Chinese renminbi

	Spot close 30.11.17	Q4 2017	Q1 2018	Q2 2018	Q3 2018
USD/CNY	6.6272	6.6000	6.7000	6.8000	6.9500
USD/HKD	7.8099	7.8050	7.8000	7.8050	7.8000
		Range	Range	Range	Range
USD/CNY		6.5500-6.7000	6.6000-6.7800	6.7000-6.9000	6.8500-7.1000
USD/HKD		7.7800-7.8250	7.7800-7.8250	7.7800-7.8250	7.7800-7.8250

MARKET UPDATE

Stronger; bond yields stabilized but it took some work

The renminbi strengthened slightly but again vs. USD, with USD/CNY falling to 6.6170 from October's 6.6272 London close. It was a full-time job for PBOC to restrain bond yields intra-month. On paper, they succeeded; but underneath the surface not all seemed well.

OUTLOOK

Less capital outflows than anticipated

We've brought down the level of USD/CNY in the forecast horizon significantly. Near-term, in the month ahead, it reflects our continuing error on the pace of outflows emanating from China. It's not that outflows have stopped (though bank net purchases on behalf of clients are suggesting capital inflows, the October reserve add was barely positive) but they don't seem of sufficient size to push the cross up to previously forecasted levels. (We've also noticed headline USD FDI growing in recent months.)

Real estate to slow, check; credit must be throttled, check; credit costs rising, check; slowing, check

But even the 6.7000 level we now posit for 1Q18 contains a hint of exchange authorities losing a bit of control over the near term. We remain comfortable with the fundamental outlook. We had expected real estate in China to slow either late this year or by early next year and that still seems on tap. We also think China's frenzied, credit-driven infrastructure push is unsustainable and will need to be throttled back in 2018; that also seems on tap. Most importantly, the rise in yields and credit spreads means China's credit costs are rising (with a discouraging knock-on effect for equities). In an economy so heavily dependent on credit (perhaps the most credit-dependent in the world), that should mean slowing in 2018. China may retain a 6.5% growth target for 2018 and report it as much, but we suspect growth on the ground might feel closer to 6.0% (which is our official growth forecast for 2018 = a -50bp handicap for overestimating growth).

De-leverage will be more serious in 2018 but not if it threatens growth

Financial risks have made it into the apex of official priorities for 2018 and while we downplayed de-leverage in 2017 as mainly talk with little action, a new triumvirate of Mr. Liu He as eventual head of the new super-regulator, Mr. Jiang Chaoliang as the likely next PBOC Governor and Mr. Guo Shuqing still at CBRC – all to be installed around the time of the March NPC – will be tasked by top leadership with taking this tack a little more seriously next year. The crucial question is whether they can be allowed to threatened growth, the achievement of which we had pointed out last month is of paramount importance for President Xi. If not, China's debt challenges will remain ineffectively addressed with underlying risks growing, not just lurking but spilling over.

Seems more natural to expect depreciation

In an economy with rising credit risks spilling over into equities, our reaction has been to look for the currency to weaken over time (which seems the natural view). The government will continue to exercise price-keeping operations.

	Interest Rate Close	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.35%
7-Day Repo Rate	3.44%	3.50%	3.75%	4.25%	4.00%
5-Year Yield	3.93%	4.05%	3.75%	4.15%	4.15%

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

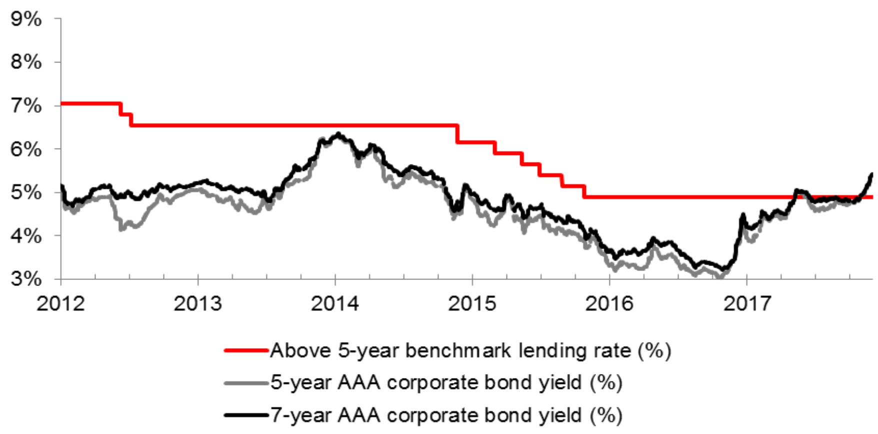
INTEREST RATE OUTLOOK

Some parts of shadow banking may be sliding off the rails

The strongest impressions we got out of November were of even more strident growth in China's shadow banking sector, in parts growth is unmonitored and at risk of sliding off the rails. Most distressing are suggestions of growing complexity in the shadow world which exists only to disguise the extent of true leverage. Though PBOC struggled through a difficult month to keep bond yields capped, there is still another month of massive refinancing before year-end. The extent of refinancing – given unmonitored growth described above – could be even larger than we think. Our benign expectations for global central banks (who sometimes seem so risk averse about recovery we wonder how they get out of bed in the morning?), led by a Fed under new management, will seem like a cooling salve to China's central bankers, but yields are normalizing everywhere anyway. Though benchmark yields remain < 4%, more telling are some policy bank paper that traditionally had been treated as near-sovereign but which all of a sudden seems no longer the case. Yields are higher and credit spreads wider, but may have farther to run.

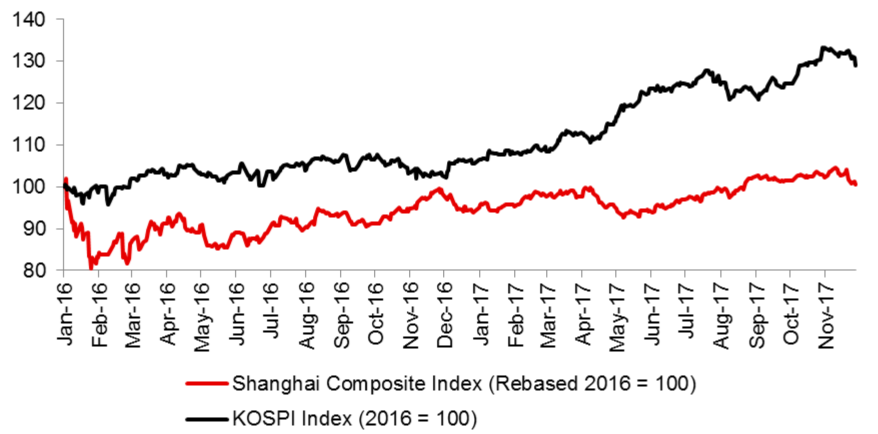
Wider but may have farther to run

THE AA- BOND SPREAD IN CHINA



Underperformance despite supposed 25% profit growth

SHANGHAI A-SHARES VS. THE KOSPI



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