Asia FI & FX Strategy Watch

Singapore trip notes (March 2024)

Clients remain on long carry trades; waiting on the Fed

From Feb 26 to Mar 1st, we met with close to 30 institutional clients (including real money, hedge funds, corporates and bank treasuries), based in Singapore, to discuss their expectations for the macro outlook, especially North Asia. The consensus was that Asian clients lack directional convictions. Most are seeking returns in carry trades and idiosyncratic stories such as understanding the behavior of Taiwanese lifers and the fiscal outlook for the Hong Kong SAR government. Overall, many clients are frustrated over the low FX volatility environment and agree with the consensus trades of being long carry. However, given the rich and crowded positioning on USDINR, clients were hesitant to further add. Almost all the clients we spoke with were long the SGNEER, given the MAS' current hawkish positioning. On the short side, clients were still happy to fund using CNH and TWD

Clients wanted to understand unique stories such as Taiwan lifers' FX-hedging behavior, HK's FY24-25 budget

A majority of hedge fund and real money clients were interested in understanding the FX-hedging behavior of the Taiwanese life insurance companies (lifers). Almost all of them wanted to understand why 1-month NDF points are very volatile and has the reaction function of the lifers structurally changed, resulting in their FX-hedging behavior being more reactive to spot movement in FX.

On Hong Kong, our visit corresponded with the unveiling of the FY24-25 budget. The biggest news to the market was the removal of market restrictions on the purchase of HK property and the financing of future infrastructure spending through bond issuances. Clients wanted to understand the market implications of those developments and whether there are any trades to conduct. We recommend paying **10-year HK vs US IRS** (current: 0bp, entry: -2bp, target 40bp, stop: -22bp, carry: -2.4bp/ quarter) on the back of a potential increase in the supply of HKD duration and loans due to the measures announced in the budget. Key risk to the trade is the HK government issuing bonds in foreign currency, thus, resulting in no net impact on the HIBOR curve.

05 March 2024

GEM FI & FX Strategy
Asia

Chun Him Cheung, CFA
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 3644
chunhim.cheung@bofa.com

Asia FI Strategy & Economics
Merrill Lynch (Hong Kong)

GEMs FI Strategy & Economics
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For a full list of our trade recommendations, see: Global Emerging Markets Weekly: What if the Fed doesn't cut? 23 February 2024

DF – deliverable forward

NDF - nondeliverable forward

HK – Hong Kong

HIBOR – Hong Kong Interbank Offered Rate

WGBI – World Government Bond Index

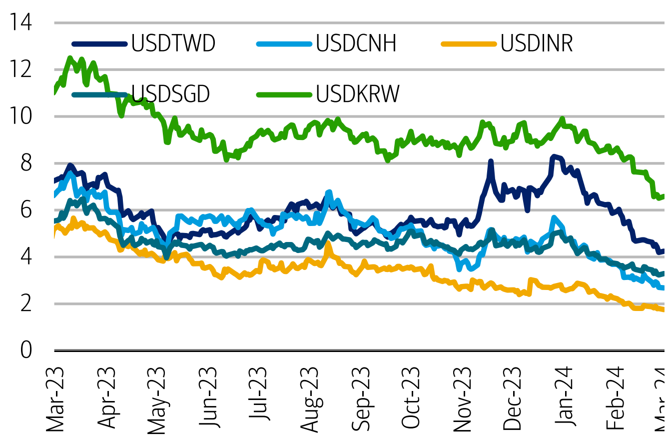
Timestamp: 05 March 2024 02:17AM EST

Singapore trip notes (March 2024)

"Trading USDINR and USDCNH has become trading USDHKD". This is a bit tongue-in-cheek, but this is the comment from a hedge fund client. Indeed, FX volatility in Asia has significantly fallen. The lack of directionality of the USD and conviction of the Fed has driven the market to seek carry, especially as FX volatility is declining, increasing the Sharpe ratio of carry trades. The favorite carry trades in the region remain long INR versus TWD and CNH and long SNEER. There were concerns that these carry trades are getting crowded, but overall BofA Research and clients are somewhat comforted by the strong fundamental story behind India's growth and do not see many scenarios on significant INR depreciation.

Clients remain pessimistic on the CNH and see short CNH to offer both good carry and as a geopolitical hedge. One large real money account noted to us long INRCNH remains his favorite trade. He liked the trade from both the carry perspective and from increased geopolitical risk perspective – especially as former President Trump's polling numbers are strong. However, none of the clients we spoke with think the Chinese government will let USDCNY rise rapidly as they think the Chinese government is cautious this will repeat the August-2015 experience and trigger another painful round of outflow pressures.

Exhibit 1: 1-month FX implied volatility in across Asia FX
FX volatility has significantly declined in Asia in 2024



Source: Bloomberg

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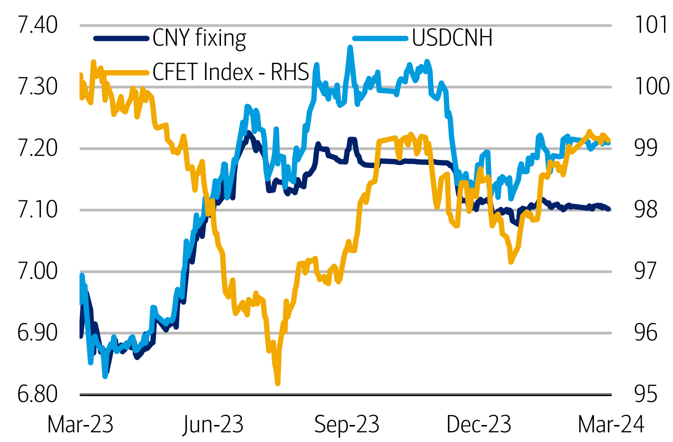
Exhibit 2: Comparison of CNY fixing and USDCNH
The flatting lining of the USDCNH is resulting in the CFETS RMB Index to strengthen



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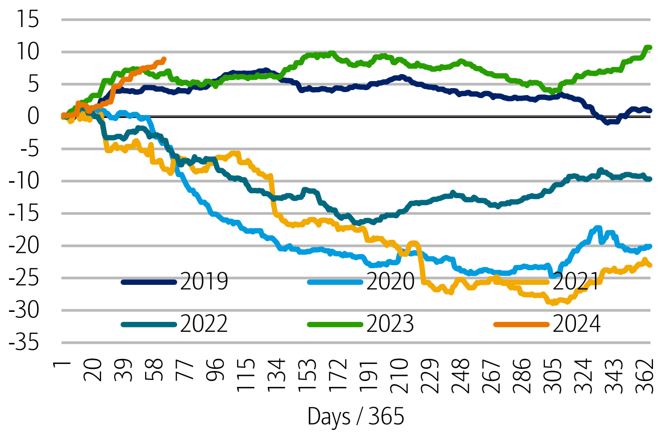
A corporate client told us about accessing both CNY and CNH funding. A corporate client told us one of the best trades in the region remains to take advantage of the wide difference in CNH and CNY forward points. Corporates have the unique ability to access CNY funding given their needs in interacting with the real economy in China. This client noted that, currently, the funding cost between CNH and CNY exceeds 1.5%, which is more than the 1% net cost paid on the reserve requirement for CNY forwards. Hence, there remains an attractive spread to capture despite the regulatory requirements. Corporate flows can keep CNY on this back-foot as long as funding cost between US$, CNH and CNY remains wide.

Many clients were frustrated by the lack of KRW performance given the strong equity inflow. A common conversation topic during the trip was why has the Korean Won underperformed relative to the strong equity inflows seen in the past five weeks. **Exhibit 3** shows that the pace of equity inflow in 2024 has exceeded the pace of the past five years. The foreign interest, because of Korea's Corporate Value-Up program, is undoubtedly strong. Year-to-date, net equity inflow into Korea reached US$9.1bn.

However, net equity flow of this size should have brought material Korean Won strength, but as **Exhibit 4** shows, this has not been the case.

Exhibit 3: Net year-to-date inflow to Korean equities (US$ Bn)
In 2024, year-to-date equity inflow exceeded the pace of the past five years



Source: Bloomberg

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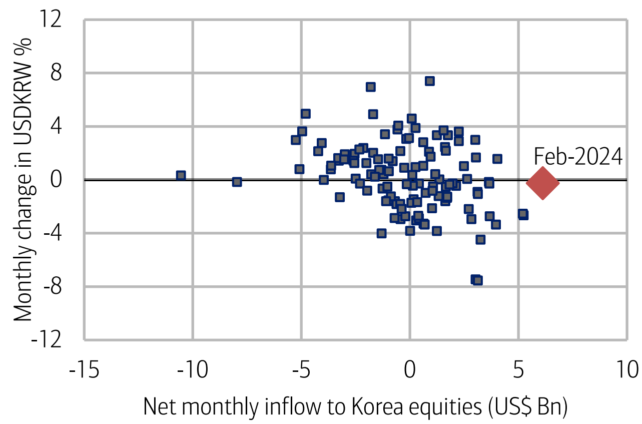
Exhibit 4: Net monthly inflow into Korean equities and USDKRW (%)
USDKRW has barely moved in the past month despite sizable equity inflow



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Singapore's macro community is split on whether Corporate Value-Up will meaningfully remove the Korea discount. Speaking with clients who are veterans in Korea's financial markets, about half are skeptical whether the government's efforts in the ongoing Corporate Value-Up program will yield results in meaningfully eliminating the Korea discount.

The skeptical half noted that the Korean government has previously tried similar measures and did not result in much. Moreover, the Japanese regulators prepared for up to three years before launching their reform program, whereas the Korean government appears to have announced this program almost overnight.

The more optimistic half suggest 'this-time-is-different' given the strong relationship President Yoon has with the Korean corporate sector and Korea's overall drive to enter international financial indices such as WGBI for fixed income and MSCI DM for equities. Given the significant discount Korea has across a number of sectors, even a marginal convergence of Korea's valuation to peers can drive significant KOSPI performance.

A partial explanation for relative KRW weakness could be attributed to the outflows of the NPS. A source of strong US$ buying from Korea would be Korea's National Pension Fund (NPS) and other public sector pension funds (which we will collectively call the NPS). The balance-of-payment (BoP) data show that the foreign claims of Korea's public sector pensions increased by US$31bn in 2023 and have been rising relative to the past three years. The January 2024 BoP is not yet available, but the average monthly foreign purchase of foreign securities was close to US$2.6bn/month. Thus, if the NPS place pace of outflows continued into 2024, then the strong equity inflow in the first two months of 2024 would have been offset by close to US$5bn in US$ buying from the NPS, thus negating much of the FX impact on equity inflow.

Exhibit 5: Year-to-date purchase of foreign securities by the NPS (US$ Bn)
In 2023, the NPS bought a record US$31bn in foreign securities

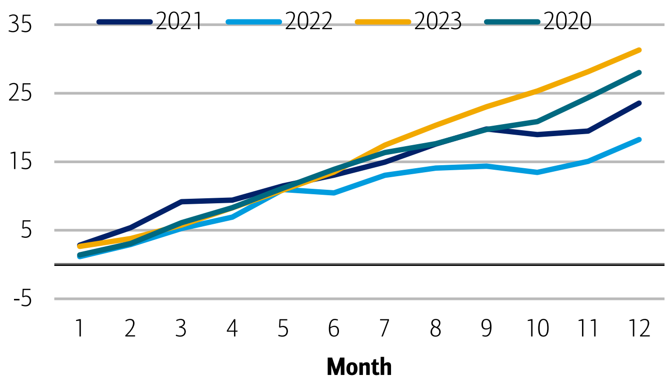

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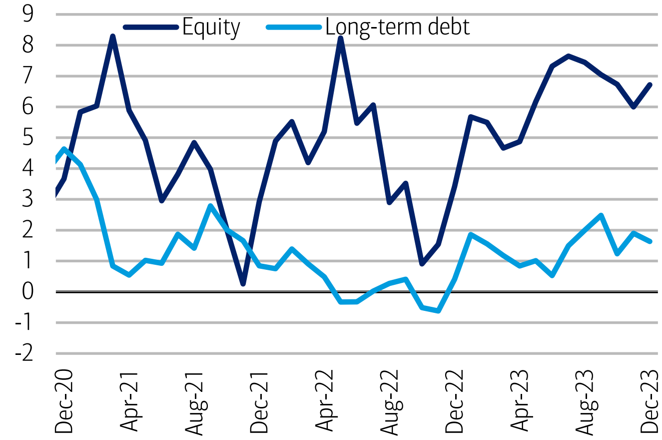
Exhibit 6: NPS purchase of foreign securities (US$ bn, 3-month sum)
About ¾ of foreign securities purchase by the NPS were in foreign equities



Source: Bloomberg

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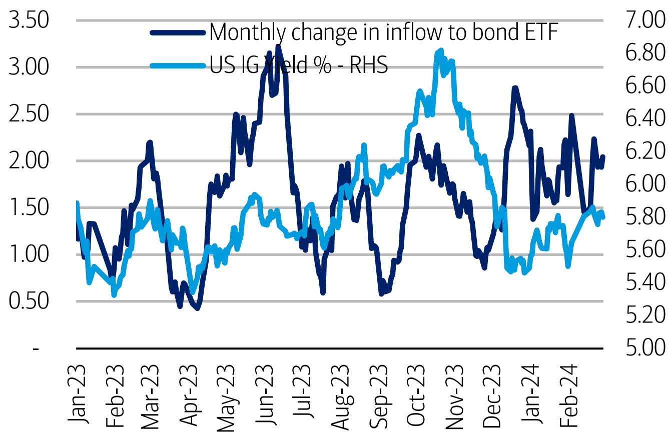
Clients wanted color on the sell-off in TWD despite the strong equity inflow
Similar to Korea, net equity inflow into Taiwan has also been strong year-to-date, yet USDTWD has risen 2.7%. In Emerging Insight: The mysterious divergence between Taiwan's exports and TWD's performance, we discussed in-depth why TWD may have underperformed relative to the strong export figures and net equity inflow. However, an angle that we did not cover in that report is the role of inflows into bond ETFs. Our estimates show that year-to-date net inflow into Taiwan-listed bond ETFs reached US$4.3bn, while year-to-date net equity inflow are US$6.2bn. Inflows into Taiwan's bond ETFs would result in the ETF manager buying US$ to purchase US IG and US Treasuries and is a source of US$ buying.

Clients also asked a lot about the FX-hedging behavior of the Taiwanese lifers and the interaction with NDF and spot USDTWDs. Another question raised was "Has the FX-hedging behavior of the Taiwanese lifers changed?". Clients noted that volatility of spot 1-month NDF is suggestive that the lifers are chasing spot movements and are no longer as patient with their hedging and their flows as they previous had been. One of the reasons, we pointed out, might be tied to the higher FX-hedging cost relative to the past. In the past, prior to the Fed's hikes, onshore DF points were less negative, and this allowed the lifers to be more patient with their FX-hedging position. However, now with both DF and NDF FX-hedging cost at around 4.5-5%, the lifers cannot afford to wait as they previously had. We have seen lifers' monthly FX-hedging cost rising to US$1.2bn in December 2023, doubling from US$600mn in December 2022.

Exhibit 7: Net bond inflow (US$ Bn) and US IG yield (%)
Inflows into bond ETFs accelerated in 1Q24 vs 4Q23



Source: Bloomberg

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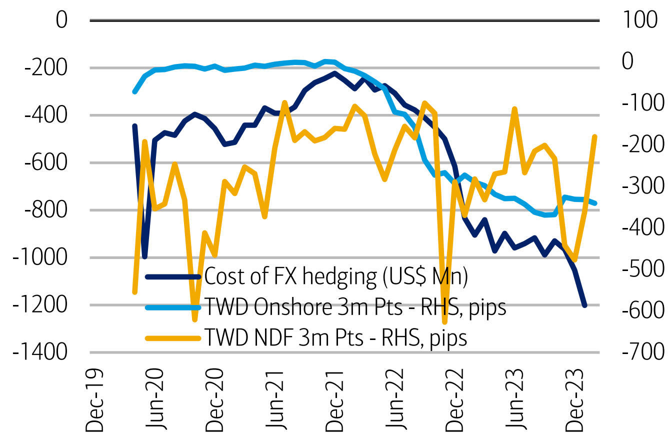
Exhibit 8: TWD forward points and lifers' FX-hedging cost
Lifers' FX-hedging cost have significantly increased in 2023



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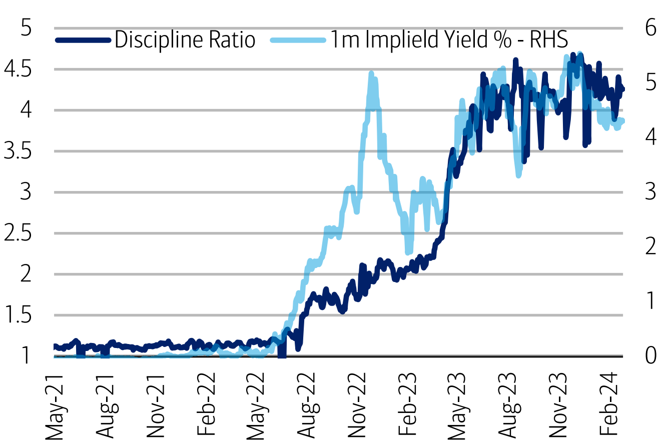
Clients were curious to understand why HKD funding remains flushed. Currently, despite the repricing of Fed cuts and the Chinese government trying to support financial settlement, Hong Kong money market dealers are not concerned about funding conditions and continue to lend out HKD at a relatively low cost. We note that HKD settlement in 1Q24 so far has been soft. We gauge the level of HK$ settlement with the intra-day growth in aggregate balance, which is captured by our Discipline Ratio, as shown in **Exhibit 9.** Moreover, HK bank treasuries have been willing to lend, as evident from the increased frequency of higher relative submissions overnight HIBOR submission by HSBC versus the 19 HIBOR submissions of banks (**Exhibit 10**).

Exhibit 9: BofA's Discipline Ratio and 1-month implied yield (%)
The Discipline Ratio has trended lower in Jan and Feb 2024, suggesting looser HKD funding conditions



Source: Bloomberg

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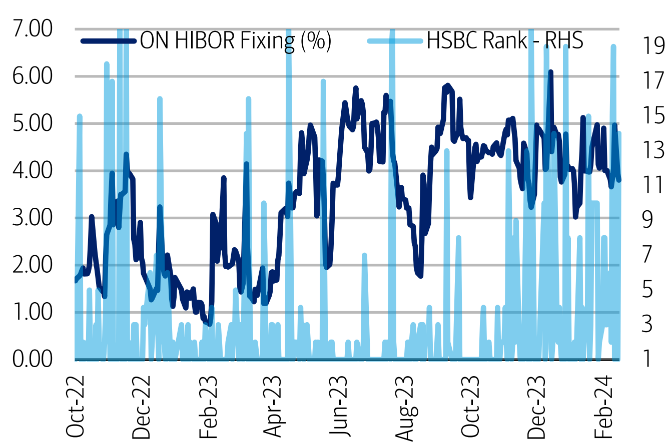
Exhibit 10: HSBC ranks of overnight HIBOR fixing and the overnight HIBOR fixing
In 1Q24, the frequency of higher submission by HSBC is indicative of loose HKD funding



Source: Bloomberg

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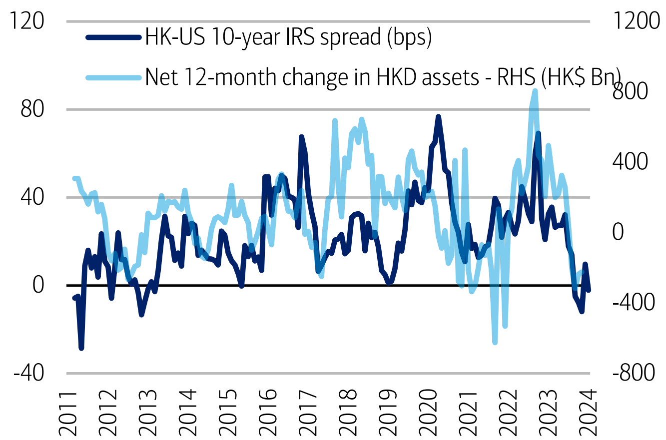
Quite a few clients to buy the USDHKD outright. A number of clients mentioned continuing to buy USDHKD outright for both decent carry and hedge against any pressure on the HKD peg. USDHKD 2-year outright continues to trade below the strong-side of the band at 7.73 and is continually drawing attention of clients. Client asked if there are large structural outflows happening from the Hong Kong banking system.

However, the data on HKD M2 does not suggest there are material outflows from Hong Kong at the moment.

Clients wanted to understand the market implication of HK's FY24-25 budget
Hong Kong's FY24-25 budget was unveiled during our Singapore visit, and clients wanted to know if there are market implications. We covered the budget outcome in-depth in Hong Kong Watch: Retail sales disappointed in Jan 2024; Policy tailwinds may have limited impact 04 March 2024 and the market implications in EM Alpha: The market implications of the HK FY 24-25 Budget 29 February 2024. For us, the major implication was that the Hong Kong government announced it would increase its bond issuance by around HK$95-135bn for the next five fiscal years. Moreover, this issuance would be conducted for a new category of bonds known as 'infrastructure bonds'. If infrastructure bonds are to be issued in HK$, this can meaningfully correct the back-end HIBOR-SOFR spreads which are depressed by the asset-swap activities of HK banks and lifers. However, if the issuance is conducted in foreign currencies, then the impact will be clearer on the cross-currency swap. Lastly, the HK government has now removed all market restrictions on purchasing property. If this measure spurs new mortgage growth, this can also help correct the back-end HIBOR-SOFR spreads.

Exhibit 11: HK-US 10-year spreads and net changes in HKD assets of HK banks
Since 2021, 10-year US-HK spreads have been motivated by the change in the net HKD position of HK banks



Source: CEIC, Bloomberg

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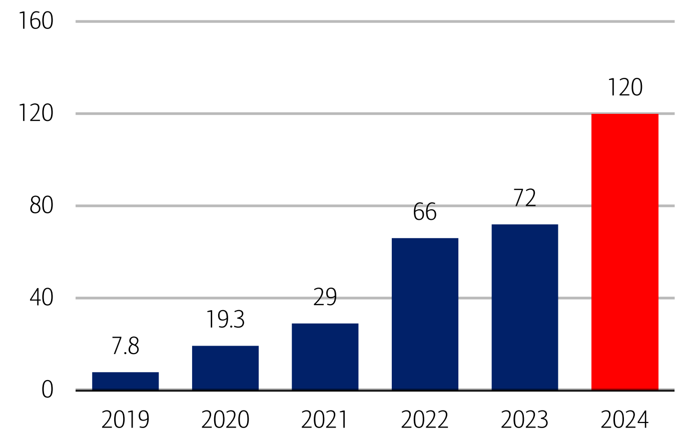
Exhibit 12: Proceeds from issuance of Hong Kong government bonds (HK$ Bn)
Net issuance of HKGBs which impacts fiscal reserves is set to rapidly increase in FY 24-25



Source: HK Treasury

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