

Asia Alert

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China Under Fire: Top 7 FAQ

WEDNESDAY
07 JANUARY 2016

1. **What is happening to the currency?**
2. **What is happening to the equity market?**
3. **Why is the CNY and CNH spread widening?**
4. **Why does the spread matter?**
5. **Is this currency war?**
6. **What is our view on CNY and Chinese equity going forward?**
7. **How does this impact the rest of the world?**

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1) What is happening to the currency? China's currency (CNY) is losing value and moving fast. CNY has weakened almost 10% vs the USD in just 2 years and over half of the weakness has come in the last 4 months (Chart 1) starting from the 2% devaluation on Aug 11. We are heading to 6.83; the level China pegged to the USD post the Global Financial Crisis of 2008. What's more important is how fast CNY and CNH are moving. CNH (offshore traded CNY) 3 month volatility has moved the most in Asia in the last month and is considered just as volatile as free floating Japanese Yen as you can see on Chart 2.

2) What is happening to the equity market? China's equity market has hit the daily 7% loss limit today, second time in the first week of 2016. We think two drivers are leading the weakness. First is supply. The stock market artificially stabilized in 2015 because the government prevented selling. This week the selling bans were to be removed and showed that current prices were too expensive for buyers to soak up the extra supply coming onto the market. Second, the currency weakness is hurting the equity market. Theoretically, with very little foreign ownership, currency weakness should not translate into domestic equity market weakness. However, CNY weakness and more importantly PBoC allowing CNY to reflect weakness in economic fundamentals, send a more accurate signal on the state of the Chinese economy and a bigger threshold for the government to accept pain. The floor is getting lower.

3) Why is the CNY and CNH spread widening? As Chart 3 shows, the CNY/CNH spread has widened to historical highs, past the stress we saw in autumn 2011 when the European debt crisis ballooned. However, the 2011 case was an infrastructure and quota problem, which was adjusted and alleviated quickly. We are in a different phase now where the widening spread show that capital flows are bigger than the commercial flows. Commercial transactions (e.g. goods and service exports/imports) have the ability to switch between CNY and CNH and help the spread narrow. What makes it widen are the capital flows, which only have access to the offshore market. Capital flows are overwhelming than the commercial arbitrage flows.

4) Why does the spread matter? The CNH market is China's proxy foreign exchange market, which are not subject to capital controls. Individuals and corporates use the CNH market to hedge onshore CNY exposure. If the spread widens and CNH does not track the onshore CNY value, the CNH market becomes useless. When IMF included CNY in the SDR basket as one of the "elite" reserve currencies of the world, IMF specifically mentioned that that CNY/CNH spread should be limited because CNH market was the door connecting offshore to onshore market or opening in China's capital account. If the spread widens, the door is dysfunctional and means the capital account is not opening up, making CNY less of an "elite" currency and losing reserve status.

5) Is this currency war? It's looking more like it. Chart 4 shows the USD/CNY rate and the CNY Nominal Effective Exchange Rate (NEER) based on trade weights from the Chinese government (CFETS – China Foreign Exchange Trade System). CNY weakness since August 11 has moved in step with weakness in the NEER meaning, CNY is cheaper across the board, not just versus USD. Yes, it playing catch up since CNY NEER strengthened in 2013 and 2014 but there is no doubt CNY is gaining from its competitors.

6) What is our view going forward on CNY and Chinese equities? As we wrote in our 2016 Asia Outlook, CNY and Chinese equities will move like developed market currencies and equity markets. Only with fundamental improvement, will CNY and Chinese equities recover. Economic outlook is still for further weakening. Incoming data is showing that main supporter of growth in 2015, services, are showing signs of weakness, following manufacturing. Furthermore, recent government announcement emphasizes reducing excess capacity in heavy industry such as steel and cement, which will put more pressure on the labor market and consumption. Hence, we still prefer to be short CNY and CNH and we are short TWD as a proxy trade. As stated above, 6.83 is target on CNY but stronger USD or weaker Euro can weaken it further. We also recommended long JPY vs CNH but we understand that it has moved and suggest waiting for a pull back before entering. Equity outlook is weak so we are recommending relative value trades where we like Philippines relative to Korea.

7) How does this impact the rest of the world? Not good as you are seeing. Allowing the currency to reflect economic fundamentals means that the rest of the world feels more of what China is feeling. Under the old currency regime of a semi-peg to the USD, the world was insulated from inheriting Chinese domestic events. That is no longer the case. With PBoC allowing for more volatility and weakness in CNY, this transmission mechanism will only amplify. For those of you outside of Asia (e.g. US), please get ready for more contagion. China is getting more attention than US payrolls.

Chart 1: CNH/JPY to 16.6

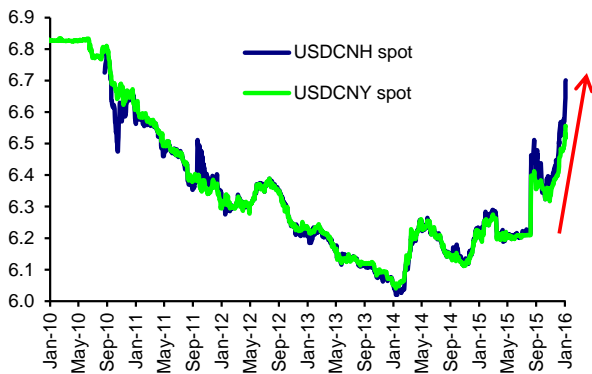


Chart 2: CNH 3 month implied vol as high as JPY

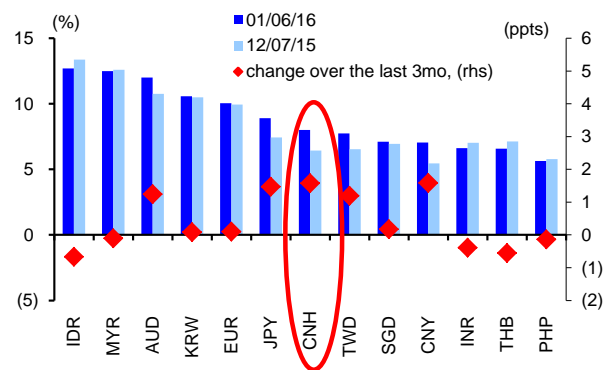


Chart 3: CNY/CNH spread at new levels

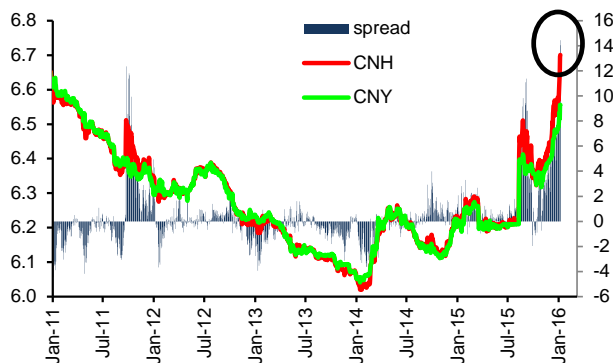
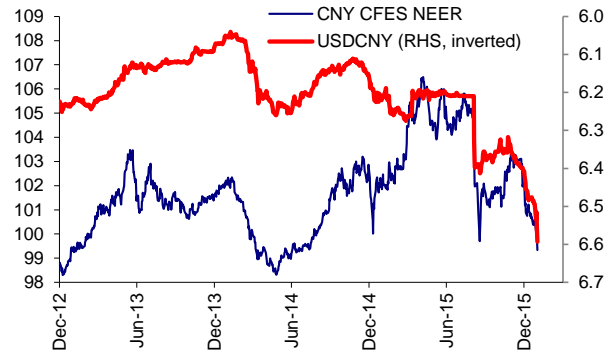


Chart 4: CNY weakening across the board



Source: Bloomberg, CEIC, Bol, SEB

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