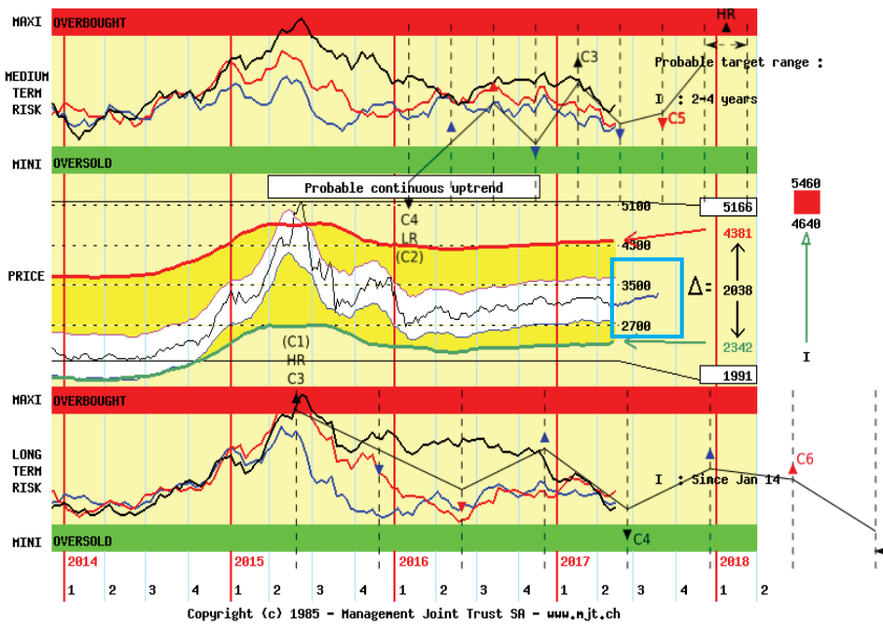
TIMING AND TACTICAL INSIGHT

Chinese Equities could outperform during H2 2017

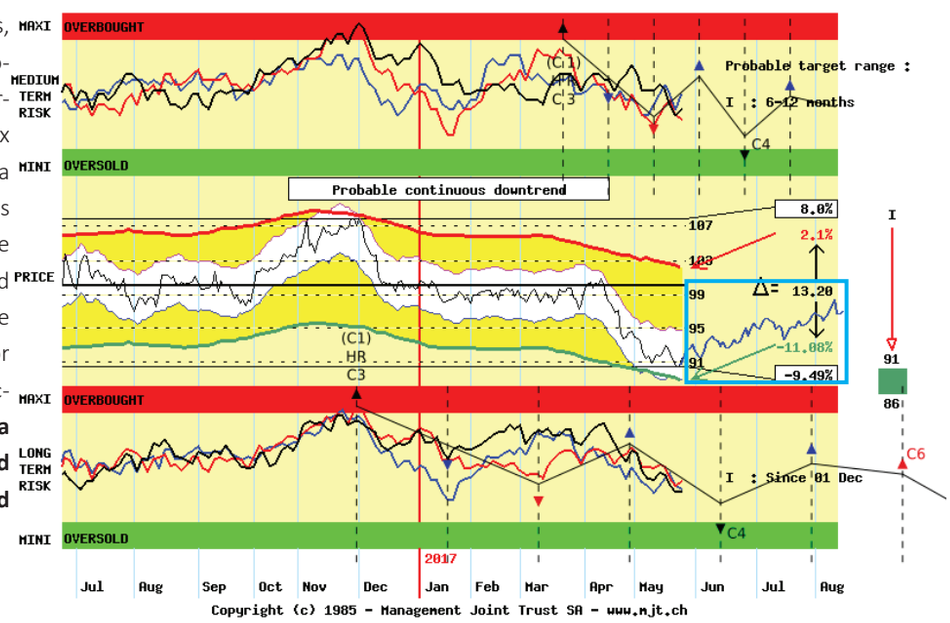
Shanghai Composite Index
(Weekly graph or the perspective over the next 2 to 4 quarters)



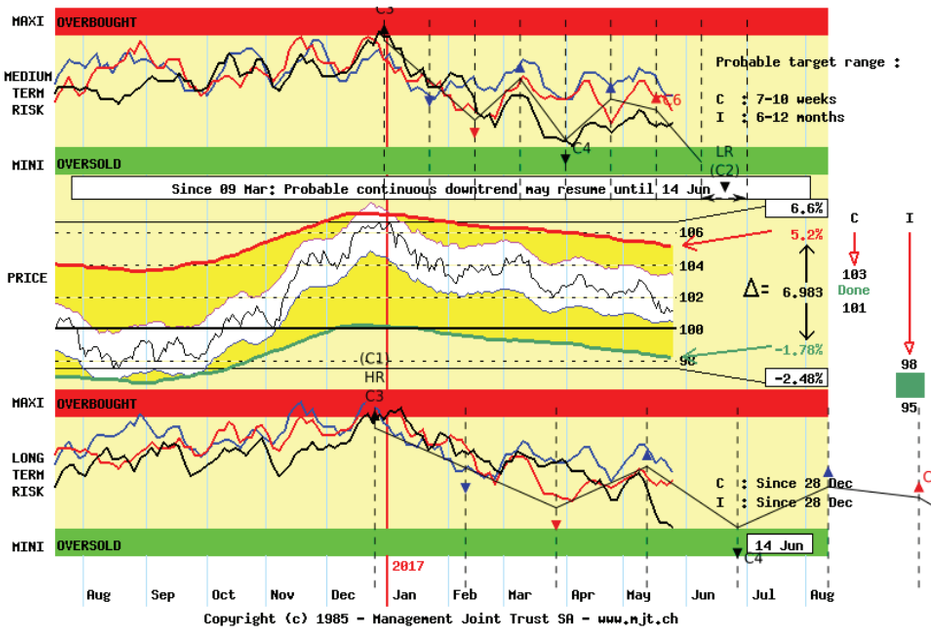
On both our oscillators series (lower and upper rectangles), the Shanghai Composite Index is approaching intermediate lows. **This could trigger a reaction up potentially towards year-end**. Without validating the 'I' Impulsive targets yet (right-hand scale), the Index could start by retesting the upper end of our Corrective targets up toward 3'600 (0.8 times our 2'038 delta from the 2014 lows).

Shanghai Composite Index vs MSCI WORLD INDEX (Currency hedged)
(Daily graph or the perspective over the next 2 to 3 months)

Over the last few months, the Shanghai Composite Index has underperformed the MSCI World Index quite substantially (circa minus 15%). The ratio has now reached its 'I' Impulsive targets down (right-hand scale) and the sequences we project on both our oscillator series (lower and upper rectangles) would imply that **a bottom vs the MSCI World will probably be confirmed towards mid / end June**.



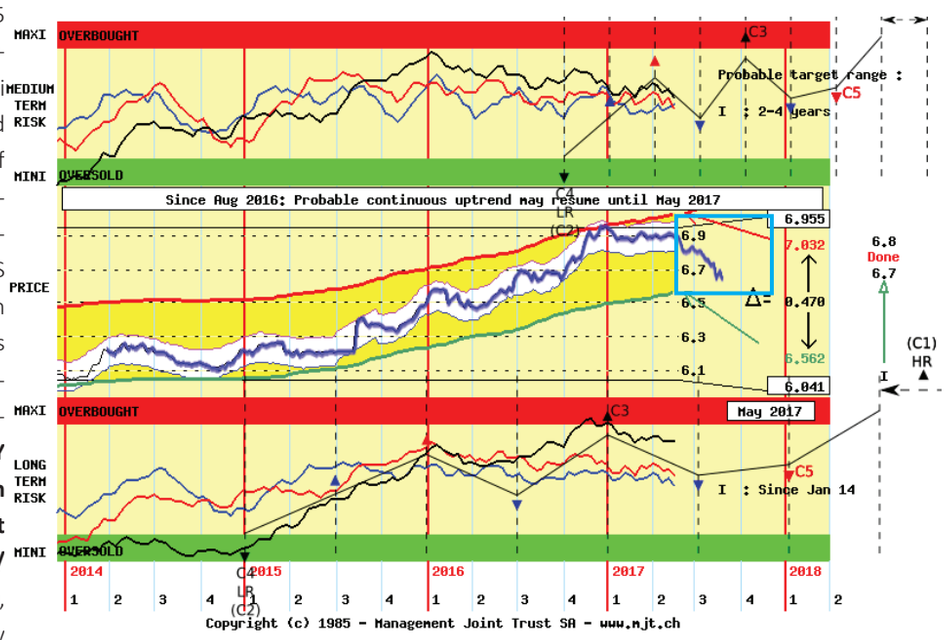
USD vs Yuan Trade weighted basket of currencies
(Daily graph or the perspective over the next 2 to 3 months)



Weakness in the Dollar could explain some of the recent underperformance of the Chinese market. The chart above looks at the US Dollar versus a basket of currencies representing China's trade partners. To a certain extent, the downtrend in the Dollar fits quite well with the underperformance of the Shanghai Composite Index above vs the MSCI World. According to the sequences on both our oscillators series (upper and lower rectangles), **the Dollar should also find support and make a bottom mid to end June against this basket. Its reaction up towards the Summer could correlate with a reaction up in the Shanghai Composite.**

Yuan Renminbi per U.S. Dollar
(Weekly graph or the perspective over the next 2 to 4 quarters)

Indeed, since the 2015 Chinese equity sell-off, performances in the Shanghai Composite have correlated quite well with periods of monetary stimulus (weakening of USD/CNY). Such stimulus was halted as the US Dollar started to correct in December. The sequences on both our oscillator series (lower and upper rectangles) suggest that **CNY could start to weaken again from mid year until at least early Q4 2017 (i.e. USD/CNY resumes its uptrend)**, which could indirectly imply that the Dollar could start to strengthen again and that further CNY devaluation would be possible. **These dynamics would support the move up we expect on Chinese equity markets.**



USD vs Yuan Trade weighted basket of currencies
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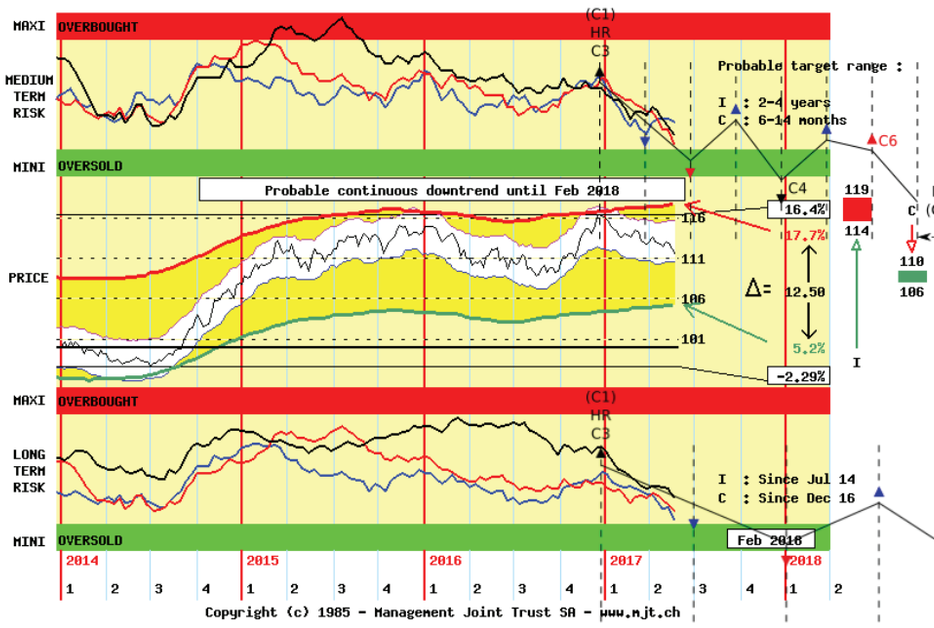
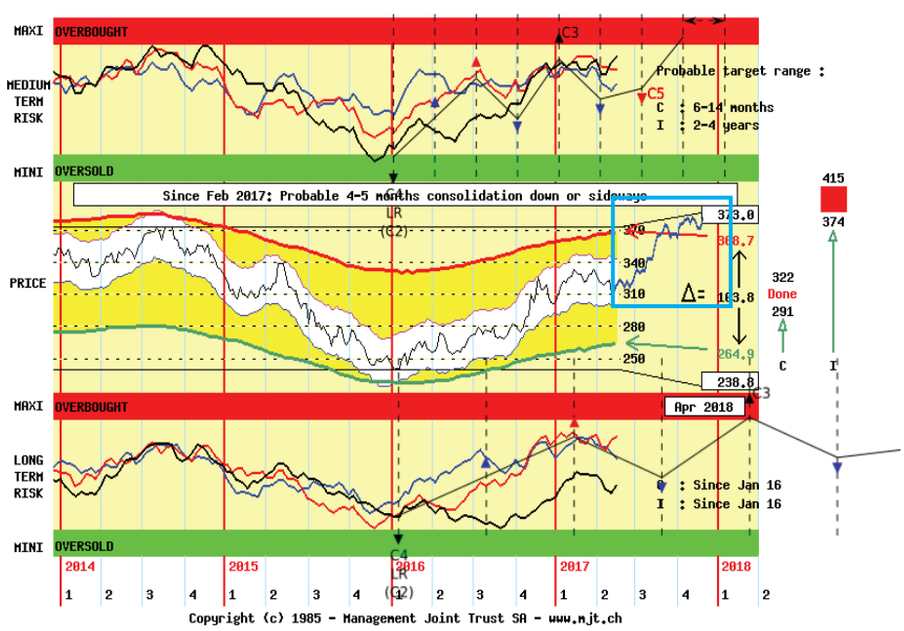


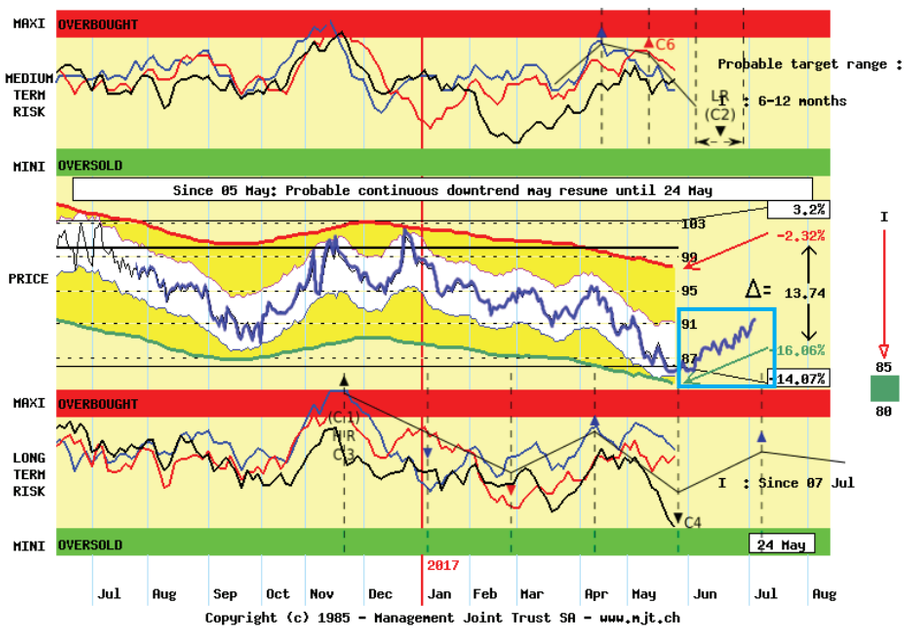
Following up on this argumentation, we now consider the USD versus the basket of currencies (representing China's trade partners) over a longer term period (Weekly graph). The projection on both our oscillator series (lower and upper rectangles) indeed suggest **that the Dollar could bounce during Q3 2017, but that it could probably weaken again towards year-end and early 2018. This may imply renewed headwinds for Chinese equities.**

Goldman Sachs Industrial Metals Index
(Weekly graph or the perspective over the next 2 to 4 quarters)

The value of the Yuan is certainly not the only factor influencing the Chinese economy and its stock markets. Indeed, more generally we believe that "Chinese growth should remain buoyant well into the middle of next year" (see the previous article in this document). Typically, trends in Industrial metals would be reliable indicators of this economic strength. On the chart above, the sequences on both our oscillators series point to a re-acceleration of the uptrend in the prices of industrial metals from sometime in Q3 2017 into the Spring of 2018. **This would confirm our positive view on the Chinese economy and hence on its stock market towards the later part of the year.**



Shanghai Composite Index vs FXI - iShares FTSE China 25 Index Fund (Daily graph or the perspective over the next 2 to 3 months)



When investing in China, investors may consider the option either to invest in the China's longstanding FXI large cap ETF or a selection of broader CSI 300 ETFs. In recent history, when the USD has strengthened vs the Chinese trade weighted basket of currencies, the Yuan's devaluation has only compensated for circa 70% of these moves. This implies that when the USD strengthens, the Yuan also strengthen vs its trade weighted basket of currencies. Incidentally, this favors the broader, more domestic Shanghai Composite Index vs the large cap exporter weighted FXI ETF. This can be noticed in the chart above during the 4Q 2016 (and vis versa during H1 2017). **Given our scenario and the oscillator sequences above (lower and upper rectangles), we would favor CSI 300 ETFs during Q3 2017 as the US Dollar strengthen and switch back to FXI towards the later part of the year.**

Concluding remarks:

As the Dollar starts to strengthen in late Q2, Chinese stock markets should start to react to the upside, probably until early Q4. We believe that following that strong Chinese growth should help support the Chinese stock markets potentially into the Spring of 2018, even if the Dollar starts weakening again.