UOB 大華銀行

Global Economics & Markets Research
Company Reg No. 193500026Z

Suan Teck Kin Suan.TeckKin@UOBgroup.com

Thursday, 29 January 2015

Flash Notes

China: Reassessing RMB Outlook Post-MAS

- Global central banks are jumping on the easing bandwagon, with MAS the latest one which could set a precedent for other central banks to move ahead
- China's inflation situation is also facing similar downward pressure, and the correlation with PPI suggests there is still much downside room
- We think that PBoC still has plenty of room to adjust its policy and maintain our view of further interest rate and RRR cuts this year. In addition, we are also cutting our end-2015 RMB forecast to 6.29/USD from 6.18 previously.

Global Easing Ensemble In Motion

With the surprise shift yesterday (Wed 28 Jan 2015) to an easier SGD NEER policy stance in response to a low-inflation and slow-growth environment, Singapore's MAS became the latest to join the wave of central banks gravitating towards an easier policy stance. Just last Thur (22 Jan), European Central Bank – with its refi rate already at historic low of 0.05% – unleashed a historic EUR1.1tn Quantitative Easing (QE) programme.

In January 2015 alone, of the ten central banks that made interest rate changes, nine lowered their benchmark interest rates – scheduled or otherwise: Pakistan (24 Jan), Canada (21 Jan), Denmark and Turkey (both on 20 Jan), Switzerland, India, Egypt, and Peru (all on 15 Jan), and Romania (7 Jan), with Brazil the lone one raising interest rate (21 Jan). New Zealand looks poised to join the "easing ensemble" as RBNZ this morning (Thur, 29 Jan) announced that it has shifted to a "neutral stance". Yesterday, both Bank of Thailand and Bank Negara Malaysia held their interest rate policies unchanged but were unanimous in cautioning about slowing inflation in their countries. In contrast, the US Federal Reserve continued to stay on its "normalization" rhetoric early this morning (29 Jan), and we still expect the US interest rate hikes to commence from mid-2015.

The recurring theme of these central banks is their concern over disinflationary/deflationary pressures as a result of falling crude oil and commodities prices since the middle of last year. The Brent crude oil price has fallen more than 50% to around US$48 per barrel currently, from its peak of US$115 per barrel. Headline inflation rate in the G20 fell from an average of 3.45%y/y in Dec 2013 to 3.13% in Dec 2014, while the G10 Developed Markets saw more acute deflationary pressures, with headline inflation rate falling from an average of 1.31%y/y in Dec 2013 to 0.85% in Dec 2014.

PBoC Facing Similar Dilemma

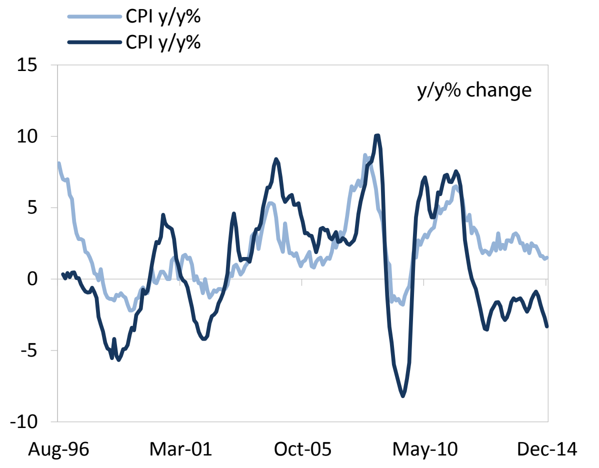
China is also facing a similar situation as it shifts into slower growth mode in the "new normal" environment. Recall that China's GDP growth in second half of 2014 averaged 7.3%y/y, bringing full year 2014 growth rate to 7.4%, at the slowest since 1990. Meanwhile, China's headline inflation rate has drifted down to 1.4-1.5% by Nov-Dec 2014, down from above 2.5% just a year ago. The PPI measure has been in negative territory for a record 34 consecutive months with no signs of turning, exceeding the previous record of 31 months in 1997-99, during the Asian Financial Crisis years. The close correlation of the two inflation measures, at 0.68, suggests that there is considerable downwards pressure on China's CPI especially with the more than 50% drop in crude oil prices and with 10% of China's CPI basket consisting of transport and communications items. In the previous 3 cycles of deflationary readings, China's CPI typically lagged the PPI by 2 to 8 months. While the current cycle has not seen – or may not even see – any negative CPI readings so far, the downward pressure is likely to be significant in the months ahead.

More Room For The PBoC To Steer Policy

With China facing a similar situation as major central banks around the world, the PBoC has in fact been on the easing train since Nov 2014 when it made surprise interest rate cuts. On 21 Nov 2014, PBoC surprised with lowering of 25bps in deposit rate and 40bps on lending rate and the lifting of deposit rate ceiling to 1.2x of benchmark from 1.1x previously, the first reductions since July 2012. Reserve requirement ratio (RRR) was left untouched at 20.0%.

With inflation rate at current pace of 1.4-1.5% and even if it matches our full year forecast of 2.1%, there is still room for PBoC to lower interest rates and still keeping real interest rate above zero. We maintain our expectations that PBoC would lower lending rates into the first half of 2015, as well as deposit rates (raising ceiling limit at the same time), and RRR to ensure sufficient credit in the system (see table below for our forecasts).

China: CPI and PPI



Source: CEIC, UOB Global Economics & Markets Research Estimates

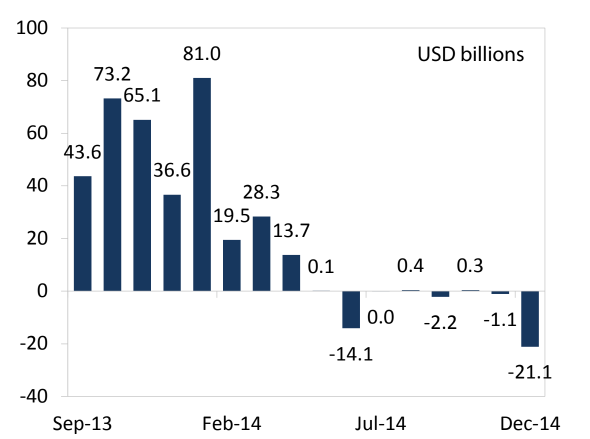
China: Interest Rate and RRR Forecasts					
%	4Q14	1Q15F	2Q15F	3Q15F	4Q15F
1-year Best Lending Rate	5.60	5.35	5.10	5.10	5.10
1-year Deposit Rate	2.75	2.50	2.25	2.25	2.25
Reserve Requirement Ratio	20.00	19.50	19.00	19.00	19.00

Source: UOB Global Economics & Markets Research Estimates

On the FX front, there has been significant depreciation pressure on the RMB since late 2014 are generally on two fronts: 1) domestic concerns on growth and whether the shift towards "new normal" is sufficient maintain growth momentum, and 2) the dominant strength of the US dollar.

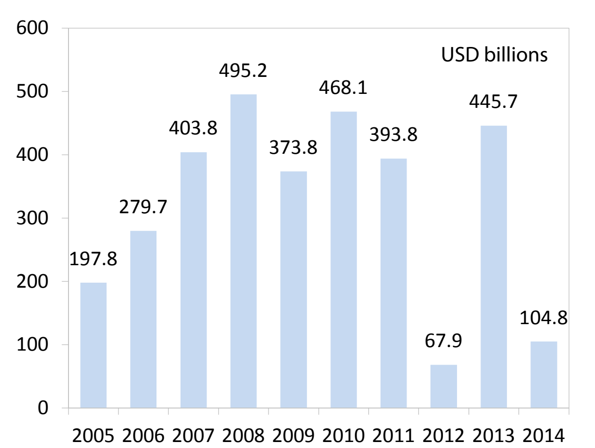
There have signs that capital flows are reflecting such domestic concerns. PBoC's data suggest that capital outflows accelerated in Dec 2014 with more than US$21bn flowing out, the largest on record for the month. For 2014, net inflows slowed to US$105bn, down from US$445bn in 2013. The last time that saw a yearly decline was 2012 during the height of the Eurozone debt crisis, which also resulted in the RMB under pressure during that time.

China: Capital Flows



Source: CEIC, UOB Global Economics & Markets Research Estimates

China: Annual Capital Flows



Source: CEIC, UOB Global Economics & Markets Research Estimates

On the back of domestic concerns and strong US dollar trend, RMB trading recently has been under significant downward pressure, with the downside of the 2% band close to being tested this week on two occasions, on Wed (28 Jan) and Mon (26 Jan). Adding to the pressure was PBoC deputy governor Pan Gongsheng's comments last Fri (23 Jan) that the ECB's newly announced QE program could add depreciation pressure to the RMB against USD due to its impact on capital flows.

However, a prolonged period of RMB depreciation should not be on the table, given the rapid internationalization of RMB means that it is essential to at least keep the currency in line with both domestic and global fundamentals and market dynamics. However, this could also see more two-way moves and volatility for the currency as the one-way appreciation trend of the past fades away. Just last week, the PBoC (on 21 Jan 2015) signed up Switzerland as the latest offshore RMB center, following similar announcements for Thailand and Malaysia since the beginning of 2015. The rapid pace of development is most evident in 2014 as China moved out of Asia and PBoC appointed 8 offshore RMB centers around the world in rapid succession, covering Europe (London, Frankfurt, Paris, Luxembourg), North America (Toronto), Australia (Sydney), Middle East (Doha), and also Asia (Seoul), in addition to the existing ones (HK, Macau, Taipei, and Singapore).

Having said that, we see further downside to the RMB in view that US Fed's interest rate normalization to be on track for mid-2015 "lift off". In addition, the MAS' surprise move could set a precedent for other central banks to jump on the easing bandwagon. With much room to move for the PBoC, we are adjusting down our forecasts for RMB further to 6.28/US for end-1Q15 (from 6.21 previously) and to 6.29/USD for end-2015 (from 6.18 previously).

FX OUTLOOK	As of 29 Jan 15	End 1Q15F	End 2Q15F	End 3Q15F	End 4Q15F
USD/JPY	117.9	121.0	125.0	126.0	127.0
EUR/USD	1.1274	1.10	1.09	1.09	1.08
GBP/USD	1.514	1.50	1.48	1.49	1.50
AUD/USD	0.788	0.80	0.78	0.78	0.76
NZD/USD	0.733	0.75	0.74	0.74	0.75
USD/SGD	1.354	1.37	1.39	1.40	1.40
USD/MYR	3.635	3.65	3.68	3.70	3.68
USD/IDR	12,524	12,900	13,000	13,000	13,000
USD/THB	32.6	34.1	33.7	33.5	33.4
USD/PHP	44.16	45.0	44.0	43.0	42.0
USD/INR	61.49	63.7	64.9	66.3	67.8
USD/TWD	31.41	32.3	32.5	32.6	32.4
USD/KRW	1,094	1,140	1,150	1,150	1,150
USD/HKD	7.75	7.75	7.75	7.75	7.75
USD/CNY	6.250	6.28	6.33	6.34	6.29

Source: Reuters, UOB Global Economics & Markets Research

Technical Trends

USD/CNH: 6.2600

The recent spate of weak China's data has led to further speculation that PBOC may embark on more stimulus measures. With that in mind, the strong rally from 6.2090 is likely the early stages of a sustained USD rally that may move above the May 2014 high of 6.2710 towards 6.3000. Only an unlikely break back below the 6.2090 would indicate that the current upward pressure has eased.