CNY Outlook

More weakness ahead

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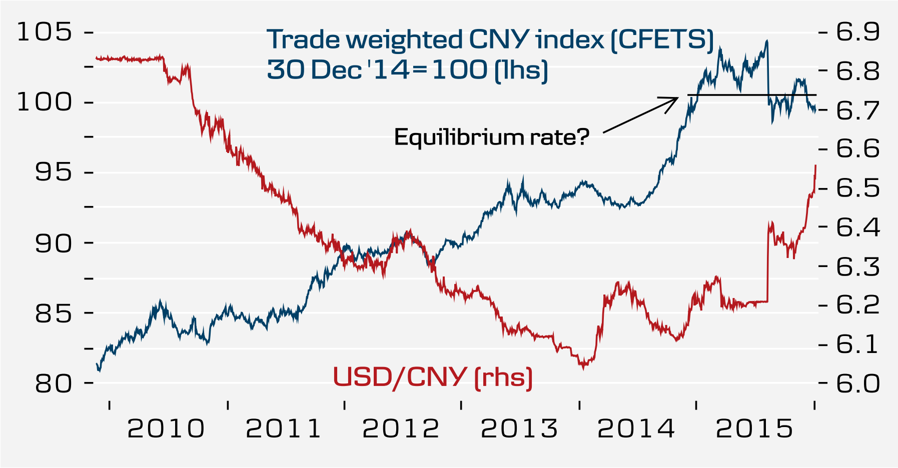
Conclusions

- We look for a continued weakening of the CNY versus USD and EUR of 7% and 15% respectively, over the next year. This is more weakness than in the forward market.
- We continue to recommend corporates with receivables to hedge.
- Hedging should be done using the CNH market.
- The CNH-CNY spread is expected to stay wide but come down over time.

For more details see *FX Strategy: CNY outlook – More weakness ahead*, 7 January 2016

Key takeaways from China's FX policy

1. CNY more market based – but still managed.
2. However, China manages against a basket and no longer the USD. The markets do not understand this yet.
3. China states officially that currency is at equilibrium. But this is evaluated against the basket – not the USD.
4. China allows depreciation against the USD as long as the trade weighted CNY is around 'equilibrium rate'.
5. The CNH-CNY spread has proved hard to keep tight – it is likely to stay wide short term but narrow over time.



Source: Macrobond Financial, Bloomberg, Danske Bank

	USD/CNY		EUR/CNY	
	Danske	Forward	Danske	Forward
06-Jan	6.56		7.05	
+3M	6.70	6.74	7.10	7.26
+6M	6.85	6.83	7.54	7.38
+12M	7.00	6.93	8.12	7.55

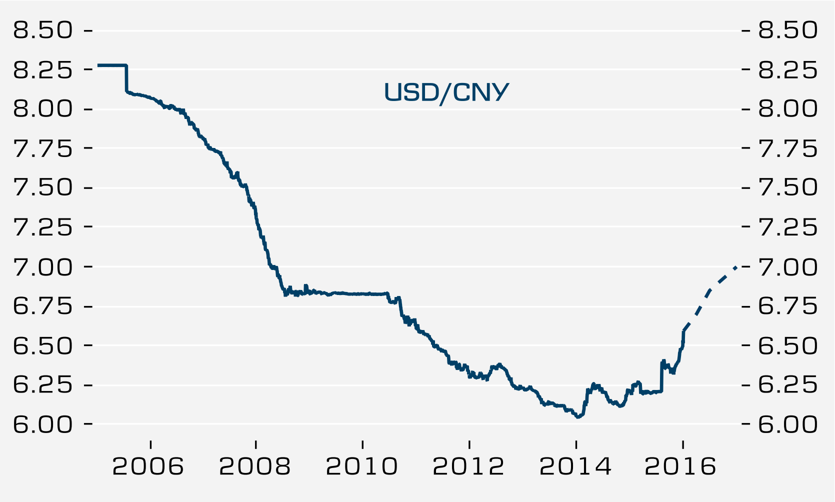
	USD/CNH		Spread CNH-CNY	
	Danske	Forward	Danske	Forward
06-Jan	6.70	6.70	6.700	
+3M	6.83	6.78	0.13	0.05
+6M	6.95	6.84	0.10	0.02
+12M	7.05	6.93	0.05	0.00

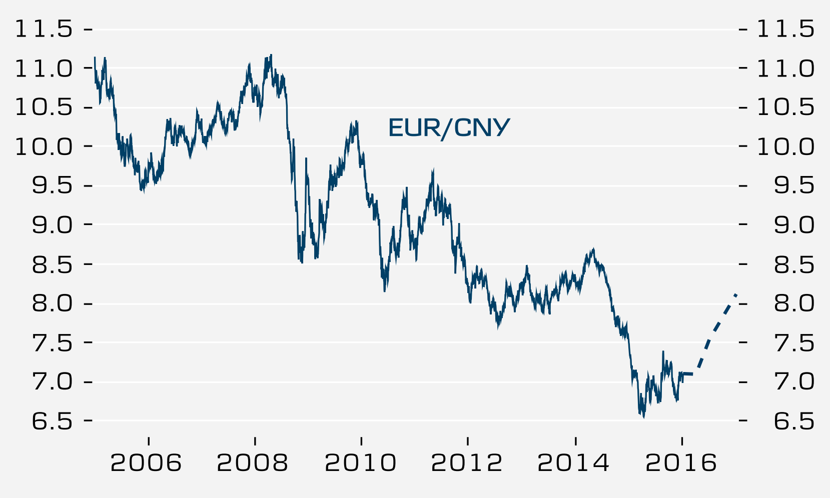
Source: Bloomberg, Danske Bank

More weakening ahead – hedge receivables

The depreciation pressure is likely to continue and we look for a further 7% decline of CNY versus USD. Diverging monetary policy and a higher risk premium for weaker CNY are expected to continue to drive USD/CNY higher.

Given our forecast of a rise in EUR/USD to 1.16 on 12m this implies an even bigger decline of CNY against EUR of around 15% over the next year.



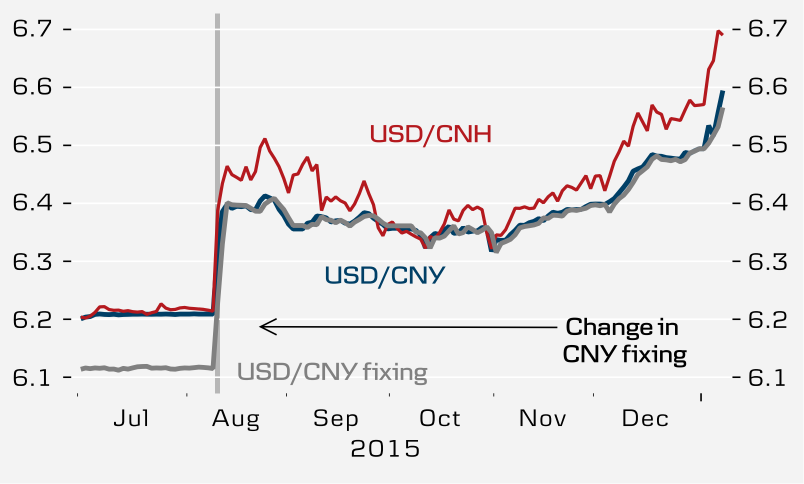


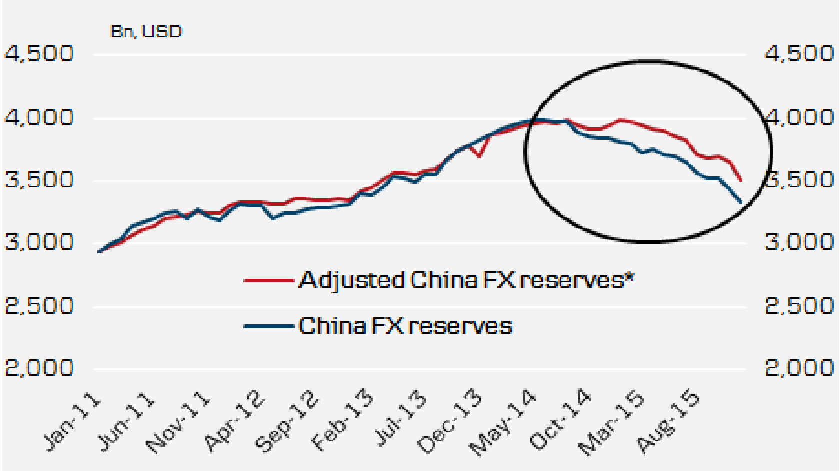
Source (both charts): Macrobond Financial, Bloomberg, Danske Bank

CNY is weakened by markets – not by the PBoC

The market is pushing the CNY and CNH weaker against the USD. A weaker fixing than what is warranted by the market close levels and the set back in stock markets have added fuel to the CNY sell-off.

China has intervened extensively to stem the decline in the CNY. Currency reserves adjusted for valuation effects fell USD135bn in December. This does not indicate that China is deliberately weakening the CNY. On the contrary it is trying to dampen the decline.

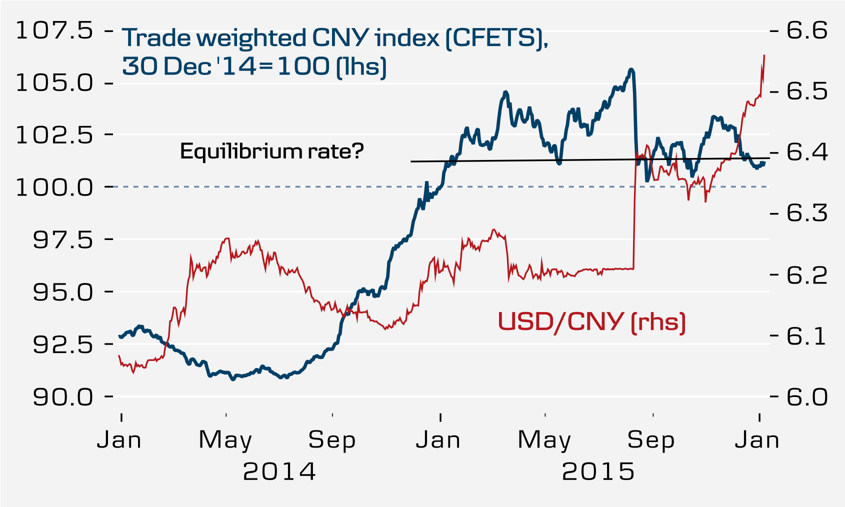




Source (both charts): Macrobond Financial, Bloomberg, Danske Bank

China is managing against a basket – not USD

China is managing the CNY against a basket – not the USD. The CNY has not weakened much when measured against the basket.



Source: Macrobond Financial, Bloomberg, Danske Bank

China stated very clearly in early December 2015 that it evaluates the CNY on the back of a basket and not the USD

The explicit move to managing against a basket rather than only USD

Extract from the PBoC press statement on 11 Dec 2015 on trade weighted CNY:

"For quite long, market participants have used bilateral exchange rate of RMB against USD to assess RMB exchange rate movements. However, as fluctuations of exchange rate serve to adjust trade and investment activities with multiple trading partners, the bilateral RMB-USD exchange rate is not considered a good indicator of the international parity of tradable goods. Therefore, it is more desirable to refer to both the bilateral RMB-USD exchange rate and exchange rate based on a basket of currencies... Compared with referring only to one currency, a basket of currencies can better capture the competitiveness of a country's goods and services."

Weights in the CFETS trade weighted currency

USD	EUR	JPY	HKD	GBP	AUD	NZD	SGD	CHF	CAD	MYR	RUB	THB
0.26	0.21	0.15	0.07	0.04	0.06	0.01	0.04	0.02	0.03	0.05	0.04	0.03

Source: People's Bank of China

China has a managed float system

– sees the currency as at the equilibrium rate (on a trade-weighted basis)

China made the fixing market-based on 11 August, but kept a managed float system and sees the current rate as equilibrium. Note that fixing is set on the back of reports from market makers and that the PBoC sets the rate on the back of market makers' reports. Hence the PBoC does not signal policy any more through the reference rate.

China's new FX system2015

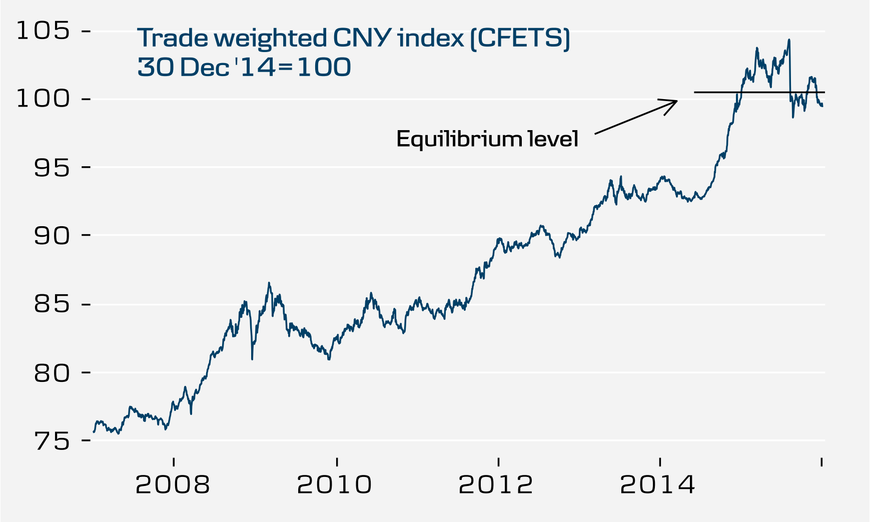
Extract of quotes from China's press release on 11 August illustrating the new FX regime:

*"Effective from 11 August 2015,the quotes of central parity that market makers report to the CFETS daily before market opens should **refer to the closing rate** of the inter-bank foreign exchange market on the previous day, in conjunction with demand and supply condition in the foreign exchange market and exchange rate movement of the major currencies.*

*China is implementing the **managed floating exchange rate regime** based on market demand and supply. The fluctuation of exchange rate is a normal phenomenon, to which, we should take an objective view. In the future, the PBC will strive to further improve market-based formation mechanism of RMB exchange rate, maintain a normal fluctuation of RMB, and keep the exchange rate basically stable at an adaptive and **equilibrium level**"*

Source: People's Bank of China

After many years of appreciation, China now sees the CNY at the equilibrium level. This is likely to be where it will aim to keep it. However, we think China will allow it to weaken somewhat over the next year.

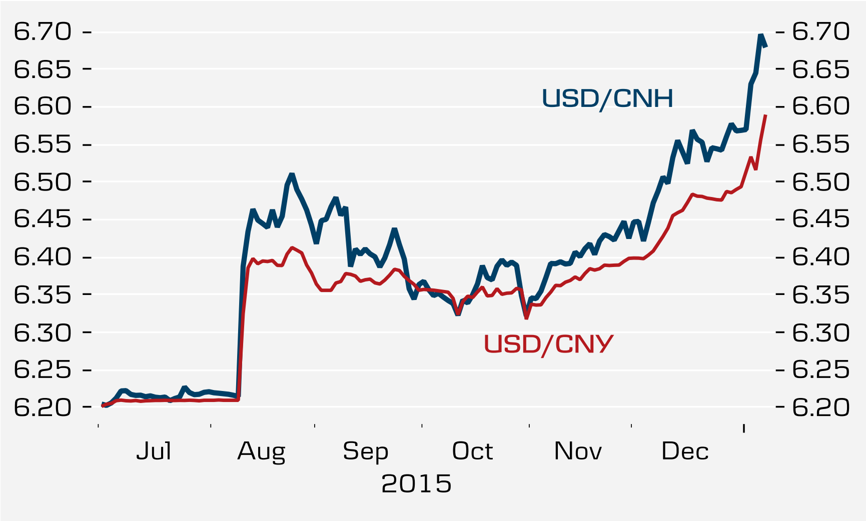


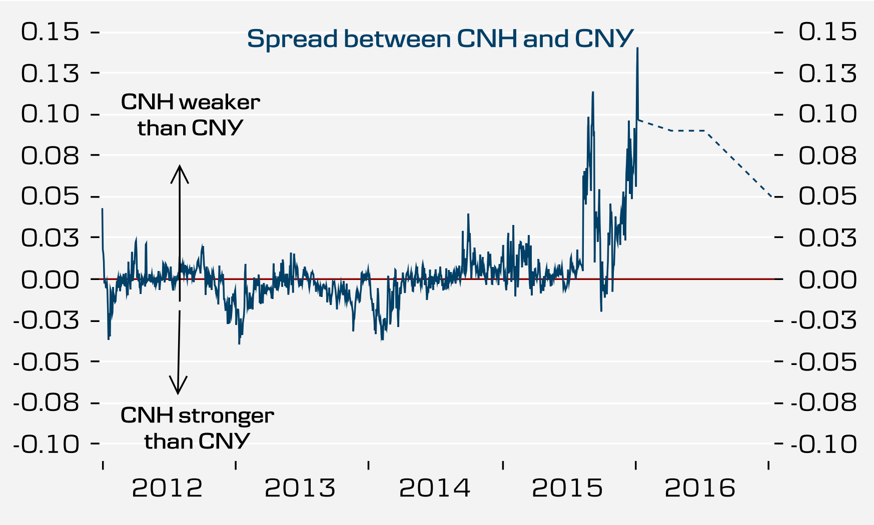
Source: Macrobond Financial, Bloomberg, Danske Bank

CNH-CNY spread to stay wide short term

The selling pressure has pushed USD/CNH (offshore currency) further away from USD/CNY as most hedging and positions for a weaker CNY are done in this market because it can be traded freely.

As long as the selling pressure is there, we expect the spread to stay wide. Intervention in the offshore market has not been enough to keep the spread tight, but we expect it to come down as selling pressure eases later in 2016, when we look for EUR/USD to go higher.





Source: Macrobond Financial, Bloomberg, Danske Bank

The impossible trinity

The impossible trinity states that a country cannot simultaneously have sovereign monetary policy, free capital flows and a fixed exchange rate. As China has gradually freed up capital flows the currency has become more market based, and it has become more difficult for China to manage the currency.

Source: Danske Bank

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