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FX Insight

Understanding Trade Deal Phases, What's Next for Dollar?

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The "Momentous" Inking of the Deal

The US and China have finally sealed a partial pact and the wait for it has added around 5% for the Dow Jones industrial average (performance from 12th Dec 2019 to date). For the Shanghai Composite, it was >6% (over the same period). While China only managed to dismantle ~7.5% of the tariffs imposed on $120bn of goods, leaving $370bn of its goods still subjected to existing levies (7.5% on $120bn and 25% on $250bn) unless phase 2 can be achieved, what contributed to the rally was essentially the prospect of a moderation in global trade uncertainty. It will take time to see if the enforcement mechanism incorporated in the deal—i.e., imposition of tariffs in proportion to damage caused by any China non-compliance—is indeed a game-changer as touted by US.

Trump is Unlikely to Escalate the Trade War This Year

Trump is less likely to escalate the trade war this year as there are signs of activity momentum slowing and any escalations would drag on growth leading into elections. The 10-month review period post the signing of phase-1, before further trimming in tariffs are considered, could see Trump try to avoid more direct confrontation with Xi, but instead play up his accomplishments thus far, including ensuring a more levelled playing field for American firms in China without having to cede their tech know-how, as well as promise of more sales in key sectors including manufacturing and agriculture. [Table of deal details in main report.]

Challenging for Yuan & AxJ FX to Rally Further in Interim

Phase 2 negotiations would incorporate long-standing issues such as the subsidization of China's state-controlled businesses, which are tougher nuts to crack. US, EU and Japan also appear to have reached consensus to ask for stronger WTO rules against subsidies, with the main target being China's offerings of "unfair" assistance to its firms, including excessive financial aid to troubled firms and unlimited guarantees in some instances. The potential for a slightly bumpy road ahead could cap some of the euphoria which has seeped into yuan and AxJ FX pricing in the past few weeks. Going forward, there could be a greater focus on macro fundamentals. Taking USDCNH for instance, some retracement from the current spot at 6.8880 cannot be ruled out as China gets back to business on rebalancing growth and deleveraging priorities.

Dollar Could Take Time to Soften

A more benign (relative to 2019) trade policy environment could put the greenback on the backfoot a tad for 2020, even as any eventual move lower will hinge on a whole host of factors, including developments in Trump impeachment proceedings, US election uncertainty, as well as evidence of fading in US' growth outperformance.

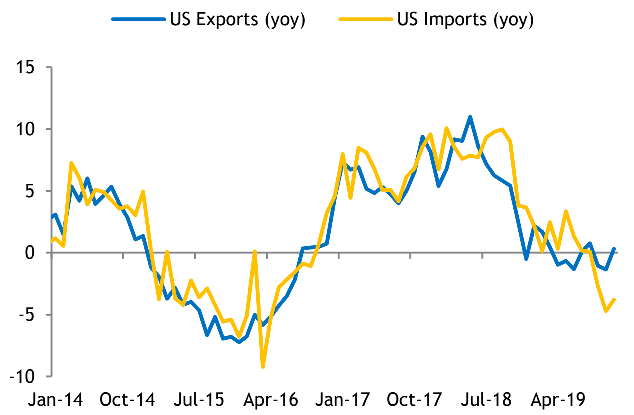
The flare-up in US-Iran tensions at the start of the year also reminds us of the impact of geopolitics on dollar's trajectory. Nonetheless, the kind of double-digit decline in dollar levels observed at the start of the 2003 Iraq war is unlikely, even if actual escalations in tensions occur. One key difference this time round could be dollar's evolving relationship with oil, due to greater self-reliance of the US over time.

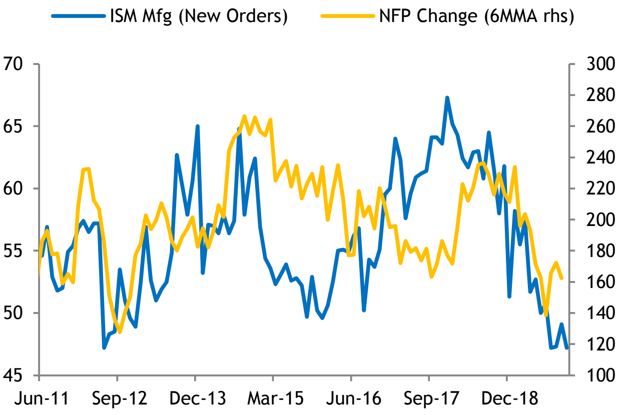
Trump is Unlikely to Escalate Trade War This Year

The lead-up into the event had some interesting nuances with sources cited by Bloomberg saying that further dismantling of tariffs is unlikely until after the Nov Presidential Election (3rd Nov). Although this was quickly dismissed by Treasurer Secretary Steven Mnuchin who stressed that there is no link between the timeline and the Presidential election, we cannot help but think that there could be some element of truth in the matter. Further tariff removals for China may risk drawing more criticism from the Democrats and undermine support from Trump's base, especially from the farm belt that suffered the brunt of the trade war. It would be wiser to play up the deal that he achieved with China (which includes ensuring a more levelled playing field for American firms in China without having to cede their tech know-how; promise of more sales in key sectors including manufacturing and agriculture), retain the leverage that the US has in the form of tariffs for further negotiations as well as a way of ensuring compliance by China.

Trump is less likely to escalate the trade war this year as there are signs of activity momentum slowing and any escalations would drag on growth leading into elections. In fact, Trump said last week that he might want to "wait to finish it till after the election because by doing that I think we can actually make a little bit better deal, maybe a lot better deal".

US Did Not Escape the Trade War; Unlikely to Inflict More Damage in an Election Year





Source: US Census Bureau, Bloomberg Maybank FX Research & Strategy,

What is in this Deal?

Intellectual Property	Intellectual Property broadly covers trade secrets, pharmaceutical-related IP, patents, online counterfeits and piracy. Incorporation of criminal penalties along with a pledge by China to implement an Action plan which has to be announced within 30 working days of the agreement. This is likely a compromise from the May 2019 text where China is said to have removed plenty of references to changes of its own laws to protect intellectual property.
Technology Transfer	China to end its long-standing practice of pressuring foreign companies to transfer their tech know-how to Chinese companies as a condition for obtaining market access, administrative approvals or receiving advantages from the government. China will also refrain from supporting outbound investment meant to acquire foreign technology to meet its MIC2025 plan.

Trade	**Broadly, China agrees to buy $200bn more of US goods over the next two years, referencing 2017 levels as a baseline.** More specifically, the $200bn is split as follows: $32.9bn in 2020, $44.8bn in 2021 of manufacturing goods, $12.5bn in 2020, $19.5bn in 2021 of agricultural goods, $18.5bn in 2020,$33.9bn in 2021 of energy products and $12.8bn in 2020, $25.1bn in 2021 of services vs. levels in 2017.
Currency	Commitments to **refrain from competitive devaluations** and targeting of exchange rates, while promoting transparency and providing mechanisms for accountability and enforcement. Ensure that China will not use currency practices to unfairly compete against US exporters (taking reference from the commitments undertaken by the G20 Communique).
Tariffs	China pledges to exempt certain US products under its duties in order to meet the purchasing targets laid out in the deal. US to halve its 15% tariff on estimated $120bn of Chinese imports (imposed last Sep). This leaves the Sep tranche of $120bn still taxed at 7.5%, and 25% tariff on $250bn of Chinese industrial goods.

What can We Expect in Phase 2?

Treasury Secretary Mnuchin had said that phase 1 is mainly about ensuring enforcements. Most of the terms therein are widely seen as lower hanging fruits, although enforcements are unlikely to be scrutinized too closely within 2020 if the US has no intention of escalating the trade war before the Nov Presidential elections. Phase 2 should incorporate long-standing issues such as the subsidization of China's state-controlled businesses.

In line with that, on 14 Jan, the EU, US and Japan recently released a joint communique to "unconditionally prohibit" practices of

- unlimited state guarantees,
- subsidies to insolvent or ailing companies without a credible restructuring plan,
- subsidies to companies unable to get private financing,
- some direct forgiveness of debt.

These practices could be added to WTO's Agreement on Subsidies and Countervailing Measurements.

While this development suggests more pressure on China to reduce its aid to its SOEs, the joint communique also indicates more potential collaboration among the three global powers (a phenomenon that we have hinted in our Fengshui piece here, that Trump is less likely to pick fights with other nations compared to the previous two years).

The smooth development of the US-China trade deal thus far would likely mean a review of some of our earlier forecasts, especially for USDCNY at 7.08. However, we refrain from snap adjustments at this point as we see a lot of euphoria already in the price, and greater focus could return to macro fundamentals from now on.

Some retracement from the current spot at 6.8880 cannot be ruled out as China gets back to business on rebalancing growth and deleveraging priorities. Activity numbers are due this Fri including 4Q GDP, expected to come in at 6.2%.

Industrial production for Dec is expected to soften to 5.9%y/y from previous 6.2%. Any weakness in the data prints could temper the CNY strength.

USDCNH (Daily Chart) – Falling Wedge, Strong Support

Source: Bloomberg, Maybank FX Research & Strategy

USDCNH has touched a key support level around 6.8708 and retraced. The falling wedge suggests that there could be some short term bullish retracement towards 6.9560 (21-dma) before the next at 7.00. If support at 6.8710 breaks, next support in focus is at 6.8170.

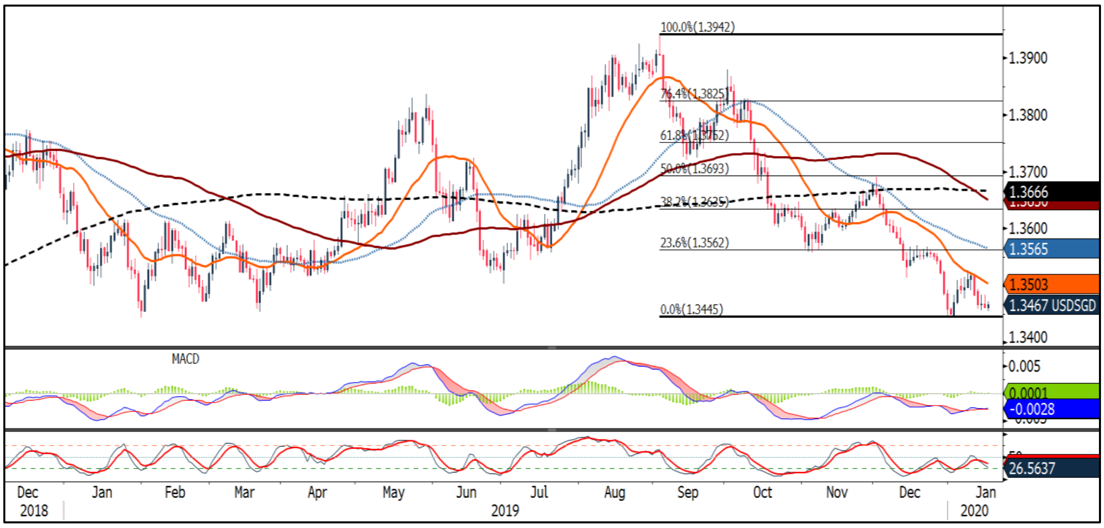
On the side, our long CNHPHP trade that we initiated since 13th Jan has been playing out well. We continue to look for CNHPHP to head towards 7.4850 before eventual target at 7.5830. The cross is last seen around 7.3694. This trade was initiated last Mon with spot reference at 7.3075. Stoploss at 7.20. Risk-reward ratio is 1:2.56. (Chart for illustration in the next page)

Long CNHPHP Call Playing Out

Source: Bloomberg, Maybank FX Research & Strategy

Meanwhile, we think that some of the valuations in AxJ FX are looking a tad stretched, after building on the euphoria from the past two weeks. Given market recognition that phase 1 is only the beginning of a long ride, it might be challenging to see large gains for AxJ FX in the interim. We discuss some selected charts here.

Strong Support at 1.3450 for USDSGD



Source: Bloomberg, Maybank FX Research & Strategy

Momentum on daily chart is neutral while stochastics are inching lower. A combination of near-oversold conditions, and a triple bottom of 1.3450 (2019 lows in Feb, Mar, Dec), could mean that further down-moves could be challenging in the interim.

Admittedly though, the 100-DMA has just cut the 200-DMA to the downside, a somewhat bearish signal. Besides 1.3450, next support is some distance away at 1.3370. Resistance at 1.3560 (23.6% fibo retracement from Sep high to Dec low), 1.3640 (38.2% fibo).

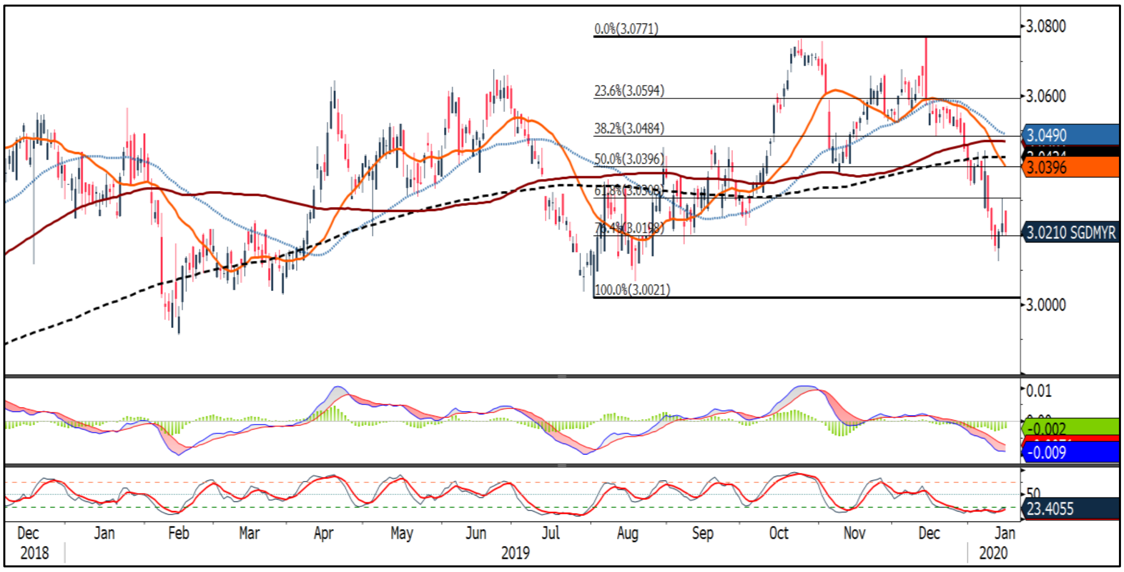
USDMYR Bearish But Oversold; 4.0540 could Hold in Interim

Source: Bloomberg, Maybank FX Research & Strategy

USDMYR touched near the 2019 low of 4.0540 two days ago, rebounded, and has been trading ranged since then. Momentum on daily chart is bearish (but fading), while stochastics are showing signs of climbing up from oversold territory. These signs suggest that support at 4.0540 could hold in the interim.

Besides 4.0540, next support at 4.04. Resistances at 4.08, 4.0960, 4.1060 levels.

Fading Bearishness for SGDMYR

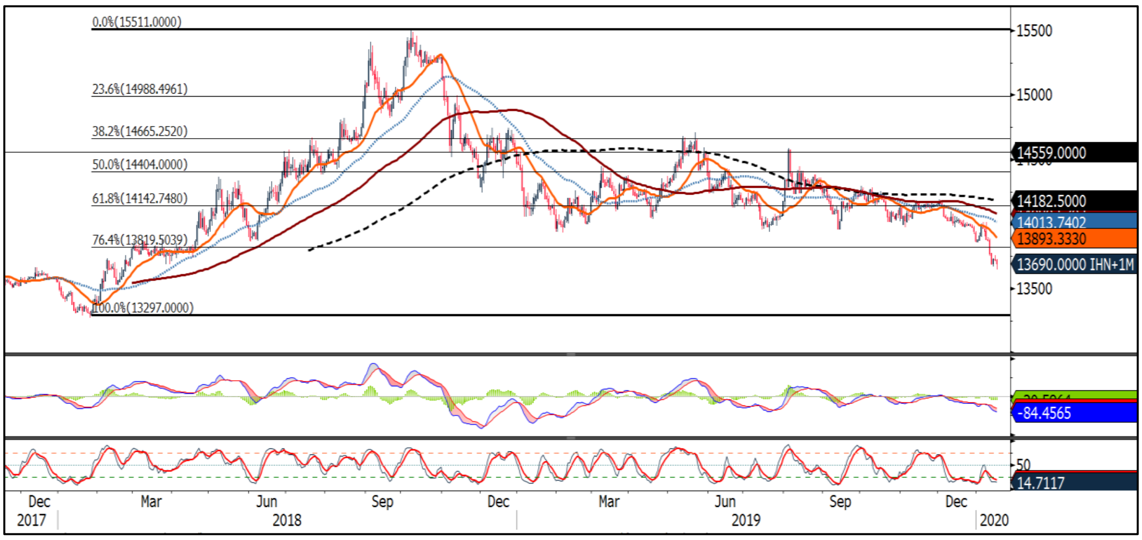


Source: Bloomberg, Maybank FX Research & Strategy

Bearish momentum on daily chart remains intact (but fading) while stochastics also show signs of inching up from oversold conditions.

We note that the rally in MYR over the last few weeks has been a lot stronger than that in SGD. Any retracement could see SGDMYR pair bounce up slightly. If downward momentum persists though, 3.00-level is expected to be a strong support. Resistance at 3.03, 3.0420 (200 DMA).

IDR (NDF) Strength Seems a Tad Stretched



Source: Bloomberg, Maybank FX Research & Strategy

Following the NDF's sharp decline from 14000 levels since the turn of the year, another strong down-move could be challenging at this point. Modest correction upwards not ruled out in interim. There does seem to be a longer-term downtrend towards 5-year low of around 13,000, but this could take a long time to play out.

Momentum on daily chart is still mildly bearish, while stochastics are in oversold conditions. Support at 13,600, then 13,400. Resistance at 13,860 (recent low), 14,040 (50 DMA).

Life for the Dollar After Phase-1? Other Factors Could Exert…

One of our core calls for 2020 includes a weaker DXY and the US-China trade pact (phase 1) is supportive of that. Heading into the deal signing, the DXY index did slip a tad, but the magnitude was relatively modest (97.4 to 97.2).

Besides deal-related benign sentiments putting the greenback on the backfoot, there was also some domestic focus on impeachment developments. Nancy Pelosi (House speaker) appointed Trump impeachment managers, and Trump impeachment articles were ceremonially delivered to the Senate. As we have noted before, history has shown that the USD tends to come under pressure when the incumbent President is under political pressure. We continue to look for political uncertainty as one of the drivers that chip away at the USD strength this year.

Incidentally, our report last week also finds that based on a model incorporating macro fundamentals, the dollar could be as much as 10% overvalued on a real effective exchange rate basis compared to its peers. For comparison, back in a mid-2019 report, the IMF also estimated the dollar to be anywhere from 6-12% overvalued. In short, actual dollar strength, after rising by around 15% on a REER basis over the past five years, could have climbed past levels where fundamentals suggest it should be.

Nonetheless, this estimated "misalignment" is not expected to correct over a short period of time. Markets will need to see more evidence of:

(i) a US Federal Reserve that is more ready to ease than hike,

(ii) some indication that US activity momentum is softening—we note that some recent manufacturing activity figures have been weaker than expected,

before more softness in the dollar can set in.

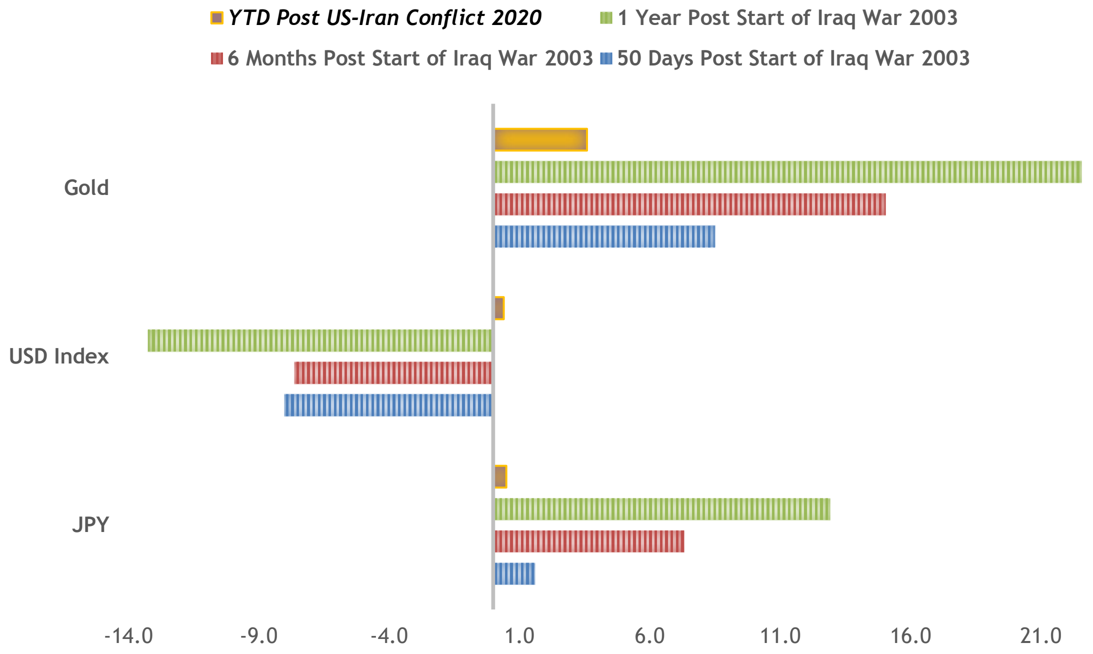
Besides aforementioned impeachment proceedings, the US elections in November could possibly trigger bouts of volatility in the dollar as well. Certain candidates such as Senator Elizabeth Warren are advocating policies which may put a strain on government budget, which is usually negative for dollar sentiments.

The US-Iran episode at the start of the year also reminds us of the potential for geopolitics to influence dollar trajectory.

Admittedly, the impact of this factor on the dollar is somewhat less clear. The dollar is viewed as a semi-safe haven at times, due to inflows into US Treasuries and other haven assets when tensions rise in ROW. But when the US is involved as a key party in the conflict, any dollar impact could be more uncertain.

As a quick aside, we attempt to delve into this risk in more detail here. First, we note that as a result of the **quick de-escalation of the situation**, FX reaction has been generally "well-behaved" in this episode vs. 2003 Iraq War. The up-move in gold was more discernible (to >US$1,600), but retraced shortly after 8 Jan, when tensions were seen to be defused.

% Impact on Gold, USD, Yen—Now & Then



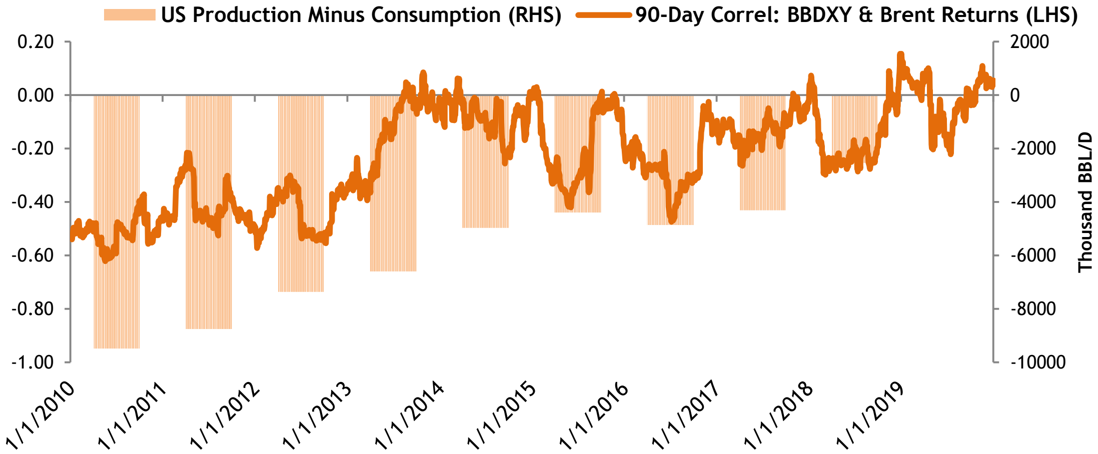
Source: Bloomberg, Maybank FX Research & Strategy
Note: Iraq war was a protracted armed conflict which started in Republican President Bush's Administration from Mar 2003 - Dec 2011. Countries involved include US, UK, Australia, etc. "YTD" impact of 2020 conflict on assets was estimated as change occurring from 3 to 8 Jan, after which tensions were defused.

Nonetheless, despite the broad de-escalations in tensions, points of contention in US' new sanctions as well as Iran's push to remove US influence and troops from the Middle East remain. We do not rule out sporadic spikes in tensions on this front going forward. While largely a tail risk at this point, **USD could underperform should geopolitical conflict greatly intensify**, especially if it is expected to drag on for a protracted duration. Channels for this softening would include widened US fiscal deficit as a result of the likely rise in military spending, as well as fears of Iranian retaliation weighing on US asset sentiments.

We highlight that one key channel that had amplified the impact of the US-Iran conflict in 2003 on dollar strength was likely the spike in oil prices. Brent price had risen from around US$27 in Q1 2003 to above US$46 just six quarters later. There was an evident negative correlation between oil and dollar then, partly because the US has historically been a net importer of oil, and sharply higher oil prices likely weighed on USD sentiments as well.

But that relationship is changing. According to recent data, the US is beginning to see exports of petroleum (crude oil and other petroleum products) exceed its imports in certain months. The International Energy Agency (IEA) assesses that the US could become a sustained net exporter in late 2020 or early 2021. As shown below, the increasing self-reliance of US in oil due to its increased shale production in recent years means that the **broad negative relationship between USD and oil returns could be dissipating**. The "amplification effect" (from oil moves) on dollar declines in times of US-Iran conflict could be significantly more modest.

US Oil Self-Reliance and Dollar-Oil Relationship



Source: EIA, Bloomberg, Maybank FX Research & Strategy

On balance, we are unlikely to see the kind of double-digit decline in dollar strength observed at the start of the Iraq war, even if actual escalations in tensions do occur going forward. Geopolitics involving US as a key party could still be negative for the dollar, but impact would depend on extent of escalation, and magnitudes could be more modest relative to historical experience.

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