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MACROCOSM

China the Currency Manipulator, and So What?

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A toothless move, but it shows Trump no longer cares about scaring the stock market.

It's not obvious to us that Monday's 1.6% weakening of China's currency – breaching the psychologically important 7 level – was truly an act of manipulation (see "RMB Breaks 7: Is this 'the Edge of Chaos'?" August 5, 2019). The People's Bank set the fix at 6.92, and the market took it from there. And it's precisely the understandable market reaction we predicted in the wake of President Donald J. Trump's announcement-by-tweet of new tariffs (see "On the New China Tariffs" August 1, 2019). *Yet yesterday, when the stock market had closed after an awful day*, *the US Treasury officially determined that China is a "currency manipulator."*

- Trump campaigned in 2016 promising to name China a currency manipulator on his first day in office. He didn't follow through, nor did Treasury Secretary Steven Mnuchin in a succession of no less than five semi-annual "Reports to Congress on the Macroeconomic and Foreign Exchange Policies of Major Trading Partners of the United States."
- *As a practical matter, the determination means almost nothing, and the markets' immediate reaction yesterday evening would seem way overdone, and it has been entirely reversed already this morning, as of this writing, pre-opening.* Mnuchin's next step comes off as comically naïve – under the powers granted in the Trade Facilitation and Trade Enforcement Act of 2015, he "will engage with the International Monetary Fund to eliminate the unfair competitive advantage created by China's latest actions." *But that's pretty much all the teeth the law has.*
- It's a far cry from the Schumer-Graham China Tariff Act of 2005, which threatened to declare China a currency manipulator, slapping it with a 27-1//2% tariff on all exports. Without even actually being passed by Congress or signed by the president, the mere threat of it scared China into beginning a decade-plus of currency appreciation. *But now, what would be the point of a Treasury determination allowing tariffs to be imposed? They already have been!*
- *No, what's scary about the determination that China is a currency manipulator is its ad hoc quality*, coming out of the blue in the form of a brief press release – with none of the laboriously articulated rationales offered when such determinations are made in the semi-annual Foreign Exchange Report (indeed, as they were in the May

Update to strategic view

US MACRO, ASIA MACRO, FX, US STOCKS: Treasury's determination that China is a currency manipulator is of little consequence, as the enabling law doesn't confer any important new powers on Trump. But coming after a terrible day for markets, during which Trump inflamed the situation with tweets rather than offering the usual assurances, it shows that Trump no longer feels constrained to not scare markets, seeing them now as collateral damage in the process of scaring Xi. The risk of a currency crisis for China now echoes 2015 when RMB underwent a surprise devaluation, driving US stocks down more than 11% in a matter of days. At the moment it seems China is keeping the weakening of RMB orderly, which is what helped stocks find their footing in 2015. But Trump seems set on creating continuous headline risk – we expect something about Huawei will be next. Things will likely have to get worse before they get better – but the fright that will make them worse is the same thing that will drive China to a deal.

[Strategy dashboard]

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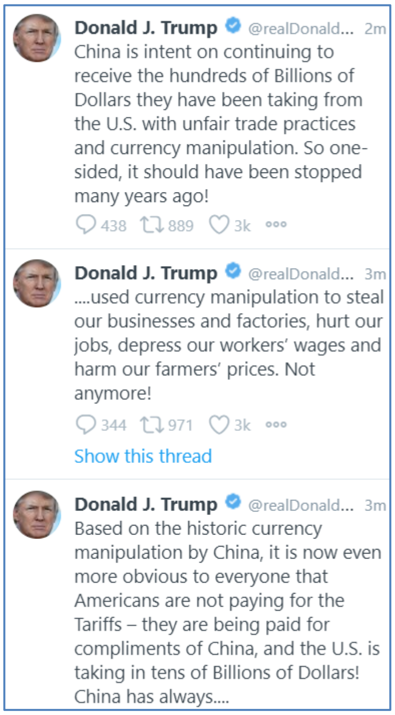

1992 report when China was last determined to be a manipulator, or the December 1994 report when China was let off the hook).

- And the determination came just hours after a sequence of Trump tweets posted during market hours, in the midst of a panicky risk-off day, the kind of situation in which investors have come to expect, instead, something from the president offering some vague but encouraging reassurance that the resolution to the US-China trade is just around the corner. *It has seemed that Trump has never been willing to tolerate very much downside in equities. But yesterday, first with the tweets and then with Treasury's announcement – it would seem that Trump just doesn't care anymore.*
- *He seems to be looking for every possible weapon with which to threaten China, all at once if possible, markets be damned. We wouldn't be at all surprised if the next move, today or tomorrow even, would be to announce some draconian move against Chinese telecom "champion" Huawei – to which China would have to respond with some form of harrassment against an American company.*
- In a fundamental sense this isn't a surprise to us, but rather the arrival of an inevitability. *We have said many times that the only way Trump can get a trade agreement from China is by scaring President Xi Jinping out of his wits – and we've said that Trump can't scare Xi at the same time as he comforts investors in US equities. He has to scare them both, or this thing won't work.*
- Where will this lead for US equities, already off more than 6% from all-times highs attained just last week?

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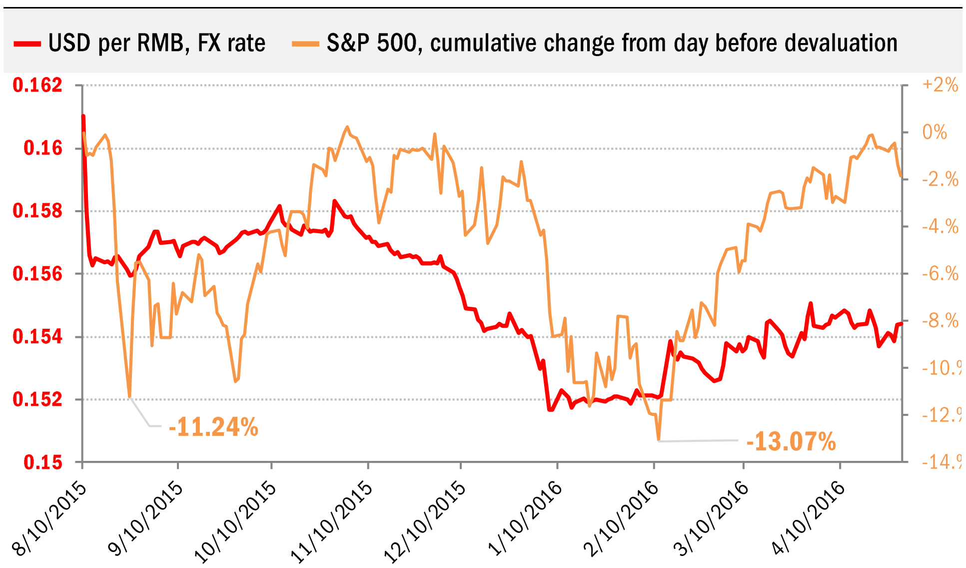
- One way of scaling how bad this might get is by recalling the experience almost exactly four years ago when China, on a Monday morning, surprised the world with a 1.9% devaluation of the yuan (see the chart below, and "On the RMB Devaluation" August 11, 2015), an even bigger move than yesterday's. This is a useful model for the current situation, *because we believe the salient threat here – just as it was then – is the possibility of a currency crisis that could throw China into a disorderly first-ever recession, taking the emerging markets with it, and next, the rest of the global economy*.
- Arguably the 2015 event was more benign than the present one in some ways. This time we have the advantage of knowing about the prior experience. But that wasn't taking place in the context of a trade war, with all its additional uncertainties. And the devaluation then was on purpose, an intentional and rational response to more than a year of headlong USD strength that was strangling the dollar-pegged yuan versus the rest of the world's non-dollar currencies. And RMB wasn't anywhere near the critical 7 level. *Yet for all that, the prospect that the devaluation would trigger a speculative attack or a run on the bank was threatening enough that the S&P 500 fell 11.25% in a matter of days, and only stopped falling when RMB found its footing – which, by the time it was all over, cost China a trillion dollars in foreign reserves* (again, see the chart on the previous page).
- Maybe it's no coincidence, but then as now, the Federal Reserve didn't respond appropriately. While the China threat was initially playing out, for all the turbulence it caused, Fed Chair Janet Yellen bullheadedly proceeded with her much advertised "liftoff" from the zero-bound at the December 2015 FOMC (see "On the December FOMC" December 16, 2015). We think that policy error played back into further RMB weakness, and a 13.07% correction for the S&P 500 that, again, ended only when RMB stabilized (again, see the chart on the previous page).



Source: Bloomberg, TrendMacro calculations

- *We expect that unless China moves to placate Trump so that the new tariffs will not take effect, as currently scheduled, on September 1, that RMB will continue to weaken – not by way of manipulation, but as a sane market response to the tariffs. Indeed, the only "manipulation" will be China trying to keep the weakening an orderly one. If China can keep it orderly* – *and so far so good, as of this writing, with a PBOC fix this morning that was weaker, but didn't violate the 7 level – then global markets will gain confidence that no currency crisis is in the offing.*
- *At the same time, it seems that Trump is dead set on throwing the book at China – and every bit of that will be a headline risk, even if it's mostly form-over-substance like yesterday's Treasury determination.*
- *We'll know it's really out of control if Trump sides with Hong Kong protestors against Xi. So far Trump has been very courteous to Xi on that, keeping open the door of personal diplomacy that Trump seems to feel is his signature technique. If Trump turns against Xi, we will be hearing the sound of the door slamming shut.*
- For now, we're going to operate on the assumption that Trump does want a deal with China – though at this point, it seems he is insisting on a great one, and would walk away from a merely good one (see "RMB Breaks 7: Is this 'the Edge of Chaos'?" August 5, 2019). *Again, to get a deal, he's going to have to scare markets, which will be collateral damage while he scares Xi. With Trump playing the bear in the China shop, our guess is that things will have to get worse before they get better – but getting worse, in this case, is a necessary stage on the way to getting better.*

Bottom line

Treasury's determination that China is a currency manipulator is of little consequence, as the enabling law doesn't confer any important new powers on Trump. But coming after a terrible day for markets, during which Trump inflamed the situation with tweets rather than offering the usual assurances, it shows that Trump no longer feels constrained to not scare markets, seeing them now as collateral damage in the process of scaring Xi. The risk of a currency crisis for China now echoes 2015 when RMB underwent a surprise devaluation, driving US stocks down more than 11% in a matter of days. At the moment it seems China is keeping the weakening of RMB orderly, which is what helped stocks find their footing in 2015. But Trump seems set on creating continuous headline risk – we expect something about Huawei will be next. Things will likely have to get worse before they get better – but the fright that will make them worse is the same thing that will drive China to a deal.