

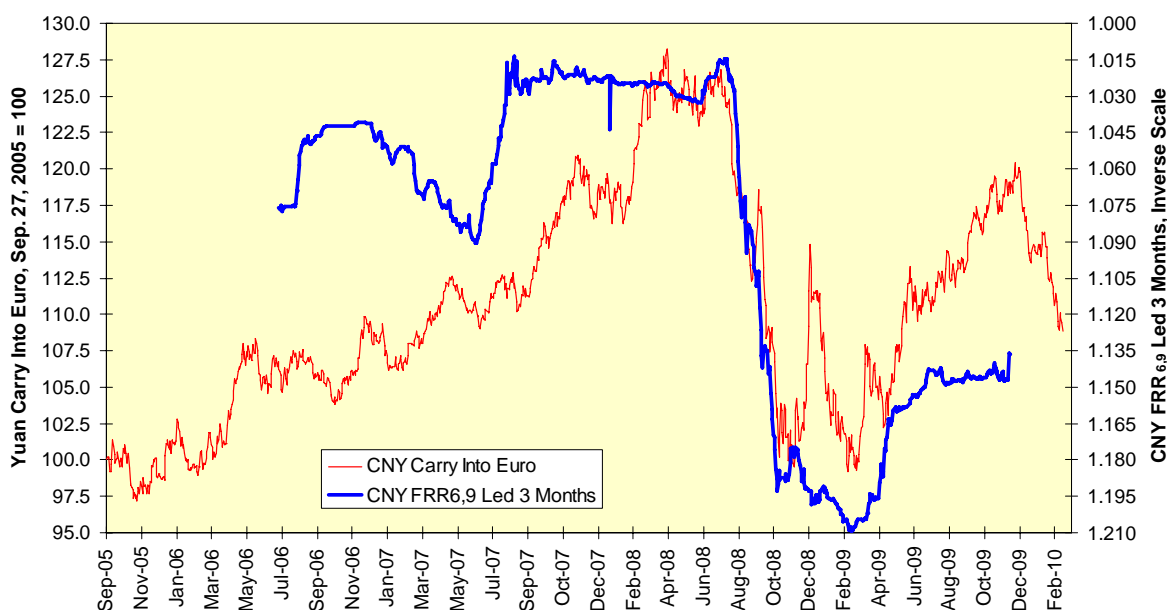
Chinese Monetary Policy And Base Metals

We have addressed the role of Chinese monetary policy for **global equities** and for **U.S. Treasuries** in the first two articles in this series; the time now has come to get down to brass tacks. Or bronze shields, lead balloons, tin cans or anything else made with base metals such as copper, aluminum, nickel, lead, tin and zinc. China has played a dominant role in setting the prices and final demands for these metals in recent years, especially a year ago when their state purchasing agency began stockpiling these metals as if it were the last chance to get long.

We noted in the previous article how the Chinese money market curve as measured by the forward rate ratio between six and nine months ($FRR_{6,9}$) has been tightening since May 2009. The $FRR_{6,9}$ 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. The more the $FRR_{6,9}$ exceeds 1.00, the steeper the yield curve is.

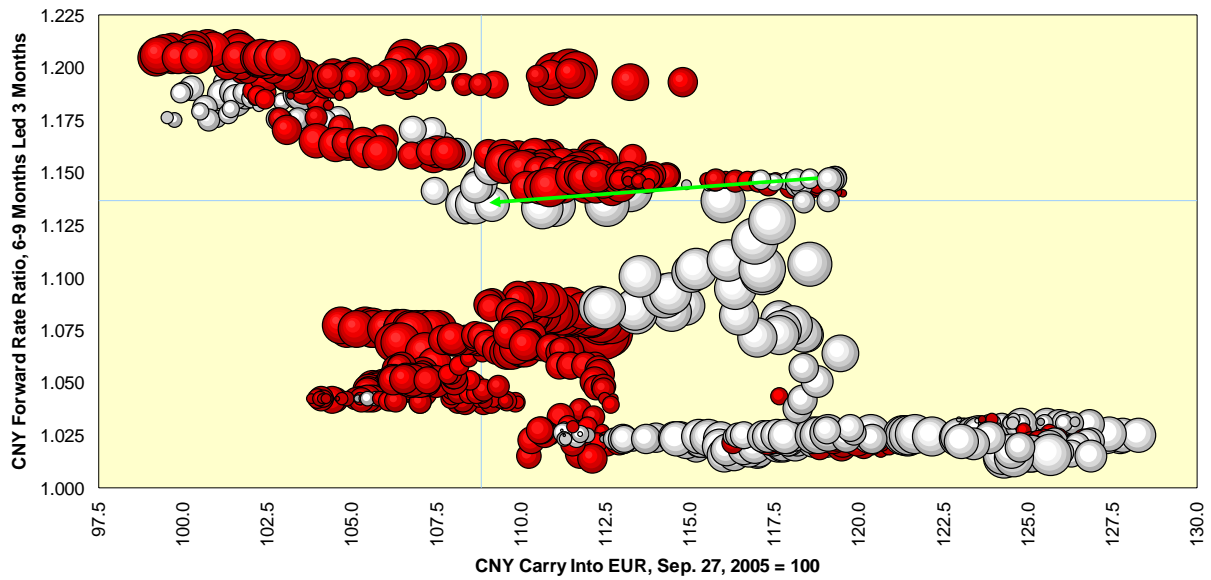
We noted in reference to global equities how the return on carrying yuan into euros peaked in late November 2009, right at Dubai's warning of default and right at the beginning of rumblings about sovereign debt problems in Greece and Spain. As it turns out, the yuan carry into the euro leads the yuan $FRR_{6,9}$, here plotted inversely, by about three months. By the international trade logic expressed previously, this leading relationship could be maintained in the weeks to come in China tightens domestic credit and then starts buying the sovereign debt of Greece, Portugal, Spain and others in the acronym whose name shall not be written.

CNY Money Market Yield Curve And Carry Into EUR



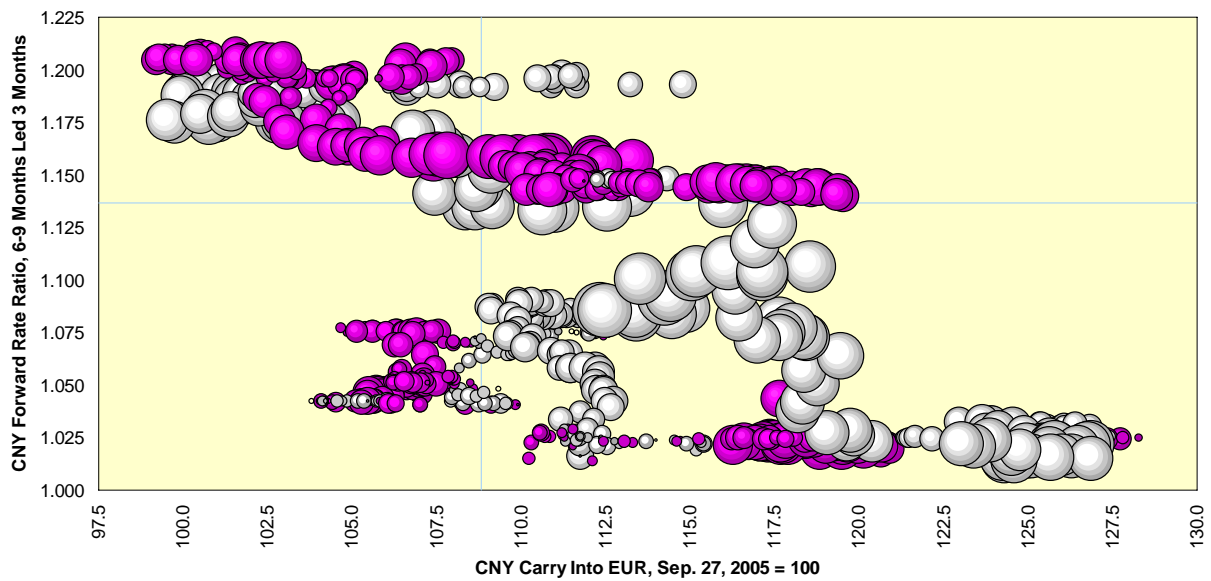
Such an eventuality is still speculative. What can be demonstrated is the relationship between three month-ahead prices for the base metals against the dimensions of the yuan $FRR_{6,9}$ led three months and the yuan carry into the euro. The chart below, for tin, displays the price returns as bubbles; positive returns are displayed in red and negative returns are displayed in white. The absolute magnitude of the price change is depicted by the diameter of the bubble. Current values are noted with a bombsight, and the path from three months ago is noted with a green arrow.

Three-Month Ahead Tin Price Changes As Function Of Chinese Monetary Variables



Current trends for Chinese monetary policy are pushing the bombsight toward the southwest corner of the chart. Of the six metals analyzed, only tin and lead have any sort of positive price expectations from this zone; in the interests of space, let's confine that display to aluminum and stipulate the others.

Three-Month Ahead Aluminum Price Changes As Function Of Chinese Monetary Variables



The warning should be clear as a bell: The more China tightens credit, the lower its internal demand for base metals will be and the more at-risk miners will be. This is recognized in the stock prices of global miners; the HSBC global diversified mining index has retreated 14.7% in January 11, 2010, while the MSCI World index has retreated 8.1%. This prudence toward the sector seems more than warranted.