AMG Market Commentary

12 August 2015

Will RMB Have A Further Sharp Devaluation? What's the Impact of RMB Devaluation on Investments?

<u>Chinese Government Devalue RMB First Time in Years</u>

On August 11, The PBOC adjusted down the RMB middle price by 1.9% (The USDCNY price on Monday was 6.1162, but on Tuesday it dropped to 6.2298). The PBOC stated in the announcement that from now on, the previous day's closing price will be taken into account when setting the middle price and that they will strengthen the market's role in the fixing and promote the convergence of the onshore and offshore rates. Even though the market to some extent has already expected RMB depreciation, both domestic and global markets have experienced substantial volatilities when the news comes.

Investors need to understand the following things when forecasting the future movement of RMB and its impact to the investment world.

1. **<u>RMB Pricing Mechanism</u>**

There are two markets involved in domestic RMB trading; inter-bank market and retail market. The onshore exchange rate of RMB is only influenced by the inter-bank market (the Chinese Government could easily control the exchange rate through the inter-bank market as the major participants are state-owned banks). Apart from the inter-bank market, the Chinese government has also controlled the exchange rate of RMB in many ways. For example, the PBOC sets a middle price for the inter-bank market every day. The price then becomes the reference rate of RMB in that particular day. According to current regulation, RMB price could float either up or down within a 2% range, meaning the inter-bank market price could not be higher or lower than the reference rate by more than 2%.

Therefore, RMB is not a free convertible currency as the currency market is still under strict control of the government. Simply speaking, Chinese government is capable of kicking up or stamping down RMB price totally by their will.

2. **<u>Pros and Cons of RMB Depreciation</u>**

Pros: decrease the production cost and increase the export competitiveness. In the past ten years, the country's export competitiveness is substantially disadvantaged by the long-term appreciation of RMB, the rising salary, and the increasing production cost. The competitiveness has been further weakened as the exchange rate of other Asian currencies has substantially dropped in the recent two years.

In the past two years,

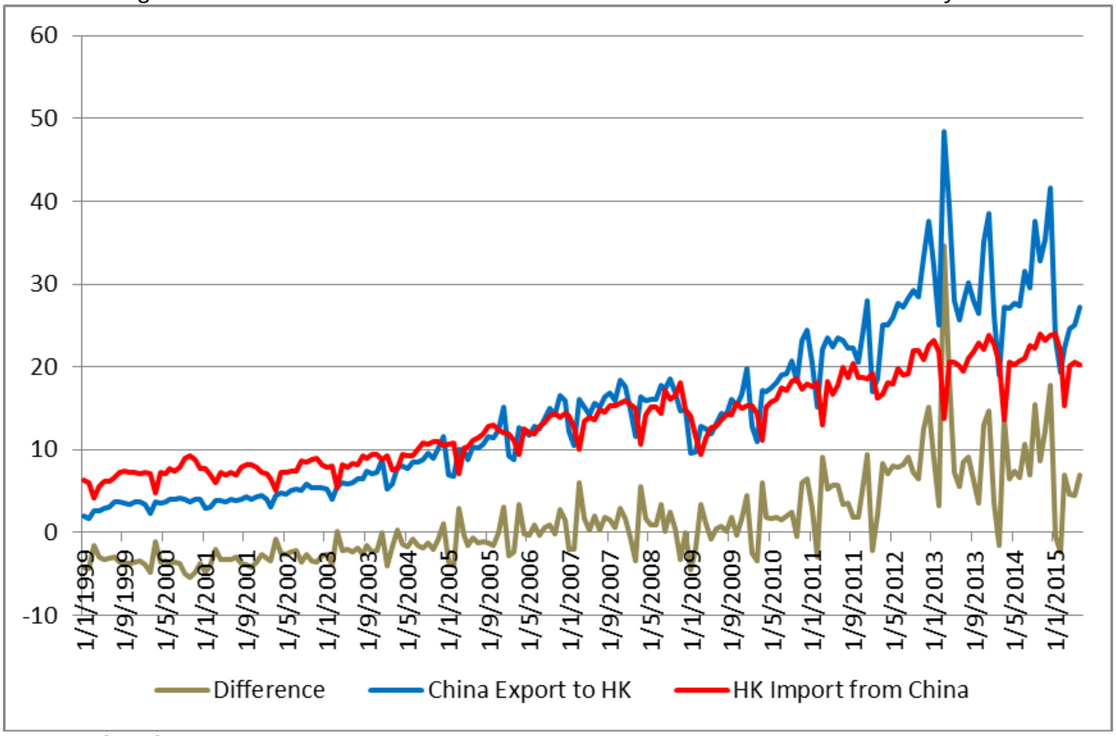
- Japanese Yen: drop 43%
- South Korean Won: drop 11%
- Thai Baht: drop 15%
- Singapore Dollar: drop 15%
- Indian Rupee: drop 18%
- Indonesian Rupiah: drop 39%
- Renminbi: up 0.5%

Cons: If investors expect RMB will continue to depreciate, the capitals held by domestic and foreign investors would flee from China. Capital flight could cause real damage to the economic development and the stability of the financial market.

Even though not all capitals could flow in and out of China freely as the country is under capital control, it doesn't mean China is not facing the trouble of capital flight.

- Legally flow in of foreign capitals are not under capital control;
- Capitals could flow out of China through illegal channels such as fake trading, and underground market.

Fake trading has become a tool for domestic investors to move in and out money



Source: Bloomberg

3. **<u>Will RMB Continue to Devalue?</u>**

Whether RMB will continue to devalue depends on the Chinese government's will. As we mentioned earlier, RMB market isn't a free market and the price of RMB is controlled by the Chinese government.

Therefore, to anticipate the future movement of RMB, we need to think beyond economic statistics (which include export growth, trade surplus, capital account surplus, foreign reserves, etc.), and consider in the government's point of view.

The future movement of RMB is largely influenced by the following factors;

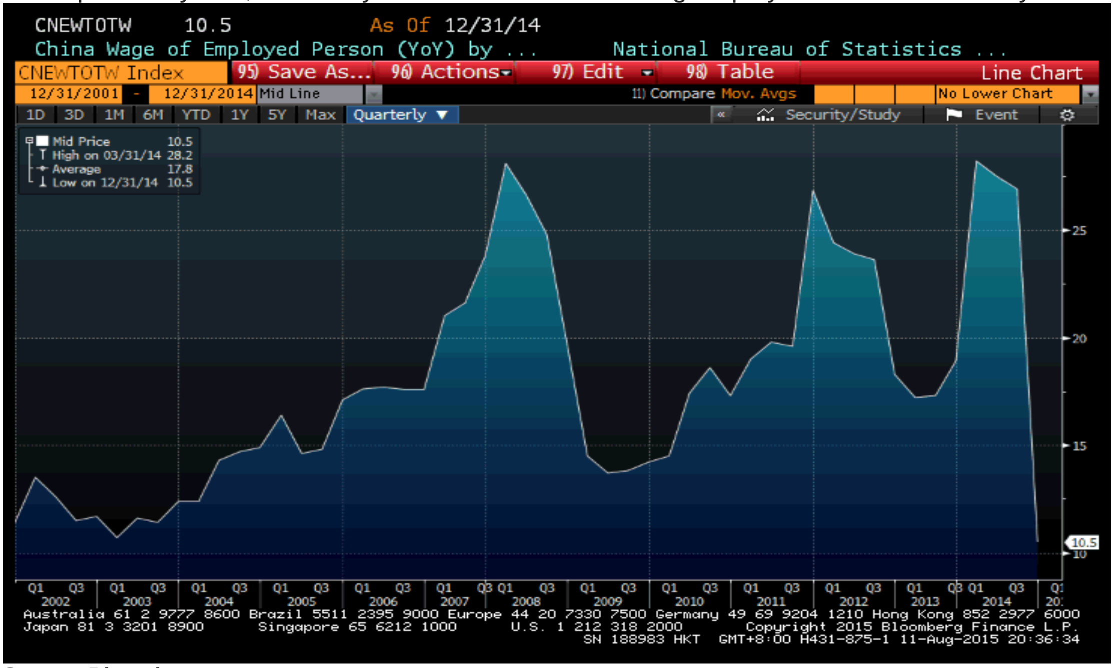
a. **How much will RMB devaluation contribute to export?**

Even though RMB devaluation could increase the export competitiveness of China, how much will RMB need to depreciate to substantially boost up export?

- 2%?
- 5%?
- 10%?
- 20%?
- Will China be able to endure such level of depreciation?

The export industry in China is influenced not only by the strong RMB, but also the increasing production costs which includes the labor price and land price. However, the price increase of raw material does not undermine the competitiveness of Chinese export industry since it affects other countries all the same.

In the past ten years, the salary of Chinese manufacturing employees has increased by more than 10% annually.



Source: Bloomberg

The 2% devaluation couldn't possibly offset the negative impact of increasing production cost. However, if the Chinese government continues to devalue RMB by 5% or 10%, will the Chinese economy and financial market be able to shoulder the negative impact from the devaluation? We don't think so. If the government substantially devalues RMB, investors will lose confidence on RMB and expect the currency will fall deeper. By then, the government will have to face serious capital flight and the economic and financial market will become unstable. (Remember, China has hundreds of trillion RMB deposits. It could be a risk to the financial system even if only a few percentage of the amount flows out of China!)

b. Government need to consider the risk of capital flight

In a controlled market such as RMB currency market, the price never truly reflects the real demand and supply. Therefore, neither the investors nor the government know what the reasonable price for RMB is.

Therefore, if the investors lose confidence and capital flight becomes a trend, RMB could be under tremendous depreciation pressure and might even be pushed to the edge of collapse. By then, the government would be forced to defend its own currency by purchasing huge amount of. Many emerging country currencies, such as Russia ruble and India rupee, have experienced sharp devaluation in the past few years. To defend the currency price, the government has had to increase interest rate and spent huge to buy back its own currency. Even though the currency price could be stabilized, the economy has already been substantially affected. The Chinese government won't ignore the lessons that other countries have learnt.

c. Consider beyond the economic factor.

The Chinese government needs to consider its international reputation in the matter of adjusting the RMB currency price. As a great power of Asian and the world, could China remarkably devalue its currency as did Japan? To become a leading country in the world, *Great Powers* have their own burdens, meaning they could not only consider their own economic benefits.

The devaluation of Japanese yen has been seen by many Asian countries as irresponsible and invasive. Cheaper yen has enhanced the competitiveness of Japanese export industry; but in the meanwhile hurt the export business in other Asian countries.

If the Chinese Government devalues the RMB sharply as what Japan did in the past two years,

- Asian countries will blame China. Mutual trust relationships will broke.
- Asian countries might compete to devalue their currencies, **<u>leading to a currency war in which no one could win. Asian economy and financial market will be exposed to huge risks.</u>**

We believe the risk of further devaluation exists. However, we don't think RMB will be devalued too sharply. In one to two years, we think the further devaluation would be within 2-4% (Chances are 30-50%).

4. Impact of RMB Devaluation on Investment Markets

a. RMB deposits are directly affected: The interest rate for RMB deposits in Hong Kong is around 3%. After the 3% depreciation, investors have already lost 1-year interest income. If RMB is further devalued, the interest income will be further reduced. However, we think RMB deposit is still one of the choices among the very conservative investment vehicles. It is because we don't think RMB will further devalue by more than 5%. Compared with other high interest currency such as AUD and NZD, the currency risk of RMB is relatively lower but the interest rate for RMB is much higher than the interest rate for AUD or NZD (HKD deposit rate: less than 1%, AUD or NZD deposit rate: 1-2%).

b. RMB bond: the impact to RMB bond is very similar to the impact to RMB deposit

c. Stock market: some laugh, some cry
   - Export companies will definitely be benefitted from the devaluation (However, unless the government continues to devalue the RMB significantly, the positive influence won't be substantial).
   - Companies that earn RMB but spend other currencies will be disadvantaged (e.g. import companies).
   - Companies that earn RMB and hold large amount of foreign debt will be disadvantaged (e.g. domestic airline companies).
   - Companies that have large amount of RMB quoted tangible assets (but the asset value and companies' business won't be benefitted by the devaluation) will be disadvantaged (e.g. mainland real estate companies).

In general, the devaluation has a negative impact on the Hong Kong stock market. Among HK listed mainland companies, more are disadvantaged than benefitted from the RMB devaluation, no matter counting by number of companies or market capitalization. Fortunately, the current RMB devaluation isn't that big. And if you are a mainland investor, you don't need to worry at all because RMB depreciation is in nature beneficial for all RMB investors.

5. Conclusion

The government has made the decision of currency devaluation in order to enhance the competitiveness of export industry and deal with the substantial depreciation of other Asian currencies in the past two years (Compared with other Asian currencies, RMB has appreciated a lot). We think RMB won't depreciate sharply as what we saw of Japanese yen in the past years because the Chinese government also worries about the possible capital flight and the risk of currency war, and also wants to maintain its reputation as a *Great Power*. We anticipate there is 30-50% chance that RMB will further devalue 2-4% more. It will lead to a negative impact to the HK stock market. Fortunately, the damage will not be too much.

* Unless otherwise stated, all figures and information are collected from WSJ, Bloomberg or Haver Analytics.

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