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2023 Asian rates and FX outlook

A slower pace ahead

By the Asian Fixed Income Team
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Outlook for 2023

2022 delivered adverse shocks that sparked a surge in inflation, prompting a hawkish shift from global central banks, which in turn resulted in a significant tightening of financial conditions and a dramatic rise in the US dollar. The US Federal Reserve (Fed) has hiked the Fed Funds Rate by a total of 375 (basis points) bps since February 2022 and headline inflation is already showing signs of easing. Despite the significant tightening of real yields, we have yet to see a considerable impact on the US economy. As monetary policy operates with a protracted and unpredictable lag, the risk of a recession for the US economy has increased.

Recent data from the US indicate that growth picked up in the third quarter of 2022, although the rebound was driven largely by an improvement in net export trade, with domestic demand remaining sluggish. The slowdown in the housing market—which has borne the brunt of tighter financial conditions—looks set to persist and some longer leading indicators are starting to signal a broader slowdown of the economy. These factors, together with US dollar strength weighing on import prices, support our view of more downside pressure to inflation moving forward.

Global markets await the Fed's pivot, and we are convinced the initial phase of this could be close. We share the view that the pivot will likely be in three phases, starting with the Fed tempering its pace of monetary policy tightening, followed by a pause in rate hikes to assess the impact of the delivered tightening measures, before the central bank eventually signals that the inflationary trend has turned and that a rate cut is imminent. The hurdle to the first phase —smaller interest rate increases—is relatively low. Given rate hikes often take time to impact the real economy, a step-down in the pace of hikes can begin as soon as the policy rate hits a reasonable range for the terminal rate. With the Fed Funds rate at around 4%, the change in pace could come as soon as the next Federal Open Market Committee (FOMC) meeting in December 2022. Meanwhile, we believe there needs to be some softening in the labour market and convincing signs that core inflation is finally abating before the Fed will be open to considering a pause in this policy tightening cycle, the second phase of the pivot, as it tries to avoid mistakes of the past. In our view, this could materialise sometime first half of 2023.

In sharp contrast to the first two phases, the hurdle to signal rate cuts—the third phase in the Fed's pivot—would be largely driven by the severity of demand contraction resulting from the ongoing aggressive monetary tightening. We foresee this happening no earlier than the tail-end 2023 or early 2024 for it must be reasonably evident that inflation is easing towards the Fed's target for the projection horizon.

From a market perspective, we expect monetary policy outlook to persist as the primary driver of global rates moves in 2023. We believe that a Fed pivot will prompt a decline in global bond yields. Consequently, we have shifted to be more positive view on duration overall, on the assessment that we are likely past peak hawkishness from the Fed and other developed markets central banks. In particular, with the Fed Funds rate at around 4%, we believe the Fed is on the cusp of decelerating the pace of monetary policy tightening. We expect the US Treasury (UST) curve to remain inverted in the near term, as rising concerns around growth coupled with easing inflation expectations place downward pressure on long-end yields. That said, should the actual terminal rate fall short of what the market is currently implying (i.e. > 5%), short-end UST yields could start to outperform, as the Fed's first phase of pivot materialises.

Over in Asia, inflation remains above the upper tolerance level of most central banks. The outsized rate hikes by the Fed have boosted the strength of the US dollar significantly, contributing to rising inflation in Asia via more expensive imports. As the Fed decelerates the pace of tightening, demand for the US dollar, together with inflation expectations, will likely soften. This could in turn provide room for monetary authorities in the region to temper the pace of interest rate hikes or even pause monetary policy tightening (for those central banks which have so far been relatively more aggressive with policy tightening).

Regarding the economy, most countries are expected to grow at a slower pace than they did in 2022. As opposed to recent years, fiscal stimulus will no longer be a dominant factor driving growth in the region in 2023, as most economies have opened up their borders. Hence, we anticipate fiscal deficits to gradually narrow as the need for pandemic support decreases. China has begun its exit from a "zero-COVID" strategy but it could be a gradual path to normalcy with potentially high number of cases necessitating some small pullbacks along the way. As such, the economy is likely to worsen before it gets better.

Political noise is expected to increase in Thailand, Indonesia and India in 2023. Thailand is expected to hold general elections in May 2023, while Indonesia and India are scheduled to hold national elections the year after. Although there could be some form of increased fiscal support ahead of these elections, any impact is likely to be minimal. Meanwhile, China's politics should remain in focus until March 2023 when changes to the top posts at various government agencies, notably the premiership and central bank, are to be announced.

Against regional peers within Asia, we favour Singapore and South Korean government bonds, given their relatively higher sensitivities to stabilising UST bond yields. Potential inclusion into the FTSE Russell World Government Bond Index should provide an additional boost for South Korean government bonds. With sluggish growth and inflation under control, China onshore bond yields have adjusted higher recently but should continue to be stable, at least in the near term. Meanwhile, demand for India and Indonesia bonds is likely to be supported when upward pressure on global bond yields eases as market focus turns to their attractive real yields relative to those of their regional peers.

Asian central banks drew on their large foreign exchanges reserves—accumulated during periods of capital inflows and low US interest rates—to help prop up their currencies amid the relentless rise in the US dollar in 2022. Despite the decline, most Asian countries continue to have adequate reserves coverage. On currencies, we take a neutral to underweight view on the US dollar, as we see waning demand for the currency when the Fed pivots. We expect overall Asia FX to outperform the dollar and see further room for the Singapore dollar (SGD) to outperform against other regional currencies as sticky core inflation will prompt the Monetary Authority of Singapore (MAS) to keep the Singapore dollar nominal exchange rate (SGDNEER) on an appreciating stance. Meanwhile, demand for the Thai baht could increase meaningfully once China reopens its borders and further boosts tourism flows into Thailand.

Individual country outlooks

China

China's GDP growth will likely come in around 3.0-3.5% in 2022, falling short of the official growth target of "around 5.5%" set in March of 2022. For 2023, consensus forecast is for economic activity to pick up to 4.8%. In our view, actual GDP growth delivery rests heavily on the country's success in transiting out of its zero-COVID policy. The central government has begun to roll back restrictive COVID-19 controls, but we think that the path to normalcy would be gradual with temporary pullbacks along the way if the number of cases threaten to overwhelm the medical system. Although the recent relaxation in financing conditions for real estate developers is a positive sign, China will also have to contend with a slowdown in exports as global growth moderates. Meanwhile, the upcoming Central Economic Work Conference in December 2022 and the National People's Congress in March 2023 should provide key guidance for economic policies.

Inflation remains relatively muted in China. The most recent readings showed headline CPI at 2.1% in October 2022. Excluding food and energy prices, core CPI rose by just 0.6% in the same month. Meanwhile, the producer price index slipped into deflationary territory for the first time since December 2020. Moving forward, relaxation of COVID-19 controls is likely to push inflation higher. That said, we believe impact on inflation from further reopening will be tempered in China relative to other countries as employment remains weak and may take time to recover as global demand softens. While the People's Bank of China is keeping an eye on inflationary pressures, we believe there is minimal risk of a meaningful acceleration in in the near term that will force it to hike interest rates aggressively.

With sluggish growth and inflation under control, China onshore bond yields should continue to be stable in the near term. A less restrictive COVID-19 policy and the country's reopening should provide a boost to the Chinese currency as sentiment improves. Thereon, other fundamental factors would weigh on the equation. Export growth may have

peaked and foreign investors may be evaluating the political climate relative to their investments. Outbound tourism spending is also likely to increase, albeit at a later stage. That said, with the renminbi having weakened significantly since 1Q22, some of these factors have arguably been already priced in. Nonetheless, the renminbi is seen benefitting from a pick-up in the Chinese economy amid an expected global slowdown.

Foreign relations with most developed nations—particularly the US—is currently tense and will likely remain so. US attempts to isolate China in strategic sectors such as semiconductors will continue to be an overhang. Despite these risks, China remains one of the most important trade partners to many nations. In addition, it has a large domestic economy which remains an attractive investment destination for many foreign firms.

South Korea

We expect weakness in external demand amid the technology sector downcycle, together with lag effects of higher interest rates, to be key drags on the South Korean economy in 2023. Notably, export growth moved into negative territory in October 2022, as the contraction in chip exports continued. Consensus forecast is for GDP growth to come in at 2.6% in 2022, moderating thereafter to 1.8% in 2023.

Funding pressures have increased in the financial system, reflecting a credit crunch following a corporate default on short term paper. Authorities have, however, been quick to provide liquidity support, and our base case for now is that the situation will remain under control.

Headline inflation is showing signs of stabilising, albeit still at relatively elevated levels, while recent data suggest consumption could be peaking. Having commenced its rate hiking cycle much earlier relative to other central banks in the region, the Bank of Korea (BOK) may be slowing down the pace of its monetary tightening. At its most recent monetary policy committee meeting, the central bank signalled a preference for less aggressive hikes, with two dissenters favouring a smaller (25 bps vs. 50 bps) hike. Moving forward, we believe that growth and financial stability concerns will start playing a bigger role in the BOK's considerations.

The slowing growth outlook and stabilising inflation supports our positive view on long-end Korean Treasury Bonds. Medium term technical positives include a lower net supply of government bonds next year, as well as their potential inclusion into the FTSE WGBI bond index. Meanwhile, the Korean won has been a relative underperformer in the region for most of 2022, reflecting the recent string of trade deficits as well as the downcycle in the technology sector. While the outlook remains challenging near term, a turn in the bullish US dollar sentiment and that a lot of negatives could already be priced-in warrant investor consideration.

India

Domestic demand in India remains strong, with robust consumption growth helping to offset weakness in external demand. Meanwhile, capital expenditure by the government is expected to sustain investment growth. Economic activity is likely to moderate in 2023, as consumption growth normalises and the drag from monetary policy tightening impacts household purchasing power. Consensus expectation is for fiscal year 2023 growth of around 7%.

India's fiscal position remains stretched with a central fiscal deficit of over 6% of GDP. Similarly, public debt to GDP ratio remains elevated at more than 80% of GDP. Such statistics have raised concerns around the country's capacity to sustain these levels of debt. We believe the key to India's debt sustainability rests on policymakers' ability to implement structural reforms through the strategic allocation of capital expenditure.

Headline inflation is set to gradually peak as food prices stabilise. We expect the Reserve Bank of India to continue with its monetary policy tightening into early 2023, as it resolves to anchor core inflation. Our projection is for a terminal rate of around 6.5%, with real interest rates gradually moving back into positive territory.

Heading into 2023, India faces rising risks of deterioration in its trade deficit. Prospects of an extended period of subdued global growth could cast a shadow over India's external sector via slower exports. This, together with higher imports resulting from the still-elevated oil prices, can potentially weigh on the Indian rupee. Overall, the currency may remain sensitive to big moves in oil prices and equity flows, as well as to the broader dollar trend.

India government bonds have traded fairly stable of late. Our constructive view on India bonds is supported by a confluence of factors including decent yield, slowing inflation and the possibility of a pause in rate hikes early next year. India government bonds would also benefit from the resumption of inflows into emerging markets.

Singapore

The MAS expects GDP growth to come in at 3–4% in 2022. For 2023, growth is forecasted to register "below trend" as the drag on economic activity from the globally synchronised monetary policy tightening intensifies. Inflation is expected to remain elevated, with upside risks due to global commodity price shocks and domestic wage pressures. The MAS is projecting 2023 headline CPI to come in at around 5.5–6.5%, taking into account the one-off impact of the Goods and Services Tax (GST) increase. It sees core inflation—which was initially expected to peak around mid-2022—to remain high in the next few quarters before easing in the second half of 2023, averaging around 3.5–4.5% in the same year.

The MAS has moved aggressively to dampen inflation, strengthening the Singapore dollar at an unprecedented pace of five times since October 2021. However, with labour market conditions remaining tight, passthrough effects from wages to core inflation will likely persist into 2023. Consequently, we expect further policy tightening from the MAS, and do not rule out the possibility of yet another off-cycle move in the first quarter of 2023, particularly if core inflation lingers at current levels.

With monetary policy moving further into a restrictive setting, the Singapore dollar is expected to stay resilient against the US dollar and outperform other currencies in the region going into 2023. A stronger Singapore dollar relative to the basket of currencies will in turn support demand for SGD-denominated assets. We head into 2023 with a positive view on Singapore Government Securities (SGS). The issuance of sovereign and statutory board green bonds is likely to increase as the nation aims to achieve net zero by 2050.

Malaysia

Malaysia's economy rebounded swiftly from the pandemic. Bank Negara Malaysia (BNM) is projecting full-year 2022 growth to be between 6.5-7%, before moderating to 4-5% in 2023 on the back of a sharp slowdown in external demand offset by domestic drivers. Fiscal deficit in 2023 is expected to narrow to 5.5% of GDP versus 5.8% in 2022, remaining expansionary to benefit consumers and small businesses. The official budget will be re-tabled after the November 2022 elections.

The government forecasts core inflation to average closer to the upper end of the 2.0%–3.0% forecast range in 2022 after peaking in the third quarter of 2022, with upward pressures to inflation remaining partly contained by existing price controls, subsidies, and the remaining spare capacity in the economy. Moving into 2023, food inflation is likely to remain a key contributor to price pressures, while tighter labour markets could lift services inflation amid continued border reopening tailwinds.

BNM has hiked its Overnight Policy Rate by a total of 100bps in this policy tightening cycle. We expect it to raise rates by a further 25 to 50bps in 2023. The central bank has emphasised that adjustments to monetary policy settings will continue to be "measured and gradual", ensuring that monetary policy remains accommodative to support sustainable economic growth in an environment of price stability.

Elections were held in November 2022 and the country now faces a hung parliament. As of this writing, early results reveal opposition leader Anwar Ibrahim's Pakatan Harapan alliance secured the most seats, albeit falling well short of a majority, while Prime Minister Ismail Sabri Yaakob's ruling Barisan Nasional coalition—which includes the dominant United Malays National Organisation (UMNO)—suffered a major upset, losing several stronghold seats. The results likely mean that the 2023 budget will have to be re-tabled by the new government. While there could be some changes made, most elements are likely to be retained. Key issues to watch are the implementation of the targeted fuel subsidy mechanism and the reinstatement of the GST.

Malaysia's current foreign currency debt exposure amounts to less than 5% of total debt. Gross issuance will increase to Malaysian ringgit (MYR) 180 billion in 2023 (from MYR 171 billion in 2022) but we think supply is digestible, supported by captive real money demand onshore and steady inflows from the Employees' Provident Fund (EPF). Separately, we expect weakness in the ringgit vis-à-vis the US dollar to persist, for as long as the Fed continues to hike while BNM maintains its gradual policy stance. We expect this trend to reverse towards the end of the Fed's hiking cycle.

Thailand

We expect Thailand's economic recovery from the pandemic to extend into 2023, driven by tourism revival. While the tourism industry has bounced back and gained ground in the latter half of 2022, international arrivals are still far behind pre-pandemic levels. For comparison, Thailand welcomed nearly 40 million overseas visitors in 2019 compared to around just 7 million in the first 10 months of 2022. China's stance on its zero-COVID policy is one of the

biggest wild cards to Thailand's growth outlook in 2023, as its tourism sector has historically been heavily dependent on Chinese tourists. Undoubtedly, a reopening of China's borders will meaningfully boost to Thailand's tourism receipts. Nonetheless, pending China's reopening, we expect release of pent-up demand for air travel from other countries to support a sustained pick-up in tourist arrivals.

Higher tourism revenue, together with easing oil prices as global economic activity moderates, is seen improving Thailand's current account. We expect the current account balance to return to surplus in 2023. Meanwhile, we do not anticipate any major fiscal expenditure plans until there is greater clarity on composition of the new government following an election in 2023.

Bank of Thailand (BOT) projects headline inflation to average 6.3% in 2022 and 2.6% in 2023. We share the view that overall inflation has peaked and headline CPI will gradually trend lower hereon. Core inflation may, however, remain sticky, reflecting effects of the minimum wage hike and tourism recovery. This notwithstanding, we see limited likelihood of the central bank turning more aggressive in raising rates, while possibly pausing monetary policy tightening in the first half of next year. BOT has constantly defended its gradual and measured pace of tightening by citing well-anchored medium-term inflation expectations and subdued demand-pull inflation pressures.

Turning to politics, Thailand is scheduled to hold general elections in May 2023. While recent polls suggest a win for the opposition Pheu Thai Party, we will closely monitor political developments heading towards the elections.

We hold the view that the Thai baht will benefit from an improved current account balance as tourism receipts increase. Meanwhile, demand for Thai government bonds is likely to be well supported once the Fed starts to signal a pivot, which in turn could prompt the BOT to pause monetary policy tightening.

Indonesia

We expect growth in Indonesia to remain resilient in 2023, supported by strong investment and robust consumption. Strong commodity prices prompted a sharp improvement in Indonesia's current account in 2022 and has supported the resilience of the Indonesian rupiah against other currencies in the region. Against a backdrop of subdued global growth, commodity prices are likely to ease going forward. With the boost from high commodity prices waning, the government will have to rely more on strong foreign direct investment to support Indonesia's basic balance in 2023. Taking a longer-term perspective, Indonesia's growth story hinges on its plans to benefit more from the anticipated boom in the global EV industry—including the development of its domestic nickel processing and refining sectors, as well as domestic production of EV batteries.

Headline inflation is starting to ease, although core inflation remains sticky. We expect Bank Indonesia to continue hiking rates into 2023 and pause when the Fed ends its hiking cycle. Nonetheless, the need to anchor FX stability will also be an important determinant of future monetary policy action.

We hold a constructive view on Indonesian bonds going into 2023. Demand will likely find support when upward pressure on global bond yields eases as market focus turns to their attractive real yields relative to regional peers. The government has also committed to bringing the fiscal deficit back down to below 3% in 2023, which is positive for Indonesian government bonds. However, we note that the central bank will cease the "burden sharing" programme in 2023, which would reduce some support for local bonds. Nonetheless, we anticipate foreign inflows to improve in 2023 as the Fed concludes its tightening cycle. We are relatively more neutral on the FX outlook, reflecting our anticipation of easing commodity prices.

Philippines

The Bangko Sentral ng Pilipinas (BSP) remains sanguine about the economic recovery and expects full-year 2022 and 2023 GDP growth to come in at 6.5-7.5% and 6.5%, respectively, albeit acknowledging downside risks to the latter. We anticipate growth momentum to similarly weaken in 2023, following the strong recovery seen in 2022. Similar to most countries in the region, lag effects of higher interest rates and elevated inflation are key factors that could weigh on domestic demand next year. While corporate borrowing may continue to recover, it may be tempered by the high interest rate environment. Global economic slowdown will also likely be a drag on exports and remittances in the coming year.

BSP has moved aggressively to dampen inflation, raising its policy rate by a total of 300 bps* so far in this policy tightening cycle. Although inflation is likely to ease next year as a result, we expect headline CPI to remain above the central bank's 2–4% target as strength in domestic consumption together with a weak Philippine peso provides upward pressure to inflation. Consequently, we expect BSP to maintain its focus on inflation, keeping the currency under a watchful eye. BSP Governor Felipe Medalla recently declared that the central bank may have to keep on

matching the Fed's consequent rate increases to maintain about 100 bps of policy rate differential against the US, potentially taking the policy rate level to 5.5–6% next year.

The government plans to gradually reduce the country's fiscal deficit—which ballooned in the wake of the pandemic—back to 3% by 2028. It seeks to rely mainly on strong revenue growth (rather than reductions in fiscal spending) for this adjustment.

Heading into 2023, we expect the Fed's monetary policy outlook to continue to be the primary driver of Philippine government bond yields. In our view, a Fed pivot, when it comes, will prompt a retracement lower in global bond yields, including those of the Philippines. In addition, Philippine government bond yields are also expected to decline once inflation eases. However, potentially higher supply in 2023 on the back of the still sizable fiscal deficit, could offset some of the rally. On FX, we see potential for the peso to rally in line with other Asian currencies once US inflation eases and the Fed signals readiness to pivot from its tightening cycle. However, renewed focus on infrastructure spending in the Philippines will translate into greater imports. This, together with the high fiscal deficit, could offset the rally in the currency. BSP has drawn upon its foreign exchange reserves to manage the volatility of its currency and to limit its depreciation. On the other hand, foreign worker remittance and business process outsourcing revenues had added to the amount of reserves keeping it at a healthy level.

Twin deficits are the main risks for the Philippines; deficit deterioration together with a slowdown in economic growth that is worse than expected could lead to outlook downgrades by global rating agencies.

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