Asia FI & FX Strategy Watch

China rates & FX chartbook – relentless duration demand

China rates – a brave new world

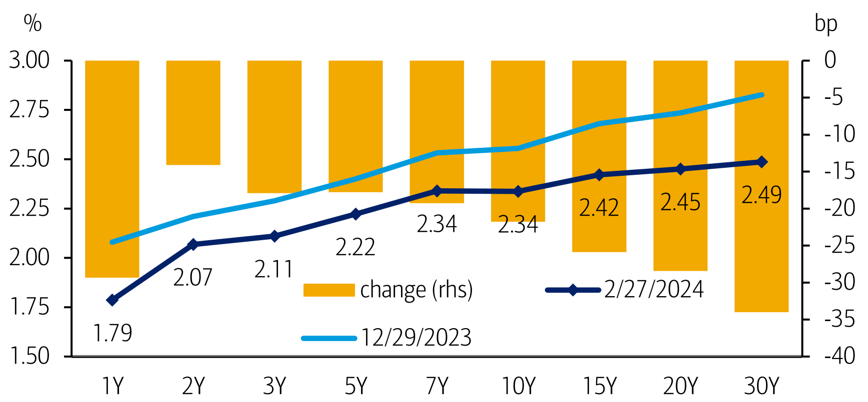
China rates' bull market that started in Dec-2023 continues to run its course so far in 2024. Besides the conducive macro backdrop of weak growth sentiment and monetary easing, we believe limited net supply of central and local government bonds was another key driver for the market rally. The 30y CGB continued to outperform (Exhibit 1). After declining by about 34bp ytd, 30y CGB is now trading at 2.49%, slightly below the 1y MLF rate. To put it in context, during 2023, the 30y CGB yield only declined by 37bp.

We think the risk-reward for long 30y CGB has become less attractive and would advise investors to be more cautious. Tailwinds from limited supply of government bonds may start to fade if fiscal policy steps up after the NPC. Long-duration bonds' supply should pick up when 1) the issuance rate of local government special bonds accelerates, and/or 2) the central government decides to issue super-long special bonds as reported earlier.

Portfolio flows and FX – lack of support for CNY

Net FX settlement by banks on behalf of clients stood at -US$4.4bn in Jan 2024, marking the seventh consecutive negative reading. Despite seeing more USD selling by exporters during Dec and Jan, those weren't large enough to offset USD purchase needs derived from service and financial accounts. We remain bearish on CNY in 1H given the unfavorable yield differential and economic growth headwinds. Externally, a resilient US economy and a later cutting cycle by the Fed may keep USD strong in the near term.

Exhibit 1: Key tenor CGB yield
30y CGB has continued to outperform



Source: Bloomberg, BofA Global Research

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29 February 2024

GEM FI & FX Strategy
Asia

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CFETS - China Foreign Exchange Trade System

CGB - China government bond

LPR – Loan prime rate

MLF - Medium-term lending facility

NPC - National People's Congress

NCD - Negotiable certificate of deposits

OMO - Open market operation

PBoC - People's Bank of China

PFB - Policy financial bonds

PSL - Pledged supplementary lending

RRR - Required reserve ratio

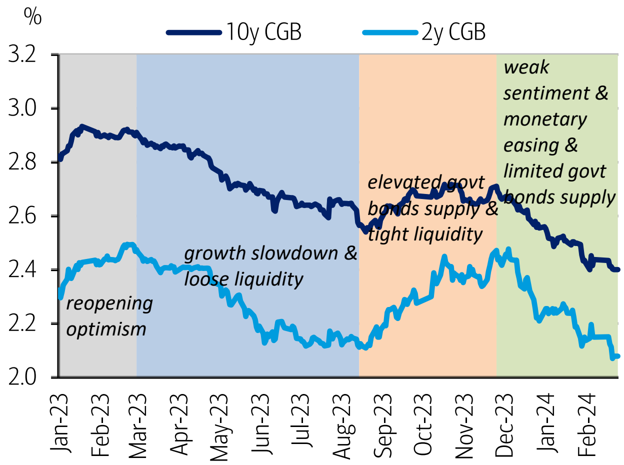
SOFR – Secured overnight funding rate

Ytd – year-to-date

Timestamp: 28 February 2024 03:30PM EST

China Rates

Exhibit 2: 2y and 10y CGB yield movement
The bull market that started in Dec last year continues



Source: Bloomberg, BofA Global Research

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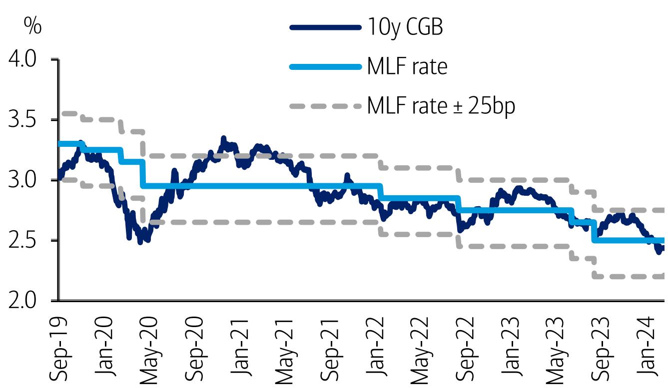
- China rates' bull market that started in Dec-2023 continued to run its course so far in 2024. Besides the supportive macro backdrop of weak growth sentiment and monetary easing, we believe limited net supply of central and local government bonds was another key driver for the market rally.
- Our year ahead trade of long 2y CGB has reached our original target. We have recently tightened the stop loss and revised lower our target (spot: 2.07%, entry: 2.35%, revised target: 1.95%, revised stop: 2.25%). Risk to the trade is CNY depreciation and tight funding. See details in EM Alpha - Extending the target for long 2y CGB.

Exhibit 3: 10y CGB yield vs MLF rate
10y CGB have been trading around MLF +/- 25bp in recent years



Source: Bloomberg, BofA Global Research

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- As one of the key policy rates, MLF rate not only has influence on the lending rates through the LPR formation mechanism, but also can directly impact banks' medium-term funding costs.
- In recent years, 10y CGB have been trading around MLF rate +/- 25bp for most of the time. Also, past experiences show that 10y CGB yield tends to trade below MLF rate before rate cut announcements.
- Currently, 10y CGB is trading around 2.34% - 16bp lower than the MLF rate - suggesting that the market is positioned for further rate cuts. We see a higher likelihood for MLF rate cuts in 2Q once external constraint subsides.

Exhibit 4: CGB yield forecasts (end of period)
We see room for yields to continue trending lower going into 2Q

		1Q24	2Q24	3Q24	4Q24	1Q25
10y CGB	New	2.3	2.3	2.25	2.35	2.35
	Old	2.7	2.7	2.6	2.6	
2y CGB	New	2	2	1.9	1.95	1.95
	Old	2.25	2.25	2.1	2.1	

Source: BofA Global Research

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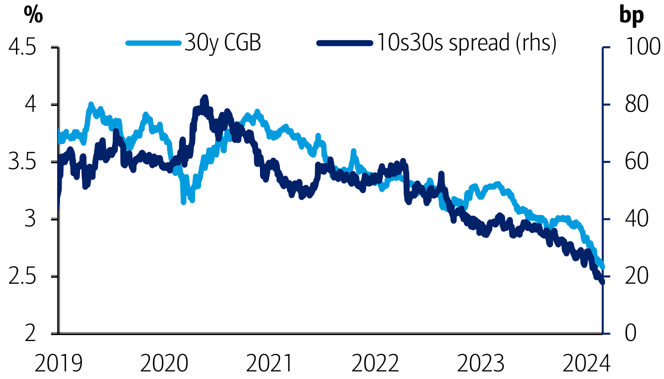
- Given the sharp moves in recent months, we mark-to-market and revise lower our yield forecasts for CGBs. We now expect 2y and 10y CGB to be at 2% and 2.3% by end-2Q24, respectively.

Exhibit 5: 30y CGB and 10s30s spread

30y CGB yield has declined by more than 30bp since end-2023



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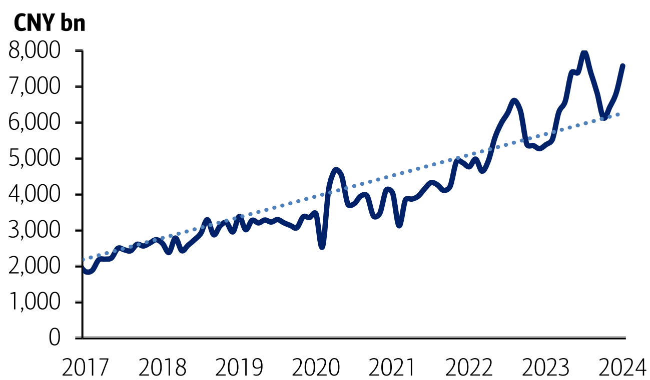
- 30y CGB has continued to outperform the rest of the curve. After declining by about 34bp ytd, 30y CGB now trades slightly below 2.5%. To put it in context, during entire 2023, 30y CGB yield only declined by 37bp.
- We think the risk-reward for long 30y CGB has become less attractive and would advise investors to turn more cautious. The tailwind from limited supply of government bonds may start to fade if fiscal policy steps up after the National People's Congress.
- Long-duration bonds' supply may pick up when 1) the issuance pace of local government special bonds accelerate, and/or 2) the central government decides to issue super-long special bonds as reported earlier.

Exhibit 6: Monthly average repo transaction volume

Transaction volume remains largely in line with historical growth trend



Source: Wind, BofA Global Research

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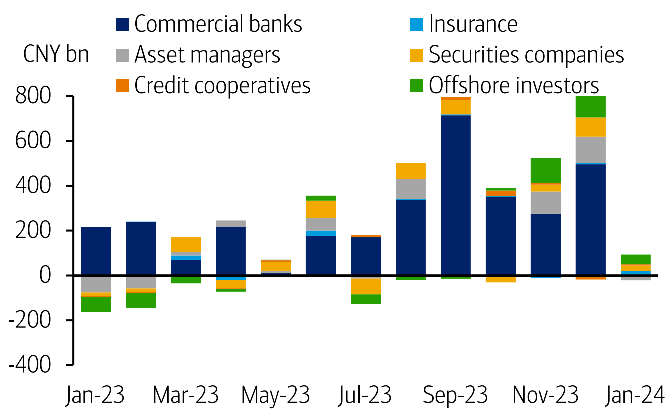
- Repo transaction volume has continued to rise during Jan as stable liquidity condition and accommodative gestures from the PBoC (including the RRR reduction announcement) encouraged market participants to put on more carry trade positions.
- The deviation of monthly transaction volume from long-term trend was not as extreme as it was back in July 2023. Nonetheless, it is worth close monitoring bond market leverages as the risk of long position getting excessive has risen.

Exhibit 7: Changes in CGB holdings by investors (CNY bn)

Aggregate CGB deposited at CCDC increased by CNY77bn during Jan



Source: CEIC, BofA Global Research

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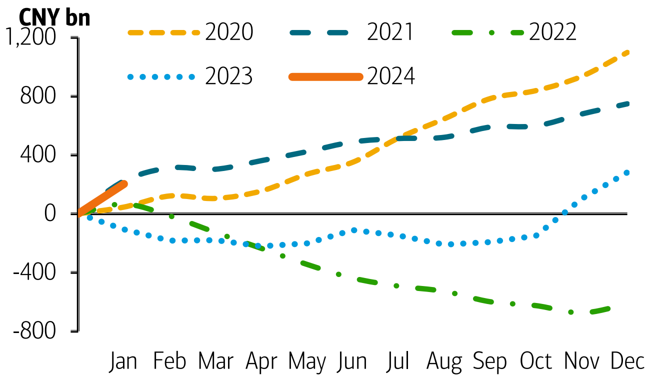
- Net supply of CGBs has been very muted at the beginning of 2024, in line with historical seasonal pattern. According to China Central Depository & Clearing (CCDC) data, there was a CNY77bn increase in aggregate CGBs deposited amount during Jan 2024.
- Offshore investors and securities companies, and insurance firms were major net buyers, while asset manages reduced their holdings. There was little change in CGB holdings by commercial banks.

Portfolio flows & FX

Exhibit 8: Cumulative bond inflows
Offshore investors expanded their China bond holdings by CNY203bn in Jan



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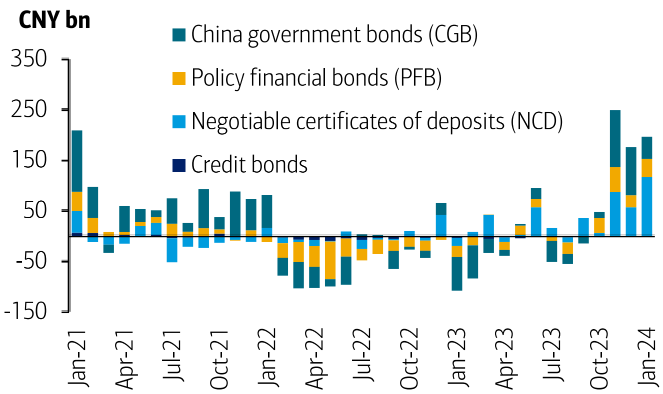
- Offshore investors expanded their China bond holdings by **CNY203bn** in January 2024, sustaining the strong inflows since Nov last year.
- As of Jan 2024, total foreign holdings of China bonds were around CNY3.87tn – the highest since Mar-2022.

Exhibit 9: Monthly changes in offshore investors' bond holdings
NCDs saw the largest inflows from foreign investors at CNY117bn during Jan



Source: CEIC, BofA Global Research

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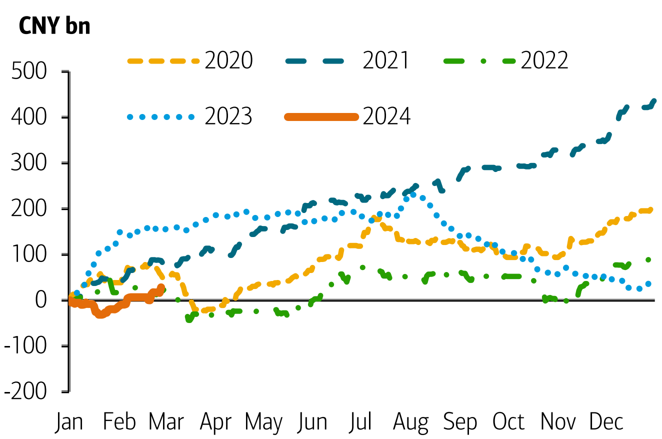
- In terms of breakdown, negotiable certificates of deposits (NCDs) saw the largest inflows from foreign investors at CNY117bn during Jan 2024. Foreign holdings of CGBs and PFBs rose by CNY44bn and CNY26bn, respectively.
- We think the meaningful amount of bond inflows in Nov was driven by appealing yield pick-up on a FX-hedged basis. Suppose foreign investors buy 1y AAA NCD fully FX-hedged through sell/buy 12m USDCNY swaps, the total return would be close to 6%, offering some yield pick-up over SOFR.

Exhibit 10: Cumulative Northbound Stock Connect net flows
Cumulative northbound equities net inflows turned positive in February



Source: Wind, BofA Global Research

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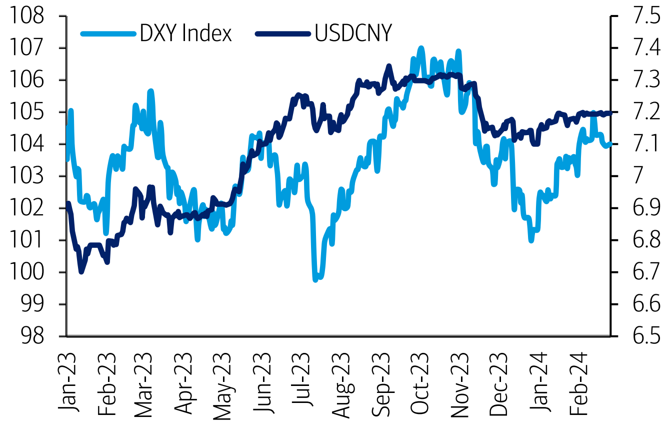
- Cumulative northbound equities net inflows turned positive in February, in tandem with the rebound in onshore equities index.
- That said, the amount of net inflows in recent weeks are much more modest vs year-ago period; therefore, it is unlikely to lend much support to the CNY.

Exhibit 11: USDCNY vs DXY Index
CNY only depreciated 1.36% ytd vs USD despite broad USD strength



Source: Bloomberg, BofA Global Research

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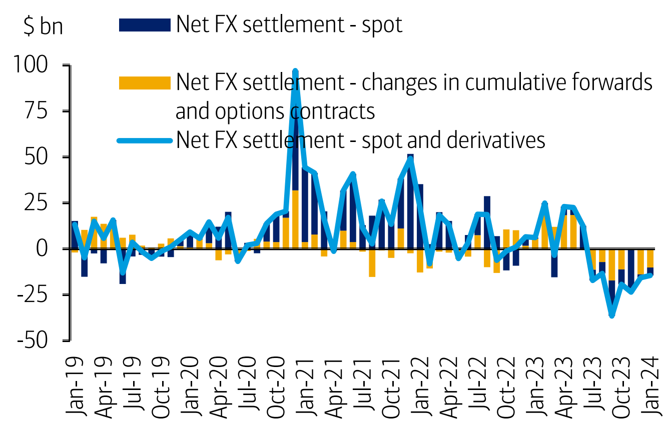
- USDCNY has been trading within a narrow range lately. Despite broader USD strength, CNY only depreciated 1.36% ytd bilaterally underpinned by unequivocal policy focus on exchange rate stability. As a result, CNY has been strengthening against its trading partners, with RMB CFETS index rebounding by about 2% to 99.4 year-to-date.
- We remain bearish on CNY in the 1H given the unfavorable yield differential and economic growth headwinds. Externally, resilient US economy and a later cutting cycle by the Fed may keep USD strong in the near term. See details in The EM Asia FX Strategist – Waiting for the Spring.

Exhibit 12: Net FX settlement by banks on behalf of clients
Net FX settlement by banks on behalf of clients stood at - $4.4bn in Jan



Source: SAFE, BofA Global Research

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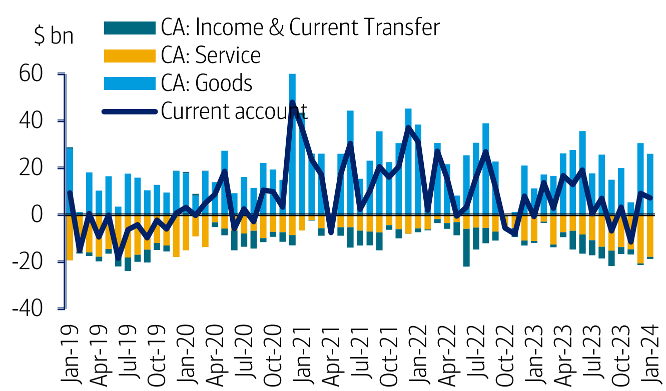
- Net FX settlement (the difference between FX settlements and FX purchases) by banks on behalf of clients stood at -US$4.4bn in Jan 2024, marking the seventh consecutive negative reading.
- After incorporating changes in outstanding forwards and options contracts, the adjusted net FX settlement amounted to -US$14.5bn, suggesting USD demand continued to outweigh supply among banks' clients.

Exhibit 13: Net FX settlement by banks on behalf of clients - CA
Net FX settlement surplus for goods trade was strong over the past two months



Source: SAFE, BofA Global Research

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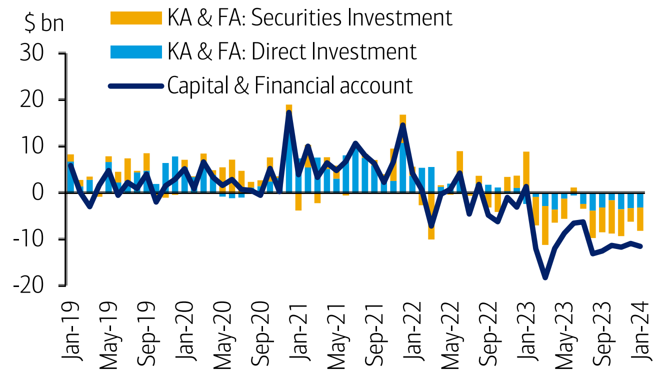
- Zooming in to the FX settlement and sales activities under the Current Account (CA) categories, net FX settlement surplus for goods trade was strong in Dec 2023 and Jan 2024, which can potentially be explained by domestic exporters' seasonal USD selling ahead of Lunar New Year.
- That said, net FX settlement deficit under 'Services' category continued to widen, on the back of gradual normalization in outbound tourism.

Exhibit 14: Net FX settlement by banks on behalf of clients – KA & FA

Continued to see net FX settlement deficit under KA & FA account



Source: SAFE, BofA Global Research

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- Net FX settlement under Capital and Financial account (KA & FA) stayed in the deficit zone during Jan 2024 as growth sentiment remained weak and equities outflows continued.

PBoC policy tools

Exhibit 15: PBoC's key policy rates

Another asymmetric rate cuts in Feb

	7d OMO	1y MLF	1y LPR	5y LPR
Feb-24	0	0	0	-25
Aug-23	-10	-15	-10	0
Jun-23	-10	-10	-10	-10
Aug-22	-10	-10	-5	-15
May-22	0	0	0	-15
Jan-22	-10	-10	-10	-5
Dec-21	0	0	-5	0
Mar/Apr - 20	-20	-20	-20	-10
Feb-20	-10	-10	-10	-5
Nov-19	-5	-5	-5	-5

Source: Bloomberg, BofA Global Research

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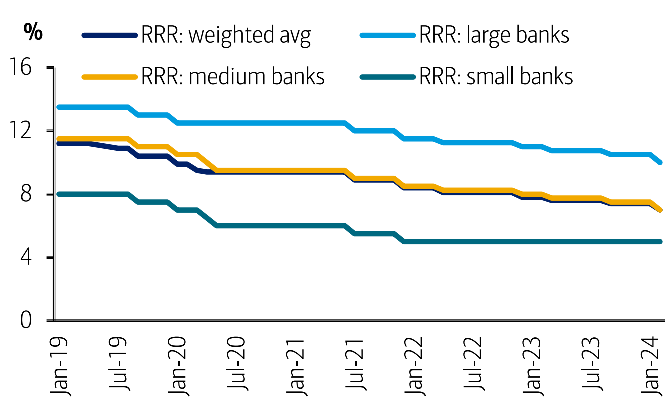
- PBoC delivered another asymmetric rate cut in Feb – lowering the 5y LPR by 25bp while keeping other policy rates unchanged. Such asymmetric adjustment was not uncommon in recent years. The notable reduction to the 5y LPR demonstrated greater policy support to mortgages and medium- to long-term corporate loans.
- Given that the PBoC has already delivered a series of monetary easing in recent months, we think it might take a pause in the near term while waiting for fiscal policy to step up.
- Over the rest of 2024, our economists expect 1y LPR to be reduced by 45bp in total, which is more likely to happen once external constraint subsides.

Exhibit 16: Required reserve ratio (RRR)

The weighted average RRR was lowered to 7% after the latest reduction



Source: PBoC, CEIC

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- The 50bp reduction to RRR that went into effect on Feb 5th unleashed about CNY1tn funding in the banking system and helped to keep interbank liquidity ample.
- The weighted average RRR was lowered to 7% after the latest reduction.
- We expect one more RRR reduction (either 25bp or 50bp) in the 2H to replenish liquidity and facilitate government bonds issuances.

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