From right to left:

Rod Smyth
CHIEF INVESTMENT STRATEGIST

Bill Ryder, CFA, CMT
DIRECTOR OF QUANTITATIVE STRATEGY

Ken Liu
GLOBAL MACRO STRATEGIST

Signs of Stability in China but EM Risks Remain

RiverFront has had no emerging market (EM) debt exposure this year and is underweight emerging market stocks, which has served us well. Many emerging currencies and bonds have been under severe pressure in recent weeks, and the MSCI Emerging Market Index is down 12% since May 8. Since such sharp price declines sometimes present buying opportunities, we are reassessing this underweight, but we intend to be very selective. We see continuing problems in Brazil, India, and certain areas within of Southeast Asia, but there are early signs that China may be stabilizing.

China's 'flash' purchasing manager index (PMI) for manufacturing rose 2.4 points in August to a four-month high of 50.1, according to Markit/HSBC. A final reading above 50 (reported September 1) would add to our optimism from the flash report. China is approximately 20% of the benchmark emerging market stock index and contributes substantially to global economic growth, so signs of stability are welcome for global markets. Since June, the MSCI China Index has significantly outperformed other emerging markets in part because much of the weakness has been focused on emerging market currencies in those countries with current account deficits. China has ample foreign exchange reserves and a managed currency.

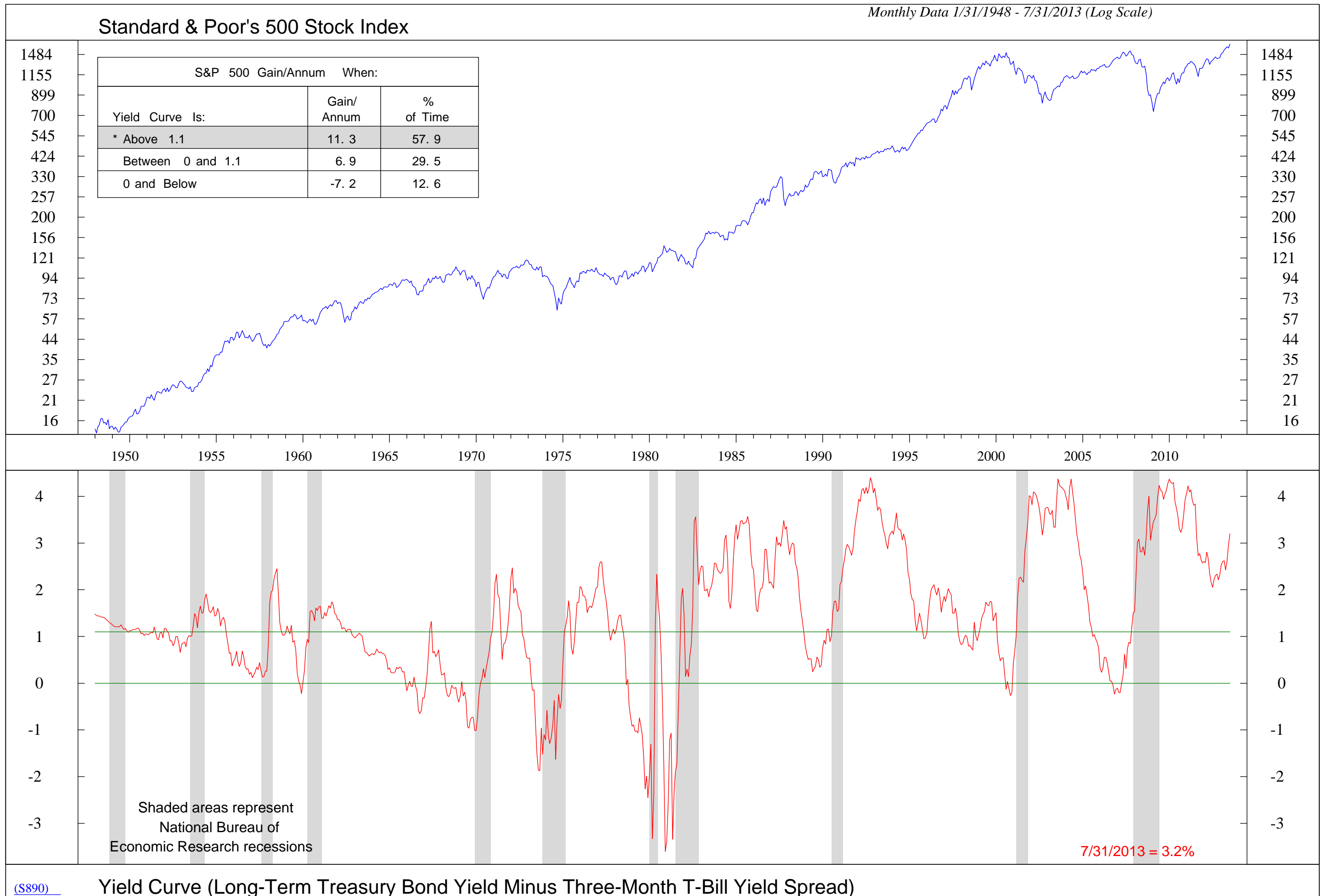
We believe China has the resources to mitigate a further sharp decline in its growth rate, but any financial bailout is likely to be prolonged and a drag on growth. This is important for developed markets as it limits any contagion from the troubles in other emerging countries.

Within the subcomponents of China's manufacturing PMI, new orders (a lead indicator) showed slight expansion but new *export* orders decreased at a faster rate, suggesting further contraction and weakness in China's export markets. We think this reflects a few recent developments. First, the Chinese yuan has strengthened to levels not seen since it was devalued in 1994. We believe this is a deliberate policy choice to help wean China's economy from its export-dependence and encourage domestic consumption, but it could lower overall growth, especially given the currency weakness in many other emerging markets over the last few months. Second, fiscal authorities implemented a 'mini-stimulus' in July, which eliminated taxes for small businesses and outlined plans to reduce costs and provide funding for select industries, such as railway construction. We think this has helped spur activity for the targeted areas. Third, following a spike in interbank lending rates in June, monetary authorities have allowed credit to flow again. We question the long-term wisdom of letting 'shadow financing' activities propagate further, with many loans structured specifically to avoid regulatory oversight. However, a free-flowing credit market is generally positive for economic growth, as long as it lasts.

China's dilemma is that the costs of indiscriminate bank lending eventually come due, as the US discovered in the subprime mortgage crisis. When they do, these costs have a tendency to fall on taxpayers (rather than politically connected banks) and there is already anecdotal evidence that Beijing is leaning towards bailouts. As the *Financial Times*' Gavyn Davies writes: "China has about $3.5 trillion of foreign exchange reserves, and holds net assets overseas worth 30 per cent of GDP. In the last financial sector work-out, these reserves were used to recapitalize the banking system, and the same could happen again." Beijing has ordered a nationwide audit of local government debt, which could catalyze greater investor confidence, similar to the US 'stress tests.' Furthermore, the October plenary session of the National People's Congress could produce proactive structural reforms to meet some of China's medium-term challenges in rebalancing its economy.

Our overall conclusion is that we believe China has the resources to mitigate a further sharp decline in its growth rate, but any bailout is likely to be prolonged and a drag on growth. This is important for developed markets, in our view, as it limits any contagion from the troubles in other emerging countries. Looking specifically at the US, with the messages from the Federal Reserve's conference in Jackson Hole designed to prepare the markets for a reduction in the quantitative easing, our Weekly Chart shows how stocks have reacted to an environment of long-term interest rates rising faster than short-term ones.

THE WEEKLY CHART: STEEPENING YIELD CURVE POSITIVE FOR STOCKS



Tapering of the Fed's asset purchases could begin at their next meeting on September 17-18. While we see little evidence of "substantial improvement in the outlook for the labor market," which the Fed has said is a precondition for tapering, the rise in Treasury yields over the last few weeks suggests investors expect the Fed to taper. There is a possibility for a mix shift in bond buying — towards more mortgage-backed securities and fewer Treasuries — and more aggressive 'forward guidance' — lowering the unemployment threshold for rate hikes to 6% from 6.5%, for example. This will likely keep the yield curve steep as we continue to expect gradually rising longer-term interest rates. As our chart shows, since 1948 a steep yield curve (longer-term rates are more than 1.1 percentage points above short-term rates) has been a positive environment for stocks.

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