INVESTMENT STRATEGY UPDATE

"May You Live in Interesting Times"

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"May you live in interesting times."

This somewhat ominous send-off phrase is often called—without any credible provenance—"the Chinese curse." Whether it originated there or not, the words now apply to China itself. Given its status as the most populous country and second-largest economy, it figures that China's interesting times would have more than a glancing impact on the rest of the world. Below we assess recent developments in China and implications for global markets and policymakers.

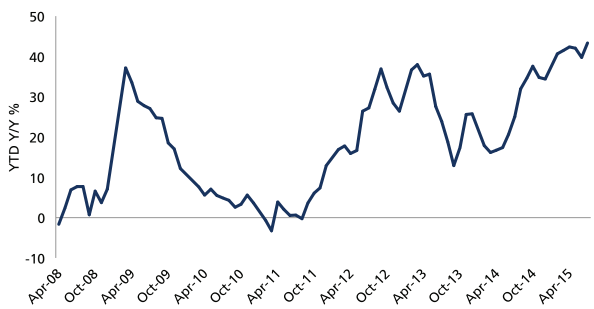
On August 11, the Chinese central bank (PBOC) shocked the markets by devaluing its currency—the yuan—and allowing market forces to play a slightly larger role in setting the value going forward. The cumulative impact over one week was a 3% drop in the yuan's value versus the U.S. dollar. This is a relatively modest correction for a currency that had appreciated by about 14% over the prior year.* However small in percentage terms, the PBOC's move is rife with symbolism related to the state of the Chinese economy.

China's growth surge coming out of the Great Recession of 2008 is credited (along with Federal Reserve policy) with pulling the world away from a potential depression. For a decade or more, it has become cliché to refer to it as the "world's global growth engine." No more—at least for the foreseeable future. While official statistics report that growth has slowed to 7%, there is good reason to believe that data is either extremely optimistic or behind the curve. In July and August, private sector sources reported falling auto sales, weakness by retailers, rising residential and commercial vacancy rates, tepid electricity consumption and plummeting exports. Taken together, it suggests an economy that is slowing much more dramatically than official statistics indicate.

China Vehicle Sales

Source: Cornerstone Macro Research as of 7.31.2015.

China Vacant Floor Space, Office Buildings



Source: Cornerstone Macro Research as of 7.31.2015.

Since the PBOC's action, a vigorous debate has ensued over the true motivation for the currency devaluation and more flexible float of the yuan. Was it driven by pressure to shore up a weakening economy by making the currency more competitive as Europe, Japan and others have done? Or, was China driven by its long-term structural goal of making the yuan a bigger player in global trade, with eventual reserve currency status?

We reject the either/or nature of the debate, and view this as a policy "two-fer." China has been pressured for years by the IMF and others to allow market forces to set the yuan's value if they wanted it to be treated like a currency befitting the second-largest economy in the world. This was a small step in that direction. The prior day's market price will now serve as the next day's midpoint for the permitted trading band.

We also believe that the economy has slowed more dramatically than the government expected, and they are playing catch-up on the policy front. We have seen interest rate cuts, a variety of intrusive attempts to prop up the shaky stock market and yet another infrastructure program. Thus, it also makes sense to view the currency devaluation as a next step in the government's attempt to push back against a weakening business cycle for which it has started to lose control.

Importantly for global markets, both motivations imply that this was just an opening salvo in changes to China's currency policy. The announced structural reform was minor, and the yuan has a long way to go before it resembles a market-based,

Source: Bank for International Settlements.

freely exchangeable currency. From a cyclical perspective, the 3% devaluation of the yuan does not move the needle in improving China's terms of trade. Further moves to weaken the currency are likely. In keeping with the government's approach to policymaking, future changes will be incremental rather than sweeping, and opaque rather than clear. In other words, this will be a continuing source of market volatility in the months ahead.

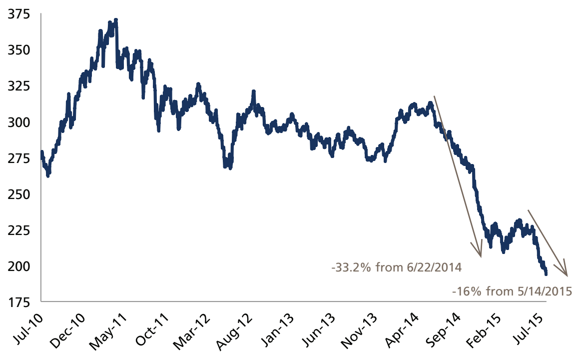
WHAT IT MEANS FOR THE REST OF THE WORLD

The relative calm of the U.S. stock and bond markets this year (until the last week) may have caused some investors to miss that bear markets are breaking out elsewhere. Both emerging market equities and global commodity markets have plummeted. These downtrends are related to one another and also related to China. The economic and financial market instability in China will also be a factor for other policymakers around the world, including the Federal Reserve.

MSCI Emerging Markets Index (in U.S. Dollars)

Source: Bloomberg as of 8.19.2015.

CRB Commodity Index



Source: Bloomberg as of 8.19.2015.

Emerging Markets (EM). The yuan devaluation—and potential for more of it—adds pressure to already beleaguered developing economies. China's slowdown has hurt the many emerging economies who are greatly reliant on exports to China. Most EM currencies have been under severe pressure for months: The Brazilian real and Russian ruble are down more than 30% and 50%, respectively, over the last year.** China's economic weakness and currency policy direction mean there may well be more pain ahead for most developing economies.

Commodities. There is a strong linkage between Chinese economic performance and commodity prices. The hyper-growth and massive infrastructure build in China were key factors in the commodity boom that occurred in the early/mid 2000s and again from 2009-2012. In today's slow-growth environment, China's demand for commodity imports has plummeted. There is also a near-perfect negative correlation between commodity prices and the value of the U.S. dollar. Thus, the strong appreciation of the dollar has been another powerful depressant on commodity prices. At the margin, an ongoing yuan devaluation policy is a "double whammy" for commodity prices—making commodity imports more expensive within China, and adding to the case for a stronger U.S. dollar.

The Fed. At its July meeting, The Federal Reserve's Federal Open Market Committee (FOMC) policymaking committee cited the risk that a sharp slowing in China's economy could have a negative ripple effect on the U.S. outlook. The subsequently announced yuan policy gives them even more to think about. A weaker yuan means the price of U.S. imports from China will go down. In other words, the yuan devaluation is viewed by the Fed as a deflationary force, at a time when inflation is already running well below its target. Ultimately, the FOMC decision on whether to enact a rate increase this year will be driven by its confidence in the overall U.S. growth outlook, which is fairly good. But, if they choose to delay, China is bound to be a key reason.

U.S. Financial Markets. In a nutshell, yuan devaluation is good for investment-grade bonds and a challenge for equities. As just mentioned, the deflationary impact of the new yuan policy, as well as the possibility that it slows U.S. growth potential, supports a lower yield regime for Treasuries. The U.S. stock market has struggled in 2015 with a flat line in corporate earnings, and the energy/materials part of the high-yield bond market has been hit by the fall in oil and other commodity prices. China's currency path makes a hoped-for profit rebound in the second half of the year more difficult to achieve. The direct impact is that U.S. exports to China become more expensive, and sales in China convert back into fewer dollars for purposes of reported earnings. The indirect impact—a slower global economy—will likely also reverberate in softer earnings and even weaker commodity prices than previously anticipated.

In summary, while China's economy has weakened, its influence on the global economy and financial markets continues to grow. ■

*** Source: Bloomberg, as of 8.20.2015.*

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