Chinese renminbi

	Spot close 29.03.18	Q2 2018	Q3 2018	Q4 2018	Q1 2019
USD/CNY	6.2904	6.3400	6.3900	6.4500	6.5300
USD/HKD	7.8481	7.8500	7.8400	7.8300	7.8200
		Range	Range	Range	Range
USD/CNY		6.2000-6.4000	6.2400-6.4900	6.3000-6.5500	6.3500-6.6000
USD/HKD		7.8000-7.8500	7.8000-7.8500	7.8000-7.8500	7.8000-7.8500

MARKET UPDATE

Stronger; tiny hike in OMO rates achieved

Renminbi traded mostly within a narrow range till a spurt of late-month strengthening left USD/CNY at 6.2904 compared with February's London close of 6.3335. CFETS had been also weaker till late but ended a little stronger. PBOC made the tiny +5bp hike to RRP and SLF rates it signalled in February, the mildest possible reaction to Fed hike #6. Markets expect another +5bp reaction in 2Q18 to hike #7.

OUTLOOK

US-China trade seems prime driver for Chinese exchange rate policy

A 2-day sprint down in USD/CNY broke our 1Q18 lower bound and also the 6.25-6.36 range discussed last month (lo = 6.2418). Just as elections seem to be playing an inordinate role in US President Trump's decisions, the nearest proximate motivator for recent Chinese exchange rate management may be US-China trade tensions. It appears more likely a part of China's strategy towards threatened US tariffs and protection is, again, via a stronger currency and offers to open up financial services – ie, 2005 redux. The Chinese may find such well-worn tactics a harder sell as US businesses have hardened attitudes; Wall Street may not swing the argument alone. Upcoming trade/investment talks seem complicated and we think it could take a decade for Section 301 talks to conclude. Along the way, an even stronger currency plus official dominance in renminbi markets bring down levels of USD/CNY forecasts but we retain an upward trajectory. Though we have 6.34 now at 2Q18, suffice to say we're not expecting a straight line.

We remain watchful for export moderation and a smaller growth contribution from net exports

Though quite late on our part, credit is due to Chinese authorities who stabilized growth in 2017, what has been the first and most key element in our framework for stabilizing capital flows. The official lean now seems to be for growth to moderate very gradually and capital outflow controls to be loosened very, very gradually, which implies a small bias to the upside for USD/CNY if Big Dollar is stable. If last year's growth was due to credit, and if corralling risks means a credit squeeze, logically growth should slow. That's one reason for a weaker currency. We remain watchful for moderation in Chinese export growth rates as very good global growth moderates and may have driven commodity prices lower. A trade surplus shrinkage should be joined by more overseas tourist spending due to a stronger CNY, leading a smaller contribution to growth from net exports. Property sales and construction in some (but not all) parts of the country shows retreat, and prices may decline if smaller developers are forced to clear inventory. If authorities decide they can't countenance slower growth and turn credit taps back on, that worsens the already heavy debt problem and provides another reason for the currency to weaken.

Actual tariffs = stronger USD?

Finally, though nowhere in markets yet, should tariffs be actually implemented, the best trade/macro models we know of would suggest USD could even strengthen! (The easiest intuition: How do you offset a tariff? A weaker currency comes to mind.)

	Interest Rate Close	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.60%
7-Day Repo Rate	3.50%	4.00%	3.50%	4.50%	4.50%
5-Year Yield	3.66%	3.25%	3.75%	4.25%	4.50%

** Interest rate assumptions incorporated into BTMU foreign exchange forecasts.*

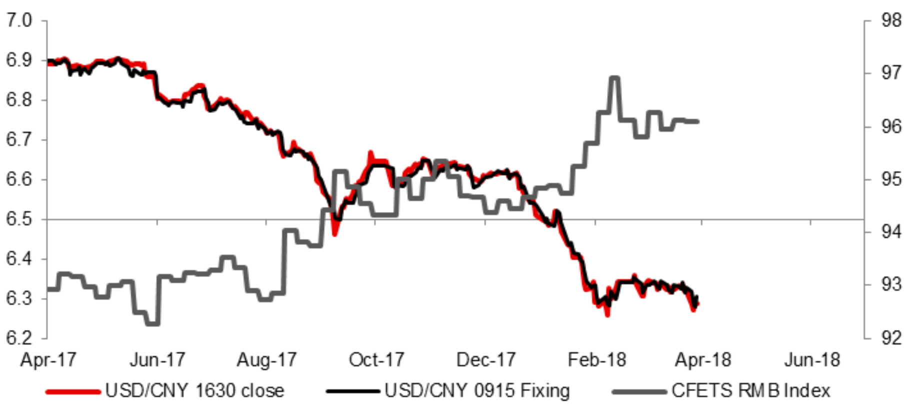
INTEREST RATE OUTLOOK

Interest differentials will play a bigger role and credit spreads have widened

As Fed normalization progresses, US-China interest differentials should play a bigger role in FX/rates from 2H18; attractions of holding USD will increase for Mr. and Mrs. Chen so PBOC hikes in 1Q19. It's still 2018 and not 2013 for the capital account, as a stable currency co-exists with what still looks like USD30-50bn of flow out of the country every month. That pace may matter more if the trade surplus shrinks. Safe haven government bond yields have indeed declined as posited in January, but towards Fed hike #7 in June there may be a limit to official nudging. There remains much to refinance, eg CNY800bn+ of puttable bonds this year and even more next year. Onshore credit spreads have already returned to near-record wides, happening faster than what we'd expected. Our 4Q18-1Q19 currency forecasts assume continuation of a murky, non-transparent workout of bad debts in the system (eg, we are pretty certain there have been unpublicized cash calls for smaller unlisted banks, but we are not certain about losses, haircuts, etc.). We would consider changing forecasts if there is more transparency; alternatively, no transparency is a bad sign.

Paying attention to Mr. Trump

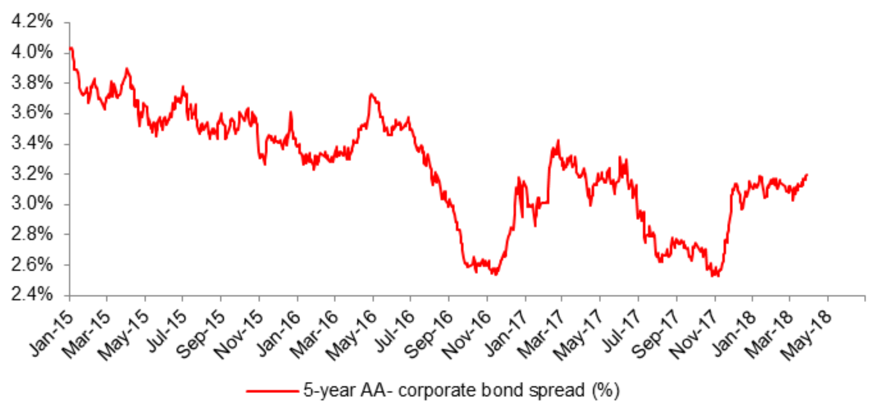
CHINA: INDICATORS OF CURRENCY PREFERENCES



Source: Bloomberg, MUFG Bank

Widening out again

CHINA: THE AA- CORPORATE BOND SPREAD



Source: CEIC, MUFG Bank

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