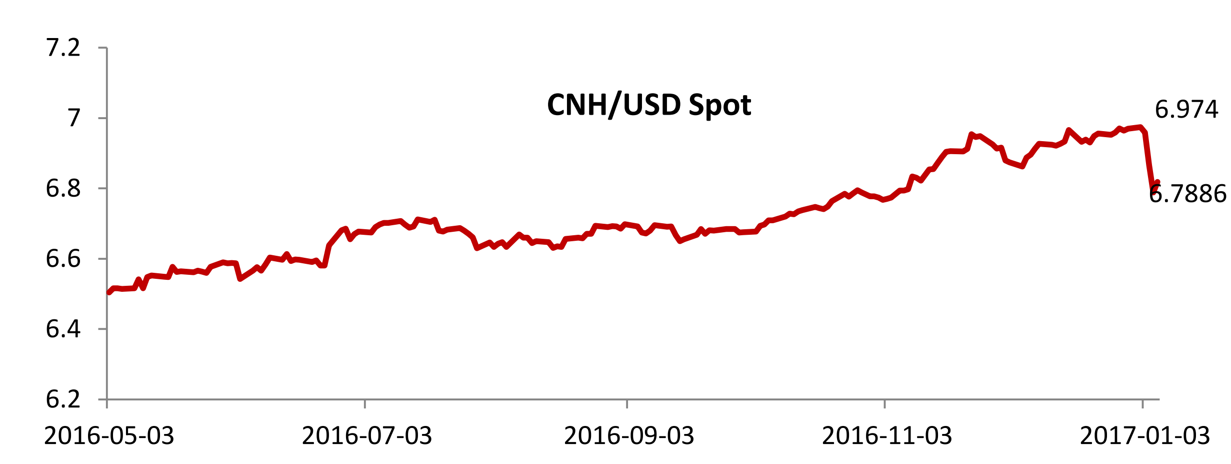
Behind the CNH Surge

A two-day bloodbath for CNH bears in the offshore market

After sliding for a good part throughout 2016 and almost breaking the 7.0 psychological threshold, CNH has reclaimed territory from 6.97 to 6.78 in merely two trading days.

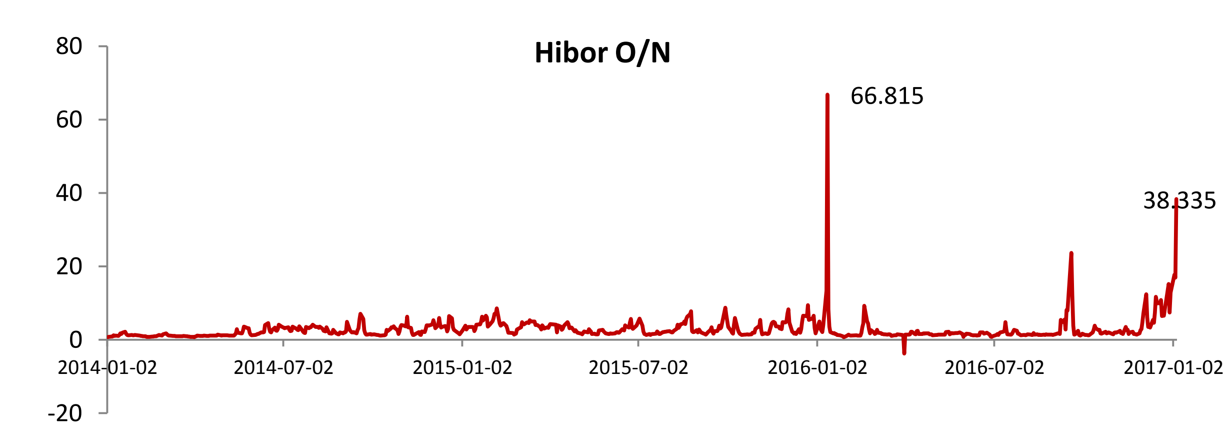
Exhibit1: CNH/USD surging almost 2000 pips



Source: Wind as of Jan 07, 2017

During 4th and 5th of January, currency traders scrambled for CNH in the offshore market regardless of cost. The short squeeze has led CNH overnight funding cost (38%) shooting over the roof. It was like January 2016 all over again. Back then, the short term borrowing rate for offshore RMB touched as high as 66.8% with the market participants convinced that PBoC, acting through state-owned banks in HongKong, were buying up CNH to curb its weakness.

Exhibit2: Overnight Hibor touches 38%



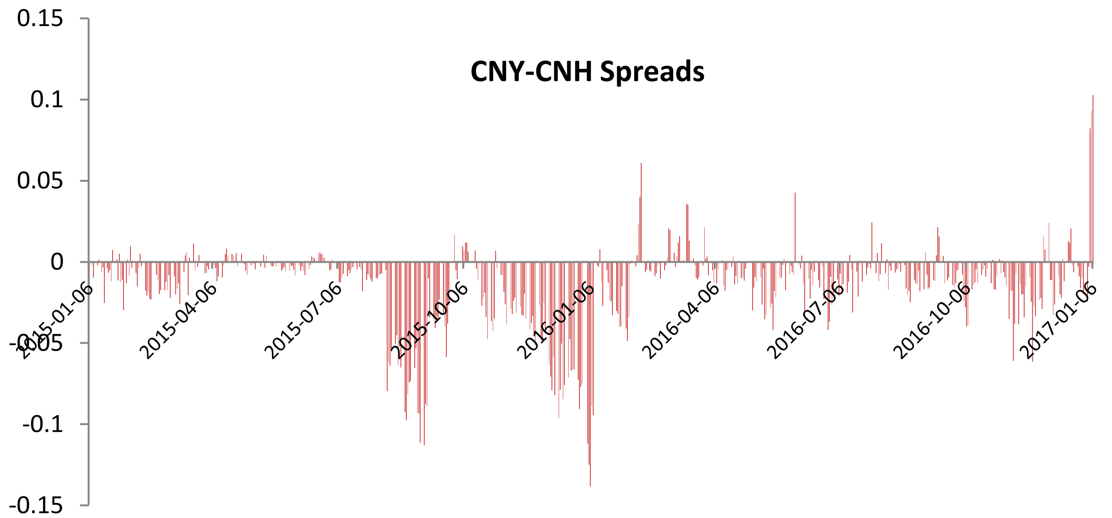
Source: Wind as of Jan 07, 2017

What is driving the CNH rally?

1. Carry trade leaves the CNH market vulnerable to short squeeze

As depreciation pressure starts to take shape, traders wishing to short the Chinese currency tend to favour the less-regulated CNH market in Hong Kong over the closely monitored onshore – or CNY – market. This has led to CNH trading in discount to CNY since early 2015. Arbitragers would funnel the cheaper CNH back onshore to become CNY (they are essentially the same currency) to earn a risk-free profit. The direct consequence of such carry trades are that, absent from PBoC deploying more RMB offshore, the CNH market will continue to shrink. CNH deposit balance in HongKong has dropped from 979 Billion in Aug 2015 to 627.6 Billion in Nov 2016. So without PBoC really stepping in the offshore market and intervene, all they need to do is tightening capital outflows and it is just a matter of time before the short squeeze happens.

Exhibit3: CNH/CNY carry trade remained attractive throughout 2016



Source: Wind as of Jan 07, 2017

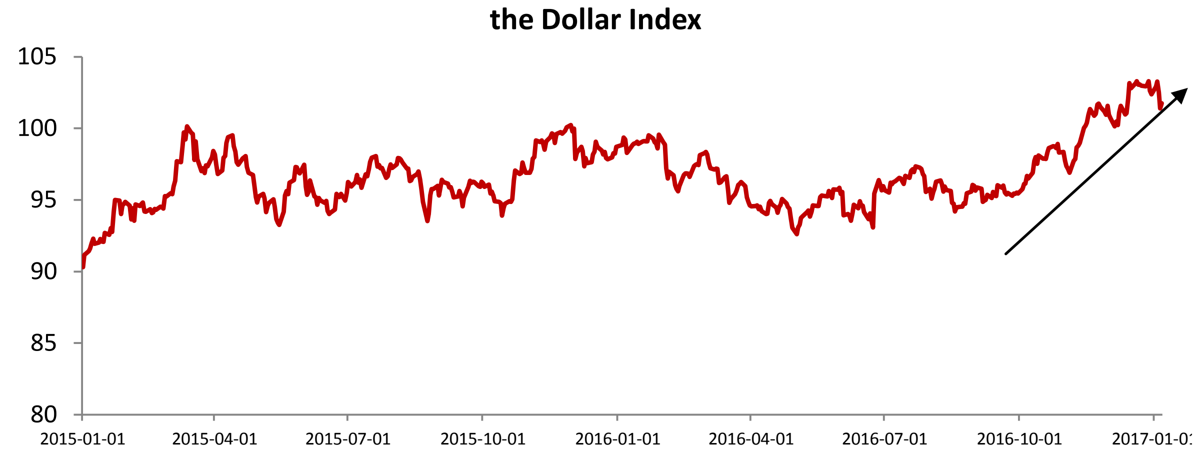
2. PBoC tightened scrutiny for capital outflow

Weighing between a falling FX reserve balance that is rapidly approaching the US$ 3 Trillion mark, and defending the RMB at the 7.0 threshold, stepping up the scrutiny on outbound capital flows comes in as a natural choice. From individuals to corporate, China's policymakers have elevated the review process on capital flows leaving the country in recent weeks, imposing fresh restrictions on outbound remittance for personal use, corporate acquisitions and investments.

3. The Dollar rally has taken a pause

The dollar index has rallied since Oct of 2016, coupled with US equities making new highs and US treasuries yield soaring. All pointing to the optimism in the US economy, or as some may call it, the "Trumpflation Rally". The risk here is that, this optimism may have already been priced in. Any data disappointment or the Fed''s rate decisions falling short of expectation could undermine this rally. Three factors have dictated this week's dollar volatility — strong US manufacturing data, the minutes of the Federal Reserve's December meeting and the renminbi's biggest-ever two-day gain.

Exhibit4: Dollar rally has taken a pause



Source: Wind as of Jan 07, 2017

4. A Message from PBoC

During the past year, RMB has unveiled a dollar fixing formation mechanism of "closing price+ a basket of currency ".The CFETS RMB Index will measure the yuan's performance against a basket of 13 currencies, with weightings based mainly on international trade. On the 5th of January, the onshore fixing remained relatively calm and did not join the rally of CNH. A signal which carries three implications:

- Reduce the impact CNH has on CNY. The CNH is more vulnerable from RMB speculators and in the past, tend to drag onshore CNY along with it.
- Hint the market of further "de-pegging" of CNY with the dollar.
- Promote the CFETS RMB Index, which will be used as the main instrument for gauging RMB's value.

RMB Outlook

Short term: RMB will like to remain stable

Externally, the Dollar strength has been well priced in. It calls for continuous upward surprise from the economic readings to further fuel the rally. Domestically, economic growth is on track, monetary policy remains prudent and well in-check. PBoC has elevated capital flow supervision and stand ready for market intervention when necessary. Hence 7.0 threshold is not to be broken easily.

Longer Term: RMB long term value hinges on real estate and economic reform

China is in a better shape than the US when Look at GDP growth, trading surplus and interest levels. However, at merely half of US aggregated economic value, China's real estate rally in the past few years has led the nation's total real estate value dwarf that of the US. Hence, the overhanging real estate bubble could put downward pressure on the RMB. With huge trading surplus and being accused of a currency "Manipulator" by the president-elect Donald Trump, foreign policies also spells complication for the RMB should it further softens. The key to RMB value in the longer term lies with the authorities handling of the real estate price, implantation of the supply-side reform and finding new engines for the economy.

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