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USD/CNY – What If Neither Side Blinks?

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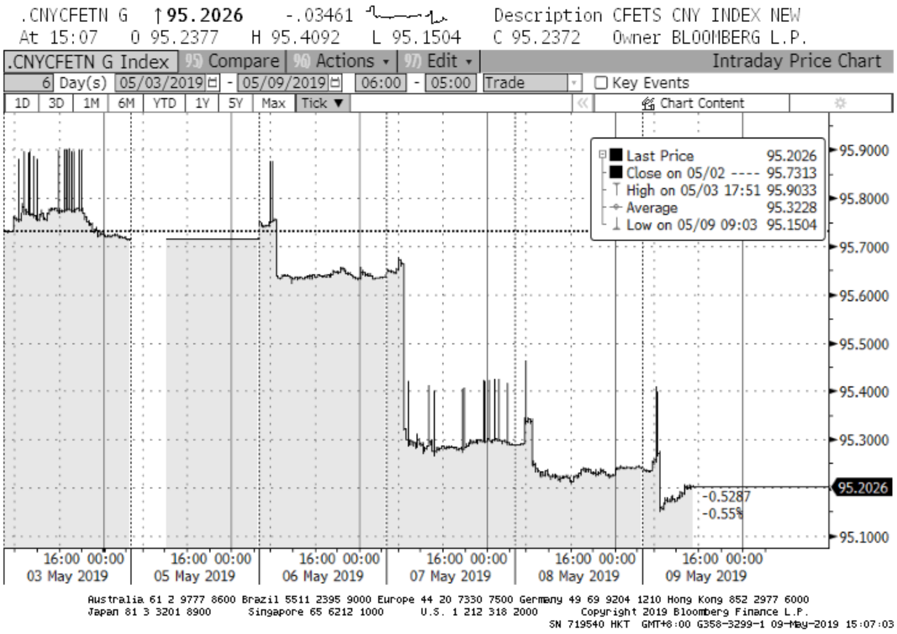
Key Points:

- **The renminbi basket has already weakened in reaction to Trump's tweeted threat to escalate the US-China Trade War**
- **Escalated Trump tariffs are very likely, despite Vice Premier Liu's next visit to Washington**
- **In return, we think Chinese retaliation is also very likely**
- **Though we don't think we cross above 7 in the short run, we think USD/RMB has higher levels to test**
- **While the issue is ostensibly international trade, increasingly we think domestic politics is key to an ultimate solution or non-solution**
- **Both sides are backed into corners from which it's difficult to extricate**
- **So our outlook is for stalemate for a while**
- **The most critical conclusion for us from the weekend is that the collective leadership in China appears to have decided it is not willing to play ball on Trump's terms**
- **This makes it difficult for President Xi to back down, even if he wanted to**
- **In terms of re-election politics, Trump is even more vulnerable on China than he was when we wrote about it in February**

CFETS WEAKENS FOLLOWING TRUMP TWEETS



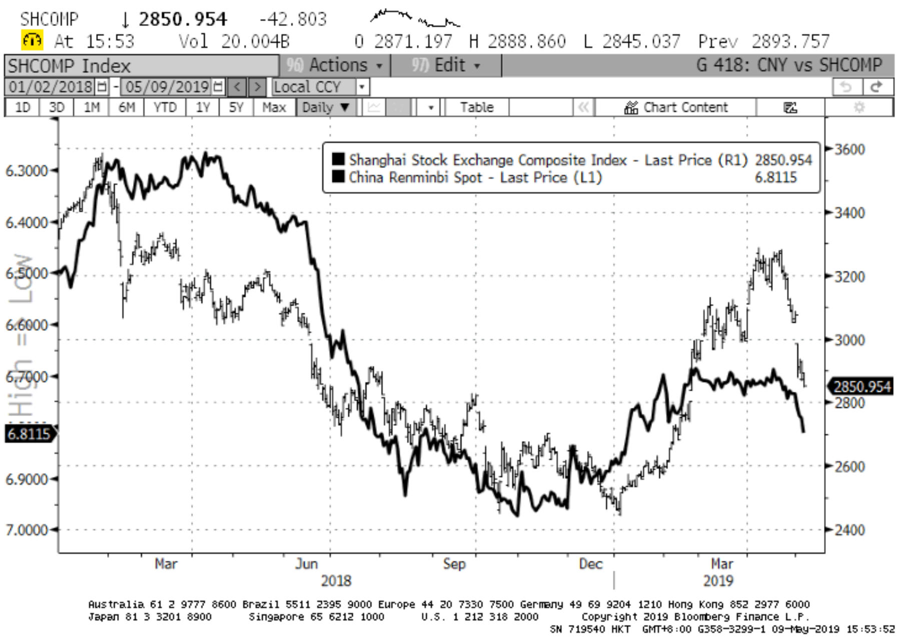
Source: Bloomberg, MUFG Bank

Market Reactions

CFETS, USD/RMB, Shanghai Comp all weaker since Trump's tweets

Since President Donald Trump's tweets last Sunday, announcing his intention to escalate the Trade War between the US and China, the renminbi's trade weighted value has already softened in anticipation of higher US tariffs (chart above), with the USD/CNY spot rate and onshore equity market also weakening (chart below). With hindsight, it can be judged the currency market was more cognizant of Trade War risks than equities.

CNY, SHANGHAI COMPOSITE GIVE UP GAINS



Source: Bloomberg, MUFG Bank

Based on our bottom lines, we think USD/RMB has further to rise

In [*Asia Cross Current: USD/CNY – Caving to China Probably Won't Help Trump's Re-Election,*]() 21 February 2019, we explained how a number of theoretical models suggested a stronger USD as one of the results of a US-led tariff war. Back of the envelope calculations also suggest the degree of USD/CNY increase necessary to fully counter 25% tariffs on roughly half of US imports from China would require USD/CNY to rise far above 7. But after the 2015-16 experience, we think Chinese exchange authorities will be loath to see their cross > 7 anytime soon. **Hence it seems to us a reasonable first guess is for USD/CNY to hit 6.90 again based on our bottom lines.**

Bottom Lines

Because we believe US tariffs on China will rise

Our view is based on two conclusions. Vice Premier Liu He returns to Washington, DC once again as President Trump tweets he's coming to make a Deal **but we doubt he can do so before Friday when tariffs are scheduled to rise.**

And because the Chinese will retaliate with higher tariffs of their own

And our view is then that a US escalation will be met by what the Chinese have called "necessary countermeasures," meaning Chinese tariffs on US exports to China will also rise.

It's the Politics, Stupid

Xi Jinping asked, which side blinks first?

The title of this note is a reference to a quote attributed to Chinese President Xi Jinping around the time of his December dinner with President Trump in Buenos Aires, after which he was supposed to have said to aides, "Let's see which side blinks first."

Our short-term answer is neither side, leaving us in stalemate

We think the spectacular breakdown of US-China trade talks (reminds us of the Trump-Kim Summit in February, regarding which ironically China was eager to avoid) so close to what most in markets had assumed was all over but the signing is because China thought Trump and the US would blink first. But our thesis in the short term is that **neither side will blink.** Both sides are now backed into corners from which there is no easy extraction. Despite the way US-China tensions have initially played out under the Trump Administration – ie, in international trade – **we think it's increasingly domestic politics that will drive the ultimate solution / non-solution.**

Not Ruled by Law

Though we are talking about trade, it's domestic politics that will drive the ultimate outcome

In a way, it's strange that US trade negotiation leaders – US Trade Representative Lighthizer and Treasury Secretary Mnuchin – would have put so heavy an emphasis on changing Chinese law in conformity with the Trade Deal under negotiation. China is not a nation ruled by law. Normally, laws in China have to be hashed out within the Party and across its giant bureaucracy, sometimes for years, before they can be rubber-stamped at the once-a-year National People's Congress. The new FDI law which came out of this year's NPC is an exception and not the rule, made for the unexpressed benefit of Americans and their trade-related demands. And even then, a new negative list for FDI was not due out till June.

And both sides are backed into corners from which it's difficult to extricate

So in a way, Chinese Vice Premier Liu He was right in that administrative measures and rules can always change much more quickly than law in China. Eg, authorities just approved new rules allowing onshore insurance companies to buy the perpetual bonds that authorities are pushing this year to further capitalize the banks (any liquidity in a squeeze).

China has nearly run out of a reservoir of goodwill in the US

But China has persistently failed to recognize that at present, it has only about an inch-deep reservoir left of goodwill in the US, a fact that Trump is taking advantage of. The idea that a non-Trump alternative – any non-Trump alternative – is going to give China a much better Deal may be wishful thinking. Even if a new Democrat President is elected in #2020, we think such a person will definitely be harsher than Obama on China and not all that different from Trump when it comes to the essential areas under trade negotiation now (IPR protection, technology transfer, genetically modified crops, industrial subsidies, cyberhacking, etc., etc.).

The Collective Leadership Has Spoken

But the most important outcome from the weekend is a message the Chinese collective leadership is not willing to play ball on Trump's terms

What impressed us most about the surprising Chinese pushback that became evident in its diplomatic cable last Friday night is the implication that collectively, top Chinese leadership has concluded the Trump Team's demands are not acceptable. This is not only the decision of Xi Jinping, since obviously he is in charge (and despite Trump's claims of a good relationship). More importantly to us, it seems there is a good chance this is the collective decision of what we call The Collective Leadership, meaning the set of current and former Politburo members that together must largely agree before something as important as enshrining commitments made to Americans into law. **This is critical. What happened last Friday should be read as a message that China's collective leadership has little intention of doing business with America on Trump's terms.**

If so, it will also be difficult for President Xi to back down

Now imagine after all this deliberation and the conscious jab to see if Trump will cave, Xi Jinping suddenly reinstates all the crossed-out sections in last Friday's cable. He will not have only Donald Trump to contend with, but also with a collective leadership in which he may have less maneuvering room than perhaps the Americans understand.

Locked In

Trump is newly vulnerable to Democrats on China

When Trump tells his base, as he did in Panama City (about 100 miles from where your correspondent grew up), that China broke the Deal! of course the alternative is I broke the Deal! In our February *ACC,* we explained why caving to China (as much of the markets expected then and up till just a few days ago) might not help Trump in his quest to get re-elected (surely his #1 goal at present). The new wrinkle is his vulnerability on this topic to the Democrats vying to take over his seat in #2020.

If Trump caves, it'll be obvious and so will the reasons, making him look weak

This is true even when you consider market factors which markets had counted on to bring Trump to heel and get us the fabled Deal. Suppose from now on the Dow really chokes so Trump caves. By this stage It should be more than obvious (as we had argued in the *ACC*) both that Trump caved and the reasons that he caved, and that makes him vulnerable to Democrats on the campaign trail. If instead the Dow soars and the US economy stays strong, Trump will feel he has much more leverage over China.

There is the potential that Trump decisions will be locked in till #2020

Politicians are never fond of admitting mistakes but ahead of the Keep America Great Again campaign (Trump's slogan, selected at or before his Inauguration), we probably are looking at an Immaculate Presidency from the incumbent's point of view = **admit no mistakes, which implies that from now on, every major Trump decision is locked in. Including the tariffs he proposes to escalate on Friday.**