Emerging Insight

USD-Asia amid US rates rally

Key takeaways

- Recent volatility in US rates has yet to spill over to the FX space, and USD-Asia remains very stable.
- With the current US policy rate much higher than regional peers, the cost to sell USD now remains very high.
- When market sentiment shifts to risk-on, we like to sell USD against KRW and THB due to good carry-to-vol properties.

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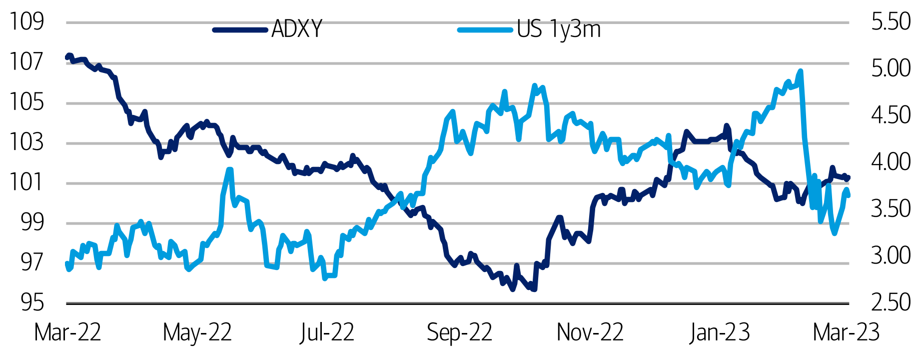
By Chun Him Cheung

Exhibit 1: ADXY and front-end pricing for US rates
Asia FX has not reacted much to the recent risk-off sentiment in the US banking sector



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Asia in Focus

The sharp increase in implied volatility in US rates did not filter into the FX space, and USD-Asia has remained remarkably stable throughout the latest episode of the banking sector risk in the US and Europe. The current shape of the US curve is pricing in for aggressive Fed cuts in 2H23, resulting in US rates outperforming Asian rates on a forward basis, but a number of Asia curves posted similar performance as the US on a spot basis. With the Fed funds rates still much higher than most regional policy rates, across Asia, most forward points for most currencies remain deep and negative. We believe the market currently lacks incentives to sell USD given the steep carry cost, and will only sell USD once there are clear signals for a risk-on environment supported by equities inflow. In 2H23, we prefer to sell USD against KRW and THB because of our 2023 FX forecast and a relatively low negative carry-to-realized volatility ratio.

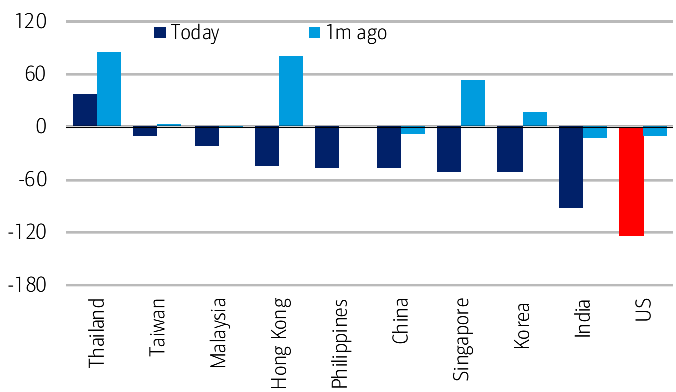
Asia FX stable amid turmoil in US rates market. Our G10 FX team has written extensively on the global FX/ Risk disconnect (see: Liquid Insight: The FX/Risk Disconnect 27 March 2023). The risk aversion expressed in sharp rate cuts priced in by the US rates did not result in the historical experience of the USD smile, where USD strengthens and high-beta EM sells off. **Exhibit 1** shows during the period of maximum panic around the US banking system (the week after SVB's implosion on 12 March), the aggressive movement in US rates resulted in a negligible reaction in the ADXY, our proxy for regional currencies in Asia. The lack of movement in the ADXY relative to the movement of US rates is the regional expression to the global observation that global FX volatility has had a muted reaction to the explosive upward move in US rates volatility following the introduction of the global financial sector risk in the recent weeks.

US rates significantly outperformed Asia peers on forward starting basis. When we look at the performance of regional rates since the implosion of SVB, Asia rates have had a larger reaction than in the FX, especially for forward starting rates. **Exhibit 2** compares the expected 1y change in 3-month regional rates (i.e. the difference between 1y3m and 3m). A month ago, prior to the realization of the US banking sector risk, most regional curves priced in an essentially flat to hiking profile (i.e. Thailand, Hong Kong, Singapore). However, by the last week of March 2023, all Asia curves have turned inverted, with the sole exception of Thailand. However, their level of inversion is less than that of the US, resulting in the 1-year starting rates in the US to outperform their Asia counterparts.

Performance of spot rates in Asia vs the US more muddled. The outperformance of US rates vs Asia rates in the belly of the curve is evident. However, at the very front-end (i.e. 1-year or less), US outperformance is less clear. As shown in **Exhibit 3,** movement of 1-year spot rates in Hong Kong outperformed the US rates (see: Asia FI & FX Strategy Watch: Why are HKD forward points at record low? 28 March 2023), while Singapore and Korea saw similar levels of decline. The outperformance of the belly of the US curve (vs Asia) shows the market expects the Fed to aggressively cut in the future – but *not in the immediate future*. This delay in expectations has material impact on the incentive to sell USD, especially in a risk environment where USD is struggling to find a predominant narrative.

Carry cost to sell USD in Asia remains very high. The expectation that the Fed will cut in the future increases the opportunity cost to sell USD now. Across most Asia, policy rates locally remain lower than the US, resulting in negative forward points and high carry cost to sell USD forward. **Exhibit 5** shows the carry cost to sell USD in late-March vs a month ago (prior to the SVB implosion). Relative to a month ago, the currency that saw the sharpest narrowing of forward points was USDJPY, with 12-month

Exhibit 2: Expected 1y change in 3-month rate (Asia and US)
Following the SVB implosion, most rates curves in Asia turned inverted except Thailand



Source: Bloomberg

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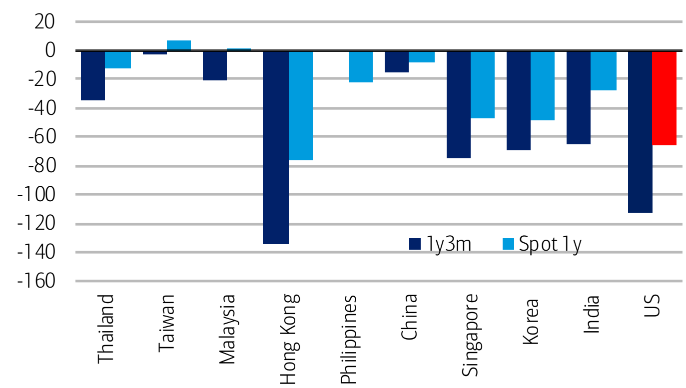
Exhibit 3: 1-month change in 1y3m versus spot 1y IRS
The performance of some of the spot rates in Asia was similar to that of the US



Source: Bloomberg

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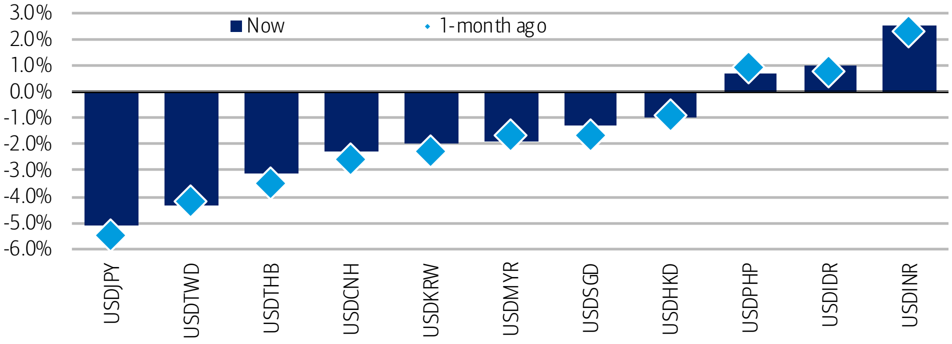
carry cost declining by 50bp. However, this provides little reprieve, as the annualized cost to sell USDJPY still remains at 5%. This carry is punitive in an environment where USD has yet to find a firm direction.

Exhibit 4: Carry cost to sell US$ 12-month forward
The carry cost to sell USD 12-month for Asia currencies barely changed in the past month



Source: Bloomberg

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We expect most USD-Asia pairs to be down by 2023 year-end. In such an environment, positioning for USD weakness in the region becomes a question of timing and cost efficiency. For this, we can use our latest Asia FX forecast revisions (see: [Asia FI & FX Strategy Watch: Asia FX Monthly 28 March 2023)]() for guidance. In our latest FX revision, we took note of the downward revision our US economists made to the US terminal rate in conjunction with upside risk to growth that may be coming out from China (see [China Watch: Jan-Feb activity data confirmed a solid recovery under way 15 March 2023]()). Faster China growth amid an earlier end to the Fed cycle has us putting the forecast for USD-Asia lower. By the year-end, we are not bullish on any EM USD-Asia pairs (we still expect spot USDJPY higher though), are neutral on CNY, HKD, MYR, and PHP, and outright bullish on INR, IDR, KRW, SGD, and TWD.

Korean Won as prime candidate in the region to position against eventual USD weakness. Exhibit 6 compares the carry-to-realized volatility ratio. Although in absolute terms, we expect USDTHB to decline the most in 2023 (Exhibit 6), when taking into consideration the carry-to-realized volatility ratio, the best candidate in the region to sell USD against is the KRW, in our view. Despite our lower expected absolute return, the forward points are less negative in KRW in addition to having a slightly higher realized volatility. As such, when USD weakness comes, we expect the most cost efficient play for USD downside is cheaper for KRW than for THB. However, by these metrics, THB

Exhibit 5: Asia FX carry-to-realized volatility
Throughout Asia, USDKRW and USDSGD are among the best low yielders to position for USD weakness

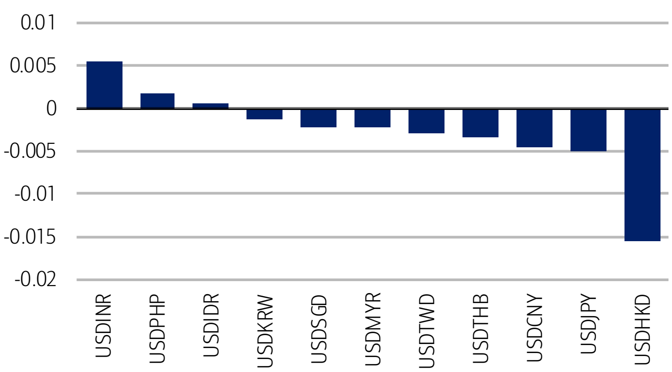

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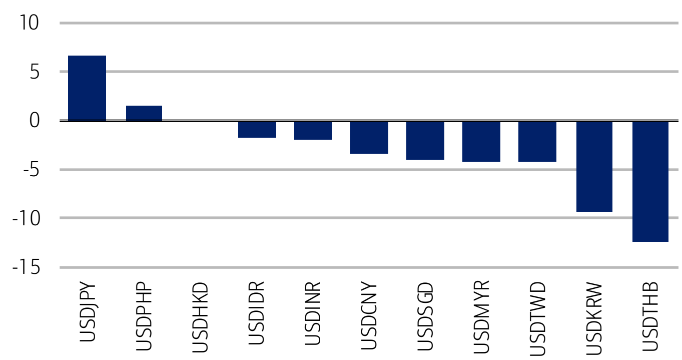
Exhibit 6: BofA's 2023 Asia FX forecasts
On spot terms, we expect the biggest decline in USDKRW and USDTHB in 2023



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ranks second because of our expectation for large spot gains against USD, followed by MYR and SGD.

News and views

Brazil: Unemployment goes up to 8.6% in February, as labor market continues to deteriorate

David Beker	Natacha Perez
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Unemployment rate increased to 8.6% in February (vs 8.4% in January), totaling 9.2mn unemployed, according to the Nation-wide Job Market Survey (PNAD). The result was slightly better than our and market's expectations at 8.8% and 8.7%, respectively. The negative trend in February, however, didn't go beyond unfavorable seasonal effects, as the seasonally adjusted unemployment rate was stable at 8.7%.

The employed population growth pace continued to decelerate in February, marking a 3.0%yoy increase (from 3.4% in January), as the occupied population reached 98.1mn, down from 98.6mn in the previous month. Informality declined one tenth, to 38.9%. Labor force growth was once again close to stability in February (growing 0.1% yoy, from 0.1% yoy in January). In turn, participation rate declined for the fifth consecutive month, reaching 61.7% (vs 61.9%). Three out of five sectors lost workers at the margin: Agriculture (-0.5% momsa), Industry (-0.3% momsa), and Services (-0.2% momsa); with Construction (+1.1% momsa) and Retail (0.15% momsa) increasing the number of employees. On a positive note, real income increased and reached 7.5% yoy growth (from 7.7% yoy previously), while total wage bill gained 10.8% yoy in real terms (from 11.3% in Jan23).

- **To follow:** The results were negative once again, pointing towards the fact that the post-pandemic labor market recovery has come to an end. Despite a stable seasonally adjusted result, declines were again registered in occupied population and participation rate, as the out of the workforce population increased. In the 1H23, real wages should increase further, reflecting the higher minimum wage (to be increased once again on May 1st, reaching R$1320), as well as the expected wage increase to public workers. Given the economic activity slowdown this year, we expect labor market to deteriorate further, reaching 9.0% by the end of 2023.

Brazil: public sector primary surplus declines to 0.93% of GDP in February

David Beker	Natacha Perez
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The public sector posted a R$26.5bn primary deficit in February (from a R$99.0bn surplus in January), according to the Brazilian Central Bank (BCB). The result was in line with market expectations, of a R$27.1bn deficit. The Central Government contributed with a R$39.2bn deficit (vs a R$79.4bn surplus in January), regional governments posted a R$11.8bn surplus (from a R$21.8bn surplus previously) and state owned companies posted a R$0.9bn surplus (from a R$2.2bn deficit). The interest payment in February reached R$64.2bn (vs R$52.3bn in January) and the public sector reached a nominal deficit of R$90.6bn (from a R$46.7bn surplus). In 12 month accumulated terms, the primary surplus declined to R$93.5bn (or 0.93% of GDP), from R$123.2bn in January (1.23% of GDP); while the nominal deficit went up to R$565.9bn (5.62% of GDP, from 4.97%). Gross debt/GDP has now started to go up, and reached 73.0% of GDP (from 72.5% in Jan23), as did net debt, now at 56.6% of GDP (from 56.1%).

- **To follow:** Following the weak central government primary print, the public sector results were also negative, posting the worst print for the month since 2001.

Despite the negative central government numbers, regional governments and state-owned enterprises surprised on the upside. Gross debt started to go up, after almost two years of decline, reinforcing the negative general stance ahead. With interest rates peaking, the nominal balance should remain pressured. Meanwhile the resumption of fuel taxes should help fiscal numbers, while the higher minimum wage should have a downside impact. We expect a primary deficit of 0.6% of GDP by 2023YE, with the gross debt to GDP ratio going up to 77.3%. Regarding the fiscal rule announced by the government, there are still many uncertainties, with expectations regarding the bill that should come out next weeks. Regardless, debt/GDP trajectory should remain very challenging ahead.

Brazil: 1Q23 Inflation Report: BCB keeps hawkish tone

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The Brazilian Central Bank (BCB) released its 1Q23 Inflation Report (IR) and it did not bring much news. The staff´s inflation forecasts (same as the last Copom meeting) increased for '23 and ´24, compared to the 4QIR, in line with the statement and the minutes. That is, forecasts are above the target of 3.25% for '23, but in line with the upper band for '24 (target at 3.00%, with the upper band at 4.50%). A highlight was the increase of 2025 forecast, now at 3.2% (from 2.8% in the 4QIR), above the inflation target for the year. Meanwhile, the GDP forecast for 2023 was also revised, going up to 1.2%, from 1.0% (we have 0.9%). Despite the upwards revision, the report reinforced expectations of economic activity deceleration, if compared to the past two years.

Regarding the external sector, the report emphasized the resilience of inflation and the tightening monetary policy across the globe. It also recognized the shifting financial conditions due to the banks distress and credit squeeze in the EU and the US. Domestically, despite acknowledging the better conditions on the fiscal side, the BCB reiterated that will not hesitate to resume the tightening cycle if needed, highlighting the still high inflation and deanchored long term expectations. The tighter credit market conditions were pointed out, but suggested a dynamic in line with the current state of monetary policy. The report also emphasized the growing uncertainty in its base scenario.

- **To follow:** The inflation report was consistent with the tone of the statement and minutes of the last Copom meeting, highlighting global pressures and the continuing in the monetary tightening globally, while signaling the resilience of domestic inflation numbers and the deanchoring of expectations. The report points towards the maintenance of Selic at 13.75% for a longer period. However, we continue to expect the next move to be a cut in May, with 23' year-end Selic at 11%.

Brazil: IGP-M increased 0.05% mom in March, reaching the lowest 12-month acc rate in 5 years

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March's IGP-M inflation print was driven by higher consumer prices, especially due to transportation, healthcare, and housing. Industrial and wholesale prices held the print back. Inflationary pressures on producer prices continue to be very reduced, mainly pushed by consumer prices.

IGP-M inflation increased 0.05% mom in March (from -0.06% in February), below our and market's expectations at +0.15% mom. With this print, IGP-M inflation reached 0.17% yoy (from 1.86% yoy in February), the lowest since February 2018. Wholesale inflation was -0.12% mom (from -0.20% mom previously), while consumer inflation went up to +0.66% mom (from 0.38% mom) and construction inflation went down to 0.18% mom (from 0.21% mom).

- **To follow:** Among wholesale prices, agricultural prices remained stable for the month, while industrial prices dropped 0.16% mom (vs -0.10%). The price of consumer fuel fell from 4.07% mom to -1.46% mom, driving down final goods inflation. The price of raw materials, however, increased from 0.20% to 0.71% - highlights were iron ore (4.95% mom vs 3.50% previously) and poultry (1.93% mom from -1.82%). Within consumer prices, the Transportation category was the main driver of the acceleration, pushed up by gasoline prices (+6.52% mom). Housing prices also increased, going from +0.37% to +0.84% mom in March.

Brazil: Industrial production declines in January

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In January, industrial output declined 0.3% momsa, after a stable print in December. The momsa print was in line with our and market's expectations, at -0.4% and -0.3%, respectively. The index increased 0.3% (vs -0.4% yoy previously), helped by an extra business day, compared to Jan22; declining 0.2% in 12-months accumulated terms. It is key pointing out that this is the first release after methodological changes announced by the Brazilian Institute of Geography and Statistics (IBGE), with updates in the sample and adjustments in the weights of products and activities.

With January's print, industrial production remains 2.3% below pre-pandemic levels (February 2020) and is 18.8% below its highest levels (reached in May 2011). Out of 25 sectors surveyed, 11 posted momsa declines (from 15 previously). The main negative drivers were automotive vehicles (-6.0% momsa) and food products (-2.2% momsa) – each with a -41bp contribution to the print. Among the main categories, capital goods production declined 4.2% momsa (vs -1.6% momsa previously), while consumer goods rose 0.2% momsa (from 2.0% momsa), with durables declining 1.3% momsa (from 2.4% momsa) and non-durables increasing 0.1% momsa (from 2.0% momsa).

- **To follow:** Today´s figures show a slow start to Brazilian activity in 2023, reinforcing the negative trend seen since 2H22. High cost of credit, elevated indebtedness, and high uncertainty (particularly regarding the fiscal and monetary policies) support the negative results. Our preliminary forecast for February's industrial production is -0.8% momsa; while January's IBC-Br is expected at 0.9% momsa, supported by stronger retail sales and services numbers.

Brazil: Central government primary surplus declines to 0.35% of GDP in February

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The Central Government reported a primary deficit of R$41.0bn in February (vs a R$78.8bn surplus in January), according to the National Treasury. The result was a touch worse than market expectations at -R$35.7bn, following weaker tax collection data for the month. Total revenues were R$153.4bn (from R$257.3bn) and transfers to states and municipalities were R$50.7bn (from R$36.7bn), resulting in net revenues that declined to R$102.7bn (from R$220.7bn), -4.5% in real yearly terms. Meanwhile, total expenditures grew to R$143.7bn (from R$141.9bn). increasing 2.4% yoy in real terms. The negative reading was a result of a R$20.0bn deficit from Treasury, a R$21.0bn deficit from social security and a R$83mn surplus from the Central Bank. In 12-month accumulated terms, the central government primary surplus declined to R$35.4bn or 0.35% of GDP in February (from 56.1bn or 0.56% of GDP in the previous month).

To follow: The central government posted the first primary deficit print of the year. Revenues were impacted by seasonally lower income taxes and smaller extraordinary revenues (mainly through concessions and dividends), with the resumption of fuel federal taxes expected to positively influence March's print. Meanwhile, expenditures were higher than in January, as expected for the month, with more spending guided towards social security.

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