

### China - one year on from the panic

We have held direct exposure to Chinese equities across our portfolios since late 2011. We also believe that the performance of the Chinese economy and markets is critical to the health of the broader Emerging Markets region. Needless to say, our exposure at times has been subject to market volatility during some of the more testing periods. It is with this in mind that we recall the events of one year ago, when the People's Bank of China made a one-off currency adjustment, the consequences of which rattled world stock markets.

The fracas that erupted after the daily reference rate was lowered by the largest amount in one day since July 2005 was a part of the broader efforts to bring a more market-determined focus to China's exchange rate regime. In recognition of these efforts, the International Monetary Fund included the renminbi in its Special Drawing Rights in November 2015. The Chinese renminbi is now one of only five currencies with international currency reserve status. A further currency adjustment was made in January 2016, contributing to significant market volatility and fears that China's authorities were losing control of the 'managed' slowdown.

### Financial markets more comfortable with renminbi depreciation

As global equity markets have settled since early February, it has perhaps been somewhat surprising that financial markets have overlooked the steady depreciation of the renminbi at the same time that the US dollar has strengthened. The renminbi has fallen 3% versus the US dollar since the end of March, while the US dollar has appreciated 2% on a trade-weighted basis. While the numbers appear relatively small, this trend represents a meaningful shift over the longer term. Since the end of 2013 to the time of writing, the renminbi has depreciated 10% against the US dollar, while the US dollar has appreciated 2% on a trade weighted basis.

In contrast to the volatility seen at the start of this year, it is noticeable that financial markets seem to be more comfortable with renminbi depreciation. We believe there are three main reasons:

1. The Chinese authorities have made efforts to improve their communications with financial markets and clarify the exchange rate regime, which has gone some way to easing investors' concerns.
2. Policy measures implemented since late last year are taking effect and we have seen a cyclical improvement in recent months. Second quarter real GDP was reported in line with expectations (7.1% quarter-on-quarter, annualised). Exports have improved, retail sales growth remains solid and manufacturing surveys have stabilised. Moreover, we are continuing to see further progress in the authorities' efforts to rebalance China's economy. June's activity data showed a divergence between shrinking investment in industrial sectors of the economy versus stronger investment in technology and service industries. In particular, fixed asset investment growth continues to slow in industries suffering from overcapacity.
3. Capital outflows have stabilised since March of this year and foreign exchange reserves rose by US\$13.5 billion in June, notwithstanding renminbi depreciation and the unfavourable valuation effects of the US dollar. The central bank has also provided indications of further financial market liberalisation, including the opening of the domestic bond market to foreign investors, which could boost flows into China in the longer-term.



## Contact

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### What is the outlook for China's currency?

As ever, a lot will depend on the US Federal Reserve policy and the trajectory of the US dollar. There would be more pressure for the renminbi to depreciate if the US dollar were to strengthen than weaken. In a 'lower for longer' interest rate environment and with the Federal Reserve seemingly in no hurry to raise interest rates, then we do not believe we are about to enter another period of significant US dollar appreciation.

Another factor influencing the currency's performance is domestic economic data. Any significant deterioration in China's economic data would obviously be negative for the currency. We have just been through a relatively benign period of China's economy, which has benefited from positive cyclical momentum in response to policy easing measures enacted since late last year. However, the Chinese economy continues to face challenges, not least the build-up of corporate debt to around 150% GDP. This presents a dilemma for policy makers who are trying to manage a structural slowdown while at the same time avoid stoking a credit bubble. For these reasons, we believe that most of the policy easing has already been done, and we are not expecting additional monetary or fiscal stimulus in the near term. Our central case remains intact that a soft landing in China will be achieved, but expect bumps ahead as the economy continues through its transition.

Finally, it is also worth highlighting that the real effective exchange rate of the renminbi remains nearly 25% overvalued, according to the Bank of International Settlements. There is room for further gradual depreciation against the US dollar and we expect this trend to remain intact. Furthermore, as China's currency receives more recognition of its global currency reserve status, we would expect investors to focus less exclusively on the US dollar and consider its performance against a broader range of currencies.

**Jade Fu**  
Investment Manager

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Registered Head Office: No.1 Kingsway, London, WC2B 6AN | Registered in England Number: 4132340  
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