Weekly Market Flash

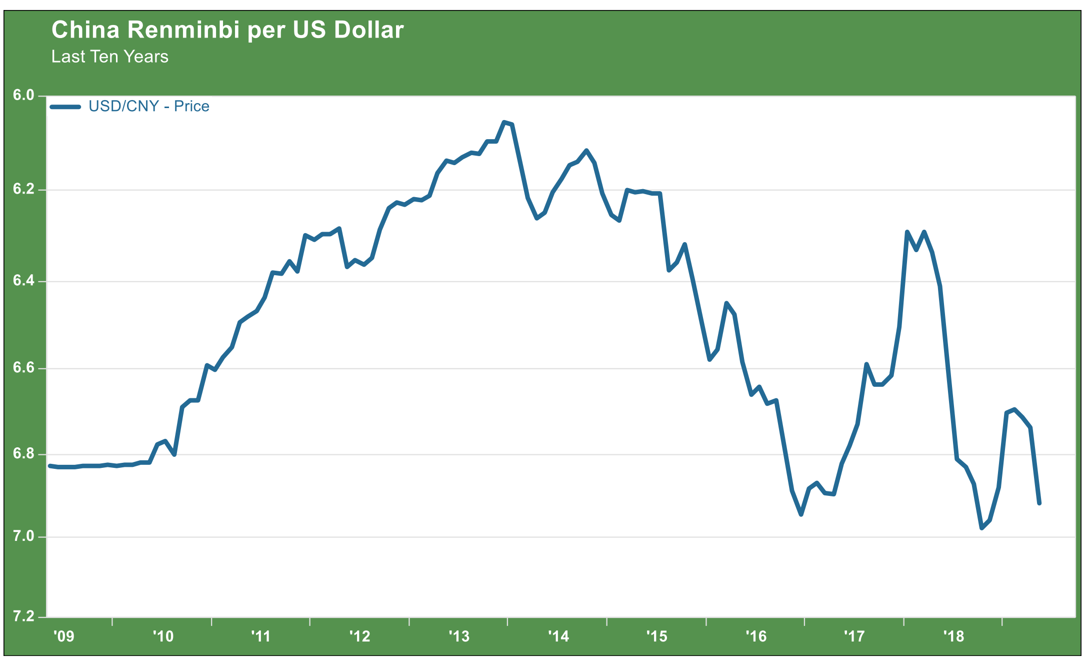
Seven and Ten In China

May 17, 2019

This week's financial news cycle has been all about China, and a wacky week it has been. On Monday major global equity indexes experienced their biggest pullback since January as trade tensions continued to fill up the Twitter feeds of the investor class and their trader bots. Not that it was all that much of a pullback: the S&P 500 was off a bit more than two percent, the Nasdaq a bit more than that. Predictably, of course, the mainstream news outlets chose to ignore the relatively minor percentage point drop and put up instead the screaming headline "Dow Plunges 600 Points!" "Six hundred" is sort of a big number, unlike "two percent" and so it had to be thus to maintain the focus of their audience for a few more minutes before they all went back to whatever this year's Candy Crush diversion happens to be. Anyway, stock markets recovered as the week wore on though in a somewhat jittery state. But a potentially more consequential development was playing out a bit behind the scenes in the bond and currency markets. In numerological terms those developments played around the numbers seven and ten.

Unlucky Number Seven

The seven in question refers to the amount of Chinese renminbi that one US dollar buys. Right now the RMB/USD exchange rate is hovering above that threshold, at about 6.9 renminbi to the dollar. That's not the lowest level for the Chinese currency since Beijing implemented a managed float system to replace the old fixed rate back at the turn of the decade, but it is close. The chart below shows the currency's price trend over this period.



Source: MVF Research, FactSet

In the past, China has been accused of purposely undervaluing its currency in order to make its products more attractive to export markets. If that were the case, one would expect Beijing's monetary authorities to be perfectly happy to let the renminbi fall below seven. The reality, though, is that currency manipulation of this sort has been out of favor for many years. Since the middle of the present decade China's currency policy has consisted of two main aims: first, to open up the currency to a more prominent role in global financial flows in a manner more befitting of the world's second largest economy; and second, to prevent massive capital outflows by domestic owners of renminbi-denominated assets. This second point, remember, was a major concern back in August 2015 and again in January 2016 when economic concerns sparked a wave of outflows. At that time Beijing commenced a sustained program of reducing their substantial holdings of foreign exchange reserves in an effort to bolster the currency – in effect, to keep the currency from falling below that threshold of seven to the dollar.

The Tenacious Ten

Which, in turn, brings us to the number ten, as in "10-year Treasury." Because when talk turns to China's store of foreign exchange reserves, the dominant asset in question is US Treasuries, the 10-year benchmark prominent among the spectrum of maturities therein. How important is it for China to support its currency above that seven threshold? Important enough to accelerate the pace of Treasury sales – perhaps goaded on by the parallel role such a move could play as a salvo in the trade disputes?

The good news is that a massive sale of Treasuries is probably not in the cards, at least not given the current state of things where China's economic health remains relatively robust and the trade war is still more about posturing than actual infliction of damage. For one thing, it's hard to think of a useful asset China could find to replace US government paper for its FX reserves. Japanese government bonds or German bunds? Those are similar in risk profile, but they also carry negative interest rates all the way out to the ten year maturity band. Nein, danke.

Nor is it even certain that substantial Treasury sales by the asset's largest foreign holder would have a deep impact. The Treasury bond market is around $16 trillion in total size, of which China holds a bit more than $1 trillion in its FX portfolio. There is vanishingly little evidence of any widespread distaste for Treasuries among investors, many of whom expect Fed rate cuts in the next couple years and a general flight to quality sentiment as the global economy slows. That sentiment would likely attract plenty of buyers to any fire sale operation mounted by Beijing.

So that's the good news. But it is also pretty clear that Beijing will try and do whatever it takes to prevent the kind of financial instability experienced in 2015-16, and a stable currency is a big part of that equation. The headlines may all be about bellicose trade war tweets (and they will no doubt continue to push and pull short term stock price movements), but there is much more going on with China that could play out in uncertain ways in the weeks and months ahead.

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