Renminbi Inclusion in SDR basket

Stratton Street

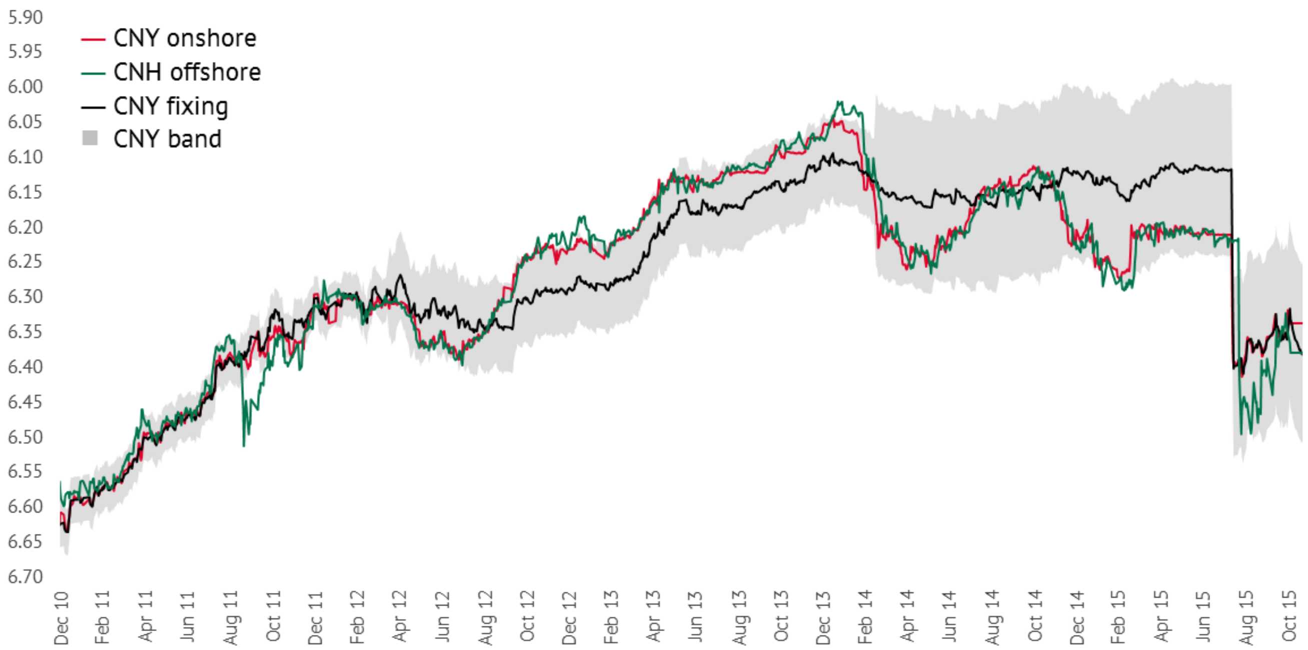
On the 8th anniversary of the original Renminbi Bond Fund ("RBF"), the Chinese renminbi should finally receive the official global reserve status we have been patiently anticipating.

The number 8 in Chinese culture represents luck, fortune as well as “strong intuition and insight”. For us therefore it seems particularly fortuitous that Monday’s anticipated inclusion of the renminbi into the SDR arrives the same day as the 8th anniversary of our Renminbi Bond Fund.

Launched in 2007, before any other fund of its kind and well before the launch of the Dim Sum market itself, RBF aimed to create a sensible high grade asian bond product with exposure to the appreciation of the Chinese renminbi. The latter on the premise that this highly competitive superpower - accounting for their large reserves, current account and trade surpluses, inflationary pressures and welfare/prosperity aspirations - would pursue a lofty ambition of equal global reserve status with the US dollar.

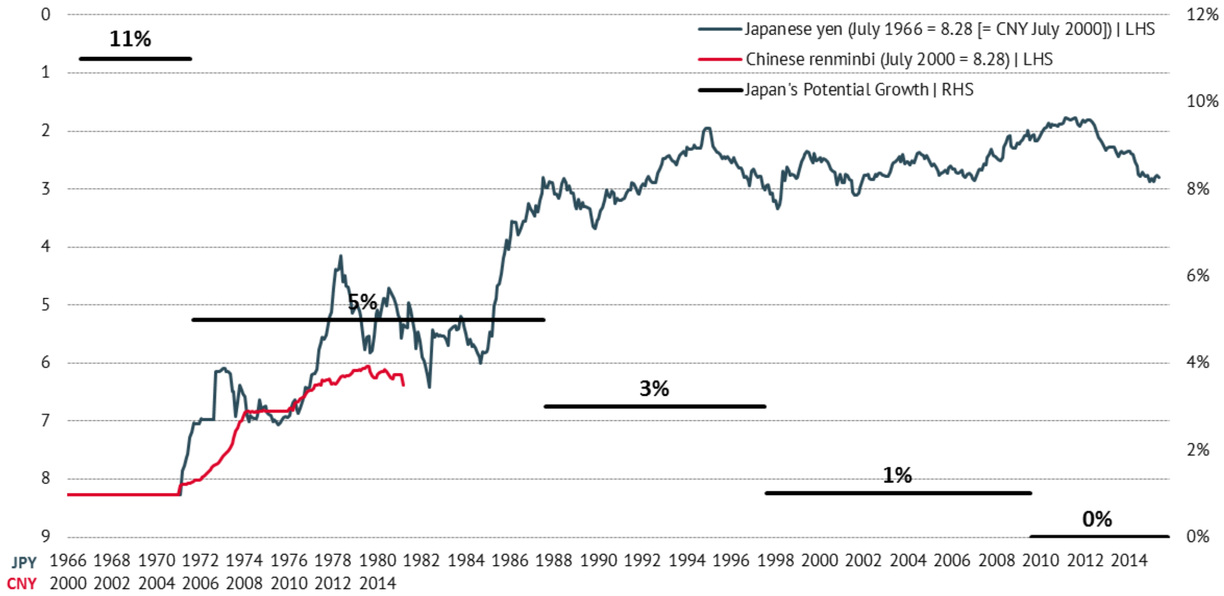
For the best part of the past decade China has been clear in this ambition in both their rhetoric and accomplishments; working through roadmaps and IMF checklists systematically, not without the odd roadbump, but clear in their direction. SDR inclusion will be a major milestone and indeed a worthy accomplishment but certainly not the end of the road. Noting that during Japan’s industrialisation the yen appreciated 400% over 40 years from the early 70's even as its growth halved in each of those decades (see chart 2); one cannot simply conclude that the renminbi is out of steam simply because growth and exports have declined. The renminbi’s 23% appreciation over the past decade, since the dollar peg ended in 2005, still leaves it 4% weaker than the 5.8 level it stood at in 1993 before the forced devaluation (to 8.8) and four times the 1.6 level it was back in the early 80's (see chart 3). On a longer term view the currency still seems undervalued and under-owned.

1. Chinese renminbi onshore and offshore



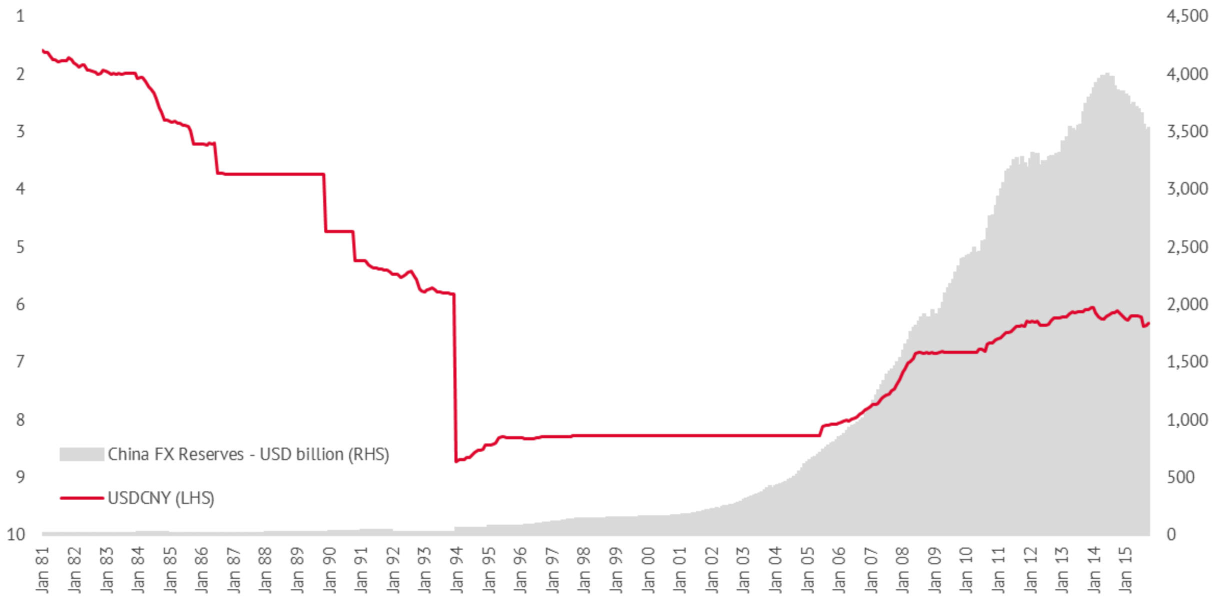
Source: Bloomberg

2. Chinese renminbi vs Japanese yen and growth over four decades



Source: Bloomberg

3. Chinese renminbi and reserves pre and post US dollar peg



Source: Bloomberg

Since the inception of RBF in November 2007 the renminbi has appreciated 16% against the dollar despite recent dollar strength and investor misunderstandings about Chinese policy. This compares to currencies like the real, ruble and lira which are down 52-62% over the period. Many of the underlying factors that have driven the appreciation of the renminbi thus far are still ongoing. And with the current development it is possible to make some sensible forecasts for further medium term progress.

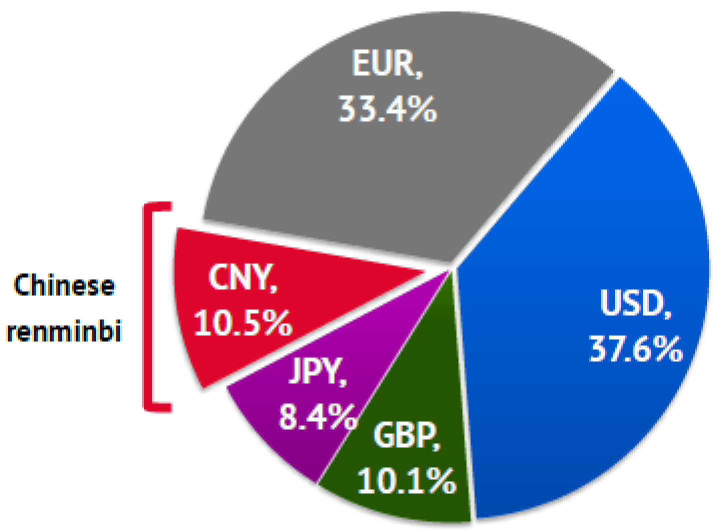
China's weighting in anything from financial indices to corporate and central bank reserves has been constrained by capital controls which will continue to be relaxed. Currently we estimate that the Chinese renminbi only represents around 1% of global reserves. This is miniscule when compared to the 64% share of global reserves for the US dollar and 20% for the euro. Although much smaller than these two, sterling represents around 4% of global reserves with the Japanese yen accounting for around 3.5%. Given the importance of China in the world economy, central banks holdings of renminbi can only increase from here.

The expected announcement on Monday of China's entry into the exclusive SDR club, with a weight similar to that of the UK and Japan, will likely mean inflows of around USD 150 - 200bn from central banks (USD ~30bn directly to fulfil the SDR requirement), based current holdings of sterling and yen.

Our Expectations for the Announcement:

- Inclusion of the renminbi as the 5th currency in the SDR[1]
- Renminbi weighting of around 10% owing to a likely change in IMF staff calculations and recent statements from IMF staff. (see chart 4 - Back in 2012 we began forecasting that the renminbi would attain a 10.5% weighting in the forthcoming review) If they were to use existing methodology[2] the figure would be closer to 14%.
- Interest rate calculations will continue to be set weekly and the proposal to switch to daily will be postponed again. This will make it easier for China to comply with requirements as instruments for estimating interest rates are vital to maintaining the SDR basket. This association was made directly in an IMF paper in July.

4. Stratton Street's SDR forecast from 2012



Source: Stratton Street Capital LLP calculations

Transition and a Turning Point

Monday's announcement should mark a turning point in Chinese domestic and market sentiment as China begins to reap the rewards of this difficult transitional year. As central bank assets begin to flow in, further capital inflows should be expected, placing ongoing pressure for continued renminbi appreciation. The SDR 204bn (which equates to USD282bn) in SDR reserves represents only around 2.5% of the USD11.5tn in total global foreign exchange reserves.

Simultaneously, capital outflows should wane as a proportion of this was a short term consequence of easing regulations (i.e. funds that had been waiting to relocate rather than a substantial shift in domestic or global sentiment). Furthermore, Global, Asian and emerging indices, for both bonds and equities, will see increased weights with investors needing to continue to increase allocations to China as they remain vastly underweight given the importance of China in the global economy. Corporate entities and countries with significant business with China will increasingly follow the example of the SDR and retain some reserves in renminbi as trade settled in renminbi continues to increase.

The Chinese authorities are likely to respond to the increased demand by further increasing international investors' ability to access the domestic bond market. In what is likely to become a self-reinforcing, virtuous circle, the opening up of the bond market will boost the usage of renminbi and reserves in the currency could surpass the current combined allocation of sterling and yen before the next IMF SDR review in 2020. By that date the allocation to the renminbi in the SDR basket would likely have grown to 14% - 16%, in just five years.

Although investors are always faced with uncertainty, one thing is pretty certain; in the future investors will hold more renminbi and with short rates in China around 3%, early-adopters will likely reap the greatest rewards.

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1. In 2011 IMF, "agreed that the number of currencies in the basket should not be prejudged, but should remain relatively small as the SDR evolves." The decision to reduce the basket from 16 to 5 in 1976 (implemented 1980) was based on (amongst other things) challenges to gauge interest rates for all the currencies - not a problem for existing SDR constituents. The underlying desire to have the SDR reflect global trade accurately and the recognition that the yen and sterling are of similar importance makes us believe that neither will be excluded on account of the renminbi's inclusion. The SDR will then be representative of around two thirds of global GDP.

2. IMF states "artificial adjustment to the [currency] weight would constitute a fundamental change, thereby requiring an 85 percent voting majority" The historical decision to stick to the weighting methodology and not to scale back the dollar weighting when the basket was redefined in the 80s leaves us uncertain as to whether the same approach will be taken with the renminbi. Changing to the proposed methodology, which uses different metrics for assessing trade and financial importance, seems likely but is far from certain. With the renminbi considered viable it would leapfrog the sterling and yen well into the middle of the basket should the methodology not be revised.

Contact details:	Ben Day, Head of Sales
Email:	Benday@strattonstreet.com or Sales@strattonstreet.com
Address:	Stratton Street Capital LLP, 200 Aldersgate Street, London, EC1A 4HD
Telephone:	+44 (0)20 7766 0806 or +44 (0)20 7766 0800
Website:	www.strattonstreet.com
