AMRO
ASEAN +3 MACROECONOMIC RESEARCH OFFICE

Market Insights

# Is the US Fed Tightening a Seismic Shift for ASEAN+3 Markets?[1]

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*"It takes an earthquake to remind us that we walk on the crust of an unfinished planet."*

~ Charles Kuralt
American journalist

## I. Introduction

1. **The US Federal Reserve's ("Fed's") monetary policy tightening has roiled markets most of this year.** Heading into 2022, markets were initially anticipating a phase of elevated inflation and found comfort in the Fed's forward guidance and accommodative stance. However, the war in Ukraine, which contributed to more persistent and rising inflation and spikes in commodity prices, coupled with a potential slowdown in the Chinese economy from COVID-19 outbreaks, cast a pall on sentiment. But the most disruptive development for markets was the quick pivot by the Fed from its dovish to very hawkish stance. Although the sharp switch likely helped manage market expectations around the path of future inflation, it raised fresh concerns that tighter financial conditions could cause a recession.

2. **ASEAN+3 markets saw limited spillovers from global markets during the first-half of 2022, but with recessionary concerns building up, the risk of severe capital outflows has increased.** Global equity market weakness, a strong US dollar, rising US Treasury yields, and surging commodity prices have been the dominant themes in the markets this year. But the reaction in regional markets has, thus far, not been as severe as those in the West and consequently, capital outflows from regional markets have been limited. That said, with recessionary fears lingering and with the pace of Fed's Quantitative Tightening (QT) set to pick up from the beginning of September, the risk of an episode of severe capital outflows remains elevated. In this note, we consider some of the factors that could directly or indirectly play a role in triggering or aggravating capital outflows from the region's economies.

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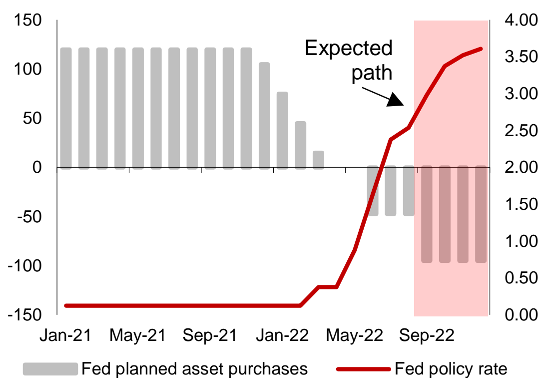
## II. Shift in Fed Stance and Impact on Markets

3. **The Fed has moved away from the "transitory" inflation rhetoric and shifted its monetary policy stance from dovish to extremely hawkish over the past few months.** The US central bank had maintained a view for most of 2021 that inflation would be temporary. Indeed, it started tapering its asset purchases (Quantitative Easing, QE) in November 2021 (Figure 1), while it was still holding that view. However, with no respite in inflation, it dropped the word "transitory" in December 2021 in describing inflation, and also doubled the pace of tapering. Tapering ended in March 2022 and it was almost immediately followed by a lift-off (25 basis point hike). In May, QT was announced along with a 50 basis point hike. The June 2022 FOMC meeting saw another ratcheting up in Fed hawkishness as it delivered a 75 basis point hike in response to unrelenting inflation, followed by another 75 basis point hike in July. Overall, the Fed had moved from QE tapering to QT within six months and delivered cumulative rate hikes of 225 basis points in five months, while shifting its focus to inflationary pressures.

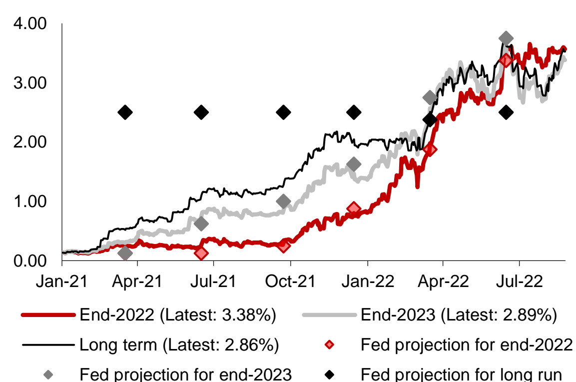
4. **The Fed has not only tightened monetary policy but also made sure that markets are ready for continued tightening at a breakneck pace.** As the Fed delivered its interest rate rises, it also progressively strengthened its forward guidance toward greater hawkishness. The FOMC member projections, as well as market expectations of the Fed's policy rate, have increased significantly over the past seven months (Figure 2), which indicates that the Fed has prepared markets for a rapid tightening in monetary policy. The Fed also provided a clear path of its QT, which started at the rate of USD 47.5 billion in June 2022 and will be increased to USD 95 billion in September.

**Figure 1. Change in Fed Policy Rate and Planned Asset Purchases**
(Billions of US dollars; percent)




Sources: Bloomberg Finance L.P.; Fed; and AMRO staff calculations.
Note: Expected path for Fed policy rate is as implied by market pricing while that for asset purchases are as projected by the Federal Reserve.

**Figure 2. Market Pricing of Fed Rates and Fed's Projections**
(Percent)

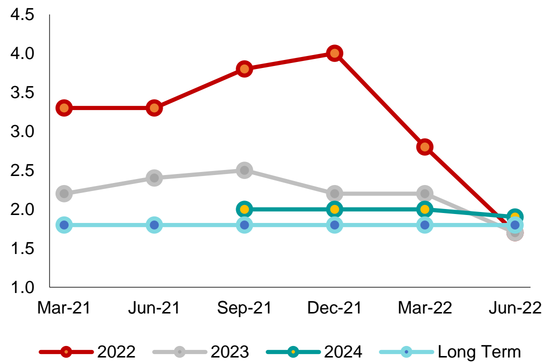



Sources: Bloomberg Finance L.P.; Fed; and AMRO staff calculations.
Note: The pricing of Fed rates in five years is used as a proxy for Longer term pricing.

5. **However, the most important development in the Fed's stance has been the recent emphasis on inflation, even at the expense of growth.** Various Fed interlocutors, including Chairman Powell, have acknowledged the rising recession risks from high inflation and rapid monetary policy tightening. But, they have also clarified that despite a "soft landing being difficult" and the possibility of a recession (Torres and Munhoz, 2022), their unwavering focus is on inflation. At the June 2022 meeting, the Fed downgraded growth projections and raised unemployment and inflation forecasts (Figures 3–6), which confirm

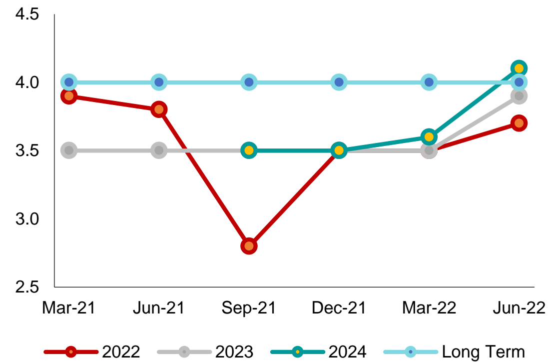
that the central bank will likely maintain its tight policy stance despite the impact on growth. It made markets more concerned about the risks of weakening growth and, by extension, a potential recession, adding another layer of uncertainty and increased the stress for markets.

**Figure 3. Fed Projections: Growth**
(Percent)



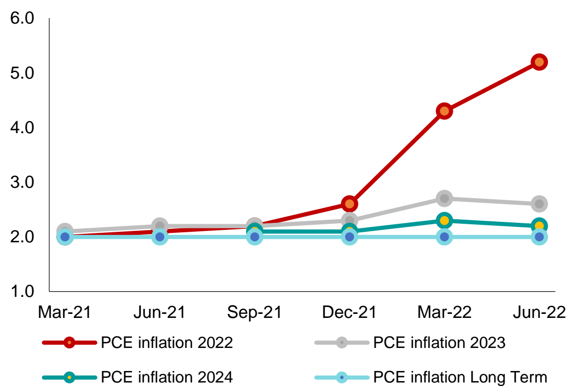

Sources: Fed; and AMRO staff calculations.

**Figure 4. Fed Projections: Unemployment**
(Percent)



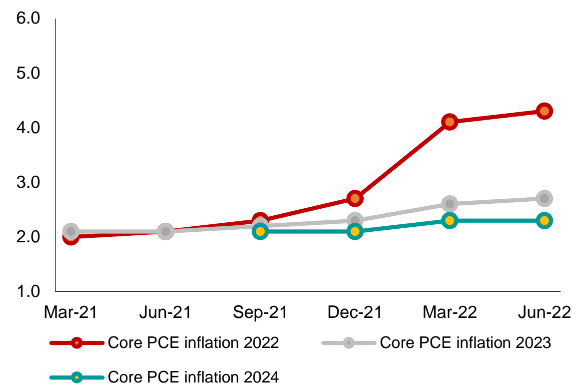

Sources: Fed; and AMRO staff calculations.

**Figure 5. Fed Projections: Headline Inflation (PCE)**
(Percent)




Sources: Fed; and AMRO staff calculations.

**Figure 6. Fed Projections: Core Inflation (PCE)**
(Percent)



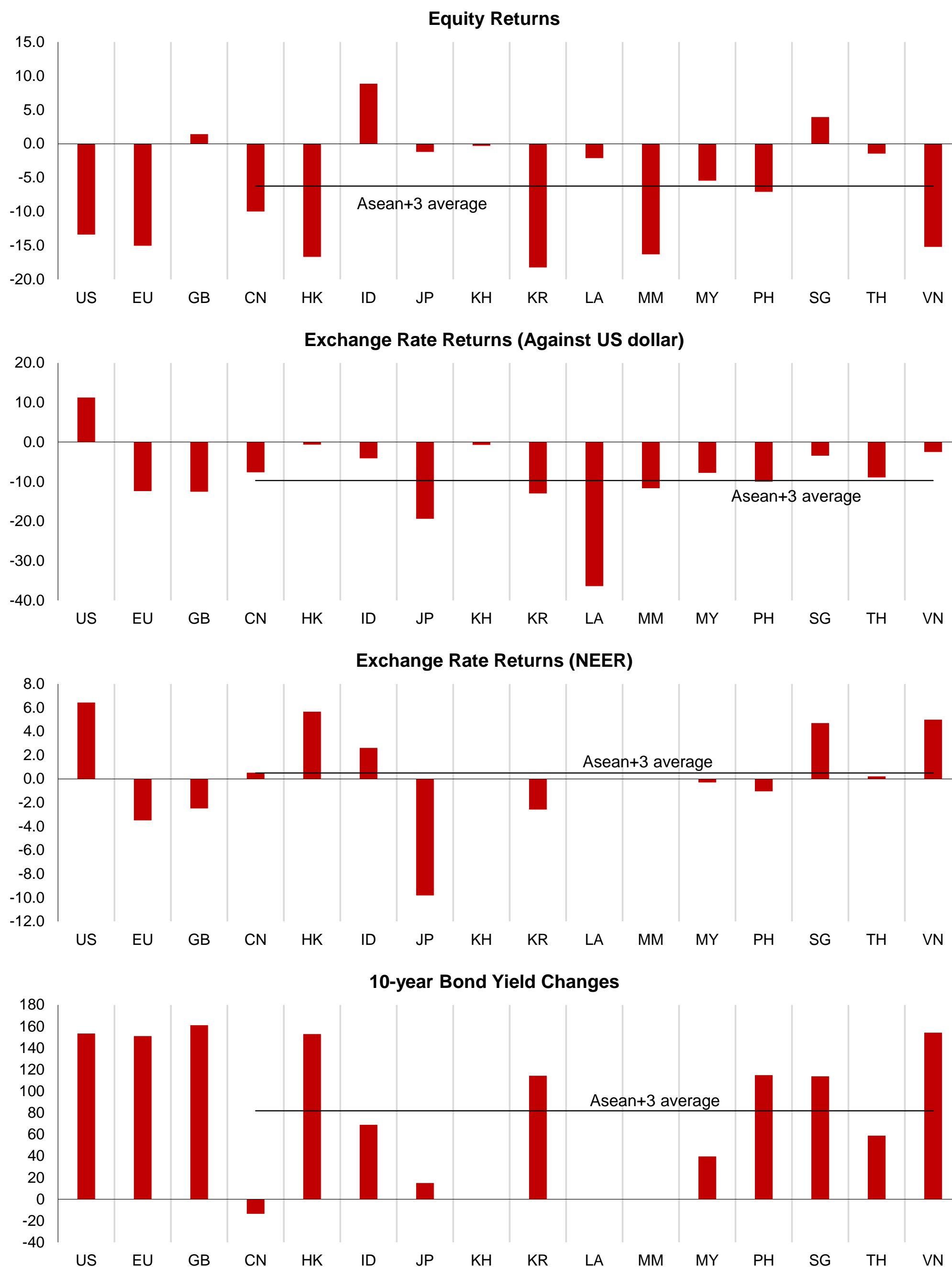

Sources: Fed; and AMRO staff calculations.

6. **In this context, the US Q2 GDP release on July 28, 2022 was an important data event.** It showed an unexpected contraction of 0.9 percent quarter-over-quarter compared to market expectations of 0.4 percent growth. With economic activity having already shrunk by 1.6 percent in Q1 2022, the two consecutive quarters of negative growth pointed to a technical recession. However, Chairman Powell emphasized that the economy was not in recession, highlighting the strong labour market (Reinicke 2022). The July US non-farm payrolls data suggest that the job market remained strong and the rise in average hourly earnings may reflect inflationary pressures spilling into labour markets. The combination of slowing growth and a hawkish Fed remains one of the key risks for global financial markets.

7. **Broadly, global markets reacted severely to the Fed's hawkish shift amid geopolitical uncertainty, although the impact on ASEAN+3 markets was more contained.** Surging oil prices, and the Russia-Ukraine conflict were the other primary drivers of equity weakness, US dollar strength, and rise in bond yields in global markets. However, the weakness in ASEAN+3 equities and currencies (against the US dollar) and the rise in

bond yields were subdued compared to some of the advanced economies (Figure 7). Indeed, underperformers (such as Korean and Vietnamese equities, the Japanese yen and the Laotian kip, and Philippine bonds) and outperformers (Indonesia and Cambodian equities, Chinese bonds) were hostage to more dominant domestic and technical factors. For example, tech sector weakness was the primary reason for the observed softness in Korean equities; the Japanese yen depreciated due to widening US-Japan interest rate differentials; and Philippine bonds reflected rising inflation concerns.

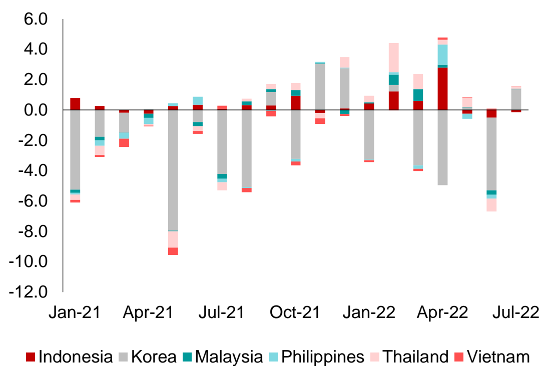
**Figure 7. Major DM and ASEAN+3: Market Returns**
(Percent year-to-date)




Sources: Bank for International Settlements (BIS); Bloomberg Finance L.P.; Haver Analytics; and AMRO staff calculations.
Note: The exchange rate (vs. US dollar) in the case of the United States represents the year-to-date change for the US Dollar Index. Nominal Effective Exchange Rate (NEER) data is unavailable for Cambodia, Laos and Myanmar, sourced from JP Morgan NEER for Vietnam and BIS broad NEERs for all other currencies. 10-year bond yield data is unavailable for Cambodia, Laos and Myanmar.
US = United States; EU = European Union; GB = Great Britain; KH = Cambodia; CN = China; HK = Hong Kong, China; ID = Indonesia; JP = Japan; KR = Korea; LA = Lao PDR; MY = Malaysia; MM = Myanmar; PH = Philippines; SG = Singapore; TH = Thailand; and VN = Vietnam.

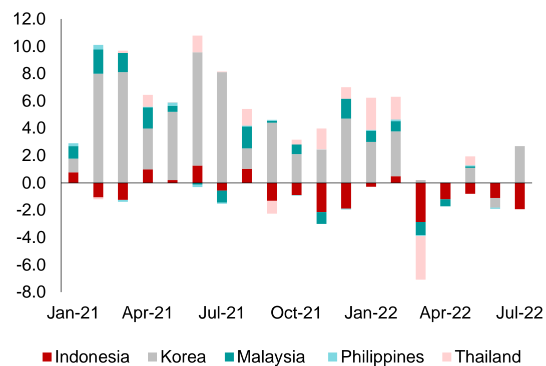
8. **With ASEAN+3 markets broadly performing better than most other global markets, the capital outflow pressures have been limited thus far.** The region's capital flow situation has been relatively stable. Regional equity markets (excluding China and Japan) (Figures 8 and 9) saw outflows last year but many of them have recorded inflows thus far in 2022. The notable exception is Korea, where equity weakness has been accompanied by outflows. Debt flows into the region were strong in 2021 and, excluding March 2022 (when the re-pricing of Fed tightening was sharpest), retrenchments have been limited this year. China's equity and debt markets saw large outflows between March and May (Figure 10), when China imposed lockdowns in response to surges in COVID-19 cases. Japan's debt markets have also seen outflows in 2022, predominantly in June (Figure 11), as a result of the widening yield differentials between Japan and the United States.

**Figure 8. Selected ASEAN+3: Foreign Flows in Equity Markets**
(Billions of US dollars)



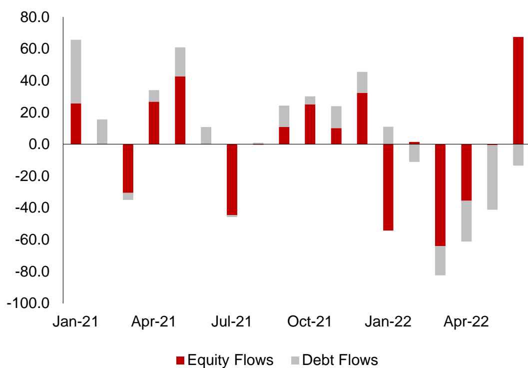

Sources: Bloomberg Finance L.P.; Haver analytics; and AMRO staff calculations.

**Figure 9. Selected ASEAN+3: Foreign Flows in Debt Markets**
(Billions of US dollars)



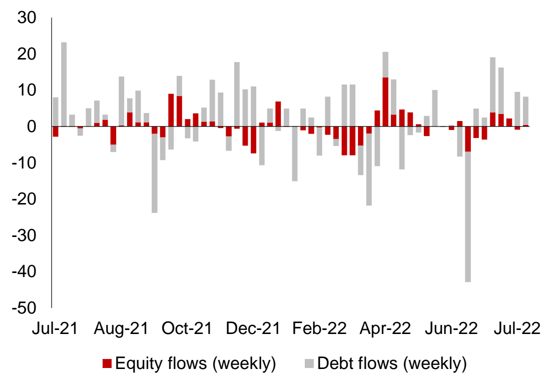

Sources: Bloomberg Finance L.P.; Haver analytics; and AMRO staff calculations.

**Figure 10. China: Foreign Flows in Capital Markets**
(Billions of US dollars)




Sources: Haver Analytics; Institute of International Finance (IIF); and AMRO staff calculations.
Note: The data from the People's Bank of China are available as of March 2022. We use data from the IIF for April and May 2022

**Figure 11. Japan: Foreign Flows in Capital Markets**
(Billions of US dollars)




Sources: Bloomberg Finance L.P.; Haver Analytics; and AMRO staff calculations.

## III. Factors Relevant for Capital Flows in the ASEAN+3

9. **Different factors influence capital flows across the region's economies.** They could be potential triggers or may aggravate episodes of capital outflows, and are not exclusive (Appendix I). Some key factors for the region are:

- **Interest rate differentials.** The difference in yields between domestic and foreign yields (typically US Treasury yields) is a measure of the relative attractiveness of investments in the domestic economy. Portfolio flows in Indonesia, Korea, Malaysia, and Thailand have historically been sensitive to interest rate differentials to varying degrees. Widening interest rate differentials have also been a key reason for the recent weakness in the Japanese yen, which was accompanied by some outflows from debt markets. Capital outflows from China (which depend more on the growth outlook) and Vietnam (lower proportion of portfolio investments) have tended to be relatively less dependent on interest rate differentials.

- **Monetary policy stance.** A country's monetary policy stance feeds into investor decision via two channels: (1) the change in nominal rates, which impacts the attractiveness of domestic assets; and (2) the perceived position on combating inflation, which dictates the real rates of the domestic economy. Central banks that have turned hawkish in curtailing any early sign of inflationary pressures are likely to find more support for their currencies and face less capital outflow stress. The region's central banks, however, face a challenging trade-off between tackling inflation and preserving the nascent economic recovery from the pandemic.

- **Exchange rate regime and foreign exchange (FX) reserves.** A flexible exchange rate allows the market to quickly price in any lingering uncertainty but excess volatility could also force investors to liquidate their investments. Many central banks in the region typically allow market forces to determine the exchange rate and intervene only to smooth excess volatility. This approach has been effective in reinforcing investor confidence in assets denominated in the respective currencies. Clear communication by authorities and sufficient capacity (such as adequate FX reserves) to conduct policy have helped mitigate capital outflow risks. Many of the region's central banks have built up their FX reserve buffers since the Asian financial crisis.

- **Foreign participation in local currency debt markets.** In periods of heightened volatility in global markets, foreign investors tend to liquidate their investments in emerging markets. Hence, capital markets with high participation from foreign investors are more susceptible to large capital outflows. Among local debt markets, foreign participation in Indonesia, Japan, Korea, and Malaysia is greater than 10 percent. It is much lower than pre-pandemic levels in Indonesia and Malaysia, while the share of long-term investors has increased in both these countries and Korea, reducing the risks of large capital outflows.

- **Foreign participation in local currency equity markets.** Foreign participation is on the higher side for Hong Kong, Indonesia, Japan, Korea, and Thailand, which makes these equity markets vulnerable to capital outflows. However, among these markets, foreign equity holdings in Indonesia and Thailand are lower as a percentage of FX reserves. It suggests that the central banks have some space to manage FX volatility in the event of severe outflows from equity markets. On the other end of the

spectrum, foreign ownership of equities in Japan and Korea is higher than their FX reserves (Figure 12).

- **Economic conditions.** Some of the macroeconomic factors are key in creating differentiation among regional markets. For instance, commodity exporters (such as Brunei, Indonesia, Malaysia), which are enjoying better terms of trade in the current environment, are more resilient against capital outflow risks. Similarly, the growth outlook can play an important role for some economies, as was the case for China when lockdowns were imposed in March 2022.

- **Perceived safe haven status.** Investors consider certain assets to be "safer" than others and may allocate more capital to the former during periods of market stress. In the region, the Japanese yen and Japanese government bonds (JGBs), the Chinese renminbi and renminbi government bonds, the Singapore dollar and Korean bonds have exhibited some degree of safe haven behavior in recent years, suggesting that investors retain their preference for these assets during periods of market stress.

**Figure 12. ASEAN+3: Foreign Ownership of Local Equities**
(Percent of FX reserves)

Sources: Bloomberg Finance L.P.; and AMRO staff calculations.
CN = China; HK = Hong Kong, China; ID = Indonesia; JP = Japan; KR = Korea; MY = Malaysia; PH = the Philippines; SG = Singapore; and TH = Thailand.

## IV. Conclusion

10. **Some of the factors which can trigger or aggravate capital outflows are structural but others could be mitigated in the near term to minimize capital outflows:**

- Against the backdrop of rising inflation, Fed hawkishness and tighter global liquidity conditions, interest rate differentials and the monetary policy stance of the region's central banks are expected to be the focal points for investors. While monetary policy should be governed largely by domestic growth and inflation dynamics, a hawkish shift by the central bank could help improve valuations and provide currency stability.

- Authorities' approach to currency management will likely be the next important factor during periods of market stress. A sharp depreciation in the currency may have an impact on investor sentiment but the ability to allow exchange rate adjustments while limiting volatility will be important in maintaining investor confidence.

- Finally, issues such as the size of FX reserve buffers, foreign participation in domestic markets, and macroeconomic conditions are difficult to address quickly when market conditions deteriorate but, within the ASEAN+3 region, policymakers have made concerted efforts over the past two decades to continually strengthen economic fundamentals.

## References

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