NEPC MARKET CHATTER

China's Devaluation of the Yuan

Believe it or not, it's been over three weeks since we've last written about China. We are being facetious of course. When we discussed the concept of the NEPC Market Chatter, we envisioned ourselves sending timely, relevant, educational and diverse thought pieces to you. So far, we feel that we have managed to hit the first three criteria, but the jury is still out on the diverse measure. Once again, China is the headline act and we will take you through the ins and outs of their recent currency devaluation.

What Happened?

Last week, China's central bank, the People's Bank of China (PBoC), took swift but measured actions to devalue the Chinese yuan (also known as the Renminbi) relative to the US dollar, resulting in a loss of about 3%. Following the devaluation, the PBoC signaled it will allow the market to have a greater role in setting the daily yuan/dollar exchange rate.

The central bank's policy shift, from a tightly controlled currency float to a more market sensitive approach, can be interpreted in a couple of ways.

1. Idealists would reason that China's recent action is the next step in a long-term process to expand market oriented economic reforms and ultimately shift to a fully flexible exchange rate.
2. Cynics might argue the yuan's decline is a policy lever the PBoC may continue to pull, or allow the market to pull, merely to stimulate a slowing economy.

Certainly, support can be found for both views. Keep in mind that the recent decline in the yuan pales in comparison to the relatively recent depreciation of the yen, euro, and other regional competitors **(Exhibit 1)**. And in reality, this stimulus measure is not entirely different than the easing policies of developed market central banks. But reversing the long-term appreciation of the yuan and letting market forces push the currency lower clearly benefits ailing exporters in China and is a timely tool to manage a cyclical downturn in their economy.

Background

It's no secret China's growth has been decelerating as it manages a delicate evolution from an export and investment-reliant economy to a consumer-oriented growth model. This evolution has been a long road for China as the government has incrementally liberalized mainland financial markets. Since eliminating its explicit currency peg to the U.S. dollar (USD) in

Exhibit 1: Cumulative Change in Spot Price (Versus USD since 12/31/2004)

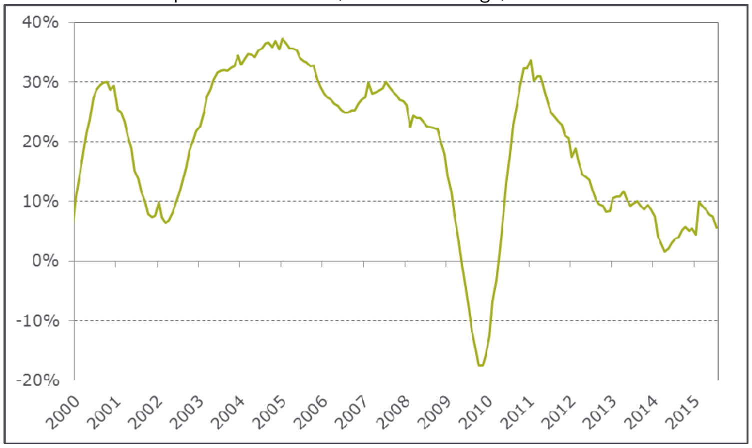
Source: NEPC and Bloomberg

2005, China has employed a tightly controlled currency float which has allowed the yuan to steadily increase in value by nearly 25% versus USD. While the strengthening yuan has bolstered China's effort to encourage a more consumer-oriented economy, the opposite has been true for export growth **(Exhibit 2).** This has been exacerbated more recently as the yen, euro and other regional currencies have rapidly sold off and depreciated versus the yuan.

How Does This Affect Your Portfolio?

To be clear, we believe it is unlikely your portfolio has significant yuan exposure. The MSCI Emerging Markets index has a heavy weight (almost 18%) to China, but nearly all of the exposure is in Hong Kong dollars which is pegged to USD. (See our previous NEPC Market Chatter for an explanation of Chinese "H"-shares versus "A"-shares.) In our minds, the likely impact of China's new currency policy is the transmission of higher volatility to the currencies of its major trading partners and export competitors. Much like when a central bank devalues its currency via quantitative easing, the net effect is often an increase in external currency volatility as the market and other central banks adjust to trade implications. While China has significant trading partnerships with developed economies such as the US and Germany, many emerging or geographically proximate economies such as Indonesia, Malaysia, South Korea, and Australia rely more heavily on trade with China. Perhaps most importantly, economies, and ultimately the financial markets, of these countries are likely to experience increased volatility and trade adjustments as the effects of the yuan policy change take hold.

Exhibit 2: China Export Growth Rate (12-Month Average)



Source: NEPC and Bloomberg

While it is too early to speculate what the long term implications the yuan's devaluation and PBoC's policy shift will be, it is clear that the Chinese government is closely monitoring external market conditions and is willing to take proactive measures to protect growth as part of its longer term transition to a consumer-focused economy. As part of an emerging market allocation, NEPC recommends that clients seek exposure to benchmark-agnostic strategies, preferably with managers that attempt to exploit the emerging market consumption theme as well as smaller capitalization stocks. Talented managers, who are not tethered to a benchmark, are able to adjust and move as opportunities evolve and the emerging market story plays out. In addition, recognizing China's impact on the global economy, we continue to recommend a partial hedge of developed market currency exposure as uncertainty surrounding the potential weakening of the yuan may elevate currency volatility globally.

We encourage you to reach out to your consultant with any lingering questions you may have regarding the impact of the yuan on your portfolio. While China has dominated our Market Chatter pieces to date, we look forward to sharing a broader range of our views in the future.

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