



Theme #9: Asian provocateur – Buy USD vs TWD, KRW and THB

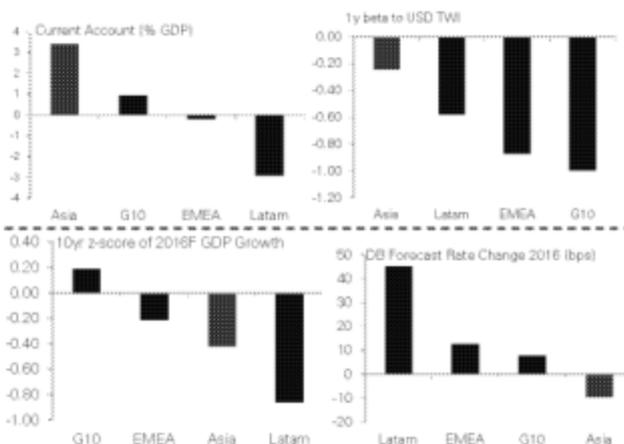
Investors should diversify their focus from external vulnerabilities in EM (current account deficits, reserves, foreign ownership) to include internal vulnerabilities (output gaps, domestic indebtedness). As the Fed hikes, rate differentials will narrow more in internally vulnerable EM markets. THB, TWD, KRW & CNY stand out as the shorts to capture this theme in Asia.

For global FX investors, Asia has arguably been a place to hide in recent years. On average, current account positions in Asia are healthier; the beta to the USD has been significantly lower; and FX volatility much lesser than other regions (Chart 1, top half). Admittedly, there is large intra-Asian heterogeneity, with the likes of Malaysia and Indonesia hardly subscribing to these favorable characteristics. But on average, Asian currencies can be said to have been less externally vulnerable than her EM and even G10 peers.

However, when shifting focus to internal vulnerabilities – such as output gaps, domestic indebtedness, and demographics – the picture no longer looks as positive for Asia. The slowdown in growth in Asia, measured by the 10 year z-score of 2016 growth forecasts, is second worst to Latin America. Importantly though, unlike Latam, where central banks are still expected to hike rates along with the Fed this year, Asian central banks remain biased to ease further (Chart 1, bottom half). Asia is the only region where policy rates on average will be coming down. This will be led by cuts in China, Indonesia, and India, but with the risk that other economies performing below potential also feel compelled to ease. Interestingly, the performance of average Asian REERs has tracked the growth ‘advantage’ of Asia over developed markets very tightly in the past (Chart 2). The recent correction in Asian REERs is consistent with a ‘catch-down’ to the narrower gap between Asian and DM growth, as Asia has slowed and developed markets picked up some pace. But, the Asian FX adjustment appears incomplete, with room for more weakness before the slower growth reality is fully priced in.

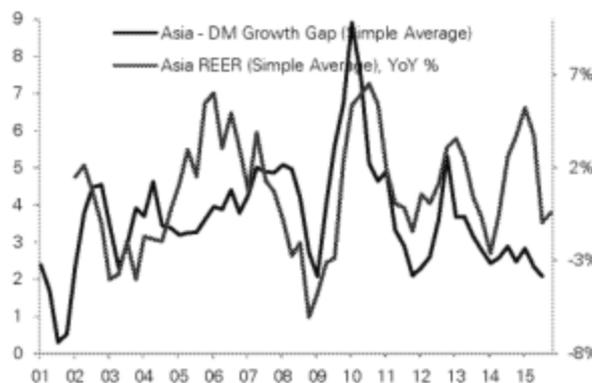
In EM crises, the focus is traditionally on external vulnerabilities: current account deficits, foreign ownership of domestic securities, USD denominated external debt, commodity exposure, and reserves coverage, amongst others. Indeed, these have been the differentiating metrics for EM FX for the past few years. In Asia, the two currencies which show up on the rear end of these metrics are Indonesia and Malaysia. Reserves coverage for short-term external debt is the poorest (Chart 3), foreign ownership of local currency government bonds the highest at 39% and 47% respectively, and current accounts are most exposed to lower energy prices. These vulnerabilities will keep IDR and MYR most liable to weaken during times of risk

External vs. internal vulnerabilities: Asia scores highly on the former, but increasingly poorly on the latter



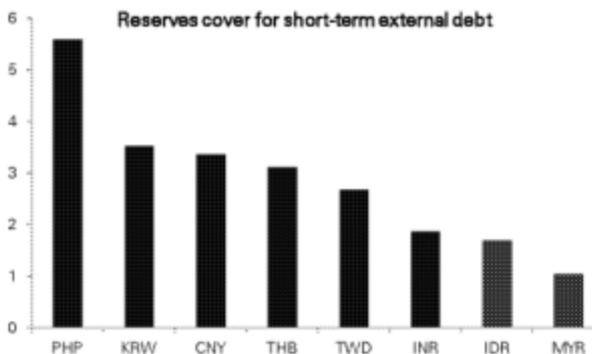
Source: Deutsche Bank, Bloomberg Finance LP, CEIC  
 Note: We calculate simple averages for each region. The charts on current accounts, growth and rates use DB Economics forecasts for 2016

Asia FX adjusting to slower growth reality – more to go



Source: Deutsche Bank, CEIC, BIS, Haver Analytics

MYR and IDR are still at the rear end on almost all external vulnerability metrics



Source: Deutsche Bank, CEIC