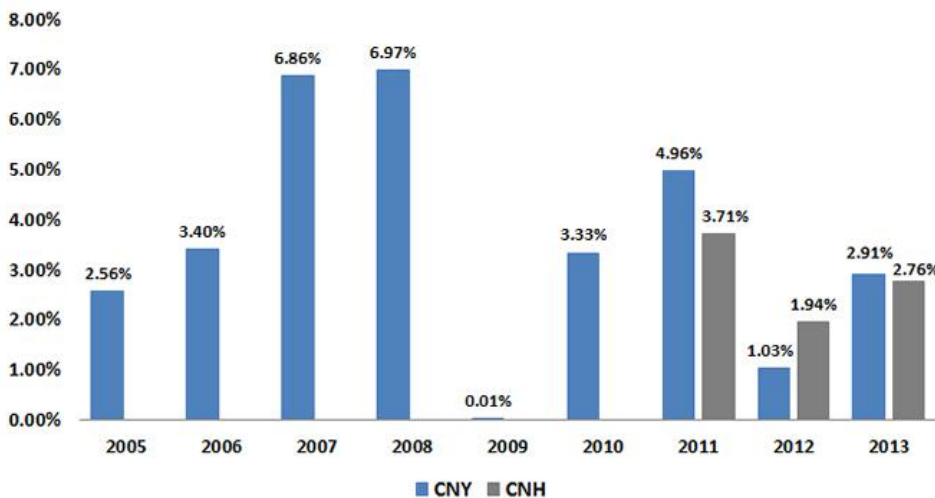

AFTER STRONG PERFORMANCE IN A TOUGH YEAR FOR CURRENCIES, WHAT'S NEXT FOR THE CHINESE YUAN?

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In a year dominated by a resurgent U.S. economy and a focus on Fed “[tapering](#),” the U.S. dollar became the primary focus for currency investors and equity investors alike. However, as strong as the dollar’s performance was against many of its largest trading partners, the Chinese yuan quietly appreciated by nearly 3%¹. With positive momentum continuing into 2014, what is next for the Chinese yuan from a performance and policy standpoint? As we mentioned in a previous [blog post](#) we believe that the path of gradual yuan internationalization and regionalization will continue over the next several years. As this trend continues, we believe that demand for the yuan and yuan-denominated assets may continue to grow. And we believe this strong demand will continue to be supportive of gradual yuan appreciation. Although fears about a slowdown in Chinese growth unnerved markets in early 2013, we believe that Chinese growth will reach the government-projected target of 7.5% on the back of strong exports this year. In 2013, the Chinese yuan held outside mainland China achieved several important milestones: 1. It rose to become the eighth most traded currency in the world² 2. It became the second most used trade finance currency behind the U.S. dollar in December 2013, displacing the euro³ 3. Deposits of Chinese yuan outside mainland China have grown to an all-time record of CNH 1.15 trillion (\$190.5 B) in Hong Kong, Singapore and Taiwan⁴ As impressive as 2013 was from a growth perspective, the Chinese yuan has proven remarkably resilient in its gradual appreciation over the last several years. In fact, last year, the yuan was the second best-performing currency in Asia (behind the Korean won) and the third best performer across emerging markets (also behind the Romanian leu).⁵ Among major economies⁶ only the euro outperformed the yuan in 2013. However, when factoring in returns from short-term interest rates, the yuan actually outperformed the euro on a total return

b a s i s . Chinese Yuan Performance: 2005–2013



Source: Bloomberg, as of 12/31/13. Past performance is not indicative of future results.

Note: CNY represents the official Chinese yuan exchange rate for mainland China. CNH represents the exchange rate for Chinese yuan held outside of mainland China, principally in Hong Kong. The Chinese government announced in July 2005 that the yuan would be permitted to float in value relative to a basket of currencies, including the U.S. dollar. This policy was temporarily suspended during the global financial crisis.

What's Next for

2014? In November, top Chinese government officials met for the Third Plenary Session of the 18th CPC Central Committee (3rd Plenum). As part of the most significant slate of reforms announced in two decades, we believe some of the most interesting relate to the future path of exchange and interest rates. The key takeaway from the announcement implied that the government should allow the market to play a bigger role in the allocation of capital and resources. Similarly, many economists believe that the government is currently taking steps to allow the market to play a greater role in setting interest rates. We view this development as significant, given that we outlined it as one of the necessary prerequisites for the opening of the capital account, eventually leading to the free flow of capital into and out of mainland China. For 2014, we believe that demand for Chinese assets and currency will continue to increase, supporting a modest appreciation of the yuan. As we mentioned in a previous [blog post](#) with concern in the U.S. about [rising interest rates](#), we believe the yuan continues to be an attractive alternative to short-term U.S. fixed income. With a historical [volatility](#) of approximately 2%, the Chinese yuan may present investors with yet another way to increase the geographic breadth of their international investments. In our view, the Chinese yuan continues to make strides in global trade and financial markets. As a result, we believe that the yuan may continue to increase its significance in many investors' portfolios. ¹Source: Bloomberg, as of 12/31/13. ²Source: Bank for International Settlements (BIS) Triennial Survey, 2013. ³Source: SWIFT data, as of 12/3/13. ⁴Standard Chartered Bank, as of 1/7/14. ⁵Source: Bloomberg, as of 12/31/13. ⁶Group of 10: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, United Kingdom and United States.

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