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Investment Strategy Bulletin

The US-China trade stand-off and what it means for FX markets

Investment Solutions

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Key takeaways

- US-China trade talks appear to have turned into a stand-off. The silver lining is that both sides have agreed to continue with the negotiations.
- Our central scenario remains that a deal will be reached in the end; however, resolving all differences by June is now less likely.
- We think there is still a chance that significant progress will be made in the G20 meeting (28-29 June). Equally likely, things could drag on for a number of months before the situation is resolved.
- This warrants cautious management of FX exposures. More specifically, we now think that the US dollar will remain resilient against high-beta G10 currencies for the time being. EURUSD is likely to stay in a tight range while the yen should be the main beneficiary.
- USDCNY is subject to more upside in the near term. More broadly, in EM FX, we have turned neutral and now prefer relative value trades that we think can benefit from further CNY weakness.

The latest developments

What a difference a week makes. Early in the month, investors were positioned for the announcement of a trade deal between the US and China, effectively removing a big source of uncertainty for global growth and asset prices. However, US President Trump's tweet on 5 May turned the situation on its head. Mr Trump accused China of backtracking on a number of initially agreed principles to be included in the trade deal, and threatened that this situation could lead to further increases in US tariffs on imported Chinese goods.

Despite the harsher rhetoric, the Chinese delegation, led by Vice Premier Liu He, arrived in Washington to engage in a two-day discussion with the US (8-9 May 2019). While the talks did not lead to a full-blown collapse in negotiations – as some might have feared – they did not manage to break the gridlock, either. As a result, the US increased tariffs from 10% to 25% on USD 200 bn of Chinese imports and announced that it was making preparations for the imposition of a 25% tariff on the remaining USD 325 bn of Chinese products. In retaliation, China announced that it would increase some of the tariffs (up to 25%) it had imposed on USD 60 bn worth of US products.

That said, following the conclusion of the discussions, both sides characterised the talks as "candid and constructive" and pledged to continue with the negotiations. The next official point of contact is likely to be the G20 meeting in late June.

Our scenarios going forward

Following these developments, we have modified the probabilities of the scenarios we discussed in last week's Investment Strategy Bulletin ("A serious setback in US-China trade talks? What could happen next and market implications"). Specifically:

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- **Scenario 1 (40% probability, vs 60% before)**: A trade deal is reached in June, or there is a significant breakthrough that paves the way for a deal shortly afterwards. This would be comprised of a number of commitments on both sides, including a commitment for the future removal of all or some of the tariffs currently in place.
- **Scenario 2 (40% probability, vs 25% before)**: A trade deal is postponed to late 2019 or 2020. Minimal progress is made by June, and tariffs remain in place. However, the two sides pledge to continue the negotiations. A deal is potentially reached later than anticipated. In this scenario, 1) sentiment does not fully recover: negotiations continue and dispense some relief, but uncertainty about the end result persists, and 2) the implementation of tariffs for a protracted period implies that the recovery of global trade is delayed. This raises the risk of negative spillovers to the domestic side of the economies, dragging global growth further down.
- **Scenario 3 (20% probability, vs 15% before)**: Here, we assume a complete breakdown in negotiations and a full-blown escalation of the trade war. A significant disruption in trade would feed through to domestic demand, making it difficult to avoid a global recession.

FX market implications

Given the high degree of uncertainty and the recent U-turn in the trade discussions, we feel that our working assumption is somewhere between scenario 1 and scenario 2 (hence the equal probabilities assigned). What was considered to be initially a "bluff" morphed into actual implementation of additional US tariffs, with the threat of more to come.

Under this working assumption – i.e. a deal is reached in the end but the path could equally be short or long – it makes sense to adopt a more prudent approach to the management of FX exposures.

As we have noted on numerous occasions, the macro backdrop was conducive to carry trades largely because of the Federal Reserve (Fed)'s) pivot towards a dovish stance and expectations that the US-China trade dispute would be resolved. The new uncertainty surrounding the latter point is bound to disrupt sentiment and FX positioning.

More specifically, we now think the **USD will be resilient against high-beta G10 currencies such as the AUD, NZD, and CAD** (any updates to our forecasts will be provided in the next few days, in our May edition of the FX Monthly).

We plan no changes to our EURUSD forecasts (Q2 19 at 1.12 and Q4 19 at 1.14), because the euro has been used as a funding currency this year. To the extent that carry trades see a reversal, the EUR should receive some support, at least enough to offset any trade-related weakness.

Naturally, **we believe the JPY will continue outperforming** as it is the only remaining global safe haven, and the latest positioning is still quite stretched on the short side. **The CHF is likely to benefit**, albeit to a lesser extent. The history of the last four years or so has revealed that in periods of global risk aversion, the CHF underperforms the JPY. The Swiss currency performs particularly strongly only when the risks are specific to the euro area. **This is why we feel that JPYCHF has further upside from here**.

Turning to the CNY, we will be updating our forecast trajectory for USDCNY soon in order to factor in the increased likelihood of more drawn-out and difficult negotiations. We will still base our forecasts on the assumption that the hurdle remains quite high for a fundamental change in China's stance on the currency, which is currently being signalled as the stability of the yuan's value vs the CFETS basket above the implicit lower bound of 92. (The CFETS basket tracks the value of the yuan against various currencies.) The reason for this view is simple. Despite the latest setback, trade diplomacy is continuing ahead of the G20 summit in June, and any action that allows the yuan to depreciate past the implicit lower bound at this juncture would incur significant costs for Beijing in terms of private capital outflows, drain in foreign currency reserves (as a new lower bound has to be established eventually), and the loss of goodwill from trading partners other than the US. Furthermore, China still has non-monetary policy instruments to provide additional offsets for the negative impact of the tariffs. If diplomacy fails to produce a ceasefire by June, however, the temptation for and pressure on Chinese policymakers to consider an outright change in its currency guidance will rise.

More broadly, EM FX is likely to struggle, because the potential trade disruption and hit to sentiment will make investors far more cautious towards pro-risk EM assets. At the same time, the prospect that negotiations will continue (i.e. the avoidance of a complete collapse in trade talks) should be a positive factor, at the margin. Additionally, in sharp contrast to early H2 18, the Fed is now on hold and the US 10-year yields are considerably lower (by about 80 basis points), acting as a pressure relief valve.

Taking everything together, **we have now turned neutral on emerging market currencies** pending a significant breakthrough in US-China negotiations. Since the CNY will be at the forefront of these events and further downside in the near term seems likely, we would prefer to look into relative trades, i.e. to anticipate outperformance for FX with low beta to CNY and underperformance for those with high CNY beta. This implies expecting upside in RUB against TRY and ZAR[1]; in LatAm, some upside from BRL against MXN and CLP; and in EM Asia, upside of PHP and MYR against KRW, IDR and INR (see table 1).

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[1] Although there are other currencies with a lower beta (correlation) to CNY in EEMEA, the use of RUB mitigates some of the negative carry of being short the Turkish lira.

Table 1: Historical impact of a 1% increase in USDCNY

	Currency pair	Based on estimates over the last 60 days	Based on estimates over the last year
Main EEMEA currencies	USDTRY	1.8%	1.1%
	USDZAR	1.5%	1.6%
	USDHUF	0.6%	0.8%
	USDRUB	0.6%	0.7%
	USDPLN	0.5%	0.8%
	USDCZK	0.5%	0.6%
	EURHUF	0.3%	0.3%
	EURPLN	0.2%	0.3%
	EURCZK	0.1%	0.2%
Main LatAm FX	USDCLP	1.2%	0.8%
	USDMXN	0.9%	0.7%
	USDBRL	0.0%	0.5%
Main EM Asia FX	USDKRW	0.7%	0.5%
	USDINR	0.6%	0.4%
	USDIDR	0.6%	0.5%
	USDSGD	0.5%	0.5%
	USDTHB	0.4%	0.4%
	USDMYR	0.3%	0.3%
	USDPHP	0.0%	0.2%

Sources: Bloomberg, Lombard Odier calculations

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