The Weekly Update: Concerns about Chinese credit markets to remain in place

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Trading environment:

- **Even as the Federal Reserve Open Market Committee (FOMC) will provide fresh guidance on the direction of US monetary policy, concerns about the Chinese credit markets could take center stage**
- **Investor concerns are growing about whether China's real estate company—Evergrande—can meet its scheduled bond payments that are due over the next fortnight. Investor anxiety is also growing about whether the real-estate company will default on its medium-term payments given its outstanding liabilities**
- **Until there is clarity on the matter, broad risk aversion could persist on concerns about a possible 'credit event' in the pipeline. Markets will also want to see whether Chinese policymakers are willing to engineer a debt restructuring program to ensure that a hard default is avoided**
- **Meanwhile, we think that the FOMC meeting (21-22-September-2021) could provide a more hawkish guidance primarily via its 'dot plot'. The dot plot could show that further rate hikes are in store for 2023-24**
- **We also expect the FOMC to make an important tweak in its policy statement to indicate that 'tapering' could commence by December. However, markets have already priced this in**
- **Several other central banks—UK, Japan, Brazil, Indonesia and Philippines—will also have their respective monetary policy meetings in the week ahead. The Bank of England (BoE) could provide some indications that the policy rate could be hiked in Q42022, we see another 100 bps worth of rate hikes in Brazil and see the other central banks maintaining their respective accommodative frameworks**
- **The combination of a hawkish message from the FOMC's dot plot and concerns about Chinese credit markets could ensure that the USD remains supported on a trade-weighted basis**
- **US real yields could drift higher. However, the effect of the FOMC's message from the dot plot could get diluted by acute risk aversion ensuring that US nominal yields trade flat**
- **In Germany, the election result that is due on 26-September-2021 is unlikely to invoke a sharp response**
- **In the local markets, we see some risk aversion as concerns about China could have an adverse knock-on effect. However, expectations of a possible inclusion of Indian bonds in to global bond indices could work as an important support. Investors also view India as a stronger relative play within the EM basket that will subsequently also work to offset acute global risk aversion**
- **Hence, we maintain our call of a flat trajectory for the USD/INR pair in the near-term, even as global risk aversion persists**
- **Range trading in the local bond markets could also continue to linger for a while driven by risk aversion and supported by RBI's unconventional measures**

Risk aversion returns with a vengeance: **Even as the FOMC Chairman provided a dovish tapering guidance at Jackson Hole, there appears to be a new risk on the horizon.** Focus will be on the Chinese real estate market especially on concerns about the real estate company Evergrande's ability to meet its near-term financial obligations. Evergrande's problems started when the People's Bank of China (PBOC) tightened lending norms in 2020 that was done to curtail speculative activity. At the same time, a lot of the debt that has been accumulated has been from the less regulated shadow banking market. While the company has been on a deleveraging course since 2020, concerns have grown on rumors in the market that it failed to meet its commercial paper obligations in June-2020. On 16-September-2021, the company suspended trading in its offshore bond market after substantial ratings downgrades that were made. **The root cause of the problem is an asset-liability mismatch given that the company has large amounts of unsold inventory that is concentrated in tier 2 to tier 3 Chinese cities and at the same time it has funded its growth by a massive debt build-up that requires continuous repayment.**

In the near-term, focus for investors is on whether it can meet payments of: (a) USD 83.5 mn interest rate payment on 23-September-2023 for its March-2022 bond and (b) meet another interest rate payment to the tune of USD 47.5 mn that is due on 29-September-2021 for its March-2024 note. The company has to meet these payments within 30 days of the schedule payment dates before an official default is declared. **While these payments are due in the near-term, the problem is more structural given the outstanding liabilities of USD 300 bn and close to USD 7.4 bn worth of bonds that are due to mature over the next year.** The total debt exposure of Evergrande in H12021 was at CNY 834 bn—that was made up of CNY 633 bn in loans and CNY 200 bn in offshore bonds and other debt. In terms of financial institutions that have an exposure, as we understand that would consist of 128 banks and 121 non-banking institutions. Evergrande's debt is roughly 2-3% of Chinese bank's core tier 1 capital. It also has a substantial work force of 200K staff and it generated 3.8 mn additional employment for the various projects that it is involved in.

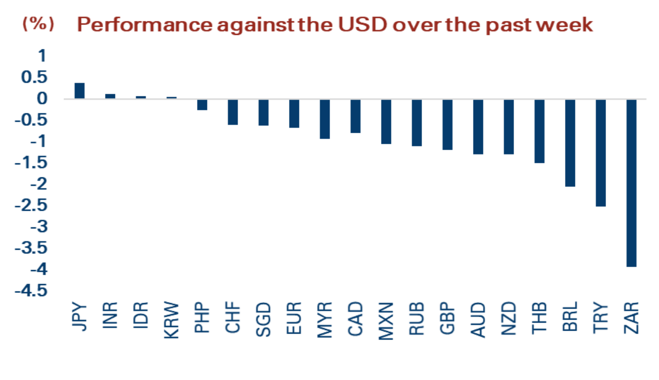
In short, there are ongoing concerns about a disorderly default and the possible repercussions of such an event both on the financial markets and the real economy respectively. Chinese CDS spreads have already started to widen quite sharply but are still some distance away from record high levels. An adverse event could lead to a pick-up in counterparty risk resulting in substantial freezing in credit markets similar to what happened during the Lehman Brothers episode of 2008. The effects of an adverse credit event are unlikely to be localized given the financial linkages and will subsequently be felt across the globe. **Some of the risk aversion that has taken place over the last few trading sessions can be attributed to these set of concerns. An adverse event would also pose further downside risks to Chinese growth prospects after the weakening trend that was visible July-August in response to lockdowns that were imposed to curtail the spread of the delta variant.**

As we understand, Evergrande has a lot of real estate and land at its disposal to sell to meet its debt obligations. However, given that the problem is somewhat durable in nature, we would at some point expect Chinese policymakers to step in to provide some relief or announce a bail-out package. Until there is clarity on whether a hard default will be avoided, we suspect that risk aversion could remain dominant and markets could ignore economic indicators and guidance from central banks, particularly the FOMC, in the interim period. For its part, the PBOC has been fairly aggressive in injecting liquidity over the last week but a monetary response is unlikely to work as a game-changer. The Chinese government needs to intervene in the form of an explicit or implicit bail-out package.

Chart 1: China CDS spreads have started to

Source: Bloomberg & ICICI Bank Research

Chart 2: USD has gained across the board but INR has remained resilient



Source: Bloomberg & ICICI Bank Research

US assets: driven more by risk than the FOMC policy meeting

- Even as the FOMC will present its update on US monetary policy, the impact could be much more muted given that concerns about Chinese credit markets are expected to linger. **On balance, we think that the FOMC will have more of a hawkish guidance for investors to ponder over.** The FOMC will also introduce its projections for 2024.
- We expect a small tweak in the post policy statement for the FOMC to signal that tapering could commence from December but that is already priced in. We also do not expect the FOMC to release a QE tapering calendar. Instead, it will be guidance on inflation and the dot plot that we think could come in on the hawkish side that the market will respond to. The dot plot will show median of members voting for status quo in 2022, 50 bps for 2023 and another 75 bps for 2024.
- The FOMC will likely also lower its GDP growth projections for 2021 and at the same time increase inflation projections but that is again largely priced in. GDP growth and inflation projections could be left unchanged over 2022-23. The labour market guidance and unemployment rate projections could remain unchanged from the previous policy meeting. The economic projections that the FOMC will provide for 2024 will be consistent with the economy growing at its trend level.

- The majority of high frequency economic indicators that were released last week—retail sales, industrial production, NFIB small business optimism index and University of Michigan consumer confidence survey—showed some improvement over August-September relative to a very weak showing in July indicating that the delta variant is not derailing the recovery.
- US CPI inflation moderated from 5.4% YoY in July to 5.3% YoY in August in line with expectations reflecting a slowing in sequential increase in August. Core CPI inflation came in at 4% YoY in August from 4.3% in July reflecting a sharp sequential moderation in transitory components such as used cars & trucks (-1.4%), airline fares (-12.6%) and transportation services (-2.2%). Some further moderation is likely as the transitory components soften. However, we still expect US inflation to average above the 2% mark over the remainder of 2021-22 that would be consistent with the FOMC's inflation mandate and subsequently paving the way for interest rate hikes.
- We maintain our bullish projections on the DXY and see a range of 92.00-94.20 in the near-term as investors respond to a hawkish FOMC and ongoing concerns about Chinese credit markets.
- Even as the dot plot could show that US rates have bottomed out and are likely to head higher in the medium to long-term, ongoing risk aversion will keep any sharp uptrend in check. We think that the UST 10 year will continue to trade in the 1.2%-1.45%. However, we think that real yields could start to drift higher as investors prepare for tapering. Risk aversion in the near-term will primarily depress breakeven inflation rates in the near-term.

Domestic assets: Bullish environment to remain in place

- Even as global risk aversion has intensified on the back of Chinese credit concerns, the INR has outperformed its peer group reflecting two key reasons.
- **First, the Indian economy is being viewed as a safe-haven within the EM asset class** because of the recovery that is taking hold post the hit from the second-wave. The strong pace of vaccination, limited concerns about fiscal slippage and a comfortable external position are working as important supports.
- **Second, there are ongoing expectations of local bonds getting included in global bond market indices that is supporting the INR and even local bond markets for that matter.**
- In short, the capital flow outlook remains favourable and India's basic balance of payments remains in surplus territory. Hence, we maintain our call of the USD/INR pair trading in the 73.20-74.10 range in the near-term with upside possibility in case of an unexpected adverse shock from China.
- Yields on the 10-year benchmark fell from a 13th September high of 6.20% to 6.14% on the back of the lower August CPI inflation print. August headline retail inflation came in as a positive surprise for the market, easing to 5.3% YoY from 5.6% YoY in July. The core inflation also eased to 5.77% YoY. While wholesale price data remained sticky at around 11%, the pass-through to retail prices has remained muted so far. The lower than expected inflation numbers provides weight to the "transitory" argument made by the Reserve Bank of India (RBI).
- Meanwhile, the 10-year benchmark regained its tag of "most liquid" security the previous week after it became the most traded fixed-income security for the first time this fiscal. The upside risk on yield could come from elevated energy prices. High import dependency raises the risk of transmission of international oil prices to the domestic consumption basket. However, we maintain our near-term range of 6.1% to 6.3%
- RBI also announced the open market purchase of government securities under the G-sec Acquisition Programme (G-SAP 2.0) worth INR 150 bn and simultaneous sale of securities worth of an equal amount all maturing in 2022. This makes the event liquidity neutral. This may also flatten the yield curve by pushing up short term yields because most of the security sale is in the shorter tenor while the GSAP purchases focus on the longer end of the yield curve. RBI is also expected to conduct 14-day variable rate reverse repo (VRRR) auction worth INR 4 tn to mop up the huge built up of liquidity. Quantum of GSAP purchases will likely be reduced going forward which will push up overall cost of liquidity going forward. Given the recent statements of the monetary policy committee (MPC) members, we expect the MPC to continue with its accommodative stance in the October policy.

EUR/USD pair: German elections are unlikely to invoke a sharp response

- The EUR/USD pair has fallen reflecting overall risk aversion in the global markets as well as monetary divergence between the ECB and the FOMC. We see more downside potential as concerns about Chinese credit markets could have a more pronounced effect particularly given strong trade links that China has with the German economy.
- Euro-zone PMI surveys for September and the German IFO survey that are due later in the week should show some moderation indicating that the pent-up driven surge that was seen in Q22021 is cooling.
- However, there could also be some response to the German elections that are due to take place on 26-September-2021. We do not expect a substantial negative response given that most of the mainstream political parties and different possible political coalition combinations indicate that fiscal policy will remain expansionary. The mainstream parties also remain supportive of the Euro-project.

- The polls seem to suggest that the ruling center right political coalition led by the CDU party might lose considerable ground to the center left ruling SDP party. If the polls are correct, there could be the formation of a left-leaning political configuration. This will mean a much more expansionary fiscal environment in Germany than is currently assumed in the medium-term.
- However, we reiterate that the election outcome could have a fairly modest impact on the EUR/USD pair. Instead, we see more downside potential in the pair with a possible range of 1.16-1.19 in the near-term.

GBP/USD pair: Unresponsive to the BoE

- The GBP/USD pair has been fairly volatile responding to a several factors: (a) weak retail sales and slowing monthly GDP in July and (b) sharp spike in inflation rates and a much tighter labour market than assumed that has forced the OIS curve to aggressively price in rate hikes in 2022.
- However, concerns about the recovery remain in place given that the furlough scheme is due to expire shortly in October that could drive unemployment rates higher. The consumption outlook has also deteriorated from the pick-up in the delta variant.
- Despite the lingering uncertainties about the outlook, BoE officials have gone out of the way to indicate that conditions for some monetary tightening in 2022 could have been met. In this regard, the BoE policy meeting (23-September-2021) will be important to gauge whether any decisive change has taken place. We still expect the BoE to maintain its current framework and provide a neutral guidance to the market.
- We remain bearish on the GBP/USD pair and expect a further weakening trend in the near-term driven by overall global risk aversion. We see a range of 1.35-1.38 for the GBP/USD pair.

USD/JPY: In a tight range driven by risk aversion

- The pair continues to move in sync with overall global risk sentiment and US nominal yield movements. Given that risk aversion could remain dominant in the near-term, we see range trading and limited upside potential in the pair. We see the USD/JPY pair trading in the 108.50-110.50 range in the near-term.
- We expect the Bank of Japan (22-September-2021) to keep its current policy framework in place: (a) YCC, (b) ETF and J-REIT purchases and (c) continuation of the credit measures that were introduced to fight-off the stress from COVID-19.

Emerging economies: Review of key developments

- High frequency Chinese economic indicators showed that growth momentum slowed in August. In particular, there was a visible fall in retail sales from 8.5% YoY in July to 2.5% YoY in August reflecting the stringent lockdowns that were imposed that hit private consumption. Industrial production and fixed asset investment growth also showed a marked reduction. We also maintain our call of more downside risks to the growth outlook with possible more strain from the credit market. A disorderly default will mean a sharp hit to the economy.
- The Brazilian Central Bank is poised to deliver another 100 bps worth of rate hikes that would result in a cumulative tightening of 425 bps over 2021 primarily in response to ongoing inflation concerns. Other EM Asia Central Banks—Philippines and Indonesia—are expected to maintain status quo.
- Given the ongoing concerns about a default by a major Chinese real estate company, we expect EM currencies to continue to under-perform.

EM FPI flows update:

- Since January 2021, India has witnessed a strong capital inflow worth USD 8.2 bn which is mainly dominated by the equity inflows worth USD 9.2 bn while debt witnessed a net outflow of USD 994 mn. For the overall emerging markets (EM), total inflow stands at USD 17.1 bn dominated by equity inflow.
- For the week ending 17th September, India witnessed an overall inflow of USD 496.5 mn of which USD 526.1 mn was in equity and while debt outflow stood at USD 29.6 mn. Overall outflows from EM in the same week stood at USD 1.2 bn and was dominated by the equity inflow worth USD 247.5 mn while debt witnessed a net outflow of 1.4 bn.

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