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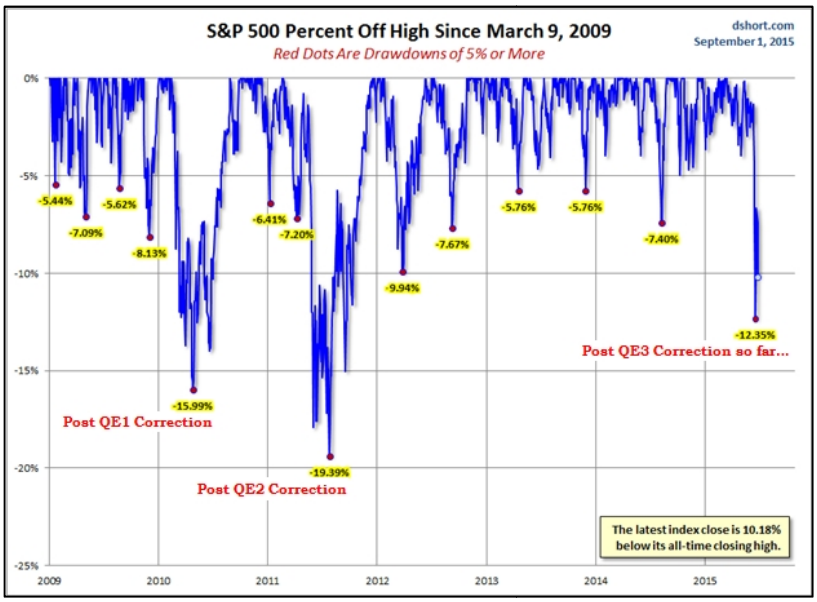
September 1, 2015 – ***The Yuan and the When?***

As the lazy days of summer have wound down, over the last several weeks global financial markets have been anything but lazy. After spending the first 157 days of the year, through August 17, in its tightest ever range through that point in the year, the Dow Jones Industrial Average* proceeded to fall -10.36% in the next six trading days. The two day bounce of more than 5% that immediately followed was confirmation that volatility has finally made a comeback.



As of the date of this letter, the Dow and the S&P 500 are down –9.9% and –7.04% so far in 2015, respectively, and -6.08% & -4.46% over the past 12-months, again respectively. By the time this letter reaches your mailbox those numbers are likely to have changed dramatically. Thus is the nature of the phase of the market cycle that we have now entered. Extreme day-to-day swings in either direction are likely to be the norm until market participants receive greater clarity on the two issues that are driving this current period of increased volatility. Those two issues are the Chinese government's attempts to stabilize their crashing stock market and slowing economy, most recently by devaluing their currency, the Yuan, and the timing of the Federal Reserve's first interest rate hike since 2006. Thus the title of this letter: 'The Yuan and the When?'

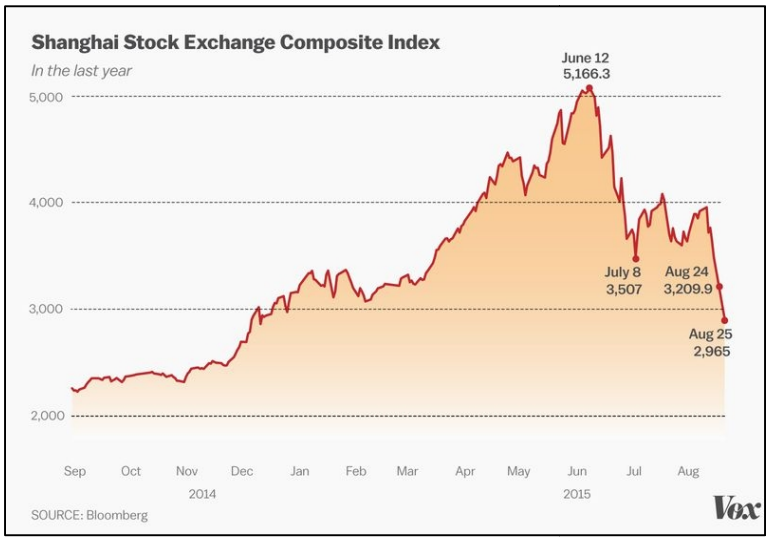
We first discussed the risks to the global economy posed by a slowing Chinese economy in our February 2014 letter entitled *The Oracle of Omaha and Swimming Naked*, available on the homepage of our website. For those who know who the 'Oracle of Omaha' is, that title probably does not conjure the most favorable of images. What we were referring to, however, was a famous quote from the aforementioned oracle:

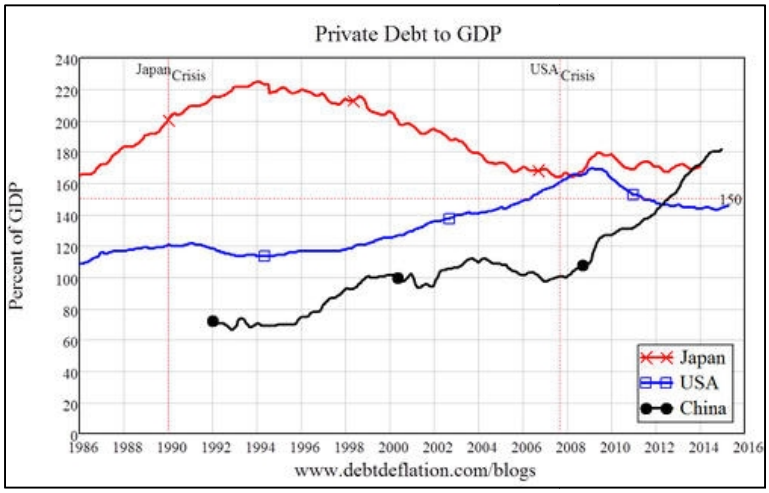
"After all, you only find out who is swimming naked when the tide goes out."

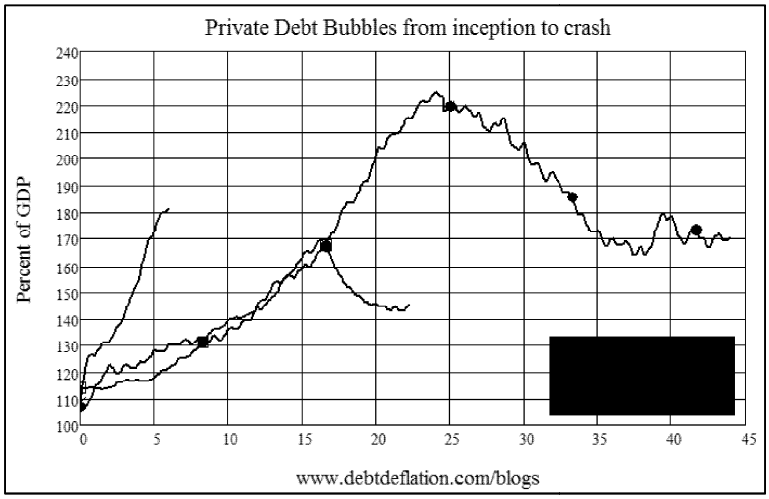
-Warren Buffett, 2001

Mr. Buffett was referring to the all-too-revealing effect of a sudden shift in investor psychology or risk appetite. During periods of market stability, as we've seen in domestic equity markets since late 2011 when the Fed began the most recent round of quantitative easing (Operation Twist/QE3), businesses, households and financial market participants historically tend to assume greater degrees of risk than they otherwise might deem prudent. The tendency of the average investor is to extrapolate the recent calmness forward, and assume that those conditions will perpetuate. When volatility rears its ugly head and the perceived market

stability disappears, as it has over the past several weeks, those who have overextended or overexposed themselves to risky positions find themselves in an uncomfortable spot.







The most recent population revealed to have been swimming naked is the Chinese retail investor. The incredible increase in private debt in China since the 2008 Global Financial Crisis has led to two massive bubbles: a real estate bubble, which burst in late 2013, and a stock market bubble which peaked out in June of this year and is still in the process of deflating. From January 1 through June 12, the Shanghai Composite Index was up by more than +60%. Every bit of those year-to-date gains had dissolved by August 25th despite massive amounts of intervention by the Chinese government.

As you can see in the two charts to left, in the last several years China's private debt to GDP ratio surpassed those of the United States and Japan. Japan's massive debt bubble finally topped out in the early 1990's, a few years after their real estate and stock market implosions. Here in the US, 2009 marked the peak of our private debt bubble and was similarly preceded by bursting housing and stock market bubbles. China, whose private debt bubble inflated in a fraction of the time necessary for the US and Japan to get to dangerous levels, appears to be following the exact same bubble bursting play book.

Since the Japanese crisis in 1989, their economy has been anemic and their financial markets have still not regained that 1989 peak, 26 years later. In the US, despite six years of zero interest rate policy and trillions of dollars in quantitative easing, our economy is still just bumping along at an annual growth rate of roughly 2%. Equity prices have certainly roared back, but only time will tell if those Fed-induced gains are sustainable. China, the world's second largest economy, appears to be following the same well worn path from debt-induced bubbles to anemic growth and likely recession.

Central Bank Easing in 2015			
Count	Country	Date	Easing Measure
1	Romania	7-Jan	25 bps cut to 2.5%
2	India	15-Jan	25 bps cut to 7.75%
3	Switzerland	15-Jan	50 bps cut to -0.75%
4	Egypt	15-Jan	50 bps cut to 8.75%
5	Peru	15-Jan	25 bps cut to 3.25%
6	Denmark	19-Jan	15 bps cut to 0.05%
7	Turkey	20-Jan	50 bps cut to 7.75%
8	Canada	21-Jan	25 bps cut to 0.75%
9	Eurozone	22-Jan	QE (1.1 trillion Euros)
10	Pakistan	24-Jan	100 bps cut to 8.5%
11	Albania	28-Jan	25 bps cut to 2.00%
12	Russia	30-Jan	200 bps cut to 15.0%
13	Australia	3-Feb	25 bps cut to 2.25%
14	Romania	4-Feb	25 bps cut to 2.25%
15	Sweden	12-Feb	10 bps cut to -0.1%, QE
16	Indonesia	17-Feb	25 bps cut to 7.5%
17	Israel	23-Feb	15 bps cut to 0.1%
18	Turkey	24-Feb	25 bps cut to 7.5%
19	China	28-Feb	25 bps cut to 5.35%
20	India	4-Mar	25 bps cut to 7.5%
21	Poland	4-Mar	50 bps cut to 1.5%
22	Thailand	11-Mar	25 bps cut to 1.75%
23	South Korea	12-Mar	25 bps cut to 1.75%
24	Serbia	12-Mar	50 bps cut to 7.5%
25	Russia	13-Mar	100 bps cut to 14.0%
26	Sweden	18-Mar	15 bps cut to -0.25%
27	Pakistan	21-Mar	50 bps cut to 8.0%
28	Hungary	24-Mar	15 bps cut to 1.95%
29	Romania	31-Mar	25 bps cut to 2.00%
30	Serbia	9-Apr	50 bps cut to 7.00%
31	Sri Lanka	15-Apr	50 bps cut to 6.00%
32	Hungary	21-Apr	15 bps cut to 1.80%
33	Thailand	29-Apr	25 bps cut to 1.50%
34	Russia	30-Apr	150 bps cut to 12.50%
35	Australia	5-May	25 bps cut to 2.00%
36	Romania	6-May	25 bps cut to 1.75%
37	China	10-May	25 bps cut to 5.1%
38	Serbia	11-May	50 bps cut to 6.5%
39	Pakistan	23-May	100 bps cut to 7.00%
40	Hungary	26-May	15 bps cut to 1.65%
41	India	2-Jun	25 bps cut to 7.25%
42	New Zealand	11-Jun	25 bps cut to 3.25%
43	South Korea	11-Jun	25 bps cut to 1.50%
44	Serbia	11-Jun	50 bps cut to 6.00%
45	Russia	15-Jun	100 bps cut to 11.50%
46	Norway	18-Jun	25 bps cut to 1.00%
47	Hungary	23-Jun	15 bps cut to 1.50%
48	China	27-Jun	25 bps cut to 4.85%
49	Sweden	2-Jul	10 bps cut to -0.35%, QE Increase
50	Jordan	8-Jul	25 bps cut to 3.75%
51	Azerbaijan	10-Jul	50 bps cut to 3.00%
52	Canada	15-Jul	25 bps cut to 0.5%
53	Hungary	21-Jul	15 bps cut to 1.35%
54	New Zealand	23-Jul	25 bps cut to 3.00%
55	Russia	31-Jul	50 bps cut to 11.00%
56	Serbia	13-Aug	50 bps cut to 5.50%
57	China	25-Aug	25 bps cut to 4.60%

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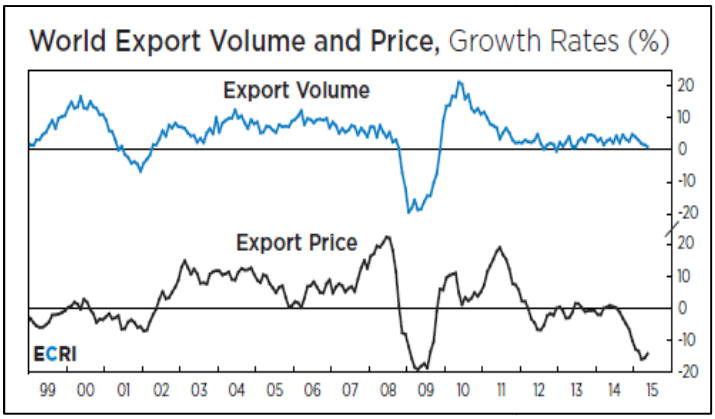
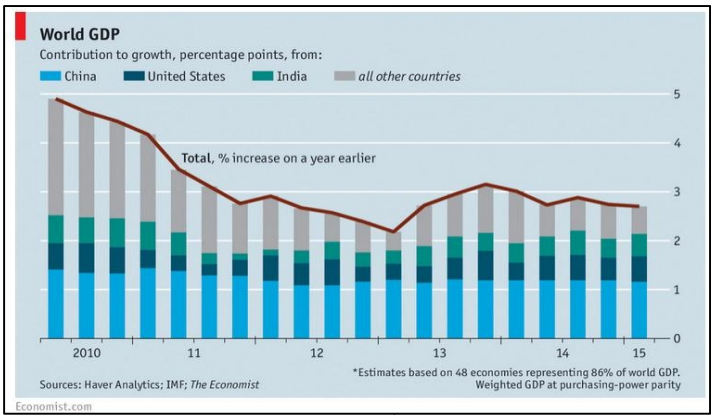
Recent data revealed that year-over year, Chinese exports are down -8.3%; imports are down -8.1%, home prices are down -4.4% and their Manufacturing Purchasing Managers Index (PMI) was measured at 47.1. A PMI above 50 indicates growth and a PMI below 50 indicates contraction. Chinese Manufacturing PMI hasn't been this low since the recession following the Financial Crisis.

The other driver of market uncertainty over the past several weeks, the Fed's pending rate hike, has been front and center on many investors' minds since last October. When the most recent (but probably not the final) round of quantitative easing ended and the Federal Reserve indicated that its next move would likely be a normalization of interest rates, the Fed broke from the global pack of central bankers who until then had all been moving in lock step since the end of the Global Financial Crisis. As we discussed in our last letter, this divergence has led to a rapid appreciation in the value of the US Dollar relative to virtually all other global currencies. (see chart at bottom of next page)

The appreciation of the US Dollar, the world's primary reserve currency, coupled with the slowdown in China, has wrought havoc on the finances of emerging market economies and spurred an intensification of the currency war that has been raging since 2008. In a world of decreasing economic growth (see charts at top of next page) the only way for many export-dependent nations to avoid recession is to make their goods and services cheaper overseas by devaluing their currency. As of August 25th, there have been 57 distinct actions taken by central banks around the world intended to ease monetary conditions (i.e. weaken their currency) in an effort to grab a larger slice of a shrinking global economic pie.

The action that set off the recent volatility was the outright devaluation of the Chinese Yuan by the People's Bank of China. Because the Chinese currency had previously maintained a loose peg to the US Dollar, the massive appreciation of the USD over the past 14 months had been a de facto tightening of monetary policy on the Chinese economy, making their exports considerably more expensive relative to those of their largest export competitors Japan, Germany and South Korea.





What is most important to understand about the surprise Chinese devaluation and the Fed's potential rate hike is the phase transition that these could represent to global market participants. In a complex system, much like a pot of water on the stove, a stable state can be maintained for a period of time but once it reaches a tipping or boiling point there can be a sudden and dramatic change.

In a recent article entitled 'What Happens When a Dragon Flaps Its Wings?', Evergreen GaveKal's chief economist Worth Wray likened the Chinese devaluation to the Butterfly Effect from chaos theory, which suggests that small events in a complex system can result in big, unforeseen changes over time:

Global Currencies vs. US Dollar

Country/Region	Currency	Ticker	% Change (Since 6/30/14)	52-Week Low
Russia	Ruble	RUB	-48%	12/16/2014
Colombia	Peso	COP	-39%	8/26/2015
Brazil	Real	BRL	-38%	8/26/2015
Turkey	Lira	TRY	-28%	8/20/2015
Norway	Krone	NOK	-26%	3/18/2015
Australia	Dollar	AUD	-24%	8/24/2015
Malaysia	Ringgit	MYR	-23%	8/26/2015
Mexico	Peso	MXN	-23%	8/26/2015
Sweden	Krona	SEK	-21%	4/13/2015
South Africa	Rand	ZAR	-20%	8/24/2015
Poland	Zloty	PLN	-19%	3/13/2015
Canada	Dollar	CAD	-19%	8/25/2015
Denmark	Krone	DKK	-18%	3/16/2015
Eurozone	Euro	EUR	-18%	3/16/2015
Nigeria	Naira	NGN	-18%	2/12/2015
Japan	Yen	JPY	-17%	6/5/2015
Iran	Rial	IRR	-15%	8/28/2015
Indonesia	Rupiah	IDR	-15%	8/26/2015
South Korea	Won	KRW	-14%	8/24/2015
Israel	Shekel	ILS	-13%	3/20/2015
Argentina	Peso	ARS	-13%	8/28/2015
Singapore	Dollar	SGD	-12%	8/24/2015
United Kingdom	Pound	GBP	-10%	4/13/2015
Thailand	Bhat	THB	-10%	8/28/2015
India	Rupee	INR	-9%	8/25/2015
Switzerland	Franc	CHF	-8%	1/14/2015
Taiwan	Dollar	TWD	-8%	8/24/2015
China	Yuan	CNY	-3%	8/12/2015

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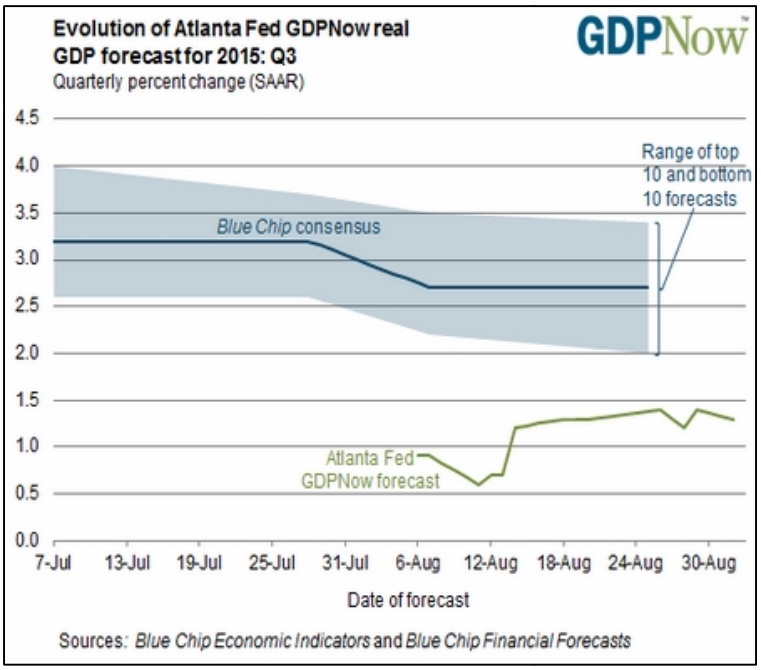
Make no mistake, China has just changed the game in a thousand ways that are not entirely straightforward. ***While a 3% devaluation in the USD/CNY exchange rate is not the kind of global deflationary shock that some people are saying, the un-anchoring of expectations and the possibility of further depreciation in the coming months sets a series of events in motion that dramatically raises the odds of a global deflationary bust in the not-so-distant future.***

Keep this in mind: In a world where everything is connected, where every major economy has a debt problem, where money has flooded the world for seven years, and where volatility remains low even in the face of collapsing commodity markets, the Federal Reserve is tightening at a time the rest of the world has been easing. And in the event that its first rate hike in nearly a decade sends the US dollar higher, Beijing will have the plausible deniability it needs—if it so chooses—to let the USD/CNY exchange rate drop like a stone.

- Worth Wray, August 21, 2015

The odds of the Fed's first rate hike occurring in September fell considerably as a result of the Chinese currency devaluation and the subsequent global market sell-off. The next FOMC meeting on September 16-17 will likely come and go without a surprise. The last thing the Fed wants to do is bobble this all-important market event. But as we stated in our last letter, the Fed is woefully ill-equipped to fight the next recession as long as interest rates are at the zero lower bound. They are eager to put the arrow of interest rate policy back in their quiver, and absent recent market volatility they have sufficient domestic economic data to justify the small 'one and done' hike they've been telegraphing for months.



The Fed may not get another chance if they pass on raising rates at their upcoming FOMC meeting. Second quarter GDP growth in the United States was recently revised up to a greater-than-expected +3.7%, after posting a weak +0.6% in the first quarter. The historically accurate Atlanta Fed's GDPNow forecast estimates that third quarter GDP is running at just a +1.3% rate, based on the economic data released for the quarter so far, which has not yet registered the hit to economic activity likely caused by the market gyrations and China-induced uncertainty of the back half of August. With a strong second quarter GDP print in support of a small initial hike, does the Fed dare risk that support being withdrawn by a weak third quarter growth estimate which will be announced well in advance of the December FOMC meeting?

Unfortunately, many economists and analysts feel that the Fed may have already missed their window of opportunity. On August 24th, Harvard economist and former Treasury Secretary Larry Summers made the following comments in a Washing Post op-ed:

> There may well have been a financial-stability case for raising rates 6 months or 9 months ago, as low interest rates were encouraging investors to take on risk and businesses to borrow money and engage in financial engineering… That debate is now moot. With credit becoming more expensive, the outlook for the Chinese economy clouded at best, emerging markets submerging, the US stock market in correction, widespread concerns about liquidity, and expected volatility having increased at a near-record rate… the risk is that a rate increase will tip some part of the financial system into crisis with unpredictable and dangerous consequences.
>
> - Lawrence H. Summers, August 23, 2015

And the next day Mr. Summers, who was the other major contender for the role of Chairperson of the Federal Reserve prior to Janet Yellen securing the position, made the following pronouncements on Twitter: "It is far from clear that the next Fed move will be a tightening." "As in August 1997, 1998, 2007 and 2008 we could be in the early stage of a very serious situation."

The Fed is absolutely in a no-win situation. If they tighten, the US Dollar will continue to appreciate markedly and further destabilize the emerging markets. If they delay, the damage being done by the commodity collapse and Chinese slow down could worsen and they could be facing a wave of global deflation and recession with no bullets in the chamber with which to defend the economy.

As we have maintained for some time now, the most prudent investments in this environment are the safe haven assets to which market participants always return in times of financial panic: US Treasuries and cash.

Please feel free to share this newsletter and do not hesitate to call or email with any questions or comments or to schedule a face-to-face portfolio review.

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