HIGHLAND

MARKET BRIEF
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CHINA'S CURRENCY TANGO

Since the mid-2000s the People's Bank of China ("PBOC") has kept its currency, the yuan, tightly pegged to the U.S. dollar. This policy benefited China for many years due to the dollar depreciating versus its trading partners. However since 2014, the U.S. dollar broad index has risen 16%. With the dollar peg in place, the Chinese currency appreciated in a similar manner. For a country that is heavily dependent on exports, this is a strong headwind for their exporting business.

China's economy has been experiencing a slowdown since the second half of 2014 and on August 8th, China announced that exports fell 8.3% in July. Two days later the PBOC announced a change to the methodology used to determine the yuan's fixed pricing level. Instead of the PBOC solely determining the exchange rate, the PBOC will now apply a formula that takes into account the previous day's closing rate to determine the yuan's initial trading level. The PBOC proclaimed that this will allow market to play a larger role in determining the exchange rate. After the announced change, the yuan depreciated 2% which was the largest one-day move since 1993.

There are two schools of thought as to why the PBOC enacted this change – boost economy via exports or obtain reserve currency status.

ECONOMIC BOOST

China is faced with a predicament. It needs to move towards a more consumption driven economy, but the only way the country knows how to grow is through exports and investment. For years, China has grown by allocating capital to inefficient state-driven investment and low-wage jobs focused on exports. China has been able to endure this malinvestment because it had a growing workforce and ample foreign capital flows. However, both of these tailwinds have subsided. Morgan Stanley recently pointed out that China is projected to experience a decline in its working age population beginning in 2016. China's one child policy as well as its attitudes toward immigration is hurting its future growth prospects.

We are not aware of a country that has ever successfully transitioned its economy from an export and investment driven economy to a consumption driven economy. This evolution by China's ruling party has been dubbed the "Great Economic Miracle." With the change to a more consumption driven economy comes the agony of lower growth. From 2003-2007, China's export growth on a year-over-year basis averaged 31% growth, while exports the last two years have only averaged 5% growth. Since 2008, net exports have detracted on average 0.4% from China's GDP while Consumption has contributed 4.3% to GDP each year. During that same time, GDP growth has declined from 10% to 7% per year as investment has continued to be a big driver of growth. Only so many empty condos and infrastructure can be built before time runs out on their ability to make this conversion.

China's current account as a percent of GDP has fallen from 9% in 2008 to 2% as of March 2015. This type of decline is not an issue as long as China is continuing to see net inflows of foreign capital. However, China has recently seen capital flowing out. Since June of last year, foreign reserves have declined $350 billion, or 3.4% of GDP, as China has drawn on these to support its currency.

Weakening a country's currency can be a powerful tool by Central Banks to boost its economy. A weaker currency can help an economy by potentially boosting exports, jobs and inflation, as well as increasing corporate earnings. Europe and Japan have enacted massive quantitative easing programs which weakened their currencies significantly against the yuan. The yen has fallen by

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about a third since September 2012 while the euro has fallen by a fifth since March 2014. By weakening its currency, China can become more competitive and lift its economy through increased exports and manufacturing production.

It is China's desire to grow its economy through consumption which is a more stable and reliable way to increase the country's wealth. A strong yuan supports domestic buying power and makes imports cheaper. China needs to continue with reforms that increase productivity as well as make it easier for private companies to grow and compete in sectors that have been dominated by state-owned enterprises. Despite all of this, China is utilizing its "old playbook" of investment and exports to get its economy on stronger footing. China's actions demonstrate that the country may not be ready to make the necessary reforms to boost its productivity and standard of living for its inhabitants. It is important to realize that although China has the 2nd largest economy in the world, its GDP per Capita in U.S. dollar terms is less than $8,000 which ranks them below Colombia, Romania and Costa Rica.

RESERVE CURRENCY STATUS

A reserve currency is a currency that is held in significant quantities by governments and institutions as part of their foreign exchange reserves. This means the currency can be utilized for international trade and settlement. The PBOC has been very upfront of its desire for the yuan to be included the International Monetary Fund's ("IMF") Special Drawing Rights ("SDR"s) which would give it reserve currency status. Being encompassed in the SDR would cement China as a global economic powerhouse. This would place its currency on par with the other currencies in the SDR, the U.S. dollar, euro, yen and the pound. In addition, if China is concerned about capital outflows, then being included in the SDR would force countries to keep yuans on hand for international trade and settlement. This could certainly aid the Chinese capital account.

On August 5th, the IMF indicated the Chinese yuan is not ready for inclusion in the basket of SDRs. The IMF extended the deadline for its review of the current SDR until September 2016, therefore the yuan still has a good chance of being included in the near future. The IMF specifically questioned the yuan's exchange rate flexibility and whether the currency is "freely usable". One week later the PBOC announced the change to the pricing of their currency to be determined more by market forces. Since this announcement, the IMF has stated it welcomes this change and that it is certainly a step in the right direction for making the yuan more freely usable.

HIGHLAND'S VIEWPOINT

Since the PBOC changed their methodology for the yuan, the yuan has depreciated 3% versus the dollar. Is this a function of market forces or their central bank weakening their currency? Probably a little of both. If the PBOC declares it is weakening its currency, then it risks a massive outflow of foreign capital. By stating this is a move towards a freer exchange rate, they appease the IMF while also allowing the currency to weaken. Most likely the yuan will continue to weaken against the dollar.

We expect the dollar to continue to remain strong. This most likely will not deter the Federal Reserve from raising interest rates for the first time in 9 years. We would expect commodity prices to remain lower as the dollar strengthens. If China continues to weaken its currency, this should put a ceiling on bond yields as inflation is suppressed. In addition, since China is one of the largest consumers of commodities and many of these are imported into China, we would expect countries like Brazil and Australia to be negatively impacted by the yuan weakening. Inflation should remain subdued globally as deflation is exported to the rest of the world. China will drop its prices on exports to try and take market share from its competitors. While China's revenues should rise, we expect this will put pressure on China and its trading partners' margins. This could impact U.S. earnings where profit margins are still close to all-time highs. Therefore, we continue to favor a global equity approach where valuations are cheaper and margins are not as elevated.

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