

FX Insight

CNH: Temporary Respite Against The USD

PBoC Seizes Opportunity To Punish Yuan Bears

In the absence of USD strength, PBoC seized the opportunity to squeeze offshore yuan liquidity right after they tightened capital controls in the past few days. Since this morning, we have seen the USDCNH and USDCNY recover partially from the sharp declines in the past two days ahead of the US NFP release. Still, the spread between the USDCNH and USDCNY widens as we write.

Expect More of Such Episodes This Year

The liquidity squeeze has happened before, one year ago when the yuan was also under pressure. The situation is different this year. Residents are gearing to utilize their annual FX quota (of US\$50,000) in a year of a rising USD and US rates as (we have written in our previous note). Capital outflow has been rising and FX reserves were spent to keep the yuan stable against the basket. The expectation for USD to strengthen further is a lot more than the past. That explains why ahead of the NFP release tonight, USDCNH and USDCNY have seen significant rebounds already. We continue to expect both pairs to head higher for the rest of the year but such recent episodes could happen again - PBoC could venture into the offshore market on and off to temper the momentum of yuan bears by increasing the funding cost such as what we have seen in the past two days.

Reforms, Financial Risks Mitigation Take Priority. Yuan Stability Needed

In a year of political leader transition, President Xi Jinping continues to push for reforms. PBoC aims to mitigate financial risks with neutral prudent monetary policy. There seems to be no room for bold FX experiments that we have seen in 2015-2016. As such, we expect yuan to remain stable against the CFETS basket. We favour longing yuan against higher beta, lower yielding currencies like EUR and JPY.

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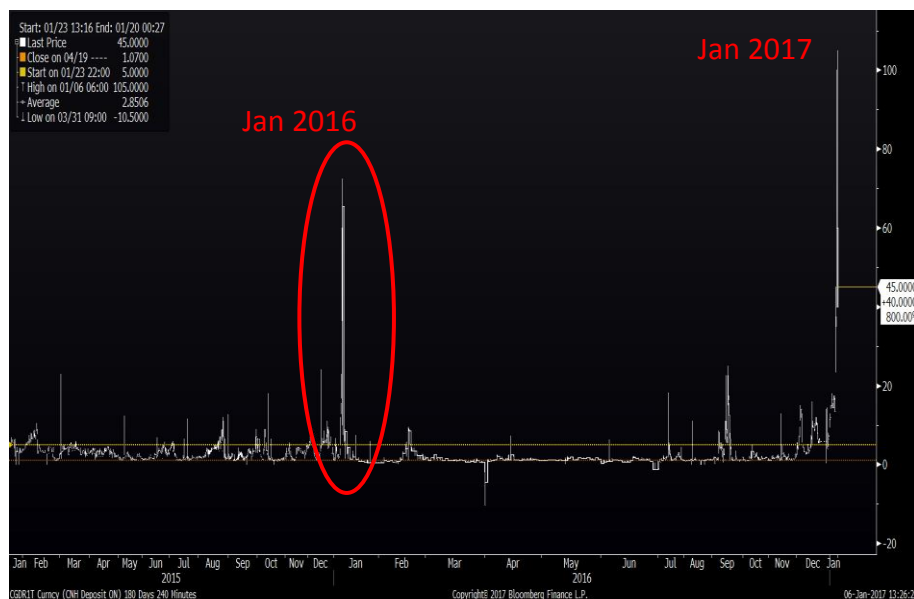
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An Opportunity To Act

Chart 1: DXY Index (Daily) Bearish Divergence That Foretells Its Correction

Source: Bloomberg

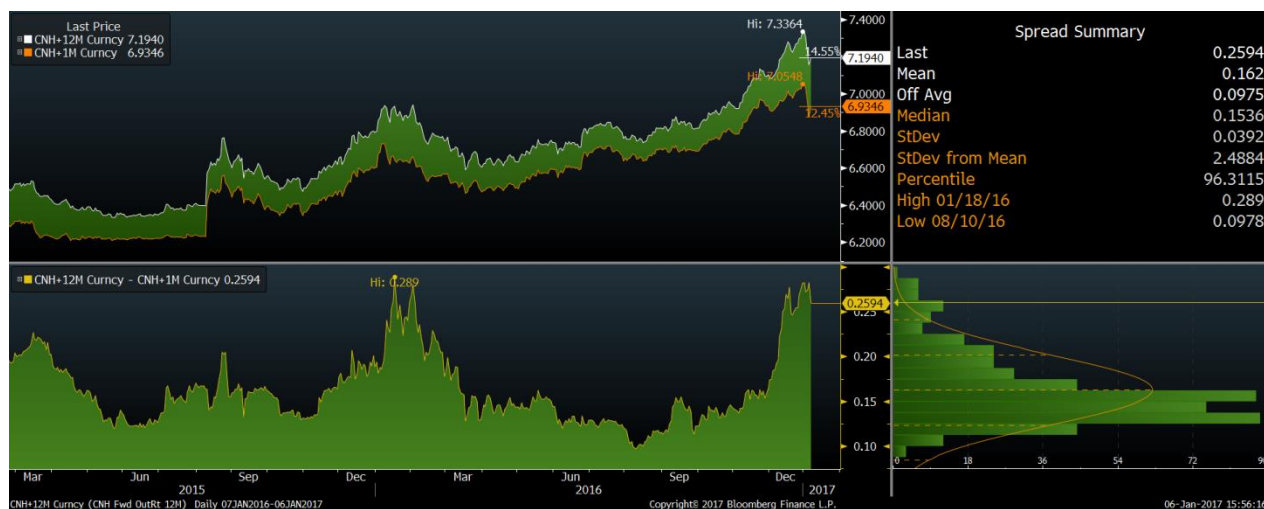
Since the start of the year, we have flagged a potential USD correction. The bearish divergence on the daily charts, the significant run-up that suggest stretched positioning, the FOMC Minutes that suggests uncertainty of fiscal expansion signaled that it is time for USD to make a meaningful correction before the next leg up. That was the opportunity for PBoC to act. In the absence of USD strength, PBoC tightened its capital controls by increasing the number of reporting requirements for residents who want to use their FX quota. They also suspended overseas acquisitions for Chinese companies with investments over US\$10bn. On top of that, UnionPay also prohibit Chinese residents from using its cards to buy insurance in Hong Kong except accident and medical coverage.

Chart 2: CNH Overnight Deposit Rate spikes to a high of 105%

Source: Bloomberg

Now that Chinese residents and companies have more difficulty moving cash out, the yuan liquidity in the Hong Kong offshore market has been under pressure as the overnight CNH deposit rate spiked to a high of 105% (Chart 2, previous page) just this morning. The first spike past the 100% happened yesterday. The overnight CNH Hibor rates also rose to 61.3% today. Raising the interbank rates effectively punishes leveraged speculators - those that borrowed in CNH to buy foreign-denominated assets or currencies. This is most evidenced by the spread between the USDCNH 12M forward and USDCNH 1M NDF which has narrowed, as indicated by the lower diagram in Chart 3.

Chart 3: Spread Between USDCNH 12M and 1M Narrows



Source: Bloomberg

In fact, the overnight CNH Hibor has been rising since Dec but only gained exaggerated momentum at the turn of the year. The recent spikes have pushed USDCNH well below the USDCNY. That has allowed USDCNH to trade at a widening discount to USDCNY.

Chart 4: Spread between USDCNH and USDCNY is Widening



Chart 5: The Spread Widens (in Chart 4) Even As USDCNH and USDCNY Rebound



Source: Bloomberg

Even as the USDCNH and USDCNY rebounded ahead of the US NFP release tonight, USDCNH is trading almost 1000pips lower than the USDCNY, suggesting that with PBoC keen to support the CNH (which typically leads the CNY) and a rather uncertain USD environment at this point, the most lucrative bet for local corporates who have offshore business is to engage in arbitrage activities between the CNH and CNY.

Not the First Time

The liquidity squeeze has happened before, one year ago as you can see in Chart 2 (page 2) when the yuan was also under pressure. So this is not the first time that PBoC drains liquidity in the offshore yuan market to dampen yuan depreciation bets. However, the situation is very different this year. Last year, the introduction of the CFETS basket, new central parity (USDCNY) fixing mechanism and the failed circuit-breaker mechanism of the stock markets along with mild USD strength increased yuan depreciation bets. It was a situation of a few experiments gone wrong that shook confidence amid mild USD strength. USDCNH made a steep retreat for a few months thereafter.

What Is Different This Time...

The situation is different this year. Residents are gearing to utilize their annual FX quota (of US\$50,000) in a year of a rising USD and US rates (as we have written in our previous note). Capital outflow has been rising and FX reserves were spent to keep the yuan stable against the basket. The expectation for USD to strengthen further is a lot more than the past. That explains why ahead of the NFP release tonight, USDCNH and USDCNY have seen significant rebounds already. We continue to expect both pairs to head higher for the rest of the year but such recent episodes could happen again - PboC could venture into the offshore market on and off to temper the momentum of yuan bears by increasing the funding cost such as what we have seen in the past two days. However, this can only be done in a period of subdued USD as PBoC still wants to keep the spirit of a more market-determined yuan given January 6, 2017

broader initiatives of the China interbank bond market and various bond and equity indices inclusion including MSCI and JPMorgan.

Yuan To Remain Stable Against the Basket

Yuan will remain stable against the CFETS basket in this year of USD strength and this is likely how the yuan will be played by the authorities until we get genuinely sustainable growth in China. Bear in mind that this is a year of power consolidation and leadership transition in the politburo as we look forward towards the 19th National Congress this autumn. President Xi Jinping will be looking to appoint personnel to critical positions that could either be groomed to be his successors or see him extending his term beyond 2022. Garnering political support is key. Reforms have been high on his agenda, likely higher than even growth at this point. Deleveraging, housing destocking, reducing excess capacity, environmental improvement are key to sustainable growth.

In the latest quarterly monetary policy statement by PBoC, the central bank has reiterated the importance of mitigating financial risks. This was actually stated in the Central Economic Work Conference earlier in Dec as well. As such, we do not expect any bold exchange rate experiments in a year of rising global yields like “another one-off yuan devaluation” that had been rather disastrous in 2015-2016. As such, yuan will have to remain relatively stable (at least against the basket). We favour relative beta plays - longing CNH against higher beta currencies that are lower yielding like EUR, JPY. We maintain our view for USDCNH and USDCNY to reach 7.10 by end 3Q.

On the side, the sharp CNH move has allowed us to reach our SGDCNH and EURCNH targets.

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