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Will The Yuan Be Trumped?

- Trump's victory means that U.S. tariffs on Chinese goods are likely, which would require a cheaper yuan, at least from a macroeconomic perspective.
- The nature and severity of U.S. punitive action toward Chinese exports is highly uncertain.
- The sharp decline in China's foreign exchange reserves in October was mostly due to currency translation effects, though capital outflows have accelerated since November 9.
- We introduce the *MRB Yuan Market Pressure Gauge* to estimate the daily currency intervention of the People's Bank of China.
- China is highly likely to defend the trade-weighted exchange rate, at least until Trump's trade policies are more clear.
- PBoC intervention should ensure that the yuan outperforms an EM currency basket in periods of elevated global economic uncertainty, such as the transition to a Trump administration. Stay overweight.

Donald Trump's surprising victory in the U.S. presidential election has added to investor fears of a yuan devaluation, even if he promised the opposite outcome to his supporters. The new threat of a U.S.-China trade war follows on the heels of a US$45.7 billion decline in China's foreign exchange reserves in October, suggesting the yuan was already vulnerable to downside market pressure.

This report introduces the *MRB Yuan Market Pressure Gauge*, which estimates the daily currency intervention of the People's Bank of China (PBoC). The indicator suggests that downward pressure on the yuan spiked on November 9, suggesting the PBoC was intervening to prop up the exchange rate.

The PBoC did not sell its FX reserves in a vacuum, as the prospect of a Trump presidency sparked a sharp selloff in other EM currencies. In this sense, PBoC intervention should be interpreted positively by investors, as it reduces a potential source of instability for global markets by ensuring a stable trade-weighted yuan. As we have noted repeatedly in the past[1], China's foreign exchange reserves are more than sufficient to ensure that the PBoC can achieve this target. Moreover, current macroeconomic conditions in China do not call for a cheaper currency, as the "old" industrial sectors are thriving and chronic producer price deflation has been broken, at least temporarily.

The PBoC will provide some stability for global markets

The yuan should continue to outperform an EM currency basket in the absence of punitive U.S. sanctions and/or a collapse of the overheating property market. These risks may well prompt a downgrade to neutral in 2017, but for now we continue to recommend holding the yuan at an overweight position within in an EM foreign exchange portfolio.

[1] **MRB** ***Research Highlight***, "*Falling Reserves Do Not Signal Yuan Crisis*", February 16, 2016

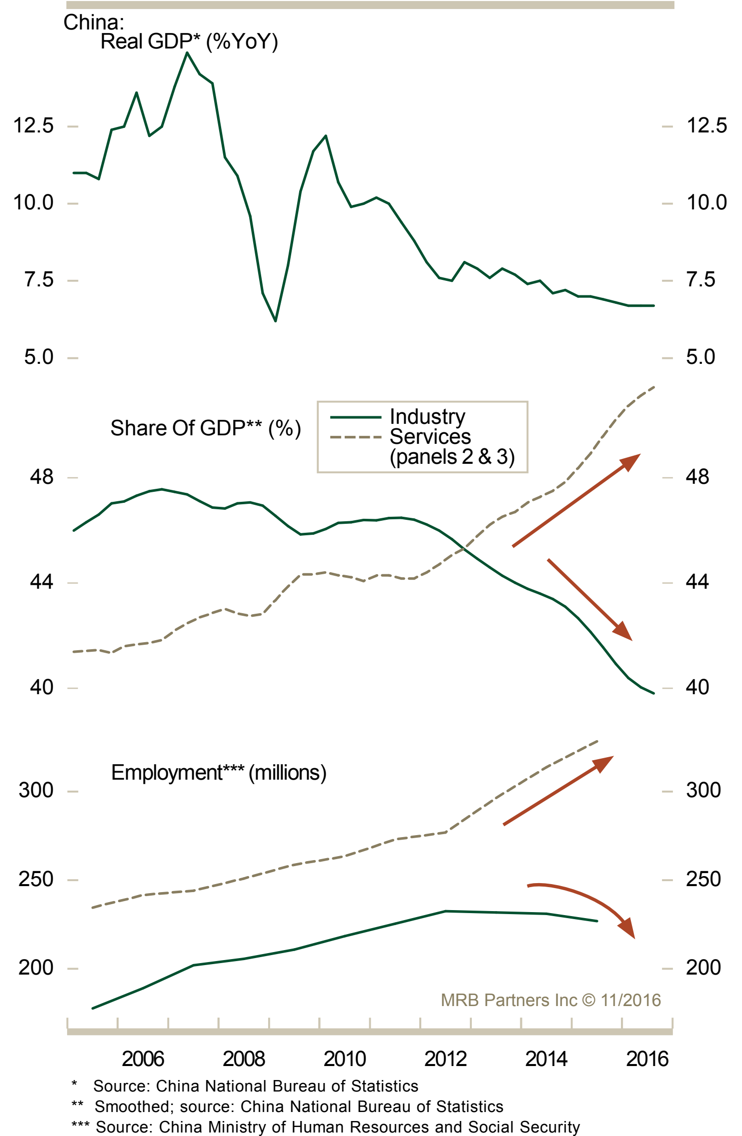
China In Trump's Crosshairs

In the Presidential election, Trump pledged to impose harsh tariffs on Chinese imports ***and*** label China a currency manipulator. The idea being that China's bilateral trade surplus has hollowed out U.S. manufacturing jobs that will return if relative prices/wages can be skewed in the U.S.'s favor.

We are skeptical th<at he could push through such punitive measures, or that they would prove effective—the Chinese economy that Trump described on the campaign stump no longer exists anyway. China has "lost" about 2 million manufacturing jobs since 2012 as its economy rebalances toward services (**chart 1**). Still, given his campaign commitments and the advisors that he has brought in to build out his economic team, Trump is highly likely to take some sort of action against Chinese exporters early in his administration.

The currency manipulator tag would be difficult to justify, as the PBoC has been actively propping up the yuan exchange rate for the past 18 months and most estimates suggest the currency is fairly valued. Moreover, Beijing is very unlikely to let itself be forced into some sort of *de facto* Plaza Accord without retaliating. (Remember that all the signatories to the original accord in 1985 were under the U.S. security umbrella.)

Chart 1 China Not Creating Manufacturing Jobs Anymore



* Source: China National Bureau of Statistics
** Smoothed; source: China National Bureau of Statistics
*** Source: China Ministry of Human Resources and Social Security

This implies that Trump is more likely to use tariffs to target Chinese exports. The U.S. could join the E.U in imposing tariffs on Chinese steel through the WTO, and the Obama administration has already been preparing the ground for similar measures on aluminum. Such action would likely trigger the normal tit-for-tat response from China, most likely targeted against U.S. auto parts, technology hardware or agriculture. We would consider this to be a continuation of the status quo, and it would have a minimal impact on our global asset allocation strategy.

Trump's attitude toward China is clear; his policies are not

Nevertheless, Trump might try to gain leverage by imposing tougher measures that could later be ratcheted down in reward for Chinese cooperation. For example, under the Trade Act of 1974, the President has the power to impose tariffs of up to 15% for 150 days on a country with a large current account surplus, which can be extended by declaring

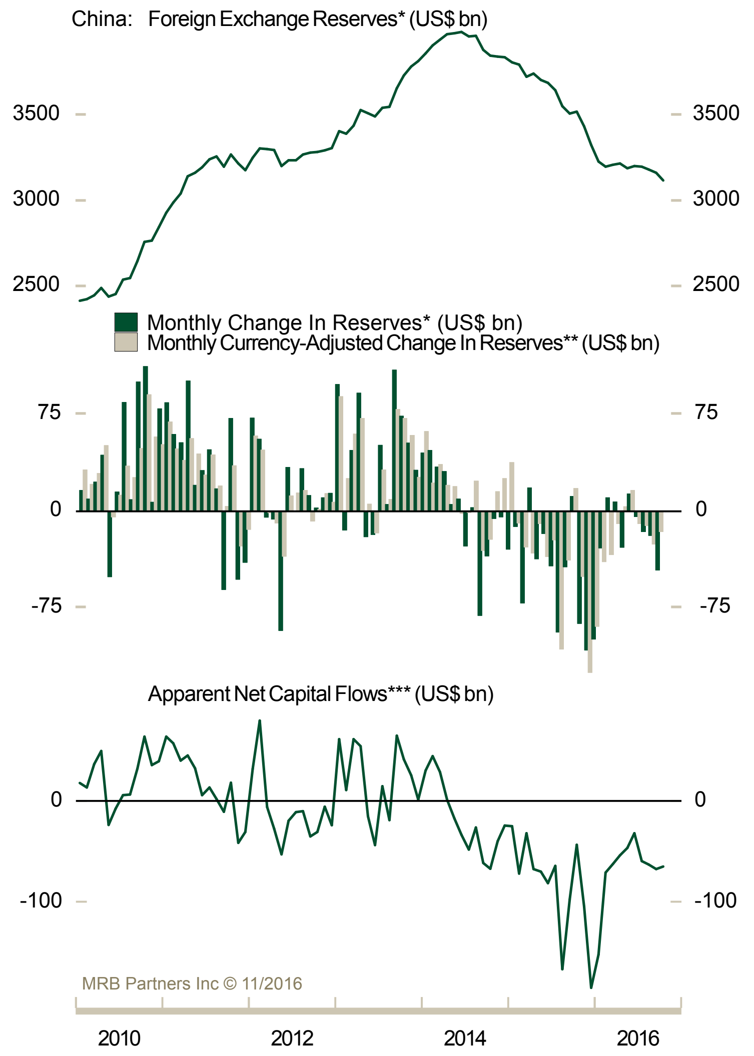
a national emergency[2]. We strongly believe that going down this route would be highly detrimental to the U.S. and global economy[3]. It would also clearly be negative for Chinese and global risk assets. We assume such an aggressive policy shift is unlikely.

Final Word: *Trump's policy preferences seem reasonably clear—he favors "getting tough" on China to reduce the U.S.'s bilateral trade deficit. However, it is extremely difficult to predict how this will translate into policy action. For now, we assume a gradual ratcheting up of targeted tariffs on some steel and aluminum products is the mostly likely path forward.*

Is Capital Flight Reigniting?

Increased fears of yuan devaluation come at an inopportune time for China, as the currency was already under pressure. China's foreign exchange reserves fell by US$47.5 billion in October, which was the largest monthly decline since February 2016, when "hard landing" and yuan devaluation fears were reaching a zenith (**chart 2**). Moreover, Chinese exports fell by 7.3% over the previous year in October, which, to some observers, might imply a need for further currency depreciation to boost international competitiveness.

Chart 2 October Decline Was Mostly Due To Rising Dollar



* Source: People's Bank of China
** Assumes the currency composition of China's reserves is equal to the global average, as reported to the IMF
*** Merchandise trade balance minus currency-adjusted change in FX reserves

However, most of the decline in the PBoC's reserves last month was due to the currency translation effects on its non-dollar assets. Assuming China's foreign exchange portfolio is in line with the global average, some US$30 billion of the decline was simply due to the 3.1% rally in the dollar (DXY) index. This implies that on a flow basis, China's reserves really only declined by about US$15 bn in October, slightly less than US$22 bn fall in September.

Most of the decline in China's FX reserves was due to U.S. dollar appreciation

Additionally, market signals which typically signal downward pressure on the yuan eased over the course of October. The *MRB Yuan Market Pressure Gauge* aggregates daily data

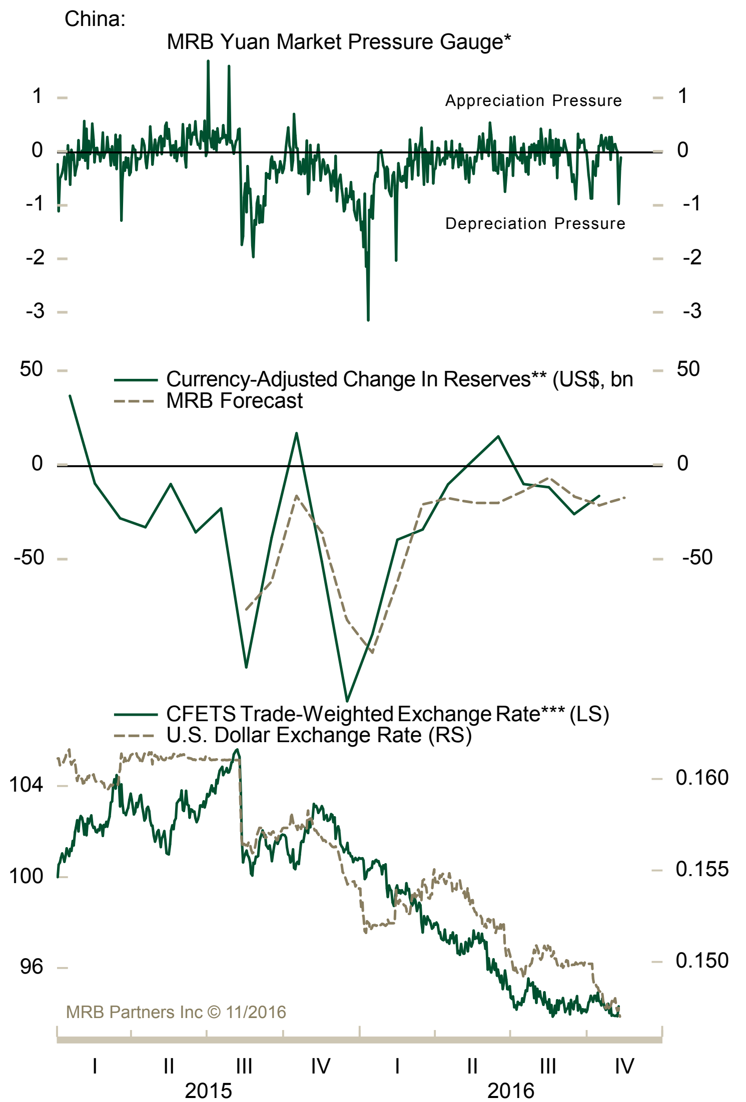
[2] See The Peterson Institute For International Economics Briefing "Assessing Trade Agendas in the US Presidential Campaign" for an overview of the U.S. President's prerogative on trade policy.

[3] **MRB *Theme Reports***, "***Forced De-Globalization (Part I): Benefits And Costs Of Trade***", November 8, 2016 and "***Forced De-Globalization (Part II): Blame Technology Not Trade***", November 10, 2016

into an indicator to estimate the PBoC's intervention in the foreign exchange market (**chart 3**). The indicator is composed of the following:

- The deviation between the PBoC's daily fixing rate and the market-implied fixing rate based on the previous 24-hours of trading,
- One-month option-implied volatility in the yuan/dollar exchange rate,
- The spread between the offshore and onshore 1-week yuan interbank rates,
- The gap between the offshore and onshore yuan spot prices,
- Intraday volatility in the onshore CNY spot market.

Chart 3 Trump Reignited Yuan Pressure



* Standardized; includes measures of volatility, spreads and policy intervention
** Assumes the currency composition of China's reserves is equal to the global average, as reported to the IMF
*** Rebased to December 2014; MRB calculation based on China Foreign Exchange Trade System CNY index weights

This metric captures the signals of PBoC intervention in the post-August 2015 regime, in which the central bank has given up its primary method of exchange-rate management—the daily fixing rate against the U.S. dollar—which is now (mostly) market determined. Recently, the MRB gauge signaled modest devaluation pressure in the run up to the October 1 inclusion of the yuan in the IMF's SDR basket, and the period immediately following its inclusion[4].

This pressure had been easing in recent weeks, but Trump's shock victory appears to have prompted PBoC intervention once again. A simple regression-based forecast using the MRB gauge shows that the PBoC has been selling reserves at roughly the same average daily pace this month as seen in the previous four months, though all of that selling has occurred since November 9.

> Trump's win motivated PBoC exchange rate intervention

There is no reason to believe that the PBoC cannot continue to prop up the trade-weighted exchange[5]. Measures of "reserve adequacy" do not apply to counties with current account surpluses, especially those with official reserve currency status. The

[4] ***MRB Weekly Macro Strategy***, September 30, 2016

[5] See **MRB *Research Highlight***, "***How Far Can China's Reserves Fall?***", February 16, 2016 for a full discussion of the merits of applying the IMF's reserve adequacy ratio to China circumstances.

only plausible metric that China falls short of in these estimates is the notion that reserves should exceed 20% of the domestic money supply (M2). The IMF's own work suggest that this measure is highly problematic, and the sign actually changes in regressions if hyperinflation countries are excluded from the sample (meaning an elevated M2 level actually reduces the risk of a currency crisis, which is equally implausible). Regardless, China's banking system has a huge liquidity buffer. The PBoC could fund about US$2.5 trillion in outflows without worrying about the impact on domestic broad money by lowering the RRR to 6%.

Chart 4 "Old China" Is Booming Again

* Includes electricity consumption, rail freight volume and bank loans; equally weighted; smoothed
** Source: China National Bureau of Statistics

Beyond market pressure, there is little reason to believe that Chinese policymakers would like to pursue significant currency depreciation. The weakest parts of China's economy are now booming on the back of the frothy domestic property market. The "Li Keqiang Index" and other measures of heavy industry indicate the strongest growth since 2013 (**chart 4**). The space for additional monetary easing has now closed, and rising producer prices alongside an overheating property market are likely to put pressure on the PBoC to tighten policy at the margin in the coming months. Additionally, the threat of being labeled a currency manipulator by President-elect Trump is likely to dissuade Chinese policymakers from devaluing the yuan.

China has little need for monetary easing or a cheap yuan

Of course, our baseline economic forecast for China anticipates a decline in property sales and starts at some point next year, which will have negative knock-on consequences for heavy industry, and potentially the yuan[6]. The data released this morning suggest that macroprudential measures imposed at the start of last month were a modest drag on property demand in October, but developers ramped up their investment in new supply. It may take a few more months before it is clear whether additional tightening measures are needed, or if the market has already peaked.

Final Word: *The yuan exchange rate is unlikely to prove problematic for global markets in the near term. Market pressure on the currency has increased since Trump's victory, but there is little policy rationale for devaluation and the PBoC has more than sufficient resources to defend the trade-weighted exchange rate.*

[6] **MRB *China Research Highlight***, "How China's Property Boom Goes Bust (Again)", October 11, 2016

Investment Implications

We expect the PBoC to continue targeting a basically stable yuan on a trade-weighted basis. The PBoC's policy stance should ensure that the yuan outperforms other EM currencies during "risk off" periods of global economic uncertainty, as it has done since November 9 (**chart 5**).

Chart 5 The PBoC Provides Yuan Stability

However, Trump's election could alter the risk/reward for the yuan. Should Trump make punitive action against Chinese exporters a central component of his "100-day plan," it would likely induce very sharp downward pressure on the yuan. In such a scenario, geostrategic concerns would likely guide Chinese policy to a larger degree than macro fundamentals. The outcome would be inherently less forecastable, though yuan depreciation would still likely trigger even worse performance in other EM currencies with weaker national balance sheets.

As such, the upside for the yuan would be limited, while the relative downside risk would be contained by the fact that other currencies would be even worse off in a global trade war. Moreover, we already expect downward pressure on the yuan when the spillover effects from a weaker property market start to show up in the broader economic data at some point next year. Thus, while we recommend maintaining an overweight position on the yuan within an EM currency portfolio for now, we have a bias to pare back exposure to at least neutral in 2017.

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