From West to East

Weekly Investment View
8th July, 2018

The trade spat is becoming a currency war

On Tuesday, the yuan began to reverse a 5.9% decline that started on 13th April as the People's Bank of China set the currency fixing stronger than the market expected. It was a clear sign that they were pausing in what seemed like the deliberate devaluation of the Chinese currency.
Indeed, the downward movement started exactly in the same way, with the central bank surprising traders by setting the daily fix weaker than expected. Yi Gang, the Governor of China's central bank, on Wednesday added some soothing words, saying the country was not using its currency in the trade war. However, the events suggest the 5.9% devaluation between 13th April and 2nd June was not only market-driven.
In February, the yuan halted an eight-month streak during which it rose 10.5%. The gains started as President Donald Trump took office, promising to name China as a currency manipulator. In January 2017, the yuan was trading at almost 7 per dollar, its weakest level in a decade.
Then, last February, shortly after President Trump began to promise tariffs on Chinese products, that appreciation stopped and the yuan began to trade in a band between 6.25 and 6.35 per dollar. The currency stayed at the bottom of that range as a visit of US trade officials to Beijing approached. Finally, on 13th April, after having announced tariffs on steel and aluminum imports on 8th March, the Treasury Department and the Office of the US Trade Representative said they were mulling restrictions on Chinese investment into US advanced technology. The gloves were coming off.
China's ability to retaliate against US tariffs is limited given the large trade imbalance between the two countries. The US imported US$462 billion in goods from China in 2016 and exported US$115.6 billion. The US bought one fifth of the US$ 2.27 trillion that China exported, making it the top destination for the Asian country's products while China's imports from the US are a much smaller portion of foreign purchases.
China can still impact American trade with the rest of the world. By devaluing the yuan, Beijing forced the hand of other nations to let their currencies slip too – or risk being less competitive – and therefore helped the dollar strengthen. Between 16th April and 28th June, the dollar index increased 7.2%. That, in turn, is making American products more expensive everywhere, which may cause the US trade deficit to widen.
The funny thing is that the Chinese yuan is not even part of the dollar index. The biggest component is the euro, which has a 58% weight, followed by the yen, at 13.6% and the pound at 11.9%. However, since the Federal Reserve began to hike rates, the one-year correlation between the euro and the Chinese yuan has been the highest in at least 30 years. The same is true for the Japanese yen, the Canadian dollar, the Swedish Krona the Swiss Franc and the British pound.
The move may help explain the recent rise in US Treasuries even as benchmark rates increase.

"China's drive to devalue the yuan means it has to buy more US Treasuries."

China succeeded if it was trying to show the US it can also impact American trade. However, in the process the country has unleashed a host of unintended consequences.
The one closest to Beijing was the sell-off in its local stock markets. The Shanghai-Shenzhen 300 index is down 14% in the past month alone, a period in which the yuan devalued 3.5%. The index is down 23% since this year's high on 26th January. The losses beat the 21% drop recorded in the month following an unexpected 2% devaluation of the yuan on 11th August 2015.
Then, quiet government intervention halted the slide. This time, again, there are signs Beijing has started to enter the stock market to stop the bleeding. Last week, the index staged a small intraday gain twice, always led by stock of large state-owned companies. The same pattern was seen when Chinese shares stopped dropping in 2015. Later, it transpired that the Chinese state-owned pension plan was buying the biggest state-owned companies, helping the index recover.
In 2015, the sudden shift also caused large outflows. China's current account balance dropped to US$202 billion at the end of 2016 from US$304.2 billion a year earlier. It continued to drop in the first half of 2017.
Fears of yuan devaluation onshore also pushed Chinese investors into dollar-denominated assets onshore. All through 2016, frenzied trading in iron ore in the Dalian Commodities Exchange pushed the price of the resource up 81% in China. In the past three weeks, as the yuan devaluation accelerated, the Dalian iron ore price has rallied 2.7%, while the same contract in Singapore dropped 3%.
If China is now trying to contain the potential damage to its economy and markets from the quick slide of its currency, the US authorities may also have to revisit their strategy. A stronger dollar reduces American exports and could become a drag on the economy. The Federal Reserve Board's economic model predicts that a 10% rise in the value of the dollar could increase the output gap by 75 basis points over two years. In other words, the US could see growth slow down. Inflation also slows under this scenario and, most important, the trajectory of benchmark interest rates shifts as well.

"If the dollar continues to strengthen, it could reduce the pressure on the Fed to raise interest rates two more times this year."

The US economy, however, is so hot that not even a stronger dollar may stop the Fed from making two rate hikes this year, as it signaled in its last meeting. Last week offered further proof of that as 213,000 new jobs were created in June, a number that beat median estimates of economists surveyed by Bloomberg. Unemployment rose to 4.0% from the 18-year low of 3.8% recorded the month before. That, however, was partly attributed to more people looking for jobs, a sign of economic strength.
Manufacturing jobs growth, in particular, doubled, an important outcome for the Republican Party ahead of midterm elections for Congress. Donald Trump rose to office partly thanks to the electorate in states associated with the steel, aluminum and car industries. Hence, talk of tariffs so far has centered around these sectors. Recent state GDP data already shows manufacturing accelerating in these states. In the overall US economy, manufacturing expanded 2.9% last year, four times faster than the average growth in the past decade. These results may help explain why the Trump Administration has been emboldened and slapped tariffs on US$34 billion of Chinese products last week.
The positive jobs message boosted US equities on Friday, and the S&P 500 rallied 0.85%, led by technology and biotech stocks, even as tariffs were confirmed. That was a reversal from the previous week, when defensive sectors outperformed the market amid fears the trade war could impact US growth. Industrial stocks rallied 1.1% too, though so far they have not reflected the stronger growth in the sector. Year-to-date industrial shares in the S&P 500 are down 5%, partly reflecting trade fears. Indeed, many of America's largest listed manufacturers are exporters. A higher dollar reduces revenues in their home currency and they are the most likely target of reprisals.

"Most US companies, particularly mid- and small-caps, focus on the domestic economy and would benefit from strong growth while being relatively insulated from a trade war"

Oil could also dampen US economic growth. Furthermore, the Fed's model predicts that a US$10 rise in oil prices has a lasting effect on inflation.
It is no wonder Donald Trump has been asking OPEC to curb oil prices. Even with manufacturing jobs on the rise, US consumers paying more at the pump may choose not to vote for Republicans.
Brent crude did fall 2.9% last week to US$77.11. That, however, was due to an unexpected increase in US inventories and news that Saudi Arabia increased daily output to 10.5 million barrels, not a response to President Trump's 'oil tweets'. Oil prices may be stabilizing, but they are not showing signs of weakening. Supply is still very constrained, especially as Iranian oil is being taken out of the market at a time when Venezuelan, Nigerian and Libyan exports are dropping.

"Brent crude can be expected to continue within a projected range of US$65-US$90 until the end of the year."

The commodity could even test the top of the band toward the end of the year after US midterm elections in November.
India stands to lose from China's upward pressure on the dollar and rising oil prices. The result has been seen on the value of the rupee, which closed at a record low against the dollar on 5th July. The Indian currency has lost 7.6% of its value so far this year. That, along with higher energy prices, has spurred inflation to nearly 5% in May, and could force the Reserve Bank of India to increase interest rates again after a surprise 25 basis-point hike earlier this year.
The good news, however, is that the rupee is now probably at a near-neutral level, in purchasing power parity terms. **A favorable monsoon season could help the rupee, which could also recover at any sign of a slowing Fed.**
Finally, higher oil prices should continue to benefit stocks and bonds of oil-producing countries in the Gulf Cooperation Council. The commodity tailwind seems to be finally making it into the minds of investors. The Dubai Financial Market Index rallied 2.1% last week after losing 4.8% in June. Stocks in Dubai benefit not only from higher oil, which may boost the UAE's economy, but also from multi-year low valuations. Kuwait was the other star in the region as foreign investors front-run an expected inclusion of local stocks in the FTSE and MSCI emerging market indices. The Boursa Kuwait index gained 4.0% last week, after rallying 3.3% in June. Similarly, Saudi Arabia's Tadawul All-Share Index rose 1.3% last week after gaining 1.9% in June, still buoyed by the inclusion in the MSCI and FTSE indices as well. Bonds are also performing, with the Bloomberg Barclays Middle East Composite index gaining 1.3% last week following a rise of 1.5% the previous week.
The moves, however, reflect more than excitement about index inclusion or higher oil prices. GCC nations have recently taken several steps to diversify and modernize their economies, and that is starting to bear fruit.

"Index inclusion reflects growing international awareness of opportunities in the GCC as the region enters a new stage of strong growth."

INVESTMENT SUMMARY: The FAB Asset Allocation Committee meets this week. In the previous meeting, the AAC decided to favor stocks from developed markets over emerging markets, given the strength of the dollar and rising US interest rates. Within that context, the AAC also decided to reduce its overweight position in Indian equities. The AAC believes the US economy is going through a long growth cycle that favors US stocks. However, members will be watching earnings reports of American companies, which begin in earnest this week, for indications of whether corporate revenue growth remains healthy.

For inquiries related to this article, please contact:

Christofer.Langner@fgb.ae

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