Emerging Insight

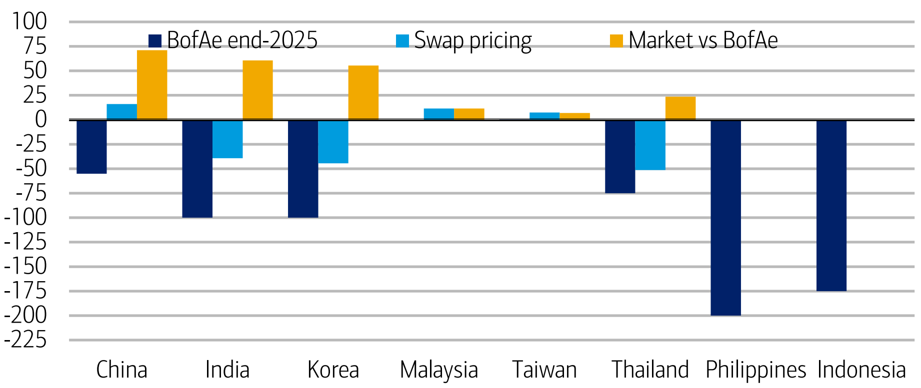
ASEAN – Forming-up for the turn

Key takeaways

- Fed cycle turnaround mid-year may ease external pressure on ASEAN FX. Domestic dynamics to determine relative beneficiaries.
- High yielders, nominal and real, to get more debt flows. FX to see better conversion against reserves build-up in MYR & IDR.
- Near-term received bias on Thai rates vs paid SGD and MYR. Rotation to Indonesia bonds mid-year for deeper cuts and carry.

By Abhay Gupta

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



Source: BofA Global Research, Bloomberg

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ASEAN in Focus

EM currencies are forming-up for the Fed cutting cycle around the middle of the year, which is expected to ease the pressure. Within a broader bullish backdrop, the domestic dynamics would determine relative beneficiaries and timing of moves across markets. In the near term, Thai rates would trade with received bias vs paid SGD and MYR front-end. Around mid-year, high-yielders, Indonesia and Philippines, may attract more debt flows on a deeper cutting cycle and carry. Within FX, SGD offers low-volatility carry relative to low-yielders like CNH and MYR. We expect THB volatility to remain high for now but may decline towards end of the year as the current account buffer improves. IDR would continue to need more active management until the Fed cuts.

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GEM Fixed Income Strategy & Economics
Global

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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

EM: Emerging markets

FC, FX: Foreign currency

FDI: Foreign direct investment

MAS: Monetary Authority of Singapore

NEER: Nominal effective exchange rate

ASEAN – Forming up for the turn

EM currencies are forming-up for the beginning of Fed cutting cycle around the middle of this year, which is expected to ease the pressure. While that may mark a broader medium-term rally in rates and FX, 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 that could limit the extent of rally.

In the near term, we expect Thai rates to trade with received bias vs paid SGD and MYR front-end. Around mid-year, Fed cuts could allow high-yielders, Indonesia and Philippines 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 the 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 toward year-end as the current account buffer improves. IDR would continue to need more active management until the Fed cycle begins.

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 and Philippines stand out as the top candidates for a deep cutting cycle of seven to eight 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 front-end spreads as well.

Exhibit 1: 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)

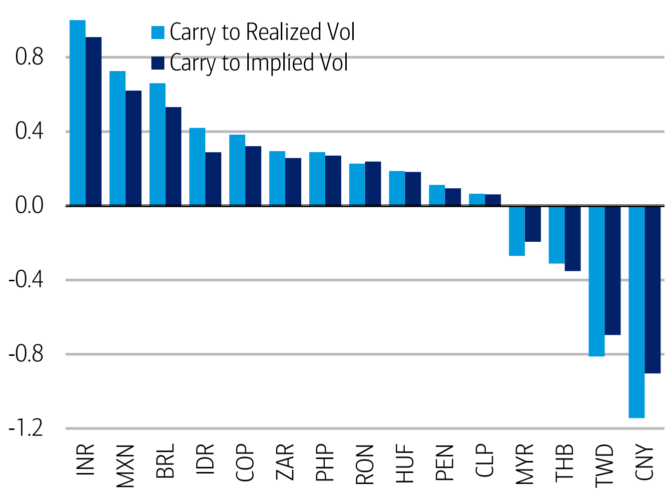

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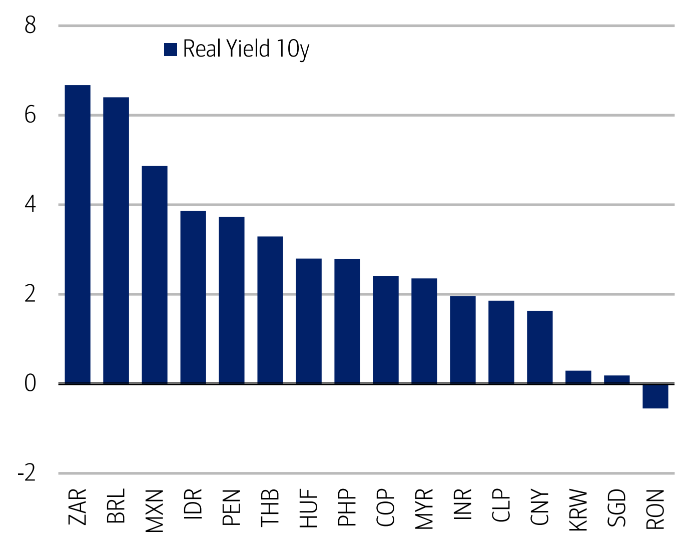
Exhibit 2: Gradual disinflation across EMs has improved the real-yields

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 in the bulk of the cuts that we expect in this cycle. Given 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. The 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, Thailand and Philippines stand 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 a 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 impending subsidy rationalization this year.

…carry flows for high-yielders to stay longer

Carry buffer remains relatively thin vs history, but high-yielders are still better placed vs the rest. But with CBs in Indonesia and Philippines 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 1).

… 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 at close to 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.

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 the ASEAN region over the last few years but a 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 dipped last year ahead of elections. On the other hand, Malaysia has seen a significant increase in approvals while Philippines' government has accumulated large commitments, but it remains to be seen how much materializes this year. Geopolitical risks from Philippines's boundary issues with China may impact investments and trade relations with China.

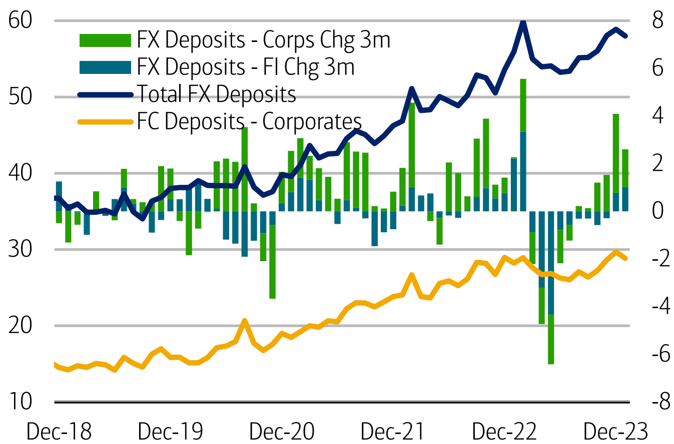
FX support from end of USD hoarding

Over the last few years, even countries with current account surpluses, 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 4 and Exhibit 5). That shows that corporates were unconvinced on market pricing of Fed rate cuts and would rather wait for actual delivery of the Fed's cutting cycle later this year before changing hedging behavior.

Fluctuations with corporate conversion has also increased FX volatility as the 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 a still elevated level of USD rates, the dependence on the Fed cycle would not completely fade that quickly.

Exhibit 3: 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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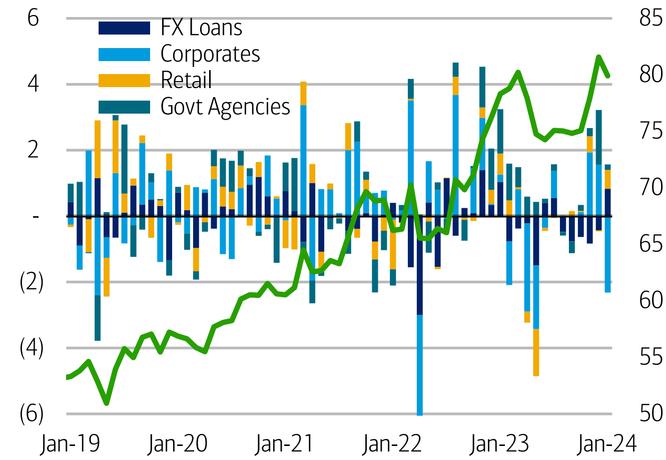
Exhibit 4: Indonesia FX deposits remain elevated but off from the peak
Indonesia monthly change in FX deposits by depositor and loans (USD Bn, lhs). Total stock of FX deposits (USD Bn, rhs)



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 a widespread conversion deficit even as the government and BI solved the repatriation issue to a large extent. Philippines' also had a similar surge in FX deposits over 2022-23 but banking system flows from the government's offshore funding, including bonds and ODA (official development assistance) loans don't suffer from the 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 upper-middle income status from 2025 would reduce this support.

But some may need to rebuild reserves buffer

Central banks that 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.

News and Views

Brazil: Economic activity index started the year on a positive note

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Economic Activity (IBC-Br Index) increased 0.60% in January, after 0.82% momsa in December, according to the Brazilian Central Bank (BCB). The number was in line with market consensus, although above our forecast of 0.3% momsa. In yoy terms, IBC-Br increased 3.5% yoy, accelerating from 1.3% yoy in the previous month. With this read, the 1Q24 started on a positive note for activity. The IBC-Br statistical carry-over for 2024 is at 1.30%.

- **To follow:** Although confidence indicators brought mixed signals in January, three out of the five indicators we follow registered increases. Looking ahead, sentiment seems more negative, as only one of them improved at the margin in February.

Brazil: IGP-10 posted deflation of 0.17% mom in March

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IGP-10 prices declined 0.17% mom in March (vs -0.65% in February), above market expectations of -0.30% mom. In annual terms, prices accumulated a decline of -4.1% yoy, from -3.8% yoy previously. Wholesale inflation remains the main downward pressure (-0.40% mom), as industrial prices deflation continues, despite agricultural prices acceleration. On the consumer side, it rose 0.48% mom, with emphasis on the food inflation – mainly due to perishable items. Meanwhile, construction inflation increased 0.27% mom, given services and materials price acceleration.

- **To follow:** The downward pressure coming from wholesale prices should reach consumer inflation in the coming months.

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