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USD/CNY – Possibly a Side Currency Agreement

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Key Points:

- **YTD USD/CNY trading is suggestive of an undisclosed side agreement between China and the US to return CNY strength back to pre-805 levels, in return for lifting the currency manipulator tag**
- **Seasonality in 2020 YTD shows CFETS strengthening at its fastest pace in six years; why?**
- **Because Trump cancelled or rolled back most of maximum escalation, it's "proportionate" for the Chinese to restore CFETS to pre-805 levels (93, using old trade weights)**
- **But not 95, because the Chinese didn't get as good a deal as they hoped**
- **When coronavirus lifts (we hope soon), look for a return to 93**
- **Team Trump has shown its hand as not only managed traders, but for managed currencies as well**

Precis

2020 USD/CNY trading to date suggests a side US-China agreement

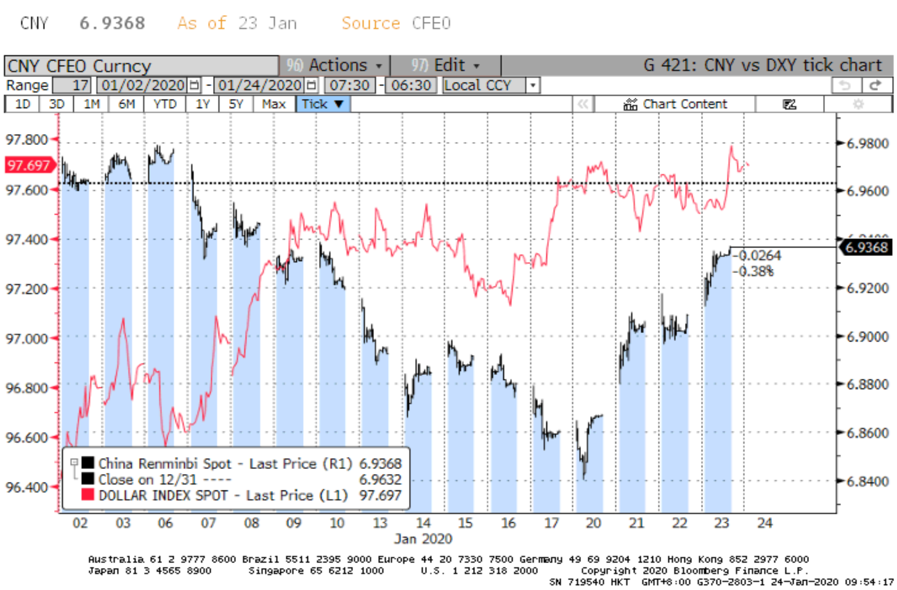
The first three weeks of USD/CNY trading in 2020, pre-Chinese New Year, has convinced us that, in addition to a currency chapter in phase 1 (Chapter 5), there may be an undisclosed side agreement between China and the US to return renminbi back to pre-805 levels, as part of a deal to release China from its currency manipulator tag.

Dollar Strength but Not in China

USD strength ignored in CNY

YTD, mild USD strength had hardly lapped onto USD/CNY shores – except in recent days due to a new coronavirus outbreak in Wuhan. Recent closing of the gap with USD, we think it fair to say, is likely spurious relative to the focus of this note.

MILD DOLLAR STRENGTH, BUT NOT IN CHINA



Source: Bloomberg

I Can't Tell You Why

In the past we couldn't always tell why

Over the past three years when we spotted strong January seasonality in favor of renminbi strength, we nonetheless had not been able to pinpoint a clear motivation behind the trend. Eg, were authorities seeking to:

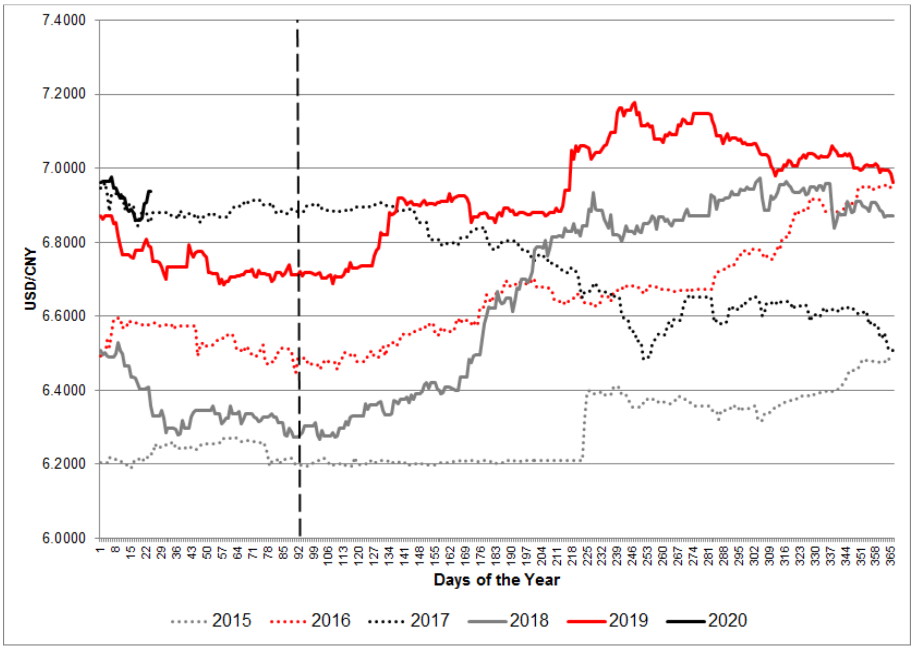
- Strengthen the currency so as to make it easier to repay overseas borrowings at the beginning of each year?
- Or, similarly, make Chinese borrowers prospectively more appealing as credits in the usual start of the year rush to refinance?

Especially since the economy was weakening

As we have written before, because Chinese authorities have not specified objectives to exchange rate management, *anything goes.* We think at this stage in Chinese development, however, all economic levers are probably tied to only one goal, which is growth, and for an economy continuously slowing the thought of strengthening your currency to start the year had not always made sense.

Seasonality

THE USUAL SEASONALITY CHART FOR USD/CNY



Source: MUFG Bank, Bloomberg

A seasonality chart for CNY

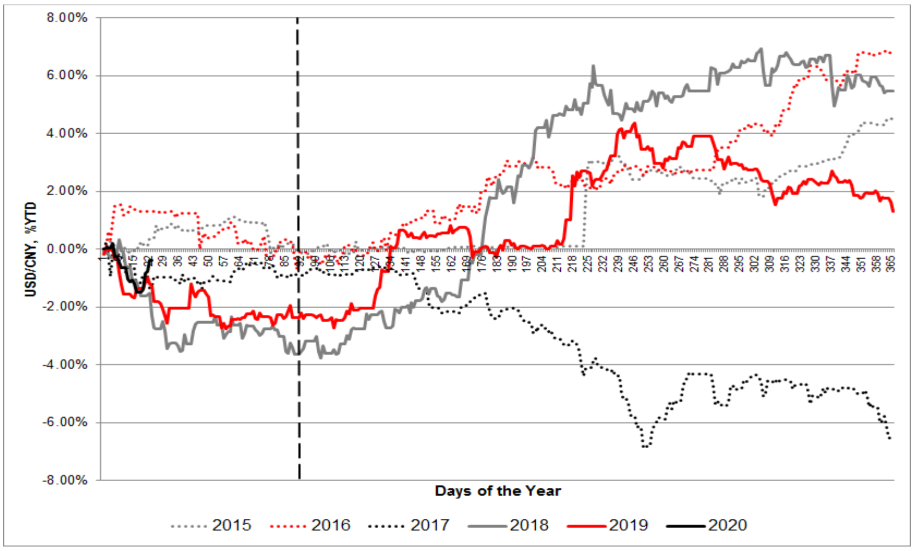
The chart above is a typical seasonality graph for USD/CNY; the thick black line is this year, and we look back five years. We've carried over values so each year has 366 values, so the vertical dashed line shows the end of 1Q.

Shows a persisting pattern of weakening from 2-4Q

As seen, due to similar levels, up till a few days ago 2020 USD/CNY in levels was starting out very similar to 2017. But even in this chart we can see how 2017 was an outlier relative to seasonal trading patterns of other recent years. After the first quarter, there has been **a persisting pattern in recent years for the renminbi to weaken over the remainder of the year.** Underlying weakening began in 2015 with the 811 shock, which stands out in the chart.

Normalized Seasonality

NORMALIZING SEASONALITY FOR USD/CNY



Source: MUFG Bank, Bloomberg

Normalized, we see the same January effect

It seems more useful to put seasonality into a more standard finance framework and look at USD/CNY in logs to examine %YTD patterns. The chart above does that. While this chart again shows a resemblance between 2020 and 2017, it also shows 2020 resembled 2018 and 2019, too. A recent break due to coronavirus also shows.

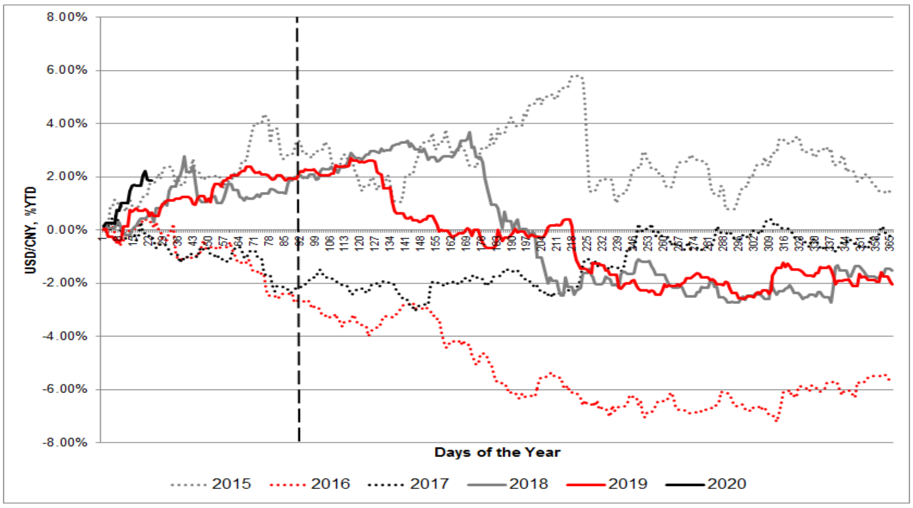
We'd argue, however, this January's strength was nearing its end

As we argue below, however, **we think 2020's January appreciation was probably nearing its end just before the coronavirus broke** (there were some onshore press hints of such just before the coronavirus story broke).

It may be more useful to look at CFETS

If we move away from bilateral crosses, it seems both more natural and more accurate to look at January renminbi strength in terms of baskets. So we turn to CFETS, the China-designed benchmark that PBOC wants the Markets to use, to gauge truer renminbi direction and, one day, perhaps policy.

SEASONALITY IN CFETS



Source: MUFG Bank, Bloomberg

Because when the US and China were negotiating phase 1, we think they were both looking at CFETS

To mimic CFETS, we use a Custom Index of Bloomberg that one staff member put together. This is an older index using the 2015 trade weights that applied till the end of 2019. We are doing this partly for convenience but, **much more importantly, because we think when the US and China were negotiating phase 1, this is likely close to the currency index they used.** To minimize tedium, we are only replicating the second type of chart for CFETS as we did for CNY.

And CFETS strengthened in 2020 at its fastest pace in six years; why?

What we want to (forcefully) note in the above chart is:

- Unlike the bilateral cross, **CFETS has weakened far less** than the exchange rate **even after the coronavirus hit**
- Unlike all previous years, including 2017, CFETS started 2020 at a **much more determined pace of strengthening** than in any of the previous five years

The question, of course, is why?

Possibly a Side Agreement

Because of phase 1

As we said above, without an explicit objective for the exchange rate, in principle anything goes. But while we hadn't come to anything too conclusive regarding motivations behind previous January rallies, this year we think the motivation could be clearer. As Einstein said, everything should be made as simple as possible, but not more so. And what's simpler to correlate this year's January strength to than to that other major item of recent China news, the phase 1 trade agreement (*Asia Cross Current: USD/CNY – Welcome to Managed Trade*, 21 January 2020)?

There may not be any side agreements on Tariffs (remember Tariff Man)

Both US Treasury Secretary Mnuchin and USTR Lighthizer were at some pains to emphasize, the day before phase 1 signing, that there were no secret side agreements besides the text that was released:

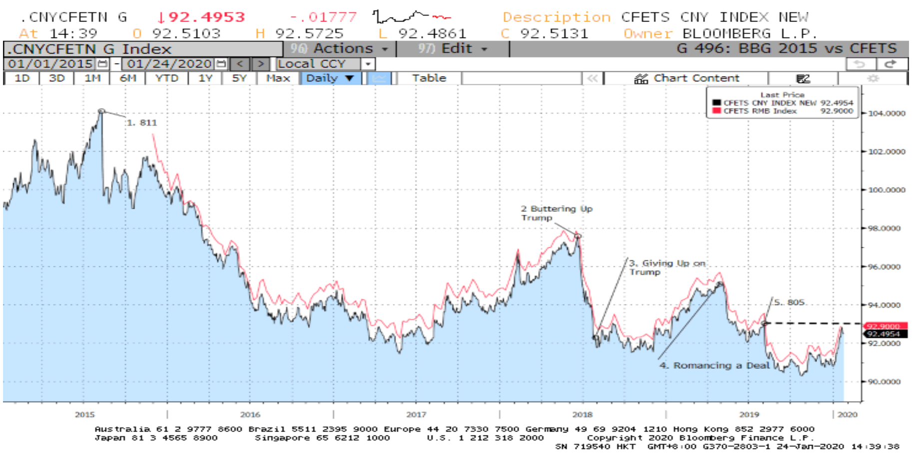
"There are no other oral or written agreements between the United States and China on these matters, and there is no agreement for future reduction in tariffs. Any rumors to the contrary are categorically false."

But there could be elsewhere

But in context, we think they meant Tariffs. Since there are already rare and secret annexes built into this agreement (see our 21 January 2020 note), perhaps it wouldn't be too surprising if there was secrecy elsewhere, even if not for Tariffs.

No Currency Manipulator Tag (*quid*); for Currency Strength (*quo*)

CFETS AND POLICY MOTIVATIONS BACK TO 2015



Source: MUFG Bank, Bloomberg

We offer an interpretative history of CFETS since 2015

The dark line above is the Bloomberg custom index we have used in this note; the red line is the official CFETS index; and the gap between the two shows tracking error of the Bloomberg CIX.

With annotations

We hand-scribbled annotations in the chart above outlying some possible policy motivations we have assigned to Chinese authorities in past notes. Since the annotations may be hard to read, we spell them out here:

1. This is the 811 (11 August 2015) shock.

For the Chinese, the currency has always been the cheapest-to-deliver concession

2. From mid-2017 to mid-2018, as the Chinese were assessing how serious Trump was about a threatened Trade War, we believe there was an initial effort to show a stronger currency. **For most of its post-1994 history, we believe the renminbi has been the preferred Chinese method to manage the US relationship, given sometimes extreme US focus on this one single variable.**

   It's worth noting and asking why the Chinese always seem willing to concede on the currency front, beginning with the 2005 de-peg (which we believe was a "gift" from former President Hu Jintao to former US President George W. Bush)? In any negotiation it makes sense for either side to offer what would be its cheapest-to-deliver concession, and it strikes us that **for the Chinese, the currency always seems to be cheapest to deliver.** By always choosing the currency, the Chinese are suggesting this lever might be most immaterial for more substantial internal policy goals, such as growth, jobs and internal cohesion. This despite the frequent drama in Markets about the currency.
3. After Trump showed he was serious about starting a live-fire shooting Trade War in 2018, we think the Chinese gave up. Why carry a stronger currency if there was no return to it, as far as American policy was concerned?
4. After the Buenos Aires dinner at the end of 2018, there was another effort to negotiate a deal, all the way up till the end of April 2019 when the Chinese scuttled what the Americans had mistakenly concluded was a near-deal. Again the currency had begun to strengthen on a trade-weighted basis.
5. Trump accused the Chinese of breaking their word; escalated Tariffs; and the Chinese gave up again. Capping all this off was the 805 shock (5 August 2019), after which Trump made his maximum escalation and named China a currency manipulator.

Since Trump cancelled most of maximum escalation, it'd be "proportionate" to go pre-805 (ie, 93)

As known, the currency manipulation tag didn't last long and slipped off of China just days before phase 1 signing. We might reasonably asked what changed to remove this designation (since we hadn't been sure what changed to inspire the designation in the first place, other than Trump's pique). Since Trump cancelled or rolled back most of the maximum escalation in phase 1 (but not all; 7.5% tariffs remain on a set of about USD116bn of goods imposed on 1 September 2019), it might have seemed reasonable (or "proportionate," as the two sides now like to say) for Americans to ask the Chinese to strengthen their currency back to approximately the level (93 on the old index) it held before maximum escalation. That would be point 5, the 805 shock, in the chart above. And **look how CFETS made a beeline to that level – represented by a dashed horizontal line segment from 805 - as soon as 2020 began.**

But not to April 2019 (95)

There was a previous peak for CFETS in April 2019, just before the Chinese pulled the rug from underneath negotiations. Why not go back there (which would take us back to 95 on the old index)? We will argue at that earlier stage, the Chinese thought they were getting a much better deal than what they eventually received in phase 1.

To allow their currency to go back to April 2019 levels would not be “proportionate.”

So we thought January strength was nearing an end, before coronavirus

Hence, we thought, just before the coronavirus broke, this year’s January appreciation might have neared its end. It is, of course, ironic that in order to shed the manipulator tag, China may have had to generate some manipulation in January.

Team Trump has clearly shown it wants to manage currencies, too

A more important point is that, in addition to Managed Trade, for the rest of the Trump years we assume <u>the US will be quite willing to manage currencies, too</u> (*Asia Cross Current: USD/Asia – From Currency War to Trade War,* 26 January 2018) .

Bottom Line

After coronavirus, we may return to push CFETS higher

We don’t know how long the coronavirus scare will remain in China (we hope it is short). Whenever it lifts, if our read of the implicit commitment from China to the US is correct, **we should expect to see the return of efforts to lift CFETS.**