CHINESE YUAN GETS INCLUDED IN THE SDR BASKET

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On October 1, the Chinese renminbi (denominated in yuan) became part of the Special Drawing Right (SDR) of the International Monetary Fund (IMF). This decision and its implementation are historic, as the renminbi became the first emerging market currency to be incorporated into the basket. The yuan joins the U.S. dollar, euro, yen and British pound in the SDR basket. We view this development as another level of the yuan's evolution over the past 10 years. For China, the inclusion of the yuan represents another significant milestone in its development as a global economic superpower.

History of the SDR The Bretton Woods conference of 1944 is most frequently associated with the creation of the gold standard for global currencies. But the IMF also emerged from the conference. IMF created the SRD in 1969 as a supplementary international reserve asset, in the context of the Bretton Woods fixed exchange rate system. At the time, each SDR was worth 0.889 grams of gold, which was the value of the U.S. dollar. As the Bretton Woods gold standard collapsed in the early 1970s and major currencies switched from fixed to floating rate regimes, the value of the Special Drawing Right was reset to be equivalent to the value of these floating rate currencies relative to the U.S. dollar. Every five years, the IMF decides which currencies should be included in the basket and with what weights. The last review concluded in November 2015, when it was decided that the Chinese renminbi would be included. The table below shows the changes in the composition of the SDR basket.

Special Drawing Right Basket Composition

	Prior to 10/1/2016	10/1/2016
U.S. dollar	48.1%	41.7%
European euro	32.6%	30.9%
Chinese renminbi	-	10.9%
Japanese yen	7.2%	8.3%
British pound	12.2%	8.1%

Source: IMF.

As we wrote in July 2015, China's acceptance into the SDR basket is an indication of its continued success at internationalizing the yuan and could represent an opportunity for U.S. and global investors.

Evolution of the Yuan As mentioned earlier, over the past 10 years, China has been working toward liberating its currency and becoming an integral part of not only regional but international trade. In 2005, the government decided to lift its fixed exchange rate against the U.S. dollar.[1] In 2013, China announced that it would remove the floor on loan rates—signaling that market-determined interest rates would come sooner, rather than later. Between these periods, and even since 2013, China has widened and rewidened the daily trading band of the yuan to allow for further (and freer) price movement. Let's not forget about the creation of CNH, or the offshore Chinese renminbi, to complement the onshore CNY. The use of the offshore renminbi allowed for a gradual and controlled offshore trading facility for the currency, a measured yet significant step for a country that is used to exacting control over most facets of its economy. As part of its analysis, the IMF deemed the renminbi to be "freely usable" and used its exports and other financial indicators to determine its weight in the basket. It should be noted that its weight is larger than that of the Japanese yen and the British pound.

Does This Mean the Yuan Should Increase in Value? The immediate impact of the inclusion into the SDR is more statement than action. Given that China and the yuan have increased their role in global commerce, many central banks have already made the renminbi a part of their foreign exchange (FX) reserves. However, its inclusion in an otherwise fairly restricted basket speaks volumes about the currency's role in global trade—namely, that it will continue to be an increasing part of global markets. It also provides confirmation of China's success in liberalizing its currency. This liberalization and other associated steps to enhance external access to Chinese assets could lead to more widespread inclusion in global benchmarks—both bond and equity—in the coming years. These points could have a lasting positive impact on the value of the Chinese yuan and make it an increasing fixture in client portfolios. The developments are also likely to spark greater two-way volatility in the currency, as market forces play a growing role in its valuation. With regard to direction of the yuan, there is also a possibility that the currency could depreciate, given that official intervention in the currency's movements could be scaled back. **CYB** The WisdomTree Chinese Yuan Strategy Fund (CYB) provides cost-effective exposure to the currencies and interest rates in the rapidly evolving Chinese currency. Total return of the strategy would come from currency appreciation, implied yield of the CNY and CNH forward contracts and potential income generated from U.S. money market collateral securities and CNH time deposits. Low volatility combined with moderate interest rates make it one of the most attractive currencies from an interest rate-to-volatility perspective, in our view. CYB has evolved with new ways of achieving exposure to the Chinese yuan, and it retains the flexibility to continue to adapt because of its unique status as an actively managed currency Fund. As the Chinese currency and trade markets continue to evolve, CYB could be an attractive option for investors looking to benefit from those trends. [1]Source: Xinhua News Service, 7/21/05.

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Special Drawing Rights (SDR) : an international reserve asset and accounting measure created by the IMF.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Implied yield : The annualized rate of return generated by a fund's investment in forward currency contracts. The calculation is intended to show the yield of forward currency contracts, assuming that foreign exchange rates remain constant.

Forward contracts : Agreements to buy or sell a specific currency at a future date at an agreed upon rate.

CNH time deposit : Offshore Chinese Yuan deposited with a bank for a defined period of time.

Actively managed ETFs : Investment strategy where a manager selects securities in an attempt to outperform the performance benchmark.