On Monday 30th November, the IMF welcomed the Chinese currency, the yuan, into its selective basket of reserve currencies. The yuan now joins the US dollar, euro, Japanese yen and British pound in the exclusive group of currencies that have Special Drawings Rights (SDRs) at the IMF. Whilst the inclusion is more symbolic than economically significant (the yuan is now just one more currency into which governments can place their reserves, or use freely to make payments), the move sends a strong signal about China's importance on the world's financial stage.

The IMF move prompted us to write this overview about the world's major currencies, to explore the reasons for their fluctuations over the last 18 months and to consider the implications of further currency gyrations on global stock-markets in 2016.

Confusion surrounding the relevance of movements in the Chinese currency has wreaked havoc in 2015, creating significant volatility in equity markets as a result. The name itself is confusing - remnimbi or yuan? What is the difference? Nothing, as it turns out – 'renminbi' is the currency's official name and means "the people's currency" in Mandarin whereas 'yuan' is the actual official currency unit, much akin to 'pound' and 'sterling'.

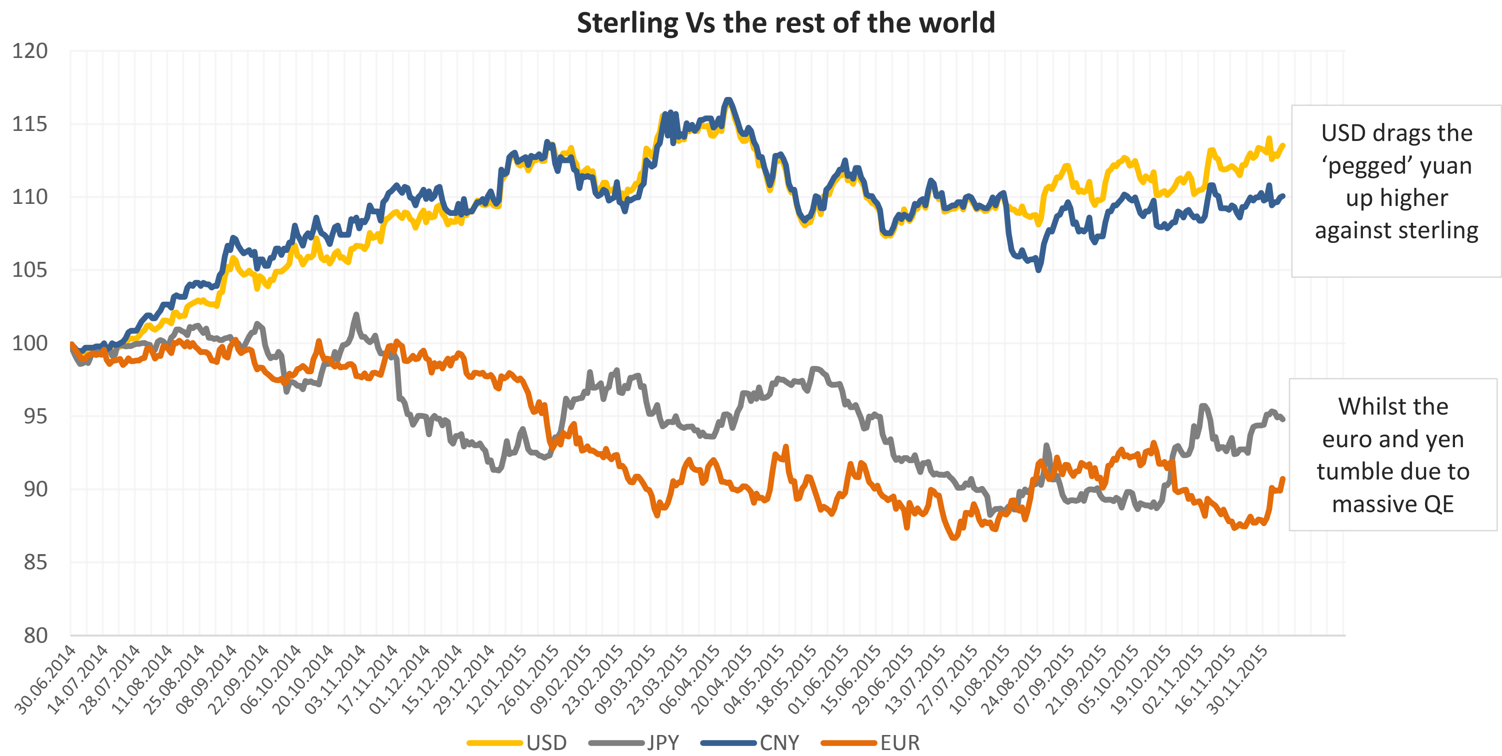
Whilst the Chinese have been allowing a gradual revaluation of their currency over the past couple of years in anticipation of the yuan's acceptance into the IMF reserve basket, the move is significant because it is the first change to the basket since 1999 when the euro replaced the Deutshce mark and the French franc! It was also only recently (August) that China's 2% devaluation badly rocked the stock-markets and analysts have therefore questioned the general timing of the move, citing concerns that further yuan fluctuations may have an even bigger impact on markets now that China is part of this exclusive club.

The good news in the short term is that the changes won't come into effect until 1st October 2016 so markets at least have a while to become used to the idea. In the meantime any additional devaluations of the yuan will therefore cause no further damage as a direct result of China's inclusion in this basket. In fact, in the run up to its inclusion, China will shift to a 'managed-float' system before it transitions into a fully floating currency meaning less direct government intervention.

Welcome to the club. The IMF includes the Chinese yuan in its basket of global reserve currencies

When the basket is re-jigged, the yuan will supersede both sterling and the yen in terms of weighting. The US dollar will account for 41.73%, the euro for 30.93%, 10.92% for the yuan, 8.33% for the yen, and 8.09% for the British pound.

In the short term predicting movement in the yuan is very difficult due to the uncertainty of possible government intervention, although we suspect that further devaluations are unlikely. As China recovers the yuan should strengthen but when this recovery begins is a matter of some contention. In the meantime we believe that it is prudent to steer clear of direct exposure to the yuan.



Japanese yen

The surprise election victory for Shinzo Abe in 2012 and subsequent shift in economic policy, resulting in massive expansion of the Japanese money supply, has driven the yen significantly lower for over two years now. As was the case with quantitative easing (QE) in the UK and more notably in the US, whilst there was not an implicit statement stating that they wished to weaken the currency, a large increase in the supply of money led to an inevitable dilution of the currency's purchasing power. The yen has been in freefall against both the dollar (19%) and sterling (12%).

Currently the central bank of Japan aims to expand its monetary base by a further 80 trillion yen per year. Whilst this enormous intervention has not yet properly kick-started the Japanese economy, we have confidence that the incumbent government have the ability to force Japan out of its deflationary spiral. From an economic perspective this makes Japanese exports very competitive in the long term and re-affirms our view that Japan is still a good investment opportunity. The Nikkei 225 is up c105% since Shinzo Abe took power in 2012 and we feel that there is more to come.

But what of the currency specifically? The yen has traditionally been seen as a "risk-off" currency to which investors flock when times are tough. Over the last couple of years Japanese stock market strength has been coupled with yen weakness and therefore hedging exposure to the yen has been sensible for anyone thinking that Japanese markets will rise. However the rationale for this "short yen" trade is starting to diminish and whilst QE will continue for the foreseeable future we are starting to wonder whether the yen has weakened too much. For the time being whilst QE continues unabated we are happy enough to continue hedging the yen but will be looking to change this if momentum for the trade runs out of steam.

Euro

Like with the yen, the Eurozone's massive quantitative easing programme started by the ECB in November 2014 has significantly weakened the euro, to the point where the Eurozone currency has approached parity with the dollar and has seen the GBP/EUR rate reach highs not seen since 2007. QE was a bold move politically for Europe, with the Germans historically very reluctant to embark on any policy that might lead to uncontrollable inflation. However, needs must and the ECB is currently buying €60bn worth of bonds a month with the possibility of further support if required.

Whilst the euro hit a low of €1.43 versus GBP recently, there was some respite last week, after Mario Draghi's announcement that QE would be extended by six months to March 2017 but crucially not expanded further (remaining at €60bn a month). Stock-markets also tumbled on the news. However we actually see this as good news for the Eurozone as it could signal that the ECB are becoming more confident about the possibility of a recovery and that they wish to temper QE accordingly.

However the economic data suggests that there is much work to do. Given that Q3 economic growth in the Eurozone was a lowly 0.3%, that inflation in the Eurozone is still far off the ECB's target of just under 2% (year-on-year inflation is a dismal 0.1%) and with unemployment at a 4 year-low of 10.8% it is clear that further QE expansion could be necessary.

On balance we therefore believe that the euro will weaken further from here, particularly if you factor-in that both the US and the UK will probably start raising interest rates, with the US maybe as soon as next week and the UK at some point over the next 12 months.

US dollar

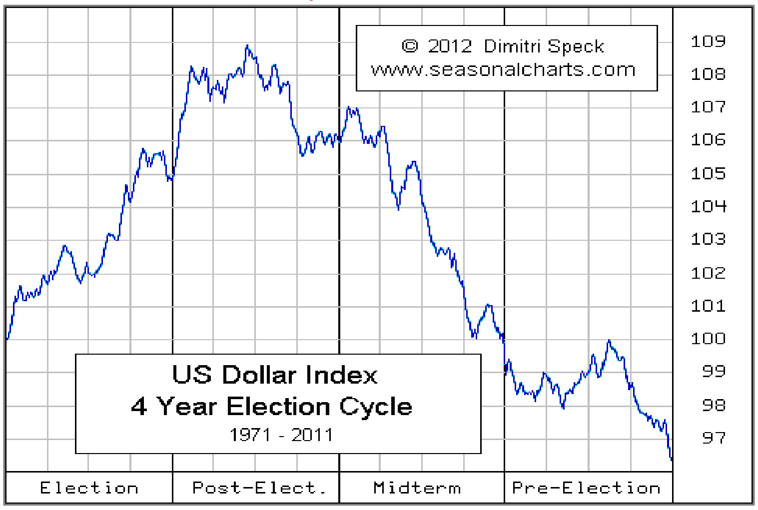
We've been supporters of the dollar for the last 3 years and having sunk as low as $1.71 versus GBP in July 2014, the 'Greenback' has since been on an unstoppable march higher ever since and currently it sits at c$1.50, having hit $1.46 in April. We believe that dollar strength should not have been much of surprise. Ben Bernanke signalled the impending end of QE in mid-2013, indicating a stronger outlook for US growth and therefore we couldn't really see any rationale for the dollar falling 15% from July 2013 to mid-2014. Then with the announcement by Janet Yellen in October 2014 that QE was over it became increasingly evident that the US economy was well on the way to recovery and that a stronger dollar was therefore justified, yet it was only at this point that the markets in general started to take notice.

With the renminbi now part of the IMF reserve basket of currencies and Yellen priming the markets for a rise in interest rates, it is no wonder that the dollar is appreciating versus almost all other major currencies. QE in the Eurozone and in Japan has pushed the dollar upwards versus their respective currencies. Currently it looks like monetary policy in the Eurozone and the US is heading in the opposite direction and such divergence between expansive and restrictive monetary policy could push the dollar and the euro even closer to parity and perhaps even beyond it.

A possible additional boost for short-term dollar prospects is the upcoming election in 2016.

Historically the dollar weakens in the year before the election and then strengthens in election year (see chart below):

US Dollar-Index Election Cycle



However there are several factors that could drag the US dollar lower. Firstly whilst the dollar does tend to rise pre-election (as above), it could be argued that we've already seen a large pre-election dollar spike and that further appreciation could be muted in election year itself. Also the big risk for the dollar in the short-term is that the Fed does not increase interest rates next week. If no raise is announced (although highly unlikely now) we would expect the USD to fall materially in the short-term.

Finally, it is unusual for rates to be increased aggressively pre-election, as Federal Reserve bankers are reluctant to muddy the waters politically before another four-year term is decided. Janet Yellen gave some indication last week that supports this stance, listing a range of factors that will lead the Fed to proceed very gradually and cautiously with the tightening of interest rates, notably emerging market fragility. This may curb much further dollar upside in the short term.

Over the next few years we expect further dollar strength against both the yen and the euro but the GBP/USD relationship is trickier given that both economies have stopped QE and are now starting to grow (although this is most notable in the US, which is reaching full employment).

These short term considerations to one side, the US recovery is well ahead of the UK's and this explains why over the last few years the Bank of England has trailed the Fed when it comes to monetary policy.

On balance we expect that the US dollar has further to climb against sterling given the longer-term growth outlook in the US versus the UK.

Sterling

So this brings us finally round to GBP. As already mentioned above, recently we have seen sterling gain strength versus a weak euro and Japanese yen due to aggressive QE in these economies but also because the UK economy is relatively stable in comparison. With year-on-year economic growth in the UK running between 2-2.5% and with Eurozone growth remaining weak, this adds merit to the argument that the pound should strengthen further against the euro.

The effect of the yuan's inclusion in the IMF's basket of reserve currencies has proven to be rather negligible for the pound presently because sterling lost very little overall weighting as a result of the re-shuffle (the real loser was the euro).

As demonstrated by the imminent interest rate rise in the US, the US economy has recovered faster than the UK, and thus we believe that (as above) this will drive the US dollar higher against the pound.

How do we position for these movements

Whilst currency movements are generally a barometer for the underlying strength of an economy we do not typically look to invest in a geography or sector purely to 'play' the currency, as this proves very difficult to time correctly. Inexplicable US dollar weakness in 2013 is the perfect example of how timing currencies in the short-term can go badly wrong.

However if a longer-term trend is spotted, such as massive monetary expansion, this should be a clear signal that a currency will weaken. When such an obvious trend is identified, it is now far more feasible to remove a specific currency's risk within a portfolio by buying funds that 'hedge' the currency back to sterling and this forms a core part of our fund selection process. Removing the risk that currencies will weaken against your base can add real value to investment returns - as demonstrated by the hedged MAN GLG Japanese fund that we own compared with its unhedged counterpart (see below).

We believe that speculating in currencies is very dangerous for the inexperienced investor and even the best traders in the world make a wrong call more than 40% of the time. However it is certainly sensible to consider eliminating currency risk in the right circumstances and we adopt this approach when managing our clients' portfolios.

A tale of two share classes - simply hedging out exposure to the yen has made a huge difference to investment returns in what is otherwise the very same fund: