The Yuan After The Fall

One of the worst things for a market commentator is being right about bad things. Consider this conclusion from a January column on the Chinese yuan:

If China continues to use a rising yuan as a policy tool while the rest of the world is slowing down, with the various effects noted above as evidence, the results are going to remain ugly. Our focus as investors really has to remain, "how should I protect my capital" far more than "what should I buy?"

The yuan was appreciating at a metronomic rate against the dollar at the time, so much so I heard the trade referenced as "free money" by some. That was then and this is now; the appreciation stopped in mid-July for reasons discussed in a September column, and then weakened significantly on December 1.

As nothing happens by accident in this currency, let's revisit some of the connections noted in January, as promised in last week's column on the yen-euro cross-rate. And, while we are at it, let's revisit a topic from April 2006, the cross-rate between the yen and the yuan and its effect on American markets.

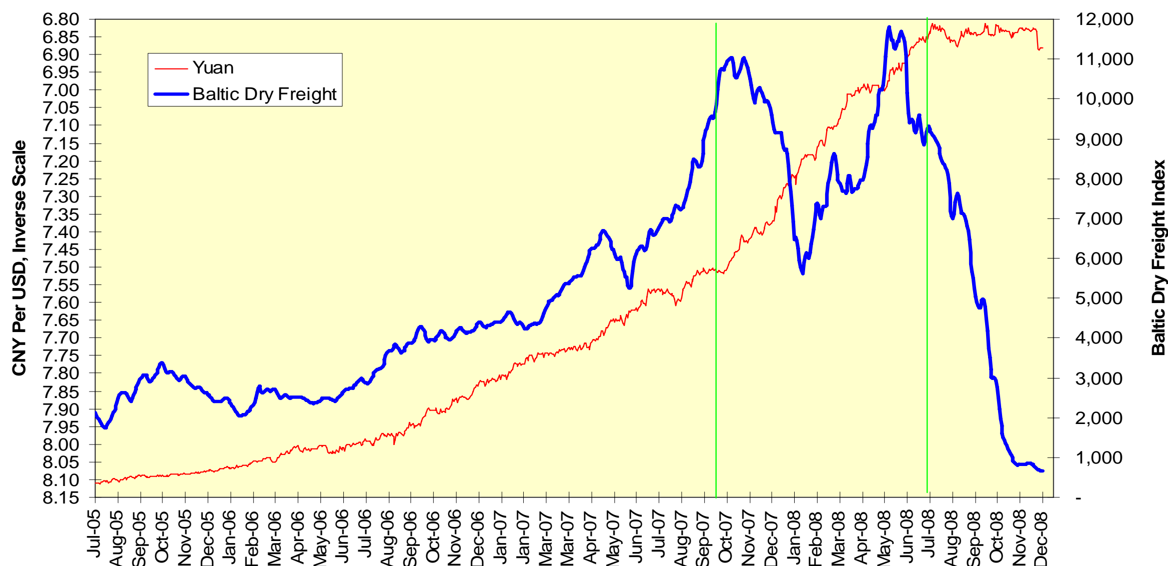
The Revaluation Era

In addition to December 1, 2008, three other dates stand out in the yuan's recent history. These are July 20, 2005, the date when China agreed to allow a controlled revaluation, October 12, 2007, when this revaluation was allowed to accelerate, and July 15, 2008, the date when the revaluation stopped. The October 2007 and July 2008 dates surrounding the accelerated revaluation era will be marked in green vertical lines in the charts below.

One of the most important variables affected by China's economy is the Baltic Dry Freight index (BDIY). This index largely measures the demand for bulk raw materials such as ores moving into China and demand for China's exports. Its collapse over the past six months has been nothing short of spectacular; few stocks that have been the alleged victim of short-sellers ever have plummeted so quickly.

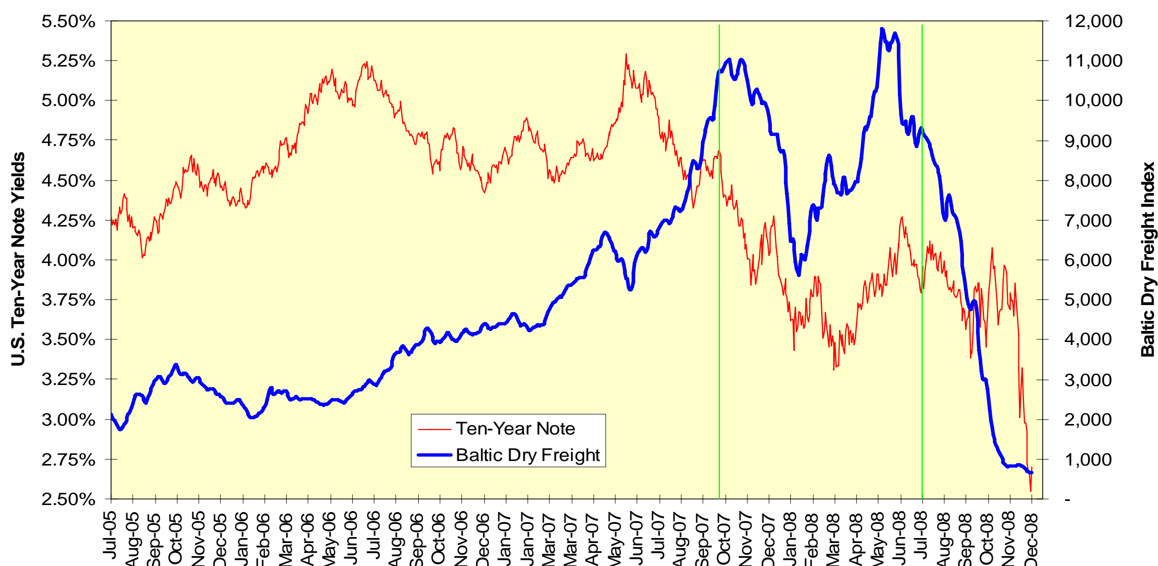
One might be forgiven for thinking that Chinese authorities aware of declines in their order books and in Olympics-related demands might have put their feet down regarding further yuan revaluation. The sequence is revealing: First the BDIY fell, then the U.S. agreed to backstop Fannie Mae and Freddie Mac and then the yuan, the currency of our largest creditor, stopped appreciating. It all may be perfectly innocent, but somehow I doubt it.

Freight Rates Fell After Revaluation Ended



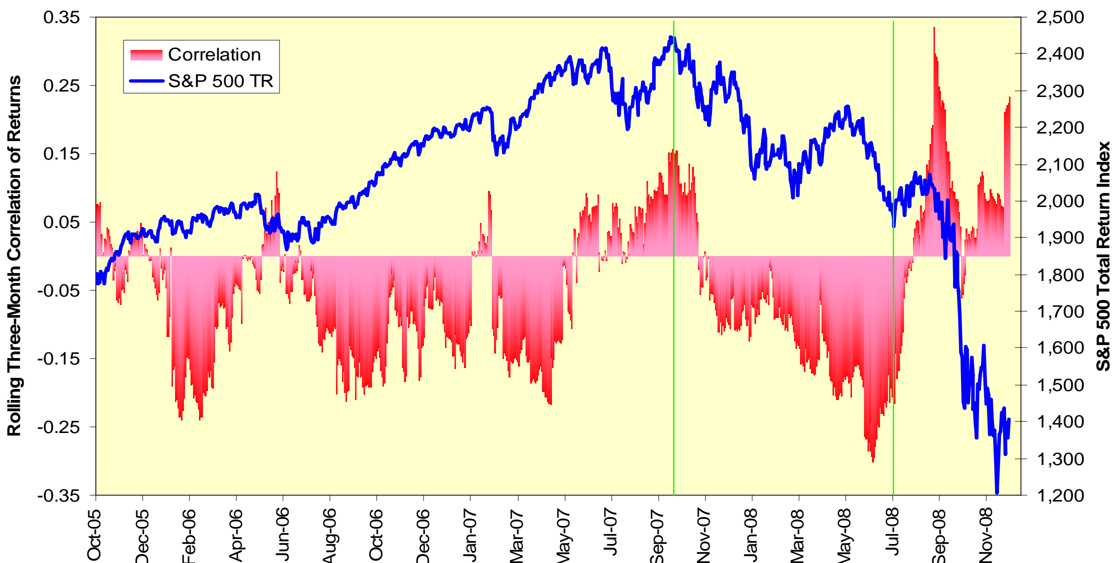
The link between the BDIY and U.S. long-term interest rates, a topic I first discussed in December 2002, become much stronger and more direct during the revaluation era. Once revaluation ended the BDIY fell further and faster than did our ten-year note yields, but the ten-year note's yield has caught up over the last two weeks.

Of Notes And Boats



What did change after the revaluation era ended was the rolling three-month correlation of returns between the yuan and the S&P 500's total return index and its relationship to the S&P 500's total return itself. That correlation had been negative with minor exception from July 2005 onwards; it since turned positive after July 2008. Once China stopped allowing revaluation, the S&P 500 collapsed regardless of the chain of causality. We could argue the deepening of the credit crunch led to the collapse of stocks and to Chinese unwillingness to allow further revaluation more or less simultaneously.

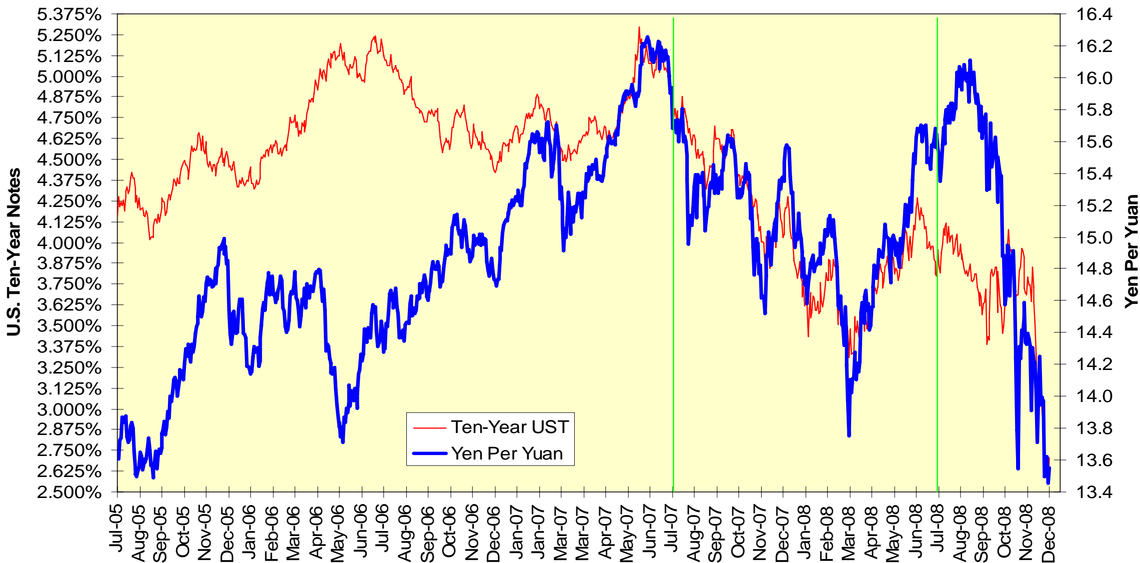
U.S. Stocks And Yuan During Revaluation Era



The Yen-Yuan Cross-Rate

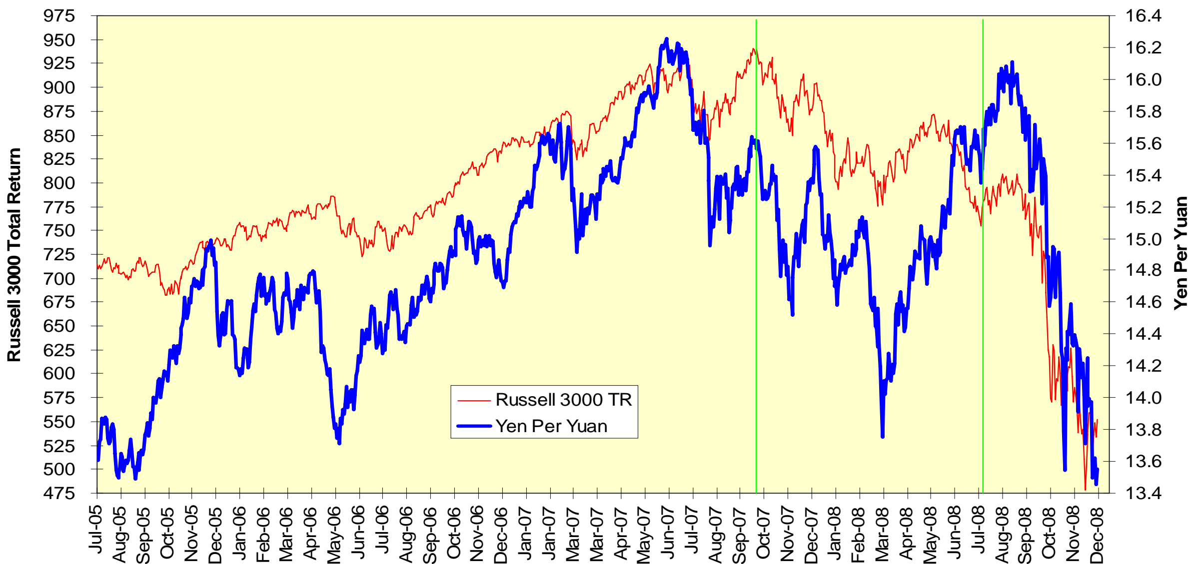
As they say on the late-night television ads, "But wait, there's more!" That "more" would be the cross-rate between the yen and yuan expressed in yen per yuan. Once the revaluation era began, the cross-rate and U.S. ten-year note yields started to move in lockstep. The yen weakened in mid-June 2008, the revaluation era ended a month later, and then in late August, the yen began to strengthen strongly against the yuan. It moved right back into lockstep with ten-year note yields, suggesting China might be weakening the yuan against the dollar by buying U.S. Treasuries at the very time the yen started to skyrocket as carry trades were unwound. If China wanted to keep a competitive currency advantage to Japan, this set of events certainly would have been welcome.

The Yen-Yuan Rate And U.S. Notes



But if China was selling yuan and buying dollars, it certainly was not buying U.S. equities with those dollars. The total return path of the Russell 3000 index collapsed as the yen firmed against the yuan after July 2008.

The Yen-Yuan Rate And U.S. Stocks



Where Now?

Leo Melamed, long the driving force behind the Chicago Mercantile Exchange, said it well: "What caused the [1987] crash was all that (fooling) around with the currencies of the world." He was absolutely correct. In a floating exchange-rate world, you can fix a currency rate by manipulating interest rates, or you can fix interest rates and ignore the currency rate, but you cannot do both. And if you do start (fooling) around with currencies, you affect the allocation of resources within an economy.

The pressure by economic luminaries such as Senators Schumer and Graham to revalue the yuan was also pressure for the Chinese to increase their interest rates and for American consumers to accept the implicit tax increase of a stronger yuan. The consequences have been devastating. Markets do not care what the level of a currency is, only if that level is perceived to be fair without official manipulation.

If China now chooses to join the rest of the known universe in monetary stimulus, which appears to be the case, the yuan will weaken, all else held equal. The important thing is for China to resuscitate its domestic demand so that it is less reliant on exports. If this involves a weaker yuan, so be it. It may also involve revived demand for raw materials, higher freight rates, non-crisis interest rates and, who knows, higher stock prices.

This is a risk I am willing to take.