

MNI Market Analysis: Stagflation Risks Surging in Asia, CNY Weakness Weighing on Asia FX

5 May 2022, Yvan Berthoux

Executive summary

- We saw that inflation has started to surprise positively also in Asia/ SE Asia after remaining 'quite low' in 2021, which could push policymakers to adopt a more hawkish stance to avoid political uncertainty and social unrests.
- With inflation expected to remain elevated in EM economies and the economic activity expected to decelerate, stagflation concerns have been surging. Historically, stagflation has been the worst environment for equities.
- CNY weakness also leaves EM FX (especially Asia FX) vulnerable in the near term.

RBI kickstarts tightening cycle after two years of status quo

On Wednesday this week, the Reserve Bank of India unexpectedly raised its repo rate by 40bps, announcing the start of a tightening cycle after nearly two years of status quo. Even though it seemed like a surprise for market, inflationary pressures have started to pick up since the start of the year, with CPI breaking above the 6% RBI upper band (figure 1). As a reminder, the RBI cut its policy rate by 115bps to 4% following the Covid19 shock and left interest rates unchanged to stimulate the economic recovery as CPI inflation had remained within the RBI range band (2 - 6%) until recently.

However, the new inflation shock generated by the Ukraine war combined with the renewed global supply disruption amid strict lockdown policies imposed by the Chinese governments have led to a resurgence in inflation in recent months.

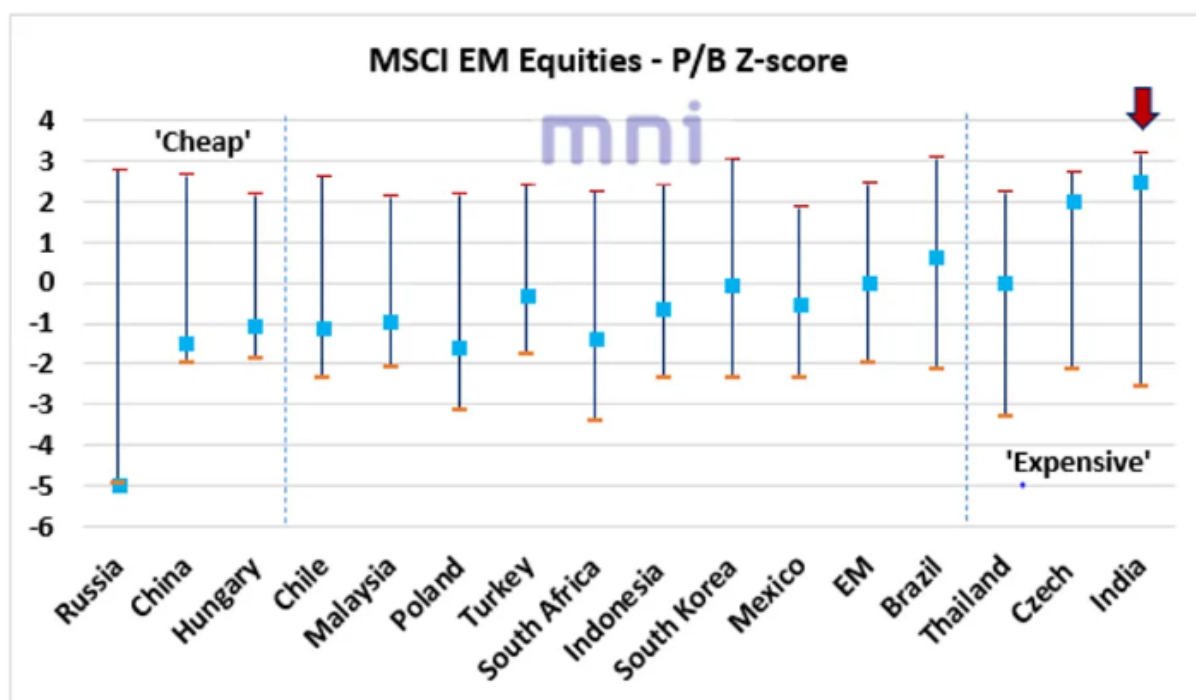
Equities have been trending lower following the decision, registering their biggest correction since February (Ukraine invasion shock). Even though the NIFTY index is trading over 10% below its all-time high reached in October 2021, India remains the most expensive market among the EM world according to a range of 'value' metrics. For instance, the chart below ranks EM equity market using a P/B z-score approach (using data since January 2010).

Figure 1



Source: Bloomberg/MNI

Figure 2

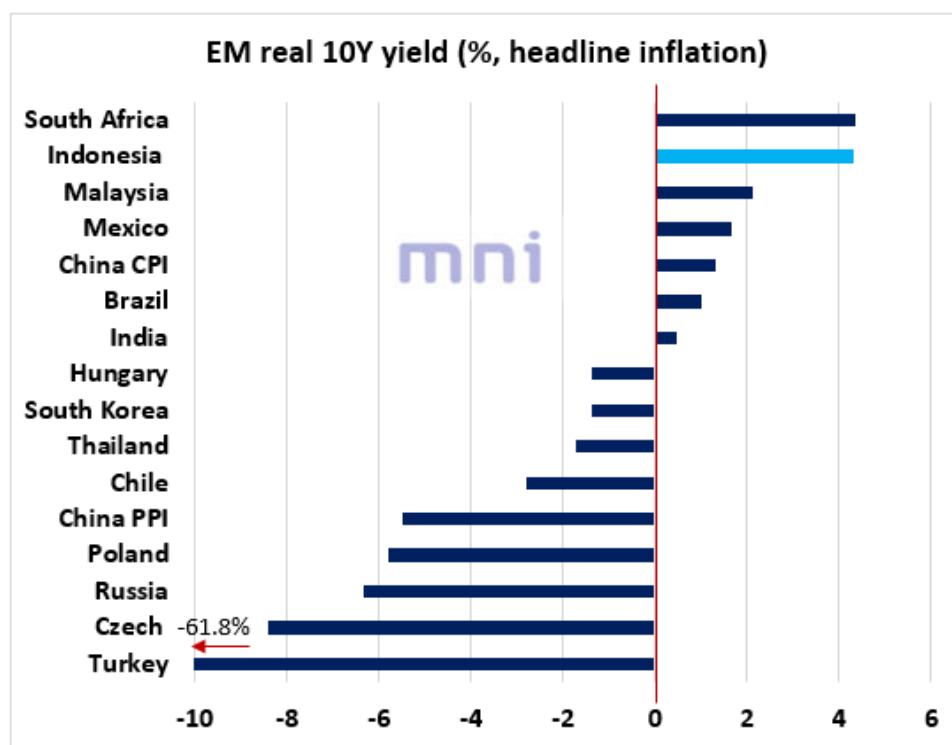


Source: Bloomberg/MNI

We saw that inflation has started to surprise positively also in Asia/ SE Asia after remaining 'quite low' in 2021, which could push policymakers to adopt a more hawkish stance to avoid political uncertainty and social unrest. CPI inflation surged above the central bank's upper band in Thailand and Philippines and has started to accelerate in Indonesia and Vietnam (still within the central bank target range).

Indonesia still offers the highest 10Y real yield among the EM world (+4.3%, long with South Africa) even though inflationary pressures have started to accelerate in recent months (figure 3).

Figure 3



China: we also use PPI for China as it shows stronger relationship with the 10Y yield*

Source: Bloomberg/MNI

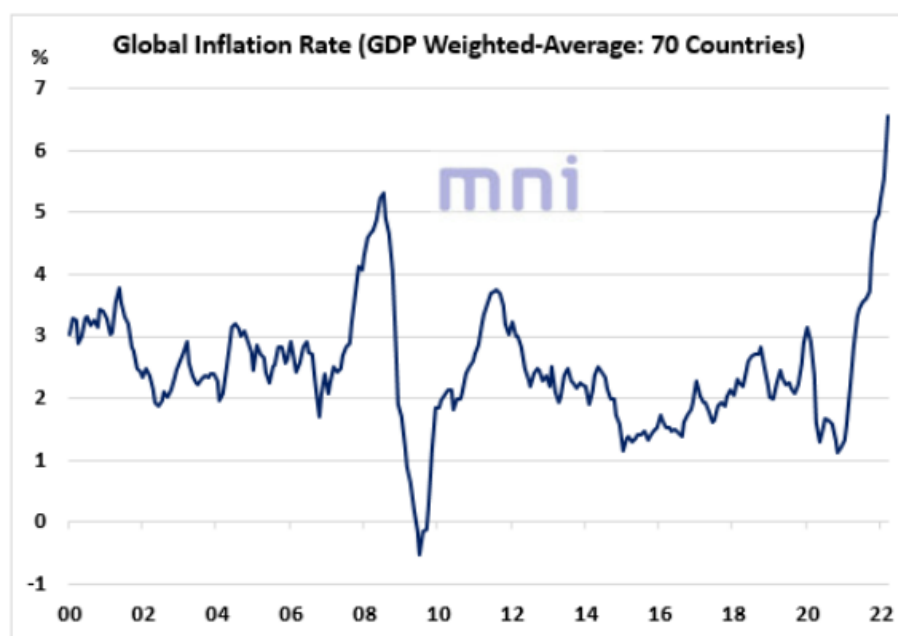
Stagflation risks surging in EM, historically negative for stocks

Our global inflation gauge rose to a new high of 6.5% in March (based on the inflation rate of 70 DM and EM countries) after breaking above its 5.3% peak reached just before the 2008 Global Financial Crisis last month (figure 4).

With inflation expected to remain elevated in EM economies and the economic activity expected to decelerate (some analysts argue that recession risks have increased considerably in the past two months), stagflation concerns have been surging. Historically, stagflation has been the worst environment for equities.

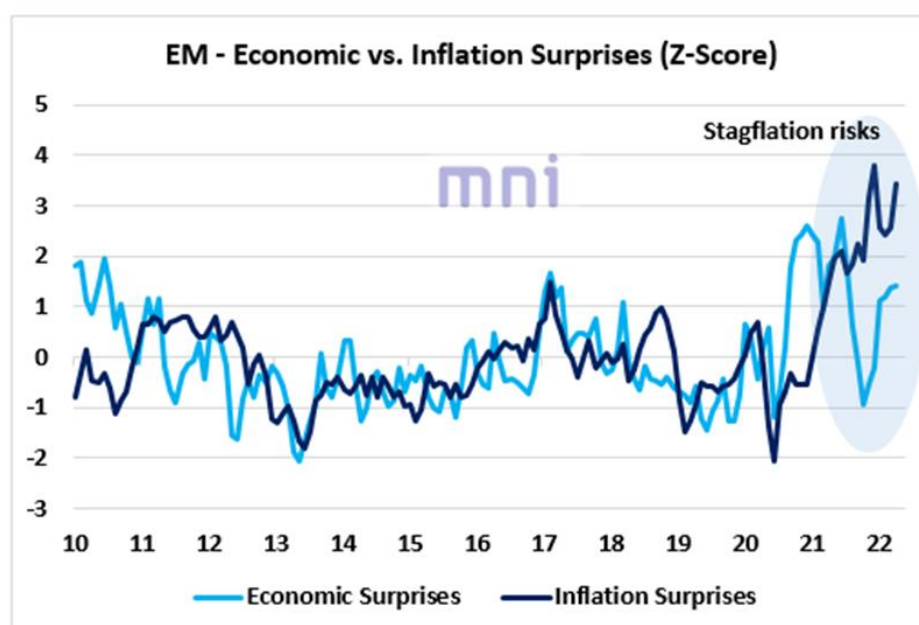
The Ukraine war shock combined with the supply chain disruptions caused by the severe lockdown policies imposed by Chinese officials are likely to continue to support inflation in the SE Asia region in the medium term.

Figure 4



Source: Bloomberg/MNI

Figure 5



Source: Bloomberg/MNI

CNY weakness weighs on EM Currencies

The recent CNY weakness has been weighing on EM currencies in recent weeks. The chart below shows that all EM currencies are down since the start of the CNY depreciation in mid-April (to the exception of the RUB).

At the bottom, we find Latam currencies and risk-on ZAR. EM FX have historically been sensitive to periods of significant CNY depreciation as FM portfolio managers reassess their risk when implied vol on the yuan surged following the August 2015 'CNY devaluation' that generated a market shock (SP500 was down 10% following that event).

Figure 6



Source: Bloomberg

USDCNY is up over 4% in the past three weeks and broke above the 6.64 support last Friday, which represents 38.2% Fibon retracement of the 6.307 – 7.1780 range. Next level to watch on the topside stands at 6.70 (Nov 2020 highs).

Figure 7



Source: Bloomberg

Further weakness in CNY will continue to weigh on the rest of the Asian currencies. The chart below shows that the ADXY (heavy in CNY) has maintained its LT bearish trend of the past cycle, not showing a great outlook for Asia currencies.

Figure 8

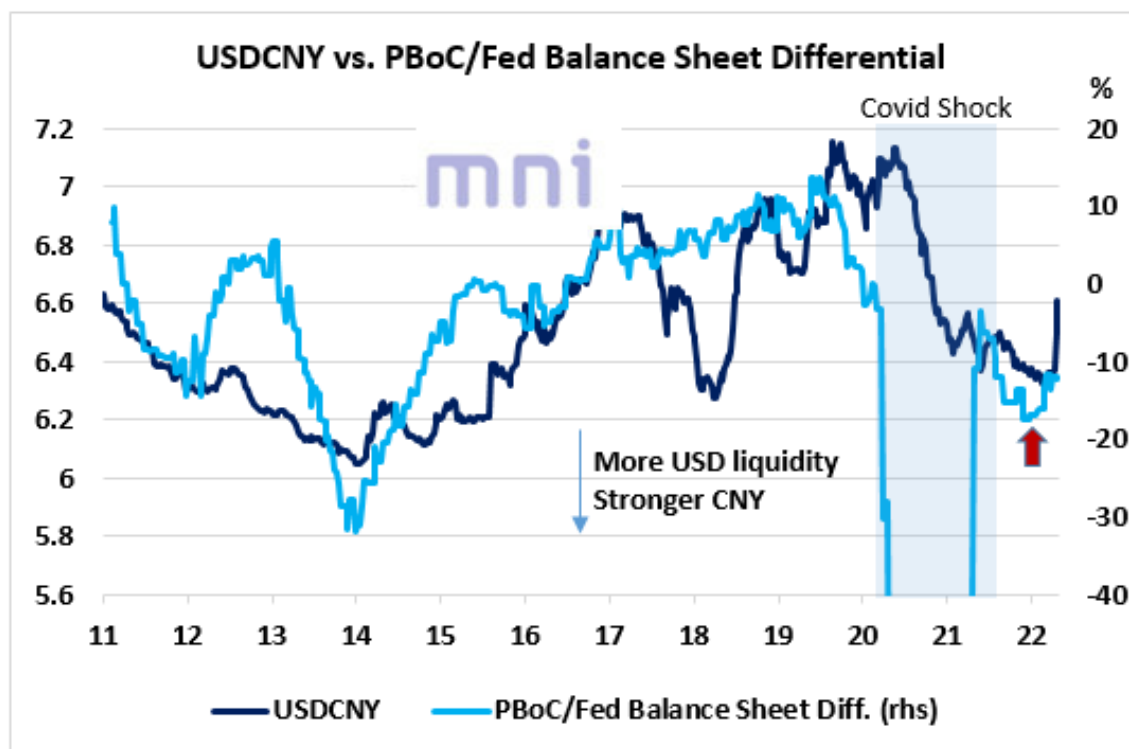


Source: Bloomberg/MNI

More CNY weakness to come?

MP divergence could continue to support USDCNY in the medium term, particularly if the Fed starts to wind down its balance sheet while PBoC keeps expanding it in the coming months. Figure 9 shows that the central banks' balance sheet asset differential has been an important driver of currencies in the past cycle.

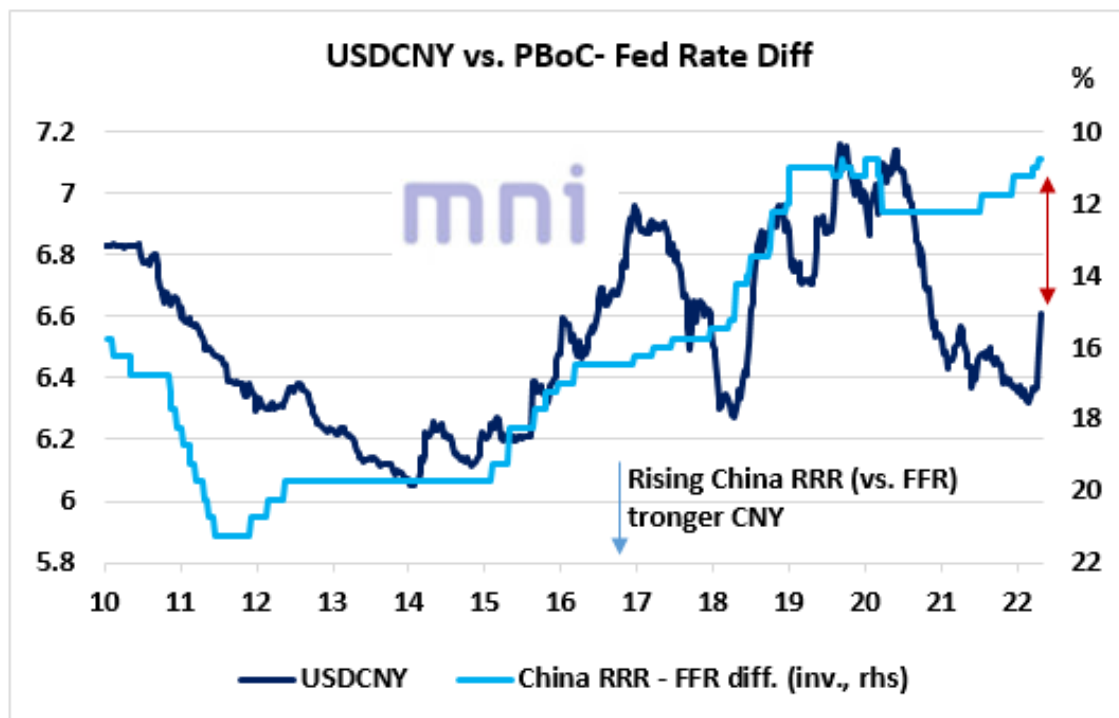
Figure 9



Source: Bloomberg/MN

Falling IR differential between China RRR and US FFR (figure 10) are also pricing in higher USDCNY (i.e. cheaper CNY).

Figure 10



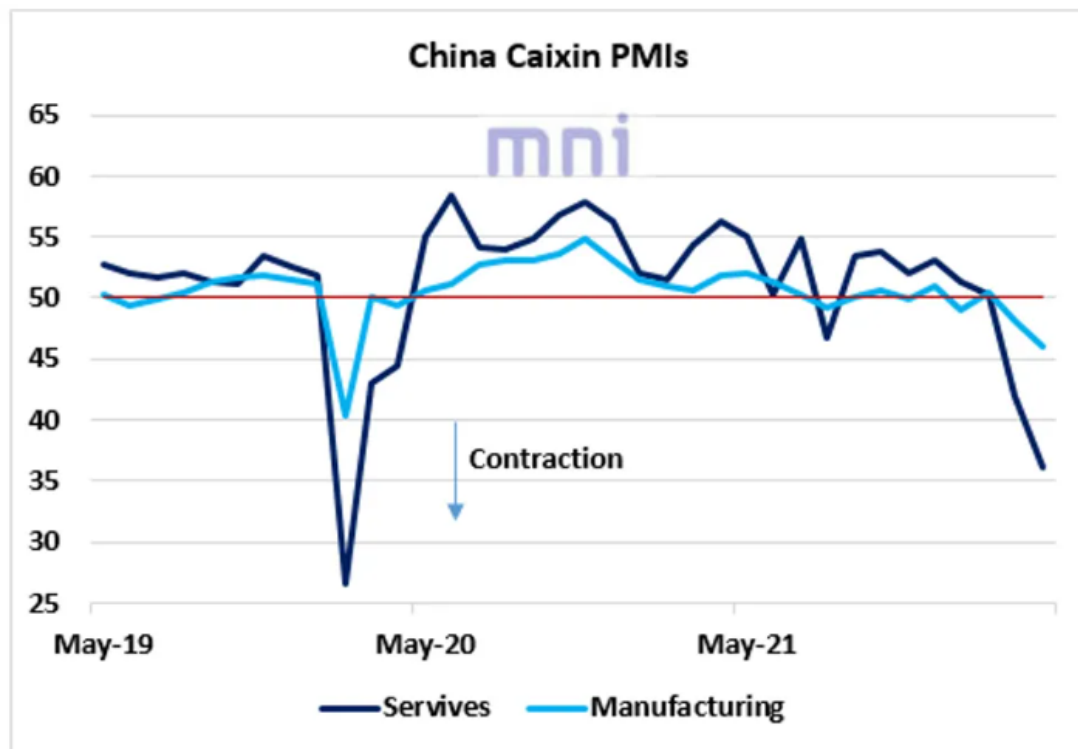
Source: Bloomberg/MNI

Investors' skepticism rising over China 2022 growth target of 5.0 - 5.5%.

Fundamentals continue to deteriorate in China, with China Caixin PMI services plunging to 36.2 overnight (significantly below expectations of 40), its lowest level since February 2020, down from 42 the previous month. This follows the downtick in manufacturing PMI last week, which fell to 46 (vs. 47 exp), raising investors' concerns over China's GDP growth target of 5%-5.5%.

The economic costs of the strict lockdown policies imposed by the government in recent weeks have been surging, forcing Chinese officials to send more easing signals to stimulate both the real economic activity and domestic risky assets. A number of sell-side firms have been revising their 2022 growth forecasts significantly lower. For instance, Fitch recently cut its growth forecast to 4.3% YoY, down from 4.8% previously.

Figure 11



Source: Bloomberg/MNI

We have seen lately that China officials have been introducing a series of measures to rebuild confidence on the equity market: crackdown on 'malicious short sellers', cutting A-share stock transaction fee, pausing on the campaign against tech companies.

However, China equities remain fragile in the short term; Hang Seng index is still down over 30% from its high reached in February 2021, which also corresponds to the peak in the Chinese economic activity.

HSI index has been testing its 21,287.60 resistance in the past week, which corresponds to the 23.6% Fibo retracement of the 18,235.50 – 31,168.30 range. In addition, the bearish sentiment in US equities in recent months and the global risk off environment are also not helping China risky assets at the moment.

Figure 12



Source: Bloomberg/MNI

Hence, the rebound in 'liquidity' since the start of the year may not be enough to stimulate liquidity-sensitive sectors such as tech equities (figure 13).

Figure 13



Source: Bloomberg/MNI

Another challenging time for HKD?

USDHKD has been rising sharply since the start of the year, with the pair currently trading slightly below the high of its range band at 7.85 (chart below). The last time the pair tested the upper band was in 2018/2019 as HK protests in addition to the Sino-US trade spat spurred capital flight and increased pressure on HKMA to maintain the 'peg'. This time, pressure has stemmed from the strong divergence in monetary policy between Hong Kong and the US.

HK generally has to mirror Fed policy in order to ease the pressure on the USDHKD 'peg'.

In addition, economic data showed this week that economic growth contracted significantly more than expected in Q1 by 4% YoY (vs. -1.3% exp.), down from +4.8% in Q4 2021, as 'Zero-Covid' policy has been strongly weighing on growth expectations (for both Hong Kong and mainland China).

Strong support for the USD has also been constantly on the rise this year amid 'hawkish' Fed tone and surging geopolitical uncertainty. Will the HKMA be able to preserve the 'USDHKD' and keep a loose policy to stimulate the economy?

Figure 14



Source: Bloomberg/MNI

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