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First Trust

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Monday Morning Outlook

Brian S. Wesbury - Chief Economist
Robert Stein, CFA - Senior Economist

China Rising

China just decided it will once again let its currency – the yuan – get stronger against the US dollar. This is an important milestone for China and a positive signal about its long term economic prosperity. The immediate reaction of the equity markets was very positive and we agree.

In essence, China is saying it thinks its currency will do a better job than the US dollar of retaining its value over time. Put another way, China is committed to having lower inflation than the US and China seems willing to deal with the natural consequences of that strategy, which is a currency that gains value.

Previously, China was hesitant to allow its currency to gain value versus the dollar. From the early 1990s until mid-2005, despite a combination of rising trade surpluses with the US and growing attractiveness for global capital investors, the yuan-dollar exchange rate was fixed by the Bank of China. In other words, China was willing to import US monetary policy.

But this became problematic. As the dollar weakened versus gold and other commodities, inflation picked up in China. In addition, the US Congress threatened trade retaliation against China. So, from mid-2005 through mid-2008, the yuan was allowed to appreciate by 21% against the US dollar. This was the largest gain since China moved toward opening its economy after the death of the tyrant Mao in the late 1970s.

Once the financial crisis hit, the peg was reinstated at the new, higher exchange rate and China's currency didn't budge. Now, it appears another period of managed appreciation is in play. The exact nature of the move is open to question, but we would not be surprised by significant yuan appreciation in the next several years.

Yuan appreciation does two things. First, it will lower Chinese inflation relative to US inflation. Second, it will raise the living standards of Chinese citizens. China has a growing middle-class. So where previously the government might have wanted the peg in order to encourage export growth, now the political calculus is starting to favor expanding the purchasing power of its workers. This is a sign of maturity for both the economy and Chinese policymakers. Good for them. Chinese workers have been accustomed to saving an extremely large share of their earnings. But with their global wealth and purchasing power boosted by a stronger currency, they will likely spend a larger share of income.

In terms of the impact on the US, the decision signals less demand for our Treasury securities, but more demand for the goods and services we produce.

With a pegged exchange rate to the US dollar, rapid economic growth in China requires a rapid expansion of their local currency base, which, in turn, calls for a rapid expansion of Treasury securities as reserves. But if the yuan goes up in value relative to the dollar, that means the local currency base can grow more slowly, in turn, reducing the need for reserves.

At the margin, this means higher Treasury interest rates in the US, but an increase in yields that is completely justified by a shift in economic fundamentals. More purchasing power for Chinese workers will help the US economy grow faster. Higher interest rates and faster economic growth go hand in hand.

The one thing we don't understand is the way the move by China is being hailed in some quarters as a triumph for the "quiet diplomacy" of the Obama Administration. China's decision, just like its currency changes in 2005-08, is ultimately about itself.

A fixed exchange rate can be a very good thing. It's what the US does across 50 states. But when a country pegs to a currency that is managed poorly, then letting go is often the best policy. Often a country will let go of a peg so that it can devalue its currency. In this case, China is letting go of the peg and will experience an appreciating currency. Maybe the US should peg to the yuan.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-22 / 9:00 am	Existing Home Sales - May	6.15 Mil	**6.35 Mil**		5.77 Mil
6-23 / 9:00 am	New Home Sales - May	0.410 Mil	**0.460 Mil**		0.504 Mil
6-24 / 7:30 am	Durable Goods - May	-1.3%	**+0.5%**		+2.8%
7:30 am	Durable Goods (Ex-Trans)- May	+1.0%	**+1.8%**		-1.1%
7:30 am	Initial Claims - Jun 19	460K	**462K**		472K
6-25 / 7:30 am	Q1 GDP Third Report	+3.0%	**+2.8%**		+3.0%
7:30 am	Q1 GDP Chain Price Index	+1.0%	**+1.0%**		+1.0%
8:45 am	U. Mich. Consumer Sentiment	75.5	**76.0**		75.5