Mizuho FX Update (May '22)

Economics & Strategy | Asia ex-Japan

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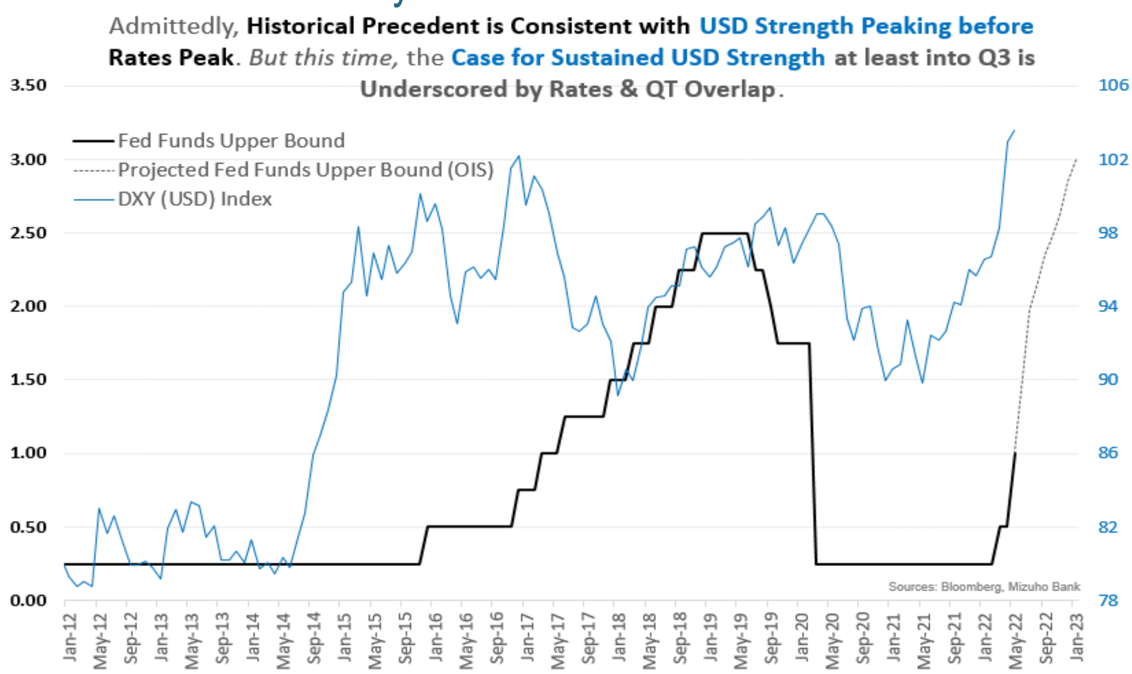
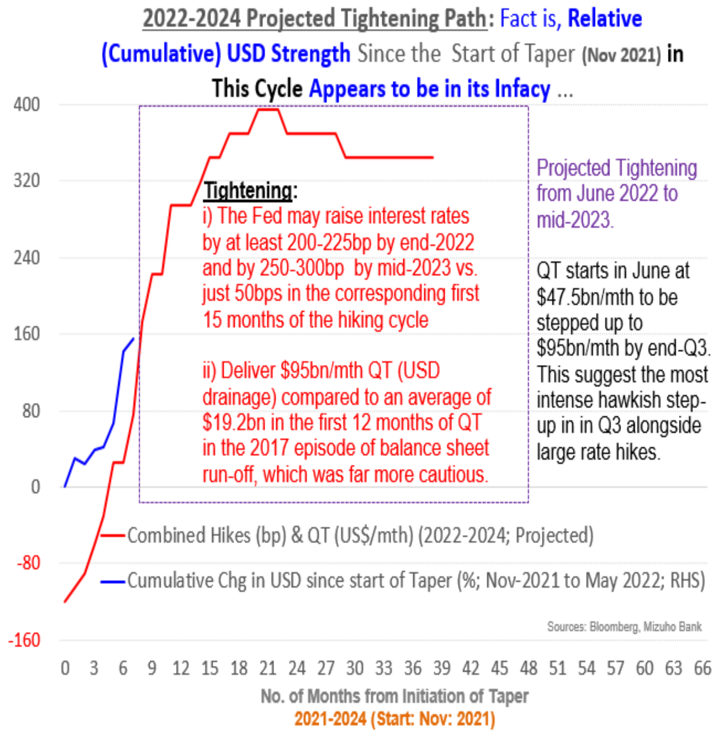
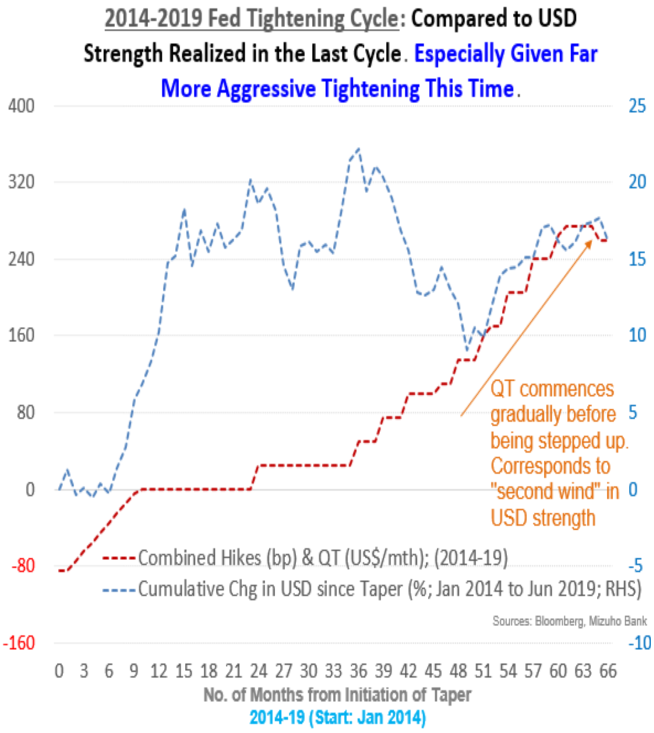
Why Fed Hawk-USD Bulls May Not be Exhausted







"Never trust to general impressions ... but concentrate … upon details." – **Sherlock Holmes**

Beware Premature Bets on Peaking USD: At first blush, **received wisdom** about anticipatory markets **and past experience** appear to concur with the notion that **USD strength derived from a hawkish Fed tend to be front-loaded**; *peaking well before the Fed's policy rates*. This is **not wholly inaccurate**. In fact, it is consistent with the logic of Fed rates expectations based projection of USD strength (see top Chart).

But equally, any **conclusions about USD bulls having exhausted a hawkish Fed risk being premature, if not outright misguided**. As Sherlock Holmes put it, "*general impressions*" **of USD strength on the cusp of exhaustion** (due to hawkish rate hike expectations being mostly priced in) **may be debated, if not debunked,** if one "*concentrate(s) upon the details*" of this far more tightening cycle. In particular, once appropriate distinctions on the intensity, extent from the last cycle are drawn.

Intensity of Fed to Instigate USD Bulls: First, the intensity **of the Fed's tightening cycle this time appears to be** under-accounted for by USD bull sceptics drawing parallels to the early USD peak in the last hiking cycle. Crucially, the **coincidence of aggressive rate hikes and balance sheet run-off** (also known as quantitative tightening or QT) is likely to **extend and emphasize USD strength**.

Whereas the *"second wind" of USD strength followed after pause due to the interval between rate "lift-off" and QT in the last cycle,* the conspiracy of rising rates and diminishing USD supply at the margin may instead induce **comparatively more profound and persistent USD strength.** In particular, **given near-term inclination for upsized 50bp hikes** (June and July FOMC) and a **step-up in QT** (commencing June) from $47.5bn per month to $90bn/mth in three months, **Q3 looks primed for further USD strength**.

Extent of Tightening Matters: Second, **peak Fed rates and QT** are set to materially exceed the last cycle (that began in 2014 and ran through mid-2019). Especially ***as the Fed warns that high inflation may require*** some degree of ***policy over-steer.*** Upshot being, a **far larger degree of cumulative tightening** (rates and QT) ought to correspond to a **greater degree and duration of USD strength** (See Charts above).

Risk Retrenchment & USD Reinforcement: Finally, a **conspiracy of sharply higher US rates** and **significant USD liquidity drainage** may **induce larger-than-expected self-validating USD strength**; as the impact of the rising price (higher rates) and shrinking supply (from QT) of USD **feed into, and off, each other**. **Especially amid a retrenchment of risk** as richly valued asset markets correct amid risk re-pricing. And liquidation of assets may **reinforce USD (haven) demand**; and hence USD **strength**.

Resultant EM Asia Soft Spots & Slippery Slopes: What this means is that **resulting weakness in EM Asia currencies (AXJ) may not only endure into Q2, but likely extend into Q3**. And even if AXJ regain traction into end Q3 as Fed hawks mellow, downside risks within Q3 remain significant (See Tables overleaf).

In particular, **vulnerabilities are likely to be most pronounced in currencies exposed to twin deficit risks** (e.g. PHP, INR & IDR) as uncomfortably elevated energy prices (amid Ukraine risks) **collide with a hawkish Fed inciting sharply higher US rates/yields**.

In addition, commodity- (AUD, IDR, MYR) and China's supply-chain (KRW, TWD) and Zero COVID border restriction (THB, PHP) may induce more downside AXJ volatility.

Finally, **upside risks to inflation and attendant monetary policy response** will **further differentiate AXJ outcomes** based on the Fed-EM Asia policy divergence narrative into Q3. IDR may be vulnerable unless Bank Indonesia walks back on "patience", AUD will hinge on the RBA's hawkish pivot, while BoT, BNM and BSP are watched for propensity to calibrate judiciously.

FX Forecasts	Jun 22	Sep 22	Dec 22	Mar 23	Jun 23	Sep 23
USD/CNY	6.60 - 6.95 (6.88)	6.70 - 7.02 (6.82)	6.46 - 6.96 (6.62)	6.27 - 6.73 (6.48)	6.18 - 6.64 (6.38)	6.16 - 6.53 (6.36)
USD/INR	75.0 - 79.1 (78.3)	75.5 - 80.1 (77.5)	73.4 - 78.5 (76.2)	71.4 - 77.7 (75.3)	70.6 - 76.8 (74.4)	70.0 - 76.3 (73.8)
USD/KRW	1220 - 1340 (1290)	1230 - 1370 (1280)	1220 - 1330 (1270)	1190 - 1290 (1240)	1180 - 1300 (1230)	1190 - 1290 (1240)
USD/SGD	1.38 - 1.44 (1.41)	1.35 - 1.43 (1.40)	1.34 - 1.44 (1.37)	1.32 - 1.41 (1.35)	1.31 - 1.39 (1.35)	1.31 - 1.38 (1.34)
USD/IDR	14360 - 15210 (14750)	14330 - 15240 (14680)	13960 - 15000 (14390)	13840 - 14990 (14300)	13700 - 14880 (14150)	13650 - 14810 (14100)
USD/MYR	4.17 - 4.51 (4.43)	4.33 - 4.56 (4.38)	4.04 - 4.45 (4.30)	4.07 - 4.40 (4.26)	4.08 - 4.41 (4.26)	4.05 - 4.41 (4.23)
USD/PHP	51.4 - 53.7 (53.3)	52.1 - 54.5 (52.8)	50.2 - 53.9 (52.4)	49.7 - 53.5 (52.0)	49.5 - 53.3 (51.7)	49.1 - 53.3 (51.3)
USD/THB	33.4 - 36.4 (34.9)	34.7 - 38.1 (35.3)	32.7 - 36.4 (34.6)	32.1 - 35.2 (34.0)	32.9 - 35.2 (33.8)	32.6 - 34.8 (33.5)
USD/VND	22600 - 23400 (23250)	22600 - 23400 (22950)	22500 - 23100 (22700)	22400 - 23000 (22550)	22400 - 22900 (22550)	22300 - 22900 (22550)
AUD/USD	0.637 - 0.714 (0.683)	0.649 - 0.730 (0.705)	0.688 - 0.775 (0.742)	0.726 - 0.808 (0.765)	0.737 - 0.811 (0.775)	0.759 - 0.830 (0.790)

Central Bank Policy Outlook

Country	Central Bank	2021		2022				2023	
		Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
US	Fed	0.00-0.25%	0.00-0.25%	0.25-0.50%	1.25-1.50%	1.75-2.00%	2.00-2.25%	2.25-2.50%	2.50-2.75%
Australia	RBA	0.10%	0.10%	0.10%	0.50%	1.00%	1.25%	1.50%	1.50%
China	PBoC	3.85%	3.80%	3.70%	3.60%	3.50%	3.50%	3.50%	3.50%
India	RBI	4.00%	4.00%	4.00%	4.25%	4.75%	5.25%	5.50%	5.75%
Indonesia	BI^	3.50%	3.50%	3.50%	3.50%	3.75%	4.00%	4.25%	4.50%
Malaysia	BNM	1.75%	1.75%	1.75%	2.00%	2.25%	2.50%	2.50%	2.50%
Philippines	BSP	2.00%	2.00%	2.00%	2.25%	2.50%	2.75%	3.00%	3.00%
Singapore	MAS*	Restore a "Slight" S$NEER Slope (0.5% per annum)		**Unscheduled "Steeper" Slope to 1.0% p.a.**	**Re-center Mid-Pt Higher & "Slightly" Increase S$NEER Slope (1.5% p.a.)**	"Slightly" Increase to S$NEER Slope (2.0% per annum)		Maintain S$NEER Slope (2.0% per annum)	
Korea	BoK	0.75%	1.00%	1.25%	1.75%	2.00%	2.00%	2.00%	2.00%
Thailand	BoT	0.50%	0.50%	0.50%	0.50%	1.00%	1.50%	1.50%	1.50%
Vietnam	SBV	4.00%	4.00%	4.00%	4.00%	4.25%	4.50%	4.50%	4.50%