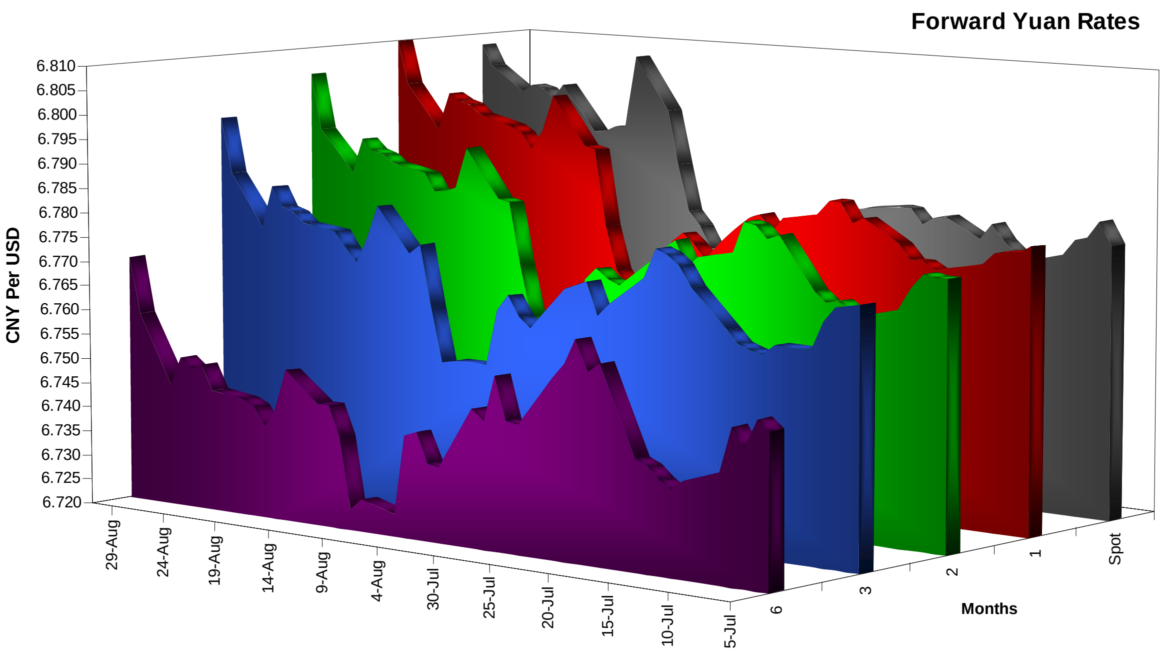
Yuan Revaluation Fizzles

Some of the best analysis about China's yuan policy might begin with the oft-used doggerel, "Here I sit, broken-hearted…" After China grudgingly acceded to a yuan revaluation in July 2005 and allowed the currency to trade higher in straight-line fashion for nearly three years, they ceased and desisted without announcement in July 2008.

But in a concession to the U.S. we can summarize as, "If I do it, will you shut up, already?" they let it be known by late March 2010 they would begin a revaluation at a time of their choosing; we discussed the market for yuan forwards in April. They hinted this round of revaluation would not be of the straight-line variety; one thing Chinese Communists share with American politicians is a morbid fear someone, somewhere is making some money.

What was unknown, though, is just how quickly the revaluation, launched with much fanfare, would fizzle. Not only is the spot rate of 6.8108 at the time of this writing just a tad stronger than the 6.825 rate prevailing just before the revaluation began, but yuan forwards at the one-, two-, three- and six-month horizons are signaling the 6.77 rate reached at the start of July is going to be the ceiling for the next six months at least.

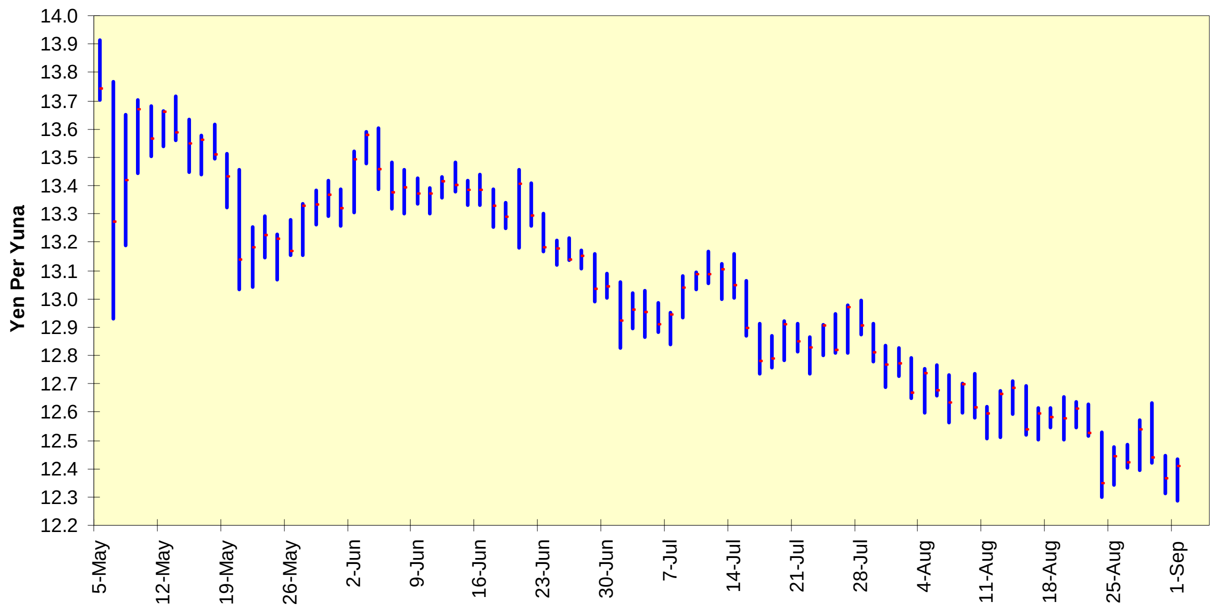


As the yuan returns to school this September, it can write the obligatory "How I spent my summer vacation" essay simply by saying, "I weakened under the August sun."

And Then The Yen

If Beijing has weakened against the greenback, it has taken a dive against the yen. Both Japan's economy and its financial markets have been stressed by the yen's strength. While there is no evidence the yen's strength is the result of Chinese purchases as part of their never-ending quest to "diversify" their $2.45 trillion of foreign exchange reserves by buying anything and everything in sight, it would not take much in the way of Chinese purchases of Japanese assets to push the yen higher. As the yen has gained 10% against the yuan since the height of the European sovereign credit crisis in early May, and as all countries use exchange-rate policy as a strategic tool, how much of an accident can all of this be?

The Yen-Yuan Cross-Rate



The unexpected revaluation reversal has put a dent in instruments such as Wisdom Tree's China Yuan Fund (CYB); this seeming one-way bet has lost 1.855% over the past year and 2,24% since the supposed revaluation began in June.

In addition, the weakness of the yuan against two currencies, the dollar and the yen, whose central banks have been spewing forth paper serves as a reminder there are no easy solutions to currency trades. Anyone who focuses on macroeconomic variables such as trade surpluses, foreign exchange reserves, growth rates and the like stands a chance of losing against politics.

As the wise man once said, "Age and treachery beat youth and vigor every time." A country determined to keep its currency undervalued can do so when it is the world's creditor.