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A MILLION TO YUAN

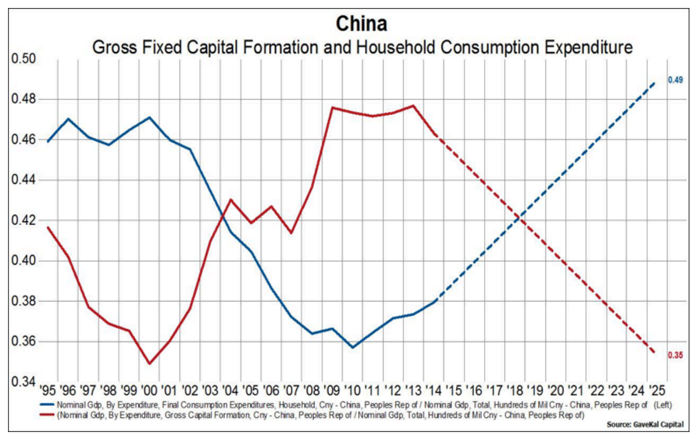
To suggest that what occurs in the Chinese economy is important to investors and business decision makers is an understatement. Growth in the Chinese economy over the last few decades has been nothing short of eye opening. Never in the economic history of the world has an economy grown so fast and accumulated such wealth over such a short period of time.

In very good part, financial market volatility we have experienced since the beginning of the year is related to two intertwined concerns regarding China – concerns over economic growth and the direction of the Chinese currency (Yuan). As we stated at the outset of this year, we believe what happens outside of the US (the non-US economy) this year will be most influential in shaping the domestic economic outcomes. We believe it is important to look at a number of very meaningful issues for China as these items have implications for the US domestic as well as global economies.

THE CHINESE ECONOMY AND THE STOCK MARKET

We need to realize that unlike the US economy and stock market, the direct linkage between the real Chinese economy and their own stock market is tenuous at best. The real crash we have seen in Chinese equities over the past 6-9 months does not preordain that their economy is necessarily falling apart. In fact, Chinese officials themselves acted to instigate higher Chinese stock prices back in 2014, all with the thought that their highly indebted companies could issue stock at higher prices and retire meaningful existing debt on their balance sheets. They are currently reaping the consequences of this failed market intervention policy of overinflating assets that are now feeling the inevitable pull of financial gravity. So in part, the decline in Chinese stocks over the last 6-9 months is only partially related to economic concerns and more a reflection of the downside consequences of government manipulation in equity markets.

Is the Chinese economy slowing? Without question, but are we looking at some type of veritable implosion? Not a good bet, although slowing in and of itself is a concern really for the global economy. Looking over the next two to three years, the key to the Chinese economy will be how it transitions from a largely export driven growth engine, to one more balanced between exports and domestic consumption. The following chart recounts the history of China's household consumption as a percentage of the total economy (GDP) set against the buildup of export manufacturing capacity (fixed investment) as a percentage of the economy. We rest at the very beginning of this rebalancing process between manufacturing and consumption.



Will this transition be linear? Will it be seamless? Neither of these are good bets, and hence near term global concerns about the immediacy of impact of the very large Chinese economy on global economic prospects. A major economy in transition rarely, if ever, moves in a straight line. There will be bumps along the way, which is one of the reasons global investors became jittery last August when China acted to initially devalue their currency. Those jitter have simply resurrected in the current year.

What lies ahead for the Chinese currency (the Yuan) and why is this important to global investors?

THE CHINESE CURRENCY – YUAN DOWN, MORE TO GO?

Before discussing the importance of forward Chinese currency trajectory specifically, it is instructive to step back and understand why relative global currency movements are so meaningful in the current cycle. You already know that at present, short term interest rates in the major developed economies rest near or

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below zero – completely unprecedented in market and economic history. In prior cycles where zero percent interest rates were never the norm, country specific interest rates acted as "pressure relief vales" between various economies globally. As an example, if a specific economy was experiencing slow growth amidst an otherwise healthy global economy, the central bank of that country could lower interest rates in hopes of stimulating its own economy relative to others. They hoped to gain a relative advantage. But when virtually all global short term interest rates are now set near or below zero, this pressure relief value or equalization mechanism is gone. The new pressure relief valve, if you will, then becomes relative currency values.

Quite simply, relative currency values are influenced by central bank money printing, otherwise known as quantitative easing. The thinking is that if a specific economy can "cheapen" its currency relative to its global trading partners, more of its now cheaper goods and services (priced in a cheapened currency) will be purchased in the global marketplace, all else being equal.

Is this something new on the global economic scene? Hardly. It has been going on in earnest for years now, China is simply late to the game. We have watched both the European and Japanese central banks print trillions in new "money," all in an effort to put downward pressure on their currencies, and it has worked in spades. The value of the Japanese Yen has fallen over 30% relative to the US Dollar over the last three years. For the Euro, it has been a 30% fall in 18 months. Although the Fed printed money from 2009-2014, once they stopped the relative value of the Dollar against global currencies rose over 20%.

Getting back to China, we need to remember that a longstanding Chinese policy had been to tie the Yuan to the US Dollar. With the 20% move up in the Dollar post 2014, the Chinese currency was dragged up with it, meaning Chinese goods and services became more expensive in Yen and Euro terms, just to mention two alternative weakening currencies. Set against a macro backdrop of very subdued demand and zero percent global interest rates, the only available path for China to attempt to stimulate its still largely export driven economy is to devalue its currency, exactly as Japan and Europe have been doing for years now.

So why does the market now seem more concerned with a Yuan devaluation than was the case with the very meaningful and already in place declines in the Yen and Euro?

DEFLATION – IT CAN HAPPEN HERE

Back in the early 2000's before Ben Bernanke became Fed Chairman, he authored a paper entitled, "Deflation: It Can't Happen Here." The paper dealt with the potential Fed response to a highly indebted US economy should it start to contract. Bernanke's solution was that the Fed printing of money (the printing press, as he called it in his paper) would produce enough inflationary tendencies to "inflate away" the debt burden. Inflation is a debtor's best friend and deflation a debtor's mortal enemy (remember US housing from 2007-2010?). The Bernanke solution was his exact playbook as Fed Chairman, but bringing this to our present circumstances, Bernanke was incorrect. Despite over $16 trillion in new money printed by central banks globally over the last seven years, the market is currently pricing in forward ten-year inflation in the US at just 1.5% - the lowest level seen since late 2009, and a key reason for what is playing out in China right now.

To the key point – Chinese currency devaluation is academically deflationary for the global economy. This is the risk investors are grappling with right now. We need to remember that the buildup of emerging market infrastructure and export capacity was a key investment theme of the last two decades. This "demand" underpinned the global economy in good part. In three short years ending in 2014, China used more cement than the US used over the entire 20th century. Does this give you a feel for the magnitude of prior period commodity demand that is now seriously in question?

We have watched the global commodity complex almost implode over the last 12-18 months. It's not just oil, but copper, lumber, etc. This simply tells us that the decades long theme of capacity buildout in the emerging

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markets is over, which leads to falling hard asset prices. Deflationary pressures are real, just ask anyone in the global energy business. In the US, the killer for the domestic energy business is that highly levered balance sheets are now meeting up with revenue generation that has dropped like a rock. This is very much a microcosm of why investors are now worried about the entirety of the global economy. Falling prices in a very highly levered global economy is not a prescription for strength, quite the opposite.

So now what?

The facts are what the facts are. China has no other choice at this point in the global economic cycle except to continue devaluing their currency. The key questions become, by how much and over what period of time? Either that, or the risks of recession and civil unrest grow meaningfully. Will a further Yuan devaluation necessarily be deflationary for the global economy? It depends. The risk is that China's trading partners throughout Asia act to further devalue their own currencies in an attempt to "stay even" with ongoing Chinese devaluation.

To further compound the problem, throwing gasoline on an open fire, we watched Japan a couple weeks back introduce negative interest rates in their country for the first time in their history. This is important as this act is clearly an attempt to further push down the value of the Japanese Yen against global currencies, including the Chinese Yuan, as Japan is also a major global exporter. We do not expect China to stand still in response to this further Japanese Yen devaluation attempt. Rather, we believe the Chinese will have no choice except to respond with tit-for-tat further devaluation measures of their own. We expect the European Union to also do more to devalue the Euro in the first quarter of this year. As you can see, this whole mechanism of currency devaluation can become self-reinforcing and a very tough cycle to break.

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Will further Chinese currency devaluation send a deflationary impulse across the global economy? To a point this has already occurred, especially in the commodity complex. Think Russia, Australia, Canada and many a commodity dependent emerging market economy. As we move into 2016, investors are correct to incorporate this risk into thinking and decision making. As to whether a larger deflationary impact is transmitted from China really depends on the response of other countries to what will certainly be further Yuan devaluation. Japan dropping short term interest rates into negative territory recently is exactly what we are referring to when we speak of the response of other countries.

The global economy can handle a little deflationary pressure, but not a lot. Reason being, the developed economies are more indebted today than was the case in 2007! As we said at the dawn of the current year, it is what happens outside of the US in 2016 that will have the most meaningful impact on the US economy. The relative global currency issue is just one of the issues inclusive in this comment. When we review the US economy and contemplate what the potential for heightened deflationary pressures means, it simply reinforces our thinking that 2016 will not be the year of the business of the US economy, but rather a year in which individual businesses fair quite differently in this amalgam we call the US economy.

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