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MACROCOSM

China's Currency Crisis is Over… Yuan to Bet?

Monday, September 9, 2019

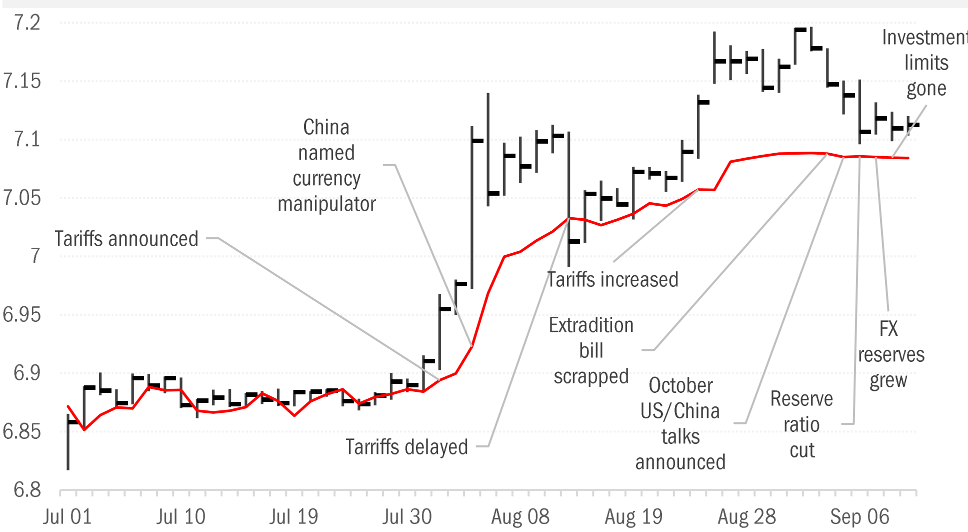
Donald Luskin

Nice to see risk-back-on. We doubt Trump – with his new enabler Bill Dudley – will let it last.

Having called the top in July (see "FOMC Preview: 25 or 50?" July 19, 2019) and gotten ahead of August's volatility by correctly predicting the Chinese yuan would break seven to the dollar (see "On the New China Tariffs" August 1, 2019), *did we snatch defeat from the jaws of victory by not buying the dip? Maybe. The risk-back-on in equity prices and bond yields is palpable.*

- *But we continue to think that the weakening RMB is the spearpoint of the most salient global risk – a chaotic hard-landing in China*, deliberately catalyzed by President Donald J. Trump's trade war strategy of driving China to "the edge of chaos" (see "RMB Breaks 7: Is this 'the Edge of Chaos'?" August 5, 2019). *Has that risk really run its course already? We very much doubt it.*
- *To be sure, as of this writing, at least the yuan has stopped weakening*. Apparently it's in response to a quintet of headlines suggesting more rather than less stability for China (please see the chart below) – the scrapping of the controversial Hong Kong extradition bill, the announcement that the Chinese team would come to Washington in October for trade talks, and the easing of reserve ratio requirements for Chinese banks, the report that PBOC

Chinese yuan to USD — Official midpoint fix — Offshore trading range



Source: Bloomberg, TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, FX, US FED, US MACRO, ASIA MACRO: The Chinese yuan has stopped weakening, after a 4.1% drop during August – greater than the initial drop after the 2015 devaluation. Markets have responded with a risk-back-on posture that may mean the August panic will have been just another buy-the-dip opportunity. Maybe, but we think it won't be that easy. New tariffs are in place, and more are coming, which can't help but drive the yuan lower, with all the risk of an outright currency crisis that implies. It appears China did nothing to support RMB in August, which means it was willing to risk a crisis in order to offset the new tariffs. It is constructive that the Chinese team is coming to Washington in October for talks. An ironic unintended consequence of the Dudley editorial will have been to nudge the Fed toward easier policy, enabling Trump to play from greater strength against China in October – as…

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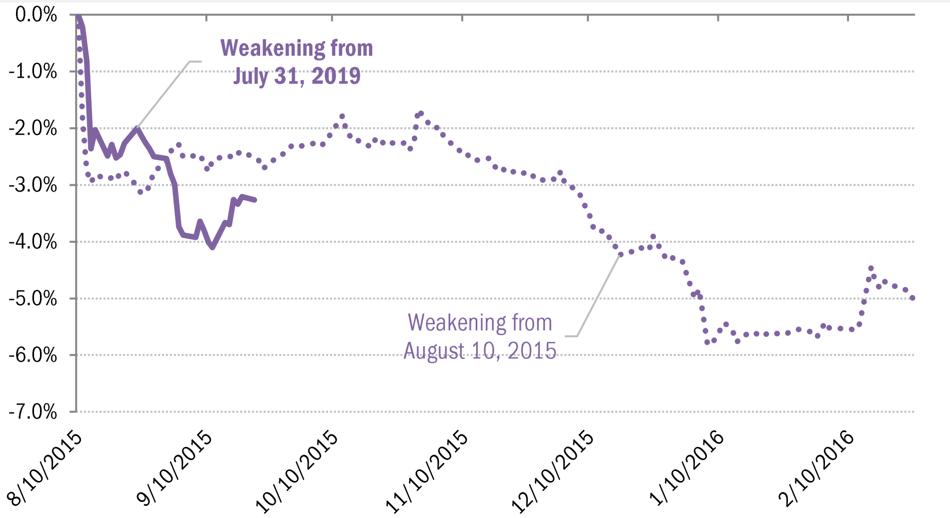
FX reserves expanded in August, and the abolition of limitations on foreign investors' holding of Chinese stocks and bonds.

- We'll look at these one by one in a moment, using them as lenses through which to view the state of play of the trade war, and of China's own battle for self-mastery. But we are confident that the better tone in markets is mostly about these issues. Equity risk premia narrowed everywhere in the world last week, but by far the sharpest narrowings were in China and Hong Kong (see "Investment Strategy Summary" September 9, 2019).
- We caution against too much optimism that the weakening of RMB – and the threat to China's stability – is over. Yes, at most so far it's been 4.1%, which already exceeds the 3.1% experienced over the same number of days following the August 2015 weakening when China shocked the world by devaluing the RMB (please see the chart below, and "On the RMB Devaluation" August 11, 2015).

RMB versus USD, percent change, recent weakening versus 2015 devaluation



Source: Bloomberg, TrendMacro calculations

- *But additional tariffs worth $17 billion per annum snapped into place on September 1, calling for a further 3.2% weakening. More are scheduled for October 1 and December 15, which should drive a further 6.9% weakening.*
- *In the 2015 episode, the eventual maximum 5.8% weakening was just shy of double that of the initial surge, and that was all driven simply by pure speculation, not an American president deliberately trying to bash China into submission. Doubling the 4.1% we already got in August wouldn't even be enough to cover the presently anticipated tariffs.*

Maybe this is just a dead-cat bounce for RMB – that's our instinct – but then again maybe Mr. Market is right, and we have missed the turn. For that to be true, though, we'd have to believe that China has already experienced sufficient pain and fear to drive it to a deal. *If that's not true, then the new tariffs will kick in – and Trump will use every other lever of power, too, such as his life-or-death stranglehold on Huawei – and RMB*

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…will a new trade deal with Japan, likely in his pocket by then. Trump will heap more pressure on China to drive a deal, which in order to be effective will have to expose markets to more risk.

[Strategy dashboard]

<u>will relentlessly move lower, the Chinese economy will continue to slow, and the risk of a disorderly first-ever Chinese recession will get more and more real, until it finally actually happens, and plunges the global economy into recession.</u>

- The announcement that the Chinese team is coming to Washington for more trade talks is certainly encouraging – at least it beats the opposite. But the whole thing has become somewhat surreal to us at this point. *<u>Until now, we've always confidently expected negotiations to continue just when everyone else had given up, and just as confidently expected them to blow apart when everyone else thought a deal was imminent. The signals for such contrarian calls now seem very murky to us.</u>*
- It's as though negotiations both are and are not underway, as though they are both making progress and not making progress – as when the US team came back from talks in Shanghai on July 31, with promises about agricultural purchases and a claim by China that there would be more talks in September – and then the very next day Trump laid on a whole new round of tariffs, and then named China a "currency manipulator" the following week (again see "On the New China Tariffs" and "China the Currency Manipulator, and So What?" August 6, 2019).
- The withdrawal of the Hong Kong mainland extradition bill – it had previously just been removed from the legislative calendar – is probably a good sign. At least it means China is willing to try some form of compromise to avoid self-destruction, and isn't overly concerned about losing face by doing it. And once you start compromising, and start losing face, doing it again gets a little easier.
- But it doesn't seem to have calmed the protests. The good news about that is that ongoing protests represent a form of pressure on Xi that, all else equal, incentivizes him to cut a deal with Trump to dial down the aggregate threat-level that China faces all at once. But the bad news is that until he does cut that deal, the pressure is mounting – and the global economy can only watch helplessly hoping that this won't be the week for Code Blue in the boiler room.
- The cut to reserve ratio requirements for Chinese banks – to levels not seen since the Global Financial Crisis – is just another attempt at stimulus, designed to alleviate some of the pressure coming from China's quite visibly slowing economy (the most recent evidence of which is outright deflation in factory producer prices). But it's based on wishful thinking. It will only be effective to the extent that reserve requirements have been a binding constraint against lending to borrowers who are standing there waiting in line for loans. We doubt such borrowers exist.
- The lifting of restrictions on foreign investment in Chinese equities and bonds is mostly wishful thinking, too, and for the same reason. Foreign buyers have yet to even come close to hitting the existing limitations.
- The most intriguing recent headline is the announcement over the weekend that the People's Bank of China's foreign currency reserves grew by $3.4 billion in August, to $3.107 trillion. There's a

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lot of noise in that number – and maybe more than a little deception. But if it's true, *it's remarkable to see reserves rise in a month when the RMB/USD exchange rate weakened by as much as 4.1%. The clear implication is that China did nothing to intervene to support the yuan. And the clear implication of that it is that China didn't want to.*

- *To take it one step further – the implication of that is that China made the decision to risk a runaway currency crisis in order to offset the incentive effects of the new tariffs on US buyers of Chinese exports. In other words, this was a devaluation by omission – by standing back and doing nothing to stop a run on the bank.*
- Maybe Trump was right to instruct Treasury to designate China a "currency manipulator."
- It's not obvious that China can continue in this manner. At some point, currency weakness triggers unacceptable levels of capital flight and domestic inflation – and an outright crisis can lead to catastrophic rupture in confidence.
- In the 2015 devaluation episode, after about six months RMB ultimately bottomed after having weakened by 5.8%. By the time the Chinese authorities had stabilized RMB, they had spent about $1 trillion in reserves, depleting their stockpile by about one quarter. If stabilization ends up being as costly this time, China will be left with a mere $2 trillion in official reserves. For an economy China's size, whose own currency is very much not a reserve currency, and whose volume of imports and exports is so large, $2 trillion is arguably insufficient.
- We don't want to put too much confidence in a dog that didn't bark in the night argument, somehow convincing ourselves that the recent respite for the yuan, and the corresponding risk-back-on move in markets, means everything is all clear just because catastrophe *didn't happen* – yet.
- There is no thing that can affirmatively *happen* that will tell us that the risk of a currency crisis – an outright run on the bank against China – is safely passed. *We just have to live day by day of it not happening, until we finally conclude, having been ground down by the sheer passage of time – and even then, perhaps conclude falsely – that it won't, simply because it hasn't so far. We think it's too soon to reach such a conclusion*.

- The crisis of civil unrest in Hong Kong has a similar risk structure. Just as the potential currency crisis has been egged on by Trump's tariffs, the stand-off between authorities and protestors has been egged on by his mischievous tweets calling on Chinese President Xi Jinping to personally intercede to end the crisis without violence – by meeting with the protest movement's leaders (see "On Trump Playing the Hong Kong Card" August 15, 2019). Unfortunately, the movement has no leaders. So we don't know how the crisis can ever be said to have "ended" in any determinable way.

- We do know that when *the Chinese negotiators come to Washington in October they will be under the Sword of Damocles of two new rounds of US tariffs, with a third in the wings. That tariff pressure will be a lot greater than it's been before. And by then, Trump will likely have devised some new way to drive it even higher.*
- *And by then the US will likely have signed a trade deal with Japan*, which it appears was concluded in principle between Trump and Japanese Prime Minister Shinzo Abe at the recent G-7 in Biarritz (after what seems to have been a frosty meeting with Xi). Naturally, the media is portraying that deal as an act of desperation by Trump – though it seems to us he won many concessions and gave away virtually nothing except to forgo the threat of new tariffs. Trump will have now concluded trade deals with South Korea, Canada, Mexico and Japan, and used the threat of tariffs to make border-control deals with Mexico and Guatemala (see "Video: What you're not hearing about the US/China trade war after Trump's Mexico tariff gambit" June 14, 2019).
- So for the October talks in Washington, Trump will be flush with confidence that his bullying tactics – however obnoxious they may be – are in fact effective.

If you will please indulge what may seem like a sudden change of topic, we want to mention another factor that will – very ironically – strengthen Trump's resolve coming into the October trade talks. We think it will turn out that the poisonous dynamic between Trump and the Fed under Jerome Powell has changed for the better. That's thanks to the scandalous op-ed by former New York Fed President William Dudley, calling for the FOMC to blackmail Trump into halting the trade war with China, and sculpting policy to be sure he loses the 2020 election (see "Video: What you shouldn't have to hear about William Dudley's attack on Fed independence" August 28, 2019).

- We think it's conceivable – no, we think it's likely – that *the naked vileness of the op-ed, and the universal condemnation that was heaped on Dudley for it, has set up a useful guardrail against the Fed failing to be as dovish as it needs to be now, because now that will risk being interpreted as deliberately anti-Trump. That's the necessary counterforce to the opposite guardrail Trump himself had already inadvertently put in place against policy that might be interpreted as being influenced by him.*
- *So Dudley's op-ed, for all its loathsomeness, will end up being both stabilizing and pro-growth. We give some of the credit for the recent risk-back-on mood to this wonderful development.*

***Schadenfreude* alert!**

If you were as dismayed as we were by Dudley's op-ed, you will take a certain cruel satisfaction in his new one last week, trying, with hilarious lack of success, to excuse the inexcusable. He has obviously never learned the first law of holes.

The Dudley affair is a good example of how threats tend to be self-correcting over time thanks to negative feedback. But in the case of the trade war with China, we have a powerful participant – Trump – who is a human positive feedback loop. His strategy is to always make things worse in order to make China submit. That is the fundamental reason why we still think things have to get worse – on purpose! – in order to get better.

Bottom line

The Chinese yuan has stopped weakening, after a 4.1% drop during August – greater than the initial drop after the 2015 devaluation. Markets have responded with a risk-back-on posture that may mean the August panic will have been just another buy-the-dip opportunity. Maybe, but we think it won't be that easy. New tariffs are in place, and more are coming, which can't help but drive the yuan lower, with all the risk of an outright currency crisis that implies. It appears China did nothing to support RMB in August, which means it was willing to risk a crisis in order to offset the new tariffs. It is constructive that the Chinese team is coming to Washington in October for talks. An ironic unintended consequence of the Dudley editorial will have been to nudge the Fed toward easier policy, enabling Trump to play from greater strength against China in October – as will a new trade deal with Japan, likely in his pocket by then. Trump will heap more pressure on China to drive a deal, which in order to be effective will have to expose markets to more risk.