Scotia Asian FX Update

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IS USD/ASIA ON THE VERGE OF ANOTHER BREAKOUT?

- Eurozone coherence worries continue to wreak havoc on Asia.
- Our measure of sudden Asian FX depreciation risk suggests pressures are building.
- Indian April WPI inflation measures rise, complicating the RBI's decision in June.
- Singapore's March retail sales (ex-auto) are expected to remain robust at 3.5% y/y.

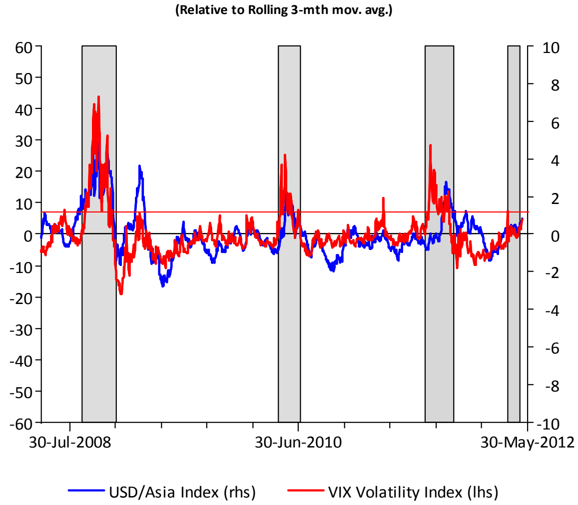
% Change	
S&P 500	-1.11
Nikkei	-1.39
Shanghai Comp.	-0.81
Hang Seng	-0.03
Crude Oil	-0.57
Gold	-0.12
US 2yr Yield (level)	0.26

FX Market Update - The trend decline in risk assets over the past 24 hours has continued with global equities losing 1.5% in aggregate according to the MSCI index, the most in over a week. Commodity prices have also slumped as the CRB commodity index has hit its lowest level since October 2010. The press is now focusing heavily on the ability of the Eurozone to maintain cohesiveness, with major financial news outlets running stories that question the ability of Spain to weather a Greek exit and just what a messy exit would entail for Europe. This harkens back to August of last year when financial markets came unhinged, suggestive of what may be to come.

Outside of Eurozone issues, there is little relevant for Asia as a global macro driver of financial market developments, though China's economic deceleration is playing some role and doing no favours for the region's risk assets and currencies. Currently the US economic outlook, as it relates to FOMC policy, has taken a back seat for the region as financial market volatility may be threatening to bring us back to the circumstances of fall 2011. During that time financial market volatility spiked for such a sustained period that Asian central banks were forced to refocus their macro risk outlooks towards growth rather than inflation, the latter of which was a serious issue at the time. The Eurozone-driven financial shock was such that central banks eventually allowed for greater currency depreciation against the USD despite inflation concerns. Indeed, the need for monetary accommodation (via weaker currencies) as an offset to the impact of financial market volatility on Asian real economies became obvious.

Is USD/Asia Set To Surge Higher - For speculators in Asian currencies, it bears asking how the current iteration of Eurozone related stress stacks up in this context. Currently financial market volatility intensification is only in its infancy, as the VIX index is just breaking to a new three month high. Ahead of the late summer 2011 breakout we constructed an index in order to measure the degree of risk of an Asian currency move lower against the USD (or our USD/Asian trade-weighted index moving higher).

USD/Asian FX Index vs. VIX Volatility Index



Source: Scotia FX Strategy, Bloomberg

Financial market volatility edging higher and increasing the risk of an Asian currency weakening

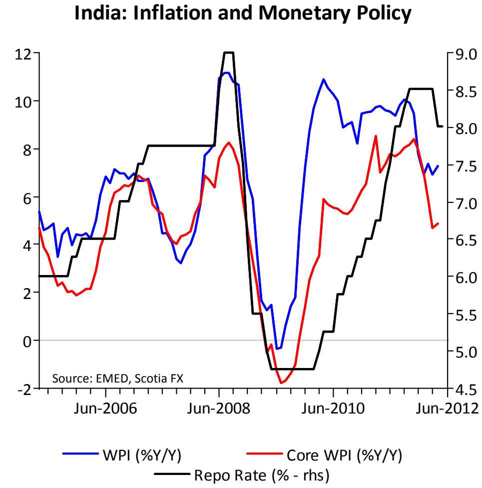
Currently we don't appear to be at a "crisis moment" insofar as a USD/Asian FX breakout is concerned, as the level of the VIX relative to its 3mth moving average (our risk measure) is still quite contained. The nominal VIX index would likely have to break above 25% for a sustained period (21.87 as of the end of NY trading yesterday). It of course does bear mentioning that our USD/Asian FX index is not too far off of the highs achieved when the Eurozone last went through its period of volatility, as a combination of Asian central bank resistance and a better fundamental medium term US outlook have contained structural USD weakness. We will need to see our measure of risk aversion relative to its trend reach 7.25 (marked in a horizontal red line in our above chart) or an equivalent 25 on the nominal VIX index, to see a serious increase in the risk of an Asian currency selloff. Though we are not there yet, the risk is building the more Eurozone difficulties persist. The fact that global commodity prices are much lower than they were back in late summer / fall of 2011 suggest that central banks may be more willing and able to permit currency weakness than they were in the fall of 2011. Indeed, back then we argued that central banks resisted pressures to a greater degree initially due to inflation risks. The lessening of risks now argues for an earlier reaction in currency weakness.

In a nutshell, the risk of sudden and sharp Asian FX depreciation is rising, though for the time being we remain away from levels of risk aversion that would suggest that it is imminent. As catalysts, we'll likely need to see a combination of a sustained move in the VIX index above 25% (representative of global financial market stress), USD funding strains, and further stresses on European sovereigns (and banks) in order to create the "perfect storm" for sharp Asian currency depreciation.

Sticky Indian inflation keeps a rate cut in June as far from certain

USDINR• The horror show for INR continued yesterday as the currency traded to its weakest level since the December 15th, 2011 following the release of the country's very disappointing April wholesale price index inflation data. Headline inflation came in at 7.2% y/y, an increase from the previous 6.9% y/y and above the 6.7% y/y expected. Core inflation bounced to some degree as well, increasing to 4.9% y/y from the previous 4.7% y/y. The fact that core WPI has stopped its plunge while headline WPI remains fairly stable at near 7.5%, despite a higher base from last year, does introduce some degree of risk for core considering the impact the latter can have on inflation expectations. Another rate cut in June is far from a done deal, despite the very much weaker read on April industrial production.

USDINR is very likely to target the December 15th high considering global macro conditions, which will make it more likely that the RBI attempts further measures to cap weakness in the currency.



S$NEER currently trading towards the middle of its band

USDSGD• Singapore receives its March retail sales data today, with the market looking for sales to increase 0.2% m/m on a seasonally adjusted basis, and 3.5% y/y on the ex-autos measure. Retail sales ex-autos have been fairly resilient in growing at an average of 7.7% y/y over the past year. This shows the strength in Singaporean domestic demand, a factor that has helped to keep inflation conditions in the city state rather challenging. This again supports the hawkish stance of the MAS, which is fighting a bit of a battle against price pressures via its more aggressive appreciatory management of the S$NEER. Currently we estimate that the S$NEER is approximately 1.5% - 2% away from its upper bound, which leaves significant scope for appreciation. However, general market conditions are opening up the potential for a drift to the downside; we currently view the S$NEER band to be around 3% in width.

Key Pricing & Levels

	30 Day Hist Vol	Spot	1 Day % Chg	1 Week % Chg	1 Month % Chg	50 Day MA	100 Day MA	200 Day MA
USDCNY	2.6	6.3225	-0.02	-0.23	-0.11	6.3090	6.3079	6.3394
USDHKD	0.3	7.7660	0.00	-0.05	-0.10	7.7624	7.7610	7.7729
USDIDR	3.3	9264	-0.14	-0.27	-0.81	9,183	9,118	8,993
USDINR	8.6	53.78	0.33	-1.18	-3.91	51.50	51.19	49.69
USDJPY	6.6	79.86	0.00	0.03	0.70	81.53	79.78	78.47
USDKRW	5.1	1154.00	-0.42	-1.58	-1.33	1,134	1,134	1,131
USDMYR	4.0	3.0825	0.00	-0.83	-0.49	3.0577	3.0642	3.0858
USDPHP	4.2	42.75	-0.02	-1.14	0.07	42.698	42.916	43.053
USDSGD	3.7	1.2565	0.14	-0.71	-0.66	1.2535	1.2605	1.2636
USDTHB	3.6	31.36	0.03	-1.12	-1.82	30.86	30.99	30.84
USDTWD	2.6	29.53	-0.10	-0.68	-0.01	29.47	29.63	29.78
AUDUSD	8.8	0.9977	0.20	-1.41	-3.65	1.0357	1.0455	1.0330

Pricing Source: Bloomberg *5/15/2012*

Key Asian Economic Events Over Next 24 Hours*				Period	Cons	Last	Significance
Tues.	13:00	SI	Retail Sales Ex Auto (YoY)	MAR	3.50%	7.70%	High
	13:00	SI	Retail Sales (YoY)	MAR	8.00%	19.00%	High
	13:00	SI	Retail Sales (MoM) sa	MAR	0.40%	-2.00%	High
		PH	M3 Money Supply (YoY)	MAR	--	7.20%	Low
		PH	Overseas Remittances (YoY)	MAR	--	5.80%	Low
		PH	Overseas Workers Remittances	MAR	--	$1587.4M	Low
Weds.	7:00	SK	Unemployment Rate (SA)	APR	3.40%	3.40%	Medium

*indicated times are relative to GMT+8

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