Will China Take Up Where Federal Reserve Leaves Off?

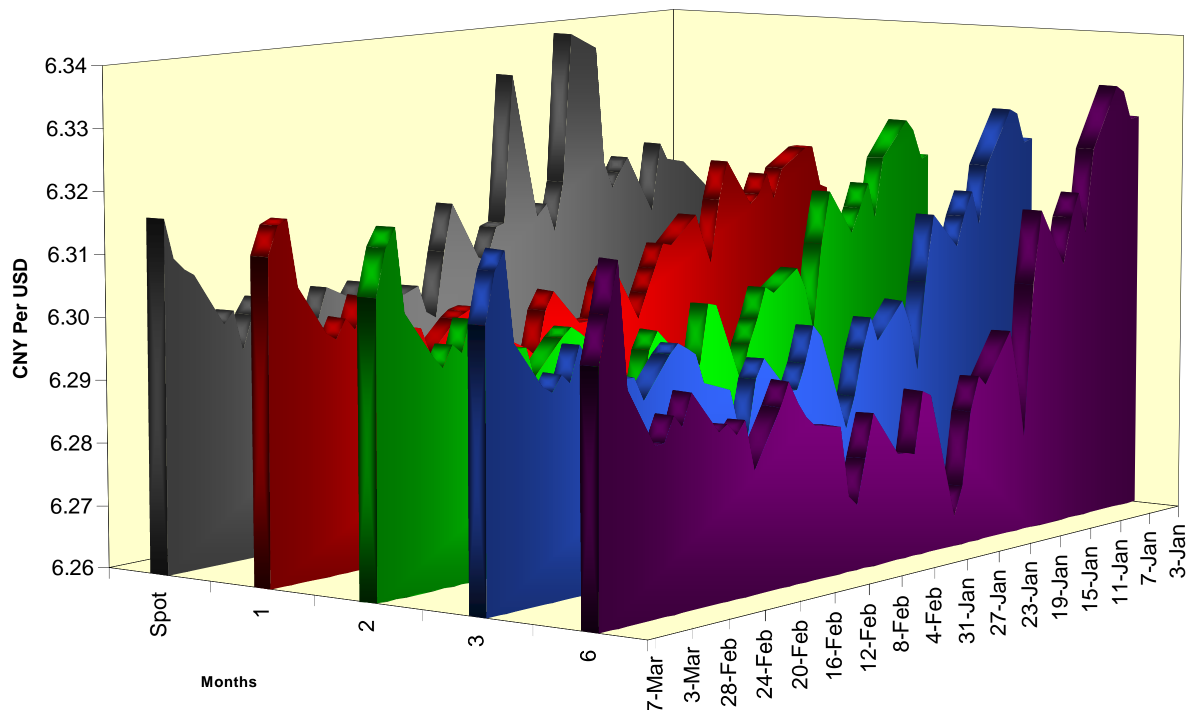
The Great Oscillation Is Part Of The New Normal, After All

I managed to conclude yesterday's column with a screed about how no one in their right mind should be long the Treasury market these days; only the Federal Reserve and foreign central banks are buying. Those buyers may be enough, especially if they are working in a tag team.

This has been a favorite theme of mine since February 2010's Chinese Monetary Policy and US Fixed-Income. The U.S. and China have an odd symbiosis: We need Chinese credit and want a stronger yuan; China needs its American customer and wants a weaker yuan. So we dance a little dance, and on occasion tell each other to, um, shove it, as I noted in China Ignores Obama's Plea for Yuan Appreciation, Fair Trade. When the Federal Reserve turns on its printing press, U.S. need for Chinese funds slows and the yuan appreciates. When the Federal Reserve stops, China resumes large-scale buying of U.S. assets and the yuan magically stops appreciating. We are in such a period right now.

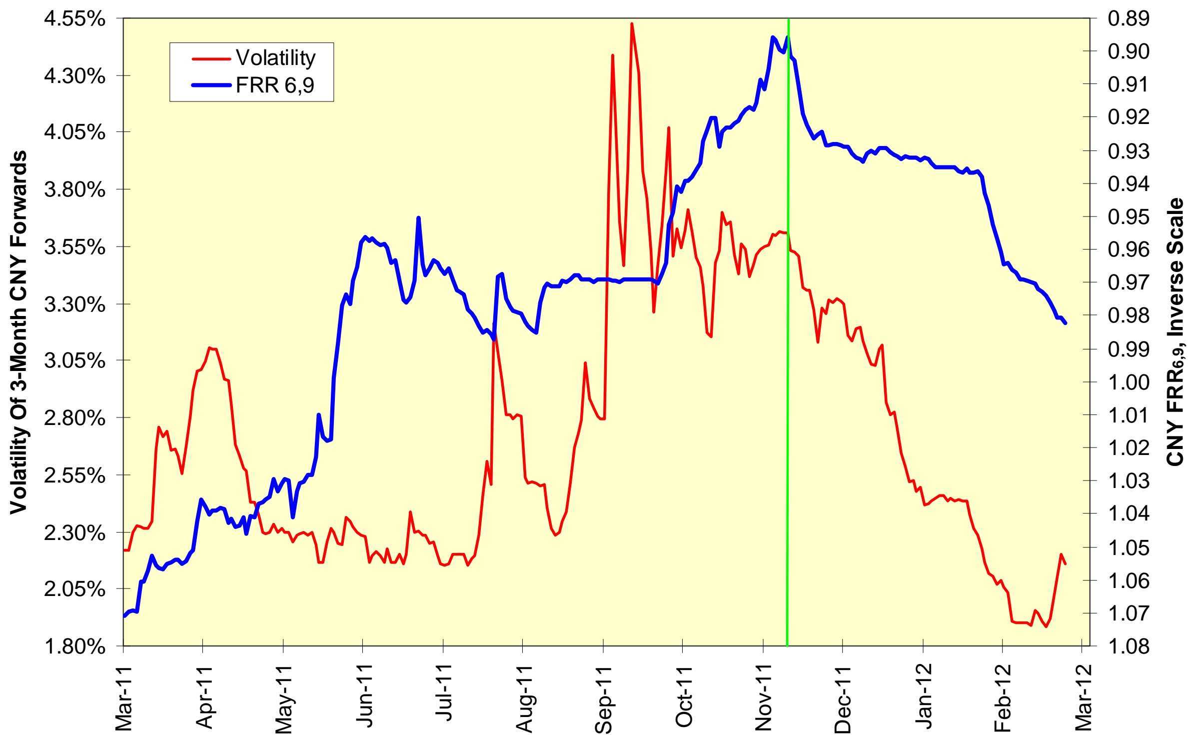
Back To The Forwards

The CNY has been on a weakening trend since mid-February, and this trend applies to yuan forwards as well as to the spot rate. The forward curve indicates a lack of concern about yuan appreciation over the next six months.



The picture is a little different when we look at the implied volatility of three-month yuan non-deliverable forwards; it has ticked higher since China lowered its growth forecast to "only" 7.50% for this year. The recent weakness in the CNY is seen as temporary by these traders.

However, the slope of the Chinese money-market yield curve as measured by the forward rate ratio between six and nine months ($FRR_{6,9}$) tells a more compelling story. This 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. An inverted yield curve has a $FRR_{6,9}$ less than 1.00, and that is where we have been since late 2011. However, this curve has been moving rapidly back to normal levels since the November 30, 2011 joint central bank expansion of currency swap lines. Chinese monetary policy is getting easier, and that money has to go somewhere.



A good place for that "somewhere," in addition to European equities (China did not accumulate $3.2 trillion in reserves by being stupid enough to buy European sovereign debt) is U.S. debt. While Benny's Boys are taking a well-deserved R&R break, China can print yuan, swap them for dollars and finance their customer. That will keep a bid under U.S. Treasuries (do not buy those TBT yet) and keep U.S. interest rates low in defiance of economic reality.

Future economic historians are going to love dissecting this stuff.