



FLASH REPORT

China's Currency Revaluation

The financial markets were caught partially unawares last Wednesday night when the Chinese government announced two changes with respect to the value of the renminbi. The headline news is that the government agreed to revalue the currency, increasing its value relative to the US dollar by a little over 2%. The second change is that the renminbi will no longer be pegged to the dollar, but rather to a trade-weighted basket of currencies. We say partially unawares, because some change in currency policy was expected; the only questions were how and when. The expectation continues to be that the Chinese government will revalue the currency by somewhere between 10-15%, though Chinese officials deny that this move is a first step.

Newgate has expected for some time that the Chinese government would revalue gradually, allowing the economy to adjust to each change. A gradual adjustment also allows the Chinese government to be seen as not caving in to Western demands to act on its currency. Ultimately, we believe the deciding factors in when and how China revalues will be determined by domestic (that is, Chinese) considerations. One consideration for the Chinese government is to make Chinese assets attractive to both domestic and foreign investors, reducing the risk of mass capital flight that affected so many Asian countries in the financial crisis of 1997.

The biggest effect the revaluation of the renminbi should have is a slowdown in the growth of the Chinese economy. Official measurement of Chinese real GDP growth came in at 9.5%, higher than expectations and higher than most observers believe is either wise or sustainable. Various Chinese

government and central bank officials have called for a reduction in GDP growth for some time. A rising renminbi also reduces Chinese inflation. We have seen an immediate, if somewhat knee-jerk, rise in other Asian currencies.

Newgate's Emerging Markets Portfolios have been over-allocated to Asia generally, but also under-allocated to China itself. This modest revaluation, and the more technical but equally significant change in the peg to a basket of currencies, does not alter our fundamental thesis. On the margins, we believe that these changes will be beneficial to Asian stocks generally, but there may be internal shifts within the markets. Strengthening currencies should weaken export-based companies, often market leaders in countries like South Korea, in favor of more locally-based companies.

Changes in Chinese currency policy may also have an impact on commodities prices, though it is not clear what the result will be. Slower economic growth in China could lead to lower demand for commodities. Yet a rising renminbi will make imports to China cheaper, allowing for greater demand.

In light of the above, we remain bullish on Asia, with an emphasis on technology stocks. Over the past year and a half, the Newgate Emerging Markets Portfolio has been underweight China based on a combination of valuation concerns and excess new issuance. We believe that our overweight Taiwan, Malaysia and Hong Kong exposure should more than compensate us for the current under-allocation to mainland China. ♦

Please feel free to contact us with any questions or concerns that you may have.