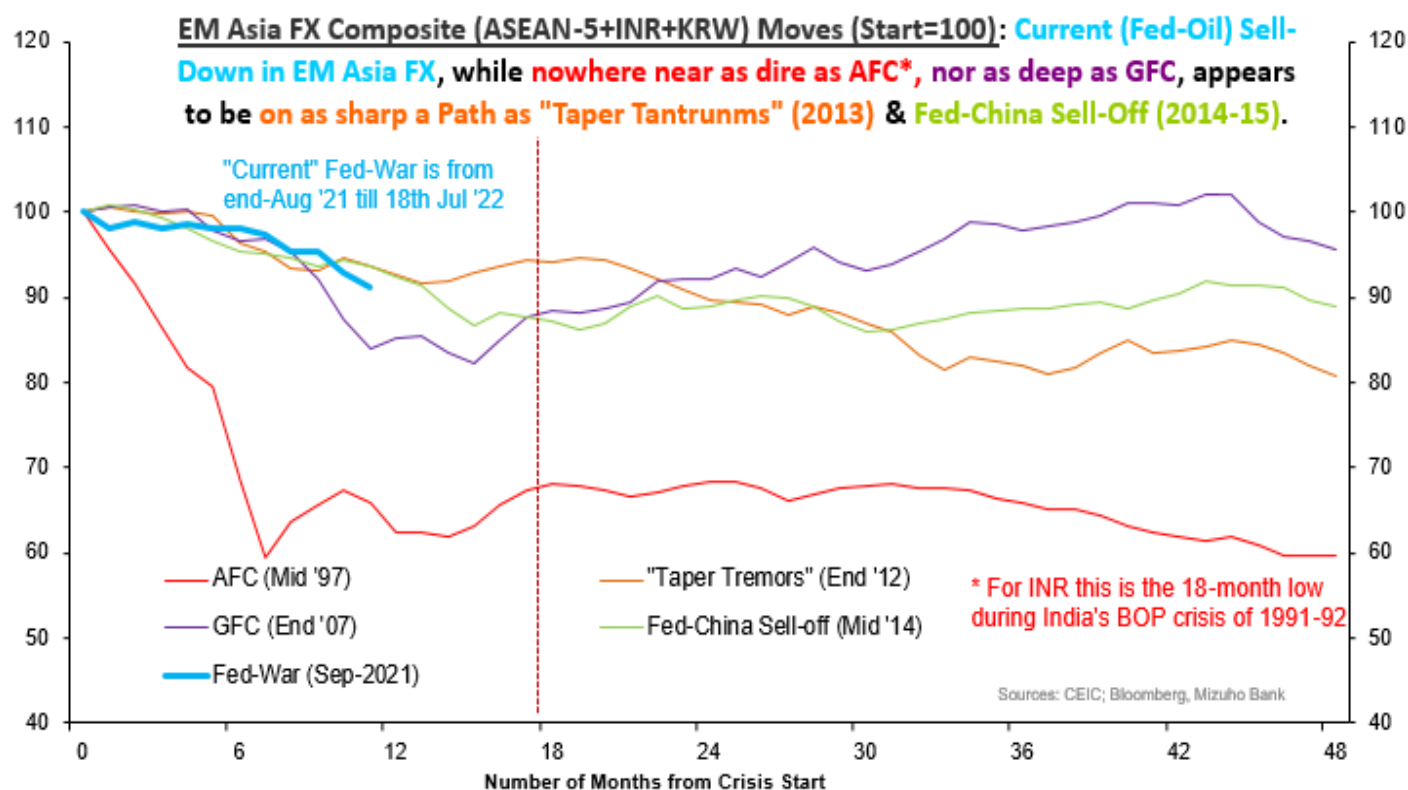


EM Asia FX Risks (Part 1): Overblown, But Not Obviated



“Great, kid, don’t get cocky” – Han Solo, Star Wars

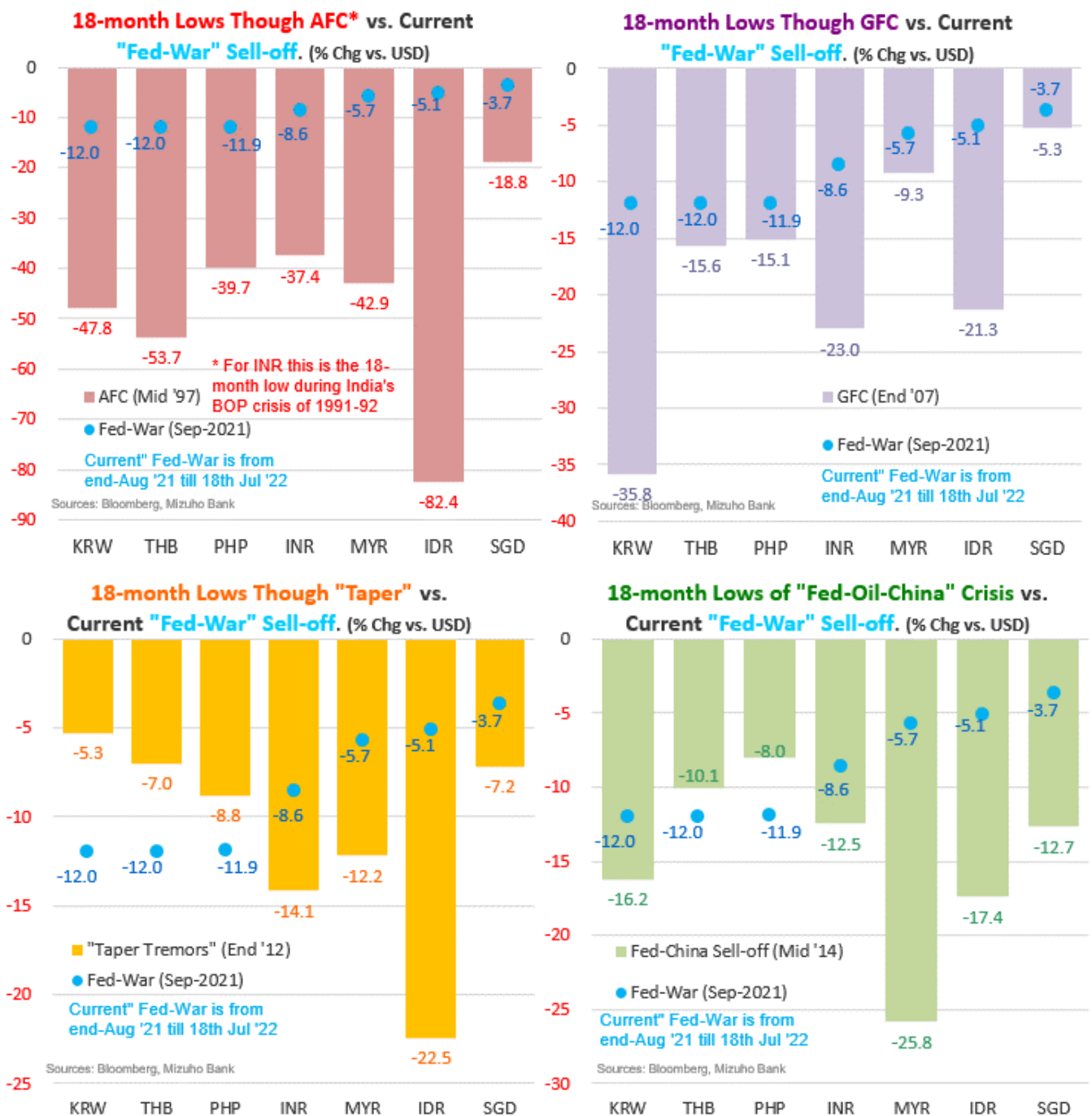
In a Nutshell: Panic about an impending financial crisis, and attendant collapse in EM Asia FX is arguably overblown. Fact is, the speed and depth of EM Asia FX sell-off is nowhere in the vicinity of the 1997-98 AFC, and is in fact also not as severe as the 2008-09 GFC experience. But that said, the threat of persistent FX turbulence is not obviated either. As Han Solo put it with flair, “Great...” so far, but given the obvious risks ahead “don’t get cocky”.

Not only are there echoes of the financial turbulence endured during the 2013-14 “taper tantrums” and 2014-15 “Fed-China sell-off”, but mounting risks associated with a brutally hawkish Fed and consequent threat of a hard-landing suggest that FX market pressures may remain persistent and potentially turn more profound. Especially if currency sell-off and capital outflow risks feed off and aggravate one another; as recession risks overtake and/or “cash burn” concerns with regards to FX reserves (more in Part 2 to follow) begin to take over. Notably, counter-intuitive, relative resilience in IDR, INR and to a lesser extent MYR are arguably temporal, and certainly tentative in nature. Thus catch-down risks ahead are worth keeping an eye out for.

Risk of FX Crisis Overblown: To be fair, panic about EM Asia FX plunge, to unprecedented (INR, PHP) or multi-year (KRW, THB, MYR) lows, heralding an imminent FX crisis is overblown.

Point being, **soft starting points for EM Asia FX overstate the sell-off**; when gauged by snapshots of current levels to which EM Asia have dropped to. Whereas, the **depth and speed of EM Asia FX sell-off are far from crisis-type tailspin** (See Chart above). Certainly nowhere near as dire as the **1997-98 Asia Financial Crisis (AFC)**, and *as of now*, **shallower than the 2008-09 Global Financial Crisis (GFC)**.

Admittedly there are **echoes of the so-called “taper tantrums” of 2013-14** as well as the rolling **2014-15 financial shocks** – from Fed’s normalization, Oil’s plunge and “China crisis”. Nevertheless, **EM Asia FX market are arguably not staring down the barrel of an imminent FX crisis**. Certainly **nothing as devastating as the AFC of 1997-98** (for ASEAN and Korea) **or the BOP Crisis that struck India** (early-90’s), which resulted in 40-80% loss in currency values across EM Asia FX (with the exception of SGD). And for the time being, not as severe as the GFC in 2008-09 either (See Bar Charts below).



But Threat of On-Going Turbulence Not Obviated: **But**, while risks of a full-blown EM Asia FX meltdown may be overblown, **the threat of significant FX turbulence is not obviated**. Not by a long shot. **Especially**

as an increasingly hawkish Fed – that poses a double whammy of more brutal rate hikes and quicker USD liquidity drainage – accentuates capital outflow risks and attendant currency market turbulence.

What’s more, sharply rising inflation in EM Asia set to catch-up with, and potentially overtake, US inflation may exacerbate capital outflow, and associated currency outflow risks insofar that EM Asia’s real rate differentials with US are further compromised. And the juxtaposition of stagflation/recession threats in the midst of brutal Fed rate hikes may aggravate capital outflows-currency sell-off loops.

FX Risks May Persist, Perhaps Eclipse: In fact, whilst the current EM Asia FX sell-off is far from AFC-type crisis, it is no reason for complacency. The parallels with turbulence encountered during “Taper Tremors” and “Fed-China Sell-off” (See Title Chart again) episodes suggest that FX risks may persist for another 6-12 months – consistent with the risk outlook ahead.

Crucially, the sell-off this time may imaginably eclipse the 2013-14 (“Taper Tremors”) and 2014-15 (Fed-China) experience; and quite easily if a brutal Fed fails to avert a “hard-landing”. Lurching from Fed-inflicted policy pain to Fed-induced economic gloom threaten to accentuate “twin deficit” stress and amplify “risk off” capital flight. In which case, the confluence of currency pressures and risks of reflexivity may conspire to flirt with, and exceed, the depths and scale of GFC losses in EM Asia FX.

Differences, Not Defiance: Admittedly, the nature of EM Asia FX sell-off this time differs somewhat from past experiences in scale, speed and dispersion across various currencies (See Bar Charts above). But the evidence suggests there is no defiance of significant, perhaps sweeping, EM Asia headwinds from strong dollar tides amid a hawkish Fed or capital capitulation from amid “risk off”/recession fears.

Counter-intuitive Resilience & Catch-Down Risks: That said, KRW, THB and PHP are notably at the bottom of the pile while two of the worst-performing during “taper tantrums”, the Indonesian rupiah (IDR) and Indian rupee (INR), are counter-intuitively holding up far better. As is the MYR, for now.

These differences are attributable to several factors such as:

- i) commodity buffer and uncharacteristically lower inflation for IDR;
- ii) significantly larger FX reserves (more than doubled from 2013) buffering INR, and;
- iii) Oil revenue offset helping cushion the MYR.

But relative resilience may be temporal insofar the IDR’s commodity buffers are fading as recession risks creep (similarly for MYR) up while its low inflation backstop is on borrowed time as fiscal strains challenge subsidies. And INR’s FX reserve cushion is being quickly eroded by mounting “cash burn” risks (watch this space for Part 2 of this report where we will cover this in detail).

Warrants Caution: The upshot is that while fears of an impending FX crisis is overblown, the threat of persistent FX turbulence, possibly leading to greater depreciation pressures, is not obviated. And given the risks ahead, the EM Asia FX space warrants due scrutiny and caution.

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