2016 Renminbi Outlook and Beyond

Before focussing on the renminbi it is worth understanding the framework under which we think about currencies. Whilst many factors influence exchange rates, the dominant factor in our analysis is the net foreign asset position of a country.

Definition of Net Foreign Assets

By definition, a country that runs a current account deficit has to finance this by borrowing from abroad. This is due to the fact that the capital account and current account must always sum to zero. Conversely, countries that run current account surpluses are forced to invest abroad in order to maintain this accounting identity.

Traditional balance of payments accounting defines net foreign assets as follows;

Net Foreign Assets (NFA) = Cumulative Current Account (CA)

However, these assets will rise and fall in value over time and so net foreign assets is frequently defined so as to include valuation effects;

Net Foreign Assets (NFA) = Cumulative Current Account (CA) + Valuation effects (VE)

It is helpful to think of the current account as a flow concept and net foreign assets as a stock concept. The current account measures the flow of assets for the country as a whole, and so captures the build-up of assets or liabilities not just of the government, but also the debt or asset accumulation of corporates, banks and individuals. Consequently, the concept of net foreign assets measures the aggregate savings or borrowings of the entire country, not just government debt.

The problem with adjusting net foreign assets for valuation effects is that valuations can change very rapidly and are difficult to measure directly. However, Belkar, Cockerell and Kent (2007) note that in the case of Australia, the first estimate of net foreign assets matched very closely the cumulated current account deficit (as a share of GDP) for the previous 120 years. So for ease, cumulative current account positions are often used as a simplified estimation of net foreign assets.

Why are net foreign assets an important driver of currencies?

The current account is most easily thought of as the sum of the trade balance plus income generated from the assets held abroad. However, it also measures the balance between national savings and national investment.

Current account (CA) = National Savings (NS) - National Investment (NI)

Consequently countries that save more than they invest run current surpluses and vice versa. Net foreign assets are the sum of these current account balances and it is tempting to assume that it is the current account that is more important as it is a flow concept which seems to link better with currency movements. However, this is incorrect; net foreign assets are more important.

In **"Dollars, Debt and Deficits : Sixty Years After Bretton Woods"**, compiled by the Bank of Spain and the IMF, the authors provide a simple explanation as to why net foreign assets, rather than current accounts, are more important;

'Moreover, there is an obvious interplay between the financial and trade accounts that provides another link between net foreign asset positions and exchange rates: a long term debtor may require real depreciation in order to generate the trade surpluses that are the counterpart of sustained income outflows.'

The inverse of this is that countries that have positive net foreign assets will need depreciation in order to accommodate the needs of debtors.

This is an important point which we will come back to later.

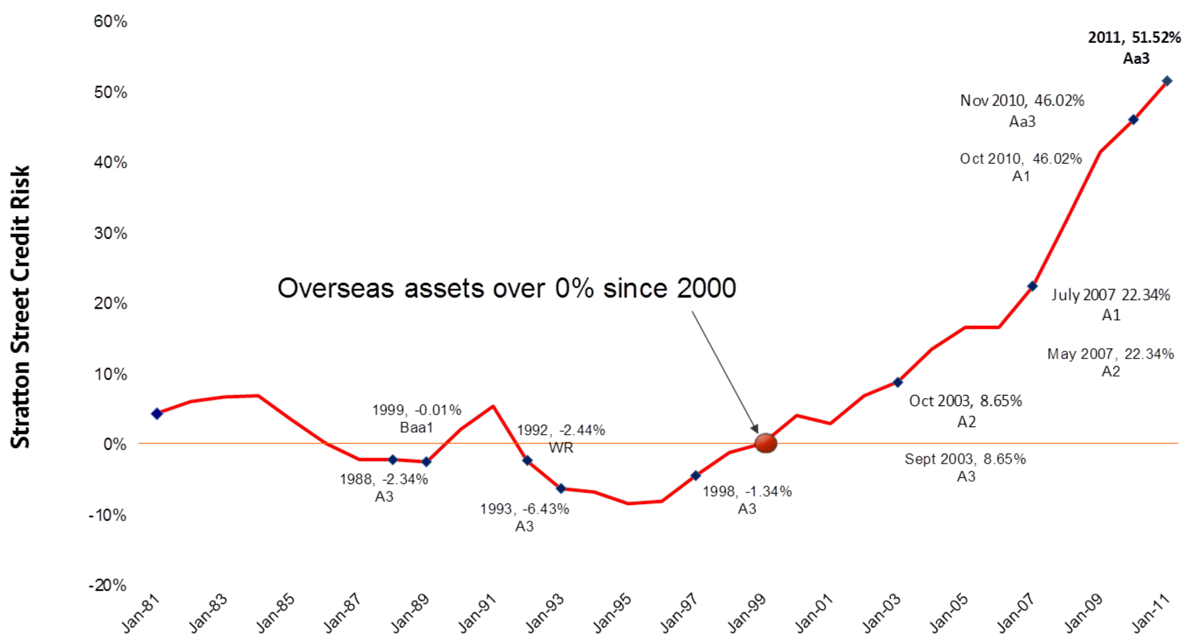
Other factors to consider

Whilst a dominant factor net foreign assets are not the only influence on exchange rates. Other factors that are important drivers are growth, inflation and interest rates but all of these must be considered RELATIVE to the rest of the world. Finally, the extent of undervaluation or overvaluation of the exchange rate is also important. For the latter it is most useful to think of the current exchange rate relative to purchasing power parity.

China's high savings rate

China has one of the world's highest savings rates at just under 50% of GDP. We saw earlier that the current account is the balance between savings and investments and so it should come as no surprise that China runs a current account surplus. Equally, it should be clear from the earlier discussion that these surpluses are helping to boost China's net foreign asset position.

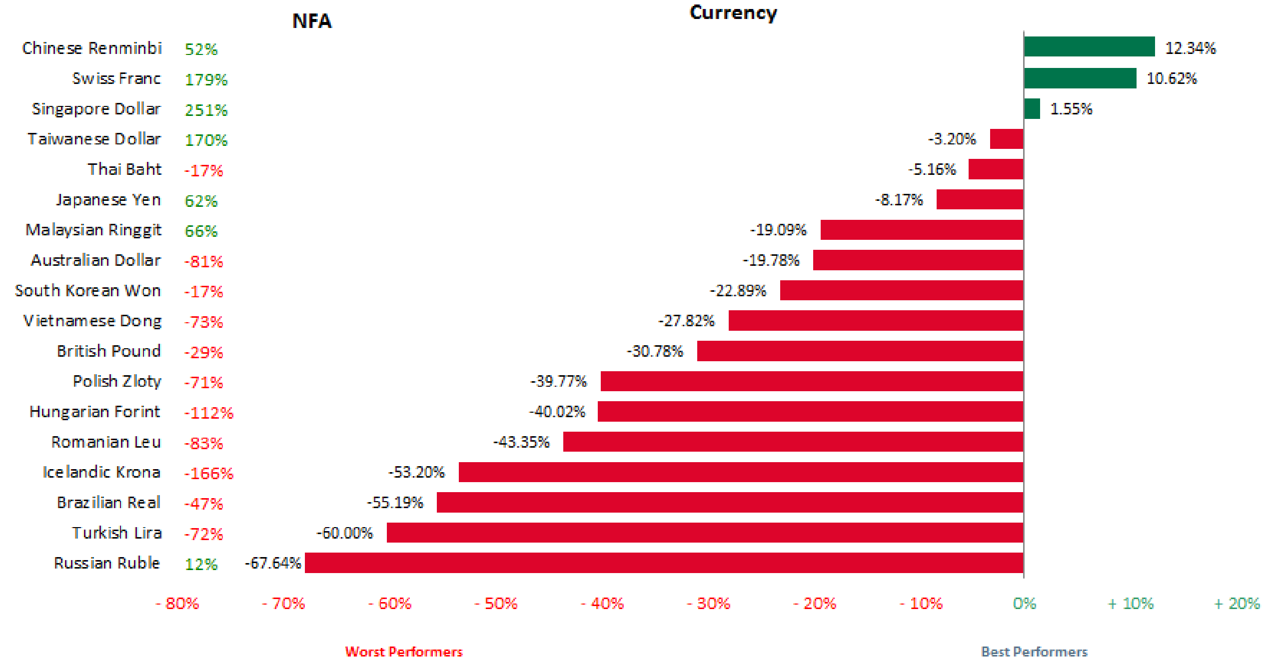
China - Net Foreign Asset Analysis



Source: IMF, Stratton Street Capital LLP calculations to end Dec-2011

If net foreign assets are an important long term driver of currencies then the Chinese renminbi should be amongst the strongest currencies over the past few years. The chart below shows the spot return versus the dollar with each country's NFA position. The fact that the top four performing currencies are all creditors lends weight to the argument that NFA is an important long term driver of currencies. It is also no surprise to us either that the renminbi tops the table in terms of performance.

Currency Shifts Support NFA Analysis - 2007 to 2016

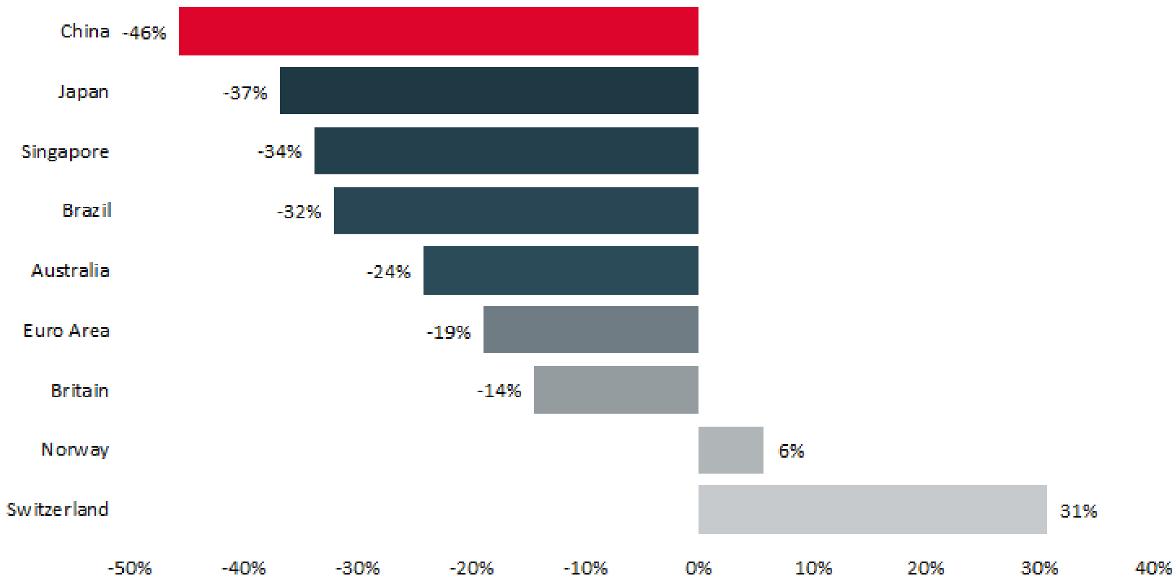


Source: (FX) Bloomberg from RBF inception (end Nov-2007) to end Jan-2016, (NFA) Stratton Street Capital LLP calculations (2011) and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti (2007)

Purchasing power parity

Valuations also play an important role in driving exchange rates and purchasing power parity is a useful concept; unfortunately it is frequently misunderstood.

The chart below shows a selection of major currencies versus PPP using the Big Mac Index for convenience.



Source: The Economist, as at Jan-2016

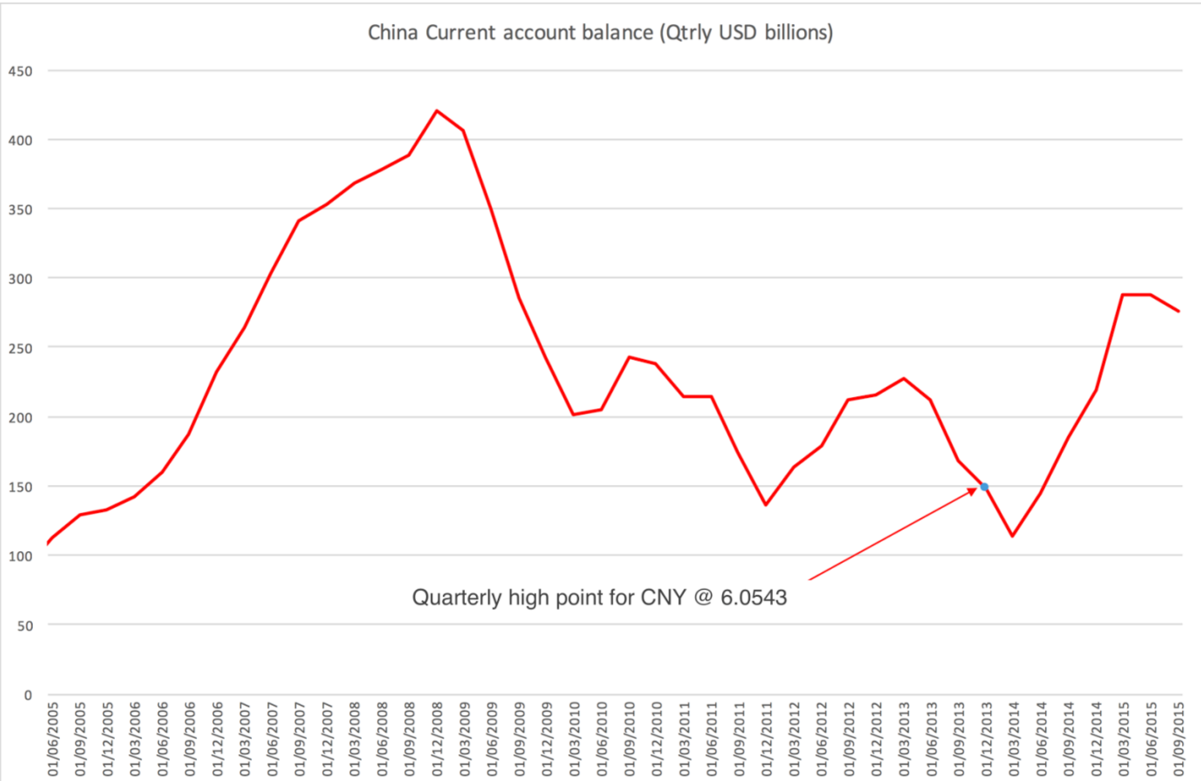
On this basis, the renminbi is currently 46% undervalued. However, this does not mean that the currency should appreciate purely because it is undervalued in PPP terms as is commonly assumed. Purchasing power parity measures the relative prices of non-tradeable goods of which a Big Mac is just one example. Another example would be the price of haircuts.

However, the price of non-tradeable goods in wealthy countries will be higher than in poor countries leading to the result that haircuts will be more expensive in rich countries than in poor countries. The consequence is that rich countries should have overvalued exchange rates versus PPP and poor countries should have undervalued exchange rates.

The IMF estimates US GDP per capita at PPP to be USD 55,904 and USD 8,280 for China. Clearly, as the poorer of the two countries, China should have an undervalued exchange rate in terms of PPP. If we start with the premise that China's relatively low income per head means that the renminbi should be undervalued in PPP terms but that China is likely to grow faster than the United States, then it is reasonable to assume that the renminbi will be less undervalued in PPP terms in the future than it is today.

But how undervalued should it be today? This is a complex question but if we use the fact that countries with positive net foreign assets will see currency appreciation, then the simplistic answer is that the exchange rate will need to reach a level at which the net foreign asset position and the current account are both at zero. However, China's net foreign assets currently stand at 52% of GDP, so to get to a balanced net foreign asset position this would require China to run a current account deficit for many years.

An intermediate step would be the exchange rate that causes the current account to be in balance. The chart below shows China's current account balance



Source: Bloomberg

Shortly after the renminbi peaked in late 2013 the current account surplus ballooned from a low of USD 114.3 billion to USD 275.9 billion! This is by far the world's largest current account surplus and the surplus equates to the annual GDP of Finland. In fact, China's current account surplus is the largest surplus ever recorded by any country since records began.

Where is the current account headed?

China has undergone a remarkable transformation over the past thirty years. From being a poor and largely agricultural economy China is now one of the world's industrial powerhouses. The high growth rates of previous years were achieved on the back of productive investment and relatively low wages. China is already the world's largest exporter and there are limits to how much further China can boost exports in an environment of weakening global growth.

Stratton Streets Global Growth Model

Source: Bloomberg, Stratton Street

The Chinese government is acutely aware of this. Every five years the government publishes a five-year plan, or guideline as they are now known, which lays out the goals of the government over the next five years. One of the aims of the 12th five-year plan was to achieve an annual growth rate of 7% for the period 2010-2015 with the Chinese economy actually growing at 7.8% over that period.

The latest five-year plan won't be fully published until March 2016 but a communique issued in October gave us the broad outline. Aside from the specifics, one of the key objectives is to shift from a low-skilled manufacturing economy to a high-skilled manufacturing and services based economy, i.e. *more domestic consumption and less export oriented*. This is not a new goal, it is an extension of the goal set in the prior plan. China has one of the highest saving rates in the world of ~50% of GDP and this untapped source of demand can help boost growth rates over the next few decades. This, combined with a more highly skilled workforce is how China plans to avoid the middle income trap experienced by countries when rising wages eventually lead to a loss of export competitiveness.

So let's return to our definition of the current account;

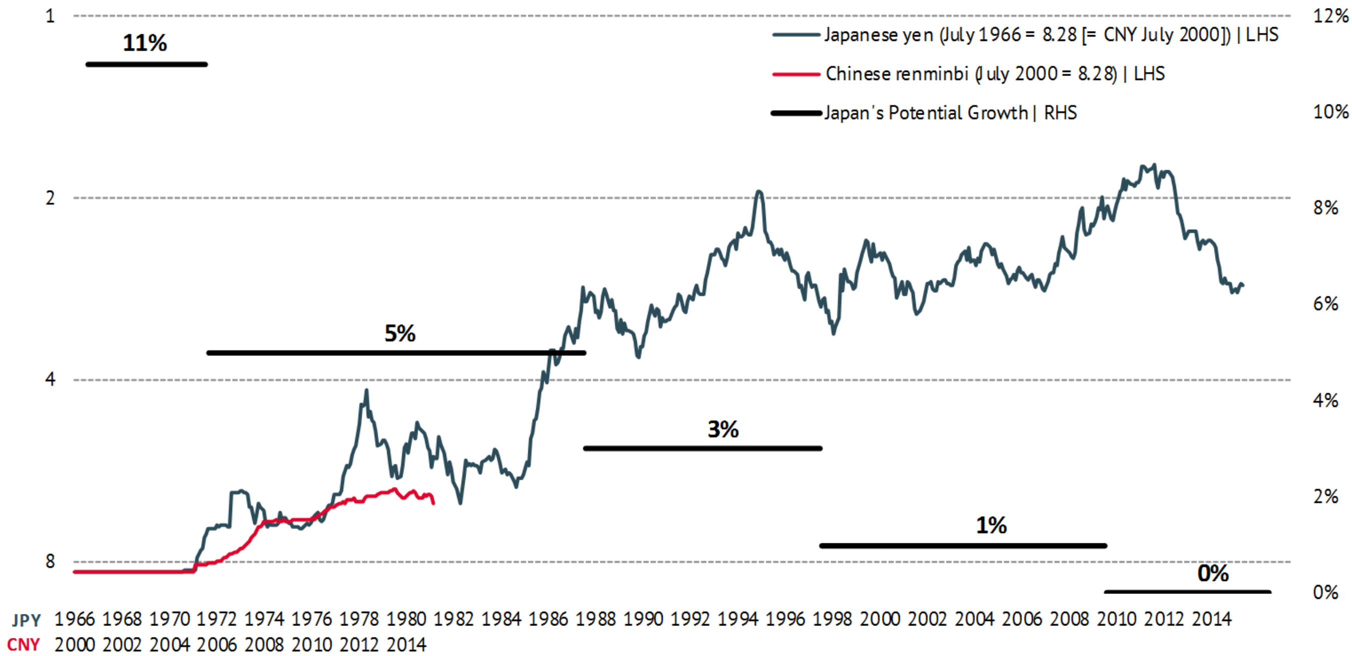
Current account (CA) = National Savings (NS) - National Investment (NI)

Whilst in the longer run we would expect the savings rate to decline if the government succeeds in promoting greater domestic consumption, in the shorter run, the shift away from exports will go hand in hand with a reduction in investment. In the perverse world created by years of quantitative easing the world has serious overcapacity in many industries and China is no exception to this. However, the shift to lower investment, whilst eminently sensible in the long run, will result in the current account shifting further into surplus.

At the same time, *greater domestic consumption would be encouraged by a **stronger**, not a weaker exchange rate*. During a rebalancing of the economy, not only would a weaker exchange rate result in a ballooning of the current account surplus, but it would also export deflation to the rest of the world. China, as a major oil importer, also benefits from lower oil prices further boosting the current account surplus.

The bottom line here is that China's goals are inconsistent with a weakening exchange rate.

In our view, the long term path for the renminbi is likely to be similar to that of the Japanese yen. Japan successfully avoided the middle income trap by shifting to high value added production.



Source: (FX) Bloomberg and Stratton Street calculations, end Nov-2015. (Potential Growth) Fenwick Advisers estimates

Whilst most fundamental factors point to strength in the renminbi, that is not to say that the currency will never go down. The key to understanding China's exchange rate policy is to recognise that China has managed its currency against a basket of trade weighted partners since the currency was unpegged in 2005. At the time the basket weights were not disclosed but recently the current weights were published for the first time. Back in 2005 we speculated that the US dollar represented around 80% of the basket, whereas

today the US dollar weight is just 26.4%. The other major components are EUR 21.39%, JPY 14.68% and HKD 6.55% with other Asian currencies making up the bulk of the difference. Recently the PBoC has also announced that "stability against the basket will be enhanced" although noting that there is not a "tight peg to the basket" which implies a band within which the currency will be allowed to fluctuate. We speculate the band remains at 2%.

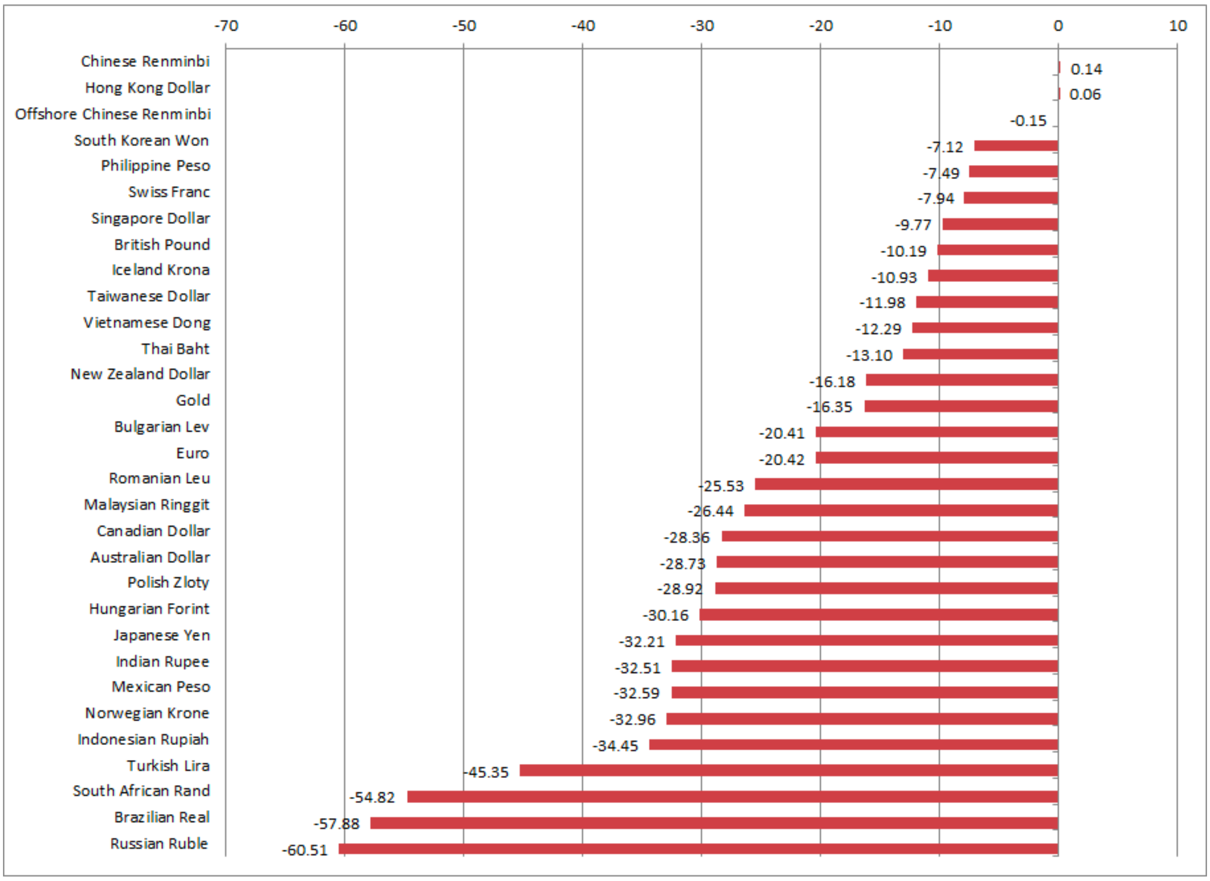
Going forward we expect the Chinese renminbi to follow this basket (although at present we have insufficient data to prove this is the case) with a degree of divergence being tolerated. Leaving aside Chinese policy for one moment, the basket mechanism means it will be more difficult for the ECB and the BoJ to weaken their currencies as the response from the Chinese would be allow the renminbi to weaken, negating some of the advantage to Japan and Europe.

Our expectation is for the dollar to soften over the course of 2016. Although most investors are focussed on non-farm payrolls, unfortunately employment and unemployment are lagging indicators. At Stratton Street we are more interested in what will happen in the future and so we are therefore more focussed on the weak US ISM manufacturing figure which at 48.2 was not only the weakest reading in six years, but also below the level recorded when the US last entered recession in December 2007.

We are not yet forecasting a US recession, but are concerned about the ultimate consequences of the Fed raising rates with manufacturing at already depressed levels. Never before has the Fed started a tightening cycle with the ISM below 50 (the average of the past three is 57.2) which suggests to us that rate increases will be very modest. The median estimate from the Fed is for 4 more rate hikes this year to give a target range of 1.25-1.5% by the end of 2016. We are more pessimistic on the outlook for growth and expect a Fed Funds rate of 1% at the end of the year at most. If we are right, then we will start to see a resumption of the trend appreciation of the renminbi as it tracks the basket which has quite a low US dollar weight.

Which brings us on to perhaps the most frequently misunderstood part of the renminbi equation; interest rates. Over the past five years, despite the strength of the US dollar, the renminbi is the only currency that has matched the performance of the US dollar.

Currency returns versus US dollar 28th January 2011 to 29th January 2016



Source: Bloomberg

However, Chinese interest rates have been above those of the US over that period with the result that **holding the renminbi would have generated a return of 13.36% over the past five years.**

The interest rate differential between faster growing economies and slower growing developed countries is often overlooked by investors who often miss out on opportunities. Even with growth slowing to 6.5%, Chinese rates are likely to be above those of the US for the foreseeable future and the total return from holding renminbi is likely to exceed that of the US for many years. Currently Chinese short rates implied by 1 month forward rates would boost returns by 5% per annum (assuming these persist for 12 months) which is a significant cushion. Over time, investors will become more familiar with the renminbi and weightings are likely to increase. The *Chinese bond market is already the third largest in the world*, so any increase in the speed of opening this market to international investors will only serve to accelerate this process.

Positive Reasons to Hold Renminbi

1. Undervalued currency in PPP terms.
2. Faster economic growth than most countries.
3. Large positive net foreign asset position.
4. Merchandise trade balance in excess of USD 600 billion per annum.
5. Projected current account surplus in excess of USD 300 billion per annum.
6. Significant interest rate differential between China and US, currently approx 5% p.a.
7. Under-owned by international investors.
8. Composition of basket means renminbi will strengthen on US dollar weakness.

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