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Commentary

Market Opinions and Topics of Interest

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Was There A Global Currency Deal?

Clint Eastwood's fictional Inspector Harry Callahan understood the power of distraction:

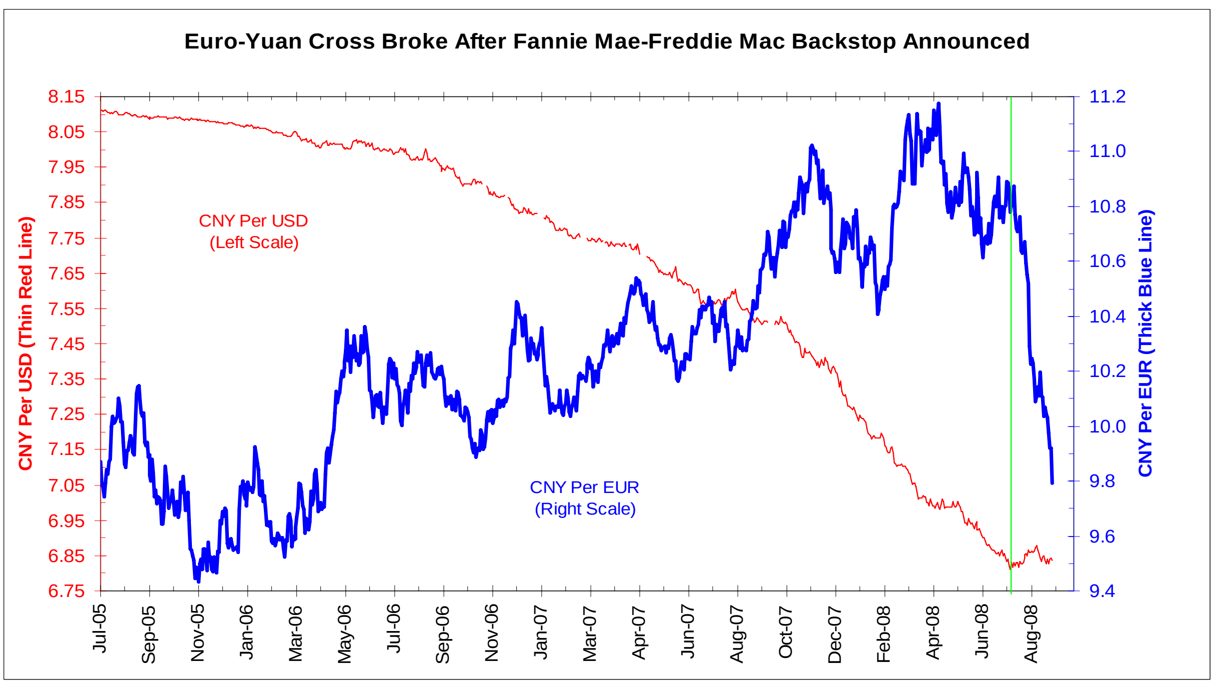
> *"Now, I know what you're thinking. 'Did he fire six shots or only five?' To tell you the truth, I forgot myself in all this excitement."*

Lost in the excitement of the mid-July de facto nationalization of Fannie Mae and Freddie Mac (green vertical line, here and subsequently) was an unannounced but profound change in global currency markets. The Chinese yuan-U.S. dollar exchange rate (thin red line) broke what had been a one-way trade; it ceased strengthening against the dollar. Simultaneously, the yuan-euro exchange rate (thick blue line) broke a longstanding trend in the euro's favor.

If there was an official policy announcement in regards thereto, we missed it. If there was no such policy announcement, we are free to speculate on motives.

As noted in our most recent [Treasury International Capital Statistics]report, the 12-month rolling sum of agency securities from mainland China itself – delving into purchases from the U.K or from tax havens would involve a second layer of speculation, which we shall abjure – was $71.49 billion, and the 12-month rolling sum for Treasuries was $24.11 billion.

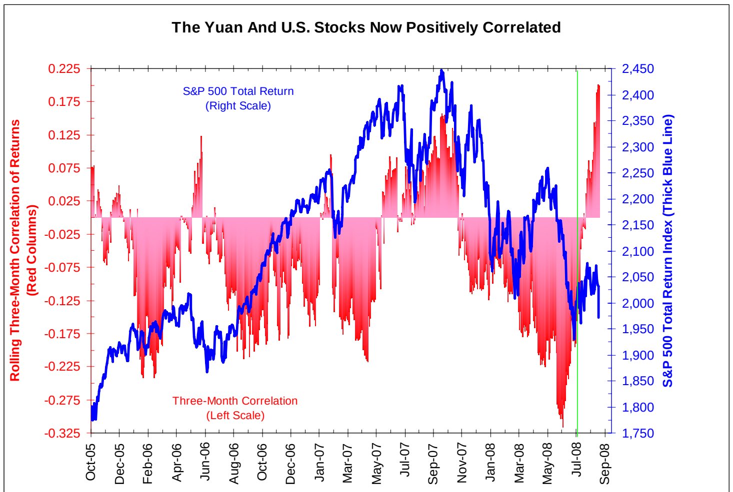
If a global agreement to shift the burden of CNY appreciation from the USD to the EUR was in fact reached, the U.S. would receive capital inflows from China, the Eurozone would be relieved of the burden of an ever-rising EUR and China would receive some measure of currency protection for its existing portfolio of USD securities. This had all the makings of a win-win-win deal.

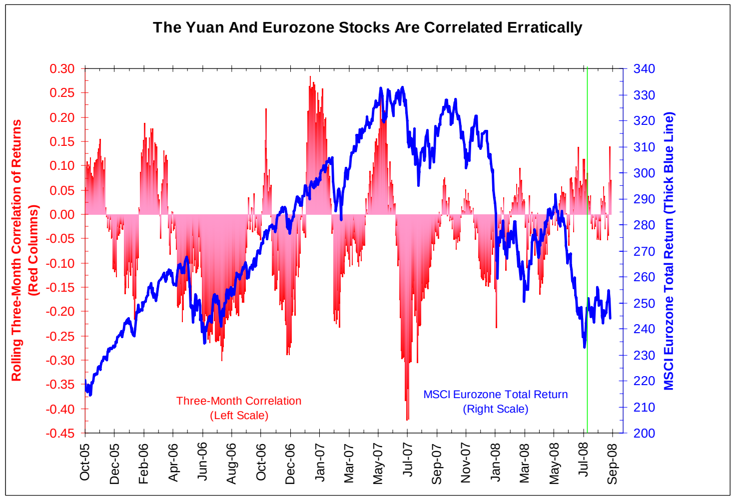


Equity Market Linkages

We can speculate as well the authorities were aware of a conclusion reached in a June Market Facts: A stronger CNY acted as a tax on the beleaguered American consumer. As we noted at the time, the three-month rolling correlation of returns (red columns, left-hand chart) for the S&P 500 total return index (thick blue line) and the CNY had been negative for nearly all of the post-July 2005 revaluation era. **That correlation moved suddenly and sharply higher from late June onwards, and is strongly positive today. Restated, if one intention of ending the CNY's rise against the USD was to support the U.S. stock market, it joins the long list of failed policies from the past year.**

What of a parallel between the EUR-CNY rate and the total return in EUR terms of the Morgan Stanley Eurozone index (thick blue line, right-hand chart)? Here the three-month correlation of returns (red columns) has been erratic over time. **The fate of Euro-denominated equity returns over time has been systematically independent of the EUR-CNY exchange rate.**





Conclusion

Elaborate theories involving complex motives generally fail for the simple reason they give the alleged perpetrators far too much credit. Quite simply, a crowd whom we have criticized for ad hoc and inconsistent policies was unlikely to have acquired near-superhuman powers of planning and intrigue whilst simultaneously lowering the credit quality of sovereign debt and nationalizing the mortgage giants in a fit of absent-mindedness.

However, we are unwilling to accept the massive changes noted above in two key currency rates against the CNY occurring at the very time of the mortgage bailout as being just one of those things. As noted above, it could have been a win-win-win situation, and an observer at the time could be forgiven for thinking it would lend some modicum of support to the U.S. stock market in the face of a still-horrific credit market.

If such policies were undertaken, they were undertaken without the informed consent of the citizenries involved. Given the track record of official statements and conditions from all involved during the ongoing credit crunch, we find such conduct unacceptable.

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