This large policy divergence will put further upward pressure on USD/CNY, as narrowing rate differentials encourage carry-seeking trades to unwind and support onshore repayment and refinancing of USD liabilities. A simple historical relationship would suggest that for every 100bp of narrowing in rate differentials, USD/CNY tends to move higher by 30 big figures.

Finally, FX outflows will likely persist and remain an important driver of RMB weakness this year. In 2015, China recorded about $700bn of FX outflows despite having a sizeable current account surplus. In 2016, we believe this will be repeated, considering: 1) growth headwinds are unlikely to dissipate; and 2) corporate are likely to continue to unwind FX liabilities. Extrapolating the latest total foreign claims reported by BIS (through June 2015), we estimate the total amount of FX claims at around $800bn as of end-2015. During the Asian Financial Crisis in 1997/8, the FX liabilities of Hong Kong, which has a pegged FX regime, fell ~30% while those of Korea, which has a flexible FX regime, fell ~55%. Assuming China stays with a managed rate of depreciation, this would suggest ~$300bn of FX liabilities could still need to be delevered. This is only marginally smaller than the current account forecast of $314bn from DB Economics. And there are other possible outflows to consider, like: 1) increased desire for domestic investors to buy more offshore assets, evident in an increase in services deficits; and 2) further unwind of carry trades, evident in China's widened E&O deficit over the past two years. Put together, we expect outflows to continue to overwhelm inflows, putting upside pressure on USD/CNY.

We see risk of RMB weakness being front-loaded in first half of the year, because 1) current account surpluses tend to be smaller in 1H vs. 2H; 2) seasonal economic data tends to be weaker in the first half; 3) expectations that the Fed will hike more actively in 1H (two 25-bp hikes) while the PBoC could cut more actively; and 4) ahead of CNY's official entry into the IMF's SDR basket on 1 October.

We favor buying 6M USD/CNY 6.85/7.15 call spreads to express our view that RMB weakness is not yet over. We also see value in buying USD/TWD as a proxy trade to CNY, given the close economic links between the two economies and the high beta exhibited by TWD to CNY.

Trades:

- Buy 6M USD/CNH 6.85/7.15 call spread
- Buy USD/TWD, target 35

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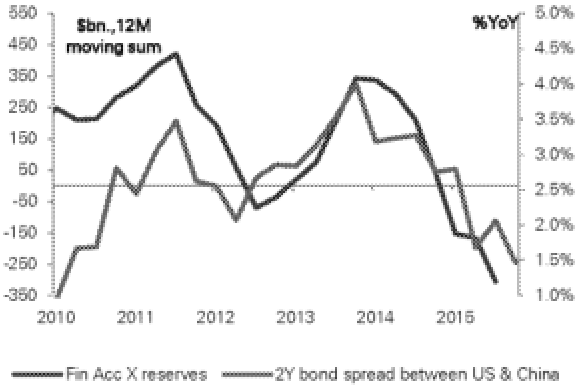
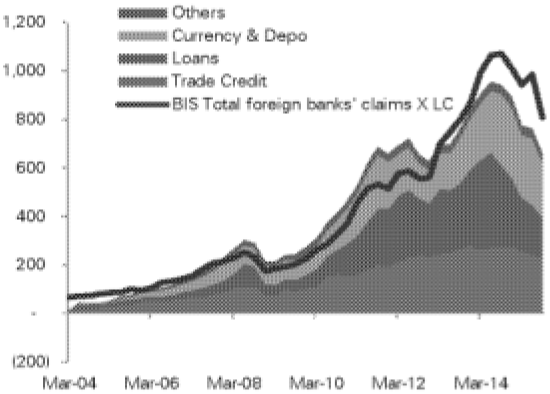
...by encouraging more capital outflows



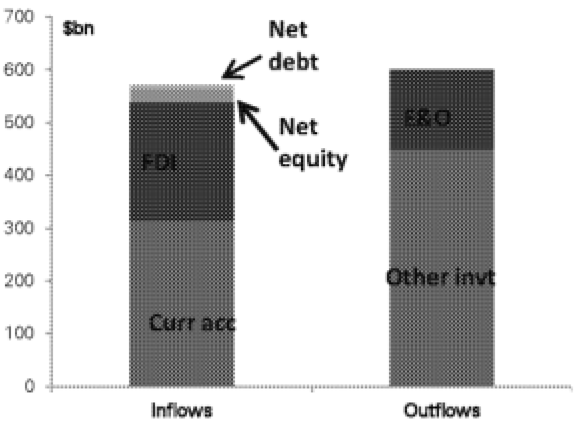
Source: Deutsche Bank, Bloomberg Finance LP, CEIC, Haver Analytics

FX liabilities in China are declining but remain large and further adjustments are still likely



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

Outflows from China should still be large enough in 2016 to recycle sizeable inflows



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