How to Protect Your Portfolio From the Devalued Yuan

Description

Earlier in the week, news that China devalued its currency by 2% against the U.S. dollar sent the value of the loonie tumbling by approximately 1% against the U.S. dollar, and the TSX as a whole is down by 1.5%.

These moves weren't random. The decision by China to devalue its currency has important implications, not only for the Canadian economy as a whole, but also for Canadian equities. The move by China to devalue its currency can be seen as an effort to boost exports and offset a serious—and likely permanent—slowdown in a country that has been an economic engine for many of the commodities Canada produces.

Fortunately, Canadians can insulate their portfolio from coming headwinds by avoiding commodity names and sticking with stocks like **Agrium Inc.** (TSX:AGU)(NYSE:AGU) and **DH Corp.** (TSX:DH).

How China's currency affects Canadian equities

Firstly, it is important to understand how China's currency can affect Canadian equities. One of the major ways is through commodity prices. From the late 90s until recently, nearly every commodity has enjoyed unprecedented increases. Oil prices, for example, rose 1,060% from the late 90s to 2008, with coal prices rising over 600% for the same period.

This growth was driven by double-digit growth rates from China. Now, China is seeing its growth rate fall from as high as 15% to an expected 7% this year as the economy switches from an investment to a household consumption-based economy.

The move to weaken the yuan is a symptom of this broader issue, as China hopes to make its exports more attractive and further stimulate growth. Slowing growth from China will weigh on commodity prices like coal, copper, and oil (which directly affect over 30% of the TSX and indirectly affect much more).

More directly, the weakened yuan means that that price of imports for China will rise (since commodities are priced in U.S. dollars). This will weigh on demand for key commodities, which will in turn affect Canadian mining, energy, and even financial businesses that are exposed to these sectors.

In addition, the devalued yuan could lead to strength in the U.S. dollar. This in turn could weaken the Canadian dollar relative to the U.S. dollar. The end result is that Canadian businesses with assets in the U.S., or that generate revenues in U.S. dollars with costs in Canadian, are poised to benefit.

How to insulate your portfolio

The first step is avoid stocks that are heavily dependent on commodities. Stocks like pure-play synthetic crude producer **Canadian Oil Sands Ltd.** (TSX:COS) or **Teck Resources Ltd.** (TSX:TCK.B)(NYSE:TCK) would meet this criteria. The devalued yuan means demand for imports of these products will likely be reduced, and the weak economic growth from China that precipitated the devaluation will further weigh on these stocks.

Teck Resources is of particular concern. The company produces metallurgical coal, which is used in steel-making. With China being the world's largest steel consumer, falling demand for steel combined with the weak yuan will likely lead to China reducing imports and using more domestic supply.

Instead, focus on stocks with minimal commodity exposure that profit from a weak loonie and have a low "beta" (or correlation to the overall TSX). Stocks like Agrium Inc. and DH Corp. are excellent choices in this regard. While agricultural company Agrium does produce fertilizer (which is technically a commodity), half of its revenue comes from its agricultural retail segment. In addition, the majority of the company's sales are in U.S. dollars, and a majority of its costs are in Canadian dollars, which means it benefits from the weak Canadian dollar.

Financial technology provider DH Corp. is also poised benefit. Not only does DH Corp. have no exposure to commodity prices, but it also generates 70% of revenue in U.S. dollars, which receives a boost when converted back to Canadian.

Most importantly, both DH Corp. and Agrium have a low beta. That is to say, they are not strongly correlated to the TSX. When the TSX falls due to weak commodity prices or a weak dollar—helped by a devalued yuan—DH and Agrium can be expected to fall less.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TECK (Teck Resources Limited)
2. TSX:TECK.B (Teck Resources Limited)

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