Living up to mounting challenges – 38

Stronger ringgit a bane to forex gains

- **Unhedged** foreign fixed income funds may lose lustre as ringgit strengthens
- **Investors** interested in diversifying into foreign assets should not use currency gains as the sole consideration

by **Stephanie Jacob**

The ringgit expected to have limited downside for the rest of this year

IN the latter half of 2014, the ringgit began depreciating against the US dollar. The plunge in oil prices and the tightening of US Federal Reserve monetary policy hit the local note hard.

This continued into 2015 with the ongoing weakening of the local currency against the greenback. The ringgit started that year at 3.5165 to a US dollar and finished it 22% down at 4.2943.

Last year, the ringgit was on an uptrend but a strengthening US economy, which prompted the likelihood of quicker US Federal Reserve interest rate hikes and dragged down the local note again.

Donald Trump's surprise victory in November that year exacerbated the ringgit's downtrend; the sharp dip of the local currency forced Bank Negara Malaysia to take a series of actions to stabilise the local note *(see sidebar)*.

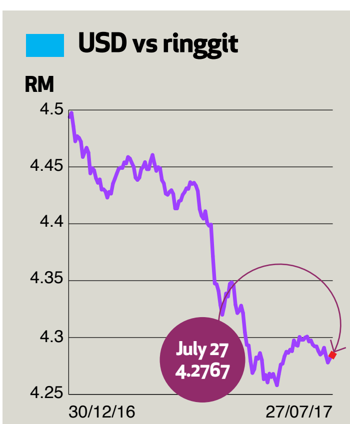
Weak ringgit a boon

Against the backdrop of a weak ringgit, some investors went heavily into foreign income funds and assets with the hope of tapping foreign exchange (forex) gains.

"Investors were mostly motivated by the strength of the US dollar which appreciated against many currencies in the past few years," Hong Leong Bank Bhd managing director (global markets) Hor Kwok Wai tells ***FocusM***.

He adds that the quantitative easing in multiple foreign currencies meant that upside for fixed income funds were likely to be larger offshore.

Fundsupermart.com research analyst Tan Wei Yine says the ringgit's hefty depreciation over the past few years would mean that investors have enjoyed decent returns on their foreign



Source: Bloomberg

assets. The beneficiaries include those who have invested in foreign fixed income funds.

"As these funds often invest in bonds and debt instruments that are denominated in hard currency, the ringgit weakness provides investors with the currency translation gains on top of the bond yields," he observes.

This has enabled such funds to deliver high single-digit or even double-digit annualised returns over the past three years to investors.

Limited downside

However, the general view among many economists and analysts for some time has been that the ringgit is undervalued and will likely strengthen. Many saw the weakness being sentiment-driven rather than fundamental.

This year the ringgit has started to see improvements. The local note started the year at 4.4938 per US dollar on Jan 3 but has since appreciated 4.68% to 4.2767 as of July 27.

With the ringgit expected to have limited downside for the rest of this year, investors with large exposure to foreign denominated funds may see a reduction of their currency gains. This is given foreign fixed income funds have benefited from the weaker ringgit over the past several years.

"Judging solely based on the funds' past performance, we wish to caution investors who are planning to invest into these funds," he points out. "[Back then], their performance figures were buoyed by a depreciating ringgit but there are [now] fewer reasons for the ringgit to depreciate further."

On the contrary, Tan expects to see less volatility in the ringgit on the back of a rebound in commodity prices. Furthermore, the surge in exports growth and better corporate earnings also bodes well for the local economy.

"These positive elements have fuelled [positive] sentiments and attracted foreign fund flows back into Malaysia; they would have probably channelled some strength back to the ringgit," he stresses.

In the view of RHB Asset Management chief investment officer (fixed income) Michael Chang, a recovery in the ringgit may start to hurt the funds' performance from a pure forex perspective if foreign funds are not hedged back to the ringgit.

Nevertheless, he maintains that the underlying investments of those foreign funds may have a different correlation to the movement of the ringgit against the greenback. In such cases, those factors may have a more significant impact on those funds.

Hedged instruments

However, this does not mean that investors should not look to diversify into foreign denominated assets or should totally shy away from fixed income funds.

Against a backdrop of a possible stronger local note and the modest outlook for the fixed income segment, investors might consider foreign fixed income funds with a hedging strategy, according to Fundsupermart.com Tan.

Another option would be to invest in the ringgit-hedged share class of the foreign fixed income funds.

"Having a hedging position in place provides a shelter for investors against the currency translation loss from a strengthening ringgit," notes Tan. However, he is quick to caution that should the ringgit depreciate, investors will also have to forego the currency translation gains.

To RHB's Chang, there are still many ways for investors to gain foreign investment exposure.

"The most cost-effective way is still through investment in a collective investment scheme with an investment objective in a foreign denominated currency," he suggests.

Hong Leong Bank's Hor believes that investors who are taking a view of the strengthening ringgit should look at investing in local fixed income funds.

"These should be of interest to them as yields seem to be at the higher end of the range now," he adds. FocusM

Measures to stabilise local currency

THE currencies of many emerging markets fell in an immediate reaction to Donald Trump's US presidential election triumph on Nov 8 last year. This was due to his campaign promises that were centred on large infrastructure plans which would drive inflation and likely lead to more interest rate hikes.

However, the sharp decline in ringgit on Nov 11 gave rise to concerns that the local currency was coming under attack from speculators.

This led Bank Negara Malaysia to step in to curb the high volatility in the US dollar-ringgit exchange rate in the offshore market, otherwise known as the ringgit non-deliverable forward (NDF) market.

Under Foreign Exchange Administration rules, offshore trading of the ringgit is prohibited, hence such transactions of the ringgit are not recognised.

This prompted the central bank to step up its enforcement of these rules. It reminded onshore banks to stop facilitating NDF trades in the ringgit. They were also instructed to avoid engaging with any non-resident banks that are suspected of offshore ringgit trading.

Various measures were mooted to strengthen the onshore market, including:

- Allowing residents, including resident fund managers, to freely and actively hedge their US dollars and Chinese renminbi with an exposure of up to a limit of RM6 mil per client per bank.
- Residents with domestic ringgit borrowings are free to invest in foreign currency assets – both onshore and abroad – up to the prudential limit of RM50 mil for corporates and RM1 mil for individuals.
- Exporters are only allowed to retain up to 25% of export proceeds in foreign currency with the remaining 75% in ringgit.

Although the immediate clampdown on the offshore market led to a flood of foreign funds leaving the market, the trend has since seen a reverse. After recording a RM3 bil outflow last year, the cumulative inflow into Bursa Malaysia reached RM10.35 bil – the highest among its Southeast Asian peers – as of July 21.

In fact, a recent Bloomberg report named the ringgit as Asia's best currency in the second quarter of this year, pointing to the fact that it has climbed twice as much as the next best, the Chinese renminbi.

Considering the country's healthy economic fundamentals, many local and international banks and research houses are mildly positive on the ringgit moving forward.

The more bearish Nomura Holdings Inc which is currently underweight on Malaysian stocks has cited expensive valuations and doubts that the growth momentum can be sustained.