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Doctor Copper suggests China risks financial flu

By John J. Hardy, Head of FX Strategy

The copper market has become a very different beast from what it was in the old days, when it was only about global demand for the metal in automotive, industrial and building applications (wiring, pipes, etc.). In those days, it became known as “Doctor Copper” because it was such an excellent leading indicator on economic growth cycles. In recent years, however, it may have become more of an indicator of China’s financial health, as China dominates world demand for the metal.

That’s because in recent years, it has become a highly-financialised product in China, stored in enormous quantities in warehouses and used as collateral for all kinds of lending/credit activities in addition to traditional industrial and construction applications. The ultimate expression of this new financialisation, a process which started several years earlier, was reached over the last couple of years as the warehoused copper and other collateral was employed in a sophisticated series of transactions aimed at taking advantage of the tremendous positive interest rate carry available in holding mainland Chinese Yuan, financed with virtually non-yielding US dollars. This was the great USDCNY carry trade, which now appears to be in its death throes.

The trick for those looking to profit from this trade was in overcoming China’s capital controls, which they did [as described in an FTAlphaville post](#) on the subject back in February. Copper and other products played a critical part in these transactions, as the warehoused collateral was “exported” to offshore entities in Hong Kong that then sold it and sent fresh dollars back into the mainland economy to pay back borrowed dollars that had been transformed into high-yielding CNY investments.

Now, China has moved to nip this USDCNY carry trade in the bud with an engineered devaluation in recent weeks that will force losses on those who have recently put on this carry trade strategy (especially [buyers of exotic derivative strategies called TRFs](#) which even added leverage to the trade).

As well, the move to weaken the Yuan has also likely stopped fresh attempts to put on new positions, as the government wants to prove the point that CNY can move either way, sowing uncertainty on future policy moves. For China, after all, this carry trade was proving highly problematic, as it has been a huge conduit of hot money feeding China’s dangerously accelerating credit growth and was very costly for PBOC, the Chinese central bank, because it forced it to add hundreds of billions of dollars to its already massive FX reserves to keep the CNY from strengthening even further. As well, it aggravated the risk to China from the extensive creation of USD-denominated debt at a time when the US Federal Reserve is withdrawing accommodation. Other, less resilient EM countries have already shown the strain this can cause on their currencies and economies starting with the first distant early warning of the Fed’s tapering from Ben Bernanke in May of last year.

So this move lower in copper and even iron ore, which was curiously also used in some of these collateral schemes, is a natural follow-on after the official move to disrupt the carry trade by weakening the CNY. It has

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left those who have imported huge quantities of additional collateral high and dry because the demand for warehousing any additional collateral to grow this trade has likely collapsed. And those holding large amounts of collateral that can't use it in new financing deals are likely dumping it on the market. How far copper and/or iron ore prices can fall from here, I have no idea, though I suspect copper can fall much lower still as it remains so far above its historic trading ranges, and the hundreds of thousands – even millions – of tons of copper that have been warehoused in China and elsewhere represent a significant chunk of standard, industrial demand for several months or longer.

But besides the anticipation of where industrial metals prices may go from here, bigger questions beg. The most pressing of these, now that China's leadership is moving to crack down on excess credit growth is this: how they think they can manage to slow the Chinese credit growth engine and still engineer the targeted, steady 7.5 percent GDP growth rates? It can't be done. Correction — it can be done, but only with an even higher adjustment cost down the road than the already steep present one.

Investment implications:

With potential pressure on Asian growth from this, looks for weakness in the Australian dollar to continue, and AUDUSD to head toward 0.8500 or lower. One-year target is sub-0.8000.

Chart: AUDUSD

Be aware there is an Australian employment report out tonight that could push the action either way in the shortest term.

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Source: Saxo Bank

Elsewhere, I would expect the Asian exporters to come under pressure, so looking to go long USDSGD with a target of 1.3000 (currently sub-1.2700).

Chart: USDSGD

The 40-week moving average (200-day m.a.) remains intact and the focus could shift to 1.30 or higher on concern of wider fallout from Asian export-demand concerns.

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Hong Kong could experience considerable growth pressures as well, so the Hang Seng Index could fall back toward 20,000 (currently just below 22,000)

Chart: Hang Seng Index future

The Hong Kong Hang Seng Index could be vulnerable from here as there is heavy exposure to mainland China in the banking system, and Hong Kong's property market is in bubble territory and the bubble could be pricked here as well as on the mainland this year.

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Originally from Texas, John Hardy graduated from the University of Texas at Austin with high honors. He has been with Saxo Bank since 2002 in various roles in FX Strategy and Asset Management. Today, John works as Head of FX Strategy.

John has developed a broad following from his popular and often quoted daily FX Update column, received by Saxo Bank clients, the press and sales traders. He is a regular guest and commentator on television networks, including CNBC, CNBC Arabia and Bloomberg. Alongside his column and media appearances, John writes regular ad-hoc commentary focusing on the major currencies, central bank policies, macro-economic trends and other developments.

John Hardy is available to comment on FX and the major asset classes from a macro perspective.

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