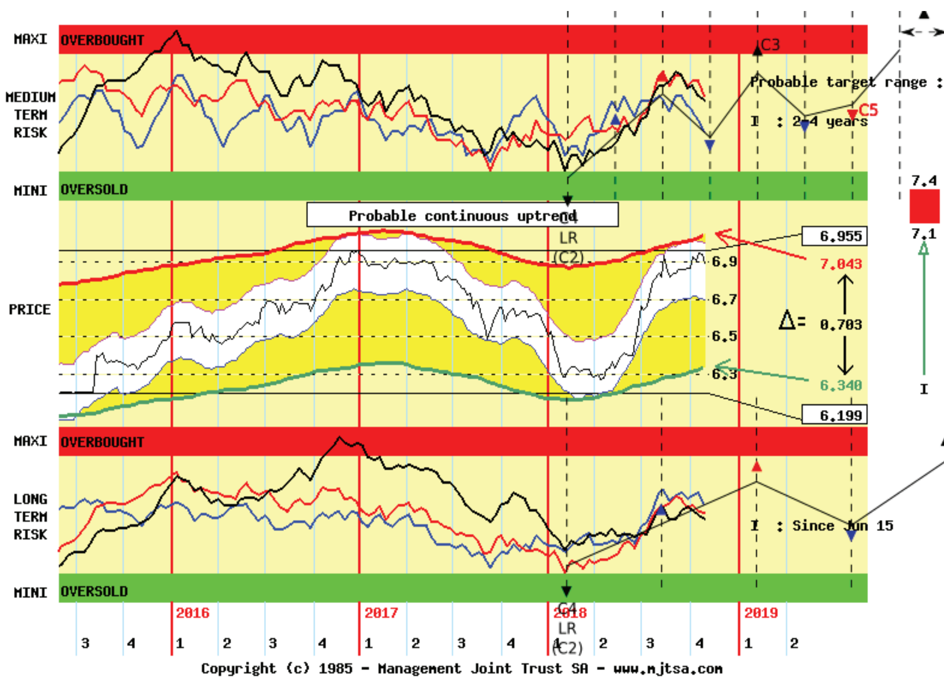
Exploring the links between China, Emerging Markets and Commodity Producers

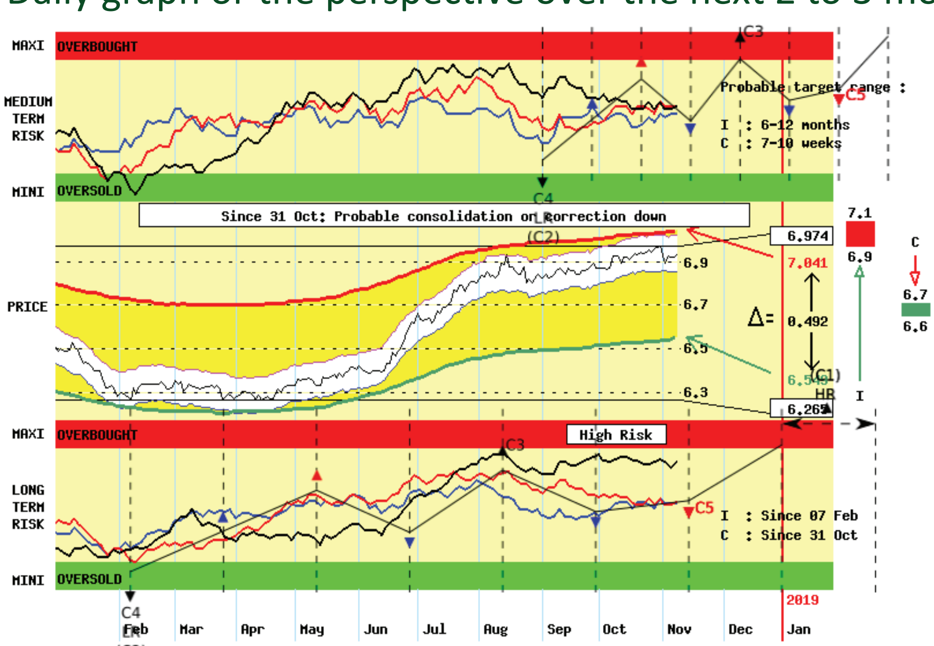
In our early September issue we warned our readers on China and related trades. We expected that by end September, Chinese and Emerging Market equities, Industrials Metals or sectors related to them, could start to resume lower, on an absolute, but probably also on a relative basis, potentially into early 2019. These projections have partly been fulfilled as most of these assets did sell-off quite aggressively during the equity markets correction in October. Yet, on a relative basis, some have shown more resilience. We believe it's now time to review the Chinese and Emerging Markets Investment case in order to gain more clarity.

USD/CNY
Weekly graph or the perspective over the next 2 to 4 quarters



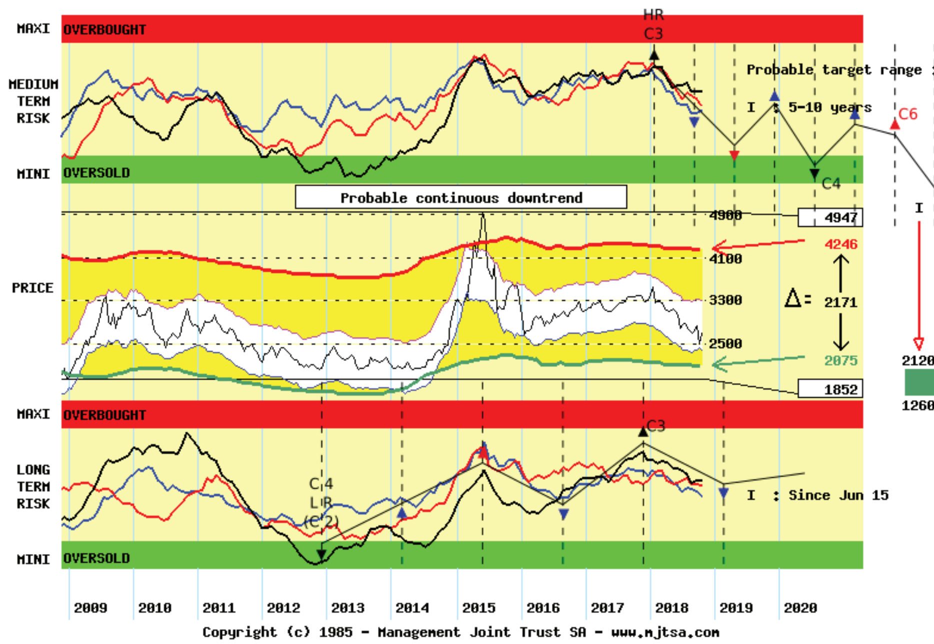
We start this article on China with the Yuan. Indeed, since April, the POBC has been in a quasi quantitative easing mode. It has lowered its Required Reserve Ratio for banks three times already in an attempt to push more liquidity into the market. Recently, it vowed to defend the Yuan around the psychological 7.00 mark vs the US Dollar. Yet, giving the easing measures mentioned above, this commitment does sound somewhat unconvincing. At least, this is what our oscillators series are suggesting. Indeed, **the uptrend on USD/CNY seems well in place, and both our oscillator series (lower and upper rectangles) are pointing to further USD/CNY strength, probably into mid Q1 and then possibly again towards H2 2019. Our I Impulsive targets to the upside (right-hand scale) are projecting that the pair could reach the 7.1 – 7.4 range over the next few quarters**. Since the Spring, such falls in the Yuan vs the US Dollar have usually corresponded to corrections in Chinese equity markets, probably due to capital flight towards other regions. We believe this could happen again if our USD/CNY projections materialize over the next few months.

USD/CNY
Daily graph or the perspective over the next 2 to 3 months



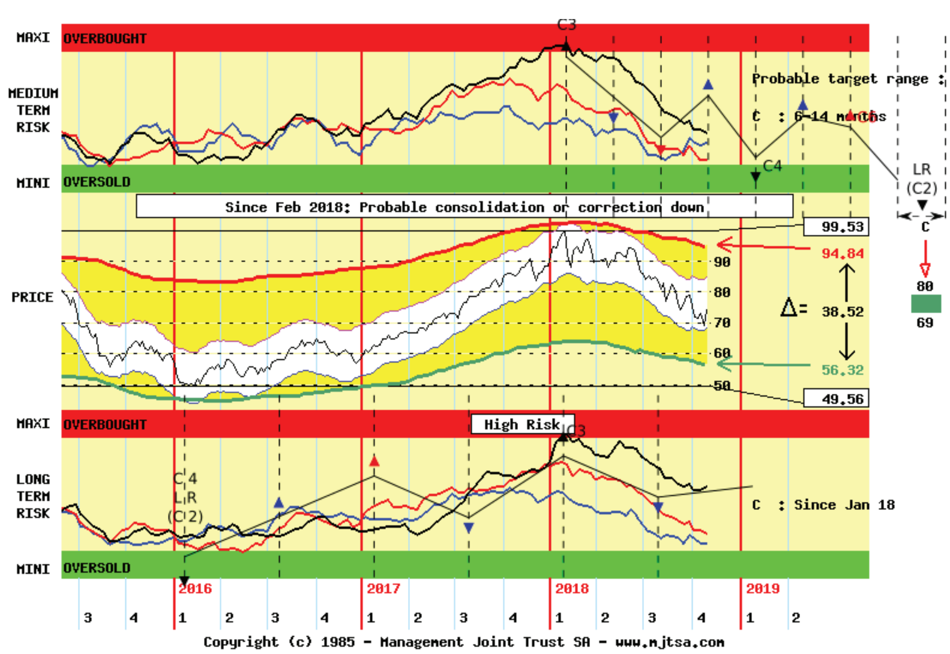
On the Daily graph, USD/CNY has been in a high level consolidation since August on both our oscillator series (lower and upper rectangles). Although, our target to the upside may look somewhat exhausted (right-hand scale), **we would still expect the pair to resume higher between now and late November, probably towards February or March**. This renewed US Dollar strength should once again put pressure on Chinese and Emerging Markets equities and related trades as capital flows will probably seek cover into other regions.

Shanghai Composite Index
Bi-monthly graph or the perspective over the next 1 to 2 years



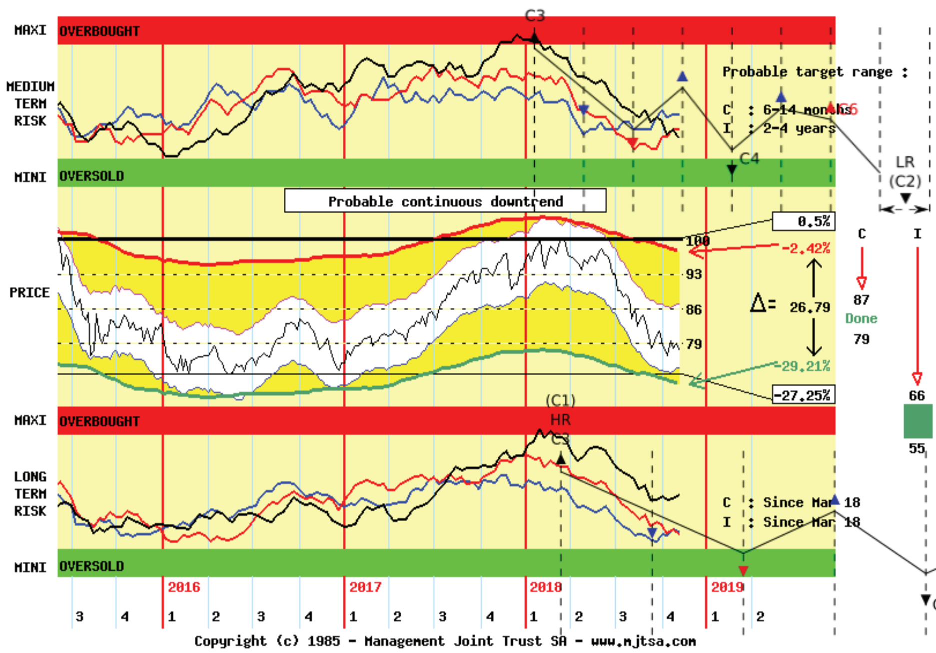
Indeed, the configuration of China's domestic equity market is in our view still quite negative. When considering the 2016-2017 Bull market, it does pale in comparison with the stock market bubble of 2015. Such series of declining tops (2015, early 2018) usually trigger **between 2 to 3 years on correction to the downside** on a bi-monthly graph according to our methodology. This is the sequence we show on our medium term oscillators (upper rectangle). In the meantime, both oscillator series (lower and upper rectangles) are pointing towards a **first move down into Q1 2019, where the Shanghai Composite could mark an intermediate low**. On the target front, our I Impulsive targets to the downside are suggesting that the **Shanghai Composite could reach below the 2'000 mark over the couple of years, and possibly even substantially below that** (right-hand scale).

MSCI China Index
Weekly graph or the perspective over the next 2 to 4 quarters



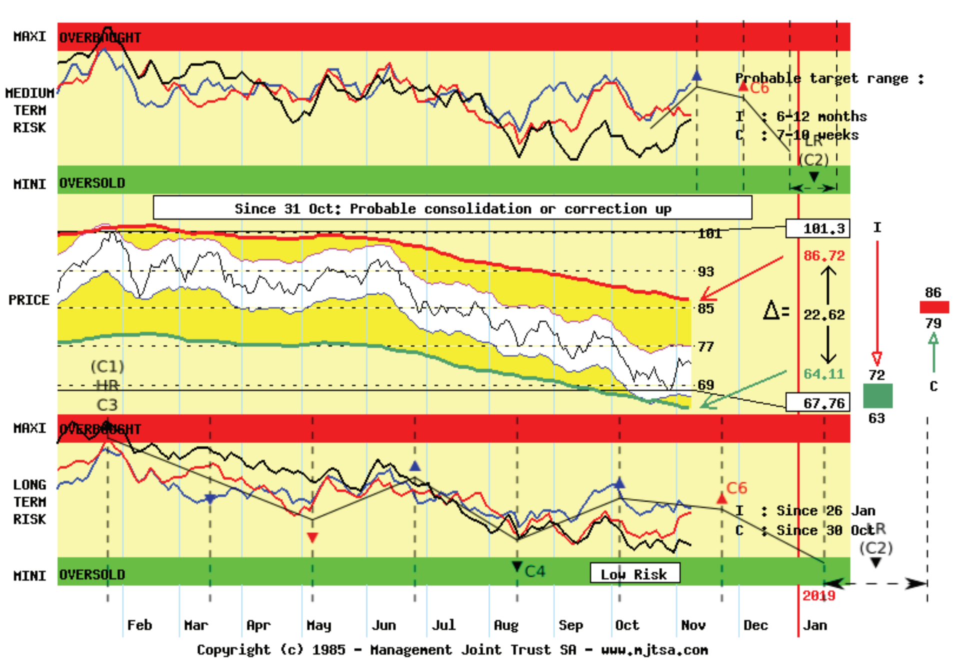
We now focus on the MSCI China index, which includes China's larger international companies and especially the 3 BATs (Baidu, Alibaba and Tecent). The index largely outperformed the Shanghai Composite during the 2016-2017 reflationary period, yet since June this relation has started to reverse. Indeed, since the beginning of the year, the MSCI China Index has lost almost 30% of its value. It is now hitting the support of our C Corrective targets to the downside (right-hand scale). If these were to break, the next level of targets we can calculate would probably be much lower and imply **a full retracement of the 2016/2017 reflationary Bull market. This is what our medium term oscillators (upper rectangle) are suggesting. We expect a further move down into mid Q1, when we expect an intermediate low and a bounce into Q2. Then the downtrend probably resumes again in H2 2019.**

MSCI China Index vs All Country World Index
Weekly graph or the perspectives over the next 2 to 4 quarters



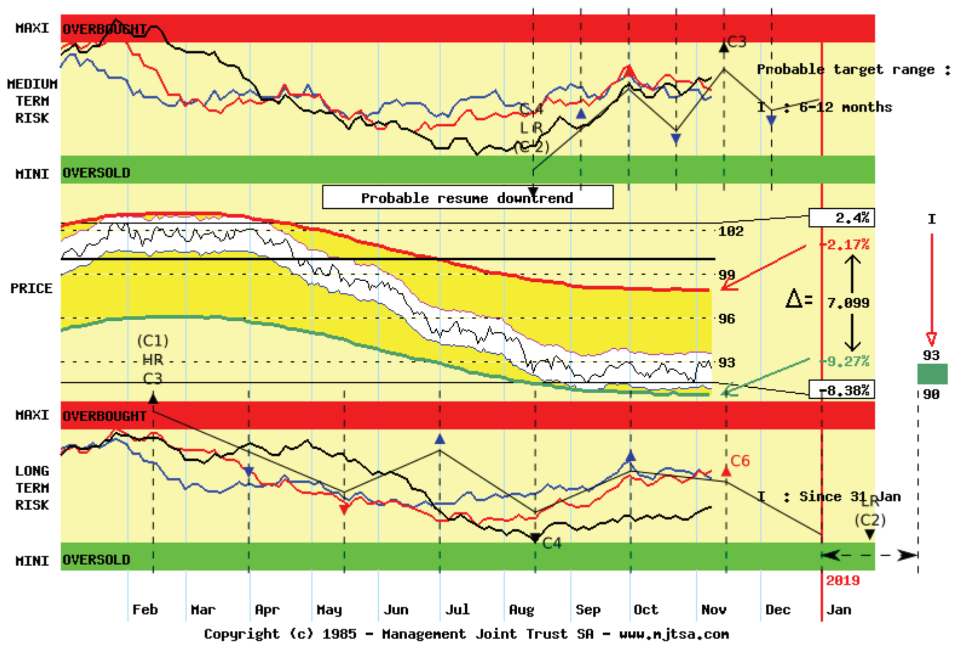
One may argue that China has stabilized over the last couple of months vs other equity markets. This graph compares the MSCI China Index to the All Country World Index. Indeed, China has held ground on a relative basis since September, yet on both oscillator series (lower and upper rectangles), **the downtrend is still well in place and should probably resume lower soon towards mid/late Q1 2019.** It then probably drops again in H2 2019. The ratio recently broke below the support of its C Corrective targets to the downside (right-hand scale). **The I Impulsive downside range we are now targeting suggests another 15% to 30% underperformance for China vs Global equities over the next 6 to 12 months. We would hence remain very prudent on China at least into mid Q1, and probably towards the end of next year.**

MSCI China Index
Daily graph or the perspective over the next 2 to 3 months



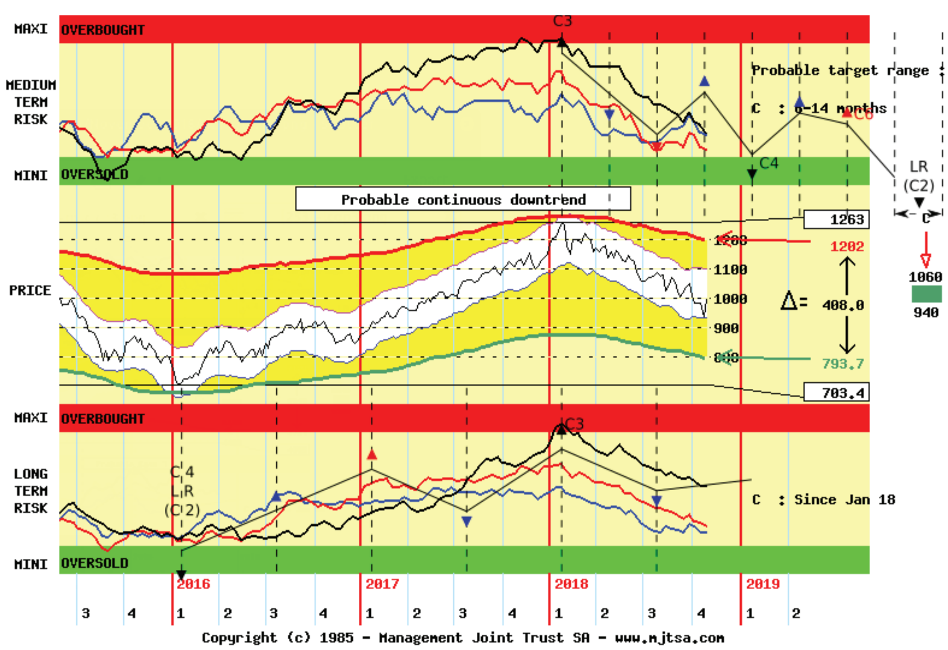
Shorter term, we consider the MSCI China index on a standalone basis. Our long term oscillators (lower rectangles) would suggest that an intermediate low was made mid August. Yet, the bounce since then has been very weak, and new lows were made in October. Both our oscillators series (lower and upper rectangles) are still pointing to further downside potential towards year-end and Q1 2019. New inflexion points to the downside are awaited towards late November. Hence, **over the next few weeks, the MSCI China Index should resume its downtrend, probably towards February next year, perhaps March. Our I impulsive targets to the downside (right-hand scale) are pointing to a further 10 to 12% of downside potential during this period.**

Top 8 Cap. Weighted Emerging Markets Currency vs USD
Daily graph or the perspective over the next 2 to 3 months



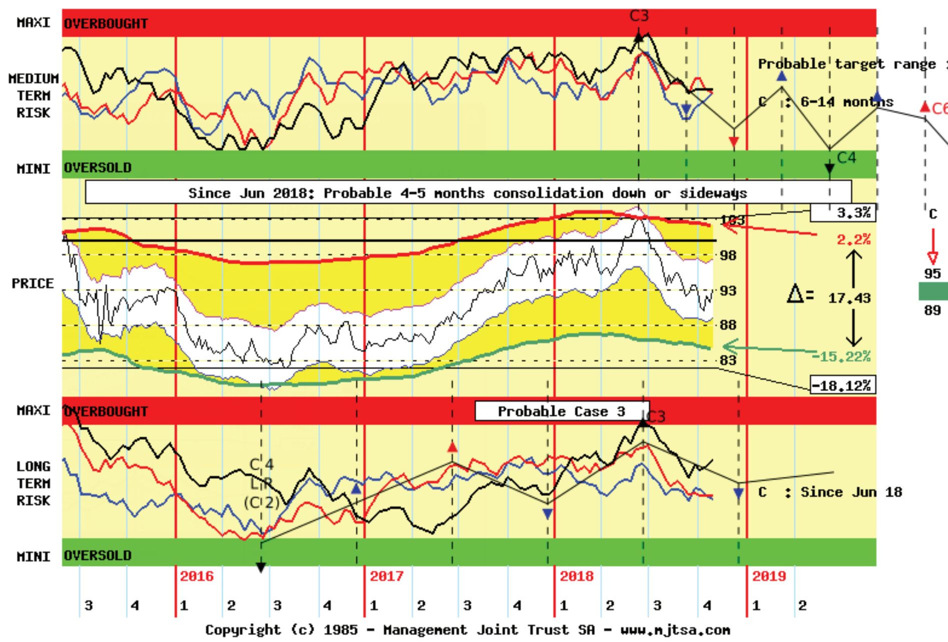
As we mentioned above, an interesting parallel can be made between Yuan and Chinese Equity weakness. This is also true when considering other Emerging markets currencies. Indeed, the Daily graph of Emerging Markets currencies vs the US Dollar does show a similar profile. The portfolio we use here includes the largest 8 emerging market currencies (China, South Korea, Taiwan, India, Brazil, South Africa, Russia and Mexico), cap weighted according to their respective countries' weighting in the MSCI Emerging Markets index. On both our oscillator series (lower and upper rectangles), **we expect this portfolio to resume lower vs the US Dollar, probably from mid November towards January / February 2019**. It is however interesting to note here that this timing is slightly in advance to the one we mention on the MSCI China above (by 1 to 2 weeks). This may be suggesting that **while the US Dollar starts to accelerate up again from mid November, it will start to weigh on China and other Emerging equity markets with a slight lag, probably by late November.**

MSCI Emerging Markets Index
Weekly graph or the perspective over the next 2 to 4 quarters



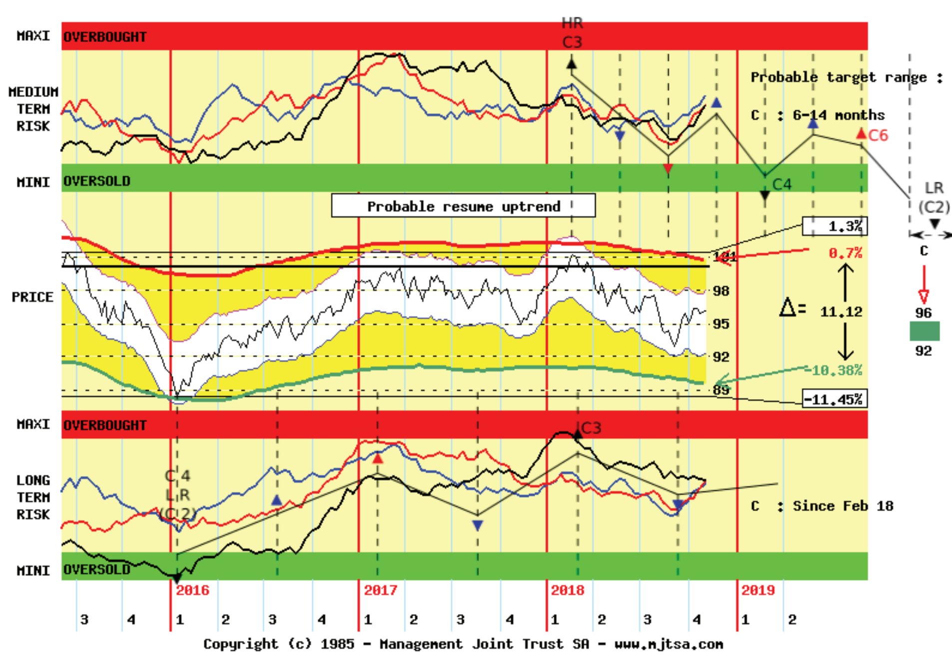
This study would not be complete without showing the resemblance between the wider Emerging Markets index to the MSCI China. Indeed, these show a very similar profile. The index is very much weighted towards China as well as other Asian developing equity markets (China accounts for more than 30% of the index, while together South Korea, Taiwan, India, Thailand, Malaysia and Indonesia account for another circa 40%), yet other Emerging Markets are also linked to China through their important exposure to Commodities and their sensitivity to the US Dollar. As with the MSCI China index, the Emerging Markets index reached a intermediate lows this Summer on both our oscillator series (lower and upper rectangles). Yet, the bounce has been very weak and new lows were made during October. We now expect it to continue lower towards mid Q1 at least, and then following a bounce towards mid next year, we would expect further weakness in H2 2019. Here also, we are currently working through the support of our C Corrective targets to the downside (right-hand scale). Any break below these (below 940), could open the door to additional downside potential, possibly towards a full retracement of the 2016-2017 Bull market. **Given these common negative dynamics, we will continue to avoid hunting for value in Emerging Markets, along with China.**

MSCI China Index vs MSCI Emerging Markets Index
Weekly graph or the perspective over the next 2 to 4 quarters



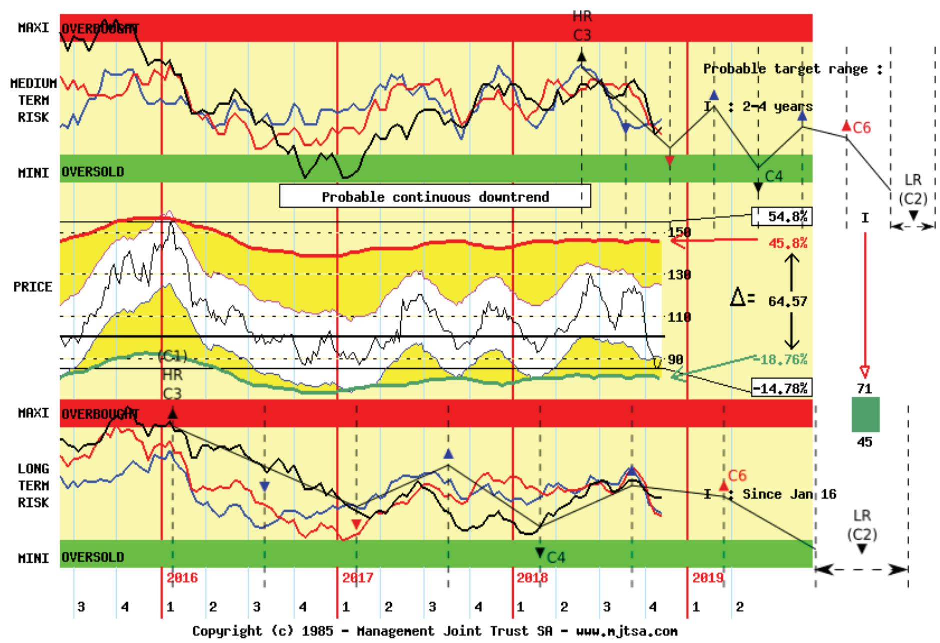
We now attempt to differentiate between the two, i.e. China vs other Emerging markets. Since June and the acceleration in the Yuan's devaluation, China has indeed been underperforming other Emerging Markets. **It is interesting to note that the ratio seems to be lagging the MSCI Emerging Markets index by about 4 to 6 months. This was the case on the lows made in 2016, and again on the tops made this year. Going forward, our oscillators series (lower and upper rectangles) could be indicating that this lag will probably continue**. Indeed, we expect an intermediate low on the ratio towards year-end. Yet, following a slight bounce, China may then continue to underperform other Emerging Markets towards late Q2 next year (as shown on our medium term oscillators; upper rectangle). This is quite worrying as the ratio is currently working through the support of our C Corrective targets to the downside (right-hand scale). If these were to break, the next relative performance support levels are 15 to 25% below current levels. Such developments would probably weigh quite heavily on the whole Emerging markets space, at least well into H1 2019.

EM Currencies – Commodity Producing vs Importing Countries
Weekly graph or the perspective over the next 2 to 4 quarters



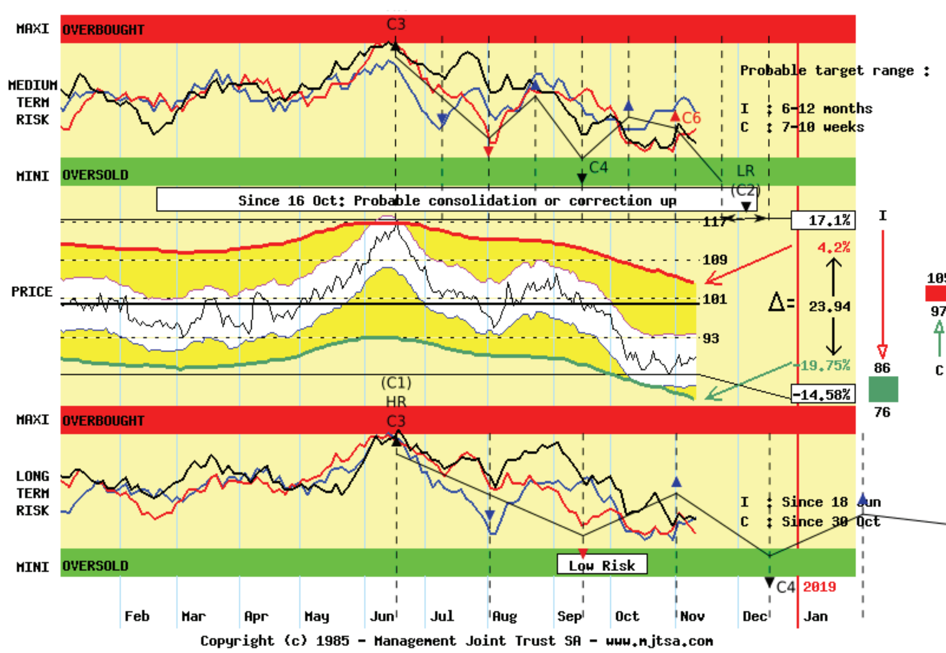
Within the Emerging Markets currency space, it is also interesting to highlight the relative strength between Commodity producing and Importing countries. We have left out the Yuan (and China) for now to focus on other plays, i.e. RUB, BRL, ZAR (Commodity producers) vs INR, MXN, KRW (Commodity importers). The portfolio is equal weighted among all positions (a neutral portfolio). **Commodity producers have seen a decent bounce since September vs Importers. Both our oscillator series (lower and upper rectangles) are now suggesting that they could soon resume lower, probably from the end of this month and towards mid Q1. We then expect them to bounce into the Spring.** Once again here, we are monitoring the support of our C Corrective targets to the downside (right-hand scale), which would probably need to hold, if our bullish case on Commodities, following a last downside retest into Q1 is to have any credence (see our articles on Commodities further up in this issue, pages 37 to 45). Note: interestingly, shorter term, the currencies of Commodity producing countries may hold up a while longer vs the US Dollar, probably until early December, following that, they should catch up to the downside with other Emerging market currencies, probably until mid Q1.

South Korean's KOSDAQ Index vs Brazil's Bovespa in US Dollars
Weekly graph or the perspective over the next 2 to 4 quarters



We now take this comparison to the equity level and compare the South Korean Kosdaq to Brazil's Bovespa (an Asian Growth profile vs a Commodity producer profile). Our oscillator series (lower and upper rectangles) are suggesting that Importers will probably underperform exporters over the next 12 to 18 months. Indeed, while South Korea may bounce slightly vs Brazil from late Q4 2018 into late Q1 2019 (which is in line with our EM currency analysis above), it then probably underperforms throughout the rest of 2019 and into 2020. Our I Impulsive targets to the downside (right-hand scale) for the ratio are much lower than today, some 25% to 50% lower. This suggests than **Asian Growth's underperformance vs Commodity producers may be quite compelling from Spring to end 2019**. Indirectly, it also confirms our view that Commodities may start to bounce again from mid/late Q1 next year.

MSCI China vs a portfolio of Commodity producing countries
Daily graph or the perspective over the next 2 to 3 months



Finally, we compare the China MSCI Index to an equal weighted portfolio of Commodity producing Emerging markets (Brazil, Russia and South Africa). Interestingly, yet not surprisingly, the profile here offers a zoomed version of the graph above. Both oscillator series are suggesting **that China could underperform Commodity producing Emerging markets until mid December, before a bounce is triggered into January / February. Following that, from mid Q1 2019, we expect China (and by extrapolation, Asian Growth equity markets) to start to resume lower against these Commodity producing ones.**

Concluding remarks:

Over the next few months, into mid/late Q1 at least, we remain prudent on China and other Emerging markets. Indeed, during November, we expect the US Dollar to start to strengthen again vs Emerging Market currencies. This process should first impact Asian Growth Currencies and with a slight lag their equity markets, while the process could then spread to Commodity producing Emerging Markets towards early December. We then expect China and all Emerging markets to remain weak until mid/late Q1. Looking into next year, and beyond Q1, our analysis suggests that Commodity producing Emerging Markets could outperform China and Asia Growth countries for the rest of 2019.