Macro Hive Pro: EM Focus: New Trade – Short CNH vs Basket

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Summary

- We remain pessimistic about Chinese assets due to a fundamental mismatch in aggregate demand and supply, which authorities are failing to resolve.
- PBoC will prevent outright FX devaluation. But a gradual weakening vs basket may be more acceptable.

Market Implications

- We expect the CFETS to fall from the current level of 98.15 to 95, a pre-covid average, in the next 3 months.
- **We buy IDR (30%), KRW (30%), SGD (30%), BRL (10%) funded out of CNH, targeting a return of 4%, with a stop loss of 2%.**

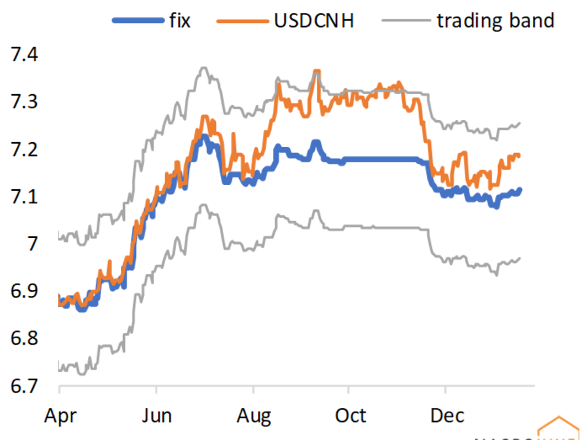
RMB Is Under Pressure Again

Thanks to the Fed's pivot, depreciation pressure on the RMB eased in December. FX settlement data showed much smaller capital outflows over the period, and USDCNY traded down to central parity of the band.

The relief rally now appears over. USDCNY spot has started to drift higher in the daily band. The daily fixing 'bias' – the gap between the market estimate of the fixing and the official one – is widening again.

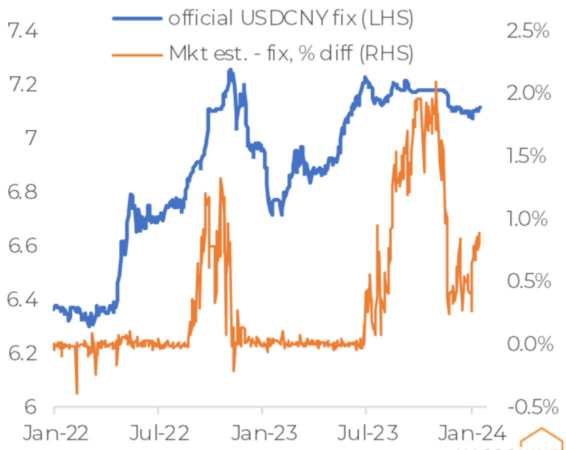
Absent clear policy guidance on how the government will support growth in 2024, both domestic and foreign investors are again becoming impatient. The CSI 300, a sentiment gauge, has fallen to a five-year low. In the first two trading weeks, foreign investors withdrew RMB 3bn from the onshore equity market, compared with a RMB 13bn outflow in November and a RMB 2bn outflow in December.

Chart 1: USDCNY Spot Drifting Higher in Band



Source: Macro Hive

Chart 2: Daily 'Fixing Bias Widening Again



Source: Macro Hive

Deflation Becoming Entrenched

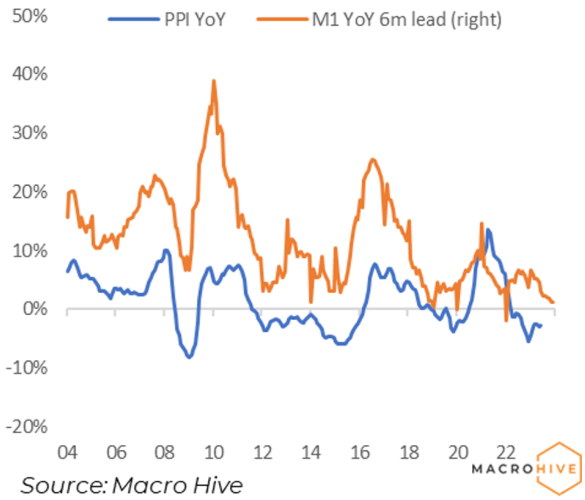
Meanwhile, the latest inflation data shows the lowest CPI print (0.2%) since 2010 and the lowest PPI print (-3%) since 2016. The December M1 YoY growth rate dropped to 1.3%, the lowest level outside January months. This indicates no recovery of PPI going forward. Historically, the M1 YoY growth rate is a good leading indicator for the PPI six months ahead (Chart 3).

Investors are waiting for Shanghai's 'two sessions', to be held 23-26 January, to get a glimpse of how ambitious the 2024 growth target will be for the nation. Historically, the growth targets set by Shanghai and Beijing have been a good guide to the national target.

Unfortunately, an ambitious growth target will not help the country escape deflation. Demand-side measures like easing rules on the property sector have failed to lift consumer demand, while the supply-side push for the 'three new industries' (EVs, batteries and renewables) and infrastructure investment has been more effective. Consequently, even as headline growth appears stable, the imbalance between aggregate demand and supply is deteriorating.

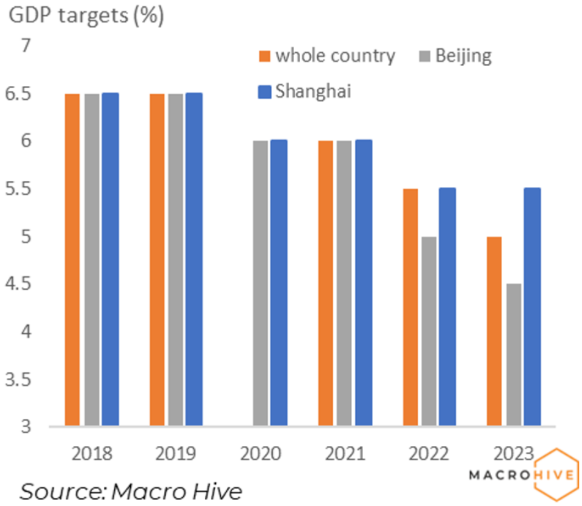
Moreover, the unresolved issue of local government debt and slowing global growth are further complicating the return of inflation to positive territory.

Chart 3: China PPI YoY vs M1 YoY (6m lead)



Source: Macro Hive

Chart 4: Regional and National Growth Target



Source: Macro Hive

Short CNH vs Basket

Despite the threat of deflation, the PBoC has followed a cautious approach on rate cuts to protect the banks' interest rate margin and prevent capital flight. This week, the PBoC kept the MLF rate unchanged at 2.5% despite market consensus for a 10bp cut. China's current political climate allows the central bank very little leeway to contemplate bold action against deflation.

As such, we expect PBoC will continue to manage the FX rate, and USDCNH will trade in line with its beta to the USD. However, CNH will underperform other EM currencies. We think the CFETS index could fall from the current level of 98.15 to 95, roughly its pre-covid level.

Trade: We go short CNH vs long a basket of IDR (30%), SGD (30%), KRW (30%) and BRL (10%).

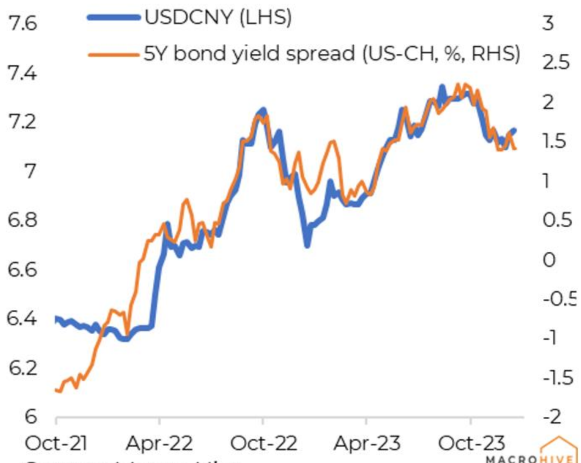
We set a return target of 4% and a stop loss of 2% from entry. The trade has positive carry of 2.5% annualized.

The 3m fwd ref rates are: USDCNH 7.1717, USDSGD 1.340, USDKRW 1334, and USDBRL 4.95.

Chart 6 below shows our proxy trade basket vs the official CFETS RMB Index.

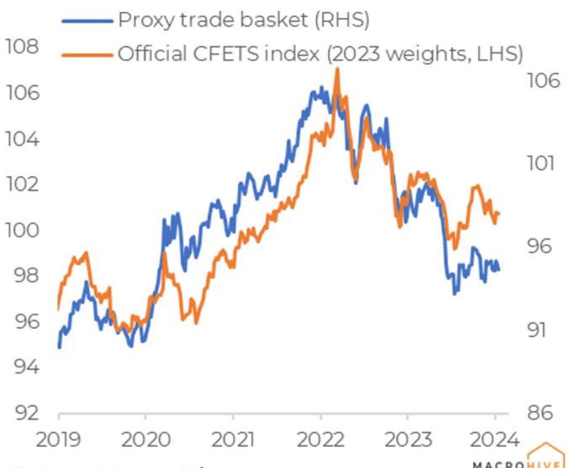
Due to the defensive nature of the CNH, our portfolio has a slightly negative correlation with the DXY (-0.24). The risk of our trade is thus a rapid deterioration of the global risk sentiment, or a sharp rise in the US dollar.

Chart 5: USDCNY vs 5Y US-CH Bond Yield Differential



Source: Macro Hive

Chart 6: CNY CFETS vs MH Proxy Trade Basket



Source: Macro Hive

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