EM Alpha

Pay 1x3 USDTWD NDF on rising US$ risks

Key takeaways

- With the March FOMC soon, we seek to hedge out the higher US$ risks by paying 1x3 in TWD NDF.
- Pay 1x3 TWD NDF benefits from both stronger US$ and offers good FX-roll up as 1s are anchored by spot USDTWD.
- Local TW factors such as rising FX-hedge cost, inflow into bond ETFs, net equity outflows support keeping spot USDTWD stable.

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Hedging higher US$ risks ahead of March FOMC

With the March 2024 FOMC around the corner and a possible resumption of US$ strength, we seek to hedge our Asia FX portfolio by taking a quasi-long US$ position via paying USDTWD 1x3 NDF (current: -163 pips; target: roll to spots 2s at -111 pips; stop: -190 pips). Our economists in their base case continue to expect for a June cut by the Fed, which should begin to prompt a period of US$ weakness. However, before then, the risk may be for stronger US$. Risk to the trade is an immediate weakening of the US$.

Local Taiwan factors also suggest for the USDTWD to remain high. Firstly, the IMM roll this week should result in net US$ buying. Secondly, with the lifers are currently quite dependent on realized FX gains to support pre-tax profits. Moreover, with rising FX-hedging costs and the replenishing of the FX valuation reserves, we do not believe the lifers are in a rush to increase their FX-hedging ratio. Thirdly, net inflows into the listed bond ETFs remain strong and should result in their demand for US$ to remain high. Lastly, net inflows into equities are beginning to cool, as the SOX index retraces from its recent all-time high.

Elevated 1-month points results in good FX carry to pay TWD NDF curve

With the US$'s strength currently rebounding, TWD remains a good funder vs other currencies while paying the NDF curve results in decent FX roll-up. At present, the difference in implied yields between the spot 1s and 2x3 in TWD NDF has reached 3%. Should the US$ remain broadly stable, 1s will remain elevated as it is anchored by the spot, while further down the TWD NDF curve sees little volatility.

IMM – international money market

NDF – non-deliverable forward

DF – deliverable forward

SOX – Philadelphia Semiconductor Index

TWD – Taiwanese Dollar

FSC – Financial Supervisory Commission

For a full list of our trade recommendations, please see: Global Emerging Markets Weekly: Dropping the USD diet for real yields 15 March 2024

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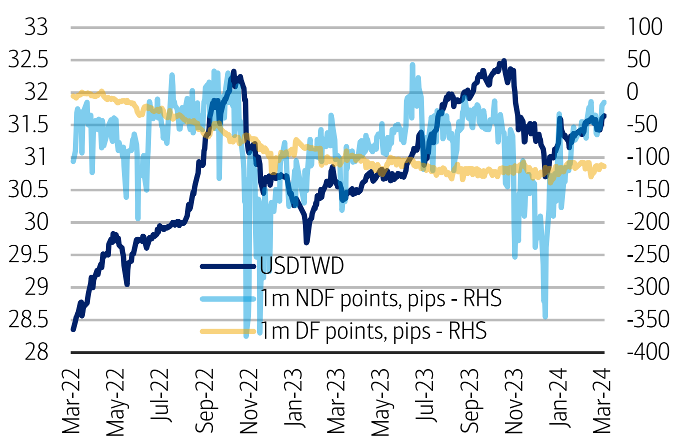
US$ strength seems to be returning as the market prices in fewer Fed cuts in 2024. The continuation of strong data from the US and the March 2024 sell-off in front-end US rates have kept the US$ strong. Despite a strong current account position and impressive equity inflows, USDTWD looks to be approaching the top-end of its year-to-date trading range of 31.0-31.6. With key events this week (third week of March 2024), such as the March IMM roll, and more importantly, the March FOMC, we believe it is prudent to take a long US$ position through pay 1x3 TWD NDF.

We take a quasi-long USDTWD position for carry and as an internal hedge. This positioning is taken partly due to our views that the USDTWD can remain on an uptrend as the market continues to use the TWD a funder using periods of US$ strength, in addition to as a hedge for our sell EURKRW position (see: [EM Alpha: Switching from sell USDKRW to EURKRW 14 February 2024]), which would suffer on continued US$ strength.

Front-end TWD NDF curve is highly impacted by spot USDTWD. Exhibit 1 shows that the front-end (1-month) of the TWD NDF curve is highly impacted by the direction of the spot USDTWD, whereas the 1-month DF points are much stable as they are anchored by the interest rates differential between the US and Taiwanese policy rates. The reason behind the high correlation between the spot USDTWD and the 1-month TWD NDF points is that the life insurance companies (lifers) often use the 1-month NDF to hedge their FX position. When the spot USDTWD goes up, the lifers would unwind or reduce their FX-hedging activities, causing the 1-month points to narrow. The opposite would occur when spot USDTWD declines.

TWD NDF volatility is clustered around the first month. **Exhibit 2** shows the general relationship between the forward path of the 1-month points on the TWD NDF curve. The general takeaway here is that the volatility of the TWD NDF curve is clustered around the front month tenor while the volatility quickly drops afterwards. As such, should 1-month TWD NDF points stabilize, led by a stabilization in spot USDTWD, these are good opportunities to earn FX roll-up on the TWD NDF curve.

Exhibit 1: USDTWD and 1-month TWD DF & NDF points (pips)
1-month NDF points are highly influenced by the direction of spot USDTWD



Source: Bloomberg

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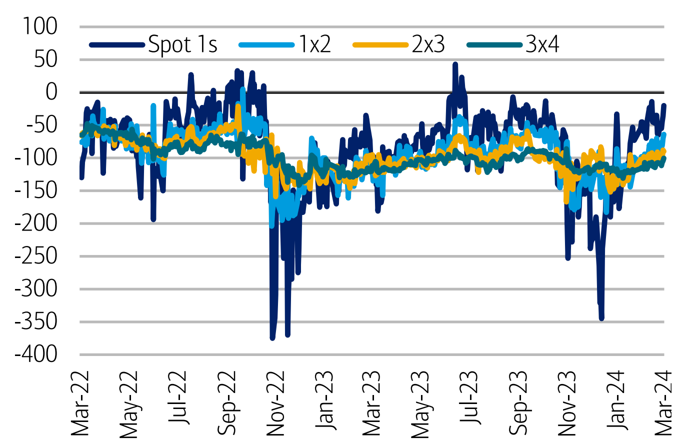
Exhibit 2: Forward path of 1-month NDF points (pips)
Volatilities of the TWD NDF curve is driven by the 1-month tenor



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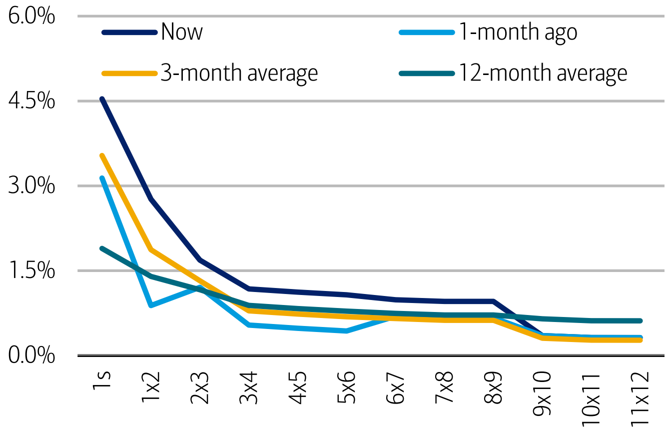
The front-end of the TWD NDF curve is currently highly inverted. Exhibit 3 and **Exhibit 4** shows the current shape of the TWD NDF curve, in implied yield and in pips terms, respectively. Both show that the current shape of the TWD NDF curve is highly inverted with an attractive FX roll-up to be earned through paying longer tenors and receiving the front-end. Since the majority of the difference in FX roll-up is between the 1–3-month tenors, we currently like to pay 1x3 TWD NDF to capture this spread.

Exhibit 3: Shape of the TWD NDF curve (implied yield %)

The current shape of the TWD NDF curve is inverted compared to the recent past…



Source: Bloomberg

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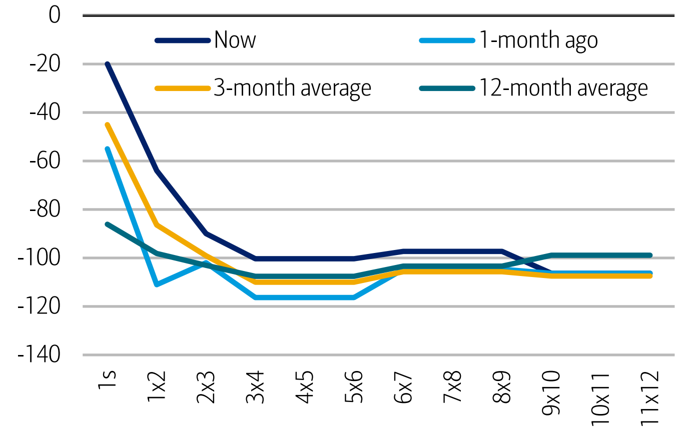
Exhibit 4: Shape of the TWD NDF curve (in pips)

… with most the inversion coming from the next two months



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TWD NDF carry trades requires the US$ to remain broadly stable. First and foremost, the most important consideration is that the broad US$ must at a minimum be stable. Should the US$ decisively turn weaker, this will result in the 1-month TWD NDF to follow the movement in spot UDSTWD, resulting in a sell-off in the rest of curve. However, given the relatively short tenor of this trade, we are somewhat comforted by the steep FX roll-up offered. Currently, the 1-month difference 1x3 TWD NDF and spot 2s is close to 50pips.

Local Taiwan factors also support higher spot USDTWD. Several local Taiwan factors are also supportive to keeping spot USDTWD high, at least until the Fed has taken a clear dovish turn.

Firstly, judging from lifers' January 2024 data financial statement data provided by the FSC, the lifers appear to be in a consolidation mode. As **Exhibit 5** shows, monthly changes in USDTWD splits directly into the lifers' realized FX gains and losses. Historically, every 1% increase in USDTWD results in realized FX gains of the lifers to increase by US$4bn, all else equals. **Exhibit 6** shows, the realized FX gains is a major contributor to the lifers sustaining a positive pre-tax profit. In January 2024, the lifers' pre-tax profit was US$1bn, boosted by realized FX gains of US$7.6bn.

The spillover of realized FX gains to higher pre-tax profit, in addition to foregoing FX-hedging cost, is what incentivizes the lifers reduce their FX-hedging ratio during periods of US$ strength. Reducing FX-hedging puts upward pressure on the spot USDTWD.

Exhibit 5: Lifers' pre-tax profit and USDTWD

Currently, the lifers' pre-tax profit is highly driven by movements in the spot USDTWD.

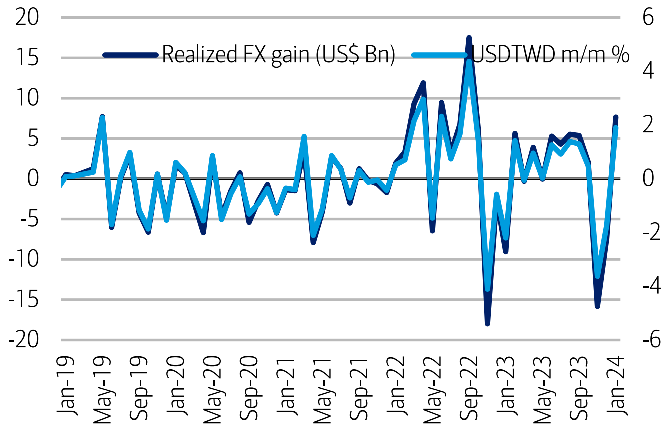

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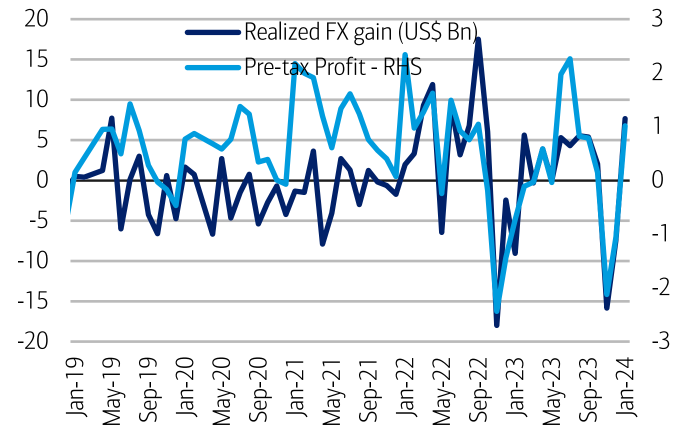
Exhibit 6: Lifers' realized FX gains and pre-tax profit

Realized FX gains – a big driver of the lifers' pre-tax profit



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FX-hedging cost continues to rise in January 2024 despite tight NDF points. Secondly, **Exhibit 7** shows the realized FX-hedging cost for lifers continued to climb in January 2024 despite NDF points having moved higher that month. This may reflect that despite NDF points having moved higher in January, DF points, which is the main FX-hedging tool remained unchanged. Moreover, the income premium increased in Dec-2024 and Jan-2024 to close to US$7bn in both months rising from the trough of US$4bn in Sept-2023. Improving income premium provide more funds to invest overseas, which over time, should result in higher absolute FX-hedging costs.

Lifers are slowly replenishing their FX valuation reserves. In Asia FI & FX Strategy Watch: Taipei Trip Notes – February 2024 06 February 2024, we discussed how the lifers significantly drew down their FX valuation reserves in Nov and Dec-2023 given the US$ sell. January 2024 saw the lifers marginally replenish this account as USDTWD rose that month. Replenishing the FX valuation reserves is a cost to the lifers as it reduces the amount of realized FX gains they can recognize. The need to use realized FX gains to support pre-tax profits and replenish the FX valuation reserves will reduce the lifers' net FX-hedging activity, until the US$ begins to show strong signs of weakness.

Exhibit 7: Lifers' FX-hedging cost and TWD DF & NDF

In 2024, FX-hedging cost continues to rise to US$12.5bn/ month

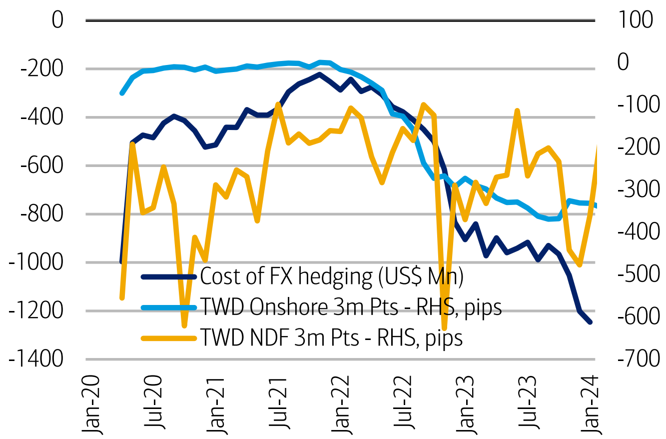

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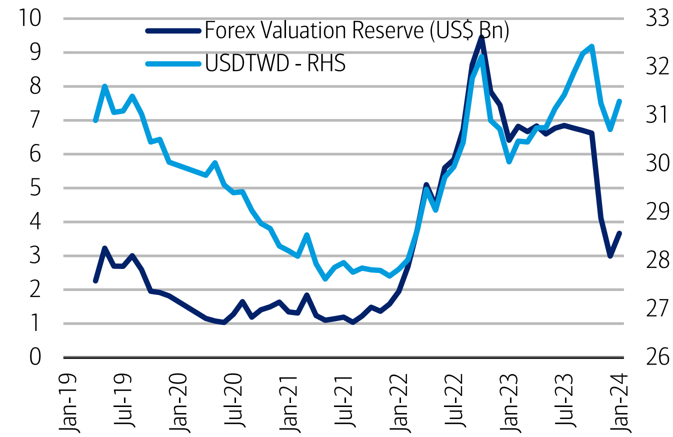
Exhibit 8: Lifers' FX valuation reserves and spot USDTWD

Lifers' FX valuation reserves recovered to US$3.7bn in Jan-2024, from US$3bn in Dec-2023



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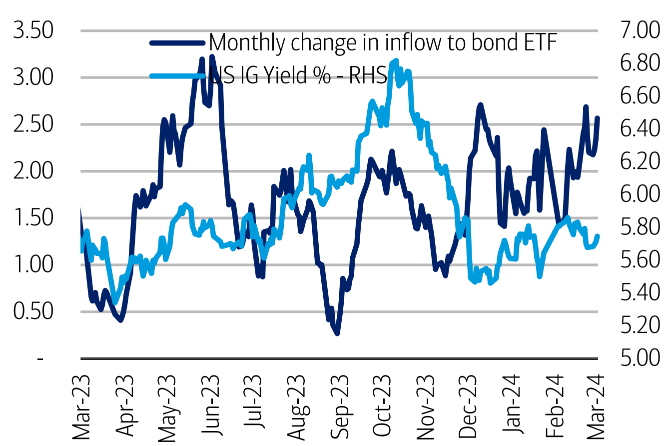
Continued strong inflow into Taiwan's bond ETFs will keep spot USDTWD biased higher. Moreover, inflows into bond ETFs have been strong in 2024, at close to US$5bn year-to-date. As we noted in [Asia FI & FX Strategy Viewpoint: The return of bond ETFs and impact on USDTWD 12 July 2023], in the past year, Taiwan's listed bond ETFs are receiving additional inflows and are having an increasing impact on the spot USDTWD market. To some extent, the US$ buying activities of the bond ETFs are offsetting the US$ selling from foreign investors in Taiwan equities.

Weaker equity inflow will also keep USDTWD higher. Historically, and until now, net foreign inflow into Taiwanese equites have been the biggest driver of USDTWD (**Exhibit 10**). However, with the SOX Index appearing to be retreating from its recent all-time high, net inflows into Taiwanese equities have also slowed. The stalling of the global tech rally should also help with the tactical view of a higher spot USDTWD.

Exhibit 9: Net inflow into Taiwan's bond ETF (US$ Bn)

Year-to-date inflow into bond ETFs remains strong at US$5bn



Source: Bloomberg

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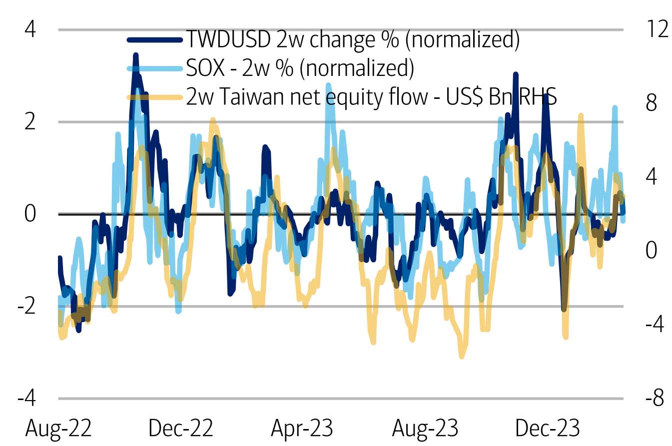
Exhibit 10: Net equity inflow into Taiwanese equities, SOX and USDTWD

USDTWD remains highly influenced by movements in SOX and net inflow into Taiwanese equities



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