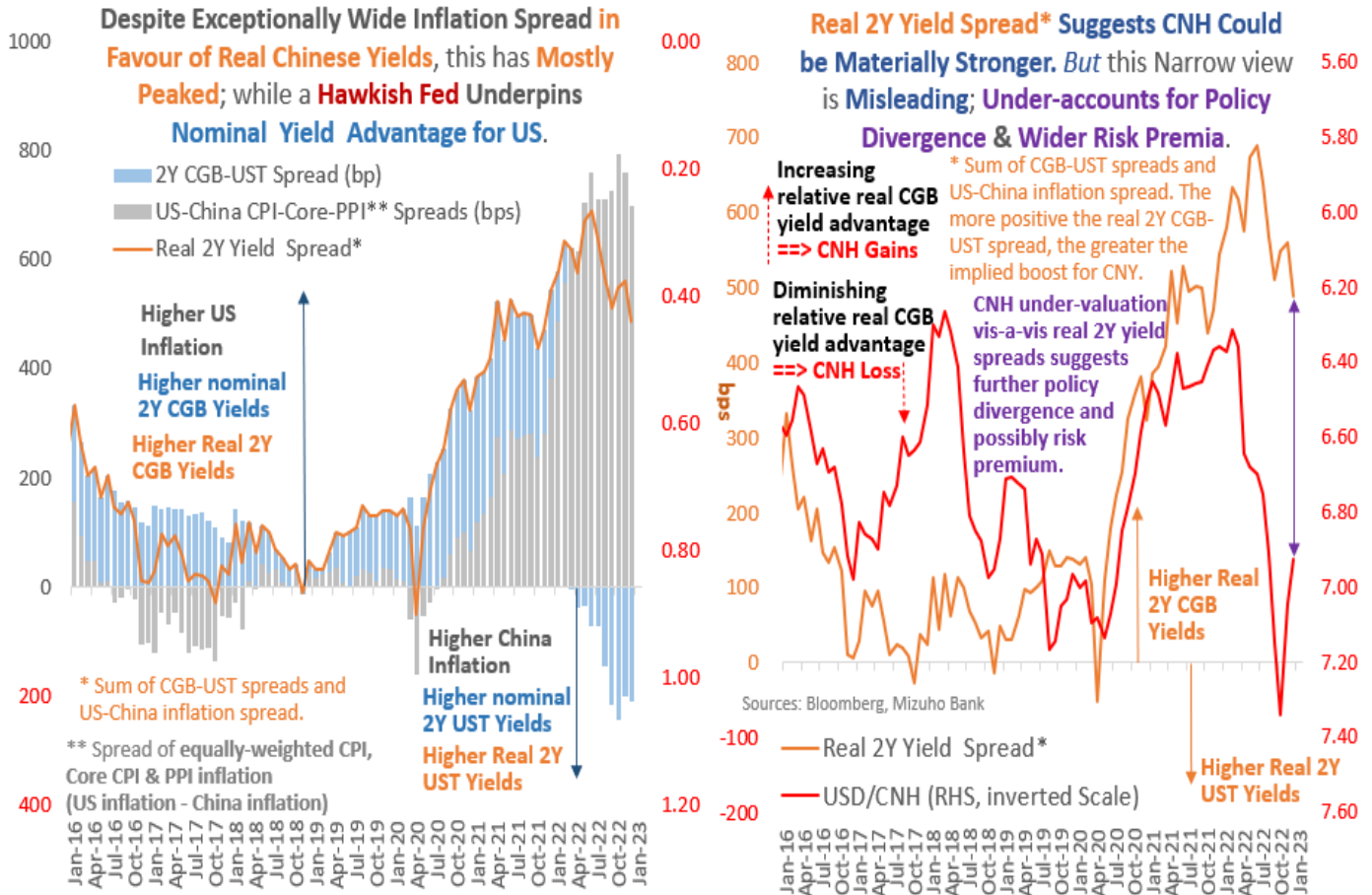


Mizuho Chart Speak: CNH Risks

Why CNH May Not Exploit Untapped Real Yield Advantages



“Not all those who wander are lost.” - Bilbo Baggins, Lord of the Rings

In a Nutshell: A quick glance at **real yield spreads between CBGs and USTs suggest significant upside potential for the CNH. But this is at best overstated, if not misleading.** First, peaking US inflation means that **backward-looking inflation spreads overstate implied CNH advantage.** Second, **sustained policy divergence, not fully reflected in the real yield spreads, also overstate scope for CNH gains.** Finally, and most importantly, **real yield spreads fail to reflect material, and arguably mounting, risk premium (both economic and geo-political) that will stifle CNH gains.** And so, unchallenged CNH gains may be stifled, and accordingly a smaller bullish CNH tide may not lift other EM Asia FX currencies by as much.

China Cheer: A whirlwind of sweeping China-positive policy announcements has sparked robust enthusiasm about all things China. From the macroeconomic outlook, cascading down to beaten down Chinese equities as well as languishing Chinese bonds (on the brink of default).

“Real” CNH Boost?: In turn, this begs the question of whether CNH could have more emphatic gains in the bag. Especially with regards to unexploited potential for significant gains as suggested by real yield differentials (see Chart). This is a tempting, but nevertheless misleadingly narrow proposition.

Primed for Rallies ...: Admittedly, **CNH wandering off the path of appreciation otherwise suggested by real rate spreads**, insofar that it may have been attributable to earlier economic gloom (from COVID lockdowns and property/tech crackdowns), **may be ripe for a reversal; consistent with appreciable CNH rallies**. And arguably, this CNH rebound kicked off since late November last year.

... Or Pitfalls: But there are **three distinct pitfalls in assuming linear catch-up corresponding to real (CGB-UST) yield spreads**.

Overstated Inflation Spread Boost: First, with US inflation emphatically, **backward-looking inflation spreads (in favour of CNH) may be grossly overstated**.

Lingering Policy Divergence: Second, with the Fed still in hawkish mode and the PBoC tilting dovish (albeit with a suite of tools) the **policy divergence in favour of USD may be understated** by the real yield spreads.

Mounting Risk Premium: Finally, and perhaps most importantly, the **assumption of real yield spreads being fully exploited requires risk equivalence** (across US and China). Whereas, **scope for CNH gains based on real yield spreads are materially stifled by significant, arguably rising, risk premium**. Not just from **cyclical global recession risks** or **structural economic impediments**, but also by **elevated and mounting geo-political risks** (e.g. US coordinating chip sanctions against China).

Purposefully Unexploited: And so, as Bilbo Baggins put it, **CNH wandering off an emphatic appreciation path may not be because the real (CGB-UST) yield spreads are lost on it**; but precisely because it finds itself in the cross-hairs of rising risk premium. And so, this gap in CNH (under-)valuation may be purposeful.

Riding Tides or Ripples?: What this means is that **projecting linear CNH gains based on late-2022/early-2023 momentum may be negligent, if not outright risky**. And it follows that the **ability of other EM Asia currencies to hitch a ride higher on anticipated CNH may also be limited**, if not impaired. While rising the CNY ripples. It is best not to get carried away expecting tides.

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