Macrowrap-up

Phone A Friend

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Stocks were down early in the week and bond yields fell to what people are describing as record levels. Why is this happening? WHY????

There were some signs that the trade war was worsening. It started with the U.S. announcing 10% tariffs on $300b in Chinese goods, effective September 1. Then, this was followed by some back and forth between the U.S. and China on agricultural products and currency rates.

The tariffs couldn’t have been the start—hasn’t the trade war been going on for a while?

Yes. It doesn’t happen often, but you’re right. The meeting between Trump and Xi at the G20 summit at the end of June had calmed markets’ fears on trade. Trump delayed tariffs and eased a bit on Huawei, while Xi may have promised that China would buy U.S. agricultural products. However, those purchases have not materialized, and Chinese spokesmen have denied that the promise was ever made. This is probably why the Trump administration decided to reinstate the tariffs. It’s a real he said/Xi said situation.

Dad jokes won’t end the trade war. What is all of this talk about currency manipulation?

Earlier in the week the Chinese yuan fell below 7 to the U.S. dollar. While arbitrary, people think it is an important level. The U.S. promptly responded by labeling China as a currency manipulator.

What does it mean to be a currency manipulator and what are the consequences?

It is a label given by the Treasury Department to countries that have large current account surpluses and are deemed to be manipulating their exchange rates to gain an unfair trade advantage. The remedy is to initiate negotiations with the manipulator. The Treasury has the option of calling the IMF for help. In other words, it probably won’t lead to any action.

Did China manipulate the currency to bring it past 7?

China heavily manages its currency. It controls the end-of-day fixings and intervenes in spot markets. The trade war caused depreciation pressure on the renminbi as investors and hedgers moved to safe havens like the U.S. dollar. In all likelihood, China had been intervening to prevent it from depreciating against the dollar, then it pulled back on the interventions, which allowed the yuan to fall. In all likelihood, China had been intervening to prevent it from depreciating against the dollar, then it pulled back on the interventions, which allowed the yuan to fall. So China didn’t directly cause it to go down – markets did that. Chinese authorities chose not to stop it. It seems that in reaction to the uproar, China has resumed interventions to prevent it from falling further.

How do we know when they intervene?

You can ask the audience. Unfortunately the audience doesn’t answer, nor do authorities in China. The changes in China’s FX reserves are the best proxy. When reserves go up, the People’s Bank of China is probably intervening to depreciate the yuan and when reserves go down, the PBOC is probably intervening to hold it up. Recently the reserves have been falling.

Ok so you’re saying China was interfering in currency markets, but briefly stopped. Because China stopped interfering it was labeled a currency manipulator. Then, in an attempt to defuse tensions, China started interfering again??

Yes, that’s pretty much what happened.

Has the world gone crazy??

No, it was always this way. At least that is what following FX markets for 25 years would make you think.

Why did stocks react so negatively? Isn’t U.S./China bilateral trade a small part of global GDP?

The consequences for investment and growth are significant if it continues to escalate. Investors are worried that the dispute could spill over into other areas. Each side can inflict serious damage on the other and on itself, even though trade isn’t statistically as large as you might think.
How could it escalate from here?

More tariffs would be one way. One of the harshest blows the U.S. could serve would be to accuse Chinese banks of violating U.S. sanctions on Iran. On the other side, China could disrupt U.S. supply chains. Both of these would likely cause some additional market chaos, but there aren’t clear signs that either of these will happen soon.

Is any of this related to what has been going on in Hong Kong?

There is little direct connection. Some officials in China have accused the U.S. of stoking the protests, but the U.S. administration has not shown much interest in getting involved, at least not publicly. This is worth watching in case it does spill over.

Why have bonds been up so much? Why have stocks been down? Why haven’t they been down more?

Equity investors are worried about the threats to growth and stability. Bond investors like threats to growth and stability. Equities would probably be down more, but many people think that central banks will act as a lifeline for markets.

Will it result in more easing?

The Fed and other central banks have listed trade as a downside risk. They will probably cut more aggressively if the trade situation worsens. Central banks in India, Thailand, New Zealand, and the Philippines cut rates this week.

Why did bonds give back some of the move on Thursday? Was that because of an improvement in the trade situation?

Probably not. It doesn’t seem like the trade situation is getting better. This move may have been caused by something even less likely. There was a rumor that Germany is considering fiscal easing in the form of spending on climate change measures. The rumor may have less substance than initially thought, but German fiscal stimulus could dramatically move markets if it ever happens. Just the mention of it is enough to put fear in the hearts of bond holders.

Do you think we’ll have this conversation again in a few months?

The odds are better than 50/50.

What We Are Watching

China Industrial Production, Retail Sales, Fixed Asset Investment (Wednesday)

With market sensitivity to the U.S.-China trade dispute at a high level, next week’s slate of Chinese monthly activity data will receive special attention. The latest data for June showed stronger-than-expected activity in all three releases, with industrial production and retail sales rebounding notably. Supporting the recovery in investment and consumption, credit growth in June staged a substantial increase. July data to be released next week may be boosted by the transient trade war truce reached at the late-June G20 meeting in Japan. However, considering recent developments, market reaction to the data may be asymmetric in that improvement may be interpreted as short-lived, while disappointing data would suggest greater downside risks to growth following recent trade war escalation.

U.S. Retail Sales, Industrial Production (Thursday)

Retail sales and industrial production data this week will provide an update on two diverging segments of the U.S. economy. After some weakness towards the end of 2018, retail sales have rebounded and appeared strong in recent months. On the other hand, industrial production growth has slowed, weighed down by weaker auto and aviation production, slower global growth, and on-going trade uncertainty. The divergence between manufacturing trends and the larger service sector has also been a theme across other data releases, including recent employment reports. Given the large weight of consumption in U.S. GDP, continued strength in retail sales would be an important positive for the economy. While the manufacturing sector is comparatively small, weakness in industrial production may still be important, as industrial data may lead overall growth and employment trends. If both releases are disappointing this week, it would bolster expectations for additional rate cuts from the Fed in the next few months.

Mexico Central Bank Meeting (Thursday)

From 2015 to 2018, the Mexican central bank (Banco de México, or Banxico for short) raised rates aggressively from 3.00% to 8.25%. Higher rates were intended to contain inflation by supporting the value of the Mexican peso in the face of multiple headwinds: Federal Reserve tightening, uncertainty around U.S. trade policy, and domestic political uncertainty before and after last year’s general election. The peso has been broadly stable over the last year and inflation has moderated, allowing Banxico to strike a more dovish tone at the least meeting in June. The post-meeting statement introduced new language on potential downside risks to inflation, and one member of the committee voted for an immediate rate cut, following the Fed’s rate cut in late July, economists surveyed by Bloomberg now expect a similar move from Banxico. If the central bank instead chooses to keep rates unchanged, it could boost the peso while weighing on domestic fixed income.

[1] The yuan is indexed per dollar, so when it falls the number goes up. It goes backwards like everything else this week.


[3] This is not perfect. If China uses currency forwards to intervene it may not show up here. Also, China holds some non-dollar currencies so the value of those reserves can fluctuate in dollar terms.
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