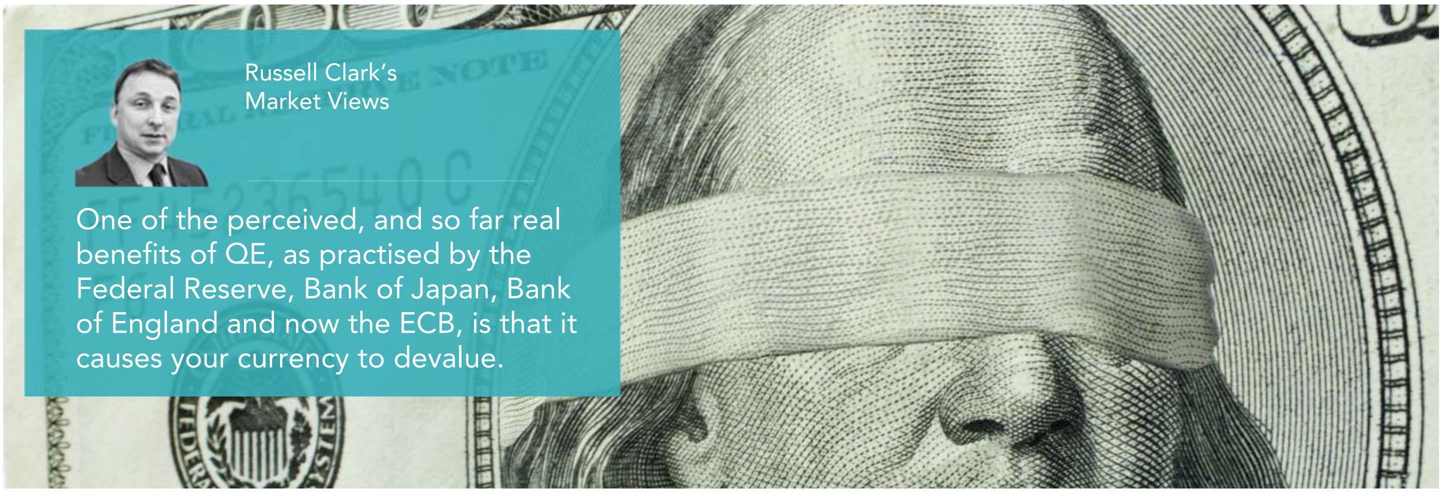
HORSEMAN
CAPITAL MANAGEMENT

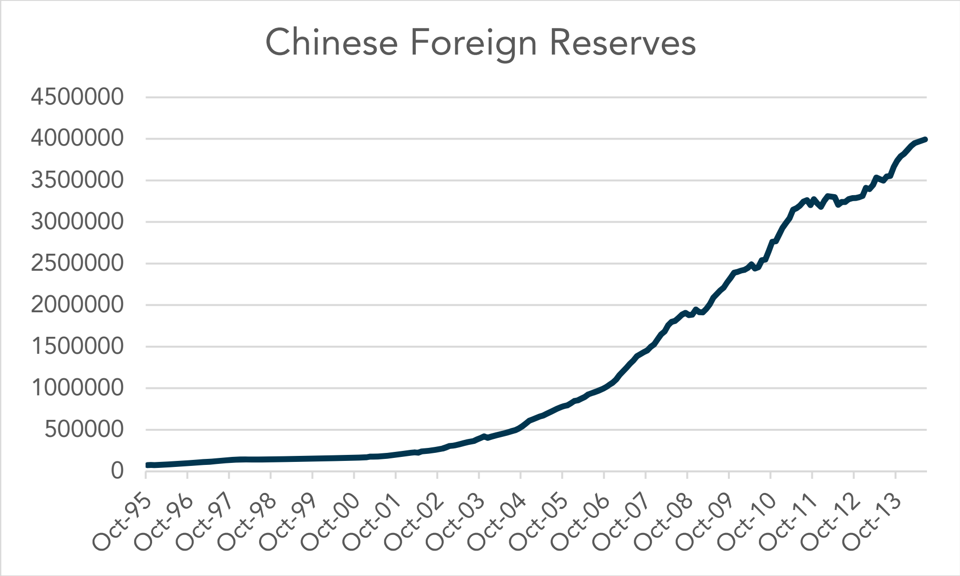
CAN QE BE CURRENCY BULLISH?



One of the perceived, and so far real benefits of QE, as practised by the Federal Reserve, Bank of Japan, Bank of England and now the ECB, is that it causes your currency to devalue. However, as the ever expanding list of central banks utilising QE attests to, not everyone can devalue at the same time. The only large economy not to use QE is China. This has had a predictable effect on its currency.

China saw a rapid appreciation of its currency in the late 90s as the rest of Asia devalued. China had devalued in 1994, which is not picked up in this index. The Yuan was remarkably stable until 2011, and has moved much higher since then.

The appreciation of the Chinese Yuan has caused the current account balance to shrink significantly, but bulls on Yuan would argue that it is still positive.



China has also built up the largest foreign reserves in the world. This is also considered currency bullish.

However a close examination of Chinese current account data throws up an interesting counter point to these currency bullish arguments. While China generates a positive current account on exports of goods, it actually generates a negative return on its net investments with the rest of the world.

Net Primary Income	2005	2006	2007	2008	2009	2010	2011	2012
China	-16	-5	8	28	-8	-25	-70	-42
Germany	30	55	59	46	82	72	81	82
Japan	103	118	139	155	136	141	175	179
US	67	43	100	146	123	177	232	223

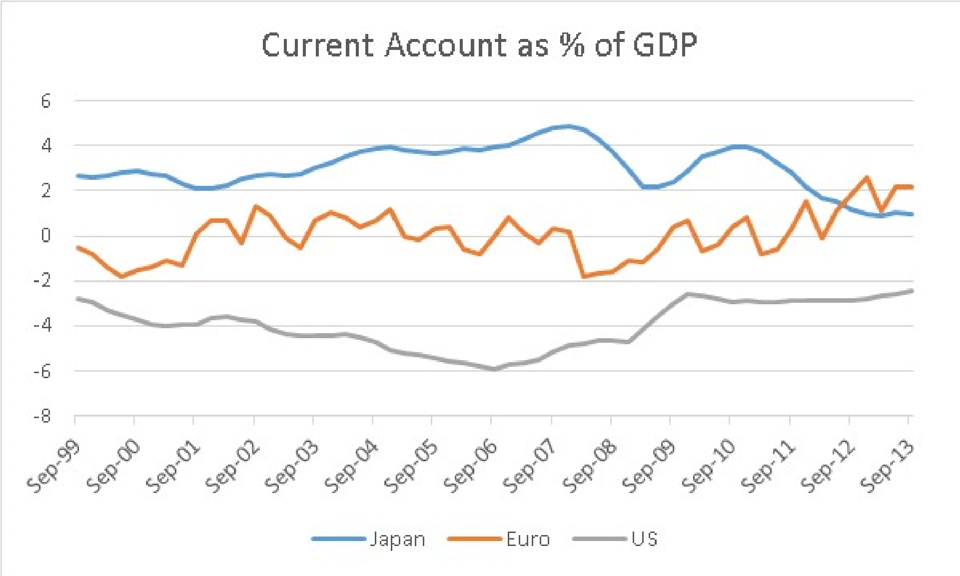
The above data is taken from the World Bank. It is curious to note that China's investment income has deteriorated significantly since 2008, despite its foreign reserves nearly doubling. We can get an idea of why this is the case by looking at the net investment position of China.

USD bn	Net Int Inv Pos	Foreign Reserves	Priv Sector
China	1736	3993	-2257
Germany	1463	284	1179
Japan	3452	1209	2243
US	-5385	-	-

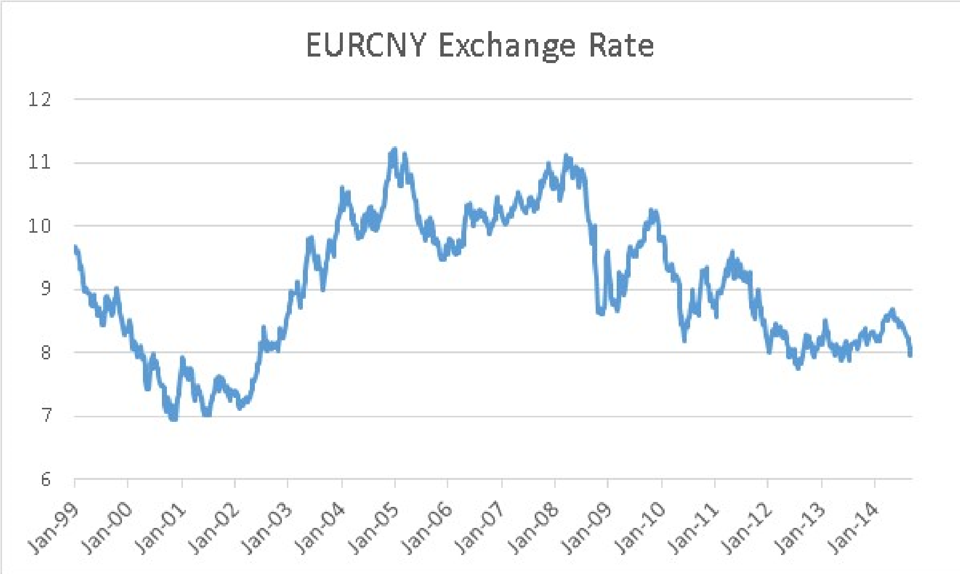
US as reserve currency has no need for foreign reserves

While China has a positive net international investment (NII) position, almost all of China's international assets are held as foreign reserves, while its private sector is net short. That is the Chinese private sector has attracted significant capital from overseas, either in the form of loans or FDI.

Keen-eyed observers may well be wondering how the US can generate such substantial investment income despite being a net debtor to the world. A Federal Reserve of New York research note points us in the right direction http://www.newyorkfed.org/research/current_issues/ci11-12.pdf. As the note points out, most of the US liabilities are interest rates sensitive. In equities and FDI the US runs a net positive position. And US tends to earn a far higher rate of return on its FDI and equity investment than foreigners earn on their investments in the US. Hence the key variable in the US investment position is the interest it pays on US debt which makes up the majority of China's international assets.



If we think of QE as a policy to devalue a currency to help correct a current account deficit, then the Federal Reserve's QE was both warranted and effective in reducing the size of the current account. Japan saw a significant decline in its current account before it launched its QE program. However, Europe is launching its QE program after a significant improvement in its current account.



European QE has had a significant effect on lowering not only European but global yields. The lower Euro should effect the trade balance, but should also effect the investment income that China earns. The combined effect could be very significant for the Chinese current account.

If European QE causes the Chinese current account to deteriorate significantly, it may cause the Yuan to weaken. Or in other words western currencies to appreciate against the Chinese Yuan. From my perspective I believe more QE will prove to be counter-productive – either from a pure economic perspective via a deteriorating Chinese current account, or via a political perspective as Chinese authorities lose patience with its trade partners choosing to devalue rather than reform.

INFORMATION

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