Chinese renminbi

	Spot close 31.10.18	Q4 2018	Q1 2019	Q2 2019	Q3 2019
USD/CNY	6.9734	6.9800	7.0300	7.0800	7.1500
USD/HKD	7.8412	7.8350	7.8250	7.8150	7.8050
		Range	Range	Range	Range
USD/CNY		6.8000-7.0000	6.8300-7.0800	6.8800-7.1300	6.9000-7.2000
USD/HKD		7.7900-7.8500	7.7900-7.8500	7.7900-7.8400	7.7800-7.8300

MARKET UPDATE

Weaker, equity/credit rescue operations underway

The renminbi weakened vs. USD in October by the most since the June-July selloff, with USD/CNY rising to 6.9734 at its London close from 6.8814 in September. PBOC was busy setting up equity/credit rescue operations and continued to flood markets with liquidity.

OUTLOOK

Still congested but an earlier break above 7

Our outlook continues to assume congestion around USD/CNY=7 till year-end, though the final month after the G-20 Summit ends may be volatile. Given ongoing market pressure, we are assuming an earlier break above 7, now in 1Q19. We also foresee larger reserve losses and tightening of capital controls.

Authorities are having to massage more and more asset classes; the key new development is in credit

Authorities started earlier this year to lower onshore interest rates, given the refi challenge in 2018. But guess what, they soon found they needed to control the exchange rate as well (in which they've so far failed). With a semi-open capital account, that meant they had to tighten screws on capital controls. But now there is evidence of *increased* capital outflows despite tighter *de jure* controls. Then in the last month, they've discovered not only are they having to control interest rates, having to control exchange rates, but now a third asset class, equities, has entered the picture. We're guessing next up might be price-keeping operations in credit.

Problems migrating across asset classes is a sign you're not resolving the real problem

A word to the wise: When problems migrate from one asset class to another, it probably means you're not resolving underlying issues. Reappearing credit problems were our third leg of the triangle of renminbi weakness in 2018 (the others being slowing growth and narrowing interest rate differentials). Policy actions in October indicated the pledged shares problem (which we mentioned last month) is a far more serious problem than admitted (this was also a common problem during the Asian Crisis, in places such as Malaysia and Thailand.) All sorts of funds – from SOEs, brokers and insurance companies – are being set up to forestall forced selling that could send equities down further. This suggests a more extensive underlying debt rot. S&P released a report claiming USD5.4 trillion (that's US dollars not renminbi) of hidden debt at local governments (almost double a supposedly comprehensive audited level in June 2013). In FX markets, unlike past episodes we have seen only sporadic and measured squeezes higher in CNH rates, not enough to prevent USD/CNY from rising. The reason we think obvious: China, Inc. needs lower interest rates, and as written before, this is an economy that will sacrifice the exchange rate before it will the interest rate (we think it already has to an extent). Though we've been seriously concerned about debt since late Summer 2015, for the first time we are beginning to wonder if even China, Inc. has enough money to paper over problems one more time?

	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	2.78%	3.00%	3.50%	3.75%	4.00%
5-Year Yield	3.36%	3.25%	3.45%	3.75%	4.00%

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

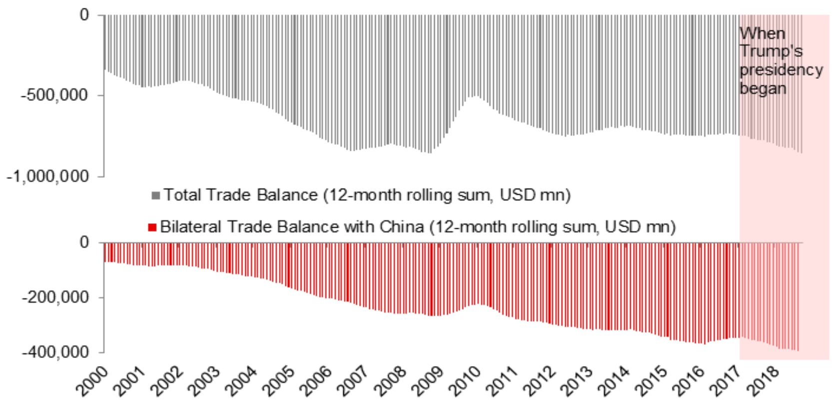
INTEREST RATE OUTLOOK

China's slowdown is now priced into lower yields but still-wide credit spreads; housing is a key concern

China's slowdown combined with panicked policy reactions have contributed to even lower bond yields in October. This despite a major US Treasury correction higher in yields earlier in the month and higher inflation readings. Housing is emerging as a key weakness in the economy. As all year, none of this reassured credit spreads, which continued to punish lower-rated firms. A Singyes Solar Energy default was the least of this. Even the old onshore definition of 'investment grade," AA-, seems more junky by the day. None of this will reverse official policy, which is to flood markets with liquidity and push safe government yields down, reflected now in our changed forecasts. The implied convergence of the US and Chinese government yield curves in future months at tenors like 5-years makes us wonder whether the currency might not weaken further, but we leave that a risk for now. We like the personal income tax reform. It's smart policy but it's too small to turn the economy around. Given structural rigidities in China's financial system, we can't rule out a return of shadow banking, maybe even by next year.

By Trump's criteria, the US is losing the Trade War

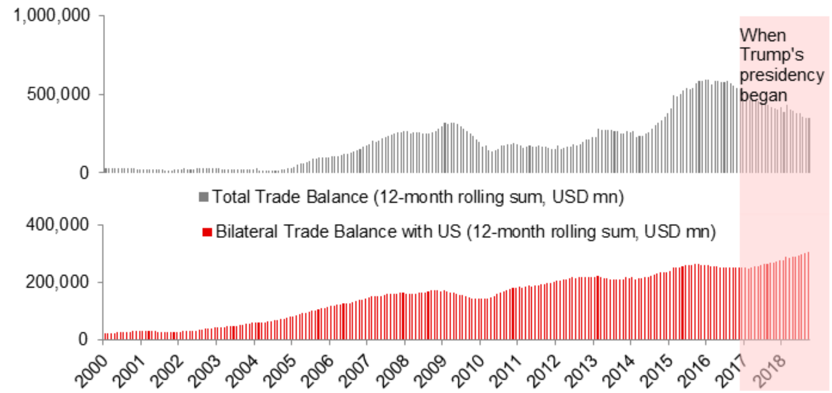
US TRADE BALANCES: TOTAL + BILATERAL WITH CHINA



Source: CEIC, MUFG Bank

By Trump's criteria, China is winning the Trade War

CHINESE TRADE BALANCES: TOTAL + BILATERAL WITH THE US



Source: CEIC, MUFG Bank

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