APAC Macro Insight

China: Exploring the valley

FX & Rates

Mainland China

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- China's economy seems to hit the bottom already with several stimuli supported, including a recent RRR cut, relaxation of housing purchase rules, lower mortgage rates for existing loans, and so on.
- USDRMB will continue to be capped at the 7.2 – 7.4 range in the rest of 2023 given the more hawkish Fed, carry disadvantages, risk-off sentiment, and soft external demand.
- In our view, China rates could be slightly steepened with more policies introduced, which provide a more solid base for better growth and inflation anticipation.

CUIRS Insights

Improved risk sentiment is anticipated ahead of China's national holiday. The latest statistics for August, including industrial production and retail sales, indicate a broad-based recovery. As a result, it is expected that CGB yield will remain supported at current level for the time being. However, the FAI continues to face weakness due to sluggish demand in the real estate industry. Although investments in the manufacturing and infrastructure sectors have surpassed expectations, the persistently weak demand suggests that local authorities need to announce and implement more stimuli policies to restore and strengthen confidence among the population.

Furthermore, **the August Caixin PMI has shown a flat performance,** with a slight improvement in the manufacturing PMI but a decline in the service PMI from 54.1 to 51.8. Some of these improvements can be attributed to increased issuance of local government bonds and higher infrastructure spending. The easing fiscal policy, combined with relaxed property regulations, will alleviate some of the burden on monetary policy. With the implementation of further policy measures, a modest recovery in China's economy is expected in Q4. However, the weaker service PMI implies that retail confidence has yet to fully return to normal levels.

Fig. 1: Breakdown of Fixed Assets Investment

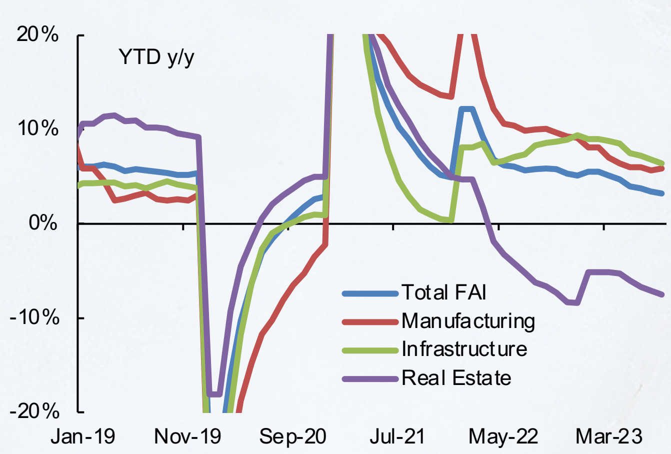
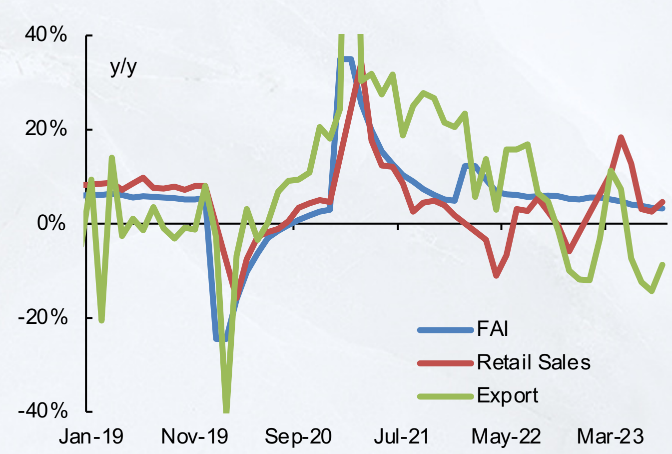


Fig. 2: Retails Sales, exports, FAI



Source: Bloomberg, CEIC, SAFE, CUIRS

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Recent cut on RRR comes as no surprise

Fundamentally, the RRR cut and the increased issuance of medium-term lending facility (MLF) loans provide timely support, as onshore liquidity has been tight since August due to an accelerated issuance of special local government bonds and an increase in total social financing (TSF) activities resulting from the relaxation of property policies and local government financing vehicle (LGFV) debt swaps. Government bond issuance in September is expected to remain substantial to support the forthcoming stimulus policies.

Looking ahead, PBoC monetary policies are likely to be accommodative. Lowering mortgage rates and reducing the burden of LGFV financing are still necessary, which will continue to put pressure on banks' net interest margin (NIM). However, the RRR cut, policy rate adjustments, and potential deposit rate cuts are likely to offset the NIM pressure. As fiscal and credit policies are relaxed, the impact on interbank interest rates will be mixed. Overall, it can be observed that Chinese interest rates are currently undergoing a gradual recovery along with a gradual increase in the Producer Price Index (PPI), TSF, and economic data. Furthermore, judging from history, China rates track PPI rather well, which leads its domestic inventory cycle by roughly one or two quarter.

Are there rates cut again in sight? Our base case is NO for the rest of 2023. In our view, the latest Reserve Requirement Ratio (RRR) cut and Aug's policy rate cut conducted by PBoC are likely the follow-up measurements for politburo's task to increase monetary strength in aggregate terms, which is completed, we think. Hence, we don't expect any further cut occurred in the rest of 2023. However, the risk tilts to the downside (another cut) for the slower-than-expected China's recovery, but the recent improvement on economic data strengthens our viewpoints. Corporates' earning guidance also show optimism in the near-term future (Yicai, Aug 16th 2023).

Fig. 3: China's reserve required ratio for banks

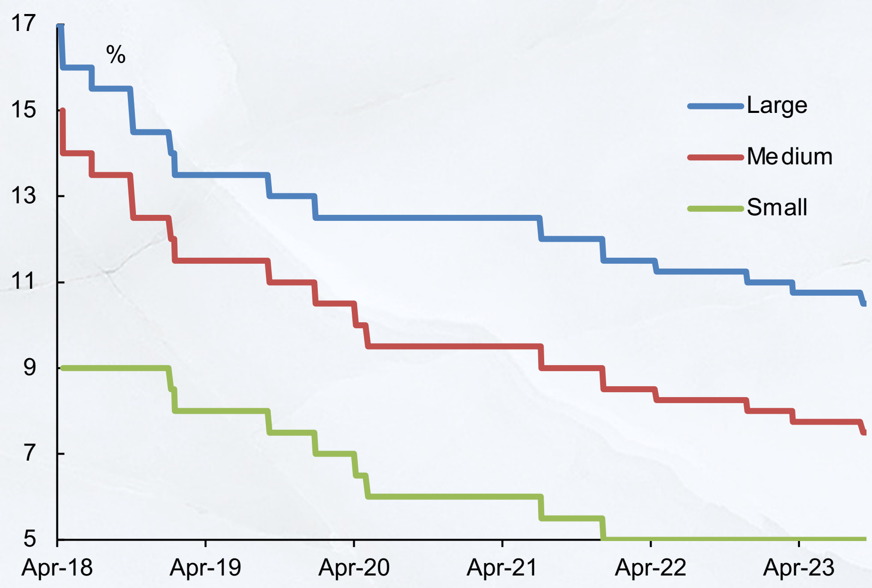
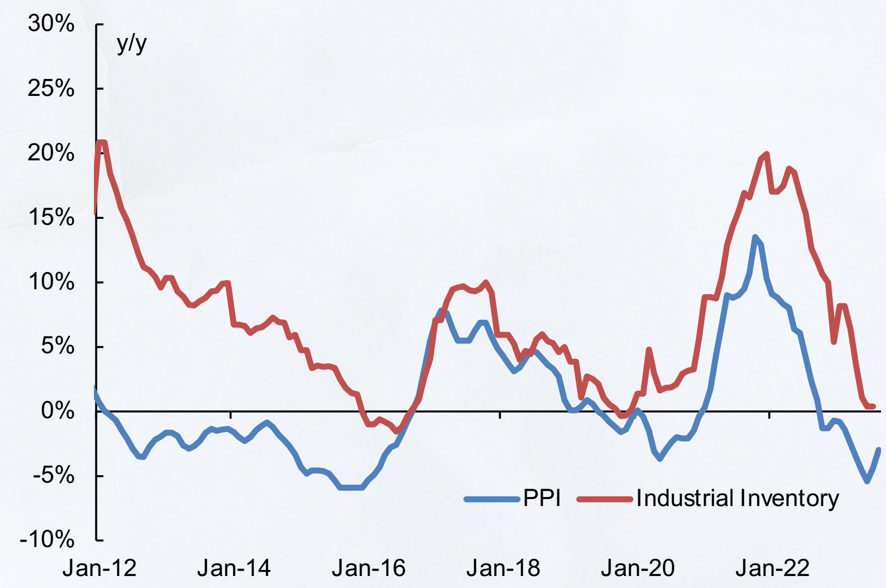


Fig. 4: Cyclical indicators sign that China is at the trough



No signs of significant recovery in external demand

Exports continue to decline, falling by 8.8% year-on-year, while imports have shown better-than-expected improvement with a decline of 7.3% year-on-year. This improvement can be attributed to increased demand for commodities and intensified infrastructure development, as well as some positive developments in domestic economic activity.

Export manufacturers continue to face challenges due to the drag from global demand and tighter credit conditions, coupled with a shift towards increased services consumption. Notably, although August's auto exports recorded a 35% y/y increase, the impact remains limited as auto exports account for a small share of total exports (approximately 3%). Exports are expected to remain subdued until at least 2024H2 when the Federal Reserve may begin its rate-cutting cycle.

However, it is expected that export momentum will slightly improve during the peak season for electronic products in the third and fourth quarters (Q3E-Q4). South Korea's imports from China have already shown a 1.9% year-on-year increase in the first 10 days of September's trade, compared to a decline of 13.4% in August, which strengthens our viewpoint to some extent. Nevertheless, it is important to acknowledge the significant uncertainty in this regard, given the volatility usually observed in South Korea's first 10 days of trade.

Fig. 5: Asia exporters are still suffering from industrial recession

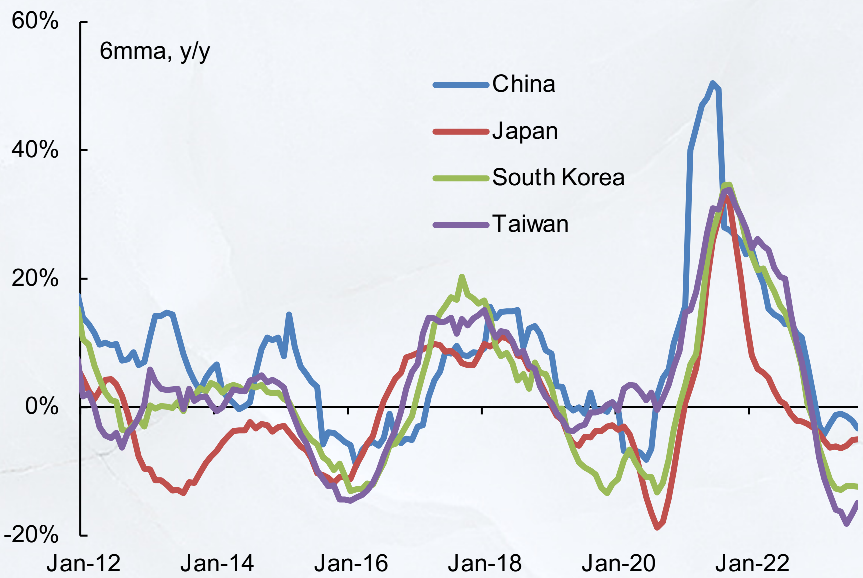
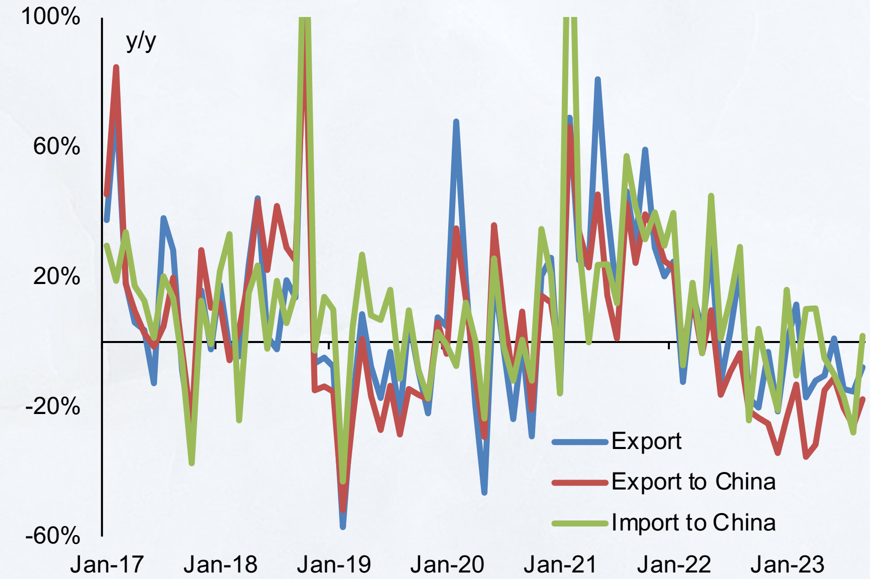


Fig. 6: Korea first 10-day foreign trade show an early sign for recovery



FX: Tug of war

As the People's Bank of China (PBoC) PBoC keeps the USDCNY fixing low (Fig. 8) and CNH funding tight (Fig. 9), the temporary breakdown of the relationship between spot and carry should continue to exist. We believe the central bank is keen to guide spot not to break 7.4 level. Moreover, as long as other Asian central banks (especially BoJ) keep capping the USD upside, the PBoC's approach will likely work, especially considering exporters, who have been hoarding the dollar throughout the year and will consider offering into the year-end.

Fig. 7: USDCNH are trading near the CNY upper band recently

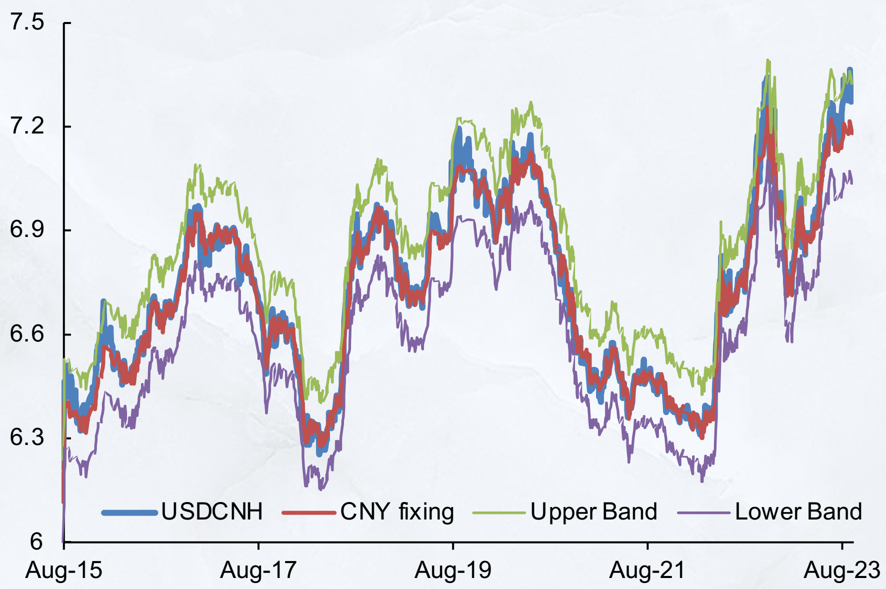


Fig. 8: Unprecedented strong CNY fixing has shown to curb RMB depreciation pressure

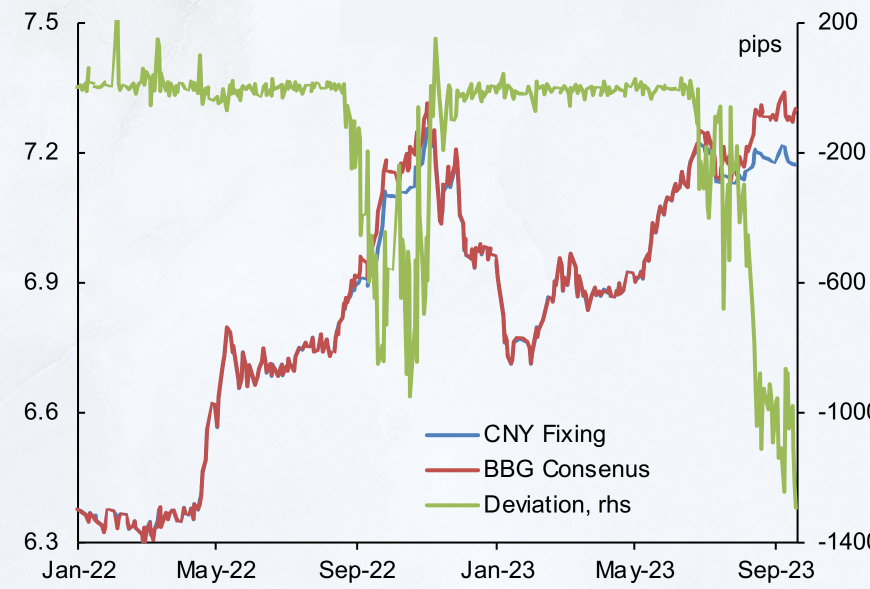


Fig. 9: CNH T/N points have been pushed to positive

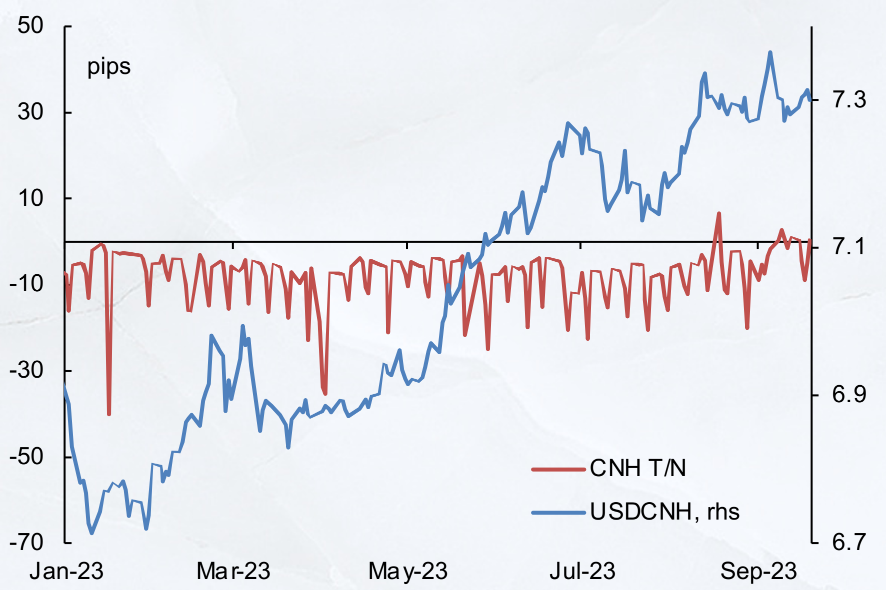
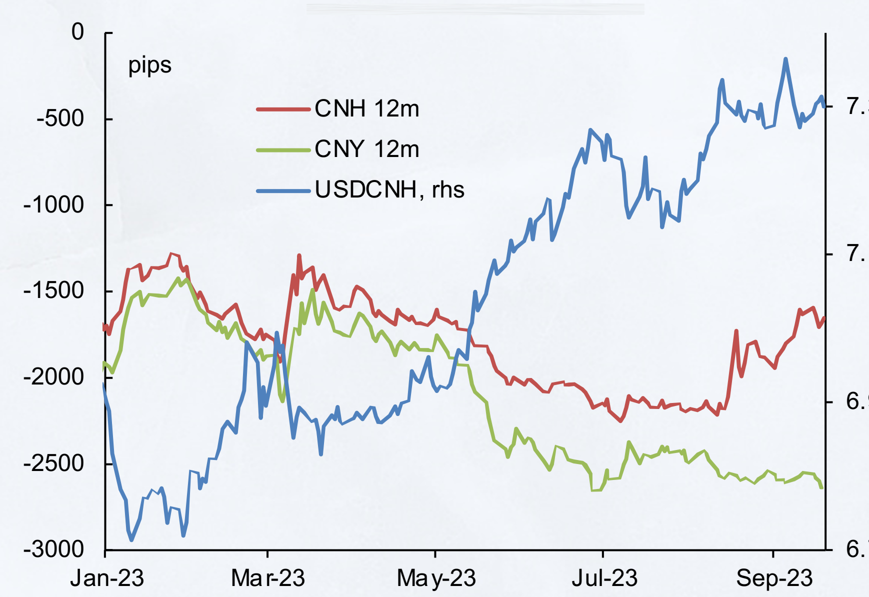


Fig. 10: Tightened CNH liquidity kept USD-CNH forward curve at a premium versus USD-CNY



So far there is persistent upward pressure on the pair from aforementioned macro headwinds, yield differentials (Fig. 11) and capital outflows. The large outflows through the Stock Connect since August (USD29bn, Fig. 12) suggests to us that the market needs more than policy announcements to regain the confidence; We think it needs actual data improvements in China before it can recover, which may take time.

Meanwhile, PBoC has increased its efforts to curb excessive RMB weakness. There have been strongly worded statements, periodic CNH funding squeeze, more CNH bill issuance, media reports of USD selling by state-owned banks (Bloomberg, 11 September), and additional measures to ease onshore USD liquidity tightness. As long as the PBoC keeps setting the USD-CNY fixings much lower than market expectations, which limits the extent to which onshore spot can rise.

The offshore RMB liquidity tightening is not a new policy tool for PBoC. There's similar episode between 2016 and 2018. For example, CNH T/N (Tom Next) points rose to positive high-double digit in early 2017 (Fig. 13). But the story this time is more like Aug-Oct 2018 (Fig. 14), when we saw smaller but more frequent CNH funding squeeze. The squeeze is likely to trigger some carry unwinds that have RMB as a funder, which should ease some pressure on RMB depreciation. We hold the view that PBoC is using these FX policy tools to buy time for further stimulus measurement to be introduced (Ex: LGFV assets swap, lower interest rates for existing mortgage loans). As mentioned, it needs some time for stimulus and confidence to be introduced and recovered. Hence, we are of the view that PBoC will stay in the market for a while, and there may be other FX policies being introduced, including further FX RRR cut, stronger CNY fixing, FX Risk Reserve ratio hike for onshore corporates flows, macro-prudential parameter adjustments, etc.

Fig. 11: Huge carry disadvantages are likely to cap USDRMB above 7.2

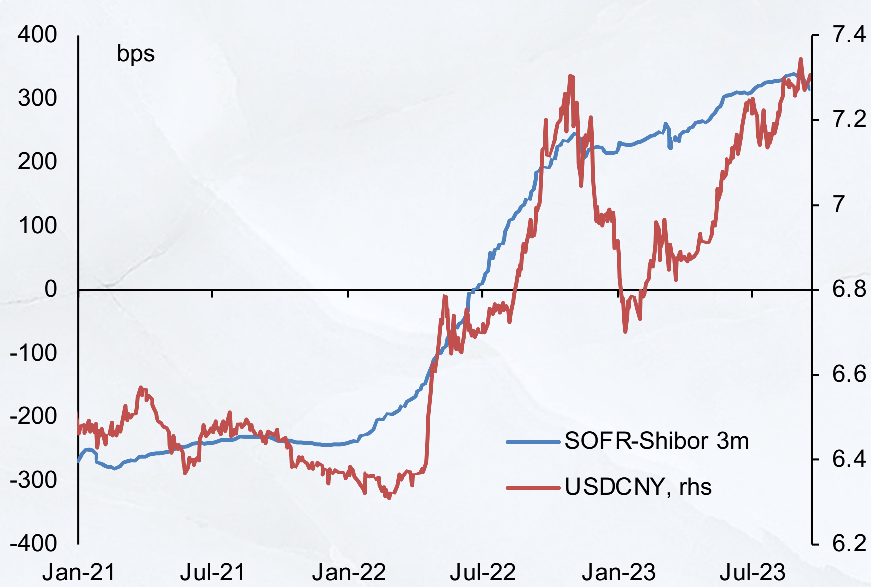


Fig. 12: Outflows via Stock connect has large since August

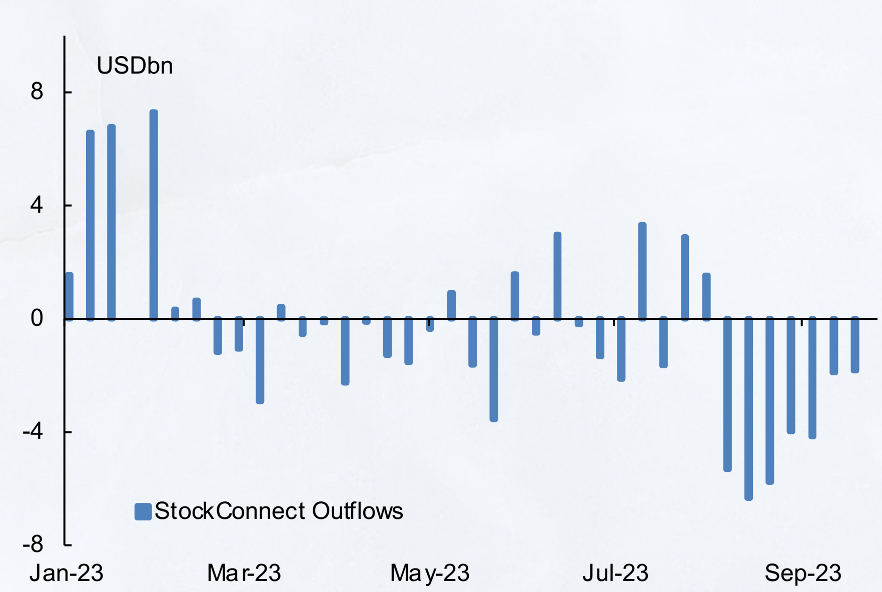


Fig. 13: CNH funding squeeze was much more intense in early 2017

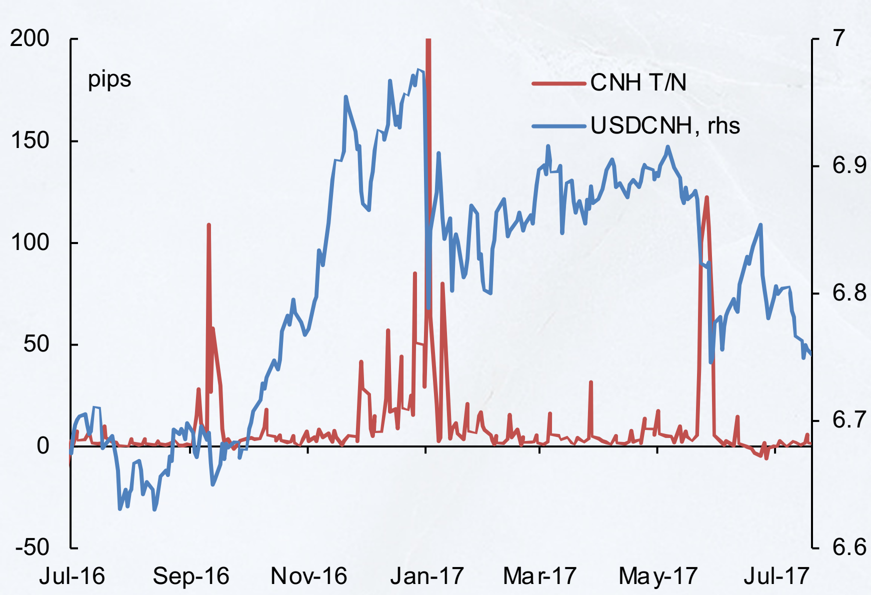
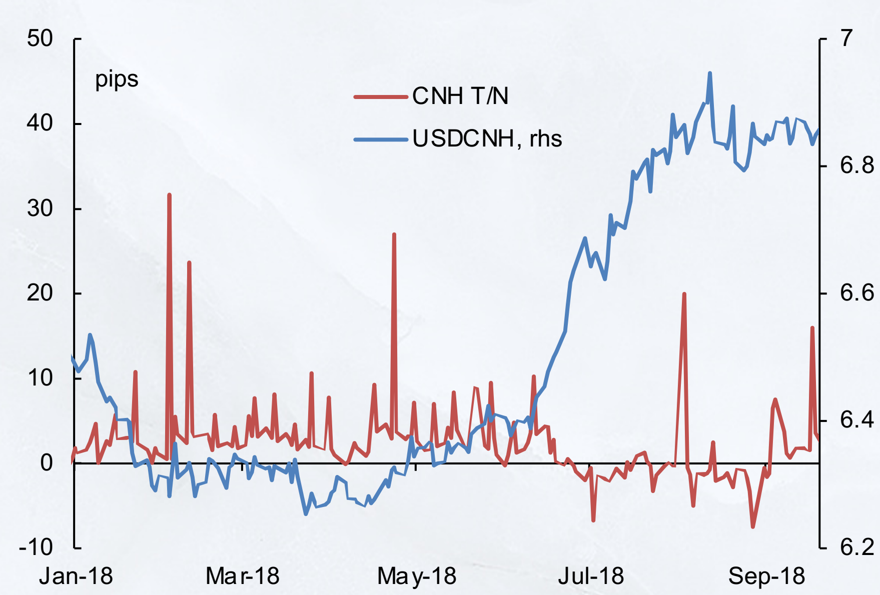


Fig. 14: CNH funding squeeze in 3Q 2018 was more modest but frequent



Weakening negative effect from cross-border flows

Moreover, cross-border flows are likely to become less consistently negative since the May-Aug dividend season has passed (Fig. 15); the market's growth expectations have been lowered again recently and foreign investors are already underweight. From a position perspective, it's unlikely to see large retreatment for their bond position, given most of the foreign holders (>80%) are sovereigns and overseas banks (Fig. 16, SAFE, Mar 31st 2023). Looking ahead, China bonds should be attractive for foreigners given 1) Strong diversification effect resulting from China's independent economic cycle; 2) competitive real rate and current account; 3) Low portion (~3%) for foreign holdings, which shows that it still has significant room for improvement compared to other major bond markets. But admittedly, the government must win the market confidence back at first.

Similar to bonds, we don't expect risk-off sentiment to trigger huge position unwind via northbound stock connect given most of the "foreign investor" here are actually overseas Chinese. The cheapened value of A-share also provides the incentive for investors to step into the market, in our view. Recent combinations of fee reduction, leverage expansion, shareholder return enhancement, and new product launches may give investors more instruments for expressing their long-term views, which is likely to attract long-term capital.

Fig. 15: Weaker dividend seasonality, less pressure on RMB

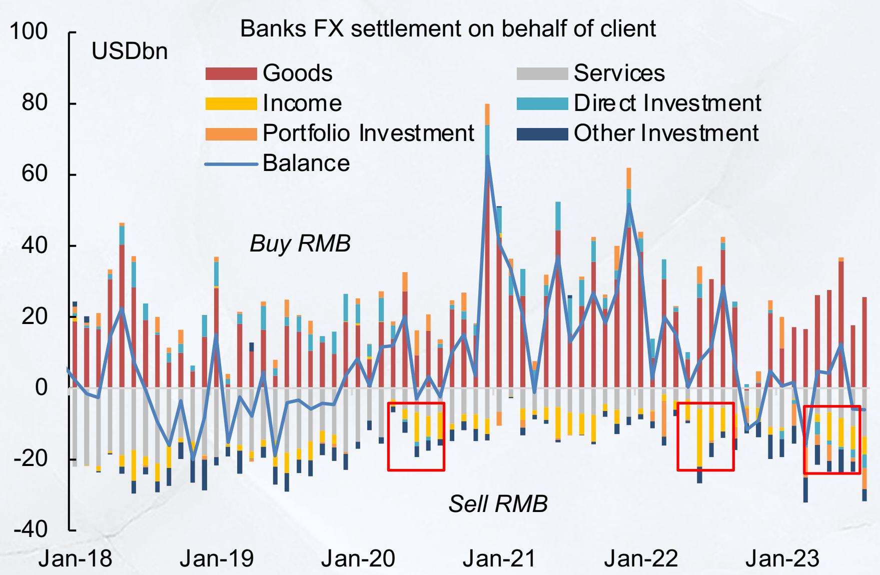
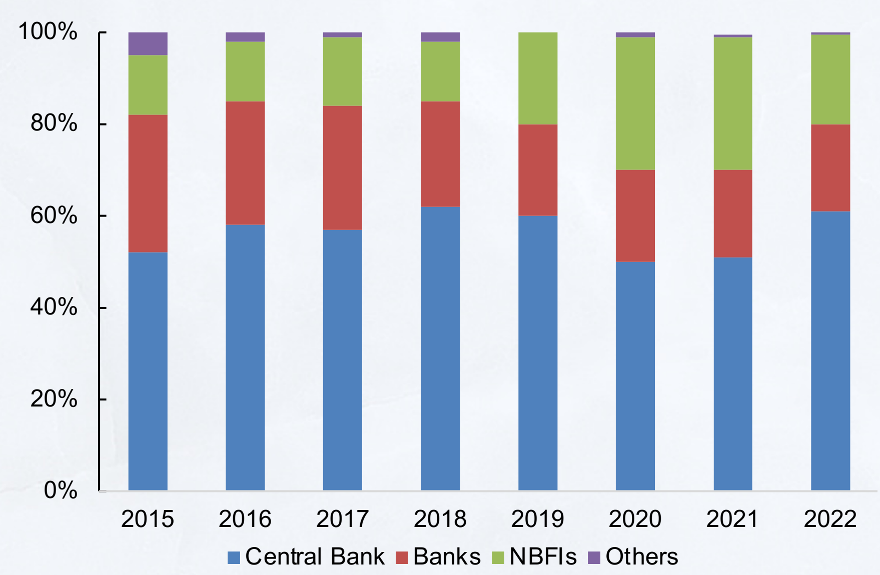


Fig. 16: Sovereigns are the main foreign holders of RMB bonds



Potential catalysts for RMB rebound

We monitor several things to call for the meaningful rebound on RMB exchange rate:

- **Lower US front-end yields**: With the US economy staying resilient along with 525bps rate hikes, the pricing of the Fed rate cuts has moved further into the future and US yields have risen. This has added to the USD's carry advantage and provides solid support to USDRMB. The dynamic is now mixed, given the strong US econ and more Hawkish Federal reserve. However, we think Fed is too optimistic in the September FOMC and expect US economic data to lose momentum in the coming quarters, which should bring US rates lower with cheapened equities. But recent UST 2s30s steepening suggests that market has continued to prepare for higher-for-longer regime, which may sign that the time for lower US rates will be later than expected.

- **Electronics cycle recovery**: We envisage electronics business cycle bottoming in Q3E-Q4. But the persistence of high interest rates in developed markets is likely to restrain investments and lead to a sluggish recovery in electronics demand. While excitement around AI and EV price cuts provide some support, soft consumer electronics demand continues to bite. TSMC also stated in the 2023 Q2 earning call that the recovery is "All about macro". Hence, we don't expect a material recovery until 2H 2024.

- **China's inventory cycle turn**: Recent Caixin PMI suggests China's manufacturing sector has entered the expansion phase, and CPI & PPI indicates that the economic cycle in China may have bottomed. In our view, we are now at the very early stage of upward cycle. Incoming policy stimulus and the effect it brings could be closely monitored.

Material RMB rebound need to wait till 2024H2

We don't see a strong rebound on RMB, but more a two-way range (7.20 - 7.40) versus USD for the next few months. Given Fed's stronger projection on fewer cuts conducted in 2024 and the pain resulting from structural transformation in China, we forecast USDRMB can only go lower to 7 by late 2024.

Nonetheless, the balance of risks is still tilted to the upside for USD-RMB in the near term if growth fails to stabilize and/or Beijing resorts to more aggressive monetary easing, which will trigger China to conduct a significant rate cut cycle, offering more solid advantages for carry trade players. Thus push USDRMB higher.

Fig. 17: Stronger USD environment is likely to be persist in near term…

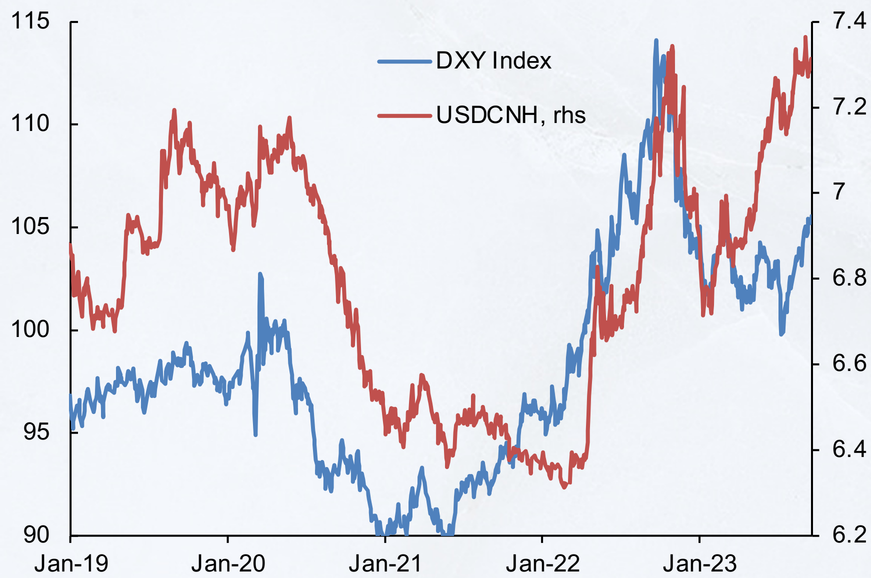
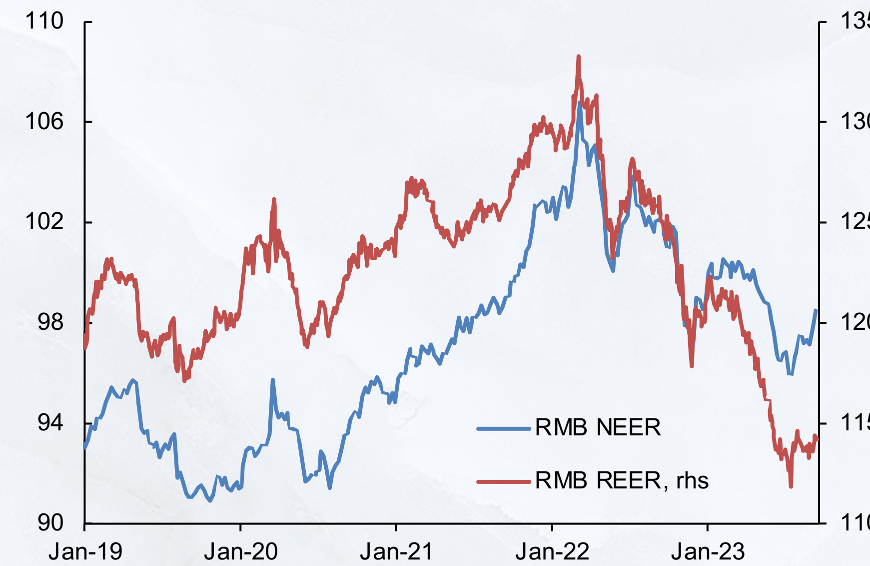


Fig. 18: …but cheapened RMB offer incentive for long-term capital investment



Rates: Stay at trough for a while

Given the huge uncertainty both in the domestic and overseas markets, we don't expect local risk appetite can soon recover. In turn, we are of the view that the incoming stimulus combination will gradually pick local confidence up and make them turn to riskier assets like A-share. As for August, the wealth management product is still attractive in onshore market, which can be seen in onshore mutual funds' increasing position on fixed income products (Fig. 20). But the decline in the new increase position is likely to suggest the slow recovery on locals' sentiment. The bear-flattening trend in CGB curve since late August also sign that the risk appetite in China has recovered, though it's more likely to be a muddling through.

The implemented credit and fiscal policies, such as property relaxation and acceleration of special LGB issuance and LGFV debt swap are spurring and creating more business activities. China's total social financing data rebounded meaningfully in August, and onshore interbank funding has normalized from very flushed levels (Fig. 21), which is likely to be sustainable into year-end.

Notwithstanding the recent good news, we are still aware of further external risk from liquidity tightening with G4 central banks starting QT, which should result in a significant slowdown in global economy in the coming quarters. Even though China has its own economic cycle, it can't refuse to be drawn into the matter, not to mention that China is now shifting to the export-oriented growth model (like its North Asian peers Japan and Taiwan), which makes China exposed more to external risks. Hence, we favor engaging China recovery with steepener trade instead of outright pay, so as to hedge the global slowdown risk (likely to trigger policy rates cut again if things worsen sooner than expected).

Fig. 19: Foreigners' position in China bond has decreased since 2022

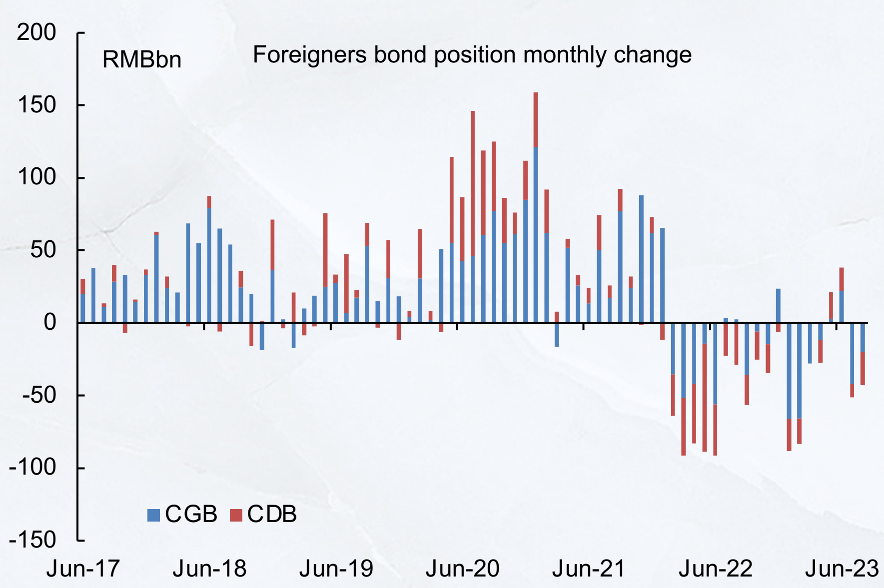


Fig. 20: Onshore mutual funds are still buying bonds

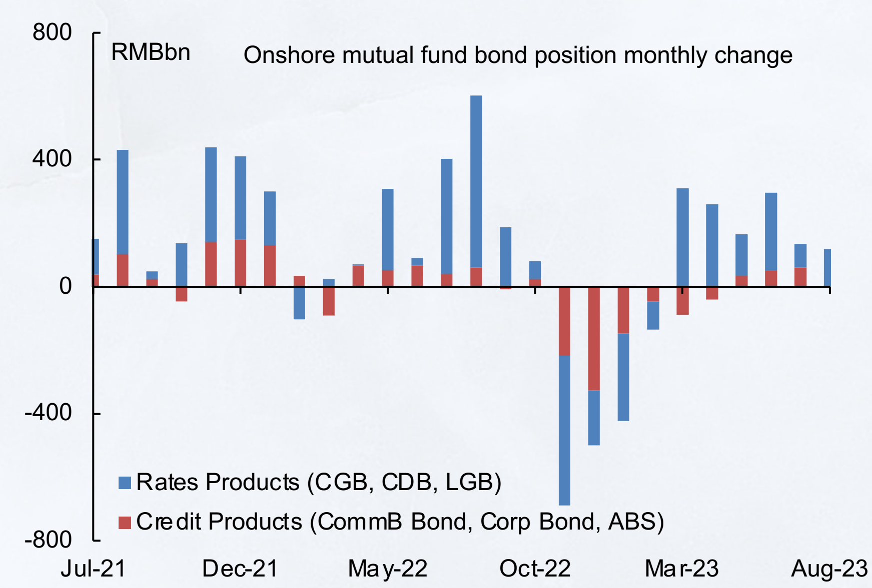


Fig. 21: Onshore funding tighten with improving credit demand

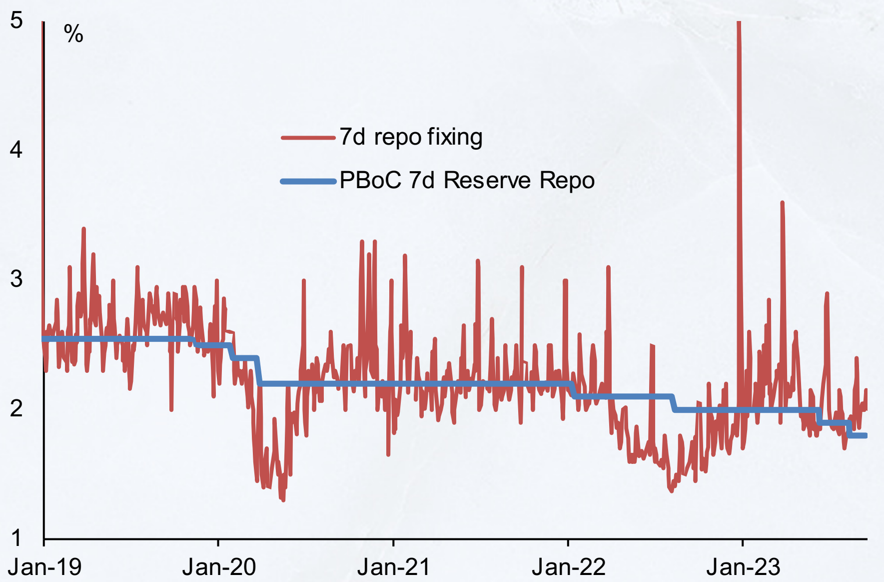
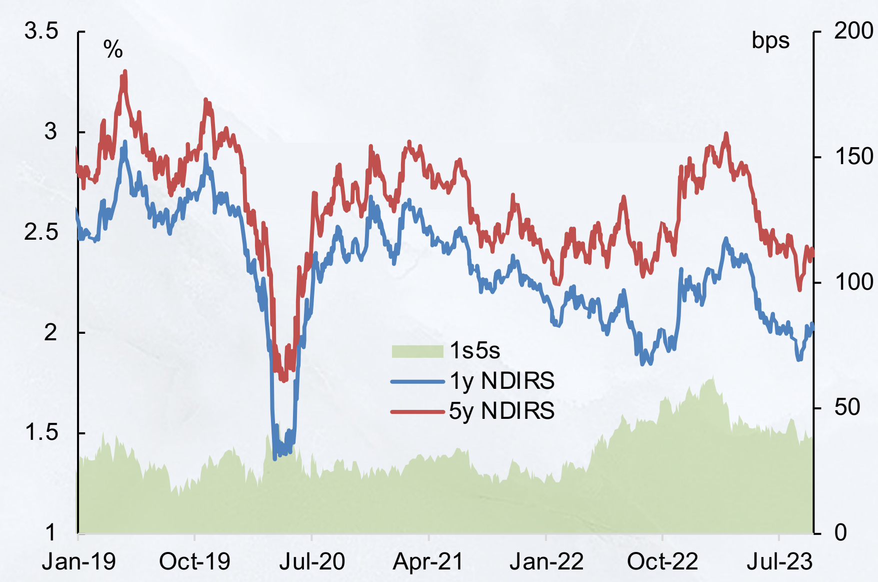


Fig. 22: We like steepened more than outright pay given the risk of another policy rates / RRR cut



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