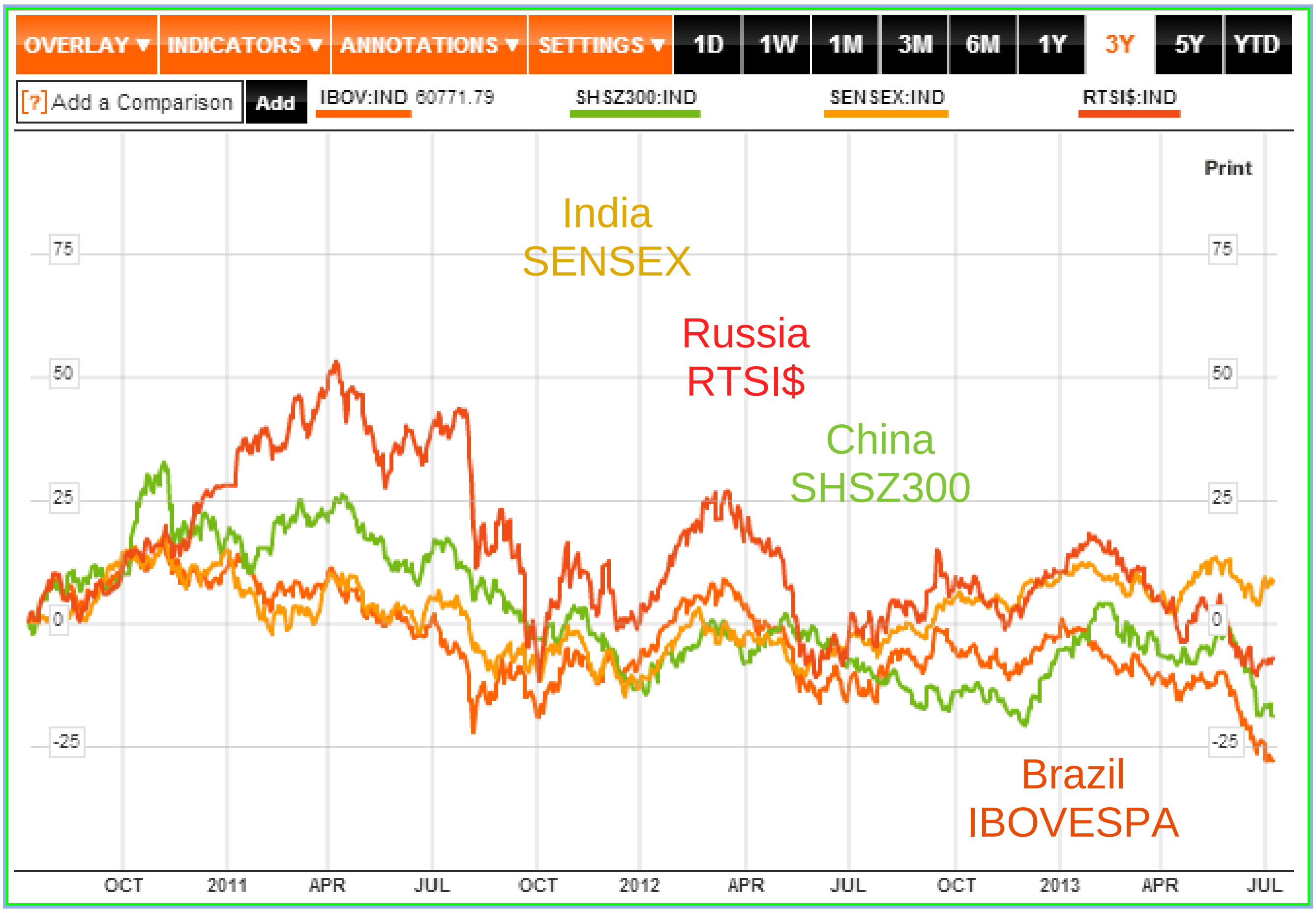
AMG Market Commentary

July 2013

BRIC – Are They Still Relevant?

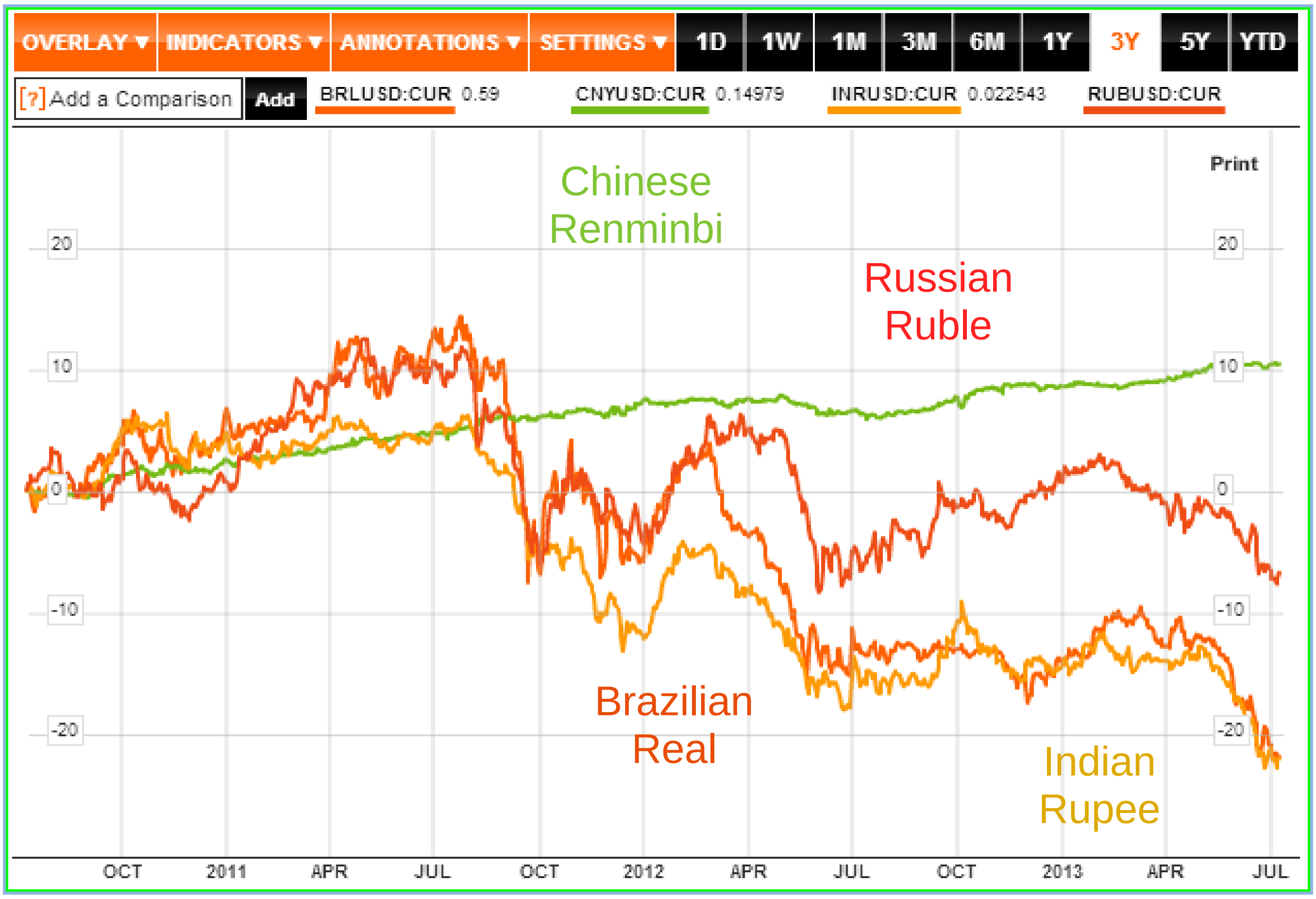
The term BRIC (which stands for Brazil, Russia, India and China) was first coined by Jim O'Neill, when he was an economist at Goldman Sachs, back in 2001. O'Neill was convinced that these four emerging economies will grow rapidly into economic superpowers that will rival developed countries and lead global growth for years to come. According to International Monetary Fund data, the combined gross domestic product of the BRIC nations reached US$14.5 trillion last year from US$2.8 trillion in 2002. Collectively, the group's GDP is getting close to matching that of the U.S. at US$15.7 trillion. The group has also played an important role in boosting global growth, accounting for 62 percent of growth in 2012, up from 11 percent a decade ago, as per IMF data.

In a recent interview, O'Neill said the term was used to explain an economic aspect rather than an investment concept. However, the term only became a household name after investment funds bearing the name mushroomed and popularized. In Chinese, the term BRIC is translated as "golden brick" (金磚四國). And for a period, these funds had delivered *gold* to investors thanks to stellar market returns. Not so for the past 3 years.



As shown in the above chart, with the exception of India's Sensex, these once roaring stock markets have suffered varying degrees of decline over the past three years. It should be noted though the returns were based on local currency terms. For investors outside of these four countries, equally important is to see how their currencies' exchange rate versus the U.S. dollar changed over time. This information is presented in the chart below.

As we can see, apart from China's renminbi, which has steadily risen against the USD, the other three currencies have fallen considerably during this period and that added to decline in share prices. Hurt by stubbornly high current-account deficit, reaching an all-time-high of 4.8% of GDP in the first three months of this year, India's rupee has fallen to record low earlier this month.



According to data compiled by Bloomberg, the MSCI BRIC Index fell 12% in the first quarter quarter while the nations' currencies sank 4.1% against the U.S. dollar. At the same time, government bonds also fell having lost an average of 0.6%. Such universal decline of stocks, bonds and currenices is quite uncommon, with the previous occassion dating back to 2006. As one would expect, investors have reacted with their feet. According to EPFR Global, a research firm that tracks fund flows into and out of mutual funds, investors withdrew $13.9 billion from equity mutual funds invested in the four countries in the first six months of this year, or 27 percent of aggregate net inflows since 2005.

	GDP Growth			
	Brazil	Russia	India	China
2010	7.5%	4.5%	10.1%	10.4%
2011	2.7%	4.3%	6.8%	9.3%
2012	1.3%	3.4%	6.2%	7.8%
Latest Qtr	0.6%	1.8%	5.0%	7.7%

Disappointment in financial market performances notwithstanding, there is a growing and broadening feeling of gloom and doom among investors and analysts alike in BRIC economies. To some extent, this is justified by sharp deceleration of GDP growth in recent years, as can be seen in the table to the right. For instance, Brazil's GDP growth in the first quarter of this year, at an annualized 0.55%, is only a fraction of the pace of 2010. Even China's once-almighty economy has slowed to a pace, if sustained for the rest of the year, that is the weakest annual expansion since 1990.

Facing such grim prospects, should investors write off BRIC categorically? We do not think so. From a valuation stand point, these markets are now trading at multi-year or even record low levels. Brazil's Ibovespa Index has a price-to-book ratio of 0.9, the cheapest since 2005 versus the global index. The 0.7 multiple on Russia's Micex

Index is the lowest among equity gauges in 21 developing nations that Bloomberg tracks. China's Shanghai Composite Index is near the lowest level, in terms of price-to-earning ratio, ever recorded.

Moreover, despite growing at slowest pace in years, these four economies remain a tour de force that will drive and propel global growth. Jim O'Neill contended that "Before the end of 2015, they will be collectively bigger than the U.S.." In our view, these economies are entering the consolidation phase of economic evolution. After years of near break-neck growth powered by mindless and reckless fixed investment and borrowing, as well as insatiable demand of base materials and commodities from China and India, it's time to rein in the excesses and over-capacity in various sectors.

To be sure, such transformation will not be without pain, not to mention the extended period of time these processes may take. During which companies will fail, jobs will be lost and asset prices may collapse. Good example from the past include the Russian debt default in 1998, and the economic reform instituted by former Chinese premier Zhu Rongji in the early-90s. For investors, they should carefully examine their investment horizon to make sure they have sufficient time to encapsulate the whole transformation cycle (and then some). Given the open-ended question of how long such cycle may last, it is also advisable to adopt a regular savings scheme so as to smooth out the volatility. And because such a scheme stipulates buying in a periodic fashion, investors would be able to bottom-fish as markets move lower without the need to worry about missing out.

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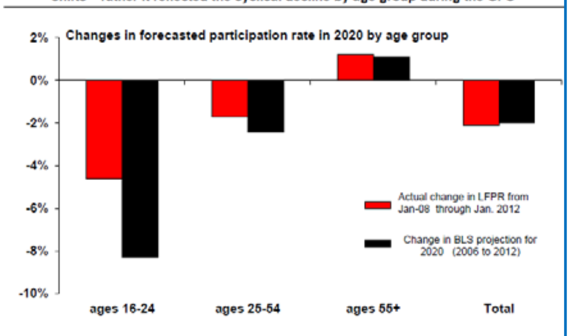
Market Review & Outlook

U.S.: Neutral

Given historical focus on the unemployment rate, it is easy to see how consensus may be missing the impact that a rebound in participation could have on policy. Aside from a longstanding embedded focus on the headline unemployment rate, there are other reasons to believe consensus is missing this rebound. The Fed's Survey of Primary Dealers indicates consensus expects an average of ~200k jobs per month in coming years. At this pace, the Fed's 6.5% unemployment threshold would only be reached in 2H14 if participation fell back to its April lows

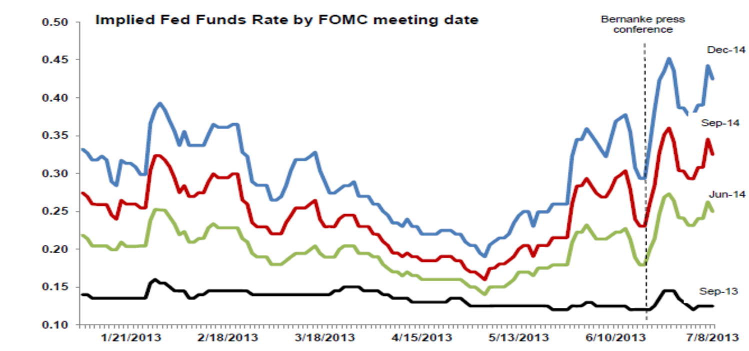
Fig 4 But the BLS forecasted change was not due to new information on demographic shifts – rather it reflected the cyclical decline by age group during the GFC



Source: BLS, Macquarie Research, July 2013

There are several reasons to expect a rebound in participation. As improvements in the labour market continue, participation should continue rebounding, with the result of only a gradual decline in the unemployment rate

Fig 1 Consensus is pricing in a rate hike in 2H14



Source: Bloomberg, Macquarie Research, July 2013

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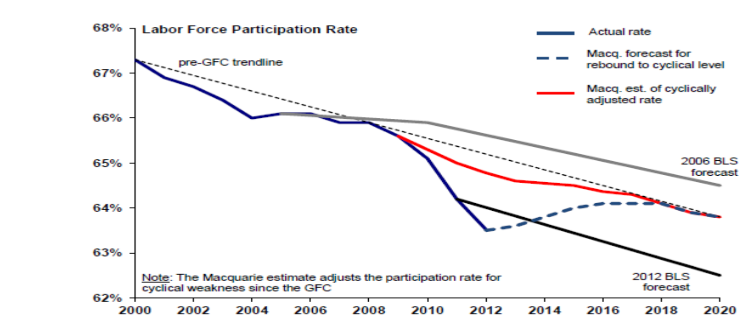
Fig 3 The BLS reduced its longer-term participation forecast in 2012

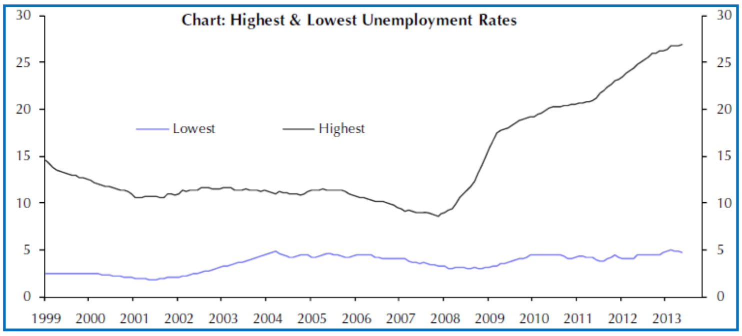


Source: BLS, FactSet, Macquarie Research, July 2013

Europe: Neutral

Latest euro-zone inflation and labour market figures brought a slight note of caution after recent improvement in some of the region's activity indicators.

Inflation in euro-zone rose from 1.4% to June's 1.6%, which was in line with expectations and was driven entirely by base effects reflecting energy price falls last summer. Core inflation – which excludes energy and food prices and is now published in the flash release – remained subdued at 1.2% and core goods inflation slipped to just 0.7%.



Meanwhile, May's euro-zone unemployment rate of 12.1% was lower than expected, thanks to some downward revisions to previous months' rates. Note too that the increase in unemployment of 1.34m seen over the last 12 months is the smallest annual rise since December 2011.

Nonetheless, the big story is still the continued divergence in unemployment rates between different countries, ranging from 4.7% in Austria to 26.9% in Spain. This rather undermines recent suggestions that economic imbalances within the currency union are narrowing.

Euro-zone Consumer Prices (%y/y)

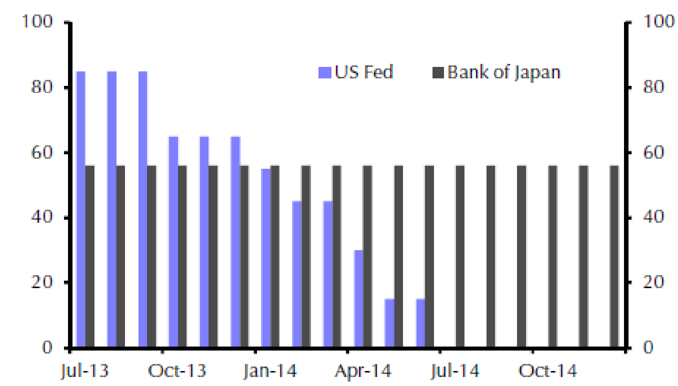
	2012							2013					
	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Headline inflation	2.4	2.4	2.6	2.6	2.5	2.2	2.2	2.0	1.8	1.7	1.2	1.4	1.6
Core (ex. food & energy)	1.6	1.7	1.5	1.5	1.5	1.4	1.5	1.3	1.3	1.5	1.0	1.2	1.2
Food, alcohol, & tobacco	3.2	2.9	3.0	2.9	3.1	3.0	3.2	3.2	2.7	2.7	2.9	3.2	3.2
Energy	6.1	6.1	8.9	9.1	8.0	5.7	5.2	3.9	3.9	1.7	-0.4	-0.2	1.6
Non-energy ind. goods	1.3	1.5	1.1	1.2	1.1	1.1	1.0	0.8	0.8	1.0	0.8	0.8	0.7
Services	1.7	1.8	1.8	1.7	1.7	1.6	1.8	1.6	1.5	1.8	1.1	1.5	1.4

Source – Eurostat

Japan: Positive

For investors in Japan, there is a crucial question to ponder, namely whether additional purchases by the Bank of Japan can offset broader impact of likely tapering of purchases undertaken by the Fed. In principle, a dollar's worth of additional liquidity in the hands of a financial institution in Japan has just as much potential to support global markets as a dollar in the hands of one in the U.S.. But there are a number of caveats.

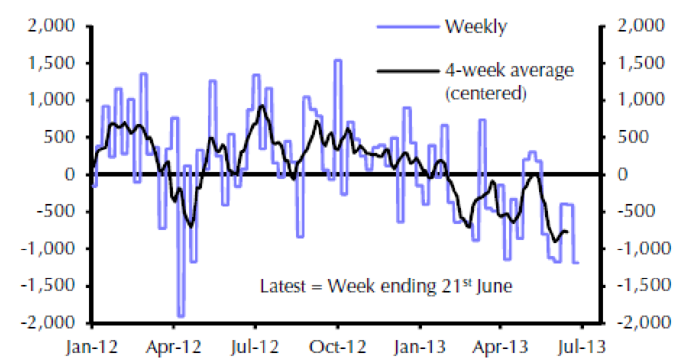
Chart 1: Projections of Monthly Asset Purchases ($ Bn.)



Source – Capital Economics. Based on unchanged exchange rates.

For a start, the asset purchases plans by BOJ were announced back in April. Although actual benefits of the additional liquidity has not yet been provided, some of the potential support are clearly reflected in asset prices. To achieve further boost, BOJ would need to step up the pace of purchases over and above its current plans.

Chart 2: Net Japanese Purchases of Foreign Bonds (¥ Bn.)



Source – Thomson Datastream

Some of the potential support could also be offset by currency movements. For example, market is forecasting the yen to fall to 110 against the U.S. dollar by the end of 2014. This would reduce the dollar value of BOJ's monthly asset purchases from around $56bn to $50bn.

Finally, Japanese institutions may have a lower propensity to recycle funds into riskier assets than their U.S. counterparts. Indeed, BOJ's "bold easing" to date has failed to unleash the wall of Japanese money into overseas markets that some had hoped for. There was a brief flurry of excitement when

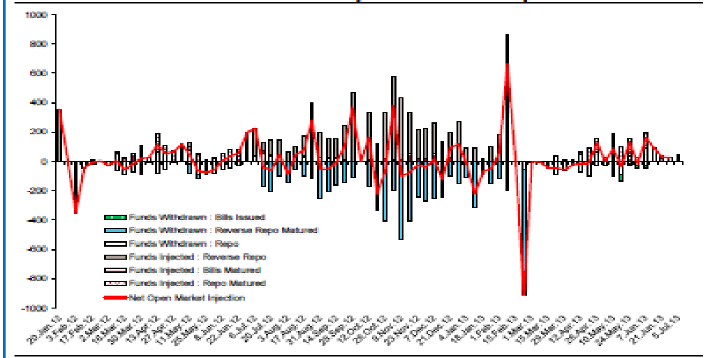
Japanese financial institutions turned net buyers of foreign bonds in early May, but they have returned to being heavy sellers ever since.

China: Neutral

The PBoC issued a statement on June 25 confirming liquidity injection into some financial institutions, adding that it expects “the spike in the interbank rate and liquidity tightness to ease gradually”.

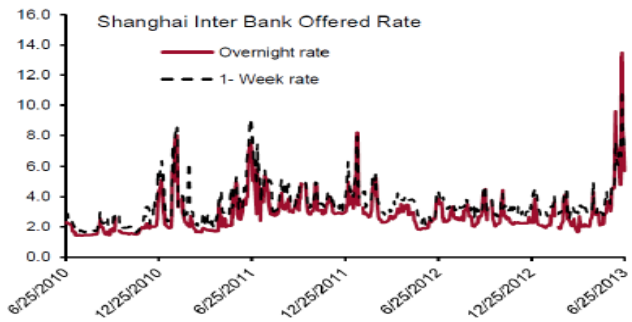
But liquidity wasn't provided universally. Banks are required to continue to promote their liquidity and asset-liability management. For those following prudent credit policy to support the real economy and showing stable credit growth, the PBoC will provide liquidity in the event of a temporary shortage.

Exhibit 7: China: PBoC’s open market operation



Source: SHIBOR.Org, Credit Suisse

Exhibit 8: China: The central bank sees SHIBOR spike to ease



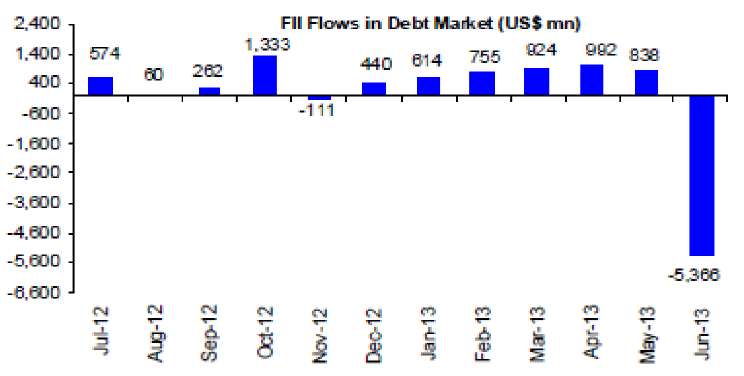
Source: SHIBOR.Org, Credit Suisse

This statement indicates the central bank’s support to stabilize interbank liquidity and to smooth short-term volatility in the money market and prevent systematic risk spillovers in certain situations. However, PBoC’s statement also explicitly spells out the discipline set for commercial banks and an orderly deleveraging signal. With strict implementation, this should have an impact on developments in the real economy in the medium term.

India: Neutral

Foreign institutional investors (FIIs) turned sellers of Indian equities in June after being buyers for 12 consecutive months. Collectively, they sold stocks worth ~US$1.8bn compared to ~US$3.8bn buying in the previous month. In contrast, domestic institutions turned buyers after being sellers for 11 consecutive months. Domestic institutional investors purchased stocks worth ~US$1.5bn versus ~2.2bn selling in the previous month. FIIs remained sellers in the futures market at ~US$0.7bn, and also turned sellers in the debt market at ~$5.4bn (highest in a single month)

FII Debt Flows Breach Worst for Any Month

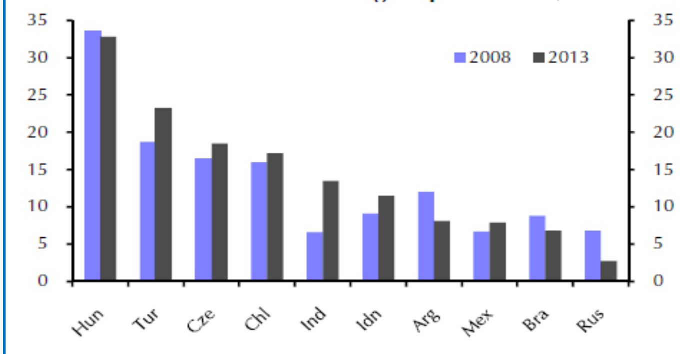


Markets showed high volatility with low volumes during June. Implied volatility was up 4% MoM and realized volatility breached 14-month highs. Cash and derivative turnover was down 22% MoM and 14% MoM respectively. Open interest was up 15% MoM. Among other indicators, the put-call ratio was up 36% MoM to an all-time high whereas the advance-decline ratio fell 10% MoM to multi-month lows.

Russia and Emerging Markets: Mixed

Expectations the Fed will start tapering its asset purchases under QE3 later this year has weighed on emerging markets (EM) financial markets, but economic impact of Fed tapering on EMs is likely to be limited. A handful of countries with large external financing requirements are vulnerable, but most EMs have cut their dependence on overseas borrowing over the past decade. Meanwhile, although the major EM economies are slowing, this is due to domestic problems rather than scaling back of policy support in the developed world.

Chart 1: Gross External Financing Requirements (% of GDP)



Sources – IMF, Capital Economics

Consumer price inflation across the emerging world edged down to 4.2% YoY in May, from 4.3% YoY in April, according to a GDP-weighted average of 56 countries. Inflation looks likely to remain subdued, in spite of recent sell-off in EM currencies.

At a regional level, inflation in emerging Asia has been weakest in recent months, pushed down by falls in Chinese and Indian inflation. Inflation is also on a downward trend in emerging Europe as well as in the Middle East and North Africa. Latin America was the only region to witness a pick-up over the first five months of the year, mainly due to rises in Brazil and Mexico. Nonetheless, inflation appears to be close to peaking in both countries.

Chart 1: Emerging Market Consumer Prices (% y/y)

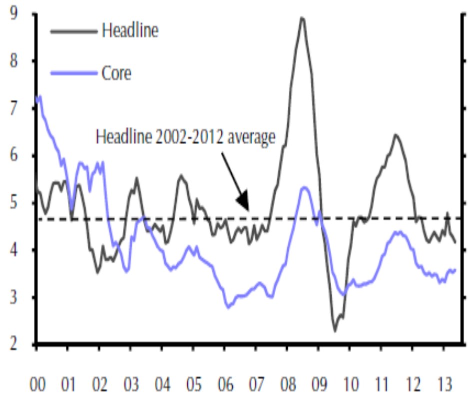


Chart 2: Consumer Prices By Region (% y/y)

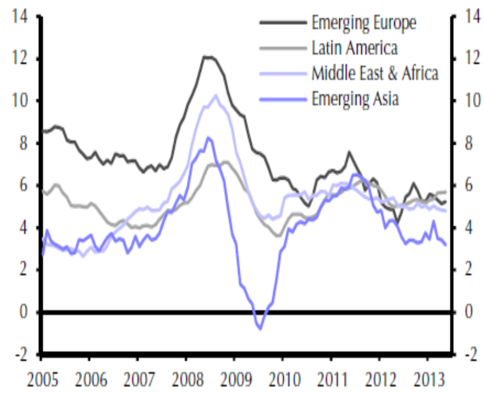


Chart 3: Selected Consumer Prices (% y/y, latest)

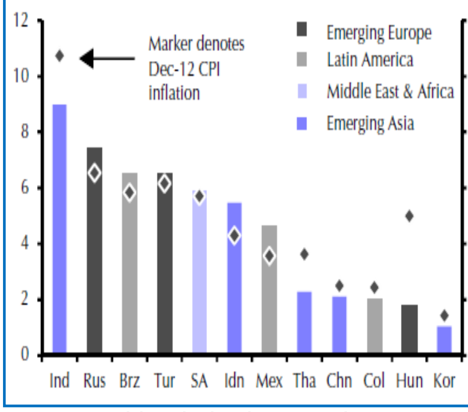
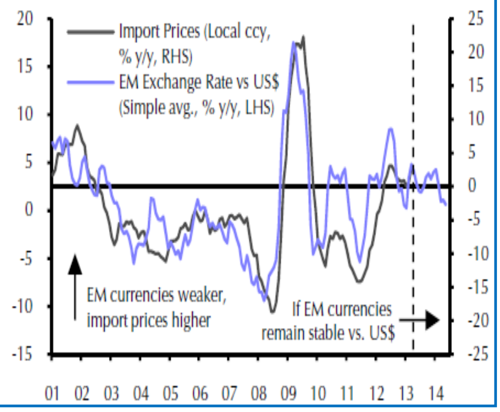


Chart 4: Emerging Market Exchange Rates & Emerging Market Import Prices



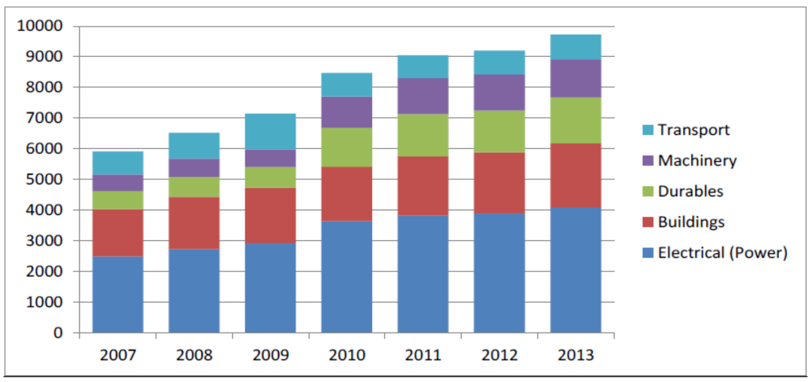
Commodities: Negative

China accounts for 43% of world copper use, measured at the semi-fabricated level (i.e., including the direct use of scrap at the fabrication stage, a total of about 9.7 Mt). Therefore, it is important to understand how copper is being used in China nowadays. It turns out copper's end use in China is dominated by its role as a conductor of electricity and heat.

Looking back over recent years, it is clear that copper, like many industrial commodities, received a strong fillip from China's massive investment stimulus programs of 2009. Since then, the pace of growth has moderated. In particular, growth in the main use, the power grid, has slowed. This reflects a priority focus on high voltage and ultra-high voltage (UHV) networks, which in general are more aluminium intensive.

Exhibit 5: Copper's use in China is dominated by electrical applications and both consumer and capital goods

Total use of copper (including direct use of scrap), kt



Source: IWCC, BGRIMM, Credit Suisse estimates and forecast for 2013

Exhibit 6: Copper semis demand is expected to average 5% in 2013, but most of the growth has already taken place

kt contained copper

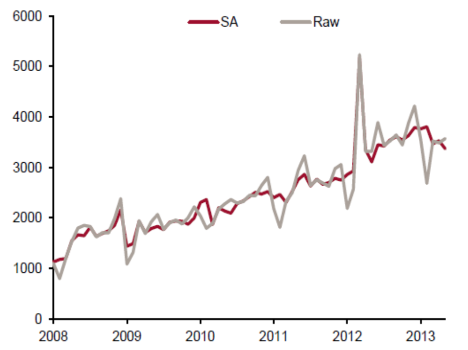
	2009	2010	2011	2012	2013
Cathode Consumption	5,950	7,089	7,764	8,037	8,552
Direct Use of Scrap	1,201	1,227	1,286	1,160	1,170
Semis Production	7,151	8,316	9,050	9,197	9,722
Of Which: Wire Rod	4,564	5,340	5,661	5,848	6,140
Semis Imports	577	620	530	465	426
Semis Exports	223	232	234	230	257
Total Use of Semis	**7,505**	**8,704**	**9,346**	**9,432**	**9,891**
Growth	*10%*	*16%*	*7%*	*1%*	*5%*

Source: BGRIMM, Credit Suisse

The State Grid is spending almost US$500 billion on UHV lines, with 27 UHV DC transmission links to be completed by 2020. For copper, the benefit is in installation of power transformers, circuit breakers, and switchgear rather than the cabling itself, much of which will require importing. Similarly, copper-containing equipment sales will be boosted by an aggressive program to improve the rural grid in 2H 2013.

Exhibit 7: Power cable manufacturing entering a lull after 2012's surge?

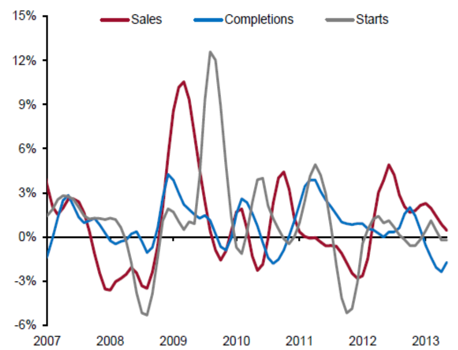
Thousand line-km, Monthly



Source: Credit Suisse, China NBS

Exhibit 8: Construction activity – cooling measures likely to impact in 2H 2013

Trend monthly change, SA



Source: Credit Suisse, China NBS

Wire rod production in 2Q was strong, rising by about 8% on 1Q levels. Investment in the power sector climbed 9.4% in the first four months of the year, with spending on the grid up by almost 30% YoY. There was also strong demand for marine power cable, the high-speed train rollout, as well as a jump in power cable exports of more than 6%. However, output of power cable appears to have abated after 2012's strong advance, possibly reflecting inventory build-up.

Thanks to a series of large inventory injections, U.S. natural gas prices have been pushed down steadily in June and enter the third quarter just below $3.60/MMbtu, which is 18% shy of their April 19 high of $4.41. The YoY storage deficit has shed about one-third of its size since early April, and now sits at 522 Bcf, while the deficit against five-year norms hovers at 31 Bcf.

Exhibit 23: April EIA-914 gross production estimates in Bcf/d

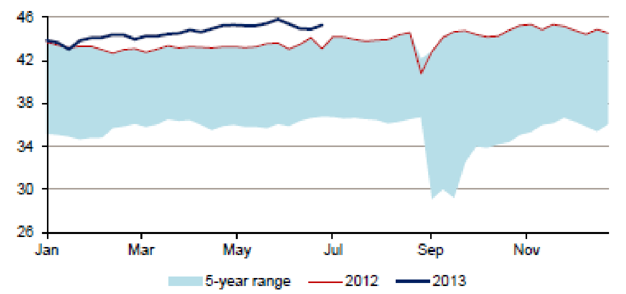
	Initial est	revised									
Bcf/d	Apr-13	Mar-13	M-o-M		Apr-12	Y-o-Y		Q2/2013	Q1/2013	Q-o-Q	
New Mexico	3.6	3.5	0.1	2.8%	3.6	0.0	1.2%	3.6	3.4	0.2	6.2%
GOM	3.9	3.9	0.1	1.6%	4.5	(0.6)	-13.7%	3.9	4.0	(0.1)	-1.4%
Oklahoma	5.8	5.8	0.0	0.9%	5.4	0.4	6.8%	5.8	5.7	0.1	1.9%
Wyoming	5.8	5.9	(0.0)	-0.5%	6.3	(0.5)	-7.5%	5.8	5.8	0.0	0.0%
Louisiana	6.8	7.0	(0.2)	-2.7%	8.2	(1.4)	-17.3%	6.8	7.2	(0.4)	-5.9%
Other States	25.1	24.7	0.5	1.9%	22.1	3.1	13.8%	25.1	24.6	0.5	2.2%
Texas	22.2	22.1	0.1	0.5%	22.3	(0.1)	-0.4%	22.2	22.0	0.2	0.8%
Lower 48-Land	69.3	68.8	0.5	0.7%	67.8	1.5	2.2%	69.3	68.7	0.6	0.9%
Lower 48 (Inc. GOM)	73.2	72.7	0.6	0.8%	72.4	0.9	1.2%	73.2	72.7	0.5	0.8%
Alaska	9.5	9.5	(0.1)	-0.8%	9.2	0.3	3.0%	9.5	9.7	(0.2)	-2.5%

Source: EIA, Credit Suisse

Given stubbornly high natural gas production, U.S. gas price remains trapped in a range: simply put, natural gas will compete with coal for demand from electric power generators, and depending on the weather this summer, will oscillate between about $3.50 to around $4.30/MMbtu.

Exhibit 24: Unadjusted interstate supply sample

(Weekly Average in Bcf/d)



Source: Bentek Energy, Credit Suisse

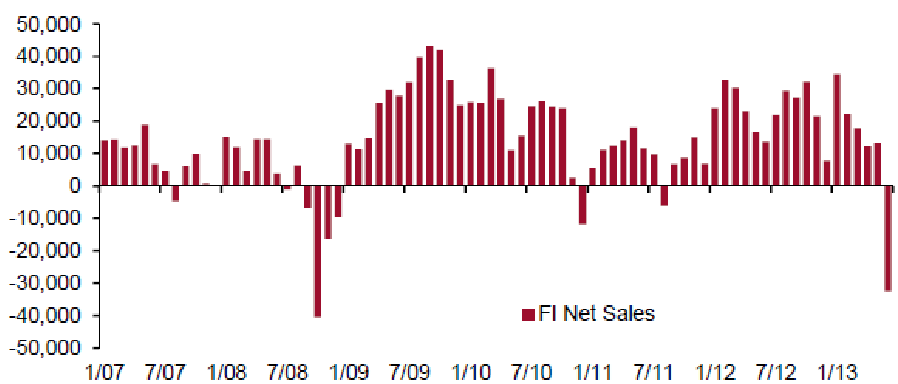
Recently released "official" supply figures by EIA confirm the bearish view of the driver of U.S. gas prices. In April, Lower 48 onshore gross production of natural gas increased 0.5 Bcf/d mom to 69.3 Bcf/d – in line with daily pipeline-scraping models that indicated a 0.58 Bcf/d mom increase. The EIA's April number was 1.5 Bcf/d higher YoY and 0.60 Bcf/d above first quarter total averages.

Bonds: Mixed

Through June 19, fixed income mutual fund outflows for the month are already the second largest on record, behind only October 2008's $40bn outflow, which has coincided with worst quarterly fixed income performance in at least 18 years.

Exhibit 1: June is already the second largest outflow month on record

Through June 19, 2013, for all Fixed Income Mutual Funds

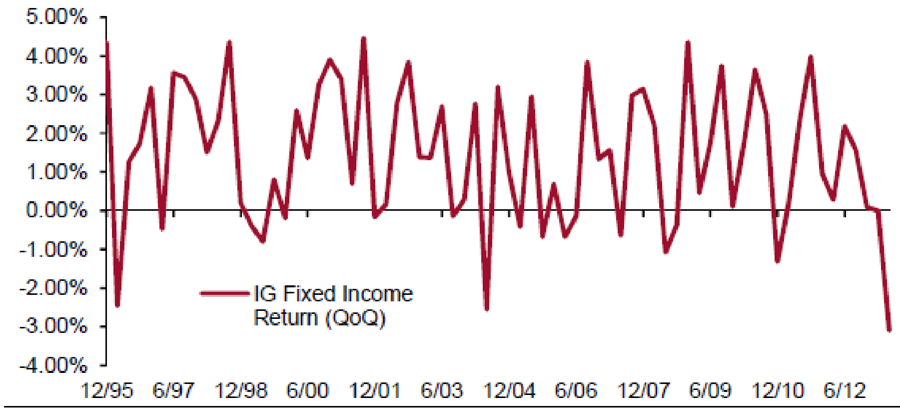


Source: Credit Suisse, ICI

2Q is poised to post the worst performance for U.S. fixed income in almost 20 years. As noted above, this poor performance has coincided with exceptionally strong outflows from bond mutual funds, which had been an important support for fixed income markets the last several years. As mentioned, the concern is that liquidity in some asset classes could be poor, meaning more volatility, particularly in the traditionally less-liquid portions of the market where dealer balance sheets are more constrained than ever thanks to the regulatory environment.

Exhibit 2: This quarter is already the worst in at least 18 years

Quarterly IG Fixed Income Total Return



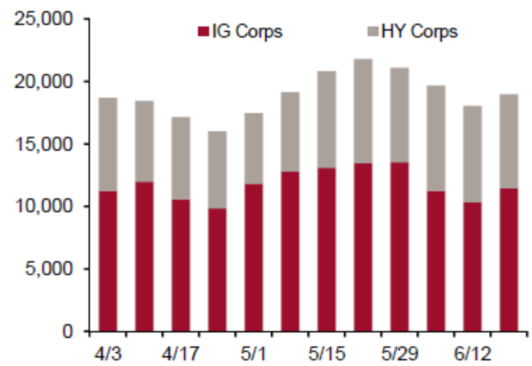
Source: Credit Suisse

More retail outflows would lead to additional selling of most fixed income products. Given poor liquidity in some spread product, it is possible that managers will first sell Treasuries to raise cash for redemptions. As time goes on, however, managers will be uncomfortable with their growing weight to spread product and will reduce exposure to them even if it means spreads widening.

As evidence of how little risk appetite the Street has, dealer positions in corporates and ABS remains near the lowest level in over a decade (Exhibit 5). Although the Fed's new history of corporate-only positions is quite short, even during the significant spread widening and risk reduction, exposure to corporates has not increased beyond mid-May levels (Exhibit 6). As it appears demand may remain slack, additional selling may result in further downward movement in price.

Exhibit 6: Dealer inventory of corporates is stable

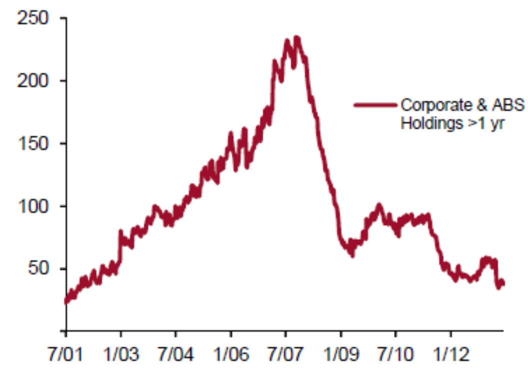
US$ millions



Source: Credit Suisse, Federal Reserve

Exhibit 5: Dealer inventories remain at decade lows

Primary Dealer Positions, US$ billions



Source: Credit Suisse, Federal Reserve

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

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