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RMB CRACKING OPEN USD

Monthly Report – December 2025

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TRACE: RMB Cracking Open USD

"Yesterday's home runs don't win today's game." – Babe Ruth

Theme: RMB Rising in a Fracturing World Order

Back in 2016 when I was launching Invealth Capital, the predecessor of KFI HK, I wrote the following.

"*In an interconnected world, the uncertainty created by a large economy's exchange rate regime shift can last years or even decades. History is littered with such, the break-up of Bretton Wood in 1971, the Plaza accord in1985 and the creation of Euro in 1999. Their impacts, however, might be underrated at the point and only be appreciated fully at a much later time.*

China's inclusion into SDR and the first RMB devaluation on August 11th after a decade-long appreciation signifies one thing, the RMB is to decouple from USD, making 2015 a year equivalent to one of the above, be it 1971, 1985 or 1999!

Given China's manufacturing output already larger than US and Japan combined, it is inevitable for Asia currency to cling closer to RMB, a new source of uncertainty coming with the decoupling. As a result, politics and policies out of Beijing, good or bad, will be as important as, if not more than, that of New York/Washington, Tokyo and London/Brussels in driving macro investing in the next decade!

Thus, a deep Local Insight into the opaque China becomes ever more critical to generate great Global Foresight for excess returns in the macro world!".

The hope then gradually rolls into reality now. The RMB is no longer knocking on the door of the global monetary system. The currency has already walked through quietly and persistently without fanfare. Over the past three years, its share in SWIFT trade finance has surged from under 2% to mid-8%, overtaking the euro's stagnant mid-6% to become the world's second-most-used currency in this dimension. In the same period, the U.S. dollar's dominance has eroded from near 90% to just below 80%. This is not a statistical blip. It is a structural signal. And it arrives at the precise moment when the old rules-based order is giving way to something more fragmented, more contested, and more transactional.

Mark Carney was right in Davos: we are not in transition. We are in rupture. The era of assumed cooperation, where integration meant mutual benefit, is over. China anticipated such rupture long before most nations realized this was happening. Its approach has been neither rushed nor reckless. It has been deliberate, patient, and deeply integrated into its long-term planning. The 15th Five-Year Plan, now taking shape for 2026–2030, will enshrine RMB internationalization not as a speculative ambition, but as a pillar of national resilience. The goal is not to replace the dollar overnight, but to create redundancy in a world where reliance on a single hegemon has become a liability. If we were to be serious about the health

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of global financial market, for such a critical system, one currency dominant does not really make sense. After all, even for an individual, however insignificant for the systemic risk of human being, one has two lungs, two kidneys, two eyes and two ears. The world might need at least one back-up currency, RMB is right on top of the candidate list.

China's strategy is already bearing fruit. Cross-border RMB settlement hit ￥64.1 trillion in 2024, a 22.5% jump from the year before. Of this, capital account flows accounted for 74.6%, driven by surging securities investment, while trade-related settlements grew 15.9%. These are not empty flows. They reflect real transactions: Saudi crude priced in yuan, Brazilian soybeans settled in RMB, Argentine hospitals paid for with digital yuan liquidity drawn from a bilateral swap line. Russia, Iran, Venezuela, and the UAE now settle nearly one-fifth of their energy exports to China in RMB, up from less than 5% just a few years ago. Each deal chips away at the petrodollar's monopoly due to convenience, necessity, and mutual interest when dealing in RMB.

The architecture backing this shift is equally robust. CIPS (Cross-border Interbank Payment System), China's alternative to SWIFT, now connects over 1,600 institutions across 110 countries. Bilateral central swap lines have opened with 41 countries in total, worth $570 billion. Different from Fed's swap line with many central banks for liquidity management during crisis, the PBoC's swap serves dual purposes, to offer a cushion for crisis management and to make RMB available out China to facilitate RMB transactions. When Argentina faced hyperinflation and dollar shortages, it tapped its RMB line for nearly $10 billion to keep essential imports flowing. Pakistan drew $1.4 billion to sustain Belt and Road projects. Indonesia used its arrangement to enable direct RMB-rupiah trade, bypassing the dollar entirely. These are not emergency measures. They are proof that the RMB functions as a real-world alternative, though still limited, when in need.

Even more forward-looking is China's leadership in digital currency. Through the mBridge project with Hong Kong, Thailand, and the UAE, China has already trial processed over 20 billion RMB in live cross-border corporate payments using the digital yuan. The mBridge can handle 15 currencies with end-to-end processing time under 7 seconds. This is not a pilot. It is a prototype of the next financial rails: faster, cheaper, and outside the reach of U.S. sanctions.

Critically, this push aligns with deeper regional trends. Within ASEAN, the RMB now accounts for 25% of China's cross-border settlements. Among BRICS nations, that figure exceeds 35%, up from just 12% in 2021. The message is clear: the Global South is not waiting for the West to fix its contradictions. It is building parallel systems with RMB as the glue.

Of course, the dollar remains dominant in reserves and deep capital markets. But dominance is not immunity. As trust in U.S. institutional continuity wanes amid arbitrary tariffs, political interference in central banking, and disregard for treaty obligations, the appeal of alternatives

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grows. The RMB offers not perfection, but optionality with little ideology and a lot of utility. Like often talked China model, they are there showcasing an alternative rather than forcing any party to join. Willing leads to billing, that's China's approach.

The results are already visible. According to the 2025 China Bank RMB Internationalization White Paper, 94.1% of Chinese firms and 78.4% of foreign enterprises plan to maintain or increase RMB usage. In ASEAN, that figure rises to 85.9%. More tellingly, 29.6% of foreign firms now use RMB in third-country transactions, offering proof that the currency is gaining network effects beyond China's borders. Panda bonds and offshore RMB debt both have hit record issuance, signaling growing acceptance of RMB as both financing and investment vehicles.

The 15th Five-Year Plan will double down on this logic. It will prioritize "high-quality" internationalization: trade invoicing, green finance, supply chain settlement along with gradual capital account liberalization. It will deepen regional clearing mechanisms, expand digital yuan corridors, and link RMB adoption to climate investment and South-South cooperation. The vision is to offer an alternative in productive currency in the new multipolar world and a hedge against the hegemonic dollar.

The timing for capital account opening is also about right though the country remains cautious. When compared to Japan, the system looks eerily like post 1st Oil Crisis in 1974, a time when Japan's equity market capitalization tops 25% that of US. The market capitalization of China including Hong Kong now sits at 28%. From 1975 to 1985, before the Plaza Accord and the onset of Japan bubble, Nikkei outperformed Dow Jones by 138%, a result Chinese government would love to see and get if the capital market becomes more open.

Challenges remain. Full capital account convertibility is still uncertain. Market depth, though deep in recent months with high turnovers, can change quickly. Regulatory unpredictability and geopolitical assertiveness temper enthusiasm among cautious economies. An HKUST study notes that true RMB internationalization beyond Mainland-Hong Kong flows requires deeper financial reform, credible rule of law, and market thickness that only full convertibility can provide. China knows this. Its strategy is not to rush, but to build demand first, then supply the plumbing.

Capital is too liquid to be totally blocked, no matter how hard government tries. Looking back, one number stands out. Over the 12-year period between 2014 and 2025, China's net goods and service trade surplus amount to more than $6 trillion while the net FX settlement and sales altogether add to less than $1 trillion. That leaves a whopping $5 of capital outside China. If capital accounts were to become open, the flow might not be as one way as many might believe, even ignoring the potential flow to China due to the huge under-allocation of foreign community to the world largest economy by PPP.

The opportunity for investors is clear: the RMB is transitioning from a tactical hedge to a structural asset. Its role in portfolios will evolve from

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currency overlay to core holding. Though the yield is mediocre, the manufacturing dominance and the rapid growth of high-tech sectors to fill the gap with US will offer uncorrelated investment returns and plug in a stabilizing node in an unstable system. For multinational corporations, it is becoming the default for Asia-Pacific operations. For sovereign wealth funds, it serves as a beneficial diversifier with real economic backing. For emerging market central banks, it is a lifeline during crises.

This is the quiet ascent of a new monetary order. It was not declared but built. And as the fractures in the old system widen, the RMB's path from regional anchor to global alternative becomes not just possible, but inevitable.

Risk: The Fractured Order in Trump's Action and Carney's Words

The old international order is fracturing. What once appeared as a rules-based system now reveals itself as a fragile consensus, sustained less by shared values than by the temporary convenience of hegemonic restraint. That era is over. In its place a world emerges where "great powers have begun using economic integration as weapons, tariffs as leverage, financial infrastructure as coercion, supply chains as vulnerabilities to be exploited." The implications for asset prices are profound and underappreciated. Markets have priced stability into perpetuity, naively assuming or pretending that institutions like the WTO, IMF, or even central bank coordination will contain disorder. But as Mark Carney warned in Davos 2026, we are no longer in transition, we are in rupture.

Middle powers, as Carney argued, are responding by building strategic autonomy in energy, food, finance, and critical minerals. But such a risk centered protectionism and fragmentation has a cost: higher capital allocation inefficiency, duplicated infrastructure, and reduced economies of scale. For investors, this means lower trend growth, higher volatility, a premium on real assets over financial claims and higher inflation, leading to stagflation which hurts both equity and bond.

Looking back a year and ironically, Vance's blunt accusation of Europe at Davos that the greatest threat comes not from abroad but from within and the danger is not invasion, but institutional decay seems to have thrown a boomerang at Trump. When leaders treat treaties as optional, courts as obstacles, and markets as tools of statecraft, they erode the very foundation of long-duration investing. Asset prices built on decades of declining volatility, converging regulation, and credible central banks now face a world of divergent regimes, contested sovereignty, and transactional diplomacy.

The seismic regime shifts reprice everything, but the market has yet to confront the reality. It clings to the fiction that the old order can be restored, that cooperation will return once elections pass. But as Havel taught, systems collapse not when the powerful fall, but when the powerless stop performing belief in the lie. Investors are beginning to remove their signs. Curiously, starting with the rise of new, the bitcoin, challenging the establishment, but now old, the trusted gold. Onshoring

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accelerates. Currency hedges multiply. And the great repricing of the post-rupture world has only just begun.

Under the risk scenario, our long themes of virtual to physical will accelerate. Alternatives are emerging not in virtual crypto, but in physical networks: power grids, semiconductor fabs, lithium mines, and sovereign payment rails.

Gold, long dismissed as a relic, is regaining its ancient logic. Not because of inflation alone, but because trust in institutional anchors is evaporating. When the U.S. unilaterally imposes sweeping tariffs on allies and adversaries alike, when it captures foreign heads of state without extradition treaties, when it dictates corporate ownership limits in housing or caps credit card rates by executive fiat, it signals the end of predictable rule. Gold thrives not in chaos, but in the space between broken promises and uncertain enforcement. The rally is a silent vote of no confidence in the legal scaffolding that once underpinned global capital flows.

This erosion will spread to equities, especially in the G2. American stocks, particularly mega-cap tech, have traded on the assumption of open markets, stable regulation, and benign globalization. Yet Trump's disregard for international law drives up risk premium and arbitrary interventions in domestic finance inject deep uncertainty into earnings models. AI may be transformative, but its valuation assumes frictionless scaling across borders. If supply chains fracture, if data flows are restricted, if chip exports face new controls, then the "global platform" narrative collapses into regional silos. The S&P 500's narrow leadership is not strength; it is fragility masquerading as momentum. These companies are exposed not just to recession risk, but to regime risk: the risk that the rules of engagement change overnight, without consultation or appeal.

China, meanwhile, is pricing in a different kind of rupture with strategic autonomy. Beijing still seeks reintegration into the existing world order, like UN, WTO, and G20; it is also building parallel backup systems. The RMB's rise in trade finance, the expansion of CIPS, the deepening of RCEP, all reflect a deliberate decoupling from dollar dependency. Chinese equities have lagged not because of weak fundamentals, but because global investors still view them through an outdated EM lens. Yet China's manufacturing dominance, its current account surplus, and its control over green supply chains make it increasingly resilient to external shocks. The real risk for China is not isolation, but miscalculation—overconfidence in self-reliance while underestimating the cost of technological bifurcation. Still, its asset prices are anchored in tangible production, not speculative narratives, giving them a floor absent in overvalued Western counterparts.

In bonds, the fracture is most acute. The G3—U.S., German, and Japanese government debt—has long been treated as interchangeable safe havens. But this homogeneity is dissolving. U.S. Treasuries now carry political risk: a Congress willing to weaponize the debt ceiling, a Fed whose independence is questioned after the dismissal of Governor Cook,

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and a Treasury actively rebuilding its balance sheet while the reverse repo facility drains liquidity. Bunds, though supported by EU cohesion, face existential questions about fiscal union in a world of resurgent nationalism. But Japan's JGBs reveal the sharpest contradiction. With government debt-to-GDP near 260%, Prime Minister Takaichi's push for aggressive fiscal stimulus, echoing Truss's fatal miscalculation, threatens to shatter the illusion of perpetual BOJ control. The yen's slide toward 160 is not just a currency move; it is a referendum on whether markets still believe Japan can defy gravity indefinitely. A sudden loss of confidence could trigger a violent repricing, not just in JGBs, but across all duration-sensitive assets, as the "Japan exception" evaporates and taking down equity with it.

In the end, what started as a risk scenario just turned to a theme discussion. This is not a bug but a feature of our TRACE framework. There are two types of risk, one is pure come-and-go shock we need to aware of and set up contingent plan for. The other is a rupture during tectonic shift, creating long repercussions. The latter turns a risk to a theme we can trade on. This month witnesses the latter type.

Asset: A Quiet Rebalancing

December 2025 saw global equities moved in narrow ranges as the macro narrative faded into the background. The Fed's widely expected rate cut removed uncertainty but also removed momentum. Traders who had front-run policy shifts took profits, triggering a modest style rotation. The air was calm, but beneath the surface, capital was shifting its weight.

In China, A-shares experienced distinctive two-phases. Early December saw a pullback after the Central Economic Work Conference concluded without the sweeping consumption stimulus some had hoped for. Funds that had bet on aggressive fiscal easing retreated, dragging broad indices lower. But the story changed in the final ten days. Several A500 ETFs launched by managers to qualify for new options contracts to be listed. This triggered over RMB 100 billion in incremental buying, much of it diverted from CSI 300 and SSE 50 ETFs, leading to a rally of 6% by CSI 500, significantly outpacing large-cap benchmarks. Tough mechanical, tactical, and temporary, the flow revealed where marginal capital sees opportunities: not in state giants, but in the agile, policy-aligned mid-tier firms driving new-quality productivity.

Hong Kong underperformed. The primary reason was due to China's four major state banks paying dividends in early December, prompting income-focused investors to lock in gains and trim positions. At the same time, the Fed's rate cut drew some liquidity back toward dollar-denominated assets. The retreat was orderly.

Coming into January, some of the A500 ETF surge are being un-winded gradually, with little disruption. More importantly, China's insurance sector is preparing its annual "Good Start (开门红)" allocation. Early signals suggest a barbell approach: low-valuation dividend payers for

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stability, and high-growth tech / green energy names for upside. As this fresh capital deploys, equity markets should find renewed support.

China's yield curve steepened as short-term rates fell on ample liquidity, while long-end yields edged up on growth hopes. The PBOC injected 300 billion yuan via MLF and repo operations, keeping interbank rates stable near 1.25%. Banks, relieved of funding pressure, bought short-duration bonds aggressively. But sentiment shifted mid-month when official media hinted at larger 2026 fiscal spending, including a 295-billion-yuan early batch of central investment projects. Bonds sold off, especially at the long end. Yet the move was orderly. Fund regulations on holding-period related redemption fee were finalized with lighter-than-feared terms, removing major uncertainty.

Looking forward, short-end carry remains attractive. Long bonds may get bid at some point given the relative attractive yield compared to last year for passive allocators who tend to front load their positions. Disinflation expectation is firmly ingrained in many. However, we see those rallies as selling opportunities amid deflation turning mild inflation domestically and global super-long end selling off aggressively.

Ignoring the reality of range bound bond and equity, convertibles rallied further, offering fatty premium over intrinsic value and into bubble territory. The CSI Convertible Index rose 2.13 for the month, even ahead of Shanghai composite. Demand from fixed-income-plus funds continues to outstrip supply, which is to dwindle even further. This dynamic will likely persist in 2026. As such, though overvalued, the market will likely buy on any dip especially in innovative small and mid-caps sectors.

US rates have also been mostly range-bound in December, along with the curve. Clearly showing trends are JGBs whose rates rose 25bp in December and another 30bp in the first three weeks in January. The move was a trend bet on Takaichi's aggressive fiscal stance to push for a high-pressure economy with strong fiscal, weak currency and hopefully accommodative central bank rates. It has worked initially to induce strong stock performance, but Nikkei implied volatility has risen meaningfully from 18s in late December to break above 30 by the time of writing, suggesting the recent move of dissolving lower house of the Diet. The uncertainty should help JGB to recover some grounds.

Commodities told a story of divergence.

In bulk, steel prices drifted sideways as both supply and demand contracted. Mills operated at low rates, constrained by annual production caps, yet profits remained healthy. Rebar inventories fell faster than usual for December, supported by mild winter weather. But demand was uneven, strong in eastern China, weak in the north and south. Hot-rolled coil faced stiffer headwinds. State-owned enterprises delayed orders amid year-end budget closures, while downstream fabricators added capacity, worsening oversupply. Exports offered little relief. New licensing rules curbed unofficial shipments, and looming EU carbon tariffs and anti-dumping probes are accelerating a "rush-to-export" dynamic that cannot

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last. Iron ore, meanwhile, defied fundamentals. Global supply is abundant. Port inventories sit at record highs. Yet prices held firm due to a technical bottleneck: Chinese mills, facing restrictions on certain Australian and Brazilian grades, scrambled for alternative medium-grade ores. This shortage means no scarcity but logistics friction, a tenuous rally.

Base metals surged on global liquidity and U.S. strength. Copper hit record highs, driven less by Chinese demand and more by American reflation. U.S. Q3 GDP surprised at 4.3%, with consumer spending robust at 3.5%. The Fed's dovish pivot added fuel. Yet physical markets told a different story. Spot premiums collapsed. Downstream buyers balked at record prices. Inventories swelled, especially in COMEX warehouses, now holding over half of global visible stock. The rally is financial, not industrial. Aluminum followed copper higher, lifted by expectations of China's 2026 fiscal push into equipment upgrades and consumer trade-ins. Prices neared 23,000 RMB, but domestic demand softened under the weight of high costs. Social inventories rose for the first time in months, suggesting the metal's rise sit also more on sentiment than substance.

Oil retreated through December, testing $58 again. The pressure came from two directions. First, hopes for a Ukraine-Russia peace deal with new U.S. proposals, however unlikely implementation may be. Second, markets began pricing in 2026 inventory builds. Fundamentals remain soft. Refining margins have compressed. Global stocks, outside China, are creeping up. Geopolitics like Netanyahu's Washington visit, protests in Iran provided brief but unsustainable rally. The Venezuela raid, though dramatic, left oil infrastructure untouched. The U.S. signaled it would fast-track Chevron's return and boost output once stability returns. That is a bearish signal for 2026. For now, the path of least resistance is down, but caution is warranted with a looming full flown war risk in Iran. With prices near $60, the downside cushion is thin, and speculative short positions are crowded. A sharp short-covering rally could be accidentally triggered by deterioration in Iran situation, an extremely cold weather or other unforeseen factors.

In FX space, RMB appreciated as we expected but the pace has been slower than we anticipated. PBoC has been reluctant to let the guard down, refusing to fix USDCNY below 7 despite USDCNH firmly breaking down below and consistently trading under in January. As we approach the Chinese New Year, FX net selling might start to slow down and we become a little bit cautious with renewed uncertainty on dollar side of the story with the Greenland fiasco.

Capital: The Money Puzzle in None-ASEAN RCEP Countries

As of January 2026, the region is awash in liquidity yet starved of economic vitality. We start with liquidity in this section and discuss economic activity in the next section.

Across China, Japan, South Korea, and Australia, monetary aggregates are rising—but not in ways that translate into real demand, investment, or confidence. The promise of policy easing has run headlong into structural

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bottlenecks, exposing a growing disconnect between money supply and economic activity throughout the none-ASEAN RCEP bloc.

In China, M2 growth accelerated to 8.5% year-on-year, the highest in four months. Yet this expansion is not driven by credit creation or business optimism. Instead, it stems largely from external liquidity: banks reported net foreign exchange settlement of 705.5 billion yuan in January, as firms converted dollars amid RMB appreciation. At the same time, M1 growth slumped to just 3.8%, widening the M2-M1 gap to 4.7 percentage points, a classic sign of stagnant transactional activity. Households are still saving, not spending. Corporates are hoarding cash, not investing. The PBOC's accommodative stance has succeeded in stabilizing the currency and boosting broad money, but it has failed to ignite the animal spirits needed for self-sustaining recovery. Liquidity is abundant, but it pools rather than flows. With M1 growth peaking in September at 7.2% and undershooting M2 growth, it becomes a worrying sign for the equity market which tends to be negatively correlated with M2 – M1 growth.

Japan presents a different kind of stagnation. M2 grew only 1.7% year-on-year, while M1 contracted by 0.7%, indirectly linked to BoJ's QT. Base money fell nearly 10%, with BoJ hiking its policy rate to 0.75%. Yet real interest rates remain negative, weakening yen and lending support to equity. Global demands for Japan stock remain robust. On rolling 52 weak basis, foreigners bought the most Japanese stocks in yen terms, averaging 186 billion per week. To witness a higher number, we must go all the way back to January 2013, right after Abe became the prime minister and signaled he would do appoint a new BoJ governor who only needs to one thing, a massive QE. To say the least, current BoJ QT should not be taken as a conducive environment friendly to Japan stocks.

South Korea shows a flicker of life in M1, which rose 6.9% against M2's 4.8%, suggesting some revival in transactional demand. But this is overshadowed by capital flight. The won weakened to 1470 per dollar, its lowest level since 1998, as investors fled geopolitical risk and weak export prospects. Despite a 9.38% surge in the KOSPI in December, the rally was fueled by foreign speculative flows into tech stocks, not domestic liquidity or earnings momentum. Korean households face rising import costs, eroding real incomes, while firms delay capex amid uncertainty over U.S.-China trade tensions and semiconductor cycles. Money may be circulating, but it is not translating into durable economic energy.

Australia, meanwhile, records a robust money growth in the group with M3 up 7.11%. Yet this too is misleading. Credit expansion remains tightly linked to bank risk appetite and resource-sector collateral, not broad-based private demand. The mining boom and recent indication of funds increasing hedging support AUD strength, but five-year government yields rising to 4.4%, reflecting persistent inflation concerns and spillover from global bond selloff. Equity markets have remained mostly steady with rally since November low recovering about half the peak drawdown of 8%. But the upward momentum lags the robust money growth.

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The common thread across all four economies is clear: more money does not mean more economic life. China suffers from a savings glut and weak consumption confidence. Japan remains trapped in a low-velocity equilibrium. Korea battles currency-driven cost-push pressures. Australia leans on commodity rents rather than organic demand. In each case, monetary policy is bumping against the limits of what it can achieve without deeper structural reform in labor market flexibility, corporate governance, fiscal coordination, or domestic demand rebalancing.

The RCEP region, for all its trade integration and supply chain cohesion, lacks a unified monetary-credit-confidence triangle. Liquidity is fragmented, policy transmission is uneven, and confidence is fragile. Without stronger domestic engines including wage growth in Japan, consumption in China, tech investment in Korea, and non-resource demand in Australia, the region will remain vulnerable to external liquidity shocks, to a smaller degree given the size of China being in the center and its willingness to step in during crisis.

Economy: Promise and Peril of None-ASEAN RCEP Countries

December 2025 revealed a region in transition. Across China, Japan, South Korea, and Australia, the none-ASEAN economies are increasingly bound not by shared policy alignment but by the quiet logic of supply chain realignment, divergent inflation paths, and asynchronous policy cycles. The result is a deeply interlinked yet internally strained economic bloc, where external demand provides a fragile floor, domestic consumption remains tepid, and structural transformation faces headwinds from within.

China's manufacturing PMI edged back above 50 at 50.1, surprising to the upside by 0.2 ppt and marking its first expansion since April. Industrial output grew 5.2% year-on-year, driven by equipment manufacturing and high-tech sectors. Yet beneath this surface resilience lies persistent weakness. Private investment fell 6.4% yoy, while property development investment plunged 17.2%. Residential completions dropped 14.2%, signaling continued housing sector deleverage. Consumption remains subdued: retail sales rose just 0.9%, lowest since pandemic time, with goods retail up only 0.7%. Short-term support from "trade-in" subsidies and Lunar New Year stockpiling masks deeper fatigue in durable goods demand. Inflation tells a similar story. Core CPI remains inert, while headline CPI's modest 0.8% rise stems largely from gold and targeted subsidies rather than broad-based demand. Meanwhile, PPI sits at -1.9%, underscoring persistent industrial deflation. The anti-involution policy did help avert a continued slide, as the PPI recovered from mid-year's -3.6%, the measure may only turn positive by 3Q 2026 at current pace.

South Korea, positioned as East Asia's export nexus, shows stronger momentum. In the first 20 days of December, exports to China hit $8.45 billion, rising sharply yoy, consistent with a much warner and improved bilateral relationship. Polysilicon shipments alone reached $1.88 billion, double the prior year, feeding China's solar and semiconductor ambitions.

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Though full PMI data is pending, export strength suggests manufacturing remains robust. Corporate capex expectations are stable, and household spending grew 1.82%. The housing price expectation index climbed to 121, hinting at restored confidence in asset values. Yet like China, Korea's recovery is externally anchored. Domestic demand still rides on the coattails of Chinese and global tech orders, negatively impacting 4th quarter GDP with -0.3% seasonally adjust qoq and 1.5% yoy below consensus 1.8%.

Japan presents a more complex picture. Composite PMI in December slide 0.4 ppt from November, but household spending rose a surprising 2.9% in December, against -1.0% consensus and -3.0% last month. Corporate pricing power holds: PPI rose 2.4% year-on-year, though off recent highs. Trade is mixed, import growth ticked up 4 ppt while exports weakened by 1 ppt from November, adding further pressure to the yen. Spending growth due to price effect has weak sustainable power as wages remain stagnant, demographics weigh heavily, and consumer sentiment lags.

More critically, political tensions with China are now biting into the real economy. In December, Chinese tourist arrivals to Japan collapsed by 45% year-on-year, falling to just 330,000 visitors. This was no market fluctuation, it was a direct response by China to Japanese Prime Minister Sanae Takaichi's comments on Taiwan in November, which triggered Beijing's quiet but effective call to limit travel. The impact is material. In Q3 2025, Chinese tourists spent $3.7 billion in Japan, 22% more per capita than other foreign visitors. They filled hotels, bought electronics, and lined up at drugstores in Osaka and Tokyo. Their sudden absence has left a void that European and Southeast Asian tourists cannot fully fill, given differences in spending patterns and group-tour dynamics. While Japan's total inbound tourism exceeded 42 million in 2025, setting a record, the loss of its highest-value segment threatens service-sector revenues and local economies reliant on Chinese foot traffic. The government acknowledges the gap but insists it is being offset. That may hold for headline numbers, but not for margins. With GDP already contracting in Q3 and core inflation eroding real wages, this tourism shock adds another drag on growth heading into 2026, potentially a headwind for Nikkei and tailwind for JGBs to reverse course.

Australia, meanwhile, remains tethered to China's industrial pulse. December manufacturing data came in 0.6 ppt lower than November while service PMI barely barged. December trimmed mean dropped slightly to 3.2%. Together with slightly positive employment data print, the RBA will most likely stay put for more data. The economy leans heavily on resource exports, with over 40% of total shipments going to China, weak property sector in China will unlikely offer strong push for Australia economy, so we see market pricing in two more hikes as being too aggressive a reaction to previous inflation.

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Overall, the regional architecture is clear. Two parallel chains now define RCEP integration: a “technology corridor” running from China through Korea to Japan, and a “resource artery” linking China to Australia. China exports semiconductor equipment and electronic components to Korea; Korea ships advanced materials and precision instruments to Japan; Japan sends industrial machinery and parts back to China. Simultaneously, Australia feeds China’s factories with iron ore and copper. This dual-track system has proven remarkably resilient amid U.S.-China decoupling. It is not built on ideology, but on mutual necessity. The complementary nature of RCEP offers potential pareto improvement for countries in the pact.

Looking ahead, AI-driven demand for copper, silver, lithium, and rare earths will deepen these linkages. Yet structural vulnerabilities persist. China’s consumption-led rebalancing is slow. Japan’s fiscal space is constrained by debt exceeding 250% of GDP. Korea’s export dependence leaves it vulnerable to global tech slowdowns. Australia’s inflation remains stubborn. All four economies share a common dilemma: growth is propped up by external demand, but transformation requires internal renewal. Without stronger domestic engines, the bloc remains exposed to shocks beyond its control.

Monetary policy divergence adds another layer. If the Fed cuts rates earlier than expected in 2026, Asian currencies could stabilize, boosting export competitiveness. But this relief may be fleeting. U.S.-China tech decoupling continues to fracture supply chains. Geopolitical flashpoints, from Taiwan to the Diaoyu Islands and to the south China sea, threaten to disrupt trade flows. And while RCEP reduces tariffs, non-tariff barriers and regulatory fragmentation persist with Trump throwing sands into the gear with poison clauses in its bilateral trade deals targeting China.

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End notes

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