

Finding safe harbour

As regional banks cautiously develop currency markets and sovereign risk threatens global market stability, Société Générale explains why going back to basics is a sound strategy

Asian economies have fared well

Although Asian economies have fared well compared to their Western-hemisphere counterparts in maintaining stability in domestic currency markets, the real test for regional central banks will be if exports continue to prove weak.

It is likely that markets in Europe and the US will remain sluggish, in which case the second half of 2010 will pose a challenge for Asian economies.

Asian markets, which are heavily reliant on exports and have amassed trade imbalances, will be hard pressed to contain currency appreciation in the case of economies such as China and India. While currencies such as the Australian dollar, which were in fashion from a carry trade perspective, will be faced with decreased demand.

However, while the US dollar has taken a beating in the 12 months ending January 2010, namely in currency pairs such as USD/HKD and USD/JPY, there is still stability to be found in the greenback.

Sovereign risk in what are dubbed 'the PIIGS' [Portugal, Iceland, Ireland, Greece and Spain] has virtually ruled out any moves into the euro by global central banks, and currencies such as the Swiss franc and Japanese yen are proving volatile in their own right.

As a result, we now see an about-turn on the sentiment of 24 months ago, where central banks had made it quite clear that diversification away from the US dollar would become the norm. Central banks, such as those of China and India, had indicated a rebalancing of reserves to alternative currencies as early as 2007.

The backtrack on being net sellers of the USD has been quite evident. The USD/HKD has gone from 7.75, where it was fixed for the large part of last year, to 7.78 within the first three weeks of this year. The Indian rupee, Korean won, New Taiwan dollar and New Zealand dollar, among others, have also had a roller-coaster ride against the dollar.

For now, Asian economies have successfully managed their economies through the crisis by maintaining their currencies at current levels. Once the crisis passes, we can expect the Asian economies will allow their currencies to appreciate.



Robert Reilly

Developing debt markets

While diversifying currency risks is any central bank's priority, asset value appreciation is also of growing importance. Making it easier for monetary authorities and sovereign wealth funds (SWFs) to invest in stable assets such as bonds should be a regional priority.

Temasek Holdings is at the forefront of this but, with China and India looking to establish their own wealth funds, in the nascent stages, bond markets will be an ideal entry point for these investing entities.

Sovereign risk is inherent in the market. Obviously there are some countries that carry more risk than others. In free economies this sovereign risk can be transferred through a free-floating currency regime. In Europe this is a constraint as there is a single common currency across 16 countries. So the only means of control is through fiscal measures, to raise taxes and repay debt.

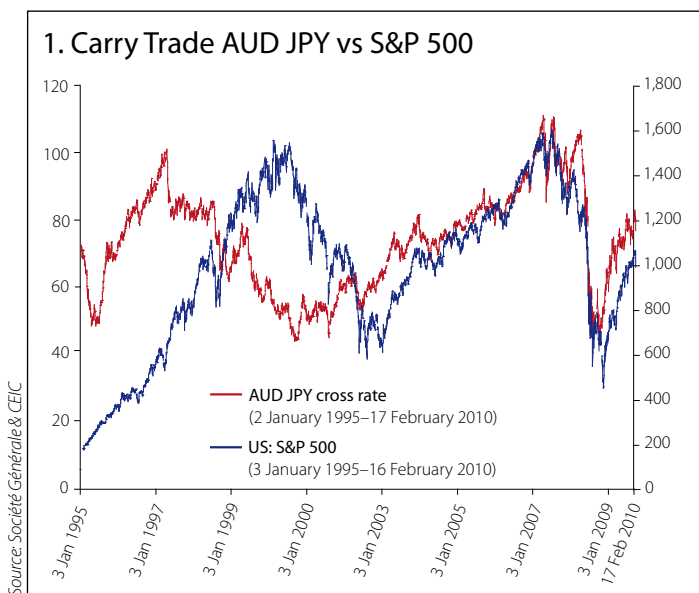
For Asian central banks, the best measure they can take is diversification of their investments. With the development of high-grade credit in the region, it is logical to expect to see SWFs invest in the local markets. This will provide diversification from their current investments, while at the same time aiding in the development of local debt capital markets.

But, in order to have higher-grade non-sovereign debt, markets need to have risk-free yield curves, explains Robert Reilly, Asia co-head of flow fixed income & currencies at Société Générale Corporate & Investment Banking, Hong Kong. "Especially in the open market economies of South Asia," he says. "The higher-grade credit market will be allowed to develop after this and I think central banks and SWFs would be investors in these bonds."

Easing restrictions in the yuan

There is also anticipation around moves in yuan convertibility and the effect this will have on global currency markets. And, although this is both a political and economic debate, there are far-fetched implications on global currency markets when the yuan does become freer to trade.

With pressure on China to ease open their currency market and an intrinsic urge to relinquish some control – albeit minor – there is



reward for those markets that start early in positioning themselves to benefit from easing restrictions on the yuan.

And, although an offshore non-deliverable currency market exists for the renminbi, there are concrete plans by governments to develop their own renminbi-denominated markets. Moreover, speculation on the appreciation of the CNY has also intensified.

In February, Hong Kong announced the development of a yuan-denominated bond market. This development will be watched closely, especially by those markets that have currencies that are non-deliverable; it provides an access point to invest in these currencies.

There is a large offshore market in the renminbi, and this development would provide more flow in interest rates for the offshore market. With the buy side restricted on investing in CNY, this development would enable foreign investors to allocate funds to CNY-denominated assets.

But again we don't expect to see a development away from USD-denominated assets in the near future, particularly not with the euro facing sovereign risks at the moment.

"At this point in time, the USD is providing a safe harbour for currency reserves. Until we see liberalisation in the Chinese yuan, I don't see this changing," says Reilly.

China as a reserve currency is a long way off; by becoming a reserve currency, China would relinquish control over their currency and the economy is far from being developed, or having mature capital flows. The concern over the development of bubbles still exists in equities and property.

Emerging market and commodity crosses

With the increased demand for commodities, the demand for the USD will be on the rise.

In the last 12 months we have seen the development of risk being expressed in currency crosses. The risk taking is expressed in the JPY carry trades. Still dominating this risk are the JPY crosses, but emerging markets and commodity currencies have also been fashionable and we expect this to continue.

KRW and AUD/JPY remain the favoured trades to express this view. For base metals and precious metals, AUD is still a favoured currency to make this play on commodities.

Back to the basics

Gold also looks bullish. In times of uncertainty, investors look towards gold as a true store of value, and a hedge against inflation, and this is still the case. This was exemplified by India's purchase of gold in rapid succession towards the end of 2009.

Dogged by inflation and currency instability, Indians – who are the largest buyers of gold – already find that gold is unrivalled in its store of wealth and hedge against rising prices.

We are also bullish on the USD in the short to medium term. Unless there is no new development in the debt crisis in the US, the demand for the greenback will be on the rise.

Changing the regulatory landscape

Further developments in regulation to allow cross-border flows would help the regional markets evolve.

For Asia to develop and prosper it is important to recycle the capital within Asia rather than looking for it elsewhere. With the balance-of-payments surpluses within Asia this capital should be abundant.

With the development of our hub in Hong Kong, we are close to the growth and development in China. I expect this to accelerate over the second half of 2010, with more capital inflow into Asia. The development of our onshore centres also means we can provide solutions for clients looking to invest or transact in the region.

For risk management services, the bank is also developing its corporate and advisory strategy for the region. This, combined with the development of our cash trading capabilities globally, will also mean we can cater to our clients' investment needs.

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