CLIFF TAN

East Asian Head of Global Markets Research
Global Markets Division for the East Asian Region

T: +852 2862 7005
E: cliff_tan@hk.mufg.jp

Bank of Tokyo-Mitsubishi UFJ
A member of MUFG, a global financial group

CNY – R.I.P. Countercyclical Factor

10 January 2018

Key Points:

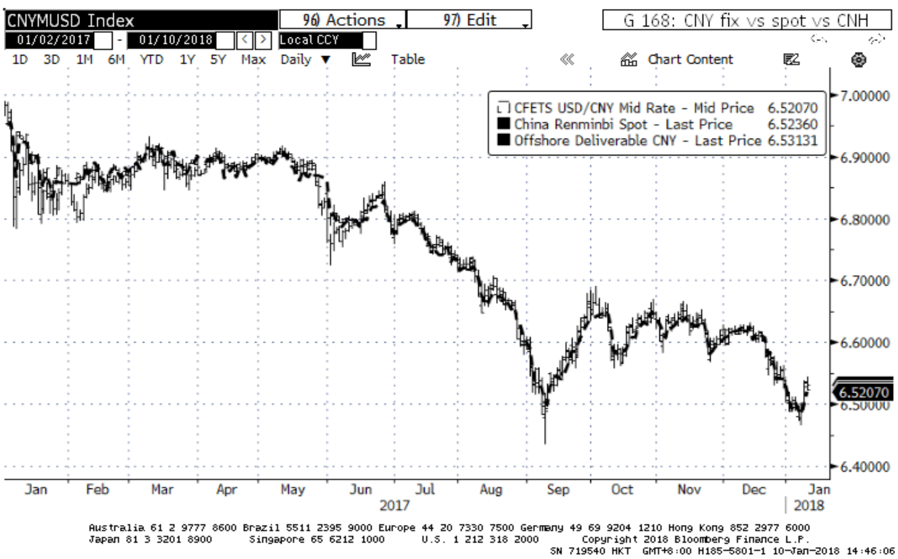
- **PBOC officially laid to rest its bizarre, asymmetric countercyclical factor (CCF)**
- **Which implies official confidence about capital inflows and growth**
- **But we don't think PBOC is signaling a reversal of USD/CNY direction**
- **Instead our best guess of official preferences is for a preferred USD/CNY range of 6.50-6.60 and a slightly stronger CFETS**
- **Which implies we won't see 2017 lows anytime soon so buy riskies**
- **We actually haven't seen CCF play a big role in daily fixings for several months but removing it could help the CNH market**

What Happened

PBOC officially announces CCF is dead

By leaking to Bloomberg (hence to international markets) then issuing a non-denial denial, PBOC confirmed yesterday an end to its countercyclical factor (CCF) experiment in the setting of daily fixes (which in our notes was version 3.0 of its daily fixing model), which began in May 2017. Today the central bank fixed at exactly the 1630 Shanghai close yesterday (the only close that matters), communicating that, *see, no more CCF at play.*

RENMINBI: FIX, ONSHORE, OFFSHORE



Source: Bloomberg

An Interpretation

The best interpretation of yesterday's move is authorities, feeling more confident about capital inflows and the economy, no longer need the CCF

Reviewing a recent history of the daily fixes, onshore spot and offshore spot since the start of 2017 will reveal the following patterns (and it's our contention the long-run trend of the fix *always* reveals official policy preferences, as we tried to intimate in the first chart of our January 2018 *Foreign Exchange Outlook* CNY section):

- After CCF was communicated to onshore fixing panel banks (full disclosure: we are one of them) in May, CNY/CNH saw a continuous appreciation to September
- Then we concluded 2017 with a bout of “two-way volatility”
- This is still not your father’s volatility as is commonly understood in global FX markets; what Chinese authorities seem to mean by “two-way volatility” (since February 2014) is that USD/CNY displays bi-directionality, over periods of up to a year – in this case, we saw bi-directionality in the final four months of 2017, between September and December
- **The proclamation yesterday suggested that authorities, given recent capital flows (remember we had, in yesterday’s *pm call note,* indicated more SAFE optimism on capital inflows) and the strength of the economy, now feel confident they can push this cross up and then down *at will***
- **Hence no more need for a CCF**

A Stronger Near-Term Economy

Near-term indicator of growth

In fact, that was the cleanest interpretation of yesterday’s action we found – that Chinese authorities are confident enough in the real economy to step away from the CCF, consistent with our admission in yesterday’s *call note* that Caixin PMIs since the New Year are stronger than our outlook.

A Signal of Direction

We don’t, however, think PBOC signal a reversal of direction

The most important connotation of yesterday’s move comes not in somewhat obscure changes in the daily fix for a handful of pips, but if PBOC intended yesterday to send a signal of a fundamental change in exchange rate management for 2018, such as in direction. That was the way some traders took it initially but is *not* our interpretation.

Best guess at official preference: Stable 6.50-6.60 range, slightly stronger CFETS with no trend

It’s hard to rationalize just now why authorities would suddenly have a preference for higher USD/CNY and, all else equal, a weaker CFETS Index. Rather our best guess of official exchange rate policy preferences at this stage is for a stable bilateral range of between 6.50 and 6.60 (our end-1Q18 forecast is 6.55 and end-2Q18 is 6.60). Because year-end bilateral appreciation sent CFETS above 95, whereas last year we thought authorities were comfortable with a 93-95 range without trend, we shift up our guess this year to 94-96, again without apparent trend. We note PBOC advisor Sheng Songcheng, who proved prescient in his late October 2017 remarks calling for USD/CNY to trade within a 6.50-6.60 range (USD/CNY finished 2017 at 6.5012) and who has, again, at the start of 2018 called for USD/CNY at the 6.60 level.

Which implies we won’t see 2017 lows anytime soon

However, if the signal is not so much about direction but a preferred range (above), this implies lows we saw in 2017 (6.4350 for the year) will not be breached; eg, we don’t think we see 6.4350 again in 1Q18. Since authorities presumably have already proven to themselves they are back in a regime where policy is decisive more than markets are decisive, there is no further utility to recreating another episode of bi-directionality but maybe they will do it anyway over the next four months (January-April), if only to prove how freely the renminbi trades.

No signal of volatility

And buy 1-year riskies

Taking the above guidance onboard implies two biases in 1Q18:

- **Buy on dips**
- More important, **buying USD/CNY riskies at a 1-year horizon** – which look super cheap – appeals

But probably not higher volatility

If there is no CCF, which after all was a leaning-against-the-wind mechanism, logically that should mean more volatility. But aside from the fact that this is still not your father's volatility (*"CNY – not your father's volatility,"* from the 25 October 2012 *FX Weekly* of more than five years ago!) – ie, actual daily variation is far, far below what's legally allowable day-to-day – see also our thoughts below.

CCF Has Been on the Back Burner for Several Months Now

We haven't seen CCF play a big role in fixings for several months now

Though some in markets have tied the appreciation of CNY that ended 2017 to CCF, our impressions for several months is very different: That CCF could have just been a piece of sophistry, because we really hadn't seen it have that big an impact on daily fixings. In fact, rumors had it a couple of months back PBOC had already informed banks to no longer use the CCF (this was also stated in the leak yesterday); but then we saw strange fixings anyway. So who knows? Bottom line is we've always thought PBOC mostly fixes however it likes, which to be sure has been closer to Big Dollar from 4Q17 on but CCF can hang for all it's been worth in the daily game. The implication here is we don't think officially removing CCF *by itself* is any reason to go long USD/CNY unless there are other reasons (as discussed above).

Oh Brother CNH, Wherefore Art Thou?

Removing CCF might help in CNH

One final motivation for yesterday's announcement is that there have been rumblings authorities might return this year to promoting the offshore CNH market they had effectively killed for the past 2-3 years (one reason we stopped publishing *The Global Renminbi*). Removing wildly mysterious factors in currency management could help.