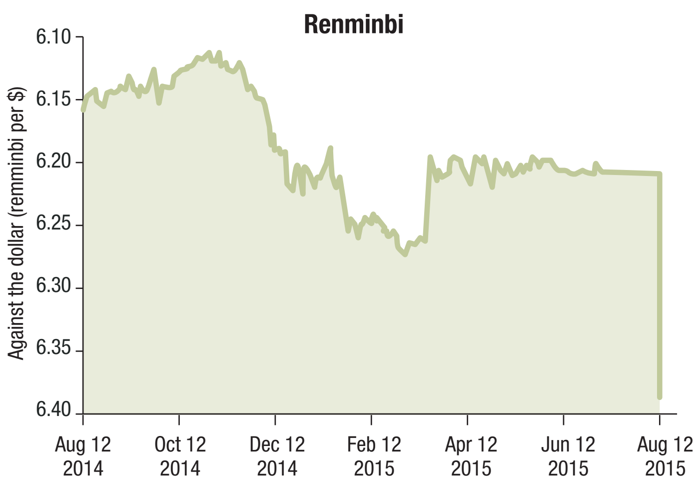
China's Currency Devaluation

Developed: August 14, 2015

The current situation

On Tuesday, August 11, the People's Bank of China (PBoC) surprised markets by raising the daily fixing price of the renminbi (or yuan) by 1.8 percent, which was an effective 1.9 percent depreciation in the value of the renminbi versus the dollar. This devaluation is the biggest one day move in the currency since 2005. In addition, the PBoC announced that future fixings would now be set by the previous day's closing spot price. On Wednesday, August 12, the PBoC followed through on that promise with an additional 1.6 percent depreciation, followed by a 1.1 percent depreciation on Thursday, August 13.



Source: Bloomberg

In our view, this is not part of a broader "currency war," nor is it a "Hail Mary" by the Chinese authorities to shore up a slowing economy. Rather, we think there are three primary motivations for this action:

1. Create a more flexible exchange rate, a requirement to qualify for admission to the International Monetary Fund's (IMF) Special Drawing Rights (SDR) basket of reserve currencies
2. Push forward a market reform agenda that was showing signs of slowing
3. Show credibility after the government's heavy-handed intervention in China's equity markets

Market reaction

The timing and magnitude of the moves surprised markets. We believe (as did many others) that China's currency would remain relatively stable in the run-up to the IMF decision in November regarding the inclusion of the renminbi in the SDR basket.

The market response was swift: assets such as equities and commodities sold off, while assets with a lower degree of risk, such as U.S. Treasuries and developed market government bonds rallied. The euro appreciated slightly, but Asian currencies such as the Korean won and Taiwanese dollar fell sharply against the U.S. dollar.

Situation analysis

While China's export competitiveness has improved somewhat by the devaluation, we view this as a convenient benefit, not the primary motivation for action. Nor do we see this as the start of a competitive devaluation across Asia.

The move was certainly large relative to the history of the renminbi peg and a significant three-day move relative to general market determined exchange rates. However, after this week's 4.6 percent drop, the renminbi is still the fourth best performing currency relative to the U.S. dollar. When weighted by China's trade with its partners, the recent move in the renminbi is very modest. Since 2005, the renminbi has appreciated more than 50 percent relative to its trade partners on a trade-weighted basis; this week's 4.6 percent drop in the trade-weighted renminbi is quite small in comparison.

China's trade-weighted currency

Source: Bloomberg and U.S. Bank

China's current account surplus has been between 2 percent and 3 percent of Gross Domestic Product (GDP) each of the last four years; that's down from 10 percent in 2007. We see this more modest amount of surplus as evidence that China is rebalancing its economy away from export dependence.

We think the devaluation of the renminbi by the PBoC is primarily a part of a longer-term process of liberalizing China's exchange rate policy on China's path to economic adulthood, and the next step will be the addition of China's currency to the IMF reserve currency basket.

To gain membership in the IMF's SDR basket of currencies, the PBoC is required to liberalize the mechanism for setting its exchange rate and move away from an implicit peg to the U.S. dollar. Otherwise, inclusion of the renminbi in the SDR would simply have the effect of "doubling down" on the dollar weighting in the basket and serve little purpose.

Possible Outcomes

Shorter term, we believe the move by the PBoC may potentially accelerate the outflow of private capital from China. This is likely negative for Chinese assets in the short term. A depreciated renminbi should be positive for Chinese firms with costs denominated in renminbi and revenues primarily in U.S. dollars. Also, we think a devaluation of the currency of the world's second largest economy will most likely add to global deflationary forces. In the near term, this could have a negative effect on commodities and corporate bond spreads, but a potentially positive effect for U.S., core Europe and Japanese government bonds, particularly long duration bonds.

In our view, the biggest short-term issue is that this development in China comes at an inconvenient time for the U.S. Federal Reserve (Fed), as the Fed considers whether to raise interest rates above an upper bound of 0.25 percent for the first time since December 2008.

Intermediate term, this may increase pressure on the political risk between China and the United States and potentially complicate trade negotiations, such as the Trans Pacific Partnership (TPP). While the currency move was received warmly by the IMF, members of the U.S. Senate were not as positive. For example, Sen. Charles Schumer (D-New York) was recently quoted saying:

> "For years, China has rigged the rules and played games with its currency, leaving American workers out to dry. Rather than changing their ways, the Chinese government seems to be doubling down."
>
> — *New York Times*, August 11, 2015

Longer term, we think this development can be potentially positive not only for China, but also for the Asian region and the world economy. First, China is the world's second largest economy. It accounts for 11 percent of global trade, and it is an ever-increasing source of financing for regional and global trade and infrastructure investment. The renminbi exchange rate is one of the last prices controlled by the central government. Freeing up the exchange rate and allowing market forces to determine the value of the renminbi should help enable China's reform agenda to continue. Second, this week's actions may likely increase the probability of a positive outcome regarding the inclusion of renminbi by the IMF. Finally, having a freely usable alternative currency to the U.S. dollar may provide Asia with additional sources of financing, enabling more rapid growth. We see all of these potential developments to be positive longer term for Chinese equities and fixed income.

Confidence in China's economic and financial reforms took a major hit with the government intervention in the equity markets, and now places the PBoC front and center. While we were surprised by the timing, because our thinking was that the exchange rate volatility would occur after the IMF decision in November, we think the actions suggest that the PBoC is placing longer-term reforms over shorter-term stability. Over the next few days, we think market attention should return to key longer-term drivers, including the pace of global economic growth (which has been solid in developed markets and somewhat softer across emerging markets) and the fate of the Fed's zero-interest-rate policy.

Investment analysis and guidance

In the near term, we expect to see little effect of the currency devaluation on China's economy. Economic growth in China is clearly slowing. Retail sales, industrial production, and fixed asset investments all slowed in July. Current monetary policies appear to support China's property market and our base case remains that China's economic growth rate will stabilize in the 6.5 percent to 7 percent range.

We believe the global economy is likely to remain on stable footing, with mixed to softer growth in emerging markets. Based on current data, we still expect the Fed to conclude its zero-interest-rate policy at the September meeting, although China's actions certainly add to uncertainty whether lift-off will occur in September or December. U.S. data releases over the next four weeks will be an important factor, especially the August employment report, which will be released on September 4. For now, we continue to recommend some moderation of equity exposures in the near term, with a preference for equity oriented hedge funds (when appropriate), and a small cash allocation.

Contributed by:
Thomas M. Hainlin, CFA
Global Investment Strategist
U.S. Bank Wealth Management