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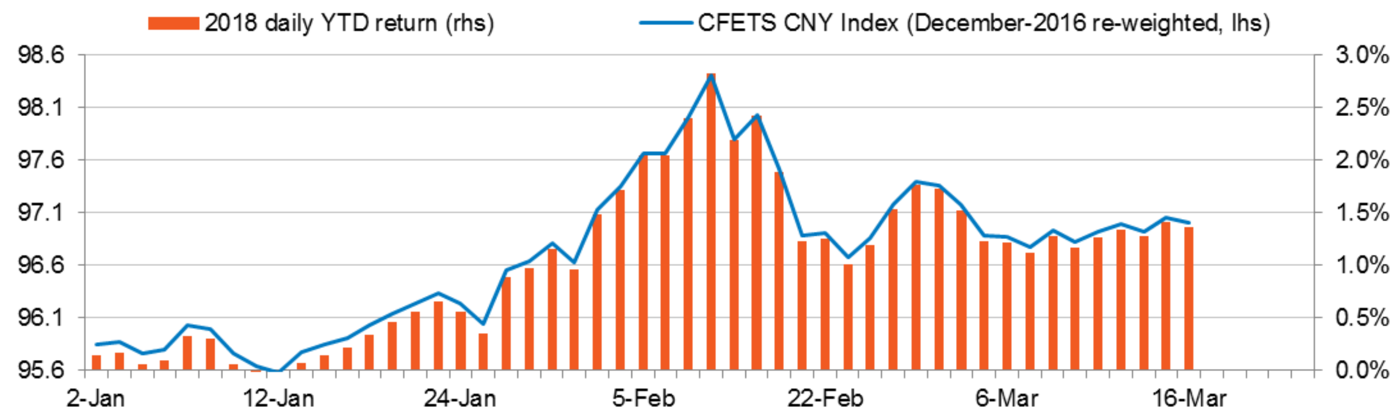
RMB Monthly: tougher trade

- The PBoC still appears to be promoting a policy of controlled RMB appreciation
- It looks as if US President Trump wants to escalate his recent trade decisions & rhetoric into a broader trade war
- We expect China to put further emphasis on RMB stability and take a cool-hand approach to Trump's trade stance
- We look for USDCNH to hold in a 6.30/6.35 range over the coming month ahead of further downside in 6-12M

The trade-weighted RMB is flat over the past month but higher in year-to-date terms

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



Sources: Bloomberg, CFETS, BMO FX Strategy

The CFETS CNY Index (trade-weighted mid-rate) is unchanged from its month-ago level but up 1.4% on a year-to-date (YTD) basis (**Figure 1**). Against the USD, the offshore RMB (CNH) has traded in a narrow range over the past month, but it is up 2.9% YTD. This YTD return is above the performance of most G10 currencies (save NOK, JPY and GBP).

Short-term onshore rates experienced sustained upward pressure in 2017. However, the upward pressure on short-term rates has subsided since the start of 2018. For the most part, the flatter short-term rate profile has coincided with reduced downward pressure on the USDCNY mid-rate over the past month (**Figure 2**). The USDCNY fix is down 88 pips since the last trading day in February before the Lunar New Year, while USDCNY spot has declined more than 140 pips.

The aforementioned data from the last month indicate a consistent approach to RMB management on the part of the PBoC. Given the tendency of the RMB to appreciate in recent quarters, at varying times the PBoC has utilized the CNY mid-rate and its influence over RMB rates to moderate – but not fully resist – the pace of RMB strength. As a result, we have not yet observed a shift in the PBoC's policy of promoting controlled RMB appreciation.

Trade tension is the [biggest] elephant in the room

If we take his recent trade decisions and rhetoric at face value, it would appear that US President Trump is seeking to provoke a trade war with China. However, a full-scale US/China trade war is not our base scenario because both sides have too much to lose and are aware they are in a prisoner's dilemma.

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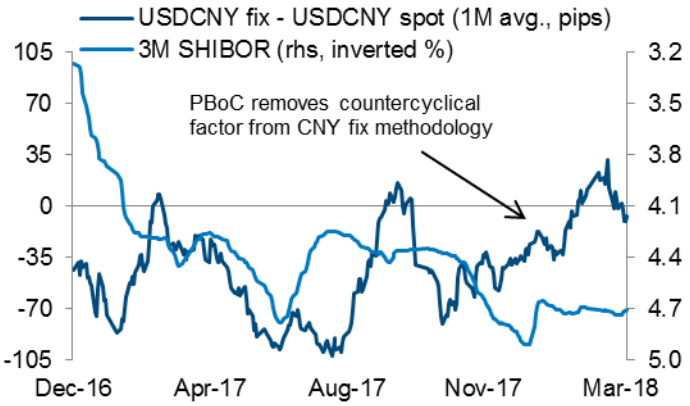
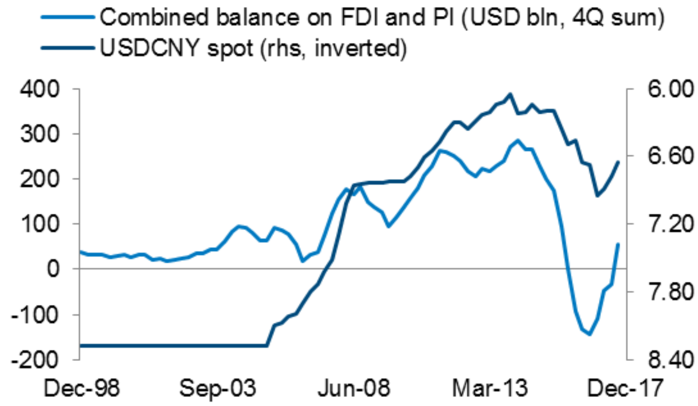
Nevertheless, we do acknowledge that the risk of a full-blown trade war has increased materially in recent weeks. Such an escalation could cause expectations for global growth to be materially reduced. If that were to happen, we would expect many EM currencies to suffer and our outlook for further RMB strength vs the USD would need to be revised.

Figure 2. USDCNY mid-rate vs spot and 3M SHIBOR



Sources: Bloomberg, BMO FX Strategy

Figure 3. USDCNY spot vs net FDI & PI (through Q3 2017)



Sources: Haver Analytics, BMO FX Strategy

A major RMB devaluation is a last resort option for China

However, we don't foresee a period of major RMB weakness or instability ahead, regardless of how US/China trade tensions play out. It is crucial that the recent US/China trade war hype has emerged just as the National People's Congress (NPC) voted to scrap the two-term limit for China's presidency. A key reason for this change in China's constitution is President Xi's status as a reformer and his pursuit of developed market status for China's economy.

The reforms in question span many areas including financial markets, government institutions, public housing, fiscal policy and infrastructure development. Our view is that RMB instability would be a major distraction from those reform efforts and a hindrance to their progress. When there are problems at the global level, China will be keen to avoid the instability from the type of exchange rate volatility that besets many of its EM peers.

However, in the case of China, there are also direct links between reform progress and exchange rate stability. Many of the reforms in question are reflationary in nature and have been partly responsible for the recent upside in the consumer price index (CPI). As such, it is easy to see why prolonged RMB weakness would be undesirable at this juncture.

We would also expect elevated exchange rate volatility to coincide with sharp moves in RMB rates, leading to complications for China's monetary and macro-prudential policy stances. Moreover, some of the latest balance of payments data show significant direct and portfolio investment inflows from abroad. We do not think regulators would want to do anything to encourage a reversal of these flows (**Figure 3**).

Our view

BMO FX Strategy expects a pause in the USDRMB downtrend on a 1-3M basis followed by a resumption of USD weakness in 6-12M. A key factor behind the current pause is the recent shift in US trade policy, which may have implications for global growth. We therefore see USDCNH trading at 6.32 in 3M, 6.29 in 6M, 6.25 in 9M and 6.11 in 12M.

For the month ahead, we would look to play the 6.30/6.35 range in the pair. Given Trump's trade rhetoric and China's recent acceptance of RMB appreciation, we would not be surprised to see the PBoC use the USDCNY mid-rate or other administrative tools to lean into a temporary period of broad based USD strength. As a result, we would avoid getting short of USDRMB below the 6.30 level over the coming month.

We do not foresee a period of major RMB weakness or instability ahead regardless of how US/China trade tensions play out. Put simply, we would view RMB instability as a major hindrance for China on the basis of four key factors including: 1) the structural reform path, 2) competition for foreign capital, 3) international credibility and 4) domestic market tranquility.

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

Variable	1M	3M	6M	9M	12M
CFETS RMB Index FX strategy view (% chg.)	0.00	+0.10	+0.75	+0.50	+0.40
USDCNY spot FX strategy view	6.33	6.32	6.29	6.25	6.11
USDCNH spot FX strategy view	6.33	6.32	6.29	6.25	6.11

Sources: BMO FX Strategy

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