August 2015

Market Update – China Edition

Over the last couple of days we have dramatic movements in the markets that have been attributed to China manipulating their currency. We have even heard the "Donald" telling the world that the Chinese are manipulating their currency to our detriment. Unfortunately Mr. Trump skipped economic class. He is tapping into a fear that is unfounded in economic policy. Here is why.

First we need to understand what currency is and isn't. Take the US dollar, for example. What is it? It is a store of value for goods and services that we purchase. The US dollar used to be backed by gold. This prevented the government from manipulating the value of the dollar. They could not print more dollars unless they had more gold. This restricted the money supply in the system. Today, however, we have a "fiat" currency. The US dollar is no longer backed by gold. For all intents and purposes, the US government could print as many dollars that it wanted to pay for whatever it so desired. The only thing that prevents the government from doing this is the realization that if they printed too many dollars, the price of things would be inflated upwards, but their "value" will not have changed. In other words, we have monetary inflation.

Take a small self-sufficient community that has $1,000,000 of dollars in circulation. If you could not go outside the community to buy or sell things, you would generally have a stable currency. Prices would not rise nor fall. However, if long lost Uncle Sam came to town with a briefcase of $1,000,000 and decided to give the money away, what would happen? Prices would rise by $1,000,000 in aggregate. No additional products or services would be needed (demanded), but the value of the money in circulation declined by 50%.

Now let's add a second self-sufficient community, Chinatown, to the mix. Suppose one enterprising young person left the US town for Chinatown. He discovered that he could buy items in Chinatown, but they did not accept his dollars, they only accepted China currency. Ok, how much China currency would a $1 get you? Suppose it was a 1:1 relationship; for every dollar you gave them, you would get one China dollar back. When you bought that $20 bath brush, you would pay 20 China dollars.

This is a pretty straightforward transaction. But what happens over time as the communities have changes with their currency? Suppose Chinatown wanted to spur more sales to US town. They could "devalue" their currency. That means they had a long lost Uncle that came to town and gave away 1,000,000 China dollars. When our young person came to town to buy a bath brush, instead of paying $20 for the brush, he would only spend $10, because the China dollars are only worth half as much.

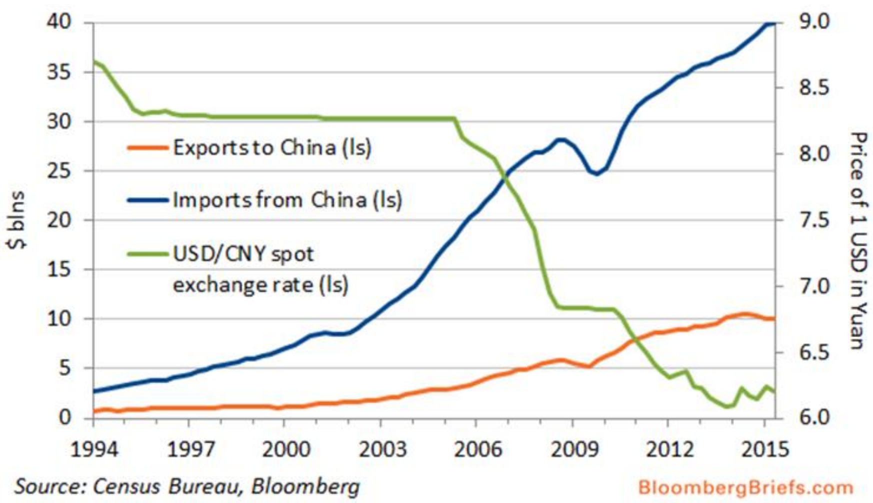
This is what is currently happening in China. They are devaluing their currency relative to US dollars. The word "devalue" here is relative. We have seen currencies like Russia fall on the magnitude of 80% in the past year, the Chinese yuan, however, has been devalued less than 2%. In relative terms, this is a very small move. As the chart suggests, the value of the Chinese Yuan to the dollar has been strengthening since 2006. This has made products and services we buy from China more costly. As they devalue, they will become less expensive.

What are the negatives to this move? The negatives come to foreign manufacturers trying to sell into the China market. Dollar based manufacturer's products and services will become more expensive than local ones. The same holds for Euro based manufacturers. When the announcement was made, you saw stocks of companies that had a high level of sales to China fall, such as car makers, mining companies and luxury good makers.

The larger concern is that we will continue to see the Chinese currency fall, if it is allowed to trade openly without Chinese intervention. This would continue to put pressure on equities and commodities going forward. This is because China is a significant global buyer of goods and services. If foreign manufacturers are now going to compete with Chinese with a depressed yuan, the local manufacturers would have a price advantage.

Another potential impact of this move is that it could put the highly anticipated Federal Reserve rate hike on hold. With China allowing its currency a wider band to float, any interest rate increase in the US will, more likely than not, cause the US dollar to continue to strengthen. This will continue to slow exports to the degree that they will not be as competitive in price as foreign sources; essentially tightening the demand for US goods on a global scale.

So where do we go from here? Ultimately currency changes that are allowed to follow market forces are much better than those that are restricted by policymakers. So in the long run, we see this development as positive for global growth. We also see a strengthening US dollar as good for the US consumer. Inflation will be kept at bay for a very long time as we import much more goods and services than we export (see chart).



The arguments against this are going to come from the political pundits that will argue from a populist perspective. "We are sending all our jobs overseas." And, in effect, this is true. Low paying manufacturing jobs will be best utilized in lower cost countries. However, trading lower paying jobs for a more competitive cost for goods and services will ultimately be good for the US economy (we import more than we export). The other argument that you will hear is that the Chinese are manipulating their currency. Again, this may be true, but keep in mind that all the QE programs that the Federal Reserve embarked on, also manipulate currency. There are very few Central Bank decisions that do not have an impact on currency. So the politicians should tread lightly on this one (we know they won't in an election year.) We certainly do not want to get to an overt currency war that could have dramatic impacts on all the markets in the future.

Does this change our investment strategy? At this point, no, it reinforces it. The country that has the most to gain from this devaluation is China, or emerging markets in general. The country that has the most to lose are those countries that export the most to China, mainly the US and Australia. The US will continue its slog through a 2% GDP growth. The US companies that are large enough to move operations overseas will, where it merits it. In the long run, free floating currencies always find the right place to go. It is, however, very difficult to try to time or guess where any particular currency will go, as they are very dependent on Central Bank policies. We would prefer to see the markets work themselves out, rather than make a guess.

As always, please don't hesitate to let us know if you have additional questions.

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