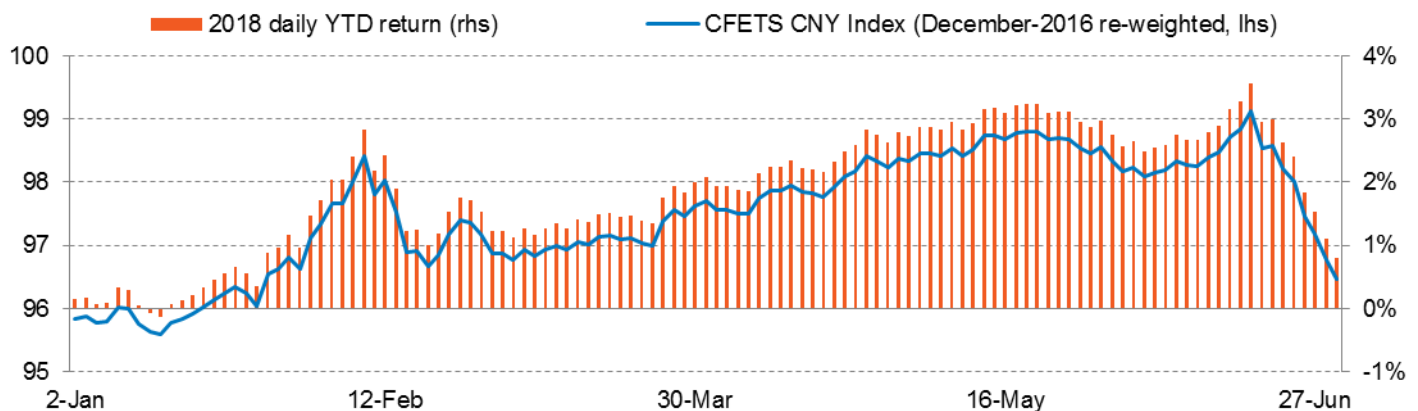


RMB Monthly: wildfire or controlled burn?

- There has been a major shift towards RMB weakness but the reasons for the decline are less than straightforward
- We think this latest episode of RMB weakness is partly a PBoC-orchestrated move that has further to run
- China may be preparing to use RMB weakness as a last resort option in the escalating trade war with the US
- We favour buying the 3M USDCNH forward and look for a potential move to 6.85 as soon as the coming month

The trade-weighted RMB is down 1.75% in June and 1.18% in Q2

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



Sources: Bloomberg, CFETS, BMO FX Strategy

The CFETS CNY Index (trade-weighted mid-rate) has fallen 1.75% in June. After a strong start to Q2, the weakness in June has brought the 3M return to -1.18%. As shown in [Figure 1](#), the recent decline in the Index has been fairly dramatic. At its 2018 peak in mid-June, the Index was up 3.6% YTD. As of now, the YTD return is just +0.79%.

We see two possible causes of RMB weakness. The first possible cause is that the RMB is succumbing to an indiscriminate increase in outbound flows which the PBoC has failed to arrest (i.e. in a similar vein to the 2015 episode). The second possible cause is that the move in the RMB has been fully orchestrated by PBoC, given the worsening US/China trade relationship and China's previous loss of competitiveness vs other local market currencies ([Figure 2](#)).

We do not think there is conclusive evidence either way, so our judgement is that a mix of the two is occurring. Anecdotal information suggests that RMB inflows declined substantially in late-June. The recent increase in the CNH discount to the CNY is consistent with the general trend towards local market outflows.

However, China's outbound flow restrictions and oversight are, on balance, higher today than in 2015, particularly in the area of FDI. China has also had a large basic balance surplus, which averaged \$56 billion per quarter in the four quarters through Q1 2018.

We may have also observed at least one additional sign of damage control on the part of regulators. China's foreign currency denominated debt is already quite low. But on June 28, news broke that the National Development and Reform Commission (NDRC) was considering a ban on USD debt sales in Hong Kong by some mainland entities. Such a move would fit with the general trend towards deleveraging and insulating China from further RMB weakness vs the USD.

Greg Anderson, Global Head of FX Strategy, +1 212 605 1409

Stephen Gallo, European Head of FX Strategy, +44 20 7664 8124

Canada Sales

Toronto +1 416 359 8681
Montreal +1 514 282 5950

U.S. Sales

Chicago +1 312 845 4080
New York +1 212 702 1284
San Francisco +1 415 591 2102

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London +44 20 7248 0424

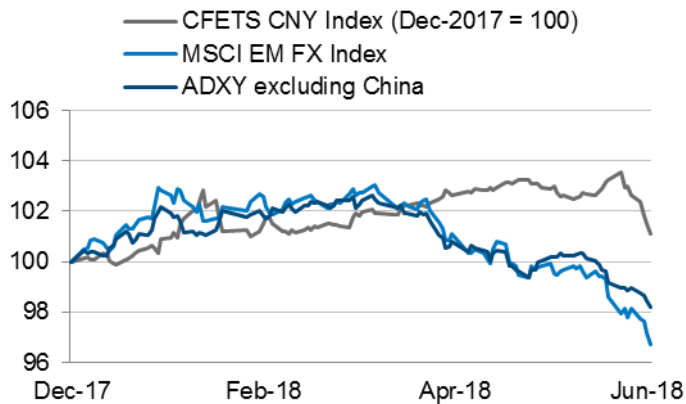
Asia Sales

Guangzhou +86 20 8669 5148
Hong Kong +85 2 3406 0670
Shanghai +86 21 6136 3628

This confluence of factors suggests that a portion of the weaker RMB has been orchestrated by PBoC in response to escalating US/China trade tensions. Given China's strong BoP and PBoC's ability to control the RMB, we are reasonably confident that China can execute a 'controlled burn' without it turning into a wildfire of uncontrollable RMB weakness.

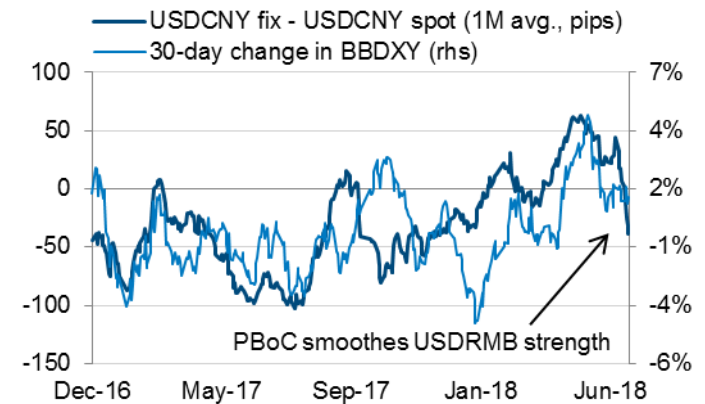
However, the risk of policy misstep and a spiraling decline in the RMB is clearly greater than zero. As such, we expect PBoC to use various measures to smooth the extent of the move higher in USDRMB.

Figure 2. CFETS CNY Index vs other EM currencies



Sources: Bloomberg, CFETS, BMO FX Strategy

Figure 3. USDCNY mid-rate vs USDCNY spot & BBDXY



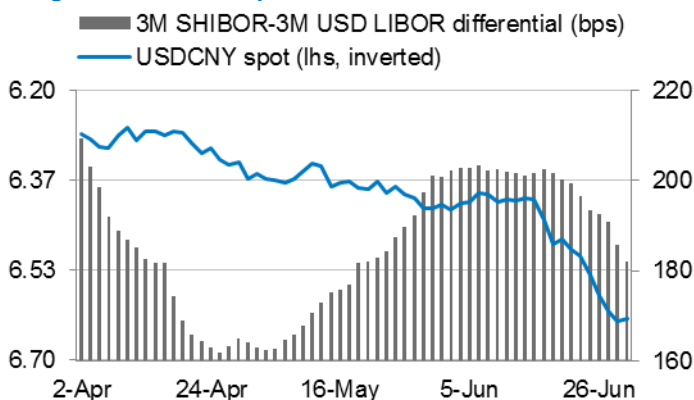
Sources: Bloomberg, BMO FX Strategy

China was already slowing the pace of RMB strength

In prior Monthlies we highlighted the extent to which PBoC was moderating the pace of RMB strength (i.e. putting a floor underneath USDRMB). With hindsight, it appears as if PBoC was doing so in part because it viewed an escalation of US/China trade tensions as a high-risk scenario. As shown in **Figure 3**, the trend in the USDCNY mid-rate relative to spot for most of Q2 was generally higher, prior to late-June. This aforementioned trend has been supporting the USD.

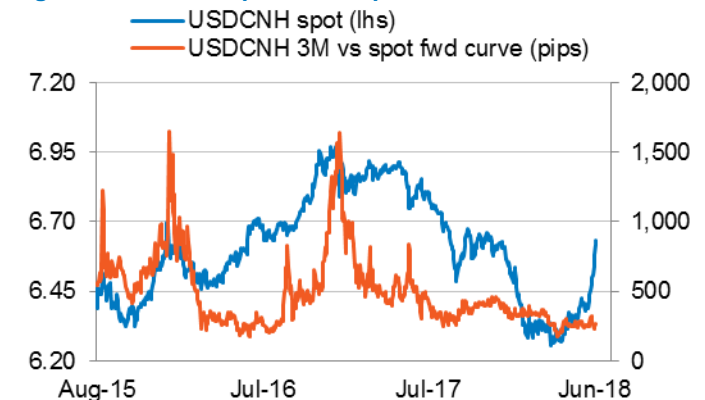
There have been other signs that PBoC has been putting a floor underneath USDRMB. By our calculations, SAFE experienced a valuation-adjusted reserve build of \$20 billion in the five months through May on a cumulative basis. PBoC has also held key onshore and offshore RMB rates fairly steady for the past few months. One result has been the 3M USD LIBOR/SHIBOR rate differential generally holding below 200bps in Q2 (**Figure 4**).

Figure 4. USDCNY spot vs 3M SHIBOR/LIBOR differential



Sources: Bloomberg, BMO FX Strategy

Figure 5. USDCNH spot vs 3M/spot forward curve



Sources: Bloomberg, BMO FX Strategy

A long 3M USDCNH forward position is a bet on PBoC smoothing

In **Figure 5** we highlight the current position of the USDCNH spot/3M forward curve in comparison with prior episodes of RMB weakness. In those prior episodes, the common denominator was the degree to which higher RMB rates were used

by PBoC to halt RMB weakness. At the current juncture, the flatness of the USDCNH forward curve suggests that we are not yet at a stage where PBoC is uncomfortable with the degree of RMB weakness.

Given China's large bilateral goods trade surplus with the US and the unflinching nature of the Trump administration's stance, we suspect that the first move towards de-escalating trade tensions will have to come from China as it cedes some ground to the US. It therefore seems logical to us that China will want to enter the forthcoming negotiations with a meaningful degree of RMB weakness already in train, in view of concessions that may need to be offered.

We therefore believe that PBoC will be willing to tolerate some further tightening of financial conditions in order to smooth the pace of RMB weakness, and we expect some upside in the 3M USDCNH forward to materialize through the summer. PBoC has recently kept a lid on RMB rates through targeted forms of monetary easing, but longer-term concerns about leverage growth suggest that this is likely to be a temporary phenomenon.

Our view

We expect USDCNH to trade at 6.70 in 1M and 6.74 in 3M ahead of a resumption of USD weakness in the 6-12M part of the outlook curve. We think the latest episode of RMB weakness partly reflects an orchestrated response from PBoC to the escalating US/China trade war. In our view, China can benefit from some further weakening of the RMB but the PBoC has the necessary tools to control the extent of the decline.

The current flatness of the USDCNH forward curve suggests that we are not yet at a stage where PBoC is uncomfortable with the degree of RMB weakness. We eventually expect RMB rates to rise as PBoC seeks to put a floor under the RMB, and our preferred strategy right now is to get long of the 3M USDCNH forward in anticipation of a move towards 6.85 over the next 1-3 months.

Table 1. FX Strategy views for onshore, offshore RMB and the CFETS CNY Index

Variable	1m	3m	6m	9m	12m
CFETS RMB Index (change from today, %)	-0.50	-1.00	0.00	+1.00	+1.25
USDCNY spot FX strategy view	6.70	6.74	6.73	6.48	6.33
USDCNH spot FX strategy view	6.70	6.74	6.73	6.48	6.33

Sources: BMO FX Strategy

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