A LOW VOLATILITY PLAY ON CHINA: ITS CURRENCY

Bradley Krom – U.S. Head of Research
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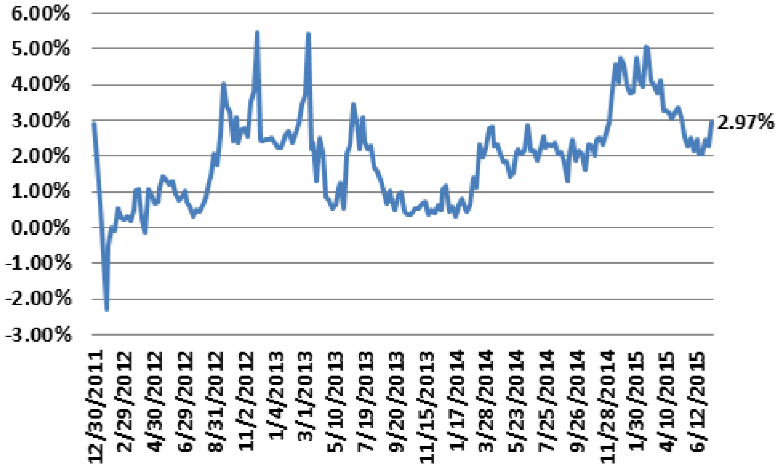
For many investors, China is either the land of opportunity or a risk to global growth. Over the last several weeks, Chinese equity markets have certainly reflected that view.[1] As the Chinese government continues to enact reforms intended to stabilize markets, we believe investors should turn their attention to an often overlooked play on Chinese growth: the yuan. While 2014 was a difficult year for virtually all foreign currencies against the U.S. dollar, the yuan stands out as one of the few currencies to rebound through the first half of 2015 against the U.S. dollar.[2] **Importance of Yuan Stability in 2015** On July 21, 2005, the Chinese government announced that it would no longer maintain a fixed exchange rate against the U.S. dollar.[3] Over the last decade, the government has continued to implement a series of pragmatic steps aimed at increasing the use of the Chinese yuan in global markets while limiting volatility. While we are still a few years away from a full "free float" of the yuan, the Chinese government has continued to signal its intention to regionalize and ultimately internationalize the use of the yuan. In addition to its use in trade, the Chinese hope to increase the holdings by international organizations and central banks as a store of value. Just recently, on July 14, China took additional measures to relax constraints around foreign investment in its multitrillion-dollar interbank bond market.[4] Foreign central banks, sovereign wealth funds and global financial organizations will be able to file a one-page registration form with no restrictions on how much they can invest. This is being viewed as big step toward liberalization of capital flows.[5] As we have seen throughout history, so-called reserve currencies can enjoy lower interest rates and faster economic growth as their markets and currencies power global markets. In October or November 2015, China hopes the yuan will officially join the club of international reserve currencies through its inclusion in the International Monetary Fund's Special Drawing Rights (SDR) basket. While the inclusion of the yuan could have a greater impact symbolically than economically, Chinese Premier Li Keqiang has repeatedly asked publicly for the yuan to be included. As a result, the Chinese government will likely do everything it can to maintain a low-volatility, modestly appreciating exchange rate in the lead-up to this decision. Additionally, we view the probability of Chinese officials actively depreciating the yuan to help their exports as extremely remote. In our view, this makes the yuan an attractive alternative for investors looking to diversify away from the U.S. dollar. Since its inception in 2008, the WisdomTree Chinese Yuan Strategy Fund (CYB), which is designed to provide exposure to China's currency, has had an annualized volatility of just 2.25%.[6] **Alternative to Short Duration U.S. Fixed Income** While low volatility ultimately caps total return potential to the upside and downside, the ability to capture higher interest rates in China creates a comparatively attractive alternative to short duration U.S. fixed income. Investments in foreign currencies involve at least two sources of return: changes in the relative spot price and the interest rate differential between the markets. Interestingly, from 2008 to 2011, many investors wanted to gain exposure to the Chinese yuan and were willing to accept a negative implied interest rate in order to bet on currency appreciation. With only limited options for investors to gain exposure to the yuan, the laws of supply and demand meant that the currency would need to appreciate by at least 2% per year just to break even.[7] As we show below, as the means of getting access to the yuan has continued to evolve, investors' ability to generate potential income on their yuan investments has continued to increase. **CYB Embedded Income Yield, 12/31/11–7/10/15**



Source: WisdomTree, as of 7/10/15. Past performance is not indicative of future results.

Click to see CYB standardized yield information. Since mid-2011, some investors have generated positive carry by investing in the Chinese yuan against the U.S. dollar. This income potential is largely driven by the fact that interest rates in China are higher than they are in the U.S. Compared to three-month U.S. Treasury bills, the Chinese yuan can provide a significant carry advantage for modestly higher volatility. While last year marked the first time since 2005 that the Chinese yuan depreciated against the U.S. dollar, the -0.36% return was one of the strongest performers globally. So far this year, the yuan is basically flat against the U.S. dollar.[8] In our view, the ability to capture higher income potential combined with a low-volatility profile means exposure to the Chinese yuan may represent an attractive alternative to more volatile plays on Chinese growth.

[1]Source: Bloomberg, as of 7/10/15. [2]Source: Bloomberg, as of 6/30/15. [3]Source: Xinhua News Service, 7/21/05. [4]Source: Bloomberg, as of 7/14/15. [5]Source: "China Opens Interbank Bond Market Wider to Foreign Buyers," Bloomberg, 7/14/15. [6]Source: Bloomberg, as of 6/30/15. [7]Source: J.P. Morgan, as of 12/31/11. [8]Source: Bloomberg, as of 7/10/15.

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DEFINITIONS

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

free-floating : an exchange rate regime whereby the value of the currency is determined by supply and demand against other currencies.

Interbank : a transaction or transfer occurring between two financial entities.

Sovereign : A national government.

Reserve currency : A foreign currency held by a central bank or monetary authority as a long-term store of value.

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

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

Duration : A measure of a bond’s sensitivity to changes in interest rates. The weighted average accounts for the various durations of the bonds purchased as well as the proportion of the total government bond portfolio that they make up.

Spot price : The current price at which a particular security can be bought or sold at a specified time and place.

Implied interest rate : The annualized interest rate implied by forward currency contracts relative to spot rates.

Embedded Income Yield : Represents the annualized rate of return generated by a fund’s investments in both fixed income securities and derivatives exclusive of interest rate changes and movement in foreign exchange spot rates. The calculation is intended to capture the Fund’s potential to earn income return over the following year given current holdings and market conditions. The embedded income yield will differ from the portfolio’s yield to maturity, due to the incorporation of derivatives in the embedded income yield. Embedded income yield and portfolio yield to maturity may differ from a Funds actual distribution and SEC yield and do not reflect Fund expenses.

Carry : The amount of return that accrues from investing in fixed income or currency forward contracts.

Three-month U.S. Treasury bill : a debt obligation of the U.S. government with an original maturity of 3 months.