Sucden Financial

FX Monthly Report

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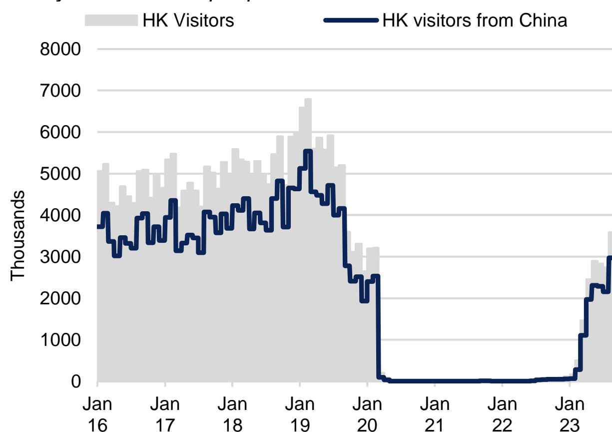
Hong Kong Focus

As Beijing continued to boost confidence in the market through stimulus support, particularly through a property boost, stocks in Asia continued to sour. Markets whipsawed in anticipation of policy from the July Politburo meeting, but the optimism reversed rapidly as the pro-growth messaging failed to deliver swift and forceful actions. Continued jitters over the potential collapse from the property crisis further soured optimism, triggering the risk-off sentiment in recent weeks. This indicates little confidence in consumer sentiment as the government attempts to resurrect the economy that struggles since the reopening of lockdown restrictions in January. While each new release from the government seems to lift sentiment, this is often short-lasting, and we expect that until the market sees continued improvement in economic indicators, and in particular, in consumer spending, prices are likely to remain low in the meantime. Still, we believe that risk assets are oversold with downbeat sentiment, which diverges from current market fundamentals, but the pessimism is now reflected in the price. With the slew of measures implemented throughout the year, we expect optimism to reverse from strongly oversold to neutral in Q4, in line with market fundamentals. As cheaper valuations and expectations of more stimulus are giving investors reasons to be optimistic again, a slew of bid buyers might emerge soon. In this report, we look at the HKD currency that is now trading near its fix of HK$7.85 to the dollar.

Hong Kong Visitor Number

The number of tourists travelling into HK has start to pick up this year but is yet to reach the pre-pandemic levels.

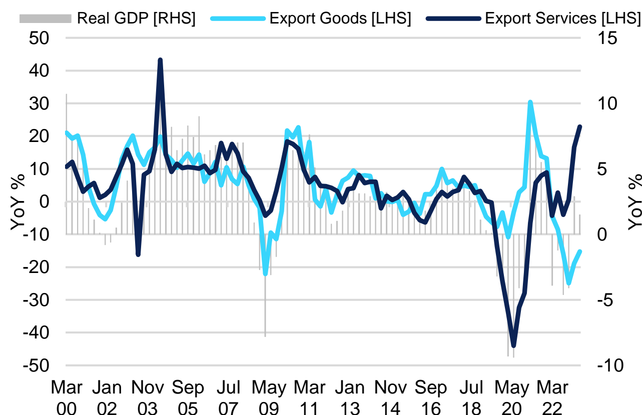


Source: Hong Kong Tourism Board

Hong Kong benefitted from the reopening more than China; however, that optimism is also seen waning. While offshore yuan declined by 2.00% during August, the decline was much more pronounced in HKD, which saw the largest losses since 1985, declining by almost half of the possible maximum swing within its target range. Moreover, the Hang Seng index is currently August's worst performer across global equity gauges. The main reason behind the decline across asses is the foreign fund outflows, with investors offloading $12.3bn of onshore stocks, marking a record low in net buying/selling. Moreover, warning signals are flashing in the region's economy: GDP rose by just 1.5% y/y in Q2 2023, far weaker than the 3.5% estimated by the market. Exports continued to contract, falling by 9.1% y/y in July, as waning global demand and slowing momentum in China weighed on the city's economy.

HK Real GDP vs Export of Goods and Services

The city's GDP is seen improving on the back of growing services export.

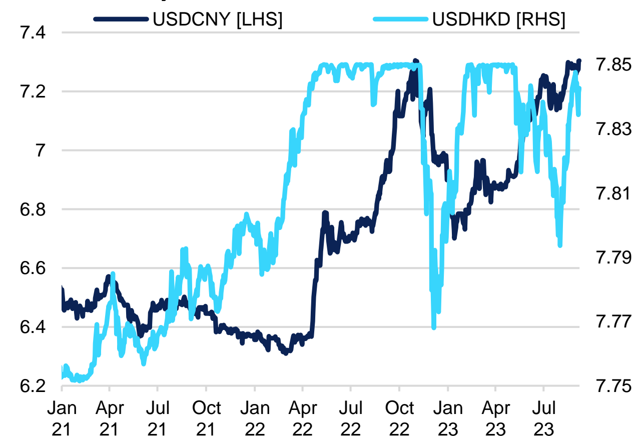


Source: Census and Statistics Department Hong Kong

Hong Kong pegs its currency value to the US dollar. It is an arrangement that has long been considered a guarantee of financial stability; however, in recent months, the central bank has had to burn through cash to purchase the HKD to maintain its peg. Hong Kong's aggregate balance, a gauge of liquidity levels in the banking system, has declined rapidly, falling by more than 90% from the highs of 2021. The city still has ample foreign reserves to prop up the currency, but that has not calmed market concerns. With the apathy towards the yuan at the moment, the financial appetite for the HKD remains dismal. This has been highlighted by the growing correlation between two currency pairs measured against the dollar. While we expect the peg to hold, higher-for-longer interest rates in the US have been key in driving investors away from the HK currency. Aggressive rate hikes by the Fed have encouraged traders to engage in carry trade, borrowing HKD and using the currency to purchase assets in US dollars to earn higher interest. As the pause in the Fed's tightening is pretty much priced in now, the pressures on the HKD should begin to alleviate. Still, we do not expect to see strong gains on the upside.

CNY vs HKD Performance against the Dollar

HKD lost half of its value within the target range, following growing weakness in the yuan.



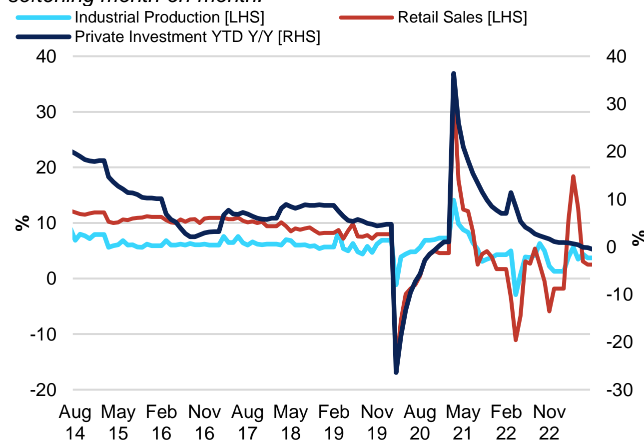
Source: Bloomberg

China Focus

Against the yuan, the picture looks more promising. Despite greater dependence on Chinese economic performance, HKD continues to be exposed to greater volatility, and local banks do not seem to have any issues with liquidity. Given its appealing institutional system for foreign investors, HK benefits from being the capital flow territory to and from China. However, if China was facing strong capital offloading, the city's market environment could appear more as a vulnerability than a strength. Economic performance is moderating from the highs seen post-reopening. China's manufacturing increased to 49.7 in August; however, it remained in contractionary territory for a fifth straight month. A jump in production and an improvement in new orders were the main factors behind the month-on-month improvement. Outside of manufacturing, some signs suggest the economy's recovery continues to be dragged down by the property sector and muted consumer spending. Demand remains lacklustre, and the question investors pose is whether service spending can continue to grow sustainably.

Chinese Economic Performance

Post-reopening optimism seems to have peaked, and indicators are softening month-on-month.

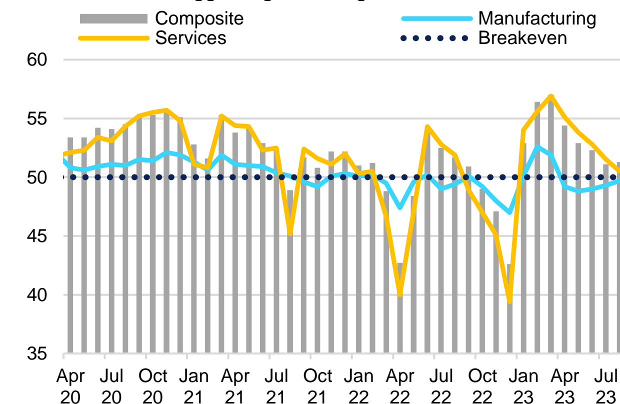


Source: National Bureau of Statistics

However, despite worrying economic signs, market focus remains on stimulus measures to prop up the economy. Policymakers have been reluctant to roll out massive stimulus measures, and we have seen economists downgrade their GDP expectations as a result. As of now, the broad projection remains slightly above the 5% target rate. Among the newly announced measures, authorities have bolstered specific sectors in recent weeks, including plans to increase consumer goods and car sales, and extending tax breaks. The move indicates the latest push from policymakers to encourage spending; however, the prevailing low level of confidence is dampening consumer willingness to spend. While this is an incremental step forward for the Chinese government, we do not see it as a game-changer. The Chinese economy is struggling under the weight of deflationary pressures, waning exports, and a persistent property crisis. This, coupled with the unwillingness to overinflate debt, will likely cap the scale of potential stimulus changes. China is now set to endure a period of moderate growth while it alleviates some of the debt-service constraints that are weighing on local governments. As of now, there is no quick fix for this issue. However, lower interest rates and easier borrowing conditions seem more likely to emerge.

China's PMI Performance

Both service and manufacturing performance are close to the breakeven level, suggesting no change MoM.

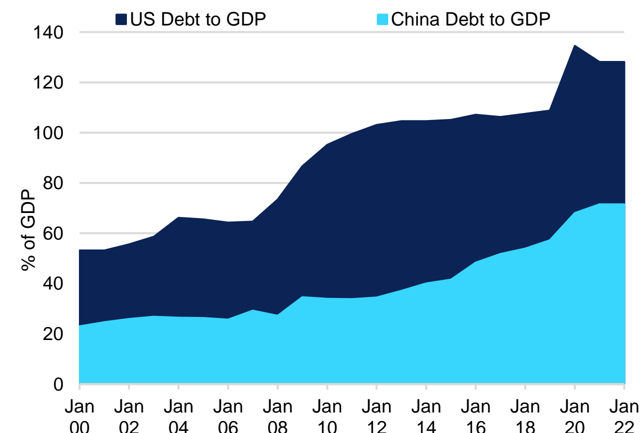


Source: China Federation of Logistics and Purchasing

China has space to expand government borrowing so long as private-sector savings remain high. The debt is large, and with youth unemployment at record highs, savings rates are likely to be skewed on the downside. The complex and layered systemic issues that the economy faces imply a more narrow and targeted approach towards segmented parts of the economy to work together. While this might not boost growth immediately, it should create a sustainable path for Chinese recovery from lockdown restrictions while balancing stimulus without over-inflating debt. In particular, the top priority for the builders would be to ensure the completion of unfinished projects to ensure that property returns to those buyers who placed their downpayments ahead of the collapse. Alongside the fiscal support, another cut in RRR might alleviate some of the liquidity pressures if necessary. Further cuts are likely, especially in the face of further spending on fiscal support. We believe the yuan will recover back to historical averages; however, gains are unlikely to materialise until late 2023/ early 2024. HKD should follow suit, and we see stronger gains relative to the yuan given its more volatile nature.

US vs China Debt to GDP Ratio

Whilst US debt to GDP ration remains consistently higher, Chinese debt growth in recent years flashes warning signs.



Source: IMF

Desk Comments

GBP

GBP has steadily declined since the start of Q3. Higher for longer rhetoric in US has helped demand for USD but the main driver of GBP weakness is the significantly weaker data in the UK. Retail sales came in at -1.4% MoM, expected -0.7% in July and the PMI release last month lead to GBP weakening 1.2% against the USD. The disappointing data is a sign the monetary policy tightening and persistently high costs of living beginning to have an increased toll on households.

On a positive note, inflation is falling and the aggressive pricing of the BOE policy rate has eased. The rate by year end is being priced at 5.6% from a high of 6.4% at the end of June. Andrew Bailey has reiterated rates are 'near top of the cycle'.

Although we still see further weakness in GBP, implied vol remain near yearly lows 8% and some technical support levels between 1.2310 – 1.2440 may limit the sell off. In addition, the higher for longer rhetoric from both the FED and BOE see both rate paths converge so we see a period of consolidation with a bias towards a slightly weaker GBP.

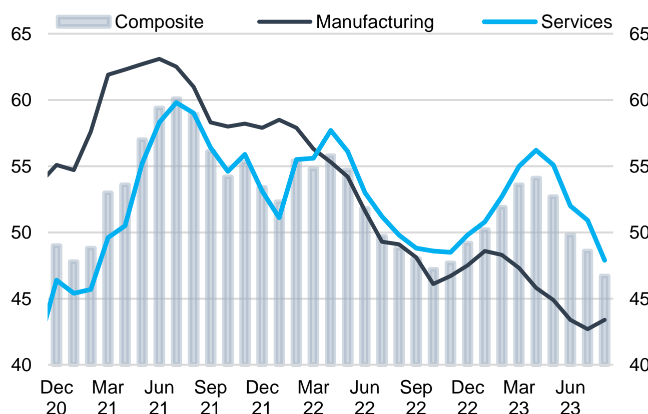
EUR

European yields have moved gradually lower, fuelled by some encouraging signs that core inflation is heading lower. The headline figure was 5.3% last month with easing in goods and services inflation a welcome sign and an indication the decline in activity is feeding through to companies' prices.

Overall, the economic outlook has worsened since the last ECB meeting. PMI releases in the EU disappointed and the standout was the German service PMI showing 5 index point decline, which has only happened three times before with the latest being in March 2020 during the Covid-19 lockdown. Retail sales have also dropped in the past two months notably due to weaker auto fuel sales and small gains in food and drink.

Eurozone PMIs Performance

Service performance is seen softening in recent month, catching up with the manufacturing.



Source: Markit

EURGBP continues to trade in 0.85 – 0.8650 range. Implied vol remains at low levels so we expect a continuation of recent trends implying a slight weak bias vs USD and sideways price action vs GBP.

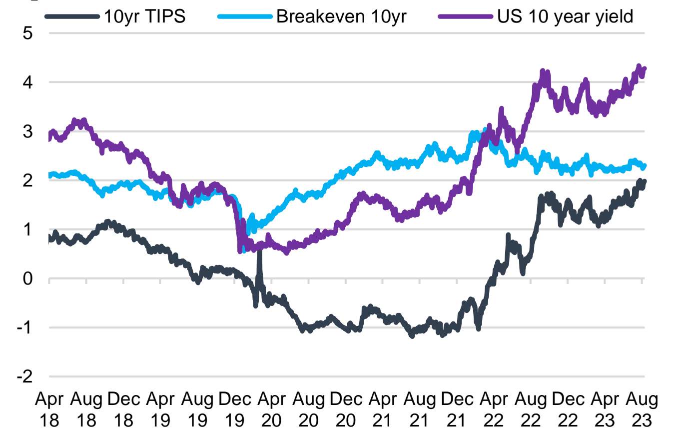
USD

USD has strengthened for 7 straight weeks since mid-July, despite market expectations that terminal rates have now been reached in the USD. Recent Economic date has shown US economy to be resilient, but still slowing enough to alleviate pressure for the FED to hike further, increasing the probability of softer landing in the US. Recent JOLTS and NFP numbers showed labour market cooling, with unemployment rate rising and average wage growth pace slowing to 0.2%

The data would have been well received by Powel, who during recent speech at Jackson hole indicated monetary policy is likely to stay restrictive as he remains concerned about core inflation and is willing to allow growth to slow below neutral rate.

10yr TIPS vs 10yr Breakeven vs 10yr Yield

Breakeven yield continues to drift lower as US real yield pushes higher.



Source: Federal Reserve

These comments and recent data reinforce our view that Terminal rates have likely peaked in line with market expectations. However, we expect the rates to remain around these levels and expect the rate cuts to come a lot later than markets expect. We expect USD strength to continue especially amid Chinas struggle and as the US economy remains in a lot healthier position compared Europe and UK where possibility of recession is almost afore gone conclusion.

CFTC showed net long positions decreased their net long positions last week, but spec positions are still positioned long.

Technical Analysis

GBPUSD

GBPUSD failed to break above resistance @ 1.3163 and is now trending lower after breaking below Red Up trendline. On the downside furthers losses towards 1.2309 support likely, support beyond there is @ 38.2% fib (1.2077). On the upside, a break above blue trend line will likely lead to a period of consolidation below 200 day MA and 1.3163.

EURUSD

EURUSD After failing to breach 61.8% fib (1.1272) has broken below the uptrend and close below this line paves the way for further declines towards 1.05 where we expect to see strong support. We expect EURUSD to continue trading range bound between the 200 day MA and 1.05. On the downside a sustained close below 1.05, would lead to further declines to 1.02(61.8% fib). On the upside a break above red trendline could lead to a period of consolidation, beyond, there is a strong resistance is at 200 day MA and the 61.8% fib @1.1272.

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