Fannie, Freddie, Hank And Currencies

*"What caused the [1987] crash was all that f**king around with the currencies of the world."* – Leo Melamed

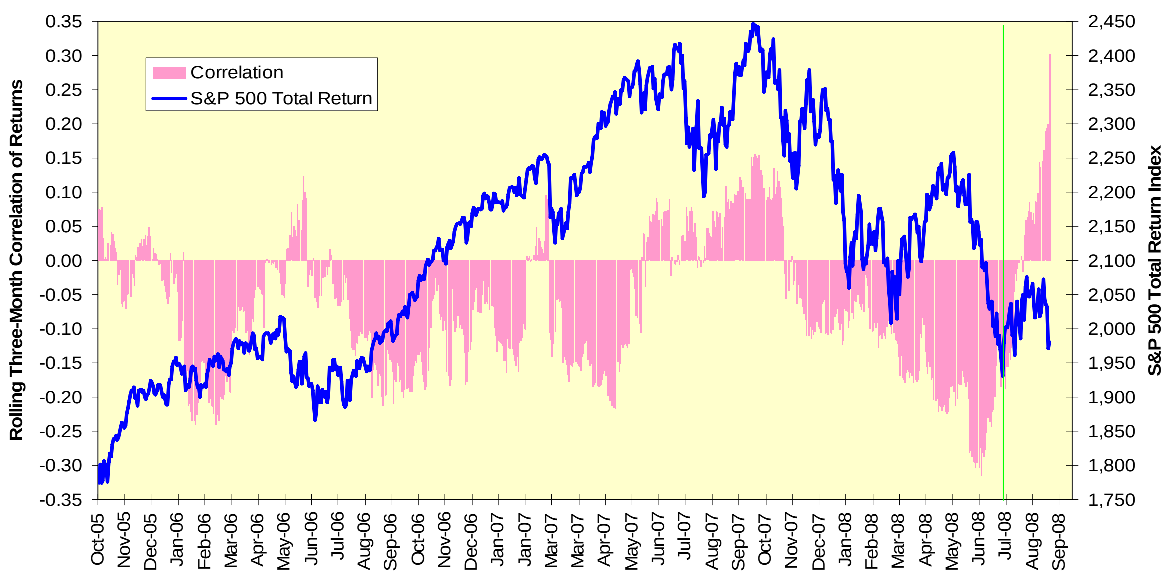
As many *RealMoney* readers who have corresponded with me over the years can attest, I hate conspiracy theories. They are fun, to be sure, but they violate the famous principle of Occam's Razor: The simplest explanation is the best explanation.

Every goofball hedge fund trader who hears a tidbit from a surely disinterested broker or counterparty falls into the trap of thinking he or she has the inside scoop on something. No, someone just had to buy or sell for whatever reason, and in a combination of the Hindu parable of the Six Blind Men and the Elephant and the childhood game of Telephone, that generally worthless information regarding a tiny part of the puzzle recirculated endlessly takes on great meaning.

Means, Opportunity, Motive
But what if a backroom deal *is* the simplest explanation? Let's take the Chinese yuan. I demonstrated this past January how the yuan and the total return of the S&P 500 were negatively correlated over the vast majority of the post-July 2005 when the good people of the Peoples' Republic permitted the yuan's gradual and very managed revaluation. Regardless of whether U.S. stocks rose or fell, the rolling three-month correlation of returns generally was negative.

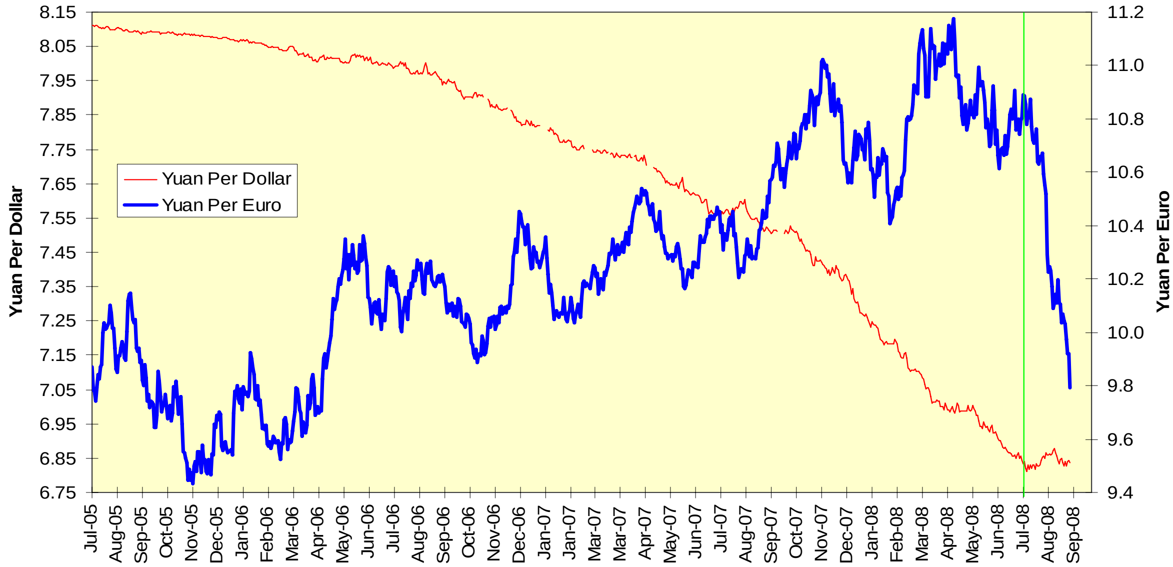
But starting on the very day of the Fannie and Freddie backstopping, July 14, 2008, marked on all of the charts with a green vertical line, the yuan ceased its metronomic rise against the dollar and entered into a trading range. And the very negative correlation of returns between the yuan and the S&P 500 turned higher and ended last week at its highest point ever. "Ever," just to clarify, is a long time.

The Yuan And U.S. Stocks Now At Peak Of Positive Correlation



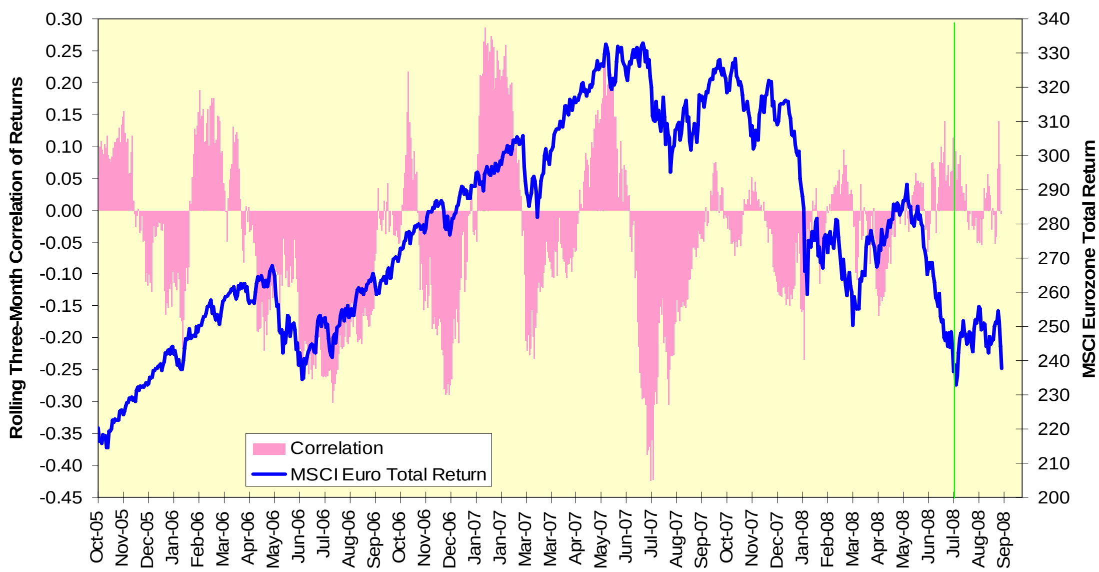
Now let's take a look at another exchange rate, that of the yuan against the euro. As the yuan flat-lined against the greenback, it took off like a scared rabbit against the euro; it has appreciated about 8.5% against the common currency in less than two months.

Euro-Yuan Cross Broke After July's Fannie Mae-Freddie Mac Plan



Now let's add a third piece of evidence, the three-month rolling correlation of total returns between the Morgan Stanley Capital International European Monetary Union index in euro terms and the euro-yuan exchange rate. You should look at this chart and think, "Why, unlike the American situation, there's no relationship over time." And that is the point, precisely.

The Yuan And Eurozone Stocks Are Correlated Erratically



An Attempt To Win It All

Let's postulate there was a global deal at the finance ministry level made in July: The Chinese, who had bought $71.49 billion in agency securities and another $24.11 billion in Treasuries in the year ended in June, would continue to be a financing source if we stopped pressuring them to strengthen the yuan. Such a deal would have the additional benefit of stopping the continuously rising de facto tariff on Chinese exports to the U.S., which is also a tax on the American consumer, and would preserve the currency-adjusted value of China's existing portfolio.

Second, let's suppose the negative relationship between U.S. equities and the yuan had been noticed by parties other than *RealMoney* readers. Both the Federal Reserve and the Treasury along with the SEC have demonstrated an absolute willingness to gamble tens of billions of your tax dollars on supporting stocks through pre-opening rate cuts, restrictions on selling financial stocks short, rescues of wayward investment banks and other measures. Would they be willing to roll the dice with your credit card one more time and bet an end to the yuan's rise would support our stocks? Why not?

Third, the Europeans had been very unhappy over the euro's rise to $1.60. They felt, correctly, the euro had been taking most of the adjustment brunt of our weak dollar policy. The European Central Bank was under pressure to weaken the euro, but they did not want to violate their mandate of fighting inflation. Allowing the euro to crater against the yuan and the dollar, perhaps with a few pushes over the ledge from interested parties, was a relatively cheap way of achieving this goal.

Finally, they could look at the non-relationship between their stock markets and the euro-yuan exchange rate and think there was no real cost involved.

Consent Of The Governed

If I was involved in putting that plan together, I would give myself a pat on the back. There is just one problem, though, and that is the United States of America and the members of the European Union pride themselves on being representative democracies. You know: Of the people, by the people, for the people; that stuff.

Previous watershed currency agreements, such as the Plaza Accord of 1985 and the Louvre Agreement of 1987, were announced to the public. Central banks now announce their rate-change decisions in public to the point where we dissect their statements on a word-by-word basis.

If such a currency deal was reached – and the evidence is consistent with the motives and the opportunity to do so when the world's attention was focused on Fannie Mae and Freddie Mac – it should have been announced to the public. After all, if I am a European citizen, my purchasing power for Chinese exports has been reduced by 8.5% in less than two months, and no one in my governments thought it was important to tell me. At least when the U.S. agreed to reduce the purchasing power of its citizens in a similar fashion in the three years between July 2005 and July 2008, the policy was announced by China and acknowledged by the U.S. And the three-year change was just under 16%, to put the euro's 8.5%, two-month collapse into perspective.

We are in one of the worst and certainly one of the most perplexing financial crises since the Great Depression. For governments to repudiate the principle of "open covenants openly arrived at," as the first of Woodrow Wilson's Fourteen Points is often summarized, is a breach of conduct undertaken by a group of officials who have demonstrated no special skills over the past year beyond cobbling together seat-of-the-pants stopgap measures.

If you are going to do it in secret, you had better do it correctly, especially when it comes to currencies: Leo Melamed's comment about the 1987 Crash is apt. Do it right and you can ignore the conspiracy theorists yapping at your heels. Do it wrong and, well, no one ascribes conspiratorial powers to the incompetent, do they?