Global Macro Strategy

Should we prepare for regular Yuan drama?

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This story is not going away

There was no warm up this year – renewed volatility in the CNY ensured that the markets were in the thick of things from the word go. The new yuan regime has likely entrenched a slightly higher risk premium in both EM and DM assets. We should expect future episodes of yuan weakness too - continually increasing leverage is compromising the efficacy of monetary and fiscal efforts in China, so a weaker exchange rate must form a key part of the policy tool kit over time. However, from a near-term perspective, both the carry and implied volatility have risen strongly, and present a poor risk/reward in chasing the CNY weaker. A spell of a more subdued CNY should ensue, helping risk assets stabilise.

Tactically, think catch-up rather than chase. Buy CNY vs. INR via 3m NDF

Instead, investors should expect catch-up weakness in other EM currencies. Waning external competitiveness, contained inflation and lacklustre growth are conditions afflicting several other EM currency markets, arguably to an even higher degree than China. We recommend a tactical long on CNY vs the INR through 3m NDFs. The positive carry on this trade is 2.9% annualised.

Don't expect the same relief in global assets as CNY volatility declines this time

First and foremost, the bar for 'rates relief' in the US is higher now. The Fed is now 'on the road', and recent commentary suggests its mind may not yet be in sync with the market as the latter has already pared back the degree of expected hikes. Second, the promise of easier policy from ECB, which was arguably a big factor in driving risk assets higher in early Q4 post yuan volatility in August, is unlikely to be repeated. Also, with commodity prices having slipped further, financial conditions have tightened and further downward revisions to earnings remain key risks.

These may be attractive levels to sell the JPY

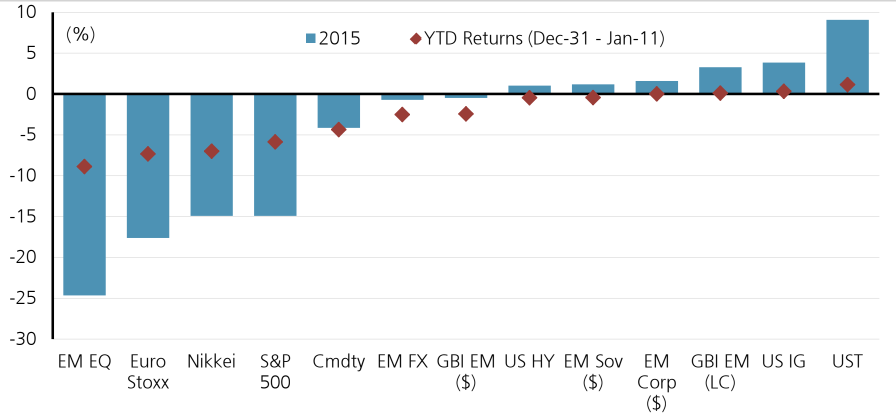
From a tactical perspective, we think USD/JPY upside is attractive at current levels, and in combination with selling EUR/USD downside is one of our top recommended trades for 2016. We recently showed that in order for Japanese policy to be consistent with a gradual increase in inflation expectations toward 2%, a much weaker JPY is required. At the same time, our Japanese economist thinks that if USD/JPY were to fall below ¥118 (the level companies are forecasting for H2 FY15) and global market concerns persist, further easing by the BoJ will become increasingly likely.

Should we prepare for a regular dose of Yuan drama?

A multitude of shocks have rattled in EM at the onset of 2016

2016 is just over 10 days old, but it has already given investors a lot to think about (Figure 1). The dominant forces in global markets remain China's weakening economy, having cast a spell on commodities and spreads, and the tension between Fed guidance and market pricing of US monetary policy. What's new is the deepening negative momentum in US earnings, and early signs that wider spreads in energy are infecting lower rated borrowers in other sectors. These challenges are not likely to go away, and may intensify.

Figure 1: 2015 and YTD 2016 moves across asset classes



Source: Bloomberg, Datastream, UBS

Continued FX weakness in China has been particularly striking

Also contributing to a more interesting 2016 than many would have bargained for is continued currency weakness in China, and uncertainty over how this process will be managed in the future. In this note we detail how we are thinking about the yuan, its relative position in EM, and its influence on global assets.

How we are thinking about the Yuan

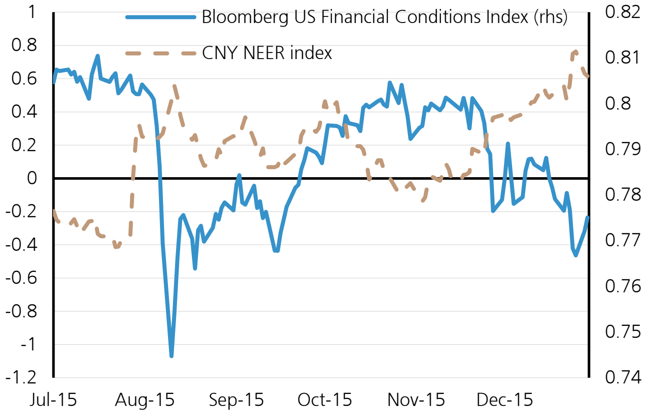
Aug 11 2015 marked the start of China's new FX regime

The new yuan trading regime has been in place only since Aug 11, 2015. The market is learning about the new set-up more by trial and error than clear policy guidance. Below is a summary of what we have been able to infer from the limited data points since the regime's introduction.

Despite moves towards flexibility, make no mistake, this is still a managed currency

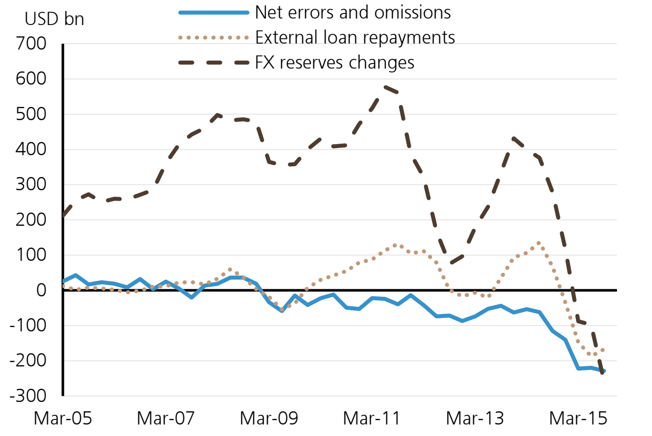
First, while there have been moves towards the freeing up of exchange rate trading and letting market forces play a greater role, consistent with the yuan's recent inclusion in the IMF's SDR basket, this is still a closely managed currency. Policy intent, not market demand or supply for USDs, remains the dominant driver of direction. In order to show that CNY fixings are not arbitrary, they are indeed being set closer to previous day's close, but, of course, the previous day's close always receives a healthy dose of official support (Figure 3).

Figure 2: CNY weakness has been contemporaneous with tightening in US financial conditions



Source: Bloomberg, UBS estimate. Index, 31 Dec 2014 = 100.

Figure 3: China has moderated the pace of CNY depreciation with significant intervention

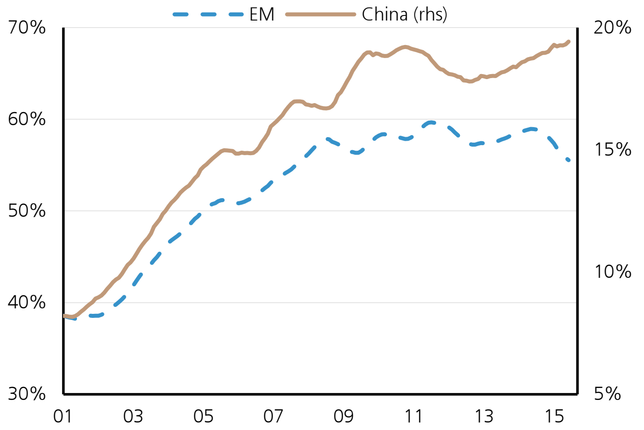


Source: Bloomberg, UBS. Data presented here in 4-quarter rolling terms

Limited risk of China losing control of the FX market

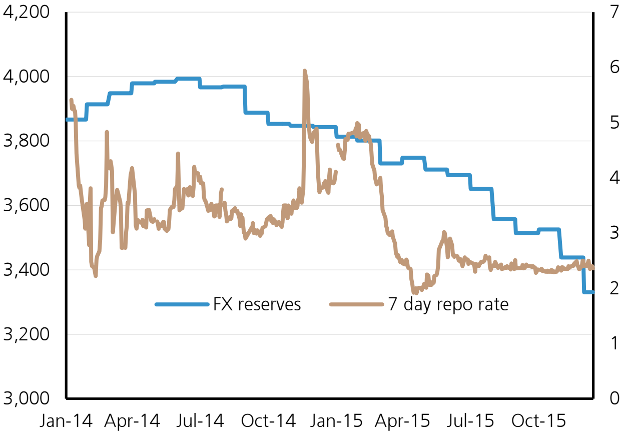
Second, we don't expect policy makers to lose control of the CNY. Yes, it's not helpful to lose 15% of a large reserves war-chest within 6 months, but let's keep in mind that at the margin the increase in outflows has been driven by a reduction in liabilities, i.e. the paying down of external debt and an unwinding of the carry trade. One should not expect these capital outflows to persist at the same pace into the indefinite future. China's outstanding external debt is roughly USD 1.5 trillion (compared to GDP of USD 10.5 trillion and reserves of USD 3.3 trillion) of which just under 50% is actually denominated in local currency. This, of course, makes it easier to pay off debt, especially when local liquidity conditions remain easy, as they currently are (Figure 5). Massive outflows due to foreign asset accumulation or capital flight are unlikely, with capital controls limiting outflows likely to be executed with greater force. And, oh, did we mention that there is a near USD 450-500 billion annual surplus in China's basic balance? No run on the currency here.

Figure 4: China and EM ex China's share of developed world imports



Source: Haver, UBS

Figure 5: Reserves depletion has not caused a tightening in domestic liquidity



Source: Haver, UBS

That's the good news. But just because policy makers are still in charge, it doesn't mean that the currency won't depreciate.

Why did Chinese currency policy change when it did?

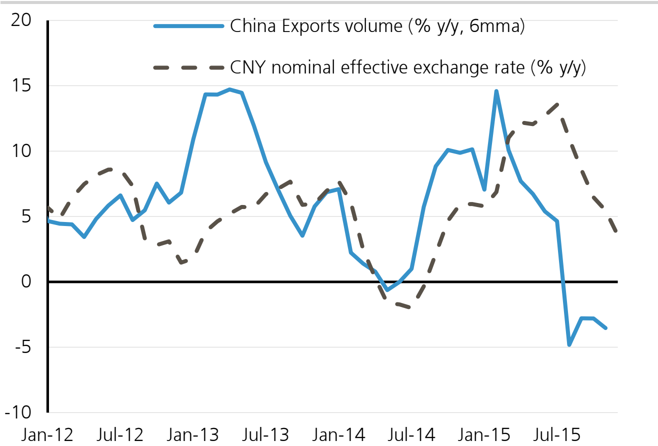
Chinese policy makers have spoken about moving away from a USD anchor for the yuan for some time now[1], but the move towards referencing the currency to a broader trade-weighted basket received serious recognition at the time of the change in fixing mechanism on Aug 11, 2015. The market was more formally educated on Dec 11, 2015, when CFETS, a sub division of the PBoC, published the reference trade-weighted basket[2].

USDCNY itself bottomed out around Q1 2014, but the trade weighted index of the CNY did so only in August this year, as the change in fixing regime likely marked the end of nearly a decade of strong trade weighted gains in the CNY. What happened then in particular, and what can this tell us about the future?

Waning efficiency of domestic growth levers, early signs of labour market weakening prompting Chinese caution on the currency

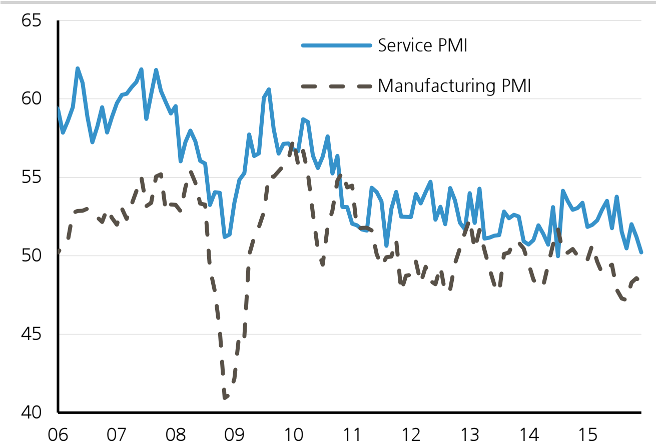
We think the shift in currency regime was driven by the twin recognition that a) domestic policy levers were not working as well as the authorities may have hoped, which made it that much more important to not suffer any loss of external competitiveness; and b) to pre-empt further aggressive effective appreciation of the CNY should the USD strengthen (see What Next for the RMB? Fair Value, Market Reform, and Impossible Trinity). The timing of the move also complemented China's efforts to pass the IMF's SDR pre-conditions in time for November nicely. It is interesting that late Q2/Q3 2015 export volume growth also began to slip clearly into negatively territory (Figure 6), as did the GDP deflator. The latter blunted the impact of rate cuts and credit expansion on aggregate demand, particularly unhelpful at a time when there was early evidence of labour market conditions weakening modestly, including in services (Figure 7).

Figure 6: CNY NEER vs. export volumes



Source: Haver, UBS

Figure 7: Labour market: manufacturing and services PMI



Source: Haver, UBS

'Basically stable' currency regime classification remains open to interpretation

In response to these negative forces along came a change in the interpretation of the yuan from being 'basically stable' against the USD to 'basically stable' against the broader reference basket. This, of course, meant that the degree of freedom against the USD increased substantially[3]. However, the CNY has not been stable

[1] In fact the talk about a trade weighted reference basket is at least as old as 2005.
[2] The publication of the index was described by policy makers as "helping bring about a shift in how the public and the market observe CNY exchange rate movements"
[3] 3m implied USDCNY volatility averaged 1.7 for the year before Aug 11, 2015, and 5.7 since then. At the time of writing it is at 8.51, closer to EURUSD or USDJPY volatility than its own history.

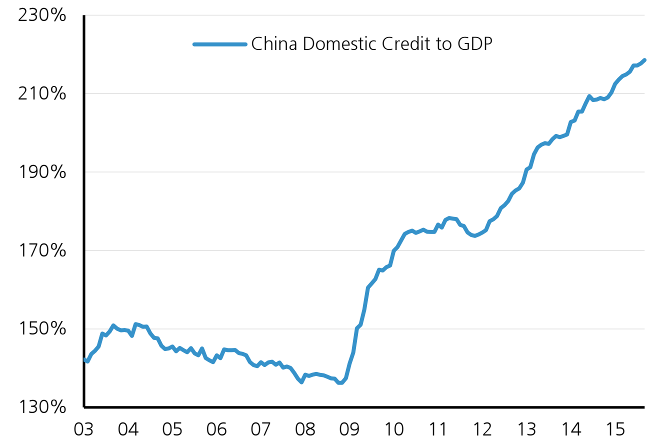
against the reference basket either - since August 2015 the CNY has lost close to 5% against the CFETS reference basket.

China's structural problems are getting worse

The big picture: credit excesses are still rising. This creates medium term CNY risks

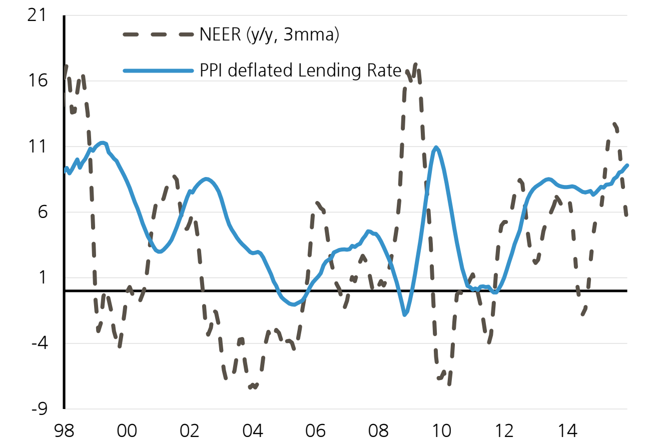
And here's the thing – the factors that we believe have motivated the shift in currency regime are unlikely to change anytime soon. Weak international demand will likely keep a lid on export growth. Most importantly, lest we miss the woods for the trees, let's remind ourselves that China's key issue is that it is levering up almost at the same pace as it was 5 years back, when investors first started worrying about credit misallocation (Figure 8). The more levered the economy, the less effective countercyclical monetary will be. Clearly, then, all growth enhancing options need to be on the table. From a 2-3 year perspective, we do believe that the CNY can be considerably weaker than what forwards are implying.

Figure 8: Credit to GDP in China



Source: CEIC, Haver, UBS

Figure 9: PPI-deflated lending rates and NEER



Source: Haver, UBS

But the price has moved too

All this said, from a near-term perspective, the risk reward of chasing the CNY weaker isn't particularly attractive, in our view.

CNY weakness more likely to play out in a step-wise fashion

Chinese authorities may have front loaded some of the desired CNY move in the shift to a new regime. The way they have managed the CNY historically would suggest that a spell of flat performance should surprise no one. Indeed this morning PBC appears to have intervened in the offshore market to support the CNH, propelling the overnight Yuan HIBOR (offshore yuan borrowing rates in Hong Kong) to new record highs, tightening CNH liquidity significantly.

CNY now offering up yields seen in much weaker credit stories.

What really tilts the balance on the near-term call is that both in terms of the cost of carry, and implied volatility, the CNY is not an obvious sell by any means. At the time of writing 3m NDFs were implying annualized CNY weakness of 9%. This carry cost is less only than RUB, BRL, TRY and IDR (Figure 10). Based on USDCNY forwards, and assuming forward prices are realised also for the other 12 currencies CFETS refers to, the yuan is already being priced for 5-6% depreciation against the basket over the coming year. That a higher pace of depreciation is permitted is possible, of course, but the risk-reward to such a trade is not compelling.

Moving on from CNY, focusing on the laggards: Buy CNY against INR

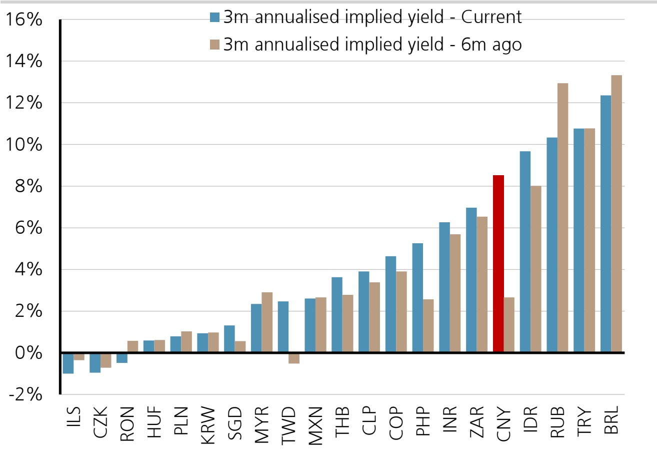
INR's appreciated real exchange rates, competitiveness risks may warrant catch-up

Instead, we think the market should turn its focus to currencies that have not yet reacted to the slowdown in the external sector, and to the dismantling of the CNY anchor. A prime example here is the INR. India's export performance is amongst the weakest in EM (Figure 11), and yet its nominal trade-weighted exchange rate has appreciated modestly (more, in real terms, of course) over the last 2 years. Through all the volatility in the CNY, INR spot, forwards and implied volatility[4] have remained very stable. We think it make sense to play for a spell of stability in the high carry CNY and simultaneously look for catch up weakness in stable EM currencies such as the INR[5]. The positive carry on a long CNY short INR position expressed through 3m NDFs is 2.9% annualised.

We recommend tactically buying the CNY vs. INR via 3m NDFs

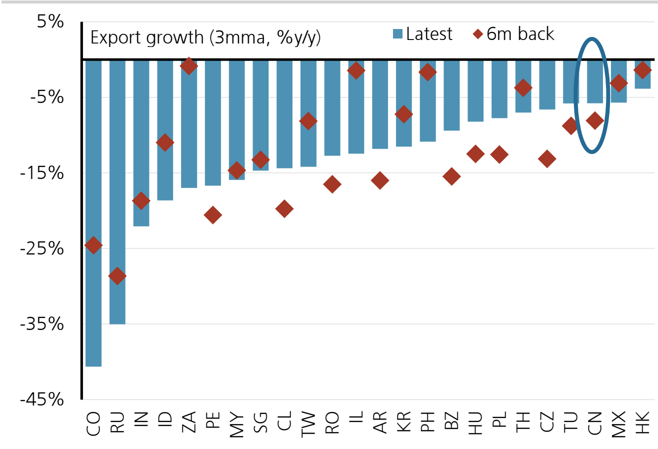
At the time of writing the representative spot references for USDCNY and USDINR are 6.5725 and 66.87 while the 3m NDF rates are 6.7170 and 67.90 respectively. We recommend buying the CNY-INR cross with a 2% stop and target 5% gains.

Figure 10: EM 6m annualized carry



Source: Bloomberg, UBS

Figure 11: EM export performance % y/y, 3mma



Source: Haver, UBS

A big rally in global assets as the CNY stabilises near term?

Could we see a risk rally post CNY move as in September 2015? This looks less likely.

As the first bout of major yuan volatility subsided in September last year, global stock markets saw a big relief rally. Some apparent stability in Chinese equities, temporary rates relief in the US, ECB easing and expectations of stabilization in oil prices supported that rally. Based on our view of renewed near term calm in Chinese FX markets, we do see some stabilisation of risk assets ahead, but this time it is unlikely that we get the same degree of bounce as we saw in early Q4 2015. Why?

Bar for US rates relief now higher

First and foremost, the bar for "rates relief" in the US is higher (Figure 12). The Fed has already begun its tightening, and recent commentary suggests that its mind may not yet be in sync with the market as the latter has quickly pared back the degree of hikes. Against slowing momentum in recent growth data and as a result of tighter financial conditions, the market has scaled back its tightening expectations for 2016. And this means that for the Fed to become more supportive for risky assets here, they would need to shift their communication much more significantly. Barring that, and against a backdrop of lower-than-

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[4] USDINR 3m implied volatility is currently below USDSGD 3m implied volatility
[5] In playing tactically for a weaker INR we are temporarily playing against our structural long INR (against TRY) position.

expected headline inflation and inflation expectations, less-dovish-than-expected Fed speak would lead the US curve to flatten (with back end-rates declining – for a description of the trade-offs in the US curve see our 2016 Global Macro Strategy Outlook.

ECB has already shown its hand

Second, the promise of easier policy ECB, which was arguably a big factor in driving risk assets higher in October, is unlikely to be repeated. Domestic and industrial activity indicators in Europe remain firm and core inflation remains sticky at 0.9%. Despite the growth risks from China, we would need to see a substantial deceleration in the growth/inflation profile for another leg of ECB easing to set in according to our views. And strength in domestic credit dynamics may partly offset external shocks, as argued in our relevant work (see European Impulse).

Commodities not stabilising yet

Third, commodity prices – both energy and metals- have slipped much further since Q4 2015. As argued, there are three main effects from declining oil prices:

- Further pressures in related credit (and equity) sectors are weighing on risk sentiment disproportionately given the ongoing tightening in US non-bank credit conditions. What started out as a shock to oil spreads has spread out to non-oil related sectors in High Yield credit. And in turn, it is translating into tighter liquidity in relevant segments of the market.

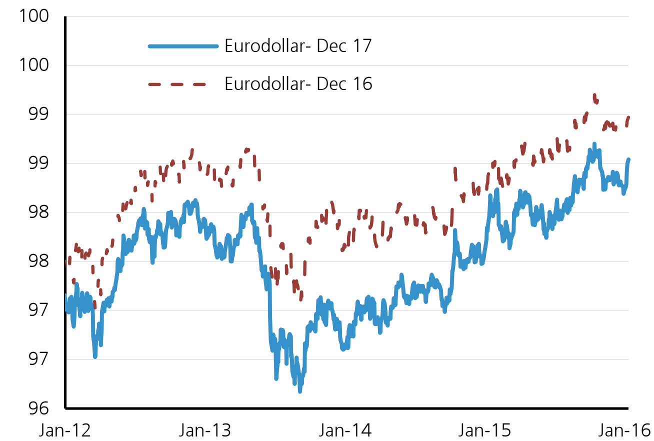
- While lower oil prices tend to boost consumption in G10 economies, there are also negative effects to US growth via lower capex in the energy sector. The asymmetric cost to the US is likely to continue weighing on US bonds and support the EUR against the USD.

- Headline inflation in G10 will remain low for longer. The eagerly anticipated inflation base will be delayed and will be milder than markets expect. It is also likely to contribute to broad disinflationary dynamics. While this leaves more room for policy accommodation, it also amplifies the real rates impact of central bank communication that is less dovish than expected.

US earnings revisions remain under pressure

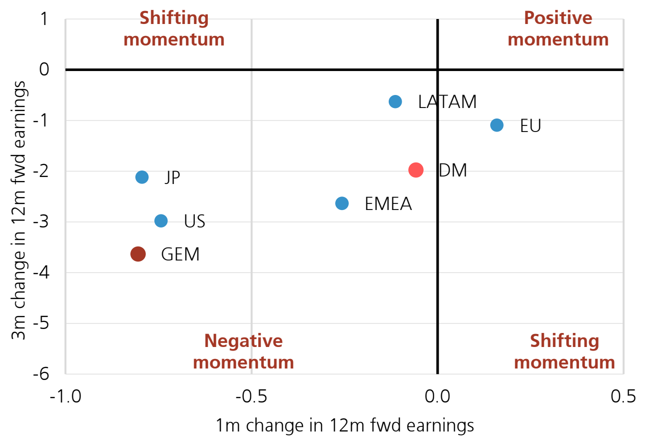
Fourth, earnings momentum has clearly deteriorated over the last 3 months, especially so in the US, presenting a much higher hurdle for a US equity rally.

Figure 12: Dec 16 and Dec 17 Eurodollar futures



Source: Bloomberg, UBS

Figure 13: 3m and 1m change in 12m fwd earnings : EM and DM



Source: IBES, Datastream, UBS

So how should we think of the confluence of macro shocks vs our strategy views and recommendations for 2016? 2016 was always likely to be a tricky year for risk-assets. Net-net, the portfolio of our top trades for the year has avoided an outright long directional bias (small overall correlation of the portfolio to risk) and this remains appropriate. Most of the directional elements of our portfolio of recommendations are linked to European equities, a view which is has come under pressure but which we still see macro support for in the months ahead. Instead, the long duration aspects of our recommendations are likely to benefit in this environment (receiving Australia rates and US Treasuries (vs Bunds)). We would recommend investors hedge HY credit risks by being short US small caps (vs large caps). We remain short commodity currencies (AUD, MXN, ZAR across various implementations). We remain short EM in FX (SGD, TWD, TRY and ZAR) and in equities (EM financials vs DM financials). Finally, the asymmetries of the macro shocks vs market pricing imply the EUR has bottomed.

From a tactical perspective, we think USD/JPY upside is attractive at current levels, and in combination with selling EUR/USD downside is one of our top recommended trades for 2016. We recently showed that in order for Japanese policy to be consistent with a gradual increase in inflation expectations toward 2%, a much weaker JPY is required. At the same time, our Japanese economist thinks that if USD/JPY were to fall below ¥118 (the level companies are forecasting for H2 FY15) and global market concerns persist, further easing by the BoJ will become increasingly likely. This combination of limited further downside and potential significant upside gives long USD/JPY positions favorable risk-reward from current levels, and is a good tactical expression of the stabilization in USD/CNY that we expect.

Figure 14: Structural Trade Monitor 2016

	P&L Units	Date of entry	Entry level	Date of closing	Current level	P&L
Long DM Financials vs EM Financials						**5.5%**
Long DM Financials	%	17-Nov-15	159.63		146.55	-8.2%
Short EM Financials	%	17-Nov-15	441.53		381.11	13.7%
Long USD vs Asian currency basket of TWD, PHP, SGD and THB						**1.3%**
Long USDTHB	%	17-Nov-15	36.00		36.33	1.3%
Long USDPHP	%	17-Nov-15	47.19		47.39	0.8%
Long USDTWD	%	17-Nov-15	32.84		33.46	1.8%
Long USDSGD	%	17-Nov-15	1.4241		1.4394	1.2%
Overweight Taiwan Equities vs Malaysia (FX-hedged)						**-6.8%**
Long Taiwan Equities	%	17-Nov-15	8,419		7,768	-7.7%
Short Malaysia Equities	%	17-Nov-15	1,662		1,646	1.0%
Long 5yr CNY onshore government bond, Short Australian Dollar vs Chinese Renminbi						**-0.1%**
Long 5Yr CNY onshore government bond	%	17-Nov-15	3.100		2.680	1.9%
Shot AUDCNY	%	17-Nov-15	4.535		4.595	-2.0%
Long India fixed income vs Turkey (FX-unhedged)						**11.6%**
Long Jul-24 IGB's	%	17-Nov-15	7.67		7.75	0.5%
Short Jul-24 TurkGB's	%	17-Nov-15	9.72		11.01	6.2%
Long INRTRY	%	17-Nov-15	0.0435		0.0455	4.6%
Short USD/CLP, long USD/ZAR						**15.8%**
Short USD/CLP	%	17-Nov-15	711.37		731.46	-3.4%
Long USD/ZAR	%	17-Nov-15	14.27		16.86	19.2%
Buy 3y NTNF's vs equities in Brazil						
Receive Jan'19s	bps	17-Nov-15	15.76		16.43	-58
Short Ibov equity index	%	17-Nov-15	47,248		39,950	15.4%
Receive MXN 1y1y rates. Long USD/MXN						
Receive MXN 1y1y	bps	17-Nov-15	4.8		4.7	8.7
Long USDMXN	%	17-Nov-15	16.7		17.9	7.7%
Long US IG against EM low-beta credit						**-1.0**
Long USD IG	bps	17-Nov-15	83.39		95.97	-13.05
Short EM low-beta credit	bps	17-Nov-15	117.28		130.06	12.01
Sell Brazil 2y CDS protection						**56.4**
Short Brazil 2y CDS	bps	17-Nov-15	317.48		299.25	56.40

Source: UBS, Bloomberg, Datastream — Market Pricing as of 1030 GMT on 12-Jan-16

Past performance is not an indication of future results

Since 17-Nov-15, the EMBI-GD benchmark (hard currency debt) has returned -1.6%. The local currency debt GBI-EM benchmark has returned -5.1% (In USD terms)

Final PnL (in bp) includes carry/roll

Figure 15: Tactical Trade Monitor 2016

	P&L Units	Date of entry	Entry level	Date of closing	Current level	P&L
Long CNY Short INR position expressed through 3m NDFs						
Long USDCNY	%	12-Jan-16	6.56			
Short USDINR	%	12-Jan-16	66.75			
Long Indian Rupee vs South African Rand						**28.0%**
Short ZARINR	%	1-Dec-14	5.59	12-Dec-16	3.99	28.0%
Receive Israel 5y5y against USD						**-21**
Rec ILS 5y5y	bp	26-Oct-15	3.06		3.03	3
Pay USD 5y5y	bp	26-Oct-15	2.69		2.45	-24

Source: UBS, Bloomberg, Datastream Market Pricing as of 1500 GMT on 12-Jan-16

Past performance is not an indication of future results

Year to date, the EMBI-GD benchmark (hard currency debt) has returned -0.5%. The local currency debt GBI-EM benchmark has returned -

Final PnL (in bp) includes carry/roll

Valuation Method and Risk Statement

Risks of multi-asset investing include but are not limited to market risk, credit risk, interest rate risk, and foreign exchange risk. Correlations of returns among different asset classes may deviate from historical patterns. Geopolitical events and policy shocks pose risks that can reduce asset returns. Valuations may be adversely affected during times of high market volatility, thin liquidity, and economic dislocation.

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