Daily Insights

June 22, 2020

Rising Chinese Repatriations

NZD/CAD Has Upside

Can Modi Deal With India’s Crisis?

Do Retail Flows Matter?

Style Indicators Need Further Improvements

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Rising Chinese Repatriations

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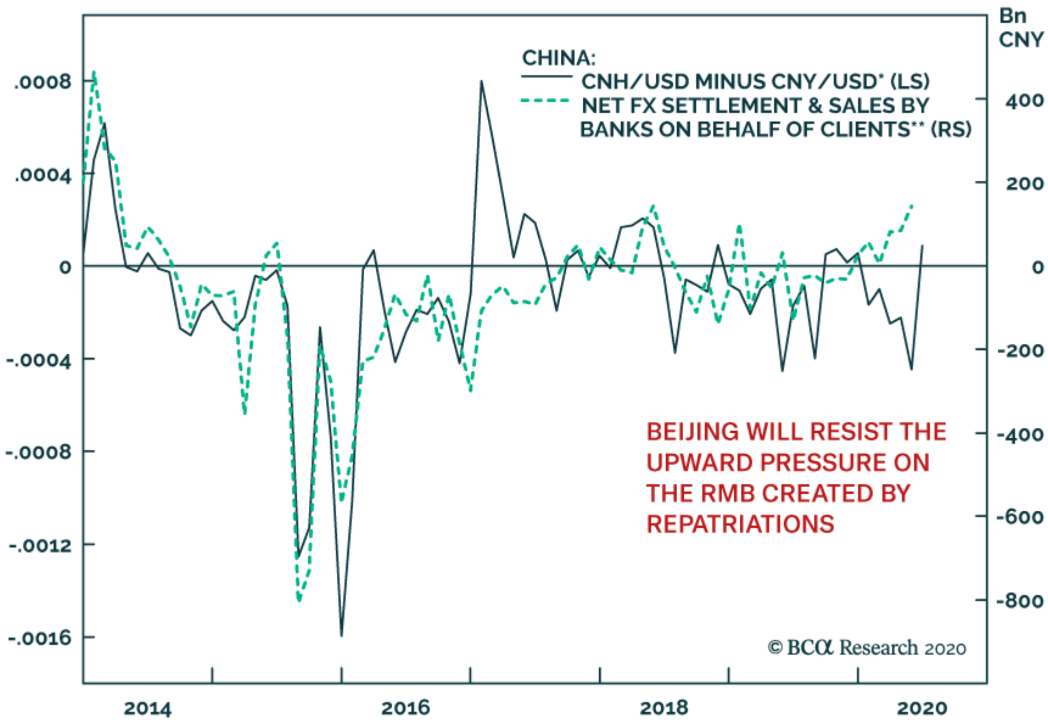

* SHOWN AS A MONTHLY AVERAGE.
** SOURCE: STATE ADMINISTRATION OF FOEREIGN EXCHANGE.

A measure of inflows into China, FX Net Settlements for CNY Clients, has risen to CNY142.9 billion in May, the highest level since March 2014. This increase indicates that Chinese domestic investors are repatriating funds at home.

Historically, a rise in FX net settlements puts upward pressure on the CNH vis-a-vis the CNY. This appreciation of the offshore renminbi relative to the onshore one exists because the CNH is a better reflection of market forces than the more heavily managed CNY. Hence, growing flows put upwards pressure on the CNH relative to the CNY.

Why are Chinese domestic investors repatriating funds back? First, the Fed policy easing has cut US interest rates relative to China, creating an incentive for Chinese investors to exit the US market and keep their money at home. Second, the Sino/US tensions are creating another incentive, as Chinese citizens may perceive that keeping money in the US banking system is a risk. The Huawei saga illustrates this fear.

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In the near-term, Chinese authorities will resist the appreciation of the CNY caused by rising domestic inflows. Beijing wants to protect exporters while global trade is suffering from the worst recession in 90 years. Additionally, a strong CNY would accentuate downward pressures on PPI, which is already contracting by 3.7% annually. Moreover, China may want to resort to a mini devaluation if the US imposes new tariffs, which is a risk BCA's Geopolitical Strategy service estimates to be greater than the market believes. Finally, by fighting the appreciation of the CNY when money is coming into the country, the PBoC is allowing domestic liquidity conditions to ease further, which helps stimulate the domestic economy.

However, over a one-year horizon, the RMB is likely to appreciate as flows are unlikely to abate. Moreover, as we discussed on Friday, BCA's China Investment Strategy and Foreign Exchange Strategy services estimate that the CNY is currently trading well below fair value.

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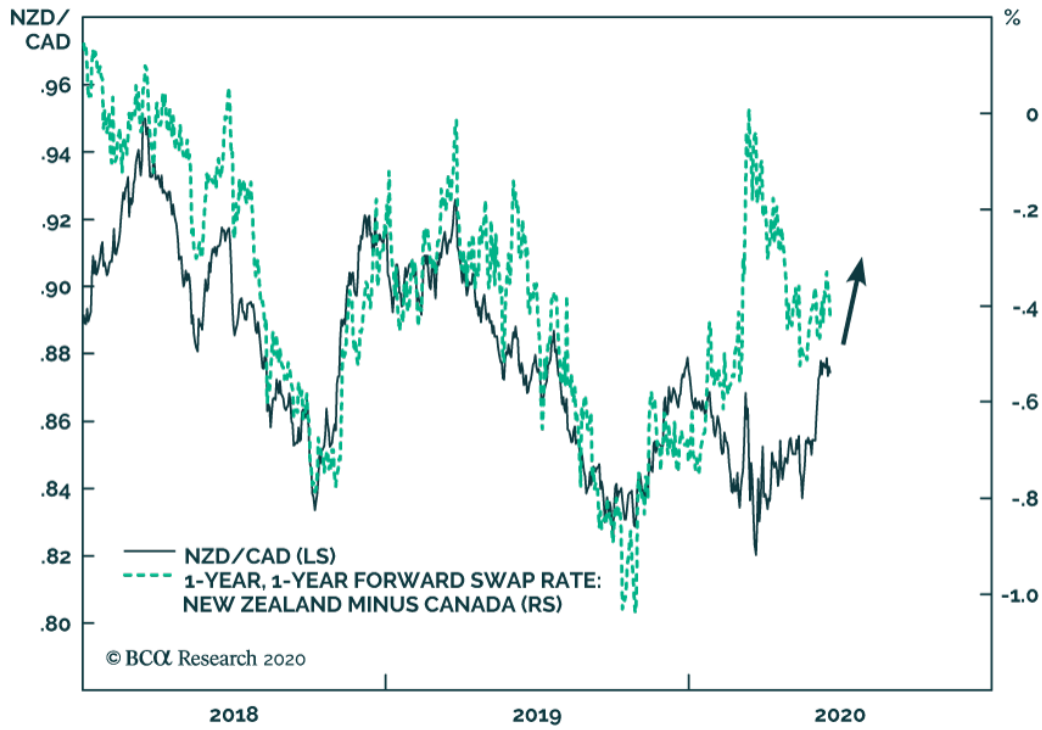

NZD/CAD is likely to appreciate over the coming six to nine months.

For the past two and a half years, the NZD/CAD cross has closely followed the 1-year/1-year forward swap rate differential between Canada and New Zealand. We expect this interest rate gap to widen further.

First New Zealand has dealt with its COVID-19 epidemic much more successfully than Canada. As a result, the Kiwi economy is re-opening much quicker than that of Canada's economy, which will allow for a faster recovery. This stronger recovery will let the RBNZ be slightly less dovish than the BoC in the coming months.

Second, while the Canadian economy is tied to the US, the Kiwi economy is tied to Australia. The Australian unemployment rate is contained relative to the US, which puts upward pressure on Aussie interest rates relative to US ones. Since New Zealand and Canadian rates are partly driven by Australian and US rates, respectively, these dynamics will accentuate the ability of kiwi rates to increase relative to Canada's

Finally, a global growth rebound is negative for the USD. Historically, a weak USD handicaps the CAD versus the NZD. Moreover, NZD/CAD has dissociated from the price of agricultural commodities relative to energy, which limits the downside risk to this pair created by the rally in oil prices.

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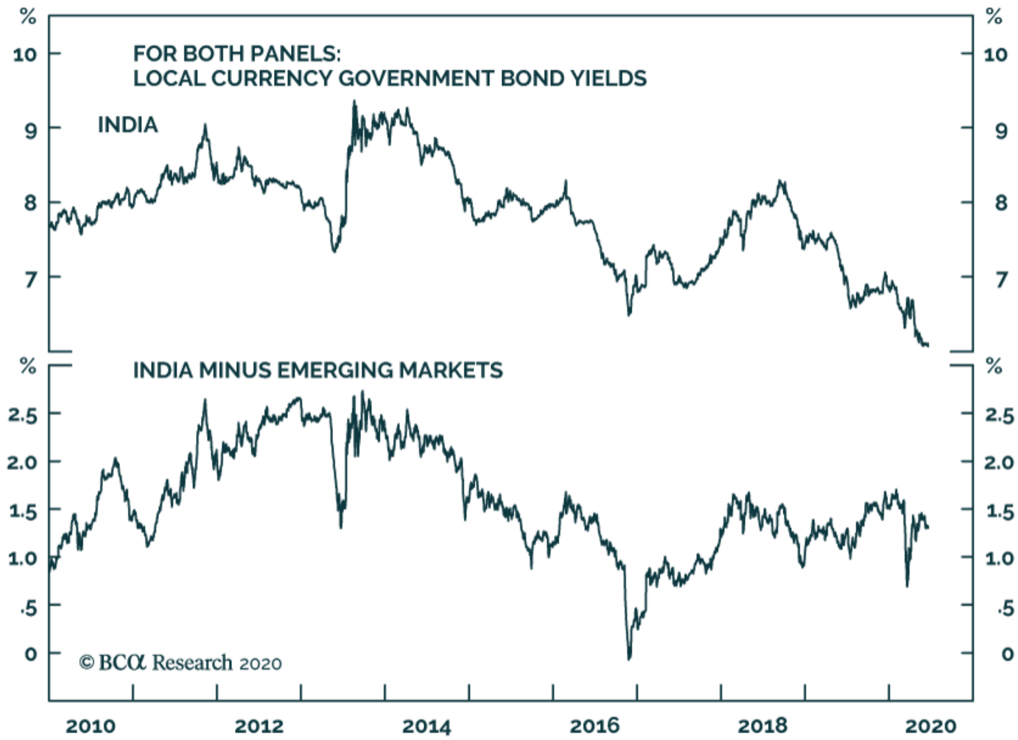

NOTE: BASED ON EMERGING MARKETS GBI-EM BROAD DIVERSIFIED INDEX.
SOURCE: J.P. MORGAN CHASE & Co.

BCA Research's Geopolitical Strategy service maintains a bullish long-run outlook on India and views a selloff as an opportunity to buy Indian assets.

The Indo-Chinese conflict on the Himalayan border is unlikely to have a significant impact on global financial markets. A major escalation could cause short-term volatility. However, it would have a regional impact and present a buying opportunity for Indian, Chinese, or Pakistani equities.

We also recommend investors go long Indian local currency bonds relative to emerging markets. These bonds are protected by the fact that foreign ownership and capital outflows are limited, as our Emerging Markets Strategy observes.

We remain bullish India on a secular basis, however, because there would remain an underlying national consensus on the need to prioritize economic development. That will not change anytime soon, as Modi has demonstrated to the public and the opposition that it is a winning formula.

That being said, Prime Minister Narendra Modi faces a threat to his popular support because of the economic shock of the COVID-19 pandemic. Insufficient fiscal stimulus will lead to a faltering recovery. Lingering large-scale unemployment will motivate social unrest.

Can Modi Deal With India's Crisis?

Thus, Modi will struggle to ensure economic recovery and law and order in his second term. Our base case is that he has the political capital and enough time on the political clock to stabilize the country and his rule. However, a failure to handle domestic challenges poses a risk to our view. And a foreign policy defeat at the hands of the Chinese would further undermine our view.

Do Retail Flows Matter?

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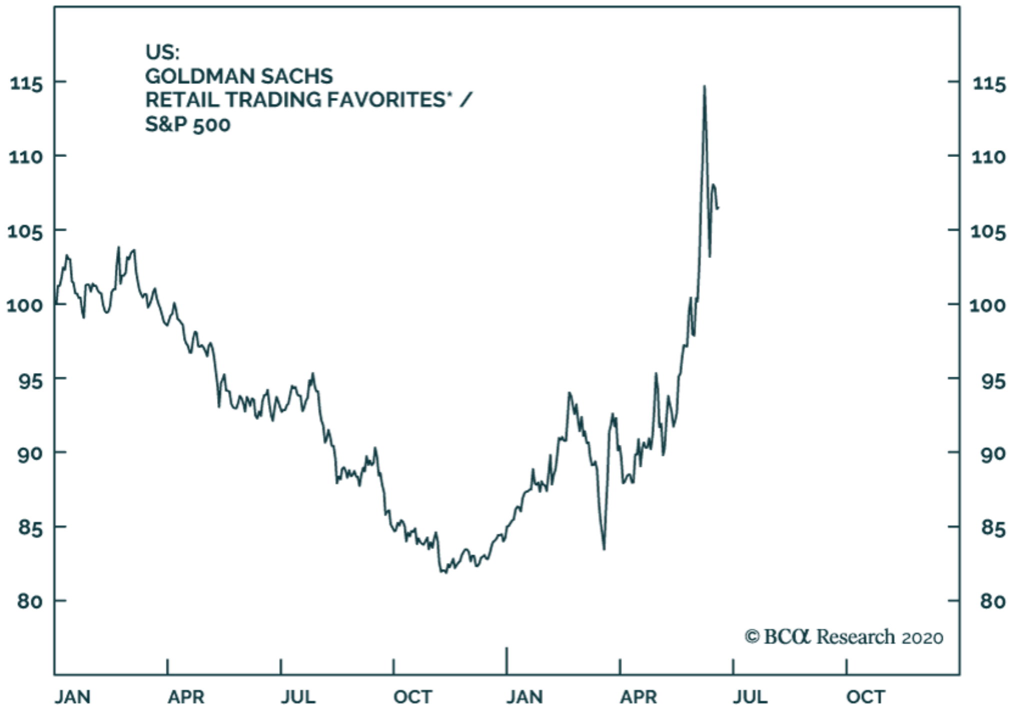

* US LISTED EQUITIES THAT ARE POPULARLY TRADED ON RETAIL BROKERAGE PLATFORMS.
SOURCE: GOLDMAN SACHS (VIA BLOOMBERG LP).
NOTE: SHOWN REBASED TO JAN. 2019 = 100.

BCA Research's Global Investment Strategy service analyzed the market implication of retail investors' flows.

Retail investors have probably been more important than widely portrayed. Many of the online brokerages touting zero-commission trades make their money by selling order flow to hedge funds. Thus, the trading of institutional investors magnifies the trading of individuals. More liquid markets tend to generate higher prices.

Stocks popular with retail investors have outperformed the S&P 500 by 30% since mid-March. As the value of investors' stock portfolios rise, the percentage of their net worth held in cash falls. This game of hot potato only ends when the percentage of cash held by investors shrinks to a level that is consistent with their preferences.

Importantly, this means that changes in the amount of cash on the sidelines can have a "multiplier" effect on stock prices. For example, if cash holdings go up by a dollar, and people want to hold ten times as much stock as cash, then stock market capitalization has to go up by ten dollars.

Despite the rally in stocks since mid-March, cash held in money market funds and savings deposits is still 10% higher as a share of market capitalization than at the start of the year. This suggests that the firepower to fuel further increases in the stock market has not been fully spent. Thus, retail investors will bring down their cash balances.

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To read this report in full: please click here

Style Indicators Need Further Improvements

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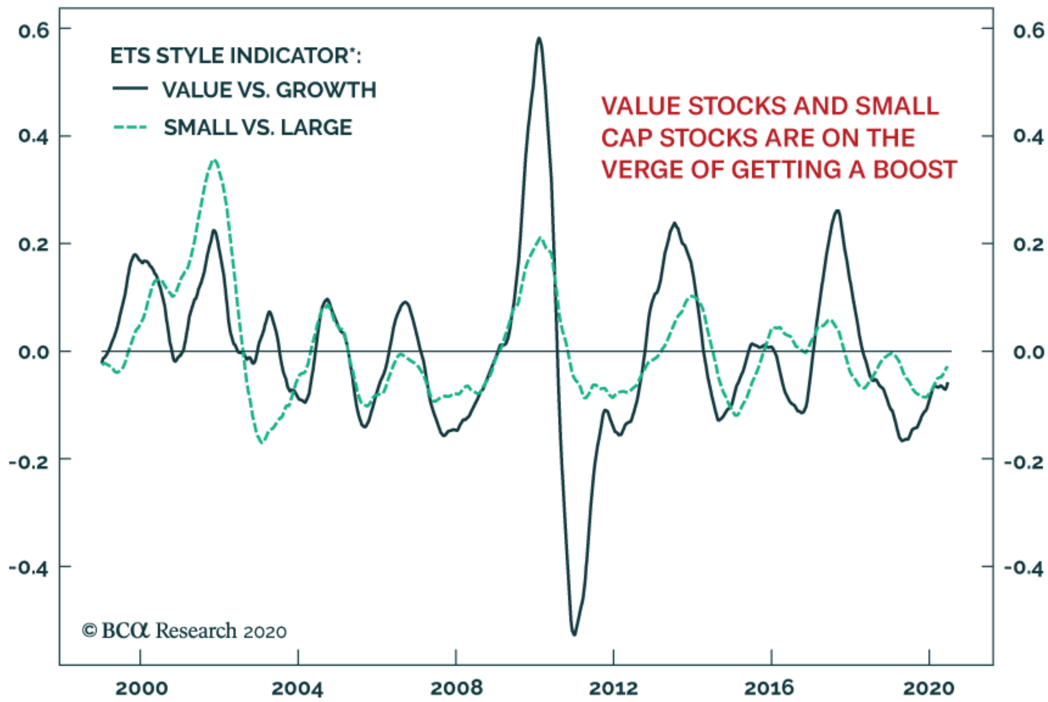

TECHNICAL INDICATOR BASED ON GLOBAL STOCKS WITH MARKET CAP. ABOVE $1B.
VALUE/GROWTH STOCKS ARE DEFINED AS THOSE IN THE TOP/BOTTOM DECILE BY BOOK TO PRICE.
LARGE/SMALL STOCKS DEFINED AS THOSE IN THE TOP/BOTTOM DECILE BY MARKET CAP. (USD).

Using BCA's Equity Trading Strategy service's tools, we can measure how the performance of various investment styles are evolving.

Based on bottom-up data, we built portfolios of stocks that encapsulate the value versus growth spectrum and the small-cap versus large-cap spectrum. Then, the ETS Style Indicators remove the statistical noise to measure how the two styles are evolving at the margin.

On the style versus growth spectrum, it is still too early to assert definitively whether the value factor now has the upper hand on the growth factor, despite the recent short-term outperformance of value stocks. Nonetheless, the penalty suffered by the value factor in recent years is ebbing. On the small-cap versus large-cap spectrum, from a quantitative perspective, it is also too early to declare whether the underperformance of small-cap stocks has genuinely ended but small caps are close to a fundamental shift in their performance relative to large firms.

BCA's expectation for a meaningful recovery in the second half of 2020 should push our ETS Style Indicators into positive territory. A global economic recovery and a weak dollar boost value stocks relative to growth ones and small-cap equities relative to large-cap ones. An absence of progress on the value vs growth and small vs large ETS Style Indicators would raise a question mark on the strength and durably of the economic recovery.

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