Chinese renminbi

	Spot close 28.09.18	Q4 2018	Q1 2019	Q2 2019	Q3 2019
USD/CNY	6.8814	6.9500	7.0000	7.0500	7.1000
USD/HKD	7.8248	7.8250	7.8150	7.8050	7.7950
		Range	Range	Range	Range
USD/CNY		6.8000-7.0000	6.8000-7.0500	6.8500-7.1000	6.8500-7.1500
USD/HKD		7.7900-7.8500	7.7900-7.8500	7.7900-7.8400	7.7800-7.8300

MARKET UPDATE

Weaker, rates still low but Mundell is winning

CNY weakened against USD in September with the USD/CNY London close rising to 6.8814 from 6.8299 in August. Steady price action continued to confirm there are probably not many spec longs left to flush out. PBOC kept liquidity flushed, supporting the short end of the curve (low rates) but appears to be losing the battle against Mundell's impossibility theorem.

OUTLOOK

A grind higher though congestion at 7

If the earth continues rotating on its axis but nothing else changes in October, our forecasted levels (unchanged except for a new 3Q19 level) would convey: Steady USD buying onshore with occasional official friction, for congestion around 7 into 2019's Spring quarter. During past crises (eg, 2008-10), official China seemed to prefer a hibernation mode where the main aim is to keep everything (and we mean everything) stable, particularly for the currency. (The thought has crossed our mind the Chinese might want to wait out Trump, who represents a crisis all in himself.)

The preponderance of evidence suggests continued Chinese slowing

Anecdotal evidence on growth seems mixed. We've had good reports on cement (infrastructure) and airlines could benefit from tourism (all rooms in Macau were booked ahead of Golden Week), if they could only get past jet fuel. At the same time, however, Komatsu smartmeters on excavators in China showed *slowing.* Macro measures still seem to suggest overall slowing, with the stimulus mode and measures in place from May not particularly effective thus far.

And interest differentials with the US will continue to narrow

And of course the interest differential with USD rates has just gotten narrower after Fed hike #8 (with our expectation for hike #9 in December). At present, it does not appear to us the urgency to refi will drop away just because the calendar clicks into 2019. That means continuing need (greed?) to keep Chinese rates low no matter what the Fed is doing, and suggests interest differentials will narrow further.

Shifting exports around only suggests more pallid growth readings in 2019

Risks to our forecast seem balanced. On the potentially positive CNY side, the first thought is the economy could strengthen. Certainly we agree exporters will frontload shipments away from whatever tariffs come out of Trump's tweets. But shifting around of activity only argues for more pallid readings later in 2019 (to recap, our forecast for 2018 had been 6% actual growth with a 50bp handicap for inaccurate reporting and headline growth of 6.5%; next year we are positing 5.75% growth with the same 50bp handicap, ie, headline growth of 6.25%). Officials could also push USD/CNY down below our forecasts if they were willing to tolerate a faster rate of reserve depletion. Perhaps they could even leave it unsterilized (higher rates) for a while if there were a window of opportunity in the debt repayment schedule. But eventually this strategy is unlikely sustainable given the refi.

And Trump will escalate tariffs

On the negative side of the CNY ledger is Bob Woodward's new book *Fear,* which left us convinced US President Trump *will* escalate tariffs further.

	Interest Rate Close	Q4 2018	Q1 2019	Q2 2019	Q3 2019
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.35%
7-Day Repo Rate	2.66%	3.00%	3.50%	3.75%	4.00%
5-Year Yield	3.44%	3.60%	3.60%	3.90%	4.00%

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

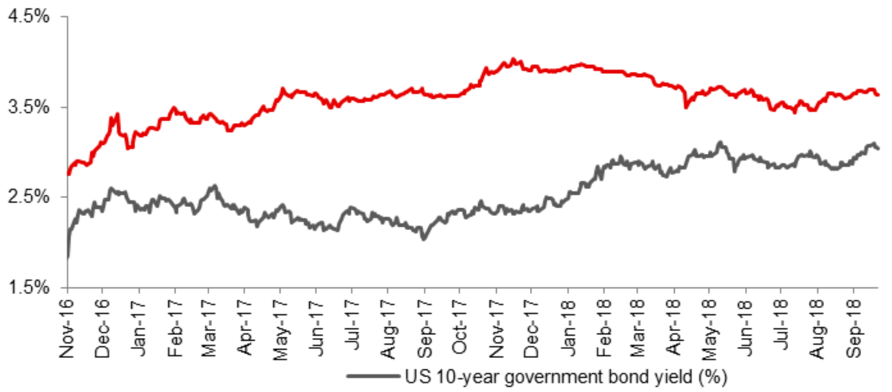
INTEREST RATE OUTLOOK

Clogged monetary policy connotes credit risk to us

Then there are continuing credit problems in China (which contain seeds for far higher USD/CNY levels). Not all news is bad. Baowu announced a new fund to rationalize the steel industry. Had it been any other company than Baosteel we might have been more skeptical. But another murky Qinghai Provincial bailout and news that 12% of China's stock market has been pledged to shareholder loans do not fill us with confidence. China's leadership complains about clogged monetary policy but it's better to ask why it may be clogged? Increased credit risk perceptions by banks come to mind. Onshore there is talk of another RRR cut but will it do any good in terms of stimulus? There had also been concerns about an inflation spike but our judgment is this will pass. Instead, what will drive up govvie yields in China is a continuing grind higher (in yields) of its Treasury counterparts.

The Fed tightens, China tries not to

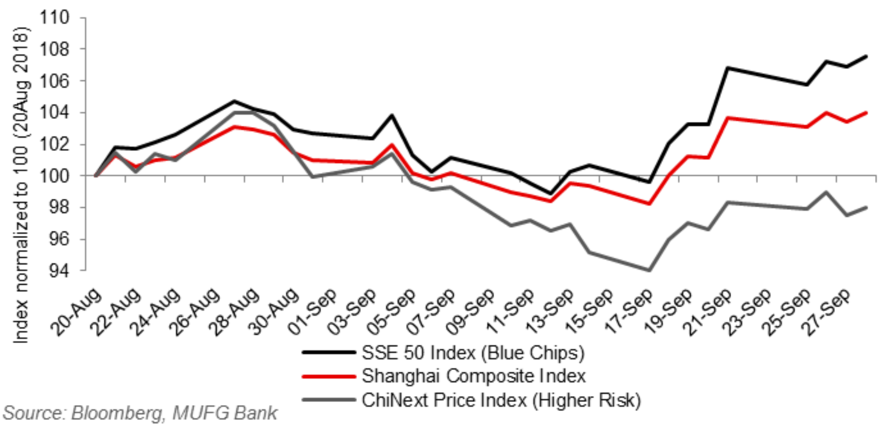
AS US YIELDS GRIND HIGHER, SO WILL CHINA'S



Source: Bloomberg, MUFG Bank

And the National Team is back in play

CHINESE PRICE-KEEPING OPERATIONS



Source: Bloomberg, MUFG Bank

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