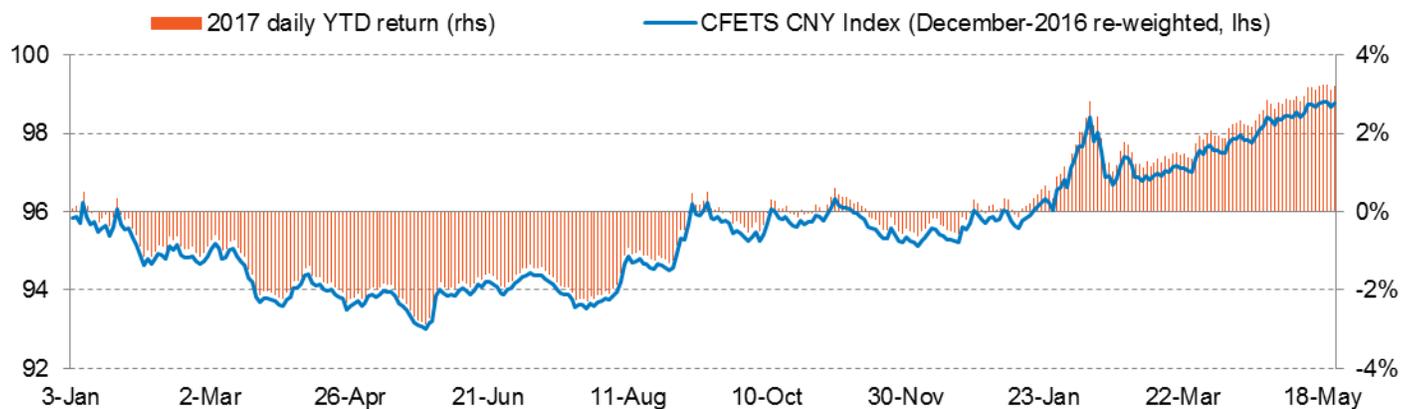


RMB Monthly: the stable local market anchor

- China's influence over the USDCNY mid-rate is a critical component of broad based moves in the USD
- The PBoC is in a gentle tightening cycle and promoting a controlled appreciation of the RMB
- The forthcoming MSCI inclusion of CNY-denominated A shares is part of a supportive RMB flow dynamic
- We favour getting short of USDCNH at 6.45 during the month ahead

The trade-weighted RMB has appreciated at a 2% quarterly pace thus far in 2018

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



Sources: Bloomberg, CFETS, BMO FX Strategy

The CFETS CNY Index (trade-weighted mid-rate) is up 1.6% from its month-ago level and 3.1% on a year-to-date (YTD) basis (Figure 1). Against the USD, the offshore RMB (CNH) has fallen slightly on a 1M basis (and thus far in Q2) but it is up 2.5% YTD. The aforementioned returns make the RMB one of the top performing local market currencies in Q2 to-date and since the beginning of 2018.

The recent performance of the RMB is reflected in the implied volatility trends across the FX space (Figure 2). Three-month implied volatility in USDCNY has been materially lower than average volatility for the whole of the FX space. As such, the RMB has been far removed from the distress experienced by some of its local market peers over the past month.

Using a combination of capital controls and administrative measures, PBoC is promoting stability and a controlled appreciation of the RMB. We expect this dynamic to continue through the first round of MSCI A share inclusion and in the month ahead. In addition to maintaining steady foreign investor interest in CNY assets, RMB stability is an important cornerstone to the ongoing China/US trade dialogue, which appears to be making incremental progress.

PBoC's stance on the RMB is a key determinant of USD moves

The degree to which PBoC sets the USDCNY mid-rate above or below USDCNY spot has an influence on the broad value of the USD. As demonstrated in Figure 3, the aforementioned relationship appears to have been a key driver of the broad based rally in the USD, which began in Q2.

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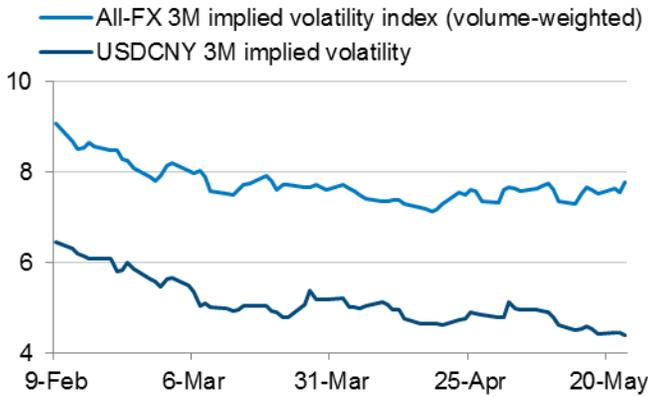
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Figure 2. USDCNY implied volatility comparison



Sources: Bloomberg, BMO FX Strategy

Figure 3. USDCNY mid-rate vs changes in BBDXY



Sources: Bloomberg, BMO FX Strategy

It's no coincidence that SAFE's reserve account recorded its largest build in seven months during April. On a valuation-adjusted basis, our calculations show that SAFE probably experienced a \$27 billion increase in its reserves last month. Given the relationship shown in [Figure 3](#), we're fairly certain PBoC slowed the decline in USDRMB in early-Q2.

However, we do not expect PBoC to encourage further USDRMB upside during the month ahead. In recent weeks, oil prices have continued to march higher along with the USD. As such, a weaker RMB could seriously interfere with PBoC's gradual normalisation path ([Figure 4](#)). Moreover, PBoC's encouragement of a weaker RMB would send very negative signals to investors about China's economy and interrupt the flow of capital to China and other local markets.

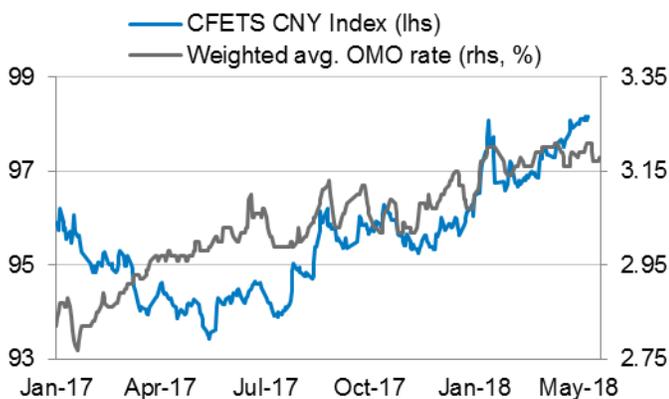
As demonstrated in [Figure 3](#), the 1M trend in the USDCNY mid-rate appears to have peaked in early-May and started to gently converge with spot USDCNY.

Impact of PBoC's normalisation path offset by local government spending

Broadly speaking, macroeconomic policy in China is currently aimed at keeping financial risks contained on the monetary side and delivering targeted spending on the fiscal side. There will be some deleveraging fallout on the economy from the monetary stance, but state-sponsored spending by local governments appears to be accelerating.

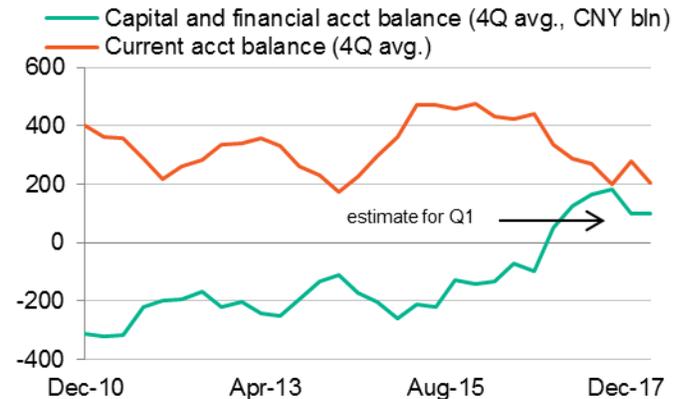
These dynamics point to a very balanced environment for the RMB in the short-run. Given the steps regulators have taken to encourage some deleveraging, a sharp decline in the RMB is probably one of the last things PBoC needs. Persistent RMB weakness would not only dent confidence in the economy and the deleveraging process; it could also trigger a wave of self-fulfilling RMB outflows that would leave regulators with another 'fire to fight'.

Figure 4. CFETS CNY Index vs average OMO rate



Sources: Bloomberg, BMO FX Strategy

Figure 5. Current and financial account data



Sources: Haver Analytics, BMO FX Strategy

RMB flows remain net-positive

Although China's current account surplus has been on a steady downward trend, net capital flows have turned positive in recent quarters, thanks in part to steady debt and equity inflows from abroad (**Figure 5**). These flows are allowing China to run a balance of payments surplus, which is a supportive factor for the RMB.

However, it is important to note that the concentration of BoP flows is shifting away from net exports towards net capital inflows. This shift in the concentration of flows means that protracted RMB instability (or weakness) could have a damaging impact on the BoP if the direction of investment flows were to reverse. As a result, we think China probably has even greater incentives to encourage RMB stability than before, especially with MSCI A share inclusion on the horizon.

Our view

We believe the current environment for the RMB is very well balanced, and we do not expect the PBoC to encourage a further strengthening of the USD during the month ahead. We think USDCNH will settle at about 6.38 in 1M before a decline to 6.33 ensues at the 3M horizon.

During the month ahead, our preference is to look for USDCNH selling opportunities in the vicinity of 6.45. Using a combination of capital controls and administrative measures, PBoC is promoting stability and a controlled appreciation of the RMB. We expect this dynamic to continue through the first round of MSCI A share inclusion and in the months ahead.

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, %)	+0.75	+1.00	+1.50	+1.55	+1.55
USDCNY spot FX strategy view	6.38	6.33	6.29	6.25	6.15
USDCNH spot FX strategy view	6.38	6.33	6.29	6.25	6.15

Sources: BMO FX Strategy

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