In Case You Missed It: CSOP's Weekly China Wrap Up

China's onshore currency strengthens to ten-month high against USD

China's onshore currency strengthened nearly a full percentage point over the past week, clocking an intra-week high of 6.6469 against the USD.[1] Several overseas hedge funds reportedly cut their short position losses, triggering a cycle of additional cut-loss orders from algorithmic trading firms.

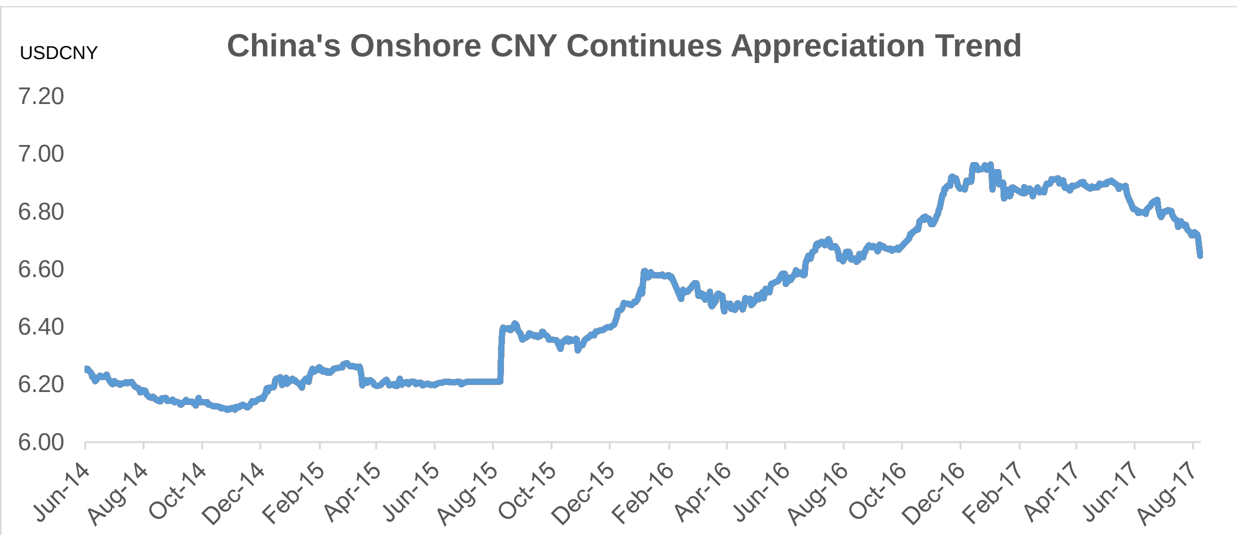
What's behind the movement?

Traders observed an uptick in trades unwinding RMB short positions after the USDCNY exchange rate broke the 6.7 level.[2,3] The aggressive unwinding pushed the RMB significantly higher in the offshore market, triggering cut-loss trades from quantitative models.

Meanwhile, several Chinese firms with large USD positions couldn't withstand the increasing foreign exchange loss. They started buying RMB aggressively in the onshore market, pushing the spread between onshore CNY and offshore CNH to over 200 basis points. As investors began realizing the inevitability of RMB appreciation, they came to understand that RMB put options would be difficult to strike at maturity, choosing instead to unwind their positions.

What to look for moving forward?

As the deleveraging process continues and China's financial system becomes increasingly stable, more bearish currency bets may be closed. Therefore, the chances are low that RMB will depreciate further against the USD in 2017, external shocks notwithstanding.



Source: Bloomberg, as of 8.10.2017

China's commercial banks conduct RMB 1 trillion debt-to-equity swap

China's commercial banks converted more than RMB 1 trillion (~USD 150 billion) of debt into equity holdings, according to the country's state news agency. More than 70 state-owned enterprises in the steel, coal, chemicals and manufacturing sectors benefitted from the arrangement, lowering their aggregate debt ratios.

The views expressed represent an assessment of market conditions at a specific point in time, are opinions only and should not be relied upon as investment advice regarding a particular investment or markets in general. Such information does not constitute a recommendation to buy or sell specific securities or investment vehicles.

Why conduct the swaps?

China's policymakers first employed debt-for-equity swaps in the late 1990s to reduce the burden on overleveraged zombie companies. Premier Li again proposed the policy to remedy China's worrisome corporate debt-to-GDP ratios, which have soared from 100% to 170% between 2008 and 2016, according to the Bank of International Settlement.[4] Anxious to maintain social stability ahead of this autumn's Party Congress, leadership has opted to extend a financial lifeline to debtors rather than face the mass unemployment that would accompany widespread bankruptcies.

Market reaction

Not all market players support the government's line of thinking. Some onlookers argue that the effort to prevent SOE bankruptcy comes at banks' expense.[5] Bank management is especially worried, concerned that the underlying shares of zombie companies are worthless and fear that the swaps will further deteriorate balance sheets in a time of slowing economic growth.

China's macro roundup: import and export growth slows though trade surplus widens

China announced a mixed bag of macro data in July. The month saw industrial output, retail sales, fixed asset investment and export and import growth slow more than expected. Heartening investors, China's trade surplus widened, contributing to the sixth straight month of rising foreign reserves.

Explaining the figures

Onlookers attribute the slowdown to the year-long crackdowns on property market, excess debt, and industrial overcapacity. The weaker export figures were blamed on the RMB's growing strength against the dollar. Taken together, the figures suggest that China's export-oriented growth model is transitioning to one in which domestic consumption plays a more crucial role. Morgan Stanley analysts predict that this transition will result in slowing growth in the second half of the year, though ultimately remain robust.

On the foreign reserve side, two widely-quoted reasons explain the extended recovery. First, USD weakness reduced depreciation pressure on the RMB, which appreciated against the USD but depreciated against a basket of currencies. Second, capital outflow controls have proven effective since the end of 2016 as Chinese firms' outbound purchases have dropped off significantly. As onlookers don't expect capital control to loosen anytime soon, foreign reserve figures are anticipated to remain above the USD 3 trillion level in the second half of 2017.

People's Bank of China orders centralized nationwide clearinghouse for online payments

China's central bank has established a new nationwide clearinghouse, mandating that all online payment firms direct transactions through the platform. Forty-four financial institutions and fin-tech firms have signed onto the agreement and will begin routing transactions in July 2018.

What explains the need for a new model?

Already a world leader in mobile payments, China's dominance only continues to expand: transaction volumes grew fivefold to USD 8.8 trillion in 2016 alone, according to iResearch.

However, regulators take issue with the decentralized nature of the existing infrastructure. The current model relies almost exclusively on third parties, allowing customers to link Alipay or WeChat Pay accounts directly to commercial bank accounts. Under this structure, a company like WeChat would appear as the payment recipient when a user makes a purchase. As a result, regulators cannot see transaction details like the merchant's name and location, obviating the government's ability to track flows and monitor abnormalities.

Remedying these gaps, the new setup will ensure that every transaction between users of online payment services and their commercial bank accounts are recorded at the central clearing house.

Pros and cons of the new arrangement

Some onlookers are cheered that the new arrangement will render it easier for regulators to monitor capital flows and close loopholes for money laundering.

On the contrary, representatives of the third-party payment providers are less-than-thrilled. Ant Financial and Tencent currently dominate China's payment ecosystem, and some company representatives believe that the new structure will force them to share proprietary transaction data with competitors. They argue that the unified regulation will reduce their market power and increase transaction costs for online payment service providers, ultimately resulting in higher costs for consumers.

Beijing introduces new plans to calm property market and provide affordable housing

Beijing is reportedly planning to introduce creative measures to provide affordable housing and calm the city's hot property market, among which include jointly-owned properties and renter rights to premium school districts.

Context of the measures

Thanks to easy credit and an influx of immigrants, Beijing has seen property prices double every few years for the past decade. Young people from less privileged families lament the situation and are often forced to move to lower-tier urban centers as a result of the skyrocketing prices. Authorities view the prohibitive property prices as a major impediment for retaining talented members of the so-called "sandwich class," those too rich to partake in low-income assistance programs, but too poor to afford a private house. The "jointly-owned homes" program thus seeks to provide these lower-income buyers a foothold into the market through government support.

Under the scheme, buyers under 30 who do not already own property can buy a share of a house while enjoying full usage rights. They will be allowed to sell their shares back to the government at market price five years after purchasing, a measure that allows owners to enjoy the property price surge while staving off worries about potential bubbles. Corresponding school district reforms ensure that renters can enroll their children in local premium school districts—a privilege formerly restricted to homeowners rather than tenants.

Sticking points

Despite the plans' theoretical merits, some critics questioned the feasibility. Some worry that low-end homes in secondary markets while be negatively impacted, while others doubt that a fair and transparent lottery system can be established to manage the huge number of applicants.

Notes:

1. USD: US Dollar, the official currency of the United States
2. RMB: Renminbi, the official currency of the People's Republic of China
3. USDCNY: The exchange rate between the US Dollar and onshore Chinese currency
4. GDP: Gross Domestic Product
5. SOE: State-Owned Enterprise