33 / China's CNY, and Gold: linked at the hip, and hobbled by the US Dollar's ascendancy, China's growth implosion

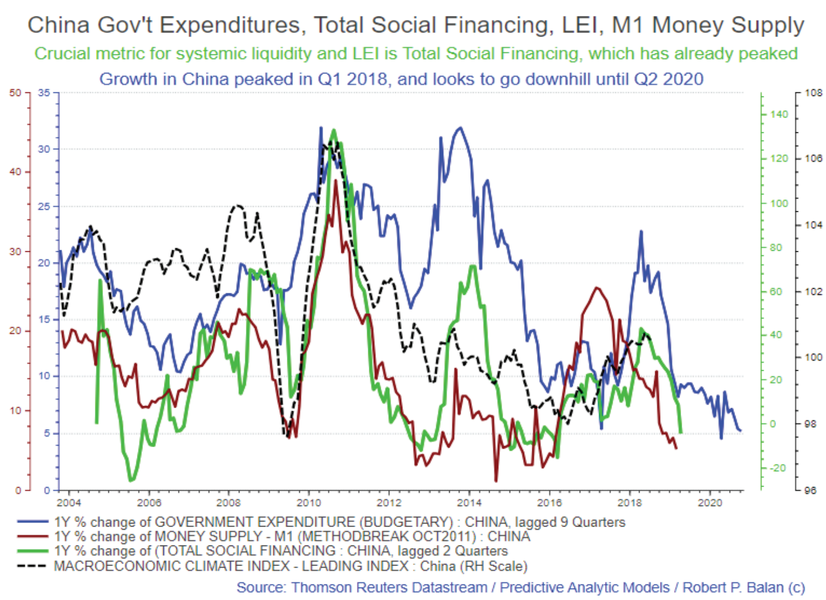
As Emerging Markets equities (proxy: MSCI EM$) entered into a negative spiral again last week, gold analysts, almost to every man or woman, feared that the yellow metal would sell off once again in response. The gold price held firm, however, but nonetheless leaving analysts to ponder the yellow metal's immediate future.

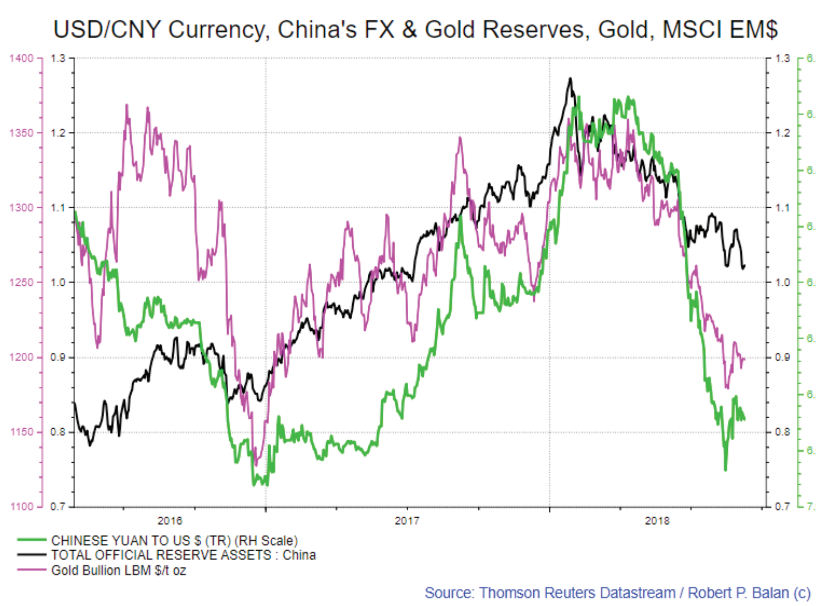
Gold's future is generally tied to the trend of the US Dollar, but for practical purposes, gold is currently tied at the hip with the Chinese CNY (*see 1st chart on this page*)**. And the CNY is hostage to the escalating trade war between the Trump government and Chinese President Xi Jinping.**

But even before the tit-for-tat escalation of tariff rhetoric between the US and China, gold has already been weakened by the severe underperformance of EM assets due to the resurgence of the US Dollar and by weakness in China and Emerging Markets economy *(see 2nd chart on the right*).

Much of that weakness is reflected in EM currencies, and the price of gold suffered alongside them. We discussed the weakness of the Chinese economy in another article in this month's Capital Observer which has led to some weakness in CNY, which should extend further as China's economy will likely spiral lower over the next few quarters.

A month ago, the People's Bank of China intervened to try and stabilize the yuan after the currency experienced several weeks of sustained weakness. **The CNY stabilized after the People's Bank increased its reserve requirement ratio on some foreign exchange forwards in an attempt at supporting the local currency. This had the effect of stopping, at least temporarily, the yuan's bleeding and has allowed the currency to build some support.**



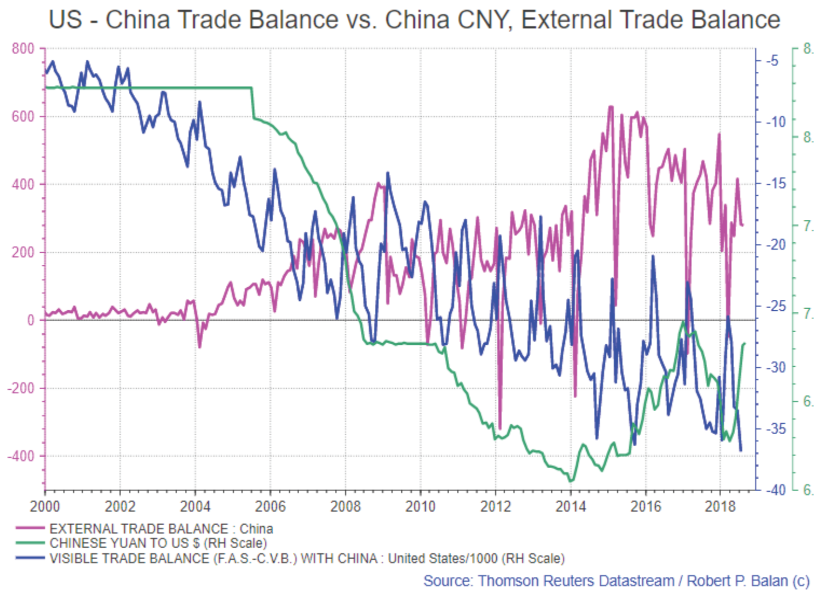


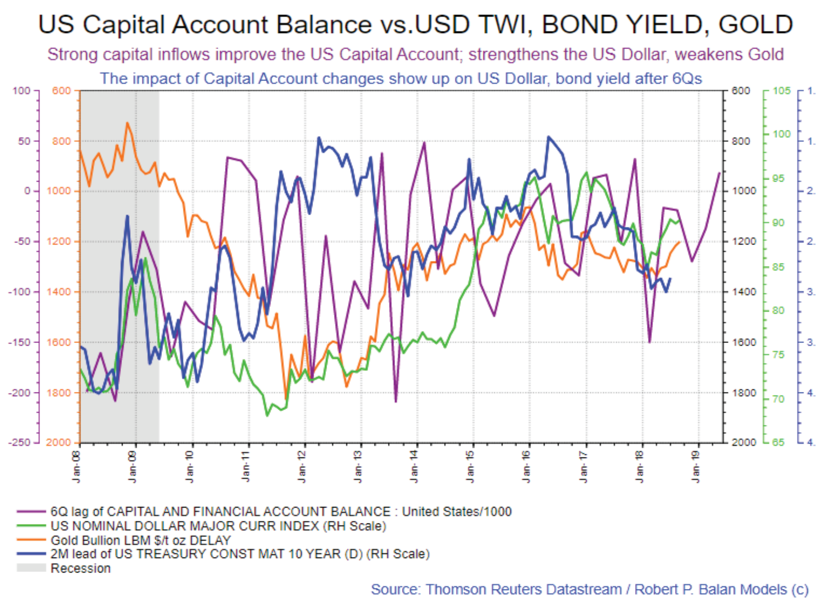
Some analysts also say that China can start backing the CNY with gold, which would basically stop the rot of the domestic currency. According to China watchers, China has a lot more gold than the 1,842 tons the government officially admits to holding in its reserves. Beijing has been diversifying away the US Dollar for the last three decades and may have accumulated “more than 20,000 tons of gold”, according to some China watchers. Should China decide to back the yuan currency with its gold reserves, it could also significantly undermine the dollar’s hegemony, according to some analysis.

Nonetheless, the immediate prospects of gold are tied up with the published intentions of the Trump administration to impose further 25% tariff on $200bln or 40% of China's exports to the U.S. at any time. With the U.S.'s trade deficit with China hitting a new record high in July (*see 1st chart on this page*)**, there seems little doubt that The Donald will proceed with those tariffs; it is unlikely that Mr. Trump will blink first**. All that remains to be determined is how they will implement them and how will China respond?

New tariffs on Chinese exports to the US can be calibrated different ways, with several degrees of nuances. The worst-case scenario is that the new US tariffs are implemented all at once and immediately, which would prompt the most negative response from China. **China may again choose to continue to devalue the CNY on a sustained basis. Consequently, Gold could continue to decline further.**

Alternatively, the tariffs could be implemented in stages. For example, they could roll out tariffs on $50bln of Chinese exports per month over four months. This would delay the impact to U.S. consumers and businesses and therefore, would reduce their potentially negative impact on the US November mid-term elections.





The trade war and its effect on the USD/CNY exchange rate remain the immediate determinant of Gold prices in dollar terms. Until either the trade war ends or the dollar falls, either of its own accord or due to a Fed reversal in policy, CNY is likely to go lower, followed in its wake by the gold price.

In the medium term, the outlook for gold is tied with the outlook for the US currency until credit risk factors and/or the debt crisis starts to spread. With the US Dollar expected to appreciate to Q1 2019 due to the lagged impact of capital flows (*see 2nd graph on this page*), there seems to be little benefit in investing in gold.

We therefore expect gold to briefly shine over the next two to three weeks, but could thereafter resume the downtrend until Q1 2019, when presumably (according to our models) the US Dollar bull trend pauses. That would be a period more apropos to investments in the precious metals sectors and in the Miners’ equities.