

FX Insight

RMB a Natural Alternative but Far from Perfect

Can War in Ukraine Propel the Yuan to Rival the USD?

Russia's invasion of Ukraine set off one of the harshest sets of economic sanctions ever inflicted on a major economy in the modern history. They encompass trade bans, financial blockades meant to inflict significant damage in the hope of halting Russia's attack on Ukraine. China's determination to remain diplomatically neutral could mean yuan becomes a natural alternative. For one, Russia declared that the country will use the yuan portion of its foreign reserves. In addition, Saudi Arabia is also in "active talks" with China to price some of its oil deals with the latter in yuan. The use of SWIFT as sanction on "pariah nations" over the years could gradually drive more to search for alternatives to USD or EUR payment. China has the trade and investment clout as well as a budding payment system in place to serve as one in the future. The pricing of commodities in CNY by major commodity producers could be a game changer and incentivize central banks to hold more CNY as reserves but it is still some way from challenging the USD.

Trends in Trade, ASEAN FX Volatility Benign for Increased Yuan Usage

ASEAN-5 have seen robust growth (3% to 8% CAGR) in trade with China over the past decade. While closer trade relations do not explicitly translate to greater yuan usage in pricing and settlement, it can provide the necessary foundations for efforts in this direction. Local currency settlement arrangement between ID and China is one such attempt. Looking at weekly FX swings, we see that ASEAN FX (less THB) have been relatively less volatile post-2020, after markets adjusted to the initial Covid shock. Notable relative stability in CNH-ASEAN FX crosses can be an additional incentive for increased yuan adoption in regional trade and investment. 52-week rolling correlations in CNH and ASEAN FX changes are also steadily positive since mid-2020, reflecting the anchoring effect of yuan on ASEAN FX, which can help mitigate impact of other external shocks.

Emergence of New Risks to Pose Intermittent Upward Pressure to USD

There are near term upside risks to USD owing to (1) increasing downside risks to growth, especially with the war in Ukraine persisting; (2) continuing supply chain pressures; (3) elevated energy prices, inflationary pressures globally; (4) Importantly, Fed turning more hawkish in recent week is a significant risk to consider. But USD strength will however be uneven. Amongst the DM majors, negative/low yielders such as EUR and JPY are vulnerable to the downside but commodity-linked FX such as AUD, CAD and NZD could still gain the upper hand vs USD due to soaring commodity prices and respective central bank biases. Amongst ASEAN FX, Fed's hawkish monetary policy divergence may marginalize some ASEAN FX, including MYR whose monetary policy maybe perceived to be relatively accommodative. On the other hand, SGD could find solace from a hawkish MAS. To sum up, near-term (coming 2-3months) risks could be skewed to the upside for broad USD, and our forecasts for some FX such as EUR, JPY and MYR are under review for potential downward revision. However, our over-arching view continues to call for USD nearing its peak.

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Update on Thematic Trades Recommended 28 Jan

Themes	% Returns (28 Jan to 24 Mar)
Covid-endemic, Reopening Play	+1.2%
G7-China Policy Divergence Play	+8.7%
Benign Commodity Outlook	+3.7%
Intra-ASEAN Policy Divergence Play	+1.4%
USD - the Long and Short of It	+1.9%

“The U.S. dollar isn’t about to suffer an imminent demise as the dominant currency in the global financial system, but we could see pockets where we might see shifts happening... We are likely to see some countries reconsidering how much they hold of certain currencies in their reserves.”

Gita Gopinath
IMF First Deputy Managing Director
Interview with Foreign Policy, 22 Mar 2022

Discussions about USD’s reserve currency status and RMB internationalization appear to intensify lately, especially with the swath of aggressive US sanctions over Russia and reports of Saudi Arabia in active talks with China to price some of its oil exports in RMB. In a paper just released (24 Mar), IMF warned of USD dominance being stealthily eroded as it noted the decline in USD share of international reserves. The shift out of US\$ did not go to EUR, GBP and JPY but has been in 2 directions: 1/4 into the RMB, and 3/4 into the FX of smaller countries (including AUD, CAD, SGD, KRW and SEK amongst others) that have played a more limited role as reserve currencies. We explore the potential for RMB to become a more significant reserve currency in the second part of the report.

Before we get to the highlight, we start by sharing our USD baseline view taking into consideration the emergence of new market developments, including the ongoing military conflict in Ukraine and Fed’s recent hawkish shift. We also look at how the USD sensitivity to UST yields could matter less during periods of yield curve flattening.

We then conclude with a recap of our 5 thematic plays that were shared in the end-Jan report “AXJs in the Face of Dovish PBoC and Hawkish Fed”. In particular our G7-China policy divergence trade and benign commodity play saw robust gains.

Table 1: Thematic Plays Outlined on 28 Jan

Themes	FX Strategies	% Returns (28 Jan to 24 Mar)
Covid-endemic, Reopening Play	Focus on Covid-endemic (less econ. drags) vs. zero-Covid policy stance in countries. Basket of equal-weighted long SGD, THB, KRW, vs. short TWD, CNH.	1.2%
G7-China Policy Divergence Play	Long CAD, AUD and NZD (potential rate hikes) vs. short CNH and JPY (easing spectrum).	8.7%
Benign Commodity Outlook	Long AUD, IDR, MYR, CAD vs. short net energy importer INR. Demand could broaden post 1Q Omicron drags; geopolitical events risk impacting energy supplies.	3.7%
Intra-ASEAN Policy Divergence Play	Tactical buy dips in SGD vs. short MYR, PHP. MAS first mover vs. slower normalization start for BNM, BSP. Buy dips preferred as S\$NEER near top of policy band, long positioning near overcrowded.	1.4%
USD - the Long and Short of It	Tactical long USD in the lead-up to first Fed hike but get ready to turn short post first hike as DXY typically fall 2% - 4%.	+1.7% (long DXY from 28 Jan to FoMC on 17 Mar 2am); +0.2% (short DXY post-FoMC, as of 24 Mar)

Source: Maybank FX Research & Strategy

I. Our USD Baseline View

With the emergence of new risk drivers, USD risks could be skewed to the upside in coming months. Some of these risk drivers include (1) increasing downside risks to growth, especially with the war in Ukraine persisting; (2) continuing supply chain pressures; (3) elevated energy prices, inflationary pressures globally; (4) Importantly, Fed turning more hawkish in recent week is a significant risk to consider. Though hawkish Fed expectations may already be in the price, we are cautious of Fed turning more restrictive. This is one risk that is not fully priced and may well provide that intermittent upward pressure to the USD.

USD strength will however be uneven. Amongst the DM majors, negative/low yielders such as EUR and JPY are vulnerable to the downside but commodity-linked FX such as AUD, CAD and NZD could still gain the upper hand vs USD due to soaring commodity prices and respective central bank biases.

Amongst ASEAN FX, Fed's hawkish monetary policy divergence may marginalize some ASEAN FX, including MYR whose monetary policy maybe perceived to be relatively accommodative. On the other hand, SGD could find solace from a hawkish MAS.

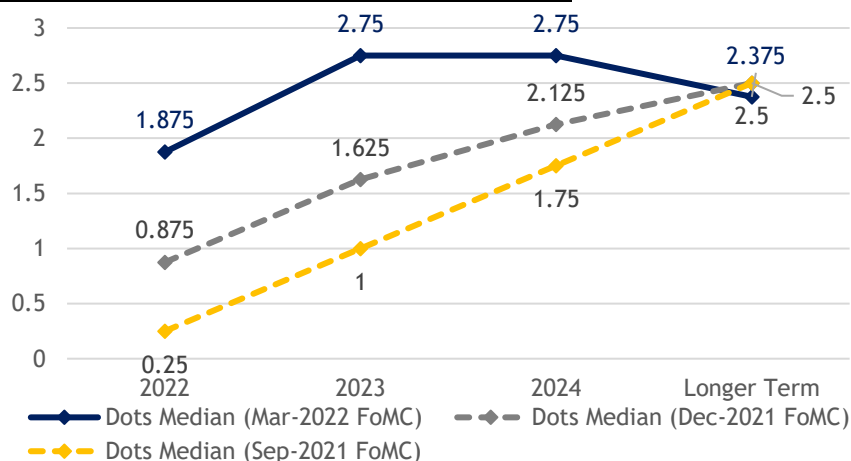
To sum up, near-term (coming 2-3months) risks could be skewed to the upside for broad US, and our forecasts for some FX such as EUR, JPY and MYR are under review for potential downward revision.

But our over-arching view continues to call for USD nearing its peak, underpinned by: (1) hawkish Fed expectations somewhat in the price and that USD's sensitivity to yield moves tend to weaken during current episode of yield curve flattening; (2) Fed is not the only one tightening; (3) global economic backdrop to remain somewhat supportive (no recession or stagflation) to support synchronous policy normalisation; (4) ongoing talks between Russia-Ukraine in hope of reaching a comprehensive deal (that may take weeks to month to forge). Any changes to (3) and (4) will extend the USD support.

Fed's Hawkish Shift Yet Again

At the last FoMC (16-17Mar), FoMC voted 8-1 to raise rate to 0.25% - 0.5%. Bullard was the only dissenter as he called for 50bps hike. Dots plot signalled another 6 more hikes this year (vs. their Dec-2021 FoMC projection for 3 hikes). For 2023, Fed is now looking for about 3 - 4 more hikes and none for 2024.

Fig 1: Fed Front-Loads Rate Hike Expectations



Source: Bloomberg, Maybank FX Research & Strategy

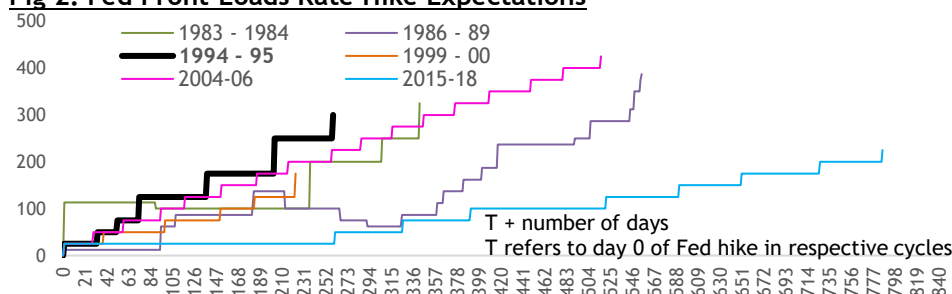
Fed Chair Powell then told reporters that inflation is too high, labor market is over-heated and price stability is a “pre-condition” for Fed. While he noted that Ukraine war had highly uncertain implications for US economy that create near term upward pressure on inflation while weighing on economic activity, he played down the risk of recession and emphasized that US economy is “very strong” and can handle tighter policy. Powell also signalled that balance sheet announcement could come as soon as May and the rolldown framework to move faster than last time.

Recent Fed Speaks Lean Towards Neutral Rate, Restrictive Stance

This week (starting 21 Mar), comments made by Fed officials are starting to shift significantly, looking for much faster pace of policy normalisation, in terms of **magnitude of rate hikes and trajectory**. We believe this is due to inflation showing no signs of abating and may even be at risk of going higher for longer amid Ukraine situation exacerbating supply chain disruptions. So far, markets have taken Fed’s hawkish shift in its stride (i.e., no major sell-off in equities or FX) and we opined that this is because the Fed is playing catch-up with markets (i.e., dots plot have been lagging markets’ pricing). But if the tide shifts and markets end up playing catch-up with the Fed instead, then we would be more cautious as surprise shocks can undermine sentiment and add to USD support. And the risk is that markets may not have priced in rates above 3% or 4% into 2023. This is also 1 risk to be mindful of and how that can intermittently add to USD support.

- Mester is not ruling out 50bps hike and backs front-loading rate hikes in 1H this year, given the underlying strength of the economy and the Fed fund rate is at low levels. She also wants to get policy rate up to 2.5% this year and follow up with more increases next year to rein in 40y high inflation.
- Daly also share similar view in **getting rates up to neutral** (Fed estimates neutral at ~2.4%) and that **Fed could consider tightening to restrictive policy** to ensure that inflation comes back down. She is also looking at +50bps hike and decision to shrink balance sheet at May FoMC (if economics data in coming weeks support).
- Bullard reiterate his stance that the Fed needs to move aggressively to keep inflation under control. He is also looking for rates to get to neutral at least so as not to put upward pressure on inflation. Bullard’s estimate neutral at 2% while the median of FoMC officials is at 2.4%. He also cited the 1994 tightening cycle as an analogy on how fast Fed should move. That cycle was indeed one of the fastest but most compressed cycle since 1980s, where then-Fed Chair Greenspan tightened by 300bps over a 1y period in 1994-95, which included two 50bps hike and one 75bps hike. “Soft-landing” was achieved, recession and inversion of 2y10y yield curve was also averted.

Fig 2: Fed Front-Loads Rate Hike Expectations

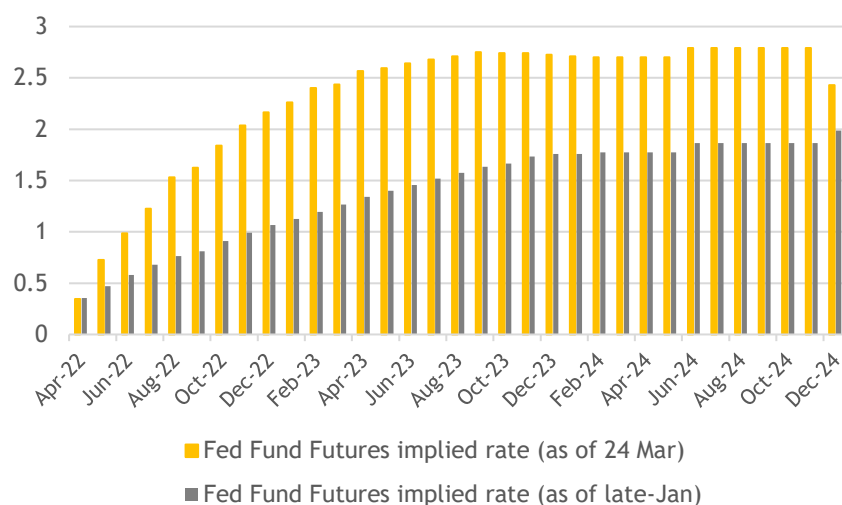


Source: Bloomberg, Maybank FX Research & Strategy

- During a NABE seminar (21 Mar), Powell had also sounded more hawkish in saying, “We will take the necessary steps to ensure a return to price stability. In particular, if we conclude that it is appropriate to move more aggressively by raising the federal funds rate by more than 25 basis points at a meeting or meetings, we will do so. And if we determine that we need to tighten beyond common measures of neutral and into a more restrictive stance, we will do that as well.”

The 30d Fed fund futures are now (as of 24 Mar) pricing in rate to go up to 2.25% by end-year (vs. 1.95% a week ago vs. 1.06% as of late-Jan 2022). The fed fund futures are also implying >50% probability of 50bps at the next 2 FoMCs on 4th May and 15th Jun.

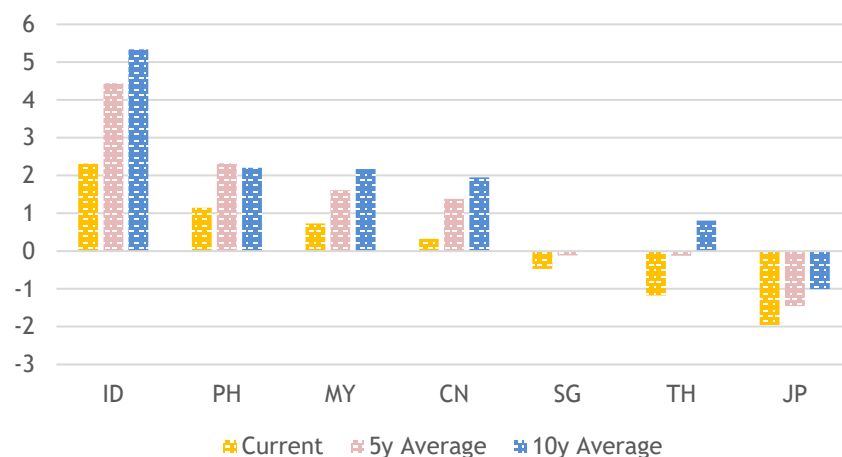
Fig 3: Markets Re-visiting 50bps Hike



Source: Bloomberg, Maybank FX Research & Strategy

The case of Fed increasingly becoming more hawkish is one risk that may provide intermittent support for USD. Amongst Asian FX, Fed’s hawkish monetary policy divergence may “punish” those FX, whose monetary policy are perceived to remain accommodative or in no hurry to tighten. Looking at 2y yield differentials between ASEAN sovereigns and USTs, the typical carry advantage of Indonesia, Philippines and Malaysia have eroded and that may drag on respective FX.

Fig 4: Erosion of ASEAN Carry

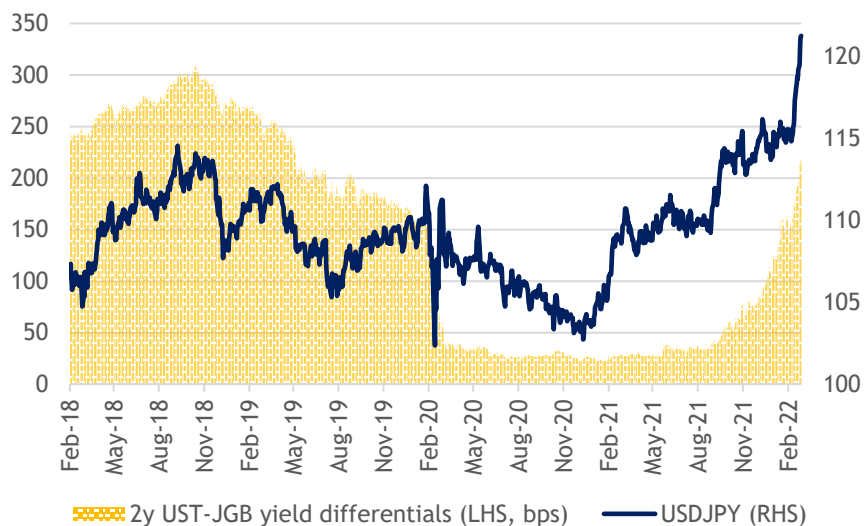


Source: Bloomberg, Maybank FX Research & Strategy

Amongst ASEAN central banks, the MAS is the most hawkish as it has tightened twice in Oct 2021 and as well as at an inter-meeting (25 Jan 2022) and looks set to tighten again at its upcoming bi-annual policy meeting in Apr. Our house looks for a re-centering of the band while maintaining the current slightly steeper slope. Apart from MAS, our house believes BI could potentially raise rates thrice this year. On relative monetary policy divergence basis, the IDR and SGD may well be better supported over PHP and MYR, where our house view expects two +25bps hikes, one +25bps hike in 2022, respectively.

But comparatively, the BoJ stands out as a major policy laggard as it remains committed to dovish stance. BoJ said earlier that there's "absolutely no need" for the central bank to raise rates to react to cost-push inflation. The bank's stance that a weaker yen was net positive for the overall economy also remained unchanged. 2y UST-JGB yield differentials have already widened to multi-year of 216bps (as of 24 Mar). Any further upticks on 2y UST yield in anticipation of Fed front-loading rate hikes to arrest inflation may put more upward pressures on USDJPY.

Fig 5: Widening 2y UST-JGB Yield Differentials Drove USDJPY Higher



Source: Bloomberg, Maybank FX Research & Strategy

USD Less Sensitive to Yield Moves when Yield Curve Flattens

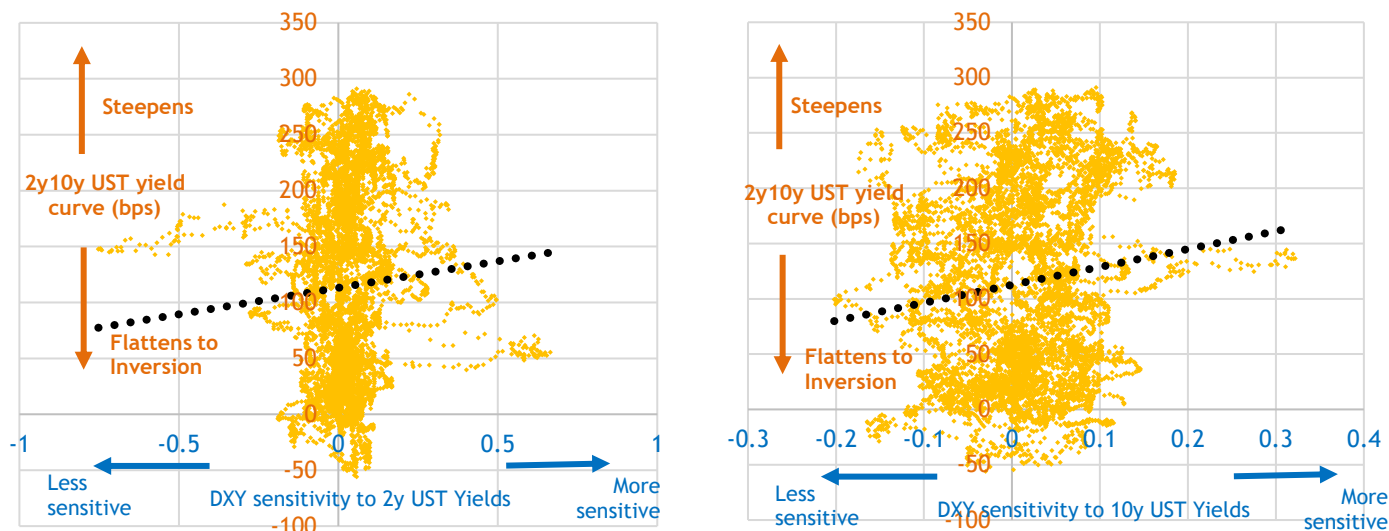
While higher US rate expectations typically add to USD upward pressure, we think it may be useful to consider how USD sensitivity to rate moves can vary in different yield curve regimes (i.e., steepen vs flattening period).

We look at past 32 years of daily data since 1990 on DXY sensitivity (90d rolling basis) to 2y and 10y UST yields against different regimes of 2y10y yield curve episodes.

Historically, USD sensitivity to yields picks up when 2y10y yield curve steepens - a proxy for brighter economic prospects. However, the relationship starts to weaken in episodes of yield curve flattening. This may suggest that markets are cautious that aggressive Fed tightening may hurt US economic growth and thus dent its appeal of its rate advantage. The current yield curve regime is one where 2y10y is flattening (last at +20bps vs +89bps peak of the year in early-Jan 2022). So technically, USD's sensitivity to yield uptick should be weaker as compared to periods when

the yield curve is steepening.

Fig 6 (a) and (b): Weaker Sensitivity between USD and Yield when UST Yield Curve Flattens



Source: Bloomberg, Maybank FX Research & Strategy

Geopolitics - Still 2 Way Risks for Markets

Market sentiments are also driven by geopolitical situation in Ukraine. As of now, there is no resolution as Ukraine and Mariupol authorities have rejected an ultimatum to surrender Mariupol city to Russian forces. There have also been more sanctions against Russia, alongside President Biden's call to exclude Russia from G20 as well as G7's efforts to crack down on Russia's ability to sell its gold. In response, Russia President Putin plans to demand that "unfriendly" nations pay for natural gas in RUB, in retaliation to US and Europe sanctions. Italy said it declined to pay in RUB while Germany said that such a shift is a breach of contract.

Developments remain fluid with negotiations and shelling ongoing at the same time. And geopolitical risks will continue to pose 2-way risks for markets.

A comprehensive deal for ceasefire, withdrawal of troops, neutralisation and demilitarisation may take up to weeks to forge but given that both sides have already started work to iron out a peace agreement, we think this is at least still a good start.

II. Can War in Ukraine Propel the Yuan to Rival the USD?

Russia's invasion of Ukraine set off one of the harshest sets of economic sanctions ever inflicted on a major economy in modern history. They encompass trade bans, financial blockades meant to inflict significant damage on Russia's economy in the hope of halting its attack on Ukraine, far worse than what it has endured since its annexation of Crimea in 2014. Some of the most potent measures include taking some of the banks off the SWIFT system and freezing the Central Bank of Russia's access to the euro and dollar components of its \$630bn foreign reserves (>50%). The latter limits its ability to support its currency and make repayments on maturing debts amongst other functions.

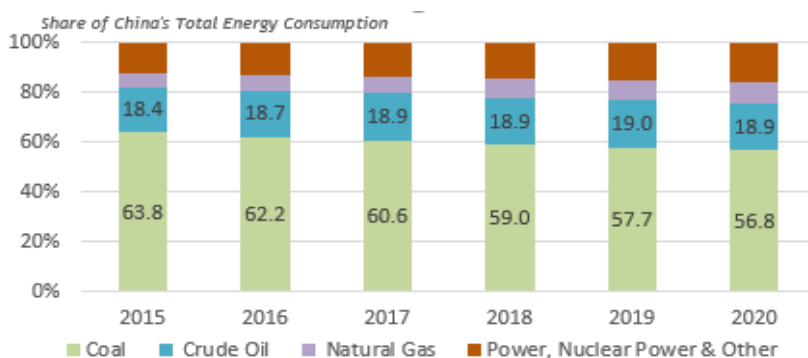
On 14 Mar 2022, Russia's Finance Minister Anton Siluanov declared that the country will use the yuan portion of its foreign reserves and flagged repayments could be made in ruble in case forex requests are rejected.

Last week, Russia managed to repay the \$117mn coupon payment on two USD-denominated bonds but there is an estimated \$255.1mn coupon payments pending/due by the end of Mar with a \$2bn bond maturity on 4 Apr (BBG). Russia's ability to make repayments on its existing debt/equity issuance (before 24 Feb) could be further crippled when the exclusion clause provided by OFAC expires on 25 May 2022¹. Choking sanctions enabled western nations to empower embattled Ukraine to have leverage over Russia in their on-going peace-talks. However, the so-called weaponization of the broader financial system by the US and the allies, effective as they can be now on Russia, run the risk of longer-term repercussions on their control of global financial interdependence via the USD in favour of other substitutes such as the yuan.

Economic Sanctions on Russia May Aid Yuan Internationalization

Perhaps a not-so-subtle detractor from the Western allies is Saudi Arabia and its "active talks" with China to price some of its oil deals with the latter in yuan, highlighted by WSJ. Potential hurdle includes the Riyal's peg to the USD. Many pointed out that this has been a topic of discussion for over six years without much concrete progression and thus there are also doubts that "active talks" at this point would bear fruit. However, the use of the harshest economic sanctions on Russia and some deterioration of US-Saudi Arabia's relations might nudge Saudi Arabia to seriously consider diversifying its transactions away from the USD. Pricing some of its oil deals in yuan could be an experiment in that direction. China is the world's top oil consumer and in spite of its endeavors for green transition, it has been keeping the oil component of its energy consumption mix steady. Part of the reason could be to maintain relations with crude oil producing nations.

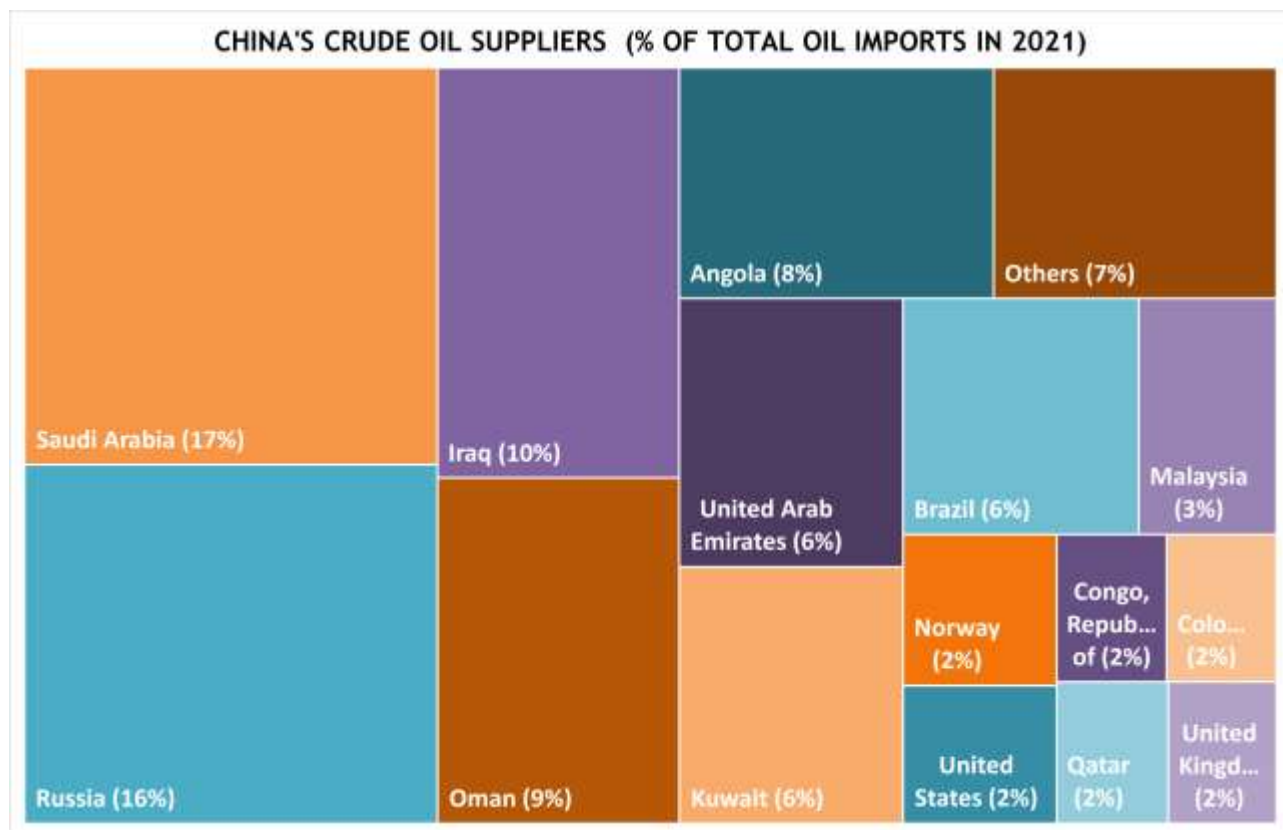
Fig 7: Oil Share of Energy Consumption in China has been Steady



Source: National Bureau of Statistics, Maybank FX Research & Strategy

Saudi Arabia is China's top oil supplier while China is Saudi Arabia's top trading partner. The start of yuan-denominated oil deals could fortify the economic relations between the two nations that have been criticized by the Biden administration (China for being a tech rival and human rights violator, Saudi Arabia's Crown Prince Mohammed bin Salman for the murder of journalist Jamal Khashoggi). Given China's position as the world's largest oil and gas importer, other crude oil producers could then be tempted to price their oil transactions with China in RMB as well. Any traction on that front has the potential to snowball into greater usage of RMB and potentially, elevate its status as a global reserve currency.

¹ According to General License 9A, 10A of the OFAC Directive of Russian Harmful Foreign Activities Sanctions Regulations.

Fig 8: Saudi Arabia and Russia are China's Top Crude Oil Suppliers

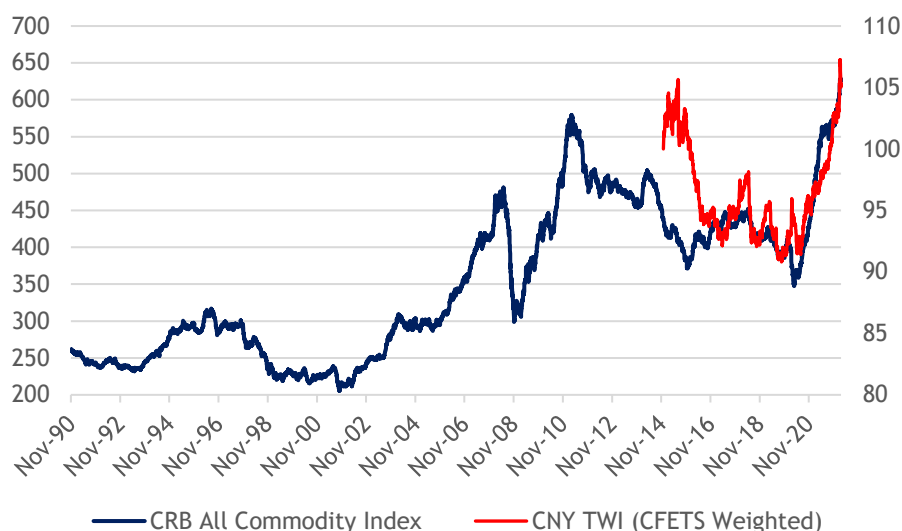
Source: General Administration of Customs, CEIC, Maybank FX Research & Strategy

That said, there could be some hesitance on Saudi Arabia's part to make a symbolic break-away from the Petrodollar. According to an unidentified US official cited by Bloomberg, the US has transferred a sizeable number of Patriot antimissile interceptors to Saudi Arabia over the past month to counter the attacks from the Houthi group, underscoring Saudi Arabia's reliance on the US for its military defense.

Second Largest Exporter of Crude Oil, Russia Could Resort to Pricing Oil Deals in Yuan

Even as Saudi Arabia does not price any of its oil deals in yuan, Russia could be forced to do so given current economic sanctions that limits the use of the USD and EUR. In addition, Russia faces the risks of having oil embargoes imposed by more countries, especially the EU. For one, India (net energy importer and world's third largest crude oil importer in 2020) intends to purchase discounted oil from Russia on a CIF basis (Cost, insurance, freight borne by seller) via a rupee-ruble transaction and wants to explore using yuan as reference rate. Yuan could be preferred as a reference rate given that it is the only currency in the five reserve currency (of the IMF SDR basket) that belongs to a more "diplomatically neutral" country.

Pricing oil deals in yuan is significant, especially in a potential commodity super-cycle and Russia is also a major export of food and minerals too.

Fig 9: The CNY TWI and CRB BLS Spot Index

Note: CRB BLS Spot Index comprises of all commodities (Metals, Textiles, Livestock, Fats and Oils, Industrial price, Foodstuffs)

Source: CRB, Bloomberg, Maybank FX Research & Strategy

Such a situation sparks imagination of the **Petroyuan** given the similar environmental conditions that started the Petrodollar. The Petrodollar was birthed after the collapse of the Bretton Wood system in 1971 and the oil embargo imposed by OPEC on countries supporting Israel during the Yom Kippur war. The oil embargo lasted from Oct 1973 to Mar 1974. The US and Saudi Arabia reached an agreement to set oil prices in USD. The resulting oil revenue surpluses (in USD) were thus recycled for domestic consumption, investment, lent or reinvested in the US through the purchase of US treasuries. Based on available data, oil producing countries became major foreign holders of UST by the end of 1974 which contributed to the dominant reserve status of the USD.

Yuan Internationalization Could Make Progress

China had been striving for more yuan-invoiced oil transactions for a while as part of its yuan internationalization endeavors. In 2018, China launched the Shanghai International Energy Exchange in order to start pricing oil futures in yuan. When it comes to crude futures, observations are that there is still some hesitance for foreigners to participate due to exchange rate risk. Shanghai crude futures, notwithstanding the use of medium sour crude oil as underlying product that cannot be comparable to Brent and WTI, had also been trading at a discount to the USD-denominated peers due to China's import of discounted Iran's crude oil.

Fig 10a: Shanghai Crude oil Futures Have Been Tracking International Peers

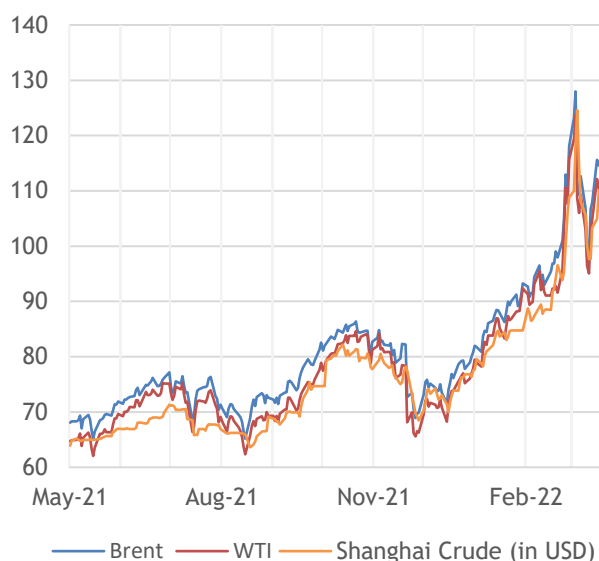
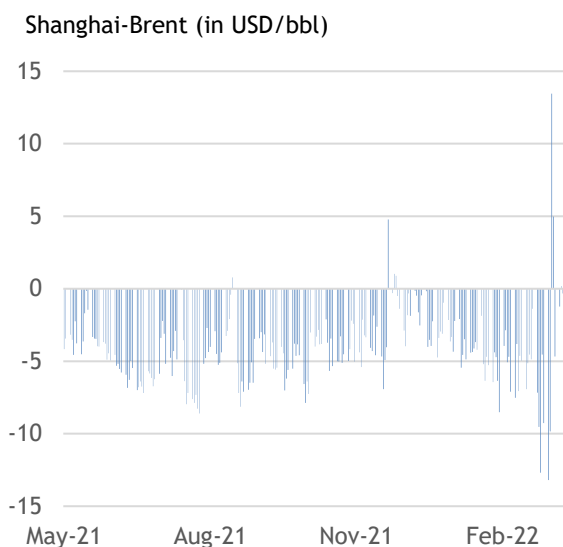


Fig 10b: ...Albeit Trading at A Discount To Brent Most of the Time



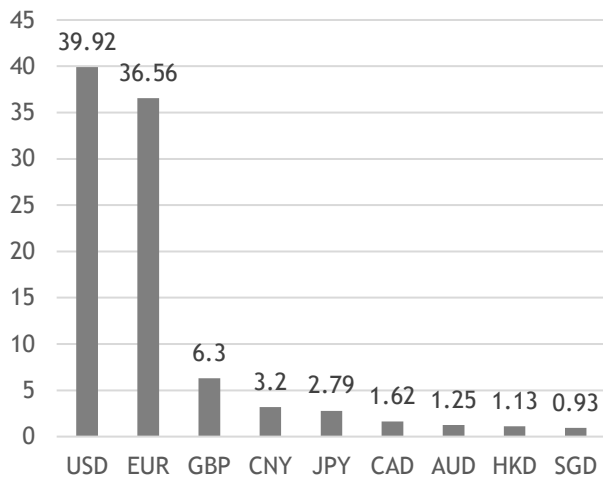
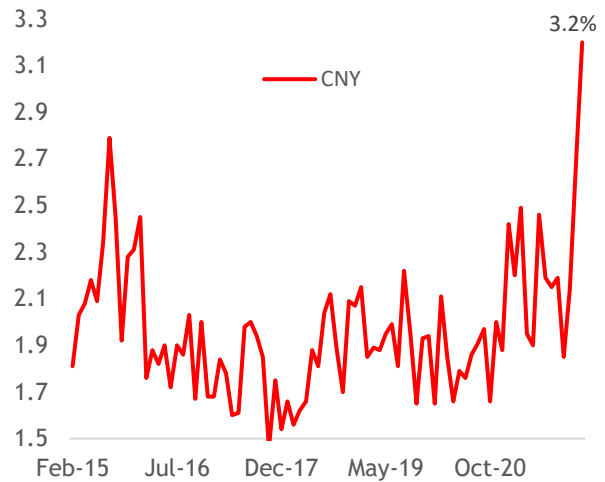
Note: Shanghai crude oil futures are priced in yuan but converted using daily USDCNY spot.

Source: INE-Shanghai International Energy Exchange, Bloomberg, Maybank FX Research & Strategy

The launch of the energy exchange comes after IMF's inclusion of the RMB to its Special Drawing Right reserve basket in 2015. China had also reached some milestones since to promote yuan internationalization including

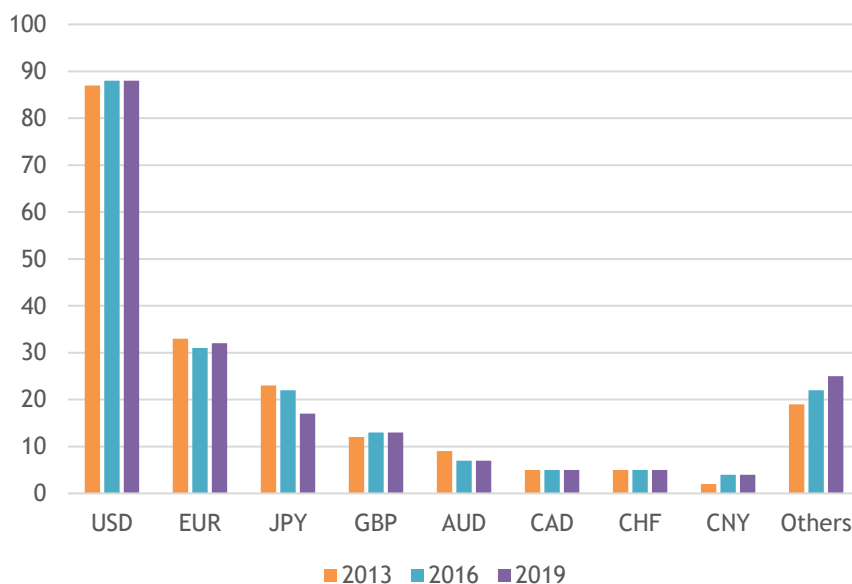
- 2015: the launch of the Cross-Border Interbank Payment System.
- 2015: LME Clear members can use CNH as eligible cash collateral for margin requirements
- 2016: China Interbank Bond Market (CIBM) Direct scheme was created for foreign investors to buy onshore bonds
- 2018: Large-cap A shares were included in MSCI EM index
- 2019: CGBs and Policy bank securities are included in Bloomberg Barclays Global Aggregate Index
- 2021: China enters FTSE Russell World Government Bond Index (WGBI)

More recently, we are becoming to see small progress as CNY edged JPY out to be the fourth most active currency for SWIFT payment in Jan 2022 (before dropping back to fifth position for Feb 2022) but it is far from challenging the top two positions.

Fig 11a: Shares of Global Payment (%) as of Jan 2022**Fig 11b: Historical Trend in CNY Share of Global Payment (%)**

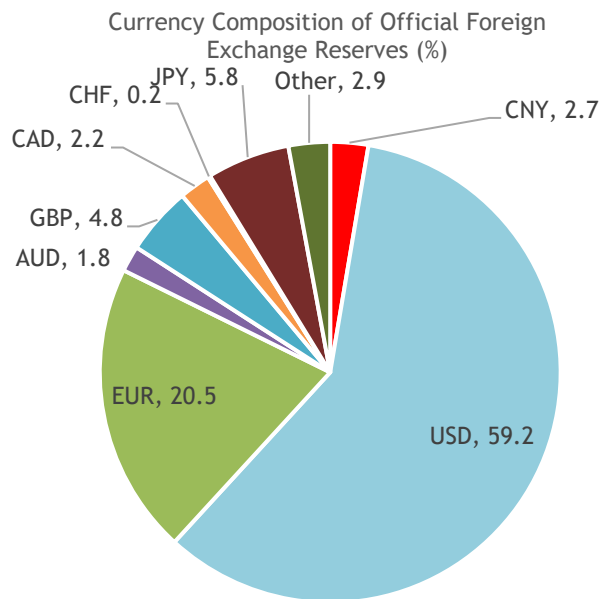
Source: SWIFT, Bloomberg, Maybank FX Research & Strategy

The current geopolitical crisis coincides with the upcoming SDR review in mid-2022 where IMF could potentially raise the weights of yuan in the five-currency SDR basket from the current 10.92%. The new SDR basket will come into effect on 1 Aug 2022. The current weight of 10.92% was set in 2015 when yuan inclusion into IMF's SDR basket was announced. Since then, China has maintained its lead as the world's largest exporter (\$2.5trn as of 2020) and raised the usage of the RMB a tad. Based on BIS Triennial Central Bank survey, share of CNY OTC turnover has risen modestly from 2% in 2013 to 4% in 2019.

Fig 12: Turnover of OTC Forex Instruments by Currency (% Daily Avg.)

Note: Sum of shares will total 200% as two currencies are involved in each transaction.

Source: BIS 2019 Triennial Central Bank Survey

Fig 13a: Share of CNY in Forex Reserves Remains Non-Threatening,**Fig 13b: ...But is Rising**

Source: IMF COFER, Bloomberg, Maybank FX Research & Strategy

USD Diversification In Progress

Table 2: Non-traditional Currencies in Global Foreign Exchange Reserves, end-2020

	in bil US\$	as % of Total
Total	1070	100%
Australian dollar	217	20%
Canadian dollar	247	23%
Chinese renminbi	272	25%
Swiss franc	21	2%
Other	315	29%
Korean won	81	8%
Swedish krona	63	6%
Singapore dollar	51	5%
Norwegian krone	49	5%
Danish krone	47	4%
New Zealand dollar	12	1%
Hong Kong dollar	11	1%

Note: The size of "other" currencies is estimated based on Arslanalp and Tsuda (2014).

Source: IMF, COFER, CPIS

In a working paper freshly published by the IMF on *The Stealth Erosion of Dollar Dominance*, the IMF noted a shift out of dollars in two directions: a quarter into the RMB and three quarters into the currencies of smaller countries that have played a more limited role as reserve currencies. The IMF pinned the shift to *active portfolio diversification of central bank reserves managers*, spurred by growing liquidity of markets in those currencies, falling transaction costs with electronic trading platforms, the desire to actively chase returns after accumulating substantial portfolios of financial assets and the fall in bond yields issued by governments of the Big Four (USD, EUR, JPY and GBP).

CIPS cannot be Russia's way out of SWIFT entirely

As some Russian banks are being excluded from the SWIFT system, one may consider the possibility for China to take the opportunity to expand the use of its own Cross-Border Interbank Payment System (CIPS). Chief of Russia's financial committee Anatoly Aksakov said that Russia and China will establish some form of cooperation between their respective financial messaging systems in order to maintain trade and to mitigate payment risks. Greater fusion between Russia's System for Transfer of Financial Messages (SPFS) and China's CIPS should be supportive of CNY-RUB bilateral trades. However, given that CIPS is primarily a yuan payment clearing system, it is unlikely to be Russia's way of getting round SWIFT entirely.

Apart from China's goal to remain diplomatically neutral so as to avoid attracting sanctions from the West, there are technical challenges.

While CIPS was launched in 2015 to internationalize the use of yuan, SWIFT has been acting as the financial messaging channel to connect CIPS with its own global community since 2016. There is hardly any basis for competition given the fact that SWIFT serves more than 11,000 financial institutions in more than 200 countries. In contrast, CIPS only has 1288 participants out of which only 76 are direct participants consisting mostly of overseas subsidiaries or branches of Chinese banks as of Feb 2022. 1212 participants are indirect. Indirect participants have to use the SWIFT messaging system for information transfer with CIPS.

Amongst the indirect participants, 164 are from Europe, 43 from Africa, 29 from North America, 17 from South America, 936 are from Asia (of which 540 are within China) and 23 from Oceania. CIPS tends to draw the participation of banks from African countries due to China's involvement in its infrastructure development. CIPS also expands via China's Belt and Road Initiative which spans from East Asia to Europe.

Based on data from CIPS, the average daily volume of business has been rising rapidly.

Fig 14a: Usage of CIPS has been Rising Significantly

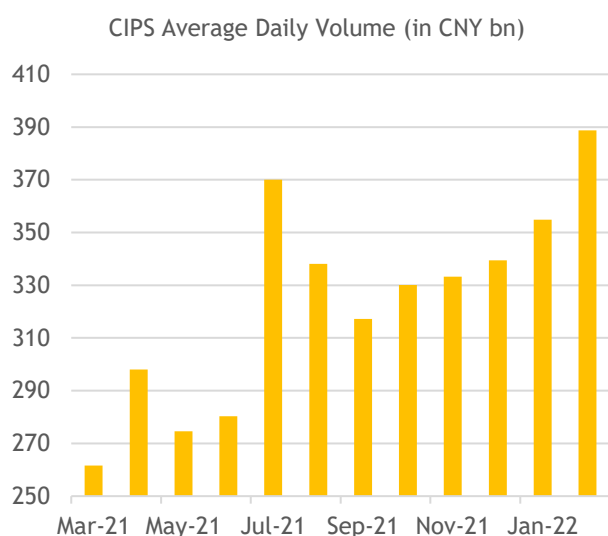
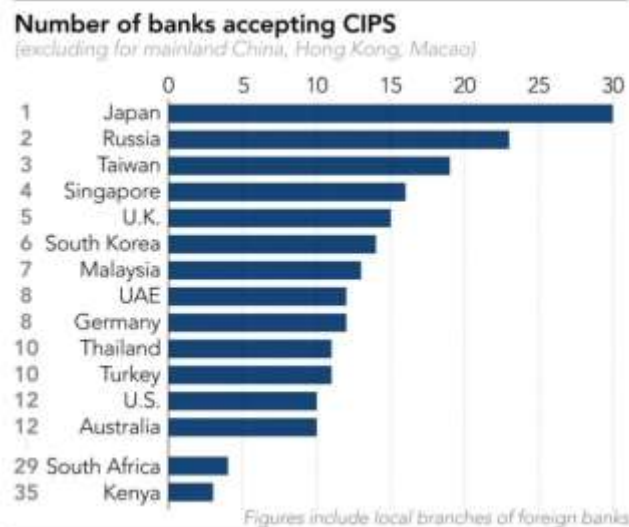


Fig 14b: Banks Accepting CIPS



Source: LHS - Cross-Border Interbank Payment System, Maybank FX Research & Strategy, RHS Chart - Nikkei in 2019

As of now, CIPS' messaging ability is limited. Rising daily volume of CIPS could probably justify greater development in its messaging functions to reduce reliance on SWIFT at some point. The latest sanctions on Russia and Iran previously may spur more foreign banks to participate in CIPS as a form of diversification in the medium term. China's role in broad trade agreements such as RCEP and potentially CPTPP could also draw more foreign banks to CIPS. However, the gap with SWIFT's global reach is incomparable at this point.

RMB is Far From Being a Rival to USD At this Point

Taken together, data suggests that progress made by CNY as an active mode of payment and as a reserve currency have been rather marginal in spite of key milestones achieved such as China's inclusion in global indices, providing a platform for energy exchange priced in yuan as well as the SDR inclusion. This could primarily be due to the capital controls still in place that discourage FX speculations. In addition, China does not have the complete payment infrastructure to be independent of SWIFT yet; CIPS' creation based on a geopolitical purpose, could also be a reason for the poorer adoption by western banks.

However, there is growth in CNY usage, albeit not exponential. In addition, the use of SWIFT as sanction on "pariah nations" over the years could gradually drive more to search for alternatives to USD or EUR payment and China has the trade and investment clout as well as a budding payment system in place to serve as one in the future. The pricing of commodities in CNY by major commodity producers could be a game changer and incentivize central banks to hold more CNY as reserves but it is still some way from challenging the USD.

RMB and ASEAN

Micro data on RMB usage trends in ASEAN is lacking, but here we note two positive developments that could point to potential for RMB to play a greater role in the regional financial ecosystem going forward.

The first table below focuses on Bilateral Currency Swap Agreements (BCSAs) as well as the Chiang Mai Initiative Multilateralization (CMIM). These arrangements mean that PBoC and regional central banks can access FX liquidity in mutual domestic currencies to support trade and investment financing, and to stabilise financial markets in times of need.

Table 3: BCSAs Between PBOC and ASEAN Central Banks

Country	Year First Established	Value	Notes
Singapore	2010	CNY300 bn	Last renewed in May 2019, for three-year term.
Malaysia	2009	CNY180 bn	Last renewed in Nov 2021, for five-year term.
Indonesia	2009	CNY250 bn	Last renewed in Jan 2022, for three-year term.
Thailand	2011	CNY70 bn	Last renewed in Jan 2021, for five-year term.
Philippines	2003	-	US\$2bn swap line with PBoC lapsed, and put on hold since 2020.
Multilateral— Chiang Mai Initiative Multilateralization (CMIM)	2010	US\$240 bn	Multilateral currency swap arrangement for liquidity support among ASEAN+3 members (Brunei, Cambodia, China, Indonesia, Japan, Korea, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam), and the HKMA. Started at US\$120bn, doubled in 2014.

Source: Various central bank websites, Maybank FX Research & Strategy

Excluding Philippines and the CMIM, we note that the size of the local currency swap lines with PBoC among the key ASEAN economies sum to about CNY800 bn or US\$125bn. To put this in perspective, this is about one-third the size of total trade flows between China and the four ASEAN economies (SG, MY, ID, PH) in 2020.

The second table below focuses on trends in trade relations between China and ASEAN countries.

Table 4: ASEAN-China Trade Linkages and Trends

Country	Value of Country-China Trade in 2019	China's % Share of Country's Trade Basket in 2019	CAGR Growth, 2011 to 2019 (%)
Singapore	US\$84 bn	13.8%	3.2%
Malaysia	US\$114 bn	21.3%	3.5%
Indonesia	US\$79 bn	20.9%	4.0%
Thailand	US\$97 bn	19.2%	4.2%
Philippines	US\$47 bn	21.8%	8.4%

Note: Full-year data is available till 2020, but trade volumes are depressed due to pandemic lockdowns. 2019 values are utilized for comparison instead.

Source: Bloomberg, Maybank FX Research & Strategy Estimates

All 5 ASEAN countries have seen robust growth (3% to 8% CAGR) in trade with China over the past decade, with Philippines seeing the fastest growth from a low base. China is now the top trading partner for all 5 key ASEAN economies.

While closer trade relations do not explicitly translate to greater RMB usage in pricing and settlement, it can provide the necessary foundations for efforts in this direction. For instance, we recall that last Sep, the framework for local currency settlement between Indonesia and China officially came into effect, which is expected to result in incremental use of yuan and IDR for bilateral transactions.

Local currency settlement arrangements generally aid businesses in terms of lower conversion costs, and allow more options for trade financing and direct investment in local currencies. Broadly, BI is aiming to leverage on expansions of LCS arrangements with more partners, and moving away from dollar reference rates in financial transactions, to help reduce the volatility of the USDIDR pair.

Table 5: Standard Dev. of Weekly % Changes in ASEAN FX, 2016-2022

	SGD		MYR		IDR		THB		PH	
	CNH Cross	USD Cross	CNH Cross	USD Cross	CNH Cross	USD Cross	CNH Cross	USD Cross	CNH Cross	USD Cross
2016	0.6	0.9	1.3	1.4	0.9	0.8	0.6	0.6	0.8	0.6
2017	0.5	0.6	0.6	0.5	0.5	0.4	0.6	0.5	0.7	0.6
2018	0.5	0.5	0.8	0.6	0.9	0.8	0.7	0.7	0.9	0.5
2019	0.5	0.4	0.6	0.4	0.6	0.7	0.9	0.6	0.6	0.5
2020	0.6	0.9	0.7	0.9	1.9	1.9	0.8	0.9	0.6	0.4
2021	0.4	0.5	0.5	0.5	0.7	0.6	0.8	0.9	0.6	0.6
2022 Jan-Mar	0.5	0.5	0.5	0.5	0.5	0.4	1.0	1.2	0.5	0.5

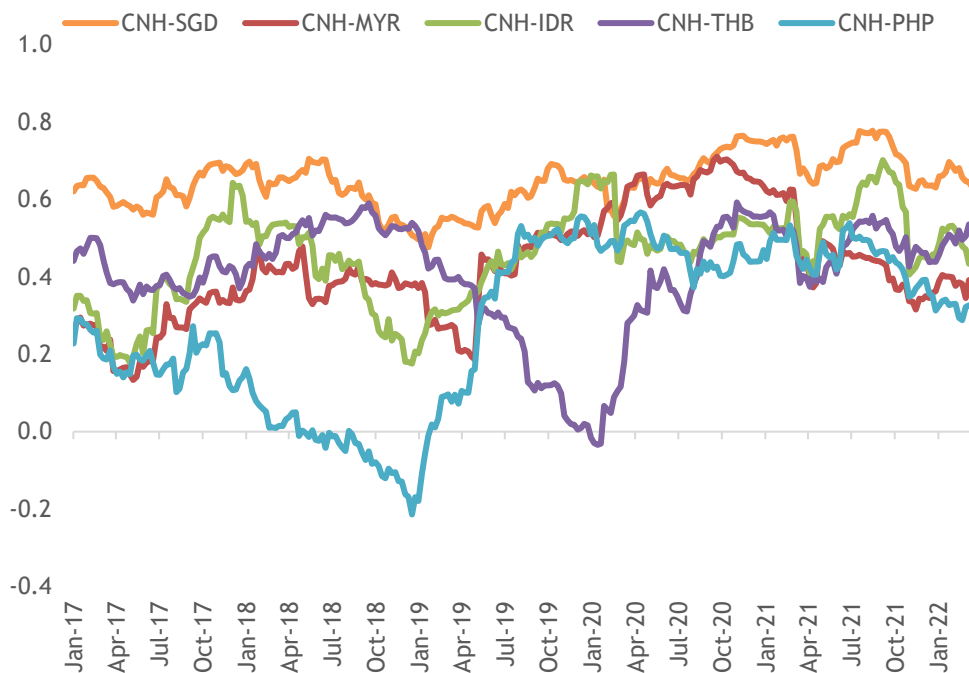
Source: Bloomberg, Maybank FX Research & Strategy Estimates

From the table, we see that despite lingering pandemic impact and other risk drivers, ASEAN currencies have been relatively less volatile post-2020,

after markets adjusted to the initial Covid shock. The only exception is THB, where extent of swings is still higher versus historical trends, likely given its elevated tourism dependence (i.e., outsized sentiment swings from shifts in narratives on global reopening and onset of new variants).

More importantly, we note that the extent of ASEAN FX volatility, when expressed in CNH crosses, is similar to, if not slightly lower versus USD crosses, from 2020 onwards. **The relative stability of CNH-ASEAN FX crosses can be an additional incentive for increased adoption of yuan in regional trade and investment.**

Fig 15: 52-Week Rolling Correl. of % Changes in ASEAN FX and CNH



Source: Bloomberg, Maybank FX Research & Strategy Estimates

Broadly, the correlation between changes in CNH and ASEAN FX also looks to be steadily positive since mid-2020, reflecting the anchoring effect of yuan on ASEAN FX on account of tightened trade and financial linkages.

III. Recap of End-Jan Strategies...

In our end-Jan report “AXJs in the Face of Dovish PBoC and Hawkish Fed”, we listed some potential opportunistic plays, based on our findings and analysis on Fed rate hike cycles, PBoC moves, central bank divergence, flows and positioning and technical indicators.

Let us take stock of how these trades have performed.

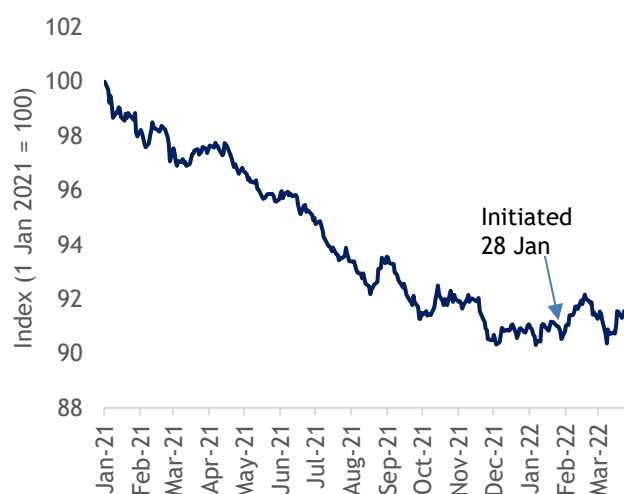
Table 1 (Repeated for Reference): Thematic Plays Outlined on 28 Jan

Themes	FX Strategies	% Returns (28 Jan to 24 Mar)
Covid-endemic, Reopening Play	Focus on Covid-endemic (less econ. drags) vs. zero-Covid policy stance in countries. Basket of equal-weighted long SGD, THB, KRW, vs. short TWD, CNH.	1.2%
G7-China Policy Divergence Play	Long CAD, AUD and NZD (potential rate hikes) vs. short CNH and JPY (easing spectrum).	8.7%
Benign Commodity Outlook	Long AUD, IDR, MYR, CAD vs. short net energy importer INR. Demand could broaden post 1Q Omicron drags; geopolitical events risk impacting energy supplies.	3.7%
Intra-ASEAN Policy Divergence Play	Tactical buy dips in SGD vs. short MYR, PHP. MAS first mover vs. slower normalization start for BNM, BSP. Buy dips preferred as S\$NEER near top of policy band, long positioning near overcrowded.	1.4%
USD - the Long and Short of It	Tactical long USD in the lead-up to first Fed hike but get ready to turn short post first hike as DXY typically fall 2% - 4%.	+1.7% (long DXY from 28 Jan to FoMC on 17 Mar 2am); +0.2% (short DXY post-FoMC, as of 24 Mar)

Source: Maybank FX Research & Strategy

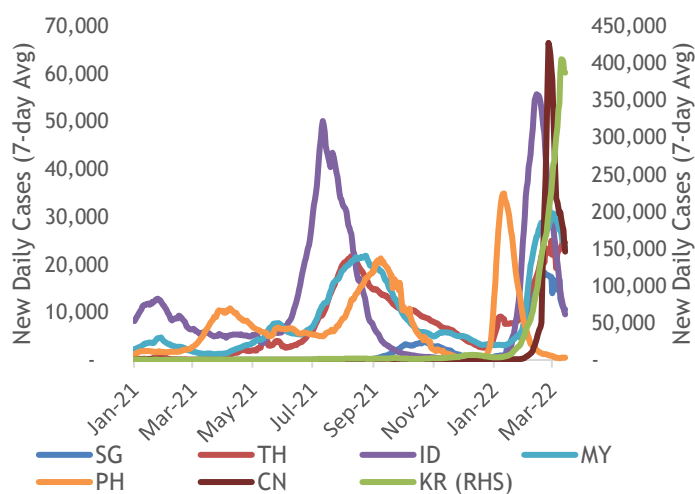
(i) Covid-endemic, Reopening Play

Fig 16a: Basket of Long SGD, THB, KRW, vs. short TWD, CNH



Source: Bloomberg, Maybank FX Research & Strategy

Fig 16b: Regional Covid Waves May Have Peaked



Source: Bloomberg, Maybank FX Research & Strategy

Our preference for FX of Covid-endemic economies vs. zero-Covid economies did quite well in Feb, but this bout of benign performance was disrupted to some extent by the wave of Omicron cases (and concomitant pause in reopening momentum that swept across the region) then. Going forward though, we note that with there are signs that the current waves of Covid cases in Asia ex-China (with the exception Korea) have either peaked or already reverted to down-trends in most regional countries.

Looking at Figure 1a, our basket found a tentative trough in early-Mar (which was coincidentally around the same level as when we recommended the trade), and looks to be ticking higher again.

On a related note, President Xi said that China will “strive to achieve the greatest prevention and control effect with the smallest cost”, and this seems to be bringing to fruition our separate call that China could be more adaptive in their Covid control measures as consumption is sluggish. Nonetheless, it is unlikely to see a complete u-turn in policy towards Covid-endemic stance anytime soon, especially with only about half of Chinese people aged 80 and over having gotten two shots.

As of 24 Mar, the basket has returned slightly >1%. Given a return to reopening trends across the region, we prefer to stay long in our equal-weighted basket of long SGD, THB, KRW, vs short TWD, CNH.

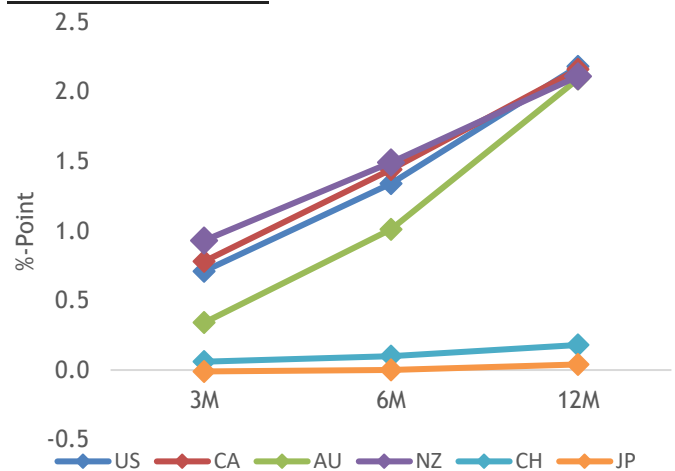
(ii) G7-China Policy Divergence Play

Fig 17a: Basket of Long CAD, AUD, NZD vs. Short CNH, JPY



Source: Bloomberg, Maybank FX Research & Strategy

Fig 17b: Market Expectations of Policy Rate Moves Over Next 12 Months



Source: Bloomberg (24 Mar), Maybank FX Research & Strategy

Our preference for long CAD, AUD and NZD (tightening bias) vs. short CNH and JPY (easing spectrum) did exceptionally well since our recommendation in late Jan. To a large extent, this trade was aided by sharp weakness in JPY, alongside widening in UST-JGB yields (as shown earlier).

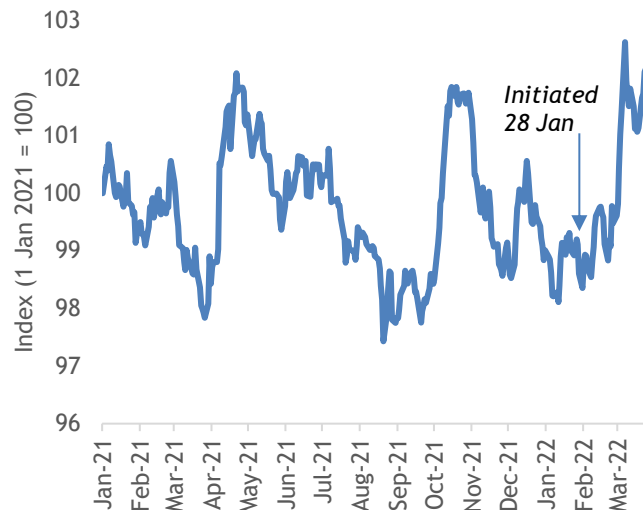
Notably, BoJ stood pat in its latest March policy meeting, maintaining an easing bias versus clearer normalization plans by other central banks. It did tweak the characterization of inflation outlook, saying that it's expected to “clearly” rise and cited oil as key driver, but we note that BoJ is unlikely to respond meaningfully to supply-side risks now. PBoC is also likely to stay accommodative in monetary given the policy pivot towards supporting growth.

Given the >8% gains seen in the basket as of 24 March, we recommend to Mar 25, 2022

take partial profit, but to remain net long in the basket as policy divergences continue to play out.

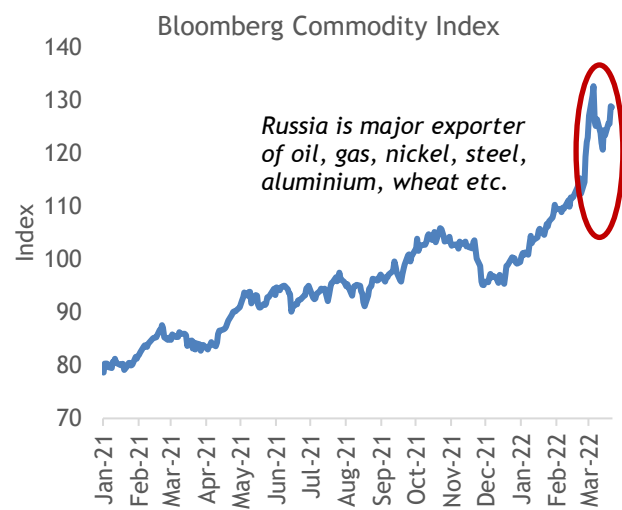
(iii) Benign Commodity Outlook

Fig 18a: Basket of Long AUD, IDR, MYR, CAD vs. Short INR



Source: Bloomberg, Maybank FX Research & Strategy

Fig 18b: Russian Invasion Exacerbated Commodity Price Pressures



Source: Bloomberg, Maybank FX Research & Strategy

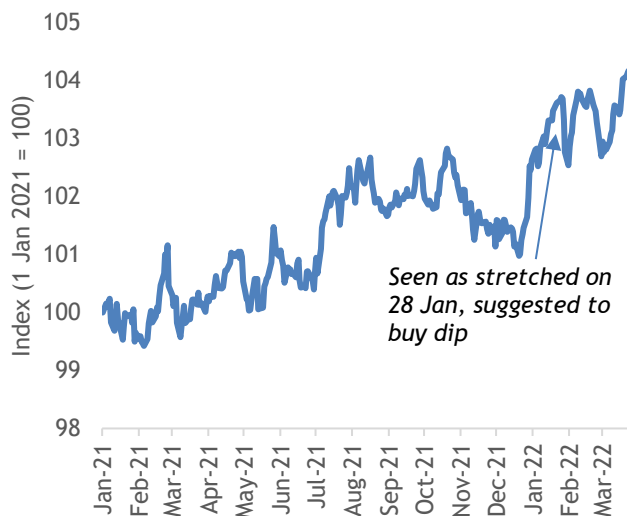
At end-Jan, we had remained positive on commodity plays, as we maintained that global demand should remain resilient while geopolitical risks in Europe present upside risks to crude oil prices.

Since then, Russian attack on Ukraine and more severe-than-expected bout of sanctions by the West on Russia have led to a boon for oil and other commodities. Brent rose from US\$90/bbl to an interim peak near US\$140/bbl before paring gains. Besides crude, most other commodities had also seen a similar rally in prices at some point. Russia and Ukraine are the world's second- and fourth-largest wheat suppliers, and concerns over resulting shortages have rocked sentiments in this segment. Russia is also among the top-five global producers of steel, nickel and aluminium, with latest sanctions forcing a metals rally as well.

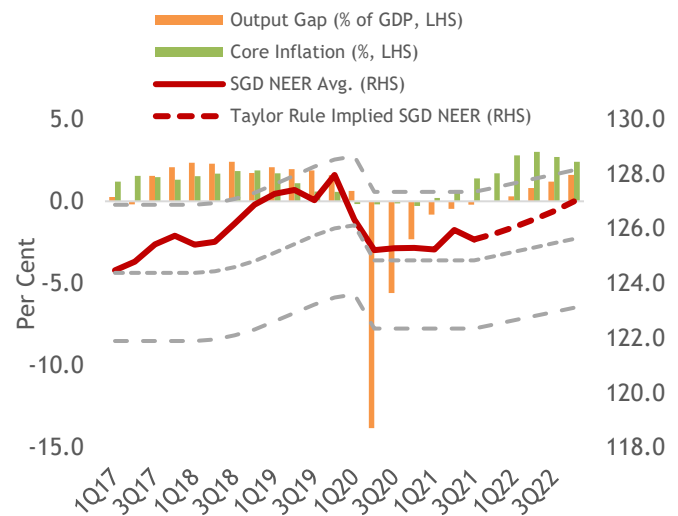
The concern now is if the commodity rally can sustain in the interim. The focus is likely again on when the war will end and whether EU will indeed move closer towards sanctioning Russian energy exports. According to reports, Baltic countries including Lithuania are pushing for an embargo on Russian energy imports, while Germany is warning against acting too quickly because of already high energy prices in Europe. Moscow has threatened that EU sanctions on Russian oil could prompt it to close a gas pipeline to Europe. And the EU relies on Russia for 40% of its gas, with Germany among the most dependent among the EU's large economies. More signs of progress in diplomatic resolution to the conflict, and continued ramp-up in OPEC+ production in coming months might be needed for clearer signs of moderation in oil prices from current elevated levels.

As of 24 March, our recommended basket has returned about 3.7%, and we similarly recommend to take partial profit.

(iv) Intra-ASEAN Policy Divergence Play

Fig 19a: Basket of SGD vs. Short MYR, PHP

Source: Bloomberg, Maybank FX Research & Strategy

Fig 19b: Upward Pressures on SGD NEER on Inflation Risks

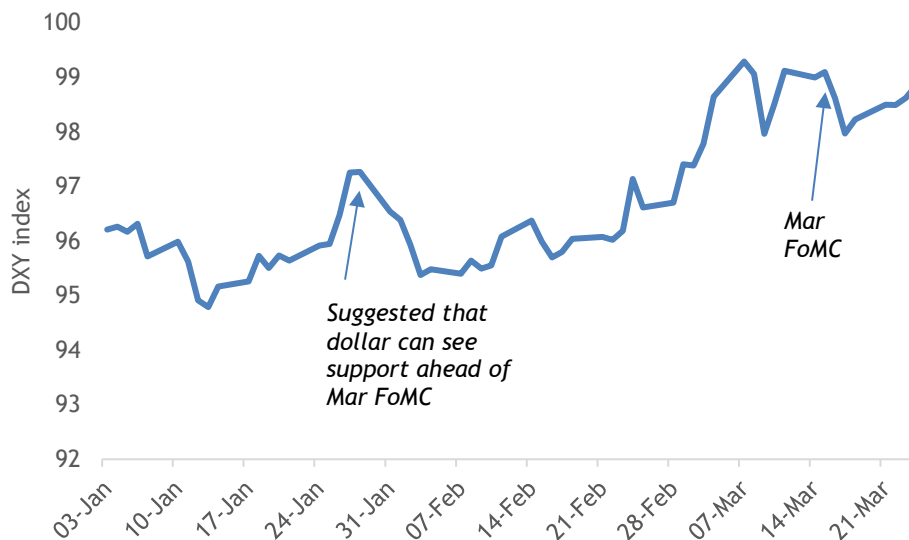
Source: Bloomberg, Maybank FX Research & Strategy

In late Jan, we had suggested a trade based on MAS' earlier and more aggressive tightening bias versus slower normalization start for BNM, BSP. We had caveated this recommendation with the note that SGD NEER was trading near the top of the policy band then, and that buy dips was preferred instead. Dips did come soon after. But even if the position had been initiated on 28 Jan, position would still be in the green (+1.4% as of 24 March).

As of writing, SGD NEER is still testing the +2% upper bound, by our estimates, reflecting market expectations for MAS to stick to a tightening bias in mid-Apr to contain imported inflation. Our economist team's 2022 forecasts for headline CPI and core CPI are +3.6% and +2.7%, respectively. The Ukraine-Russia conflict drove both food and energy prices higher in March, and could continue to contribute to supply-side pressures in the interim.

As mentioned earlier, current house view is for MAS to tighten in the upcoming April meeting by re-centering the S\$NEER band to the current prevailing rate, following the steepening of the slope in the Jan inter-meeting policy move. There is a possibility that MAS may couple this with another slope-steepening move. Comparing past episodes of recentring, we think that SGD has the potential to see gains of 1% or more if this materializes. Given the above, we maintain our bias to stay long on this basket.

(v) USD - the Long and Short of It

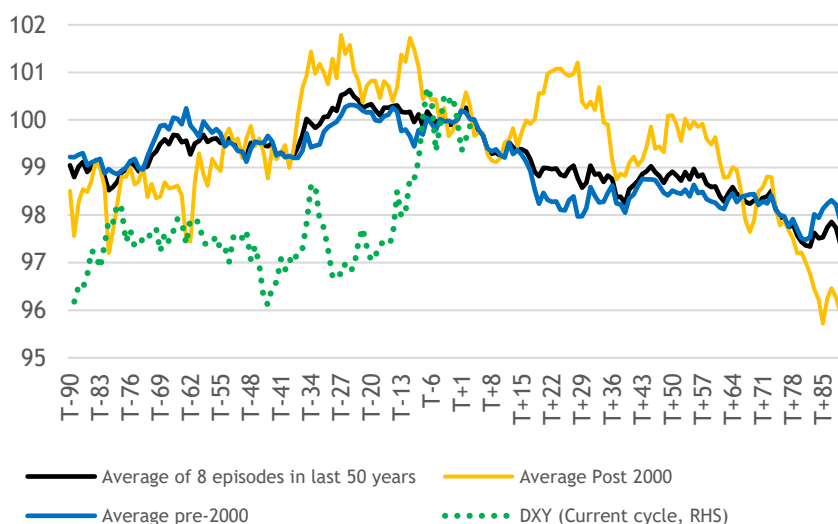
Fig 20: DXY Saw Support into FoMC and Dipped Slightly Post

Source: Bloomberg, Maybank FX Research & Strategy

Historically as seen in past 7 Fed rate hike cycles over the last 50 years, the 90 days run-up to Fed's first rate hike is typically supportive of DXY strength and at times, can overshoot before easing into first rate hike.

This time round, the Feb-Mar support for DXY was likely due in part to the occurrence of the Russia-Ukraine war. Initially, in the two weeks following Russia's attack on Ukraine, there was a clear rush into dollars. USD seems to be the preferred haven of choice given concerns over financial market contagion. I.e., sanctions on Russian central bank, exclusion of some local lenders from SWIFT, and signs of reallocation of assets out of Russia, have led to broad international demand for USD.

Money market stress can be seen from the FRA/OIS spread for one-month contracts widening the most since March 2020. But this spread notably peaked around 10 March, and shows signs of easing alongside tentative progress in Russia-Ukraine talks. Unwinding in money market stresses could be exerting net drags on the dollar post-FoMC as well, despite two-way swings still in geopolitical developments.

Fig 21: DXY Still Tracking Historical Trajectories

Source: Bloomberg, Maybank FX Research & Strategy

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Historically, post-first Fed hike also witnessed the DXY declining by 2% to 4% on average in a T + 90 trading days window as USD long positions unwound post-event risk. As of now, DXY moves are still tracking historical trajectories near the start of the Fed hike window.

But as we cautioned prior, while hawkish Fed expectations may be in the price, we are cautious if monetary policy turns restrictive. Ongoing war and spillover impact on global prices through the supply disruption channel add a key dimension of uncertainty to the macro and policy outlook and there is a risk that dollar softness post-first Fed hike may not be as forthcoming this time round. We await more clarity in the Russia-Ukraine conflict and prefer to sell dollar rallies in the interim.

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