Scotiabank
Global FX Strategy

FX SNAPSHOT
September 22, 2021

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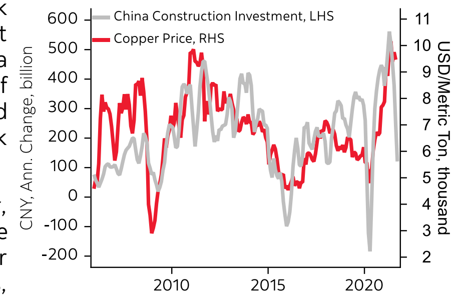
China's Credit Stress Adds to AUD Headwinds

China Construction Helps Drive Copper



Source: Macrobond, Scotiabank FICC Strategy

The emergence of China's Evergrande Group, China's number two property developer, as a threat to global markets has been swift but has its roots in the Chinese government's own efforts to rein back excesses in highly leveraged domestic property developers introduced in 2020. A Bloomberg report in June noted that eight of the world's ten most-indebted property developers are based in China while construction and related real-estate sectors accounted for a disproportionally large 29% of China's overall economic output (citing an NBER working paper)—above Spain's pre-GFC peak and compared to about 15-20% in the US in recent years. S&P Global Ratings reported earlier this week that default was likely, driving the company's stock and its bonds sharply lower.

This is a very complex issue and we are not attempting to dive deeply into the specifics at all. Rather, in response to questions from clients, we will attempt to assess the potential impact of the developing situation on markets generally. Clearly, this event has emerged at a sensitive time for global markets. Volatility has been on the increase and investors are focused on Fed policy risks, Europe's power supply issues and the US debt ceiling as more obvious risks. We think Evergrande's problems can be distilled (very broadly) into three issues—1) Is the situation contained? 2) Is there a risk of contagion? And, in a related way, 3) What does the situation do for market confidence?

We feel there is a good chance that the issue can be "contained". That is a loaded phrase, however, and the 2007/08 experience tells us that problems in one sector can quickly escalate into a global problem of significant proportions. As we noted above, the challenges for Evergrande (and others in the sector) stem from a domestic policy decision. As such, we have to think that the Chinese authorities would have been aware of the risks they were introducing when capping the ability of the domestic property sector to borrow. China has the means to ensure that Evergrande re-organizes its finances in a relatively smooth fashion (considering its sprawling complexity).

The risk of contagion hinges largely on whether an eventual default is contained but we think China's banking system should have sufficient provisions for absorbing losses while China's low foreign debt load generally suggests that foreign banks and investors may be relatively sheltered from the situation. Given the Chinese leadership's focus on "common prosperity" it seems logical to us that China's retail investors and house purchasers exposed to the Evergrande situation are likely to be provided with a high degree of protection from the government. This should help prop up domestic confidence and limit international risks. The PBoC also stands at the ready to inject large amounts of liquidity to keep markets functioning smoothly and economists are anticipating another reduction to the bank's reserve requirement ratio (RRR) in the coming months to support the slowing recovery.

There are, however, likely to be longer term consequences; first and foremost, a recalibration across property developers suggests lower demand for raw materials moving forward. Copper has already experienced a significant repricing but risks staying somewhat softer even as the global economy rebounds if Chinese demand is diminished. The Evergrande problems and their impact on steel demand also come at a time when China is cracking down on pollution by limiting steel production (already impacted by checks on construction volumes). Iron ore has recovered about 20-25% since Monday's low thanks to news that Evergrande has negotiated an agreement on a set of payments due Thursday, but the outlook for iron ore demand remains weak (and a supply glut is now forming). Under these conditions, we expect the AUD to be the main underperformer among the majors given its reliance on Chinese demand for materials (and its broader link to the Chinese economy). Combined with a dovish RBA and the anticipation of the Fed's rate-tightening cycle, we see AUD losses extending to 0.70 in the near term. The CAD's reliance on metals prices will also weigh on the currency, though a comparatively hawkish BoC should keep it relatively better supported against the USD.