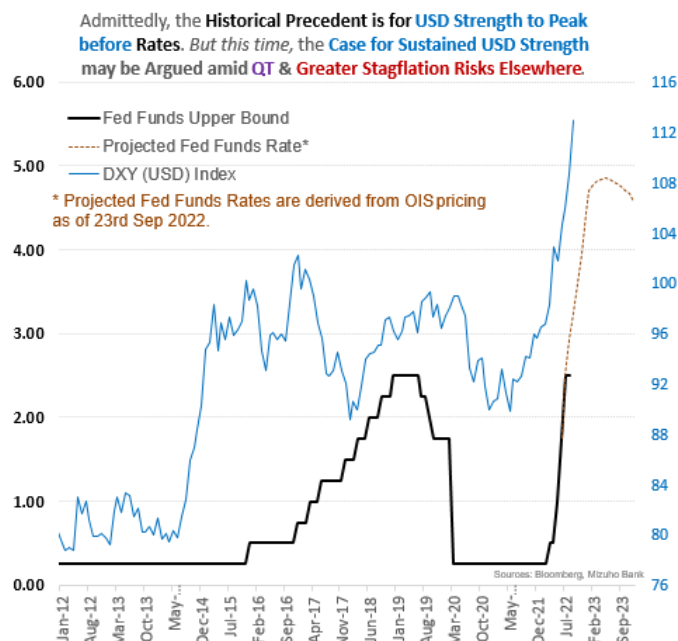


Dealing with “Higher for Longer” USD

In a nutshell: Between fear-induced haven demand and hawkish Fed boost, sweeping USD strength may be poised for an unusually longer tenure in this Fed tightening cycle. Point being, “higher for longer” rates may resonate with the USD.

For one, more aggressive QT (doubled to US\$95/mth), which coincided with last cycle’s “second wind” for USD bulls, accentuate policy-induced USD strength. Crucially, the so-called TINA (there is no alternative) USD allure is underpinned by more dire stagflation risks in other developed markets (DM); given starker policy trade-offs from greater exposure to geopolitical vulnerabilities. The upshot is that USD dominates; both as a hawkish reflex and haven refuge.

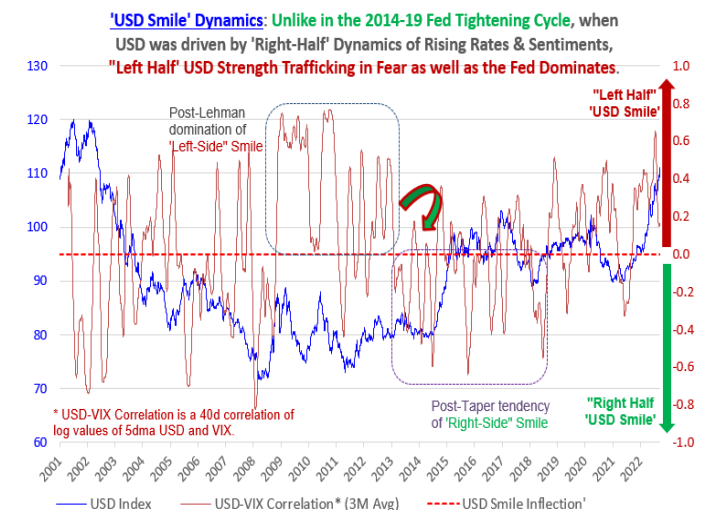


But such unrelenting USD surge inevitably extracts a toll; exacerbating pre-existing (imported) inflation risks for most economies and imposing adverse financial feedback loops.

The resulting conspiracy of disadvantageous real rate mechanics, deterioration in credit fundamentals and attendant risk re-pricing warn of potentially destabilizing capital market dynamics; which in turn darken the clouds of recession risks.

And while DM FX have so far borne the brunt of USD dominance, risks of EM Asia FX “catch down” are mounting markedly; as eroding temporary buffers and rising recession risks reveal fundamental soft spots, that could snowball into “tip over” risks. Especially in the context of heightened uncertainties with regards to China.

USD Bulls: Trafficking in Fed & Fear



Clearly, the sheer amplitude of the current rendition of sweeping USD strength suggests it is not merely the “garden variety” Fed tightening reaction. A conjecture that is supported by “left-half” ‘USD Smile’ dynamics, whereby the USD rises with risk aversion (or “fear”), rather than the typical “right-half” dynamics where USD tends to rise with rising rates and improving (economic sentiments).

Hence, it is more likely a projection of USD bulls trafficking in both the Fed (with its exceptional hawkishness) and “fear” that has been exacerbated by volatile geo-politics; more prone to brinksmanship. What this means is that the USD is able to gain from hawkish reflex or haven refuge.

Fear & Fed Not Mutually Exclusive

To be clear, the two (Fed and “fear”) are not mutually exclusive. Point being, insofar enduring damage from unmoored inflation expectations is deemed to be far

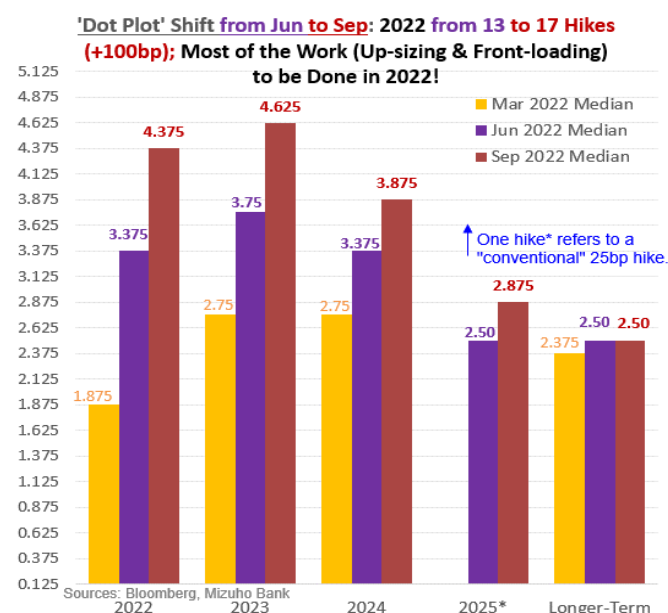
greater than from “necessary economic pain” to curb inflation, it may **perversely tighten into geo-political uncertainty and risks**; if escalation in the Russia-Ukraine war is deemed to **result in price shocks** from global commodity (food/energy) disruptions.

Amid Resilience and Divergence Advantages

Moreover, perceptions are that the US economy (be it due to exposures, resources or fiscal cushion) is **better positioned** to withstand headwinds. And so, **Fed-induced recession fears could ironically boost the USD** further. Especially as **boost from policy divergence** (or less acute policy dilemma) is flattered by a **solid layer of haven demand for USD** – *the ultimate safe-haven fiat*.

“Higher for Longer” ‘Dot’ Plot

Admittedly, the **main fodder for USD bulls’ endurance** has been derived from unwavering hawkish flex. In particular given **exceptional Fed aggression post-Jackson Hole**; invoking *Volcker-era references of “break(ing the grip of inflation)”*.



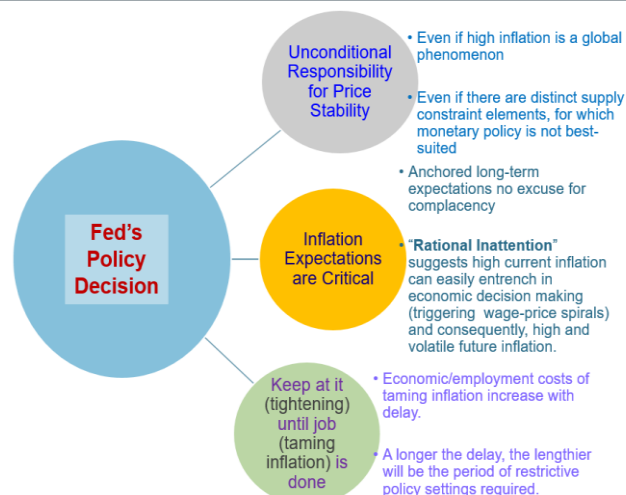
And so, despite September FOMC’s 75bp hike being fully baked in, the **unflinching hawkish revision to the ‘Dot Plot’** unequivocally expressing the “*higher for longer*” message – with emphasis on both “higher” as well as “for longer” – **underpins an extension of bullish USD bets**.

Why USD is Not Peaking Before Rates

But whereas the USD has historically peaked ahead of the anticipated (and hence, priced) **peak rates**, this time, **bullish USD tendencies are likely to be persist**. And there are **three primary reasons** for this.

i) **Policy/Peak Unfamiliarity**: First, **unfamiliarity** with this iteration of **hawkish Fed** that is drawing **hawkish lessons from Jackson Hole**; imaginably **overhauling policy calculus** and attendant **thresholds** for the Fed to *slow the pace hikes* and beyond that, *pivot* to re-lowering rates back to *neutral rates* **are all up in the air**. And *post-Jackson Hole upside bias/stickiness to rates*, may *rub off on to the USD*.

Jackson Hole’s Three Lessons (from High Inflation of ‘70s, 80’s & Low Inflation from 2000’s)



ii) **TINA**: Crucially, **USD appears to be the most attractive option out of a dismal bunch**. With the full brunt of a *devastating energy shocks from Russia undermining EUR* amid “fragmentation” risks, *JPY submerged in the BoJ’s dovish stance* (amid Current Account drag) and GBP hobbled by stagflation-type forces amplified by Brexit, **there is simply no viable alternative to the USD**. This peculiar post-COVID supply-constrained environment buffeted by Russia’s war makes for “**TINA**” **USD boost**.



iii) **Real Rates & Dilemmas**: Finally, with **EZ and UK inflation overtaking the US** (where inflation appears to be peaking, even if likely to remain uncomfortably elevated), **rate real rate differentials will penalize EUR and GBP**; even if it is assumed that the ECB and

BoE could keep up with the Fed.

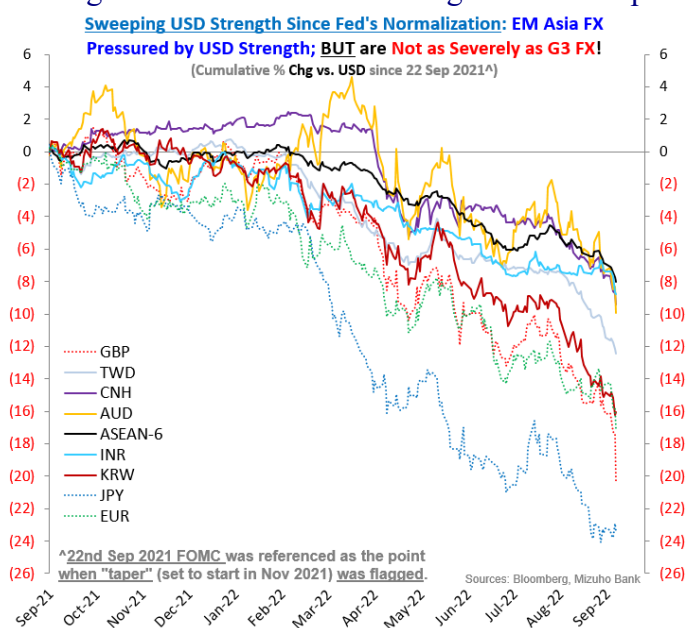
But the **thing is, neither can keep up with Fed hawks**. And arguably, **nor should they**, given **acute policy dilemma** and **far more precarious “hard landing” risks** amid the ravages of energy price shocks and labour crunch that has already resulted in demand destruction.

And these factors also apply to the **relative inflation-policy tightening dynamics** (vis-à-vis US) for Japan and EM Asia more widely. Which is to say, **USD dominance is fairly unilateral**. Upshot is, **reverence for ‘King USD’ is real** – quite literally.

USD: Unilateral Strength & Ubiquitous Risks

Here’s the thing. This **atypical prolonged USD strength into late-cycle Fed tightening** (riding up to, rather than emphatically front-running, peak rates as has been the case in the past) is not agnostic. It comes with its own risks; often **amplifying pre-existing inflation and currency pressures**.

In its *most extreme* rendition, **sweeping USD strength will result in destabilizing spirals** as *outflows and plunging currencies/asset prices get entangled in adverse feedback loops*. And invariably this **worsens real rate differentials** (inflation and policy trade-offs rendered more acute) and **stagflation-type risks** driving TINA/ “haven” USD strength in the first place.



Exacerbating Inflation: Sharp USD strength tends to amplify imported inflationary pressures given USD-denomination for commodity and goods pricing. In turn, eroding the external balance (Current Account) and FX reserves (both “flows” and “stock” impact).

Deteriorating Credit: In addition, sharply higher **USD-denominated debt burden/risks** and **mounting fiscal pressures** will undermine credit metrics; *entailing credit ratings (downgrade) risks* and more generally *higher risk premium*.

Risk re-pricing: With sharply higher inflation, compromised external accounts, already heavier post-COVID debt burden now faced with a double whammy of rising rates and USD, **asset prices could some under fresh pressures due to risk re-pricing**.

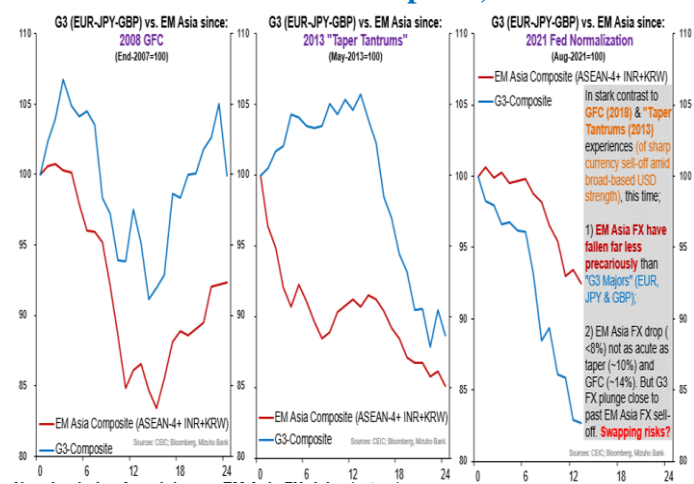
Adverse Feedback Loops: Most worryingly, **sharp currency corrections accentuate vulnerabilities to “reflexivity”**. That’s to say, capital outflows (amid risk-repricing) and currency drop get into two-way cause-and-effect spiral. Such de-stabilizing financial shocks end up worsening a downturn, if not triggering a recession/crisis.

USD Bulls: Reflection & Risks

As such, such emphatic **USD strength is not merely an isolated reflection** of exogenous policies and reactions events, **but an interactive endogenous risk** that could feed off itself. And **with increasing bouts of unrelenting USD strength**, the **dangers of dislocations in the market also grow**.

To be sure, it is **imperative to be watchful of the risks to global financial markets**, from a bullish USD under the current circumstances. And on that note, it is arguably **even more urgent to be wary of “catch-down” risks in EM Asia FX**; from the current relative out-performance vis-à-vis Major currencies since a year ago.

EM Asia FX Resilience: Temporal, Not Tectonic



As we have recently pointed out **EM Asia’s relative FX have out-performance is peculiar**.

But this is owed to **post-COVID supply-side snags followed on by Russia's war hitting the West harder**. Whereas, inflation pass-through is quickly catching up in EM Asia eroding real rate advantages. What's more, external accounts could also be under pressures as cost-push persist, but in addition, the top-line also softens on pipeline demand slowdown.

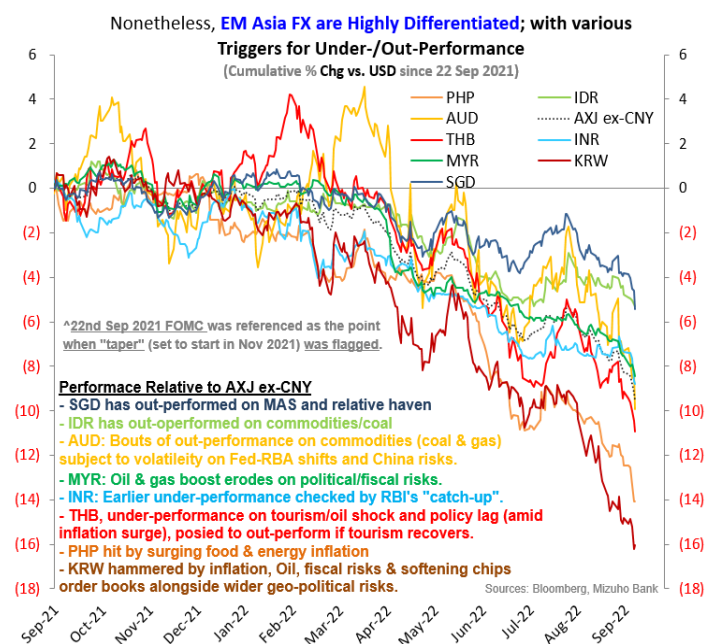
And so, this may well be a **temporal aberration** (of EM Asia out-performance vis-à-vis non-USD Majors), **not a tectonic shift** underpinning sustained preference for EM Asia FX over DM at times of stress (from Fed and war uncertainty).

In Fact, Risks May Flare

On the contrary, as inflation rises and erodes the real “carry” narrative for EM Asia, then sobering questions amid **sustained pressures from a hawkish Fed and war** may **challenge EM Asia FX further**; and in particular *with “catch down” risks*.

Especially *as “twin deficit” risks flare up* further amid **external shocks** and **pre-existing fiscal stress**; only compounded by surging inflation catching post-COVID overhang on a weak footing. The projected **credit deterioration that results and rising risk-premium flags risks of a sharp drop**.

Differentiation ...



While conceding that downside risks loom large, it is important to recognize that EM Asia is not a monolithic bloc with identical risk profiles. And so, quite justifiably, **EM Asia FX performance will continue to be differentiated**. In some cases, working

even working off distinct risks; such as MAS policy-related bets on SGD gains (albeit measured).

The bigger picture being, evolving **“twin deficit”, (external) debt burden, housing-banking sector vulnerabilities, and financial market risks** alongside *wider export-dependence as well as specific China-linkages will determine the specifics* of relative out- and under-performance in the differentiation ahead.

... Not Deflection

But that said, at this stage of the global economic cycle and the Fed's tightening path, it will be fair to conclude that **none of the EM Asia currencies will deflect overarching waves of USD strength** amid **rising USD rates and tightening USD liquidity**; against a backdrop of **elevated geo-political risks** and **lamentably expensive energy and food** (despite growing fears of a recession).

In fact, **if sharp CNY correction persists, intervention to backstop JPY proves futile and KRW continues to lurch**, then pressures for a **deeper correction across the board in EM Asia FX may be a matter of “when”, not “if”**. Fact is, credit and currency risks could quickly ripple across what are fairly proximate, high-transmission, trade and investment channels in EM Asia.

China a Potentially Large Swing Factor

Notably, with a **lack of clarity on China's Zero COVID policy** (with huge implication for EM Asia's tourism), PBoC's CNY stance amid risks of credit risk spill-over from its property sector and “cross-Straits” tensions, **China may potentially be an abrupt, inadvertent swing factor for EM Asia FX**.

5 Key EM Asia FX Take-aways

- 1) **USD bulls dominating risks exacerbating inflationary pressures**; thereby amplifying EM Asia FX risks via feedback loops.
- 2) **EM Asia FX will be confronted with “catch down” risks** rather than remaining resilient in the relative out-performance against Majors.
- 3) **Nonetheless, EM Asia FX performance may continue to be starkly differentiated**.
- 4) **Volatility will dominate** as tensions between a large number of moving parts surprise.
- 5) **China may have outsized impact on EM Asia FX** given exceptional policy uncertainty.

FX Forecasts

FX Forecasts	Sep 22	Dec 22	Mar 23	Jun 23	Sep 23	Dec 23
USD/CNY	6.76 - 7.29 (7.15)	6.75 - 7.26 (7.08)	6.78 - 7.31 (6.95)	6.56 - 7.04 (6.78)	6.47 - 6.95 (6.68)	6.47 - 6.85 (6.68)
USD/INR	77.4 - 83.1 (80.8)	78.2 - 82.9 (80.2)	74.3 - 79.5 (77.2)	72.7 - 79.0 (76.6)	71.5 - 77.9 (75.4)	71.0 - 77.4 (74.8)
USD/KRW	1330 - 1490 (1415)	1340 - 1500 (1400)	1330 - 1450 (1378)	1310 - 1420 (1360)	1300 - 1430 (1355)	1300 - 1410 (1350)
USD/SGD	1.385 - 1.462 (1.432)	1.387 - 1.445 (1.418)	1.360 - 1.443 (1.395)	1.341 - 1.430 (1.378)	1.310 - 1.392 (1.346)	1.306 - 1.382 (1.342)
USD/IDR	14370 - 16280 (15160)	14890 - 15830 (15250)	14450 - 15530 (14900)	14310 - 15490 (14780)	13990 - 15200 (14450)	13940 - 15130 (14400)
USD/MYR	4.40 - 4.90 (4.58)	4.44 - 4.69 (4.50)	4.18 - 4.60 (4.45)	4.18 - 4.53 (4.38)	4.12 - 4.45 (4.30)	4.07 - 4.43 (4.25)
USD/PHP	57.2 - 60.7 (59.3)	57.2 - 60.1 (58.2)	53.6 - 57.6 (56.0)	53.3 - 57.4 (55.8)	51.7 - 55.6 (54.0)	51.1 - 55.5 (53.4)
USD/THB	35.5 - 38.2 (37.8)	36.3 - 39.5 (37.3)	34.8 - 38.7 (36.8)	34.4 - 37.7 (36.4)	35.2 - 37.7 (36.2)	34.9 - 37.3 (35.9)
USD/VND	23400 - 24100 (23800)	23300 - 24200 (23700)	23400 - 24000 (23600)	23400 - 24000 (23500)	23300 - 23800 (23400)	23100 - 23700 (23300)
AUD/USD	0.629 - 0.726 (0.650)	0.611 - 0.693 (0.638)	0.619 - 0.698 (0.668)	0.643 - 0.716 (0.678)	0.678 - 0.747 (0.713)	0.709 - 0.775 (0.738)

Note: For FX forecasts, level in parentheses pertains to period end forecasts; and the period's range precedes this.

- AUD: Fresh Fed-RBA divergence amid housing market risks and recession/China headwinds amplified by commodity channels could keep AUD on the back foot; before scope for traction into 2023.
- CNY: Ahead of the mid-October NPC, a stable CNY is arguably desired, but bullish USD and lingering China risks will challenge this. USD/CNY is bound to test higher amid calibrated CNY NEER dips; but pullback in 2023.
- INR: Admittedly opposing forces may be at work as Oil's decline provides some relief. But Fed risks could ultimately overwhelm and if capital outflow current pick-up a test above 80 to 82 cannot be ruled out.
- IDR: Despite a strong USD bias, USD/IDR has been fairly stable; further support for the pair will come from BI having started policy normalization but buoyancy above 15000 in late-2022 may be inevitable.
- MYR: Depreciation pressures persist as portfolio outflows have continued despite the economy benefitting from the upswing in global commodity prices. Some relief for MYR may be on the cards in 2023 as USD moderates.
- PHP: BSP's rate hikes have backstopped PHP weakness to some degree but fundamental 'twin deficit' concerns on the current account and fiscal balance, along with oil import pressures, will provide little to no reprieve for PHP.
- SGD: A conspiracy of CNY and EUR setback amid USD strength to drag SGD (1.42-1.44 tests) near-term despite unprecedented policy push for S\$NEER upside (scope). A rich S\$NEER too limits relative SGD out-performance.
- KRW: Weakness persist as dire terms of trade continues to weigh on their industrial complex while the BoK's best efforts unable to overcome widening interest rate differentials. More room for recovery in 2023.
- THB: Tourism recovery will backstop THB slips though sustained recovery may only kick-off early-2023 and outperformance remains limited as BoT's policy room remains restrained. China-reopening still the wildcard.
- VND: Strong growth and contained inflation enables regional outperformance but does not imply immunity from strong USD trends. Especially as CNY and KRW rumble pressures for now.

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