



# currency crunch

Which currency is safe to invest in now, and is the Chinese RMB all its cracked up to be? *Martin W. Hennecke* has some timely advise

**W**ith one currency after another appearing to lose ultimate safe-haven qualities, investors are getting increasingly nervous. First it was the US Dollar (USD), pressured by America's total 'fiscal gap' funding shortfall of US\$211 trillion (and by extension the pegged Hong Kong Dollar (HKD)). Then the Euro came a cropper – its days may be numbered as both the possibility of a Eurozone breakup or several Eurozone-member national bankruptcies are now being openly discussed. And by extension, even more recently, the Swiss Franc tumbled due to its Euro peg, which it may or may not be able to keep.

So the answer to the question, 'Which currency is safe right now?', is probably none, except gold and precious metals, if we count them as a currency. A very high or hyperinflation in either or both the USD and the Euro now seems inevitable, as a result of further rounds of ever larger bailout and/or Quantitative Easing (QE) measures. Money printing appears to be the only way to address the

unsustainable debt/ deficits in those economies and avoid national bankruptcies on a large scale.

Since we live in a global world, such hyperinflation would probably result in imported inflation around the world, and currency devaluations everywhere. No country likes its own currency to appreciate too fast and too much against the currency of a major export market. Remember the 'currency war', anyone?

## Evaluating currencies

While no currency truly appears safe anymore, it still seems that some may be relatively safer than others, and some ways of investing in such currencies may again be relatively better than other ways.

*The Economist's* 'Big Mac Index' (overleaf) gives us a clear indication of which currencies appear to be the most overvalued and which the most undervalued, on a ▶

### The Big Mac Index

Country	Big Mac Price		Implied PPP Rate (Purchasing Power Parity)	Today's Exchange Rate 1 USD =	Over (+) / Under (-) Valuation against the USD, % ++
	In Local Currency	In US dollars			
United States	\$ 4.07	4.0700	---	1.0000	---
Australia	A\$ 4.56	4.7699	1.12	0.9560	17.1548
Brazil	Real 9.50	5.6497	2.34	1.6815	39.1615
Britain	£ 2.39	3.7943	0.59	0.6299	-6.3343
Canada	C\$ 4.73	4.7433	1.16	0.9972	16.3257
China	Yuan 14.7	2.2881	3.60	6.4245	-43.9645
Euro area	€ 3.44	4.6918	1.18	0.7332	60.9384
Hong Kong	HK\$ 15.1	1.9366	3.71	7.7972	-52.4188
India	Rupee 84.0	1.7727	20.7	47.3850	-56.3153
Indonesia	Rupiah 22534	2.6230	5543	8591.07	-35.4795
Japan	¥ 320	4.1227	78.7	77.6189	1.3928
New Zealand	NZ\$ 5.10	4.1893	1.25	1.2174	2.6778
Norway	Kroner 45.0	8.0928	11.1	5.5605	99.6223
Philippines	Peso 118	2.7709	29.0	42.5860	-31.9025
Singapore	S\$ 4.41	3.5889	1.08	1.2288	-12.1094
South Africa	Rand 19.45	2.6515	4.78	7.3355	-34.8374
South Korea	Won 3700	3.4288	910	1079.10	-15.6705
Sweden	SKr 48.4	7.3948	11.9	6.5451	81.8154
Switzerland	SFr 6.5	7.3480	1.60	0.8846	80.8727
Thailand	Baht 70.0	2.2902	17.2	30.5647	-43.7259

Source: *The Economist*, July 28, 2011

purchasing power basis. We find that the currencies of Norway, Sweden, Switzerland and even the Eurozone seem rather expensive, with overvaluations against the USD ranging from 100% (Norway) to 61% (Eurozone). Yet none of these countries stand out significantly as models of economic growth and development. As a result it is questionable whether high-currency prices are justified. It's worth noting too that the high-currency value of Norway, Sweden and Switzerland, in particular, may have more to do with panicked Eurozone investors seeking a nearby non-Euro haven than anything else.

On the other hand, the highest currency-discounts versus the USD can be found in India (at -56%), followed by Hong Kong (-52%), China (-44%) and Thailand (-44%); economies which also happen to be stronger than those of the West. But then India is suffering from rather high inflation and budget deficits, the HKD is pegged to the

USD, and Thailand is a rather small country where political uncertainties remain.

#### Considering the Chinese RMB

Hence the craze for the Chinese RMB (RMB), that has recently engulfed Hong Kong investors, in particular, does not seem to be all ill-founded. China is deemed to overtake the United States as the world's number one economy by 2016 in real economic output terms, according to the International Monetary Fund (IMF), with a consistently strong Gross Domestic Product (GDP) of 9.5% in the second quarter of 2011.

Even the much-talked about local government debt problem may not be as bad as analysts seem to believe. China's total debt level, including both national and local governments, remains well below that of the average levels

in the West. Meanwhile, the country's tax revenues jumped 30% in the first half of 2011 to RMB 5 trillion, which should go a long way to enhancing China's ability and financial strength to deal with any bad-debt fallout.

Yet, for investors, three main problems remain: firstly, since the RMB is not freely traded, it can be difficult or troublesome to get hold of cash or bonds in the currency. Secondly, although RMB inflation eased to 6.2% in August, this number is still vastly higher than the yield on most RMB deposits or bonds. As a result, investors are going backwards in purchasing power terms net of inflation. And thirdly, experts are concerned about what would happen to the stability of all of the world's currencies in general, including the RMB, if inflation was to accelerate globally, as a result of further QE measures in the West.

### Gaining exposure to Chinese equities

For all of these reasons, a better way to gain RMB exposure than queuing up for RMB bonds yielding 1.5% (or minus 4.7% net of present inflation) may be, very simply, to gain exposure to Chinese equities or equity funds with RMB income. (Many of which happen to be trading at rather attractive prices after the recent pullback). This is because equities represent companies, and companies, as long as they have got a competitive edge in the market, can put up prices for goods and services sold in line with inflation and can thereby 'float' on inflation. Clearly equities differ from bonds or cash which do not have an intrinsic value and are fully exposed to inflation.

Importantly, it should be well understood that such Chinese stocks or funds do not have to be RMB denominated in order to offer RMB exposure. As long as the income of the underlying assets is derived mostly from the mainland, the currency of the underlying asset/ income will be the actual currency exposure/ performance driver. Not the currency of denomination of the stock or fund.

While you can find good value stocks across many different sectors in China at the moment, the Chinese banks appear to be offering a particularly good risk/ return potential trade-off. This is because the banking sector has largely been shunned recently by investors, on the back of fears about property/ bad-loan exposures, and lending restrictions/ monetary tightening. Yet these fears may have been exaggerated considering that the recent weakness of bank stocks has reduced them to relatively good value again based on price-earnings ratios. And profits are growing. Moreover, Chinese banks may increasingly profit going forwards from the internationalisation and liberalisation of the RMB.

However, as with all investments, there are still many risks involved with both Chinese stocks and funds, and there can also be no doubt that the seriousness of the sovereign debt crisis in the West continues to pose severe challenges and risks to all economies and markets around the world.

Therefore, caution should remain the priority when investing nowadays. It is advisable to enter positions of relatively high volatility only if the invested capital can be spared for the medium- to long-term. And only as part of a diversified portfolio that also includes a solid exposure to gold/ precious metals for the purpose of financial-crisis (and inflation) protection. Ideally, investors should also avoid using any form of leverage or debt, including mortgages, to enhance overall investment security. **B**

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