Topic: a brief note on China and its currency devaluation

If you are on vacation, you aren't missing much. In the US, Europe and Japan, GDP growth, wage growth, payroll growth, long-term interest rates, inflation targets, credit expansion and a bunch of other variables are all at around 2%. As a result, global markets are going nowhere fast.

Today's brief note is about the **Chinese currency devaluation**. I will start with a quote from a research source that I read regularly, and which will remain unattributed (emphasis mine). They believe that it's in the government's interest to hold the new RMB level for a significant amount of time since if promises to defend it are not kept, and if the implied promise to support the stock market at around 3500 is not kept, it would lead to a loss of credibility and/or "*the appearance that the marketplace is more powerful than the government".* In essence, arguments for the government to keep intervening.

Unintentionally, this quote brings to mind an important axiom, and not just about China: **over the long run, economics and markets generally ARE more powerful than the government, at least from the perspective of equity, credit and currency market investors**. I consider that to be a positive thing, although that sentiment is not universally shared. As such, I am more interested in what China's economy and profits are doing than in what the government is doing.

In April's "***Chinese Gymnasts***" *Eye on the Market*, our Chief Market Economist Michael Vaknin and I highlighted the sharp deterioration in earnings of Chinese companies whether they list in Hong Kong, Shenzhen or Shanghai; the sharp acceleration in China's exchange rate in trade-weighted terms; the surge in Chinese corporate debt; and the decline in Chinese real GDP growth, industrial production, retail sales, electricity consumption, railway traffic, real consumer activity and housing starts. The surge in Chinese equity markets and P/E ratios were therefore best explained by rising margin debt. And with respect to China's currency, we wrote this in April:

> "**If China's economy remains weak, pressure will probably rise on China to depreciate the Renminbi and regain export share, another step in the never-ending global currency depreciation battle. Given the recent sharp rise in the Renminbi, we are less convinced that a sustained corporate or economic revival will be happening any time soon, even with the cut in bank reserve requirements and other growth-oriented monetary and fiscal policy measures**."

Nothing much has changed since then, other than (a) a sharp decline in Chinese equities during which 50% of stocks by value were subject to trading halts[1]; (b) another round of weak economic data in July, with the biggest miss coming in the important industrial production figure; (c) a y/y doubling in Chinese labor market strikes, reflecting poor labor market conditions shown on the next page; and (d) more evidence of capital outflows, as some of China's elites benefit from the government's defense of the exchange rate. Some believe that China's currency depreciation has nothing to do with cyclical economic management and everything to do with China's long-term goals of creating a more flexible exchange rate mechanism and associated market-oriented reforms. I don't know how to respond to that other than it appears to fly in the face of most available evidence to the contrary.

Yes, of course, the government will now probably respond with another round of loosening measures, such as reduced bank reserve requirements and other support for banks, fiscal stimulus financed at the federal level, and pressure on local governments to deploy available cash into more infrastructure projects. I don't think any of this will change the tractor beam that is pulling China towards the 4% GDP growth rate cited by the Conference Board in its 2015 Global Economic Outlook[2].

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[1] Fascinating Chinese government rules to the media on reporting on the stock market, from China Digital Times: http://chinadigitaltimes.net/2015/07/minitrue-rules-on-stock-market-reporting/

[2] **The Conference Board estimates that Chinese growth will gradually decline to 3.9% by 2020-2025** due to lower productivity, decreased capital formation and demographics. They assume lower efficiency of capital investment as the economy matures, since China has largely closed its technology gap vs. the OECD; slower productivity gains as the economy shifts to higher value-added goods/services; slower capital formation due to excess real estate inventory; and a shrinking workforce/higher dependency ratios as a result of its one-child policy.

As for the rest of the region, when looking at countries that either have a high correlation of trade with China and/or a high level of exports to GDP, Thailand, Taiwan, Malaysia, Korea and Vietnam may be impacted most by the Chinese depreciation (and whatever depreciation is still in the pipeline). China's move isn't good news for Turkey either, a country where business and consumer surveys are already bad, non-gold exports and imports are weak, and where corporate and sovereign debt refinancing needs are very large. It is also not a fun time to be Janet Yellen, given the disinflationary impulse from China. Enjoy the rest of your vacation. More in early September.

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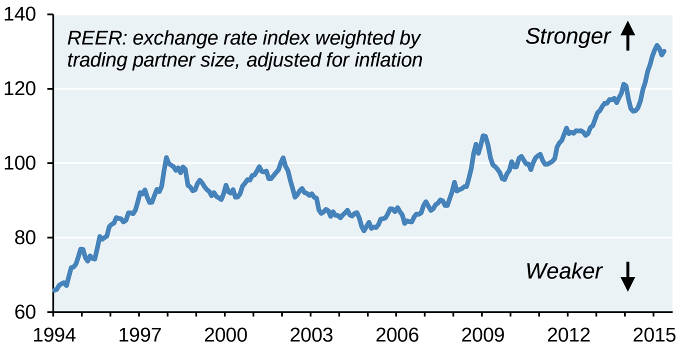
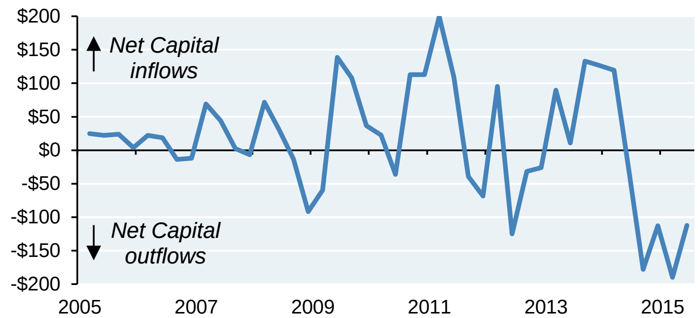
*Some charts on **The China Syndrome**, in addition to those shown in the April EoTM link on the prior page*

Chinese Renminbi real effective exchange rate (REER)
Index



Source: Bank for International Settlements. June 2015.

Some are benefitting from the Central Bank's decision to defend the exchange rate
Change in FX reserves less current acct. balance, USD billions

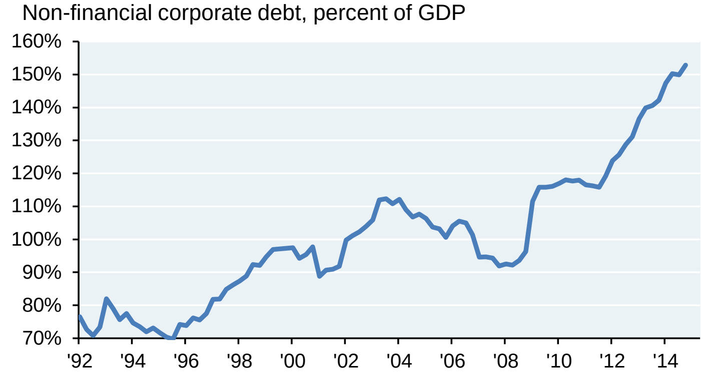


Source: People's Bank of China, IMF, China SAFE. Q2 2015.

Deteriorating Chinese labor market conditions
Index level

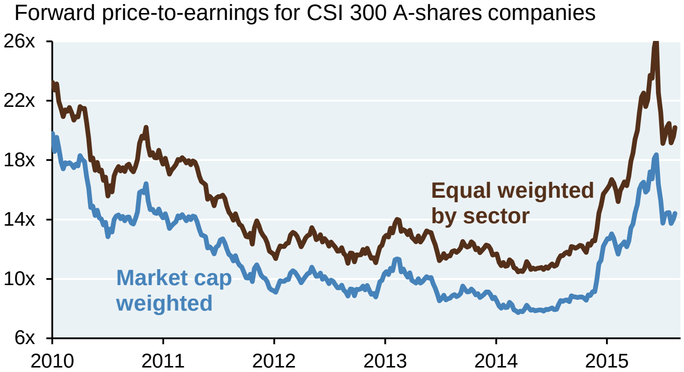
Source: Lombard Street Research. Q2 2015. Q3 2015 is preliminary.

Rising levels of corporate debt in China
Non-financial corporate debt, percent of GDP



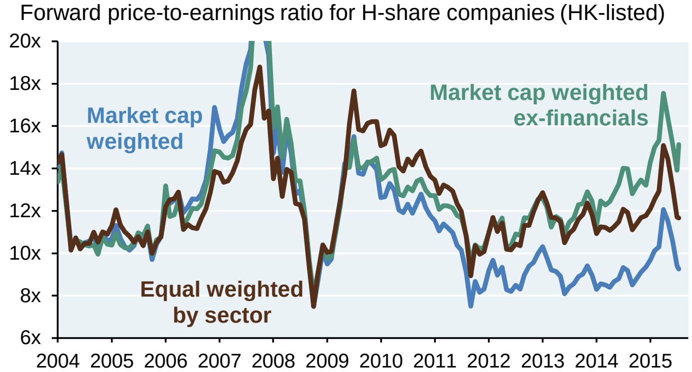
Source: Bank for International Settlements, China NBS. Q4 2014.

China: onshore equity P/E multiples
Forward price-to-earnings for CSI 300 A-shares companies



Source: Bloomberg. August 12, 2015.

China: offshore equity P/E multiples
Forward price-to-earnings ratio for H-share companies (HK-listed)



Source: MSCI. August 12, 2015.