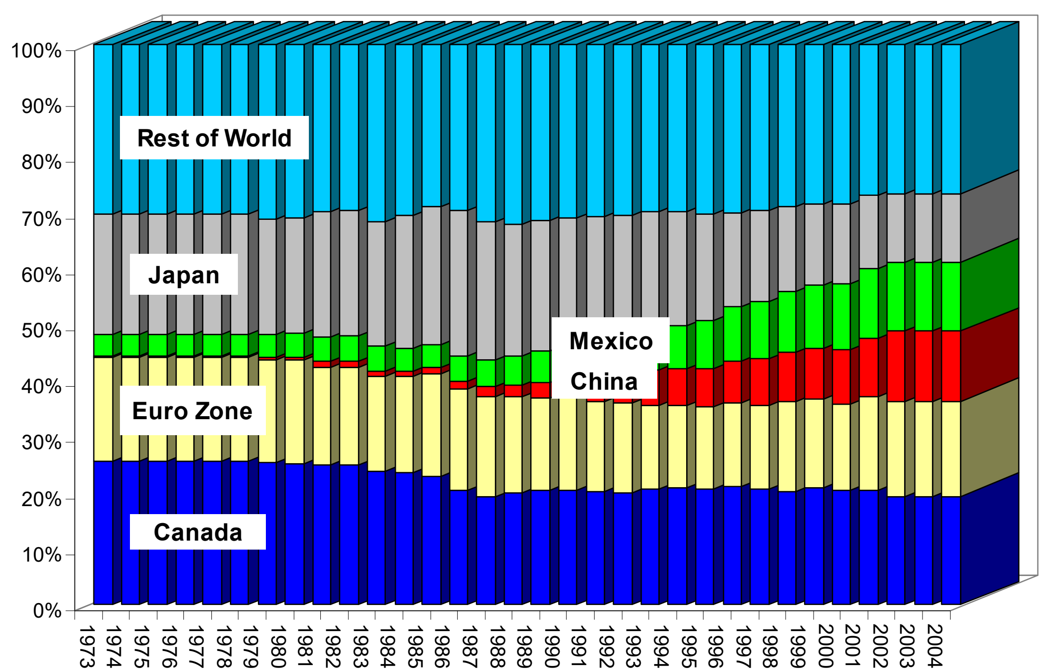
Yuan Flew Over The Euro's Nest

Financial markets are subject to optical illusions: Stare at anything long enough, and its appearance changes. And, like the behavioral transformations known to result from mental misinterpretations of visual data at Closing Time, the results are not always the ones for which we hoped.

Take the issue of the Chinese yuan (CNY), please. A large number of manufacturers and the politicians who love them are convinced if only the CNY, which has been pegged near 8.277 to the dollar, were allowed to trade freely, it would zoom higher. Left unsaid is the presumption this would be a good thing for the U.S. Why I should celebrate higher prices for imported goods and a lower capital surplus is unclear, and that does not even begin to address the *Blazing Saddles*-like gun-to-the-head logic of recent threats to impose a 27.5% tariff on imports from China.

The presumption that a stronger CNY will by itself correct a trade imbalance is a bit of a stretch. It takes years of significant currency appreciation for an exporter to lose market share. The Japanese yen buys 2.7 times as many dollars as it did in 1973, but Japan's share of exports to the U.S. did not decline until NAFTA made Mexico a significant exporter and until China began to emerge from its isolation.

Total Import Weights For U.S. Dollar



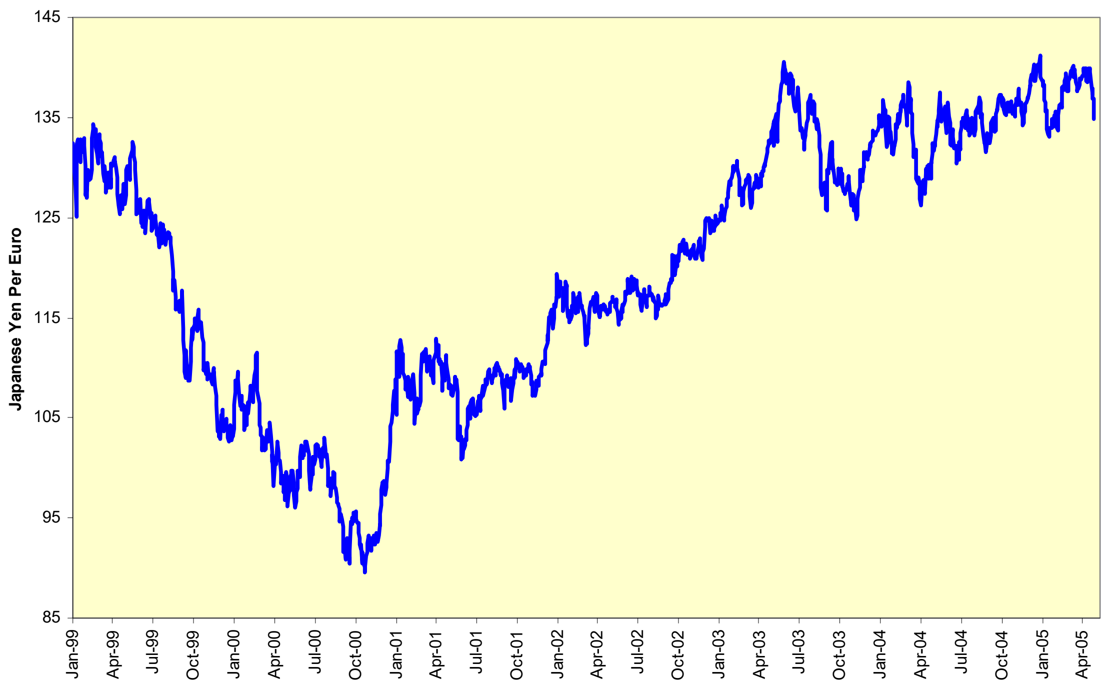
What will happen if and when China releases the peg is unknowable; who amongst us predicted the response to the euro's introduction in January 1999 would be three years of unmitigated selling? China has been flooded with speculative capital waiting for a revaluation, and this capital could jam the exits when it is allowed to leave. We tend to forget in our new view of China that it is still ***The People's Republic*** of China and people's republics of anything - Santa Monica, the Upper East Side, etc. - tend to have their own views of property rights. It is not a warm and fuzzy home for your money.

How many times would the CNY have to appreciate before China's advantages of labor cost, lack of environmental, health and safety protections, and newer capital equipment stock disappear? We are not talking about a 27.5% increase, as proposed for the tariff. We are talking about a several hundred percentage-point increase, and that simply will not be permitted by the Chinese authorities.

An Adjustment Play Today

Two global economic imbalances resulting from the CNY peg have been an appreciation of the euro against the dollar and a manic attempt by the Bank of Japan to suppress the yen's rise against the dollar by buying U.S. Treasuries. The cross-rate between the yen and the euro weakened between late 2000 and mid-2003, and now appears ready to move the other way. This will especially be the case should the CNY be allowed to float and if it moves higher as a result.

The End Of A Trend?



Which industry groups in the U.S. equity market will benefit as a result of a yen/euro appreciation? Let's employ a methodology first introduced here in February for isolating how much a stock group's performance relative to the S&P 500 can be attributed to a given factor; here we are looking at the related factors of a stronger yen and a weaker euro.

Japanese Yen

Group	Relative Performance Beta
FOOD RETAIL INDX	(0.268)
DRUG RETAIL	(0.247)
BIOTECH	(0.228)
HLTH CR EQIP	(0.179)
HYPR & SUPRCNTRS	(0.172)
FOOD DISTR	(0.171)
PACKG FOODS	(0.122)
PUBL&PRNTNG	(0.115)
AIR FT&LOG	(0.109)
PHARM	(0.105)
OFF SERV&SUP	(0.101)
PAPER PRDCTS	0.110
CONSUMER FINANCE	0.139
BUILDING PCT	0.141
THFTS & MRTGE	0.150
OTHR DV FN SC	0.154
ASST MNGMT & CST	0.157
FOOTWEAR	0.170
HOUSHLD APPL	0.178
ALUMINUM	0.185
SPECIALIZED FIN	0.198
COMP&ELECT	0.250
TIRES&RUBBER	0.255
STEEL	0.265
HOMEBUILDING	0.376
DIV MTLS&MIN	0.756
GOLD	0.969

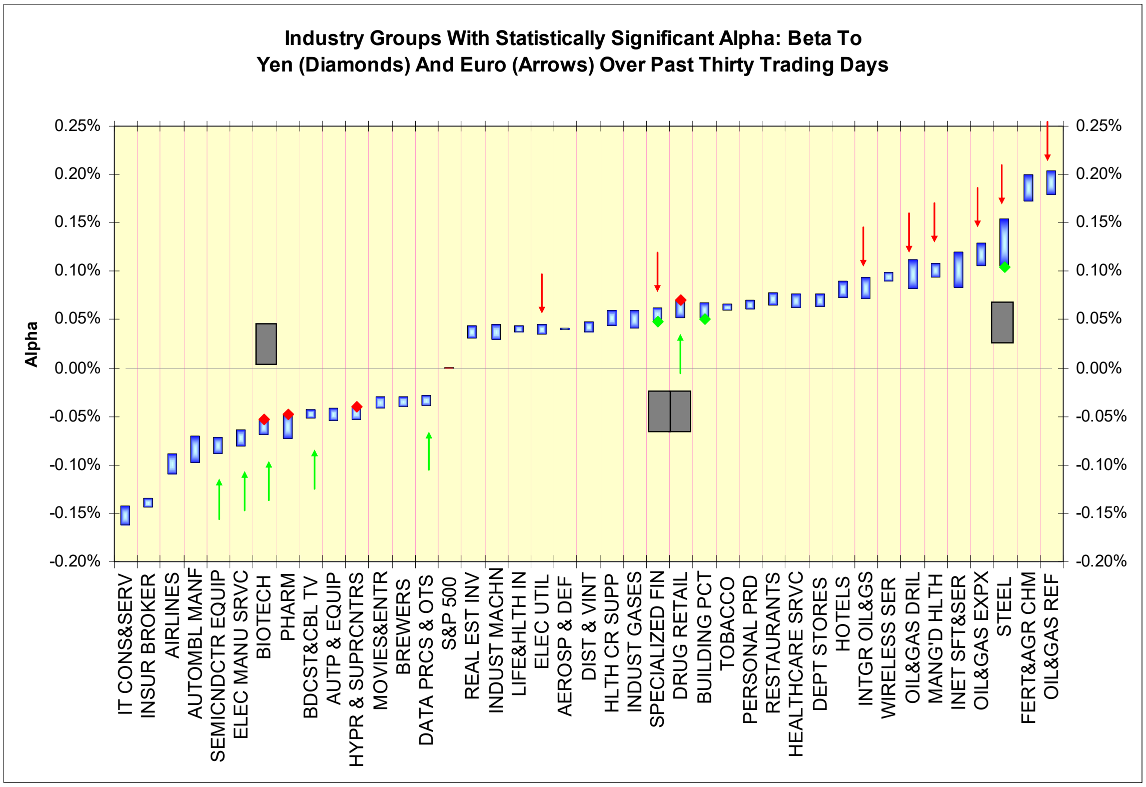
Euro

Group	Relative Performance Beta
EMPL SERVS	(0.318)
SEMICNDCTR EQUIP	(0.284)
SEMICONDUCTORS	(0.221)
COMP STG&PER	(0.214)
SYSTEMS SFTW	(0.195)
DRUG RETAIL	(0.191)
ELEC MANU SRVC	(0.189)
APPLIC SFTW	(0.180)
COMMUNCTN EQUIP	(0.178)
BIOTECH	(0.150)
FOOD RETAIL INDX	(0.145)
COMPUTER HW	(0.144)
DATA PRCS & OTS	(0.142)
BDCST&CBL TV	(0.130)
APRL & ACCES	(0.098)
ELEC COM&EQU	(0.092)
SOFT DRINKS	0.086
OTHR DV FN SC	0.088
REGIONAL BANKS	0.091
HOUSHLD APPL	0.100
DIV BANKS	0.107
MULTI-UTIL	0.114
GAS UTIL	0.127
MANG'D HLTH	0.162
ELEC UTIL	0.168
SPECIALIZED FIN	0.173
THFTS & MRTGE	0.183
INTGR OIL&GS	0.240
OIL & GAS EQU	0.263
STEEL	0.286
ALUMINUM	0.314
OIL&GAS REF	0.320
OIL&GAS DRIL	0.362
OIL&GAS EXPX	0.397
HOMEBUILDING	0.504
DIV MTLS&MIN	1.050
GOLD	1.663

There is no overlap between the beneficiaries of a stronger yen, the list beginning with Paper Products and extending to Gold is the left-hand column, and the beneficiaries of a weaker euro, the list beginning with Employment Services and extending to Electrical Components & Equipment. You could assemble a long-only portfolio of stocks out of both lists and catch the tailwind of the long yen / short euro trade.

Making The Alpha Bet

Let's narrow the search by employing a methodology introduced here last March, the systematic search for expected over- or underperformance, or alpha. The statistically significant alphas for various industry groups over the past thirty trading days are depicted below; the heights of the bars indicate the variability of these alphas. The green diamonds on the bottom of the bars indicate a positive impact from a stronger yen; the green arrows below the bars indicate a positive impact from a weaker euro. Conversely, the red diamonds and arrows indicate negative impacts from either a stronger yen or a weaker euro. Whew.



Four groups, marked with gray boxes, have offsetting impacts, Biotech, Specialized Finance, Drug Retailers and Steel. The remaining marked bars give you the raw material with which to work. If you fancy yourself a value investor, the beaten-down groups aided by the weaker euro include Semiconductor Equipment, Electrical Manufacturing, Broadcast & Cable TV and Data Processing & Outsourcing. Groups indicated as overvalued in a falling euro environment include Electrical Utilities, Integrated Oil & Gas, Oil & Gas Drilling, Managed Healthcare, Oil & Gas Exploration and Oil & Gas Refining.

We can summarize the trades above as long tech and short energy.

There are no momentum-style trades indicated; this is unsurprising given the prominence of the short yen / long euro trade until this point.

Is this a lot of work to get from the macroeconomic inkling of a stronger yen upon revaluation and an intermediate yen/euro trade to an industry group-specific set of trades in the U.S.? Yes, I suppose so. If it is worth having, it is worth working for, or so I have heard. Stare at it for a while and it will start to make sense.