INDEPENDENT
STRATEGY

China

GLOBAL MARKETS

RMB: the end of the peg

INVESTMENT CONCLUSION

The shift in the Chinese exchange rate policy reinforces our strategic positions of being short renminbi (see our report *China — pressures of a strengthening dollar*, 27 January 2015) and the currencies, corporate debt and equity of a wide range of other Asian EM's (see our reports *Asset allocation: what, where and why*, 14 July 2015 and *Abe's style drift*, 5 August 2015). The upshot is also negative for commodities and currencies such as the Australian and New Zealand dollars.

ANALYSIS

The People's Bank of China (PBoC) has altered the renminbi exchange rate regime, allowing the currency to weaken nearly 2% against the US dollar. The daily renminbi fixing will now align more closely with the onshore spot rate, taking into account "market demand and supply". The PBoC aims to use this to reduce the discrepancy (which has averaged 1.5% recently) between the spot and the daily fix (called the central parity rate). The bands around the parity rate (+/-2%) were not altered this time.

The PBoC represents this change as a one-off adjustment that addresses the issue raised by the IMF; that the exchange rate regime resulted in a renminbi exchange rate that was inappropriate for inclusion in the SDR basket. But making the daily fixing dependent on the onshore spot rate will mean that markets will have a much greater influence on where the renminbi goes.

The policy shift must also be seen in the context of China's poor export performance (July -8.3% yoy); the persistent increase in the REER — which has risen 14% in the last year alone — and political pressure to "help" state-owned enterprises (SOE's), which are battling output price deflation, overcapacity and high debt burdens. Finally, the further marked weakening of other Asian EM currencies in recent months must have focused the Chinese authorities' minds.

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While the PBoC is likely to defend the new exchange rate in order to contain any surge in capital flight, our view is that China is set up for a progressive renminbi devaluation. Indeed, a one-off move, as the authorities have suggested, will in no way address the issue it is intended to.

The drivers of a weak renminbi will be:

1) Fed monetary tightening causing the repricing of excessive US dollar corporate debt throughout the Asian EM theatre and resulting in further weakening of a wide range of currencies in the region (see below);

2) Capital flight from China and problems related to servicing domestic corporate US dollar debt (USD1trn, 10% of GDP);

3) A further reduction in China's sustainable GDP growth rate, to 6% or below;

4) China's legacy problems of leverage, over-investment and a dysfunctional fiscal mechanism for stimulating growth;

5) The need for the Chinese authorities to offset domestic deflationary pressures. These stem from a business sector over-leverage and resource misallocation causing low capacity utilisation and outright deflation in the corporate sector.

From a market perspective, the messages are clear. It reinforces our strategic positions:

- Short EM Asian currencies — Thai baht, Korean won, Malaysian ringgit, Indonesian rupiah and the Chinese renminbi.

- Short New Zealand and Australian dollars — the slow growth weak currency dynamic of the Asian "factory" economies is very bad for commodities and their dependent currencies.

- Long US dollar — and Japanese yen against our Asian currency basket.

- Short Asian EM corporate debt.

- Short EM Asian equity.

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