Insight from Standard & Poor's

MARKET VIEWS

By Sam Stovall

The Yuan and You

What effect will China's currency shift have on U. S. investors? Maybe not very much at all, says S&P

Sam Stovall

China's unexpectedly sudden move to revalue its currency, the yuan, on July 21, has sparked much speculation as to its ultimate effect on world markets. But what does it mean for U.S. investors? And should they make any changes in strategy?

First, let's examine how the move may play out, looking at the positive side of the ledger first. Standard & Poor's thinks China's plan is likely to have several beneficial effects. Specifically, the revaluation is likely to trim the U.S. trade deficit with China in the longer term, as the increased cost of imported goods eventually reduces demand.

In the short-run, however, our trade gap may actually widen, as the pace of price increases for imported goods will outweigh businesses' efforts to secure less-expensive substitutes.

PRESSURE RELIEF. The revaluation is also likely to improve the competitiveness of U.S. goods in U.S. markets against more expensive Chinese goods (if the U.S. still produces goods that are in direct competition with their Chinese counterparts, that is). On the other hand, Chinese suppliers may decide to reduce the nominal cost of the exported items to offset the effect of the stronger yuan.

The move could relieve pressure on key political fronts as well by reducing the threat of trade sanctions imposed by the U.S. Congress on Chinese imports, and by possibly helping to stem the tide of U.S. job losses overseas. It's likely to weaken the value of the U.S. dollar from a reduced need to peg the yuan to the dollar. (Manufacturing groups have cited a strong U.S. dollar as an impediment to U.S. export competitiveness.)

For China's part, economic growth there may slow from the 9.5% rate recorded for the second quarter, in S&P's opinion -- an outcome that could please Beijing, as policymakers there have been trying to moderate the pace of economic growth. Lastly, oil prices may decline as a result of reduced Chinese demand (See BW Online, 7/19/05, **"China's Shrunken Thirst for Oil"**).

THE BIG PICTURE. However, there are also some

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likely negatives from the move. The revaluation is likely to raise the cost of Chinese imports, thus putting pressure on margins for retail and tech companies.

Another possibility is that the revaluation could increase the threat of higher inflation in the U.S. as a result of these higher costs. Gold prices could rise in response, as they traditionally do on the possibility of higher U.S. prices for goods and services. S&P thinks the prices of other metals may rise in response to the prospects of reduced competition from Chinese exports.

Amid the conflicting currents, then, it's important to study the balance of positives and negatives, and put them into context. In reality, according to Beth Ann Bovino, senior economist for S&P, the move to peg the yuan to a basket of currencies was expected, and the overall economic effect should be small.

Overall, S&P believes the removal of the dollar peg is a positive, as it addresses a major imbalance in the world economy. But the initial adjustment was on the modest side, revaluing by 2.05% vs. the dollar. It probably won't satisfy U.S. government calls for currency adjustment, which will likely intensify when President Hu of China visits Washington in the fall. We think the small appreciation vs. the dollar won't have much of an impact on the U.S. current account deficit.

MAINTAINING BALANCE. Even if Beijing ratchets up the revaluation strategy to a 5% adjustment, the overall economic and market impact shouldn't be that great, in our opinion. As of July 22, the euro was at 1.219 vs. the dollar, little changed from where it was on July 20. The Japanese yen has gained more than 1% vs. the dollar since the move by China, but we believe a 1% impact won't likely push the Bank of Japan to increase their purchases of U.S. Treasuries. (Japan has intervened in currency markets in the past to prevent excessive appreciation of the yen vs. the dollar.)

And in the Middle Kingdom, the impact may not be dramatic either. Since many China-based companies source and manufacture locally, S&P analysts believe the yuan revaluation will only have a modest impact. However, a key positive is that earnings generated in China will be greater after conversion to other currencies. And in a spillover effect, the recent strength in the yen engendered by the move could benefit U.S. companies with a presence in Japan.

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Finally, should the yuan revaluation make any difference to a U.S. investors' overall strategy? Well, S&P continues to recommend that the typical investor who aims for a balanced portfolio should have a 50% exposure to U.S. equities and a 15% holding in foreign stocks, while maintaining 20% in short-to-intermediate term bonds, and 15% in cash. Our yearend 2005 target for the S&P 500 is 1270, implying a more than 5% advance from the yearend 2004 level.

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