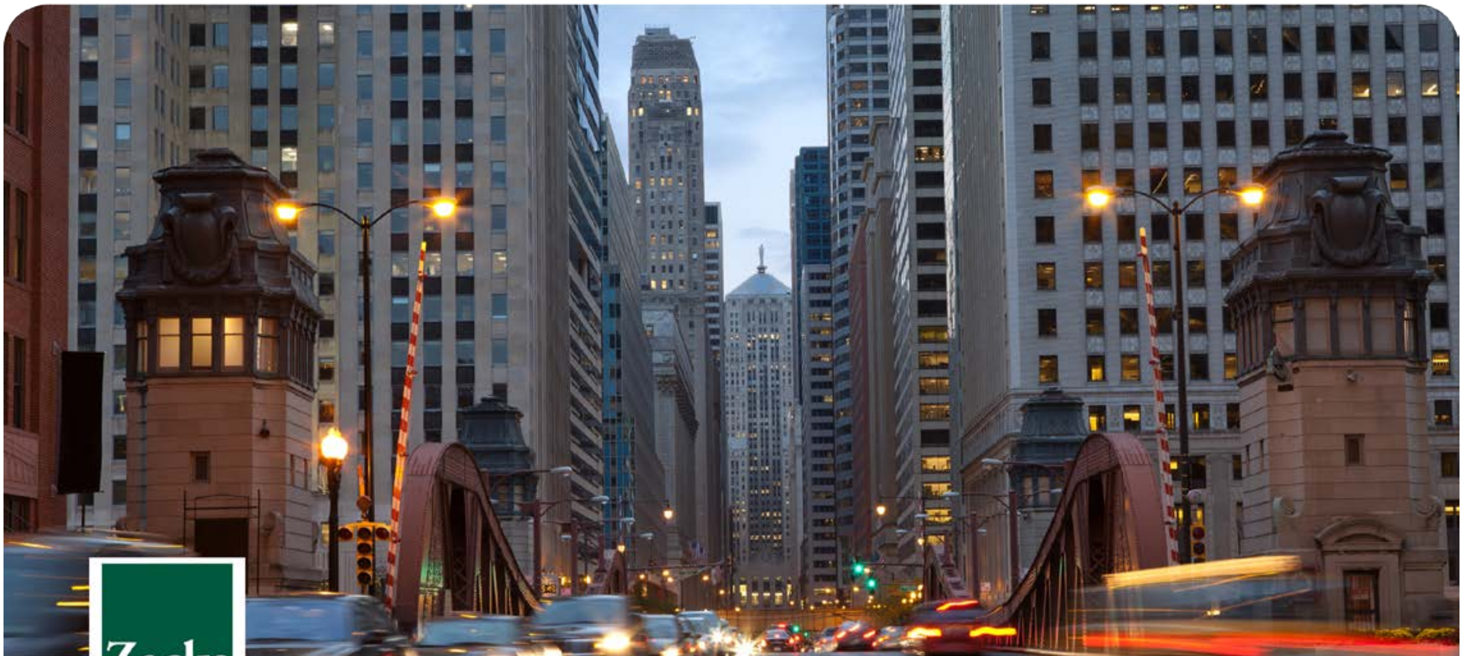

Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Demise of the Dollar?

By Mitch Zacks
Senior Portfolio Manager

I've received several questions from clients over the last few days regarding China's currency, the yuan. Almost all of them were some variation of these three: *with its acceptance into the International Monetary Fund's (IMF) 'Special Drawing Rights' basket, is the yuan a threat to the dollar's status as the world's top reserve currency? If central banks around the world start replacing dollars with yuan at an alarming pace, will it threaten the U.S. economy? Is this just another sign of China taking over the U.S. as a global economic superpower?*

When I hear questions like this (which is often), I get the increasing sense that investor bearishness is on the rise. It certainly doesn't help when the media narrative makes it seem like this IMF decision is somehow the 'beginning of the end' for the U.S. dollar. Is this something we should be worried about?

3 Challenges to the 'Rise' of China's Currency

If you're old enough to be reading this article, then in my view, there's less than a 1% chance the yuan will overtake the dollar in your lifetime as either (1) the most held foreign reserve currency or (2) the primary currency used for international trade. Simple as that - here are three reasons why.

1. **It May Not be Mathematically Possible –** according to the IMF, there are about $11.5 trillion in foreign exchange reserves (forex) in the world. *Quick note: a foreign exchange reserve is an asset held by a central bank, usually in the form of a sovereign bond (like a U.S. Treasury) or bank notes.* Of those $11.5 trillion, *about $4.2 trillion* of them are in U.S. dollars. That means the U.S. dollar accounts for over 60% of all foreign reserves! China is barely a grain of sand in the forex markets and, while that may change going forward with its status as a global IMF currency, it will be decades upon decades until it can surge to

overtake the U.S. But here's where the mathematical impossibility comes in:

- The U.S. towers over all other countries in terms of foreign reserves *because the U.S. has the most available currency assets to trade*. We have about $13 trillion tradeable U.S. Treasuries out there, which foreign central banks love to own – *it's the safest, most liquid debt in the marketplace.* For the yuan to overtake the U.S. dollar, it would mean that enough yuan and "tradeable Chinese securities" have to be available in the marketplace for central banks to buy it. That's simply not the case today – there is only around $1.5 trillion in Chinese government debt. Even if central banks wanted to ditch all their dollars for yuan (which they absolutely don't), it wouldn't be possible – there aren't enough yuan to go around.

2. **China Doesn't Have Enough Currency Agreements –** as of right now, the yuan is only convertible into six currencies: the USD, the yen, euros, British pounds, Russian rubles, and Australian dollars. If someone in Mexico wants to buy goods direct from China, they have to convert their pesos to dollars in order to make the purchase. If it's going to become the top currency in the world, it's got a mountain of currency agreements to make first. Don't expect that to happen overnight.

3. **Capital Controls in China Make it Difficult (and Unattractive) to Access –** China still has scores of regulations for how foreigners can invest, who can participate in their stock markets and how the yuan's exchange rates are set. Additionally, Chinese state debt is not necessarily available for purchase from any central bank – it's regulated. Capital controls of this scale are not conducive for being at the center of the global marketplace. China needs fairly radical change before achieving that designation, which could take decades if it even occurs at all.

Bottom Line for Investors

Inclusion of the yuan into the International Monetary Fund's 'Special Drawing Rights' basket is simply an acknowledgement of China as a legitimate player on the global economic scale. It reflects recognition that China has developed to the point where it deserves a seat at the 'global capital markets' table. For now, though, the U.S. dollar reigns supreme. The weights for the IMF's drawing basket will be: 41.73% for the U.S. dollar; 30.93% for the euro; 10.92% for the Chinese yuan; 8.33% for the Japanese yen, and 8.09% for the British pound.

Investors need not fear China's increased participation in global capital markets, nor should anyone read too much into what this means for the dollar. As long as the U.S. remains the largest, most diverse and most sophisticated economy in the world, the U.S. dollar will be the most important currency in the world.

- **Mitch**

About Mitch Zacks

Mitch is a Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

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