The Global *RMB*

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Highlights

- **Our big call this month is towards an end of China's efforts to nudge borrowing costs lower, as the Fed further normalizes**
- **At some point interest rate differentials must matter for the currency**
- **Signs of onshore funding tightness extend offshore**
- **China opens up a second commodity futures, iron ore, to foreigners**

CNY: Review and Outlook

Trader Color. In April, CNY spot started within a tight 6.2600/6.3200 range with fewer corporate needs and dull USD, though rumors said authorities may lead a CNY depreciation as a countermeasure to trade war. The price finally broke the top of the range but the CNY index remained at a high level. Tight funding may contribute to this situation.

Weaker; lowering bond yields and an RRR cut. Renminbi weakened in line with a stronger USD in April, finishing at 6.3439 vs. the dollar compared with its 6.2904 March London close. CFETS strengthened back > 97. In our eyes, PBOC continued to encourage onshore bond yields lower while cutting its large-bank RRRs 1ppt, effective 25 April.

Not fear of floating, but fear of depreciation. We still believe a 94-97 range is most comfortable for PBOC, which reiterated a commitment to a basket peg in remarks by the Governor at the Spring IMF Meetings. That CFETS is still > 97 implies other parts of government are not so much fearful of floating but of showing any depreciation vs. USD (which means China is not strictly following a basket peg). Should the latter faction win in May we may see some re-appreciation, but with a stronger USD level we raise near-term forecasts a tiny bit and continue to think they seem reasonable relative to fundamentals.

Eventually USD yield differentials must make a difference. While the rest of the world see US Treasury yields rise there is the gut feeling USD interest rate differentials must begin to make a larger difference in the balance of the year. China, following its late 2015 – early 2016 currency scare, may have oriented currency policy last year largely toward puffing up stability even though capital was still flowing out; higher interest rates were the result. This year it feels confident enough to return to nudging interest rates lower. But we think we may be seeing an end to the narrowing yield differential vis-à-vis the USD and <u>don't think they can narrow much further</u>. Eventually for a debt-addicted economy, interest rates matter far more than an exchange rate, and to keep the former down against a normalizing Fed authorities may need to re-tighten capital controls before the year's out and also see the exchange rate go.

PBOC's RRR cut was more about demand than supply. PBOC's 1ppt RRR cut was to have freed up CNY1,300bn with CNY900bn of that going to pay off the MLR, leaving supposedly CNY400bn of free liquidity. But we have interpreted this exercise as more a statement about liquidity demand than liquidity supply. Because there was no announcement effect. In the run-up to implementation money market rates continued to grind higher, suggesting that though 10-year CGBs fell in yield to as low as 3.50%, that may mark a near-term bottom. Our way to communicate a bottom in rates/yields is to leave former forecasts unchanged.

Growth puzzles. China's March trade figures were puzzling, possibly indicating pre-shipments in anticipation of Trump's tariffs and then a giveback. The 1Q18 trade surplus, however, was the smallest since 1Q14 and should have meant a smaller net export contribution. We are also watchful for EU slowing impacts. But 1Q18 GDP growth reported out at 6.8%YoY anyway. Seventeen provinces, however, reported growth < national average. The official PMIs seem to be ignoring slowing in input prices again.

Temporarily tamping down credit demand – that's over. First quarter local government bond issuance was half 2017's pace, creating the temporary withdrawal of credit demand we had earlier thought might be happening. This will now step up from this quarter, which is partly why we think the yield massaging (down) we talked about in January may be nearing an end; with credit spreads also widening. With the yield curve having flattened, it occurred to us annual refinancing might include some extension of tenor, but that only increases duration risk in both banking and shadow systems. Ag Bank, one of the Big Four, issued new Tier 2s, but we wondered who was buying? Despite coming into the cross-hairs of top authorities, it turned out HNA's debt load increased in 2017 (by 21%), despite bank credit taps supposedly turned off. And Huarong Asset Management's chief appears under detention. We think investigators are following all links in the daisy chain towards their logical conclusions, but it surely must be embarrassing to have one of the original four AMCs caught up in the lending bubble. Murkiness remains core to China's debt cleanup strategy.

CNY: Onshore RMB

CNH: Offshore RMB

CNY Snapshot *4-May-18*

	Last			Last Month Range	
Tenor	*Bid*	*Ask*	*Mid*	*Min*	*Max*
Fix			6.3521	6.2764	6.3393
Spot	6.3493	6.3506	6.3500	6.2600	6.3498
O/N	-2.15	-1.95	-2.05		
T/N	-4.50	-4.50	-4.50		
1W	6.15	6.21	6.18		
1M	52.65	52.65	52.65		
2M	118.65	118.65	118.65		
3M	168.65	168.65	168.65		
6M	326.65	328.65	327.65		
9M	483.65	483.65	483.65		
12M	628.65	628.65	628.65		
2Y	1243.65	1243.65	1243.65		
3Y	1893.65	2018.65	1956.15		

CNH Snapshot *4-May-18*

	Last			Last Month Range	
Tenor	*Bid*	*Ask*	*Mid*	*Min*	*Max*
Fix			6.3467	6.2640	6.3310
Spot	6.3509	6.3511	6.3510	6.2549	6.3408
O/N	4.00	8.00	6.00		
T/N	1.00	5.00	3.00		
1W	9.90	12.40	11.15		
1M	78.15	79.00	78.57		
2M	158.65	168.65	163.65		
3M	235.15	246.65	240.90		
6M	450.82	460.82	455.82		
9M	670.07	685.07	677.57		
12M	868.65	888.65	878.65		
2Y	1533.65	1653.65	1593.65		
3Y	2233.65	2313.65	2273.65		

CNY Curve *4-May-18*

	Outrights (mid)			Implied Rates (%, mid)			NDS		
Tenor	*Onshore DF*	*NDF*	*Diff (pips)*	*Onshore DF*	*NDF*	*Diff (%)*	*Bid*	*Offer*	*Mid*
Spot	6.3500	6.3500							
O/N	6.3504								
T/N	6.3501								
1W	6.3512	6.3555	-42.97	3.4198	8.4747	-5.0549			
1M	6.3559	6.3645	-86.50	3.4942	5.6233	-2.1292			
2M	6.3625	6.3750	-125.50	3.5340	4.9909	-1.4569			
3M	6.3675	6.3855	-180.50	3.4976	4.7147	-1.2171			
6M	6.3834	6.4090	-256.50	3.4934	4.3208	-0.8275			
9M	6.3990	6.4340	-350.50	3.5543	4.2327	-0.6785			
12M	6.4135	6.4515	-380.50	3.6076	4.2482	-0.6407	4.45	4.65	4.55
2Y	6.4750	6.5265	-515.50	3.7575	4.1292	-0.3717	4.10	4.30	4.20
3Y	6.5462	6.5686	-223.50	3.8513	4.0771	-0.2258	4.10	4.30	4.20

CNH Curve *4-May-18*

	Outrights (mid)			Implied Rates (%, mid)			CCS		
Tenor	*Offshore DF*	*NDF*	*Diff (pips)*	*Offshore DF*	*Depo*	*Diff (%)*	*Bid*	*Offer*	*Mid*
Spot	6.3510	6.3500							
O/N	6.3516								
T/N	6.3513								
1W	6.3528	6.3555	-27.50	3.7754	3.5000	0.2754			
1M	6.3595	6.3645	-50.07	3.9146	3.4000	0.5146			
2M	6.3680	6.3750	-70.00	3.9214	3.7500	0.1714			
3M	6.3757	6.3855	-97.75	3.8958	3.9500	-0.0543			
6M	6.3972	6.4090	-117.83	3.8508	4.1500	-0.2992	3.80	3.95	3.87
9M	6.4194	6.4340	-146.08	3.8925	4.1500	-0.2575	3.88	3.98	3.93
12M	6.4395	6.4515	-120.00	3.9529	4.2500	-0.2971	3.91	3.96	3.94
2Y	6.5110	6.5265	-155.00	3.9947			3.95	4.01	3.98
3Y	6.5790	6.5686	104.50	4.0140			3.96	4.02	3.99

USD/CNY Onshore Implied Volatilities (in %) *4-May-18*

	Mid				
Tenor	*ATM*	*20D Z-Score*	*25C*	*25P*	*25DRR*
1W	3.55	0.25	3.78	3.71	0.08
2W	3.57	0.07	3.81	3.74	0.07
3W	3.61	-0.12	3.84	3.81	0.03
1M	3.65	-0.40	3.89	3.84	0.05
2M	3.58	-1.50	3.84	3.78	0.06
3M	3.56	-1.81	3.84	3.75	0.09
6M	3.56	-2.07	3.85	3.75	0.10
1Y	3.75	-1.96	4.05	3.91	0.14
18M	4.17	-2.36	4.77	4.43	0.34
2Y	4.42	-2.45	5.10	4.67	0.43

USD/CNH Implied Volatilities (in %) *4-May-18*

	Mid				
Tenor	*ATM*	*20D Z-Score*	*25C*	*25P*	*25DRR*
1W	5.43	1.56	5.75	5.38	0.37
2W	5.19	1.22	5.52	5.12	0.39
3W	4.98	0.93	5.31	4.87	0.45
1M	4.90	0.52	5.26	4.83	0.43
2M	4.93	0.25	5.34	4.86	0.49
3M	4.96	-0.02	5.42	4.88	0.53
6M	5.11	-0.53	5.62	5.04	0.59
1Y	5.35	-1.44	5.99	5.27	0.72
18M	5.59	-1.40	6.36	5.50	0.87
2Y	5.71	-1.39	6.58	5.62	0.96

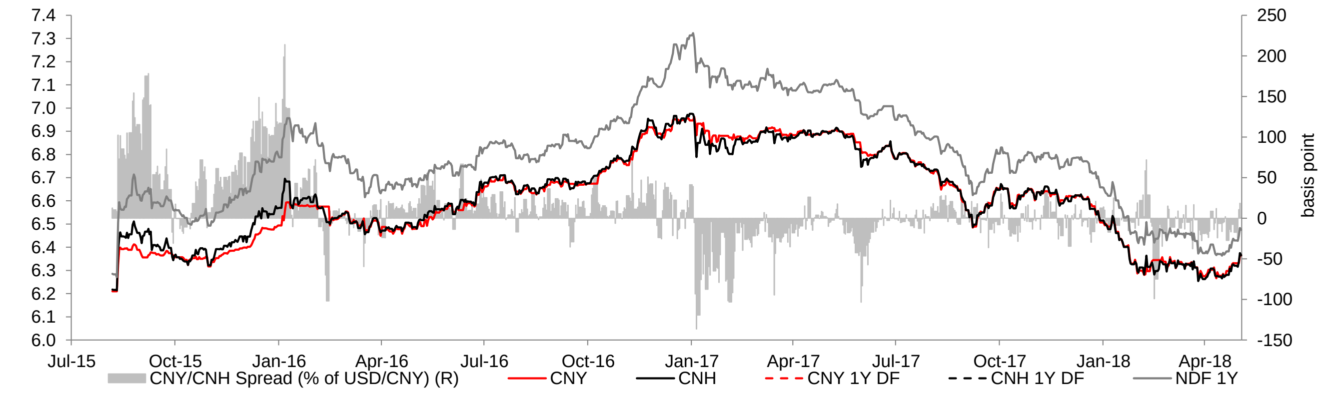
USD/CNY Offshore Implied Volatilities (in %) *4-May-18*

	Mid				
Tenor	*ATM*	*20D Z-Score*	*25C*	*25P*	*25DRR*
1W	4.98	1.15	5.29	4.92	0.37
2W	4.90	1.01	5.23	4.83	0.40
3W	4.85	1.10	5.20	4.75	0.45
1M	4.77	0.52	5.11	4.70	0.41
2M	4.82	0.34	5.22	4.73	0.50
3M	4.89	0.27	5.34	4.80	0.54
6M	5.03	-0.22	5.52	4.95	0.57
1Y	5.24	-1.57	5.84	5.16	0.68
18M	5.47	-1.48	6.22	5.40	0.82
2Y	5.61	-1.37	6.44	5.54	0.90

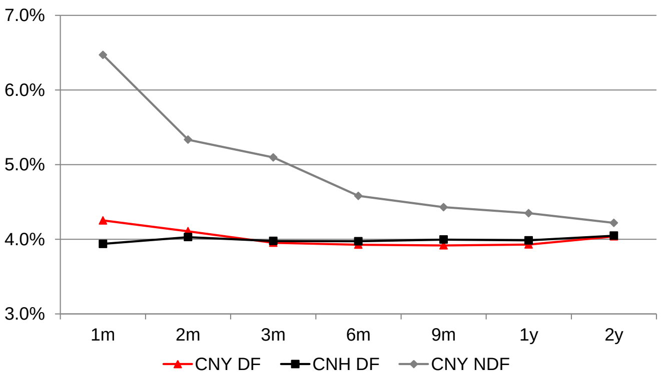
Source: Bloomberg, MUFG Bank

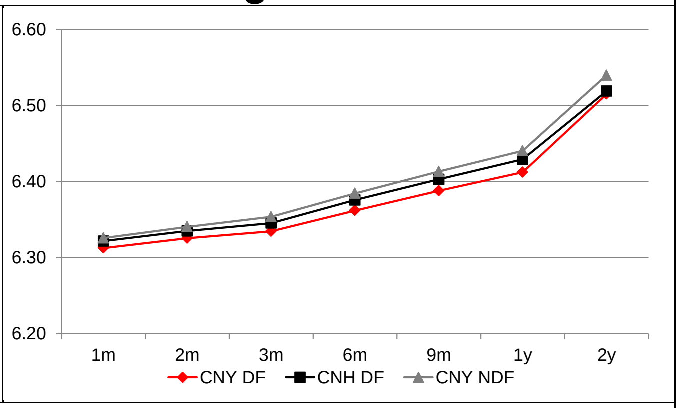
CNY: Onshore RMB

CNH: Offshore RMB

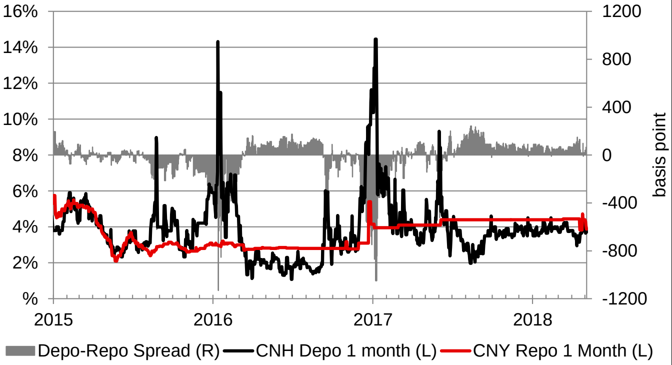


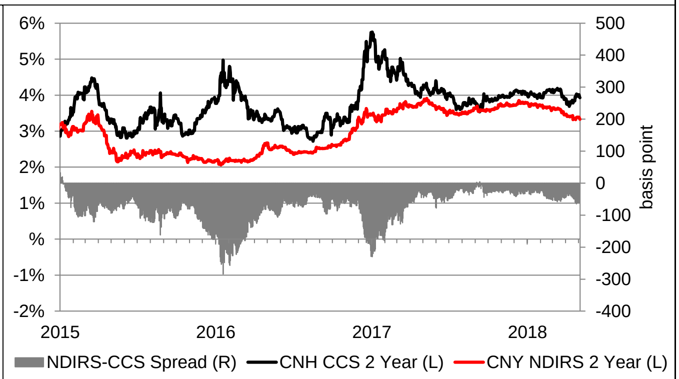
RMB Curve: Rates vs. Outrights



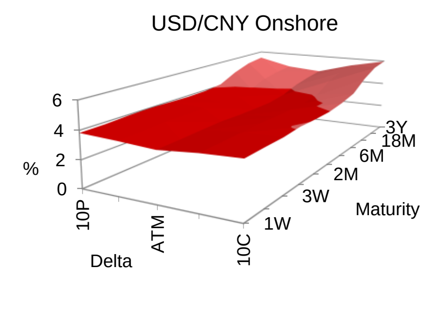


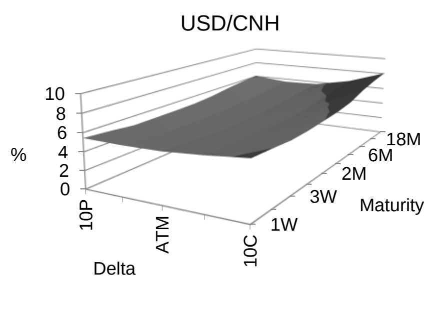
RMB Rate: Offshore vs. Onshore

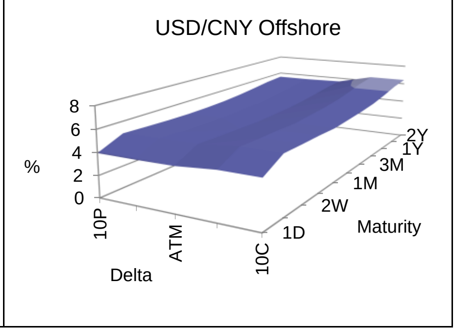




RMB Implied Volatility: Offshore vs. Onshore







Source: Bloomberg, MUFG Bank

OUR LATEST FORECAST: CNY AND CNH

	Spot close 02.05.18		Q2 2018	Q3 2018	Q4 2018	Q1 2019
USD/CNY	6.3602	Our forecast	6.3600	6.4000	6.4500	6.5300
		Forward price	6.3749	6.4008	6.4235	6.4444
USD/CNH	6.3747	Our forecast	6.3600	6.4000	6.4500	6.5300
		Forward price	6.3672	6.3892	6.4107	6.4313

Source: Bloomberg, MUFG Bank

CNH: Review and Outlook

Trader Color. USD/CNH spot generally traded at a 50pips discount to onshore. The pair rallied on speculation China would allow depreciation due to a trade war and traded above 6.3200, but that was quickly denied and spot headed back to 6.2700, with the pair stuck in a 6.26/6.32 range the rest of the month. DF traded down to a 700 handle with a lot of stop losses triggered, which compared to onshore cash is petty low. Funding turned tight at month end with 1-year traded back up to +950 and funding at 7.5pips over golden week.

Spot. Till the April turnaround in USD/RMB, it seemed fair to say there were stronger offshore sentiments for RMB appreciation than on (which hadn't always been the case). But as the CNY-CNH spot basis chart shows overleaf (note how thin divergences have become since the 2015-16 scare), spot divergence may also not be a great indicator for turnarounds. Even before 2015-16 we had characterized onshore straddling of offshore trade as akin to shutting down instruments in a plane, making the spot basis less useful as a barometer. While we can still use measures like riskies to gauge market expectations, more instruments are better (even for regulators).

Forwards/Rates. Since February traders have taken note of a persistent Northbound Stock Connect flow back to the Mainland. Yet A-H share premia have persisted and not narrowed much. In fact, we may be hearing client interest in borrowing more offshore. The most likely interpretation of all this seems to us a simple one: Onshore funding tightness which has necessitated more use of the offshore CNH liquidity pool. This, when you think about it, is not so encouraging for offshore business development. In fact, we had an odd RQDII regulatory change, to the effect that such yuan funds when they convert to FX (which they have to do by their very definition) must do it onshore. That's a bit renewed capital tightening. If we didn't know better, we might suspect some sort of liquidity loosening is afoot.

Products. Iron ore futures on the Dalian Commodity Exchange (DCE) will be open to foreign investors starting today. This is the second commodity that China is opening up to foreign investors, after the launch of crude oil futures in late March. As of 27 April, DCE has completed the entrusted services of 16 members of 16 futures companies and 21 overseas brokerage agencies, according to DCE's press release on 2 May. Major commodity traders, including Glencore, Trafigura and Cargill, already traded DCE iron ore via China registered units before the announcement, according to Reuters. In 2017, DCE iron ore futures volumes reached nearly 33bn tons notional versus actual global physical trade of about 1.5bn tons per annum, and the massive trading volume makes iron ore one of the few commodities whose global pricing takes its cue from China.

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