

China: Devaluation of the RMB

Commentary

Over the last few weeks we've seen, a major market meltdown in the China sector. There are two 'black swan' events one was the suspension of trading securities in July and more recently the devaluation of the RMB.

On August 11th, the People's Bank of China (PBOC) suddenly announced reform of the yuan central parity rate calculation. The central parity rate is based on a weighted average of prices offered by market makers before the opening of the interbank market each trading day. The currency is then allowed to trade within 2% of this rate. This is a median price, and the mechanism that changed was the bottom range value was allowed to adjust downwards dragging the median price down.

Currently the RMB is only devalued against the USD, as most worldwide currencies are also lower. There are various explanations seen on the market such as: boosting the economy for better export, anticipating the US interest rate hike and thus devalue first to stimulate economy, etc. We believe the main reason is to get into SDRs. SDRs, or Special Drawing Rights, play a key role in the global financial system, as they constitute an international reserve asset balancing countries with large debts to those abundant with cash. China is eager to turn the yuan into a reserve currency and if successfully can have the QE weapon for its use. Currently the IMF, which manages the SDRs, is reviewing the basket of currencies.

Theoretically, devaluation is beneficial to China's exports and industries including: railway infrastructure, nuclear power, automotive, wind power equipment, textile and others. It is not beneficial to the PE of companies with large exchange rate risk in their businesses such as airline companies who lease aircraft in USD with revenue in RMB.



Fig 1: China Southern Airlines currently around \$4.3 (3 month low Sep 4th)



Fig 2: China Eastern Airlines currently around \$3.6 (Sep 4th)

Timing & Positions

Unfortunately our forecast of a phase 2 consolidation for the Chinese market did not follow through as the bottom of the channel was broken on Aug 20th (Fig 3). **Thus rather than sit and watch and hope it comes back, the portfolio was proactively switched to the safety of USD cash and balanced funds to preserve capital.** Only exposing the portfolio to 20% China and encompassing several other balanced funds is a good risk mitigation strategy. At this stage we will have to wait for the next bull market to take risk again. This is the same strategy we used prior to the financial crisis of 2008, that is to step to the sidelines and await the next opportunity.



Fig 3: Shanghai Comp Index bottom of Phase 2 channel broken on Aug 20th

Portfolio Alpha China Positions

These figures are taken from my excel spreadsheet and are accurate to the best of my knowledge.

The Portfolio invested in this 'Weak-Bull' cycle from 2012-09 until 2015-09. China positions are as follow:

YGCH: Fidelity Greater China Fund

Start: 2014-04-10, Completed 2015-05-04

Avg Entry Price: 15.106

Avg Exit Price: 19.130

ROI Weighted: +26.6% Completed

YCHI: Fidelity China Focus Fund

Start: 2012-10-05, Completed 2015-09-01

Avg Entry Price: 21.602

Avg Exit Price: 17.499

ROI Weighted: -8.3% Completed

NOTE:

YCHI We exited 50% on Aug 20th (Price @ 15.22) and the remainder 100% on Sep 1st (Price @ 14.11). As of Sep 4th (Price @ 13.86) and volatile.



Fig 4: FIL Greater China Fund (Source Fidelity.com.hk)



Fig 5: FIL China Focus Fund (Source Fidelity.com.hk)

Portfolio Beta China Positions

Baring Hong Kong China Fund

Start: 2014-08-05, Completed 2015-09-01

Avg Entry Price: TBA

Avg Exit Price: TBA

ROI: TBA Completed

Conclusion

Markets are quite volatile at the moment and I will detail a total ROI for this 'Weak-Bull' cycle in due course. More to come but a conservative strategy is in place.

Best,
Michael

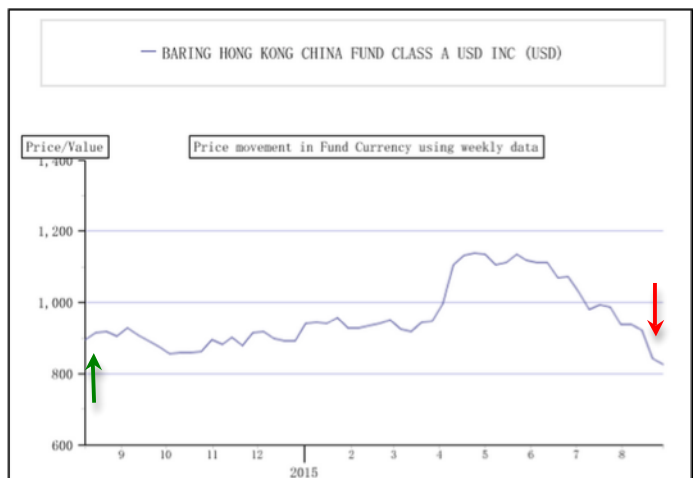


Fig 6: Baring Hong Kong China Fund (Source hang seng.com.hk)

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