Theme #3: Monkey business - Buy USD/CNH, buy USD/TWD

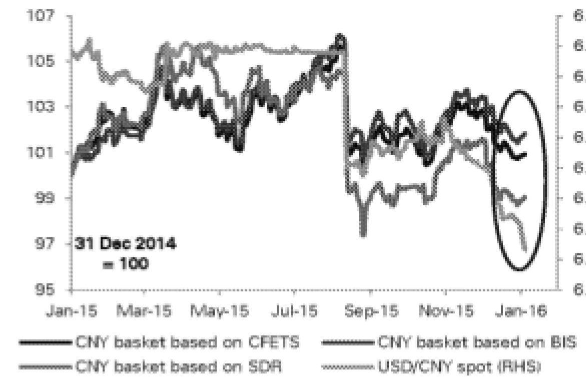
RMB weakness is not over yet. We see three reasons why it should continue; 1) further unwind of carry-sensitive trades, driven by widening interest rate differentials; 2) hedging of FX liabilities due to poor underlying fundamentals and rising credit risk; and 3) higher tolerance for currency depreciation by the Chinese authorities. They would result not only in a higher USD/RMB but also inevitably higher vol. We see value in buying USD/CNH call spreads. We are also buyers of USD/TWD as a relatively cheap proxy for RMB.

The latest round of FX reforms from the Chinese authorities has had two key features: (1) a change to the USD/CNY fixing methodology in August, with an intent to align the spot and fix rates (although this resulted in CNY devaluation); and 2) introduction of a CNY effective exchange rate basket (in December) to shift market perception of FX management from bilateral USD/CNY to a trade-weighted focus. Although these are positive steps towards making CNY a more international and market-driven currency in the medium term, the short-term consequence we feel is a weaker RMB accompanied by higher volatility.

One, with China encouraging the market to shift its focus to a trade-weighted basket of currencies, the authorities are sending a clear message that should USD strengthen against its trade-partner currencies, they would be willing to accommodate USD strength against CNY as well, and the same should not be seen as a devaluation tactic. In other words, CNY weakness against the USD can/will be tolerated as long as CNY vs. the basket is "basically stable". Recent price action (see chart) supports this thesis. We believe USD/CNY has potential to reach 7.0 this year without the authorities getting overly concerned. Using DB's 2016 global FX forecasts, the CNY CFETS index would remain ~100 even if USD/CNY reached 7 by the end of the year, as China's trade partner currencies are likely to weaken even more.

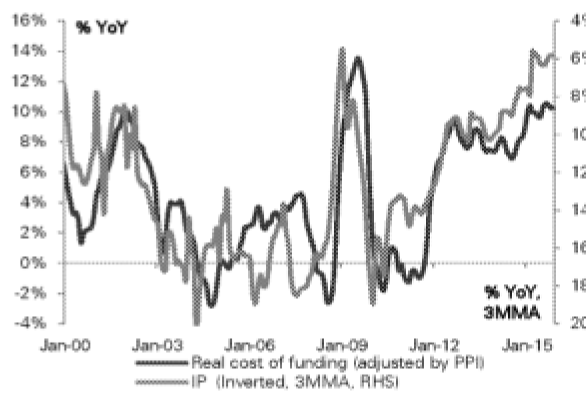
Two, given the various challenges of rebalancing the economy, the Chinese policymakers, we feel, are shifting priority to growth as against currency stability. In 2015, the authorities undertook monetary and fiscal easing, while attempting simultaneously to keep USD/CNY stable through intervention and various macro-prudential measures. It's a tenuous strategy, as China came face-to-face with an impossible trinity - monetary easing and a gradual opening of the capital account were in direct conflict with its desire to keep USD/CNY stable. As the focus shifts to stabilizing growth, the authorities are likely to ease monetary policy more actively, even at the expense of a weaker currency. DB Economics expects the Fed to hike rates by 75bp this year, versus 50bp of cuts by the PBoC.

CNY depreciation against the USD will likely be accommodated as long as CNY is stable vs. the basket



Source: Deutsche Bank, Bloomberg Finance LP, CEIC, Haver Analytics

The real cost of funding in China remains too high and policy easing has not been quite as effective



Source: Deutsche Bank, Bloomberg Finance LP, CEIC, Haver Analytics

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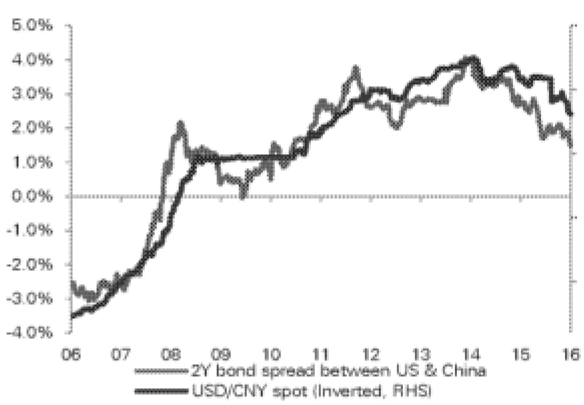

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