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Flash Notes

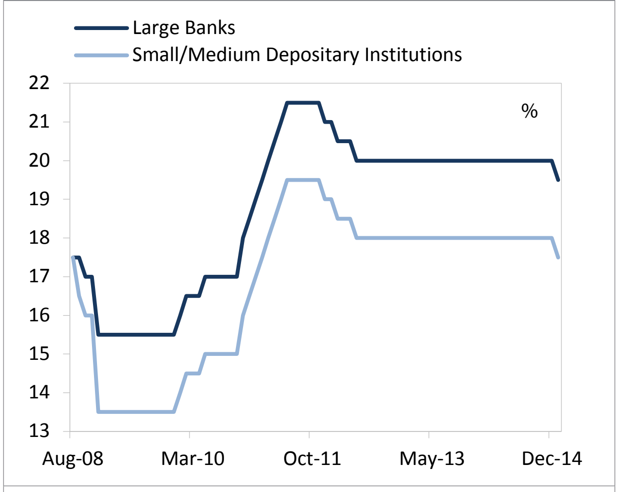
China: PBoC Cuts Broad-Based RRR

- PBoC made its first broad based RRR cuts since May 2012, moving away from its previous "targeted" approach and extending the wave of global central bank easing
- The move is within our expectation and looks to shore up its previous efforts of "targeted" RRR cuts and interest rate reductions, and to mitigate the impact of capital outflows
- The PBoC is likely to ease further and we maintain our call for at least one more round of RRR reduction, as well as further interest rate easing in 2015. Our end-2015 forecast for RMB is unchanged, at 6.29/USD and we anticipate a widening of trading bands this year
- FX technical chart suggests that USD/CNH upside remains intact long term, with current consolidation to last several weeks. For onshore interbank rates, funding costs are expected to turn lower, though more significant reductions may only take place post Chinese New Year. We also look for the 2Yx5Y curve to remain flat in the short term before steepening pressures build on more significant reduction in funding costs.

China's central bank announced late on Wed (4 Feb 2015) the reduction of reserve requirement ratios (RRR) by 50bps to 19.5% for major banks and to 17.5% for small/medium financial institutions. In addition, the PBoC also cut an additional 50bps for city commercial banks and rural commercial banks that met the small business loans requirements. These changes take effect from 5 Feb 2015. We estimate that the RRR cuts should free up about RMB590bn of funds in the banking system.

With its first broad-based RRR cut since May 2012, PBoC signals a further bias towards policy loosening and extends further the global easing wave that involved more than 10 central banks around the world since the start of 2015.

China: Reserve Requirement Ratios (RRR)



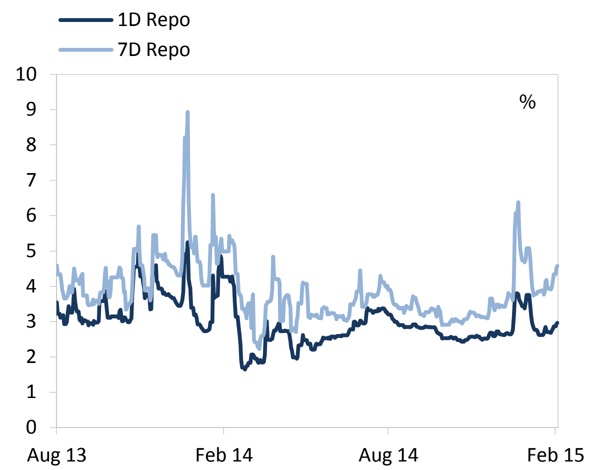
Source: CEIC, UOB Global Economics & Markets Research

The latest move is largely within our expectation, though the timing seems to be somewhat early given that economic data for January will only be released starting from Sunday (8 Feb) with the external trade report. The timing however may be spurred by the January manufacturing PMI reports that showed the official NBS PMI index drifting into the contraction zone for the first time since Sep 2012.

The fact that PBoC adopted a broad based approach this time suggests that its previous efforts of "targeted" RRR cuts may not be entirely satisfactory. In addition, the effect of PBoC's surprise interest rate cuts in Nov 2014 have largely faded, as interbank interest rates have actually risen soon after, and remained elevated. The 7D repo rate rose from just around 3% prior to the Nov rate cut, to above 4.5% recently, suggesting that interbank liquidity remains tight.

The higher interbank interest rates partially reflect capital outflows taking place over the past 6 months, as PBoC's FX position data show that 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 an annual decline was 2012 during the height of the Eurozone debt crisis, which also resulted in the RMB under pressure during that time, accompanied by interest rate and RRR cuts as well during that year.

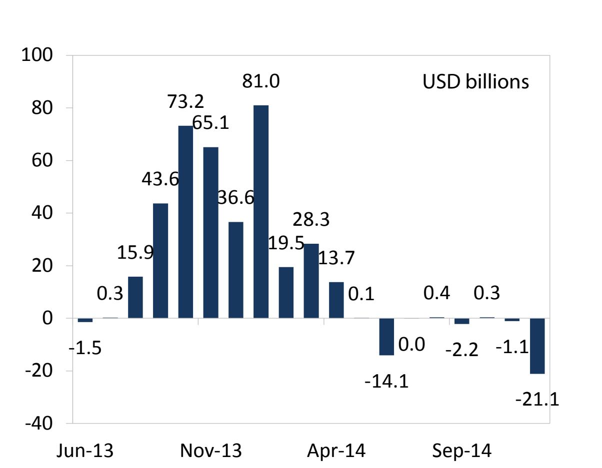
China: Repo Rates



Source: CEIC, UOB Global Economics & Markets Research

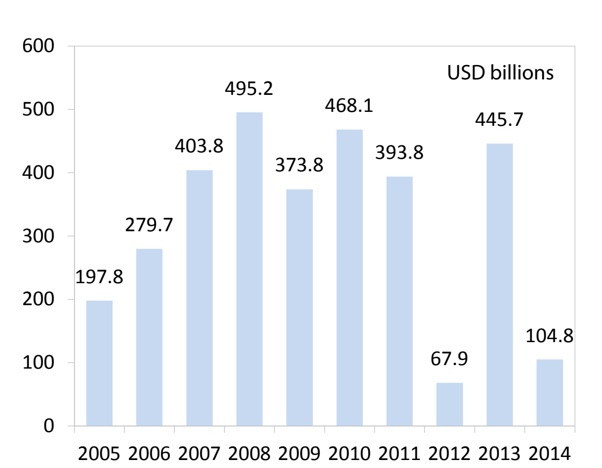
Meanwhile, China's headline inflation rate has drifted down to 1.4-1.5% by Nov-Dec 2014, from above 2.5% just a year ago. The PPI measure has been in negative territory for a record 34 consecutive months with no signs of turning around, exceeding the previous record of 31 months in 1997-99, during the Asian Financial Crisis years. The close correlation of the two inflation measures, at 0.68, suggests that there is considerable downward 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 downside pressure is likely to be significant in the months ahead.

China: Capital Flows (Monthly)



Source: CEIC, UOB Global Economics & Markets Research

China: Annual Capital Flows



Source: CEIC, UOB Global Economics & Markets Research

With China's 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 keep real interest rate above zero.

We maintain our view that PBoC would lower lending rates before mid-2015, as well as deposit rates (raising ceiling limit at the same time). For the RRR, we look for just one more round before mid-2015 to bring it to 19.00% as we do not expect PBoC to move aggressively given that the authorities are still looking for ways to reduce leverage in the system.

China: Interest Rate and RRR Forecasts

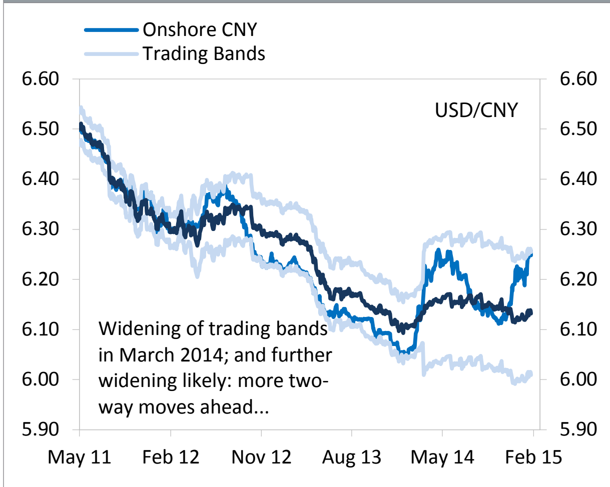
%	4Q14	1Q15F	2Q15F	3Q15F	4Q15F
1-year Best Lending Rate	5.60	5.35	5.10	5.10	5.10
1-year Deposit Rate	2.75	2.50	2.25	2.25	2.25
Reserve Requirement Ratio	20.00	19.50	19.00	19.00	19.00

Source: UOB Global Economics & Markets Research Estimates

Recent trading actions on the RMB suggest that the ongoing downward pressure is likely to remain for sometime, especially with the latest PBoC's RRR move. In the past 8 trading sessions since 26 January, the onshore spot prices have closed for 7 occasions of at least 1.8% below the midpoint, near the 2% limit. This is similar to the development in January 2014, when the spot prices consistently closed at around 0.7% to 0.9% stronger than the midpoint (then at +/-1% around the midpoint) and settled down somewhat subsequently, before PBoC widened the trading band on 17 Mar to 2%.

However, we do not expect substantial depreciation of the currency unless PBoC guides the daily fixing significantly weaker. As mentioned in our previous article "China: Reassessing RMB Outlook Post-MAS" dated 29 Jan 2015, the rapid internationalization of RMB means that it is essential to at least keep the currency in line with domestic and global fundamentals and market dynamics. In addition, PBoC is likely to be concerned that expectations of sharp depreciation of the currency could provoke further capital outflows that exacerbate the already tight liquidity conditions in the interbank market. Nevertheless, the currency should see more two-way moves and volatility for the currency as the one-way appreciation trend of the past fades further away.

Onshore CNY Trend



Source: Bloomberg, UOB Global Economics & Markets Research

In January 2015 alone, PBoC has appointed three offshore RMB centers: Switzerland, Thailand and Malaysia. The fast 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". We are maintaining our forecasts for RMB at 6.28/US for end-1Q15 and at 6.29/USD for end-2015. We also anticipate a widening of trading bands from 2% currently to 3%, before the end of the 2015.

FX OUTLOOK	As of 05 Feb 2015	End 1Q15F	End 2Q15F	End 3Q15F	End 4Q15F
USD/JPY	117.3	121.0	125.0	126.0	127.0
EUR/USD	1.1339	1.10	1.09	1.09	1.08
GBP/USD	1.518	1.50	1.48	1.49	1.50
AUD/USD	0.777	0.75	0.73	0.72	0.70
NZD/USD	0.737	0.69	0.67	0.65	0.65
USD/SGD	1.348	1.37	1.39	1.40	1.40
USD/MYR	3.583	3.65	3.68	3.70	3.68
USD/IDR	12,639	12,900	13,000	13,000	13,000
USD/THB	32.61	34.1	33.7	33.5	33.4
USD/PHP	44.15	45.0	44.0	43.0	42.0
USD/INR	61.75	63.7	64.9	66.3	67.8
USD/TWD	31.38	32.3	32.5	32.6	32.4
USD/KRW	1,088.3	1,140	1,150	1,150	1,150
USD/HKD	7.75	7.75	7.75	7.75	7.75
USD/CNY	6.256	6.28	6.33	6.34	6.29

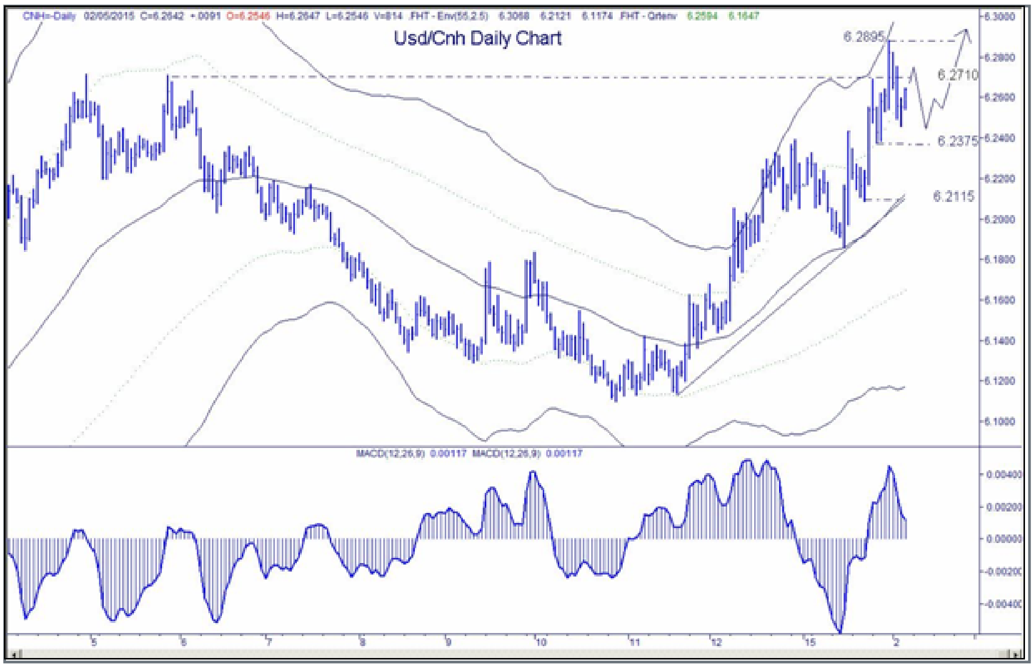
Source: Reuters, UOB Global Economics & Markets Research

PBoC announcement: 中国人民银行决定普降金融机构存款准备金率 并有针对性地实施定向降准措施 (4 Feb 2015)
http://www.pbc.gov.cn/publish/goutongjiaoliu/524/2015/20150204181725633492601/20150204181725633492601_.html

Technical Trends

USD/CNH: 6.2650

Corrective rebound could extend to 1.1675.



While the longer-term outlook for USD is still clearly bullish, the deeper than expected pull-back from the recent high of 6.2895 suggests that a temporary top is in place. The current price action is likely part of a consolidation/correction phase which may last for a couple of weeks. From here, we expect pull-back to hold above 6.2375 but only an unlikely breach of the major key support at 6.2115 would indicate that the bullish expectation is wrong. A break above 6.2895 would indicate the resumption of the bullish trend with an initial target of 6.3000 followed by 6.3535.

Rates View

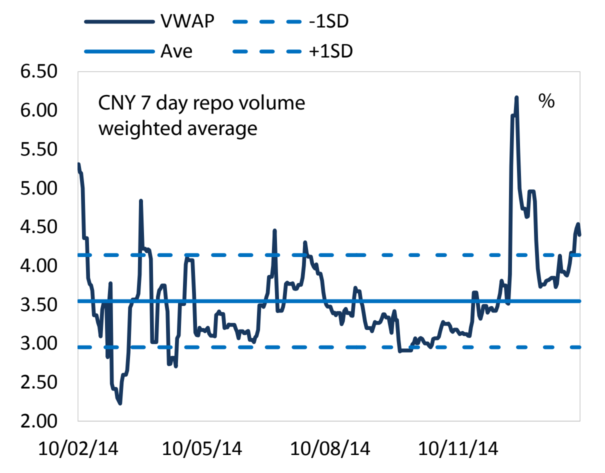
Impact on CNY rates market from the 50bps RRR cut will mainly be felt through easier liquidity in the funding market, which has been on the tight end of the scale in recent months. This is illustrated by the trend higher in funding costs as measured by the volume weighted average price in the 7 day repo (7D vwap).

Previous instances of system wide RRR cuts back in February and May of 2012 showed that 7D vwap was on average lower post RRR cut but magnitude of decline varies significantly. Reduction in funding cost was only marginal by May 2012 since that was the last of a three step RRR reduction cycle. 04 February RRR cut is the second policy easing measure announced since the lending rate cut, thus diminishing returns would not be apparent at this early stage of policy easing. Therefore we are expecting funding costs to turn lower over time, though more significant reductions in funding costs may only take place post Chinese New Year.

The expected reduction in funding stress has resulted in CNY IRS yields falling significantly across the curve post RRR cut. The 2Y CNY 7 day repo IRS fell by 20bps to an intraday low of 3.07%, yields have recovered halfway from the low water mark as the market moderated their expectations on the immediacy and magnitude of funding cost impact.

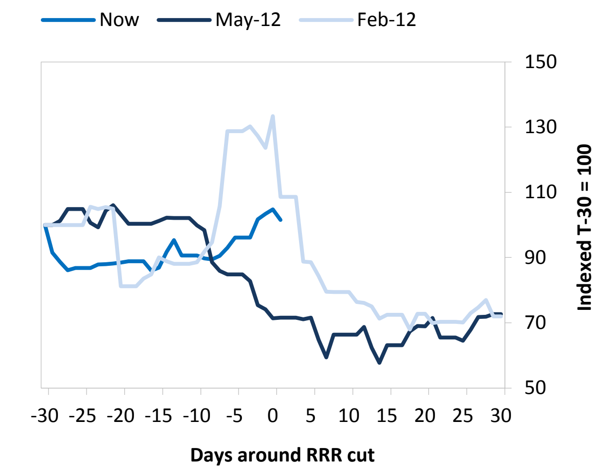
The yield curve reaction to the RRR cut has been relatively muted as the outright yield reductions have been evenly spread across the maturities. 5Yx10Y CNY IRS is marginally flatter as received positions roll up the curve to reduce holding costs. 2Yx5Y has steepened back and is fluctuating around parity. The propensity for 2Yx5Y IRS curve to steepen will depend on the magnitude and sustainability of reductions in funding costs (i.e. 7 day repo fixing). With Chinese New Year just round the corner, we expect the 2Yx5Y curve to remain flat in the short term before steepening pressures build on more significant reduction in funding costs.

Single Curve With +/- SD



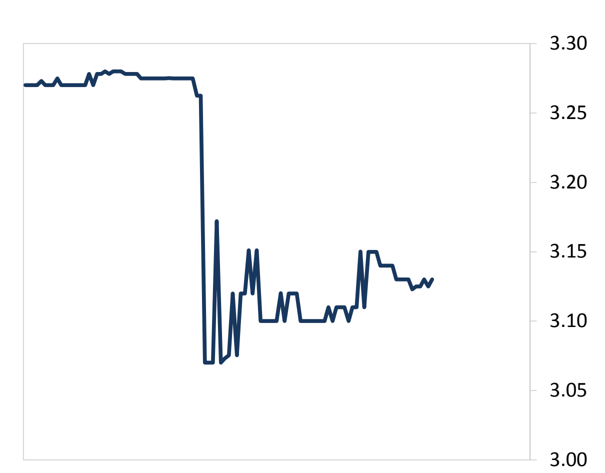
Source: Bloomberg

Funding Impact of RRR Cut



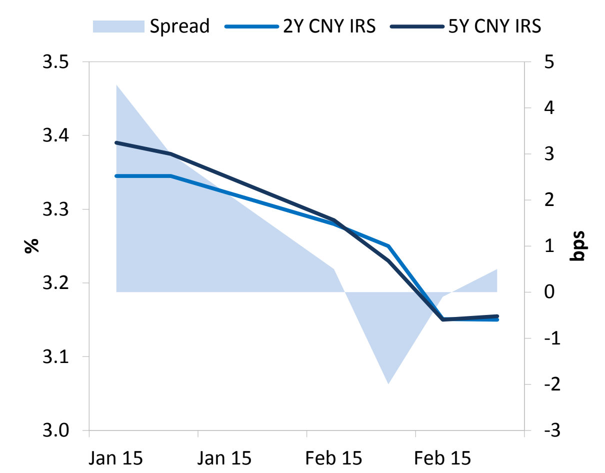
Source: Bloomberg

Intraday Fall in 2Y IRS



Source: Bloomberg

2Yx5Y Marginally Steeper Post RRR Cut



Source: Bloomberg