Perspectives

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The Impact of China's Currency Devaluation

In response to the latest round of tariffs announced last week and set to take effect September 1st, China devalued its currency on Monday. Predictably, this currency devaluation roiled markets with major equity indices plummeting 3% on Monday, with a slight recovery Tuesday as China walked back its devaluation intentions. However, Wednesday's markets featured further volatility and lower bond yields as investors flocked to safety amidst the longer-term uncertainty created by this week's news.

Ben Mohr, CFA
Director of Fixed Income

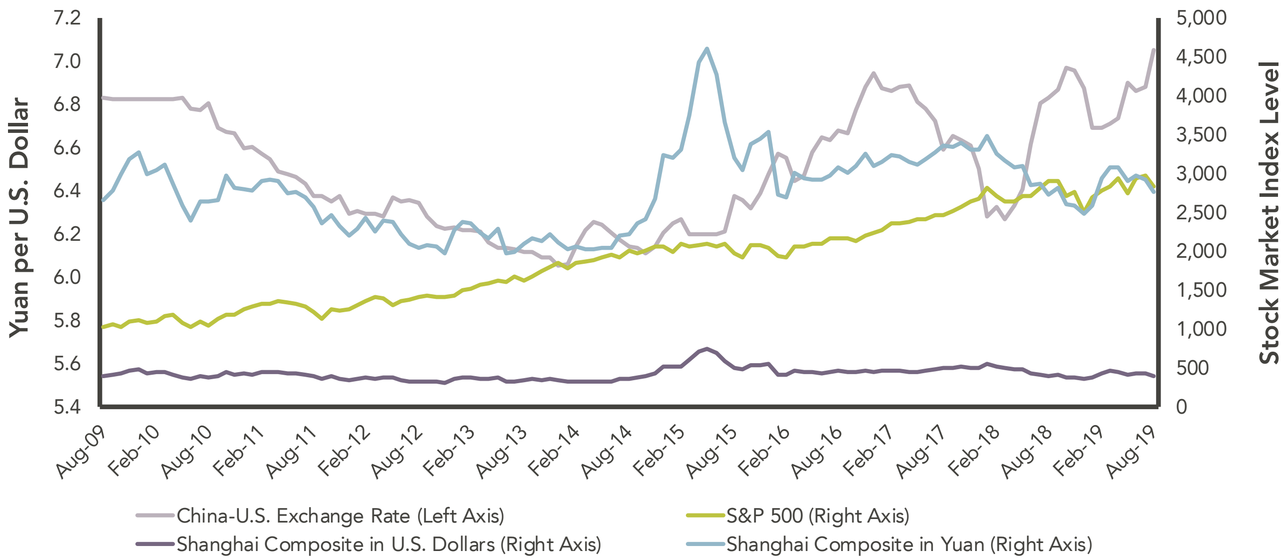
Beyond the market drops, why should investors be worried about China devaluing its currency? A weaker Chinese currency would make Chinese products cheaper to buy from the perspective of the U.S. buyer, allowing U.S. businesses and consumers to more easily digest the incremental tariff that Trump imposed on Chinese goods, thereby fueling stronger economic growth in China.

However, there are downsides. The devaluation could hurt Chinese companies, many of which — especially in heavy industry and real estate — have taken on large amounts of debt denominated in U.S. dollars. The devaluation means that the debt to them has become more expensive. It will also drive up the cost of oil for Chinese businesses and consumers because it is priced in U.S. dollars. These higher costs create a significant headwind for Chinese companies.

In addition, if China allows its currency to decline further, other countries in Asia could be pressured to devalue their own currencies, which could lead to a rise in inflation and exert downward pressure on household spending, thereby further slowing global growth.

We can examine the impact on investments in both the U.S. dollar and Chinese yuan using the previous two Chinese currency devaluations over the last five years. Exhibit 1 on the following page shows the impact of China's previous currency devaluations in 2015/2016 as well as 2018. Of course, it is impossible to attribute market performance over longer time periods like this to just currency appreciation or depreciation, but the following analysis may help investors formulate expectations on what may happen as we move forward from Monday.

Exhibit 1: China-U.S. Exchange Rate and U.S./China Market Performance



Source: Federal Reserve, Bloomberg

When China previously devalued its currency from August 2015 to December 2016, the S&P 500 fell 8.2% in seven months but rebounded to end up 6.4% across the overall period from August 2015 to December 2016. However, the Shanghai Composite, which is composed of all China A and B shares, was down 24.2% across this period in U.S. dollars and down 15.3% in yuan.

More recently, China devalued its currency again from April 2018 to October 2018. The S&P 500 rose 2.7% across this period but fell immediately thereafter in the market dislocation of the fourth quarter of 2018 that was partly driven by elevated global tech valuation multiples. Across this period from April 2018 to October 2018, the Shanghai Composite dropped by 26.1% in U.S. dollars and fell by 17.9% in yuan.

The U.S. markets as represented by the S&P 500 rose in both devaluations, perhaps partly driven by the devaluations making Chinese goods cheaper and thus offsetting the incremental tariffs, thereby benefitting U.S. business supply chain costs.

While the Chinese markets as represented by the Shanghai Composite fell in both devaluations, the devaluations may have softened the blow. In other words, without the devaluations allowing U.S. businesses and consumers to more easily digest the incremental tariffs and purchase additional Chinese goods, the Shanghai Composite might have fallen even more. However, the offset of this is that debt and oil became costlier to Chinese businesses, which would have had the effect of depressing Chinese stock prices.

If nothing else, the additional tariffs and currency devaluation movements have cast further uncertainty over U.S.-China trade relations and the long-term threat to global economic growth. It is all but guaranteed that volatility will remain elevated until these issues are resolved or at a minimum, meaningful progress is made. For patient long-term investors, this may be a buying opportunity for equities given the recent price drops over the last week, but if investors are risk averse and sensitive to short-term market losses, now may be a time to take some equity risk off the table.

PREPARED BY MARQUETTE ASSOCIATES

180 North LaSalle St, Ste 3500, Chicago, Illinois 60601
CHICAGO BALTIMORE MILWAUKEE PHILADELPHIA ST. LOUIS

PHONE 312-527-5500
WEB MarquetteAssociates.com

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