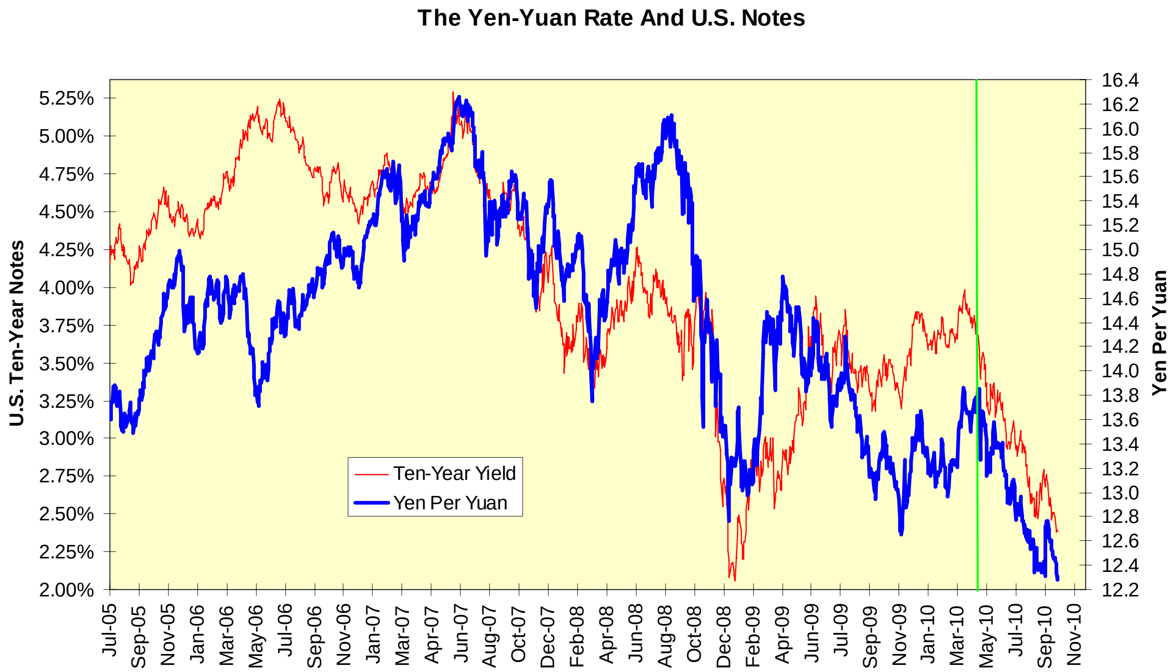
U.S. Bonds Win China-Japan Spat

I cannot be certain whether every language has an idiom similar to our "pot calling the kettle black," but it seems likely given the central role this stratagem occupies in the *Annals of Annoying Behavioral Traits*, Volume 3. It is a good working model for the world of modern currency trading where every country is trying to achieve prosperity by making its money absolutely worthless faster than its trading partners can do with their money.

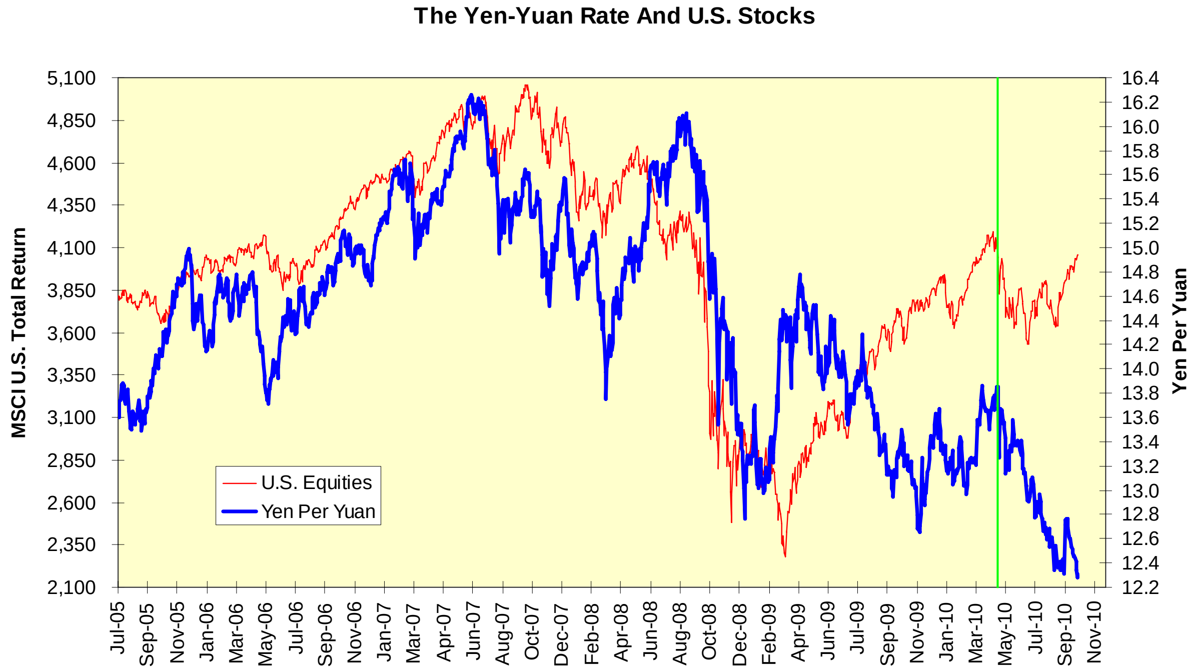
Yes, when we are all bankrupt, we will all be rich! One only can hope our ancestors threw people with similar inclinations off cliffs to reduce their presence in the gene pool, but even if they had done so, generations of mutations have given rise to this double-recessive mental disorder.

The role of Chinese monetary policy in determining U.S. Treasury rates was discussed here in February, and Chinese purchases of Japanese bonds (the "hot-foot thy neighbor" trade) along with the yen/yuan cross-rate were discussed here in September. That cross-rate has had an extraordinary linkage to U.S. ten-year Treasuries in recent years. Every time the yen strengthens against the yuan, U.S. yields decline as Japan tries to weaken the yen by printing them and then buying U.S. Treasuries.



The relationship has become especially acute since China began to prepare for modest yuan revaluation following the European sovereign debt crisis in May marked with a green vertical line; the one that was going to kill us all but somehow failed to do so. The r^2, or percentage of variance explained, between U.S. ten-year yields and the cross-rate has been 91.1% since that time; such relationships seldom exist between apparently separate markets.

The linkage between the cross-rate and U.S. equities has been far more episodic and disconnected. We have had several periods where U.S. stocks have declined as the yen firmed on the cross-rate and other periods such as today or September-October 2009 when U.S. stocks rose as the yen firmed. Neither correlation nor strong causality are present.



If China heeds our pleas to stop manipulating their currency so we can get on with the serious business of destroying ours, what will the likely results be? The dual histories above suggest a back-up in long-term Treasury yields and U.S. stocks outperforming bonds. This is an indicator, the cross-rate, easy to follow with trades that easy to execute arising therefrom.