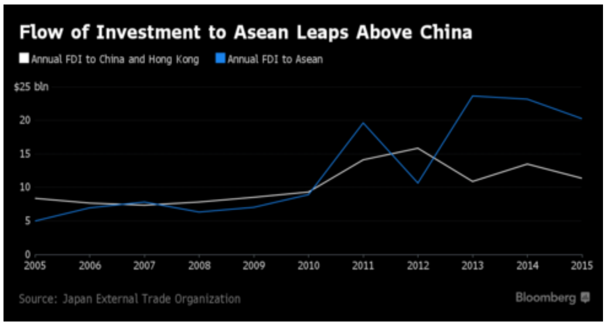
FX Tactical Outlook 31 May 2016

Long IDRJPY:



Earlier last month, we discussed the idea around being long IDR on the pretext of global investors seeking yield in relatively attractive geographies in the EM complex (of which SEA was one of them), as a function of the persistence of global monetary easing and negative rates in Japan and Europe. The trade idea was based on a lack of a responsive move in the volatility of Indonesian assets (FX, CDS, Jakarta composite) during the January-March risk aversion move. Across peers like Malaysia, Singapore, Phillipines for example during the period, short-end FX vols traded relatively tight. Indonesian equities also remained rangebound, and rallying in the late stages of the risk-off period, when peers like Thailand and Malaysia and Singapore barely broke highs. Domestic macro proves constructive with YoY GDP at 5.0% with the time series looking to turn higher, after a consistent drag lower since 2011, inflation is stable at 4.5%, unemployment is at historical lows of 6.0%, and credit growth is at 9.6% YoY alongside good banking system resilience, with NPL's at 2.7% gross. With a BI rate of 6.75%, cut from 7.50%, one can't lie the yield is stil attractive, and the monetary policy cutting itself is more as a function of global factors (Fed, China, etc), more likely than not than idiosyncratic elements. In addition to this, FDI inflows remain strong with Japan notably increasing annual FDI to the SEA region at levels faster than to China and Hong Kong. A long on most EM now, is an implicit USD short, and with the Fed opening the door for a Jun/Jul hike (July if just wanting to dodge the Brexit risk premium, and avoid tightening financial conditions further globally and the USD and US short end responding, being short USDIDR, doesn't make quite sense, unless say the Fed disappoints or the trade banks on a 'sell-the-fact' event on June/July. Due to the carry-trade nature of the JPY, and the FDI inflows mentioned, being long the IDRJPY may make more sense to avoid being caught with the implicitly long USD characteristic of the trade.

Besides the fact that spot is sitting at 2009 lows, we can see that spot tracks the 5y yield spread (ID5y – JP5y) between the two nations, and only having recently diverged quite significantly. The chart to the right shows the overlay between the 5y Indonesia CDS, and spot IDRJPY (inverted) although the relationship looks to be a lot more spurious, we can see that since 2011, spot lagged CDS tightening episodes, of which we are currently witnessing. Furthermore, Jakarta Composite's newly established range with lower extremes in at 4500~, looks to also imply a higher IDRJPY rate. **On a total-return perspective, one can see spot move to at least 12% higher in a 4-6 month time span, with a very attractive risk:reward of 3-4:1 depending on how tight stop placement goes, and carry accumulates to 285 bps over 5 month period.** The real 'cost' to the trade would most probably bethe fact that you may not be able to get a direct price or execution for IDR/JPY and that you'd need to do it long USDJPY vs USDIDR short.

General Market Thoughts:

Despite the dollar's current rebound, one needs to keep in mind just how far it has gone in recent history. We take a look at the BBDXY (Bloomberg Dollar Index – trade weighted), and we can see that we may only have just a bit more in the current rally before perhaps a pause (index currently at 1200, some support/resistance comes in at 1220). A lot of Fixed Income charts also turning lower,looking vulnerable for continued hike repricing. A look at EDZ6 shows that we probably could make a move below 98.90, targeting the 98.00 base.

One of our current trades for expressing USD bid leading up to June/July is a 1.0800 EURUSD 1mth one-touch. In hindsight, a 1x2 put spread right when we had the mini-stop run above 1.1500 seemed quite a good idea, but nonetheless, with EUR 1m implieds still trading quite low, long options are still quite cheap, and since the lull in vol from '13 – mid '14, we saw an inverse relationship with vol where a higher EUR translated to lower vol. This relationship continued when vol picked up and EUR sold off heavily, and may look to see a pickup perhaps if USD gets significantly bid to continue.

Looking at the nominal 2y rates spread, we can see that we may have some short-term EUR downside ahead of us. At least a 1.0800 nab does not seem too poor a call (or put so to speak). At worst, we'd probably hang around current levels, as looking at real yields (as measured by EU and US CPI) on the same tenor, we're just about fair at current spot levels.