MARKET INSIGHT REPORT

China and Germany: Twin Export Bullies

June 17, 2010

By John R. Taylor, Jr.

Chief Investment Officer

Over the past few years, many analysts have noted the enormous growth of the Chinese manufacturing and export machine. The Chinese economy has absorbed an increasing percentage of the global supply of industrial raw materials and the growth of its own internal steel production has dwarfed that of the rest of the world. China has become an export powerhouse, pushing the country into the modern world at a very rapid pace. Exports of finished manufactured products have expanded rapidly and the Chinese current account balance has ballooned, allowing the country to accumulate a $2.5 trillion hoard of currency reserves. As China can produce the most technically complex goods at a minor fraction of the cost of producing the same things in the United States or in Europe, its export surge has spread deflation into the rest of the developed world. As China grows, most of the G-10 suffers. At the same time, the recycling of global reserves has meant an explosion in global liquidity and a drop in interest rates. The US and European authorities are not happy as both countries are worried about their own manufacturing base and the global financial imbalances that China's strategy has created.

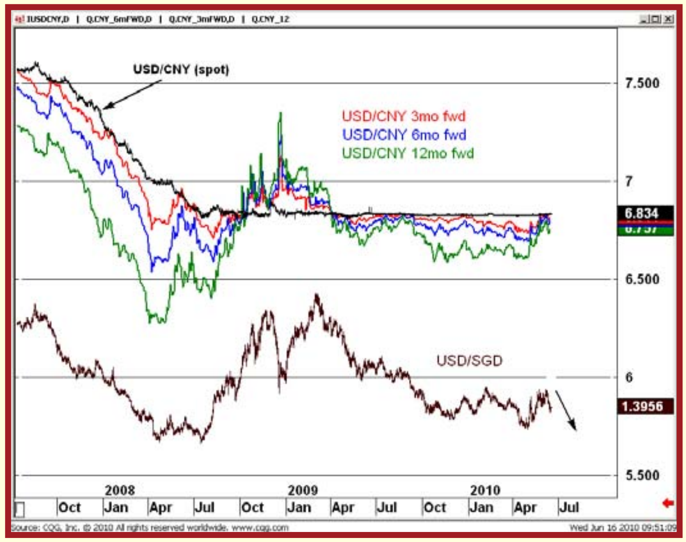
Although the Chinese situation is widely regarded as a global problem with many applying pressure on the Chinese state capitalists, the bigger problem actually lies within Europe as Germany occupies much the same position within Europe that China occupies in the global economy. Because of the constricted corset of the euro, this problem is totally contained within the Eurozone. The countries seeing their manufacturing bases hollowed out and their current accounts collapsing are the fellow members of the Eurozone. Although Germany can not see the explosive growth in their currency reserves, instead its banks are seeing an explosive growth in their holdings of other Eurozone government debt securities. The debt mountain is not just that issued by the PIIGS (Portugal, Ireland, Italy, Greece, and Spain), but includes the debt of all the countries bound within the euro. These holdings are more dangerous than China's holdings of dollars because the European banks have liabilities against these dubious assets, while the Chinese reserve hoard is free of those liabilities – marking its value down by 50% wouldn't really hurt anyone, but even a small haircut in Europe would precipitate a system-wide banking crisis.

Within the current global economic structure, the Chinese, and those that are buying their exports, have multiple levers that they can manipulate to alleviate the Chinese dominance, but within Europe there are either no levers available or the German government and populace seem to have ruled them out. China is trying to expand its domestic economy by helping its consumers by building more infrastructure and by building more adequate housing for its people. Domestically, it has been expansive, but Germany has done the opposite. First, it passed a constitutional law saying that the government accounts must be in balance and then recently it tightened fiscal policy to offset the cost the recent euro rescue plan. These moves are deflationary. Chinese labor is beginning to demand a higher pay level that would represent an inflation adjustment in the cost of Chinese exports and it seems that the authorities, as good Communists should, are looking kindly upon this movement. Germany's rigid labor structure is pushing wage increases lower. The EU does not allow restrictive tariffs against German goods, but the US and Europe can certainly threaten the Chinese with them. Finally the Eurozone does not allow currency devaluations or revaluations, something that would definitely clear the air. With all the safety valves, the Chinese issue will probably not prove fatal to the world economy, but the rigidities of Europe will probably upset the global applecart in the year ahead.

CURRENCY – Asia Long-Term View

Go Short USD/CNY NDFs for the Next Six Weeks

By Jonathan Clark



The spot rate in dollar/renminbi is tightly controlled by the Peoples Bank of China (PBOC). During the past year this has had no significance to currency managers like us because the rate is essentially pegged to the US dollar. We trade the renminbi using derivative contracts called non-deliverable forwards (NDFs), which are more volatile. These contracts are still influenced by the PBOC, but also by supply and demand, and this is the only place where currency managers, hedgers and speculators can place bets on the direction of future USD/CNY spot rate movements. Dollar movements exert an influence and when the dollar rises, USD/CNY NDFs converge with the spot rate and when the dollar declines USD/CNY NDFs fall further below the spot rate. **We are expecting dollar weakness into late July, which argues the USD/CNY NDFs should decline as well, and we recommend going short.**

The larger issue regarding a de-pegging of the Chinese currency is political and is therefore much more difficult to predict. The Chinese maintain that the exchange rate is not to blame for the trade surplus with the US, which is clearly their state capitalist view and ignores historical realities. US Senator Charles Schumer is pushing for legislation to allow the US to use anti-dumping and countervailing duty laws against China because of currency manipulation. The US isn't the only country suffering from this undervalued renmimbi and eventually it will have to strengthen, but it might only move when it is in China's interest? Evidence of a self sustained global recovery would probably be enough to trigger a change in Chinese currency policy, allowing a USD depreciation similar to the one between 2005 and 2008, or possibly just linking the renmimbi to an undisclosed basket of currencies.

The current cycles call for the US dollar to trend lower into the end of July or early August. This downmove should be less severe against the major European currencies and more severe against the commodity and Asian currencies. There is a high correlation between the NDFs and USD/SGD, but the 12-month forward only has ¼ the volatility of USD/Singapore. If USD/SGD declines back to the low in late April this only implies about a 1% decline in the 12-month USD/CNY NDF, but there is a chance the PBOC will switch policy during this time, which would result in much larger gains.