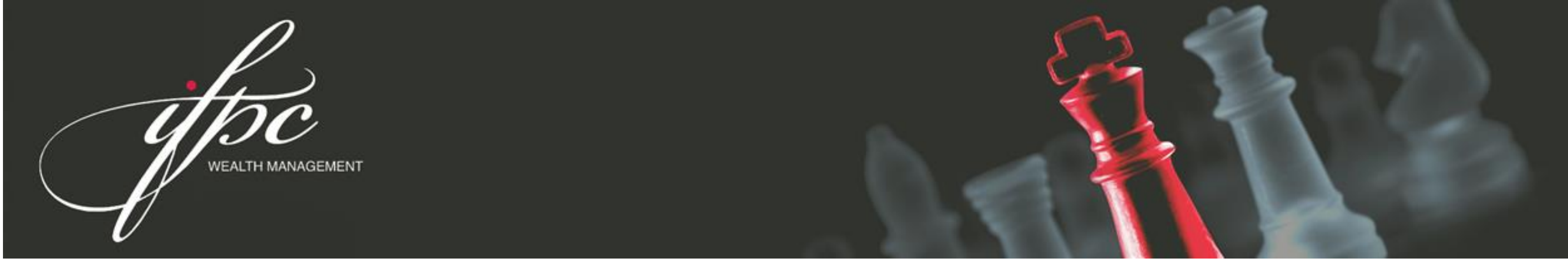


Enter The Dragon - The Impact Of China's Entry To The Currency Wars

Last year we highlighted the sudden eruption in currency volatility and why this could materially impact wider investment markets, most notably because the centre of gravity for this shift was a stronger US dollar. Within our analysis, one of the key risks was the likelihood that China's currency peg to the US dollar would have to give way, and this would further intensify pressure on commodities and the wider universe of emerging markets.

"China will never resort to a currency war," Chinese Premier Li Keqiang, Sep 2015

In our investment thought-piece last March (Navigating the Currency Wars) we examined the unfolding currency wars and what the potential implications would be for investment markets including commodities, emerging markets, China, and hence how we might prudently position our portfolios. Although the precise path can never be predicted in advance, it is apparent that our central scenario is playing out – that in which the pressure of a dollar-centric currency war has become unbearable for China.

US dollar strength has intensified

The dollar index chart below shows how the US dollar measured against a basket of America's major trading partners has fluctuated since the 1980s. Although it embarked on a similar period of strength in the late 1990s, this coincided with the 1997 Asian Financial Crisis in which several Asian currencies were forced to devalue. Since then, of course, the explosion in global trade, Chinese growth and US dollar debt (necessary to offset the recessions in 2001 and 2008) have significantly raised the stakes in terms of how US dollar shifts affect the global economy and financial system.

Chart 1: US dollar index still rising

Although this recent change of around 5% is somewhat modest against America's major trading partners such as Europe and Japan, it has been wreaking havoc elsewhere due to the continued slide in energy and raw material prices (shown in Table 1).

Table 1: US dollar price falls in commodity spot prices as at 23.01.16

	Since post '09 peak	Since March'15
Crude oil	-72%	-36%
Iron Ore	-75%	-32%
Copper	-56%	-27%
Aluminium	-51%	-16%

Source: www.infomine.com

Within the currency movement table shown below in Table 2, it is notable that despite further rounds of quantitative easing (QE) from both Japan and Europe over the last 12 months, both the yen and euro have failed to depreciate further. Yet as the rate of collapse in commodity exporter currencies start to slow, some of China's closest trading partners in Asia have started to devalue against the US dollar at a more meaningful pace.

Table 2: Currency movements measured against the US dollar as at 23.01.16

	Since post '09 peak	Since March'15
Canadian dollar	-49%	-13%
Australian dollar	-37%	-13%
Brazilian Real	-62%	-37%
South African Rand	-60%	-31%
Japanese yen	-35%	0%
The euro	-28%	0%
Malaysian ringgit	-31%	-16%
Taiwanese dollar	-15%	-7%
Singaporean dollar	-16%	-6%
Chinese renminbi (RMB)	-6%	-6%

Source: FE analytics

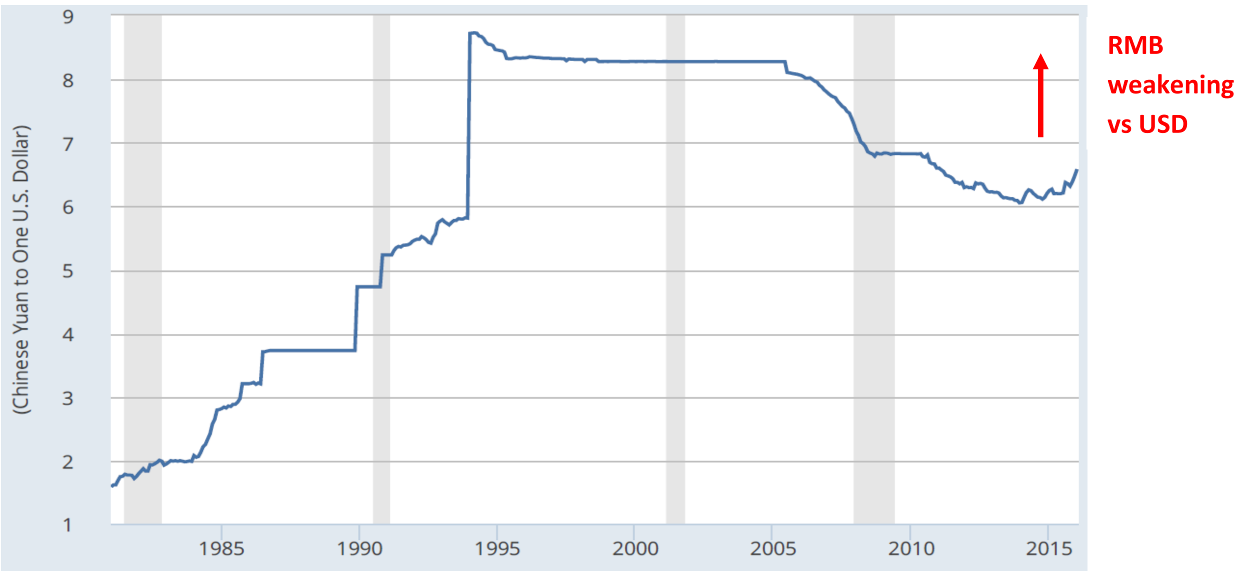
August was only the beginning for the RMB

Throughout most of its recent history, China's RMB has been pegged to the US dollar in one form or other, and between 2005 and 2014 China allowed it to gradually appreciate against the dollar in order to ease trade tensions. But in August last year, equity markets nose-dived heavily when China devalued the RMB by 3%, the largest single move since 1994.

This RMB shift, and the trend of creeping weakness that we have seen emerge subsequently, represents a new phase of the global currency war, in which China has decided to gradually allow market forces to move the peg lower and in doing so it will take its turn at the head of the beggar-thy-neighbour table.

The dynamics that are forcing China to devalue have been establishing themselves for decades, however the massive stimulus program that the government enacted in response to the 2008 crisis has allowed dangerous imbalances to build. Most notably, China's growth strategy has been driven by significant debt accumulation, with a total debt burden around 250% of GDP, a ratio which has doubled since 2007. With nominal GDP growth in China now slowing rapidly (and confirmed by very sharp falls in data points such as exports and power consumption), this debt/GDP ratio will continue to rise because the growth rate of outstanding credit is twice as high as the broader economy. Furthermore, China has a huge overcapacity problem throughout many of its core industries such as steel mills, real estate, metals & mining, power generation and shipbuilding. And its external trade partners are not exactly in a position to absorb this overcapacity, since thanks to aggressive central bank policies of zero interest rates and eye-watering liquidity injections (via QE), over-capacity problems are affecting almost every industry we look at.

Chart 2: Chinese RMB now weakening in US dollar terms



Source: www.stlouisfed.org

Capital flight is accelerating

As the currency movements shown above in table 2 highlight, capital has 'flown' meaningfully from those countries experiencing economic difficulties and where the exchange rate is free floating. Domestic governments will often intervene in currency markets in order to ensure an orderly move in their exchange rate, and this causes their currency reserves to be depleted. For 2015, it is estimated that $735bn in net capital left emerging markets, with all but $59bn of that coming from China. Ordinarily, this would have pushed the RMB much lower than it did, and therefore China must have intervened massively in order to prevent it. In fact, this is confirmed by a sharp decline in China's foreign exchange reserves, which have been on a rising trend for decades but are now contracting.

Some analysts believe that China's policy of encouraging a bull run in the Shanghai stock market in early 2015 was a botched attempt to prevent capital flight accelerating. Unfortunately this policy backfired terribly when the stock market more than doubled over the course of 12 months but then crashed by half. Unsurprisingly, reports suggest that many ordinary, retail investors piled in at the peak and have since seen their savings destroyed.

As China and the world economy slows, an over-valued RMB exchange rate becomes a serious headwind. On the one hand, if China continues to intervene in order to offset the capital flight, it will need to plunder its reserves and yet the domestic stresses will continue to build. On the other hand, if it embraces devaluation of the order of magnitude we have seen in Japan and Europe in order to protect its domestic industries and exporters, the ramifications for the rest of the world are severe.

Carry trades under threat

It is difficult to overstate the extent to which the relative strength of the world's reserve currency, the US dollar, is critical to the financial system. Throughout much of the last 30 years the US has implicitly sought to weaken the dollar in response to economic downturns. In doing so, it has encouraged a global 'carry trade' in which dollars were borrowed cheaply in the US and then exported overseas to China and emerging markets in pursuit of higher returns (creating a positive 'carry'). Large quantities of US dollar debt has been created in the process. The carry available from this trade has now turned negative as growth falters and the dollar strengthens, leading to an unwinding. When this process started to unravel in 2008 during the financial crisis, it was eventually short-circuited when the US Federal Reserve (the Fed) slashed interest rates to zero and started QE. Yet at this juncture it is difficult to see how this can be repeated because interest rates remain close to zero and the Fed recently raised rates by just 0.25% for the first time in this recovery.

Similar carry trades have also been initiated in the euro and yen. Again, it is the process in which the ECB (European Central Bank) and Bank of Japan have collapsed interest rates, initiated QE and encouraged euros and yen to flow overseas, often into emerging markets.

All of these carry trades are being threatened by the current volatility we are seeing in investment markets, and it could mean that emerging markets will bear the brunt of the de-risking process with potentially much further to fall.

In the very short term, of particular interest will be the Fed's response, since at present they appear to be locked into the mind-set of raising rates by 1% per annum for the next two years. Their projections also suggest that they believe neither growth nor inflation will be negatively impacted by these rate rises. Needless to say, market action is telling us that this is wholly inappropriate, which could bring some relief in the short term if their rhetoric starts to soften.

Key investment implications of China's move

The key investment implication of this shift by China can be described in one word: deflation. And this is a problem because virtually the entire array of monetary intervention that we have seen following the initial capital injections provided to back-stop the banks in 2008 were rolled out for one purpose – to raise inflation and hence nominal GDP to a level which would allow very high debt levels to be serviced.

The global commodity price collapse and anaemic recovery in wages mean that inflation levels are now declining sharply again throughout the major economies. All of the points discussed above which exacerbate this deflationary problem can therefore be summarised as follows:

- Debt levels now are much higher than 7 years ago
- A stronger US dollar is tightening global liquidity conditions
- The Fed is attempting to lift interest rates by 2% over the next 2 years
- Japan, Europe and now China want to export their deflation problem elsewhere

Furthermore, when we look at incoming data and price action across investment markets we observe the following:

- Global manufacturing surveys show widespread recession
- Corporate profit margins have peaked and will be anaemic at best
- Major equities markets have fallen 10-20%
- Borrowing costs for companies across both developed and emerging markets have increased meaningfully

On the latter point, up until recently the rise in borrowing costs had been largely confined to mining and energy, where profitability has been devastated by the collapse in prices. Yet, more recently, poor economic data confirming a broader slowdown has meant that borrowing costs are rising quite widely. In turn this means that companies will be more reluctant to raise capital through debt issuance, leading to a contraction in credit which itself adds to the self-reinforcing negative cycle in the economy.

Finally, if the currency wars continue and even intensify along the lines that we are seeing at present, it would be reasonable to expect trade wars to follow i.e. greater protectionism and tariffs introduced in order to prevent countries like China flooding the world with cheap exports such as steel.

Strategy

As a wealth management firm, we draw input from external strategists, including economists, hedge funds and investment banks. The vast majority of these strategists have completely misjudged the situation in China and the impact of where we are today on investment markets. Two years ago, when we started examining the tail risks of a strong US dollar, excessive QE and the potential deflationary problem we were seen as ill-informed or even naive. As recently as last summer, most of the strategists were flagging a successful growth rebalancing in China coupled with modest growth and a highly unlikely alteration to their exchange rate peg. Yet now, following China's modest devaluation and the sell-off in equity markets, the consensus has now apparently shifted to expecting a much stronger slowdown in China.

This shift may itself lead to a short term relief rally because quite a lot of exuberance has quickly been taken out of equity valuations. Ideally, though, we need to see some stability in the oil price and a change in the Federal Reserve's rhetoric, which will allow the US dollar to pull back from its current strength. As volatility subsides, there is no reason that equities cannot retrace a reasonable portion of the recent losses, but if a negative cycle has indeed begun then it is likely that this rally will fade as investors start to position their portfolios for recessionary conditions.

Within our portfolios, capital preservation is always our primary concern. The risk 'hedges' that we have sought to use in the form of long-dated US treasury bonds and hedge funds have worked well and dampened the impact of declines in our equity exposure. Furthermore, the equity positions that we have held were deliberately chosen for their defensive postures and have outperformed the broader market. Finally, the large, conviction position in UK commercial property that we established in late 2013 has been a persistently positive contributor.

Since the key balance of the portfolio is working effectively, there is no requirement to make immediate structural changes. However, in response to these abrupt market shifts we will be aiming to further strengthen our portfolio hedges through long-dated government bonds which will be the prime beneficiary of deflation. We have also selectively clipped our exposure to commercial property as a rebalancing exercise.

In addition, for our lowest risk investment strategy (Cautious) we have removed exposure to short-dated high quality corporate bonds. This has meant that cash levels for this strategy have climbed significantly, which we believe is appropriate following such a strong run over the last 2 years.

Looking ahead, one of the asset classes that we reduced significantly last year was high yield bonds, which are the riskiest part of the corporate bond market. After so many years of yield-chasing by investors this market had become quite bloated in our view, and we felt that liquidity was poor. Yields of bonds issued by energy and mining companies have spiked enormously as stresses in these sectors build and investors demand higher returns, and this is starting to infect the entire asset class. Going forward, however, as bankruptcies start to come through and institutional investors start to withdraw, we feel that there will be some very compelling opportunities to re-build our exposure to 'distressed' parts of the market at very attractive valuations.

Similarly, valuations in emerging market equities are becoming much more interesting on a long-term view, especially since local currencies have dramatically devalued against sterling and the US dollar. Despite that, we believe that the cleansing process is in the early stages and we will need to move into a phase of bankruptcies that will allow excess capacity to be taken out of the system. As this process unfolds we should be presented with compelling entry points to those companies and countries that eventually emerge in good shape from the downturn.

Summary

Many of the concerns that we articulated in March last year about how a persistently strong US dollar might impact the investment landscape are now becoming a reality. Indeed, having seen a crisis in North American housing in 2007, a European debt crisis in 2011, we are now potentially entering a new phase in which emerging markets and China are at the core. Although attempts will be made, in our view, to administer yet more monetary policy solutions such as QE and negative interest rates, in an attempt to push the problem further down the road, these methods can only alleviate the shorter term liquidity constraints and cannot address the underlying solvency issues that arise from the persistent rise in excessive debt burdens. In due course, once it becomes apparent that the current central bank toolkit is effectively impotent, we believe that more unorthodox policies will ultimately be deployed in order to short circuit yet another unravelling of systemic risk in the financial system – even more unorthodox than the estimated $9 trillion that has been thus far spent by the major central banks. 'What happens next' will be topic of our next investment note.

In the short term, a number of positive catalysts could provide relief to equity markets. These include the fact that commodity prices have crashed almost without interruption and it would not be a surprise to see some stability. Secondly, now that the US economy is also succumbing to weakness in the rest of the world, it quite likely that US interest rates will not rise as fast as feared, thus allowing the US dollar to soften and in turn this will relieve the immediate pressure on China and emerging markets. Finally, although consumers have thus far been reluctant to spend the windfall gained from lower energy costs, this may not continue indefinitely and a period of stability may allow spending patterns to strengthen.

Overall, our portfolios continue to be positioned cautiously in the near term and we believe that risks are to the downside. However, as some of the excesses and imbalances in investment markets are unwound we expect to be presented with some exceptional, long-term investment opportunities.

February 2016