Chinese renminbi

	Spot close 30.11.18	Q4 2018	Q1 2019	Q2 2019	Q3 2019
USD/CNY	6.9436	6.9500	6.9850	7.0500	7.1000
USD/HKD	7.8242	7.8250	7.8150	7.8050	7.7950
		Range	Range	Range	Range
USD/CNY		6.8300-7.0000	6.8300-7.0500	6.8800-7.1000	6.9000-7.1500
USD/HKD		7.7900-7.8500	7.7900-7.8500	7.7900-7.8400	7.7800-7.8300

MARKET UPDATE

Stronger; buying more NPLs

The renminbi firmed vs. USD during November as USD/CNY remained below 7 and fell to 6.9436 from October's London close of 6.9734. PBOC continued to flood the front end of the curve with liquidity while four AMCs set up in the 1990s were pushed to acquire more NPLs.

OUTLOOK

Slower Fed hikes mean interest rate differentials that will help support RMB

Of operative themes we have identified as driving USD/RMB, we think the biggest change in November was in prospective interest rate differentials with USD rates. Chairman Powell's 28th November speech took at least one hike out of our expectations (with some in markets romancing more). We expect more debate about "neutral" in 1H19 (see our KRW section) but with at least one fewer 2019 Fed hike, it's logical to lower USD/CNY forecasts over 2-3Q19.

Trump wants a deal

As for remaining themes, the trade war has bullied its way to the front of the queue as a crescendo builds over the post-G20 Trump-Xi dinner. We wonder if markets should care as much. Markets appear to have gotten smarter at distinguishing between a "deal" (for the cameras, lots of pomp, lots of pageantry, little policy; think North Korea) and a <u>deal</u> (one with real substance). When Trump tweets, almost daily, that the Chinese want a deal, that really means Trump wants a deal. He wants a deal because he's gotten worried about the US stock market, which is hovering on the border between loss/gain for 2018 (the Powell Put could eventually be re-christened the Trump Put). Because for this President, it's now all about re-election (registering his re-election committee was the very first act of the Trump Presidency).

So does Xi, if he can get temporary tariff relief and lower interest rates

For President Xi, would a ceasefire on tariffs be appealing if it lasts only a few months? You bet. Chairman Powell just did China a tremendous favor by signalling a break in the Fed's recent pattern of rate hikes. "Gradual" was not gradual enough for China's massive refi problem; even more gradual is more like it. There is a massive struggle to corral China's overweight bundle of debt before something toxic breaks into the open, so every month – every basis point really – matters.

So we expect a "deal" but markets will ultimately demand a <u>deal</u> (real substance); a "deal" has only short-term effects

So we expect a "deal" but when real negotiations begin, over specific issues the Americans want resolved, expect enthusiasm to die. A "deal" will have only short-term effects. There are areas – eg, in ownership restrictions – where the Chinese can conceivably offer something of substance. But when Americans demand action on cyberhacking or some attempt at major currency management, expect the Chinese to fall silent. And if they do, remember Trump recently declared, "I'm the tariffs guy." China may not even be the main attraction in 1Q19, when auto tariffs may be in play.

Chinese growth and credit problems remain

As for remaining themes, China slowing and China's re-emerging credit problems are both still a go from where we sit. Therefore it's still a slow grind higher for USD/CNY for now.

	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	2.80%	2.90%	3.00%	3.00%	3.50%
5-Year Yield	3.14%	3.10%	3.20%	3.50%	3.75%

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

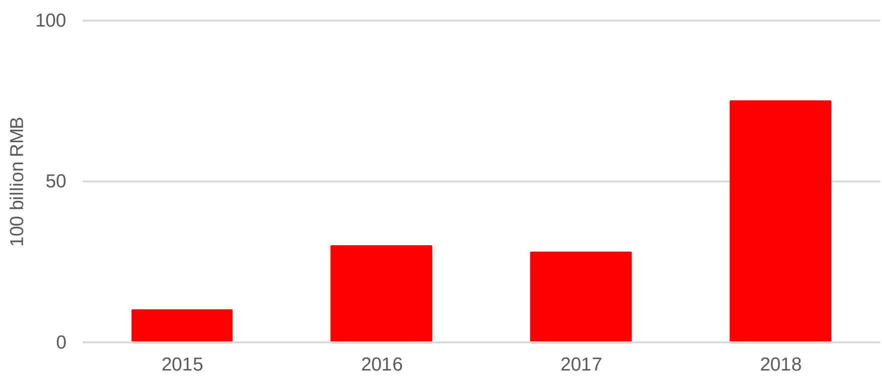
INTEREST RATE OUTLOOK

Powell's opening provides Chinese authorities more leeway to lower yields

Powell's opening will give Chinese authorities more leeway to lower onshore interest rates without hurting the currency, particularly for bond yields, which we have updated into our forecasts. Notwithstanding higher headline inflation, more defaults in 2018 and a great majority of LGFVs not even covering costs, interest rates must decline! Though China's original four asset management companies are buying up more NPLs, a couple of these that have gone public really behave more like investment banks nowadays, and we suspect NPL disposals will ultimately need new entities. After activities by China's national team in equities in preceding months, the securities regulator sent out a directive to onshore analysts in early November that can only be described as the "happy talk" directive – that onshore analysts take care not to denigrate Chinese assets too much. There have been talk analysts even had to sign agreements but we have not been able to confirm that. One wonders whether that's necessary, as a number of analysts and many Mr. and Mrs. Chens seem content with the Xi Jinping put.

Markets are muffled but not altogether silent

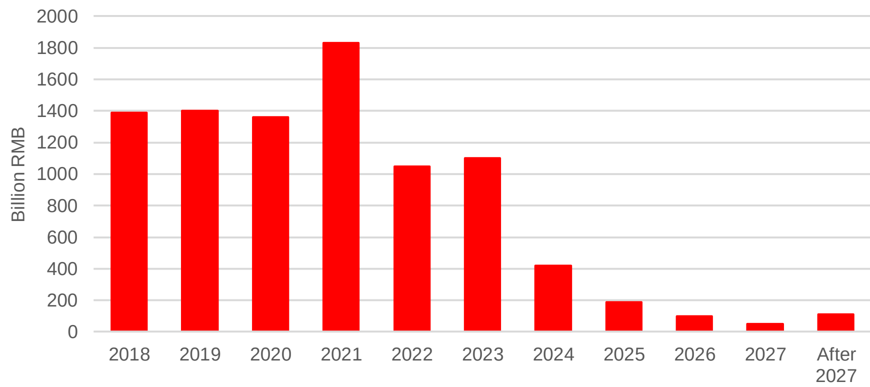
ONE MARKET REACTION TO CHINA'S REFI: MORE DEFAULTS



Source: Bloomberg

Draw a vertical line at 100

MOST CHINESE LGFVS DON'T EVEN COVER COSTS



Source: WIND, S&P Global Ratings

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