

Asia FI & FX Strategy Watch

China rates – consolidation before further rally

PBoC back to “counter-cyclical adjustment” mode

PBoC cut the 7-day reverse repo rate by 10 bp on 13 June, and subsequently lowered the MLF rate by the same amount on 15 June. The next focus points will be the 1y and 5y LPR fixings on 20 June. Reductions are widely expected, but past patterns suggest the magnitude of cuts could be asymmetric. Our economists expect 1y LPR to be lowered by 10bp and 5y LPR to be lowered by 10-15bp (see [China Watch – Chart book series #99](#)).

Both the CGB and swap rates curve bull-flattened on the day of the reverse repo cut, but soon after profit-taking flows started kicking in. Past experiences indicate that 10y CGB yield tends to decline in the 10 days following the rate cut, by a magnitude of 9bp on average (Exhibit 1). After that, market developments start to diverge, depending on subsequent policy actions and changes in growth outlook.

So, will there be more rate cuts in the pipeline?

Amid the backdrop of insufficient domestic demand and subdued inflation, we think PBoC can potentially deliver more rate cuts and reduce financing costs further for the real economy in 2H. Developments in the FX market may also have implications for the PBoC's choice of policy tools. CNY has depreciated 6.5% versus the USD since the turning point in mid-January. So far, the PBoC has been showing greater tolerance to USDCNY breaking some of the key levels, with daily fixings very much in line with market estimates. That said, if USDCNY continues to march higher on the back of dollar strength and disappointing economic data out of China, it could start exerting more pressure on the PBoC to lower policy rates further.

Ample liquidity will remain a tailwind for the bond market

Given that the PBoC has already switched back to the ‘counter-cyclical adjustment’ mode, we think interbank liquidity will likely remain ample. Similar to previous easing episodes, both short and medium-term market funding costs are likely to stay lower than the corresponding policy rates, due to a combination of more generous liquidity injection from the PBoC and subdued credit demand. In fact, 1y AAA NCD rates have already declined by more than 40bp since mid-March (Exhibit 2). Another one or two 25bp RRR cuts in 2H seem very likely, which would help to replenish long-term liquidity and reduce banks' funding costs.

CGB: Bull market may take a pause, but it's not over

Taking into account weaker-than-expected economic recovery, softer inflation, and recent policy rate cuts, we've made notable downward revisions to our CGB forecasts (Exhibit 3). While we see some room for rates to go lower by 3Q-end on further monetary easing, market consolidation seems likely in the near-term, given 1) crowded positioning, and 2) expectation of more policy support measures being rolled out.

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GEM FI & FX Strategy
Asia

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Asia FI Strategy & Economics
Merrill Lynch (Hong Kong)

GEMs FI Strategy & Economics
BofAS

PBoC: People's Bank of China

MLF: Medium-term lending facility

LPR: Loan prime rate

CGB: China government bond

NCD: Negotiable certificates of deposits

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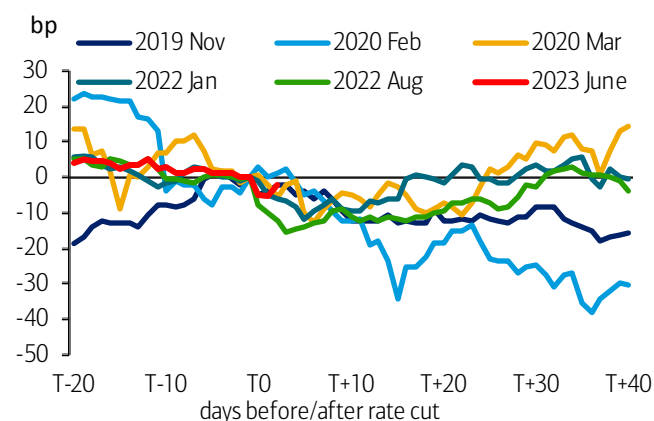
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Positioning: CGB curve has been bull-steepening during the past few weeks prior to the rate cut announcement. This is accompanied by a sharp rise in daily repo transaction volumes, as the market built up more carry trade positions by borrowing overnight repo to fund front-end bonds positions. Monthly average of daily repo transaction has already reached CNY7.4tn during May – significantly exceeding the long-term trend (Exhibit 4). Month-to-date average daily transaction has risen further to CNY8.3tn. Such high leverage would make the market very susceptible to liquidity fluctuations around tax payment day or month-end. Even a temporary rise in overnight repo rates may lead to profit-taking of some leveraged positions.

Further policy support: Besides monetary easing, market now widely expects more policy support measures to be rolled out to support property market and stimulate domestic consumption. If the eventual delivery can effectively turn market sentiment around, back-end yield may face stronger resistance to go lower. Any additional fiscal stimulus that needs to be financed by bond issuance would pose upside risks to our revised forecasts for CGBs.

Exhibit 1: 10y CGB yields before and after 7-day reverse repo rate cut

Yield tended to decline in the 10 days following the cut

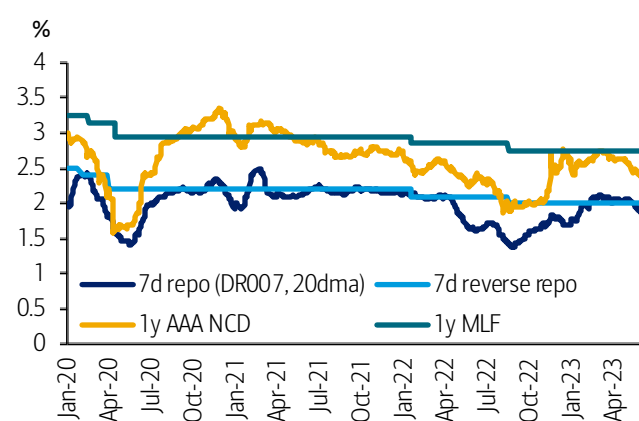


Source: Wind, BofA Global Research

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Exhibit 2: Policy rates and market rates

PBoC cut 7-d reverse repo and 1y MLF rate- by 10bp



Source: Bloomberg, BofA Global Research

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Exhibit 3: CGB yield forecast (eop, %)

We revised down yield forecasts to reflect weaker-than-expected growth recovery and monetary easing

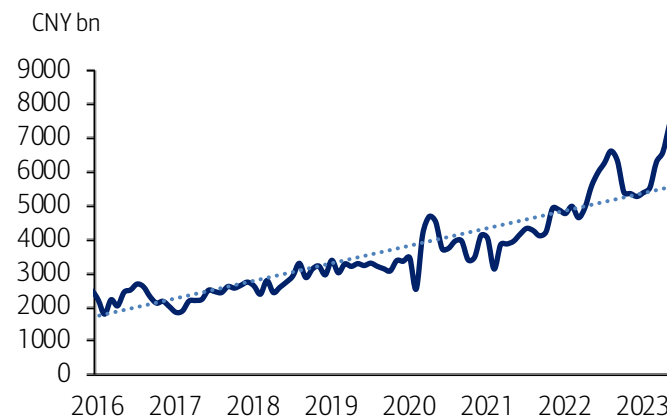
		2Q23	3Q23	4Q23	1Q24
2y CGB	New	2.10	2.00	2.10	2.20
	Previous	2.35	2.35	2.4	2.45
10y CGB	New	2.60	2.50	2.65	2.75
	Previous	2.95	2.95	3.00	3.00

Source: BofA Global Research

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Exhibit 4: Repo transaction volume – monthly average

Repo transactions have risen sharply as more carry positions are being added



Source: Wind, BofA Global Research

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