Revising yuan forecast

We are revising our USD/CNY forecast following the Chinese government's decision to allow the yuan to cross the 7 handle

We were right and wrong

We didn't think China's authorities would allow USD/CNY to pass the 7.0 handle because of the disruption such a move would cause in asset markets, not just in China but around the world.

We were partly right; the People's Bank of China let the currency pair pass this key level on 5 August, whereupon global markets experienced a sharp fall. China's CSI300 index fell 1.91%, the Hang Seng Index fell 2.85% and the Dow Jones Industrial Average index tumbled 2.90% on the day.

We thought China would refrain from using the yuan as a 'weapon' in the trade war because triggering a currency war would not be helpful to China's economy. But Chinese leaders appear to have concluded that the currency can be used as a tool to provoke Trump and inflict political damage.

Near term: What's next after 7?

We think it unlikely that USD/CNY will fall below 7 unless upcoming trade talks go particularly well, which is not our base case. Both sides are to blame for escalating this situation. The US raised tariffs on $300bn goods to 10%, China stopped buying US agricultural products and let the yuan pass through 7.0, and the US immediately labelled China a currency manipulator. On Wednesday, the US imposed a ban on federal purchases of equipment and services from five Chinese companies, including Huawei. We expect further retaliation.

In the near term, we think the yuan will trade in a range of 7.00 to 7.10. Further weakness would send a signal that China wants to start a currency war, which we strongly believe is not the case because this would do little to benefit the Chinese economy as other Asian currencies would just weaken along with the yuan.

The market is currently trying to work out how much the yuan will deviate from the fixing price. As such, the difference between the fixing and closing prices of USD/CNY is still quite large (more than 250 pips). We believe that as the market gets used to the yuan's new level, the daily fixing of the USD/CNY will be closer to the closing price.

Medium term: Progress of the trade war is now key for yuan

USD/CNY passing 7.0 shows that China is going to fight this trade war hard, at least while President Trump is in office.

There is a chance, in the medium term, that the yuan could weaken past 7.10 if:

1. The trade war escalates even further and the Chinese government uses the yuan to create market volatility. This could be a tool to frustrate Trump's 2020 re-election campaign.
2. The Chinese government has a plan to compensate for the loss of economic activity caused by the trade war. Asset market turmoil, led by a far weaker yuan, may not hurt China so much as it hurts the US.

We think the chances of this happening are very small but we don't rule out the possibility.

Forecast of USD/CNY and USD/CNH

We forecast the USD/CNY will reach 7.05 (previous 6.95) by the end of 3Q19 and 7.10 by end 4Q19 (previous 6.90). The USD/CNH should be 150 pips higher than USD/CNY.

We think USD/CNY will fall to 7.05 by the end of 1H20 (previous 6.85) and to 7.00 by the end of the year (previous 6.75), as we expect positive progress in the trade war after the US presidential election in November 2020.

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