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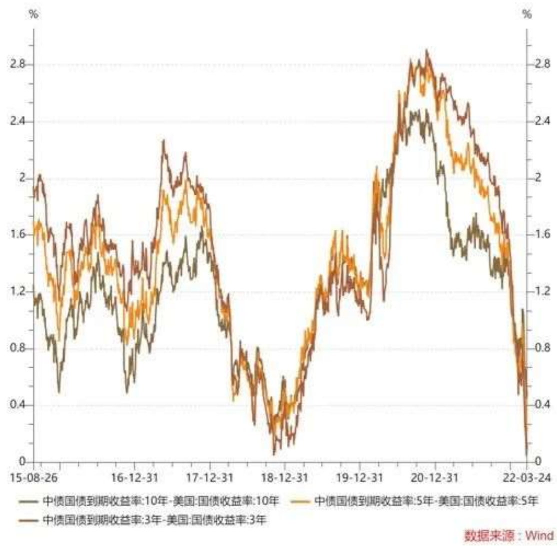
# Rosefinch Weekly

## How does US-China Rate-Differential Affect A-shares?

The US-China rate differential has tightened to historical low levels which has generated some market interests on the impact on offshore capital movements. Currently, the 10-year yield spread between US Treasury and Chinese Government Bond is about 30 bps, with 5-year and 3-year UST yields above those of CGB by 1 bp and 12 bps respectively. This compression of yield spread came mostly from market expectations of future monetary policies. Much of the future FED hikes have been priced in by the US debt market, with relatively high inflationary pressures expected in the coming two years. On the other hand, the Chinese domestic monetary policy is on steady footing, thus the higher US rate hike expectations drove the quick tightening of the rate-differential.

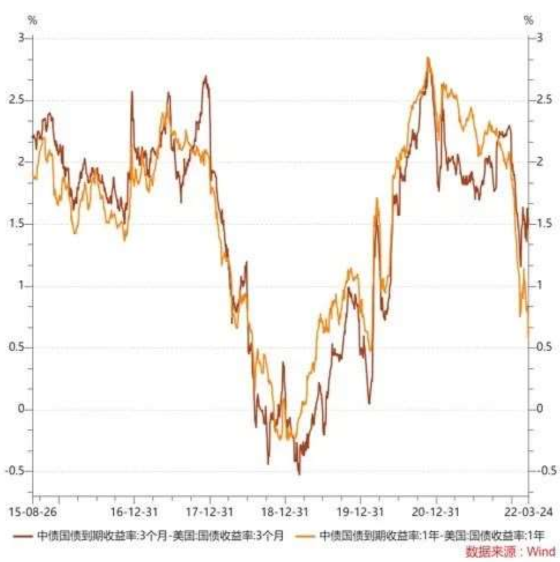
图 1：中美利差 3-5 年期已经开始出现显著倒挂，10 年期也压缩至历史低位附近




资料来源：wind

Source: Wind. Graph of 10y, 5y, and 3y yield differences between CGB and UST since 2015.

图 2：中美短端利差近期快速压缩，但仍然维持相对较高位置




资料来源：wind

Source: Wind. 3m and 1y rate differential between China and US bills.

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Since Foreign Exchange policy update on Aug 11th, 2015, there was a round of quick rate-differential compression during 2017-18, when the FED started its hiking cycle and China prepared for RRR cuts to loosen monetary conditions. The differential went from 155 bps at end of 2017 to 30 bps at end of 2018. During this period, CNY exchange rate showed noticeable depreciation from 6.4 to 6.9. We are at a similar macro-backdrop as the 2017-18 period with bond spread now about 30 bps, and front-end inverted. But compared to the 2017-18 period, there's limited scope for sustained US rate rally since much of expectations are priced in. The current foreign exchange environment is less stressful than the 2018 period. The CNY has been appreciating over the last two years and remains near recent highs. This provides some breathing space for future monetary policy decision. At the same time, the front-end, especially the sub-1y tenors still see Chinese bills with higher yields. The US yield curve is reflecting FED's quick tightening steps, while the US economy is showing slowdown in the recovery rally, with consumer confidence weakening and PMI coming off the 2021 peaks.

**As US-China rate-differential tightens, stock markets' reaction varies across different periods.** Both in 2018 and early 2022, we saw large compression of rate-differential and significant drop in the A-share. But in 2H2020, the A-shares actually rallied despite the continued rate-differential compression. **The most important factor is the fundamental underlying trends.** In 2018, China had major risk in domestic credit bubble bursting, with GDP dropping from 6.9% to 6.5% and exports dropping quickly too. Similarly, at turn of new year in 2022, market had relatively weak expectations to fundamentals which impacted investor sentiments. In contrast, in 2H2020 China experienced its post-pandemic rebound with noticeable strong growth trend and sharp increase in exports. The rate-differential compression came mostly from US economic recovery which was positive for export sector. So the fundamental picture was significantly better for the A-shares, especially the export sector.

The US-China rate-differential will affect offshore capital allocation, to some extent. Overall, offshore investors have been net buyers of Chinese assets with high correlation between rate-differential and foreign stock holdings. FED tightening increases US rates and compresses US-China rate differential, causing liquidity to return to US market, including less allocation to A-shares. Looking at 2022's North-bound capital flows, there's significant drop in foreign holdings with big A-share corrections. **But going forward, offshore investors may not become the core determining factor for the A-share.** For the institutional investors, their China stock investments are subject to both global financial conditions and domestic economic fundamentals and policy expectations. There in high correlation between foreign stock holdings' increases and the China export volumes. So with China exports remaining resilient, it's a stabilizing factor for foreign holdings. On the other hand, the US long bonds already priced in significant US tightening expectations, so further large rate-differential compressions are less likely.


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Overall, there may still be some impact from global liquidity tightening to A-share market as offshore investors become less aggressive buyers or even net sellers. But the domestic monetary policy is still expected to be independent from FED with supportive measures. Given the market has largely priced in FED hike expectations, most of the adjustment has taken place. Last week's Stock Connect Northbound flows was a net 12.8 billion HKD outflow, which is slightly lower than the previous two weeks. As A-share rebound consolidates, there's less outflow pressure. For the medium to long term, while the global financial conditions will have impacts, the core factor will still be domestic fundamentals and policies. **As government implements steady growth policies and maintains ample domestic liquidity, the domestic assets will likely withstand global impacts and remain stable.**