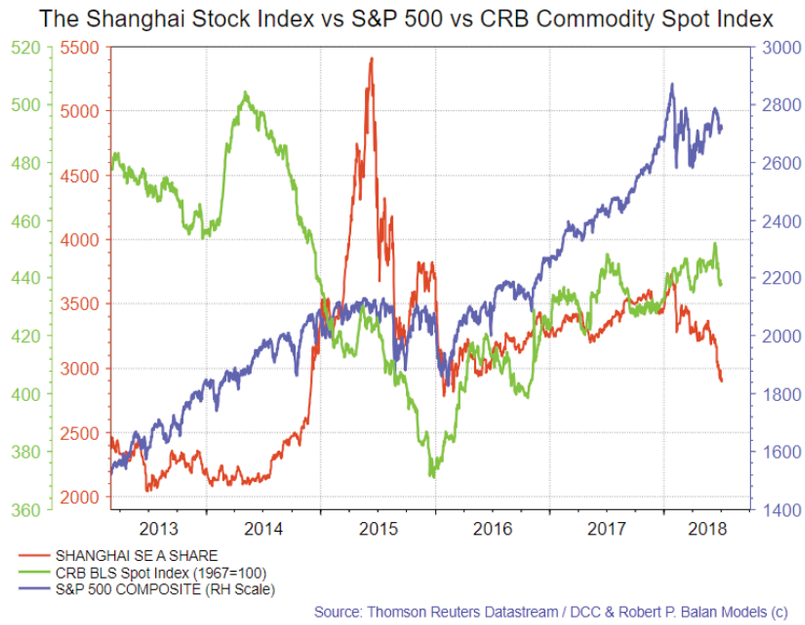
32 / CNY devaluation: China got what it wants, and dealt The Donald a stunning riposte; Mr. Xi will not use the devaluation route any further as weapon in the trade spat

It started out as media speculation: about 5 weeks ago, business and popular media claim that as part of the trade wars, China may have the ultimate weapon at hand, i.e., inject further liquidity and devalue the Yuan (CNY). The point of the media, something which we discussed at length in last month's Capital Observer *("Devaluing The CNY: China's Secret Weapon In The "Trade Wars"? Not Really, But An Opportunity Too Juicy To Ignore, Or Waste"):*

> *The media claims that this squeezes the US Dollar strongly higher, thereby worsening the US competitive situation. On the other hand, it allows China to come through relatively unscathed through the upcoming economic crisis by having a competitive currency. Thereby it can continue to export its products even in the event of a US economic crisis (and subsequently, a global crisis).*

Our counter-argument in the article: "For us, we conclude that devaluing the CNY is not a secret weapon in the "trade wars" -- China has to do it to kickstart a flagging economy. It is also an opportunity that is too juicy to ignore or waste. "

The situation that was subject of the intense discussion – a CNY devaluation – has come to pass, as the China-US trade spat deteriorated into a tit-for-tat exchange of increased trade tariffs for each country's export products. The exchanges of threats and counter-threats has roiled the global financial markets; the Shanghai stock market index (SHSE), which was slowly regaining momentum since early 2016 following a sharp breakdown from a bubble top in 2015, has already fell 12% since mid-May when the trade spat reached a crescendo. The S&P 500 fell as well, but at a less threatening 4%, while the CRB commodity Index fell 3.5% *(see 1st graph on this page)*.



When will the blood-letting end? The obvious answer, of course, is when US and China stop exchanging threats and counter-threats. However, by the time they do, anyone just reading the news will be too late to take advantage of a relief rally which will certainly follow. Equity markets from both sides of the Pacific are less worried about the fallout from the increased tariffs, which most companies can pass off to consumers anyway. **What has caught the markets' attention has been the sharp decline of the CNY in its valuation against the US Dollar. Simply put, will China really use the devaluation of the CNY as a weapon? And if so, to what extent? And what are the consequences?**

Therefore, the primary key to calling the bottom of the risk assets is understanding why China is letting its currency devalue, in the first place. Deliberately devaluing a currency is not a trivial thing to do for a sovereign country. And letting it fall in value abruptly and to a great extent, is fraught with risks that are non-linear. The devaluing country has to be careful as other parts of the economy are also impacted by the sudden swings in the international exchange value of the domestic currency. **In many emerging economies, the currency is a primary expression of domestic "wellness" and is the main link to international trade and capital inflows**. Manipulating the domestic currency value could open cans of worms that would have been otherwise tucked away out of sight.

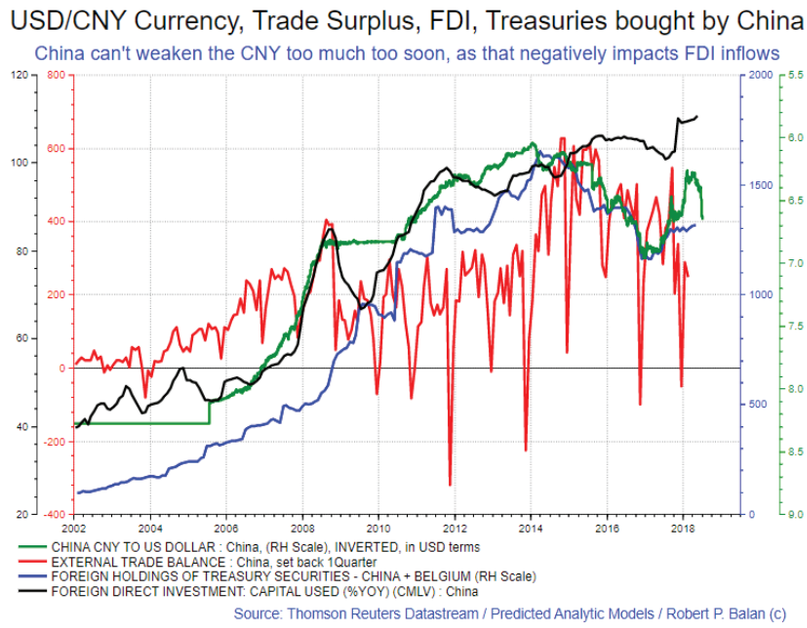
And in the case of China, the risks are even greater. There is fine balance that China has to observe in manipulating their currency (yes, that is what they do). If this is not the case, the CNY would always be undervalued against its peers. Forever.

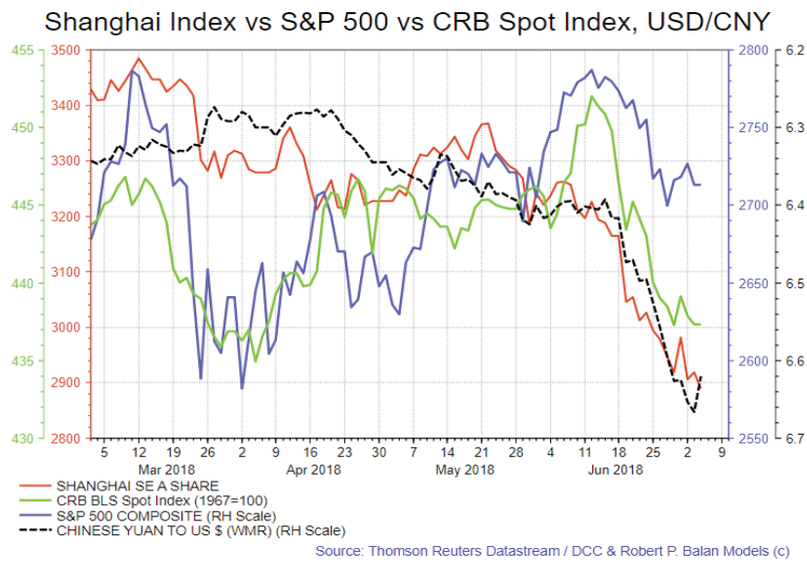
There is a reason why China cannot lower the value of CNY too much too soon. Weaker CNY will negatively impact FDI inflows -- and for China incoming FDI is even more important than higher trade balances (which is like a red rag for Trump, and the EU). Therefore, China cannot devalue CNY steeply in one go. Moreover, Chinese

corporates have a huge overhang of USD-denominated external debts, so a sharp CNY devaluation is driving those companies witless -- hence the collapsing Shanghai Index has been an expression of these corporate fears. *(see 1st chart on this page)*

However, the predictability of Mr. Trump's mindset has given China an opportunity. **Many China observers say CNY devaluation was a weapon -- to us, it is an admission that the economy is in dire straits, which Mr. Xi, et al, expect to get worse. We explained that in last month's Capital Observer. The Chinese were practically counting of this trade spat to get what they want, i.e., a CNY devaluation, and still put the onus of the blame on The Donald.**

In this aspect, the Chinese have largely exceeded. There is no peep from the Trump administration, the EU or from other trading partners about the sharp decline in the value of CNY. Many consider the sharp devaluation as a rightful riposte to Mr. Trump, not understanding that the Chinese have basically manipulated the trade spat narrative to justify doing just that. Of course, they were aided by what we described as The Donald's Pavlovian reaction function to resistance to his demands. It was clear that the Chinese used natural market mechanisms to depress the CNY at the start; when the CNY was not falling as fast as they wanted (because meanwhile, Chinese corporates were blood-letting at the Shanghai Exchange), they engineered sharp declines to get to where they want the CNY to be, ASAP. That started on June 22, which sent the CNY plunging vs the USD until Tuesday, July 3, when the domestic currency plumbed a low at 6.66. That day, the SAFE (agency in charge of FX business in China) started to intervene in small quantities. But on Wednesday, July 4, when many FX traders are off the trading desks due the US Independence Day holiday, the agency came out in force. The CNY staged a remarkable comeback rising





1,200 pips in 24 hours after the PBOC issued a "red line" on further devaluation *(see 2nd graph on this page)*.

So, it's over then? Further weakness in the CNY of course can not be discounted, but considering that the PBoC drew a red line means to say that further declines, if any, will be met with appropriate countervailing force, or else the PBoC will "lose face". In this respect, we should consider that the Shanghai Composite, which after staging a sharp rebound on Tuesday the 3rd during the violent yuan reversal, resumed its selloff deeper into bear market territory Wednesday the 4th. The stock market ignored a better than expected print in the China Caixin services PMI (53.9 vs 52.7 est) -- it closed lower by 1% with Chinese stocks dropping to their lowest since March 2016. The ill-timed PBOC's latest reverse repo net drain of 80bn Yuan did not help as well. **However on the short term, for us, it's all over – China got what it wants -- a devaluation of its currency, and a chance to shove a shiv up Mr. Trump's figurative behind**. When China's FX regulator say's China is confident of maintaining the CNY basically stable, and keep it at reasonable level, then that is what will happen. They will have to keep the CNY "stable" because Foreign Direct Investments (FDI), which have been

slowing, will actually fall three to 4 months from now – that is pretty much baked in the cake. **Therefore, a stable CNY is desired to make sure the fallout from slowing FDIs will not go out of control** *(see graph on this page)*.

Summary:

We believe that the worse is over on the short term, and there will be no more sharp devaluation of the CNY – further declines will now be working against China in the longer run. The trade spat has not blown over, it is true, but if exchange of words do not translate into declines in the value of the domestic currency, then fallout in global risk assets will be limited. The Chinese are also now leery of a repeat of the early 2016 partial CNY devaluation which triggered a large amount of capital flight from China. The devaluation was widely misinterpreted as the start of a downward trend, hence it only accelerated the capital outflows. As a result, the Chinese central bank, the PBoC had to spend $1T of its forex reserves in order to stem the rot and to impose strict capital and currency controls to throw sand in the wheels of the capital flight. The Chinese will also be likely leery of the Fed's desire to tighten policy further and shed a significant portion of its balance sheet – a double whammy which will serve to strengthen the US Dollar. Even if the PBoC will keep the CNY level "stable," a much stronger US Dollar will make the CNY weak in relative terms, and therefore the domestic currency will have to be shored up, so as not to trigger any weak CNY syndrome again. We believe that the Chinese will not use this "weapon" again in the trade spat with The Donald.