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Selling Yuan Advised by Deutsche Bank to Barclays on Flows

By Ye Xie and Belinda Cao - Jun 18, 2013

Currency strategists from Barclays Plc to Deutsche Bank AG are telling investors to sell the yuan, this year's best-performing emerging-market currency, as growth slows in the world's second-largest economy and inflows wane.

Policy makers will widen the yuan's trading band, damping the one-way bet on yuan gains, Barclays analysts led by Igor Arsenin said in a June 13 report. Deutsche Bank analysts wrote two days earlier that the yuan carry trade will probably unwind as Treasury yields rise. The yuan will start weakening after the central bank set its fixing at a record high yesterday, according to Amer Bisat, a money manager at Traxis Partners LP, the $1.2 billion hedge fund started by Barton Biggs.

China has used a stronger exchange rate to help curb credit expansion, Bisat said in an interview yesterday in New York. Total lending in China climbed by a record 2.5 trillion yuan ($408 billion) in March, government data showed, generating concern that some loans may turn sour as banks loosen standards.

"We are not far away from the point where they can take their foot off the brake," said Bisat, a former International Monetary Fund economist. "Chances are they would loosen policies. It's tough for me to see them strengthening the fixing any further from here."

The yuan's fixing was set 0.09 percent weaker at 6.1651 per dollar today. The currency, which is allowed to trade a maximum 1 percent either side of that level, declined 0.06 percent to close at 6.1285 in Shanghai, according to China Foreign Exchange Trade System. It has climbed 1.7 percent against the greenback this year, the best performance among 24 emerging-market currencies tracked by Bloomberg.

Call Options

One-month non-deliverable forwards fell 0.2 percent to 6.1840 as of 9:20 a.m. in New York, data compiled by Bloomberg showed. That's the biggest one-day drop since May 10.

Barclays analysts advised their clients to buy one-month call options on the dollar against the yuan, predicting the Chinese currency will weaken to 6.223 per dollar in overseas trading. The yuan will drop 1.1

percent to 6.2 in the offshore market as the slowing economy leads to currency depreciation in line with Asian peers, Westpac Banking Corp. (WBC) analysts led by Jonathan Cavenagh wrote in a June 7 report.

Capital inflows are slowing as China's regulators demand lenders curb foreign-currency loans on concern companies may have exaggerated shipments to facilitate carry trades, in which foreign investors seek higher yields abroad funded by borrowing in countries with lower rates of interest. Yuan positions at domestic lenders from foreign-exchange transactions, a gauge of capital inflows, rose 67 billion yuan in May, the smallest gain since November, data released by the People's Bank of China on June 14 showed.

Cheap Credit

Foreign-direct investment rose 0.3 percent to $9.26 billion in May from a year earlier, the smallest gain in four months, the Ministry of Commerce said in a statement in Beijing today.

The unwinding of the yuan carry trade could "end an important source of cheap credit for China," the Deutsche Bank analysts wrote in their June 11 research note.

The yuan's recent appreciation "suggests that the Chinese government feels the economy is stronger than most believe," Stephen Roach, a senior fellow at Yale University and former non-executive chairman for Morgan Stanley Asia, said by e-mail. "Otherwise, it wouldn't be condoning a development that might inhibit export growth."

Room to Appreciate

Eswar Prasad, a former IMF official who teaches economics at Cornell University in Ithaca, New York, said there is still room for the yuan to appreciate as the economy recovers in the second half of the year.

Chinese growth will hold at 7.8 percent this year, maintaining the slowest expansion since 1999, according to the median forecast of 53 economists surveyed by Bloomberg. China is still expanding faster than the average 6.4 percent rate across Asia, the survey showed.

The median estimate of 49 analysts surveyed by Bloomberg is for the yuan to strengthen to 6.1 per dollar by year-end, and rally further to 6 by the conclusion of 2014.

"Fundamentals in China are better than many other emerging markets," Prasad said in an interview yesterday. "That's why we are seeing the yuan performing better than the other Asian currencies."

Band Widening

As speculative capital retreats, it's a "propitious time" for policy markets to widen the currency's trading band, loosening control over the yuan, he said. The yuan is closer to its fair value in terms of trade balance, and it's a priority for the central bank to make the currency a two-way bet to increase room for further reforms, Andrew Colquhoun, the head of Asia-Pacific Sovereigns at Fitch Ratings, told reporters in Hong Kong today.

Growth in the world's largest economy after the U.S. is losing momentum. Exports (CNFREXPY) increased 1 percent in May, after gaining 15 percent the previous month, government data June 7 showed. Industrial production rose 9.2 percent, trailing the median forecast of 9.4 percent among 39 economists surveyed by Bloomberg.

Interbank funding costs soared this month on speculation the Chinese authorities are moving to rein in credit to avoid bad loans. The seven-day repurchase rate, a gauge of interbank funding availability, has averaged 6.11 percent in June, the most since the National Interbank Funding Center began compiling a weighted average in 2006.

"We are in a moderately tightening cycle," said Traxis Partners' Bisat. "The strengthening of the fixing is part of that story."

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