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MACROCOSM

Yuan Direction

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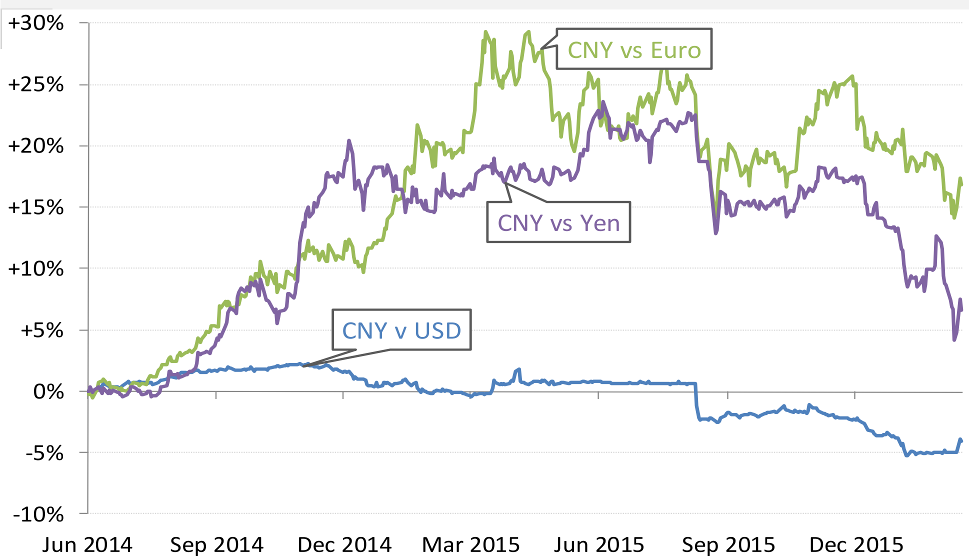
An end to RMB instability and a stealth rally in commodities should relieve the air of panic.

Yesterday the Chinese currency strengthened against the US dollar by 1.2% – the largest jump in a single day in more than ten years. This followed an interview Sunday in the state-run press with People's Bank of China Governor Zhou Xiaochuan, which is being eagerly interpreted as ruling out further RMB depreciation.

- This would seem to mark the end to the RMB weakening that began last August, which was arguably the starter's pistol for the present period of global financial market turbulence (see "On the RMB Devaluation" August 11, 2015). *It will probably break the fever of panic that had begun to grip markets over the past two weeks, and mark the successful test we expected of the 2014 lows for US equities* (see "Is This 2016, or 2008?" January 15, 2016).
- In the interview, Zhou explains the post-August RMB weakening in very much the same terms that we have. We both see it not as evidence of a Chinese credit panic, but as a rational policy response to a too-strong USD, which excessively strengthened the RMB against the yen and the euro (please see the chart below).

RMB Cumulative appreciation/depreciation from June 1, 2014



Source: Bloomberg, TrendMacro calculations

Update to strategic view

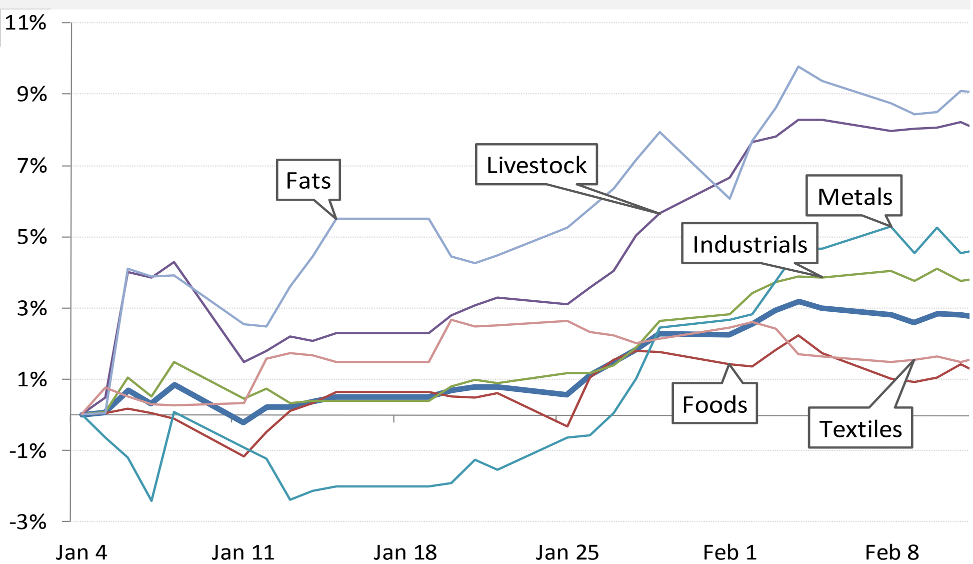
FX, US STOCKS, ASIA MACRO, OIL, COMMODITIES, US FED: China's one-day revaluation, and Zhou's statements indicating that RMB needn't weaken further, should help dispel the atmosphere of panic in markets, likely establishing last week's double-test of the August 2014 lows by US stocks as a bottom. The twin causes of the unwelcome appreciation of RMB – triggering six months of destabilizing devaluation – have dissipated. The Fed has been knocked off its rate-hiking course, whether or not it truly understands its "liftoff" error. And oil probably double-bottomed last week, while most other commodities have been quietly rallying throughout the New Year even as panic has taken hold. Much longer-term, we think that China will want to divest is vast USD holdings, which would have the paradoxical effect of weakening both RMB and USD – and triggering an inflationary boom.

- In Zhou's words: "…in order to explain the depreciation pressures on the RMB against the US dollar, one has to examine major factors such as the rapid appreciation of the US dollar against other currencies..."
- A strong dollar in and of itself is of little *direct* concern to China, as the RMB is pretty much pegged. The issue is *indirect*: by being pegged, when USD strengthens versus the yen, the euro and other currencies, the RMB automatically strengthens along with it.
- This was especially harrowing for RMB in the dollar's "rapid appreciation" that began in 2014, because RMB had already appreciated versus USD by as much as 37% since 1995.
- *So versus the trade-weighted basket of non-USD currencies, RMB had appreciated by as much as 60%. China had little choice but to devalue, as an act of monetary self-defense. Indeed it was not a devaluation at all – but rather a "dis-revaluation."*

What was responsible, in the first place, for USD's "rapid appreciation" beginning suddenly in June 2014? We think two conditions came together then to cause it.

- At that point, the Fed's QE3 had already been tapering for six months, and new chair Janet Yellen had signaled that the first rate-hike would come six months after it was ended. What *changed* in June 2014 was the ECB's surprise introduction of negative interest rates (see "On the ECB June Policy Decision" June 5, 2014), signaling divergent policy directions between the Fed and the rest of the world's central banks.
- Later the same month, the global crude oil price topped above $116, and then proceeded to crash (see "The Stench of CrISIS" June 25, 2014). We have demonstrated that throughout history, falling oil and commodity prices have been associated with a

CRB Spot Commodities Index Cumulative gain in 2016



Source: Bloomberg, TrendMacro calculations

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strengthening USD (see "Dollar Strength: A Crude Connection" April 23, 2015).

We think – and we can infer that the PBOC thinks – that both these two causes for a strong USD have run their course, at least for a long while. This is why RMB depreciation can at least take a lengthy pause here.

- First, whether or not the Fed understands why or will ever overtly admit error, surely it sees that "liftoff" was a mistake. It is unlikely to double-down on that mistake with further hikes this year, especially with an increasingly turbulent presidential election coming up (see "Will Yellen Get Trumped?" February 11, 2016).
- Second, we think that crude oil has made a double-bottom at WTI $26. Despite having done so, oil is actually among the weakest commodities. Most have been quietly rallying throughout the New Year even as financial markets have moved lower and global macro data have weakened (please see the chart on the previous page).

This will all be bad news in the short run for hedge funds who have bet on continued RMB weakness. Disciplining them is an end in itself now for Zhou, who in his interview speaks contemptuously of "speculative forces" who are "are always looking to bet on something," and who "have gathered astonishingly large amount of liquidity after several rounds of QE."

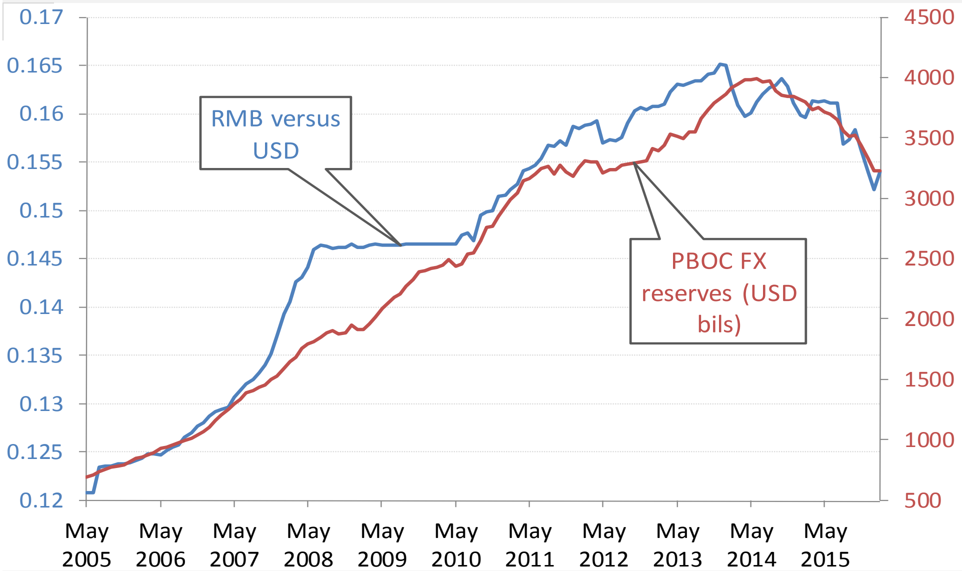
That's what yesterday's RMB move is about – an attempt by the PBOC to ensure that its "dis-revaluation" remains orderly. Longer term, we feel strongly that the RMB will continue to weaken. We don't see how the "dis-revaluation" of the last six months is sufficient (again, please see the chart on the first page).

Taking an even longer view, we don't see this as primarily an exercise in exchange rate management at all, but rather as part of a very long-range and hopefully very gradual program of China divesting itself of its massive dollar holdings.

- *We think this will have the side-effect of weakening both the RMB and the USD.*
- Yes, we aware that this seems not only counterintuitive, but impossible
- But it is possible. It happened yesterday, in fact: we had RMB's biggest strengthening versus USD in ten years – and yet the trade-weighted USD was stronger, too.
- And since August 10, 2015 (just before the first overt RMB devaluation), RMB is 4.4% weaker versus USD. Yet over the same period, USD itself is 1.3% weaker on a trade-weighted basis (against a basket that includes RMB).
- *We think this seemingly anomalous result can be explained by the drop in China's foreign currency reserves, which are primarily held in USD.*
- The conventional wisdom is that China weakens RMB by

accumulating USD reserves. But the historical record shows the opposite: RMB *strengthened* versus USD during almost a decade of *rising* reserves, and *weakened* while reserves were *falling* (please see the chart below).

RMB/USD strength and PBOC reserves



Source: Bloomberg, TrendMacro calculations

- China has been hinting at divesting its USD reserves since 2009. Just as the Fed was beginning its first round of quantitative easing, Zhou complained openly that China's dollar reserves made it a victim of Triffin's Dilemma – in which a reserve currency is rendered uncreditworthy by the very act of its being issued to satisfy the demand for reserves.
- Shortly before, Luo Ping, Director-General of the China Banking Regulatory Commission, fearing that QE would weaken the dollar and the value of China's USD holdings, had said, "We hate you guys… but there is nothing much we can do."
- Since then, China has grown to be the second largest economy in the world, and has earned the honor of having its currency join the IMF's Special Drawing Rights basket. *China has grown up.* It no longer needs to hold foreign exchange reserves as, in effect, collateral to earn the trust of other nations.
- *So now there is something it can do. It can divest its dollars – and then take its place among the great nations, and at the same time no longer be hostage to the vagaries of the Fed.*
- The challenge is: how? It would be pointless to exchange USD for euros or yen – that would just move the skeleton from one closet to another. The only answer would be to use the dollars to buy dollar-denominate goods, services and productive assets – to go on a buying spree.
- *Zhou, in his interview, approvingly hints at all this in the context of the capital account.* He says, "Chinese enterprises make more outbound investments than before as they 'go global'… Outbound investments have been growing rather rapidly, which is a good

thing."

- We've seen it before in the case of Japan, in the wake of the massive yen strengthening following the Plaza Accord in 1985, and as viable investment opportunities in Japan itself began to become scarce. Japanese companies bought Rockefeller Center, the Pebble Beach Golf Course, the Bel Air Hotel, and every van Gogh put at auction.
- *If the Chinese follow in those footsteps, it would likely mean a weakening of the RMB, as the collateral that had underpinned it was removed – as we have seen recently. But it would also mean a weakening USD, as the volume and velocity of dollars in circulation would surge, and long-dormant inflation would spring back to life.*
- Has not one of the great anomalies of the crisis-era and its aftermath been the collapse in monetary velocity, and with it, a period of persistently low inflation despite the best efforts of central banks to revive it? Perhaps that would change when the vast hoard of dollars that has been immobilized on China's balance sheet suddenly enters the stream of world trade. *It could be an inflationary boom.*
- We're aware that we have veered off into the realm of sheer speculation here, piling what-ifs on top of maybes, and linking them with dubious causal relationships.
- But we want to put a marker down, even if we don't have a firm grasp of all the possibilities, probabilities and mechanisms. It is certain that eventually the day will come when China doesn't hold all those dollars. One would be a fool not to begin to think through how we get from here to there, and what it will mean when it happens.

Bottom line

China's one-day revaluation, and Zhou's statements indicating that RMB needn't weaken further, should help dispel the atmosphere of panic in markets, likely establishing last week's double-test of the August 2014 lows by US stocks as a bottom. The twin causes of the unwelcome appreciation of RMB – triggering six months of destabilizing devaluation – have dissipated. The Fed has been knocked off its rate-hiking course, whether or not it truly understands its "liftoff" error. And oil probably double-bottomed last week, while most other commodities have been quietly rallying throughout the New Year even as panic has taken hold. Much longer-term, we think that China will want to divest is vast USD holdings, which would have the paradoxical effect of weakening both RMB and USD – and triggering an inflationary boom.