Will There Be a U.S. - China Currency War?

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At a September Senate hearing over U.S. currency and trade policy vs. China, Charles Schumer, a prominent Democrat from New York, was grilling U.S. Treasury Secretary Tim Geithner, and thundered:

"At a time when the U.S. economy is trying to pick itself up off the ground, China's currency manipulation is like a boot to the throat of our recovery. This administration refuses to try and take that boot off our neck!"

For his part, Secretary Geithner has been resisting calls to openly impose sanctions on China. But the Administration could soon make a mostly symbolic move to name China as a "currency manipulator" in an upcoming report on world currencies this fall. The next report is due on October 15th. Congress, meanwhile, is considering a bill that would impose harsher sanctions against trade partners identified as currency manipulators, including barring the U.S. government from purchasing goods from those countries unless they already covered under the International Monetary Fund's procurement agreement.

Currency and Effects on Trade

Most investors grasp the impact of currency valuation on exports. The lower your currency is relative to your export market, the easier it will be for you to sell your products abroad. Conversely, however, when you lower the value of your own currency, you contribute to inflationary pressures at home. This is because just as your products are cheaper abroad, products you import are more expensive.

Historically, nations have occasionally deliberately accepted inflation risks and jettisoned "hard-money" approaches in favor of boosting exports by devaluing their currency - a strategy called "beggar-thy-neighbor." This is a very pro-employment policy and tends to particularly benefit manufacturers and their workers who are making the exports. Not incidentally, this very pro-growth policy can help keep workers busy and happy - and therefore disinclined to cause trouble.

Background

Chinese currency issues are now becoming a serious point of contention between the U.S. and China. Between 2008 and 2010, China had been pegging the value of the yuan to a consistent exchange rate against the U.S. dollar. However, China moved to de-peg its currency in the summer of 2010. The value of the yuan rose initially, while the U.S. central bank embarked on a massive quantitative easing that threatened to devalue the dollar - already under pressure because of the tremendous debt level of the United States.

China's finance minister, Zhu Guangyao, objected to the 2010 round of quantitative easing, warning that the move threatened to flood emerging markets with $10 billion in "hot money," and disrupting their economies.

Soon afterward, China began to let its currency fall -sparking objections from President Obama and prompting hearings in Congress. What's more, the Chinese - flush with cash from a high savings rate and much more stable balance sheets - began to make huge purchases of U.S. currency in the open markets, shoring up the dollar and pushing the yuan's value in dollar terms still lower in the weeks after the decoupling.

The conflict has been gradually building steam ever since. Some observers, including Guido Montega, the Brazilian Minister for Finance, believe that the uncoupling of the Chinese yuan from the dollar was the first salvo in a global currency war, the likes of which we have not seen since the 1930s.

Perspective

At this point, we believe that talk of a new currency war between the U.S. and China are overblown. It is simply in neither country's serves interest. Yes, Chinese finance officials are talking tough, but they already seem to be stepping back from the precipice. The yuan has, in fact, already begun to gain back lost ground against the dollar.

Second, The U.S. needs to maintain good relations with China in order to finance its deficit spending, but also to protect its interests in Taiwan. Meanwhile, China, owns massive amounts of U.S. debt, and relies on a healthy economy in the U.S. to protect its investment. If the China provokes the U.S. into more devaluation, China's interest payments from U.S. treasuries and other dollar-denominated investments fall, in real terms.

Third, if U.S. politicians, succumbing to protectionist impulses, imposes sanctions on Chinese imports, China has options short of retaliating directly and getting drawn into a trade war: They can go to the World Trade Organization for redress. Moreover, we think China would have an excellent case, if it came to that.

More directly, China has an interest in keeping the U.S. economy humming, without disruptions. It is true that absent any externalities, Chinese manufacturers may get a small boost in keeping their currency low. But they will not get a boost by sparking a currency or trade war that would disrupt both economies: Unemployed American workers don't buy very many Chinese-made iPhones! And conversely, a stronger yuan increases Chinese purchasing power across the board - which further boosts the burgeoning Chinese middle class.

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Outlook

Our expectation is that we will see some election-year saber-rattling in the United States - and perhaps the passage of a few largely symbolic measures as Congress looks for ways to keep manufacturers and labor unions happy. But even if there is protracted currency battle, our investment thesis remains the same: The underlying fundamentals in the Chinese markets remain strong, either way. The growing Chinese middle class will continue to drive growth - especially for consumer products. Valuations in Chinese equities remain compelling compared to the West. And balance sheets are incomparably stronger in China vis -a-vis the West, which gives investors in China an important margin of safety. Meanwhile, China is in an excellent position, as it should be well set up to complete its current round of tightening and move into an expansion phase, even as the West must continue to deleverage and tighten its own monetary policies. This should result in China and Asian markets taking the lion's share of global economic growth for years to come. ■

How To Invest in Chinese Urbanization

October 11, 2011
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Urbanization - the massive demographic shift of the Chinese population from agrarian inland communities to the modern major cities along the coast - is fueling China's emergence as a global economic superpower. The migration has already been so huge that China is faced with a so-called 'floating population' of over 200 million people from the provinces already residing in the cities, but with no permanent right to reside there. These Chinese are themselves a ready source of inexpensive labor for Chinese factories and the urban service businesses that have sprouted to service them. But as the claw their way into the middle class, they are also generating demand for housing and services themselves, and creating a need for a substantial logistics build out to move food and material from the provinces into the cities.

China's transformation from an agrarian society to a largely urban one has been astonishing: In 1978, only 18 percent of Chinese lived in urban areas, according to Clarence Kwan, the National Managing Partner of the Chinese Services Group at Deloitte. Today, fully 47 percent of Chinese live in the cities - and that figure is set to grow by another 280 million people by 2030.

This is a substantial tailwind for companies involved with the expansion of infrastructure to support this massive migration. Flush with a ready supply of capital, thanks to China's huge personal savings rate, the Chinese government is now busy encouraging and fostering immense investments in infrastructure projects, ranging from residential construction to rail and roadways to the construction of huge "logistical cities" in the provinces to ease the population burden on the major coastal cities while facilitating the free movement of goods from the countryside to the cities.

But how does a foreign investor get involved? Here are two ideas:

China Metro Rural (AMEX - CNR)

China Metro Rural is a fairly young company that focuses on the construction of modern logistical centers in 2nd and 3rd tier Chinese cities. The company looks for areas where demand for logistical throughput is strong - generally within 1 to 3 hours' drive of the coastal cities - and then works closely with local governments to build huge, modern commerce areas to service business and logistics operations - complete with office towers, restaurants, megamalls, luxury retail space, huge car dealerships, and 5-star hotels.

Currently, China Metro Rural has ▶

broken ground on three separate logistics centers in Dezhou, Qiqihaer and Tienin, with Tienin the closest to completion. In each case, local government officials have donated substantial amounts of land - between 5 and 7 square kilometers each - to facilitate construction. With much of their land costs free, the company's overhead is reduced, and the supportive regulatory environments they have negotiated with local governments.

As of October 2011, CNR is currently trading at less than four times 2011 earnings and below its book value, with a strong balance sheet and solid earnings growth.

Greater China Fund

No appetite for single stocks? You can get exposure to a broad array of Chinese companies through the Greater China Fund (NYSE-GCH), a closed-end mutual fund and part of the Barings Asset Management family of funds, managed by Agnes Deng. Deng focuses on opportunities presented by the growth of the Chinese middle class, which is already generating a ferocious demand for everything from cell phones to televisions to modern medical care. Deng is currently emphasizing the retail, Internet services and health care industries in China. Deng states that she is still finding decent value in the Chinese market, compared to the west - especially when you take the growth rate of the Chinese economy into account.

At the time of publication, the fund is trading at a ___ percent discount to NAV. No guarantee of profit, but an opportunity for value-conscious investors to buy Chinese assets at relatively bargain prices.

Caution

Don't go hog wild on Chinese property developers. Some companies appear to have overexpanded, and yields on bonds issued by Chinese property developers have started to rise, as fears of a Chinese property bubble come to a head. Standard & Poor's' downgraded a number of development firms last month, as investors feared that some Chinese developers could not withstand a sharp downturn in sales figures. China Metro Rural's in a different position: Their profits are easily enough to pay their debt service costs many times over - and it's tough to beat free land. But many other Chinese developers are in a much tougher position, as China brings its economy in for a landing at 6-9 percent growth instead of the double digit growth that some of these developers were counting on. Hence, look for indirect ways to play the Chinese migration.

At the time of publication, the author, Jason Van Steenwyk, has no position, long or short, of any security mentioned in this article, nor of any Chinese equities whatsoever. ■