BNY

iFlow

MACRO MORNING BRIEFING

August 21, 2024

FX Valuations Supporting FDI Drive

FDI focus for APAC asset allocation instead of listed markets

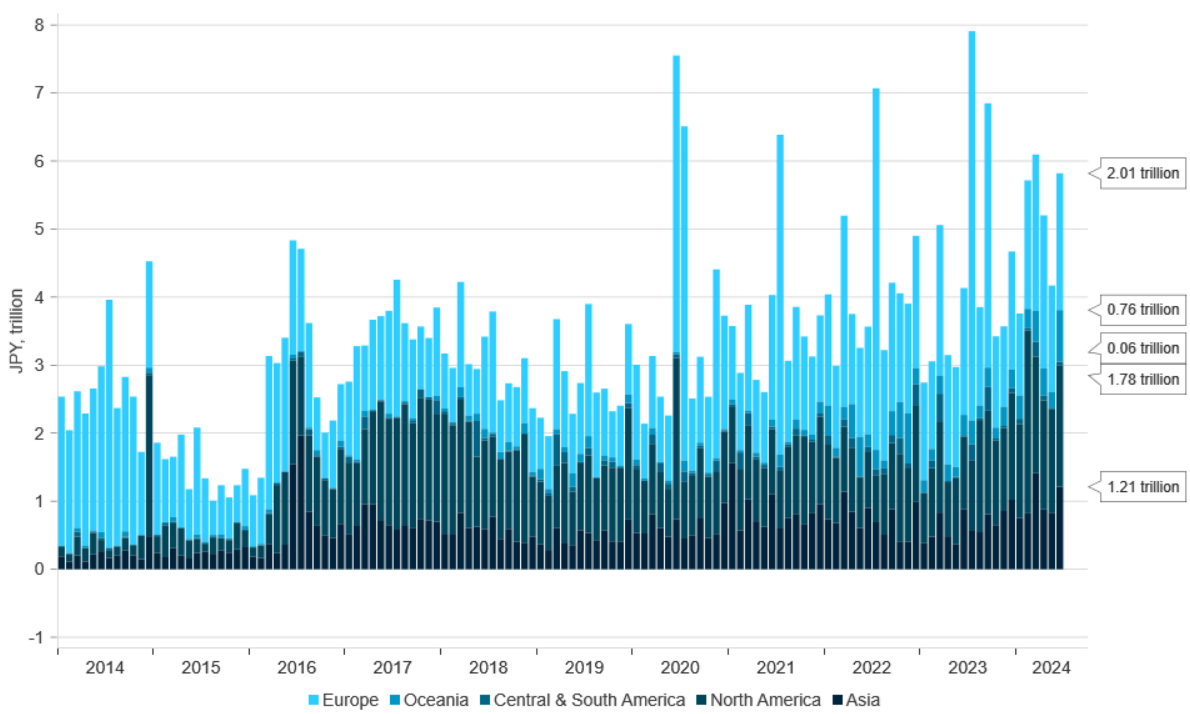
- Corporate interest in Japan and Korea showing FX sensitivity
- Diversification and advantageous USD valuations a factor behind flows
- US flows continue to benefit from earnings reinvestment

Tech struggle and strong dollar shifting FDI focus

This month, financial press reported that a Canadian firm announced its intent to acquire a Japanese company in the consumer sector. It is the biggest takeover of a Japanese company ever proposed. The history of M&A involving Japanese companies and foreign counterparts is a major topic in financial history itself. Without taking a view on the deal's fundamental merits or chances of success, it is perhaps important to look at timing in a price context. First and foremost, it appears that most international asset allocators now believe the JPY's weakness has reached its limits. The sharp appreciation episode at the beginning of August is a forewarning of price action and potential valuation adjustments to come, especially if the BoJ continues down its normalization path. Meanwhile, dollar-based investors are acutely aware that the greenback's valuation limits are also approaching and the window for acquisitions is starting to close. As Japanese equities have performed very strongly during the JPY's slide, which inhibits more attractive equity valuations, taking advantage of the exchange rate can serve as a useful offset.

Exhibit #1 shows the most recent trends in inbound (classified as "executed" under Japanese balance of payments statistics) FDI over the past decade. Based on the latest available figures (monthly), we can see that Europe, the US and Asia account for the vast majority of total inflows. Smoothing for seasonality, on a six-month sum basis, European inflows are also at the top, totaling JPY 11.21trn, which is slightly above the corresponding sum for the US (JPY 10.67trn). APAC flows are well behind at JPY 5.92trn. As the latest data from the Bank of Japan are from June this year, the figures also correspond to year-to-date flows. Also on this measure, we note that the rolling six-month sum of inbound FDI from APAC and US have approached or surpassed the strongest levels in a decade, with particular acceleration seen in 2023. European interest in Japan overtook the US in 2020 and has remained on ever since. The manufacturing linkages between the two regions are traditionally strong and likely had lower sensitivity to exchange rates. In contrast, the more recent FDI flows into Japan from North America and Asia likely have a stronger tech and services component but shifts in the latter can only be explained by sudden valuation gaps opening up as this sector traditionally has not been seen as a high-growth sector within the Japanese economy.

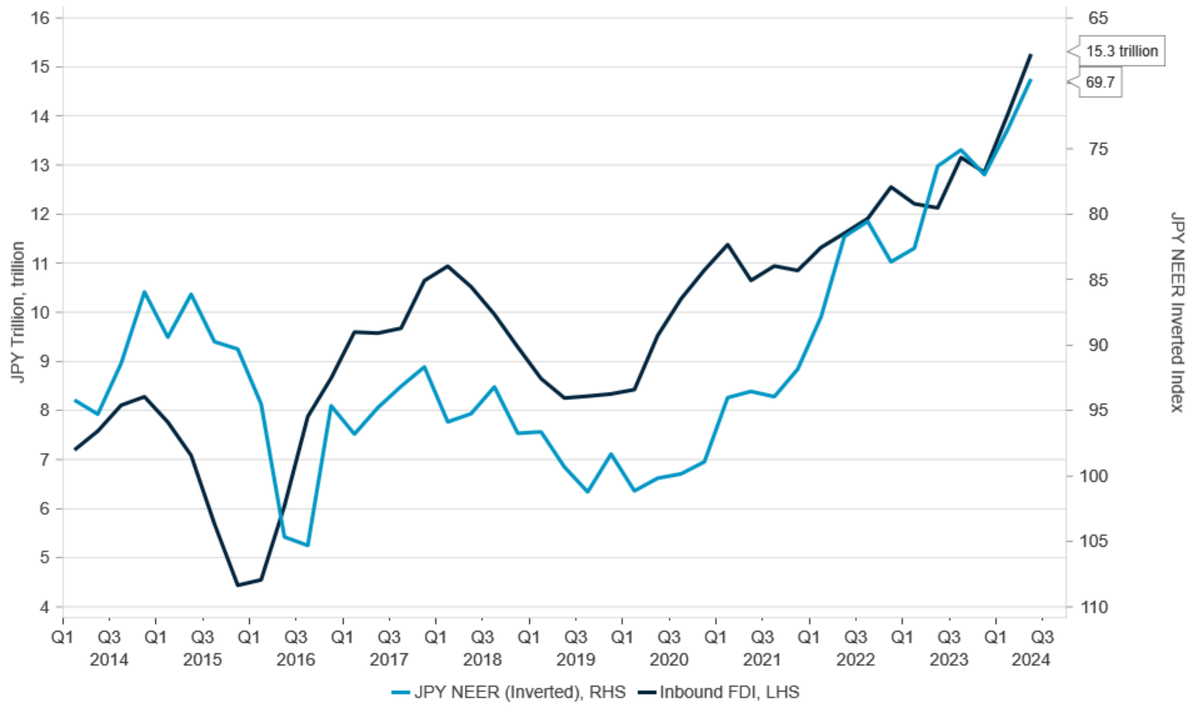
Exhibit #1: Composition of FDI into Japan



Source: Macrobond, BNY

Exhibit #2 shows the four-quarter average total inflows into Japan versus changes in the exchange rate. On this basis, the link between FDI and valuations is even stronger as coincidental moves have been in place since 2016. Looking back at the history of the dollar cycle, even though the Fed was moving forward with rate hikes throughout this period, long-dated US yields held a narrow range which inhibited JPY losses. It was not until JPY valuations began to collapse strongly in 2022, as the global tightening cycle picked up, that the discount on local assets truly picked up.

Exhibit #2: Inbound FDI vs. NEER, Japan



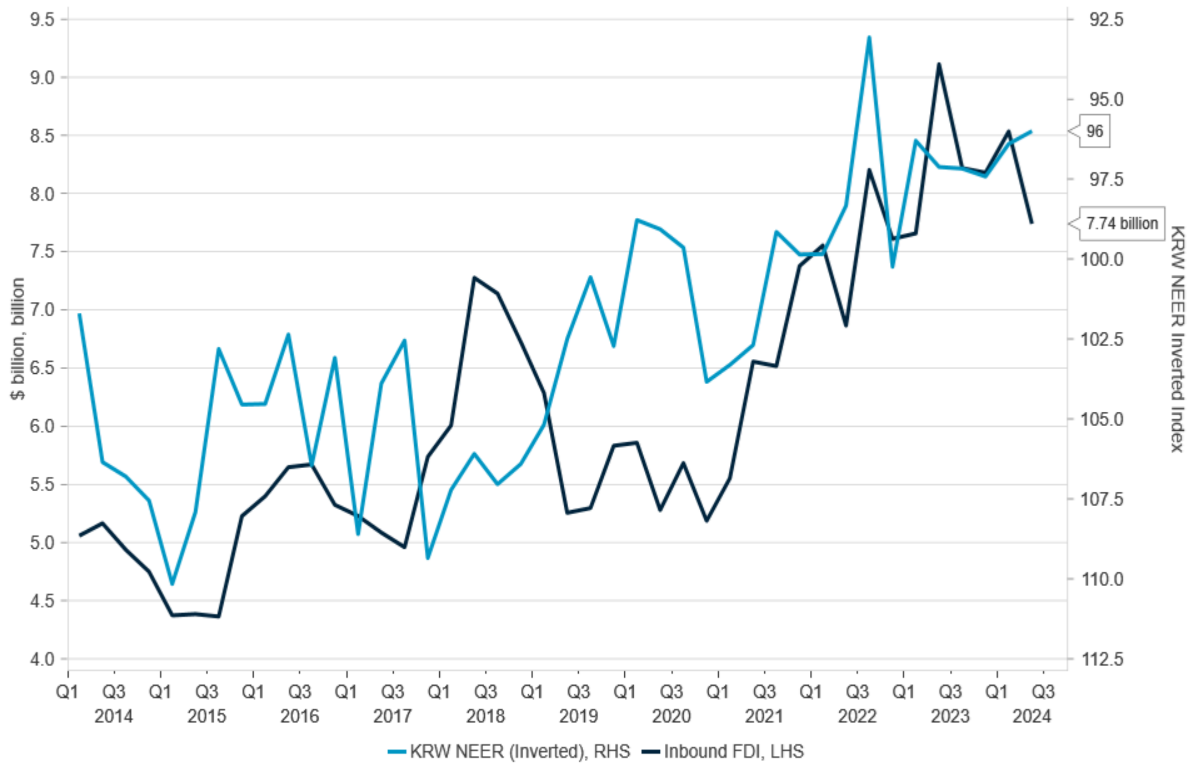
Source: Macrobond, BNY

A similar relationship between FX valuations and FDI can also be seen in Korea (Exhibit #3). As the KRW's nominal effective exchange rate (NEER) has fallen over the last few years, the four-quarter moving average of FDI inflows increased by nearly 80% from 2019 levels and is still 20% higher compared to the high seen in the last decade. Had it not been for JPY weakness and its corresponding impact on regional currency valuations, we suspect the FX discount on local assets would have been even stronger. As KRW yields are non-zero, there is likely a slightly larger earnings reinvestment component in FDI in the region, but the bulk of the marginal increase in flows would be new investments taking advantage of Korea's prowess in the semi-conductor industry.

We recently highlighted in iFlow that a material increase in buying of Korean equities has contributed to strong improvements on the portfolio account. Combined, the KRW is the first "funding" currency in APAC to move back toward overheld due to total return interest. This represents a perfect storm of attractive FX valuations and structural advantages in an industry where global demand is inelastic. If dollar-based investors believe that FX-related discounts will only decline from here as the Fed moves toward an easing cycle, then the risk is of an even stronger near-term push to lock in advantageous exchange rates for FDI. Balance of payments risks up ahead would be slightly to the downside, though narrower rate differentials may keep more funds onshore through the earnings reinvestment column. The bottom line is that the current experience of Japan and South Korea contrast strongly with

China's FDI balances, which continue to show outflows due to structural factors and more muted expectations of improvement in rate differentials relative to the dollar.

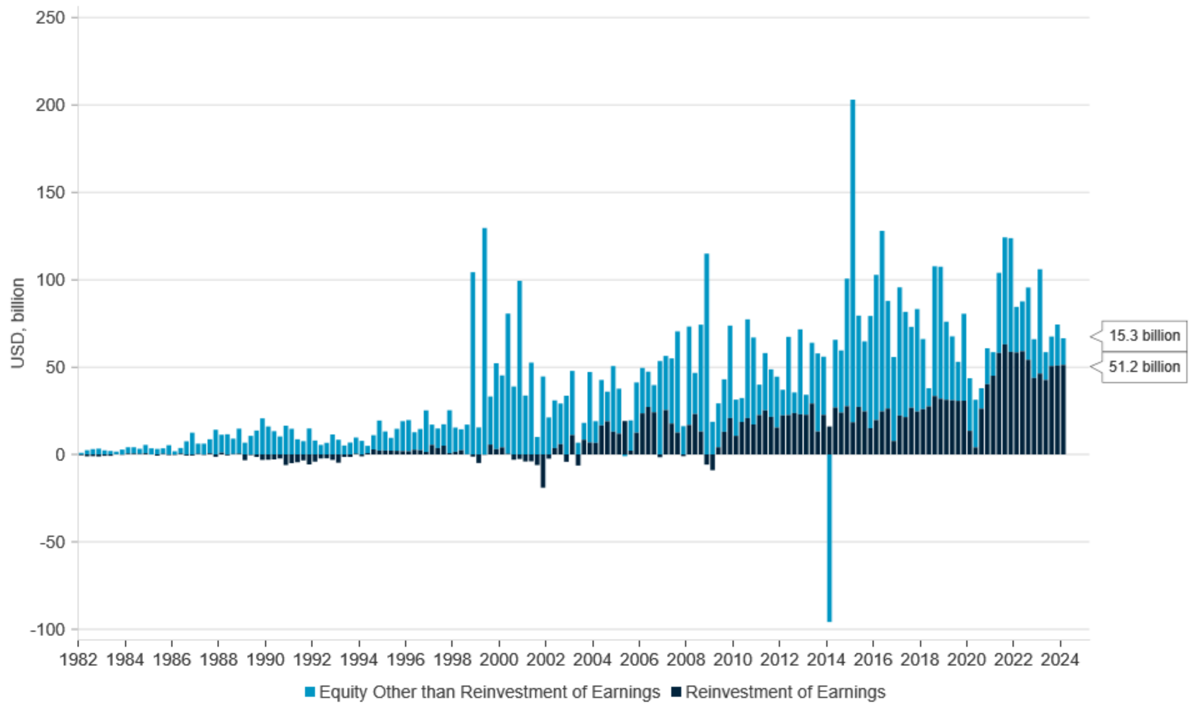
Exhibit #3: Inbound FDI vs. NEER, Korea



Source: Macrobond, BNY

Finally, it would be remiss of us to not look at the current situation with US FDI, not just due to the inflection point being reached in dollar valuations but also because of potential policy adjustments up ahead as the election may also have material implications for FDI-related flows. For example, Treasury guidance aimed at restricting tax inversion clearly had an impact on the overall FDI balance into the US in 2014. Furthermore, the Fed outlook will be just as important for the FDI posture vis-à-vis the US. For international firms, lower dollar yields and a general correction in the US growth outlook could encourage more outflows – we can see that there has been a structural shift in earnings reinvestment in the US since 2020 and that has also contributed to the US' balance of payments. For US firms' overseas holdings, however, barring material changes in tax policy, earnings reinvestment may increase due to more favorable earnings translation, but new equity- or debt-based FDI flows could become more prohibitive on a cost basis if the FX and FDI relationship remains in place in these areas. The dollar impact will be felt most on the foreign investment into the US side, as the country remains by far the most favored destination for global FDI. As the dollar cycle turns, it is possible that global savings pools will start to see US assets as attractive, and the global FDI compact seen over the last two years will start to reverse.

Exhibit #4: US Inbound FDI Flow Composition



Source: Macrobond, BNY

Disclaimer & Disclosures

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

Geoff Yu

EMEA MACRO STRATEGIST

CONTACT GEOFF

Can't see the email? View online

We take our data protection and privacy responsibilities seriously and our privacy notice explains how we collect, use, and share personal information in the course of our business activities. It can be accessed here.

This message was sent from an unmonitored email box. Please do not reply to this message.

.