

Putting China's Devaluation into Context?

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Over the last six weeks, financial markets have continued to grapple with the current and future implications of the one-day devaluation of the Chinese yuan. While market participants failed to see this move coming, it is important to put this shift in policy into context and attempt to understand what Chinese officials are ultimately aiming to achieve. Below, we outline our top four thoughts on this unforeseen development as global markets attempt to digest exactly what China's next step may be.

1) How common are $\pm 1.84\%$ moves in one day for currency markets? As shown in the table below, in China, it is unprecedented. However, in other markets, they occur much more often than you would think. This is precisely why the market is continuing to debate whether additional devaluations are possible. In our view, they should not because a policy of uncertainty is unlikely to be in China's long-term interest.

1-Day Moves in Perspective: 21/07/05–25/09/15

Source Bloomberg, as of 25/09/15 Chinese yuan (CNY), Chinese yuan Hong Kong (CNH), European euro (EUR), British pound (GBP), Canadian dollar (CAD), Australian dollar (AUD), New Zealand dollar (NZD), Japanese yen (JPY), Swiss franc (CHF), Mexican peso (MXN)

When a government is the primary catalyst for a change in monetary policy (i.e., Swiss National Bank [SNB], People's Bank of China [PBoC]), the market tends to fixate on issues such as "currency wars" and "competitive devaluation." In our view, China has always taken a pragmatic approach to its economic and monetary policy. During the Asian currency crisis of 1997, its exchange rate policy remained intact and rejected an opportunity to devalue. During the financial crisis of 2008, China reinitiated a peg against the U.S. dollar. Today, a slightly weaker currency is in China's best interest. Until proven otherwise, the statement of The People's Bank of China (PBoC) should be taken at face value that the devaluation was not the start of a new, continuous trend and that it is not trying to devalue the currency by 10% to stimulate exports, as some reports suggested. However, the yuan may ultimately continue to weaken against the U.S. dollar, but when compared to other emerging markets, the yuan remains one of the most appealing alternatives for its relatively attractive interest rates and still historically low volatility.

2) Why did the Chinese choose to guide the fixing lower now? While our primary view was that the International Monetary Fund (IMF) would be announcing a decision on the yuan's inclusion in the Special Drawing Rights basket in October or November, the IMF gave guidance that there would be no change to the existing basket before September 2016. With China's economy facing headwinds and the Federal Reserve likely to hike rates in the coming months, policy makers in China believed that a move sooner rather than later could help relieve some economic stress. Further, this flexibility could allow the

yuan to de-peg from the dollar in the event the dollar strengthens considerably more against other foreign currencies. We anticipate that the PBoC will continue to use other conventional tools such as reserve ratio cuts and special-purpose-vehicle loans to provide a lift in output. In response to China's move, the IMF noted that it welcomed China's willingness to allow market forces to drive the value of the yuan.

3) How does China's devaluation compare to Britain's Black Wednesday in 1992? In addition, a focus on devaluation misses the point if it doesn't factor in the magnitude of the move. In the most famous devaluation in modern financial history, the Bank of England devalued the pound by over 4% on September 16, 1992. The pound fell by 15.23% from September 6 through September 22. While China's latest moves were surprising, they are so far in no way comparable in magnitude to what occurred in the early 1990s in Britain or other recent devaluations in some emerging markets. Since August 10, 2015, the yuan is down less than 3%.

4) The Chinese yuan began to float on July 21, 2005. Has China's view on the currency changed? Since 2005, the Chinese yuan has appreciated by 29.8% versus the U.S. dollar in nominal terms. Over this same period, most other major currencies actually depreciated against the dollar. However, a more interesting development is what has occurred between the yuan and its other major trading partners: the appreciation of the euro, Japanese yen and Korean won of respectively +40.8%, +38.7%, and +48.50% in the same period. In many respects, while U.S. investors are focusing on the yuan against the dollar, recent moves may be more of a response to the unsustainable path of appreciation against China's other major export markets and competitors. While China will continue to focus on a transition to domestic consumption from investment and exports, this transition cannot occur overnight. The currency, along with changes in domestic policy, will also have a significant impact. Ultimately, China's actions were a surprise to our outlook for the yuan. However, we believe the market's reaction to this policy shift should not be overstated. St. Louis Federal Reserve President James Bullard has a point when he said in August this year that the spike in volatility and change in equity values appears to be an overreaction to little real news out of China. Investors sharing this sentiment may consider the following UCITS ETFs:

[WisdomTree Emerging Markets SmallCap Dividend UCITS ETF \(DGSE\)](#)

[WisdomTree Emerging Markets Equity Income UCITS ETF \(DEM\)](#)

All data is sourced from WisdomTree Europe and Bloomberg, unless otherwise stated.

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