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# On RMB Revaluation

Sunday, June 20, 2010

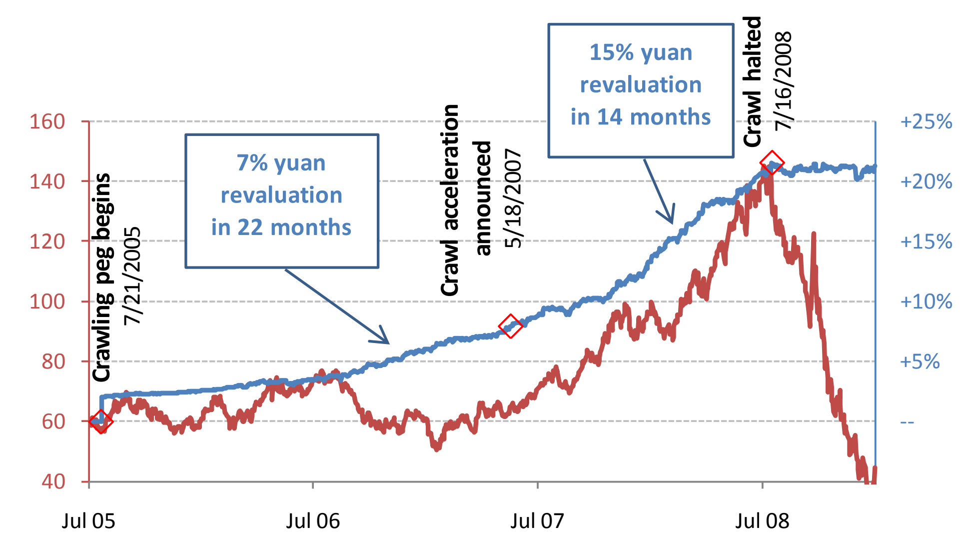
**Donald Luskin**

**Buy the dip if there's a "strong yuan" panic. This is good for China and the world.**

The People's Bank of China announced Saturday "further…reform of the exchange rate regime" in what amounts to a gradual revaluation of the yuan. The announcement was silent as to timing, but otherwise affirms the resumption of the flexible peg against a basket of currencies that had been suspended in July 2008 when the global banking crisis began in earnest. This is fully consistent with what we predicted in March when senator Chuck Schumer (D-NY) threatened legislation that would use the Smoot Hawley Tariff Act of 1930 to punish China for alleged currency manipulation (see "No Protectionism Threat: Yuan To Bet?" March 18, 2010). Here are our immediate thoughts.

- The most critical takeaway is that with this announcement China has significantly lowered the risk of a trade-war with the US. No matter what other negatives might be adduced, the reduction of

**— Chinese yuan appreciation to US dollar and — Crude oil's "super spike"**
Spot WTI; yuan indexed to 7/20/2005




Source: Reuters, TrendMacro calculations

**Update to strategic view**

**EMERGING MARKET MACRO:** China's resumption of gradual exchange rate reform significantly lowers the risk of a trade war with the US, and should be seen as a large positive for China's economy and the world's.

**US STOCKS, US RESOURCE STOCKS, GOLD, COMMODITIES, OIL:** Buy the dip if equity and commodity markets react negatively to China's announced exchange rate reform, citing it as evidence of a "China bubble." Reduction of protectionist risk enhances global growth, and a stronger yuan makes China a more powerful buyer of all strategic commodities.

**US BONDS:** We see no reason to expect China's announced exchange rate reform to affect its appetite for holding or buying US Treasuries. With the yuan pegged to a basket of currencies, a depreciating dollar is no less attractive than any other depreciating currency.

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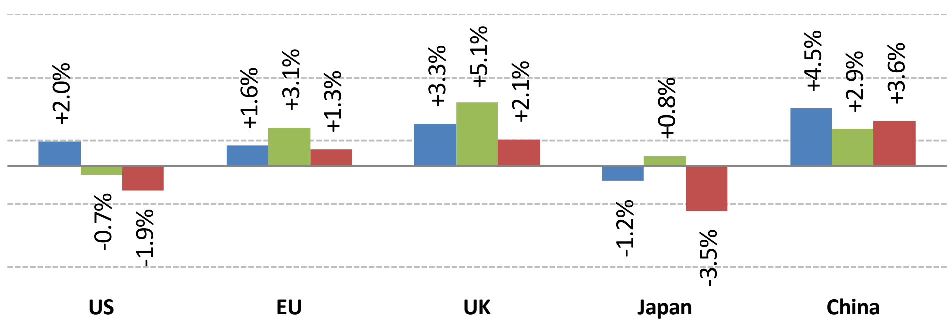
that risk is an enormous positive for China and the global economy.

- China must have been put under intense diplomatic pressure to make this move at this exact time. Reform was suspended in 2008 when credit markets came unhinged, so why else would China resume it now, just when the European sovereign debt crisis has thrown markets into turmoil again?
- There's no reason to assume that this will necessarily slow China's growth. The 22% appreciation of the yuan versus the dollar between 2005 and 2008 certainly didn't slow it. Exchange rate flexibility gives China more control over monetary policy, allowing it to appropriately address issues of price stability. Without it, importing ultra-loose monetary policy from the US via a fixed dollar peg, China has the hottest inflation rate among the large economies (please see the chart below), and no way to combat it other than credit and price controls.

CPI inflation: YOY 3-mo annualized 1-mo annualized




Source: BLS, Eurostat, ONS, Cabinet Office, NBS, TrendMacro calculations

- If a revaluation of the yuan makes China's exports *more* expensive to the rest of the world, then it must make the rest of the world's exports *less* expensive to China. Indeed, that's the whole theory of "global rebalancing" that is often cited as a rationale for bullying China into revaluing. An important side-effect is that this could significantly raise the dollar price of strategic commodities such as oil, just as it did in the 2005-2008 period of revaluation (please see the chart on the previous page).

## Bottom line

China's resumption of gradual exchange rate reform significantly lowers the risk of a trade war with the US, and should be seen as a large positive for China's economy and the world's. Buy the dip if equity and commodity markets react negatively to China's announced exchange rate reform, citing it as evidence of a "China bubble." Reduction of protectionist risk enhances global growth, and a stronger yuan makes China a more powerful buyer of all strategic commodities. We see no reason to expect China's announced exchange rate reform to affect its appetite for holding or buying US Treasuries. With the yuan pegged to a basket of currencies, a depreciating dollar is no less attractive than any other depreciating currency.

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**Recommended Reading**

**Resolution of Banking Crises: The Good, the Bad, and the Ugly**
Luc Laeven and Fabian Valencia
IMF Working Paper 10/146
June 1, 2010

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