Chinese renminbi

	Spot close 31.01.18	Q1 2018	Q2 2018	Q3 2018	Q4 2018
USD/CNY	6.2920	6.3500	6.4000	6.4500	6.5500
USD/HKD	7.8208	7.8200	7.8200	7.8000	7.8050
		Range	Range	Range	Range
USD/CNY		6.2500-6.5400	6.3000-6.5000	6.3000-6.5500	6.4000-6.6000
USD/HKD		7.7900-7.8300	7.7900-7.8300	7.7600-7.8150	7.7800-7.8200

MARKET UPDATE

All-time monthly strengthening but basket more stable as were rates

The renminbi strengthened by a monthly record percentage vs. USD – exceeding even its gain after the July 2005 de-peg – as USD/CNY fell 3.40% from 6.5120 to 6.2920 in terms of London closes. Movement in the CFETS Index (explained below) was far more muted, rising from 94.85 to 95.70 at pixel time. PBOC continued best efforts at keeping onshore yields corralled.

OUTLOOK

Forecasts have to be adjusted downward due to the USD meltdown

This will probably not be the last USD meltdown we witness in our lifetime. With spot below our last lower bound clearly forecasts have to be and have been adjusted. But though cosmetically it may seem all we've done is shift previous forecasts down 2,000 pips, there is a deeper logic.

USD/CNY has been looking a lot more like USD/SGD

A simple comparison between USD/SGD and USD/CNY, normalized since 1 April last year (so during the Japanese fiscal year) shows a tight correlation that can be instructive. Because we've long known SGD is managed as a basket peg and the last two MAS policy statements during this juncture called for a continuation of 0% appreciation with the same bandwidths and center point. That sounded eerily similar to our call last year for CFETS to trade between 93-95 with no trend. A basket peg can be considered a filter: As major currencies gyrate, sometimes wildly, a basket filters such influences down to a moderated path for the local currency – in this case either USD/SGD or USD/CNY – deemed appropriate for the local economy. A basket peg for China had long been seen (eg, by BIS) as perhaps a more appropriate form of monetary policy than simply anchoring renminbi to the dollar (early on after de-peg, China may have also consulted MAS).

China appears to have started to follow a true basket peg

The USD meltdown we witnessed to begin 2018 has been a good test of China's resolve to stick with a basket. To their credit, exchange authorities have stuck to their guns. Our prior guess for 2018 was a CFETS trading between 94-96, again with no trend. The revised CNY forecasts in this issue for 1-3Q18 are all consistent with CFETS staying within the 94-96 corridor; as we approach year-end we still see the return of credit problems as stimulating more outflows. Onshore feels short, perhaps encouraged by official circles with some banks seeking much lower levels. We should know in the next month whether there's a positive crawl (stronger) to this peg (we assume not); that's what will be required to get to much lower USD/CNY levels, but not till year-end. We're still not seeing the return of the capital inflows of old; this move feels more like prop positioning.

Credit problems will show up in interest rates but not exchange rates

It seems appropriate to note for the record our error in thinking the credit problems we have highlighted since late Summer 2015 will show up in exchange rates; they won't, for most of 2018, mainly because of effective capital controls. They have and will show up in interest rates, which is the next section.

	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	3.20%	3.50%	3.00%	3.50%	4.50%
5-Year Yield	3.84%	3.50%	3.25%	3.75%	4.25%

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

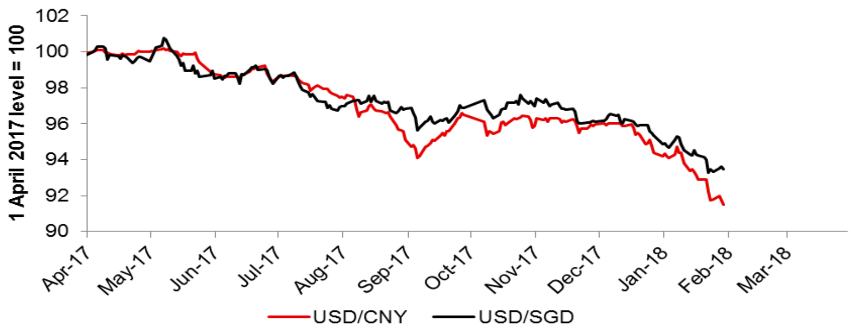
INTEREST RATE OUTLOOK

Slower credit growth is not exactly the same as de-leveraging

The last three months have seen authorities implement actual de-risking. Trend growth of new bank loans and (Somewhat) Total Social Financing has slowed, immediately after the 19th Party Congress ended. There is press talk that unlike all previous Januarys, new lending is also slowing indicating credit quotas are not being taken up. That China has de-levered without rising yields may reflect an underlying effort to tamp down credit demand. But we also have news local governments will issue a lot more special bonds, a product which only started from last September. This is a sign the local debt re-profiling led by former Finance Minister Lou from 2014 on *did not and has not solved the problem,* with Lou adding his voice to those worried about a Minsky Moment for China. A key litmus test awaits in 2Q18 if de-leveraging slows growth, placing a tough choice before top leaders. Whenever a credit event in the past had given leaders an opportunity to restructure, they have always backed away. There are influential onshore voices saying China should expect to accelerate from 2017's 6.9% growth rate but using *less* credit; we judge that unlikely.

Too close to be a coincidence

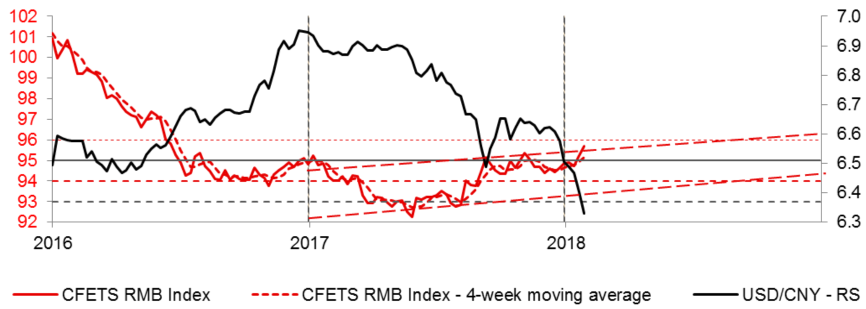
CNY VS. SGD: THE DARK MATTER OF BASKET PEGS



Source: Bloomberg & MUFG Bank

To crawl or not to crawl

CNY CFETS: THE WAY FORWARD



Source: Bloomberg & MUFG Bank

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