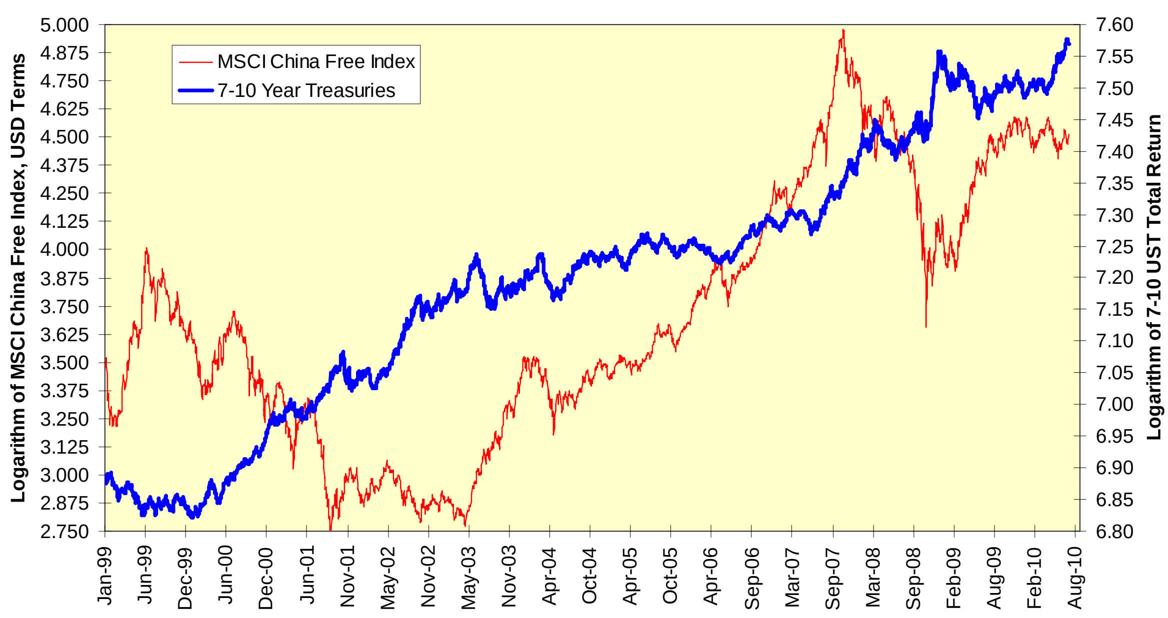
# Link Between Chinese Stocks And U.S. Treasuries Is Temporary

As any trend-follower knows, two points make a line. Two lines on a chart start inviting your eyes to look for patterns of correlation and lead- and lag-times; numerous psychological studies show our minds are hard-wired to look for patterns where nothing other than randomness exists. Of course, psychologists spent a lot of time as students making white mice run through mazes, so judge accordingly.

What do we do, then, when two previously disconnected markets start acting like one another? A recent research note suggested ten-year Treasury yields were starting to act like the Shanghai Composite index, and on the surface this is indisputable. Both Chinese stocks and long-term U.S. Treasury yields, two markets whose fundamental connections we explored back in February, have declined in 2010.

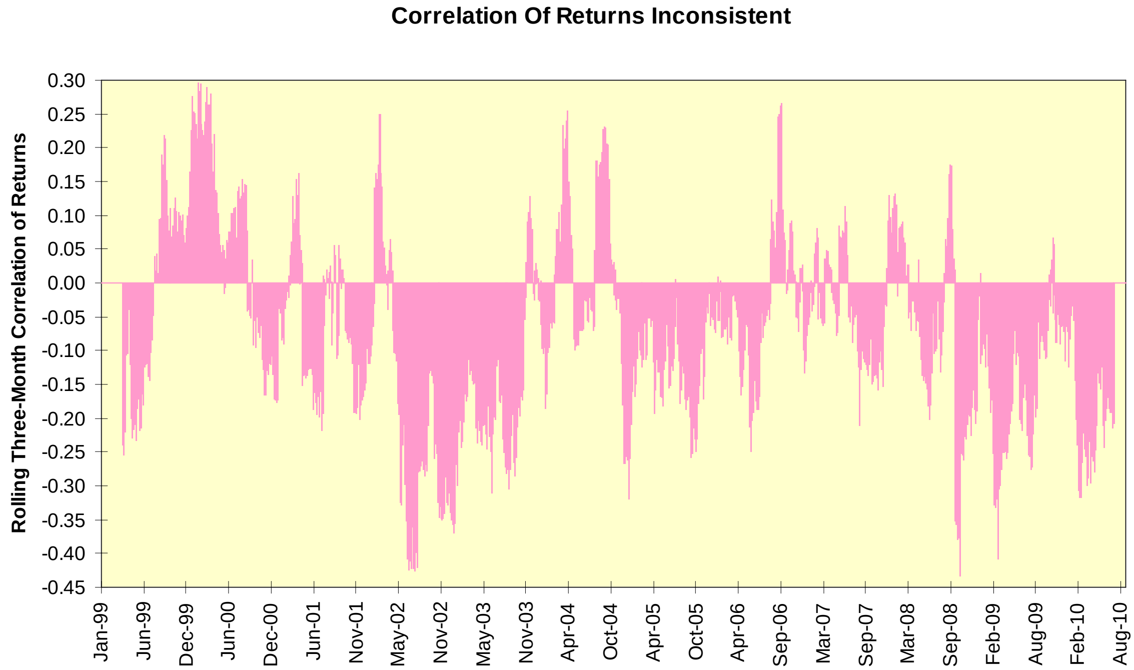
However, U.S. investors do not see the Shanghai index in yuan and as the dollar value of each basis point lower in yield increases, we need to compare the two total return streams in U.S. dollar terms. In addition, we should use as much data as we can on a daily basis, which in this case means January 1999 for the MSCI-Barra China Free index. Treasuries are measured by the total return on the Merrill Lynch 7-10 year index.

**Chinese Equities And U.S. Treasuries Do Not Match Over Time**




The visual impulse now becomes one of rejection: What correlation? Even if we start shifting the series back and forth in time, we cannot see anything of note prior to the mid-2009 point when Chinese stocks were moving straight up and U.S. bonds were declining in price.

If we run a few numbers to take our lying eyes out of the equation as much as we can, the answer does not emerge. A rolling three-month correlation of daily returns is inconsistent; moreover, neither the positive nor the negative values are very significant. The fundamental argument applicable since mid-2009, that Chinese stocks were suffering relative to U.S. Treasuries as the Peoples' Republic was shipping the peoples' money to Uncle Sam to finance the Peoples' Stimulus Extravaganza and Clambake and, not coincidentally, to tighten domestic credit and simultaneously maintain the yuan peg, may have applied recently but certainly was not a factor during the last prolonged period of negative correlation, 2002-2003.




Let's recall the principle a relationship must hold at all times and in all market conditions unless there is a sound fundamental reason for the exception. In this instance, we have to conclude the observed correlation between U.S. Treasury yields and Chinese stocks is a short-term phenomenon related to a policy already on its way out as China allows greater yuan revaluation.

A good test when you encounter some obvious correlation emerging in the short-term is to ask yourself, "What would I have though X years ago?" If the answer is you would not have given the relationship a second thought then, chances are you should not give it a second thought today.

There does seem to be one minor consolation prize, though: The current negative correlation of returns means U.S. Treasuries and Chinese stocks do provide diversification when held together in a portfolio.