GLOBAL FX STRATEGY

Scotia Asian FX Update

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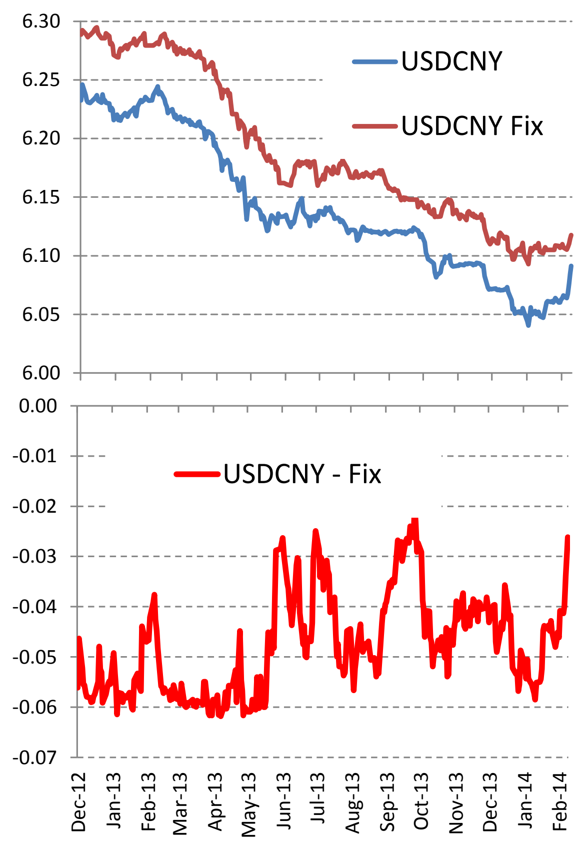
CNY & CNH: THE SQUEEZE IS ON

•Significant carry unwind in renminbi markets as the message from policymakers for CNY and CNH is: “Thou shalt not buy!”
•CNY fixes higher displaying PBoC intention to kill onshore/offshore premium, and perhaps close the fixing/spot gap.
•CNH vols finally explode, with the short end looking far too rich relative to the 5-6mth term.
•USD/Asia boosted on the week by EM Asia underperformance and a touch of China risk.

The thrust of onshore policymakers this week has been to keep USDCNY pushing to the upside, with spot market USD buying support and fixing intentions that have shown a decided inclination for a weaker renminbi trading level. The market has been fairly complacent in pro-carry, long CNY positions, but looks to have capitulated with today’s violent price action feeding on itself and driving the cutting in long renminbi positions. With the weak flash PMI yesterday to enhance the perception of a risky China macro situation, and combined with yet another +30 pip fix for USDCNY (a net +106 pip weekly fixing shift; large but not massively so), CNY and CNH selling is highly in vogue today.



Source: Bloomberg, Scotia FX

What may policymakers be up to currently? For a hint we can consider the statement published by the PBoC this week putting forth the notion that 2014 would see a band-widening. What was surprising to us is that this did not immediately drive a reaction in option vol despite the fairly sharp move higher in USDCNY on Wednesday and Thursday; today’s vol reaction is obviously different. The price action today suggests a convergence in onshore spot and the fixing, seen by many as a precondition to eventual band widening and refinement to the daily fixing procedure, which incidentally may eventually see less official involvement once the band widening is in place. Also possible is that policymakers were dissatisfied with the size and persistence of the seasonal offshore renminbi premium to CNY, a feature that also ties in to a refinement in the onshore trading band.

Regardless, the reaction in the rest of Asia has been a bit muted when considering the degree of movement in USDCNY, though there is some spillover evident in KRW and SGD. The muted reaction suggests to us that this is heavily a CNH, CNY-driven positioning move, and an unwind of carry, probably with not insignificant amount of market ‘panic’ (rather than a ‘buy US vs. Asia move). What’s more, short term vols have gone crazy in both CNH (particularly) and CNY. The USDCNH vol curve has inverted with 1-month vols indicating 1.3 vols higher than just yesterday, with 1mth indicative vols on Bloomberg are showing 3.5%. This is likely not a liquid tradable price, but it is at least indicative of violence of the short term vol spike.

The spike in the shorter term CNH vol curve has been massive (much more so than CNY) and we’d say that it would be perhaps well indicated to fade the spike in short term vols by selling in the 1-3month part of the CNH curve and buying the 5-6 month part, considering the macro background and potential for a band widening within the coming months. There is some degree of risk that the trend could continue in the short term however, the spike has been so massive that a degree of divergence between shorter term and longer term spreads seems totally unsustainable (Bloomberg indicative 1.29 vols higher in the 1-month than the 6-month). When Monday rolls around, it is very possible that Chinese policymakers will sit back and be generally pleased with the impact of their handiwork. This is not to say that we don’t see further convergence in spot and the fix or in CNY and CNH, which would likely continue into any band reform, however the movement in spot and volatility markets today smack of panicked unwind to some degree of long renminbi carry, and as such most of the jitters may settle by the end of the session and promise a more orderly Monday with a bit of retracement.

GLOBAL BANKING AND MARKETS

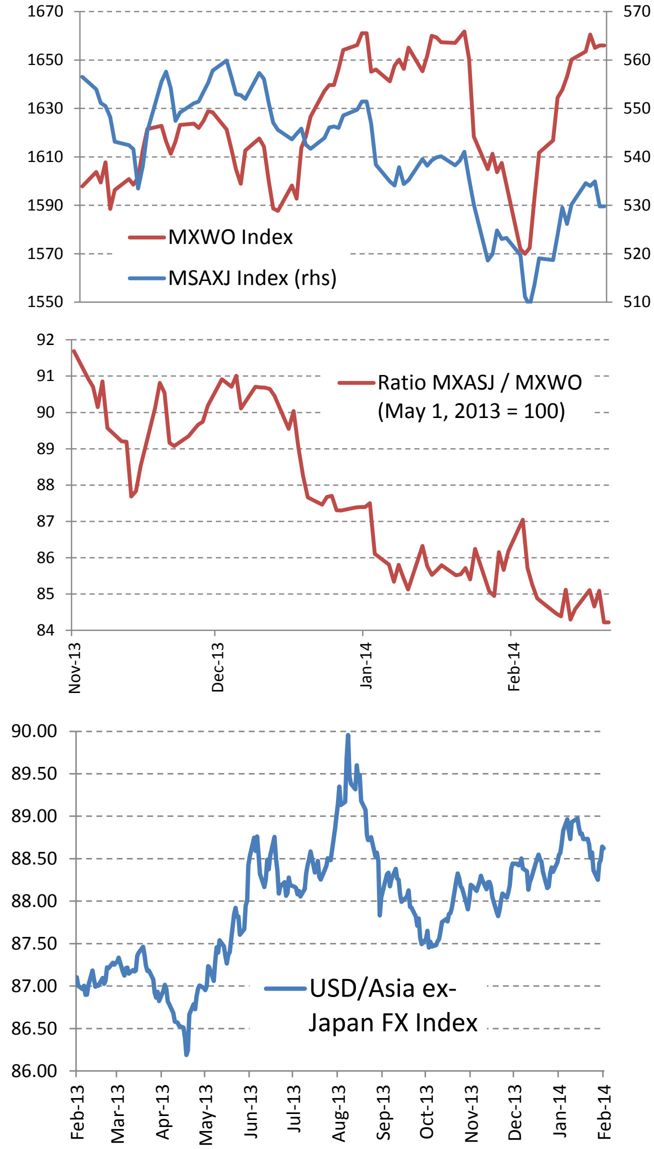
USD/Asia Rebounds

The trade weighted USD managed to gain over the North American session, placing the greenback on track for its best performance in 4 weeks by snapping the two week slump and making solid gains not only against Asia, but also the broader G-7 space. Hard to pin the blame on yields this time as they have been fairly flat on the week, though the Fed minutes did keep away from sounding overly dovish despite the implication of a coming refinement to forward guidance. EM equity underperformance and hints of risk aversion were likely the more common factors providing a better USD bid, particularly in Asia as China's flash PMI yesterday reiterated the risk to the EM complex, hampering regional currencies.

Indeed Asian equities look to have turned to some degree and at the least halted their rebound from the lows of early February (see chart). It is also obvious that EM Asia is looking less buoyant on its bounce than the global aggregate due to the outperformance of developed markets, despite still abundant negative data surprises from the US.

The end result for Asia has been a better bid USD and a continuation of an uptrend in USD/Asia that was threatened by the past two weeks of broad USD weakness. Again, just as a touch of risk aversion has played a USD-supportive role in this week's trading, the weakness in Asia has been related to the degree of underperformance in the equity space and the concern regarding growth trajectories. Singapore NODX were weak in January and electronics exports remain suppressed, never good as a bellwether for global demand indications, nor was the contraction in Taiwan's export orders in January.

It is a bit too early to call whether this represents trouble in DM demand or something more regionally based, however we believe that unless we see a reversal in US data prints to soothe the macro investor's mind a bit, weaker Asian data results will have a growingly acute negative impact on regional risk assets and hang on currencies.



Source: Bloomberg, Scotia FX

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