UOB 大華銀行

Global Economics & Markets Research
Company Reg No. 193500026Z

Suan Teck Kin Suan.TeckKin@UOBgroup.com
Quek Ser Leang Quek.SerLeang@UOBgroup.com

Wednesday, 03 September 2014

Flash Notes

China: The Shanghai-HK Through Train–Pushing Ahead Market Reforms

- The Shanghai-Hong Kong Stock Connect is slated to begin in October to allow investors to purchase Shanghai-listed stocks, thus opening up a new investment channel to deploy offshore RMB.
- This latest initiative reflects China's determination in market reforms and towards the opening of the capital account, and the speed of which is astonishing given that an equivalent program, QFII, has existed more than a decade.
- The excitement at the official launch is likely to squeeze the RMB liquidity but we do not expect persistent disruption given the availability of offshore RMB. Nevertheless it is advisable to stay long on RMB going into the launch.

Background

The Shanghai-Hong Kong Stock Connect (also known as "through-train"; 沪港股市互联互通机制 ("沪港通")) will allow investors in Mainland China to trade Hong Kong stocks, and Hong Kong (and overseas, in general) investors to trade Shanghai-listed stocks. One key aim of this project is to deepen China's integration with international markets and for the greater global role of the RMB.

The initiative was announced on 10 April 2014 by regulators in China and HK. The connectivity test has been completed and another test is scheduled for mid-September before official implementation, which is widely expected to be on 13 October, one week after the end of China's National Day Golden Week holiday.

To understand how the new program will impact on the offshore RMB market, it is important to have some understanding of the mechanism.

The Stock Connect is a new capital-account channel for cross-border capital flows. The existing channels include the QFII/RQFII schemes for foreign institutional investors ("Qualified Foreign Institutional Investors"/"Renminbi Qualified Foreign Institutional Investors") to invest in mainland securities and QDII for mainland investors ("Qualified Domestic Institutional Investor") to invest in overseas stocks and bonds, all of which are limited to institutional investors and required to be licensed, and subject to restrictions in terms of injection and repatriation of capital, among other limitations.

One key differentiating feature of the Shanghai-HK Stock Connect is that it is open to both institutional and retail investors, thus broadening the investor base which is expected to lift trading liquidity significantly in both Shanghai and HK stock markets, subject to daily and cumulative trading limits, which are explained in detail below.

Northbound Trading Link (Hong Kong ➡ Shanghai)

Allows HK and overseas investors to purchase stocks traded on the Shanghai Stock Exchange (SSE)
Daily net quota = RMB 13bn (~13.3% of SSE's daily turnover)
Aggregate net quota = RMB 300bn (~3.1x of SSE's average daily turnover)

Southbound Trading Link (Shanghai ➡ Hong Kong)

Allows China investors to purchase stocks traded on the Hong Kong Stock Exchange (HKSE)
Daily net quota = RMB 10.5bn (~21% of HKSE daily turnover)
Aggregate net quota = RMB 250bn (~7.1x of HKSE daily turnover)

It is important to note that the daily quotas under the Shanghai-HK Stock Connect scheme are on a NET BUY basis, rather than gross amount, i.e. investors will always be allowed to sell their cross-boundary securities regardless of the quota balance. This means that theoretically the daily limits would not be hit if buy and sell orders offset each other.

The calculation is: Daily Quota Balance = Daily Quota – Buy Orders + Sell Trades + Adjustments. Note that the Daily Quota will be refreshed and remain the same every day, subject to the balance of the Aggregate Quota. Unused Daily Quota will NOT be carried over to next day's Daily Quota.

Based on this mechanism, it is our view that the cumulative quotas (for both northbound and southbound) will not be exhausted anytime soon, due to the daily limits.

Assuming the net daily quota is maxed out continuously, it would take 23 sessions for Northbound (RMB300bn ÷ RMB13bn), and 24 sessions for Southbound (RMB250bn ÷ RMB10.5bn), to exhaust the cumulative quotas.

This means that on a daily basis, even in the extreme situation of one-sided net purchases (no sale) of Shanghai stocks by HK investors, the maximum liquidity that will be absorbed offshore is RMB13bn. Will it cause distress to the offshore RMB liquidity condition?

Considering the availability of RMB liquidity in HK, we believe it is unlikely to cause severe stress to the system persistently: RMB deposits in HK reached RMB937bn as of July 2014, with global RMB deposit pool (including HK) exceeding RMB1.5tn. RMB loans outstanding in HK was RMB123bn as of end-February, meaning a loan-deposit ratio of 13%. In addition, HKMA has a bilateral swap line of RMB400bn on standby should the system run short of RMB liquidity. IMF estimates that average daily trading volume of RMB in HK at close to US$50bn (~RMB300bn equivalent). These figures suggest that offshore liquidity should be sufficient to handle quotas being maxed out temporarily, though it should be conceivable that the regulators would step in should financial conditions are being disrupted.

For comparison, the current size of the QDII/QFII/RQFII schemes are (as of 26 August 2014): Approved QDII quota US$82.593bn; Approved QFII quota US$59.674bn; and Approved RQFII quota RMB278.6bn.

Implications For The RMB

The latest initiative highlights China's determination to move along the market reform path, with greater sense of urgency, and the shift towards less cumbersome regulation.

Consider that the QFII program started in 2003 (QDII in 2007 and RQFII in 2011), it has taken more than a decade to arrive at today's scale. In contrast, the Shanghai-Hong Kong Stock Connect project was first announced in April 2014 and is slated to commence operation in less than a year. This is truly an astonishing pace considering the operational complications that need to be overcome and coordinated: different sets of regulatory and legal frameworks, operating environments, clearing and settlement cycles, down to different trading hours and holiday schedules and potential weather interruptions. In addition, unlike the QFII/RQFII/QDII schemes where Mainland China regulators have to sole discretion to dictate the conditions that investors must abide by, the "through train" project requires coordination and cooperation of regulators from both sides.

As for the RMB, the opening of the Shanghai market to foreign investors will allow another alternative to deploy offshore RMB liquidity, in addition to the usual loans, insurance, bond, and other investment vehicles. This will increase the attractiveness to for offshore RMB holders with an alternative avenue to generate yields and returns. The program is also another step towards opening up of the capital account and further RMB internationalization, as it allows an opening for backflow of the RMB to the mainland.

Notwithstanding the daily limits set, as the Northbound trade is required to be funded by RMB, it is conceivable that there would be upward pressure on the offshore RMB FX rate and interest rates, and tightened liquidity in the initial stages of the program, though the situation is likely to normalize once the excitement is over.

Nevertheless, it may still be prudent to keep sufficient RMB liquidity at hand, rather than short, ahead of the launch. The extent of offshore RMB tightness should be short lived and may not be as large as some expect, as explained earlier.

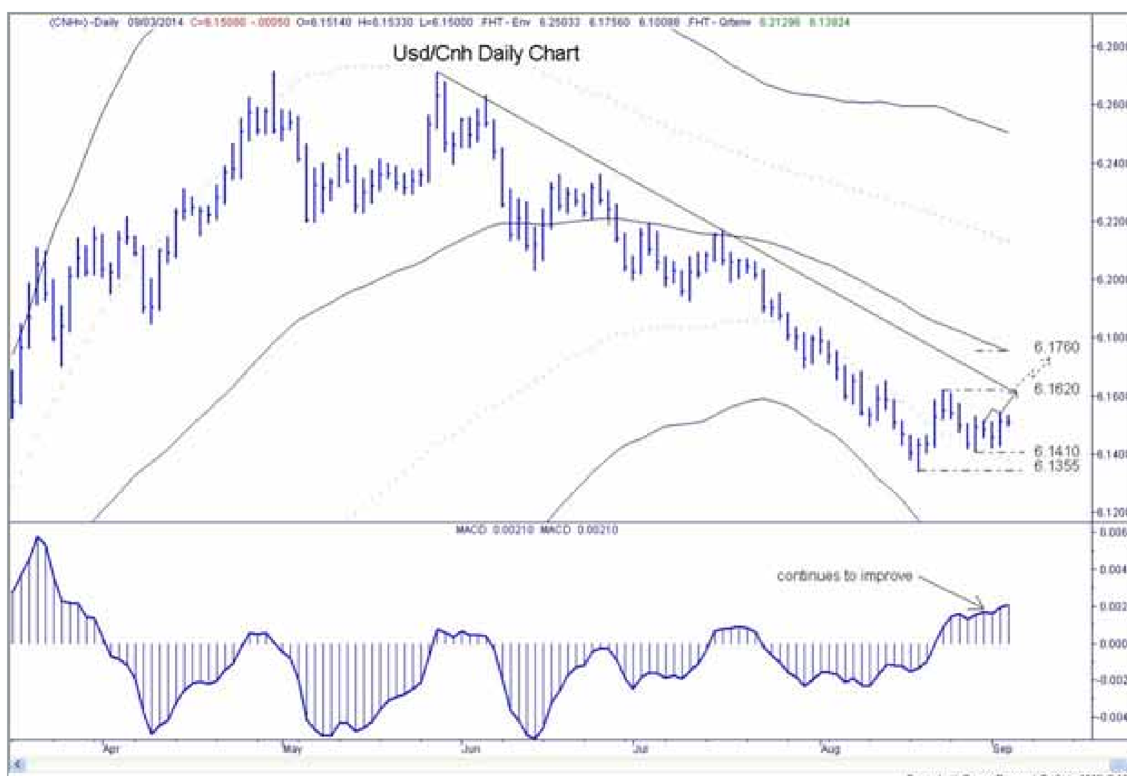
Over the medium term, we remain positive on RMB, with our end-2014 target of 6.15/USD already within sight, our preference is for a firmer RMB exchange rate for end-2014 but should be capped inside 6.10/USD. However, we are wary of the impact of US Federal Reserve's moves ahead with the upcoming FOMC meeting in mid-Sep and the winding down of the US Fed's QE tapering program by October, which would see USD supported and possibly further volatility for the RMB and other Asian currencies ahead.

Near term, as noted below, there is still scope for weaker RMB on technical basis, and it shows that the movements for the currency will remain volatile especially after the widening of the daily trading bands from 1% to 2% on 17 March early this year. This is one important point to keep in mind after the currency enjoyed a period of almost uninterrupted appreciation against the USD from 2005 to 2013.

Technical View

USD/CNH: 6.1515

We hold the view that USD is in a recovery phase and expect a rebound towards 6.1620. A move above this level could lead to extension towards 6.1760 but a clear break above this level appears unlikely at this stage. Only an unexpected break below last month's low at 6.1350/55 would indicate that the longer-term bearish trend towards 6.1000 has resumed.



For more information:

Shanghai-Hong Kong Stock Connect: Information Book for Investors, HKEx

http://www.hkex.com.hk/eng/market/sec_tradinfra/chinaconnect/Documents/14051596_HKEx_Shanghai-Hong%20Kong%20Stock%20Connect(e)full.pdf

Disclaimer: This analysis is based on information available to the public. Although the information contained herein is believed to be reliable, UOB Group makes no representation as to the accuracy or completeness. Also, opinions and predictions contained herein reflect our opinion as of date of the analysis and are subject to change without notice. UOB Group may have positions in, and may effect transactions in, currencies and financial products mentioned herein. Prior to entering into any proposed transaction, without reliance upon UOB Group or its affiliates, the reader should determine, the economic risks and merits, as well as the legal, tax and accounting characterizations and consequences, of the transaction and that the reader is able to assume these risks. This document and its contents are proprietary information and products of UOB Group and may not be reproduced or otherwise.