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FX Insight

USD Turn Opens Up Opportunities for Yuan Bears

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USD Depreciation Opens up Opportunities for Yuan Bears

We have long warned that the risks to the USD have been asymmetric – that the 3Q rise in UST yields and the greenback have priced in US' superiority in economic activity, policy divergence with the rest of the world and the fear of higher-for-longer. In addition, there was geopolitical conflict that tend to spur safe haven USD demand. Since the start of Nov, we have had downside surprises to two significant data including Oct NFP as well as CPI. That has shifted the narrative as markets now perceive US growth, monetary policy as potentially converging with the rest of the world (notwithstanding a gulf of divergence still) and the risk of higher-for-longer seem less threatening for now. The downside risks that we have been warning about have come to fruition with the DXY index now almost 3% off its 1 Nov high and the asymmetric risks have become less asymmetric.

We look for the USD to ease further into end 2024 towards 101 as

1) we see potential for **its fiscal deficit to worsen into 2024** – the US finds its finances increasingly stretched to support multiple conflicts and as such, increasing concerns on its fiscal health, not helped the least by high interest rate burden, could offset USD safe haven allure in a case of another geopolitical conflict (e.g over Taiwan).

2) **higher-for-longer narrative dissipates** as US data continues to paint a picture of soft-landing and market shift to bets on more rate cuts and potential for policy convergence. We acknowledge the possibility that the higher-for-longer narrative could return and **look into past tightening cycles to have a sense of whether the actual length of the pause and aggressiveness of cuts would affect the USD behaviour.** Our study suggests, **they may not**. If the Fed chooses not to cut and leave rates on hold at their peak, longer than what markets anticipated, this does not necessarily mean that the USD will strengthen, as illustrated in the period post Fed tightening cycle that peaked in May 2006 where Fed Fund Target Rate was held unchanged at 6.50% (upper bound) for 14 months. USD can still weaken as long as global growth starts to recover.

3) markets are still cognizant that China is still weak and Eurozone PMIs are contractionary but **this could shift once there is stronger evidence of recovery and therein lies the room for USD to fall further. We are already seeing some signs of stabilization on that front.**

Near-term, there is room for rebound and consolidation as disinflation route is likely to remain bumpy and there is still lingering evidence of resilience in the US economy. We continue to look for the DXY index to hover within 103.60-105.00 before moving more decisively towards 101 in 2024.

Along with our expectations for the USD to weaken further, **we see an opportunity for yuan bears** given the fragile recovery for China. CNY trade-weighted index had risen due to the combination of PBoC's line-in-the-sand actions via the daily fix as well as the rise of the USD. Should the USD continue to ease lower, CNY could have room to weaken against other non-USD peers.

USD Likely to Consolidate For Now

A data-dependent Fed could mean that the Fed has given up some of its control over the rate narrative and market continues to dance to the tune of every data release. We have long warned that the risks to the USD have been asymmetric – that the UST yields along with the greenback have priced in 1) US' superiority in economic growth, 2) policy divergence with the rest of the world and the 3) fear of higher-for-longer as well as 4) geopolitical risks. Since the start of Nov, we have had downside surprises to two significant data including the Oct NFP as well as CPI. That has shifted the narrative as markets now perceive US growth, monetary policy as potentially converging with the rest of the world (notwithstanding a gulf of divergence still) and the risk of higher-for-longer seem less threatening for now. The downside risks that we have been warning about have come to fruition with the DXY index now almost 3% off its 1 Nov high and the asymmetric risks have become less asymmetric.

In the following section, we will address the factors underpinning the USD and our projection for the USD to ease further into 2024.

Will Geopolitical Tensions Spur Safe Haven USD Demand Again?

The Xi-Biden summit turned out to be a four-hour meeting on 15 Nov and ended with pledges to resume military communications, cooperation on fentanyl (to help the US with its opioid crisis) and to have a dialogue on artificial intelligence. The tone of the meeting seemed rather constructive until President Biden called Xi a dictator in his press conference on the meeting. With regards to Taiwan, Biden urged Xi not to interfere with Taiwan's electoral progress while Xi asked the US to stop arming Taiwan and that reunification is "unstoppable".

Regardless, tensions over Taiwan could remain as senior US military officers said Xi has ordered the PLA to prepare for invasion of Taiwan by 2027. This scenario is not improbable as the US is already embroiled in two other conflicts in the world (in Ukraine and Gaza) and that could allow China a higher chance of success should there be an invasion in the near-term (not our house view).

We recall that the Biden administration had asked Congress for USD105bn in funding for Ukraine, Israel, Taiwan and its own border securities in Oct, underscoring how stretched the US is in terms of funding its foreign policies.

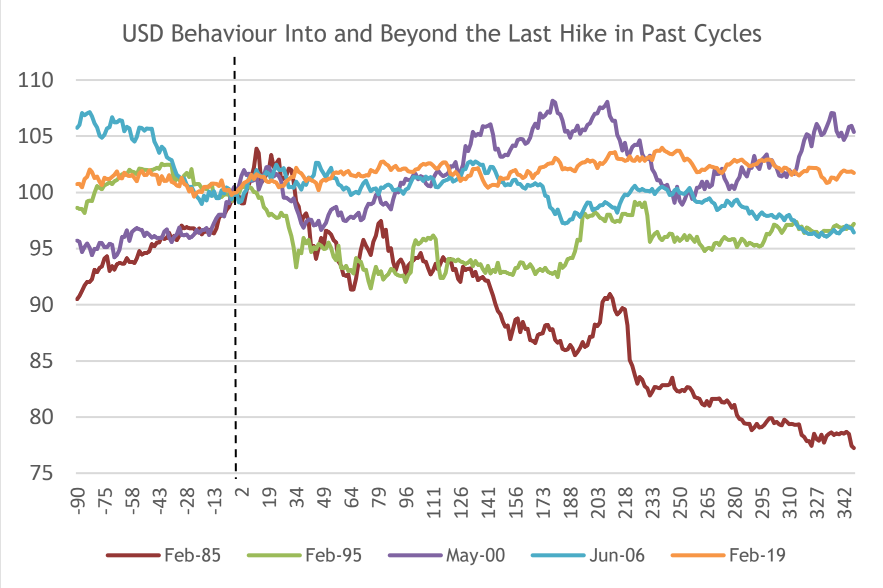
So even as the USD could continue to witness sporadic support from geopolitical episodes, concerns on further fiscal deterioration could offset the greenback's safe-haven allure.

Shifting Focus from *Higher-for-Longer* to <u>*How Long and How Low*</u>?

The DXY index has derived its strength from three other primary factors. 1) US' economic outperformance, 2) concomitant policy divergence, 3) fear of higher-for-longer. Let us look at the third factor first. To some extent, the fear of higher rates had dissipated with the release of recent data – softer-than-expected CPI and NFP for Oct. The question at this point is for how long with rates settings be kept unchanged for and how much easing there could be in 2024.

We re-visited the USD behavior when Fed reached the peak of its past tightening cycles. The dates Feb 1985, Feb 1995, May 2000, Jun 2006 and Feb 2019 denote the months in which the Fed hiked for the last time in each respective cycles. At first glance, the USD tends to trade sideways after the last hikes as we have noted in a piece written last Nov and that has come to fruition to a significant extent for 2023.

Chart 1: Past USD Behavior Around the Peak of Each Cycle Seem Mostly Sideways



Note: Day 0 denotes the date of the last hike for each cycle
Source: Bloomberg, Maybank FX Research & Strategy

We delved deeper to understand whether the length of a pause matters to the USD and whether the USD performance is tied to the magnitude of easing in the following year.

What we found is that the higher-for-longer narrative does not guarantee USD strength. For one, the DXY dropped -4.2% over the 350 days that followed the last hike in **Jun 2006** even though the Fed did not cut rates until 14 months later. However, for the similar period that followed the last hike in **May 2000**, the DXY index actually gained 5.1%. Fed only held rates at 6.50% for 7 months from May 2000 and proceeded to deliver a cumulative 150bps cut by the end of the period. That was the most aggressive start of an easing cycle compared to the other four periods observed here. 2y yield also fell the most (by -2.59%). Yet, the USD still rose +5.1%. This suggests that the magnitude of the rate cuts does not guarantee a significant depreciation in the USD as well.

Table 1: High-For-Longer vs. the DXY index

	Feb-85	Feb-95	May-00	Jun-06	Feb-19
From How High? (Upper Bound)	9.00	6.00	6.50	5.25	2.50
For how long? (in months)	1	4	7	14	6
Target Rate (ppt)	-1.25	-0.50	-1.50	0.00	-0.75
10y yield (ppt)	-2.26	-1.97	-1.07	-0.06	-1.08
2y yield (ppt)	-1.94	-2.24	-2.59	-0.28	-1.06
Dxy (+/- %)	-22.8	-0.41	+5.11	-4.20	+2.49

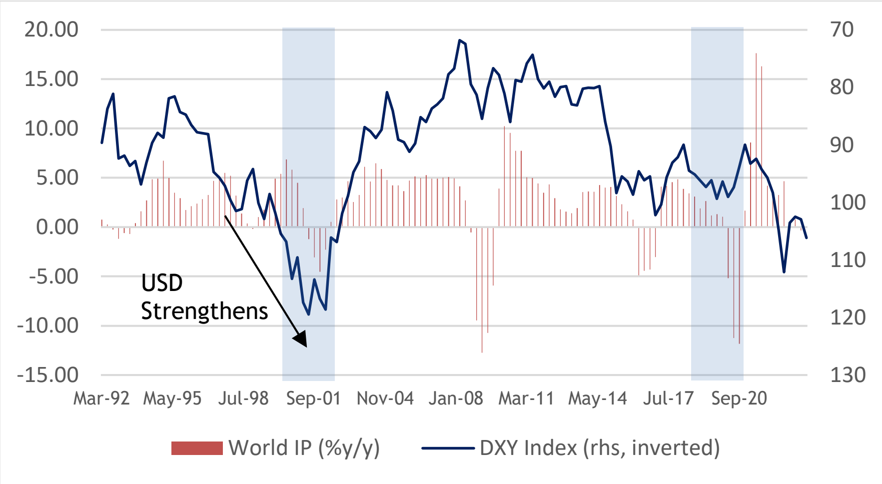
Source: Bloomberg, Maybank FX Research & Strategy

So while rate hikes tend to contribute to USD strength (amplified by other abovementioned factors), the USD performance beyond the Fed peaks could be predominantly driven by other factors.

Global Growth Could be a More Imperative Driver of the USD

One of the more compelling drivers of USD strength in those periods (peak of May-2000 and Feb 2019) could be the left SMILE effect where the rest of the world is seeing a slowdown in activity which is what we have been witnessing for a while now. That typically props up the USD as investors flock to the most liquid currency of choice for payment and concomitantly, store of value.

Chart 2: USD Strengthens when Global Growth Slows Down



Source: World Bank, Bloomberg, Maybank FX Research & Strategy

We therefore look at other parts of the world. While there are no expectations for China to stage a V-shape recovery (recovery is more likely to be protracted), there is a growing consensus that the country has stabilized, fragile as it may still be. As for the Eurozone, recent manufacturing and services PMIs seem to be showing some signs of bottoming. The Eurozone ZEW economic expectations also show some signs of improvement more recently and stronger evidence in data could take the EURUSD higher.

Chart 3a: Eurozone Mfg PMIs seem to be bottoming out

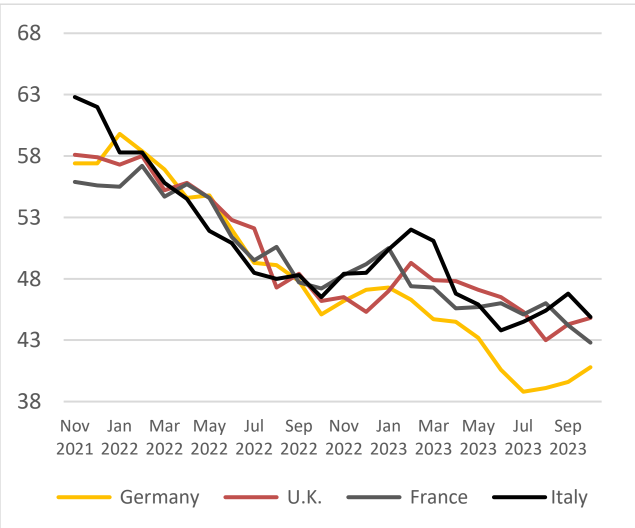
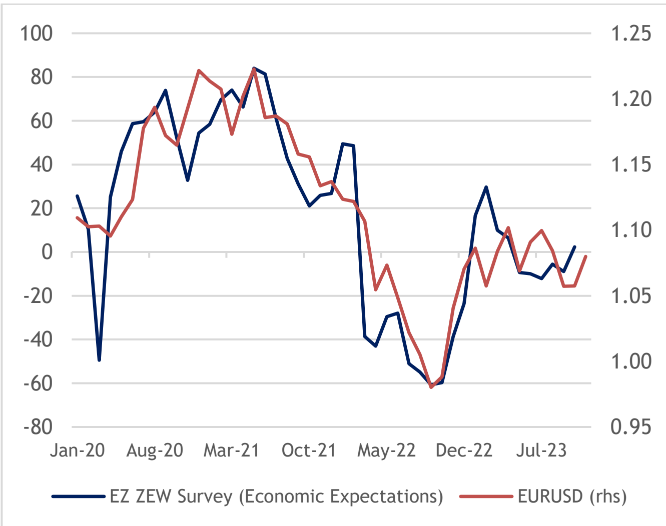


Chart 3b: Economic Expectations Improve in the Eurozone



Source: Bloomberg, Maybank FX Research & Strategy

It is thus, possible that the USD still has more room to ease should the narrative of a global growth slowdown start to shift. Thus far, we have had data that suggest the US could head towards a soft-landing. However, we have not had solid data that suggest that Eurozone or China are on the mend and while that keeps the USD from making sharper retreats at this point, that also suggests that the USD can have room fall further once that narrative gains traction.

Finally, the USD's Carry Advantage to Keep the Greenback Buoyant on Dips

As we look for a very gradual grind lower over the next one year, the USD could continue to remain buoyant on dips as the USD still retains quite a bit of carry advantage and any upside surprises to its data in the near-term could also shift expectations of Fed's rate trajectory and lift the USD.

Chart 4a: USD Retains Carry Advantage

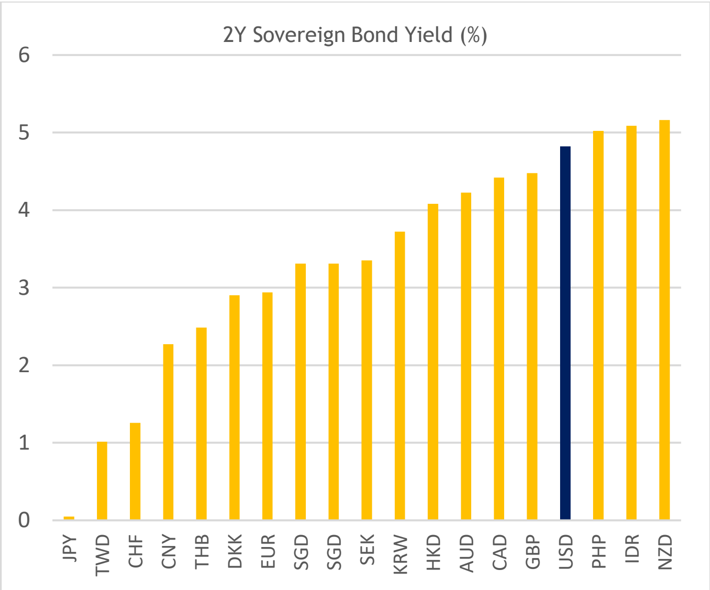
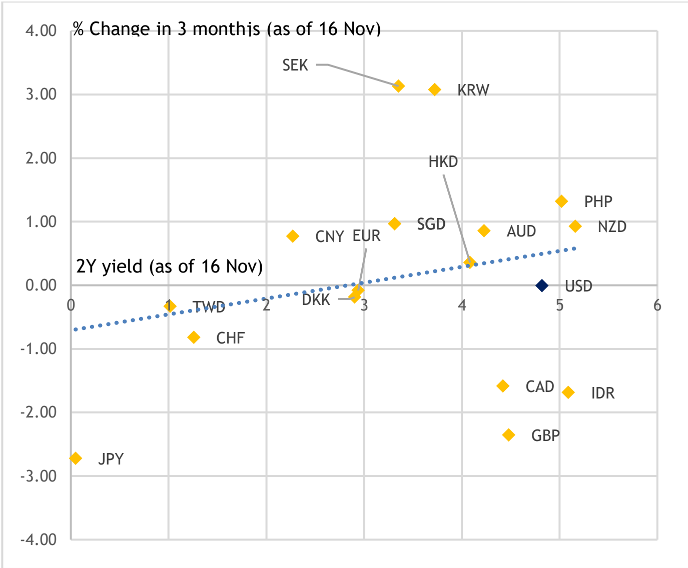


Chart 4b: Carry still contributes to the Performance of Currencies



Source: Bloomberg, Maybank FX Research & Strategy

We are Likely Past the Peak USD… but Retracement Risks Beckon Near-term

The sharp pullback of the USD post CPI is telling, that the growth and policy divergence between the US-RoW was well priced in at that level and it takes a significant regression in disinflation/ fresh risks to the inflation outlook, cratering of the Eurozone/UK/China economy for the USD to test new highs (above 107).

In fact, markets are cognizant of the fact that the US economy is still outperforming as we just had a mixed bag of China data for Oct and ECB flagging downside risks to growth in its policy statement as well as its Economic bulletin for Nov. And as such, DXY still hovers around 104-figure, just 3% off its peak. any signs of further slowdown or any signs of bottoming out in the Eurozone/UK/China would probably bring the greenback gradually lower. With the risks to the USD less asymmetric, we stress that the USD is susceptible to retracement risks and we look for more consolidative action within the 103.60-105.50.

The case for Yuan Bears

With the USD turn in mind, bumpy as it could be, we are proponents of shorting the RMB TWI. This has been mentioned as early as our FX weekly dated 27 Oct as well as the one dated 3 Nov.

Should the USD and UST yields continue to decline, most Asian currencies should benefit including the RMB. So it could be counterintuitive for us to see opportunities to short the RMB. The truth is that even as the worst could be over for the Chinese economy cyclically, a V-shape recovery is not likely and with consumption still in the driver seat of growth, further recovery on that front could potentially drive the external balance into deficit and that is structurally negative for the RMB.

CNY has strengthened around 3.8% on a NEER basis (BIS) from its low in Jul this year, mainly because of PBoC's management of the exchange rate.

Chart 5a: Fixing Deviations Narrow

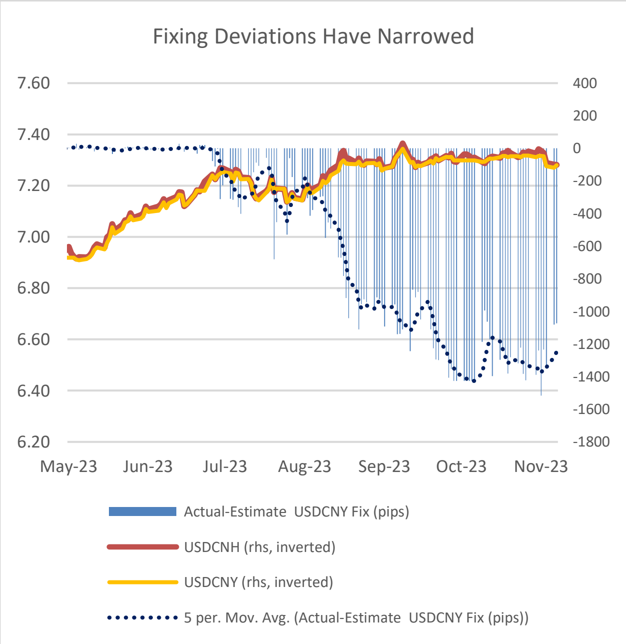


Chart5b: USDCNY no longer tests the Upper bound of Trading Band

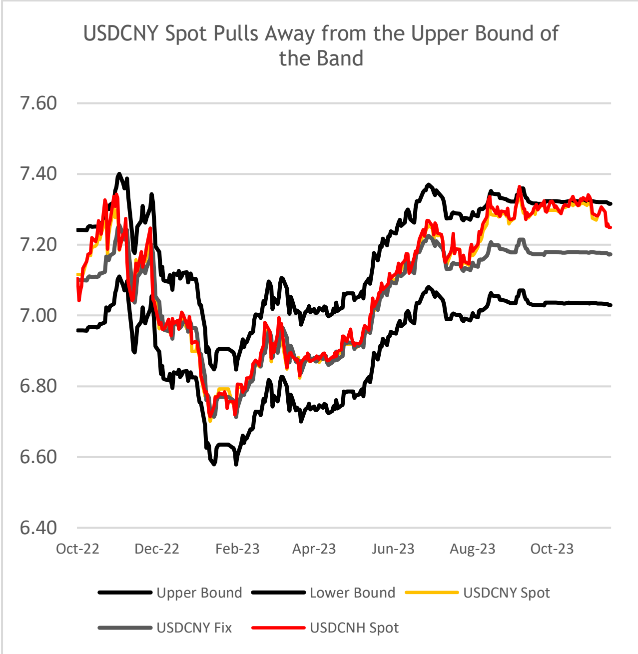
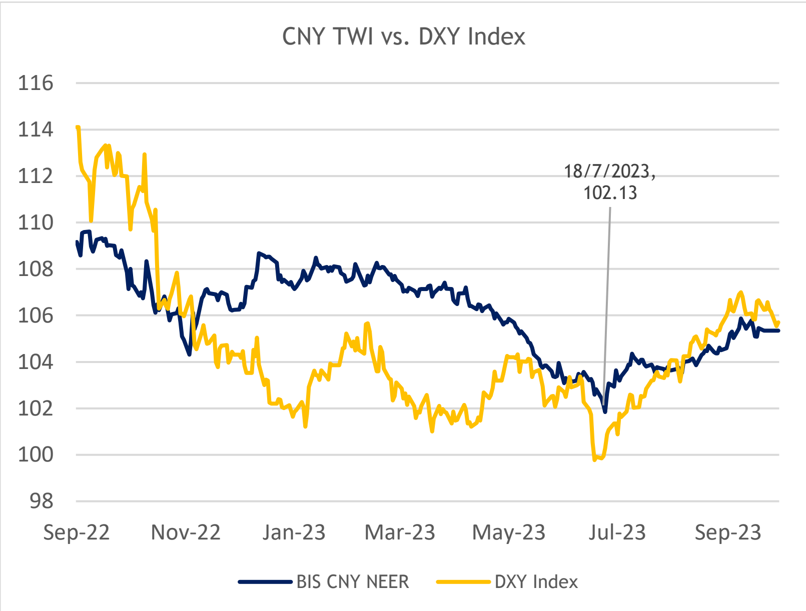


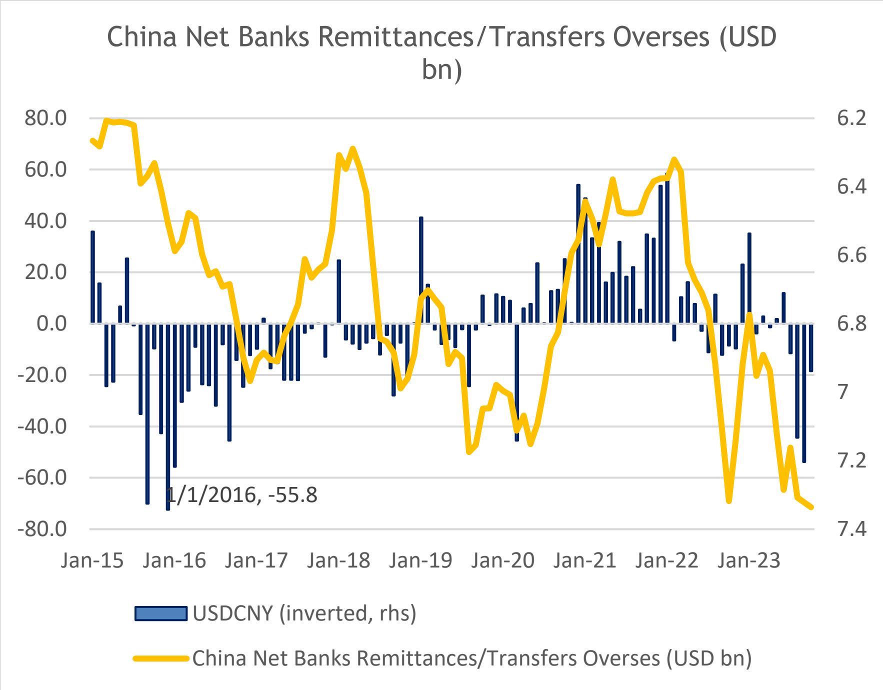
Chart 6: CNY NEER by and large Moves in Tandem with the DXY index



Source: BIS, Bloomberg, Maybank FX Research & Strategy

This could be counterintuitive as SAFE had reported the largest net transfer/remittances by banks overseas of around $53.9bn since Jan 2016, even as this has somewhat reduced to a net outflow of USD18.5bn in Oct.

Chart 7: Yuan under pressure Amid Outflows



Source: SAFE, Macrobond, Maybank FX Research & Strategy

We also had the release of the quarterly data for 3Q which indicate worsening balance of payment pressure with capital outflows due to declining FDIs as well as portfolio flows. The outflows from its capital account could be driven by two broad factors in our view - 1) structural; 2) cyclical. Corporates' supply chain diversification and de-risking due to ongoing China-US tensions and US' export and investment restrictions on China to restrict access to advanced technology in the name of national security. So these trends are somewhat structural may not reverse easily but the rather constructive outcome of the Xi-Biden summit could potentially put a halt in plans for further restrictions to come from the US.

We attribute cyclical factors to the widening of the US-CH yield differential that had weakened the yuan vs. the USD for much of this year. So that could have also spurred more repatriation of corporate earnings. Should yield differential start to narrow, these sort of flows are likely to slow. USDCNH could also fall.

Should the USD continue to ease lower, CNY could have room to weaken against other non-USD peers. We had mentioned this trade in our FX weekly dated 27 Oct and 3 Nov, singling out our preference for TWD and KRW. This has been playing out due to signs of semi-conductor cycle bottoming that leads to trade improvements. While the Presidential Elections in Taiwan could continue to weigh on the TWD, a fair extent of the risk premium has been priced in for much of this year.

Conclusion and Manifestation of Strategic Thematics

In light of our analysis above, along with our expectations for the USD to weaken further, we see an opportunity for yuan bears on a trade weighted basis (for example vis-à-vis TWD and KRW as well as JPY), as we continue to doubt a strong recovery in China. CNY TWI has been appreciating due to the combination of PBoC's line-in-the-sand actions via the daily fix as well as the rise of the USD. Should the USD continue to ease lower, CNY could have room to weaken against other non-USD peers.

We retain the strategic bias of a sell USD on rally, with USDJPY especially in favour as UST yields could start to look lofty when the US economy slows more discernibly in 2024. Given China's expected protracted and modest recovery into 2024 (led by infrastructure), it would likely provide boost for base metal-linked AUD, MYR. A narrowing of current account surplus should keep CNY TWI on the backfoot in the short to medium term.

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