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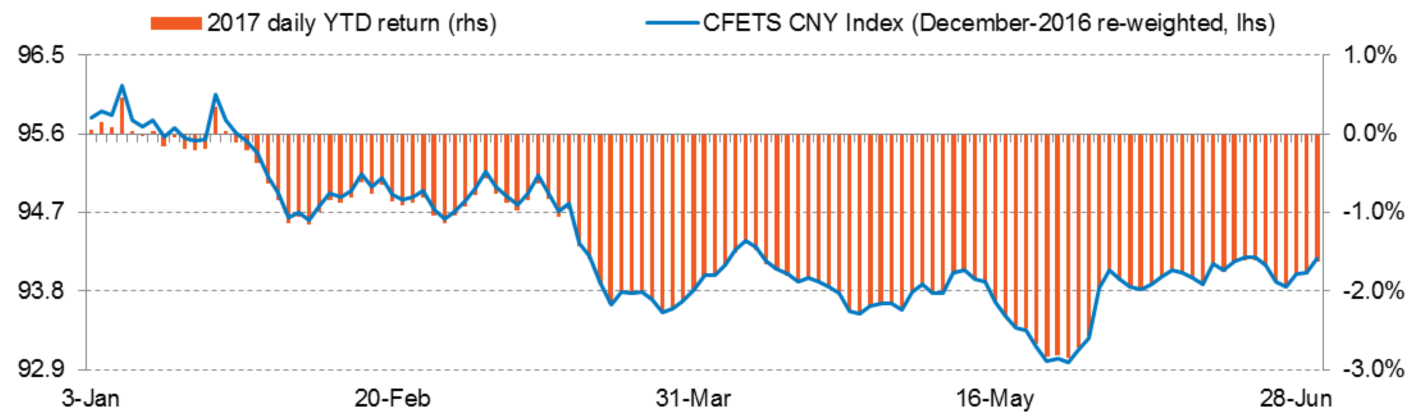
RMB Monthly: the adjustment continues

- Given the weak USD, China has relaxed the 'harder' USDRMB peg it initiated earlier this year
- China may undergo a slight growth deceleration in 2H 2017 but the RMB is unlikely to weaken much as a result
- Stability enhancements for the RMB are likely to increase in scope and duration as onshore markets slowly expand
- We would favour selling rallies into the 6.85/6.90 range in USDCNH

The trade-weighted RMB has appreciated slightly over the past month

Figure 1. CFETS CNY Index (trade-weighted mid-rate)



Sources: Bloomberg, CFETS, BMO FX Strategy

The CFETS CNY Index (i.e. the trade-weighted mid-rate) has appreciated by 1.1% over the past month (**Figure 1**). Against the basket of its trading partners' currencies, the RMB has been in a gentle downtrend since the start of the year. We ascribe the downtrend in the trade-weighted RMB to weakness in the trade-weighted USD (**Figure 2**).

Since the CFETS CNY Index is a trade-weighted mid-rate, PBoC has direct control over the extent of RMB appreciation or depreciation vs every single currency in the basket. This feature has allowed PBoC to set lower CNY mid-rates vs a range of currencies in lockstep with USD weakness. Effectively, the result has been a 'harder' USDRMB peg which has overlapped with enhanced Sino-US cooperation along the lines of trade and defence.

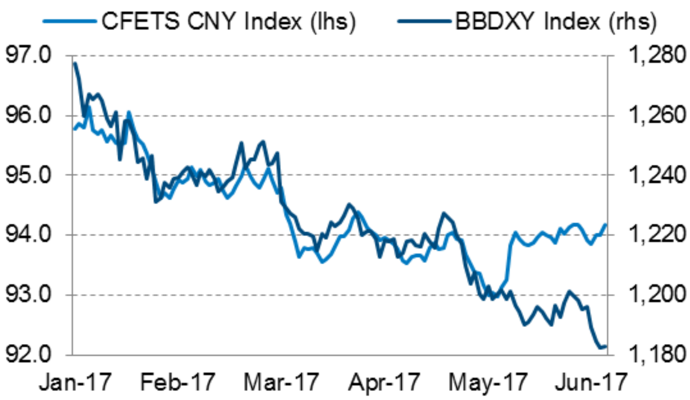
However, the tight relationship between the USD and the RMB broke down in June, setting the stage for modest RMB appreciation (**Figure 2**). We believe this development further highlights PBoC's commitment to a stable RMB as well as its desire to avoid measures of a protectionist nature. China can exert a degree of control over its currency without being a 'currency manipulator'. If anything, PBoC's behaviour towards the RMB since the start of the year demonstrates its commitment to two-way price action as opposed to persistent, one-sided intervention.

Making sense of the macro-policy mix

For many central banks, 2017 has been marked by a shift away from excessively loose policies. China has generally drifted in the same direction. PBoC's policy stance must always be analyzed from the perspective of two distinct spheres: one is the balance of payments (including the RMB) and the other is onshore macro economic conditions. Along these lines, efforts to keep the RMB stable and mitigate financial stability risks have 1) led onshore rates to remain above their end-2016 levels and 2) kept the annual growth rate of PBoC's balance sheet under its 12M average for most of Q2.

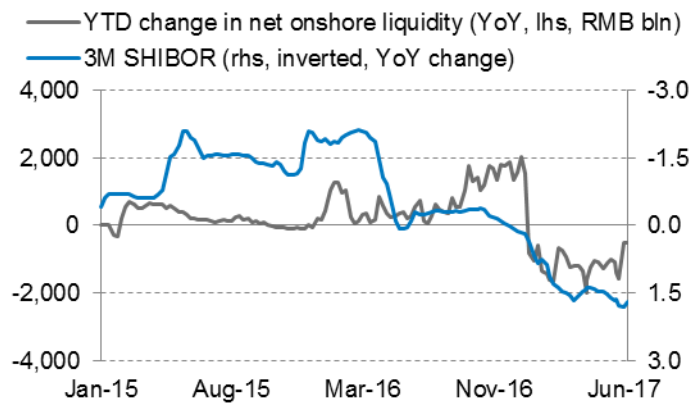
Onshore liquidity conditions eased slightly in June as PBoC sought to head off funding stress around quarter-end. However, year-to-date, the net injection of onshore liquidity is comfortably in negative territory (**Figure 3**). As a result, a slight deceleration in economic activity could materialise in 2H 2017. Indeed, some leading indicators may reflect this.

Figure 2. CFETS CNY Index vs BBDXY spot



Sources: Bloomberg, CFETS, BMO FX Strategy

Figure 3. Net onshore liquidity vs 3M SHIBOR



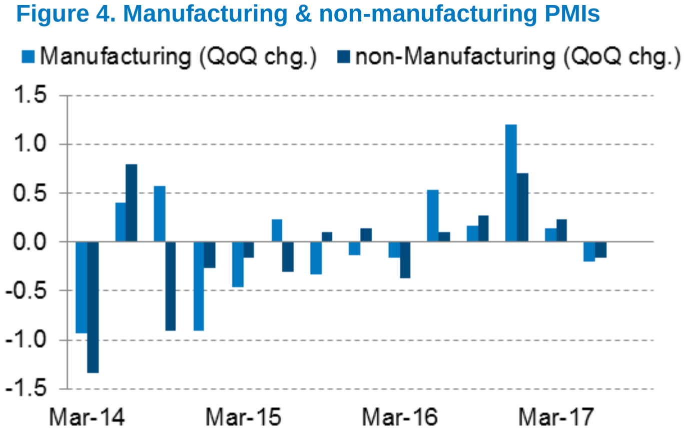
Sources: Bloomberg, PBoC, BMO FX Strategy

During April & May, China's Li Keqiang Index – which is a proxy for GDP growth and industrial activity – fell materially below its Q1 peak. At the same time, the manufacturing and services PMIs both dipped in Q2 relative to their Q1 averages (**Figure 4**). Moreover, the OECD's measure of broad (M3) money supply growth continued to decelerate in Q2, and China's credit impulse appears to have weakened just as the RMB started to appreciate.

We would not expect a growth deceleration in 2H 2017 to weigh on the RMB very much. On the one hand, the range of leading indicators highlighted above does not foreshadow a big enough deceleration to provoke large-scale capital flight. Meanwhile, the weaker USD and relatively high onshore (CNY) rates should continue to mitigate net capital outflows.

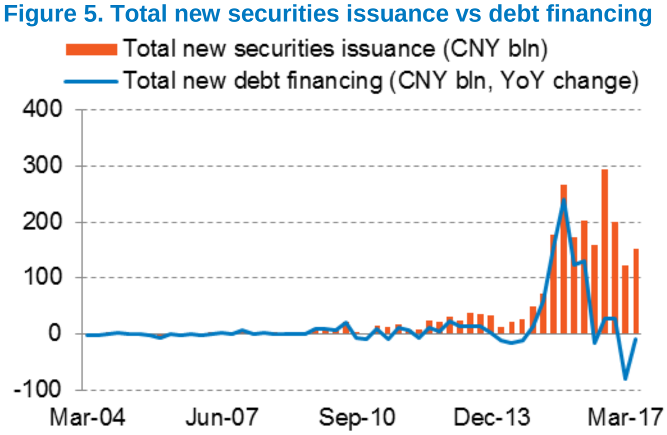
We don't expect PBoC's management of the RMB to change drastically between now and the CPC leadership elections in the autumn. Although net capital outflows from China decelerated this year, by our calculations, they still totaled $45 billion in the five months through May (valuation-adjusted basis). Based on this, we think China will continue to prioritize measures aimed at attracting capital inflows rather than measures related to the loosening of restrictions on outflows.

Figure 4. Manufacturing & non-manufacturing PMIs



Sources: China Federation of Logistics, BMO FX Strategy

Figure 5. Total new securities issuance vs debt financing



Sources: Haver Analytics, BMO FX Strategy

Market developments are critical to the economic adjustment

We think officials are well aware of the risks associated with debt-fueled growth, especially since China's traditional export/investment-led model is past its peak. As demonstrated in **Figure 5**, onshore debt issuance declined materially in the twelve months through April 2017. We associate this decline with various forms of macro-prudential & regulatory efforts aimed at reducing financial stability risks.

Another factor in play is the development of the onshore debt markets. Since Q1 2016, eligible investors have gained access to various markets for CNY-denominated debt. Offshore investors will be able to trade onshore bonds in Hong Kong later this year and a Hong Kong-mainland Bond Connect programme is also expected to be rolled out. The late-May downgrade of China's local & foreign currency ratings by Moody's was a setback, but in combination with the aforementioned developments, it marks a step towards greater transparency as far as risk perceptions are concerned.

Market developments of this nature are why we believe PBoC will prioritize RMB stability for the foreseeable future. We would classify further efforts to attract inbound long-term debt flows as stability enhancements. This is not only because greater interest from foreign investors reduces net capital outflows, but also because involvement from foreign investors will diversify China's lending sources, reduce the strain on bank balance sheets and allow debt restructuring to continue.

Our view

We expect USDCNH to trade at 6.75 in 1M, 6.86 in 3M, 6.86 in 6M, 6.70 in 9M and 6.65 in 12M. We expect USDCNH volatility to remain subdued in the month ahead and we look for this environment to persist into the autumn CPC leadership elections. We currently expect the debate on looser fiscal policy in the US to support the USD at the 3-6M horizon, but we look for a full reversal of USD strength at the 9-12M part of the curve due to a weaker US 'twin sins' score.

The opening of China's onshore debt markets to foreign investors appears to be gathering momentum, and RMB stability is a crucial element of this process. Therefore, in the months ahead we expect PBoC to prioritize the loosening of restrictions on inbound flows over the loosening of restrictions on outbound flows. On balance, this should provide support to the RMB and reduce periods of RMB weakness to a minimum.

China needs the sanction of foreign investors in order to expand its onshore debt markets, diversify its funding sources and attract sustained capital inflows. RMB stability is a critical link between the management of financial stability risks and attracting increased interest in CNY-denominated assets from abroad. For the time being, the alignment of these factors suggests limited upside potential for USDCNH, and our preferred strategy would be to sell rallies into the 6.85/6.90 range.

Table 1. FX Strategy views for onshore, offshore RMB and the USDCNY mid-rate

Variable	1m	3m	6m	9m	12m
USDCNY spot FX strategy view	6.75	6.86	6.86	6.70	6.65
USDCNH spot FX strategy view	6.75	6.86	6.86	6.70	6.65
USDCNY mid FX strategy view	6.74	6.85	6.85	6.69	6.64

Sources: BMO FX Strategy

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