

People's Bank of China's move to market-based currency setting a game changer

The Chinese renminbi (RMB) fell 1.9% on 11 August 2015¹ and had shed a further 1.6% as at noon on 12 August¹ following the People's Bank of China's move to devalue the currency against the US dollar and implement a market-based determination of the official fixing rate. All major Asian currencies followed the RMB down. In this note, Manulife Asset Management's Greater China equity and Asia fixed income specialists discuss the potential for increased currency volatility across the region in the short to mid-term and the implications for Asian capital markets in the longer term.

The People's Bank of China (PBoC) unexpectedly weakened the RMB on 11 August 2015, lowering its official fixing rate almost 2% to 6.2298 to the US dollar – its lowest point in almost three years – from 6.1162 the previous day¹. The central bank stated this was a one-off adjustment to better reflect market rates.

The PBoC also announced an important change to how the onshore USD/CNY fixing rate would be determined². Up till now, the central bank had set the mid-point of the exchange rate at 9:15am each trading day (Beijing time) with the onshore RMB spot rate allowed to trade within a +/-2% band around the mid-point. Effective immediately, the mid-point will be based on market maker submissions based on the previous day's USD/CNY spot market closing price, thereby taking into account supply and demand dynamics and the movement of other major currencies.

RMB volatility increased immediately following the announcement, but bond markets were relatively stable as onshore government bonds and policy banks moved up by around 5 basis points while investment-grade CNH bonds (offshore-traded RMB bonds) moved up by an average of 10 basis points.

Short to mid-term investment challenges

In the short to medium term, the devaluation has significant implications for both China's and regional markets. On the domestic front, the move followed the 8 August announcement of weaker-than-expected export and import numbers, potentially signalling that the slowdown in China's economy is more severe than many market watchers had imagined. From this perspective, the revaluation could be interpreted as a stimulus measure aimed to boost exports and re-invigorate the Chinese economy – indeed, the move follows four interest rate cuts since November 2014.

From a regional perspective, the RMB had served as an anchor for Asian currency markets over the past 18 months, remaining relatively stable even as other major currencies in the region lost significant ground to the US dollar. With the anchor having slipped, all major Asian currencies lost ground following the announcement as international investors moved to trim regional capital market positions – a development that could be exacerbated if other central banks in the region move to devalue their currencies to boost their export competitiveness versus cheaper Chinese exports.

¹ Bloomberg, 12 August 2015

² http://www.pbc.gov.cn/publish/english/955/2015/20150811090338341860668/20150811090338341860668_.html

Our base-case scenario is that RMB devaluation signals increased equity and fixed income market volatility across Asia, wider fixed income credit spreads and weaker Asian currencies in the short to mid-term. A worst-case perspective is difficult to formulate this early, but it could include lowering economic growth forecasts for China and potentially for other affected markets. If this were the case it could even lead the US Federal Reserve to delay the long-anticipated interest rate hike that many had expected as early as September 2015.

View from the Fixed Income desk

Paula Chan, Senior Portfolio Manager and Chinese bond market specialist with Manulife Asset Management, described the move to more market-based exchange rate determination by the PBoC as a “game changer”.

“The devaluation essentially marks the end to a stable carry trade where investors were able to invest in relatively high yielding Chinese assets with limited downside currency risk,” explained Chan. “In the short to mid-term, we are likely to see increased volatility as markets undergo price discovery and establish a new equilibrium. In fact, there is a high chance that market sentiment will lead the RMB to overshoot its equilibrium value in the coming days and weeks and fall further than market fundamentals warrant.”

That being said, from the longer-term perspective Chan sees the move as a net positive: “The move towards a market-based fixing rate brings the RMB into line with other internationally traded currencies and we expect it to behave more like a G7 currency in the future. We note that the PBoC has pledged further reforms such as the opening up of the foreign exchange market, the extension of the RMB trading hours and promoting convergence between the onshore and offshore exchange rates.”

From this perspective, the move is likely an important step towards the RMB's inclusion in the IMF's special drawing rights (SDR) basket, which could occur as early as December this year, and towards further internationalisation of the currency.

In terms of market implications, Chan believes that the potential for the RMB to overshoot its fair value could represent an attractive entry point. Against this backdrop, investors could consider adding RMB exposure on currency weakness. She expects the RMB/USD to trade between 6.3 and 6.4 over the next 12 months.

View from the Equity desk

Meanwhile, China and Hong Kong equity markets were relatively unmoved following the devaluation as the CSI 300 closed 11 August 2015 down 0.43%¹ while the Hang Seng Index fell just 0.09%¹. As of 12:00 noon local time on 12 August Chinese equities remained relatively stable, having fallen a further 0.36%, while Hong Kong equities had shed 1.75%¹.

Commenting on the market implications, Kai Kong Chay, Manulife Asset Management's Greater China Equities specialist, said, “Chinese equity markets could see increased short-term volatility as investors digest the implications of the PBoC's move. While we do not rule out further small currency adjustments in the coming weeks, we do not believe the authorities will implement another substantial devaluation to further support exporters. Rather, we believe that further stimulus measures will be implemented in support of the broader economy, including further interest rate and reserve requirement ratio (RRR) cuts and moderate liquidity injections in the months ahead.”

Chay acknowledges the potential for higher US dollar debt servicing costs to curtail corporate capex and dent growth for affected airlines and minerals, steel, shipping and property companies, among others. As a result, he remains most positive on export-oriented companies and structural growth sectors such as environmental protection, media and travel services companies that will benefit either directly from the currency devaluation or from further stimulus measures in the months to come. He is also watching closely to identify sectors that are likely to benefit from ongoing efforts to modernise and automate industrial production to address the challenge of China's shrinking work force.

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