

JANUARY 15, 2016

"When written in Chinese, the word crisis is composed of two characters. One represents danger and the other represents opportunity."

- President John F. Kennedy

SUMMARY

- The steady depreciation in China's RMB is starting to unhinge global markets for the second time since August 2015. Moreover, we are seeing some disturbing signs that Beijing may be losing control as the country's available foreign exchange reserves dwindle in the face of accelerating capital outflows.
- There is an uncomfortably high chance that, by the end of 2016, China may be forced to float the currency and let it fall just as the US economy may be rolling over. While the overnight 15% depreciation (or more) would likely send a shock wave through global financial markets and throw much of the world into recession, our investment team is prepared, and we believe our portfolios are well-positioned to add value in a chaotic market.
- While we remain underweight equities and junkier bonds (which could see serious declines in the coming months), we are overweight cash (which can be rolled into bombed-out markets to take advantage of generational buying opportunities), US Treasuries (which can deliver tremendous positive returns in a global panic), and high quality corporate debt (which could hold most of its value while providing better yields than cash or Treasuries).
- Since our main goal for most clients is to provide income while protecting their portfolios against a US equity bear market, we do own a healthy allocation of carefully-selected midstream Master Limited Partnerships. While we admit these positions can fall further in the event of a Chinese RMB-inspired panic, we believe they present good value after falling 56% from their 2014 peak, can provide a steady stream of durable cash flows despite short-term volatility, and can make otherwise defensively positioned portfolios more bearable as we wait for the cycle to turn.

CHINA SHAKES THE WORLD... AGAIN

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China's Stock Market Gets All the Attention...

The People's Republic of China (PBoC) came screaming back into the headlines last week as steep losses on the Shanghai (-18% year to date) and Shenzhen (-22% year to date) equity markets and an accelerating depreciation in China's currency triggered yet another round of global risk aversion.

In its wake, year-to-date stock trading has been a sea of red in every major market from the British FTSE 100 (-7%) and the American S&P 500 (-9%) to the German DAX (-11%) and the Japanese Nikkei (-10%).



But while China's stock market has gotten all the attention, it's actually a sideshow.

Domestically traded Chinese stocks (commonly called "A-Shares") are still the most overvalued of any major equity market in the world with median price-to-earnings multiples north of 60x and margin debt that continues to tumble despite Beijing's best efforts to prevent another correction.



Source: Evergreen GaveKal, Bloomberg

Though Chinese stocks will, in all probability, continue to deflate over the course of 2016, the long-term damage to China's economy has already been done. With the breakdown in its national debt restructuring plan (to attract foreign investors and deleverage debt-burdened companies by issuing equity at stupid valuations), Beijing has run out of easy options for managing its massive private sector debt burden. Now it's just a matter of choosing between propping up zombie banks and state-owned enterprises (likely leading to a Japanese-style stagnation as rising government debt weighs on growth) or letting them fail (leading to a more credit crisis and collapse in real GDP growth).

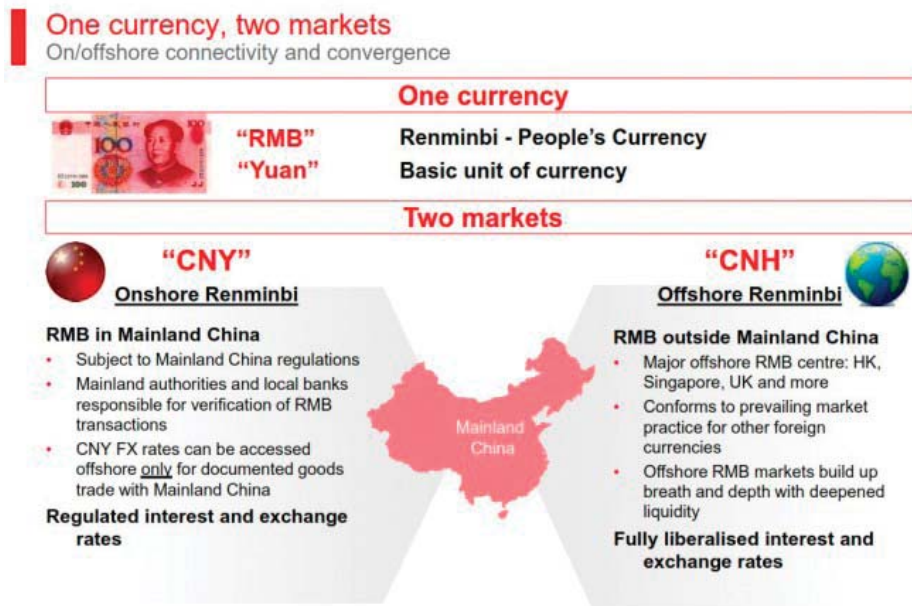
So while the rising risk of a harder slowdown in China continues to give me nightmares, the crashing Shanghai Composite Index is not something that keeps me up at night.

The renminbi (RMB), on the other hand, is a very different story.

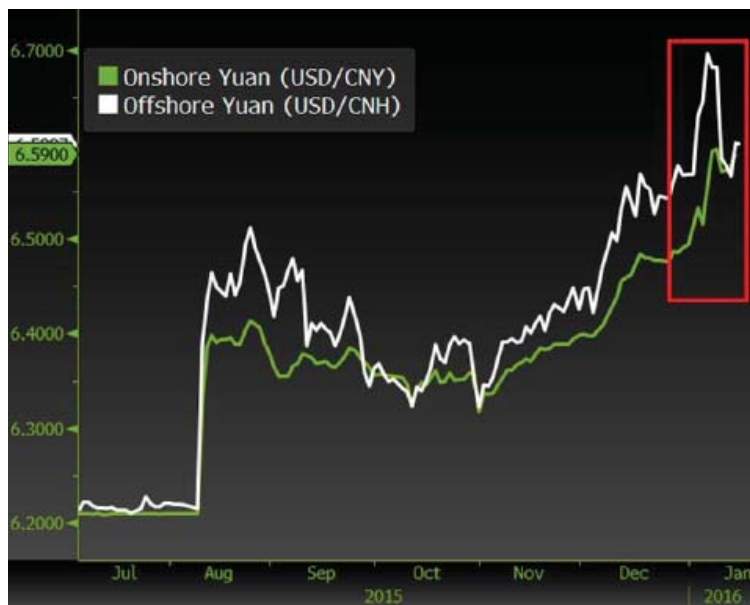
... But a Renminbi Shock is the **BIG** Risk

Regular EVA readers may recall that China's currency, the renminbi or "RMB" (also called the yuan), trades in both onshore and offshore markets. While the onshore yuan (CNY) is tightly managed within a +/- 2% daily trading range that has supposedly become more market-driven since reforms in August and December 2015, the offshore yuan (CNH) floats freely in the open market.

If you're still trying to wrap your head around how the "one currency, two markets" system works, this illustration from HSBC may help.



Because it trades in different markets and under different rules, the aspiring reserve currency also trades at different prices whether it's inside or outside of China. I should point out that PBoC's continues to heavily influence both markets (it's not the only currency manipulator among the world's central banks, by the way), so neither exchange rate necessarily reflects "true" market expectations. That said, onlookers often interpret steep falls in the offshore CNH as a reflection of future depreciation not yet priced-in to the slower moving CNY exchange rate, which may play a role in stoking capital outflows and/or encouraging speculation.



Source: Evergreen GaveKal, Bloomberg

As you can see in the charts at the bottom of page 3, the CNH-CNY spread (right chart) reached an all-time high last week, as both markets weakened more sharply in open trading than at any point since August, and prompted a surge in depreciation expectations as reflected in the media chatter and revisions to Wall Street analyst forecasts.

This is exactly the scenario I warned about last August (*What Happens When a Dragon Flaps Its Wings?*) and last September (*China's Currency, Our Problem*), but with a very important twist: Beijing may be losing control.

While it's pretty clear that the People's Bank of China intentionally positioned the CNY to weaken in the wake of a Fed hike – a veiled effort to regain export competitiveness as an “unintended” side effect of IMF-endorsed reforms – managing that gradual depreciation process has become more expensive than planned.

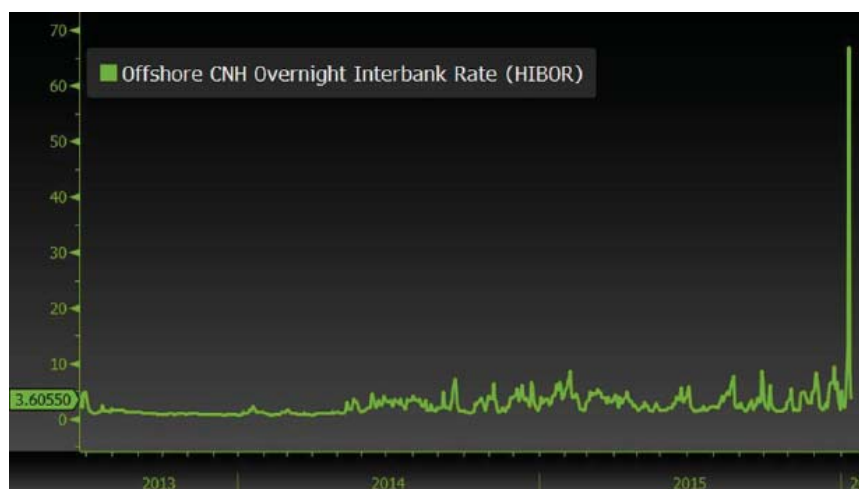


Source: Evergreen GaveKal, Bloomberg

Not only have capital inflows failed to materialize after the IMF's decision to include the RMB in its Special Drawing Rights (SDR) reserve currency basket, but capital outflows have actually been accelerating in the wake of last month's Fed hike.

Over the last year, China has lost over \$1 trillion in outflows as foreign investors withdrew and locals began to get nervous; but the trend is building momentum as the PBoC tries to offset the domestic tightening effects of rapidly unwinding foreign exchange (FX) reserves with lower interest rates. As you can see in the chart above, the PBoC spent \$150 billion resisting outflows and defending the CNY in the second half of 2014, over \$500 billion in 2015, and more than \$100 billion in December 2015 alone.

Moreover, a number of analysts believe the PBoC may be on target to spend roughly \$200 billion in January after its headline-grabbing war against speculators. As you can see in the Hong Kong Interbank Offered Rate (HIBOR) chart below, the central bank crushed the CNH-CNY spread earlier this week and sent the cost of overnight bank-to-bank CNH loans soaring from 4% to 68% in just two days. But rather than slowing outflows, such an aggressive measure may have contributed to the growing sense of panic.



Source: Evergreen GaveKal, Bloomberg

This move may have impressed a few journalists, but to investors who understand Beijing's predicament it reeks of desperation and reveals a troubling lack of staying power. If the central bank had kept the CNH market frozen and interbank interest rates at such great heights for much longer it could have created some very nasty effects for credit markets tied to the offshore yuan. But that's not what most concerns me about the PBoC's latest "shock and awe" intervention.

What worries me is that the PBoC is losing more credibility by the day and stoking real world depreciation expectations just as the Beijing's failed intervention in the stock market led to more panic selling last summer.

Now that the offshore CNH market has thawed and the interbank market has normalized, the RMB is falling once again in both the onshore and offshore markets. While Beijing "successfully" collapsed the spread between its CNY and CNH markets, we're now getting more reports of Chinese residents draining mainland banks of their limited US dollar supplies.

While recently washed-out speculators are already returning to the offshore CNH market and may stage another widening in the onshore-offshore spread (inviting another battle with the PBoC), Beijing is still missing the big picture. Foreign speculators may be driving the USD/CNH exchange rate; but Chinese residents are driving the massive capital outflows for a few reasons: (1) slowing economic activity and a breakdown in the China growth story; (2) Chinese investors having to contend with credit and currency risk for the first time ever; (3) and tightening Fed policy, which is collapsing the interest rate differential between the US assets and Chinese assets.

From that perspective, it's no wonder capital outflows are accelerating and should remain elevated at least as long as the US dollar remains strong. But what most investors still fail to realize is that – unless Beijing can prevent its own residents from evading capital controls – its available FX reserves may not last much longer.

If that sounds ludicrous, then just bear with me.

Beijing claims to have a massive \$3.3 trillion in FX reserves available to defend the RMB (which may be closer to \$3.1 trillion by the end of this month), but a closer review of what we know about the asset pool reveals that up to \$1 trillion of China's FX reserves are illiquid.

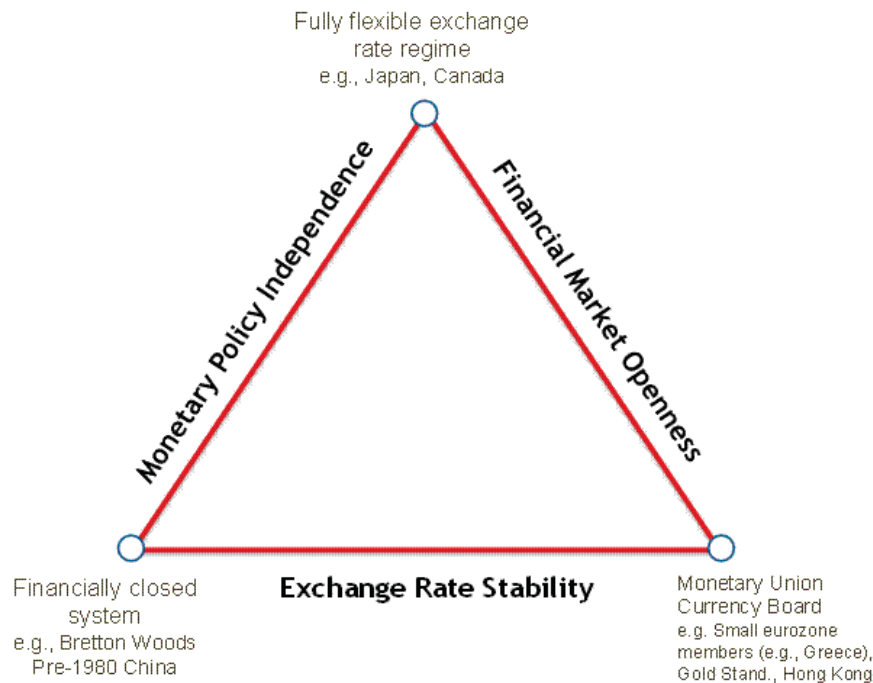
Moreover, another \$1 trillion is essentially earmarked for Xi Jinping's mission-critical "One Belt, One Road" strategy to lift China out of Japanese-style stagnation over time, establish the People's Republic as a superpower, and ensure that the Chinese Communist Party does not meet the same fate as their Russian comrades in the 1980s and 1990s. (Click [here](#) for a short video that will give you a bit of background on the "One Belt, One Road" initiative.)

That leaves only about \$1 trillion to \$1.5 trillion to defend the currency (which covers only covers 5% to 7% of China's \$21+ trillion M2 money supply). And it means that President Xi Jinping – who has made an aggressive push in recent months to consolidate power in every arena from military command to financial market oversight – may have to make some very difficult decisions in 2016 if outflows remain elevated or accelerate into a crisis.



As GaveKal's Joyce Poon (one of the top analysts at our partner firm in Asia) explained just a few days ago, China cannot continue cheating the basic laws of economics by trying to achieve exchange rate stability, independent monetary policy, and financial market openness at the same time. Here's an excerpt from her note:

"Until last August, China was just able to balance the contradictory objectives of cutting interest rates, keeping a stable renminbi, and liberalizing its capital account.¹ The People's Bank of China managed this breach of the 'impossible trinity' through carefully calibrated interventions. That ability to cheat fundamentals, however, was lost in the aftermath of last summer's botched shift to a more flexible currency regime... As a result, the market no longer gives Beijing the benefit of the doubt and hence the basic laws of economics are now being asserted. The central bank can delay the inevitable by selling foreign exchange reserves, but confidence in the unit is waning as shown by its currency pile declining by a record \$107.9 billion in December versus an expected \$23.3 billion. This leaves policy makers with some hard choices."



Something's gotta give, and with outflows running at a pace that could drain the PBoC's available foreign exchange reserves in less than a year, it will probably be the exchange rate.

"At the current rate of FX depletion, capital outflows with possible acceleration, and level of liquid assets, Beijing is looking at facing an increasingly critical reserve level as soon as July 2016," observes Peking University's [Christopher Balding](#). "\$3.3 trillion is frequently referred to almost in awe. However, when placed in proper context, and given its rapidly declining nature, it should inspire real trepidation."

Whether he realizes it now or not, Big Daddy Xi (or "Xi Dada" as he's known in China) has only three options:

(1) **He can attempt to strengthen China's capital controls to prevent further outflows and hold the onshore RMB stable against a basket of global currencies (without draining FX reserves).** While doing so would clearly work against China's efforts to internationalize the RMB, GaveKal's Arthur Kroeber and Chen Long now argue that "pragmatism trumps global ambition... [and] the international renminbi's downsides now outweigh its advantages." But even if Beijing is willing to backtrack on its internationalization efforts and back away from its capital account reforms – as Beijing's decision to effectively shut down CNH-related markets this week suggests it may – doing so may prove to be an impossible task. Chinese savers are already evading the existing capital controls today in a number of ways from fraudulent trade invoicing and underground banks to Bitcoin.

(2) **He can waste China's war chest trying to buy time, eventually float the RMB from a position of weakness, and lose the world's confidence in the process.** It's foolish to think Beijing can hold back the flood forever with their FX reserves

¹ In theory, a country that liberalizes its capital account starts to allow capital to move more freely in and out of the country.

falling at a rate of \$100 billion per month, but Beijing's plan may just be to hold it back long enough for the US dollar to fall and for capital outflow pressures to calm. If, however, those outflows and outflow pressures persist (or worse, accelerate) – either due to a leaky capital account, prolonged US dollar appreciation, and/or fading confidence in holding Chinese assets – delaying would put Beijing in a progressively weaker situation as time drags on. In that event, we would need to have a conversation about the potential collapse of the Chinese Communist Party.

(3) **He can save China's remaining FX reserves, float the RMB in the next few months from a position of strength, and call it bold IMF-endorsed reform.** It may sound wild, but floating the currency from a position of strength is probably the best and most practical option Beijing can make at this point in the game. If President Xi and his colleagues recognize the need to maintain their FX reserves to escape the stagnation that will follow a massive financial system backstop, and have at least some remaining resources to reestablish stability at a lower level (essentially devaluation dressed up as reform), they may yet be able to salvage the "Chinese dream" over the longer-term through radical internationalization.

Yes, there's a lot of risk involved with free floating the aspiring reserve currency earlier than planned, but waiting around for a major RMB buyer to suddenly emerge is downright reckless.

If Beijing opts to go sooner rather than later, there's a chance they could stem the tide after a -15% to -20% fall in the newly unified RMB. The resulting move would fuel a big rally in the trade weighted US dollar, put already highly-leveraged emerging markets under intense strain, and undoubtedly put a dent in China's gross exports during that crisis period (although their share of world exports would likely increase). While floating the currency prematurely would involve some pain, it could very well play to Beijing's geopolitical advantage by allowing it to blame the RMB shock on aggressive Fed policy for triggering such large outflows in the first place (a shared experience in the emerging markets these days).

Making the story about the US dollar and not about Beijing's earlier desires to gradually weaken the currency has been the strategy for months now.

Over time, it's conceivable that President Xi could rally countries representing more than 60% of the world's population and half of global GDP around his "One Belt, One Road" strategy; expand China's geopolitical sphere of influence; win the exorbitant privilege of reserve currency status; pick up significant competitiveness against other high-value-added exporters like Germany, Japan, and South Korea; and finally deal with its currently unmanageable debt problem. The future could still be bright.

But, if they waste their resources in an effort to buy time, the RMB could join some of their emerging market peers in the -30%+ range against the US dollar with inadequate resources to limit the damage. Fortunately, Chinese firms have been hard at work since last August refinancing their dollar-denominated debts back into onshore yuan; but in this scenario, it's likely that Beijing would have a very hard time keeping a lid on a homegrown credit crisis.



With those choices in mind, the odds are now uncomfortably high that US investors will wake up one morning to learn that Asian and European markets have crashed after a sudden drop in the RMB just in time to see junk bonds and the S&P 500 crash right along with it. Think of the August 24, 2015 flash crash on steroids (we've never seen an actual crash in a market so dominated by passive investment structures and high frequency trading), but with lasting consequences for the global economy.

The first major market resistance level would be about 1600 (a 17% decline), but it's important to note that a CNY shock, a strong US dollar, competitive devaluations abroad, and weak commodity markets would not be the only downside catalysts in that environment. Considering that the Fed (a big contributor to China's post-2008 credit boom and its post-2014 outflows) has been tightening for at least 20 months and the US economy may already be rolling into recession on its own (see [Tapering is Tightening & QE4 is Inevitable](#)), there's no telling how far the stock market could ultimately drop.



Source: Evergreen GaveKal, Bloomberg

That's why my colleagues and I on the Evergreen GaveKal investment Committee have been putting so much emphasis on (1) large cash reserves, which can be rolled into bombed-out markets to take advantage of generational buying opportunities; (2) healthy US Treasury allocations, which can deliver tremendous positive returns in a global panic; and (3) high quality corporate debt, which could hold most of its value while providing better yields than cash or Treasuries.

We're not perma-bears; but since we believe the last seven years of overly-accommodative Fed policy have scattered the seeds of an epic crisis in equity, credit, and commodity markets all around the world, we tend to prefer beaten-up assets where we believe the underlying cash flows will prove durable over time (like certain midstream MLPs) over significantly overvalued markets with earnings eroding beneath them (like junkier bonds and equities). While sticking to such a discipline can be difficult, we believe it's the most prudent way to protect and preserve wealth in a world with few historical parallels. And based on our macro view, we believe it's the best way to generate long-term value for our clients.

Yes, our energy-sensitive positions could certainly take a deeper hit as oil prices fall toward the low \$20s in a global recession, but we also believe that such a shock would mean deeper supply cuts and a quicker recovery in energy prices as demand starts to come back over the next couple years. Considering that the rest of our portfolios are well protected from a shock, and our clients are receiving total portfolio cash flows in the mid-to-high single digits from beaten-up assets we like on a longer-term time horizon, we're willing to withstand some selling pressure along the way while continuing to monitor those positions closely. The important thing to keep in mind is that improving portfolio cash flows with modest allocations to high-quality, beaten-up assets helps our clients stay committed to otherwise defensive portfolios in the run up to these opportunity-creating crises. Otherwise, a longer-than-expected wait in cash can become demoralizing.

Is your portfolio prepared for another bear market in US equities? How about another global recession? If your answer is yes, you can breathe easy. If the answer is no, it may be time to make some changes.

As the Fed continues to tighten (or at least pause for the time being) and China runs through its remaining FX reserves, 2016 could prove to be a year of crisis. For most investors, that means danger; but for a patient, disciplined few, it means enormous opportunity.



CRISIS & OPPORTUNITY

"Opportunity is always present in the midst of crisis." The Chinese word for crisis carries two elements, danger and opportunity. No matter the difficulty of the circumstances, no matter how dangerous the situation, ... at the heart of each crisis lies a tremendous opportunity. Great blessings lie ahead for the one who knows the secret of finding opportunity within each crisis.

OUR CURRENT LIKES & DISLIKES

Changes are bolded below.

WE LIKE

- Large-cap growth (on a deeper pull back)
- International developed markets (on a deeper pull back)
- Canadian REITs
- Intermediate Treasury notes
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Cash
- Publicly-traded pipeline partnerships yielding 7%-12% (MLPs)
- Intermediate-term investment grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Intermediate municipal bonds with strong credit ratings
- Long-term municipal bonds
- The Indian stock market
- Long-term Treasury bonds
- **Select blue chip oil stocks**
- Emerging bond markets (dollar-based or hedged)

WE'RE NEUTRAL ON

- Most cyclical resource-based stocks
- Large-cap value
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Long-term investment grade corporate bonds
- Short yen ETF
- Emerging market bonds (local currency)
- Short euro ETF
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Canadian dollar-denominated bonds

WE DON'T LIKE

- Real Estate Investment Trusts (REITs)*
- Small-cap value
- Mid-cap value
- Small-cap growth
- Mid-cap growth
- Floating-rate bank debt (junk)
- Lower-rated junk bonds
- Emerging stock markets

*However, some small and mid-cap issues look attractive

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