4X Global Research

Olivier Desbarres ▌contact@4xgr.com ▌+44 (0) 20 3811 0454

Fixed Income Research & Macro Strategy (FIRMS) – 8th December 2020

Far more to Renminbi than USD/CNY cross

The prevailing market view, as depicted in a recent [Reuters] article, is seemingly that Chinese policy makers are happy to allow further Renminbi appreciation versus the Dollar driven by a rising domestic trade surplus and strong capital account inflows.

The Renminbi has indeed appreciated 2.2% versus the Dollar since our last report on 22nd October ([PBoC likely to keep Renminbi on tight leash]), with the USD/CNY cross currently trading near its lowest level since mid-2018.

However, the US accounts for only about 20% of Chinese trade in goods. The Renminbi Nominal Effective Exchange Rate is thus a far more accurate measure of overall Chinese export competitiveness and of the currency's potential (dis)inflationary impact.

The Renminbi NEER slowly appreciated further in the run-up to the US elections on 3rd November but has since then depreciated about 0.9%, with the Renminbi underperforming many major currencies including the Euro and Korean Won. The Renminbi NEER is currently trading at the same level as it was on 22nd October, in line with our forecast that "*near-term the PBoC is more likely in a first instance to slow the pace of Renminbi appreciation and ultimately arrest the currency's climb*".

The Renminbi has weakened recently despite evidence of strong balance of payments inflows, including a record trade surplus of $74.4bn in November and a 11.8% yoy increase in FDI inflows, and data pointing to seasonal Renminbi strength in the month of November.

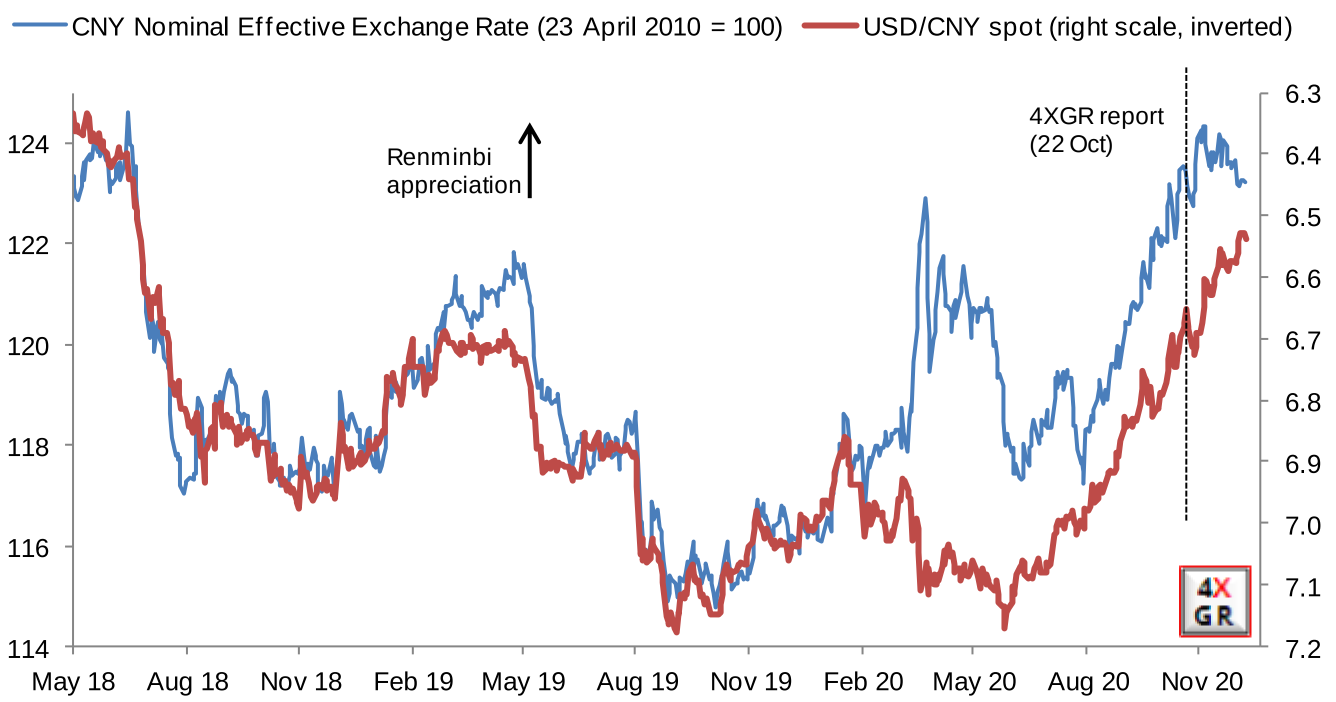
Price action in the past seven weeks suggests to us that the People's Bank of China has been fixing the daily USD/CNY central parity rate slightly higher than implied by underlying market forces, allowing modest Renminbi NEER depreciation mainly to put a floor under Chinese consumer prices flirting with deflation (a view we expressed on 22nd October).

Near-term we expect the Renminbi to continue appreciating versus a slowly depreciating Dollar ([Emerging Market currencies: Hopes and Realities], 2nd December 2020). However, we think the risk is tilted towards the PBoC further weakening the Renminbi NEER in coming weeks to the levels which prevailed in early September.

Renminbi has appreciated versus Dollar but more importantly depreciated in NEER terms

The prevailing market view is seemingly that Chinese policy makers are happy to allow the Renminbi to continue appreciating versus the Dollar because the rising domestic trade surplus and strong capital account inflows are driving the currency's appreciation. That at least is the conclusion seemingly reached by Reuters in an article published on 4th December 2020. We think a more accurate interpretation is that Chinese policy-makers have stalled the more relevant Renminbi Nominal Effective Exchange Rate (NEER), in line with our expectations, *despite* strong balance of payments inflows.

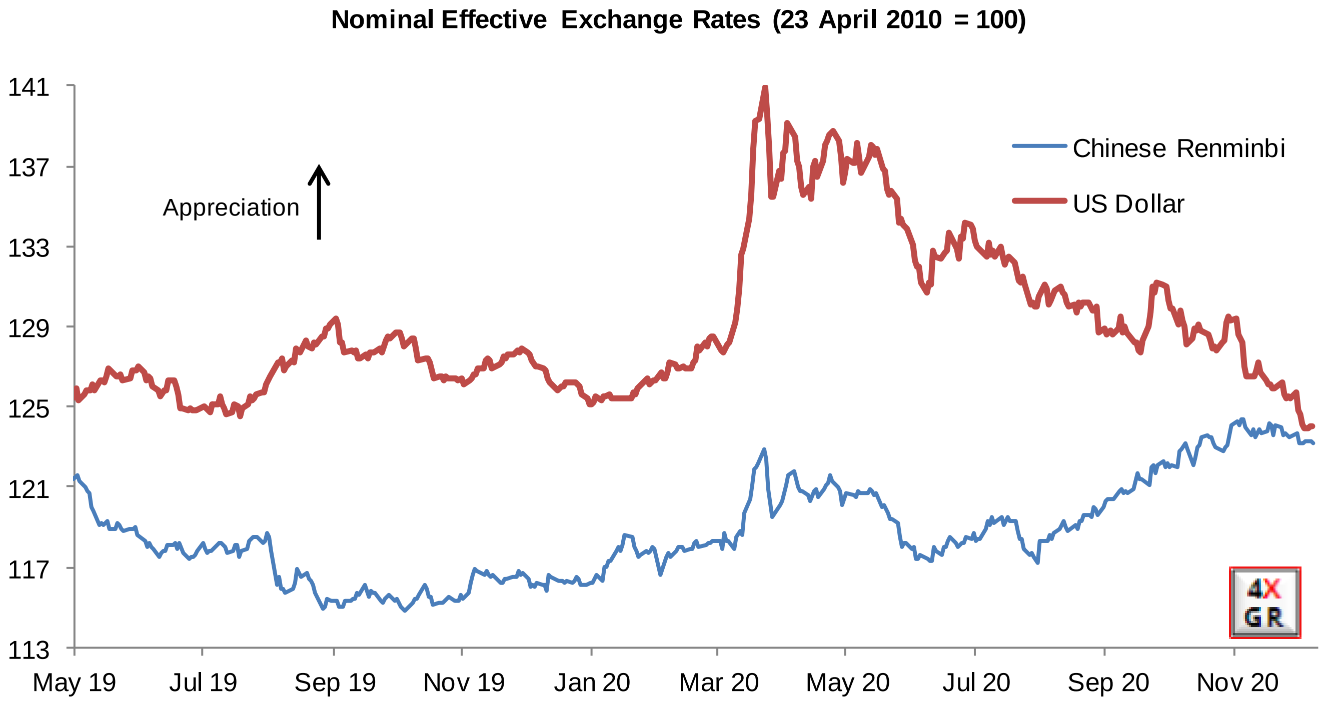
Figure 1: Renminbi has appreciated about 2.2% vs Dollar since 22nd October but flat in NEER terms



Source: 4X Global Research, BIS, investing.com

The Renminbi has appreciated about 2.2% versus the US Dollar since our last report on 22nd October (see PBoC likely to keep Renminbi on tight leash), as depicted in Figures 1 and 3, with the USD/CNY cross currently trading near its lowest level since mid-2018. However, the US accounts for only about 20% of Chinese trade in goods. The Renminbi NEER, a trade-weighted index of the Renminbi versus the currencies of China's main trading partners, is thus a far more accurate measure than the USD/CNY cross of overall Chinese export competitiveness and of the currency's potential impact on Chinese imported inflation. It is not without reason that in December 2015 the China Foreign Exchange Trade System (CFETS), a sub-institutional organization of the People's Bank of China (PBoC), introduced a new exchange rate index which values the Renminbi against a trade-weighted basket of 13 currencies.

Figure 2: Renminbi NEER has depreciated since US elections despite Dollar's ongoing depreciation

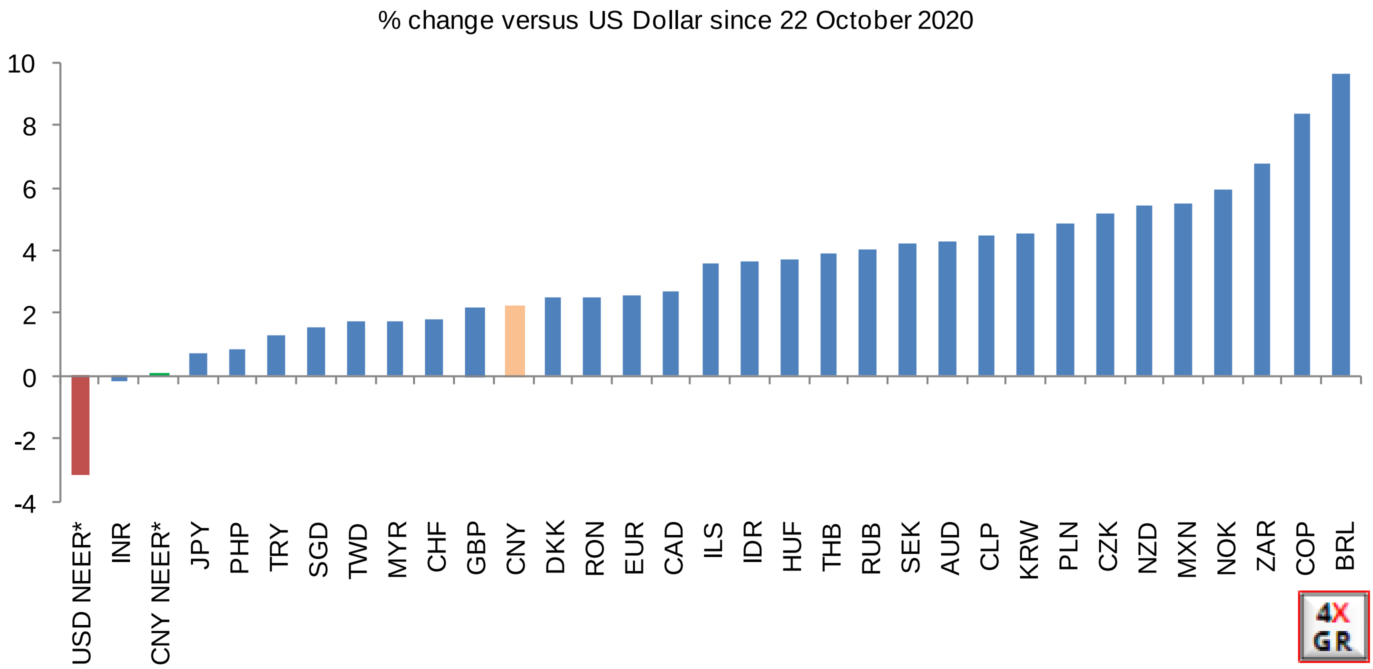


Source: 4X Global Research, BIS, Federal Reserve, investing.com

The more relevant Renminbi NEER appreciated further in the run-up to the US elections on 3rd November and hit a 136-week high on 4th November. However, it has since then depreciated about 0.9%, according to our calculations, and remains within its very narrow seven-week range of only 1.2% (see Figures 1-3). The Renminbi NEER is currently trading at the same level as it was on 22nd October.

This price action is in line with our forecast that "*near-term the PBoC is more likely in a first instance to slow the pace of Renminbi appreciation and ultimately arrest the currency's climb*" (see PBoC likely to keep Renminbi on tight leash, 22nd October 2020). The Renminbi has appreciated only modestly against a weakening US Dollar (see Figures 2 & 3), only marginally outperformed the currencies of a number of China's main trading partners, including the Taiwan Dollar, and underperformed the likes of the Euro and Korean Won (see Figure 3).

Figure 3: Renminbi has underperformed many major currencies in past seven weeks, including Euro and Won

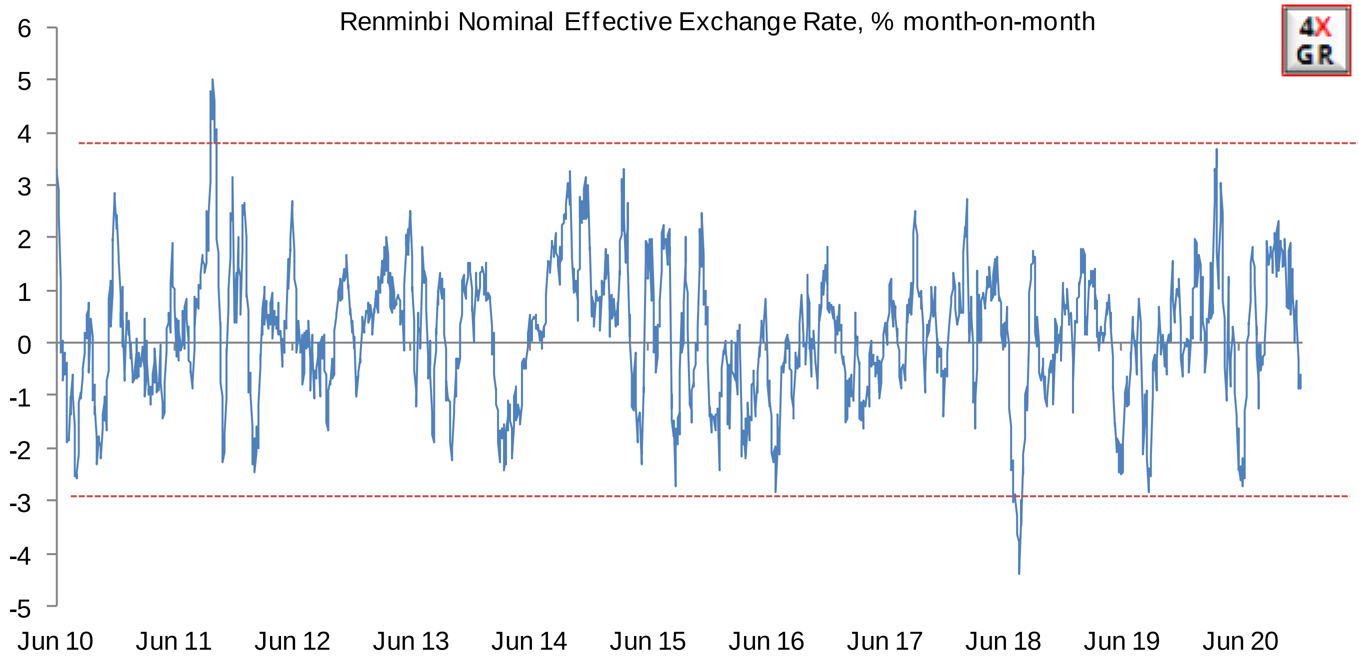


Source: 4X Global Research, BIS, Federal Reserve, investing.com

Note: USD NEER is US Dollar Nominal Effective Exchange Rate; CNY NEER is Renminbi Nominal Effective Exchange Rate

As a result the monthly pace of NEER appreciation slowed from about 1.8% in the four weeks to 22nd October to about 1.1% in the four weeks to 16th November before turning negative in early December (see Figure 4). Again this is in line with our prediction that *"[a broadly stable Renminbi NEER] would translate into slower month-on-month appreciation, which would in turn be commensurate with the historical pattern of a reasonably rapid pace of appreciation preceding slower appreciation and eventually month-on-month depreciation*".

Figure 4: Pace of monthly Renminbi appreciation has slowed sharply and turned negative in December

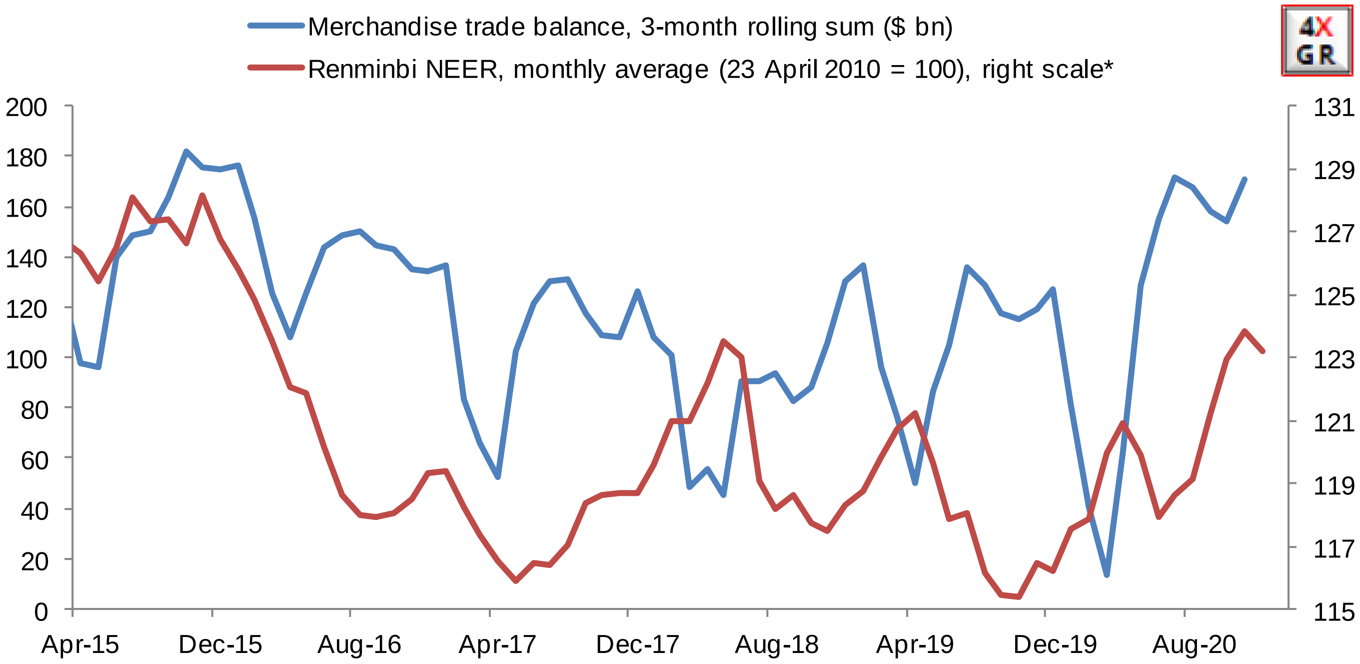


Source: 4X Global Research, BIS, investing.com

Tepid Renminbi performance in past seven weeks despite strong FX inflows into China

Importantly, the Renminbi NEER has weakened slightly since 4th November despite evidence of strong balance of payments inflows and historical data pointing to seasonal Renminbi strength in the month of November. The Chinese goods trade surplus, not seasonally-adjusted, hit an all-time high of $74.4bn, while the three-month rolling surplus of $171bn was one of the largest on record. Figure 5 suggests that all things being equal this should have led to further Renminbi NEER appreciation. Moreover, the strength of China's trade balance has been underpinned by the ongoing surge in exports, which were up 14.1% year-on-year in November and hit an all-time high of $268.1bn rather than a collapse in imports which were up 4.5% yoy in October-November (see Figure 6).

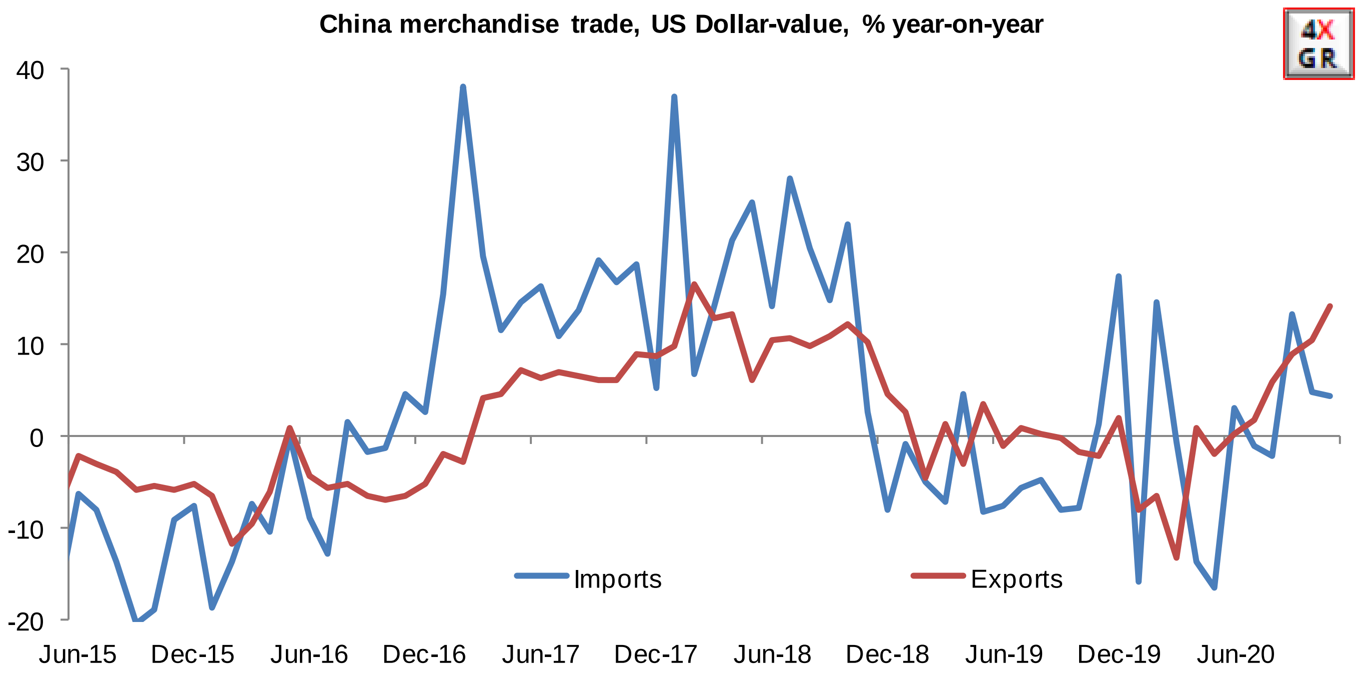
Figure 5: Renminbi has treaded water despite surge in Chinese external trade surplus…



Source: 4X Global Research, BIS, investing.com, National Bureau of Statistics of China

*Note: *Renminbi NEER is Renminbi Nominal Effective Exchange Rate. Last data point is average for 1-8 December 2020*

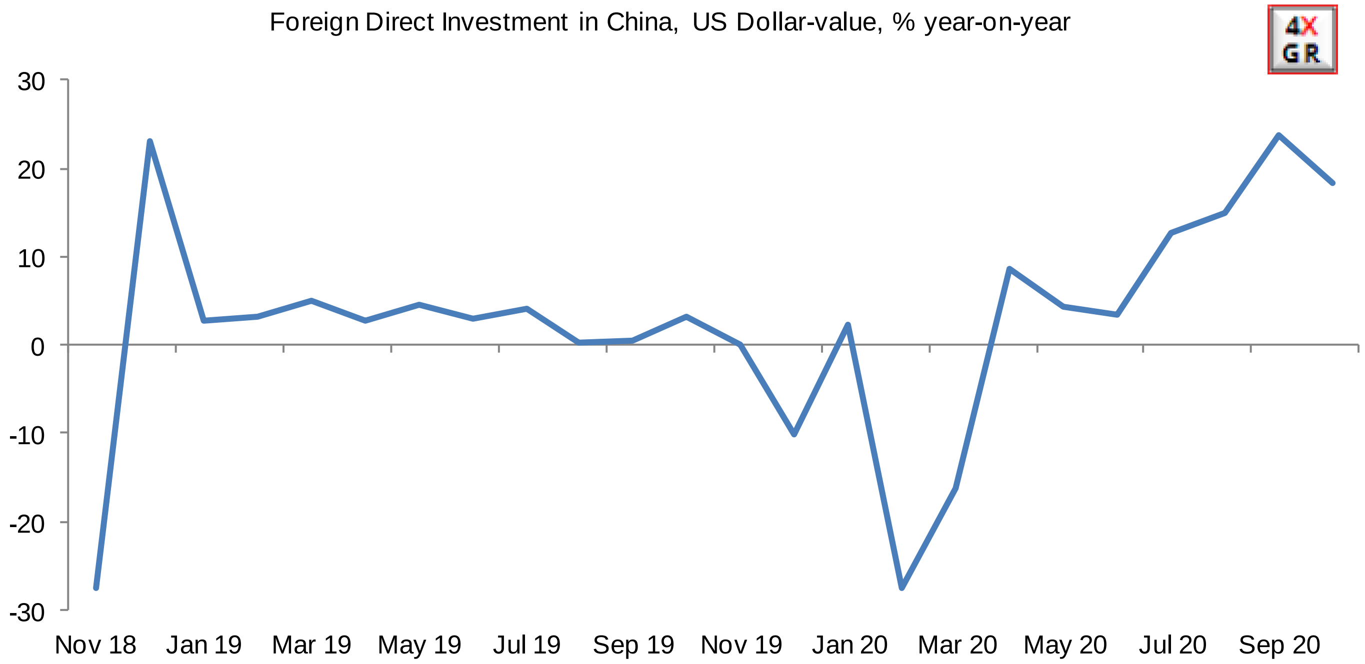
Figure 6: …thanks to record-high exports in November



Source: 4X Global Research, National Bureau of Statistics of China

At the same time Foreign Direct Investment (FDI) inflows into China remained strong in November, with their USD-value rising 11.8% yoy (see Figure 7).

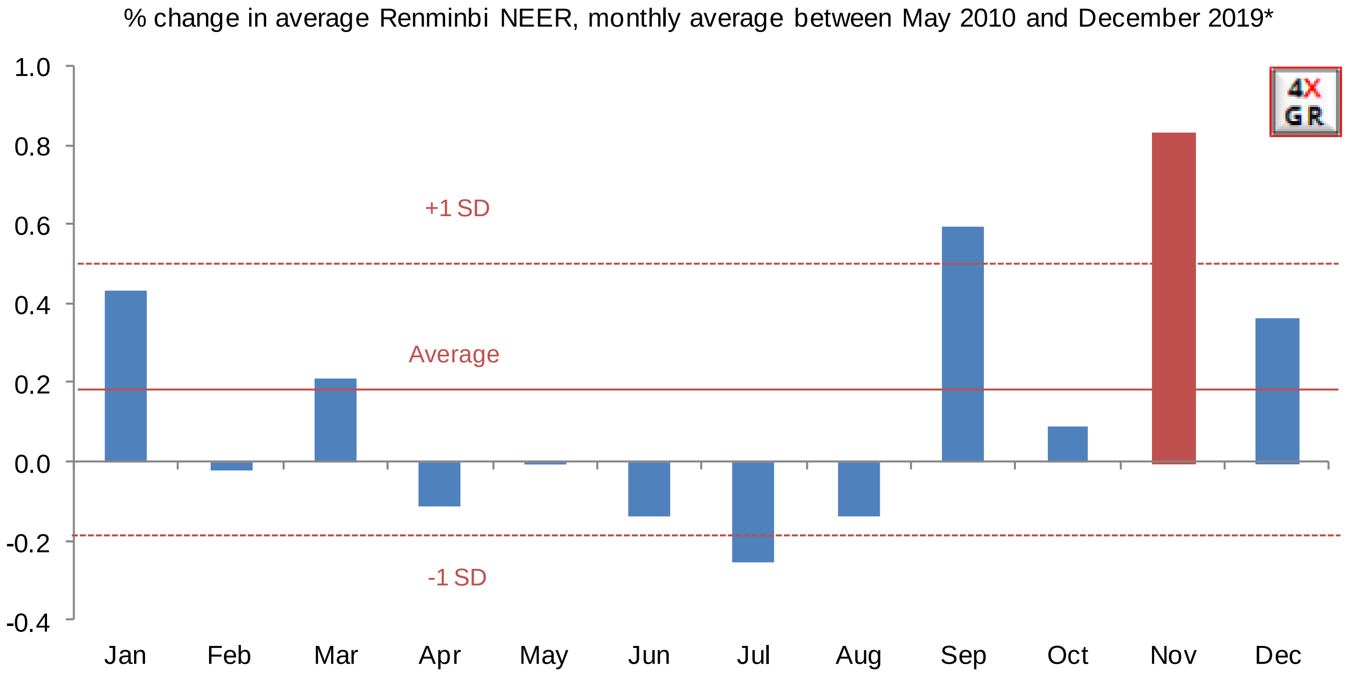
Figure 7: China's rapid economic recovery has attracted material rise in FDI inflows



Source: 4X Global Research, National Bureau of Statistics of China

Finally, monthly average NEER data for the past decade suggest that the Renminbi underperformed slightly in November 2020. Since 2010, the Renminbi NEER has on average appreciated by over 0.8% in the month of November, by far its strongest month of the year according to our calculations and more than one standard deviation from the monthly average gain of about +0.15% (see Figure 8). In comparison, the (average) Renminbi NEER in November 2020 was up only 0.7% over the (average) NEER in October 2020.

Figure 8: Historical seasonal patterns pointed to stronger Renminbi performance in November



Source: 4X Global Research, BIS, investing.com

*Note: * We calculated the average (rather than end-month) Renminbi NEER for every month between May 2010 and December 2019. We then calculated the average percentage change for each of the 12 months of the year.*

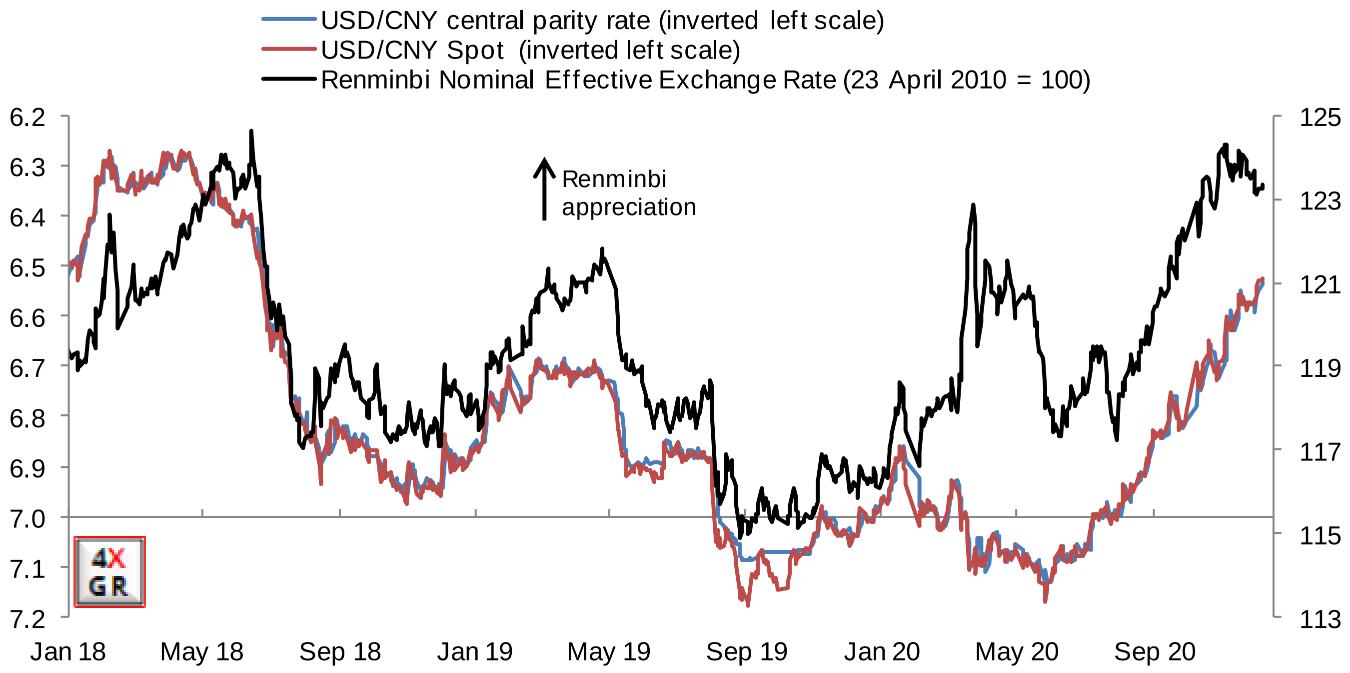
PBoC seemingly leaning against Renminbi to minimise deflationary pressures

One possible explanation for the Renminbi's rather tepid performance in the past seven weeks is that speculative and portfolio inflows into China, attracted by the country's rapid economic recovery and higher bond returns, have slowed materially and potentially turned to outflows. Daily or weekly capital account flow data are at best patchy but in any case we think this is an unlikely explanation. A recent Reuters poll found that on average analysts expected China's GDP to rise about 2% this year, the only major economy forecasted to record positive growth in 2020.

A more plausible explanation, in our view, is that the PBoC has fixed USD/CNY to keep the Renminbi on a tight leash, in order to protect domestic exports' competitiveness and more importantly minimise deflationary pressures. The PBoC fixed the daily USD/CNY central parity rate, around which USD/CNY spot can trade 2% either side, at 6.532 on 8th December, about 1.9% lower than on 22nd October according to our calculations. Since then Renminbi (spot) has weakened about 2.2% versus the Dollar while the Renminbi NEER has been broadly unchanged as noted above (see Figure 9).

In the past 28 trading sessions USD/CNY has closed higher than the daily central parity rate (i.e. Renminbi weak versus fixing) only seven times. Put differently Renminbi spot has closed stronger versus the daily fixing three quarters of the time.

Figure 9: PBoC has lowered USD/CNY fix only 1.9% since 22nd December despite Dollar's sustained weakness



Source: 4X Global Research, China Foreign Exchange Trade System, investing.com

This suggests to us that the PBoC has been fixing the Renminbi slightly weaker than implied by underlying market forces, mainly in a bid to put a floor under very low CPI-inflation. We had already argued on 22nd October that while "*the case for the PBoC to weaken the Renminbi is not particularly compelling at this juncture given the underlying strength of the domestic economy and export sector […] the PBoC cannot ignore the deflationary impact of the Renminbi NEER's appreciation. We think that near-term the PBoC will opt to keep the Renminbi NEER broadly stable*" (see PBoC likely to keep Renminbi on tight leash).

Since then data released by the National Bureau of Statistics of China showed that headline CPI-inflation fell sharply in October to just 0.5% year-on-year, its lowest level in eleven years. Core CPI-inflation, which excludes more volatile food and fuel prices, remained at 0.5% yoy, its lowest level since March 2010, for the fourth consecutive month (see Figure 10). The Renminbi NEER's 5.9% depreciation in July-October has arguably contributed to weak imported inflation and in turn to the 2.2 percentage point fall in headline CPI-inflation over that timeframe, even allowing for the transmission lag between the currency's appreciation and consumer prices. We think that policy-makers will want to avoid consumer price deflation and the possible ensuing hit to business and consumer confidence.

Figure 10: Collapse in Chinese CPI-inflation likely providing incentive to stabilise and even weaken Renminbi

Source: 4X Global Research, National Bureau of Statistics of China

Near-term, we expect the US Dollar to continue slowly depreciating (see Emerging Market currencies: Hopes and Realities, 2nd December 2020) and for the Renminbi to continue appreciating versus the US Dollar. Indeed we think that sources close to the PBoC recently quoted as saying that the central bank did not see any need to intervene against Renminbi appreciation driven by strong fundamentals, including a current account surplus, were referring (implicitly) to the USD/CNY exchange rate.

However, we think the PBoC will at the very least try to keep the Renminbi NEER broadly stable in coming weeks, with the risk tilted towards the central bank weakening the Renminbi NEER by a couple of percent to the levels which prevailed in early September. This would translate, according to our estimates, to the pace of month-on-month depreciation accelerating towards around 2% in coming weeks, which would still not be extreme by historical standards (see Figure 4).

DISCLAIMER & DISCLOSURE STATEMENT

THIS MATERIAL IS: (I) FOR YOUR PRIVATE INFORMATION, AND WE ARE NOT SOLICITING ANY ACTION BASED UPON IT; (II) NOT TO BE CONSTRUED AS AN OFFER OR A SOLICITATION OF AN OFFER TO BUY OR SELL ANY SECURITY IN ANY JURISDICTION WHERE SUCH OFFER OR SOLICITATION WOULD BE ILLEGAL; AND (III) BASED UPON INFORMATION THAT WE CONSIDER RELIABLE.

4X GLOBAL RESEARCH DOES NOT WARRANT OR REPRESENT THAT THE PUBLICATION IS ACCURATE, COMPLETE, RELIABLE, FIT FOR ANY PARTICULAR PURPOSE OR MERCHANTABLE AND DOES NOT ACCEPT LIABILITY FOR ANY ACT (OR DECISION NOT TO ACT) RESULTING FROM THE USE OF THIS PUBLICATION AND RELATED DATA. TO THE MAXIMUM EXTENT PERMISSIBLE ALL WARRANTIES AND OTHER ASSURANCES BY 4X GLOBAL RESEARCH ARE HEREBY EXCLUDED AND 4X GLOBAL RESEARCH SHALL HAVE NO LIABILITY FOR THE USE, MISUSE, OR DISTRIBUTION OF THIS INFORMATION.

The analysis and information presented in this report (Report) by 4X Global Research Ltd (4X Global Research), an independent research company registered in the UK, is offered for subscriber interest only. The content is intended for investment professionals only, and is not to be viewed or used by individual investors in any regulatory jurisdiction. By accessing this Report you confirm that you meet these criteria.

This Report is not to be used or considered as a recommendation to buy, hold or sell any securities or other financial instruments and does not constitute an investment recommendation or investment advice. The information contained in this Report has been compiled by 4X Global Research from various public and industry sources that we believe to be reliable; no representation or warranty, expressed or implied is made by 4X Global Research, its affiliates or any other person as to the accuracy or completeness of the information. 4X Global Research is not responsible for any errors in or omissions to such information, or for any consequences that may result from the use of such information. Such information is provided with the expectation that it will be read as part of a wider investment analysis and this Report should not be relied upon on a stand-alone basis. Past performance should not be taken as an indication or guarantee of future performance; we make no representation or warranty regarding future performance. The opinions expressed in this Report reflect the judgment of 4X Global Research as of the date hereof and are subject to change without notice.

This Report is not, and should not be construed as, an offer or the solicitation of an offer to buy or sell any securities. The offer and sale of securities are regulated generally in various jurisdictions, particularly the manner in which securities may be offered and sold to residents of a particular country or jurisdiction. Securities referenced in this Report may not be eligible for sale in some jurisdictions. To the fullest extent provided by law, neither 4X Global Research nor any of its affiliates, nor any other person accepts any liability whatsoever for any direct or consequential loss, including without limitation, or lost profits arising from any use of this Report or the information contained herein.

No director, officer or employee of 4X Global Research is on the board of directors of any company referenced herein and no one at any such referenced company is on the board of directors of 4X Global Research. 4X Global Research does not invest in any securities although it is possible that one or more of 4X Global Research's directors, officers, employees or consultants may at times be invested in the securities referenced.

4X Global Research is not authorized or regulated in the United Kingdom by the Financial Conduct Authority (FCA) or by any other regulator in any jurisdiction for the provision of investment advice. Specific professional financial and investment advice should be sought from your stockbroker, bank manager, solicitor, accountant or other independent professional adviser authorized pursuant to the Financial Services and Markets Act 2000 if you are resident in the United Kingdom or, if not, another appropriately qualified independent financial adviser who specializes in advising on the acquisition of shares and other securities before any investment is undertaken.

 This document is produced using open sources believed to be reliable. However, their accuracy and completeness cannot be guaranteed. The statements and opinions herein were formed after due and careful consideration for use as information for the purposes of investment. The opinions contained herein are subject to change without notice. The use of any information contained in this document shall be at the sole discretion and risk of the user. Investors should consider this report as only a single factor in making their investment decision and, as such, the report should not be viewed as identifying or suggesting all risks, direct or indirect, that may be associated with any investment decision.

No liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of the recipient acting on such information or opinion or estimates. 4X Global Research employees may have or take positions in the markets and securities mentioned in this document. The stated price of any securities mentioned herein is not a representation that any transaction can be effected at this price. Investing in securities may entail certain risks. The securities referred to are not suitable for all investors and should not be relied upon in substitution for the exercise of independent judgment. This material is not directed at you if 4X Global Research is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. 4X Global Research and its analysts are remunerated for providing independent investment research to financial institutions, corporations, and governments.

DISCLOSURE: This Report is not to be copied, forwarded or otherwise disseminated to non-subscribers in electronic or physical form without prior consent.