China Bulletin: CNY View

Outlook for CNY

CNY saw a volatile first quarter following development of the Covid-19 epidemic in China and globally. Breakout of COVID-19 in mid-Jan reversed CNY's appreciation trend against G3 currencies following the phase 1 trade deal. By end of Feb CNY had appreciated after the Chinese authorities finally managed to control the situation by locking down the country for a month. Into March, CNY saw selloff pressure from capital outflows triggered by the plunge in oil prices and the global spread of the epidemic. Most recently, with the US dollar retreating, CNY depreciated against most currencies, gauged by the CFETS RMB Index.

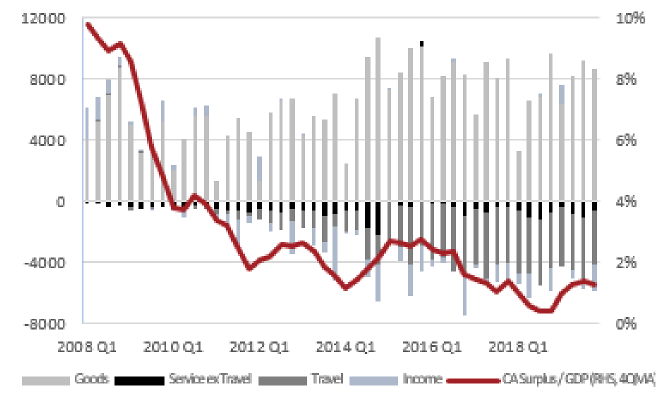
Based on the balance of payments CNY may be more volatile in the short-term, but its current level is about its medium-term equilibrium level, and risk to its outlook actually tilts to the upside.

Current account implies a stable CNY in the medium-term

Current account dynamics in recent years imply that CNY is around its medium to long-term equilibrium level. Despite trade tensions potentially motivating production to move elsewhere, China is very likely to remain one of the world's largest exporters for the foreseeable future based on the comprehensive supply chain and its possession of the largest well-trained labour force. Additionally, with the US goals of containing China by restricting the availability of certain high technology goods, China is in the process of substituting imports of such goods with domestic supply and this substitution will consequently alleviate pressure on the current account surplus. The most notable examples are LCDs (liquid crystal displays) 6-7 years ago and more recently, integrated circuits. China spends 1/6 of its import expenditure on integrated circuits and is eager to develop its own capability to manufacture reliable products. Recent experience shows that the current account is able to maintain a stable surplus with USDCNY around 7 and the CFETS RMB Index between 93-94, even in 2016 when external demand was sluggish due to the collapse of the oil price.

Indication for CNY in the short-term is mixed, as domestic demand recovers faster than external demand, oil imports potentially decrease due to lower oil prices, and overseas travel shrinks. In early Apr, 90% of China is back to normal while the epidemic is causing a shutdown for the rest of the world. The asynchrony implies a lower current account surplus in the short-term. Yet the pressure is partially offset by lower spending on overseas travel, which accounts for 1/2 of total service imports and 1/6 of total goods imports, and lower oil imports, which is about 1/7 of total goods imports. Thus, the CNY exchange rate may be dominated by the movement of capital flows.

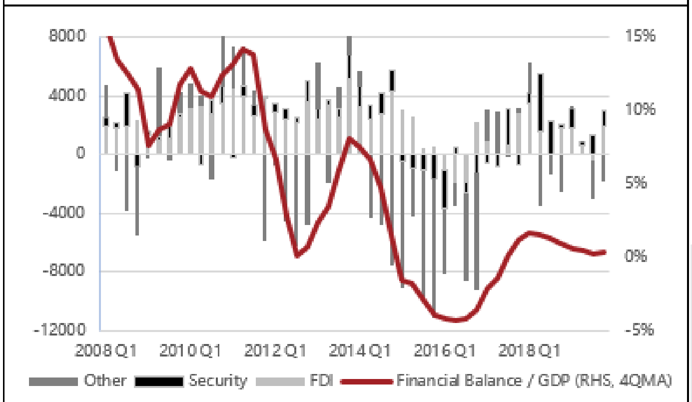
Figure 1 China Current Account Surplus and Components



FDI may see outflows, and portfolio flows may remain stable

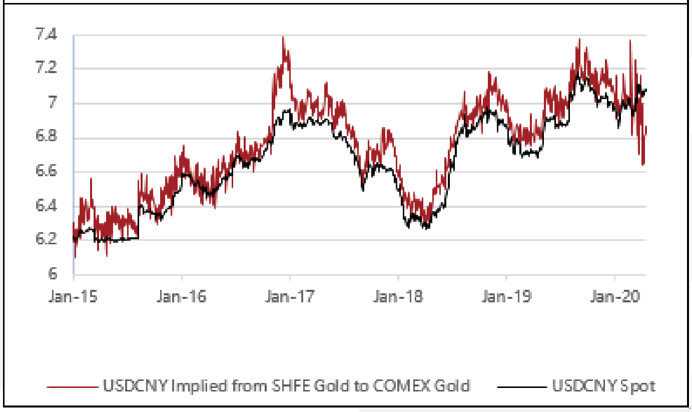
Foreign Direct Investment into China has been hit by trade tensions and is expected to see another blow from the plunge in the oil price. Net FDI inflow almost halved from 18Q2 to 19Q4 upon trade tensions, despite global and China growth momentum improving during the same period. The collapse of oil and commodity prices in 2015-2016 caused a net outflow of FDI by impairing commodity exporters' balance of payments and now a similar story is happening. We're quite pessimistic about the development on both sides and so believe that FDI may see net outflows in 2020, though the magnitude is still uncertain.

Figure 2 China Non-reserve Capital Account



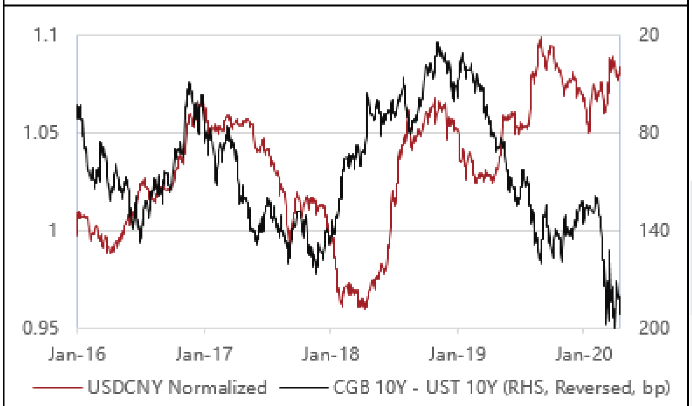
Domestic depreciation expectations are well contained currently and will pass limited pressure through capital outflows. The depreciation expectations, shown by the price spread of gold futures traded in SHFE and COMEX in figure 3, is more anchored to current USDCNY level than in 2016-2017. Domestic development doesn't support the recurrence of massive capital outflows either. The last round of capital outflows and depreciation in 2015-2017 was partially encouraged by PBoC's unprecedented accommodative monetary policy which turned out to be inefficient and boosted an asset bubble instead of growth. After 2 years of deleveraging policies, it is unlikely we'll see capital outflows of their previous scale now, and portfolio flow may be the swing factor in the short term.

Figure 3 USDCNY Spot and Gold Implied Exchange Rate



For portfolio flow the most prominent indicator is the spread between the 10Y CGB rate and 10Y UST rate, which has risen to a high level and implies appreciation pressure on CNY. The spread works as a gauge of the difference between returns in CNY and USD, with a low-level spread implying less appetite for CNY assets and thus CNY. A lower CGB rate always follows worsening fundamentals in China and massive easing by PBoC, while a lower UST rate is not necessarily due to the problems of the US. Based on the latest high frequency data, the US may step into a recession as early as 20Q2, the length of which is uncertain. Economic policy in the US has adopted crisis mode and started massive easing. On the other hand, China is less exposed to shocks than 2015-2016, considering lower levels of financial risk, trimmed excess capacity and still adequate economic policies at its disposal. Employment remains as the top priority for policy makers, likely to pose less pressure going forward given China's working-age population has decreased by about 10 million in the last 5 years and another 15 million in the next 5 years. The balance looks in favour of China at the moment.

Figure 4 USDCNY vs Spread between 10Y Rate of US and China



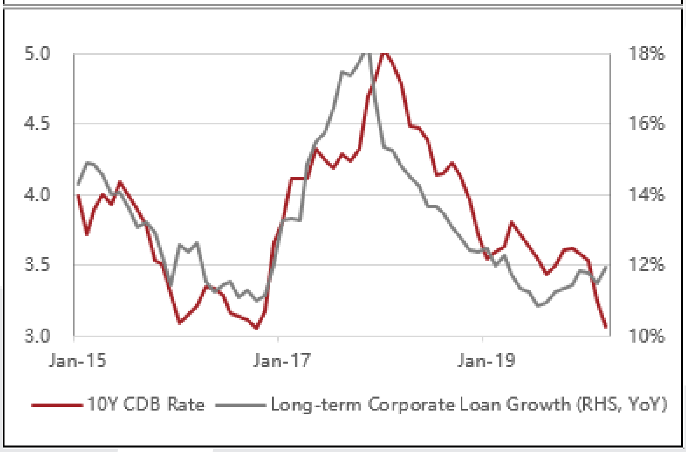
Update on recent fundamental data and policy developments in China

Q1 data was weaker than expected even before the deterioration of global demand fully kicks in. Industrial production and fixed asset investment are firstly delayed by the epidemic and now risk decelerating due to worsening external demand. The shock from the pandemic could be short-lived, though rising geopolitical tension and protectionism may potentially erode the current market share of Chinese manufactured goods. Concerns about external uncertainty will continue to suppress the outlook for fixed asset investment while existing orders may keep production running at a relatively high level.

Latest March data offers certain relief and confirms a notable improvement. Fixed asset investment saw a much narrower contraction and is likely to revert to positive in 20Q2 after fiscal policy turned to infrastructure investment to absorb rising unemployment. Industrial production has been picking up fast since March after the epidemic in China has come under control, while shutdowns and lock-downs caused by Covid-19 have started to appear across the globe. The service sector seems to be in a better position due to buoyant growth in the information technology and finance sub-sectors and is expected to improve further after authorities gradually lift lock-down measures. Seasonally in China, production and fixed asset investment are inactive while consumption was strong in Q1, thus the impact on whole year growth of the sharp decline in Q1 may not be as intense as the number suggests.

Financial data looks promising, which explains PBoC's relatively restrained accommodative stance after the epidemic shock. The most important indicator of financing demand, growth of long-term corporate debt, recovered from its decline in February, though this improvement will be tested by the possible deterioration of external demand, as if this continues it will imply upward pressure on rates.

Figure 5 10Y CDB Rate and Long-term Corporate Loan Growth



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Predictably, policy makers are mobilising all tools to support the economy and employment, except for the housing market. Distress relief measures have been introduced such as tax exemptions, rental relief, lowering financing costs and extending debt terms. Local governments are racing to prepare plans for infrastructure investment in the hope of getting support from the central government, which must be ratified by the NPC and makes the coming NPC session so important. The Central government has also accelerated approval of projects in the pipeline, especially focusing on railway and subway construction. Spending on automobiles is particularly encouraged with the aim of boosting the sector and its related supply chain. Housing market policies have been discarded as a form of stimulus after recent experience stirred asset bubbles and unsustainable household debt levels.

Lastly, let us bring to your attention the newly pledged reform of strengthening the market's role in the allocation of factors of production, including land, capital, labour, technology and, innovatively, data. The detail and implementation of these is unquestionably crucial, but the statement is enormously important as well, showing policy makers' determination to stay the course of reform and open-up in spite of growing protectionism, intensifying technology embargoes and rising political prejudice.

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