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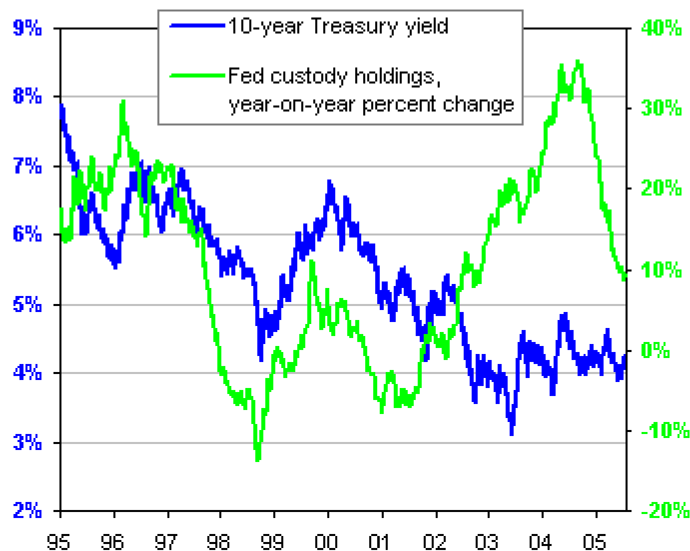
Bonds and the dollar refute the conventional take on the Chinese currency revaluation.

Though it's through no lack of earnest effort by all the media chatterers and financial "experts," the **forex** and **fixed income markets** are not following the script set out for them positing last week's **yuan revaluation** as a pivotal event. We don't downplay the importance of the **Chinese** move as a good-faith gesture to help defuse **protectionist** sentiment arising from the widely held myth that the **yuan-dollar peg** kept the **renminbi "undervalued"** (see "On the Yuan Revaluation" July 21, 2005). But according to the hours of air time and reams of print devoted to the modest change in Chinese currency policy, this was a move with potential consequences reaching far beyond the merely political, with the **US bond market** and the dollar seen vulnerable to sharp sell offs.

So far it hasn't happened, nor is it likely to, at least not as a result of China's plans for its currency's exchange rate. Yes, the immediate knee-jerk response to the revaluation announcement saw the **10-year Treasury** touch 4.3% and the dollar's forex value fall back below $1.22 against the **euro** and drop to near ¥110, from above ¥112. The bulk of those moves, however, were quickly reversed. Perhaps the best indication yet that this was much ado about not much came early yesterday following a **People's Bank of China** statement intended to thwart speculation that the 2% revaluation was merely the first step in a process leading to a significantly stronger yuan. Conjecture on **Wall Street** had it that a further 5% to 7% upward adjustment in the new 8.11/$ rate was likely by year end. No sooner had the PBOC posted its statement that the 2% revaluation "does not in the least imply an initial move which warrants further action" than the wires were spitting out chatter that bonds were poised to rally on relief from the risk that the Chinese would be sharply curtailing their Treasury purchases. Somehow, though, market participants failed to perceive the big buying opportunity, as the 10-year Treasury finished with just a negligible uptick on the day, the **yield** falling two basis points to 4.23%. In early trading today, even that slight gain had evaporated.



In fact, the supposition that purchases by Chinese authorities -- or by any **foreign central bank** for that matter -- have been a driving force in the Treasury market is a fallacy, in our view. The

attention devoted to Chinese participation in the Treasury market belies it, but the actual level of official Chinese investment has been surprisingly small. In the past year, **Chinese net Treasury purchases** have amounted to just over $30 billion. In a market with a total stock of some $4.5 trillion in publicly held **US debt**, that's hardly a blip. In that vein, we also wonder whether those who insist bond prices are being held up by foreign central banks ever bother to look at the data. Since last June, the 10-year Treasury yield has rallied, on net, from just below 5% to a little over 4%, but official net investment flows have totaled $117 billion over the past year, down from $193.7 billion the previous year.

Another perspective on this phenomenon is captured in the chart on the previous page, plotting **the Fed's custody holdings** for foreign central banks -- a measure of their dollar reserves -- against the 10-year yield. After growing at a year-on-year rate of 35% through the third quarter of last year, the growth in Fed custody holdings has fallen off to about a 9% rate. It's also worth noting that over the 10 years covered by the chart, there has been no reliable positive relationship between central bank flows and Treasuries. In the late 1990s, in fact, once consequence of the Fed's **deflationary** squeeze was a forced liquidation of reserves by foreign central banks to meet rampaging global demand for scarce dollars. At the same time, as the deflationary pressures seen in the relentless dollar appreciation collapsed **inflation** expectations, bonds rallied.

As for the dollar, we see the Chinese move as having very little consequence. Were the Chinese to indicate that their program would involve a liquidation of **dollar reserves**, it might have some short-term negative impact, due mostly to the effect on confidence in the currency. As it is, the Chinese have given no such indication, and from all appearances continue to regard their dollar holdings as a treasured demonstration of their growing economic maturity. In the final analysis, a currency's real value is a function of the central bank's facility in balancing **supply and demand** for **monetary liquidity**. It's conceivable that an announcement such as China's might have had a short-run negative impact on **dollar demand**, but movement in the price of **gold** -- the most reliable indicator of supply and demand in the market for dollar liquidity -- suggest any such decline was slight indeed, and has already been reversed. After rising about $2 to above $425 last Thursday, the day of the announcement, gold is today trading in a range unchanged from its prior levels.

Bottom Line: While we continue to see bonds as vulnerable at these levels, the Chinese yuan revaluation is largely immaterial to that outlook, even if it should eventually involve further significant appreciation. We don't dismiss the risk of another dollar downturn either, but again prospects for the Chinese currency have little bearing on that assessment. Rather, both bonds and the dollar will ultimately reflect the Fed's ability to reach an **equilibrium monetary posture** before embedding further substantial erosion of the currency's purchasing power. But that said, even an expeditious restoration of equilibrium is unlikely to leave Treasuries unscathed. Bonds remain mispriced both for the level of **short term rates** that will be required to attain monetary balance and for the inflationary impulses generated by the Fed's overly **accommodative posture** that have yet to feed through the system. TM