Deal or no deal? Initial thoughts on AUD and NZD

• US President Trump and China VP Liu He shake hands on ‘Phase-1’ trade deal. October 15th US tariff action won’t proceed, but there’s no wind-back of existing tariffs.

• The “deal” should for now spare AUD and NZD re-tests of early October lows assuming USD/CNY ranges beneath September highs, but it isn’t a pretext for higher AUD or NZD forecasts.

The much anticipated 13th round of US-China trade talks ended with a so-called trade “agreement”, which looks more symbolic than substantial, and might be better described as simply an interim trade war truce.

The substance of the handshake agreement between US President Trump and China’s Vice Premier Liu He on Friday, described as Phase-1 of a potential multi-phase broader agreement and intended to be inked when Mr. Trump meets with Chinese President Xi at the APEC leaders’ meeting in Chile in November, is that:

1. China will increase its purchases of US agricultural goods to between $40bn and $50bn annually, with the increase versus pre-Trump Presidency levels concentrated on soybeans and pork. This should help shore up Trump’s support base in agricultural heartlands which, we’d judge, is the key motivation behind his willingness to do this interim deal.

2. An agreement not to proceed with the scheduled increase in tariffs on $250bn of China imports from 25% to 30% from October 15th, but no wind back of existing tariffs, including the 15% levy on $110bn of previously un-tariffed goods on September 1st – and no commitment as yet not to proceed with the scheduled 15% tariffs on the remaining $160bn of currently un-tariffed Chinese imports from December 15th.

3. Some as yet unspecified – and as far as ‘Phase-1’ is concerned probably vacuous – commitments from China on intellectual property, financial services and the currency. The latter will probably be confined in practice to nothing more than a commitment not to engage in competitive currency devaluations, in return for which the US Treasury is expected to ‘de-label’ China a currency manipulator. We can be sure there is no Plaza-style currency accord in the works.

Of note, there was no agreement on the future of Huawei, with the US looking to keep any decisions on the company as part of a separate process.

Assuming this is how things proceed, it represents no more than an agreement by the US not to take a further step forward in the dispute after ‘four steps forward’ since March 2018, where each of four specific phases of White House tariff actions was met with retaliation from China, in each case including currency depreciation. As a reminder, USD/CNY has risen by some 15% over this period, versus a 10% rise in the DXY dollar index.

The significance of Friday’s agreement, slender as it is, is that for the time being at least it challenges the assumption underlying our current end-of-year forecasts of 0.65 for AUD/USD and 0.6150 for NZD/USD. This is in so far as the absence of fresh tariffs that had been planned for October 15th reduces the pretext for a further immediate move higher in USD/CNY and expected broader emerging market spill-overs, to which AUD and NZD have been so highly correlated all year.

At the same time, with no wind-back of existing tariffs, there is no reason to expect USD/CNY to materially fall from here, other than perhaps in the context of significant USD depreciation (more below). A 7.00-7.15 range looks probable in coming weeks. Any forays beneath 7 are only likely to be shallow and brief, while if the USD trend remains upward, pressuring USD/CNY to challenge the early September highs (~7.1875), we can reasonably expect the PBoC to resist, in order not to inflame President Trump’s sensibilities at a time when
the two sides move on to discuss a Phase-2 deal after having (hopefully) inked Phase-1 in 4-5 weeks’ time.

Does this mean upward revisions to our AUD and NZD forecasts are now warranted? Not so fast.

For one, anything can still happen on the trade front between now and year-end (and remembering the 15% tariffs on nearly $100bn of goods are still slated for December 15th.)

Second, this Phase-1 agreement, if inked, does little to immediately brighten the outlook for global trade and growth, including inspiring a pick-up in business investment. And while it shouldn’t prevent the Fed from agreeing to cut rates by another quarter-point on October 30th, it doesn’t provide a firm pretext for significant or sustained US dollar depreciation. The US is set to remain the least dirty shirt in the global laundry and with a still formidable interest rates advantage. This remains the case even if we do now have more convincing evidence of a slowdown in the US economy that extends well beyond the manufacturing sector. It doesn’t though come close to bordering on outright US economic contraction. Q3 GDP later this month expected to print only a little shy of 2%.

And thirdly, to the extent the outlook for the global economy remains poor, it doesn’t lessen the chances of the RBA being forced down the path of near zero rates and unconventional monetary policy next year in the absence of fiscal stimulus. This represents downside risk to our existing AUD forecasts. The same can be said for the RBNZ, where the bias for further policy easing remains clear, with the economy on track to substantially undershoot RBNZ growth forecasts.

All we would say for now is that the chances of a near-term re-test of the early October post-GFC lows on AUD around 0.6770 and NZD just above 0.62 have receded a little.

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