

RMB Watch

US-China Tensions Back in Focus

Friendship Cracking, CNY To Underperform Peers

Key View:

- USDCNY has rebounded back around the 7-figure after the forced closure of the Consulates in the US and China. This pair is in locked steps with offshore USDCNH. That said, we still see broad USD weakness guiding the USDCNY lower given the prolonged battle with Covid in the US (relative to its peers including China), increasing concerns on its fiscal gap and massive QE measures that are structural drags on the greenback. A key resistance is seen at 7.0350, marked by 200-dma while 6.98 guards downsides.
- In a USD-negative environment, the CNY could underperform its peers. The uncertainty trajectory of the US-China relation could keep the CNY on the backfoot vs. EUR, GBP and even its Asian peers. Thus, in such a setting, our bearish MYRCNH call is abandoned.
- With China treated increasingly like Russia by the US, it is also worth noting the rise of its digital currency although its use to circumvent any financial sanction would be highly unlikely in the near-term. This edition of the RMB Watch has a small introductory section on the digital currency that is officially known as Digital Currency, Electronic Payment (DCEP).

What We Watch:

- 31st Jul - NBS Mfg, Non-Mfg PMI (Jul)
- 3rd Aug - Caixin Mfg PMI (Jul)
- 5th Aug - Caixin Non-Mfg PMI (Jul)
- 7th Aug - Trade (Jul), Foreign Reserves (Jul)
- 10th Aug - Inflation

Analysts

Saktiandi Supaat
(65) 6320 1379
saktiandi@maybank.com.sg

Fiona Lim
(65) 6320 1374
fionalim@maybank.com.sg

Christopher Wong
(65) 6320 1347
wongkl@maybank.com.sg

Tan Yanxi
(65) 6320 1378
tanyx@maybank.com.sg

Update on Our Calls from the Last Watch

USDCNY has rebounded back above the 7-figure after the forced closure of the Consulates in the US and China. This pair is in locked steps with offshore pair. On net, we still see small downside risks to USDCNY and USDCNH. CNY to underperform most other non-USD currencies.

A Step to Cut Ties

The US Consulate in Chengdu was offered the same courtesy after the US suddenly ordered the closure China's Consulate in Houston within 72 hours. China was allowed 5 Consulates in the US just as the US was allowed 5 in China. Now, they are each down to 4. The Consulate in Chengdu is located in the Western part of China and not coincidentally, strategically close to the Sichuan, Yunnan and Guizhou provinces along with the widely scrutinized region of Tibet. On the other hand, the Consulate in Houston had covered eight southern US states including (Texas, Oklahoma, Louisiana, Arkansas, Mississippi, Alabama, Georgia, Florida and Puerto Rico).

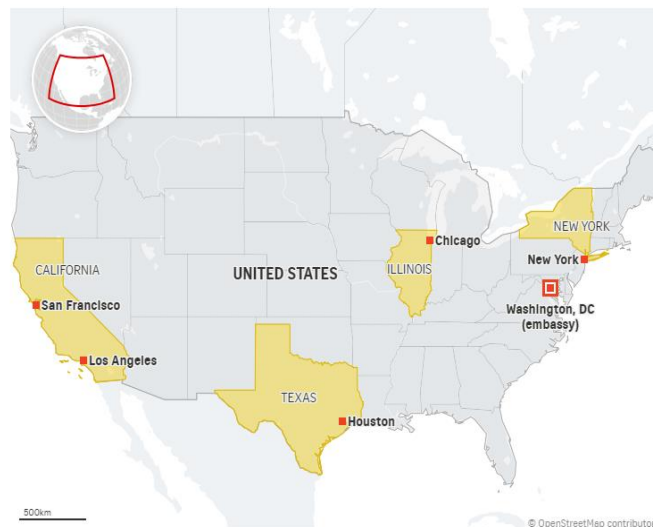
US Consulates in China

■ US consulates in China



Chinese Consulates in the US

■ Chinese consulates in the US



Source: Straits Times

Consulates are typically established to support the commercial affairs of its citizens in the foreign country. In China's words [here](#), the consular services amongst others is meant to serve as a "bridge to strengthen cooperation between China and consular district, and deepen friendship between our two peoples". Regardless of the extent to which businesses and individuals would be affected within the areas supported by the Consulates or whether the respective nations can continue to monitor strategic interests, the move to kick Consulates out can be seen as a significant step of decoupling, initiated by the US. Russian consulates in Seattle and San Francisco were forced to close in Mar 2018 and Sep 2017 respectively.

Pompeo Rallying Chinese Against Xi and Gathering a Coalition

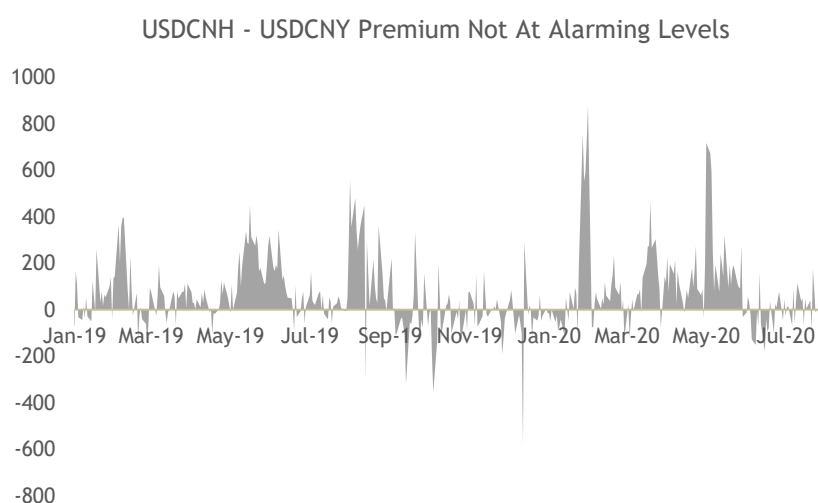
US Secretary of State Pompeo is at the forefront of the recent spat with a speech (23rd Jul) rallying Chinese citizens to change the Communist Party's behaviour, accusing China President Xi of believing in a "bankrupt totalitarian ideology". He even went as far as suggesting that US-China trade deal "no longer ranks first in issues with China" and said that "Communists almost always lie". This came after his trip in London and Denmark earlier this week which saw him mention about gathering a "coalition" to deal with China as a "threat". UK Raab seemed to have concurred and suggested further action at the "G7 level".

That same day, Trump chimed in saying that the "trade deal means less to me now than when I made it" but he also added that there was a record purchase of corn made by China recently. This suggests that while he is still likely to treasure the trade deal, the unravelling Covid situation could force Trump to consider more aggressive actions against China in his bid to get re-elected.

USDCNH spiked above the 7.02 upon the forced closure of the Consulates. The mentions of the trade deal (hints of some risks there) dampened risk appetite even more. The alleged "forced entry" by the US law enforcement agents into China's Houston Consulate after the diplomats had left last Fri likely lifted the USDCNH to cross the 7.03, even if moves there were brief. The strength of the EUR dominated the FX space thereafter into Asia this morning. Since 21st Jul, CNY has also weakened considerably against regional peers, resulting in the official CFETS RMB index to fall 0.6% between 17th Jul to 24th Jul last week.

With the sudden rise in the USDCNH, it is also useful to check if the usual metrics indicate an increasing expectations of yuan depreciation. The USDCNH-USDCNY premium has widened a tad but not as much as what we have seen in depreciating episodes in Jan, Mar and May.

USDCNH-USDCNY Spread is Still at Modest Compared to Recent Episodes

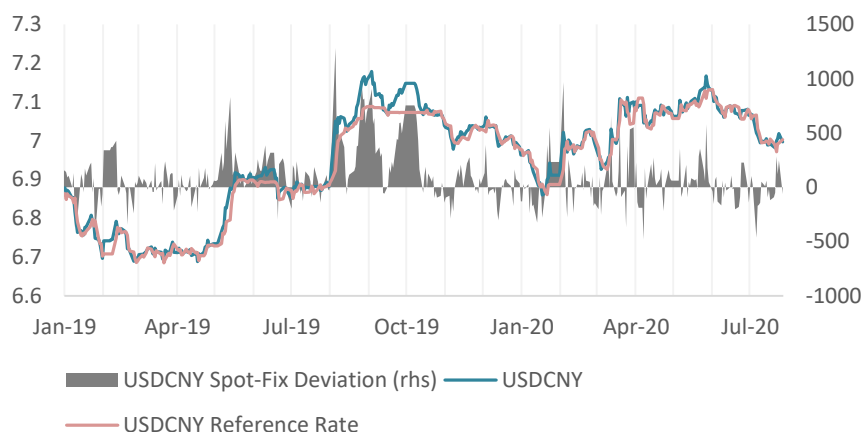


Source: Bloomberg, Maybank FX Research & Strategy

The differential between the daily USDCNY fix by PBoC and USDCNY spot did not widen substantially too, suggesting some resilience in the CNY vs. the USD.

Depreciation Pressure is Not Seen Increasing Judging by the Spread Between the USDCNY Fix and Spot

USDCNY Spot - Fix Deviation Remains Modest

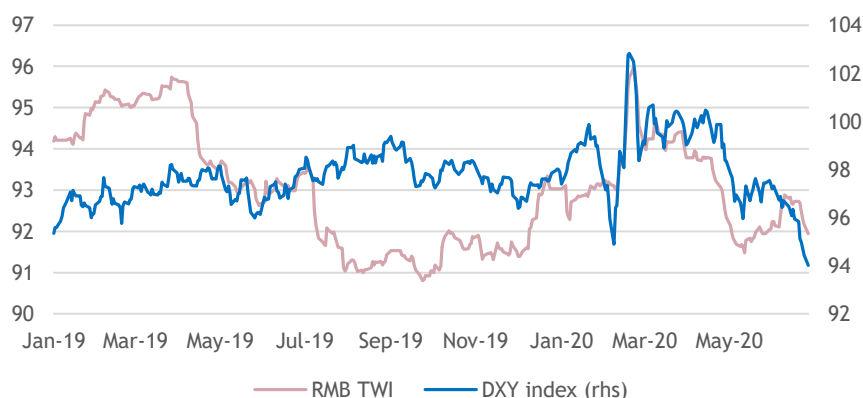


Source: Bloomberg, Maybank FX Research & Strategy

The lack of depreciation pressure on the CNY vs. the USD could be due to the fact that the USD is on a different path this year vs. 2018-2019. Factors including 1) massive QE measures in the US and 2) widening fiscal deficits along with the 3) reasonable expectations that the US could see a delayed recovery vs. the rest of the world given its relatively prolonged battle with Covid have placed the greenback on the backfoot. This is in contrast to China's management of Covid-19 and economic recovery trajectory as well as PBoC's restraint in easing further. Hence, the CNY's underperformance that tends to surface in times of US-China tensions is somehow mitigated by USD's structural weakness.

China's Idiosyncratic tension with the US leaves the TWI in lock steps with USD Weakness

CFETS RMB Index in Locked Steps with DXY



Source: Bloomberg, Maybank FX Research & Strategy

In addition, the step-up in US aggression comes just ahead of elections and a change in administration in Nov could mean that the current spat may not intensify much beyond this period. While an administration headed by Biden would not be China-friendly, it is also likely that Biden does not have the baggage of the COVID-19 mismanagement and that could afford him more room to be less confrontational with China and more capacity to focus on resolving the epidemic at home as well as economic recovery. Correspondingly, any weakness of the CNY is less likely to sustain, especially against the structurally weak USD. That said, given the uncertain trajectory of the US-China relations, CNY is also more likely to underperform other non-USD peers.

On net, we still structural weakness in the USD to tilt the risks to the USDCNY to the downside. However, CNY will see less appreciation, leading to an underperformance vs. other non-USD currencies in an environment of USD weakness.

With China being treated increasingly like Russia (recall that Russia also had two of its Consulates in the US ordered shut in 2016-2017), Iran, North Korea, there is an increasing possibility of more economic sanctions used against China just as economic sanctions were used against Russia, Iran and North Korea. In addition, Pompeo seems to be rallying other countries to form a “coalition” that looks upon China as a “threat”. This is a shift towards from Trump’s whimsical tactics to a more strategic approach. While the trade war has been an unilateral move by the US against China, Pompeo’s recent comments suggest he is now seeking more international support via various issues (China’s management of Covid, imposing the National Security law on Hong Kong, national security risks posed by Chinese technology firms amongst others). It is thus ever more likely that China may step up its work on its digital currency as a way to get around the USD clearing should the US makes the (still unlikely) move to impose financial sanctions on China. We do see that scenario as extremely unlikely given the still substantial volume of trade between the two nations. Any economic, financial sanction could result in great economic pain. With the US and China already on the collision course in the medium term however, it is worth noting the recent developments on the digital currency.

Mini Introduction on China's Upcoming Digital Currency, Electronic Payment (DC/EP)

When?

The former PBoC Zhou Xiaochuan set up the Digital Currency Research Institute of the PBoC and the research on cryptocurrencies and digital currencies started in 2014. Since 2019, around the same time that Facebook was promoting its stablecoin Libra, China also expedited the development of the digital currency known as the Digital Currency Electronic Payment (DCEP). In Aug that year, Chief of the Research Institute Mu Changchun told a public forum that it was "almost ready".

What is Known About DCEP so Far?

The DCEP would be issued by the central bank and backed by its fiat currency deposit. Hence it is unlike stablecoins such as Libra which is supposedly backed by a basket of currency. The DCEP is not for speculation and it will not have other prominent characteristics of cryptocurrencies such as Bitcoin. DC/EP, being issued by the central bank, does not necessarily use blockchain technology and it cannot be decentralized.

According to People's Daily, the DCEP would include a digital currency exchange, wallet management and transaction records along with the function to pay and receive the digital coin. Focus of the digital currency is on faster payment and PBoC has even been developing a "double offline payment" technology that allows transactions to be done even if both sides are offline. The digital currency also allows option to conduct transaction without a bank account.

Taken together, the DCEP facilitates ease of payment, allows for better monitoring of transactions with the potential to replace cash. A successful launch of the DCEP could mean stronger policing for counterfeit, money laundering and illegal financing. Monetary policy transmission could also arguably be improved since there is more information on transactions.

Recent Developments

18th Apr 2020 - Shenzhen, Chengdu, Xiong'an and Suzhou will be the first 4 cities to test the DCEP with half of their public sector workers' travel subsidies paid in DCEP. Xiong'an will witness DCEP testing with catering and retail companies. Plans are also made for its potential use at the 2022 Winter Olympics in Beijing.

22nd Apr 2020 - 19 companies including Starbucks, Subway and McDonald's are said to participate in the pilot program for DCEP within Xiong'an. However, a Starbucks spokesperson later told CNBC that the company is "not participating in any digital currency trial in China".

9th July 2020 - Didi Chuxing (ride hailing company) is said to partner PBoC to test the use of DCEP on its smart transport platform. Caixin also cited sources saying that Meituan Dianping, Bilibili and ByteDance Ltd (parent of Tiktok) may also be participating in trials.

USDCNH (Daily) - Could Still be Bearish Bias



USDCNH rebounded recently from its Jul low of 6.9643 to swivels around the 7-figure. This pair may seem to be settling in range-trades within the 6.98-7.03-figure with price actions guarded by Fibonacci levels on either side. However, recent moves are still within a probable falling trend channel and we still see some downside risks on net. Key resistance at 7.0350 (200-dma) and an interim one at 7.0210. Support at 6.9797 (61.8% fibon retracement of the Jan-May rally).

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Published by:



Malayan Banking Berhad
(Incorporated In Malaysia)

Foreign Exchange

Singapore

Saktiandi Supaat
Head, FX Research
saktiandi@maybank.com.sg
(+65) 6320 1379

Christopher Wong
Senior FX Strategist
Wongkl@maybank.com.sg
(+65) 6320 1347

Fiona Lim
Senior FX Strategist
Fionalim@maybank.com.sg
(+65) 6320 1374

Yanxi Tan
FX Strategist
tanyx@maybank.com.sg
(+65) 6320 1378

Fixed Income

Malaysia

Winson Phoon Wai Kien
Fixed Income Analyst
winsonphoon@maybank-ke.com.sg
(+65) 6231 5831

Se Tho Mun Yi
Fixed Income Analyst
munyi.st@maybank-ib.com
(+60) 3 2074 7606

Indonesia

Juniman
Chief Economist, Indonesia
juniman@maybank.co.id
(+62) 21 2922 8888 ext 29682

Myrdal Gunarto
Industry Analyst
MGunarto@maybank.co.id
(+62) 21 2922 8888 ext 29695

Sales

Malaysia

Adoni Mastura Bte Mohamed Idris
Head of Global Markets, KL
adonimastura@maybank.com
(+60) 3 27869106

Singapore

Janice Loh Ai Lin
Co-Head of Sales, Singapore
jloh@maybank.com.sg
(+65) 6536 1336

Joanna Leong Wan Yi
Co-Head of Sales, Singapore
JoannaLeong@maybank.com.sg
(+65) 6320 1511

Indonesia

Endang Yulianti Rahayu
Head of Sales, Indonesia
EYRahayu@maybank.co.id
(+62) 21 29936318 or
(+62) 2922 8888 ext 29611

China (Shanghai)

Dymond Tai
Head, Global Markets, Greater China
dymond.tai@maybank.com
(+852) 35188812

Joyce Ha
Senior Sales Dealer
joyce.ha@maybank.com
(+86) 21 28932588