Suan Teck Kin, CFA
Suan.TeckKin@uobgroup.com

Peter Chia
Peter.ChiaCS@uobgroup.com

Global Economics & Markets Research
Email: GlobalEcoMktResearch@uobgroup.com
URL: www.uob.com.sg/research

Thursday, 07 January 2016

Flash Notes

China: The Beginning Of Trend RMB Depreciation?

- The substantial fall in RMB central parity fixing triggered another bouts of volatility in the global financial markets, as worries about China economic outlook and further depreciation of the RMB are back in the spotlight

- We think the RMB decline may be excessive given domestic economic fundamentals and could be driven by the robust USD strength. However, with the move towards a trade-weighted RMB model, there would be further two-way moves and flexibility of the RMB through 2016, which should not mean a one-way depreciation (or appreciation) of the currency. In view of the sharply weaker fixings, we have also adjusted our forecasts for USD/RMB.

- Strategy: Given the recent market jitters, the USD/CNH ATM vols have inched up to over 8% annualized, which is higher than that during Aug. As we do not foresee a repeat of the Aug event of a "surprise devaluation", it is more prudent to fade the vols, than an outright short-dollar trade at this juncture as even technically, USD/CNH may be overbought.

Sharply Weaker RMB Fixing Today
PBoC this morning (7 Jan 2016) set the RMB fixing at 6.5646/USD, 0.5% below the 6.5314 fix from previous day, the biggest percentage and point drops since 13 Aug (amidst central parity mechanism reform), and after 3 consecutive days of 0.2% move.

On the spot FX market, year-to-date, the onshore CNY has declined about 1.50% to 6.5920/USD and offshore CNH has declined about 1.75% to 6.3830/USD. CNY central parity has been weakened to 6.5646 from 6.4936 (on 31-Dec), a 1.09% move. The onshore-offshore spread has widened from 750 to a record of over 1900 pips early today before tapering to about 900 pips. These moves appear to have also infected equity markets, as Shanghai stock market halted trading early in the morning, for the second time this week, after hitting the down limit of 7%. Global financial markets were thrown into a turmoil as currencies and stocks reacted negatively to the news and also the reported intervention in the offshore CNH market, as the fixing should not have been so weak in the first place.

These market developments again raise the question of whether the RMB is on a depreciation path, and whether another devaluation is imminent? Our short answer is "unlikely" for both, as these sharp drops in the RMB are not justified by fundamentals, and could be largely driven by US dollar strength on the back of US Fed's interest rate normalization and geopolitical tensions ("risk aversion"), worries about China's economic outlook, and the way the daily RMB fixing is derived post-11 Aug 2015 reform.

Why The RMB Weakness?
US dollar strength has been much more robust than we had anticipated after the US Fed interest rate normalization, and is likely to be spurred on further by risk aversion sentiment from the Middle East and North Korea geopolitical tension. Our view is that the USD strength could fade off in the second half of 2016 as expectations for the US Fed policy trajectory becomes fully priced in, while other central banks may begin to slow their policy easing trend.

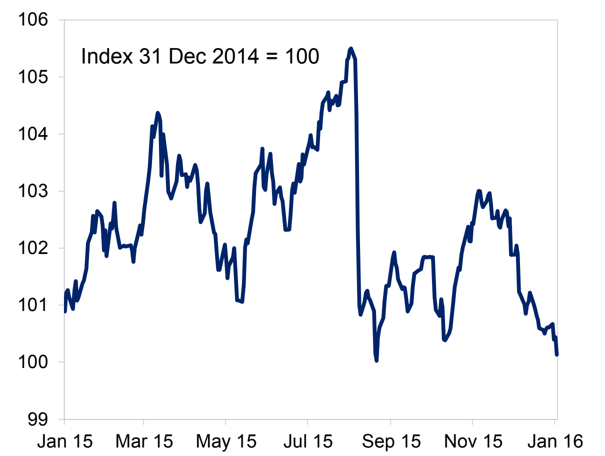
The perpetual concerns about China's economic outlook also feed on the negative view on the currency. While there are risks on the broader economy, we believe this overly negative view is overblown and unjustified by economic fundamentals even with the slowdown in headline growth. For instance, it should be noted that with a bigger base, 1%pt of GDP growth in 2014 in China would generate RMB554tn in output, or 2.6x larger than the RMB214bn output generated in 2004. Look at it the other way, the 7.3% headline in 2014, the slowest in 24 years, would be equivalent to a growth of 18% in 2004, which reported "only" 13.1% expansion for that year. As such, talk of a "slowdown" in China masks some of the facts and requires proper perspective.

FX OUTLOOK	07 Jan 16	End 1Q16F	End 2Q16F	End 3Q16F	End 4Q16F
USD/JPY	118.1	126	127	128	129
EUR/USD	1.082	1.12	1.13	1.13	1.14
GBP/USD	1.463	1.50	1.51	1.54	1.56
AUD/USD	0.704	0.74	0.74	0.75	0.76
NZD/USD	0.663	0.65	0.65	0.66	0.67
USD/SGD	1.435	1.45	1.46	1.44	1.42
USD/MYR	4.411	4.33	4.36	4.25	4.20
USD/IDR	13,900	14,100	14,300	14,000	13,900
USD/THB	36.3	36.2	36.5	36.8	37.0
USD/PHP	47.1	47.5	48.0	47.0	46.0
USD/INR	66.9	68.0	69.5	68.0	66.0
USD/TWD	33.3	33.9	34.1	33.9	33.6
USD/KRW	1,197	1,190	1,220	1,180	1,160
USD/HKD	7.75	7.80	7.80	7.80	7.80
USD/CNY	6.592	6.55	6.60	6.47	6.45

Source: Bloomberg, UOB Global Economics & Markets Research

For the daily fixing itself, the 11 Aug central parity mechanism reform may also have contributed to the continued weakening in the RMB trading. To recap, one of the factors determining the daily fixing is to reference the previous day's closing price at 430pm. If the RMB closed lower at 4pm e.g. due to risk sentiment, stronger dollar, or pessimistic view on China, then the next day's fixing is likely to be weaker against USD. Market (and other currencies) also take the cue from the morning fixing, resulting in weaker trade for the day unless some new positive catalysts reverse the sentiment and break the "self-feeding" cycle. Our studies suggest that there are more than 70% chance that a higher USD/CNY fix would lead to a higher USD/CNY close, which would then result in a higher USD fix the following day. In the current situation, the weakening of RMB could be extended although this weakness is not justified by domestic fundamentals mentioned above, and there are no signs of deterioration of economic activities even after taking into account the disappointing manufacturing PMI data.

CFETS RMB Index



Source: Bloomberg, UOB Global Economics & Markets Research

With China having moved towards a trade-weighted RMB regime, it is important to note that view on USD/CNY (and USD/CNH) would be dependent on where the RMB index would be and how other currency pairs would react. At end-2015, RMB index ended at 100.94, or 0.94% stronger from 2014. The recent turmoil in the CNY and CNH market saw the RMB index weakening to 100.2 this morning. The authorities continued to caution that there is no basis for continued depreciation of exchange rate and it has the conditions to keep the RMB stable against a basket of currencies. Taking RMB index holding at around the 100 level, this should imply USD/CNY at 6.62, holding other currencies at current levels. If one holds a view of weaker RMB index, say at 90.0, would imply USD/CNY at 7.30 which we think is overly excessive given the economic fundamentals, and could trigger similar negative reaction from other Asian currencies ("currency war").

Having said that, we are lifting our USD/CNY forecasts to reflect the substantially higher USD/CNY fixings. We changed our USD/CNY forecasts for end-1Q16 to 6.55 from 6.45, and to 6.60 from 6.51 for end-2Q16. Given our view on the USD trajectory lower in the second half of 2016, we have left our forecasts for USD/CNY as they were. What is even more important to recognize is that the two-way moves and flexibility of the RMB will become more apparent as PBoC continues to execute the trade-weighted model through 2016. This means that it may become increasingly risky to make one-way bets on the currency.

FX Strategy (Peter Chia)

Today's USD/CNY fixing of 6.5646 over yesterday's 6.5314 is the highest since 13 Aug. Considered that the onshore USD/CNY closed 6.5554 at 4:30pm yesterday, it is a surprise for PBoC to fix another 100 pips higher especially when the US dollar wasn't that strong overnight even after taking into account of geopolitical developments in the Middle East and North Korea's claim a successful testing of hydrogen bomb. Perhaps the fixing was driven by higher bids/polls the agent banks gave this morning.

Technically, both the USD/CNH (and on-off spread) look very overbought from conventional indicators such as RSI, which is at 79.

As such, the PBoC could feel more "compelled" for measures or verbal statements to calm the market especially when the Shanghai stock market has been halted for the second time this week and the ongoing concern that the RMB devaluation could spiral out of control. Indeed there were reports of intervention in the offshore CNH market in the morning, compressing the onshore-offshore spread from record high of 1,700 pips on Wed evening, to 970 pips late morning today.

Also CFETS RMB index has fallen close to the 100 handle which supported the RMB during Aug's devaluation.

Given the recent market jitters, the USD/CNH ATM vols have inched up to over 8% annualized, which is higher than that during Aug. As we do not foresee a repeat of the Aug event of a "surprise devaluation", it is more prudent to fade the vols, than an outright short-dollar trade at this juncture even technically USD/CNH may be overbought. With this, we initiate "Sell 3-mth 6.7000 USD/CNH straddle" to receive 2.25%. Breakevens at expiry on both sides are 6.5492 and 6.8507 respectively.