Are we headed for a currency war?

The triple whammy of greater-than-expected rate cuts in New Zealand, India and Thailand and China letting the yuan slip past seven to the dollar has fuelled President Trump's fury and jawboning but has that increased the risk of FX intervention from the White House? We think there is a 25% probability to such an outcome,but the chances are clearly rising

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President Trump is accusing China of a ‘major violation’ by lowering the rate of the CNY. The Chinese deny they are using the yuan as a trade...

By Chris Turner and Francesco Pesole

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USD/CNY pushes above 7.0

The People's Bank of China fixed the renminbi at 6.9225 today, up from 6.8996 on Friday in what they suggest is a response to the latest round of...

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US FX intervention: What are the chances?

A further tirade from President Trump over the strong dollar begs the question whether he's prepared to weaken it through FX intervention? We would...

Donald Trump nominates Jerome Powell as Fed Chair, November 2017

The dollar is increasingly on the White House's radar

This week's move above 7.00 in USD/CNY and widespread monetary easing across Asia has provided further fuel to the President's criticism that the Fed has kept US interest rates too high and the dollar too strong.

The term 'currency wars' has also made a strong come-back – a term last used as countries were softening their currencies to compete for diminishing external demand after the Global Financial Crisis. We agree with most that China has not devalued its currency this week, but has instead allowed market forces to play a greater role in setting its value.

In fact, the US Treasury's statement supporting the designation of 'currency manipulator' against China reads something like 'if you claim you're so good at controlling your currency, why couldn't you keep $/CNY below 7?'.

Intervention: Is it a strong dollar or weak renminbi problem?

There are two schools of thought on FX intervention:

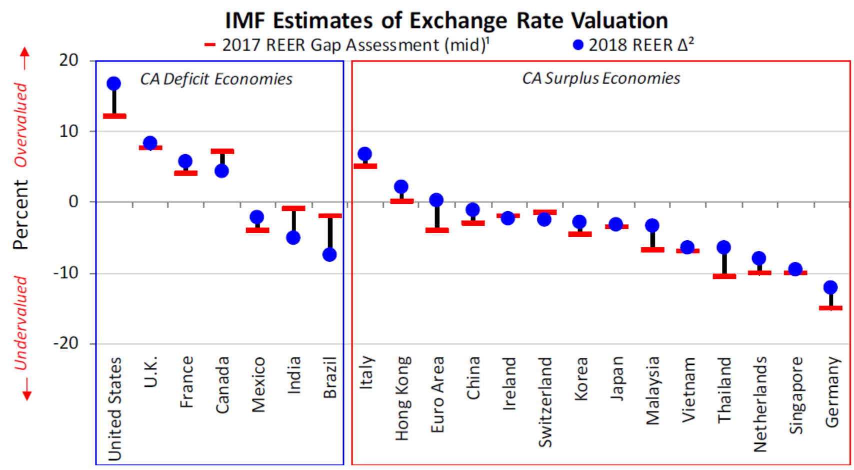
1. Is Washington's key focus an over-valued dollar that is hurting the US manufacturing sector?
2. Is the main concern that China is manipulating its currency lower for trade gain and to offset tariffs?

The answer to these questions will require different policy responses.

Listening to the President yesterday, the former certainly seems to be the case. The response required from the White House to this is largely to pressurise the Fed into more aggressive easing and, in exceptional circumstances, to get the US Treasury to instruct the Fed to sell dollars against the EUR and JPY (the two currencies already in the Exchange Stabilisation Fund (ESF). Washington's sense that the dollar is too strong could be backed up by the IMF's own calculations of FX valuations, where the dollar stands out as over-valued (see below).

The latter issue would see US FX intervention entertained against USD/CNY. After the admission of the Renminbi to the SDR in 2016, China has been welcoming public sector investments into its onshore bond markets. In theory then, the Fed should be able to buy the onshore CNY, with the proceeds parked in onshore CNY government bonds, just as fellow FX reserve managers do.

IMF estimates of FX valuation: over-valued dollar stands out



Sources: IMF 2018 External Sector Report, IMF 2018 Article IV Consultation Staff Reports for Vietnam and Ireland, BIS REER Indices, JP Morgan, and FRB.
1/The IMF's estimate of real effective exchange rate (REER) gap (expressed as a range) compares the country's average REER in 2017 to the level consistent with the country's medium-term economic fundamentals and desired policies. The midpoint of the gap range is depicted above.
2/Change through December 2018 versus 2017 average.
Note: The IMF does not provide an estimate of Taiwan's REER gap.

Source: IMF

What are the chances of intervention?

There is no perfect way to judge the market's view here, but a rough gauge is to look at FX options and see what probability the market attaches to certain outcomes. If we assume that unilateral US FX intervention (near unprecedented) would knock the dollar, say, 3% lower, what probability is attached to that for USD/JPY, EUR/USD and USD/CNY? Looking at One Touch option prices, the probability of the dollar falling 3% over the next month against the JPY, EUR and CNY is 23%, 13%

and 9% respectively. The USD/JPY is more volatile than the EUR/USD and USD/CNY, so the probability of a 3% move is naturally higher – but the exercise does provide some idea of what's priced.

We see the probability of intervention around 25%

We see the probability of intervention around 25%, largely because of the risk of failure. How would the White House react to headlines of 'failed intervention' if after selling USD/CNY at 7.05, the spot rate trades above that level over later days and weeks as the Fed fails to re-appear with a sustained bout of USD/CNY selling?

We've written about the US Treasury's available fire-power here, but after further discussion and assuming that neither: i) Congress approves a massive increase in ESF resources for intervention, raising US debt levels in the process or ii) the Fed decides to print money and support the US Treasury in unsterilized intervention, most seem to think the US Treasury's resources for FX intervention is around the US$100bn mark. Not much by international standards.

Indeed, there is much academic literature on the failure of sterilised FX intervention (i.e. the monetary base doesn't change). And the chances of getting another 1985 Plaza Accord to weaken the dollar, involving co-ordinated FX intervention and co-ordinated monetary policy, look virtually zero.

What would be a significant game-changer here would be if the Fed were to give greater weight to the drag from the international environment, including the strong dollar. The Fed might not wish to risk its credibility in getting sucked into a currency war, but FX intervention backed up by more aggressive Fed easing would be a more compelling proposition for the FX market.

Dollar forecasts

Based on a slowing US economy and the Fed being drawn into deeper easing, we maintain a view that USD/JPY will head down to the 102/103 area later this year. This will be exacerbated by broadening trade tensions over the coming months.

For EUR/USD, we see a risk that the recent narrowing in EUR:USD short rated differentials actually accelerates as US rates fall further, while EUR rates get stuck on the view that the ECB can't cut the deposit rate below the -0.70/80% threshold.

Narrowing rate differentials – and perhaps a re-think over Washington's dollar policy – have prevented EUR/USD breaking down to the 1.08 area. We continue to favour a 1.10-1.15 range for the remainder of the year, but will carefully watch the trade-off between US and Eurozone policymakers within a global slow-down.

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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.

Article | 7 August 2019 United States

President Trump and the Fed - we've changed our view

President Trump is ratcheting up the pressure on the Fed to support his efforts on extracting concessions from China on trade. Policymakers appear...

Source: Shutterstock

US President Donald Trump and Federal Reserve Chairman Jerome Powell

President piles on the pressure

President Trump has been active again on Twitter this morning, saying that the Fed must make "bigger and faster" interest rate cuts and that it as an institution is "too proud to admit their mistake" of - in the President's view - raising interest rates too aggressively over the past couple of years.

The latest blast follows the sharp sell-off in equities, but the President is also likely to have been irked by the fact that other central banks around the world are easing by more than expected. Today, we saw surprisingly aggressive moves from India, New Zealand and Thailand's central banks. At the same time, the European Central Bank appears to be gearing up for more aggressive stimulus in response to weak growth and low inflation. Meanwhile, in the Federal Reserve, President Trump has a central bank that seems far more reticent to offer the kind of support he feels is necessary as he battles China over trade practices.

> *In the Fed, President Trump has a central bank that seems far more reticent to offer the kind of support he feels is necessary as he battles China over trade practices*

Yesterday, St Louis Fed President James Bullard, arguably the most dovish voting member of the FOMC, pushed back against the market pricing four further 25bp rate cuts over the next 18 months. He admitted that in June he was one of the eight FOMC members to have pencilled in 50bp of policy easing this year to the Fed "dot plot" and said his view has not changed dramatically since then. After all, the US is "not in recession mode here" and that "monetary policy cannot reasonably react to the day to day give and take of trade negotiations".

Today, Charles Evans from the Chicago Fed talked similarly. He acknowledged the risks have "gone up", which can justify "more accommodation", and acknowledged the other central bank moves, commenting that "once a substantial number of central banks consider repositioning their monetary policy, it's natural that other central banks might be thinking that too".

Trade proving tricky

For now the US economy is in far better shape than other developed markets. Unemployment is low, growth remains "solid" and wages are rising. It was this contrasting story that had emboldened President Trump to push hard on trade with the narrative that trade partners would be desperate to cut a deal.

> *We simply don't have the visibility on the outlook for trade policy to give us much confidence in our forecasts when President Trump appears to over-rule his trade negotiation team on a whim*

It hasn't worked out that way with China offering domestic monetary and fiscal stimulus whilst also allowing the yuan to weaken against the dollar. Moreover, there is growing evidence that the US activity story is softening, with particular concerns over investment spending. Certainly, escalating trade tensions through higher tariffs and restricted access to markets is hurting sentiment, increasing costs, damaging supply chains and weakening corporate profitability. And the knock-on effect is that this deters companies from putting money to work, such as delaying investment decisions and hiring fewer workers – or even raising the prospect of lay-offs in key impacted sectors such as export manufacturing. This then feeds through into consumer sentiment and spending more broadly in the economy with recession risks mounting.

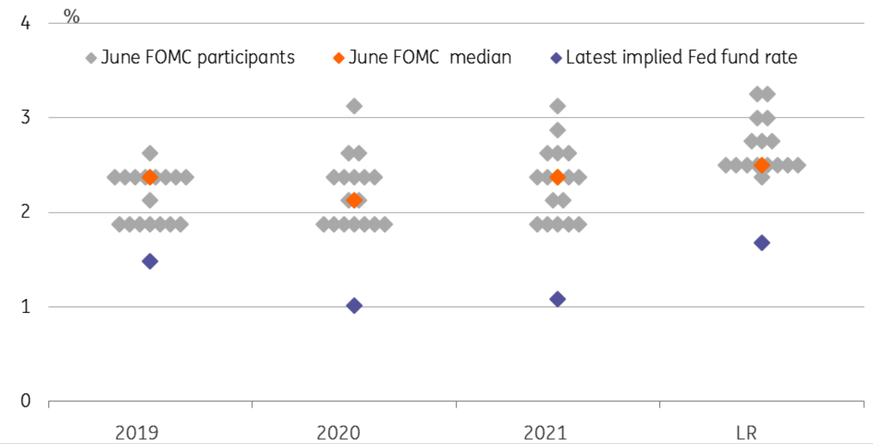
It is important to point out that this is in the realms of the "worst-case scenario". We simply do not have the visibility on the outlook for trade policy to give us much confidence in our forecasts when President Trump appears to over-rule his trade negotiation team on a whim. It may well be that in the next couple of weeks he rows back on the prospect of additional tariffs. Alternatively, he could go harder.

Things set to get worse before they get better

Our assumption is that the tensions will escalate over the next couple of months, which will add to economic headwinds and result in weaker growth. China talks of the need for "respectful" negotiations, which it doesn't feel it is getting when President Trump takes unilateral decisions, so there is little incentive to offer anything meaningful until there is.

This runs the risk of the US ramping up the pressure on China and further weakening global sentiment and economic activity. With commodity prices falling broadly, particularly oil which is in a bear market, and with the dollar remaining in the ascendancy there are more downside risks for headline inflation too.

Markets are priced for the worst



Source: Macrobond

The market is ramping up the pressure for action

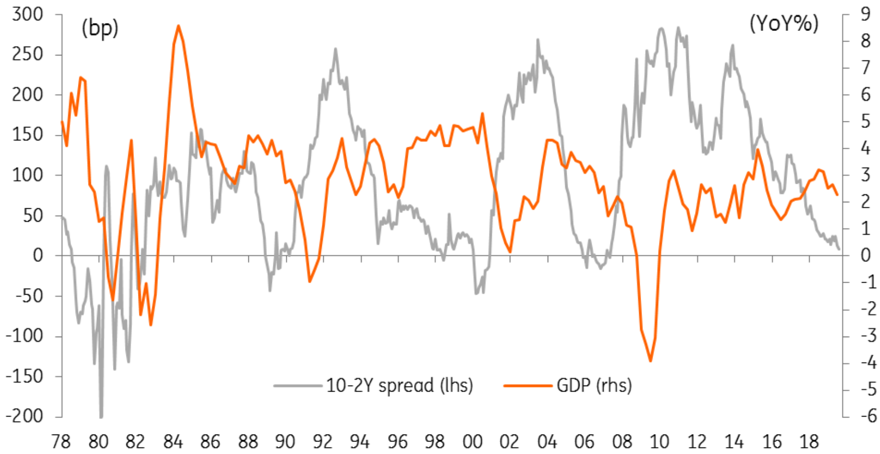
The ever flattening yield curve is also adding to a sense of nervousness. All nine recessions since 1955 were preceded by an inverted yield curve and we are there already on the 3M-10Y and only 8bp away on the 2-10Y. However, there have been false signals before and this time we have to recognise there are factors in play that are depressing longer US dated yields and thereby perhaps overhyping the threat of a recession.

> *What worries us more about a flat/inverted US yield curve is that it hurts banks and can disrupt and deter the process of credit creation*

The lagged effects of the Fed's quantitative easing programme is making the curve flatter than it otherwise would be (relative to previous cycles) while negative yields in Europe are also contributing to the demand for US Treasuries given the US safe-haven status and the fact investors at least get a positive return and the dollar remains strong.

What worries us more about a flat/inverted US yield curve is that it hurts banks and can disrupt and deter the process of credit creation since banks typically receive long term and payout short-term. This means weaker profitability while setting off warning signals about future credit quality in risk models. Less willingness to lend can, therefore, contribute to making the bond market's downturn expectations self-fulfilling.

Yield curve recession warning



Source: Macrobond

Fed set to cut rates further, but not as much as the market wants

All of this suggests to us that our current forecast of just one further Fed rate cut in September is looking too cautious. Growth risks and inflation risks are looking increasingly to the downside in the wake of the latest trade escalation. With other central banks easing aggressively, this risks exacerbating upside pressure on the US dollar, which could further dampen growth and inflation and add to the pressure on the Fed to ease policy.

> *It looks increasingly likely that the Fed will step in with more easing – with two 25bp cuts in either September and October or September and December (our preference)*

As such it looks increasingly likely that the Fed will step in with more easing – with two 25bp cuts in either September and October or September and December (our preference). In this regard, the Jackson Hole symposium 22 -24 August will see a lot of Fed discussion on this topic with Fed Chair Jerome Powell's favourite phrase of late that an "ounce of prevention is worth a pound of cure" likely to crop up again.

Though, we continue to doubt that the market will get the four additional rate cuts they are discounting. After all, we think that President Trump wants to be re-elected next year and recognises that a robust economy with rising asset prices is critical for that to happen. We continue to look for a "deal" even if not all of President Trump's demands are met later this year.

Relief in business and markets that trade uncertainty has been lifted and with interest rates globally offering a decent stimulus, may well give President Trump what he needs.

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China fixes the yuan higher

Today's fixing is an even bigger depreciation move, but some were expecting the fix to be higher still, and the market response is more balanced

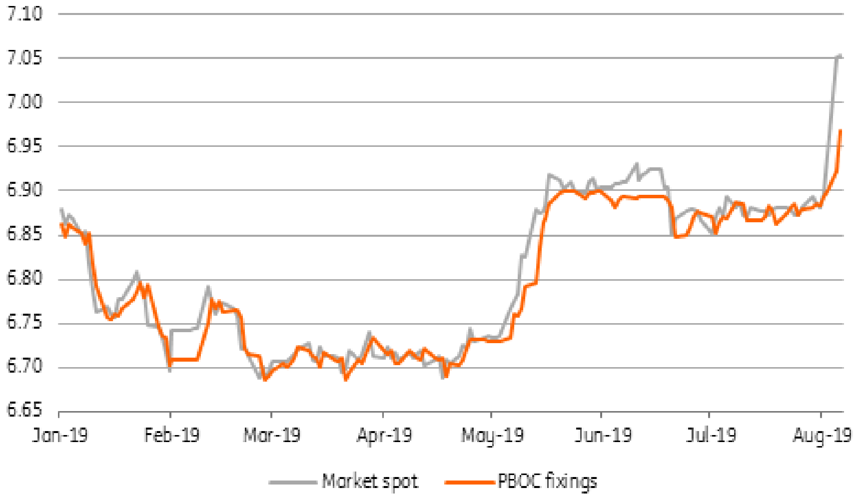
New mid-point for CNY is 6.9683

Today's fix at USD/CNY 6.9683 comes close to the estimates published each day by some of those attempting to mirror how the People's Bank of China sets its mid-point relative to its trading partners. But it is nonetheless quite a big move and about double the increase seen yesterday. As we noted in our morning note today, a move of this size could theoretically see USD/CNY spot rise to 7.10, given the 2% trading band permitted.

But the moves so far don't look anything like this big, and it seems that some market participants were expecting the fix today to be even higher, so the actual result is "less unsupportive" than some had imagined.

High yielders in the region, like the Indonesian rupiah and Indian rupee, are still looking soft, but the low yielders, Korean won, Singapore dollar, seem to be taking some support from this fix.

USD/CNY - PBOC Fixing and the market spot rates



Source: Bloomberg, ING

Bill issuance announcement also provides some CNY support

Backing up what some are viewing as a stronger than expected fix, the PBoC also announced they would issue 30 billion of yuan bills in Hong Kong next week. The sales are part of regular issuance, but the amount is larger than needed to simply replace maturing bills, so should provide some boost to short term Chinese rates, and thereby to the CNY.

So, far from looking like the PBoC is embarking on an aggressive depreciation, it is looking more likely that they are now trying to put the brakes on yesterday's move and bring some two-way risk back to the CNY outlook.

This probably has nothing to do with the announcement from the US earlier this morning, that they would label China a "currency manipulator". Moreover, with that decision now made, and the implications of this less worrying than tariffs already in place, that genie is now out of the bottle, and can't readily be re-used.

We now have to wait to see how the US President views today's move, as it looks like he is personally taking control of US trade policy. If he views it negatively, the next step for the US could be to consider increasing the tariff rate on the latest $300bn of goods from the planned 10%, to 25%. Then we will have to see how China responds to that. Watch this space...

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Article | 5 August 2019 FX

What $/CNY through 7.00 means for FX markets

President Trump is accusing China of a 'major violation' by lowering the rate of the CNY. The Chinese deny they are using the yuan as a trade...

Leading members of the People's Bank of China, including Governor, Yi Gang (waving)

A move through 7.00 is a big deal

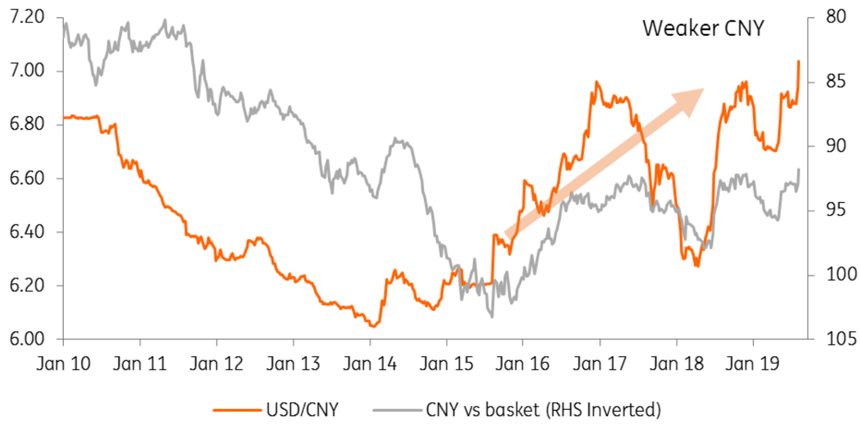
Having threatened to break it in late 2016 and again in late 2018, $/CNY has today moved cleanly through the 7.00 area. The move coincides with a significant fall in the CNY against its trading basket confirming that this is indeed a renminbi move and not just a strong dollar, weak EM story.

Rob Carnell covered this first for us today, arguing the higher $/CNY fixing looked to be a 'deliberate decision' from the PBOC and it begs the question whether a weaker renminbi should also be added to the list of possible retaliatory measures Iris Pang identified last week.

Over the next twenty-four hours, the focus will again be on the PBOC's fixing. This is announced at 0315CET and the fixing will be assessed against model-based estimates and some whisper-numbers on where the fixing should come in. Unless the PBOC fixes USD/CNY below those model-based estimates, the market will again conclude that Chinese authorities have dropped their concern over a weaker Renminbi. Recall that concern prompted quite a few remedial measures from the PBOC last summer (tighter reserve requirements, fixing adjustments and closing loopholes for outflows).

Unless the PBOC tries to reverse today's important break-out in USD/CNY, global investors will be left adding the risk of a CNY devaluation to their currently lengthening list of global concerns.

CNY weakens against both the dollar and the basket



Source: ING, Bloomberg

What are the implications for the rest of the FX market?

Investors have had plenty of experience with CNY weakness over the last four years – ever since the PBOC's poorly managed fixing reform in August 2015. Below we look at FX correlations through broad periods of CNY weakness:

- August 2015 until late 2016 as CNY devaluation fears lingered,
- June-October 2018 as CNY reacted to the imposition of US tariffs and
- May 2019 until today, representing the breakdown of the trade truce.

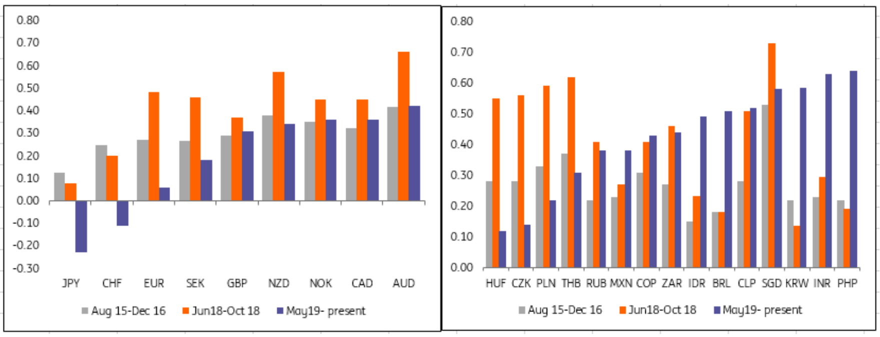
Familiar patterns are seen across G10 and EMFX markets. The JPY is the clear out-performer, with little or inverse correlation to daily CNH moves. The commodity currencies – those currencies already under pressure on stagnation fears and flatter yield curves - are the under-performers.

In the EM space, Asian FX is showing increasing correlation to China's FX moves – though the strong SGD link is pretty stable based on the CNY's role in the SGD basket management. These trends should not be a surprise as Asia grapples not only with softer global trade and the China slow-down but also with the semi-conductor cycle and most recently deteriorating relations between Japan & S. Korea.

Typically CE3 is the least correlated – although they did suffer last year as CNY weakness coincided with poor growth figures out of the Eurozone. Unless EUR/USD breaks down to 1.05/1.08 – and we haven't made that our base case yet, we think CE3 FX lags weakness in Asian FX and also the commodity centric Latin currencies.

An additional point to mention here is that President Trump's comments about the USD/CNY move being a 'major violation' bring US unilateral currency intervention a little nearer. We've discussed the issue in detail here, but remind readers that if it did take place (probability still under 30%), it would likely see the US Treasury to instruct the Fed to buy EUR/USD and sell USD/JPY.

Correlation in daily changes between CNH and G10/EMFX currencies



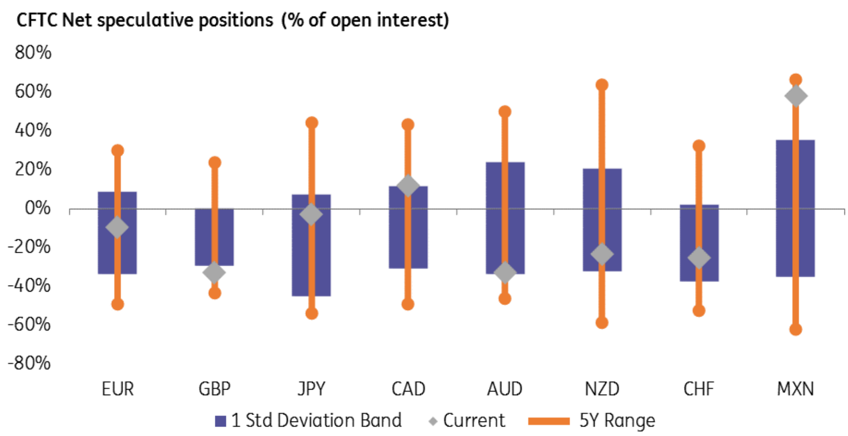
Source: ING, Bloomberg

Indiscriminate deleveraging?

This extra layer of uncertainty has un-nerved global equity markets and accelerated the rotation from equity to debt markets. Were this equity correction to extend much further, even high-conviction trades in FX markets could be unwound on the back of indiscriminate deleveraging.

Looking at FX positioning through the lens of net speculative positions at the IMM shows the stand-out story is MXN. The 8% nominal, 4%+real rates have made the MXN a popular choice this year. We think MXN would look pretty vulnerable if equities sold off much further, with USD/MXN moving to 20.50 not out of the question.

FX net speculative positioning in Chicago futures markets



Source: ING, Bloomberg

CNY devaluation is added to the list of investor fears

The PBOC's acceptance of USD/CNY above 7.00 has un-nerved investors further. Expect the safe-haven JPY and CHF to remain in demand and pro-cyclical currencies to stay under pressure. Only some surprise conciliatory wording on trade or the Fed surprising with more to offer in terms of easing can reverse this defensive risk environment.

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Snap | 5 August 2019 China

USD/CNY pushes above 7.0

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USDCNY

7-broken - what now?

Today's fixing at 6.9225 was up from 6.8996 last Friday and a little more than had been expected from models looking at market swings in the basket of currencies against which the CNY is managed. Markets have immediately taken the spot USD/CNY rate above 7.0. With that level now broken, the key question is what now?

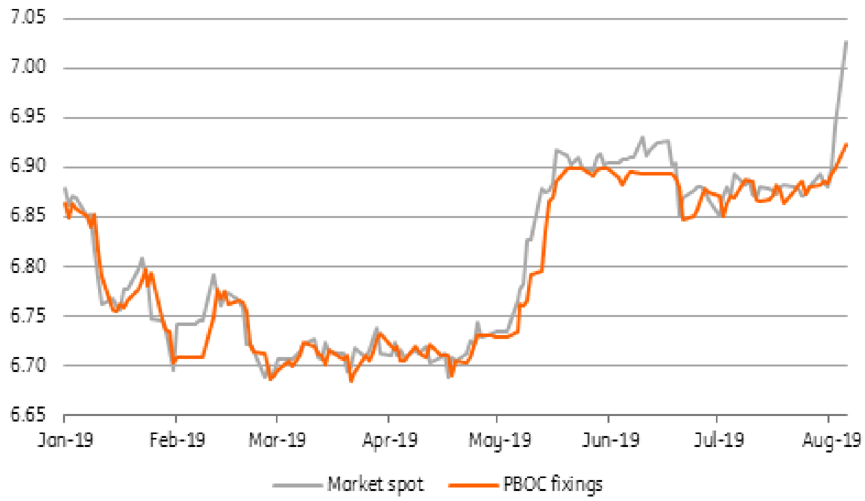
We, like most of the consensus, have been reluctant to forecast a 7+ figure for USD/CNY, at least whilst trade negotiations were ongoing, assuming that this would immediately lead to the breakdown of talks. So it is probably fair to assume that today's move was a deliberate decision, and part of what we imagine will be a concerted series of steps aimed at pushing back at the latest US tariffs. For more on this, see the note Iris Pang published last Friday.

Absent from that list was any currency action. It appears the Chinese authorities no longer see the need to limit the tools at their disposal and that the currency is now also considered part of the arsenal to be drawn upon.

The PBoC's website explicitly links the weaker fixing to the latest US tariffs, saying "Affected by unilateralism and trade protectionism measures and the imposition of tariff increases on China, the RMB has depreciated against the US dollar today, breaking through 7 yuan, but the renminbi continues to be stable and strong against a basket of currencies" (translated from original).

The website goes on to intimate that a move back below 7.0 is quite possible and suggests that not too much should be read into this currency movement.

China Spot FX rate vs Fixing



CNY spot vs fixing

7.0 a psychological hurdle only

With 7.0 now broken as a resistance level, a number of analysts are looking to set new forecast levels for the currency - with figures of 7.2 and 7.3 widely mentioned. In time, these may indeed be plausible levels, though the arguments against excessive weakening remain - namely, that it is likely to be damaging to the value of risk assets, such as Chinese stocks. Also, that it could result in more efforts to get currency offshore, which could tighten market liquidity and result in further economic weakness.

Moreover, we don't believe the currency is a strong transmission channel for the effective stimulus of the economy, so given the non-negligible costs of depreciation, a meaningful depreciation is not a clear choice for the Chinese authorities.

Of course, what today's move does do, by taking away the USD/CNY 7.0 hurdle, is provide much greater room for the PBoC if it does decide that the currency has to be part of the response to the latest round of the trade war.

But we're not leaping to any conclusions and will take our time in considering if this is more of a gesture of defiance (today's fixing was only 0.33% weaker than last Friday's fix) or the beginnings of a concerted currency move. The next few days fixing levels will provide some useful information.

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