HindeSight

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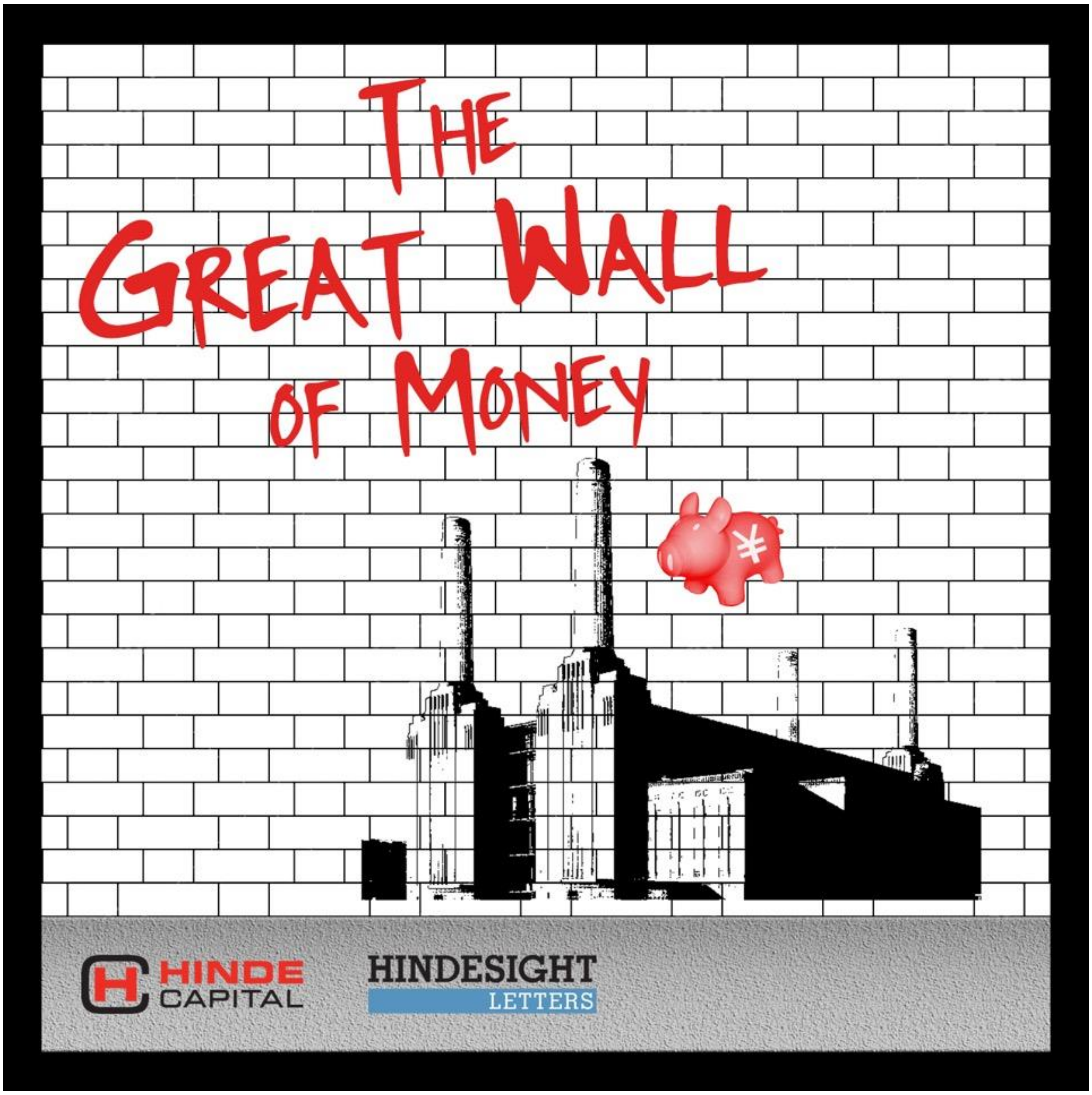


"It doesn't matter if the cat is black or white as long as it catches mice."

Deng Xiaoping, 1904-1997

On the 1st January 1994, the PBoC moved from a dual-track currency system to one transparent reference rate for the renminbi against the USD, the Hong Kong dollar and the Japanese yen based. This was based on the weighted average price of foreign exchange transactions of the previous day’s trading, marking a new stage for the exchange rate regime. China had taken both its first major foreign exchange wager and step to Yuan liberalisation.

Over two decades later, on the 11th August 2015, the Yuan experienced another sudden depreciation. The PBoC lifted the daily USD/CNY exchange rate fixing to 6.2298 – a 1.86% devaluation compared to the fixing of 6.1162 on August 10th. To put this in perspective, just in case we get lost in the hyperbole, the 1994 dual-track system amalgamation of the official rate of 5.8 and the swap market rate of 8.6 was effectively equivalent to a rather hefty 33pc decline of USD/CNY. So it's not so much the magnitude of the devaluation that interests us this time but the cause and intent.

Has the PBoC signalled what could be the final step in a well thought out, two decade long exchange rate management process before it fully liberalises and floats the Yuan? Or has this move been an unavoidable step of economic pragmatism (panic). rather than true reform? And is it part of a veiled attempt to appease IMF officials for SDR inclusion?

The Communist Party (CP) is desperately trying to keep China's economic growth from falling precipitously. They seem to be acting reactively rather than along a continuum of proactive policy making. Reading the clarity of decision-making is comparable to observing the Air Quality Index (AQI) of Beijing – it’s foggy and toxic.

Chinese leaders have seemingly escalated their panic gambling to keep their country on the 'rails'. Our recent July HindeSight Investor Letter – ‘Another BRIC in the Wall’ – documents our analysis of these wagers to rebalance SOEs debt-for-equity by propagating and encouraging stock market investment. It failed spectacularly, as the stock mania they cheer-led flamed out with debt-for-debt accumulation, rather than debt-for-equity. To add fuel to the fire, their *dictat* to arrest the fall in their stock markets caused a searing backdraft, which is now burning stock gains down to ashes.

Rather alarmingly, we see this currency move coming hot on the heels of a series of other policy gambles. We say 'policy', as if this infers there was some game plan, we don't mean it to. It would appear they are 'all-in-gambles' and the CP and PBoC have sadly resorted to age old 'fixes' by devaluing the Yuan to prop up exporters. Some habits are just too hard to break. It is true though that in opening up to markets in a period of such instability, they are now at the mercy of the very markets which they aspire to join. The transition was never going to be easy from a command economy to a more market-based economy. In our opinion, they have remained closed for far too long and now their ecosystem is too unstable to handle the realities the market will meter out to them.

The China 'Miracle' has been a real growth story with China rocketing from the 8th to the 2nd largest economy by GDP and trade. Their stature in international finance has likewise started to catch up, as the Yuan emerges as a major international currency and the set-up of the Asian Infrastructure Investment Bank suggests they feel emboldened to muscle in on global governance. We find it highly ironic that at the precise moment China is feted to become the next reserve currency, their economic system is contracting and alarmingly so. Unfortunately, like most economic cycles with a boon, the miracle is less productivity achievement and more about credit accumulation. China's economy became underpinned by excessive credit expansion, except it was on a monumental scale to anything history had witnessed before.

The Chinese currency devaluation has heightened macro risks in an environment of heightened Chinese policy uncertainty. The fear of sustained currency depreciation and risks of capital flight are palpable. The media has sensationally labelled China as yet another currency war beggar. If central banks (CB) acted in unison before, it’s now each CB and country for itself, as the parcel of rotating domestic liquidity is passed from one country to the next and back. First one devalues and eases, then the next follows suit and so on, and so on, until an end game is reached – with reduced productive output everywhere. China has admonished and rebuked market commentators for insinuating that this is the beginning of a concerted devaluation to improve both domestic liquidity conditions and their terms of trade with the rest of the world. They have no choice but to devalue. In reality, the market will force it upon them, as on a REER basis the country is expensive.

China is in severe trouble and that trouble has already been reverberating around EM exporters for a number of years. It is just one of many dollar currency peg countries that have experienced tightening conditions because of higher US interest rate guidance and dollar strength. An unwelcome addition to their own domestic issues, but always a circular outcome, as they are inextricably linked to the US by their Bretton Woods II relationship. By devaluing and thus de-stabilising the 'nominal' anchor for Asian exchange rates, they will crush the growth engine of the developed countries on whose consumption they so rely on.

Since 2009, we have forecast and documented the unwinding of the Bretton Woods II currency system. Financialisation of our economies and markets, which escalated post- 2008 at the instigation of governments and central bankers, is going to go into full reverse for all asset classes. So entwined are economies and markets that a drop in asset classes will lead the world back into recession. In 2013, we believed the odds had tilted firmly towards increasing debt deflation at the hands of China. Large current account deficits had led to unsustainable debt creation, and as a consequence the trade deficit countries were the first to experience a severe financial crisis. However, on the other side of the equation, the surplus countries were now experiencing their reaction to the crisis.

In November 2013, we wrote: **"The deleveraging process which began in 2008 has been a slow burner but is likely now in full swing. The deflationary risks are very high. China is the driver. All eyes on China."**

We conceive that this slow-burner of deleveraging, which has occurred since the 2008 crisis, is potentially about to engulf all asset prices. **We are beginning to think the unthinkable – that just maybe asset prices will back up 20 to 30% and fast** and that this fall we could experience even greater price depreciation.

Almost 8 years on from the GFC, the Dow Jones Industrials are perched on the edge of a sharp drop. Will the Ghost of 1937 revisit us eight years on from the Great Crash of 1929, when U.S. stocks and the world economy got roiled all over again? This is already unfolding as we speak. Sean Corrigan's macro analysis in our 'MidWeek Macro Musings and Money, Macro and Markets' at HindeSightletters.com has highlighted where the fissures are opening in the global economy and markets. We are posting samples of our work from May to July in this letter to share how we began to believe that a global asset crash is at hand.

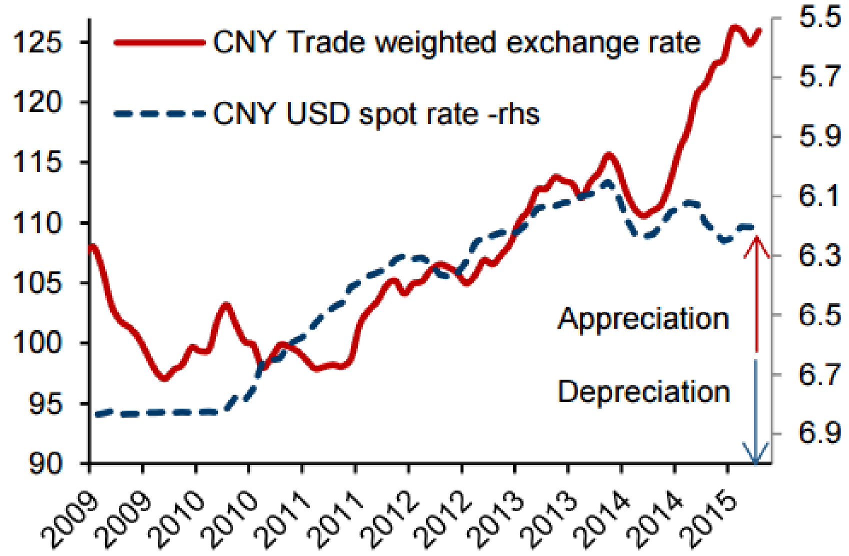
The Yuan movement may well send more Chinese capital floating across the globe into financial assets and real estate, such as those at Pink Floyd's and London's iconic Battersea Power Station, but it will be short-lived. The debt deleveraging which has been engulfing Emerging Markets has just begun to turn into a ranging inferno, which will eventually burn down all, especially overpriced global assets.

Since the GFC, 'The Great Wall of Money' that Bretton Woods II has furnished via its vendor-financing relationship, has masked the deleveraging of our world economy. The Great Wall is about to collapse and fall.

A Probable Trinity

In October 2010, we began our oft repeated narrative about the vulnerability of the Bretton Woods II monetary system in the provocatively entitled letter - 'The World Monetary Earthquake - The Dash from Cash' (The Orient Perspective). The financial literati at the time had just begun to catch on to the idea of 'beggar-thy-neighbour' currency devaluations. There was a subtle nuisance to this though, which had escaped them. The People's Bank of China (PBOC) had announced in June 2010 that it had decided to proceed further with the reform of the RMB exchange rate mechanism and to enhance the RMB exchange rate flexibility.

CNY TWI Expensive



Source: Credit Suisse

However, instead of competitive devaluation, China was seeking *competitive* diversification, by buying foreign bonds other than those from the US. In this case, they were primarily Japanese government bonds. The impact of which was to help strengthen the Yen. This led Japan and other countries in the region to intervene in the FX markets to issue more domestic currency to stem such strength. So, whilst the PBOC hadn't itself embarked on devaluation, we felt their actions would usher in a wave of devaluations via the FX market and / or in the form of Qualitative and Quantitative Easing (QQE) around the world. This, in turn, would help fuel the on-going asset boom in Western equities, bonds and real estate.

Since that time, when we first discussed the dash from cash and the potential impact on equities and bonds, there have been over 500 interest rate cuts. Some of these were co-ordinated and some because countries had no other choice but to cut, in order to maintain liquidity in their economies and fair terms of trade. We have also witnessed trillions of QQE amongst the major trading countries around the world.

Back then we made an analogy between the **TR**il**EM**m**OR** of the Japanese and an economic trilemma:

"On the 2nd Sept 2010 the Japanese government conducted the largest ever disaster drill, under the scenario in which three massive simultaneous earthquakes struck a wide area along the Pacific coast in central Japan. This was the first of many drills undertaken on Disaster Prevention Day, which was established to mark the anniversary of the Great Kanto Earthquake of 1923, when over 100,000 died.

A 'Trilemma' (or the 'Impossible Trinity') refers to a difficult choice from three options, each of which is (or appears) unacceptable or unfavourable. The Japanese **TR**il**EM**m**OR** of a three-way earthquake leaves a horribly difficult choice of where to assign resources most effectively. Two is possible three unlikely. But this is not the only trilemma that has besieged the Japanese."

Japan suffers from an International economic trilemma.

An economic trilemma (Mundell–Fleming) is a conundrum that befalls all countries. It expresses the logic that there is a choice among three favourable options, only two of which are possible at the same time. Or, to put it another way, it is impossible to have all three of the following at the same time:

- A fixed exchange rate.
- Free capital movement (absence of capital controls).
- An independent monetary policy.

All countries in theory want to achieve the following:

Make their economy open to international flows of capital. Capital mobility lets a nation's citizens diversify their holdings by investing abroad. It also encourages foreign investors to bring their resources and expertise into the country.

Use monetary policy as a tool to help stabilise the economy. The central bank can then increase the money supply and reduce interest rates when the economy is depressed, and reduce money growth and raise interest rates or reserve requirements when it is overheated.

Maintain stability in the currency exchange rate. A volatile exchange rate, at times driven by speculation, can be a source of broader economic volatility. Moreover, a stable rate makes it easier for households and businesses to engage in the world economy and plan for the future.

The Chinese trilemma is a special case in point though. As a command-based economy, China has not necessarily wanted to allow its citizens access to capital mobility, whilst at the same time wishing to participate in the capitalist miracle of industrialisation. This could only really be fostered by a monetary credit machine and access to international capital markets, most notably via open trade.

Japan, on the other hand, has adopted a different response to the trilemma like the US. Both US and Japanese citizens can invest abroad, and foreigners are free to purchase stocks and bonds on their domestic exchanges. Monetary policy is implemented by both, but at the expense of a more volatile currency. Both are subject to the vagaries of this BWII USD/CNY peg.

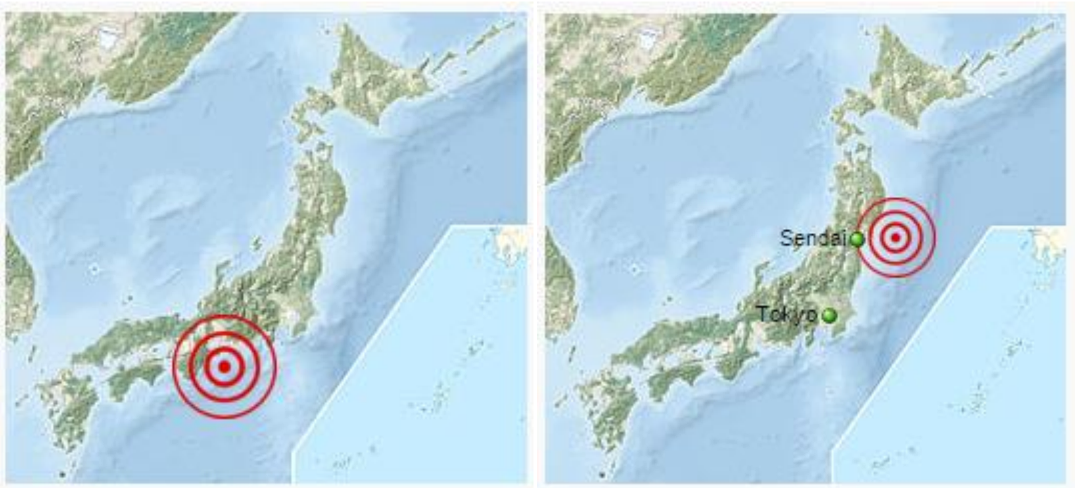
Japan has had a history of conflict with China that pre-dates this currency arrangement, and their prolonged distrust of each other has been aggravated by China's management of the 'dirty' float. Japan has responded consistently to the China revaluations, which exerts upward pressure on the yen by intervening forcefully in the free floating yen dollar rate. This fractious relationship has helped fuel the global asset boom, by what was termed the 'global carry trade'. Japan exported capital to the world, due to its low interest rates and weak yen, which made it an attractive funding currency.

In March 2009, PBOC Governor Zhou expressed his own frustration with this global trilemma. He called for a new reserve currency for the World (non-US), "that is disconnected from individual nations and is able to remain stable in the long run, thus removing the inherent deficiencies caused by using credit-based national currencies." This was a clear reference to the US and the Triffin dilemma a country faces when acting as holder of the world reserve currency. Such a country will have to run a current account deficit to meet demand for its currency. A prolonged and growing deficit undermines confidence in that currency, which undermines its integrity as the reserve currency. A country cannot simultaneously run a balance of payments current account deficit and surplus at the same time. Ever since this statement China has continued to reduce its dependence on the reserve dollar standard by setting up bilateral trade agreements and Yuan trading centres around the world. The renminbi-dollar currency plate tectonics that really define our current monetary system have been colliding ever since.

Since then, events in Japan since have had a defining impact on these plate tectonics. Little did we know at the time of writing, that the Tohoku earthquake (right image) would strike within six months, on March 11, 2011. It was the 4th most powerful earthquake in the world since seismological record-keeping began, and unleashed a tsunami with waves reaching over 40.5 metres. The tsunami inflicted over 18,000 deaths (2,584 missing, assumed dead) and circa 6,000 injured. It destroyed 3 nuclear reactors, Fukushima Daiichi being the most badly affected. This effectively ended the country’s nuclear power program, as fear over radiation leakage remains to this today.

In 2010, the Japanese were more concerned about a repeat of the 1944 Tonankai earthquake (left image), which just goes to show no government has omnipotent knowledge, especially when it comes to the unpredictability of nature.

Japan, which was already struggling under the burden of too much indebtedness and ageing demographics became crippled by a new burden –_ that of heightened energy import costs. The loss of its cheap source of nuclear power exposed its industrial fragility and reliance on external energy sources.



Faced with his own trilemma, Prime Minister Abe undertook radical measures to reignite his countries growth and announced a war chest of QQE and reform programs. The Impossible Trinity has such probable outcomes.

Tragedy of the Commons

As the traditional English folk tune rhymes, "*Tinker, Tailor, Soldier, Sailor, Rich Man, Poor Man, Beggar Man.... Thief"*. Rich or poor, you beg from your neighbour. There is no two ways about it in the world of current accounts – you are a thief. It is politically more savoury to expropriate the output from another country, unfortunately this will be at the loss of the majority.

Ever since the crisis first arose in 2007, global GDP has been anaemic. The inevitable conclusion of most countries today is that the best way to extricate themselves from the current mess is to shift effective demand away from imports onto domestically produced goods. The preferred method is competitive currency devaluations.

Unfortunately, this is not possible for all and leads to friction as countries effectively steal other nations output to bolster their own. Plato and Aristotle referred to this as 'overgrazing', then 'tragedy of the commons' (people). Nothing changes. This always leads to heightened tensions and conditions of capital controls and other protectionist behaviour, such as punitive tariffs and quotas on imports often prevail. Friedman's flat world aside, it is already happening.

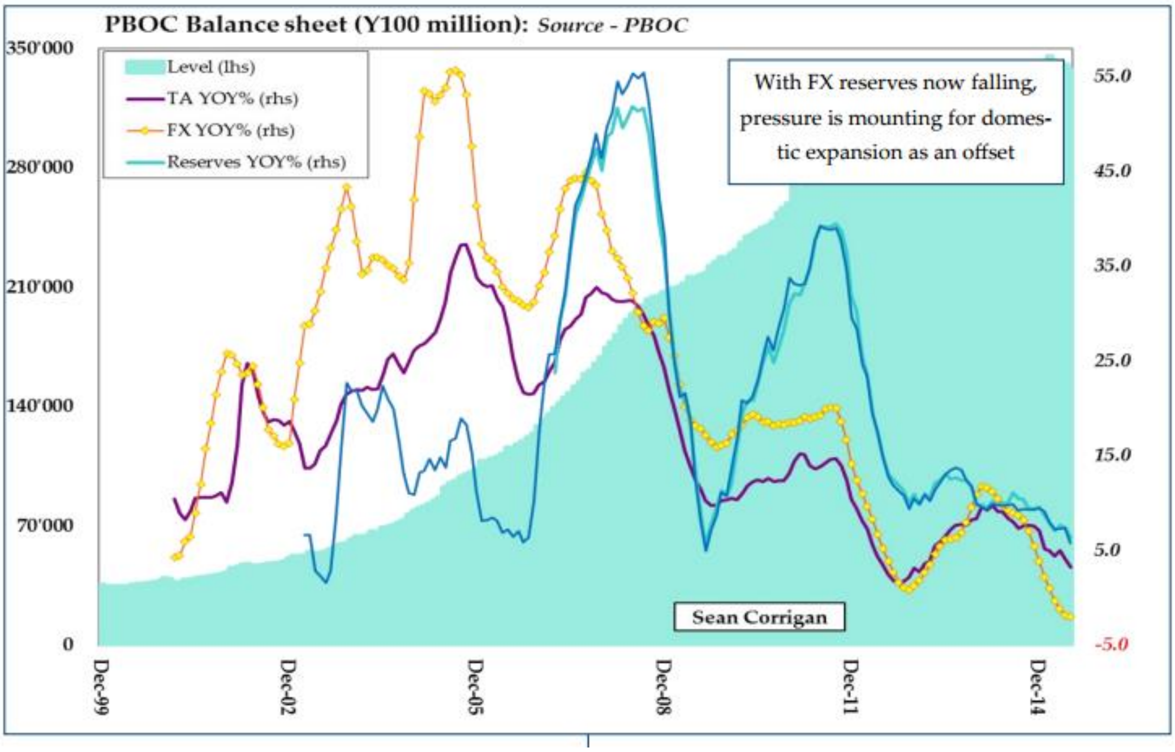
The use of currency devaluation as a means to erode the debt problem and as a means of stimulating exports to grow revenues, always creates international friction. Japan precipitated over the devaluation of its currency under Abenomics, which negatively impacted China's ability to export cheaply within APAC.

To alleviate the blame for economic woes and misery at home, both countries have diverted attentions by raking up age-old enmities, as symbolised by the ownership dispute over the Senkaku or Diaoyu islands, as they are known in Japan and China respectively. The governments in both countries have polarised sovereign identity and ownership internally and turned nationalistic unity outward as a means to prevent the inward cannibalisation of their own power base. Globalisation and technology had done so much to recede such frictions over the past few decades as individuals and not governments communicated at the inter-personal level. It is such a shame to see governments undoing this connection.

Yuan More Time

Despite PBoC protestations, this Chinese currency move is not a one off event. There will be many more devaluations because, as you will read, FX reserves can abate rapidly. Besides which, we believe the markets have them on the back foot. The PBoC very forcefully stated that the currency move was a genuine reformist undertaking. They argued that China's resilient growth, current account surplus and abundant foreign exchange reserves mean there is no basis for sustained depreciation. They referred to calls for a10 percent depreciation as nonsense.

PBoC FX Reserves are Falling



The PBoC and CP, who for so long ran a command only economy, have resorted in desperation to more open market tactics to bail-out their economic collapse. At a time of such economic instability it seems highly imprudent to add such a dynamic to the mix. The more they open up the more they have had to bow to market pressures brought to bear on economic reality. The Yuan move may be less a gamble than the fact they had no choice. The market pressure exerted by the weakening offshore CNY (CNH) and an onshore CNY, which was closing at the weaker end of its 2 per cent trading band, forced the issue. In fact, from June to July the PBOC had responded to this market behaviour by spending ~ US$350bn in FX reserves, just to maintain the Yuan peg to the dollar where it was. The PBoC's FX reserves have fallen from US$4 trillion to US$3.65 trillion in that time.

There will be a substantial impact on FX reserves from any attempt by China to create a "managed float" with a downward CNY drift. Under these conditions, Chinese and global investors would be incentivised to sell the CNY, while Chinese policymakers would be forced to sell dollar FX reserves to provide the necessary exit for such players and smooth CNY weakness.

The CNY 12 month non-deliverable forward is telling the PBoC they are wrong, just as the offshore CNH had been forcing the issue of devaluation on the onshore spot market.

Until last week, the USD/CNY worked like this: each day the PBOC would set a reference rate for the Yuan against the U.S. dollar and limit moves to 2 percent on either side. It also bought and sold the currency to influence the exchange rate, thus having knock-on effects on the liquidity situation at home.

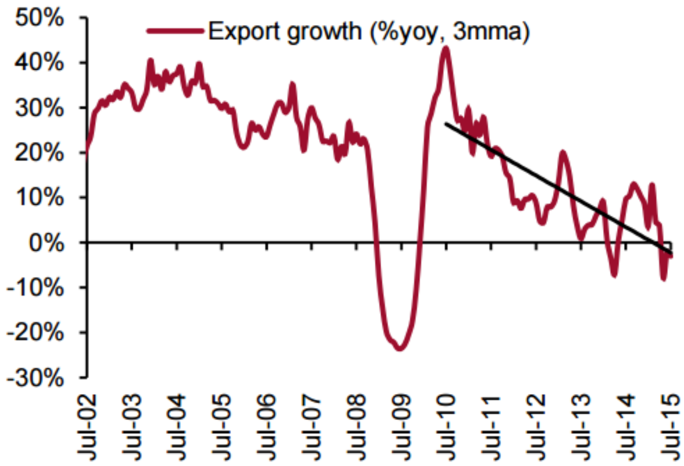
So for most of the past decade, that meant printing and selling yuan and buying dollars to keep the currency from strengthening too much. This resulted in a foreign exchange hoard of almost $4 trillion and a broad money supply of 135 trillion yuan ($21 trillion), which is almost double that of the US's level. To offset the resulting liquidity surge, the central bank would lock away funds by raising the ratio of deposits that lenders had to park at the PBOC as reserves.

This modus operandi went volte-face over the last year. As the Yuan appreciation pressure shifted to depreciation pressure, and as more capital began moving out, the PBOC found itself on the defensive. When reserves dropped, it lowered banks' reserve ratio requirements to try and prop up the Yuan to discourage outflows and maintain stability as it pushed potentially for reserve currency status.

Yuan 12mo. NDF Signals Substantial Devaluation

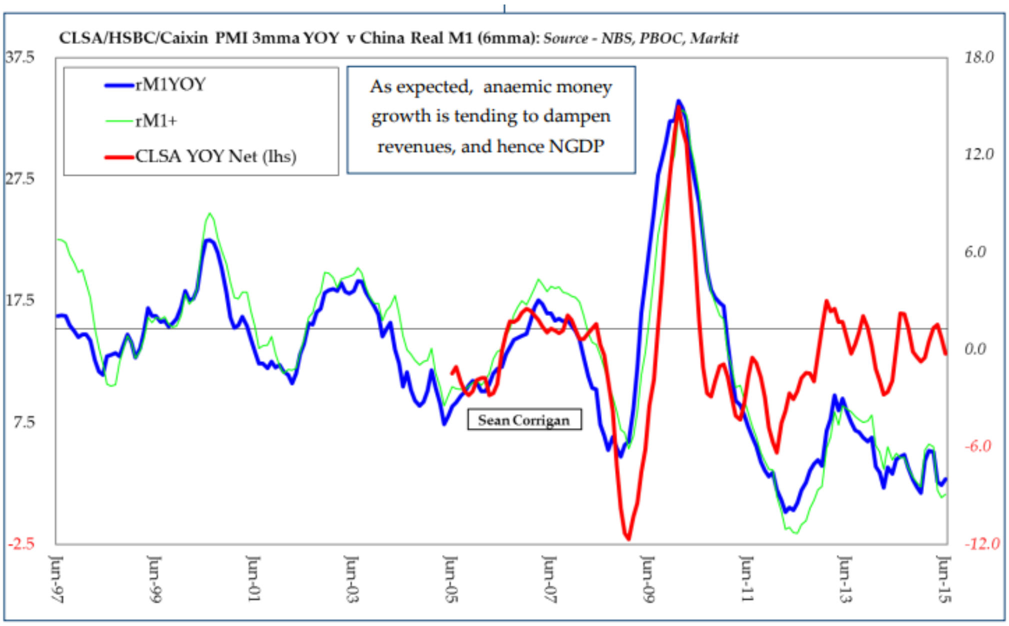
Beijing must be highly concerned about the potential flight of capital (to Battersea Power Station), but with growth prospects deteriorating rapidly, both domestically and due to global demand conditions, they need looser liquidity conditions. They may want some export competitiveness back and more importantly they need some internal liquidity to off-set financial weakness.

We expect China to cut banks' required reserve ratio amid this tightening liquidity and expectations that the yuan will remain weak. To try and offset any further capital outflows, the central bank will most likely inject more liquidity into specific TBTF lenders. Benchmark interest rate cuts will then be used to lower borrowing costs. Although the purpose of the "floating" of the yuan is to solve for the trilemma by giving the PBoC more control of their domestic economy through monetary policy, the easing of conditions like other countries pursuing forms of QQE will likely keep pressure on the currency. Furthermore, the Yuan has been bought aggressively on leverage for its yield versus the euro and yen – this is a structural trade which is unwinding as we speak.

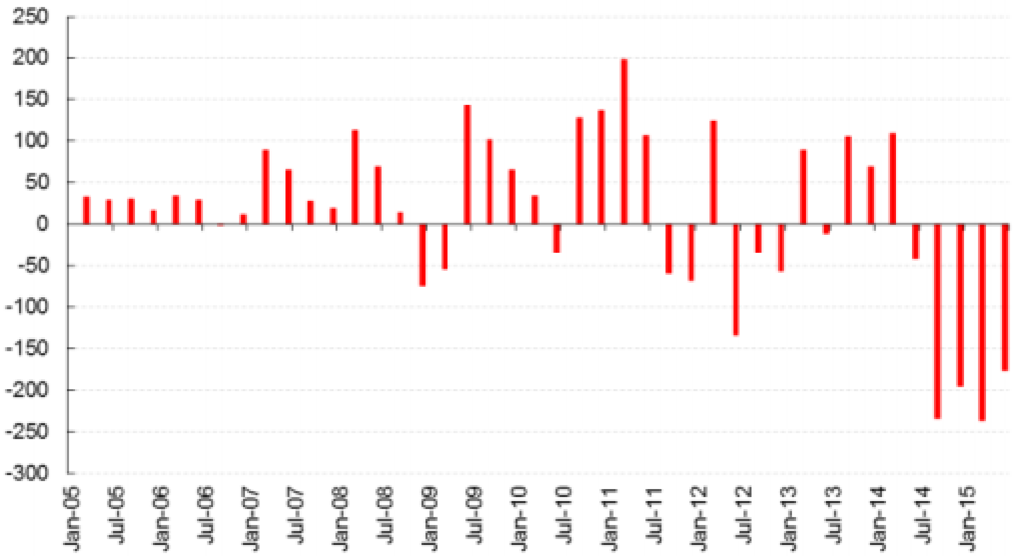


Source: Credit Suisse

No China Growth



China Quarterly Capital Outflow Proxy $bn



Source: Variant Perception

Let's get things in perspective, the spot Yuan has declined 3% since the PBoC announcement. Previously it had appreciated 40% on a real-effective basis these 5 years. This also tells you it can devalue a long way.

Taels from Cathay

Cathay, as in the airline, is an alternative English name for China. It comes from the anglicised version of 'Catai' which originates from the word Khitan, the name of the nomadic people who founded the Liao Dynasty. They used the tael (the Cash), a Chinese unit of weight and currency. One tael is equivalent to 1.2 oz or 37.4 g. and is widely traded in Chinese-speaking countries, mainly Hong Kong and Taiwan. Interestingly the ryō (両?) was a gold piece in pre-Meji Japan and was originally a unit of weight from China, the tael. We mischievously ask – will the Chinese replace stock units with gold taels again?

As Sean put it in the July/Aug Money Macro & Markets (MMM):

"Wherever you look around the fringes of China—and, by extension, Greater Asia—it is hard to avoid evidence of the woes being suffered. Caterpillar sales in the region are as depressed as they have been since the GFC. Not just rail traffic, but both shipping rates and air cargo loads are flat or falling and output (of the tangible kind, at least) is decelerating in its turn.

This is causing ripples across the capital structure not just of China, but of the globe. For instance, in its latest quarterly report, IATA noted that, after enjoying a boost related to the disruption to sea cargo to America’s strike-bound West Coast ports, air freight volumes had relapsed back to the levels of last year in a deceleration which was being aggravated by high inventory levels and sharply reduced semiconductor shipments."

It is clear that global capacity has not been immune to easy money, as despite the drop in global trade wide-body freighter, payload capacity has actually increased every year since 2010 to record levels of storage. Asia has led the charge, as it has been responsible for over 40% of all new capacity since the GFC. Sean notes:

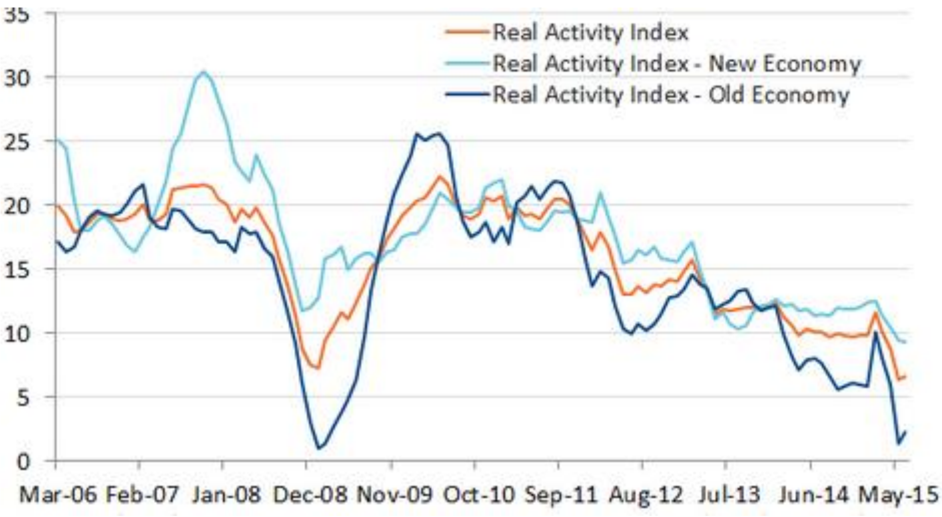
"Out on the ocean wave, the travails of the industry there are well-known. Container rates out of China’s main hubs, as recorded by shipbrokers Drewry, are off by nearly a half YTD. The SSE versions of these are likewise depressed: the Shanghai spot index is making new lows at barely a half of its autumn 2009 inaugural value while the broader CCFI index of spot and forward rates has recently inched back above lows not seen since it was first introduced back in the dark days of the Asian Contagion in 1998."

The New Bazaar

The New economy index that captures output of the private sector, high value added firms, consumer services and clean energy should be followed closely to see how successful China is in transitioning to a more domestic and private market driven economy. Zhejiang province, home of internet giant Alibaba and China's e-business hub, was the only province where growth accelerated in the first quarter of 2015 – from 7.6 percent in 2014 to 8.2 percent year on year. The software and information sector posted 27.6 percent year-on-year growth in revenue and online sales increased 28.6 percent in the province.

Unfortunately, since then revenue and guidance has disappointed at Alibaba, China's answer to Amazon. Activity is now falling here as well.

New 'Domestic' Economic Activity Slowing



Source: Bloomberg

The Great Wall of Money FALLS

We wrote in a recent Investor Letter:

"What is increasingly evident is that market participants are increasingly embroiled in a reflexive relationship between central bank actions, guidance and price action. The more the market moves contrary to central bank desires – i.e. downwards - the more the central bank injects the bubble money and reassures markets with the promise of more infusions of its rich elixir. This reflexive behaviour has led to a mindset that extends beyond institutional traders and investors but to populations as a whole. We are observing a complete financialisation of the global economy and markets by this mindset. The speculative mindset that my house is now my investment, that my 401K or pension pot is my productivity for the future or that oil is some kind of arcade game rather than a highly productive resource for our economy is accepted as normal behaviour. This is the behaviour of the maddening crowd."

The Great Wall of Money, which has driven asset prices higher globally, is in full-on reverse and the EM currency and market woes will engulf the RoW as China's debt deflation continues unabated to impact capital flows and terms of trade.

The sequence of collapse has migrated from China to commodities, then to other EMs and round and round in a virtuous and vicious circle. The China collapse is finally about to visit the US and other Anglo-Saxon shores.

EM Tremors to Earthquakes (2013 to 2015)

In our HindeSight Investor Letter November 2013 – '[ToP of the BoPs'](ToP of the BoPs) we discussed the extent of hot money flows:

"The consequences of multiple rounds of QE have heightened global risks as it has both exacerbated 'currency competition' and hot capital flows into countries seeking desperately for a return both from income and capital growth. This has created major distortions in term rates, equity and bond values, driving them artificially high in price.

"These distortions have created risks far greater than the fragilities of EM countries of yesterday years. The system of credit creation has produced unstable growth underpinned with collateral which is both mobile and suspect in its integrity.

"Investors have nowhere to turn, emerging market countries growth is faltering in response to export disadvantages brought about by rampant G10 currency devaluations. China is finally succumbing to its side of the global imbalance excesses. First it was the deficit nations now it's the turn of the creditor nations to falter, primarily China.

"Trade flow reversals are leading to massive capital outflows out of EMs and the question remains will the central banks of these countries sell their FX reserves, UST-bonds and euro government bonds (bunds) to finance this surge in outflows.

"In 2009 once the system was seemingly 'backstopped', capital flew into emerging markets on the belief they had strong economic fundamentals driven by positive demographics and developing infrastructure needs. The real effective exchange rates of many of these countries have fallen as dollar funding dynamics led to a demand for dollars at the expense of most currencies in the world. The temptation of high yielding currencies at undervalued levels was too tempting for most investors. What we witnessed next was unprecedented, an excessive net cumulative foreign capital flows into emerging market countries (ex-China) which was twice that of the flow prior to the crisis (and that had been ‘unprecedented’ as a percentage of global GDP).

Trillions of dollars found their way into EM domestic economies and markets. The resulting credit accumulation merely drove economies and markets higher for a time.

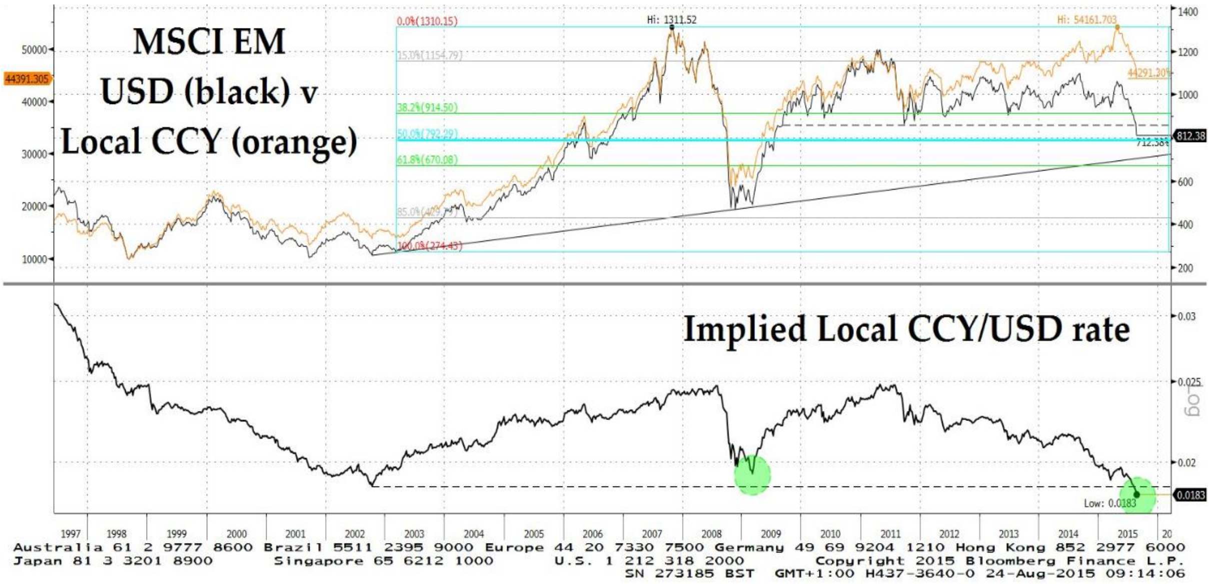
EM MSCI /Commodity Collapse

The collapse of commodity prices, induced by China's lack of demand, triggered a reversal in fortunes for the EM countries both exporters and importers. EM equities have been intimately with commodities over the past 12 years. The fit with LATAM equity indices is the best. Conditions are far worse than in 2008 in EMs, so despite 30 to 50% corrections in some indices, the worst is yet to come.

EM CCY/Stock Collapse

Since we wrote our 2013 letter, EM currencies and their stock markets have really begun to fall and they continue to do so. Even though there is value within sectors of these markets we continue to see a full blown EM crisis in play. Slowing growth and higher US yields have encouraged outflows. The FX reserve buffer of these countries is beginning to fall faster than they were accumulated, these currencies and markets can fall much further than one can even perceive.

EM stocks in dollar terms have fallen 27% and in local currency terms 20%. Individually, local currencies have fallen as much as 50% since 2013 – such as the SA Rand.

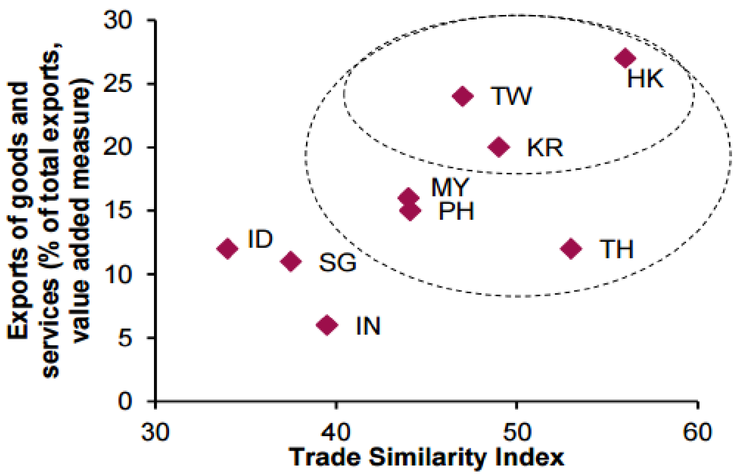


As you can see there is much more to come.

Budgetary habits have become exceedingly lax in these countries and as the terms of trade turn into a negative shock and capital flows fully reverse, credit will dry up completely. At some point, these countries will hike rates to try and stymie capital outflows and then their economies will enter a very severe recession.

Cyclical risks are more acute in the rest of Asia. The past ten years have seen growing trade interdependence within the Asian region, so the capacity of economic shocks to amplify themselves through trade channels has increased and Asian trade volumes have slumped since the start of the year. Korea, Taiwan, Hong Kong, Malaysia, Thailand and the Philippines stand to be hit hardest by the devaluation reality.

Asia exposure to China



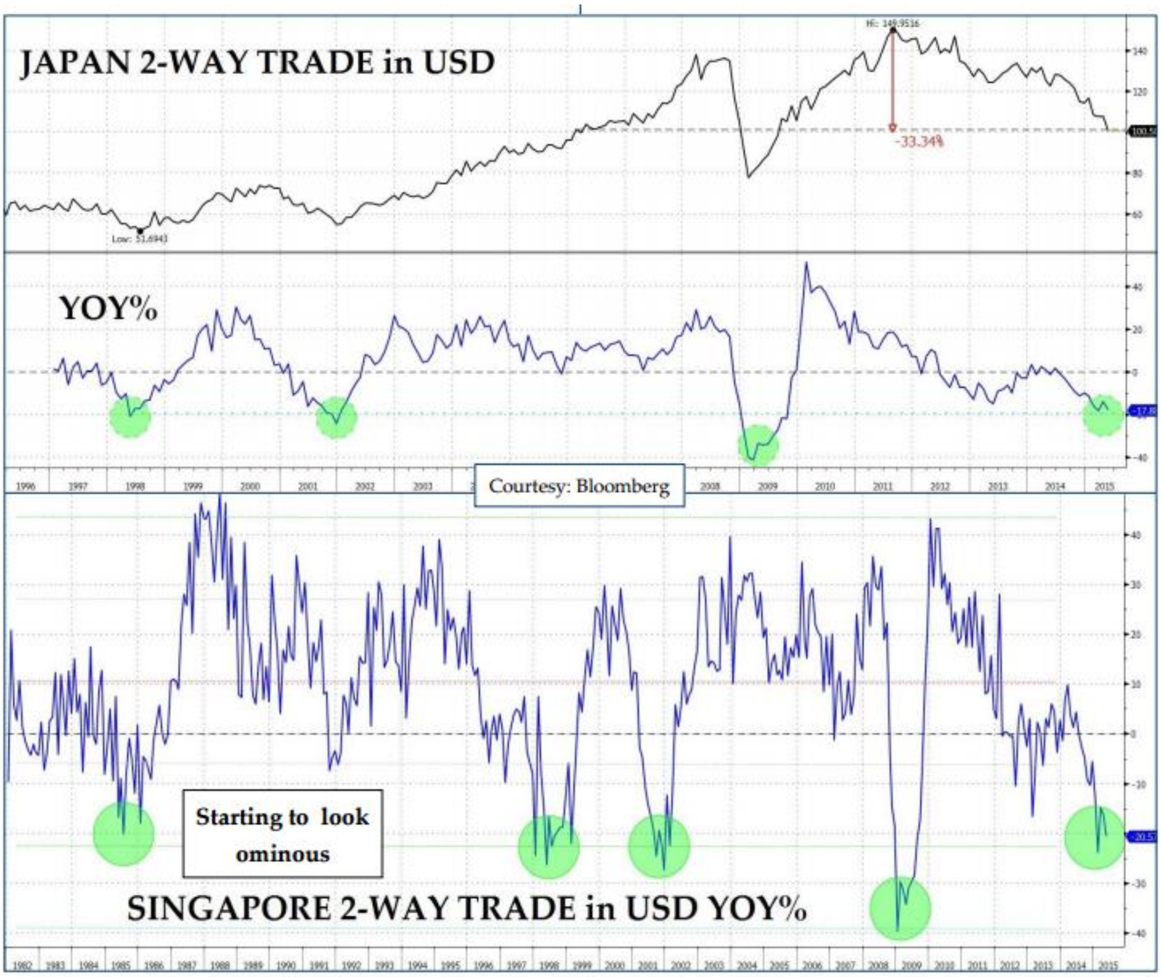
Source: Credit Suisse

Stinky Dollar Pegs

Countries which have some sort of peg to the dollar will suffer disproportionately. Capital leaving an emerging-market country has more of a deteriorating impact on domestic monetary conditions when the local currency is pegged, as more of the local currency needs to be retired when the exchange of capital back in to dollars is made.

So, a rising USD has a double-edged effect for countries with pegs: capital is encouraged to leave as the local currency weakens, and when that capital leaves, it leaves a gaping hole in the domestic money supply and credit. This has major implications for growth, thus intensifying yet more capital flight.

Trade and capital flows will embroil in a downward vicious circle. The Yuan devaluation shoves the proverbial horns of the trilemma right back up countries in Asia. China granted Singapore a very happy 50th birthday. The worry here is 2-Way trade already shows the extent of economic collapse. The Yuan devaluation will only exacerbate this.


JAPAN 2-WAY TRADE in USD
YOY%
-33.34%
Courtesy: Bloomberg
Starting to look ominous
SINGAPORE 2-WAY TRADE in USD YOY%

Anglo-Saxon APP'mosphere Polluted

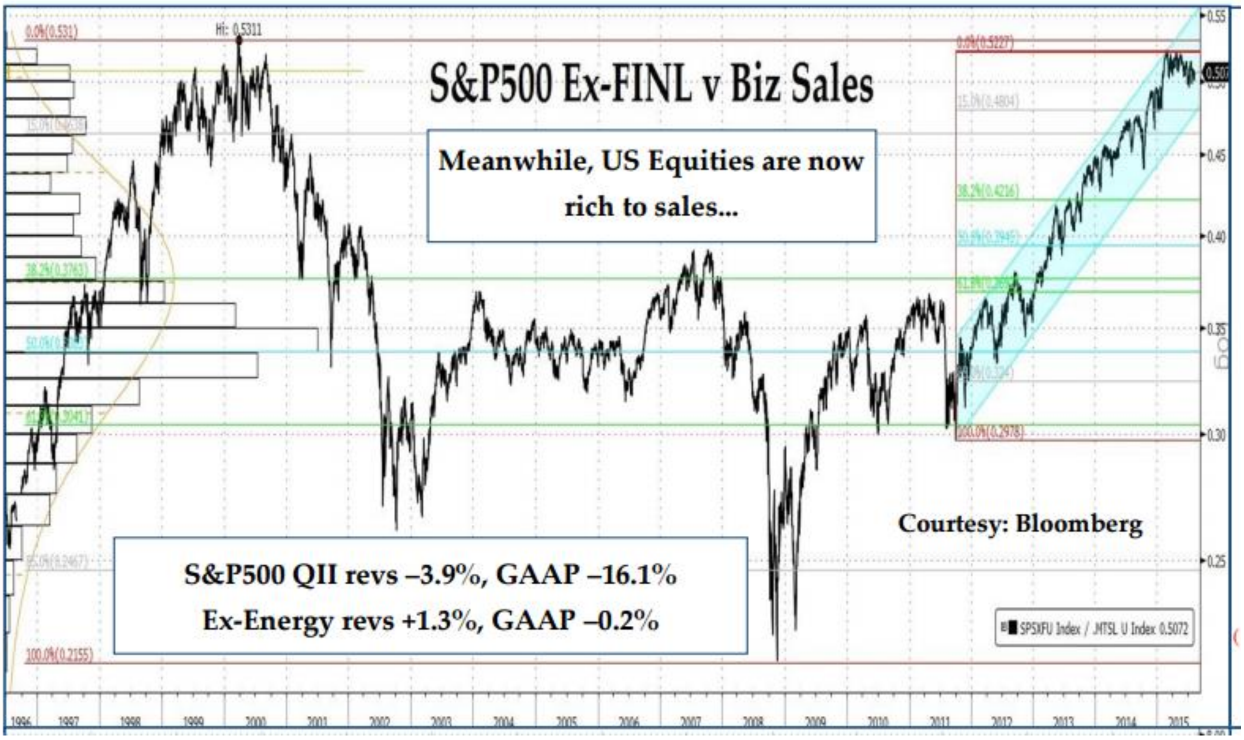
A strong dollar currency has created headwinds for the U.S. economy through a range of channels. Latest actions of the Chinese central bank will intensify the negative impact by fostering more dollar appreciation. The U.S. already runs a significant trade deficit with China which will only be exacerbated now. The dollar has already become too restrictive and the global carry trade, which borrowed capital from the East (and lately Europe), was parked in the U.S. and other *safe* Anglo-Saxon currencies and markets. This capital is very vulnerable.

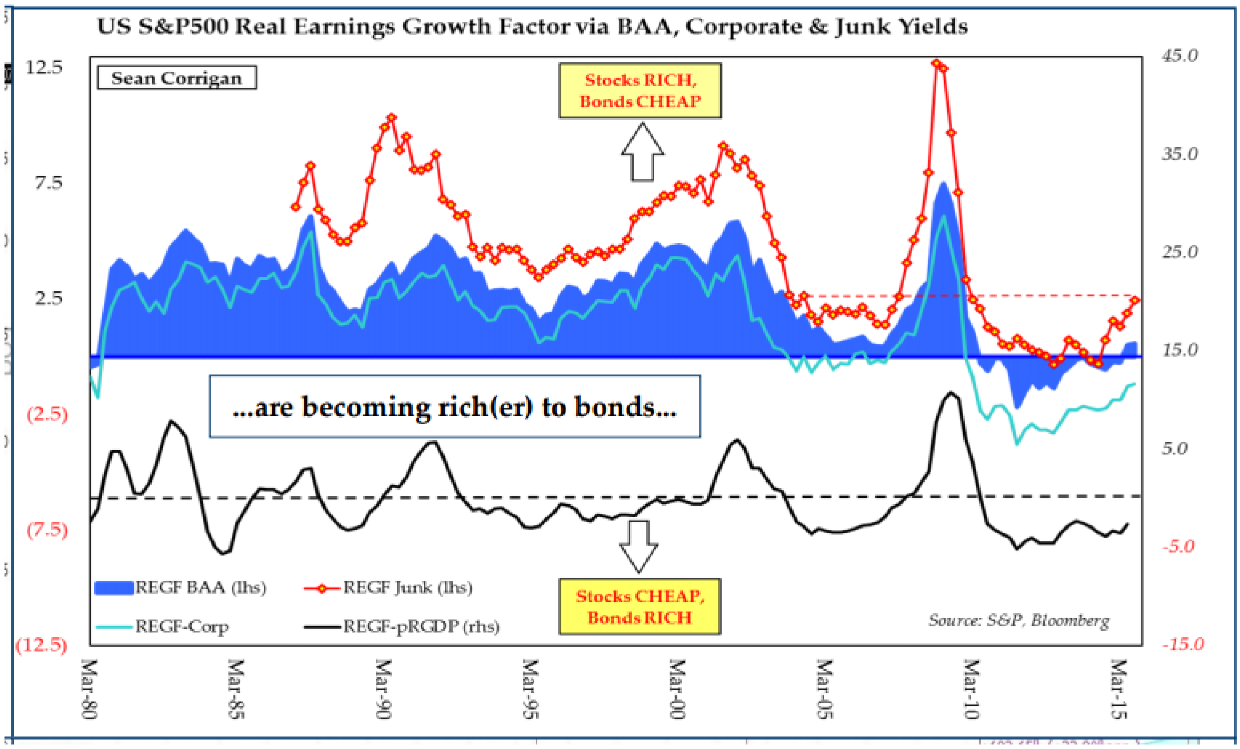
We first flagged a number of issues that faced markets back in our Investor Letter - 'Equities: A Rarefied 'APP'mosphere.' Back then. we began calling the market on many names but were waiting for trend exhaustion, which we finally got in 2014 when we felt it was worth playing for a top. The NYSE topped out, but the NDX did one last surge which is now unravelling.

MSCI US Total Return Back to Zero Return?

The S&P500 has price/sales that have not been not seen since the peak of the (last) Tech Bubble, with P/E ratios not seen since the exceptional circumstances of the GFC; and with GAAP operating margins 1.3 pts (14% expressed as a ratio) below that of 9 months ago. Global liquidity is in reverse, financial engineering has stopped, i.e. buyback announcements have ceased due to valuations and lack of spare capital. You can only change the spare tyre once until you replace it.

Sean's recent MidWeek Market Musings highlight how failure of these markets was imminent and we believe this has begun in earnest.


S&P500 Ex-FINL v Biz Sales
Meanwhile, US Equities are now rich to sales...
S&P500 QII revs –3.9%, GAAP –16.1%
Ex-Energy revs +1.3%, GAAP –0.2%
Courtesy: Bloomberg


US S&P500 Real Earnings Growth Factor via BAA, Corporate & Junk Yields
Sean Corrigan
Stocks RICH, Bonds CHEAP
...are becoming rich(er) to bonds...
Stocks CHEAP, Bonds RICH
REGF BAA (lhs)
REGF Junk (lhs)
REGF-Corp
REGF-pRGDP (rhs)
Source: S&P, Bloomberg
12.5
7.5
2.5
(2.5)
(7.5)
(12.5)
45.0
35.0
25.0
15.0
5.0
-5.0
-15.0
Mar-80
Mar-85
Mar-90
Mar-95
Mar-00
Mar-05
Mar-10
Mar-15

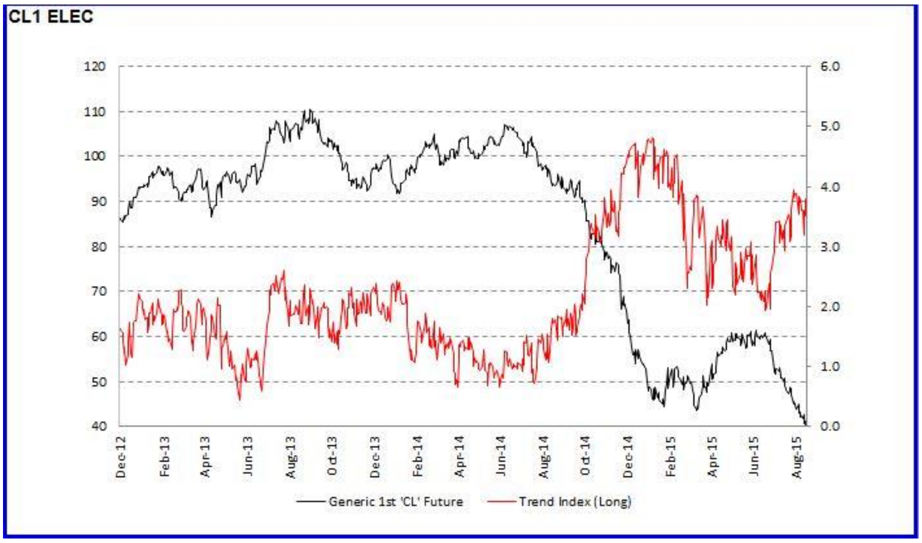
US Stocks are rich to RoW equities.

US Stocks are rich to the GSCI (commodity) Total Return index. Looks like a very good time to go the other way.

We would note that it's not so much that we want to buy commodities rather we believe they will continue to fall albeit at a slowing rate. We, however, believe oil is near trend exhaustion and would look at energy stocks – suppliers and producers, as well as the commodity to buy versus US assets.

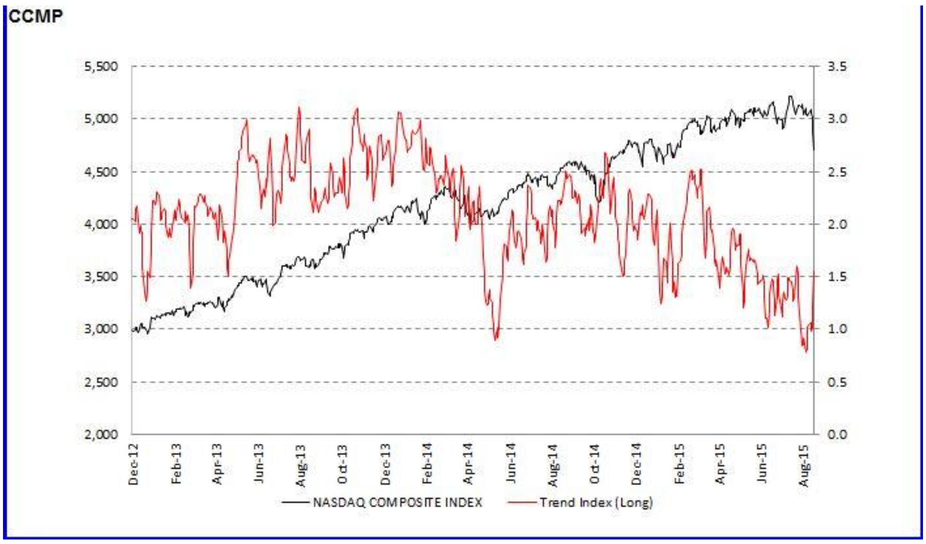
Oil Trend Exhaustive

This is the Hinde Capital Trend Index for Oil – long term. Below 1.25 is trend ready and above 4.0 is trend exhaustive. Note that it flagged the sell-off in 2014 and now it is flagging a positive divergence as oil has traded new lows. But the trend exhaustion reading is not as high as in February of this year.

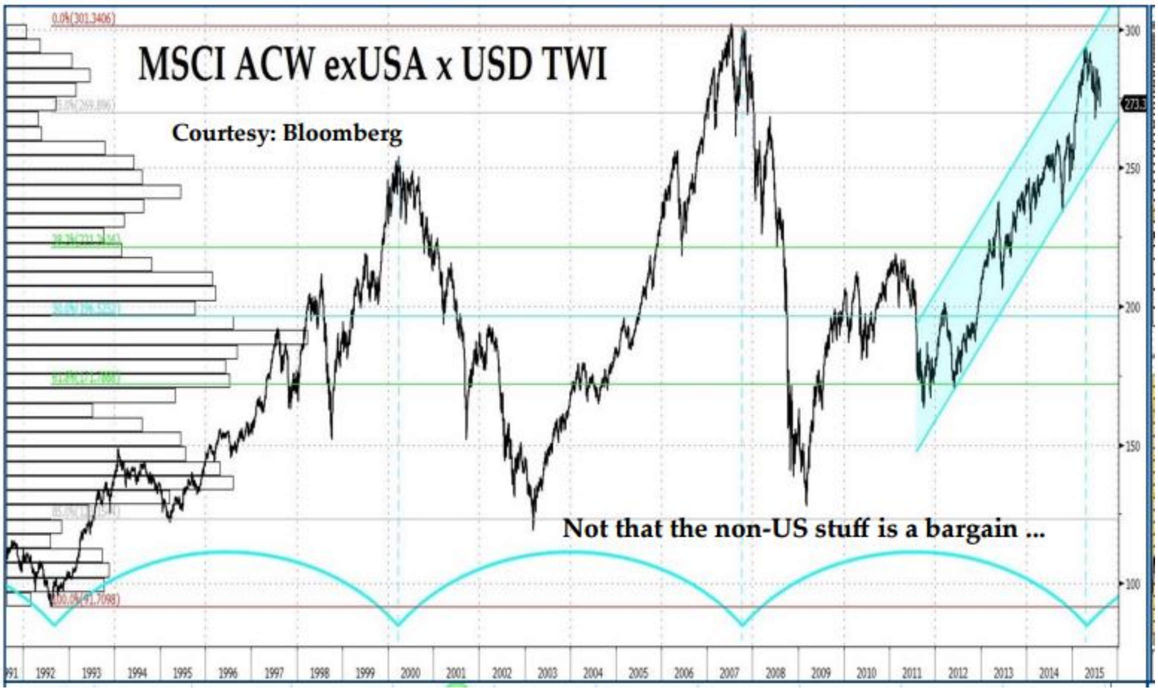


US Stocks Trend Ready

We have been trend ready on US stocks. The market just broken down, so on the basis of all we present before you, it is time to sell and go with this breakdown. NDX (US Stocks) was trend ready in July 2015. This reading has been low for long time. The down move will be big.



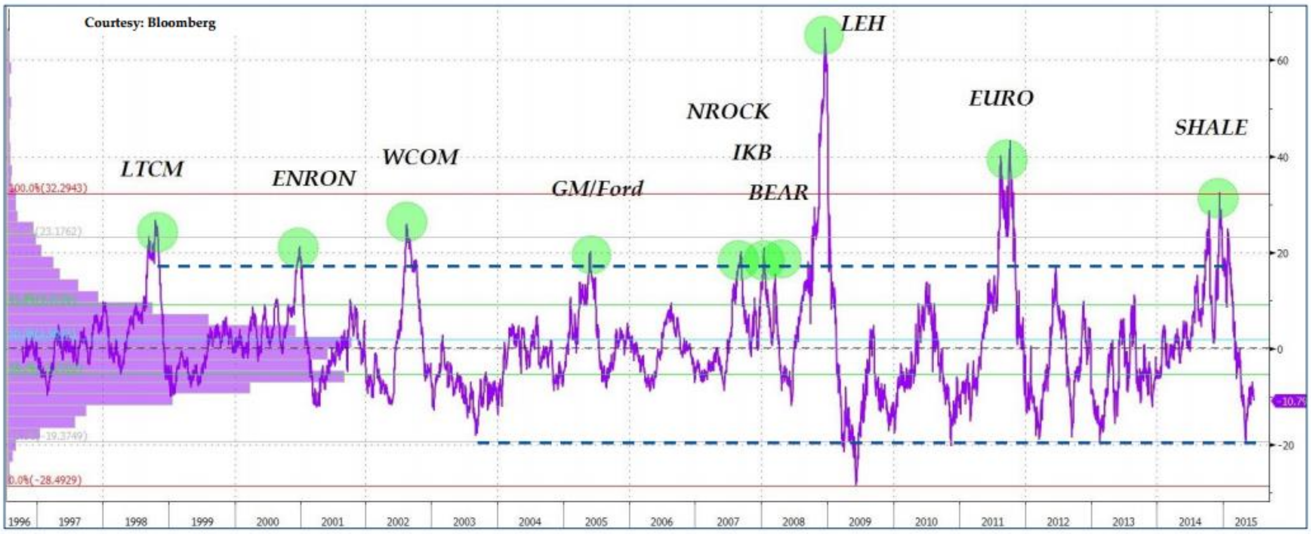
EM stocks may have fallen some, but MSCI ACW (RoW stock indices) shows global equity markets can enter into a bear market here.



Clues to a Collapse

A number of indicators we follow show global markets will soon come under stress. Credit indicators are widening and key bond yields have risen considerably relative to stocks.

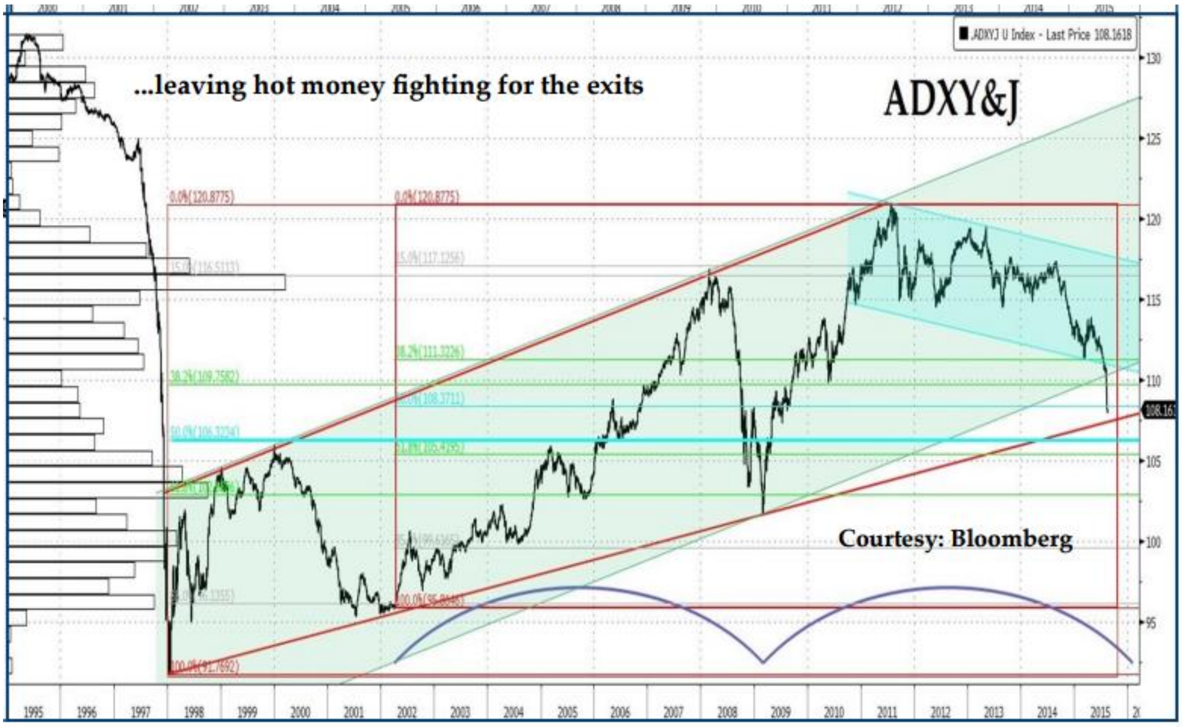
Credit spreads rebounded substantially after the Shale/ WTI bust, but with oil continuing to fall sub-40, as described in Sean's work from last year. We will be presenting his views on the energy complex in our September HindeSight Letter.



EM FX volatility is breaking-out. This is bad for all stock markets considering the dollar exposure around the world. The USD is a sign of deleveraging, not US economic strength.

Emerging bond yields have been breaking higher, highlighting tightening liquidity conditions. This is negative for stocks.

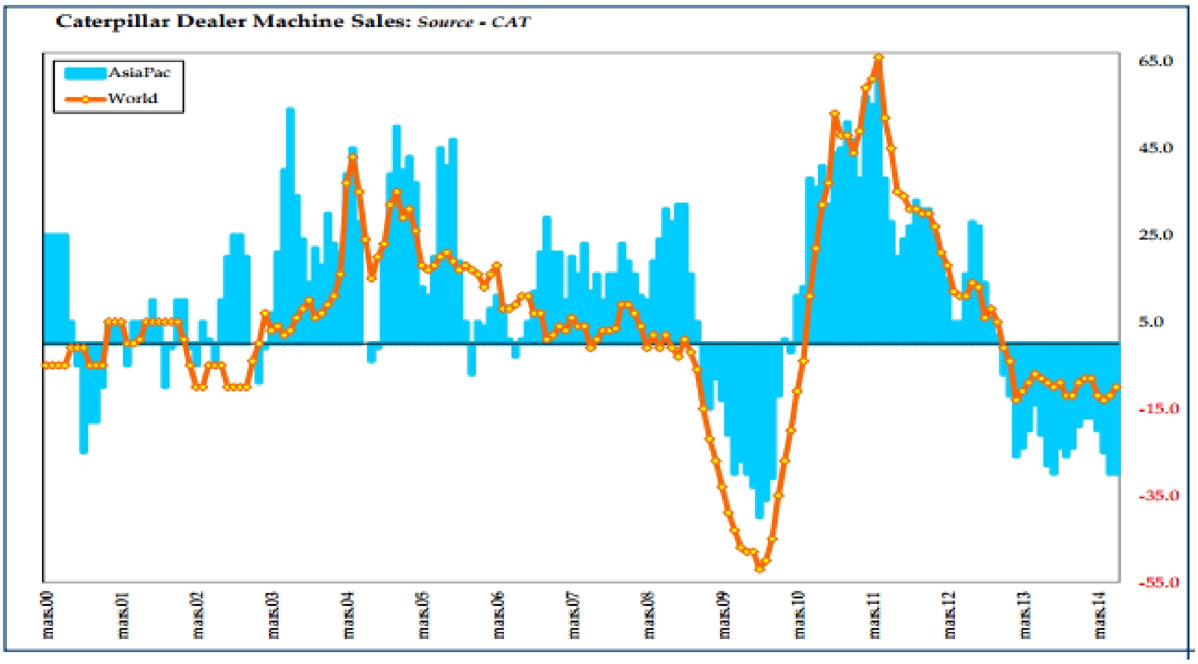
Asian Dollar index shows the hot money outflows. Will EM countries hike rates to stem the capital outflow? Not yet, but soon maybe. This will kill their economies as they are so reliant on overseas capital to grow domestic credit.



EM/Commodity Giants, Glencore and Vale are warning that a Global asset rout is at hand.

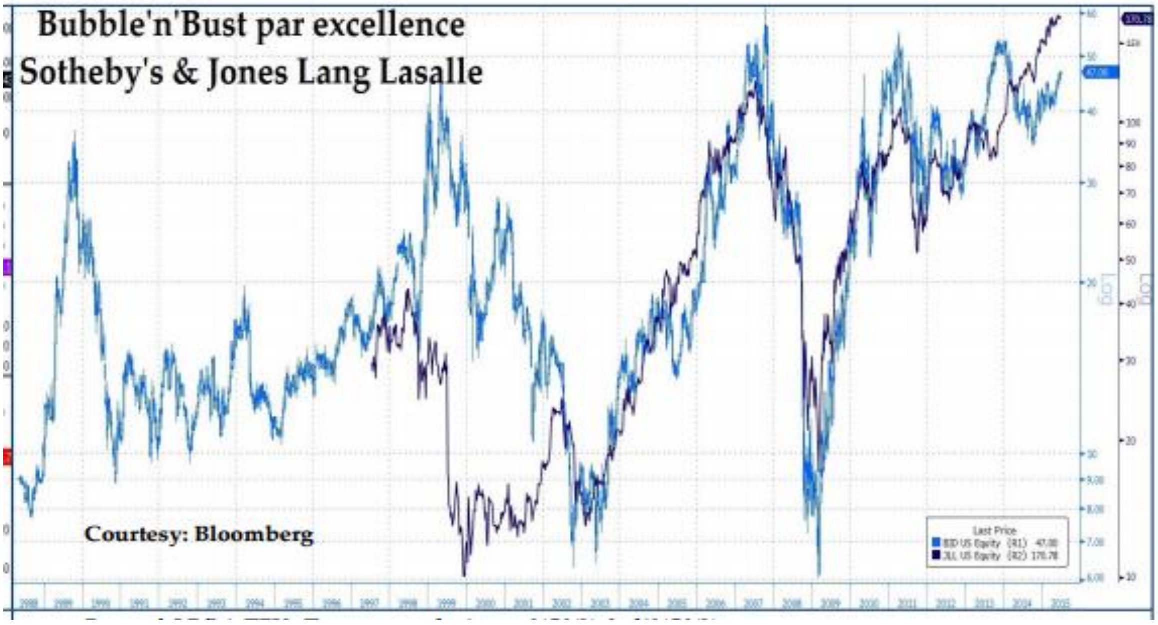
www.hindesightletters.com

Caterpillar Machine Sales are ugly.



Global Housing Bust Coming

Jones Lang Lasalle, the global real estate company, is heading south now since we flagged risks of imminent top back in June this year. Could this be flagging some real wealth destruction? If housing plummets around the world, then consumption will fall back to basic necessities even for the uber-wealthy.



Discretionary and luxury goods brand are responding to the China collapse and potential housing rout to come. This is multi-decade chart of luxury good producer LVMH shows the stress.

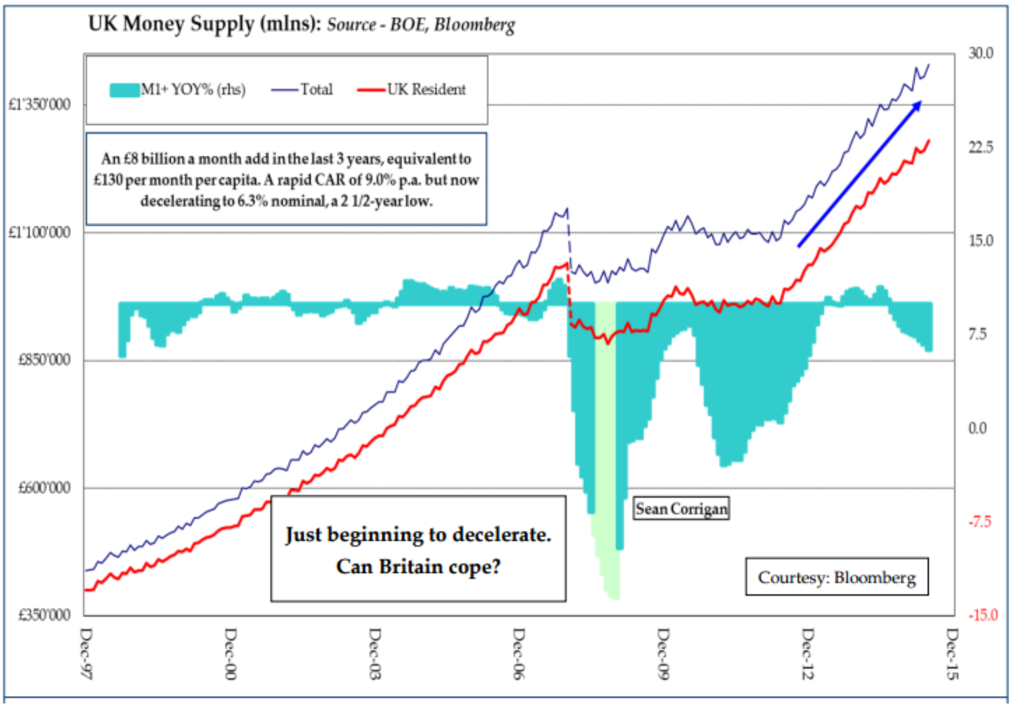
When the biggest VCs and PE companies – the smartest financial sharks in the pool – are in free-fall we should be alarmed. Perhaps the CFO leaving for Airbnb, a vastly overinflated private company, is a sign of a top for both Blackstone (BX) and Airbnb. An insider leaving (and his stock options behind) – may be a telltale sign of troubles ahead. No doubt Airbnb paid up to compensate him for his equity opportunity cost. We surmise only. Sourced from Bloomberg.

KKR has been blighted by losing leveraged shale investments. It would seem some decade long sales, such as Sungard to FIS, have not been as profitable as the hype surrounding the largest joint PE investment in history at the time.

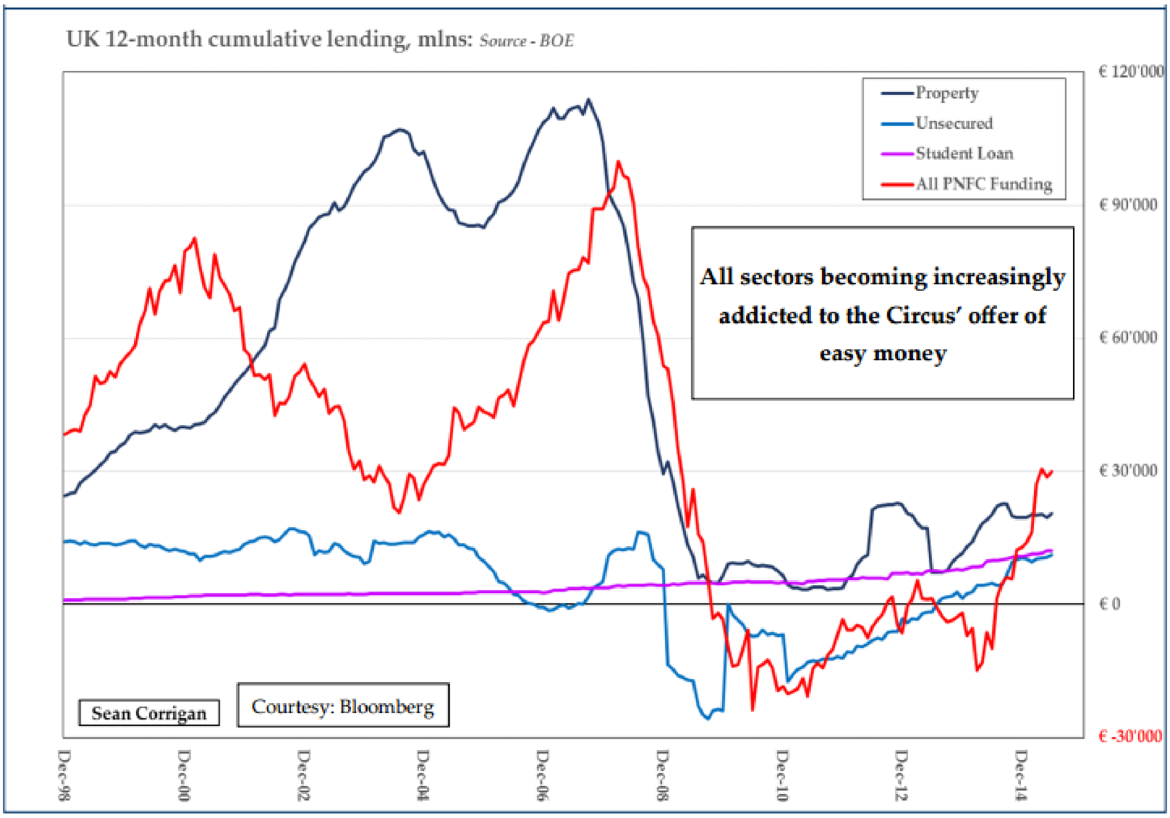
Chinese Smog Pollutes Albion

Australia, UK and Canada have all benefited from domestic credit booms, and the Commonwealth countries from exporting resources to China.Whilst the UK has the export rule of law and services to the resource rich (until now) in the world – the Arabs, Chinese, Russians, and even South Americans.

The resource sector collapse and likely end of a 32-year cycle in 2011 has signalled that these countries are near the end of receiving the foreign capital they need to balance their books. Bar a flurry of Chinese flight capital, housing prices will begin to revert to their mean as the debt deleveraging impulse sends the Chinese smog over Albion and its commonwealth compadres.



THE FIRE ECONOMY ignites on CREDIT AGAIN



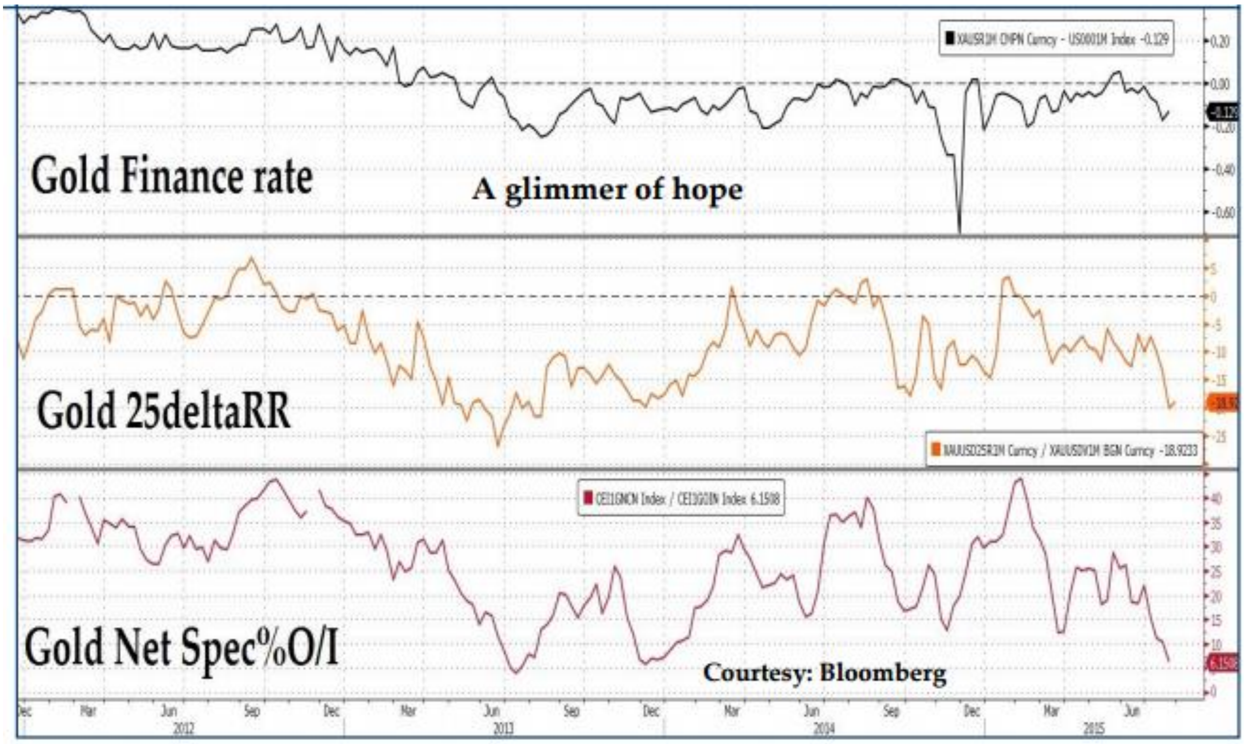
ReMeBer Gold?

On 20th July, gold was very much not the flavour of the month. The Shanghai bear raid, which saw gold flash from $1130 to 1086 a tr.oz in the overnight Asian trade, received an inordinate amount of media attention. Interestingly, even the mainstream media spoke of sinister intentions and manipulation. In truth, the market was bullied by traders out of China and with there being little interest elsewhere to buy the falling market, gold had a cascade that had commentators revising their downside forecasts, from 1050 to 800 and beyond – usually a sign of a bottom.

This year, I spoke to RealVision TV and stated that the market was trend-ready in gold and that, as managers of a long-only gold fund, we were trying to be agnostic and position ourselves for a break either way. I did, however, mention that when our models are trend-ready, we often get a false sharp break one way first, only to see a snap back within a few days or weeks.

Gold became so out of favour at the lows that the net spec longs had all but completely evaporated for the first time since the Great Bull Market began at the turn of 2001. Without doubt, all sorts of technical measures, from basic RSIs to risk reversals, also pointed to the fact that selling pressure was getting far ahead of itself.

Taken from the 29th July MidWeek Macro Musings:



So, even before the PboC shocked the markets last week, we were writing that gold was due a bounce. Elevated speculative and commercial shorts – the first of its kind for money managers – a net position that was no longer strongly long, negative forward rates and a wide put-call skew, all testified to an imminent short-squeeze potential.

This was all in the face of an asset that looked decidedly expensive to its industrial counterparts and black gold – the WTI. However, one must consider the fact that gold – in its customary anti-commodity role – frequently rallies against the industrials at times of financial stress or economic weakness. And, as we have written, downside volatility is about to rise.

Taken from 19th August MidWeek Macro Musings:

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Since the PboC made an adjustment to the **RMB**/yuan on 11th August that sent it to its lowest rate in three years versus the dollar, followed by another adjustment the next day, people have begun to fear that this opening up to the market could lead to an uncontrolled flight of capital out of China. The adjustment opens up the possibilities of a market-induced devaluation that the PboC couldn't easily control. Worse still, investors have finally begun to consider that China's economy really is ailing, since the PRC's botch job of managing the stock mania and crash, and started to think that this might have serious consequences for the RoW, beyond emerging economies. It's as if no one has been watching the tea leaves of excess debt in China.

Even gold seemed to disbelieve the intendant implications of RMB's devaluation, as it seemed to rally and stall on the announcement, spending the morning back below the $1100 mark.

www.hindesightletters.com

It was like participants had forgotten gold, but the PboC move helped them to **R**e**M**em**B**er. Out of the depths of the gloom, gold was back to a glimmer, then a glisten, and then a full shine. Since the chart above was posted, gold has climbed, firmly and aggressively through $1150 to $1169. If it can hold above $1150 next week, it will migrate back to the High Volume Point (HVP) at $1,200. I believe it will.

Since the events of the 11th, the world has been awash with ruminations, even rumours that China is trying to capture the gold market. Sean Corrigan and myself disagree over the extent of China's interest in the metal. I have, since 2008, been on record as saying that China would become an increasing source of demand for gold – part per capita wealth accumulation, part monetary reserve accumulation. But one thing we would both agree on at this stage is this – there is no chance of China backing the RMB to gold. For Sean, this is never. For me, it could occur, but only at much, much lower currency levels, if at all. Right now, they need a weaker currency to aid their export market, which China still can't transition away from as the major driver of her economy.

So, we would be hesitant to say this announcement is a cause for the resumption of the Gold Bull Market just yet. We think it is more likely that gold will hold its purchasing power relative to other assets and will only begin to rise again, forcibly, in the last stages of the likely debt collapse to come.

PBoC and Gold

After six long years of paranoid radio silence, the country's gold reserves were some 57% more voluminous than had been made public. Following hard on the heels of this revelation, we learned that a further 610,000 ounces had been acquired in July. This was a timely declaration, which is now obligatory as part of the PboC's drive for SDR inclusion.

Sean has spent long hours trying to reconcile the conflicting and partial Chinese data on gold. It has yielded little result, other than the fact that the reserves appear to be held at some sort of yuan historic cost measure on the PBoC's books, while being declared in mark-to-market dollars in the reserve total. What we might note, however, is that the authorities have intimated that they might be absorbing domestic mine output (together with scrap resales). This would help to both bail-out the diggers and stabilise the money supply in the face of ongoing FX purchases. **As such, this is likely to be more high-powered than anything attained by giving overburdened banks new assets. It might also forestall the distress selling of collateralised gold in the manner that has already been afflicted, such as copper. Supportive, maybe. Decisive, no – not yet.**

As readers of HindeSight Investor Letters know only too well, we have been writing persistently since the GFC that China, as the creditor in the Bretton Woods II monetary equation, would soon impart a highly disinflationary headwind for the rest of the world, as it too took its turn to bow to its own credit fuelled economic excess.

In our HindeSight Investor Letter November 2013, 'ToP of the BoPs', we discussed that the instability in emerging market economies, and especially China, was a direct consequence of these global imbalances, which became stymied briefly by global bail-outs, only to have been left in a more vulnerable economic position. We wrote: **"The deleveraging process which began in 2008 has been a slow burner but is likely now in full swing. The deflationary risks are very high. China is the driver. All eyes on China."**

Two years on and that slow burn is turning into an inferno. The Great Wall of Money, that has flamed global assets higher, is now about to engulf them and bring them down in a pile of embers. The Chinese stock market is already burning down, our HindeSight Investor July Letter, 'Another BRIC in the Wall', covers all this. And now hopefully we have caught provided you with some of our thinking on what China means for the world's other economies and global asset classes.

ABOUT US

Hinde Capital is a London-based Investment Manager, specialising in developing world-class investment solutions for institutions, family offices, trustees, as well as high net worth private clients and their advisers. Hinde Capital offers investors a range of disciplined investment strategies that draw on the founders' real-world trading and risk management experience attained from previous senior trading and money managing roles at some of the largest global financial institutions.

Our principle aims are to help investors achieve real adjusted returns and provide long-term wealth protection. We offer funds and strategies that both grow capital and accrue income. These are run in Managed Accounts, Off Shore Funds and as Exchange Traded Products.

Established in 2007, Hinde Capital launched its first fund the same year specialising in the precious metals sector, Hinde Gold Fund, BVI Ltd. Hinde Gold Fund's primary aim is to provide our investors with exposure to the precious metals market through a highly liquid, actively managed fund with low leverage and security of assets.

Hinde Dividend Products were introduced in 2014 to provide a series of equity income strategies run by both strategy and geography, based on our proprietary valuation models the Hinde Dividend Value Matrix®. The SG Hinde UK Dynamic Equity ETN (50% Hedge) was the first of a series of equity traded products. We run European, US and MSCI Asian versions.

The strategies range from long only, 50% hedged to market neutral, enabling investors to switch between more or less exposure to stock markets, but without negating the reinvestment of their dividends in the stocks held.

We will monitor the growth of money and credit and try to track them as they flow through the system, changing its topography as they do. Trade numbers, business revenues, production, prices, and payrolls, whether these bring surplus or deficit and involve borrower or lender will figure. All will be examined, as will market activity itself—the building of positions, whether the mood is trend following or mean reverting, bullish, bearish or plain bamboozled.

In all, we will do our best to keep you entertained as well as informed and to provoke many of the right questions as well as to provide some of the right answers.

DISCLAIMER