

Chinese Yuan: A Potential Alternative for a Rising Rate Environment

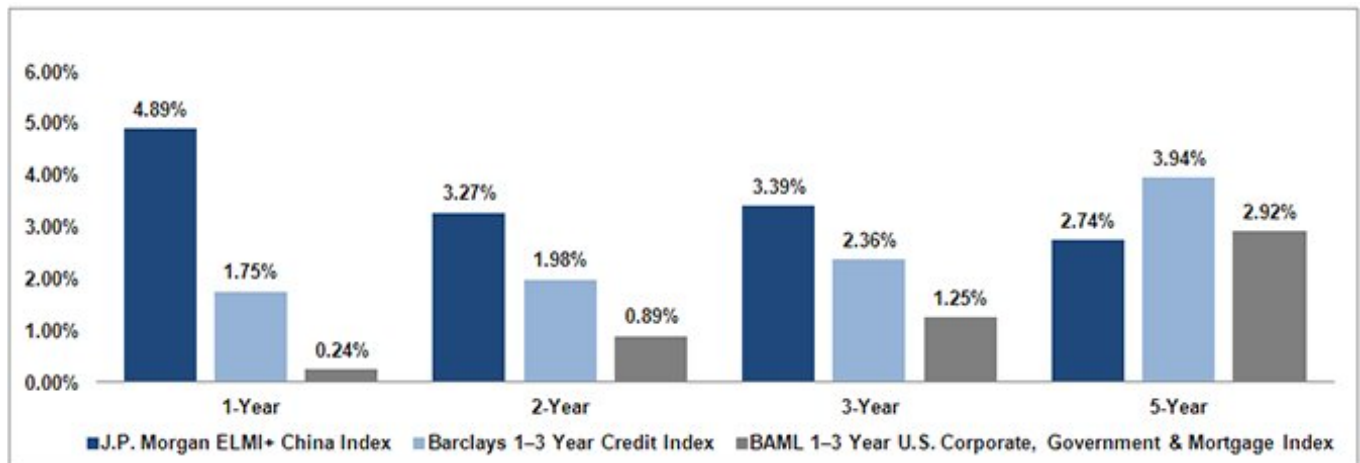
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With the market fixated on risks of “tapering”, investors are shortening their duration (and appear to be running for the hills) in fixed income. As exposure to any interest rate risk has fallen out of favor, the overwhelming flow leaders in fixed income so far this year have been short-duration, credit-focused products.¹ While we can’t argue with investor flows, we can turn our attention to another short-duration position that despite its performance has been largely overlooked by investors so far this year: the Chinese yuan. As we will discuss, the Chinese yuan has provided steady returns to investors, with comparatively attractive levels of volatility when compared to some of the fastest-growing assets this year. As investors attempt to navigate this period of global rebalancing, the yuan has quietly continued along a path of modest appreciation. **Absolute and Risk-Adjusted Returns** In absolute terms, the Chinese yuan has performed unusually well during a period of broad-based U.S. dollar strength. In our view, given the low income potential/opportunity cost in short-duration fixed income, investors could consider positions in the Chinese currency as a way to diversify their portfolios beyond the U.S. dollar and away from U.S. interest rate risk.

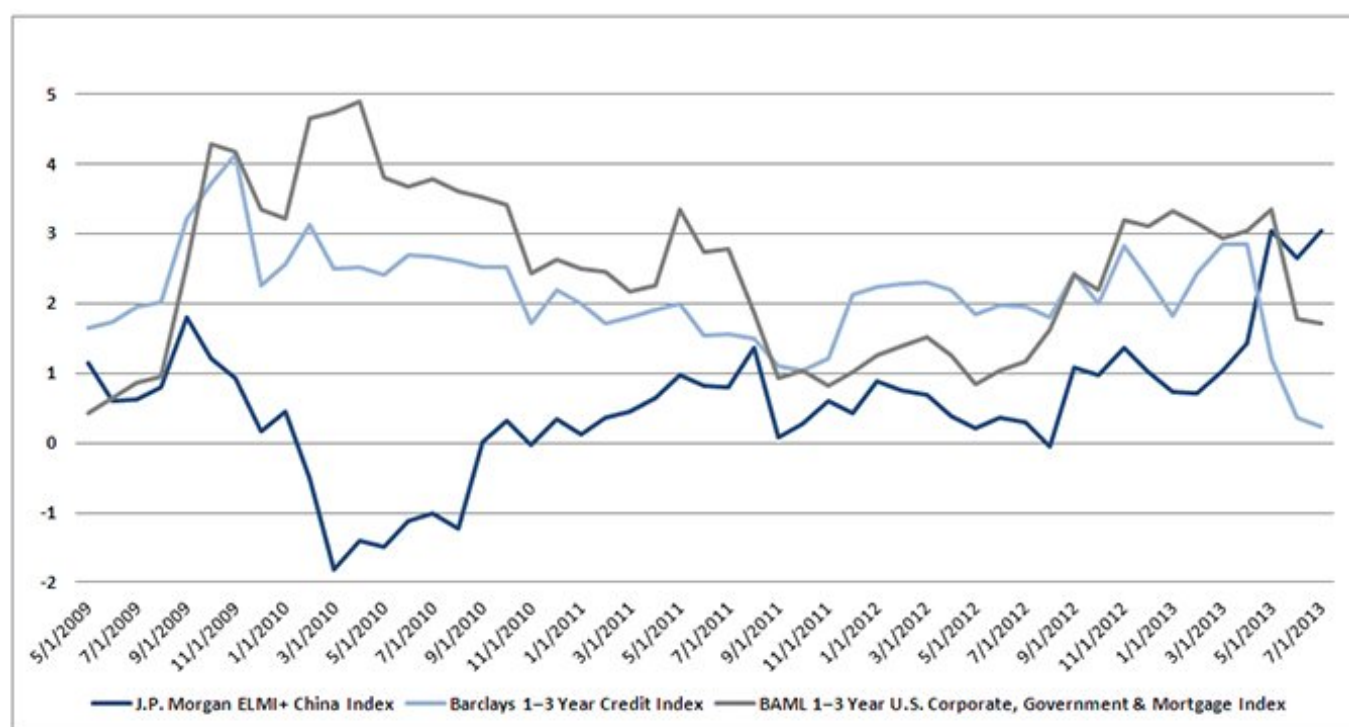
Trailing Returns as of July 31, 2013



Sources: Zephyr StyleADVISOR, WisdomTree. Past performance is not indicative of future results. You cannot invest directly in an index.

For definitions of indexes in the chart, please visit our [Glossary](#). When compared to other foreign currencies, the Chinese yuan has been broadly stable despite the sometimes volatile moves in emerging markets. This is largely a product of the “managed band” that Chinese policy makers currently impose on the yuan. Although the band prevents large upside surprises, the downside is also capped, which could be

attractive to investors seeking to limit volatility. Additionally, investors have also benefited from the higher interest rates available from short-term investments in the yuan, boosting total returns relative to spot. When taking into account the yuan's historic volatility (approximately 2.4%), investors in China's currency have achieved higher risk-adjusted returns than virtually all fixed income or currency investments so far in 2013.² In the graph below, we track the rolling 12-month Sharpe ratio of the J.P. Morgan ELMI+ China Index and two short-term fixed income indexes representing the fastest growing sector of fixed income in 2013. As volatility has increased in U.S. interest rates and returns have waned, the Sharpe ratios of U.S. fixed income have tended to trend downward. By comparison, consistent volatility and positive performance have contributed to the yuan's current upswing. **Rolling 12-Month Sharpe Ratio: June 1, 2008 - July 21, 2013**



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For definitions of indexes in the chart, please visit our [Glossary](#). But risk and return tell only part of the story. The Chinese yuan has had only modest correlation to the [S&P 500 Index](#) and the Barclays U.S. Aggregate Bond Index (0.11 and 0.06, respectively) over the last five years. Given the uncertainty related to shifts in Federal Reserve (Fed) policy, a non-correlated asset could add valuable diversification to investor portfolios.³ **What's Driving the Yuan's Performance?** Interestingly, as [China has continued down the path of currency internationalization](#), the increasing means of access have created new opportunities for income in Chinese yuan-denominated assets. So far in 2013, more than one-third of the J.P. Morgan ELMI+ China Index's performance has been driven by returns from interest rates in Hong Kong and China.⁴ The remaining performance can be attributed to a broadly stronger yuan. In our view, we can best explain this phenomenon as part of the Chinese rebalancing that is currently being overseen by Premier Li Keqiang. **Outlook** Chinese policy makers have historically proven to be extremely pragmatic. If

the best policy for U.S. investors has been to not “fight the Fed,” we believe this maxim also applies to the Politburo Standing Committee in China. During this most recent period of global rebalancing, the Chinese government will continue to make adjustments that affect the Chinese economy. So far in 2013, it seems that an appreciating yuan has been in China’s best interest. As we stated above, a gradual, low-volatility rebalancing seems to be the most logical course of action. Similar to what investors experienced during the Asian financial crisis in the late ’90s, Chinese policy makers appear reluctant to devalue the yuan in the face of market stress. In fact, since the Chinese yuan was allowed to “float” in 2005, it has yet to depreciate against the U.S. dollar in a calendar year. 1Source: WisdomTree, Bloomberg; August 23, 2013. 2Source: Bloomberg; 2013. 3Source: Zephyr StyleADVISOR, July 31, 2013. 4Source: J.P. Morgan, July 31, 2013.

Important Risks Related to this Article

Diversification does not eliminate the risk of experiencing investment losses. Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations. Investments focused in China are increasing the impact of events and developments associated with the region, which can adversely affect performance.