



Summary

Risk aversion moderates as China prepares to float the RMB

China announced on 19 June that they will “proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility”. Asian equity markets were lifted by the expectation that the RMB and the other Asian currencies are now set to appreciate.

China’s move to dismantle its peg to the US dollar has also been interpreted as a sign that the Chinese authorities see stability in the macroeconomic conditions despite the recent concern that the debt crisis in Europe may spill over to the global economy.

The futures market is currently pricing a 2.3% appreciation in the RMB over the next 12 months. For a number of reasons, our view is that we are likely to see only a 1-1.5% appreciation.

Although we expect the appreciation of the RMB to be modest, we expect the move to be positive on investors’ overall risk appetite. The debt problems in Europe and concerns that the global economy may enter a double-dip recession have led to a retreat from Emerging Market assets and an overall flight to safety in recent months. This announcement by China is a reminder to global investors of the potential strength of Emerging Market currencies, the potential for stronger spending power of Emerging Market consumers and the value of equity and fixed income investments in Emerging Markets.

On a longer term perspective, Asian currencies have been kept artificially low for a long time as Asian governments have relied on exports to drive their economies. We think China’s RMB announcement, although small in itself, symbolically marks a shift toward stronger Asian currencies. This ultimately means that Asia is reducing its reliance on exports and depending more on Asia’s own consumption demand. The emergence of Asia’s consumption power is the investment case for Asia for which we have long argued.



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RMB reform likely to lead to stronger RMB and other Asian currencies

China announced on 19 June that they will “proceed further with reform of the RMB exchange rate regime and increase the RMB exchange rate flexibility”. The announcement led to a rally in Asian equity markets on Monday. European equity markets also rose while US markets were flat or slightly lower.

Asian equity markets were lifted by the expectation that “flexibility” in the RMB means an appreciation of the RMB and by dint of that also the other Asian currencies. Asian currencies are likely to appreciate in tandem with the RMB because the majority of them are managed on a trade weighted basis and an appreciation of the RMB would likely be a trigger for the other Asian currencies to also rise.

The move by China to dismantle its peg to the US dollar has also been interpreted as a sign that the Chinese authorities see stability in the macroeconomic conditions despite the market’s recent concern that the debt crisis in Europe may spill over to the global economy. Allowing the RMB to rise amounts to a tightening of monetary policy for China.

RMB appreciation however likely to be modest over the coming 12 months

The announcement by the Chinese authorities over the weekend is different from the revaluation which occurred in July 2005. During that episode, the RMB underwent an overnight revaluation of 2.04% against the US dollar. In contrast, there has been no one-off revaluation this time and in a follow up statement issued on 20 June, the Chinese authorities emphasised their policy of “keeping the yuan basically stable at a reasonable and balanced level”.

The futures market is currently pricing a 2.3% appreciation in the RMB over the next 12 months. Our view is that we are likely to see only a 1-1.5% appreciation. We believe in a modest appreciation for several reasons:

The Chinese authorities kept the RMB fixing on Monday unchanged at 6.8275 to the US dollar. This is a clear message to the market that they are unwilling to tolerate a rapid and sharp rise in the RMB in the near term.

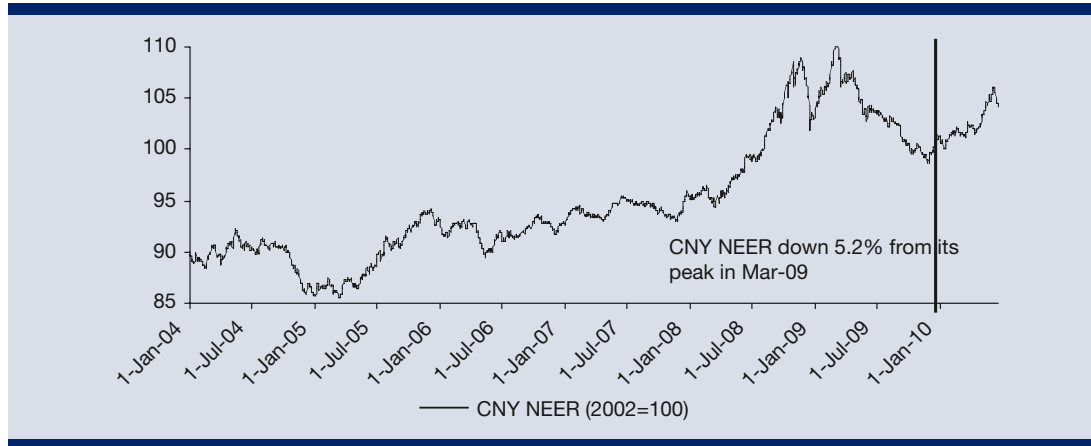
The RMB is currently also not as undervalued as it was five years ago. Since the July 2005 revaluation, the RMB has risen 19% against the US dollar and 17.8% on a trade-weighted basis. Compared to the other Asian currencies, it is fourth in terms of the level of appreciation over that period.



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CNY NEER is up 2.9% from end-2009 and 17.8% since 21 July 2005



China's economy is also likely to slow down in the second half of 2010 because of the clampdown on the property market in China and also because of potentially weaker demand from Europe given the debt crisis. As mentioned, an appreciation of the RMB amounts to a tightening in monetary policy for China and allowing a large appreciation would create more risks for the economy.

The recent strikes in China and the demand for higher wages mean that costs for the manufacturing sector have risen. The Chinese authorities will be aware that a stronger currency at this stage would increase the pain for exporters, therefore making it unlikely that we see any substantial appreciation in the RMB in the near term.

Emergence of Asia's Consumption Power

Although we expect the appreciation of the RMB to be modest, we expect the move to be positive on investors' overall risk appetite. The debt problems in Europe and concerns that the global economy may enter a double-dip recession have led to a retreat from Emerging Market assets and an overall flight to safety in recent months. The US dollar and US Treasuries have been the key beneficiaries of the rise in risk aversion. This announcement by China is a reminder to global investors of the potential strength of Emerging Market currencies, the potential for stronger spending power of Emerging Market consumers and the value of equity and fixed income investments in Emerging Markets.

On a longer term perspective, Asian currencies have been kept artificially low for a long time as Asian governments have relied on exports to drive their economies. We think China's RMB announcement, although small in itself, symbolically marks a shift toward stronger Asian currencies. This ultimately means that Asia is reducing its reliance on exports and depending more on Asia's own consumption demand. The emergence of Asia's consumption power is the investment case for Asia for which we have long argued.



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