Chinese renminbi

	Spot close 31.05.19	Q2 2019	Q3 2019	Q4 2019	Q1 2020
USD/CNY	6.9020	6.9200	6.9500	7.0000	7.0500
USD/HKD	7.8392	7.8400	7.8300	7.8200	7.8100
		Range	Range	Range	Range
USD/CNY		6.6854-6.9800	6.8500-7.0000	6.8500-7.0500	6.8500-7.1000
USD/HKD		7.8200-7.8500	7.8100-7.8500	7.8000-7.8500	7.7900-7.8400

MARKET UPDATE

Much weaker, giving up all 2019 gains; onshore yields stubbornly high

President Donald Trump's escalation of the US-China Trade War put paid to all Deal hoopla and rocketed USD/CNY back to near where it was before the dinner in Buenos Aires, finishing May at 6.9020 in terms of London closes compared with April's 6.7366. Nothing visible changed in PBOC monetary policy but onshore liquidity felt tighter with a months-long campaign to bring down yields stymied.

OUTLOOK

Congestion in the short term with upside risks for USD/CNY

Having declared explicitly a defense of 7, we expect Chinese authorities to contribute to congestion around 6.90 in the near term. A detailed explanation of all our new forecasts is in *Asia Cross Current: USD/CNY – Updated Forecasts and Discussion,* 28 May 2019. Here we clarify further that we have not assumed President Trump will follow through on the next threatened stage of escalation, which is to put 25% tariffs on the remainder USD300bn of US imports from China. Comment period on these potential tariffs begins in mid-June with earliest implementation probably not till late Summer, so we think we have luxury of gathering more information before making a call. Trump's announcement of 5% tariffs on Mexico to solve US immigration problems does not fill us with hope. We note if Trump escalates further, he will have fulfilled a long ambition to impose 25% tariffs on all Chinese imports, which he made in TV appearances long before he became a presidential candidate and made on the 2016 campaign trail. This potential, major source of upside for USD/CNY is in addition to that other major source, continuing credit risk problems highlighted by, eg, the takeover of Baoshang Bank, a city commercial bank needing the first such rescue in 18 years.

Much of US slowing may be priced, can't say the same for China

Trump's Mexican tariffs seemed like the cherry on top of a massive USD Treasury rally cake in May. The rally underscores Market fears about US growth, but the flip side is much US slowing, if materialized, is already priced. We are less sure about China. Though we have continued to chronicle the slowing of the Chinese economy, at this stage we have greater concerns about the attempts of authorities on both sides to downplay the straightforward effects of a Trade War on growth. In the chest-thumping stage of a Trade War, we hear the half-truth promulgated on both sides that even an escalated Trade War shouldn't affect the economy all that much. Baloney. At current levels of tariffs (ie, without that final USD300bn escalation) if sustained, studies we have reviewed suggest tariffs will drain 0.3-0.6ppt of growth off of the US and 0.5-1ppt of growth off of China. (Remember, a trade war has no winners.) Though politicians may think rhetoric valuable in a tête-à-tête, ordinary firms and households won't be fooled. If they feel incomes slipping, they will make adjustments (like buying fewer cars, eg).

CFETS is down two big figures

CFETS is down two big figures since Trump escalated, to us the clearest statement of Chinese exchange rate policy intentions, whatever US Treasury says.

	Interest Rate Close	Q2 2019	Q3 2019	Q4 2019	Q1 2020
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.35%
7-Day Repo Rate	2.65%	3.10%	3.00%	3.50%	3.25%
5-Year Yield	3.06%	3.00%	3.00%	3.20%	3.10%

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

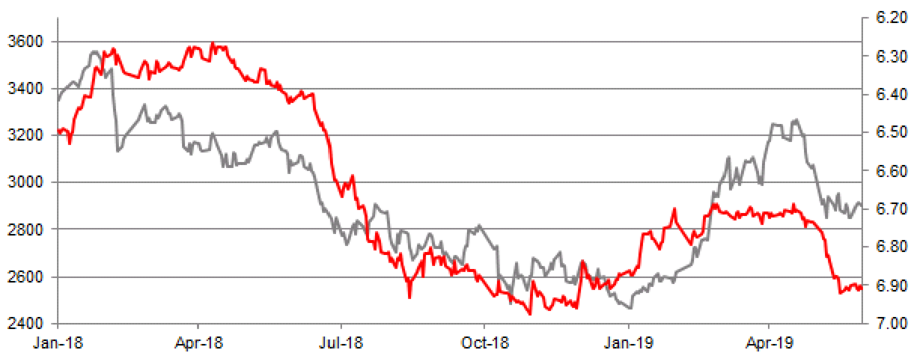
INTEREST RATE OUTLOOK

PBOC reform on hold; liquidity feels tight

Exchange rate volatility in May leads us to abandon PBOC rate cuts we had built into forecasts. As we had earlier explained, forecasted cuts were meant to illuminate the central bank's move towards a more market-determined benchmark for itself (an eventual interest rate corridor of its intervention rates) to communicate policy. With turmoil in markets, we think PBOC, like the Fed, is now a deer frozen in headlights as far as this reform is concerned. (We also hear of difficulties in adjusting SOE loans priced on the current benchmark.) Meanwhile the Baoshang failure led PBOC to announce it will undertake some unusual reverse repos at the end and beginning of months. As fake Arnold Schwarzenegger used to say, this is all to "Pump you up!" RMB liquidity felt tighter, both off and onshore, even if you won't see it at the shortest end of the curve. Approaching midyear, liquidity management figures to be tougher this year. The pronounced rally in US Treasuries appeared to have benefited Chinese govvies as well. As we'd noted in the *ACC,* higher yields provide more CNY support than previously.

Managing all markets

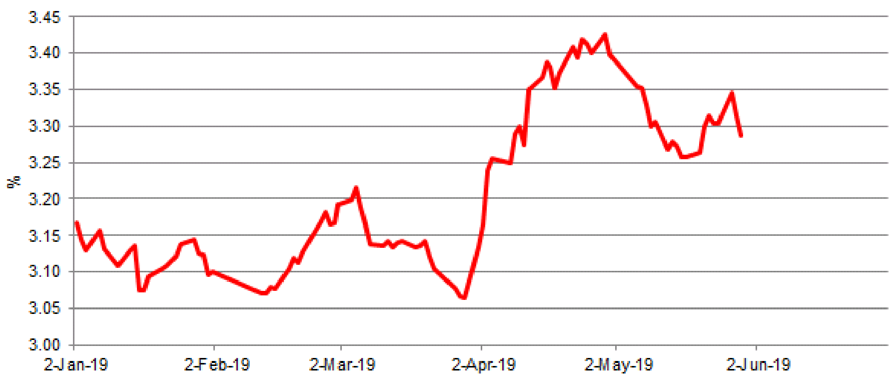
CHINA: EQUITY AND CURRENCY DEVIATE



Source: Bloomberg

Still stubbornly high

CHINA'S 10-YEAR GOVERNMENT BOND YIELD



Source: Bloomberg

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