



Joe Benevento and  
Joern Wasmund,  
Global Co-Heads of  
Fixed Income/Cash

# Fixed-income market perspectives

## The China syndrome

China and commodities continue to unsettle the markets. The PBoC started to devalue its currency in mid-August. While the adjustment so far may not look that significant, it constitutes both a monetary-policy regime shift and an implicit admission of slower Chinese economic growth.

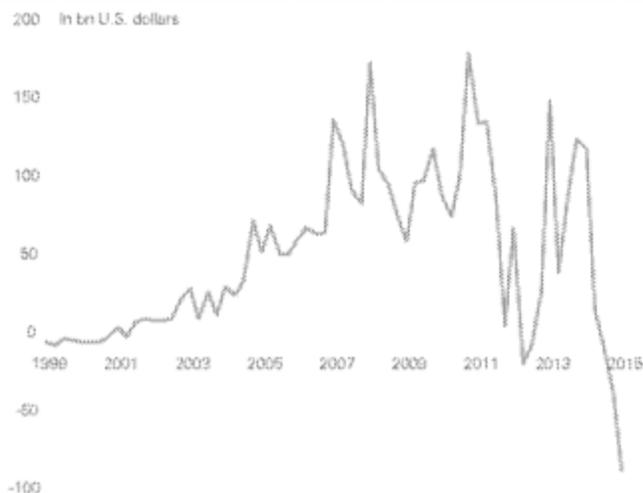
To better assess the importance of the move it is helpful to contrast the physical and economic size of China with its relatively low GDP per capita (one seventh that of the U.S., in U.S. dollar terms). This catch-up potential is important for global growth and, in particular, commodities. Externally, to underpin its global position, China also wants to establish the yuan as a key trading currency, with the aim of reducing the emerging markets' dependence on the U.S. dollar. It is therefore trying to get the yuan included in the basket of currencies which constitutes the IMF's Special Drawing Rights. Until recently, China had long seen yuan stability as a way of gaining the necessary credibility and this might explain its attempts to defend the value of the currency versus the U.S. dollar in recent years. However, the resulting real appreciation of the yuan hurt both exports and growth. In addition, defending the yuan led to a significant decrease in China's U.S. dollar reserves in both 2014 and 2015 (see chart).

China's new currency regime kills three birds with one stone. First, it is a move towards a more market-oriented exchange-rate system, as desired by the IMF. Second, currency depreciation helps export sectors, providing one way to reinvigorate growth. In this respect, it is not the relatively small adjustment in the currency so far but the potential further adjustment that matters. Finally, it has helped shifted attention away from China's equity-market interventions.

The new regime has led to "risk-off" sentiment in the fixed-income markets and significant moves in Asian currencies versus the U.S. dollar. We believe that China might devalue

further and other Asian central banks (e.g. Taiwan, South Korea, Japan) could respond with monetary easing and currency depreciation to maintain competitiveness. The resulting resurrection of deflation fears could continue to weigh on rates over the next few weeks, longer term the currency-induced growth effects should kick in. We remain long-term constructive on emerging markets and high-yield, but would currently only add selectively, for example in euro high-yield.

Quarterly change in China's foreign-exchange reserve\*



Defending the yuan against a strong U.S. dollar in the old currency-peg system led to a fall in reserves in 2014 and 2015 -- although total reserves remain substantial.

\* Based on balance-of-payments data  
Source: Chinese State Administration of Foreign Exchange, as of 08/2015

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