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What happens when China stops playing the music?

What if we told you there was a trade that was appealing, obvious, talked about daily and yet you hadn't heard of it? Would you be interested?

What if we told you there are fixed income instruments being bought with a higher yield than US treasuries in currencies that are undervalued; and there is a high probability these currencies will soon appreciate; and the yields on the bonds will decline?

What if we told you the same institution that is buying the bonds controls the timing of the bond's underlying currency appreciation and is directly responsible for the current undervaluation of the currency, and the higher yield offered?

What if we told you the institution was China?

China's peg to the dollar and recent lack of flexibility has led to unprecedented amounts of intervention throughout Asia and Latin America, as all emerging markets nations have struggled to keep their currencies from appreciating; fearing currency appreciation would hurt their ability to export, and certainly affect their relative price competitiveness. In Asia, the Central Banks of Indonesia, India, Malaysia, Singapore, South Korea, Thailand, Taiwan and the Philippines have all been buying dollars against their currencies in order to remain price competitive. In Latin America the Central Banks of Argentina, Brazil, Chile, Colombia and Peru have also been buying dollars with similar aims.

They have all been buying dollars to keep their prices competitive relative to their neighbors, who are doing so because the price of labor and exported goods are artificially cheaper in China because of the dollar-peg, (or as it is now, lack of flexibility). Buying dollars has created inflationary fears within all of these countries, prompting them to raise rates while the developed world is cutting. These higher rates are attracting more capital investment, meaning the Central Banks have had to buy even more dollars to stem local currency appreciation.

When China allows its currency to strengthen against the dollar all of these countries will be able to lower their dollar purchases and allow currency appreciation in lock step with China's, thus remaining relatively price competitive. The appreciation of their currencies will stem inflation and allow them to cut rates, and normalize their trade balances.

The most interesting thing we are seeing lately is China's actions in diversifying its foreign exchange reserves as it readies the CNY appreciation (flexibility) cycle. China is selling US treasuries, taking the dollars, selling them to the Central Banks of the developed and developing world, and buying their fixed income instruments; if not fixed income then corporations and mineral/mining interests. In Asia it was announced yesterday that China's holdings of South Korean fixed income more than doubled to KRW3.99Tn. An astonishing amount yielding 4.3%. The announcement has since seen a move lower in USD/KRW from 1200 to 1170, and KTB yields have dipped considerably.

We understand that last night's price action saw significant moves throughout Asia in the fixed income space, especially in Thailand, where there were reportedly no offers... i.e. no-one wanted to sell. We are sure they are doing the same

throughout Asia and look forward to the release of other individual country data. In Latin America we are attuned to China's purchases of minerals and mining concerns, specifically in Chile, Brazil and Peru. Most interesting to us is that China is doing this before they revalue the CNY. After all, when the CNY strengthens, all the currencies of the developing world will strengthen, just as was witnessed during the flexibility program of 2005-2008.

How do the Central Banks in the targeted emerging markets feel about this? Most welcome the investment, believing an investment by China is a seal of approval. But what is the consequence to these countries? Well their Central Banks are buying dollars at inflated rates (caused by China); they are then selling fixed income at inflated rates (caused by China); and with the dollars they receive they are investing in US treasuries at 0.7%, or passing that hot dollar potato onto another country's Central Bank's dollar bid. Buying dollars at expensive rates and receiving 0.7%, while selling your own currency at an inexpensive rate and paying 4.3%+ is a recipe for disaster, especially given what's on the horizon - China strengthening the CNY.

Colombia and Chile are already debating what to do about this confounding situation, and Japan has seemingly backed away from market intervention, realizing the futility of the operation. The SNB has also stepped aside, as it licks its wounds after losing 14.3Bn Bio CHF following an ill-advised intervention program. In Malaysia yesterday the government opened up to further liberalization of their foreign exchange controls, allowing for further MYR appreciation. Governments are beginning to realize the absurdity of this situation and are now looking at ways they can create incentives for exporters while letting their currencies naturally float. Surely incentives are cheaper than the losses governments are currently taking on.

One by one Central Banks throughout Asia and Latin America are figuring this out and moving to internal ways of incentivising exporters without taking dollars on their balance sheets with negative returns. As intervention halts, it will mean a lot less dollars are bought in the market. This will coincide with China allowing its currency to appreciate, and will fuel a much more rapid dollar decline against emerging markets and other G10 neighbors. We feel these internal moves will take on a domino affect, as more and more Central Banks realize their conundrum.

No one wants to be the Central Bank with no chair when China stops playing the music.