Chinese renminbi

	Spot close 30.11.16	Q1 2017	Q2 2017	Q3 2017	Q4 2017
USD/CNY	6.8870	7.0000	7.1000	6.9000	6.8000
USD/HKD	7.7565	7.7550	7.7550	7.7600	7.7600
		Range	Range	Range	Range
USD/CNY		6.8500-7.1500	6.9000-7.2000	6.7500-7.0000	6.7000-6.9000
USD/HKD		7.7500-7.7650	7.7500-7.7650	7.7500-7.7650	7.7500-7.7650

MARKET UPDATE

Much weaker again; return of liquidity problems

We were bullish but not bullish enough, as the #Trump victory shock helped to also power USD/CNY higher to 6.8870 from a previous London monthly close of 6.7708 (another huge monthly rise of 1.7%). While we continue to believe PBOC is constrained to keep onshore interest rates lower for longer, some liquidity management problems have returned and pushed yields higher.

OUTLOOK

A journey of 10,000 pips started with policy

We think it's okay to give #Trump credit for the most recent, say, 1,200 pips higher in USD/CNY. But not for the entire, now nearly 10,000-pip journey from the all-time nadir (so far) of USD/CNY: A journey of 10,000 *li* may begin with the first step; the journey of 10,000 pips began with PBOC policy – you can't pin it on the US and you can't pin it on #Trump.

It's not only #Trump

In fact, we like the theme **it's not only #Trump,** meaning the fundamentals that have driven USD/CNY persistently higher are still here: A weakening economy, uncertain prospects and capital outflows - those, and the well-researched conclusion that **sterilized intervention never works.** (Given the enormity of the issues and usual space limitations, we will largely analyse #Trump and China elsewhere.) In fact, the capital control tightening that Chinese authorities announced at end-November is a very good indicator that capital outflows continue from China (as we have asserted for some time) and are turning threatening. (It's also a good sign that China's capital account is at least partially open, with some outflows able to skirt controls that had been put in place.) China's capital controls – as we relayed to clients earlier in the year – have borne out a longstanding intuition: That controls tend to last longer than expected (eg, Cyprus) and, if anything, to be tightened over time. We recall hearing of officials hinting to MNCs earlier this year that controls might be loosened by as early as May, which proved a false hope. Going forward, we expect authorities to be pretty heavy-handed in December and January on the 1-year anniversary of last year's turmoil, to keep USD/CNY < 7. But despite controls and regardless of #Trump, the fundamental factors above still point to an even higher USD/CNY. #Trump could not exist and this would still be true.

#Trump likely to name China a currency manipulator, but USD/CNY higher anyway

We do, however, expect a new President #Trump to name China a currency manipulator very early in his new term (maybe on Day 1). We can see a two-sided response by markets. Some might see this as the US drawing a line at 7 in the sand above which CNY can't weaken while the US begins what will likely be a protracted and multi-year process of negotiations. But if the Chinese economy is still slowing (the fundamentals listed above), others will conclude USD/CNY ***has*** to be above 7 eventually. In the end, we think fundamentals win.

	Interest Rate Close	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.35%
7-Day Repo Rate	3.24%	2.75%	3.25%	3.25%	3.50%
5-Year Yield	2.73%	3.00%	3.25%	3.50%	3.50%

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

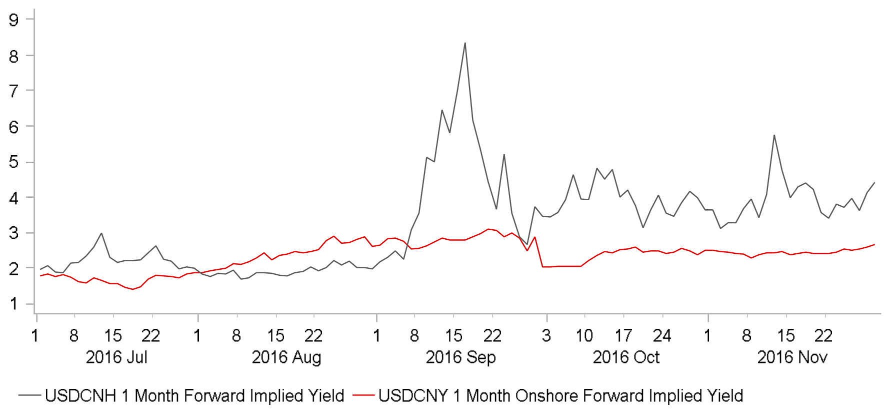
INTEREST RATE OUTLOOK

Government yields have bottomed but inflation likely under control

Though headline inflation has headed higher we look for both CPI and PPI measures to finish 2016 at around 2% and don't see them appreciably higher in 2017. We are witnessing the same sort of bank bidding for New Year liquidity as last year so expect tighter liquidity to persist into 2017 and likely into the Chinese New Year holidays (in late January). Historically there isn't much evidence of a Fisher effect in Chinese government bonds (ie, higher inflation leading to higher bond yields), especially not last year when inflation was rising but authorities encouraged a massive bond rally. PBOC continues to fight symptoms of property risk – this month curtailing developer bond financing – without, we think, the ultimate willingness to markedly slow down the housing sector (land auction prices are still setting new record highs). Many onshore expect liquidity to tighten further in the new year but we suspect this will not happen if growth begins to slow. China's liquidity hiccups have already crossed into commodities, underscoring the fragility of China's financial system and its dependence on liquidity.

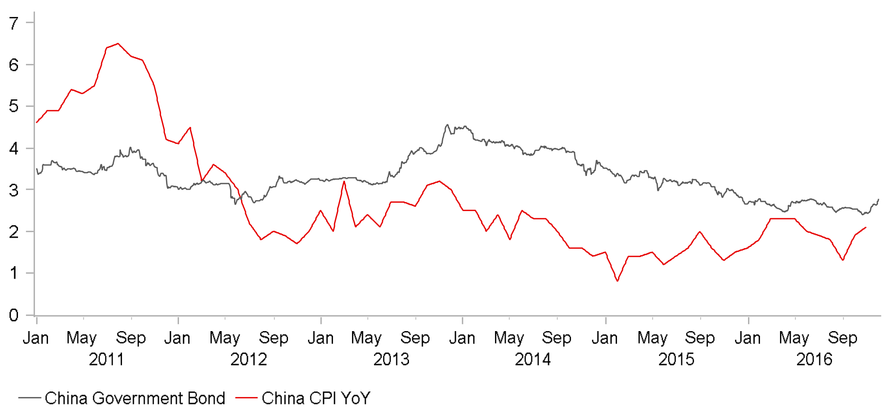
CNH clearly freer to trade

CHINA: CURRENCY NERVOUSNESS GROWING



Chinese inflation in 2017 should remain manageable

CHINA: LITTLE EVIDENCE OF FISHER EFFECT IN GOVERNMENT BONDS



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