

## Emerging Insight

## A heavy downside skew to USDTWD ahead of the election

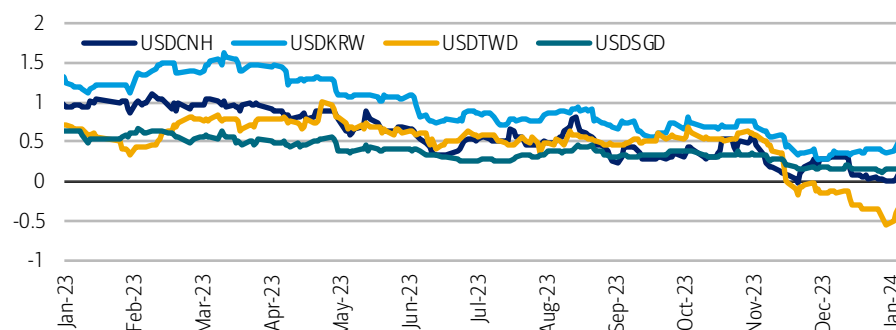
## Key takeaways

- The upcoming Taiwan election on 13 Jan will be well watched and will impact pricing across equities, FX, NDF and FX options
- Historical analysis suggests equities rally, TWD performance is mixed while FX vol cools following the election election.
- Watch for mismatch between Presidential leadership and Legislative Yuan majority which may make policymaking more difficult.

By Chun Him Cheung and Miao Ouyang

**Exhibit 1: Comparison of 3-month 25-delta risk reversals across Asian currencies**

Compared to peers (USDCNH, USDKRW and USDSGD), USDTWD stands unique in having a negative 3-month risk reversal



Source: Bloomberg

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## Taiwan election in focus

Taiwan's general election (hereinafter referred to as election) is scheduled for 13 January 2024. While much attention is placed on the Presidential race, we think investors should equally focus on the dynamics of the legislative race and the potential outcomes. Historically, we have found that Taiwan equities tend to rise and outperform the global benchmarks in the 10-trading days post-election. FX performance tends to be muted but FX-implied volatility mostly peaked close to the election date before subsiding afterwards. In terms of the market skew, the USDTWD risk reversal also tends to increase following the election. We are expecting a similar pattern for the 2024 election, especially after the recent increase in USDTWD-implied volatility and the collapse of risk reversals, triggered by the rapid decline in spot USDTWD and NDF in the last two weeks of 2023.

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NDF – non-deliverable forward

**All eyes on the upcoming Jan 13 election.** The Taiwanese general election is scheduled to be held on 13 January 2024. The three major presidential candidates are Lai Ching-te from the ruling Democratic Progressive Party (DPP), Hou Yu-ih from the Kuomintang (KMT) and Ko Wen-je from the Taiwan People's Party (TPP). The president and vice president will be elected by a simple majority, i.e., the candidate with the most votes wins without a runoff requirement. The new president will assume office on 20 May, with a four-year term.

**The legislative race will also be important.** The legislative elections will be held concurrently with the presidential election. There are 113 seats in the Legislative Yuan (Taiwan's parliament), and 57 seats are needed for a majority. The Legislative Yuan elections use a mixed-electoral system — among the 113 seats, 73 are elected by a first-past-the-post voting in single-member districts, six are reserved for indigenous candidates by a single non-transferable vote, and 34 by the party-list proportional representation. Specifically, each voter will cast votes in two ballots – one for a candidate in their district and one for a political party. A party needs to have at least 5% of the total party votes to gain seats in the Legislative Yuan. The term of the upcoming Legislative Yuan will begin on 1 February 2024.

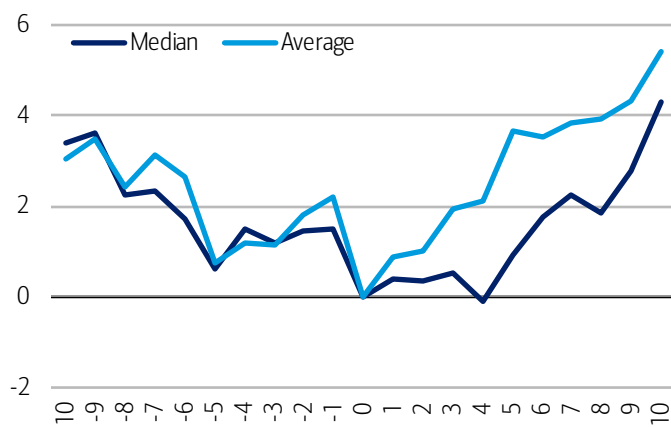
**What to watch for?** The market has been closely watching the presidential race and its potential geopolitical implications. The legislative elections are important to track too, despite the relatively little attention paid by the market.

**Why does it matter?** Over the past 16 years since 2008, the President and the majority in the Legislative Yuan have always been from the same party. The key to watch for the 2024 elections would be whether there will be a party with a clear majority in the legislature. A mismatch between the party of the President and the majority party in the Legislative Yuan could potentially make it more difficult to roll out some policies such as the annual budget.

How have different asset classes behaved before and immediately post-previous elections in Taiwan? Exhibit 2 and Exhibit 3 show the performance of Taiwan's benchmark equity index (TWSE) and the alpha of the TWSE over the NASDAQ, respectively, 10 trading days before and after the election. Analysis of the TWSE and the NASDAQ is necessary as Taiwan's equity benchmark is heavily influenced by global factors impacting the technology sector. Exhibit 3 shows that after stripping out the global factors (as proxy by the NASDAQ's performance), both on an average and median basis, the TWSE tends to outperform by 2-4% in the 10-trading days after the Taiwanese election.

### Exhibit 2: Average and median performance of the TWSE (%) around the Taiwanese election

In the past six elections, the TWSE rallied between 4-6% in the 10-trading days after each election

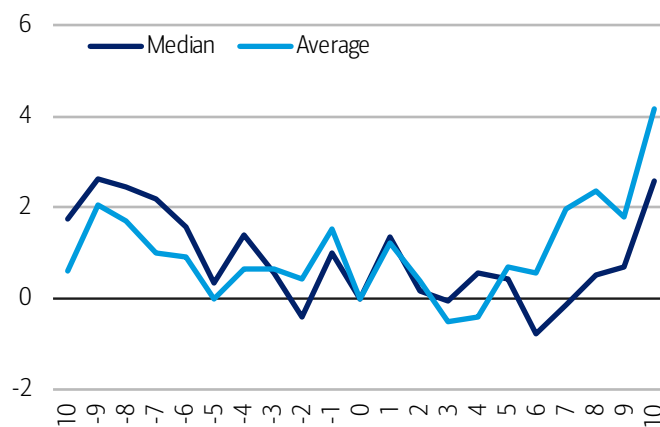


Source: Bloomberg; Note: Day 0 is the first trading day after the election

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### Exhibit 3: Average and median alpha of the TWSE versus the NASDAQ (%) around the Taiwanese election

In the past six elections, the TWSE tends to outperform the NASDAQ in the 10-trading days after each Presidential election



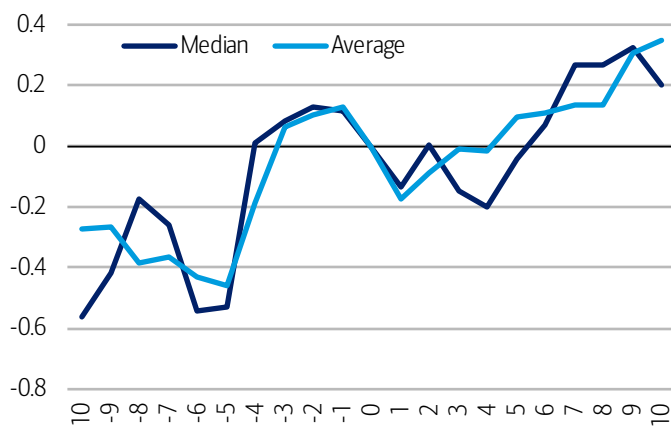
Source: Bloomberg; Note: Day 0 is the first trading day after the election

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**The performance of the TWD FX is more mixed around the election.** Despite the TWSE's strong average equity performance in the 10-days following the Taiwanese election, the performance in the FX market is less clear. We found that the average and median performance of TWDUSD rose by around 0.2% - 0.3% in the 10-trading days following the election (**Exhibit 4**). In terms of the TWD NEER, the average and median increase was only around 0.1% over the same period (**Exhibit 5**).

### Exhibit 4: Average and median performance (%) TWDUSD around the Taiwanese election

In the past six election, the average and median performance of TWDUSD was 0.2%-0.3% 10 trading days after each election

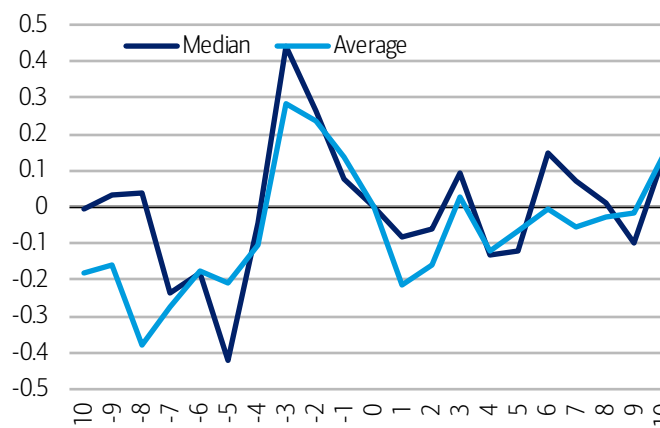


Source: Bloomberg; Note: Day 0 is the first trading day after the election

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### Exhibit 5: Average and median performance TWD NEER (%) around the Taiwanese election

In the past six election, the average and median performance of TWDUSD was 0.1% 10 trading days after each election



Source: Bloomberg; Note: Day 0 is the first trading day after the election

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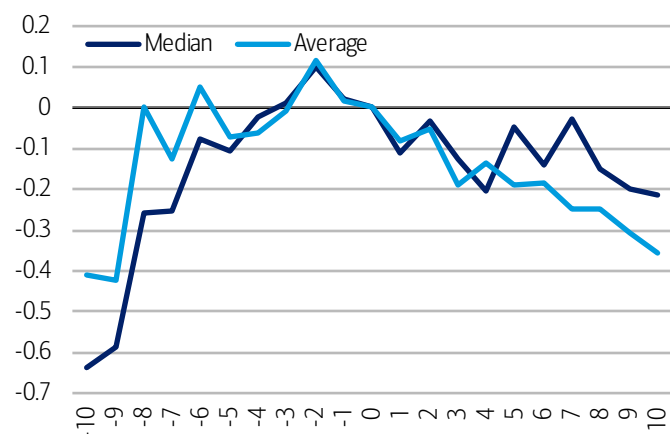
**The asset class that demonstrates the clearest trend following the Taiwanese election is the FX volatility.** Relative to the performance of spot equities and spot FX, the pricing behaviour of FX options are more consistent around the time of the last five Taiwanese elections. **Exhibit 6** shows the average and median pricing of the 3-month USDTWD-implied volatility around the election period. Five out of the six (exception being the 2012 election) previous Taiwanese elections, the 3-month implied FX volatility

on USDTWD was lower in the 10-trading days prior to the elections, suggesting there is some election risk premium priced in around the election time.

The historical pricing of USDTWD risk reversals suggest that the market risk is often skewed to the downside prior to the election. Exhibit 7 shows the performance of 3-month 25-delta risk reversals on USDTWD around the time of the past five elections (starting with the 2004 election). In four out of the five cases, the pricing of risk reversals rose by around 0.25 vol following the election. We interpret this historical performance as, the market on net, unwinding the USDTWD put options placed in hopes of a significant USDTWD downside, based on a risk-on outcome of the election. When the Taiwanese Dollar failed to show a significant upside momentum following the election, these structures were unwound, resulting in a net reduction of the value of puts vs calls.

#### Exhibit 6: Average and median performance of 3-month USDTWD implied volatility around the Taiwanese election

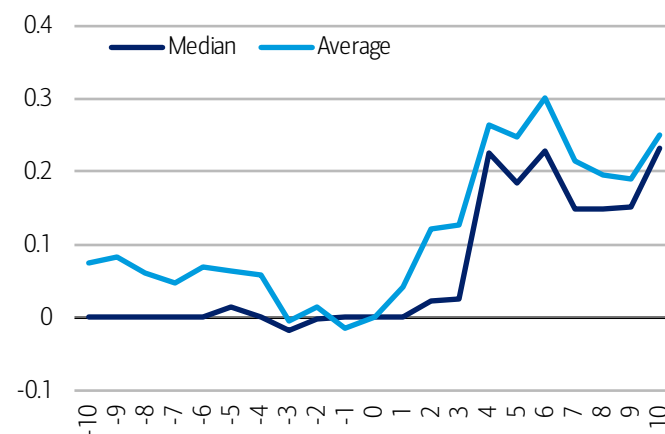
In the past six elections, the average and median performance 3-month USDTWD implied vol rose by around 0.7 in 10 days prior to the elections and declined afterwards



Source: Bloomberg; Note: Day 0 is the first trading day after the Presidential election  
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#### Exhibit 7: Average and median performance of 3-month USDTWD risk reversals around the Taiwanese election

In the past five elections, the average and median performance of 3-month USDTWD risk reversals increases by around 0.2 vol 10 days following the Taiwan elections



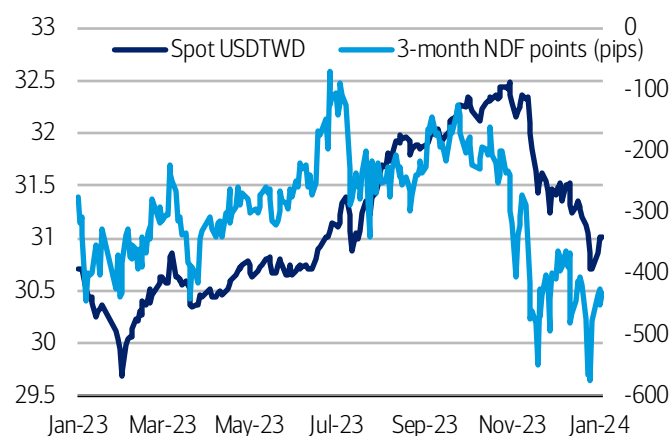
Source: Bloomberg; Note: Day 0 is the first trading day after the Presidential election  
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**The collapse in spot and NDF in December 2023 caused the FX-implied volatility to rise.** For likely reasons partially tied to the upcoming election in January 2024, we saw performance of the spot USDTWD and NDF points collapsed in the second half of December 2023. A strong risk backdrop, supported by the rhetoric pivot in the December FOMC, and a heavy net equity inflow pushed the spot level of USDTWD lower from 31.5 to a recent bottom of 30.7 (**Exhibit 8**). This downward move in the spot likely motivated Taiwan's life insurance companies to increase FX hedging, resulting in an aggressive forward US\$ selling, and thereby, depressing the NDF points.

**USDTWD risk reversals reconverged with its December 2020 low.** The downward movement in the spot and forwards decreased the outright forward price of the USDTWD, increasing both realized and implied FX volatility. The downward movement also pushed the skew to favour the downside as opposed to topside, pushing the risk reversal in negative to reapproach its recent low in December 2020.

**Exhibit 8: Recent pricing of USDTWD spot and 3-month NDF points**

Both spot USDTWD and 3-month NDF points collapsed in the second half of December 2023...

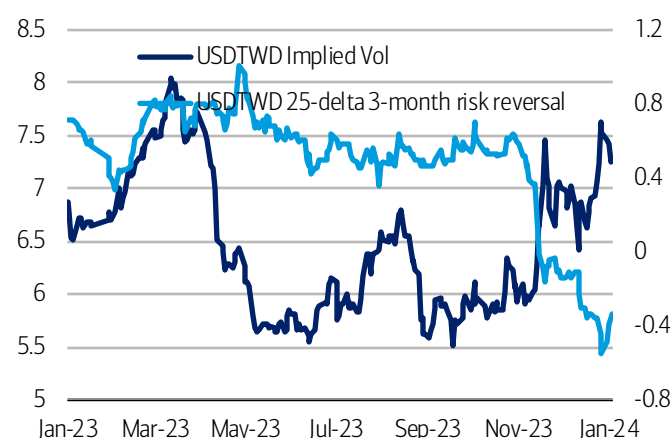


Source: Bloomberg

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**Exhibit 9: Recent pricing of USDTWD implied volatility and 3-month 25-delta risk reversal**

... resulting in implied volatility to increase as well as a heavy skew of puts over calls



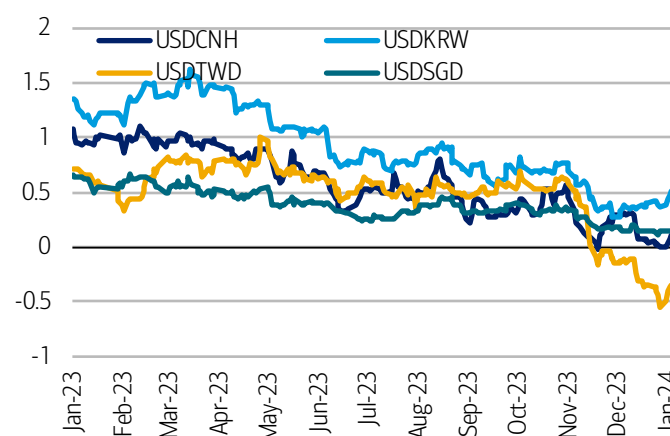
Source: Bloomberg

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**Recent behaviour of USDTWD risk reversals is unique among regional peers.** The weak USD performance in the second half of December caused risk reversals across the North Asia region to decline. However, relative to peers (CNH, KRW and SGD), only USDTWD's risk reversals turned negative, and showed a net market skew towards puts over calls (**Exhibit 10**). Relative to its own history, the current price of USDTWD risk reversals is pushed to its sixth percentile vs its post-2010 sample (**Exhibit 11**). If the historical median case plays out for the upcoming election, we would expect a mild decline in USDTWD, FX implied volatility to decline and risk reversals to normalize but towards par or slightly positive, in line with the regional peers' performance.

**Exhibit 10: Comparison of 3-month 25-delta risk reversals across Asian currencies**

Compared to peers (USDCNH, USDKRW and USDSGD), USDTWD stands unique in having negative 3-month risk reversal

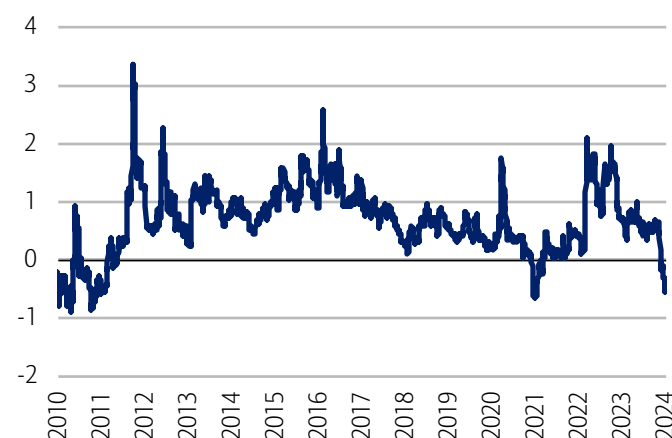


Source: Bloomberg

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**Exhibit 11: USDTWD 3-month 25-delta risk reversal**

Recently, 3-month risk reversal in USDTWD reconverged with its December 2020 low



Source: Bloomberg

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## News and Views

### Mexico: Mexico added 651k formal jobs in 2023

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According to IMSS, formal employment fell by 384.9k in December. In annual terms, formal jobs grew 3.1% yoy. For all of 2023, 651.5k jobs were created, of which 75.9% are permanent jobs. By industry, construction (8.1%), transport and communication (6.3%), and trade (3.9%) were the sectors with the highest annual growth. Two southern states, Quintana Roo and Yucatan, are among the states with the highest year-on-year growth (above 5.0%). The average salary in formal jobs increased 10.5% yoy to MXN\$537.9.

- **To follow:** On one hand, formal job creation and wage growth are decelerating which point to a softening of the labor market. On the other hand, wage growth is still too high, as it has been above 10% yoy since March 2022, which represents an upward pressure for inflation. Finally, the Government's infrastructure projects in the South seem to be propping up job creation, as we can see in the case of Yucatan and Quintana Roo.

### Mexico: Banxico minutes portray a mostly dovish board

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Minutes of the Banxico meeting on December 14<sup>th</sup> are out. All members highlighted the strength of economic activity, which can be seen in the quarterly GDP, investment and labor market indicators. Regarding inflation, most members underlined the progress made in inflation reduction throughout 2023. Moreover, most members pointed out the downward trend in core inflation and attributed the recent uptick in headline inflation to the non-core component. However, most members acknowledged the lack of a downward trend in services inflation. In general, the board considered the inflation outlook as challenging, hence the unanimous decision to maintain the policy rate at 11.25%.

- **To follow:** Minutes of Banxico's December meeting came in with almost no extra information. 1 out of 5 board members remains hawkish (likely Espinosa). The other four continue to talk about cuts. One member mentioned 1Q as a time to evaluate the possibility of cuts (likely Borja). One more member (likely the Governor) said that there are now conditions to start talking about cuts, which when they come would be very gradual and likely non-continuous. Another member (who seems to be Heath) continued to talk about small adjustments, not a cycle. All-in-all, Banxico continues to communicate that cuts are a possibility in 1Q. We still think that inflation data in December and January make a cut in February and potentially even March, unlikely. We do think that once the economy decelerates (2H 2024) there will be room for Banxico to do a proper cycle.

### Mexico: Consumer confidence drops by 0.4 points in December

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Consumer confidence in December decreased by 0.4 points mom sa to 46.8 points, down from +1.0 pts in November. The fall was broad based, but the main drivers were future household conditions indicator at -0.7 points mom sa (vs +1.0 in November) and future national conditions at -0.3 points mom sa (vs +1.7 in November). Moreover, the current household conditions and current national conditions indicators fell by 0.1 and 0.2 points mom sa, respectively. The likelihood to buy durable goods indicator remained unchanged.

- **To follow:** Despite the fall, the level of confidence remains high by historical standards, even above pre-pandemic levels, which will likely continue supporting consumption.

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