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Chinese basket weaving Global bonds and currencies



The U.S. dollar's reserve-currency status is under threat, but is there an alternative? The largest holders of currency reserves, the Chinese, may be pointing to a solution.

Recent U.S. dollar weakness has several underlying causes. The **pro-risk trade** that has

been growing since the first week in March tends to be dollar negative, while the realization that the U.S. will require zero interest rates for longer makes the U.S. dollar a low-cost funding currency for the **carry trade strategy**. In addition to these short-term considerations, there is also a longer-term threat to the value of the dollar - **its diminishing status as a reserve currency**.

To be an effective 'reserve', a currency (or asset) has to be perceived as a good store of value. A burgeoning budget deficit and concerns over debasing through quantitative easing are leading investors to question that store of value in relation to some of the world's leading currencies. Neither of these concerns should be levelled at the U.S. alone; other major currencies such as sterling and the euro are also tarred with the same brush.

The switch away from the dollar as a reserve currency has always been held back by a lack of suitable alternatives. The euro is undermined by the imbalances within the eurozone; surpluses at the 'core' and deficits in the 'periphery' are not sustainable. Sterling has had its day and the yen has never made it as a true reserve currency despite Japanese exports being a large part of global trade. The U.S. current account deficit allows the dollar to dominate international finance.

The lack of one clear alternative does not prevent large dollar holders (notably China) worrying and the comments of the Chinese earlier in the year about U.S. quantitative easing are testimony to this.

Another way of diversifying reserves is to match trade flows. The dollar remains the main currency for trade flows and attempts to use the yen and the euro in the past have not come to much. However, recent changes have long-term implications.

At the end of August this year, with much of the world still recovering from the Great Recession, the International Monetary Fund took action to bolster its members' reserves through an allocation of SDRs (Special Drawing Rights).

An SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. Its value is based on a basket of four key international currencies, and SDRs can be exchanged for freely usable currencies. With a general SDR allocation taking effect on August 28 and a special allocation on September 9, 2009, the amount of SDRs will increase from SDR 21.4 billion to SDR 204.1 billion (currently equivalent to about \$317 billion).

Source IMF website

An allocation, equivalent to \$250 billion, was made on August 28 and was followed by an additional, albeit much smaller, allocation of \$33 billion on September 9. With the two allocations amounting to roughly \$283 billion, the outstanding stock of SDRs has increased nearly ten-fold to total about \$316 billion. The value of these SDRs is determined by a basket of four currencies (U.S. dollar 44%, euro 34%, yen 11% and sterling 11%).

Emerging-market economies have substantially rebuilt their reserves and have been increasingly willing, and perhaps more able, to help fund the IMF and its expanded lending. The Japanese agreed a bilateral borrowing agreement of U.S.\$100 billion of additional funding in February 2009 on top of their original substantial commitment. The Chinese have committed to lend the IMF the equivalent of \$50 billion of Chinese yuan in exchange for a bond denominated in SDRs. Brazil and Russia have made pledges of U.S.\$10 billion each. With Chinese reserves being roughly 70% invested in U.S. dollars, this SDR-denominated bond represents a more diversified allocation than China's existing reserves. Further moves towards a basket approach should be expected.

More importantly, Chinese involvement in the financing of the World Bank is also a significant shift in the global rebalancing story. Those Asian economies with surpluses are being called upon to finance the IMF/World Bank during those institutions' time of need. It is likely that such financial provision will be undertaken in exchange for greater influence. One area of influence could be in reconfiguring the SDR.

The basket composition is reviewed every five years by the Executive Board to ensure that it reflects the relative importance of currencies in the world's trading and financial systems. In the most recent review (in November 2005), the weights of the currencies in the SDR basket were revised, based on the value of the exports of goods and services and the amount of reserves denominated in the respective currencies which were held by other members of the IMF. These changes became effective on January 1, 2006. The next review will take place in late 2010.

Source: IMF website

As the list of funding nations grows the group of currencies in the basket should also grow and the existing four currencies should be reduced (but only if there is increased use of the new member currencies in other central bank reserves). This

will only happen if these currencies are freely tradable. As a result there will be growing calls for the Chinese to improve the tradability of their currency, which will probably result in the yuan's appreciation against the dollar.

Since the beginning of March (when the 'pro-risk trade' began), the SDR has appreciated against the dollar by around 8%, which is poor compared to the 'carry trade' currencies' appreciation against the dollar of 20%. The dollar's trade-weighted index has fallen by 13% over the same period. The reserve-currency status story is likely to remain in the background, undermining the dollar for a long period. Short-term dollar-negative factors such as the dollar's use as a funding currency for the carry trade and the move out of safe-haven investments will also be dominant for a while.

Conclusion - the U.S. dollar is low in our currency rankings for reasons other than merely its diminished reserve-currency status. However, as some short-term influences fade, our long-term global realignment theme remains significant in relation currencies.

Unless otherwise stated, all data is sourced from Bloomberg or Thomson Datastream.

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