Asia FI & FX Strategy Viewpoint

ASEAN – Forming up for the turn

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GEM FI & FX Strategy
Asia

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ASEAN – Forming up for the turn

EM currencies are forming-up for the beginning of Fed cutting cycle around middle of this year which is expected to ease the pressure. While that may mark a broader medium-term rally in rates and FX, the domestic dynamics would determine the relative winners and the timing of the moves across markets. We explore how rates and FX drivers across the region this year may vary in terms of the sequencing, along with the constraints which could limit the extent of rally.

In the near-term, we expect Thai rates to trade with received bias vs SGD and MYR front-end paid. Around mid-year, Fed cuts could allow high-yielders like Indonesia to begin a deep cutting cycle and attract more carry flows. Malaysia rates may remain constrained by FX, negative carry and limited room for rate-cuts, if any. Within FX space, SGD remains preferred carry position relative to low-yielders in the region like CNH and MYR. THB's volatility would likely remain high for now but may decline towards end of the year as current account buffer improves. IDR would continue to need more active management until Fed cycle begins.

Inflows to chase real-yields and carry

Over the next two-years, Indonesia stands out as the top candidates for a deep cutting cycle of 7-8 cuts (175-200bps) compared with bond yields implying only 1-2 cuts vs front-end bills. Easier liquidity conditions due to lower bill issuance would also lead to compression in the front-end spreads.

Carry buffer remains relatively thin vs history but high-yielders are still better placed vs. rest. But, with CBs such as Indonesia following the Fed on cuts, the carry pick-up is likely to remain limited. That would entail a trade-off between FX appreciation and lower rates. Other markets like Malaysia and Thailand would remain negative carry well into and likely throughout the Fed cutting cycle. Along with expected index changes this year, that would limit the interest in these markets in 2H24.

FX support from end of USD hoarding

Over the last few years, even countries with current account surplus, like Malaysia and at times Indonesia, suffered from low conversion. Even positive yield pick-up didn't prove sufficient to avoid hoarding of USD deposits by corporates. FX deposits went-up further during 4Q'23 in Indonesia and Malaysia even as currencies appreciated, which shows that corporates prefer to see actual Fed's cuts before changing hedging behavior.

On the other hand, CBs which defended their currencies have either lost spot reserves or accumulated short forward positions and FX liabilities. Malaysia and Indonesia have built up significant short forward books of USD 24Bn and USD 12Bn respectively. These would be unwound as FX appreciates and would slow the pace of appreciation.

For a full list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, please see Global Emerging Markets Weekly: Dropping the USD diet for real yields 15 March 2024

Glossary:

ASEAN: Association of south-east Asian nations

BI: Bank Indonesia

BoP: Balance of payments

BNM: Bank Negara Malaysia

BoT: Bank of Thailand

BSP: Bangko Sentral Ng Pilipinas

CA: Current account

CB: Central bank

EM: Emerging markets

FC, FX: Foreign currency

FDI: Foreign direct investment

MAS: Monetary Authority of Singapore

NEER: Nominal effective exchange rate

RBI: Reserve Bank of India

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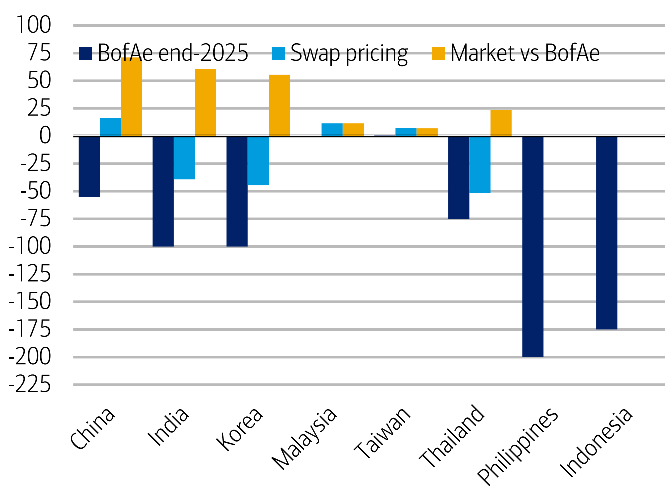
Rate-cut pricing to draw initial debt inflows...

Most CBs in the region have decisively marked an end to tightening cycle now but are maintaining hawkish rhetoric to hedge risk of inflation moving higher again. That shift in outlook has been incorporated in lower money-market yields from the peak across many markets, including Indonesia, Malaysia and India. However, the spread of money-market rates over policy rates in many markets remains elevated compared to historical levels.

We compare current market expectations, implied by swap markets, with BofA economist projections of rate-cuts over the next two-years. Indonesia stands out as the top candidates for a deep cutting cycle of 7-8 cuts (175-200bps) compared with bond yields implied pricing of around two-cuts vs front-end bills. That would likely be accompanied with easier liquidity conditions due to lower bill issuance and lead to compression in the front-end spreads as well.

Exhibit 1: Market wary of pricing rate-cuts on hawkish CB guidance
BofA rate cuts projection by end-2025 vs swap implied pricing (bps)



Source: BofA Global Research, Bloomberg

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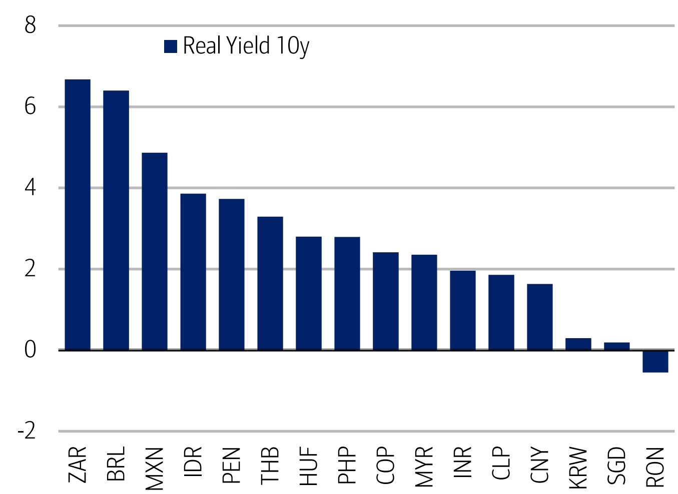
Exhibit 2: Gradual disinflation across EMs has improved the real-yields
Real yield on 10y bonds over current inflation



Source: BofA Global Research, Bloomberg

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In terms of timing, Thailand has garnered more interest and priced bulk of the cuts that we expect in this cycle. Given the weak growth and inflation in Thailand, any spikes on rates would likely be received in the near-term as risks are tilted towards markets pricing earlier and faster cuts. Curve may steepen later in 3Q once the easing is partly delivered and well-priced, and focus shifts towards supply for next FY.

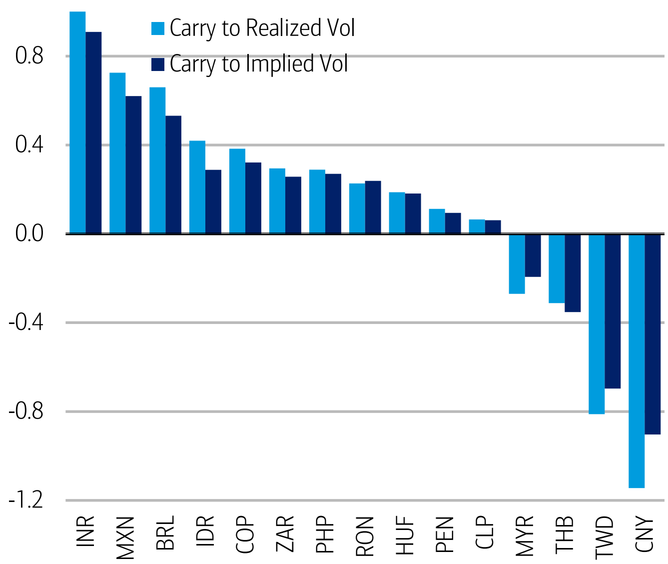
...into markets with high real yields

Real-yields in Indonesia and Thailand stands out while Malaysia and India are close behind (See Exhibit 2), which bodes well for comfort on duration exposure in these markets. With the exception of Thailand, the others have been constrained by USD strength which has necessitated keeping yield-buffer to attract flows. Further bonds rally and foreign flows into these markets would be more directly linked to Fed cuts materializing.

Real-yields in most markets have gone higher over the last year due to disinflation, while fiscal risks have reduced due to steady fiscal consolidation, except in Thailand. Malaysia's low inflation also provides some room to absorb the impact of the impending subsidy rationalization this year.

Exhibit 3: High-yielders remain attractive for carry positions but rest of Asia screens as a funder for other EMs

Carry-to-volatility of 2y bond yields over FX volatility (3m tenor)



Source: BofA Global Research, Bloomberg

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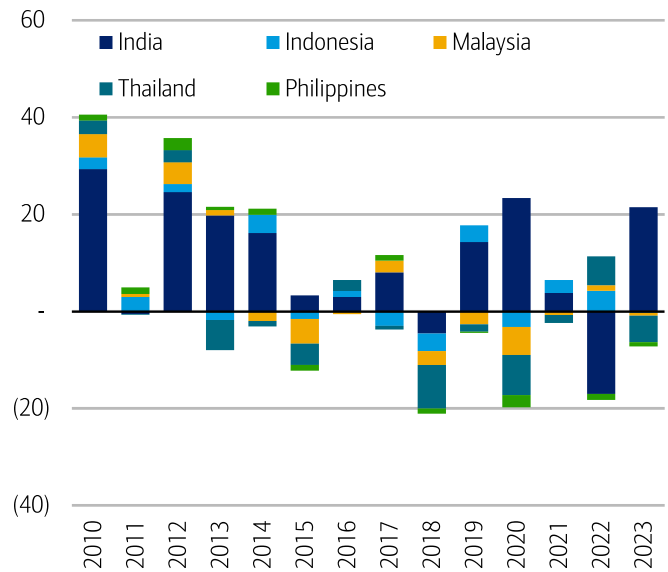
Exhibit 4: Equity flows may become more relevant for Indonesia

Equity flows across countries (USD Bn)



Source: BofA Global Research, Bloomberg

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...carry flows for high-yielders to stay longer

Carry buffer remains relatively thin vs history but high-yielders are still better placed vs rest. But, with CBs in Indonesia following the Fed on cuts, the carry pick-up is likely to remain limited. That would entail a trade-off between FX appreciation and lower rates. Weaker growth could then have a larger impact on FX if CBs turn more dovish, further removing the yield pick-up.

Other markets like Malaysia and Thailand would remain negative carry well into and possibly throughout the Fed cutting cycle. Even with our forecast of three cuts in the US this year, these markets would have little to offer to carry-seeking flows (See Exhibit 3Exhibit 3.

... along with one-off Index composition changes

This year is also going to see major index constituent changes for GBI-EM (Government bond index – emerging markets) with the addition of India bonds from June. Malaysia and Thailand are likely to see their weights reduced by around 2% each to make room, while Indonesia may remain relatively intact near the ceiling of 10%. Our real-money survey indicates already underweight investor positions in these bonds, likely in anticipation of index changes but incremental flows become less likely for these markets

(See GEMs FI & FX Strategy Watch: Real Money Tracker – Rehabilitating underweight positions 11 March 2024).

Growth seeking flows may take longer

For most of ASEAN, equity portfolio flows have been less significant than debt flows. Indonesia has begun to see equity inflows this year in anticipation of pro-growth fiscal policies. Overall, flows have been negative for ASEAN region over the last few years (See Exhibit 4) but soft-landing in the US could be supportive of risk-sentiment and indirectly for regional FX.

FDI flows have been more significant and are broadly expected to improve. Indonesia and India's net FDI has dipped last year ahead of elections. On the other hand, Malaysia has seen significant increase in approvals while Philippines' government has accumulated large commitments, but it remains to be seen how much of these get materialized this year. Geopolitical risks around Philippines's boundary issues with China may impact investments and trade relations with China.

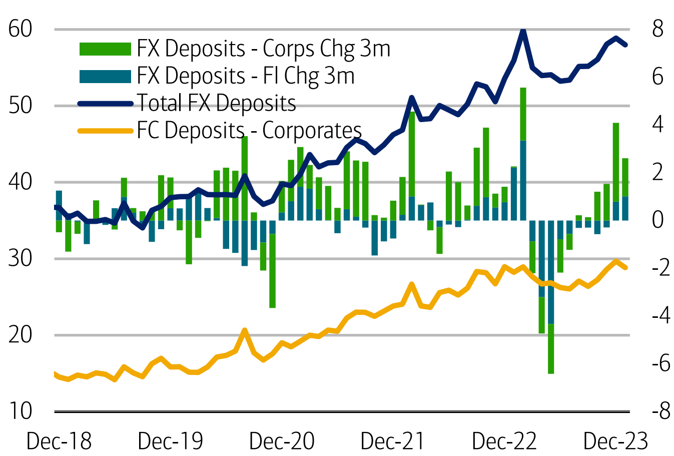
FX support from end of USD hoarding

Over the last few years, even countries with current account surplus, like Malaysia and at times Indonesia, suffered from low conversion. While positive yield pick-up helped some countries, it didn't prove sufficient to avoid hoarding of USD deposits by corporates. FX deposits remain at multi-year highs across the region and went-up further during 4Q'23 in Indonesia and Malaysia even as currencies appreciated (See Exhibit 6 and Exhibit 7). That shows that corporates were unconvinced on market pricing of Fed rate cuts and would rather wait for actual delivery of Fed's cutting cycle later this year before changing hedging behavior.

Fluctuations around corporate conversion has also increased FX volatility as effective current account balance worsened, which increased dependence on portfolio flows and US rates cycle. As Fed cuts come into picture, the medium-term trend would turn supportive but with still elevated level of USD rates, the dependence on Fed cycle would not completely fade that quickly.

Exhibit 5: FX deposits built-up again during 4Q23

Malaysia total FX deposits (USD Bn, lhs) and 3m rolling change split by corporates and financial institutions (FI) (USD Bn, rhs)



Source: BofA Global Research, Bloomberg, BNM

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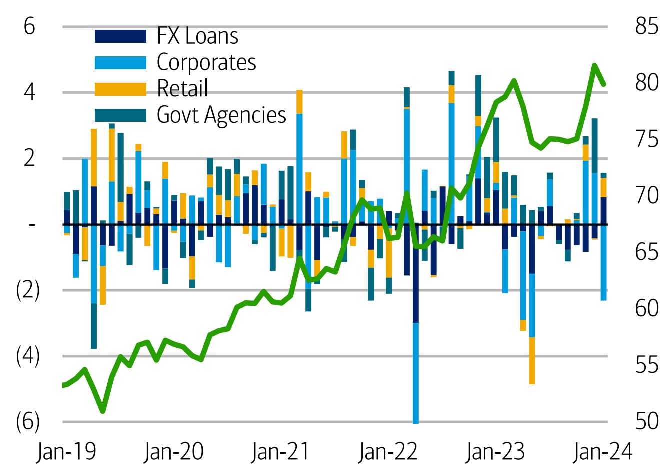
Exhibit 6: Indonesia FX deposits remain elevated but off from the peak

Indonesia monthly change in FX deposits by depositor and loans (USD Bn, lhs). Total stock of FX deposits (USD Bn, rhs)



Source: BofA Global Research, Bloomberg

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MYR and THB remain more exposed to capital flight or lower hedging due to negative carry. Indonesia saw widespread conversion deficit even as the government and BI solved the repatriation issue to a large extent. Philippines has seen similar surge in FX deposits over 2022-23 but the banking system flows from government's offshore funding, including bonds and ODA (official development assistance) loans don't suffer from conversion issue and have been crucial in funding the current account deficit. That would continue to provide a cushion for Philippines this year but its ascent to the upper-middle income status from 2025 would reduce this support.

But some may need to rebuild reserves buffer

Central banks which defended their currencies have either lost spot reserves or accumulated short forward positions and FX liabilities. Malaysia and Indonesia have built up significant short forward books of USD 24Bn and USD 12Bn respectively. These would be unwound as FX appreciates and would slow the pace of appreciation.

BSP, BoT and MAS have long forward positions and have worried more about avoiding overvaluation to strike a better external balance. These would be better placed but given the current account deficit, heavy reliance on debt funding and relatively lower reserves, BSP may still be well-advised to continue building reserves buffer.

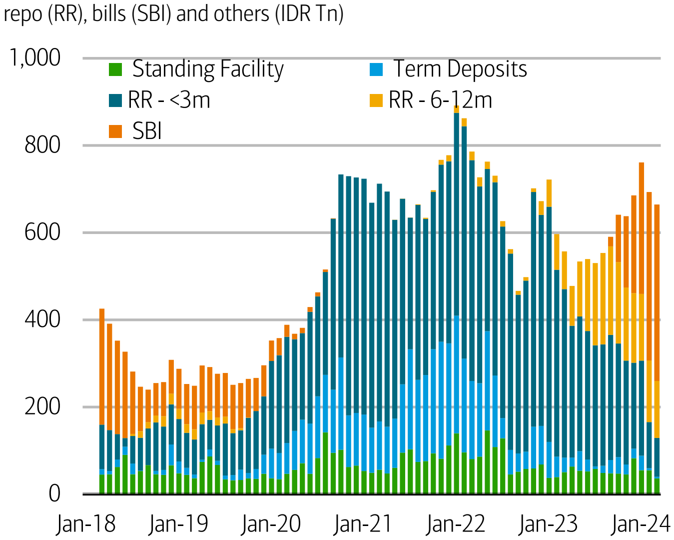
Country themes

Indonesia

Indonesia remains most directly linked to US rates and USD cycle and that may continue to weigh on IDR's near-term outlook. Seasonal imports during festival period and later dividend payments around April-May would remain near-term themes for IDR. Around mid-year, clarity on Fed policy outlook and key policies of the incoming administration could help provide a positive trigger. Until then, IDR would likely need more active management by BI. DNDF book appears to be cleaner now, providing room to keep USDIDR contained below 16,000 level withing a broader range of 15,500-16,000/USD.

We expect bonds to stay range-bound in a wait-and-watch mode until 2Q. The market would await clarity on BI's rate-cutting cycle and on the fiscal deficit trajectory under the new government. Longer-end has recently been supported by BI purchases which has flattened the curve (See Exhibit 9). We see more value in 5y IndoGBs as front-end yields have room to move lower on easing expectations and reduction of premium in the bill yields over policy rate.

Exhibit 7: BI has tightened liquidity with longer tenor operations
Indonesia monetary operations for liquidity absorption including reverse repo (RR), bills (SBI) and others (IDR Tn)



Source: BofA Global Research, Bloomberg

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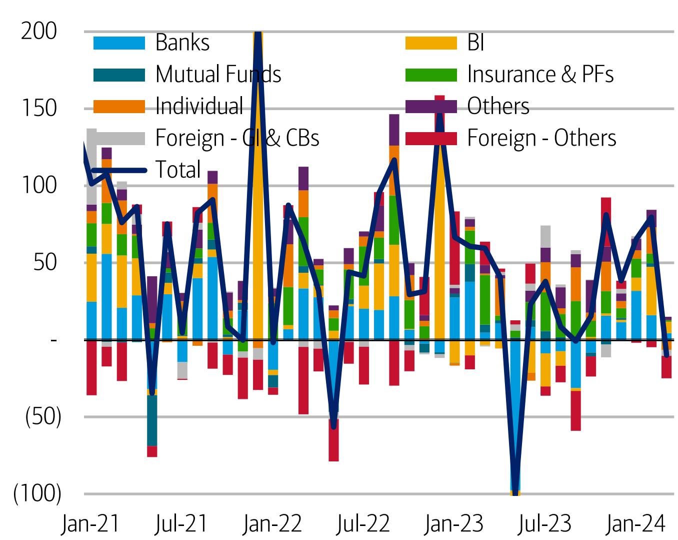
Exhibit 8: BI purchases have picked-up this year
IndoGB monthly ownership changes (IDR Tn)



Source: BofA Global Research, Bloomberg

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Malaysia

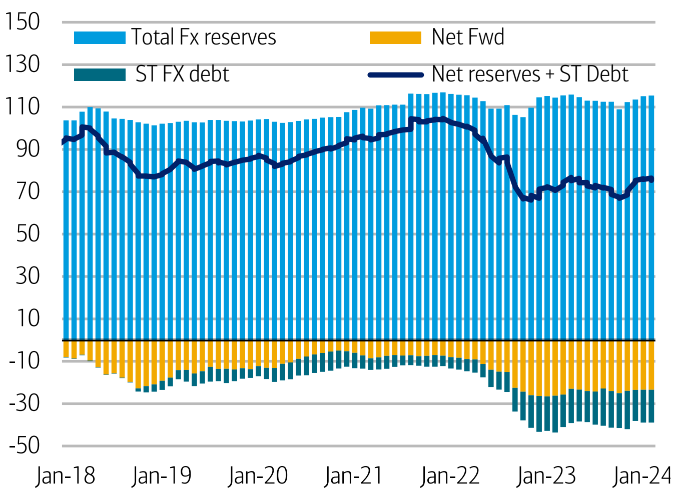
We expect MYR to remain stable in the near-term within 4.7-4.8/USD range due to BNM's efforts and support from GLICs (Government linked investment companies).

Political pressure would likely sustain until at least the current parliament session which ends on 27th March. MYR's under-valuation supports further improvement in the FDI flows and a broader turn-around in exports could help improve the outlook for MYR. However, in the near-term, negative carry on MYR and need for BNM to unwind the short forward book could remain drags on MYR.

As BNM stabilizes MYR, the pressure will be felt in the front-end rates which would price risk-premium for chances of tighter liquidity and lower chances of rate cuts. The other theme for Malaysia has been strong AUM growth of EPF and a larger proportion of net contributions being invested in domestic assets (See Exhibit 11). This would likely remain an anchor for the longer-end of the curve. Along with weaker growth recently, that may keep curve historically flat in the long-end as seen recently.

Exhibit 9: Malaysia needs to rebuild FX reserves and unwind short forward sales

Malaysia FX reserves in spot and net reserves adjusted for forward book (Fwd) and short-term FX liabilities (USD Bn)



Source: BofA Global Research, Bloomberg

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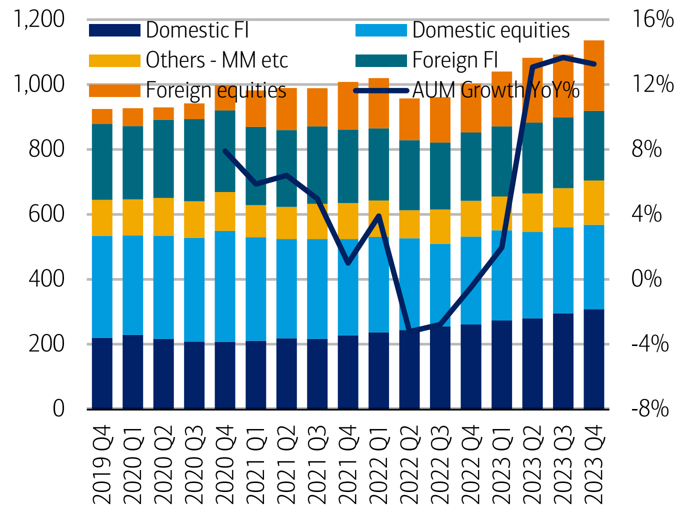
Exhibit 10: Strong asset growth and higher allocation to domestic assets by EPF has supported long-end

EPF asset allocation (MYR Bn, lhs) and growth year-on -year (YoY, %, rhs)



Source: BofA Global Research, Bloomberg

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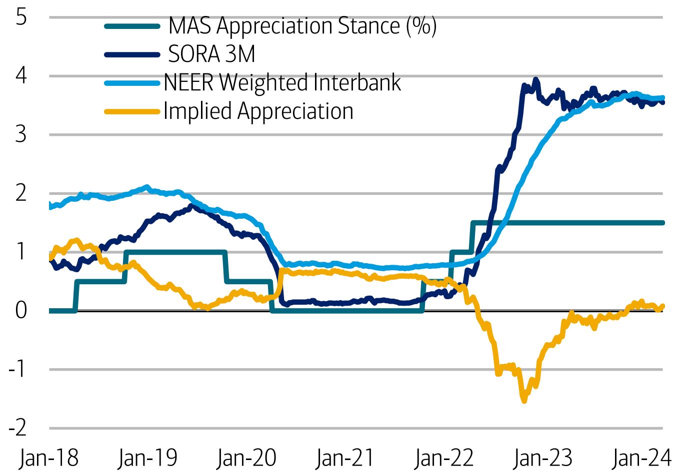
Singapore

Given the steady policy backdrop and reduced chances of a move either way, our strategy views remain focused on earning carry in Singapore FX and rates. The SGD NEER has moved up slightly to 1.8% from earlier range of 1.4-1.7% above mid, on our model. While that leaves limited room for further appreciation before it hits the top of the band, it still provides steady carry from slope with low volatility. We expect SGD NEER to trade in the upper half of the band and any dips towards 1-1.5% above mid would be short lived.

Basket yields on SGD NEER are in line with Singapore overnight rate average (SORA) 1-year, which indicates that front-end rates remain well above those implied by uncovered interest-rate parity (See Exhibit 12). Higher implied yields on SGD forwards make long SGD NEER an attractive carry position compared with its volatility. Other appealing ways to express SGD appreciation views could be against lower-yielding currencies like CNH, MYR or THB.

We expect SORA front-end rates spread vs. US rates to compress as SGD fixing would remain sticky until inflation concerns ease further. SORA fixings have been steady and monthly average has recently moved back up to 3.69% from 3.53% earlier. Any liquidity injections by MAS due to FX accretion continue to be sterilized via bills issuance and other money-market operations (See Exhibit 13). That reflects the MAS's comfort with the current policy settings as being sufficiently tight and intention to not let lower rates ease financial conditions prematurely. We expect SORA to remain relatively sticky in the front-end and any easing on Singapore rates or global rates to be priced-in the belly of the curve. That makes the front-end rates biased to stay higher and curve flatteners appealing for positive carry.

Exhibit 11: Implied appreciation in SGD rates flat on interest rate parity
SGD NEER policy slope stance and implied appreciation using SORA vs NEER weighted average rate (%)



Source: BofA Global Research, Bloomberg

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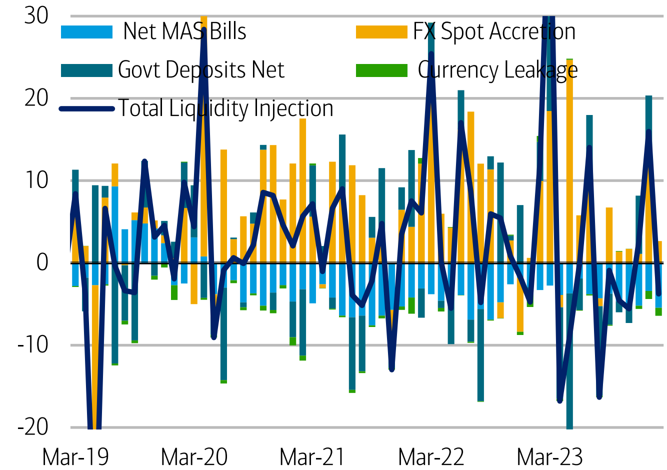
Exhibit 12: Liquidity injection from FX accretion absorbed by bills
Liquidity injection (SGD Bn) due to various factors – MAS bill issuance, government deposits, FX intervention and currency leakage



Source: BofA Global Research, Bloomberg

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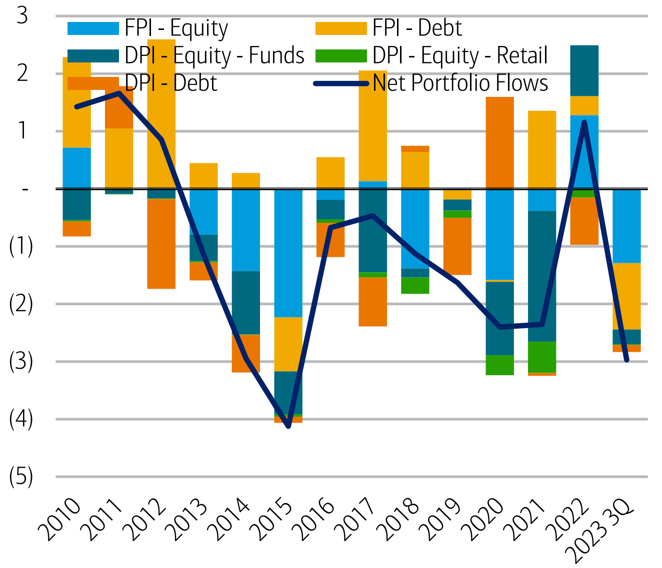
Thailand

THB is likely to trade with a high beta to USD moves due to low buffer from current account along with negative carry. Equity outflows have stabilized and bearish positioning appears less stretched now. But with fiscal stimulus looking less likely, the pressure on BoT to cut rates would keep THB under pressure. Additionally, THB remains most vulnerable in the region to higher freight costs which could be impacted by global geo-political risks.

While foreign outflows tend to have a more direct impact on THB, domestic outward portfolio flows may remain in focus. Higher hedging costs make it more prohibitive to maintain a higher hedge ratio on these products, which has likely increased the impact on FX over time. Direct retail equity outflows remain limited as a proportion of total equity flows but would become more significant over time.

On the rates front, the market would continue to price at least 2 rate cuts and extend duration until growth bottoms-out. Further cuts may be priced closer to the delivery of the first-cut in June meeting. Bonds are likely to remain well-supported until 3Q into next FY issuance announcement in September, which could bring back focus on supply for next year at a time when the positioning may be already bullish and the cuts would been well-priced. That could form the backdrop for curve steepening later in the year.

Exhibit 13: Structural capital outflows continue in Thailand
Thailand portfolio flows (% of GDP) categorized by foreign (FPI) and domestic outbound flows (DPI) across debt and equity



Source: BofA Global Research, Bloomberg

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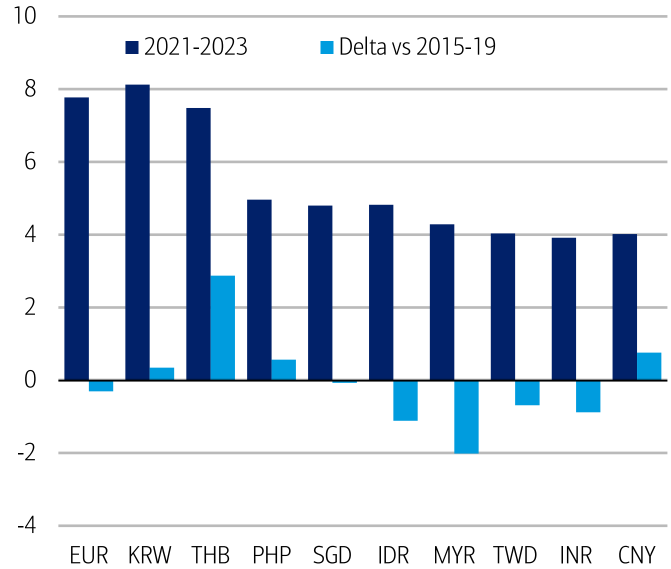
Exhibit 14: THB remains more volatile compared to pre-covid period
Realized FX volatility during 2021-23 and delta vs pre-covid



Source: BofA Global Research, Bloomberg

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Philippines

PHP's fundamental outlook remains a concern but the improvement over 2023 has provided comfort to the market. However, PHP remains dependent on government's funding flows and BSP's reaction function which determines how these flows impact the PHP. Partially absorbing the flows into reserves to fund future liability, would be prudent while also keeping PHP stable. We expect PHP to remain range-bound and driven by these flows and broader USD in the near-term.

Continued fiscal consolidation with a focus on fiscal reforms bodes well for medium-term duration exposure in Philippines, along with the scope for a deep rate-cutting cycle beginning around middle of this year. In the near term, BSP may keep the front end elevated with bills issuance, thus limiting room for front-end bonds to rally further.

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