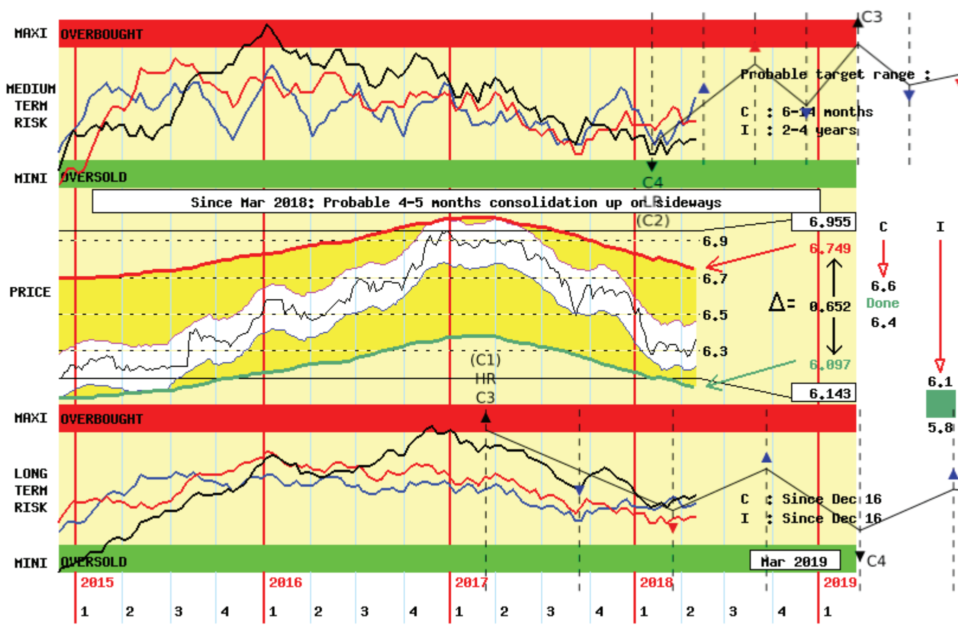
A rising Dollar should strengthen the Trade Weighted Yuan. In the past, China has devalued to counter this effect.

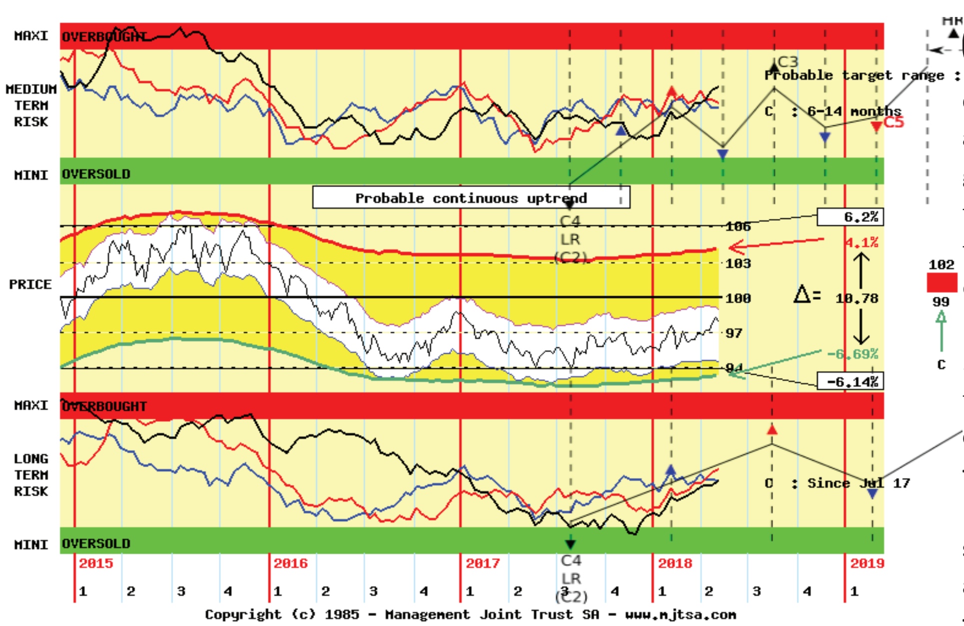
The People's Bank of China recently lowered the reserve-requirement ratio on commercial lenders. The move should unleash a strong inflow of onshore liquidity and boost lending to small and medium sized companies. It is seen as a clever move as it is very targeted on easing funding conditions for lenders allowing them to lend more to dynamic companies, without being assimilated to full blown easing, which would be contrary to China's current push to curb financial leverage. That said, it may be revealing of a growth situation that is currently deteriorating amid the strong contraction in on-shore liquidity over the last few quarters, and the looming risk of a trade war with the US. Rather counter-intuitively, if the recent Dollar bounce does continue to gather momentum, it will probably add additional pressure for further easing. We attempt to show why below.

USD/CNY - Weekly graph or the perspective over the next 2 to 4 quarters



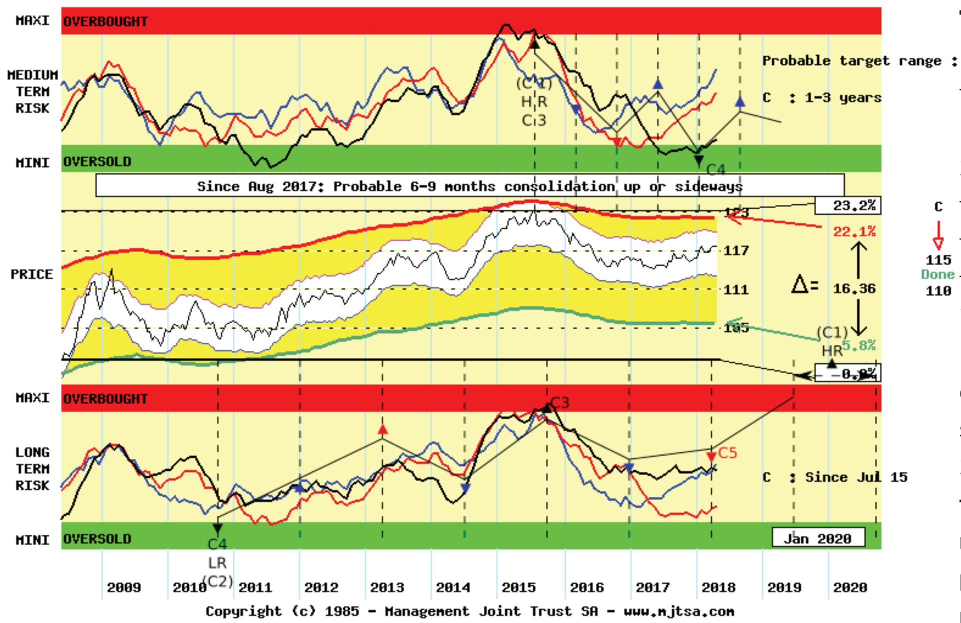
The Yuan has strengthened substantially vs the US Dollar in 2017. This was the resultant of a weak Dollar across the board, but also of a significant tightening in China's onshore liquidity in order to curb financial leverage. **With the recent Dollar bounce, both our oscillator series (lower and upper rectangles) have made an important low, and could now continue to rebound towards the Summer. We wonder about the scope and length of this potential move up in USD/CNY, especially if economic conditions in China are slowing down. Will the People's Bank of China stick with its current financial and monetary discipline, or could it reverse course and consider more widespread easing initiatives, perhaps even a Yuan devaluation**. This is a question we cannot answer today, yet over the next few pages, we will try to highlight the underlying trends that we can currently read from the markets.

Traded Weighted Yuan top 9 positions (i.e. ex USD)
Weekly graph or the perspective over the next 2 to 4 quarters



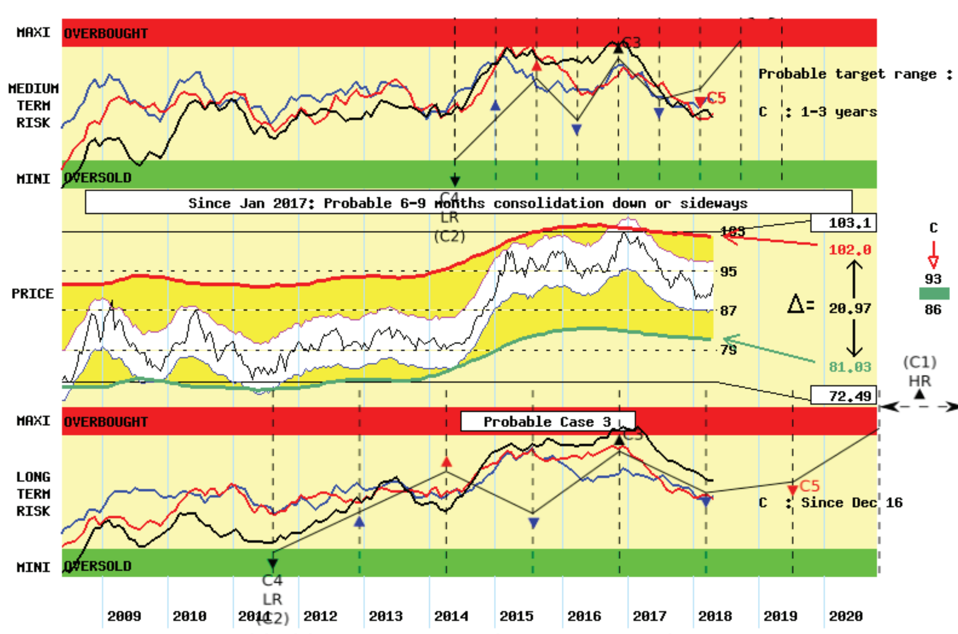
Our first observation is that, the recent tightening of onshore liquidity in China has led to a stronger Yuan across the board since Q3 2017. In this graph we have excluded the Dollar from the equation and have concentrated on the Yuan weighted against the currencies of its other 9 top trading partners (e.g. circa 21% EUR, 14% JPY, 14% KRW, 25% USD – which we have excluded from the basket). **That said, and rather counter-intuitively, the move seems to be accelerating with the recent US Dollar bounce. On both our oscillator series we expect it to continue higher at least until the Summer and then, following some consolidation towards year-end, potentially into 2019**. Our point is that the Yuan is less volatile than other currencies against the Dollar and that as the Dollar strengthens, the Yuan also strengthens vs the currencies of its other trading partners. This may add additional pressure on China's export industry, on top of the looming trade war with the US.

Traded Weighted Yuan top 10 positions (including the USD)
Bi-Monthly graph or the perspective over the next 1 to 2 years



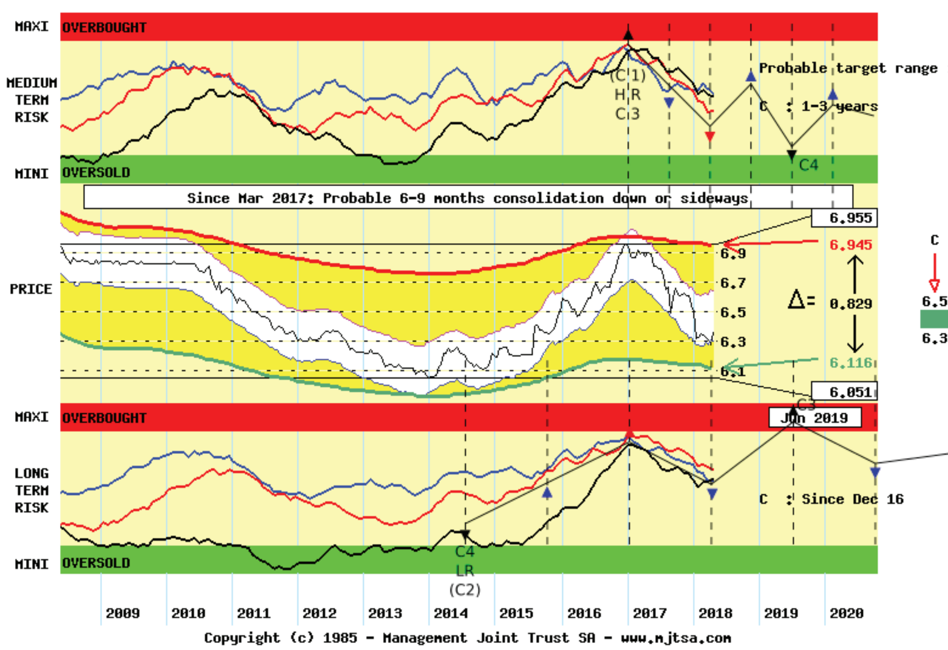
The observation in the graph above wouldn't be too worrying if there wasn't a precedent. Indeed, during the 2011 – 2015 period that's exactly what happen. Considering this graph (where we've added the USD 25% weighting back into the basket) and the one below of the USD Index, we can notice that as the US Dollar started to rise mildly between 2011 and late 2013. **The reaction up of the Yuan vs the currencies of its Top 10 trading partners was more than proportionate during that period, leading to a deterioration of China's competitive situation. From 2014 however, the proportionality reversed and the Yuan started to strengthen at a slower pace that the Dollar Index. This reversal corresponded to the effect of the Yuan devaluation (see first graph on the next page)**. Hence, when the US Dollar strengthens, the Yuan strengthens across the board vs the currencies of its trading partners (i.e. strength in USD/CNY is usually more than compensated by the weakness of other currencies vs CNY and the USD, unless China decides to devalue).

Dollar Index
Bi-monthly graph or the perspective over the next 1 to 2 years



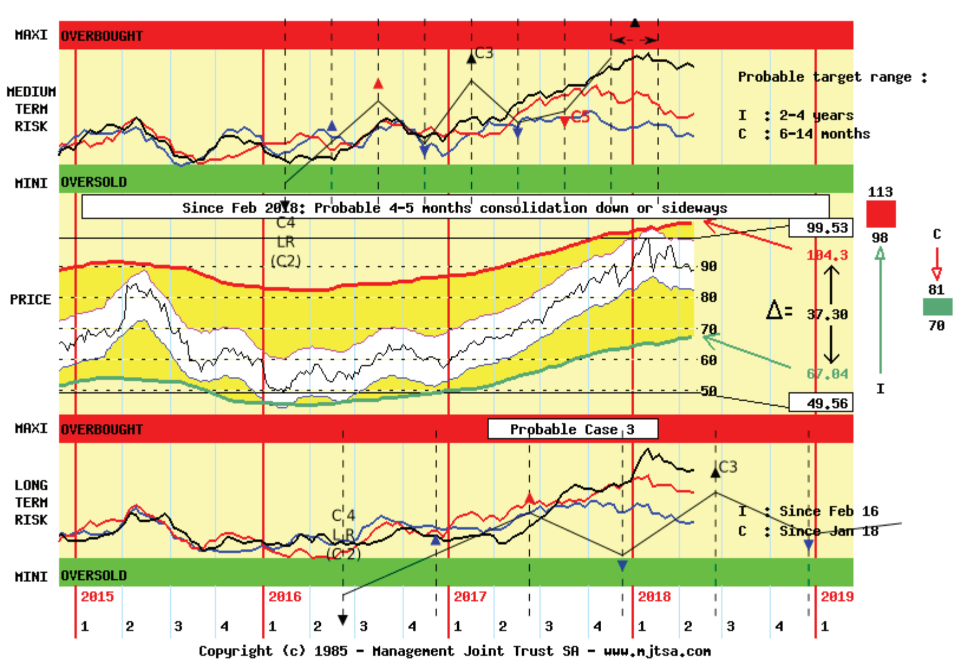
We now look at our current projections for both graphs on this page. Both the US Dollar Index and our CNY Trade Weighted basket above, may have finished their recent corrections to the downside on all oscillator series (upper and lower rectangles on both graphs). **Both Indexes could now be getting ready to resume up towards late 2018 and potentially even towards late 2019/2020. If history is any guide, the Yuan trade weighted basket should strengthen even more than the Dollar Index, unless China decides to devalue once more.**

Yuan Renmimbi per USD
Bi-monthly graph or the perspective over the next 1 to 2 years



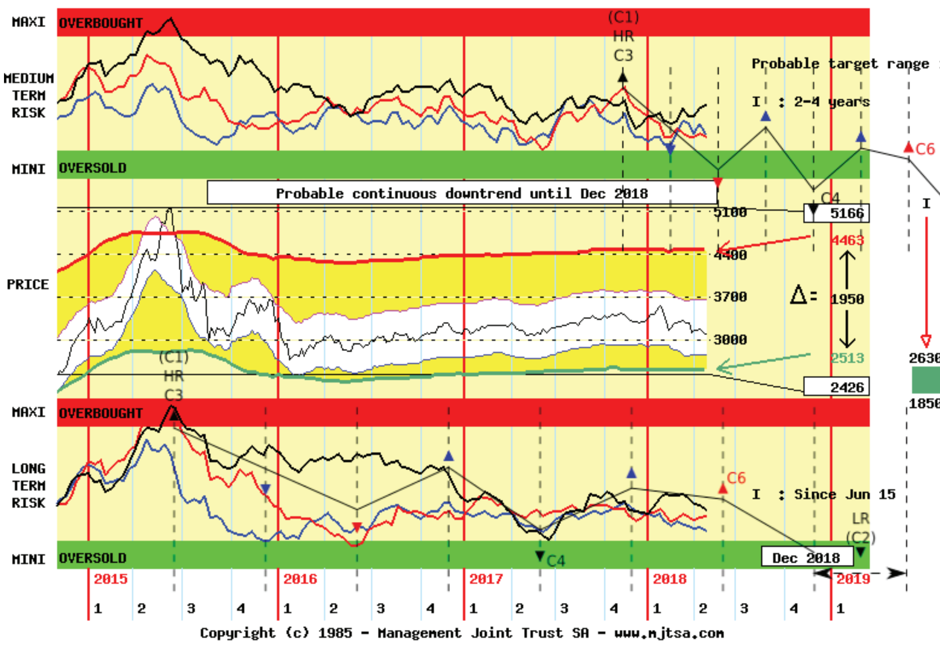
This graph of USD/CNY is especially telling as it shows the scope and speed of the strong CNY devaluation between 2014 and late 2016. **Since late 2016, this move has pretty much been retraced, yet on both our oscillator series (lower and upper rectangles) it may be getting ready to re-sume up probably into late 2018 and possibly even into late 2019** on our long term os-cillators (lower rectangle). As precise as it may be (or not) to monitor Chinese monetary policy, a strong weakening of USD/CNY is what the graph is currently forecasting over the next 3 ti 6 quarters.

MSCI China
Weekly graph or the perspective over the next 2 to 4 quarters



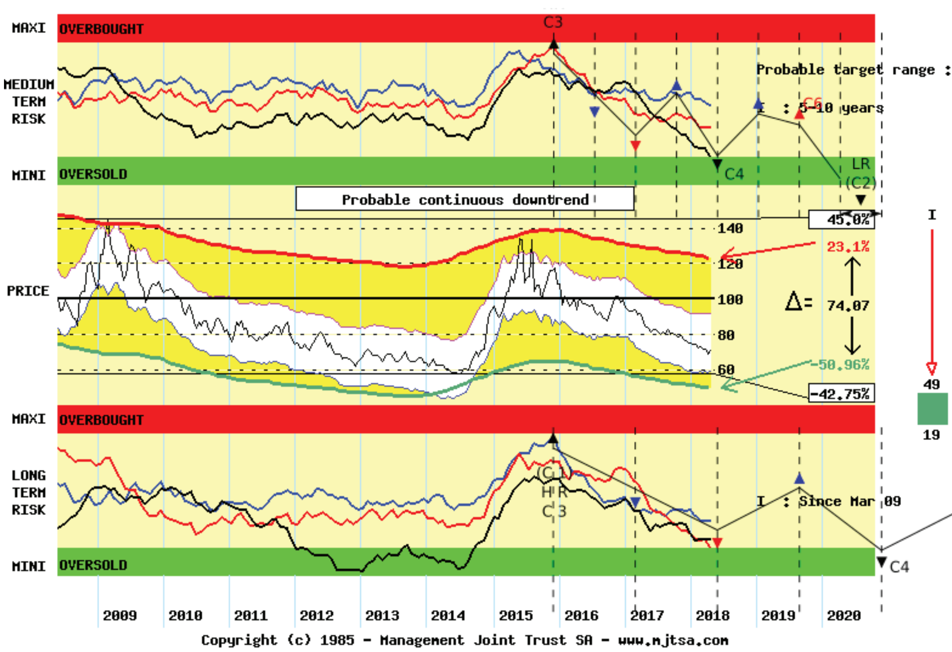
We now switch to the Chinese equity markets to examine if they are due for a strong correction (or not) thereby signaling potential trouble for the Chinese eco-nomy. The MSCI China Index is mostly composed of Chinese large cap shares which are in-vestable off-shore. **The 3 lar-gest technological stocks on their own, Tecent, Alibaba and Baidu represent 35% of the index. These are called the BATs and are equivalent to the US FANGs. The index is hence very much skewed towards "Big Growth". No wonder it was one of the best performing indexes in the world last year. As with other large equity markets, we expect the MSCI China index to top out at some point between now and the Summer**. The sequence up since early 2016 on our medium oscillators (upper rectangle) has already been completed, while on our long term oscillators (lower rectangle), we may ex-pect once last push up, probably towards midyear.

Shanghai Composite Index
Weekly graph or the perspective over the next 2 to 4 quarters



The picture for stocks listed on the domestic Chinese market is however much weaker. Indeed, the **Shanghai Composite Index, which is featured here, already seems to be weakening. Companies in the index on average generate 80% of their revenue domestically, and the tightening of on-shore liquidity conditions over the last few quarters is probably starting to bite. On our long term oscillator series (lower rectangle), the index could be rolling over, and from mid-year may start to accelerate down, probably towards year-end**. On our medium term oscillators (upper rectangle), the sequence we show is already in a downtrend. It may bounce slightly between now and early Summer, but thereafter also continues lower towards year-end. **The picture seems to signal some kind of deceleration in the Chinese onshore economy**.

Shanghai Composite Index/MSCI Emerging Markets Asia (currency hedged)
Bi-Monthly graph or the perspective over the next 1 to 2 years



Chinese A shares will soon be included in the MSCI World index (gradually in June and September this year). From what we can see from this graph, over the last 2 years they have massively underperformed other Asian Emerging markets equities (main index weightings ex China are in South Korea, Taiwan and India). Yet, both our oscillators series (lower and upper rectangles) are signaling **an important reversal, and we expect the Shanghai Composite to bounce probably from midyear towards year-end, and perhaps well into 2019. What will be the trigger for this move is difficult to anticipate. It may be that China today is more defensive than other Emerging Asian markets, and that if we are headed for a global risk asset correction it may resist better than other Emerging markets in the region. It may also be that China eventually devalues as it did in 2014/2015. It might also be a bit of both, as China attempts to mitigate the market downturn that may lie ahead.**

Concluding remarks

If we are correct in projecting that the US Dollar could strengthen into the Fall, and then perhaps again into late 2019, the Chinese Yuan will probably feel some upside pressure. Indeed, historically the currencies of its main trading partners on average tend to weaken more than the Yuan when the Dollar is strong. Such Yuan revaluation would create additional pressure on an economy which is already showing signs of deceleration. That said, the People's Bank of China is currently set on financial discipline, and over the last few quarters it has considerably tightened onshore financial conditions to curb financial leverage. Any widespread easing, for example to weaken the currency, would be considered a complete reversal of its current policy. That said, an aggravation of the trade war with the US, may at some point, provide an excellent excuse to justify such a change of course.