HKEX 香港交易所

INSIDE FIXED INCOME AND CURRENCY MONTHLY NEWSLETTER

May 2016 Issue No 17

MONTHLY HIGHLIGHTS

- HKEX and Thomson Reuters signed an agreement for the creation of a new series of RMB currency indices on 24 May 2016. The new index series will give the world benchmarks that reflect the development of the RMB's effective exchange rate against other major currencies.
- HKEX's Chief China Economist, Dr Ba Shusong, investigates the various economic impacts of negative nominal interest rates.
- In the Expert Corner, Mr Ken Cheung of Mizuho Bank Hong Kong sees that the CNY fixing is going to remain relatively steady and USD/CNH spot will range bound in Q2.

RECAP ON HKEX'S THIRD ANNUAL RMB FIC CONFERENCE AND RMB INDEX SIGNING CEREMONY

HKEX's 3rd Annual RMB Fixed Income and Currency (FIC) Conference was held on 24 May 2016. Around 650 industry participants and experts gathered to discuss various RMB-related topics and share their thoughts on current trends and future developments. At the conference, HKEX and Thomson Reuters signed an agreement for the creation of new RMB currency indices.

FROM THE CHIEF CHINA ECONOMIST'S VANTAGE POINT

WHAT ARE THE ECONOMIC IMPACTS OF NEGATIVE NOMINAL INTEREST RATES?

Dr Ba Shusong, Chief China Economist, HKEX

The Bank of Japan (BoJ)'s unexpected announcement, at the end of January 2016, of the implementation of negative nominal interest rates has made negative nominal interest rates, or more generally negative interest rates, a major concern of the global financial industry since the beginning of 2016. Indeed, the Bank of Japan is not the first central bank to adopt a policy of negative interest rates. In August 2009, the central bank of Sweden made the first move to impose negative interest rates on bank deposits. Other central banks that have so far implemented negative interest rates include Danmarks Nationalbank, Swiss National Bank and European Central Bank.

Since the implementation of negative interest rates, market concerns have been placed on the policy's economic effects and the relatively large divergence between its short-term and long-term effects.

Some think short-term effects are significant to help economic recovery

Negative interest rates can stimulate and boost economic development in the short term mainly due to the following reasons:

The credit channel. Negative interest rates are a form of tax imposed on commercial banks by central banks. They are aimed at encouraging commercial banks to expand lending. In transferring this tax to depositors and lowering lending rates, commercial banks practically make negative interest rates a de facto tax imposed on small deposits. While they hurt depositors, they certainly also increase lending hence liquidity for the real economy.

The asset price channel. Negative interest rates raise asset prices through lowering the discount rates of the assets' future cash flows. Moreover, an environment of relaxed monetary policies also improves public expectations on the running conditions of the economy and leads to higher expectations about future gains from the assets.

Chart of the Month: CNY Against Other Currencies (Jan-May 16)

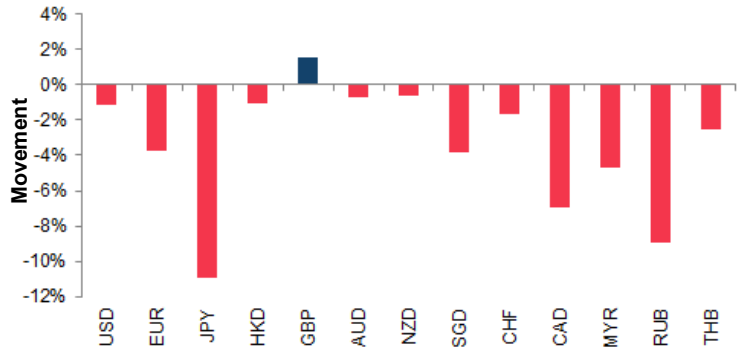
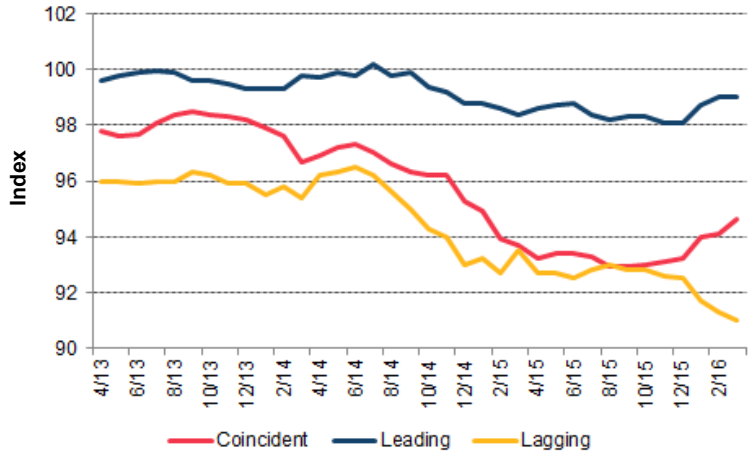


Fig 2: China's Macro-Economic Climate Index



- The coincident index is the index reflecting the current basic trend of the economy, and it is calculated using the following data: (1) industrial production; (2) employment; (3) social demands (including investment, consumption and foreign trade); and (4) social incomes (including the government taxes, profits of enterprises and income of residents).
- The leading index is calculated using a group of leading indicators, which take a lead before the coincident index, and is used for forecasting the future economic trend.
- The lagging index is calculated using the lagging indicators, which lag behind the coincident index, and is mainly used for confirming the peak and valley of the economic cycle.

TABLE 1

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.7	6.8	↓	07/15/2016
CPI (yoy %)	2.3	2.3	→	06/09/2016
PPI (yoy %)	-3.4	-4.3	↑	06/09/2016
Industrial Production (yoy %)	6.0	6.8	↓	06/12/2016
FAI (yoy %)	10.5	10.7	↓	06/12/2016
Foreign Investment (yoy %)	6.0	7.8	↓	06/08/2016
CFLP Manufacturing PMI	50.1	50.1	→	06/01/2016
PBOC Bankers Confidence Index	38.1	37.9	↑	TBC
PBOC Bankers Loan Demand Index	62.7	56.8	↑	TBC
CEMAC Leading Economic Index	99.1	99.04	↑	05/31/2016
Exports (yoy %)	-1.8	11.5	↓	06/08/2016
Imports (yoy %)	-10.9	-7.6	↓	06/08/2016
M2 Money Supply (yoy %)	12.8	13.4	↓	06/10/2016
Retail Sales (yoy %)	10.1	10.5	↓	06/12/2016
Consumer Confidence Index	114.2	117.8	↓	06/29/2016
Regulated Reserve Ratio (%)	17.5	18.0	↓	Infrequent
Official Foreign Exchange Reserves (USD bn)	3219.7	3212.6	↑	06/07/2016
Three-Month SHIBOR (%)	2.95	2.85	↑	Continuous
10-Year Gov't Bond Yield (%)	2.97	2.91	↑	Continuous
CNY/USD Exchange Rate	6.59	6.47	↑	Continuous

CHART OF THE MONTH

- CNY has depreciated against most currencies in the China Foreign Exchange Trade System (CFETS) basket in daily fixings for the period from 1 January 2016 to 31 May 2016. The People's Bank of China (PBOC) has continuously contained USD/CNY volatility and allowed for orderly depreciation against non-dollar currencies. Indeed, the CFETS RMB trade-weighted index dropped by 3.8 per cent, with CNY depreciating less than 2 per cent against USD, but depreciating more than 10 per cent against Japanese yen (JPY) and Russian rubble (RUB). This clearly stipulates the risk management needs for other RMB currency pairs.

REGULATORY/POLICY DEVELOPMENTS

- The PBOC issued an announcement on 6 May 2016 that qualified institutional investors can open accounts for trading at interbank bond market, including the wealth management products operated by mid-and-small banks. The new rules lower the account-opening threshold and simplify relevant procedures. Detailed rules are expected to follow soon to boost bond investment.
- The PBOC said on 29 April 2016 that it will expand a pilot program of cross-border financing management to be available nationwide, allowing companies and financial institutions to sell RMB or foreign-currency debts without pre-approval from regulators. Cross-border financing ceiling will be calculated for each entity based on a formula relating to its capital or net asset levels, while the PBOC can make counter-cyclical adjustments on the macro-prudential parameters in the formula so as to control leverage and mitigate currency mismatches.
- On 27 May 2016, the PBOC released details for global investors' registration for China inter-bank bond market (CIBM) access, and the State Administration of Foreign Exchange (SAFE) issued guidance on capital remittance related to CIBM investments.

MACRO ECONOMIC UPDATE

- China's economy will follow an L-shaped path as downward pressures weigh in and new growth momentum has yet to pick up, the People's Daily on 9 May 2016 quoted an "authoritative figure" as saying in an exclusive interview. The unnamed source also cited a range of potential difficulties, including a real estate bubble, excess industrial capacity, bad loans, debt-laden local governments and market volatility.

MARKET/PRODUCT DEVELOPMENTS

- HKEX and Thomson Reuters signed an agreement for the creation of a new series of RMB indices on 24 May 2016. The new index series will track the RMB effective exchange rate against other world currencies, and are designed to be transparent, tradable and compliant with the International Organisation of Securities Commission's principles for financial benchmark governance and administration. Details of the new index series will be announced in the next few weeks. The official launch date is 23 June 2016.

RMB FX MARKET DYNAMICS

OFFSHORE USD/RMB

- In May 2016, CNY fixings moved between 6.4565 and 6.579, and CNH was trading 1.5 per cent lower versus the US dollar from a month ago, as the PBOC lowered the CNY fixing to 6.579 on 31 May 2016, the weakest level since March 2011, amid growing expectation of the Federal Reserve's rate hike in June 2016.
- The one-month OTC USD/CNH options' implied volatility fluctuated between 3.9850 per cent to 5.0475 per cent as the PBOC pushed back against claims it has abandoned market-orientated exchange rate reform.

Fig 3: Onshore/Offshore RMB Price Range

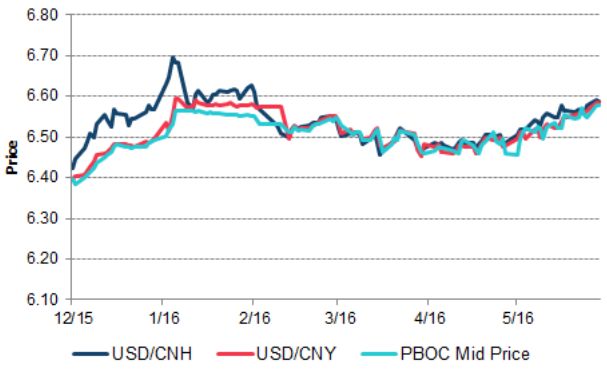


Fig 4: Implied Volatilities of OTC USD/CNH ATM Options

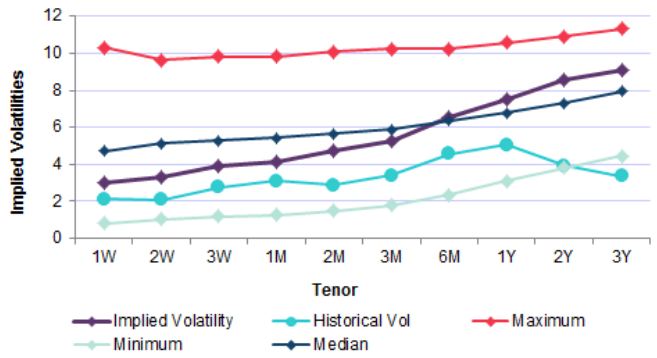
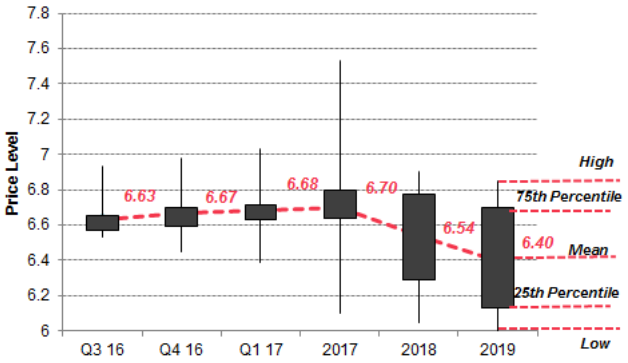


Fig 5: Market Forecasts for the Level of USD/CNH



HKEX'S USD/CNH FUTURES

PRODUCT HIGHLIGHTS

- Average daily volume of HKEX's USD/CNH futures was 1,118 contracts (US$112 million notional) in May 2016. Open interest (OI) was 28,323 contracts (US$2.8 billion notional) as of the end of May 2016.
- Trading volume was high in the Jun-16, Sep-16, and Jun-17 contracts, which accounted for 64 per cent of total volume in May 2016. Open interest concentrated in the Sep-16, Dec-16, and Mar-17 contracts, accounting for 73 per cent of total open interest at the end of May 2016.

Fig 6: USD/CNH Futures Turnover and Open Interest

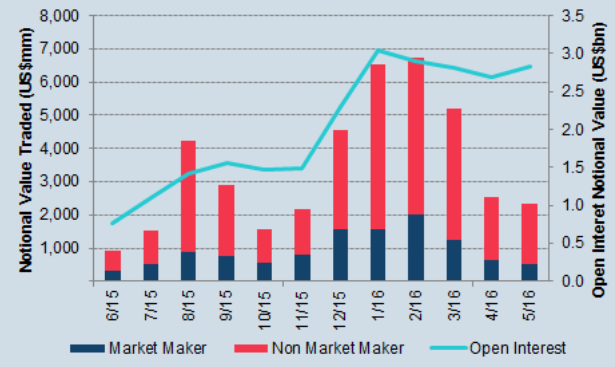


Fig 7: HKEX USD/CNH Futures Contract Provides Best Liquidity in Volatile Market

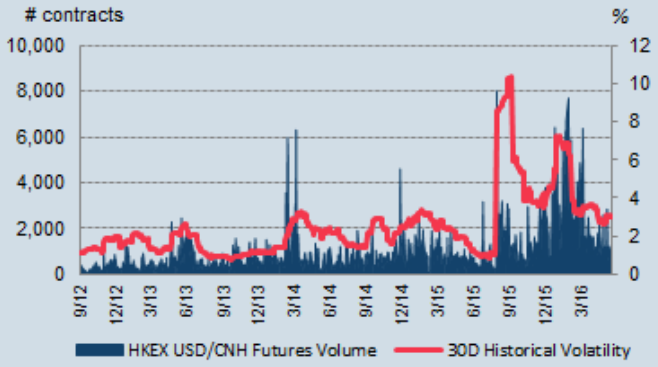


Fig 8: Breakdown of Volume by Contract Month (5/2016)

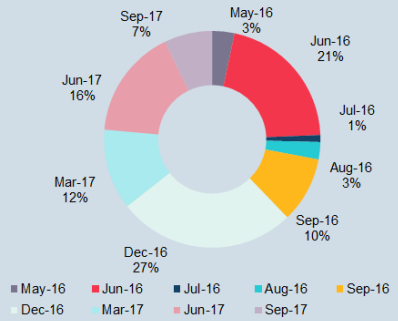
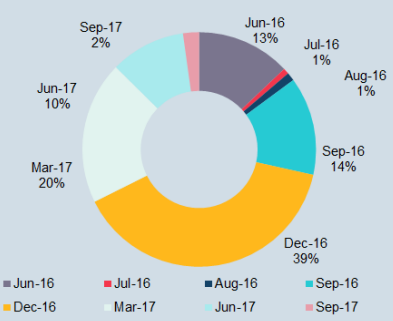


Fig 9: Breakdown of OI by Contract Month (31/5/2016)



Sources: Bloomberg, WIND (31 May 2016)

OFFSHORE RMB AGAINST OTHER CURRENCIES

EUR/CNH

- The CNH was trading 1.3 per cent higher against the EUR in May 2016 from a month ago as the lackluster inflation data weakened the European currency. Eurozone inflation remained at -0.1% as forecasted even though the European Central Bank (ECB) has been hoping for inflation to begin to go up.
- The implied volatility of 3M OTC options continued to drop, falling to 9 per cent in May 2016.
- On the FX radar, the fundamental and risk factors were well below their historical average.

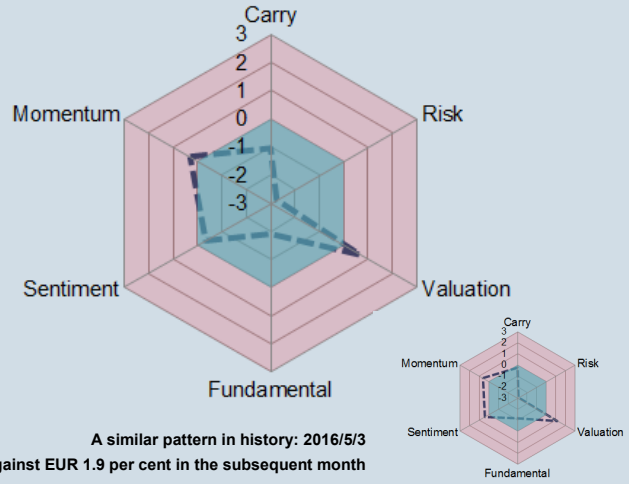
Monthly CNH Performance vs EUR

⬆ 1.3%

Implied Volatility

9.2%

Fig 10: FX Radar*



A similar pattern in history: 2016/5/3
The CNH appreciated against EUR 1.9 per cent in the subsequent month

Fig 11: FX Volatility (3M Implied, %)

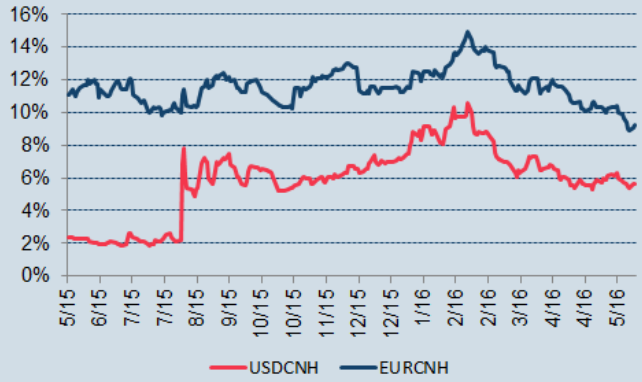
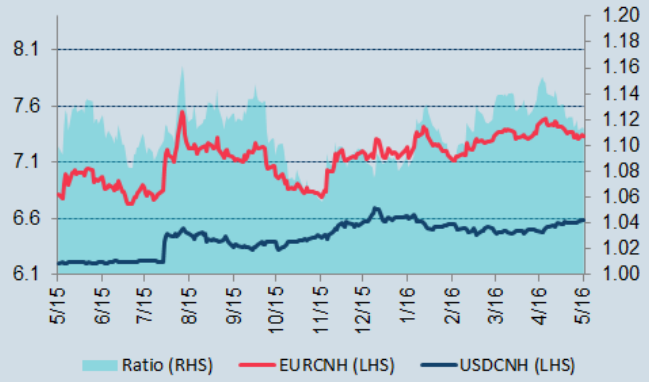


Fig 12: Price Ratio: EURCNH / USDCNH



AUD/CNH

- The CNH was trading 3.4 per cent higher against the AUD in May 2016 from a month ago. The Australian Bureau of Statistics stated on 30 May 2016 that gross operating profits fell 4.7 per cent in the first three months of the year, and declined by 8.4 per cent year-on-year on a seasonally-adjusted basis.
- The implied volatility fell to 11 per cent in May 2016.
- On the FX radar, the fundamental and carry factors were below their historical average.

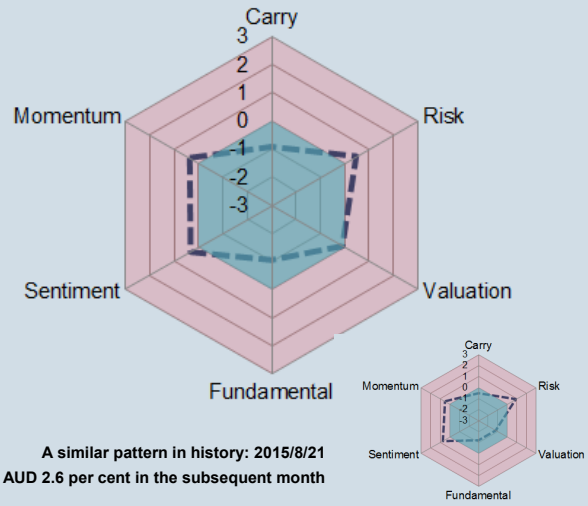
Monthly CNH Performance vs AUD

⬆ 3.4%

Implied Volatility

11.1%

Fig 13: FX Radar*



A similar pattern in history: 2015/8/21
The CNH appreciated against AUD 2.6 per cent in the subsequent month

Fig 14: FX Volatility (3M Implied, %)

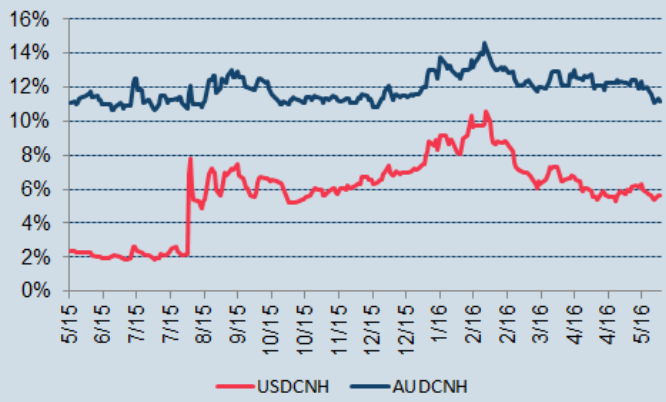
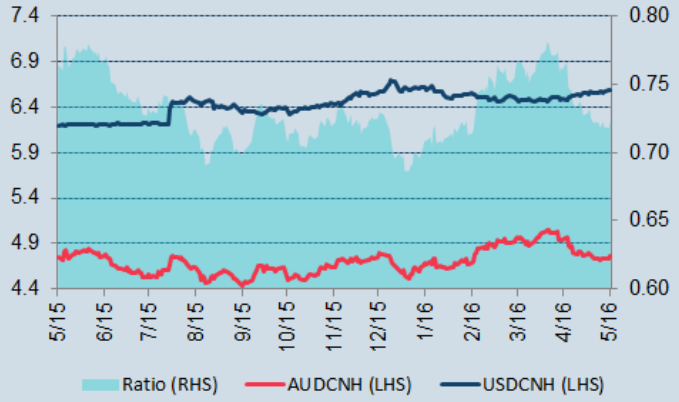


Fig 15: Price Ratio: AUDCNH / USDCNH



Sources: Bloomberg, WIND (31 May 2016), Australian Bureau of Statistics
* For detailed information, please see appendix

JPY/CNH

- The CNH was trading 2.4 per cent higher against the JPY in May 2016 from a month ago, after JPY/CNH receded from its one-year high of 6.1020 on 3 May 2016. The BoJ has insisted that the yen's net gains this year have been excessive and warned that it could intervene to lower the yen's value, since a high-flying currency poses a significant risk to the stability of the economy.
- The 3-month implied volatility OTC options fell towards 11 per cent in May 2016.
- On the FX radar, all risk factors except the carry factor were above their historical average.

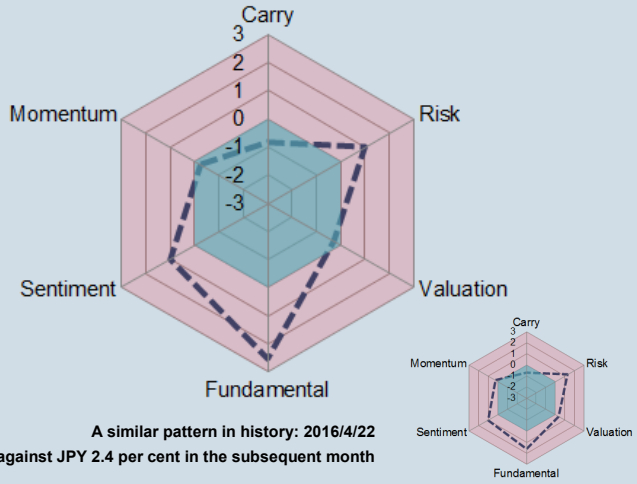
Monthly CNH Performance vs JPY

2.4%

Implied Volatility

11.1%

Fig 16: FX Radar*



A similar pattern in history: 2016/4/22

The CNH depreciated against JPY 2.4 per cent in the subsequent month

Fig 17: FX Volatility (3M Implied, %)

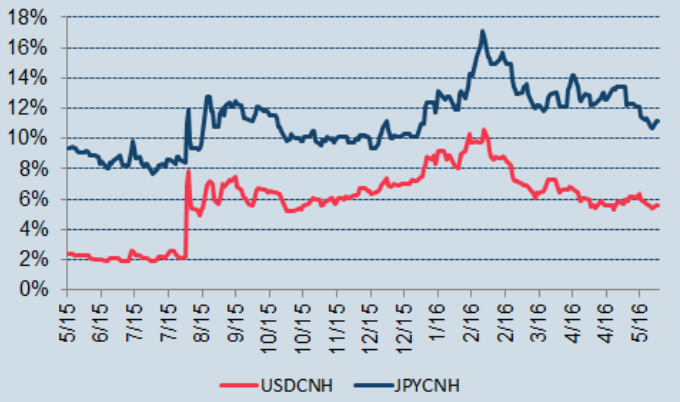


Fig 18: Price Ratio: JPYCNH / USDCNH

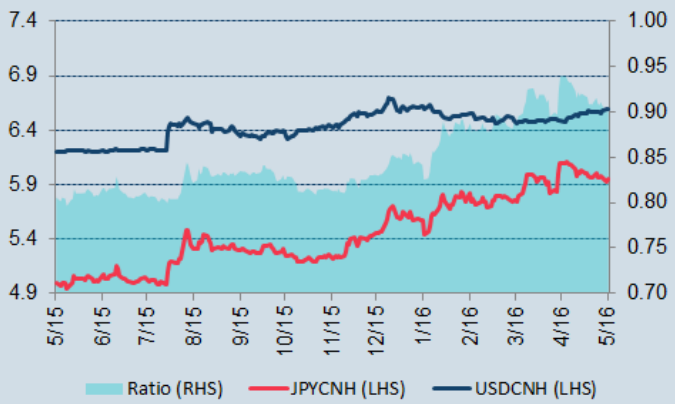


TABLE 2: Summary Table for RMB Currency Pairs

Performance

	Current Month	Prior Month	Chg	Prior 3 Month	YTD	Correlation with USDCNH
USDCNH	-1.5%	-0.4%	↓	-0.5%	-0.3%	1.00
EURCNH	1.3%	-1.0%	↑	-2.9%	-2.1%	0.34
AUDCNH	3.4%	0.3%	↑	-1.8%	0.5%	0.06
JPYCNH	2.4%	-6.1%	↑	-2.3%	-9.2%	0.41

Volatility

	Implied	Prior	Chg	Historical	Prior	Chg
USDCNH	5.6%	5.6%	↑	3.3%	4.6%	↓
EURCNH	9.2%	10.1%	↓	7.1%	8.2%	↓
AUDCNH	11.1%	12.3%	↓	11.5%	11.3%	↑
JPYCNH	11.1%	12.6%	↓	11.5%	12.1%	↓

Sources: Bloomberg, WIND (31 May 2016)

* For detailed information, please see appendix

OFFSHORE BOND MARKET DYNAMICS

OFFSHORE RMB BOND MARKET COMMENTS

- There was one primary issue in CNH in May 2016, as Chinese property firm Fantasia Holdings Group Limited completed its sale of RMB 600 million ($92.36 million) offshore yuan bond, becoming the first public issuance of the so-called "dim sum" bond by a Chinese name this year.
- RMB deposits in Hong Kong decreased by 4.8 per cent month-on-month to RMB723 billion in April 2016. The total remittances of RMB for cross-border trade settlement amounted to RMB358.1 billion in April 2016, compared to RMB370.7 billion in March 2016.

Fig 28: Offshore RMB Deposits vs Outstanding Dim Sum Bonds

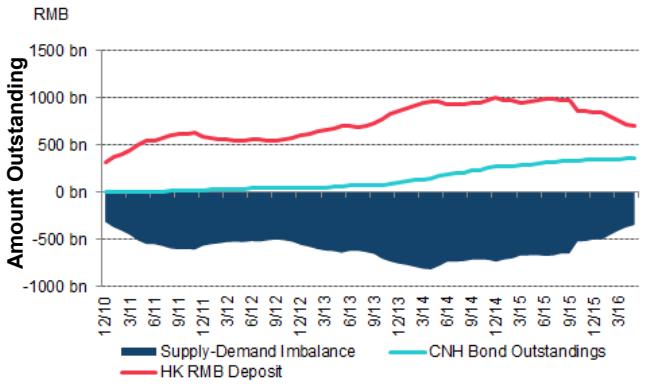


Fig 29: RMB Bond Issuances by Issuer Type

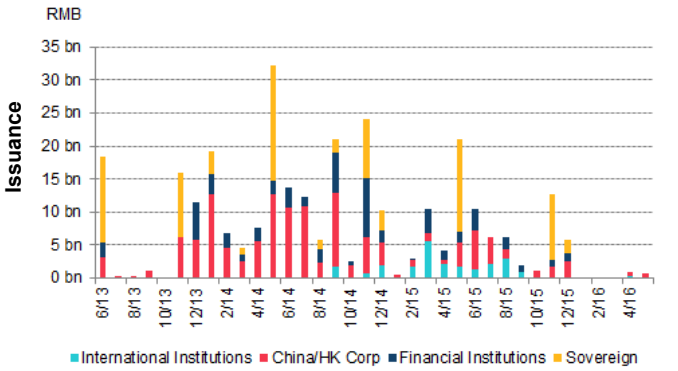
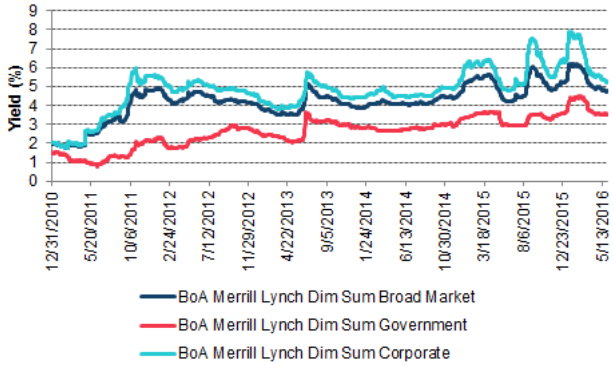


Fig 30: Dim Sum Bond Performance



ONSHORE BOND MARKET DYNAMICS

ONSHORE RMB BOND MARKET COMMENTS

- Onshore bond issuance increased 70 per cent to RMB 2.9 trillion in May 2016 from RMB1.7 trillion in May 2015. Corporate bonds issuance in May 2016 was up 1,078 per cent from a year ago. Corporate debt now amounts to 160 per cent of China's gross domestic product, compared with 98 per cent in 2008, according to Standard & Poor's Ratings Services earliest this year.
- The onshore/offshore five-year Ministry of Finance (MoF) Treasury Bond (T-Bond) yield spread continued to narrow in May 2016. The spread narrowed to around 0.6 per cent, as the five-year MoF T-Bonds were trading at 2.89 per cent onshore versus 3.51 per cent offshore towards the end of May 2016.

Fig 31: MoF T-Bond Yield 5Y: Onshore vs Offshore (%)

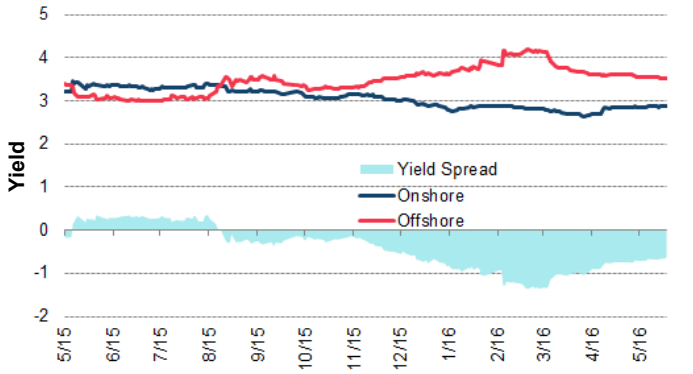


TABLE 3

Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types)

Bond Type	Number of Deals	Trading Value(RMB 100M)	Yield to Maturity(%)
Policy Financial Bond	47,573	48,683.91	3.0453
Treasury Bond	7,431	8,939.18	2.6921
Medium-term Note	12,454	9,381.43	4.8178
Corporate Bond	12,154	7,607.91	4.7632
CDs	4,377	9,187.81	3.0392
Commercial Paper	14,179	11,714.49	3.7036
Central Bank Paper	111	386.09	2.4123
Others	3,124	3,486.87	4.1992
Total	**101,403**	**99,387.69**	**3.4220**

Fig 32: MoF T-Bond Outstanding Split by Tenor

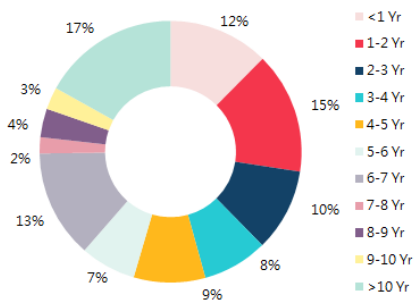


TABLE 4

NAFMII Guidance for Non Financial Institution Debt Issuing (as of 2016/5/30)

	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.11	⇩	3.62	⇩	3.83	⇩	4.19	⇩	4.45	⇩	5.04	⇩	5.21	⇩	5.48	⇩
AAA	3.31	⇩	3.76	⇩	4.01	⇩	4.52	⇩	4.78	⇩	5.35	⇩	5.63	⇩	5.91	⇩
AA+	3.55	⇩	4.12	⇩	4.49	⇩	5.01	⇩	5.40	⇩	5.98	⇩	6.32	⇩	6.64	⇩
AA	4.10	⇩	4.67	⇩	5.04	⇩	5.67	⇩	5.96	⇩	6.66	⇩	7.03	⇩	7.49	⇩
AA-	5.49	⇩	6.04	⇩	6.47	⇩	7.38	⇩	7.80	⇩	8.34	⇩	8.73	⇩	9.02	⇩

NAFMII – National Association of Financial Market Institutional Investors

Sources: Bloomberg, WIND, NAFMII (31 May 2016)

ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- Hong Kong's overnight Treasury Markets Association CNH HIBOR dropped to less than 1 per cent on 30 May 2016, the lowest level in 2 months.
- The CNY SHIBOR yield curve was flatter at the end of May 2016 than it was at the end of May 2015 (see Figure 34).
- The CNH HIBOR yield curve was steeper at the end of May 2016 than it was at the end of May 2015 (see Figure 35).

Fig 33: CNH Implied Yield vs. USD/CNH

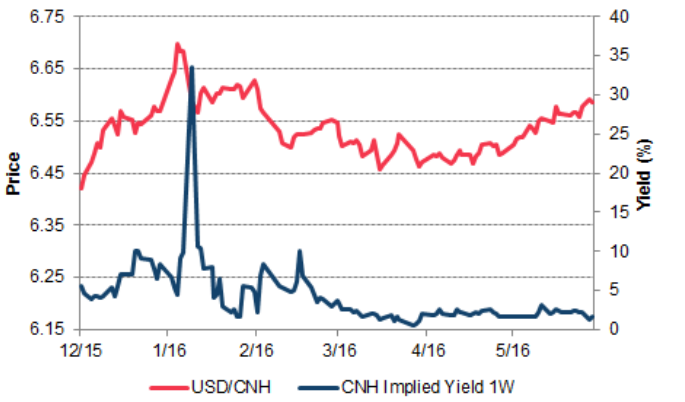


Fig 34: CNY SHIBOR Yield Curves

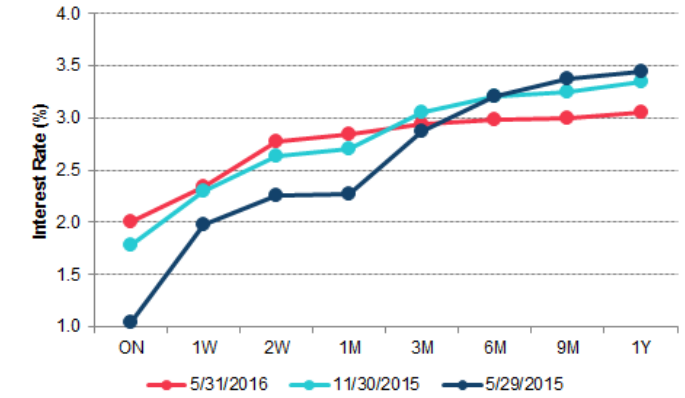


Fig 35: CNH HIBOR Yield Curves

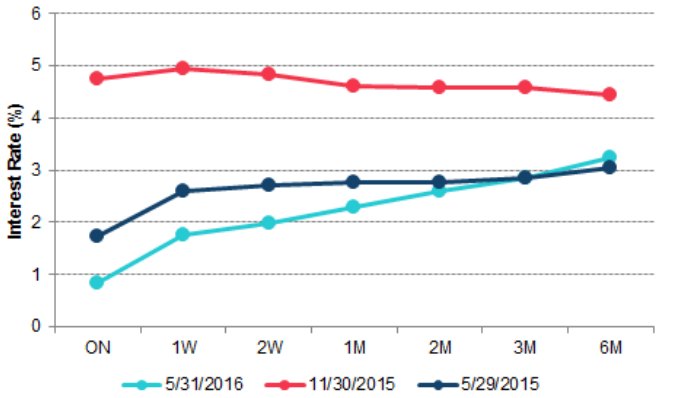


Fig 36: Onshore IRS (7D Repo) Yield Curves

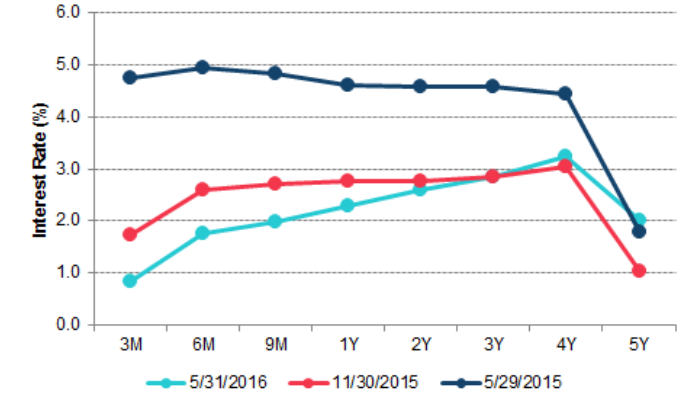


Fig 37: Onshore IRS Trading Notional Principal

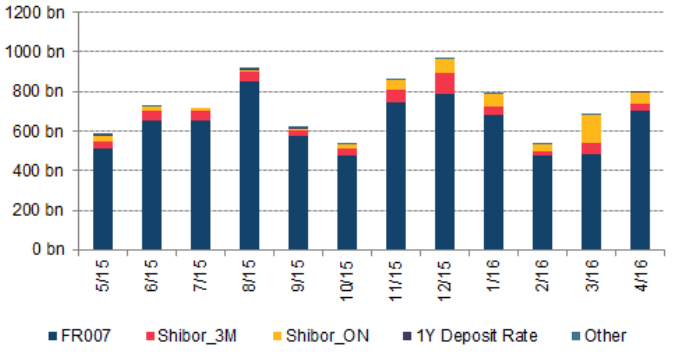


Fig 38: CNY SHIBOR vs CNH HIBOR

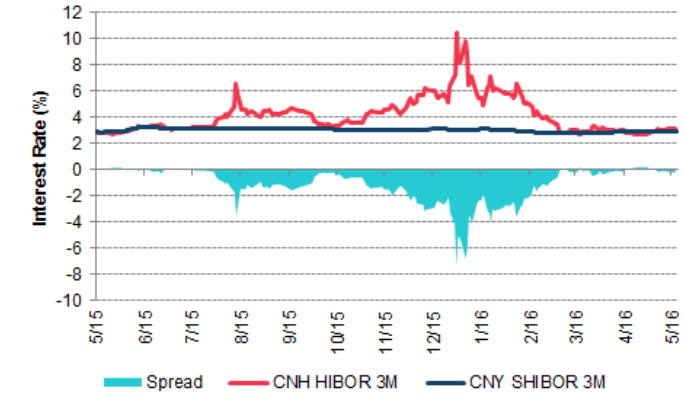
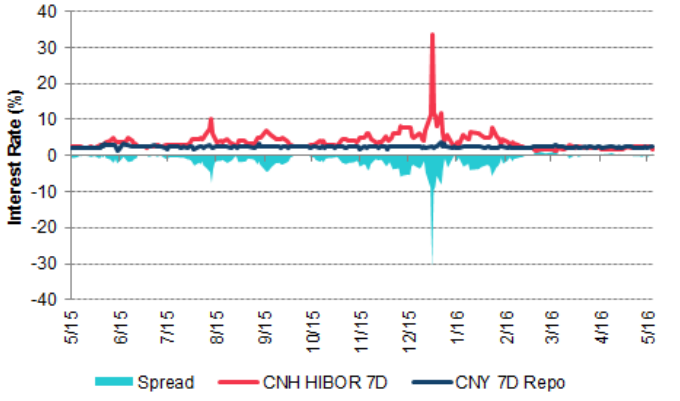


Fig 39: CNY 7D Repo vs CNH HIBOR



(continued on page 8)

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The asset portfolio channel. As negative interest rates lower the yields of safety assets, investors will pursue assets of higher risks and adjust their asset portfolios for higher returns.

The inflation channel. A loose monetary environment will heighten inflationary expectations and guide the real inflation rate towards the central bank's target inflation rate.

The FX channel. Negative interest rates can cause the domestic currency to depreciate which increases net exports. Higher import prices can increase inflationary expectations and stimulate economic growth further.

Negative interest rates are hot potatoes. To avoid loss, the public will try harder to find buyers for their assets. This will increase asset turnover and asset velocity thereby enlarging the total trading volumes in the economy.

Negative interest rates can buy time for banks to repair their balance sheets. They are also good news for those with massive outstanding debts.

Some think negative interest rates are effective in the long run despite more uncertainties

Negative interest rates stimulate the economy in the long run, but they also involve greater risks and uncertainties, mainly due to the following reasons:

The restrain effect. When interest rates are at very low levels, there is not enough pressure on governments to settle debts. In fact, negative interest rates even encourage governments to borrow more. If government borrowings become free lunches, there will be significant impacts on fiscal discipline.

The distraction effect. When the financial market pays too much attention to monetary policies, its attention on the real economy will be distracted. Balance sheet deterioration after the financial crisis has weakened financial institutions. There is no way financial institutions can effectively transfer monetary stimulus to the real economy through credit expansion.

The distortion effect. Negative interest rates distort asset prices. Current Eurozone bond prices do not fully reflect the intrinsic risks of the zone's massive debts. Investors are still being encouraged to allocate their wealth to high-risk assets. Stock prices are being artificially elevated. Advocates of negative interest rates think prudent macroeconomic tools can offset financial risks and price distortion brought by accommodative monetary policies. But this is unrealistic because prudent macroeconomic policies and monetary policies are complementary. They are not each other's substitutes.

The destruction effect. Low interest rates for a long time can have a devastating effect on the business models of financial institutions. This is because the traditional business models of these institutions do not include a variable such as negative interest rates (or zero interest rate). Negative interest rates, meanwhile, also undermine the normal operation of banking systems.

Commercial banks struggle to evade negative interest rates. In face of negative interest rates, commercial banks do not increase lending at first. Instead, they try every means to mitigate the negative impacts or carry out arbitrage activities. In terms of financial market operations, it is not difficult for large commercial banks to evade negative interest rates. For example, an international bank can deposit its reserve fund in the central banks of other countries or maintain liquidity through overnight borrowing and other related risk-free credit.

Proponents of negative interest rates mainly hold the view that in the prevailing economic gloom, negative interest rates expand banks' credit and stimulate expectations of inflation. Opponents, however, are concerned that in the course of implementation, there may be plenty of risks and uncertainties. Countries that implement negative interest rates are also launching other monetary easing policies. For example, the Eurozone increased quantitative easing at the same time it introduced negative interest rates, hoping to increase economic stimulus through a package of monetary policies. Many academics also think negative interest rates should be complemented by necessary fiscal policies and structural reforms as returns can only be maximised through a combination of macroeconomic policies. In terms of effects, Denmark has had some success in using negative interest rates to stabilise the value of its currency, while Sweden was less effective in this respect. The Eurozone and Japan, both bigger economies, have only implemented negative interest rates for a short while. It remains to be seen how that policy will affect these two regions.

EXPERT CORNER

EXPLAINING STEADY CNY FIXING AMID USD SELL-OFF

Contributed by Mr Ken Cheung, Asian FX Strategist, Treasury Marketing Department for Mizuho Bank Hong Kong

The PBOC illustrated the CNY fixing mechanism in its Q1 Monetary Policy Operation Quarterly. In the report, they defined that the CNY fixing mechanism is based on two components: the CNY daily close at 16:30 on the previous trading day and the change in the RMB baskets indices including CFETS, BIS and SDR baskets. This clarification of the CNY fixing mechanism helps explain the persistent gap between the CNY fixing and previous CNY daily close, and we look for the steady CNY fixing going onwards.

In the report, the PBOC elaborates that the CNY fixing mechanism is based on market demand-supply conditions with reference to the RMB baskets movement. To recap, the PBOC introduced the CNY fixing reform on 11 August 2015, noting that the CNY fixing has to refer to the previous CNY daily close. After 3 months, the PBOC published the CFETS RMB Index and stressed to increase reference of RMB basket to the CNY fixing formation. In May, the PBOC introduces the detailed explanation of the CNY fixing mechanism.

According to the PBOC, the CNY fixing mechanism is based on two components: the CNY daily close at 16:30 on the previous trading day and the change in RMB baskets including CFETS, BIS and SDR baskets. The latter component is of interest as the PBOC has never defined which RMB baskets should refer to. In the PBOC's Governor Zhou's interview on 13 February, he mentioned that the FX basket selection to link the CNY fixing mechanism is "debatable" and the design of the mechanism can be adjusted appropriately corresponding to the macro trend and demand-supply conditions.

Back to the report, the PBOC notes that market makers consider the CFETS basket with reference to BIS and SDR baskets in submitting fixing quotes. The weight of these three baskets is different and ambiguous among market makers. However, we reckon that the CFEFTS basket should take heavier weight as market makers have to "consider" the CFETS basket instead of merely "refer to". However, the exact weight of each RMB Indices baskets is unknown.

The spread between USD/CNY fixing and previous USD/CNY daily close movement was largely in line with the CNY fixing framework. Since the launch of the CNY fixing reform on 11 August, the CNY fixing was being aligned with the previous CNY daily close until early January. Afterwards, the PBOC appeared to transmit its strong CNY bias via setting lower CNY fixings consistently in order to contain prevailing RMB depreciation expectation. After the Chinese New Year, the reference of the FX basket adjustment plays a more important role in determining the CNY fixing and the spread widened with two-way volatility.

Under the existing framework, the USD movement drives the CNY fixing in two ways through changing USD/CNY spot close directly and the RMB Indices indirectly. On the one hand, the USD Index holds the positive relationship with USD/CNY spot as market participants refer to USD Index movement in trading USD/CNY spot. When the USD Index falls, market participants predict that the USD/CNY fixing next day will fall and therefore sell USD/CNH immediately. On the other hand, the USD movement drives the RMB Indices across different baskets, and in turn places adjustment to the USD/CNY fixing. Given that the RMB maintains relatively stronger linkage to the USD, the RMB Indices drifted lower since the launch in December and broadly in line with the weakening USD simultaneously.

Theoretically, the lower RMB Index should lead to upward adjustment for the USD/CNY fixing, i.e. negative correlation. To examine the relationship, our analysis shows that 1-month correlation between the CNY fixing and the previous CFETS RMB index has been turning to be significantly negative (-0.68) recently. This negative correlation coefficient is in line with our theoretical thought: decrease in the RMB Indices (weaker CNY across the broad) leads to upward adjustment to the USD/CNY fixing (weaker CNY against the USD). In other words, the latter component of RMB basket indices acts as a stabilizer in setting the CNY fixing. And the mechanism explains the phenomenon that the USD/CNY fixing was broadly stable amid the heavy USD sell-off since February. The USD sell-off directly pulls down USD/CNY spot but indirectly places upward adjustment to USD/CNY fixing via lower RMB Indices. However, the change in RMB indices should also capture the CNY movement after the daily close (16:30) and it will be difficult to decompose such impact.

For FX implications, the CNY fixing is going to remain relatively steady with the stabilizer of the RMB Index under the current mechanism if the USD index maintains the positive relationship with the RMB Indices. We maintain our call that USD/CNH spot will range bound in Q2. While the CNY fixing mechanism operated smoothly amid the USD sell-off and the run of improving China data over past two months, it is subjected to the test of stronger USD and resurfacing concern over China outlook in the near term. While the PBOC is reluctant to set the CNY fixing below 6.45 amid the previous USD sell-off, the PBOC can also keep the CNY fixing below 6.55 to maintain RMB depreciation expectation.

Ken Cheung joined Mizuho Bank Hong Kong in March 2015 as a Asian FX Strategist in the Treasury Marketing Department, covering Asian FX and rates markets with an emphasis in CNY and CNH markets.

He is in charge of various Asian currencies publications and formulating FX and rates view on CNH & CNY. He contributes his article to Japanese news magazine and has frequent exposure on media such as Bloomberg and local TV.

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APPENDIX: DEFINING THE FX RADAR

We selected a number of factors that drive RMB currency pairs, including carry (yield spread), risk (volatility), valuation (terms of trade), fundamentals (trade balance), sentiment (risk reversal), and momentum (three-month return). Factor values were normalized based on the most recent one-year data and plotted on our FX radar graph. For example, a factor value of 1 for "carry" indicates that the current yield spread is one standard deviation above its mean over the past year.

The red dotted line represents the prevailing factor dynamics of the specific RMB FX pair. Against the current factor dynamics, we identified the most similar patterns in past history by means of optimization across the six driving factors. The historical price movement of that particular period is shown for reference.

For more information about the USD/CNH Futures,
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