Chinese Markets Not Affecting Treasuries

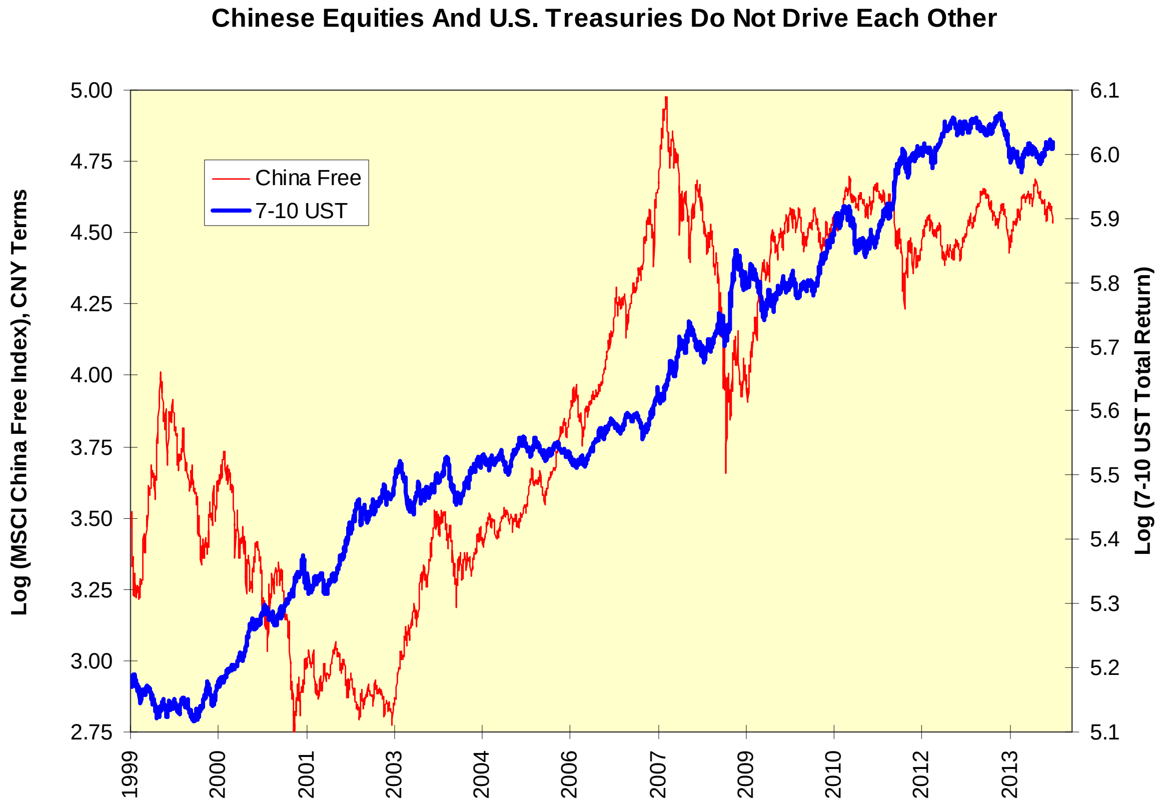
One of the downsides of market globalization and interconnectedness is we are trained to believe every hiccup here has an effect there. When our good friends at the Peoples' Bank of China (This is such a cool name. I think Goldman Sachs (GS) should change its name to the Peoples' Bank of Lower Manhattan and invite Bill DeBlasio over to unveil the new plaque) ended the one-way bet on yuan appreciation last month, I received a number of worried inquiries as to whether this was a sign of impending doom or even worse.

No worries, mates. Those concerns should be reserved for currencies such as the Japanese yen, Swiss franc and U.S. dollar used to fund carry trades and only when those funding currencies start to appreciate unexpectedly. As the yuan is not a funding currency and as it was weakening, not strengthening, we would not see the usual round of emerging market shellacking normally reserved for such occasions.

U.S. Treasuries

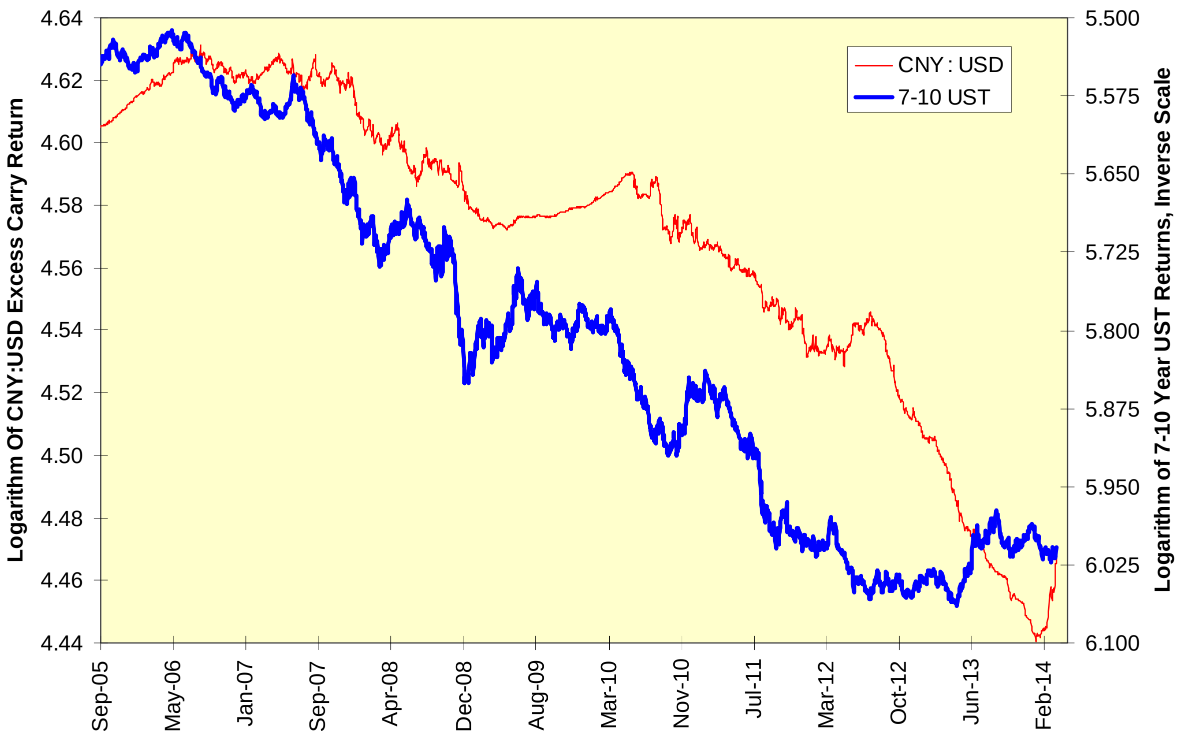
What, then, about the relationship between Chinese markets and U.S. Treasuries? Let's take a look at the returns for 7-10 year Treasuries as a function of Chinese equities' long march to nowhere over the past six and one-half years and against the excess carry return in the implicit carry trade for a yuan-domiciled investor lending money to Uncle Sam.

The total return on the MSCI-Barra China Free index in CNY terms is at August 2007 levels; this was the time when both the Federal Reserve and European Central Bank began their long series of financial market interventions. U.S. Treasuries have returned 50% over this same period. While their correlation of returns has been negative, this is simply a statistical artifact of two unrelated markets moving in different directions; there is no causation in either direction.



We can arrive at a similar conclusion for the yuan and Treasuries. Treasuries have returned 0.93% since tapering was postponed in September 2013; this qualifies for a pretty flat return in my book. The CNY:USD excess carry return between then and the yuan's peak in February was 1.69%; it lost 2.62% thereafter. Treasury returns across these two yuan periods were equivalent to each other at an 88%+ confidence level. Restated, whatever the yuan did in either direction was fine with Treasuries.

Long-Term Treasuries Unfazed By Yuan



Finally, if China continues in a weak-yuan policy, it will have to execute it via monetary accommodation. The end result, as noted earlier this month, will be a flow into either USD- or EUR-denominated assets; this will offset the Federal Reserve's actions in tapering QE and will be bullish for financial markets. Whether such a policy will be effective macroeconomically is another matter altogether.