

Cautious Calm

How Asia fares amid seesawing volatility

Mar 31, 2016

- It's as if nothing has happened. After bursting out of the gate with so much shocking angst at the start of the year, market volatility has since turned curiously tame as we inch closer to Q2.
- The relative calm has much to do with stabilizing oil price and a less acute sense of unease about China. Still, a more steadfastly dovish Federal Reserve was the ultimate reason behind the subdued volatility – which makes any hawkish surprise all the more unsettling going forward.
- Hence, for Asia, while it is tempting to assume all is well, policymakers will choose to remain cautious. They are likely to be still wary of sharp currency appreciation, keen on building up reserves, and more restrained with monetary easing.

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Back to the Start

"It was the best of times, it was the worst of times." That was how Charles Dickens summed up the highs and lows of human behaviour during the French Revolution era. The same words can perhaps describe how sentiment has been throughout Q1 2016.

It may feel like a while back, but it is worth recalling how the year had begun. Even as market players were still recovering from hangover of New Year's celebration, a quick succession of risk factors burst forth mercilessly in the first few weeks. Egged on by China's currency devaluation concerns, a renewed slump in oil prices and topped up with worries about European banking sector, global market volatility shot up suddenly.



Source: Bloomberg, OCBC.

Wellian Wiranto*Economist*

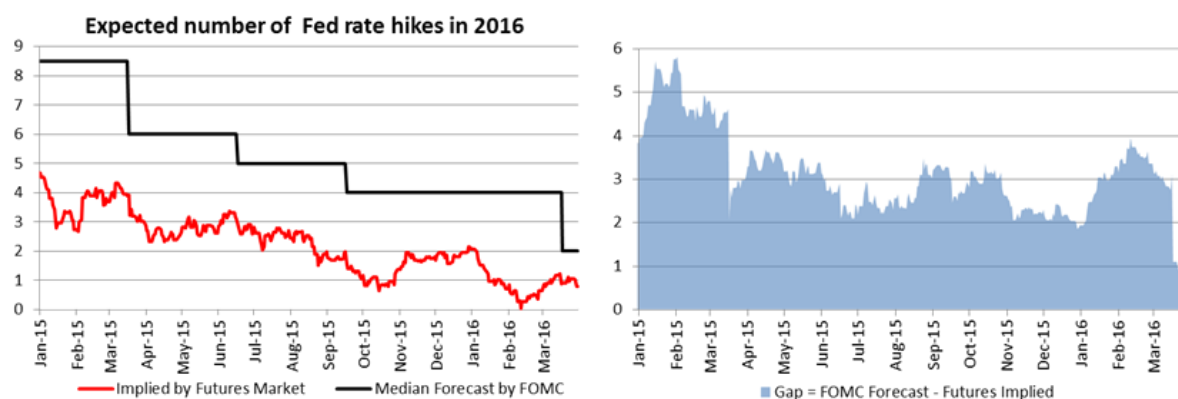
Treasury Research &
Strategy,
Global Treasury,
OCBC Bank

+65 6530-5949

wellianwiranto@ocbc.com

The VIX index, for instance, soared to levels above 25 by the end of the first trading week, compared to being around 15 just two weeks before. It stayed elevated before turning south in mid-February. A feeling that not all hope was lost began to take hold, as out-of-the-blue as the initial pervasiveness of fear had been, with some factors in mind. Assurances from PBOC Governor Zhou Xiaochuan that capital outflows from China were temporary, bolstered by actual strengthening of CNY against USD in the days after the Lunar New Year break helped to counter concerns about the economy. Talks about production cut among major oil producers, while ultimately fruitless, helped to arrest the decline in prices.

Meanwhile, better-than-expected data from the US became another useful anchor of sentiment at an important time. In particular, the significant upside surprise of February's nonfarm payrolls data was especially helpful, coming in at a strong 242k and showing that the world's largest economy managed to largely withstand the global turmoil at that time. Since then, the improvement in sentiment has been bolstered further by a dovish FOMC statement on March 17th. The dotplot, in particular, showed a marked downshift in rate hike expectations by the Fed officials, from four hikes originally thought likely in 2016, to just two. While some Fed officials have since then dialled back some of the dovishness, the most recent speech by Chair Janet Yellen has reassured market that the central bank will retain a largely cautious stance when it comes to raising rates.

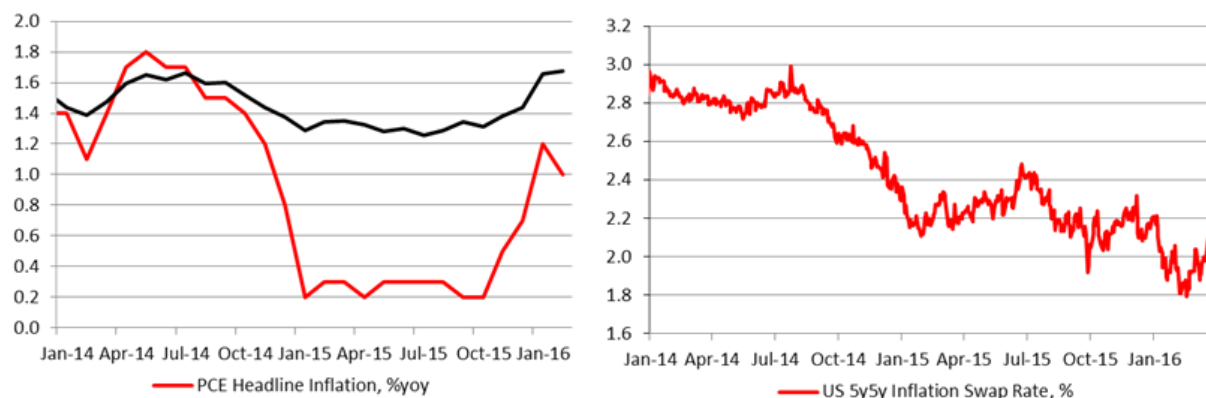


Source: Bloomberg, OCBC.

Price Matters

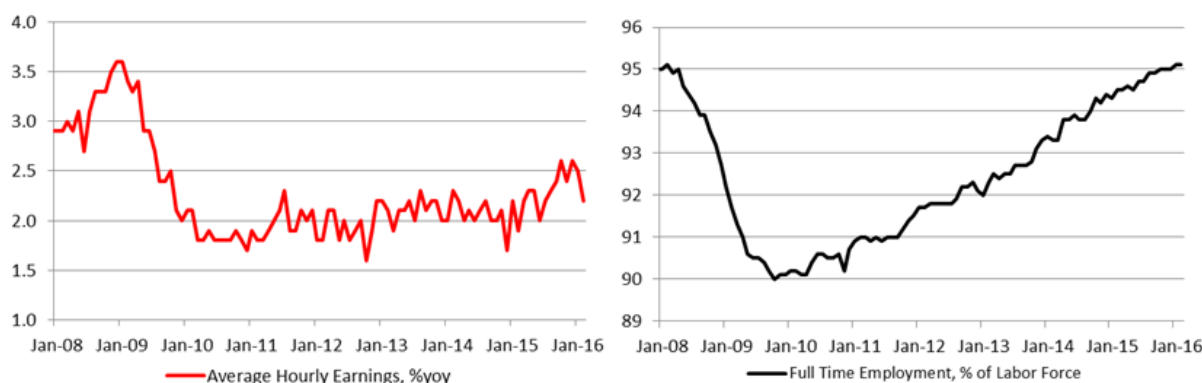
Our sense is that the gingerly gradual stance that is telegraphed by the Fed would remain the key variable to watch. Precisely because of its role as the anchor of global market sentiment – and how beholden the current market calm is on this factor – any unanticipated hawkish shift in Fed funds rate outlook could be tricky. To be sure, Yellen appears to have been reluctant to spook the market, which is expecting a mild one hike this year.

However, she and other Fed officials have been equally keen in emphasizing the notion of data dependence, as well. And, if the inflation segment of the broad data they are looking at manages to surprise on the upside for a few months, the risk of them backtracking on the relatively dovish outlook cannot be dismissed. Already, both headline and core PCE inflation, which the Fed tracks most closely, have exhibited upticks. Moreover, there has also been an upturn in inflation expectations, judging from the 5-year, 5-year USD inflation swap rate.



Source: Bloomberg, OCBC.

To that end, it is especially important to pay attention to how the labor market is doing. While much attention will be splashed on nonfarm payrolls print this Friday, we believe that market should watch for the hourly earnings print in particular. It has shown some signs of trending up, even if the last print of 2.2%yoy was lower than expected. As the US economy creates enough jobs for employment to normalize to pre-Lehman levels, wages may well pick up further and become an increasingly important factor in pushing up market expectation of US inflation – and, thus, that of Fed rate hikes.



Source: Bloomberg, OCBC.

What does it all mean?

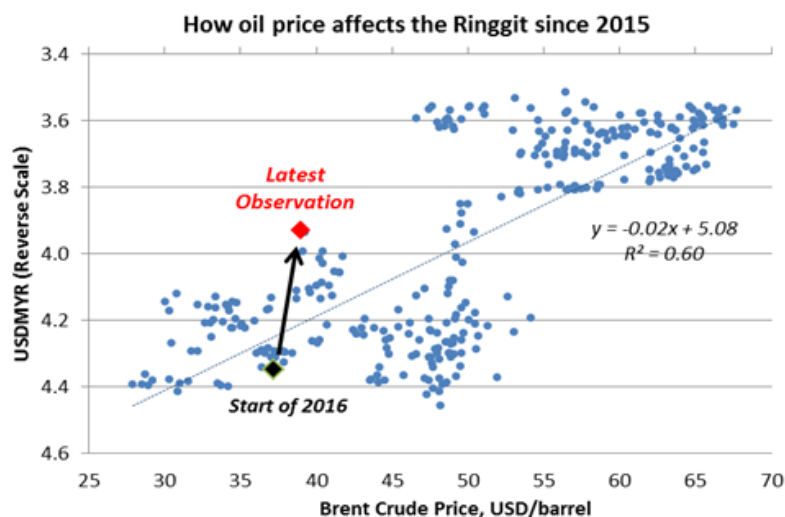
To circle back home to Asia, Fed rates trajectory is important not just because it affects market sentiment and liquidity directly, but also its broader effect on US Dollar. While the recent weakness in USD has been in part caused by the strength in Euro and Japanese Yen, the dampened US rate hike expectations has also played a role. In turn, this means that if there is any upward shift in market expectations of US rates trajectory, USD is likely to be lifted along as well.

Now, EM currencies have benefited from the USD weakness of late. Like a loaded spring, however, they could well bounce back into weaker territory too should USD strengthen again. That could present a tricky situation for a region that is seeing capital inflows anew again. Indonesia, for instance, has seen around USD5bn and USD300mn net inflows into its sovereign bond and stock markets, respectively, year-to-date.



Source: Bloomberg, OCBC.

Meanwhile, Malaysia has turned into a relatively unlikely darling of investors lately, with its currency appreciating by over 9%, making it easily the best-performing Asian currency this year. Interestingly, while stabilization in oil prices helps, the degree of strengthening appears to have gone on a much sharper gradient so far this year than suggested by the historical relationship between the currency and price of crude.



In other words, Ringgit's recent strength appears to be driven not just by oil price alone. While political noise and central bank succession uncertainty linger, investors appear to be comforted also by news flow suggesting that 1MDB has managed to raise enough money to pay off their debts, and thus lessening concerns about potential contingent liability for the government. For now, a certain sense of nonchalant tedium seems to have set in too with regard to the political risk factor, given how long the drama has dragged on.

Reluctant Strength

The return of capital inflows and the resurgent strength in Asian currencies can be a comforting thing, especially after the tumult at the start of the year. However, our sense is that, Asian policymakers would remain cautious and choose to adopt a generally prudent mindset.

Specifically, the worry that currencies might have strengthened too much, too quickly is likely to permeate. Bank Indonesia's Governor, Agus Martowardojo, for example, reportedly said on March 22nd that the central bank does not want Rupiah to be too strong, even as he added that the current level reflects economic fundamentals. For good measure, the element of caution will prevail on the policy rate front as well. Having delivered three rate cuts in rapid succession from 7.50% to 6.75% this year, we think BI would wait a few months before embarking on another trim.

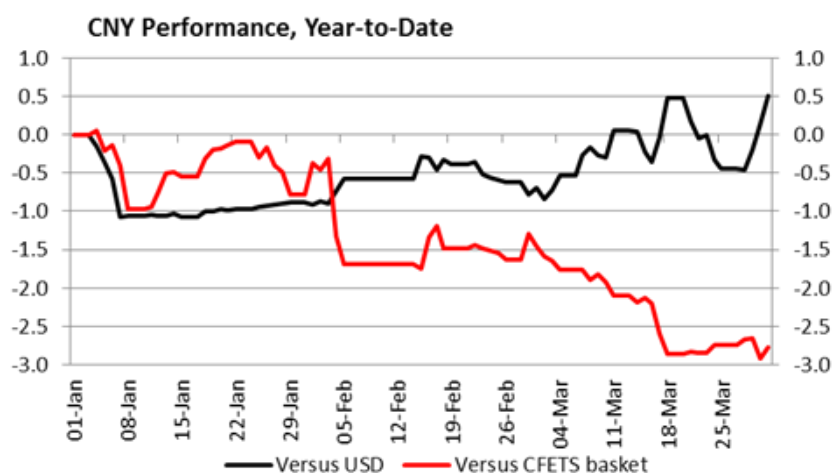
Meanwhile, Malaysia's central bank has been relatively less candid in signalling whether it would allow further strengthening of the currency or start to throw sand in the wheels. Given the degree of weakening last year – whereby MYR was the worst performing in the region, weakening by 18.5% against USD – it may make sense for Bank Negara to be comparatively more comfortable with the spurt of strength this year.

One thing that Bank Negara's outgoing chief, Zeti Aziz, did signal more clearly is that there remains potential for the current calm to peter out. In a press conference on March 23rd after the launch of BNM's annual report, the eminent governor said that "What we are projecting is for volatility."

While she did not detail the potential sources of volatility, a resurgent USD cannot be too far from her mind.

This is particularly so if we think about how any renewed USD strength may also complicate the relative stability in Chinese Renminbi that the market has witnessed in the past few weeks. After generating so much fear in the market early this year with the sudden uptick in USDCNY fixing, the pair has actually

reverted to being largely unchanged for the year, or indeed with a slight 0.5% renminbi appreciation. Against the broader CFETS basket, however, the Chinese currency has quietly weakened by around 3% year-to-date.



Source: Bloomberg, OCBC.

In essence, the Chinese authorities might have found a convenient way to have a broadly weaker currency by riding on the coattails of a weaker USD. The uneasy question is the following: Would they remain this comfortable in hugging USD so closely if the greenback strengthens sharply down the road, or would they yet again weaken the renminbi versus the USD? The latter scenario could unfortunately rekindle concerns about the possibility of competitive devaluation and bring down other Asian currencies again – leaving us back to where the year started, potentially.

All in all, it can feel like a huge relief that the worst fears that afflicted market sentiment as the year began seem to have receded, with capital surging back to the region to buoy currencies and investors' mood alike. However, too much of a good thing can potentially be problematic. After all – to bring Dickens back in again – vices are sometimes only virtues carried to excess.

With that in mind, if the inflows continue to gush in, Asian policymakers would likely focus more on dampening the potential negative consequences, especially given the possibility of a sudden reversal. Curbing currency strength and building up foreign reserves would rank high as a policy priority.

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