Focus on Asia – Volatility in EM currencies

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Q1) Year-to-date, we have seen some Emerging Market currencies, especially Latin America, being sold off on the prospects of US rate normalization. It seems that Asian currencies have been more resilient. In your opinion, what's the reason behind this?

Dr Greenwood: Those EM currencies that sold off most in early 2018 were those that had been plagued by recent monetary or political instability (Argentina, Turkey, Brazil). Conversely, those EM currencies that have outperformed have been mainly those that are seen as oil/energy exporters (Colombia, Mexico and Malaysia). This is in line with the recent strong performance of oil prices.

The resilience of the Chinese CNY, Thai THB, Taiwanese TWD, Korean KRW and Singapore SGD seems to be due to the fact that they are mostly manufacturers that have enjoyed a year or two of improving exports, in line with improving world trade. Although recently economic growth has slowed in the US (Q1) and is slowing in Europe, these slowdowns are probably only temporary following a very strong end to 2017. In my view the most likely scenario is a continued expansion of the US business cycle which should translate into further growth of Asian exports.

Q2) Recent global / Asia economic data have come in softer than expected (e.g. as shown in Citi's Economic Surprise Index), what do you think are the major reasons for the data disappointment?

Dr Greenwood: The main reason for the recent weakness is that economic expectations and growth were at an unsustainable level in the final quarter of 2017. Encouraged by the proposed personal and corporate tax cuts in the United States that were under discussion at that time and signed into law on December 22, global equity markets continued with a strong rally until the end of January. By any standards that upswing was over-exuberant. The correction in February and March has returned US stock market indices to roughly where they were at the end of December.

It was a similar story in the US economy. Coincidentally, the Citi Economic Surprise Index for the US (an index that measures data surprises relative to market expectations) peaked at 84.5 on December 22 – the same day Mr Trump signed the Tax legislation -- but has basically been falling since then, declining to 10.9 on May 22.

Consistent with the slowdown in developed economies, emerging Asian economies have seen falls in their exports in recent months. For example, Korean and Taiwanese exports (in US$ terms) have both declined since yearend. Others have seen declines in PMIs, factory orders and so on. All this is essentially a spill-over effect from temporary softness in the US and European economies.

Q3) Do you think Asian currencies would be vulnerable for sell-off in the months ahead? What are the positive and negative factors you could see for Asian currencies in the coming few months? And more importantly, under this situation, could further rate hikes by the US pose a threat to Asia?

Dr Greenwood: The main negative for all EM currencies is the continuing increase in USD interest rates and bond yields under the Federal Reserve's normalization policies. If interest rate differentials between the USD on the one hand and Asian and EM currencies on the other continue to widen, we should expect some further appreciation of the USD. A strong USD has historically been negative for EM currencies, especially commodity producers. This is a ***price effect*** that will hurt higher cost EM economies, and benefit only those that are price-competitive, which includes some Asian manufacturers.

However, provided that the US economy continues to grow (i.e. this is only a rise in US rates and not a downturn in US economic growth), then Asian manufacturing exporters should continue to benefit from ***volume growth***. But we should not exaggerate these movements and effects. So far the USD has strengthened only 4-5% on a trade-weighted basis since mid-April, essentially recovering the ground lost in December and January. The USD is still about 8% below where it stood in December 2016. Compared to Asian and EM currencies the USD is still relatively weaker than it was in December 2016.

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