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Investing in renminbi assets：
Long term value is key consideration amid short-term volatility in yuan

In April, the CNH depreciated to one-year low due to the Covid situation in China, Stronger USD Index, and higher global market volatility. RMB retained its position as the fifth most active currency in global payments; US-China 10-years government bond yield spread inverted, the first time since 2010. Foreign capital outflows continued in April, yet, eased compare to March. With market priced-in some short-term factors, foreign institutional investment in China market will return to a steady pace.

I. CNH experienced depreciation in April

In April, the CNH depreciated from 6.3678 to 6.6303, down nearly 2,800 basis points during the month and hitting a one-year low. The main reason is that higher US inflation has led the US Federal Reserve to accelerate the pace of interest rate hike, driving up the 10-years treasury yield and USD, causing capital outflow from emerging markets. The RMB was therefore weakened. The CNH traded in a narrow range of 6.37 to 6.38 from the beginning to mid of the month. Then, from 18 April to 22 April, the market expectation for Fed tightening increased as St. Louis Fed President Jim Bullard publicly supported a 75 basis point of rate hike in the next FOMC meeting in May. The Fed Chairman Jerome Powell mentioned in the IMF’s annual meeting on 21 April that a 50 basis point rate hike would be on the table in the May FOMC meeting and it is likely to keep the hiking pace for the next couples of FOMC meeting. Affected by the hawkish message from Powell, the USD index was above 100 firmly. In addition, the IMF lowered China’s 2022 economic growth forecast by 0.4%, leading to a rapid adjustment of the CNH. The CNH closed with depreciation for several days and fell below 6.6 at the end of the month for the first time since November 2020. On 25 April, the RMB market sentiment was cooled down by the PBOC’s decision to cut the Required Reserve Ratio (RRR) by 1% to support the real economy. On 29 April, the central parity rate of RMB against US dollar published by CFETS was 6.6177, down 4.25% MoM; the CNY closed at 6.6085 that day, down 4.24% MoM. The CNH closed at 6.6404, down 4.50% MoM.

The risk of US entered into recession was rising in April. Energy, housing and food prices have risen sharply due to the Russia-Ukraine conflict and supply chain disruptions, further pushing up inflation. US inflation is unlikely to fall back to the Fed's 2% target anytime soon, adding pressure on the Fed to tighten and strengthening the USD against a basket of currencies. On April 11, for the first time since 2010, the spread of 10-year treasury bond yield between the US and China inverted. In short-term, given the continued high inflation rate in the US and considerable downward pressure on China's economy, the US-China monetary policy divergence may continue, causing US-China government bond yield to narrow or even invert. Looking ahead, trade surplus, foreign capital's allocation in China equities and bonds, and oversea central banks' quantitative easing will play an important to RMB exchange rate.

Regarding offshore RMB liquidity, as of April 29, the overnight and 1-week CNH Hibor rates were 1.21467% and 3.1478% respectively; the 1-month CNH Hibor rate stood at 3.307%; and the 3-month CNH HIBOR rate was 3.516%.

II. Review of major offshore RMB business indicators

Offshore RMB business maintained stable with partial decrease in some indictors in March 2022. According to HKMA, as of the end of March 2021, Hong Kong's RMB deposits reached RMB 791.34 billion, down 12.7% MoM. US interest rate hike, market financing activities and lower attractiveness in RMB's interest rate may be the reasons of the decrease. However, RMB deposits rose 2.4% when compared to March 2021, showing the drop in recent months can be a one-off incident with no implication of continuous decline. RMB loans stood at RMB 177.99 billion, up 0.8% MoM. The total remittance of renminbi for cross-border trade settlement amounted to RMB 801.6 billion in March, up 60.1% MoM and RMB 2 trillions in the first quarter of 2022, up 17.8% YoY.

According to HKICL, RMB RTGS turnover was RMB 28.09 trillion in April 2022, accumulated 129.6 trillion in the first 4 months, up 15.8% YoY. According to SWIFT, the RMB has maintained its position as the fifth most active currency for global payments by value, with a share of 2.14%, lower than last month at 2.20%, behind USD (41.81%), EUR (34.74%), GBP (6.26%), and JPY (3.08%). According to Bloomberg, offshore RMB bond issuance in primary market amounted to RMB 40.037 billion in the 4 months of 2022, down 4.08% YoY (RMB 41.74 billion).

III. Investing in China's Interbank Bond Market

Cross-border investment continued to experience short-term fluctuations in April due to multiple external factors such as the expectation of US interest rate hike and the narrowing US-China yield spread. Foreign institutional investors reduced RMB 108.5 billion worth of bond holdings. According to PBOC, by the end of March 2022, foreign institutions held RMB 3.77 trillion worth of inter-bank bonds, accounted for 3.2% of the total (vs RMB 3.88 trillion in March). In terms of bond type, foreign institutions held RMB 2.39 trillion in government bonds (vs RMB 2.43 trillion in March), and RMB 0.97 trillion in policy bonds (vs RMB 1.01 trillion in March), respectively accounted for 63.4% and 25.8% of the total.

According to CFETS, foreign institutional investors invested RMB 487.2 billion in bonds and sold RMB 533 billion in April, with net selling of RMB 45.9 billion. Bond Spot transaction by Foreign institutional investors amounted to RMB 1.22 trillion, up 13% YoY and down 17% MoM. Meanwhile, two more foreign institutions entered the interbank bond market in April, bringing the total number of foreign institutions to 1,035 by the end of April. Among them, 514 entered the market through the direct investment channel, 749 through the bond connect and 228 through the above two channels simultaneously.

The latest report from Bond Connect showed a stable market participation in April, with monthly trading volume reached RMB 591.1 billion. Average daily turnover stood at RMB 31.1 billion, up 10.3% from the previous month. Chinese Government Bonds (CGBs) and Policy Financial Bonds (PFBs) were the most actively traded products, accounting for 51% and 32% respectively of the monthly turnover. The number of investors under Bond Connect continued to grow, with 36 added in the month. The total number of approved investors reached 3,483.

Since 2022, the shift of monetary policy of major economies increased the volatility in global stock, bond and FX market significantly, causing cross-border capital flows more unstable. In recent months, the adjustment of China’s cross-border investment is a normal market reaction. With the market’s digestion of short-factors, foreign investment in China’s securities will return to a steady pace. Long-term value investment will still be foreign investors’ consideration. In the first quarter of 2022, the current account and direct investment recorded surplus, reflecting China’s economic prospect and market potential. Foreign capital outflow eased in April, with inflows resumed in some trading sessions. RMB bonds are relatively attractive in the global financial markets. With continuous effort in market opening, the long-term trend of increasing foreign investment in China will not change.

The China-US 10Y bond yield spread turned negative for the first time in almost 12 years

On April 11 Beijing time, the yield spread between Chinese 10-year government bonds and comparable US Treasuries reversed for the first time since June 2010. The yield on China's 10-year government bond was closed at 2.7402%, while the yield on US 10-year Treasury bonds rose more than 2.76%. The fundamental reason is the divergence of China-US economic cycle and monetary policy, and the Fed tightening expectation is the driving force behind the rapid rise of US bond yields. The State Council held an executive meeting on April 13, and decided to use monetary policy tools like reserve requirement ratio cuts at an appropriate time to increase the credit input capacity of banks, strengthening financial support to virus-hit sectors, micro, small and medium-sized enterprises and self-employed individuals.

China cut reserve requirement ratio for foreign currency deposits

On April 25, the People's Bank of China (PBOC) announced to cut the reserve requirement ratio for foreign currency deposits by one percentage point from the current 9% to 8%, starting from May 15, 2022. The move is aimed at enhancing capabilities of financial institutions in managing foreign exchange funds, adjusting the balance of supply and demand in the foreign exchange market. The market reacted quickly to the news, with both onshore and offshore renminbi strengthening.

PBOC steps up support for real economy

On May 9, the People's Bank of China (PBOC) released the first-quarter monetary policy report. The monetary policy report showed the central bank's emphasis on coping with risks, including policy adjustments by overseas central banks, global inflationary risks aggravated by geopolitical tensions, and a surge in local COVID cases. The report said major developed economies have sped up monetary tightening with spillover effects such as greater volatility in global financial markets and cross-border capital flows. The central bank will pay close attention to monetary adjustments in developed economies, strengthen macroprudential management of cross-border capital flows and improve the management of market expectations, in a bid to ensure normal foreign exchange market operations and keep the yuan's exchange rate basically stable at a level of equilibrium, the report added.

RMB exchange rate outlook – Impact of China-US interest rate spread

Ding Meng, Economist

I. Summary of exchange rate determination theory

There are four parts of main exchange rate determination theory:

1.Purchasing power parity theory

The theory is based on the law of one-price. two currencies are in equilibrium when goods and services are priced the same in both countries. The change of exchange rates is determined by the inflation rate.

2.Interest rate parity theory

The interest rate parity theory considers the interest rate and spot rate to make currencies in equilibrium. FX trader cannot take interest rate arbitrage opportunity by borrowing a currency with lower interest rate.

3.Balance of payment theory

The balance of payment theory is a demand-supply theory of exchange. The exchange rate is related to demand-supply in the domestic foreign exchange market and externally the international payment of the currency. This theory assumes the short-term foreign exchange rate is determined by the position of the balance of payments. Balance of payment theory is the fundamental of all the other theories. It is an important tool to analyze the fundamental of an exchange rate.

4.Asset market theory

The theory was formed after the Bretton Forest system disintegrated in the 1970s. it regards currency as an asset, so the exchange rate can be priced like other types of asset, meaning the exchange rate is the price of domestic and foreign currencies. Generally, FX analysis framework and asset allocation framework were used according to the alternative effect of currency and other securities.

For RMB exchange rate, the interest rate parity and asset market theory emphasize the influence of short-term factors such as interest rate differences. Meanwhile, Balance of payment theory consider relative impact of current accounts and capital accounts. The purchasing power theory emphasizes the importance of long-term factors, so it is not being used for analyzing short-term exchange rate.

II. RMB exchange rate - Analysis and outlook

1. RMB exchange rate is under high pressure in the short term

Generally, based on the short-term exchange rate determination theory, with free capital flow, the short-term interest rate spread has a relatively direct impact on the exchange rate. For example, the US-Germany 2-year Treasury bond yield spread has a more direct impact on EUR/USD. Compared with short-term government bond yields, tenor higher than or equal to 10-year cannot accurately reflect the difference in monetary policy. It is more affected by the long -term inflation forecast and the risk aversion market sentiment. Theoretically, the correlation between the long-term bond and the exchange rate is lower when compared to short-term bond. The 10-year US-China treasury yield spread was often used because other short-term tenor (1 and 2 year) of government bond between US and China are incomparable. Therefore, as an alternative, the 10-years are often used for comparison, yet, with a limited representation. Although it is hard to accurately quantify the spread between US and China's government bond yield, the yield spread is likely to narrow, causing foreign capital to outflow.

As affected by the economic cycle divergence between China and the US, the monetary policy between the two countries was significantly different. On one hand, in order to boost the economy, the People's Bank of China (PBOC) adopted an easing monetary policy on currency, credit, and interest rate. On the other hand, in order to control high inflation, the Fed has continuously accelerated the pace of interest rate hike and began to discuss tapering. As of April 8, the US-China 10 -year government bonds yield spread narrowed to only 3 basis points. Data showed that foreign holding in RMB bonds reduced RMB 80 billions in February, and further declined RMB 112.5 billions in March, the largest outflow since the record inception in 2017. It is believed that it will have a short-term negative effect on the RMB exchange rate. However, with the effective capital control and Bond Connect mechanism, the RMB exchange rate will be affected more by the current accounts. It is no doubt that narrowing spread has a negative impact on the exchange rate in short-term but the RMB will depend on China's current accounts in the middle and long term.

2. The RMB depreciation won't last

Although the RMB is currently trading under pressure in short-term because of a few negative factors, such as narrowing spread and loosening monetary policy, there is no evidence that the RMB will unilaterally depreciate in the future.

The international payment and the demand-supply in foreign exchange market will still play an important role to RMB exchange rate while the narrowing spread will only play a minimal role. Currently, although the growth rate of current account surplus and non-reserve financial account may be slower, they are still in a large surplus currently and the onshore USD liquidity is still sufficient. In addition, the capital outflow of direct investment is still manageable. Therefore, it is believed that the RMB won't depreciate in the long-term.

Compared with other period of US-China economic cycle divergence, the narrowing spread trends are similar. Historically, when the US and China's interest rate policy were different, the RMB often depreciated and experienced fluctuation. For example, it happened from the second half of 2015 to the beginning of 2016 and in 2018.

However, compared with this time, the previous two periods were with the condition of continuous capital outflow and deficit in capital and financial accounts. The reason behind as follows: 1. The decline in foreign exchange reserve is caused by the transforming economic development, making the RMB, stood at a high level since 2010, lack of fundamental support. 2. It was at the time of the second half of bull equities market, foreign investors needed to take profit from the equities market, driving up the selling demand in RMB. 3. The change of sentiment in equity market caused foreign investment outflow in securities and direct investment, causing a structural imbalance. 4. The "811" reform caused a one-off RMB depreciation and caused depreciation expectations. 5. The strategy of "going out" increased overseas merger and acquisition project which reduced the amount of lending projects. 6. The above-mentioned factors have contributed to the market expectation on RMB depreciation, making foreign companies to settle foreign exchange in advance and domestic companies to hold USD by deferring settlement. The capital and financial account were therefore worsened.

Although the PBOC had continuously adopted an active fiscal policy to intervene the market, and lowered the interest rates for 5 consecutive times. However, it still took nearly two years to change the depreciating expectations. Compared with the situation in 2015 to 2016, the main reasons for the depreciation from 2018 to 2019 are the narrowing current account surplus. With the current challenges of China-US trade conflict and the US entering into interest rate hike cycle, China has always an independent and stable monetary policy to prevent systemic financial risks. The main interest rates such as Loan Prime Rate (LPR) remained unchanged for a long time. Also, the rising US bond yield made non-saving accounts flow slightly.

In addition, the tariffs imposed on Chinese goods have greatly affected US-China trade. As a result, both inflow and outflow of regular accounts has shrunk YoY, causing the market expectation on RMB depreciation. This also prompted China to a relatively stable and neutral monetary policy and comprehensively support the real economy and employment stability in the second half of 2019.

In 2022, the US-China spread has been rapidly narrowed, however, it is significantly different from the previous two times as the international income and expenditure accounts accumulated in 2020 and 2021 can effectively support the RMB. Despite the current depreciating RMB and foreign capital outflowing the stock and bond markets in China, the outflow and exchange rate fluctuation are mainly caused by short-term sentiment. Also, the demand for foreign exchange settlement in the securities market only accounts for 6%-8%. Although the growth rate of international revenue and expenditure has slowed down, it can still maintain sufficient onshore USD liquidity. In addition, the current RMB exchange rate is still relatively high. Therefore, the pressure on foreign exchange settlement is still controllable. In conclusion, there is a loose correlation between the narrowing US-China spread, capital outflow, and RMB depreciation. Instead, external shocks may play a more significant role to RMB depreciation. But with the support of international income and expenditure balances, it is hard for the RMB to have a unilateral depreciating trend in the future.

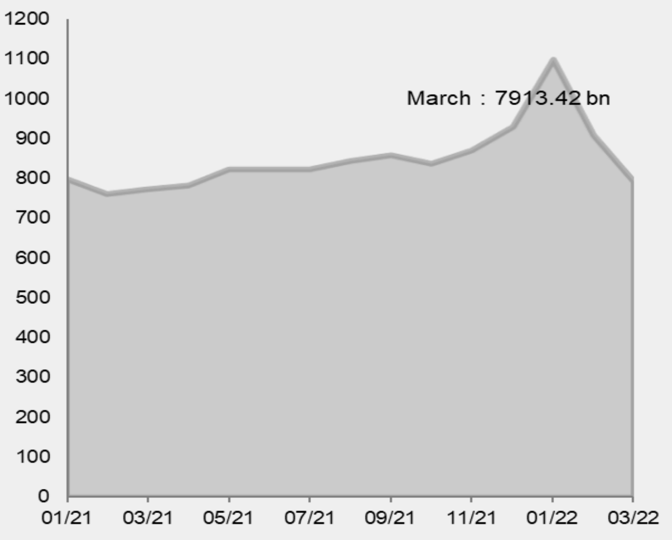
3. Hedging is particularly important under the two-way fluctuations of the exchange rate

Based on the above analysis, although RMB is weak in the short-term, the gaming force on middle and long term are generally balanced, therefore, RMB is unlikely to continue to weaken. In the future, the two-way fluctuations of USD/CNY are normal: the short selling power of the RMB mainly comes from market pessimistic expectations caused by the political and economic situation. In contrast, there are support from the current international revenue and expenditure account surplus and the demand foreign exchange settlements. If the RMB accelerates the pace of decline, corporate's willingness to settle the foreign exchange at a high level will support the RMB.

It is recommended that to follow up with the trend of USD/CNY, focusing on the spread of onshore and offshore market and the spot and forward rate. The changes of surplus and deficit in the balance on current account should also be monitored. In the short term, the risk of RMB depreciation is small. However, considering the recent increasing volatility in the international financial market and changes in the domestic economic environment and monetary policy, it is recommended to hedge at range of 6.3-6.6 .

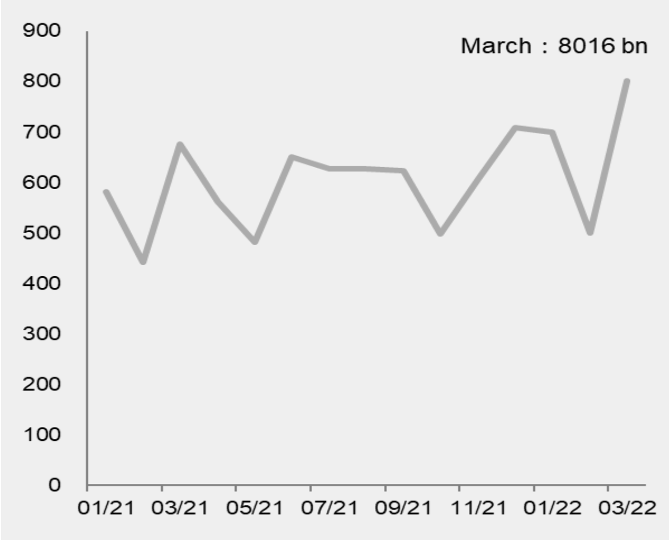
Market Indicators

Hong Kong RMB Deposits (RMB bn)



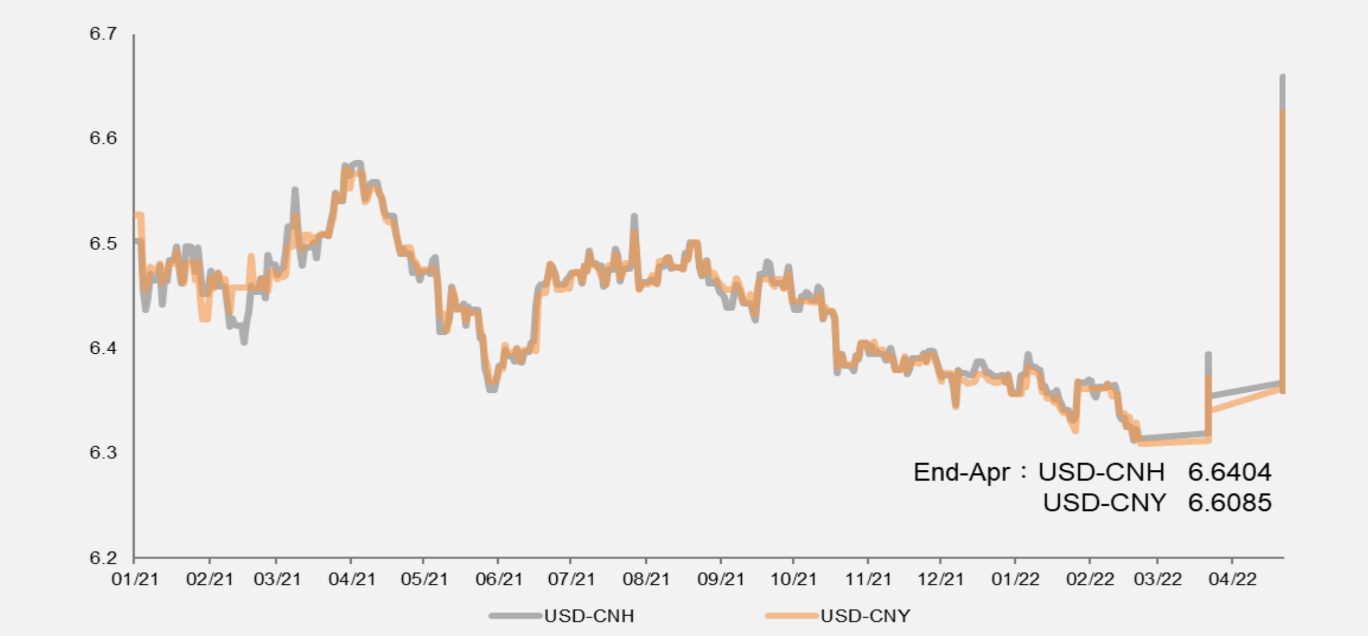
Source: HKMA

Hong Kong RMB Cross-border Trade Settlement (RMB bn)



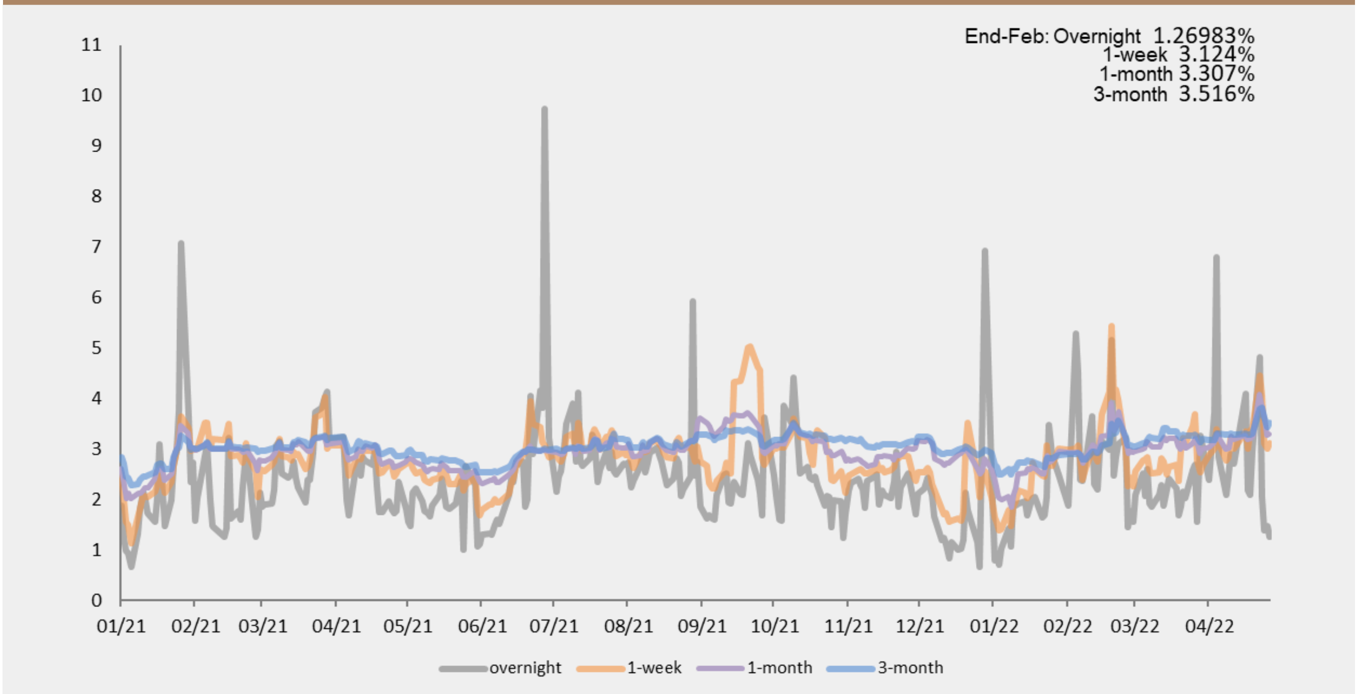
Source: HKMA

USD-CNH and USD-CNY Exchange Rates



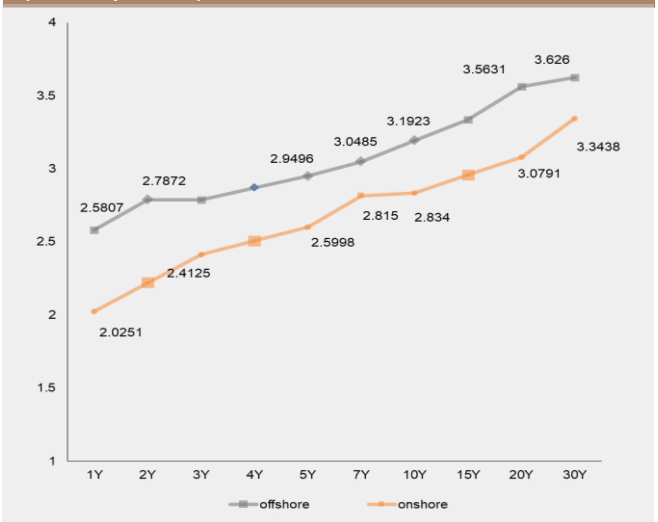
Source: Bloomberg

CNH HIBOR Fixing (%)

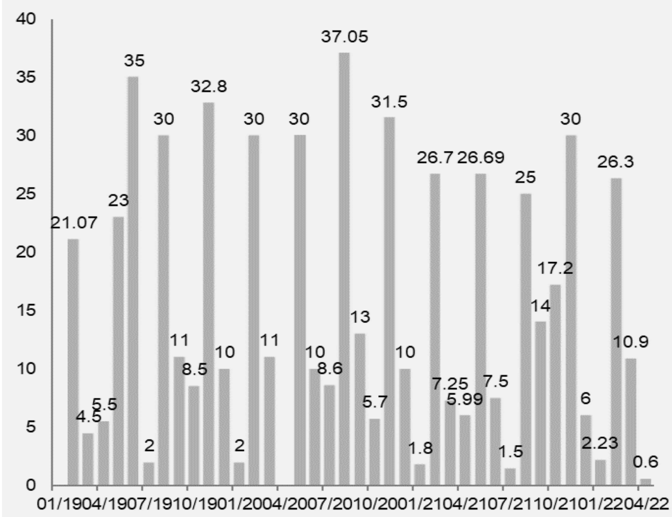


Source: Bloomberg

CNH & CNY China Sovereign Curve (%, 29 Apr 2021)



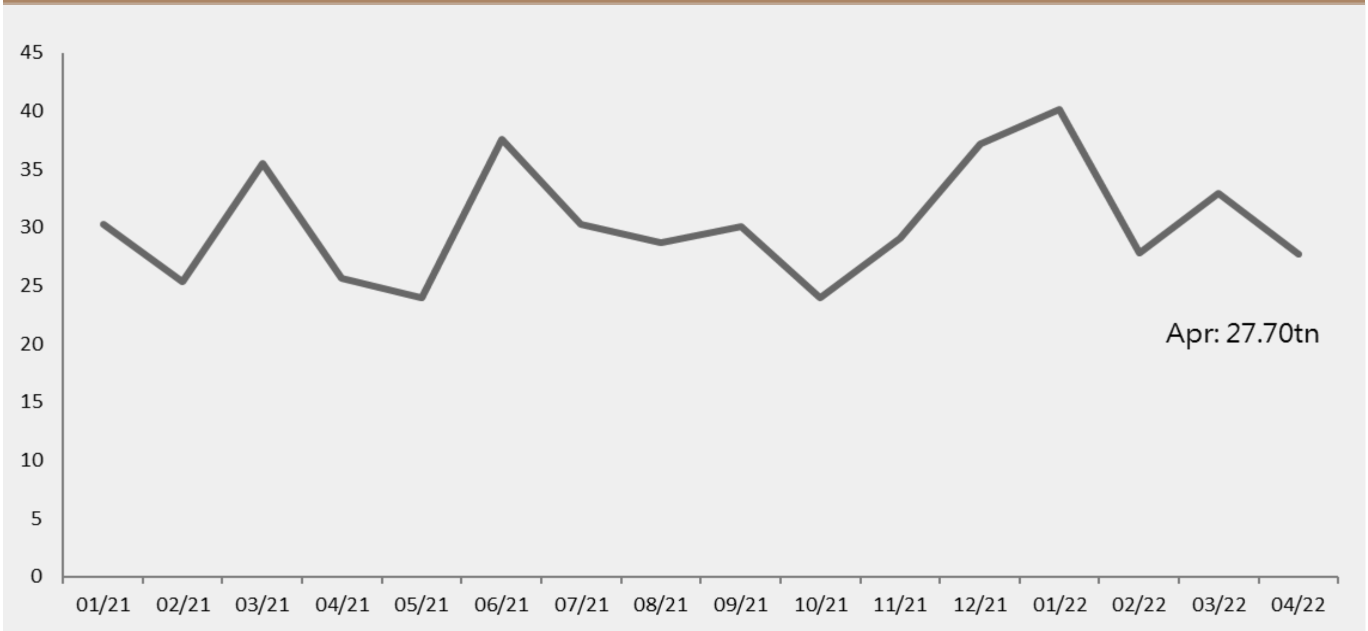
Hong Kong Offshore RMB Bond Issuance (RMB bn)



Source: Bloomberg

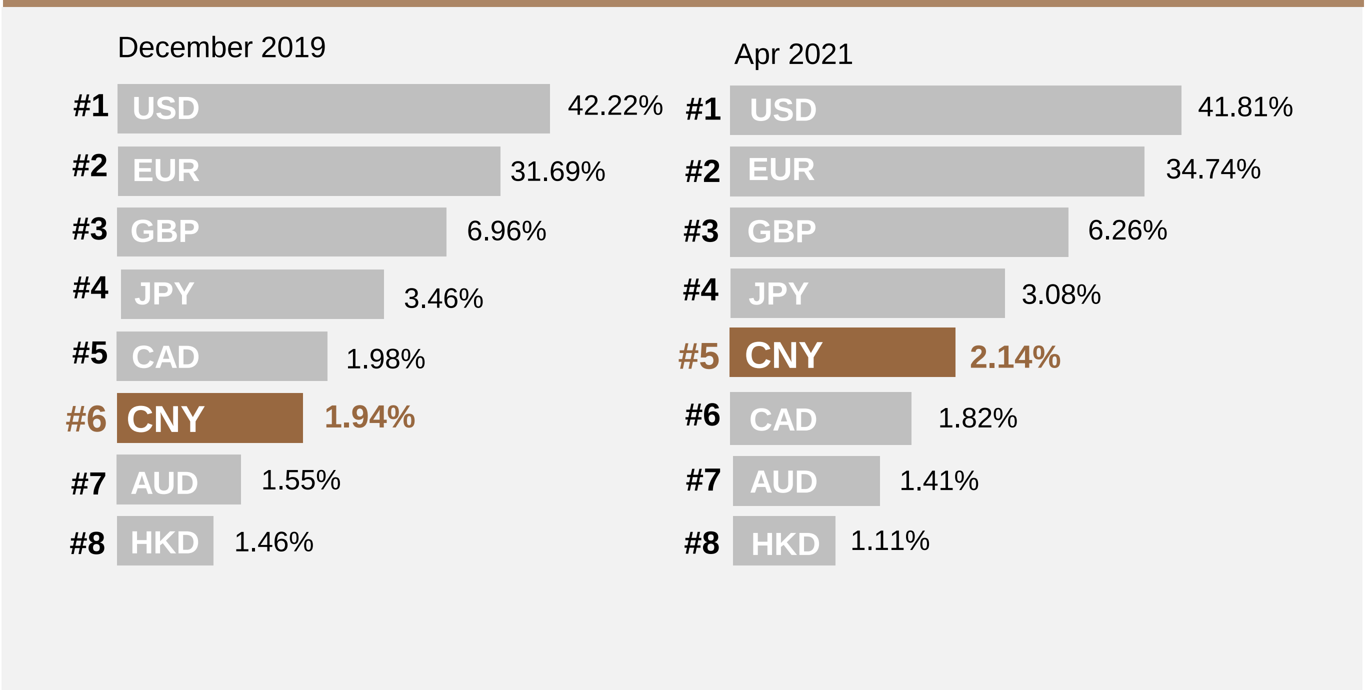
Source: BOCHK Global Market estimate

RMB Clearing Transaction Value (RMB tn)



Source: HKICL

SWIFT World payments currency ranking & market share



Source: SWIFT

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