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USDTWD fall: Forewarning or outlier?

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The sharp but short-lived decline in the USDTWD amid growing optimism over potential trade war de-escalation has sparked concerns about contagion. While a couple of other Asian currency pairs might experience similar pressure, we do not expect broad contagion. The USDTWD had some unique vulnerabilities, but going forward the USDKRW might come under some pressure. We continue to see the USD as a sell-on-rallies, and would use short-term USD rebounds to diversify into other major currencies such as the AUD, the EUR, the GBP, and the JPY.

As talk of tariff rapprochement swirled in the market, the USDTWD began a sharp 9.2% two-session decline last Friday. The perceived passiveness of Taiwan's central bank (CBC) has added to the market speculation that the sharp TWD appreciation might have been a preemptive quid pro quo offering as part of back-channel talks. The logical progression from that assumption has been market worry that the rest of the Asian currencies are likely to see similar pressure to appreciate against the USD. Should we look to Asia FX to express expectations of medium-term USD weakness?

Despite the temptation to paint Asian FX with a broad brush, we would advise against it given the sheer diversity in the fundamental backdrops of most other Asian currencies. This should serve as a bulwark against contagion in the Asia FX space, and investors should be selective in FX and equities when trying to navigate the medium-term USD weakness.

The TWD was uniquely vulnerable to a USD negativity. For starters, the TWD has been an especially popular regional funding currency in recent years for carry-trade strategies—a sharp unwinding of these would entail the market buying back the TWD. Another aspect that made the TWD particularly susceptible to expectations of USD weakness was the net international investment position (NIIP)—economies with larger holdings of foreign assets will likely exhibit a greater tendency to hedge their FX exposure. Taiwan's NIIP stands out (at an elevated 218% of GDP), followed by Singapore

(150%) and South Korea (63%). The rest of Asia has relatively moderate NIIP; and even negative in the cases of India (-9%), the Philippines (-14%), and Indonesia (-18%). Hence, the pressure to hedge overseas USD assets looks most intense for the TWD, the SGD, and the KRW.

Risk of contagion is low but KRW stands out. The market's current focus on the prospects of a de-escalation in trade tensions creates space for a near-term USD rebound. In such an environment, one determinant of potential spikes in appreciation pressure on Asia FX is the amount of FX deposits held by both private and public sectors. Setting aside the financial centers of Hong Kong and Singapore, and discounting Indonesia and the Philippines where FX deposits tend to be larger on account of their developing status, Taiwan and Malaysia stand out as the main concerns.

Another key metric is the real effective exchange rate (REER), which provides a window into a currency's valuation of sorts. Currencies that are trading at depressed levels could attract buying interest from investors looking to position for potential pressure from the US. Here, the sharp falls in the CNY and KRW REER over the past 3-4 years might potentially flag these two out for added US scrutiny, not least that these currencies are also on the US's watch-list for currency manipulation. While the INR and PHP REERs are also languishing at multi-year lows, these are a lot less likely to invite pressure from the US, in our view.

USD remains a sell-on-rallies. The sudden drop in the USDTWD highlights the importance of managing USD holdings. While the USD could be resilient in the near term, we expect US economic data to weaken in the coming months, which should open the way for the Federal Reserve to ease through 2H25. This could compound the medium-term diversification out of the USD on account of the erosion of confidence in US policymaking. We reiterate that investors should use short-term USD rebounds to hedge USD exposure or diversify into other major currencies such as the AUD, the EUR, the GBP, and the JPY.

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