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CHINA RATTLES FINANCIAL MARKETS BUT ECONOMIC SCENARIO REMAINS UNCHANGED

International stock markets took a hit at the start of 2016 on yet another wave of worries about China. It's widely accepted that a severe economic crisis in China is the most important risk again for 2016. That said, it's important to keep a close eye on what's really happening. Unlike what many investors seem to believe at the moment, the equity slide and downward pressure on the RMB tell us very little about the underlying economic picture. If anything, the mix of confidence indicators and economic data seen in recent months suggest that earlier stimulus measures start to have a stabilizing effect on the Chinese economy. Therefore, our scenario that a hard landing will be avoided against the back of the authorities' challenging economic rebalancing strategy remains valid.

What then was responsible for the significant drop in Chinese equity market and depreciation of the RMB? The most likely answer is that the anticipation of the planned lifting on share sales (introduced in mid-2015 when Chinese financial markets crashed following a speculative bubble) triggered the equity sell-off. Moreover, it seems that a new circuit breaker system has exacerbated the situation as investors rushed for the exit before markets are closed down when prices drop too fast. There is still a long way to go before China will have a soundly developed financial system in place. If you believe that equity prices in the Western world are heavily subject to mood changes among investors, then investing in the Chinese stock market comes close to playing casino games. At the same time, as relatively few Chinese citizens own equities, the recent stock market crash will not have a meaningful impact on domestic consumption.

All this has also put downward pressure on the RMB but with regards to the latter, the main answer is that in the second half of last year authorities have taken further measures to relax the currency's peg to the USD. The RMB has now lost more than 5% against the USD since last summer, back to around the level where it was 5 years ago. Some observers are arguing that the country is entering a currency war in an attempt to shore up economic growth via a boost of exports and that much more currency depreciation lies ahead. However, we think this view ignores a crucial point. First, versus a broad basket of currencies, the RMB has remained broadly stable last year. More importantly, over the last five years, the RMB has appreciated more than 25% against the currencies of its major trade partners. Talking about a currency war, therefore, seems vastly overdone. Looking ahead, the risk of the RMB sharply moving lower remains contained in our opinion. The chance that the currency loses more against the USD is indeed real but ample FX reserve ammunition implies that any depreciation against the USD will play out gradually. As stated before, authorities are increasingly managing their currency against a broader range of currencies which of course makes complete sense from an economic point of view. Indeed, it totally fits in the much needed rebalancing of the economy and gradual opening of the capital account. Viewed from this perspective, we think the RMB will remain fairly stable in the near future.

The upshot is that the recent financial market turmoil in China and beyond should not signal further economic weakness. True, the latest confidence indicators remained slightly below expectations but that

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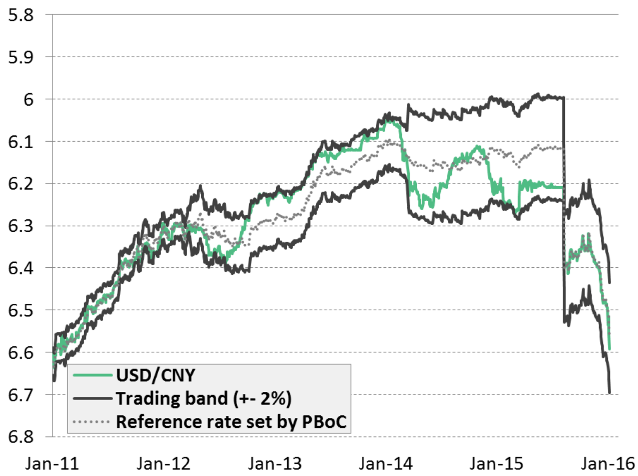
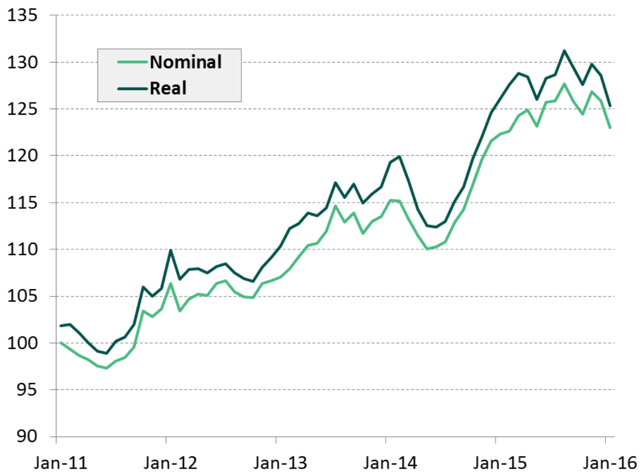
simply cannot explain the storm on financial markets. The data mix from the last couple of months suggests that earlier stimulus measures are starting to do their work and that economic activity is stabilizing. As is the case every year, the upcoming Chinese New Year will make sure that incoming data for January and February will be much harder to interpret. This means we might have to wait until March or April before getting a clearer picture. Those who think that the Chinese economy will quickly rebound are likely to be disappointed. Those who think that growth will continue to slow down over the next couple of years will probably be proven right. This has been our view since many years now. Rebalancing the economy is challenging but earlier stimulus measures and available policy options are likely to make sure that China's economy will do fairly ok in 2016 even though China's stock market may see further trouble.

USD/CNY



CNY effective exchange rate



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