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Yuan to Dance?

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A butterfly could flap its wings in China and trigger a chain of complex events that spawns a trailer park-trashing tornado in Texas, according to proponents of the complex branch of mathematics called chaos theory. Should a group of senior officials at China's central bank flap their own bureaucratic wings and revalue the national currency, most U.S. economists say we're safe from the fallout — unless, of course, it falls out in a way no one expects.

Among Wall Street economists, the consensus is that few U.S. companies that buy goods from China would be seriously affected if that country revalued its national currency, known formally as the renminbi and also as the yuan, now firmly pegged at 8.28 to the U.S. dollar. But in what Merrill Lynch economist David Rosenberg says is a "classic example of the law of unintended consequences," more significant effects could come from a rise in U.S. interest rates, which could hit the bond market and then the housing sector. And housing, he points out, is providing "the last vestige of stimulus in this economy."

By keeping the value of the yuan artificially low, Treasury Secretary John Snow and other critics of the current rate say that China has piled up trade surpluses because it can flood U.S. and European markets with cheap goods. That's become a political football to be kicked around after any mention of the U.S.'s staggering $162 billion trade deficit with China, though few observers believe a yuan revaluation will help close the gap.

"It's convenient to point to one distortion in the market as the source of those ills when the reality is that there are multiple causes for the U.S. trade imbalance," says CIBC economist Avery Shenfeld.

Still, a partial revaluation seems increasingly likely because of Chinese domestic pressures, mainly a need to slow the rate of growth in its rapidly expanding economy. Some published reports speculate that the yuan could rise 5% within the next three months, though Zhou Xiaochuan, China's central bank governor, was vehemently denying such a move late last month. Rumors that a revaluation would accompany a planned expansion of the country's national foreign-exchange trading system on May 18 sparked the denial.

So what does this mean for U.S. companies and consumers? Opinions vary, but the general consensus is that some sectors, particularly retail and apparel stocks, might see some short-term volatility if the yuan moves, but that it won't change their fundamentals. Tim Craighead, an economist at Goldman Sachs, says a 5% or less revaluation won't mean a lot from a global perspective. But in a May 2 note he adds that, "if it is 5%-10% and if it precipitates a lifting of Asian currencies more broadly and if it happens sooner rather than later, then the intrigue builds."

In the measured language of his profession, Craighead says the sky won't fall, but keep an eye out anyway. "There are many valid caveats to simplistically drawing stock-specific conclusions," he says. "But a revaluation would nonetheless be an important fundamental consideration for stock investors when it happens."

Over time, shoppers might see marginally higher prices at Wal-Mart Stores (NYSE:WMT - News) or Target (NYSE:TGT - News), or any of the thousands of retailers that stock all those Chinese-produced goods that help create the trade deficit. That is, unless those stores start buying their goods in other countries that can provide very cheap labor, such as Bangladesh or Vietnam. CIBC's Shenfeld says only about $1 of the cost of a $3.99 t-shirt at Wal-Mart comes from its manufacture in China — transportation, marketing and, of course, profit margins account for the rest of the markup.

What American investors and shoppers won't see are new jobs for U.S. companies. The sectors where many manufacturing jobs went overseas — toys, appliances, electronics and apparel — migrated because foreign labor is cheap, and domestic labor isn't. We won't see a sudden domestic resurgence if China becomes a fractionally more expensive place to do business, cautions Merrill's Rosenberg. "Consider for a moment that the U.S. employs just over 1.5 million people in the sectors where we import most from China," he wrote. "And let's not forget. U.S.-China wage differentials being what they are, the trend towards outsourcing to China is not going to go away."

The downside to an appreciation of the Chinese currency would be a regional currency boost, making U.S. trade with Asia a more expensive proposition. Craighead echoes a widely held opinion when he says U.S. interest rates and inflation "would likely tick up."

That would put the brakes on the low-interest-rate-fueled growth in the U.S. economy, which Robert Brusca, president of Fact and Opinion Research, says has played out principally through reckless spending from refinanced real estate. "I'm convinced that people have taken this money and blown it on gewgaws and junk," he says. "We're basically borrowing money to support our consumption, and we are living well beyond our means."

If interest rates keep rising, that flow of cheap money dries up, and so does the real-estate market. Rosenberg points out that there area about nine million construction and real-estate jobs — six times more than the sectors that have lost market share to China. "For every 1% loss of employment in the construction and real-estate sector due to the prospect of higher interest rates... we would have to create 12% more jobs in the apparel/textile industry just as an offset (the income tradeoff is even larger)."

If and when the Chinese currency butterfly takes its first flaps, Rosenberg has one piece of advice for politicos who point to the yuan as the bane of our trade balance: "Be careful what you wish for."

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