CHINESE CURRENCY VOLATILITY & BAND WIDENING COULD SPELL OPPORTUNITY

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On March 15, 2014, the People's Bank of China announced that it would widen its trading band for the Chinese yuan to 2% from 1%. While rhetoric about widening the trading band had increased in recent weeks, most analysts believed this change in policy would occur later in the year. After appreciating by nearly 3% in 2013,[1] recent losses in the Chinese yuan have given some investors pause. Could this be a symptom of an impending "hard landing"? In our view, this most recent period of volatility is not connected to potential economic troubles in China, but rather a deliberate move by policy makers to rattle speculators before announcing a change in policy. Similar to the last widening in 2012, the yuan could drift or become slightly weaker in the near-term as investors mull the heightened impact of greater currency volatility. Ultimately, we remain confident that the Chinese yuan can appreciate against the U.S. dollar by the end of 2014. While 2013 was a volatile year for most emerging market currencies, we noted that the Chinese yuan quietly appreciated by nearly 3%. However, in early 2014 this differentiation in performance proved short-lived. In the final two weeks of February, the Chinese yuan depreciated against the U.S. dollar by over 1.3%. Next, during a 2 week period in mid-March, the currency depreciated by over 1.7%. For a currency with a historical volatility of only 2%, these dramatic moves (by comparison) caught many China watchers flat-footed. Up until this point, the consensus view was that China would be widening its currency band sometime in 2014, and that policy would eventually inject more "two-way volatility"[2] into the market. **Recent Market Volatility** The best way to describe Chinese policy makers' recent guiding of a decline in the value of the yuan is "a shot across the bow." The principal reason why Chinese policy makers have historically rejected pressure to allow the yuan to float freely and permit conversion on the capital account is the potentially destabilizing effect of "hot money." As money pours into an economy, the currency strengthens, but the country also becomes awash in excess liquidity and exports become more expensive by comparison. For a strongly export-oriented economy such as China, an excessively strong currency can have a significant impact on economic growth. This was precisely what many emerging market central banks complained about in early 2010, when the value of their currencies rose sharply against the dollar as the U.S. sought to lower interest rates via quantitative easing. Given the potential for the destabilizing effect of "hot money," China has imposed certain restrictions in order to protect its economy and, by extension, keep domestic constituents contented. To affect this policy, China has historically permitted its currency to fluctuate by a predetermined percentage per day (now 2%) and placed caps on the amount of yuan that can flow from markets outside of China into the mainland. Although this recent depreciation in the yuan has been unsettling, China may have achieved the intended goal of causing pain for leveraged speculators in its currency market and injected some doubt into the one-way appreciation bets. While the future path of China's currency is still far from certain, it is worth noting that the Chinese yuan has yet to depreciate against the U.S. dollar in a calendar year since it began to float back in 2005. **Yuan Depth and Liquidity Increasing** To put these most recent moves in context, this most recent sell-off in the Chinese yuan represents one of the sharpest reversals since September 2011. At that time, analysts explained that the sudden drop was particularly violent due to a lack of liquidity in the CNH market[3]. Fast-forward to the end of 2013, the offshore yuan market has doubled in size in terms of assets over the past year.[4] Additionally, we noted in a previous blog post, liquidity and trading volume have been increasing steadily, offshore centers are cropping up in Singapore, Taiwan, London and now potentially Korea, and the amount of global trade being invoiced and settled in yuan is continuing to rise. Taken in totality, we believe that the Chinese leadership is committed to regionalizing and ultimately internationalizing the Chinese yuan. In order to continue down the path of liberalization confirmed by the Third Plenum, this most recent move to widen the band implies that the Chinese leadership is confident that the economy is strong enough to proceed with reforms. While this most recent widening of the band will inevitably lead to higher volatility for the yuan, we still view the currency as an attractive long-term holding. Additionally, a big development last year was the increased yuan use for purposes of trade settlement. However, in some respect increased volatility flies in the face of broader use, and increased volatility could give pause to Western buyers accustomed to transacting in dollars. In our view, this trend of increased use in global trade will continue in 2014. China and its interests may simply be too large to ignore. **Recent Developments from the National People's Congress** Each year, the Chinese party leadership assembles to set the economic and social targets for the year. For 2014, there was some conjecture that China may reduce its official 7.5% growth target given the potential "rebalancing" under way in the domestic economy. However, early reports suggest that China is committed to maintaining the 7.5% target. While greater details about future policy changes continue to trickle out, support for the growth target represents a clear positive for broader emerging market sentiment that has come under pressure over the last 12 months. **Conclusion** Although volatility may be poised to increase going forward, we believe that the Chinese yuan represents an attractive opportunity for returns in 2014. Given that a gradual appreciation of the yuan is also in China's best interest as the country transitions toward a domestic demand-driven economic model, investors' interests remain aligned with policy makers'. [1]Source: Bloomberg, as of 12/31/13. [2]Or that the yuan wouldn't continue to slowly appreciate against the dollar in perpetuity. [3]Also referred to as the offshore yuan market. [4]Source: Standard Chartered, 1/7/14.

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DEFINITIONS

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

Capital account : Sometimes referred to as the financial account—second component of a country's balance of payments that reflects the net change in the nation's ownership of assets.

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

Quantitative Easing (QE) : A government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital, in an effort to promote increased lending and liquidity.

Liquidity : The degree to which an asset or security can be bought or sold in the market without affecting the asset's price. Liquidity is characterized by a high level of trading activity. Assets that can be easily bought or sold are known as liquid asset.

Third Plenum : Known more formally as the Third Plenary Session of the Central Committee of the Communist Party of China. This meeting allows Party leaders to lay out a blueprint for achieving the political and economic goals of the government.

Rebalance : An index is created by applying a certain set of selection and weighting rules at a certain frequency. WisdomTree rebalances, or re-applies its rules based selection and weighting process on an annual basis.