Chinese renminbi

	Spot close 29.12.17	Q1 2018	Q2 2018	Q3 2018	Q4 2018
USD/CNY	6.5120	6.5500	6.6000	6.7000	6.8000
USD/HKD	7.8145	7.8100	7.8200	7.8000	7.8050
		Range	Range	Range	Range
USD/CNY		6.4500-6.6300	6.5000-6.7000	6.5500-6.7500	6.6500-6.9000
USD/HKD		7.7900-7.8300	7.7900-7.8300	7.7600-7.8150	7.7800-7.8200

MARKET UPDATE

Stronger, reversing 2016 losses (which was the point)

Renminbi strengthened 6.4% vs. USD in 2017, reversing its 7ppt loss the previous year – which was the point. 2016 losses were embarrassing for Chinese leadership, implying a loss of control, so the playbook last year was to show a reversal to communicate China is past its problems with the key operational tool capital controls. Peak USD/CNY in 2017 occurred at year-start in January at 6.9628 and the trough of 6.4905 ended the year. CFETS meandered most of the year between 93-95 without trend (and in accordance with our expectations), finishing at 94.85. PBOC proved unable to manage every single interest rates as credit spreads widened.

OUTLOOK

A final push down to end 2017

Authorities took advantage of thin liquidity at year-end 2017 to push USD/CNY down to around 6.50 (maybe the original intent of 811 and perhaps also to head off Trump trade threats). We start 2018 at a lower level but maintain the depreciation path. Looking back, we acknowledge error in forecasting USD/CNY above 7 in 1H17. We acknowledge surprise at the effectiveness of Chinese capital controls throughout 2017, which equalized a continuing outflow of capital to a positive basic balance and led to a stable renminbi basket and a stronger renminbi vs. USD. Second, we underestimated the extent of the global recovery in 2017, which aided Chinese stability.

The Year of Possibly Going through the Looking Glass

We updated credit risks in a separate topic note (*Fen* on the *Yuan*). Despite further, mysterious surges in local government debt. authorities managed to cut #overcapacity in some key sectors, an achievement that buys more time on debt – six to nine months, we'd reckon, so come 2H18 it will be time to re-assess in this Year of Possibly Going through the Looking Glass. If there is further foot-dragging on debt, a half-dozen or so major default events we witnessed in 2017 could mushroom to 15 or more this year.

Capital controls are here to stay

In 2017 authorities tightly managed the exchange rate but let the interest rate go. The intriguing question now is whether in 2018 they might not loosen exchange rate management in favor of managing the interest rate instead!? In order to do this safely, authorities need continued effectiveness of capital controls, which is a hint to not expect Chinese authorities to let go of capital controls anytime soon. In fact, controls were tightened at year-end with a new cap on permissible ATM withdrawals abroad. Such measures put paid to thoughts of a basically open capital account by 2020; sometimes we also wonder about the current account.

The Chinese consumer remains strong

It's fair to note the Chinese consumer remains on a strong footing, boding well for a service sector that has been leading growth. Such growth if it sustains will support government efforts to manage debt. We still have questions about reported industrial profits data.

	Interest Rate Close	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.35%
7-Day Repo Rate	6.00%	3.50%	3.00%	3.50%	4.50%
5-Year Yield	3.89%	3.50%	3.25%	3.75%	4.25%

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

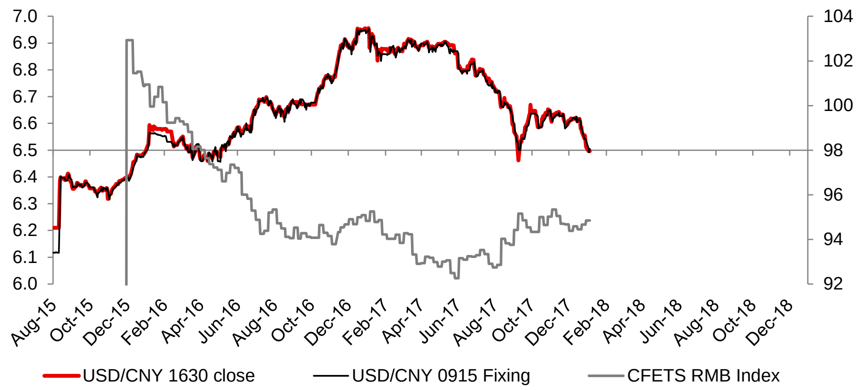
INTEREST RATE OUTLOOK

We anticipate another campaign to push down yields in 1H18, but they will pop back up

Because of a stage-managed bond rally that began in 2015, refinancing will become more troublesome in 2018. If companies – particularly the state ones – had to refinance at year-end 2017 interest rate levels (in the same neighbourhood as 2014), many firms may get in trouble. Therefore we expect another campaign in 1H18 to push down yields. Though the A-team of Liu (new super-regulator), Jiang (likely successor to PBOC Governor Zhou Xiaochuan) and Guo (continuing head of CBRC) are nearly in place, monetary tightening may be less tight than feared, at least judging by stock prices of China's largest developers which rallied to begin 2018. It was notable the 12-month trend growth of (Somewhat) Total Social Financing slowed immediately after the Party Congress ended, but it was only one month. How new lending quotas are disbursed in January will be key; if they disappear like US H1-B visas that would not bode well for prudential regulation. PBOC will be able to ignore a benign Fed another year due to noflation and capital controls.

Stability is key here

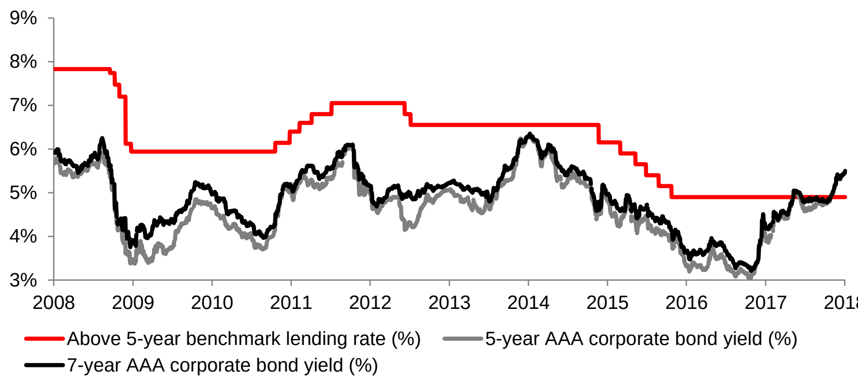
CNY: EXPRESSIONS OF POLICY INTENTION



Source: Bloomberg, MUFG Bank

Still wider, later, in 2018

CHINA: CORPORATE BOND SPREADS



Source: CEIC, MUFG Bank

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