A case for renminbi exceptionalism

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IN BRIEF

- The renminbi may be attractive to investors maintaining a selective approach to emerging market currencies, who are seeking higher-yielding alternatives to the US dollar.
- Renminbi strength could have several drivers. First, China's balance of payments is now neutral, supported in part by cyclical factors, such as better management of the pandemic resulting in stronger economic growth than other regions.
- Initiatives to open Chinese markets to foreign investors, leading to the further inclusion of Chinese assets in global indices, should also support renminbi flows and could increase central bank allocations to the currency.
- We expect Chinese GDP should be back in line with its pre-Covid trend by 2021, while the US and euro area will take several years to make up lost output. This strong growth relative to other economies is helping to catalyse a rotation away from export-driven growth towards greater self-reliance, a model that should prove more tolerant of exchange rate appreciation.
- Regarding the outcome of the US election, we believe the risk premium for the renminbi would be lower with a Biden win, which would be positive for the currency, and remain roughly at current levels with a Trump win.

RISE OF THE RENMINBI

The renminbi has led the positive performance of Asian currencies against the US dollar over the past quarter amid a tenuous recovery across global emerging market currencies. The Chinese currency endured an extended period of depreciation pressure due to deteriorating underlying currency fundamentals, policy rate differentials and trade tensions with the US.

The Covid-19 shock has facilitated a re-statement of risks around the renminbi in light of the global re-set of economic policy stances and a sharp, broad-based redistribution of external balances. The renminbi may be attractive to investors maintaining a selective approach to emerging market local currency-denominated assets, while seeking higher-yielding alternatives to the US dollar; it is likely to benefit from China's progress in liberalising access to onshore capital markets and a period of growth exceptionalism spurred by targeted policy accommodation (Exhibit 1).

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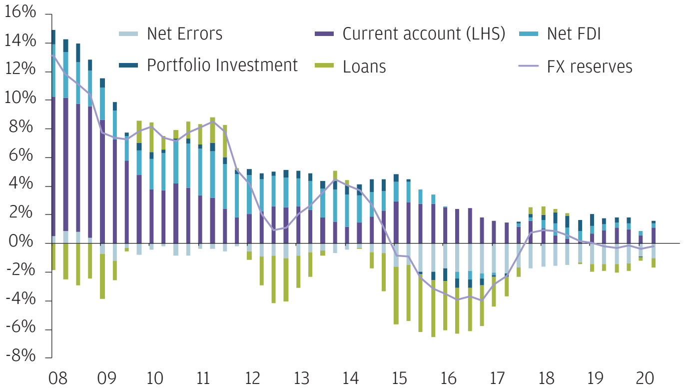
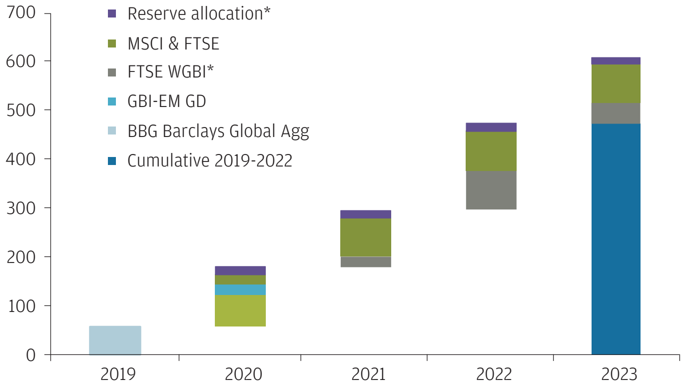
EXHIBIT 1: BALANCE OF PAYMENTS AND INCREASED FLOWS SUPPORT THE RENMINBI





* Assumes staggered inclusion into WGBI bond indices starting Oct 2021 up to 5% weight and CNY share in global reserves ex-China rising 0.2pp/year.

Source: J.P. Morgan Asset Management, Bloomberg. Data as at 30 June 2020.

Cyclical and structural support

The balance of payment trends in China previously featured as a negative factor in our broad assessment of the renminbi's valuation; a steady current account erosion since the early 2000s was driven by negative demographic trends and episodic surges of capital outflows that suggested incomplete currency adjustments.

But the breadth of the economic shock caused by the pandemic, compounded by idiosyncratic capital account factors, have arguably changed the outlook for the year ahead. After a negative first quarter caused by the initial shock of the coronavirus outbreak earlier this year, China has quickly reversed into a current account surplus, driven by resilient external demand for its manufactured goods exports and unprecedented mobility restrictions that are depressing imports.

In addition to these cyclical developments there are significant structural forces at play, such as China's efforts to internalise the production of advanced manufacturing components, which has accelerated with the uncertainty over trade agreements with the US. This could sustainably decrease China's demand for high-tech imports. While bouts of trade data volatility are still possible, depending on the near-term impact of the pandemic, China's external balance looks likely to be settling into a modest 1% to 2% of GDP surplus range over the coming year, a level consistent with a fairly valued currency.

The positive cyclical support for the renminbi from the trade balance is likely to be further amplified by China's efforts to structurally solidify its ability to compete for overseas investment flows. Since 2017, gradual changes have facilitated greater foreign investor access to renminbi-denominated fixed income and equity onshore markets; this structural change was validated by China's ongoing inclusion into global bond and equity benchmark indices.

The "coming of age" theme on an international scale for Chinese local assets is particularly exceptional given the current risk-averse environment; global emerging market currencies have broadly lacked investor flows so far in this downturn. Deeper local markets, more consistent with China's importance to regional and global trade, could also boost renminbi allocations in global central bank reserve holdings. Furthermore, a respectable yield differential over competing developed currencies would play to the renminbi's advantage.

In summary, without making any strong predictions about the risk environment, one could rationalise an extended period of support for the renminbi based on the scope for greater foreign participation and an increase in index-eligible Chinese assets, bringing annual gross inflows of up to 0.6% to 0.8% of GDP.

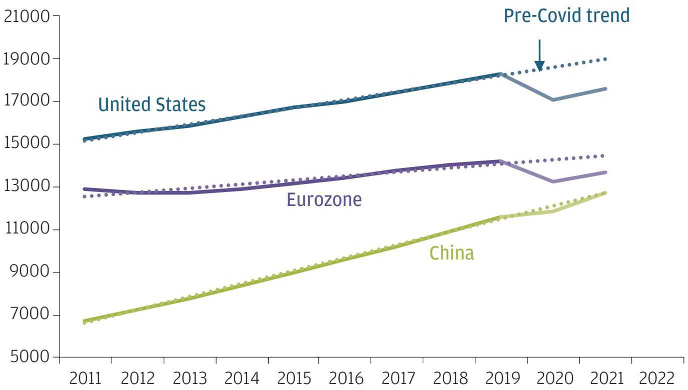
Chinese growth exceptionalism

Despite being at the epicentre of the coronavirus outbreak, China has undoubtedly weathered the crisis much more successfully than the rest of the world. The resilience of its economy to the Covid-19 shock signals a newfound Chinese growth exceptionalism. China is the only major economy expected to avoid a recession this year.

Effective suppression of the virus has enabled a full reopening of the economy, while other parts of the world are once again increasing restrictions. Based on our growth forecasts, Chinese GDP should be back in line with its pre-Covid trend by 2021, while the US and euro area will take several years to make up lost output (Exhibit 2).

Importantly for the currency, China's strong growth relative to other economies is helping to drive a rotation away from export-driven growth towards greater self-reliance. A more domestically-driven growth model should prove more tolerant of exchange rate appreciation. The lack of official pushback against significant renminbi appreciation in the third quarter suggests this shift in exchange rate policy is underway. Growth exceptionalism coupled with a less interventionist stance are key ingredients to a structural renminbi-appreciation trend.

EXHIBIT 2: ONLY CHINA'S GDP IS SET TO RETURN TO ITS PRE-COVID TREND



Source: World Bank GDP constant prices USD, J.P. Morgan Asset Management projections as of 5 October 2020.

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Positive risk skew around (geo)political events

Ongoing trade tensions with the US have also driven a desire for greater self-reliance. Clearly, the outcome of the US elections will prove key in shaping future trade relations, as well as other areas of confrontation such as intellectual property and military expansion.

A Biden victory would likely reduce the current market risk premium that reflects the erratic, unilateral unpredictability of recent tariff policy. Trade policy under such a US administration is likely to remain hawkish but more predictable and rooted in multilateralism. Nonetheless, a lower risk premium should be a positive driver for the renminbi. Under a second Trump administration, the current risk premium would remain embedded in the currency but is unlikely to rise materially. This suggests an appealing asymmetry in the renminbi's reaction to the elections.

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- Dynamic "intelligent" currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
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Important information

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