China's move to market-based currency setting a game changer – implications for Malaysian and Chinese markets

The Chinese renminbi (RMB) fell over 4% in the three days 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 on 11 August 2015. All major Asian currencies followed the RMB down. In this note, Manulife Asset Management's Malaysia investment desks share their views on the impact on Malaysia equity and fixed income markets and their outlook. In addition, the company's Greater China equity and fixed income desks 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's (PBoC) move to unexpectedly weaken the RMB on 11 August saw the currency decline by 4.58% in the space of three days[1] before stabilising as China's central bank fixed the value of the RMB against the US dollar up by 0.05% on 14 August. Immediately following the revaluation, 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 determined[2]. Previously, 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. The mid-point will now 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 PBoC's move, 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. However, all major Asian currencies lost ground following the announcement as international investors moved to trim regional capital market positions. Other central banks in the region may also move to devalue their currencies to boost their export competitiveness versus cheaper Chinese exports.

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[1] Bloomberg
[2] http://www.bloomberg.com/news/articles/2015-08-11/china-weakens-yuan-reference-rate-by-record-1-9-amid-slowdown

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.

Implications for Malaysia

The devaluation of the RMB has so far had a limited impact on the Malaysian ringgit. While the majority of Asian currencies reacted by falling in tandem with the RMB, the ringgit strengthened initially before giving back its gains against the Chinese currency.

The ringgit was up as much as 3.4% against the RMB touching RM0.6123 per RMB on 13 August 2015, three days after the People's Bank of China's (PBoC) devaluation announcement[1]. However, sentiment subsequently turned negative, forcing the ringgit lower to close at RM0.6384 per RMB on 18 August 2015, slightly weaker compared with the RM0.6339 per RMB level prior to the PBoC announcement[1]. This follows a broad slump in the ringgit since the beginning of the year, which has seen the currency plunge 16.7% against the US dollar and 13.3% versus the RMB, due to deteriorating economic fundamentals and negative investor sentiment[1].

Consistent with the broader implications under our base-case scenario, the RMB devaluation is expected to translate to increased volatility in the equity and bond markets in Malaysia.

According to a Credit Suisse research report[3], while Malaysia's exports do not compete directly with those from China, a weaker RMB could lower China's domestic spending on imported goods. This would mean downside risk to Malaysia's export growth to China based on the above worst-case scenario of lower economic growth in China (due to slowing domestic demand). On the flip side, assuming there is no further large-scale devaluation by the PBoC, the weaker ringgit vis-a-vis the RMB could actually boost Malaysia's exports to China, which account for 12% of the country's total export value[4].

View from the Malaysian Equity desk

While the initial currency market impact was somewhat moderate, the PBoC's actions generated further uncertainty among investors. The FTSE Bursa Malaysia KLCI (FBM KLCI) fell 1.6% on the day of the PBoC's announcement and hit a low of 1,572 points on 17 August 2015, extending its year-to-date losses to 10.7%[1].

At this level, we believe market valuations are looking more attractive and seem to suggest the bulk of risks have been priced in. The FBM KLCI is now trading at a rolling three-year forward price-to-earnings (P/E) average of 14x, a whopping two standard deviations below its historical mean. While the FBM KLCI may decline further on fragile investor sentiment, past experience tells us that extreme low valuations are unlikely to last for a sustained period, presenting a potentially attractive entry point for investors.

Our current portfolio strategy is to focus on: 1) core holdings – stocks with strong earnings visibility and re-rating catalysts; and 2) fallen stocks with low foreign shareholdings backed by attractive valuations (as these stocks will be relatively shielded from any further foreign-led sell-down). Conversely, we would tend to avoid investing in companies with high US dollar borrowings and little US dollar income.

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[3] Credit Suisse Economic Research Report, 13 August 2015.
[4] JP Morgan Asia Pacific Equity Research Report, 12 August 2015.

View from the Malaysian Fixed Income desk

Malaysian bond yields have risen amid increased trading volatility following the PBoC's devaluation of the RMB. Due to increased selling, 10-year Malaysian Government Securities (MGS) yields rose from 4.161% on 10 August 2015 to 4.224% on 12 August 2015 and have continued to rise to 4.302% on 18 August 2015[1].

Going forward, the risk remains that foreign investors may be tempted to cut their exposures in view of the weakening ringgit. With foreign MGS holdings still high at 48.5% (translating to RM166.8 billion) as of June this year[5], there is a possibility that further withdrawals of foreign funds from the local bond market could exacerbate the downward pressure on the already weak ringgit. Nonetheless, the relatively high yields currently offered by Malaysian bonds may provide downside support from any further selling of these instruments. For example, the 10-year MGS is currently trading at an attractive yield of 4.302%, its highest level since January 2010[1].

View from the Greater China 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 Greater China 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]. However, Chinese equity markets have since seen increased volatility, with the CSI 300 declining more than 6% on 18 August on fears of further RMB depreciation.

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

[5] Maybank IB Research Report dated 31 July 2015.

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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