

JVB Financial Group, LLC

CRONIN'S CORNER MONTHLY

A Perspective on the International Economy

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by Keith Cronin, JVB Senior Vice President of US Credits and International Sovereign Trading

As the second anniversary of Greece's tragic fiscal allegory prepares to pounce, one of the lasting legacies of its profligate stanzas will be how a butterfly flapping its wings in Athens can indeed cause chaos. The global financial and economic nimbus that continues to sprinkle uncertainty and omit the effluvium of desperation has been an unfortunate testament to the interconnectivity of the world's stage of commerce. Of course, the broadening of trade bears with it such flaws but it has also provided a bounty for some and for others a political podium. This month's vote by the US senate, which would permit Washington to label any currency that was deemed to be undervalued as a subsidy and which would consequently be subject to tariffs, is basically the impotent realization of years of failed diplomacy to force the Chinese to allow their currency to appreciate faster against the US Dollar. The probability of this bill actually being ratified into law we think is negligible and even if it did succeed in being passed in the House of Representatives, we question the positive impacts it might have upon the struggling US economy. This bill was a message from the political panjandrum that is a Washington attempting to reclaim some of the respect that it has lost and the opening of the political campaigning season which, under the current administration, seems to maunder ad nauseam. However, the bill is also an attempt by American politicians to realign the opprobrium for the feeble US economy onto somewhere – anywhere – else and China it seems was the obvious target.

The argument that cheap Chinese imports are costing Americans their jobs is inevitably destined to be a popular aphorism for the campaign of 2012 and just as Barack Obama criticized the Bush administration for being too soft on the Chinese, thus the accusations will tilt full circle with rampant splenetic politicking that will promise to remove the imbalances caused by the undervalued Chinese currency. Whilst there is little doubt that the Chinese Yuan should be trading higher versus the US Dollar we question the wisdom of imposing tariffs upon Chinese imports and furthermore we seriously doubt that a weaker Chinese unit would be the panacea for American business that some lawmakers have forecasted.

Firstly, imposing duties upon Chinese imports would be a legal faux-pas. According to the World Trade Organization (WTO) a country's undervalued currency is not considered an illegal subsidy to promote a country's exports and the US would almost certainly face an official complaint from the WTO if tariffs were lashed onto Chinese imports based on that premise. This would obviously be extremely counterproductive for the US and her exporting companies especially since one of the main foundations of the American economic recovery may be American exports to the world.

Furthermore, the Chinese could very possibly fulfill their own prophecy of a Sino-US trade war which would obviously be detrimental to an already supine American economy and any imposition of American tariffs would almost certainly be met with reprisals. These reprisals would be felt most by the companies already doing business in China as this protectionist policy would backfire on them as the Chinese would very likely cancel orders – especially for bigger industrial ticket items – and thus the economic squeeze would develop into strangulation. Arguments abound that by the Chinese not allowing their currency to appreciate faster versus the Dollar that it has actually impeded a shift in demand towards other emerging market economies which is acting as a drag on global growth. Since 2006 the Chinese currency has actually appreciated over twenty percent versus the Dollar from the time when the Chinese authorities starting loosening their peg versus the Greenback. This is hardly a sign of a regime keeping its currency undervalued and we think that the severe revaluation that some US lawmakers are calling for is unrealistic. The Chinese cannot truckle to Washington and let their currency freefall as it would imperil their own economy, and stifle the exports that fuel it and especially since China isn't immune to what currently ails the world of economics. In the third quarter of this year the economy grew at a pace of just over nine percent. Whilst such a number is a desideratum for the rest of the world, given the size of China, the amount of people joining the labor force and the size of the population double digit growth is really necessary for the country to sustain its people. This was the slowest rate of growth in two years and other data on the highly significant export sector revealed a less than ten percent growth rate of exports to Europe in September. The previous year it was twenty two percent and given that Europe is now China's biggest customer this statistic resonates. Even if, for arguments sake, the Yuan fell another thirty percent versus the US Dollar we doubt that we would see an immediate plunge in the unemployment rate in the US. Whilst American manufacturers argue that they are being priced out of markets by cheap Chinese products, countries like Malaysia, Indonesia and India are also in the market and with cheap labor at their disposal they also represent a threat and would quickly occupy any vacuum left by China. A weaker currency should theoretically make American exports to China cheaper but since the fact that China exports about four times as many goods to the US as goes the other way, we again doubt that this would provide the halcyon that has been theorized. The Chinese consumer has but a modicum of the purchasing power that his American counterpart has thus a plunging Yuan may only serve to, in fact, effectively damage the

ABOUT KEITH CRONIN

Keith Cronin is
Senior Vice
President of
US Credits and
International
Sovereign
Trading at JVB



Financial Group, LLC. With almost a decade of fixed income trading experience, he began on HSBC's retail desk and moved on to HSBC's proprietary trading desk, wherein his specialty became trading Investment grade US Corporate Bonds. Mr. Cronin is a graduate of the University of Cork in the Republic of Ireland with an Honors Masters Degree in Economics.

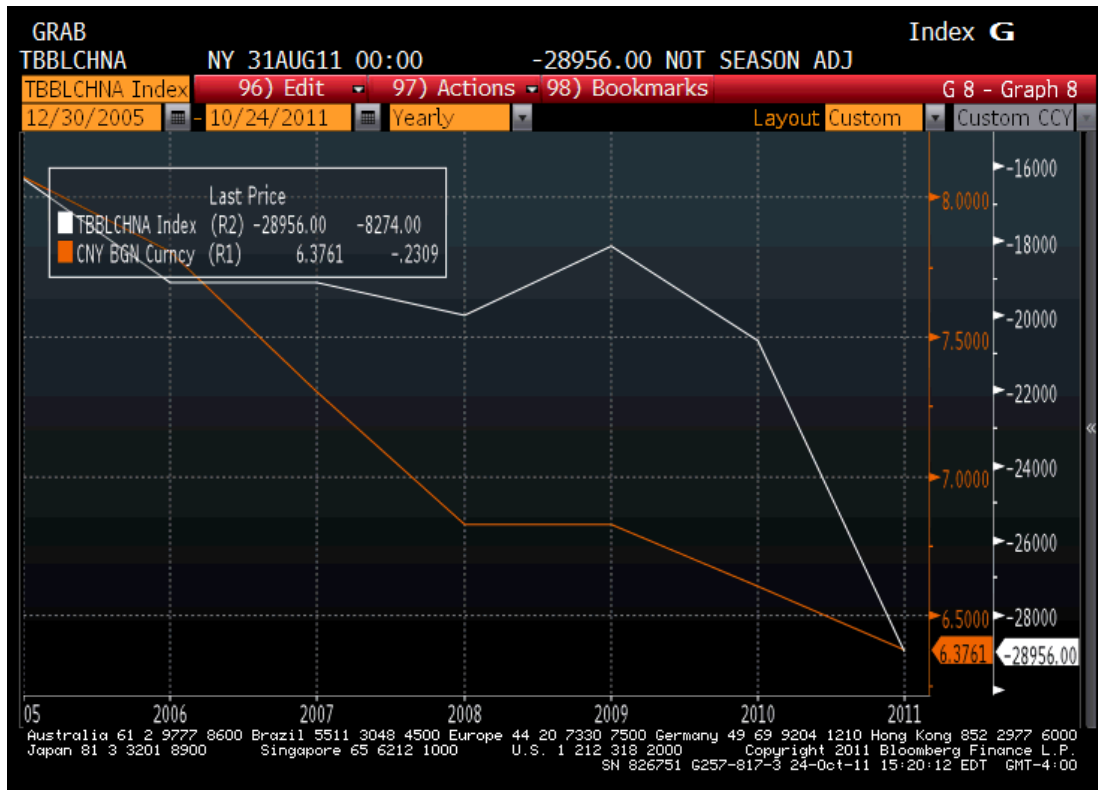
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US export sector. Many US exporters depend upon Chinese components to complete their orders and thus if they became more expensive the highly vulnerable export sector would experience a dilution of its global competitiveness. The deficit with China continues to hit monthly records (\$29 billion in August) despite the stronger Yuan and of course one has to inevitably address the significant fact that China is America's biggest creditor holding, at the time of writing, over one trillion dollars in Treasuries. If the Chinese no longer have to support the Dollar versus their unit because they are 'forced' into leaving their currency appreciate, then their purchase of Treasuries would surely diminish making it then significantly harder for the US to continue to finance its trillion dollar plus federal deficit. A Chinese abstention from the US Treasury market could put upward pressure on yields at a time when the FED's quantitative easing measures and recent operation twist have been implemented to achieve exactly the opposite. China has recently seen violent protests as a result of inflation

affecting the, already limited, people's purchasing power. If the Yuan were to rise dramatically the social affects resulting from the economic affects, as export plunge dragging with it employment, would be dangerous and no-one wants to see a socially unbalanced China. Whilst we believe China is certainly at fault for keeping its currency artificially low, and also providing domestic industries with export subsidies and blatantly blocking competitive imports of American products, this is not the right time for America to begin another war. We think fundamentally that US lawmakers recognize this but are attempting to nebulize their political campaigns with oriental gammon and China as yet another reason as to why the American labor force and the economy as a whole remain in a state of corybantic weakness. These politicians would be better served by trying to solve the country's long term deficit problem, resuscitate small businesses, focus on making America a manufacturer again and find an effective restorative from within. What ails America is not China but America.

Keith Cronin
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Although the Chinese Yuan has appreciated since 2005, the US trade deficit with China continues to widen.

Image source: Bloomberg 10/24/11



JVB FINANCIAL GROUP, LLC
MEMBER FINRA - SIPC

2700 N. Military Trail, Suite 200 / Boca Raton, FL 33431 / (561) 416-5876 / www.jvbfinancial.com

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