FX Viewpoint

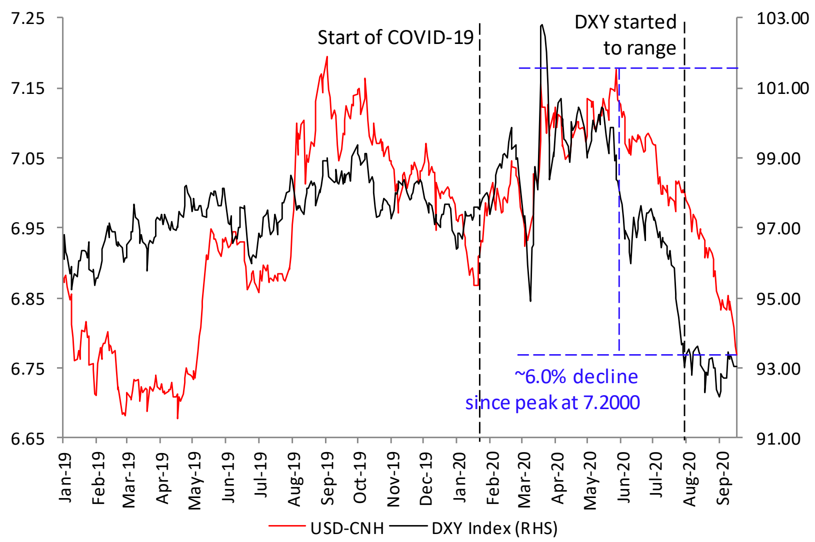
20 September 2020

Terence Wu
FX Strategist
+65 6530 4367
TerenceWu@ocbc.com

Treasury Research
Tel: 6530-8384

RMB: Still room to strengthen

- Since hitting a high on 27 May 2020, the USD-CNH has gone on an extended run from 7.2000 to sub-6.8000 levels on 18 Sep 2020. Aside from the weak USD complex since April, our view is that this move is backed strong structural underpinnings in the RMB front. **Going forward, we see these structural drivers persisting, leaving us partial towards further RMB strength ahead.**



Sino-US relations: Phase 1 trade deal in place, other issues can be tolerated

- The potential worsening of Sino-US tensions ahead of the US elections had been a negative for the RMB. It formed our main thesis for expecting the RMB to lag the rest of the Asian currencies back in June (see FX Dots and Plots – RMB, 18 June 2020). What transpired since then has generated less market concern than we expected. The trade relations between the US and China should be regarded as the paramount issue for the market. Thus, the fact that both sides reaffirmed the Phase 1 trade deal after a phone conversation on 24 August goes a long way in allaying concerns.

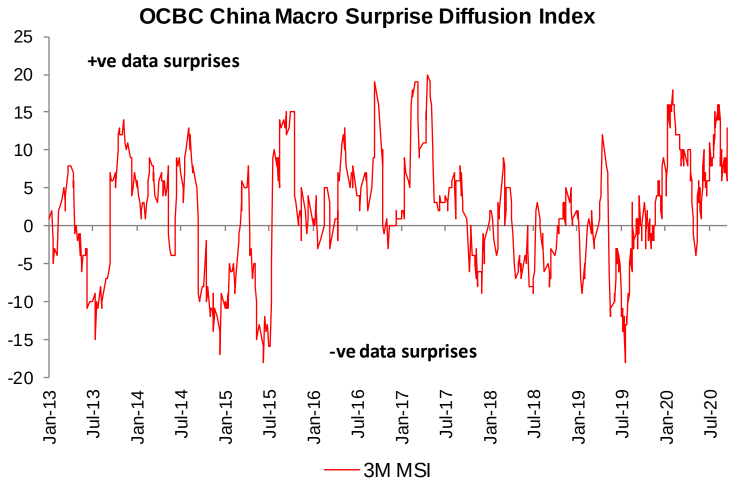
- To be sure, there have been numerous flashpoints (South China Sea, Huawei and other tech-related restrictions etc). However, the market impact typically did not last beyond the immediate few sessions. Heading into the November elections, **so long as the Phase 1 trade deal is not jeopardized, anti-China rhetoric and sporadic skirmishes over various issues may see limited traction in the market**.

Chinese macro recovery on track

- China is essentially first-in-first-out in terms of the experience with the

COVID-19 pandemic. The management of the situation is successful in the sense that a large second wave of infections did not materialize after the first wave was contained, allowing China to focus on the rehabilitation of the economy. **The latest round of data releases has further reinforced the health of the macro recovery**. Prior, the recovery was largely driven by the export sector and industrial production, while domestic consumption was the main laggard. More worryingly, there was a sense that the momentum was waning, with the July data prints largely underperforming expectations.

- These concerns were allayed with the release of August data, which largely entered better than expected. Importantly, August was the first month in which retail sales outperformed expectations, suggesting that domestic consumption is shaking off its laggard tag and emerging as another engine for the macro recovery.



- The Macro Surprises Index, which tracks the number of positive data surprises against negative data surprises over a specified time period, is a quick way to illustrate the health of the recovery. The gauge for China, on a rolling 3-month basis, has recovered smartly from the dip in 2Q 2020, suggesting that the Chinese data prints are consistently firmer than analyst expectations in the aftermath of the pandemic. **In an environment where the pace of recovery will dominate the economic narrative, the on-track recovery in China provides the RMB with a structural positive**, especially with the market remaining skeptical about the longevity of the European recovery (fundamentally soft EZ economy, resurgence of virus cases) and perceiving that the US recovery will weaken into 4Q 2020 (roll-off of fiscal stimulus, political uncertainty).

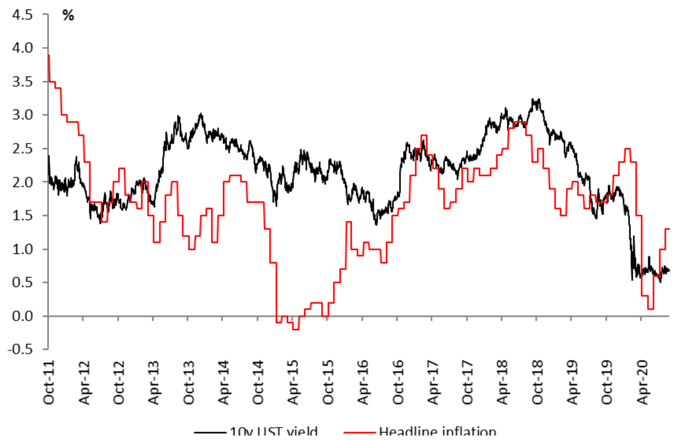
Official tolerance for a firmer RMB?

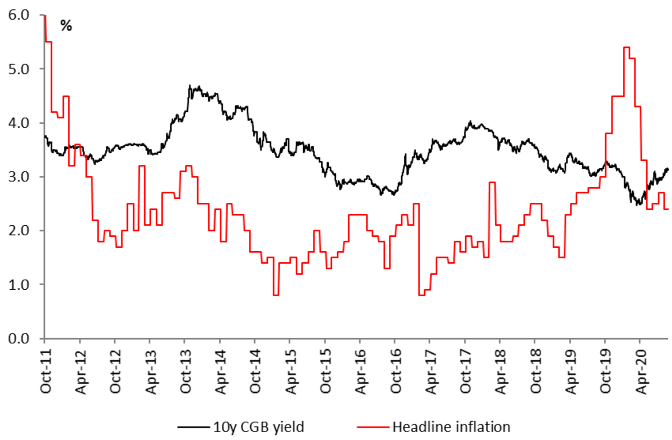
- **There has also been recent market chatter onshore about a potential shift in the official stance towards the RMB**. A firmer RMB is now believed to be tolerated as it would make imported goods cheaper and spur domestic consumption. This is in line with the shift towards domestic consumption to drive the Chinese economy. Previously, a weaker RMB was perhaps viewed more positively as it would support the export sector. Notwithstanding the geopolitical sensitivities surrounding a weak RMB, this argument seemed to have weakened in recent months, with export performance relatively firm even as the RMB strengthened.

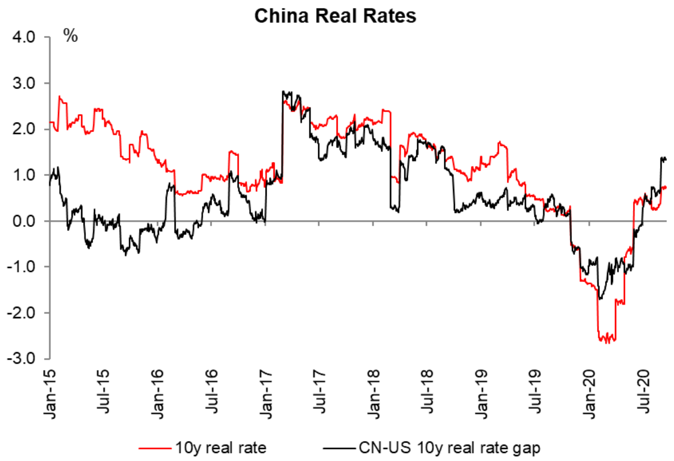
- **Overall, we are seeing little signs of an official push-back to the strengthening RMB.** Typically, if the RMB is strengthening beyond comfort levels, we would expect some jawboning by PBOC officials. Otherwise, the PBOC could use the daily USD-CNY morning fixes to signal some directional preference. We have seen limited signs of these so far, with little PBOC rhetoric on the RMB noted and morning fixes are coming in largely in line with model-driven estimates.

Rate differentials continue to be supportive of the RMB

- A direct impact of the waves of monetary stimulus instituted by the major central banks is that DM govie yields have remained depressed. In contrast, Chinese CGB yields have recovered back towards the 3.0% handle. Nominal yield differentials now look more favourable for the RMB compared to the USD.



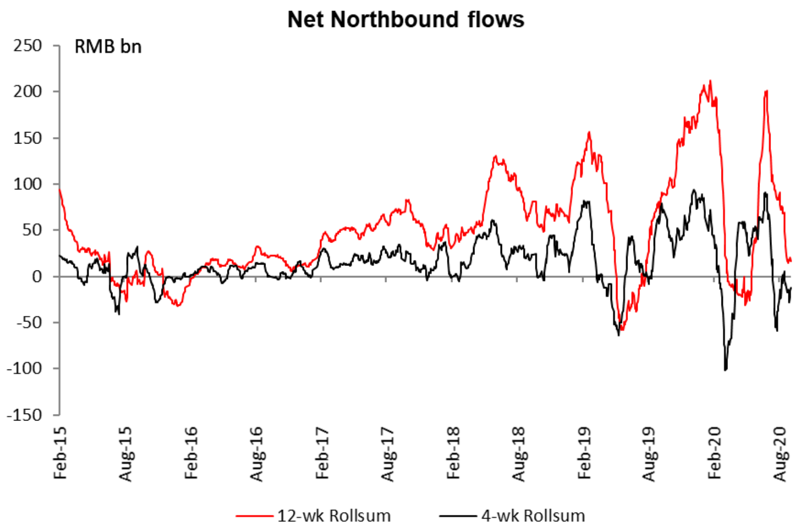




- This is also true in terms of real yields**. The real yield gap (10y real CGB yield – 10y real UST yield) has consistently moved in favour of China this year**. Fundamentally, this implies that it is increasingly rewarding to hold the RMB relative to the USD over the course of this year, providing another structural positive for the RMB.

Lack of strong equity inflows is a dampener

- While there are a number of structural positives for the RMB at this point, consistent portfolio inflows are not one of them. In fact, inflows have eased considerably compared to May-Jun period when the recovery first started to gain traction. To be fair, the lack of portfolio inflows in not unique to China. Aggregate equity and bonds flows into the rest of Asia (ex. China) are equally weak. At this juncture, this factor is limiting our overall positivity towards the RMB.



Still room for the RMB to strengthen

- For now, the RMB positives clearly still outweigh the negatives. In particular, the on-track macro recovery has generated significant market interest in China and the RMB. The absence of the official intervention in the course of this rise has also emboldened the RMB bulls to test the extremes of the RMB extension.

- Using the CFETS RMB Index as a gauge, we note that the last two peaks topped off between 95.00 and 96.00. These levels need not be a cap on the Index in this occasion, especially if there is a shift into a firmer RMB stance. Nevertheless, **the 95.00 level on the index may be the first waypoint where the extent of RMB gains need to be re-assessed**. The current index level is estimated at between 93.50 and 94.00, suggesting further room for RMB strengthening. **On the USD-CNH front, we expect 6.7100 to be the next target on the downside on a multisession horizon**.

Treasury Research & Strategy

Macro Research

Selena Ling
Head of Research & Strategy
LingSSSelena@ocbc.com

Tommy Xie Dongming
Head of Greater China Research
XieD@ocbc.com

Wellian Wiranto
Malaysia & Indonesia
WellianWiranto@ocbc.com

Terence Wu
FX Strategist
TerenceWu@ocbc.com

Howie Lee
Thailand, Korea & Commodities
HowieLee@ocbc.com

Carie Li
Hong Kong & Macau
carierli@ocbcwh.com

Dick Yu
Hong Kong & Macau
dicksnyu@ocbcwh.com

Credit Research

Andrew Wong
Credit Research Analyst
WongVKAM@ocbc.com

Ezien Hoo
Credit Research Analyst
EzienHoo@ocbc.com

Wong Hong Wei
Credit Research Analyst
WongHongWei@ocbc.com

Seow Zhi Qi
Credit Research Analyst
ZhiQiSeow@ocbc.com

Co.Reg.no.:193200032W