Chinese Monetary Policy And Global Equity Risk

Americans are way too jingoistic about their financial markets. We tend to think the world is run out of Washington, D.C., and the most important person there, in addition to being the Person of The Year, is whomever we install and subsequently deify as chairman of the Federal Reserve.

Balderdash, which sounds suitably dismissive even though I would be hard-pressed to tell you or anyone else exactly what "balderdash" is. The marginal supply of investable funds in the world today is China's $2.4 trillion stash of foreign reserves. Where they invest those funds, for how long they peg the yuan at its present rate near 6.83 per dollar and their own internal credit policies are the dog; everyone else right now is the tail, and what a wonderful view that is.

Global markets began to correct in mid-January when China *announced* the first of its moves to tighten internal credit conditions; while the sovereign credit troubles in Europe are more entertaining, these were known in November 2009 and did nothing to impede advances elsewhere. But this announcement masks a little-known reality: The money-market yield curve in China had been flattening since May 2009 while money-market yields curves elsewhere, the U.S. in particular, had been steepening to record levels. The details of this trade and its importance to fixed-income markets will be discussed in the **next article** in this series.

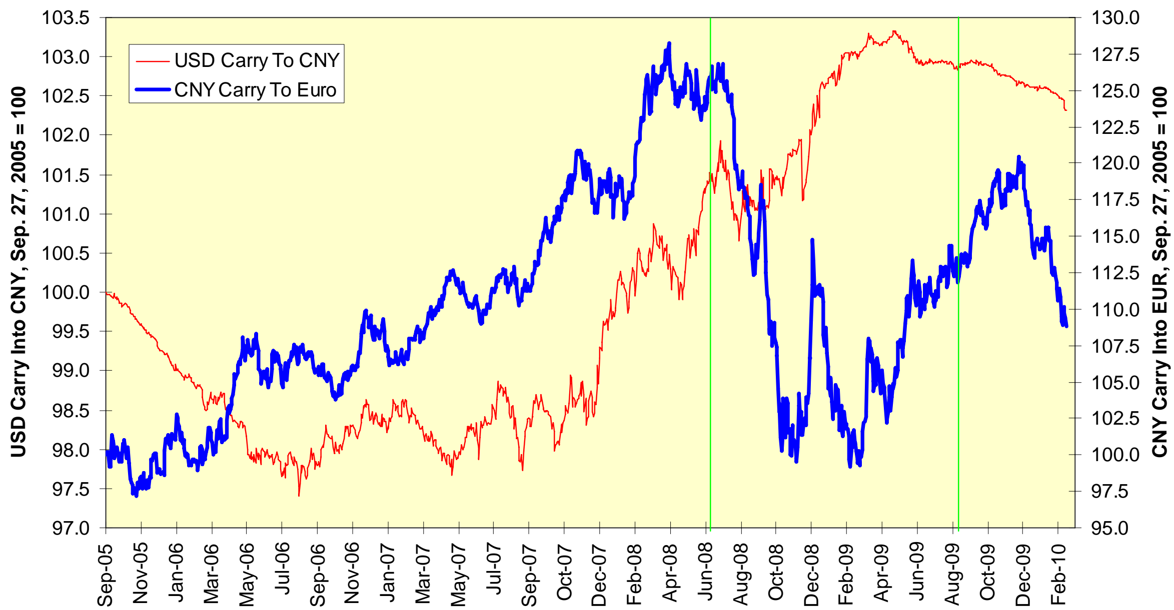
The Carry Trades

There are two key dates in the recent history of the yuan and its importance; both are highlighted in the charts below with green vertical lines. The first is July 14, 2008; this is when the U.S. acceded to a Chinese re-pegging of the yuan in exchange for China's continued investment in newly semi-nationalized Fannie Mae and Freddie Mac securities. This cemented the yuan's massive undervaluation.

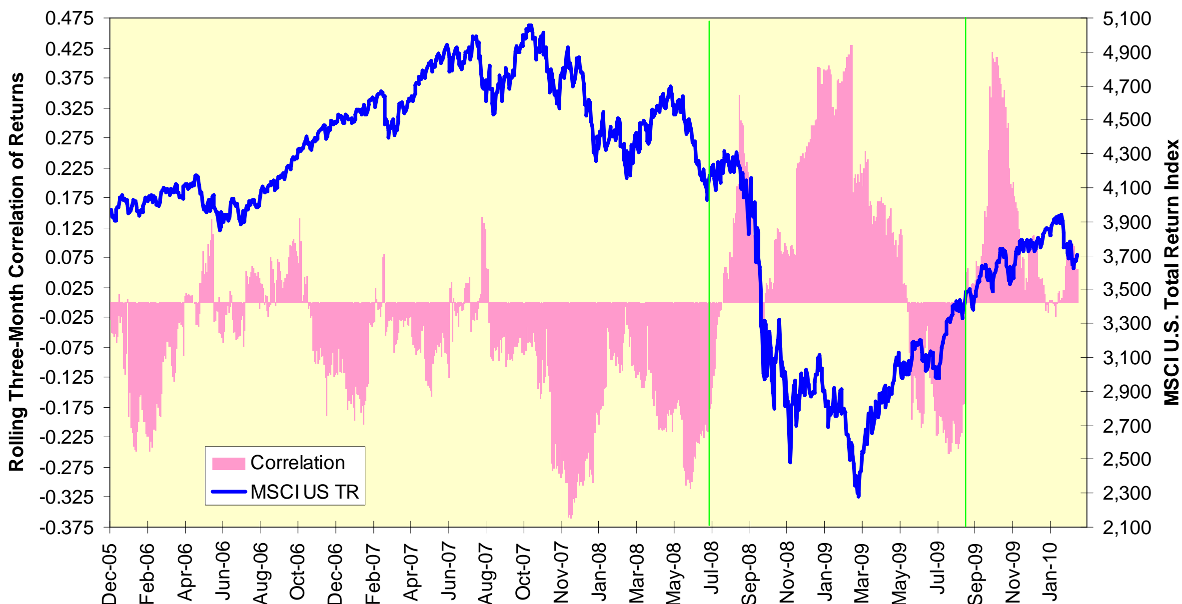
The second date is August 24, 2009; this is the date when the dollar became cheaper to borrow than the Japanese yen. That led to an unwinding of Japanese yen carry trades and their replacement with dollar carry trades. As the yuan is pegged to the dollar and as China's pool of reserves is 30.677% of the world's total, risky assets worldwide could be funded now with dollars and yuan more cheaply and in greater size than with yen.

Unless China raised the return on holding yuan, sort of like the Federal Reserve is considering doing with a Term Deposit Facility, the risk of cheap dollars/yuan reigniting a global speculative bubble of Biblical proportions became a clear and present danger. Unlike their American counterparts, who remain convinced in spite of overwhelming evidence to the contrary that cheaper money is the answer to problems caused by cheap money, they acted.

The net result can be seen in two carry indices. The first is the total return on borrowing dollars and lending in yuan; this peaked in May 2009 and has been accelerating downwards since then; this is the stark warning to the Chinese their short-term rates are too low. The second is the total return on borrowing yuan and lending in euros; this peaked right at the Dubai default warning in late November 2009 and has plunged along with the euro. Here the stark warning is to the world: Raise the rates on borrowing the yuan and overleveraged currencies and markets elsewhere will suffer.



Will tighter credit in China affect the U.S. markets? To quote certain politicians, "You betcha." The total return on U.S. stocks peaked right at the first Chinese tightening, and while the direct correlation of returns between the U.S. stock market and the dollar carry into the yuan is well off its October 2009 highs, the message is clear: A reduction in global carry trades into risky assets will be transmitted back to U.S. equities through slower growth and higher interest rates elsewhere.



There is an old Scottish proverb, "He who pays the piper picks the tune." China is paying all of the world's pipers, and the tune now is tighter credit conditions. Come to think of it, maybe we should update the Wall Street adage, "Don't fight the Fed," to "Don't fight the Peoples' Bank of China."