CIO Special

April 27, 2022

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ASEAN: medium-term investment positives

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Key take aways

- Despite spillovers from Ukraine and China's Omicron struggle, we see supportive growth drivers for Southeast Asia, particularly from regional border reopening's.
- With the rising interest rate environment and high commodity prices, ASEAN's financial and energy sectors could continue as key sectoral drivers.
- Singapore has tightened monetary policies three times in past six months; more central bank tightening is likely to follow in Southeast Asia.

01 Solid growth this year despite near-term headwinds

From a macro perspective, we think ASEAN economies will continue to see solid growth this year. Fixed investment in many markets proved quite resilient during the pandemic, compared with household spending. There are reasons to expect this to continue: foreign direct investment flows into several ASEAN economies, notably Indonesia, Malaysia, and Vietnam, remain strong.

02 Mixed impact of higher commodity prices

The Ukraine/Russia war has affected the supply of energy and hard commodities as well as certain agricultural products, pushing their prices to record highs. The regional losers – those ASEAN countries which are both net energy importers and large grain importers – will bear the brunt of this. Assuming an oil price level of around USD 120/b, analysts see a 1-3% percentage points change from baseline for headline CPI in the Philippines, Singapore, and Thailand. Overall, current account balances in 2022 are likely to be weaker than their pre-pandemic average in several economies, notably in the Philippines and Thailand.

For the possible winners – Indonesia and Malaysia – the opposite is true: here, current account balances will likely be stronger over the coming year thanks to surging commodity prices. Malaysia is the region's net oil exporter, and its current account surplus could benefit from the higher international oil price. Indonesia could benefit from a range of higher commodity prices including coal, palm oil, natural gas, steel, and copper, offsetting the increased cost of its deficits in crude oil imports.

In near-term, ASEAN food and beverage producers face the risk of a profit margin squeeze due to high input costs as well as limited room to pass these costs on to consumers. But in the medium term, overall demand is likely to be supported by economic re-opening, government fiscal subsidies, and higher income of sectors such as agriculture, energy, and mining – partially offsetting the negative inflationary impact.

03 China's economic weakness and ASEAN

ASEAN's March manufacturing PMIs suggest that rising Omicron cases in China are adding pressure on already disrupted supply-chains and may be weighing on ASEAN trade. Against this backdrop, in early April the World Bank downgraded its 2022 GDP growth forecast for the region from 5.4% to 5.0%. The ASEAN manufacturing sector is closely linked to China, which is one of the largest sources of intermediary goods (i.e., ASEAN imports) and is also a major destination for final consumption (i.e., for ASEAN exports).

Manufacturing hubs like Vietnam, Thailand and Malaysia saw the largest downturns in their March PMIs, although only the latter slipped into contractionary territory (49.6). Although the China impact is likely to leave its trace in the region's upcoming Q1 and Q2 earnings season, the PMI future output sub-component remains strong across the broad, showing that ASEAN manufacturers overall remain confident about their business outlook on a 12-month time-horizon.

04 Border reopening as a new growth driver

Most ASEAN countries have been starting to remove travel restrictions in recent months. They have been reopening their borders to international visitors as part of efforts to support the tourism industry, which has been hit hard by Covid-19 in the past two years. Tourism has long been important for many ASEAN countries. According to the World Travel & Tourism council, in 2019 (when tourists could still travel freely) tourism contributed to 11.8% of Southeast Asia's GDP.

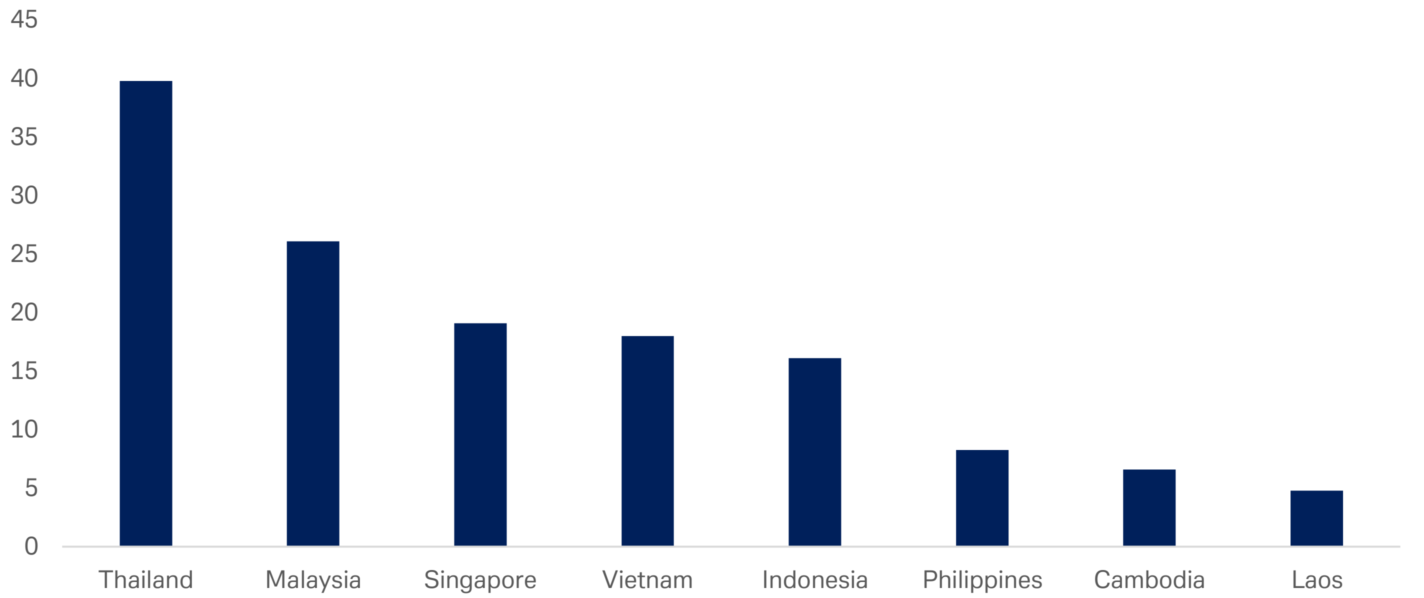
Recently Singapore announced significant border reopening measures, with international visitors only required to do one Covid-19 test before they board the flight. Then on April 22, Singapore announced further reopening and they removed this testing requirement. Vaccinated international visitors can enter Singapore without any testing requirements just like in 2019 before Covid-19. Thailand has also simplified entry requirements for foreign visitors, who now do not require any testing before and after arrival. Malaysia has introduced similar programmes to allow international visitors to enter the country without quarantining.

Such measures have encouraged a significant increase in flight and hotel bookings in recent months. While there's still no return of Chinese tourists so far (previously the largest tourist group in ASEAN), we think reopening efforts could trigger significant pent-up travel demand, with the reopening theme gaining momentum in coming months. Thailand, Malaysia, and Singapore could benefit the most from the revival of the tourism industries.

05 More central bank tightening in H2

So far, ASEAN economies have largely escaped the strong inflationary pressures gripping other parts of the world. The reason is that there are no strong demand-pull forces pushing up prices, at least not yet. As a result, regional central banks have been able to limit their policy response. The commodity price shock, however, is beginning to challenge this tranquil picture. Singapore's MAS recently tightened its monetary policy for the third time in past six months. We highlight more details of Singapore's monetary policy tightening in the last section of this report. In the face of higher inflationary pressures, more central banks in the region, including Indonesia, Thailand, Malaysia are likely to raise interest rates in H2 this year.

Figure 1: Tourist Arrivals in Southeast Asia, 2019 (million)



Source: Statista, Deutsche Bank AG. Data as of April 2022.

06 Asset class implications

ASEAN equities – financials and energy attractive

In Q1 this year, ASEAN equities were among the best performing markets with positive returns (in USD terms) in Singapore (+8%), Indonesia (+7%), Malaysia (+4%), and Thailand (+2%) compared to MSCI Asia ex. Japan (-7%), EMs (-6%) and DMs (-5%).

But, as we move deeper into Q2, where are ASEAN markets heading from here? While we do see some near-term headwinds, we remain constructive on the medium to long-term outlook for the region – with a preference for certain industries and markets. Two issues are in particular focus:

a) **The correlation of ASEAN equity and global GDP performance.** ASEAN direct trade exposure to Russia and Ukraine is almost irrelevant. However, the economic toll of the Ukraine war and sanctions against Russia are dampening global GDP growth dynamics and thus are expected to have spillover effects for the region – including on equity performance. Comparing real global GDP growth (QoQ, seasonally adjusted) versus ASEAN equity returns since 1998 shows that ASEAN equities' average quarterly returns tended to be positive when global GDP growth was above the trend rate of 2.7%. Note that our current global GDP growth forecasts for 2022 and 2023 are at 3.5% and 3.3%, respectively, hence well above the historically supportive threshold of 2.7%. Export industries and economically-open economies with exports accounting for more than 50% of GDP, like Singapore, Thailand and Malaysia, should benefit the most from this growth. Deeper analysis reveals that, in times of above-trend global growth, the average quarterly return of ASEAN stock markets has tended to oscillate between almost +6% and +3% depending on whether global growth momentum was increasing or slowing. The latter seems to be the case at the moment.

b) **ASEAN financials and the rising rate environment.** From a sector perspective, ASEAN financials have already benefited from globally rising interest rates, although to a lesser extent than in other parts of the world. Increasing inflation pressures in ASEAN economies (as discussed above) will lead to tighter monetary conditions across the board, and thus may generate further upside potential for regional financial names. As stock markets in Singapore and Indonesia show the region's largest exposure to financials (at 40% and >50% of respective total market capitalisation), our view is particularly constructive on these two markets for the months ahead. In addition, Indonesia's oil and gas exporters as well as its mine operators and producers of industrial metals, which represent another 13% of Jakarta's stock market cap, will welcome persistently high energy and commodity prices.

If potentially adverse seasonality is combined with possible headwinds from inflationary pressures, stressed supply chains, and slowing external demand, the near-term outlook for ASEAN stock markets may be subdued to some extent. But regional reopening, above-trend global growth expectations and regional GDP growth prospects brighten-up our view on the region's medium to long-term prospects. As a result, we believe investors could consider possible temporary set-backs of ASEAN equities as an opportunity to re-balance their regional positioning. From a country perspective, over the course of this year, we would prefer Singapore and Indonesia, now trading at 12 months forward price/earnings (P/E) ratios of 13.2x and 17.9x respectively.

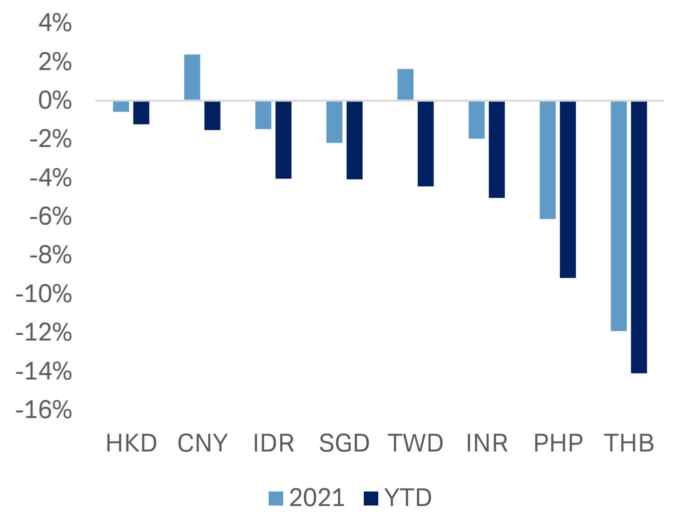
ASEAN fixed income could still underperform

Most ASEAN credit had negative returns in Q1, e.g., Singapore (-5.4%), Indonesia (-6.2%), Malaysia (-6.3%) and Thailand (-6.8%) compared to China (-7.0%). Negative returns were attributed to both higher U.S. Treasury yields and wider credit spreads in the quarter. Sentiment on ASEAN credit has been weak, due to the concerns over rising U.S. interest rates, China's property credit defaults, and geopolitical risks. We think these macro headwinds could continue to affect the performance of ASEAN credit in the near term. Having said that, we think there could be selective opportunities in the region, including some Indonesian high yield (HY) names within the energy sector.

Currencies – commodity prices and central bank policies in play

The ASEAN FX market will continue to be affected by external factors, including possible U.S. rate hikes, geopolitical risks, and the performance of the CNY. With the Fed likely to hike rates faster than previously expected, USD could see strong near-term support. Most ASEAN currencies may be under pressure in this external macro environment, but some could still outperform, especially those of economies with strong commodity exports and hawkish central banks. Possible outperformers could include the MYR (Malaysian Ringgit) and IDR (Indonesian Rupiah) which both benefit from higher commodity prices and wide current account surpluses. The SGD (Singapore Dollar) could be supported by any more central bank actions, with the Monetary Authority of Singapore (MAS) on a tightening bias.

Figure 2: Broad-based weakness in Southeast Asia currencies this year



Source: Refintiv Eikon, Deutsche Bank AG. Data as of April 2022.

07 Singapore: tightening monetary policy amid higher inflation

In its half-year monetary policy statement on April 14, the Monetary Authority of Singapore (MAS) tightened monetary policy again. It was the third policy tightening in the past six months. Based on the statement, the MAS is to readjust the mid-point of the exchange rate policy band up from the prevailing level of the SGD's NEER (nominal effective exchange rate). There will also be a slight increase to the rate of appreciation of the policy band. The MAS does not intend to change the width of the policy band.

Recent tightening of Singapore's monetary policy was in line with market expectations. Singapore's inflationary pressures have been rising fast recently. CPI inflation rose to 5.4% in March, compared to 4.3% YoY in February, driven particularly by higher private transport and accommodation prices. In its statement, the MAS said that Singapore's inflationary pressure could move higher from here, due to the "sharply higher global commodity prices" and "renewed supply chain disruptions". That said, expectations are that Singapore's inflation will moderate in late 2022 with some possible stabilization of commodity prices and easing supply chain disruptions. Overall, the MAS revised up its 2022 core inflation forecast to 2.5-3.5%, compared to 2.0-3.0% previously. It raised the all-item CPI inflation forecast to 4.5-5.5% this year, compared to 2.5-3.5% previously.

The MAS expects Singapore's GDP growth to be 3-5% this year. Advance estimates indicate that Singapore's GDP expanded by only 0.4% QoQ seasonally-adjusted in Q1 2022, compared to 2.3% in Q4 last year. The MAS says that, due to global geopolitical and other disruptions, Singapore's trade-related and modern service sectors could grow more slowly this year than in 2021. However, the domestic-oriented and travel-related sectors could show stronger growth this year with the recent easing of social distancing measures and border controls.

We think the MAS will maintain a tightening bias in the current macro environment. While headline inflation is expected to ease in late 2022, macro uncertainty remains high with lingering supply-side issues due to the sanctions against Russia, the Omicron infections and lockdowns in China. The latest surge in agricultural commodity prices could add to the domestic inflationary pressures too. Singapore's Goods and Services Tax is expected to go up to 8% in January 2023 from 7% currently. Given low unemployment, wage growth in Singapore could increase. Inflation pressures may therefore remain in the medium term.

Faster Fed rate hikes and global trade slowdown remain key external risks to Singapore's economy. However, given eased Covid restrictions and the strong labour market, we would expect a continued recovery of Singapore's domestic-oriented sectors. Border reopening across Southeast Asia could trigger the release of pent-up demand, benefiting Singapore's travel and tourism sectors.

We think the SGD will stay supported by the resilient domestic economy as well as Singapore's border opening strategies, but MAS guidance needs to be watched.

08 Conclusion

ASEAN has been affected by several external macro headwinds, including expectations of faster Fed rate hikes, higher commodity prices, and supply chain disruption in China. However, with the upcoming summer holidays, we think that border reopening and the surging tourism could become growth drivers for many ASEAN economies. In addition, higher commodity prices could benefit some net commodity exporters (Malaysia and Indonesia) in the region. In equities, we would favour ASEAN financials in the rising rate environment as well as energy sectors (given higher oil prices). ASEAN credit could face headwinds with higher U.S. interest rates, but selective sectors (e.g., certain Indonesian HY) could offer opportunities. Broad ASEAN FX may be affected by strong USD, but we think currencies of commodity exporters and economies with hawkish central banks may outperform.

Glossary

The Association of Southeast Asian Nations (ASEAN) comprises Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar and Vietnam.

CNY is the currency code for the Chinese yuan.

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

An emerging market (EM) is a country that has some characteristics of a developed market in terms of market efficiency, liquidity and other factors, but does not meet all developed market criteria.

The Federal Reserve (Fed) is the central bank of the United States.

Gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

High yield (HY) bonds are higher-yielding bonds with a lower credit rating than investment-grade corporate bonds, Treasury bonds and municipal bonds.

HKD is the currency code for the Hong Kong dollar.

IDR is the currency code for the Indonesia Rupiah.

INR is the currency code for the Indian Rupee.

JPY is the currency code for the Japanese yen, the Japanese currency.

KRW is the currency code for the Korean won.

The Monetary Authority of Singapore (MAS) is the central bank of Singapore.

MYR is the currency code for the Malaysian ringgit.

A nominal effective exchange rate (NEER) is the weighted exchange rate of a currency against a basket of other currencies.

PHP is the currency code for the Philippine peso.

Price/earnings (P/E) ratios measure a company's current share price relative to its per-share earnings. In this context, LTM refers to last twelve months' earnings.

Purchasing manager indices (PMI) provide an indicator of the economic health of the manufacturing sector and are based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment. The composite PMI includes both manufacturing and services sectors. They can be published by public sector or private agencies (e.g. Caixin, Nikkei).

SGD is the currency code for the Singapore dollar.

THB is the currency code for the Thai baht.

Treasuries are bonds issued by the U.S. government.

TWD is the currency code for the Taiwan dollar.

USD is the currency code for the U.S. Dollar.

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