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Highlights

- **China seems to be losing the war against Mundell orthodoxy**
- **Slowing growth, narrower interest differentials to USD and continuing credit problems suggest a grind higher to above 7**
- **But official congestion below 7 will continue a while**
- **With the occasional measured squeeze in CNH rates**

CNY: Review and Outlook

Trader Color. USD/CNY spot traded in an upward channel during September following news on US-China trade problems and the FOMC's rate hike. A new round of additional tariffs and cancellation of a meeting reversed expectations the trade war might cool down. Though authorities claimed no competitive depreciation, reversal of USD/CNY positions and season-end corporate buying needs supported USDCNY to close at the high at 6.8840 in September. The curve rose as the market anticipated tighter liquidity in September and the potential FOMC hike risk. 1-year DFs closed at +20 compared with -170 last month.

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.

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. Go figure. 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.

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 US Treasury counterparts.

CNY: Onshore RMB

CNH: Offshore RMB

CNY Snapshot						5-Oct-18						CNH Snapshot						5-Oct-18					
Tenor	Last			Last Month Range			Tenor	Last			Last Month Range												
	Bid	Ask	Mid	Min	Max	Bid		Ask	Mid	Min	Max												
Fix			6.8725	6.8183	6.8569		Fix			6.9038	6.8310	6.8850											
Spot	6.8725	6.8725	6.8725	6.8050	6.8910		Spot	6.8963	6.8966	6.8965	6.8219	6.8937											
O/N	1.13	1.13	1.13				O/N	4.00	8.00	6.00													
T/N	-6.87	-6.87	-6.87				T/N	2.00	10.00	6.00													
1W	-4.37	-4.37	-4.37				1W	50.85	55.35	53.10													
1M	1.13	1.13	1.13				1M	173.10	193.10	183.10													
2M	3.13	3.13	3.13				2M	285.10	298.10	291.60													
3M	7.63	7.63	7.63				3M	385.60	405.60	395.60													
6M	10.63	10.63	10.63				6M	592.00	607.00	599.50													
9M	0.13	0.13	0.13				9M	733.50	763.50	748.50													
12M	12.13	12.13	12.13				12M	845.60	878.10	861.85													
2Y	108.13	108.13	108.13				2Y	1393.10	1493.10	1443.10													
3Y	-80.87	-80.87	-80.87				3Y	1778.10	2278.10	2028.10													

CNY Curve										5-Oct-18		
Tenor	Outrights (mid)			Implied Rates (% mid)			NDS					
	Onshore DF	NDF	Diff (pips)	Onshore DF	NDF	Diff (%)	Bid	Offer	Mid			
Spot	6.8725	6.8725										
O/N	6.8733											
T/N	6.8725											
1W	6.8728	6.8985	-257.50	2.6221	8.2522	-5.6301						
1M	6.8733	6.9130	-397.00	2.5787	6.4631	-3.8844						
2M	6.8735	6.9265	-530.00	2.5375	5.4168	-2.8793						
3M	6.8740	6.9375	-635.50	2.5198	5.2826	-2.7628						
6M	6.8743	6.9600	-857.50	2.6772	4.7404	-2.0632						
9M	6.8732	6.9742	-1010.00	2.7850	4.4649	-1.6799						
12M	6.8744	6.9910	-1166.00	2.8762	4.3642	-1.4880	4.56	4.76	4.66			
2Y	6.8840	7.0610	-1770.00	3.1251	4.2828	-1.1578	4.00	4.20	4.10			
3Y	6.8651	7.1310	-2659.00	3.2950	4.2770	-0.9820	4.05	4.25	4.15			

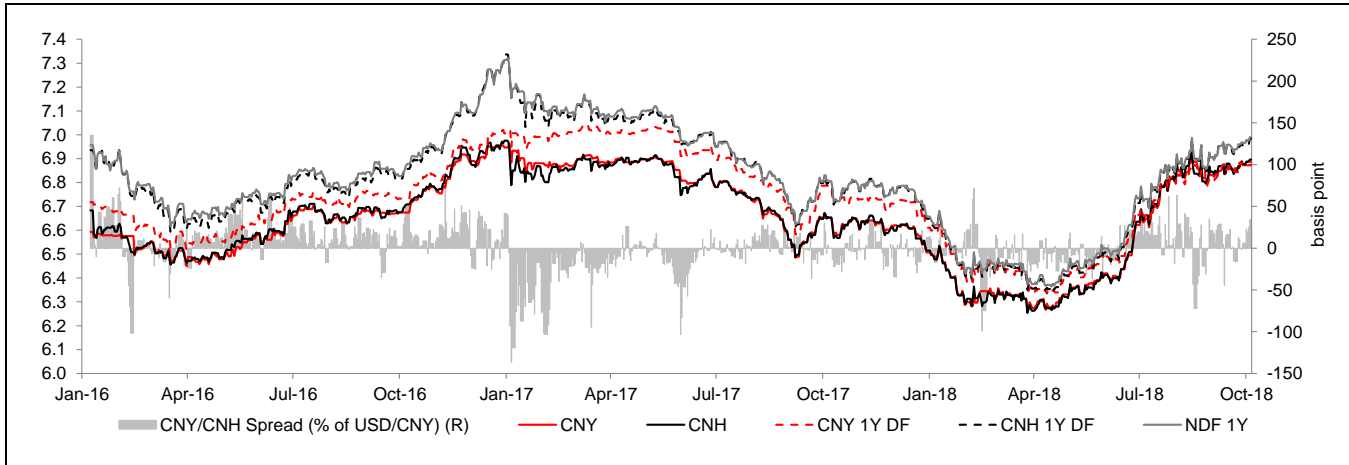
CNH Curve										5-Oct-18		
Tenor	Outrights (mid)			Implied Rates (% mid)			CCS					
	Offshore DF	NDF	Diff (pips)	Offshore DF	Depo	Diff (%)	Bid	Offer	Mid			
Spot	6.8965	6.8725										
O/N	6.8971											
T/N	6.8971											
1W	6.9025	6.8985	39.50	6.8459	6.4020	0.4439						
1M	6.9155	6.9130	24.50	5.6956	5.2500	0.4456						
2M	6.9263	6.9265	-2.00	4.9307	5.0700	-0.1394						
3M	6.9367	6.9375	-8.00	5.0136	4.4000	0.6136						
6M	6.9571	6.9600	-29.10	4.3573	4.6600	-0.3027	3.24	3.34	3.29			
9M	6.9720	6.9742	-22.10	4.1918	4.2000	-0.0082	3.06	3.16	3.11			
12M	6.9833	6.9910	-76.75	4.0912	4.1500	-0.0588	3.97	4.04	4.01			
2Y	7.0415	7.0610	-195.50	4.0915			3.99	4.07	4.03			
3Y	7.1000	7.1310	-310.50	4.0957			4.03	4.13	4.08			

USD/CNY Onshore						USD/CNH						USD/CNY Offshore								
Implied Volatilities (in %)						Implied Volatilities (in %)						Implied Volatilities (in %)								
Tenor	Mid					5-Oct-18	Tenor	Mid					5-Oct-18	Tenor	Mid					5-Oct-18
	ATM	Score	25C	25P	25DRR			ATM	Score	25C	25P	25DRR			ATM	Score	25C	25P	25DRR	
1W	4.01	-1.61	4.29	4.06	0.23	1W	6.01	0.47	6.57	5.90	0.67	1W	5.55	0.15	6.07	5.40	0.67			
2W	4.09	-1.48	4.35	4.11	0.25	2W	5.81	0.24	6.40	5.66	0.74	2W	5.44	0.07	6.00	5.27	0.73			
3W	4.15	-1.44	4.45	4.13	0.32	3W	5.75	0.27	6.39	5.59	0.80	3W	5.44	0.14	6.03	5.23	0.80			
1M	4.27	-1.34	4.59	4.28	0.32	1M	5.76	0.09	6.39	5.57	0.82	1M	5.33	-0.18	5.89	5.20	0.69			
2M	4.29	-1.43	4.67	4.27	0.40	2M	5.75	-0.12	6.48	5.54	0.94	2M	5.36	-0.33	6.05	5.14	0.91			
3M	4.32	-1.46	4.75	4.28	0.48	3M	5.80	-0.08	6.65	5.53	1.12	3M	5.41	-0.33	6.23	5.15	1.08			
6M	4.48	-1.37	5.07	4.50	0.57	6M	5.88	-0.05	6.86	5.54	1.33	6M	5.52	-0.32	6.45	5.19	1.26			
1Y	4.51	-1.33	5.12	4.42	0.70	1Y	6.00	-0.12	7.15	5.63	1.52	1Y	5.69	-0.32	6.80	5.36	1.44			
18M	4.77	-1.52	5.52	4.71	0.82	18M	6.15	-0.17	7.36	5.78	1.58	18M	5.83	-0.35	7.03	5.50	1.53			
2Y	4.93	-1.50	5.75	4.84	0.92	2Y	6.25	-0.18	7.49	5.87	1.62	2Y	5.92	-0.35	7.17	5.60	1.58			

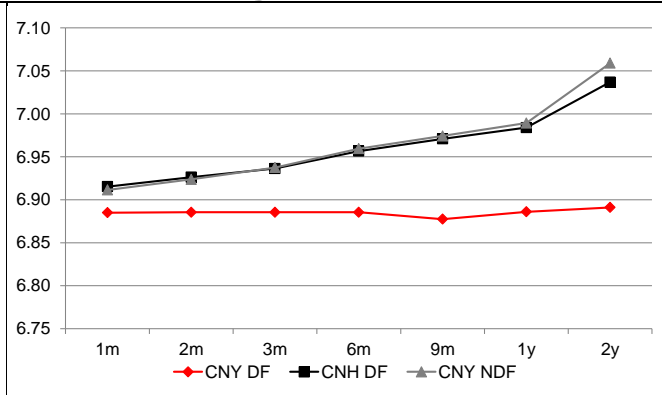
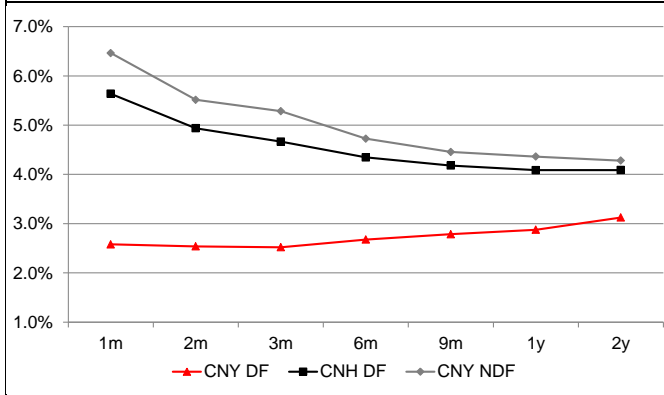
Source: Bloomberg, MUFG Bank

CNY: Onshore RMB

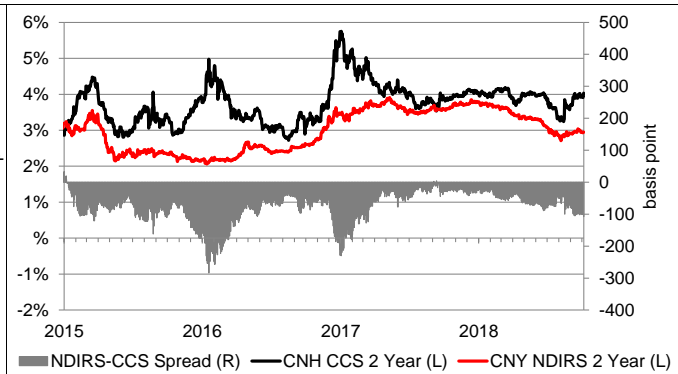
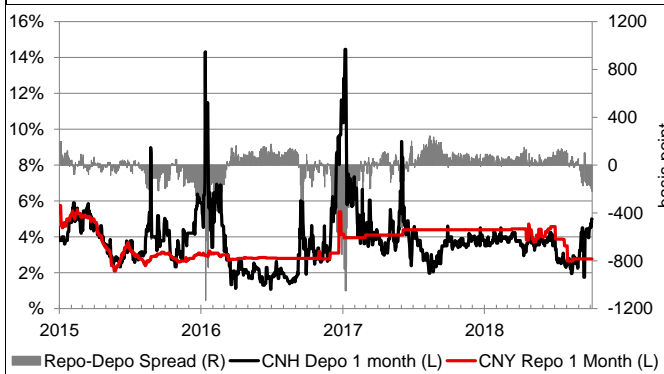
CNH: Offshore RMB



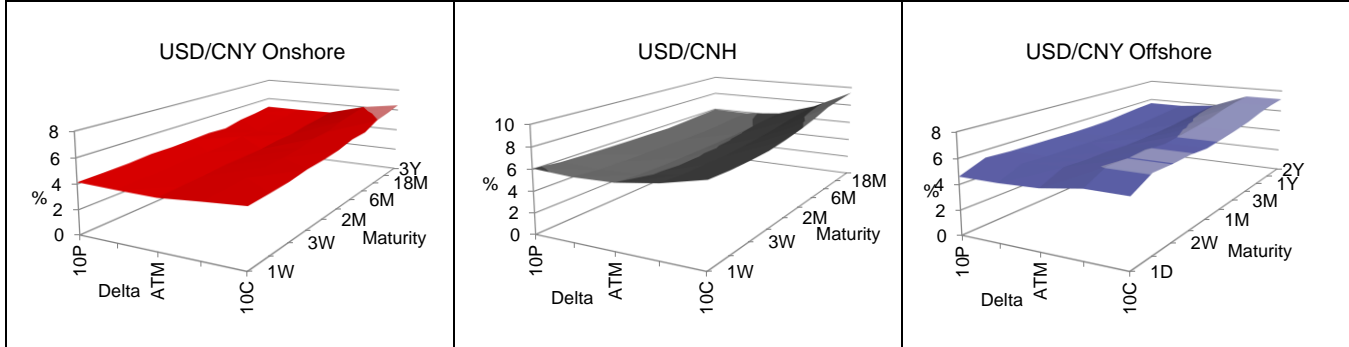
RMB Curve: Rates vs. Outrights



RMB Rate: Offshore vs. Onshore



RMB Implied Volatility: Offshore vs. Onshore



Source: Bloomberg, MUFG Bank

OUR LATEST FORECASTS: CNY AND CNH

	Spot close 4.10.18		Q4 2018	Q1 2019	Q2 2019	Q3 2019
USD/CNY	6.8689	Our forecast	6.9500	7.0000	7.0500	7.1000
		Forward price	6.9308	6.9534	6.9679	6.9836
USD/CNH	6.8962	Our forecast	6.9625	7.0150	7.0675	7.1200
		Forward price	6.9335	6.9540	6.9684	6.9816

Source: Bloomberg, MUFG Bank

CNH: Review and Outlook

Trader Color. Spot CNH traded in a 6.81/6.88 range during the whole of September. After presumptive US-China trade talks were canceled we saw corporate buying flow offsetting possible official smoothing. On/offshore spot differentials flipped to +50 from -100 pips. PBOC issued its annual CNH bond in Hong Kong. Chinese names were bidding front end DF and selling back end continuously. 1s traded highest at +200, while funding once traded +30 per day. 1y traded highest +950. CFETS index closed at its low of 92.6.

Spot/Rates. Main novelty during October Golden Week was some squeeze in CNH rates to try to stabilize spot (and presumably influence CNY when onshore traders return from holiday). As we'd commented in the *MUFG FX Weekly*, this squeeze is attenuated by the need to keep onshore rates low and discourage rates arbitrage. SWIFT reports the RMB's share of payments has been rising slowly in recent months, but it appears mainly due to payment flows between the Mainland and Hong Kong.

CNH in London. Yuan transactions of all types in London averaged around GBP70 billion/day (USD91.9 billion) in 2Q18, marking a 32.9% increase on the same period last year and a 13.5% increase to the first quarter, according to the London RMB Business Quarterly report from the City of London Corporation and the People's Bank of China's Europe Representative Office. Some 102 dim sum bonds had been listed on LSE with a total size of CNH31.1 billion (USD4.6 billion) as of end 2Q. Total actual cross-border yuan settlement between China and the UK increased almost one-and-a-half times to CNY176.2 billion from last year. London represents the second biggest offshore yuan clearing center to Hong Kong, with a daily average clearing volume of over CNH40 billion. (Source: *Yicai Global*)

RQFII on a modest rise. The State Administration of Foreign Exchange (SAFE) has approved CNY640.2bn in Renminbi Qualified Foreign Institutional Investor (RQFII) quotas as of 29 September 2018, up from CNY627.5bn on 30 August, CNY605.1bn at end 2017 and CNY528.5bn at end 2016.

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