All Signal, No Noise

MARKET ANALYSIS

MNI Market Analysis: Fundamentals Pricing In ‘Cheaper’ CNY

21 April 2022, Yvan Berthoux

Executive summary

- **The last few days have seen significant moves in the CNY, with USDCNY breaking above the key topside 200DMA and finding resistance at the 6.45 level.**
- **While CNY had first benefited from ‘safe-haven flows’ following the Ukraine invasion, fundamentals are currently showing that the risk reward remains biased towards CNY weakness in the medium term.**

USDCNY Breaks Above 200DMA Resistance

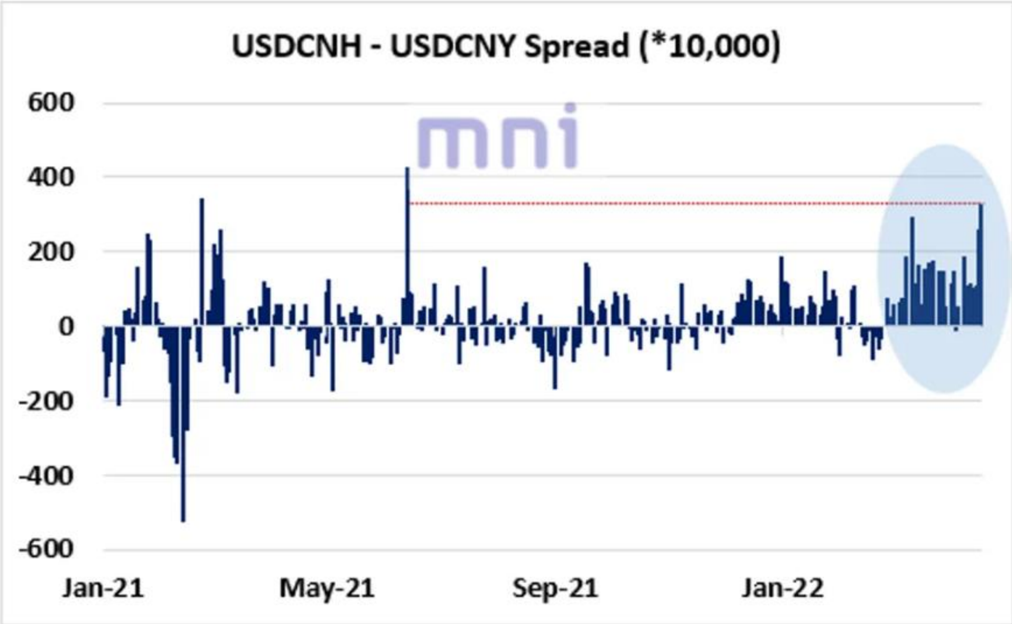
The last few days were marked by some significant moves in the CNY, with USDCNY breaking above the key 200DMA before finding resistance at the 6.45 level. Figure 1 shows that 200DMA has historically acted as a strong resistance; therefore, the bull trend could extend further in the near term following the recent breakout.

Figure 1: USD/CNY

Source: Bloomberg/MNI

We have seen that the CNY weakness has been mainly driven by the increase in selling pressure on the offshore yuan rather than the PBoC fixing (figure 2). According to a former SAFE official (article from MNI Policy team, see appendix), the CNH weakness is a sign that foreign investors are starting to sell their Chinese assets and the tighter policy in the West could continue to lead to portfolio outflows and further CNH depreciation in the medium term.

Figure 2: USDCNH – USDCNY Spread



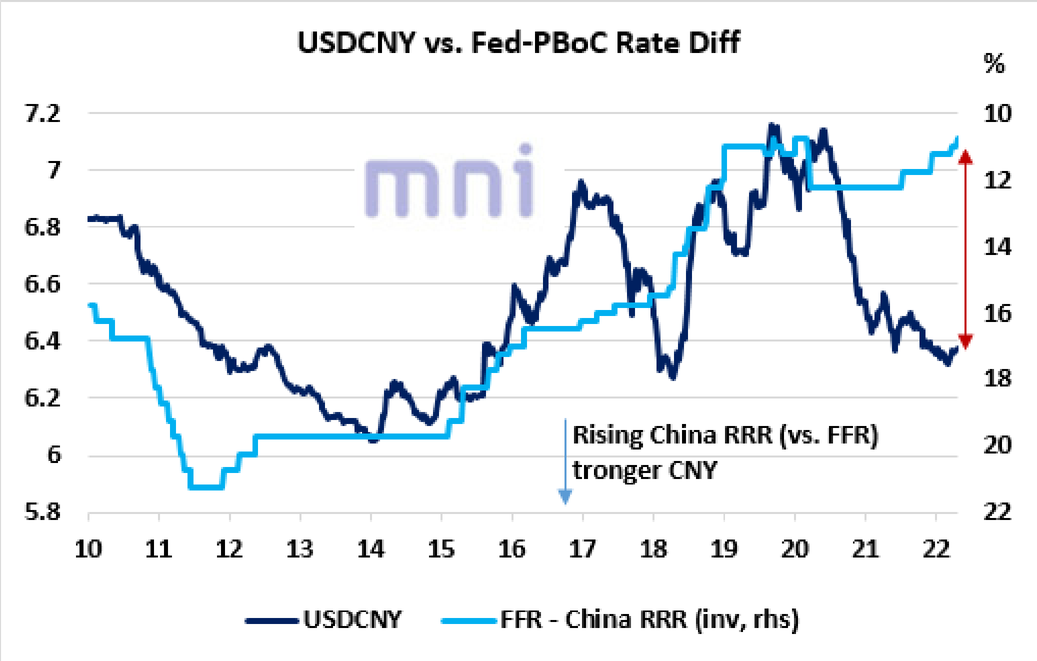
Source: Bloomberg/MNI

So far, 'fundamentals' have been pricing in a weaker CNY in the medium term

For instance, the differential between China's Reserve Requirement Ratio and the US Fed Funds Rate has been pricing in a higher USDCNY exchange rate (i.e. 'cheaper' CNY, figure 3. The PBoC most recently announced a 25bps cut in the RRR over the weekend (as expected), lowering the required reserve ratio for all financial institutions to 11.25%, lowest level since May 2007 (effective from April 25).

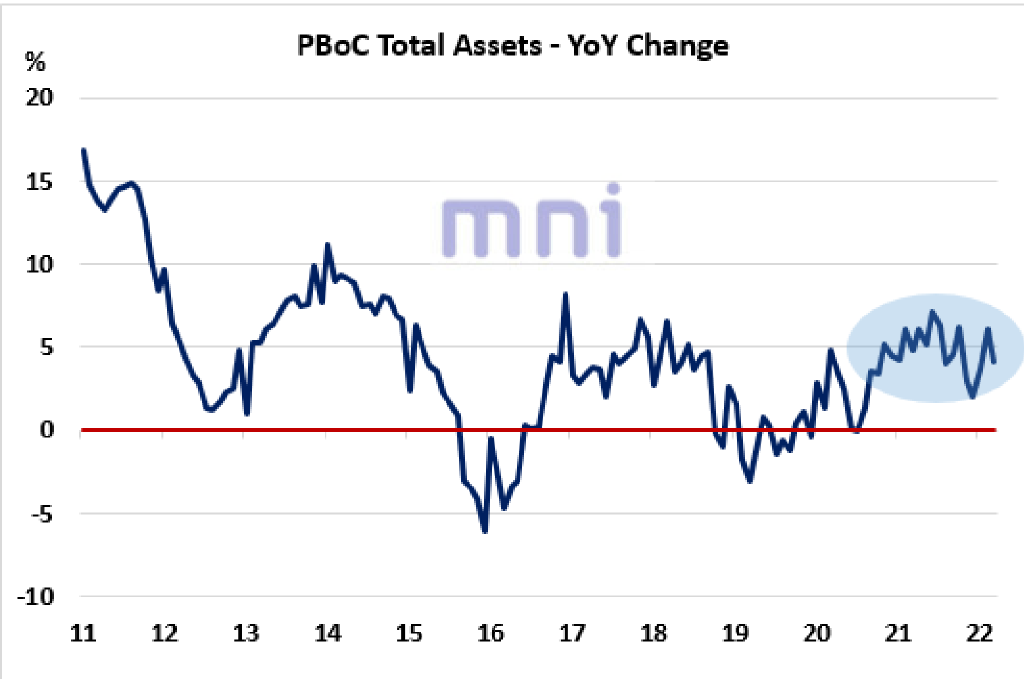
In addition, we have seen that the PBoC keeps expanding the size of its balance sheet at a pace of 5% YoY (figure 4), while the Fed ended POMO purchases last month, leading to a bounce in the PBoC-Fed assets differential (figure 5).

Figure 3: USDCNY vs. Fed-PBoC Policy Differential



Source: Bloomberg/MNI

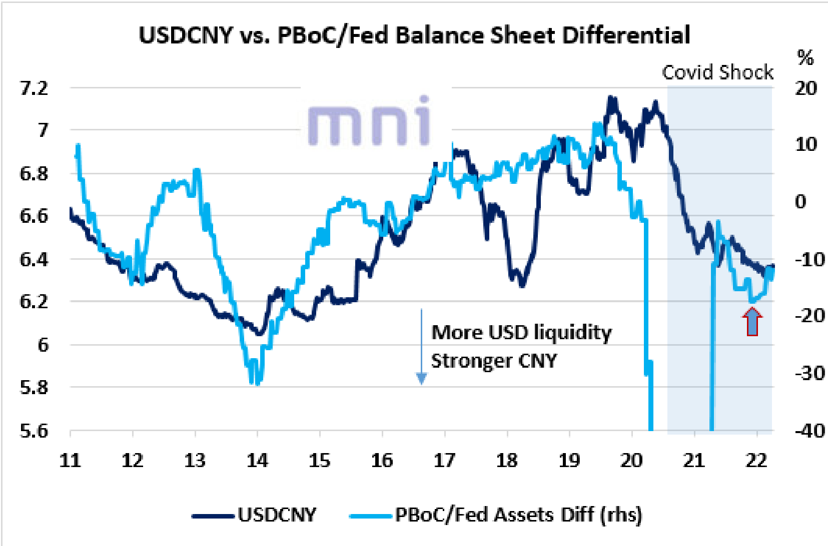
Figure 4: PBoC Total Assets



Source: Bloomberg/MNI

Figure 5 shows that balance sheet assets differential has been a major drive of exchange rates in the past cycle.

Figure 5: USD/CNY vs. PBoC/Fed Balance Sheet Differential



Source: Bloomberg/MNI

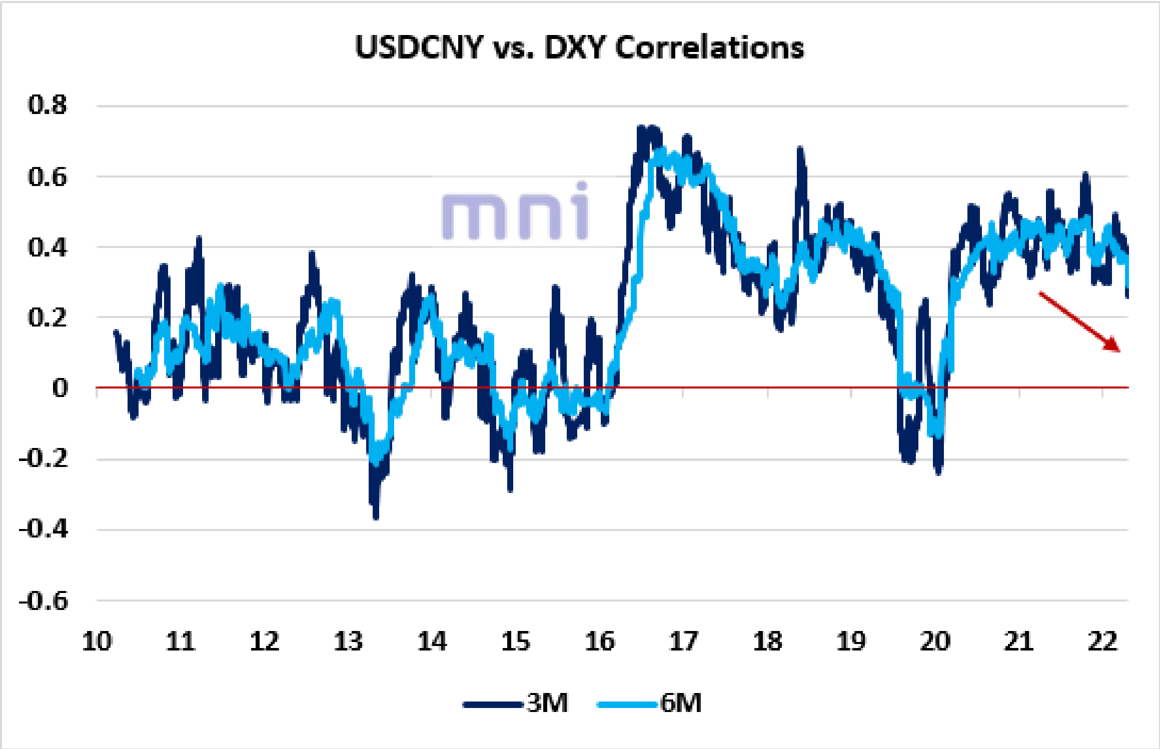
Moreover, as the China 10Y bond premium has now completely 'vanished' (following the sharp increase in US LT bond yields), interest from CNY carry traders has fallen, therefore also pressuring CNY to the downside in the medium term. Figure 6 shows that the 10Y interest rate differential (between US and China) has smoothly led the exchange rate by 12 months.

Figure 6: USD/CNY vs. US/CH Rate Differentials

Source: Bloomberg/MNI

Correlations between USDCNY and 'broad' DXY (daily returns) could continue to fall in the medium term with CNY becoming less sensitive to USD moves (figure 7). Most of the USD weakness post Covid has been reflected in the USDCNY exchange rate; however, the dynamics could change through the rest of the year with CNY gradually weakening even if the USD stabilizes.

Figure 7: 3M, 6M USDCNY / DXY Correlation



Source: Bloomberg/MNI

CNYJPY Approaching 1993 Highs, a problem for China's competitiveness?

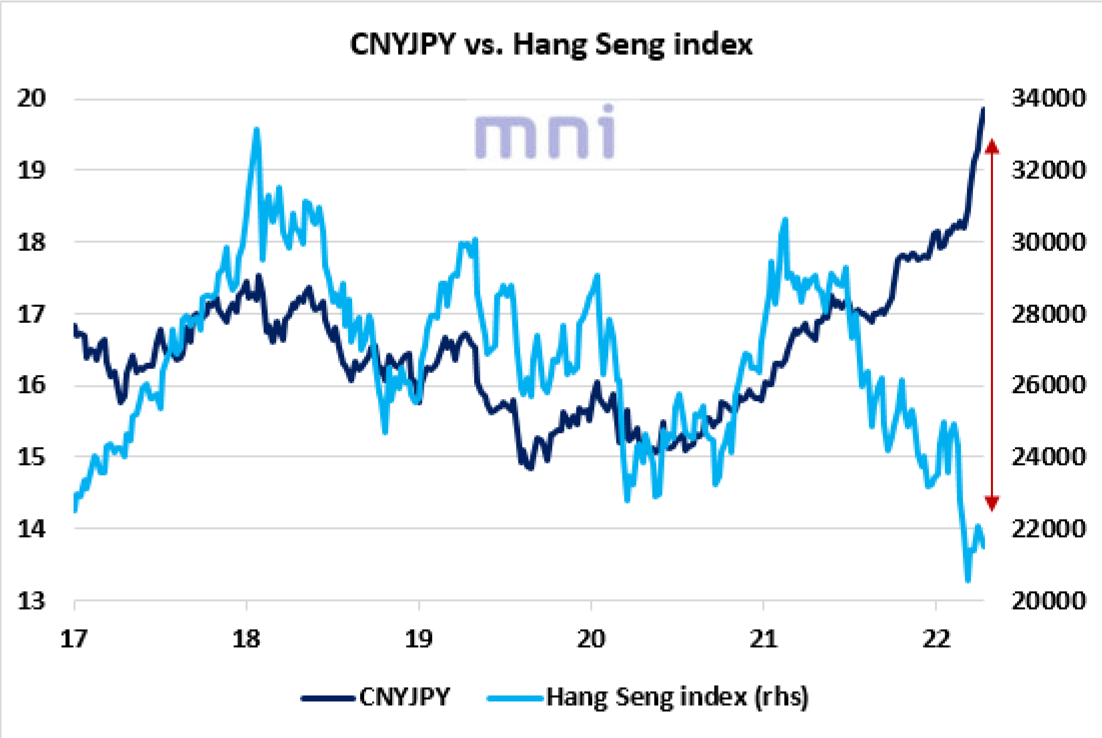
Another interesting observation has been the surge in the CNYJPY cross rate amid the sharp JPY depreciation in recent weeks following BoJ dovish comments. The pair is approaching its key resistance at 20.2850 (figure 8); a break above that level would bring us to early 1993 highs. It is clear that the tightening in financial conditions via the exchange rate channel will matter at some point for China, which is losing 'competitiveness' against Japan amid stronger exchange rate.

Figure 8: CNY/JPY

Source: Bloomberg

CNYJPY has also been diverging significantly from the Hang Seng Index in the past year as the global risk off, the significant deceleration in the domestic economy and the government's crackdown on a range of industries have been weighing on risky assets. CNYJPY and Hang Seng Index have historically shown strong co-movement; periods of appreciating CNY (relative to JPY) have been associated with trending equities and vice versa.

Figure 9



Source: Bloomberg

Appendix

MNI INTERVIEW: CNH Signals Capital Outflows - Ex SAFE Official

BEIJING - The recent underperformance of the offshore yuan is a sign that foreign investors are beginning to sell Chinese assets, a former senior official at the country's foreign exchange administration told MNI, adding that there is a danger that portfolio outflows could weaken the currency if western central banks tighten monetary policy more abruptly than expected.

The offshore CNH rate has closed lower than the onshore CNY every day since the beginning of March, with the spread between the two hitting 360 pips last Friday, the highest since June 2021 in a sign that overseas investors could be selling mainland Chinese assets and exchanging the proceeds for dollars in Hong Kong, said Guan Tao, a former director general of Balance of Payments at SAFE.

This month's yuan depreciation has been mainly driven by CNH weakness, rather than led by the CNY fixing set by the PBOC, he noted.

The currency could come under more pressure, together with the country's equity and bond markets, and perhaps even reverse its rally since 2020 if the Federal Reserve and the European Central Bank surprise markets with their pace of tightening, said Guan, now global chief economist at BOC International. About 70% of the net CNY10.8 trillion of yuan-denominated assets held by foreign investors are stocks and bonds, he said.

TRADE SURPLUS SEEN LOWER

The Mainland China-Hong Kong Stock Connect scheme has seen CNY50.7 billion in capital outflows in six consecutive trading days since March 7, including CNY14.4 billion on March 14, the most since Jan. 27, according to financial data provider Wind. Overseas investors also cut Chinese bond holdings by CNY67 billion in February, the first such reduction since November 2018, according to China Central Depository and Clearing Co. Ltd.

Other factors supporting the yuan may also change, including China's large recent trade surplus, said Guan, adding that Chinese exporters may also be holding on to more of their foreign exchange earnings in order to hedge FX risk. China's banks sold a net USD27.8 billion worth of yuan in January, almost half the USD46 billion in December and versus USD40.8 billion last January, according to SAFE data.

The yield spread between 10-year Chinese-government bonds and equivalent U.S. Treasuries is likely to further narrow from about 70 bps currently, falling out of the 80-100 bps "comfort range," said Guan.

But Fed tightening in line with market expectations should produce moderate capital outflows and only healthy two-way yuan trading, Guan said. China's private sector external liabilities fell by USD1 trillion to the end of September, compared with June 2015, equivalent to a manageable 8% of gross domestic product, he said.

Some yuan strengthening in February was prompted by Russian investors reacting to sanctions, but the currency is still not a safe haven asset on the level of the dollar or the yen, Guan said.

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