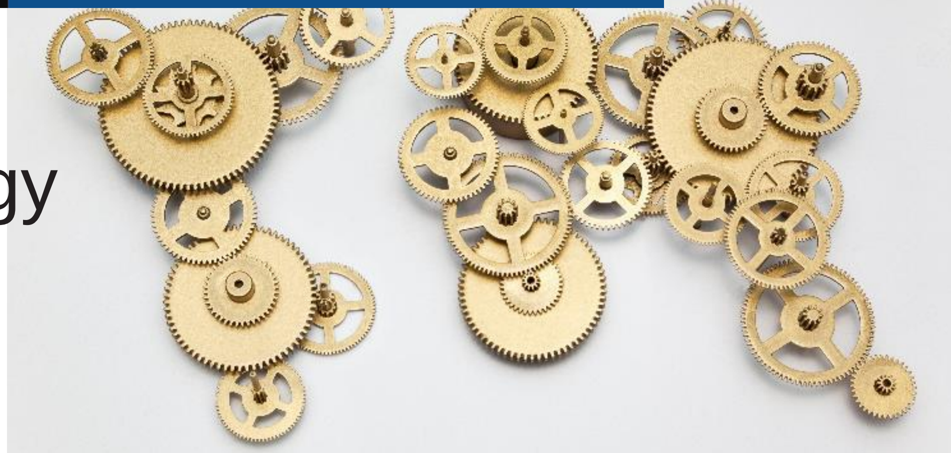
Private Bank

Asia Strategy Bulletin



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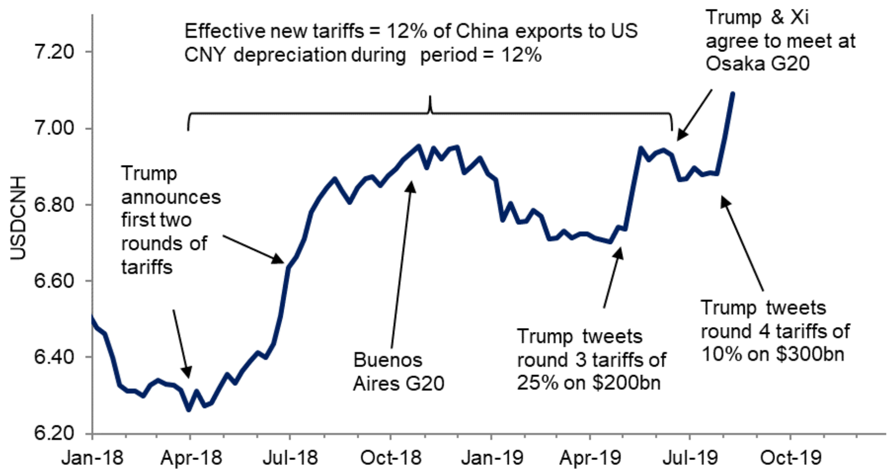
RMB takes the lead in China's response to trade war

- The Chinese currency has been propelled to the forefront in the latest escalation to the trade war, depreciating sharply by 2% in the two days after Trump tweeted about additional tariffs. This was quickly taken by President Trump as evidence of manipulation.
- Since April 2018, tariffs actually implemented amount to 12% of China's exports to the US. During that period, the RMB also depreciated by 12% (Figure 1).
- The additional 10% tariffs on $300bn of Chinese goods would be another 5% of China's exports to the US. Offsetting that with the RMB would suggest a level of around 7.25.
- Near term, additional depreciation is likely, as both policymakers and markets try to ascertain the extent of this bout of escalation. But clearly, the currency has become a primary tool for China's trade negotiations, just like tariffs are for the US.
- Sharp RMB depreciation in recent years has caused relatively widespread risk off. HK equities have become the primary market to express bearish sentiment from multiple risks including trade and economic slowdown. Chinese A-shares have been relatively resilient. Indeed, valuations in Chinese A shares have fallen 32% since their peak in 2015, suggesting it is too simplistic to say we are experiencing 2015 all over again.

Figure 1: Exchange rate depreciation has virtually offset all of the tariff impact in aggregate



Source: Bloomberg, Reuters, as of 5 Aug 2019

One for one depreciation for tariffs

- China's response to the latest escalation has been sharper and quicker than usual, promising retaliation and casting doubt whether further negotiations will take place in September.
- With only $20bn US imports not already under retaliatory tariffs, China would have to use non-tariff measures in a retaliation. This would probably involve the "Unreliable Entities List," which was announced in May, but not yet published. This list is meant to penalize firms, organizations and individuals who damage Chinese corporate interests for noncommercial purposes.
- The currency has become the more immediate channel. Central bank officials said that the depreciation is the result of tariffs and unilateral protectionism, while they are confident to keep stability for the RMB against a basket of currencies.
- Up to now, US has implemented tariffs on Chinese goods worth 12% of total Chinese exports to the US. Not coincidentally, the CNH has depreciated by 12% versus the USD in the same period (Figure 1).
- The new 10% tariffs on the rest of Chinese exports would amount to 5% of total Chinese exports to US. If all of this would have to be offset via the exchange rate, then 7.25 is the level, or another 2.5% from now for the CNH. If all of US-China trade is tariffed at 25%, then 7.75 would be the level.

Where is the trade war going? Perhaps look at the US election

- During the trade talks in Shanghai, there was press speculation that China might be delaying a deal, so it can negotiate with a new president in the US. But this theory seems too simplistic. There is no expectation that a Democratic alternative might be more willing to make a deal favorable to China.
- However, China might be waiting for the incumbent Trump's need to protect the US economy closer to the election next year. In other words, now is the time for Trump to escalate and still have time to turn around, while the Fed still has ammunition. By mid-2020, any economic damage from escalation could be much more costly in terms of votes.
- In sum, we continue to see the Fed and other central banks as poised to ease monetary policy. This policy support could help to cushion the impact of trade conflicts. While trade talks are unpredictable, expectations are also low and the US election next year places limits on escalation.

What happened last time when CNY depreciated?

- In 2015-16 and again in 2018, CNY had gone through substantial depreciation.
- In the 2015 episode, CNY devalued by 3% on August 11, which was then followed by 10% more depreciation through the end of 2016. This was first correcting substantial overvaluation after Chinese authorities held the CNY essentially unchanged versus USD in 2013-15, while other EM currencies depreciated substantially during a USD bull market. The devaluation also followed the bust of an epic credit fueled stock market bubble. It was also the time when the US was withdrawing from QE, while ECB and BOJ QE programs were at full force, causing policy divergence. CNY devaluation sparked a global financial panic that lasted over a half year. The most impacted were HK and Chinese equities. USDJPY crashed from 125 to 100.
- In 2018, CNY depreciation was driven by US tariffs plus a hawkish Fed. But as we laid out in Global Bulletin, the Fed is decidedly dovish, and has taken "sustaining the expansion" as its third mandate. This allows for more easing in China and other EMs such that currency depreciation might not have as much impact on capital flows as in the 2015 and 2018 episodes.
- In all, we do believe that in the short term, the CNY is likely to further weaken, and global equities are likely to correct lower. But central bank liquidity is likely to curb the spillover.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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