

Taking a cue from China

Intervention in forex markets using reserves will continue to exert pressure on Asian currencies

By **BERNARD AW**

THE great run in Asian currencies over the last few years has come to a head recently. The weakening of the Asian exchange rates comes at a time when the global economy is still trying to bolster growth and falling inflation expectations. A slowing China compounded the worries surrounding the global growth outlook.

The bulk of the appreciation in Asian currencies piggybacked on the cheaper US dollar (USD), which was the result of an aggressive expansionary monetary policy when the global financial crisis (GFC) broke out in late 2008. Unconventional measures such as the quantitative easing (QE) programmes, as well as very low interest rates, drove the greenback down.

The Bloomberg JP Morgan Asia Dollar Index (ADXY) rose 19 per cent in two years, from around 100 in February 2009 to 120 in January 2011. During the same period, the Dollar Index (DXY) struggled to climb above 90, and finally succumbed to low-70 in 2011, dragged by a one-two combination of sluggish US economic recovery and an accommodative monetary policy.

In the aftermath of the GFC, China unveiled a four trillion yuan (\$888.6 billion) fiscal stimulus package on Nov 9, 2008. The massive economic stimulus helped to mitigate the defibrillating impact of the GFC. The ensuing stability in the global economy triggered the start of the carry trade, and increased investment flows into emerging economies.

This exerted upside pressure on these countries' currencies. It also led to a strong increase in Asian countries' foreign exchange (FX). China's FX reserves doubled to almost US\$4 trillion in five years, between 2009 and 2014. All of these factors helped Asian currencies strengthen against the USD in the post-GFC period. At its strongest on record, the Singapore dollar (SGD) advanced to almost 1.20 per USD on Aug 16, 2011. From that peak, it has since fallen almost 20 per cent to over 1.40 per USD.

While China's enormous fiscal injection went a long way to prevent a full-blown economic depression, it was not the panacea for global recovery. Many economies struggled to boost economic activity, therefore their respective central banks loosened monetary policies to push floundering industries along. The situation was unprecedented. The global expansion of money supply created the era of cheap money, and excessive monies soon found their way into higher-yielding assets such as equities.

Global equities rallied through recent years. S&P 500 more than tripled from the bottom in early 2009, advancing from 700 to above 2,000 in late 2014. The index segued into a sideways grind for much of 2015 before the recent stock rout dragged it down by over 10 per cent in just four sessions.

Likewise, the DAX index surged 235 per cent from below 4,000 in February 2009 to over 12,000 in April 2015. Closer to Asia, the Nikkei 225 broke out above its four-year consolidation zone, helped by the Bank of Japan's version of quantitative easing that was rolled out in April 2013. The index added around 8,000 and stalled ahead of the 21,000 level.

However, the bull market came to an abrupt end on Aug 18, with the S&P 500 plunging 11 per cent in the following six sessions. The Shanghai Composite nosedived 27 per cent. It was interesting to note that there was no clear catalyst for the global stock market rout, which caused market sentiments to pinball back and forth between markets in different time zones. Some put the blame on China's yuan (CNY) devaluation a week earlier while others think slowing global growth and deflation risks were the reasons.

On Aug 11, 2015, China adjusted the way it sets the daily reference rate for yuan, resulting in a 1.9 per cent drop in the renminbi. The one-off tweak of the reference rate fixing was a step towards a more market-determined mechanism, but it raised concerns of a global currency war. The new fixing will now be based on the previous close price, which would allow market forces to have more say in the direction of the FX space. China has supported the yuan and kept it steady around at 6.20 for much of this year, but this is increasingly costly for the central bank. While the dollar index advanced over 7 per cent since the start of 2015 to Aug 10, USD/CNY inched up 0.1 per cent in the same period.

Asian currencies, according to the ADXY index weakened by not more than 4 per cent. This should put to bed any suggestions that China is maliciously devaluing its currency to gain export advantage. Meanwhile, the weaker yuan also led regional currencies lower.

Large volatility

However, the writing has already been on the wall for Asian currencies for some time. The slowing China growth momentum and the end of the Fed QE3 programme has resulted in a strong USD and large currency volatility. This reduced the attractiveness of the carry trade. A carry trade is a trading strategy where an investor borrows money at a low interest rate to purchase another asset that is expected to provide a higher rate of return. This strategy is particularly common in the foreign exchange market.

The unwinding of the carry trade led to the reversal of capital flows from emerging markets back to the originating countries, such as the US. Capital outflows from China and Asia saw the use of FX reserves to stabilise exchange rates. This has been significant and the continuation of this trend will continue to put Asian currencies under pressure, as frequent intervention in the FX markets using reserves is untenable in the longer run and carries risks.

China's reserves fell by the most on record in August, dropping US\$93.9 billion to US\$3.557 trillion. Admittedly, there was some relief that the fall had not been larger, given China's aggressive support for the yuan. Nevertheless, China faces a tough road ahead where efforts to support the yuan may simply be not worth it. Certainly, the People's Bank of China still has significant firepower to deal with this issue and it will still need to mitigate the negative impact of tightening financial conditions (when drawing down FX reserves) by easing monetary policy.

The market still expects the Federal Reserve to raise interest rate this year, with December looking to be the most likely month. This plays into the idea that the dollar could strengthen further when the timing of rate hike becomes clearer. Therefore, going long on USD/Asians pairs seems to be one of the most compelling trades around, especially if investors are prepared to hold the positions for six to 12 months. **W**

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