

## Good MornING Asia - 28 August 2019

The latest tit-for-tat-retaliation in the trade war may have given China new confidence that it has tools with which it can push back against the US - one of these is the CNY - we are revising our CNY forecasts upward.

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# China's new approach to the trade war

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## Torn between trade and Brexit

As I mull the various headline articles today to choose a theme for today's note, the key themes seem to boil down to yet another commentary on trade, or a further review on the Brexit debacle. The trade story and China's new strategy in this is probably the most interesting, so I will start with that.

## Trade: and China's reaction to the latest escalation

### Trade:

I had a good chat with our China expert Iris Pang yesterday, and for all the talk of China asking to get back around the negotiating table in September, we don't see the upside for them. In the end, the question has to be, who are they negotiating with? If it is really with President Trump, then there is very little merit in them making concessions to the trade team only to be told at the last minute "Not good enough" by the President and be asked to do more.

Which is why we think the currency has come into play as a further tool for China to use in the tit-for-tat retaliation that has escalated recently. And this is also why we think that there is further

upside to USDCNY, with an end of 4Q19 high of 7.20, rising to 7.30 at end 4Q20. Within this, we don't rule out even higher rates as currency spikes are used as tools in the trade war. The effective trading range thus widens out to 7.05 to 7.50.

We have penciled in a modest quarterly CNY appreciation thereafter, but that far out, our conviction is pretty limited, so let's stick with the near-term view.

Yes, this does run some risk of re-igniting capital outflows. But China has sewn up its capital account pretty tightly in recent years, so that may be limited. Moreover, by judicious use of the fix, enough two-way volatility can be generated that on a day to day basis, this is not a one-way bet. Together with their own "entity list" we think China is gearing up for no deal.

The longer note on this from Iris can be found [here](#).

## Brexit: a thawing in Europe, a hardening in the UK

GBP looks a little stronger following some slightly less vitriolic comments on Brexit at the G-7 from Merkel and Macron, though I suspect Macron would just like to get those irritating "rosbifs" out of the EU as quickly as possible and get on with the EU project's other ambitions. So I'm less optimistic that a solution involving as yet uninvented technology or "trusted vendor" arrangements can deliver for the Irish Backstop question what previous negotiators have failed to do before.

Meanwhile, in Westminster, a plot is brewing to force PM Johnson to ask the EU for a further extension, and to stop the UK from crashing out on Halloween. The move takes an election off the table for the time being - the thinking being that if a no-confidence motion is called, the PM could drag his heels over calling a new election and the UK could simply drift out of the EU like a rudderless ship in the interim.

So the extension would deliver two goals:

1. It would provide more time if the Johnson government really is looking for a deal and not just a hard Brexit
2. It would allow for a no-confidence motion and a general election within a defined extension providing an opportunity for an incoming government (assuming it isn't the same one - which isn't at all clear) to set out a new Brexit vision.

Adding to the all of this, Nigel Farage's Brexit party has offered to back the Conservatives in a pact at the next election if they pursued a no-deal Brexit. The fun never ends.

## Day ahead

Nothing, literally nothing.

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## We're revising our yuan forecast again and expect far more volatility

China's unexpected retaliation last week and the hasty US reaction means we can expect China to use tools other than tariffs for future retaliation. The yuan is likely to be one of these, but the central bank probably wouldn't want one-way depreciation lest it triggers capital outflows. Therefore, we revise our USD/CNY forecast.. again



Dollars surrounded by Chinese yuan

### It's all kicking off again

Last Friday, China surprised markets by imposing new tariffs on more US goods imported into China. The retaliation in terms of the amount is small (simply because China exports more goods to the US than it imports), so in principle this shouldn't have much of an impact on the US. It could ignore this - after all it was retaliation.

### The unexpected announcement hit a nerve

Another [perspective on the entire situation](#) is the flurry of tweets that came almost immediately

from President Trump displaying his anger. The Chinese tariffs seem to have hit a nerve.

## The wobbly stock market

This marginal increase in tariffs might not be a substantial issue for China as the initial tariffs should have already been enough of a hindrance for Chinese businesses exporting to the US.

But with the surprise increase in tariffs, the Chinese action pretty much had the desired impact on the stock market.

## Over to China

The ball is now firmly in China's court. We think imposing more tariffs isn't the most effective way to create more hurdles for a Trump Administration that will soon begin to campaign in earnest for the 2020 presidential elections. Instead, China could probably cause more disruption if it keeps catching US stock markets - as well as potential Trump voters - off guard.

There are two possibilities open to China:

1. **Unreliable entity list:** Inclusion of any US companies in the list means those companies cannot tap into the Chinese market. This is a very powerful tool that has the potential to lead to increased volatility as well as periods of sudden yuan weakness.
2. **Firm stance on trade talks:** Talks without progress are more likely to provoke additional tariffs from the US. Even though this is to be expected, it is likely to weaken the yuan significantly. USD/CNY could cross 7.18 (the recent high) to near 7.20. This alone, without any retaliation from China, has the potential to create further market disruption.

## Revising yuan forecasts

Arguing that both measures will end up with a weaker yuan, we revise our USD/CNY forecasts.

We also think the central bank won't want the market to believe that the yuan can only depreciate against the dollar. So we expect that - in between these "unexpected" events - the yuan will strengthen against the dollar from time to time.

If we draw a monthly chart of USD/CNY, we should see increased USD/CNY volatility, even we only see a linear weakening yuan trend at every quarter-end.

Our range forecast of USD/CNY for the rest of 2019 is 7.05 - 7.50. Volatility should be high given that China's objective is to use the yuan as a surprise tool for the market. The spikes in USD/CNY may not be reflected in the quarter-end point forecasts. Our previous forecasts were 7.10, 7.00 and 6.90 for the end of 2019, 2020 and 2021, respectively.

**Revised yuan forecasts as of 27/8/2019**

	1M	3Q19	4Q19	4Q20	4Q21
USD/CNY	7.18	7.18	7.20	7.30	7.20

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# China industrial profits turned positive thanks to infra

China industrial profits turned positive in July, mostly because of support from infrastructure projects and a technically low base last year. Both factors will continue to support industrial profits' yearly growth, which continues to mask the negative impact of the trade war.



Workers at an electronic factory in Eastern China

## Infrastructure projects support industrial profits

Industrial profits amounted to CNY512.67 billion in July, up 2.6%YoY in July from a contraction of 3.1%YoY in June.

The most prominent profit contribution to this growth was support from infrastructure projects, specifically from the construction of railways, which pushes up profits in the mining and electrical products sectors. Electric products enjoyed profit growth of 30.8%YoY in July. Well up from 4.2%YoY in June.

## Trade war still dragged profits in trade related sectors

The negative impact of the trade war was masked by supportive fiscal stimulus in the form of railway construction. Trade-related sectors continued to suffer from shrinking profits. Paper

making, which is heavily related to packaging for exports, saw its profits shrink by 23.7%YoY YTD in July.

### **But risks faced by manufacturers haven't gone away**

The average payback period for account receivable was 54.2 days, an increase of 1.1 days over the same period last year. The longer the account receivable cycle, the higher the risk of low liquidity and the higher the risk of business closures.

We believe that most private enterprises suffer from long account receivable cycles. They may be the low-end subcontractors of infrastructure projects. We worry that they may be the last to receive payments from their construction works.

It is, therefore, possible that even though infrastructure projects help to support the economy as a whole, the government is expected to support the lower-end sub-contractors to avoid any chance of a series of defaults of small private firms.

The central bank can offer more targeted liquidity for small private firms to keep them liquid. Policies could be targeted at the medium term lending facility and/or targeted RRR.

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