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Highlights

- **CNY seems to be following a basket peg, with the USD Meltdown having been a helpful test; we still see weakness toward YE2018 on credit problems; de-risking is not de-leveraging**
- **February trading has continued with interest to sell USD/RMB, pushing CFETS higher**
- **Forward forward pay has a positive carry, while vols may have shifted permanently higher**

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CNY: Review and Outlook

Trader Color. CNY appreciated by a record percentage vs. USD in January, mainly driven by the weak USD along with corporate USD/CNY selling and long cover flows. We have not seen firm action by PBOC to interfere with the fast appreciation, including in the daily fix. USD/CNY may be mispriced for the moment but corporate needs to sell USD/CNY at 6.3 make it a good level to sell on rallies if the USD index remains bearish. In forwards, funding flows are still interested in paying 3, 6, 9 months and 1 year, steepening the curve. A lower t/n level recently restrained the upside.

All-time monthly strengthening but basket more stable, as were rates. Renminbi strengthened by a monthly record percentage vs. USD – exceeding even its gain after the July 2005 de-peg – as USD/CNY fell 3.40% from 6.5120 to 6.2855 in terms of London closes. Movement in the CFETS Index (explained below) was far more muted, rising from 94.85 to 95.71 at pixel time. PBOC continued best efforts at keeping onshore yields corralled.

Forecasts have to be adjusted downward due to the USD meltdown. This will probably not be the last USD meltdown we witness in our lifetime. With spot below our last lower bound clearly forecasts have to be and have been adjusted. But though cosmetically it may seem all we've done is shift previous forecasts down 2,000 pips, there is a deeper logic.

USD/CNY has been looking a lot more like USD/SGD. A simple comparison between USD/SGD and USD/CNY, normalized since 1 April last year (so during the Japanese fiscal year) shows a tight correlation that can be instructive. Because we've long known SGD is managed as a basket peg and the last two MAS policy statements during this juncture called for a continuation of 0% appreciation with the same bandwidths and center point. That sounded eerily similar to our call last year for CFETS to trade between 93-95 with no trend. A basket peg can be considered a filter: As major currencies gyrate, sometimes wildly, a basket filters such influences down to a moderated path for the local currency – in this case either USD/SGD or USD/CNY – deemed appropriate for the local economy. A basket peg for China had long been seen (eg, by BIS) as perhaps a more appropriate form of monetary policy than simply anchoring renminbi to the dollar (early on after de-peg, China may have also consulted MAS).

China appears to have started to follow a true basket peg. The USD meltdown we witnessed to begin 2018 has been a good test of China's resolve to stick with a basket. To their credit, exchange authorities have stuck to their guns. Our prior guess for 2018 was a CFETS trading between 94-96, again with no trend. The revised CNY forecasts in this issue for 1-3Q18 are all consistent with CFETS staying within the 94-96 corridor; as we approach year-end we still see the return of credit problems as stimulating more outflows. Onshore feels short, perhaps encouraged by official circles with some banks seeking much lower levels. We should know in the next month whether there's a positive crawl (stronger) to this peg (we assume not); that's what will be required to get to much lower USD/CNY levels, but not till year-end. We're still not seeing the return of the capital inflows of old; this move feels more like prop positioning.

Credit problems will show up in interest rates but not exchange rates. It seems appropriate to note for the record our error in thinking the credit problems we have highlighted since late Summer 2015 will show up in exchange rates; they won't, for most of 2018, mainly because of effective capital controls. They have and will show up in interest rates.

Slower credit growth is not exactly the same as de-leveraging. The last three months have seen authorities implement de-risking. Trend growth of new bank loans and (Somewhat) Total Social Financing has slowed, immediately after the 19th Party Congress ended. There is press talk that unlike previous Januarys, new lending is also slowing suggesting credit quotas are being taken up less rapidly. That China has de-levered without rising yields may reflect an underlying effort to tamp down credit demand. But we also have news local governments will issue a lot more special bonds in 2018, a product which only started from last September. This is a sign the local debt re-profiling led by former Finance Minister Lou from 2014 on did not and has not solved the problem, with Lou adding his voice to those worried about a Minsky Moment for China. A key litmus test awaits in 2Q18 if de-leveraging slows growth, placing a tough choice before top leaders. Whenever a credit event in the past had given leaders an opportunity to restructure, they have always backed away.

CNY: Onshore RMB

CNH: Offshore RMB

CNY Snapshot						5-Feb-18					
Tenor	Last		Last Month Range			Tenor	Last		Last Month Range		
	Bid	Ask	Mid	Min	Max		Bid	Ask	Mid	Min	Max
Fix			6.3019	6.3267	6.5207	Fix			6.2891	6.3280	6.5284
Spot	6.3009	6.3015	6.3012	6.2845	6.5385	Spot	6.3112	6.3113	6.3113	6.2838	6.5465
O/N	-4.80	-4.70	-4.75			O/N	-2.00	4.00	1.00		
T/N	-4.30	-4.30	-4.30			T/N	-2.00	4.00	1.00		
1W	13.03	13.70	13.36			1W	7.44	11.94	9.69		
1M	111.20	114.70	112.95			1M	96.69	101.69	99.19		
2M	232.70	238.70	235.70			2M	222.69	242.69	232.69		
3M	324.70	325.70	325.20			3M	323.69	343.69	333.69		
6M	598.70	607.70	603.20			6M	623.69	643.69	633.69		
9M	856.89	863.70	860.29			9M	906.53	931.53	919.03		
12M	1110.70	1116.20	1113.45			12M	1158.69	1188.69	1173.69		
2Y	2083.70	2163.70	2123.70			2Y	2103.69	2173.69	2138.69		
3Y	3233.70	3293.70	3263.70			3Y	2823.69	2963.69	2893.69		

CNY Curve										5-Feb-18		
Tenor	Outrights (mid)			Implied Rates (% mid)			NDS					
	Onshore DF	NDF	Diff (pips)	Onshore DF	NDF	Diff (%)	Bid	Offer	Mid			
Spot	6.3012	6.3012										
O/N	6.3014											
T/N	6.3014											
1W	6.3032	6.3155	-123.34	3.3620	9.2578	-5.8958						
1M	6.3131	6.3280	-148.75	4.2531	6.4707	-2.2177						
2M	6.3254	6.3435	-181.00	4.1080	5.3354	-1.2274						
3M	6.3344	6.3550	-206.50	3.9548	5.0977	-1.1429						
6M	6.3622	6.3855	-233.50	3.9281	4.5818	-0.6538						
9M	6.3879	6.4133	-253.91	3.9185	4.4305	-0.5120						
12M	6.4132	6.4405	-273.25	3.9310	4.3505	-0.4195	4.45	4.65	4.55			
2Y	6.5142	6.5405	-263.00	4.0393	4.2208	-0.1815	4.10	4.30	4.20			
3Y	6.6282	6.6280	2.00	4.2234	4.2342	-0.0107	4.10	4.30	4.20			

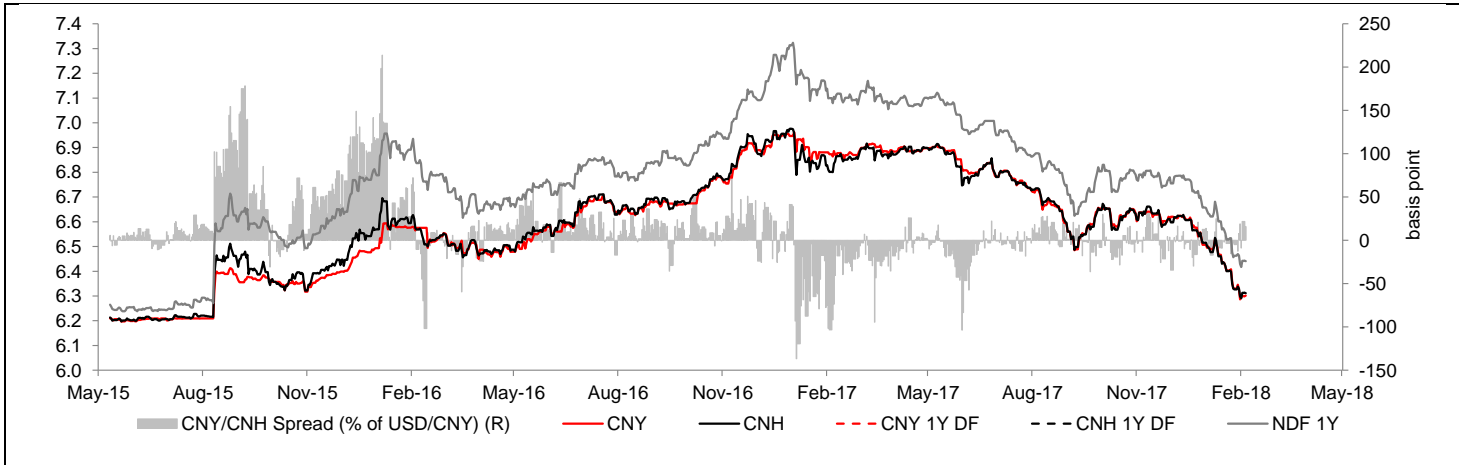
CNH Curve										5-Feb-18		
Tenor	Outrights (mid)			Implied Rates (% mid)			CCS					
	Offshore DF	NDF	Diff (pips)	Offshore DF	Depo	Diff (%)	Bid	Offer	Mid			
Spot	6.3113	6.3012										
O/N	6.3114											
T/N	6.3114											
1W	6.3129	6.3155	-26.50	3.0895	3.0000	0.0895						
1M	6.3218	6.3280	-62.00	3.9385	4.1000	-0.1615						
2M	6.3352	6.3435	-83.50	4.0294	4.3000	-0.2707						
3M	6.3453	6.3550	-97.50	3.9778	4.4000	-0.4223						
6M	6.3753	6.3855	-102.50	3.9749	4.5000	-0.5251	3.80	3.95	3.87			
9M	6.4038	6.4133	-94.66	3.9963	4.5000	-0.5037	3.88	3.98	3.93			
12M	6.4293	6.4405	-112.50	3.9860	4.6500	-0.6641	3.91	3.96	3.94			
2Y	6.5258	6.5405	-147.50	4.0485			3.95	4.01	3.98			
3Y	6.6013	6.6280	-267.50	4.0326			3.96	4.02	3.99			

USD/CNY Onshore Implied Volatilities (in %) 5-Feb-18						USD/CNH Implied Volatilities (in %) 5-Feb-18						USD/CNY Offshore Implied Volatilities (in %) 5-Feb-18					
Tenor	Mid 20D Z-					Tenor	Mid 20D Z-					Tenor	Mid 20D Z-				
	ATM	Score	25C	25P	25DRR		ATM	Score	25C	25P	25DRR		ATM	Score	25C	25P	25DRR
1W	5.32	1.65	5.34	5.53	-0.19	1W	6.64	1.43	6.92	6.63	0.29	1W	6.28	1.44	6.46	6.27	0.19
2W	5.28	1.76	5.31	5.41	-0.11	2W	6.30	1.33	6.62	6.28	0.34	2W	5.97	1.49	6.27	5.98	0.29
3W	5.18	1.65	5.25	5.33	-0.09	3W	5.92	1.24	6.26	5.90	0.36	3W	5.79	1.14	6.14	5.78	0.37
1M	5.17	1.54	5.30	5.35	-0.05	1M	6.16	1.67	6.56	6.15	0.42	1M	5.95	1.60	6.30	5.93	0.38
2M	5.16	1.64	5.33	5.36	-0.03	2M	6.14	1.68	6.57	6.10	0.47	2M	5.97	1.69	6.39	5.93	0.46
3M	5.01	1.44	5.22	5.17	0.05	3M	6.14	1.74	6.60	6.09	0.52	3M	5.96	1.71	6.42	5.91	0.51
6M	4.82	1.23	5.13	4.97	0.16	6M	6.14	1.77	6.67	6.08	0.60	6M	5.96	1.73	6.48	5.91	0.58
1Y	4.92	1.48	5.24	5.00	0.24	1Y	6.16	1.81	6.87	6.12	0.76	1Y	5.97	1.79	6.63	5.92	0.71
18M	4.99	1.51	5.69	5.13	0.56	18M	6.36	1.94	7.15	6.32	0.83	18M	6.17	1.84	6.97	6.11	0.87
2Y	5.05	1.12	5.89	5.17	0.72	2Y	6.48	2.00	7.35	6.44	0.91	2Y	6.30	1.84	7.17	6.23	0.94

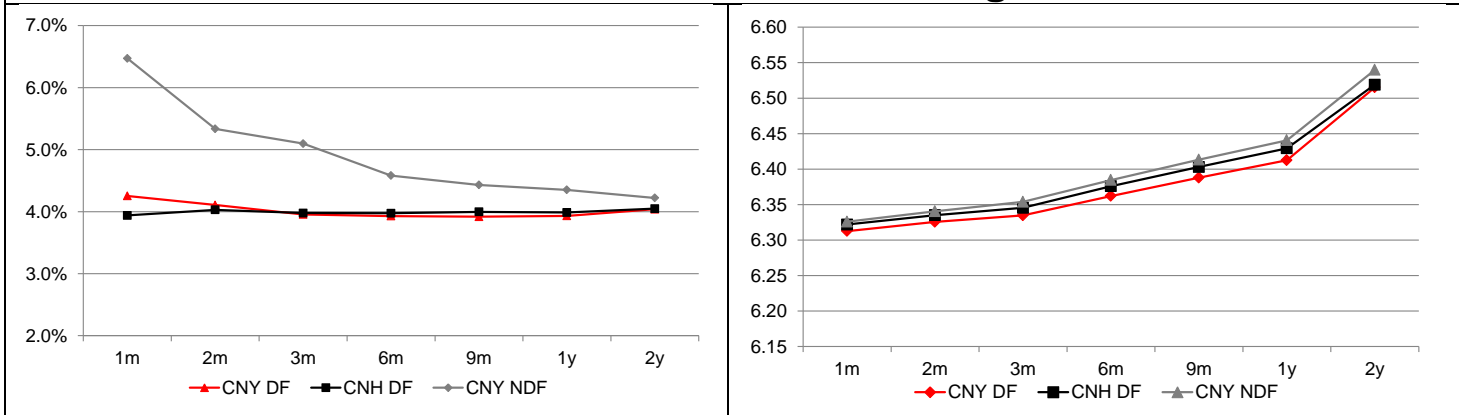
Source: Bloomberg, MUFG Bank

CNY: Onshore RMB

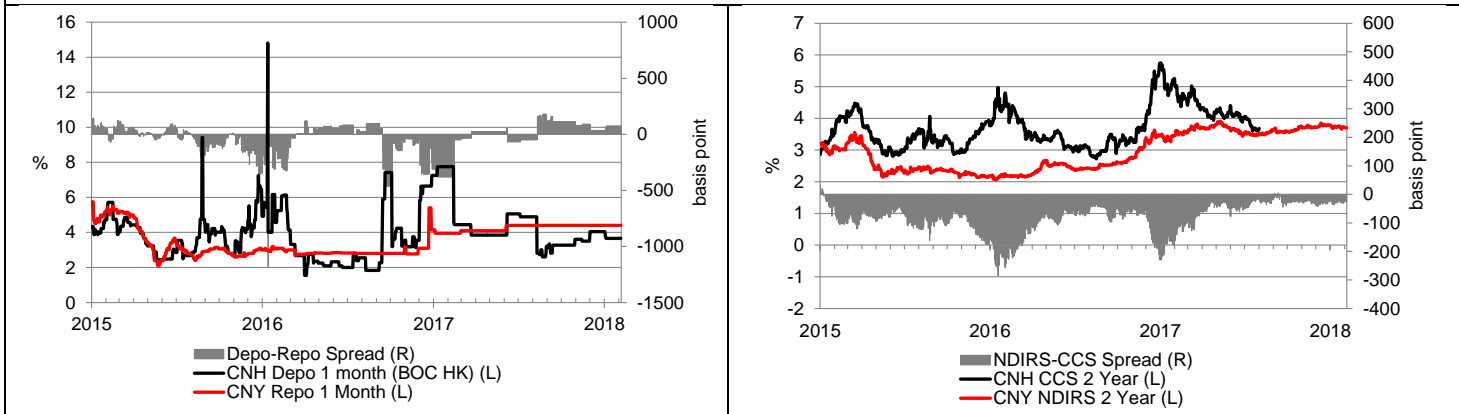
CNH: Offshore RMB



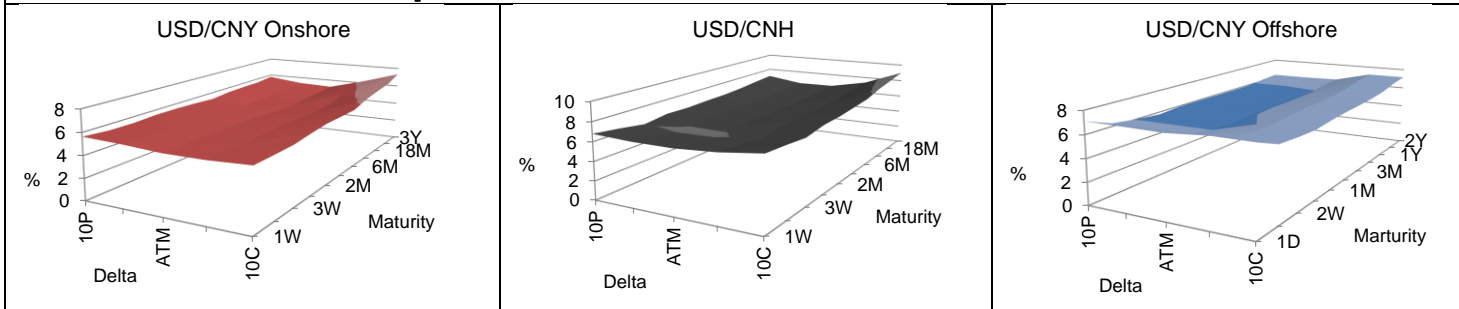
RMB Curves: Rates vs. Outrights



RMB Rates: Offshore vs. Onshore



RMB Implied Volatilities: Offshore vs. Onshore



Source: Bloomberg, MUFG Bank

OUR LATEST FORECASTS: CNY/CNH

	Spot close 31.01.18		Q1 2018	Q2 2018	Q3 2018	Q4 2018
USD/CNY	6.2920	Our forecasts	6.3500	6.4000	6.4500	6.5500
		Forward prices	6.3159	6.3541	6.3808	6.4090
USD/CNH	6.2985	Our forecasts	6.3500	6.4000	6.4500	6.5500
		Forward prices	6.3149	6.3455	6.3704	6.3957

Source: Bloomberg, MUFG Bank (Last update on 5 February 2018)

CNH: Review and Outlook

Trader Color. In January, CNH appreciated 3.5% vs. USD as USD/CNH dropped from 6.5000 down to 6.2800. 1-year DF trended gradually lower to +1140 from +1300, just +20pips away from onshore forwards. Funding in CNH remained very ample. Corporate selling drove the spot collapse, while there was some hedge fund RHS interest. USD/CNH spot is expected to be heavy before Chinese New Year as some corporates may need to square USD before the 7-day holiday.

Spot. The USD Meltdown of January has been joined by the Equity Meltdown of February. As VIX doubled in a day, this would normally be risk off but February trading has begun with continued interest in selling USD/RMB. Fixes stronger brought CFETS up to near 97. If CFETS was a true reference that implies authorities want RMB even **stronger** vs. its basket. One interpretation could be that authorities – unlike the framework laid out in the CNY Section – don't care much about CFETS and just want to get to some level like 6.20 in a hurry. Contrary evidence have included daily fixes weaker than models and some agent bank bidding. Of course, we can also be wrong with respect to the bandwidth and the rate of crawl in our formulation. Past experience suggests there may be more policy guidance after the Spring Festival, with the first trading session on 22 February.

Forwards/Rates. This year, pre-Chinese New Year funding seems ample, but some pre-holiday tightness may still be experienced. Forward-forward pay is a positive carry, helping to keep the offshore and onshore curves close together. On CCS we see dim sum flows and surplus funds selling; the only payers appear hedge funds looking for roll ups (eg, 3Y2Y).

Options. PBOC's willingness to follow a basket peg may imply higher USD/CNY volatility so implied vols have shifted up, putting us into a new, higher volatility regime.

Products. Yuan appreciation has, predictably, attracted return of business interest. Chinese corps are aggressively raising unhedged funds offshore. Dim sum interests are also rising but coming up on the 1-decade mark, popular tenors remain frozen at the 3-year, a discouraging sign for this market's longevity. Official interest continues on re-promoting internationalization of RMB in 2018. Eg, authorities are pushing onshore CNY payment champions offshore into Hong Kong. We still wonder if offshore netizens will be as willing to surrender privacy rights as onshore. The renegotiated ECB swap line did not increase.

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