Special Update: China Acts to Devalue Its Currency

August 13, 2015

On August 11, the People's Bank of China (PBOC) made a surprising move to devalue its currency, the renminbi (or yuan), against the dollar by 2%. It was the biggest devaluation since the yuan officially de-pegged from the U.S. dollar in 2005. The central bank also decided to fix the yuan's value moving forward to the previous day's close in an effort to make the yuan more market based.

China's move to weaken its currency heightened concerns over the health of the world's second largest economy and caused rippling effects throughout the global markets. Major global equity indices initially fell more than 1%, and oil and other commodities declined sharply. Gold—which has been under pressure—and Treasuries rallied. The yield on the 10-year U.S. Treasury note fell to the lowest level in two months. Asian currencies also tumbled, notably the South Korean won, Australian dollar and Thai baht.

As the markets digest China's central bank's actions, investors are wondering what is behind its policy move, what implications it may have for the global economy and what it means for investors.

THE REASONS FOR CHINA'S ACTION

China's latest action is a departure from its tightly controlled currency, leading investors to speculate about the motivations behind its adjustment. It is recognized that China is in the midst of a slowdown as it shifts from an export-led economy to a consumer-led economy. In fact, China has taken several actions to help stimulate economic activity over the past year including cutting interest rates four times, increasing the amount of money banks can lend and supporting its stock market. By shifting towards a more market-oriented exchange rate, China is taking yet another step to help stimulate growth by making its exports, which have been hindered by their strong currency, more attractively valued.

Another driving force behind China's move is its desire for the yuan to be included in the International Monetary Fund's (IMF) basket of reserve currencies, known as the Special Drawing Rights. This would put the yuan on par with the U.S. dollar, euro, the Japanese yen, and the British pound. The bank's move to include more information when setting its daily fix can be seen as a relaxation of controls, moving the currency a step closer to satisfying the IMF's entry requirements.

BNY MELLON
WEALTH MANAGEMENT

GLOBAL IMPLICATIONS

China's actions have several global implications. A cheaper yuan should make Chinese products less expensive in global markets and help boost exports, which declined more than 8% year-over-year through July. The action may also partially disconnect the yuan from any further dollar strength that may occur as the Federal Reserve (Fed) begins to tighten, thereby limiting any further erosion of Chinese competitiveness. Commodities denominated in U.S. dollars will become more expensive to buyers in China. This could further weaken demand from the world's top consumer of many raw materials and put additional downward pressure on commodity prices.

Many Asian and emerging markets' currencies have been pressured this year. But a weaker yuan may put additional pressure on some of these countries. For example, the Indonesian rupiah and the Malaysian ringgit fell this year against the dollar by more than 8% and 9% respectively, as China's demand for commodities slowed. Other countries' currencies have been impacted by recessions, such as Brazil and Russia. At this point China is attempting to control the pace of the renminbi's weakening.

Slow growth and lower commodity prices will likely lead to most central banks maintaining their easy monetary policies for longer. In the U.S., low inflationary pressures and a stronger dollar could slow down the Fed's pace as it normalizes interest rates. However, in some emerging markets, commodity exporters, countries with large current account deficits and/or corporations with excessive debt denominated in dollars could see financial conditions worsen even with continued easy monetary policy.

OUTLOOK AND INVESTMENT STRATEGY IMPLICATIONS

Moving to a more market-based currency policy will require a delicate balancing act by China's central bank. We do expect additional volatility in the coming days and weeks as the market adjusts to China's new way of fixing its daily reference rate for the renminbi. There is potential for capital outflows and further yuan depreciation as the market seeks a new equilibrium level.

During this risk-off period, government bond rates move lower or fluctuate within a tight range, but we expect these levels to be temporary. U.S. interest rates are likely to gradually move higher as the economy improves and the Fed initiates its first interest rate hike.

For now, our overweight to U.S. dollar-denominated equities, underweight to emerging market equities, and modest weight to commodities should prove helpful during this period of uncertainty. In addition, our allocation to strategies that are less correlated to equities should help smooth out the market choppiness.

We have been more cautious about emerging market equities over the last year in light of China's slowdown and challenging growth prospects in other emerging market countries, such as Brazil, which is wrestling with high interest rates and high inflation. We continue to believe that country selection among developing countries remains important and that company-specific opportunities still exist. For example, we are looking at potential risks associated with Chinese companies that may be exposed to U.S. dollar financing and opportunities within Chinese exporters that may benefit from the devaluation.

We will continue to monitor events in China keeping an eye on the latest economic data and whether the PBOC takes any additional simulative actions to prop up its economy. We will keep you informed of any market developments that may impact your portfolio.