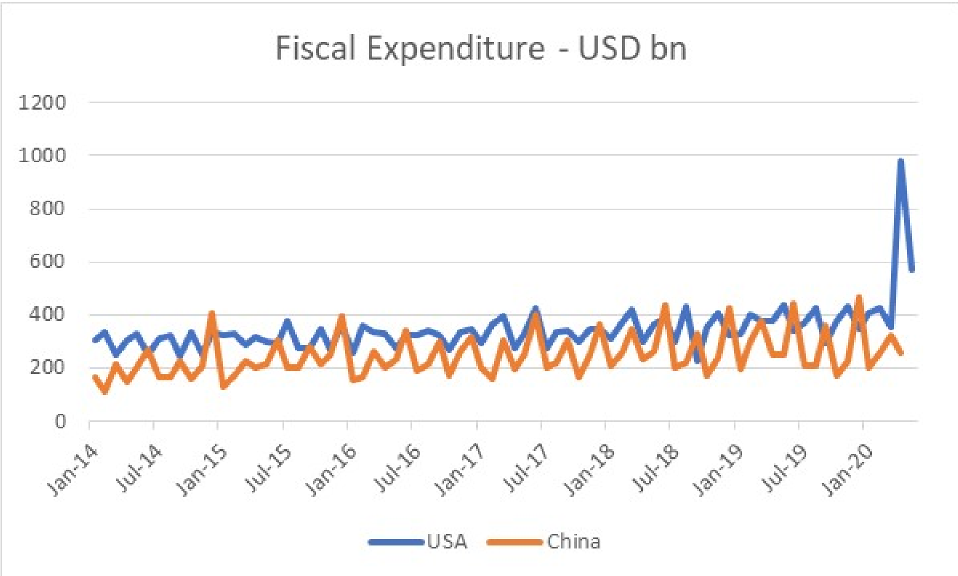
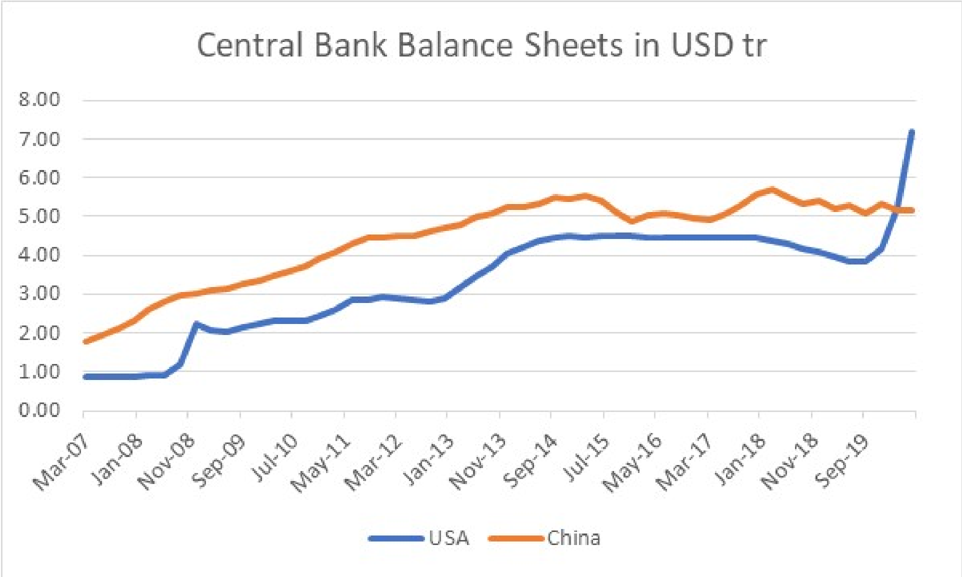
CHINA USA INFLECTION POINT

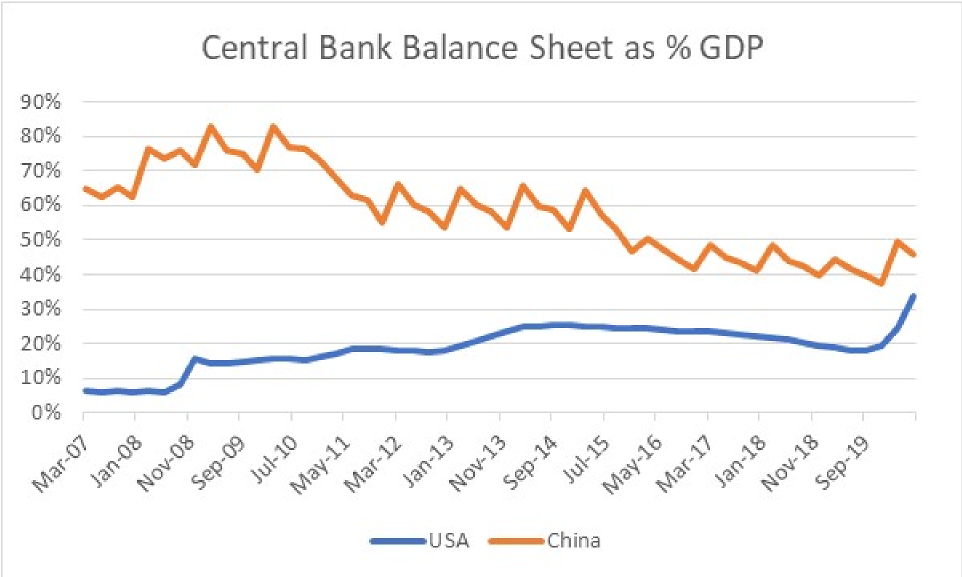
While Covid-19 had its first major outbreak in China, the response of the respective governments and central banks have been very different. The US saw a very large increase in government expenditure, while Chinese government expenditure remained subdued.



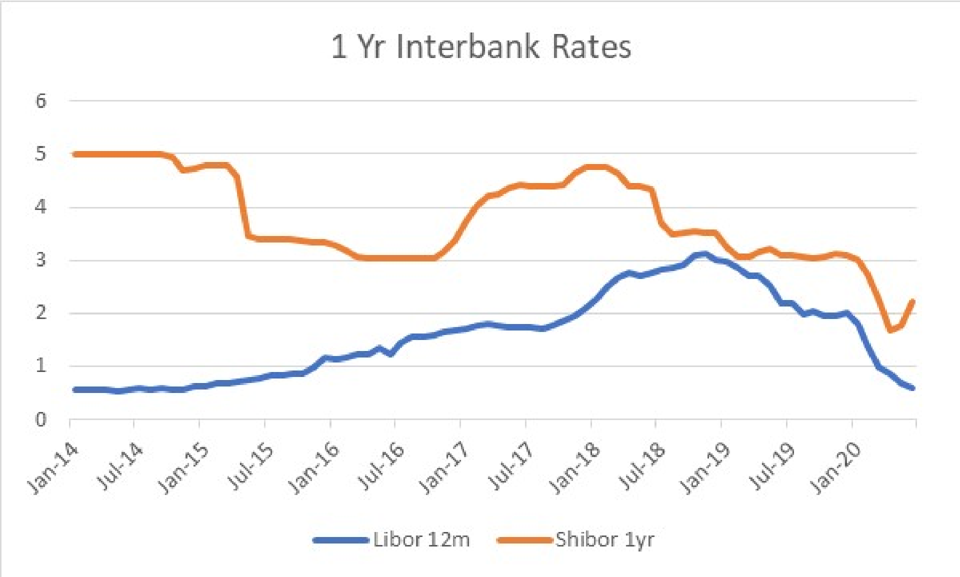
Each country's central bank response has also been starkly different. The Federal Reserve has largely monetised the huge increase in spending. In USD terms, the Federal Reserve now has a larger balance sheet than the People's Bank of China.



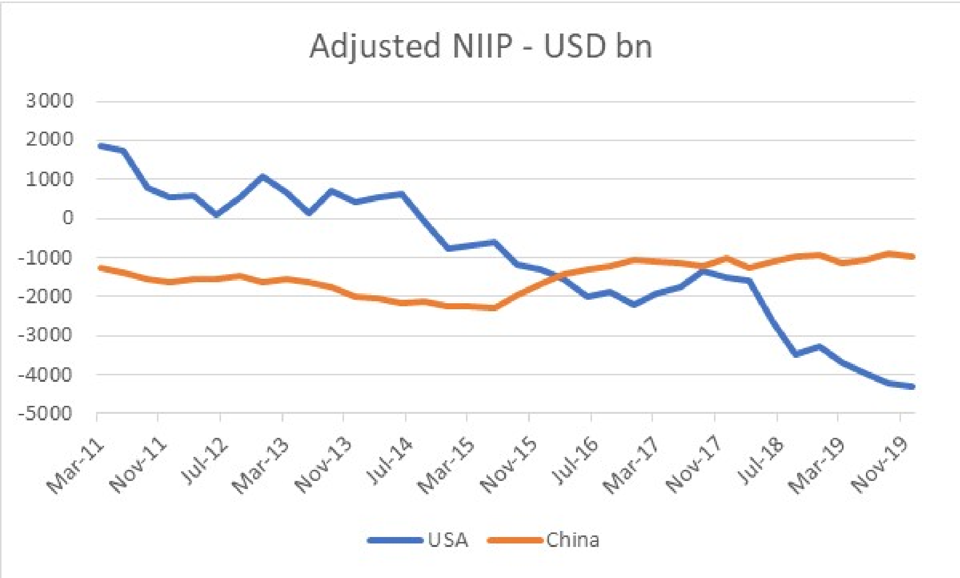
In terms of GDP, the US is beginning to catch up with China, who has been maintaining a balance sheet around 50% of GDP for the last few years. The US has increased to 34% of GDP from below 20% in a matter of months.



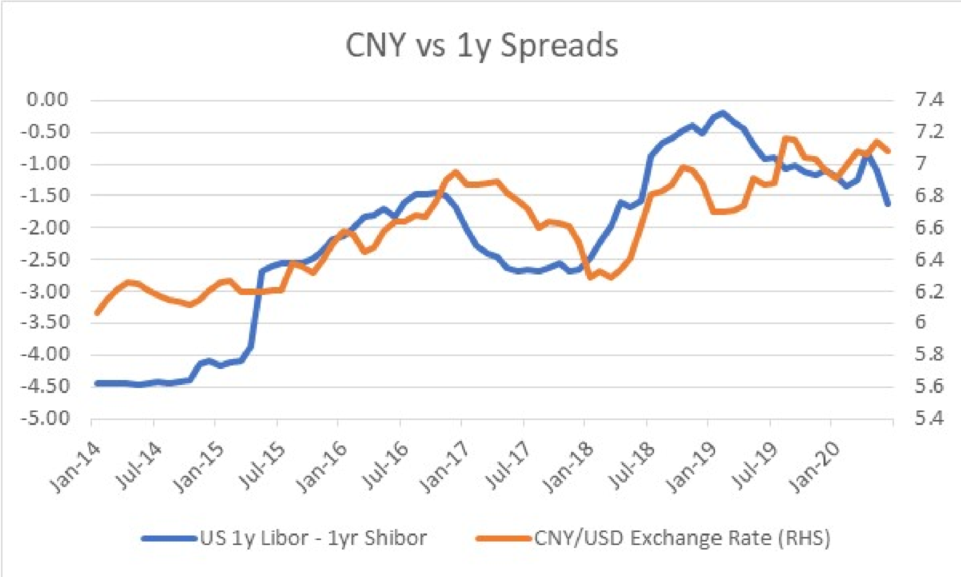
The increased demands for funds in China, without central bank monetisation has led to a rise in interest rates, in stark contrast to the USA, which has seen rates fall precipitously.



Of course, for a US dollar-based investor any pick up in yield needs to compensate for currency risk. One way we measure this is to look at net international investment positions (NIIP), adjusted for public holdings (i.e. netting out the government position). The deterioration in this measure from 2011 to 2014 was a good warning sign for CNY weakness. Likewise, recent deterioration for the US highlights potential US dollar weakness.



In essence, China now has a better fiscal position, a more conservative central bank, higher interest rates, and a relatively improved net international investment position. All of these factors would suggest CNY could potentially appreciate versus the USD. Certainly, when we compare interest rate spreads to the exchange rate, current interest rate spreads suggest a move in the currency to somewhere in the 6 USD range (see the below graph showing the lower interest rate spread is stronger for CNY).



With investors around the world record long in US assets, and largely divested of Chinese assets, the attractions of higher bond yields and more restrained government finance could lead to a substantial move in the Chinese Yuan.

INFORMATION

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