Sucden Financial

FX Monthly Report

September 2022

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Research Desk
research@sucfin.com

Press Enquiries
press@sucfin.com

Authors:

Geordie Wilkes
Head of Research

Daria Efanova
Research Associate

Daniel Henson
Deputy Head FX

Nimit Khamar
FX Desk Broker

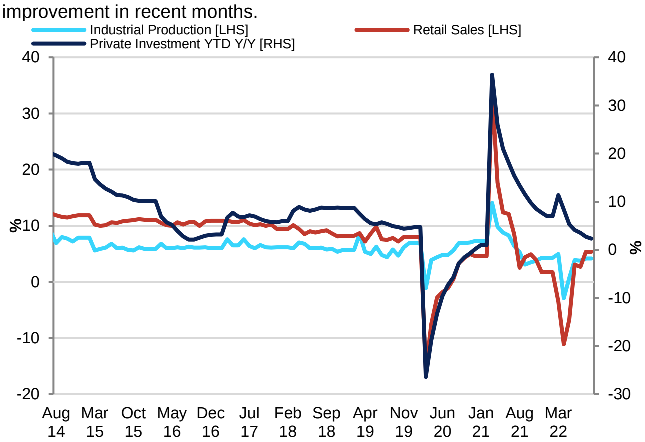
Chris Husillos
FX Desk Broker

China Focus

The saying goes, When the U.S. sneezes, the world catches a cold. However, this has been adapted and remains applicable to China, as China continues to become an undeniable force in the global economy and is a major producer of goods and services. Slow supply chains evidence this we have seen throughout COVID and continue to see as China currently refuses to shift away from their zero tolerance of COVID and region lockdowns remain a coping mechanism despite low cases, comparatively to the rest of the world.

China's Economic Indicators

Private investing continues to steadily decline while retail sales saw a slight improvement in recent months.



Source: National Bureau of Statistics

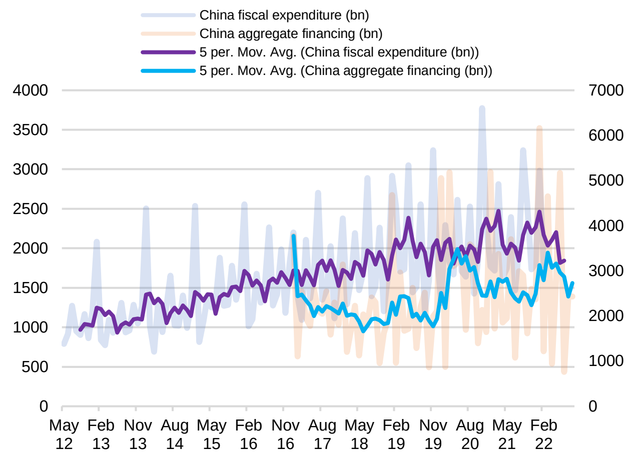
Growth in China has been lacklustre, and while we do not expect growth figures for a nearly developed economy to be above 6%, expectations were set around 4.5% this year, but the IMF has since downgraded this forecast to 3.3%. The main themes for this year have been:

- Poor performance from the property sector due to lack of credit
- Zero tolerance on COVID
- Regional lockdowns
- Power issues
- Stimulus not filtering into the economy because of lockdowns

Economic data lacks consistency with large pockets of poor data, and the property sector is a significant drag on the economy. Evergrande has restarted 668 of the 706 projects that were stalled. These projects need to be completed, property sales are still considerably negative -27.9% in September, and property starts at -22.25%. The land sales have surged higher on a year-on-year basis to 100.6% in September, and this is an indication that raw material demand could improve as these projects start, however from an absolute level, we expect poor sales, top 50 cities' land sales value increased by 22.39% in August. The property market will struggle to recover as credit and funding are expected to remain restrained as property companies cannot raise more debt. Land sales indicate an increase in starts in the next six months. Fixed asset investment was at 5.7% Y/Y in September, with industrial production at 3.8% Y/Y.

China Fiscal Expenditure vs Aggregate Financing

Average financing rates have been declining in recent months, as credit dries up.

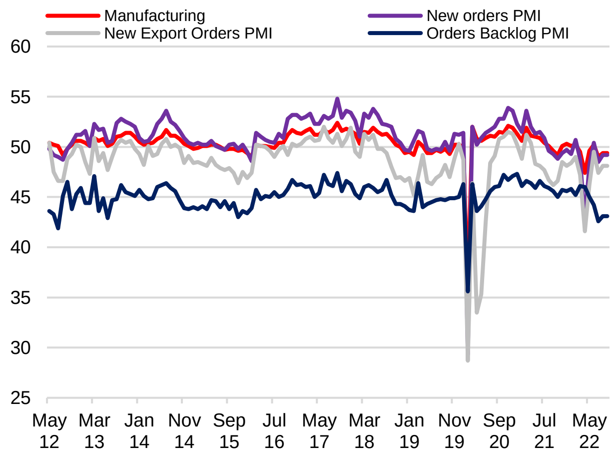


Source: Ministry of Finance of the People's Republic of China, The People's Bank of China, *Sucden Financial*

Manufacturing is contractionary, and as we previously highlighted in our [FX Options report], the August reading was 49.5. The orders backlog fell to 43.1, and new export orders also fell to 48.1 in September, with new orders falling at the fastest rate in 3 months. We also saw employment fall at the most rapid pace since 2016. Power costs have increased, and household electricity consumption has risen due to hot temperatures and demand for air conditioning. As a result of the low river levels, Yunnan Hydropower production was capped by the local government for industrial output to ensure no disruption to the residential sector. We could see further cuts in the coming months unless there is more rainfall. The higher power costs could be a headwind to the economy in the coming months from industrial production and residential perspective.

China Manufacturing PMI Performance

New orders, and, in turn, manufacturing performance continues to deteriorate.

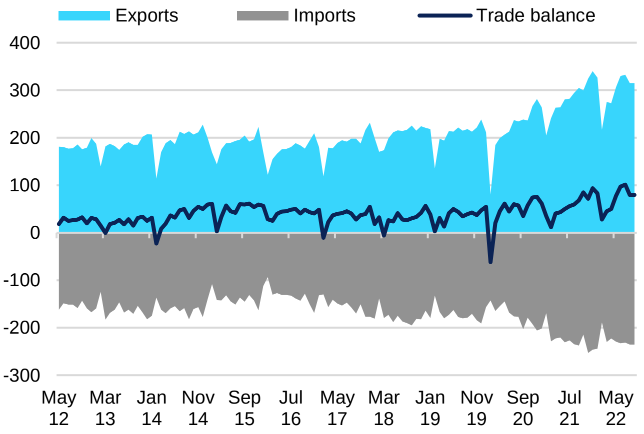


Source: China Federation of Logistics, Sucden Financial

According to the NBS, retail sales are improving and stand at 5.4% Y/Y in August. The zero COVID policy hinders retail sales; and youth employment is at 18.7%, down from a high of 19.9% in July. This indicates that there is a poor distribution of labour and an uneven distribution of expenditure. This could cap gains in retail sales in the near term, especially in the younger generation; the higher number of graduates from universities in China presents a risk of unemployment in the longer run. Retail sales for autos, oil products, clothing, and office supplies. However, we saw furniture, telecoms and building materials fall. This highlights the economic constraints with the residential property sector weak but auto sales high.

China Trade Balance (CNY)

China trade balance has widened as exports rise but imports have slowed in recent months.

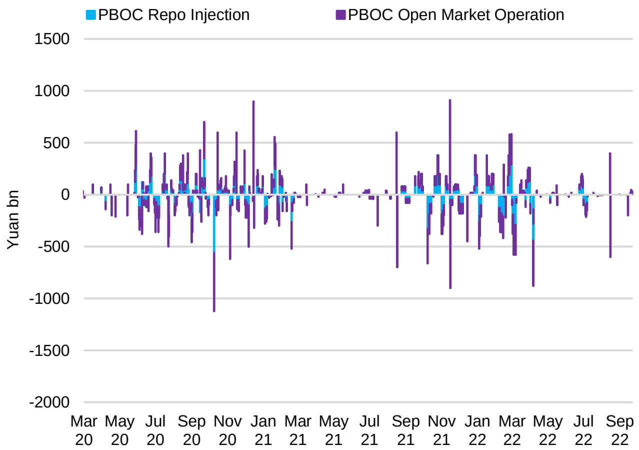


Source: Customs General Administration

China's trade data shows slow imports in August at 0.3% Y/Y, down from 2.3% Y/Y in July. Exports were also considerably below the market at 7.1% Y/Y, compared to estimates of 13.1%. Major export categories such as electronics, machinery, auto data processing machines, and telecom equipment were all down on the month. This highlights the lack of demand in the global economy, with organisations across the supply chain destocking. The cost-of-living crisis and slower economic growth is dragging on business and consumer sentiment. Therefore, we expect lower exports in the coming months as businesses and consumers cut back. As a result, the trade balance fell to $79.39bn, from a revised $101.27bn.

PBOC Repo Injection vs PBOC Open Market Operation

PBOC injections have been few and far between in recent months compared to previous years.

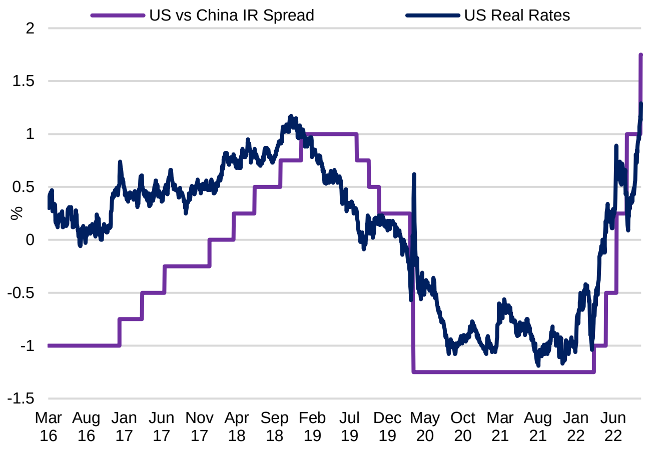


Source: PBOC, Sucden Financial

The PBOC has bucked the global trend and cut interest rates as over 100 central banks raise rates. The spread between the despite rates for the US and China has reached 1.75% as of September 23rd. The Fed has indicated they will raise rates by 125bps in the coming months, suggesting that the rate differential will increase in Q4. Loan prime rates in China have been cut, the 1yr at 4.3% and 5yr at 3.65%. The 5-year rate is traditionally a rate on which mortgages are assessed with the 1yr rate used to price corporate loans. The 12-month lending rates in China have been stable throughout the summer months at 4.35%. The required reserve ratio was cut earlier in the year to 11.25%. This will allow companies to invest more in projects to improve economic growth. It is unclear if this has worked due to the time lag. However, debt levels are high, and credit is tight, so we expect this to be more of a constraint on the economy than the RRR. Property sales remain sluggish, and developers are struggling to finish pre-sold properties.

US Real Rates & US vs China Deposit Rate Spread

Real rates are rising in the U.S., and the spread between the US and China rates has risen, boosting the attractiveness of the USD.

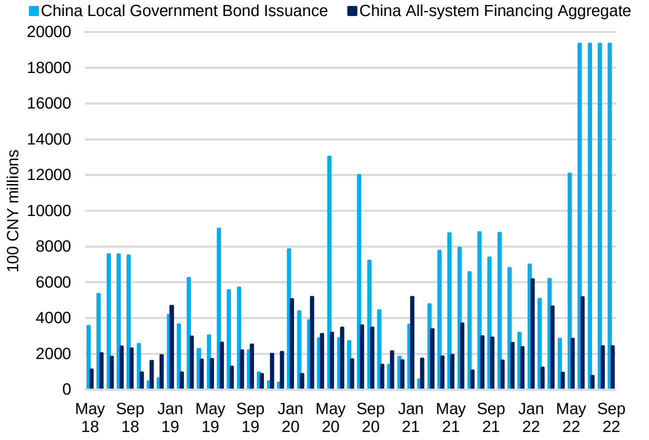


Source: Bloomberg

All-system financing in China increased in August was CNY2,430bn, with local government bond issuances at CNY19,337bn. The increase in stimulus measures should cause growth to rise, but access to credit of organisations, particularly property companies and commodity trade houses, and the regional lockdown prevent growth from rising. Pockets of data are improving, but credit and financing remain tight, and this is likely to continue in the short term. We may see new plans and policies put in place following the 20th party congress, with Xi indicating that China will continue to focus on its decarbonisation trends, and change regulations around the property sector, once Beijing believes it is stable.

China Local Government Bond Issuance vs All-System Financing

Local government issuance remained high in recent months as they try to support the softening economy.



Source: Ministry of Finance of the People's Republic of China, The People's Bank of China

CNY/CNH Spread

We ran an analysis on the CNY and CNH spread from 2010 to 2021, with USDCNY>USDCNH 48.84% of the time, with USDCNY<USDCNH 50.75%. The standard deviation was 0.02199; most of the time, the spread is between 0.02 CNY>CNH or CNY<CNH. When USDCNY>USDCNH by 0.05, 1.97% of the time, the spread always widened to >0.07 but was only >0.1 0.38% of the time. This indicates that trades would be better off waiting for 0.07 to hedge any currency risk, or there is a strong arbitrage opportunity to be made by those who can trade both.

This month, we conducted the same analysis with a marginally larger sample size of 3,154 compared to 2,942 during the last analysis. The percentage has declined from 2.11% and 1.97%. The spread has not reached these levels, but the trend remains intact. However, the current trend is that CNH<CNY and after the spread reached 0.05 CNY<CNH, the spread narrowed back towards the standard deviation of 0.02158, and as of September 27th stood at -0.0153.

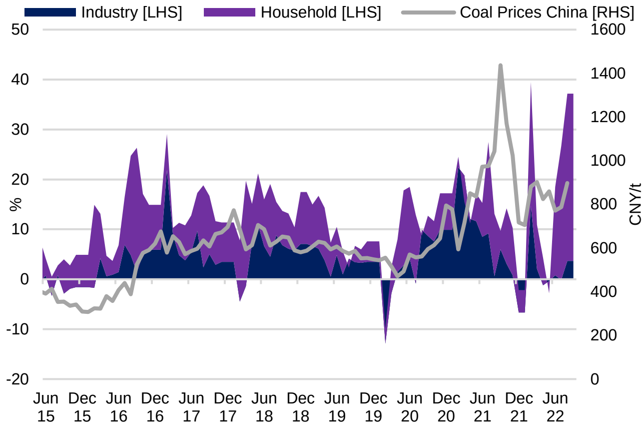
Currency View

The PBOC net repo injections have been rising as the bank look to boost the economy. However, this has been to no avail to the offshore currency, which has continued to weaken despite the weak PBOC local fixing. China's COVID policy, in conjunction with a weak economy, is not incentivising foreign investment into the country. This will remain the case before the 20th party Congress, but there is significant value in China at these levels from a currency and equities perspective. In the near term, we expect USDCNHH to continue to trend higher as the Fed raise rates and the U.S. commands the most economic and business confidence of any global region; we still favour holding capital in the U.S., but when the Fed stop raising rates, and economic data continues to weaken this will change. Now that China is desynchronised from other major economies, USDCNH will weaken in 2023 as China's growth improves and the U.S. heads into a recession. This depends on the length of the Fed's hiking cycle and China's zero tolerance to COVID but in the short term, we favour buying dips in USDCNH.

The options market suggests the currency will continue, and we still favour buying dips in USDCNH. Following the 20th Party Congress, if we see clarity on the economy, there is significant value in China in the long run with current currency levels.

Household vs Industry Electricity China vs Coal Prices

Household electricity consumption surged higher due to air con demand.



Source: China National Energy Administration

Desk Comments

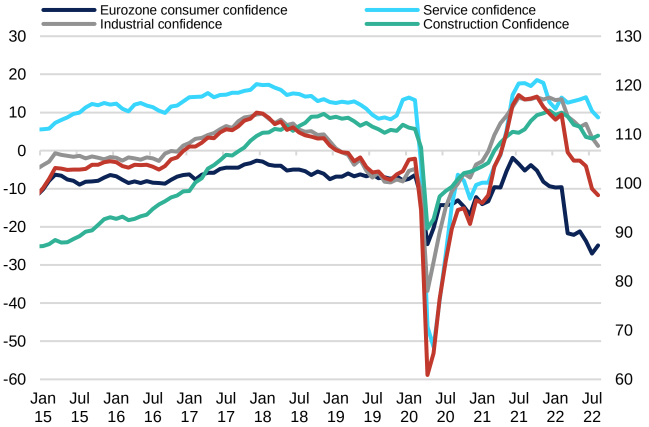
Euro

EURUSD broke parity, surging to a low of 0.9536 on the back of broad USD strength and rising gas prices. Germany has warned gas use needs to fall by at least 20% after the leakages found in the Nord Stream pipelines, even with a mild winter the outlook is bleak. Bbg estimates GDP to contract by over 4% this winter.

Euro area confidence has further waned. The 93.7 confidence reading is the lowest since the pandemic. Germany reached double digit inflation for the first time (10.9%) as discounted fuel and travel expired. However, the ECB has signalled its intent for the rest of the year to help control spiralling inflation. 75 bp priced at the October meeting and a further 50 bp by year end. Despite the tightening, one-month vols are at 13.3% as further weakness is likely. Currently trading in a downwards channel with parity seen as resistance and a test of the recent lows likely in the near term.

European Sentiment

European sentiment has nosedived in the last few months, we expect this to continue.



Source: European Commission

USD

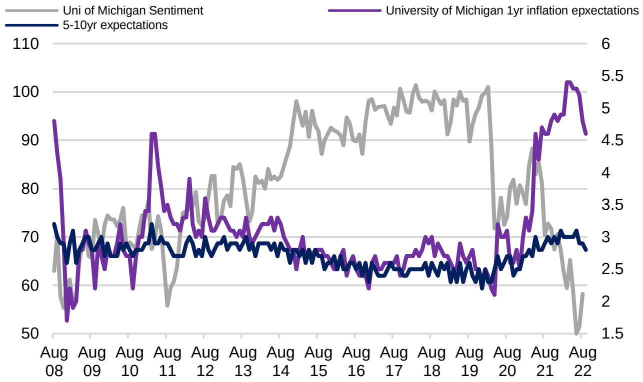
The USD strengthened against all major currency supported by higher yield expectation (US 10 year yield climbing above 4% first time since OCT 2008) as the Fed raised rates by 75bp to 3.25% and aided by safe haven inflows; Spike in volatility driven by market jitters surrounding the European and UK economies is driving this dollar move higher as economic data in the US showing higher resilience compared to rest of the world.

The Fed according to comments by member Summers does not believe strong USD is a risk for the US economy, however EM currencies are likely to be very concerned and may soon approach levels where they may need to employ FX controls.

Fundamentally, this USD move is looking overstretched, but these markets are suffering from a confidence crisis and the strong dollar dominance is likely to remain a theme until we see some market stability and lower US inflation.

US Michigan Sentiment Indicators

Sentiment is falling to multi-year lows, but inflation expectations are seen softening.



Source: University of Michigan

GBP

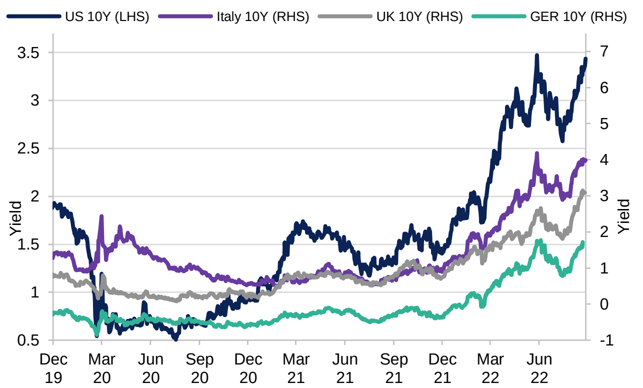
The UK mini budget sent GBP trading to record lows against the USD before recovering to 1.0800. The move by the government has been met with fierce criticism. The fiscal plan implemented to increase growth threatens to stoke soaring inflation and lead to rising borrowing costs.

As a result. The UK government bonds sold off aggressively leading to the BOE announcing a gilt purchase operation of long dated bonds to stop the gilt market spiralling out of control, but these actions will do little to address the fundamental issue driving the current weakness in the pound.

The message was clear that the BOE will not be doing an inter meeting emergency rate hike, but it is clear they will need to respond to the devaluing of the once great British pound. Markets were pricing 50bp a month ago but has increased to 150 bp for the November meeting. Moody's has been critical of the large unfunded tax cuts but has not changed the UK credit rating. The November budget will set out further details of the fiscal policy. The pressure will be on the government to send a clear message to the market to help bring confidence back to the UK.

US, UK, Italian, Germany, 10yr Yields

Yields remain elevated in the last couple of months as the ECB began to hike rates.



Source: Bloomberg

Technical Analysis

GBPUSD

GBPUSD made an all-time low after breaking below March 2020 lows @ 1.1412 and 1.0520 low from 1985. GBP has bounced from those levels, and we could now see a period of consolidation below green downtrend line and 1.0350. On the downside, a break below 1.0520 would see a test of the recent lows @ 1.0350. A close below 1.0350 could pave the way for the cross testing the psychological parity level. On the upside, resistance is @ 1.1412 and then the green downtrend, a close above could lead to further gains up to 1.23 (50% fib retracement).

EURUSD

EURUSD tested and failed to break below our support @ 0.9593 (from 05/2001). We expect the market to continue trending lower while the market remains below white trend line. On the downside, a close below 0.9593/0.953 area open doors to further decline down to 0.9330 and then 0.90 support level. On, the upside a close above white trend line could lead to test of resistance @ 1.02 and then green trend line coming around 1.04.

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Sucden Financial

United Kingdom
Sucden Financial Limited
Plantation Place South
60 Great Tower Street
London
EC3R 5AZ

Tel: +44 (0)20 3207 5000
Email: info@sucfin.com

Russia
Sucden Financial Limited
Sucden Financial (Russia)
Representative Office
Orlikov per. 3 ‘B’
Moscow 107139

Tel: +7 495 796 96 40
Email: russia@sucfin.com

Hong Kong
Sucden Financial (HK) Limited
Unit 1001, 10/F
Li Po Chun Chambers
189 Des Voeux Road Central
Hong Kong

Tel: +852 3665 6000
Email: hk@sucfin.com

USA
Sucden Futures Inc.
156 West 56th Street
12th Floor
New York, NY 10019
United States

Tel: +1 212 859 0296
Email: ny@sucfin.com

sucdenfinancial.com

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