China To Offset Great Taper Caper

For those convinced we collectively learn nothing from history, allow me to offer improved central bank/finance ministry coordination in rebuttal. Much of this was born out of the Federal Reserve and the Bundesbank working at cross-purposes in the early 1990s following German reunification. The Germans made the decision to exchange relatively worthless East German ostmarks one-for-one with the Deutsche mark and thereby expanded the German money supply by the quantity of ostmarks.

Today we might call it accidental quantitative easing, but to the inflation-phobic Germans, this was anything but a laughing matter. The Bundesbank started mopping up marks and inverting the German yield curve while on this side of the Atlantic the lugubrious Alan Greenspan was cutting short-term interest rates to the radically low level of 3% and steepening the American yield curve. Predictably, the mark soared against the dollar, other European countries such as the U.K. whose currencies were pegged to the mark one way or another struggled to keep up and then the whole farce collapsed in September 1992. George Soros cashed in on the pound's collapse.

U.S.-China Pas-de-Deux

Let's return to the thesis presented here in February 2011 that yuan revaluation is linked to U.S. monetary policy cycles. When China kept the yuan (CNY) pegged, it had to keep buying external assets, including U.S. Treasury and Agency securities, to support the USD and weaken the CNY. When they allowed the CNY to revalue, the flow into USD was slowed and the Federal Reserve took over the wheel when it came to buying Treasuries and Agencies.

The coordination works when the Federal Reserve taps the brakes, too. I noted in August 2013 how Chinese buying could offset the tapering of QE and give China the added benefit, to their way of thinking, of a weaker CNY. What happened? Tapering began in December 2013, the CNY peaked in early January, U.S. Treasury yields started to fall and, just to keep the mix entertainingly confusing, the euro stayed bid against the dollar and rose against the yuan.

Even if China does not strive to weaken the CNY through direct purchases of U.S. assets so as to avoid the appearance of picking up where the Federal Reserve is leaving off, its purchases of euro-denominated assets will have the same effect; all it takes is for holders of stronger euros to swap them for dollars and you have Chinese purchases via one intermediate step.

For those of you keeping score, this is bullish for U.S. financial assets and helps explain why financial markets have continued to rally since taper-talk began in May 2013. Equity markets started to ignore taper-talk as far back as August 2012 and as I noted on Monday, fixed-income markets figured out tapering was not the end of the world in December 2013. China's yuan-weakening moves may not be done with the panache of Japan's all-out assault on the yen starting in November 2012, but they will provide the same boost to all risky assets.

A Comment On Yuan Volatility

The normal pattern for yuan volatility has been for it to increase before a revaluation as those with a need to know find a way to know and make the appropriate options trades. Implied volatility jumped before the yuan turned lower over the past two weeks, suggesting the trades were being done in yuan puts and not calls. In either event, the excess volatility of the yuan, the ratio of implied to actual volatility, has been moderate, suggesting the current yuan weakness will be short-lived.

In any event, the end of the one-way trade in the yuan is to be welcomed. Traders need to remember this is a dangerous game and should size their bets accordingly. Moreover, volatility has a way of transferring positions from weak hands to stronger ones and for signaling both the borrowers and lenders of yuan where the economic bounds of the trade are. All of the information suppression of the controlled revaluation removed these valuable market functions. Higher market-derived, as opposed to engineered, volatility would be a sign of a healthier yuan market, one ready to take its rightful place as a major world currency.