

THOUGHTS FROM THE CHINA BEIGE BOOK

Jeremy Schwartz – Global Chief Investment Officer
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Last week I chatted with Professor Siegel and Leland R. Miller, President of China Beige Book International, about the recent yuan devaluation and its implications for the global marketplace. We focused on the various interpretations regarding recent Chinese policy action and dove deeper into macro developments in China.

China Trying to Unpeg from U.S. Dollar Professor Siegel commented that after being pegged to the U.S. dollar, the Chinese currency appreciated by over 20%. The rise in the dollar resulted in the yuan becoming far more expensive compared to its Asian neighbors, which corroded its competitiveness. Given this steep rise in the [value](#) of the yuan, the 3% [devaluation](#) is rather small by comparison.

Market Fears What Might Happen, While Devaluation Signals Growth Weakness Both Professor Siegel and Leland Miller believe that the recent devaluation was in part prompted by growth concerns and a decline in competitiveness. However, Miller believes that these concerns may be overblown. He ascribes the market frenzy—what he believed was an overreaction—as not based on what happened, but on fear of what *might* happen. Miller believes the devaluation indicates a new willingness on the part of China to liberalize its currency and allow market forces to dictate fair value. China hopes this currency market liberalization is actually a step toward potential inclusion in the [Special Drawing Rights \(SDR\)](#) later this year. Contrary to popular thinking, Miller believes that the recent devaluation does not imply a change in Chinese [FX](#) policy or mark the beginning of a protracted currency devaluation cycle.

China Capital Outflows Miller believes it is going to take time for China to fully liberalize its exchange rate—if it were left to [float](#), it would weaken significantly. Miller says the Chinese interventions over the last year have been to support the currency—and it would have been far more dramatic, had the Chinese not stepped in. It is not hard for Chinese locals to make the case for diversification outside China, which is prompting outflows. Local investors have a tough time diversifying within the country, as both real estate and equity markets have experienced large corrections¹. Miller believes that many are growing increasingly skeptical of the government, creating potential for more panic and potentially increased capital outflows.

How Long Can China Pretend and Extend Its Problem Loans? China may never have to acknowledge the size of its shadow banking sector or correct its reported numbers on non-performing loans. Given the state-owned character of many corporations, the true fragility of the Chinese economy may be kept under wraps. Miller believes it has become increasingly important to track the [credit](#) environment in terms of who is accessing capital and the cost of capital, as he considers the credit environment to be even more important than the growth environment.

Economy Not as Bad as People Think Thus far, Miller believes that all the stimulus measures introduced by the People's Bank of China (PBoC) have been broadly ineffective, seeing how the cost of capital continues to rise. The China Beige Book data suggests the economy is not as bad as people think and the PBoC doesn't need to stimulate as much as people think. Miller is encouraged by stabilizing corporate profits and a rather resilient labor market. But the key issue remains: firms are reluctant to borrow or spend, and the demand for credit is weak.

Stock Market Is Not Real Economy Miller believes the spillover in the stock market is not coming into the real economy yet. In July, the government started trying to backstop

the fall in the market and get households to leverage up to support the market, which he sees as a potential calamity in the long run. **China Beige Book Quest for Better Indicators** Chinese data is highly non-transparent, is often manipulated and does not tell corporations or investors what they need to know in order to invest in an economy. China Beige Book attempts to get to the bottom of developments in the labor market and to find better avenues of getting data from the ground up. The key to understanding China is to section data by regions and sectors, to understand what is happening in the credit markets and labor markets, and Leland Miller's group is one of the foremost experts on all this data.

Next Week's Conversation with the St. Louis [Federal Reserve \(Fed\)](#) Bank President we look forward to James Bullard joining us next week, when we will discuss the likelihood of a Fed lift-off in September, his take on how quickly the Fed may normalize policy and the idea of a new normal, where slower growth and low [inflation](#) are expected to persist. *Read the Conversations with Professor Siegel Series [here](#).*

¹Source: Bloomberg as seen by a large property price drop in tier 1 cities since 2009 and the over 30% drop in the Shanghai stock exchange since mid-June 2015.

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Value: Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Devaluation: deliberate downward adjustment to the value of a country's currency, relative to another currency.

Special Drawing Rights (SDR): an international reserve asset and accounting measure created by the IMF.

Foreign Exchange (FOREX, FX): The exchange of one currency for another, or the conversion of one currency into another currency.

Floating Rate Security: A debt instrument with a variable interest rate usually tied to a benchmark rate such as the US Treasury Bill Rate or the London Interbank Offered Rate.

Credit: A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future.

Federal Reserve: The Federal Reserve System is the central banking system of the United States.

Inflation: Characterized by rising price levels.