GLOBAL MARKETS UPDATE

What's going on in Asia's bond and FX markets?

- **We think the yields of long-dated local-currency sovereign bonds in Asia will generally fall further by the end of next year, and that most regional currencies will continue to make ground against the US dollar. But we suspect some of the intra-regional trends of the past few weeks – especially the surprising underperformance of the yen – won't last.**
- **The fall in the 10-year US Treasury yield over the past few weeks has dragged down the yields of long-dated sovereign bonds in Asia, while giving the region's currencies some respite.**
- **In broad-brush terms, that's what we'd expected as US yields began to fall.** (See here & here, for example.) **But there have been some surprises among recent market moves.**
- **In particular, even though yield gaps have generally moved in favour of Asian currencies and those currencies have strengthened, there's been little correlation *within* the region between the two.** In other words, currencies that have seen the most favourable changes in yield gaps since the late-October peak in the 10-year Treasury yield haven't, in contrast with what might have been expected, always rallied the most strongly. (See Charts 1 & 2.)

Chart 1: Changes In 10-Year Local-Currency Government Bond Yields Since 19th October 2023 (bp)

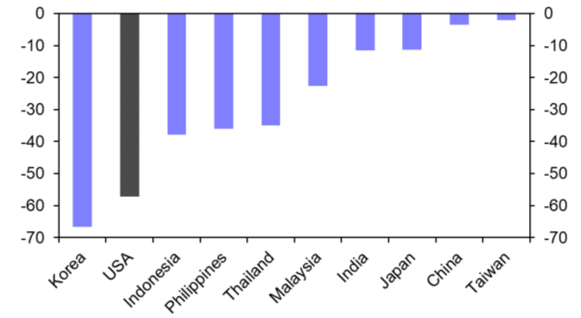
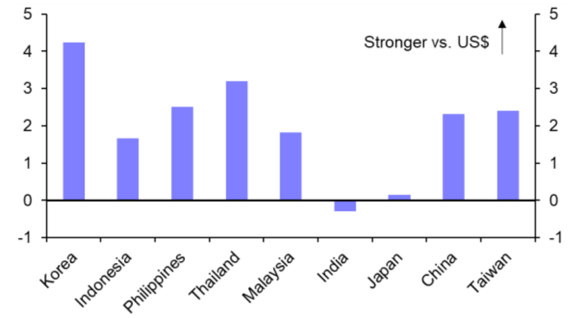


Chart 2: Changes In Currencies Against US$ Since 19th October 2023 (%)



Sources: Refinitiv, Capital Economics

- The 10-year Japanese government bond yield, for example, has declined only slightly as Treasury yields have begun to fall. But, despite the big implicit move in the yield gap with the US in favour of the yen, the currency has made little ground, on net, against the greenback. By contrast, Korea and some of the South East Asian economies have seen both big falls in yields *and* big rises in their currencies.
- **We suspect there are a few things going on. For one, alongside the fall in "safe" asset yields, investors' appetite for risk has improved over recent weeks as the perceived chance of a "soft landing" in major developed market economies has increased.** That's presumably resulted in narrower risk premia (indeed, dollar bond spreads, one measure of those premia, have shrunk lately; see Chart 3) which has probably given both bonds and currencies in some economies – such as India, Indonesia, the Philippines, Thailand and Malaysia – a particular boost.
- **On top of that, there has been some FX intervention by authorities in recent weeks – of varying degrees of directness – in the region that may have muddied the relationship between bond and FX movements.** After all, central banks in the region had been outspoken about their concern regarding the weakness of their currencies which, in many cases, are still close to multi-decade (nominal) lows against the US dollar.
- For the Indian rupee and the Japanese yen – the two major regional currencies that have fared the worst lately – intervention (or the threat of it, in the case of the yen) probably helped put a floor under them earlier in the year as they weakened. But that may have left them stronger than they might have otherwise been given their yield gaps to the US, leaving them less room to rally as US yields turned lower.
- At face value, the Chinese renminbi seems like it should fit in the same basket: authorities there seemed to have stopped the currency from weakening much through 7.3/$ (albeit through directing state banks to act rather than making use of FX reserves) as the yield gap was moving against the currency. So, like the rupee and the yen, that might have left the renminbi less room to gain when Treasury yields fell. (See Chart 4.) But in fact it's rallied strongly, especially by its own low-volatility standards.

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Chart 3: Stripped Spreads Of JPM EMBI Global Indices (bp)

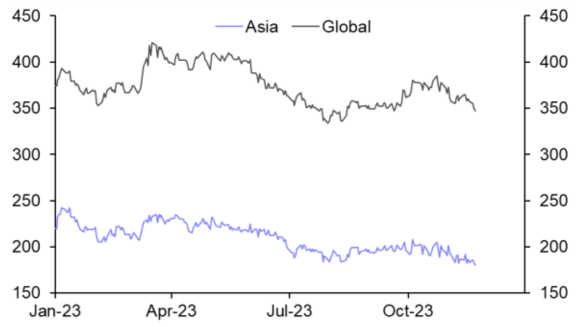
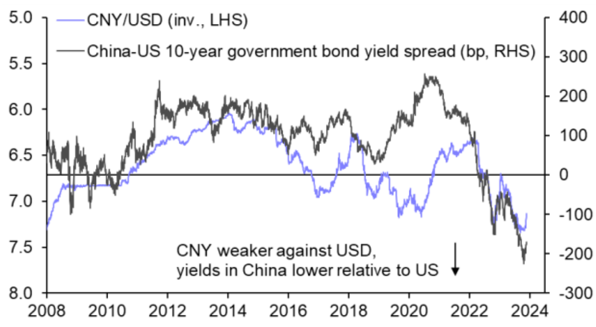


Chart 4: CNY/USD & US-China 10-Year Yield Gap



Sources: Refinitiv, Capital Economics

- It could be instead that China's authorities preferred instead to "lean in" to a strengthening currency (at least against the dollar) and give it an additional boost, given their clear concern about the low level of that exchange rate. It's also possible that other smaller central banks in the region – many of whom had been outwardly concerned about the weakness of their own currencies – took a similar approach. China's intervention, though, is especially opaque, so it is hard to say for sure.
- **Where do we go from here? We think Asian yields will generally be lower still by the end of next year, as the region's central banks turn to easing and risk premia eventually fall further.** (See here.) We think yields will decline more quickly than most in India (our forecasts imply a ~75bp fall in the 10-year yield there by end-2024), where we suspect the central bank will eventually cut more deeply than widely expected. But elsewhere, we suspect 10-year government bond yields will fall by a bit less than the ~60bp decline we project for the 10-year US Treasury yield.
- Japan and China look most likely to us to be the exceptions: we think the 10-year JGB yield will *rise* as authorities there move to some belated monetary tightening (we forecast it to reach 1.0% by end-2024, compared with ~0.75% now), while the 10-year Chinese government bond yield may only decline a little, if at all (our forecasts envisage a ~10bp fall in the 10-year yield there) given what seems to us to be limited prospects for monetary easing there as its economy continues to rebound.
- **On balance, though, we expect yield gaps, and risk premia, to work in favour of most of Asia's currencies between now and the end of next year.** But how far they rally may also depend on authorities' willingness to let them. Some – like the renminbi – may ultimately be restrained from rising too far, especially given its strength on a trade-weighted basis. (We anticipate a ~3.5% rise in it against the US dollar by end-2024.) But the yen, by contrast, is likely to suffer no such impediments. And we think the yield gap with the US will move particularly strongly in favour of that currency, which also looks very undervalued to us. **So, while we project gains in most Asian currencies against the dollar, we anticipate especially large gains in the yen: our end-2024 forecast is 130/$, ~15% above its current level.**
- Our full set of forecasts can be found on our data service.

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