China On A Path To Financial Crisis

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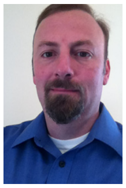

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A Warning For Investors With Exposure To China

The Bank Of International Settlement recently issued a warning that China faces a financial crisis within the next three years. Excessive credit growth and equity markets driven more by "stick than carrot" are leading to frothy market conditions and increasing risk in the banking sector. The reason, the credit-to-GDP gap rose to its highest level since tracking began in 1995 and exceeds that of all other nations. This metric tracks the level of corporate debt a nation carries and is used a an indicator of financial market health. With readings this high China poses the greatest threat to the global financial system ever faced. What makes it even more concerning is that the issuance of Chinese corporate debt rebound in the 2nd quarter, adding another $40.7 billion to the equation.

At present levels the gap between the credit-to-GDP ratio and its long running average is just over 30%. Readings above 10% are considered to be unhealthy by the BIS and a signal of impending disaster. Many economists believe that the PCB will have to recapitalize the banking sector due to an excessive amount of toxic loans. The fact that most of China's debt is held domestically is a mitigating factor that may help shield the rest of the world from the fall-out. The official stance of the government

is that the bans have sufficient capital to weather a crisis.

China's debt problems have been growing for some time and can be traced back to the boom-times seen before the 2009 global credit crisis. The more than $26 trillion in corporate and government bonds is the driving force behind years of above average growth, growth that is only now slowing to the "tepid" pace of 6.5% to 7% (it's hard to know for sure with China's government so tight lipped). At the end of 2015 total borrowing was nearly 250% of GDP. The load may be manageable, the country's growth may catch up, but with the rapid expansion of borrowing coupled with shadow banking practices, off-balance sheet investments and government assurances it is nearly impossible to tell how many loans are in default.

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Considering that there was over $1 trillion in new credit issued in the 1st quarter alone you can be sure there are some.

Chinese authorities are allowing more and more defaults to happen but even this has its risks. A rising tide of toxic loans could dampen or kill GDP growth outright as borrowing costs increase. There is an effort by the banks to swap higher interest loans for lower interest municipal bonds and there is some support from the government but will it be enough. Adding to the problem is an increasing shift to consumer driven economics. The Chinese economy has long been one based on the building of infrastructure but is now more and more reliant on the consumer. While both segments of the economy are still growing both have slowed noticeably from their peaks.

The optimistic view is that China can continue to grow its way out the problem. An expanding economy creates and supports borrowers while inflation erodes the impact of future repayments. Future repayments are more secure than in other regions as evidenced by the high savings rate among the population and current account surplus in the government budget. The pessimistic view is that it is already too late, that without trillions in bail out money and curbs to lending the Chinese financial system is doomed to crash. In between all that is a more likely reality.

The conundrum for investors is three fold. On the one hand, growth remains strong, lending and borrowing remain strong and outlook is positive although well below the peak seen a few years ago. On the other, risks are abundant including the potential for a credit bubble, a housing bubble and worse if the country is not able to sustain long term economic expansion. In between, government policies, reforms and stimulus try to fill in gaps, shore up the weak spots and control the direction of the country at every level.

JP Morgan China Region Fund; Updates On Recent Events

Needless to say investing in China is a difficult task for the average investor. This task is made easy with the JP Morgan China Region Fund and comes with the added bonus of above average dividend yield. The fund is a non-diversified closed end fund trading on the US market with the primary goal of long term capital appreciation. It is focused on the entire China economic arena, not just one segment of the market, and invests in China A and H shares, red chips, p chips and others to get exposure to Chines companies

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doing business inside and outside of China regardless of where they are incorporated.

A spillback dividend for tax year 2015 was issued for shareholders of record 12/9/2016. The distribution is $0.3446 per share, or 2%. The fund already issued nearly $0.75 in distributions during 2015 including ordinary income, short and long term capital gains. Typically this fund will announce prior year spillback in early fall and then the current year distribution later in the season. Last years regular and spillback were about 6% of today's share price leaving a possible 4% in additional distributions if this years returns equals 2015.

Earlier this summer the board of directors and managers of the fund announced plans to seek strategic means to enhance shareholder value and reduce the funds discount to NAV. Since then the board has been in negotiations with the board of the Korea Fund to merge the two funds but those talks have been suspended. The board of JFC announced that the merger negotiations were suspended on mutual agreement between the two fund boards. One reason is unlikely support form shareholders, another is appraisal hurdles presented by the onerous Maryland Business Consolidation Act. Despite this set back the board of JFC will continue to seek out other mergers and/or other opportunities to accomplish their dual goals.

Share prices have held up well in the wake of the ditched merger effort. Trading near $17.50 give the fund a discount of only -9%, below the 6 month average -10% and the 3 year average -12.5%. In terms of shrinking discount this one has been steadily since hitting a historic low last year. The low discount just over -18%, set August 2015, and has been cut in half since that time. The decline may have bottomed however as it has risen from a long term low of -7.5% in the past two months. Regardless, the rapid decline in the discount to NAV shows an optimism in the fund as well as that of the Chinese market.

From the most recent fund fact sheet:

"With the notable exception of domestic China – which is still in bear market territory – equity markets are buoyant. A fall in bond yields and some signs of supply side consolidation in selected commodities (including technology) have spurred fund flows into high-yielding equities and value cyclicals in Greater China. . . our core strategies remain technology, healthcare, consumer and environmental preservation."

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