



ECOGNOSIS ADVISORY LTD

From the Greek: OIKONOMIKH ΓΝΩΣΙΣ (Economiki Gnosis, Knowledge of Economics). Ecognosis is a global financial, economic advisory and information service, covering economic and financial developments, equities, fixed income, forex, commodities and other assets. Econotes is a research publication available free on our internet site and to the public in Hong Kong. It is not a solicitation for business and neither does it contain investment suggestions on specific and named securities including any buy, sell or hold advice. It is written by Dr. Andrew F. Freris based on 47 years of market experience which includes senior positions with GT Capital, Salomon Brothers, Bank of America and BNP Paribas as well as senior academic posts with universities in London and in Hong Kong

8/F, 2 Exchange Square, 8 Connaught Place, Central, Hong Kong. Tel: 852 3167 4591, Mob 852 9738 0944
 Email: afreris@ecognosisadvisory.com Website: www.ecognosisadvisory.com

ECONOTE No. 39

16/8/2015

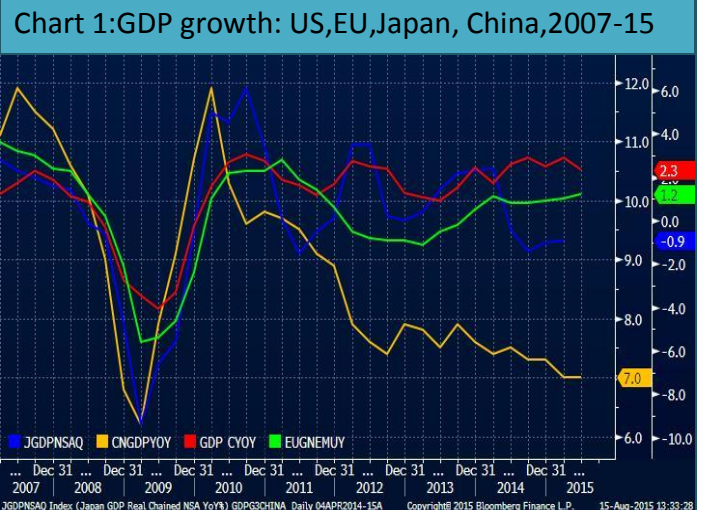
Summarizing global investment suggestions (and the meaning of life as well.....)

Summary	Investment Conclusions
<p>The US Fed is about to hike, or so it says, China mismanages its stock crash and forex rate thus adding to global volatility, Greece is bailed out(third time lucky ?),the EU economies do not show yet clear signs of sustainable recovery and Japan spends more time on WWII arguments than on the famous “third arrow” of reforms. Latam economies are hit by falling commodity prices, with Brazil toppling over. Australia is suffering as is Russia, while Asian economies present a very mixed picture with India’s reform dreams long gone now. As my mother would have said “Honestly, I can’t leave the house and the kids alone for one minute,and look at the mess now”</p>	<p>The easy ones first. Soft and hard commodities prices to stay low for the rest of 2015 and possibly to 1H.16 when the bottoming out of the Chinese economy will give a boost, except for oil where supply pressures will persist. Next come the trickier.FI assets, sovereign and corporate, will go through the Fed shock with HY, especially EMKS, suffering most. Keep to the shorter end of IG curve, especially in the EU where rates are guaranteed to stay low well beyond 2016. Equities-the hard one last. Stay in the US, progressively more in the EU, neutral in Japan and selective in Asia, bar China.</p>

Murphy’s Law in action: if something.....

First Greece wrote the book of how NOT to negotiate and then **China** bests it with the absurd stock market intervention (“Its official: equities in China can only go up”) followed up with an appalling sense of timing with two forex rate adjustments. Bottom line is that an approximately 3.5% depreciation of the CNY will do nothing for exports, which are cyclically driven, but will add some pressure on the margins of IT, etc exports where import content can be as high as 95%. In any case,, historically the contribution of net exports to China’s GDP has been very small, at times about 10bps for every 100bps GDP growth. So China’s growth will not be helped, but volatility will. China’s economy could be bottoming with all the injections of liquidity and lower interest rates (3 cuts so far in this cycle) as its growth is not dependent on global cycles but on, primarily domestic and, hence, controllable, factors. We expect that the economy will bottom in 1Q.16 and this will be good news, going forward, for commodities and the AUD. As for the **US**, the economy is doing partially better, especially in the labor front, but not inflation.

As Chart 1 shows, the **EU** (green) is struggling to recover although QoQ the last three readings of GDP growth were flat to falling. GDP-wise,**Japan** (blue), on YoY basis, is still shrinking and **China** (yellow) has flattened to “only 7.0% yoy “. Persistent low inflation to deflation is endemic in both **EU** and **Japan**, and not anywhere near the central bank targets, despite massive QE in both economies, with very high unemployment in the FI



Source: Bloomberg

ECONOTE No.39

So what happens next ?

A key assumption in the markets is that the Fed will hike rates this year. We do not expect so for 2015. As Chart 2 shows, UST bond yields (green) have declined as the markets may not be convinced and the appreciation of the USD (trade weighted, red) has flattened out. German bunds (yellow) have recovered their composure after Greece, while commodities (violet) keep falling. So no threats from inflation, but FI markets may react sharply should the Fed hike and thus blow it all back to equities. China is not an issue as all its travails are purely domestic and, as the Factbox shows, China can impact the world primarily through the impact on commodities and by very little else. Chinese equity markets are still effectively closed to the world and the CNY accounts for about 2.0-3.0% of world transactions. Concerns about Chinese local debt are just about that, **local**, not global.

FACTBOX : Why China can't have a financial crisis

All post war financial crashes (US,EU,Greece,Argentina, Brazil,Russia,S.Korea,Thailand, etc) had one or more of the following in common: Banks overexposed to the property sector, growing and externally financed fiscal and current account deficits, growing external debt, overvalued forex rates and falling forex reserves. China has virtually none of these. Its key banks are state-owned, so a banking crisis becomes a fiscal issue. China has an external surplus, a small fiscal deficit financed domestically and a USD 3.7 tr reserves making it a global creditor. Creditors don't go bust.

Asian markets have done badly so far this year with the only exception (USD ytd) being Shanghai up 19.0% and with the HSI up 1.6%. The rest of the Asian markets have negative returns with some driven further down in USD terms by weak currencies. China's recovery should not hide the fact that Shanghai peaked at over 5,100 and now still at 4,000 carries a great deal of losses. The HSI will be hit badly once the Fed hikes. S.Korea, the Philippines and Mumbai are all up in local terms which is encouraging as the rest of Asians are down both in local **and** USD terms. India has little to recommend it which leaves S.Korea and Philippines going forward, both market which we had favoured in the past. China will still be subject to volatility for months to come till the economy bottoms.

Chart 2: USD index,UST10Y,Bunds10Y,Commodities



Source : Bloomberg

Counting all the beans very carefully

Investment opportunities remain modest. In equities the US stays on top macroeconomically while Japan remains recommended only on the basis of liquidity. The EU equities have a better medium term outlook as, with Greece out of the way, growth remains very modest but the financials are significantly better, till the UK goes for a referendum ! In Asia the choices are limited, S.Korea and the Philippines, with Hong Kong too China dependent and under the threat of higher US rates. China itself will pay the price of having a closed and state-supported equity market plus now a volatile currency. Buying China will make sense in about six months' time when the economy will have bottomed, given the state support that it receives now. In the fixed income space the UST longer end may look now expensive with preference given to the shorter end IG paper, particularly in the EU, where the risks are abating notwithstanding the likelihood of further EUR weakness once USD rates rise. Hard commodities will find bottom once China's GDP does, which will be good for AUD which still keeps the highest short term rates amongst the developed economies. Brazil and Argentina may also benefit by mid- 2016, but with weaker currencies as USD rates rise. Venezuela and Russia will still stay pressed by supply-driven low oil prices especially as Saudi Arabia is not budging and shale oil continues to do basically well.

Andrew Freris (writing completed on 15/8/2015)