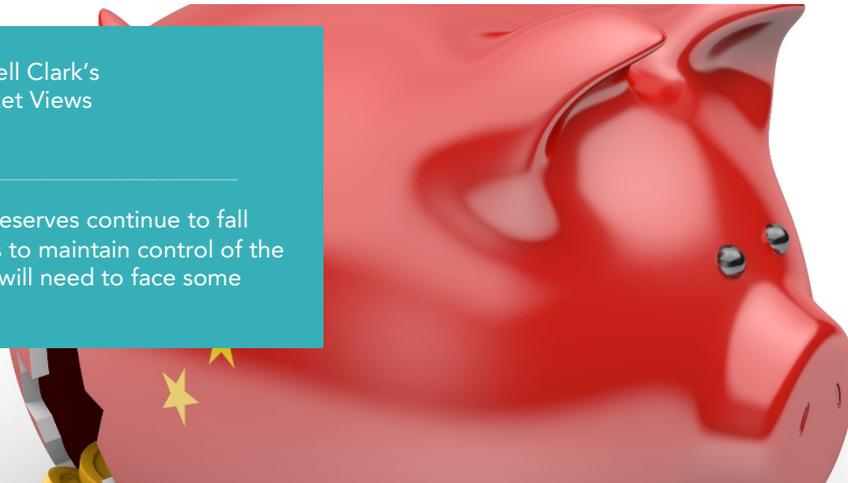


IS CHINA RUNNING OUT OF MONEY?



Russell Clark's
Market Views

"If Chinese foreign reserves continue to fall and the PBOC wants to maintain control of the exchange rate, they will need to face some difficult choices."

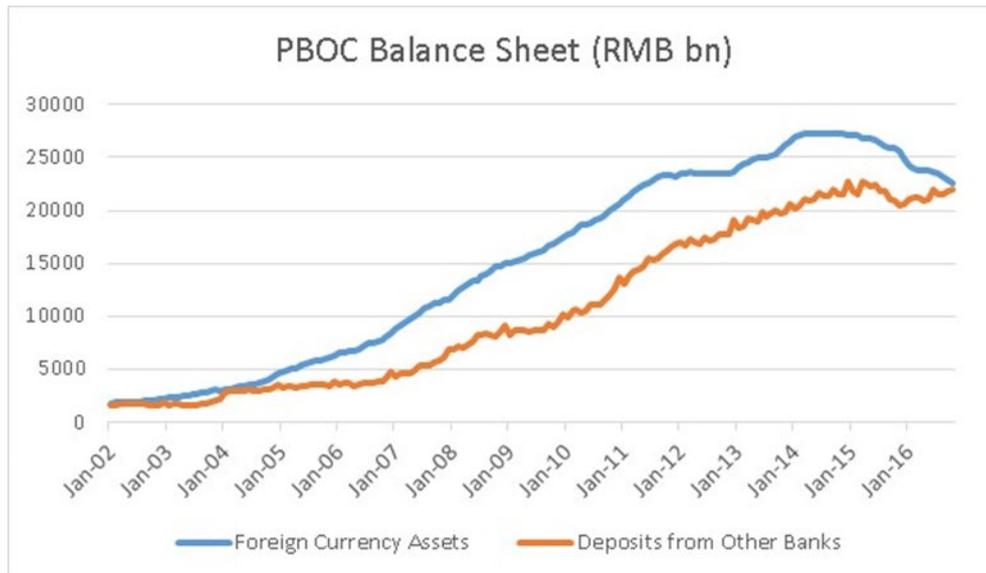


Since the global financial crisis, China has had a very strong currency, even with the recent devaluation of the Chinese Yuan.

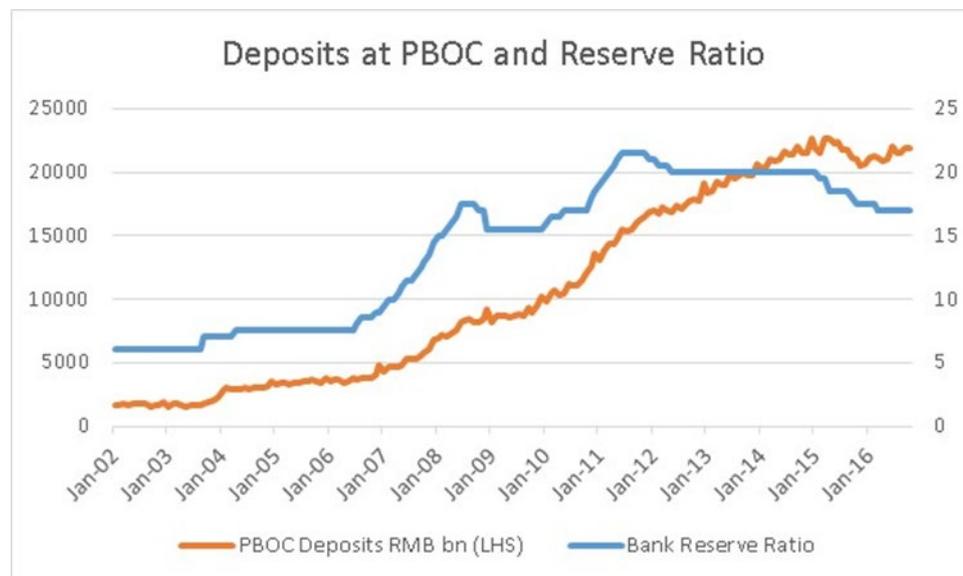


China has a managed exchange rate. The People’s Bank of China (PBOC) has had to step in to the exchange market to buy any USD coming into China. To buy the USD coming into China, the PBOC has had to create CNY for this purpose. Typically, to soak up these new CNY, the PBOC has issued CNY bonds, as well as having very high reserve requirements on the banks to control the supply of CNY.

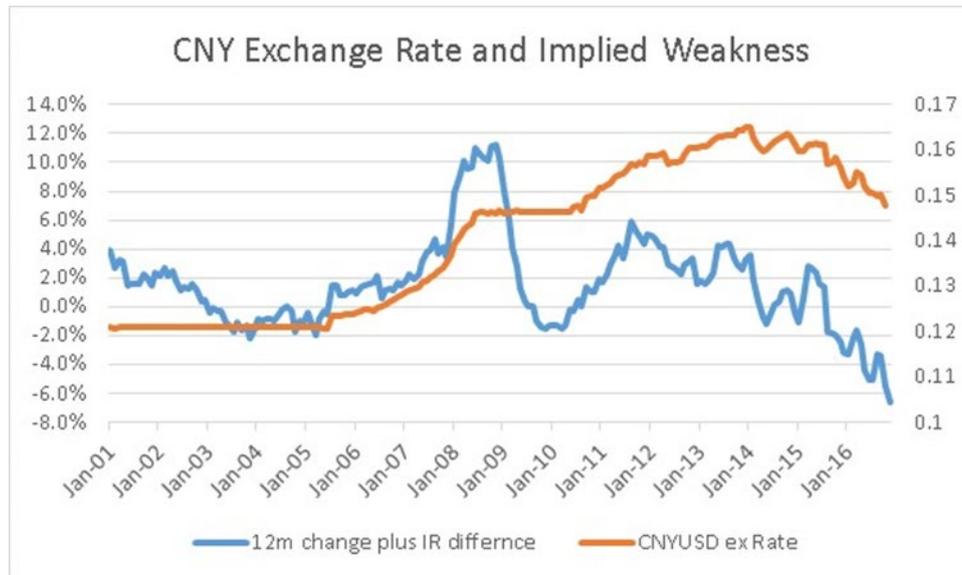
The PBOC is like any other bank, and it needs to match assets with liabilities. On the asset side, by far its biggest assets are foreign reserves. On the liability side are domestic deposits. For many years, foreign reserves were much larger than deposits, but now the gap is shrinking rapidly as foreign currency assets fall.



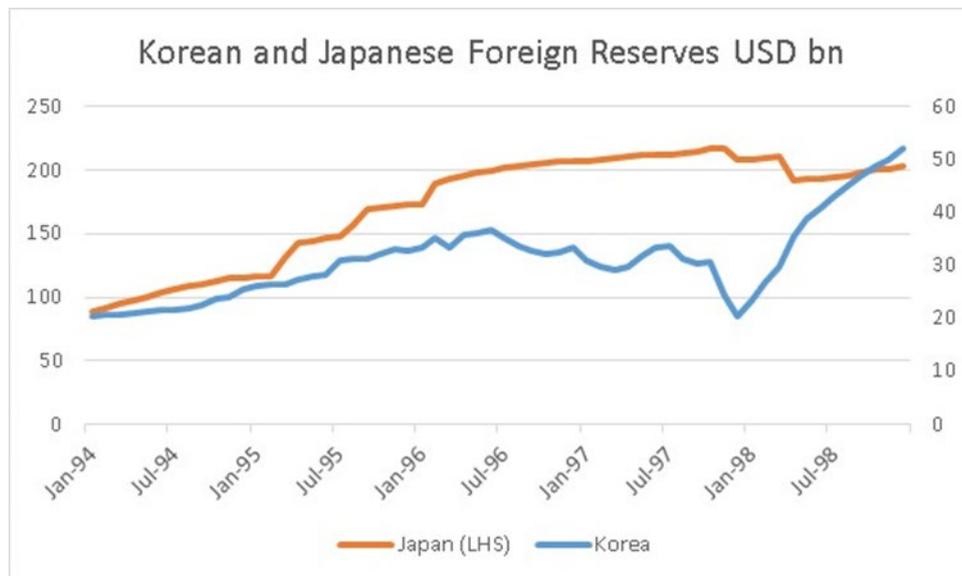
If Chinese foreign reserves continue to fall and the PBOC wants to maintain control of the exchange rate, they will need to face some difficult choices. First of all, it could raise interest rates to try and make the Yuan more attractive and reduce outflows. This however would be negative for growth, a priority of the Chinese Communist Party. The other option is to reduce the holdings of deposits at the PBOC. The large holdings of deposits at PBOC is driven by the very high reserve requirements of the Chinese banking system, and previous cuts in the reserve requirements have reduced deposits at least temporarily.



This leaves the PBOC with a dilemma. Raising rates will restrict growth but defend the currency, while cutting rates or reserve rates for banks will encourage more currency weakness. One way to think about how high interest rates need to rise to stop a currency from falling is to look at how weak a currency has been over the last twelve months. You then compare this to the difference in 10 year bond rates, and the movement in the exchange rate over the last 12 months to get an idea of the interest rates increase needed to attract US dollars. The idea is that if a currency has been weak, but interest rates are relatively high, then you are being adequately compensated. Conversely, if the currency has been weak, and the interest rates are relatively low, then rates will need to rise. Currently, it suggests Chinese 10 year rates need to be 6.5% higher, to halt currency weakness.



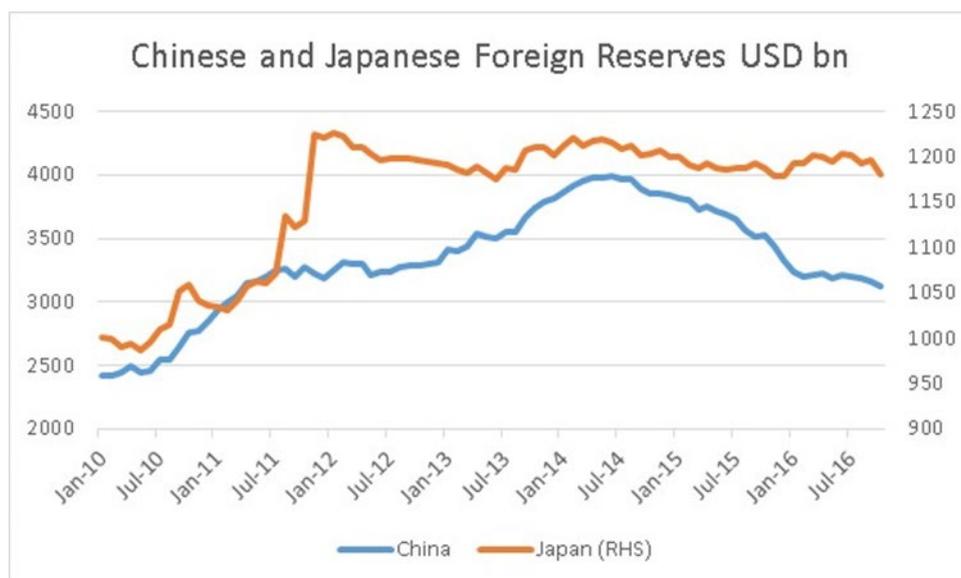
Given the large increase in rates needed to slow Chinese Yuan devaluation, devaluation must start to look like the more likely move. South Korea faced a very similar situation in 1997. In the mid-90s, Korean foreign reserves began to fall, like they are in China today. We have added Japanese foreign reserves to show that the fall in reserves was a Korean specific issue.



Like the Chinese Yuan, the Korean Won was a managed exchange rate that began to depreciate slowly then quickly.



Below we produce the same graphs, but replace Korea with China.



Given the huge increase in debt in China in recent years, such a rate increase seems very unlikely to me. Investors should be prepared for bigger falls in the Chinese Yuan.

INFORMATION

Issue Date: 29th November 2016
 Source: Bloomberg, unless otherwise stated
 Investor Relations: Alain Zakeossian, Carol Brown
 Email: info@russellclarkim.com
 Telephone: +44 (0)20 7838 7580
 Website: www.russellclarkim.com

Business and registered address: Russell Clark Investment Management Limited, 9 Chester Close, London SW1X 7BE, United Kingdom. Registered in England and Wales - Company number: 04034280

DISCLAIMER

This Market View has been prepared and issued by Russell Clark Investment Management Ltd (the "Firm") authorised and regulated by the Financial Conduct Authority. It has been approved as a financial promotion by the Firm and as such is intended **for professional clients and eligible counterparties only and is not intended for retail client use**. It is not intended for distribution to any country where such distribution or use would be contrary to local law or regulation.

This Market View is provided for information purposes only and should not be regarded as an offer to buy or sell any investments or related services that may be referenced herein. No guarantee is made as to the accuracy of the information provided which has been obtained from sources believed to be reliable. The view expressed in this Market View are the views of the portfolio manager at time of publication and may change over time. Nothing in this Market View constitutes investment, legal tax or other advice nor is it to be relied upon in making an investment decision. No recommendation is made positive or otherwise regarding individual securities mentioned herein. Past performance is not indicative of future performance. The price of investments can go up as well as down and can be affected by changes in the rates of exchange. The information contained in this document is strictly confidential and is intended only for the use of the person who has been provided the Market View by the Firm. No part of this Market View may be divulged to any person, distributed, resold and or reproduced without the prior written permission of the Firm.

Where "forward looking" information, including estimates, projections and subjective analysis and judgement are provided no representation as to the accuracy of such projections or estimates or that they may be realised. Certain assumptions used in formulating such "forward looking" information may differ materially from actual events or conditions.