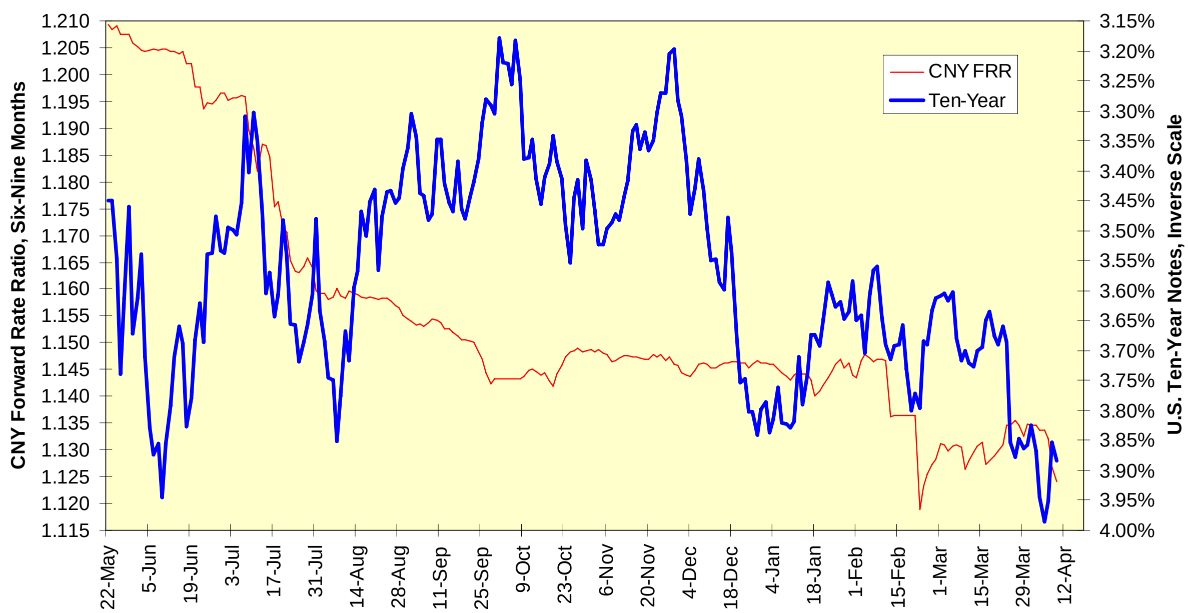
The Yuan: Forwards March!

Jazz legend Thelonious Monk made use of the space between notes to create a form of tension for the listener. The concert of financial markets, which often sounds as if it is being played by an assortment of two year-olds with pots and pans, has produced its share of in-between notes in recent years, none more so than when our good and dear friends in Beijing, they of the $2.4 trillion dollar stash, are involved.

Their re-pegging of the yuan in July 2008? A concerto in silence minor, later sung by Hank Paulson in homage to Blind Faith, “But I ain’t done nothing wrong / But I can’t find my way home.” Your loyal correspondent figured it out by the beginning of that wonderful month of September 2008. And do you remember their press release about allowing their money market yield curve as measured by the forward rate ratio between six and nine months to flatten starting on May 22, 2009? That 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. Let’s hope not, because your loyal correspondent had to figure it out once again by listening to The Sounds of Silence; yes, “hello darkness, my old friend, I’ve come to talk with you again.”

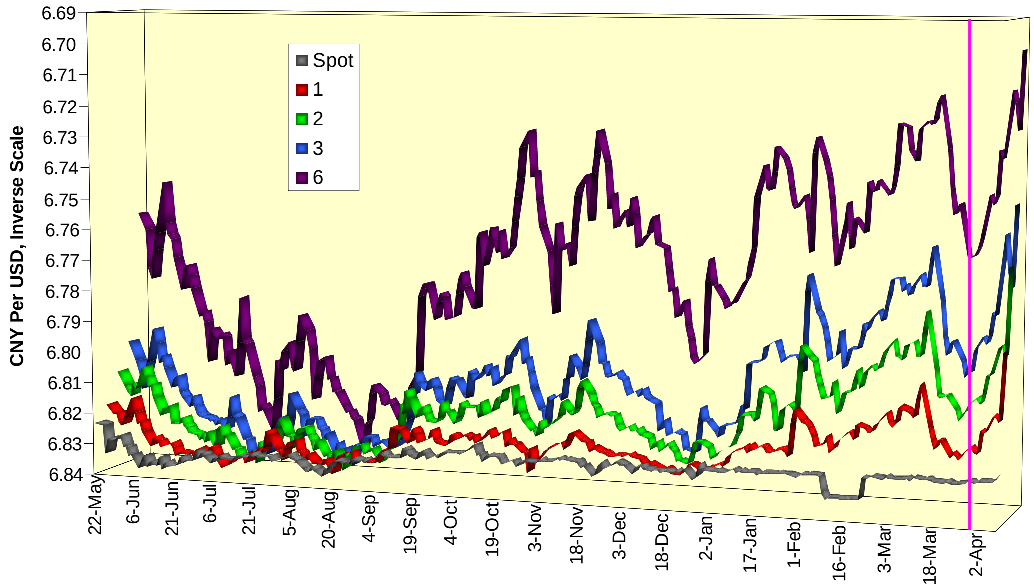
But tighten they did, and this helps explain why long-term U.S. Treasury yields were able to slide through the entire period since then without closing over 4 percent. China could have tightened domestically by issuing bills, but that would have cost them money. Instead, they sold yuan for dollars, shipped the dollars to the U.S. to support their beloved peg against the greenback and got paid interest by the U.S. taxpayer. A win-win all around: They got paid to tighten, we got to run unimaginably large deficits at low rates, they got to finance their largest customer and we could print dollars to our heart’s content without seeing them decline to zero against either (choose one) other major currencies or a handful of dirt.

U.S. Long-Term Rates During Chinese Credit Tightening



If China is about to let the yuan revalue, they would not need to buy so many U.S. Treasuries and other dollar-denominated assets, and we would see our interest rates spikes higher as they did on March 24, 2010, marked with a magenta vertical line below. This date will not live in infamy, but it certainly lines up with some interesting movements in the market for non-deliverable forwards on the yuan.

Forward Yuan Rates Marching Higher



Should you fear a wholesale abandonment of the U.S. by our major creditor? No, consider this to be part of plan – unannounced, of course – for a one-time increase in the yuan and a one-time adjustment higher in U.S. interest rates. Then it will be back to business as usual. After all, we need their financing of our consumption and spending habits and they need our incredible ability to keep buying pink bunny slippers at Wal-Mart. As musical geniuses Sonny & Cher would have said, "The beat goes on."