Maybank

FX

Global

FX Flash

Yuan Rides on Carry-Trade Unwinding

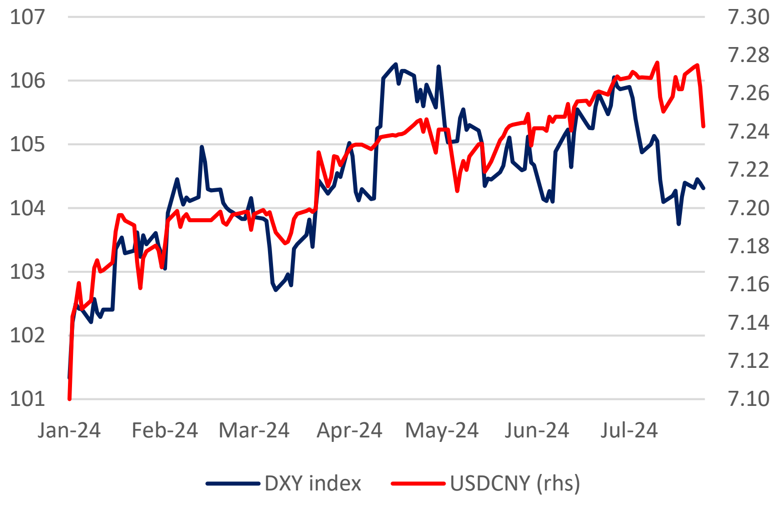
Tactical Trade of Long CNHJPY

- **USDCNY slid precipitously yesterday as the unwinding of carry trade that lifted the JPY had positive spillover to the CNY.** The external environment has turned slightly benign for the currency as **US exceptionalism fades, rate cut bets increase on the Fed** and **further softening of PMIs spurs carry-trade to unwind more vigorously amid concerns on global growth**. This concern on global growth supports typical counter-cyclical currencies such as the **CHF, JPY, CNY and to a smaller extent, the USD. Pro-cyclical AUD, NZD tend to be hurt the most.**

- **Tactical Trade: CNHJPY** has fallen 5.5% from highs of around 22.21 to levels around 21.10 as we write. This cross looks increasingly stretched to the downside. **We suspect that into the week of BoJ decision (31 Jul), JPY bulls could lose steam. BoJ has a knack for sounding more dovish than markets' expectations.** Tactical trade of buying the CNHJPY on the break of 21.30 towards the first target at 21.42, 21.70 and then at 21.80. Stop-loss at 21.10. Risk reward is 1: 2.

- Beyond the near-term, we see room for USDCNY and USDCNH to rebound. Persistent fragility in its **domestic demand** and the **prospect of further monetary easing** could still continue to keep the yuan on the backfoot. Trump trade may surface again even as likely Democratic Presidential Nominee Kamala Harris seems a more formidable opponent. Rebounds of the USDCNH to meet resistance at 7.2560 before 7.2740. We suspect moves could be now confined within 7.19-7.30 range. 7.1995 is a key support. A break there would open the way towards 7.1730.

Chart 1: USDCNY Plays Catch "Down" with the Recent DXY Pullback



Source: Bloomberg, Maybank FX Research & Strategy

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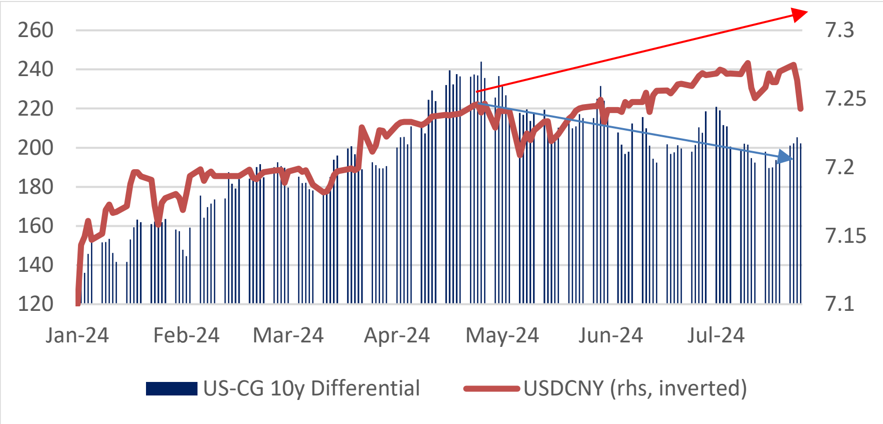
Yuan Has Been the Underperformer

We had noted on 5 Jul that the yuan would remain on a crawl lower. PBoC had resumed a trend of weaker CNY fixings against the USD after the Third Plenum this week. USDCNY continued to trade near the upper bound of the trading band as market forces drive USDCNY higher.

Chart 2: US-CH 10y Differential Has Narrowed Gradually Since its Peak in Apr but That Failed to Bring the USDCNY Lower For Much of the past Months



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There were a few reasons for the yuan's underperformance.

1) **Weak growth.** China's 2Q GDP surprised to the downside at 4.7% vs. consensus estimate of 5.1%. Home prices decline persistently.

2) **No Immediate Stimulus for the economy.** While the Third Plenum had encouraging fiscal reforms and its resolutions touched on all the key points of concerns (housing, consumption, employment, local government fiscal sustainability), there was no promise of stimulus significant enough to keep the domestic demand from sliding at this point.

3) **Rate Cuts**. On this front, we have had the 10bps cut for 7D reverse repo to 1.70% which was quickly followed by a similar cut for the 1Y and 5Y LPRs to 3.35% and 3.85% respectively. 1Y MLF was also lowered by a sharper 20bps to 2.3% from 2.5% to encourage banks to tap on this lending facility. Yuan reacted negatively to the 7D RR cut on 22 Jul but the impact from the MLF cut was relatively muted this morning despite fall in bond yields. Yuan's moves were more tethered to the JPY.

Chart 3: USDCNY has been trading near Upper Bound of Band

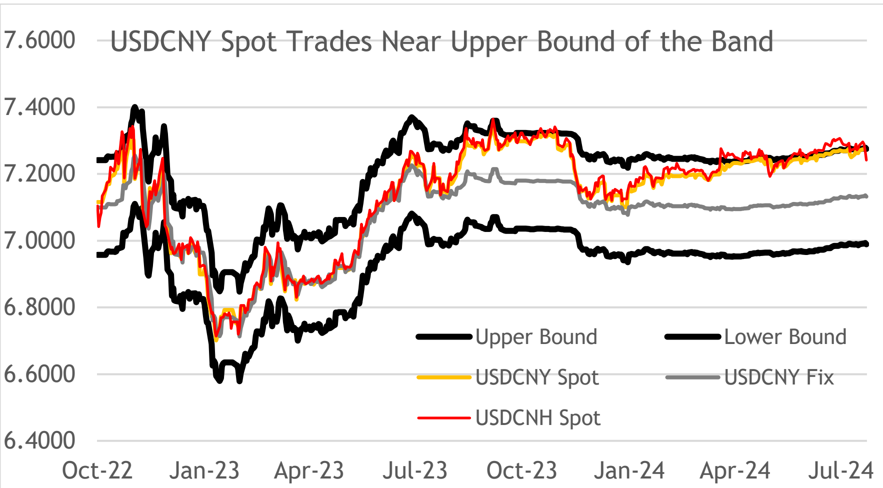

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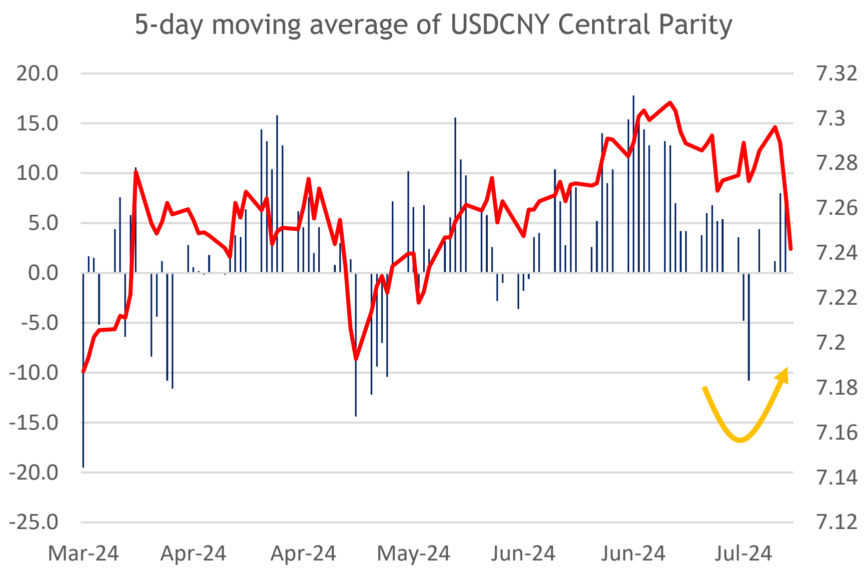
Chart 4: The Uptrend of USDCNY Central Parity Stopped around the Third Plenum and Resumed



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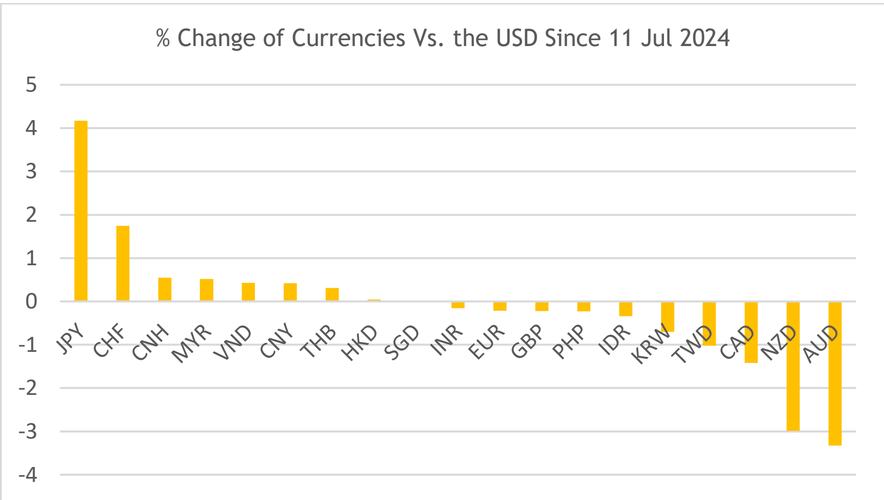
Due to the steady drop of the UST yields since Apr, narrowing of the CH-US yield differential and the fading of US exceptionalism, the PBoC finally found enough comfort to allow more room for CNY weakness in Jun.

In Apr and May, the USDCNY fix was raised by an average of 5.1 pips/day and 2.2 pips/day respectively. That seem to have shifted to around 9 pips/day in Jun with the 7-day moving averages rising to around 10-17pips in the last week of June. For the first three weeks of Jul (1-19 Jul), USDCNY was raised an average of 3.1pips/day. The fixings from the start of the week suggest that the fixed was raised again.

For most parts of the year, we see higher USDCNY fixings guiding the USDCNY spot higher. However, this time, it is different. The slump in the USDJPY has dragged the USDCNY lower as well. The widespread unwinding of carry trades, predominantly funded by the JPY seems to have positive spill-over on CNY.

Chart 5: % Change of Currencies Vs. the USD Between 11 - 25 Jul 2024



Source: Bloomberg, Maybank FX Research & Strategy

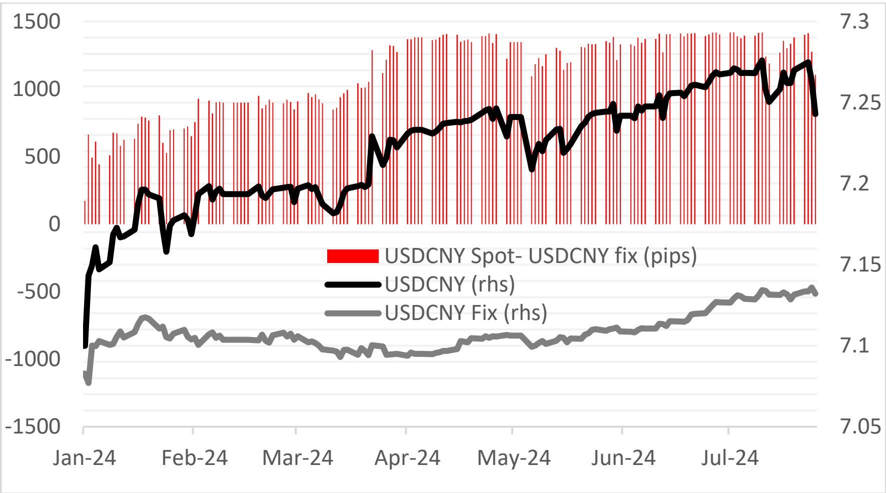
The Carry Trade Unwinding of the JPY and the CNY

The markets have been fixated on the carry-trade unwinding. There was no clear catalyst but this unwinding seems to have snowballed on a combination of reasons including the downside surprise in China's GDP that kick-started the AUD's decline, the lack of stimulus from the Third Plenum, the US election uncertainty as well as the latest slew of prelim. Jul PMI prints (Eurozone, US, etc) that suggest that the global manufacturing recovery could be stalling. All of these adds to uncertainty and volatility.

Pro-cyclical AUD clocked one of the sharpest declines amongst G10 and Asian currencies. The VIX spiked towards Apr high. Iron ore, copper, gold and bitcoin soften to varying extent. As global growth momentum seems to slow further based on leading indicators (PMIs), markets are pricing in more rate cuts (by the Fed, now 3 seen for this year) leading to further yield compression. The major funding currency JPY staged its sharpest rebound of the year as a result and that provided some positive spillovers on the yuan.

As a result, USDCNY spot moved towards the USDCNY fix. The differential between the USDCNY spot and fix narrowed sharply on 25 Jul to 1107 pips from around 1400pips.

Chart 6: Spot Moves towards Fix



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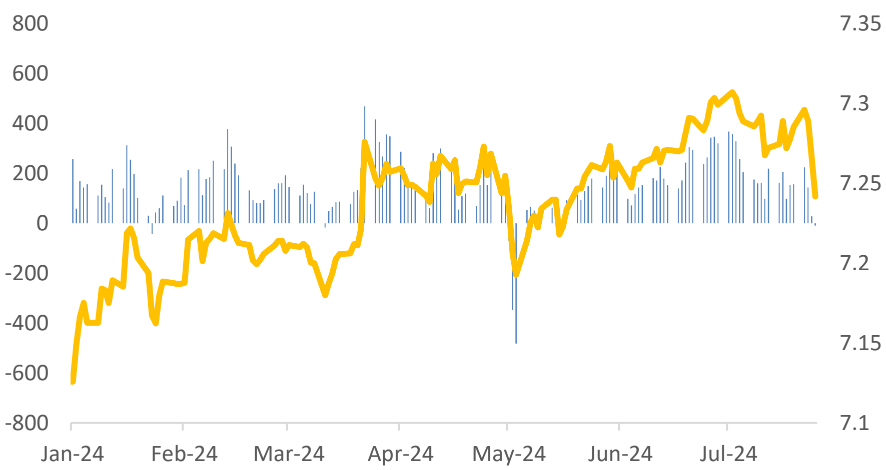
The sharp move lower narrowed the spread between the USDCNH and USDCNY.

Chart 7: USDCNH-USDCNY (aka offshore-onshore) Spread Disappears



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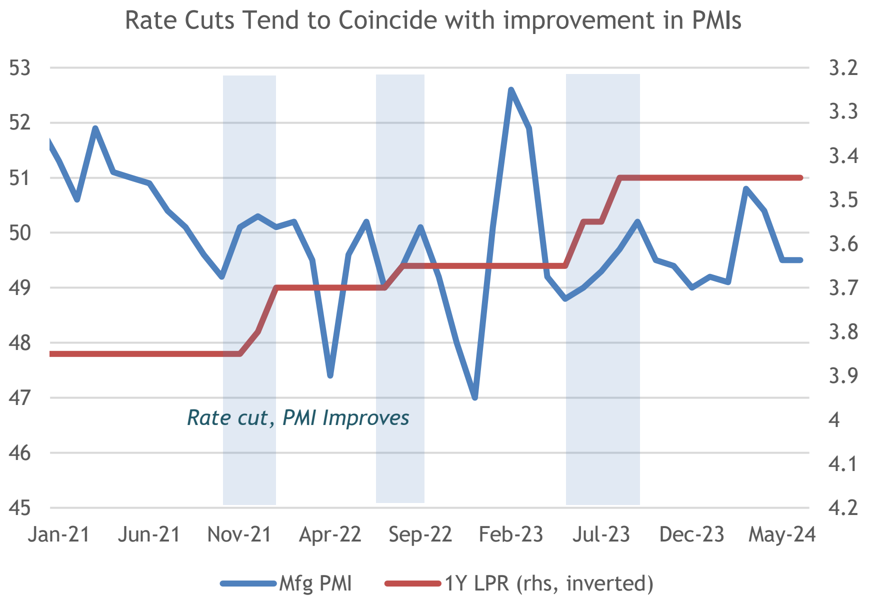
Tactical Trade Idea: Long CNHJPY

Into next week where BoJ decides on policy, we see potential for JPY bulls to lose momentum as rate hikes are being priced for the BoJ and markets are already expecting reduction in monthly JGB purchase. BoJ has a knack for sounding more dovish than market expectations. JPY's bullish surge could slow or even temporarily reverse. China's PMI prints will also be released. Consensus expects the NBS official Mfg PMI to fall deeper into contractionary region of 49.3 from previous 49.5. Non-mfg is also expected to fall to 50.2 from previous 50.5. After a slew of weaker data (GDP, retail sales, property), the balance of risks could be skewed slightly to the upside. While China does suffer from a deficit of confidence and lowering interest rates will not get to the root of its array of issues, the external environment has shifted to allow China more room to finally cut its interest rates. There could be some chance that purchasing managers may finally turn a tad more optimistic.

Chart 8: Rate Cuts tend to Coincide with PMI Improvements, Fleeting as they May



We are more comfortable with buying the CNHJPY on the break of 21.30 towards the first target at 21.42, 21.70 and then at 21.80. Stop-loss at 21.10. Risk reward is 1: 2.

A Rebound of the USDCNH/USDCNY is Still possible.

Beyond the near-term, we are wary of a rebound in the USDCNY and USDCNH as growth outlook for China remains weak. Carry-trade unwinding that is said to have triggered so-called "wide-spread liquidation" of carry trade of various risk assets funded by JPY and the CNY borrowings do not typically last very long. In this case, we are doubtful that this can last, especially with markets more at risk of becoming overly aggressive in their rate cut expectations of the Fed (-140bps), RBNZ (-180bps) over the next one year from here.

Our assumption is for the US economy to still achieve a soft landing. As the US' economic slowdown gains a bit more traction and US rates become more anchored. USD strength will also wane gradually, reducing the probability for the USDCNY and USDCNH to test new highs. However, there is certainly room for rebound. Stronger-than-expected 2Q GDP released on 25 Jul has shown that. Persistent fragility in China's domestic demand and the prospect of deeper rate cuts could weigh on the yuan. The return of Trump trade may also have a negative effect on the yuan, even as likely Democratic Presidential Nominee Kamala Harris seems a more formidable opponent. **For the USDCNH, rebounds to meet resistance at 7.2560 before 7.2740. We suspect moves could now be confined within the 7.19-7.30 range. 7.1995 is a key support. A break there would open the way towards 7.1730.**

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