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## The Chinese yuan's strength could be bothering Beijing

◆ The Chinese currency is hitting its highest in several years against a basket of currencies.

◆ The move is happening as the Central Committee of the Communist Party meets to set its five-year plan.

◆ The People's Bank of China has intervened in the past when the yuan got this strong.

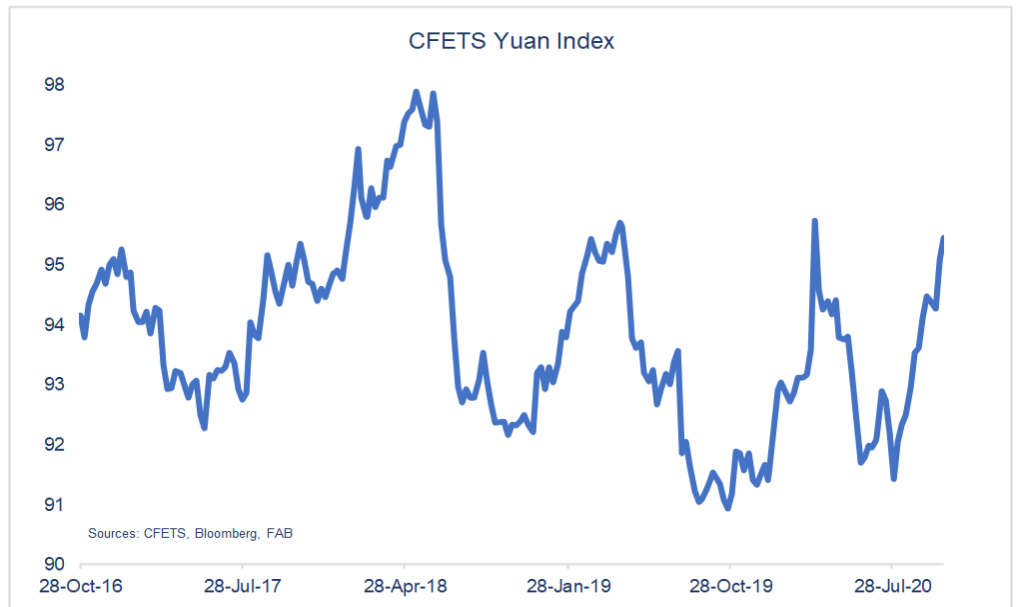
◆ China has attracted more investor flows as the country shows no signs that it could close its economy again.

◆ The high correlation between the yuan and several G-7 currencies means that depreciation in the Chinese currency could lead to dollar strength.

◆ The FAB AAC remains slightly underweight in equities, and overweight in IG bonds and gold

Most central banks say that they pay no direct attention to their currencies, but every economist knows that its value dictates a key part of the GDP equation. A strong currency may attract investor inflows, but it makes exports more expensive and imports cheaper, dampening economic growth and inflation.

The recent weakness of the US dollar has already left central bankers in Europe, Australia, New Zealand, and even Japan uneasy. Meanwhile, the People's Bank of China has been unusually stoic about the yuan's nearly 7% appreciation against the US dollar since 27 May. That is particularly troubling for China, where exports are a much bigger part of the economy. The explanation, however, is that the yuan has gained less against other currencies.



The broader CFETS yuan index, which measures the currency's strength against a broad basket of nations with which China trades, only bottomed on 31 July, and has gained just 4.4% since. Still, it is now knocking against the 95.00 level, which in the past three years has been where the PBOC draws the line.

This is happening just as all the most senior politicians in China gather in Beijing for the Communist Party Plenum, which will determine the country's five-year plan. With the currency so strong, it is likely to figure in many of the debates.

In fact, Yi Gang, the Governor of the PBOC, was quoted today reinforcing the idea that the internationalization of the yuan will continue. His remarks came a couple of days after an unnamed official told Bloomberg News that the government planned to continue to allow the yuan to be more widely used, but that it could start intervening more meaningfully in its price to ensure economic stability.

### The Chinese yuan index is hitting a point which has triggered PBOC action before

The fate of the yuan matters not only for the Chinese. The currencies of most commodity-dependent countries, from Canada and Australia to South Africa and Brazil, tend to move in tandem with the yuan, given that China is the biggest consumer of raw materials in the world.

As a result, there is a medium-term correlation between the yuan and other emerging market currencies, and, more importantly, an inverse correlation with the US dollar. Even though the yuan is a small part of the dollar index, over the past four years, it has swayed the greenback. If China really starts to push the yuan down, it could have an impact on the US dollar. That, in its turn, could have broader implications for the American economy and for other developing nations.

## Investment Strategy Update

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