Asia FI & FX Strategy Watch

Taipei Trip Notes – February 2024

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GEM FI & FX Strategy
Asia

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Taiwanese lifers neutral on US$, reduced FX hedging in Jan

We recently went to Taipei and saw a number of real money accounts and large corporates to discuss the FX and rates outlook for 2024. General sentiment from Taiwanese real money accounts (i.e., the life insurance companies) was an aversion to increasing FX hedging as long as the US$ remains in a general trend of stabilization.

The lifers we spoke to confirmed that they had to rapidly increase FX hedging in December 2023 following the dovish communication from the December FOMC meeting and the significant US$ weakness that followed. The December 2023 data shows that lifers rapidly consumed their FX valuation reserves as the USD fell. The decline in FX valuations reserves and the very dovish US$ outlook in December resulted the FX-hedged ratio rising and **monthly FX-hedging cost reaching US$1.2bn for the first time** (see **Exhibit 1**).

However, as the US$ stabilized in January 2024, lifers subsequently unwound the recent increase in FX hedges, and their latest FX-hedging ratio is likely close to where it was in 3Q23 (which we estimated to be at 61%). One lifer mentioned that the key level of 31.05 could result in that lifer accelerating FX hedging. Others mentioned that they are incrementally increasing FX hedging at 31.3 to take advantage of the better price.

Corporates bullish on export outlook but prefer to hold US$

A few Taiwanese corporates that we met confirmed that they prefer to hold their export earnings in foreign currency, especially in US$, because of the wide yield gap against the Taiwanese Dollar (NT$). Moreover, a few corporates told us that their demand for overseas investment is rising because of the need to invest in manufacturing capacity outside mainland China. The de-risking strategy is more the result of a 'push' rather than a 'pull' factor due to rising pressure from US- and Europe-based clients asking to source 'non-China' content.

On offshoring from China, one technology manufacturer told us that even though labor cost may be more competitive in Vietnam and other ASEAN countries, this manufacturer prefers to keep its core manufacturing capacity in mainland China because of the better infrastructure and the decades of experiences and relationships it has built. Overall, this corporate believes that Vietnam is more than 20 years behind China in manufacturing capacity and efficiency and that it would be hard to replace China as the central node in a global supply chain in the near future.

CNH – Chinese Renminbi

DF – deliverable forward

FOMC – Federal Open Market Committee

FSC – Financial Supervisory Commission

KRW – Korean Won

IDR – Indonesia Rupiah

INR – India Rupee

NDF – non-deliverable forward

NT$ - New Taiwan Dollar

PHP – Philippine Peso

SGD – Singapore Dollar

TWD – Taiwanese Dollar

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Lifers rapidly increased FX hedging in December 2023 in response to the dovish FOMC and weak US$ environment. As of the latest quarterly filings for 3Q23, we estimate the weighted-average FX-hedging ratio for Taiwanese lifers to be at 61% (see the report, Asia FI & FX Strategy Watch: Taiwan lifer update – December 2023 05 December 2023). In December 2023, TWD NDF points aggressively widened, falling from a monthly high of -300 pips to -575 pips upon the dovish messaging from the December FOMC. This widening in TWD NDF points was partially caused by a rapid increase in lifers' FX-hedging ratio. 4Q23 data will not be available until the end of February 2024, when the listed Taiwanese lifers report their quarterly earnings, but we estimate that the FX-hedging ratio may increase closer to 65% around that time.

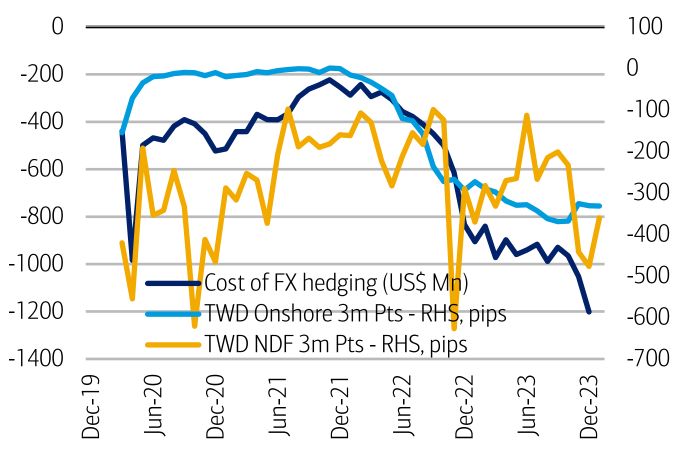
Rapid increase in FX hedging in December 2023 resulted in historic FX-hedging cost. According to the monthly disclosures provided by the FSC, the main regulatory body for the Taiwanese life insurance companies, lifers spent a record US$1.2bn in cost for FX hedging (**Exhibit 1**) in December 2023. The increase in realized FX-hedging cost corroborates with the increase in the FX-hedging ratio mentioned above. Currently, selling USDTWD 12-months outright has negative carry of 4% on the DF curve and 4.2% on the NDF curve.

Lifers remain active in using proxy FX hedges. Overall, FX hedging through different currencies to 'proxy' the movement in USDTWD remains a small but important part of lifers' total FX-hedging strategy. None of the lifers that we spoke with said that FX hedging through proxies exceeded 10% of their overall FX hedging.

Lifers are increasingly enquiring about South-East Asian currencies to use for proxy hedging. Among this 10%, the most common currencies that lifers would use for proxy hedging would be the CNH, KRW and SGD. However, during this latest trip to Taipei, lifers also increasingly expressed interest in using South-East Asian currencies, especially IDR, INR and PHP given high yields. Market flow commentary also indicated that often, when Taiwanese lifers enter the market to conduct FX hedging, their flow not only pushes TWD NDF points lower but also spills over into the FX points of other Asian currencies given the large size of some individual clips.

Exhibit 1: Cost of FX hedging for lifers (US$ Bn) and DF and NDF points

In December 2023, the life insurance industry in Taiwan spent US$1.2bn per month in FX hedging, a record high since public data was made available starting January 2020



Source: CEIC

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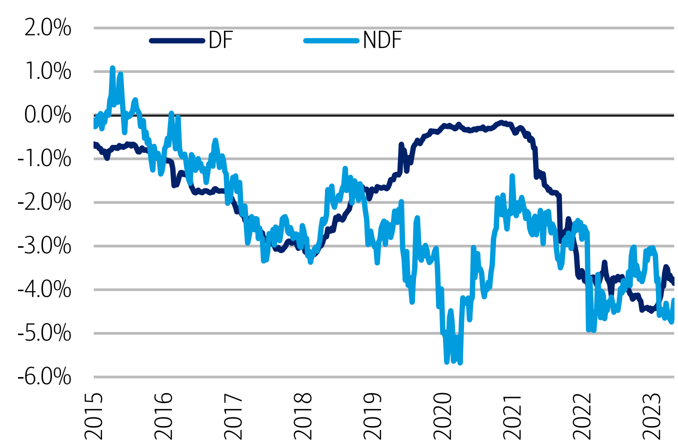
Exhibit 2: FX-hedging cost to sell USDTWD forward (annualized)

FX-hedging cost both onshore and offshore for USDTWD remains deep and expensive



Source: Bloomberg

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Lifers significantly burnt through their FX valuation reserves in December 2023. In our conversations with lifers, all of them stated a preference to consume their FX valuation reserves before adding FX hedging given high cost. FX valuation reserves are a contra-account item on the balance sheet, which in the past has been accumulated when USDTWD rises to offset for future FX losses. However, starting March 2023, lifers stopped accumulating additional FX valuation reserves despite the continued rise in USDTWD. This is because the FSC decided at the time that FX valuation reserves at close to US$7bn is a sufficient buffer against future FX losses. **Exhibit 3** shows the rapidity with which lifers consumed their FX valuation reserves as USDTWD recently declined in December 2023.

FX valuation reserves fell by 55% between October and December 2023. In the two months between the end of October 2023 and December 2023, USDTWD fell 5.3%. Despite the pace of the decline being similar to the pace seen during the last two months in 2022, the pace at which FX valuation reserves were used was much higher. Between October and December 2023, FX valuation reserves fell 55%, from US$6.6bn to US$3bn. The rapid decline may result in the FSC requiring lifers to rebuild their FX revaluation reserves, resulting in a reduction in the ability to recognize future FX gains, should USDTWD rally.

Low level in FX valuation reserves may force additional FX-hedging should US$ downside return. With FX valuation reserves significantly lower than the US$7bn limit that the FSC previously set, additional US$ weakness may force the lifers to increase FX hedging regardless of cost, akin to the behavior observed in December 2023. For these reasons, we continue to like receiving forward-forwards on Taiwan NDF to play for expected lower NDF points throughout 2024 (see the report, Asia FI & FX Strategy Viewpoint: Asia Year Ahead 2024 – A break out year 21 November 2023).

Net inflows into bond ETF will likely continue in 2024, especially should US IG rally. Our conversations with lifers indicated that their interest in using bond ETFs to obtain exposure to US investment grade (IG) bonds will likely continue in 2024. The sale of new insurance policies remains weak as FX time deposits continue to offer competitive rates as front-end rates in the US remaining high. In 2023, it appears that Taiwanese investors were 'bottom-fishing' and continued to buy US IG despite the additional sell-off. In 2024, with the Fed stance turning, Taiwanese investors now appear to be 'chasing the rally' with additional inflow into bond ETFs on the decline in US IG yields.

Exhibit 3: Lifers' FX valuation reserves and USDTWD

The rapid decline in USDTWD rapidly consumed lifers' FX valuation reserves

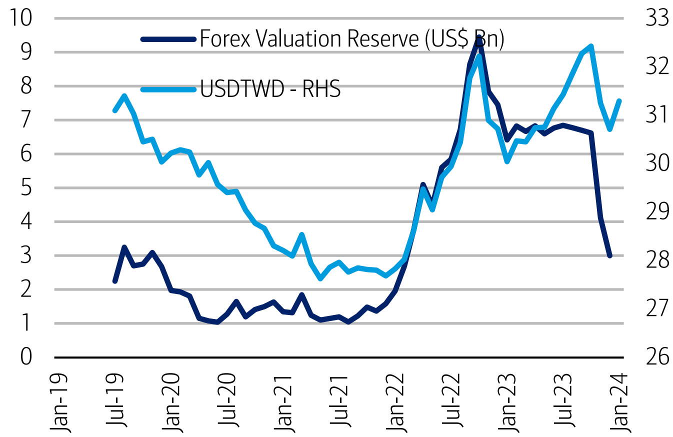

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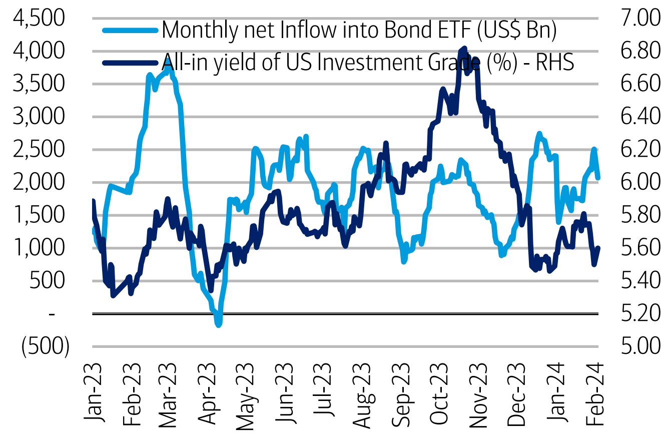
Exhibit 4: Net inflow into bond ETFs and US IG yield

Net inflows in Bond ETFs are now moving inverse to US IG yields



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Taiwanese exporters are optimistic on the export outlook. In our conversation with Taiwanese corporates, the tone was overall optimistic given the improving export outlook. In December 2023, 12-month rolling exports reached a record high, at US$ 82bn (**Exhibit 5**). However, we should not expect better net exports to result in a stronger NT$.

Percentage of export proceeds sold for NT$ remains at a record low. Exhibit 6 show that throughout 2023, the share of export proceeds that Taiwan's exporters received and that are sold for NT$ has declined to a low of 4%. Historically, and even more so now, Taiwan's exporters have retained a large net US$ position to pay for imported materials and invest overseas with the remaining amount. This implies that even with a strong current account balance, only a small percentage of this additional acquisition of foreign currencies will likely be sold in the spot market for NT$. Hence, this can help explain why, on a daily basis, the impact of Taiwan's exporters on the FX market is small relative to the other players (i.e., foreign equity investors and lifers).

Exhibit 5: Taiwan's trade balance (US$ bn, 12-month sum)

In the last three quarters of 2023, Taiwan's trade balance soared and reached a record high

Source: CEIC

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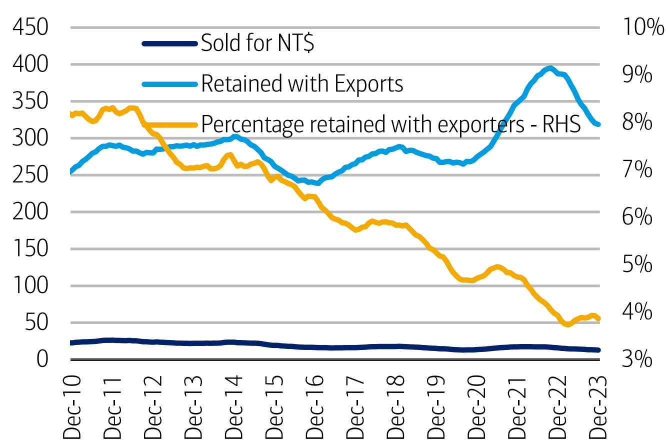
Exhibit 6: Taiwan's export proceeds (US$ bn, 12-month sum)

A declining share of Taiwan's exports proceeds are being sold for NT$



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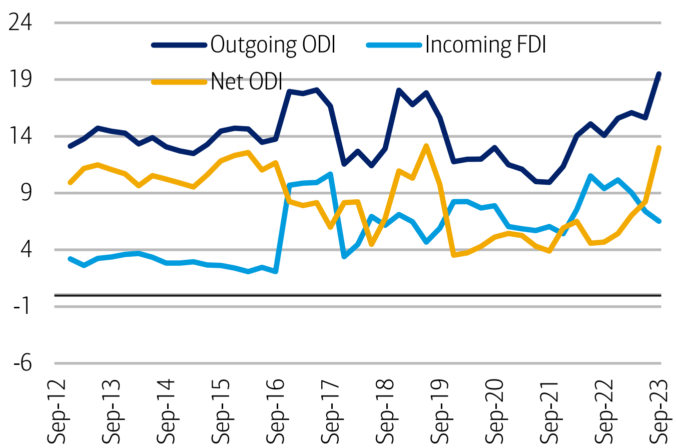
Taiwanese corporates spoke of the need to increase investments in overseas manufacturing capacity. Multiple corporates told us of the increased need to hold US$ due to the rising need to invest in manufacturing capacity overseas, thus partially explaining the declining share of export proceeds being sold for NT$. Taiwan's balance-of-payment data shows that in the four quarters prior to September 2023, Taiwan's corporates invested US$19.5bn in foreign direct investment outside Taiwan – higher than in the previous nominal peaks seen in 2Q16 and 2Q17 (**Exhibit 7**).

In the past three years, Taiwanese corporates have been significantly increasing investment in the US, ASEAN and Europe. Exhibit 8 shows the major jurisdictions into which Taiwanese corporates are investing into. Over the past decade, Taiwanese corporates have increasingly invested less into mainland China and Hong Kong SAR and more into other major jurisdictions. The recent sharp increase in Taiwanese investment into the US and Europe is especially noticeable. The strong investment in the US is likely a reflection of Taiwanese corporates reacting to the tax subsidies provided by the US Chips and Science Act.

Exhibit 7: Taiwan's net ODI (US$ bn, 4q sum)
Taiwan's outgoing FDI (ODI) accelerated in 2023



Source: CEIC

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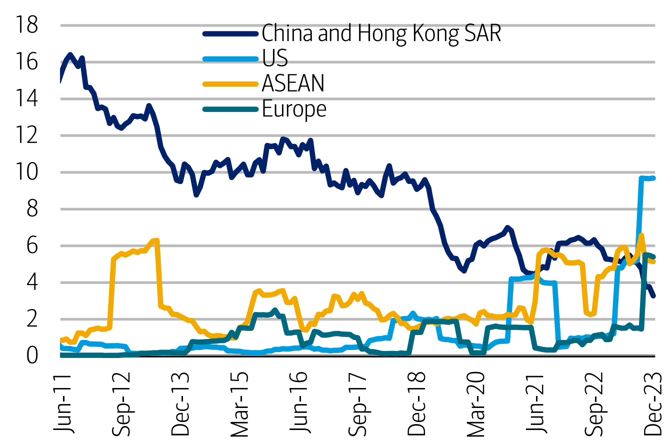
Exhibit 8: Taiwan's ODI by jurisdiction (US$ bn, 12-month sum)
In the past 12 months, investment by Taiwan's corporates into US significantly increased



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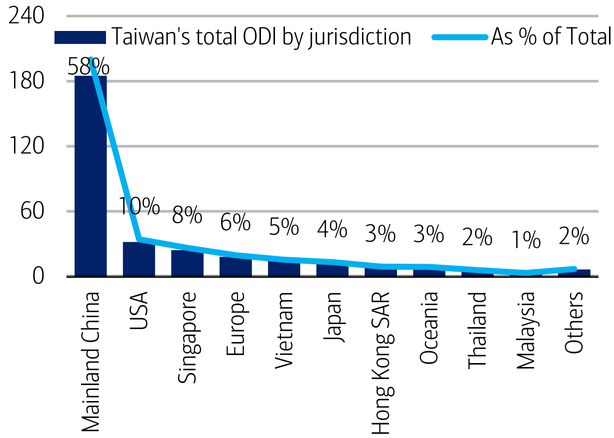
Despite 'de-risking', the majority of Taiwan's overseas manufacturing capacity will likely remain in mainland China for the foreseeable future. One Taiwanese manufacturer highlighted the limits of 'de-risking' from mainland China given the efficiency of Chinese workers and the better infrastructure in China than in other countries. However, the current need to 'de-risk' is driven by demand from American and European clients who want to reduce the Chinese content in their purchase of Taiwanese exports. As such, these Taiwan's corporates are pushed to invest in manufacturing capacity elsewhere, despite the total cost of production likely exceeding the cost of producing in mainland China. Exhibit 9 shows that 58% of total overseas investment by Taiwan's corporates is in mainland China. This implies that mainland China will likely remain central in Taiwan's manufacturing processes for years to come.

Exhibit 9: Taiwan's cumulative ODI by jurisdiction (US$ Bn)

58% of foreign investment made by Taiwanese corporates are in mainland China



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