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MARKETS

China monthly: Prepare for battle

Trade war and currency fight begins

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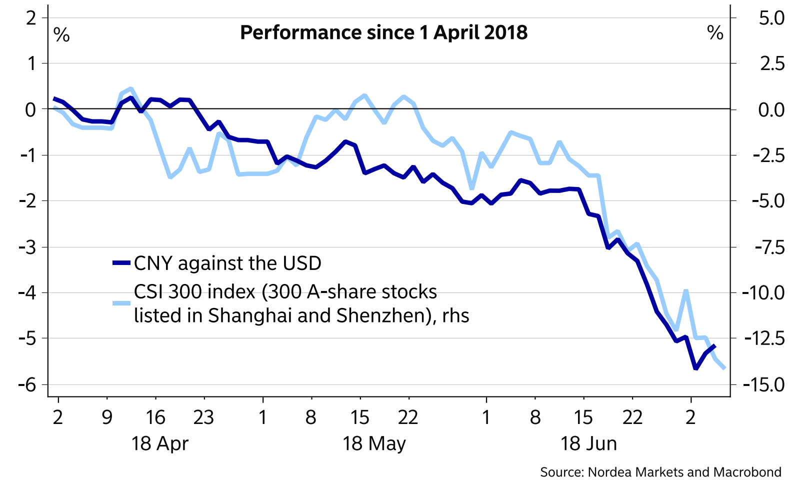
Executive summary

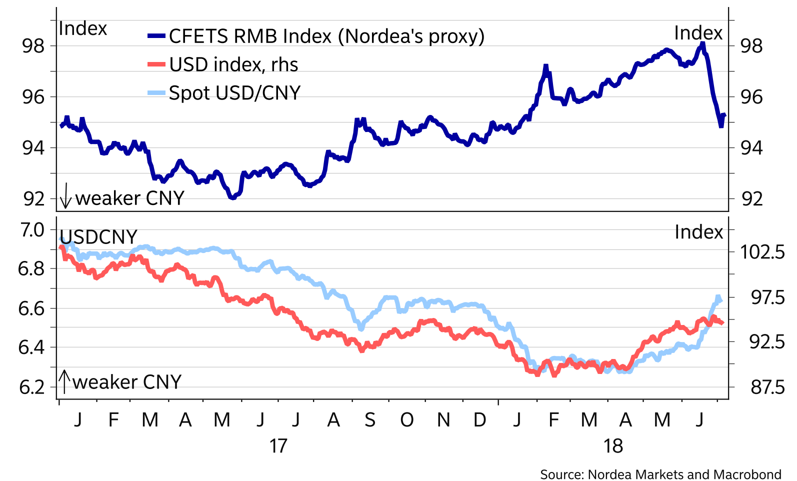
- China has been the centre of global attention during the past month due to:
  – historically large CNY depreciation and sharp stock market decline
  – the official beginning of the trade war with the US
- The extensive CNY weakness against both the USD and the currency basket caught the market off guard. The weakness is overdone, but correction might not happen now.
- The elevated near-term risk surrounding the trade war will likely keep depreciation pressure on the CNY in the coming 3-6 months. However, USD/CNY faces limited upside as the PBoC will likely defend the level of 6.70 to avoid capital flight.
- Trade war with the US officially begins on 6 July, when the two countries levy 25% tariff on USD 34bn of imports from each other. More actions might follow if negotiations fail.
- The announced trade measures are estimated to have limited growth impact. But the trade war is really the beginning of long-term rivalry for global supremacy. The relationship between China and the US will likely remain tense regardless of the outcome of the trade war.
- China's domestic economy is still expanding, but we expect the uncertain export outlook and government efforts in deleveraging and cooling down the housing sector to drag down H2 growth this year.

Too weak, too fast

The CNY weakening driven purely by sentiment

- Q2 has not been a good quarter for Chinese stocks, which lost 13% nor for the CNY that weakened nearly 6% against the USD. Most of the CNY loss came in the second half of June, when it lost 2.5% against the basket.
- The initial CNY weakness was triggered by the USD strengthening. But it has decoupled from the USD in recent weeks and continued to depreciate even when the USD has stabilised. This was due to the market pricing in a full-blown trade war.
- The spot CNY has not lost this much in 13 trading days since 1994. It suggests that the USD/CNY has overshot. Both technical indicators and fundamentals agree.
- Nevertheless, we expect the depreciation pressure to continue in the coming 3-6 months, as a possible escalation of the trade war between China and the US raises concerns about China's growth outlook.

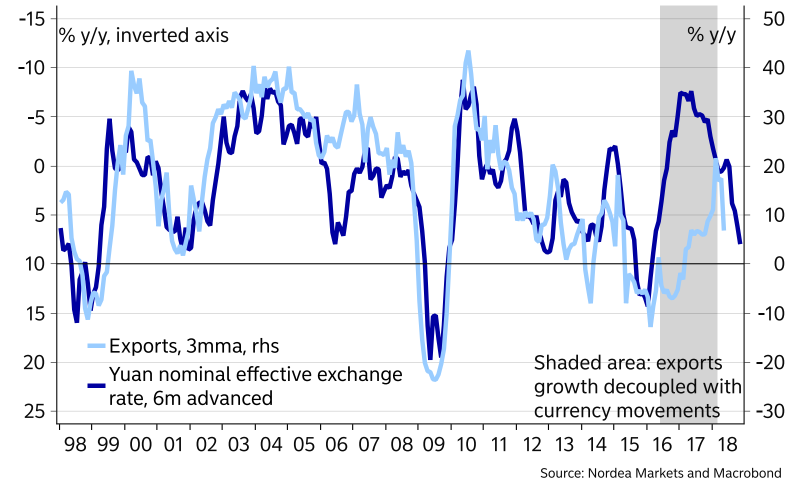




PBoC's line in the sand

6.70 seems to be a crucial threshold for USD/CNY

- As we expected, USD/CNY at 6.70 was an important threshold for the PBoC and triggered verbal intervention on 3 July. The PBoC pledged not to weaponise the currency in the trade war and to maintain FX stability.
- Beijing's stance on the currency is likely to welcome limited CNY weakness, but to avoid extensive depreciation. A weak currency might benefit exports, but risks destabilising the domestic financial market. Given the fresh memory of 2015-16, we expect the authorities to prevent capital flight at all costs.
- Thus, the PBoC will likely maintain a defence level of 6.70 for USD/CNY in the coming months. In addition to verbal intervention, the central bank's toolbox includes the daily fixing rate as market guidance, outright dollar selling and capital restrictions. Since there is no sizeable outflow currently, the authorities will not likely shut the capital borders at this point.



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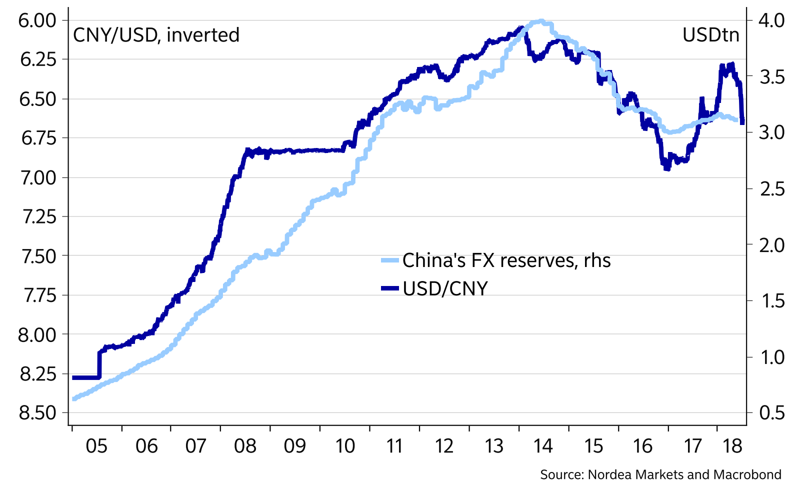

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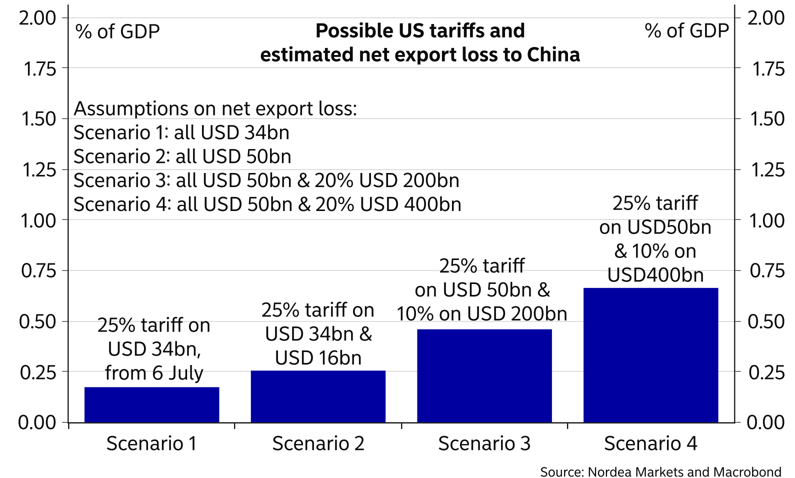
Let the trade war begin

First round of tariff is round the corner

- The long-dragged trade war between China and the US is about to kick off. The first batch of tariffs (25% on USD 34bn of goods) will take effect on 6 July, with USD 16bn following soon after. An additional USD 400bn of goods could face a tariff of 10% if negotiations fail.

- Even if a total of USD 450bn of Chinese imports are levied a tariff, the impacts on the Chinese economy is estimated to be relatively limited. Some imports to the US will likely take place via a third country and mitigate the actual export loss. Moreover, if Beijing's ability to replace export loss with domestic spending is taking into account, the final growth impact is likely marginal.

- If the US decides to tax USD 450bn of Chinese goods, China cannot retaliate equally as it imports far less than that amount from the US. In this case, China will likely utilise non-tariff options like stricter regulations for US businesses in China.



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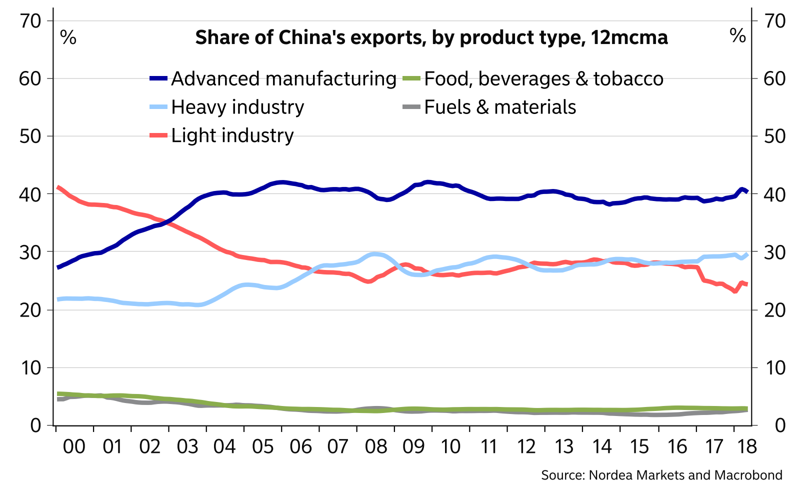
Game of thrones

Trade war is really a rivalry for global supremacy

- We have reiterated many times: the tensions between China and the US are beyond trade disputes, market restrictions and intellectual property rights. It is really the beginning of a long-term rivalry for global supremacy. Even if a win-win trade deal was struck, the Sino-US relation will remain tense for years to come.

- The rivalry is not only about the US feeling its status quo power threatened by China's rapid rise. It is equally about two regimes with different belief systems. That makes it a challenge for them to collaborate on matters ranging from economics to geopolitics.

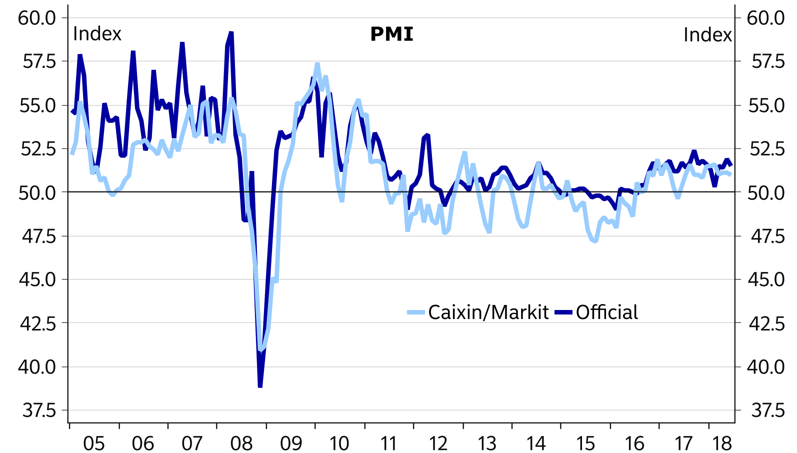
- China's ambition of transforming itself into a technological superpower will challenge its relationship with not only the US but other trading partners as well. Instead of importing high-tech intermediate goods from Japan, South Korea and Germany, China will make them itself. The rising competition inevitably causes fear and dissatisfaction.



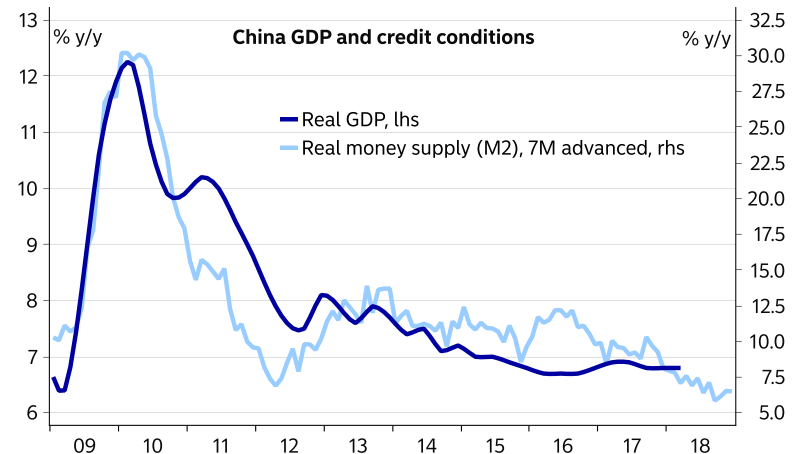
Economic growth is currently steady

A slowdown in H2 is inevitable due to domestic and external factors

- Despite the negative sentiment on China currently, the economy is still performing nicely. The manufacturing sector is expanding, as suggested by the PMI manufacturing indices, robustly above 50. Industrial production is growing close to 7%, higher than recent years' average. Growth in investments and retail sales have disappointed expectations in recent months, but the planned tax cuts this year for corporates and individuals should help stimulating demand.



- Having said that we expect GDP growth to slide down in H2. The ongoing trade war adds uncertainty to China's future export outlook, which could affect manufacturing and investment negatively already this year. The government's effort in deleveraging and cooling down the overheated property sector will drag down growth as well. However, we expect Beijing to halt deleveraging if it becomes concerned about the trade war.



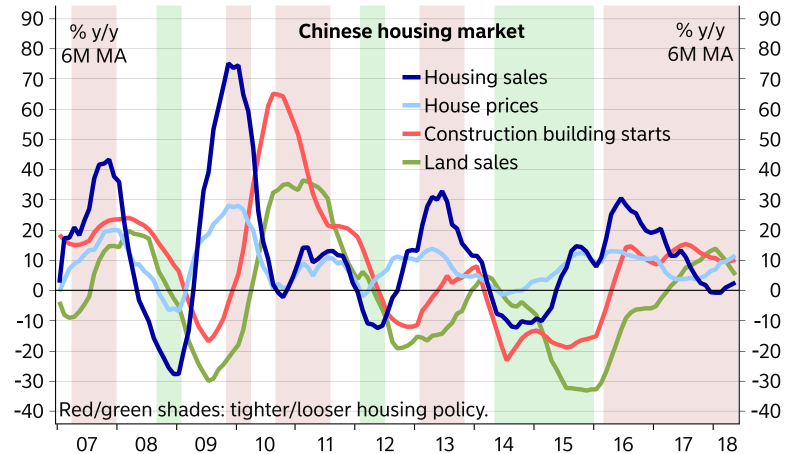
Housing market still resilient

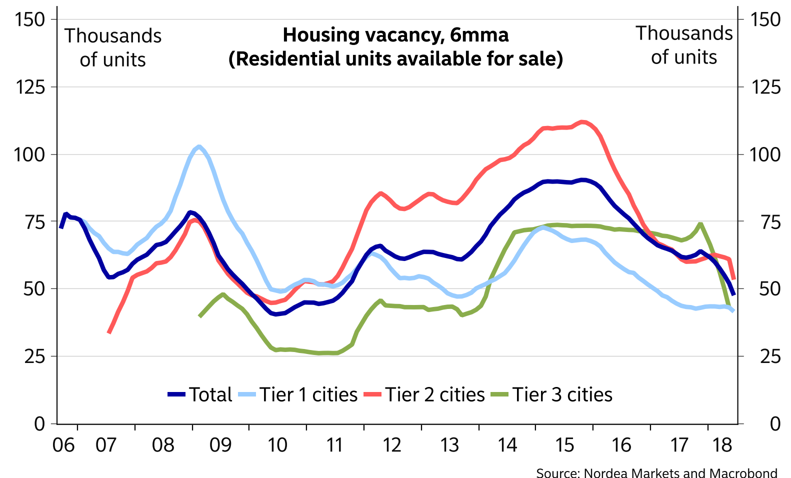
Multi-year low vacancy is likely the reason

- Despite strict regulations on the property market, housing prices are still growing 10% y/y. Growth in housing sales has rebounded. Housing activities have supported growth.

- An explanation to the surprising housing market resilience is a sharp decline in vacancy. This is the result of the government's focus on destocking the housing market. Across city tiers, home vacancy is at the lowest since 2013-14. This is likely the reason behind strong growth in land sales and construction new starts.

- Despite growth risks stemming from the trade war, Beijing has shown no signs to relax its efforts in cooling down the housing sector. As a part of deleveraging effort, developers' opportunity to borrow has been limited. It leaves house sales as the main source of revenue. Therefore, we will likely see vacancy rate coming down further and support a decent level of housing activity.





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