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A US$ Carry Trade through Chinese Dim Sum Bonds

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Investment Summary

- **The US$ Carry Trade Remains Intact:** Other potential funding currencies, such as the Euro, Japanese Yen, Pound Sterling, and Swiss Franc do not “measure up.”
- **Minimal Capital Flight Risk**: Our early warning signs of a potential capital flight risk from EM/carry trade markets do not show much current risk.
- **Protect Against Black Swan Events by Investing in a Low Capital Mobility Market:** Foreign access to Chinese offshore RMB bonds through Dim Sum Bond market.

The State of the Global Carry Trade

To ensure the long-term success of a classic carry trade, the funding currency must exhibit: 1) low volatility, 2) relatively high valuation, and 3) relatively low domestic interest rates. Consequently, a funding currency must possess the following characteristics:

- The funding currency must be accepted worldwide, and supply of the funding currency must be abundant and consistent. This can only occur in countries: 1) that run a large and consistent current account deficit, and/or 2) where the central bank is monetizing the country’s debts;
- Central bank policy of the funding country must be relatively transparent, and long-term in nature;
- There must be attractive asset classes in most other parts of the world—governed by strong property rights, decent valuations, and stable political/economic environments.

For now, let us take the final point as a given. With respect to the first two characteristics, the perfect funding currency thus resides in a country: 1) with a high and consistent current account deficit, 2) with a central bank that is monetizing its debt, 3) with a central bank that is transparent, 4) with a central bank that is expected to continue to ease, and finally, the perfect funding currency must be 5) overvalued. The below table suggests—not surprisingly—that the US$, although not perfect, continues to be the funding currency of choice. Our brief analysis of each currency follows.

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Table 1: The Five Essential Characteristics of a Funding Currency: US$ Wins!

Currency	Current Account	Quantitative Easing	Central Bank Transparency	Central Bank Outlook	Valuation
Euro	Surplus	Neutral	Neutral	Neutral	Overvalued
Japanese Yen	Surplus	Yes	Opaque	Easy	Neutral
Pound Sterling	Deficit	Yes	Transparent	Easy	Undervalued
Swiss Franc	Surplus	Neutral	Neutral	Neutral	Neutral
US$	Deficit	Yes	Transparent	Easy	Neutral

Source: CB Capital Partners, Inc.

Euro: As discussed in our January 2013 newsletter, we expect 2013 to be an "anti-climactic" year in terms of financial risks. Euro Zone break-up risks have declined substantially. Germany (which represents 27% of the Euro Zone's GDP) is rebounding, driven by a strong housing market, rising population, and the end of fiscal austerity measures. Italy's primary surplus remains high. Unless the Euro hits $1.35 or above, we are not comfortable with using the Euro as a funding currency. Pass.

Japanese Yen: The JPY has already declined by 20% from peak to recent trough. The BOJ monetary outlook remains easy, but for how long? Japan is notorious for its lack of central bank transparency, and has burned many fund managers in the past. Pass.

Pound Sterling: The BoE may announce an additional £25 billion in asset purchases when it meets this Thursday. The outlook remains easy, but the Pound Sterling just hit a two-year low of $1.50 last week. We are not comfortable with using it as a funding currency unless it rises to the $1.60 to $1.65 level. Pass.

Swiss Franc: In early September 2011, the Swiss Franc fell by over 8% against the Euro in a matter of minutes as the SNB vowed to weaken its currency by setting a ceiling of SFr1.20. At the time, the Swiss Franc was a good contender as a funding currency. Since then, however, the Swiss Franc has weakened, with one Euro now buying SFr1.23. In addition, the SNB has accumulated nearly US$500 billion in foreign reserves—thus putting long-term upward pressure on the Swiss Franc should the SNB decide to offload part of its reserves. Finally, Switzerland's main export partner, Germany, is experiencing an economic rebound. Ongoing strength in Swiss exports will discourage future SNB interventions and easing. Pass.

US$: The US$ remains our favorite choice for a funding currency, as the above table suggests. The current account remains in consistent deficit, while the Federal Reserve has indicated the need for ongoing monetary policy easing (for now). We also know that U.S. investors are still fascinated with foreign assets, attracted by higher yields in EM markets. Finally, the Global FX Volatility Index is near a five-year low—in line with our "anti-climactic" year outlook and by definition, beneficial for the US$ carry trade. Since the many benefits are well documented, we will focus on the risks of the US$ carry trade:

- The current account deficit is a nebulous number. In 2012, the current account deficit was 3.2% of GDP, with crude oil imports making up 1.7% of GDP. Crude oil imports are easy to measure—and most crude oil imports proceeds accrue to foreign governments or investors. Not so with other goods and services. The value of downloadable software exports is impossible to track, for example. More important, the profits of many imports accrue to foreign-based U.S. subsidiaries—not foreigners. For example, every iPhone purchase adds directly to the U.S. current account deficit, but most of the profits accrue to Apple—a U.S. company. The cash sits in an Apple-owned foreign subsidiary. The risk (to the US$ carry

trade) lies in possible repatriation of such cash back into the U.S. In 2005, over US$300 billion of capital was brought back into the country in this manner as the U.S. government instituted a "tax holiday"—the US$ Index strengthened throughout that year. The risk is low, however, as the 2005 tax holiday did not fulfill its purpose of being a job creator. Under the Obama administration, the chance of another corporate tax holiday is even slimmer.

- Energy "independence": The EIA expects U.S. crude oil production to rise from 6.4 million bbl/d in 2012, to 7.3 million bbl/d in 2013, and 7.8 million bbl/d in 2014, with minimal increase in consumption. At $90 a barrel, this will eliminate at least $46 billion of the annual current account deficit from 2015 and onwards. The U.S. current account deficit in 2011 was $473 billion. The jump in domestic oil production will eliminate about 10% of the U.S. current account deficit, which is not a trivial amount. That said, this trend would take a long time to play out.
- A potential "Black Swan event"—it could be financial, geopolitical, or simply a natural disaster. Historically, the US$ has been treated as a safe haven as investors de-risk. Even the August 5, 2011 S&P downgrade of U.S. government debt resulted in the U.S. dollar rallying against the Euro and the GBP. This is a profound risk, and one that is not foreseeable.

Dim Sum Bonds as a Preferred Carry Trade (6 to 9-Month Outlook)

On the other side of the trade—the investment side—Emerging Markets remain more interesting than Developed Countries despite the German recovery and the potential reversal in the 21-year decline in Japanese commercial real estate prices. As we mentioned earlier, the three necessary conditions—strong property rights, decent valuations, and stable political/economic environments—have never been more favorable in many EM countries. For example, as of last Friday, two-year government yields in Thailand, Malaysia, and Indonesia settled at 2.9%, 3.0%, and 4.4%, respectively; while the Thai Baht, Malaysian Ringgit, and Indonesian Rupiah are still 17%, 19%, and 75%, respectively, below their pre-1997 Asian Financial Crisis peaks.

More important, most of the classic warning signs preceding a flight in capital from EM countries are missing. Specifically, there are 7 signs that the IMF tracks:

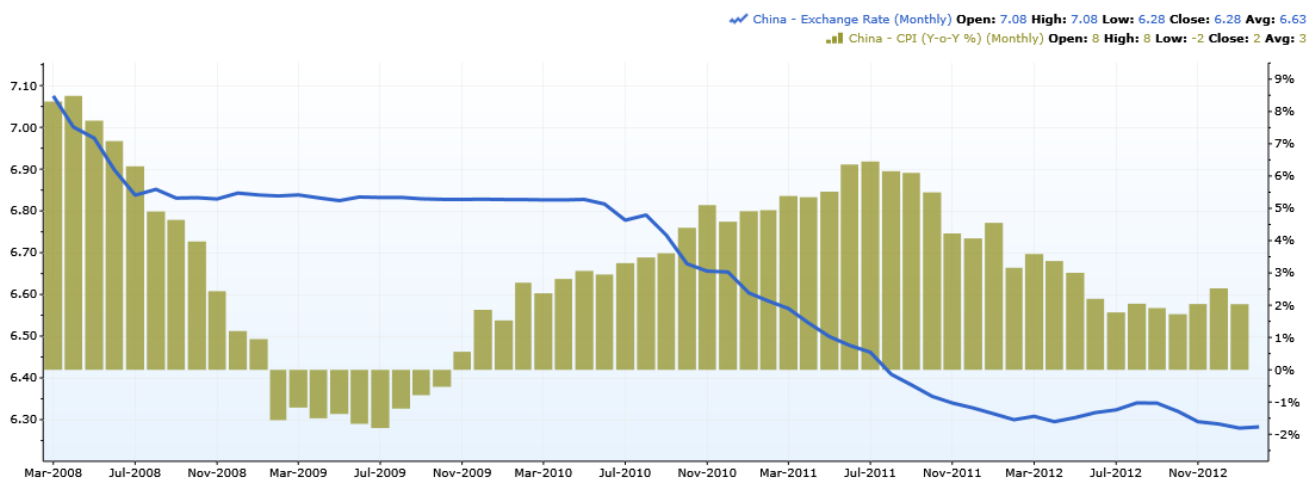
1. Significant deterioration in the terms of trade: Brazil recorded a trade deficit of $1.3 billion in February and a record $4 billion in January. However, analysts still expect a trade surplus of $15 billion for 2013. The red flag is India, which has been dealing with a current account deficit problem for many years (although keep in mind that gold imports make up a significant chunk of the deficit). Otherwise, most EM countries are not at risk. Indonesia is running a small trade deficit, while both Thailand (barely) and Malaysia are running surpluses. CB Capital Risk Rating: Low.
2. Decline in official FX reserves: The Philippines may accrue as much as US$100 billion in foreign reserves this year, while its government is expected to fund nearly 100% of its budget through domestic borrowing this year. India's FX reserves were $291.9 billion as of February 22, down by $3.1 billion on a year-over-year basis. Historically, a full-blown currency crisis has been preceded by a precipitous decline in the crisis country's FX reserves. Furthermore, members of the ASEAN (which does not include India) established a multilateral currency swap arrangement in 2010 as a means to prevent currency crises. Termed the Chiang Mai Initiative, the FX reserves pool was expanded to US$240 billion last year. CB Capital Risk Rating: Low.
3. Overvalued exchange rate: Overvalued currencies could be caused by two unsustainable factors: a) a significant surge in capital inflows, which were prevalent during the 1990s, or b) where a currency is pegged at an artificially high rate, such as the experience of Greece and other Euro Zone peripheral countries that had adopted the Euro during the 2000s. Our brief survey of EM countries does not turn up any substantially overvalued currencies. CB Capital Risk Rating: Low.

4. Higher inflation relative to tranquil periods: At this point, there is no major country with abnormally high inflation, with the exception of India. CB Capital Risk Rating: Low.
5. Rising money supply relative to bank reserves: This indicator tends to suggest excessive lending and money creation through the banking system. Money creation has accelerated over the last several years. However, banks' capital levels have risen alongside—suggesting ongoing bank cautiousness. A more detailed study would need to be carried out, but for now, we do not see much risk based on this indicator. CB Capital Risk Rating: Low.
6. A sharp rise in nominal private credit growth: Labeled as the "Republic of Credit Cards," 60% of private consumption in South Korea is made on credit cards, making up 35% of the country's GDP (compared to 14% of GDP in the U.S.). South Korea had to bail out its credit card companies in 2003, and the Korean savings rate is now only 3%. At the end of 2012, however, household credit growth sank to its lowest level in nearly eight years, although year-over-year credit growth was still over 5%. Private credit growth is expected to be 10% in Thailand in 2013, while household debt in Malaysia has become a cause for concern. In fact, the February 28, 2013 IMF Financial Stability Report singled out Malaysia's "recent rapid loan growth" as a potential source of macro risk. CB Capital Risk Rating: Medium.
7. Boom-bust cycle in equity/real estate prices: While real estate prices in China have boomed over the years, equity prices in China are still near multi-year lows. Meanwhile, the MSCI EM index is down 1.4% over the past year, with MSCI EM Asia up only 3.2%. The Philippines was up 39.4%, and Thailand 19.3%. Still, there is no widespread speculation/capital flows into equities/real estate into EM countries at this point. CB Capital Risk Rating: Medium.

In a Black Swan event—e.g. a unilateral North Korea attack on South Korea—none of the above would matter, as risk assets all around the world would flock to U.S. Treasuries or gold. But this only applies in a world of freely-flowing capital markets. In a low capital mobility environment—that by definition, is dominated by long-term investors—the risk of capital flight is nowhere near as high. This brings us to China.

As evident in the following chart, the RMB did not budge against the US$ during much of the late 2007 to early 2009 financial crisis—despite risk capital flooding back into US$ assets during that time. In fact, the RMB continued to appreciate against the US$ until early summer 2008—and thereafter, held steady until it was allowed to rise again beginning in June 2010.

Figure 1: Monthly Chart of RMB/US$ Exchange Rate vs. Chinese CPI



Source: Capital IQ.

Volatility has also been minimal, despite the wild swings in the monthly CPI readings. With the CPI having now settled in the 1.8% to 2.5% range over the last eight months, we should expect the RMB to remain steady in the near future.

In carry trade parlance, the carry-to-risk ratio in RMB yield products remains high, given low capital mobility and a recovery in Chinese economic growth in the second half of 2012. The "honeymoon" transition period for the new leadership has been relatively smooth. The major risk to the latter is a spike in oil prices, as China has now surpassed the U.S. as the world's biggest oil importer (exceeding 6 million bbl/d). The hindrance to Chinese investment has always been access, and the recent development of the Dim Sum Bond market now gives foreigners access to RMB-denominated credit products. Aside from Dim Sum Bonds, principal-protected notes paying high single digit coupons betting on a stable to slightly appreciating RMB are becoming very popular.

DSUM and Other EM Asia Yield Products are Worth a Closer Look

Specifically, we find the PowerShares Chinese Yuan Dim Sum Bond (DSUM) ETF to be quite attractive. In general, Dim Sum Bonds are offshore bonds denominated in RMB. Our view is that China's days of making major capital investments (whether through infrastructure or gaining global market share in steel, aluminum production, etc.) to drive economic growth is over. To ensure consistent growth to its full potential, China must become more efficient in capital allocation. The eventual opening of its capital account—beginning with the development of the Dim Sum Bond market is a first major step towards more efficient capital allocation. As such, we believe the Dim Sum Bond market is here to stay. That said, it is still an unproven market, and many investors continue to be skeptical about investing in China. This aversion has led to Ford's 2-year Dim Sum bond yielding 3.3%, while the Ford U.S. dollar bond yields around 1.6%. The market is implicitly discounting 1.7% of RMB depreciation over the next year, but we do not believe this is likely (we will cover this in our next newsletter).

DSUM is thus compelling: DSUM is benchmarked to the Citigroup Dim Sum (Offshore CNY) Bond Index, and is up 1.44% YTD (ranking in the 7th percentile in the EM bond category). The 12-month yield is 3.18%, with an effective duration of 3.15, and a years-to-maturity of 3.44. 30% of DSUM's holdings are Chinese government/agency issued bonds, while 62% are corporate issuances. The fund holds about 8% cash. Note that DSUM returned 8.24% in 2012, while the Citigroup Dim Sum Bond Index returned 7.87%. The latter exhibited an annualized volatility of just 1.81%, resulting in a sky-high Sharpe Ratio of 4.29. DSUM has the potential to exhibit a similarly high reward-to-risk ratio, but that will depend on how closely it can track the index. Note the average dollar value turnover of DSUM is slightly less than US$1 million a day, which could result in a higher-than-expected volatility if liquidity becomes an issue. We like DSUM and the EM Asia Carry Trade in general over the next 6 to 9 months.

Risk #1: Slower-than-expected growth in China. We understand that Chinese economic growth reaccelerated in 4Q 2012—to nearly 9% GDP growth sequentially. Chinese GDP growth numbers come with a two-month lag after the end of each quarter. In addition they are "smoothed out" for media/public consumption. We prefer to focus on Chinese coincident indicators such as the Purchasing Managers' Indexes (PMI) and Industrial Production. These tangible indicators are available for major areas of China—and are highly relevant as China is still an industrializing country. China's Services PMI declined slightly in February, but that is due to a distortion as the Lunar New Year fell in February this year. Moreover, a slight deceleration in growth is not surprising, given the reacceleration in growth during 4Q 2012. Consensus expects Chinese GDP growth to hit 8.1% this year.

Risk #2: The next source of systemic risk will likely emerge from China. That said, we don't foresee any Chinese meltdown in 2013—most likely in late 2014/2015. We will follow up on this topic in a latter issue.

Table 2: Top 25 Holdings of PowerShares Chinese Yuan Dim Sum Bond ETF

	Name	Coupon	Maturity	S&P / Moody's Rating†	Weight
1.	BIG WILL INVESTMENTS LTD 04-14	7.00%	4/29/2014	N.A./N.A.	2.94%
2.	NEW WORLD CHINA LAND	8.50%	4/11/2015	N.A./N.A.	2.82%
3.	CHINA GOVERNMENT BOND 12-20	2.48%	12/1/2020	AA-/Aa3	2.81%
4.	CHINA GOVERNMENT BOND REGS	3.48%	6/29/2027	AA-/Aa3	2.81%
5.	GLOBAL LOGISTIC PROPERTIES	3.38%	5/11/2016	N.A./Baa2	2.74%
6.	VTB BANK SA	4.50%	10/30/2015	NR/N.A.	2.67%
7.	BITRONIC LIMITED	4.00%	12/12/2015	N.A./N.A.	2.64%
8.	AGRICULTURAL BANK CHINA	3.20%	11/28/2015	N.A./N.A.	2.63%
9.	CATERPILLAR FINANCIAL SER CORP	2.90%	3/16/2014	A/A2	2.62%
10.	ASIAN DEVELOPMENT BANK 10-20	2.85%	10/21/2020	AAA/Aaa	2.59%
11.	HKCG FINANCE LTD 04-16	1.40%	4/11/2016	A+/A1	2.50%
12.	FORD MOTOR COMPANY REGS 3-15	4.88%	3/26/2015	BB+/N.A.	2.43%
13.	SINOTRUK HONG KONG LTD REGS	4.50%	8/1/2014	N.A./N.A.	2.38%
14.	AXIATA SPV2 BHD 09-14	3.75%	9/18/2014	BBB-/Baa2	2.37%
15.	CHINA GOVERNMENT BOND REGS 06-22	3.10%	6/29/2022	AA-/Aa3	2.37%
16.	CATERPILLAR FINANCL SER REGS 11-1	3.35%	11/26/2014	A/A2	2.11%
17.	CHINA GUANGDONG NUCLEAR PWR 15REG	3.75%	11/1/2015	NR/A3	2.11%
18.	CCBL FUNDING PLC	3.20%	11/29/2015	NR/A1	2.10%
19.	BEIJING ENTERPRISES WATER	3.75%	6/30/2014	N.A./N.A.	2.10%
20.	CHINA GOVERNMENT BOND REGS 06-17	2.56%	6/29/2017	AA-/Aa3	2.10%
21.	VOLVO TREASURY AB	3.80%	11/22/2015	BBB/Baa2	1.86%
22.	HAINAN AIRLINE HK REGS	6.00%	9/16/2014	N.A./N.A.	1.85%
23.	EXPORT-IMPORT BANK CHINA	2.90%	4/5/2015	AA-/N.A.	1.83%
24.	ZHONGSHENG GROUP HOLDINGS LTD	4.75%	4/21/2014	NR/N.A.	1.80%
25.	CHINA GOVERNMENT BOND 08-21	2.36%	8/18/2021	AA-/Aa3	1.76%

Source: ©2013 Invesco PowerShares Capital Management LLC
[http://www.invescopowershares.com/products/holdings.aspx?ticker=DSUM&onesortby=namedown]

Biographies

Henry To, CFA, CAIA

Managing Director of Research

Mr. To currently serves as Managing Director of Research for CB Capital Partners by leveraging his many years of investment, consulting, and valuation experience. Mr. To has extensive experience in institutional asset management, portfolio allocation, global macroeconomics, and international public policy. Mr. To brings his unique business ideas, entrepreneurial mindset, managerial experience, and professional consulting skills to CB Capital Partners.

Previously, Mr. To was the Founder and Managing Partner of MarketThoughts LLC, an investment advisory service catering to global investors, including the world's largest alternative asset management firms (e.g. Tudor Funds). Prior to MarketThoughts LLC, Mr. To held Investment, Energy Consulting, and Actuarial Consulting positions with firms such as Buck Consultants, Lukens Energy Group (now part of Black & Veatch), and Mercer, where he obtained substantial experience in institutional asset management, project management, and performed valuations on non-traditional assets such as ERISA pension/actuarial contracts, natural gas storage fields, and weather derivative contracts.

Mr. To is also an Adjunct Professor at the UCLA Luskin School of Public Affairs. In that capacity, Mr. To created a class curriculum and lectured on a variety of public policy areas, including education, crime, drug, national security, and international policy. Mr. To will be teaching two classes at the UCLA Luskin School of Public Affairs in summer 2013. In addition, Mr. To is an instructor in the USC/CFALA Review Program, where he teaches the CFA Exam Level II Economics section. Mr. To has been interviewed and quoted by the New York Times Business Section, among other publications. Mr. To has also been a featured speaker at the Western Pension & Benefits Conference (Orange County Chapter), where he discussed the role of private equity and infrastructure investing in pension fund portfolios.

Mr. To received a BA in Mathematics and Economics from Rice University, and MBA in Finance from UCLA Anderson School of Management, and a Masters of Public Policy (MPP) in International Policy from UCLA Luskin School of Public Affairs.

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Mr. Lertsakornsiri currently serves as a Global Macro Research Intern for CB Capital Partners, and is also a UCLA Anderson MBA candidate, class of 2014. Prior to CB Capital Partners and UCLA Anderson, Mr. Lertsakornsiri spent nearly three years as a structured product analyst at CIMB Thai Bank Plc., Thailand, where his expertise was in creating financial products based on interest rate, foreign exchange rates, and commodity derivatives in Southeast Asia.

Prior to CIMB Thai Bank Plc., Mr. Lertsakornsiri spent two years as an auditor at PricewaterhouseCoopers in Shanghai, China. Mr. Lertsakornsiri was responsible for the technology industry and performed a number of financial due diligence and valuation projects including spin-offs of multinational companies. Mr. Lertsakornsiri has extensive experience in advising individual and institutional clients including providing asset allocation strategies in derivatives product investment.

Mr. Lertsakornsiri graduated from Chulalongkorn University, Thailand, in 2004 with a Bachelor's degree in Electrical Engineering. Mr. Lertsakornsiri is currently a FRM holder and a CFA Level III passing candidate.

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