Viewing The Yuan From The Grassy Knoll

Conspiracy theories of all stripes generally collapse at the first whiff of reality or a little bit of objective investigation. However, they are part of the human experience and always will be if for no other reason than they give exercise to our imagination. Sometimes they are embedded deeply in a culture; a long-ago Egyptian colleague once explained how any of his countrymen who treated an official explanation of anything as truthful was regarded immediately as a fool or, worse, "one of them."

One of the great perpetuators of conspiracy theories is the government itself. Nothing along the lines of an alien landing at Roswell, New Mexico, or Area 51 in southern Nevada could exist in the popular culture if an immediate and credible explanation were offered. People who act as if they are covering something up create suspicion, as every White House press secretary learns the hard way sooner or later. More Americans today regard the Warren Commission as part of a conspiracy than was the case shortly after its release in 1964.

Moreover, technology is eroding what we consider to be true or not; think of how many believable "photo-shopped" pictures or CGI-generated videos you have seen. Can any visual image be regarded as proof-positive anymore? As an aside, think of how different world religious and cultural history would have been had such technology been available at the time. Moses parted the Sea of Reeds? Let's put in on YouTube!

Scene Of The Crime: Part I

One government who makes it exceptionally easy to believe the worst about itself and its intentions regarding its currency is China. The currency remained resolutely pegged until July 20, 2005, at which point it was allowed to begin a very limited float. Beijing had calculated it could afford to do so and that it had to placate Washington protectionists such as Senators Charles Schumer and Lindsey Graham. Even though the U.S. runs a massive trade deficit against China, the overall impact of a stronger yuan on U.S. price indices has been negligible (see "The Yuan And U.S. Inflation," December 2007). The impact of the yuan on U.S. and European financial markets as the result of the yuan's peg to the dollar were discussed here last July (see "Robin Hood Carry: The Yuan As A Funding Currency," July 2010).

China re-pegged the yuan in July 2008 over the very same weekend the Paulson Treasury backstopped U.S. mortgage giants Fannie Mae and Freddie Mac. The Chinese had bought a massive quantity of these agencies' securities under the mistaken assumption they were backed by the full faith and credit of the U.S. government. They were shocked to learn otherwise (memo to Beijing: No one here reads the Prospectus, either) and apparently demanded a currency deal to keep financing their largest customer. Unlike the July 2005 decision to allow revaluation, not even a quiet announcement was made in July 2008.

The re-pegging looked like a win-win-win situation at first. The U.S. maintained a creditor who at that point should have been running quickly in the other direction; China re-established its beloved undervaluation and the implicit support for the dollar pleased the Europeans who were worried about the euro becoming too strong.

It was all a smashing success until the world almost ended in September 2008. Eventually, China relented to another timorous round of revaluation beginning on June 18, 2010.

Scene Of The Crime: Part II

Just over a year ago, China joined a few intrepid countries in raising short-term interest rates and tightening credit conditions. Their stated reason was to quell rising inflation and speculation in property markets; as the move came just two weeks after Federal Reserve chairman Ben Bernanke's statement at the American Economics Association's annual meeting low interest rates had nothing to do with the U.S. real estate bubble, the timing bordered on a mix of horrifying and hilarious.

The Chinese move triggered suspicions just as a makeover of Dealey Plaza in Dallas would trigger suspicions. Even though the impact of large short-term moves in interest rates on currency rates are never as direct as we might assume them to be (see "Rate Shocks And The Dollar," October 2007), as a general rule making your currency more expensive to borrow is a move used by officials wishing to strengthen, not weaken or maintain, their currencies. How, then can the Chinese move be reconciled? And, while we are at it, we can address another perplexity, how U.S. Treasury yields remained low and auctions well-bid while Uncle Sam was borrowing record quantities of cash.

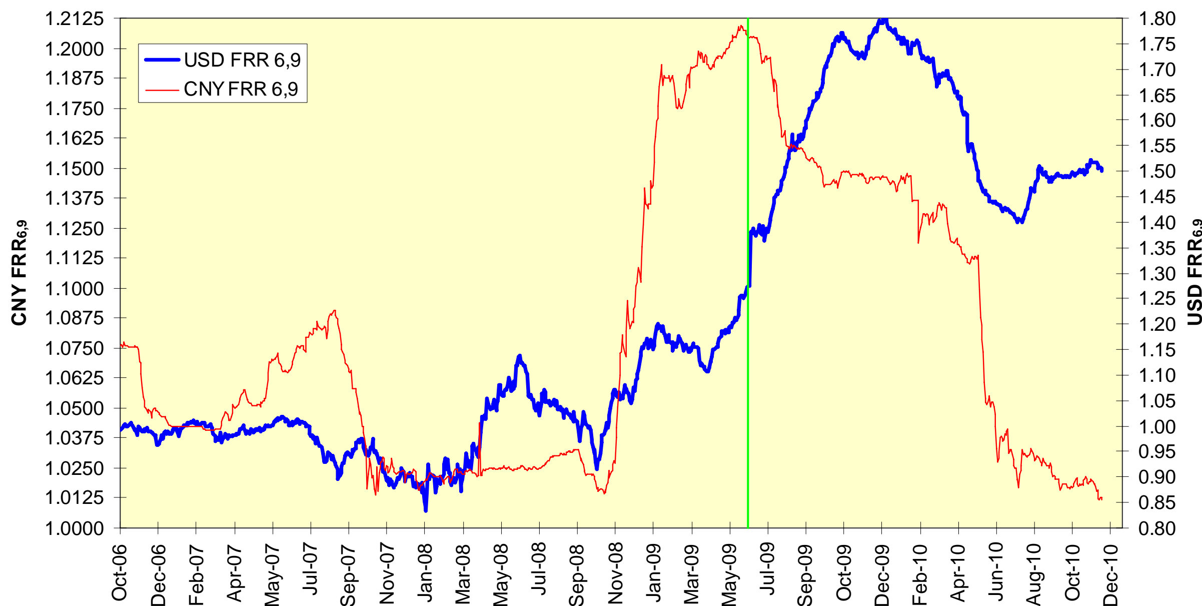
Onwards, Sherlock

If a country is tightening credit, its money market yield curve should flatten. That would be visible in a lower forward rate ratio between six and nine months ($FRR_{6,9}$); this is the rate at which we can lock in three-month borrowing beginning six months from now divided by the nine-month rate itself. The more this ratio exceeds 1.00, the steeper the yield curve.

Incredibly, the Shanghai interbank market's yield curve had been flattening since June 11, 2009. Does this date ring a bell? Probably not, but this is the very same date when U.S. Treasury yields hit a local maximum and proceeded to spend the rest of the year declining or remaining confined in a tight trading range. The June 2009 date is marked with a green line on all charts below.

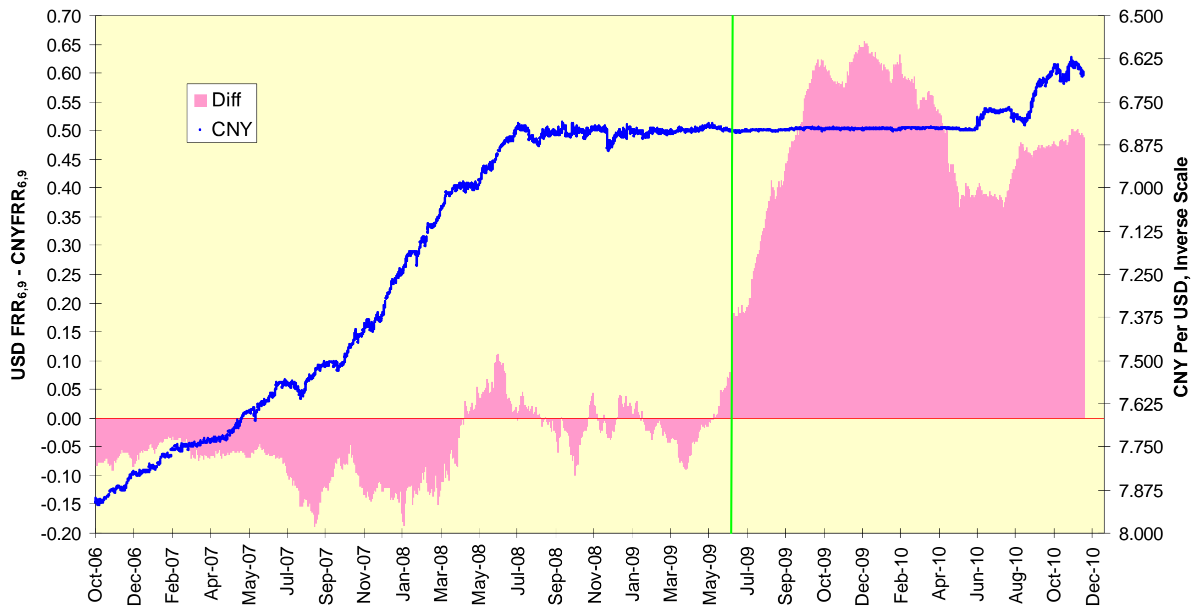
Of course, while the CNY $FRR_{6,9}$ was flattening, the USD $FRR_{6,9}$ was steepening into January 2010; it then flattened into the August 2010 move toward a second round of quantitative easing whereupon it steepened once again. Two countries whose currencies were tied together had completely opposite money market yield curves. This normally would be resolved by the steeper yield curve witnessing a stronger currency; during 2009, a state of "perma-expectations" arose across a wide range of currencies where the relationship inverted and the flatter yield curve produced the stronger currency (see "No Man Is An Island, But The U.K. Is," August 2010). Regardless, the last outcome to be expected in this situation is for the yuan to remain in a quasi-peg against the dollar.

A Tale Of Two Yield Curves



Now the first piece of the puzzle falls into place. The huge gap between the two yield curves did not produce a ripple in the yuan, nor could it given the peg. The one logical explanation for how this was possible was a capital flow from China to the U.S. Money being drained out of the Chinese banking system explained the flattening CNY $FRR_{6,9}$, and money coming into the U.S. or into dollar-denominated instruments worldwide explained the steeping USD $FRR_{6,9}$. We need to remember some very strange things were happening in the U.S. short-term money market during the fourth quarter of 2009, such as record-low three-month USD LIBOR and three-month Treasury bill rates near 0%. These cannot happen in a stabilized, non-critical economy unless someone in addition to the Federal Reserve was jamming vast quantities of cash into that currency. That "usual suspect" to be rounded up was China buying U.S. assets to keep the CNY in line with the USD.

USD Money Market Curve Steepened After U.S. Ten-Year Yields Peaked

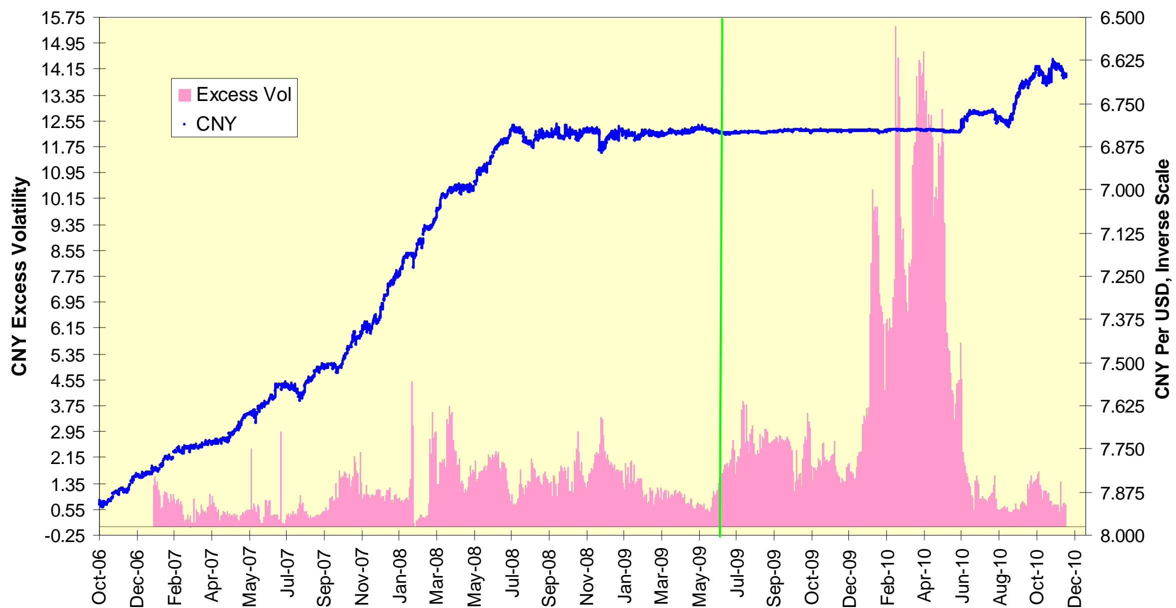


In Good Hands

One of the tools we have used frequently is excess volatility, or the ratio of implied volatility to high-low-close volatility minus 1.00. The implied volatility used is that for three-month CNY forwards. Shortly after June 11, 2009, the excess volatility on the yuan jumped as the CNY $FRR_{6,9}$ flattened. Then excess volatility stopped rising until speculation began in January 2010 the peg would be loosened, perhaps as early as March 2010.

We should note, cynically, options traders in illiquid market often trade as if they have an information advantage, perhaps linked to official contacts. In addition to the rise into the June 2010 loosening of the peg, please note how quickly excess volatility fell thereafter: Those with the information understood the revaluation to be permitted would be a tepid one. A second piece of the puzzle is joined.

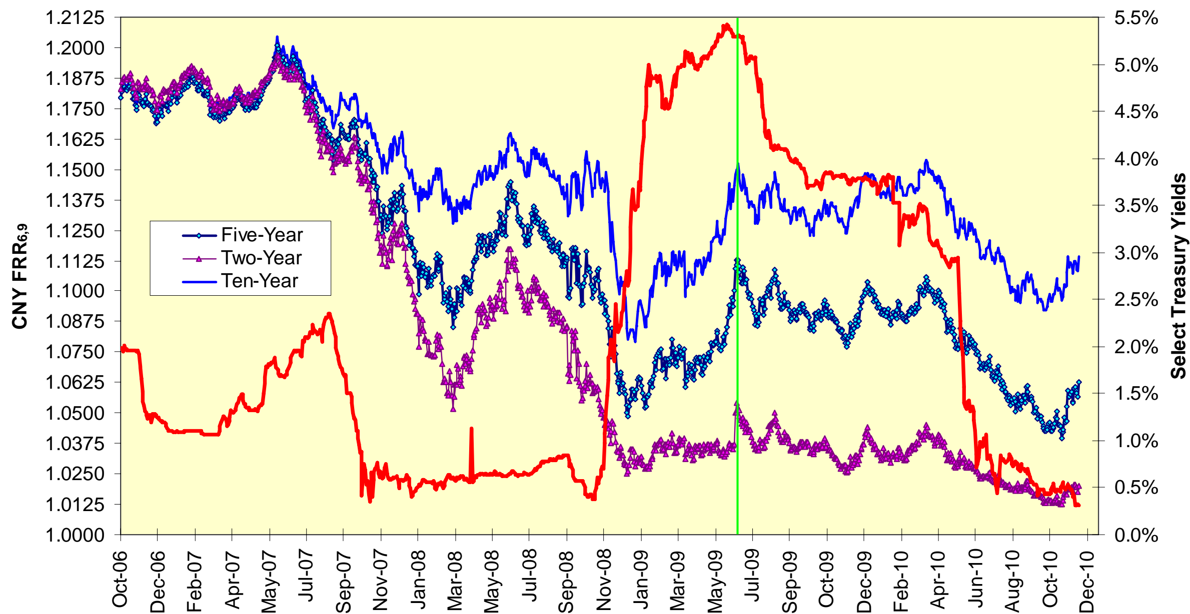
Yuan Excess Volatility



Treasure It Always

We can now add the third piece of the puzzle, and that is the behavior of U.S. Treasury rates as the CNY $FRR_{6,9}$ flattened. If money was flowing out of China and bidding up the price of USD-denominated assets, we should see

U.S. yields decline as soon as the Chinese money market curve changed direction. This twice took place exactly as predicted, first in the third quarter of 2009 and a second time in the second quarter of 2010.



This entire inference can be drawn without having to trace fund flows around the world through official channels, direct- and indirect bidders at U.S. Treasury auctions or through offshore-domiciled accounts. Let's assume someone with $2.65 trillion to throw around, an interest in keeping it quiet and a police state apparatus at its disposal knows more tricks for hiding money than you know for sleuthing it out.

We now come to the very straightforward "conspiracy theory" conclusion: China has the means, opportunity and motive to keep financing the U.S., to keep its yuan undervalued while it tightens domestic credit and to keep the dollar from collapsing against the euro during those periods when the 16-nation European Monetary Union is not forming a circular firing squad to resolve their various sovereign credit issues.

This, too, will work until the minute it stops working. No flow of this size can be maintained forever; ultimately the U.S. credit rating will fall to the point where it cannot afford to buy even financed goods out of China. China cannot afford to lose its customer. This will not end happily for either side in this unholy game, even though we can explain it to the proverbial Man From Mars.