

A shift in market correlations

Equities took fright from the pandemic on Thursday and may continue that flight today; 10Y US Treasury yields pulled sharply back too, baulking at the 1.0% level; and the USD softened - this is a changed relationship from a month ago when the USD would have rallied amidst falling yields.



arrows

A perennial problem

One of the biggest problems with economics, apart from the fact that a lot of the underlying assumptions are quite stupid, and many of the models so simplified as to be unusable, others just plain wrong, is that even if we know the macroeconomic stuff inside out and backwards, overlaying this onto markets is a very fiddly business.

For example, the last 24 hours has seen the following patterns - US equities have stopped taking comfort from commercial reports of vaccine progress, and in the absence of peer-reviewed approval and regulatory licensing, have started focussing again on the daily case numbers. And here, the news is terrible. Further lockdowns and restrictions are probably only days away in some jurisdictions. In others, they are already underway.

So as well as weaker equities, bond yields, which had been flirting with the 1.0% level in terms of the US 10Y Treasury, have also snapped back sharply in terms of yield. That move most likely got a

further nudge from the softer-than-expected US inflation data for October which were released yesterday, and which tally with a weaker economic reality.

So what did the USD do? Well, looked at entirely through the prism of the EURUSD exchange rate, the USD softened. The EUR made gains once more, clawing its way back above 1.18 again. With more of an Asian spin, most currencies managed small gains over this period, except (after India) our most Covid-affected currency, the IDR, and the region's highest beta currency, the KRW. Both fell.

That might not strike you as particularly odd. It seems in line with your gut instinct for how these things should work, and even manages to deliver what economic theory would suggest.

But if you roll the calendar back as little as a month, the relationship was quite different. For complicated and boring regulatory reasons, I can't show you the chart I have just drawn in excel, but what it shows is the 20-day rolling correlation of the daily change in the EURUSD exchange rate and the change in 10Y US Treasury yields over the same timeframe.

Right now, that correlation is negative. A falling UST yield, associated with a weaker economic outlook, is resulting in a softer USD. A month ago, the reverse was true. In other words, the USD was gaining in a softer environment, even as UST yields fell. Back then, the USD was acting like a safe haven currency, which is what it often does.

What's new?

Clearly something has changed. It's not entirely clear what that "something" is, but a quick scratch of the head comes up with the following factors which have "changed" from a month ago, and which could be playing a part in this altered environment:

1. The US election result is now known, but it did not deliver the blue wave that was supposed to bring a big stimulus and higher bond yields (also probably higher equities)
2. The pandemic, which is delivering a present second or even third wave to many countries, resulting in near-term lockdowns and more distancing but...
3. ...where the forward-looking evidence in terms of vaccines past the immediate near term pain is much improved.

There are probably other factors too, but I think it is worth keeping an eye on the transition from near-term economic pain to imminent recovery, as that is likely to see a combination of rising bond yields, rising equities, though whether that still delivers a near term stronger USD remains to be seen. We'll have to keep watching those correlation charts (at least I will, you'll have to draw your own).

ASEAN love triangle

My HK-based, colleague, Iris Pang, reminded me that the Regional Comprehensive Economic Partnership (RCEP) is due to be signed this weekend. Eh? (I hear you say...),

RCEP is the regions big new trade bloc, accounting for something like 30% of global GDP, with the ASEAN region sitting right at its heart. Indeed, the trade deal takes the 10 ASEAN countries and brings in any country with which ASEAN has a bilateral deal, with the exception of India. That means, importantly, that it brings in China, but also Japan, Australia and New Zealand.

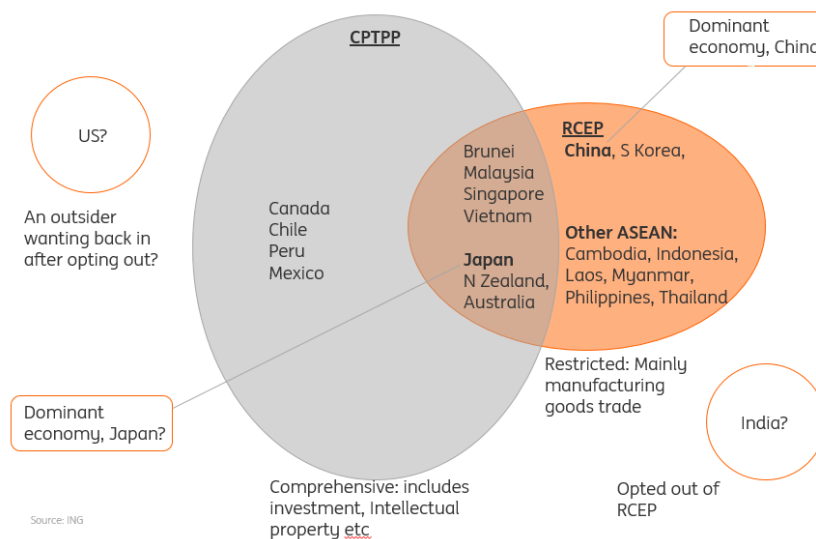
The rival trade deal, the CPTPP ([look it up here, life's too short](#)), covers only about 13-14% of global GDP. Japan is the biggest economy in the CPTPP, which lost its dominant player, the US, the day President Trump took power almost 4 years ago.

President-Elect Biden has hinted that the US might be interested in negotiating a re-joining (though only if the terms are right). But let's face it, this is a sellers' market right now for CPTPP incumbents, which include many members of the ASEAN, and which from this weekend, will also be cosseted within the RCEP.

I tentatively believe that this is a very good time to be in SE Asia, with both China and potentially the US (who knows, even the UK) looking to expand trade with the region through the CPTPP, and with China looking to offset that from its part within the RCEP. That could mean a lot of concessions from both sides, a lot of FDI inflows...

I *can* show you the Venn diagram below, which might help explain all this a bit more.

ASEAN in the middle



Source: ING

Asia today

There isn't a huge amount on the calendar for today. Malaysian 3Q GDP comes out at lunchtime and should show the usual 3Q post-pandemic outsize bounce. But Malaysia is having some issues of its own with Covid-19 right now, and I don't think you can read too much into backwards-looking indicators of the economy when they don't tell us much about the way forward.

And Indian trade data is also due. Without wanting to get bogged down in the minutiae of extremely volatile monthly trade figures, it's worth pointing out that the pandemic has been a mixed blessing for India's chronic trade deficit. Thanks to decimated domestic demand, India's trade deficit has almost approached balance. Of course, this is not exactly the preferred route for balancing the external sector, and the INR has not been rewarded with any appreciation as a result, quite the opposite. We continue to see the INR as the regions most underperforming

currency.

Author

Robert Carnell

Regional Head of Research, Asia-Pacific

robert.carnell@asia.ing.com

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