PM Datanote: FX Reserves, China, July

In one line: China's foreign reserves climb in August amid weakening dollar and falling treasury yields.

-China: Foreign reserves rose to $3,288B in August, from $3,256B in July. Consensus was $3,292B.

China's foreign reserves rose by $31.8B to $3,288.2B in August, falling short of the market consensus of a $36B rise. We estimate that the exchange rate valuation effect was around $27.1B in August, higher than the $18.2B in July, thanks to a weakening dollar. On the surface, the valuation effect accounts for 85% of the changes in official reserves. Indeed, the DXY index has fallen for the second consecutive month, by a total of 4%. August alone saw a 2.3% m/m fall, driven by a slowing US economy, particularly a weakening labour market. In August, the AUD, CHF, and JPY appreciated the most against the greenback in the COFER basket, by 3.7%, 3.5%, and 3.1%, respectively.

Other factors contributing to the increase in reserves in August include a fall in US treasury yields, with the 10Y UST sliding to 3.90% by the end of August from 4.03% a month earlier, leading to a rise in the book value of bonds held in PBoC reserves. At the end of June, China held $752.5B of treasury assets and $233.9B in agency bonds, according to official US data.

Regarding portfolio flows, China stopped publishing daily northbound equity flow data for Stock Connect in mid-August in an attempt to reduce the influence of foreign sentiment on domestic investors' decisions. Consequently, there is one fewer timely indicator for foreign inflows into Chinese assets. The data will now be published quarterly. As of July 2024, about $99.5B of foreign capital had left Chinese stock markets since the onset of the previous bout of capital outflows in August 2023. The trend of equity outflow likely continued in August, given poor economic prospects. Additionally, foreign investors are likely to be more hesitant to invest in China as market information becomes less transparent. On the other hand, bond inflows likely continued in August, with foreign investors purchasing NCDs. Bond Connect data is not yet available for August, but July data showed strong net inflows of $20B.

Looking ahead, the general trend of lacklustre global investor sentiment towards Chinese assets will likely persist in Q4 amid China's weakening economic fundamentals and policy uncertainty. Foreign outflows from equities will likely continue but moderate, while FDI inflows are expected to remain weak, as suggested by the latest BoP data. That said, the anticipated interest rate cuts by the Fed in Q4 will rapidly narrow the rate differential between the two blocs, which may lend some support to the RMB, underpinning more inflows into select RMB-denominated assets. There have already been discussions of an unwind of RMB carry trades, with domestic exporters and companies who have been hoarding dollar earnings overseas might rush back into their home currency if the USD weakens further. Following another weak set of payroll data last Friday, more market participants now expect a larger rate cut. Our US team continues to forecast a 125bp easing by year-end, with a further 150bp to come in H1 2025. In contrast, we expect China to cut only another 10bp by year-end. As a result, we have pencilled in a stronger RMB forecast of 6.95 to the dollar in Q4.