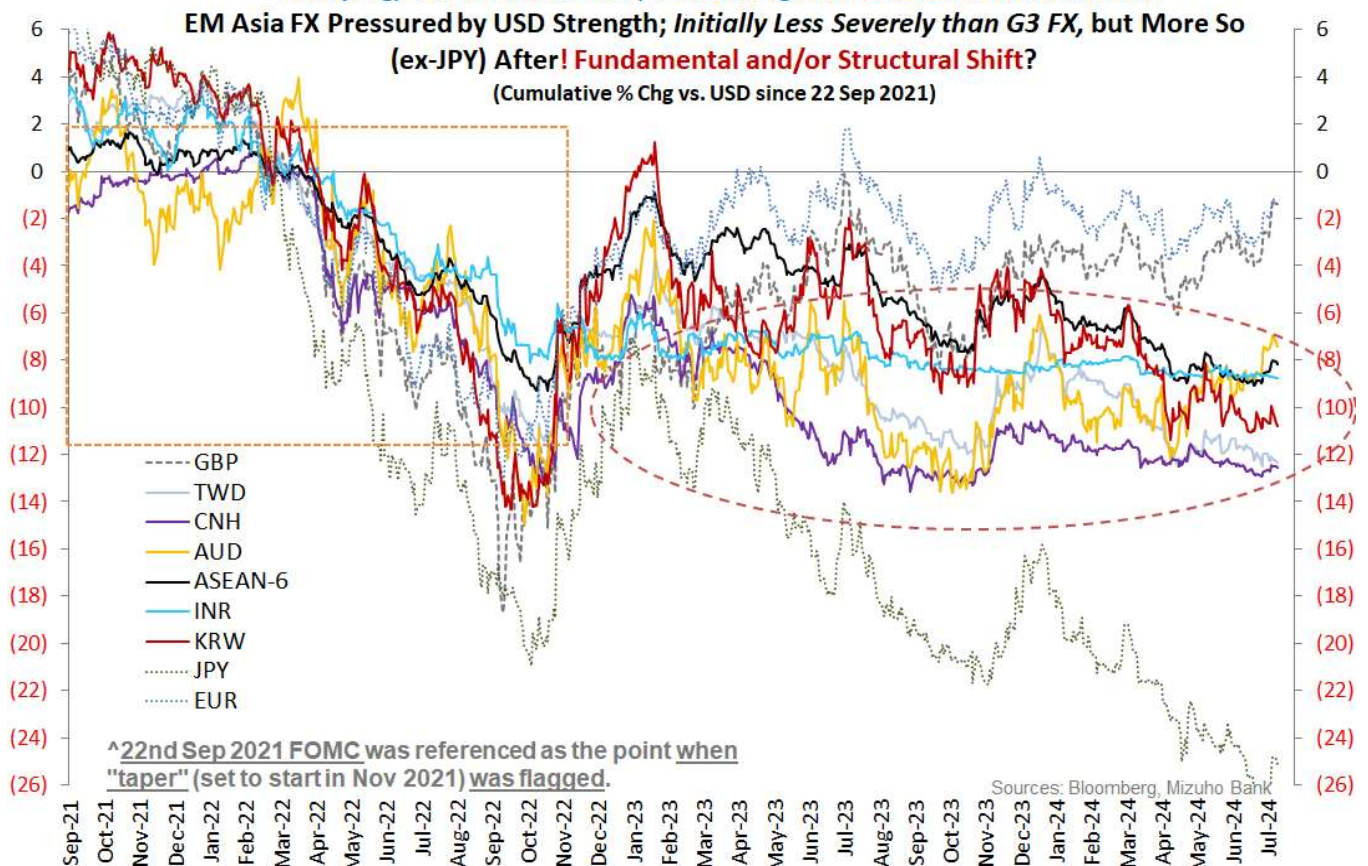


## AXJ Reversion Challenged

“There is no real going back. Though I may come to the Shire, it will not seem the same; for I shall not be the same.” – Frodo, Lord of the Rings

### Pivot, Not Revert

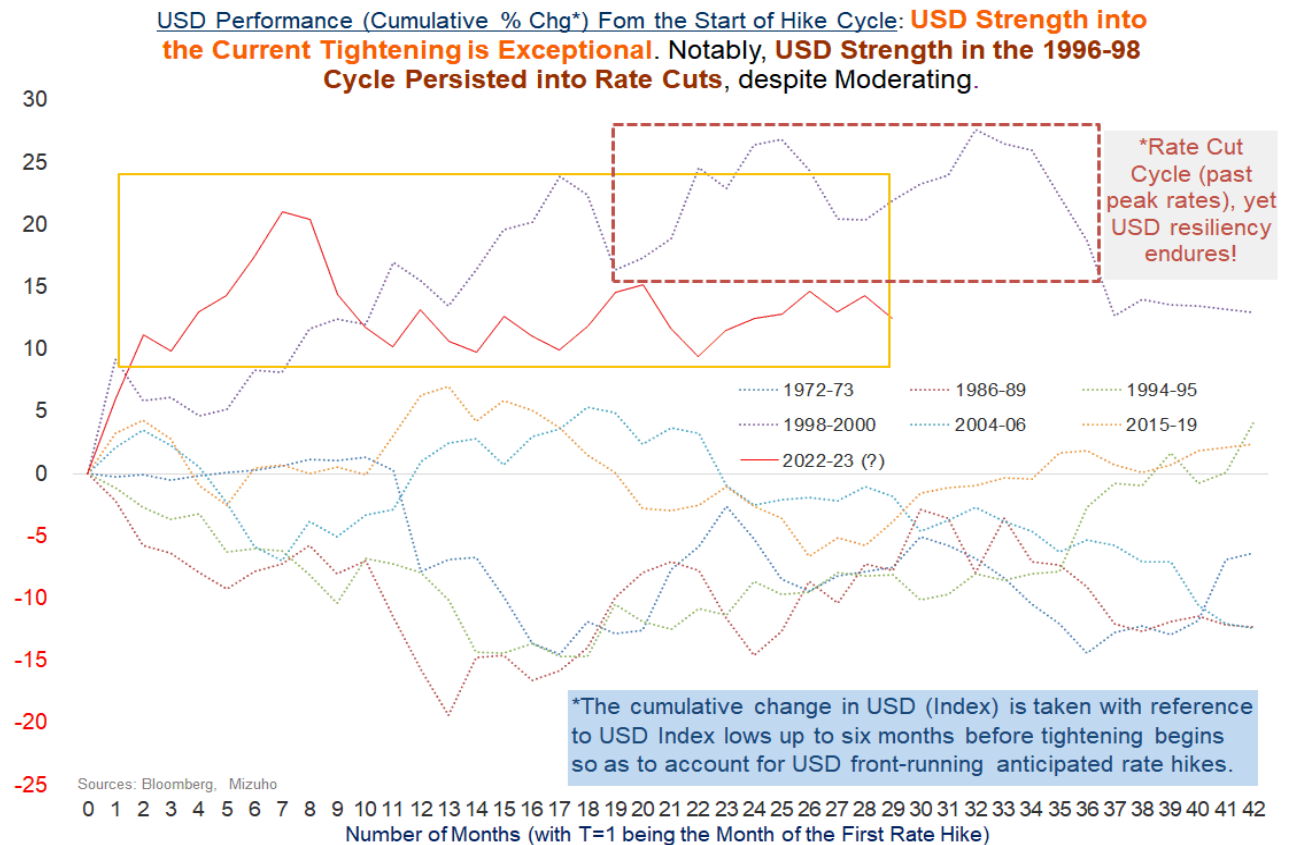
Sweeping, even if Moderated, USD Strength Since Fed's Normalization:



- Received wisdom is that a Fed pivot\* is associated with (often anticipatory) USD decline.
- The result is a “pivot USD” primed for a broad-based slide as policy sands begin to shift from tightening to easing.
- And the *assumption of attendant AXJ reversion (to pre-Fed tightening strength) is arguably embedded in this “pivot USD” thesis*. In other words, Asia FX recouping losses over the Fed’s tightening cycle (coinciding with reversal of USD gains).
- But this time*, a Fed pivot is no guarantee that AXJ will revert to pre-Fed tightening strength.
- Instead, AXJ reversion is liable to be dampened, delayed and differentiated. And under certain circumstances possibly even denied for specific Asia FX.
- This owing to a conspiracy of *anomalous USD-Fed cycle dynamics*, accentuated by *unusual policy shifts*, *geo-political disruptions* and *specific CNY risks* compounding *structural cracks*.

\*The reference to Fed policy inflection from tightening/rate hikes to loosening/rate cuts.

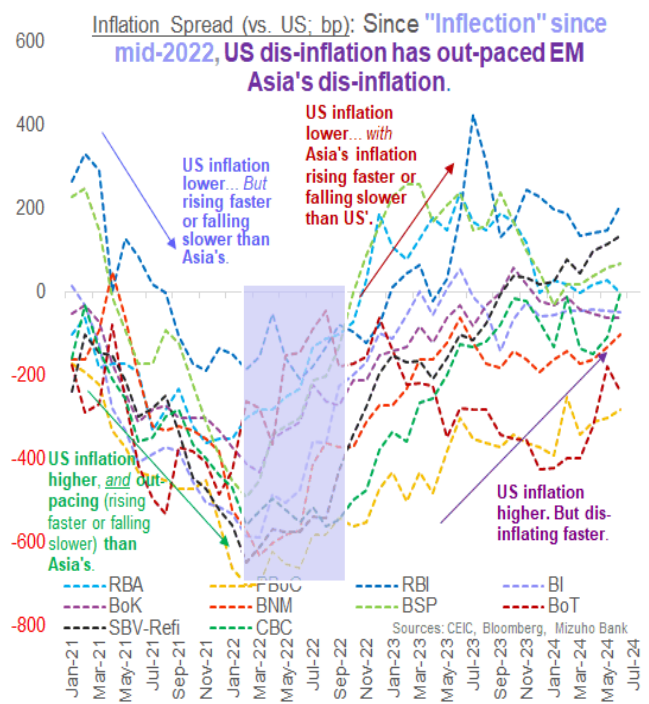
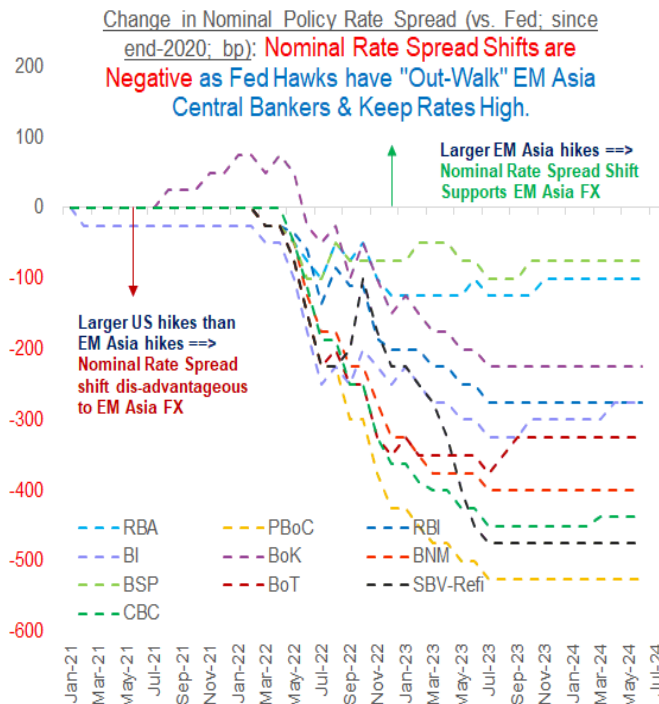
## i) Anomalous Late-Stage Dollar Dominance



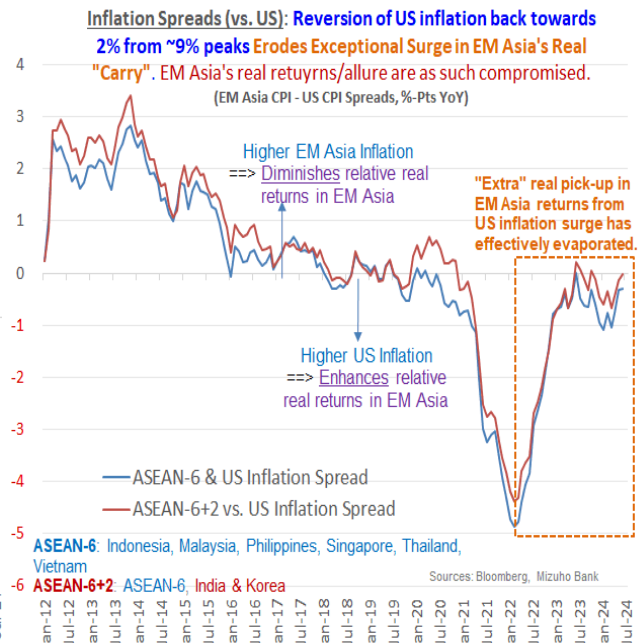
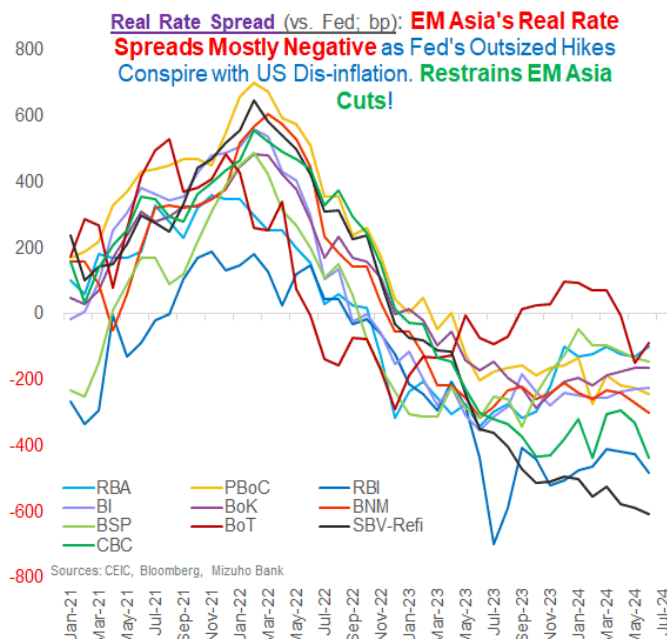
- Arguably, the most **profound challenge to AXJ reversion** (recovering to pre-Fed hike levels) is **persistent, defiant USD strength** in the context of Fed pivot, which is typically consistent with more pronounced USD pullback.
- This **anomalous USD strength** so late into the Fed tightening cycle is not merely a cyclical blip but a structural feature of *with uncharacteristic USD resilience into Fed easing ahead*; whereby *USD may soften* (from elevated levels), *but not fully surrender rate hike gains* as relative US exceptionalism and geo-politics conspire.
- Admittedly, **USD peaked** (in October 2022), **ahead of peak Fed rate** (reached in July 2023), *consistent with the idea of USD front-running the Fed*.
- And to be sure, a **mellower USD** as the Fed settles into rate cuts into 2025 is our base case.
- Nonetheless, further USD declines anticipating, or coinciding with Fed cuts, may fall significantly short of expectations* pegged to most previous cycles.
- In which case, **commencement of Fed rate cuts alone is not sufficient to fully restore AXJ to pre-2022 levels** given USD dominance be slow to fade.

## ii) Accentuated by Unusual EM Real Rate Spread Shifts

- What's more, a very unusual cycle of **real rate shifts supportive of USD** vis-à-vis **AXJ despite peak Fed interrupts AXJ reversion**.
- Fact is, **USD strength ascribed to "US exceptionalism"** not only depends on *economic out-performance* but exploits *unprecedented relative inflation shifts* too.



- Simply put a confluence of **relatively outsized Fed hikes** and **exceptional US dis-inflation** magnify **relative (Fed-EM Asia) real policy shifts** stacked against **AXJ**.
- Specifically, aggressive **Fed hikes (525bp)** far surpassing **Asian peers (averaging: 200-300bp)** alongside **exceptional US dis-inflation (500-600bp)** amplify **relative hawkish Fed edge**.
- As a result of which, **Fed pivot in nominal terms, counterintuitively, remains USD positive in real terms; with a tendency to pressure, not boost, AXJ**.
- **More so, if EM Asia central banks hasten to follow suit on Fed rate cuts from the get-go.**



### iii) Geo-Political Disruptions: US Elections & Trump 2.0

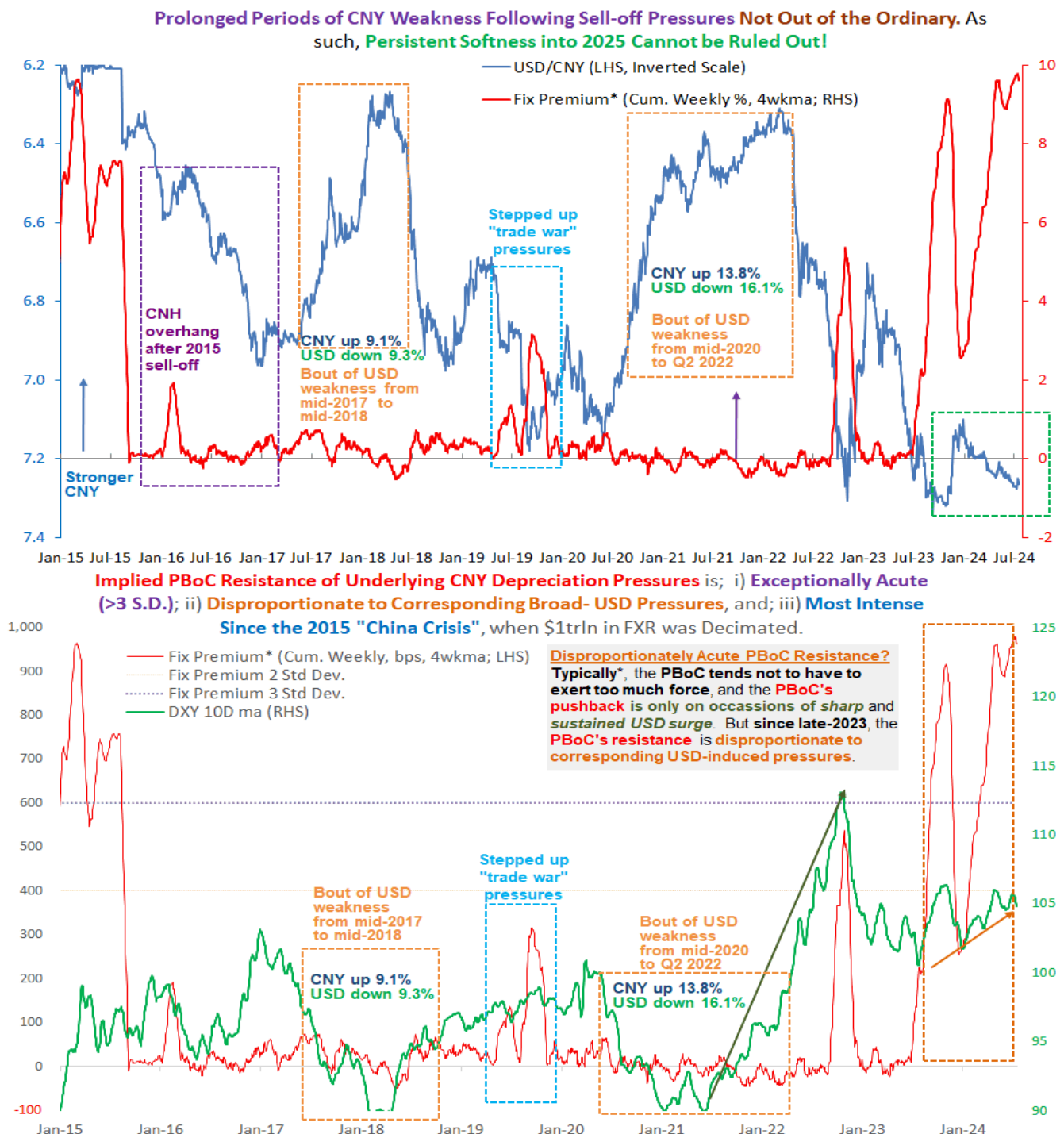
- Even if **"this time it's different"** USD anomaly and **relative policy exceptionalism** are dismissed, **geo-politics may be the proverbial wrench that hijacks AJX reversion**.



- Specifically, **US elections**, which entails *significant risks of Trump 2.0 triggers\*\**, is a notable catalyst for potential AXJ shocks. Much of which (potential AXJ pressures) are predominantly present as **China proxy risks** (via trade and financial conduits).
- But **China-related risks to AXJ** are not exclusively from Trump 2.0 and/or US-China geopolitical flares. Instead, **wider array of structural China pressures** resulting in **CNH-induced AXJ setback** warrant attention.

\*\* Please see previously published note (Mizuho FX Brief: USD Trump-Why the USD May Trump with Donald Trump, 4 March 2024) for elaboration on why Trump 2.0 in aggregate is USD-positive at the expense of CNH and wider AXJ.

#### iv) CNY Risks



- To that end, **unremitting, acute CNH pressures reminiscent of 2015-16 “China crisis”** potentially *poses significant drag for other AXJ* given exceptionally high correlation<sup>^</sup>.
- Notably, in the context of outsized financial outflows and sharp policy trade-offs, the **sheer magnitude and intensity of CNH depreciation pressures** may prove **prohibitively costly** – *in economic and/or financial terms* – **to quell**.
- Instead, the experience of ~US\$1trln *squandered in futile defense of CNH in 2015*, suggests **cost-benefit tip in favour of gradual and controlled CNH depreciation**.
- Managing a **controlled CNH descent** entails **balancing between averting an intensifying sell-off on one hand and avoiding self-defeating FX reserves depletion on the other**.
- What’s more, the **2015 CNH devaluation** is *consistent with CNH weakness persisting thereafter*, which is *evident once broad-based USD declines are accounted for*.
- Such an **enduring loss of CNH value** is **unlikely to leave AXJ unscathed**.
- Fact is, **sympathetic drag from CNY rubbing off on to AXJ** acts both *via symbiotic trade and investment dependencies* as well as *competitive exports/trade mechanism*.
- All said, **AXJ reversion on Fed pivot is likely to be challenged** on the back of **durable CNH drag** given **tight CNH-AXJ correlations underpinned by emphatic transmission**.

#### v) Structural: Specific AXJ

- Finally **structural and (economy-)specific deterioration affecting various AXJ currencies**, to varying degrees, could also **impair pre-Fed hike reversion of AXJ**.
- Some key, but non-exhaustive factors include *property-financial sector stress* (VND) to *political tensions* (VND, THB, KRW) to *accentuated geo-political threats* (TWD, PHP) to as follow.
- And *FX reserves* is notably asymmetric insurance, whereby *inadequacy* imposes a risk premium associated with structurally weaker currencies (e.g. VND) but on other hand, a notable build-up in FX reserves (e.g. INR) is no guarantee of currency boost/recovery
- In fact, *structural reforms* to boost manufacturing under “Make in India” is partly premised on a more competitive rupee, which underpins the case for rupee not reclaiming all of Fed hike losses.
- In any case, with the exception of SGD, which was boosted by an unprecedented magnitude of S\$NEER appreciation (allowing it to keep pace with the USD), **reversion to pre-Fed rate hike levels in AXJ would require substantial AXJ appreciation**.
- Which is a **high bar in the current risk climate**; amid heightened geo-political threats, fragile economic recovery and overarching China/CNH risks.

	CNH	CNY	KRW	TWD	SGD	THB	MYR	IDR	INR	VND	AUD	PHP
Since Sep '21 FOMC (Taper Flagged)	6.47	6.47	1,176	27.7	1.35	33.4	4.18	14,241	73.6	22,770	0.726	50.3
Since Mar '22 FOMC (Since First Hike)	6.36	6.35	1,220	28.4	1.36	33.3	4.20	14,321	76.2	22,862	0.735	52.3
Average of Taper Flag & First Hike	6.41	6.41	1,198	28.0	1.36	33.3	4.19	14,281	74.9	22,816	0.731	51.3
Latest (July Avg)	7.28	7.26	1,378	32.5	1.34	36.3	4.69	16,208	83.5	25,417	0.677	58.5
% Appreciation Required for "Reversion"*	13.5%	13.3%	15.0%	15.9%	-0.8%	8.8%	12.0%	13.5%	11.5%	11.4%	8.0%	13.9%

\* reversion to average of Sep'21 & Mar'22 Levels

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