《Market Flash》

FX Strategy: Hedging For A Weaker CNY

- On 20-Jul, we have revised our USD/Asia forecasts as various negative drivers against Asian currencies have intensified.
- Recent measures by Chinese authorities suggest looser monetary conditions ahead and are likely to bias towards a weaker CNY from here.
- As forward points have not caught up with spot and have diverged instead, hedging further CNY weakness via forwards appears to be attractive now.

In our recent research note (Macro + FX Strategy: Brace For More Asian FX Weakness), dated 20 Jul 2018), we have revised our FX forecasts for most USD/Asia currency pairs higher as various negative drivers against Asian currencies have intensified. The drivers are:

The U.S Federal Reserve guided by stronger growth and inflation becomes increasingly confident to normalize rates higher, thereby underpinning the USD.
There is a noticeable slowdown in Asian export growth as China's growth outlook weakens.
The Asia Dollar Index (ADXY) is catching up with the weaker yield spread.
The People's Bank of China (PBoC) seemed to have eased credit conditions and allowed for more CNY weakness.

Also, we fear that there is now an increasing risk that the Trump administration will follow through with the additional USD 200 bn of tariffs against China in September. This would almost certainly invite retaliation measures from China. Due to supply-chain effects, cautious trade in China could easily trickle down to other Asian economies, weighing on their already-slowing export engines in the various Asian economies. Coupled with the abovementioned factors, we see further weakness in Asian FX ahead.

CNY looks to heading into a more volatile second-half of 2018 as China and the U.S exchange trade blows. Already fallen by a record 3.3% in June, the CNY showed little signs of stabilizing. The PBoC also weakened yuan reference rate past 6.80 against the USD on Wednesday (25-Jul), for the first time since June 2017. Even the CFETS RMB index, a trade weighted basket of the currencies of China's key trading partners has tumbled below 93 from about 98 just five weeks ago.

In the past week, Chinese authorities has announced various measures to support economic growth amid the ongoing trade spat with the U.S and deleveraging of its financial system. The measures range from easing of credit conditions (18-Jul, see report here), a softer-than-expected stance towards wealth management products (20-Jul), a record injection of longer-term funding available to commercial lenders and fiscal stimulus (23-Jul, see report here). These measures add to signs that the PBoC is adopting a more accommodative stance, even though it has not announced any official shift from its "prudent and neutral" policy. Overall, looser monetary conditions are likely to bias towards a weaker CNY. As such, we forecast USD/CNY rising further to 6.95 by end of this year and 7.10 by mid-2019.

Despite the fast rising spot rates in USD/CNY and USD/CNH, the associated forward points have not caught up with spot and have diverged instead (see Chart 1), making hedging costs fairly attractive for now. For instance, the cost for a 12-month hedge on USD/CNH's upside is now about 480 pips (mid-price), lowest levels since April 2014 and a mere fraction of the 3,500 pips reached after the RMB central parity reform in August 2015. Another point to note is that USD/CNY outrights are still lower than our forecasts.

Level of USD/CNY as implied by:	end-3Q18	end-4Q18	end-1Q19	end-2Q19
Outrights (as at 25-Jul)	6.80	6.82	6.84	6.85
UOB forecasts	6.85	6.95	7.00	7.10

Moves in the options market are also subdued compared to the underlying spot. Implied volatility has traced the spot move high but still remains a distance from the levels reached in 2015/16 (see Chart 2). Rising risk reversals suggest an increasing preference for further USD/CNY's upside, but it remains at relatively low levels when compared to the past five years (see Chart 3). That said, recent DTCC data (week starting 16-Jul) showed a marked increase in USD/CNY options volume for strikes above 7.00 just as spot broke above 6.70.

Lastly, the tail risks to global economic outlook have clearly increased compared to a month ago. Should US-China trade relations sour further, a further front loading of Asian FX weakness cannot be dismissed. This means that the 7.00 headline big figure for USD/CNY may be reached much sooner rather than later. Then, the "calmness" in the forwards and options market may be disrupted. In that scenario, investors are better off with hedges in place while the cost is low for now.

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