LEADERSHIP TRANSITION AND THE CHINESE YUAN

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On November 14, 2012, the Chinese yuan traded at an all-time record exchange rate against the U.S. dollar.[1] As investors continue to digest the impact of the U.S. elections, fears of the pending fiscal cliff and the recent transition in Chinese leadership, now could be a prudent time to reassess portfolio exposure to foreign currencies and to the world's second-largest economy, China. The leadership transition in China has refocused many investors' attention not only on China but on emerging markets in general. Xi Jinping and Li Keqiang, the newly appointed Chinese party leader and premier, respectively, face the difficult task of continuing the transition from an export-driven, lower-middle-income economy to a consumer-based, high-income economy.[2] Chinese policy makers have long embraced moderation and pragmatism in reforms, principles we are currently seeing in the Chinese currency market. However, as China continues its economic expansion (albeit at a slower pace than during the previous 30 years), several policy goals have been made abundantly clear.[3] For Chinese policy makers, the next five years will be focused on: 1) Expanding economic prosperity more broadly 2) Avoiding a "middle income trap" through greater consumption and less reliance on exports 3) Expanding Chinese influence in the region[4] Increasing the amount of trades settling in Chinese yuan is central to all three of these stated goals. Given your investment positions in the Chinese currency, what does increased yuan trade settlement mean for your portfolio? The aim of increased trade settlement is to increase the use of Chinese yuan more broadly. A series of steps (including wider adoption for trade settlement; larger, more liquid financial products denominated in yuan; larger number of trading centers transacting in yuan) must gradually take place, but the groundwork for these developments is being laid now. The new Chinese premier has been a driving force behind the CNH (Chinese yuan in Hong Kong) initiative currently expanding to Taiwan and Singapore. In recent speeches, he signaled that China would continue to focus on initiatives to regionalize, and then internationalize, the Chinese yuan. Oftentimes, investors ask where the Chinese yuan fits in their portfolio. The volatility of the Chinese yuan is definitely being managed, given that China maintains a 1.00% daily trading band on its currency.[5] In fact, since August 2005[6] volatility in non-deliverable forward currency contracts ("forwards") has averaged 1.97% per year.[7] Over the past year, amid concerns of slowing Chinese economic growth, expectations for an appreciation of the Chinese yuan have faded. However, this has created a different opportunity in the market. From 2005 to 2011, foreign investors trying to position themselves for an appreciating yuan were limited to investments in forwards. This "one-way" trade at times became "crowded," resulting in forwards failing to completely capture movements in the spot currency. Now that appreciation expectations have moderated and investors have multiple means of accessing yuan investments, the market is providing positive interest rates for investors waiting for appreciation. As of October 31, 2012, the implied interest rate on 12-month forwards was 2.11%, over seven times the rate of 2-year U.S. Treasury bonds.[8] Given the current level of U.S. interest rates, investors' positions in short-term U.S. fixed income have limited return potential. With comparable levels of volatility, it could make sense for some investors to invest a portion of their assets in vehicles that offer exposure to the Chinese yuan. Historically low levels of volatility, positive exposure to upside surprises in Chinese gross domestic product (GDP) growth, and positive interest rate carry all support the case for increasing investor allocations to the Chinese currency, where suitable. [1]Bloomberg, 2012. [2]World Bank, 2012. [3]The policies were announced September 24, 2012, in China's 12th Five-Year Plan. [4]"China Unveils Financial Reform Plan for 12th Five-Year Plan Period," Xinhua News Agency, September 24, 2012. [5]On April 16, 2012, the Chinese government loosened the intraday trading band on the Chinese yuan, allowing the currency to vary within a 1.00% daily trading band, compared to the previous 0.50% band. [6]China has allowed the yuan to fluctuate against a basket of currencies since July 21, 2005. [7]JPMorgan, October 31, 2012. [8]Bloomberg, 2012.

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