



IS CHINA ABOUT TO SLOW AGAIN?

October 20, 2016



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KEY TAKEAWAYS

1

STRUCTURAL OUTLOOK: SOFT LANDING \neq SMOOTH LANDING

Our secular biases with respect to the Chinese economy – which, coincidentally, haven't changed much over the past ~5 years – are as boring as they are well researched. Specifically, we continue to think that China is experiencing a "financial crisis with communist characteristics". This means fiscal and monetary policymakers have both ample tools and a genuine desire to attempt to engineer a "soft landing". While they may eventually accomplish their twin goals of permanently downshifting GDP growth and rebalancing economic drivers, their insistence upon maintaining financial and economic stability throughout said process effectively transfers deflation risk from the market in the near term to the real economy over the long term. Moreover, what they are trying to accomplish has never been done before in modern economic history; therefore, it's reasonable to assume the glide path down will be less linear than Beijing hopes.

2

CYCLICAL OUTLOOK: ECONOMIC STABILIZATION IS LONG IN THE TOOTH

Phony national accounts data aside, when analyzed across a number of key high-frequency data series, it's easy to see that the Chinese economy bottomed in late-2015/early-2016 – an outcome that was predicated on massive stimulus. The confluence of cyclical factors (namely a property bubble) and structural factors (i.e. a clogged credit channel, as well as a potential resurgence in capital outflows) supports our view that the aforementioned economic stabilization is long in the tooth. As such, we expect the broad compendium of China's high-frequency growth data to resume its structural downtrend within the next 3-6 months. This has obvious [negative] implications for reflation and risk assets broadly.

3

BONUS CONTENT: THE CHINESE CONSUMER STORY IS PAST-PEAK

While official statistics trumpet China's transition to a consumer-led, services-oriented economy, our analysis suggests said success is an obfuscation at best. We go in the weeds on Chinese employment, income and demographic trends to show why consumption growth on the mainland is unlikely to meaningfully rebound any time soon.

1. SOFT LANDING ≠ SMOOTH LANDING

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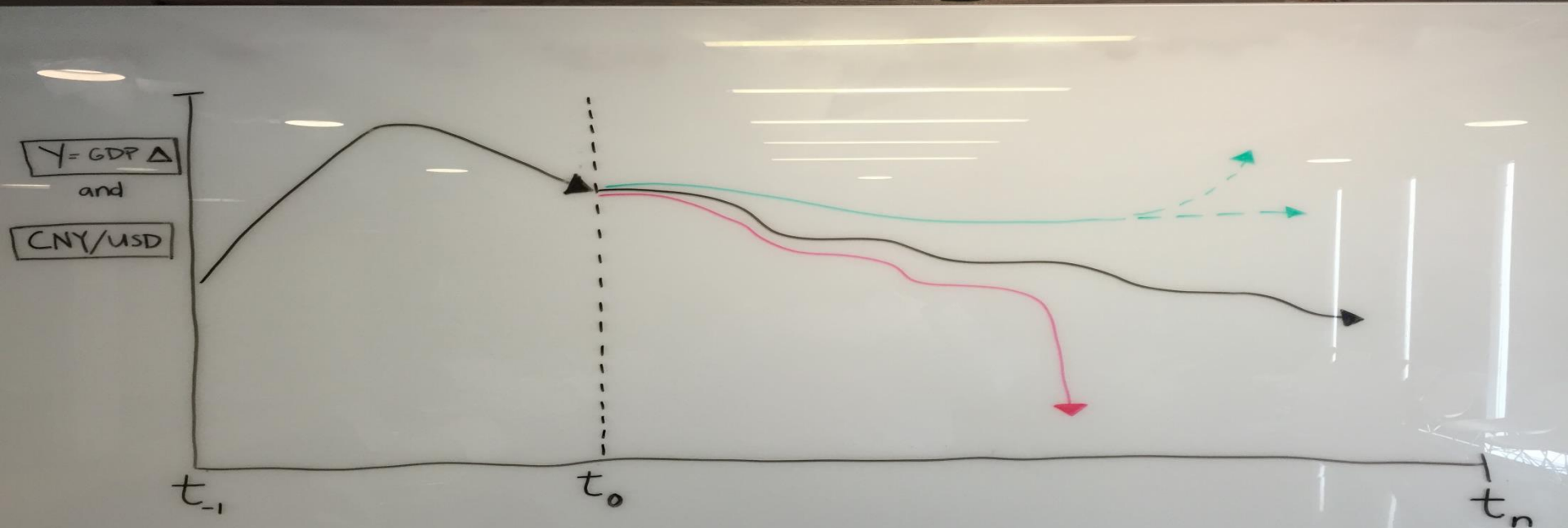
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A PICTURE IS WORTH A THOUSAND WORDS

THERE ARE THREE SCHOOLS OF THOUGHT WHEN IT COMES TO CHINA AND WE ARE DECIDEDLY IN THE MIDDLE CAMP.



REFRESHING OUR EM CRISIS RISK INDEX

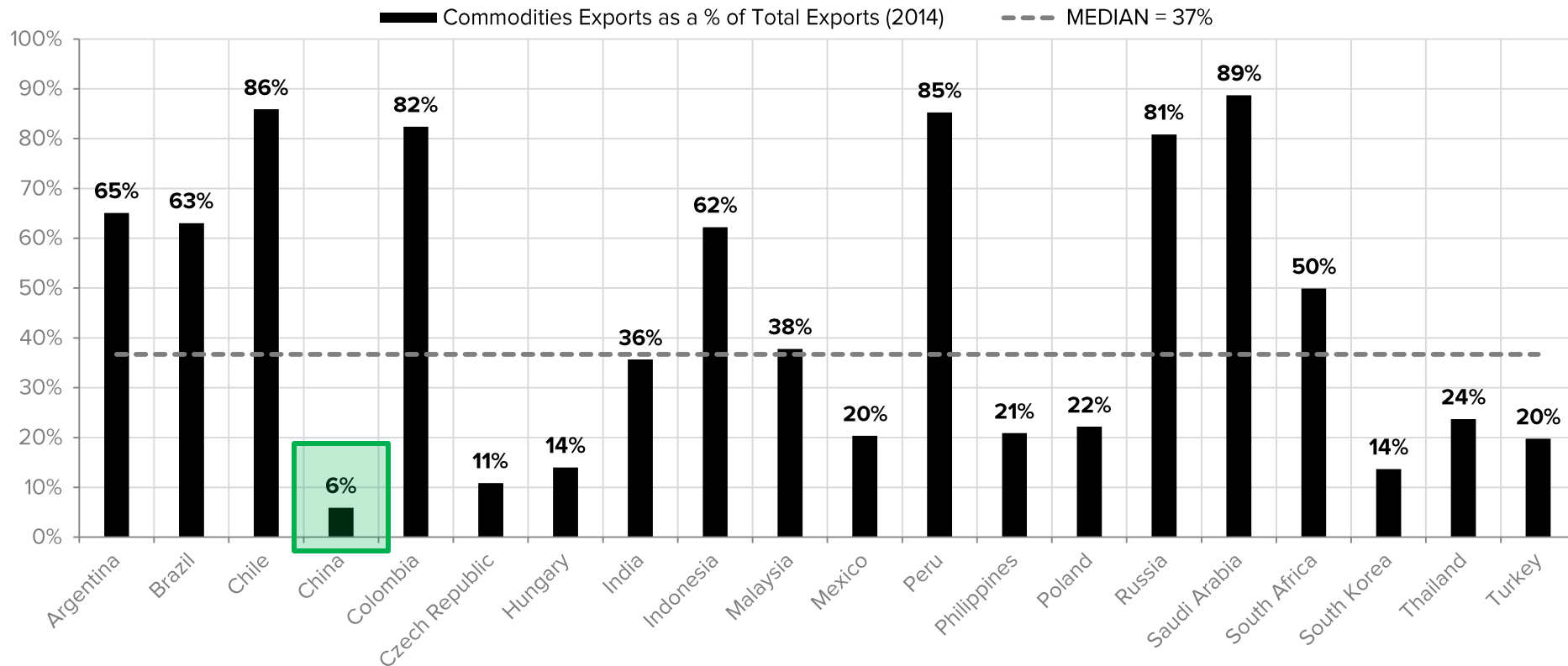
	Commodities Exports as a % of Total Exports (2014)		Current Account Balance as a % of GDP (Latest)	Energy Imports as a % of Net Energy Consumption (2012)	Fiscal Balance as a % of GDP (Latest)	Foreign Currency Assets as a % of Total Banking Sector Assets (2013)	General Government Debt as a % of GDP (Latest)	Leverage Gap of Publically-Listed Enterprises (Latest)	NEER Gap (Latest)	PPI Gap (Latest)	Private Nonfinancial Sector Credit-to-GDP Gap (1Q16)	Private Nonfinancial Sector Debt Service Ratio Gap (1Q16)	Profitability Gap of Publically-Listed Enterprises (Latest)	Real GDP Gap (Latest)	Real Property Prices 5Y CAGR (2015)	REER Gap (Latest)	Short-term External Debt as a % of Foreign Exchange Reserves (2015)	Total Inbound Portfolio Investment as a % of Total Nonfinancial Sector Credit (2015)	Total U.S. Dollar Debt as a % of Foreign Exchange Reserves (2015)	Valuation Gap of Publically-Listed Enterprises (Latest)
		CPI Gap (Latest)																		
Argentina	65%	2.0	-2.4%	6%	-2.0	4%	52%	1.7	-1.8	-0.4	-0.4	-	-0.4	-1.7	-	-1.8	90%	8%	-	1.2
Brazil	63%	1.5	-1.8%	11%	-2.7	8%	74%	2.1	-1.3	1.1	1.3	2.5	-1.3	-1.5	2%	-0.5	2%	14%	98%	1.8
Chile	86%	-0.1	-2.2%	65%	-	14%	18%	1.9	-1.2	-1.1	-	-	-1.3	-0.8	2%	-0.9	17%	-	263%	-0.2
China	6%	-0.6	2.4%	13%	-1.9	6%	43%	2.2	1.0	-1.4	2.0	1.6	-1.5	-1.0	4%	1.0	10%	3%	35%	0.8
Colombia	82%	2.0	-5.8%	-294%	-0.8	9%	51%	0.7	-1.4	1.9	-	-	-2.5	-1.2	8%	-1.4	15%	-	-	-0.8
Czech Republic	11%	-0.8	1.9%	23%	1.3	19%	40%	-0.3	-0.8	-	0.7	-0.3	0.4	0.6	0%	-1.0	19%	16%	-	0.3
Hungary	14%	-1.2	6.4%	55%	1.0	52%	75%	-1.3	-1.0	-	-0.9	-1.9	-1.0	0.6	-1%	-1.2	21%	20%	-	-0.6
India	36%	-0.9	-0.8%	31%	0.8	-	69%	2.0	-1.1	-2.2	1.0	0.6	-1.3	-0.3	10%	0.8	24%	17%	39%	0.3
Indonesia	62%	-1.3	-2.1%	-106%	-0.8	17%	27%	1.5	-1.3	-1.0	1.3	1.5	-1.4	-0.7	1%	-0.1	22%	26%	172%	1.1
Malaysia	38%	-0.4	1.9%	-9%	0.9	4%	57%	1.5	-2.4	-0.5	1.7	2.1	-1.7	-0.3	8%	-2.5	19%	24%	44%	1.0
Mexico	20%	-1.3	-3.2%	-16%	-0.2	12%	54%	1.5	-2.3	-1.1	2.3	2.5	-0.9	0.1	2%	-2.7	29%	40%	141%	1.4
Peru	85%	-0.1	-4.3%	-8%	1.4	46%	24%	1.5	0.2	0.1	-	-	-0.7	-0.7	14%	-0.2	8%	-	-	-0.4
Philippines	21%	-0.9	1.1%	43%	-0.2	15%	35%	1.6	0.1	-1.6	-	-	-1.4	0.7	6%	0.9	4%	-	91%	1.2
Poland	22%	-1.4	1.0%	27%	0.9	30%	51%	2.8	-0.8	-	1.2	0.3	-1.3	-0.3	-4%	-1.3	19%	20%	-	2.1
Russia	81%	-0.7	3.1%	-76%	-1.0	23%	16%	0.8	-1.8	0.0	1.9	1.5	-1.0	-0.5	-11%	-1.5	6%	10%	108%	0.0
Saudi Arabia	89%	-1.1	-8.3%	-212%	-	6%	5%	1.6	1.8	-	2.9	-	-1.1	-0.1	-	1.9	-	3%	-	-0.9
South Africa	50%	-0.1	-3.1%	-19%	-0.2	10%	50%	2.1	-1.6	-0.5	0.5	-0.2	-0.8	-0.9	1%	-1.2	22%	39%	95%	1.7
South Korea	14%	-1.2	7.8%	82%	-0.9	7%	38%	0.6	0.6	-1.4	1.4	-1.0	-0.7	-0.1	1%	0.6	6%	14%	39%	-0.3
Thailand	24%	-0.8	11.1%	40%	-0.6	6%	43%	0.5	0.8	-0.9	1.6	1.1	-1.0	0.1	2%	0.0	16%	15%	-	0.8
Turkey	20%	-0.1	-4.1%	74%	0.5	33%	33%	1.2	-1.6	-0.2	1.5	2.2	-1.1	-0.1	7%	-1.3	35%	17%	203%	0.1
MEDIAN	37%	-0.7	-1.3%	12%	-0.2	12%	43%	1.5	-1.1	-0.7	1.3	1.3	-1.1	-0.3	2%	-1.0	19%	16%	97%	0.6

SEPARATE THE WHEAT FROM THE CHAFF

We analyzed 20 emerging market economies through the lens of 20 predictive economic and financial market indicators to gain clues as to which economies were positioned most poorly for the next phase of #EmergingOutflows. Our focus on incorporating both stock and flow-based metrics is a key differentiator in this latest refresh of the model.

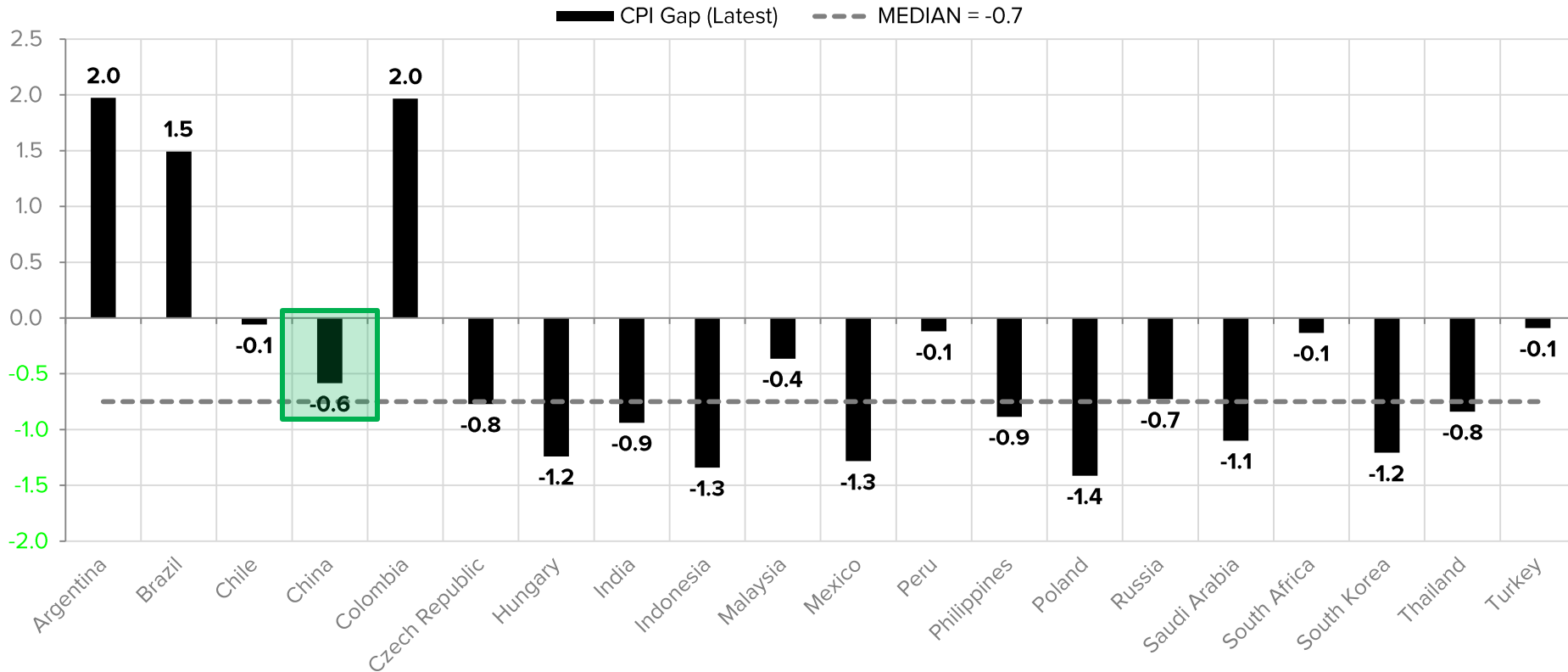
COMMODITY EXPOSURE

WITH A STRUCTURALLY BULLISH BIAS ON THE U.S. DOLLAR AND A STRUCTURALLY BEARISH BIAS ON CHINESE FIXED ASSETS INVESTMENT GROWTH, WE CONTINUE TO FLAG COMMODITY EXPOSURE AS A KEY RISK. CRUDE OIL COULD GET CUT IN HALF FROM HERE AND STILL BE ABOVE THE 1990S AVERAGE.



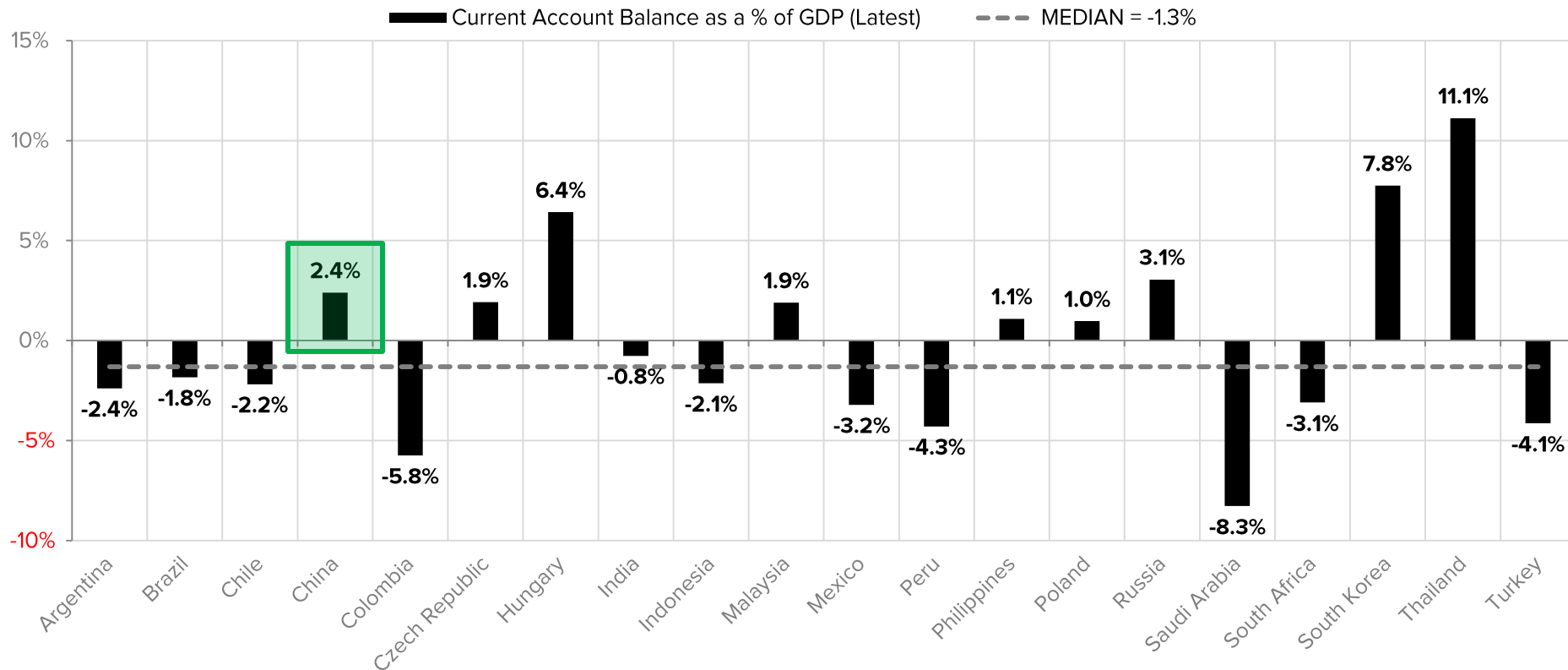
STAGFLATION RISK

OUR “CPI GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST QUARTERLY AVERAGE INFLATION READING VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH ELEVATED READINGS ARE FACING PRESSURE TO IMPLEMENT PRO-CYCLICAL MONETARY POLICY.



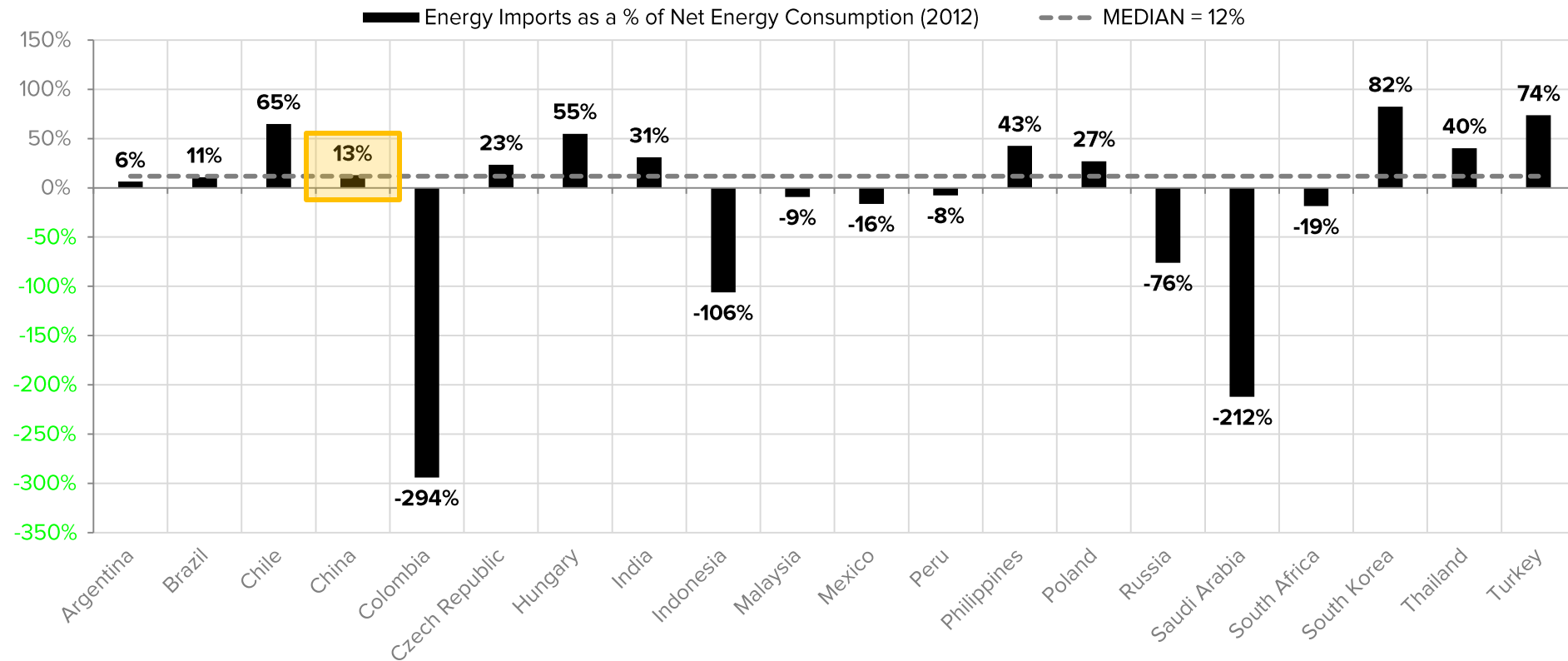
BALANCE OF PAYMENTS HEALTH

A RESUMPTION IN THE USD SUPERCYCLE AMID RISING INDEBTEDNESS AMONG EME BORROWERS MAY ONCE AGAIN PERPETUATE A DIVERGENCE BETWEEN THE ECONOMIC PERFORMANCE OF CURRENT ACCOUNT SURPLUS NATIONS AND THOSE THAT ARE RELIANT UPON INTERNATIONAL CAPITAL.



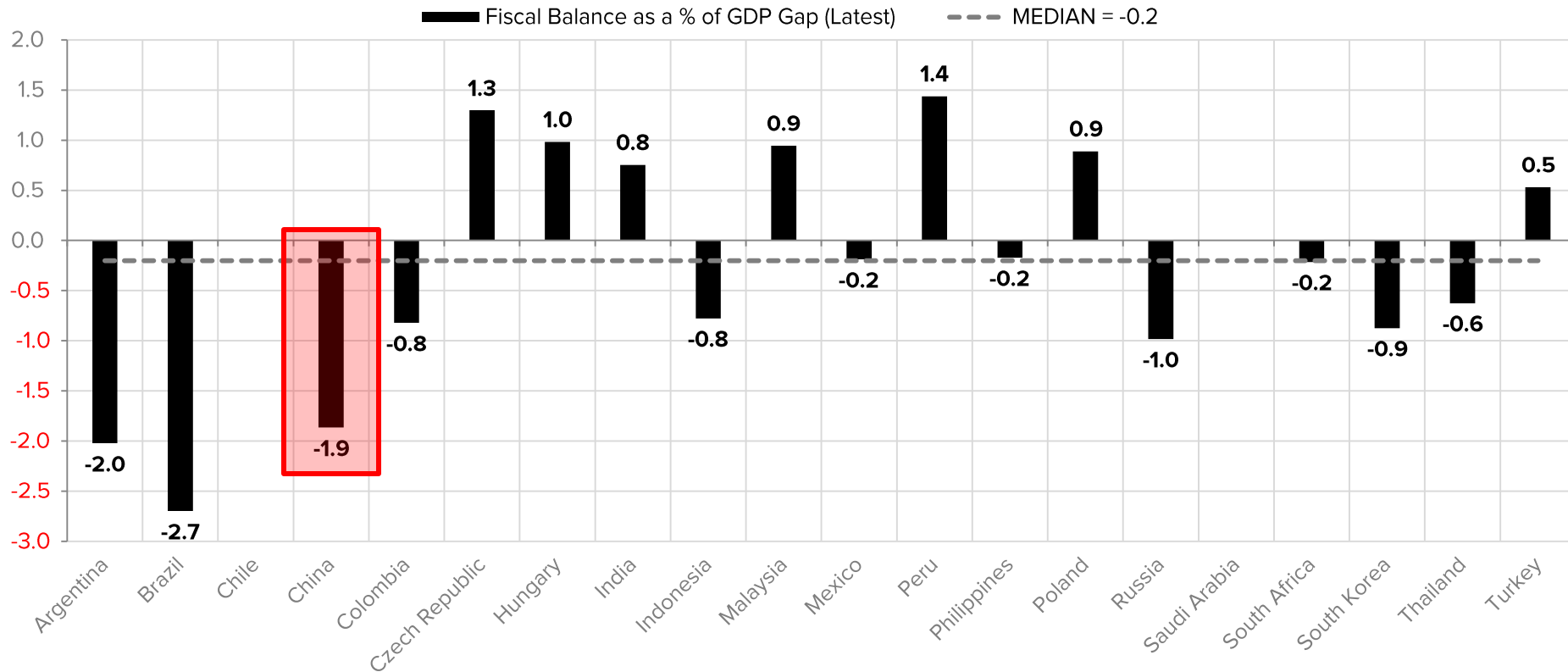
ENERGY EXPOSURE

THE PRECIPITOUS DECLINE IN CRUDE OIL PRICES HAS BEEN A WINDFALL FOR THOSE EMERGING MARKET ECONOMIES THAT WERE PREVIOUSLY SQUEEZED BY PERSISTENTLY ELEVATED ENERGY PRICES. THE NET RESULT IS A DIRECT BALANCE OF PAYMENTS TAILWIND.



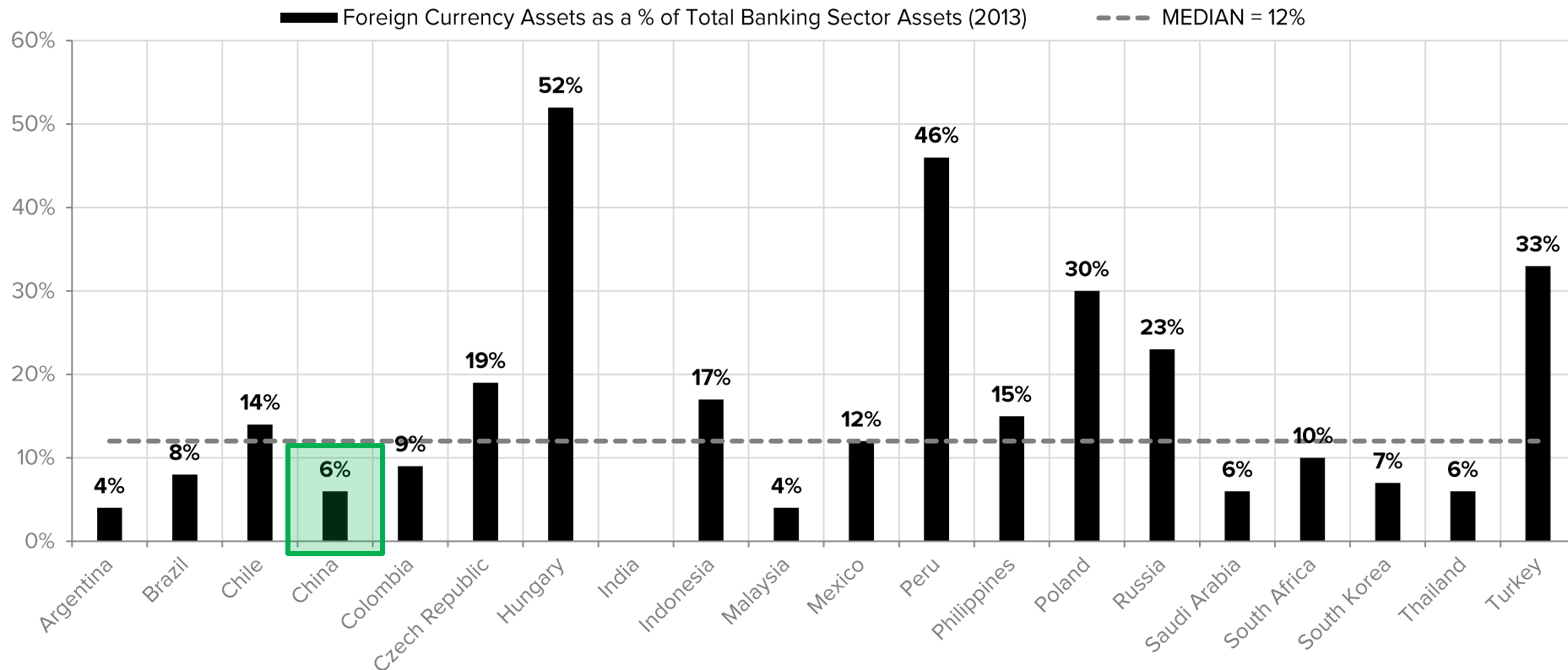
FISCAL SPACE

OUR “FISCAL BALANCE AS A % OF GDP GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST QUARTERLY BUDGET BALANCE VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH LOW READINGS HAVE LIMITED SCOPE TO EASE FISCAL POLICY FROM HERE.



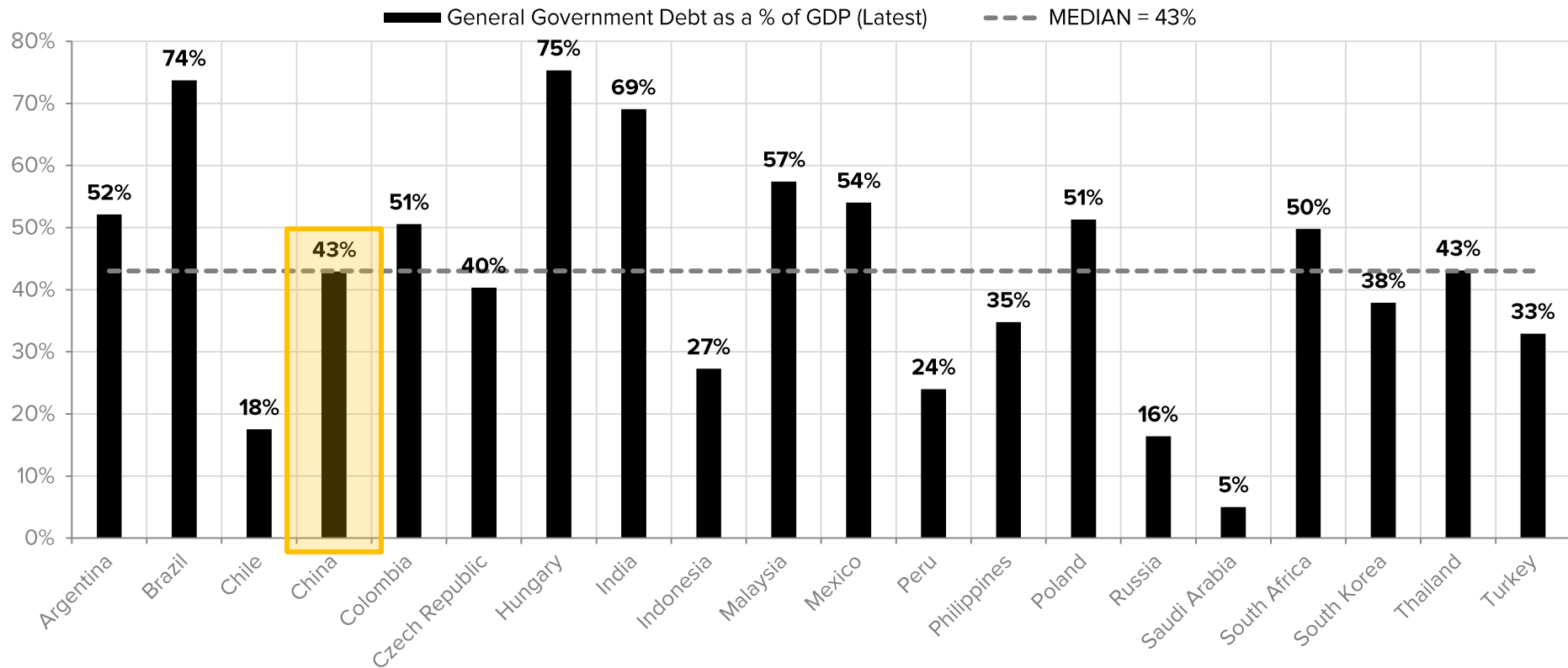
DOMESTIC CURRENCY MISMATCHES

CURRENCY MISMATCHES WITHIN THE BANKING SECTOR HAVE LONG BEEN A SOURCE OF IRE FOR EMERGING MARKET ECONOMIES. EMERGING EUROPE APPEARS PARTICULARLY AT RISK, THOUGH THAT RISK IS MITIGATED TO A LARGE EXTENT BY THE DOMINANCE OF EUR-DENOMINATED FUNDING.



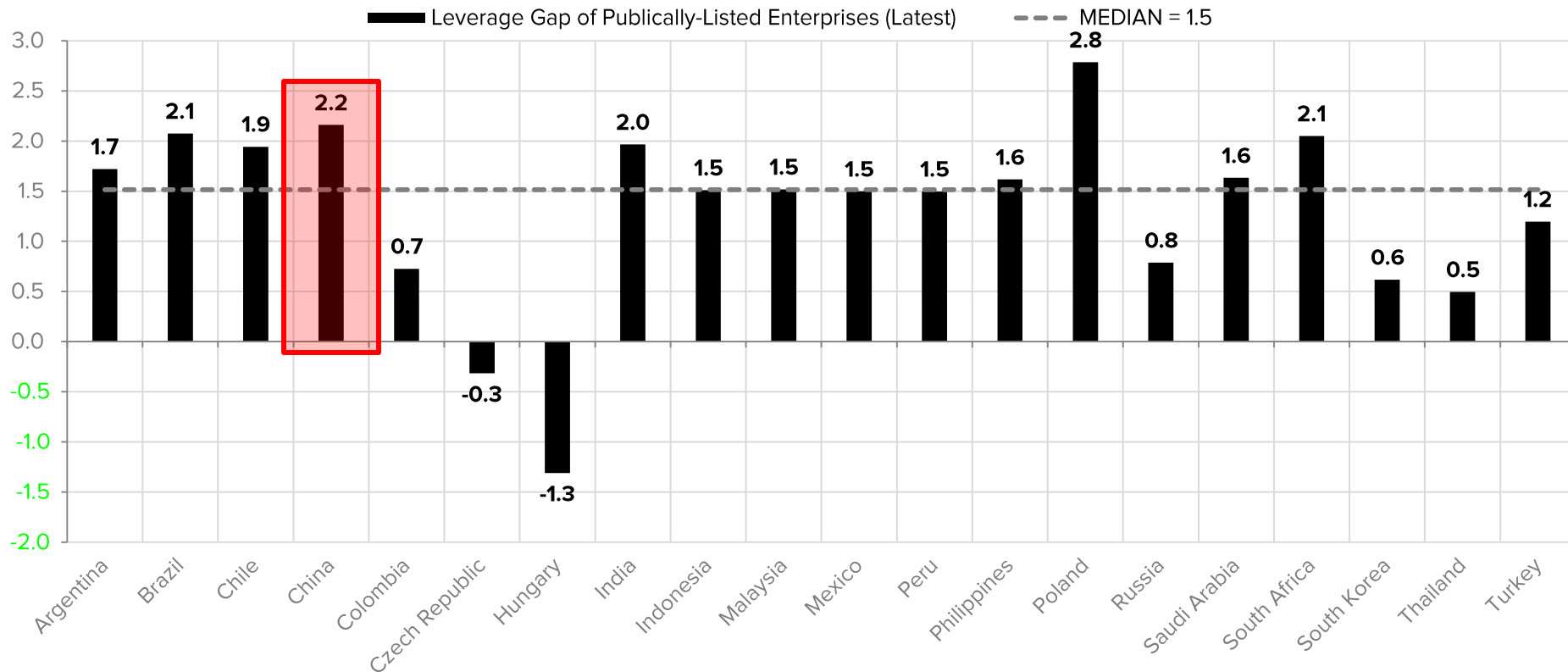
BAILOUT SPACE

IF WE ARE RIGHT ON THE LOOMING CORPORATE BANKRUPTCY CYCLE FACING EMERGING MARKET ECONOMIES, THE NEED FOR EME SOVEREIGNS TO NATIONALIZE KEY ENTERPRISES WILL INCREASE DRAMATICALLY AND ONLY THOSE WITH AMPLE FISCAL SPACE CAN TAKE DRASTIC ENOUGH MEASURES.



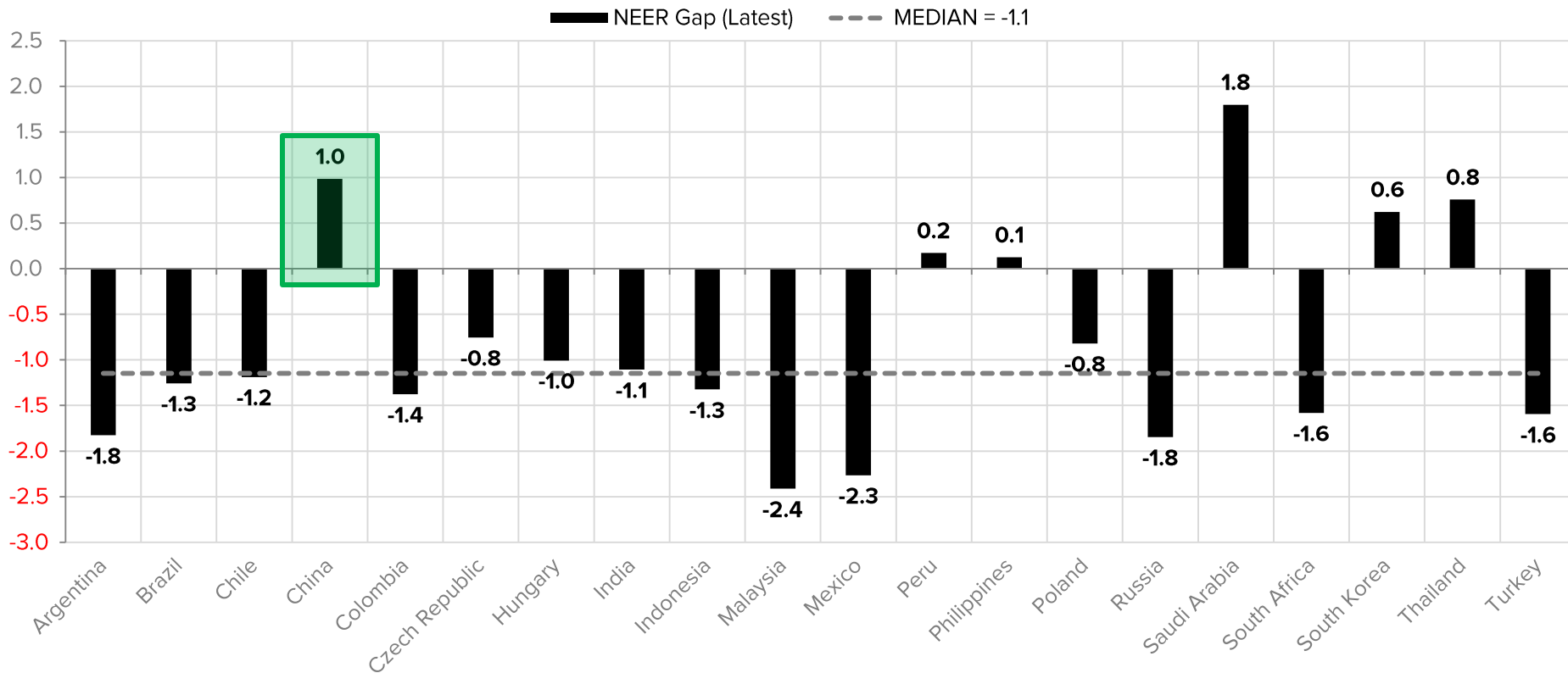
CORPORATE INDEBTEDNESS

OUR “LEVERAGE GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST DEBT-TO-EBITDA LEVEL OF PUBLICALLY LISTED COMPANIES VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH ELEVATED READINGS ARE MOST AT RISK OF A MEANINGFUL BANKRUPTCY CYCLE.



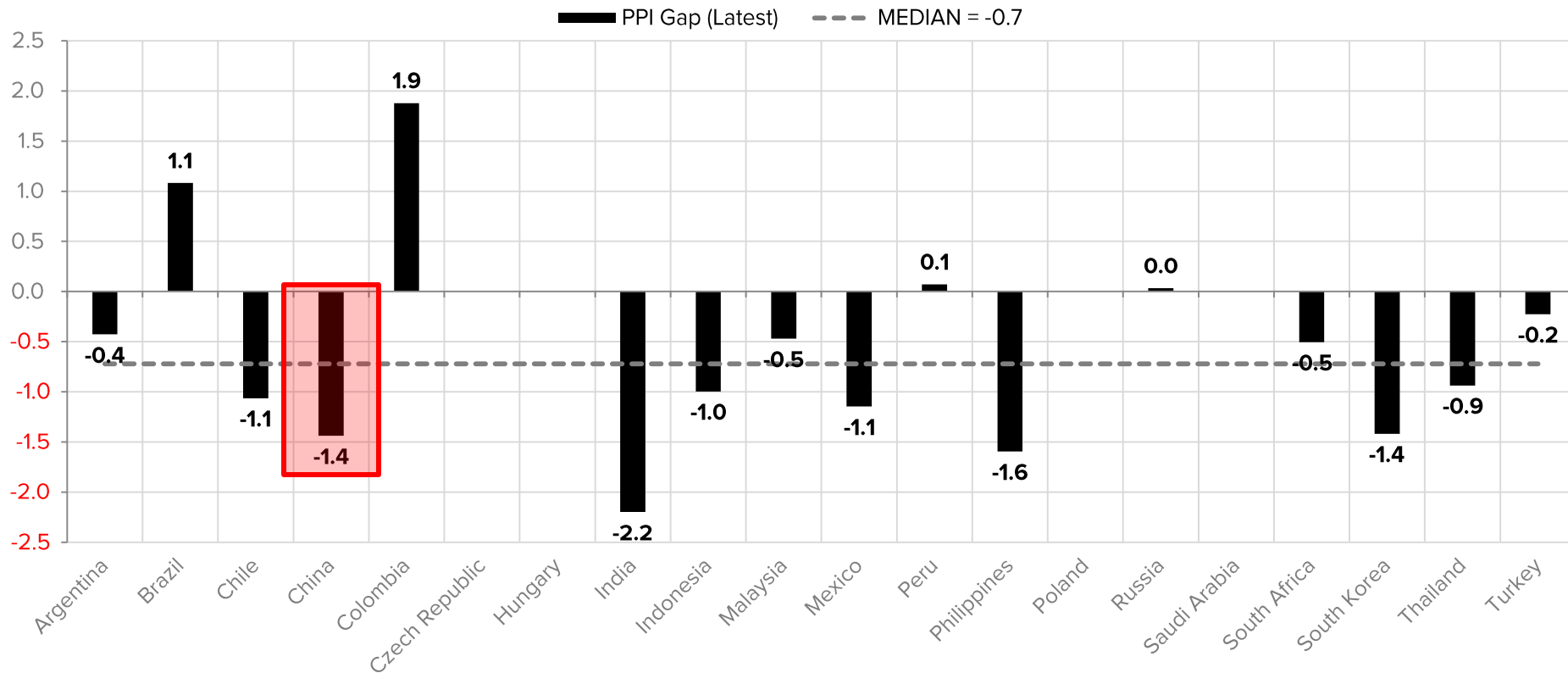
REPAYMENT RISK

OUR “NEER GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST NOMINAL EFFECTIVE EXCHANGE RATE READING VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH DEPRESSED READINGS ARE EXPERIENCING THE GREATEST DIFFICULTY REPAYING INT’L DEBT.



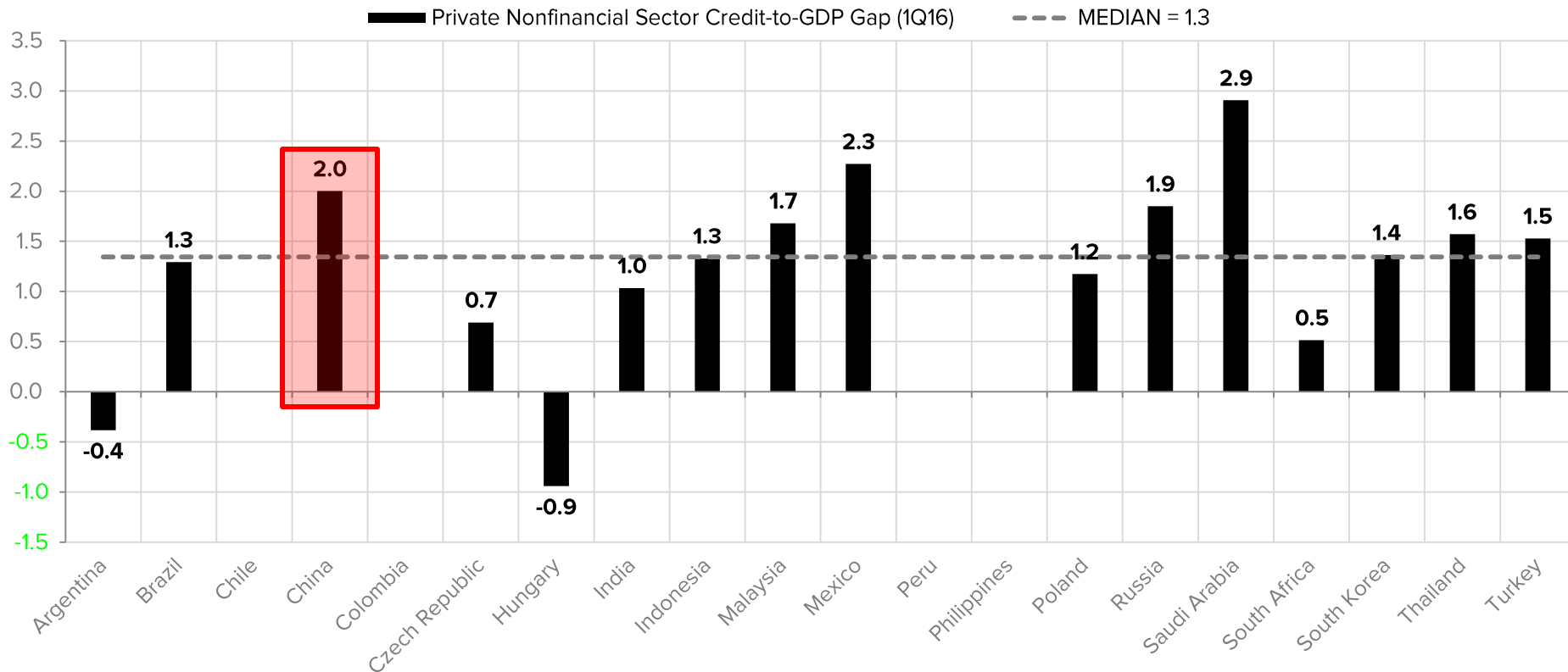
PRICING POWER

OUR “PPI GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST QUARTERLY PPI READING VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT CORPORATIONS IN COUNTRIES WITH DEPRESSED READINGS ARE SUFFERING THE MOST FROM STRUCTURAL OVERCAPACITY.



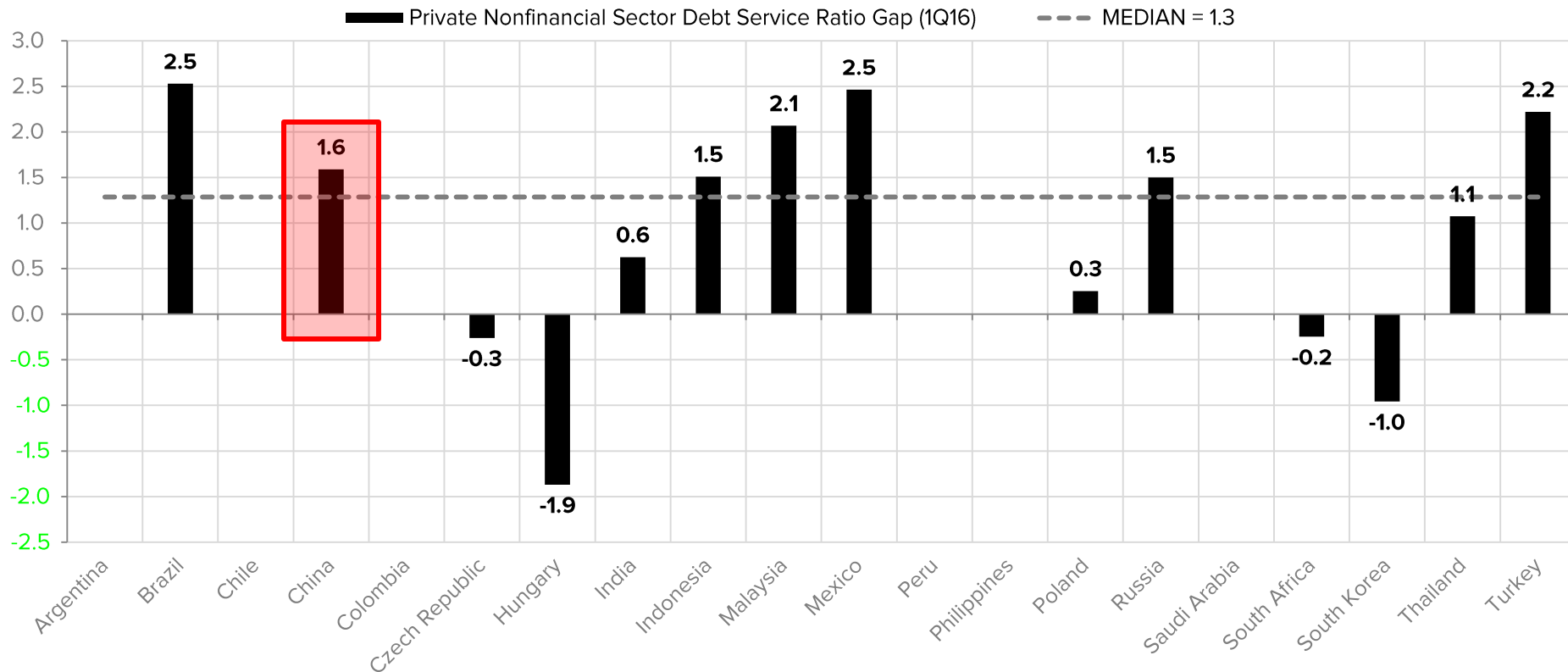
PRIVATE SECTOR LEVERAGE

OUR “CREDIT-TO-GDP GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST PRIVATE NONFINANCIAL SECTOR CREDIT-TO-GDP RATIO VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH ELEVATED READINGS REQUIRE THE GREATEST AMOUNT OF DELEVERAGING.



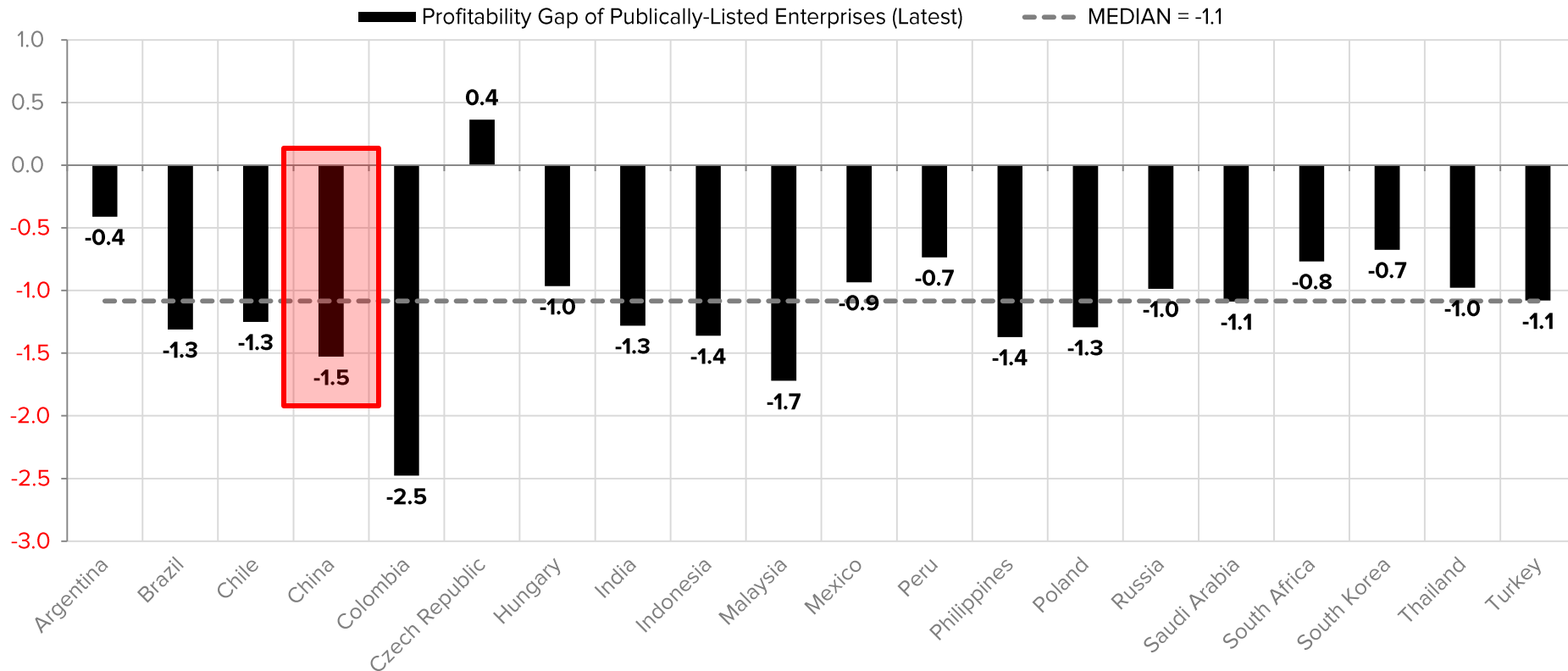
PRIVATE SECTOR DEBT SERVICE

OUR “DEBT SERVICE RATIO GAP” METRIC IS THE Z-SCORE OF THE LATEST READING OF THE AGGREGATE INTEREST-PAYMENTS-TO-INCOME RATIO VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH ELEVATED READINGS FACE ACUTE RISK OF A BANKRUPTCY CYCLE.



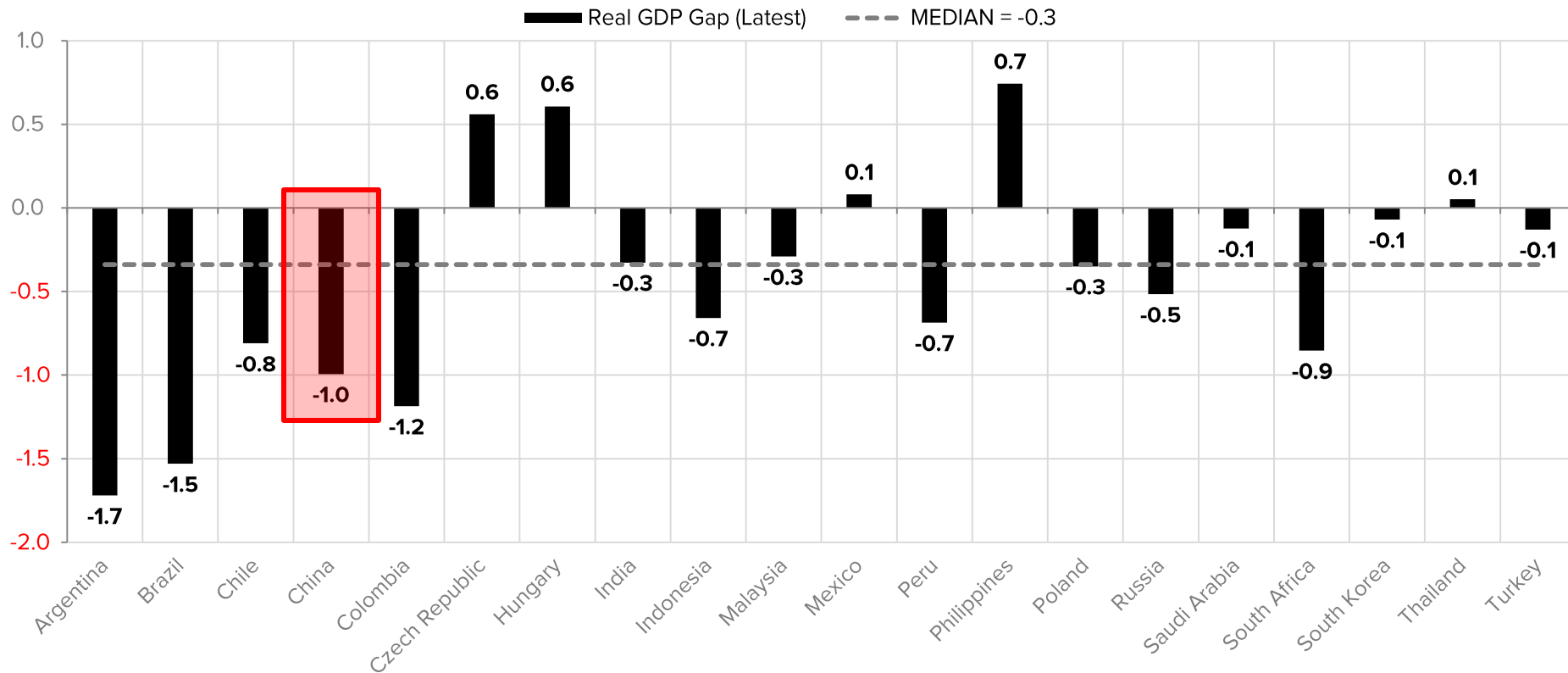
CORPORATE PROFITABILITY

OUR “PROFITABILITY GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST RETURN ON ASSETS READING OF PUBLICALLY LISTED COMPANIES VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH DEPRESSED READINGS ARE MOST AT RISK OF A BANKRUPTCY CYCLE.



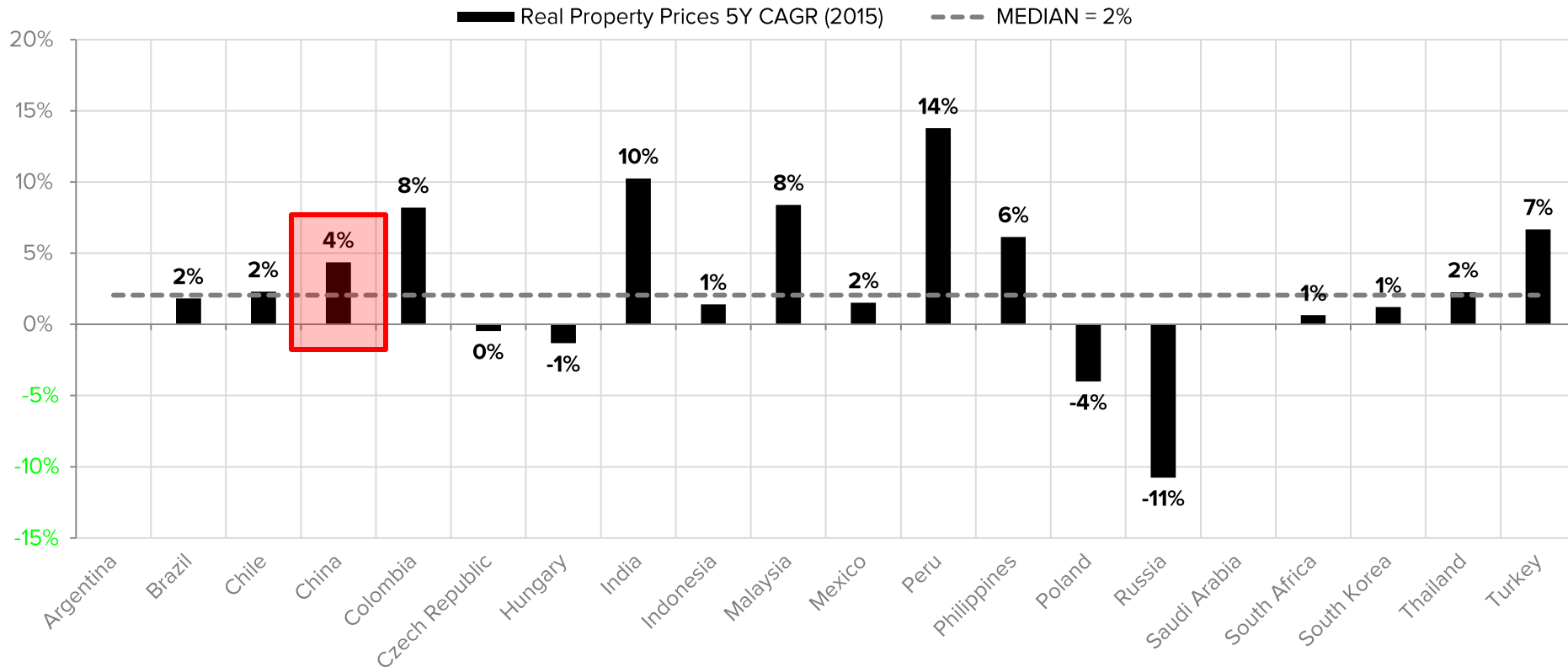
GROWTH SHOCK

OUR “REAL GDP GAP” METRIC IS THE Z-SCORE OF THE LATEST Y/Y GROWTH RATE OF REAL GDP VS. ITS TRAILING 10Y AVERAGE. COUNTRIES WITH DEPRESSED READINGS WILL FIND THE DELEVERAGING PROCESS TO BE SHARPER AND/OR MORE PROTRACTED DEPENDING ON THE POLICY RESPONSE.



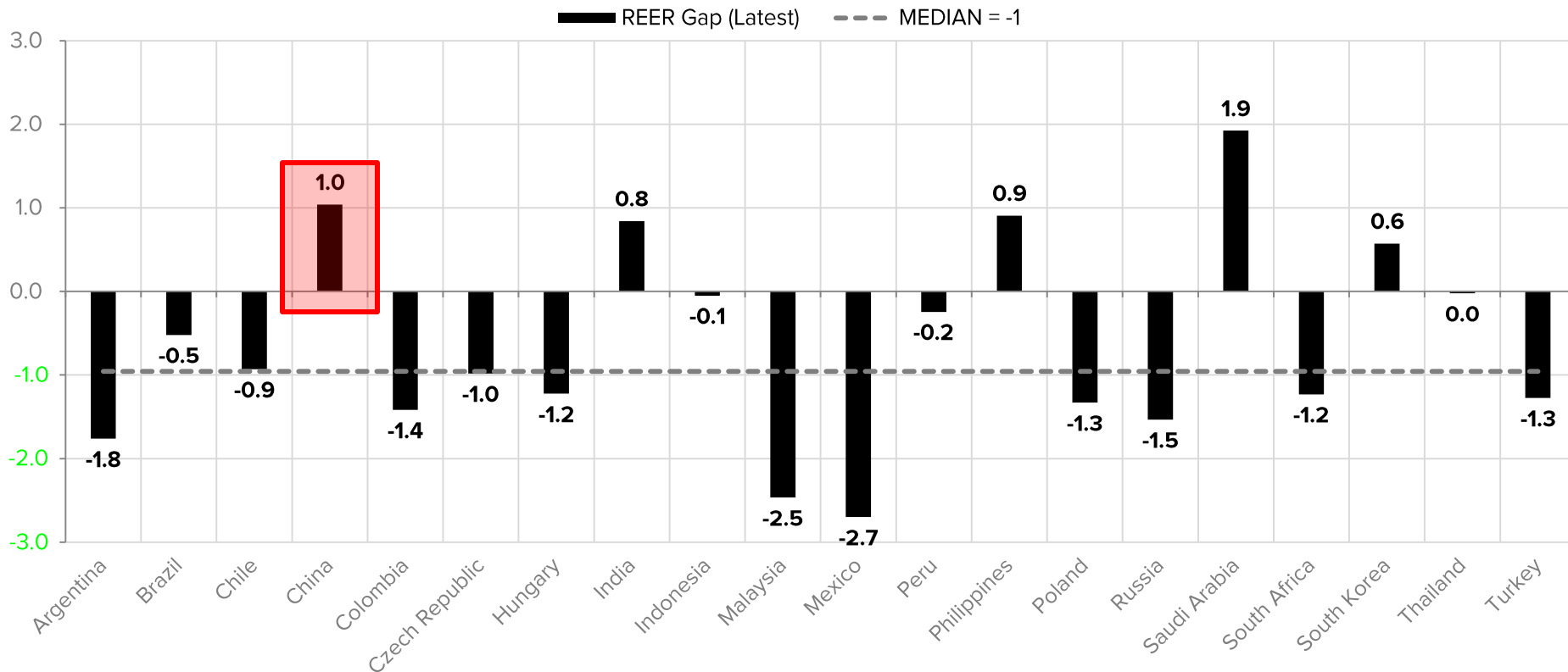
ASSET BUBBLES

MUCH LIKE WITH OUR “CPI GAP” METRIC, WE THINK COUNTRIES THAT HAVE EXPERIENCED THE GREATEST DEGREE OF PROPERTY PRICE APPRECIATION IN REAL TERMS HAVE LIMITED SPACE TO EASE MONETARY POLICY. ASSET WRITE-DOWNS WILL ACCELERATE TO THE EXTENT THESE BUBBLES BURST.



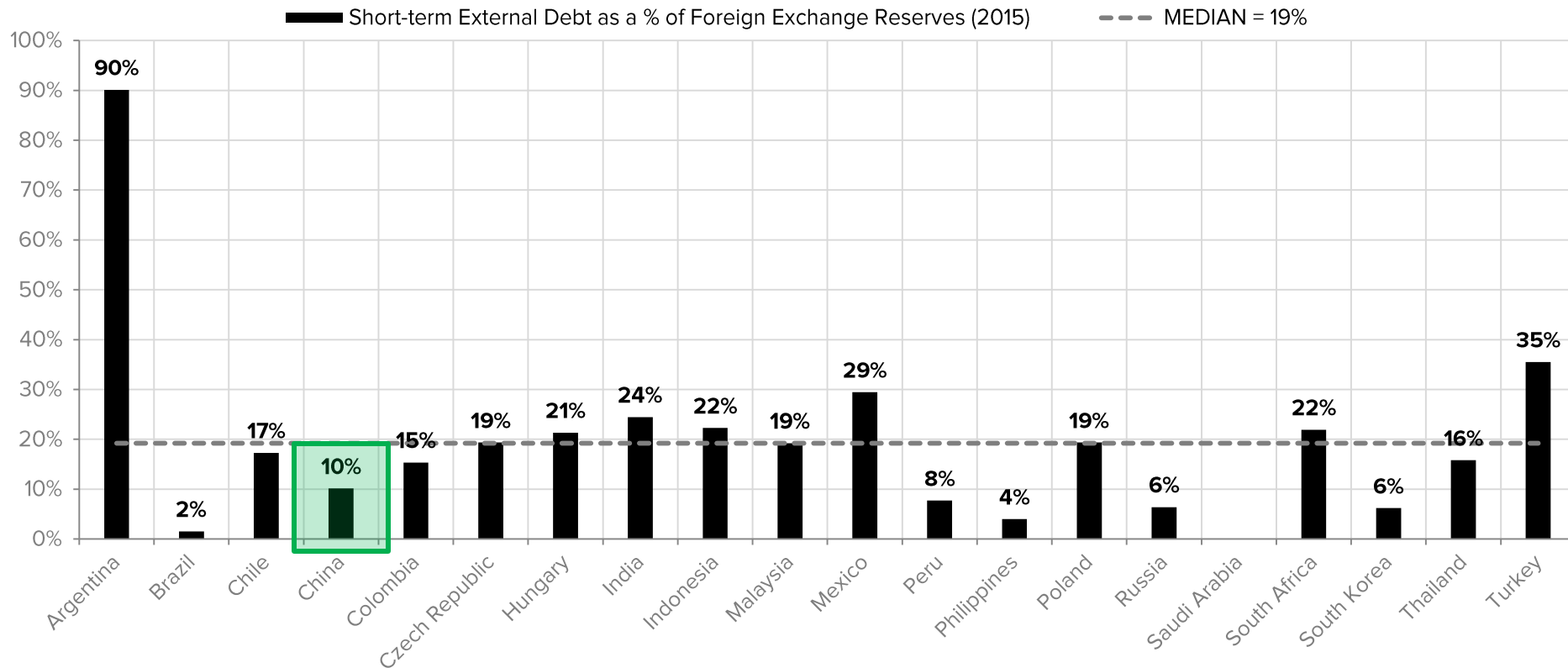
INTERNATIONAL COMPETITIVENESS

OUR “REER GAP” METRIC IS SIMPLY THE Z-SCORE OF THE LATEST REAL EFFECTIVE EXCHANGE RATE READING VS. ITS TRAILING 10Y AVERAGE. THE THOUGHT PROCESS HERE IS THAT COUNTRIES WITH ELEVATED READINGS ARE EXPERIENCING THE GREATEST HEADWIND TO EXPORT GROWTH.



EXTERNAL CURRENCY MISMATCHES

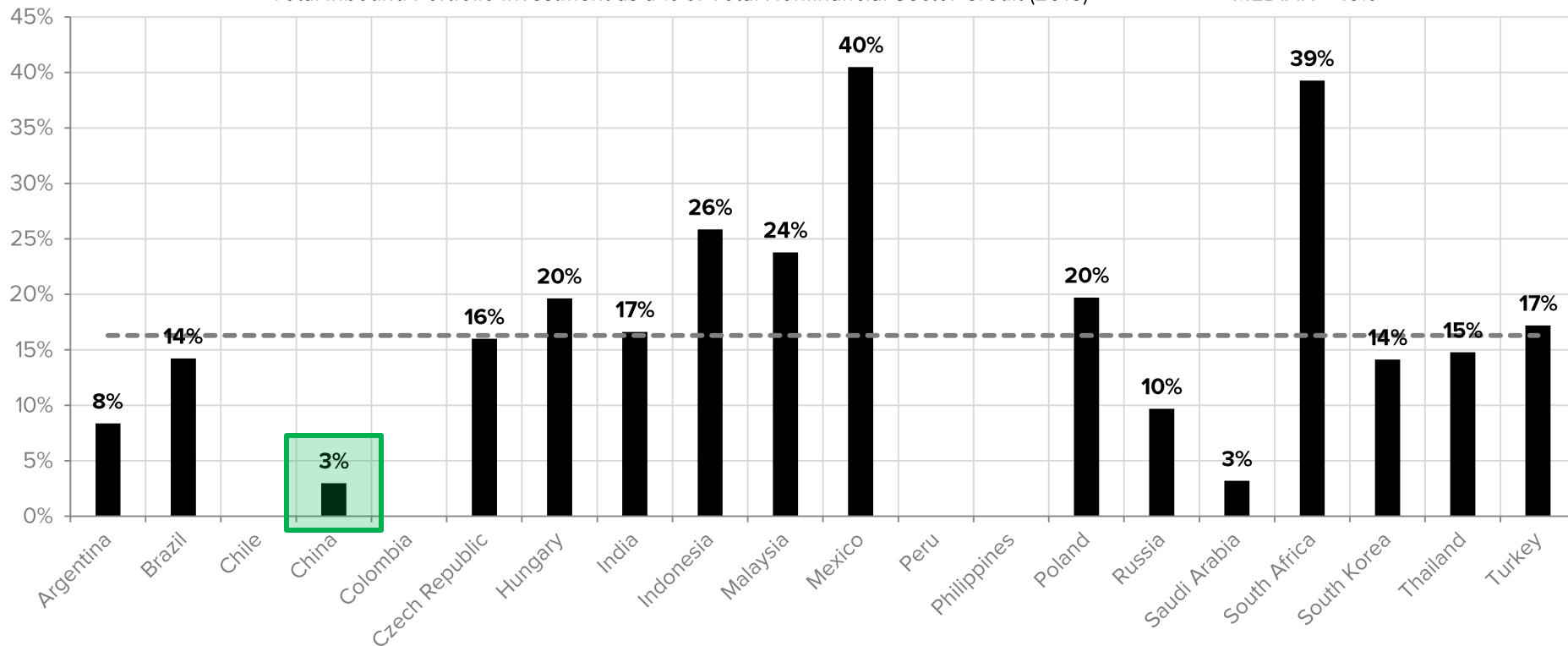
CROSS-BORDER CURRENCY MISMATCHES HAVE ALSO BEEN A LONGSTANDING RISK FOR EMERGING MARKET ECONOMIES. WHAT IS INTERESTING TO NOTE HERE IS THE RELATIVE BALANCE SHEET HEALTH OF CHINA VS. ITS EMERGING MARKET PEERS.



CAPITAL FLIGHT RISK

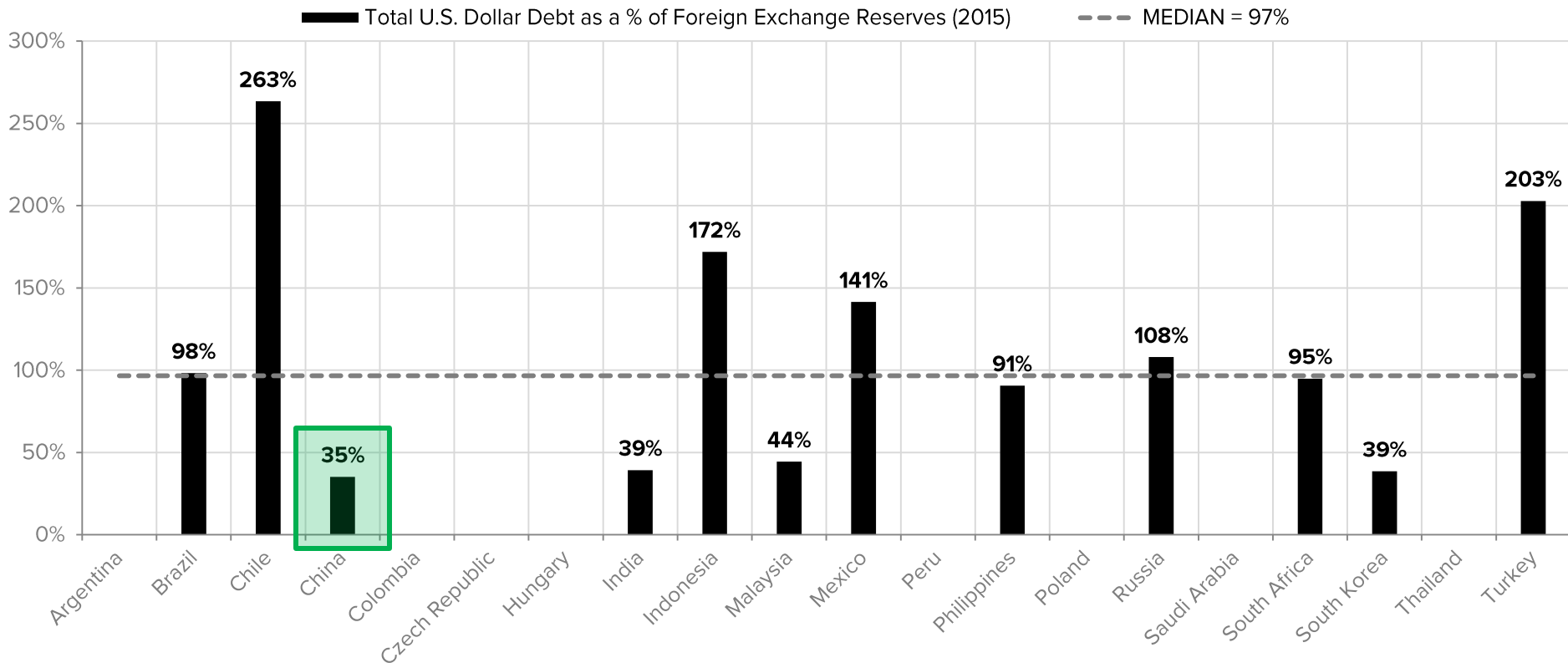
THERE IS A REASON POLICYMAKERS IN EMERGING MARKET ECONOMIES PREFER FOREIGN DIRECT INVESTMENT OVER PORTFOLIO INVESTMENT FLOWS: THE LATTER IS DECIDEDLY LESS STICKY THAN THE FORMER. CHINA'S [MOSTLY] CLOSED CAPITAL ACCOUNT HAS BEEN A BLESSING IN DISGUISE.

■ Total Inbound Portfolio Investment as a % of Total Nonfinancial Sector Credit (2015) - - - MEDIAN = 16%



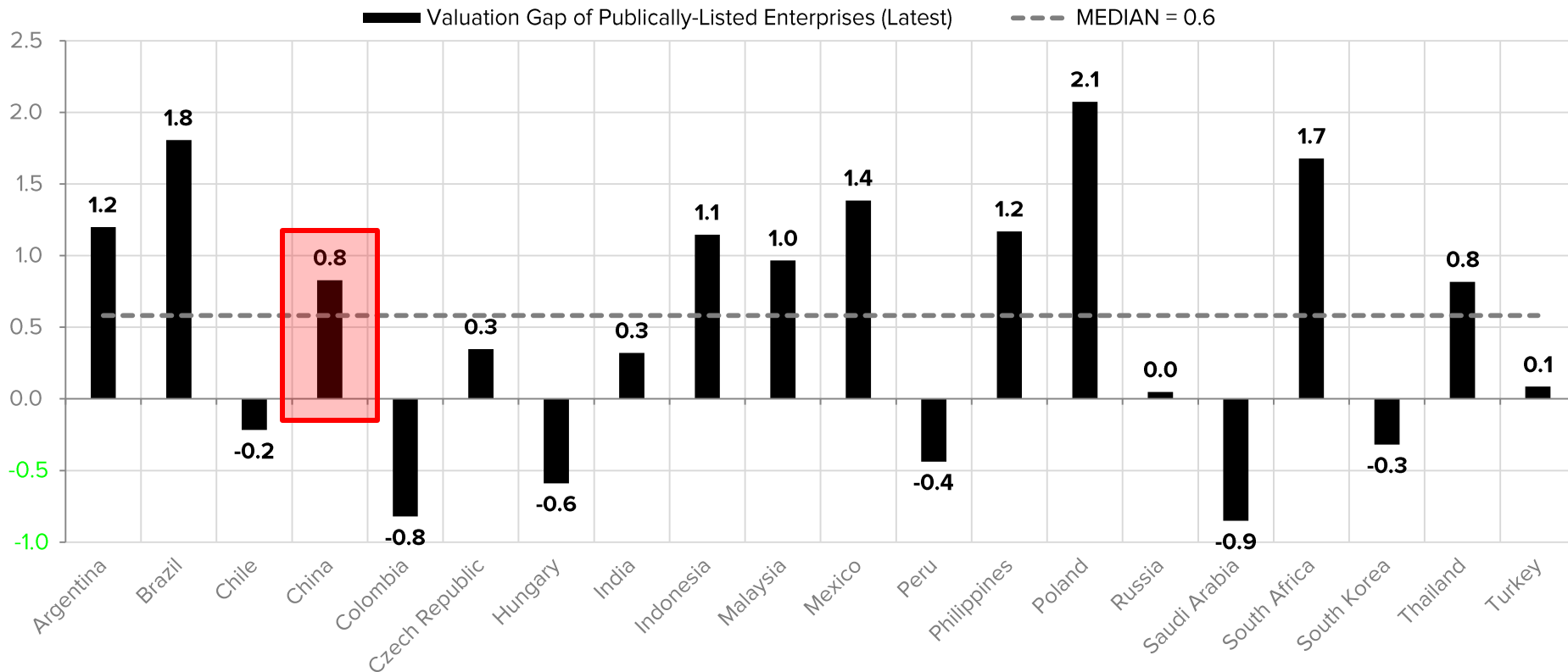
U.S. DOLLAR SUPERCYCLE RISK

TO THE EXTENT OUR STRUCTURALLY BULLISH BIAS ON THE U.S. DOLLAR PROVES CORRECT, A NUMBER OF KEY EMERGING MARKET ECONOMIES WILL BE FORCED TO MEANINGFULLY DRAW DOWN INT'L RESERVE BALANCES AND/OR ALLOW THEIR CURRENCIES TO MAKE A SERIES OF LOWER-LOWS.



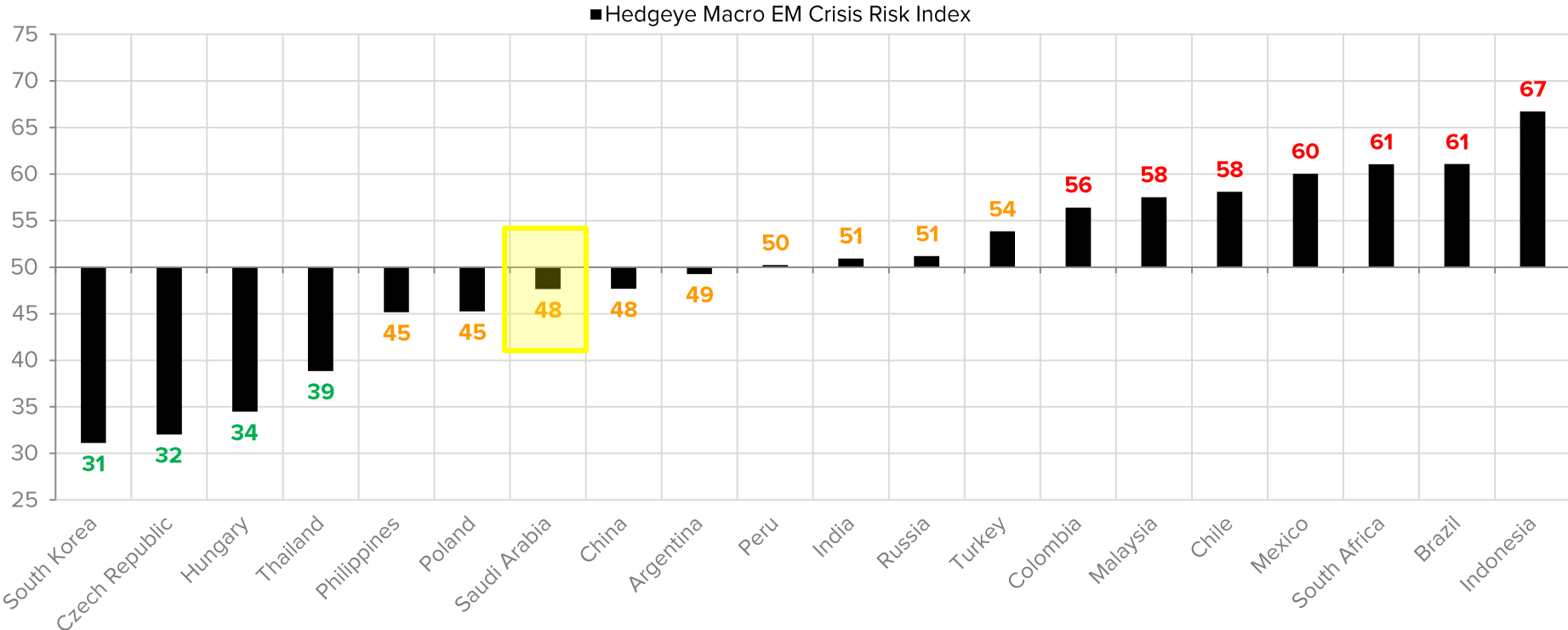
EQUITY VALUATIONS

OUR “VALUATION GAP” METRIC IS THE Z-SCORE OF THE LATEST EV/EBITDA RATIO OF PUBLICALLY LISTED COMPANIES VS. ITS TRAILING 10Y AVERAGE. COUNTRIES WITH ELEVATED READINGS ARE UNLIKELY TO SEE REAL MONEY INFLOWS AMID STRUCTURALLY DEPRESSED CORPORATE PROFITABILITY.



SUMMARY

WE AMALGAMATE THE AFOREMENTIONED 20 INDICATORS BY SCORING EACH COUNTRY ON A PERCENTILE BASIS WITHIN A RESPECTIVE FACTOR (INVERTING THOSE FACTORS WHERE A HIGHER READING IS POSITIVE). A COUNTRY'S EM CRISIS RISK INDEX LEVEL IS SIMPLY THE AVERAGE OF THOSE PERCENTILE READINGS. COUNTRIES WITH HIGHER READINGS ARE CONSIDERED TO BE THE MOST AT RISK OF A SUPER CYCLE IN THE U.S. DOLLAR.



2. STABILIZATION IS NOT SUSTAINABLE

1

STRUCTURAL OUTLOOK: SOFT LANDING \neq SMOOTH LANDING

Our secular biases with respect to the Chinese economy – which, coincidentally, haven't changed much over the past ~5 years – are as boring as they are well researched. Specifically, we continue to think that China is experiencing a "financial crisis with communist characteristics". This means fiscal and monetary policymakers have both ample tools and a genuine desire to attempt to engineer a "soft landing". While they may eventually accomplish their twin goals of permanently downshifting GDP growth and rebalancing economic drivers, their insistence upon maintaining financial and economic stability throughout said process effectively transfers deflation risk from the market in the near term to the real economy over the long term. Moreover, what they are trying to accomplish has never been done before in modern economic history; therefore, it's reasonable to assume the glide path down will be less linear than Beijing hopes.

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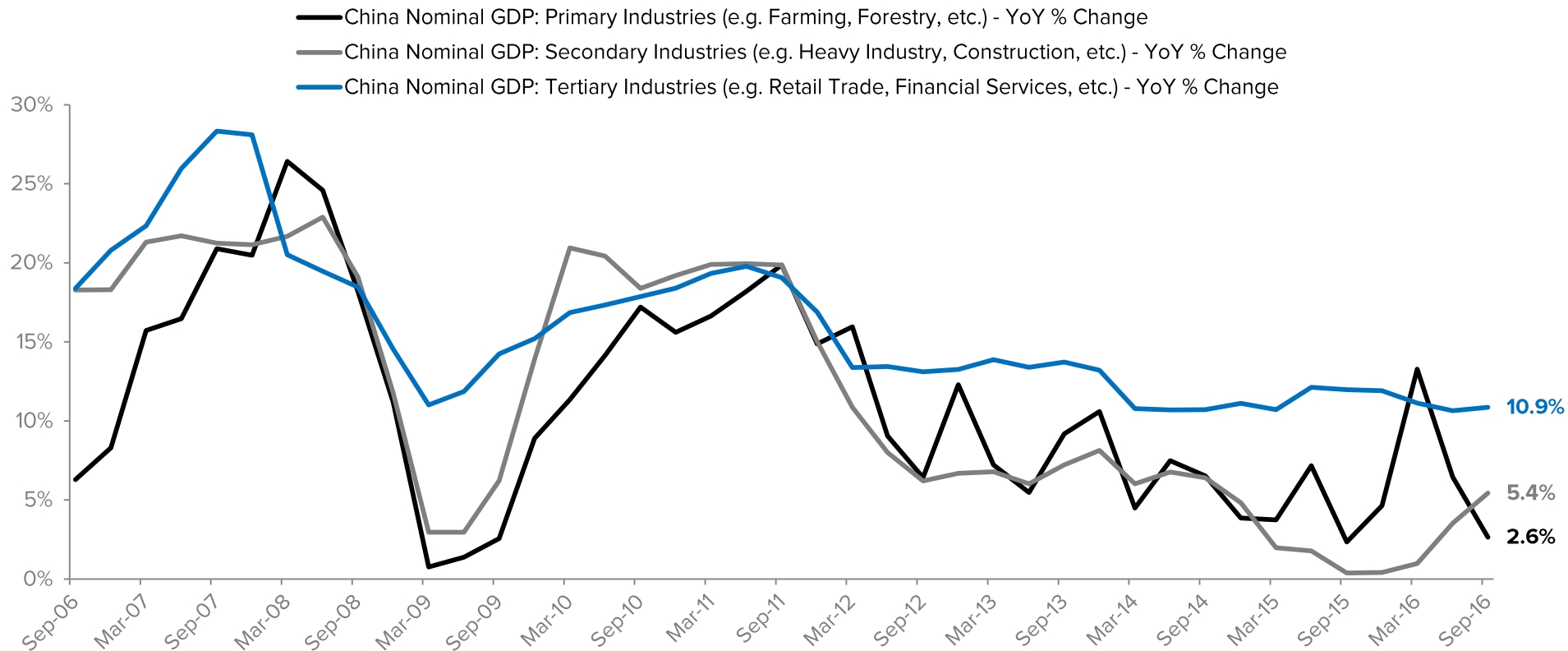
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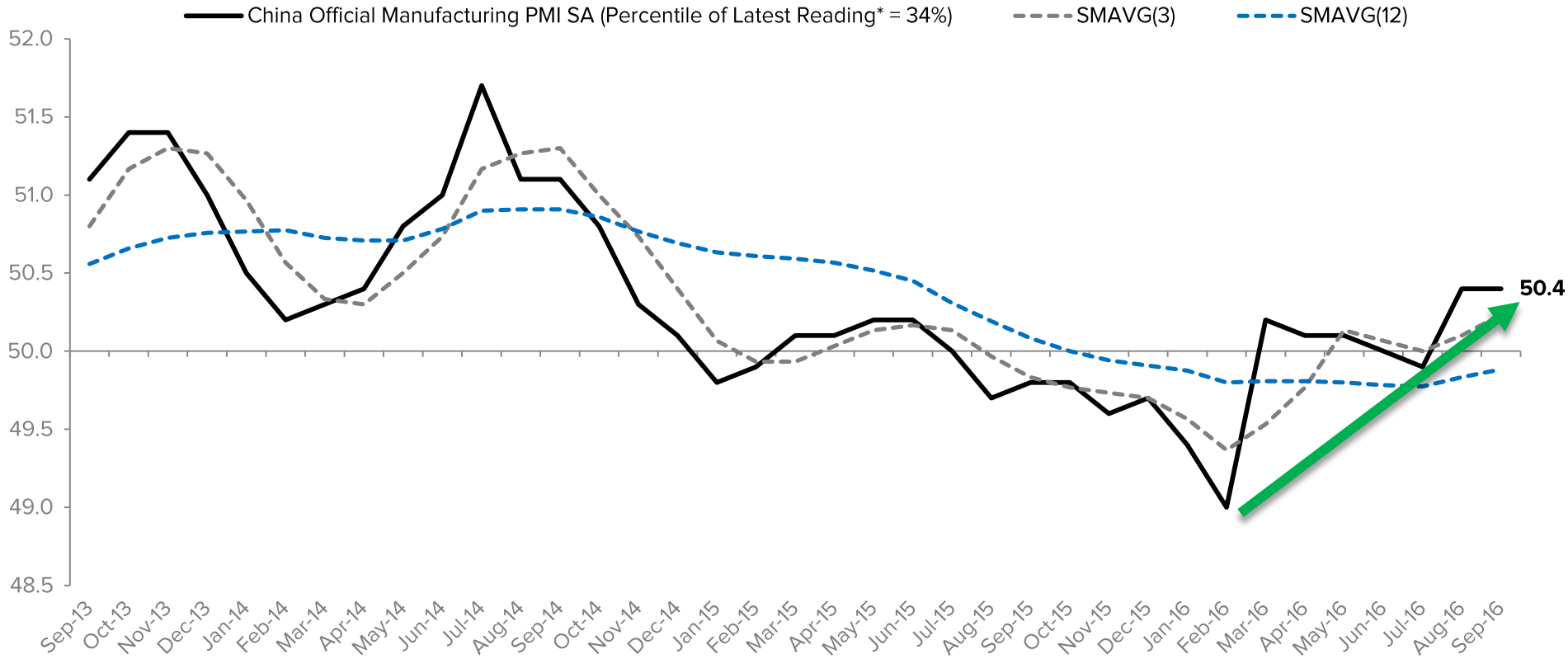
GOING BACK TO THE WOOD

CHINA'S 2016 RECOVERY HAS LARGELY BEEN DRIVEN BY A RESURGENCE IN THE GROWTH RATE OF HEAVY INDUSTRY – WHICH ITSELF WAS PERPETUATED BY A SIGNIFICANT DEGREE OF FISCAL AND MONETARY STIMULUS.



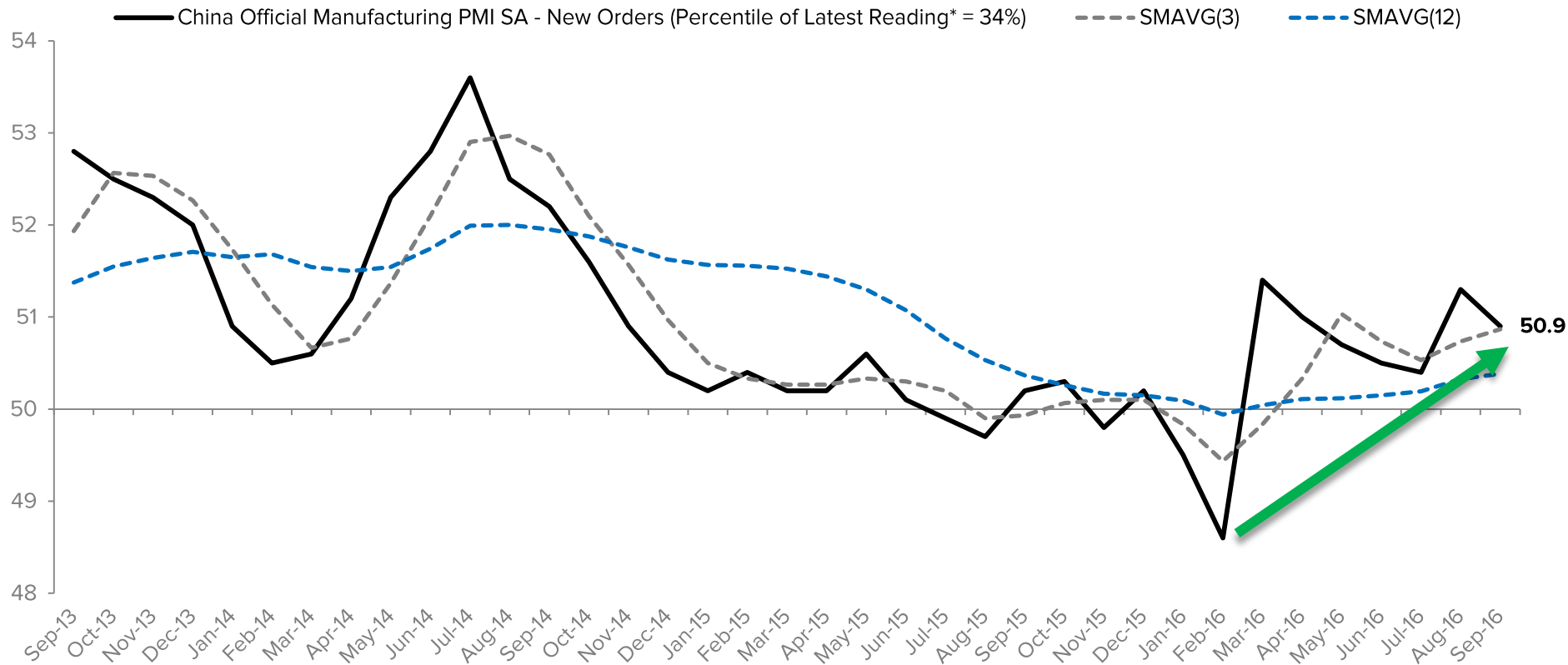
OFFICIAL MANUFACTURING PMI

TRENDING HIGHER AS OF SEPTEMBER



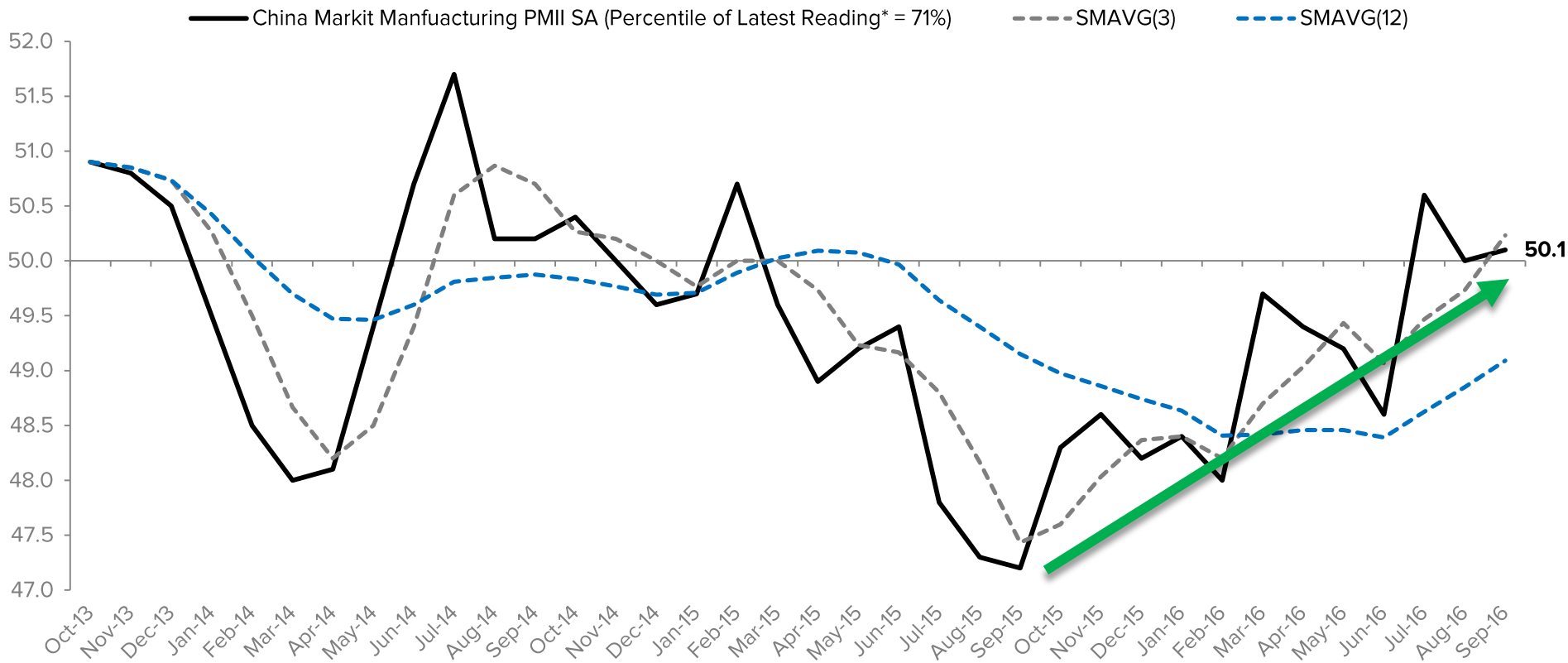
MANUFACTURING PMI: NEW ORDERS

TRENDING HIGHER AS OF SEPTEMBER



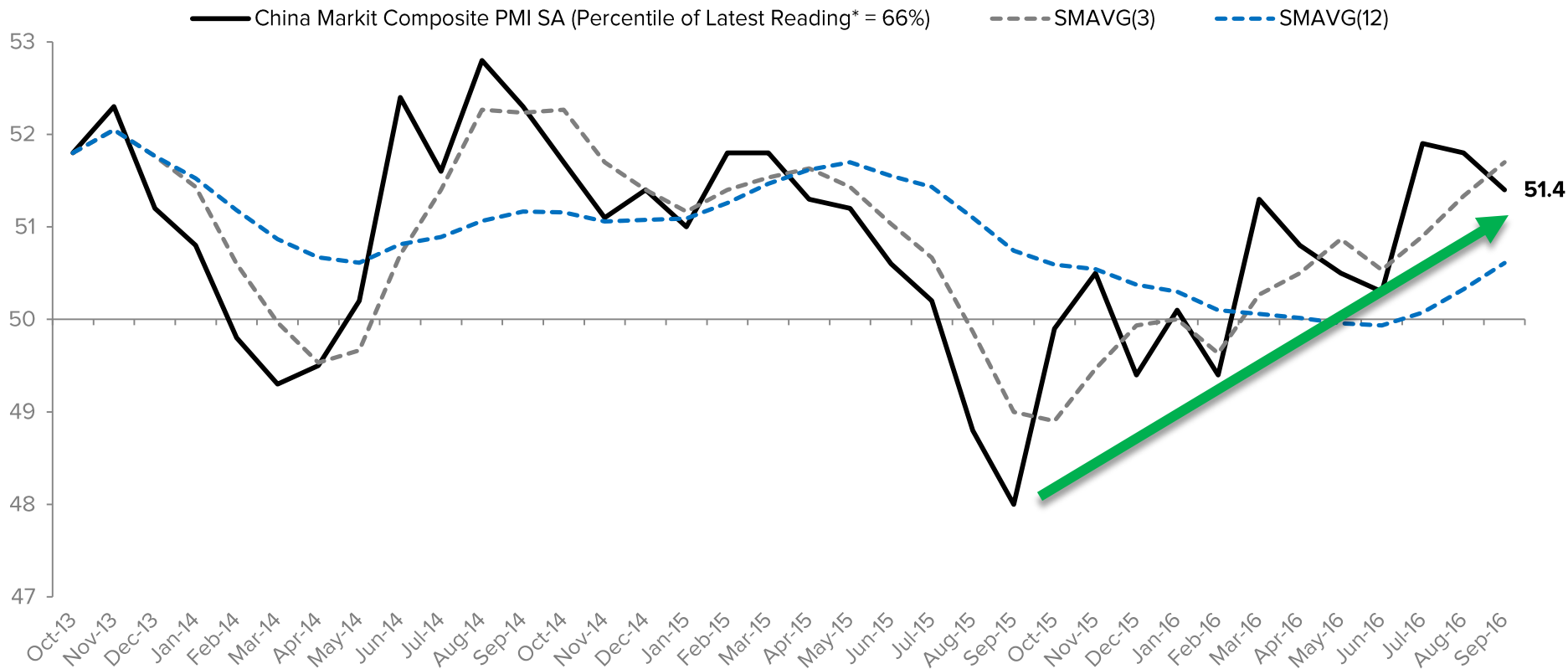
MARKIT MANUFACTURING PMI

TRENDING HIGHER AS OF SEPTEMBER



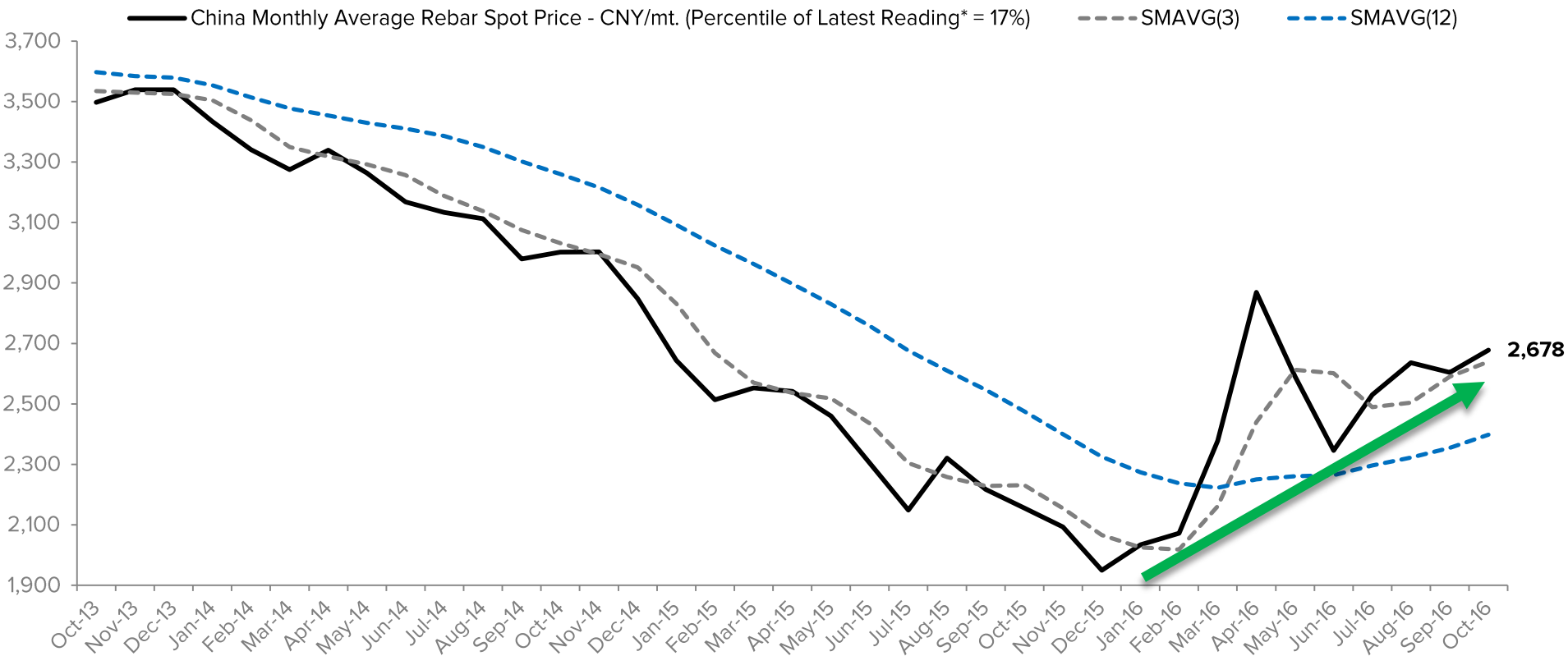
MARKIT COMPOSITE PMI

TRENDING HIGHER AS OF SEPTEMBER



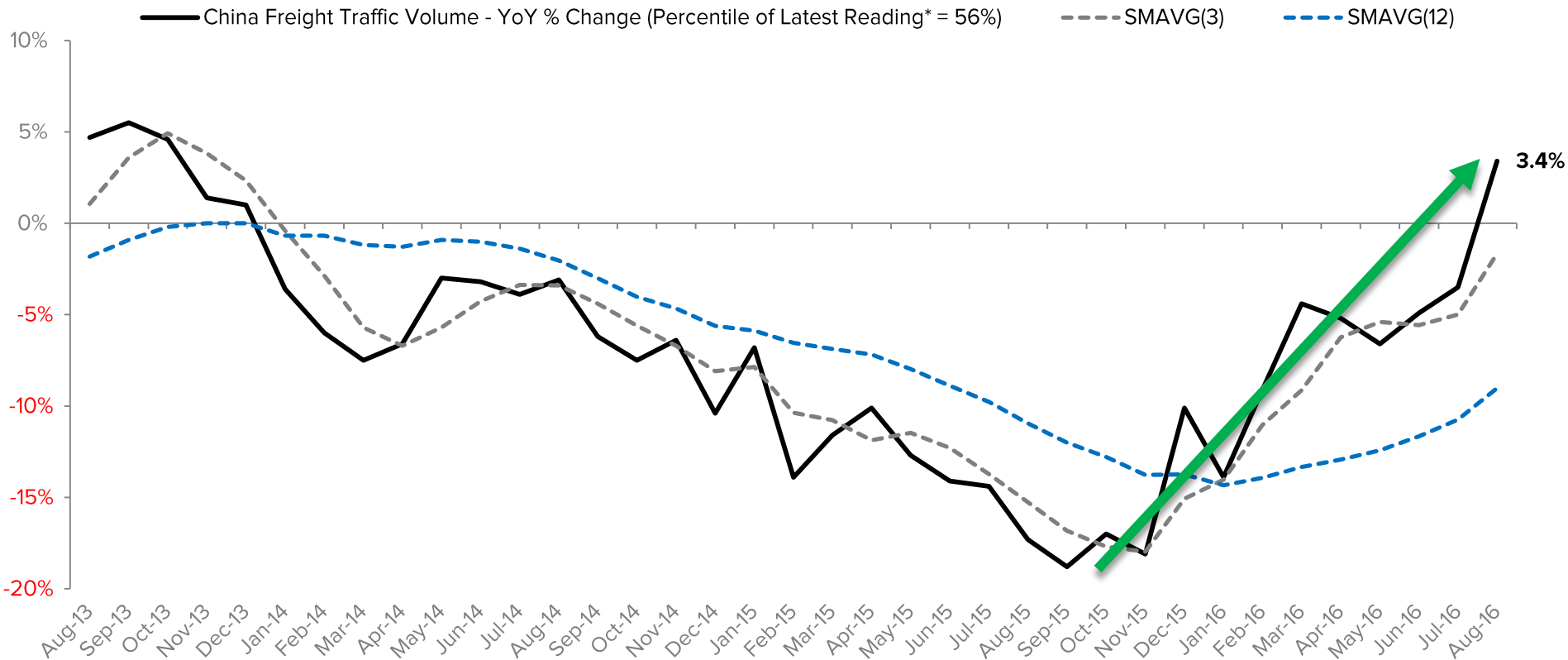
REBAR SPOT PRICES

PRICES ARE TRENDING HIGHER AS OF OCTOBER



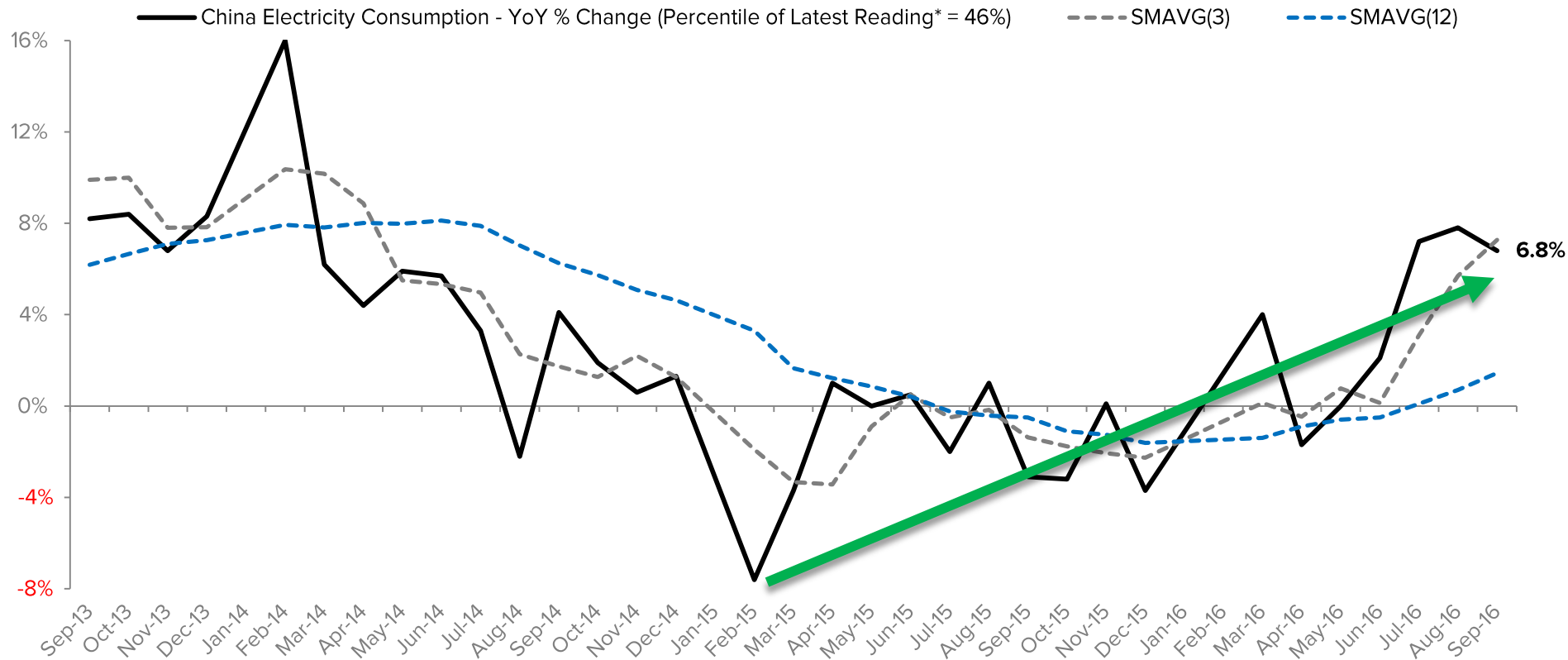
FREIGHT TRAFFIC VOLUME

GROWTH IS TRENDING HIGHER AS OF AUGUST



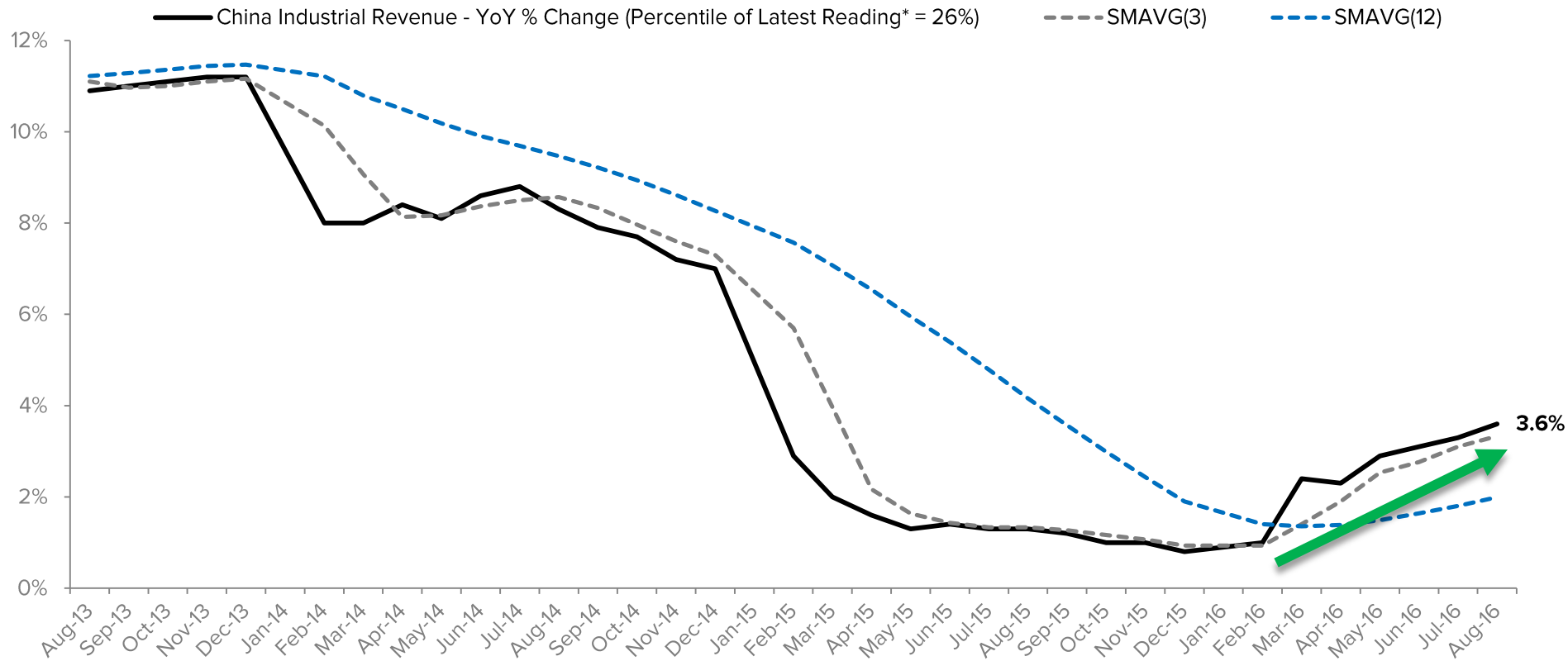
ELECTRICITY CONSUMPTION

GROWTH IS TRENDING HIGHER AS OF SEPTEMBER



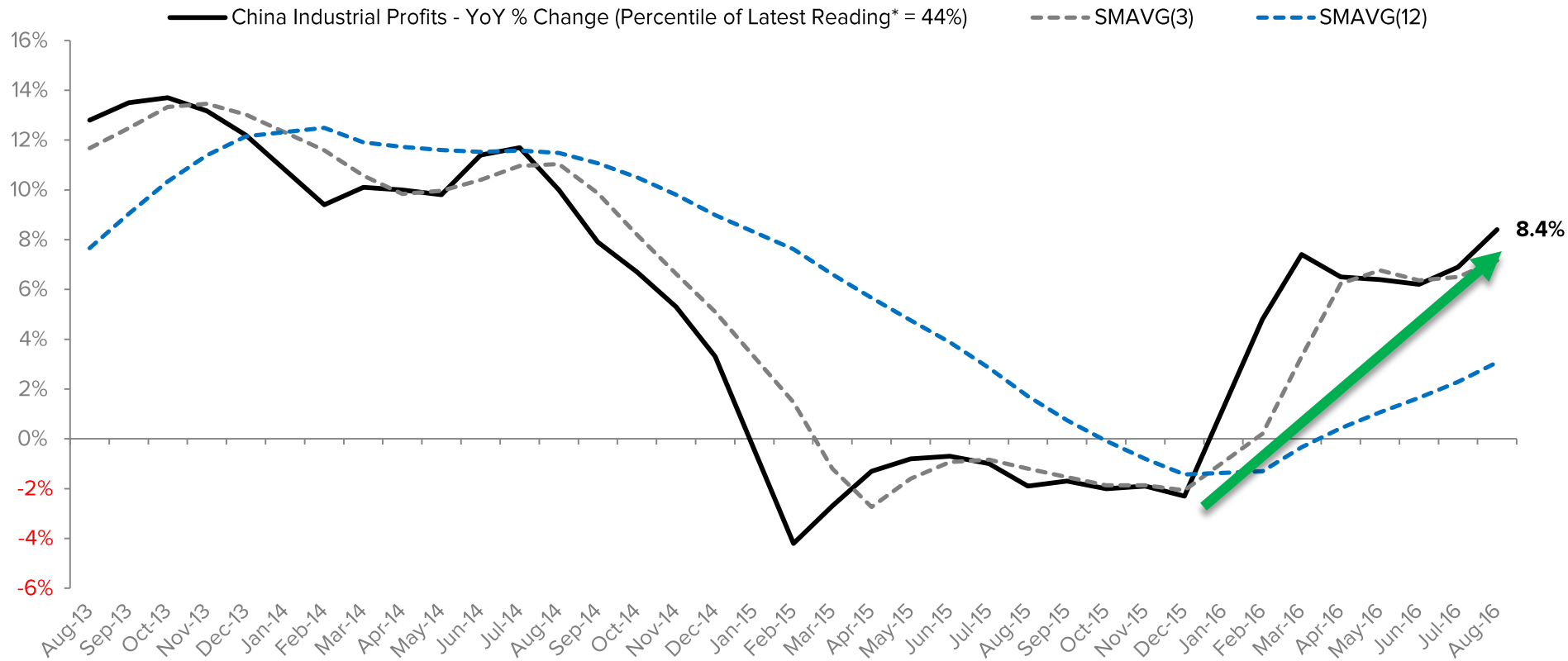
INDUSTRIAL REVENUE

GROWTH IS TRENDING HIGHER AS OF AUGUST



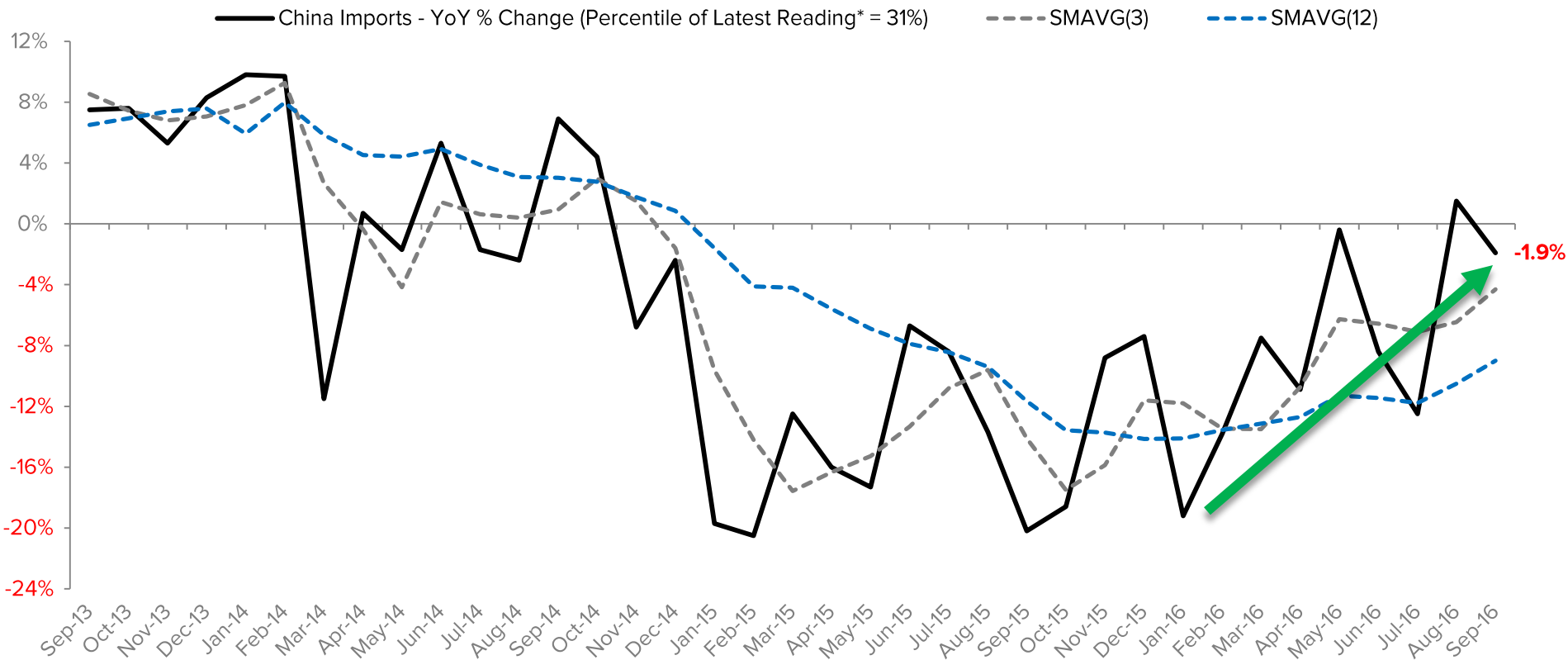
INDUSTRIAL PROFITS

GROWTH IS TRENDING HIGHER AS OF AUGUST



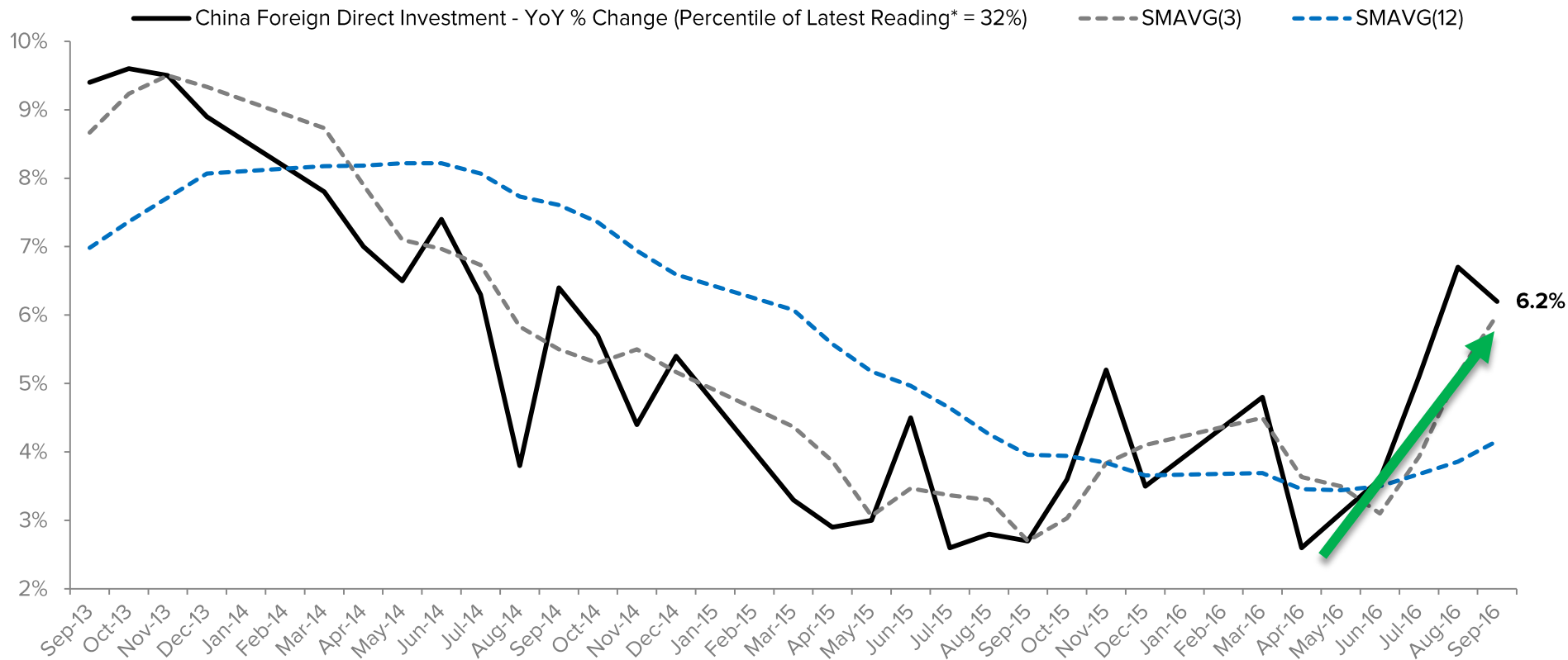
IMPORTS

GROWTH IS TRENDING HIGHER AS OF SEPTEMBER



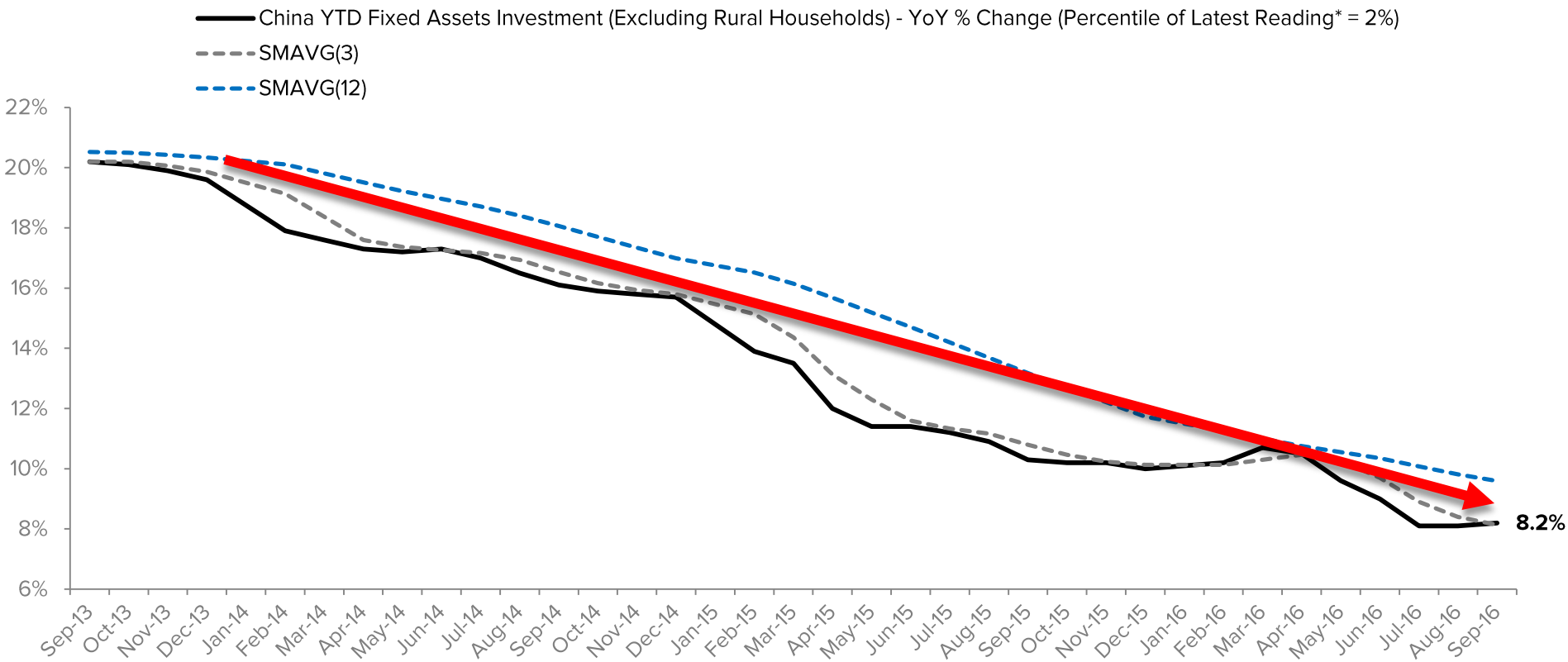
FOREIGN DIRECT INVESTMENT

GROWTH IS TRENDING HIGHER AS OF SEPTEMBER



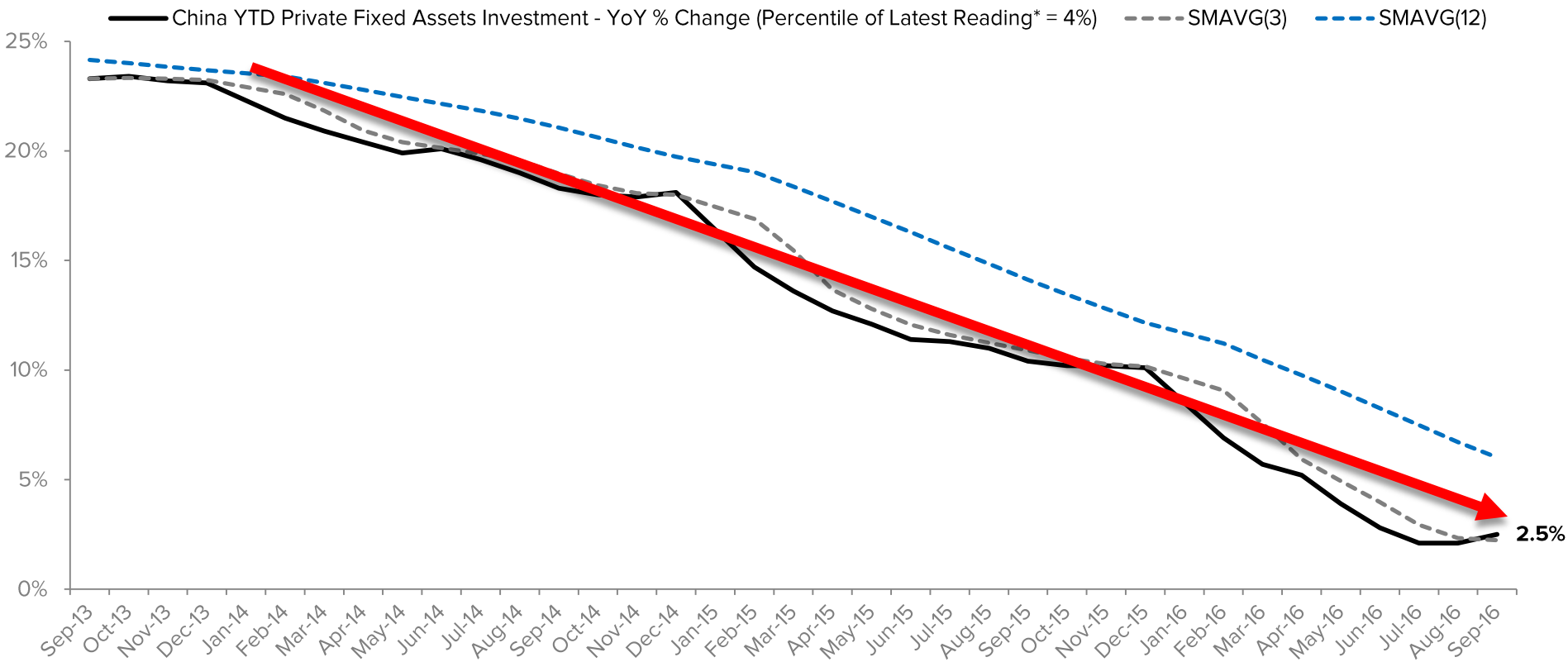
FIXED ASSETS INVESTMENT

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



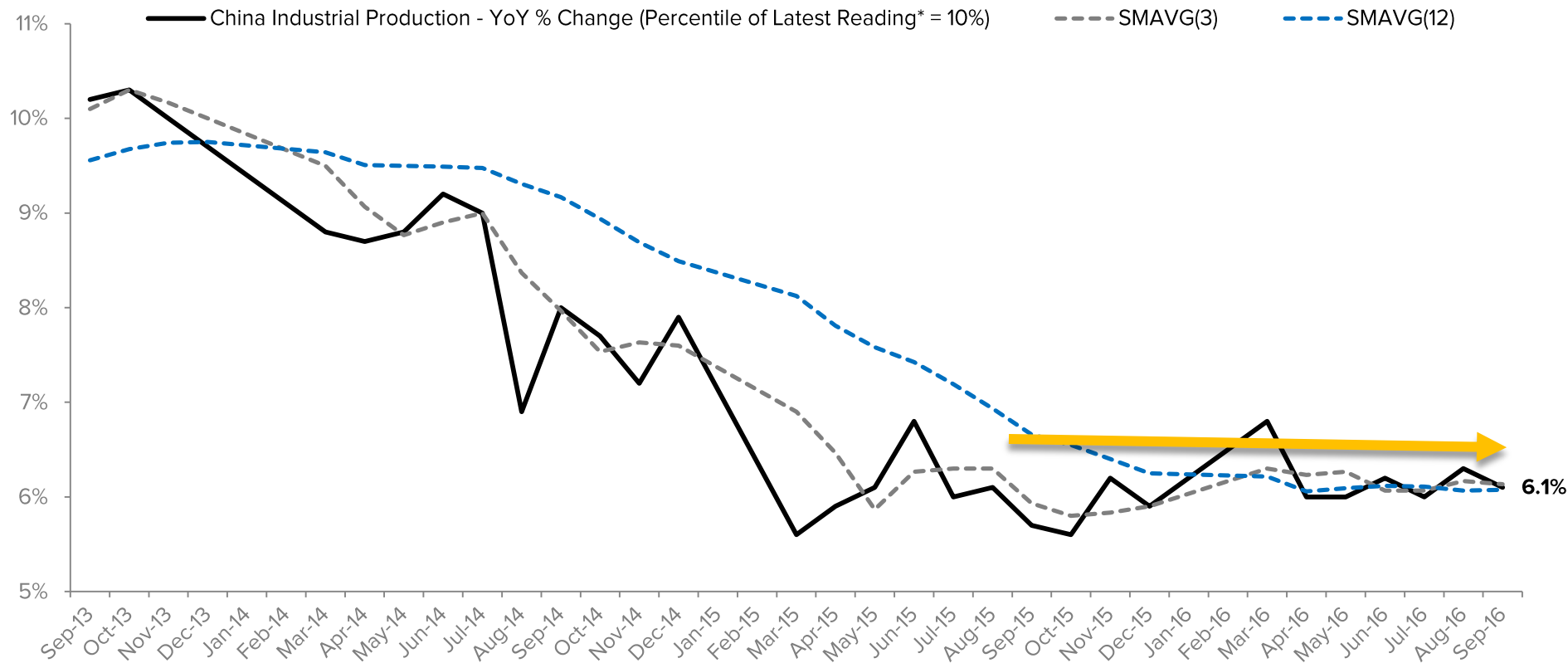
PRIVATE FIXED ASSETS INVESTMENT

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



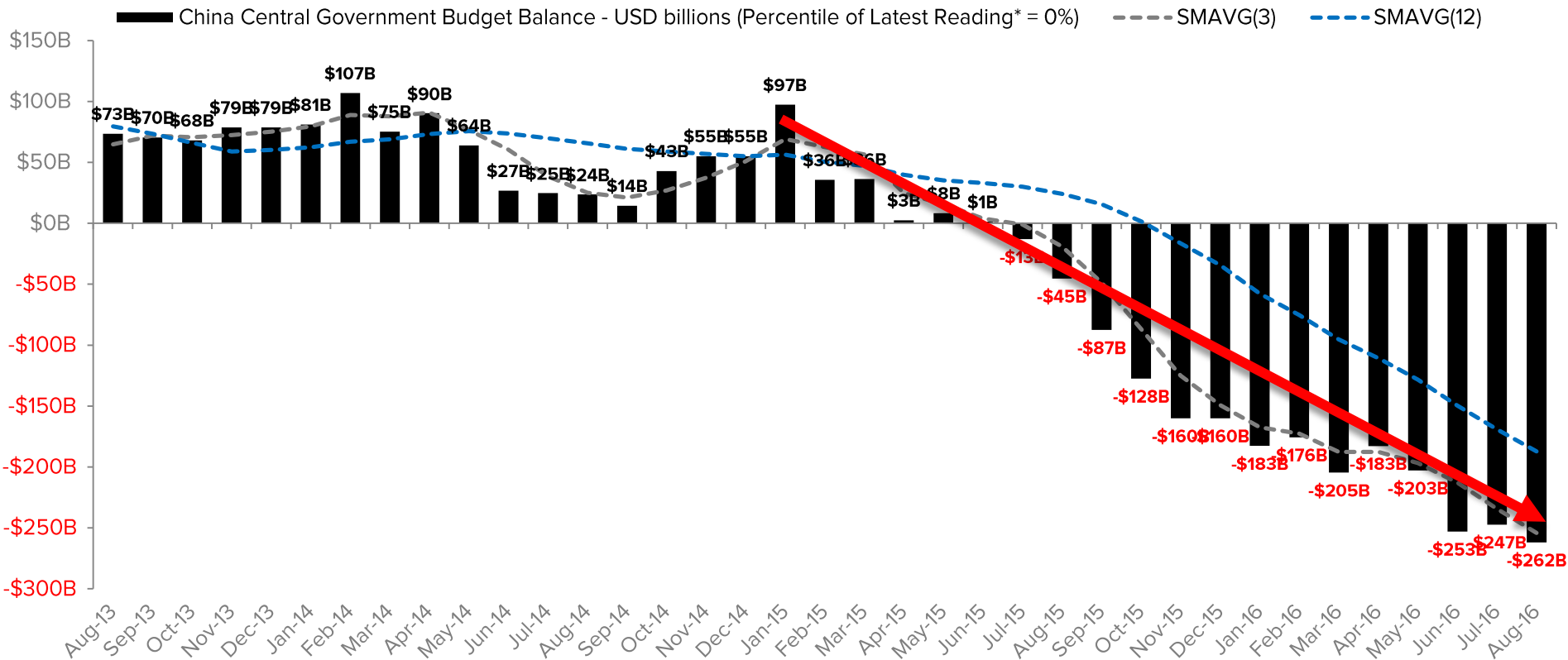
INDUSTRIAL PRODUCTION

GROWTH IS TRENDING SIDeways AS OF SEPTEMBER



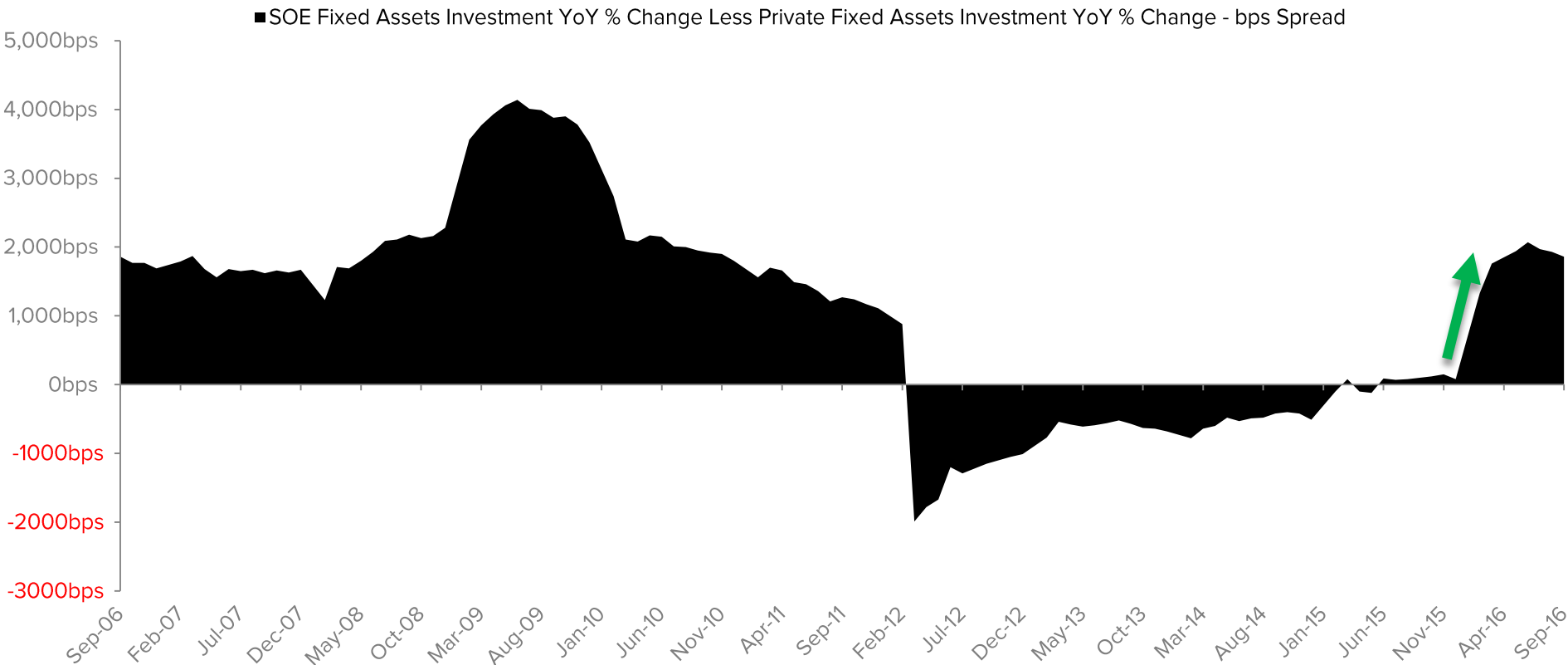
CENTRAL GOV'T BUDGET BALANCE

TRENDING LOWER AS OF AUGUST



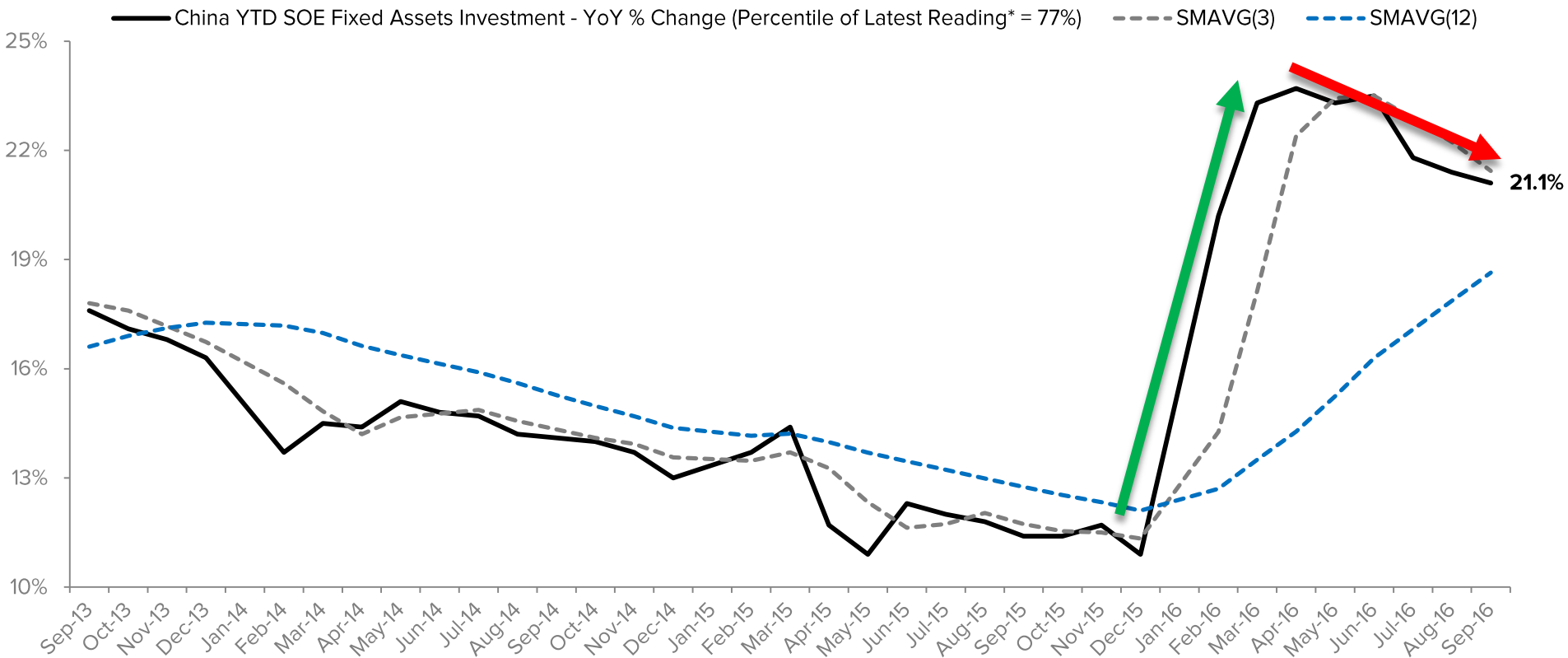
QUANTIFYING THE DEGREE OF STIMULUS

THE SPREAD BETWEEN THE RESPECTIVE GROWTH RATES OF FIXED ASSET INVESTMENT BY THE PUBLIC SECTOR AND THE PRIVATE SECTOR IS AT TRACKING AT A SIX-YEAR HIGH AS OF SEPTEMBER.



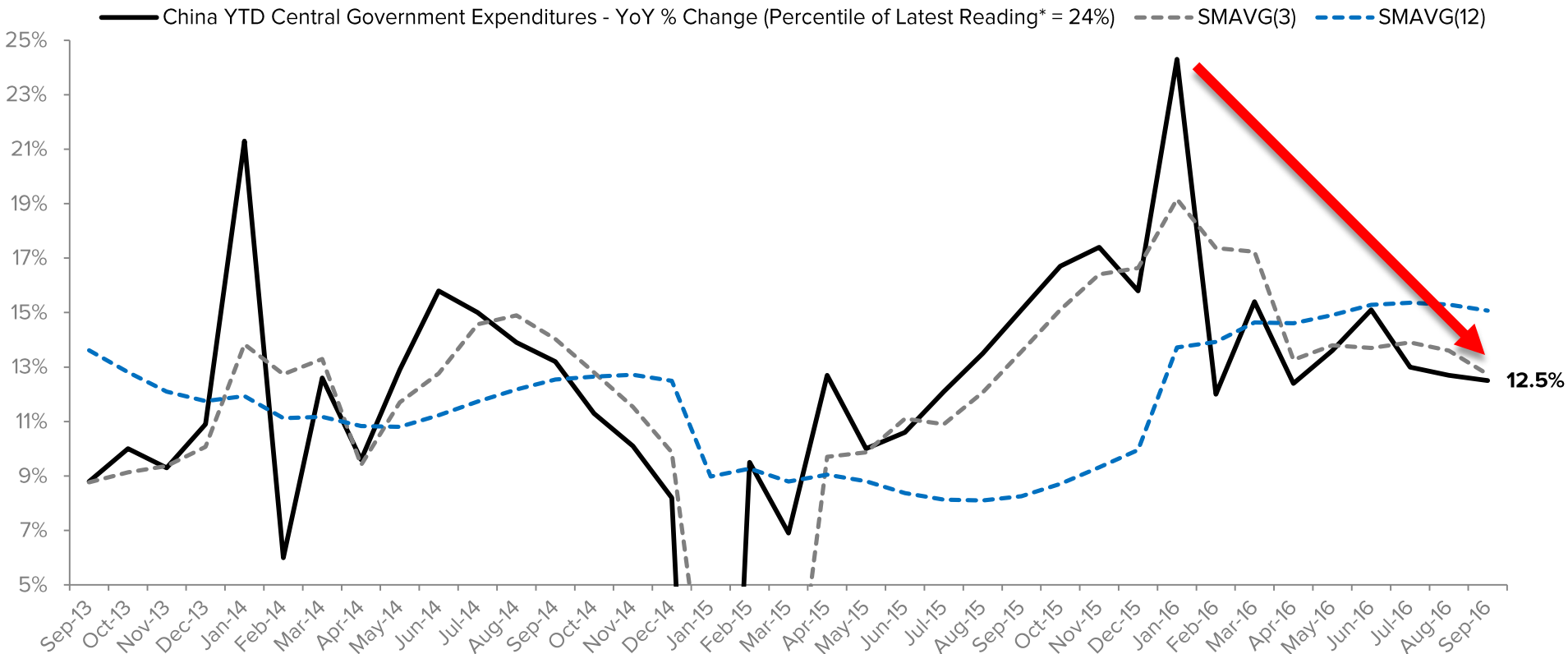
SOE FIXED ASSETS INVESTMENT

GROWTH IS IN THE PROCESS OF INFLECTING NEGATIVELY AS OF SEPTEMBER



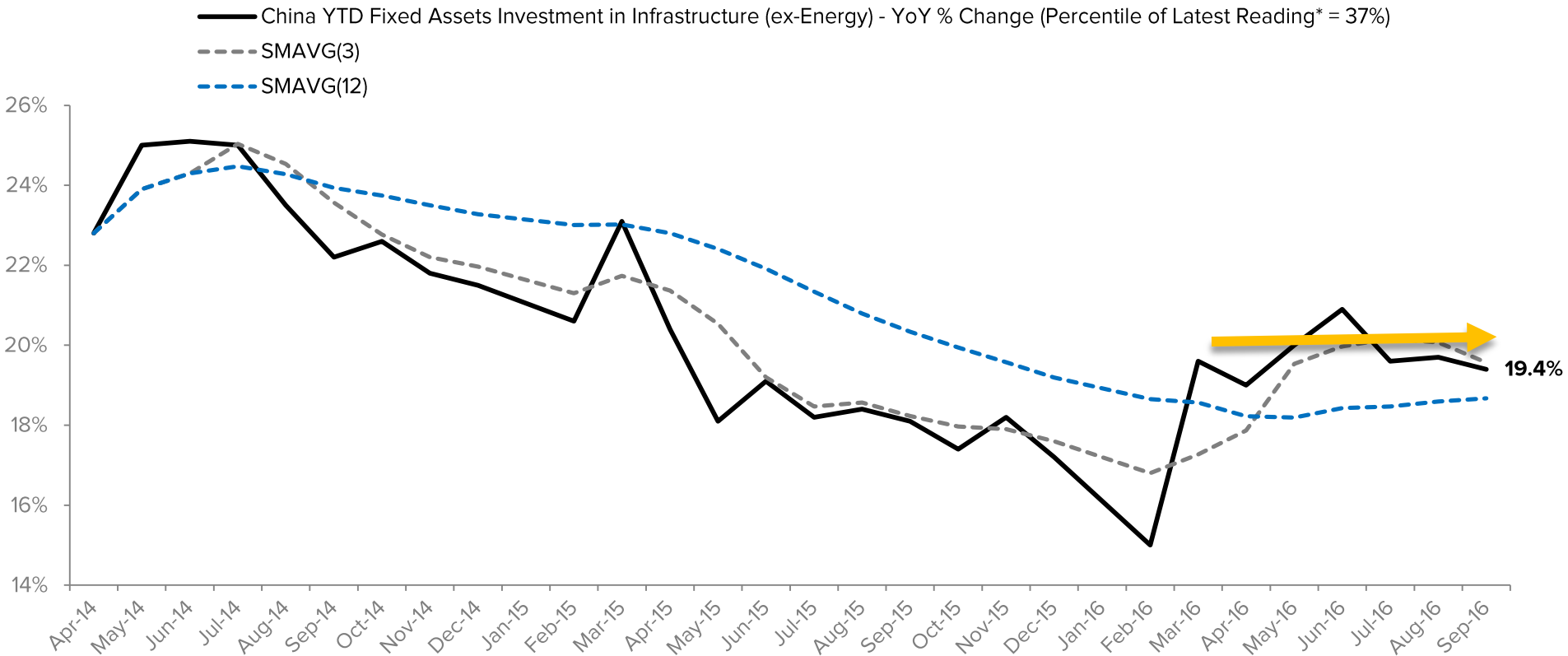
CENTRAL GOVERNMENT EXPENDITURES

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



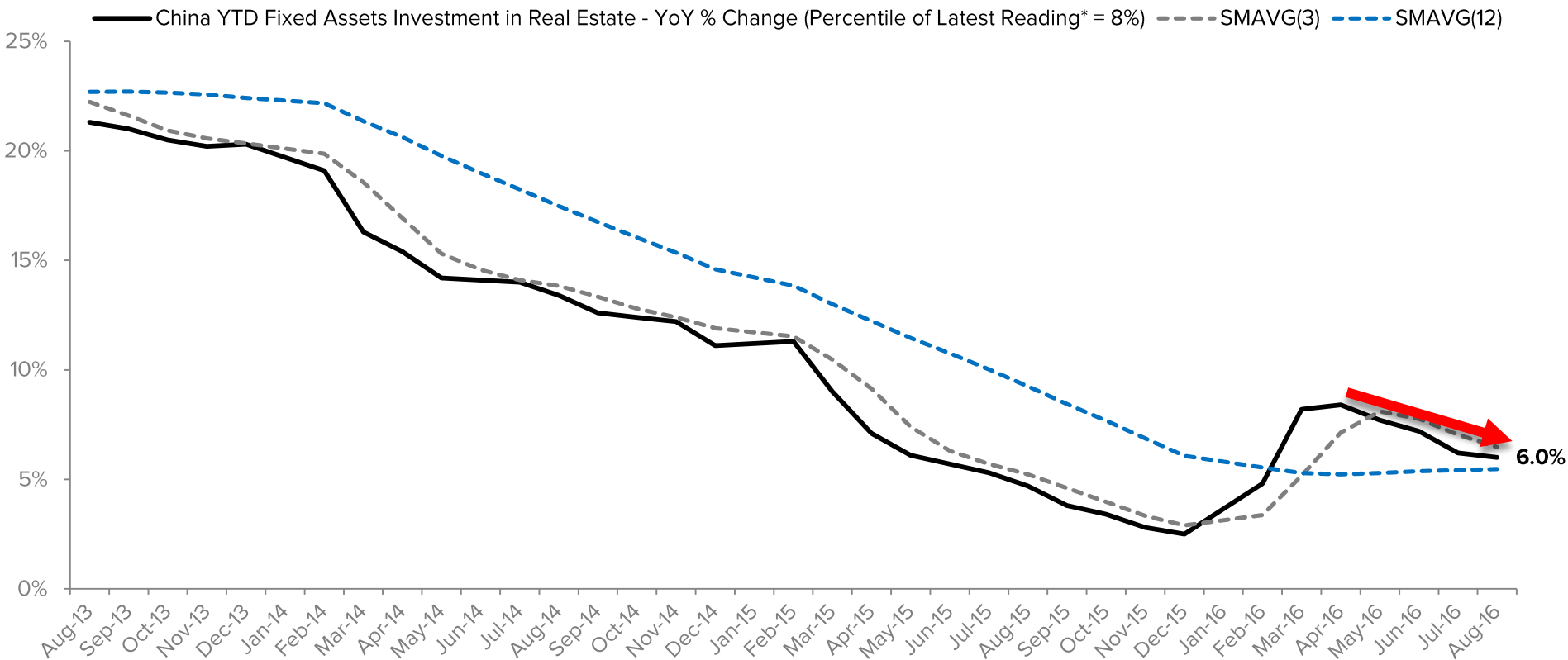
INFRASTRUCTURE FIXED ASSETS INVESTMENT

GROWTH IS TRENDING SIDeways AS OF SEPTEMBER



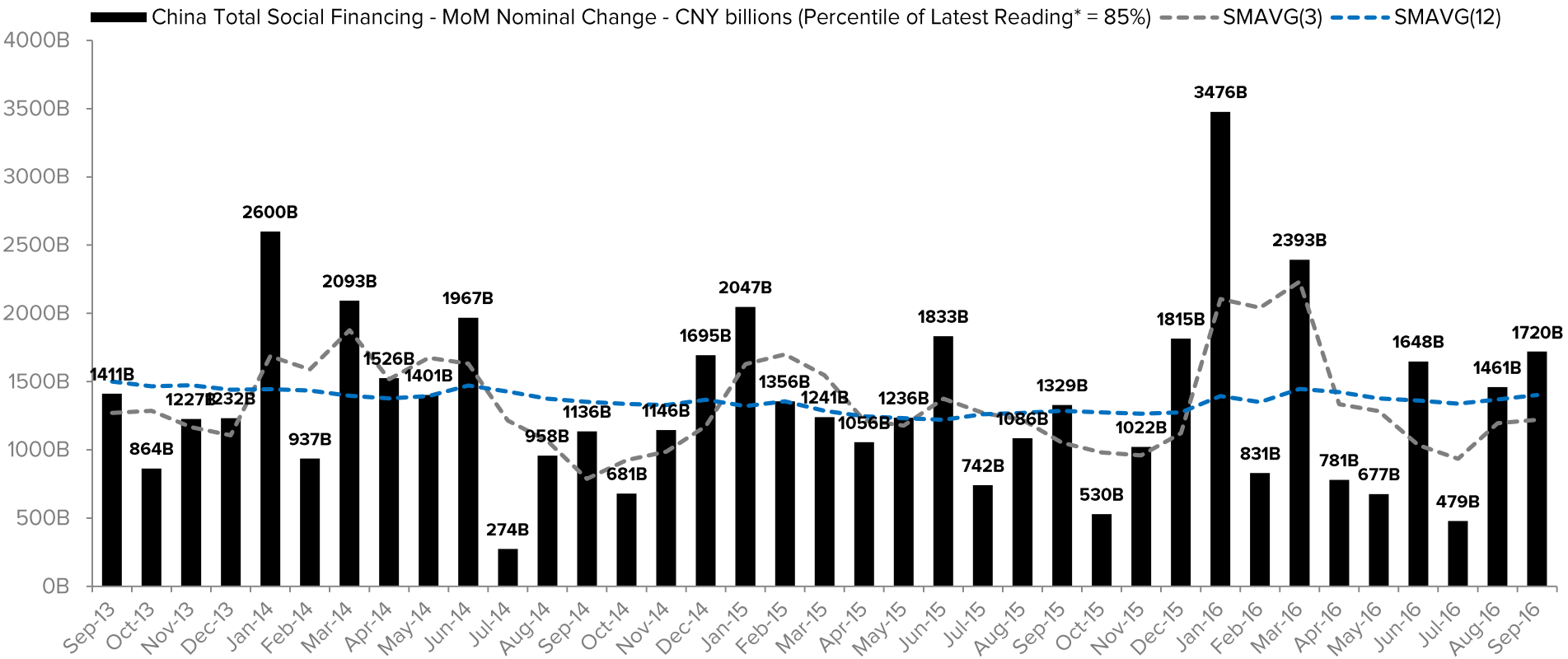
REAL ESTATE FIXED ASSETS INVESTMENT

GROWTH IS IN THE PROCESS OF INFLECTING NEGATIVELY AS OF AUGUST



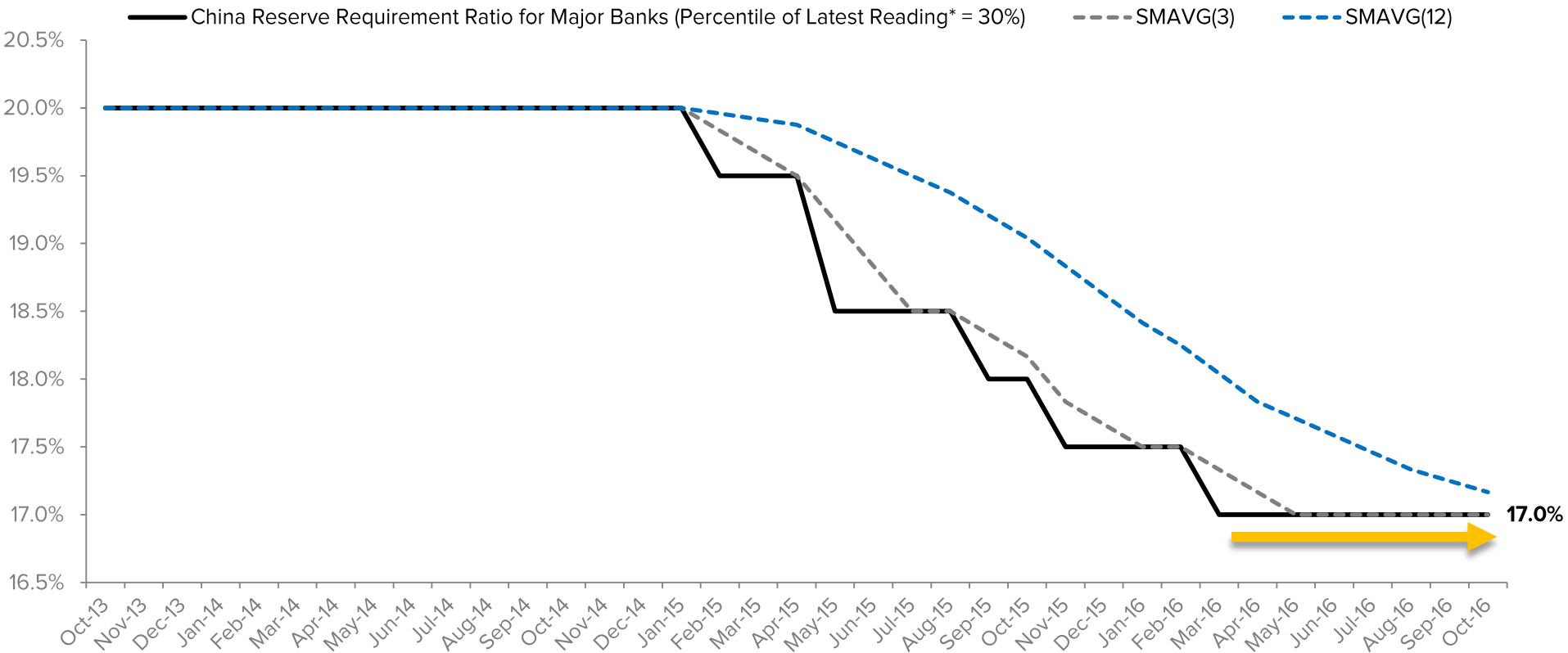
TOTAL SOCIAL FINANCING

CHINA HAS EXPANDED ECONOMY-WIDE FINANCING ON THE ORDER OF \$2.02 TRILLION THROUGHOUT THE YTD.



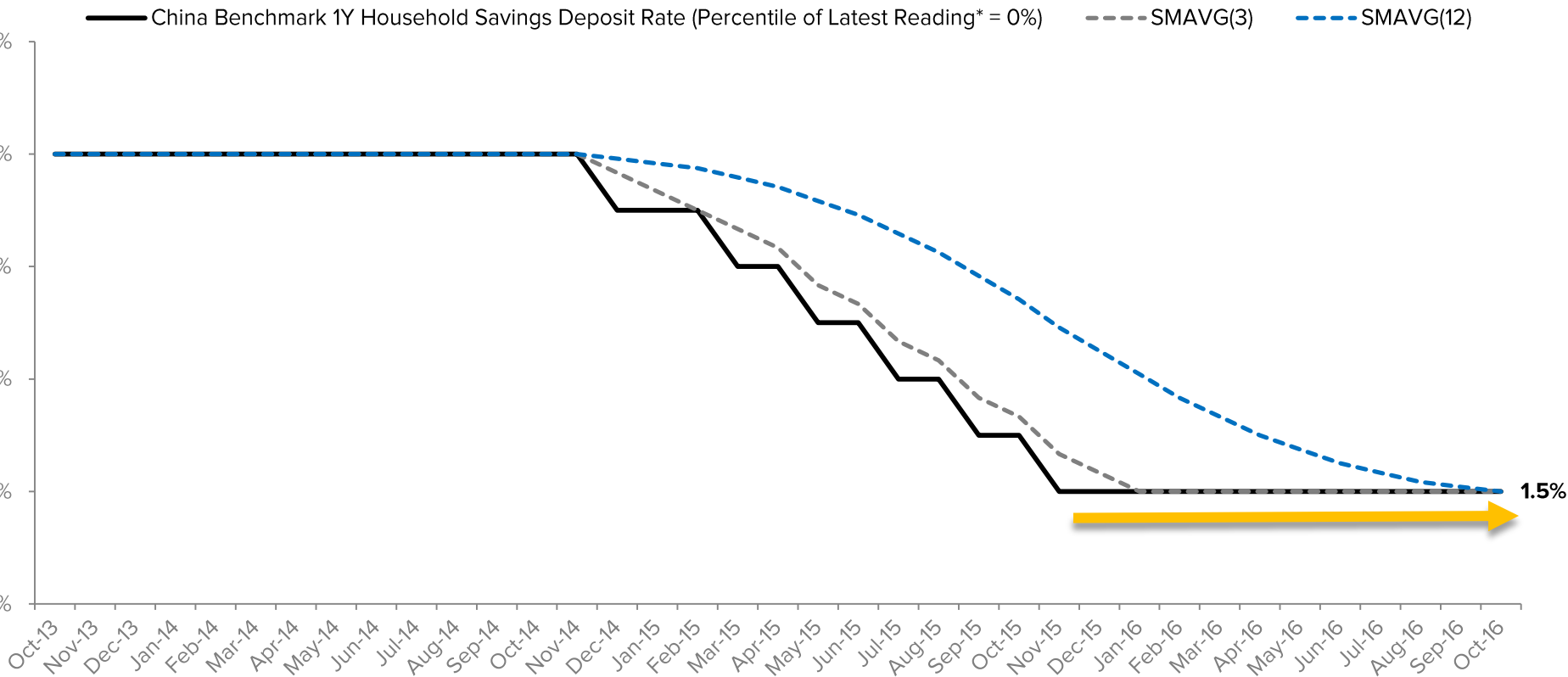
RESERVE REQUIREMENT RATIOS

TRENDING SIDeways AS OF OCTOBER



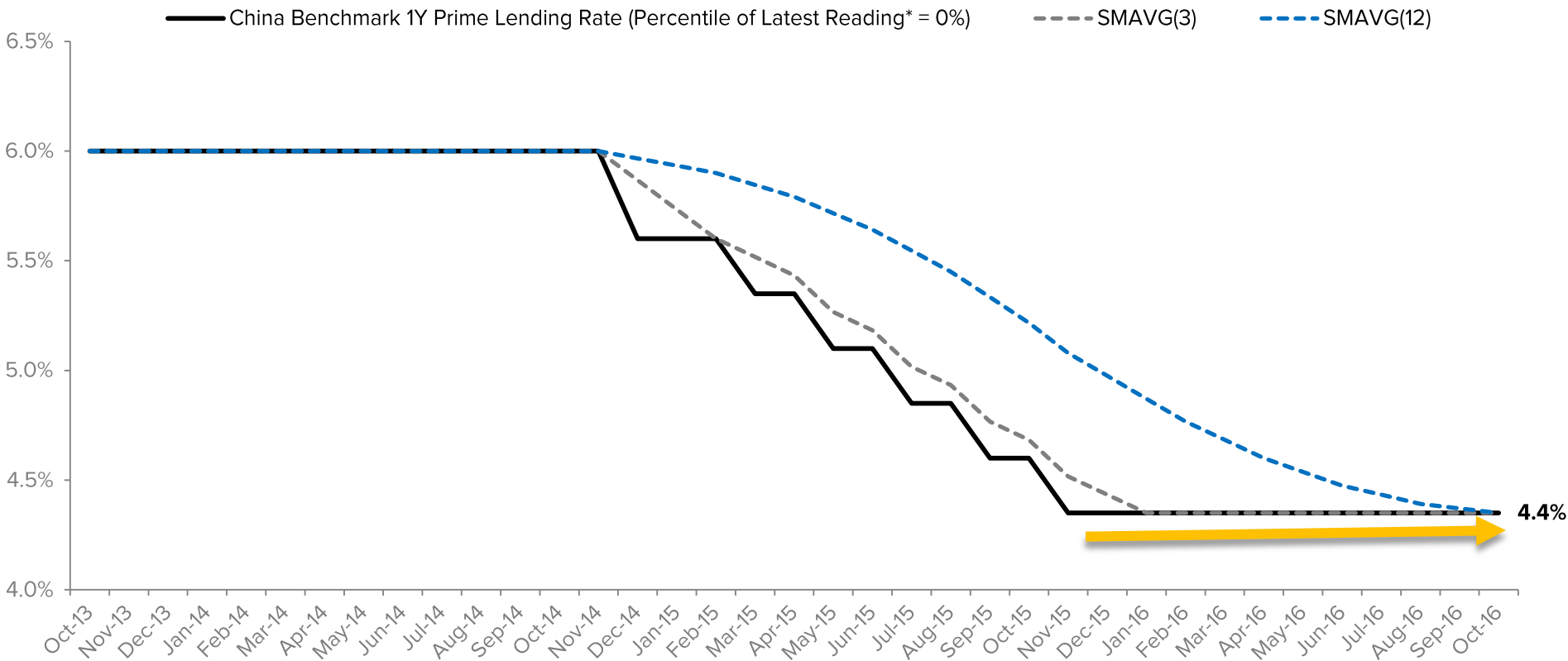
BENCHMARK DEPOSIT RATE

TRENDING SIDeways AS OF OCTOBER



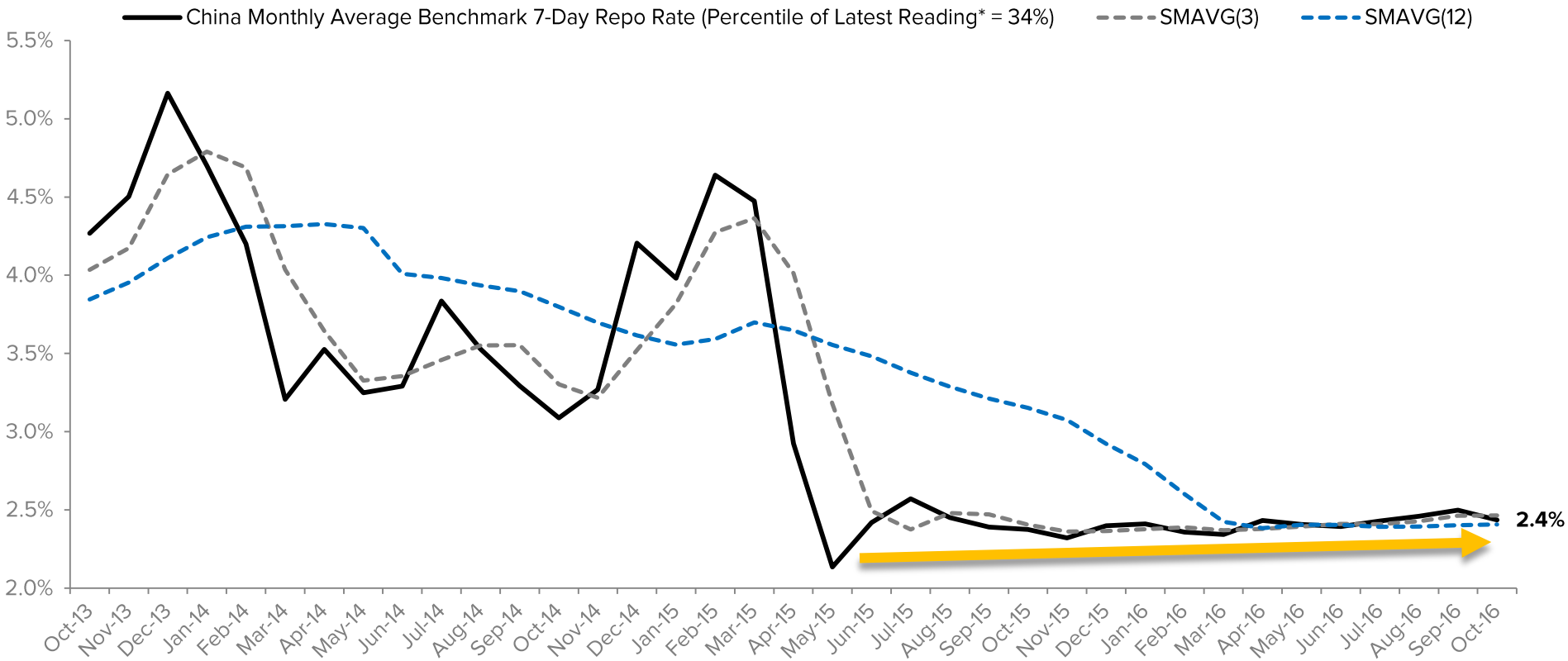
BENCHMARK LENDING RATE

TRENDING SIDeways AS OF OCTOBER



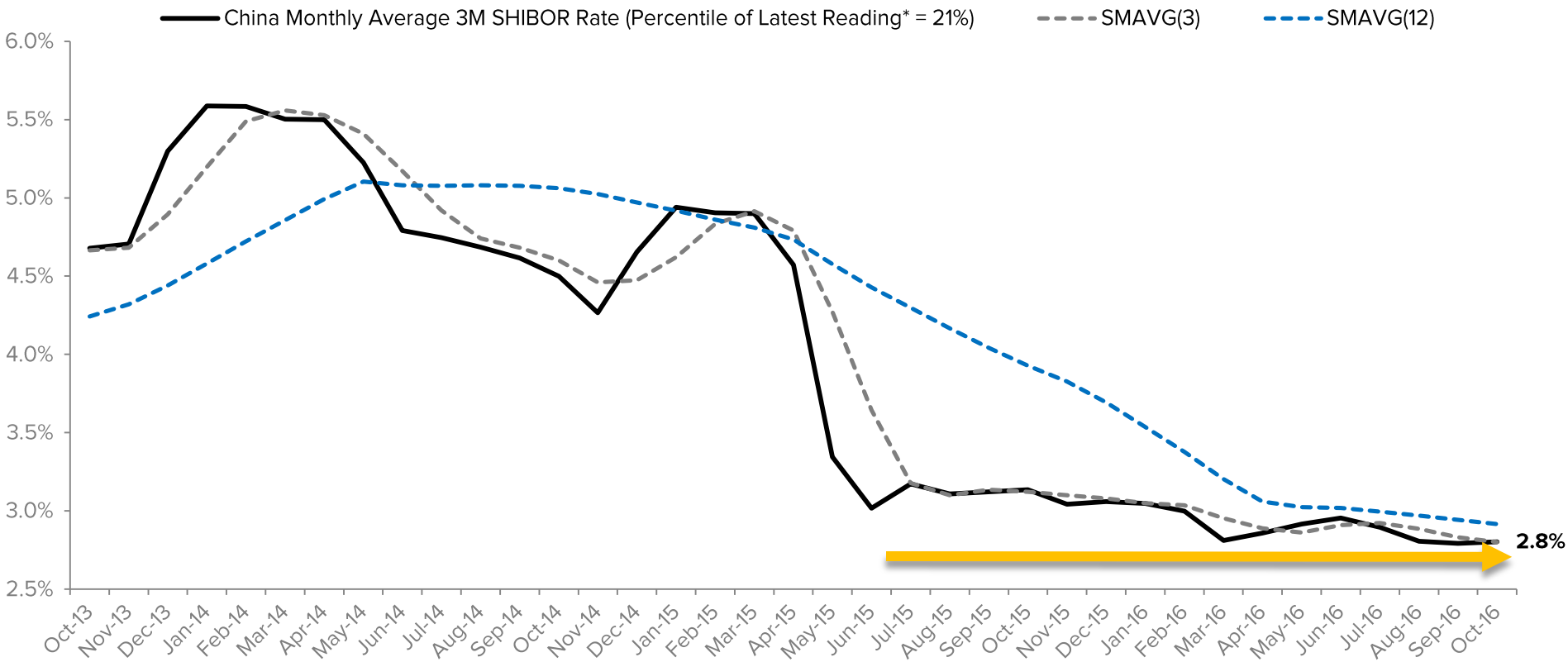
BENCHMARK 7-DAY REPO RATE

TRENDING SIDeways AS OF OCTOBER



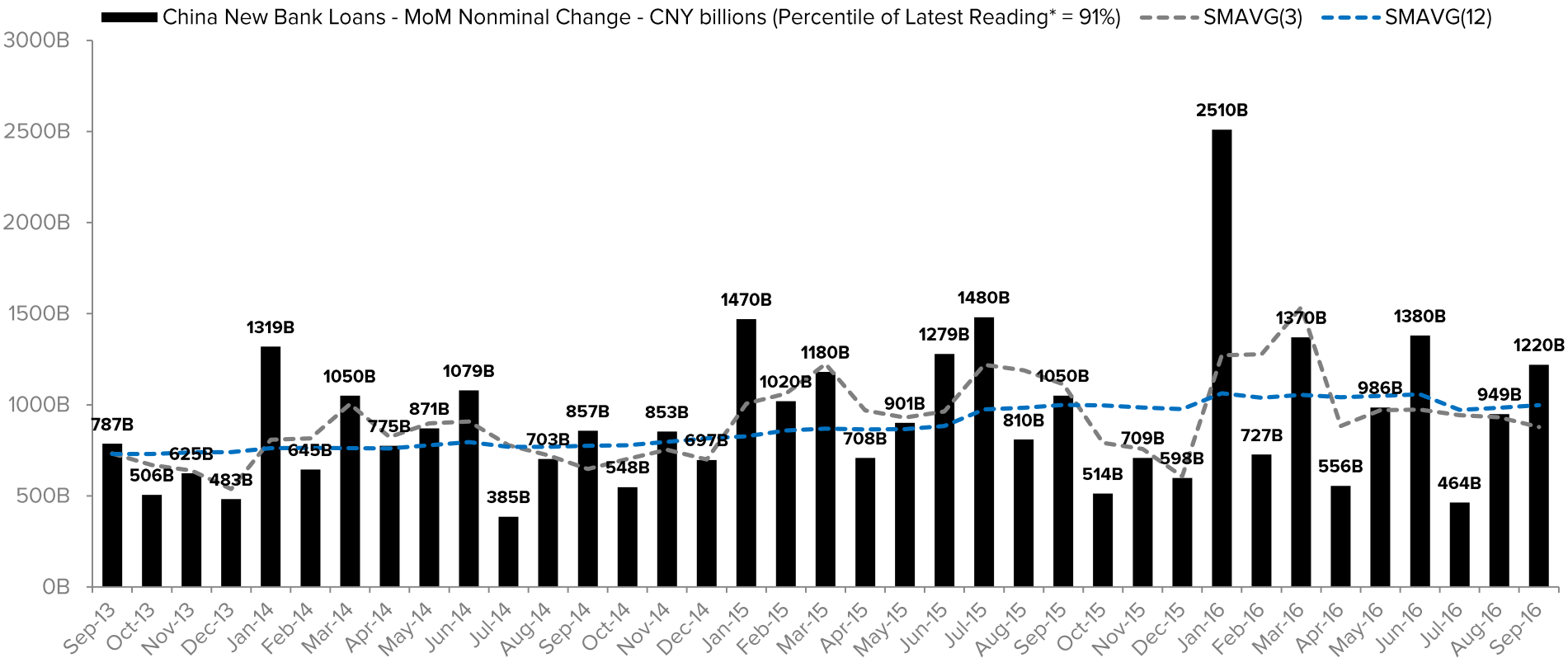
BENCHMARK INTERBANK LENDING RATES

TRENDING SIDeways AS OF OCTOBER



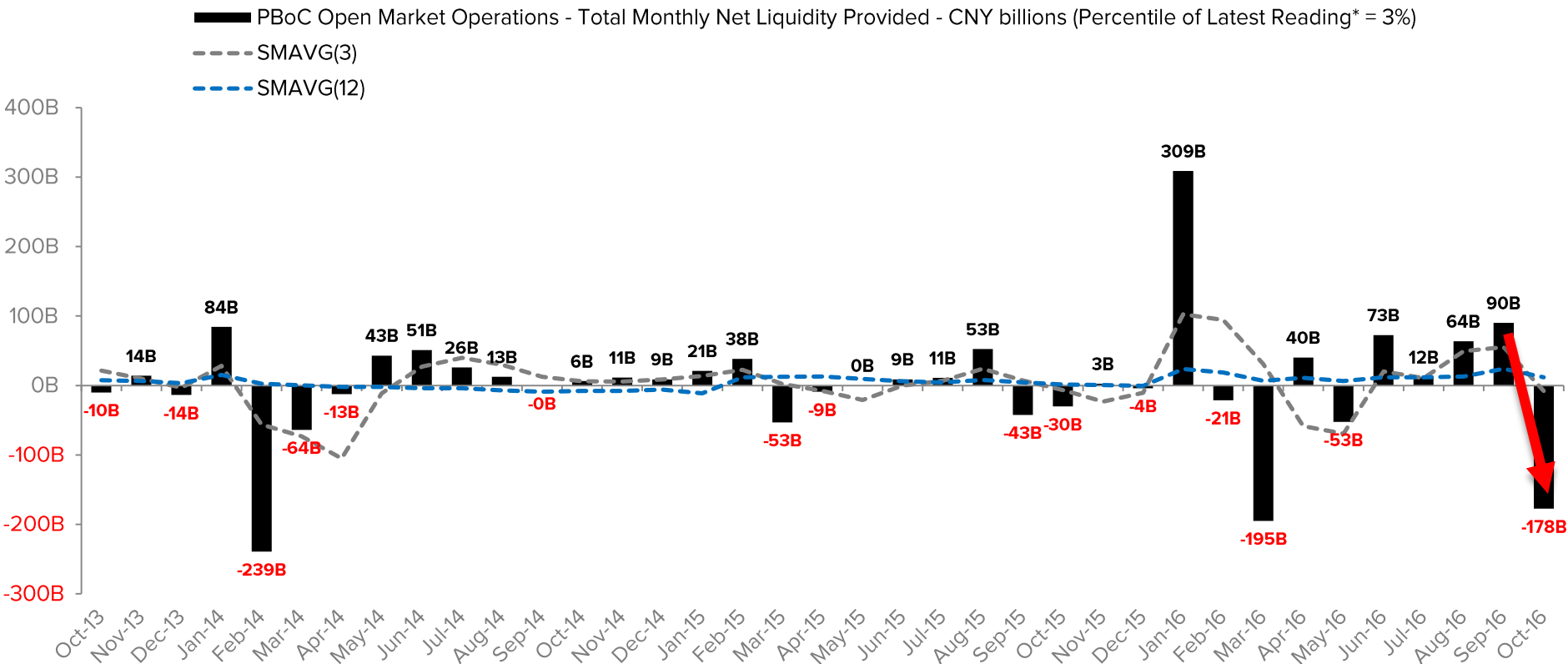
NEW LOCAL CURRENCY BANK LOANS

\$1.5 TRILLION OF THE AFOREMENTIONED FIGURE CAME IN THE FORM OF NEW LOANS – INCREASINGLY THROUGH POLICY BANKS AND IN THE FORM OF MORTGAGES (60% IN Q3 UP FROM 47% AND 23% IN Q2 AND Q1, RESPECTIVELY).



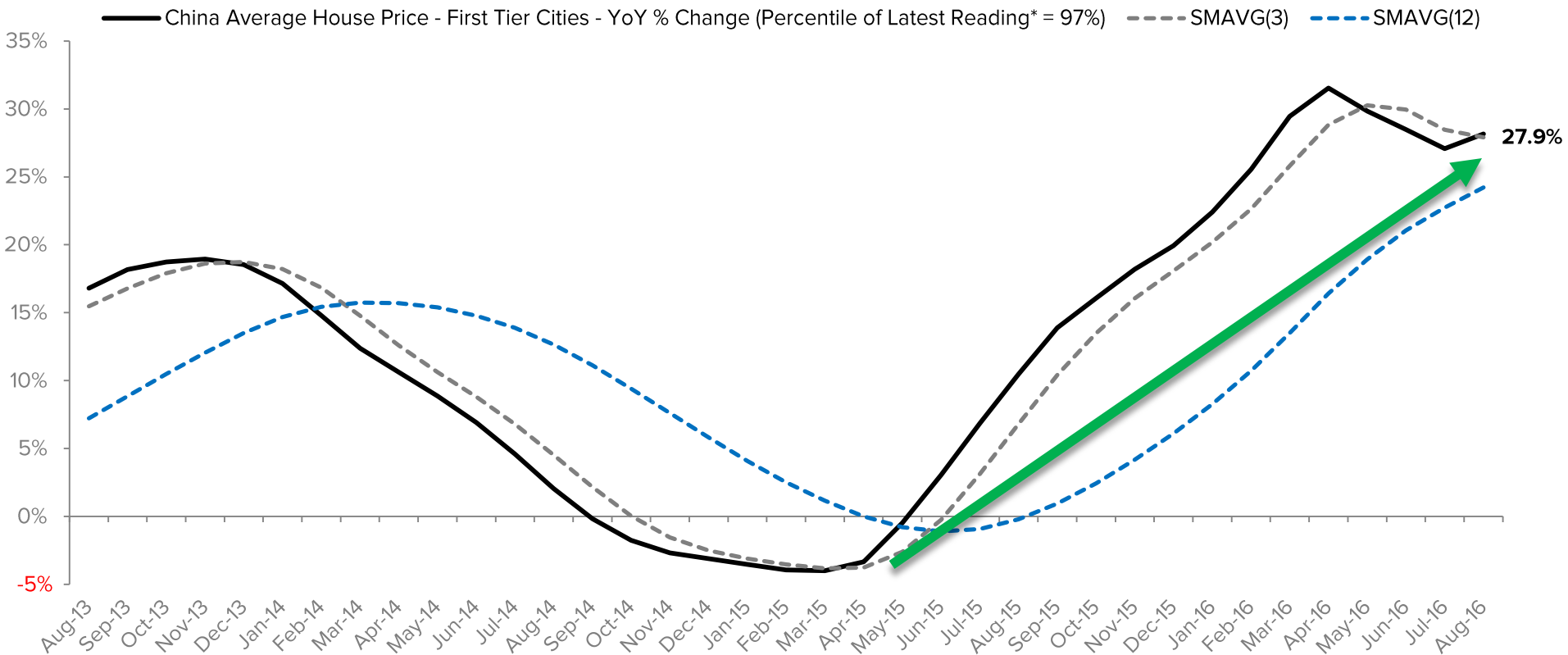
PBOC OPEN MARKET OPERATIONS

THE YTD SUM OF LIQUIDITY PROVIDED TO THE FINANCIAL SECTOR VIA OPEN MARKET OPERATIONS IS UP +2,022% Y/Y VERSUS THE COMPARABLE PERIOD IN 2015. NO THAT IS NOT A TYPO (1.06T CNY VS. 50B CNY)... NOTE THE BREAKDOWN IN OCTOBER AMID HAWKISH RHETORIC.



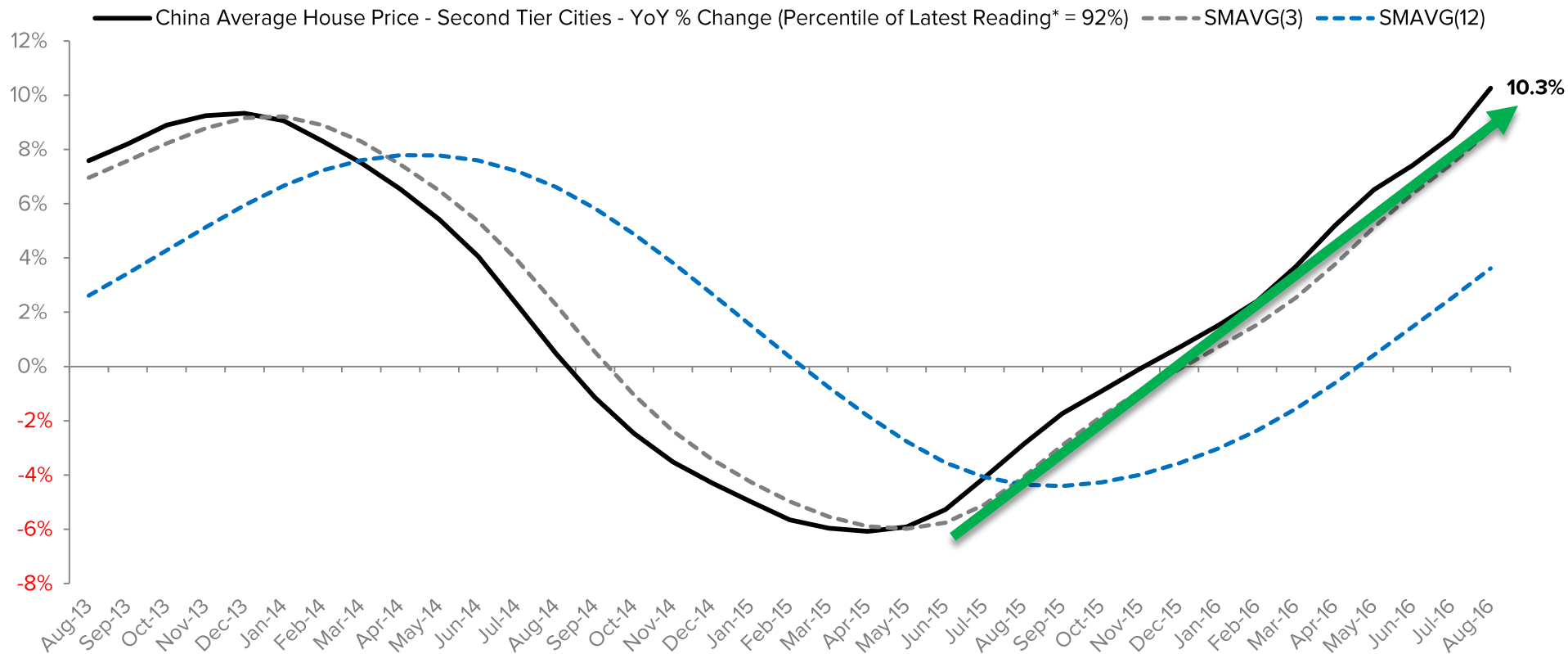
PROPERTY PRICE BUBBLE: 1ST TIER CITIES

HPI IS TRENDING HIGHER AS OF AUGUST



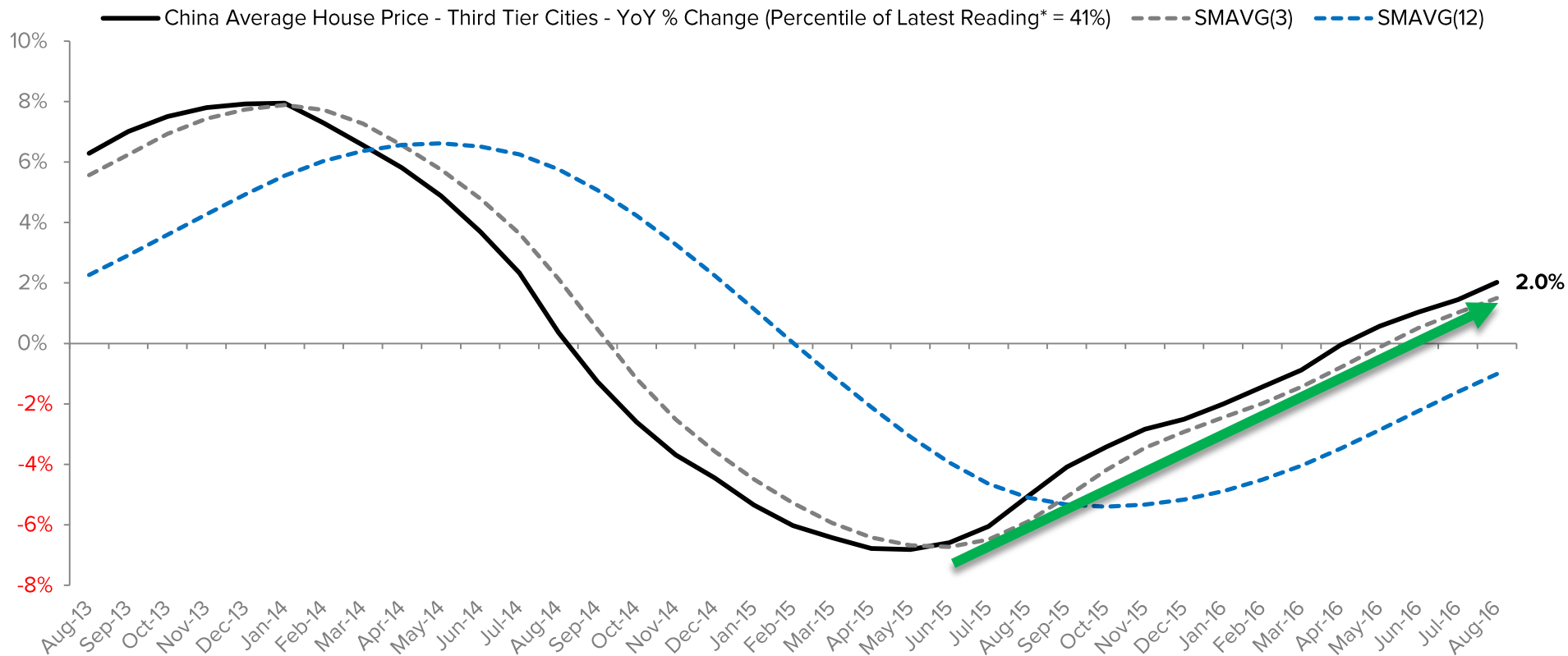
PROPERTY PRICE BUBBLE: 2ND TIER CITIES

HPI IS TRENDING HIGHER AS OF AUGUST



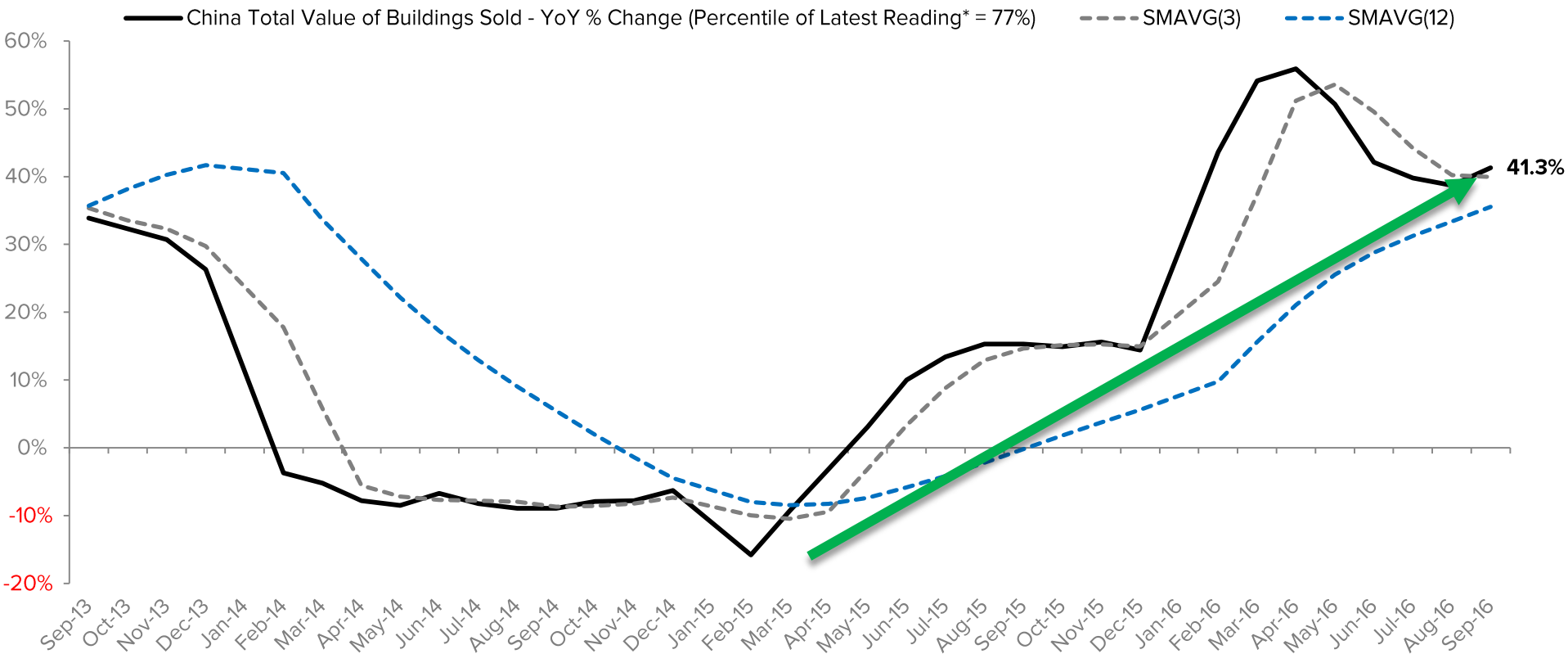
PROPERTY PRICE RECOVERY: 3RD TIER CITIES

HPI IS TRENDING HIGHER AS OF AUGUST



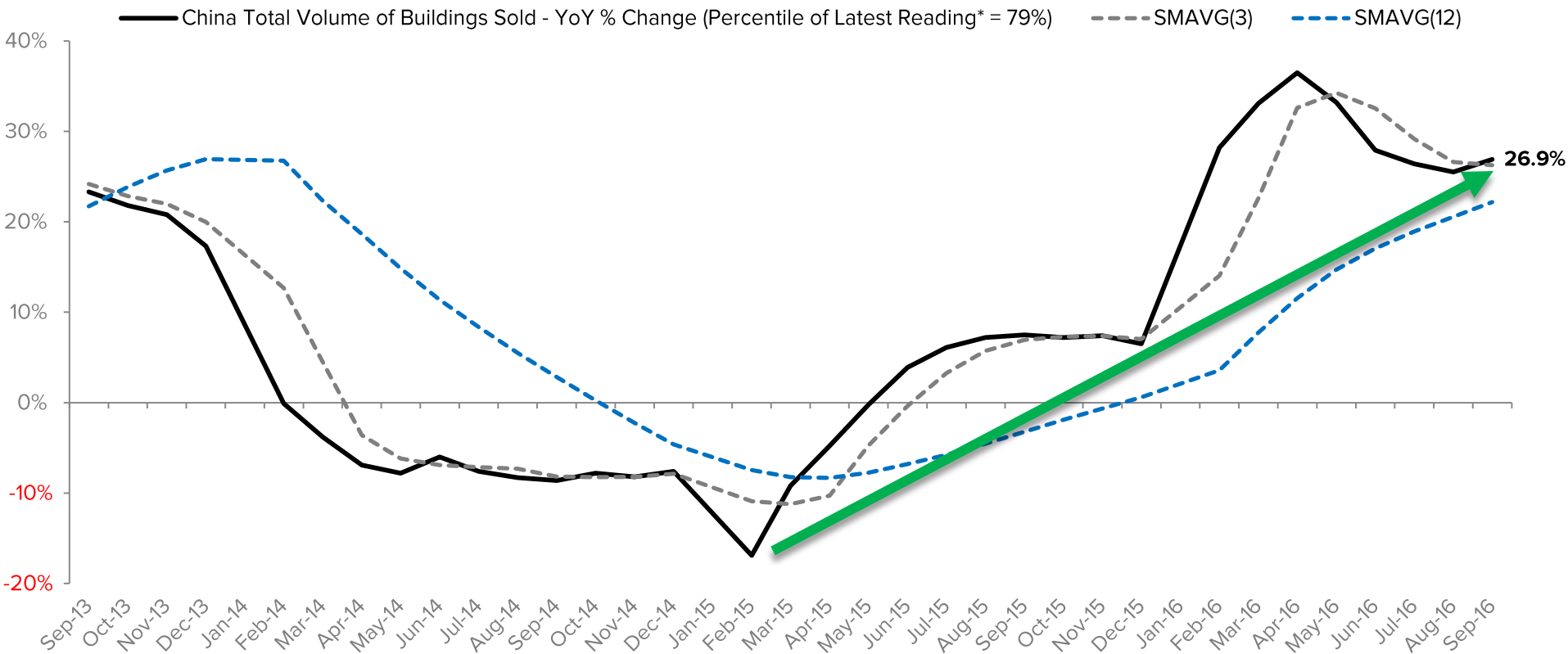
DEMAND: VALUE OF BUILDINGS SOLD

GROWTH IS TRENDING HIGHER AS OF SEPTEMBER



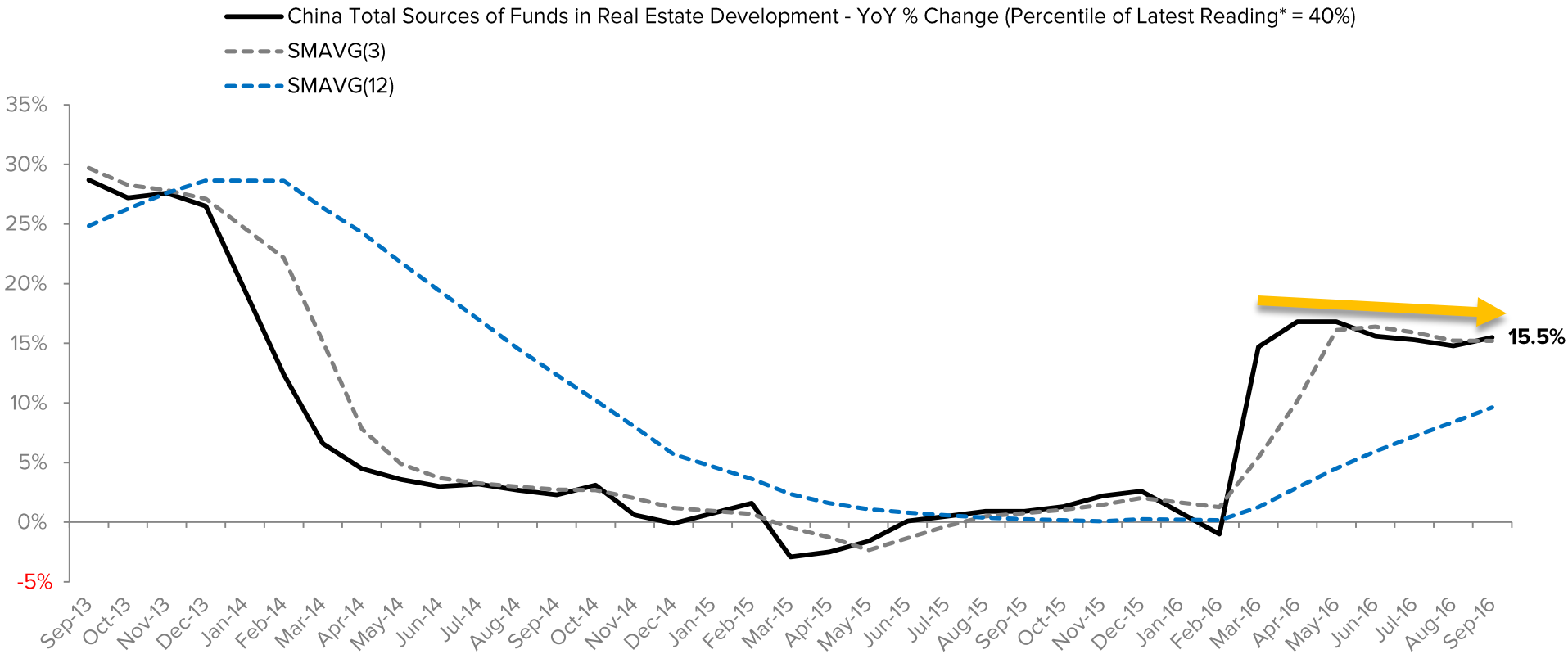
DEMAND: VOLUME OF BUILDINGS SOLD

GROWTH IS TRENDING HIGHER AS OF SEPTEMBER



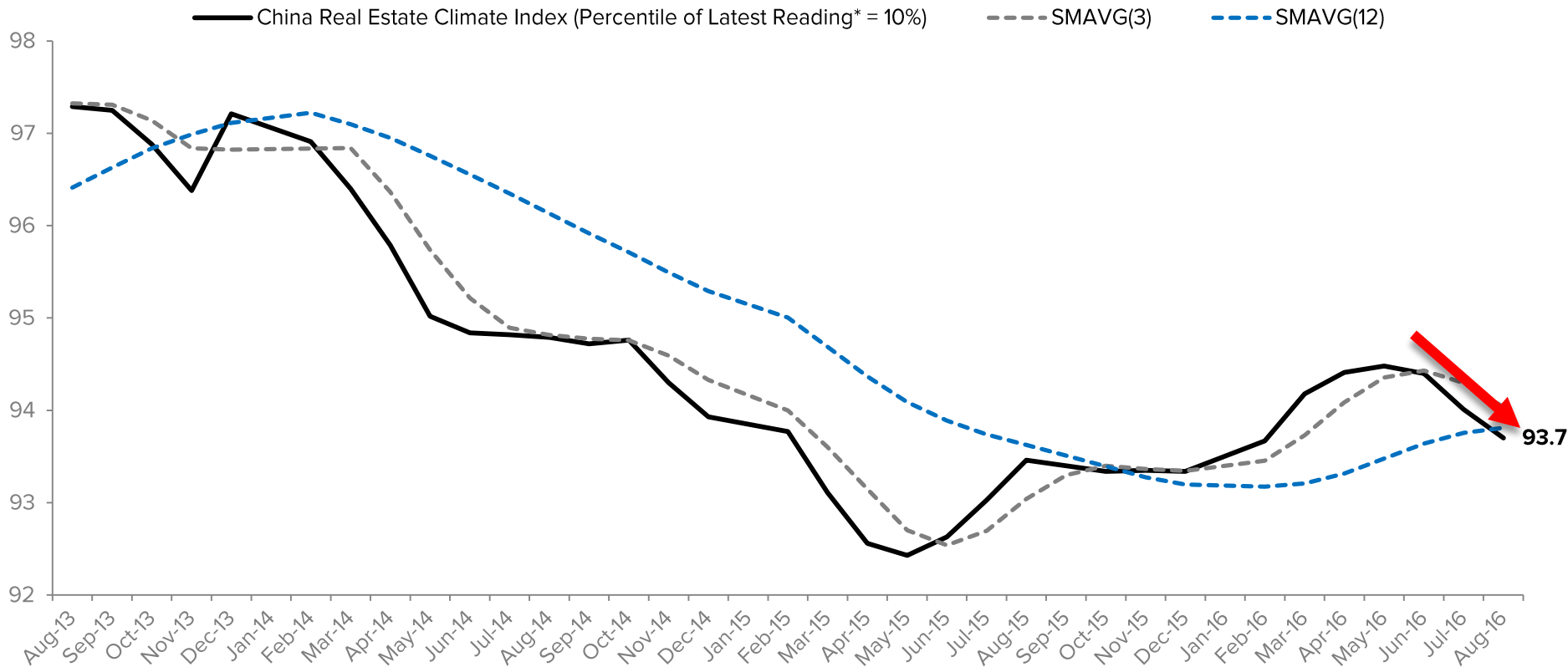
REAL ESTATE DEVELOPER FINANCING

TRENDING SIDeways AS OF SEPTEMBER



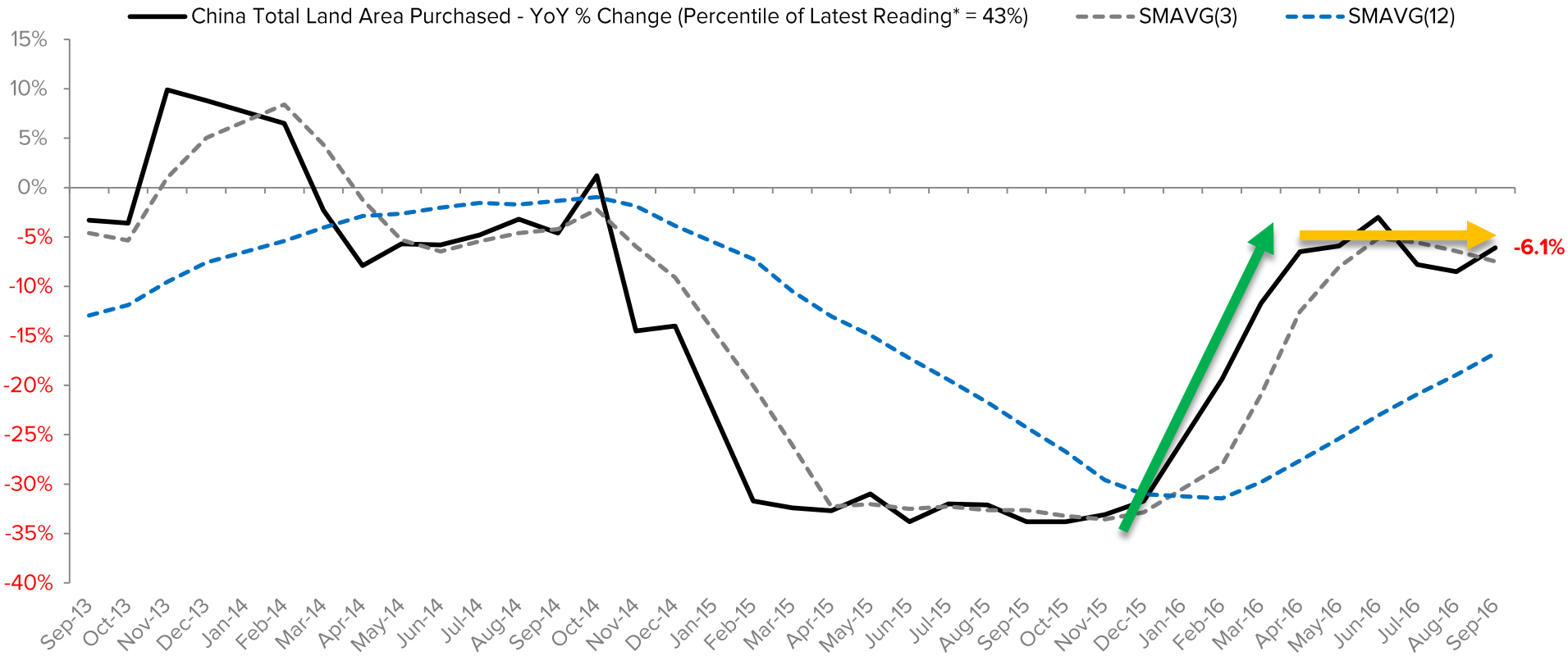
PROPERTY MARKET SENTIMENT

BREAKING DOWN AS OF AUGUST



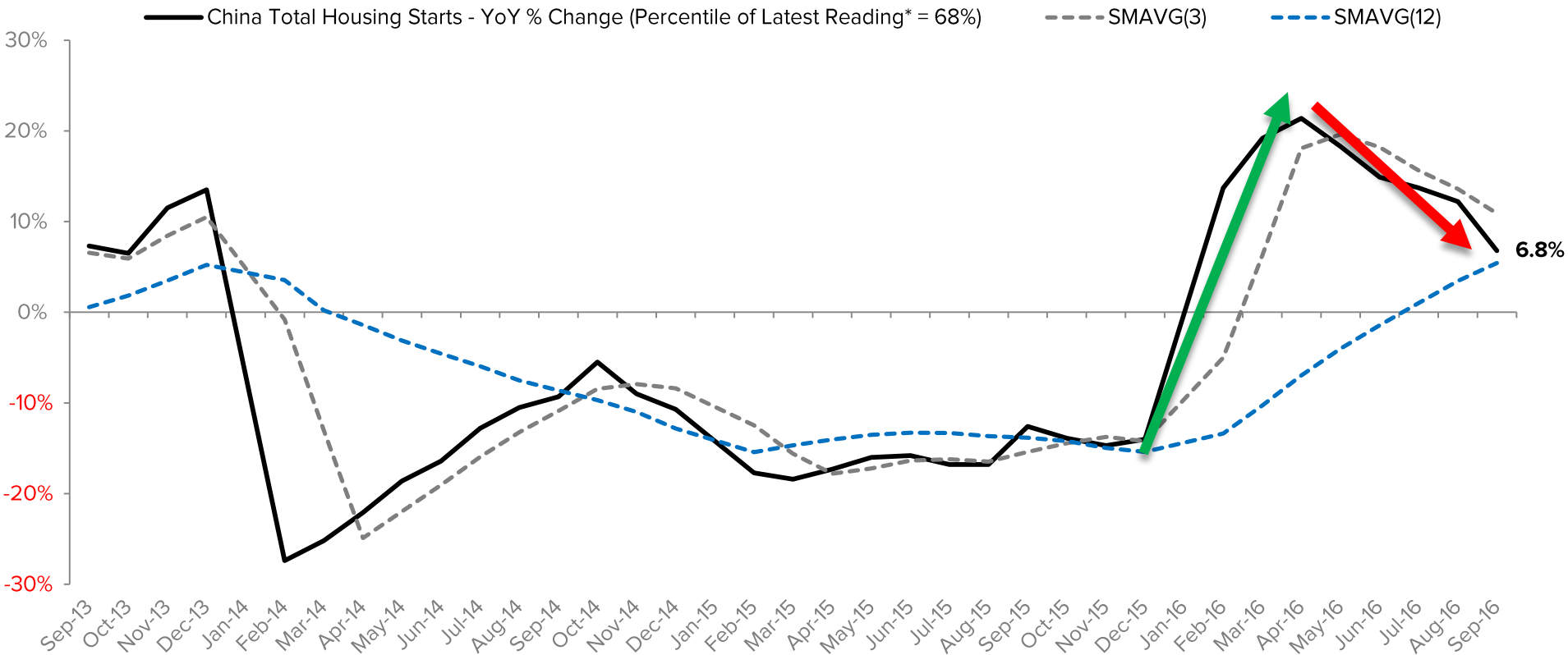
SUPPLY: LAND AREA PURCHASED

GROWTH IS TRENDING SIDeways AS OF SEPTEMBER



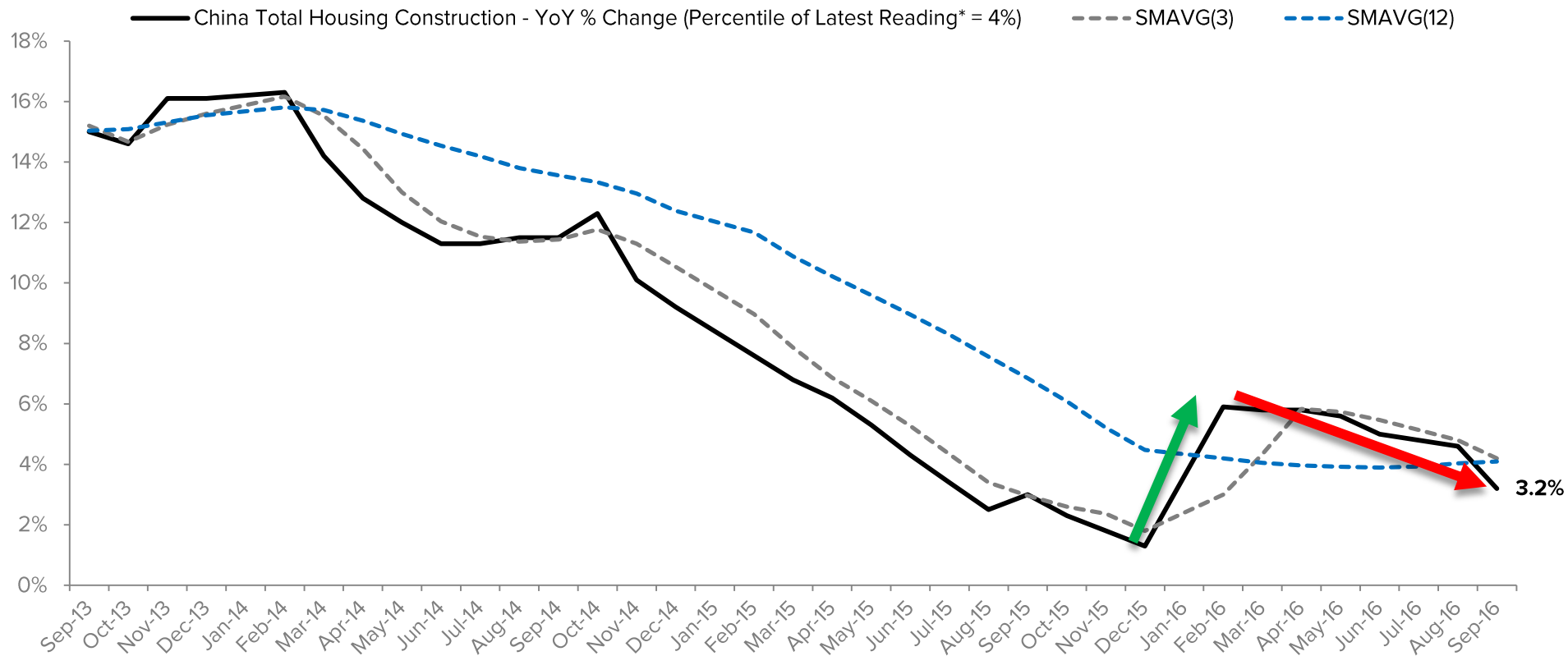
SUPPLY: HOUSING STARTS

GROWTH IS IN THE PROCESS OF INFLECTING NEGATIVELY AS OF SEPTEMBER



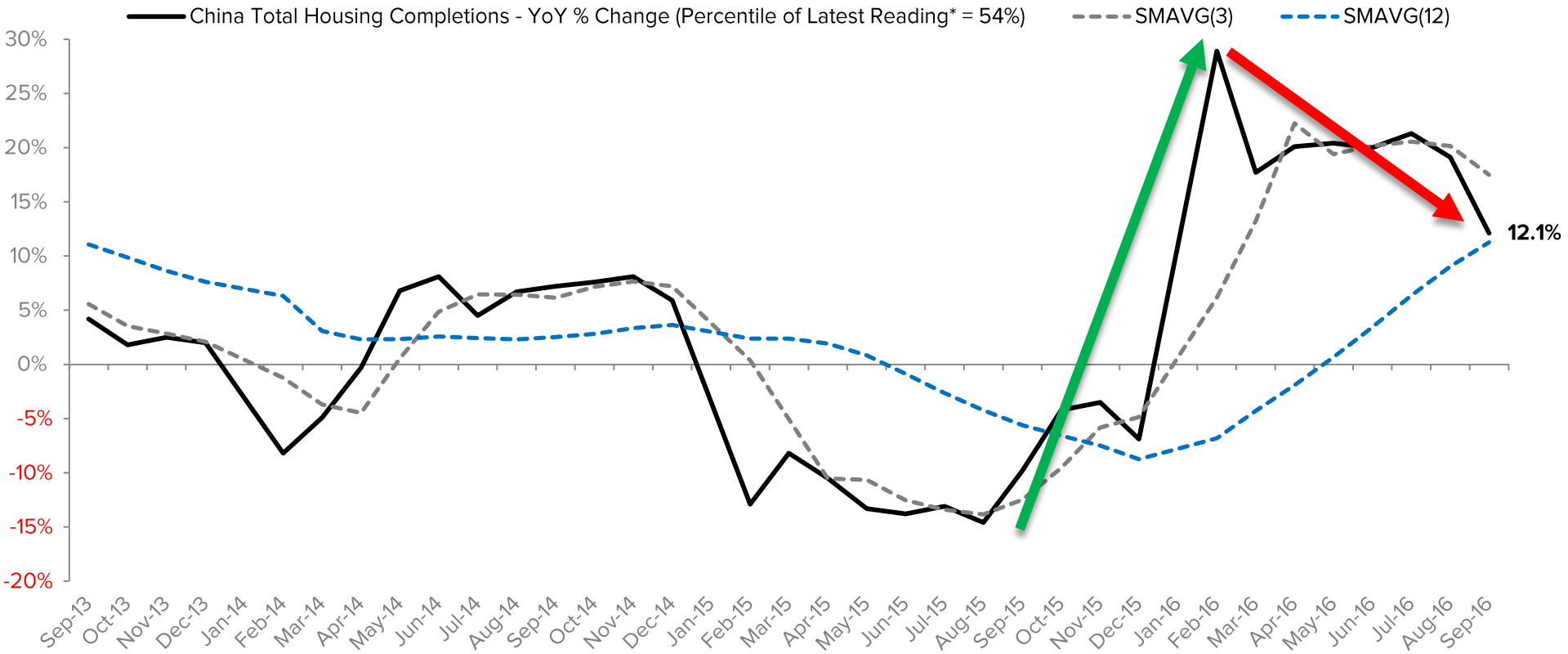
SUPPLY: HOUSING CONSTRUCTION

GROWTH IS BREAKING DOWN AS OF SEPTEMBER



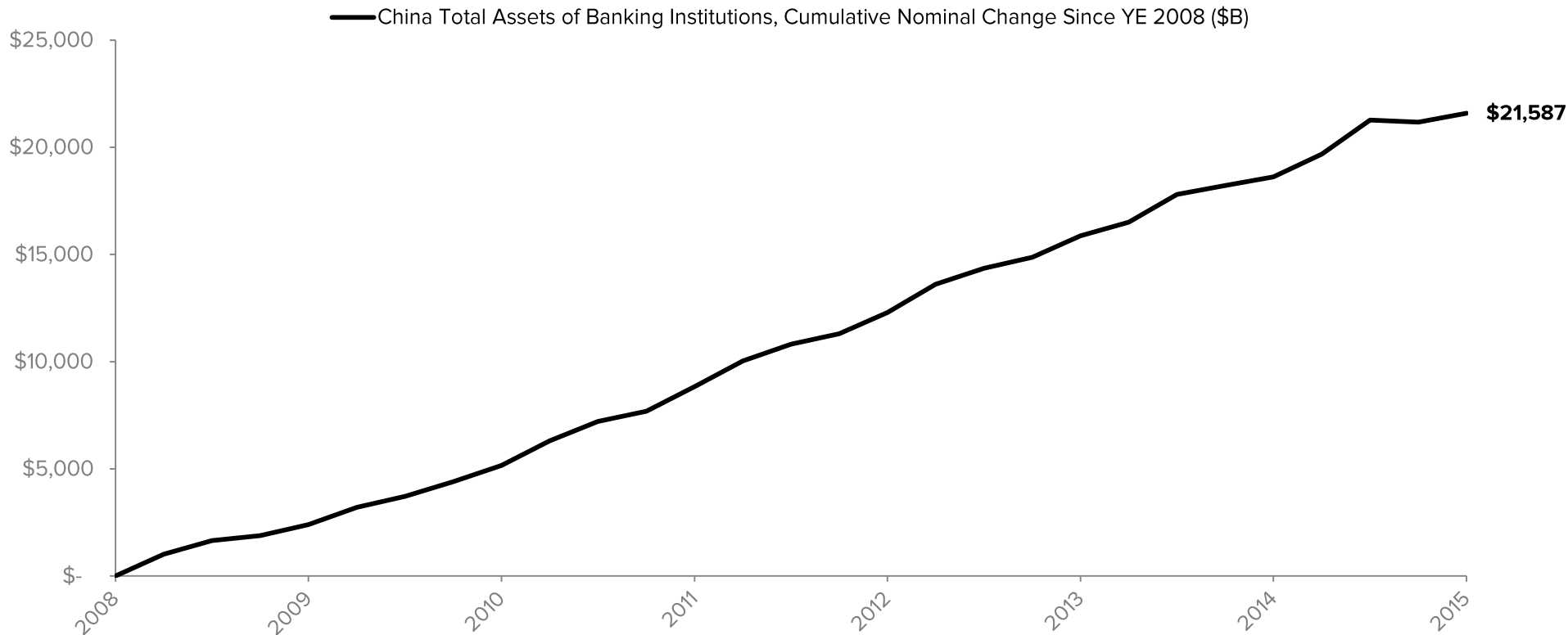
SUPPLY: HOUSING COMPLETIONS

GROWTH IS IN THE PROCESS OF INFLECTING NEGATIVELY AS OF SEPTEMBER



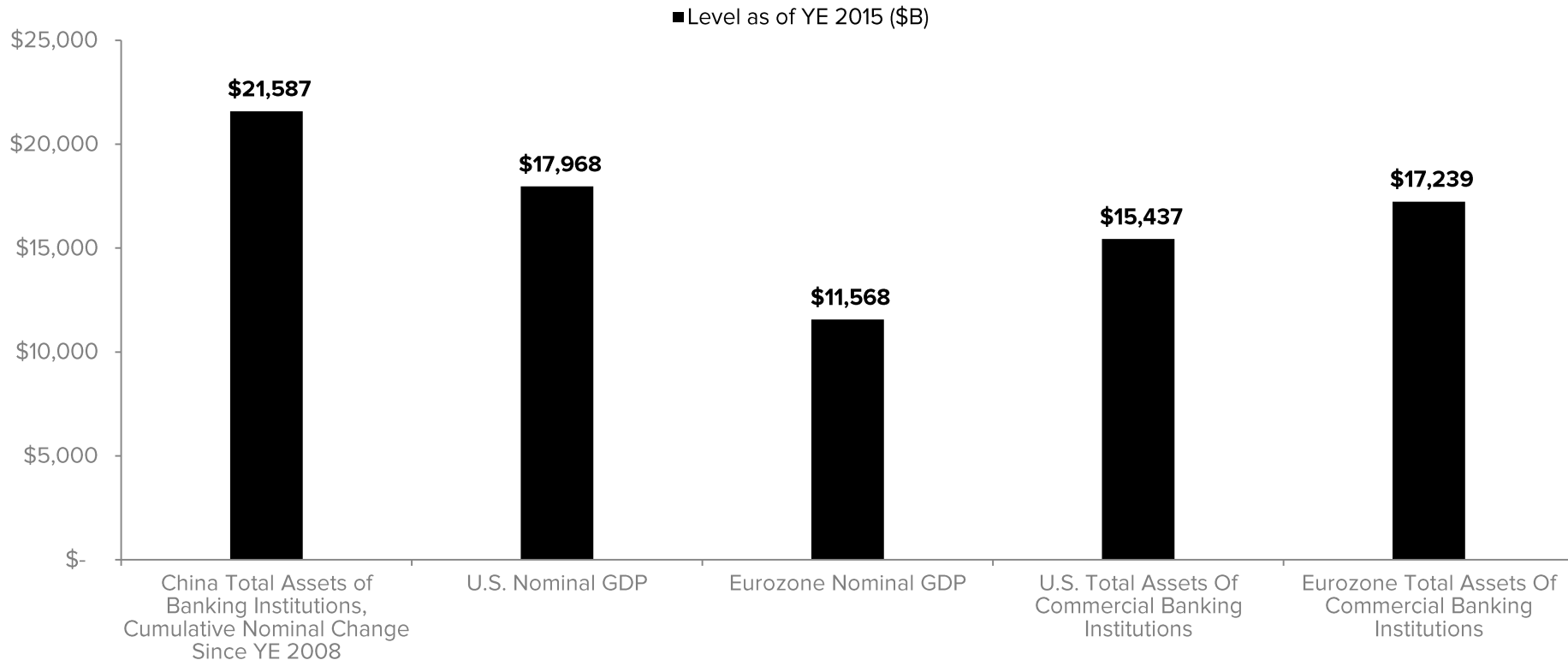
CHINA'S \$21 TRILLION DOLLAR PROBLEM

SINCE THE END OF 2008, CHINA'S BANKING SYSTEM HAS GROWN BY \$21 TRILLION DOLLARS!



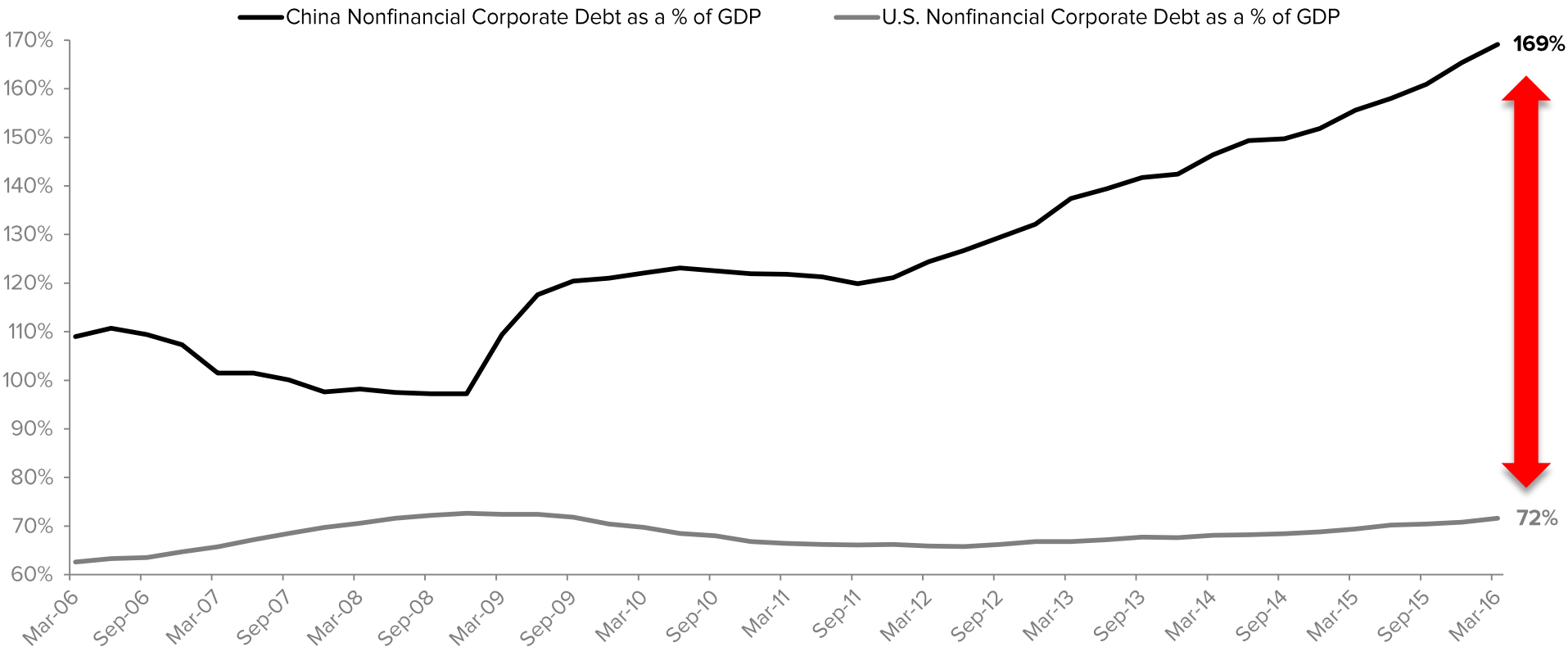
WHAT CAN \$21 TRILLION BUY?

A MORE APPROPRIATE QUESTION IS WHAT CAN'T \$21 TRILLION BUY. CHINA'S CREDIT EXPANSION OVER THE PAST SEVEN YEARS IS LARGER THAN THE ENTIRE U.S. BANKING SYSTEM!



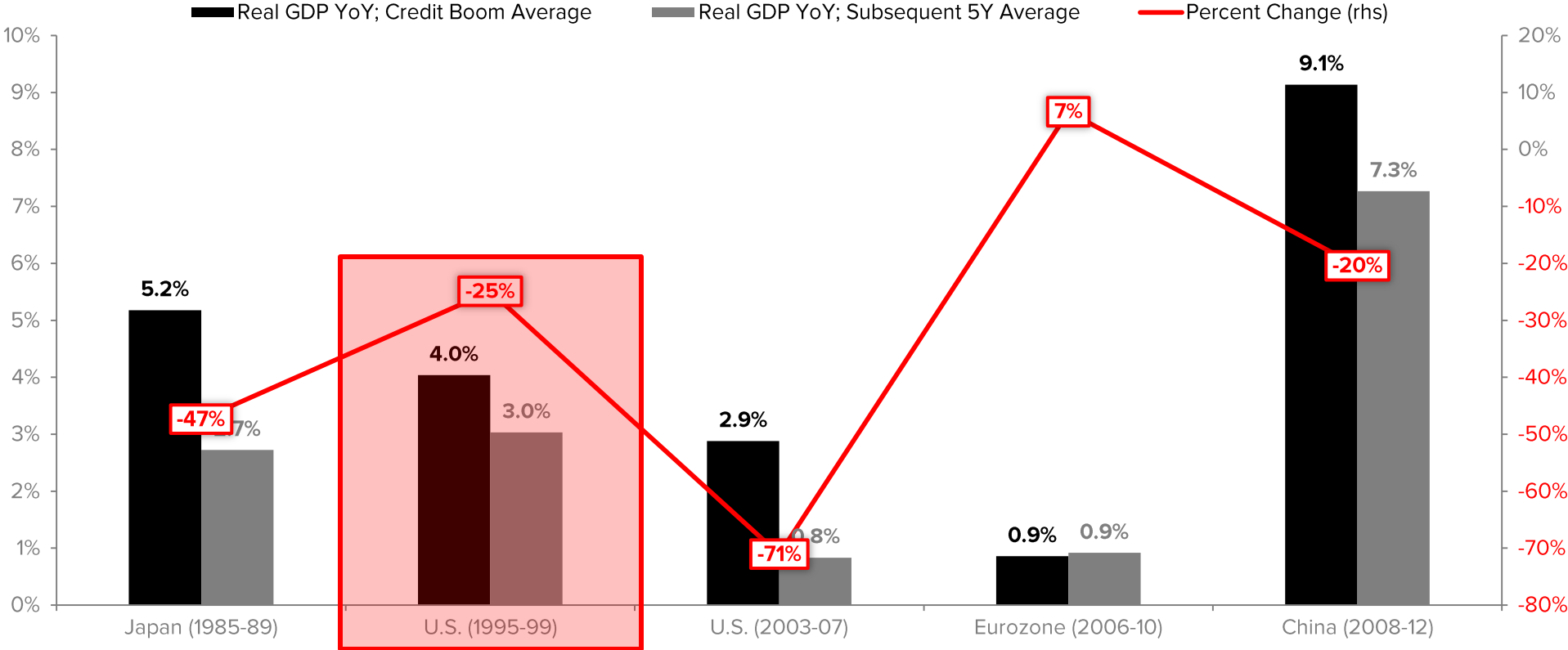
MIND THE GAP

LEVERAGE AMONG CHINESE NONFINANCIAL CORPORATIONS, AS A RATIO TO THE ECONOMY, HAS ACCELERATED DRAMATICALLY IN RECENT YEARS. THE SPREAD BETWEEN CHINA AND THE U.S. IS AS WIDE AS IT'S EVER BEEN.



WHAT HAPPENS NEXT? GROWTH SLOWS

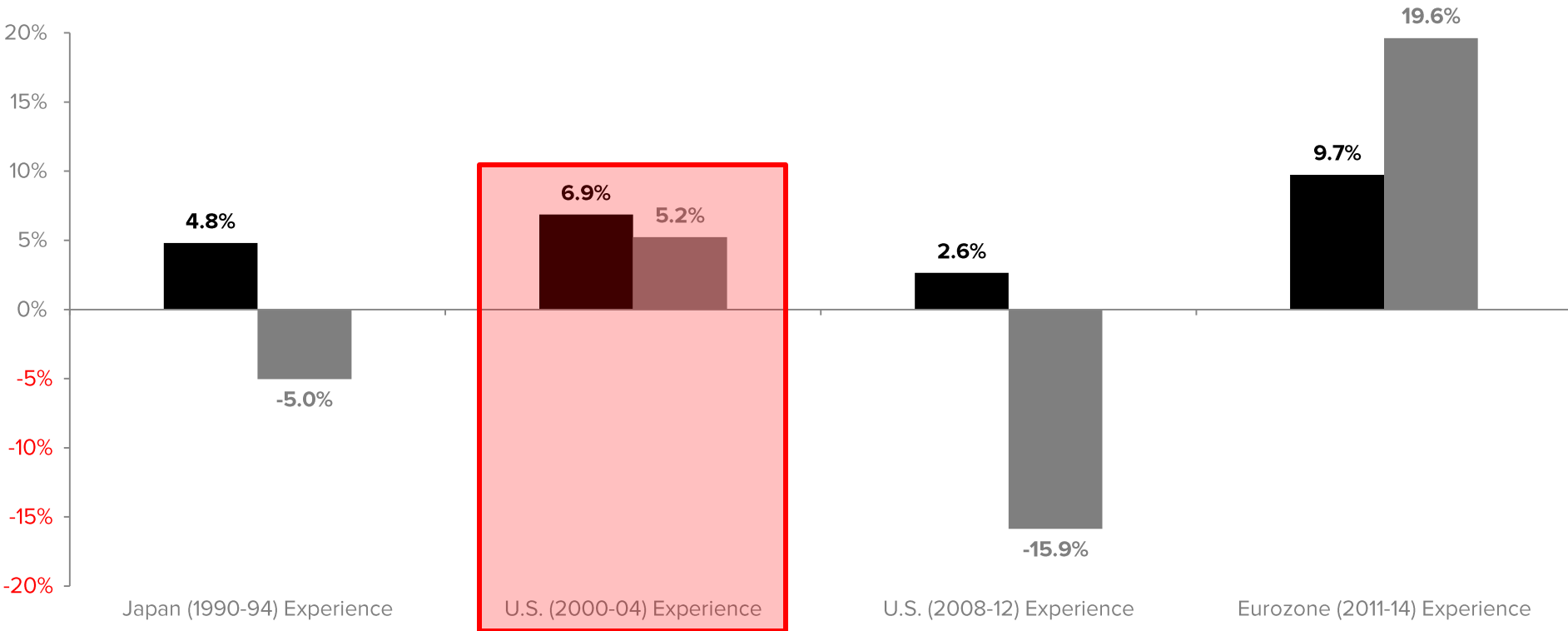
ADVERSE SELECTION LEADING TO OVEREXTENDED BORROWERS AND FINANCIAL INSTITUTIONS LEADS TO A CLOGGING OF THE CREDIT CHANNEL THAT MAKES IT DIFFICULT TO “COMP” AGAINST THE ELEVATED GROWTH RATES OF THE BOOM YEARS.



CHINESE GDP: ON ITS WAY TO ~5.5%?

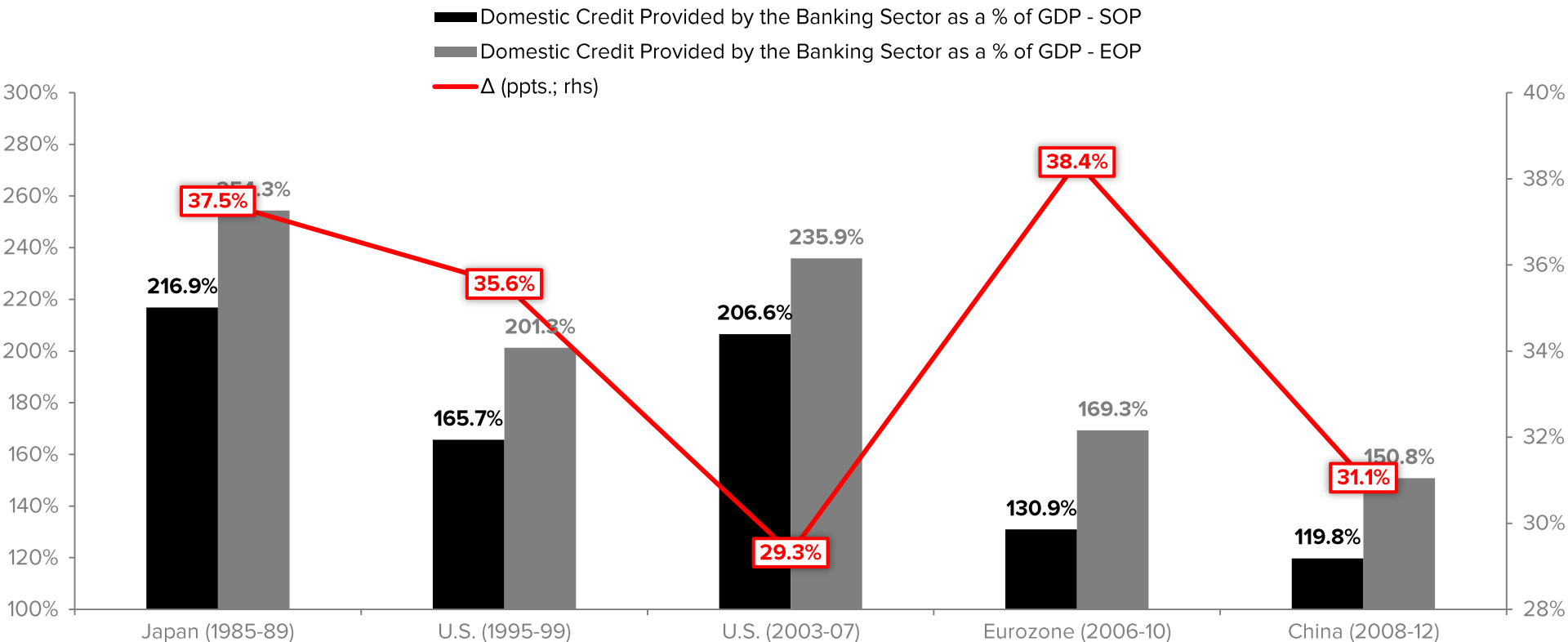
A GOLDILOCKS SLOWDOWN SCENARIO MIGHT IMPLY CHINESE REAL GDP GROWTH SHOULD AVERAGE JUST ABOVE +5% IN 2017, WITH OBVIOUS DOWNSIDE PRESSURES FROM THERE. WHILE NOTEWORTHY, THE EUROZONE POST-CRISIS COROLLARY APPEARS TO BE AN OUTLIER.

■ Est. China 2013-2017 Average Annual Real GDP Growth ■ Est. China 2017 Average Annual Real GDP Growth Required to Achieve Implied Target



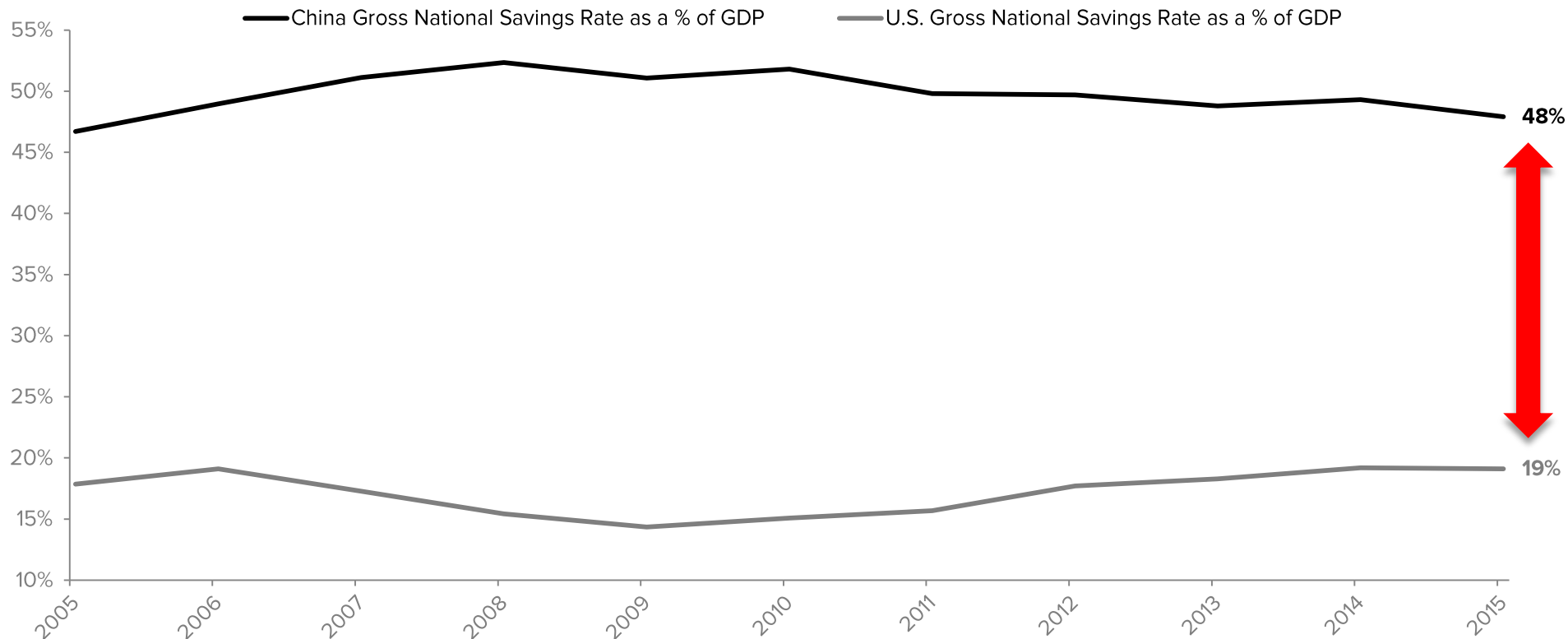
APPLYING THE “5-30” RULE TO CHINA

A CREDIT BOOM IS DEFINED AS A 30 PERCENTAGE POINT INCREASE IN A COUNTRY’S BANK CREDIT-TO-GDP RATIO OVER A SPAN OF FIVE YEARS. AS A RESULT OF ITS MASSIVE 2009-10 STIMULUS PACKAGE, CHINA IS THE MOST RECENT MAJOR ECONOMY TO EXPERIENCE THIS PHENOMENON.



MIND THIS GAP TOO

MANY INVESTORS HAVE BECOME INFATUATED WITH CHINA'S DEBT BUILDUP IN RECENT YEARS, BUT NOT ENOUGH INVESTORS HAVE FOCUSED ON THE DRIVERS – AND SUSTAINABILITY – OF THAT LEVERAGE. SAVINGS = INVESTMENT IN A [MOSTLY] CLOSED ECONOMY LIKE CHINA'S.



“AWASH WITH LIQUIDITY”

LARGELY THANKS TO THE LACK OF AN IMPACTFUL SOCIAL SAFETY NET, CHINESE HOUSEHOLDS ARE CULTURALLY PREDISPOSED TO SAVE. IN ADDITION TO THAT TAILWIND, PEAK NOMINAL CURRENT ACCOUNT INFLOWS HAVE BUTTRESSED WHOLESALE BANK DEPOSITS.

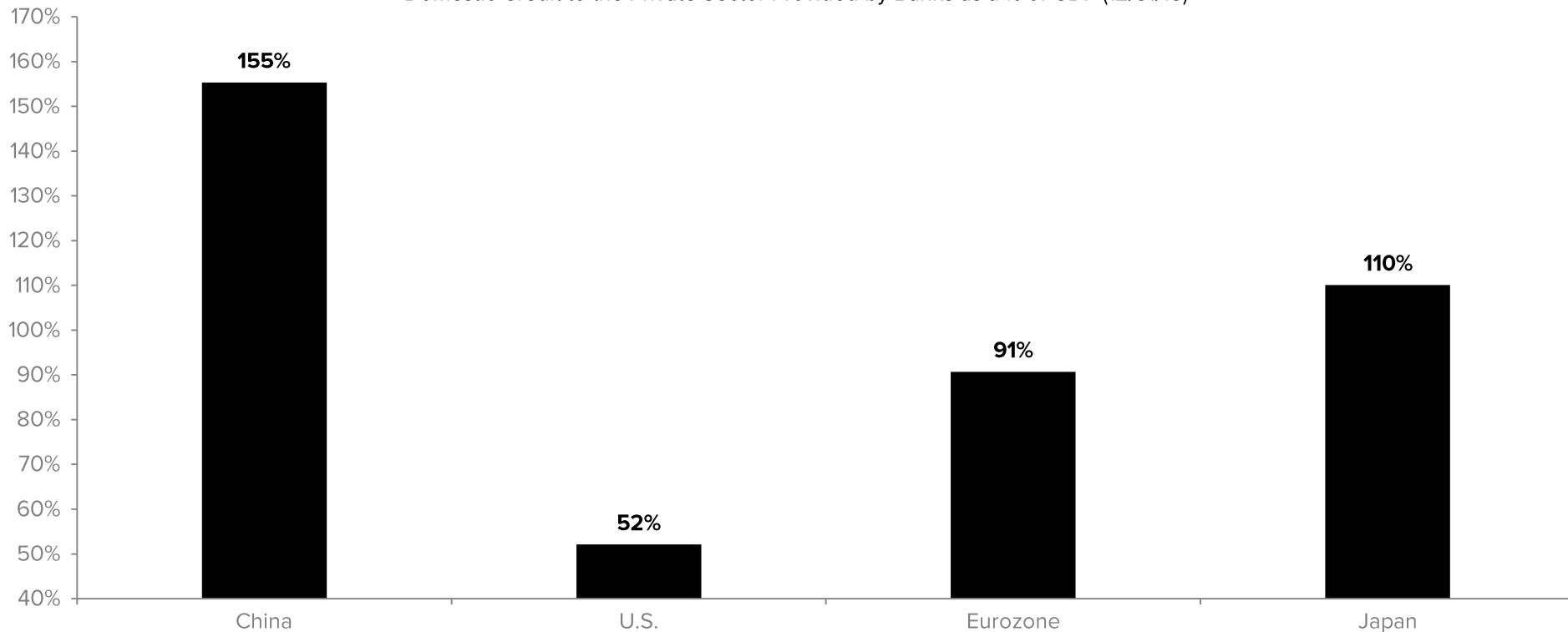
■ Total Banking System Deposits as a % of GDP (12/31/15)



MANY WAYS TO SKIN THE CREDIT “CAT”

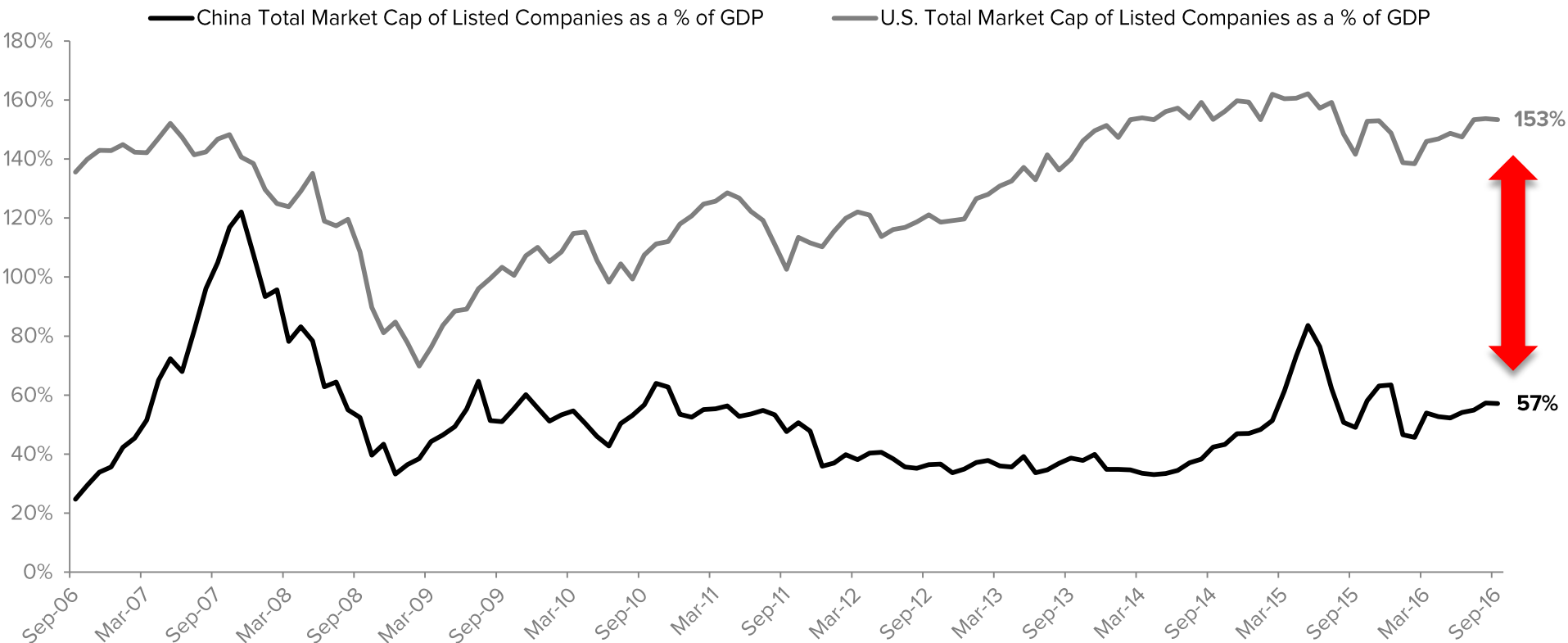
CHINA IS A COMMUNIST ECONOMY, SO ITS PREFERENCE FOR ALLOCATING CAPITAL IN A LARGELY ADMINISTRATIVE MANNER THROUGH POLICY BANKS IS VERY MUCH IN LINE WITH ITS POLITICAL OBJECTIVES. CAPITAL MARKETS – WHICH INCREASE ECONOMIC VOLATILITY – ARE INHERENTLY HARDER TO DICTATE.

■ Domestic Credit to the Private Sector Provided by Banks as a % of GDP (12/31/15)



CHINA IS A DIFFERENT “CAT” ALTOGETHER

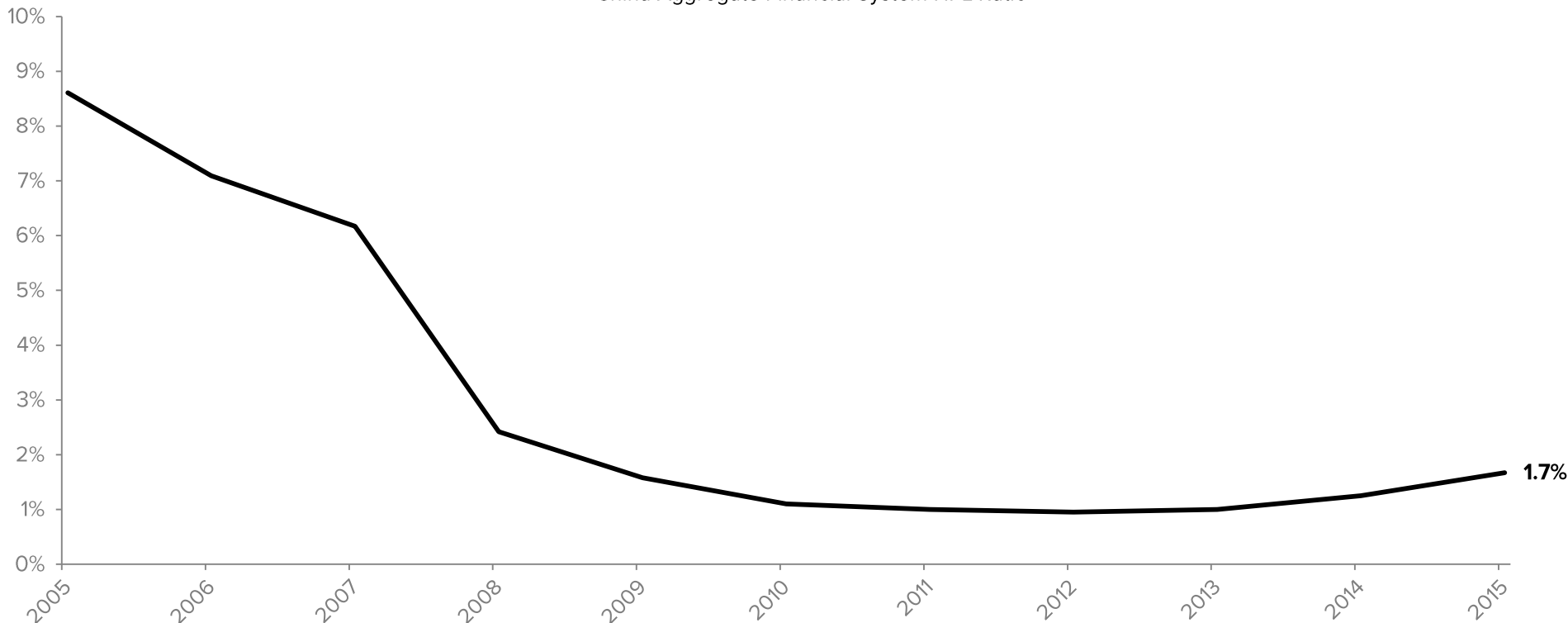
DUE TO THE LACK OF FUNCTIONING CAPITAL MARKETS THE FINANCING OF ECONOMIC ACTIVITY IN CHINA HAS LARGELY BEEN DONE THROUGH THE CREDIT INTERMEDIATION CHANNEL. THIS IS MOSTLY BY DESIGN SO THAT BEIJING CAN ALLOCATE CAPITAL AS IT SEES FIT.



CHINA'S CREDIT CHANNEL IS CLOGGED

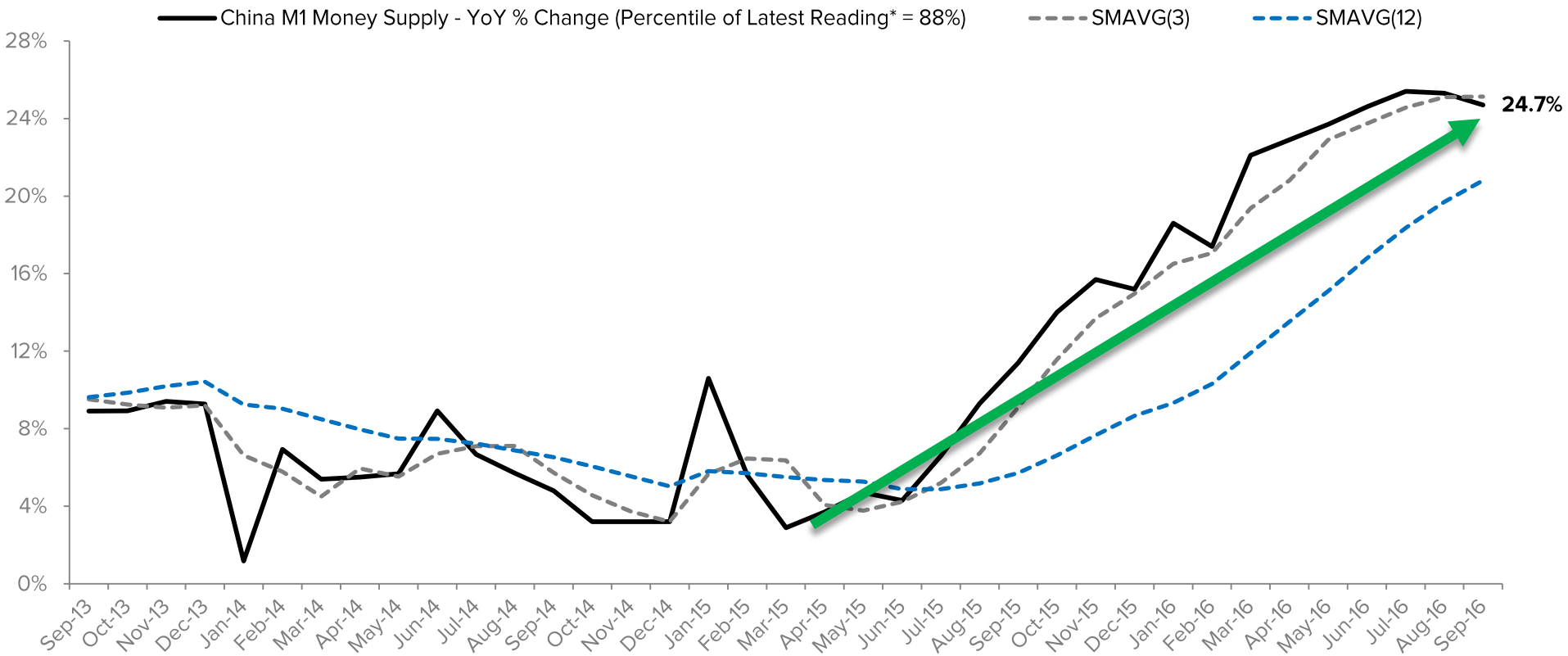
THE INEFFICIENT (I.E. FINANCIAL REPRESSION) AND ADMINISTRATIVE (I.E. MOSTLY TO SOE BORROWERS) NATURE OF CREDIT ALLOCATION IN CHINA IS COMBINING TO SUPPRESS DEFAULTS, WHILE STRICT REGULATORY TARGETS LIMIT THE SCOPE FOR INCREMENTAL ASSET GROWTH.

— China Aggregate Financial System NPL Ratio



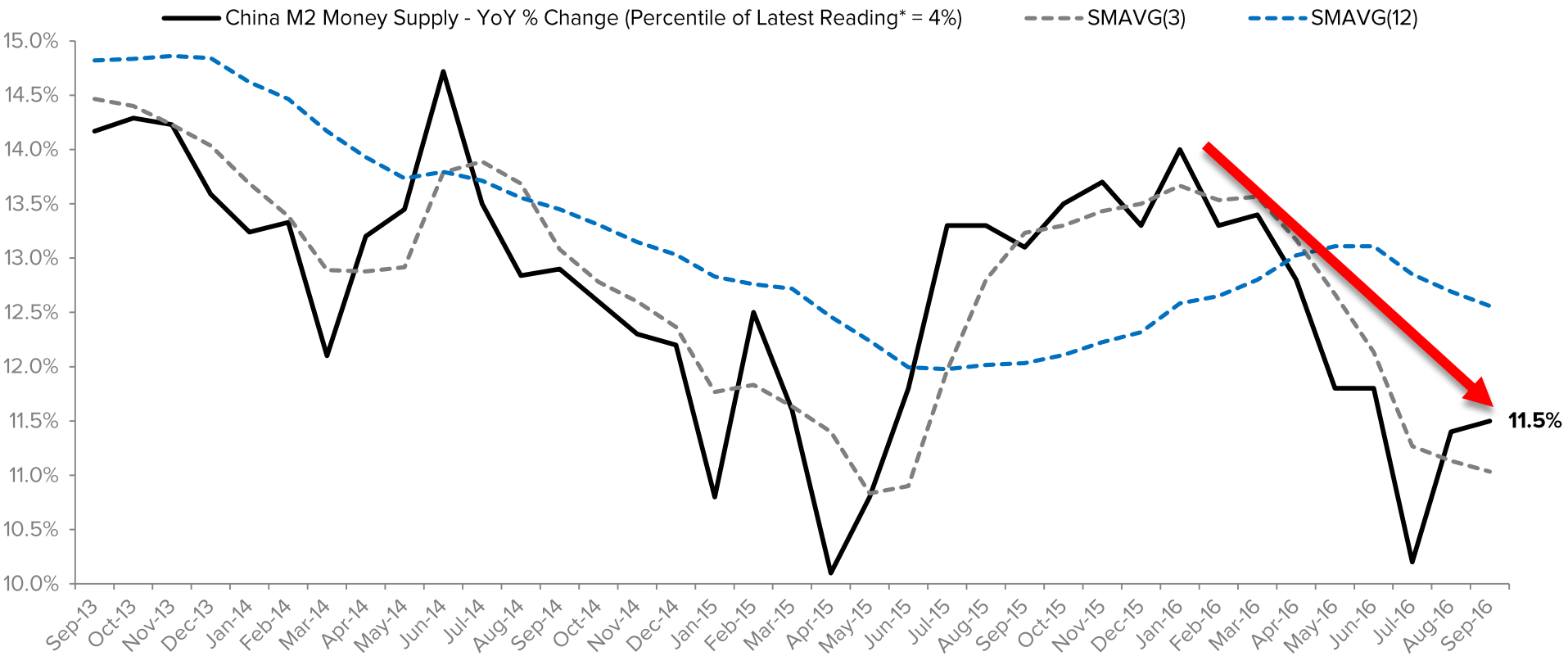
M1 MONEY SUPPLY

GROWTH IS TRENDING HIGHER AS OF SEPTEMBER



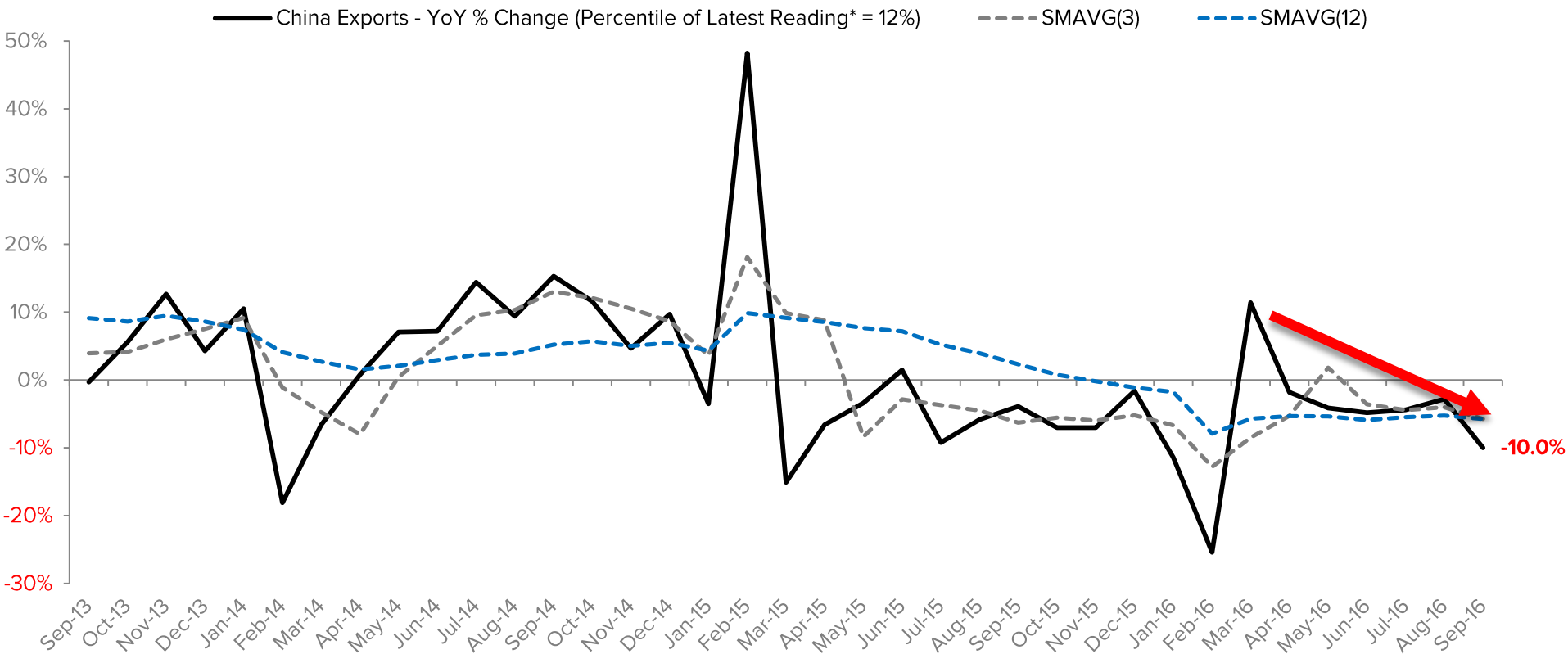
M2 MONEY SUPPLY

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



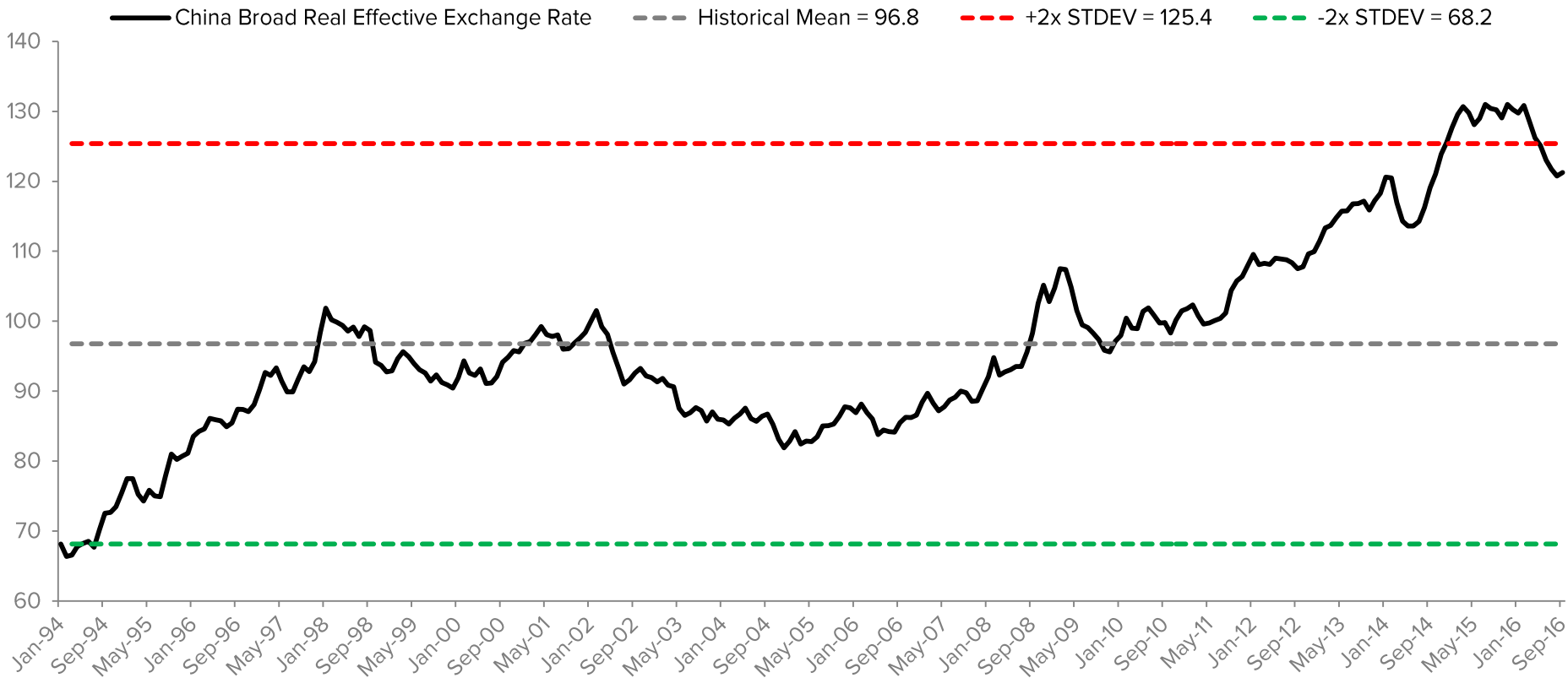
EXPORTS

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



BUSTED: INT'L COMPETITIVENESS

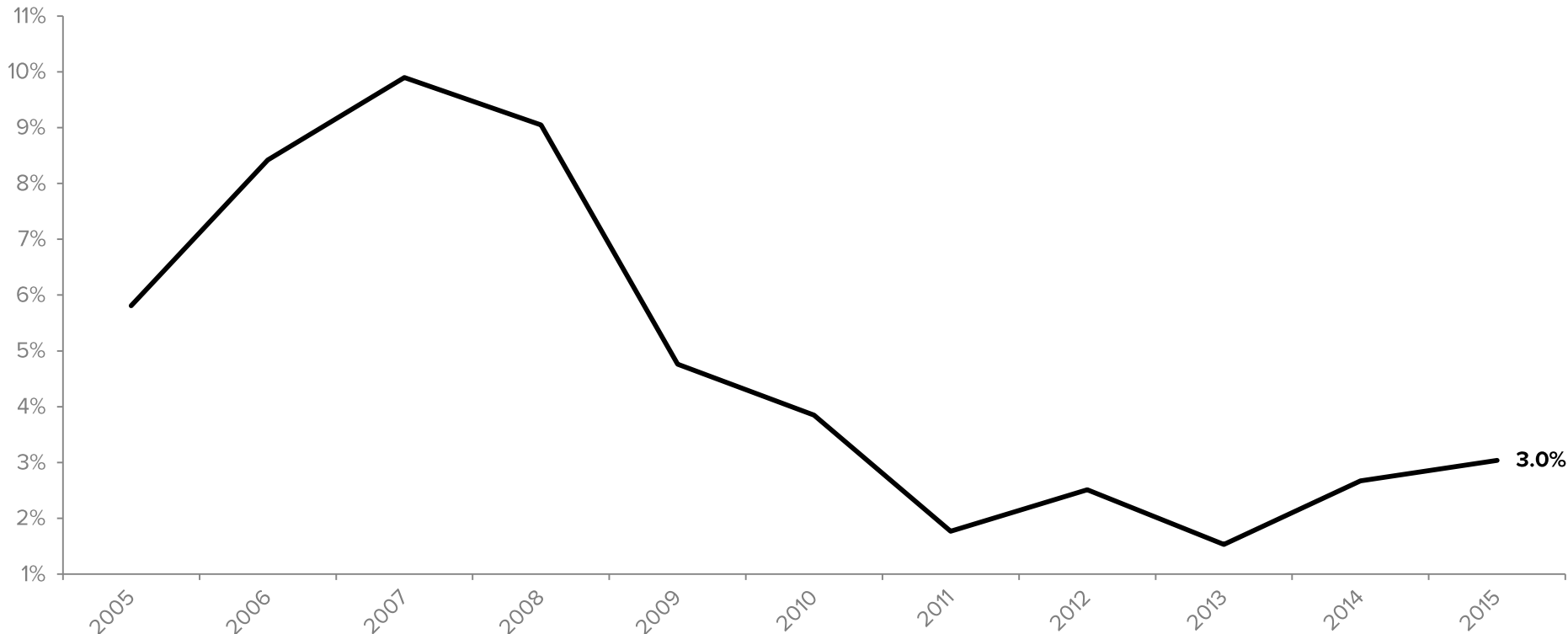
THE CHINESE YUAN HAS APPRECIATED TREMENDOUSLY ON A REER BASIS, CALLING INTO QUESTION THE SUSTAINABILITY OF CHINA'S EXPORT-LED GROWTH MODEL.



BROKEN: MERCANTILIST GROWTH MODEL

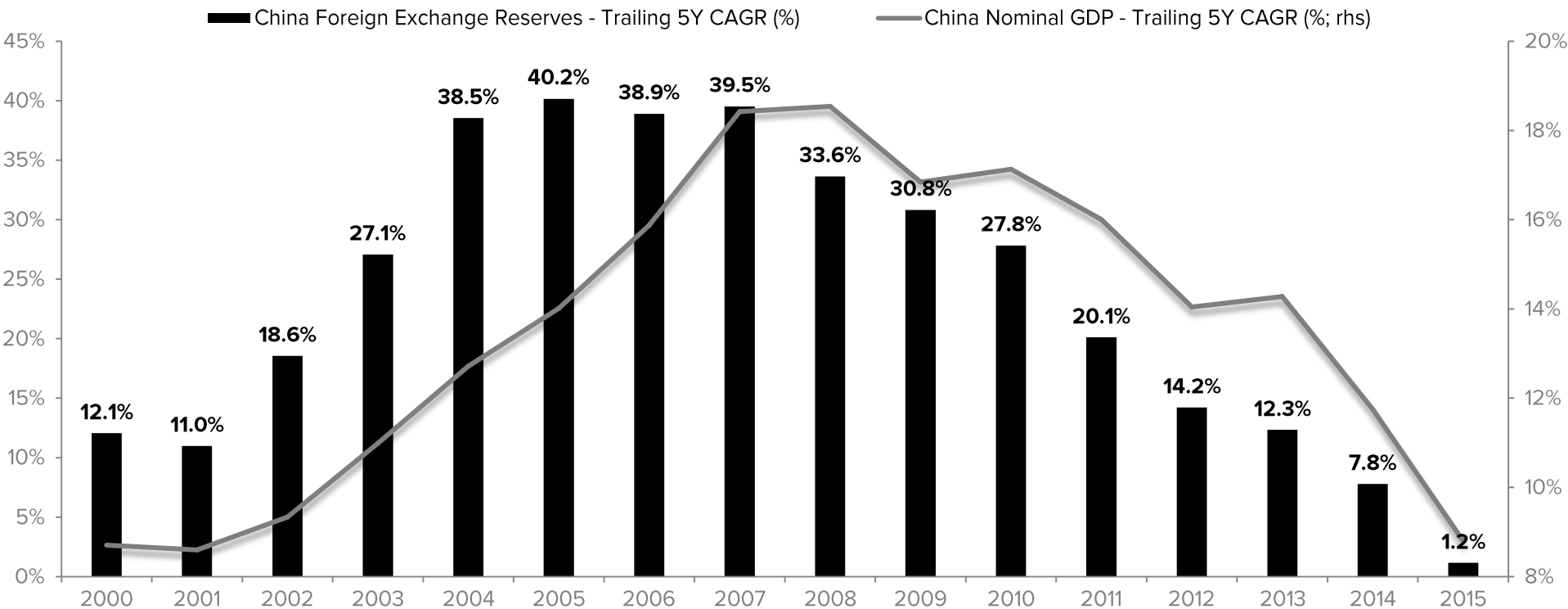
THE CONFLUENCE OF SECULAR CURRENCY APPRECIATION AND TEPID GLOBAL DEMAND HAVE PERMANENTLY SUPPRESSED CHINA'S CURRENT ACCOUNT SURPLUS.

— China Current Account Balance as a % of GDP



MISSING: A KEY SOURCE OF LIQUIDITY

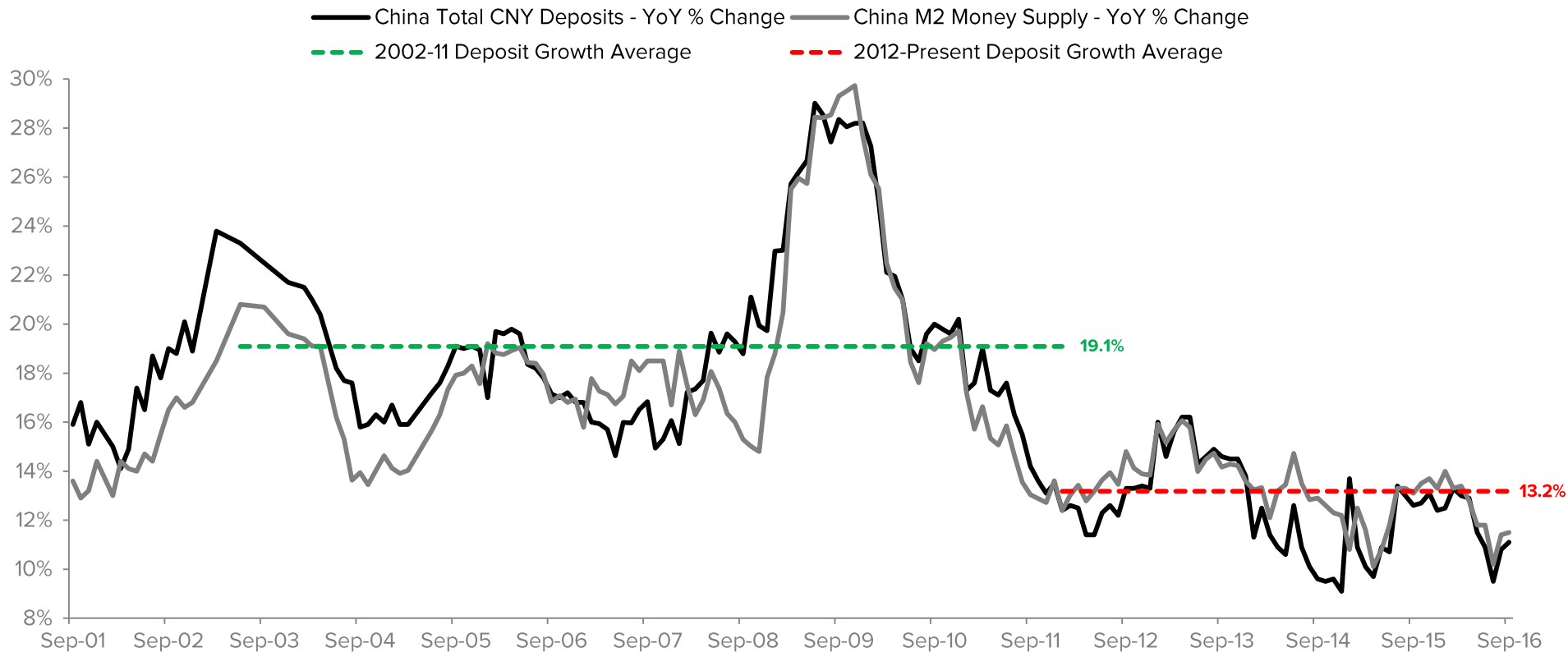
THE MOST IMPORTANT ASPECT OF CHINA'S MERCANTILIST GROWTH MODEL WAS NOT THE EXPORT INCOME IT PROVIDED TO MANUFACTURERS, BUT RATHER THE [NOW TEPID] GROWTH IN DEPOSITS IT PROVIDED TO THE BANKING SECTOR AS A RESULT OF THE CLOSED CAPITAL ACCOUNT.



Note: Data through the fourth quarter of each year.

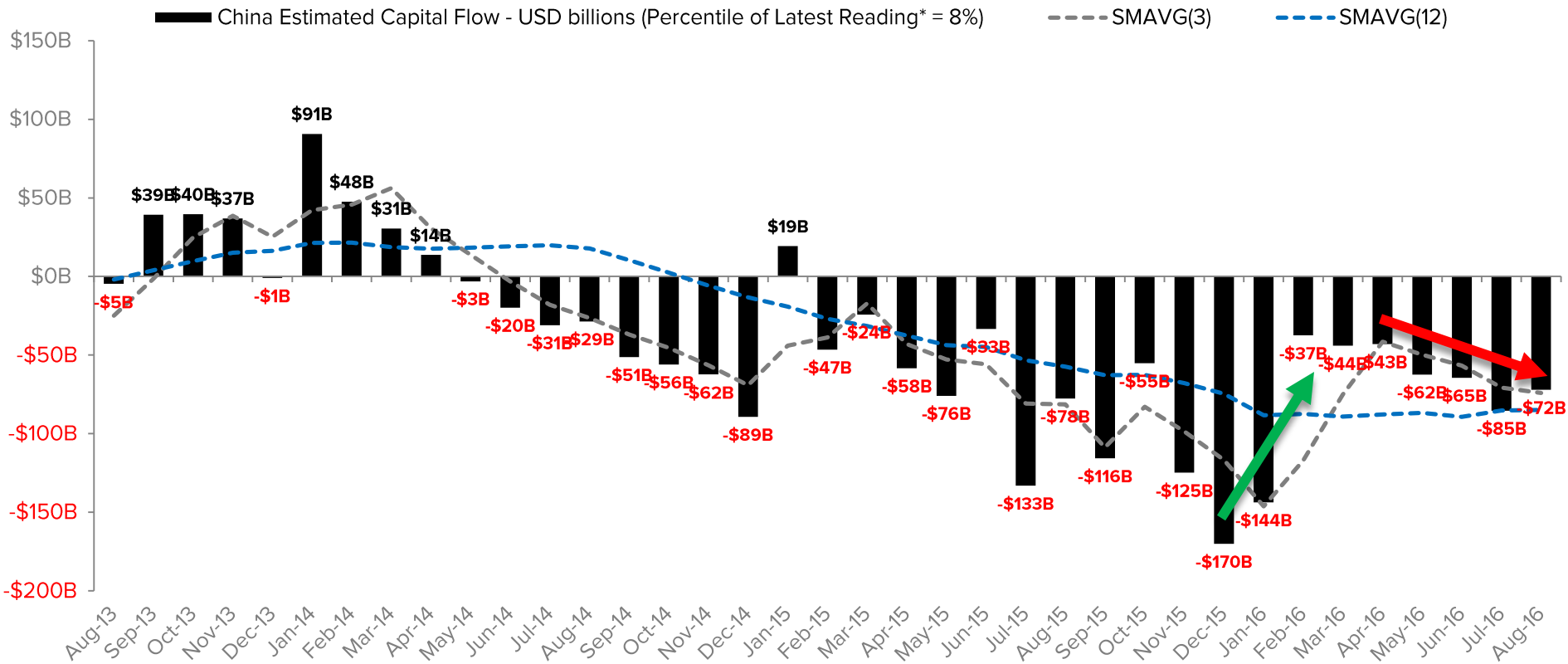
DEPOSIT GROWTH ↓; CREDIT GROWTH ↓

THE NEED TO MATCH BANKING SECTOR LIABILITIES WITH COMMENSURATE ASSETS HELPED PERPETUATE BUBBLES IN CHINESE INDUSTRIAL CAPACITY AND REAL ESTATE.



CAPITAL OUTFLOWS REMAIN A KEY RISK

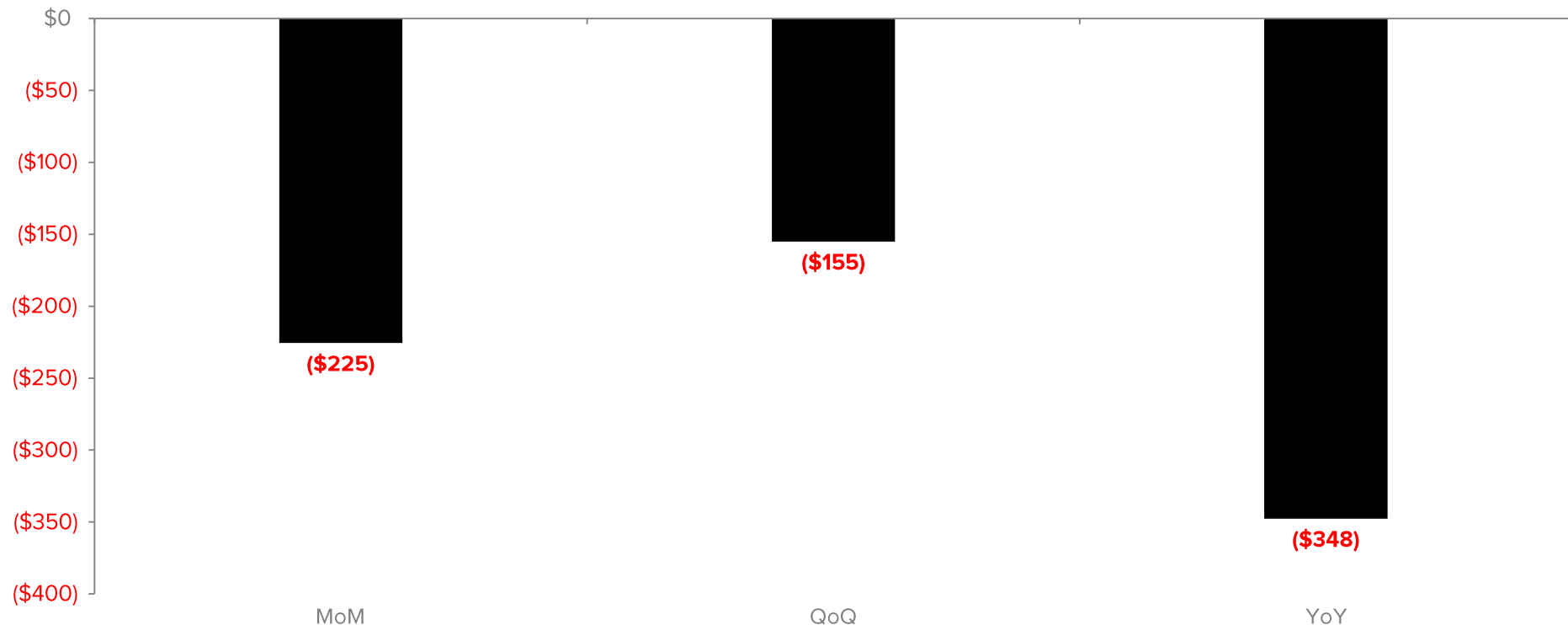
IN THE PROCESS OF INFLECTING NEGATIVELY AS OF AUGUST



CAN BEIJING MAINTAIN FX STABILITY? YES.

CHINA IS NO LONGER BURNING THROUGH ITS FX RESERVES AT AN ALARMING PACE. MOREOVER, THE RESIDUAL LEVEL OF RESERVES THAT WOULD TRIGGER A BROAD-BASED LOSS OF CONFIDENCE IN THE RMB REMAINS UP FOR [INTENSE] DEBATE.

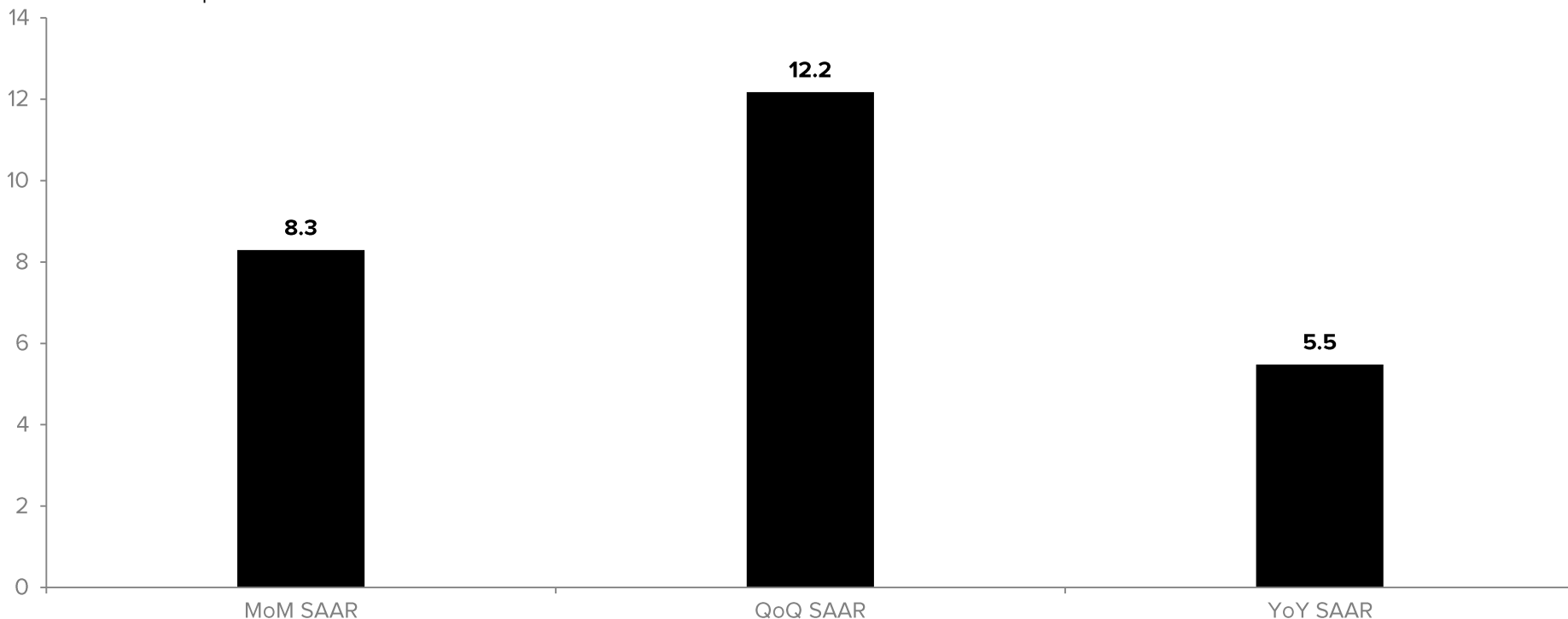
■ China Foreign Exchange Reserves - Annualized Nominal Change (\$B)



5-10+ YEARS OF BREATHING ROOM

THE IMF'S RECOMMENDED MINIMUM RESERVE BALANCE OF \$2.8T APPEARS THOUGHTFUL AT FIRST GLANCE; BUT IN REALITY, THEIR COOKIE-CUTTER EQUATION FAILS TO GRASP THE NUANCE OF CHINESE CAPITAL FLOWS. WE THINK OUTSTANDING DOLLAR DEBT IS A MORE APPROPRIATE MEASURE.

■ China Foreign Exchange Reserves - Number of Years Until Balance Less Than China's \$1.3T in FX Forward-Adjusted Outstanding USD Debt* per Various Depletion Rates



ANOTHER SILVER LINING

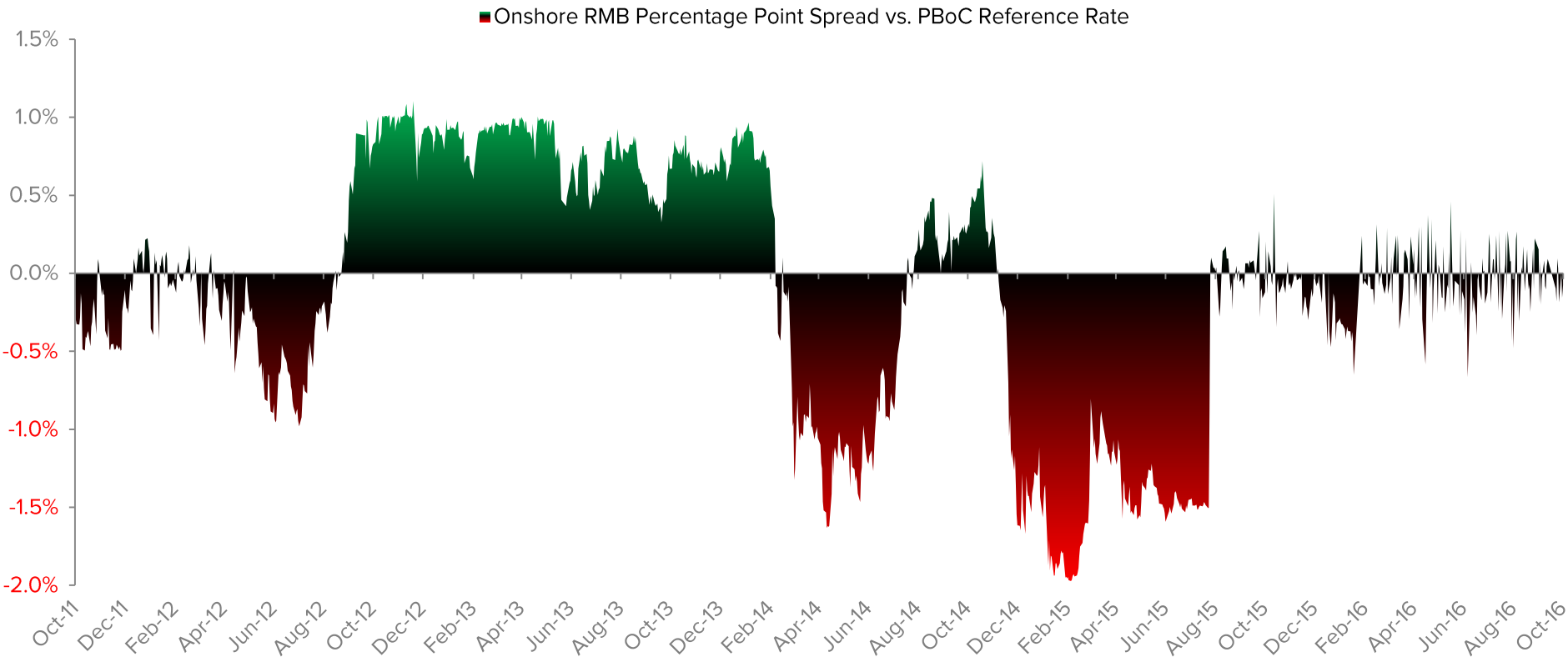
OVER A THIRD OF CHINA'S REPORTED PEAK-TO-PRESENT RESERVE BALANCE DECLINE CAN BE ATTRIBUTED TO MERE ASSET REVALUATION AMID USD APPRECIATION VS. OTHER KEY RESERVE CURRENCIES.

■ Since JUN '14 Peak in China's FX Reserve Balance:



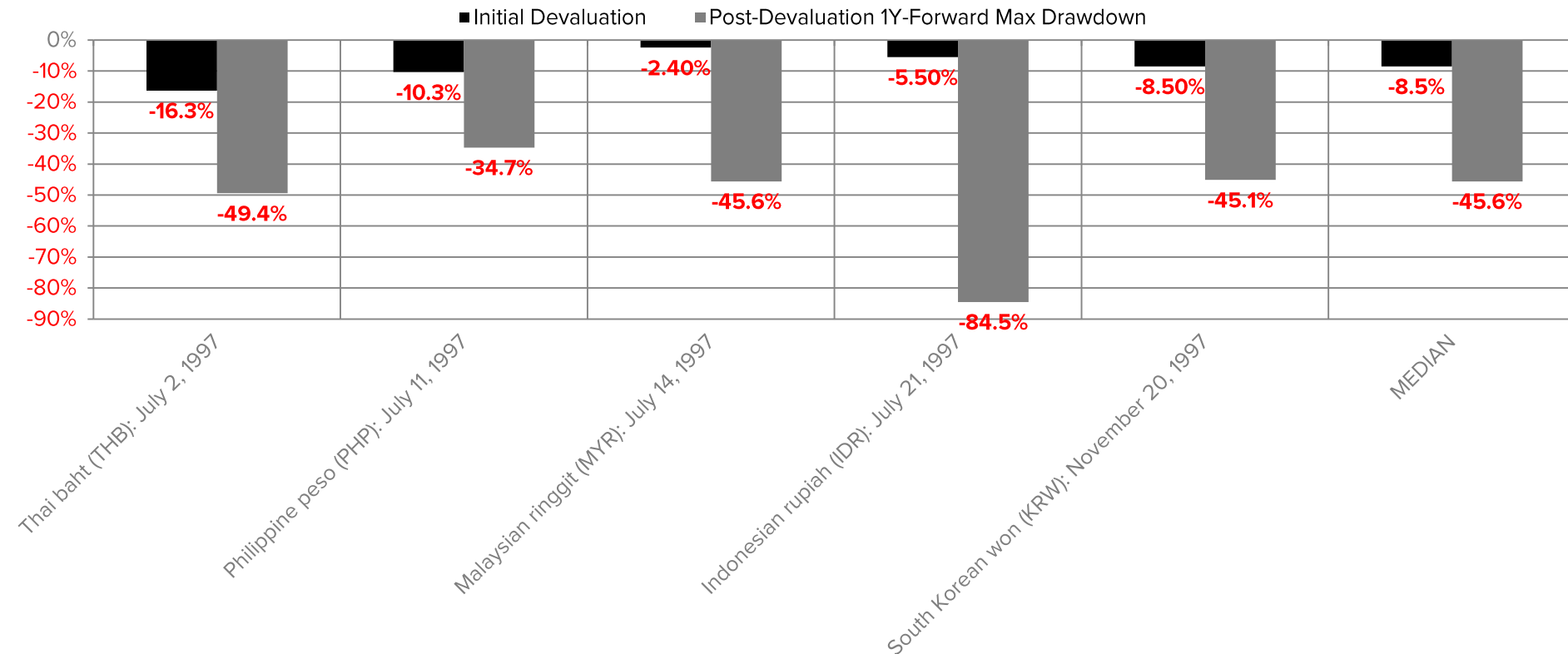
UNDERSTAND WHY THEY DID IT

LAST AUGUST'S "SHARP" RMB DEVALUATION WAS NOT INTENDED TO GAIN A COMPETITIVE ADVANTAGE, BUT RATHER TO CORRECT A LARGE IMBALANCE BETWEEN THE REFERENCE RATE AND THE SPOT PRICE.



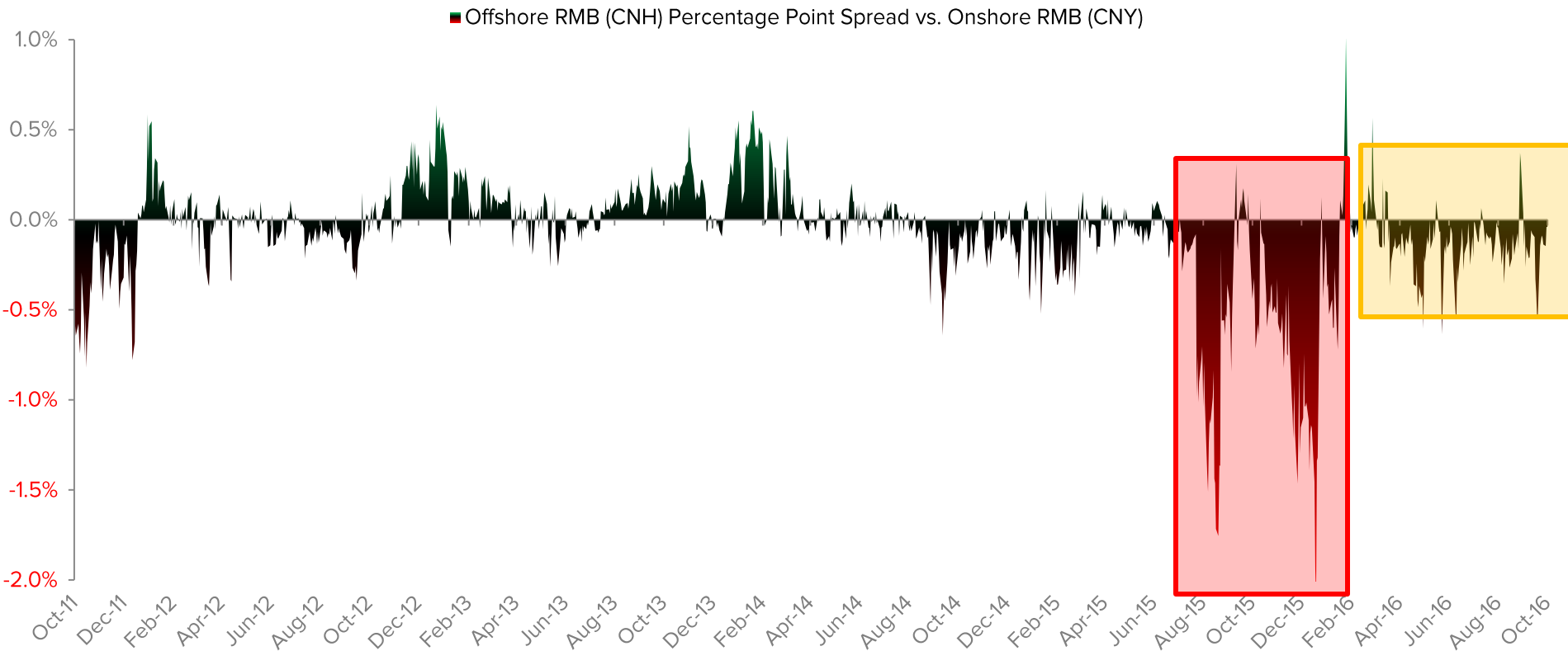
CHINA HAS NO INCENTIVE TO DEVALUE

BEIJING HAS LONG FAVORED POLITICAL, ECONOMIC AND FINANCIAL MARKET STABILITY. AND WHILE ITS SUCCESS PROMOTING THE LATTER WAS CALLED INTO QUESTION LAST FALL, THERE IS ONE THING WE CAN ALL AGREE ON WITH RESPECT TO THE YUAN: THERE'S NO SUCH THING AS A "ONE-OFF" DEVALUATION.



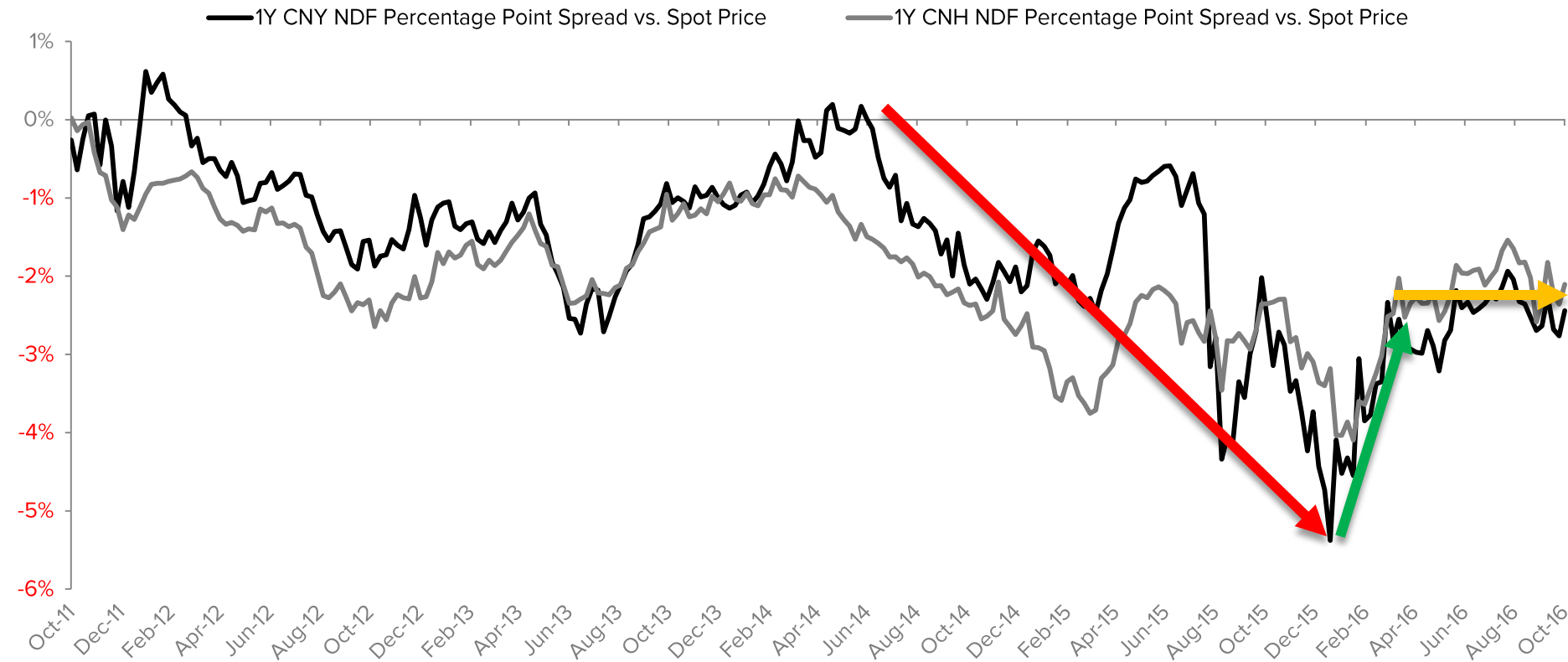
EXPECTATIONS HAVE LARGELY RESET

THANKS TO BOTH CAPITAL CONTROLS AND A SPATE OF ANTI-DEVALUATION REASSURANCE OUT OF VARIOUS CHINESE OFFICIALS, THE SPREAD BETWEEN THE OFFSHORE AND ONSHORE RMB – A KEY GAUGE OF INVESTOR SENTIMENT – HAS NARROWED DRAMATICALLY.



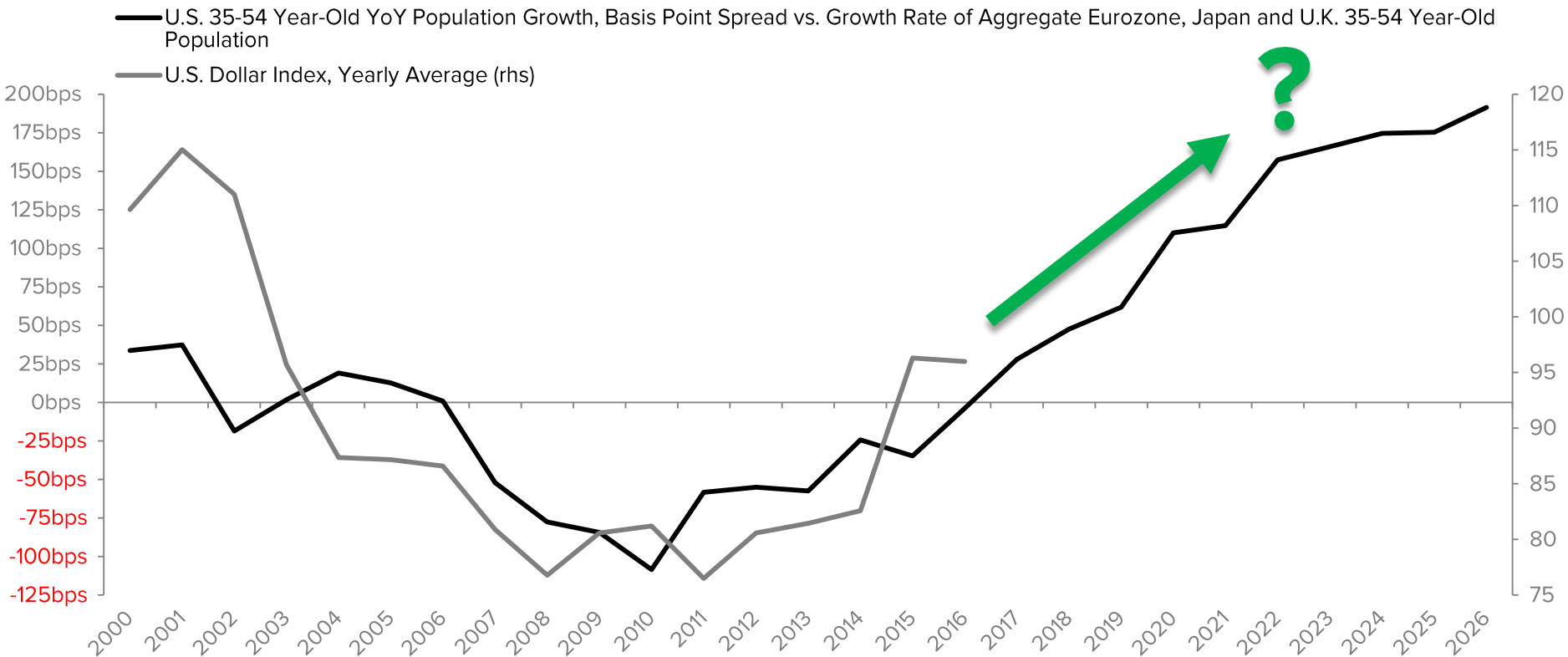
HOW DOES **-3%** PER YEAR FOR 5YRS SOUND?

AS PERVASIVELY BEARISH SENTIMENT RECEDES, THE MARKET CAN RESUME PRICING IN WHAT WE CONTINUE TO BELIEVE IS THE MOST LIKELY OUTCOME FOR THE RMB – A GRADUAL, MANAGED 15-20% DEPRECIATION THAT TAKES PLACE OVER SEVERAL YEARS.



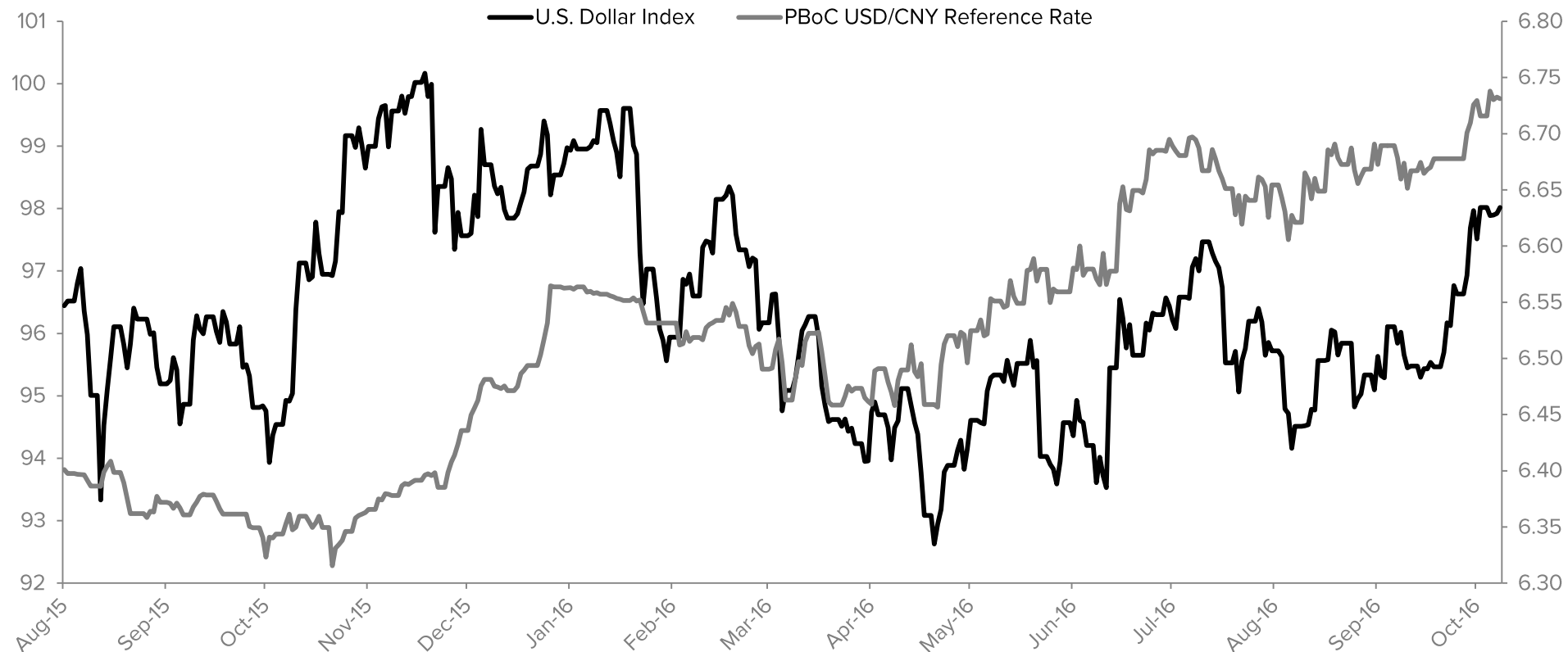
KEY RISK: THE G4 CURRENCY WAR

LIFE-CYCLE SPENDING PATTERNS WOULD SEEM TO SUGGEST THAT THE U.S. WILL INCREASINGLY BECOME THE “BEST HOUSE IN A BAD NEIGHBORHOOD” FOR YEARS TO COME – WHICH MAY PROVE TO BE STRUCTURALLY BULLISH FOR THE U.S. DOLLAR.



DOLLAR UP = YUAN DOWN

TO THE EXTENT BEIJING MAINTAINS ITS POLICY OF KEEPING THE YUAN “BASICALLY STABLE VS. A BASKET OF [PEER] CURRENCIES”, A SERIES OF HIGHER-LOWS IN THE DXY FROM HERE SHOULD REIGNITE CNY DEVALUATION FEARS.



3. THE CHINESE CONSUMER IS PAST-PEAK

1

STRUCTURAL OUTLOOK: SOFT LANDING \neq SMOOTH LANDING

Our secular biases with respect to the Chinese economy – which, coincidentally, haven't changed much over the past ~5 years – are as boring as they are well researched. Specifically, we continue to think that China is experiencing a "financial crisis with communist characteristics". This means fiscal and monetary policymakers have both ample tools and a genuine desire to attempt to engineer a "soft landing". While they may eventually accomplish their twin goals of permanently downshifting GDP growth and rebalancing economic drivers, their insistence upon maintaining financial and economic stability throughout said process effectively transfers deflation risk from the market in the near term to the real economy over the long term. Moreover, what they are trying to accomplish has never been done before in modern economic history; therefore, it's reasonable to assume the glide path down will be less linear than Beijing hopes.

2

CYCLICAL OUTLOOK: ECONOMIC STABILIZATION IS LONG IN THE TOOTH

Phony national accounts data aside, when analyzed across a number of key high-frequency data series, it's easy to see that the Chinese economy bottomed in late-2015/early-2016 – an outcome that was predicated on massive stimulus. The confluence of cyclical factors (namely a property bubble) and structural factors (i.e. a clogged credit channel, as well as a potential resurgence in capital outflows) supports our view that the aforementioned economic stabilization is long in the tooth. As such, we expect the broad compendium of China's high-frequency growth data to resume its structural downtrend within the next 3-6 months. This has obvious [negative] implications for reflation and risk assets broadly.

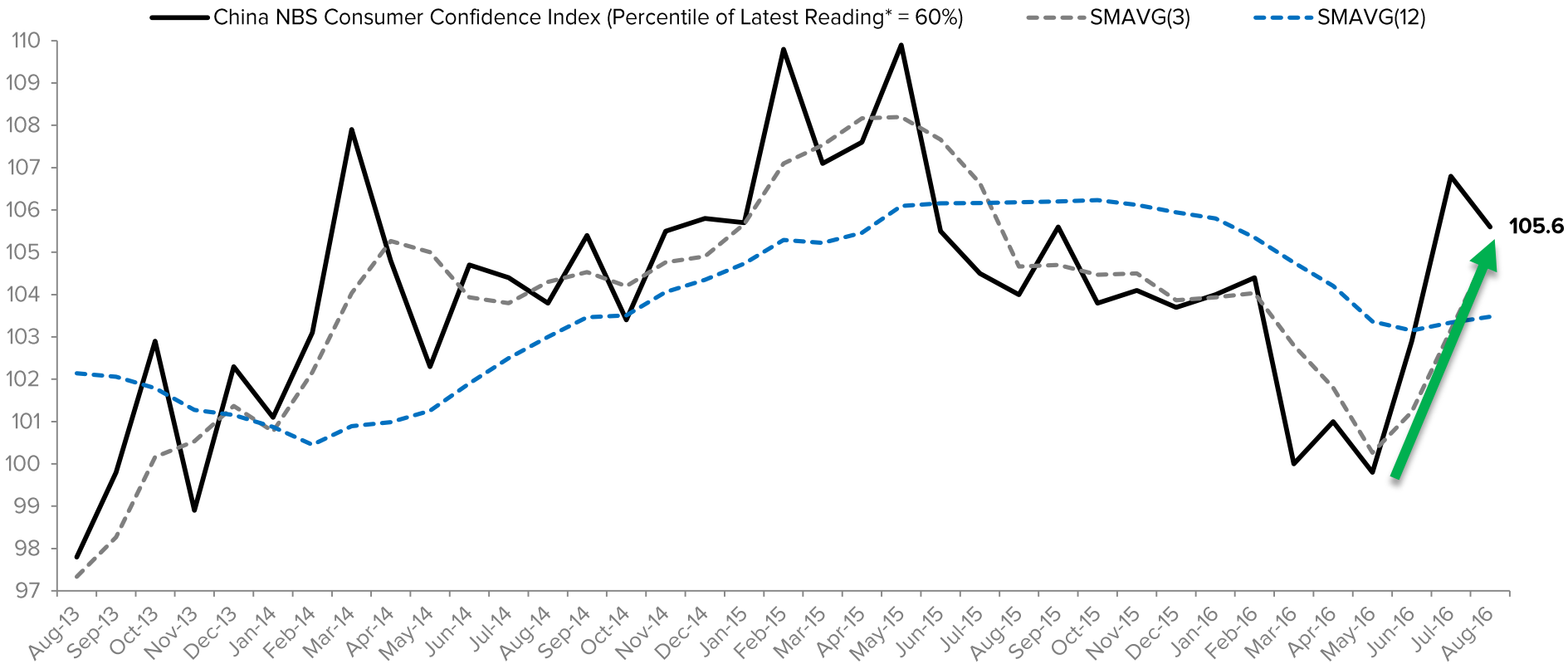
3

BONUS CONTENT: THE CHINESE CONSUMER STORY IS PAST-PEAK

While official statistics trumpet China's transition to a consumer-led, services-oriented economy, our analysis suggests said success is an obfuscation at best. We go in the weeds on Chinese employment, income and demographic trends to show why consumption growth on the mainland is unlikely to meaningfully rebound any time soon.

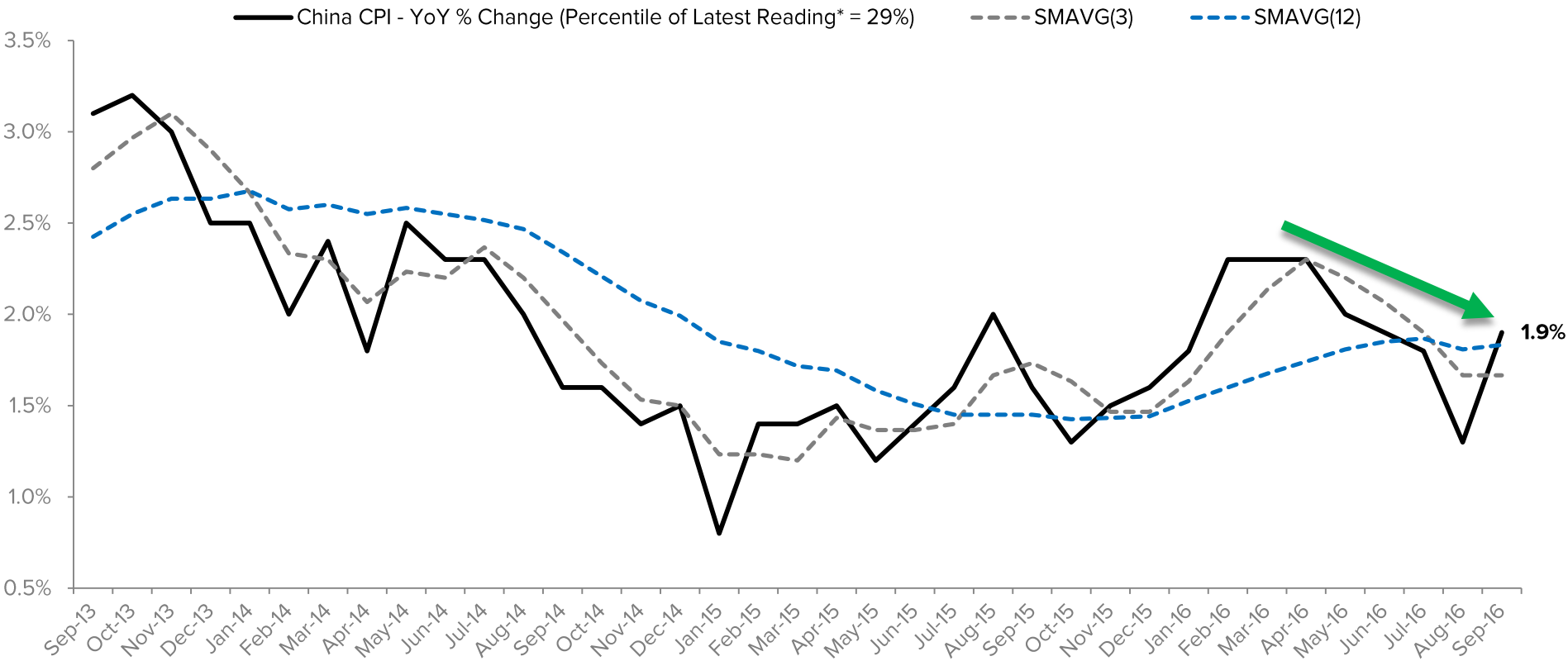
CONSUMER CONFIDENCE

TRENDING HIGHER AS OF AUGUST



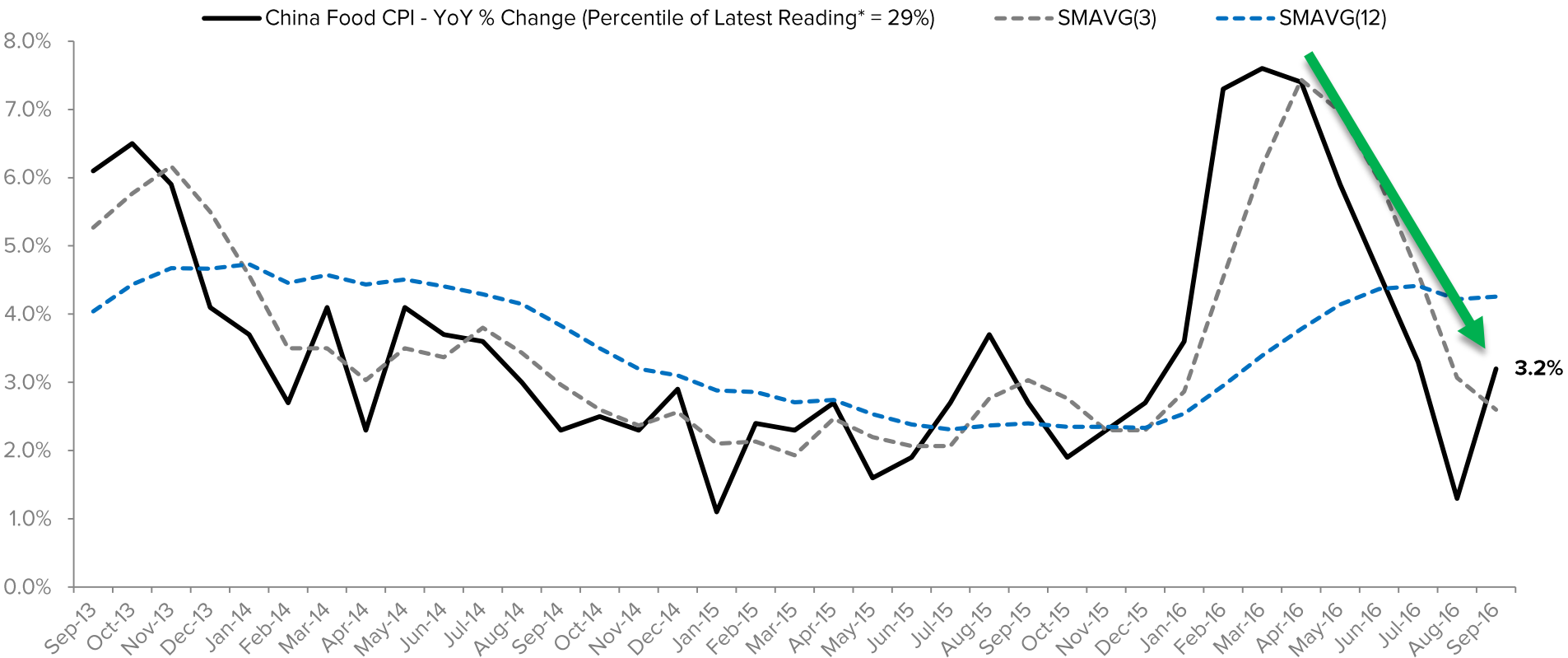
HEADLINE CPI

INFLATION IS TRENDING LOWER AS OF SEPTEMBER



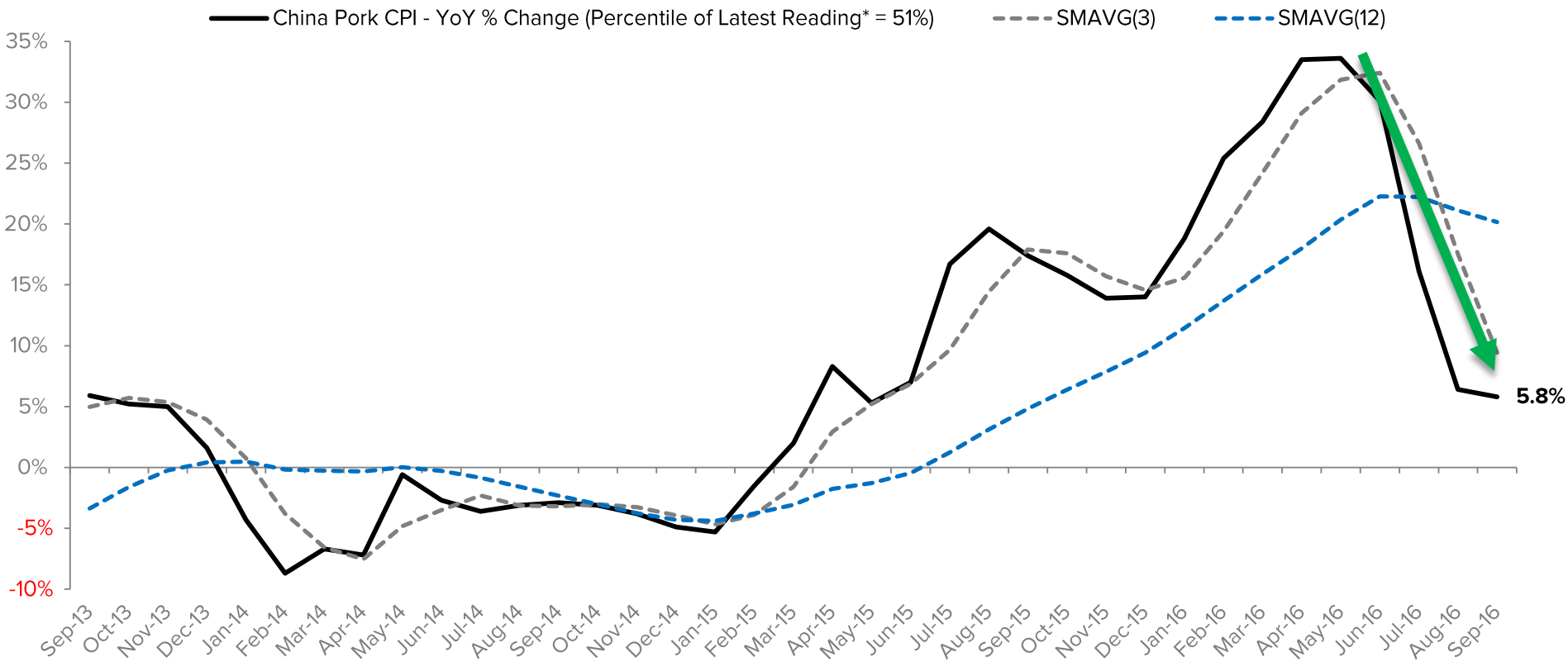
FOOD CPI

INFLATION IS TRENDING LOWER AS OF SEPTEMBER



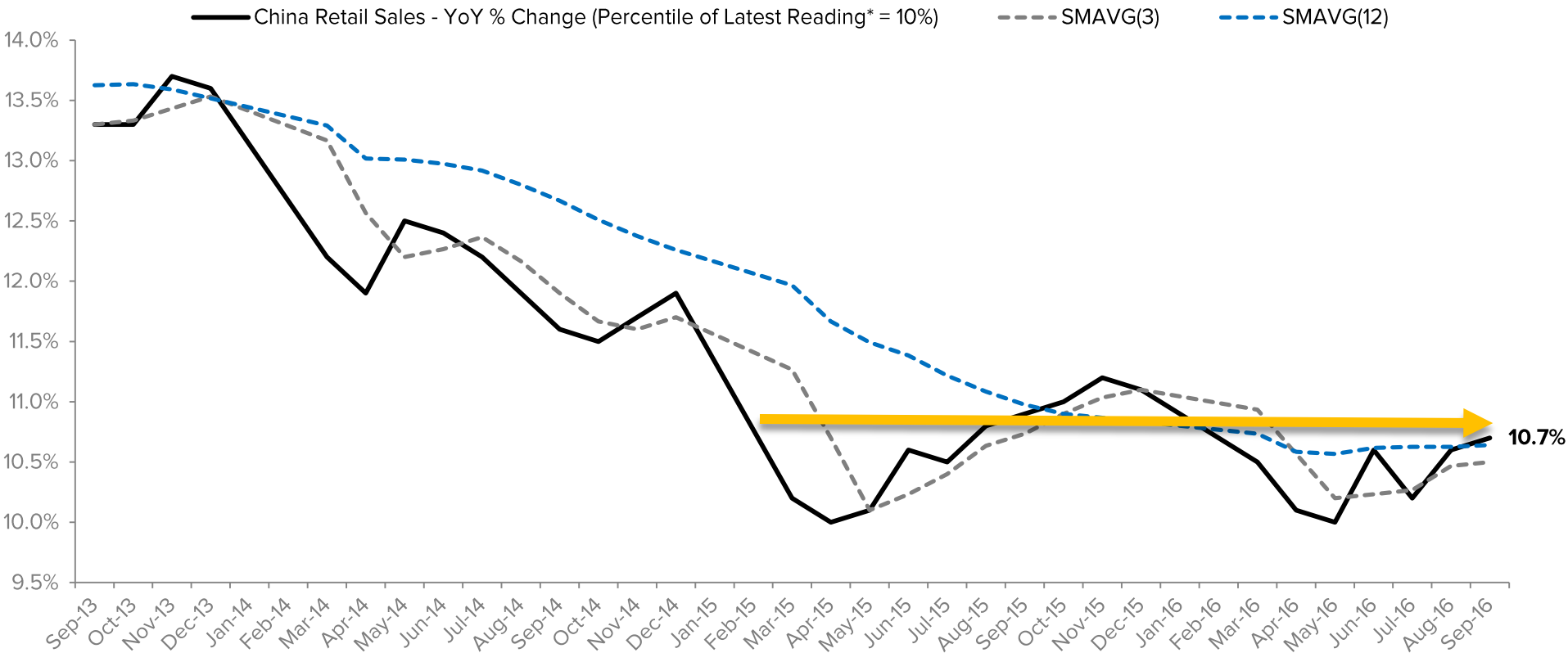
PORK CPI

INFLATION IS TRENDING LOWER AS OF SEPTEMBER



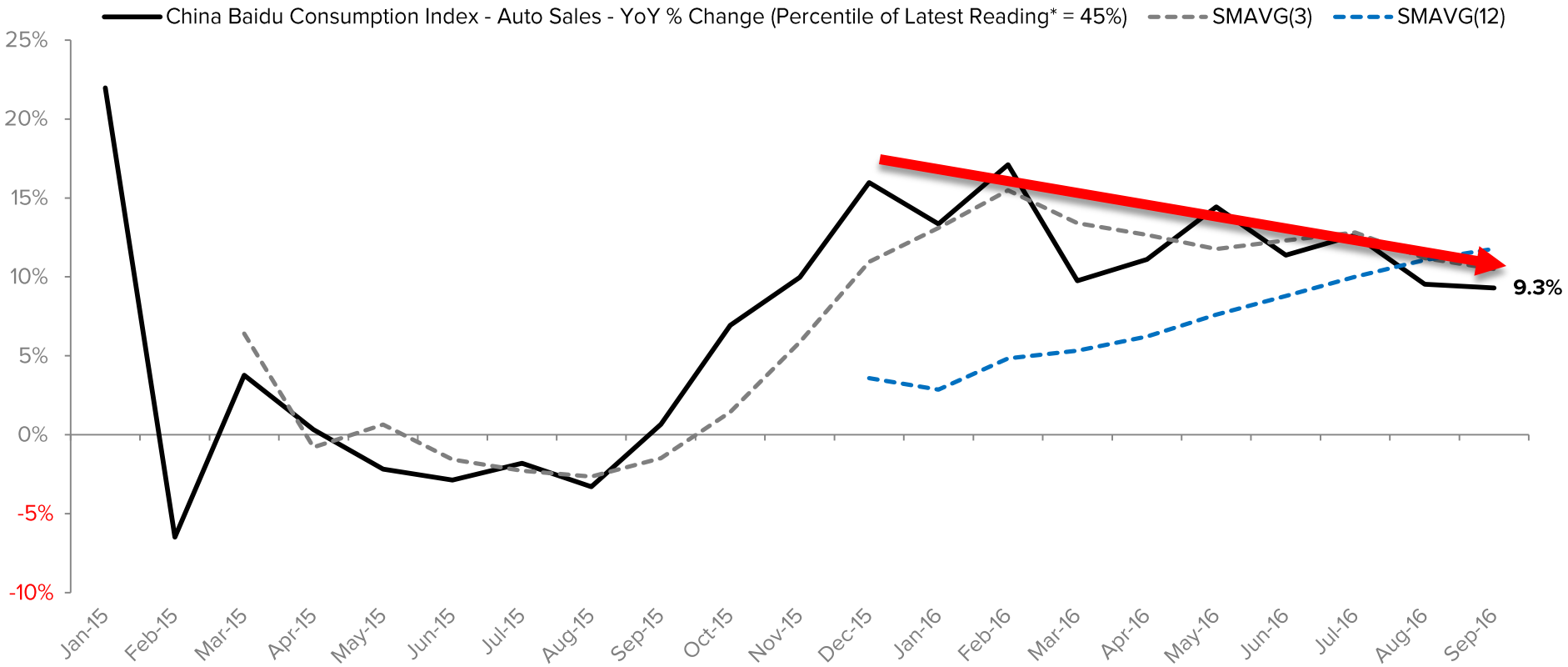
HEADLINE RETAIL SALES

GROWTH IS TRENDING SIDeways AS OF SEPTEMBER



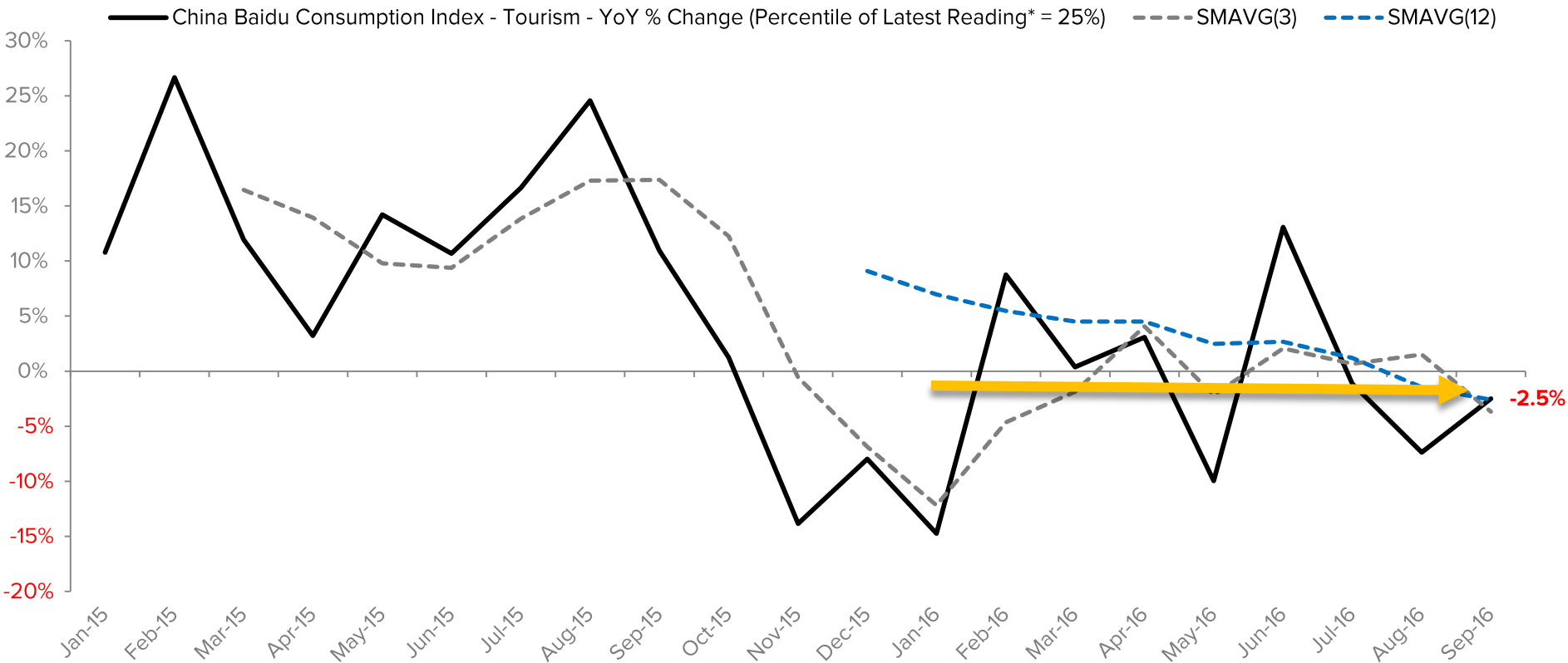
AUTO SALES

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



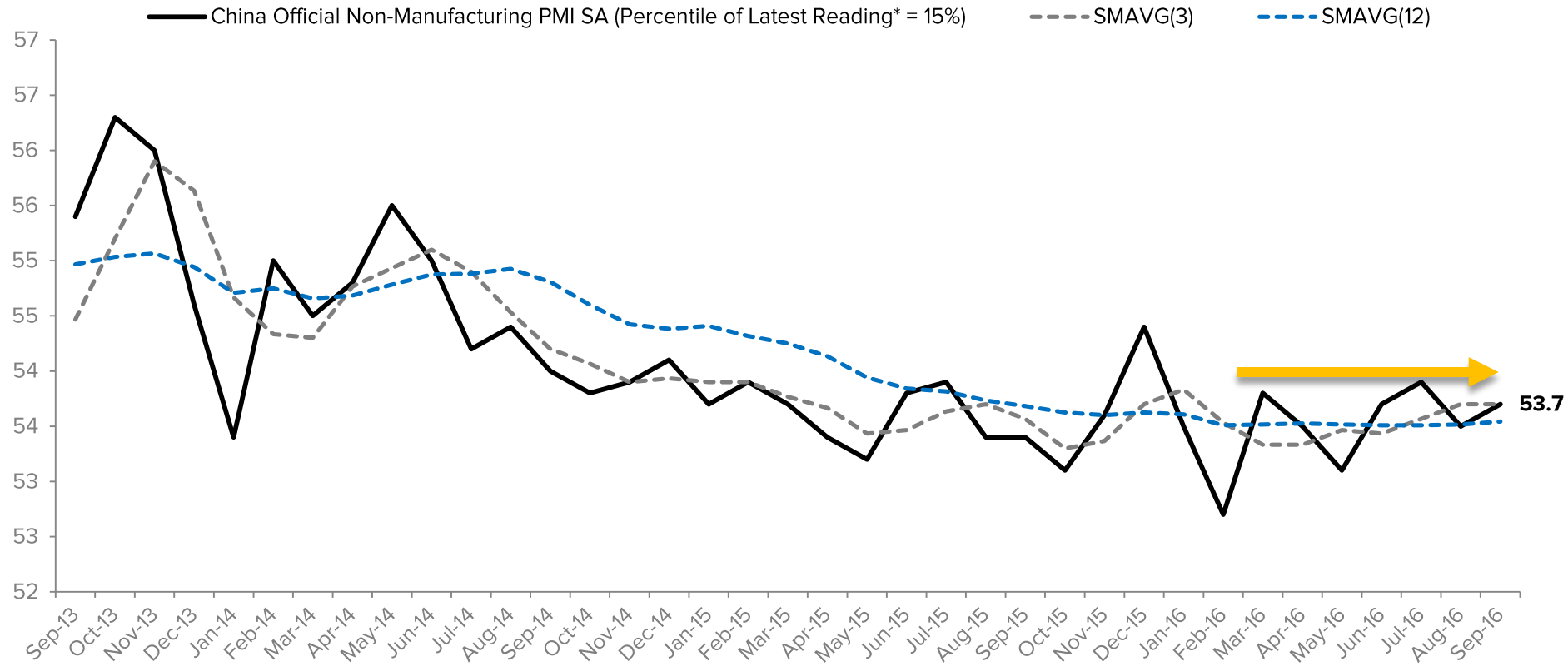
TOURISM SALES

GROWTH IS TRENDING SIDeways AS OF SEPTEMBER



OFFICIAL NON-MANUFACTURING PMI

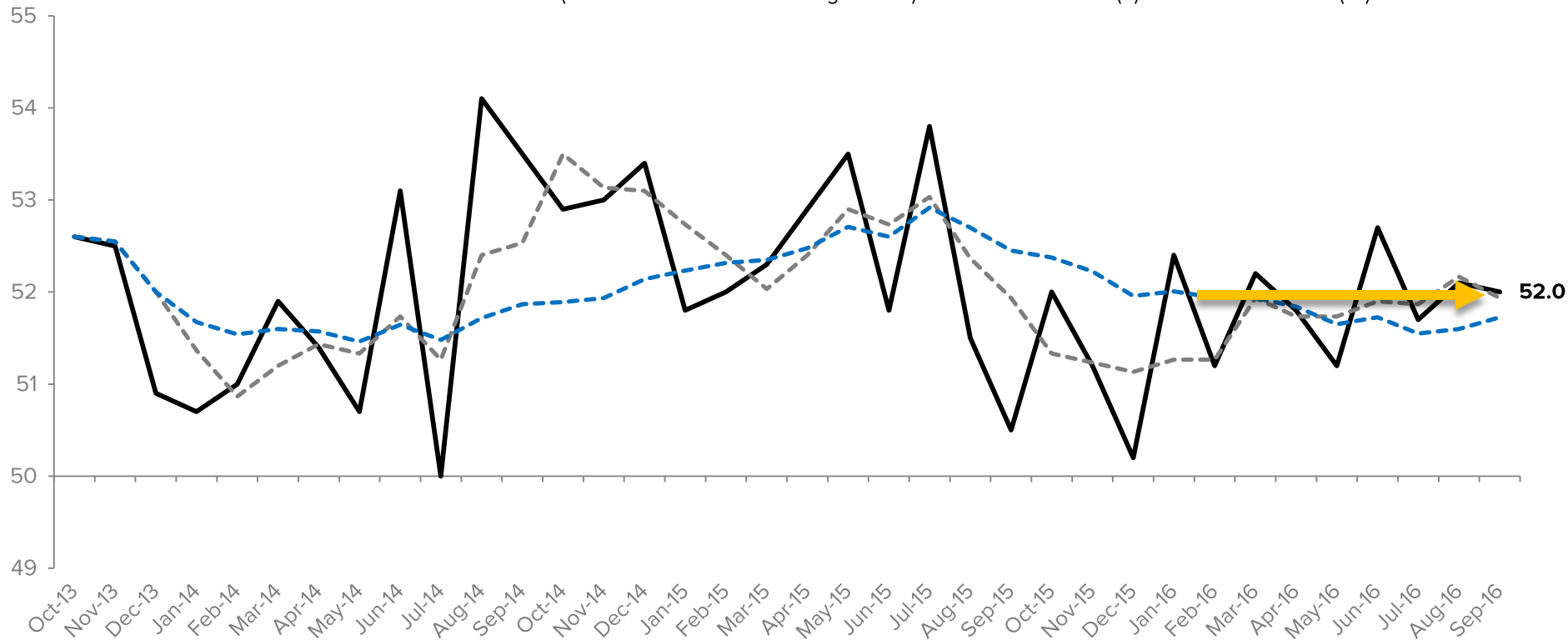
TRENDING SIDeways AS OF SEPTEMBER



MARKIT SERVICES PMI

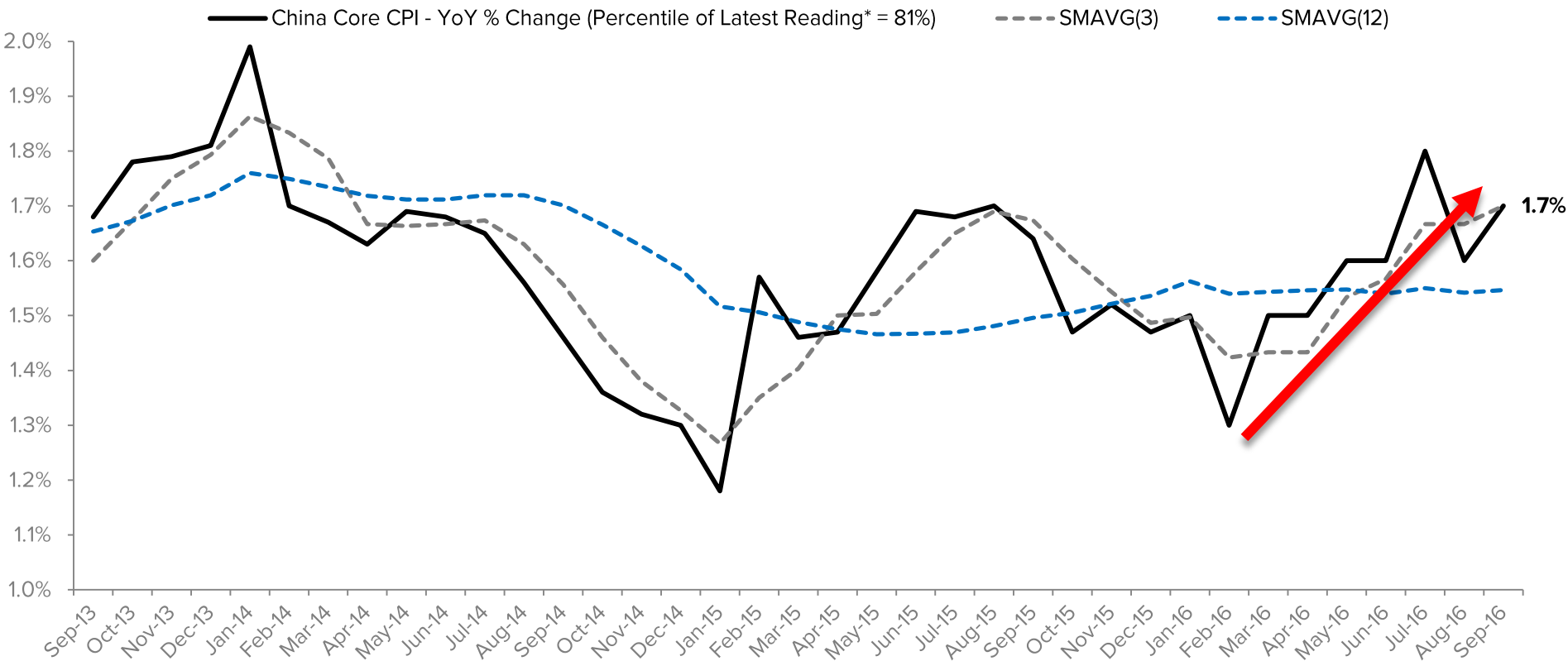
TRENDING SIDeways AS OF SEPTEMBER

— China Markit Services PMI SA (Percentile of Latest Reading* = 49%) - - - SMAVG(3) - - - SMAVG(12)



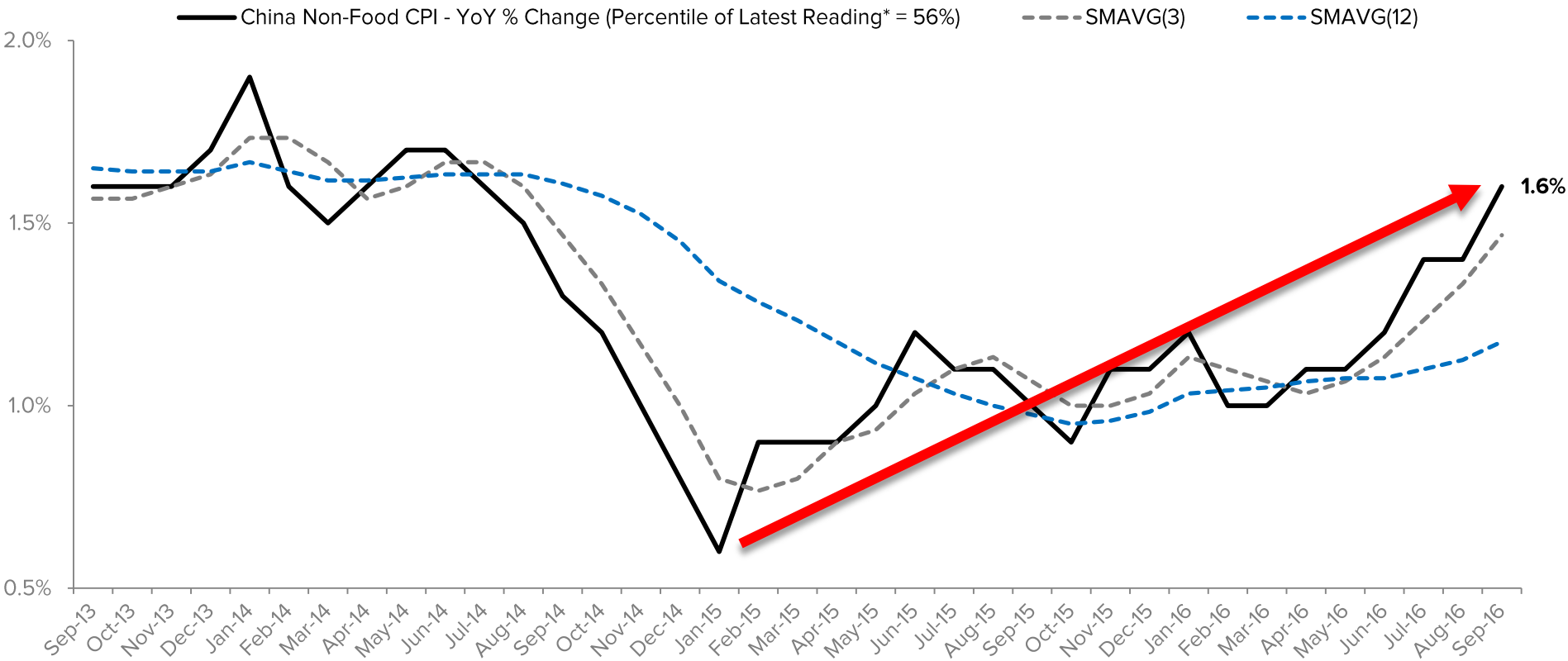
CORE CPI

INFLATION IS TRENDING HIGHER AS OF SEPTEMBER



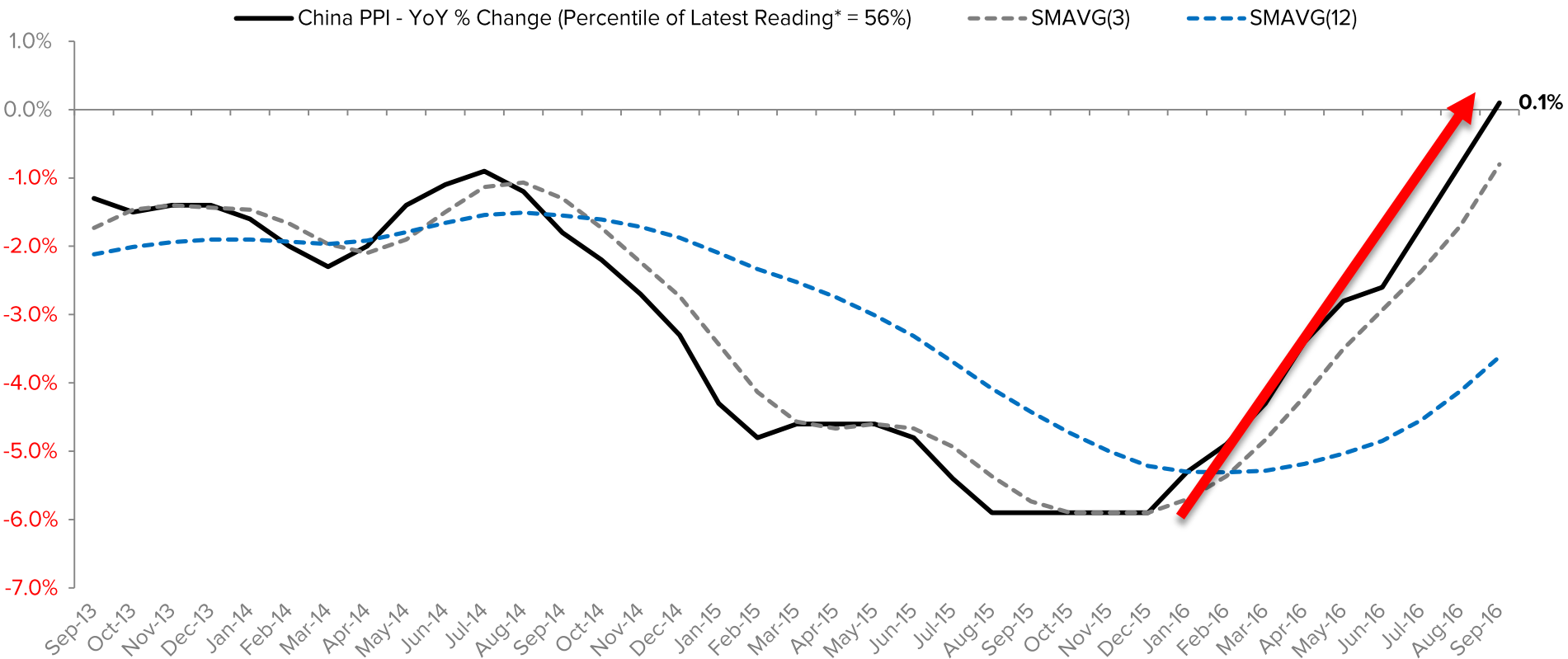
NON-FOOD CPI

INFLATION IS TRENDING HIGHER AS OF SEPTEMBER



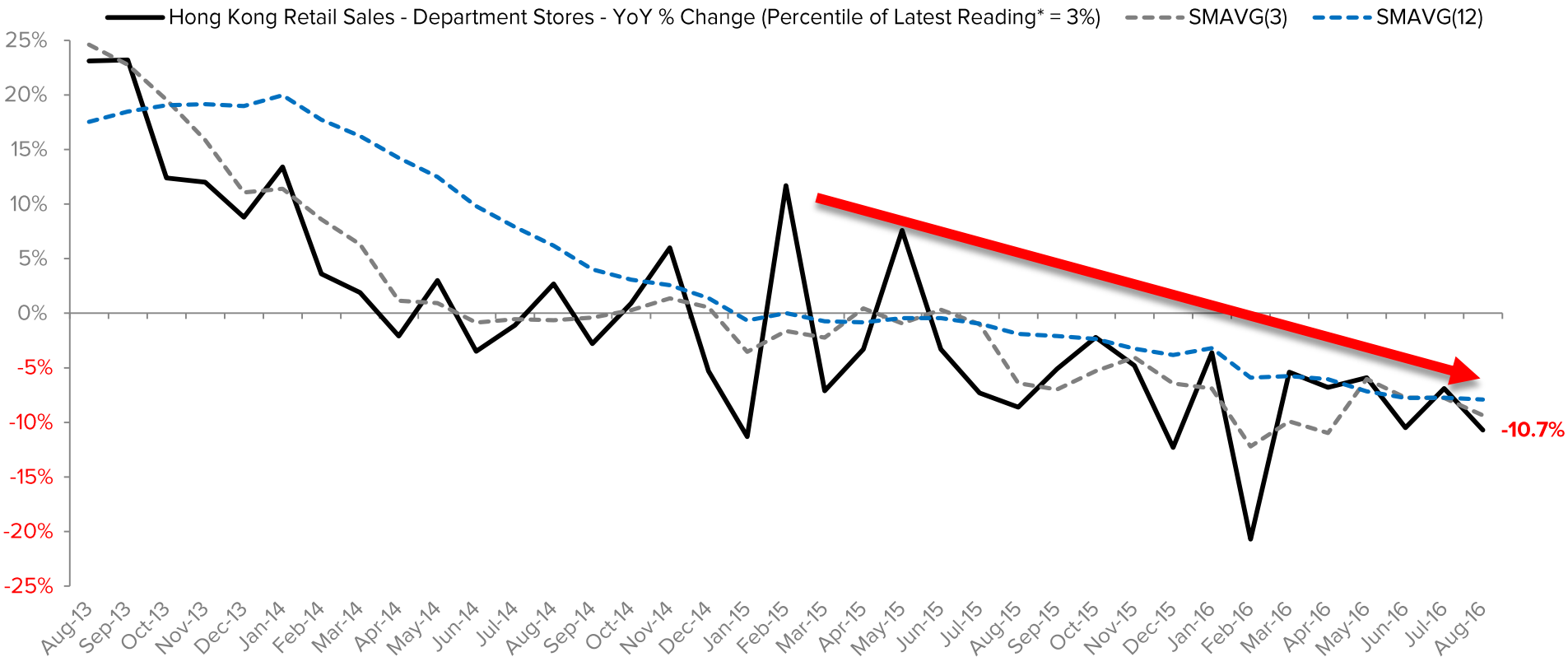
PRODUCER PRICE INFLATION

INFLATION IS TRENDING HIGHER AS OF SEPTEMBER



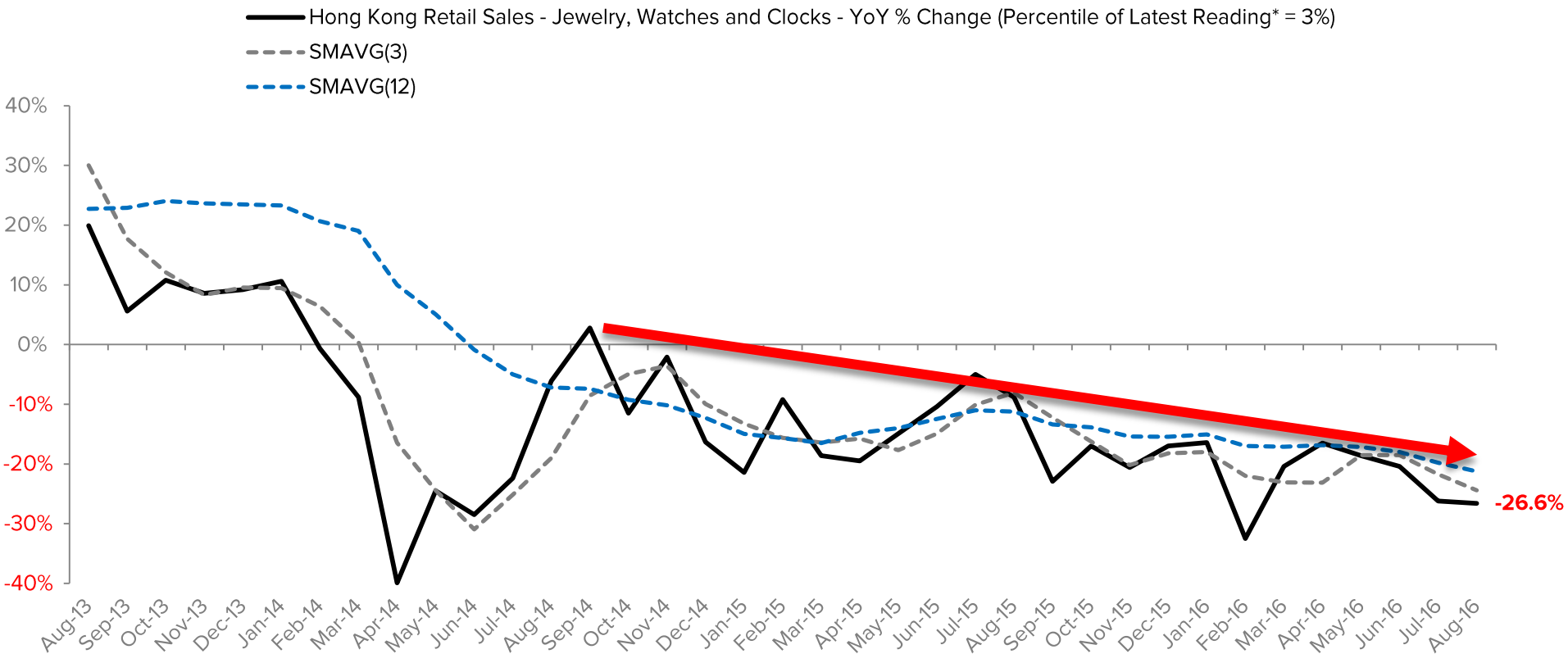
HONG KONG DEPARTMENT STORES SALES

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



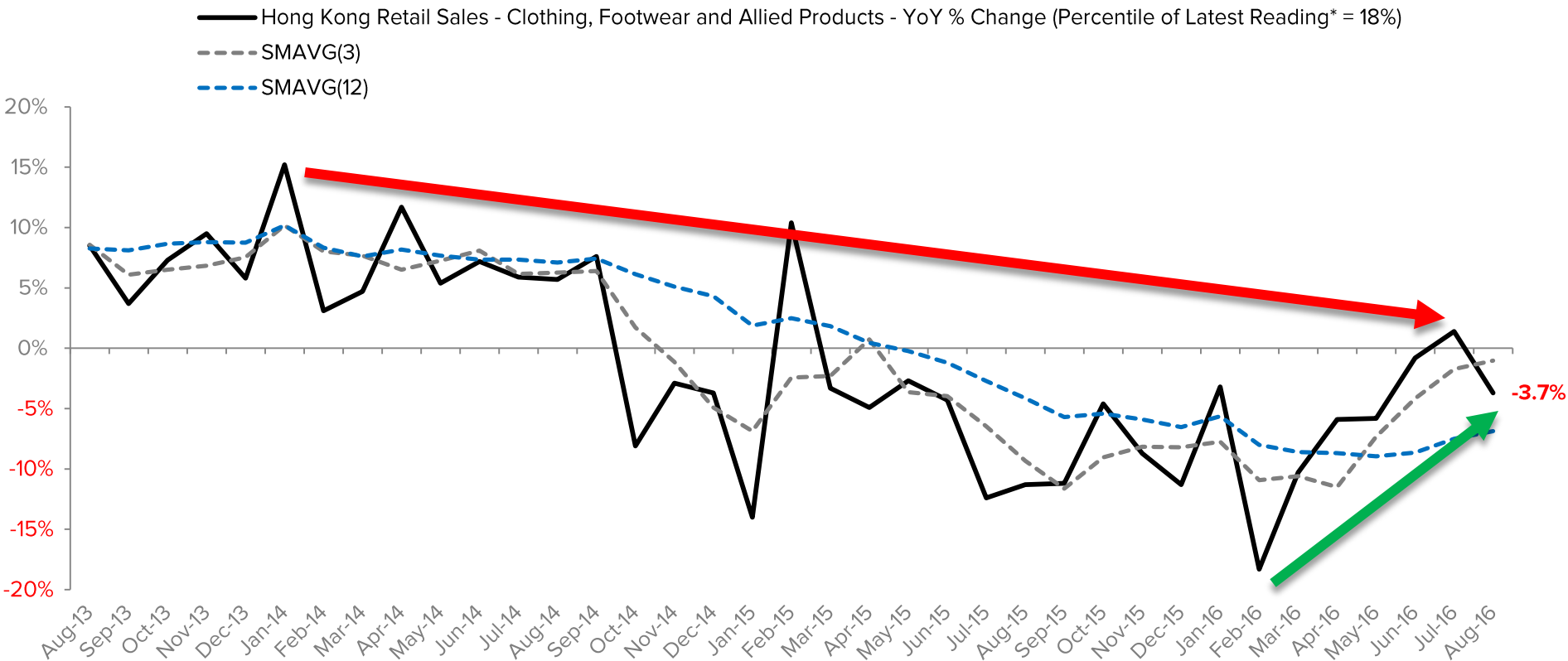
HONG KONG JEWELRY & WATCH SALES

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



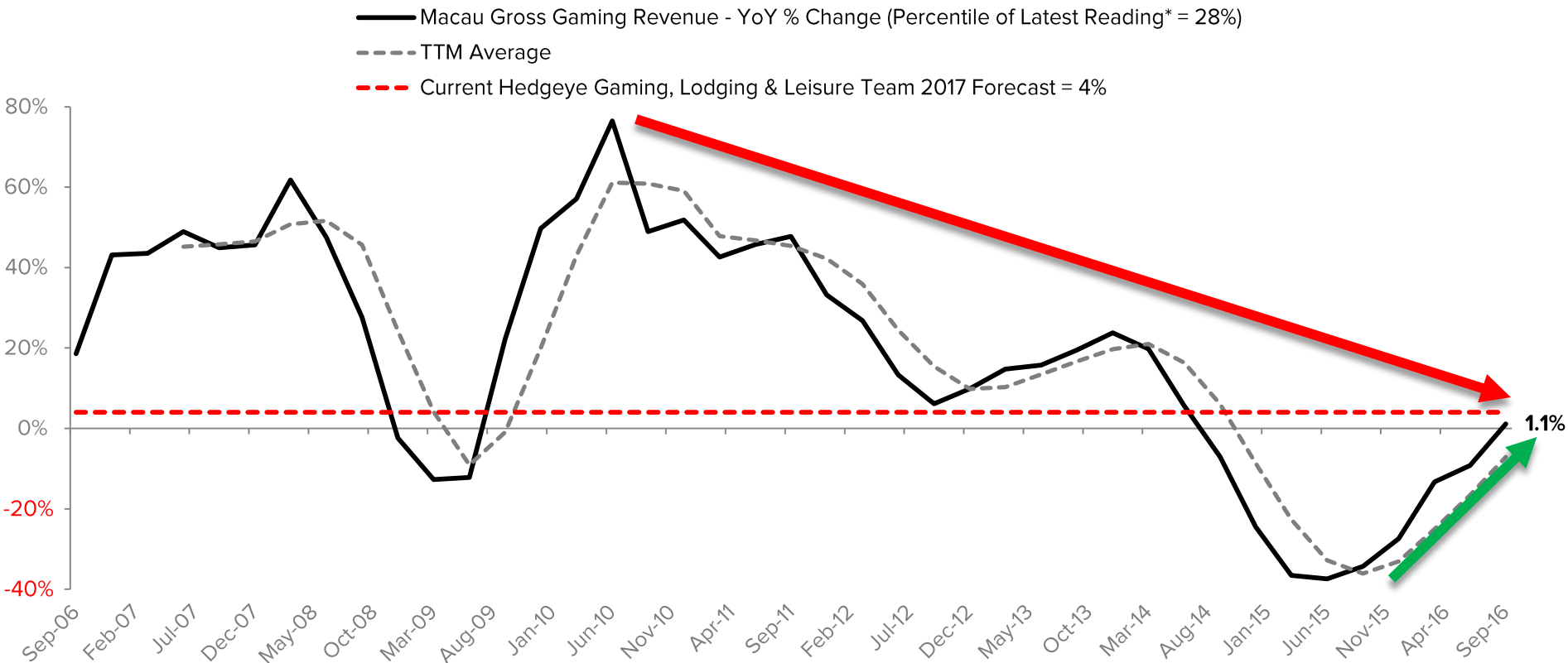
HONG KONG APPAREL & FOOTWEAR SALES

GOLF CLAP FOR THE CYCLICAL BOUNCE IN GROWTH THROUGHOUT THE YTD, BUT THE STRUCTURAL TREND REMAINS BEARISH



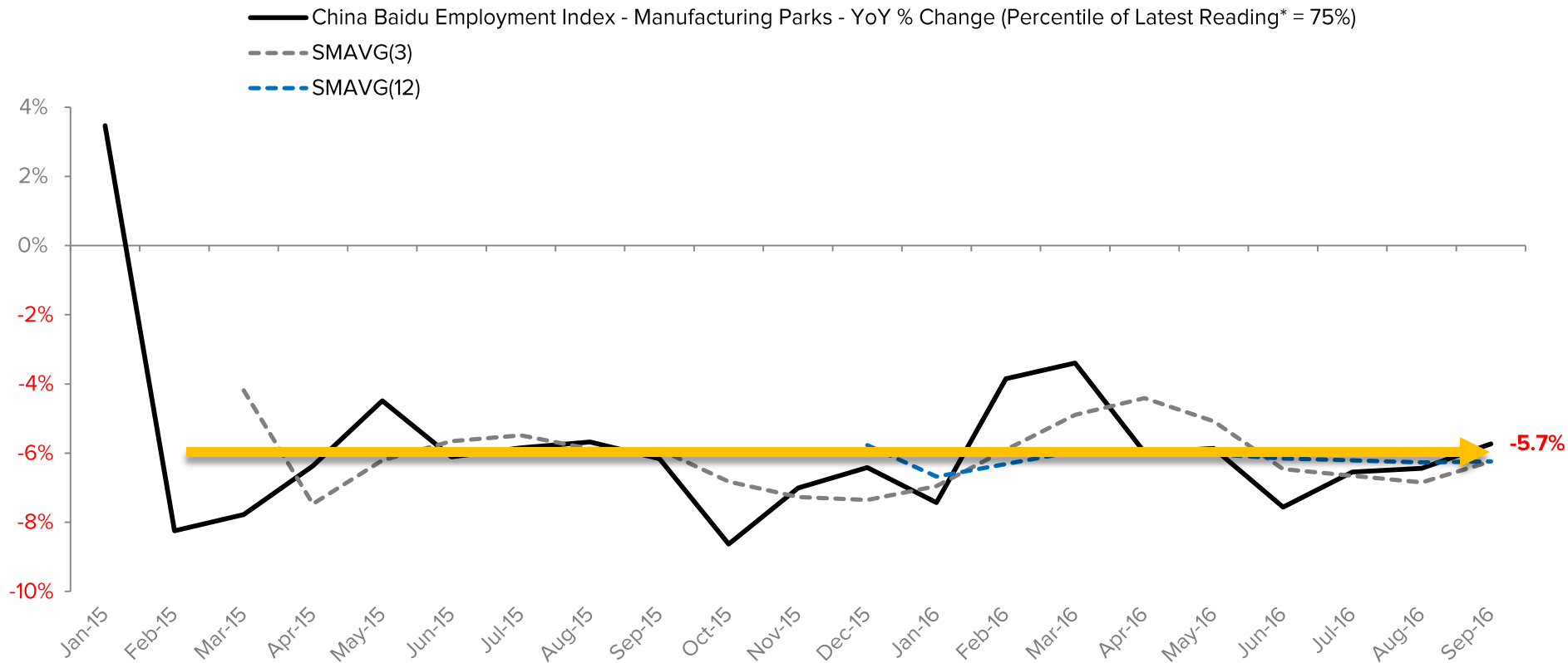
MACAU GROSS GAMING REVENUES

MACROPRUDENTIAL TIGHTENING HAS CERTAINLY PLAYED A KEY ROLE IN THE STRUCTURAL DECLINE IN GROWTH, BUT THE SECULAR TREND REMAINS LOWER REGARDLESS. IF IT LOOKS LIKE A DUCK, WALKS LIKE A DUCK AND QUACKS LIKE A DUCK, IT'S PROBABLY A DUCK.



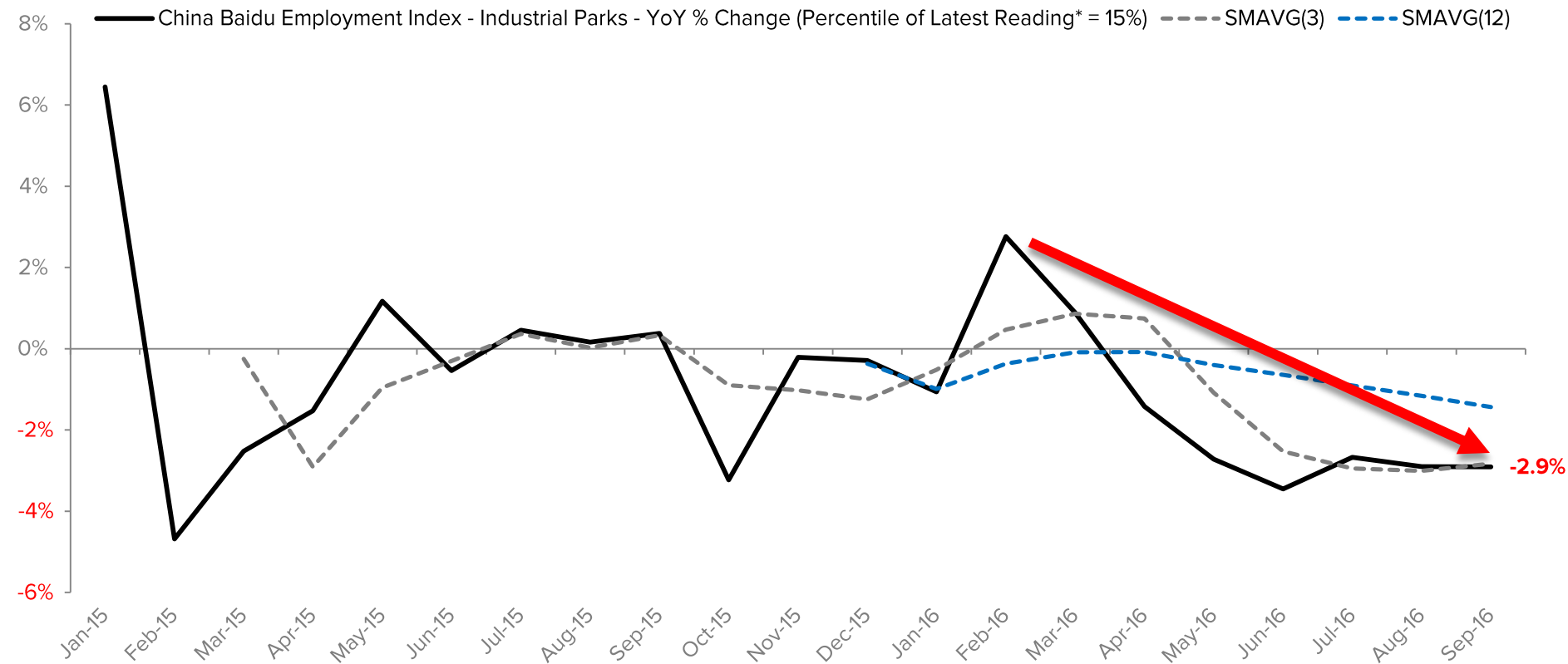
MANUFACTURING EMPLOYMENT

GROWTH IS TRENDING SIDWAYS AS OF SEPTEMBER



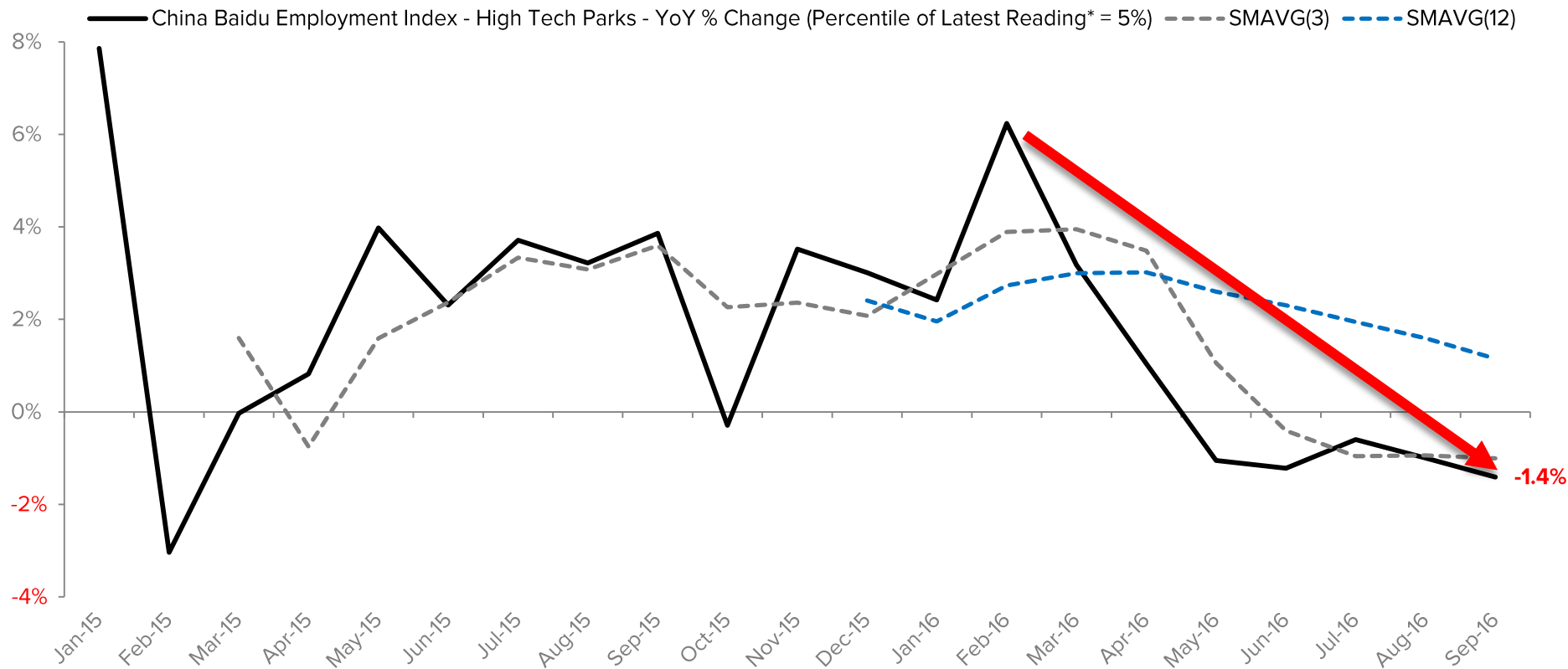
INDUSTRIAL EMPLOYMENT

GROWTH IS TRENDING LOWER AS OF SEPTEMBER



TECH EMPLOYMENT

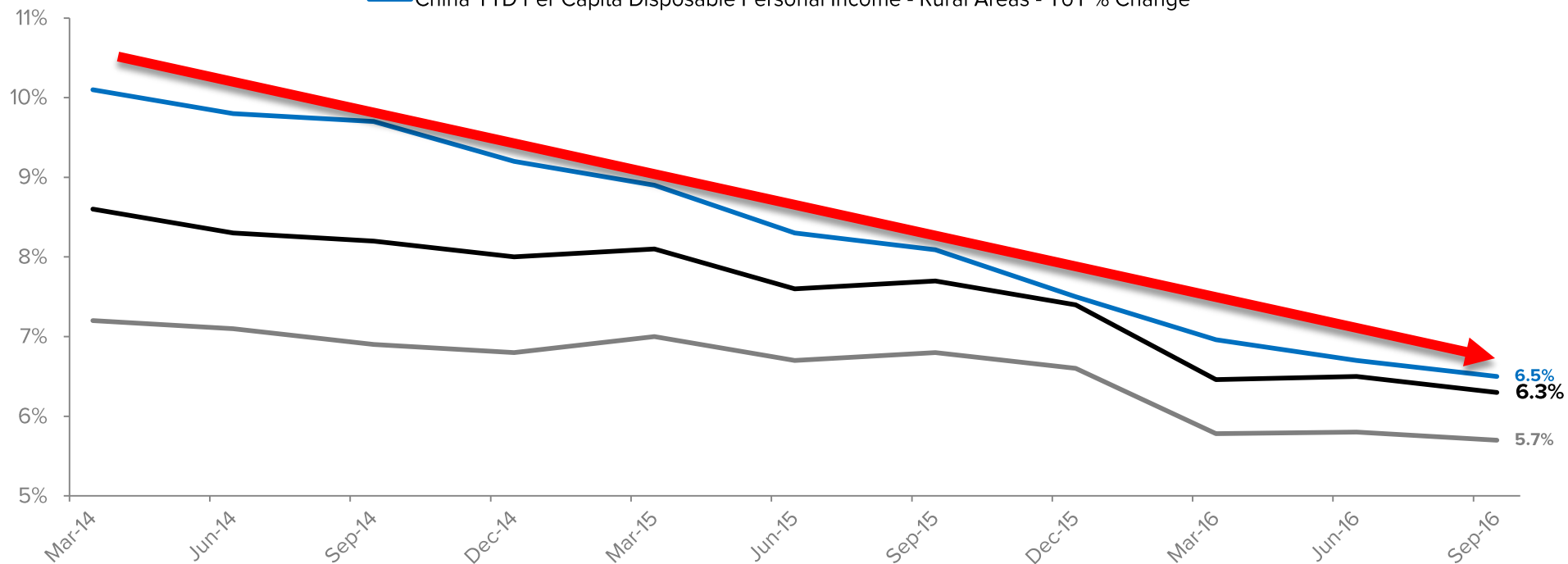
GROWTH IS TRENDING LOWER AS OF SEPTEMBER



DISPOSABLE PERSONAL INCOMES

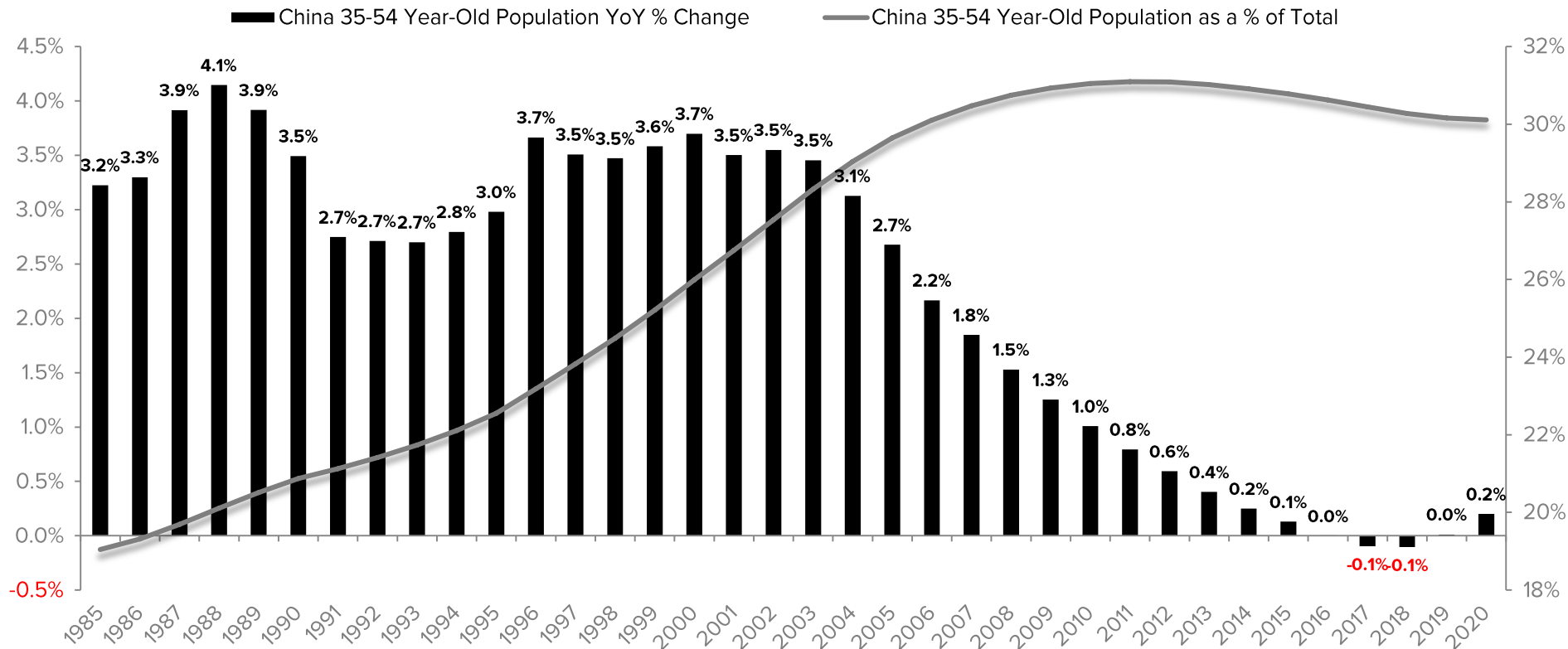
GROWTH IS CONTINUED ITS STRUCTURAL TREND LOWER IN Q3

— China YTD Per Capita Disposable Personal Income - National Total - YoY % Change
— China YTD Per Capita Disposable Personal Income - Urban Areas - YoY % Change
— China YTD Per Capita Disposable Personal Income - Rural Areas - YoY % Change



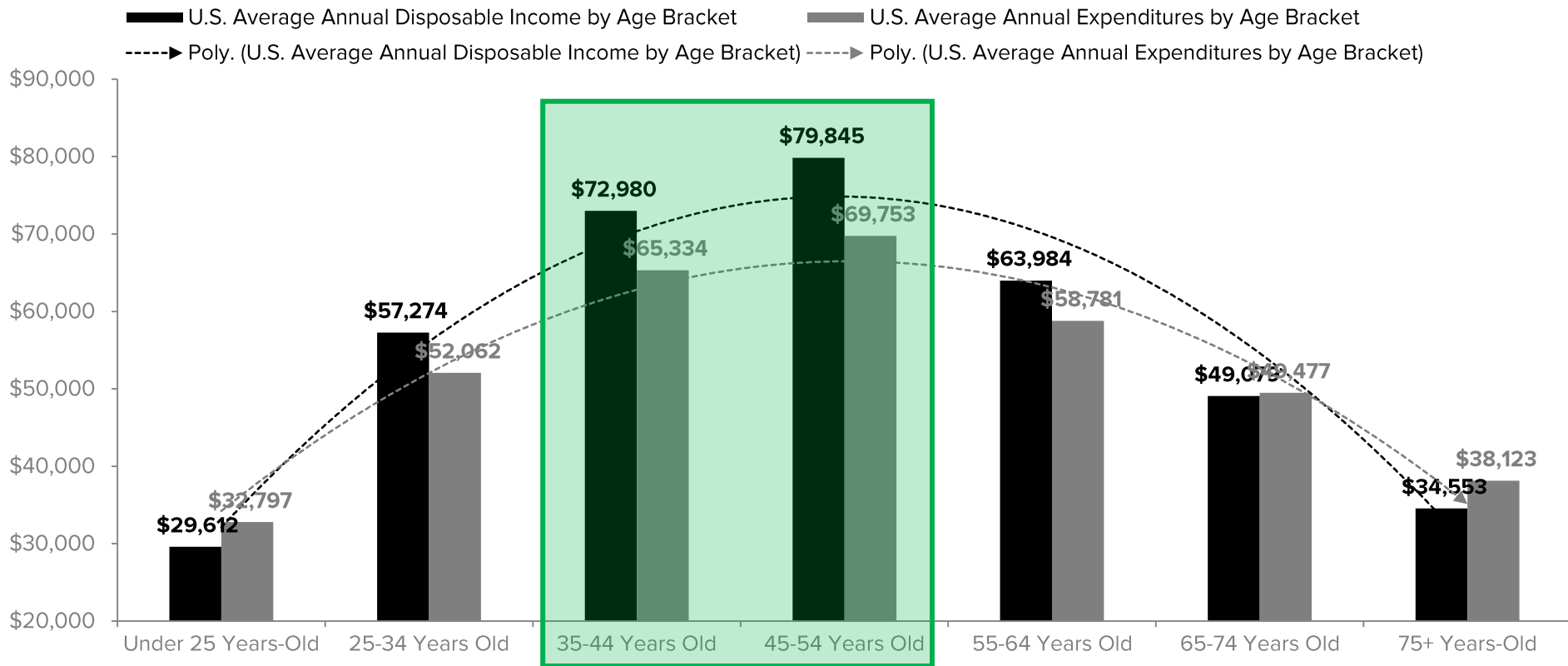
DEMOGRAPHICS IS A MAJOR HEADWIND

LET US NOT FORGET THAT CHINESE OFFICIALS ARE ATTEMPTING TO TRANSITION THEIR ECONOMY TO A CONSUMPTION AND SERVICES-LED GROWTH MODEL AMID THE SHARPEST DECELERATION OF GROWTH IN ITS CORE CONSUMPTION DEMOGRAPHIC EVER. GOOD LUCK WITH THAT.



WHY DO 35-54 YEAR-OLDS MATTER?

BECAUSE ACCORDING TO BOTH EMPIRICAL EVIDENCE AND LIFE-CYCLE ECONOMICS THEORY, THIS IS THE WORLD'S CORE END CONSUMPTION DEMAND DEMOGRAPHIC.

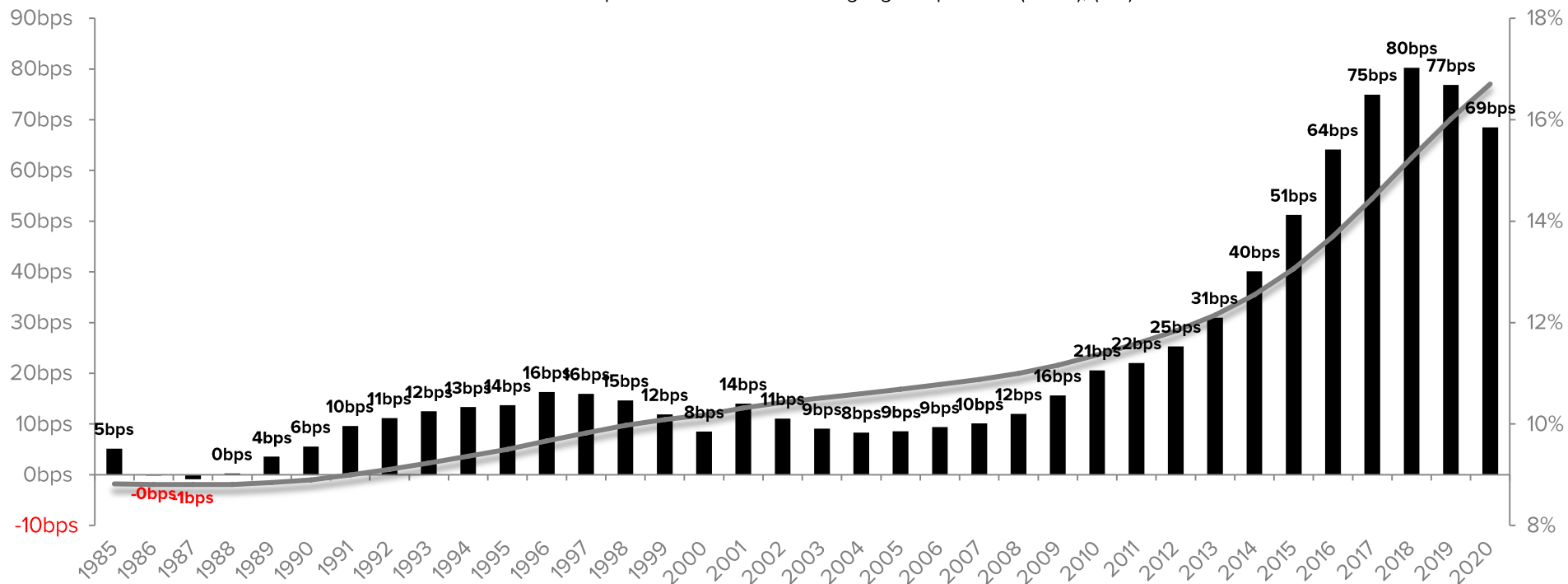


GETTING REALLY OLD, REALLY FAST

MUCH AKIN TO THE DEVELOPED WORLD, THE CHINESE POPULOUS IS AGING AT ITS FASTEST RATE EVER OVER THE NEXT 3-5 YEARS.

■ China 65+ Year-Old Population as a % of Working-Age Population (15-64) YoY bps Change

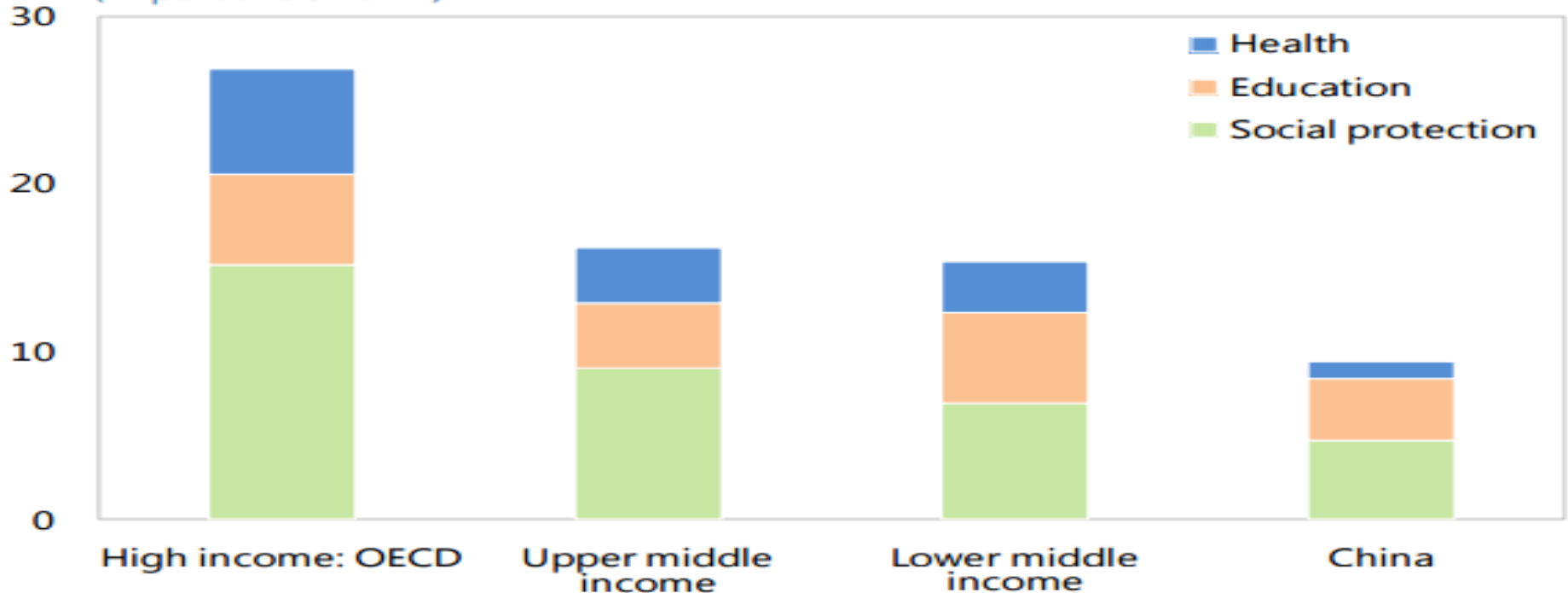
— China 65+ Year-Old Population as a % of Working-Age Population (15-64); (rhs)



WITH A MEAGER SOCIAL SAFETY NET

MUCH ADO HAS BEEN MADE ABOUT CHINA'S IMPRESSIVE HOUSEHOLD SAVINGS (~25% OF GDP), BUT WITHOUT AN ADEQUATE SOCIAL SAFETY NET (THAT WILL TAKE YEARS TO DESIGN AND IMPLEMENT), SUCH "PENNEDED UP DEMAND" FOR CONSUMPTION WILL REMAIN JUST THAT.

Social Spending by Country Group
(In percent of GDP)



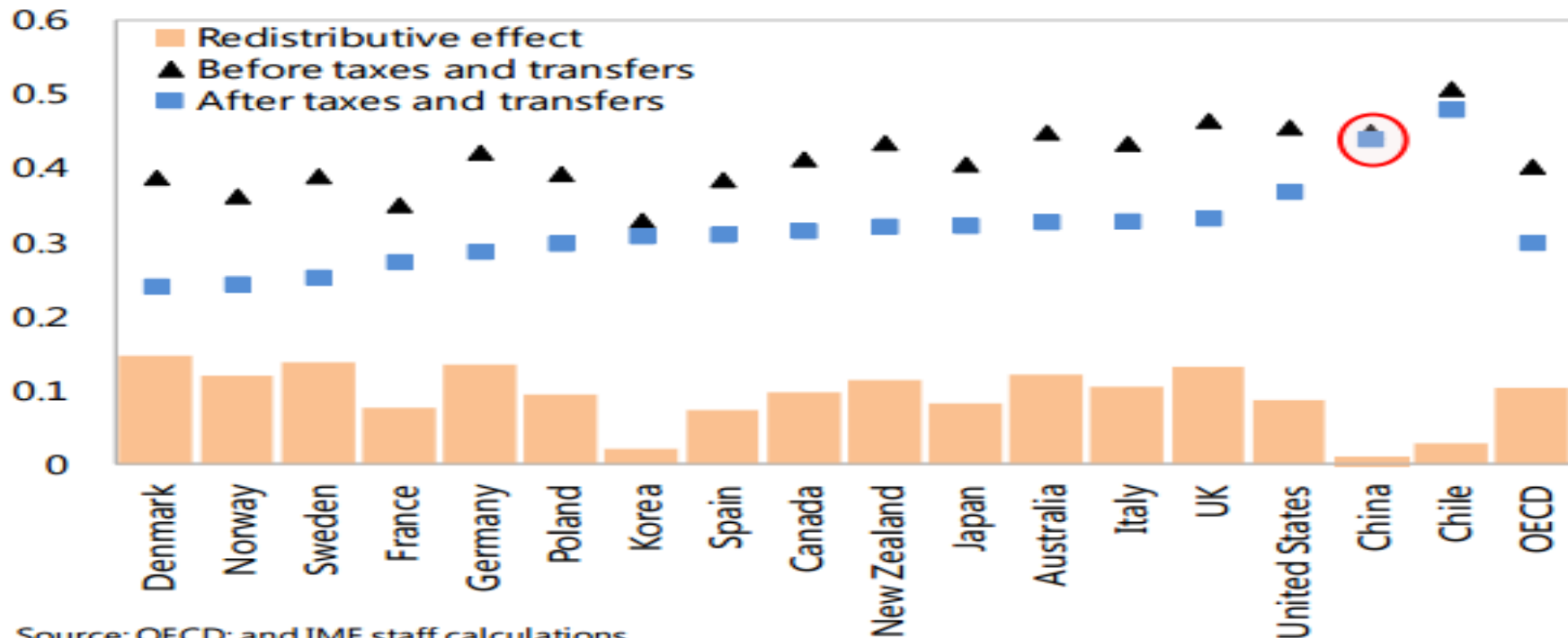
Sources: China 2030, World Bank; and IMF staff calculations.

AND TAX POLICY REMAINS OUT TO LUNCH

THE CHINESE GOVERNMENT IS DOING VERY LITTLE WITH FISCAL POLICY TO OFFSET THE AFOREMENTIONED DEMOGRAPHIC HEADWIND TO END-CONSUMPTION DEMAND GROWTH.

Redistributive Effect of Taxes across OECD relative to China

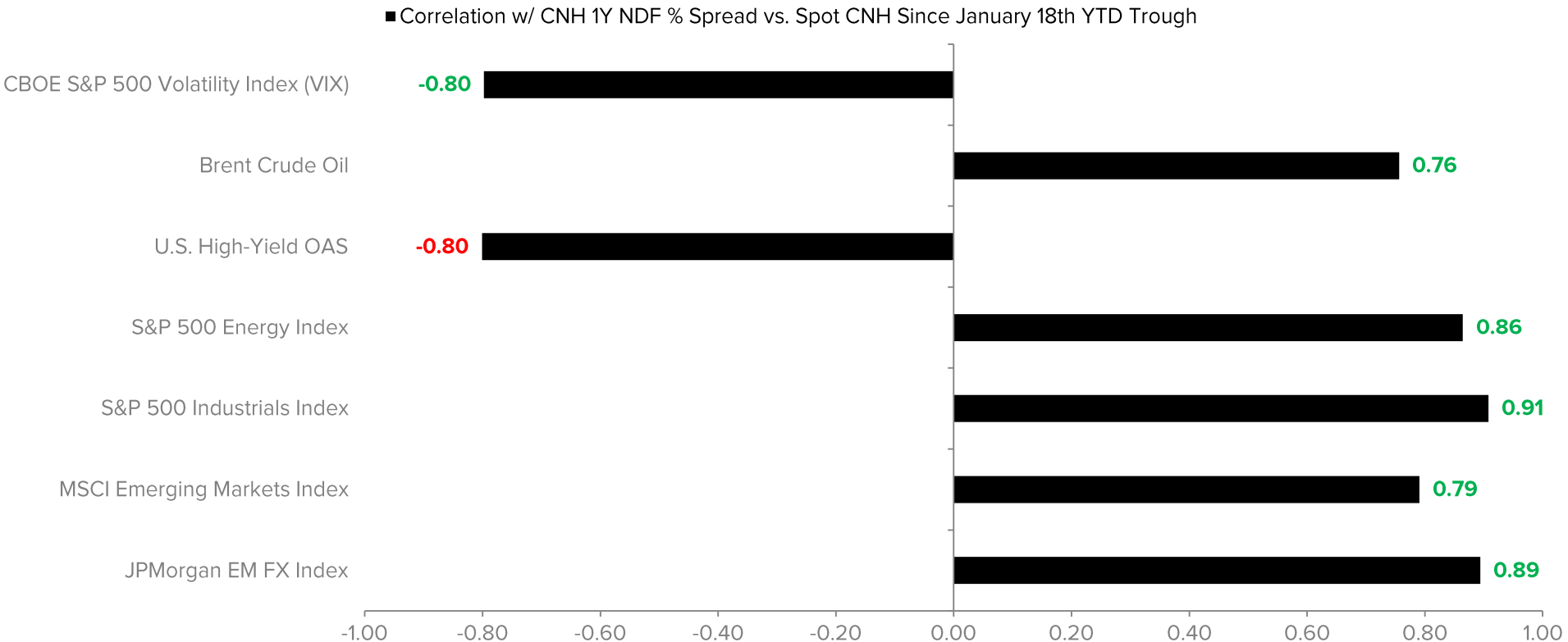
(Gini coefficient between 0 and 1)



Source: OECD; and IMF staff calculations.

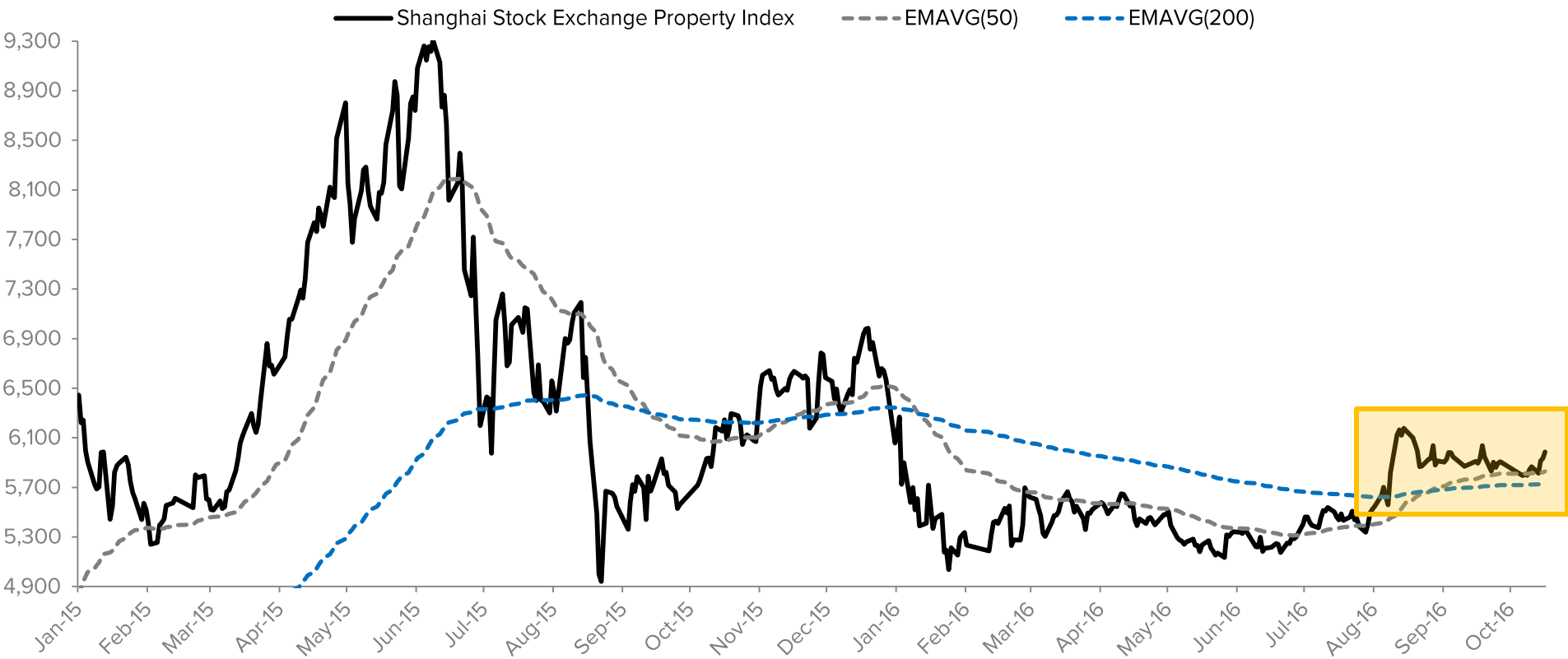
ALL TOLD, THE RISK TO REFLATION IS REAL

RISK ASSETS HAVE BENEFITTED TREMENDOUSLY FROM CHINA'S ECONOMIC STABILIZATION THROUGHOUT THE YTD. WHAT DOES AN UNWIND OF SAID STABILIZATION PORTEND TO NOW-CROWDED CONSENSUS LONG POSITIONING IN CYCLICALS AND EMERGING MARKETS BROADLY?



THE #1 REAL-TIME INDICATOR TO WATCH

MAINLAND PROPERTY STOCKS ARE CONSOLIDATING AROUND KEY SUPPORT LEVELS. BE ON THE LOOKOUT FOR A BREAKDOWN OVER THE NEXT ~3 MONTHS TO CONFIRM OUR CYCLICAL AND STRUCTURAL VIEWS.



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