Long USDCNH

Thesis: A weak economy and new covid outbreaks continue to weigh on the yuan, while the attractive carry trade that has supported CNH in spite of bearish pressures seems to be weakening.

Overall economy, easing

- The Chinese economy remains weak, even disconsidering covid factors. Real estate accounts for ¼ of GDP, and home sales declined a whopping 47% in Q1 from 1 year earlier despite strong government investments. Though part of this can be attributed to covid restrictions, a lot of it also relates to Chinese consumers' increasingly negative outlooks on the economy, income, and employment. Manufacturing and non-manufacturing PMIs recently fell to contraction levels.
- Further loosening of economic conditions will be necessary, including more rate cuts, expansion of money supply, and so on. This story isn't all that different from before, but other factors have changed pointing towards these weaknesses materialising in the FX (see subsequent sections). China hasn't actually provided much stimulus yet, and the PBOC meeting coming next week may be a good catalyst here.

Zero covid and trade

- China is very dependent on international trade, with gross trade (imports & exports) accounting for ~35-40% of GDP. Reduced economic activity due to covid policies will weaken the FX due to substantial decreases in trade activity and economic slowdown. In Shanghai, for example, an average offshore ship wait time of ~4 days prior to the lockdown has risen to ~12 days. Other lockdowns in major port cities and adjusted offloading routes have seen similar congestion in other ports (Appendix B). Further risks to trade activity come from geopolitical tensions with the US and EU, both in terms of long-run economic and political divergences as well as the short-term Ukraine dispute, which could lead to pricing-in of the former.

Carry trade: signs of weakening

- Foreign investors held Chinese assets for the strong carry, overweight ccy outlook, and dovish CB concurrent to Fed and other major CBs turning increasingly hawkish. But, the Chinese sovereign bond premium over UST is now rapidly eroding as some of these benefits fade (Appendix C). At the same time, heightened geopolitical risk makes foreign investors warier of holding on - outflows have intensified since the invasion of Ukraine. In light of this, record onshore bond outflows were posted last month (Appendix D). General flows reflect that (Appendix E). I expect this to continue and intensify as investors reposition in light of this outlook.

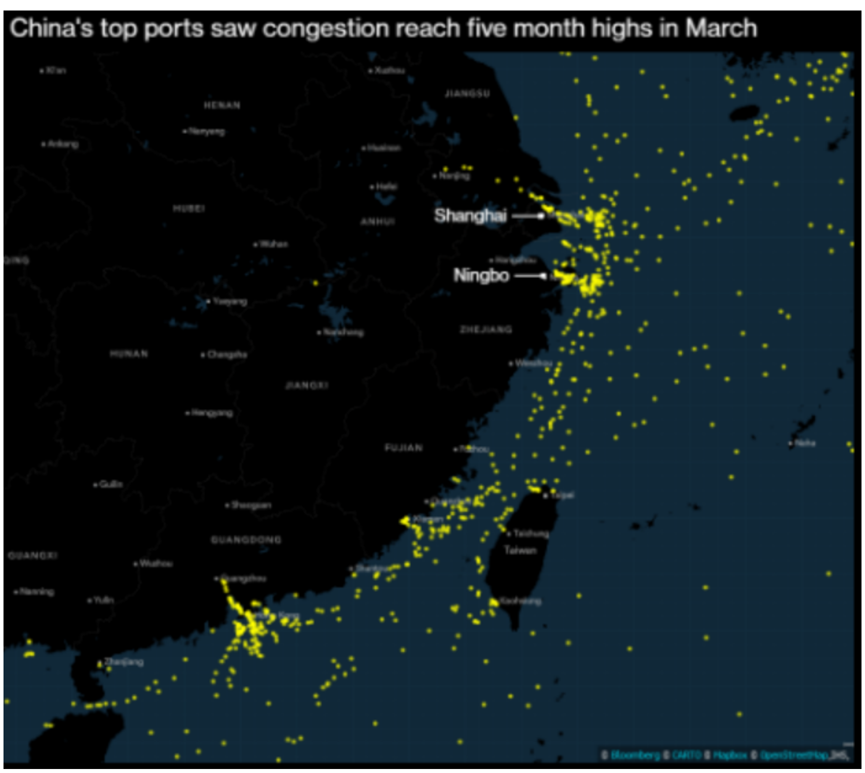
PBOC FX intervention

- The PBOC intervenes in the FX market, especially with respect to USDCNY. The Chinese premier recently stated that the exchange rate should be kept stable, but the CB has drained liquidity and weakened USDCNY fixings over the past several weeks. (They set the onshore midpoint rate and allow trading within a +/- 2% band.)
- Dollar strengthening from risk-off and a more hawkish Fed will put additional downside pressure on the RMB. But trying to strengthen the yuan by draining FX reserves is equivalent to monetary tightening. That is a policy that I don't think that PBOC would go for under weakening economic conditions and increasing headwinds to the government's 5.5% growth target.

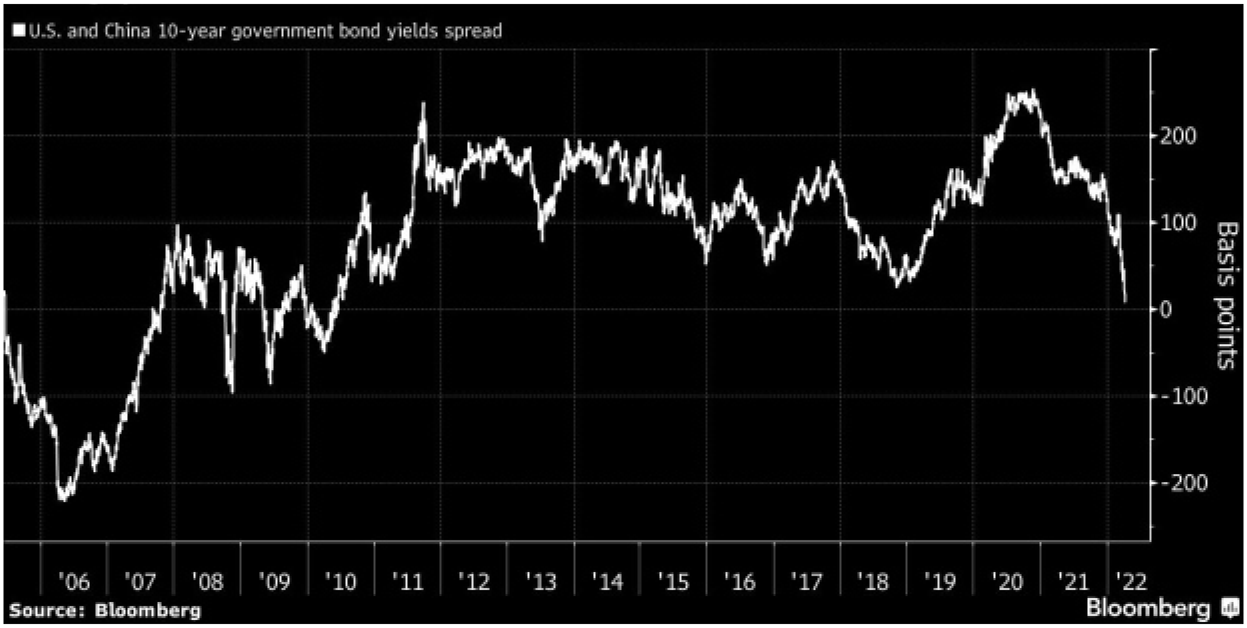
Appendix

A. USDCNH price chart

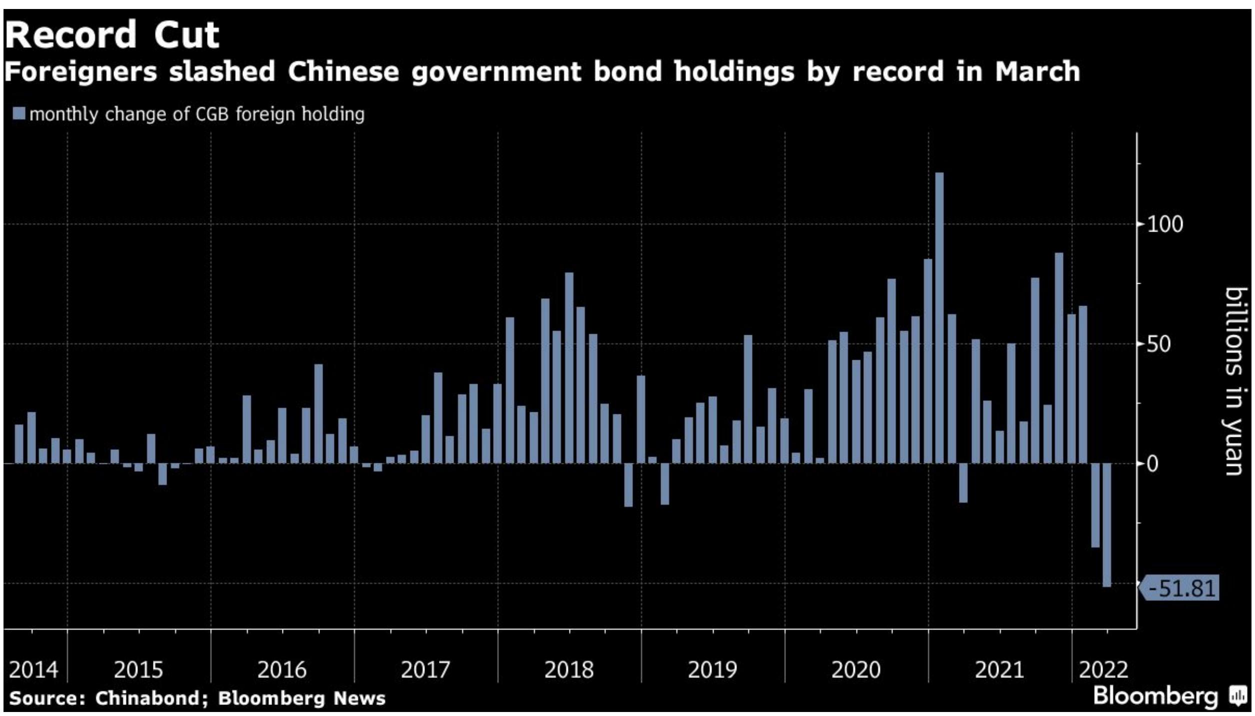
B. Chinese port congestion; ships waiting offshore in queue to dock marked in yellow



C. Yield gap between 10Y UST and same tenor Chinese GB



D. Chinese sovereign bond outflows



E. Chinese capital outflows