AMG Market Commentary

May 2013

Feeling Acrophobic on U.S. Equities

Last August in this space, we wrote about our concerns of the then-four-year rally in U.S. equities in a piece titled " *An 'Irrational Exuberant' Rally in the U.S.?*" At that time, the S&P 500 Index was at about 1,411. Fast forward to this day, which is about nine months later, the S&P 500 Index settled at 1,659 as of May 15, or more than 17 percent higher than when we wrote the previous commentary.

It's plain and clear that our previous call was wrong-timed. But instead of changing our mind and moving across to the bullish camp, we are staying put with our cautious view and in fact we are getting more nervous, even acrophobic, as U.S. equities reach new record highs almost as though a daily routine.

First, let's consider for a moment why equity prices (or asset prices in general) go up or down? In our perspective, there are basically three factors at play: fundamental (economical factor), investor confidence (sentiment factor) and money flow (capital factor). Simply put, when the economy is strong and investor confidence is high plus there are money going into the market, it is only reasonable for equity prices to go up. The reverse should also be true. This time, we will examine how U.S. equities sit using this three-factor model.

The chart below (presented in log scale) shows the S&P 500 Index from early-2002 to now. This period encompasses the final stage of the bust of the Tech Bubble, the multi-year rally fueled by the property bubble, the financial tsunami as a result of the bust of subprime mortgages, and then the current rally propelled by record low interest rates and the Fed's unconventional quantitative easing measures.

Within this period, there are two multi-year rallies. From the trough of the tech bubble bust at late-2002, the S&P 500 Index reached a peak by late-2007. Over that stretch of about 5 years, the index has nearly doubled. The financial tsunami caused the index plunging to new depth, reaching a low of 683 in early-2009. From that point, the S&P 500 Index has surged nearly 143 percent in slightly over 4 years' time. Hence, the current rally has gained more in less time than the last one, making it a clear winner in this two-horse race. However, the above chart shows one thing the current rally has lost out, and that is in terms of trading volume. As shown in the lower part of the chart, we can see that trading volume was steadily rising throughout the former rally, whereas trading volume has been trending downward during the current rally. Even in recent weeks when the index broke new grounds day after day, trading volume hardly bulge at all.

Table 1: Global asset class flows, $mn

	Wk % AUM	YTD flows	YTD %AUM	YTD return
Equities	0.0%	105,938	1.9%	9.1%
ETFs	0.3%	52,343	3.5%	-
LO	-0.1%	53,595	1.3%	-
Bonds	0.4%	77,846	2.7%	-0.3%
Money-market	-0.7%	-147,100	-4.6%	0.0%
Commodities	-1.1%	-19,272	-11.4%	-6.8%

* week of 5/01/13
Source: BofA Merrill Lynch Global Investment Strategy, EPFR Global

The lack of trading volume (at the very least the lack of commensurating rise in volume) is all the more perplexing when viewed in combination with money flow data. According to the latest such data compiled by Bank of America Merrill Lynch (as of early-May), there have been net money inflows into global equity funds year-to-date. As can be seen in Table 1, money has been coming out from money-market funds and partcularly from commodity funds and gone into bond funds and equity funds.

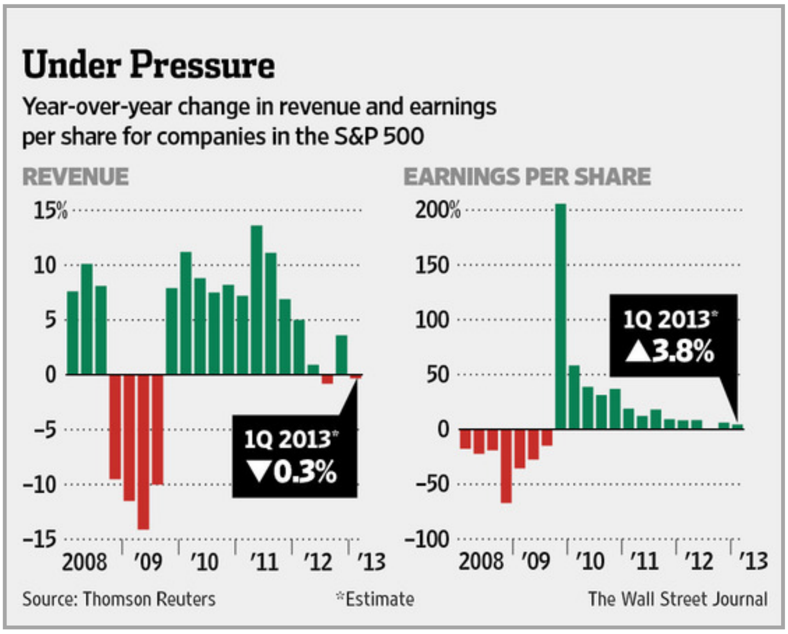
Table 2 shows that more money has gone into developed market funds than emerging market funds, with a ratio of nearly 4-to-1. Among developed markets, U.S. has received the lion's share of net inflow.

So empirical findings suggest new money has in fact moved into U.S. equity funds but this has not translated into higher trading volume. Now then, here is a $39,200,000,000-question for the Sherlock Holmes among our readers: where has the net inflow money gone? While we don't have the answer, we can help to eliminate one possibility, that money went into equity funds did not stay on the sideline as cash. According to the Investment Company Institute (www.ici.org), as of end of March, liquid assets of stock mutual funds in the U.S. stood at 3.7%. This figure is below the 3.8% in February.

Table 2: Net fund flows to global equities, $mn

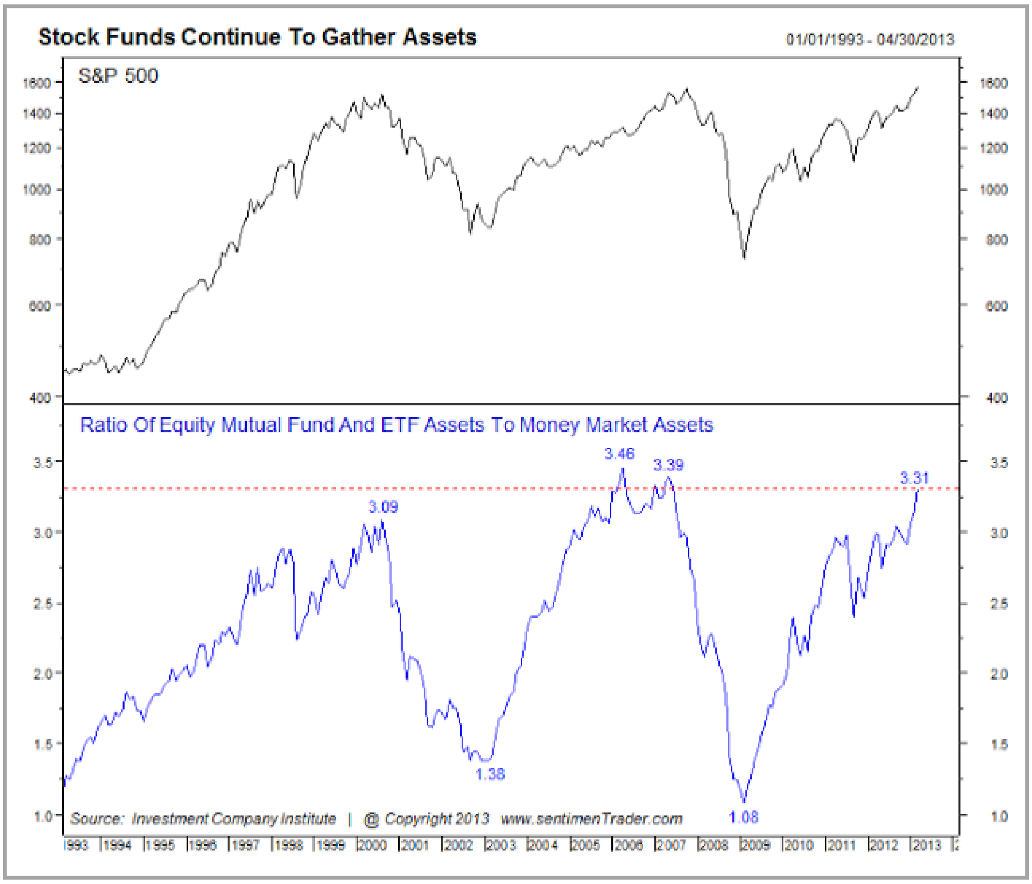
	% AUM	YTD
Total Equities	**0.0%**	**105,938**
long-only funds	-0.1%	53,595
ETF's	0.3%	52,343
Total EM	**0.1%**	**22,444**
Global EM Funds	0.3%	18,178
Asia	-0.2%	7,233
EMEA	-0.2%	-2,478
LatAm	-0.3%	-488
Brazil	-1.0%	-2,192
Russia	-0.7%	-1,478
India	0.4%	-566
China	-0.2%	-629
Indonesia	-0.8%	413
Taiwan	-0.3%	-663
Total DM	**0.0%**	**83,494**
US	0.1%	39,200
Canada	0.2%	-1,587
Europe	-0.2%	-1,589
Japan	1.0%	17,416
Pacific	0.2%	384
International	0.0%	29,673

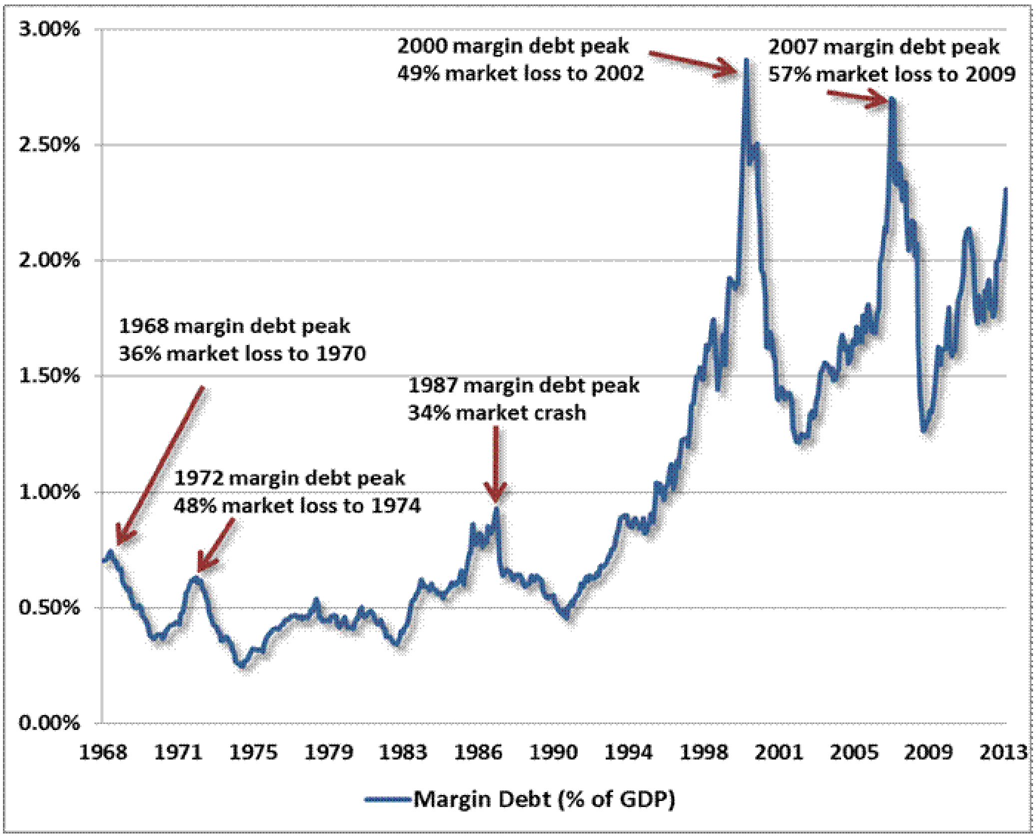
Total Equities = Total EM + Total DM
Source: BofAML Global Research, EPFR Global



So money flow data do not provide affirmative support for the market rally, let's consider the fundamental aspect.

Readers who stay abreast of economic news on U.S., or those who have been reading the Market Review section in this newsletter over the past few months, would comprehend that while the U.S. economy is growing it is at best at a pedestrian pace. Should the stock market mirror an economy's strength, such tepid rate of growth surely would not warrant the runaway rally in the U.S. stock market. If anything, one should be more skeptical of the rally in view of the two charts to the left. The charts show year-over-year growth in revenue and earnings per share (PER) of companies that made up the S&P 500 Index. Quite clearly, revenue growth has been decelerating since the peak in 2011. More importantly, PER growth has been rapidly slowing since the fourth quarter of 2009. This means share prices have been trading up on drastically slowing corporate sales and profit growth. There's not a very comforting sign to us!





The third factor to ponder is investor confidence (market sentiment). In this regard, there is little doubt sentiment is red hot.

We have shown in Table 1 above that investors have been switching out of money market funds and commodity funds and piling onto equity funds. The flow from low risk money market funds to equity funds is an unequivocable sign of investor confidence in the stock market. The lower chart to the right offers a way to gauge the current investor bullishness and how does it compare to the past. Specifically, the chart shows the ratio of total assets in equity mutual funds and ETFs to that in money market funds. Simply put, the higher the ratio, the more investors wager in stocks. As we can see, as of end-of-April, this ratio has surged to levels just shy of the peak(s) just prior to the burst of the subprime mortgage bubble.

The bottom chart offers a different look (and measure) of investor bullishness in the form of NYSE margin debt (i.e., the amount that investors have borrowed to purchase New York Stock Exchange-traded stocks on margin) as a percentage of U.S. GDP. The chart was updated as of end-of-February, and at which point shows margin debt is more than 2.3% of GDP, which is the highest level on record with the exception of the approaches to the 2000 and 2007 market peaks. While investor sentiment may drive this ratio higher still, it is important to keep in mind that the collapse of such highly leveraged positions could happen abruptly and without forewarning.

In summary, by using our three-factor model to examine the U.S. equity market rally, we have found that economic fundamental is not supportive of the strong run in share prices. And while there are evidences of money flows into stock funds, the lack of commensurated rise in trading volume makes this an inconclusive supportive. That leaves investor sentiment as the indisputable driver of ever-higher share prices. But sheer momentum without substance may not be longlasting. For those who have just hopped onto the bandwagon, we leave with this last word: *caveat emptor!*

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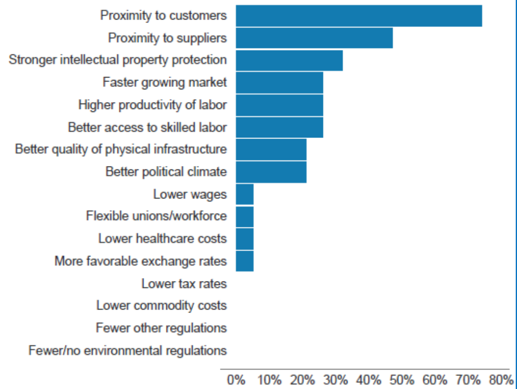
Market Review & Outlook

U.S.: Neutral

There is clear evidence that the decades-long shifting of U.S. manufacturing capacity to China/EM has stopped. Benefits of lower energy costs and superior labor productivity argue for U.S. manufacturers to "re-shore". However, there remain some stumbling blocks to deter companies from moving back to U.S. en mass. One critical factor is the U.S. corporate tax rate, which stands at 10 percents or more above major trading partners; and the other concern is whether the U.S. can provide tax benefits (such as tax incentive schemes) to attract substantial capacity expansions in automotive and energy-intensive sectors such as paper, metals, and chemicals.

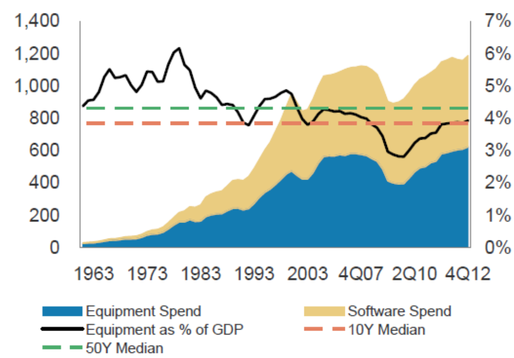
Top Drivers for Manufacturing Re-Shoring Back to the US (% of Companies Citing as a Major Factor)



Source: AlphaWise, Morgan Stanley Research, N=21

Another consideration is currency. Rising domestic energy production could put an upward bias on the US Dollar. While companies claim not to factor currency into their capacity relocation decisions, there is no question that a stronger US Dollar could reduce competitiveness of U.S.-based exports, thus offsetting some of the benefits from lower energy costs.

Private Sector Fixed Asset Investment (ex-Construction) Has Rebounded from 2009 Lows, but Is Still Relatively Low as a Percentage of GDP

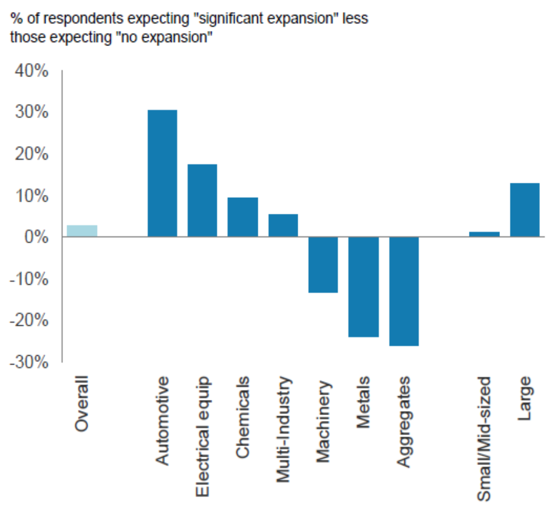


Source: Federal Reserve, Morgan Stanley Research

Much has made of China's labor cost inflation and higher energy prices as primary drivers of a US manufacturing renaissance. However, these categories are relatively minor input costs to the general US manufacturing sector, dwarfed by raw materials and component purchases. Transportation costs are also significant for many industries and there has been a clear trend towards reducing supply chain complexity. Supply chain shortening, rather than labor and energy prices, has been the primary driver for the limited US capacity re-shoring that has taken place to date.

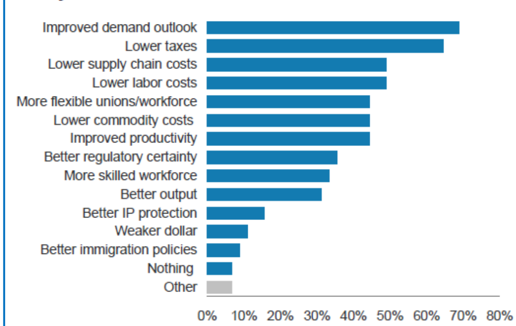
A recovery in the Industrial Production/GDP multiplier over the 2010-12 period – the first time of a positive IP multiplier since 1998 – and a pick-up in the U.S. share of global trade provide some evidence that the off-shoring trend has now stopped or, at a minimum, significantly moderated.

Over the Next 5 Years, There Is a Modest Bias Towards 'Significant Expansion' vs. 'No Expansion,' of US Manufacturing Capacity



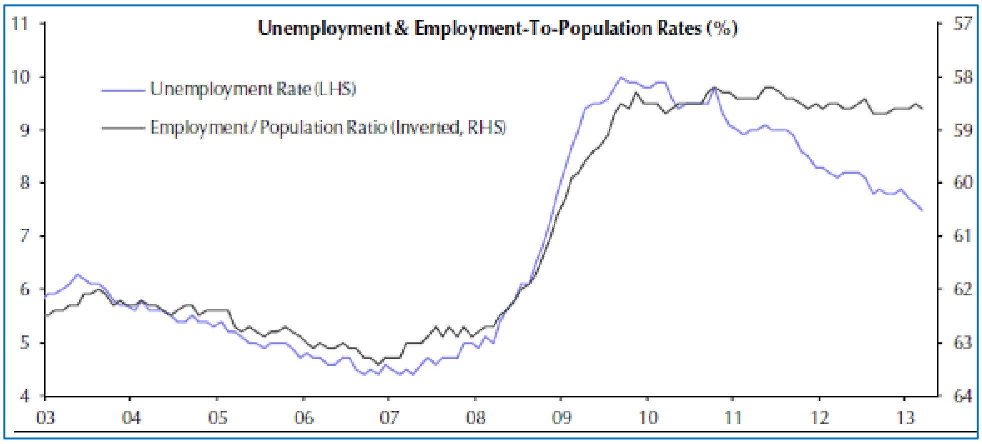
Source: AlphaWise, Morgan Stanley Research

Improved Demand Outlook and Lower Taxes Are Top Factors That Would Make Large Firms More Likely to Manufacture in the US in the Next 5 Years



Source: AlphaWise, Morgan Stanley Research

However, despite some high profile announcements of increased US manufacturing capacity, there is little real evidence of a manufacturing "renaissance" underway. Manufacturing capex is still at depressed levels, while private sector non-construction/IT investment is also at the lower end of the depressed range seen during the period following China's accession to the WTO.



The better than expected 165,000 increase in non-farm payrolls in April, combined with the aggregate 114,000 upward revision to gains in the preceding two months, has soothed fears of another spring slowdown. With the unemployment rate edging down to a four-plus-year low of 7.5%, the Fed may yet begin to slow the pace of its asset purchases sometime in the second half of the year.

Employment Report

	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr
Unemployment Rate (%)	8.1	8.2	8.2	8.2	8.1	7.8	7.9	7.8	7.8	7.9	7.7	7.6	**7.5**
Change in Non-Farm Payrolls (000s)	112	125	87	153	165	138	160	247	219	148	332	138	**165**
Average Hourly Earnings (%m/m)	0.1	0.2	0.3	0.1	0.0	0.3	0.0	0.3	0.3	0.1	0.2	0.0	**0.2**
Average Hourly Earnings (%y/y)	1.9	1.8	2.0	1.7	1.7	1.9	1.6	1.9	2.1	2.1	2.1	1.8	**1.9**
Average Weekly Hours Worked	34.5	34.4	34.5	34.4	34.4	34.4	34.4	34.4	34.5	34.4	34.5	34.6	**34.4**

Source – Bureau of Labor Statistics

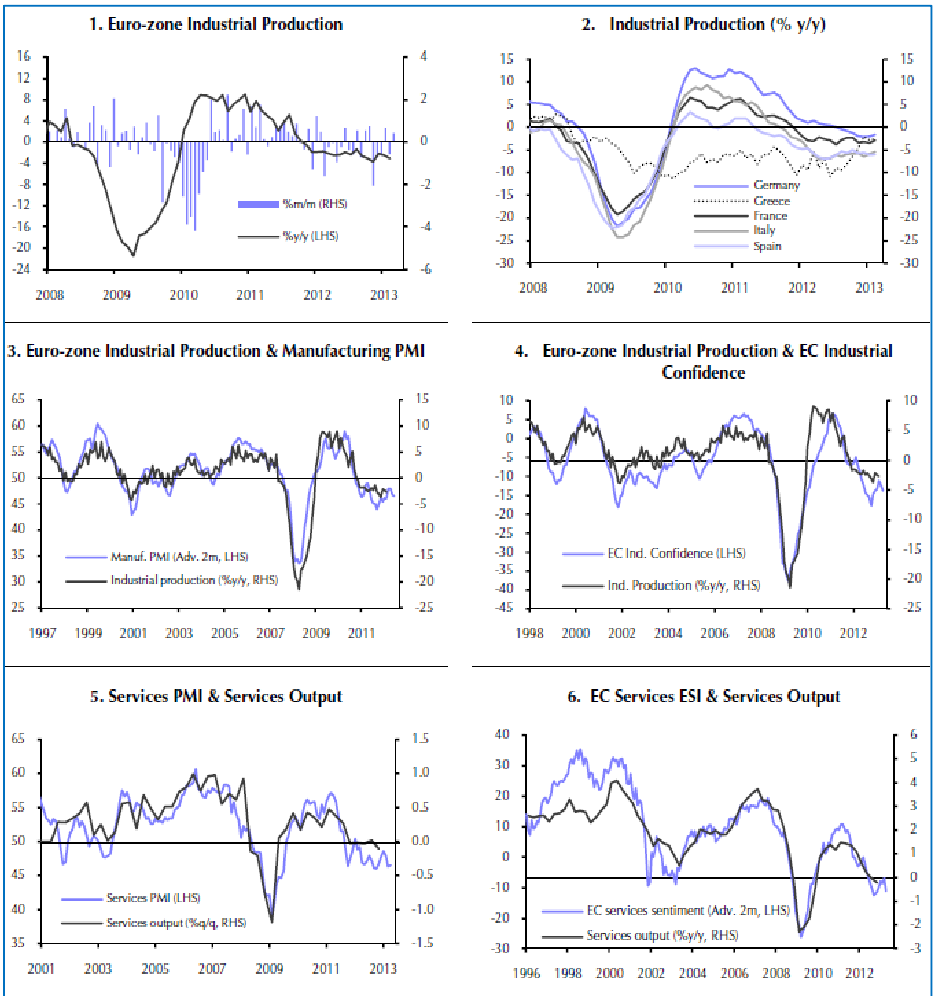
In terms of job gains in various industries, manufacturing employment was unchanged in April, while construction employment actually declined by 6,000. Retail employment increased by a healthy 29,000 and leisure increased by 43,000, suggesting that, perhaps buoyed by the recent declines in gasoline prices, households were out spending.

Europe: Neutral

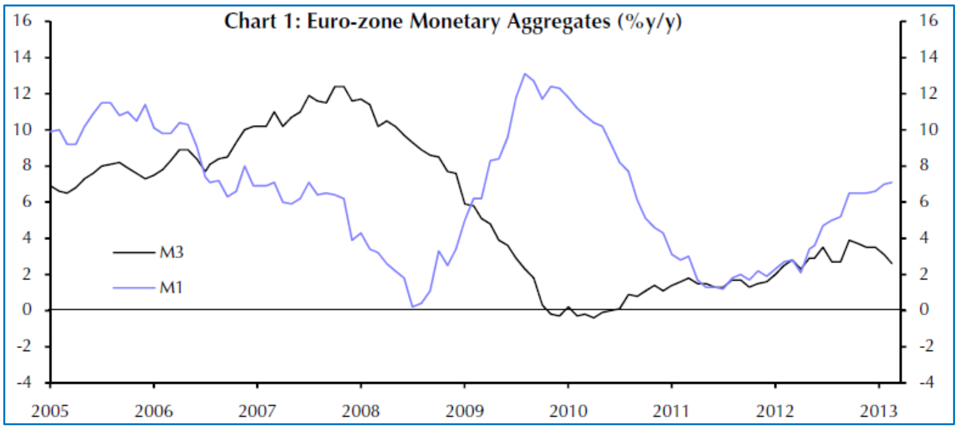
The latest euro-zone monetary data showed little sign of improvement in financial market conditions or pick-up in provision of credit to the private sector.

Annual growth rate of euro-zone broad money supply (M3) slowed from 3.1% to 2.6% in March. Encouragingly, both M1 and M2 – 'narrower' definitions of money – expanded further from previous month again. Deposits by households and firms grew a healthy 4.2% on the year. But while this suggests improvement in confidence in the overall banking sector, distribution of deposits within the euro-zone was always the bigger problem. Deposits in Cyprus, for instance, fell 3.9% from February in the wake of the country's bailout.

The slowdown in M3 growth was again driven by a fall in short-term marketable instruments. While this is a volatile component, sustained falls in repurchase agreements and the issuance of debt securities suggest tough bank funding conditions.



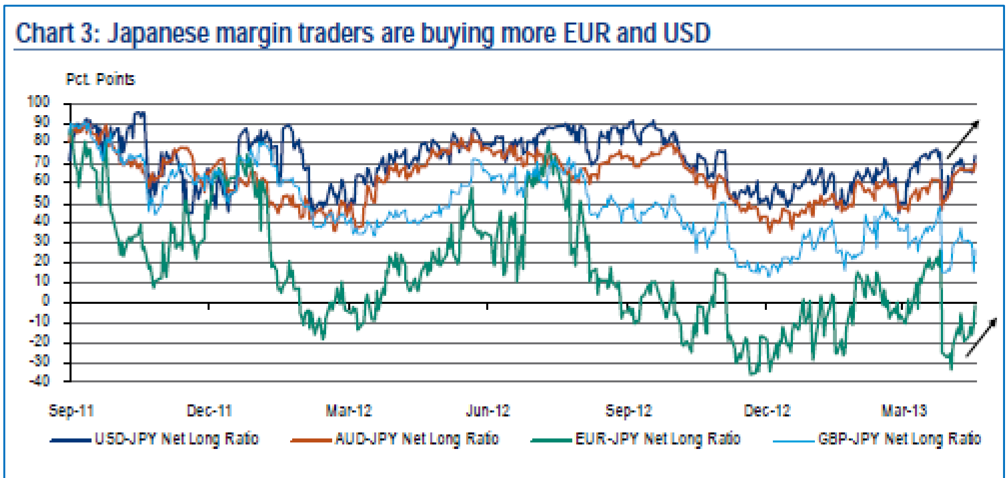
Sources – Thomson Datastream, Markit, Capital Economics



Recent euro-zone business indicators point to a renewed deterioration in the economy after a run of slightly more positive data in Q1. Although industrial production rose in February, it failed to reverse the previous month's fall. Production is now contracting fairly sharply across the euro-zone, including in Germany. Manufacturing PMI and industrial confidence indicator point to further falls ahead. Indeed, the latter is consistent with an accelerating pace of contraction.

Investors seem confident interest rates will remain low in the euro-zone. At the beginning of this year, there was a period of increased optimism towards the region which in turn exerted some upward pressure on implied overnight rates. But this has subsided in the wake of political uncertainty in Italy, the crisis in Cyprus and ongoing economic weakness.

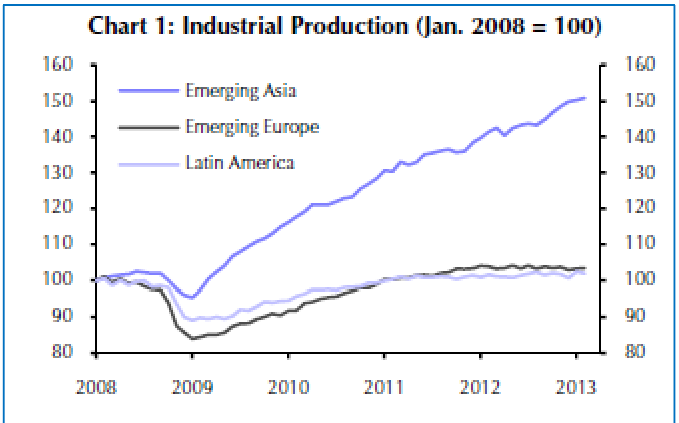
Japan: Positive



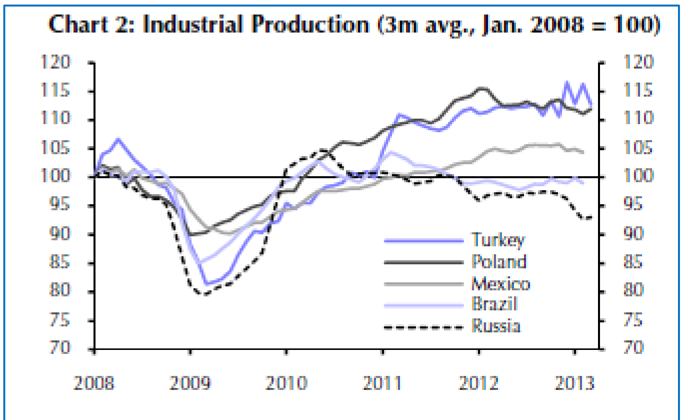
Source: BofA Merrill Lynch Global Research, Gaitame.com

While output in Asia was increasing at a fairly healthy pace over the past twelve months or so, production in Emerging Europe and Latin America has flat-lined. The strength in Asia comes despite the weakness of China's economy (from a historical perspective yet still robust in absolute terms) shows that the region will outperform over the next couple of years. The outperformance of Asian industry has been a consistent theme for the past five years. Indeed, while industrial production in Asia is now 50% larger than at the start of 2008, the size of industry in Emerging Europe and Latin America is pretty much unchanged.

Admittedly, there are a handful of exceptions at the country level. Industry in both Turkey and Poland has grown by a little over 10% since the start of 2008, while in Mexico it has grown by around 5% or so. Output in Brazil is slightly smaller than it was at the start of 2008, while in Russia output is down by more than 5%.



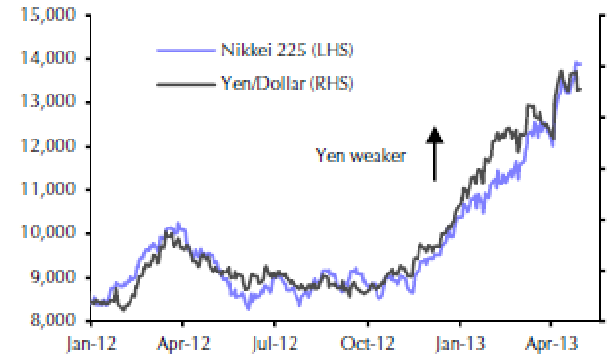
Sources – CEPB, Thomson Datastream, Capital Economics



Sources – Thomson Datastream, Capital Economics

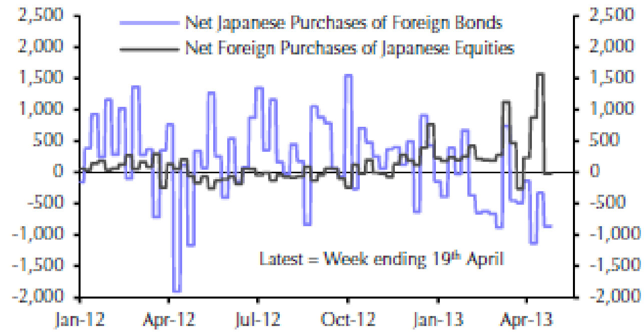
For a start, yields on Japanese government bonds (JGBs) were already very low before the Bank of Japan's announcement of doubling of asset purchases. Indeed, these purchases might actually lead to higher yields on JGBs than would otherwise have been the case, as inflation expectations rise and investors seek to rebalance their portfolios towards riskier assets.

Chart 1: Nikkei & Yen/Dollar



Source – Thomson Datastream

Chart 2: Net Portfolio Flows (Yen Billion, Weekly)

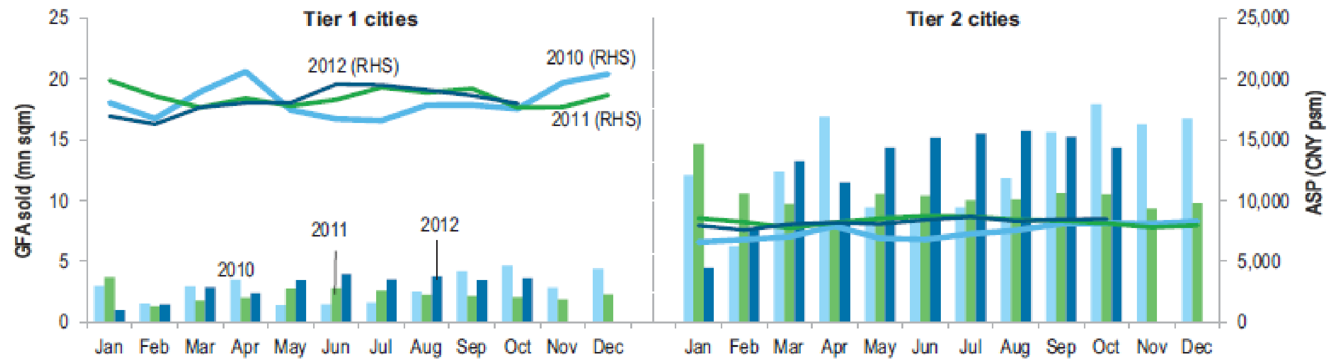


Source – Thomson Datastream

Of course, the increase in central bank purchases will reduce the supply of JGBs left for other investors, which might force some institutions which are constrained to buy bonds to increase their purchases of substitutes, such as US Treasuries. The Bank of Japan is trying hard to minimise disruption to the JGB market.

Above all, the coordinated attempts by Japan's government and central bank to end deflation and boost economic growth will surely increase the relative attractiveness of Japanese assets, including equities and property, just as much for domestic investors as they had for the foreign investors who have led the rally so far. This is probably just as well, as foreign appetite for Japanese equities appears to have waned again.

Figure 1: Monthly new sales and ASPs in Tier 1 and selected Tier 2 cities* *(2010 to Oct-2012)*

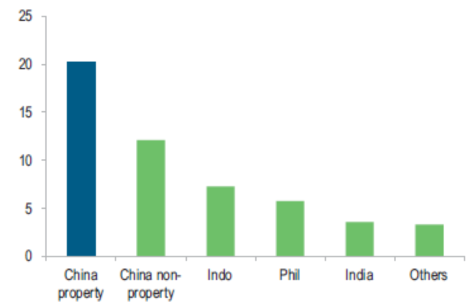


** Including four Tier 1 cities and 20 Tier 2 cities;* Sources: CRIC, Standard Chartered Research

China: Neutral

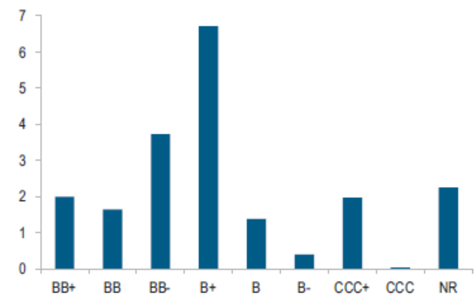
The property market cooled but did not crash. Housing prices were largely flat in 10M-2012 (Figure 1). While some cities and property segments recorded larger declines of c.5-15%, China's housing prices did not plunge by 30-40%, as some had feared.

Figure 2: Asian HY bond market by country and sector
As of 5-Dec-2012, USD bn



Sources: Bloomberg, Standard Chartered Research

Figure 3: Outstanding China property bonds by rating
As of 5-Dec-12, USD bn



Sources: Bloomberg, Standard Chartered Research

Property demand remained healthy, despite the removal of speculative demand after two years of strict policy controls. Supply risk is moderate thanks to developers' continued destocking efforts amid slowing construction progress and reduced new project starts. ┐

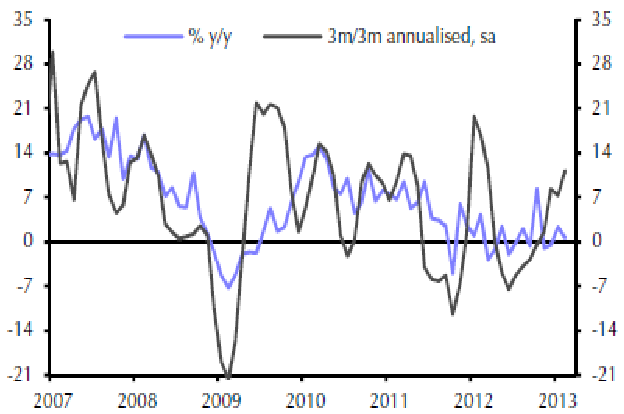
Geographically, Tier 1 and Tier 2 cities outperformed lower-tier cities. On the policy front, government property-market measures were neither loosened nor tightened, although some local fine-tuning was allowed if it did not interfere with the central government's bottom line on home-purchase restrictions. ┐

Housing affordability improved for the first time since 2009 on softening home prices and lower mortgage rates. Market consolidation continues. Some developers have exited the market upon project completions and/or disposals.

These include small developers with only a couple of projects, those with weak financial and operational management, and those for which property development is not their core business. This process has been orderly, however.

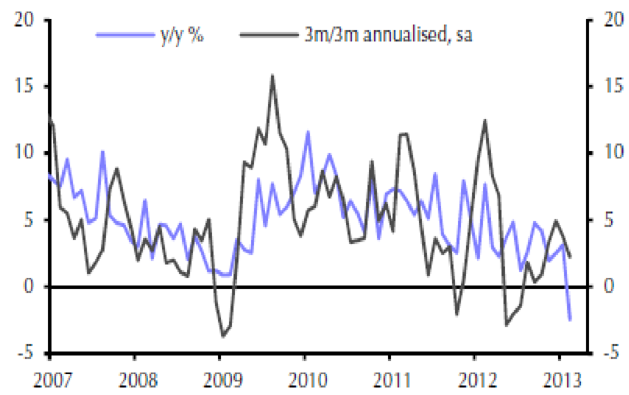
India: Neutral

Chart 1: India Industrial Production



Sources – CEIC, Capital Economics

Chart 2: India Infrastructure Index



Sources – CEIC, Capital Economics

Industrial production eked out a 0.6% YoY gain in February. This was better than consensus (the Bloomberg median was -1.3%). On a 3-mth over 3-mth (annualized) basis, the recovery was more impressive (see Chart 1). However, a sustained recovery cannot yet be taken for granted due to three main reasons.

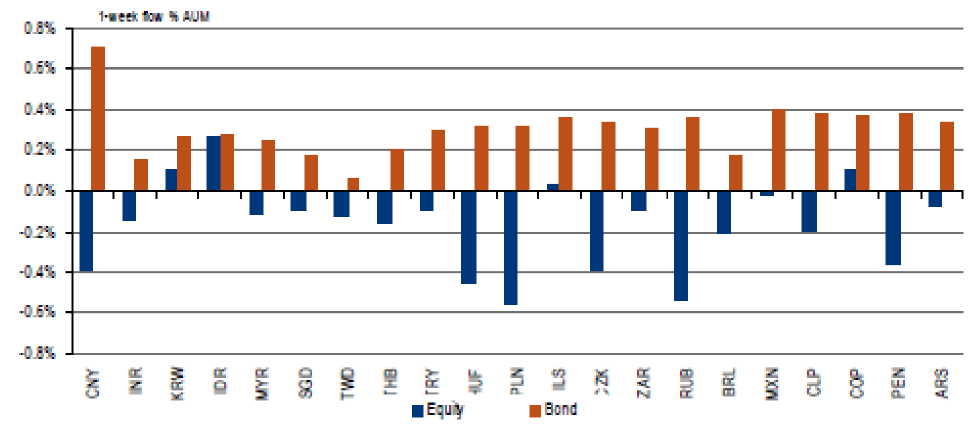
Firstly, on a YoY basis, electricity output led the downturn in the "core infrastructure index", which accounts for 37% of the overall IP index. This decline is unprecedented, and may reflect one-off factors related to ongoing problems in coal production and electricity pricing. However, if the infrastructure slump persists in coming months, the expected economic recovery this year would begin to look doubtful.

Secondly, recent data shows that the auto sector remains in a funk, with both car and two-wheeler sales contracting for the second month in a row. The slump in sales results from ongoing fuel price increases, weakening real incomes (on account of high inflation), and tight credit standards. This has negative implications for the outlook for the domestic steel industry and overall consumption.

Thirdly, the upturn in capital goods production looks unsustainable. This is because the 9.5% YoY gain was relatively strong in nearly a year, and comes amid slumping automobile demand, a sharp downturn in infrastructure and still weak exports. As such, it is still too early to call an end to India's investment drought.

Asia Pacific: Mixed

Chart 2: EM FX is driven more by bond inflows than equity recently



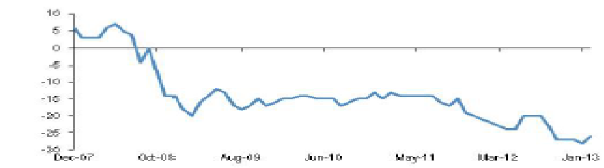
Source: BofA Merrill Lynch Global Research, EPFR

Growth concerns are causing EM investors to shift allocations. Since April, EM exposure has been preferred through bonds ($4.2bn in inflows, $1.1bn in the latest week) rather than equities ($3.8bn in outflows). The bulk of investor interest remains concentrated in local debt (Chart 2), implying inflows should continue to add support to EM currencies. Asian currency seems to be the target of international liquidity.

Malaysia has underperformed EM in general, and EM has significantly underperformed developed markets. Malaysia's experience is in sharp contrast to its ASEAN neighbors. The case for Indonesia, Thailand and the Philippines is domestic consumption and investment growth. The statistics in Malaysia are: Capex growth in 2012 was 20%oya, up from a five year average of 7%oya (funded by Savings-Investment gap of 11% of GDP).

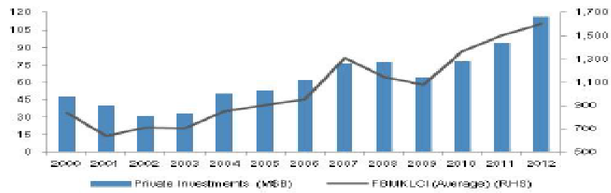
Local investors have net sold US$1.8 billion in the past 13 months. This is despite net inflows into provident funds. EM funds are significantly underweighting Malaysia.

Fund Manager positioning in Malaysia relative to EM (net OW)



Source: MSCI, EPFR.

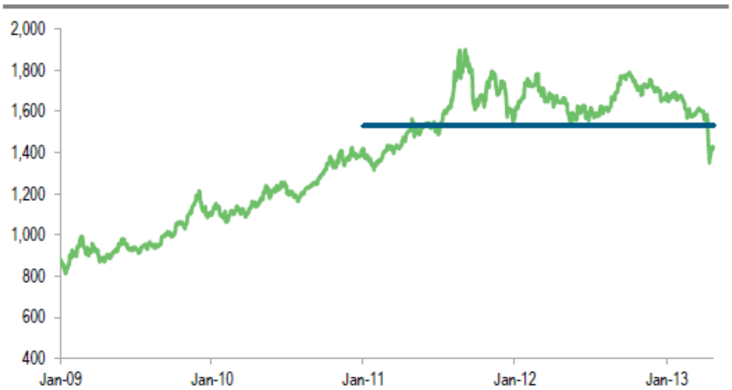
Investments vs FBMKLCI



Source: Bank Negara. Note: Correlation of private investments vs FBMKLCI : 0.9x (Total investments vs. FBMKLCI : 0.96x)

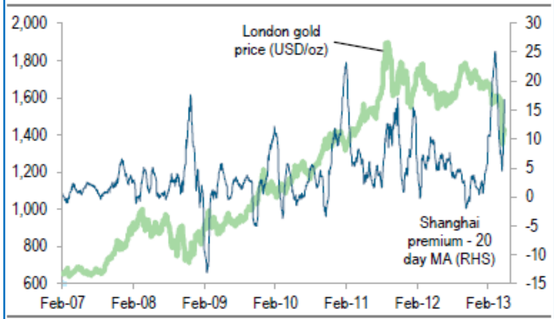
Commodities: Negative

Figure 1: The gold bull run is tested, as long-term support levels give way
Spot price USD/oz



Source: Bloomberg

Figure 2: Shanghai gold premium over London (USD/oz)
London price (LHS); Shanghai premium (RHS)

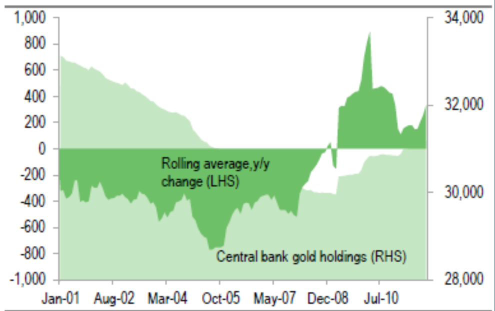


Source: GFMS

Gold price has experienced drastic drop over the past month. However, physical demand has surged across the world as individual consumers and retailers sensed a bargain and flooded to sales outlets to pick up coins and investment bars. Refineries are now trying to respond to the surge in orders but it could take 2-6 weeks to restock the system and meet pent-up demand. The strength of underlying gold demand will become more evident from around mid-May when this extra supply starts to filter through.

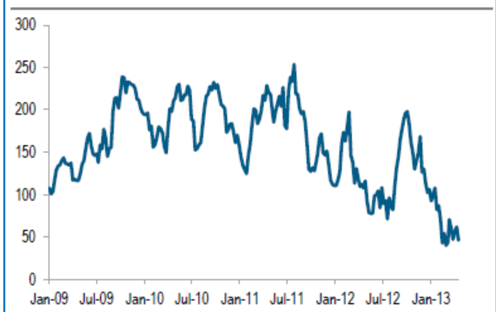
Volumes on the Shanghai Gold Exchange have also surged and reached a record high 43t on 19 April (the previous peak was 30t). The premium on Shanghai over London has reached its highest level since at least 2007.

Figure 3: Central bank sales have dried up for now
tonnes



Sources: Bloomberg, Standard Chartered Research

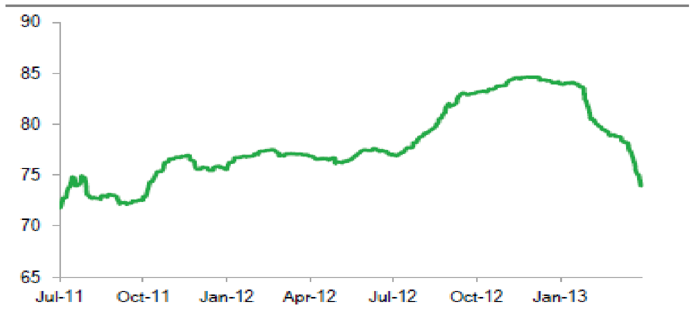
Figure 4: CFTC managed money positions in gold
'000 contracts



Source: Bloomberg

The early response from central banks adds to the bullish story. On 19 April Azerbaijan said it would buy 12t of gold. (This compares with a possible sale of 10t of gold by Cyprus.) Sri Lanka said it sees lower prices as a buying opportunity. The most recent IMF data shows that central banks continued to buy gold aggressively in the run-up to the recent price drop. Korea bought 20t in February; Turkey raised its gold reserves by 33t in March; Russia bought 5t in March. It is interesting to speculate about China's position though no official words have been given.

Figure 5: Major physical ETFs for gold
Million oz



Sources: Bloomberg, Standard Chartered Research

Bonds: Mixed

Conventional wisdom says that corporate bond yields should trade at higher premiums than their respective government benchmarks for two main reasons.

Firstly, it is assumed that there is a greater chance of a company defaulting on its debts than a government, so the market need to be compensated for default risk. Secondly, corporate bonds tend to be less liquid than bonds issued by their respective governments, so the market need some additional spread over and above that needed for default risk.

This is all quite intuitive, but things have changed dramatically during this longlasting financial crisis. Conventional wisdom regarding the relative pricing of risky corporates and risk free governments is being challenged. Put simply, many developed world governments' balance sheets have deteriorated, with debt/GDP ratios increasing to potentially unsustainable levels. So whilst corporates have remained in quite good shape, sovereign credit quality is deteriorating relative to corporate credit quality in many places, including Europe, as the figure illustrates.

Figure 1. The changing relationship between sovereign and corporate credit quality in Europe

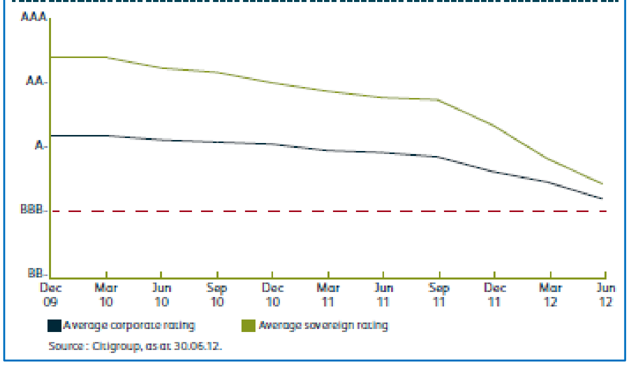


Figure 2. Pre crisis: Greece CDS trading tighter than OTE

Figures 2 and 3 show the CDS spread of Greek telecommunications firm OTE versus Greece before and after the crisis, illustrating that the dire macroeconomic picture there did have a significant impact on the viability of its corporates (OTE CDS spreads widened to more than 2300bps). However, OTE did not default or restructure when the sovereign did (note that Deutsche Telekom has a 30% stake in OTE, but OTE's bonds have no explicit support from its German partner). OTE isn't an isolated case. Other examples of Greek corporates that didn't suffer the same fate as the sovereign are Fage Dairy, Titan Cement, and Coca-Cola Hellenic (which is shifting its headquarters to Switzerland and gaining a UK listing).

Figure 3. Post crisis: Greece CDS well wide of OTE

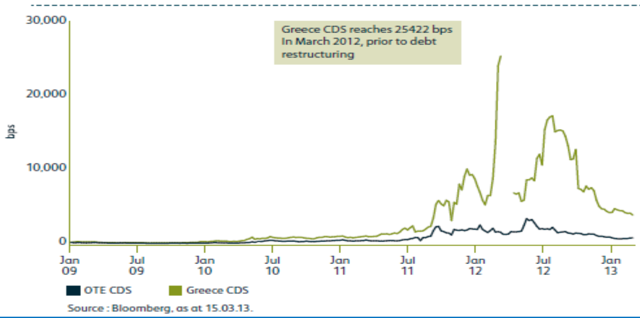
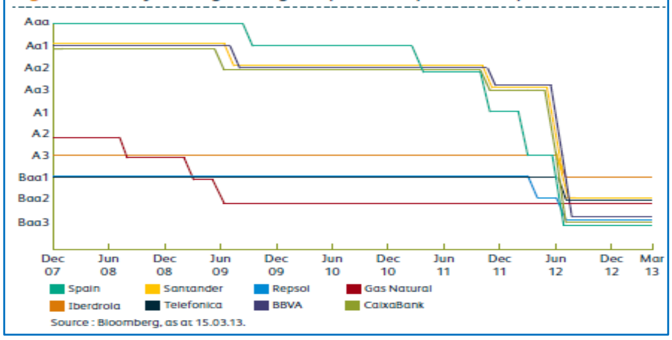


Figure 4. Moody's ratings of largest Spanish corporates vs Spain



This real change in relative risk between corporate and government debt is not just confined to countries that have fallen into junk territory. It can also be observed in economies that are under stress but are still investment grade, such as Spain, as figure 4 illustrates.

* Unless otherwise stated, all figures and information are collected from WSJ, Bloomberg or Haver Analytics.

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