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MACRO MORNING BRIEFING

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ASEAN Inflows Easing-Proof

ASEAN financial account solid despite policy turns

- Structural inflows solid through portfolio and FDI balances
- Reserve growth serves as another healthy buffer
- China reflation may help ease FX valuations

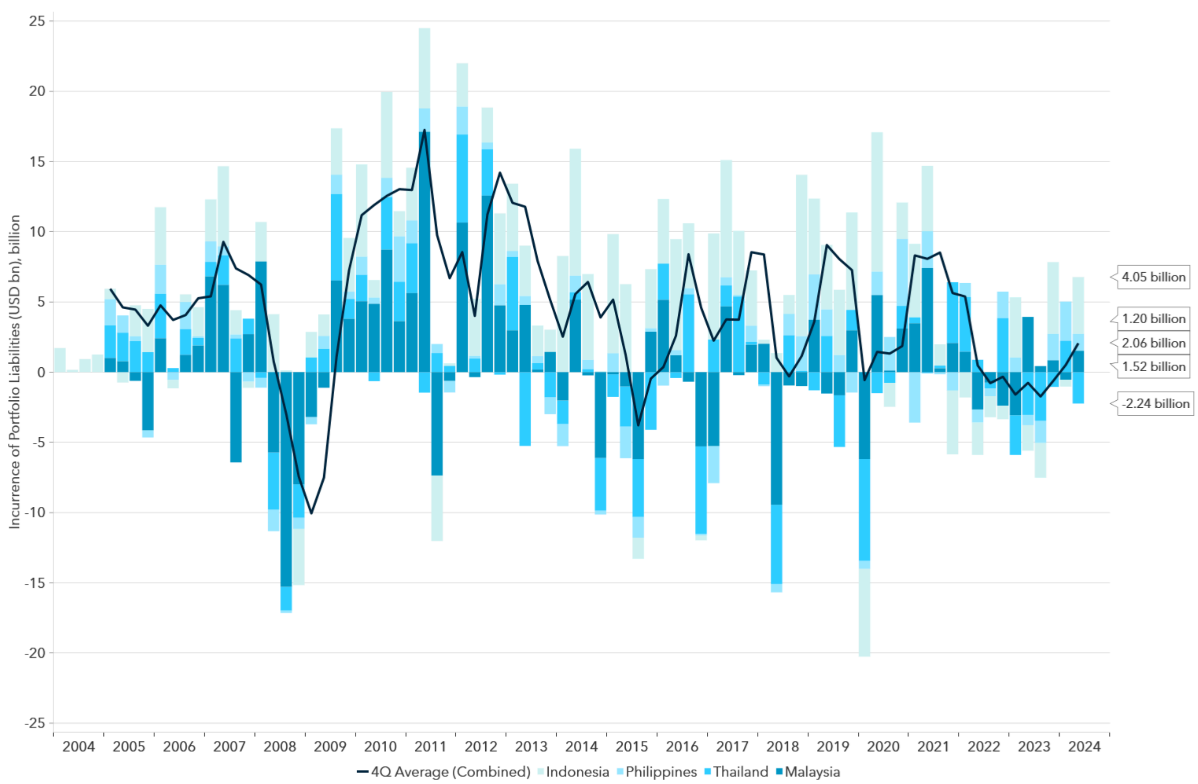
Cyclical caution belies secular strength

Policy decisions throughout Southeast Asia were mixed this week, though the balance of risks has indeed shifted towards caution, especially in Thailand's case. Even in economies where inflation remains a residual risk, such as Singapore, the direction of travel is clear as the global economy enters a new cyclical phase. Conventionally, EM economies and associated assets tend to struggle during the latter phases of an economic cycle. Central banks are often caught between the need to lower rates to support domestic economies and keeping yields high to prevent excessive depreciation and the instability of capital outflows.

The last few years, however, have generated material changes in funding conditions for ASEAN economies. Like their peers across emerging markets, policy credibility was strong during the pandemic and the inflation stress in its aftermath. Much of ASEAN managed to avoid excessive fiscal expansion and inflation levels were kept comparatively low as labour and other forms of supply strains proved more manageable comparatively. For example, Indonesian rates peaked at just above 6% to reflect the CPI peak in 2022 at just below 6%y/y. In contrast, Mexican CPI peaked at closer to 9%y/y. In nominal and relative terms, ASEAN real rates were much more manageable for the domestic economy, and this means that there is also more scope to ease at present. Furthermore, the role of domestic financing is now far more robust, which has helped limit any potential volatility from capital outflows, and any cross-border financing is now showing greater permanence. Official data indicate that such trends are continuing into the easing cycle in the region.

For example, the portfolio account has not been kind to emerging markets in general as global investors have chosen to maintain relatively heavy weightings in the US Much of APAC, especially ASEAN has also struggled with the China growth narrative as it is the region's biggest trading partner by far. However, this should not undercut the structural changes and higher levels of potential growth the region has been able to achieve itself, and this is being recognised in flows on the financial account. For example, the portfolio account struggled through 2022 and 2023 (Exhibit #1) due to the strength of the dollar and high US yields, but severe outflows were only restricted to 2020 during the liquidity crunch. Otherwise, the last four years have been more a case of limited inflows rather than strong outflows. The past few quarters have been firm, however, and it appears that rather than being worried that a weak US and Chinese economy would adversely affect the region, rotational flows are coming through which will continue to help keep financial conditions loose.

Exhibit #1: Portfolio Flows into ASEAN4

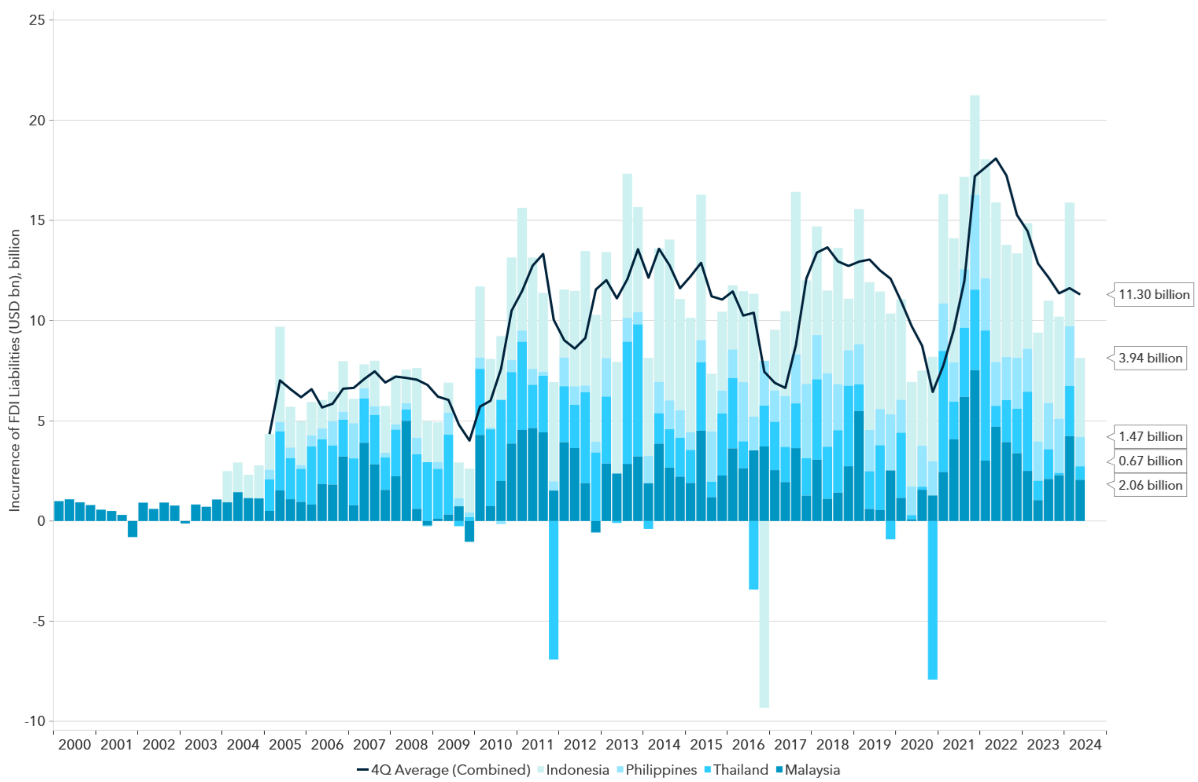


Source: Macrobond, BNY

By definition, the portfolio account is much more agile, and middle-income nations moving up the value chain continue to attach great importance to FDI inflows, which have far greater permanence. This is where ASEAN (we track Malaysia, Indonesia, Thailand and the

Philippines) is outperforming by far. Exhibit #2 shows very consistent inflows into the region, with only Thailand registering the odd quarterly outflow over the past five years. This comes amid the well-documented outflows from China, and we note that China itself has also become a major source of FDI for the region, due to value chain improvements and relative labour costs. Furthermore, relatively high yields in the region, especially relative to China and developed markets, may have helped keep large levels of retained earnings in these markets. Earnings repatriation to capture higher yields and growth in the US and (home markets in general as yields have moved to business cycle highs) have been a major drag on FDI globally. Other factors such as geopolitics will be in play and the region's ability to retain strategic autonomy will be another anchor factor for FDI.

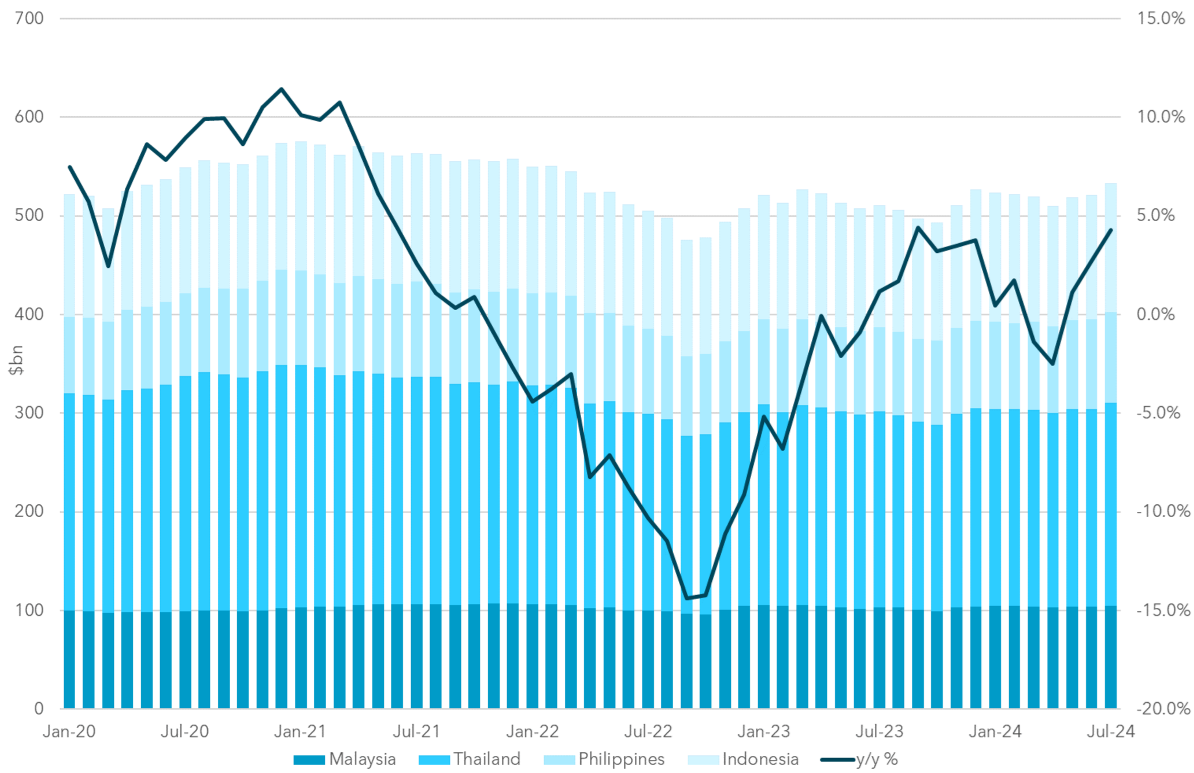
Exhibit #2: FDI Flows into ASEAN4



Source: Macrobond, BNY

While current account records in the region are mixed, the solid financial account and more cautious demand improvement have helped improve FX reserves. Like many emerging markets, surging energy import bills and portfolio outflows led to outflow pressure. The combined reserve holdings of middle-income ASEAN nations fell by almost 15% during the height of the energy crisis (Exhibit #3). The beginning of easing cycles and China-induced outflows from APAC earlier this year globally generated additional weakness, but now the growth rate has rebounded to the highest levels since early 2021. Severe outflows will not be as compromising to financial conditions and financial stability as in the past, but we see improved coverage ratios in general, especially as pressure from energy and the dollar ease up ahead.

Exhibit #3: FX Reserves and Growth, ASEAN4

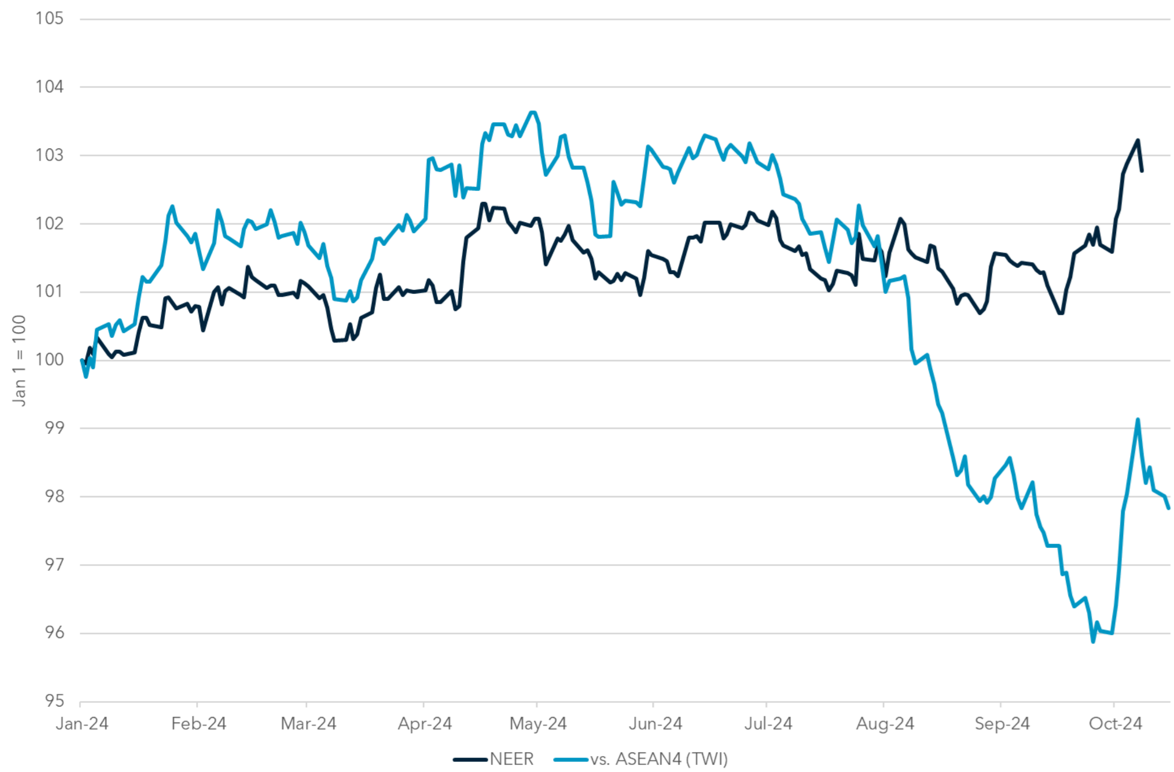


Source: Macrobond, BNY

In the near term, markets are also assessing whether the China stimulus – regardless of size and effectiveness – is a reason to strengthen rotational flows into ASEAN. While a recovery in goods and services demand in China – the biggest export destination for the four countries we track – is undeniably positive for external demand in driving GDP growth, the outlook for currencies requires a more nuanced approach. Firstly, given the downside price pressures China continues to face, the risk to the CNY remains to the downside. The currency may even serve as a funding currency to support longs in ASEAN FX. However, looking at CNY performance against the MYR, THB, IDR and PHP this year alone, weighted by total trade exposures for China (the four countries comprised over 8.5% of China’s total trade in 2023), we can see that since August, there has been a material divergence between overall CNY performance and against ASEAN (Exhibit #4). In short, the valuations gap against CNY is already very wide and additional room for manoeuvre is shrinking. Only Malaysia has a very large surplus buffer against China. Finally, Exhibit #1 indicates that nominal rates still matter for portfolio flows. If excessive strength in terms of trade starts to generate much bigger downside inflation surprises, much stronger dovish biases could emerge in the region and begin to undermine the case for financial account resilience. A stable CNY and reflation in

China are the sweet spot for ASEAN, but the jury is still out on whether this is attainable for Beijing.

Exhibit #4: ASEAN FX Outperforming CNY



Source: Macrobond, BNY

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Please direct questions or comments to: iFlow@BNY.com

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