Investment News

Monthly Bulletin from the Investment & Risk Team

September 2015

Last Month in Brief

Fears of a slowdown in economic growth in China shook stock markets in August. Shares were hit hardest in China, where they are now 40% lower than in June. Internationally, it was the worst month since May 2012 for London's FTSE 100 and New York's S&P 500. The People's Bank of China decision to allow the yuan to devalue caught investors by surprise and led to fears that China's growth prospects are weaker than previously expected (see main article for more details).

Oil prices had a volatile month on the back of this; falling from $45 to below $40, before sharply rising by 25% over three sessions to end the month near $50 per barrel. Inflation in the UK turned positive with CPI inflation of 0.1%. Whilst headline inflation remains subdued, the rate was above investors' expectations and core inflation rose to 1.2% to offset the continued falls in energy and food prices.

Elsewhere, after terms were approved on a third bailout, Greek Prime Minister Alexis Tsipras announced a snap election that will be the fourth election held in less than three and half years. Brazil, the world's seventh largest economy, entered a recession as figures showed it's economy had contracted by 1.9% between April and June of this year.

Chart 1: Equity Indices

Equity markets ended the month lower

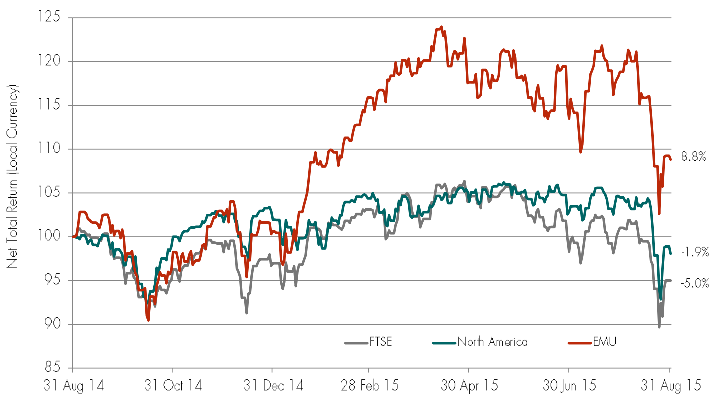


Chart 2: Sterling Credit Spreads

Credit spreads widened throughout the month

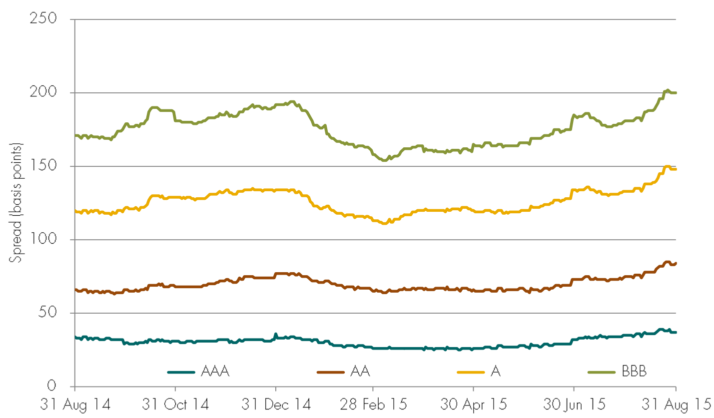


Chart 3: Gilt Yields

Yields fell for longer maturities

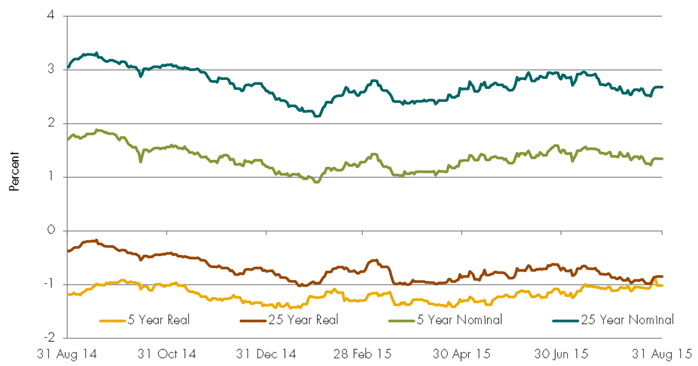
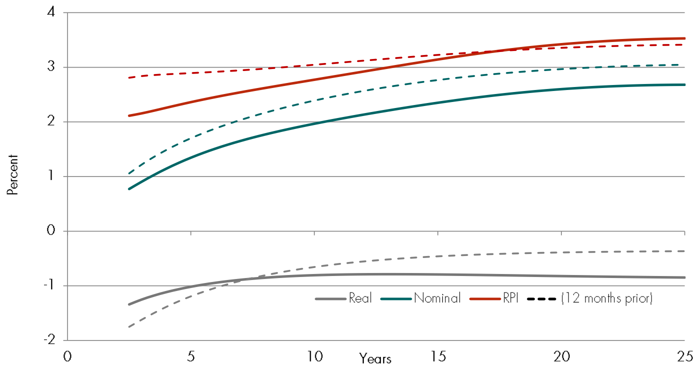


Chart 4: Gilt Spot Curves

Yield curves remain upward sloping



Source: Financial Times, MSCI, Merrill Lynch Bank of America, & Bank of England

	Latest	Previous		Latest	Previous
CPI increase (annual change)	0.1%	0.0%	**Base rate**	0.5%	0.5%
PPF 7800 funding ratio	83.2%	84.8%	**QE Level**	£375bn	£375bn
Halifax house prices (monthly change)	-0.6%	1.7%	**VIX (volatility) index**	28.43	12.12
IPD TR property index (monthly change)	1.1%	1.4%	**$/£ exchange rate**	1.54	1.56

For monthly published indices "Latest" and "Previous" refers to the two most recently published statistics, otherwise numbers are quoted as at the month end.

Chinese yuan (renminbi) devaluation

Background

For a long time China has managed the yuan's exchange rate, rather than having a floating exchange rate that is determined by market forces (and which is used by most other large economies). Before 2005, the yuan was pegged to the US dollar but this approach has been gradually relaxed so that the rate can fluctuate within 2% of a daily reference rate.

Historically this reference rate has been set by the People's Bank of China (PBoC) at a level cheaper than market forces would dictate and this led to China building up large foreign exchange reserves as a result of high export revenues and foreign investment. While China experienced strong growth this position continued for many years, despite the yuan being allowed to gradually appreciate against the dollar.

Chinese stock markets experienced particularly high returns in late 2014 and early 2015. However, recently growth has been slowing and expectations of future performance have been weakening. By the end of July, stock markets had fallen by 30% from their mid-June peak and people had been selling their yuan holdings fearing they would lose value. This is likely to have led to China having to sell their foreign exchange reserves in order to maintain their exchange rate.

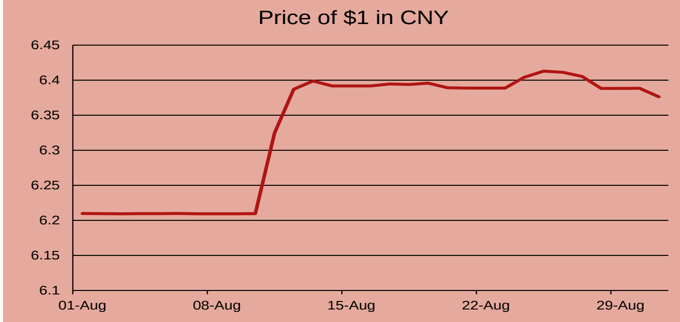
Policy changes

The PBoC surprised many on 11 August by devaluing the yuan by 1.9% against the dollar and announcing that it would let the markets play a greater role in determining the value of the yuan - by setting the day's reference rate based on the previous day's trading. The weakened currency makes Chinese goods cheaper and therefore should boost exports, which have been falling. This move appeared, at least in part, to be part of a push to encourage the International Monetary Fund to include the yuan as a part of the reserve assets known as special drawing rights.

However, the move appeared to trigger falls across global equity markets as investors in international markets worried that the willingness to devalue the yuan was a sign the Chinese economy was much weaker than expected. Equity markets strongly correlated to Chinese demand for industrial and other commodities, as well as multinationals that do business with China in general, were particularly affected.

Box 1: Devaluation of currencies

The yuan fell 1.9% against the dollar on 11 August but following a further small fall on the 12th, it has remained relatively stable.



The risk of currency devaluations exists when investing outside the domestic currency and need not only arise when investing in emerging economies. For example, Switzerland introduced an exchange rate cap on the Swiss Franc against the Euro in 2011, which caused an immediate depreciation. The cap was then removed in January 2015 which caused a major appreciation.

Box 2: Other changes taking place in China

While there have been some market based reforms in recent years, the recent falls in stock prices have led to government intervention to try to prevent a stock market crash.

Big investors have been prevented from selling shares for six months and state corporations have increased their share holdings.

In addition, the PBoC has taken steps to increase domestic liquidity including injecting liquidity into banks, cutting reserve requirements and reducing interest rates (as shown above).

The PBoC have also said that local pension funds will be able to invest 30 percent of capital in domestic stocks - though it isn't clear whether this change is a result of the ongoing volatility in the Chinese equity market, or part of wider economic changes.

Impact

Initially there were fears that the devaluation of the yuan may just have been the first of many and that it may have triggered a global currency war - with other countries seeking to devalue their currencies in response, to help boost their exports. However, the yuan has remained relatively stable following a devaluation of 3% suggesting that the PBoC is now aiming to maintain the yuan at this level.

A possible impact on the US and UK economies is the postponement of interest rate rises in these countries as a result of lower inflation due to cheaper imports. However, Bank of England Governor Mark Carney has said that China's economic problems are "unlikely" to derail plans to raise interest rates in the UK.

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