The Next Leg Of USD Weakness Begins Here

- ***Regional currencies appear to have priced in RMB re-valuation story***
  Since Oct, regional currency appreciation has been largely in line with the RMB appreciation implied by the 3- and 12-month NDF.

- ***Why it may not be the case?***
  - the market is not convinced that any RMB move will be one-off,
  - in NEER terms - the preferred measures of currency performance by central banks, regional currencies (expect for KRW) have only appreciated marginally since Oct.

- ***Regional currencies have under-priced USD weakness***
  The relatively strong external positions of Asian economies do not appear to have been fairly priced if out-performance USD/majors since 2002 is taken as a benchmark.

- ***Asian FX to eventually catch up with JPY and EUR?***
  The gap between Asian and majors will narrow. Asian FX are still some 40% off their values at the early 90s, while most majors are currently at levels which have not been sustainable for a prolong periods.

- ***Any chance of NEER appreciation?***
  *Cautious regional central bank could try to restore NEER back to pre-RMB revaluation level. That could lead to **AT LEAST** 1.2-5.7% appreciation of selected regional currencies against USD.*

Chart 1: RMB NDF Discounts Widened In Oct To Prompt 'Floating Asian' Appreciation

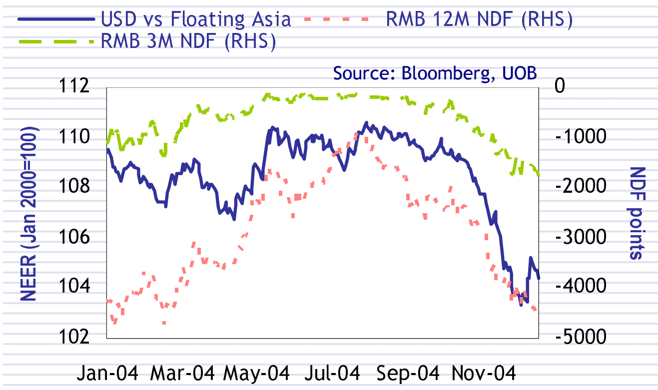
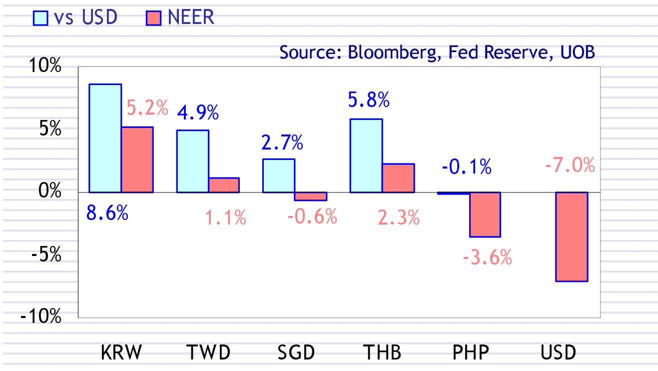


Chart 2: Regional Currency Performance Since Oct 2004



Regional currencies have fully priced in a RMB revaluation...

Market speculation of a near term RMB revaluation began to take hold in October as reflected in the widening of both 3- and 6-month RMB NDF discounts (Chart 1). Given the consensus view that i) a change in RMB regime, if at all, is likely to be a one-step widening of trading band to 3-5% on each side of 8.27/USD level and ii) the next band widening is unlikely to recur for another 12 months, it appears that the extent of regional currency appreciation against the USD in November - ranging from 2.7% for SGD to 4.9% and 8.6% for TWD and

Table 1. Regional NEER Performance If RMB Were To Revalue By 5%, Ceteris Paribus*

Since	KRW	TWD	SGD	THB	PHP	RMB	HKD	MYR
Jan 02	7.0%	-6.9%	-0.7%	-1.6%	-19.0%	-10.4%	-11.3%	-12.9%
Jan 04	8.8%	1.2%	0.5%	-1.3%	-5.1%	0.5%	-4.6%	-4.0%
Oct 04	4.2%	0.3%	-1.3%	1.7%	-4.1%	0.2%	-4.4%	-4.3%
Compared to the NEER level at 16 December 2004	-1.0%	-0.8%	-0.7%	-0.6%	-0.5%	5.0%	-1.8%	-0.6%

* based on 16 December 2004 exchange rates
Source: UOB

KRW respectively, has largely discounted the RMB revaluation story (Chart 2).

…. or may be not

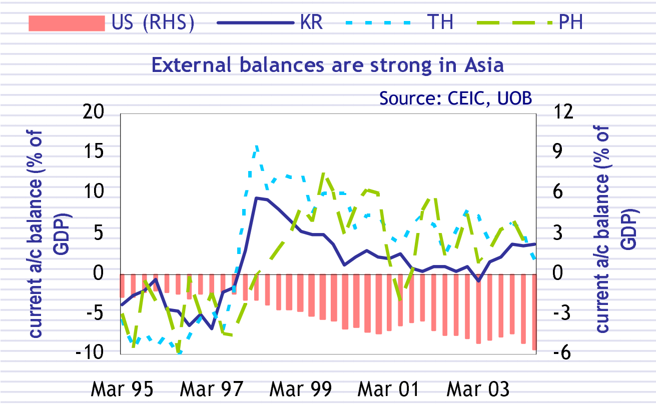
As much as it is perceived that the market has fully priced in a 3-5% appreciation and that any RMB policy change will be one-off, we are actually not too sure if players are really convinced that further adjustment will not recur in the near future, especially with the RMB perceived to be 10% to as much as 40% undervalue. Further, Asian CBs' FX policy management are still based on the USD/RMB at 8.2765 (instead of 7.8152 based on the 12-mth RMB NDFs), as reflected in regional authorities rather adamant about excessive FX strength. While there are concerns if this is an appropriate policy, as it means that we could see Asian currencies gapping when the RMB finally moves, such policy option nonetheless means that there is still upside potential for Asian FX.

Another perspective is from a trade-weighted basis, which is perhaps more relevant to CBs policy management. Our in-house nominal effective exchange rates (NEER) calculation shows that since Oct, other than the strong 5.1% KRW gains on NEER terms, most 'floating Asian' currencies have either appreciated marginally (TWD +1.1%, THB +2.3%) or even depreciated as in the case of SGD (-0.6%) and PHP (-3.6%). Clearly, both SGD and PHP have not discounted the RMB story at all on NEER terms. As for the other 'floating regional', we can verify this by checking their NEER changes since Oct in a hypothetical case of an immediate 5% RMB revaluation against USD to 7.8824 with other currency-pairs unchanged. A higher NEER value would indicate that the RMB factor has been priced in, and vice-versa. Our calculation shows KRW, THB and TWD would have appreciated by 4.2%, 1.7% and 0.3% respectively. In short, only KRW and THB have fully digested the RMB revaluation story on NEER terms, whereas TWD has barely made the cut.

Regional currencies have under-priced USD weakness

A key fundamental driver for regional currencies realignment is the relatively strong external positions of the Asian economies. In view of the inherent weakness of the US external balances as a short USD signal, the relatively strong external position of Asian economies do not appear to have been fairly priced in the current regional FX levels. The improvement of the external positions of three 'crisis economies' – Korea, Thailand and the Philippines after the Asian crisis has been remarkable. Current account balances in these three economies have turned from deficits averaging 2.1%-6.5% of GDP in 1993-96 to surpluses averaging 2.2%-6.5% of GDP in 1999-2004. In contrast, the current account deficits of the US deteriorated from 1.5% in to 4.2% of GDP in the two corresponding periods (Chart 3).

Chart 3: Asian Current Account Improves While US Deteriorates



Yet, since the USD general weakness began in 2002, the 'floating' Asians (i.e. excluding RMB, HKD and MYR) have only appreciated by 12%, which is only at half of the pace of the 25% major currencies appreciation against the greenback (Chart 4).

Chart 4: USD Weighted Against Majors And Against Floating Asians'

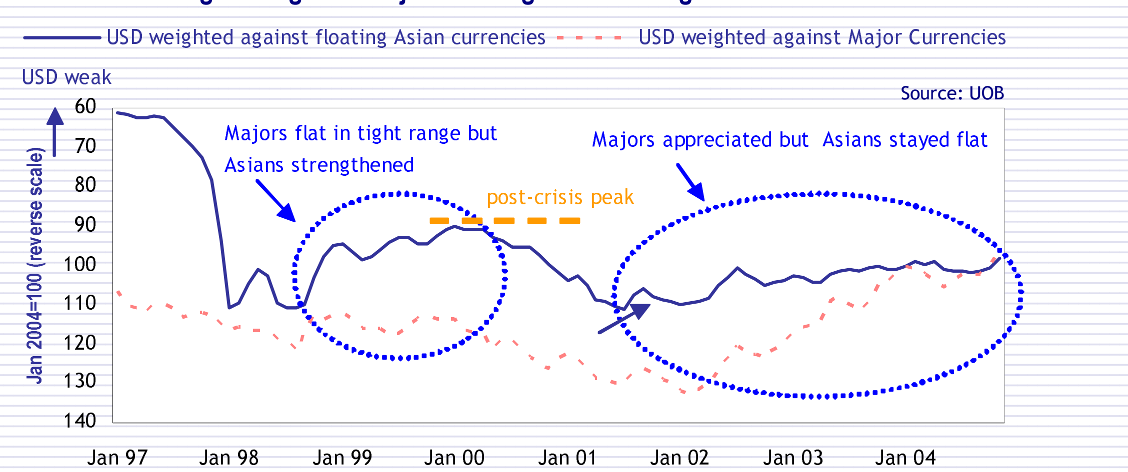
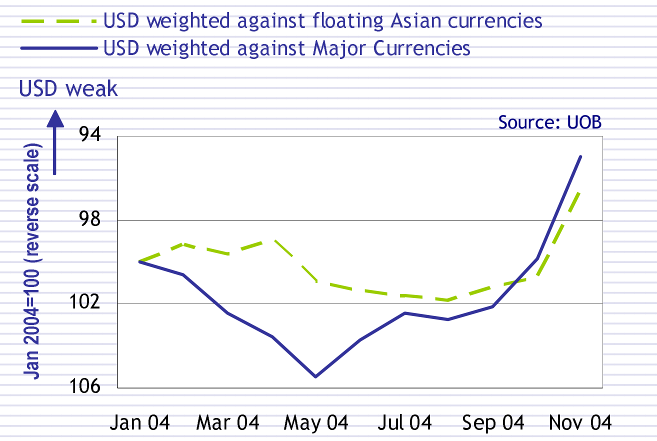


Chart 4 plots the average USD values against 'floating Asian' currencies and major currencies respectively, adjusted by a multilateral trade-weighting scheme that gives more weights to trade in markets that are important to the US. The 14-month period starting from Nov 98 probably best illustrates how the FX market priced regional fundamentals independent of the influence of the major currencies. During that period, the majors were trading within a tight 5% range against the USD, thus giving the regional currencies the opportunities to adjust to normalcy from the extreme levels recorded during the height of the Asian crisis. Fundamentally, the external positions of those economies were moving back to healthy levels, with current account surpluses averaging 5-11% of GDP in 4Q98-1Q99 compared to deficits of 2-5% of GDP in the five quarters ending Dec-97. From Nov 98 to Dec 99, 'floating Asians' appreciated by 8%, while the majors' value against the USD remained unchanged. Since Jan 2002, when majors started to appreciate, the extent of Asian FX gains has been fairly limited. This was largely due to the conservative forex management policy adopted by the regional CBs.

Asian FX to eventually catch-up with European currencies' gains?

Pricing in possible adjustment of the RMB, 'floating Asians' have appreciated by 5.6% against the USD from end-Sep (Chart 5). This is the first time since the 1997 crisis that 'floating Asians' have moved in-line with the majors. Looking forward, as the market is unlikely to be convinced that the RMB adjustment will be one-off, we could see Asian FX adjusting further. Moreover, most major currency pairs are currently at levels which have not been sustainable for a prolong periods over the past 15-20 years, while Asian FX are still some 40% off their values at the early 90s. There is definitely a chance of Asian FX to outperform the majors although the gap narrowing is limited, given that any RMB adjustment is only expected to be marginal.

Chart 5: USD vs 'Floating Asian' And vs Major Currencies



Any chance of NEER appreciation?

It is common that FX levels do diverge significantly from their underlying fundamentals for prolong periods. With the expected RMB adjustment, the question is that if this will lead to appreciation of Asian NEER in the months ahead? After all, external positions of regional economies have continued to improve, reflected on the rise in foreign reserves accumulation and the persistence current account surplus positions since post Asian crisis. However, Asian CBs appear to be comfortable with their existing conservative FX policy stance to support export competitiveness. Moreover, inflation has not been a serious in the region over the last few years. In the absence of inflationary pressure, the Fed has cut rates to almost 50 year low since 2001. Although monetary loosening has finally ended, the market is still doubtful if the US interest rates will return to neutral levels anytime soon. Indeed, despite the rise in commodity and oil prices over the past year, Asian economies inflation trajectory is not expected to hit respective CBs' threshold next year. Looking at the latest consensus estimates, the risk of sharp export deceleration appears to be much larger than the risk of inflationary pressure in 2005 (Chart 6 and 7).

Thus, except for Korea, where there appears to be a trade-off

Chart 6: Consensus Estimates For Asian Export Growth In 2005

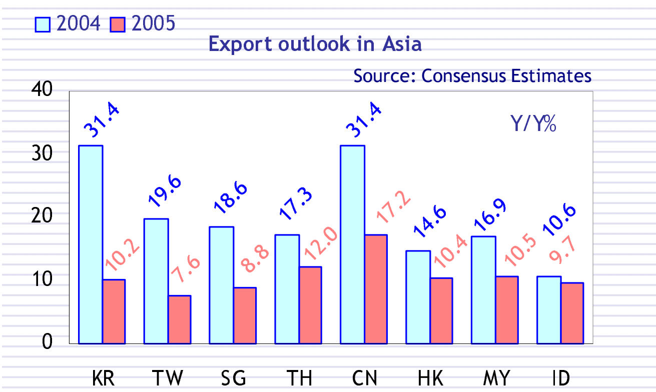


Chart 7: Consensus Estimates For Asian Inflation In 2005

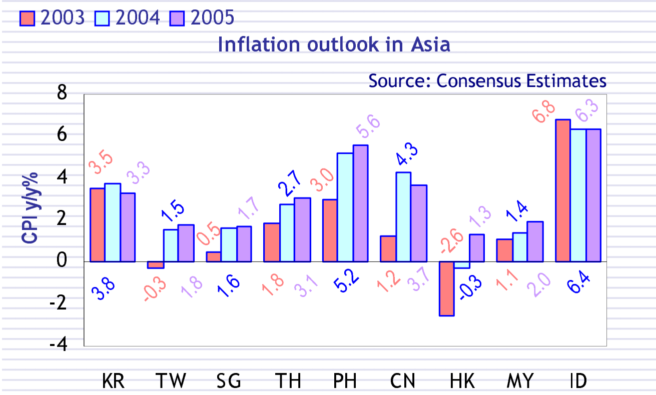


Table 2. Changes In 'Floating Asians' Required To Bring NEER Back To End-Sep Levels, If JPY=98, EUR=1.35 When RMB +5%

% appreciation (+)/ depreciation (-)	KRW	TWD	SGD	THB	PHP
from 16 Dec	-2.6%	1.2%	2.3%	2.0%	5.7%
exchange rate level (vs USD)	1,084	31.9	1.606	39.17	53.22

Note: The % calculation assumes that except for the base currency, other regional currencies remain unchanged. When RMB revalues, it is almost guaranteed that Asian FX will appreciate across-the-board, resulting in a de-facto NEER depreciation of the base currency. Thus, the base currency will need to appreciate by more than the calculated % change. As such, the '% appreciation required' could be interpreted as 'minimal appreciation', and similarly 'the % depreciation required' as 'maximum depreciation'.

Source: UOB

between interest rate cuts for FX appreciation (so as to maintain its current monetary conditions), there is really little reason for other Asian CBs to tighten monetary policy via FX adjustment aggressively. On the other hand, we cannot be sure whether Asian CBs are comfortable with their currencies' de-facto NEER depreciation in the event of a RMB revaluation, as such event will lead to the majors to trade in the same direction, resulting in a larger 'floating Asian' NEER depreciation.

We thus run a simple scenario analysis to estimate, if a 5% RMB revaluation leads to JPY and EUR strengthening to 98 and 1.35 respectively, how do 'floating regional' rates need change to bring their respective NEER values back to the levels at end-Sep (i.e. the time before the RMB revaluation story was being priced). Table 2 suggests that except for KRW and THB, most 'floating regional' still have rooms for at least 1.2-5.7% of appreciation from 16 Dec 2004 levels. Given the sharp run-up since Oct, it is reasonable to expect KRW to have overshot. But even with such excessive strength, KRW will only have to retrace at most 2.6% from 16 Dec 2004 level to 1,084/USD. This is because of our assumption of a large 6.4% (from current level) swing in USD/JPY, which carries a significant weight in the KRW NEER calculation. For the same reason, our model also suggests THB is not required to budge much from the current level. In contrast, SGD will have to appreciate by at least 2.3% to recover its 0.6% NEER depreciation since Oct. In general, the ultimate FX rates depend on the relative importance of USD-bloc currencies in the trade basket. In this regard, it appears that SGD could appreciate much more than 2.3% given that Malaysia, which is very likely to switch the MYR regime post RMB revaluation, accounts for 15% share of SGD NEER weighting in our spreadsheet.

Conclusion

With the RMB adjustment long overdue and the markets unlikely to be convinced that the adjustment is one-off, risk is that Asian FX will overshoot in terms of strength. However, respective CBs will try to keep their NEER levels flat when the dust finally settles. Based on current market valuation, there is still room for some upside potential for Asian currencies. Assuming USD/JPY stretching to 100 or even 98 (equivalent to another 3-5% from current levels), our calculation is that we could see floating FX stretching by similar magnitude. In particular, with Malaysia likely to re-visit the ringgit peg as a result of the RMB move, we could possibly see USD/SGD stretching below 1.60.