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Global

RMB Watch

Bears Taking Over

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Key View:

- Two sessions eyed and plenty of stimulus expected. Quota for special bonds issuance likely to be ramped up for local governments after much of it has been utilized and special treasury bonds (tapped on only twice in history) will be issued. Fiscal deficit ratio could increase from the 2.8% target last year to estimates around 3.5%, breaching the usual limit of 3.0%. Further fiscal deterioration normally coincides with broadly weaker RMB in the medium term.

- US-China tensions could keep RMB on the backfoot. PBoC could blunt the trauma via the daily USDCNY fixes. However, corporate actions are not likely to be as widely impacting as tariff actions. As such, RMB weakness is likely to be correspondingly smaller than what was seen in 2018/19 trade war, cushioned also by the more benign USD and US rates environment.

- We included the above risk premium into our forecasts and we look for USDCNY to head towards 7.20-25 by year end. We do not rule out a test of the Aug 2019 high at 7.1965 in the near-term.

What We Watch:

- 1Y and 5Y LPR settings on 20th.

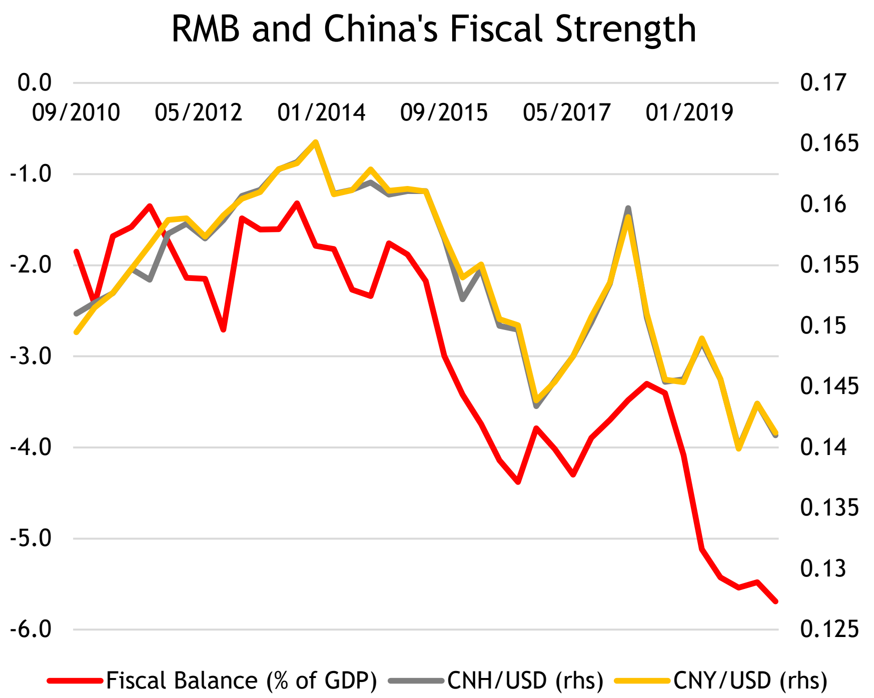
- NPC and CPPCC on 22nd and 21st May.

- Industrial Profits for Apr on 27th May, PMI prints from NBS on 31st May, Caixin PMI Mfg on 1st Jun.

Two Sessions Eyed: CPPCC and NPC

Eyes are on third plenary session of the 13th National People Congress on 22nd May. The CPPCC (Chinese People's Political Consultative Conference) top political advisory body will be held on 21 May. The two conventions are known as the Two Sessions, scheduled to be held on 5 Mar (in line with its regular annual schedule) but delayed this year due to the coronavirus.

China's Fiscal Position matters in broad Trends of the RMB



Source: CEIC, Ministry of Finance, NBS, Bloomberg, Maybank FX Research & Strategy

There are a few expectations from the Two Sessions this year and widely watched are the major stimulus plans and higher fiscal deficit ratio.

Fiscal Stimulus Via Special Bonds Issuance

The trade war weakened China's fiscal position in 2019 as the government already introduced a record scale of tax cuts and fee reductions (exceeding CNY2trn). Earlier in Apr, the Finance Ministry had already directed local governments to find projects and prepare for bond issuance by end May in order to further boost demand. NPC is likely to approve an increase in the special purpose bond quota from the current CNY1.29trn cap already reached. In addition, the NPC is expected to provide the approval for the issuance of special treasury bond - widely expected and rarely used (twice in history). The special treasury bonds is off budget and provides greater ammunition for the government. Fiscal deficit was targeted to be at 2.8% of GDP but this year, it could be raised to estimates around 3.5% for this year, breaching the usual limit of 3.0%.

The above chart suggests that while the correlation between the RMB and China's fiscal position is not perfect, its fiscal performance could still affect the broad trend of the CNY in the medium term. The pressure on the CNY is thus likely to remain south bound.

More Monetary Easing

Apart from more fiscal spending, we anticipate monetary policy to ease further on all fronts beyond the NPC. We anticipate the next cut to be around 10bps that would be guidance for both 1Y and 5Y LPR. That would be heralded by the 7day reverse repo rates as well as the next MLF offered. In its recent quarterly report, PBoC had pledged "more powerful" policies to overcome economic challenges. The omission of the phrase "will avoid excess liquidity flooding the economy" suggests that deleveraging has dropped in priority and demand support is even more pertinent. We see potential for more allowance for cuts in the 5Y LPR as opposed to the previous cuts which lagged the 1Y. 5Y LPR are tied to mortgage rates while 1Y LPR are rates offered to best corporate clients by 18 banks surveyed.

Forsaking the Growth Target for 2020

With IMF already projecting a -3% contraction in the global economy for 2020 due to pandemic that has led to The Great Lockdown, it is hard for China to set a growth target at all for 2020. Along with the release of the recent surveyed jobless rate at 6.0% (vs. prev. 5.9%), NBS warned of "challenges in the unemployment". This suggests an emphasis on supporting domestic demand as well as providing support for job creation and mitigating job losses. NBS' comments suggest a likely crawl higher in jobless rate especially in the face of 8.74 mn of higher education students that will graduate in 2020. The lack of employment could affect household spending. Retail sales have been underperforming consensus. Recent print of -7.5% was worse than the expected -6.0%, well underscoring the fact that private consumption remains tepid amid mounting financial uncertainties. Partial lockdowns in certain places like Jilin due to new clusters of the coronavirus does not help consumer sentiment in the least.

US-China Conflict Continues

US and China stepped up on conflict over the past week.

1. On 11 May, the Trump administration sent a letter to Labor Secretary Eugene Scalia, to block investment flows from a pension fund (Thrift Savings Plan) into Chinese equities. As a result, the Federal Retirement Thrift Investment Board voted unanimously on 13 May to stop its original plan to shift the I Fund (which enables exposure to foreign equities) benchmark to the MSCI ACWI ex US Investible Market Index that consists of about 8% Chinese companies as of 30 Sep. As of Dec 31, TSP I Fund had $54.3bn in assets.

2. On 15 May, the Bureau of Industry and Security has amended its rules on foreign-produced direct product rule and the Entity List to ensure that Huawei is not able to manufacture semiconductors using US software and technology in foreign foundries without the approval of the Commerce Department. (more details and history, read the appendix at the end of the report). The rule amendment coincided with the announcement by TSMC to spend $12bn to build a chip plant in Arizona. The firm makes chips for Apple Inc. and Huawei but its factories are in Taiwan. According to sources cited by Bloomberg, TSMC had promised the administration to create employment in the US and produce sensitive components domestically for national security reasons. More recently, there have been reports by Nikkei that TSMC stopped accepting new orders from Huawei today (18th May). A representative of the firm dismissed it as market rumours. There were also reports that Huawei's HiSilicon Technologies have placed extra urgent orders of $700mn of around with TSMC according to Economic Daily News.

3. US Commerce Department extended the Temporary General License (TGL) which grants temporary authorized engagement in certain transactions, involving the export, re-export or transfer of items subject to the EAR to the Huawei entities by a *Final* 90 days. The Department warned that the TGL may be modified or possibly removed on 13 Aug 2020 and urged corporates and individuals to make provision and adjustments for that scenario.

4. On 15 May, China seems to have made an indirect threat to retaliate via the Global Times, a tabloid owned by People's Daily, a newspaper of the Chinese Communist Party. Based on unknown sources cited by the press, China can activate the "unreliable entity list" and restrict or investigate US companies such as Qualcomm, Cisco and Apple. Purchase of Boeing airplanes could also be suspended. This was also tweeted by its editor Hu Xijin.

Since US' scrutiny on Huawei, threats of retaliation on major US firms have been made before in the most intense phase of trade war in 2018-2019. Afterall, Huawei was added to the Entity List along with its affiliates a year ago and that list has expanded to 114 of Huawei's affiliates. The prospect of further deterioration in the US and China relation weakened the RMB but not as much as tariffs. That is probably due to the fact that tariffs have a much wider impact on demand vs. actions on specific corporates, huge and strategically damaging for the long term as they may be for country. That said, it is also worth noting that the US was in a much stronger position in 2019, fiscally and economically relative to the rest of the world, including China. At this point, the US had erased all jobs created in the past decade within a few weeks. Domestic demand would have collapsed if not for the Fed's seemingly bottomless support as well as gargantuan fiscal spending. The convergence of the US growth trajectory with the rest of the world suggests that the USD and US rates are less threatening than a year ago.

Now comes the question on how RMB would perform in 2020?

The verbal attack by the Trump administration on China seems to be an almost daily affair. However, the recent action on Huawei suggests their unwillingness to react via tariffs. As such, in line with our original conjecture, the US-China trade war is less likely to manifest further this year. We would not rule out an escalation in the trade war in 2021 but the direction that it takes depends on who wins at the US Presidential Elections Nov 2020. Trade war is more dramatic and Trump has made the trade war as his signature by calling himself the Tariff-Man. It is more likely that Joe Biden would confine attacks on China based on allegations of it being a threat to US national security. Both are unlikely to unwind tariffs on China for fear of being seen as soft on the "culprit of COVID-19". Till then, it is likely that much of the angst is to be directed elsewhere – Huawei by the US and US corporates including Apple, Cisco, Qualcomm and Boeing by China as mentioned recently. Most of these companies may have been adjusting to the US-China tensions for a while now. Even so, a follow through on actions by China on these corporates could still have a negative impact.

*For **Apple**, even as its important suppliers are Taiwanese companies including FoxConn, Winstron and Pegatron, most of their supplier locations are still in China. That said, in an interview with Reuters last Jun, a member of the FoxConn Board Liu Young-way assured that 25% of their production capacity is outside of China, enough capacity to meet Apple's demand in the US market.*

***Cisco** has around 15% of its product revenue share coming from Asia pacific, China and Japan (APJC). However, Cisco already suffered a 16% product revenue fall in 2019 in China, according to its financial statement, a reason for its weak 1% product revenue growth for the year coming from the APJC region that was offset by stronger revenue growth from Japan and India.*

***Boeing** has already had its share of orders from China declined during the trade war. Revenue from China based on Boeing's annual report fell almost 60% in 2019 vs. 2018. Revenue from China dropped from around 13% of total revenue for 2018 to just 7.4% in 2019.*

Impact on RMB is most likely via the sentiment channel first should China follow through. CNH and CNY would be most sensitive although currency trauma can be somewhat blunted (but not at all eliminated)

by PBoC via the daily reference rate fixes. Negative wealth effect from pullbacks in equities could mean safe haven bids could flock towards the USD and that provide some support for the greenback. Overall, there is definitely some risk that China would allow the CNY to weaken in 2H 2020 on the back of the trade war risks above materialising.

In the medium term, FDI flows could be hurt as pro-longed US-China tensions could discourage investors for fear of being impacted. That said, 2019 still marks as a strong year for China in terms of FDI growth despite the trade war. China was the second largest recipient of investment flows for 2019 according to the UNCTAD, after the US.

Taking into consideration the potential fiscal deterioration, the renewed tensions with the US, we like to include the risk premium into our forecast of USDCNY notwithstanding a more benign USD and US rates environment. We look for the pair to head towards 7.20-7.25 range for the end of the year.

In the near-term, we see USDCNH possibly testing Aug-2019 high of 7.1965. Another resistance at 7.2300. Support at 7.0970.

Appendix: More Restrictions on Huawei by the US

The US Commerce Department announced plans to restrict Huawei's ability to use US technology and software to design and manufacture its semiconductors abroad. With this, the Bureau of Industry and Security amends its foreign-produced direct product rule and the Entity List to target Huawei's acquisition of semiconductors that are direct product of certain US software and technology. The Department accused Huawei of using the US software and technology to design semiconductors, *"undermining the national security and foreign policy purposes of the Entity List by commissioning their production in overseas foundries using US equipment"*.

This rule change will make following foreign-produced items subject to the Export Administration Regulations (EAR):

(i) Items, such as semiconductor designs, when produced by Huawei and its affiliates on the Entity List (e.g., HiSilicon), that are the direct product of certain U.S. Commerce Control List (CCL) software and technology; and

(ii) Items, such as chipsets, when produced from the design specifications of Huawei or an affiliate on the Entity List (e.g., HiSilicon), that are the direct product of certain CCL semiconductor manufacturing equipment located outside the United States. Such foreign-produced items will only require a license when there is knowledge that they are destined for re-export, export from abroad, or transfer (in-country) to Huawei or any of its affiliates on the Entity List.

Background:

A year ago on 16 May 2019, the US Commerce Department added Huawei and 68 of its non-US affiliates to its "Entity List" which typically includes businesses, research institutions, governments and individuals that are deemed as national threats to the US. Companies that wish to sell products and software to these entities need to apply for a license from the Bureau of Industry and Security (an arm of the US Commerce Department) under the Export Administration Regulations (EAR). That said, licenses are unlikely to be granted.

Notably, the Temporary General Licence (TGL) which grants temporary authorized engagement in certain transactions, involving the export, re-export or transfer of items subject to the EAR to the Huawei entities have been extended by a Final 90 days. The TGL was first effective on 20 May 2019 and has been extended for a few times. According to the statement on the Commerce Department website, the terms of the existing TGL have been extended following comments received from numerous companies, associations and individuals about the TGL. The Department warned that "the activities authorized in the TGL may be revised and possibly eliminated after 13 Aug 2020)", urging for companies, individuals to consider the relevant impact such a scenario. They may also need to apply for relevant licenses for activities/transactions no longer authorized by the TGL then.

On 19 Aug, another 46 non-US affiliates of Huawei were added to the Entity List.

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