USDCNH Update

Background

- CNH has weakened from ~6.4/USD early this year to >7/USD (currently ~7.13), driven by diverging monetary policies, an economic slowdown, geopolitical risks, lower foreign investment, and outflows.
- The 7.2 level is an important level for the market, as it represented the cap during the trade war.

(1) PBOC Intervention

- The PBOC has set stronger-than-expected fixings (probably due to a reversion to the 'counter-cyclical' model on behalf of local banks) for the past 22 days as it attempts to slow down the yuan's depreciation, but the market has driven the exchange closer and closer to the bound. The PBOC has numerous tools to intervene onshore which it had scrapped after 2020 and is also able to intervene in the offshore exchange by mopping up liquidity, driving up costs to borrow the yuan.
- Past precedent shows that the PBOC will come out aggressively when deemed necessary. In today's context, I think that the bank is comfortable with a tempered and spaced-out depreciation of the yuan driven by fundamentals, especially because of its role in supporting manufacturing activity at a time when foreign confidence remains timid. In my view, the PBOC will continue to weaken the fixing, rather than draw a line in the sand, but attempt to stem the pace of the decline through fixings and other measures aimed at preserving stability.

(2) Zero Covid, Upcoming Congress, Economic Stimulus

- Though some restrictions have been relaxed, Zero Covid continues to disrupt supply chains and production in China. Additionally, despite more accommodative policies and some stimulus, local government vehicles (which were used to counter past slumps) have been less effective due to their emphasis on infrastructure and land/property sales. Stimulus efforts as a whole have been insufficient, including the 19 policies announced last week.
- I expect that the current Zero Covid policy will continue due to political reasons ahead of the Oct 16th party congress; we may see a faster relaxation of this policy only months after, thus manufacturing/economic disruptions should continue. Even though the government has ramped up stimulus measures, they are not yet broad enough and - paired with continued COVID disruptions - are unlikely to restore confidence and this should continue to be a drag on the economy.

(3) Trade Tensions with US

- Chinese firms have taken advantage of Western companies' departure from Russia. Trade has risen significantly and the yuan started to be adopted as a EUR, USD alternative in Russia. Small/medium-sized banks in China have delivered yuan and helped Russia avoid sanctions. Tensions over Taiwan have also been high. As a result, the US has taken an increasingly hawkish stance against China - recently, Biden warned Xi that this may cause a drop in foreign investment.
- These tensions are unlikely to be resolved as countries prioritise politics over the economy, meaning that foreign investors' sentiment should remain weak in this respect, and likely weaken further, reinforcing the fundamental economic motives for outflows.

Conclusion

Last week, we discussed possibly taking profit on USDCNH. For the above reasons, I think that we can let this trade run for the time being. There is a risk that the PBOC may want to cap the exchange at 7.2 but, even in that case, it shouldn't appreciate sharply. Setting that aside, I see the 7.4-7.45 range as a fair price target for now.