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Featured G

Global Implications of the Chinese Yuan Devaluation

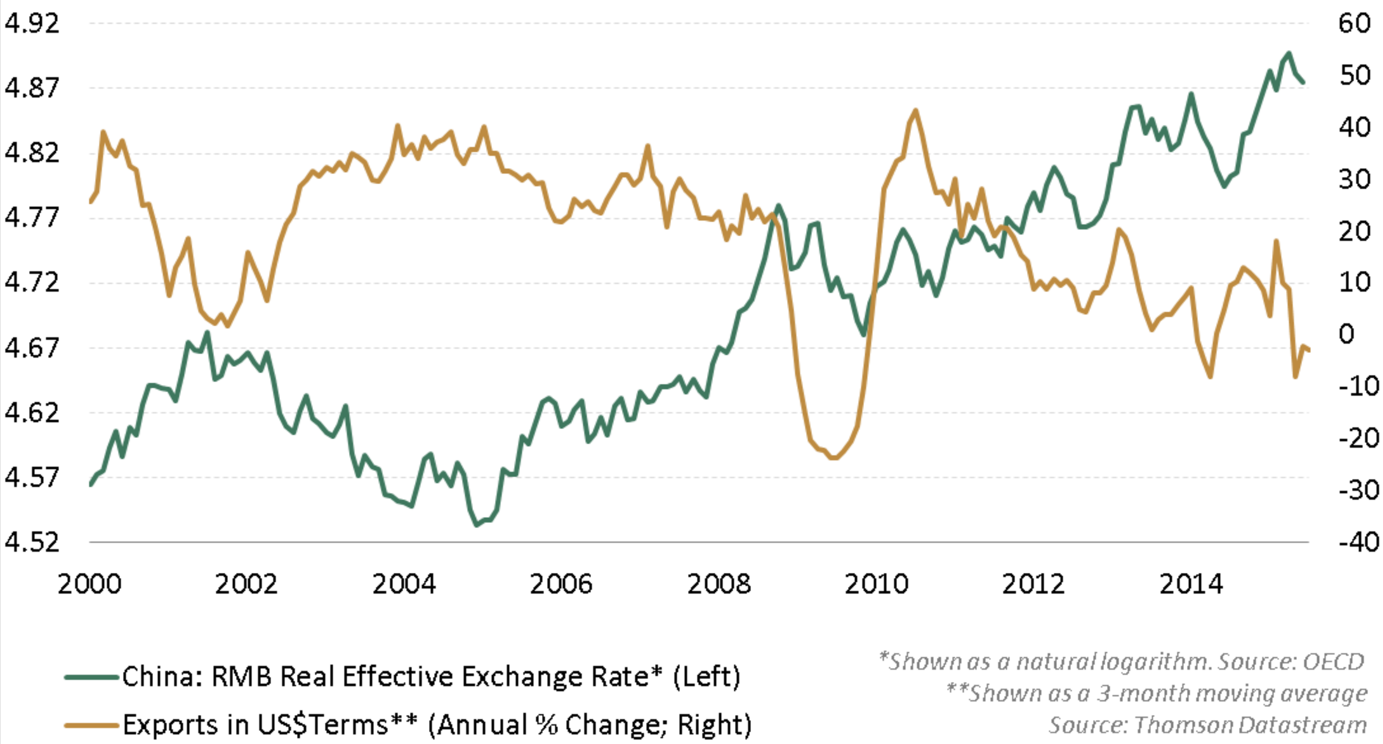
The decision by the People's Bank of China to devalue the yuan caught most of the market off guard; the action has sent shockwaves across global financial markets. Most investors are still spooked by the Chinese move and wonder what it will mean for the global economy.
Obviously, we are still in the early days of the Chinese devaluation and we shouldn't read too much into short-term market actions. Nevertheless, it seems that the dollar bull market has followed a rotational pattern: the first up-leg occurred mainly against the Japanese yen, then the dollar rose versus the euro, and now it is against the yuan, along with other Asian currencies.

With China joining the devaluation game, deflationary pressures in the world economy are intensifying. These deflationary pressures could cause the U.S. economy to soften and its inflation to fall. In other words, the Chinese devaluation has weakened the case for the Federal Reserve (Fed) to raise rates. The long end of the Treasury yield curve has fallen sharply since the Chinese devaluation, while the euro and yen have actually strengthened slightly versus the dollar. Perhaps the market is looking for a delay to the widely anticipated Fed rate hike in September.

The Chinese devaluation has been very modest, with the yuan falling about 5.6% from its record highs in early 2014. There are good reasons to believe that the yuan will continue to weaken. Total yuan appreciation since 2005 has exceeded 40% versus the dollar and about 55% in real effective exchange-rate terms, as seen in Chart 1.

Chart 1: Real Effective Exchange-Rate CPI-Based Measure and Export Growth Since 2000

As of 7/31/15



In fact, the yuan is one of the most expensive currencies worldwide based on purchasing power parity. With the Chinese economy continuing to slow, price declines spreading, and exports under contractionary pressures, the Chinese government is compelled to let the yuan depreciate much more. As recent as late 2010, the yuan was at ¥6.8 for every U.S. dollar. In my view, the Chinese currency could go back to that level in the next six months or so, bringing the total yuan devaluation to about 10% from its highs.

Further decline in the Chinese yuan would represent an additional deflationary shock to the global economy, and therefore should be a negative for stocks but a positive for bonds. Obviously, a weaker yuan will hurt dollar-based earnings for multinationals that operate in China—notably, nearly all Fortune 500 firms have business investments in China of varying size and importance. A weaker yuan could also push down tradeable goods prices further, leading to lower inflation in most G7 nations. The combination of weak nominal growth, a stronger U.S. dollar-yuan exchange rate, and the likelihood of lower inflation could allow the 10-year Treasury yield to fall below 2% again in the next 6-8 months.

Could the devaluation of the yuan persuade the Fed to abandon its planned rate hike? The potential for the yuan's effect on U.S. monetary policy is not very clear at the moment. My bet is that any additional yuan weakness could increase the odds that the Fed will postpone its planned rate hike—at least for the remainder of the year—if not longer. This could lead to a correction in the dollar and a corresponding rebound in reflationary assets such as emerging-market stocks and commodities prices.

However, if the Fed ignores global developments and begins to nudge rates higher this year, the dollar could overshoot, increasing the odds of outright deflation in the U.S. economy, and possibly a recession. I believe the U.S. stock market will not like this outcome.

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