Chinese Stocks And U.S. Bonds

Europeans had, prior to the introduction of the euro in 1999, something of a cultural advantage in currency trading; they were quite used to using different currencies and in many cases different languages within a small geographic space. Once we come back to this side of the pond and measure those small geographic spaces in miles instead of kilometers we encounter a hometown bias in investing. Just as too many people are over-exposed to their employer's stock in a 401-k plan or are overconfident when it comes to their industry, they are overexposed to U.S. stocks and bonds.

But to assume this inward gaze is unique to Americans or to any other nationality would be equally myopic. It also would ignore effects such as capital controls and official central bank interventions in markets. Both the Peoples' Bank of China and the Bank of Japan have engaged in purchases of U.S. Treasuries and other securities both as part of currency management programs and in apparent concert with the Federal Reserve's various quantitative easing campaigns (see "Viewing the Yuan From a Grassier Knoll," *Currency Trader*, August 2012).

Given the flows coming out of Asia and into U.S. financial markets, it might be logical to assume Chinese investors' incentives to move into U.S. Treasuries are affected by both the performance of the Chinese stock market and by the current direction of the yuan. The currency aspect of this analysis recalls the old fear in the 1970s and 1980s Japan would back away from buying U.S. Treasuries if the dollar weakened against the yen. This fear was preposterous; not only would such a move threaten Japan's existing holdings of U.S. securities, it would degrade the American capacity to import Japanese goods. In addition, a weaker dollar made the effective purchase price more attractive in yen terms. If we substitute China for Japan and advance the calendar by three decades, the arguments and conclusions remain the same.

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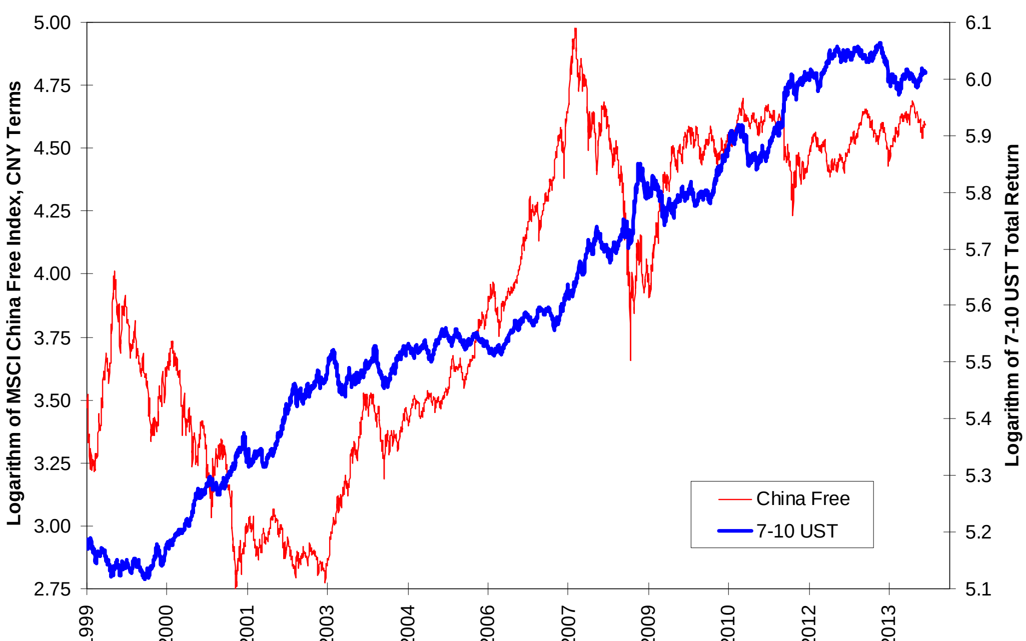
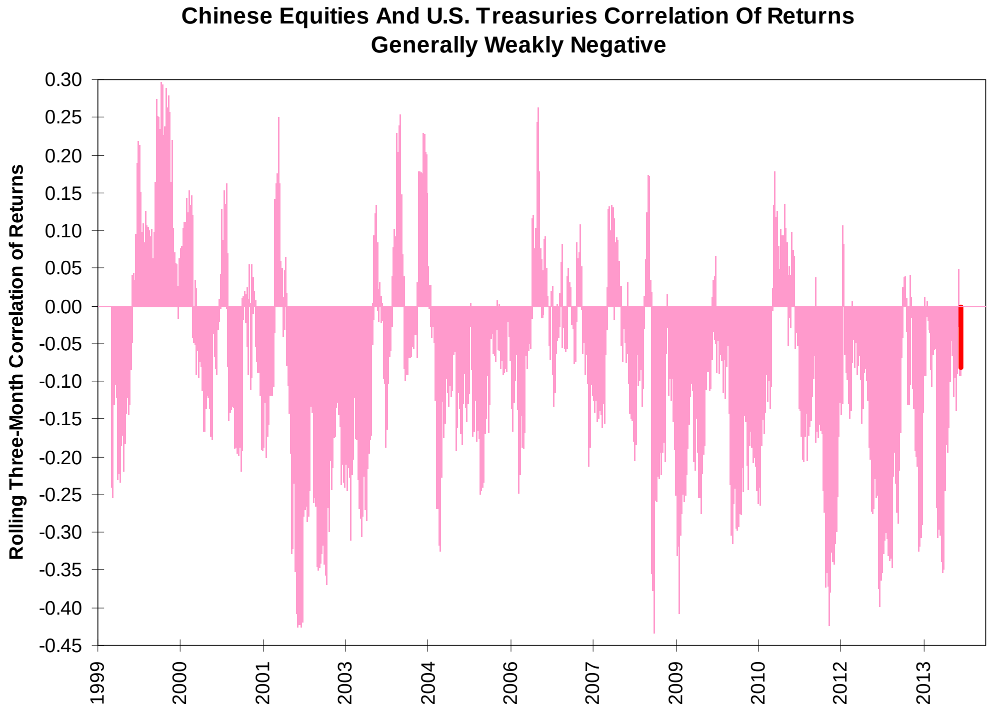
The long-term comparison of returns on Chinese equities in yuan terms and U.S. long-term Treasuries looks weak and is statistically; the r^2 or percentage of variance explained from January 1999 through February 2014 is only 0.591. Moreover, while the return path of long-term Treasuries has been remarkably constant over the course of a bull market extending all the way back to 1981, Chinese stocks have had long periods of strong performance, such as 2003-2007, and other periods of negative and stagnant performance, such as the financial crisis and its long aftermath.

Chinese Equities And U.S. Treasuries Do Not Drive Each Other



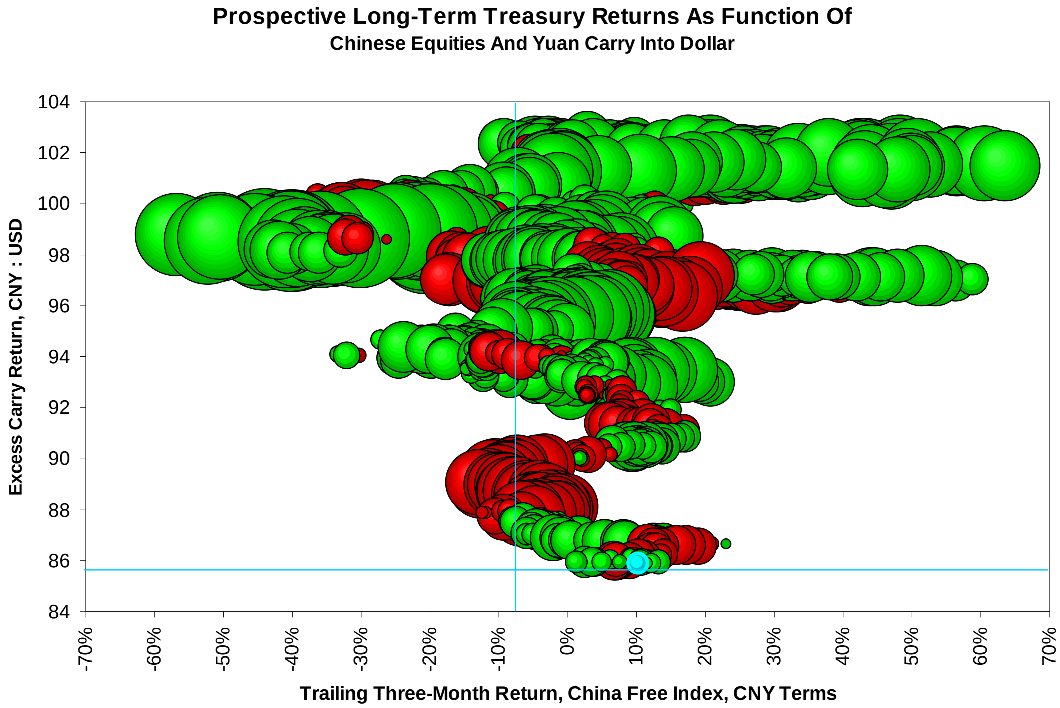
If we take a look at the rolling three-month correlation of returns between the two markets, we see it has been generally but erratically negative. Nothing here or in the time-series projection made above suggests any driving relationship one way or the other between the two markets. It is as if they exist in separate spaces even though this defies intuition in a world where capital markets are linked so strongly.



Enter The Yuan

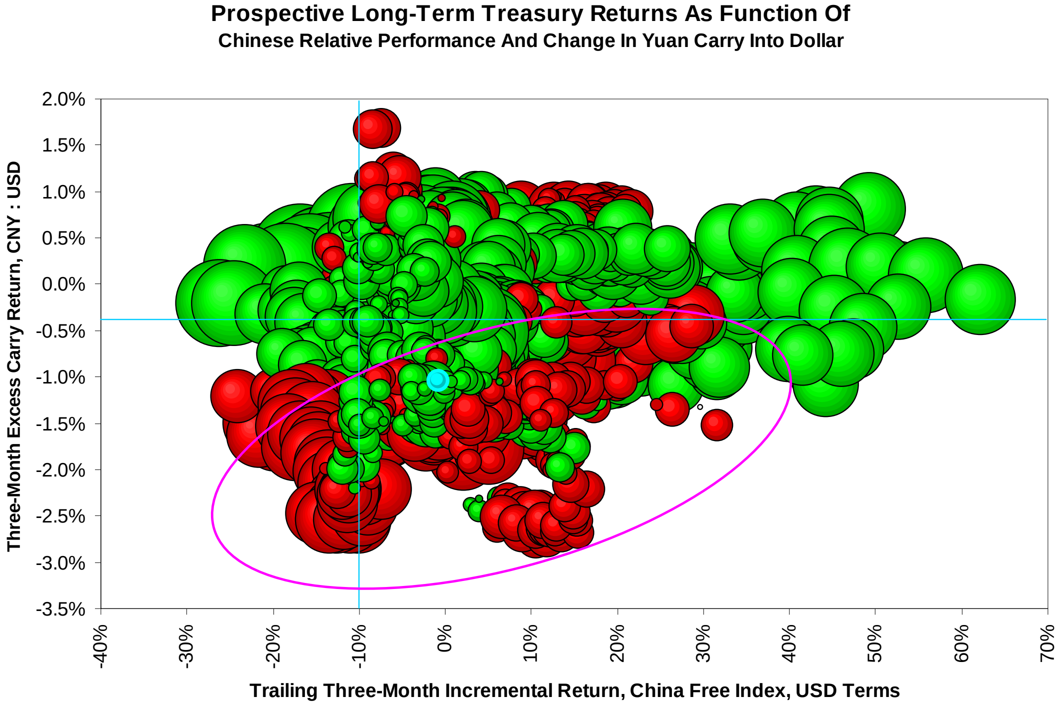
The on-again / off-again revaluation of the yuan makes it a less useful variable than other currencies would be in parallel analyses. Its first revaluation began in July 2005 and extended to July 2008; the second revaluation commenced in June 2010. A carry trade history of borrowing the CNY and lending the USD begins in September 2005, shortly after the first revaluation began and will be used below. A higher carry return index corresponds to a weaker CNY relative to the USD.

How have three month-ahead returns on U.S. 7-10 year Treasuries reacted to trailing three-month returns of Chinese stocks in yuan terms and to the excess carry return for the CNY? Positive prospective returns are depicted with green bubbles, negative prospective returns with red bubbles; the diameters of the bubbles correspond to the absolute magnitude of the returns. The present environment is marked with a blue bombsight and the datum from three months ago is highlighted.



This map, like the two charts preceding, apparently contains very little useful information. There is a clutch of red bubbles near the middle of the chart, and everything else is green. On one level this should not be surprising given the long-running bull market in Treasuries; we should expect most three-month returns to be positive. But once again it defies intuition.

Let's take one more stab at the problem by depicting the yuan's excess carry return as a three-month change and depicting Chinese stocks' returns as a three-month differential to U.S. stocks in USD terms. Now a much more information-rich picture emerges. First, the zone where Chinese stocks outperform their U.S. counterparts by more than 35% is filled with strongly positive prospective Treasury returns. Second, the zone marked with an oval lies within a region of negative changes in the excess carry return and extends further down to the southwest corner corresponding to Chinese underperformance relative to the U.S.



The tendency, therefore, is for periods of yuan strength and Chinese underperformance to be followed by negative returns for U.S. 7-10 year Treasuries. This suggests Chinese investors, a collective dominated for the most part by official entities, to shift funds into Chinese stocks after they have underperformed. It also suggests official China is willing to absorb a stronger CNY at the expense of negative prospective returns on 7-10 year Treasuries, at least for a three-month period.

A common refrain in the 1980s was Japan viewed business in military terms; if so; it did not do them much good in the long haul. A parallel refrain for today regarding China would be it takes a very strategic view of its official investing and currency management policies. This lack of a China-first official view has served them well, at least so far.