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### Theme #3: Sinothetimes – sell 6m USD/CNH DF

Chinese FX policy moves between different regimes, and trading the RMB is a lot about reading signals of regime change. We saw three policy phases in 2017. First, from Jan-May, tough capital controls compressed realized vol and flattened USD/CNY. Second, over June-August, a new fixing methodology forced greater participation in USD weakness, and a sharp down-move in the pair. And third, in September, a loosening in onshore FX hedging requirements signaled the path to more balanced, two-way price action. For 2018, we read the policy as keen to avoid FX vol, which could distract from the focus on growth, but a construct we think will still likely be more accommodative of RMB strength than weakness. We highlight three signals to that effect.

**First, a willingness to raise rates.** While the December hike in OMO rates were small in size (5bp) and practical impact (more a catch-up to market rates), they were large in messaging, coming just after the Fed hiked rates. With the Fed positioned to hike up to 4x this year, China is signaling they remain mindful of rate differentials. While front-end rate gaps have compressed again on US re-pricing, back-end rate spreads still point to support for the RMB.

**Second, an officially tipped desire to step back from volatility.** The latest China Economic Working Conference press release omitted a reference to FX “becoming more elastic,” even as it prioritized issues like deleveraging, poverty reduction, and environmental protection. We read this as 1) de-emphasising FX as a policy priority, and 2) lack of policy appetite to let FX troubles to distract from the growth project. In practice, as China continues to promote a “basically stable” basket, USD/CNY correlations to the broad USD - which have been rising since the basket framework was introduced – should remain high, and allow more space for any dollar weakness to translate into RMB strength.

**Third, tighter capital controls, and a focus on attracting inflows.** China began the year with renewed scrutiny on stubborn outflows, capping overseas withdrawals on bank cards to RMB100,000/year per individual (rather than per card). While China has had more success in reining in rampant ODI, outflows on the travel and E&O accounts are still near extremes. China will likely persist in efforts to clamp down on indirect outflow channels. Separately, one of the big swings in China’s last BoP (Q3 2017) came on debt inflows, which surged to near \$50bn after the launch of the Bond Connect. This is likely to remain a focus this year, in particular ironing out infrastructure obstacles to bond index inclusion.

**What are the risks to this positive policy narrative?** One, that a slowdown in growth rocks FX by hitting confidence and flows. The second risk is from US-China trade tensions, with US Section 232 reviews of steel and aluminium both due this month. China’s response will be key – do they escalate or appease? We doubt RMB weakness will be used as a retaliatory strategy, as this would hurt China more and unwind significant efforts in managing sentiment/flows. More likely is the offering of a slightly stronger currency between when the findings are released and President Trump chooses to act.

**We see a more one-sided tail on USD/CNY with 6.20 possible on \$ weakness and recommend short USD/CNH 6M DF**

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