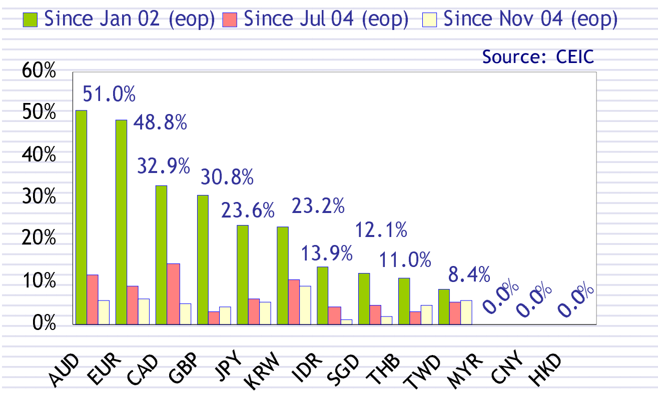
USD/SGD Into 2005 - How Much Lower ?

Summary:

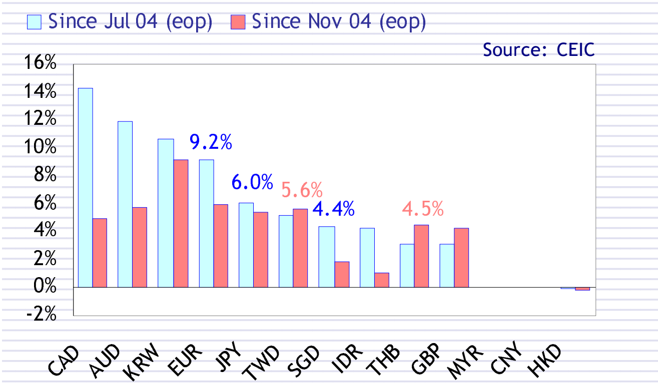
- *Since late Oct, SGD has appreciated about 4 big figures to almost 6-yr high of 1.63, also breaching our year-end target of 1.65.*
- *Although partly due to renewed broad USD weakness, a bigger factor was expected changes on the RMB, now anticipated to occur within 3-6 months. This could also lead to Malaysia re-visiting the ringgit peg.*
- *We remain convinced that European currencies are not about to appreciate another 20%, given that most currency pairs are now at levels which have not been sustainable for prolonged periods over the last 15-20 years.*
- *While SGD has appreciated about 2.5% since Oct and about 5% since Jul 2004, players are still convinced that there is upside potential for Asian currencies in the event of a change in the RMB.*
- *Besides MAS already on a tightening mode (which we are expecting 2.0-2.5% SGD NEER appreciation over a 12-mth period), USD/SGD will also have to make the necessary changes in the event of a ringgit policy shift.*
- *Many are of the view of USD/SGD towards 1.60 into 2005, with some even pricing in risk of 1.57-1.59.*

In late Oct, we put out a publication indicating that the renewed USD weakness is not a new trend, but merely a lower range for the greenback. We added that the next round of USD depreciation will have to come from Asian currencies, which is contingent to when China will move the RMB. Since then, SGD has appreciated about 4 big figures to almost 6-yr high of 1.63, also breaching out year-end target of 1.65. Although partly due to renewed broad USD weakness, a bigger factor was expected changes on the RMB, now anticipated to occur within 3-6 months. This could also lead to Malaysia re-visiting the ringgit peg. In all, our view is that Asian currencies are likely to continue to appreciate into 2005, with SGD outperforming the other Asian currencies. Besides MAS already on a tightening mode (which we are expecting 2.0-2.5% SGD NEER appreciation over a 12-mth period), USD/SGD will also have to make the necessary changes in the event of a ringgit policy shift. Indeed, many are of the view of USD/SGD towards 1.60 into 2005, with some even pricing in risk of 1.57-1.59.

Global FX Performance



Global FX Performance



USD weakness against European currencies, what has changed?

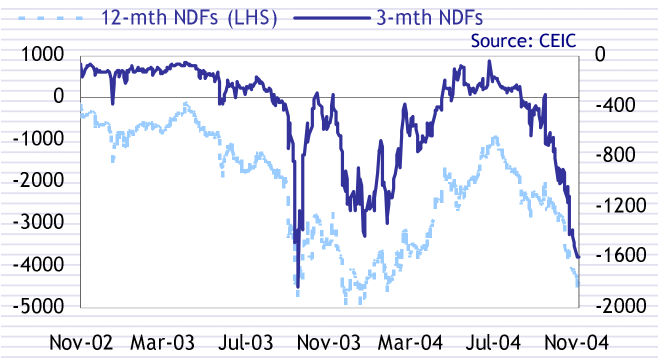
Despite cyclical positives (impressive payrolls figures, widening EU-USD bond spread in favour of the US and the Fed not expected to pause at around 2% on its key interest rate), markets remain overwhelmingly focused on structural issues — including how private sector is now less willing to finance it and the US has become overly dependent on Asian CBs' inflows. Indeed, against our previous range of 1.26-1.32, EUR was up at record high of 1.3470 in early Dec. However, it is important to note that most of these currencies are grossly overvalued against the greenback, and currently at levels that have not been sustainable for prolonged periods over the last 15-20 years. Overall, it is really quite difficult to justify extended

USD losses from here, although overshooting of FX weakness could push EUR towards 1.36-1.37.

More talks of RMB adjustment

After opting for interest rate hikes policy to slowdown the domestic economy and the US presidential elections out of the way, China actually has all the reasons to delay changes in the RMB policy. However, statements from Beijing of late clearly indicate such changes could take place within the next 3-6 months. Also, the mainland has widened its definition with regard to a stable RMB policy, emphasizing that stable RMB policy does not imply lacking in flexibility. Finally, extensive work has been done to make sure that local corporates are better equipped to cope with a firmer RMB. In a closed-door meeting hosted by a local bank, along with CB officials and FX regulators, a survey with 200 companies in Yangzhou was published, indicating that almost 80% said a 5% RMB appreciation is acceptable. As such, most participants are now expecting a 3-5% RMB revaluation within the next 3-6 months.

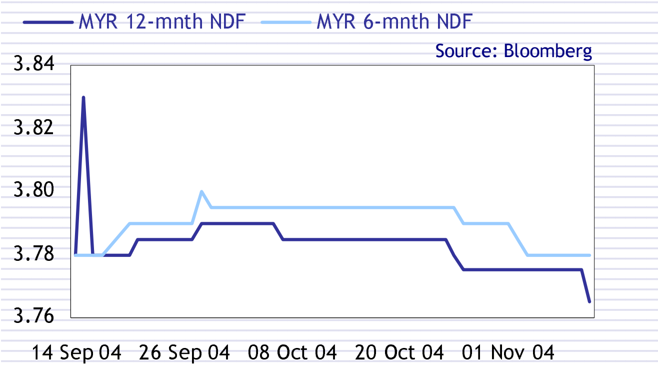
Pricing In RMB Adjustment In The Next 6 Months



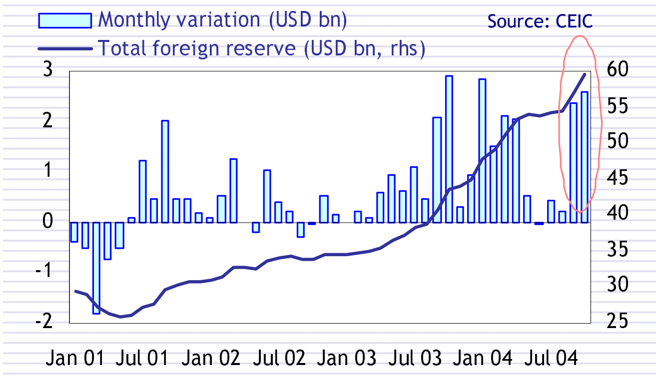
What about the ringgit?

Our call has always been there is really no compelling reason to change the ringgit peg, given the lack of domestic pressure. While inflation is expected at 2.5% in 2005 from 1.4% this year, it is still well below BNM's perceived threshold of around 3.5-4.0%. Indeed, despite the rise in Fed Funds rates, Malaysia rates are only expected to adjust upwards in H2-05. Externally, global policy makers are also not too bothered about the ringgit peg as compare to the Chinese fixed FX regime, given that Malaysia only accounts for 0.3% of global GDP as compared to China's 3.2%. Thus, any change is because Malaysian policy makers choose to undertake changes, which officials have expressed their intention to do so.

Ringgit NDF Has Priced In 1% Appreciation In 12 Months And 0.5% In Six Months



Foreign Reserve Rose Sharply In Last Two Months Compared With The Months Previously



Remarks by Malaysian policy makers

Jan 2004... PM Badawi made it clear that the government is not dogmatic about the peg and if the situation warrants a change, they will go for it.

01 Nov 2004... PM Badawi said Malaysia is closely monitoring the developments in China's monetary policy and the government is in touch with the Chinese monetary authorities. However, at the moment, they are maintaining the peg.

06 Nov 2004... The Second Finance Minister, Nor Mohamed Yakcop (also the architect of the peg), said that Malaysia would seriously consider reviewing its peg if the US currency falls to 1.40 per euro and below 100 yen. He said, "If the two currencies strengthen to beyond those levels (against the USD) we do not want the ringgit to be out of whack." Similar breaking points have also been put up by MIER last year.

30 Nov 2004... At the release of the country's Q3-04 GDP growth figures, BNM governor Zeti said the ringgit peg is not mis-aligned. She added that Malaysia's policy objective is stability, and that if there is a potential mis-alignment, the govt will review its position.

So, how high will the ringgit stretch?

Policymakers have on several occasions indicated that the ringgit is not mis-aligned and about 5% weaker as compared to Sep 98. Our in-house spreadsheet also indicated similar magnitude, about 7% weaker than Sep 98. However, our reading is that authorities prefer to keep the ringgit a little undervalue given the lack of inflationary pressure. Anyway, there is also market related pressure from funds cashing out in the event of a ringgit adjustment, which will limit the ringgit's appreciation. In all, consensus is that Malaysia will shift to a managed-float regime (a la Singapore), and that the ringgit will appreciate about 3-5% given its strong external position. This means USD/MYR trading around 3.61-3.68.

USD/SGD from here

The question now is how much of these possible changes are already reflected on USD/SGD prices? Actually, it is quite difficult to ascertain, especially in determining the appropriate reference points. Nonetheless, we have tried to pinpoint a few critical periods:

(1) Jan 2002 when broad USD started to weaken;
(2) Jul 2004 when RMB NDFs started to widen;
(3) End Oct 2004 when RMB rumours intensified;

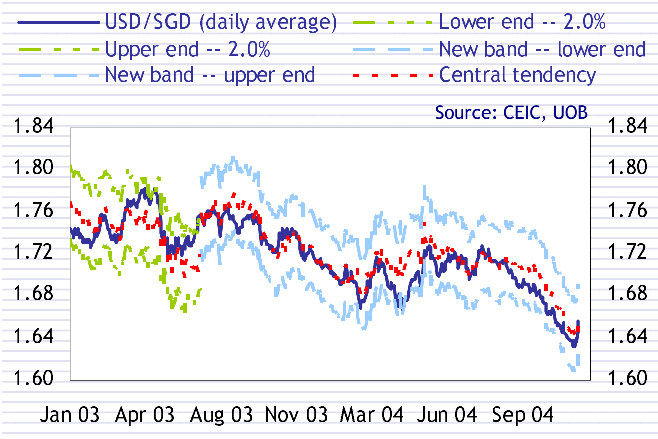
Since Jan 2002, most European currencies have appreciated about 30-55%. However, most Asian currencies only appreciated by 10-15%, with the exception of KRW and JPY, which have appreciated about 23-26%. Unless China is willing to free-float the RMB (which is impossible), Asian currencies will never appreciate by that sort of magnitude as compared to European currencies. Thus, a more appropriate reference point is perhaps Jul 2004 or Oct 2004. While the market has of late highlighted that KRW has appreciated some +10% since Oct, TWD +5.6%, THB +4.5%, and SGD only 1.9%, it is important to note that SGD actually bottomed out in Jul 2004. In fact, as compared to Jul 2004, SGD appreciation is more or less similar to TWD and THB adjustment. Roughly speaking, it appears that most Asian currencies have already priced in a 3-5% RMB appreciation.

'Buy-on-rumours, sell-on-news' strategy? May be not...

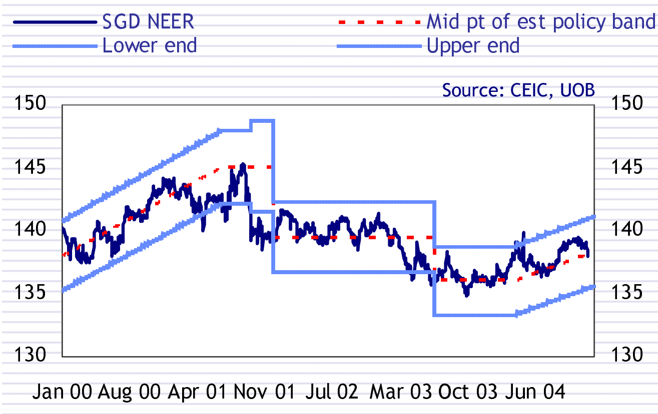
With most Asian currencies already adjusted about 5% (with the exception of KRW +9%) over the last two months, some have questioned if it would be a sell-on-news strategy when RMB is finally adjusted. We spoke to a few participants, and consensus is that this is the move everyone has been waiting since Jan 2002. Further, with the RMB under-valuation perceived to be around 10-40%, it would take a lot to convince the market that any adjustment in the RMB is one-off, and will not recur in the next 12 months. As such, our guess is that in the event of any RMB adjustment (assuming 3-5%), USD/Asian could still gap 2-3% lower, meaning USD/SGD to about 1.60.

Also, despite recent SGD gains against the greenback, SGD

UOB's Estimation Of SGD NEER

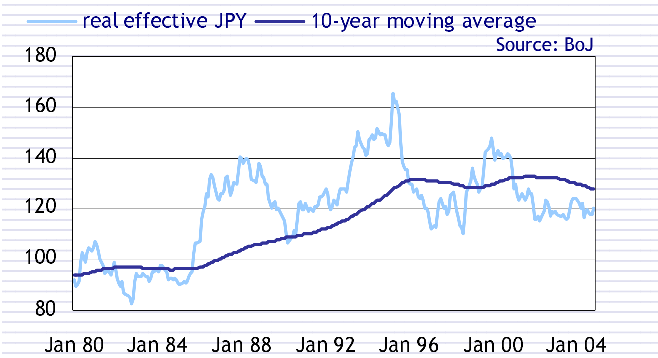


UOB Estimation Of SGD NEER (daily averages)



NEER has actually depreciated about 0.8% over the last four weeks, with talk of MAS moderating SGD gains. Here, our guess is that MAS may be of the view that the market has overplayed the RMB story, thus, there is really no need to allow SGD to adjust too sharply. Not sure if this is an appropriate policy as it means that when RMB is finally adjusted, MAS would have to let SGD gapped up. Another reason could be the MAS is trying to moderate the pace of SGD adjustment so

Real Effective JPY Still Soft



that corporates have ample time to response to the new FX environment. Whatever the intentions, such policy decision means that SGD still has room to adjust in the event of a RMB move. Indeed, for SGD NEER to return to pre-RMB rumours, USD/SGD would have to adjust to 1.6250.

Meanwhile, although USD/JPY is at 4-1/2 yr low, consensus is that the Japanese economy is now in a better shape tolerate stronger JPY. Further, JPY REER is still some 7% below its 10-yr MA as of end-Oct and Japanese assets markets have yet to show signs of distress. Thus, the general view is that if RMB adjusts, we could see USD/JPY towards 100 or even 98.00, which will again weigh on USD/SGD.

Plugging these figures into our in-house SGD NEER spread-sheet, our reading is that USD/SGD could stretch to 1.60 or even 1.59 in 2005. There is also risk of ringgit adjusting, which will keep USD/SGD heavy throughout 2005.