

MACROCOSM

Never Let a Good Currency Crisis Go to Waste

Wednesday, August 14, 2019

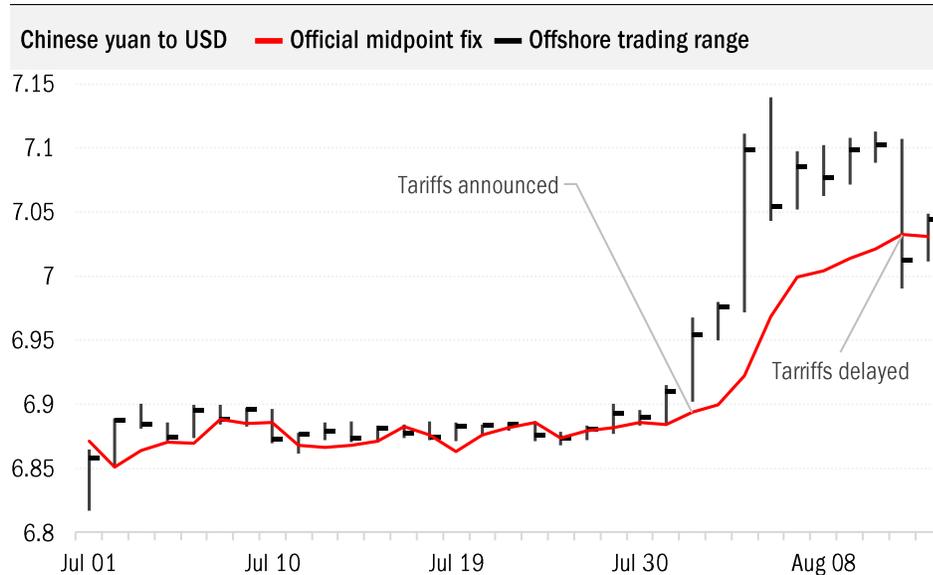
Donald Luskin

The curve inverts, with RMB (and Hong Kong's airport) at the edge of chaos.

The inversion, at last, of the 2-10 Treasury curve has taken the wind out of yesterday's risk-back-on mood. About the inversion, what can we say that we haven't already said? *The Fed is too tight – it should have cut rates at the June FOMC, and having not, it should have cut 50 bp in July* (see, most recently and among many, ["Trump Is Right – the Fed Is Still Tightening"](#) August 13, 2019).

There are a number of somber narratives out there, but we continue to think China is the biggest risk driving down long-term yields. We're not focused on the frictional effects on imports and exports arising from the trade war. *We see an increasing probability that US tariffs will push China into its first-ever recession* (today, [Chinese industrial production growth](#) was reported at just 4.8%, a 28-year low). *This could be the start of a very disorderly and globally systemic event, including large-scale social instabilities for China – with the proximate contagion-vector being a currency crisis. Yesterday's US Trade Representative announcement that some of the Chinese exports scheduled for 10% tariffs on September 1 will be exempted until December 15 doesn't eliminate that risk.*

We predicted when the new tariffs were announced on August 1 that the



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US MACRO, ASIA MACRO, US BONDS, US FED, FX:

The 2-10 Treasury curve finally inverts. The Fed is simply too tight. Among several bearish narratives, China's incipient currency crisis and increasing instability in Hong Kong are the most immediately salient. Yesterday's US tariff relief marginally backs RMB away from the cliff, but new tariffs still require it to weaken by another 4.5%, and it may be difficult to keep that orderly. On the surface Trump appears to have chickened out by deferring some tariffs, and gotten nothing in return for it. It is possible, though, that China really made "solemn representations" to the US in a call Tuesday, resulting in the relief, and that Trump's underplaying it is to allow the Chinese to save face despite capitulation under pressure.

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Chinese yuan would immediately break the psychologically important level of 7 to the USD (see the chart on the previous page, and [“On the New China Tariffs”](#) August 1, 2019). We have seen RMB weakness consistently since US tariffs were first announced in April 2018, and it’s what we would expect as an endogenous reaction to preserve trade equilibrium. Even if the new US tariffs on \$130 billion of Chinese exports still set to kick in on September 1 is all there is – that is, tariffs on another \$150 billion now scheduled for December 15 are instead deferred indefinitely – *we’d still expect to see RMB weaken by about another 4-1/2%. That’s a big move on top of the 11% we’ve already had, and it’s not at all clear that China will be able to keep it orderly. As Chinese President Xi Jinping faces the lose-lose prospect of dealing with increasingly unruly protests in Hong Kong – with the whole world watching – keeping it orderly is surely very much on his mind.*

To be sure, at least at the margin, yesterday’s tariff relief does *reduce* such risks – which makes us wonder why President Donald J. Trump granted it.

- *By helping RMB to step back a bit from the brink of crisis, Trump has moved trade negotiations back from “the edge of chaos” where the pressure might have been intense enough to force China to capitulate to a trade deal with the US* (see [“RMB Breaks 7: Is this ‘the Edge of Chaos’?”](#) August 5, 2019).



- *Until yesterday’s developments, it had seemed to us that Trump had finally steeled himself to bear the domestic consequences – including equity market consequences – of hanging China over the edge. Now it seems he’s right back in the same old vicious cycle of aggression on the one hand, and caution on the other, that has entrapped this trade war from the beginning.*

- *Is Trump letting a good currency crisis go to waste?*
- *At a press gaggle* yesterday, when asked about the tariffs, Trump started with the entirely correct claim that “the consumer has not paid for” US tariffs on Chinese exports, “because of the devaluation by China.” *But then Trump turned around and explained the delay in some tariffs purely in terms of avoiding the consumer impact he’d just said didn’t exist: “in case they might have an impact on people, what we’ve done is we’ve delayed it so that they won’t be relevant for the Christmas shopping season.”*
- *On the face of it, Trump simply chickened out. But the face of it is rarely the important thing with Trump.*
- The tariff relief seems to have its origin in a Tuesday phone call between Chinese Vice Premier Liu He with US Trade

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Representative Robert Lighthizer and Treasury Secretary Steven Mnuchin. Given the incipient currency crisis underway, it may be significant that People's Bank of China Governor Yi Gang was on the call, too.

- [According to Trump](#), it was “a very, very productive call... I think they'd like to do something dramatic... as you know, they have a problem in Hong Kong, but they would like very much to do something.”
- [According to Chinese state-run media](#), “China lodged solemn representations concerning U.S. additional tariffs on the Chinese imports starting on Sept. 1.”
- What would those “solemn representations” be?
- Just moments before the USTR announcement, [China's Commerce Ministry announced](#) that trade talks with the US would resume in September. The coincidence in timing is attention-getting, suggesting a *quid pro quo*. But September talks had [already been announced](#) at the conclusion of the Shanghai round last month.
- If anything, that's something of a Chinese snub, with the talks now planned to be conducted only by phone, [according to Chinese state-run media](#). This morning [US media is now claiming](#) the talks will be in-person, with the source being, as usual, “people familiar with the matter.”



Donald J. Trump @realDonaldTrump... 9m
As usual, China said they were going to be buying “big” from our great American Farmers. So far they have not done what they said. Maybe this will be different!

- Yesterday Trump dropped [a single cryptic tweet about all this](#), hinting at a deal for China “to be buying ‘big’ from our great American Farmers” – seemingly another *quid pro quo* – but openly questioning whether it will even happen. Not

exactly the usual Trump braggadocio – maybe he's learned to not brag about Chinese promises, but the signal is that he has at least extracted another one.

- Trump has opened himself up to entirely expectable criticism by his detractors in the mainstream media. Bloomberg's headline described the tariff relief with this scathing headline: [“Trump Bows to Economic Fears in Move to Delay China Tariffs.”](#) Others, like our friends at the *Wall Street Journal* editorial page, are just glad to see a [“tactical retreat”](#) that means fewer tariffs.
- Maybe we should just let it go at that, and indeed maybe that's all it is. *But we can't free ourselves of the sense that, with RMB through the 7 level, and with protestors thronging the streets and the airport of Hong Kong while Chinese armored vehicles mass across the border in Shenzhen, that China just might have really made some “solemn representations” in that call.*
- *At the risk of over-interpreting the Kremlinology of all this, we have to point out that Trump told the press yesterday, “I was not sure whether or not they [China] wanted to wait until a Democrat has a chance to get in.” This would seem to imply he is sure now.*
- Trump's giving the appearance of retreat would be just the thing to help China save face in some form of capitulation under pressure. Why not alibi the tariff relief as a favor for US Christmas shoppers? That makes Trump look more like Santa Claus than like a coward –

and it changes the subject from China's currency and Hong Kong crisis.

- Trump's technique all along has been to put China under economic pressure, while very much supporting China's leadership – [calling Xi his "friend," characterizing the protests in China as "riots,"](#) and so on. You don't normally think of Trump as speaking softly, but this is actually a version of [Theodore Roosevelt's maxim](#) to "Speak softly and carry a big stick: you will go far."

Bottom line

The 2-10 Treasury curve finally inverts. The Fed is simply too tight. Among several bearish narratives, China's incipient currency crisis and increasing instability in Hong Kong are the most immediately salient. Yesterday's US tariff relief marginally backs RMB away from the cliff, but new tariffs still require it to weaken by another 4.5%, and it may be difficult to keep that orderly. On the surface Trump appears to have chickened out by deferring some tariffs, and gotten nothing in return for it. It is possible, though, that China really made "solemn representations" to the US in a call Tuesday, resulting in the relief, and that Trump's underplaying it is to allow the Chinese to save face despite capitulation under pressure. ▶