Every Program Has A Sequel

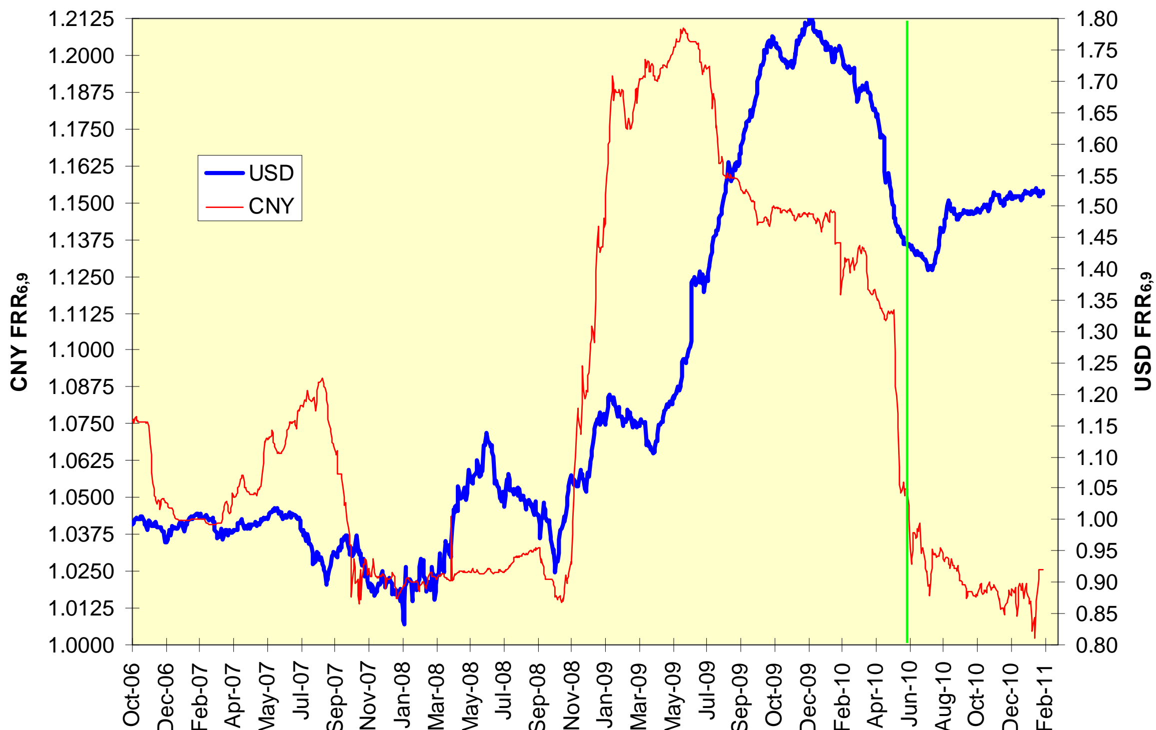
If you are of a certain age, and I certainly am, you remember when Hollywood pretended its retreads and sequels were not as half-baked as everyone knew they were. The blockbuster *Hog Jaws Attacks* would be followed by something called *Trough Trouble*, not *Hog Jaws Attacks II*.

But now we debate QE3 before QE2 has been laid to rest, which raises the real possibility Ben Bernanke might approach the twelve entries in the *Friday the 13th* franchise, all without the benefit of those occasional visuals that make teen horror flicks memorable.

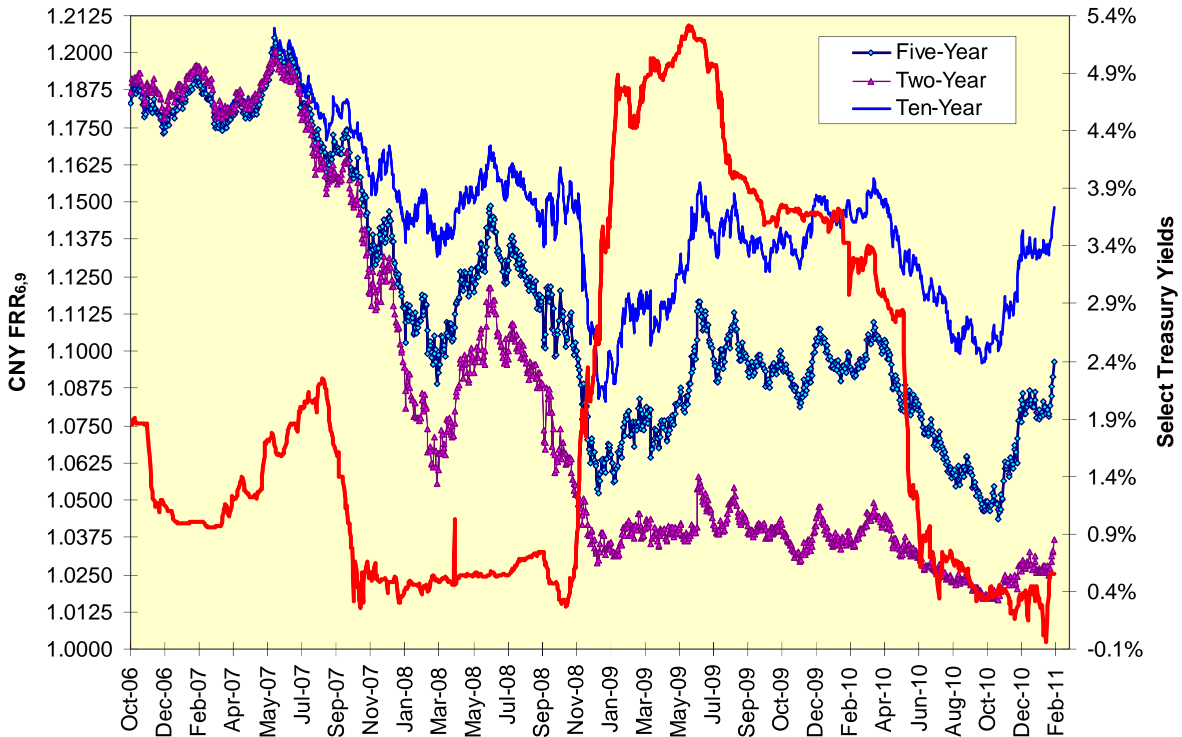
Unremarked in all of this the role the second revaluation (RV2, thanks for asking) has had in U.S. financial markets over the past year. RV1, for those of you keeping score, was the first Chinese move toward revaluation in July 2005. This ended in July 2008 when the Chinese learned all those Fannie Mae and Freddie Mac securities they were buying had the full faith and credit of a box of Cracker Jack, not of Uncle Sam. That led Hank Paulson to extend the Treasury's guarantee to the agencies; the world almost died two months later.

Let's now return to an analysis from February 2010 on the role of Chinese money-market conditions play in U.S. fixed-income markets. Briefly, China needed to buy U.S. securities to maintain the yuan peg. China was preparing for yuan revaluation at the end of March 2010, the time when QE1 was set to expire, but the move was delayed by the Greek sovereign credit crisis. Part of this preparation was lower purchases of U.S. securities at a time when the Federal Reserve was printing less money; stocks responded by selling off in May-June 2010 and bonds commenced a major rally into the start of QE2 in November.

RV2 began in June. The yuan's forward rate ratio between six and nine months ($FRR_{6,9}$), the rate at which we can lock in borrowing for three months starting six months from now, divided by the nine-month rate itself, collapsed. The U.S. waited a month and then began acting as low short-term interest rates were not low enough: QE2 would follow RV2, and the USD $FRR_{6,9}$ steepened.



Once the money started rolling in, Argentina-style, with the start of QE2 in November 2010, the extra liquidity propelled stocks higher. It also propelled inflation expectations and bond yields lower.



Where does this leave us? The answer is two-fold: First, you can ignore China's various interest-rate hikes and credit-tightenings; what matters is the speed at which the yuan will be allowed to revalue. For U.S. stocks, slower is better. Second, watch for QE3. If we get it, say bye-bye to bonds and hello to further stock gains. If not, bonds will perform relatively better vis-à-vis stocks than they have over the past four months.

It is all a theatrical production; the world is a stage and we are but actors in a string of sequels. When the good folks at various celebrity-gossip outlets start leaking news of QE3, make reservations for the stock-buying show.