

RMB: the fear of unknown

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Highlights:

- RMB depreciation accelerated on Wednesday after PBoC unexpectedly set the USDCNY fixing higher.
- It seems Chinese government has given up its spread intervention after the CNY-CNH spread is no longer the hurdle for RMB to be recognized as freely usable currency.
- The latest clampdown on cross border arbitrage also suggests that it make no economic sense for China to intervene the spread.
- Since December, we have been more confused about the RMB policy. The fear of unknown has become the largest risk for RMB in the near term.
- The only clue we have from PBoC is that we should pay more attention to basket currency. Based on this morning's fixing, the index was still at 100.80. This probably also explains why PBoC set the USDCNY fixing higher this morning.
- We think it might be better timing for us to sense China's RMB policy when RMB index falls back to 100 level. Before that, the fear of unknown is likely to persist for a while. This may lead onshore USDCNY to test 6.5800, which is about the breakeven point for the RMB index in the near term.

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RMB depreciation accelerated on Wednesday in both onshore and offshore market after PBoC unexpectedly set the USDCNY fixing at 6.5314, much higher than yesterday's 4:30 pm closing of 6.5199.

No longer an anchor of stability?

RMB's status as an anchor of stability for the past two decades was mainly the result of tight government control. After weathering through two major financial crisis successfully in 1997 and 2008, Chinese government has established such a mighty image that no investors dare to challenge PBoC despite persistent speculation on China's hard landing scenario since 2010. However, this mighty image has been questioned in the mid of 2015 after a failed government intervention in its stock market. The move towards a market driven fixing and pricing system opened Pandora box amid the turmoil and completely turn the sentiment around against RMB amid slowdown in Chinese growth and equity market rout. The sentiment driven depreciation made it more difficult to forecast RMB in 2016.

Widening CNY-CNH spread

The USDCNH touched a high of 6.7300 yesterday, up by 2.2% week to date, while the USDCNY broke the 6.5500 handle in the onshore market. As a result, the CNY-CNH spread widened to a record high of 1700 at one point since the birth of CNH in 2010. It seems government has given up its spread intervention for two possible reasons. First, China has a higher tolerance for the CNY-CNH spread. With further opening of China's onshore market to offshore reserve managers, the CNY-CNH spread is no longer the hurdle for RMB to be defined as freely usable currency by IMF. As such, China is not in urgency to close the gap between onshore and offshore market. Second, Chinese regulators has been increasingly paid attention to the cross border arbitrage activities. The latest news that a number of foreign banks have been suspended for transacting cross border RMB business in late December following the 0.3% penalty margin implemented from September suggests China's commitment to stop banks from gaming the system. With most of room for arbi has been limited, it did not make economic sense for China to intervene the offshore market aggressively.

Fear the unknown

Since late November, the speculators have met few resistances from PBoC to push the USDCNH and USDCNY higher. Frankly speaking, we are still not quite sure where the PBoC boundary is at the current stage. The fear of unknown has become the largest risk for RMB in the near term despite China's sizable current account surplus.

The only clue we have from PBoC is that we should pay more attention to basket currency, which is a trade weighted index. This probably also explain why PBoC set the USDCNY fixing higher on Wednesday morning. Despite RMB's depreciation against the dollar in 2015, RMB still appreciated against the basket currency. The RMB index ended 2015 with 100.94, meaning RMB has strengthened against the basket currency by 0.94%. Based on Wednesday's fixing, the index was still at 100.80. As such, we think in order to forecast the USDCNY fixing in future, a look at RMB index may help. As long as the RMB index stays above 100, we think China may still adopt its current wait and see approach. Given the recent weakness in RMB against the USD, the RMB index has been gradually trending down to 100 level. We think it might be better timing for us to sense China's RMB policy when RMB index falls back to 100 level. Before that, the fear of unknown is likely to persist for a while. This may lead onshore USDCNY to test 6.5800, which is about the breakeven point for the RMB index in the near term.

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