

Global central banks started to hike interest rates in 2021, with the US Federal Reserve (Fed) following suit this year. Meanwhile, rate rises across Asia have been more gradual, mainly due to a relatively benign inflationary outlook. In this Investment Note, we draw insights from our pan-Asia fixed income and equity teams, who examine the impact of US-dollar strength and what this means for currencies in the region.

How is the surging US dollar affecting Asian currencies?

With contributions from the Asian Fixed Income, China Fixed Income, Singapore Fixed Income, Taiwan Fixed Income, and Malaysia Fixed Income Teams. Additional inputs from the India, Malaysia and Philippine Equity Teams, Indonesian Investment Specialist Team.

The region's currencies – a granular outlook

- **Australian dollar – strategic opportunities amid rate hikes and exporting strength**

The Reserve Bank of Australia (RBA) is one of Asia's most hawkish central banks (behind the Bank of Korea and Monetary Authority of Singapore), due to an increasing need to tame inflation¹.

Australia's inflation rose by 5.1% year on year in the first quarter of 2022, exceeding the RBA's target range of 2-3% over time. Rising inflation is being driven by domestic and external factors, such as higher wages (a function of previous lockdown measures and labour shortages), supply-chain disruptions, and higher commodity prices.

What makes the Australian dollar unique in this macro backdrop is that Australia is one of the few Asia-Pacific economies that is a net commodity exporter with a hawkish central bank. Of note, Australia is a net exporter of base metals and soft commodities. The latter is experiencing

increased external demand due to disruptions stemming from the Russia-Ukraine conflict.

Over the year-to-date, the Australian dollar has weakened, along with other Asia Pacific currencies, amid the robust US dollar environment and economic slowdown in China (the impact of lower Chinese exports due to weaker demand). Global financial markets have priced in around ten 25 bps hikes by the Fed. At this juncture, we believe the Australian dollar could present tactical opportunities given current currency levels, RBA rate hikes, and Australia's position as a net commodity exporter.

- **Increasing inflationary pressures in Singapore**

At its April meeting, the Monetary Authority of Singapore (MAS) continued to tighten policy by re-centring the mid-point of the Singapore dollar's nominal effective exchange rate (SGD NEER) higher and slightly increasing the appreciation rate of the policy band². Much like the rest of Asia, the Singapore dollar has depreciated in the face of broad US dollar strength. We think this trend will likely continue in the short term as the Fed normalises interest rates and commences quantitative tightening.

The surge in global energy and commodity prices and a tight labour market will likely see further inflationary pressures in Singapore. As such, there is a high chance the MAS could further tighten its monetary policy in October.

¹ The Bank of Korea has already increased its policy rate by 75 basis points (bps) so far this year, while on 3 May, the RBA hiked the official cash rate by 25 bps to 0.35%, from a record low 0.10%, with the central bank signalling the likelihood of more increases in the coming months.

Australian consumer prices rose 5.1% on year in the first quarter, with core inflation rising 3.7%.

²In the last six months, MAS moved to raise the slope of the band twice amid rising inflation, including an off cycle move in January 2022.

Chart 1: Policy rate changes (% , April 2021 to 4 May 2022)

Markets	30 Apr 2021	May 2021	Jun 2021	Jul 2021	Aug 2021	Sep 2021	Oct 2021	Nov 2021	Dec 2021	Jan 2022	Feb 2022	Mar 2022	Apr 2022	4 May 2022	Change in policy rates (basis points)
United States	0-0.25													0.75-1.00	↑75
Indonesia	3.50													3.50	0
India	4.0													4.40	↑40
China	2.95									↓0.10				2.85	↓10
Philippines	2.00													2.00	0
Malaysia	1.75													1.75	0
South Korea	0.50				↑0.25			↑0.25		↑0.25			↑0.25	1.50	↑100
Taiwan	1.125											↑0.25		1.375	↑25
Thailand	0.50													0.50	0
Australia	0.10													0.35	↑25

Sources: Various central bank websites, as of 6 May 2022.

Weaker global growth could potentially weigh on the domestic economy, and we think it likely that Singapore's growth could moderate to the lower range of 3-5%. Yet, Singapore will maintain its solid AAA external rating, which should underpin higher-quality local-currency issuers with stable credit fundamentals.

- **RBI joins expeditious path to neutral rates**

On 4 May 2022, the Reserve Bank of India (RBI) unexpectedly raised its repo rate by 0.4% to 4.4% and announced a cash reserve ratio (CRR) hike of 0.5% to 4.5%. With consumer price index (CPI) inflation set to breach the RBI's upper tolerance limit of 6% year-on-year, and pressure on the current account due to high energy prices that could depress the INR (i.e., inflation due to food and energy may not be transitory), the RBI appears to have joined the "expeditious" path to neutral rates. This move is likely to maintain the stability of the INR vs. other Asian EM currencies and keep INR intact. We now expect the RBI to hike its policy rate to 5.5% by March 2023. Despite the CRR increase, the system should remain liquid with a surplus. Also, we think that lenders will raise their deposit and lending rates by 1% - 1.5% (by March 2023). In any case, the

current one-year bank deposit rate of 5.5% is low compared to the 10-year bond yield, which is around 7.2%.

- **Policy divergence puts pressure on the renminbi**

As the Fed continues to raise interest rates *and* the nominal yield differential between the US and China is removed, this could put the renminbi under further pressure in the second half of the year. Having said that, we believe that the renminbi will remain well-supported at current level given China's strong trade position. China bonds are also likely to outperform US Treasuries, given that China's monetary policy is expected to remain dovish.

The People's Bank of China is likely to persist with monetary easing despite some constraints. The impact of further policy divergence between China and the US will most likely be felt in the foreign exchange (FX) rather than rates markets. For this reason, we are adopting a more neutral view on the renminbi for now.

- **The New Taiwan dollar – outflows and rich valuations**

The New Taiwan dollar declined by 3.41% against the US dollar in the first quarter of the year, closing at 28.626 at the end of March. This downward momentum was primarily a result of the Fed's hawkish policy stance, which drove significant capital outflows. However, despite a solid external sector, we expect the New Taiwan dollar to weaken in the coming quarter, given the headwinds from outflows – both domestic and foreign – and rich valuations of TWD.

Taiwan is an export-oriented economy and has a leading position in the semiconductor and high-tech manufacturing industries. This has resulted in a sizable current-account trade surplus for decades. And even though a weaker currency may benefit exporters or the whole economy, it could increase inflationary pressures. As a result, Taiwan's central bank will need to balance and smooth any abnormal or speculative currency movements to minimise the impact on exporters and consumers.

In our view, Taiwan's central bank has sufficient monetary-policy instruments to deal with recent outflows caused by the hawkish Fed. It has raised its policy rate to narrow the differential between the New Taiwan dollar and the US dollar and released its long-accumulated US\$550 billion foreign exchange reserve to dampen depreciation pressure.

Taiwan's fundamentals remain strong. Gross domestic product (GDP) growth is above trend thanks to substantial private investment, external demand, and personal consumption recovering from the COVID-19 slowdown. Therefore, we are optimistic about Taiwan's economy and believe that the currency will stabilise once the Fed's moves are fully priced in.

- **Malaysian ringgit weakness to continue in the short term**

The Malaysian ringgit lost ground against the US dollar in the wake of the Fed's hawkish interest-rate stance, a slowing Chinese economy, and commodity-price inflation. The ringgit has always been highly correlated with China's renminbi,

which recently plunged against the US dollar. This, plus other factors, such as overseas investor outflows from the bond market and FX deposit hoarding by local participants, probably explains why the currency has performed worse than neighbouring markets.

In the short term, the dynamic of US dollar strength and ringgit weakness could persist for the reasons above. Coupled with this is the possibility of further risk-off sentiment induced by geopolitical tension, which is usually unfavourable for emerging-market currencies.

From a medium-term perspective, the outlook is brighter. As we move into the second half of the year and towards the end of 2022, the Fed may start to tone down its hawkish stance (once it has raised interest rates several times), and the Chinese economy could stabilise.

We also note that Malaysia's trade balance remains fundamentally strong, given it is a commodity-exporting country. It has also experienced substantial foreign direct investment (FDI) flows – indeed, Malaysia's FDI recently overtook Vietnam and is among the strongest in ASEAN. And we also see portfolio inflows into Malaysian equities. These factors are all supportive and should limit further ringgit depreciation, which could reverse in the second half of the year.

Furthermore, given the ringgit has not softened for a prolonged period, the impact of currency weakness has yet to filter through to the economy. We are closely monitoring issues like imported inflation together with the performance of those companies – like exporters – with potential FX exposure.

Lastly, we are also keeping a close eye on foreign investor activity in the bond market to detect signs of selling induced by a weak ringgit.

- **Economic reopening could offset the effects of a declining Philippine peso**

The Philippine peso has depreciated by 2.6% year-to-date, reaching P52.19 versus the US dollar at the end of April. The weakness was driven by the country's large account deficit coupled with the flight to more developed markets due to geopolitical risks and the country's upcoming local elections. We expect the peso to remain weak throughout 2022, primarily due to the current-account deficit³ and a delay in rate hikes implied by Bangko Sentral ng Pilipinas (BSP).

A weaker peso is typically inflationary, as the country largely imports its energy requirements, such as crude oil and petroleum products. Consequently, periods of high inflation hurt domestic consumption, accounting for two-thirds of GDP. The BSP has raised its inflation forecast this year to 4.3%, while consensus GDP estimates are around 6.7%. However, we continue to downgrade GDP estimates due to higher inflationary expectations. On the other hand, a weaker peso is typically positive for overseas Filipino worker (OFW) remittances and business process offshore (BPO) industries. OFW remittances and BPO revenues represent around 10% of GDP.

In terms of the effect on the Philippine equity market, a weaker peso is usually negative for corporate earnings. Most revenue streams still rely on domestic operations while importing a portion of raw materials. This varies from wheat and cooking oil for consumer-food manufacturers and restaurants to telecom equipment for communication services and steel requirements for construction-related activities. There are also companies with a sizeable dollar-denominated debt, given their capital expenditure requirements are in a foreign currency. So, aside from weaker consumer demand driven by high inflation, there is also an impact on corporate margins.

Overall, a weaker peso is unhelpful for the Philippines economy and equity markets. However, in our view, the reopening of the economy following the mobility restrictions of the past few years would more than offset the inflationary impact of a weak currency. Hence, GDP estimates for 2022 are still higher than last year.

- **A recovery in the tourism sector could bolster the Thai baht**

Bank of Thailand (BoT) has kept its interest rates stable at 0.5% to support economic growth. Also, it views inflation to be transitional: the BoT raised its headline inflation forecast to 4.9% (from 1.7%) in 2022 but expects inflation to slow to 1.7% in 2023.

Before the pandemic, tourism made up around 18% of Thailand's GDP, so the Thai baht could present a medium-term opportunity as the country reopens its economy and tourism recovers.

- **Indonesian rupiah supported by structural factors**

In central bank terms, Bank Indonesia remains one of the most dovish in the region, maintaining its benchmark rate at 3.5%. Indonesia is in a sweet spot amid current global volatility, given the manageable inflation and the prospect of stronger economic growth as the economy reopens this year. In addition, Indonesia benefits when global commodity prices are high as it is a significant and net exporter of these goods, and the country enjoys a strong trade surplus (which touched a 15-year high) that is supportive of its currency, the rupiah. These factors provide Bank Indonesia with the monetary space to be more accommodating than other global central banks. Robust growth and surging energy prices will likely create inflationary pressures in Indonesia. If global energy prices remain elevated, the fiscal budget will be a shock absorber, with two likely scenarios. The first is Indonesia's current ability

³ Note that in terms of consensus estimates, current account deficit is estimated to remain elevated in 2022 to 2023. Meanwhile consensus estimates point towards a depreciating PHP until 2024.

to use windfall revenue for additional subsidies. The second is allowing gradual government-administered price adjustments, such as fuel and electricity while providing additional social stimulus to support the purchasing power of the aspiring middle class and low-income groups. With administered price adjustments, we expect inflation to reach 4.4%-4.8% in 2022, much lower than the 8% inflation rate seen during the 2013 monetary tightening cycle

Bank Indonesia is expected to refrain from any rush to raise interest rates. In fact, it recently reiterated that it wouldn't increase rates based on headline inflation or the first-round impact of higher administered prices. Instead, the central bank will base its monetary tightening on core inflation and the second-round impact of increase in administered prices. Bank Indonesia can also use other tools at its disposal, such as tightening the reserve requirement ratio (RRR). Indeed, it announced that RRR would gradually increase from 3.5% to 6.5% this year (March to September). We maintain our benchmark rate forecast of 4.00%-4.25% for the year-end 2022.

Conclusion

US-dollar strength, a hawkish Fed, and slowing growth in China should continue to place pressure on Asian currencies through the summer months. Even though the region's central banks are expected to normalise monetary policy, this will be at a slower rate than developed markets. More positively, the outlook for the second half of the year is relatively upbeat.

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