

**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<sup>1</sup>; (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<sup>2</sup>.

---

<sup>1</sup> 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/>

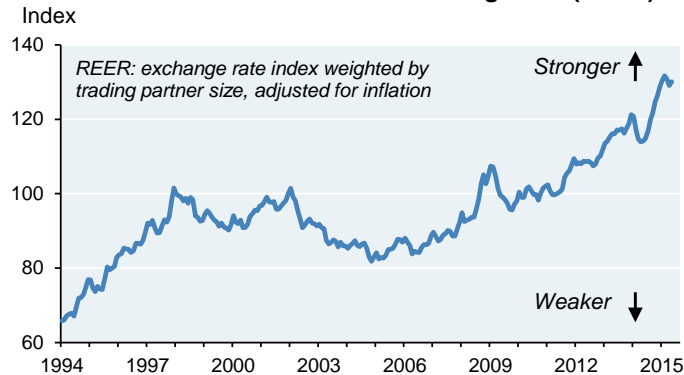
<sup>2</sup> **The Conference Board estimates that Chinese growth will gradually decline to 3.9% by 2020-2025** due to lower productivity, decreased capital formation and demographics. They assume lower efficiency of capital investment as the economy matures, since China has largely closed its technology 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.

Michael Cembalest  
J.P. Morgan Asset Management

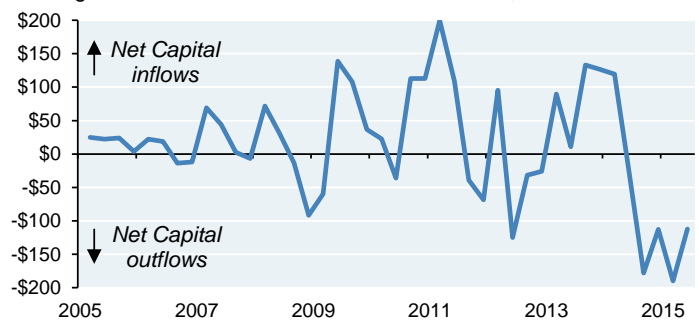
*Some charts on **The China Syndrome**, in addition to those shown in the April EoTM link on the prior page*

### Chinese Renminbi real effective exchange rate (REER)



### Some are benefitting from the Central Bank's decision to defend the exchange rate

Change in FX reserves less current acct. balance, USD billions



### Deteriorating Chinese labor market conditions



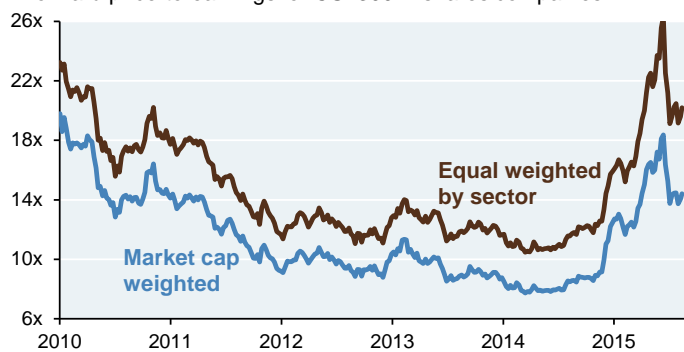
### Rising levels of corporate debt in China

Non-financial corporate debt, percent of GDP



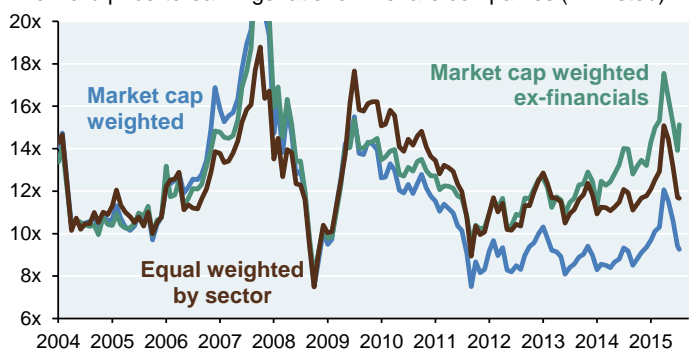
### China: onshore equity P/E multiples

Forward price-to-earnings for CSI 300 A-shares companies



### China: offshore equity P/E multiples

Forward price-to-earnings ratio for H-share companies (HK-listed)



JPMorgan Chase & Co. and its affiliates do not provide tax, legal or accounting advice. This material has been prepared for informational purposes only, and is not intended to provide, and should not be relied on for, tax, legal or accounting advice. You should consult your own tax, legal and accounting advisors before engaging in any transaction. Each recipient of this material, and each agent thereof, may disclose to any person, without limitation, the US income and franchise tax treatment and tax structure of the transactions described herein and may disclose all materials of any kind (including opinions or other tax analyses) provided to each recipient insofar as the materials relate to a US income or franchise tax strategy provided to such recipient by JPMorgan Chase & Co. and its subsidiaries.

The material contained herein is intended as a general market commentary. Opinions expressed herein are those of Michael Cembalest and may differ from those of other J.P. Morgan employees and affiliates. This information in no way constitutes J.P. Morgan research and should not be treated as such. Further, the views expressed herein may differ from that contained in J.P. Morgan research reports. The prices/quotes/statistics referenced herein have been obtained from sources deemed to be reliable, but we do not guarantee their accuracy or completeness; any yield referenced is indicative and subject to change. The views and strategies described herein may not be suitable for all investors. Certain opinions, estimates, investment strategies and views expressed in this document constitute our judgment based on current market conditions and are subject to change without notice. The information contained herein should not be relied upon in isolation for the purpose of making an investment decision. This material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. References to the performance or characteristics of our portfolios generally refer to the discretionary Balanced Model Portfolios constructed by J.P. Morgan. It is a proxy for client performance and may not represent actual transactions or investments in client accounts. To the extent referenced herein, real estate, hedge funds, and other private investments may present significant risks, may be sold or redeemed at more or less than the original amount invested; there are no assurances that the stated investment objectives of any investment product will be met. JPMorgan Chase & Co. and its subsidiaries do not render accounting, legal or tax advice and is not a licensed insurance provider. You should consult with your independent advisors concerning such matters.

In the United Kingdom, this material is approved by J.P. Morgan International Bank Limited (JPMIB) with the registered office located at 25 Bank Street, Canary Wharf, London E14 5JP, registered in England No. 03838766 and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and Prudential Regulation Authority. In addition, this material may be distributed by: JPMorgan Chase Bank, N.A. Paris branch, which is regulated by the French banking authorities Autorité de Contrôle Prudentiel and Autorité des Marchés Financiers; J.P. Morgan (Suisse) SA, regulated by the Swiss Financial Market Supervisory Authority; JPMCB Dubai branch, regulated by the Dubai Financial Services Authority; JPMCB Bahrain branch, licensed as a conventional wholesale bank by the Central Bank of Bahrain (for professional clients only). In Hong Kong, this material is distributed by JPMorgan Chase Bank, N.A. (JPMCB) Hong Kong branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as private equity and hedge funds) in which case it is distributed by J.P. Morgan Securities (Asia Pacific) Limited (JPMSAPL). Both JPMCB Hong Kong branch and JPMSAPL are regulated by the Hong Kong Monetary Authority and the Securities and Futures Commission of Hong Kong. In Singapore, this material is distributed by JPMCB Singapore branch except to recipients having an account at JPMCB Singapore branch and where this material relates to a Collective Investment Scheme (other than private funds such as private equity and hedge funds) in which case it is distributed by J.P. Morgan (S.E.A.) Limited (JPMSEAL). Both JPMCB Singapore branch and JPMSEAL are regulated by the Monetary Authority of Singapore. Dealing and advisory services and discretionary investment management services are provided by JPMCB Hong Kong/ Singapore branch (as notified). Banking and custody services are provided to you by JPMIB. The contents of this document have not been reviewed by any regulatory authority in Hong Kong, Singapore or any other jurisdictions. With respect to countries in Latin America, the distribution of this material may be restricted in certain jurisdictions. Receipt of this material does not constitute an offer or solicitation to any person in any jurisdiction in which such offer or solicitation is not authorized or to any person to whom it would be unlawful to make such offer or solicitation. The Fund may not be publicly offered in any Latin American country, without previous registration of the Fund's securities in compliance with the laws of the corresponding jurisdiction.

Conflicts of interest may arise whenever JPMorgan Chase Bank, N.A. or any of its affiliates (together, "J.P. Morgan") has an actual or perceived economic or other incentive in its management of our clients' portfolios to act in a way that benefits J.P. Morgan. Conflicts may result, for example (to the extent the following activities are permitted in your account): (1) when J.P. Morgan invests in an investment product, such as a mutual fund, structured product, separately managed account or hedge fund issued or managed by JPMorgan Chase Bank, N.A. or an affiliate, such as J.P. Morgan Investment Management Inc.; (2) when a J.P. Morgan entity obtains services, including trade execution and trade clearing, from an affiliate such as J.P. Morgan Securities LLC or J.P. Morgan Clearing Corp; (3) when J.P. Morgan receives payment as a result of purchasing an investment product for a client's account; or (4) when J.P. Morgan receives payment for providing services (including shareholder servicing, recordkeeping or custody) with respect to investment products purchased for a client's portfolio. Other conflicts may result because of relationships that J.P. Morgan has with other clients or when J.P. Morgan acts for its own account.

Prospective investment strategies are carefully selected from both J.P. Morgan and third party asset managers across the industry and are subject to a rigorous and ongoing review process that is consistently applied by our manager research teams. Recommended strategies are then subject to investment committee review and approval.

From the approved pool of strategies, our portfolio construction teams select those strategies we believe best fit our asset allocation goals and forward looking views in order to meet the portfolio's investment objective. As a general matter, J.P. Morgan provides restricted advice as we prefer J.P. Morgan managed strategies unless we think third party managers offer substantially differentiated portfolio construction benefits. Consequently, we expect the proportion of J.P. Morgan managed strategies will be high (in fact, up to 100 percent) in strategies such as, for example, cash and high-quality fixed income, subject to applicable law and any account-specific considerations.

We prefer internally managed strategies because they generally align well with our forward looking views and our familiarity with the investment processes, as well as the risk and compliance philosophy that comes from being part of the same firm. It is important to note that J.P. Morgan receives more overall fees when internally managed strategies are included.

Bank products and services offered by JP Morgan Chase Bank, N.A. and its affiliates. Securities are offered through J.P. Morgan Securities LLC, member NYSE, FINRA and SIPC, and its affiliates globally as local legislation permits.

If you no longer wish to receive these communications, please contact your J.P. Morgan representative.

**Past performance is not a guarantee of future results.**

**Investment products: Not FDIC insured • No bank guarantee • May lose value**