Global Watch

CHINA SHOCK: MARKETS SLEEPING ON RMB RISK

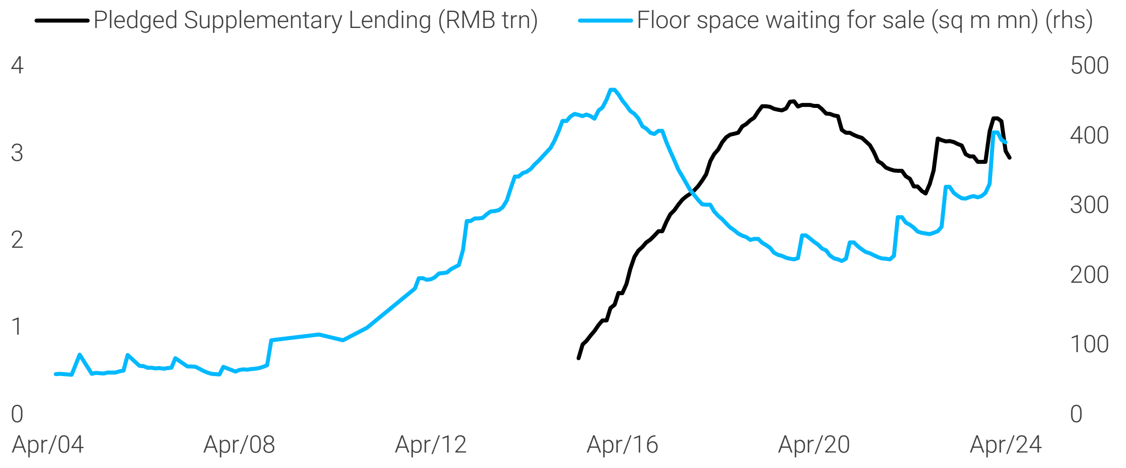
Rory Green

- Beijing is pro-growth – at last – but stimulus measures are still too small
- Ineffective stimulus will add depreciation pressure amid looming Trump risk
- Possible vicious cycle of weak RMB => trade tension => tariff conflict => weaker RMB

Beijing has shifted to favouring growth for the first time in many years. As forecast, the Party's new higher pain threshold has finally been passed. We think announced real estate easing is insufficient to put a floor under the property sector, but the political change is significant in that it removes cyclical downside risks and guarantees future supportive measures, although reaccelerating activity is still some way off. This is not a typical China stimulus: the policy reaction function has changed, as has the structural composition of both the PRC and the global economy. Easing is less effective at home and only mildly supportive of industrial commodities and demand abroad. The biggest impact will be on trade and RMB: with stimulus insufficient to accelerate activity and a pro-growth stance signalling rate cuts, the yuan is likely to weaken further. A falling currency is in the offing despite a record high share of world trade. Given an increasingly hostile geopolitical environment, there is the possibility of a vicious cycle of weaker RMB => trade friction => tariff imposition => weaker RMB.

Many observers misinterpreted political-economic changes that put greater emphasis on national security and innovation to mean that Xi Jinping did not care about growth. We argued that a minimum level of growth is a prerequisite for achieving CCP objectives and that a policy put remained in place, albeit one that had a higher strike and more limited economic efficacy. Since November last year, we have consistently maintained an above-consensus forecast for

Chart 1: More money needed to cut inventory



Sources: CEIC, PBoC, TS Lombard.

stimulus as political rhetoric, macro data and social unrest all pointed to a policy pivot towards growth.

Protest incidents, as measured by China Dissent Monitor, rose by 21% yoy in Q1/24, after having peaked well above Covid highs in H2/23. Beijing followed through with smaller scale easing measures earlier this year, an ambitious GDP target and now coordinated action on property. The scale of funding announced falls short of our full-year estimate, and we expect further easing this quarter and in H2/24. Specifically, we see 20bps of rate this year cuts along with another RMB 500bn in property support and the same amount in special purpose bonds.

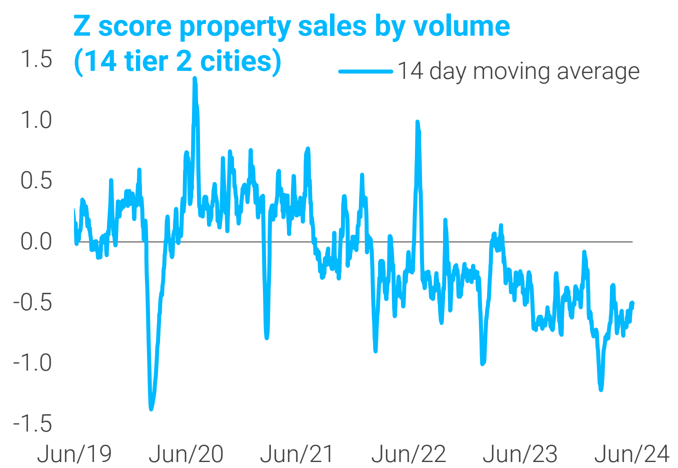
Under the new scheme, the PBoC will launch an RMB 500bn relending programme for SOEs that purchase unsold homes. (At the same time, mortgage rates and down payment requirements have been cut across the country.) Purchased properties must be converted into subsidized or social housing. The plan is positive and addresses three market issues: 1) absorbing excess inventory, 2) providing liquidity for developers and 3) providing affordable housing.

Reducing excess inventory is a good start, but the implementation of the programme faces a number of barriers. The subsidized loan rate of 1.75% is below or close to the rental yield on purchased properties, meaning cash-strapped local governments in Tier 3 and 4 cities will struggle to pay for and implement the scheme.

Our Head of Asia Property Andrew Lawrence notes that market estimates suggest there are some 3bn sq m of pre-sold but uncompleted homes in the primary housing market, of which it is estimated that at least 40% is from developers that are already in financial difficulty. The cost to fund the delivery of this pre-sold property has been estimated at RMB2-3trn – such is the funding problem facing developers. And there is any case a big question mark over whether the full RMB500bn in credit lending can be achieved given that, as the Whitelist of government "approved" projects shows, banks have been reluctant to lend on all but the best developments.

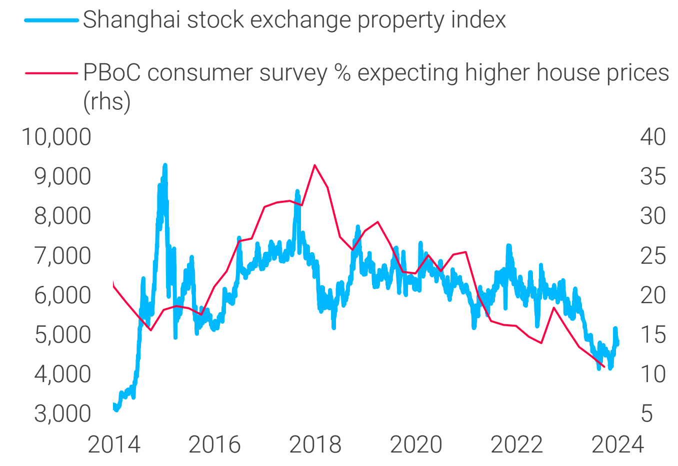
Demand-side measures implemented in a falling market tend to have the unintended consequence of encouraging a greater supply than demand response, notes Andrew Lawrence. For this reason, we expect the government's latest mortgage measures to encourage more secondary homeowners to list their investment properties for sale and so put further downward pressure on home prices. Secondary sales volumes remain positive, but the growth in sales has slowed as homebuyers are simply not in a rush to buy. But given the increasing substitution of

Chart 2: Sales bottoming out at very low levels?



Sources: Local city data, CEIC, TS Lombard.

Chart 3: Buy property shares not homes



Sources: PBoC, BBG, TS Lombard.

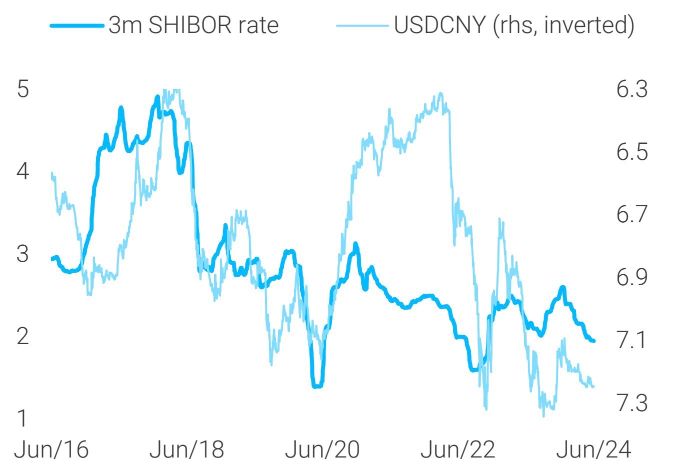
secondary for primary housing – increasing levels of available secondary stock for sale, attractive prices, completed units, etc. – it is difficult to see how the primary market can find a bottom without stability in secondary market prices.

Data since the announcement of the scheme show that stimulus is having limited impact only. Our high frequency tracker of property sales in Tier 2 cities has stabilized near record lows. WeChat and Baidu search indexes show an initial uptick in interest and a steady decline following the inventory purchase plan. Another good proxy is the stock market: property equities have rallied strongly this year. This is a sign of improving confidence in the sector; however we are inclined to believe the adage circulating in mainland markets: "Brave enough to buy real estate stocks but not enough to buy a home". Sales in May did grow 3.4% from April and contracted by *only* 33.6% yoy compared to a 45% decline in April. Still no clear indication of sustainable green shoots.

More is needed – and we think more is coming. Beijing may be pro-growth, but Xi is still unwilling to risk overstimulating the property market. Switching back to the old playbook could reverse the painful reduction in moral hazard, capital reallocation and bubble deflation of the past three years. Stabilizing the sector and allowing policy favoured industries to drive GDP to 5% yoy is the goal. Thus, fresh large-scale easing is unlikely before the July Politburo and Third Plenum. (More on the Third Plenum in a forthcoming note – spoiler alert: we think there is a chance of an upside surprise.) As discussed above, we expect more easing in H2/24: Beijing will want a stable economy ahead of the US election as well as space to stimulate ahead of the inauguration in January. The combination will be sufficient for growth to reach 5% in 2024 and for the pace of property investment and the sales contraction to slow significantly toward yearend.

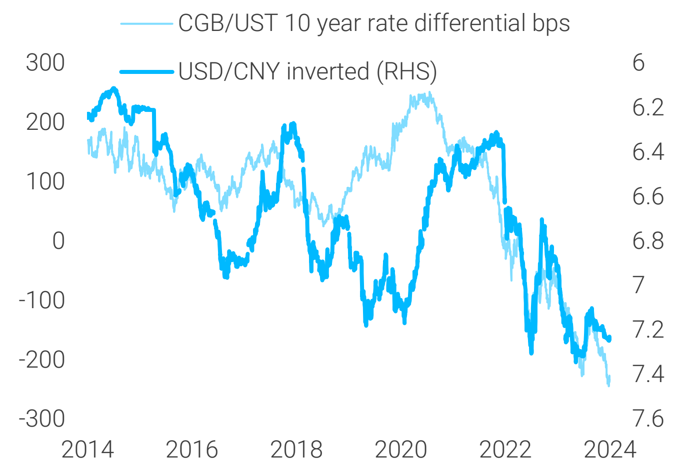
What does this mean for the rest of the world? Cyclically it puts a floor on commodity demand. Chinese imports of iron ore and copper have remained elevated despite the property slump. Metal consumption is, in part, powered by new growth drivers (EVs, batteries, electrification, etc), re-exporting and physical stockpiling as an investment/currency hedge. A modest relative improvement in property investment and economy-wide activity will help demand. However, exports of processed metals will remain elevated, too, owing to the still weak property market. Steel sales in foreign markets reached an all-time high last year, triggering trade investigations from a range of competitors. A bottom, but not much upside impetus for metals.

Chart 4: Growth goal = rate cuts and weaker RMB



Sources: BBG, TS Lombard.

Chart 5: Rate differentials will remain wide



Sources: BBG, TS Lombard.

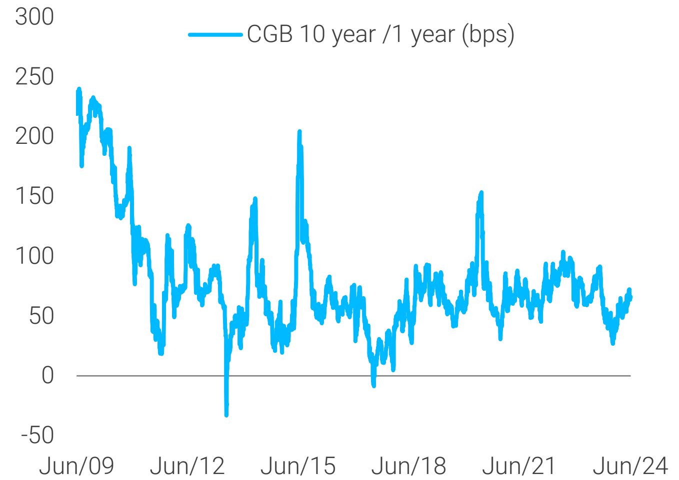
The biggest impact is likely to be a weaker RMB. Cyclically, big fiscal/monetary measures can drive growth, inflows and rates higher, ultimately strengthening the currency. The current push is clearly tilting dovish, with more easing to come; but until stimulus impacts growth, investor confidence and, eventually, rates, the result of rate cuts and monetary expansion will be RMB depreciation.

Structurally, both tighter/looser policy eventually leads to depreciation. Even if stimulus is large enough to drive a cyclical upturn in growth and currency strength, either nominal or real depreciation will eventually follow if it is not accompanied by structural reforms. Monetary expansion without demand creation (as occurred in Japan post-bubble), leads to an increase in the ratio of money to GDP (a decline in velocity): the amount of RMB exceeds what that can be bought in the real economy, ultimately reducing the value of the currency – whether through nominal or real channels.

PBoC officials are among the beneficiaries of a clearer pro-growth stance. Until recently, the bank was caught between two contradictory objectives: Xi's strong RMB policy and supporting domestic growth. Governor Pan Gongsheng made clear earlier this year that monetary easing would be contingent on dollar weakness; and until recently had been reluctant to cut rates. A pivot to stabilizing the property sector has given the bank, the leeway to guide short-end rates lower. A 10bps rate cut is likely this month; and the PBoC may make a larger reduction to its repo rate than the 1-year MLF in an attempt to steepen the yield curve. The bank has stated that CGB 10y yields should be 20-80 bps higher. Given the political and monetary backdrop discussed above and the approximate RMB4trn in central and local bond issuance to come, bull steepener trades look attractive.

China cannot simply let the RMB go. A preference for growth has meant a move to what is, in effect, a crawling peg to the dollar. The bank has allowed a gradual rise in the central parity rate around which onshore RMB is allowed to fluctuate by +/- 2%. Managed depreciation while cutting rates is a challenge, even with a semi-permeable capital account and captive state banks. We estimate that approximately US$30-50 bn in FX reserves were used to defend the currency last month, primarily via the state banks. While Beijing has plenty of ammunition left, it is often wary of burning through reserves. This backdrop has led to rumours on-shore of step devaluation being introduced. We give more credence to local chat than Western media speculation, but we still think such a move is unlikely. The PBoC will continue to manage depreciation via a combination of FX sales, market guidance and staggered rate cuts.

Chart 6: PBoC wants a steeper curve



Sources: CEIC, TS Lombard.

Chart 7: Trade share at an all time high

Sources: CEIC, Datastream, TS Lombard.

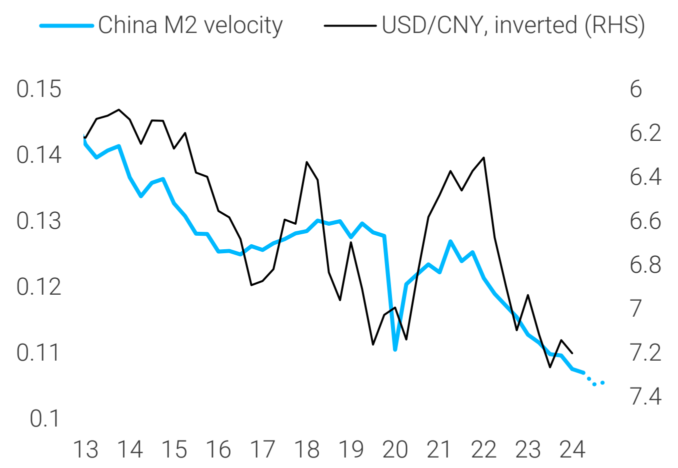
Pressure is building as Trump tariffs loom and global rates remain elevated. The last mile is proving a long one for many central banks particularly the Fed. Our chief US economist Steve Blitz notes that data were softer, not soft, in April and that it is unlikely a 250BP real funds rate is sufficient to kick off a recession. Given Fed data dependency, we think it will be late to adjust policy. Markets are pricing in 44 bps of Fed cuts in the next six months, which would leave the China-US 10y differential at roughly minus 175 bps – during the last trade war, the gap was 104 bps in China's favour! Markets need to price in a possible Trump win in November and that he follows it up with large scale tariffs against the PRC. Such a scenario would push USDCNY to a new high of 7.5. We think USDCNY could top 7.35 before the election, with the pace of managed depreciation accelerating in Q3/24.

Global spillovers from continued RMB weakness will be felt first in Asia. Pre-Covid, regional currencies were strongly correlated with the yuan; but the relationship has weakened post-pandemic. With global inflation in the process of stabilizing (or at least seeming to) and national economic trajectories decoupling further from the Covid-induced global cycle, RMB could act as a weight on Asian FX. Typically, nations with the closest trade and economic ties had the strongest correlation to moves in RMB. The Won, Yen and Ringgitt all traded closely with the yuan in pre-covid. Northeast Asian FX, in particular, looks set for tighter linkages with the yen and the yuan, which would drag the won weaker, despite much higher rates in Korea.

A negative trade, FX and political feedback loop is possible. The market is pushing for a weaker RMB just when the PRC share of global trade is at an all-time high and facing a growing political backlash. Growth, rate differentials and falling monetary velocity are overwhelming massive exports. A softer currency will only serve to bolster an already large trade surplus. Given the increasingly hostile geopolitical environment, there is a possibility of a vicious cycle of weaker RMB => trade friction => tariff imposition => more RMB depreciation. Clearly, the prospect of currency/trade wars rises if Trump is elected.

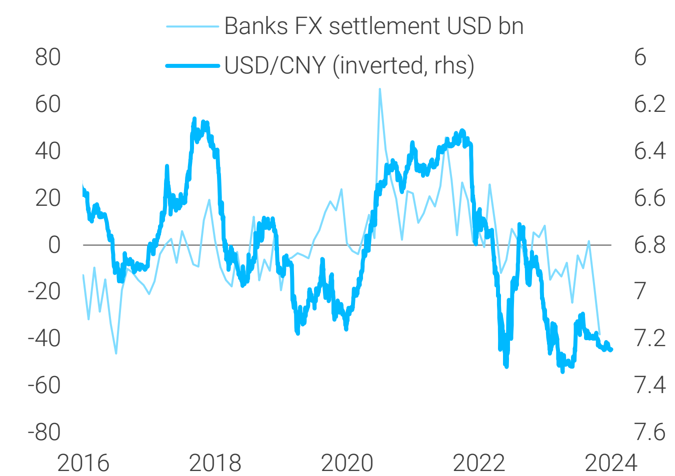
To sum up, China is back – sort of – but this is not a stimulus to drive global commodity demand and related growth. Rather, the policy reaction function is tilted towards a weaker RMB, a larger export market share and enhanced trade conflict.

Chart 8: Velocity decline leads RMB depreciation



Sources: CEIC, TS Lombard.

Chart 9: Banks intervene to defend CNY



Sources: CEIC, TS Lombard.

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