Heartwood
Investment Management

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Investment Insight

Weekly Insight

Fed policy and China's currency – should we be concerned?

Financial markets have begun to price in a higher possibility of an interest rate hike in the US this summer. The consequent rebound in the US dollar has once again shone the spotlight on China's currency, the renminbi. China's central bank this week fixed the daily reference rate at the lowest point in five years. However, unlike in August 2015, when policymakers implemented a one-off currency adjustment, and in January 2016, when the renminbi was fixed lower than the market expected, global markets appear relatively sanguine about this issue for now.

Concerns are growing, though, that likely Fed tightening (albeit modest) and the prospect of higher US interest rates are likely to start to test markets and the resolve of China's central bank in its policy of managing its currency. In particular, there are fears that the People's Bank of China could be forced to take further steps to depreciate the renminbi in an environment of US dollar strength, thereby increasing the risk of another one-off currency intervention.

Steps towards reserve currency status

We believe this scenario can be avoided and expect that the authorities will manage the renminbi's depreciation gradually and transparently - a feature that markets will learn to accept. Our long-held view has been that the Chinese authorities are not looking to aggressively depreciate the renminbi and spark a currency war to boost China's export sector, which would risk both severe capital flight and economic instability.

Instead, we believe the Chinese authorities are looking to gradually depreciate the renminbi over time, as part of policymakers' broader strategic objective to further integrate China's economy and markets into the global financial system. Indeed, the renminbi's inclusion in the International Monetary Fund's Special Drawing Right in December 2015 represented an important step towards China's currency assuming international currency reserve status. In particular, we expect the renminbi will be increasingly viewed as an alternative currency to the US dollar in Asia, as the domestic market infrastructure in China is developed, creating deeper and more liquid local bond and equity markets.

Of course, this year some of the pressure has been taken off the renminbi to depreciate as the US dollar has weakened. However, the renminbi remains expensive on a range of valuation measures. It has appreciated by nearly 20% versus the US dollar over the last ten years to 26th May, 2016, and 44% on a trade-weighted basis for the same period.[1] It is also 30% overvalued on a real effective exchange rate basis {Source: Bank of International Settlements}.

A change of tack from the Chinese authorities

Finally, recent policy initiatives have focused on fiscal stimulus and an easing of credit conditions, and the authorities appear to be moving away from currency interventions. There has also been some improvement in the transparency of policymakers' communications with markets in their efforts to avoid unwanted surprises, such as we saw last August and in January of this year. Hitherto, this change of tack from the Chinese authorities appears to be working and we have seen the policy of gradual currency depreciation playing out in 2016. We expect that this trend will continue and also believe that China's currency performance will be assessed not just exclusively against the US dollar, but also versus a broader range of currencies.

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1. Morgan Stanley CNY Trade Weighted Index, Bloomberg as of 26th May, 2016.

Risk Warnings:
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