China Devaluation

August 2015

Executive Summary

On August 11th, 2015 China rattled the global markets when it devalued its currency against the dollar by 1.9% (See Figure 1). This was the biggest one day move since China officially removed the yuan from its peg to the U.S dollar in 2005. As seen by the market's reaction, many investors were not expecting China to take such action. Here at MAP, it has been our view for the past year that the Chinese government would be forced to combat the effects of central banks from around the world devaluing their currencies. It was for this reason that we have remained vastly underweight compared to our benchmark in emerging markets, specifically in the Asia-Pacific region.

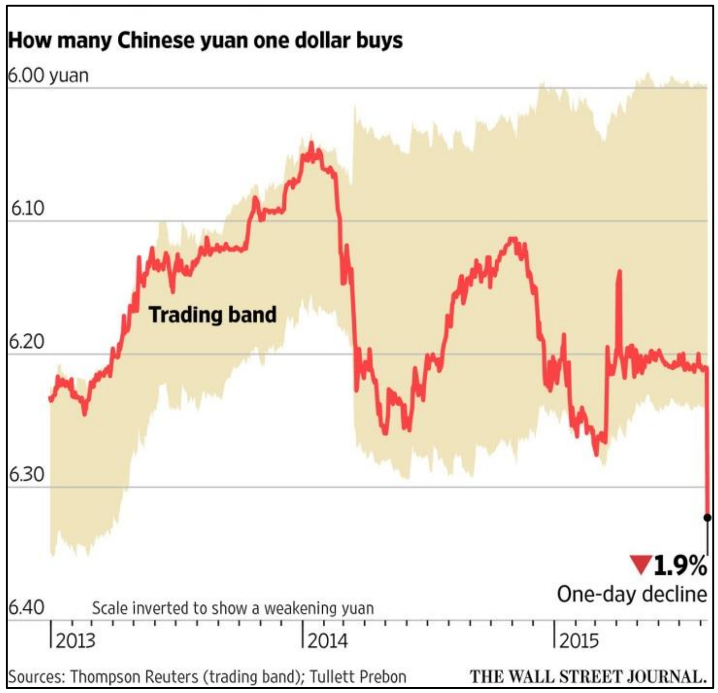
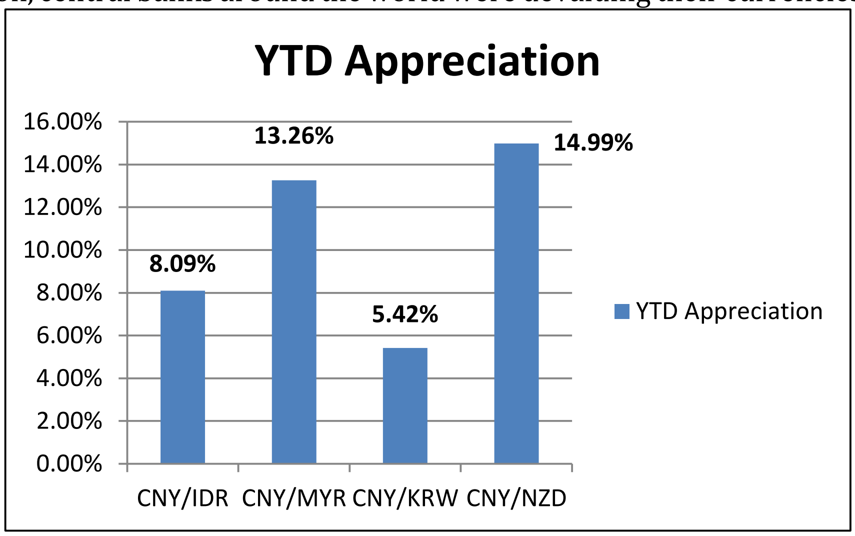


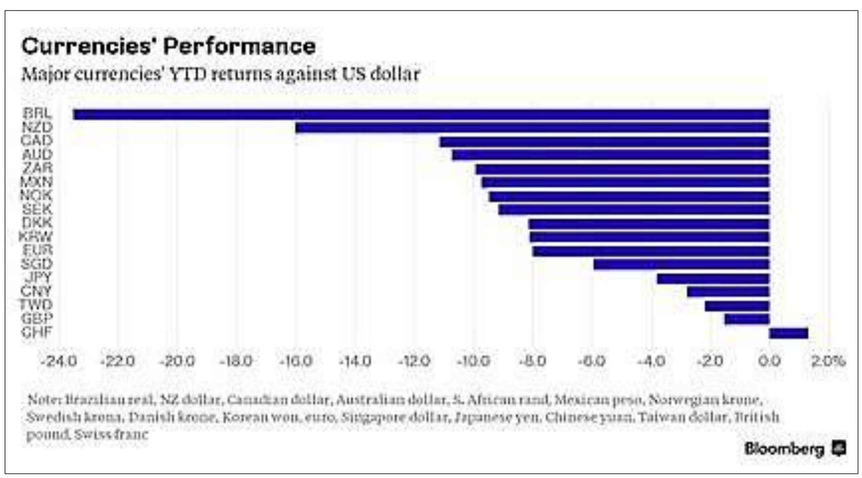
FIGURE 1

Now that the Chinese economy has begun to show the cracks in its armor, it is our belief that the government will continue to do whatever is necessary to stabilize its economy, including further devaluing its currency by up to another 10%. We do not believe, however, that the situation will get anywhere near as dire as it was during the Asian Currency Crisis of 1997-98 when East Asian currencies fell anywhere from 35% to 80%. Governments in the region have built up large FX reserves and kept their U.S dollar denominated external liabilities to serviceable amounts - and all run current account surpluses with the exception of Indonesia. A larger concern of ours is in the corporate bond market, especially amongst Chinese property developers, oil & gas companies and large industrials. Companies in these industries account for half of the entire U.S dollar denominated corporate debt in the country. Still, 70% of Asian corporates have broadly matched their U.S dollar liabilities with revenues and assets. This gives us the confidence that once the dust settles and the volatility in currencies dissipates, there will be some good opportunities in the surrounding Asia Pacific regions such as New Zealand and Thailand. The bigger development to watch out of this situation will be the effects on the U.S dollar which has the ability to be a major factor in the next U.S economic downturn.

Yuan Devaluation: Years in the Making

The devaluation of the Chinese yuan rattled investors around the globe because it came as a surprise to many; although, in our view it has been an action years in the making. While the world was recovering from a global recession, central banks around the world were devaluing their currencies. This was led by the Federal Reserve, which at one point devalued the dollar by more than 17% through QE and Operation Twist. Other central banks quickly followed suit, with the Bank of Japan allowing the yen to depreciate more than 30%, and more recently the ECB devaluing the euro through its own QE policies. At the same time, China's own economic situation has been deteriorating quite rapidly with imports, exports, PMI, PPI and industrial production numbers declining since the beginning of 2014. PMI officially reached contraction status being under 50, while exports and imports have both been declining year-over-year throughout 2015. This weakness has been felt around the globe with commodities like copper and oil dropping to their lowest points since 2009. The ripple effects of these depressed commodity prices has led to large currency depreciations for commodity exporting nations and their neighbors including many in the Asia Pacific region. To further the pain being felt throughout the Chinese economy has been the rise of the dollar against nearly every developed and emerging market currency around globe. With its currency being inadvertently pegged to the dollar, the yuan has appreciated against many of its Asia-Pacific peers. With China already losing its labor cost competitive advantage, its strong currency was further making its exports less competitive on a global scale. The PBOC (People's Bank of China) had already

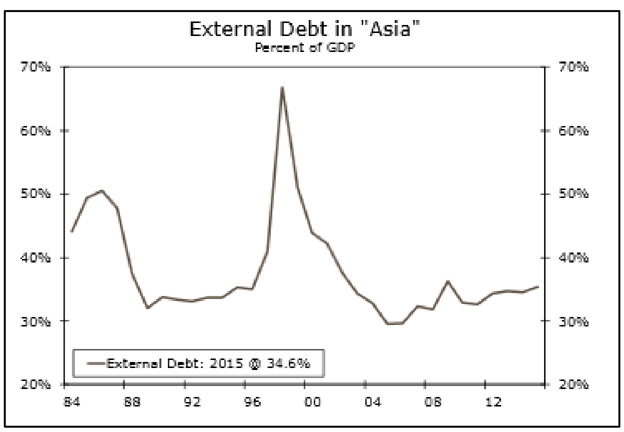


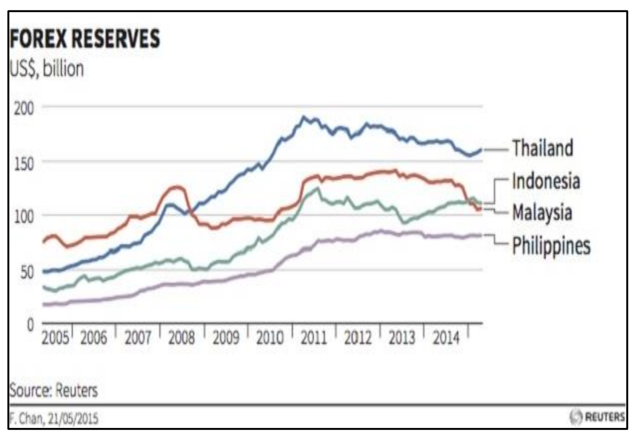


attempted to stimulate its internal economy by cutting interest rates four times since November and reducing reserve requirements, but its only tactic against the global currency depreciations was to devalue its own. We believe this will be more than a one-time event as a three percent devaluation will not make up for enough ground to combat the large scale currency depreciations going on around the world. We expect the yuan to depreciate by up to 10% over the next 12 to 18 months.

Asian Currency Crisis: Part II?

The devaluation of the yuan not only rattled markets, but it also raised concerns about another Asian currency crisis like the one experienced in 1997-98. We view this as highly unlikely for several reasons. To start, Asian governments like Thailand, Philippines, Malaysia, South Korea, and Indonesia are much more stable financially than they were in 1997, when a majority of their external liabilities were financed in foreign currency. These governments have also prepared themselves accordingly to step in and support their currencies while also covering their FX liabilities by building up large war chests of FX reserves. In comparison, during 1997 these countries each had less than $30 billion in FX reserves. Lastly, all of these countries run current account surpluses with the exception of Indonesia, which will provide support for their currencies. A bigger concern for countries in the region is that they are heavily dependent on China to import their goods and any weakness in the Chinese economy could further pressure their economies.





Opportunities

With all of the asset price turmoil being caused by declining commodity prices, weakening currencies, and overall soft global growth, the Asia Pacific region is beginning to present some intriguing opportunities at discounted valuations. Taking that into consideration, it is critical to be very selective and meticulous in the analysis of the opportunities. While 70% of the Asian corporations have broadly matched their FX liabilities to their FX revenues, some industries have ratcheted up the FX debt beyond a sustainable level. In a study done by Morgan Stanley, they noted that specifically Chinese property developers, utilities, materials and industrials have taken on large amounts of FX leverage, which puts them at a greater risk of defaulting on their U.S dollar denominated debt. We have already witnessed one Chinese property developer, Kaisa Group Holdings Ltd., default on its U.S dollar debt. This could prove to be an isolated incident, but it demonstrates the risks that are associated with Asian companies that have high leverage, especially on the FX side, now that the yuan is being more driven by market forces. With that in mind, our main focus will be on the peripheral countries outside of China including New Zealand and Thailand in the consumer staples and exporter businesses. We our scouring for companies with strong balance sheets and a minimal amount of FX leverage, that will benefit from a weaker currency and lower commodity prices. Still, we are worried about continued currency volatility and will remain patient until the storm dissipates.

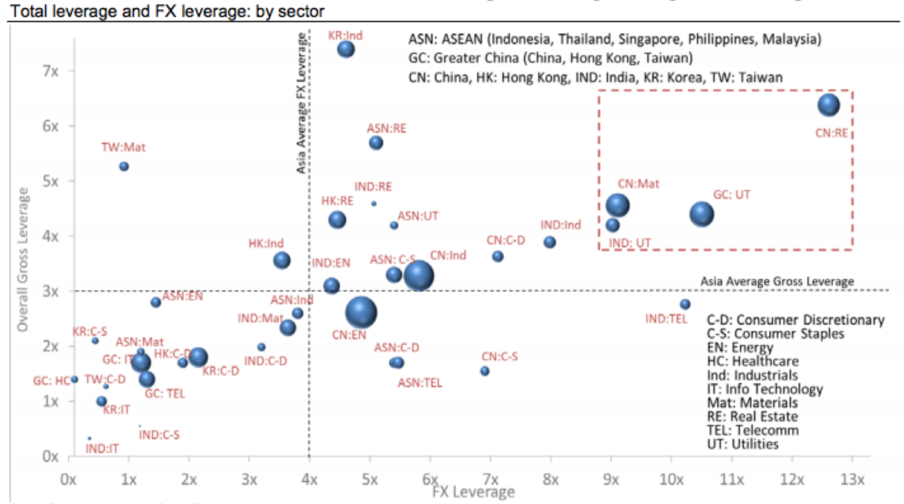
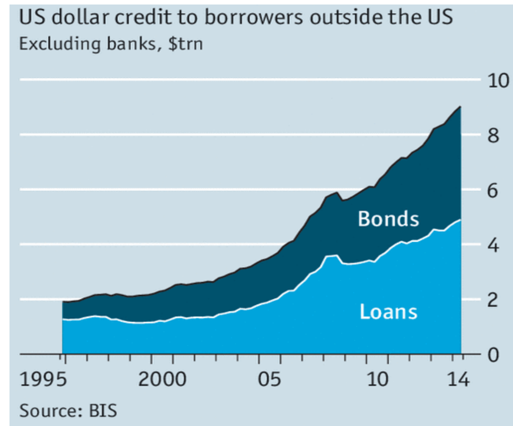


Exhibit 14
Where Are the FX Vulnerabilities in Asia? Where There's High FX Leverage *and* High Total Leverage
Total leverage and FX leverage: by sector

Source: Company data, Morgan Stanley Research

Strong Dollar: Cause for Concern



While weakening foreign currencies around the world and a devaluation of the yuan have definitely given investors a reason to pause, our biggest concern is the continued strength of the U.S dollar. In our view, it has the ability to derail the already anemic economic recovery and put the U.S. into its next economic downturn. The problem is that the fundamentals around the globe set up positively for continued dollar appreciation. Currently, there is a $9 trillion carry trade that has the ability to power the dollar much higher as weakening foreign currencies can give investors reasons to dump assets outside of the U.S. This is especially true if the Federal Reserve begins to raise interest rates and the growth in the U.S. outpaces that of many other economies around the world, as investors will begin to pile into the U.S dollar denominated assets pushing the dollar higher. Finally, U.S dollar liquidity has been shrinking with lower commodity prices since a majority of transactions are conducted via the dollar. All of these factors have the ability to push the dollar index well above 100, which might force the Fed to rethink its position on adjusting the U.S dollar market rates.

Conclusion

While the recent decision by the Chinese government to devalue its currency surprised many market participants; we have anticipated this for the past year, which is why we remained underweight in the Asia Pacific region. Central banks from around the world, including the Fed, ECB, and BOJ, have devalued their currencies since the global recession. This compounded with the fact that the Chinese and emerging market economies have been deteriorating for months; forced the government to take action. After a multitude of failed stimulus measures including interest rate cuts and lowering reserve requirements, the PBOC was forced to take action by lowering the yuan. We do not view this as a one-time event and believe the yuan could depreciate by another 10%. This will continue to spur the volatility in many of the peripheral Asian markets, but when the dust settles there will be a multitude of good investment options available to the patient investor.

As mentioned before, we doubt if these events lead to another Asian currency crisis. The Asian governments have strengthened their balance sheets by reducing their reliance on FX external liabilities; have bulked up their FX reserves to support their currencies and all, except Indonesia, run current account surpluses. These factors should help alleviate any sharp depreciation on the currency that will have a long lasting effect on the regions economics. We do have some concerns in the corporate market where some parts of the market have taken on large amounts of FX leverage. The industries to approach with caution are the Chinese property developers, materials, industrials, and utilities. Our biggest concern is the effects that these weakening markets and depreciating currencies have on the strength of the U.S dollar. With the previously mentioned current dollar carry trade going on globally, coupled with the potential for currencies to continue to weaken, investors could begin to pile back into safe haven U.S assets. This move could be exacerbated by an increase in emerging market credit risk and the Fed increasing rates too soon or too fast. With that, it is our view that the weakness and volatility in global markets will force the Fed to further delay any type of action involving interest rates until at least 2016. Once they do begin to raise rates, it will be at a much smaller and slower pace than the current FOMC dot plots indicate. If the Fed does start to hike in 2015, they will push the U.S into an economic recession.

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