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APAC FX: Weakness likely contained but risks remain

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The incoming Trump administration in the US is likely to move fast on trade tariffs; and Asia, especially China, is likely to receive significant scrutiny for alleged unfair trade practices. While currency weakness across the region is likely, it might be premature to assume sizable depreciation is inevitable. Nonetheless, given the lack of clarity, USD-based investors should stay hedged on Asian currency exposure.

Since the US presidential election, Asian currencies have fallen around 3% on average as markets priced in anticipated tariff impacts and a more hawkish Federal Reserve reacting to strong US economic data. Going forward, financial markets are likely to focus on the potential impact of tariffs. With Asia generally running a trade surplus with the US, and China already the main focus of the Trump trade narrative, investors might well be concerned about sustained downside in Asian currencies.

While we recognize that the USD has been stronger than we had earlier expected, and we have priced in greater USD strength in our 2025 forecast trajectory for Asian currencies, we nevertheless expect this weakness to be contained. We expect USD strength to peak around the middle of the year before fading gradually in 2H25, leaving most USD-Asia pairs little changed over the course of the year.

Significant amount of tariff damaged already priced in. In anticipation of tariffs, the USD (DXY index) has been pushed to around 12% above the level that it was in June 2018—the start of the trade war in the first Trump term. Asian currencies are also consequently weaker than in June 2018. We expect though that the US tariff threats could materialize quickly once the Trump administration is instated on 20 January; this should keep the DXY supported in 1Q at least.

Consequently, we expect most Asian currencies to weaken in 1H, before mostly finding their footing in 2H. Over the course of the year, we are most cautious on the CNY, KRW, and THB. The INR, IDR, and PHP are likely to be more resilient on account of their economies being less dependent on external trade, but they would still be susceptible to risk-off sentiment and capital outflows. We think the USDSGD's upside should be limited to around 1.40, given the overly-long USD positioning, conservative pricing of Fed rate cuts, and tariff uncertainty already partially priced in. A universal tariff on US imports of 10-20% would be needed to push the USDSGD beyond 1.40.

US policy rate still has room to decline. Although our expectations have become more hawkish over the past month—in line with both the Fed and financial markets—we still expect the Fed to cut rates by 50bps this year. We think that the current policy setting is still contractionary, and growth and inflation are both set to slow over the course of the year. In the near term, markets might be somewhat preoccupied with the potential inflationary impact of trade tariffs. This might serve to keep market expectations of the Fed hawkish and US Treasury (UST) yields elevated in the near term. Over the course of the year though, we expect the Fed to continue easing and UST yields to drift lower, with the 10-year yield moving to 4% by December.

One major beneficiary from this is likely to be the JPY. In addition to the Fed cuts, we also expect the BoJ to hike its policy rate by 50bps this year, and the 10-year JGB yield to remain relatively flat. This narrowing US-Japan yield differential is the key driver for our USDJPY view. Although we recently raised our USDJPY forecasts, we nonetheless expect the pair to drift lower over the latter three quarters of the year to 149 by the year's end, from a potential peak of around 160 in 1Q25. For the AUD, we expect 75bps of rate cuts (RBA's first cuts this cycle) this year, probably starting in May. We thus expect a gradual climb in the AUDUSD to begin only in 2Q, ending the year at 0.66.

Asian central banks to lean against FX weakness. With Japan, mainland China, Singapore, Malaysia, Taiwan, and Vietnam already on the US Treasury's "monitoring list" for currency manipulation, and the Trump administration keen to seek redress for perceived unfair practices, Asian central banks are likely to try to keep currency weakness contained. Most Asian central banks do have a reasonable amount of FX reserves at their disposal and should be able to contain the magnitude of FX depreciation against the USD. If Asia largely manages to avoid being targeted, and meaningful tariff hikes are confined to China, then precedence suggests that the total amount of FX depreciation for the region could be limited to around 4-5%—not much more than the 3% already priced in.

Notwithstanding the moderate medium-term impact on Asian FX, USD-based investors should nonetheless stay hedged on Asian currency exposure. The fact that hedging is carry-positive—thanks to most Asian currencies having lower interest rates than the USD—makes this all the more advisable. We also recommend maintaining a long position on the USDCNY.

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