FX Viewpoint

Friday, May 17, 2019

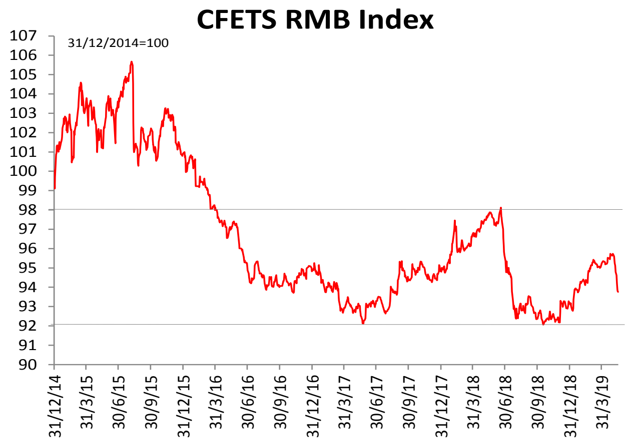
Renminbi – "Flexibility"

- The latest escalation of Sino-US trade tensions that hit investor screens from 06 May 2019 has seen the renminbi (especially the CNH) lead the way lower against the USD, not just in Asia but across EM space. Given that China is at the epicenter of the current volatility, this should not surprise. However, the behavior of the PBOC amidst the recent uncertainty we think may be particularly instructive.

- The issues at hand are multi-faceted but let's start with the **CNH**. Obviously, the CNH acted as the "first responder" of sorts as the pair ratcheted higher in reaction. As the Sino-US tensions continued to deteriorate in the subsequent sessions, the resultant daily USD-CNY mid-points (in itself an optimization problem) came under increased scrutiny.

Still in control

- As it turned out, the **USD-CNY mid-points** persistently (and systematically) underperformed (our) model-implied estimates but at the same time, the **CFETS RMB Index** was also (counter-intuitively) dropping contemporaneously. However, what is striking is that the volatility of the USD-CNY mid-points and the CFETS RMB Index in the past 2 weeks has been largely kept within historical parameters – the PBOC remains securely at the helm with respect to exchange rate management.



Source: OCBC Bank

- We think this depreciation behavior in the CFETS RMB Index in the last 2 weeks may constitute a subtle shift in policy response going ahead. Up until

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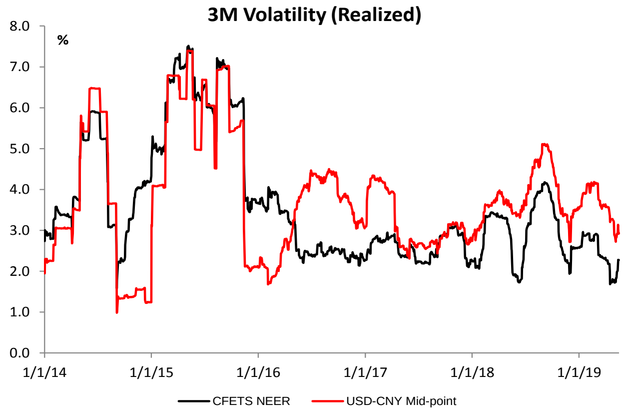
the latest Sino-US flashpoint, the index had been appreciating and effectively stood its ground against the weaker profile of the major (constituent) currencies, and in-line with the USD this year. In contrast, the recent depreciation since last week has taken the Index to near the year's lows.

More to come?

- To this end, from a fix-implied Index value of 93.76 (compared to 95.72 on 03 May 19), we think there is room for the Index to travel lower to the lower bound of a multi-year range (from mid-2016) at around 92.00 without inciting "devaluation" accusations. A potential implication then is that USD-CNY mid-points may retain theoretical upside headroom under the right conditions, notwithstanding the psychological barrier at 7.0000.

- From the policy makers' perspective, this depreciation of the Index may be a reflexive response to the expected negative economic impact from increased tariffs or alternatively, an intent to permit the currency to reflect broader dollar strength in the face of risk aversion, or a mixture of both.



Source: OCBC Bank

- On an operational level, with no end in sight for Sino-US trade tensions, expect the authorities to continuing to temper excessive renminbi volatility and weakness via signaling behavior in the USD-CNY mid-points. We would however watch for any inclination to manage and narrow the CNH-CNY spot basis (pain threshold typically near 400bps) via upside flexibility in the USD-CNY mid-points. Meanwhile, containment of excessive CNH volatility (via the Hibor and/or actual official presence in the market) may continue to be expected.

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