CROSS-ASSET ROADMAPS

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# Renminbi Revaluation Roadmap

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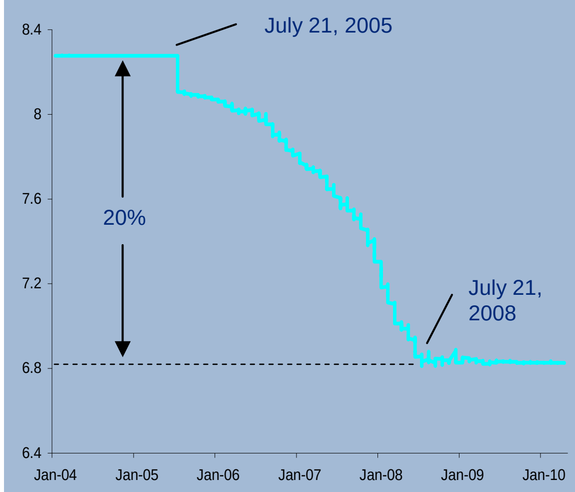
## Global Cross-Asset Strategy

**We expect the CNY to be revalued during the summer.** Secretary Geithner's announcement that the Treasury's semiannual currency manipulation report will be delayed a few months suggests to us a cooling off of recent tensions between US and Chinese officials over the renminbi's USD peg. In our view, this opens up a "sweet spot" for a mid-summer revaluation—with increasing odds of an earlier move—of 2-3% initially, with ongoing "crawling-peg" appreciation for a cumulative total of 4-5% in 2010. By comparison, the forward market is currently pricing in a more modest appreciation.

**The market implications are asymmetric.** The revaluation we expect would help extend the rally in risky assets because it would underscore China's commitment to its G20 rebalancing responsibilities and could allow the PBoC to tighten less aggressively. In contrast, were Chinese officials to balk at adjusting the currency, it could heighten trade tensions and might require more tightening. Thus, while a revaluation itself is not likely to have a significant direct effect on most risky assets, the absence of any adjustment would be a headwind.

**A revaluation would reinforce our existing views and recommendations.** Equity markets—China particularly—should react favorably, in our view, as they did in 2005. Commodities would benefit, but the impact on prices would be more likely in the medium rather than near term. AXJ currencies stand to benefit the most, especially those that serve as CNY proxies.

**Exhibit 1: USD/CNY historical spot rate**

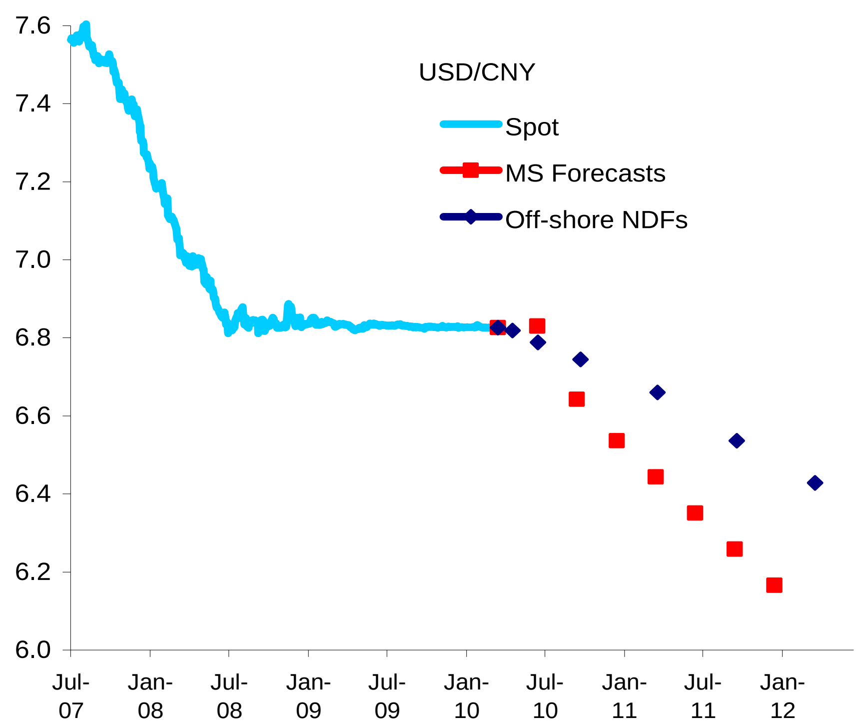



**Source:** Bloomberg, Morgan Stanley Research

# What the market expects vs. what's likely

**The revaluation priced in the market appears too low.** Our China economist Qing Wang expects the revaluation to start in July, with an appreciation from the current 6.825 to 6.54 by year end and 6.17 by the end of 2011 (Exhibit 2, see *Renminbi Exit from USD Peg: Whether, Why, When, How*, April 5, 2010). By comparison, the non-deliverable forward rates for USD/RMB imply less appreciation. Technical factors account for some of the difference, and anecdotes from China suggest that many business people expect a revaluation of at least a few percent by the summer. But this possibility is less appreciated by global investors.

**Exhibit 2: USD/CNY spot, forecast, and market-implied through 2011**




**Source:** Bloomberg, Morgan Stanley Research

**The market is too focused on the likelihood of China being named a currency manipulator.** Escalating statements throughout March by US and Chinese officials raised concerns that the US Treasury would designate China a currency manipulator in its semiannual report to Congress on international economics. The prospect of elevated tensions—at worst a trade war—between the two countries had investors looking at the consequences of a manipulator designation and for ways to hedge this risk.

**The risk of China being named a currency manipulator is quite low and the odds of a modest revalue happening fairly soon are rising.** The phone conversation last week between Presidents Obama and Hu suggests that the probability of manipulator designation is actually very low and a de-peg of the CNY from the USD now appears highly likely to take place. Treasury Secretary Geithner's decision this past weekend to delay the publication of the currency report for a few months gives China time to move on the revaluation. While we expect a modest revaluation to occur in the summer after a series of high level meetings between China and the US, the prospect of a revaluation as soon as May is increasing.

**The benefits of a revalue apply to both the real economy and risky assets.** Aside from the obvious political benefit of avoiding a trade war with the US, de-pegging the CNY would help to rebalance the Chinese economy. It would also reduce the need to raise interest rates to combat inflation. The alternative—higher rates and a pegged currency—would be a negative for risky assets. Moving quickly to revalue removes policy and political uncertainty, a positive for asset values. Thus, "buy the hike" applies to the CNY revaluation.

# Why an orderly revaluation makes the most sense

**Political considerations are as important as economic fundamentals in the revaluation decision**

- China's major trading partners consider the CNY undervalued and its hard peg against the USD a symbol of a “mercantilist bias” in China's foreign trade policy.
- While Chinese authorities have made a strong case for the *status quo*, they also recognize that allowing at least a modest revaluation reduces the risk of trade protection measures from major trading partners.
- The revaluation size and timing must balance two political constituencies: trading partners who expect a meaningful gesture and domestic policymakers who strongly oppose CNY appreciation for fear of its negative impact on exporters.
- Data over the next few months showing that China’s Y-o-Y export growth is in the low to mid-teens would help to build internal consensus for a modest revaluation.

**Economic fundamentals also justify a revaluation**

- The CNY exchange rate is fundamentally undervalued—estimates range from 10-40% undervaluation—and should appreciate over the medium term.
- Headline CPI inflation rate could climb to over 4% by mid-year. CNY revaluation could help contain “imported” inflationary pressures stemming from the rapid increase in commodity prices. This could reduce the need to hike interest rates to contain domestic inflation pressures.
- A stronger CNY helps to rebalance the economy away from an over-reliance on external trade as a growth driver toward more domestic-demand, non-tradable-sector-driven growth.
- Allowing the CNY to appreciate now should help China eventually move toward a more flexible exchange rate arrangement, which is a prerequisite for an independent monetary policy.

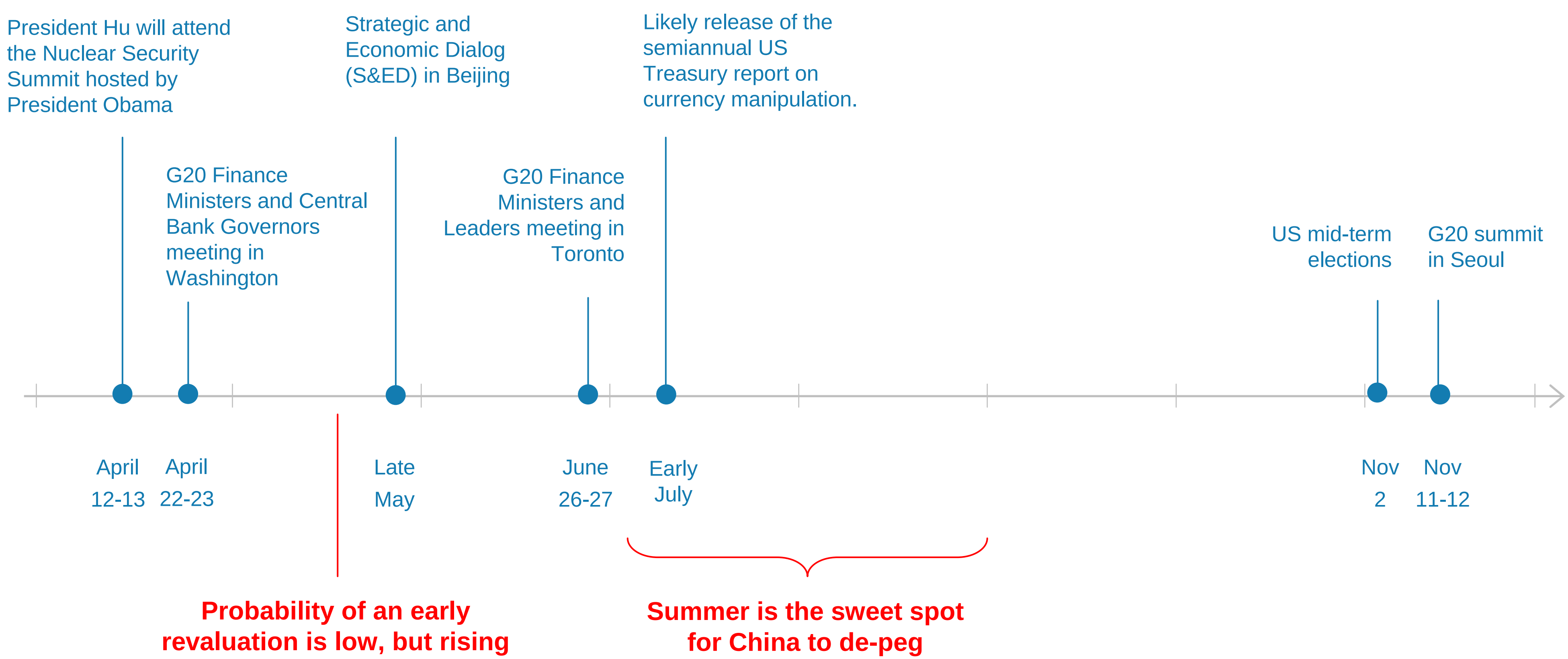
# Political event calendar suggests mid-summer revaluation

**Political considerations will drive the revaluation timing**

- With elevated political tensions between the US and China, the message conveyed by a revaluation to domestic constituencies will be a major determinant of when and how much of a revalue occurs.
- A mid-summer revaluation is most plausible to use, but a move prior to that is becoming more likely as it would mitigate potentially increasing US political pressure, especially from Congress.

**The "win-win" strategy of a mid-summer revaluation makes it most likely:**

- A successful series of meetings between Chinese and US officials and no "currency manipulation" designation from US treasury.
- The Obama administration could claim credit in the run-up to the mid-term election in November.
- The Chinese government could demonstrate global cooperation in the run-up to the G20 summit in November.



# Possible revaluation scenarios entail different risks

## Scenarios for Revaluation

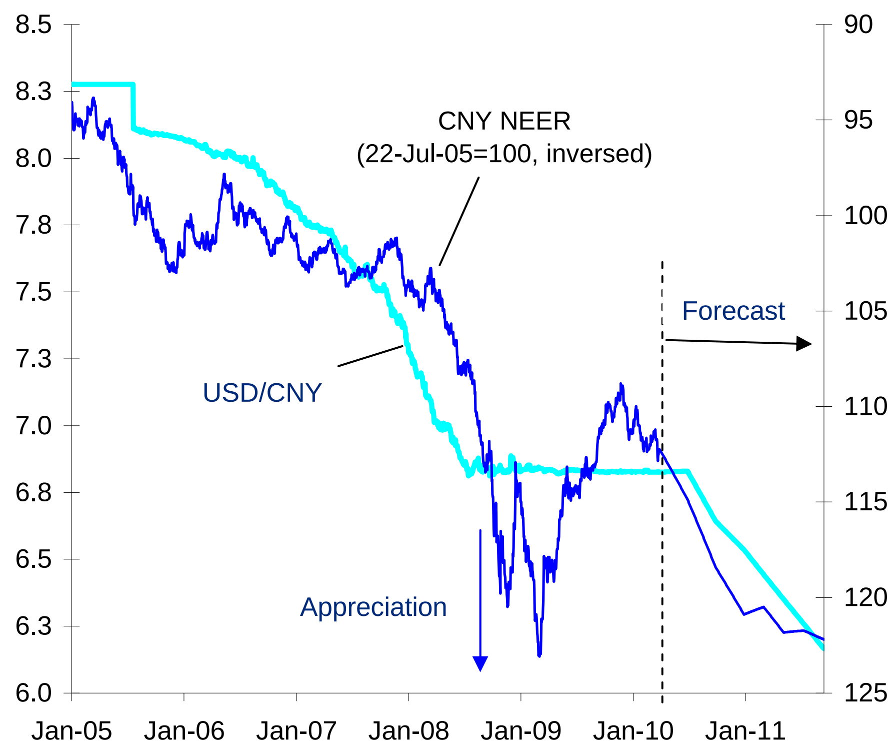
| | Description | Risks |
|---|---|---|
| **Adjust and crawl**<br>probability<br>80% | An initial one-time revaluation of 2-3% versus the USD in the summer followed by gradual appreciation—total cumulative appreciation versus the USD by year end is 4-5%<br>• The initial revaluation of 2-3% could involve a high-profile announcement or alternatively the spot rate could simply be allowed to appreciate in the weeks immediately after exiting the peg without any announcement<br>• Instead of an initial adjustment, the CNY may just begin to gradually crawl higher, with the same cumulative total by year end | • A small initial adjustment, or the absence of one, could attract hot money inflows as investors expect continued CNY appreciation—fueling asset price inflation<br>• Any adjustment ideally needs to create a two-way risk market; that is, the upside and downside risks to the CNY are more symmetric<br>• A small or gradual adjustment may be viewed as insufficient by US officials, thereby failing to reduce protectionism risk |
| **Passive to TWI**<br>10% | On a trade-weighted basis, CNY continues to appreciate as the euro and other major currencies weaken; there is no one-time revaluation, with a maximum of 1% appreciation vs. the USD by year end | • The lack of any active appreciation increases the risk of trade frictions with the US |
| **Big one off**<br>9-10% | A large one-time revaluation of 10-15% versus the USD, but no change in capital controls | • An unexpected large revaluation could hurt exporters, and consequently the domestic economy |
| **Free float**<br><1% | Free float, including the abolition of capital controls | • The CNY may overshoot on the downside; such an unexpected move could create additional policy uncertainty |

# Passive revaluation and smaller trade surplus may limit RMB action

**On a trade-weighted basis, the CNY has already begun to passively appreciate…** (Exhibit 3). Active revaluation amplifies this passive appreciation against the trade-weighted index. Our China economist Qing Wang expects the nominal effective exchange rate (NEER) for the CNY to continue to appreciate, roughly in line with the appreciation relative to the USD.

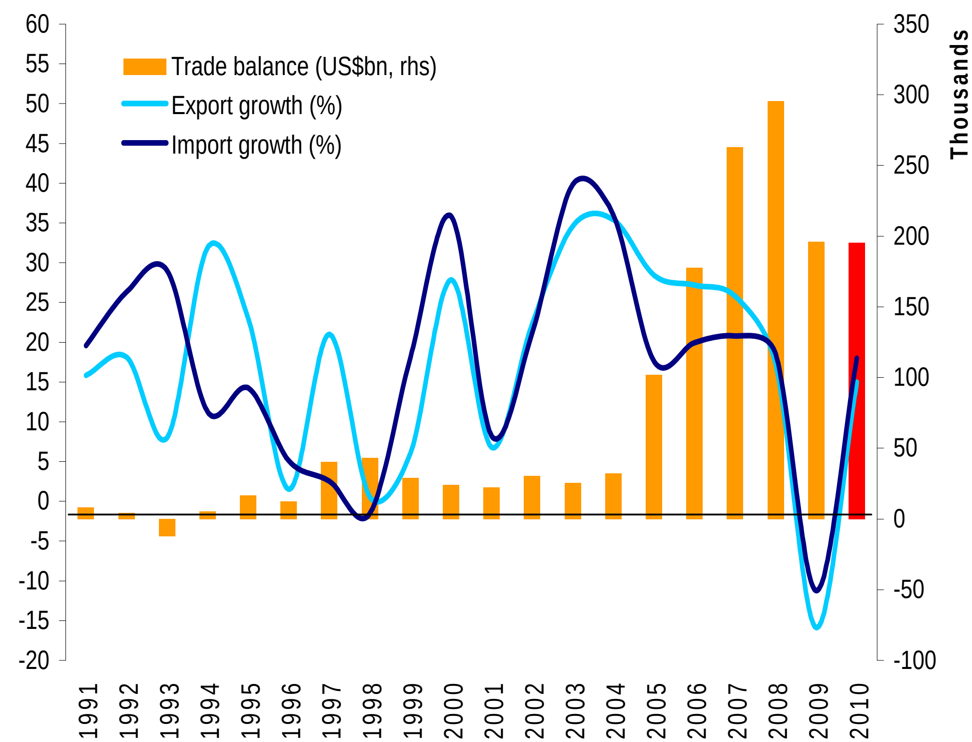
**…and any corresponding shrinkage in the trade surplus could alleviate some pressure to revalue the CNY.** With imports growing faster than exports (Exhibit 4), our forecast is for China's trade surplus to fall to 2.9% of GDP in 2011. Some Chinese officials may point to this development to argue for limited revaluation.

**Exhibit 3: CNY NEER has tracked the USD/CNY rate**




**Source:** CEIC, Morgan Stanley Research forecasts

**Exhibit 4: High import growth is moderating China's trade surplus**




**Source:** CEIC, Morgan Stanley Research forecasts

# Revaluation implications for risky assets are asymmetric

**A revaluation will benefit specific asset classes, but leaving the peg unchanged would negatively impact risky assets generally.**
A revaluation would help extend the rally in risky assets because it would underscore China's commitment to its G20 rebalancing responsibilities and could allow the PBoC to tighten less aggressively. In contrast, were Chinese officials to balk at adjusting the currency, it could heighten trade tensions and might require more tightening.

## Implications across asset classes

### Equities

- Positive for Chinese equities, provided the revaluation is moderate
- Good for AXJ ex-China equities, as investors will look to play the trade through almost all the currencies in the region
- Positive for US equities with a producer perspective – industrials, construction, machinery, and healthcare equipment – and potential negative for consumer-focused stocks in retail, apparel, and footwear

### Rates

- A slower accumulation of Chinese reserves would reduce the demand for US Treasuries, mainly of shorter-term maturities, leading to curve flattening

### Commodities

- Commodity prices should respond positively, if modestly, even if Chinese exports are somewhat impaired as domestic use is more intensive
- Commodities should benefit indirectly from a more sustainable China, as it was responsible for nearly all of the demand growth in aluminum, copper, zinc, and cotton from 2003 to 2008

### FX

- AXJ currencies that track the CNY and have large current-account surpluses stand to benefit as CNY proxies
- CNY appreciation should result in a slower accumulation of FX reserves by China, removing a key pillar of support for EUR

# Chinese equities have the most to gain from a revalue

## thesis

- EM markets reacted very positively to the start of the last revaluation in 2005, continuing through to 2008.
- Beginning the week of the initial revaluation, MSCI China traded up 13% one month thereafter, the MSCI EM was up 7%, and MSCI World (i.e., DM) was up 3% (all USD terms). Prior to that revaluation, the Chinese and EM markets had been moving sideways (Exhibit 5).
- Our China Strategist Jerry Lou believes a revaluation is positive for Chinese equities provided it is moderate and does not fundamentally hurt Chinese exporters. The expectation of further appreciation could also be positive for equities (Exhibit 6, for more details see *A Revisit to RMB Reval's Market Implications*, March 18, 2010).
- But an unexpectedly large revalue will likely trigger some immediate profit-taking and capital outflows, causing a short-lived market correction.

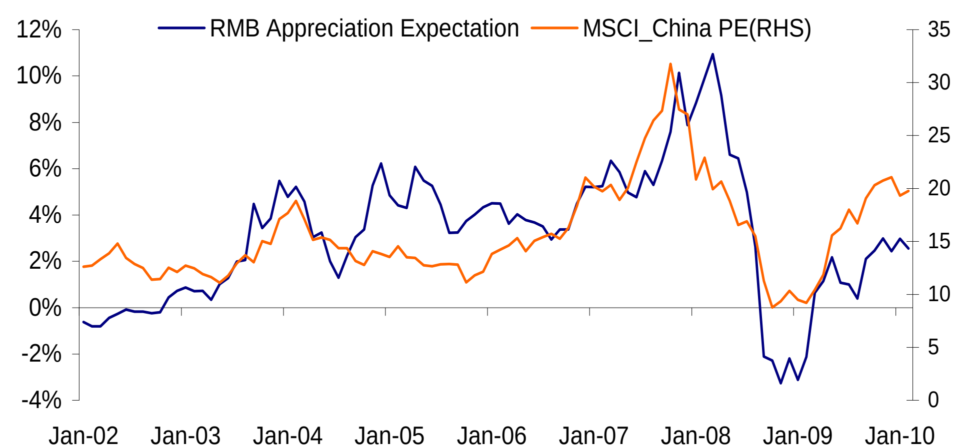
## trade idea

- Sectors that stand to benefit the most include airlines, oil refiners, and steel makers, while on the downside are mostly exporters and those with *de facto* dollar-pegged revenue, such as nonferrous refiners.
- Companies with assets in CNY financed by foreign debt would benefit from a revaluation, and vice versa. Potential beneficiaries could be property developers that have sizable land banks financed by HKD debt and airlines that have large foreign currency debt obligations.

**Exhibit 5: MSCI performance (US$)**


**Source:** FactSet, Morgan Stanley Research

**Exhibit 6: CNY appreciation expectation correlates with market valuation**




**Source:** CEIC, FactSet, Morgan Stanley Research

# AXJ currencies stand to benefit the most

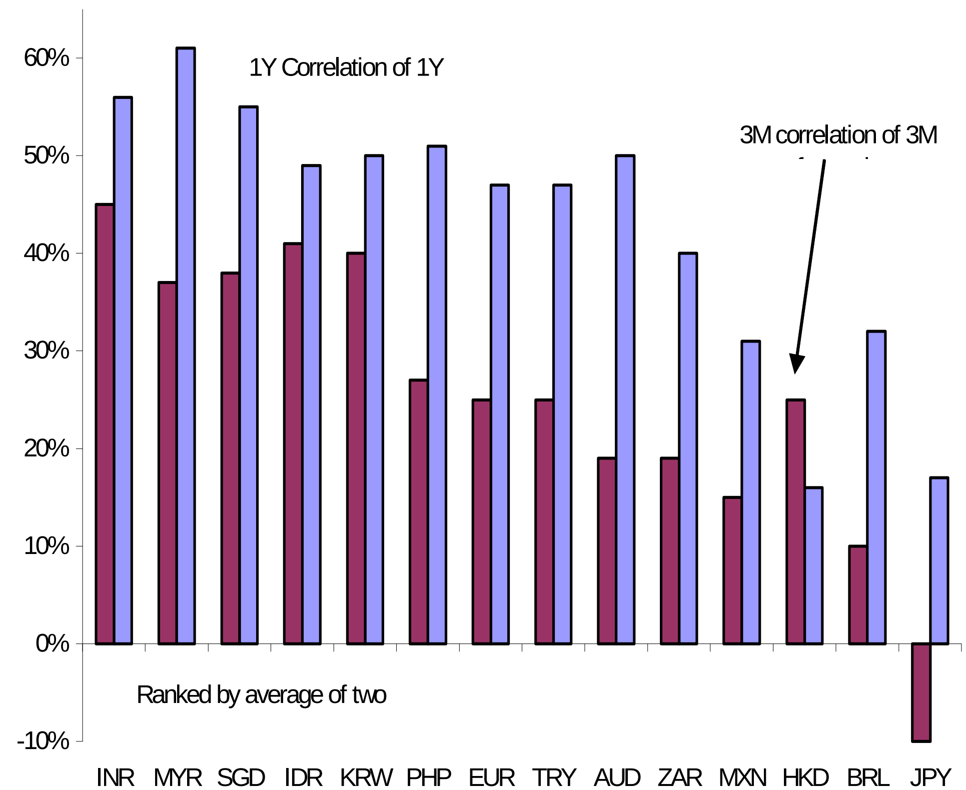
## thesis

- Should China revalue its currency in the near future, we believe there is better value in owning CNY proxies.
- Short USD/MYR is our favorite trade as Malaysia's fundamental backdrop is simultaneously improving as its central bank engages in pre-emptive tightening. These dual pillars of support should underpin MYR in our view.
- MYR and CNY correlation is not only high, but is also rising (Exhibit 7). 1-year correlation between MYR and CNY forwards has breached 60%.
- MYR vols are roughly in line with longer-term averages and among the lowest in the AXJ space, making USD/MYR puts attractive.

## trade idea

- Buy a 6M ATMS MYR Call USD Put (3.2150 spot reference) with a topside MYR3.28 knockout. This structure takes advantage of the forward MYR discount.
- Structure costs 1.17% of notional. The option has unlimited profit potential with investor risk restricted to the up-front premium.

**Exhibit 7: Correlations with the CNY and various currencies have fallen**




**Source:** Bloomberg, Morgan Stanley Research

# CNY appreciation leads to FX rebalancing: sell EUR

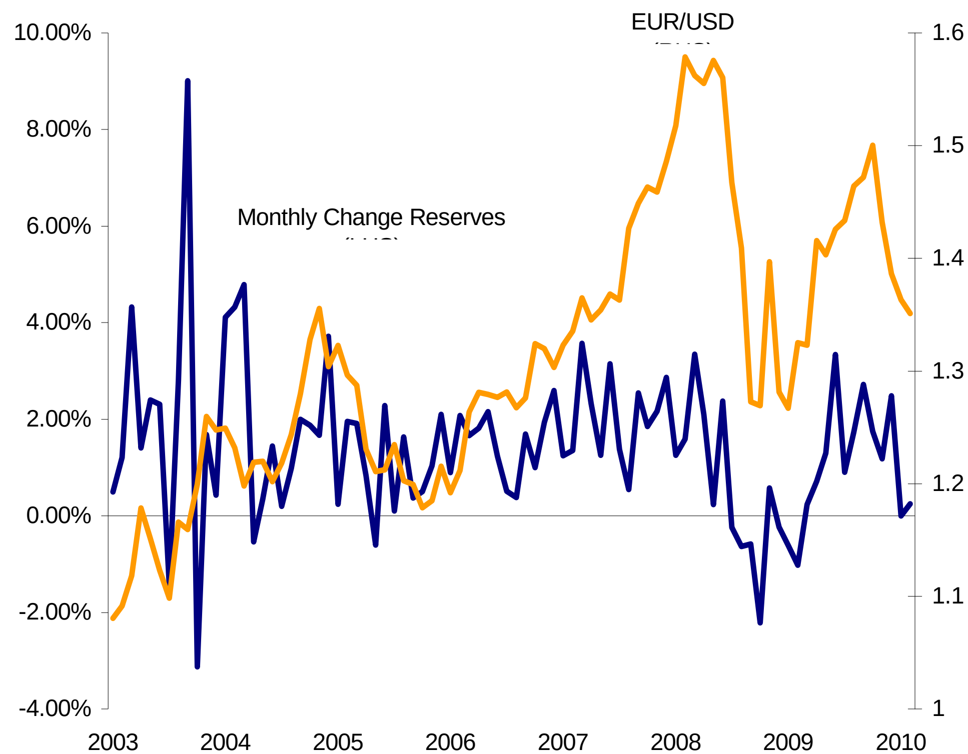
## thesis

- Allowing more RMB appreciation should result in a slower accumulation of FX reserves by China. This should take away a key pillar of support for EUR.
- EUR has disproportionately benefitted from reserve flows as official institutions look to diversify their holdings (Exhibit 8). EUR offers the second most liquid investment market after the USD.
- The RMB peg has created valuation distortions in global currency markets as some floating exchange rates have absorbed a disproportionate amount of USD weakness. If RMB is allowed to appreciate versus USD, currencies that are overvalued are likely to move back toward fair value, such as EUR.

## trade idea

- Sell EUR/USD (current spot at 1.35) with a stop at 1.3850 and a target at 1.24
- This trade offers a nearly 4:1 reward to risk ratio

**Exhibit 8: Demand for EUR reserves has been correlated with its value**



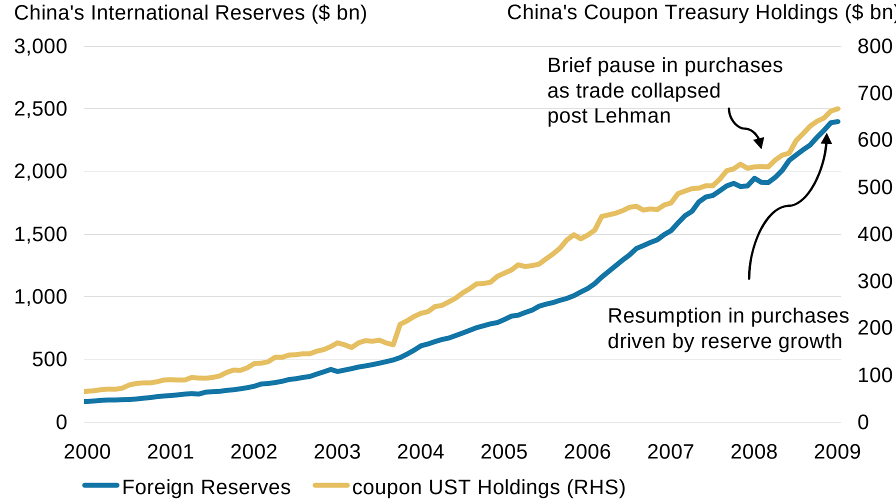

**Source:** Bloomberg, Morgan Stanley Research

# Rates at the front end of the curve most susceptible to a revaluation

## thesis

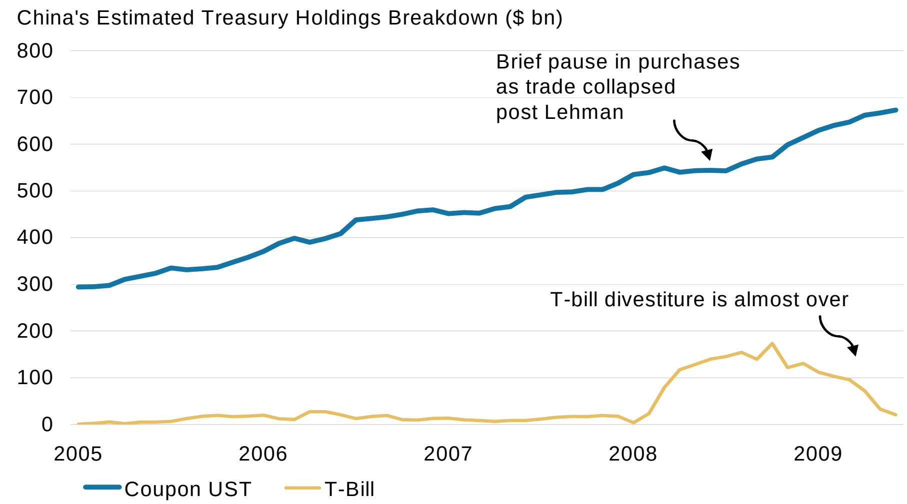
- Foreign central bank demand is often inelastic, and is essentially determined by the amount of trade and the associated trade gap the US experiences with the world.
- A lower USD/RMB will reduce the accumulation of USD reserves by the PBoC, and thus their holdings of US Treasuries (Exhibit 9).
- Post Lehman, China accommodated the Treasury's heavy T-Bill issuance. After peaking in May 2009, China's T-Bill holdings have reversed most of the increase (Exhibit 10).
- The likely sell-off in Treasuries would be led mainly by shorter-term maturities, as the Chinese have primarily been buying in the front end of the curve. This would lead to curve flattening.

**Exhibit 9: China UST accumulation driven by reserve growth**




**Source:** Treasury, Morgan Stanley Research

**Exhibit 10: Breaking down China's Treasury holdings**




**Source:** Treasury, Morgan Stanley Research

# Commodities will benefit from a revaluation, primarily indirectly

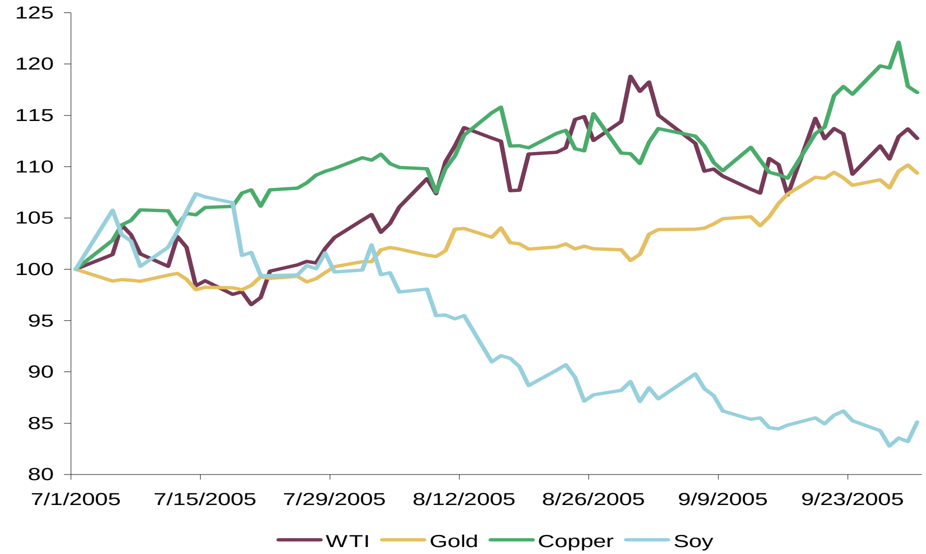
## thesis

- An upward revaluation of the RMB will be mildly constructive for commodities, in our view, with those in which China is a big importer benefitting the most.
- However, we do not anticipate commodity prices to respond significantly if the revaluation is modest.
- Instead, we expect underlying global supply and demand fundamentals to have the biggest influence on price, as was the case in 2005 when China last revalued (Exhibit 11)—copper and oil continued to march higher as balances tightened, while bean prices eased, despite China's rank as the world's largest bean importer, as balances softened on increased production
- Over the medium term, a revaluation is likely to lead to a more sustainable China, and this should benefit commodity demand and prices—China has accounted for the entire increase in global demand in some commodities over ’03-’08 (Exhibit 12).

## trade idea

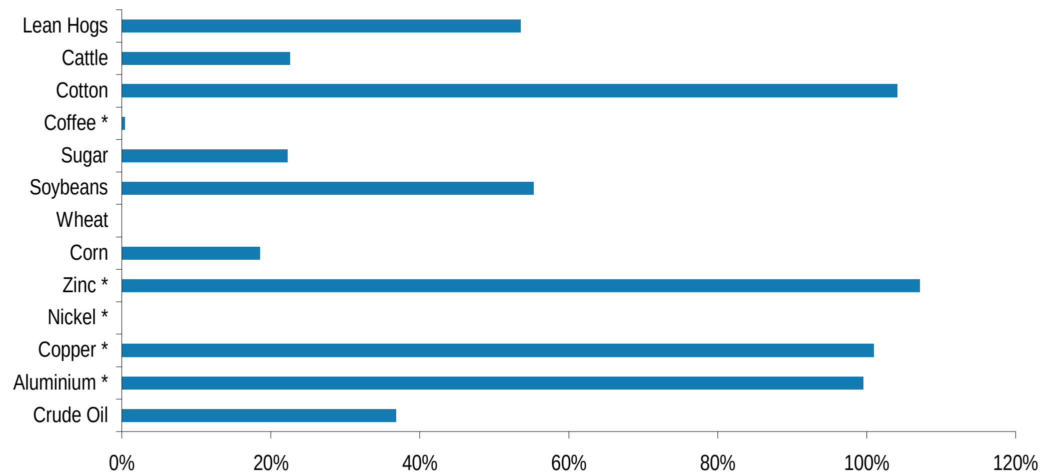
- Given our constructive view on energy, specifically crude oil, we would add to our deferred exposure (Dec 11 WTI) directly or via options, a position that we believe stands to gain from a stronger RMB.

**Exhibit 11: Major commodity prices around the first RMB revaluation**




**Source:** Bloomberg

**Exhibit 12: China’s contribution to commodity demand growth ’03-’08**




**Source:** IEA, USDA, and CRU

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