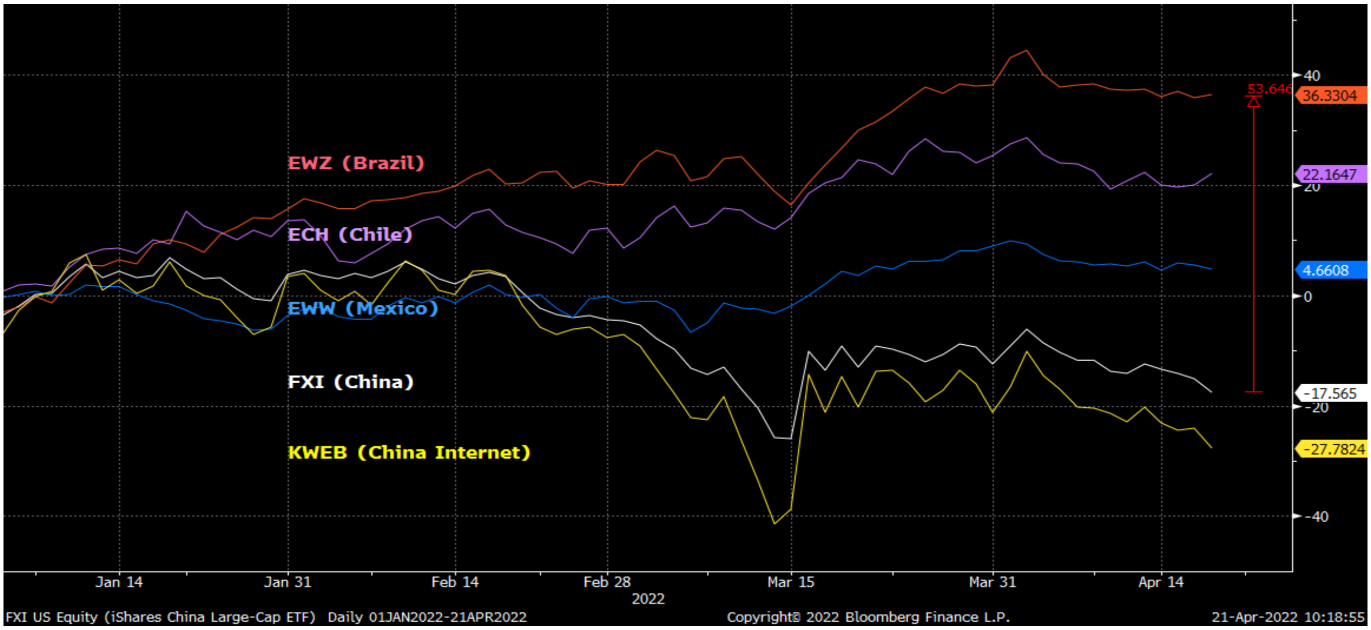
MI2 Trader: CNH Round 2

21st April 2022

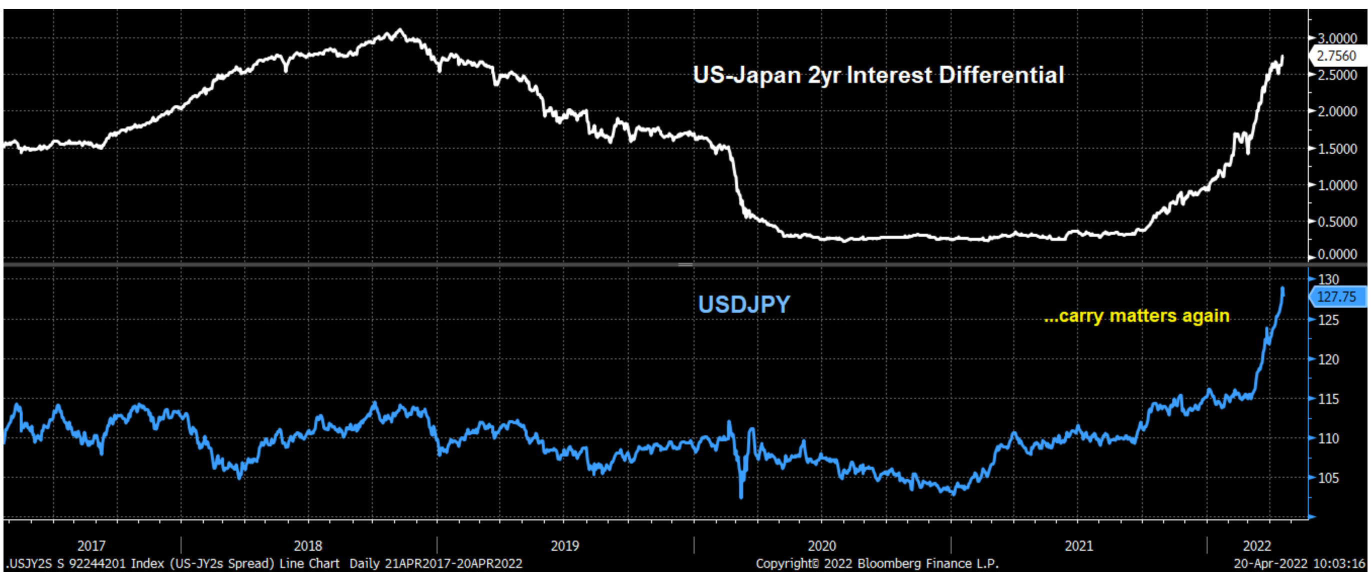
Comment

In the middle of March, we recommended buying USDCNH just below 6.40 and/or 25 delta 3-month Calls with stops below the late Feb / early March lows around 6.30 ("MI2 Trader: CNH", 14th Mar). The first month was a snoozer as USDCNH flagged and EURCNH and JPYCNH dragged the CNH basket inexorably higher. Nevertheless, both trades are marginally on-side, and we want to revisit the rationale for the trade in the light of recent developments and add further low delta topside to the USDCNH position.

The core thesis remains the same: China's zero-tolerance Covid policy is causing havoc with the economy and threatening social unrest. Among other anecdotal data shockers, there are 300 ships waiting to load or discharge in the port of Shanghai vs. an average of below 100 from 2017-21. The IMF just downgraded China's growth for this year from 4.8% to 4.4% (too high, we think). Then there is geopolitics, and China is doubling down on its averred policy of deepening and strengthening strategic coordination with Russia, infuriating her much larger trading partners. Add to that the Solomon Islands gambit, which opens the door to further destabilisation of the Asia Pacific, South China Sea arena, and it is clear the China/West deglobalisation theme is deteriorating (RIP Corporate Capitalism: Part III – Now What?", 19th Mar). Domestically, China's common prosperity policy continues to weigh on Chinese stocks, technology especially, with FXI (the China ETF) significantly underperforming global equities again this year. Below we show the divergence of FXI vs. LatAm (our EM favourites).



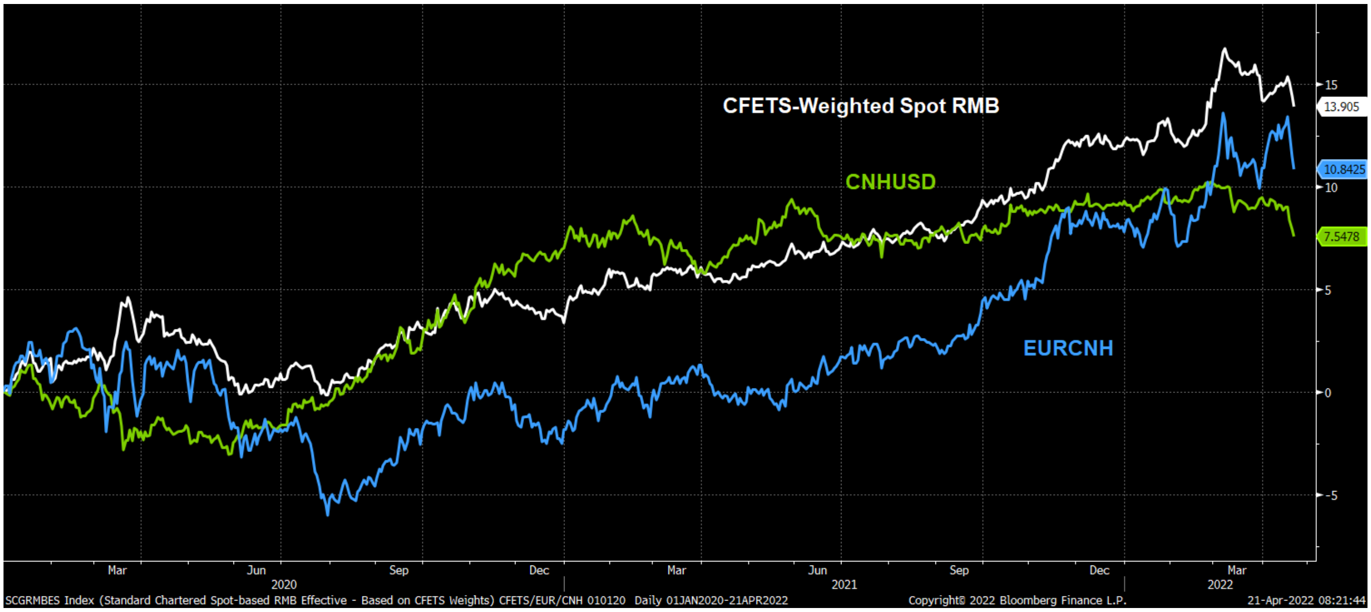
Most of the above formed the core of the original idea, but what has changed in the last month, as a function of the increasingly hawkish Fed, is the re-emergence of carry as a return driver in FX. If USDJPY is telling us that interest differentials are starting to matter again…



…then when will the dramatic narrowing of differentials vs China impact the yuan? USD yields more than China in 2yr now, with China rate cuts still very much in play.

200 bpts less carry vs. EUR has coincided with accelerating CNH strength vs. EUR, as a function of the latter's move lower since the beginning of the Ukraine conflict.

And the weakness of the EUR and JPY have dragged the CNH CFETS basket inexorably higher.



On this time frame, it is clear that it is broad renminbi strength. On a longer timeframe, clearly, a stronger EUR would be a convenient fix, but with the ECB still prevaricating and the Fed all gung-ho, it seems unlikely the EUR can develop sufficient strength to help China out of its current predicament in a reasonable timeframe. (it would need to move a lot)

Trade

Buy (a lot of) USDCNH 10 delta 3-month calls (to add to the existing spot and call positions mentioned above.) Implied volatilities jumped on the break of the 200d M.A., but ATM is still towards the lower end of its range, and 10 delta risk reversals are not egregiously priced given the chances of accelerating CNH weakness. Implieds would move quite a bit higher on a break above the 6.50-6.55 zone in spot.