ASEAN Connect

By Global Economics & Markets Research

ASEAN: Regional portfolio capital reflows likely depend on the timing of Fed's rate cut

Summary

Rhetoric from the US Federal Reserve (Fed) doesn't suggest imminent rate cut ahead as incoming US economic data painted resiliency and strength in its economy. Clearly, this has impacted the portfolio capital flows in the ASEAN region of Indonesia, Malaysia, Thailand, and the Philippines.

We found these ASEAN-4 countries' ability to receive the potential portfolio capital reflows are likely imminent should the Fed enters its rate-cutting cycle as these economies' external balances have remained adequately resilient. That will then likely spark a possible rate cutting cycle in these economies to support economic growth. However, these markets saw net cumulative outflows to-date in the bond markets amid global uncertainty and rising geopolitical tension that sparked sustained flight-to-quality assets, though surprisingly each respective stock markets receive net inflows, likely on a relatively cheap entries after sluggish 2023 performance.

Among the 4 ASEAN central banks in the region, we assess that probability is the highest for the Bank of Thailand (BOT) to be the first to cut rates given its downside growth risks in the coming quarters. Meanwhile, Bank Indonesia (BI), Bank Negara Malaysia (BNM), and Bangko Sentral ng Pilipinas (BSP) could afford to hold on a little longer before entering their respective rate cut streaks.

We also detailed some of the key highlights with regards to potential portfolio capital reflows for each of these ASEAN-4 economies.

Sound ASEAN-4 external balances bode well for potential capital reflows

The ensuing table below representing key indicators important for capital flows such as current account position, fiscal balance, FX reserves, and real policy rates across the 4 ASEAN countries suggest that these countries remain resilient and have witnessed relatively expedient and sustained improvement in the aftermath of the COVID-19 pandemic. Thailand has returned to its current account surplus while Indonesia and the Philippines saw smaller current account deficits while Malaysia maintained its current account surplus even during the pandemic, though at a smaller surplus last year as exports fell. Fiscal deficits have narrowed for all the ASEAN-4 economies (in fact, Thailand's fiscal positionturned into surplus as government spending stalled during last year's general election) ex-post COVID-19 pandemic, amid rollback in fiscal stimulus. FX reserves built up have been much higher in recent times, save for Malaysia, and likely a reflection of stronger position to anchor more stability this time round. Finally, real interest rates are still in the positive territory, a boon for capital inflows, and getting less negative for Malaysia[1].

[1] Negative real rates might reflect Malaysia's strong current account surplus position that has allowed them to focus more on supporting growth recovery by keeping monetary policy less tight.

With these relatively sound and resilient indicators that would technically draw in portfolio capital inflows into the ASEAN-4 markets, total (bonds and stocks) portfolio capital flows are still showing net outflows at the moment. This has been driven by net outflows position in the bond markets and portfolio capital inflows in the equity markets are still unable to counter the outflows in the former.

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Key indicators supporting capital flows showing resilience in the ASEAN-4 economies

Source: World Bank, UOB Global Economics & Markets Research

Country	Current Account, % of GDP						Fiscal Balance, % of GDP						FX Reserve (USD bn)						Real Interest Rate					
	2011-2015 Avg	2016-2019 Avg	2020 COVID	2021	2022	2023	2011-2015 Avg	2016-2019 Avg	2020 COVID	2021	2022	2023	2011-2015 Avg	2016-2019 Avg	2020 COVID	2021	2022	2023	2011-2015 Avg	2016-2019 Avg	2020 COVID	2021	2022	2023
Indonesia	-2.2	-2.3	-0.4	0.3	1.0	-0.1	-2.0	-2.3	-6.1	-4.6	-3.7	-1.7	108	124	136	145	137	146	-0.1	1.6	1.8	2.0	-1.0	3.4
Malaysia	5.4	2.7	4.2	3.9	3.1	1.2	-4.0	-3.3	-6.2	-6.4	-5.6	-5.0	124	101	108	117	115	114	0.7	1.2	2.9	-2.1	-2.4	-1.5
Thailand	1.8	8.2	3.2	-2.0	-3.2	1.3	-3.5	-3.9	-5.8	-2.0	-3.2	1.3	167	201	258	225	196	202	0.3	0.8	1.3	1.3	-1.5	3.3
Philippines	3.0	-1.1	3.6	-1.5	-4.5	-3.1	-1.4	-2.8	-7.5	-8.6	-7.3	-5.7	80	83	110	109	96	104	1.0	0.7	3.0	-0.8	-0.6	0.5

Note:	Horizontal
	Improve over time
	Deteriorate over time

Indonesia: Hopeful for higher portfolio inflow with political stability likely entrenched

During Covid-19 in 2020-2022, Indonesia recorded a capital outflow of nearly USD13bn. Indonesia faced intense pressure in 2020, where mobility restrictions hit Indonesia's economy hard as the economy contracted by 2.1% y/y in 2020. Post-Covid-19, Indonesia's economy faced further challenges from persistent inflation caused by higher energy and food prices. Global economic uncertainty due to geopolitical tension between Russia-Ukraine, as well as China-US and coupled with monetary tightening in many countries, put pressure on EM financial markets. The risk perception depicted by Indonesia's Credit Default Swap (CDS) in Oct 2022 even touched a post Covid-19 high of 165.6.

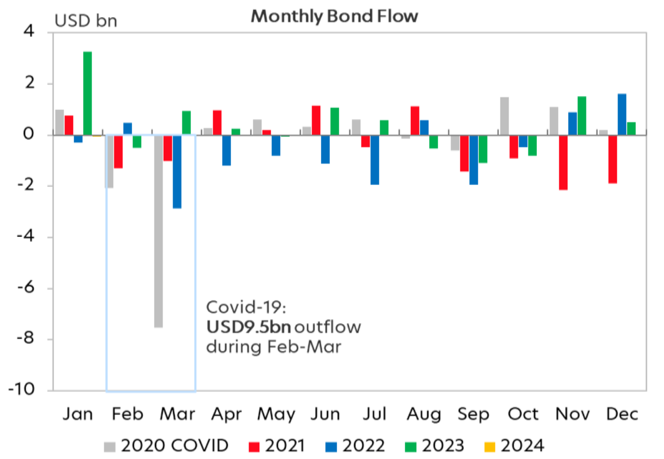
We expect monetary tightening to end in 2023, where the Fed has reached its peak terminal rate of 5.5%. Moving forward, in line with the Fed's stance to start rate cuts this year, this will be a good sign for higher portfolio inflows into Indonesia. Meanwhile, amid still resilient economic growth and manageable inflation, we expect Bank Indonesia (BI) to keep BI Rate higher for longer as rupiah stability is still the main concern. **The wider spread between BI Rate-Fed Rate will increase the attractiveness of Indonesian bonds**, attracting capital inflow back to the domestic market. We expect BI to hold steady at 6% throughout this year.

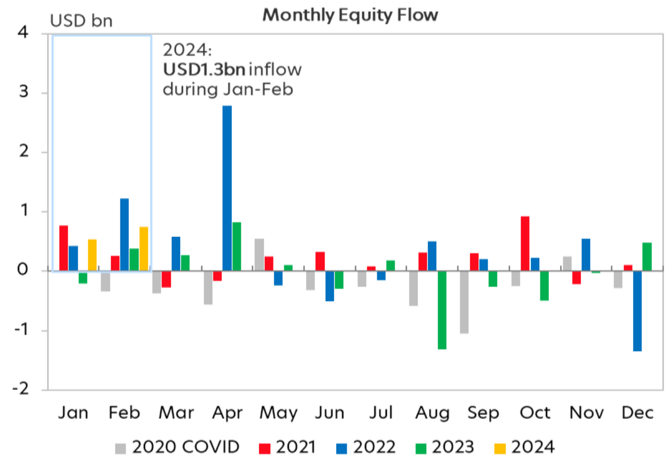
Indonesia's economic resilience and positive economic outlook during this political year will provide some upsides to market participants' perspective. However, geopolitical stability is key including with how Indonesia's next leader will determine policy over the next five years. The government is targeting fiscal expansion in 2024 which requires financing through debt securities of at least IDR666tn or up 115% from last year. We expect this higher financing needs to likely lift the fiscal deficit to 2.5% of GDP in 2024 and likely higher to 2.7% in 2025 as the new incoming government delivers its campaign promises. Nevertheless, those deficits ratio still remain below the constitutional limit of 3% of GDP.

We expect a shorter election in one round with Prabowo-Gibran coming out as the winner in the provisional real count from Election Commission, **the narrative related to "programs and policies continuity" will deliver positive sentiment to market participants**. As such, relying on the clearer expectation of Fed Rate cut, and supported by positive sentiment from the election, manageable fiscal expansion, stable rupiah as well as Indonesia's economic outlook that could potentially rebound in 2024 will provide optimism for market participants. These are good signs for stronger portfolio inflows into Indonesia market this year.

Clearer Signs of Fed rate cut this year and Indonesia's economic optimism will contribute to return larger inflows into domestic market

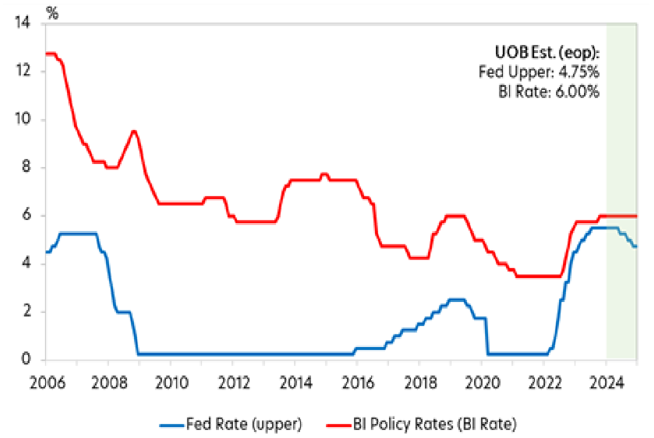
Source: Bloomberg, UOB Global Economics & Markets Research





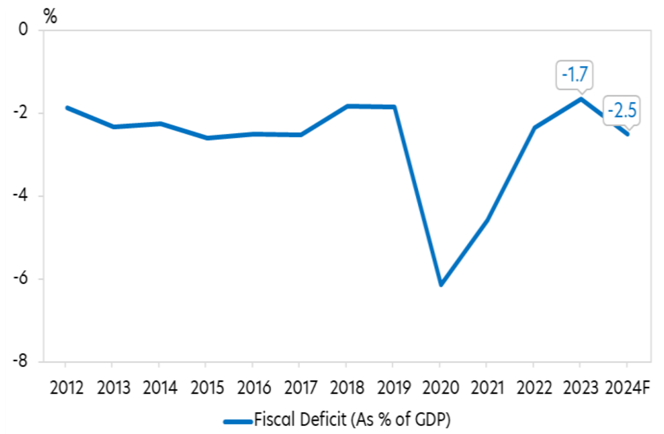
Wider Fed-BI rate spread will keep domestic market more attractive

Source: Bloomberg, UOB Global Economics & Markets Research



Fiscal expansion will bring more inflows

Source: Ministry of Finance, UOB Global Economics & Markets Research



Malaysia: BNM standing pat likely a boon for bond inflows once Fed start cutting

BNM left the Overnight Policy Rate (OPR) unchanged at 3.00% for the fourth straight meeting on 24 Jan, with a neutral statement and similar forward guidance as the previous statement. BNM maintains a positive growth outlook while staying vigilant against potential inflation risks that may arise from the government's review of price controls and subsidy rationalization measures. Jan's inflation readings together with a softer real GDP growth for 4Q23 and persistent currency weakness reinforce our view that Bank Negara Malaysia (BNM) will continue to stay the course in holding the Overnight Policy Rate (OPR) steady at 3.00% throughout 2024.

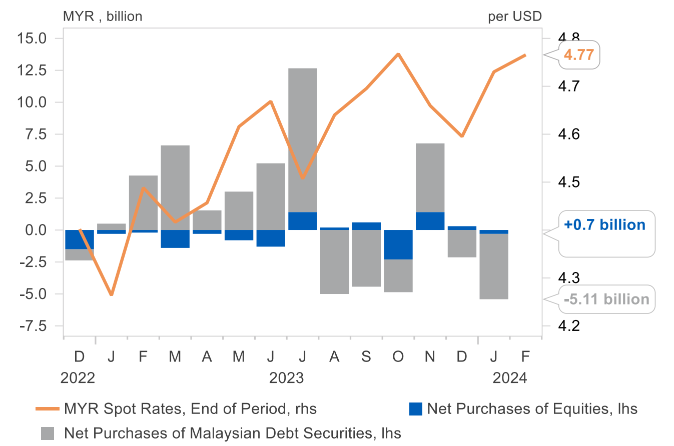
A steady OPR will also help to narrow the negative gap with US interest rates and thus support the MYR recovery. This will in turn support the case for a likely return of non-resident portfolio capital inflows in the bond market, that currently is in a net outflows position. Additionally, having witnessed the current account surplus dipped to the lowest level since 1997, we expect the surplus to revert back to MYR39bn or 2.0% of GDP in 2024 (vs MYR22.8bn or 1.2% in 2023) in tandem with a projected recovery in external trade. The implementation of various fiscal policy reforms would also deliver sizeable savings to the government that can help restore confidence in the country's fiscal position and MYR.

Bank Negara Malaysia (BNM)'s foreign reserves rose further by USD1.3bn m/m to USD114.8bn as at end-Jan (end-Dec 2023: +USD1.2bn m/m to USD113.5bn), after taking into account the quarterly foreign exchange revaluation changes. BNM has yet to publish its Jan FX swaps data but the central bank's net short position in FX swaps narrowed further by USD0.4bn m/m to USD23.6bn as at end-Dec 2023 (end-Nov: +USD1.1bn m/m to USD24bn, end-Dec 2022: USD26.4bn). It is equivalent to 20.8% of total FX reserves (end-Nov: 21.4%).

Malaysia continued to seeforeign portfolio outflows for a second straight month in Jan 2024, by a wider MYR4.4bn (vs. -MYR1.9bn in Dec 2023). This was mainly due to further foreign net selling of Malaysian debt securities (-MYR5.1bn in Jan 2024 vs. -MYR2.1bn in Dec 2023). This more than offset foreign net buying of Malaysian equities for a third straight month (+MYR0.7bn in Jan 2024 vs. +MYR0.3bn in Dec 2023). Foreign selling of MGS and GII led to a drop in foreign holdings of government bonds by MYR2.5bn to MYR251bn (or 22.07% of total outstanding), which is lower than 22.15% a year ago and marked the lowest share of foreign holdings since May 2020 at 21.2%. Non-residents held MYR201bn of MGS (or 33.8% of total MGS outstanding) and MYR50bn of GII (or 9.3% of total GII outstanding) as at Jan.

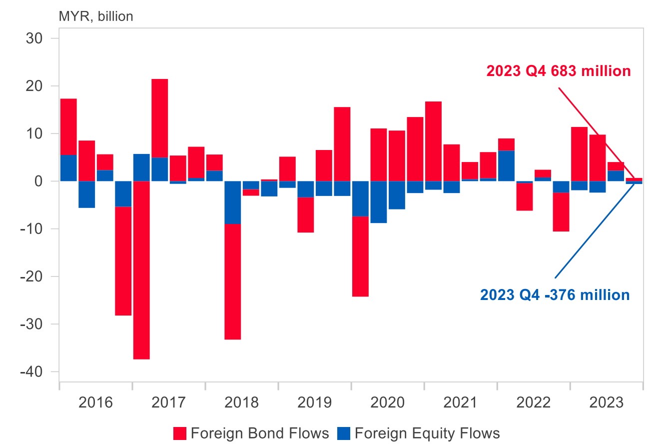
Foreign holdings of Malaysian bonds and equities

Source: Macrobond, UOB Global Economics & Markets Research



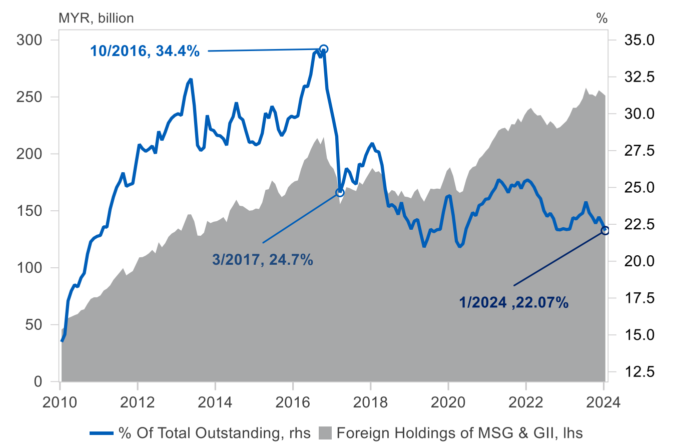
Quarterly flows into Malaysian equities and bonds

Source: Macrobond, UOB Global Economics & Markets Research



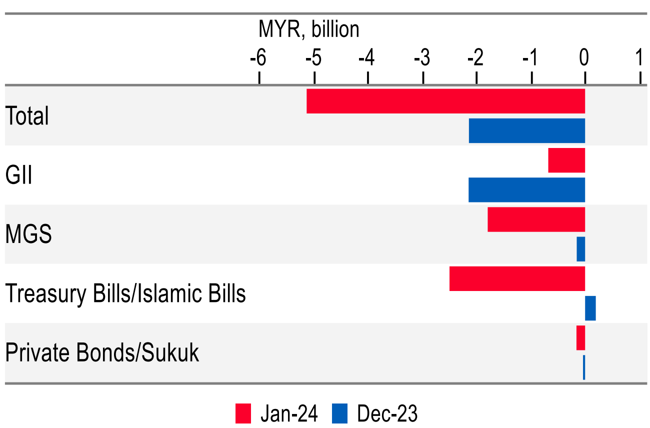
Foreign holdings of malaysia government bonds

Source: Macrobond, UOB Global Economics & Markets Research



Breakdown of foreign flows into MYR bonds

Source: Macrobond, UOB Global Economics & Markets Research



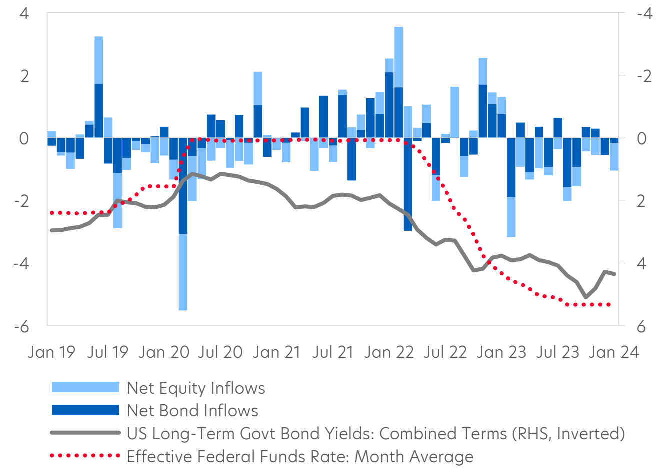
Thailand: Rate cut portends stronger portfolio reflows

Thailand had faced net foreign capital outflows for a few years before the pandemic outbreak in 2019. This was driven by both domestic and external factors. On the domestic front, uncertainties and protracted political turmoil substantially contributed to the outflows, and on the external front, Fed's policy normalization was the major driver. For example, in 2019, the net outflow was recorded at about USD-4.0bn, of which net bond inflows of USD-2.6bn, and net equity inflows of USD-1.5bn. In 2020, in the middle of the pandemic outbreak and uncertainties in the global financial markets, the net capital outflows ballooned further to USD -10.5bn, driven by both net bond outflows of USD-2.1bn and net equity outflows of USD-8.4bn. During 2021-2022, however, there were net foreign portfolio inflows in equities and bonds, resulting in net positive inflows of USD2.9bn in 2021 and USD7.2bn in 2022, before the Fed's current rate hike cycle started.

However, substantial large capital outflows from Thailand's bond and equity markets have ensued following the start of Fed's rate hike cycle in Mar 22 and its subsequent more-than-previously expected aggressive tightening, resulting in the multiple-year high policy rate in the current range of 5.25% - 5.50%. This has also led to a subsequent rise in the US government bond yields which remain elevated and attracting global capital inflows back to the US's financial markets. This resulted in net capital outflows of USD-9.7bn from Thailand in 2023, comprising net outflows of USD-4.1bn from the bond market and of USD-5.5bn from the equity market. In addition, the general election in May 2023 and uncertainties surrounding the government policies contributed to foreign capital outflows. This has also been reflected in the movement and volatility of the USD/THB exchange which has been under downward pressure in recent episodes.

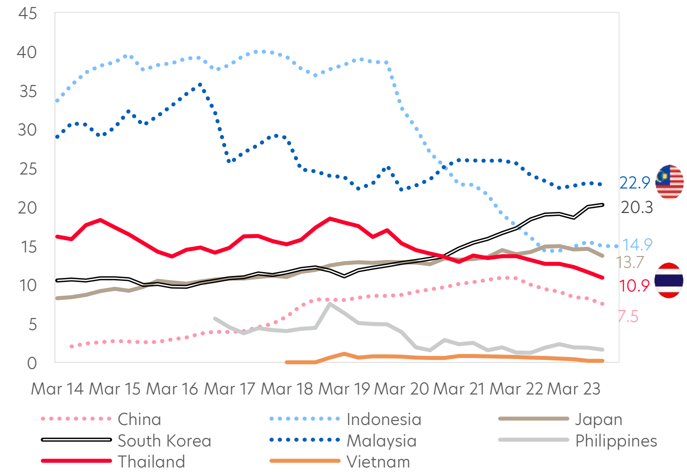
Thailand: Monthly foreign capital flows (USD bn)

Source: CEIC, UOB Global Economics & Markets Research



Foreign holdings in LCY government bonds (% of total, as of Dec 23)

Source: CEIC, UOB Global Economics & Markets Research

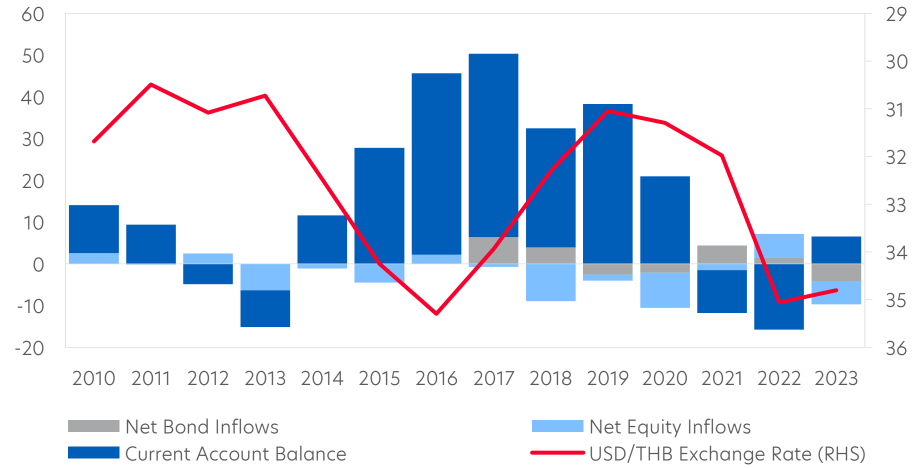


Downward pressures on the currency and overall macroeconomic stability in Thailand due to foreign capital outflows would be relatively limited compared to regional peers. This is because Thailand's share of foreign holding in local currency government bonds is lower, about 11% of the total bond outstanding, compared to that of Malaysia of about 23% and Indonesia of about 15% (as of 3Q23).

In addition, the external position of Thailand is expected to remain sound, supported partly by the sustained rebound of tourism. This would help turn the current account balance into a surplus, which would subsequently support the stability of the currency. This was obvious in the pre-pandemic periods when Thailand had run a persistent current account surplus pushing THB appreciation. Thailand is also relatively less vulnerable to large capital outflows in the recent episodes. On the back a relatively low share of foreign holding in local currency government bonds, the country is also safeguarded by the macroeconomic structure and relatively developed financial markets, together with a competent policy mix and sound macroeconomic fundamentals. However, risks and challenges on the near-term horizon remain, particularly (1) a higher-for-long policy stance of the Fed which could trigger disruptive capital outflows adding downward pressures on the currency; (2) shortfalls in tourism receipts due to changes in tourist behaviors in the post pandemic period resulting in a smaller surplus of the current account; and (3) uncertainties surrounding the implementation of large fiscal stimulus, namely the digital wallet scheme.

Thailand: Annual capital flows (USD bn)

Source: CEIC, UOB Global Economics & Markets Research



Finally, we reckon that BOT will likely to be the first central bank in the region to cut viz. BI, BNM, or BSP. Economic growth in Thailand has consistently came in weaker than expected. We have also revised our growth projections for Thailand this year from 3.6% to 2.8% while official forecasts have been downgraded to 2.2-3.2%. Timing-wise, we think that if Q1 2024 growth comes significantly weaker than expected, BOT will likely cut earliest in their 3rd MPC meeting this year due on 12 Jun, with Q1 GDP numbers already out by then. We note that BOT only meets every other month, totaling 6 MPCs in a year. In short, risk is greater for Thailand to cut first among the ASEAN-4 because the economy is indeed not recovering as robust as expected and given the elevated debt notwithstanding.

Philippines: Solid fundamentals expected to hold up capital flows

Notwithstanding an aggressive Fed rate hike cycle since May 2022, the Philippines posted two straight years of portfolio inflows, totaling USD2.5bn in 2022-2023. It recouped some of the record outflows of USD10.2bn in 2021 that was primarily due to (1) the national government and local corporates repaying their debt obligations amid a stronger currency; and (2) the central bank's investments in non-reserve assets to diversify the international reverses of the country in 2021. For 2024 to-date, similar observations of inflows in the equity market (+USD220.5mn) but net outflows in the bond market (-USD885.2mn, latest available data) took place similar to the other ASEAN-4 markets.

The USD2.5bn portfolio inflows in 2022-2023 were driven by both equity (+USD0.6bn) and debt inflows (+USD1.9bn). This was primarily credited to (1) BSP's aggressiveness in hiking its policy rates as per US Fed rate pace since May 2022; (2) solid economic fundamentals; (3) ongoing fiscal consolidation with stable credit ratings and outlook; as well as (4) smooth administration transition and broad policy continuity post the 9 May 2022 presidential election.

Larger debt inflows than that of equity over the past two years came in line with the persistent expanding sovereign bond market in the Philippines since 2019. Over the past five years, the size of the Philippine government bond market has expanded by 13.1% per annum to the largest ever size of USD224.6tn in 2023 (from USD208.2bn in 2022 and USD123.5bn in 2018). This expansion was supplied by more local currency-denominated (LCY) government bonds compared to foreign currency-denominated (FCY) government bonds in order to stabilize the performance of the Philippines peso (PHP).

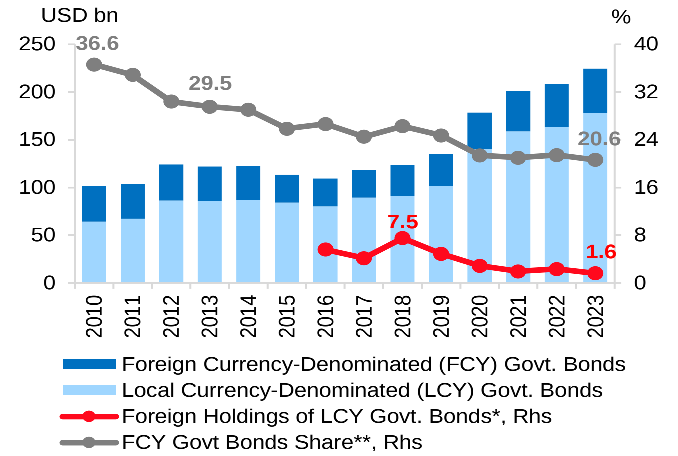
Therefore, the market size of FCY government bonds (as percentage of overall government bond market) has constantly dropped to the lowest level of 20.6% in 2023 (from 26.3% in 2018 and more than 36% in 2010). There was no data disclosed for foreign ownerships of the Philippines' FCY government bonds while the foreign shareholdings of the Philippines' LCY remained at the record low level of 1.6% as of Sep 2023.

For 2024 when is widely expected to bring a turning point in global interest rates with rising uncertainties, we still believe that the Philippines is less likely to face hefty capital flight. Nevertheless, in the bond market that has not been realized yet as to-date till Jan 2024, data from the Philippines Treasury department is showing a net outflow to the tune of more than USD885mn. The country's solid economic and financial fundamentals (i.e. stronger GDP growth, slower inflation, narrowing twin deficits, sound banking system and stable credit ratings), national plans and reforms, as well as political stability will indeed help to keep investors confident in the Philippine assets. This is reflected by the net inflows in the Philippines equity market that currently recorded to-date inflows per 1 Mar 2024 of more than USD220mn. Although BSP is anticipated to loosen its monetary policy stance in tandem with US Fed this year, but the Philippine central bank will definitely ensure positive interest rate differentials with US rate

Moreover, the Philippines has maintained ample external liquidity buffers with gross international reserves remaining over the USD100bn mark at USD103.3bn as at end-Jan 2024. The latest foreign reserves position is sufficient to finance 7.7 months of imports, and is 6.0 times short-term external debt based on original maturity. All these will make the Philippines remained an attractive investment destination in the near term. We reckon specifically that the Philippines bond market will benefit in terms of receiving inflows from the imminent rate cuts that is likely to be ignited by the US Fed that may consequently give reasons for BSP to follow suit with its rate-cutting cycle.

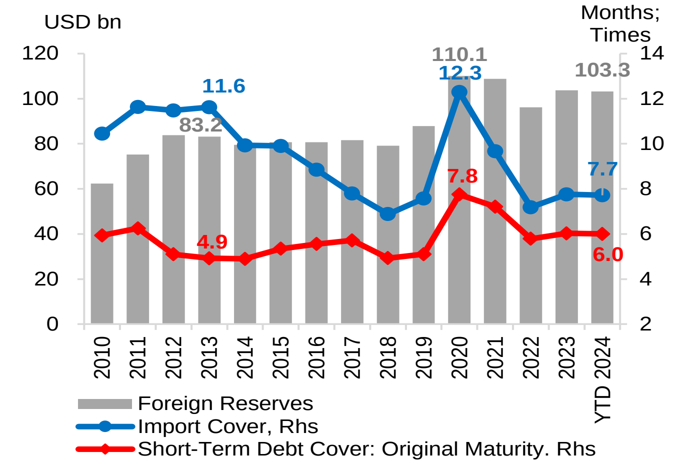
Foreign holdings of LCY government bonds remained hit a fresh low in 2023

*As % of total LCY government bond outstanding, data as of Sep 2023.
**As % of overall government bond market (LCY and FCY denominated bonds), data as of Sep 2023.
Source: AsianBondsOnline, UOB Global Economics & Markets Research



Stronger foreign reserves buffers than pre-pandemic periods

Source: CEIC, UOB Global Economics & Markets Research



Enrico Tanuwidjaja
Economist
Enrico.Tanuwidjaja@UOBgroup.com

Julia Goh
Senior Economist
julia.gohml@uob.com.my

Loke Siew Ting
Economist
jasrine.lokest@uob.com.my

Sathit Talaengsatya
Economist
Sathit.tal@uob.co.th

Agus Santoso
Junior Economist
Agus.Santoso@uob.co.id

Research insights

www.uob.com.sg/research

Contact us

Email: GlobalEcoMktResearch@UOBgroup.com
Bloomberg: NH UOB <GO>

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