

China Watch

RMB BASKET CASE

Rory Green

- For RMB, tariffs will counter improving growth and rate differentials
- Trade competitor currencies MYR and KRW may bear the brunt of FX pain
- The stimulus move is here to stay as Xi's pain threshold has been reached

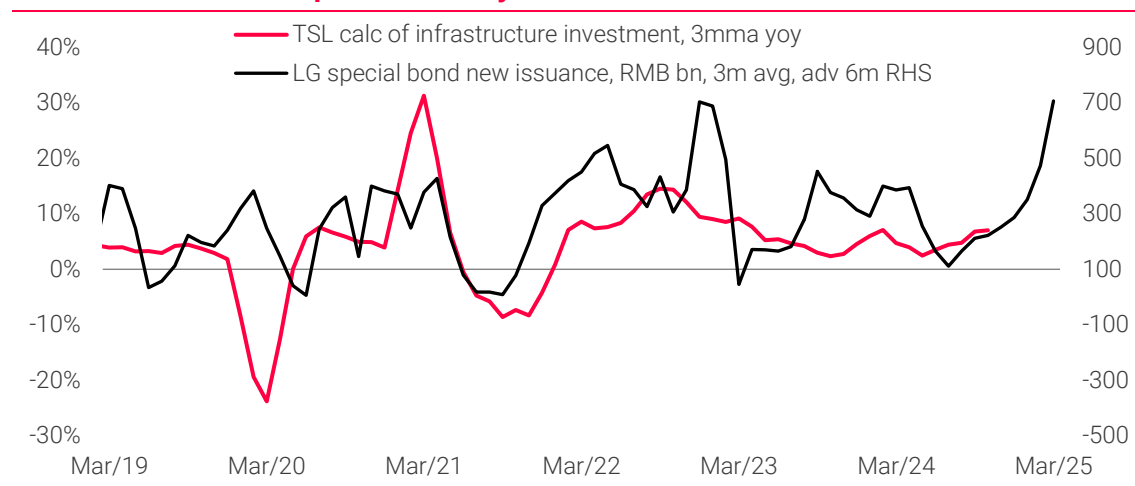
Two things will determine China macro and markets in 2025: Xi's fiscal policy and Trump's tariffs. We think a pain threshold has finally been reached and China will do "whatever it takes – eventually" to stabilize growth. However, trade conflict is likely to precede the next significant stimulus measure and result in RMB depreciation. Our base case is a managed decline to USDCNY 7.5 by mid-2025. A basket of trade competitor currencies – particularly, MYR and KRW both of which face their own idiosyncratic Trump risk – could fall further than the yuan.

Typically, USDCNY is driven by growth and rate differentials. The yuan tracks the gap between US and Chinese government bonds quite closely (see chart below). On this fundamental basis, the RMB outlook is less negative. Growth prospects have clearly improved following the stimulus pivot. We think that policymakers have committed to do "whatever it takes – eventually" to stabilize growth and that sufficient fiscal measures will be unveiled to keep GDP in the 4.5% range through 2025. This is a significant change in policy setting from the past three or four years.

Tier 1 property transactions are the key indicator to gauge the success of stimulus measures.

Improving sales in the most expensive and desirable real estate markets in China will lead a recovery in the rest of the PRC. Our proprietary high-frequency tracker (chart below) shows a clear uptick in sales over the past couple of weeks. That initial burst in activity, however, has now rolled over and is heading back to the pre-policy pivot trend. Other high frequency data – such as

Chart 1: Infrastructure primed for major revival



Sources: NBS, CEIC, TS Lombard.

car sales, rebar production and A-share margin transactions – show a similar “boom and reversal” trajectory. More is needed on fiscal to sustain the recovery.

Such dramatic policy U-turns as those over the past month tend to indicate a pain threshold has finally been reached (and that underlying economic activity is dangerously weak). The number of protests in China remains elevated, as do tragic incidents of large-scale violence. In some cases, Xi Jinping has commented directly – something he rarely does. All of this suggests to us that the policy pivot is real and the pain threshold has finally been reached. We expect an additional RMB 6trn in easing measures next year, the bulk of which to be announced at the March National People’s Congress. Spending will be split between bank recapitalization, consumption incentives, local government (infrastructure) and property. The largest growth impact is likely to come from infrastructure, with leading indicators already showing an uptick.

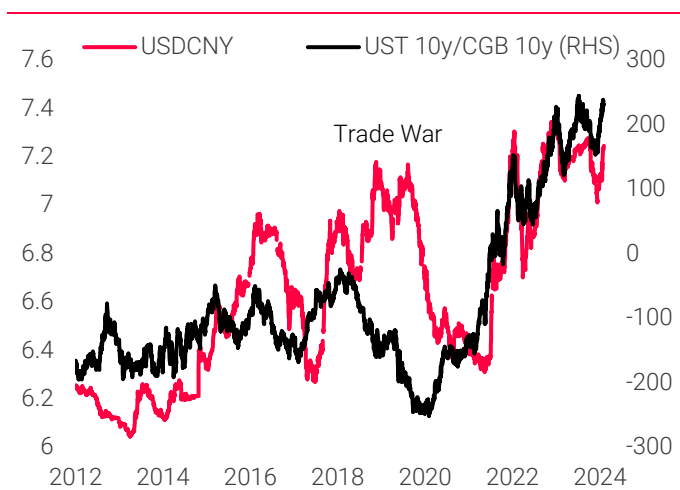
Improved domestic policy will offset some of the growth hit from tariffs. Our base case is high headline tariff numbers but a slow rollout. However, fiscal policy will not protect the currency. Tariffs will dominate growth differentials and be the key FX driver, which puts RMB firmly on a depreciation path even as cyclical growth improves. Markets still appear to be partly discounting or doubting Trump’s commitment to tariffs as price action has been relatively muted since the election win, judging from moves in spot USDCNY, implied vol and FX risk reversals. For our part, we think the 60% tariff rate is a negotiating tactic but a credible one that will be reflected in FX as January 2025 approaches.

Putting a number on FX movement. In a relatively benign RMB scenario, Beijing would implement decent-sized fiscal easing (RMB6trn), with improving household and business confidence helping the multiplier effect of stimulus. Concurrently, Washington slow rolls tariff announcements and/or is more targeted than expected. The result: USDCNY at 7.45 in six months.

The bearish RMB scenario. Stimulus underwhelms with no improvement in multipliers. Full 60% tariffs are implemented at a rapid pace. China retaliates with tariffs and restrictions on rare earth/advanced component exports. Europe, too, looks to protect domestic manufacturing by adding their own tariffs on Chinese exports. The result: USDCNY at 7.9 in six months from now.

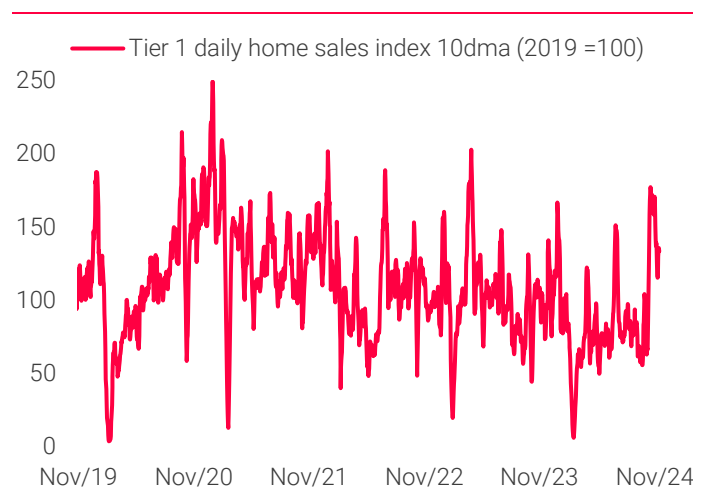
The PBoC will attempt to manage the pace of depreciation in case of benign or bearish outcome. A strong RMB is now a core political objective ([see here](#)). Throughout this year, a higher weighting of RMB in the PBoC’s reaction function has constrained the bank’s ability to loosen monetary policy and is likely to continue to do so in 2025. In practice, this means Governor Pan

Chart 2: Tariffs beat rate differential



Sources: BBG, TS Lombard.

Chart 3: Tier 1 leads national market



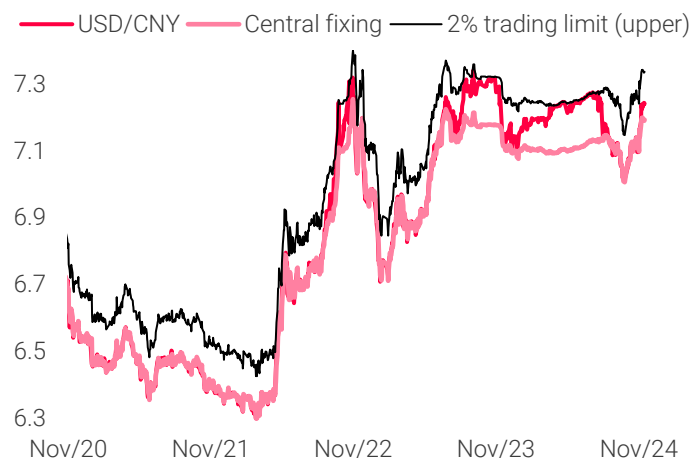
Sources: CEIC, TS Lombard.

will follow a crawling peg approach, relying on FX intervention via commercial banks, window guidance and administrative measures to slow the decline of the currency. The PBoC will intervene but not at the cost of domestic activity, higher rates and/or liquidity withdrawals. Tariffs will force the PBoC to allow a faster pace of depreciation.

For now, we remain in limbo ahead of specifics on both China fiscal and US tariffs. We think USDCNY will move quickly to 7.3, with PBoC defending that level for a time. In our base case of decent-sized stimulus and large tariffs, the next move will be higher – to the 7.5 range. The three signposts we are watching to gauge the evolving stimulus tariff mix are 1) high-frequency China data (particularly home sales and commodity production); 2) China politics and protests (the Politburo meeting and CEWC next month?, social unrest remaining relatively high); and 3) Trump team appointments (Wall St. veterans vs trade/political appointees).

The basket case. Since the PBoC is willing and able to intervene in the market, China proxies may offer a better return than RMB. The Malaysian ringgit and South Korean won have a high beta to the yuan, with both countries also facing their own idiosyncratic Trump risks. For Malaysia, the transshipment of Chinese goods and Iranian oil could come under scrutiny. Seoul is more concerned about the Inflation Reduction Act as Korean manufacturers are among the main beneficiaries. Korean exports to the US outstripped those to China earlier this year. Malaysia's Bank Negara is currently neutral leaning dovish, while the Bank of Korea is at the beginning of a mild rate-cutting cycle amid a cyclical soft patch. For Korea, the added kicker of a growing National Pension Fund allocation to foreign assets, which tends to be frontloaded into H1, will likely add to won weakness in the coming months. In last week's Macro Strategy, we went short an RMB basket.

Chart 4: CNY testing upper level of PBoC band



Sources: BBG, CEIC, TS Lombard.

Chart 5: Protests remain elevated



Source: Freedom House.

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