Chinese renminbi

	Spot close 31.08.18	Q3 2018	Q4 2018	Q1 2019	Q2 2019
USD/CNY	6.8299	6.9000	6.9500	7.0000	7.0500
USD/HKD	7.8488	7.8450	7.8350	7.8250	7.8150
		Range	Range	Range	Range
USD/CNY		6.6000-6.9999	6.7000-7.0500	6.7000-7.0500	6.7500-7.1000
USD/HKD		7.8000-7.8500	7.8000-7.8500	7.8000-7.8500	7.7900-7.8400

MARKET UPDATE

Essentially flat; PBOC is shoveling funds to local governments

It was nip-and-tuck on August's final trading day but renminbi essentially finished flat on-month with USD/CNY up fractionally to 6.8299 from July's 6.8255 London close. To stabilize renminbi required a 20% surcharge, the countercyclical factor (both of which were reprised) and trumpeted news about a trade deal abroad. Following several months of de-leveraging, PBOC is now shoveling funds to banks to hoover up about CNY1trn of newly issued local government bonds.

OUTLOOK

USD/CNY still higher in prospect, driven by narrowing rate differentials

We haven't changed our depreciation view despite a policy-laden month, because we still think the primary driver behind USD/CNY remains interest rate differentials. Chinese onshore rates will remain low even as the Fed heads to hike #8 and #9 before the year is out. The difference in USD/CNY vs. USD/SGD trading patterns from July is a reflection of Chinese interest rate policy; USD/CNY will re-discover, we think, the old adage you don't fight the Fed. On the trade front it appears President Trump may escalate with tariffs on USD200bn of Chinese exports.

Official China thinks it can beat the Mundell impossibility theorem

China has become the latest test case for the Mundell (who is well-known onshore) impossibility triangle, as official behavior connotes confidence authorities can (1) control the exchange rate and (2) control the interest rate, all with a (3) partially open capital account (one add: officials also don't seem to want foreign reserves much below USD3trn).

But that may require more capital controls

The good news is when we recently floated onshore the idea of USD/CNY above 7 we found much less panic than expected. That suggested there won't be the sort of late 2015 – early 2016 panicked outflows if USD/CNY rises above 7, perhaps because onshore is at least partially hedged. But since we're traditionalists (ie, we believe Mundell), we suspect to try to do the impossible authorities may have to squeeze capital controls tighter (as they did when they limited fund outflows from a Shanghai FTA which was promoted as a new paragon of capital account openness only months prior).

To stabilize the currency, only direct actions and higher interest rates matter

We're not impressed with the Chinese macroprudential measures and think their global impact is exaggerated. The 20% RHS surcharge is like raising the cost of prescription drugs and then trying to convince the patient his disease doesn't exist. Even banning forwards markets outright doesn't help; ask Indonesia. Onshore press hinted PBOC would take countercyclical measures, and then it was confirmed (not limited to the CCF itself, we think). The CCF is sand in the wheel, meant to slow but not change the direction of spin. Our past investigations found little evidence CCF made much of a difference to spot in periods when it was operational compared with periods when it was not. One actual PBOC rate hike, we'd guess, might be worth 10 CCFs. That's not saying PBOC couldn't make a significant difference if it was to take "countercyclical actions," but that would require losing reserves.

	Interest Rate Close	Q3 2018	Q4 2018	Q1 2019	Q2 2019
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.35%
7-Day Repo Rate	2.66%	2.75%	3.00%	4.25%	4.50%
5-Year Yield	3.38%	3.50%	3.60%	3.60%	3.90%

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

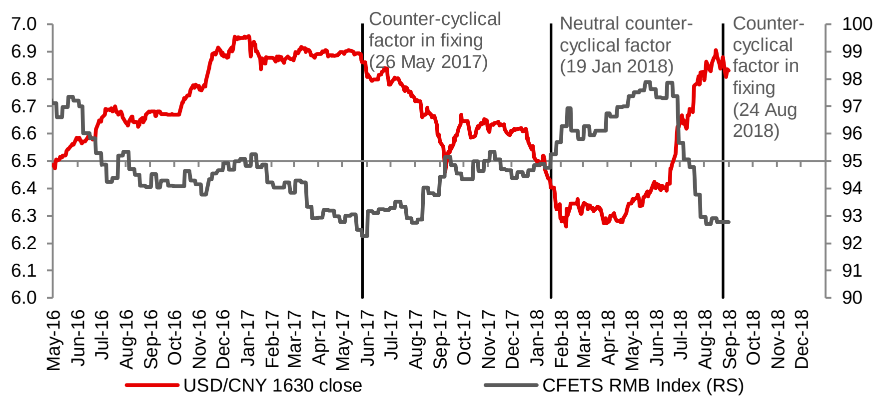
INTEREST RATE OUTLOOK

All paths point to monetary loosening

Our views are unchanged: Spirited efforts to lower money market rates but with limited benefits for credit. Until just a few weeks ago, official China had crowed about slowing down credit *growth* (credit itself was still growing). But there's nothing so determined as the government when lowering interest rates. *Caixin* reported in the 25 days following a 23 July State Council meeting, unleashed local governments sold bonds equivalent to half of the previous YTD issuance. All to support infrastructural approvals which in July *quadrupled* over June (all quality projects, we're sure). Local governments have begun to fess up to off-balance sheet debt, which in some cases are 4X what's on the books. Banks have also been encouraged to roll over small businesses which apparently cannot handle interest rates any higher than 4.77%. A Bloomberg study of defaulted bonds found a recovery rate of less than 20%.

We don't think the CCF made a difference by itself

USD/CNY, CFETS AND THE COUNTERCYCLICAL FACTOR



Source: Bloomberg, CFETS, MUFG Bank

The central bank driving it lower

CHINA: PBOC REAL LENDING RATE

Source: Bloomberg, MUFG Bank

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