UPDATE ON EMERGING ASIA

EDGE is an independent financial firm whose objective advice helps individuals and institutions realize their goals in the areas of investment management and corporate finance. The Edge Research Team's thoughtful and timely reports are based on extensive independent research and analysis of firms, financial developments, and macroeconomic trends.

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INTRODUCTION:

For many years, Edge has included the emerging Asian consumer in our portfolio allocations. In a global economy which has struggled to grow at trend rates after the global financial crisis, increasing personal incomes within developing Asia remained a persistent trend on which we could base a secular growth thesis around rising consumerism.

China is a key element to the emerging Asia story (and the rest of the world). As the second largest economy in the world, it is also the biggest trading partner of most Asian countries and the biggest single contributor to global growth over the past few years (well over double the US contribution to increases in global GDP).

Similar to many countries, China has faced its fair share of economic challenges. The shift away from the old growth model of exports and fixed asset investment towards services and consumption has caused economic growth to understandably decline from high rates in the past. In addition, certain imbalances resulted from government stimulus deployed after the financial crisis. From a financial market perspective, much of this has been reflected in equity market valuation (outside of mainland China exchanges). Combined with confidence that policy makers in China had the tools necessary to manage these complex issues, we held a positive outlook on the broader region's equity markets – specifically on consumer themes.

We maintained our outlook even despite the wild gyrations of the local Chinese equity markets these past few months. However, this week, new information was made available that has caused us to re-evaluate the fundamental risk within the region. Without prior notice, China's central bank (the People's Bank of China or PBoC) changed the methodology by which its currency value is set relative to the US Dollar to be more market-based. The result has been a series of daily devaluations of the currency with the PBoC stepping in recently to slow the pace.

On the following few pages, we provide our opinion on why this change was made, what the implications could be, and what action may be appropriate. To foreshadow our conclusions, while we still believe the long-term story of the emerging Asian consumer is intact, the degree of risk introduced by this recent change causes us to recommend reducing exposure to the investment theme.

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WHAT HAPPENED AND WHY:

As opposed to a freely floating currency such as the US Dollar (USD), the Chinese unit of exchange (called either yuan or renminbi, also referred to as CNY) is in a currency regime called a "managed float." What that means is that the value of the currency is able to fluctuate within a certain range around a mid-point that is fixed by the PBoC relative to the USD. On August 11th, the PBoC adjusted the fixing mechanism so that the market makers helping establish the rate must take into account the prior day's closing level. In doing so, the idea is that the currency becomes more responsive to market conditions. A speech by PBoC officials confirmed that the desire to move towards a market-based mechanism was the primary cause for the change and was reinforced during the Q&A section when policy maker answers were couched in market considerations rather than central government objectives.

The big question then is why make this adjustment now, so close to the sentiment destabilizing fall of the local equity market a few months ago. Shifting to a market-based mechanism which by design will offer less control to policy makers could only add fuel to the fear that they do not have the tools needed to manage the delicate transition of the economy while continuing to address imbalances. On the surface, a technical answer may be given: allowing market forces to play a bigger role in currency valuation is necessary for the IMF to place the yuan into the Special Drawing Rights (SDR) basket. Every five years, the International Monetary Fund (IMF) reviews currencies for inclusion in their basket acting as central bank reserve currencies. Key characteristics include breadth of use (which China clearly meets) and marketability (which China has been working on).

While the IMF answer is logical, it also misses something which again relates to market conditions. The yuan has been one of the strongest currencies in the world over the past year or so. Because the PBoC likely believes that the upcoming Fed rate hikes would have caused further appreciation in the yuan, the latest currency move gives it the flexibility to avoid any further monetary tightening if and when the Fed increases rates. The greater floating nature of the currency will also give the PBoC more leeway to cut rates and stimulate the economy. Notice how the consistent cries of American politicians that the Chinese manipulate their currency to support their economy seems to have faded from our ears. A little history in charts will help us understand part of the economic rationale for why the PBoC changed their process. In Figure 1 below is a chart of the USD/CNY since 2008.

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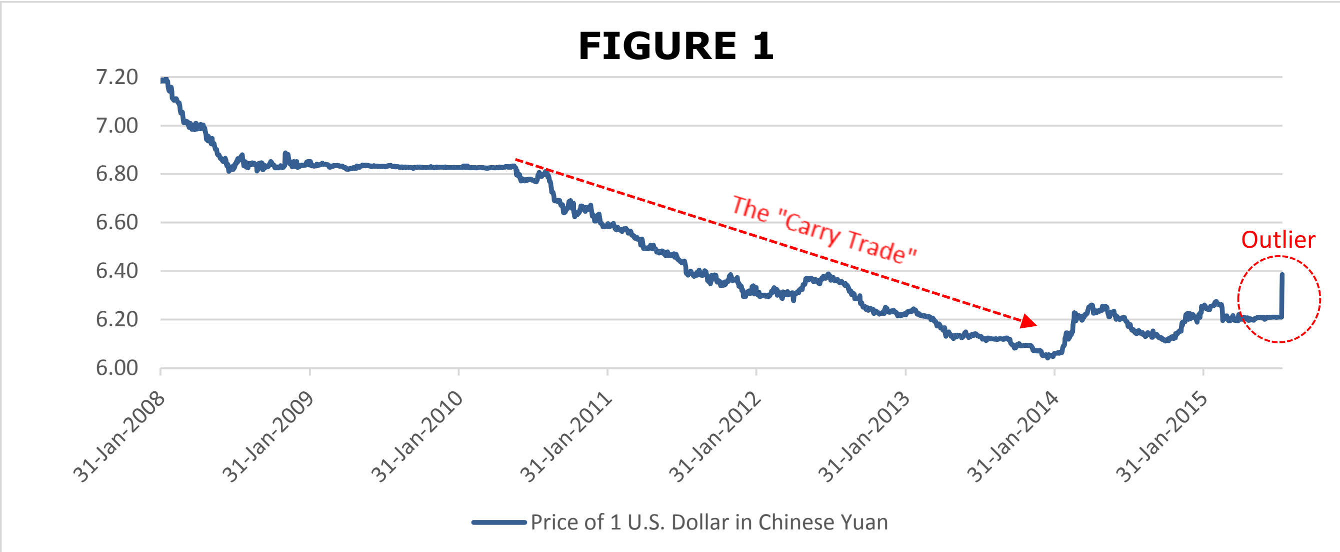

Source: Bloomberg

You will notice that the currency was tightly managed to the same exchange rate until 2010 over which time the currency started a controlled appreciation relative to the USD. It was the one directional, low volatility nature of this trend that led many to put on leveraged “carry trades” for profit. It was not until 2014 that the currency made an abrupt about face as policy makers wanted to give speculators a taste of risk so that their actions might be more prudent knowing the currency can go two ways. The revaluation that occurred this week seen on the far right appears like a clear outlier.

Since the managed float of the CNY is tied relative to the US Dollar, it has been the dollar’s significant strength in the past 12 months that might have sparked some reaction. As Europe and Japan initiated or increased their quantitative easing programs, their currencies have fallen. Figure 2 shows an index tracking the value of USD versus a basket of its major trading partners including the Euro (EUR), the British Pound (GBP), and the Japanese Yen (JPY).

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FIGURE 2

Source: Bloomberg

The ascendance of the USD has in turn created a significant economic headwind for the Chinese economy. Figure 3, which illustrates the value of the CNY relative to the EUR as an example, demonstrates that the Chinese currency has been consistently appreciating and the recent revaluation is only a modest adjustment.

FIGURE 3

Source: Bloomberg

<u>POTENTIAL IMPLICATIONS:</u>

The value of a free-floating currency acts as a countercyclical balance in an open economy. As an economy strengthens, the currency value also typically increases relative to others. The result is

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that exports of goods and services become more expensive and thus likely fall (headwind to domestic growth) while imports become cheaper (tailwind to foreign growth). The opposite happens in a weakening economy. Thus, the currency becomes an economic moderator which in theory moderates economic volatility – a global benefit.

During the previously referenced speech by PBoC officials this past Thursday, policy makers used the platform to signal to the market that the revaluation is complete and the rationale for it is technical in nature. Summarizing the comments, in the prepared remarks Assistant Governor Madame Zhang Xiaohui stated that the recent action was to correct a 3% accumulated discrepancy between the central parity rate (the official rate) and the market exchange rate while acknowledging the desirability of some devaluation given the CNY's strength. During the Q&A, Deputy Governor Dr. Yi Gang explicitly discussed market rhetoric that the currency may fall 10% or more to support exports, calling it "completely groundless and unfounded."

Regardless, there are a few issues at play. First, while the devaluation of the CNY is a classic economic action and desirable in some circumstances, viewed as a counter-cyclical tool it suggests that economic growth in China may be less than what policy makers are willing to tolerate. It coincidentally came a day after China had announced an 8.1% year over year decline in imports for July, accelerating from a decline of 6.1% in June. While official GDP figures suggest an economy growing close to 7%, a host of measures of economic activity, such as rail freight, electricity production and housing starts, suggest much weaker growth. We expect China to follow up on this currency movement with fiscal and monetary stimulus. The question is what order of magnitude may be required to not only improve the economic trajectory, but also gain the confidence of the capital markets and stem the tide of capital outflows.

Second, other emerging Asian economies are either likely to act to maintain their relative competitiveness or experience currency weakness as a result of declining growth expectations in the region. Already, the won, ringgit, and Taiwan dollar experienced 1-4% declines against the USD last week, almost matching that of the yuan. Broadly weakening currencies in the region creates potential inflationary pressure as well as the potential for further capital flight, especially if the US Federal Reserve acts later this year to raise interest rates. These developing economies need capital inflows at reasonable prices to support growth. In addition, certain countries such as Malaysia issue high levels of US Dollar denominated debt; a declining local currency makes dollar denominated debt more difficult to service. China is also a competitor to the region in many of the export segments. Taiwan, Korea, and Singapore are the most vulnerable to a weakening yuan, with the percentage of their exports to China topping 20%. The elasticity of Chinese import growth to Chinese GDP growth is estimated to be 5%, meaning a 1% decline in GDP growth would shave 5% off of import growth. This would have an outsize effect on growth in emerging Asia given its relatively larger share of exports to China vs. the rest of the world.

Third, having a more market-oriented basis for setting the CNY exchange rate introduces unexpected volatility. Currency volatility has a few potential impacts. In one example, market participants who are unprepared for a change in value could cause unintended consequences such as unwinding leveraged "carry trades." Another is confidence in the region during turbulent times. Because of its relationship to USD, China maintained relative stability in its currency during the 2008 global financial crisis. The CNY may now add to instability instead of reducing it.

Fourth is that a more market-oriented and volatile yuan adds another layer of complexity to the already long list of complex challenges that Chinese policy makers are addressing. The list includes

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de-leveraging from debt-fueled infrastructure stimulus in 2009, weak external demand in customer economies, wildly gyrating equity markets, housing market excesses, and an anti-corruption crackdown.

It has been and remains our view that Chinese policy makers are talented, patient, and have the resources necessary to address the tangled web of challenges. Part of that confidence rested in the fact that, as a still mostly centrally planned economy, China had controls that more open economies do not. A significant one to note is that China has $3.7 trillion in currency reserves that it can use to control growth. Yet adding a more freely moving exchange rate at this delicate juncture, which in the long run is a positive reform, introduces risk beyond the control of Chinese authorities: other countries may act to devalue their currencies, investors may move capital elsewhere as leveraged bets on the currency unwind, or highly indebted corporations unprepared for a weakening currency may default on their loans. According to JPMorgan chief China economist Zhu Haibin, the net amount of assets leaving China totaled $450 billion in the past year. Part of this is the result of the unwinding of liabilities by Chinese corporations in anticipation of further macro and yuan weakness. The reduction in USD liabilities and the increase in USD assets is an adjustment needed to offset the significant rise in short term foreign debt of $440 billion between 2012 and 2014. Currency volatility may make this adjustment more challenging for corporations in China, and in turn their investors.

In the PBoC speech referenced above, the Assistant Governor stated that the two day's adjustments since August 11th "has gradually led the [CNY] to market levels, releasing once and for all the accumulated depreciation pressure of around 3%...largely finishing the correction." As a market-based investor, the market tends to dictate when a correction is over, not a policy maker. On Friday, the CNY appreciated slightly, perhaps indicating that the value will be more managed than was communicated. In our view, either it is more market-oriented and it needs more devaluation to get a positive countercyclical effect to support exports, or it is not and credibility of communication is damaged.

CONCLUSION:

Emerging Asia continues to be a rising region of the world that is undergoing a long-term transformation for the better. The bloc represents a diverse mix of countries at various stages along the path of economic development which offers the opportunity for trade at the risk of sharing economic fates. This is best reflected in the fact that the largest trading partners of the countries in Asia are other countries in the region as opposed to the US or Europe as it would have been twenty years ago. At the heart of this transformation is the rise of consumerism. China's role within the region is clearly large and growing in importance, both economically and politically. Not unlike many other parts of the world after the global financial crisis, China has grappled with imbalances created as a result of fiscal and monetary support while also moving along the path of economic and political reform. The question of whether policy makers can navigate the complexity of maintaining sufficient economic growth while shifting its driver to consumption from investment has been persistent. In our view, China's decision to move to a more market-based exchange rate now creates unnecessary risk to an already complex situation. In addition, it hints at somewhat weaker growth than anticipated and creates reaction from surrounding countries. While we remain optimistic for the emerging Asian consumer in the long run, the increase in risk causes us to recommend a reduction in allocation to the investment theme in the near term.

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