Global Investment Letter

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YUAN DEVALUATION ONE OF A NUMBER OF POTENTIAL BLACK SWANS FACING MARKETS

Macro factors are currently playing, and will continue to play, an unusually large role in the generation of investment returns for the balance of the decade. Negative interest rates and other unprecedented actions by central banks, high debt levels, competitive currency devaluations and geopolitics will all play a role. The surprise devaluation of the yuan last August and its subsequent weakness in January dominated business headlines worldwide. While the easing of pressure on the yuan in the past couple of months has caused most of the attention to shift elsewhere, I believe yuan devaluation remains an important macro consideration with a greater chance of occurrence than most believe. It is one of a number of potential "black swans" extant, any one of which could prove to be a catalyst to dramatic events in the global economy.

The yuan has appreciated considerably versus the US dollar over the past decade, peaking late 2013. While the yuan has weakened since then, it has retained the bulk of its appreciation over the past 10 years. The decline of the yuan is due to a combination of growing awareness of weakness within the Chinese economy and general US dollar strength. Chinese annual economic growth has slowed from a reported circa 10% to a currently targeted 6.5-7.0%. A slowing of growth is not surprising given that the law of diminishing returns will slow growth as an economy expands. However, the current growth rate is more realistically 1%-3%. The Chinese economy has clearly slowed significantly. Chinese exports for the year ended January fell 11.2% while imports fell 18.8%. Major factors affecting the Chinese economy such as overcapacity, problem debt, corruption, etc., have been well documented and need no further elaboration here.

The combination of weakening Chinese growth and a still robustly priced yuan has attracted investor interest, and short positions against the yuan have risen substantially over the past year. Investor interest was certainly piqued by the Chinese adjusting downward the trading band with the US dollar. It is anachronistic that the currency of the second largest economy is tied to that of the first in the 21st century. It is unlikely that the current yuan/dollar peg will last.

The Chinese have responded to the slowdown with monetary easing, with the depreciation of the yuan playing a part. However, the Chinese appear to want to devalue the yuan in their own time and have reacted defensively to yuan weakness, which they attribute to short sellers. They have intervened to defend their currency, reducing their formidable foreign exchange reserves by some $800 billion from their peak to $3.2 trillion. The actual amount spent is much larger when one considers China's large ongoing trade surplus.

Pressure on the yuan eased in March, allowing the currency to rise versus the dollar and the foreign reserves account to post a modest gain. However, it is likely that pressure on the yuan will return. The Chinese economy, and indeed the global economy, remains less than robust. In time, Chinese authorities must respond to the ongoing efforts at competitive devaluations being practiced by major central banks. If one wishes to rule a one party state, as the Communist Party does, social peace is paramount. Policies that foment disenchantment and unrest must be avoided at all costs. Therefore, Chinese authorities will not hesitate to devalue if they see it as a means of arresting a continued economic slowdown. China unexpectedly made a sharp devaluation in 1994 that, in hindsight, made a significant contribution to the export fueled growth that followed.

China certainly has the reserves to defend the yuan for some time. They may continue to intervene as they have done because they don't want the value of the yuan to be set by third parties. However, spending foreign exchange pulls reserves out of the economy that could be more usefully directed elsewhere. It also does not address the issue that a lower yuan is in China's best interest. China is attempting to move to become a more consumer driven economy, but the export sector will remain important for some time given the number of people it employs. A lower yuan would benefit the export sector while aiding domestic Chinese manufacturers serving the domestic economy by making imports more expensive.

It is my belief that if Chinese authorities desire a lower yuan, they will likely implement a surprise 10%-20% devaluation rather than adopting a managed devaluation over time that will erode foreign exchange balances. Large companies in China that have US dollar exposure have greatly increased their hedging activities of late, suggesting that expectations of meaningful yuan devaluation are increasing.

What China does with the yuan remains to be seen. All an investor can do is attach probabilities to outcomes to arrive at a risk/reward balance. In my view, the probability of sudden devaluation is higher than most assume for the reasons discussed. Certainly the prospect of a sharp yuan devaluation should factor into investors exposure to yuan denominated assets.

As for the consequences of a significant devaluation, it would likely provoke another round of quantitative easing from the Fed and other central banks. The Chinese have hitherto been the "good citizens" with regard to competitive devaluation. We may not be able to count on their patience indefinitely.

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