GROW Research
China Market Strategy

19 September, 2022

“Chill” about CNY Beyond 7

- The CNY weakness reflects deteriorating global fundamentals.
- Shadow CNY suggests further USD strength and corresponding CNY weakness.
- A weakening CNY augurs for looming global risks. Stay put.

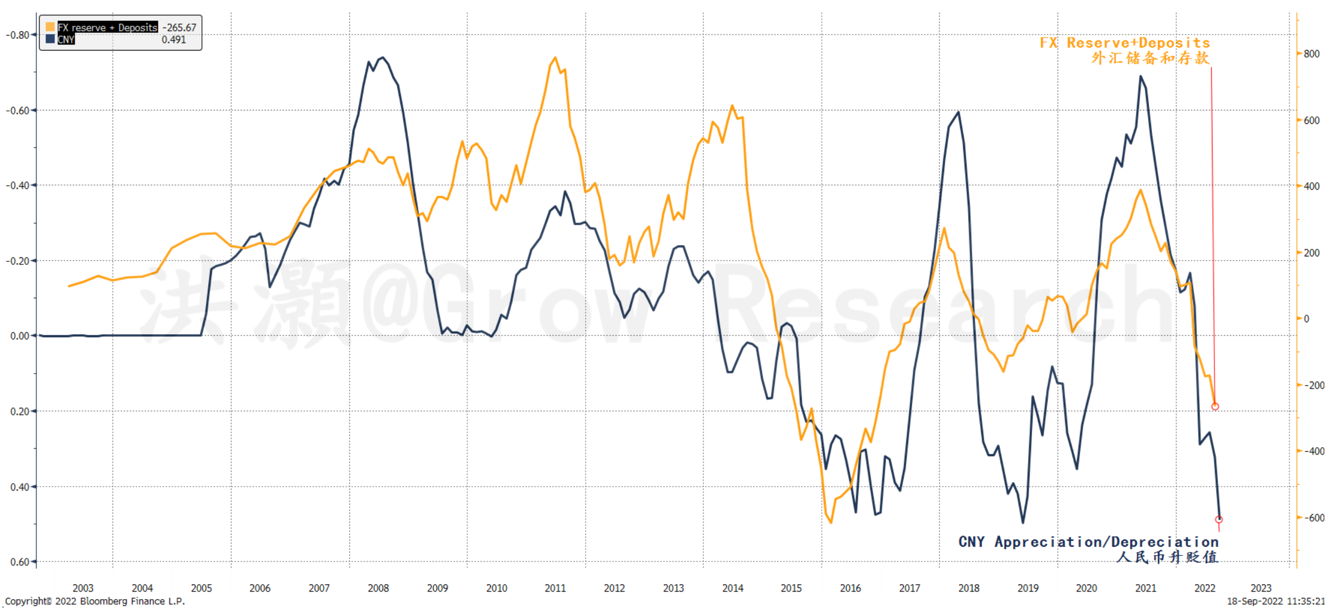
Hao Hong, CFA
hao.hong@growim.com

Chinese version of this report:“佛系‘破 7’”

Weakening CNY explained by fundamentals

Finally, the CNY has weakened past the threshold of 7. The divergence of the Fed and BoJ at the Jackson Hole summit has heralded the epic US dollar strength and JPY/EUR weakness. As the gap between 2-year US treasury yield and the Fed fund rate is around its widest in history, and the US inflation rate is peaking but likely to linger higher and longer, the Fed is unlikely to stop its tightening campaign.

Figure 1: As FX reserve & deposits fall, CNY depreciates.



Source: Bloomberg, GROW Research

Besides the divergence between global central banks, the changes in fundamentals in the Chinese economy have contributed to the weakness in the CNY as well. One of the economic puzzles in 2022 has been that Chinese exports continue to stun pundits, yet all these exports have failed to translate into rising forex reserve. Even if we include the forex deposits in commercial banks, we are still confronted with a picture of declining forex accumulation (**Figure 1**).

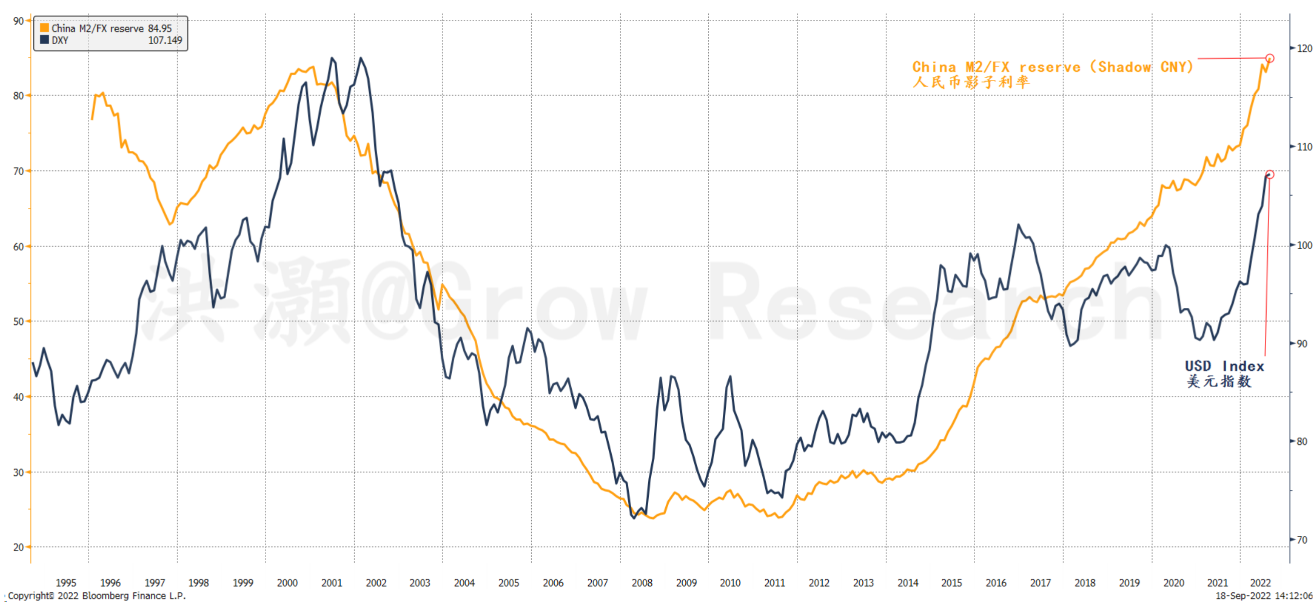
Exchange rate changes of the assets held in the forex reserve, as well as some capital outflow in the first half of the year are not enough to explain falling forex accumulation on the back of strong exports. Recent increase forward selling of the CNY at a similar magnitude to late 2015 does not shed enough light on the subject, either.

But historically the CNY has been closely correlated with the change in forex accumulation. As forex accumulation declines, the CNY weakens to the level last seen at the depth of the trade war in late 2018 (**Figure 1**).

We can also use the "*Shadow CNY Exchange Rate*" as a proxy for the divergence between the Fed and the PBoC. We define the "*Shadow CNY Exchange Rate*" as the ratio between China's M2 and FX reserve.

Recently, Chinese M2 growth continues to accelerate to its fastest in over seven years, likely a result of fiscal expenditure starting to pour into the economy. It is not surprising to see the shadow CNY exchange rate weakening to its worst in data history, while the USD strengthens (**Figure 2**). The USD strength will likely persist, as the PBoC and the Fed split further apart.

Figure 2: Shadow CNY (M2/FX reserve) at all-time high; USD is likely to strengthen further.



Source: Bloomberg, GROW Research

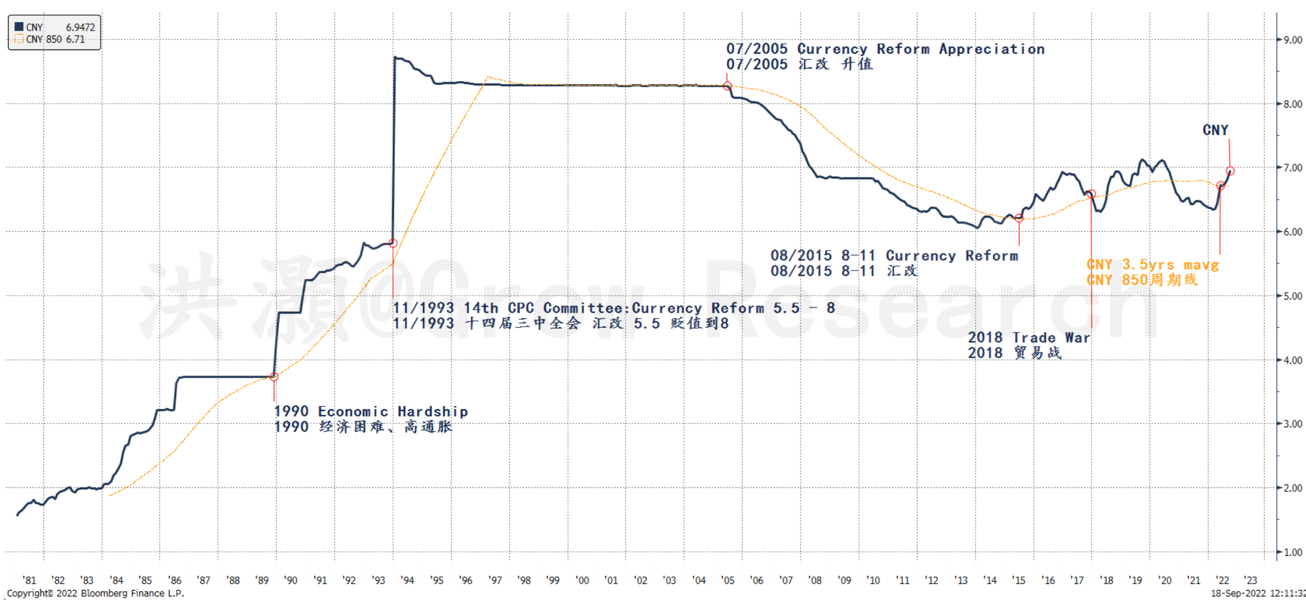
CNY long-term trend weakening

Interestingly, the significant events in the history of CNY track very closely with the intersections between the CNY spot rate and its long-term trend line, as measured by the CNY's 3.5-year moving average (**Figure 3**).

From early 1990s till before the "*7.21 Currency Reform*" in July 2005, the CNY spot rate stayed above its long-term trend line, showing a tendency of secular depreciation. The "*7.21 Currency Reform*" repeg the CNY to a basket of currencies, with a revaluation of the CNY. From then till the "*8.11 Currency Reform*" in 2015, the CNY spot rate stayed below its long-term trend line, exhibiting a tendency of secular appreciation.

Since then, the CNY has weakened and often stayed above its long-term trend line, affected by the trade war in 2018 and the pandemic in 2020. The "*8.11 Currency Reform*" in 2015 was to introduce two-way vacillations in the CNY exchange rate, and thus the CNY spot rate had been oscillating around its long-term trend line. As exchange rate movements tend to be protracted and serially correlated, the CNY will likely weaken further from 7 – corresponding to the epic strength in the USD as discussed above.

Figure 3: CNY's key historic events track closely along its 3.5-year cycle.

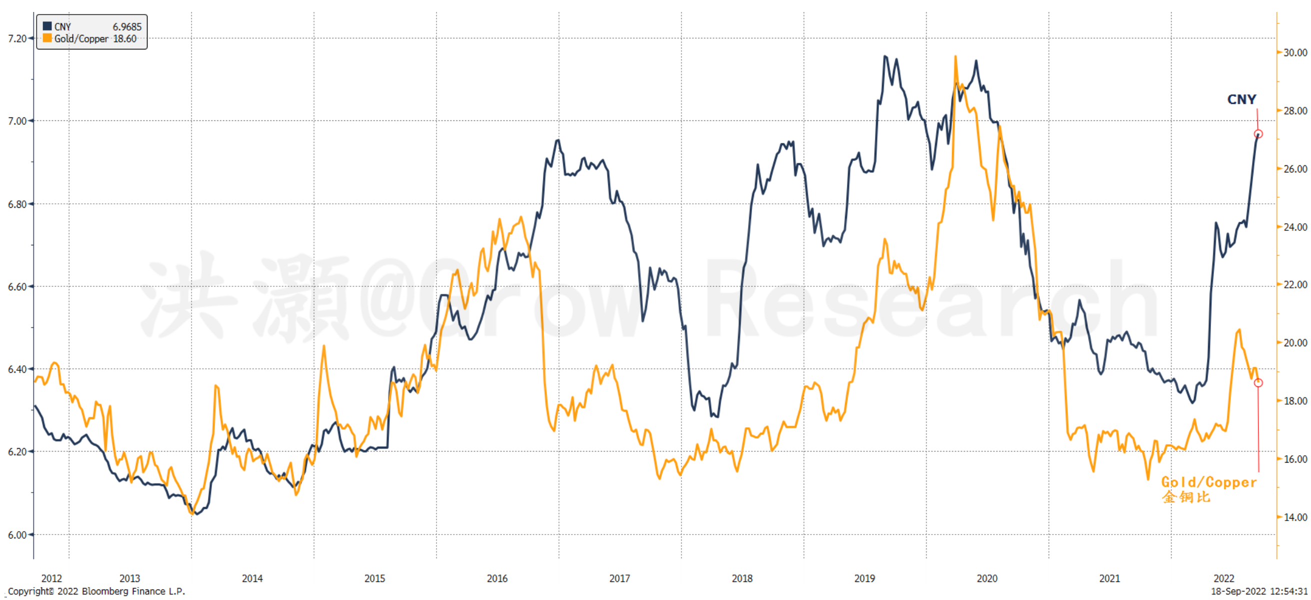


Source: Bloomberg, GROW Research

What does a weakening CNY mean for risk assets

As the currency of a country that tends to lead global economic cycle and is still largely cyclical in nature, the CNY has been a perceptive indicator of economic and market risks. For instance, the CNY spot rate is very closely correlated with the Gold/Copper ratio, a traditional risk indicator. In general, the weaker the CNY, the higher the Gold/Copper ratio, the higher the systemic risk and the lower the risk appetite (**Figure 4**).

Figure 4: CNY weakness hints at rapid deterioration of fundamentals & risk aversion.



Source: Bloomberg, GROW Research

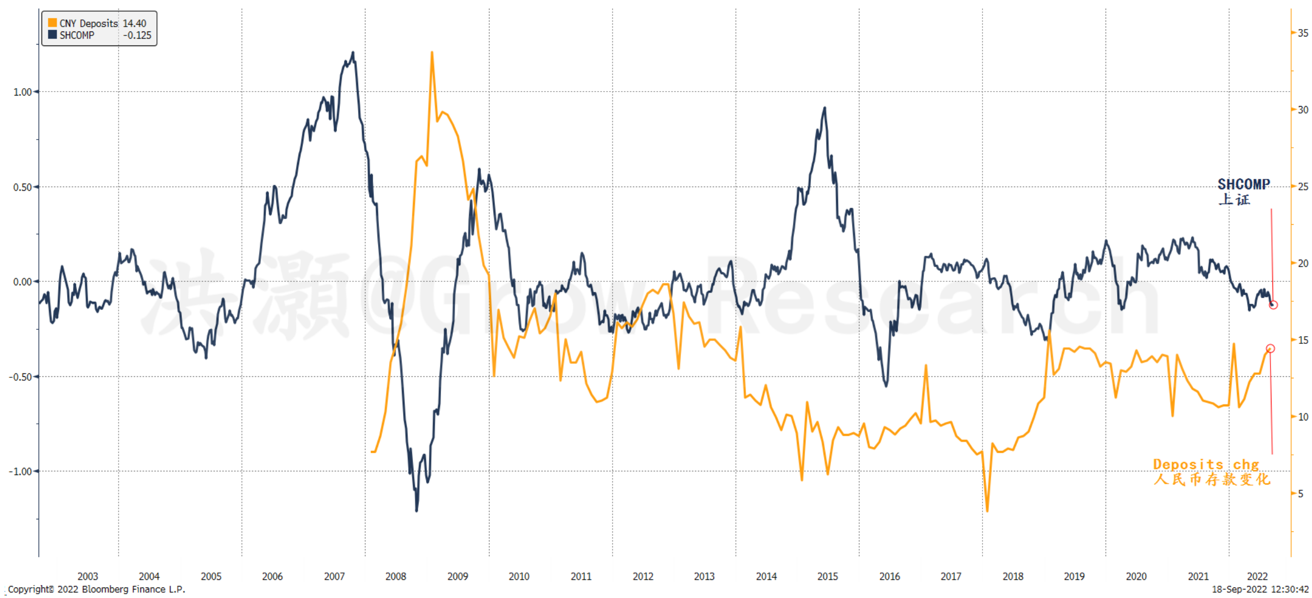
In the 2018 economic cycle and during COVID, the CNY actually led the Gold/Copper ratio in identifying risks. As aforementioned, the CNY weakness is unlikely to have concluded, as global economic data continue to deteriorate. As such, a weakening CNY hints at looming market risks ahead. While the CNY weakness is stretched in the near term, and thus could see some technical bounces, we would not recommend catching falling knives. The final plunge in global markets is impending. And the final curtain tends to fall with an abrupt blow.

August retail growth was a pleasant surprise, helped by the tax rebate for car purchases. In the past two weeks, high-frequency data suggest that car sales have started to decelerate. The spur from tax rebate seems to be tapering. Meanwhile, Chinese households are rushing to pay off mortgages, and long-term household loan growth (mostly mortgage) shown in August financial stats has yet to recover. The intention to buy a property is very low, while the intention to save soars.

Anecdotes suggest that banks are finding it easy to surpass this year's target of deposit growth. But not so much for loan growth. Gone are the days when bank branch managers went on binge drinking with potential clients to attract deposits in order to fulfill their deposit quotas. Of course, ample deposits leave leeway for banks to lend when the economic cycle eventually turns.

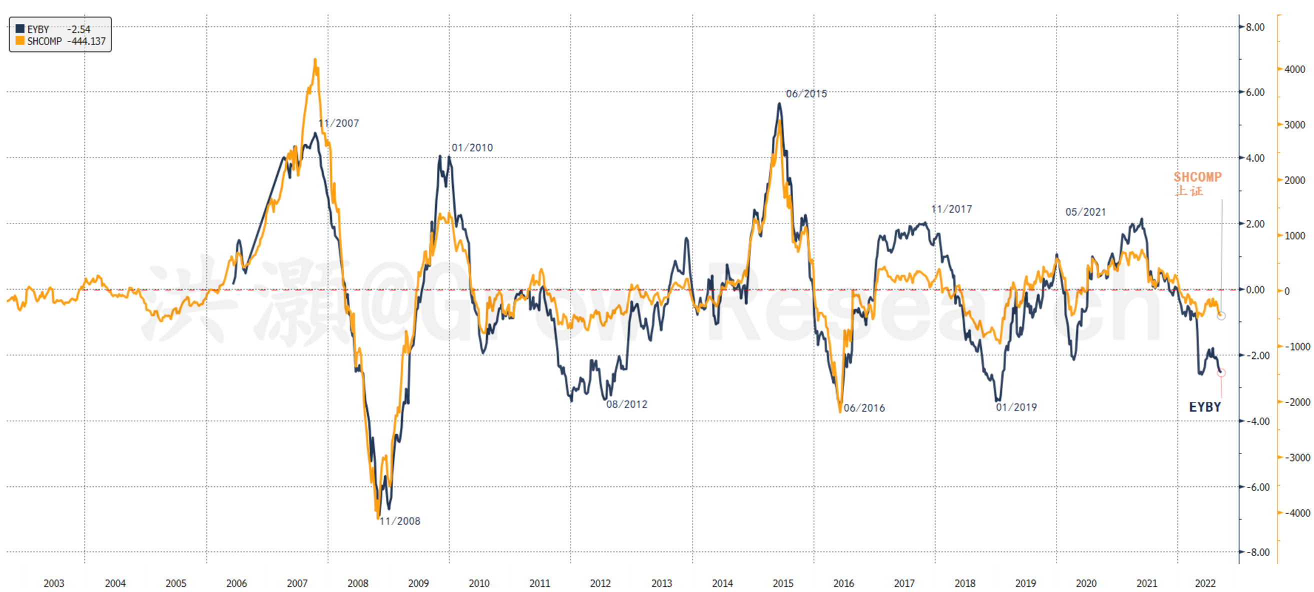
If money is sleeping in deposit accounts, then risk assets such as stocks will not have to vigor to rise. Historically, the Shanghai Composite and bank deposits are inversely correlated (**Figure 5**). Our market risk indicator EYBY has fallen to a very low level, but not yet at its extreme, especially considering the challenges that we are facing are arguably the biggest since 2009 (**Figure 6**).

Figure 5: Rising deposits bode ill for stocks.



Source: Bloomberg, GROW Research

Figure 6: Market is risk-averse, but not yet at its historical extremes.



Source: Bloomberg, GROW Research

Conclusion

The epic CNY weakness is telling. It reflects the divergence between the Fed and the PBoC, and the decline in FX accumulation despite the stunning strength in Chinese exports. The CNY is exhibiting secular weakness, and as such has the tendency to stay above its long-term trend measured by its 3.5-year moving average. It would not be surprising to see the CNY depreciate further beyond 7. It is just economic cycle at work – as always.

A weakening CNY bodes ill for looming market risks. As such, money is dormant in deposit accounts, and our proprietary market risk indicator is not yet at its lowest extreme to reflect fully the perils ahead.

Required Disclosures

This report has been prepared by GROW Asset Management (HK) Limited ("GROW AM"). GROW AM, its subsidiaries, branches and affiliates are referred to herein as GROW. For information on the ways in which GROW manages conflicts and maintains independence of its research product; historical performance information; certain additional disclosures concerning GROW research recommendations; and terms and conditions for certain third party data used in research report, please contact GROW. The figures contained in performance charts refer to the past; past performance is not a reliable indicator of future results. Additional information will be made available upon request. GROW AM is licensed by Securities and Futures Commission to conduct Type 9 (asset management) activities. Analyst Certification: Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report. For a complete set of disclosure statements associated with the companies discussed in this report, including information on valuation and risk, please contact GROW.

Global Disclaimer

This document has been prepared by GROW Asset Management (HK) Limited ("GROW AM"). GROW AM, its subsidiaries, branches and affiliates are referred to herein as GROW. **This Document is provided solely to recipients who are expressly authorized by GROW to receive it. If you are not so authorized you must immediately destroy the Document.** GROW research is provided to our clients. When you receive GROW research through, your access and/or use of such research is subject to this Global Disclaimer. When you receive GROW research via a third party vendor, e-mail or other electronic means, you agree that use shall be subject to this Global Disclaimer. **If you receive GROW research by any other means, you agree that you shall not copy, revise, amend, create a derivative work, provide to any third party, or in any way commercially exploit any GROW research provided, and that you shall not extract data from any research or estimates provided to you via GROW research or otherwise, without the prior written consent of GROW.**

In certain circumstances (including for example, if you are an academic or a member of the media) you may receive GROW research and you understand and agree that (i) the GROW Research is provided to you for information purposes only; (ii) for the purposes of receiving it you are not intended to be and will not be treated as a "client" of GROW for any legal or regulatory purpose; (iii) the GROW research must not be relied on or acted upon for any purpose; and (iv) such content is subject to the relevant disclaimers that follow. This document is for distribution only as may be permitted by law. It is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject GROW to any registration or licensing requirement within such jurisdiction.

This document is a general communication and is educational in nature; it is not an advertisement nor is it a solicitation or an offer to buy or sell any financial instruments or to participate in any particular trading strategy. Nothing in this document constitutes a representation that any investment strategy or recommendation is suitable or appropriate to an investor's individual circumstances or otherwise constitutes a personal recommendation. By providing this document, none of GROW or its representatives has any responsibility or authority to provide or have provided investment advice in a fiduciary capacity or otherwise. Investments involve risks, and investors should exercise prudence and their own judgment in making their investment decisions. None of GROW or its representatives is suggesting that the recipient or any other person take a specific course of action or any action at all. By receiving this document, the recipient acknowledges and agrees with the intended purpose described above and further disclaims any expectation or belief that the information constitutes investment advice to the recipient or otherwise purports to meet the investment objectives of the recipient. Past performance is not necessarily indicative of future results. Neither GROW nor any of its directors, employees or agents accepts any liability for any loss (including investment loss) or damage arising out of the use of all or any of the Information. Prior to making any investment or financial decisions, any recipient of this document or the information should take steps to understand the risk and return of the investment and seek individualized advice from his or her personal financial, legal, tax and other professional advisors that takes into account all the particular facts and circumstances of his or her investment objectives. Any prices stated in this document are for information purposes only and do not represent valuations for individual securities or other financial instruments. Different assumptions by GROW or any other source may yield substantially different results. No representation or warranty, either expressed or implied, is provided in relation to the accuracy, completeness or reliability of the information contained in any materials to which this document relates (the "Information"). The Information is not intended to be a complete statement or summary of the securities, markets or developments referred to in the document. GROW does not undertake to update or keep current the Information. Any opinions expressed in this document may change without notice and may differ or be contrary to opinions expressed by other business areas or groups, personnel or other representative of GROW. Any statements contained in this report attributed to a third party represent GROW's interpretation of the data, information and/or opinions provided by that third party either publicly or through a subscription service, and such use and interpretation have not been reviewed by the third party. In no circumstances may this document or any of the Information (including any forecast, value, index or other calculated amount ("Values")) be used for any of the following purposes: (i) valuation or accounting purposes; (ii) to determine the amounts due or payable, the price or the value of any financial instrument or financial contract; or (iii) to measure the performance of any financial instrument including, without limitation, for the purpose of tracking the return or performance of any Value or of defining the asset allocation of portfolio or of computing performance fees. By receiving this document and the Information you will be deemed to represent and warrant to GROW that you will not use this document or any of the Information for any of the above purposes or otherwise rely upon this document or any of the Information. GROW has policies and procedures, which include, without limitation, independence policies and permanent information barriers, that are intended, and upon which GROW relies, to manage potential conflicts of interest and control the flow of information within divisions of GROW and among its subsidiaries, branches and affiliates. For further information on the ways in which GROW manages conflicts and maintains independence of its research products, historical performance information and certain additional disclosures concerning GROW research recommendations, please contact GROW. Research will initiate, update and cease coverage solely at the discretion of GROW, which will also have sole discretion on the timing and frequency of any published research product. The analysis contained in this document is based on numerous assumptions. Different assumptions could result in materially different results.