Early Warning Signals for CNY

- **NDF outrights provided useful clue in December that market was skeptical about break of CNY 7.00**
- **Repeated a pattern seen in recent years of NDF market getting trend shifts in spot market roughly right**
- **Noticeable shift in pricing in recent days**

Through the 1980s and the early part of the 1990s one of the key indicators of mounting pressure within the European exchange rate mechanism was the performance of forward outrights.

In normal circumstances, the movement of three-month and longer forward outrights beyond the calculated range against the DEM would see the currency that had weakened below its lower bound begin to be bought by investors until it moved back within the band.

In contrast, when the three-month forward outright moved outside the band and stayed outside the band, this provided a key early warning of devaluation battles to come.

There was little sign of the NDF market becoming particularly excited about the
prospect of a significant move higher in USD/CNY in 2019

The usefulness of forward outright pricing as an indicator of changing sentiment was made apparent again in the run up to the end of 2018 when the USD was consistently pressuring CNY 7.00.

What was interesting at that point was that unlike the period between August 2015 and Jan 2016 or, again, in December 2016, there was little sign of the NDF market becoming particularly excited about the prospect of a significant move higher in USD/CNY in 2019.

Indeed, to put this into some kind of context, by mid-December the spread between spot and the one-year NDF forward outright was at about the same levels it stood at in October 2012 when the USD downtrend was starting to slow.

This, therefore, was a market that collectively believed the PBOC would be able to carry out a very effective smoothing operation in the months ahead and that any move by the USD above CNY 7 would likely prove muted.

In the event, that proved a very accurate read of the situation. This, in turn, was consistent with a broader theme. While markets can most certainly be caught unawares by events - the depegging by the SNB in January 2015 being an excellent example - the NDF market has had a history of getting trend shifts in spot CNY roughly right.

Since the start of this month these spreads have begun to widen out rapidly

So why does that matter now?

Over the course of this year the spread between spot USD/CNY and the one-month, three-month and six-month NDF outrights has been pretty well zero.

However, since the start of this month, these spreads have begun to widen out rapidly (albeit to still modest levels when compared to most points in the past three years. In other words, this is a market that’s starting to contemplate...
For the moment, even the one-year USD/CNY NDF outright has yet to break CNY 6.90, so it would be wrong to say that this is a market that is now seriously thinking about a sustained move beyond CNY 7.00. However, it’s also clear that the mood is shifting.

It will therefore be interesting to see what happens if, and when, they do reach this critical level.

Please direct questions or comments to:

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