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FX Strategy

Life Goes On After 7

Wednesday, 07 August 2019

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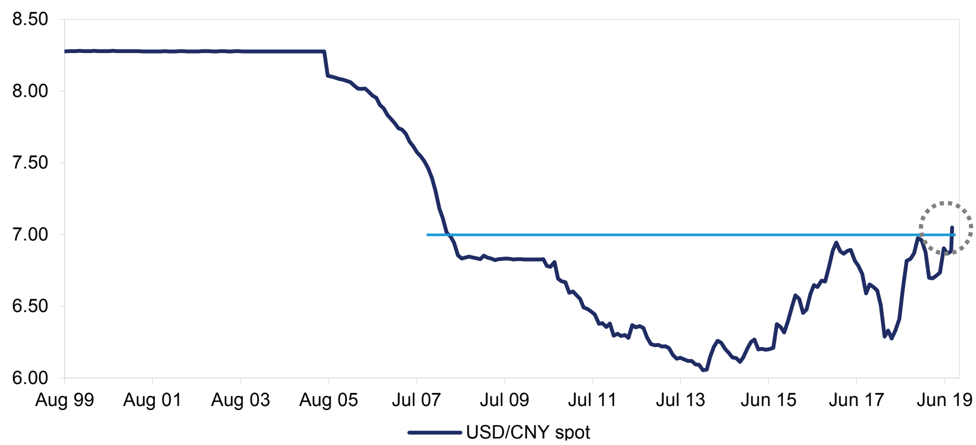
- Various CNY devaluation gauges have fired up yet again as CNY tumbled past 7.0. The breakout level of 6.95 is likely to be a strong near term support going forward. The central parity fixing rate has now been raised to just a shade under 7.0, at 6.9996 on Wednesday.
- Spot USD/CNY has now traded past our 4Q19 forecast of 6.99 and is en-route towards our 1Q20 target of 7.10. Given the deterioration in US-China trade relationship, risks have increased for USD/CNY to extend this move in the months ahead towards our previously mentioned Worst Case scenario of 7.30.
- As for Asia FX, they will likely continue to weaken alongside the CNY. Given that FX markets are volatile at this stage, we refrain from adjusting our existing forecasts, but warn that our 1Q20 targets for USD/Asia will likely trade sooner rather than later, implying further Asia FX weakness to come.

Chart 1: CNY Finally Weakens Past 7.0

Source: Bloomberg, UOB Global Economics & Markets Research



Over the past week, the US-China trade relationship soured dramatically and risk events that were previously deemed as unlikely materialized in double quick time instead.

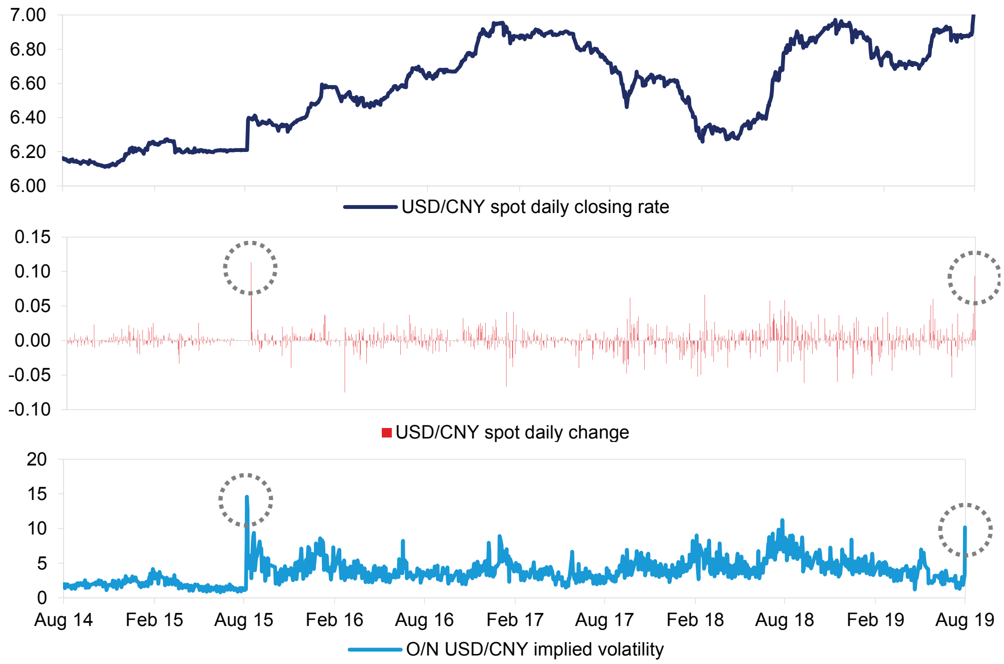
Last Thursday, after the US trade negotiating team returned from Shanghai empty handed, President Trump decided to ramp up the pressure on China by proceeding with plans for a latest round of 10% tariffs on the remaining USD 300 bn of Chinese exports into the US from 1 Sep. This was despite overwhelming concerns about potential negative economic fallout expressed from the US business leaders during the previous round of public hearing on the proposed tariffs.

Beijing responded at the opening bell on Monday morning by allowing the CNY “to fluctuate in line with market forces” which resulted in the currency tumbling headlong past 7.0. This generated a further rebuke from President Trump and ultimately led to the US Treasury Department labeling China officially as a currency manipulator.

It has been a very volatile past few days for the CNY. Here are some charts for illustration:

Chart 2: Last Time CNY Was So Volatile Was Back In Aug 2015

Source: Bloomberg, UOB Global Economics & Markets Research

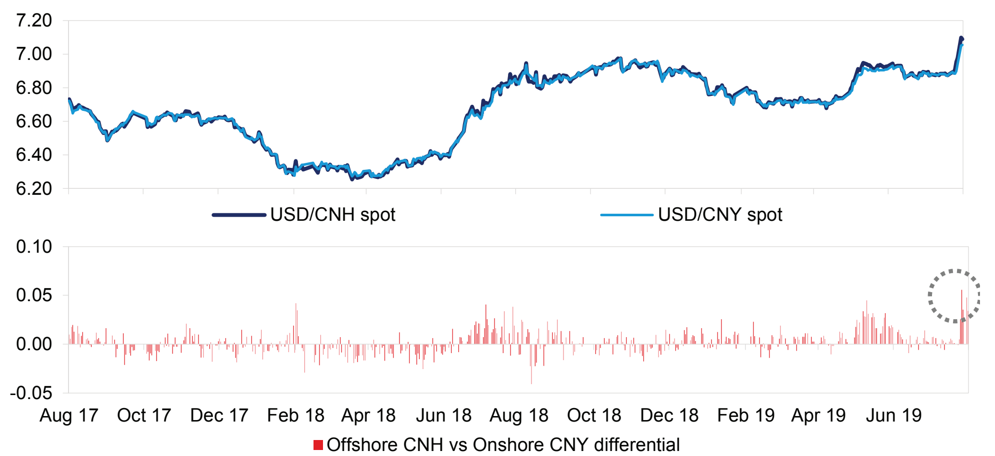


On Monday, USD/CNY spot spiked from last Friday's close of 6.9416 to 7.0352. Spot jumped by around 10 big figures in a single day and this led to a spike in o/n implied volatility from 2% to 10%. The last time USD/CNY spot had such an outsized move was on 11 Aug 2015, when People's Bank of China (PBoC) engineered a one-off devaluation of the CNY concurrent with the central parity fixing rate reform. Back then, USD/CNY spot also soared by around 10 big figures, spiking from 6.2097 to 6.3231, leading to an o/n volatility jump to nearly 15%.

One could argue that this time round, given the extended US-China trade tensions, global investors were mostly on guard for some form of CNY weakness. While the earlier Aug 2015 move largely caught global investors by surprise in its timing, given that PBoC had previously held USD/CNY large stable around 6.20 for most of 2015.

Chart 3: Offshore CNH Weakened By Much More Than Onshore CNY

Source: Bloomberg, UOB Global Economics & Markets Research

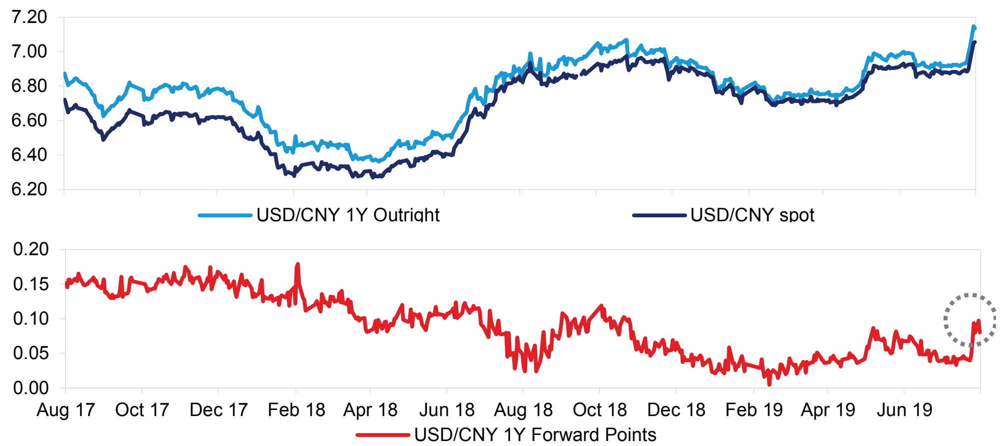


In times of elevated CNY devaluation stress, the offshore CNH tends to be sold off more aggressively compared to the onshore CNY, leading to the classic blowout in CNH vs CNY differential. On Monday, as USD/CNY spot spiked to its intraday high of about 7.05, USD/CNH spot rocketed further to as high as just under 7.13, leading to an offshore vs onshore differential of around 8 big figures.

Over the past year, in an attempt to soak up excess CNH liquidity, PBoC has been periodically issuing offshore CNH bills in Hong Kong. After the intense sell-off in the CNH, the PBoC announced that it will issue yet another tranche of CNH 30 bn worth of short term bills on 14 Aug.

Chart 4: USD/CNY 1Y Forward Points Widened Yet Again

Source: Bloomberg, UOB Global Economics & Markets Research

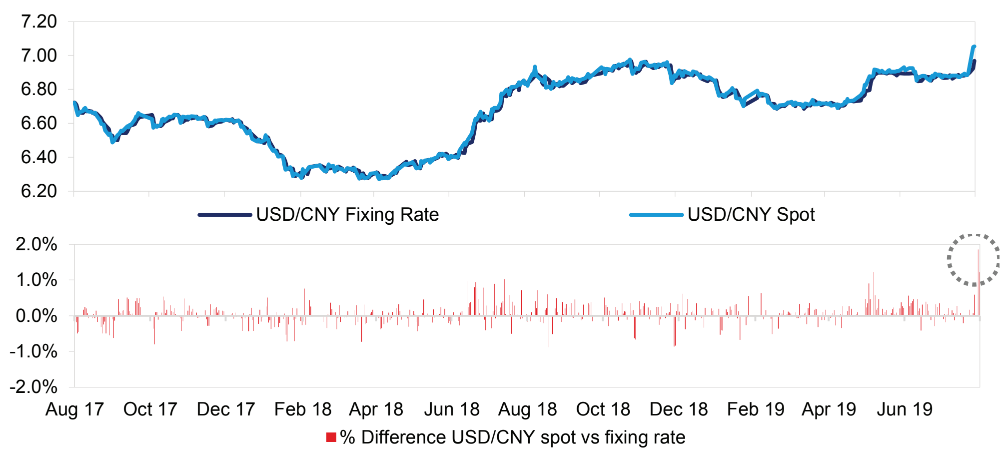


On top of the above mentioned offshore CNH vs onshore CNY differential, another classic sign of CNY devaluation stress is the 1Y forward points which widened as well. As USD/CNY spot rallied to 7.05, the 1Y forward outright spiked to 7.13. In other words, the 1Y forward points widened to as much as 8 big figures.

During the peak of China hard landing stress back in late 2016, this 1Y forward point widened to as much as 20 big figures. Subsequently, PBoC implemented the 20% sales margin on forward selling of CNY and brought the forward points back to a more reasonable level.

Chart 5: USD/CNY Spot Has Diverged From The Fixing Rate

Source: Bloomberg, UOB Global Economics & Markets Research



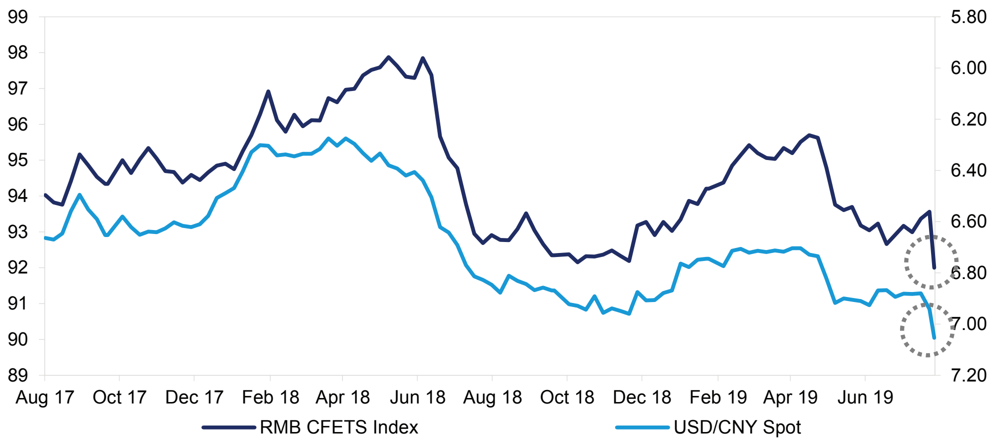
Officially, USD/CNY spot is allowed to trade on a daily basis within the +/- 2% range around the USD/CNY central parity fixing rate. Over the past two months, PBoC has effectively locked in the daily USD/CNY fixing rate under 6.90. On Monday, PBoC announced a fixing rate above 6.90 at 6.9225 and concurrently spot USD/CNY rocketed to 7.05, leading to a spot vs fixing rate differential of as wide as +7 big figures or +1.9%, i.e. just under the allowed daily +2% limit. Subsequently, the fixing rate was raised further to 6.9683 on Tuesday and 6.9996 on Wednesday, effectively playing catch-up with spot which has now traded above 7.0.

Realistically, under normal market conditions, USD/CNY spot should not stray that far away from the central parity fixing rate. Since the Aug 2015 central parity fixing rate reform by PBoC, the fixing rate itself has went through several iterations cumulating in the latest version that involves an opaque Counter Cyclical Factor that is meant to dampen any excessive volatility.

Objectively speaking, should PBoC fully implement its long term target of fully liberalizing the CNY exchange rate, the authorities should do away with the central parity fixing rate and spot USD/CNY should be allowed to float freely intra-day without any cumbersome tether to the central parity fixing rate.

Chart 6: CFETS RMB Index At Risk Of Making A New Cycle Low Below 92

Source: Bloomberg, UOB Global Economics & Markets Research



This we believe is the most important question to ask and relates directly to whether we have seen the worst (for now) in the CNY sell-off. Concurrent to the sell-off in CNY on a unilateral basis against the USD past 7.0, just how much the CNY depreciated on a trade weighted basis as well?

Every Friday, the PBoC has publishes a weekly reading of its official trade weighted index, i.e. the CFETS RMB Index. Since the US-China trade conflict started, this CFETS RMB Index has fallen from its peak of just under 98 in May 2018 to its low of 92.15 in Oct 2018 and thereafter rebounding somewhat. Last Friday's fixing for CFETS RMB Index was 93.56. A fall of 1.7% will bring the CFETS RMB Index to a new cycle low of below 92. Our internal UOB Nominal Effective Exchange Rate (NEER) model suggests that the CFETS RMB Index may have already fallen below the 92 level.

Key Implications Going Forward Now That CNY Has Weakened Past 7.0

The breakout level of 6.95 will likely be an important technical support

1. Stopping short of stating the obvious, all the above objective measures of CNY devaluation, ranging from offshore CNH vs onshore CNY differential, to 1Y CNY forward points and CNY spot vs fixing rate differential have all fired up yet again. While we are unlikely to see a repeat of the outsized move on Monday, given that the devaluation genie is once again out of the bag, it will take some time before CNY settles down. Capital flows will need to be monitored closely for any signs of outflows picking up, now that the psychological red line at 7.0 has been breached. **In other words, the breakout level of 6.95 will likely be an important technical support.**

We had ascribed a 30% probability to this Worst Case scenario and warn that should this happen, China GDP growth will likely fall below 6% in 2020 to 5.8% and that USD/CNY may threaten to break above 7.30.

2. Given the deterioration in US-China trade relationships, overall risks have now gravitated towards our previously mentioned Worst Case scenario. This Worst Case Scenario envisions that both parties are unable to reach a satisfactory resolution this year and that US will impose a 25% tariff on the additional USD 325 bn of Chinese exports to US. The latest decision by President Trump to start imposing a 10% tariff on the USD 300 bn of Chinese exports is an escalation to this Worst Case Scenario. **We had ascribed a 30% probability to this Worst Case scenario and warn that should this happen, China GDP growth will likely fall below 6% in 2020 to 5.8% and that USD/CNY may threaten to break above 7.30.** For more details, kindly refer to Marco + FX Strategy Note: "US-China: Trump Threatens New Tariffs on More Chinese Goods", dated 02 Aug 19.

3. **It is now a moot point whether China manipulates its currency. After all, we are in the midst of an unprecedented trade conflict between the US and China.** Objectively, the CNY not only weakened on a unilateral basis against the USD, but also on a trade weighted basis over the past year as US-China trade tensions escalated. President Trump has now fulfilled his election threat of labelling China as a currency manipulator and the US Treasury will likely start negotiations with the IMF to curtail China's "unfair competitive advantage". However, events have already been over superseded by several round of escalating tariffs over the past year on both sides as well as increasing challenges in the technology space as well. This official labelling of currency manipulator for China does imply a hardening of stance in the Trump administration and has indeed made it on balance more difficult for both US and China to reach a trade deal over the near term. For more details, kindly refer to Macro + FX Strategy Note: "US Treasury Labels China As FX Manipulator: The Price of 7", dated 06 Aug 19.

Given the intense volatility in FX markets currently, we refrain from adjusting our forecasts for now, but warn that our negative forecast of Asia FX will likely trade sooner than later.

4. Onshore USD/CNY has now traded past our 4Q19 target of 6.99 with offshore USD/CNH trading past our 1Q20 target of 7.10. Just slightly more than a week ago, we had updated our USD/Asia point forecasts as we published our FX & Rates Monthly. We reiterated our view since the US-China trade conflict started last May, i.e. "pressure will remain on Asia FX as long as regional economies remain under pressure from export contraction and growth slowdown". In addition, we warn that "Asia FX in general is likely to follow and keep pace with the anticipated CNY weakness in the months ahead. Thus, irrespective of the fact that the FED may cut rates further, Asia FX will still stay weak against the USD". This view remains intact. **Given the intense volatility in FX markets currently, we refrain from adjusting our forecasts for now, but warn that our negative forecast of Asia FX will likely trade sooner than later. In other words, our 1Q20 targets for USD/SGD, USD/MYR, USD/IDR and USD/THB, i.e. 1.41, 4.22, 14,700 and 31.90 respectively, will likely trade sooner than later. Investors are advised to hedge their USD risk.** For more details, kindly refer to Monthly FX + Rates Strategy: US Dollar Stays Strong After Non-Committal FED Cut, dated 01 Aug 19.

5. **We reiterate our positive conviction view for gold.** Escalating trade tensions and rising risk aversion will continue to fuel global investor demand for gold as a safe haven asset and portfolio diversifier of risk. This latest round of deterioration in US-China trade relationship has pushed gold higher from USD 1,440 / oz to USD 1,480 / oz effectively bringing Gold within striking distance of our mid-2020 target of USD 1,500 / oz.

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