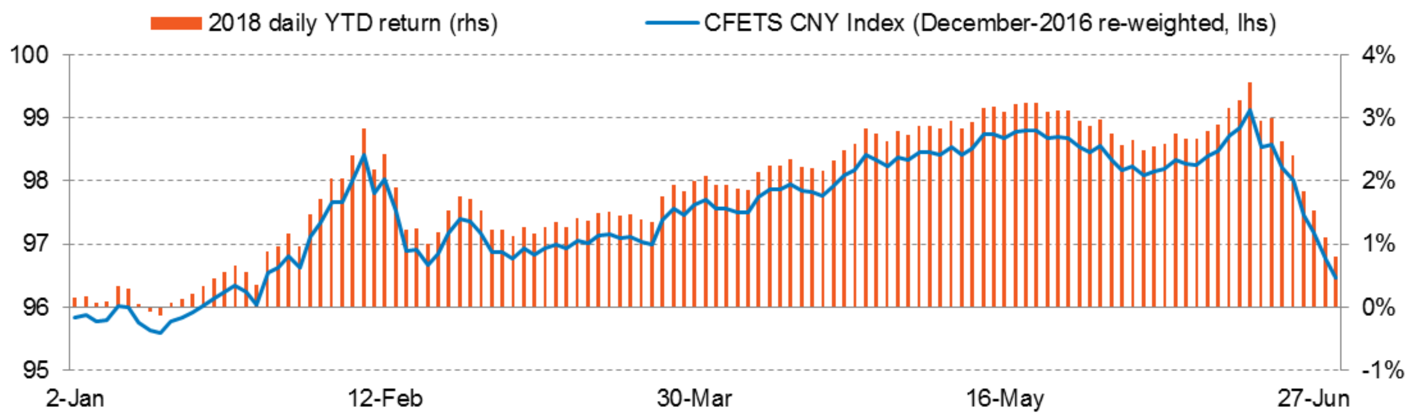
Stephen Gallo, FX Strategist (stephen.gallo@bmo.com) June 29, 2018

RMB Monthly: wildfire or controlled burn?

- There has been a major shift towards RMB weakness but the reasons for the decline are less than straightforward
- We think this latest episode of RMB weakness is partly a PBoC-orchestrated move that has further to run
- China may be preparing to use RMB weakness as a last resort option in the escalating trade war with the US
- We favour buying the 3M USDCNH forward and look for a potential move to 6.85 as soon as the coming month

The trade-weighted RMB is down 1.75% in June and 1.18% in Q2

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



Sources: Bloomberg, CFETS, BMO FX Strategy

The CFETS CNY Index (trade-weighted mid-rate) has fallen 1.75% in June. After a strong start to Q2, the weakness in June has brought the 3M return to -1.18%. As shown in **Figure 1**, the recent decline in the Index has been fairly dramatic. At its 2018 peak in mid-June, the Index was up 3.6% YTD. As of now, the YTD return is just +0.79%.

We see two possible causes of RMB weakness. The first possible cause is that the RMB is succumbing to an indiscriminate increase in outbound flows which the PBoC has failed to arrest (i.e. in a similar vein to the 2015 episode). The second possible cause is that the move in the RMB has been fully orchestrated by PBoC, given the worsening US/China trade relationship and China's previous loss of competitiveness vs other local market currencies (**Figure 2**).

We do not think there is conclusive evidence either way, so our judgement is that a mix of the two is occurring. Anecdotal information suggests that RMB inflows declined substantially in late-June. The recent increase in the CNH discount to the CNY is consistent with the general trend towards local market outflows.

However, China's outbound flow restrictions and oversight are, on balance, higher today than in 2015, particularly in the area of FDI. China has also had a large basic balance surplus, which averaged $56 billion per quarter in the four quarters through Q1 2018.

We may have also observed at least one additional sign of damage control on the part of regulators. China's foreign currency denominated debt is already quite low. But on June 28, news broke that the National Development and Reform Commission (NDRC) was considering a ban on USD debt sales in Hong Kong by some mainland entities. Such a move would fit with the general trend towards deleveraging and insulating China from further RMB weakness vs the USD.

Greg Anderson, Global Head of FX Strategy, +1 212 605 1409
Stephen Gallo, European Head of FX Strategy, +44 20 7664 8124

Canada Sales
Toronto +1 416 359 8681
Montreal +1 514 282 5950

U.S. Sales
Chicago +1 312 845 4080
New York +1 212 702 1284
San Francisco +1 415 591 2102

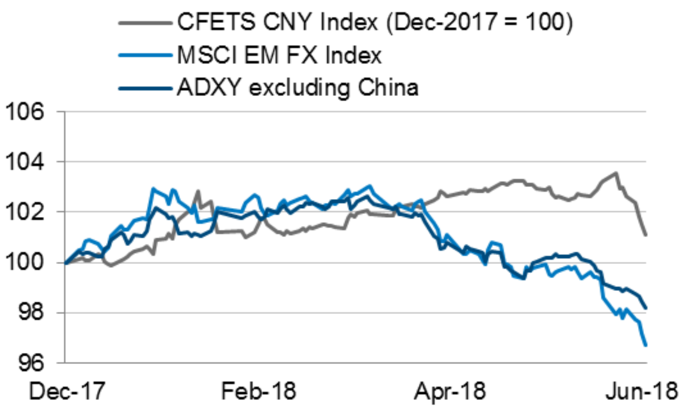
Europe Sales
London +44 20 7248 0424

Asia Sales
Guangzhou +86 20 8669 5148
Hong Kong +85 2 3406 0670
Shanghai +86 21 6136 3628

This confluence of factors suggests that a portion of the weaker RMB has been orchestrated by PBoC in response to escalating US/China trade tensions. Given China's strong BoP and PBoC's ability to control the RMB, we are reasonably confident that China can execute a 'controlled burn' without it turning into a wildfire of uncontrollable RMB weakness.

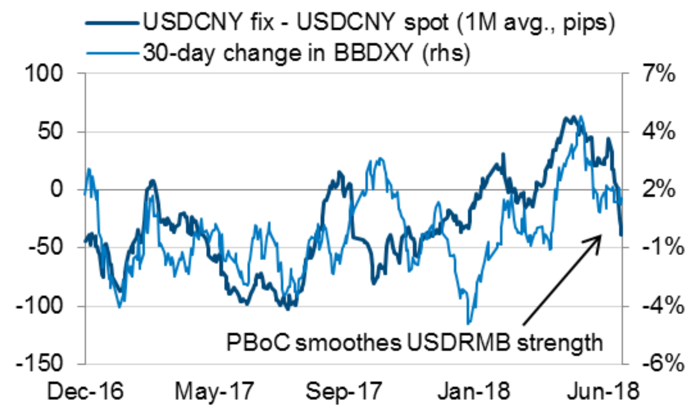
However, the risk of policy misstep and a spiraling decline in the RMB is clearly greater than zero. As such, we expect PBoC to use various measures to smooth the extent of the move higher in USDRMB.

Figure 2. CFETS CNY Index vs other EM currencies



Sources: Bloomberg, CFETS, BMO FX Strategy

Figure 3. USDCNY mid-rate vs USDCNY spot & BBDXY



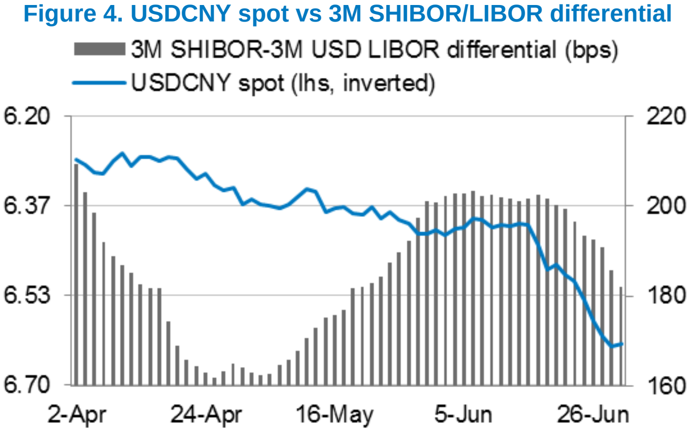
Sources: Bloomberg, BMO FX Strategy

China was already slowing the pace of RMB strength

In prior Monthlies we highlighted the extent to which PBoC was moderating the pace of RMB strength (i.e. putting a floor underneath USDRMB). With hindsight, it appears as if PBoC was doing so in part because it viewed an escalation of US/China trade tensions as a high-risk scenario. As shown in **Figure 3**, the trend in the USDCNY mid-rate relative to spot for most of Q2 was generally higher, prior to late-June. This aforementioned trend has been supporting the USD.

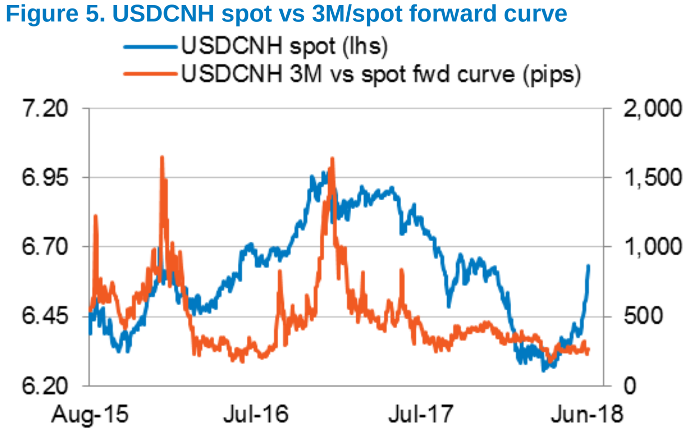
There have been other signs that PBoC has been putting a floor underneath USDRMB. By our calculations, SAFE experienced a valuation-adjusted reserve build of $20 billion in the five months through May on a cumulative basis. PBoC has also held key onshore and offshore RMB rates fairly steady for the past few months. One result has been the 3M USD LIBOR/SHIBOR rate differential generally holding below 200bps in Q2 (**Figure 4**).

Figure 4. USDCNY spot vs 3M SHIBOR/LIBOR differential



Sources: Bloomberg, BMO FX Strategy

Figure 5. USDCNH spot vs 3M/spot forward curve



Sources: Bloomberg, BMO FX Strategy

A long 3M USDCNH forward position is a bet on PBoC smoothing

In **Figure 5** we highlight the current position of the USDCNH spot/3M forward curve in comparison with prior episodes of RMB weakness. In those prior episodes, the common denominator was the degree to which higher RMB rates were used by PBoC to halt RMB weakness. At the current juncture, the flatness of the USDCNH forward curve suggests that we are not yet at a stage where PBoC is uncomfortable with the degree of RMB weakness.

Given China's large bilateral goods trade surplus with the US and the unflinching nature of the Trump administration's stance, we suspect that the first move towards de-escalating trade tensions will have to come from China as it cedes some ground to the US. It therefore seems logical to us that China will want to enter the forthcoming negotiations with a meaningful degree of RMB weakness already in train, in view of concessions that may need to be offered.

We therefore believe that PBoC will be willing to tolerate some further tightening of financial conditions in order to smooth the pace of RMB weakness, and we expect some upside in the 3M USDCNH forward to materialize through the summer. PBoC has recently kept a lid on RMB rates through targeted forms of monetary easing, but longer-term concerns about leverage growth suggest that this is likely to be a temporary phenomenon.

Our view

We expect USDCNH to trade at 6.70 in 1M and 6.74 in 3M ahead of a resumption of USD weakness in the 6-12M part of the outlook curve. We think the latest episode of RMB weakness partly reflects an orchestrated response from PBoC to the escalating US/China trade war. In our view, China can benefit from some further weakening of the RMB but the PBoC has the necessary tools to control the extent of the decline.

The current flatness of the USDCNH forward curve suggests that we are not yet at a stage where PBoC is uncomfortable with the degree of RMB weakness. We eventually expect RMB rates to rise as PBoC seeks to put a floor under the RMB, and our preferred strategy right now is to get long of the 3M USDCNH forward in anticipation of a move towards 6.85 over the next 1-3 months.

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, %)	-0.50	-1.00	0.00	+1.00	+1.25
USDCNY spot FX strategy view	6.70	6.74	6.73	6.48	6.33
USDCNH spot FX strategy view	6.70	6.74	6.73	6.48	6.33

Sources: BMO FX Strategy

DISCLAIMER

This material has been prepared with the assistance of employees of Bank of Montreal ("BMO") who are involved in derivatives sales and marketing efforts. Accordingly, it should be considered to be a solicitation of derivatives business generally and not a research report that reflects the views of disinterested research analysts.

Notwithstanding the foregoing, this material should not be construed as an offer or the solicitation of an offer to sell or to buy or subscribe for any particular product or services (including, without limitation, any commodities, securities or other financial instruments).

We are not soliciting any specific action based on this material. It is for the general information of our clients. It does not constitute a recommendation or a suggestion that any investment or strategy referenced herein may be suitable for you. It does not take into account the particular investment objectives, financial conditions, or needs of individual clients.

Nothing in this material constitutes investment, legal, accounting or tax advice, or a representation that any investment or strategy is suitable or appropriate to your unique circumstances, or otherwise constitutes an opinion or a recommendation to you. BMO is not providing advice regarding the value or advisability of trading in commodity interests, including futures contracts and commodity options or any other activity which would cause BMO or any of its affiliates to be considered a commodity trading advisor under the U.S. Commodity Exchange Act. BMO is not undertaking to act as a swap advisor to you or in your best interests and you, to the extent applicable, will rely solely on advice from your qualified independent representative in making hedging or trading decisions. This material is not to be relied upon in substitution for the exercise of independent judgment. Any recipient of these materials should conduct its own independent analysis of the matters referred to herein, together with its qualified independent representative, if applicable. Any discussion of tax matters in these materials (i) is not intended to be used, and cannot be used or relied upon, for the purposes of avoiding any tax penalties and (ii) may have been written in connection with the "promotion or marketing" of the transaction or matter described herein. Accordingly, the recipient should seek advice based on its particular circumstances from its own independent financial, tax, legal, accounting and other professional advisors (including, without limitation, its qualified independent representative, if applicable).

These materials are confidential and proprietary to, and may not be reproduced, disseminated or referred to, in whole or in part without the prior consent of BMO. Information presented in this material has been obtained or derived from sources believed by BMO to be reliable, but BMO does not guarantee their accuracy or completeness. BMO assumes no responsibility for verification of the information in these materials, no representation or warranty is made as to the accuracy or completeness of such information and BMO accepts no liability whatsoever for any loss arising from any use of, or reliance on, these materials. BMO assumes no obligation to correct or update these materials. These materials do not contain all information that may be required to evaluate any transaction or matter and information may be available to BMO and/or its affiliates that is not reflected herein.

BMO Capital Markets is a trade name used by BMO Financial Group for the wholesale banking businesses of Bank of Montreal, BMO Harris Bank N.A. and Bank of Montreal Ireland p.l.c., and the institutional broker dealer businesses of BMO Capital Markets Corp., BMO Nesbitt Burns Trading Corp. S.A., BMO Nesbitt Burns Securities Limited in the U.S., BMO Nesbitt Burns Inc. in Canada and Asia, BMO Nesbitt Burns Ltée/Ltd. in Canada, BMO Capital Markets Limited in Europe and Australia, BMO Advisors Private Limited in India and Bank of Montreal (China) Co. Ltd. in China.

TO U.K./E.U. RESIDENTS: In the UK, BMO Capital Markets Limited is authorised and regulated by the Financial Conduct Authority. The contents hereof are intended solely for clients which satisfy the criteria for classification as "professional client" under Annex II, Part 1 of the E.U. Markets in Financial Instruments Directive (2004/39/EC) and as implemented in relevant domestic legislation of each member state of the E.U. Any U.K. person wishing to effect transactions in any security discussed herein should do so through Bank of Montreal, London Branch or BMO Capital Markets Limited; any person in the E.U. wishing to effect transactions in any security discussed herein should do so through BMO Capital Markets Limited.

TO PRC RESIDENTS: This material does not constitute an offer to sell or the solicitation of an offer to buy any financial products in the People's Republic of China (excluding Hong Kong, Macau and Taiwan, the "PRC"). BMO and its affiliates do not represent that this material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any applicable registration or other requirements in the PRC, or pursuant to an exemption available thereunder, or assume any responsibility for facilitating any such distribution or offering. This material may not be distributed or published in the PRC, except under circumstances that will result in compliance with any applicable laws and regulations.

TO HONG KONG RESIDENTS: This material has not been reviewed or approved by any regulatory authority in Hong Kong. Accordingly the material must not be issued, circulated or distributed in Hong Kong other than (1) except for "structured products" as defined in the Securities and Futures Ordinance, in circumstances which do not constitute it as a "Prospectus" as defined in the Companies Ordinance or which do not constitute an offer to the public within the meaning of that Ordinance, or (2) to professional investors as defined in the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules made thereunder. Unless permitted by the securities laws of Hong Kong, no person may issue in Hong Kong, or have in its possession for issue in Hong Kong this material or any other advertisement, invitation or document relating to the products other than to a professional investor as defined the Securities and Futures Ordinance and the Securities and Futures (Professional Investor) Rules.

TO SINGAPORE RESIDENTS: This document has not been registered as a prospectus with the Monetary Authority of Singapore and the material does not constitute an offer or sale, solicitation or invitation for subscription or purchase of any shares or financial products in Singapore. Accordingly, BMO and its affiliates do not represent that this document and any other materials produced in connection therewith may lawfully be circulated or distributed, whether directly or indirectly, to persons in Singapore. This document and the material do not and are not intended to constitute the provision of financial advisory services, whether directly or indirectly, to persons in Singapore.

TO THAI RESIDENTS: The contents hereof are intended solely for the use of persons qualified as Institutional Investors according to Notification of the Securities and Exchange Commission No. GorKor. 11/2547 Re: Characteristics of Advice which are not deemed as Conducting Derivatives Advisory Services dated 23 January 2004 (as amended). BMO and its affiliates do not represent that the material may be lawfully distributed, or that any financial products may be lawfully offered, in compliance with any regulatory requirements in Thailand, or pursuant to an exemption available under any applicable laws and regulations.

TO KOREAN RESIDENTS: This material is not provided to make a recommendation for specific Korean residents to enter into a contract for trading financial investment instruments, for investment advising, for discretionary investment, or for a trust, nor does it constitute advertisement of any financial business or financial investment instruments towards Korean residents. The material is not provided as advice on the value of financial investment instruments or any investment decision for specific Korean residents. The provision of the material does not constitute engaging in the foreign exchange business or foreign exchange brokerage business regulated under the Foreign Exchange Transactions Act of Korea.