Mirae Asset - flash

Renminbi Devaluation

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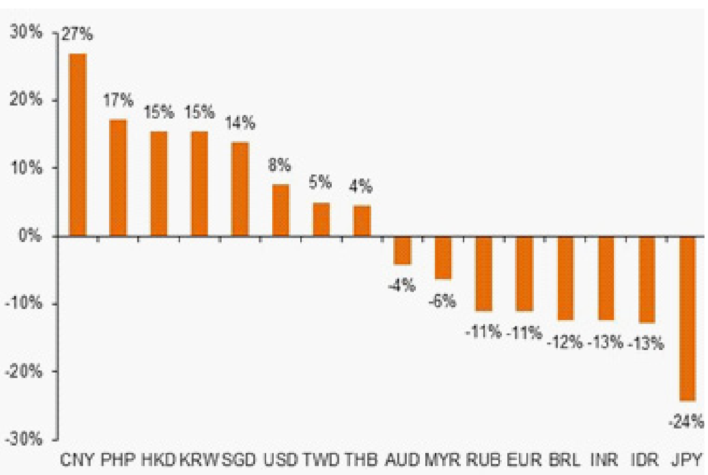
What happened?

On 11th August, the People's Bank of China (PBOC) unexpectedly weakened its daily fixing for CNY by 1.9% against USD, the largest adjustment on record. The PBOC will decide the yuan midpoint based on market makers' quotes, together with closing quotes, implying that the fixing will be much more dependent on the market and could move in a more volatile and potentially weaker trajectory than previously.

On 12th August, the PBOC moved the CNY fixing 1.6% weaker against USD, noting that the closing rate on 11th August was the major reference for market makers' quotations on the 12th.

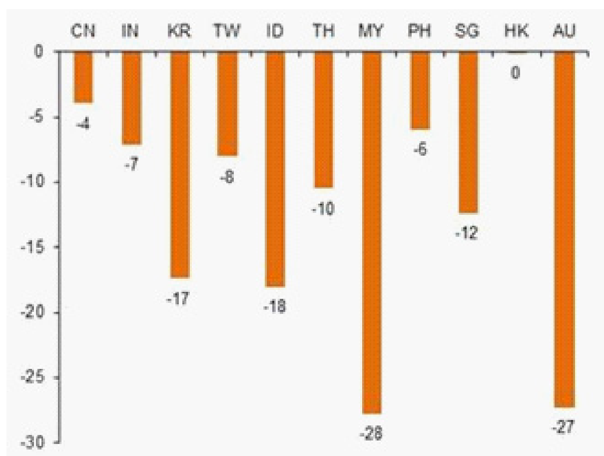
Over the first two days since devaluation, CNY depreciated by 3.6% against USD. Offshore RMB (CNH) depreciated more sharply by 5.2%. Other Asian currencies were also dragged down by 1-3%.

Real effective exchange rates - Deviation from 10y average



Source: BIS, UBS, Mirae Asset Global Investments

Currency movement vs. USD in past 12 months



Source: Bloomberg, Mirae Asset Global Investments, 12 Aug 2015

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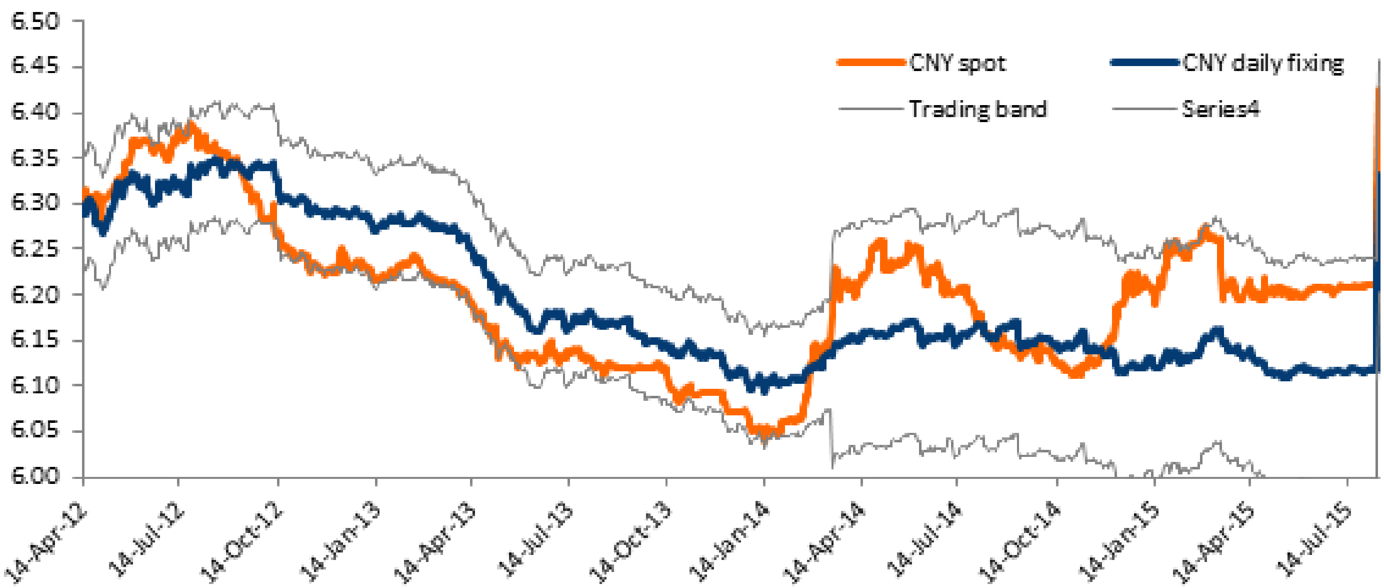
Why the change?

According to PBOC:

• CNY's Real Effective Exchange Rate (REER) is relatively strong. CNY REER appreciated 15% since mid-2014, which is not entirely consistent with market expectations

• Spot deviation from fixing. Spot CNY has been consistently trading towards the higher end of range, implying that the market views CNY as being overvalued.

CNY fixing vs. spot



Source: Bloomberg, Mirae Asset

We believe other considerations also impacted PBOC's decision to change in fixing procedure.

• Stabilize growth. The decision to depreciate is likely in response to concerns about the trade and growth outlook. Latest trade data in July released on 8th August was likely the last straw – July export growth dropped to -8.9% vs. flat expectation. A strong CNY was one key drag to export growth.

• IMF's SDR inclusion. Another potential reason for the change is to make the fixing more market-based ahead of the decision on CNY's potential inclusion in the IMF's Special Drawing Right (SDR) basket.

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Impact on China

We expect the PBOC to provide liquidity support in the event of capital outflows

• As the currency depreciates, or expectation of currency depreciation sets in, it might lead to increased capital outflows.

• We expect the PBOC to use various policy tools in its disposal including RRR cuts to support domestic liquidity.

• China's FX reserves still remain substantial at USD3.6tn. In addition to using the FX reserves, we expect the PBOC to cut RRR, which currently stands at 18.5% compared to 6% in 2002-2003. Every 1% of RRR cut releases ~US$200 bn of liquidity into the system.

Higher inflation a positive

• Due to currency depreciation, inflation might increase, which would be a good thing. Although this might limit interest rate cuts, real interest rates in the economy might still come down due to higher inflation.

• Also, PBOC might have been reluctant to cut interest rates sharply to avoid a risk of asset / property bubbles.

Direct impact on the banking sector is limited

• Currently ~10% of total corporate debt is denominated in foreign currency and assuming 10% RMB depreciation, coverage ratio would decline from 5.07x to 5.11 x on reported basis for the listed corporates.

• However, on the margin, some of the real estate developers / corporates have substantial FX borrowing (and overleveraged balance sheets), which would face some stress.

• On asset quality, there might be some increased concerns which will be partly offset by better margins (due to RRR cuts) and translation gains on FX assets.

Trade data

• Despite the REER appreciation, China has, thus far. not lost any market share of global exports. However, the pace at which it has gained share has almost ground to a halt.

• Given that the global trade pie is growing much less than it used to, this stimulus from the currency, assuming it continues, can potentially eat into market share of China's competitors, spreading disinflation impulse overseas.

Unwinding of leverage

• According to SAFE data, as of March 2015, domestic Chinese corporates have $865bn of external debt (excluding CNY) outstanding. Allowing for a weaker currency at this juncture could precipitate an acceleration in the unwinding of RMB carry trades, and possibly more domestic capital flight (like it did last year). By various estimates, China has seen $35bn of monthly capital outflows this year. However, trade surplus has ranged from USD30-35bn and FX reserve remains substantial at USD3.6tn. So the PBOC can prevent any unruly unwinding of leverage.

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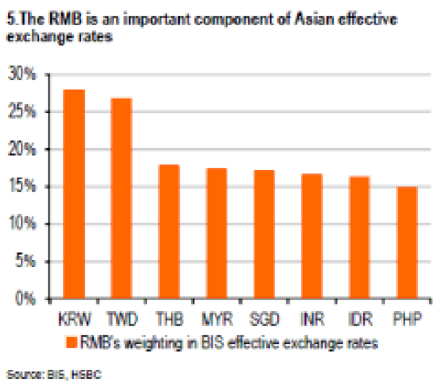
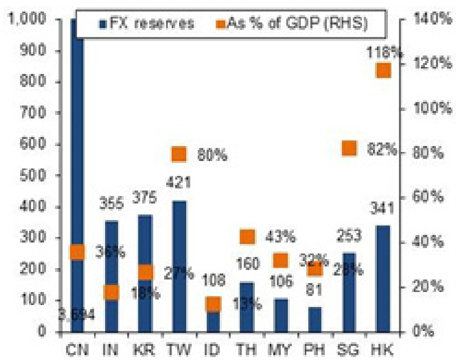
Impact on the rest of Asia

RMB's weight in effective exchange rates

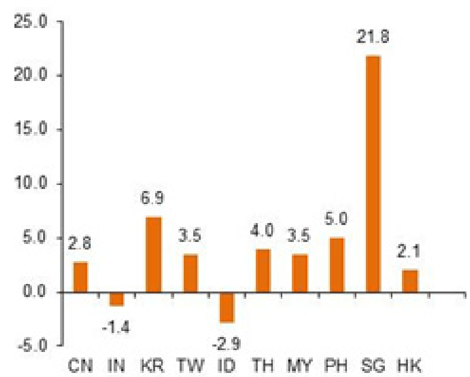


Source: HSBC

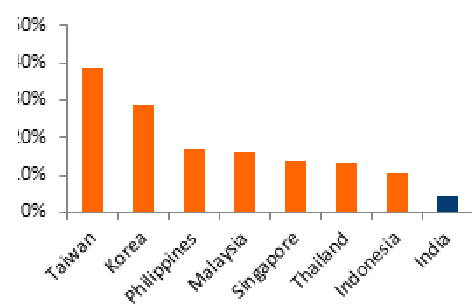
FX reserves: First line of defense



Current account balance as % of GDP



Exports to China as % of total exports



Source: CEIC, Haver, UBS estimates

India the least affected

- As all the Asian currencies depreciate, INR will also come under some pressure but should still be a relative outperformer.
- India has low trade linkages with China (4.2% of exports to China) and low commodity exports. As commodity prices decline, India, as a net importer of commodities, is a relative beneficiary.

Hong Kong / Singapore – borrowing volume to shrink

- HK/Singapore, the financial centres which have benefited from Chinese corporates borrowing overseas will see a direct impact from volume perspective, as borrowing will shrink as people prefer to borrow in a depreciating currency.
- HK cross border claims are already down 20% from their peak and trade finance loans are down 34% YoY. Furthermore, the US rate hike cycle might be pushed back, lowering the attractiveness of interest rate hike plays.
- HK economy will be impacted further due to its stronger currency, as we have seen with the drop in retail sales. The only positive for HK is that it helps to reduce inflation in the economy which is currently running at ~3%.

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Korea / Taiwan – high direct export linkage

• These countries have more direct linkages with 39% and 29% of exports to China respectively, having increased from 29% and 22% in the past 10 years. We have seen direct impact of CNY depreciation on KRW and TWD over the past days, in-line with the weight of CNY in their REER weights.

• Korea and Taiwan, being current account surplus countries, with low inflation and sufficient FX reserves, can tolerate further currency depreciation. CNY might depreciate vs USD however, CNY/KRW cross or CNY/TWD cross might not depreciate materially, hence limited negative impact on exports.

• In in the medium term, we see Korea / Taiwan exporters (40-60% of exports to China are electronics) losing competitiveness to Chinese produces.

ASEAN – Philippines relatively better, IDR/MYR more vulnerable

• The same cannot be said about ASEAN. Although trade linkages are lower, a greater portion of exports are commodity linked, which will be impacted.

• Philippines remains a relative safe haven within ASEAN, with sufficient FX reserves, strong current account surplus, limited trade linkages with China (17% of exports) and as a net importer of commodities benefits from a decline in prices.

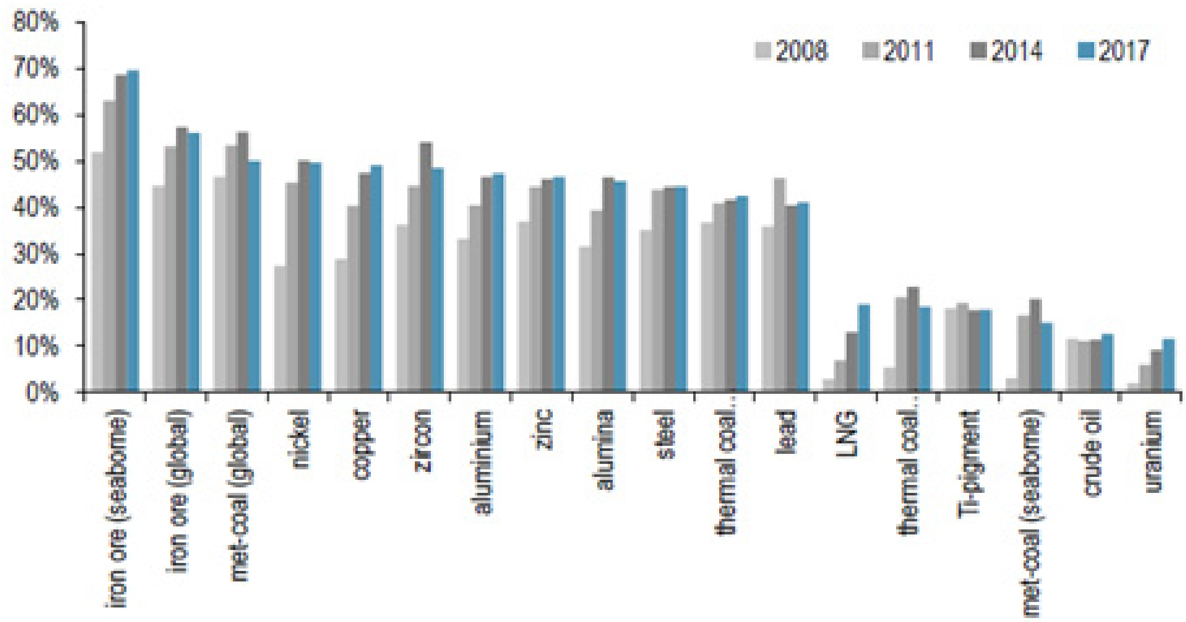
• Indonesia is impacted in the near term with 11% of exports to China, the lowest FX reserves as of GDP in Asia, a commodity exporter, and a current account deficit country. This could also push back the expectations of rate cuts in Indonesia, if the currency continues to remain under pressure.

Pressure on commodity prices in the near term

• China, as the largest consumer of commodities, will place pressure on commodity prices in the near term.

• Commodity-exporting countries, such as Indonesia and Malaysia, may see a deterioration in balance of payments.

China's share of global commodity demand



Source: Wood-Mackenzie, WBMS, CRU, McCloskey's, Tex Report, AME, Platts, Bloomberg, UBS Research

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SUMMARY

- This move shows China is using both domestic (fiscal, monetary) and external (currency) levers to support growth.

- CNY depreciation will have a negative impact on commodities (given China is the largest consumer) and commodity exporting countries. If this leads to further easing from other countries, it will be positive for equities.

- PBOC's weakening of CNY may lead to further depreciation, which might not be all negative. Historically, we have seen currency adjustment as a beneficial tool to boost exports and therefore economic growth.

- However, the risks of currency wars remain. China is in a strong position to defend its currency thanks to it's large FX reserves and low offshore borrowing. Rather than looking at USD/CNY, China might prevent further appreciation of REER. Emerging Asia constitutes about 20% of China's total trade, with Europe and Japan accounting for around 40%.

- Even if China does want to reverse the appreciation of CNY vs other Asian currencies, it would imply a ~10% depreciation in CNY. On various models, RMB is around 10% overvalued on an average of various frameworks.

- Overall, for the financial sector, we are entering into a lower growth environment, with the asset quality cycle turning and a not-so-conducive operating backdrop. As a result, we maintain an Underweight the financial sector. In such an environment we prefer countries where monetary easing will have the ability to deliver a boost to domestic demand and those with low credit penetration (India, Indonesia, Philippines). Apart from these countries, we continue to like Chinese life insurance companies where protection gap is significant and the industry is showing signs of turnaround for the past 18 months.

- However on a broader macro perspective, it is negative for exporters to China (or countries with close linkages with China) like Korea, Taiwan, Hong Kong and Singapore. ASEAN may be impacted due to second order effects with their currencies depreciation and reducing the scope of interest rate cuts as currencies remains under pressure.

- US rate hike: On the flip side, it might possibly lead to a postponement of US rate hikes, as strong USD and disinflationary impulse due to actions of various central banks (CN, EU, JP) might impact the conditions within the US. Furthermore, the notion of substantial real weakness in China (which the FX move indirectly signals) is, in itself, not immaterial.

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Investment implications

Theme	Impact	Our view
Tourism	A number of Korean tourism / consumer names exposed to Chinese outbound tourism have been hit hard on the concern that a weak CNY would hurt demand for overseas travel	We believe the market over-reacted. We expect the Korean won to depreciate against USD as well, which means that the CNY-KRW depreciation is likely to be much smaller than feared. Maintain positive view.
Health care	Indian pharmaceutical companies will benefit marginally from lower import costs for Active Pharmaceutical Ingredients from China.	No change to investment thesis.
Internet / e-commerce	Chinese IT companies will mostly be impacted by the translation effect from CNY into their reporting currencies (HKD, USD).	Remain in high quality IT names.
Environment	Need to be mindful of the debt exposure of these companies, especially foreign currency debt.	Chinese wind and nuclear companies tend to have high debt, but are primarily denominated in RMB. The gas sector suffers from the highest percentage of foreign debt exposure.
Insurance	Direct impact from net open FX positions = 1% of equity for Chinese insurers, some impact on AIA but only translational	Currency movements have limited impact on the operations of insurance companies. We remain positive on insurance in Asia given the under-penetration / large protection gap in China / Asia.

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