

## Emerging Insight

## Asia FX – look before you fade

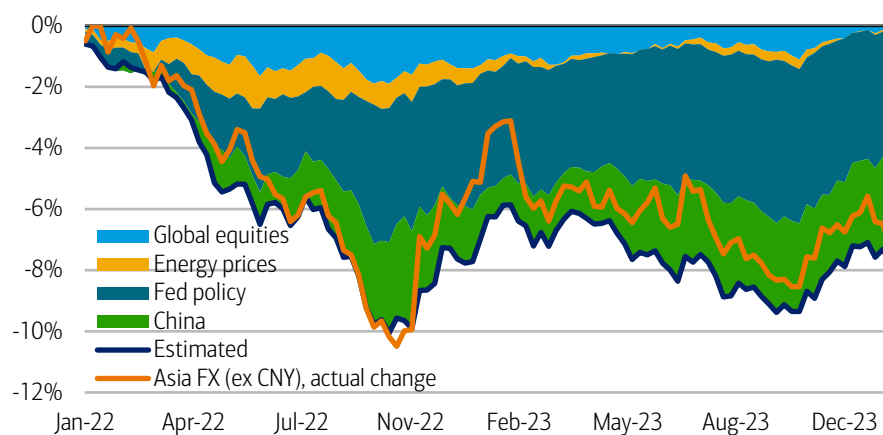
## Key takeaways

- Three optical "anomalies" in Asia FX: 1) year-to-date depreciation seems outsized relative to its key drivers;
- 2) vol dislocations in some currency pairs (INR low, TWD high relative to history); 3) risk reversal at historical lows.
- We recommend fading sell-off in KRW but broader Asia FX spot, vol & skew dynamics are more consistent than they first appear

## By Adarsh Sinha

**Exhibit 1: Asia FX (ex CNY): 2022-to-date, actual vs. estimated**

Asia FX largely in line with longer-term estimated move, despite sharp depreciation in January 2024



**Source:** Bloomberg. Note: global equities = MSCI World, energy prices = BCOMEN Index, Fed policy = US 5y real rate, China = first PC across equity, credit, bonds, FX, iron ore

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## Asia FX – more consistency than meets the eye

We note three optical “anomalies” in Asia FX: 1) year-to-date depreciation seems outsized relative to its key drivers (US rates, China sentiment, energy prices, global equities); 2) volatility dislocations in some currency pairs (INR low, TWD high relative to historical realized levels); 3) risk-reversals at historical lows on average. We recommend fading the sell-off in KRW but that aside, the broader Asia FX spot, vol and skew dynamics are more consistent with fundamentals than they first appear.

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## Pockets of opportunity to fade Asia FX sell-off

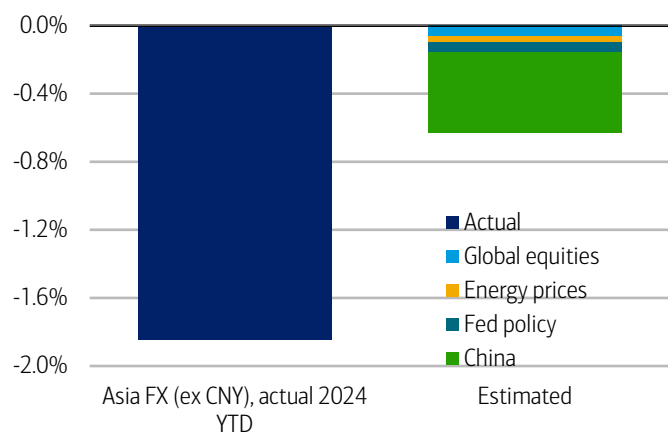
Asia FX has weakened ~2% year-to-date (on average vs. USD) – at the surface this looks excessive relative to its key drivers. Betas to US 5y real rates, MSCI World, energy prices and China would imply closer to 0.6% depreciation YTD (Exhibit 2). The deterioration in China sentiment has been a meaningful contributor but even this does not fully explain the move. KRW has been among the worst performers, amplified by the sell-off in Korean equities. The resilience of semiconductor stocks (SOX Index) and ongoing recovery in Korea exports suggests short USDKRW could offer the best opportunity to fade the Asia FX sell-off ([EM Alpha: Selling USDKRW on spike 18 January 2024](#)).

## But broader level in line with medium term drivers

The prospect of a broader Asia FX recovery however is less clear. Exhibit 1 shows our macro driver framework from a longer-term perspective (2022-to-date). Virtually the entire depreciation in Asia FX can be attributed to these drivers, especially US real rates and China. The “excessive” YTD depreciation may represent some payback for the strong rally into end-2023, consistent with our EM sentiment indicator triggering a sell earlier this month ([Sell signal triggered – tactical caution 11 January 2024](#)). The starting point matters but the divergence between actual and estimated levels is far less apparent compared to January and July of 2023.

### Exhibit 2: Asia FX (ex CNY): 2024 YTD, actual vs. estimated

Asia FX has weakened by more than its key drivers imply for 2024 YTD

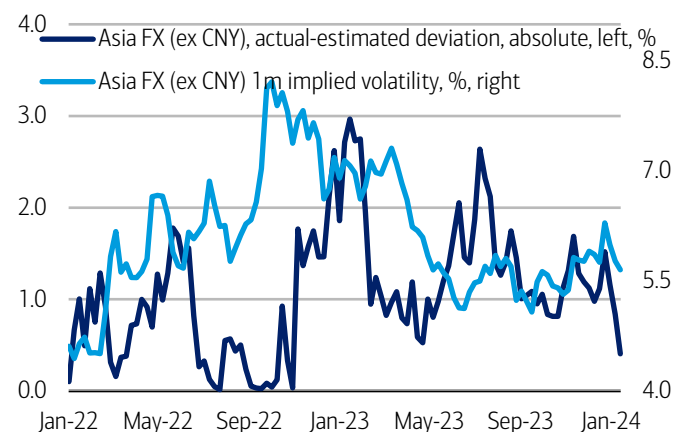


Source: Bloomberg. Note: global equities = MSCI World, energy prices = BCOMEN Index, Fed policy = US 5y real rate, China = first PC across equity, credit, bonds, FX, iron ore

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### Exhibit 3: Asia FX (ex CNY), actual/estimated deviation vs. implied vol

Convergence of Asia FX to estimated levels should be associated with lower volatility



Source: Bloomberg

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## Vol outliers – INR and TWD – also consistent with idiosyncratic factors...

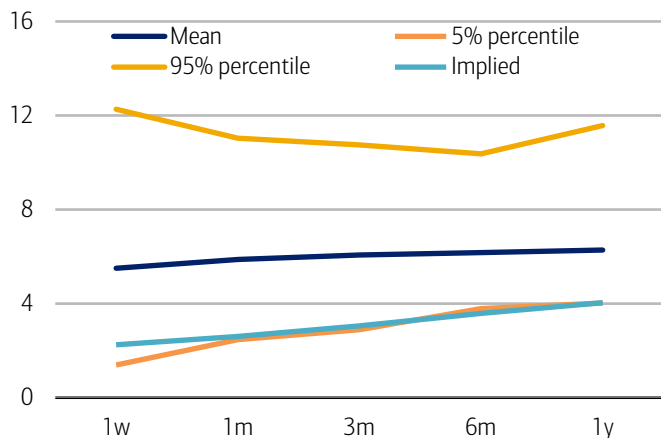
The convergence of Asia FX to estimated levels suggests low volatility could persist (Exhibit 3). Intuitively, “fairly valued” exchange rates should be associated with lower volatility than otherwise. While 3Q 2022 was an exception, this was due to the potent combination of Fed policy tightening and China lockdowns at the time. There are two standouts in Asia FX volatility when looking at “volatility cones” (implied curve vs. realized percentiles since 2009), but both seem consistent with idiosyncratic factors:

- INR volatility has collapsed, primarily driven by relentless policy intervention (on both sides) with virtually the entire curve trading at the 5<sup>th</sup> historical percentile (Exhibit 4). One-year implied volatility has fallen to 4% - a multi-decade low but still above the 2.8% realized over the past year. In our view, the combination of upcoming elections, “make in India” goals and index inclusion inflows suggest low FX volatility may remain a policy priority in 2024, consistent with market pricing.
- In contrast TWD volatility looks optically elevated especially at longer tenors, essentially pricing in volatility that has rarely been realized historically (Exhibit 5). This is difficult to fade too but for different reasons. Even with the Taiwan election

behind us, geopolitical uncertainty and low lifer hedge ratios can contribute to persistently high volatility risk premium in 2024.

#### Exhibit 4: USD/INR vol cone: implied vs. historical realized ranges

USDINR implied volatility at the lows of historically realized levels

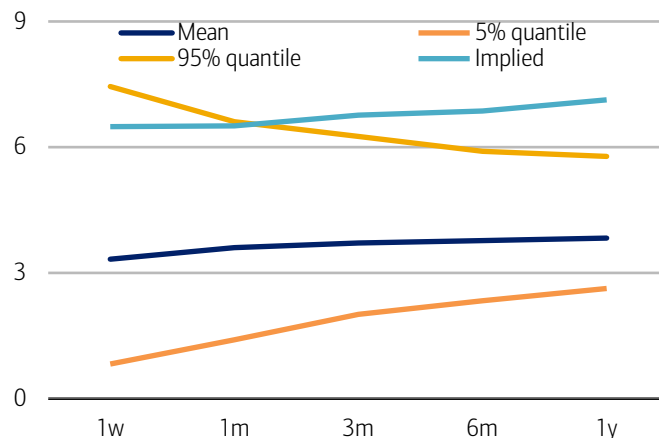


Source: Bloomberg

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#### Exhibit 5: USD/TWD vol cone: implied vs. historical realized ranges

In contrast USDTWD vols are elevated especially at longer tenors



Source: Bloomberg

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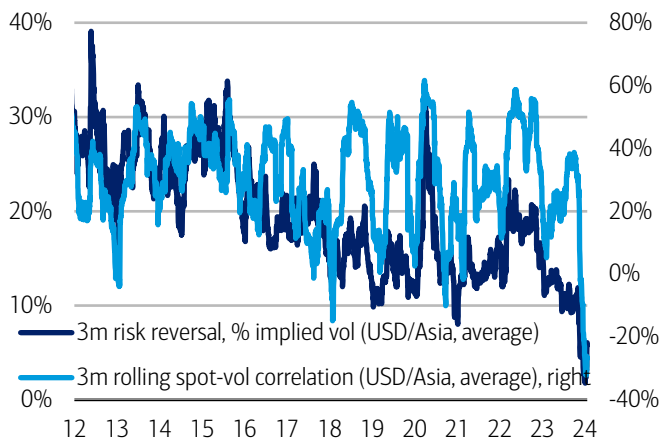
#### ... while risk reversal compression consistent with realized skew

Finally, there has been a sharp compression of USD/Asia risk reversals to historical lows on average (Exhibit 6). As is typical with the options market, this partly reflects recent reality - the narrowing of skew is consistent with meaningfully weaker spot-volatility correlation across major USD/Asia pairs. In fact, the average correlation is has recently turned negative (lower USD/Asia associated with higher volatility), a historical anomaly (Exhibit 5).

Exhibit 7 underlines this point showing percentiles of 3m risks reversals and spot-volatility correlation by currency pair. Risk reversals for most currencies are in line with their spot-vol correlation, all within the 10<sup>th</sup> historical percentile. The combination of heavy intervention (especially INR & CNH) and different carry dynamics (CNH & TWD used as funders) are likely driving this skew dynamic in both implied and realized terms. With these factors unlikely to change for now, skew premium will likely remain depressed in the near term.

#### Exhibit 6: USD/Asia 3m risk reversal vs. spot-vol correlation

Collapse in skew premium for USD/Asia...

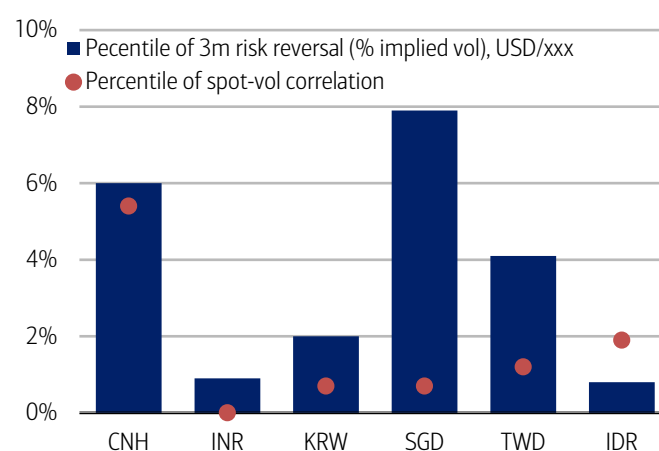


Source: Bloomberg, Note: Averages for USD vs. CNH, INR, KRW, SGD, TWD, IDR

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#### Exhibit 7: Percentiles of skew and spot-vol correlation

... mostly consistent with low spot-volatility correlation



Source: Bloomberg, Note: Percentiles over past 10 year window

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## News and Views

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### Mexico: Retail sales surprised to the downside at 0.1% mom sa in November

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Retail Sales in November surprised to the downside at 0.1% mom sa in real terms (E. 0.6%, BofA 0.6%), down from 0.7% mom sa in October (downward revision from 0.8%). Employment in retail decreased -0.2% mom sa (vs. 0.3% in October) while real wages fell by -1.7% mom sa (vs 0.1% in October). On the contrary, wholesale sales increased 0.7% mom sa (vs -6.1% in October). In annual terms, retail sales increased 2.7% yoy nsa (E. 3.4%, BofA 2.8%) while wholesale sales rose 2.7% yoy nsa.

- **To follow:** Retail sales are decelerating, which will contribute to the narrative that Banxico could cut in March.

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