PUTTING CHINA'S "DEVALUATION" IN CONTEXT

Bradley Krom — U.S. Head of Research
09/29/2015

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 we and other market participants failed to see this move coming, we believe it is important to put this shift in policy in 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 ±1.84% moves in one day for currency markets?** As we show in the table below, in China, it's 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 we do not believe this policy of uncertainty is in China's long-term interest. **1-Day Moves in Perspective: 7/21/05–9/25/15**

Moves vs. U.S. Dollar	CNY	CNH	EUR	GBP	CAD	AUD	NZD	JPY	CHF	MXN
Fall by > -1.84%	1	1	15	18	31	63	80	21	18	43
Rise by > +1.84%	1	-	17	6	16	50	59	25	22	35
Largest 1-Day Depreciation	-1.8%	-2.7%	-2.4%	-3.4%	-3.2%	-7.0%	-6.5%	-5.3%	-8.7%	-6.8%
Largest 1-Day Appreciation	2.1%	1.3%	3.5%	3.0%	4.1%	8.6%	4.4%	3.6%	21.5%	6.9%
Cumulative Return	29.8%	N/A	-7.7%	-12.6%	-8.4%	-7.0%	-5.8%	-6.4%	31.4%	-37.4%

Source: Bloomberg, as of 9/25/15. 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, we take the People's Bank of China statement 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.[1] 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 hiking rates in the coming months, policy makers believed that a move sooner rather than later could help relieve some economic stress. Further, this flexibility could allow the yuan to depeg 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.[2] **3) How does China's devaluation compare to Britain's Black Wednesday in 1992?** Similar to our first bullet, 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%.[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.[4] Over this same period, most other major currencies actually depreciated against the dollar. A perhaps more interesting development, though, is what has occurred between the yuan and its other major trading partners: euro +40.8%, Japanese yen +38.7%, Korean won +48.50%. 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. We also tend to agree with the comment of St. Louis Federal Reserve President James Bullard, that the spike in volatility and change in equity values appears to be an overreaction to little real news out of China. [1]Source: Randall W. Forsyth, "China's Yuan Could Fall 10% or More," Barron's, 8/15/15. [2]Source: Andrew Mayeda, "IMF Calls China's Yuan Moves Welcome Step to More Flexible Rate," BloombergBusiness, 8/14/15. [3]Source: Bloomberg, as of 9/25/15. [4]Source: Bloomberg, as of 9/25/15.

Important Risks Related to this Article

Investments in currency involve additional special risks, such as credit risk and interest rate fluctuations.

Investments focused in China increase the impact of events and developments associated with the region, which can adversely affect performance.

For standardized performance and the most recent month-end performance click here NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our Economic & Market Outlook

View the online version of this article here.

IMPORTANT INFORMATION

U.S. investors only: Click here to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Devaluation : deliberate downward adjustment to the value of a country's currency, relative to another currenc.

Monetary easing policies : Actions undertaken by a central bank with the ultimate desired effect of lowering interest rates and stimulating the economy.

Currency wars : a policy response in which one country attempts to weaken their currency in response to the currency weakening policies of an economic rival or group of rivals.

Competitive devaluation : a policy in which a country purposefully devalues their currency in order to improve the attractiveness of their goods and services.

PEG ratio : A stock's price-to-earnings ratio divided by the growth rate of its earning.

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

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

Reserve Ratio Requirement (RRR) : portion of depositors' balances that banks must have reserved in the form of cash.