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MACROCOSM

RMB Breaks 7: Is this "the Edge of Chaos"?

Monday, August 5, 2019

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Trump will take a great deal now, not just a good one. China may be forced to offer it.

Unfortunately, two of our recent predictions have come true. We said there would be a rough patch in markets if the FOMC only cut rates by 25 bp, not 50, at last week's meeting (see "FOMC Preview: 25 or 50?" July 19, 2019, and "Video: What you're not hearing about capex, housing and next week's FOMC" July 25, 2019). *And we said the Chinese currency would breach 7 yuan to the dollar, reflecting the threat of new US tariffs* (see "On the New China Tariffs" August 1, 2019). *It happened at the Asia open in the offshore market, after an official People's Bank of China fixing at 6.92, weakest of the year.* The two matters are not unrelated.

- *The bad news is that the RMB breach may expose China to a currency crisis, and a great deal of financial and economic turbulence – triggering China's first-ever recession, possibly a very disorderly one – which could ultimately have spillover effects into the global economy. We have said all along, throughout the US-China trade war, that this possibility – not the tax-effect of tariffs – was the downside risk to watch* (see, among many, "On the Margin: China's Scariest Fragility" August 6, 2018).
- In some sense 7 is just another number. But it is, as they say, a "psychologically important" one. The PBOC held RMB below 7 throughout the Global Financial Crisis (please see the chart below),

RMB per USD, offshore spot market

Source: Bloomberg, TrendMacro calculations

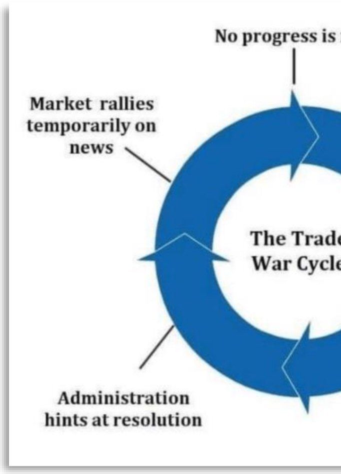
Update to strategic view

FX, US MACRO, ASIA MACRO, US FED: RMB breaches 7, potentially opening the door to a currency crisis for China. The good news is that, for the US, a cheaper RMB offsets the contractionary and inflationary effects of the new tariffs; and for China, it insulates exporters from lost US business. But if capital flight catalyzes a disorderly recession in China, that would have seriously negative consequences for the global economy. Powell should be embarrassed for having identified trade uncertainty as a risk, and then taking out too little insurance. This is "the edge of chaos" where a deal can potentially get done, because it must – when any Chinese hopes of outlasting Trump until the 2020 election are made moot. Trump has deliberately made it unclear whether he wants a deal, or whether he sides with administration hawks who want to destroy China's economy. Best guess: he'll take a great deal, but not a good deal. The unknown is how far over the edge China has to fall before it offers one.

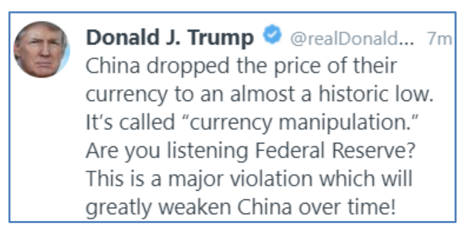
[Strategy dashboard]

despite great pressure to weaken it. Since the US-China trade war began, it's flirted with 7 more closely than it did then, and last night it broke through.

- It shouldn't be a surprise, and to us it wasn't. When a trade-deficit country imposes tariffs on a trade-surplus country, the surplus country's currency should weaken as relative demand for it shrinks . Since the US-China trade war began in April 2018, RMB had already weakened about 10% to USD, almost perfectly offsetting US tariffs. We have estimated that about another 7% weakening would be necessary to completely offset all existing US tariffs, and the new ones announced last week.



- *With 7 breached, it is possible that China has crossed a Rubicon, exposing itself now to capital flight and inflation which will be debilitating to tolerate, on the one hand, and exorbitantly costly to control, on the other hand.*
- *If China allows RMB to keep weakening, whatever the capital flight and inflation risks*, *at least that will offset the US tariffs*, *and largely eliminate the disincentive effects of the tariffs on US buyers of Chinese exports* (and it will expose itself to charges of being a "currency manipulator," even though the RMB weakening is mostly a market-driven phenomenon, in our view). *It will also insulate the US from the contractionary and inflationary effects of the tariffs – giving the US more staying power in the trade war.*
- *If China supports RMB, the US will be harmed by the tax effects of the tariffs on US buyers – but that hardly helps China, which will suffer the trade losses arising from US buyers turning away from Chinese products and supply lines.*
- Today the PBOC told state-controlled media that, on the one hand, it was capable of guaranteeing the yuan's stability – but on the other, today's fluctuations were due to "unilateral and protectionist measures." They seem to want it both ways, but that can't be had and *China loses either way.*
- *President Donald J. Trump is very aware of all these dynamics, as he expressed in a tweet this morning,*
- *But there is a third way, Door Number Three, as it were* (Trump always offers three doors – see "Did Powell Just Cut a Deal?" December 23, 2018). *Do a trade deal, and avoid the tariffs altogether. That's China's best door.*


Donald J. Trump @realDonald... 7m
China dropped the price of their currency to an almost a historic low. It's called "currency manipulation." Are you listening Federal Reserve? This is a major violation which will greatly weaken China over time!

More on China in a moment, but first a digression on the possible nexus between Trump's announcement of new tariffs, by tweet on Thursday, that just one day after the July FOMC's 25 bp rate cut.

- *Last week several clients asked whether Trump actually whipped up the new tariffs to pressure his own Fed chair, not the Chinese.*
- It seems to us that if Trump had wanted to use the tariff

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announcement to nudge the Fed toward the dovish side he would have made it *before* the FOMC meeting, not *after*. The Shanghai trade negotiations between the US and Chinese teams had concluded in plenty of time for that.

- Perhaps Trump didn't act *before* the FOMC because he was expecting a 50 bp cut, but acted *after* in anger or disappointment.
- Or perhaps Trump only wishes to influence the *September* FOMC meeting – or, for that matter, to embarrass Fed Chair Jay Powell, whom we are told by insiders Trump viscerally loathes.
- Be that as it may, Powell *should* be embarrassed.
- From the beginning of Powell's dovish turn in early June, he cited "trade negotiations" as a risk the Fed is "closely monitoring." The July FOMC statement cited "global developments" as "uncertainties" about the "outlook." The prepared remarks at the post-meeting press conference specified "trade" *four* times. In a place no less prominent than the third sentence, Powell said the 25 bp rate cut "is intended to insure against downside risks from weak global growth and trade policy uncertainty."
- *Then why the hell didn't he buy more insurance?*
- *As we see it, when Trump's tweets showed up the next day, the market reaction was surely a joint product of not only the actual risks entailed by the new tariffs, but the fact that the Fed had failed to adequately insure against the very uncertainties Powell himself seemed so aware of.*
- *The irrefutable verdict: as of this writing, the funds rate/10-year curve is inverted by 37 bp, exactly where it was before Wednesday's rate cut. It would now take two additional 25 bp cuts, on top of Wednesday's, to un-invert it.*
- *As we said of Powell on Wednesday, "The market wants to know he's got our back"* (see "On the July FOMC" July 31, 2019), *and he self-evidently doesn't. Now more than ever, we continue to expect Fed officials will find ways this week to convince markets otherwise.*

All that said, most likely, in our view, in Trump's mind the tariffs have nothing to do with the Fed at all – even though his tweet this morning doesn't miss the opportunity to get Powell's attention.

- But it doesn't have to be one or the other. As our friend Scott Adams, the Trump-whisperer, often points out, Trump is very good at taking positions that give him more than one way to win. *With a single tweet, he put pressure on both China and Powell.*
- Powell aside, it seems almost self-evident that Trump announced the new tariffs in order to exert pressure on China in the trade negotiations – so obvious it barely needs to be stated.
- But we can't actually know this for certain. There are elements in the Trump administration, and outside it yet still connected with it, who don't want a deal with China at all – but rather to use tariffs or any other available weapon to cripple China's economy and defeat its purported ambitions to emerge after a "100 year marathon" as a global hegemon. *They are no doubt delighted to see RMB slide through 7, and hope for the worst, whatever the spillovers.*

- There are others in positions of equal influence in the administration who sincerely want a deal, which would necessarily entail China becoming a more partner-like participant in the global economy. *They are no doubt horrified by the potential damage implied by RMB breaching 7.*
- *But who really knows which view Trump himself takes? No one does.*
- *We do know from close White House sources that Trump deliberately keeps literally everyone in the dark as to his intentions, believing this both allows his advisors to operate more dynamically as a "team of rivals," and blocks the possibility that his own team-members will negotiate against him knowing what he really wants.*
- *It is possible that Trump has neither intention exclusively. By being flexible between these intentions, again, he has more than one way to win. If China wants to make a great deal with the US, fine. It if wants to blow itself up, that's fine too.*
- *That can be reduced to a single slogan that captures the moment – if China offers Trump a great deal, he'll take it. But not a merely good deal. On the face of it, that makes a deal less likely.*
- *Well… yes… but… isn't that precisely what Trump would want China to think? And at the same time as Trump appears to take a hard line, he continues to be generally supportive of China in its handling of increasingly unruly protests in Hong Kong, seemingly designed to keep a line of friendly personal diplomacy open between himself and President Xi Jinping.*
- So what *does* China think? Obviously they don't return our calls, so we don't really know. We do know that early in the year, following Trump's and Xi's dinner at the G20 in Buenos Aires, China appeared to be falling all over itself to be conciliatory – removing retaliatory tariffs on US autos, resuming buying US soybeans, promulgating a law eliminating forced technology transfers, walking back its inflammatory Made In China 2025 program – and even buying rice from the US.
- Apparently that approach didn't get China what it wanted, because trade negotiations broke up in May. According to the US trade team, China "reneged" (see "Video: What you're not hearing about US/China trade talks" May 9, 2019). According to the Chinese, *Trump* did (see "On China's Trade War 'White Paper'" June 2, 2019).
- Now, after a lunch meeting between Trump and Xi in Osaka at another G20 in late June, negotiations are back on – but this time China is doing nothing to be conciliatory. *That doesn't necessarily mean China doesn't want a deal – it might be that China has learned that being conciliatory is not a very good approach with Trump. We simply can't be sure.*
- A common interpretation of China's present hard-line stance is that Xi has come to the conclusion that he can out-last Trump – that a "president for life" has more staying power than a president who must face re-election in 2020. We have no way of knowing if this is true. But on the face of it we don't find it terribly credible.
- Xi would have to have confidence both that Trump will lose in 2020, and that the Democratic winner will be easier to negotiate with. *If*

Trump wins, he'll surely drive an even harder bargain when he has nothing to lose and scores to settle. If Xi has been watching the Democratic debates, he ought to not be excessively confident that Trump will lose! But if Trump does lose, *it's not obvious that China could get a better deal from, say, Elizabeth Warren*.
- Or a variation on a theme: perhaps Xi isn't waiting for Trump to lose the election, but rather for the election to draw near enough so that *Trump will need to notch a trade deal with China in order to get a visible accomplishment that can help win it. But who's to say that Trump wouldn't prefer to campaign in the rust belt still conducting a "tough on China" trade war?* After all, we can be sure that no matter what deal Trump might get someday, the media will claim he gave away the store.
- *But if waiting is Xi's game, it's a dangerous one. Whether Trump is putting pressure on China in order to get a deal, or to destroy the Chinese economy for its own sake, either way that pressure is very real, and at the moment the key pressure point is the Chinese currency.*
- *And we haven't even mentioned Huawei, the flagship Chinese telecom "champion" whose very existence Trump and Commerce Secretary Wilbur Ross hold in their hands.*
- *Time is simply not on China's side here, 2020 election or no 2020 election.*
- We've said many times that high-stakes negotiations, especially coercive ones like the US-China trade talks, can only be resolved at the last possible critical moment, at what the complexity theorists call "the edge of chaos" – where a complex system maximizes its computational power just before it spins out of control (see, among others, "On the Margin: China Trade Talks at the Edge of Chaos" February 19, 2019).
- *August and September could be chaos-time. It starts out with neither side seemingly willing to "give an inch," in China's words. Then, suddenly, something happens – like RMB breaching 7 – and we're looking right over the edge.*
- *That's a scary place to be, and markets will indeed act scared – they already are, obviously. Maybe we have to do more than look over the edge. We have to fall off it, at least a bit. But this is where a deal can get done, because it's where a deal must get done.*
- *If it gets scary enough now for China to be driven to push for a deal, it will be up to Trump then to decide whether to press his advantage – risking demanding a deal too good for China to agree to – or, on the other hand, to take "yes" for an answer. Then we'll know for sure whether Trump wants a deal, or whether Trump wants to see China die.*

Bottom line

RMB breaches 7, potentially opening the door to a currency crisis for China. The good news is that, for the US, a cheaper RMB offsets the contractionary and inflationary effects of the new tariffs; and for China, it insulates exporters from lost US business. But if capital flight catalyzes a disorderly recession in China, that would have seriously negative consequences for the global economy. Powell should be embarrassed for having identified trade uncertainty as a risk, and then taking out too little insurance. This is “the edge of chaos” where a deal can potentially get done, because it must – when any Chinese hopes of outlasting Trump until the 2020 election are made moot. Trump has deliberately made it unclear whether he wants a deal, or whether he sides with administration hawks who want to destroy China’s economy. Best guess: he’ll take a great deal, but not a good deal. The unknown is how far over the edge China has to fall before it offers one.