PORTFOLIO INSIGHTS

A possible change in Chinese currency policy?

September 2019

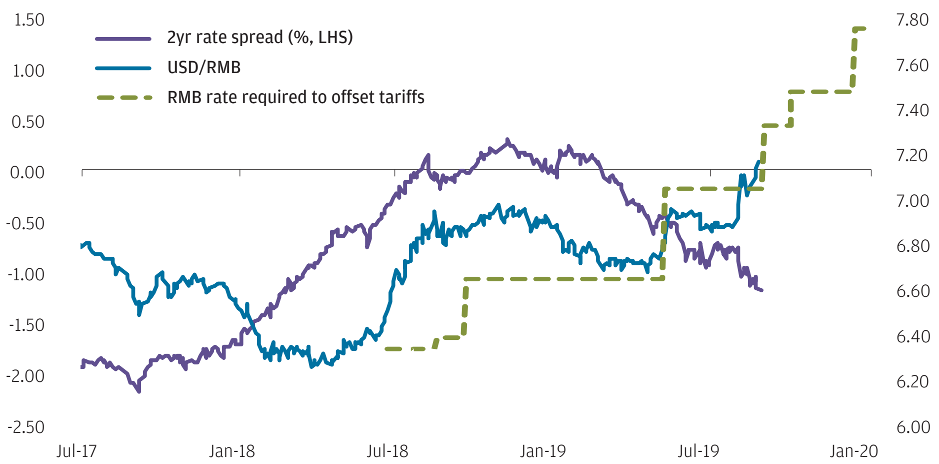
IN BRIEF

- The weakness in the renminbi since the escalation of trade tensions earlier this year has come in contrast to a narrowing in interest rate differentials versus the US dollar.
- More recently, the renminbi's weakness has become more idiosyncratic and closely linked to Chinese policy decisions rather than reflecting broader regional trends.
- Given the currency's persistent weakness, many investors are asking the same question: Is the renminbi being used as a policy tool in the trade war?
- Beyond the politics, our assessment of the underlying fundamentals suggests that depreciation pressures are likely to remain for some time.

Is the renminbi offsetting Trump's tariffs?

It is certainly striking that the renminbi has now weakened to levels that are broadly estimated to offset the US tariffs implemented to date, while the recent falls in the Chinese currency—in contrast to last year—have aligned much more closely to the timing of tariff increases. The tone of the Chinese press has also changed noticeably following the imposition of additional tariffs, which were announced following bilateral meetings that the Chinese had perceived as constructive.

USD/RMB EXCHANGE RATE VERSUS TWO-YEAR RATE SPREADS



Source: Bloomberg, J.P. Morgan Asset Management; data as of 29 August 2019

J.P.Morgan Asset Management

Has the role of rate spreads diminished?

The breakdown in the relationship between rate spreads and currencies is not unique to the renminbi. Several developed market currencies have experienced a similar trend, even as rate spreads have moved against the US dollar. We believe the dollar is broadly benefitting from the support that the US equity market is receiving from falling US rates, in a way that is typical of non-recessionary easing cycles. As a result, we have placed a greater weight on equity performance as an indicator of currency prospects across a wide range of countries. US equities and the US dollar would surely fall if the US enters a deep recession.

Trade tensions are weighing on the growth outlook globally. The US-China trade conflict, along with some specific issues in certain sectors, such as autos and semiconductors, has seen global trade contract at the fastest rate since the financial crisis. Globally, central banks have moved to a more dovish policy stance and a number have already started to reduce interest rates. Where the policy response has been, or is likely to be, insufficient to raise growth prospects, we feel currencies are still vulnerable even if interest rates are falling less relative to their peers—again in contrast to the typical relationship between rate spreads and currencies.

In the case of China, the limited policy response reflects concerns the authorities have around adding too much additional debt to sectors of the economy that are already highly indebted. So far we have seen a more tentative and targeted approach than in the past, with a greater focus on tax cuts and structural reform to support consumption. However, this approach has so far not been sufficient to mitigate investors' growth fears.

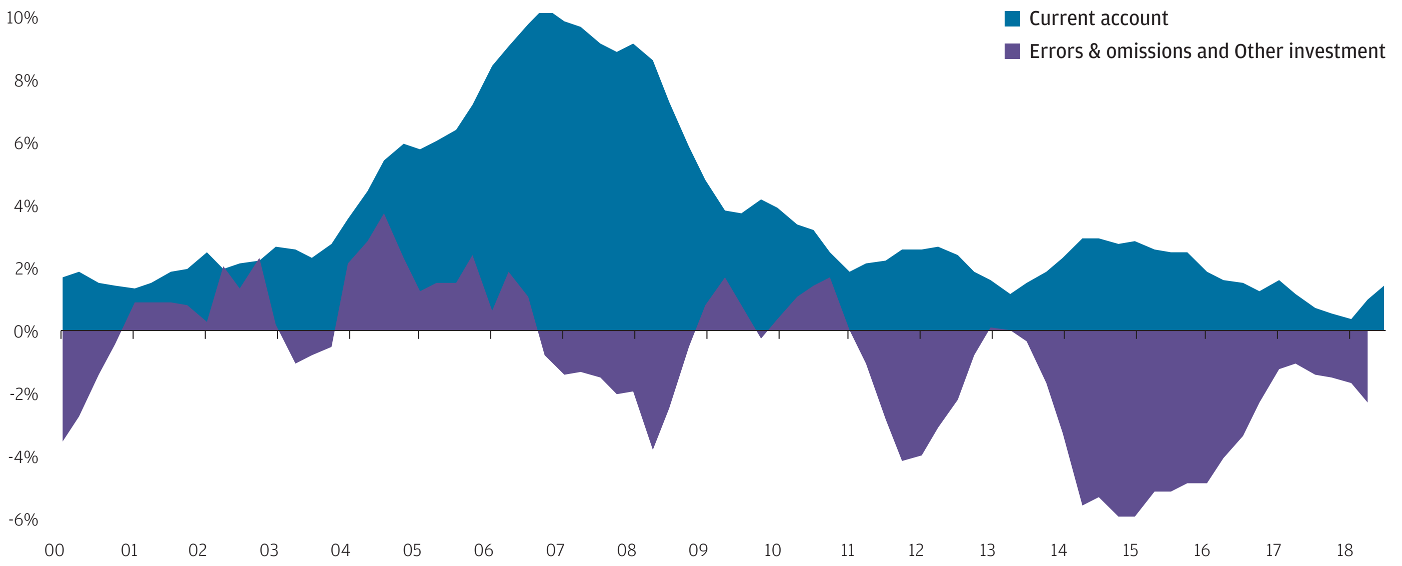
Assessing longer-term currency fundamentals

While it is hard to avoid the conclusion that the withdrawal of support for the renminbi has been a factor in the currency's recent weakness, our assessment of the underlying fundamentals suggests that depreciation pressures are likely to remain for some time. The significant trade and current account surpluses that China generated in the mid-2000s have been gradually eroded over the last decade and, while we do not yet see signs of the outflow pressures that led to the more destabilising fall in the renminbi in 2015 and 2016, we are watching this situation closely.

We note that the growth in money supply within China has materially exceeded growth in reserves since the financial crisis, raising the prospect that eventually outflows could become unmanageably large with only a small change in domestic attitudes towards the renminbi and modest gaps in the capital control framework. Our central case remains that China's highly effective capital controls will be sufficient to avoid significant reserve attrition and provide authorities with scope to control the pace of the renminbi's depreciation.

The fundamental challenges faced by the renminbi also mean that any attempt by the Trump administration to unilaterally intervene to strengthen the currency are unlikely to be successful on anything other than a short-term basis, although this prospect may not be sufficient to deter a US president who is prepared to adopt bold and unconventional policies to achieve his objectives.

CHINA CURRENT ACCOUNT, AS A PERCENTAGE OF GDP



Source: Bloomberg, J.P. Morgan Asset Management; data as at 29 August 2019.

Currency Management

Since our first segregated currency overlay mandate funded in 1989, J.P Morgan Currency Group has grown to manage a total of USD 361 billion in bespoke currency strategies. Our clients include governments, pension funds, insurance clients and fund providers. Based in London, the team consists of 20 people dedicated exclusively to currency management with an average of over 15 years of investment experience.

We offer a range of hedging solutions for managing currency risk as well as a tailored optimal hedge ratio analysis:

- Passive currency hedging serves to reduce the currency volatility from the underlying international assets. It is a simple, low cost solution designed to achieve the correct balance between minimising tracking error, effectively controlling transaction costs and efficiently managing cash flows.
- Dynamic 'intelligent' currency hedging aims to reduce currency volatility from the underlying international assets and add long-term value over the strategic benchmark. A proprietary valuation framework is used to assess whether a currency looks cheap or expensive relative to the base currency and the hedging strategy is adjusted accordingly.
- Active 'alpha' currency overlay strategy offers clients' passive currency hedging, if required, combined with an active investment process to deliver excess returns relative to the currency benchmark. Our approach is to build a global currency portfolio combining the output of fundamental models and incorporating the qualitative views of our strategy team.

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