Special Report: PBoC Fixing Policy

August 2015

Stratton Street

On Tuesday, 11th August 2015, the Chinese central bank shocked global markets by lowering the renminbi's daily "reference rate" to the USD; by an unprecedented 1.86 per cent.

It also pledged to set the reference rate (around which the currency can rise or fall by 2 per cent) closer to the renminbi's previous close; which potentially raised market expectations for a more volatile trading environment for the renminbi. This clearly has raised questions as to the motivation of the PBoC and the long term impact of the value of the RMB.

Below you will find a summary of Stratton Street's thoughts on the events of the last few days both in the short and medium / long term. We have also compiled additional Q&A that you may find of use.

It is important to note that we believe:

- *This is a positive in the long run for RMB and China as it helps their case for SDR inclusion (one of the primary drivers for the correction)*
- *The change to the fixing mechanism will make it more market driven*
- *There is no change to our long term thesis on renminbi appreciation*

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Summary

- **The renminbi depreciation was the natural result of the significant shift in PBoC policy to adjust the renminbi fixing in line with the previous close effectively freeing the currency to market forces yet retaining its ability to avoid shocks from when markets are "distorted".**
- **August 13 PBoC statement strongly confirms that the underlying rationale is not to promote exports but for meeting internationalisation requirements and aspirations to be included in the IMF's SDR this year. (link: PBoC Statement 13 August 2015)**
- **The renminbi is already at a comfortable level for the PBoC and a long term path of appreciation is still expected.**
- **Longer term comparison of China with the industrialisation of Japan points to the potential scale of further renminbi appreciation over the coming decades even as growth slows.**
- **The move has had a strong positive impact on the bond market, especially in higher grade credit and puts further strain on inflation and growth in the west which is broadly negative for stocks and positive for bonds.**

Exchange rate reform

In the short run, markets have interpreted the recent change in exchange rate policy as being one aimed at gaining export competitiveness. We do not believe that this was the motivation at all; it has more to do with the potential inclusion of the renminbi in the IMF's SDR basket. One of the criticisms of China's FX policy is that the exchange rate is not driven by market forces. Until recently, the central bank has set the fixing each day around which the renminbi can float in a band of +/-2%; now the fixing will be based on market pricing. To facilitate this change the PBoC needed to move the fixing to the (lower) market rate. This created market uncertainty with some assuming that China was starting a period of competitive devaluations. For example Reuters, reported that there is pressure from within the government to engineer a devaluation in a bid to boost exports, however in a press conference on August 13 the Chinese central bank deputy governor called such reports "total nonsense" and "completely groundless" going on to make the following comments;

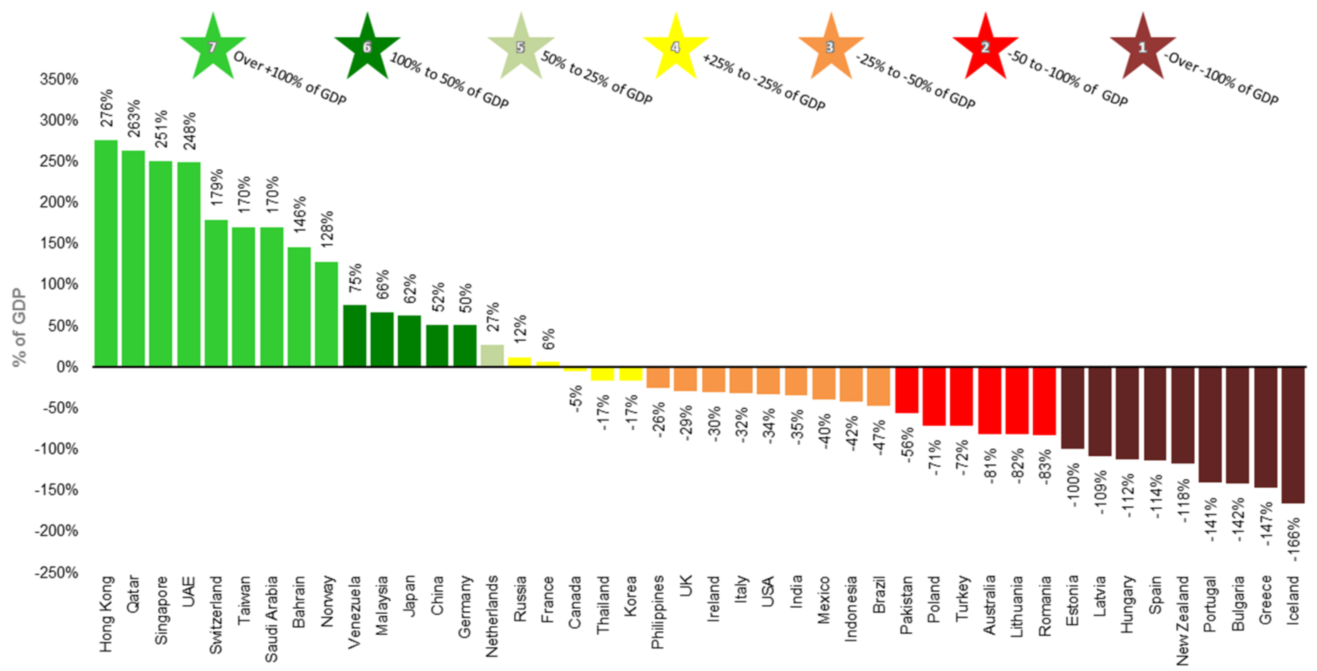
- PBoC is able to keep the renminbi basically stable
- Rigid renminbi rate not sustainable, not suitable for China
- Renminbi could return to appreciation in future

Stratton Street's View

Rather than focus on the very short term, investors should be looking at the longer term prospects for the renminbi. Our long term view of the renminbi is driven by a combination of fundamental analysis and of government policy. Both support the idea that the renminbi is headed for a sustained period of appreciation which is likely to last several decades.

There is plenty of evidence from academic research that net foreign assets is an important long term driver of currencies. By definition, the net foreign assets of a country is largely determined by its cumulative current account position. These assets and liabilities change in value over time, which needs to be adjusted for, but the easiest way to think about the concept of net foreign assets is that countries that run current account surpluses are getting wealthier and those that run current account deficits are getting poorer.

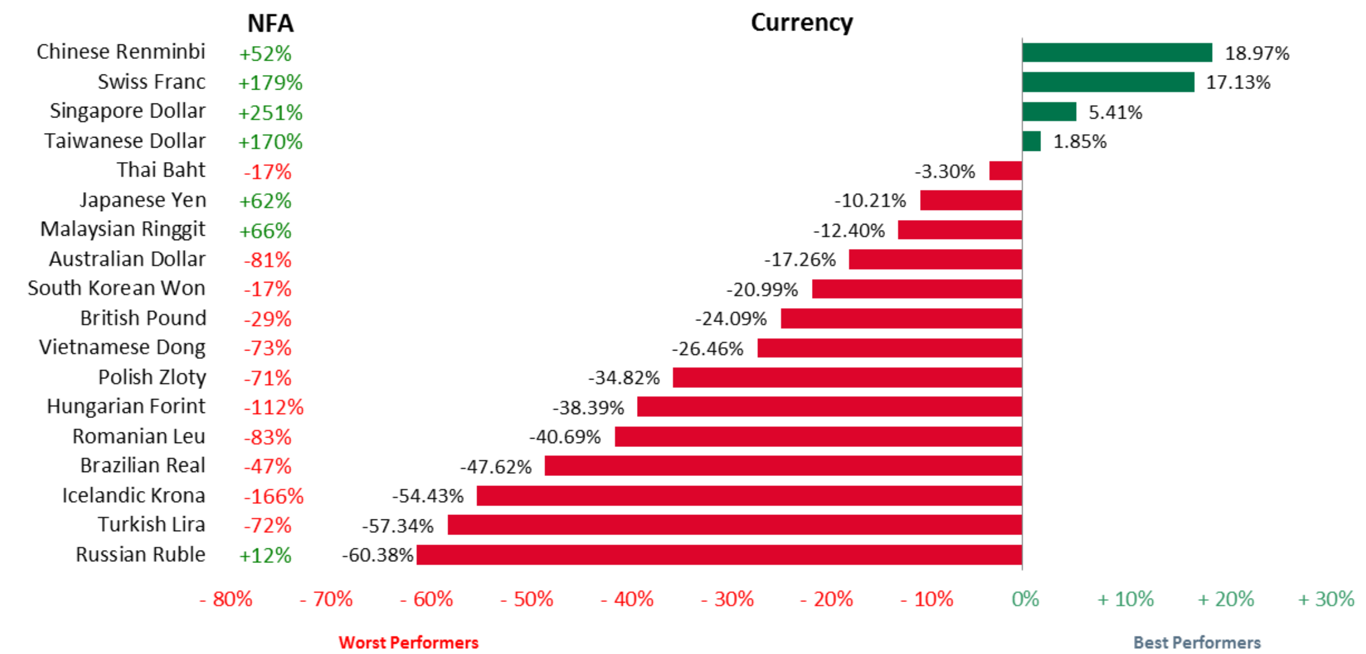
Stratton Street's Net Foreign Assets calculations as % of GDP



Source: Stratton Street Capital LLP calculations (2011) and extended version of the External Wealth of Nations Mark II database developed by Lane and Milesi-Ferretti

In the absence of portfolio flows, the only thing that would be left to drive the exchange rate would be the current account, with countries running surpluses seeing upward pressure on their exchange rates and the deficit nations seeing downward pressure. In the run-up to the 2008 financial crisis the carry trade was a dominant theme whereby the providers of capital sought out the higher interest rates offered by debtor nations. However, from late 2007 onwards we saw this process going into reverse as capital flows changed direction, leaving the debtor nations and putting upward pressure on the exchange rates of the creditors. In this deleveraging cycle, creditors are seeing upward pressure on their exchange rates through their current account balance whilst at the same time experiencing capital inflows. This is a powerful combination and helps explain why countries with net foreign assets have seen currency appreciation and vice versa.

Net Foreign Assets and currency movements against the dollar December 2007 to July 2015



Source: (FX) Bloomberg from RBF inception (end Nov-2007) to end July-2015, (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)

China, as a major creditor, has seen a significant appreciation against the US dollar over this timeframe.

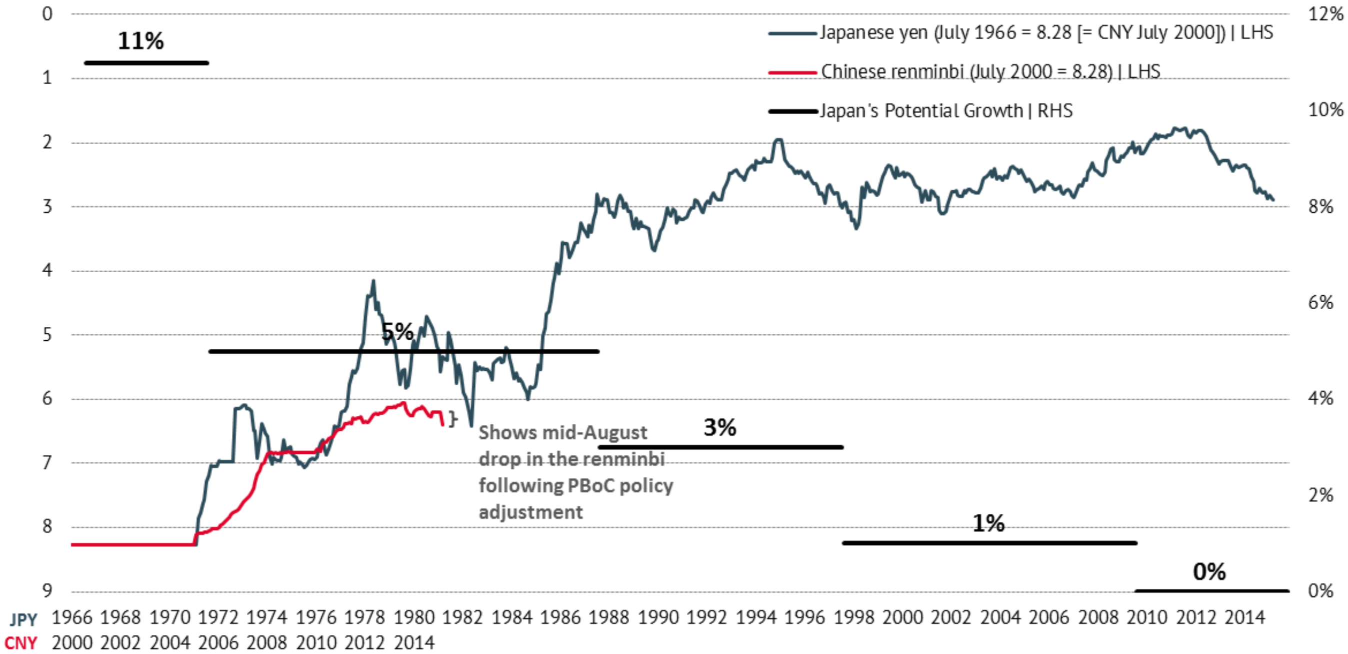
Despite the Western press arguing that China wishes to devalue to regain some lost competitiveness, this neither makes economic sense, nor is it government policy. Whilst a weaker exchange rate may make the cost of export goods slightly more competitive unless this is associated with an increase in export volumes, net exports will actually fall in value. For instance, if the renminbi were to decline by 5%, then export volumes would need to increase by 5%, just to keep the value of exports constant. Clearly if volume increases and can exceed the decline in the exchange rate, then this would be a net positive, but as China is already the world's largest export nation, this is extremely difficult to achieve. With a booming global economy, this may work, but with subdued global growth this becomes virtually impossible. Devaluing the exchange rate does not help the Chinese economy at this stage of the cycle.

It is also counter to government policy. The Chinese government is striving to rebalance the economy away from an export driven one, towards a consumer and service economy. The reasons for this are relatively straightforward. China's savings rate is just under 50% which provides plenty of scope to boost GDP by encouraging greater domestic consumption. At the same time, given that the current account balance is the difference between savings and investments, higher domestic consumption will lower China's current account surplus. This is important because global imbalance remain very large. The flip side of China's current account surplus is deficits in other parts of the world. As we know from the experience of Greece, countries cannot run current account deficits in perpetuity without eventually being forced to default. This is identical to saying that China can't run a current account surplus forever, and higher domestic consumption is one of the routes to achieving this.

The shift away from an export led focus is also aided by an APPRECIATION of the renminbi as this provides greater spending power to consume goods produced abroad. In our view the Chinese are following the right steps and the opening up of China's capital markets will ultimately lead to international investors holding more renminbi over time. Foreigners account for 60% of the US Treasury market but only 2.8% of the Chinese Bond market which at USD 5.9 trillion is the third largest bond market in the world. In due course this will change, with significant inflow into renminbi likely over the next few years.

We remain of the view that the long term appreciation path of the renminbi will be similar to that of the Japanese yen in the period from the early 1970's during which time the slowing of Japan's growth rate went hand in hand with a trebling of the exchange rate.

Chinese renminbi now compared to the Japanese yen during its industrialisation



Source: (FX) Bloomberg and Stratton Street calculations - 13Aug-2015. (Potential Growth) Fenwick Advisers estimates

Conclusion

- **The short run weakness in the renminbi provides an excellent entry level for investors who are underweight renminbi.**
- **The renminbi is already the fifth most actively traded currency in the world and will become a major reserve currency at some point over the next few years, aided by its inclusion in the IMF's SDR basket.**
- **Investors are significantly underweight Chinese assets owing to the lack of inclusion in many major indices currently.**
- **With Chinese interest rates roughly 2-3% higher than those in the US, a stable renminbi equates to gains in US dollar terms from holding renminbi.**

Additional Q&A

In the medium term, as the authorities allow the RMB to trade more freely, will market forces push the currency to depreciate further?

The PBoC have already stated that they are willing to accept higher volatility and depreciation in the short-term, but are prepared to intervene to prevent medium- to longer-term falls in the renminbi – whilst they maintain a "market-driven" methodology. Clearly we see price momentum at work and there are likely more sellers in the market – however with the largest reserves in the world, the PBoC is a buyer that can offset price momentum / retail sellers. Obviously in today's global marketplace speculators/hedge funds will take any opportunity to "run markets" following an initial move thereby exaggerating that move. The PBoC will be well aware of this and will be intervening to curtail such activity. They have plenty of firepower with USD 3.7tn in foreign exchange reserves.

When currencies start depreciating, there is usually a self-reinforcing feedback loop that drives further depreciation?

We firmly believe the aim here is not to see a large fall in the value of the renminbi and factors such as speculation can add a further depreciation. Usually markets over and under shoot equilibrium, due to this factor, however, with the large reserves the PBoC has to hand we have no concern the USD/RMB rate can be effectively controlled by speculators.

In the medium term, though they may be saying the opposite, the authorities would probably welcome further depreciation?

One suggestion from observers is that the Chinese want a weaker currency to push exports, this has been denied by the PBoC. It is doubtful that export volumes would increase enough to offset the lower value of exports that would result from depreciation, given that China is already the world's largest exporter. If you look at other export led economies in the region such as Malaysia their currency is down over 21% year to end July 2015 against the US dollar with very little pickup in export activity.

However, depreciation in renminbi will have the benefit of raising inflation in China, something the PBoC is fully aware of. The goal of the government is to rebalance the economy away from exports towards domestic consumption. The shift away from an export led focus is aided by an APPRECIATION of the renminbi as this provides greater spending power to consume goods produced both abroad and at home.

What will be the estimated impact of the Yuan devaluation vs the USD on the performance of the Fund's portfolio? To what extent has the slump in the currency been offset by higher bond prices?

The offshore renminbi has declined by 3.5% so far this month so the Renminbi Bond Funds will have declined in value by a similar amount due to the currency devaluation. Over the month bonds are little changed.

In the medium term we would expect the market to stabilise around current levels, in fact the PBoC set the new market weighted rate at 6.3975 today (August 14) against expectations of around 6.43 where they intervened after their initial 1.8% move on the fixing on Tuesday 11th so a little stronger than the market had priced during the day.

From a bond perspective we expect our holdings to perform well given our preference for quality. We remain comfortable with our portfolio positioning in China; the portfolio's holdings are USD denominated, predominantly in quasi-sovereign exposures backed by China's Aa3 rating.

What is the manager's macro / outlook view of the current Chinese scenario and its impact on the Funds?

This is an overall positive development for China along the path of becoming a dominant market economy with a currency that is recognised and used in global trade and reserves. With the size of their economy and serious plans for reform matched with their strong net foreign asset position, reserves and growth, the funds are likely to benefit significantly from the long-term appreciation of the renminbi. This question is covered in more depth in the above analysis.

Do you believe that the likely Fed rate hike will also have an impact?

The timing of the PBoC move is probably mindful of the likely path of US short term rates and the Fed, however, since the devaluation the US futures market has moved from around a 60% chance of a September hike to around 40%. This is due to the comments from Fed members who state that they do take the global situation into account when setting policy but how much weight is attributed to the PBoC move is hard to estimate.

Of course the state of the global economy will also be taken into consideration and we feel weaker global growth will have more of an impact on the Fed's timing. Even so our central view is that the Fed need to get off zero rates at least by one but probably two 25 basis point moves to defend home grown criticism before sitting back and awaiting further economic evidence regarding the global economy. By September's Fed meeting the latest PBoC move will be digested by the market and so providing there are no further surprises will have little impact on Fed thinking.

The current exchange rate already reflects the likelihood of a Fed rate hike and it is worth bearing in mind that the US dollar weakened for several months after the start of each of the last three tightening cycles.

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