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MACRO MORNING BRIEFING

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China: The CNH-CNY Basis and Counter-Cyclical Factor Normalize

Global markets have experienced acute asset volatility of late for a number of reasons, ranging from the unwinding of carry trades, concerns about liquidity as a result of BoJ policy tightening in the area of interest rates and bond purchases, and the weakening of global growth. Market volatility seems to have settled somewhat, but there are still jitters.

One of the most interesting market developments is the normalization of two valuation metrics that are unique to the Chinese yuan.

The first is the CNH-CNY basis, which measures the spread between onshore USDCNY and offshore USDCNH. The CNH-CNY basis has been volatile this year, with the spread widening on two occasions (see Exhibit #1). The CNH-CNY basis widened sharply in March 2024 on the back of USD strength and JPY weakness, but the move was brief and swiftly normalized. The CNH-CNY basis widened again, but at a slower pace, through June and stay elevated for most of July before abruptly narrowing to a neutral level. Note that recent market volatility had pushed the CNH-CNY basis into negative territory.

The CNH-CNY basis is an important indicator and gauge for RMB depreciation momentum. Given the aim of currency stability it is in the PBOC's interest to see a narrow and steady basis.

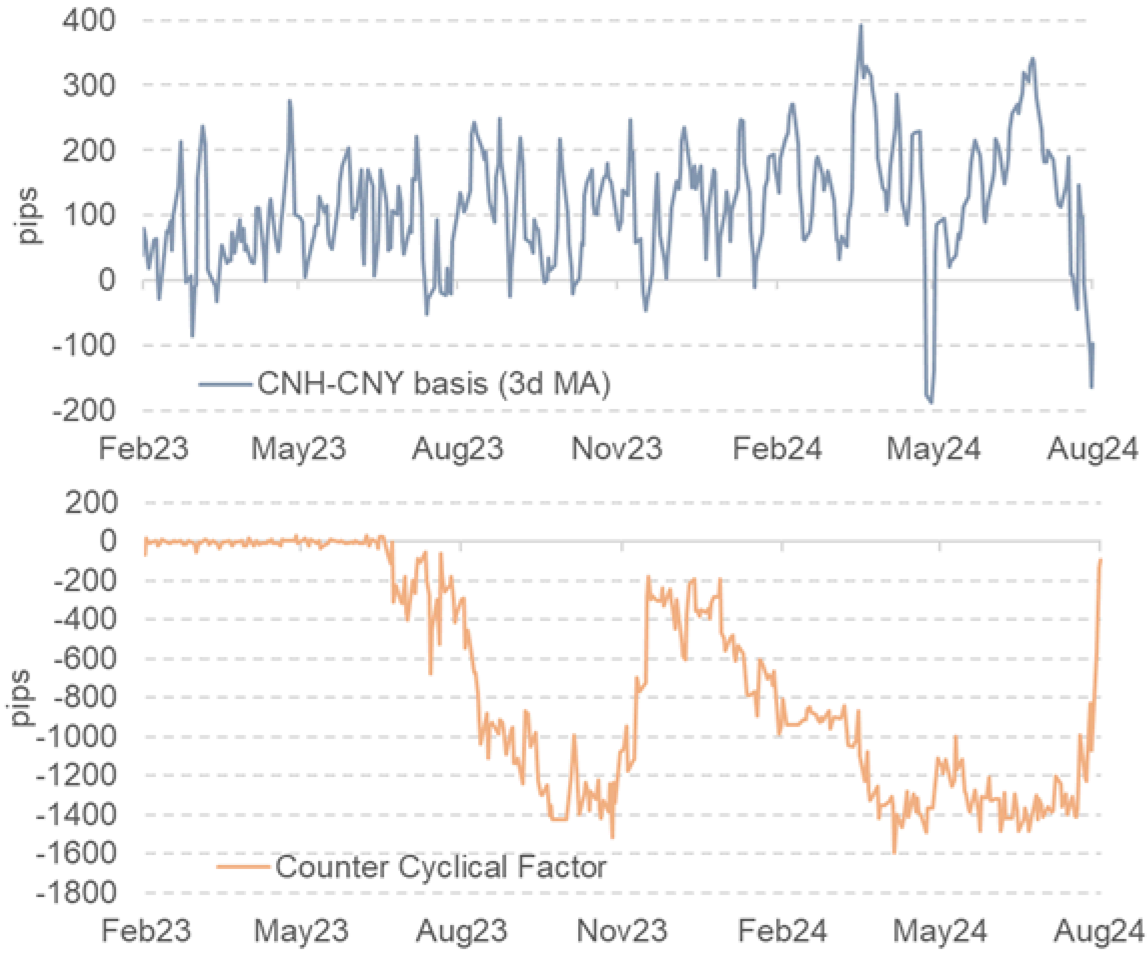
The second Chinese yuan metric is the counter-cyclical factor (CCF). The counter-cyclical factor was added to the formula for the fixing of the daily midpoint for USD/CNY central parity fixings in 2017 to effectively mitigate procyclical market behaviors and stabilize market expectations. Note that the PBOC's managed floating exchange-rate system allows the onshore CNY spot to fluctuate within a +/-2% trading band with reference to the daily USDCNY fixing level.

The CCF can be observed when there is a significant discrepancy between the implied USDCNY fixing level and the level at which the PBOC sets it that day. A negative CCF is interpreted as a sign of the PBOC's intention to keep USDCNY low. This normally occurs when the currency is under depreciation pressure. Between April and July of this year, the CCF hovered at around -1200 to -1400pips, essentially capping the USDCNY spot at near the 2% upper limit of the trading band.

The recent combination of a weaker USD and the carry unwind motivated by the Japanese yen has led to a fast-paced normalization of the CCF in a couple of days, with the CCF declining from -1073pips at the end of July to -93pips as of Wednesday this week.

The normalization of both the CNH-CNY basis and the CCF is a welcome move, as it allows the PBOC to engage in a proactive stance on RMB pricing.

Exhibit #1: The CNH-CNY Basis and Counter-Cyclical Factor Normalize



Source: BNY, Bloomberg L.P.

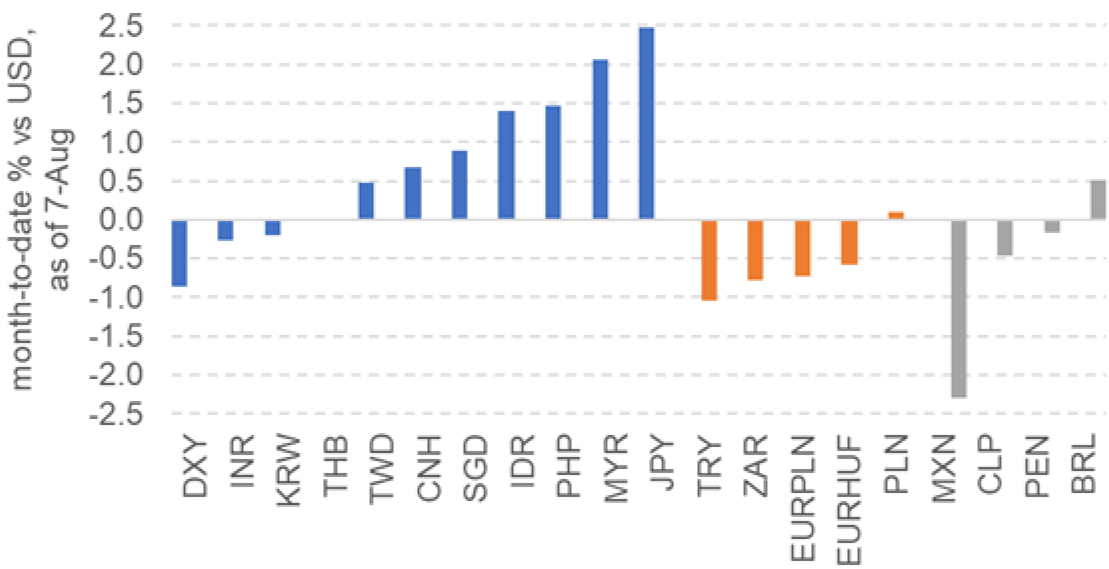
APAC currencies showed resilience, outperforming both CEE and LatAm currencies despite suffering acute downside equity and capital outflow pressure. The relative performance can be explained in part by the carry unwind, with higher-yielding LatAm currencies suffering, while the funding nature of APAC currencies, especially CNH and TWD as well as JPY, has allowed them to do relatively well (see Exhibit #2).

Focusing on the Chinese yuan, the July trade data shows that China's exports grew at the slowest pace in three months, coming in at 7.0% y/y, down from 8.6% in June, while imports rebounded strongly from -2.3% y/y to 7.2% y/y. Year-to-date, exports and imports stood at 4.0% ytd y/y and 2.8% ytd y/y, respectively. July credit lending, activities and investment data will be key to watch.

While technical factors might have favored the Chinese yuan over the past week, in the medium term, domestic fundamentals, capital flows and interest rate dynamics are what matter. Looking across equities, foreign capital flows revealed no visible turnaround in flows but are biased toward further unwinding, while domestic investors mostly stayed on the sideline, using outstanding margin trading on Chinese stock markets as a proxy. The relentless demand for Chinese sovereign bonds is also a reflection of the combination of risk aversion and anticipation of further policy easing.

Finally, the ongoing flush CNH liquidity conditions might just make it too hard for market participants to resist reengaging in “carry” trades as and when market volatility subsides, which might weigh on the currency.

Exhibit #2: Global Currency Performance in August: Strong APAC vs. CEE, LatAm



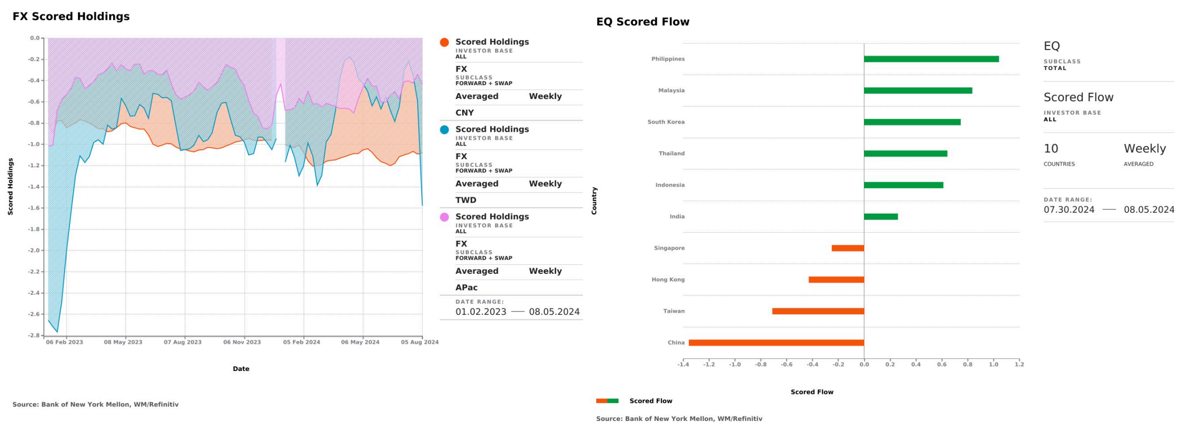
Source: BNY, Bloomberg L.P.

APAC currencies demonstrated resilience over the past week amid severe market volatility. Based on iFlow data, APAC currencies posted moderate demand with inflows, except for outsized and record outflows in TWD. TWD posted weekly average outflows of -3.0 against inflows led by KRW, INR and IDR. Aggregate APAC currencies and CNY remain underheld with stable scored holdings, while TWD scored holdings plunged to new lows on the year.

iFlow equity flows were mixed despite the market gyrations earlier in the week. Chinese, Hong Kong, Taiwanese and Singaporean equities were net sold on average over the past week, against demand in Southeast Asian countries led by the Philippines and Malaysia.

APAC sovereign bond flows were relatively muted with ongoing index inclusion-rerated demand. Indian sovereign bonds, with weekly average scored flows of 1.43, were the most within iFlow universe.

Exhibit #3: Stable APAC FX, ex-TWD Flows. Resilience of Equities Amid Market Rout



Source: BNY, Bloomberg L.P.

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

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