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MARKET COMMENTARY

Ashmore

A few thoughts on China

By Jan Dehn

The Chinese government announced that it will bring the fix in line with the currency and then let markets determine the FX rate going forward. This is exactly what is happening.

Closing the gap between the fixing and market based valuations of the RMB is one of the key requirements for SDR inclusion. This action therefore takes China one step closer to SDR inclusion – set formally to happen this year with practical implementation starting around the time of the G20 summit to be held in China in November 2016 (where Obama will give his nod of approval as a final gesture before leaving office). SDR inclusion in turn is part of a much broader set of reforms.

Remember why China is implementing reforms, including liberalising its currency regime. The entire purpose of the reforms is to prepare the economy for RMB appreciation, i.e. a rise in the Yuan once QE across the Western world creates inflation and currency weakness in the QE countries. Inflation is likely to begin in late 2016 in the US as the drags on consumers' willingness to respond to plentiful and cheap liquidity from household deleveraging, negative housing equity and unemployment ease.

In the past few years, China has been hurt by its de facto peg with the USD. The USD is up nearly 40% against its trading partners and other major currencies since 2011. The USD rally has been fuelled by QE money and a perception originating as far back as 2011 (and yet to be realised) that the US is just about to have exit velocity and the Fed is just about to raise rates.

Of course, the strong USD is now also a major problem in the US. The USD is now the single largest policy issue in the US and, at the margin, the most important determinant of whether the Fed hikes.

But China is not yet ready for the massive appreciation that has come with being de facto pegged to the USD. China still has a lot of work to do in order to get ready for RMB appreciation (and consumption led growth), including implementing interest rate liberalisation, index inclusion, currency float, SDR inclusion, capital account liberalisation, development of the local government bond market, development of mutual funds, bank reforms, etc. Many of these reforms are still in the early stages.

China has therefore wisely concluded that it makes sense to float now. Better to float now, experience weakness – if that is what the market wants – and then, when the tide turns and the QE currencies go down due to inflation, the RMB can go up hard and fast, but from a lower starting point. Sensible, in our view.

The markets are now extrapolating all kind of scenarios, including global deflation implications, etc. Some are speculating that China has joined the race to the bottom in currencies. This is wrong. China is not going to sacrifice its macroeconomic health in some massive global currency war that ultimately is self-defeating. China has its eyes on becoming a global reserve currency. The move to floating rates is consistent with its long term strategy – see *"China Roadmap"*, Market Commentary, June 2015.

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Last night the IMF welcomed the PBOC's new FX mechanism. The PBOC reiterated the bigger role of markets in determining the equilibrium exchange rate.

Should investors fear band wagon flows? No. Much of its positioning is trade finance, central bank money, hedge fund and other short term and retail flows, etc. Generally, however, global portfolio investors have very little in China. One simple reason is that China's onshore markets are not yet included in the benchmark indices. Also, very few investors have RQFII quotas (Ashmore has one) or activated QFII quotas, which in any case are small compared to market size.

There are some corporate bonds held by foreigners, but many of the bonds are in USD, so not particularly affected by a currency move. Will depreciation of RMB hurt corporates due to FX mismatches? Possibly some, but not significant, in our view.

Currencies elsewhere in Emerging Markets have moved 10-20 times more than RMB without major impact on default rates. RMB has moved 3% and might move a bit more, but the currency is close to being fairly valued, according to the IMF, so it does not need to move far. Inflation is low, growth is still strong by comparison to almost any other country in the world and China's central bank has USD 3.7trn FX reserves and can help if needed, but likely only if the moves become very large. China is not likely to let FX markets destabilise the economy.

Continued overleaf

Summary and conclusion:

- Any weakness in RMB caused by this float should be bought.
- China's RMB is going to be one of the only reserve currencies not buoyed by QE and is likely to be the strongest currency in the world over the next decade, in our view.
- China is also implementing more reforms than almost all the rest of the world combined and has massive consumption growth potential due to its high (49%) savings rate.
- Real rates in local government bonds are nearly 160bps, which is among the highest in large countries.
- Its markets have yet to join the indices, so technicals are extremely supportive.

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