CERNO CAPITAL

Investment Letter dated 14th September 2015

Sinology used to be a specialist occupation of a few classically trained civil servants: it lead to a career in the foreign service and postings to Hong Kong and Beijing. Suddenly, everybody is a sinologist. We have described the change in fix of China's currency on August 11 as a regime change http://cernocapital.com/rmb-regime-change/

On reflection, that perhaps accorded the Chinese authorities too much forethought in the matter. The true state of affairs may have been more akin to a *crise de confiance* brought about by some very poor export data against the prospect of the first rise in US interest rates since 2006. In the context of the RMB's appreciation versus neighbouring currencies, the move has economic rationale (and some smokescreen cover with the context of introducing more flexibility to currency management), however, by making such a small move and then backing away from the policy on August 14, the authorities ceded some influence, respect, not to mention a big round amount of foreign exchanges reserves, whilst gaining very little in relative export pricing.

In the global currency race, China is shackled.

The steep correction that then ensued and rippled round world equity markets in an indiscriminate fashion, has been directly linked with with China's currency move. However, conditions precedent to this correction were in place. Key markets, in particular the S&P 500 had lost momentum, market breadth was faltering and industry sectors, formerly at the vanguard, were rolling over or topping out.

Before this letter went into recess in July, we observed that almost half the world equity indices had entered a corrective phase. That correction was, at that time, sub cutaneous as it had not subsumed the S&P, FTSE 100, EuroStoxx 50 or the Nikkei. When it did in August, the correction became patently apparent and has been sufficiently sharp to be deemed a 'market event'.

In the game of expectations against what is priced, the moderation of China's growth is now widely recognised, even if the investment industry offers no clear consensus as to the likely outcome with regard to its currency.

Our own rationale for maintaining a short on the RMB, even if a further devaluation of greater magnitude is dependent on future USD strength (which is not a given), is that the possible size of the move makes the payoff attractive, <u>even if this is not the most probable outcome</u>.

Premier Li Keqiang's comments (in Dalian on September 10, captioned at the end of this letter) at the G20 summit tell us that he judged the present risks of not offering a clear rebuttal to his central banks nascent policy larger than the future risk of not having been entirely truthful (in the event the currency was once again weakened by fiat).

Capital flight, which is becoming a more enduring phenomenon in China, is a lopsided consequence of capital account opening. Whilst its effects are moderated as net trade expands, net trade is currently expanding on account of imports falling away. That in itself is a weak indicator. If weak importation presages weak exportation, capital flight will only be too noticeable and those legendary reserves shrink more rapidly.

The "contract" between the Chinese people and their authoritarian rulers is the barter of restricted freedoms for a strong economy. In a historical context, we have now entered an era where this contract may bear greater scrutiny.

This week we will discover whether Governor Yellen and her colleagues at the Federal Reserve respect the logic of their domestic data, exercise the tininess of their ears and raise rates irrespective of the agencies (IMF, World Bank) who have suggested they demur.

The writer's viewpoint is that they should and will, against the general indication of markets. That said, either decision would be understandable and explainable. To our thinking, the additional information to be gleaned from an unexpected hike relates mainly to how markets respond and specifically the Emerging Market complex.

We are not invested in EMs and have not been for several years. We look forward to new opportunities in the group as value begins to emerge even as risks mount. If the next rise in US rates results in a deepening of the severe bear trends already at work in EMs, then valuation lows will arrive quicker. If the complex exhibits unexpected resilience then that will speak to some shallowing of the profile of their bear markets.

As ever, currencies are at the vanguard of these phenomena and need to be handled with care.

So, to conclude, we know that financial assets affect real economies (2008 springs to mind).Therefore, there is a healthy debate to be had as to whether further extreme, self-serving action on the Chinese currency would give rise to a deflationary wave that would undermine global corporate profits.

Our judgement today is that this is not yet the highest probability outcome. We therefore wish to remain constructive towards our identified themes, whilst flexible in our overall portfolio settings. This entails holding a portion of assets in cash while value emerges.

The investment team at Cerno Capital is working hard on a number of investment ideas in several different asset classes across the world and forthcoming investment texts will describe this work in detail.

James Spence
Managing Partner

/ translated comments of Li Keqiang captioned below (Source: Xinhua News)

Li Keqiang: "I wish to draw your attention to one fact: Since the formation of this government, the real effective exchange rate (REER) of the RMB has appreciated 15%. As many currencies significantly depreciated against the dollar recently, developments on the international markets compelled us to adjust the quotation regime of the RMB central parity. Yet it was a small adjustment. Overall, the REER of the yuan has appreciated by a large margin during the term of this government. The truth is, after the small adjustment, the RMB exchange rate is now basically stable. There is no basis for continued depreciation of the RMB, because the Chinese economy has been operating within the proper range, we have ample foreign exchange reserves, and surplus of trade in goods has been rising. All these show that the RMB exchange rate can stay basically stable at an adaptive and equilibrium level. Yet as the Chinese often say, in some circumstances, one may get caught up in the middle of something unrelated.

We have no intention to boost exports by devaluing the yuan. This is not in keeping with our policy of structural adjustment. Still less do we want to see a global "currency war". As the Chinese economy has become so highly integrated into the global economy, a "currency war" would only bring more harm than good to China. As a matter of fact, after the small adjustment of the exchange rate, I once talked about this with relevant departments and some export-oriented firms in China. They said they hope the RMB exchange rate will remain basically stable at a reasonable and balanced level. Should there be market expectations of continued depreciation of the yuan, these companies could hardly get any long-term export order. How could this be beneficial for China' s exports?

As you know, commodity trade takes up a large part in China's total foreign trade. Between January and August this year, China imported 220 million tons of crude oil, up by 10% over the previous year. Soy bean imports rose by 7%, and iron ore imports were over 600 million tons, more or less the same as last year. However, commodity prices have dropped significantly, with some plunging 40-50%. We have been affected as a result. There were less tariffs and hence the strains on China' s public finance. But commodity prices are not something for us to decide. Total import volume has not declined, yet the value of imports has come down as a result of falling prices. Who should be held accountable for this? It is a topic that can be further discussed and debated. If international commodity prices rebound, we would get more import tariffs. This would mean more public money to spend on improving people's lives. There would be change in the PPI too, which is beneficial for improving corporate profitability and performance. This is an issue that requires joint efforts for a solution.

As for internationalization of the RMB, it should be a market-driven process. It needs to fit China's reality of economic development and will take some time. We will gradually achieve full convertibility of the RMB under capital accounts. One thing is certain: a continually devaluing RMB is not conducive to the RMB internationalization process. This is not our policy orientation. China wishes to join the SDR, not just for making the RMB more internationalized, but also for fulfilling China's due international responsibilities as a big developing country. China is not a source of risks for the global economy; China is a driver of world economic growth”.