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What to watch: drill, baby, drill no more, trade war ripple effects on Germany and Asian currencies leaving us a message?

In summary

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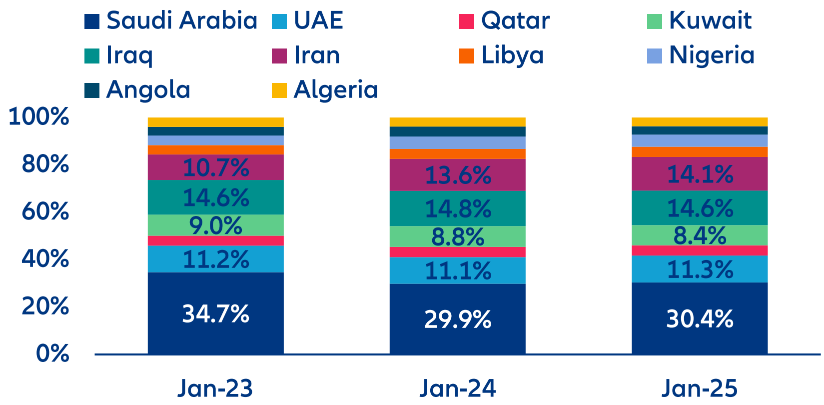
This week we look at three critical issues:

- **Oil is spilling, US shale is stalling and Europe's restocking.** In an aggressive move to reclaim market share and discipline partners that have been flouting production quotas, Saudi Arabia has triggered a supply surge, pushing OPEC+ to add 411,000 bpd in June alone – despite crude oil sliding to the low USD60s per barrel, far below its 90 USD/bbl fiscal breakeven. US shale is feeling the squeeze: low prices leave Permian producers dangerously close to their breakeven, forcing rig cuts and capex pullbacks. US output in 2025 is now expected to be 100,000 bbl/d lower than previous forecasts – drill, baby, drill no more. We now expect oil prices to range between 65 and 70 USD/bbl for the remainder of the year. Meanwhile, Europe is finding relief in the gas market: prices are down 25% from February highs, offering a window to refill storage that have been largely depleted over the cold winter. Nevertheless, even with current prices, the region faces an additional cost of about EUR10bn compared to 2024.
- **Made in China, felt in Germany: The trade war's ripple effects.** The likely trade deflection arising from the US-China trade war could increase Chinese competition in the European market, with particular risks for Germany. Over the next three years, Germany may absorb 14% of deflected trade (overall German imports +2.5%). This influx will lead to cheaper Chinese inputs and boost German value added (VA) in final consumption by up to +0.12%, but this is outweighed by a +0.47% increase in Chinese VA in German final consumption, signaling domestic manufacturing displacement. Increased competition and changes in VA could strain vulnerable sectors and regions, exposing around 500 thousand manufacturing jobs (7% of the sector), with an estimated 17 000 to 25 000 jobs or 0.2%-0.3% of total manufacturing employment potentially at risk. The Chinese trade deflection could thus slow German economic growth by -0.2 to -0.3pp over three years, with ripple effects extending to key EU supply chain partners, especially in Eastern Europe.
- **Taiwan: a bellwether for currency plays ahead of trade negotiations?** The Taiwanese dollar's unprecedented 6% surge over just two days – its largest in decades – reflects intensified hedging by domestic insurers and corporates amid unhedged foreign asset exposure. Though rumours of intentional currency manipulation amid trade talks with the US were denied, this appreciation highlights Taiwan's economic vulnerability. Taiwan is the world's fifth-largest foreign creditor with a massive net international investment position (NIIP) of USD1.7trn, of which USD300bn is in overseas life insurance investments. This casts a shadow over other Asian economies with large trade surpluses, with spillovers already visible from Malaysia to South Korea. However, contagion of a similar scale is unlikely, as Taiwan's exceptionally large NIIP makes its situation distinct among regional peers. The TWD spike also signals a shift in global monetary tensions, raising fears of a new phase of financial instability, reminiscent of the 1987 Plaza Accord.

Oil is spilling, shale is stalling and Europe is restocking

Saudi Arabia's oil output increase is its latest market-share gambit. Global oil markets already entered 2025 on the back foot, weighed down by weakening demand and slower economic activity. But despite the trade war tanking oil prices to the low USD60s per barrel (bbl) – levels unseen since 2021 – Saudi Arabia is pushing to accelerate the unwinding of OPEC production curbs. By mid-year, the group will have restored roughly 1 million barrels per day (bpd) of supply, unwinding about 40% of the cuts implemented since 2022, with the remaining cuts likely to be fully reversed by October. This sets the stage for a surge in oil supply at a time when global demand growth is faltering, non-OPEC output is also increasing and crude prices are below the level needed to balance Saudi Arabia's budget (around 90 USD/bbl). Saudi Arabia is effectively abandoning its unofficial 100 UDS/bbl target and signaling a sharp pivot towards tolerating a prolonged period of low prices in an aggressive bid to reclaim market share and "discipline" other OPEC+ members, notably Iraq and Kazakhstan, that have been flouting production quotas, as well as to send a positive signal towards the White House, which asked for more output ahead of President's Trump planned visit to Riyadh later this month. However, faced with the prospect of a supply glut, oil-dependent governments in OPEC are bracing for budget pain, with some preparing to issue more debt and slash spending to offset lost revenues. We now expect oil prices to range between 65 and 70 USD/bbl for the remainder of the year. It is difficult to see prices dipping further, while positive news regarding demand or geopolitical tensions could drive prices up.

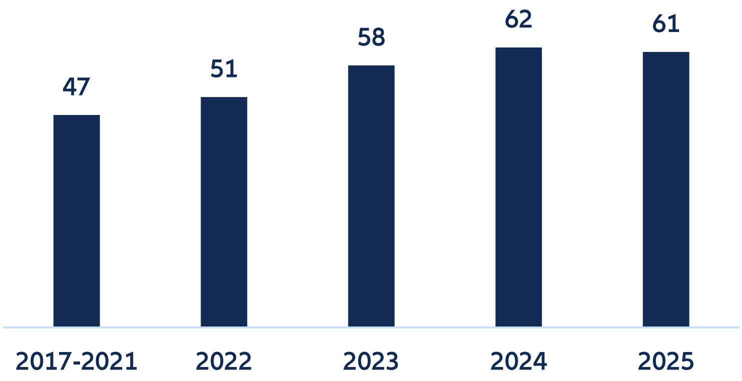
Figure 1: OPEC producers' market shares



Sources: LSEG Datastream, Allianz Research

"Drill, baby, drill"? Not while low oil prices tighten the screws on the US shale industry. US crude output is still near record highs (i.e. around 13.7 million bpd) but the growth engine is sputtering, with the Energy Information Administration (EIA) trimming its 2025 output growth forecast by 100,000 bpd (+300,000 bpd projected). Indeed, the flip side of OPEC's output surge and lower prices for the US is the pressure it places on shale producers, which account for over two-thirds of domestic oil production. The average break-even price in the Permian Basin – the heart of the shale boom – stands between 61 USD/bbl and 65 USD/bbl. With the West Texas Intermediate (WTI) recently trading in the low 60s, margins are razor thin, forcing a reconsideration of growth plans and financial prospects. Outside of the Permian's sweet spots, the economics does not look much better. For example, Wyoming's Powder River Basin needs roughly USD58 a barrel to break even. Rising costs compound the squeeze – tariffs on steel piping and other equipment have driven up well costs by nearly +10%, further eating into profits. Shale firms are responding swiftly to the new price environment. Some smaller US producers have hit the brakes on drilling and planned well projects are being shelved – independent drillers report scaling back development. Oilfield service giants like Halliburton and Baker Hughes have warned of weaker drilling activity hitting their revenues. Capex in the industry is also expected to fall by double-digits in 2025. Upstream M&A is also cooling – dealmakers face a gulf between buyers and sellers on asset value amid lower price decks, portending the most challenging environment since 2020 for shale.

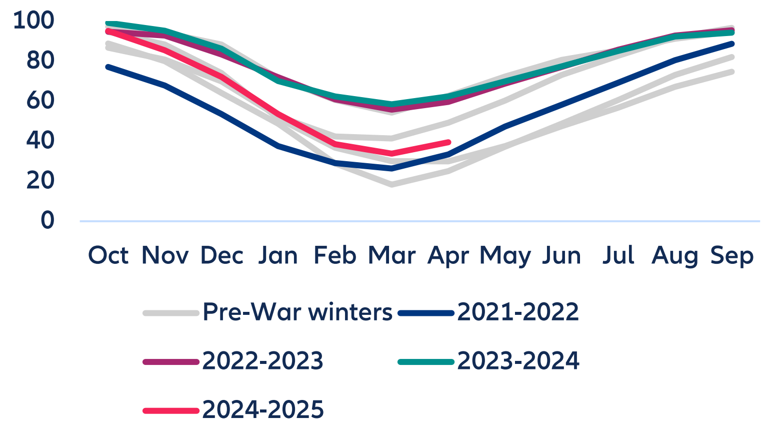
Figure 2: WTI breakeven prices for US shale producers in the Permian basin (USD/bbl)



Sources: Dallas FED survey April 2025, Allianz Research

Meanwhile, Europe can replenish depleted gas reserves at a "bargain". After two years of extreme volatility, Europe's natural gas market is enjoying a period of relative calm in 2025. Benchmark gas prices have pulled back sharply from their winter highs. In early February, European gas prices briefly hit their highest levels in two years amid a cold snap and low wind generation. The 2024/25 winter was colder and less windy than the previous year, meaning gas storage was drawn down faster despite being almost full in late 2024. By the start of spring, EU storage levels had sunk to just about 34%, the lowest post-winter level since 2022 (see Figure 3). On the positive side, by spring, gas prices had fallen by over 25% from the February peak. Lower seasonal demand – as heating needs fade and spring weather boosts renewable power output – has given the market a breather. At the same time, sluggish economic activity across Europe and uncertainty around US tariffs has curbed industrial gas consumption: output in gas-intensive sectors (chemicals, steel, fertilizers etc.), especially in Germany, are yet to recover. This decrease in demand has taken additional pressure off the gas system. As a result, European gas futures for summer delivery are trading around the 40 EUR/MWh mark. These softer prices, while not cheap by historical standards, are a welcome relief and have opened up a strategic moment for Europe to restock its gas reserves after a heavy winter drawdown. The European target is to reach 90% storage by 1 November. Achieving that will require a massive replenishment effort over the summer. The EU needs roughly 57.7bn cubic meters (bcm) of gas injected during the refill season – about 25.8bcm more than in 2024. At current prices, that additional gas bill would be around EUR10bn. Gas traders are moving carefully because many market participants anticipate prices dipping further in the coming months amid low demand. But policymakers need to be wary of not delaying restocking for too long to avoid a buying rush that could spike prices in late summer. If storage injections are smoothed out over a longer window, and if power sector gas usage remains muted through the mild spring, Europe could even see gas prices slide further from current levels before summer. Although softer gas prices are partly due to soft economic momentum, the current dynamic is something of a reprieve for Europe: it buys Europe time to prepare for next winter without the frenzy and sky-high prices that defined last year's scramble for gas. Just as oil exporters are grappling with the downside of a slower economy, European consumers are benefiting. In essence, the same demand weakness that has tipped oil into surplus is providing a much-needed breathing space for European natural gas.

Figure 3: European gas storage level (%)

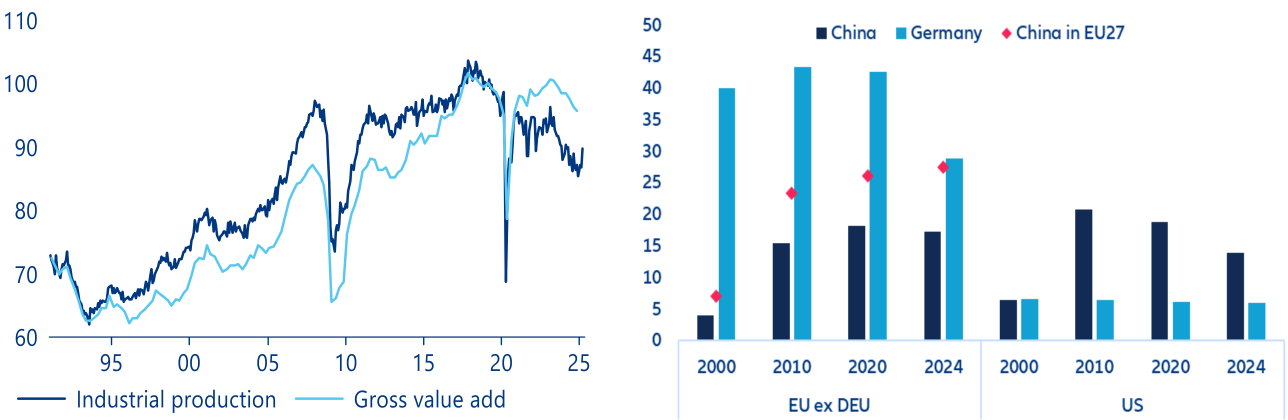


Sources: AGSI, Allianz Research

Made in China, felt in Germany: The trade war's ripple effects

Germany already faces strong competition from China and the trade war will exacerbate this. Germany's export-oriented industrial model is under increasing strain due to intensifying Chinese competition, lower demand, high energy costs and a difficult global trade policy environment. Concerns over "de-industrialisation" are rising, especially with weak domestic industrial production (Figure 4, left). However, industrial gross value added has held up better since 2021, suggesting that profitability and wealth creation may be more resilient than output numbers imply. To adapt, German firms are shifting toward high-tech products, R&D and integrated services, as competing on price with low-wage economies like China is no longer viable. Yet, Germany has steadily lost market share both globally and within the EU, including at home. Since 2000, China's share of sophisticated EU imports has grown consistently, while Germany's has declined since 2010 and particularly sharply from 2020 to 2024, when it dropped by -14pps, and a 10pps gap opened up between Chinese import shares in the EU27 excluding Germany versus including it (Figure 4, right). Sectors such as machinery, vehicles, electronics, chemicals and pharma – core to German industry – have been affected the most. With the escalation of the US-China trade war since April 2025, China is increasingly also redirecting exports to Europe, amplifying competitive pressures on German manufacturing.

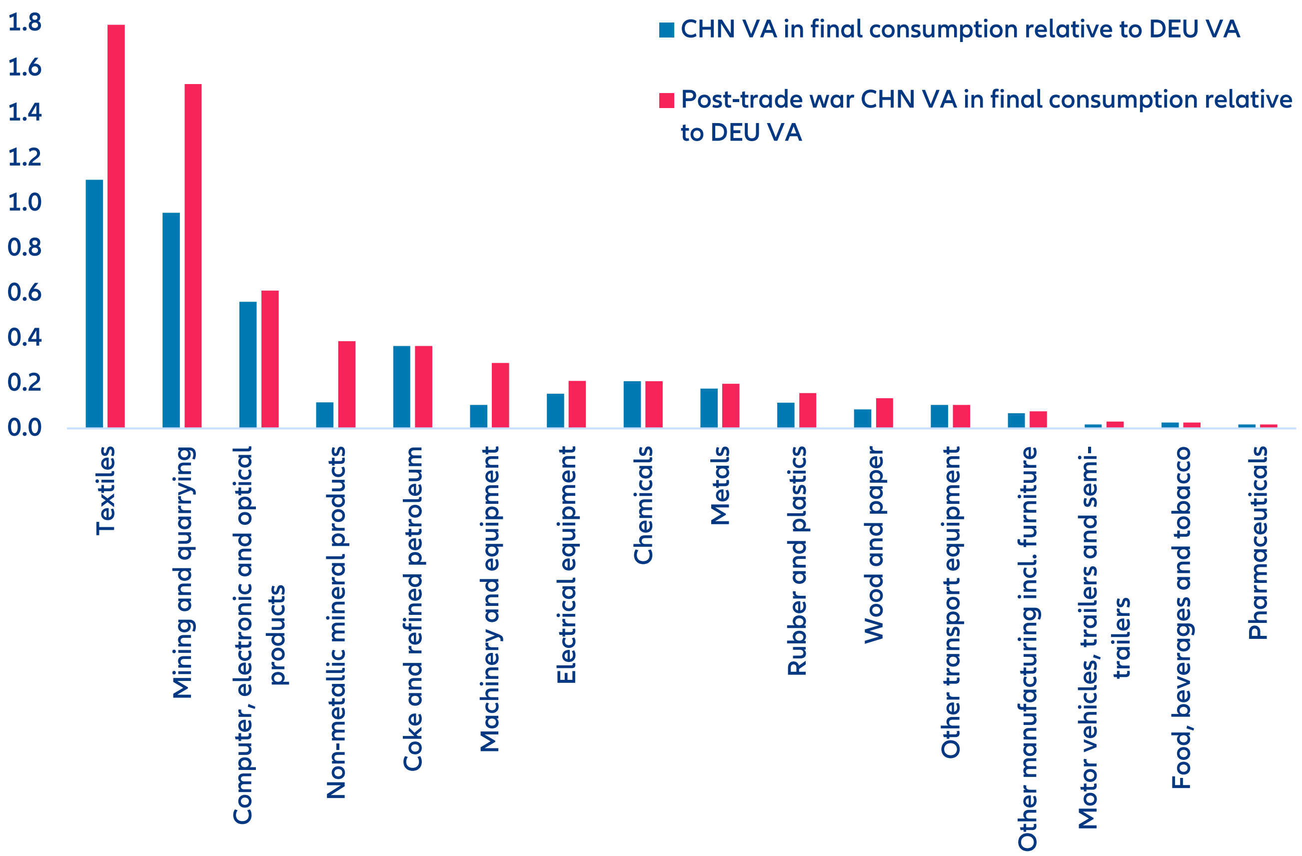
Figure 4: Industrial production and gross value added, index (left) and import shares of sophisticated manufacturing goods from China and Germany, in % (right)



Sources: LSEG Datastream, UNComtrade, Allianz Research. Notes: Sophisticated manufacturing goods are: Chemicals and chemical products, basic pharmaceutical products and pharmaceutical preparations, fabricated metal products, except machinery and equipment, computer, electronic and optical products, electrical equipment, machinery and equipment., motor vehicles, trailers and semi-trailers, other transport equipment.

Over the next three years, Germany could absorb 14% of Chinese export deflection caused by the US-China trade war, increasing German imports from China by +2.5%. Assuming Chinese export losses to the US reach a maximum of USD239bn in our baseline trade war scenario, and based on current German import patterns, sectors – like machinery and equipment, with a 19% Chinese import share – could face a USD10.4bn surge in Chinese imports out of USD54bn globally reallocated by China in that sector. Other vulnerable sectors include textiles, non-metallic mineral products, electrical equipment, computers and motor vehicles. Germany is projected to absorb USD32.8bn, accounting for 14% of the Chinese export deflection resulting from the US-China trade war. This would lead to a +19% increase in German imports from China and a +2.5% rise in overall German imports over three years, or an annual growth rate of +0.8%. Consequently, these shifts will impact value-added (VA) structures across various German industrial sectors. Based on the additional Chinese intake, textiles would see the highest increase in Chinese VA in final German consumption relative to domestic VA (+0.07pp), followed by mining and quarrying (+0.6pp), non-metallic mineral products (+0.3pp), machinery and equipment (+0.2pp) and electrical equipment (+0.1pp) (Figure 5). These shifts further pressure sectors already vulnerable to Chinese competition. On the upside, cheaper intermediate inputs from China could lower input costs by -0.1% to -0.25%, modestly boosting German VA in final consumption by +0.05% to +0.12%. However, this is small compared to the expected +0.47% increase in Chinese VA in German final consumption, highlighting the displacement of domestic manufacturing.

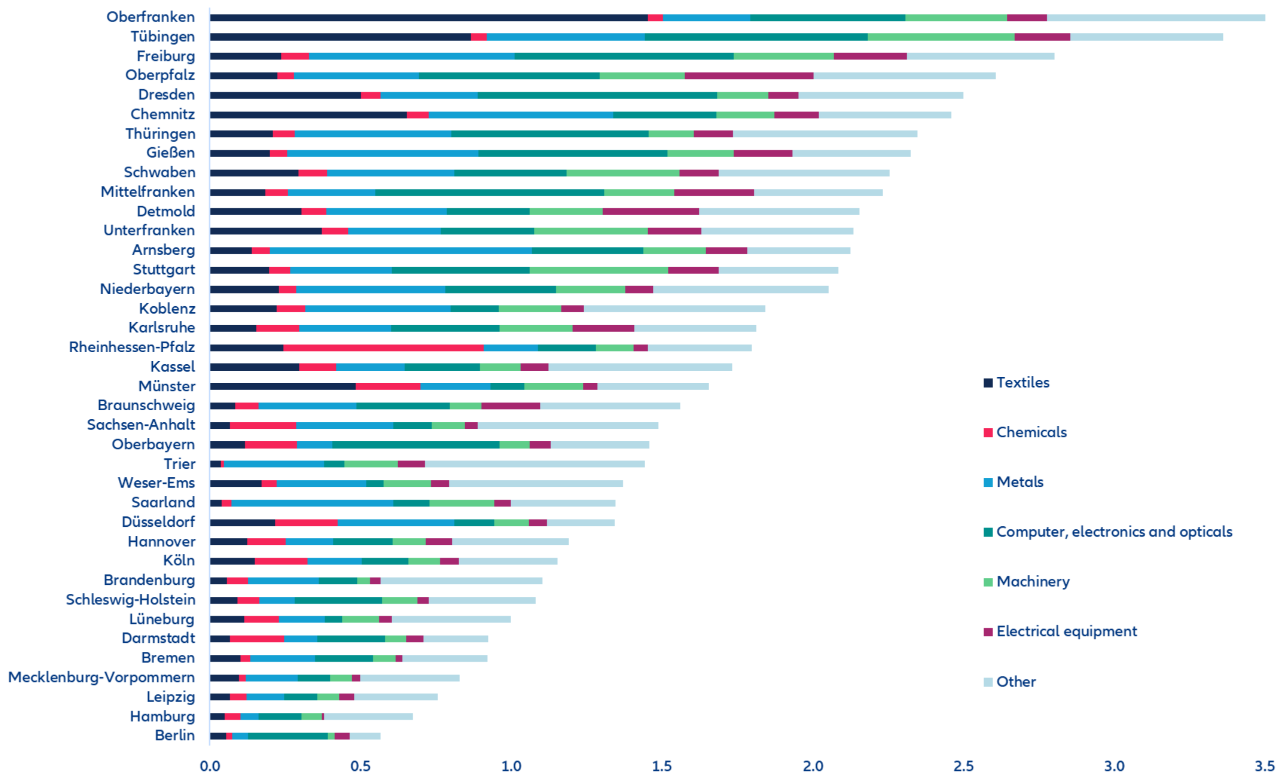
Figure 5: Change in share of CHN VA in final consumption relative to German VA pre- and post-trade war, in %



Sources: OECD TiVA, Allianz Research. Notes: applying the estimated increase in Chinese imports due to the US-CHN trade war alongside the relation between Chinese gross imports to Germany to value add in consumption.

Chinese import competition could intensify structural pressures in an already strained German labor market. Increased Chinese import competition and changes in VA could put around 500 thousand or 7% of manufacturing jobs in Germany exposed, with an estimated 17,000 to 25,000 jobs – or 0.2% to 0.3% of total manufacturing employment – potentially at risk. The most affected sectors include machinery and equipment, textiles and non-metallic mineral products, with job losses varying based on each sector's exposure and importance to the overall labor market. While the machinery and equipment sector faces significant employment vulnerability, with 31% of jobs exposed, the limited additional Chinese competition due to trade deflection is expected to result in only a modest job loss of 1%. In contrast, the textiles sector, with 13% vulnerability and 2% of jobs at risk, and the non-metallic mineral products sector, with 10% vulnerability and 1% at risk, face greater competitive pressures, despite their smaller overall employment bases. The regional impact is also concentrated. Areas such as Oberfranken and Tübingen (textiles and computer industries) and Freiburg (computers and metals) are among the most exposed, reflecting their industrial structure (Figure 6). These pressures add to an already tight labor market, shaped by two years of recession, high energy costs, weak global demand for German exports and pressures from increased protectionism.

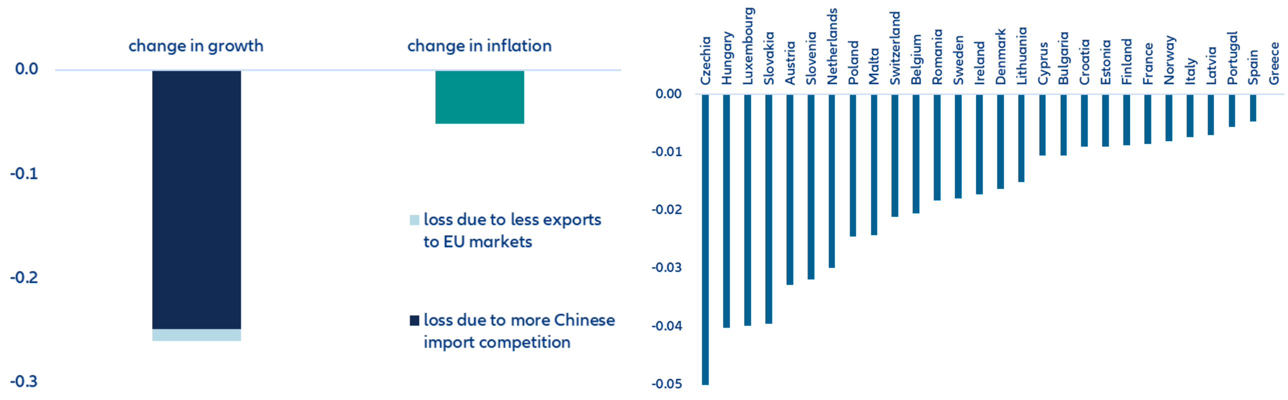
Figure 6: Employment vulnerability to Chinese import competition shock by region and industry, index



Sources: Eurostat structural business statistics (SBS) and the OECD TiVA. Note: Employment exposure calculated as multiplying for each industry the Chinese value added embedded in final consumption as a share of total value added at the national level by the share of employment in an industry in each NUTS2 region. Higher values indicate a greater vulnerability to Chinese import competition in manufacturing.

The resulting deceleration in Germany's economic growth could have limited ripple effects across key EU supply chain partners. Over the next three years, German GDP could decline by as much as -0.26pp (Figure 7, left), primarily driven by increased Chinese competition in its domestic market (-0.25pp). In contrast, reduced German competitiveness in EU markets – stemming from other EU countries excluding Germany absorbing around USD47bn, or 19.6% of the Chinese export reallocation caused by the ongoing trade war – would alter German trade dynamics within the EU economies as well. The resulting trade losses for Germany could reach up to -USD10.5bn, translating to an additional -0.01pp reduction in trade with EU partners. While the macroeconomic effect appears manageable, actual trade war exposure adds an additional -1.3pps reduction in German growth over the next three years. Inflation is expected to respond only slightly, with a projected decrease of -0.05pp over three years. EU countries linked to Germany through supply chains would face spillover effects from the German slowdown. While the overall impact on Eurozone GDP is estimated at -0.07pp over three years, the most exposed countries include Czechia (-0.05pp), Hungary, Luxembourg and Slovakia (each at -0.04pp, Figure 7, right). Though these figures may appear modest, they could be compounded by each country's own exposure to redirected Chinese trade flows and the broader effects of the trade war, particularly via export links to the US market.

Figure 7: Change in GDP growth and inflation due to Chinese export deflection over three years, in pps (left) and Cross-country GDP spillover effect of a German economic shock, in pps (right)



Sources: OECD, World Bank, Oxford Economics, Allianz Research. Notes: EU market export losses calculated using UNComtrade export structures.

Taiwan: a bellwether for currency plays ahead of trade negotiations?

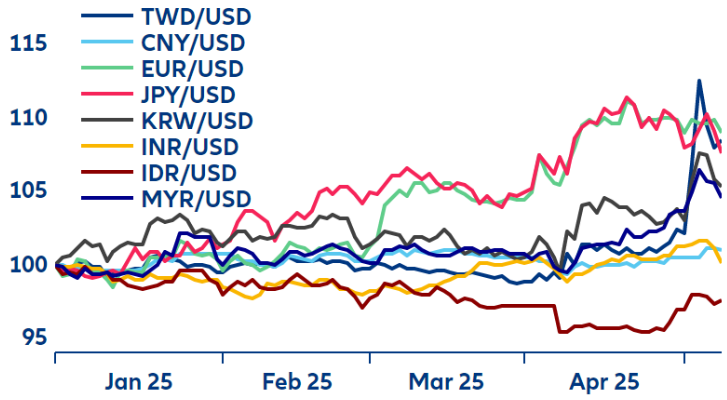
The Taiwanese dollar has experienced a dramatic surge, marking its largest two-day rally in decades (+6% vs the USD). This sharp appreciation, peaking at a near three-year high on Monday at 29.65 USD/TWD, was initially fueled by speculation surrounding potential US trade negotiations that might require Taiwan to strengthen its currency (Figure 8). However, Taiwan's central bank and trade officials denied any such requests from the US. Nevertheless, the currency's unprecedented 6% surge in just two days can be attributed to increased FX hedging activities by corporates and insurers holding significant amounts of unhedged foreign assets. Broader concerns arise about Taiwan's economic competitiveness, the impact on local industries – particularly exporters and insurers – and, above all, whether Taiwan could be a blueprint for other markets in Asia or beyond. Looking at other currencies, one can already see some contagion with the Malaysian ringgit and the Korean won getting dragged along with the Taiwanese dollar (Figure 9). However, when widening the scope to large developed market currencies such as the yen and the euro, it also becomes clear that most of these currencies are merely catching up in terms of appreciation versus the dollar in year-to-date terms while others, in particular the Chinese yuan or the Indian rupee still have room to catch up.

Figure 8: Taiwan Dollar exchange rate

Sources: LSEG Datastream, Allianz Research, latest datapoint: 8 May 2025

Taiwan is the world's fifth largest foreign creditor in absolute terms, with one of the largest life insurance industries globally. Taiwanese life insurers have invested heavily in overseas markets, with foreign investments totaling approximately USD300bn, as of the latest reports. This has been driven by relatively low domestic interest rates and the need to match long-term liabilities with potentially higher returns abroad, resulting in substantial unhedged foreign currency exposure, estimated at around USD100bn. This exposure becomes particularly relevant during periods of currency volatility like the recent surge of the Taiwanese dollar. Insurers are now facing increased pressure to adjust their hedging strategies to mitigate exchange rate risks. More broadly speaking, Taiwan boasts one of the largest net international investment positions (NIIP) at more than USD1.7trn equivalent to 229% of GDP (as of the end of 2023). This explains why Taiwan's investors are so sensitive to sharp and rapid currency fluctuations as these can have significant impacts on the nation's overall wealth.

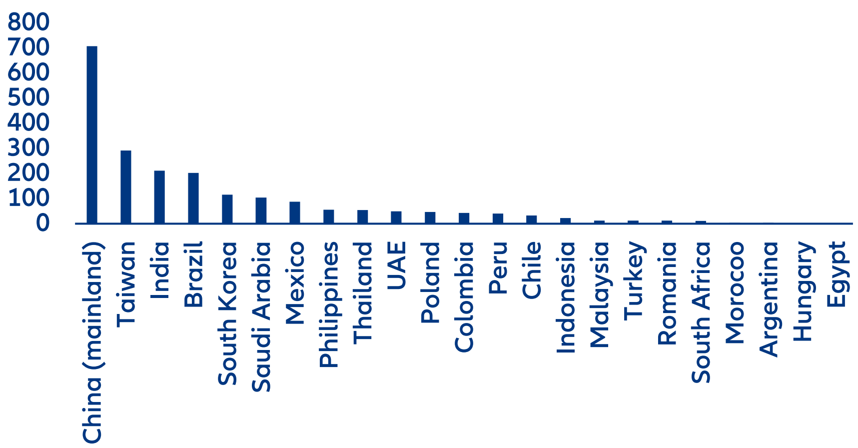
Figure 9: Currencies against the USD ytd, indexed 100 = 01/01/2025



Sources: LSEG Datastream, Allianz Research, latest datapoint: 8 May 2025

Taiwan also emerges as the second largest holder of US Treasuries after China. Since the beginning of the war in Ukraine in February 2022, Taiwan has become an even larger player in the US Treasury market. Taiwan currently holds USD295bn in US Treasuries, making it the tenth-largest foreign holder of US government debt globally (Figure 10). These figures have risen strongly over time thanks to continuous large current account surpluses. Other nations in Asia have maintained holdings since February 2022 (South Korea, +1%), while most Southeast Asian nations have also increased their holdings (Malaysia, +43%; Indonesia, +21%; Thailand, +19%; Philippines, +13%). The opposite side of the coin is China, which has offloaded above USD300mn of US Treasuries since the beginning of the war in Ukraine, which sparked sizable sanctions that targeted Russian reserves in foreign central banks. China, along with other countries such as Brazil (-14%) and Morocco (-9%), took note and offloaded accordingly.

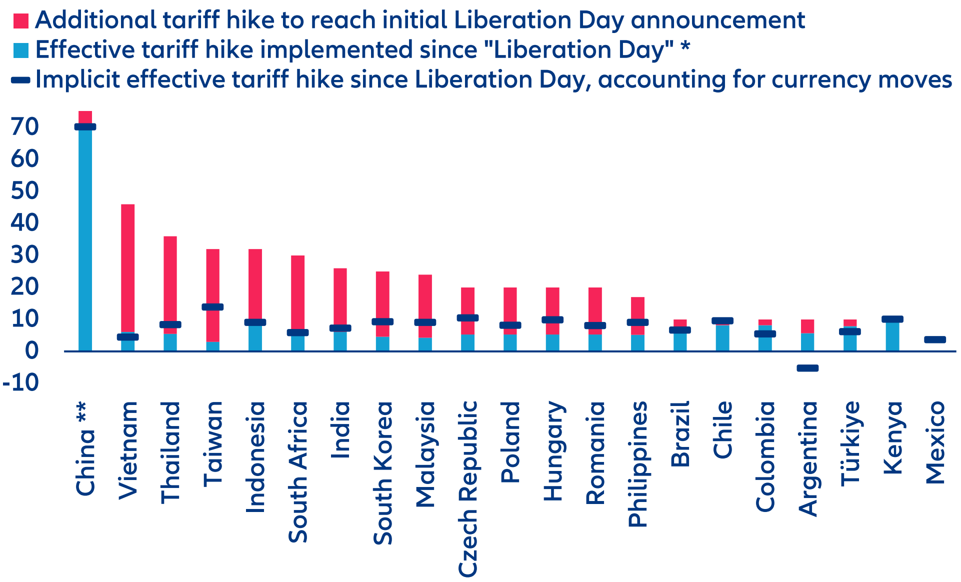
Figure 10: Foreign US Treasury ownership by country, USD bn



Sources: LSEG Datastream, Allianz Research

Taiwanese exporters could face additional export losses of up to USD8bn (0.8% of GDP) if the appreciation persists. Asian exporters were particularly targeted by US Liberation Day trade policies, subject to the highest tariff hikes initially. Subsequent sectoral exclusions have managed to reduce the impact, particularly thanks to the exemptions on certain electronics goods (see What to Watch 17 April 2025). We estimate that export losses for the main Asian exporters (excluding China and Japan) could amount to up to USD35bn in 2025, compared to USD70bn under the initial announcements. While in theory the trade war could lead to depreciating currencies that partly mitigate the impact of tariff hikes, the reality has been different. Taiwan is now facing the double whammy of tariff hikes and a stronger local currency vs. the USD: the implicit effective tariff hikes now stands at 14pps, compared with 3pps before the latest currency moves and almost halfway to the initial tariff hike planned on Liberation Day (see Figure 11). Should the strengthening of the Taiwanese dollar vs. USD prove to be long-lasting, and without any mitigation measures, Taiwanese exporters could see additional export losses of up to USD8bn (0.8% of GDP) in the rest of the year. This is likely to be an upper bound though as we expect Taiwanese exports to remain competitive, given sectoral specializations and the fact that the Taiwanese dollar exchange rate to the USD was only 1.4% stronger compared to the 30-year average, as of 6 May.

Figure 11: US tariff hikes on major emerging markets, since "Liberation Day" (pp)



** account for all sectoral exclusions*
*** China's additional tariff hike to reach the initial "Liberation Day" announcement is 55pp, for a total of 125pp tariff hike (accounting for retaliations)*
Sources: LSEG Datastream, Allianz Research

Are other Emerging Markets at risk? South Korea, Thailand, Malaysia and China have both positive net international investment positions (NIIP) and a significant trade surplus with the US, hinting that they could also be at risk of appreciation (Table 1). However, Taiwan admittedly stands out most with an NIIP significantly higher than its Asian peers (229% of GDP, versus 17.6% for China, 59% for South Korea, Malaysia 0%, and 8.1% for Thailand). This makes a similar hedging-driven appreciation episode as the one experienced by Taiwan less likely elsewhere, at least for now. China, whose alleged currency weakness is facing a recurring focus by the US, is also less exposed to appreciation pressures due to its relatively closed capital account, which insulates it from sharp market-driven currency swings. Moreover, Chinese authorities are likely to continue prioritizing currency stability, as evidenced by the modest 0.5% appreciation of the renminbi against the US dollar since Liberation Day.

Table 1: EM currency risk overview

Country	Currency move YTD	Tariff rate announced on Liberation Day	Exchange rate regime	NIIP (% of GDP)	US trade balance (% GDP)	Capital opennes index (1 = more open)	US Treasury currency manipulation report
Brazil	8.1%	10%	Floating	-34	-0.18	0.16	Yes
Mexico	5.4%	0%	Free Floating	-32	8.77	0.70	Yes
Chile	6.0%	10%	Free Floating	-17	-0.63	0.70	
Colombia	2.3%	10%	Floating	-45	-0.16	0.42	
Peru	2.6%	10%	Floating	-40	-1.03	1.00	
Argentina	-14.4%	10%	Crawl-like arrangement	9	-0.73	0.28	
Czech Republic	10.5%	20%	Free Floating	-7	0.93	1.00	
Poland	9.6%	20%	Free Floating	-28	0.32	0.70	
Hungary	11.4%	20%	Floating	-35	3.71	1.00	
Romania	7.1%	20%	Crawl-like arrangement	-41	0.81	0.88	
Turkey	-8.4%	10%	Floating	-22	0.16	0.16	
China	1.2%	34%	Crawl-like arrangement	18	1.69	0.16	Yes
Taiwan	9.4%	32%	Managed float	229	6.64		Yes
India	1.4%	26%	Floating	-10	1.32	0.16	
South Korea	4.7%	25%	Floating	59	2.98	1.00	Yes
Malaysia	5.6%	24%	Floating	0	6.98	0.42	Yes
Indonesia	-2.2%	32%	Floating	-18	1.32	0.42	
Thailand	4.0%	36%	Floating	8	8.36	0.42	Yes
Philippines	4.4%	17%	Crawl-like arrangement	-14	1.01	0.45	
Vietnam	-1.8%	46%	Crawl-like arrangement	-90	25.16	0.42	Yes
South Africa	3.6%	30%	Floating	28	1.87	0.16	
Egypt	0.3%	10%	Stabilized arrangement	-72	-0.49	0.42	
Morocco	10.1%	10%	Pegged	-43	-1.37	0.16	
Nigeria	-3.9%	14%	Stabilized arrangement	-24	0.89	0.30	
Kenya	0.2%	10%	Managed float	-54	0.39	0.70	

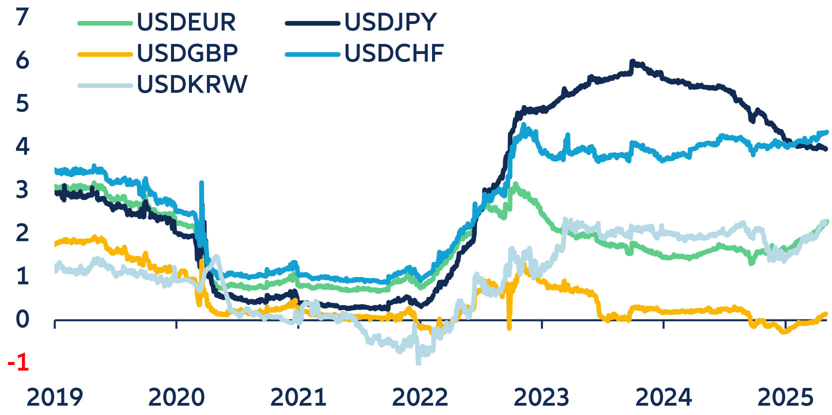
Note 1: Kenya, Nigeria, Peru, Taiwan and Egypt are referencing 2023 Net IIP. US Trade balance is also referencing 2023.

Note 2: Capital opennes Index makes reference to the Chinn-Ito Index which assesses a country's degree of capital account openness.

Sources: LSEG Datastream, Allianz Research

Short-term gain, long-term pain: Hedging rush fuels its own appreciation spiral. In the aftermath of recent events in Taiwan, more investors – from large asset owners like pension funds and insurers to retail participants – are questioning whether to hedge overseas investments and revenues. According to JPMorgan, currency-hedged US equity ETFs domiciled outside the US have seen strong inflows this year, while unhedged counterparts have lost ground. Yet for many currencies, hedging is prohibitively expensive, especially against the US dollar. In the case of the Japanese yen, hedging costs are close to 4% annualized, meaning Japanese investors are better off holding domestic government bonds (10y at 1.32%) than hedging currency risk on 10-year US Treasuries (10y at 4.29% resulting in 0.31% currency hedged on a 3m horizon). The same holds for several other currencies, including emerging markets like the Korean won. Collective hedging only compounds the issue. If investors in one country simultaneously hedge against dollar weakness, they drive up their own currencies, creating a self-fulfilling appreciation, as seen in Taiwan. In the short term, this results in a classic prisoner's dilemma: those who hedge early gain, while those who delay lose, amplifying volatility instead of mitigating it.

Figure 12: Three months FX hedging cost against the USD, annualized in %



Sources: LSEG Datastream, Allianz Research

Taiwan has become a testing ground for currency moves amid US trade negotiations but this power play could be costly for all sides. The recent turmoil in the Taiwanese currency market is a sign that USD-linked Asian economies start shifting from defensive managed floating to aggressive currency moves in a context of US trade negotiations. The Taiwanese central bank owns USD580bn of foreign exchange reserves (71% of GDP) reflecting a history of active intervention to weaken the currency. However, its decision to refrain from intervening during the latest market volatility suggests a notable shift in policy stance. This is an open challenge of the Post-Bretton-Woods monetary framework whose implicit contract was that exporting economies recycle surpluses in US Treasuries, suppress US volatility and borrowing costs in exchange for market access and eventually defense guarantees. The Taiwanese dollar has become the first major testing ground and will signal to other countries options in upcoming US trade negotiations. But this power play is costly for both sides. The US faces yield volatility and rising borrowing costs especially at the long end of the curve. Taiwanese authorities face the dilemma between letting TWD appreciate and inflicting hedging or unwinding costs on domestic life insurers or repurchasing US Treasuries, delaying FX pain but facing an even larger risk if US confidence worsens. With a weaker USD but still solid foreign demand at US Treasuries auctions, the US government seems on the stronger side for now. But as time goes by and refinancing needs rise, its position may become more vulnerable. We see two major risks arising from the current TWD turmoil. In the short-term, a spillover to other and potentially larger markets could trigger financial and economic pain in both developed and emerging markets. In the longer term, the risk that the TWD appreciation shock is just the prelude to a 1987 scenario where a weaker dollar and reduced overseas demand for US debt could fragilize the US Treasury market and create a funding squeeze that leads to a massive correction of risky assets. This situation has not yet arisen, but the possible triggers are in place.

These assessments are, as always, subject to the disclaimer provided below.