# CHINA - Sloan Global Advisors Trade Opportunity September 2021

Trade opportunity: Position for a change in FX policy by China

Term: 3 months+

Asset Class(es): Foreign Exchange options

***The following is a portfolio trade idea which Albany is actively pursuing. This ACTO is the first notification of investment ideas that are being created by the portfolio managers at Albany Capital.***

**<u>Background</u>**

The Chinese economy is slowing. Latest indicators show the economy will likely meet its goal of 6% GDP growth for 2021which became a soft target for the year given the high level of growth seen in the first half. Aside from last year's higher base that will curb the growth rate in coming months, fresh virus outbreaks and tighter government restrictions on industries from property to education are also weighing on the outlook. Despite this pessimistic outlook, President Xi says China will continue to aim for both economic and social development targets. At times these can be contradictory.

Globally we may have seen a peak in economic growth but in China we see less stimulus measures to ameliorate this contraction than in other G-10 nations. According to Bloomberg, *China has been increasing restrictions on the nation's runaway property market with measures including raising mortgage rates, temporarily halting land auctions in some major cities, and banning private equity funds from raising money to invest in residential developments.*

China's Gross domestic product (GDP) expanded 7.9% in the April-June quarter from a year earlier. This was lower than market economists' expectations of 8.1%. Higher raw material costs were evident, and the government has tackled that by seeking to punish those who speculate or hoard commodities. GDP figures for the July-September quarter are expected to be released October 18th.

Global consumers are seeing supply shortages in a variety of goods. This was exacerbated when China closed one of the world's busiest container ports for two weeks after a Covid-19 outbreak the result has been further pressure on stressed supply chains. In addition to this outbreak, the low tolerance by Chinese authorities for Covid-19 outbreaks has resulted in a decline in on consumer spending. The double hit on production and consumption has led economists to lower their expectations for growth in the second half of the year.

China's trade balance has not yet fully retraced to the pre-pandemic levels. Part of that could be due to supply chain disruptions while another contributing factor could be due to shifting demand. Consumer demand changes could be the result of higher input prices over the past 18 months.

Externally, the US Fed and other central banks are preaching that the inflationary forces may be transitory, decisions are being made globally to either support growth or fight inflation. China appears to be at a crossroad where the inflation may not be excessive while growth is certainly appearing to slow at a concerning rate.

The heatmap below, constructed by Bloomberg, shows the Nowcast growth forecast for China, (top row). After growth troughed in March of 2020, the recession was short-lived with a lively bounce that peaked in Q1 of this year. With a goal for 2021 growth at 6+%, the government will not want to see growth slow much further from here.

| | | Jan 2020 | Feb 2020 | Mar 2020 | Apr 2020 | May 2020 | Jun 2020 | Jul 2020 | Aug 2020 | Sep 2020 | Oct 2020 | Nov 2020 | Dec 2020 | Jan 2021 | Feb 2021 | Mar 2021 | Apr 2021 | May 2021 | Jun 2021 | Jul 2021 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Nowcast | BE Nowcast Headline[1] | | | -2.1 | | | 5.8 | | | 5.0 | | | 7.5 | | | 19.5 | 8.1 | 8.0 | 7.9 | 6.2 |
| Demand Side | Retail Sales[2] | | | -18.1 | -9.1 | -3.7 | -2.9 | -2.7 | -1.1 | 2.4 | 4.6 | 6.1 | | | | 33.0 | 15.8 | 10.1 | 9.8 | |
| | Electricity Consumption[3] | | -10.1 | -4.2 | 0.7 | 4.6 | 6.1 | 2.3 | 7.7 | 7.2 | 6.6 | 9.4 | | | 18.5 | 19.4 | 13.2 | 12.5 | 9.8 | |
| Supply Side | Industrial Production[4] | | | -1.1 | 3.9 | 4.4 | 4.8 | 4.8 | 5.6 | 6.9 | 6.9 | 7.0 | 7.3 | | | 14.1 | 9.8 | 8.8 | 8.3 | |
| Prices | Consumer Price Index[5] | 5.4 | 5.2 | 4.3 | 3.3 | 2.4 | 2.5 | 2.7 | 2.4 | 1.7 | 0.5 | -0.5 | 0.2 | -0.3 | -0.2 | 0.4 | 0.9 | 1.3 | 1.1 | |
| Surveys | Small, Medium Businesses Confidence[6] | 55.0 | 40.5 | 49.6 | 50.9 | 51.7 | 53.3 | 53.9 | 54.1 | 54.0 | 52.6 | 52.9 | 52.7 | 52.3 | 51.5 | 53.6 | 55.6 | 54.4 | 54.4 | 53.9 |
| Composite | CICC Cyclical Momentum Index[7] | 89.1 | 81.7 | 84.2 | 81.7 | 84.7 | 86.3 | 84.7 | 89.2 | 91.8 | 91.1 | 93.7 | 95.6 | 96.0 | 96.4 | 98.1 | 97.0 | 98.8 | 99.0 | |
| Markets | Real Effective Exchange Rate - CPI-Based[8] | 123.9 | 124.0 | 123.6 | 122.1 | 119.7 | 120.2 | 119.9 | 121.6 | 123.1 | 123.7 | 123.6 | 123.4 | 127.0 | 127.0 | 125.9 | 125.0 | 126.0 | 124.8 | 123.9 |
| | Shanghai Stock Exchange Index[9] | | 2,880 | 2,750 | 2,860 | 2,852 | 2,985 | 3,310 | 3,396 | 3,218 | 3,225 | 3,392 | 3,473 | 3,483 | 3,509 | 3,442 | 3,447 | 3,615 | 3,591 | 3,397 |

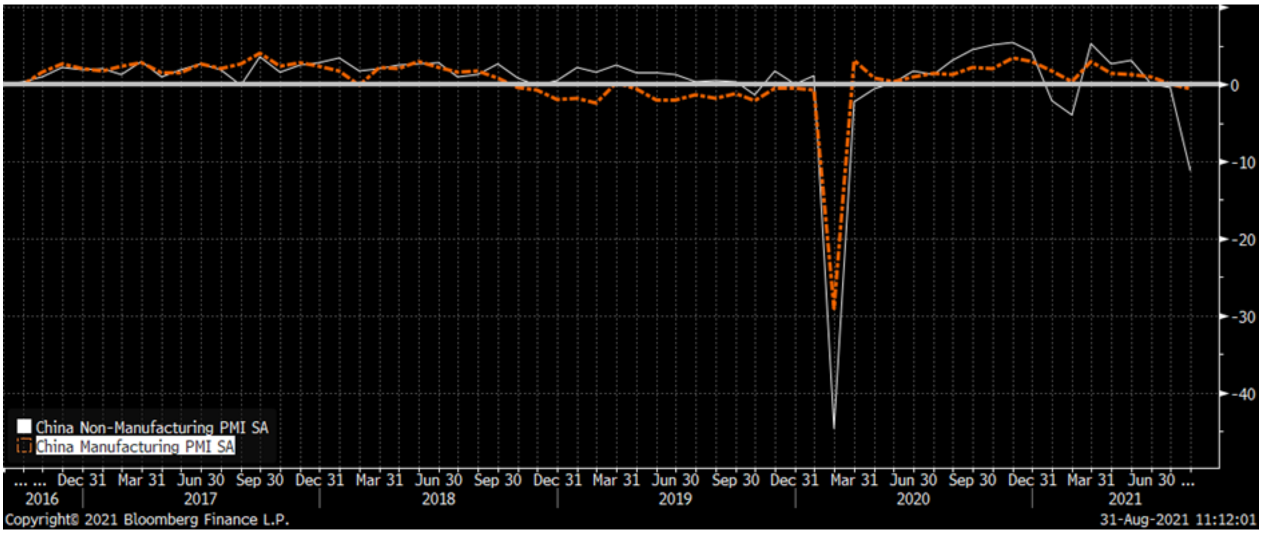
As of July 30, 2021

Notes: 1. Bloomberg Economics (%YoY); 2. National Bureau of Statistics (%YoY NSA) (CNRSRYOY Index); 3. China National Energy Administration (%YoY NSA) (CNLCTTLY Index); 4. National Bureau of Statistics (%YoY NSA) (CNCPIYOY Index); 5. National Bureau of Statistics (%YoY NSA) (CNCPIYOY Index); 6. Standard Chartered Bank (% Bal. NSA) (SCCNSMEI Index); 7. China International Capital Co. (Index NSA) (CMICOMP Index); 8. J.P. Morgan (Index) (JBDCCNY Index); 9. China Securities Index Co. (SHCOMP Index)

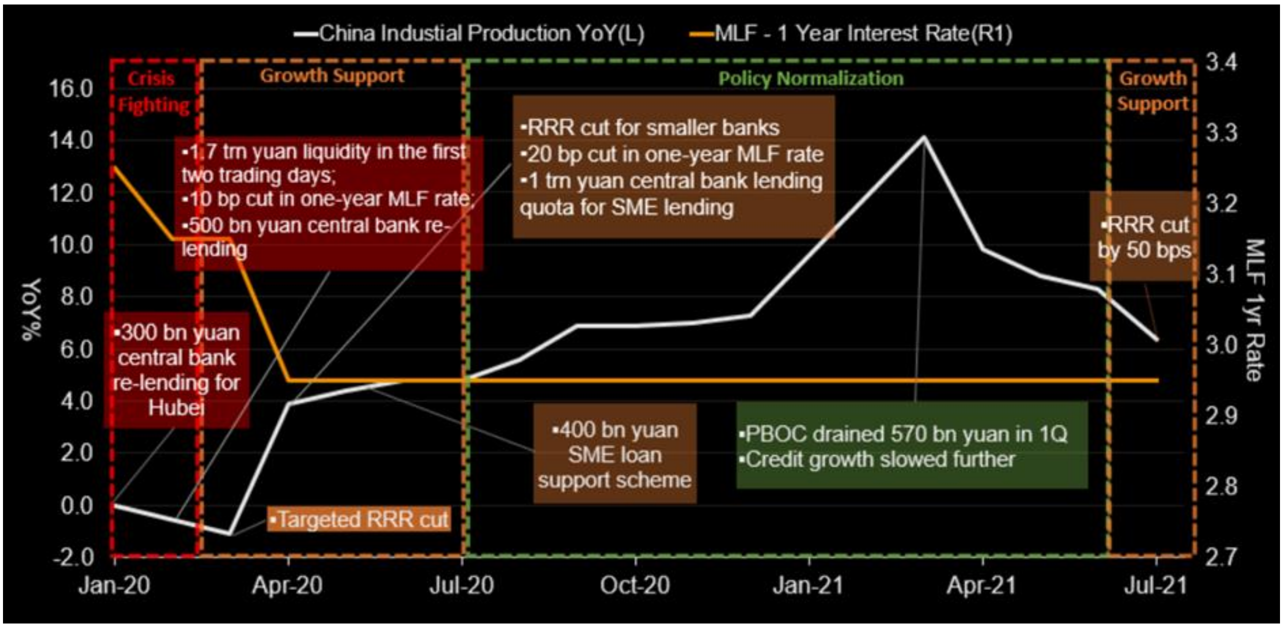
The economy is not the only battle China faces. Chinese President Xi Jinping has introduced measures to fight monopolies, battle pollution and shore up strategic reserves, all areas that are crucial to his government's push to improve the quality of life for its citizens.

As a result of their policy to conduct a regulatory overhaul of key sectors including education, technology and property, local share markets have suffered. Hundreds of billions of dollars have been wiped from the market value of tech giants this year at home and abroad as he has sought to erase income inequality and get rid of monopolies. This has been under the term of "common prosperity". We believe that CCP authorities would have been uneasy when looking at the reach and power that US tech firms have amassed and how they have been influential in politics as well as business.

The effect of the pandemic and recent regulations can have an adverse effect in the near future. This can lead to slower growth. We can see the Chinese PMI indices in the graph below. China's economic activity weakened last month when the delta virus variant slowed consumer spending and travel, while surging materials costs and supply-chain woes hindered production. Manufacturing PMI sits at 50.1, just above the expansion/contraction line while the construction and services PMI index fell below to 47.5.

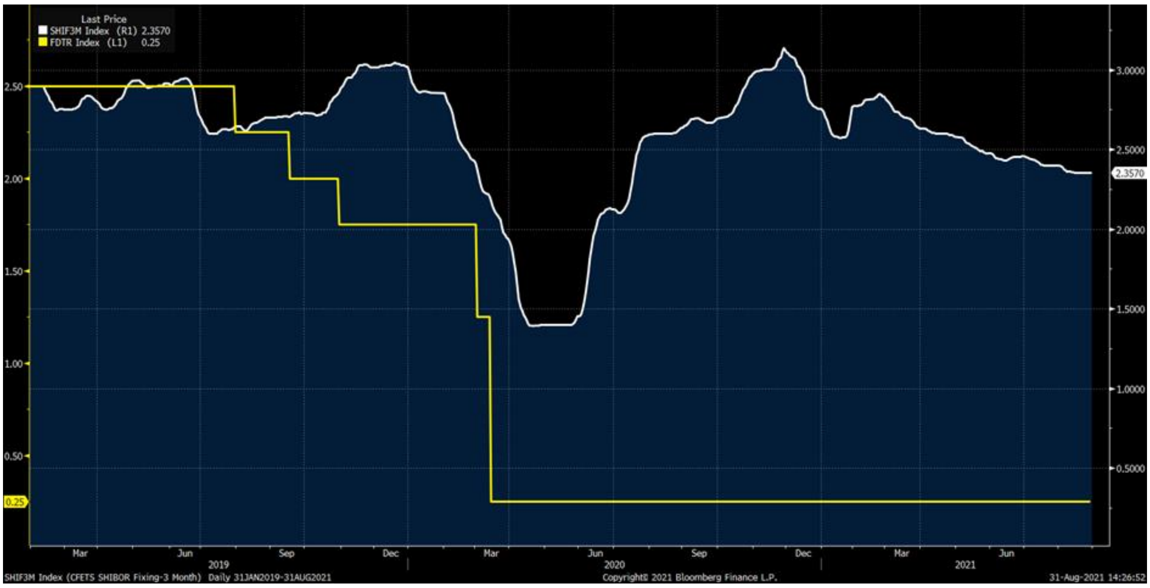



While the Chinese government wants to focus on balanced growth and common prosperity, it also knows it must avoid significant economic weakness which could also lead to social unrest. We can see the measures taken by China in response to the outbreak of Covid over the last 18 months in the graph below.




For the remainder of the year, economists expect that the government will pass fiscal measures to support employment and that the PBOC will introduce another cut in the reserve requirement ratio for banks to support small and medium-sized businesses. They last cut the RRR by 50 bp in July 2021. This effectively released the equivalent of USD$154.4 bio into the economy. Another cut is anticipated in Q4 of this year.

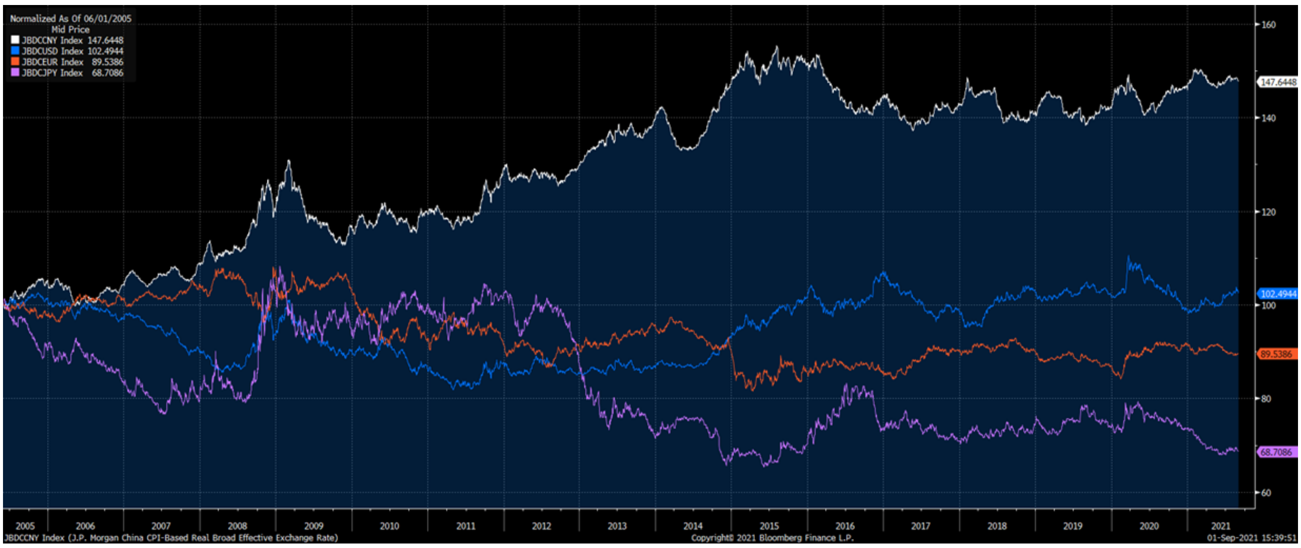
We can see the relative move in cash interest rates in China (white) compared to USA (yellow) in the graph below. China is fighting inflation and the USA is looking to maintain growth and employment.




The conclusion of this is that China has not used all of the levers it has at its disposal to ease policy. With CPI inflation at 1.1% and monthly GDP trailing off due to sequencing and the rebound growth working its way through the economy, there is room to move. Given they still have positive real rates they could lower bank rates further, but they have stated they want to be more targeted for fear of stoking the real estate sector once again.

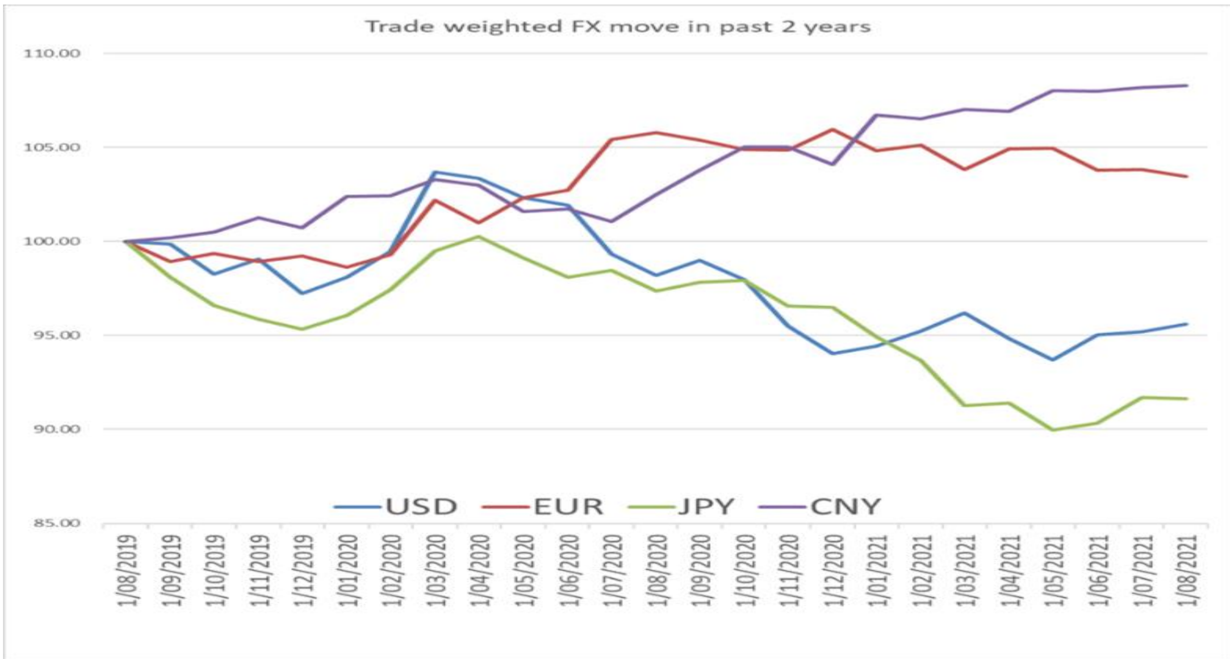
Since 2005, China's currency has appreciated 33% against the U.S. dollar. Despite the calls from the US for the CNY to be free floating, the graph below tells a different story. The authorities have allowed the currency to appreciate. The white line is the nominal trade weighted CNY which has appreciated while the other major currencies USD, EUR and JPY are in blue, orange and purple respectively. Since 2005 when the currency was moved towards a dirty float it has tended to appreciate.

In 2015, that appreciation pressure was met with a devaluation over the course of a week to weaken the currency and aid the export sector. At the time, exports were collapsing to negative annual growth.

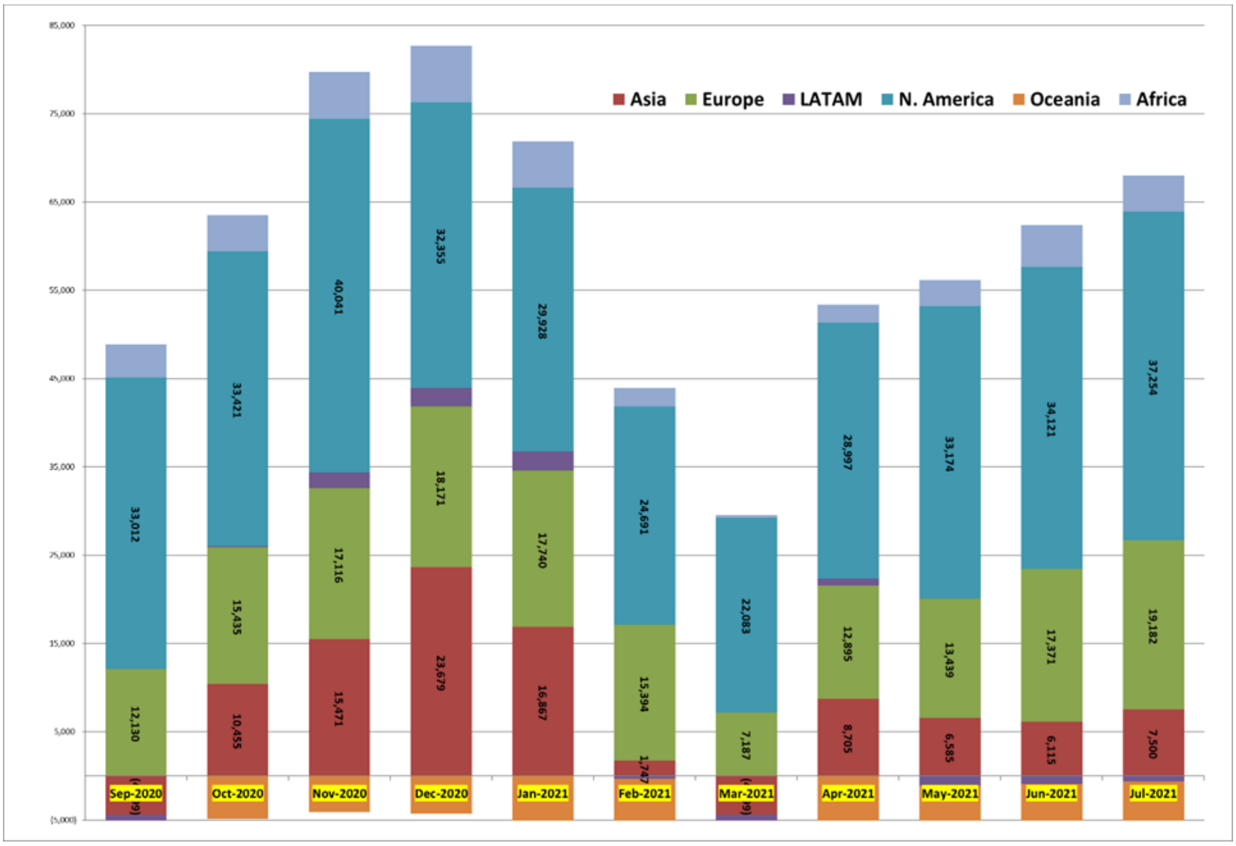



In the graph below, we can focus on the trade weighted majors, noting once again that the

CNY has appreciated substantially against the major currencies.




China's economy depends heavily on its exported goods. The graph below shows the monthly composition of export with the regions of the world.




In summary we can see that in the table below the trade imports and exports for different countries can vary due to demand, supply constraints, and price (due to FX and the of cost of production). China's imports have been growing while their exports have not grown as fast.

| China Trade Year to date change | growth |
|---|---|
| China Imports from Asia | 7.3% |
| China Imports from Europe | 0.6% |
| China Imports from Latin Ameri | 49.1% |
| China Imports from North Ameri | -7.7% |
| China Imports from Ocean Pacif | 53.5% |
| China Imports from Africa | 38.0% |
| China Exports to Asia | -5.7% |
| China Exports to Europe | 2.2% |
| China Exports to Latin America | 25.6% |
| China Exports to North America | 6.8% |
| China Exports to Ocean Pacific | -6.5% |
| China Exports to Africa | 1.2% |

When exports collapsed in 2014/5, the following occurred:

On August 11, 2015, the People's Bank of China (PBOC) surprised markets with three consecutive devaluations/depreciations of the Chinese yuan renminbi (CNY), knocking over 3% off its value that week. By devaluing its currency, the Asian giant lowered the price of its exports and gained a competitive advantage in the international markets. A weaker currency also made China's imports costlier, thus spurring the production of substitute products at home to aid domestic companies.

Would China consider such a move again?

China has kept monetary policy tight. Unlike the other global leaders, they have not opened the floodgates to increase liquidity. Below is a model that seeks to combine the moves in FX and interest rate markets to see the change in monetary conditions. We will call it the Monetary Conditions Index (MCI). The moves in FX are converted to moves in interest rates to be able to see how the authorities are able to influence the producers and consumers by varying not only interest rates but currency levels too.

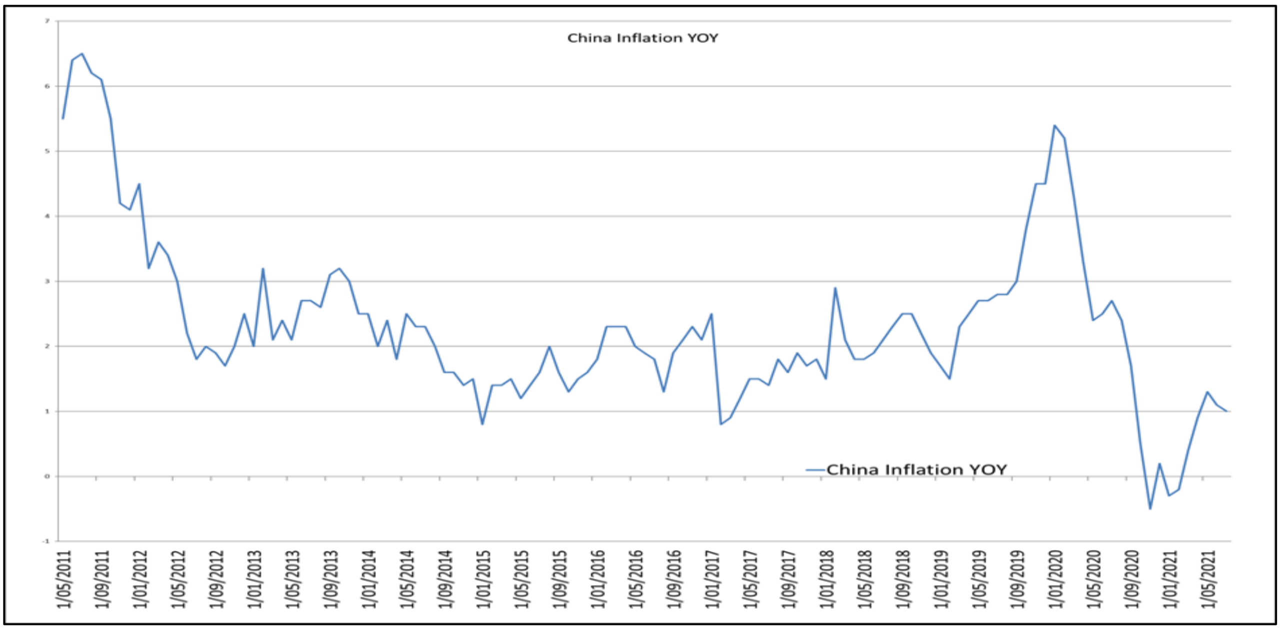
| | 30/06/2021 | 31/03/2021 | 31/12/2020 | 30/09/2020 | 31/03/2020 |
|---|---|---|---|---|---|
| EURO | 94 | 75 | 177 | 173 | 54 |
| UK | 10 | 241 | 152 | 128 | 49 |
| SWISS | 11 | 18 | 138 | 118 | 97 |
| AUSTRALIA | 36 | 246 | 222 | 142 | 120 |
| JAPAN | 16 | 7 | 144 | 88 | 43 |
| UNITED STATES | 1 | 286 | 268 | 307 | 432 |
| CHINA | 11 | 82 | 3 | 22 | 182 |

In reading the table, we can see that China has tightened monetary conditions by 1.82% since March 2020. This is seen in the bottom right-hand section of the table. In contrast, the USA has eased by 4.32% over the same time period.

So, in conclusion, markets are focusing on the level of the CNY and the interest rates. We would expand this study to note that China has room to depreciate its currency in order to support their export competitiveness. Allowing their currency to appreciate is hurting the export sector.  They will not want to revisit the devaluation of 2015. Their hopes to be a reserve currency will have them avoid this scenario. Note the last move in 2015 was just before they became an SDR currency.

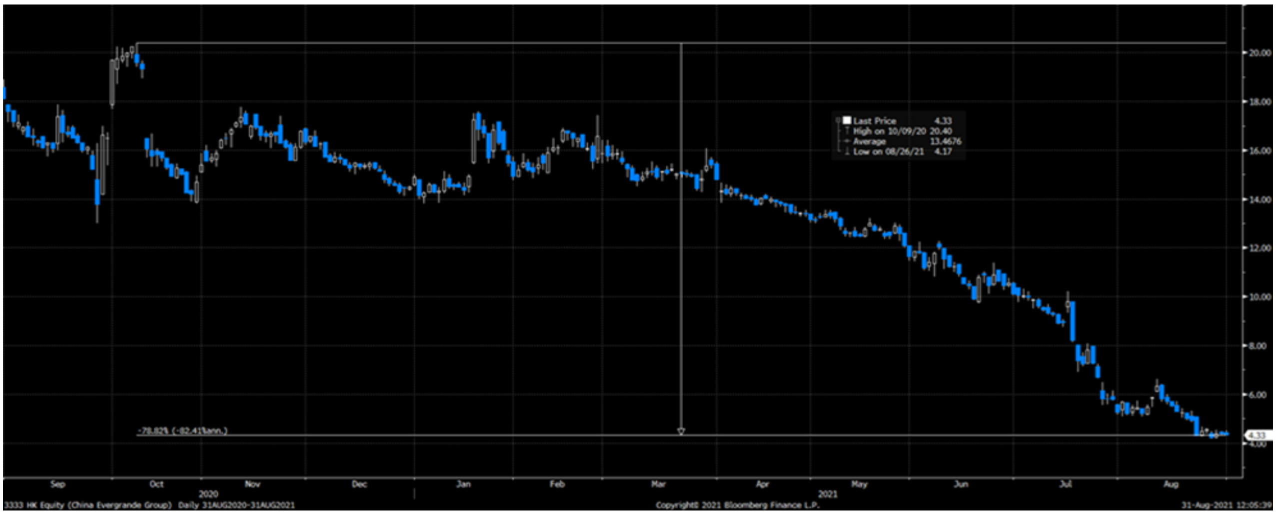
With the US already occupied elsewhere, sanctions against China are unlikely if they were to depreciate their currency. The worst that could happen would be to label the country as a FX manipulator. This label could be turned back on the US as they maintain easier money allowing their currency to depreciate over the past year. China will be loath to lose the competitiveness given the soft economy at home. They are seeing unemployment rise and exports and inflation fall. A weaker CNY would be inflationary but with current inflation at 1.1% this is not out of hand.

Why is the CNY so strong currently? US and other large asset owners, managers and banks are profiting from China opening its asset management and bond markets to allow foreigners access to what is set to become the world's second biggest capital market. Bond flows as well as equity flows have been substantial. Investors have been attracted to the local government bonds with current 3-year rates at 2.5%. With inflation falling, there is little likelihood that the next move in rates is up. We can see annual inflation for China in the graph below.

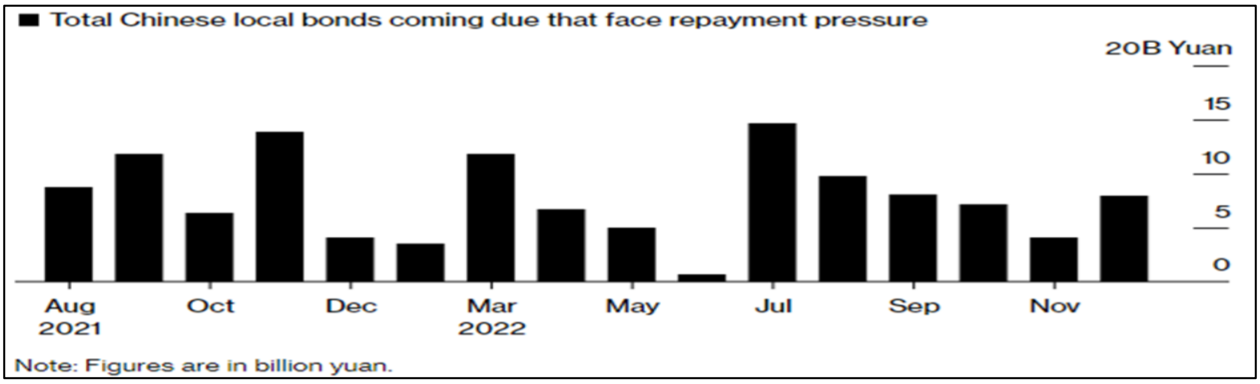



While China's government bond markets are attracting inflows, the same cannot be said of the property sector bonds. Global investors are watching with trepidation on the fate of Evergrande, a large property developer. They have debts of USD300 bio. This is not a great idea when the government has tightened liquidity- in that sector. China Evergrande Bond 2025 is shown below. The price of the bond is now into the default territory with a yield of 44.75%. Their bonds are no longer accepted as repo collateral. This scenario is reminiscent of Bear Stearns.

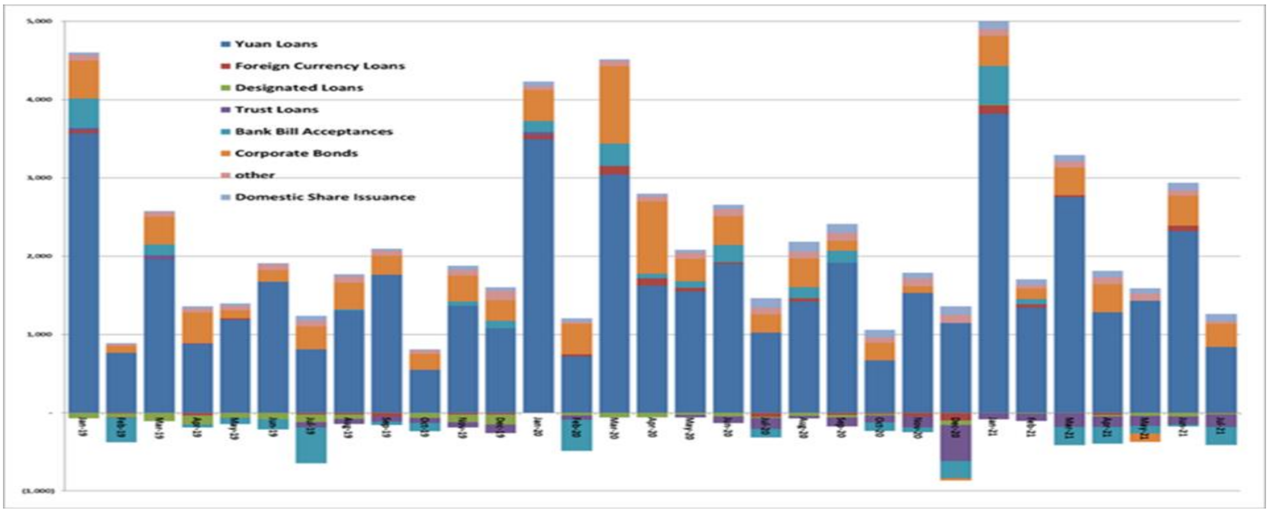
According to Forbes, Evergrande's debt is about 2% of China's 2020 GDP, 10% of China's total forex holdings. A default here seems likely without the intervention by authorities. This one really may be too big to fail. The company is in the market currently liquidating investments but the size of those investments is too small to make a material dent in their liabilities. The share price is down 83% since last October as can be seen in the graph below.



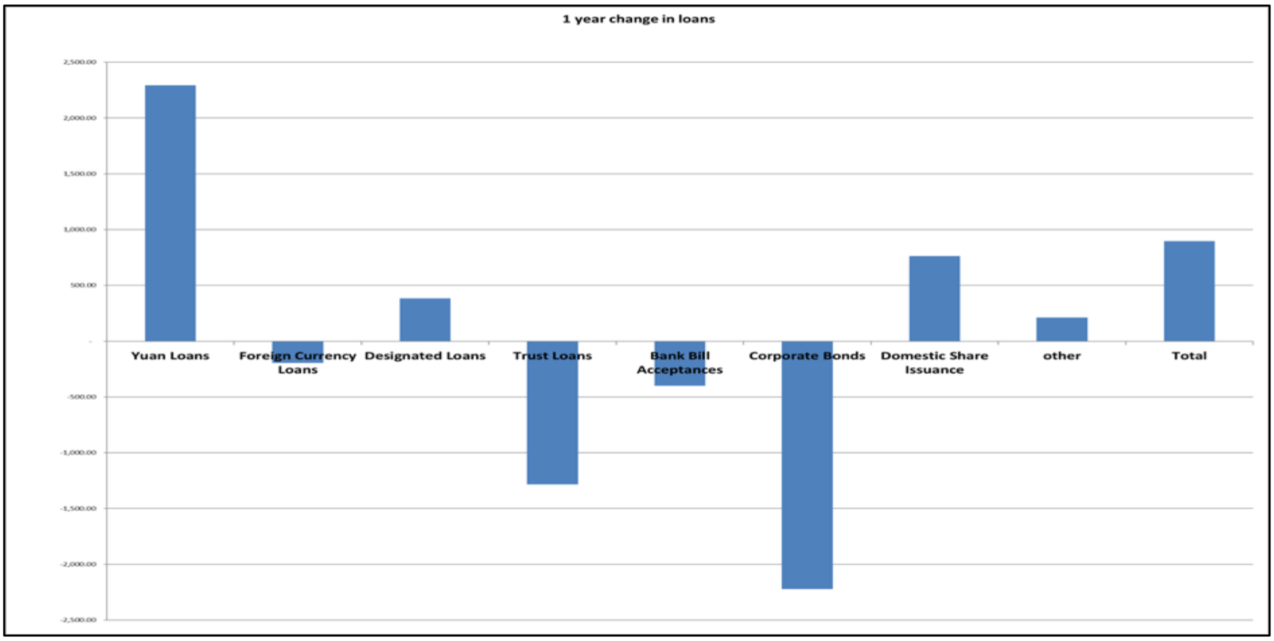
It is not just Evergrande that is facing possible troubles. The graph below shows the maturity profile for bonds in the next year. This adds up to USD 7 bio in the next 18 months.




As the graph below shows, the predominant lender for borrowers continues to be Chinese banks. We can see the Yuan loans in blue, especially the loans granted in January, drive growth. Money supply is tight and the alternative Social Financing sources have fallen as the regulators reined them in years ago. This gives the authorities more control of where capital should be deployed. Of late, we have learned they are not interested in supporting the internet sector nor in monopolies. They have already stated the real estate speculative side is not going to be supported going forward.

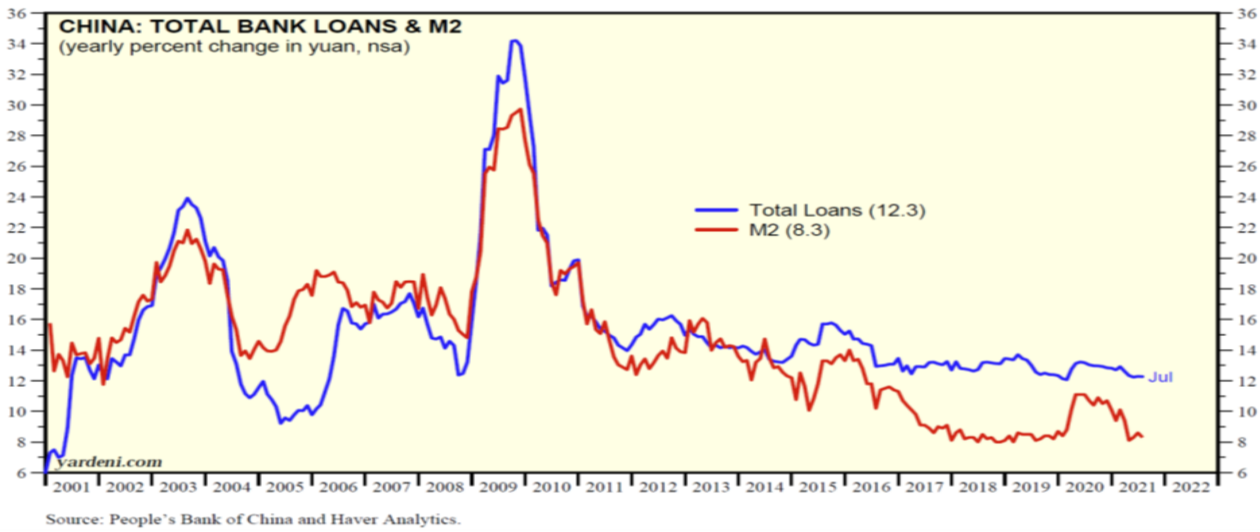


We can see the change in annual loan amounts in the graph below. Clearly the largest growth in lending have been the Yuan denominated loans. This narrows the ability of the real estate sector to procure funding. Evergrande and presumably others have a large exposure to USD funding. This is in effect circumventing the ability of the authorities to regulate the availability of credit. It also speaks to the questions on liquidity and exposure of the banks' customers to foreign currency fluctuations. This exposure was asked of those banks in the last week by the PBOC.




Credit supply this year will continually focus on serving the real economy. The financial sector maintains strong support for manufacturing, infrastructure and the services sector except for the property sector. We can see the growth in total loans and M2 in the graph below from Yardeni Research.

The PBOC's data showed that China's new yuan-denominated loans totaled 1.08 trillion yuan in July, up 90.5 billion yuan from the same period last year. Loans to the property sector fell to below 10% as they rotate towards the real economy. Rather than increasing money supply to help these companies, the PBOC has been intent on a tighter policy to head off inflation.



China's PBOC announced in June that it would raise financial institutions' required reserves for foreign-currency deposits by 2%. The increase to 7% from 5% was intended to strengthen foreign-exchange liquidity management for financial institutions. This was the first move of the ratio in 14 years. The previous change occurred in May 2007, when the ratio was raised to 5 percent from 4 percent.

The conclusion we come to is that the Chinese will be anxious to support their export sector. This can be helped by the easing of financial conditions through loans to targeted sectors. Importantly the real estate sector that is currently experiencing difficulty may not find that lower rates will help them achieve the same level of historical profitability. We have seen through the MCI that while the real interest rates have fallen elsewhere, inflation in China has fallen faster than the nominal rates. In addition, the FX policy has seen conditions tighten further. China has the ability to ease policy through a weaker CNY.

We would expect that the CNY daily fix could be slowly raised. Any USD selling by overseas investors would add to the foreign exchange reserves at the central bank. The PBOC check of bank customers' exposures to FX risks last week tells us something is afoot. They may be just checking to see how much the institutions that accessed foreign capital markets (like Evergrande) are exposed to a move in the CNY. These companies would need to purchase USD for debt coupons and capital repayments.

When the CNY was moved in a dramatic fashion in 2015, there was a large reverberation across the world in equity and FX markets. A move to a weaker CNY policy need not be so dramatic as the export sector is still seeing positive growth albeit at a lower level.

## Positioning the trade

In Albany Capital's absolute return Global Macro strategy, which is run to a USD base, we are shorting CNH through USD call options.

From a risk perspective in the current environment, we are targeting a total daily Value at Risk (at a 95% confidence level) for our absolute return portfolio at < 0.75%.
We are always looking at whether new investment positions are additive or subtractive of risk at the portfolio level when included. In the (long)USD/(Short)CHN exposure we are creating via options, we are finding the position, when looked on a historical basis, is a small diversifier (risk subtractive) to the portfolio's overall VaR.

Therefore, even as we carry modest amounts of long equity related risk, and diversifying FX risk is a welcome addition. As such, most of our weighting assessment has gone into optimising the risk reward via position sizing. The risk on this trade is bound by the option premium on the downside and an asymmetrical payoff on the upside. Overall, while it contributes only a small portion of the portfolio's total daily VaR, at its initial weighting, this may increase over time all things remaining the same, particularly the low implied volatility cost in the CNH FX market.

We are purchasing calls through FX options on USDCNH. We think this environment is conducive for this position as the macro backdrop is leaning towards our view, the cost of the trade via pricing and volatility are reasonable, and the position is a net reducer of risk vis-a-vis the rest of the fund. We are buying USD/CNH calls with a 3-month expiry on an implied volatility of 4.2%.

## Risk

As stated, our downside risk is bound by the premium paid for these options. Understandably, we are interested in scenarios (economic, political, sovereign (armed conflict), health…) that could cause CNH to appreciate. Current news is that China and the US have resumed communications that were severed during the Trump administration. This news is bullish for Chinese assets but to be clear the investors have been attracted to China throughout. It just has not always been profitable for them.

The PBOC could relent and offer corporations like Evergrande subsidised access to USD at a preferential rate to repay their offshore debts as they come due. We think this is a low likelihood and will be readily apparent in Evergrande's junk bond pricing.

There could be a widespread influx of offshore investors into Chinese assets. The main two assets with USD links are property and public equities. The CCP has sought to put the brakes on the property market where August property starts fell 21% YoY and 34% MoM, in August. However, while property construction, development and sales are mainly driven by local Chinese entities, many Chinese property developers have issued significant amounts of USD denominated debt. China's borrowers leads major peers with amount of domestic corporate bonds due in next 12 months. They owe USD 1.3 trillion. Already we are seeing cracks in the ability to finance these loans. New issuances have dried up and therefore we believe capital flows in the property industry, certainly for the remainder of this year will be looking to buy USD and sell CNH.

There is heightened risk of an armed conflict in the South China Sea as German, French, Australian, Taiwanese, Japanese and American armed naval vessels all sail through the region in support of international conventions for open seas. China's Maritime Safety Administration recently issued an edict that it required immediate notification of all foreign ships to report their cargo and call signs before entering the region. It is highly unlikely that this request will be heeded by the major powers, thereby upping the ante that some sort of naval skirmish may occur. Historically, should salvos start firing between major powers, one would expect a flight to the USD and other forms of safe havens. One would not expect a cascade of CNH buying given that the conflict is physically very close to its shores and a major disruption to its commercial trade routes. The one caveat to this could be a significant amount of USD transfers out of US jurisdictional reach by Chinese SOEs and exporters soon after the conflict, in anticipation of capital sanctions and bank account freezes by the US government. Some USD selling may occur, but most likely small in comparison to selling of CNH, JPY, KRW, TWD and ASEAN currencies, buying USD.

The probability of large external flows of capital into the country in the near future, is low. If PBOC sees further pressures on the economy from Covid, we may see lower interest rates which would lessen the relative attractiveness of Chinese bonds to foreign investors. This would also benefit the position.

For more information, please reach out to us on info@sloanglobaladvisors.com .

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