Chinese renminbi

	Spot close 31.05.18	Q2 2018	Q3 2018	Q4 2018	Q1 2019
USD/CNY	6.4010	6.4200	6.4500	6.4800	6.5300
USD/HKD	7.8442	7.8400	7.8400	7.8300	7.8200
		Range	Range	Range	Range
USD/CNY		6.2600-6.4500	6.3000-6.5000	6.3500-6.5500	6.4000-6.6000
USD/HKD		7.8000-7.8500	7.8000-7.8500	7.8000-7.8500	7.8000-7.8500

MARKET UPDATE

Sharply weaker; costs of corporate funding tightening

For a heavily managed currency, renminbi sharply weakened in May with USD/CNY up 570pips and finishing at 6.4010 compared with an April London close of 6.3439. We think costs of corporate funding are generally tightening, setting up another possible RRR cut to take effect in 2H18.

OUTLOOK

A lot can happen in a month

In just a month, USD/CNY blew past both our old 2Q18 and 3Q18 forecasts. At least we got the direction of weakening correct, a direction that didn't seem very popular with many market participants a few months ago.

The USD's strength is acknowledged but may not be unidirectional

The proximate culprit for a faster rise in USD/CNY was, of course, the dollar. Our new forecast path acknowledges the stronger level of the dollar as relevant new information for the balance of the year (also reflected in stronger USD team forecasts). But while it may look like a unidirectional path we would not be too shocked if there was some consolidation between 2Q and 3Q due to the Fed pause we have pencilled in for September.

USD demand and corporate defaults may both be about funding

Over the yuan's weakening in April and May it was impressive to us onshore USD demand which flared up from time to time. That's consistent with another observation, which is that we appear to be in another episode of corporate credit difficulties, something we expected but which seems to be occurring faster than we had thought. We still believe therefore that interest rate differentials are continuing to make a difference and will be even more influential after Fed hike #7. In the search for financing, even foreigners count.

Defaults don't proliferate in a strong growth environment

On growth, what can we say? We began this year thinking we'd have to shave another 0.5ppt off of official #s and at this stage we're not sure what to believe. Defaults shouldn't proliferate in a strong growth environment. But since we do believe actual de-leveraging is ongoing, the reluctance to show a slowdown is frustrating; a de-leveraging that doesn't affect any part of the real economy – nice work if you can get it. Some #s make sense. Infrastructure at the local level remains key as Trumped steel might as well be used at home. Housing sales so far show there is *no* sign of a property slowdown as we'd proposed (which means what de-leveraging there is is occurring elsewhere). But we think a wiser view is to expect local governments which cannot maintain their present pace of spending will have to fall back in 2H. Similar expectations should exports be frontloaded in an attempt to head off Trump in 1H18. And though early, if China is demographically shifting into an era of smaller and sometimes negative current accounts, that's material for the currency as well. The Big Turnaround, of course, would occur if the Politburo decides it's time to ease.

	Interest Rate Close	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Policy Rate	4.35%	4.35%	4.35%	4.35%	4.60%
7-Day Repo Rate	3.54%	4.00%	3.50%	4.50%	4.50%
5-Year Yield	3.45%	3.50%	3.75%	4.25%	4.50%

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

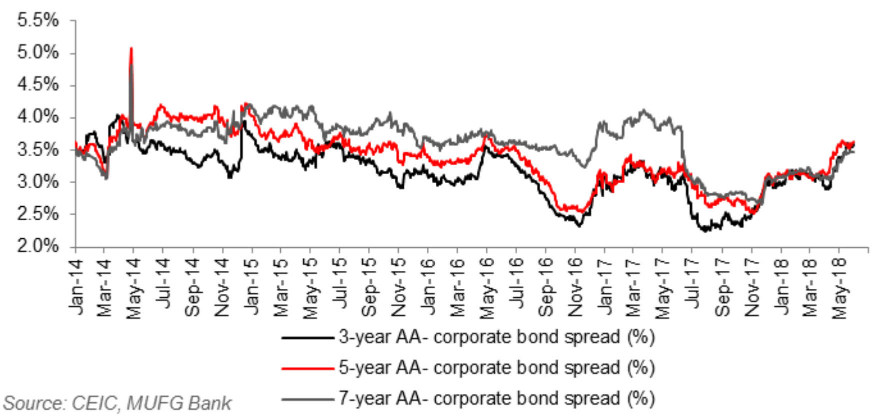
INTEREST RATE OUTLOOK

Once more, with feeling: De-leveraging is not restructuring

The jury is still out with re to expected liquidity tightness in June-July, but not so far out that we don't anticipate another RRR cut to take effect in 2H18. But as with the cut in April, we don't anticipate major interest rate effects. Instead, China safe yields are no longer tightening vs. US Treasuries as we had written, so the next Treasury sell-off will be painful for China as well. Meanwhile onshore credit spreads are still widening. The CERC default and cross-triggers added up to another USD1bn-size credit event, but it's hardly the only default. We acknowledge progress in de-leveraging: The TSF trend is still slowing; entrusted loans, trust loans and BAs appear to have been wrapped into bond form; and liquidity felt much tighter in April and likely also in May with offshore CNH rates feeling the effect. But there remain official hints the true state of banking balance sheets are not known and the extension of WMP rules (again) till end-2020 is a clear sign of forbearance meaning less resolve to tackle troublesome debt, which the market had partly anticipated. At the end of the day, it's all about restructuring zombies instead of hanging onto them.

Credit troubles lurk

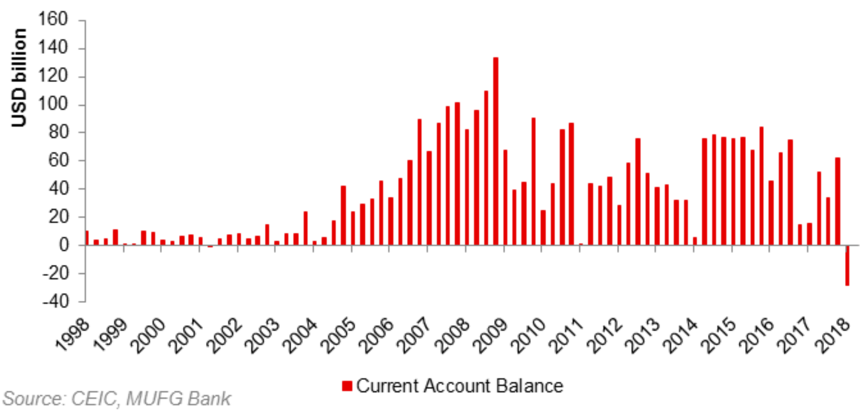
CHINA: CORPORATE SPREADS ARE STILL WIDENING



Source: CEIC, MUFG Bank

Trade remains in focus

CHINA: A RARE CURRENT ACCOUNT DEFICIT



Source: CEIC, MUFG Bank

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