

CURRENCYSHARES BRITISH POUND STERLING TRUST

Form FWP

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### **China: The Emergence of a Global Superpower**

The Great Wall of China was originally built by the Chinese people to keep out their enemies. It has become one of the Eight Wonders of the World, and serves as a subtle reminder of how China has isolated itself over the years. China has recently reemerged as a global powerhouse, and has begun to open up to the outside world, yet the symbolism of the Great Wall still stands tall.

**Currently, as the second-largest economy in the world,**

**China is growing more rapidly than most other developed countries.**

China is the second-largest economy in the world (see Chart 1), and, according to the World Bank, its economy is growing much more rapidly than most other developed economies. In the second quarter of 2011, Chinese GDP rose 9.5% versus a year earlier, boosted by domestic consumption and investment.<sup>1</sup> While there are increasing concerns about inflationary pressures, China must be watched carefully, as it is a significant player on the global stage.

The U.S. and China have had a contentious relationship surrounding trade policies; however, both superpowers are dependent upon one another. According to the World Trade Organization, China is the largest goods exporter in the world, followed by Germany, the U.S., Japan and France. China produces inexpensive goods, and sells them around the world. China is also the largest holder of U.S. Treasuries, and is one of the biggest trading partners for the U.S.<sup>2</sup>

<sup>1</sup>Source: Reuters, China quarterly growth tops forecasts, boosts inflation fight,

July 13, 2011

<sup>2</sup>Source: U.S. Department of the Treasury

### Supporting Growth in the Chinese Economy

China not only has the largest population of any country (1.3 billion) it also comprises 20% of the world's population. To put it in perspective, China has approximately 1 billion more people than the U.S. As China's population continues its migration to cities, the country must modernize its cities, and move from an agrarian society to more of an urban society. To accommodate the changes, China must invest in its infrastructure, building roads, high speed rail, housing and office buildings. And as the country's youth begins to leave the farm for the city, China must invest in bicycles, motorcycles and cars. All of this leads to significant consumption of global natural resources (see Chart 2).

### Chart 1: Size of Major World Economies in Trillions of USD (2010)

*Note: Measured at market exchange rates.*

*Source: International Monetary Fund*

### Chart 2: China's Share of Global Commodity Demand (2010)

*Source: Bloomberg, Thomson Financial*

<sup>3</sup>Source: About.com Geography

China faces numerous economic challenges: inflationary pressures, anemic population growth, lack of skilled labor, economic inequality and constant government intervention. The Chinese government has recently shown some willingness to tame inflation. While China has the world's largest population, its anemic population growth will ultimately present problems down the road as its workforce ages without adequate replenishment. The sheer size of the Chinese economy means that China will likely remain a formidable player on the global stage.

#### **Economic Challenges Facing China**

Inflation

Population growth

Skilled labor force

Income inequality

Government intervention

### Examining Issues Related to the Renminbi

One of the more contentious trade issues has revolved around China's currency. Unlike other major currencies that freely float based on the strength and weakness of the underlying economies, the renminbi (also known as the yuan), is largely controlled by the Chinese government. To keep its economy booming, the Chinese government wants to keep tight controls over the value of the renminbi. However, at the same time, the government is in the early stages of positioning the renminbi as a future global reserve currency which are two inconsistent goals.

According to the Annual Report of the International Monetary Fund (IMF), inflation, real-estate bubbles and weak monetary controls pose significant risk to the Chinese economy. The IMF has encouraged China to boost its currency to combat the risks. The IMF declared the Chinese currency was substantially undervalued between 3% and 23%, depending on the methodology used. The Chinese government wants to keep the currency undervalued for the following reasons:

A weaker exchange rate makes exports more competitive, increasing demand

Chinese economic growth is largely dependent on exports

China needs to maintain strong growth to raise living standards

Growth in exports creates jobs and fuels economic growth

**If internal and external forces prevail ... the renminbi could appreciate substantially.**

Keeping the currency artificially low, however, inevitably stokes inflationary pressures. Since China is an importer of commodities (see Chart 2), a weaker exchange rate increases the cost of raw materials. The government is thus being

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pressured from within China as well as from outside to increase the exchange rate to slow inflation. If internal and external forces prevail, and China allows its currency to seek equilibrium, then the renminbi could appreciate substantially.

<sup>4</sup>Source: International Monetary Fund, Staff Report for the

2011 Article IV Consultation with China

### **Capitalizing on the Renminbi Opportunity**

China represents an exciting investment opportunity. The sheer size of the Chinese economy warrants careful consideration. China has been accused of manipulating its currency, keeping it undervalued to fuel economic growth. With increasing pressures from home and abroad, China has gradually increased rates, thereby demonstrating its willingness to fight inflation. If China allows its currency to float, there could be significant appreciation of the renminbi.

The challenge for most investors is how to capitalize on this opportunity. The Foreign Exchange (Forex) market is primarily used to settle trades across nations, but is also used by companies, hedge funds and other institutions to hedge the impact of currency exposure, or to speculate on opportunities, by going long or short currencies. Currency investing is becoming much more mainstream with the introduction of exchange traded products (ETPs) and multi-currency solutions.

## CurrencyShares

The leader in currency-based exchange traded products based on both assets and breadth of product, CurrencyShares offers investors access to 10 currencies in a cost-effective exchange traded structure. CurrencyShares are grantor trusts that hold actual foreign currency deposits in a segregated account, rather than using futures contracts or other proxies that may lead to imprecise tracking of the underlying currency. Interest earned, if any, accrues daily. After trust expenses are paid, remaining interest is distributed to shareholders monthly<sup>5</sup>. Tickers for these products are as follows: CurrencyShares<sup>®</sup> Australian Dollar Trust (FXA), CurrencyShares<sup>®</sup> British Pound Sterling Trust (FXB), CurrencyShares<sup>®</sup> Canadian Dollar Trust (FXC), CurrencyShares<sup>®</sup> Chinese Renminbi Trust (FXCH), CurrencyShares<sup>®</sup> Euro Trust (FXE), CurrencyShares<sup>®</sup> Japanese Yen Trust (FXY), CurrencyShares<sup>®</sup> Mexican Peso Trust (FXM), CurrencyShares<sup>®</sup> Russian Ruble Trust (FXRU), CurrencyShares<sup>®</sup> Swedish Krona Trust (FXS) and CurrencyShares<sup>®</sup> Swiss Franc Trust (FXF).

The CurrencyShares ETPs provide a cost-effective means of investing in foreign currencies. The following are some additional key benefits:

**Accessibility** Investors can access the currency markets through a traditional brokerage account. Shares are bought and sold on the NYSE Arca just like other exchange listed securities.

**Transparency** CurrencyShares are grantor trusts, and they hold actual foreign currency deposits as their sole asset as opposed to money market debt instruments or derivatives contracts.

**Direct Currency Access** The foreign currencies are deposited in segregated depository accounts at J.P. Morgan (London).

**Exchange Traded** CurrencyShares are bought and sold on the NYSE Arca, providing an efficient means of incorporating tactical strategies or hedging exposures. CurrencyShares are eligible for margin.



**Liquidity** CurrencyShares are liquid. They can be purchased in the secondary market. Shares of each Trust can be created or redeemed in baskets of 50,000 units by Authorized Participants.

**Choice** With 10 different products covering the world's major currencies, investors can easily customize their trades to meet their investment objectives.

**Direct Currency Holdings** The assets of each Trust back the shares. The Trust does not hold or employ derivatives.

<sup>5</sup> Such interest is not expected to form a significant part of the shareholders' investment return.

## Rydex|SGI

**Rydex|SGI is committed to offering investors greater potential to successfully navigate diverse market conditions. Our legacy of innovation in the ETF market includes the industry's first equal weight ETF, as well as the first currency exchange traded product. With eight years of ETF experience, Rydex|SGI delivers a wide line-up of nearly three dozen exchange traded products, including 16 equal weight ETFs. Rydex|SGI has more than \$24 billion in assets<sup>6</sup> under management and offers investors more than 100 investment choices including mutual funds and ETFs.**

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<sup>6</sup> Assets as of August 31, 2011.

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