September 17, 2024

ASEAN's Breakout, Mexico's Adjustment And China's Slump

In This Report

Investors have been primarily focused on the U.S. growth outlook and the Federal Reserve's policy decisions. In the EM space, there have been important shifts in market trends among individual EM bourses. Notably, some smaller Asian markets, after languishing for years, have decisively broken out above their declining long-term trends. Meanwhile, Mexican stocks, star performers in recent years within the EM space, have weakened sharply, significantly underperforming the EM benchmark. In addition, the latest macroeconomic data suggest that China's growth slump has continued to worsen.

ASEAN: Breaking Out

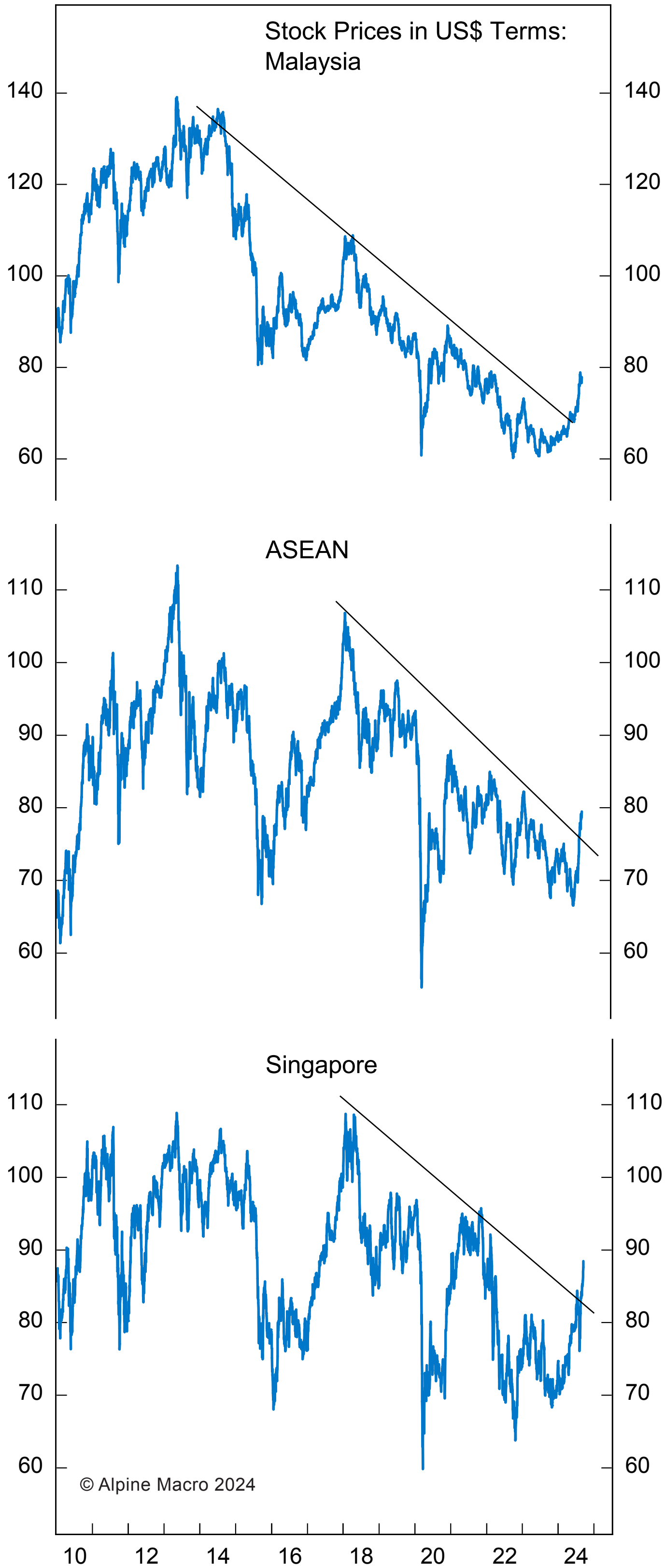
In a previous report, we discussed the breakout of Malaysian stocks,[1] and this strong momentum is now broadening to neighboring markets such as Thailand, Indonesia, and the Philippines. Stocks from the Association of Southeast Asian Nations (ASEAN), as measured by the MSCI EM ASEAN Index, have decisively moved above their long-term declining trendline (**Chart 1**). Even Singapore, another ASEAN country with a drastically different economic structure and development level compared to other member states, has followed a similar trajectory in stock prices recently.

The synchronized nature of these market moves, despite vastly different economic fundamentals, is intriguing. There could be some short-term macro factors at play. For example, the currencies of these countries have rallied sharply over the past several weeks amid expectations of the Fed easing (**Chart 2**). Domestic interest rates have also been declining in line with falling U.S. rates, benefiting interest-rate-sensitive equities in these markets.

More importantly, the synchronized upswing in stock prices across these countries likely reflects a longer-term shift, driven by shared economic and geopolitical factors. Similar to Malaysia, these economies have stagnated since the Asian Financial Crisis of the late 1990s, overshadowed by China's rapid rise in manufacturing. More recently, as some of the most open economies globally, their manufacturing sectors are being revitalized by the reshuffling of the global supply chain. Singapore, as the region's key hub, has similarly benefited from these pivotal forces.

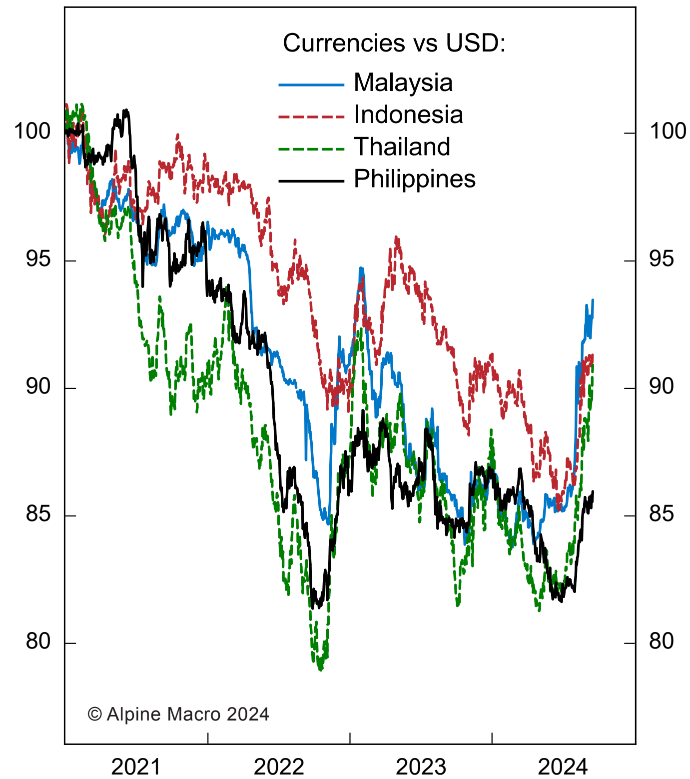
1 Alpine Macro *EM & China Strategy* "Buy Malaysia: Riding On The Tech Boom" (August 20, 2024).

Chart 1 ASEAN: Synchronized Stock Market Breakout...



Note: All series are rebased to Jan 2018=100; source: MSCI

Chart 2 ... And Currency Appreciation

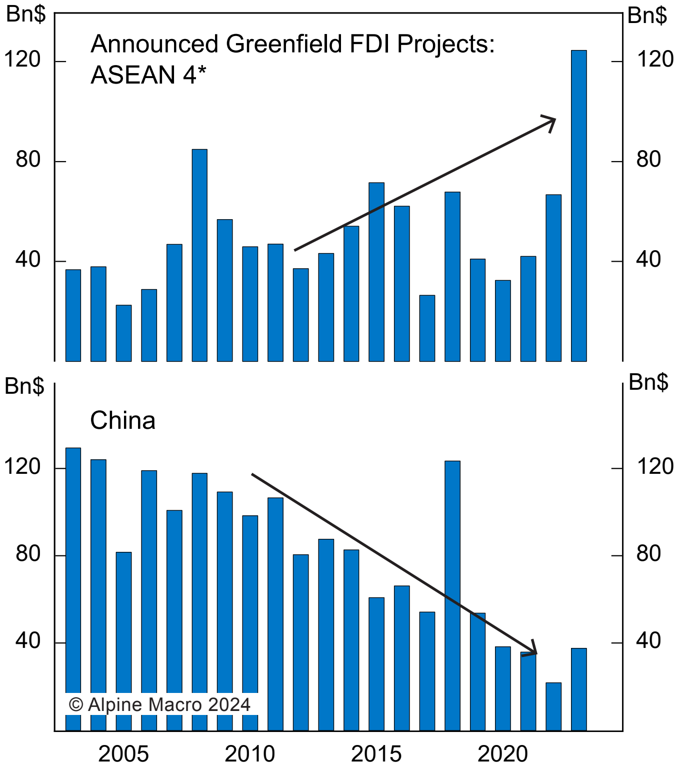


Note: Upward line represents FX appreciation; all series are rebased to Jan 2021=100

- Greenfield foreign investments in Malaysia, Indonesia, Thailand, and the Philippines have surged to all-time highs, while FDI flows to China have dwindled (Chart 3). Historically, stock prices in these countries have been closely correlated with long-term capital spending cycles (Chart 4). The stock market breakout could be an early signal of a forthcoming investment boom.

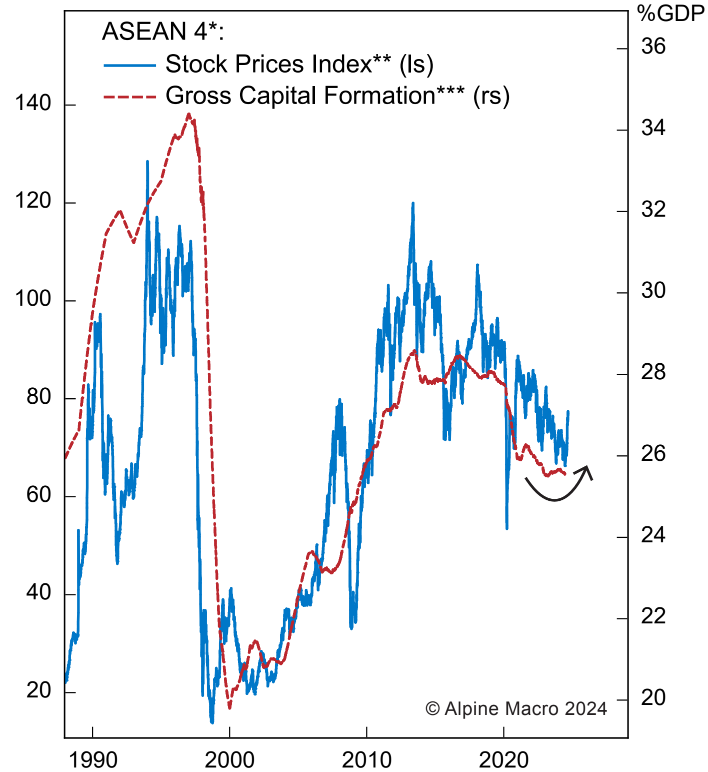
- The upswing in the investment cycle is boosting economic growth in these nations. Manufacturing PMI numbers in recent years have consistently outperformed pre-COVID averages, and unemployment rates have fallen to multi-decade lows. Indeed, these economies have been some of the fastest-growing in recent years (Chart 5).

Chart 3 ASEAN: Booming FDI Inflows



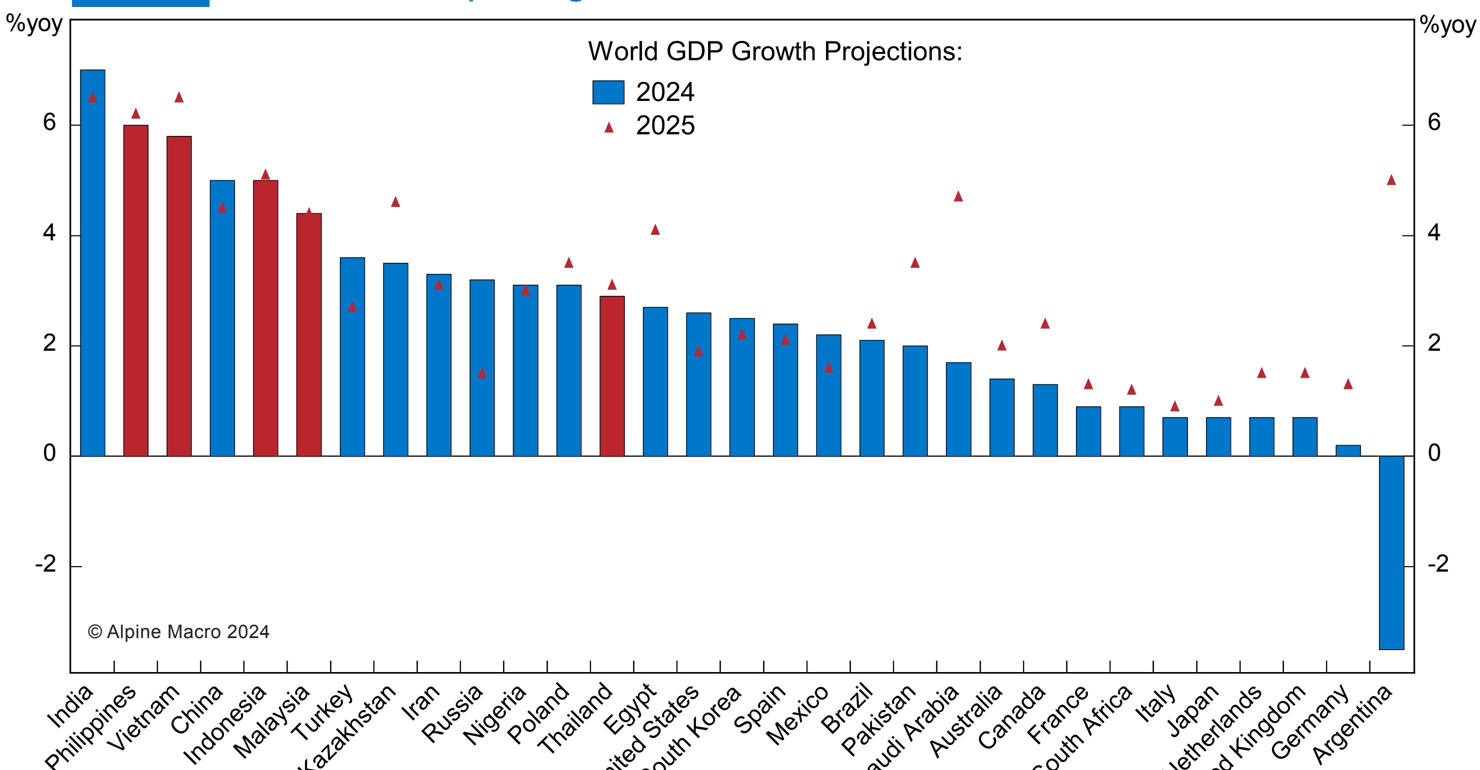
*Aggregate of Indonesia, Malaysia, Thailand and the Philippines
Source: UNCTAD

Chart 4 An Upturn In Capital Spending Cycle



*Includes Indonesia, Malaysia, Thailand and the Philippines
**Market cap-weighted of the four countries; rebased to Jan 1995=100
***Aggregate capital formation divided by aggregate GDP

Chart 5 ASEAN Growth: Supercharged

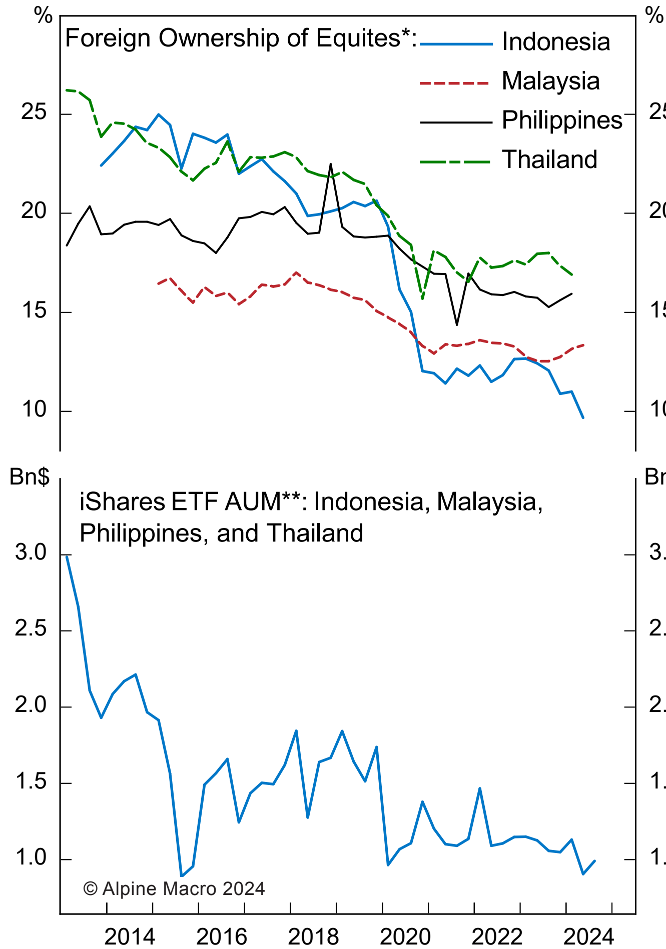


Source: IMF World Economic Outlook Update, July 2024

- From a global investor's perspective, stocks in these countries have long been overlooked due to prolonged economic stagnation and poor market performance. Foreign equity holdings in these markets have steadily declined, and major ETFs tracking these equities have seen consistent outflows (Chart 6). Equity valuations have become depressed, reflecting prevailing pessimism. The MSCI EM ASEAN Index, which includes Malaysian, Indonesian, Thai, and Filipino stocks, is trading at 14 times forward earnings, below historical norms. This is roughly in line with their EM peers, excluding the deeply depressed Chinese market, and is significantly lower than DM stocks.

Bottom Line: Last month we recommended long positions in Malaysian stocks, and we now see a similar investment case for the broader ASEAN markets, driven by common economic and geopolitical factors. This week, we are initiating long positions in these markets, as measured by the MSCI EM ASEAN Index, currency unhedged.

Chart 6 Foreign Investors Have Long Overlooked ASEAN Stocks



*Source: National Sources
**Source: Bloomberg Finance L.P.

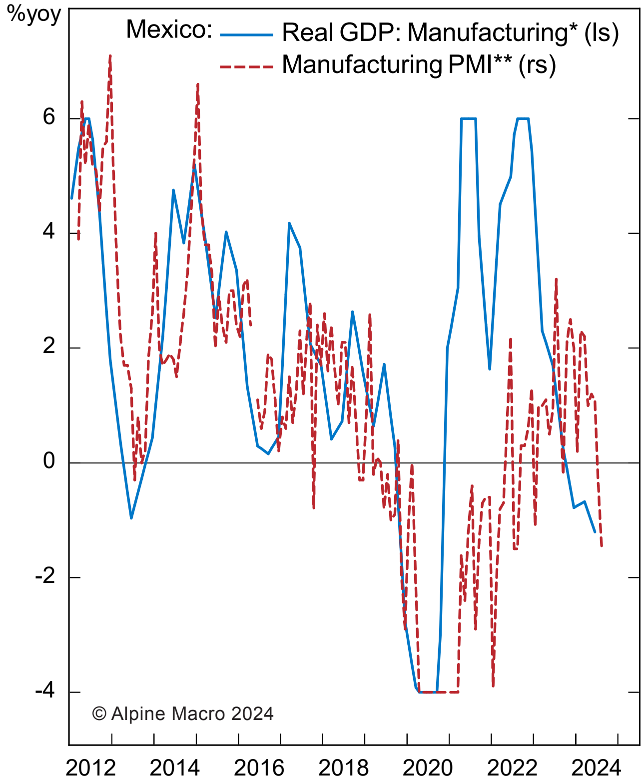
Mexico: The Adjustment Has Further To Go

Mexican stocks have been the worst performers within EM so far this year, falling by almost 20% year-to-date in U.S. dollar terms. The majority of this decline is due to currency depreciation. The Mexican peso (MXN) has depreciated by over 16% against the dollar this year, faring even worse than the inflation-stricken Turkish lira. We have maintained a very bearish view on the MXN and have been underweight on Mexican equities within EM, and these views have played out.

The case against the MXN is straightforward. The massive rally in the MXN from 2020 until early this year, driven by the "near-shoring" boom, pushed the currency to extremely overvalued levels. This, coupled with the significant increase in Mexico's minimum wages since President Andrés Manuel López Obrador (AMLO) took office, has fundamentally undermined Mexico's competitiveness as a "near-shoring" destination.[2]

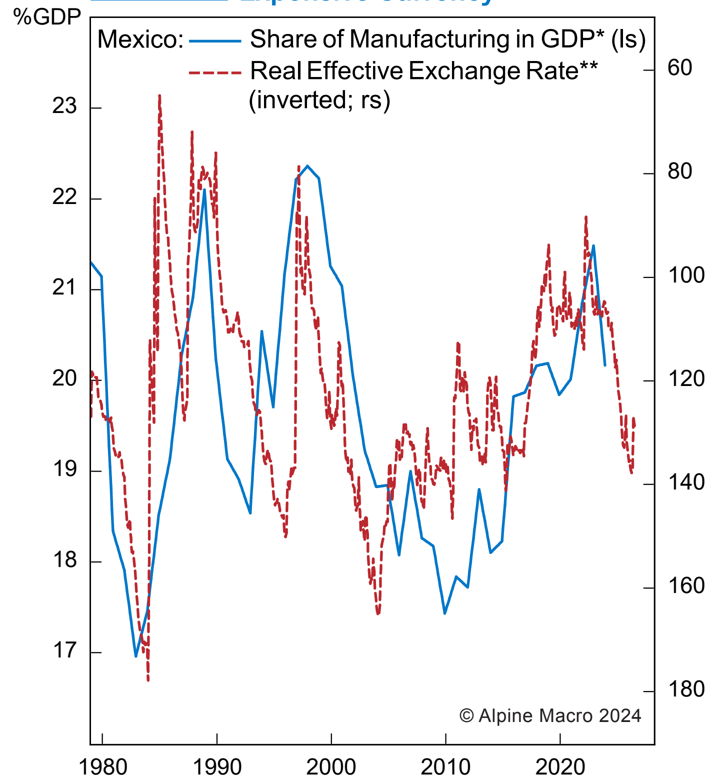
2 Alpine Macro *EM & China Strategy* "Mexico: How Far Can 'Near-Shoring' Go?" (September 19, 2023) and "Post-Elections: Back To Basics" (June 11, 2024).

Chart 7 Mexico: Manufacturing GDP Contraction...



*Truncated at +6/-4
**Truncated at 46; source: S&P Global

Chart 8 ... Under The Heavy Weight Of An Expensive Currency



*Shown as 12-month moving average; source: World Bank
**Advanced by 24 months; source: BIS

Without a dramatic improvement in labor productivity or aggressive wage cuts, currency depreciation is the only way to restore competitiveness in the manufacturing sector. We believe this adjustment process is not over.

- Economically, the negative effects of a strong MXN have become clear. Mexico's manufacturing GDP has contracted for three consecutive quarters, and the manufacturing PMI continues to decelerate, signaling further weakness (Chart 7). Manufacturing GDP, historically inversely correlated with the country's real effective exchange rate, has started to decline as a share of the overall economy (Chart 8).

- From a financial market point of view, despite the sharp depreciation, the MXN remains well above our fair-value assessment and is still one of the most expensive currencies in EM (Chart 9). Mexican stocks are not as expensive, and their relative bear market against the broader EM has become advanced, as shown in Chart 10. However, financial markets are often subject to long-term mean reversion, and once set in motion, they tend to overshoot in the opposite direction. Therefore, it is likely too early to upgrade Mexican equities within EM.

The recent weakness in the MXN can also be attributed to external and domestic political factors:

Chart 9 The MXN Remains Overvalued

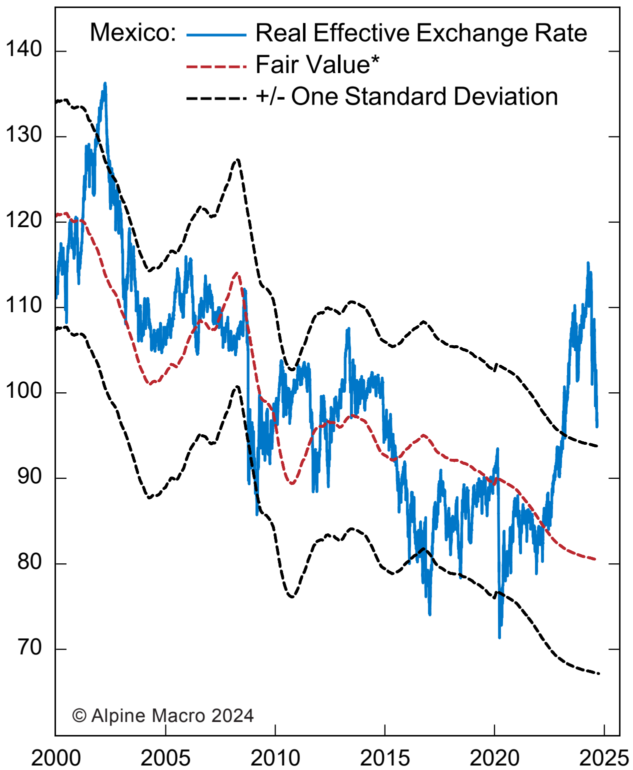
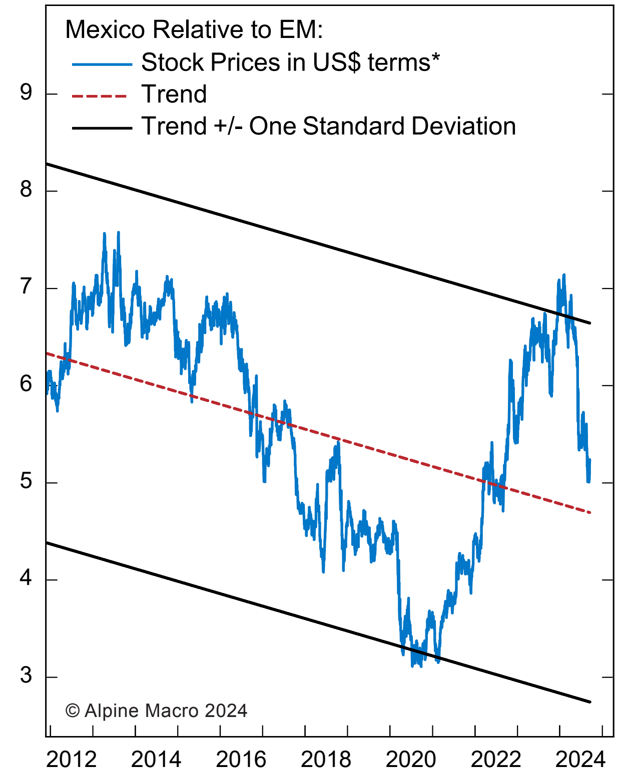


Chart 10 Stay Underweight Mexican Stocks In EM



- Domestically, outgoing President AMLO and President-elect Claudia Sheinbaum are pushing for controversial judicial reforms, including the popular election of judges. Critics argue that these reforms could undermine judicial independence and the rule of law, and therefore investors' confidence in the country.

- Externally, another major risk for Mexico, particularly its exchange rate, is the potential for more protectionist trade policies in the U.S. following the upcoming presidential election. Mexico is highly vulnerable to a "Trump 2.0" scenario due to its heavy reliance on the U.S. market.[3]

In the short term, the performance of the MXN may fluctuate depending on developments on these fronts. However, the economic imperative for a weaker currency is likely to outweigh these political and geopolitical factors. The broader trajectory of the MXN is downward.

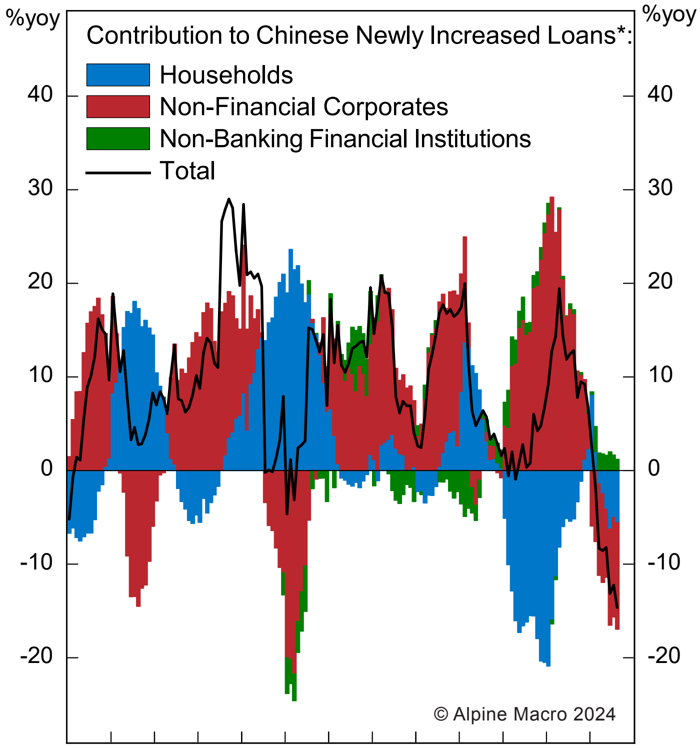
China: The Slow-Motion Implosion Continues

Last week's data release from China remains bleak, with almost all major indicators surprising to the downside. The only bright spot was slightly stronger-than-expected exports, but domestic demand is excessively weak.[4] The real estate sector has also

3 Alpine Macro *EM & China Strategy* "Trump 2.0: Impact On China And EM" (July 30, 2024).

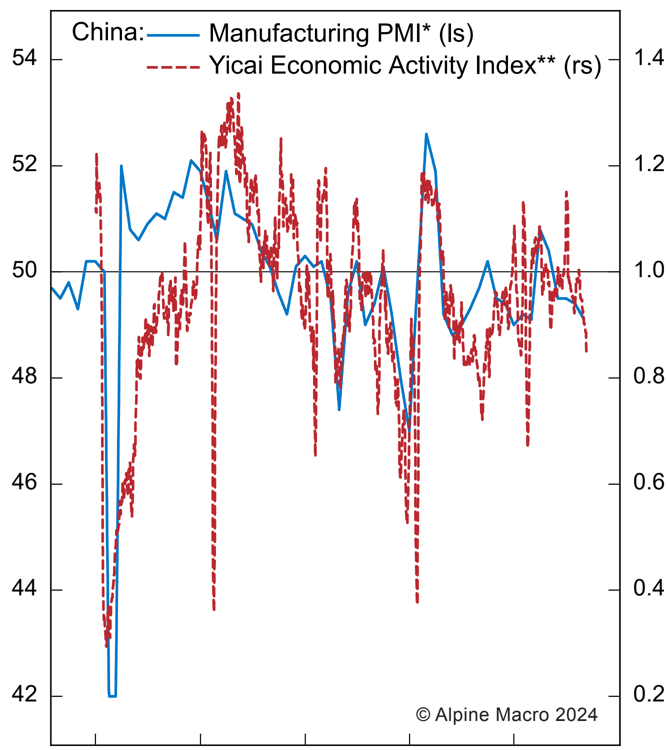
4 Alpine Macro *EM & China Strategy* "Is China In A Slow-Motion Implosion?" (August 27, 2024).

Chart 11 China: Loan Demand Has Vanished



*Calculation based on 12-month moving sum

Chart 12 China: Growth Outlook Remains Downbeat



*Truncated at 42; source: China Federation of Logistics & Purchasing
**Source: Yicai Research Institute

continued to contract from its already extremely depressed level, with no sign of improvement, despite the new rescue measures announced in May. The unfavorable base effect may have exaggerated the weakness in the year-over-year growth rates of these indicators, but there is no question that the economy is in a severe downturn.

The recent money and credit figures are particularly concerning. Narrow money supply contracted by 7.3% in August compared to a year ago, marking yet another record low annual growth rate, while credit demand has essentially vanished. Chart 11 shows that new bank loans to both households and non-financial enterprises have contracted on an annualized basis – this synchronized contraction in loans across both sectors is unprecedented. It underscores a vicious feedback loop, which urgently calls for immediate government intervention.

Unfortunately, Beijing appears paralyzed and has not responded to any recent macroeconomic developments. There have been rumors of additional policy stimulus, but none of the expected measures have materialized. Instead, last week the government officially announced plans to raise the retirement age – a necessary long-term reform to address demographic and pension issues. However, in the near term, this move could further increase precautionary savings and dampen consumption demand.

Without immediate and forceful policy intervention, China's economic growth will likely continue to deteriorate, and deflation could deepen (Chart 12). China's GDP deflator has been below zero since Q2 last year, marking the longest deflationary period since the Asian Financial Crisis. At this pace, it seems almost impossible for the government to achieve its 5% growth target.

Turning to the stock market, our long position in Chinese A shares, established on February 20th, has been incurring losses, and we are closing this position to manage risk. We still believe that the market remains deeply depressed, which should help limit further downside potential. Some high-quality Chinese companies are trading at significant discounts compared to similar firms based in other countries, presenting interesting bottom-up opportunities.

From a macro point of view, however, Beijing's policy direction is highly unpredictable, making it difficult to foresee a catalyst that could push up the broader market. Our long position in overseas-listed Chinese stocks is still in the money, and we are maintaining the stop-point to protect profits.

Beijing's policy calendar suggests that any major policy moves may only occur towards the year-end, during the Politburo meeting and the Central Economic Work Conference. Stay tuned.

Housekeeping:

Our short positions on the Thai baht versus the Indonesian rupiah and the Malaysian ringgit, established on March 5th and August 20th respectively, have not performed as expected, resulting in a 2.4% and 1.3% loss. While we continue to view the Thai baht as the weaker currency among smaller Asian economies, the near-shoring investment boom benefiting the region and Thailand's strong external position have provided support for the THB. For now, we are closing these short positions and are moving to the sidelines.

Yan Wang, CFA
Chief Emerging Markets & China Strategist

Investment Recommendations

Strategic Positions (6 - 12 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Long Colombian 10-year Government Bond, Currency Unhedged	11/21/2023		12.0%	Long Colombian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long MSCI Greece Equity Index	11/21/2023		11.2%	Long MSCI Greece Equity Index in US$ terms; stop point at -10%.
Long Indian 10-year Government Bond, Currency Unhedged	06/04/2024		3.1%	Long Indian 10-year Government Bond, Currency Unhedged; stop point at -10%.
Long Malaysian Equities, Currency Unhedged	08/20/2024		2.2%	Long MSCI Malaysia Equity Index in US$ terms; stop point at -10%.
Long ASEAN Equities, Currency Unhedged	09/17/2024		-	Long MSCI EM ASEAN Index in US$ terms; stop point at -10%.

Tactical Investment Positions (3 - 6 months)				
Recommendations	**Open Date**	**Closing Date**	**Total P&L**	**Notes**
Short CZK/HUF	06/05/2023		4.4%	Short Czech Koruna versus Hungarian Forint; rolling stop point at -5%, or -3.8% from current level.
Short TWD/ A Basket of BRL, COP and CLP	11/28/2023		-0.8%	Short TWD versus A Basket of Latam Currencies (Equal-Weighted of BRL, COP and CLP); stop point at -10%.
Long CSI 300 Index	02/20/2024	09/16/2024	-5.8%	Long China A-share Index in US$ terms; position closed.
Long MSCI China Equity Index	02/20/2024		5.5%	Long MSCI China Equity Index in US$ terms; rolling stop point at -10%, or -3.8% from current level.
Short COP/CLP	03/05/2024		8.6%	Short Colombian Peso versus Chilean Peso; rolling stop point at -5%, or -4.7% from current level.
Short THB/IDR	03/05/2024	09/16/2024	-2.4%	Short Thai Baht versus Indonesian Rupiah; position closed.
Long MYR/THB	08/20/2024	09/16/2024	-1.3%	Long Malaysian Ringgit versus Thai Baht; position closed.

EM Equity Country Allocation				
Strong Overweight	**Overweight**	**Neutral**	**Underweight**	**Strong Underweight**
	Brazil Chile China Colombia Greece Malaysia South Africa	Indonesia Philippines India	South Korea Czech Republic Hungary Mexico Peru Poland Taiwan Thailand Turkey	

EM Equity Sector Allocation	
Strong Overweight	**Overweight**
	Energy Materials Health Care Consumer Discretionary
Neutral	
Communication Services Information Technology Financials	
Strong Underweight	**Underweight**
	Industrials Consumer Staples Utilities

EM Local-Currency Government Bond Allocation		
Overweight	**Neutral**	**Underweight**
Indonesia Peru Brazil Colombia Chile India	Poland Hungary South Korea Malaysia Philippines South Africa Mexico	Czech Republic Thailand China Taiwan Turkey

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