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ECONOTE No. 33 **4/4//2015**

Asian interest and exchange rates: Don't believe headlines (Please!)

Summary	Investment Conclusions
Econotes avoids like the plague reporting that the “press/media is wrong and we are right”. Recent headlines on the “decline” of the forex reserves of EMKs, and of Asians in particular, are so factually wrong and the interpretation of their consequences so basically incorrect that we have to say something. Let us stress that what we argue here first is about facts, and only then we point to the fundamental errors of very basic economic analysis. So as far as Asia is concerned, forex reserves have hardly moved since April 2014 and, hence, there are no dire consequences to follow.	Asian interest rates are broadly falling, decoupled from the expected moves of the Fed. Asian exchange rates did not all collapse against the USD and, hence, could not have caused capital outflows, at least not as evidenced by the tiny drop in forex reserves. The eventual hike in US rates (which we do not believe will happen in 2015) will not cause a collapse in Asian capital markets nor of Asian forex rates. Investment in Asian equities remains attractive in terms of some valuations, notwithstanding forex concerns.

The (very !) basic analysis of external acounts

The net balance of sales of goods and of services abroad plus the net inflows of interest rates, dividends and profits gives the current account balance. A surplus in the balance implies that a country is giving net credit to its counterparts as it lets them buy more than they sell. This credit will appear as the purchase by the creditor country of IOUs issued by the deficit countries while they, conversely, will register them as sales of IOUs. There are also net sales (or purchases) of other financial assets including stocks and shares, bonds etc. A “surplus” country sells more of these paper assets than it buys; hence it registers a net inflow of “foreign capital”. These transactions are registered in the capital account which also includes the changes in the forex reserves. As all this is done on a double entry book- keeping principle the balances must balance, to the extent that every purchase must have a counterpart sale whether it is tons of frozen pork bellies or complex derivatives contracts. What complicates matters is the forex reserves because they are there only because countries do not like to see their forex rates fluctuate wildly. They are not there as some kind of Arnold Schwarzenegger show of financial muscle. Forex accumulate as central banks buy USD to stop the forex rising, which can cause local interest rates to fall. Sales of USD shore up the forex rate, but can lead to higher local interest rates.Whether forex reserves go up or down or forex rates fluctuate reflect the policy of the central bank.This fact keeps getting missed out in translation--there is an inverse link between forex and local interest rates

Asian 3M and USD 3M Libor 2007-2015. Libor (red),China(yell)India (green),S.K (blue),Indo(mv)

Source: Bloomberg

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So what about the Asia's "decline" in reserves ?

Assuming that a central bank intervenes,the forex reserves can only go down if the current account surplus and/or the capital surplus falls. If foreign investors decide to sell their holdings of Thai shares, they receive THB and proceed to exchange it for USD.If the central bank intervenes, then its reserves will fall as it sells USD and buys THB.If the central bank does not intervene, then the forex rate will fluctuate quite significantly. Are there any central banks that just do not intervene in forex ? Yes, the Fed and the ECB ! Fluctuations in reserves occur because the current account shrinks or expands and not just because of capital flows.In the end it is the central bank policy which determines the outcome.

FACT BOX: Asian forex reserves hardly moved

Country	April 2014	Jan-March 2015
China	3,979	3,843
Hong Kong	317.0	332.0
Taiwan	272.0	295.0
S.Korea	356.0	363.0
India	310.0	341.0
Singapore	275.0	250.0
Thailand	169.0	157.0
Indonesia	105.0	115.0
Malaysia	131.0	106.0
Philippines	72.0	72.0
TOTAL	5,986	5,874

The table shows that between April 2014 and as late as March 2015 total Asian reserves fell by 1.8%! (Bloomberg data). Indeed for most countries reserves rose: HK, Taiwan, S.Korea, India, Thailand and, Indonesia. China was the "big" loser with a 3.4% loss still leaving it with nearly USD 4.0 trillion. These movements are so small and so centered on one country as to belie belief that they represent some kind of crisis or massive capital outflows. And all this was happening as Asian short term rates were either flat or falling (Chart 1) at a time when the Fed was posturing on an imminent hike. Furthermore a careful examination of Chart 2 shows that the famous USD strength has to be tempered with the reality of facts.

Chart 2: USD index,Asian forex rates,2014=100

Source : Bloomberg

Conclusions: too much fuss about nothing

The red line in Chart 2 is the USD weighted index.Its steep rise since September 2014 shows the depreciation of the JPY, EUR, GBP, etc versus the USD.The other lines are the actual exchange rates of major and minor Asians. All indices are based on 2014=100. If the exchange rate graph rises, this means a weakening of the currencies in question while the rise of the USD index signifies strengthening of the USD.The graph for China is effectively flat, while those for India, Philippines and Thailand, since September 2014, have hardly moved away from the 100 level (no weakening or strengthening) and only the rates of Indonesia and S.Korea showed some consistent weakening during this period.

Conclusions ? The majority of Asian economies did not lose any reseves at all since April last year, the weakening of Asian curencies versus the USD was highly focused and selective, and Asian short term rates are on a declining trend. All this is supportive for the Asian economies, irrespective of what the Fed does, and thus,selectively and subject to relative valuations, also supportive of Asian equities.

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(Writng completed 6/4/2015)