

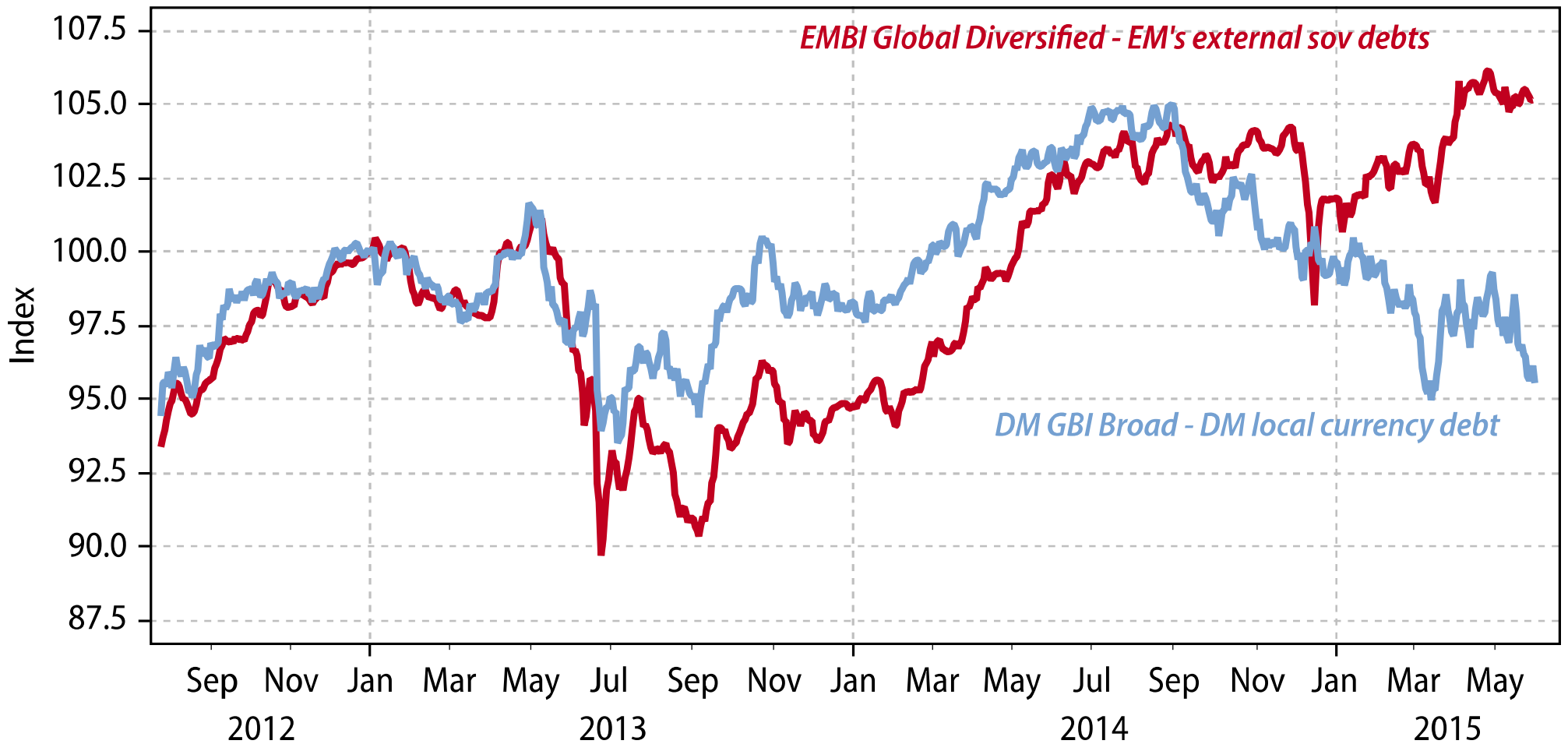
June 2015

Gavekal June Investor Call

By Louis-Vincent Gave

Emerging market is outperforming, even adjusting for US\$ strength

After taper-tantrum hic-cup, EM debt now outperforming significantly



Gavekal Data/Macrobond

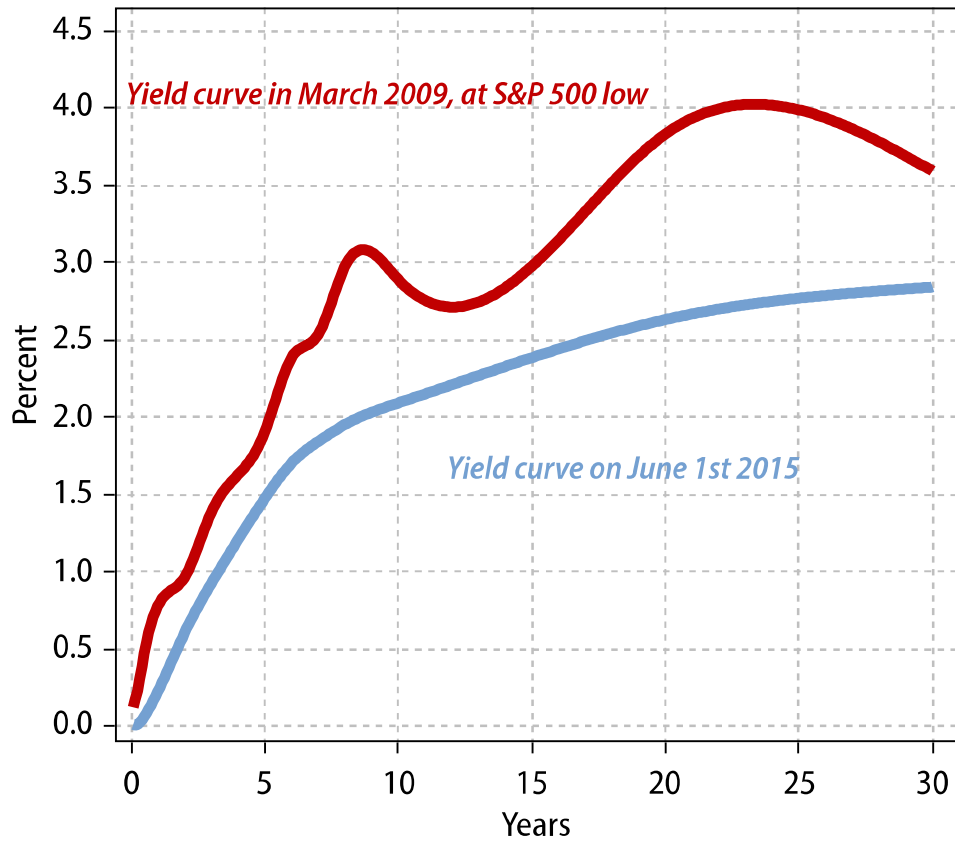
Behind the outperformance of EM, and especially Asian, bonds

- Higher yields provide more of a margin for safety
- Currencies have been broadly stable to strong
- Lower commodity prices are keeping inflation in check
- Slowing growth rates as economies mature
- Ageing populations triggers a search for income
- Financial deregulation is opening up domestic fixed income markets to yield starved foreign institutions.

1- Higher yields, easier monetary policies, stable currencies

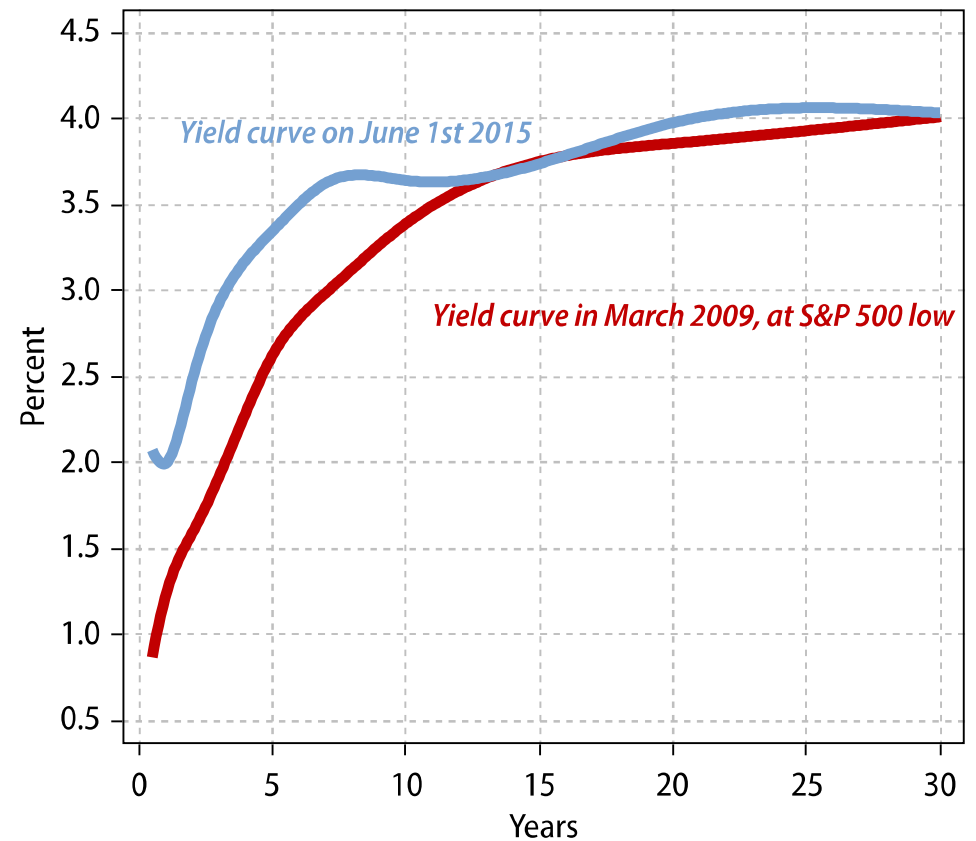
The tightening of 2011-14 is slowly getting unwound

UST yield curve: today vs March 2009



Gavekal Data/Macrobond

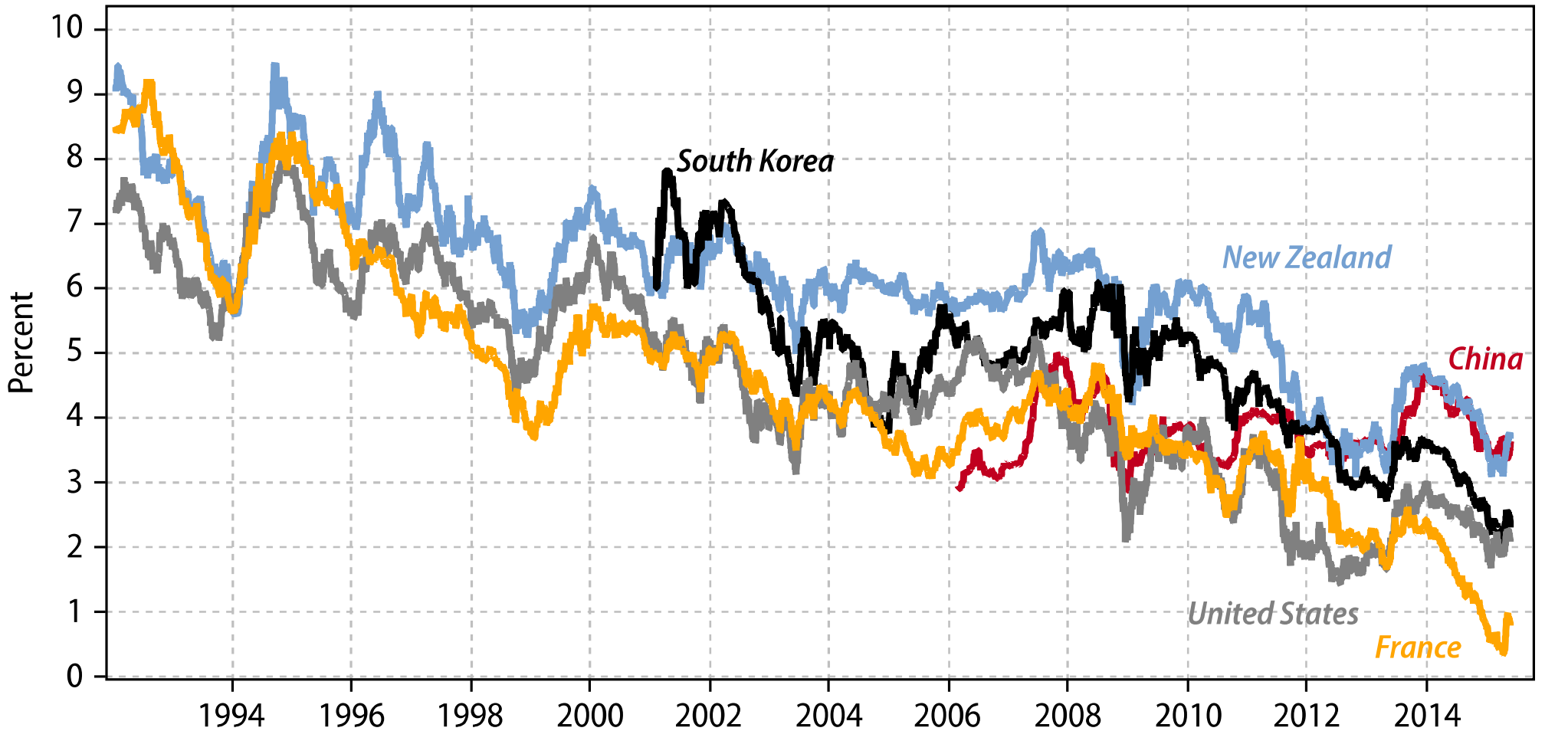
China yield curve: today vs March 2009



Gavekal Data/Macrobond

Long yields in a number of Asian countries could still go down 50-150bp

Ten Year Government Bond Yields



Gavekal Data/Macrobond

But even with easier monetary policies, currencies remain firm

On a trade-weighted basis, Asian currencies continue to make new highs, steadily

REER of 10 major Asian (ex JPY) real effective exchange rates, equally weighted



Gavekal Data/Macrobond

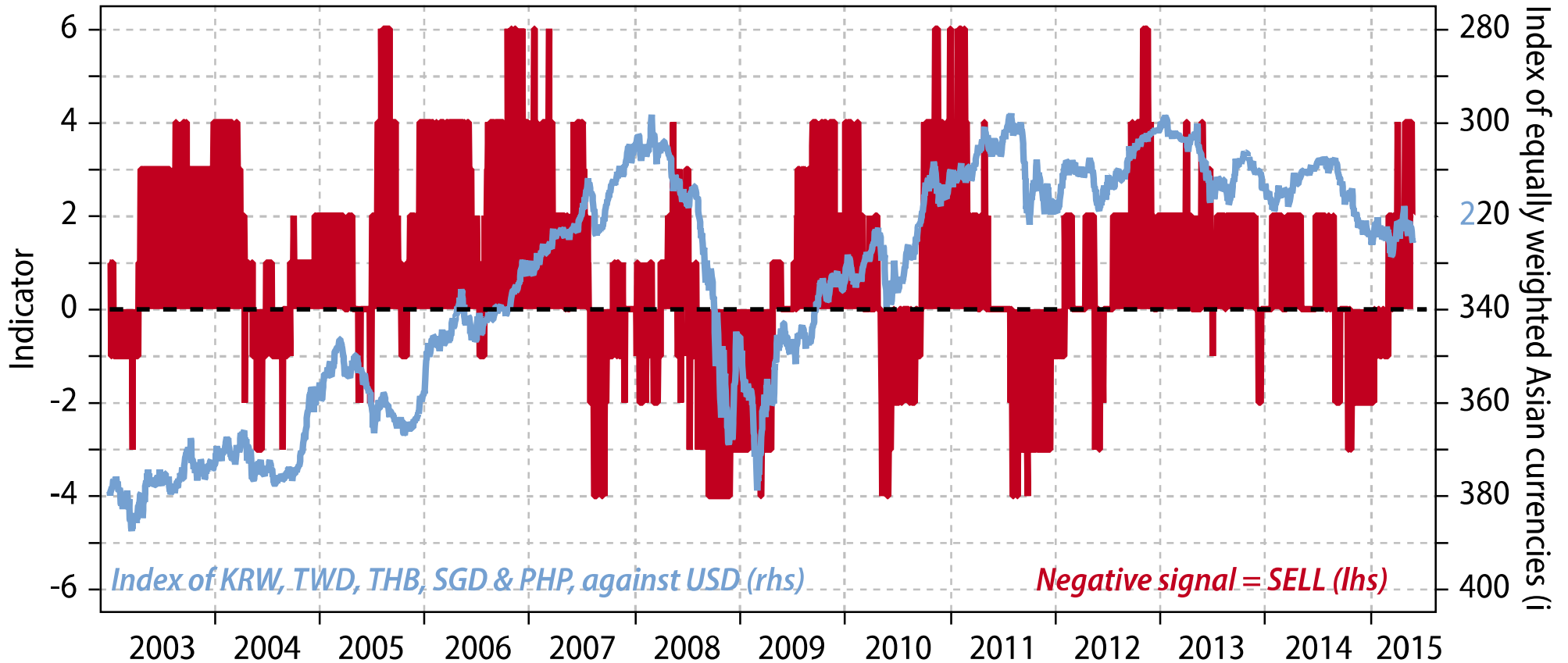
Stability in Asian currencies is anchored by strong RMB



Asian currencies have fared decently well in recent USD spike

Diffusion index on FX of the Asian countries w/ stronger fundamentals

Indicator consists of measures for market distress, eco activities and direction of anchor currencies



Gavekal Data/Macrobond

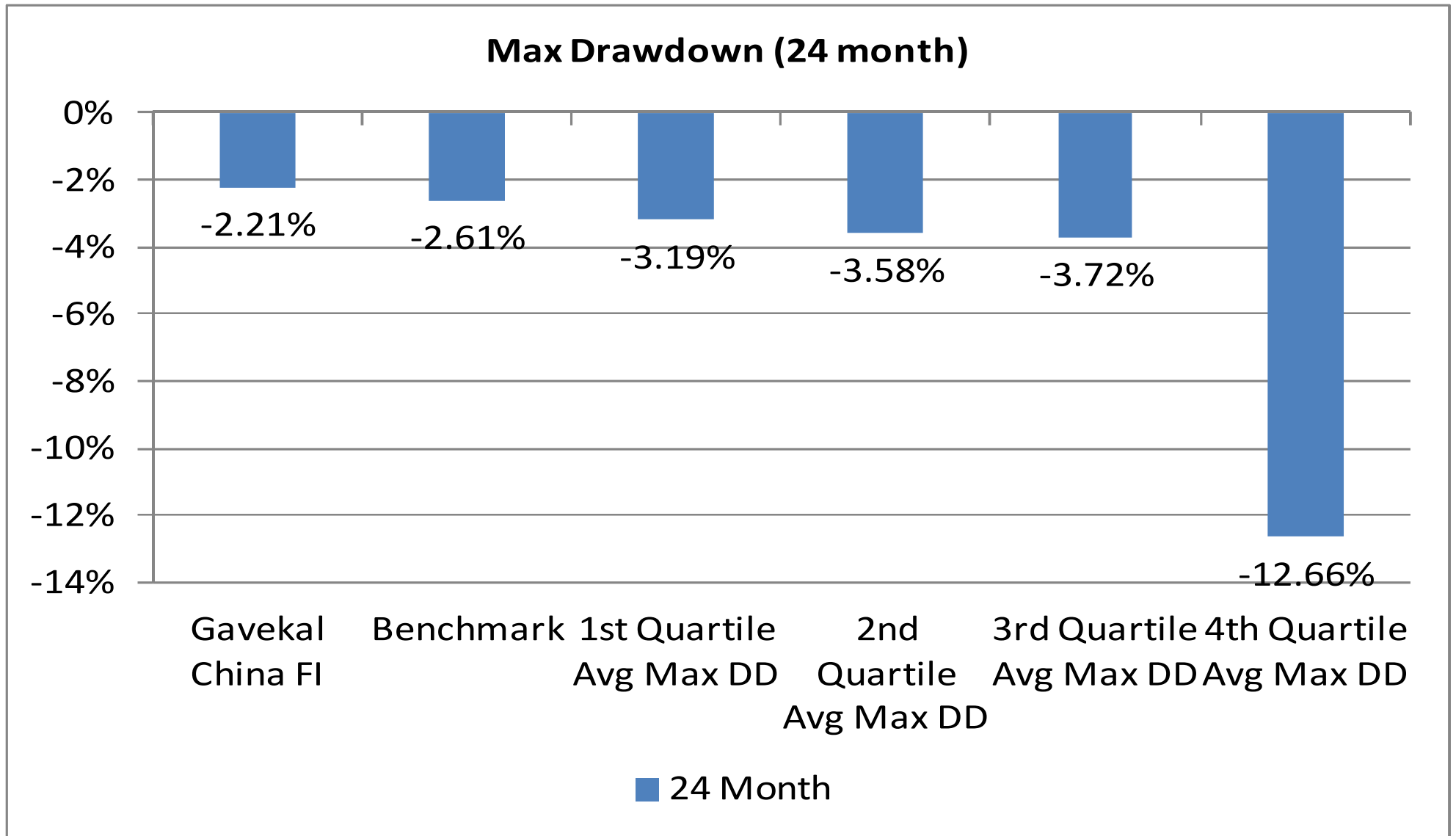
And stability of regional bond markets also anchored by China

USA and China Fixed Income Indices



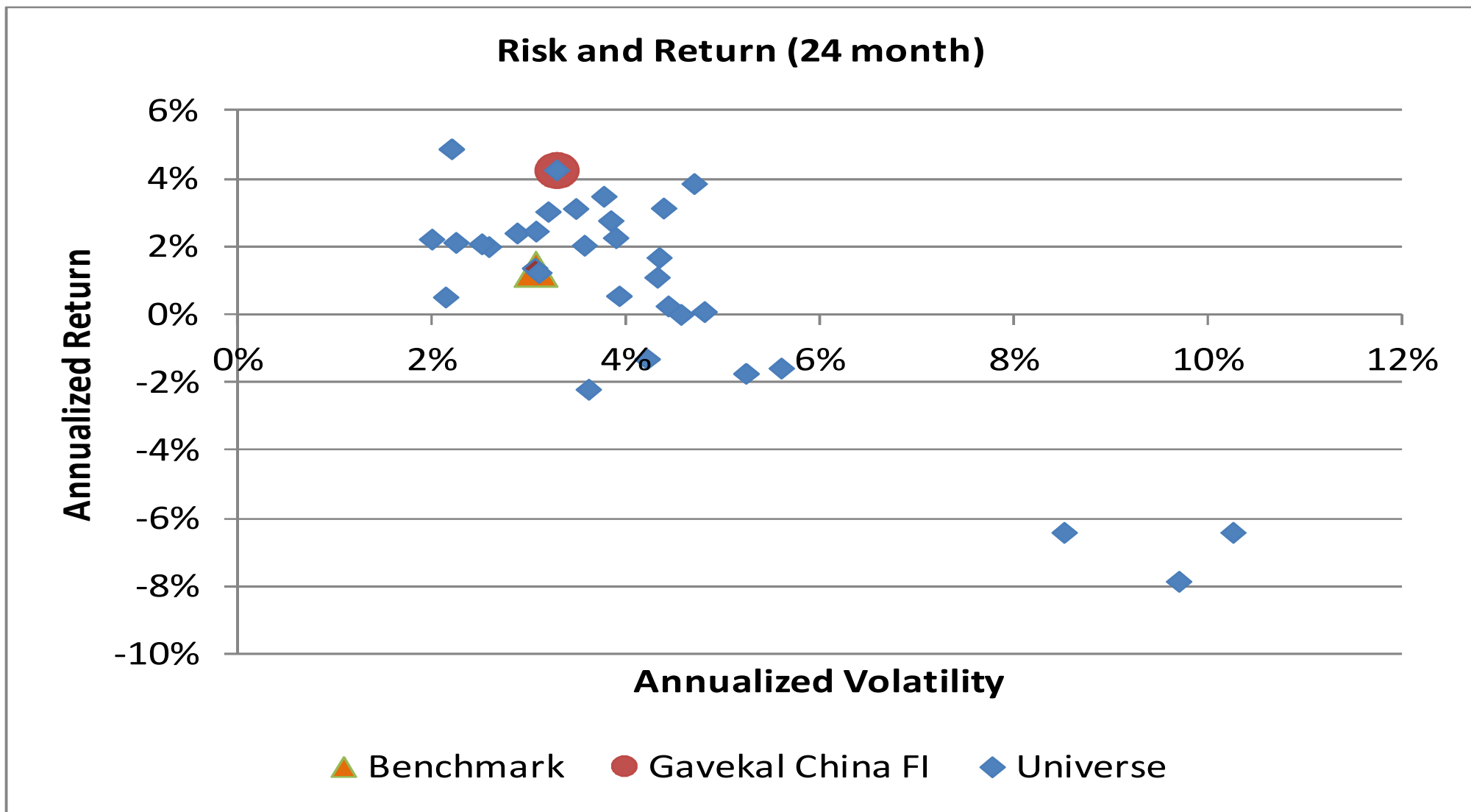
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Controlled downside even in midst of taper tantrum



As of 30 April 2015

Where else can investors find 4-6% returns with volatility of around 3%?

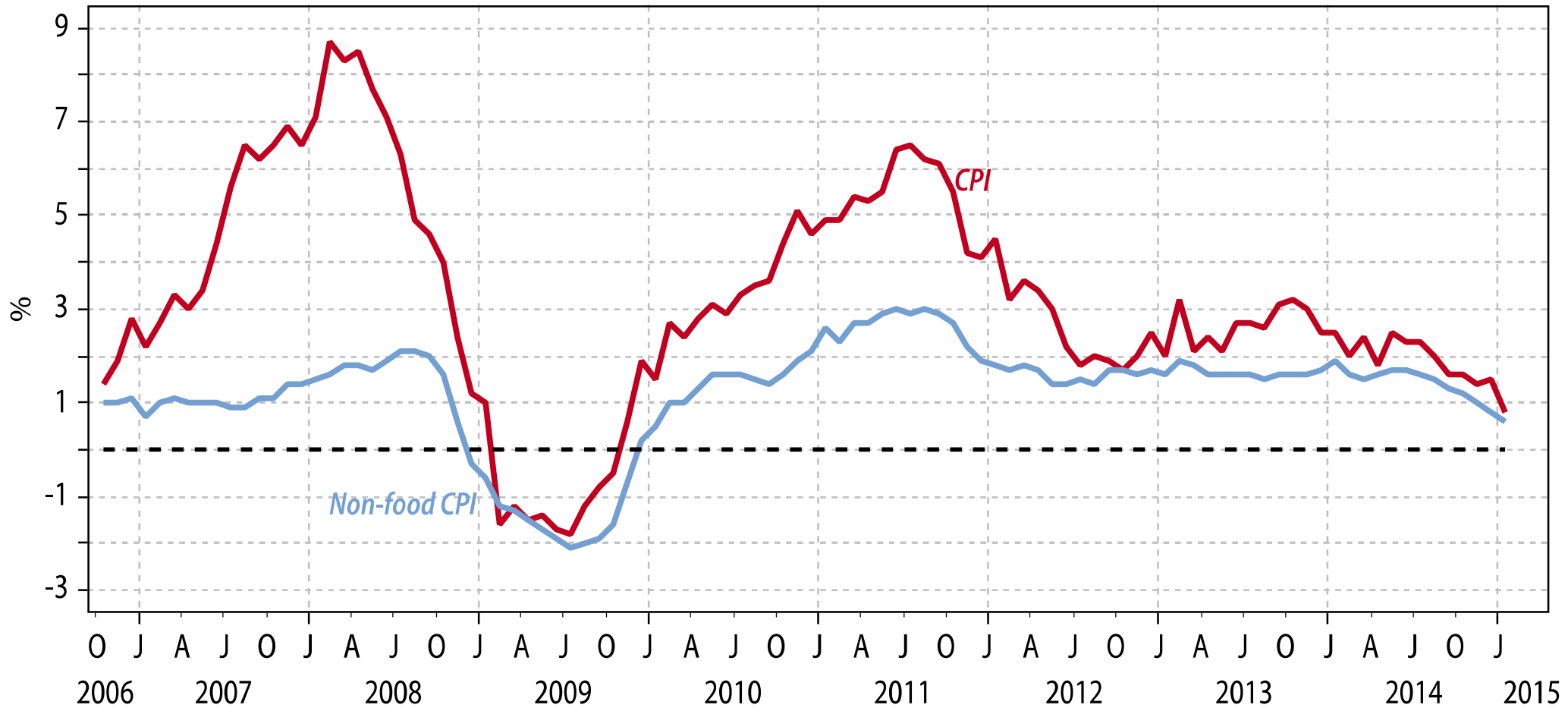


As of 30 April 2015

2- Behind the easier monetary policy: a genuinely deflationary environment

Falling inflation opens the door for easier monetary policies

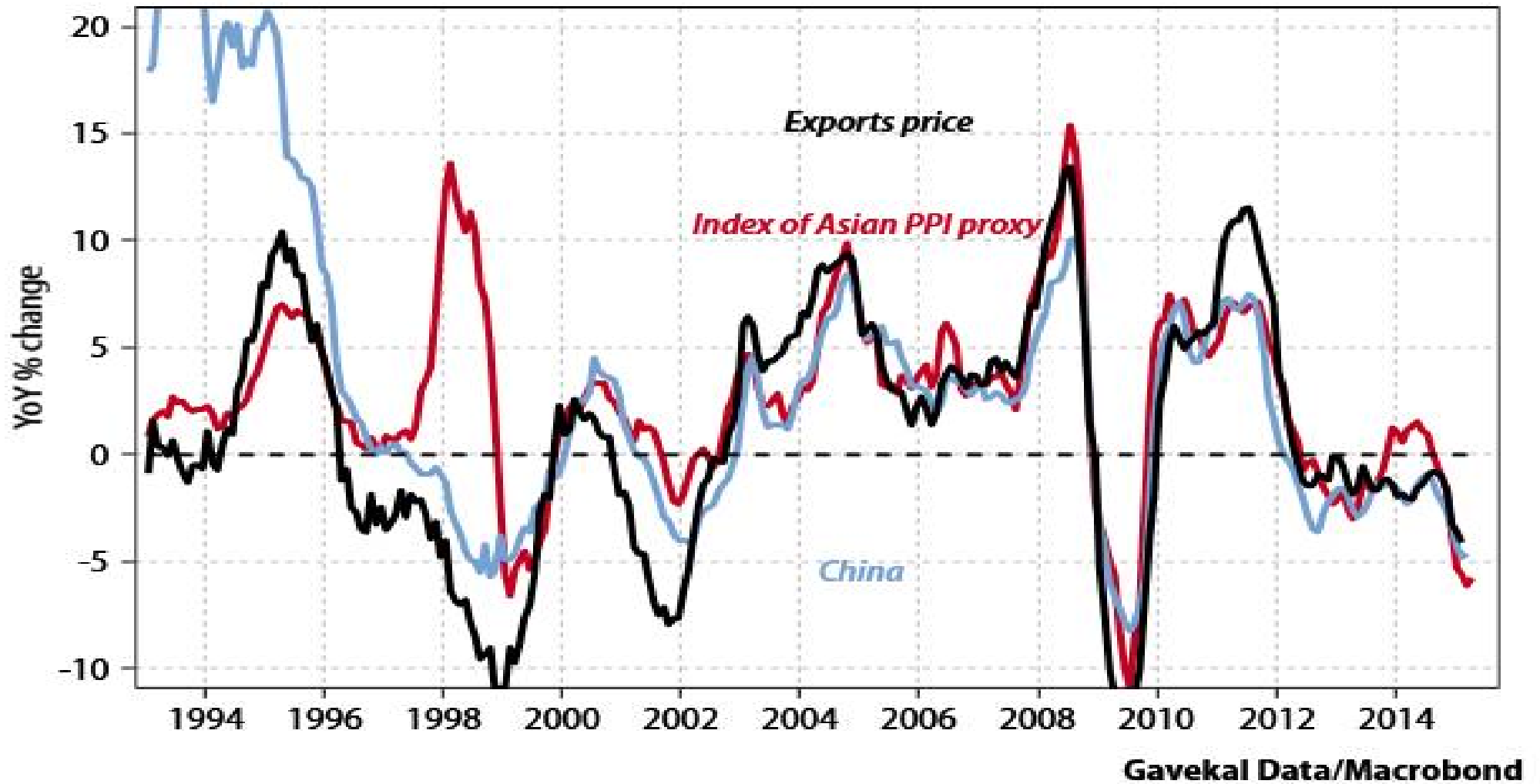
China CPI and non-food CPI



Gavekal Data/Macrobond

Inflation all around the region continues to head south

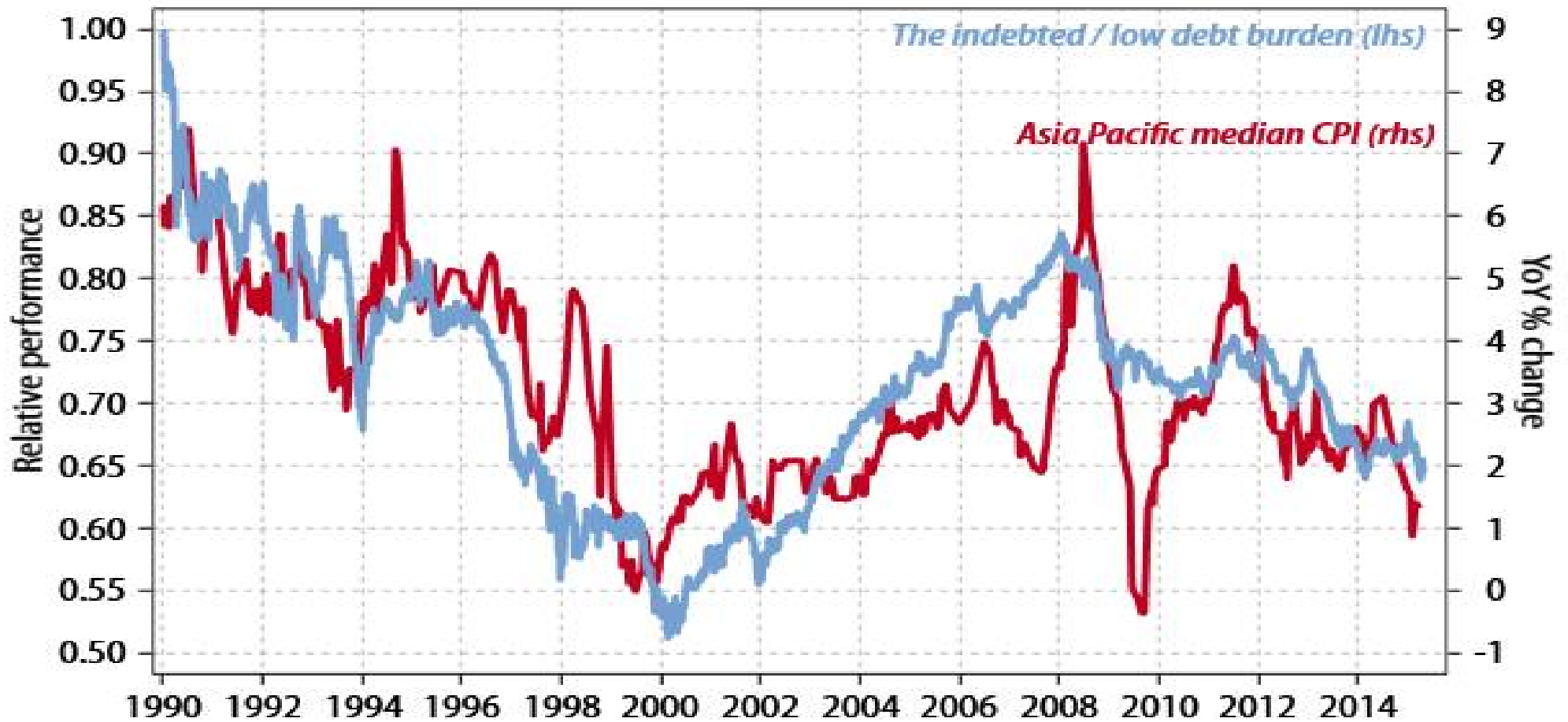
Asian producers cutting prices as if in a crisis mode



Proper deflation: companies are not rewarded for leveraging up

Taking on leverage is not rewarding for now

Asia Pacific ex financials, market cap > \$500mn, equally weighted indices, quarterly rebalancing



Compustat, Gavekal Data/Macrobond

Behind the deflation: falling commodity prices

Impact of oil prices

% of 2013 GDP

	Oil consumption	Estimated fiscal subsidy	Current account	Net oil imports
Japan	3.3	0	0.7	3.2
China	4.3	0.2	2.0	2.5
Korea	6.4	0	6.1	5.9
Taiwan	6.9	0.2	11.8	5.7
Thailand	10.1	2.1	-0.7	7.6
Malaysia	7.7	2.3	4.1	-0.2
Indonesia	6.6	3.3	-3.4	3.2
India	7.8	2.3	-1.7	4.9
Philippines	3.9	0.5	3.5	3.7

And a slowing Mainland, the former locomotive of the region

China's growth in 2014 will slow more than policymakers anticipated

It is almost a dead certainty that China will fail to hit the government's 7.5% GDP target in 2014. By year-end the run rate of GDP growth will probably be below 7%, and in 2015 a further slowdown to 6-6.5% is possible.

The slowdown was prompted by a weak property market, which will lead to slower construction and heavy industry activity. Nationwide, we expect housing completions will fall about -5% in 2014, to 10 mn units, and then stabilize; prices in most cities could correct down by 5-10% but probably not more.

On the bright side, the government has already eased monetary policy and most cities are now free to end housing purchase restrictions. So a stabilization of credit and housing sales is likely in H2.

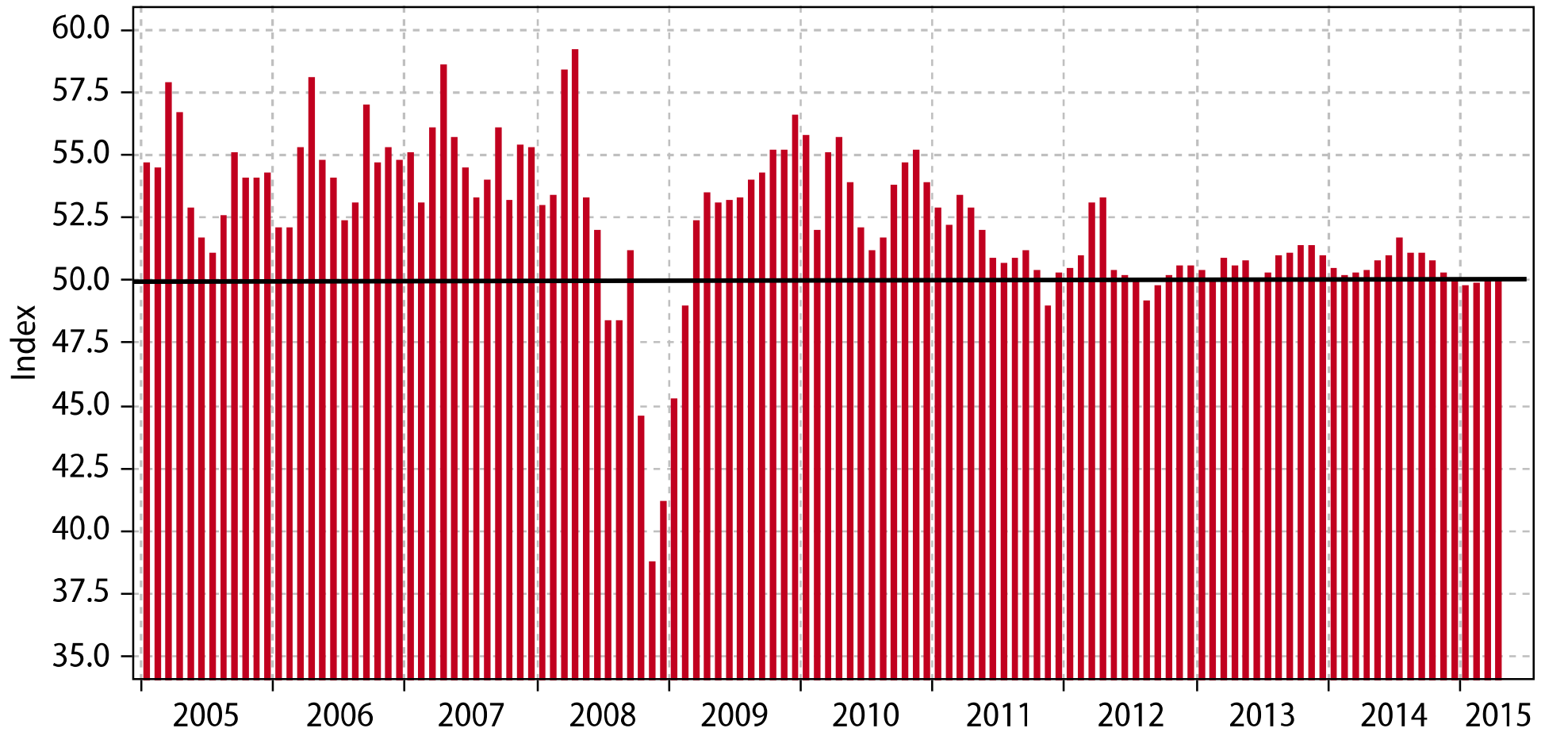
Moreover, the labor market remains very tight and exports are solid, so household consumption and the external sector should provide support for growth, making a big stimulus unnecessary.

There is little risk of a property collapse or financial crisis. Instead, the main question is how soon will we see gains from structural reform? And what is the impact of the anti-corruption drive?

Financial sector reform is proceeding smartly: a more flexible exchange rate since March is a prelude to liberalization of deposit interest rates within two years. Other reforms (fiscal, SOE and urbanization) are proceeding more slowly.

Can we have a bull market with slowing growth?

China PMI

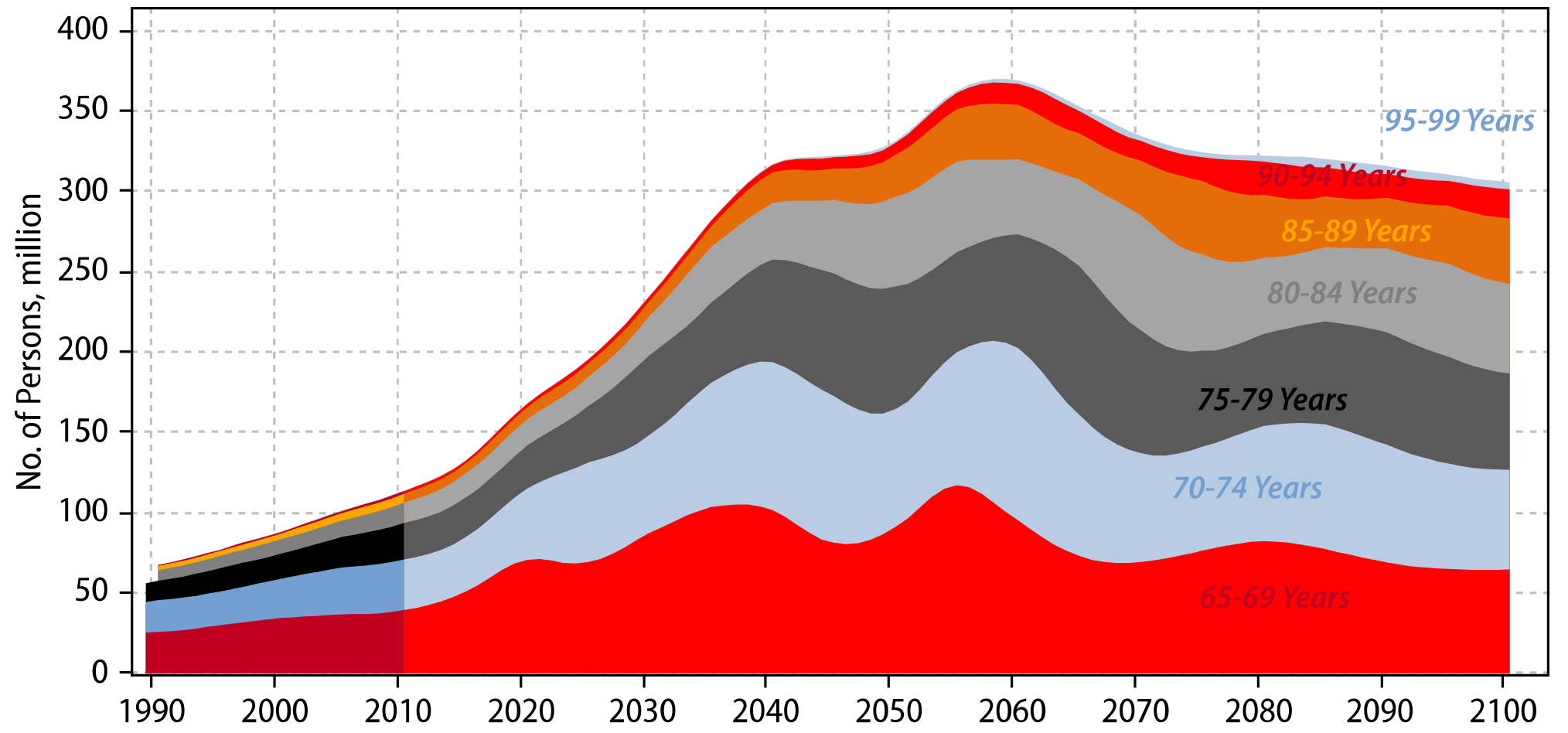


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3- Demographic pressures: a major tailwind for yield in Asia

One major tail

Over one generation, China will add almost one USA to global retiree population

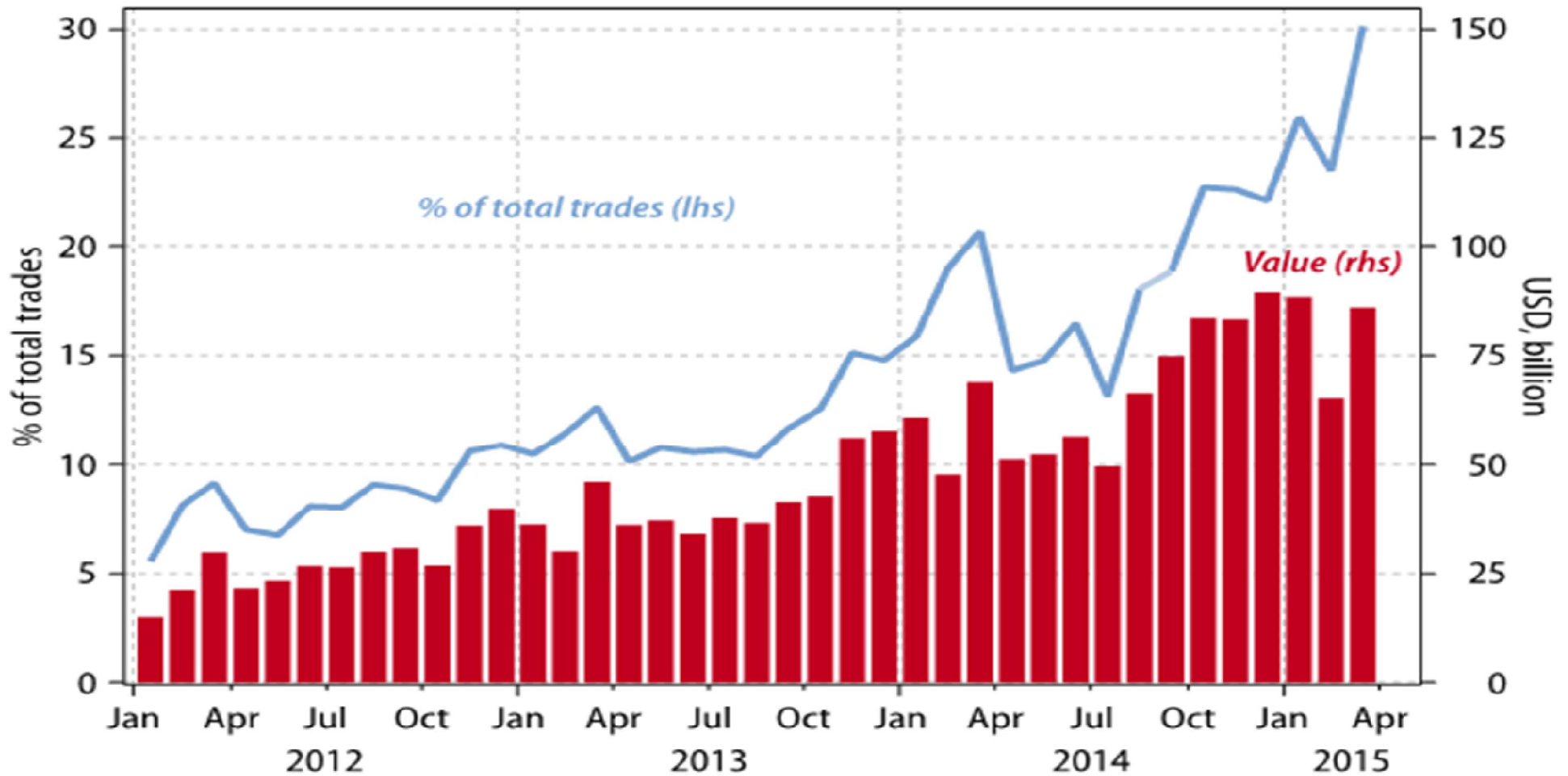


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4- Financial Deregulation – the near term catalyst

Adoption & use of the RMB is growing very fast

Trades settled in RMB



Gavekal Data/Macrobond

China has a deep, liquid, financial center – that's a huge advantage



So much about investing in China depends on key dates



Christine Lagarde in March 2015, in Beijing: “I am very impressed by the rapid internationalization of Renminbi in recent years. The authorities’ commitment to accelerate reforms, particularly in the financial and external sectors, should further facilitate the international use of the RMB. The authorities have also expressed interest in having the RMB included in the SDR basket. We welcome and share this objective, and we will work closely with the Chinese authorities in this regard.”

China’s renminbi currency to become 10 per cent of global reserves by 2025

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China’s renminbi is expected to represent 10 per cent of global reserves by 2025, up from a 2.9 per cent share by the end of 2015, according to a survey of 72 central banks responsible for US\$5.9 trillion in reserves.

Thirty-five central banks, or 53 per cent of respondents, said they were either investing or considering investing in the Chinese currency, although they retain concerns over its convertibility, the liquidity of markets, and the quality of credit in some cases, said a joint report by Central Banking and HSBC on Monday.

The report was released before the International Monetary Fund starts discussing the possibility of adding the yuan to the ranks of the world’s reserve currencies in May.

The renminbi halted its four-month decline in March as Premier Li Keqiang and central bank governor Zhou Xiaochuan expressed their hopes for the yuan’s inclusion in the IMF currency basket. The Chinese currency fell 2.4 per cent against the US dollar last year, the first annual depreciation of the yuan since the central bank ended its dollar peg in 2005.

IMF’s head Christine Lagarde welcomed the proposal, saying inclusion of the Chinese yuan to the dollar, euro, yen, and pound in the Special Drawing Rights basket is only a matter of time and the move will expand its role as a currency for international trade and investment, allowing more central banks to hold it in their reserves.

A clear roadmap of the renminbi’s full convertibility remains one of its biggest challenges.

A reserve manager whose views were close to the average commented: “Although central banks have already started gaining exposure to the renminbi, the pace at which the renminbi becomes a large reserve currency will depend on the growth and stability of the economy; the pace of the internationalisation of the currency, and deepening of the financial markets.”

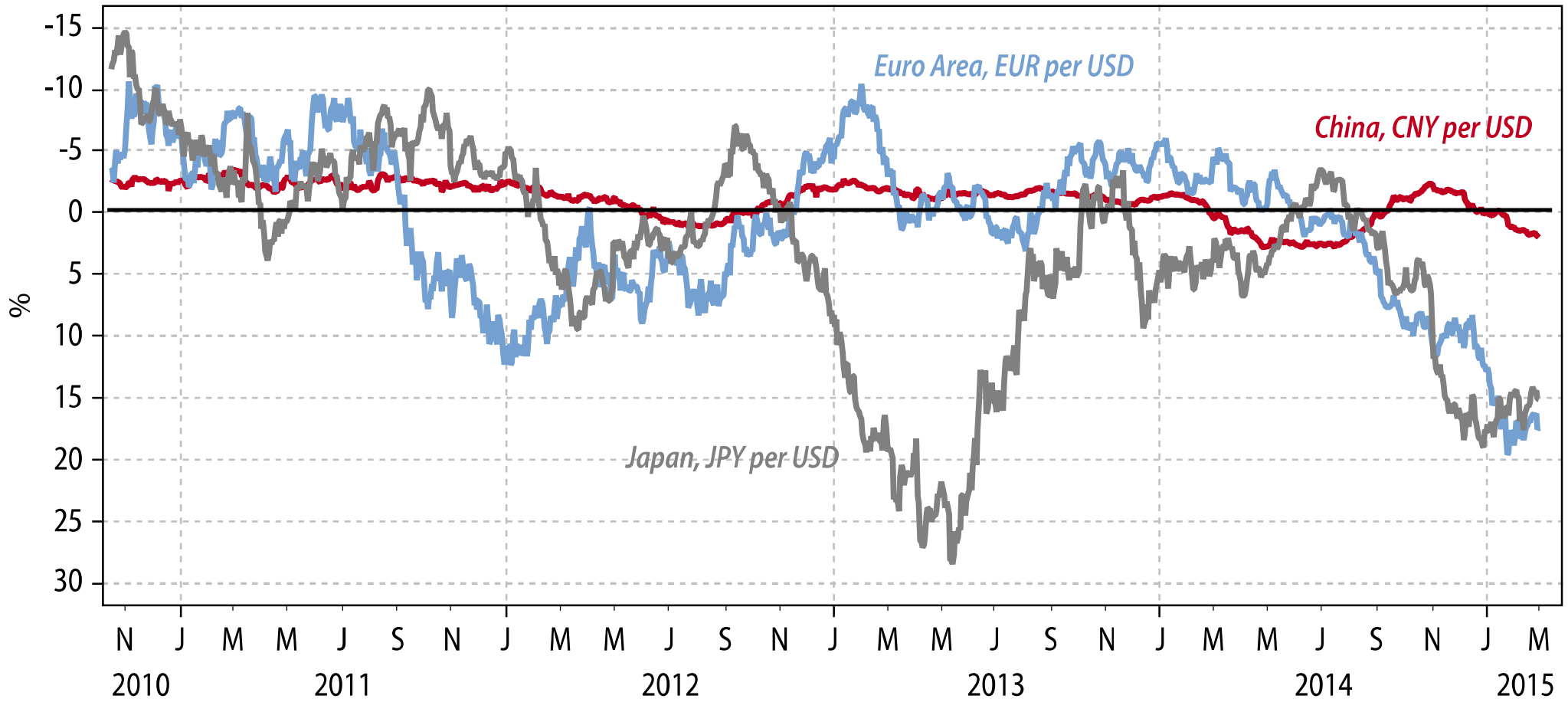
Asian central banks seem to be the most optimistic about the future of renminbi, with one reserve manager saying the share would reach 50 per cent by 2030.

“Reserve managers seem to be caught between a rock and a hard place, with deep concerns about both negative rates in Euro and the prospect of rising rates in the USD, a currency which by default has become increasingly pre-eminent as a reserve currency,” said Christian Deseglise, Global Head of Central Banks & Reserve Managers at HSBC.

“In this context, the continued adoption and steady rise of the RMB in central bank reserves is striking. Its possible inclusion in the SDR basket later this year would obviously accelerate the trend and, with the appropriate market reforms in China, enhance the range of available investment options for reserve managers.”

As we approach the November IMF vote, RMB is likely to stay very stable

6 Month % Changes in Euro, JPY and CNY vs the USD



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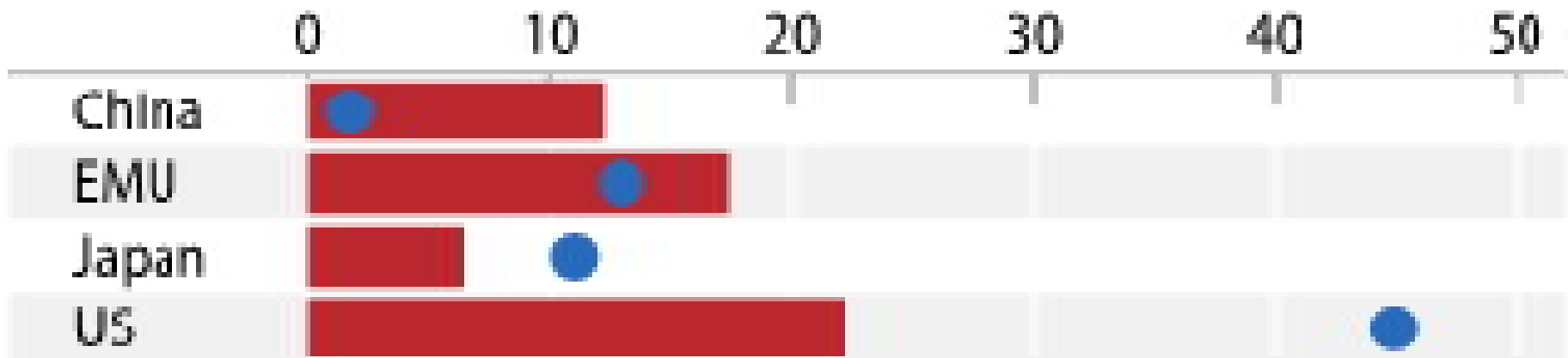
If RMB becomes a reserve currency, will the crocodile's mouth close?

The Crocodile Mouth: Two Year Govt Bond Yields in China, USA & Germany



If RMB becomes convertible, will China remain smaller than Switzerland in MSCI?

GDP vs weight in world MSCI



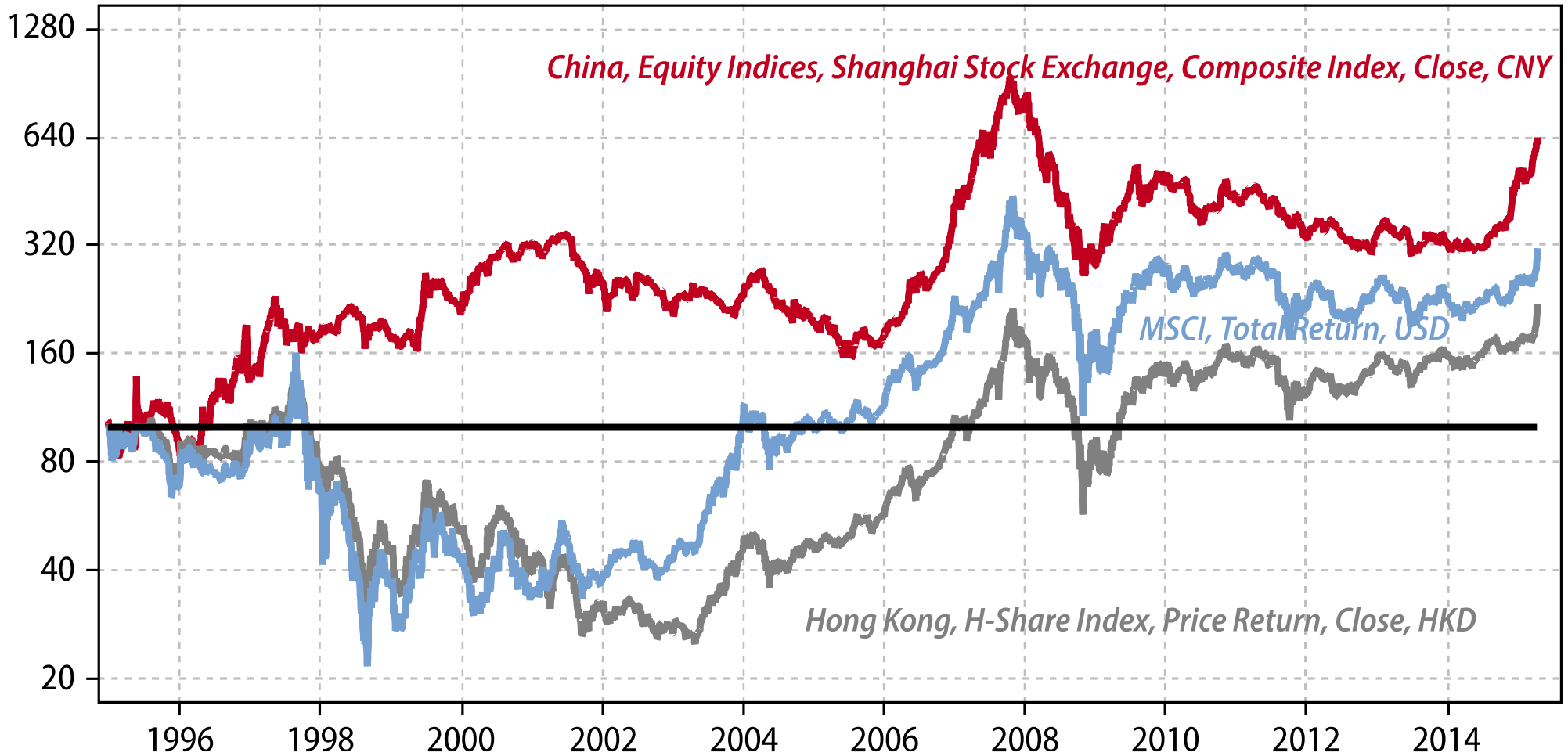
■ Weight of global GDP [Last]

● Weight in MSCI World [Last]

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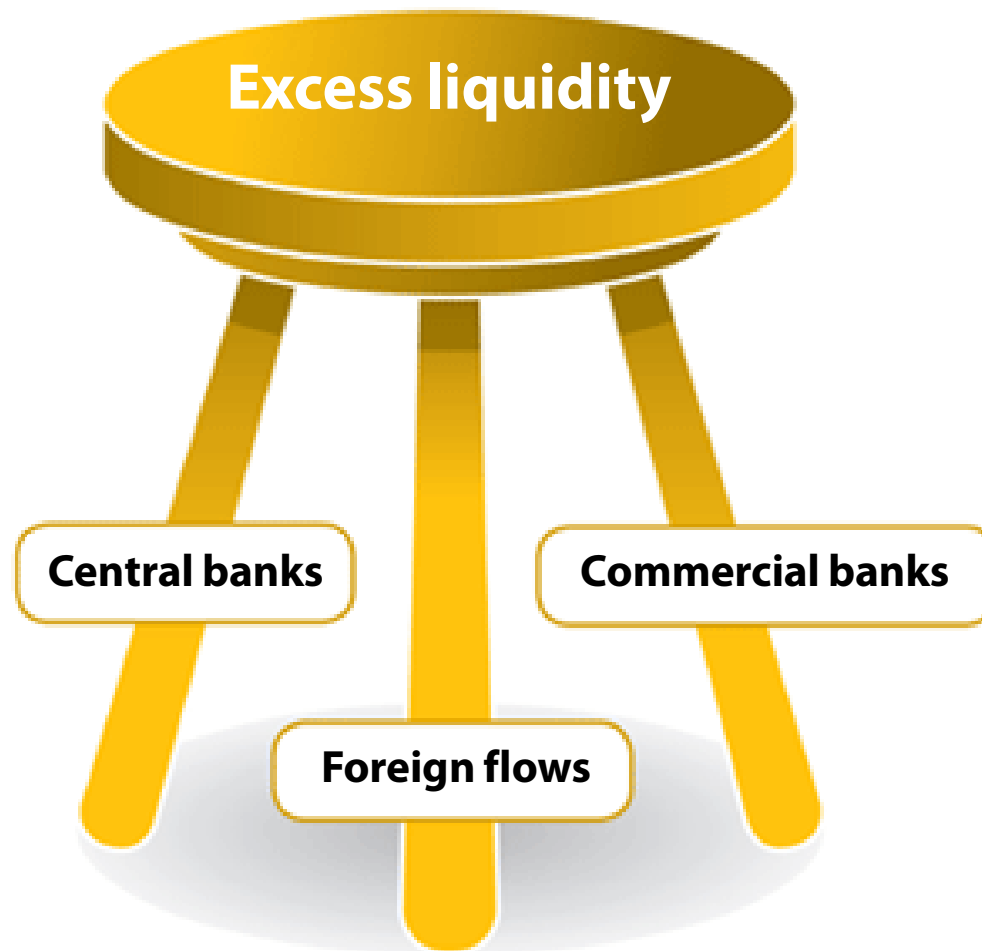
Does all this explain why equity markets are ripping higher?

China, Equity Indices on a Log Scale



Gavekal Data/Macrobond

Any market is driven by excess liquidity



China stands out as the major economy most likely to embrace easier policies

Japan? A further easing of monetary policy out of Japan seems unlikely now that the Kuroda-Abe relationship is reportedly more stressed (following Abe's decision to call a snap election right after the BoJ eased again).

Europe? Perhaps. Although the ECB has already announced a very large QE program and the ECB will likely want to see the impact of this initial QE program before announcing any new incremental measures.

USA? The US is now more likely to be on a tightening path.

UK? The UK is now more likely to be on a tightening path.

South Korea? Possibly—although if the Yen has stopped falling, then the pressure on the BoK will abate.

Australia? Very likely. Aussie rates are probably heading lower—with deep negative impacts for the AUD, and likely significant capital outflows.

India? Very likely. In fact, the RBI is already on an easing path.

China? We are there! China is already cutting, and short and long rates will likely go down from here.

Economic & financial consequences

China's geopolitical and financial liberalization strategy will have massive consequences for its economy and the world. Foreseeing all is impossible—but these seem very likely:

- **Reinforced commitment to a strong-currency policy.** China's strategy of integrating its neighbors into its domestic economy would be undermined by competitive devaluations. And China's vision of itself as the great power in Asia requires a strong currency. **The RMB will also stay stable in the run-up to the November IMF vote on SDR.** This means that, if nothing else, investors should feel comfortable reaching out for the extra yield on offer in RMB paper between now and November. In fact, why would you own any bond that was not a long dated Chinese RMB bond? **The RMB yield curve is set to absolutely collapse over the coming years** as Chinese bonds get re-rated from being "emerging market" bonds to being "reserve currency" bonds.
- **Being short China is a very dangerous proposition,** for when convertibility arrives—and it may arrive much sooner than people have been anticipating—the market will likely shoot up, if only under the weight of index buyers. If convertibility arrives, and China moves from less than Spain in the MSCI All Countries Index (1.7% weight) to more than Japan (10.6%), other markets will have to make room. At the same time, if 10% of the world's reserves move to RMB over the next decade, will this (all else being equal, which it never is!) put upward pressure on yields in the US, Europe and Japan? And what if 10% of the world's working capital and 10% of global trade starts being financed in RMB?
- **To be a successful reserve currency, China will have to push RMB abroad.** It can do this through a deteriorating trade balance (i.e. booming domestic consumption), through Chinese corporates buying foreign assets (i.e. what the Japanese did in the 1980s) or through a replica of the US's post WW2 strategy (i.e. replicas of the Marshall Plan, of the World Bank, of the IMF etc...). Clearly, policy is geared towards the third option (The Silk Road fund, AIIB etc...). This means that we are likely to see **an accelerating growth in outbound investments.** Financing foreign infrastructure projects, even at relatively low returns, is a more attractive proposition than keeping foreign reserves in low-yielding US bonds.
- **Falling interest rates and rising equity markets should help real estate form a floor.** And this, in turn, should abate concerns on the health of the Chinese banking system etc...

In short, every news item out of China in the past few months confirms that owning long-dated RMB bonds will offer some of the better risk-adjusted returns for the coming years, definitely against other bonds, but potentially against all other assets as well. But beyond that, how many investors have thought through the implications of China's rapid changes on their portfolios?

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