

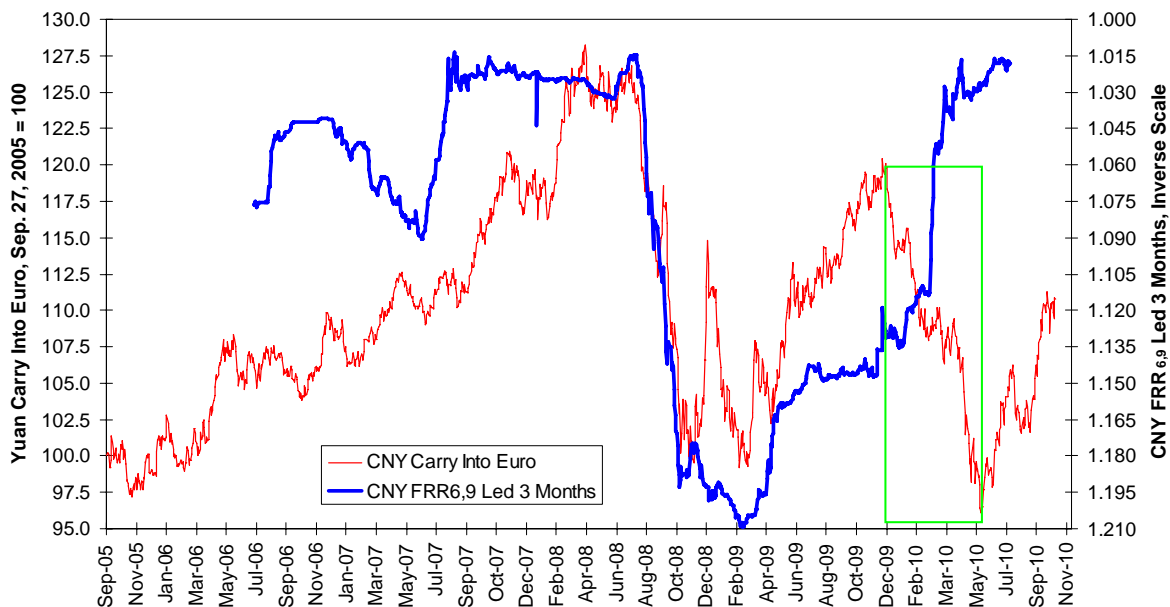
Base Metals And Chinese Monetary Policy

The various creators of the euro may have had certain goals in mind for the common currency, but there is no reason to believe its spread to various funding currencies as part of global carry trades and the use of these spreads as risk barometers were on that list. Yet twelve years into the common currency experiment, this is where we find ourselves (see “A Cross-Rate To Bear,” *Currency Trader*, May 2009).

As China has pegged its currency to the low-yielding dollar, plus-or-minus a little revaluation here and there, the excess carry return from the Chinese yuan into the euro can be used as a risk barometer the same way the yen carry has been (see “Robin Hood Carry,” July 2010). This carry trade is composed in turn of two parts, the net interest rate gain to be made from borrowing three-month yuan and lending into three-month euros and the change in the spot rate. Any increase in short-term Chinese interest rates relative to European rates has the dual effect of tightening domestic credit conditions in China and lowering the interest rate spread.

This had been readily observable in the time zones outside of the green rectangle when we mapped the carry of the yuan (CNY) into the euro against the shape of the Chinese money-market yield curve as measured by the forward rate ratio between six and nine months ($FRR_{6,9}$) plotted inversely. This is the rate at which we can lock in borrowing for three months starting six months from now divided by the nine-month rate itself; the more this $FRR_{6,9}$ exceeds 1.00, the steeper the yield curve is. The carry trade index should lead the $FRR_{6,9}$ by three months given the movement of future interest changes “rolling down the curve” into the present. This trade had been disrupted during the Eurozone’s sovereign credit crisis from December 2009 – May 2010, the time period noted in the green rectangle.

CNY Money Market Yield Curve And Carry Into EUR



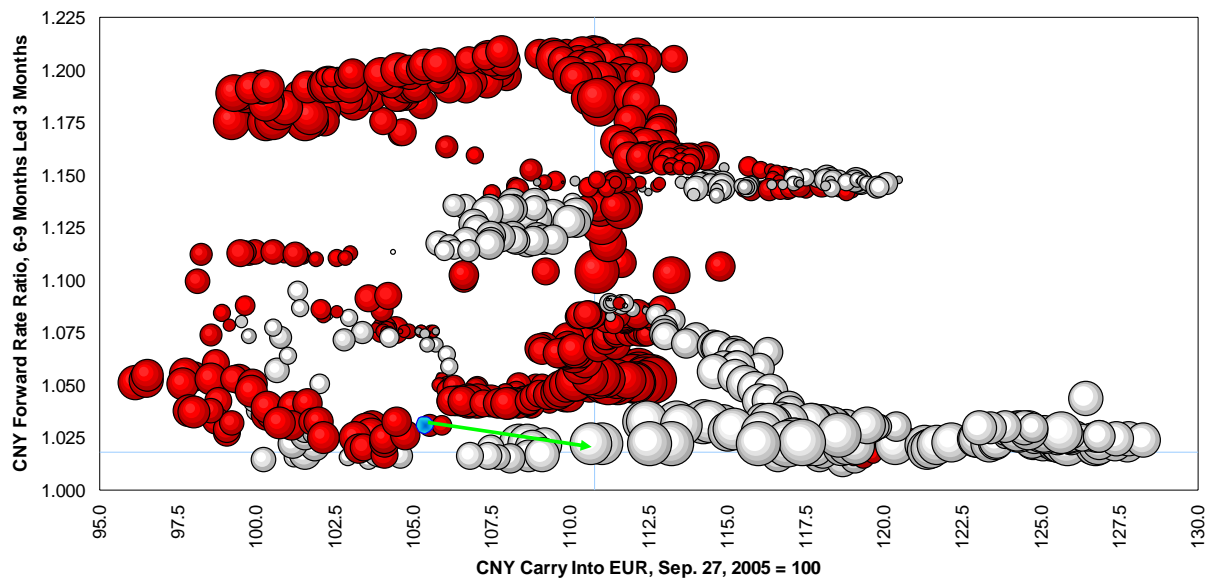
One of the great surprises of 2009 given China’s key role in arresting the global recession is interbank credit conditions in China began to tighten in late May 2009 (see “Viewing The Yuan From The Grassy Knoll,” *Currency Trader*, February 2011); they just did not bother telling anyone. Did this interest rate action and the carry trade into the euro have any impact on global growth prospects in general and on base metals prices in particular?

Money And Metals

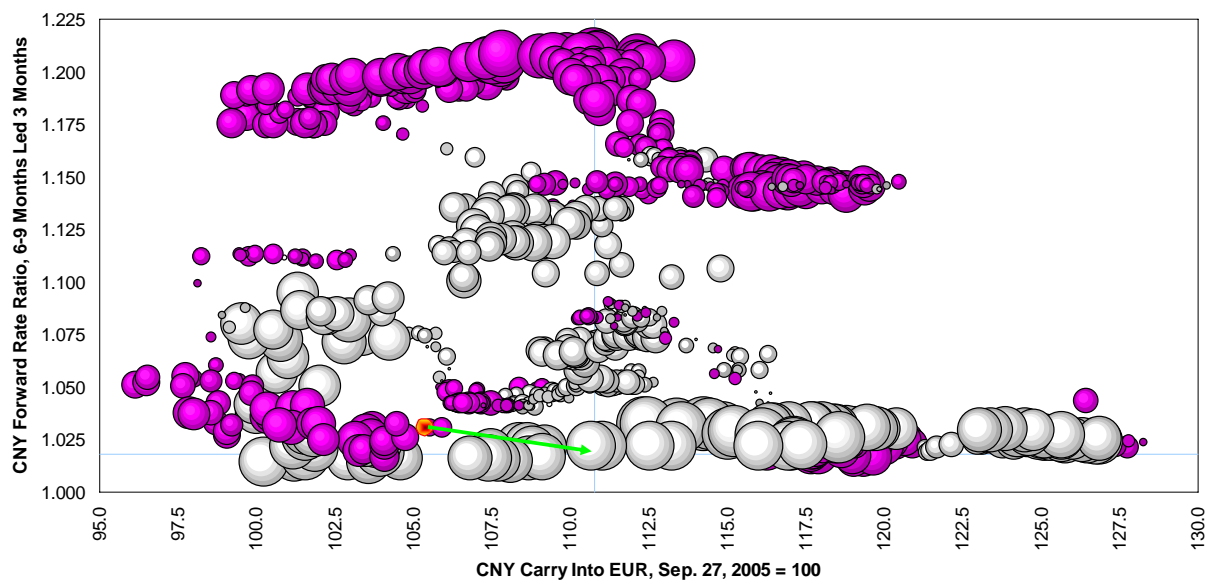
Each of the charts below depicts the three-month ahead percentage price change for an LME three-month forward as a function of the Chinese $FRR_{6,9}$ led by three months and of the yuan carry into the euro. Positive price changes are depicted in colored bubbles; negative price changes in white. The diameter of the bubble corresponds to the absolute magnitude of the price change. The current data points are indicated with a bombsight; the last datum involved in calculating a three month-ahead return is highlighted separately, and an arrow from there to the present is overlaid on the chart.

As it turns out, the high degree of correlation between the six metals involved, copper, aluminum, lead, zinc, tin and nickel, allows us to make some consistent observations. As an aside, while this is good for analytic purposes, it makes no sense economically. With the exception of lead and zinc, which often are extracted from the same ores, these metals are produced in very different areas and under different mining cycles. Moreover, the substitution between them is slight to say the least; while copper and aluminum both are used in electrical wiring, we would not suggest substituting copper for aluminum in aircraft manufacture, and the world probably is not ready for beer cans made out of lead. The high correlation of these metals' prices is due to the influence of hedge funds and other investors who insist on trading them together as a group.

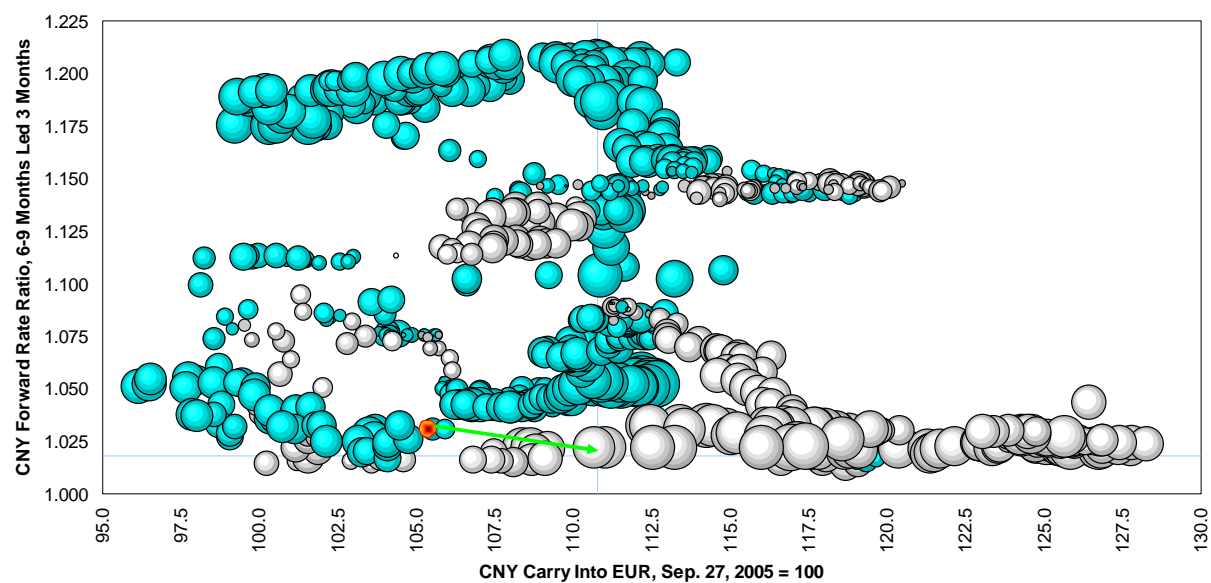
**Three-Month Ahead Tin Price Changes As Function Of
Chinese Monetary Variables**



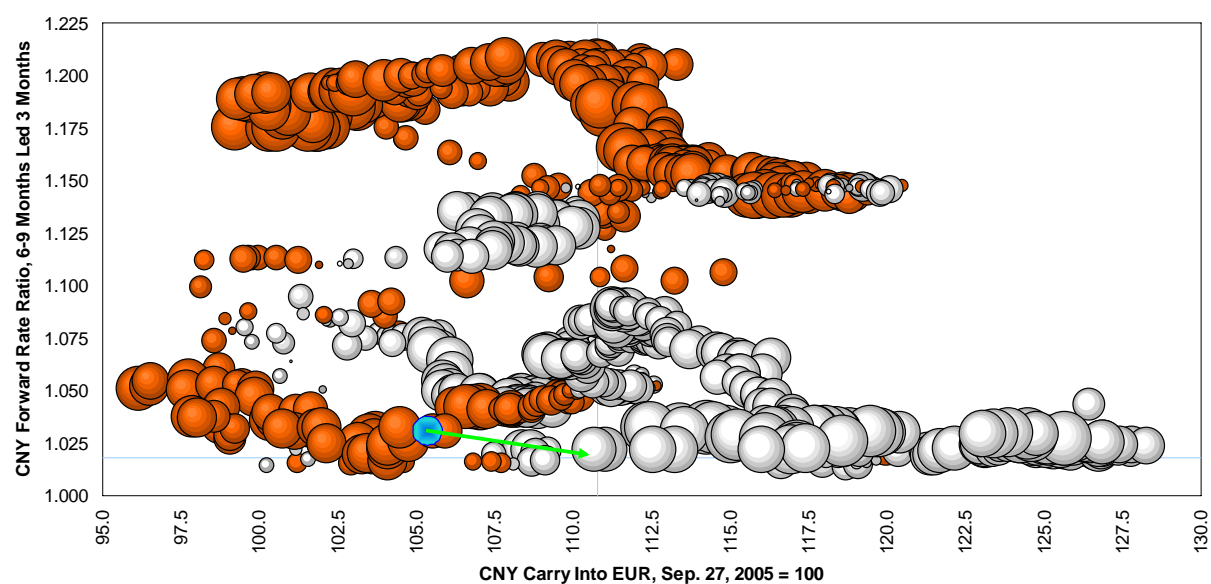
**Three-Month Ahead Aluminum Price Changes As Function Of
Chinese Monetary Variables**



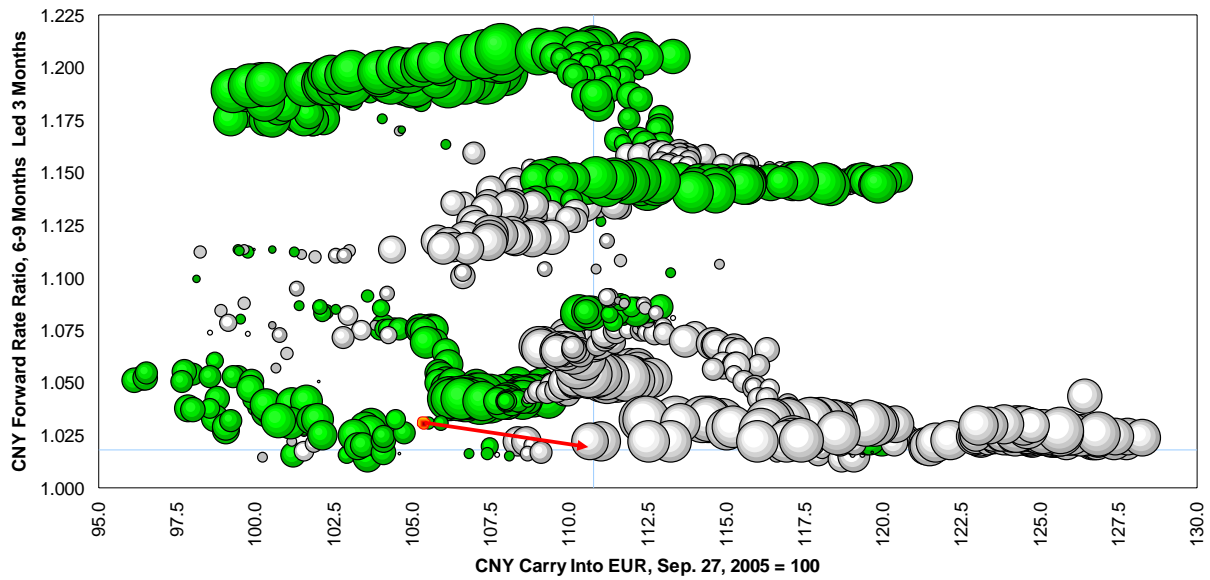
Three-Month Ahead Lead Price Changes As Function Of
Chinese Monetary Variables



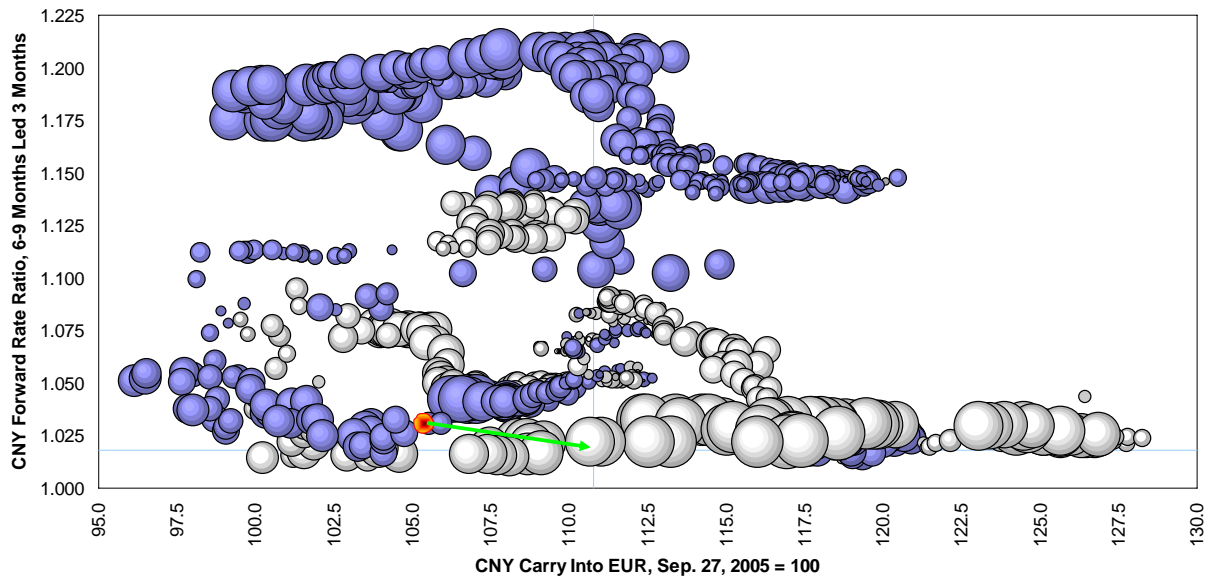
Three-Month Ahead Zinc Price Changes As Function Of
Chinese Monetary Variables



Three-Month Ahead Nickel Price Changes As Function Of
Chinese Monetary Variables



Three-Month Ahead Copper Price Changes As Function Of
Chinese Monetary Variables



The net result of tightening trends for Chinese monetary policy is the bombsight had been pushed toward the southern edge of the charts; the rebounding carry into the euro has pushed the bombsight eastward over the past three months' of data. None of the six metals examined have a positive price expectation from either this zone or trend in the bombsight. As Chinese demand has been setting the global price for more important metals such as copper, aluminum and nickel for several years now, anyone who is long those metals as commodities or who is long the equities of mining firms should run for cover each time China decides to tighten. The trade works in reverse, of course.

This should indicate global mining stocks' relative performance is nothing other than a currency trade in disguise, and had been the case until the weak revaluation began in June 2010. This development, which promised greater Chinese purchasing power along with various mining industry mergers pushed the relative valuation of the HSBC Global Mining Index for Diversified Miners against the MSCI World index higher in a quantum fashion. One this

shock has been absorbed, watch for both the base metals and for mining equities' valuations to resume being a strong function of Chinese monetary policy.

Mining Stocks Are A Currency Trade In Disguise

