FOR PROFESSIONAL INVESTORS – 11 January 2019

Chi Flash

RENMINBI TO APPRECIATE IN 2019, WANT TO BET?

I like to bet on as close to a sure thing as you can find

Bobby Riggs

The renminbi was down 5.71% YoY against the USD in 2018 on concerns about slowing domestic growth under the clouds of domestic deleveraging, a trade war with the US and a shrinking current account surplus (estimated at only 0.8% of GDP for full-year 2018). The market is predominantly bearish on the yuan with many players seeing it weaken beyond 7 per USD in 2019.

Why am I still betting on renminbi appreciation then? I think the market is overly bearish on China's BoP position, underestimating the financial account inflows and exaggerating the fears about capital outflows.

CAPITAL FLOW DYNAMICS

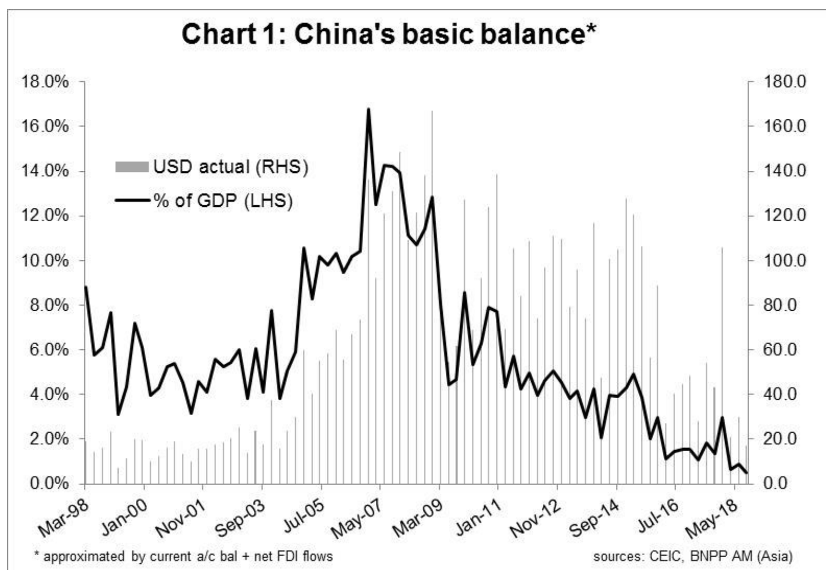
The flow support for the renminbi from the current account has dwindled along with the surplus. Net FDI inflows have also dropped. Hence, the estimated basic surplus has dropped below 1% of GDP (Chart 1). Many players are betting on a current account deficit this year.

However, China's external balance may not be so bearish. Firstly, China has sped up the opening up process for foreign investment and pledged to improve its structural behaviour such as IP protection and forced technological transfer[1]. Together with still stringent capital control, this may boost net FDI inflows.

Secondly, a slowing economy will constrain China's imports and slow the growth of its service trade deficit by slowing down outbound tourism. Meanwhile, China has diversified its exports from the US to other countries, notably the Belt & Road Initiative (BRI) countries (Chart 2). So export growth in 2019 may not drop, or not drop

[1] See "*Chi Flash: Sino-US Trade Negotiations (I): Odds Have Risen For Cooling Trade Tensions*", 7 January 2019, and "*Chi Flash: Sino-US Trade War: Truce For Now But Risks Have Mutated*", 3 December 2018.

as much as the market expects under the trade war. All this will help prevent the current account and basic surpluses from further erosion, or even boost them[2].



The capital outflow pressures have been exaggerated. After adjusted for exchange rate changes, non-FDI outflows[3], which represent both hot money and illegal capital outflows, have actually been reversing recently instead of worsening as the unadjusted data shows (Chart 3). They amounted to USD156 bn in 2017 and USD 597 bn in 2016 when capital outflows were rampant.

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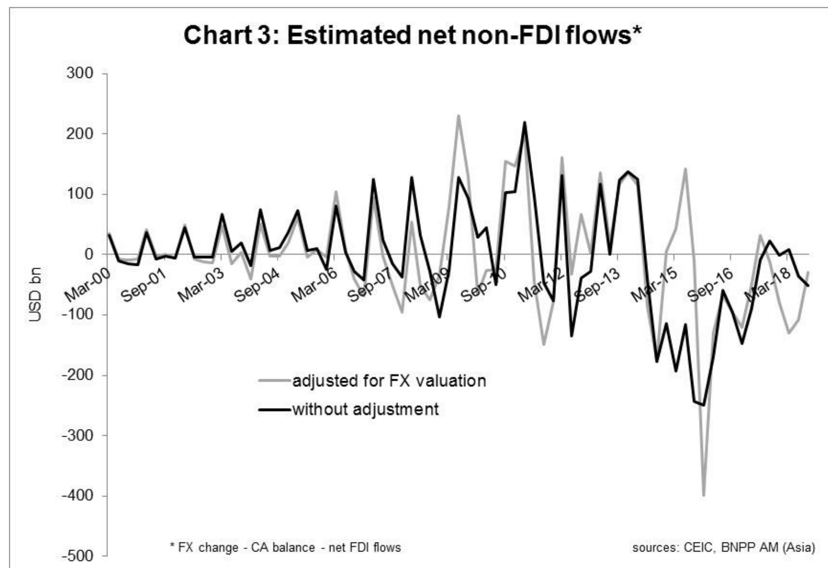
[2] Some market study estimated that a 50 bps rise in China's GDP growth rate would cut its current account balance by 1.5%. See "*Global Macro Strategy: Asia FX 10 Questions for 2019*", UBS, 5 December 2018, pp.6. This empirical evidence argues that slower growth in China should boost the current account surplus.

[3] They are estimated by subtracting China's current account balance and net FDI flows from the change in FX reserves.

In a nutshell, current account and FDI flows may not be as strong a support for the renminbi as before, but the flow dynamics may also not turn as negative as consensus has it.



Then the key question is about financial account flows, and this has a lot to do with market sentiment on China. The impact of Beijing's policy easing on market sentiment is starting to show in the recent recovery in the CNY-USD cross rate and the decline in China's bond yields. The latter reflects market sentiment turning from worrying about defaults (that has pushed up yields) to cheering about disinflation (that has recently pulled down yields).

The move by international equity and bond index service providers to add Chinese assets to their international EM indices[4] will boost sentiment, bring more portfolio inflows to China and, thus, boost the renminbi. This flow impact on the yuan exchange rate has been proven significant. Portfolio investment flows accounted for over 90% of China's financial account surplus in 1H 2018. They kept the renminbi strong against the USD despite China's current account deficit in 1Q18 and rising Sino-US trade tension (Charts 4 and 5).

Adding to the private-sector inflow is global reserve managers' asset allocation to China. The renminbi's share in global FX reserves has doubled from 1% to 2% since 2016 and its weight is now bigger than the AUD and CHF (Charts 6 and 7). If global reserve managers increase their renminbi assets by an average of 0.5ppt a year, they would bring USD40 bn into China's onshore bond market.

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[4] MSCI is mulling to raise the inclusion factor for Chinese A-share in its EM index to 20% from the current 5%, and is due to make a decision by the end of February or early March this year. FTSE Russell also announced last September that it would include 1,200 A-shares in its FTSE Emerging Index in three stage starting from June 2019, bringing in more than USD50 bn passive inflows to the A-share market in 2019.
In fixed income, Bloomberg/Barclays are going to include all CGBs and policy bonds in its Aggregate Bond Index over 20 months starting April 2019. This is expected to bring in USD110 bn of inflows. Citi WGBI and JPM GBI-EM have also expressed intention to include Chinese bonds in their indices later this year or early 2020. This would bring in an average of USD80 bn a year between 2019 and 2020, according to market estimates.

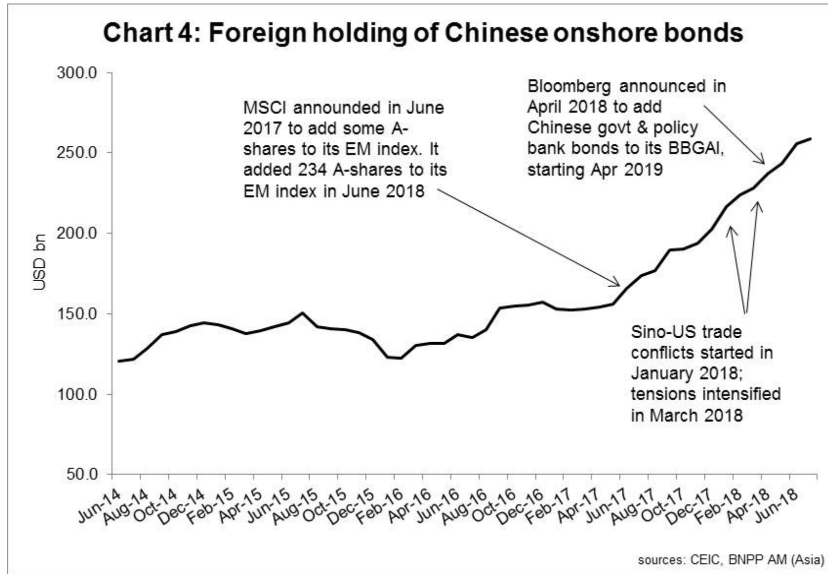


Chart 4: Foreign holding of Chinese onshore bonds
USD bn
300.0
250.0
200.0
150.0
100.0
50.0
MSCI announded in June 2017 to add some A-shares to its EM index. It added 234 A-shares to its EM index in June 2018
Bloomberg announced in April 2018 to add Chinese govt & policy bank bonds to its BBGAI, starting Apr 2019
Sino-US trade conflicts started in January 2018; tensions intensified in March 2018
Jun-14 Aug-14 Oct-14 Dec-14 Feb-15 Apr-15 Jun-15 Aug-15 Oct-15 Dec-15 Feb-16 Apr-16 Jun-16 Aug-16 Oct-16 Dec-16 Feb-17 Apr-17 Jun-17 Aug-17 Oct-17 Dec-17 Feb-18 Apr-18 Jun-18
sources: CEIC, BNPP AM (Asia)

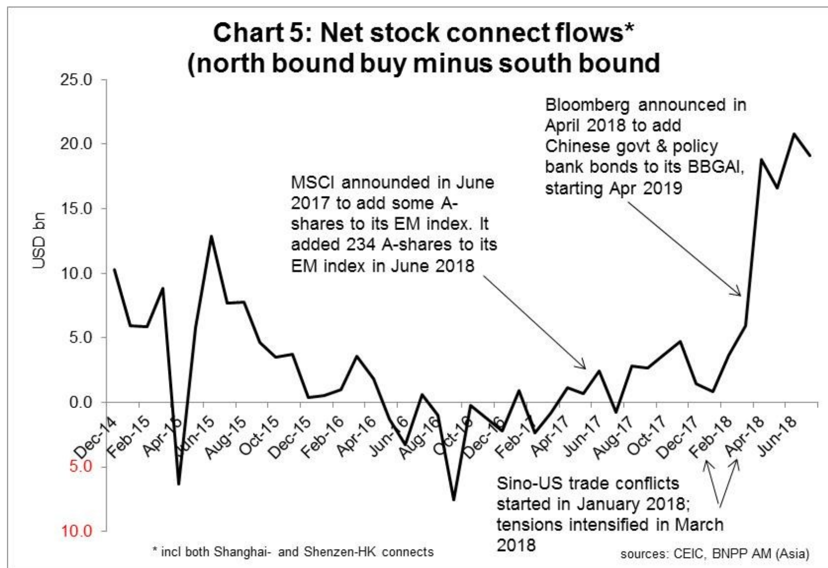


Chart 5: Net stock connect flows*
(north bound buy minus south bound
USD bn
25.0
20.0
15.0
10.0
5.0
0.0
5.0
10.0
MSCI announded in June 2017 to add some A-shares to its EM index. It added 234 A-shares to its EM index in June 2018
Bloomberg announced in April 2018 to add Chinese govt & policy bank bonds to its BBGAI, starting Apr 2019
Sino-US trade conflicts started in January 2018; tensions intensified in March 2018
Dec-14 Feb-15 Apr-15 Jun-15 Aug-15 Oct-15 Dec-15 Feb-16 Apr-16 Jun-16 Aug-16 Oct-16 Dec-16 Feb-17 Apr-17 Jun-17 Aug-17 Oct-17 Dec-17 Feb-18 Apr-18 Jun-18
* incl both Shanghai- and Shenzen-HK connects
sources: CEIC, BNPP AM (Asia)

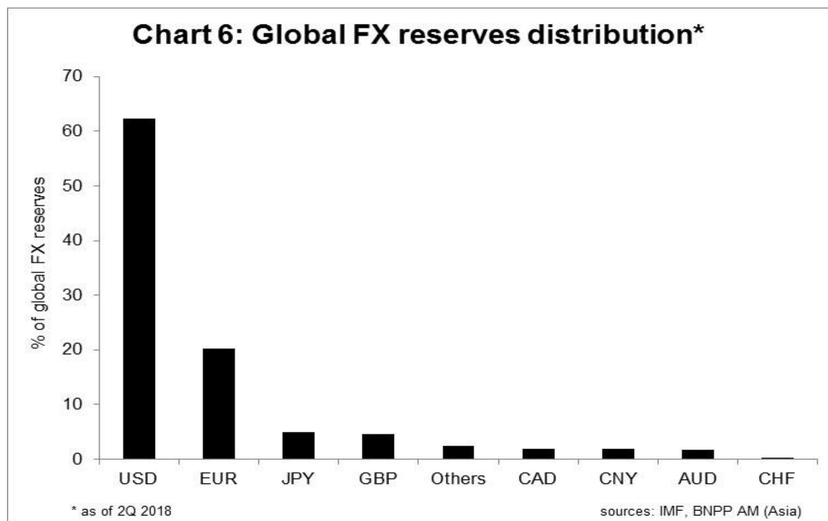
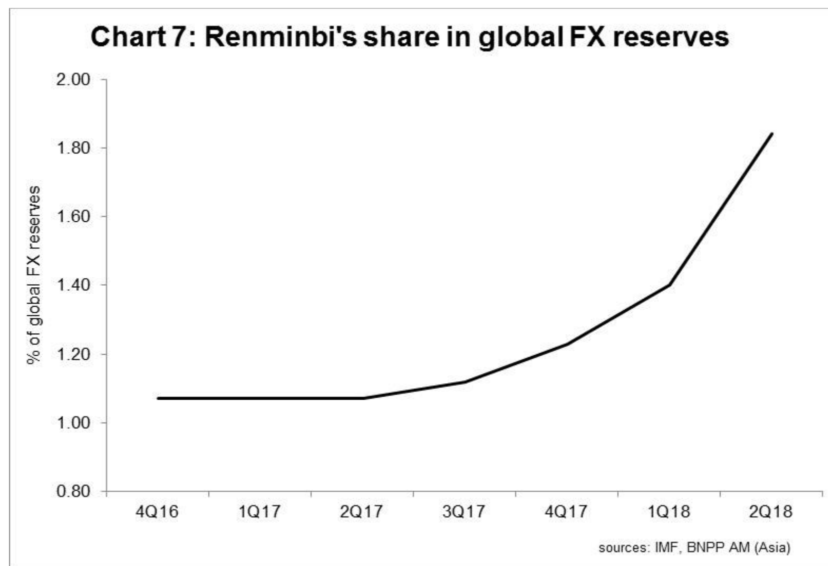


Chart 6: Global FX reserves distribution*
% of global FX reserves
70
60
50
40
30
20
10
0
USD
EUR
JPY
GBP
Others
CAD
CNY
AUD
CHF
* as of 2Q 2018
sources: IMF, BNPP AM (Asia)



Finally, easing Sino-US trade tension, which looks increasingly likely for 2019, will help improve renminbi sentiment and boost financial account inflows to China. If the USD weakens, as an increasing number of players now see due to a potential change in the Fed's rate policy, that will also help boost the renminbi.

Hence, I think there's a fair chance that the renminbi will appreciate against the USD on a year-on-year basis (by about 3.5% by my guess) this year.

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