

MARKET INSIGHT REPORT**China Helps Itself, No One Else**

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When China announced that it would be changing the policy that effectively fixed the dollar rate in the 6.83 area since August 2008 and would allow the daily peg to move significantly as it had in the 37 months between July 2005 and August 2008, there was joy in the major political capitals. Western observers saw the Chinese move as a conciliatory gesture to the Eurozone, and especially to the US, that would ease global political stresses at the upcoming G-20 meetings. Although political tempers were cooled somewhat in Toronto, the Chinese move will have virtually no impact on the trade balance and employment picture in any of the developed countries and, as a result, will not lessen the political heat that the Western authorities are facing from their electorates. Within Europe, the powerful German export machine masks Chinese import penetration and mutes the public's anger, as there are so many other economic issues agitating the voters, but in the US, the trade deficit with China stands clearly above any other global economic issue. Despite the hoopla around this move, it will have almost no impact on US imports of Chinese goods, or the US trade balance. Has this change done anything?

From the US point of view, the renminbi-dollar exchange rate sounds important, but it isn't. Even if the renminbi were to double in value tomorrow, and the Chinese lost market share in a market, like televisions, the US would import many fewer from China, but would buy more from other countries like Malaysia or Thailand. In almost every case, the lowest cost producer would not be an American manufacturer but another foreign one. In fact, it is very likely that the Chinese would not be pushed aside by others even if its currency does strengthen dramatically. The Japanese example is instructive: there were 360 yen per dollar in 1972 and now almost 40 years later there are about 88, which is roughly a 4% compound rate of annual appreciation, but the Japanese maintained their dominant trade surplus with the US throughout the entire process. China's surplus is higher than it was in 2005. In the 59 months since the renminbi began its climb from 8.255 RMB per dollar, it has appreciated at roughly the same annual rate as the yen, but the impact of this annual change is almost nil. On each individual item, like a pair of \$10.00 jeans, an increase of 4% is only \$0.40, an amount that can be covered by squeezing the margin either at the manufacturing end or at the wholesale/retail end. There is plenty of room to accommodate this increase; the customer sees nothing and he keeps on buying.

For the Chinese, restarting the creeping revaluation of the renminbi has many benefits. Near the top of the list is gently moving its manufacturing base toward higher value added items and shifting production from servicing exports to satisfying domestic demand. Way down the list is appeasing the international critics of Chinese policy. The promotion of the domestic market is already underway, but the pace will be glacial – at least from the point of view of bank traders and US politicians – taking at least a decade to have a major impact on the composition of the Chinese economy. And there is no guarantee that any shift is coming, as the Japanese economy remains basically unchanged despite the dramatic increase in the value of the yen. We can only hope that the authorities in Beijing have a more adaptive and global view than those in Tokyo have shown and will adjust their banking and financial support system to integrate the renminbi and the Chinese economy with that of the West. Although the renminbi could rise to the 4.00 area by the end of this decade, the impact of this move will be felt inside of China, not outside. Furthermore, we can be sure that the Chinese leadership will do its best to manage this process in a way that has the most positive feedback for the Chinese society. Although the stronger renminbi will be a boon for China's neighbors in Asia, it offers no help to the US or Europe.

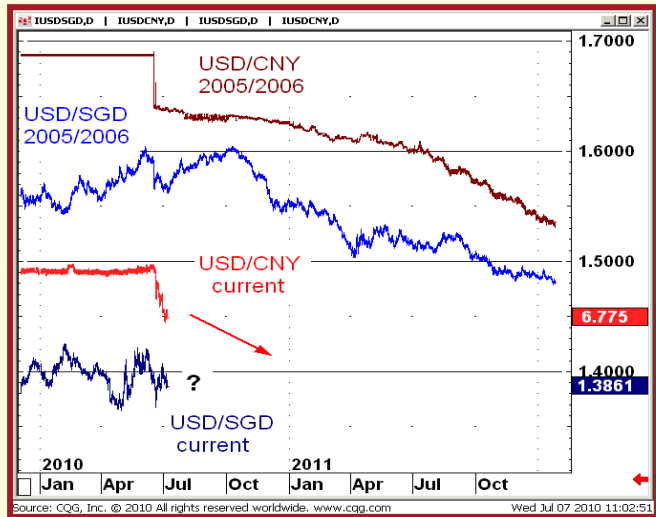


CURRENCY – Asia Long-Term View

China Saved Asia, but for How Long?

By Jonathan Clark

The financial crisis that began in 2007 started in the US, but often wreaked as much havoc on individual European and Asian economies. The 'Great Recession' and the decline in European and US tax revenues that followed is in large part the cause of the sovereign debt crisis. As the Asian economies pursued very conservative economic strategies after their crisis in 1997, they escaped this fate, but they were vulnerable to an overdependence on exports. When the global trade financing system seized up Asian countries saw their exports collapse as credit was impossible to find. The normalization of global financing resulted in a rebound in Asian exports, but only China's enormous fiscal stimulus of 15% of GDP as well as the explosion of state bank lending allowed Asian exports to climb, rescuing all the other Asian nations. China is the mother hen, but it is in the process of slowing the economy and now it has allowed the renminbi to gradually appreciate. Although a stronger renminbi is good for Asia, if Chinese GDP growth falls back to 7% in the second half of 2010, well below its long-term average growth rate of 11%, Asian export oriented economies will face renewed challenges during the remainder of this year and in 2011.



The last time the Chinese monetary authorities allowed the renminbi to strengthen versus the US dollar was in July of 2005 and this ushered in a period of strength for the Asian regional currencies. This lasted into late 2007 or 2008 when the financial crisis escalated and the regional currencies then declined for approximately a year. The renminbi is being guided higher to relieve political pressure at a rate of 5-8% per annum, but this good factor is likely to be overwhelmed as the global economy slows, and the Asian currencies will falter.

The cycles call for the US dollar vs. the Singapore dollar to drop for several weeks before beginning a sustained rally. The most likely time for a USD low is the week of July 19 or the following week and the dollar support at 1.3670 should contain any strength seen. USD/SGD should then turn higher and rally into September and **a close above 1.4110 will confirm that a major uptrend lasting into January or longer is underway. Our initial target for this upmove will become the 1.4775 area.**