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Highlights

- **In August, a large amount of policy interference thrown in**
- **CNH rates have been recently squeezed higher from time to time**
- **Our weaker currency view, however, remains intact, amid low onshore interest rates and a Trump trade re-load**
- **A weaker yuan has yet to weigh on global use of RMB**
- **Policy-wise, China announced a 3-year tax exemption for foreign bonds investors**
- **Yet, PBOC former Governor Zhou cautioned against rapid internationalization of RMB**

CNY: Review and Outlook

Trader Color. Spot CNY kept an uptrend, driven by the strong US dollar in the first half of August; but stopped later amid the implementation of PBOC's counter measures. We saw some selling needs of local names near the high of August as well as after the re-introduction of counter-cyclical factor in the yuan fixing. Growing expectation that PBOC would take further action against a weaker yuan triggered adjustments in the latter half of the month. With 20% RHS surcharge, curves went further down, but gradually returned to the opening level of the month amid no key liquidity changes in the money market.

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.

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 and even further on the remaining USD267bn.

Official China thinks it can beat the Mundell impossibility theorem. China has become the latest test case for the Mundell 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: foreign reserves to stay around 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 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.

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%.

CNY: Onshore RMB

CNH: Offshore RMB

| CNY Snapshot | | | | | | 11-Sep-18 | | | | | | CNH Snapshot | | | | | | 11-Sep-18 | | | | | |
|--------------|--------|--------|------------------|--------|--------|-----------|---------|---------|------------------|--------|--------|--------------|---------|---------|------------------|--------|--------|-----------|---------|---------|------------------|--------|--------|
| Tenor | Last | | Last Month Range | | | Tenor | Last | | Last Month Range | | | Tenor | Last | | Last Month Range | | | Tenor | Last | | Last Month Range | | |
| | Bid | Ask | Mid | Min | Max | | Bid | Ask | Mid | Min | Max | | Bid | Ask | Mid | Min | Max | | Bid | Ask | Mid | Min | Max |
| Fix | | | 6.8488 | 6.7942 | 6.8946 | Fix | | | 6.8704 | 6.8060 | 6.9212 | Fix | | | 6.8704 | 6.8060 | 6.9212 | Fix | | | 6.8704 | 6.8060 | 6.9212 |
| Spot | 6.8706 | 6.8722 | 6.8714 | 6.7863 | 6.9340 | Spot | 6.8812 | 6.8812 | 6.8812 | 6.7815 | 6.9590 | Spot | 6.8812 | 6.8812 | 6.8812 | 6.7815 | 6.9590 | Spot | 6.8812 | 6.8812 | 6.8812 | 6.7815 | 6.9590 |
| O/N | -5.27 | -5.27 | -5.27 | | | O/N | -3.00 | 9.00 | 3.00 | | | O/N | -3.00 | 9.00 | 3.00 | | | O/N | -3.00 | 9.00 | 3.00 | | |
| T/N | -5.70 | -5.70 | -5.70 | | | T/N | -2.00 | 10.00 | 4.00 | | | T/N | -2.00 | 10.00 | 4.00 | | | T/N | -2.00 | 10.00 | 4.00 | | |
| 1W | 1.58 | 1.58 | 1.58 | | | 1W | 33.87 | 38.37 | 36.12 | | | 1W | 33.87 | 38.37 | 36.12 | | | 1W | 33.87 | 38.37 | 36.12 | | |
| 1M | 20.13 | 22.13 | 21.13 | | | 1M | 123.12 | 153.12 | 138.12 | | | 1M | 123.12 | 153.12 | 138.12 | | | 1M | 123.12 | 153.12 | 138.12 | | |
| 2M | 25.13 | 26.63 | 25.88 | | | 2M | 228.32 | 240.32 | 234.32 | | | 2M | 228.32 | 240.32 | 234.32 | | | 2M | 228.32 | 240.32 | 234.32 | | |
| 3M | 28.13 | 28.13 | 28.13 | | | 3M | 313.12 | 327.12 | 320.12 | | | 3M | 313.12 | 327.12 | 320.12 | | | 3M | 313.12 | 327.12 | 320.12 | | |
| 6M | 38.13 | 38.13 | 38.13 | | | 6M | 517.22 | 533.22 | 525.22 | | | 6M | 517.22 | 533.22 | 525.22 | | | 6M | 517.22 | 533.22 | 525.22 | | |
| 9M | 43.13 | 43.13 | 43.13 | | | 9M | 703.22 | 721.22 | 712.22 | | | 9M | 703.22 | 721.22 | 712.22 | | | 9M | 703.22 | 721.22 | 712.22 | | |
| 12M | 63.13 | 63.13 | 63.13 | | | 12M | 885.62 | 910.62 | 898.12 | | | 12M | 885.62 | 910.62 | 898.12 | | | 12M | 885.62 | 910.62 | 898.12 | | |
| 2Y | 188.13 | 193.13 | 190.63 | | | 2Y | 1578.12 | 1728.12 | 1653.12 | | | 2Y | 1578.12 | 1728.12 | 1653.12 | | | 2Y | 1578.12 | 1728.12 | 1653.12 | | |
| 3Y | 198.13 | 393.13 | 295.63 | | | 3Y | 2369.12 | 2449.12 | 2409.12 | | | 3Y | 2369.12 | 2449.12 | 2409.12 | | | 3Y | 2369.12 | 2449.12 | 2409.12 | | |

| CNY Curve | | | | | | | | | | 11-Sep-18 | | |
|-----------|-----------------|--------|-------------|-----------------------|---------|----------|------|-------|------|-----------|--|--|
| Tenor | Outrights (mid) | | | Implied Rates (% mid) | | | NDS | | | | | |
| | Onshore DF | NDF | Diff (pips) | Onshore DF | NDF | Diff (%) | Bid | Offer | Mid | | | |
| Spot | 6.8714 | 6.8714 | | | | | | | | | | |
| O/N | 6.8716 | | | | | | | | | | | |
| T/N | 6.8715 | | | | | | | | | | | |
| 1W | 6.8722 | 6.8635 | 87.45 | 2.9952 | 15.2505 | -12.2553 | | | | | | |
| 1M | 6.8742 | 6.8785 | -43.00 | 2.8196 | 7.3527 | -4.5332 | | | | | | |
| 2M | 6.8747 | 6.8895 | -148.25 | 2.6725 | 5.9604 | -3.2880 | | | | | | |
| 3M | 6.8749 | 6.8980 | -231.00 | 2.5888 | 5.3194 | -2.7307 | | | | | | |
| 6M | 6.8759 | 6.9180 | -421.00 | 2.6834 | 4.6619 | -1.9785 | | | | | | |
| 9M | 6.8764 | 6.9420 | -656.00 | 2.7507 | 4.2910 | -1.5403 | | | | | | |
| 12M | 6.8784 | 6.9545 | -761.00 | 2.8361 | 4.3327 | -1.4966 | 4.04 | 4.24 | 4.14 | | | |
| 2Y | 6.8912 | 7.0270 | -1358.50 | 3.0137 | 4.1778 | -1.1641 | 3.85 | 4.05 | 3.95 | | | |
| 3Y | 6.9017 | 7.0970 | -1953.50 | 3.0880 | 4.1464 | -1.0584 | 3.80 | 4.00 | 3.90 | | | |

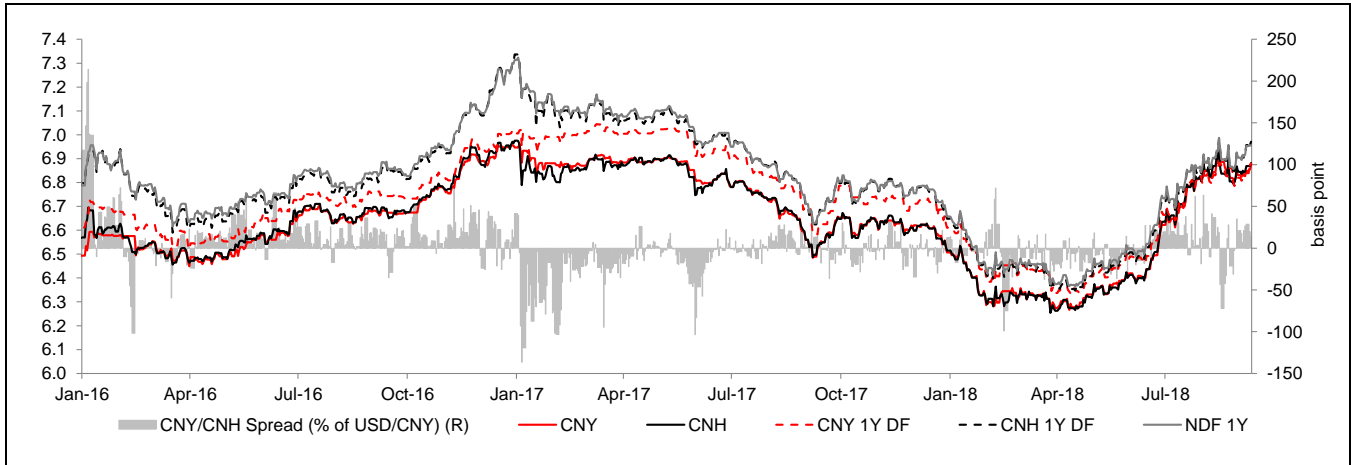
| CNH Curve | | | | | | | | | | 11-Sep-18 | | |
|-----------|-----------------|--------|-------------|-----------------------|--------|----------|------|-------|------|-----------|--|--|
| Tenor | Outrights (mid) | | | Implied Rates (% mid) | | | CCS | | | | | |
| | Offshore DF | NDF | Diff (pips) | Offshore DF | Depo | Diff (%) | Bid | Offer | Mid | | | |
| Spot | 6.8812 | 6.8714 | | | | | | | | | | |
| O/N | 6.8815 | | | | | | | | | | | |
| T/N | 6.8816 | | | | | | | | | | | |
| 1W | 6.8855 | 6.8635 | 220.00 | 5.3745 | 5.4150 | -0.0405 | | | | | | |
| 1M | 6.8957 | 6.8785 | 172.00 | 4.7546 | 4.5000 | 0.2546 | | | | | | |
| 2M | 6.9053 | 6.8895 | 158.20 | 4.4089 | 4.3000 | 0.1089 | | | | | | |
| 3M | 6.9139 | 6.8980 | 159.00 | 4.5568 | 4.3000 | 0.2568 | | | | | | |
| 6M | 6.9344 | 6.9180 | 164.10 | 4.0583 | 4.4000 | -0.3417 | 3.93 | 4.03 | 3.98 | | | |
| 9M | 6.9531 | 6.9420 | 111.10 | 4.0211 | 4.5609 | -0.5398 | 3.88 | 3.98 | 3.93 | | | |
| 12M | 6.9717 | 6.9545 | 172.00 | 4.0354 | 4.2500 | -0.2147 | 3.95 | 3.98 | 3.96 | | | |
| 2Y | 7.0472 | 7.0270 | 202.00 | 4.0955 | | | 4.01 | 4.05 | 4.03 | | | |
| 3Y | 7.1228 | 7.0970 | 258.00 | 4.1008 | | | 4.03 | 4.08 | 4.05 | | | |

| USD/CNY Onshore | | | | | | USD/CNH | | | | | | USD/CNY Offshore | | | | | |
|---------------------------------------|------|-------|------|------|-------|---------------------------------------|------|-------|------|------|-------|---------------------------------------|------|-------|------|------|-------|
| Implied Volatilities (in %) 11-Sep-18 | | | | | | Implied Volatilities (in %) 11-Sep-18 | | | | | | Implied Volatilities (in %) 11-Sep-18 | | | | | |
| Tenor | Mid | | | | | Tenor | Mid | | | | | Tenor | Mid | | | | |
| | ATM | Score | 25C | 25P | 25DRR | | ATM | Score | 25C | 25P | 25DRR | | ATM | Score | 25C | 25P | 25DRR |
| 1W | 6.05 | -0.83 | 6.43 | 6.21 | 0.22 | 1W | 6.99 | -0.49 | 7.46 | 6.87 | 0.59 | 1W | 6.80 | -1.07 | 7.26 | 6.67 | 0.59 |
| 2W | 6.00 | -0.82 | 6.33 | 6.11 | 0.22 | 2W | 6.81 | -0.58 | 7.32 | 6.65 | 0.66 | 2W | 6.61 | -0.76 | 7.11 | 6.45 | 0.66 |
| 3W | 5.98 | -0.76 | 6.37 | 6.07 | 0.30 | 3W | 6.62 | -0.60 | 7.18 | 6.42 | 0.77 | 3W | 6.30 | -0.81 | 6.86 | 6.08 | 0.79 |
| 1M | 5.93 | -0.44 | 6.44 | 6.15 | 0.29 | 1M | 6.73 | -0.13 | 7.31 | 6.53 | 0.78 | 1M | 6.45 | -0.11 | 6.98 | 6.30 | 0.68 |
| 2M | 5.56 | -0.44 | 6.06 | 5.69 | 0.37 | 2M | 6.78 | 0.65 | 7.47 | 6.54 | 0.93 | 2M | 6.51 | 1.10 | 7.18 | 6.28 | 0.90 |
| 3M | 5.35 | -0.31 | 5.94 | 5.48 | 0.47 | 3M | 6.67 | 0.25 | 7.47 | 6.40 | 1.07 | 3M | 6.44 | 0.60 | 7.20 | 6.16 | 1.04 |
| 6M | 5.11 | -0.29 | 5.95 | 5.24 | 0.71 | 6M | 6.58 | 0.01 | 7.51 | 6.26 | 1.26 | 6M | 6.34 | 0.04 | 7.24 | 6.04 | 1.20 |
| 1Y | 5.14 | -0.26 | 5.89 | 4.99 | 0.90 | 1Y | 6.60 | -0.11 | 7.80 | 6.21 | 1.59 | 1Y | 6.33 | -0.32 | 7.49 | 5.97 | 1.52 |
| 18M | 5.32 | -0.38 | 6.23 | 5.46 | 0.77 | 18M | 6.75 | -0.18 | 8.01 | 6.38 | 1.64 | 18M | 6.49 | -0.21 | 7.71 | 6.14 | 1.57 |
| 2Y | 5.39 | -0.70 | 6.39 | 5.52 | 0.87 | 2Y | 6.85 | -0.24 | 8.17 | 6.46 | 1.71 | 2Y | 6.59 | -0.15 | 7.89 | 6.25 | 1.65 |

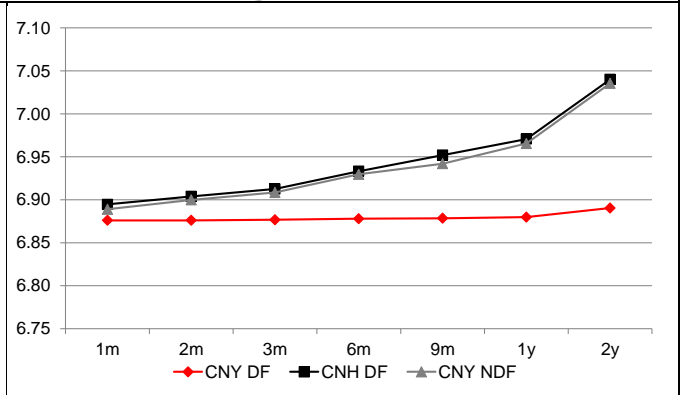
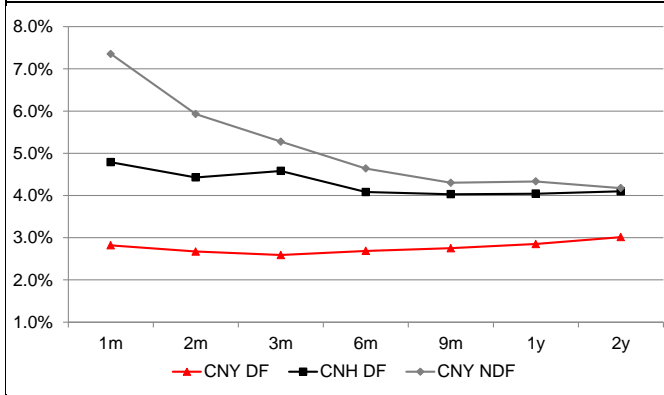
Source: Bloomberg, MUFG Bank

CNY: Onshore RMB

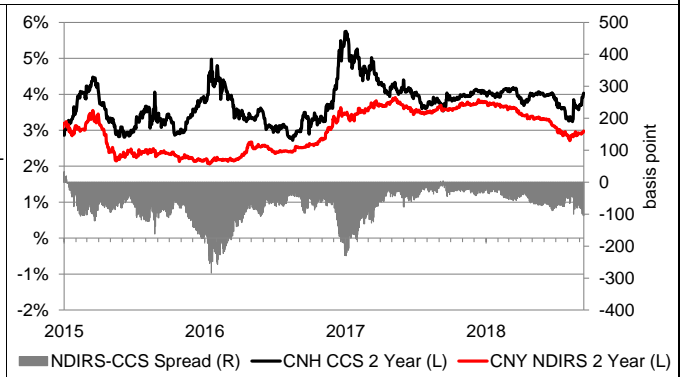
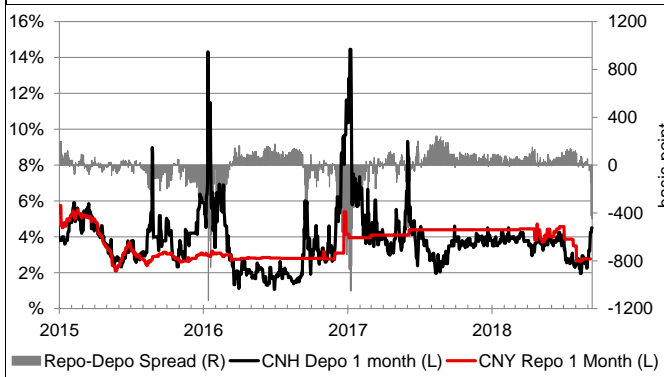
CNH: Offshore RMB



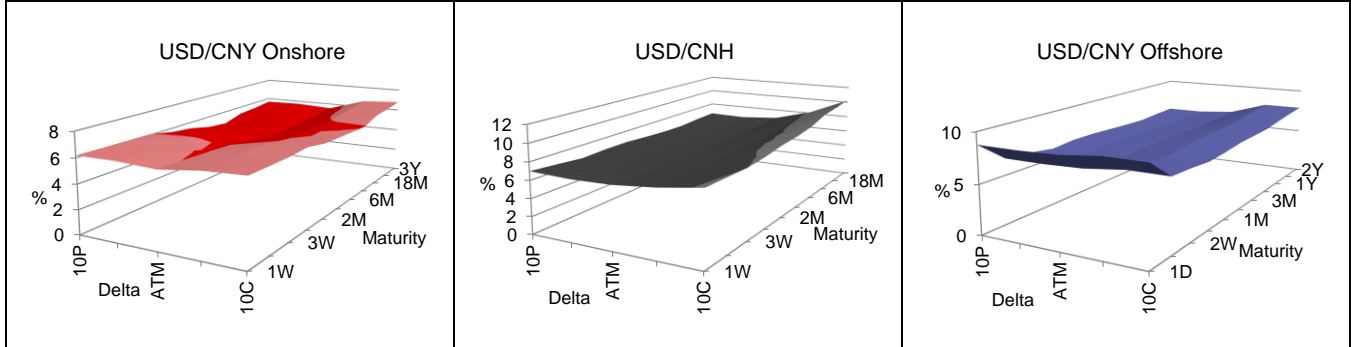
RMB Curve: Rates vs. Outrights



RMB Rate: Offshore vs. Onshore



RMB Implied Volatility: Offshore vs. Onshore



Source: Bloomberg, MUFG Bank

OUR LATEST FORECAST: CNY AND CNH

| | Spot close 10.9.18 | | Q3 2018 | Q4 2018 | Q1 2019 | Q2 2019 |
|---------|-----------------------|---------------|---------|---------|---------|---------|
| USD/CNY | 6.8655 | Our forecast | 6.9000 | 6.9500 | 7.0000 | 7.0500 |
| | | Forward price | 6.8773 | 6.9102 | 6.9290 | 6.9428 |
| USD/CNH | 6.8691 | Our forecast | 6.9000 | 6.9500 | 7.0000 | 7.0500 |
| | | Forward price | 6.8872 | 6.9161 | 6.9358 | 6.9546 |

Source: Bloomberg, MUFG Bank

CNH: Review and Outlook

Trader Color. Spot CNH traded in a range from 6.8000 to 6.9500 for the whole month. DF curve rose sharply in the mid-August. 1-year DF traded to the lowest +850 from +300. Funding traded at around par or slightly negative in most of the trading days. Counter-cyclical factor was re-introduced, making spot USD/CNH toppish at around 6.9000. Chinese names started to prepare the funding for the week-long national day holidays (i.e., Golden Week). 1-year DF on/off shore traded around 800 pips after the squeeze in the mid-August.

Technical: Abundant CNH liquidity pushed USD/CNH higher than USD/CNY, but the Chinese authorities have recently been squeezing CNH rates higher from time to time which makes the cost of shorting CNH more expensive, somewhat containing rising expectations for RMB depreciation.

3-year tax exemption for foreign bonds investors. Foreign investors can exempt their corporate income tax (CTI) of 10% or value added Tax (VAT) of 6% on interest gains from onshore non-government bond investments for three years, according to State Council's [press release on 30 August 2018](#) (simplified Chinese), while taxes on government bonds have always been exempted. Foreign investors have been increasing their holdings of Chinese bonds, with a year-on-year increase of 82.7% in July to CNY1612.3bn, according to the Bond Connect.

RMB internationalization. The use of RMB in global payments jumped to 2.04% of total transactions in July, the highest since 2016, and RMB ranks as the fifth most widely used in global transactions behind the dollar, euro pound and yen, according to data from Swift. *The former PBOC's Governor Zhou cautioned against rapid internalization of the yuan, saying the process may experience fluctuations as external conditions change,* according to Bloomberg.

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