CLIFF TAN

East Asian Head of Global Markets Research
Global Markets Division for Asia
T: +852 2862 7005
E: cliff_tan@hk.mufg.jp

MUFG Bank
A member of MUFG, a global financial group

USD/CNY – Updated Forecasts and Discussion

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Key Points:

- **We update USD/RMB forecasts and provide a detailed discussion, including Trade War updates**
- **In the end, it appeared the Enforcement Mechanism undid the US-China Trade Deal**
- **But adding Huawei into the mix will make reaching a Deal even more difficult and beyond the Market's time horizon**
- **Short-terms politics suggest stalemate**
- **Trump thinks China escalation is a political winner for him in 2020**
- **China's collective leadership is not willing to do business on Trump's terms; they have partially unleashed nationalism**
- **Markets have been rational in re-setting the level of USD/RMB**
- **We think growth and credit drivers of RMB remain largely as before, but interest differentials are more yuan supportive**
- **Our revised forecasts are a stretched out version of previous forecasts, with the stalemate stretching out RMB depreciation**
- **But we still expect to go over 7 eventually**

OUR LATEST FORECASTS: CNY AND CNH

Spot close 30.4.19			Q2 2019	Q3 2019	Q4 2019	Q1 2020
USD/CNY	6.7366	Our forecast	6.9200	6.9500	7.0000	7.0500
		Forward price	6.9027	6.9222	6.9353	6.9473
USD/CNH	6.7401	Our forecast	6.9250	6.9600	7.0150	7.0700
		Forward price	6.9179	6.9283	6.9387	6.9491

Source: Bloomberg, MUFG Bank; all forecasts, forwards = this publication date

Prologue

Updated forecasts and discussion instead of a *Global Renminbi* this month

We are publishing this note in lieu of *The Global Renminbi* this month. This is the first time we have published updated forecasts outside of the usual monthly production cycle. Though we still think our May contribution contains value (with a summary beginning, *"We remain of a mind that remaining obstacles in the way of a US-China Trade Deal are tough to overcome …"*), Trump's Trade War escalation has changed the backdrop sufficiently to require an expedited update.

Please see the Table above

Updated forecasts are in the Table above (which normally appears in *The Global Renminbi*). As always, final official GMR forecasts will appear in the June 2019 *MUFG Foreign Exchange Outlook* (out 3 June).

Latest Developments

The Enforcement Mechanism was the sticking point

Latest "channel checks" had suggested progress on a number of Real Deal fronts before the Chinese decided to poke at Trump by rescinding some commitments, followed by Trump's angry escalation of the Trade War. But it was still the case that the Enforcement Mechanism was the stickiest issue. We were surprised that to a large degree the US side might have acceded to Chinese requests to lift all tariffs, but the US was also insisting on snapback provisions. Ie, if the US side decides the Chinese side was not living up to its commitments in the Deal, it had the right to snap back previous tariffs in place. The Chinese were balking on this. The US also apparently wanted personnel on the ground in China to monitor a Real Deal; again the Chinese balked at this.

Huawei will delay and make a Trade Deal far harder

Whatever progress had been made by 1 May, when Liu He travelled to Washington, DC again, it now seems to us by subsequently introducing Huawei more forcefully into the mix (by including it on the US Commerce Department's Entity List), it is no longer possible to separate Huawei from any Trade Deal hence making a Trade Deal far more difficult to resolve and conclude; and certainly **far more difficult to resolve within anything like what significant parts of the Markets still expect in terms of timing.**

Short-Term Politics

Any Deal is also now hobbled by significant short-term politics, on both sides.

Trump thinks Trade War escalation is a political winner

For Trump, he seems to think escalating the Trade War with China is a political winner for him with respect towards #2020 re-elections (see our related discussion in *Asia Cross Current: USD/CNY – Caving to China Probably Won't Help Trump's Re-Election*, 21 February 2019). A very interesting press article out of the US Midwest indicated that farmers were suffering but sticking nonetheless with President Trump. This is despite the fact that China's retaliatory and escalated tariffs (including the higher levels slated to go into effect on 1 June) are clearly still directed at American farmers. For now, US equities also seem less dismayed by the Trade War, a factor which, if sustained, will allow Trump to hold to his more aggressive posture.

The Collective Leadership and nationalism in China also make it hard to move fast

For China, in our 9 May 2019 note (*Asia Cross Current: USD/CNY – What If Neither Side Blinks?* which predicted the Trade War escalation and also the 6.90 level at which USD/CNY is now trading, we had made a judgment that China's withdrawal from previous versions of the Trade Deal draft seemed a decision made by not only President Xi Jinping but maybe by the entire Chinese Collective Leadership. Since then, Chinese authorities have also appeared content to allow a certain degree of nationalist rhetoric directed against the United States to enter the national discourse. Uncaged nationalism will make it more difficult for Chinese leadership to extricate itself from the standoff with the US in the future.

Stalemate

What results is stalemate; we don't know how long it will last

So the operative word, as we said in the 9 May *ACC,* is **stalemate.** So while Presidents Xi and Trump may agree to meet during the next G-20 Summit in Japan at the end of June, based on the short-term politics above we have little expectation that a Deal can occur by that date or even a de-escalation. We don't know if the US and China will break off trade talks for as long as they did between May and November 2018, but we would not be surprised if it lasted that long.

Decisive Markets

Currency markets have reacted to Trump Trade War escalation rationally

We've been pleasantly surprised, since Trump's tariff escalation, by both how decisive and how rational Markets have been. From the start of this year till our last *Foreign Exchange Outlook,* the romancing of a Trade Truce + possible Deal led us to drop USD/CNY forecasts by around 2,500pips. After Trump escalated, Markets took USD/RMB right back to where we were before the Buenos Aires dinner (though Chinese equities have yet to adjust so quickly, probably because expectations for a Deal is higher in equities than in currencies). After January we rescinded an escalation in US tariffs that we had anticipated but now that escalation is fact.

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While the growth and credit problem factors remain as we'd anticipated

So one obvious recourse is to go back to our old forecasted path in January, but we need to update the driving factors behind our old forecasts from back then. With respect to two of the factors, China's growth outlook and credit problems, we think developments have unrolled largely as we had previously anticipated. As we have written, we don't think the Trade War was or is the principal driver of China's slowdown, so while some in Markets may fear the Trade War escalation itself for its effects on future Chinese growth, here we would probably put more emphasis on US slowing, if any, as a more important driver. On the credit front we still retain that arena as a major source of downside (weaker) risk for the RMB, **which we have yet to build into our forecasts.**

But the interest differential has slid in the RMB's favor since January

But it's the interest differential view between the US and China that has decisively shifted in Markets since January, with the Fed priced far more benignly than before. When the Fed change first began, we suspended the interest rate differential factor from our thinking for USD/RMB for most of 2019. In fact, Markets have now priced in a Fed rate cut by March 2020, which is the current limit to our forecast horizon. Meanwhile, Chinese rates and yields have also shifted surprisingly higher, partially a reaction to the swine flu epidemic as we explained in our last monthly. Both these factors suggest more support for CNY than factored in January.

Forecast Discussion

A stalemate stretches out previous forecasts

So our provisional forecast revisions above stretch out a bit prior forecasts: The stalemate is what stretches out the depreciation, since Markets will still likely romance the possibility of a Deal.

But we are still going above 7 eventually

The other major message which returns is **we are going above 7 eventually; it's only a matter of time.** For China's economy, **7 does not matter.** What's much more material for the economy is the CFETS reference value, and here we emphasize that even on days when the bilateral USD/CNY fixing is stronger than expected (because of the counter-cyclical factor, which in recent days have shown an impact rarely seen before) the CFETS has tended to drop (weaken). Since around the days when Trump escalated Tariffs, CFETS has dropped about two big figures and that, not the bilateral spot, seems to us to convey better the intention of China's exchange rate policy (that a weaker trade-weighted index is a sensible macroeconomic response to the escalation of Trump Tariffs).

Verbal intervention is not directed at professional markets, but at Mr. and Mrs. Chen

The very public warnings from Chinese authorities against crossing 7 (including naming the level itself, which violates a cardinal rule of thumb for central bankers: never name a level or else risk turning that level into a target), it seems to us, are unlikely directed against professional traders, **but are directed at Mr. and Mrs. Chen.** Eg, on a Monday traders came in to find a Bloomberg rewrite of a warning promulgated over the weekend by CBIRC head Guo Shuqing promising extensive losses for traders shorting the yuan. Bloomberg said Guo's remarks were front-page news in the Mainland press over the weekend. But they weren't on, eg, the front page of the Hong Kong edition of the *China Daily* Monday, surely an obvious place to send a message to offshore markets. **We think the public warnings are a reassurance to Mainland firms and households that PBOC and other central authorities have the exchange rate well under control even if Trump isn't, so that there isn't the need to accelerate the outflow of funds.** Eg, if USD/CNY were to gain 1,000pips – say from 6.95 to 7.05 – but slowly, over 10 months, the hope is that Mr. and Mrs. Chen remain calm.

A Final Summary

Politics move at the speed of tweet, economics more like a utility bill

A solution to the US-China Trade War at this juncture will be largely political and not economic. Because of the political exigencies on both sides, it's unlikely anything can be resolved in the near term. For both the US and China, of course, actual economic impacts must and will eventually matter. But as we have all learned by now, politics moves at the speed of tweet while economics moves at the speed of a utility bill (ie, monthly).