AMG Market Commentary

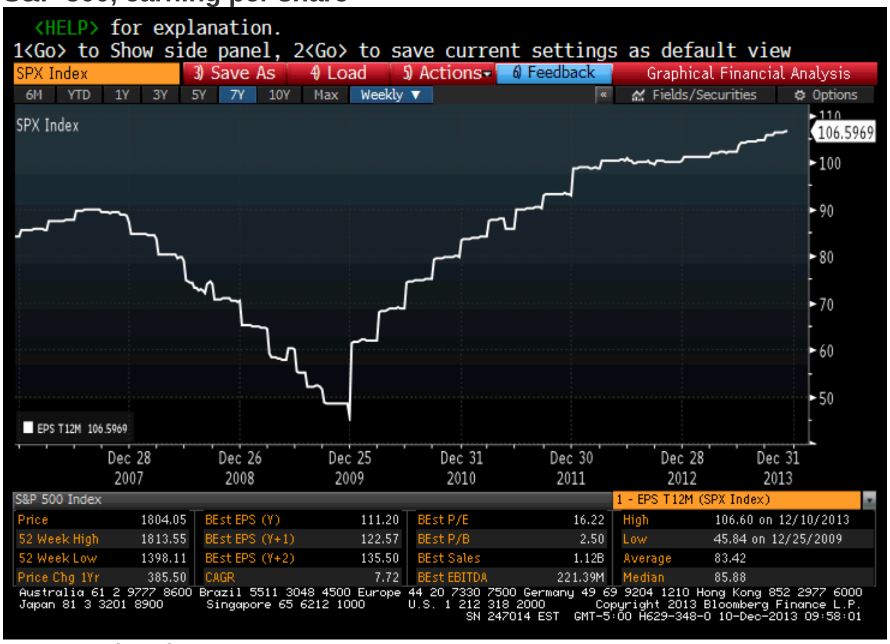
November 2013

The QE Will Be Continued In 2014

The any possible change in monetary policy is the main factor affecting the financial markets in 2013. It is because as the economy is getting better and better, some of the central banks are planning to reduce its stimulus to the economy. During June to Sept, investors were very worried about the possible tapering from U.S. Fed. It led to a fluctuation in the financial market, especially for the emerging markets as they were significantly affected by the capital outflow due to the market panic (fear that the Fed may start tapering soon).

We do not agree that QE is the only reason for the equity market to recover. Other than QE, economic recovery and the improvement of corporate earnings is also a very important factor for helping the equity market to rebound. For example, the improvement of corporate earnings is a very important factor for U.S. stock index to rebound and even record a new high. As shown in the graph below, S&P 500 members earned $90 per share in 2007. Today, they earn $106 per share. It is 20% higher than the peak recorded before the financial crisis in 2008.

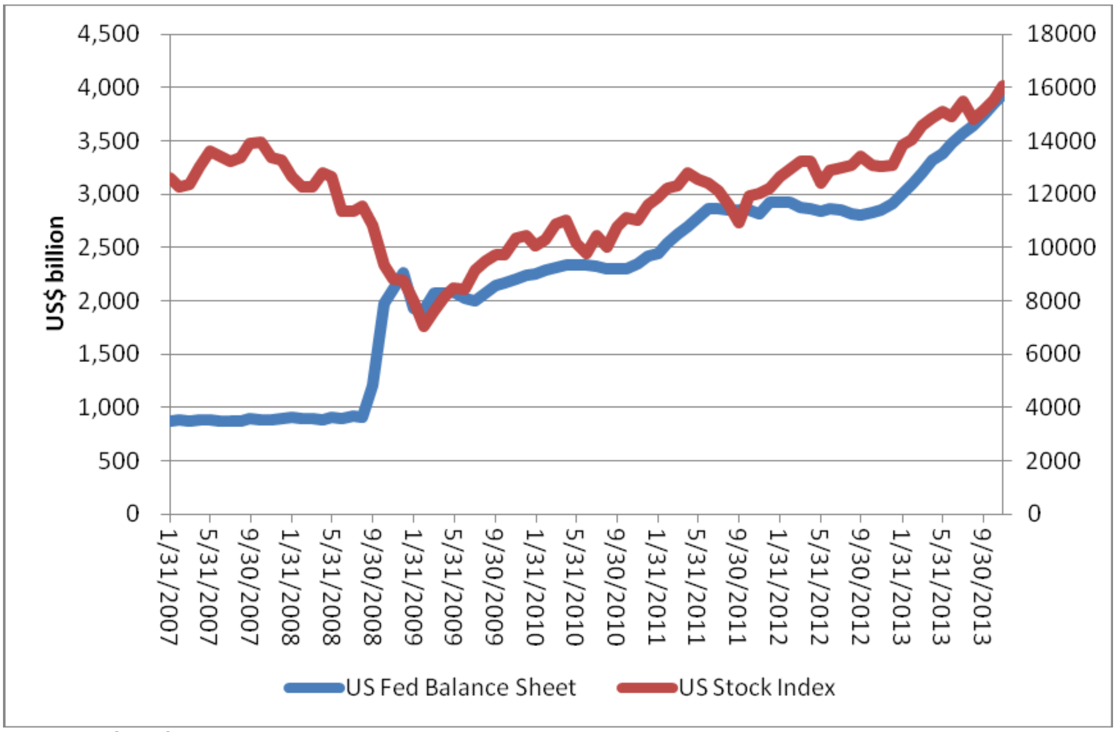
S&P 500, earning per share



Sources: Bloomberg

However, we are not trying to deny QE has a positive effect for the financial market. The following graph represents the correlation between the Dow Jones Index and the money supplied by the U.S. Fed. After the financial crisis, the Fed did not only use the zero interest policy, but also increased the money supply dramatically by buying bond directly from the market. For the past few years, the Fed's balance sheet has increased from below US.$ 1 trillion to almost US$ 4 trillion today.

U.S. Fed balance sheet vs U.S. Stock Index



Sources: Bloomberg

Fed started tapering on 19 December 2013

As of 03:00am 19December 2013 (HK time), the Fed issued the FOMC statement. In the statement, it stated that the Fed decided to modestly reduce the pace of its asset purchases. Beginning in January 2014, the Fed will add to its holdings of agency mortgage-backed securities at a pace of $35 billion per month rather than $40 billion per month, and will add to its holdings of longer-term Treasury securities at a pace of $40 billion per month rather than $45 billion per month. The Fed explained that it has decided such action because it sees the improvement in economic activity and labor market conditions over the period as consistent with growing underlying strength in the broader economy. Therefore, the down-side risk for the economy has substantially decreased.

The Fed said that if incoming information broadly supports the Fed's expectation of ongoing improvement in labor market conditions and inflation moving back toward its longer-run objective, the Fed will likely reduce the pace of asset purchases in further measured steps at future meetings. However, it is not on a preset course, and the Fed's decisions about the pace will remain contingent on the Fed's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases.

Apart from reducing the pace of its asset purchases from $85 billion to $75 billion, the Fed also provided a more explicit guidance for its exceptionally low target range of the federal funds rate. First of all, the Fed reaffirmed its expectation that the current exceptionally low target range for the federal funds rate of 0 to 1/4 percent will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Fed's 2 percent longer-run goal, and longer-term inflation expectations continue to be well anchored. Besides, it is the first time the Fed saying that it will likely be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Fed's 2 percent longer-run goal. It implied that the exceptionally low federal funds rate may last significantly longer than what investors are expected before. Thus, even though the Fed has started to reduce the pace of asset purchases, the monetary policies are still very accommodative and helpful to economic growth.

Reducing the pace of asset purchases will not lead to a long-term negative impact to the financial market

We can say that it is a surprise when the Fed said that it will reduce the pace of asset purchase after its FOMC meeting in Dec 2013. It is because before the meeting, a survey result showed that only 20% of economists being interviewed said that they expected the Fed will reduce the pace of asset purchases starting from Dec 2013. 36% of economists being interviewed said that they expected the Fed will reduce the asset purchases starting from Jan 2014 and 44% of economists being interviewed said that they expect the Fed will reduce the asset purchases starting from Mar 2014 or later.

In fact, it is a bad news for the financial markets as the Fed started to reduce the pace of its asset purchases. However, the market reaction is much smaller than expected (at least at that day). It is because first of all, the amount of reduction is not very large. The reduction is $10 billion only which is within the market expectation. Besides, the Fed saying that it will likely be appropriate to maintain the current target range for the federal funds rate well past the time that the unemployment rate declines below 6-1/2 percent, especially if projected inflation continues to run below the Fed's 2 percent longer-run goal. It implied that the exceptionally low federal funds rate may last significantly longer than what we are expected before. As a result, the U.S. stock market has increased, rather than decreased after the release of FOMC statement. The Dow Jones Industrial Average has increased 300 points at that day (though we think the increase is not reasonable).

In sum, we think that the impact from the FOMC meeting should be “Neutral”. It is because although it is negative for the Fed to reduce the asset purchase, the negative impact has been offset by the positive impact from the possible longer than expected exceptionally low federal funds rate.

In the coming months, we expect investors will remain their focus on any possible change in the monetary policies. Apart from the pace of asset purchases, investors will increase their concern on how long the exceptionally low federal funds rate can be lasted.

Again, we believe that no matter when the Fed started to reduce the asset purchases, we expect the monetary policy will remain very accommodative in 2014, at least in the 1st half of 2014. It is because:

1. Although the Fed has reduced the asset purchases from $85 billion per month to $75 billion per month, the Fed is still buying bond and injecting money to the market. Besides, even though the Fed will further reduce the amount of asset purchases in the coming FOMC meetings, it will take at least 6-9 months to totally end the asset purchases. It means that the Fed will still keep on buying bond in the 1st half of 2014. In addition, even though if the Fed eventually ended the asset purchases, it is still providing substantial money supply to the market as its balance sheet will remain unchanged at $4 trillion or more (though it stopped to increase further).
2. The end of asset purchases does not mean that the Fed has withdrawn its ultra-loose monetary policy since 2008. It is because the Fed will maintain its exceptionally low federal funds rate after the end of asset purchases. We expect that the exceptionally low federal funds rate will not change until 2015 or even later.

Last but not least, as the Fed has emphasized again and again, it is not a done deal for the Fed to reduce the asset purchases. The Fed’s decisions about the pace of asset purchases will remain contingent on the Fed's outlook for the labor market and inflation as well as its assessment of the likely efficacy and costs of such purchases. Thus, if the Fed speeds up the reduction of asset purchases, it means that the economic growth is stronger and better than expected. It is a positive factor to the financial market and we should not be too worried about this.

At last, although we expect that the reduction of asset purchases may lead to a short-term fluctuation in the financial markets, we are confident that the market can resume normal in a very short period of time as the negative impact from tapering will not be as serious as what investors are afraid of now.

Compare to stock market, we think that investors should pay more attention to the negative impact from tapering on their bond investment. As mentioned above, the Fed started to reduce the asset purchases because it thinks that the economy is improving in a sustainable manner. As the economy is improving, it is a good factor to the stock market (though tapering may lead to some short-term fluctuation in the financial markets). In contrast, it is bad to bond market even though the reduction in asset purchases is due to a better economic outlook. It is because better economic outlook is not a positive factor to the bond market. As the economy becomes more and more strong, investors will expect the interest rate eventually to rise in the future (especially for U.S. government bond as it cannot benefit from any economic improvement as its credit rating is AAA/ AA+ already).

U.S. 10-Year Government Bond Yield

Sources: Bloomberg

<u>Other than U.S., many central banks are still having a very accommodative monetary policy</u>

Other than U.S., many central banks like ECB and BOJ are still having a very accommodative monetary policy and we expect their policy stance will remain unchanged in 2014. For example:

ECB: The EU economy is improving since Q3 2013. We think that the momentum can continue. However, it is still in the edge of recession. Thus, we expect ECB need to remain its policies as accommodative as possible in 2014. In 2013, ECB has reduced its interest rate two times in order to stimulate the economy. Besides, they emphasized again and again that its loose monetary policy is very important to the economic recovery. As a result, we can quite sure that ECB will maintain a very accommodative monetary policy in 2014.

BOJ: Although BOJ did not increase the amount of QE as expected by most investors, it is highly likely that the money supply will increase 50-6o trillion yen (as planned) in 2014

Market Review & Outlook

<u>U.S. Economy and Financial Market</u>

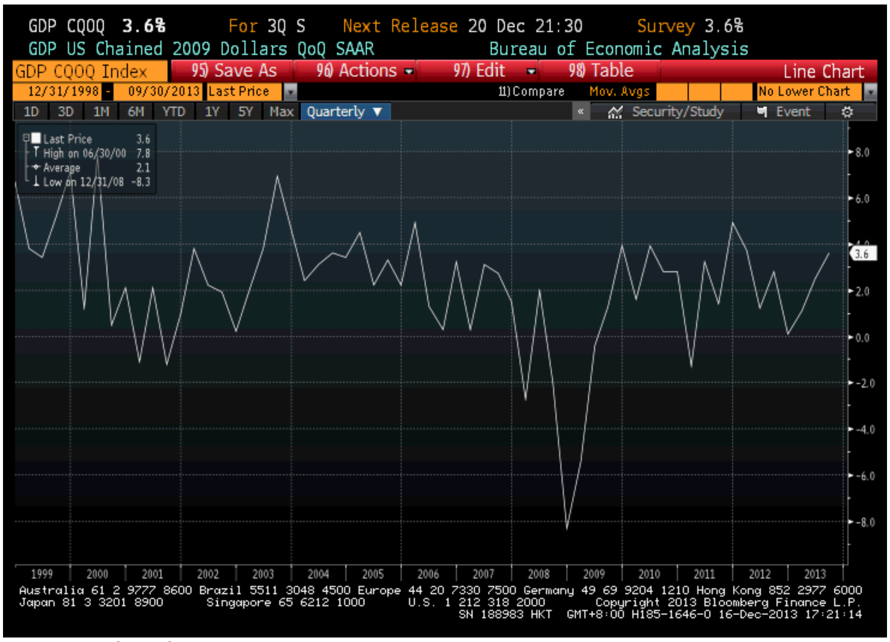
Although the Fed has started to reduce its asset purchases in the last FOMC meeting, we think that investors will remain focus on any possible change in the monetary policy. Any news of any possible changes will affect the market and may lead to a significant market fluctuation.

The economic momentum remains unchanged even though the U.S. government has stopped working for 16 days. In contrast, we have seen the economic momentum was improving in the past few months. For example, the employment data in Nov is much better than expected. The unemployment rate is 7% (the lowest since the Financial Crisis in 2008). There were 203 thousands new jobs created in Nov. For the next two quarters, we expect the economy can maintain a stable growth at around 2%.

U.S. Nonfarm Payroll

Sources: Bloomberg

U.S. GDP Growth



Sources: Bloomberg

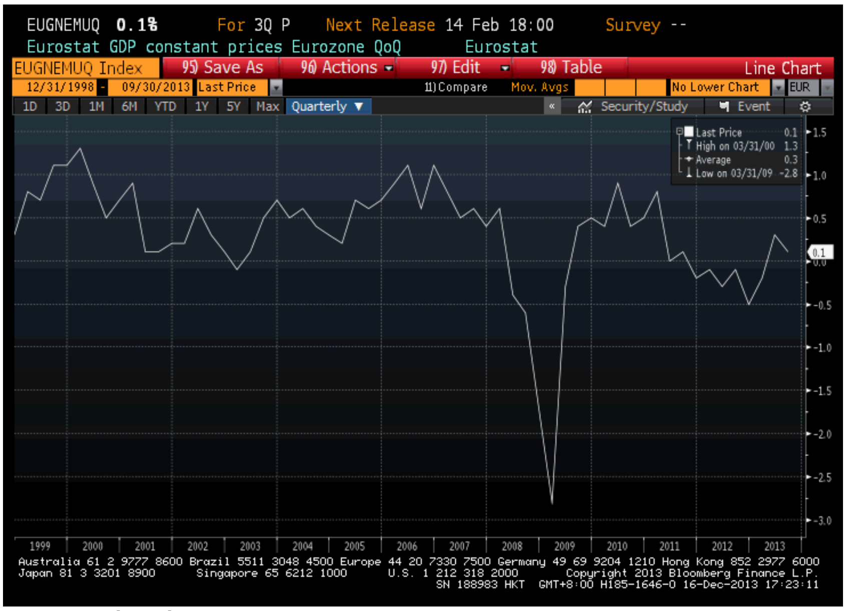
EU Economy and Financial Market

The EU economy keeps on improving since Nov. However, the improvement is not as fast as many people would like to have. We expect the EU economy can continue to improve and as a whole, it can have a positive growth next year.

The debt problem is still the main negative factor against the economic growth in EU. It is because for most EU governments, in order to lower their debt level, they need to reduce their expenses and increase tax revenues. Both of them will have a negative impact to the economic growth.

BEC will launch its stress test for banks in EU starting from early next year. As the requirements for the stress test are not announced yet, we cannot estimate how many banks may fail in the test. However, investors should pay attention to this because a minor problem can spark off a market panic and eventually lead to another European Debt Crisis.

EU Economic Growth



Sources: Bloomberg

EU PMI Manufacturing Index

Sources: Bloomberg

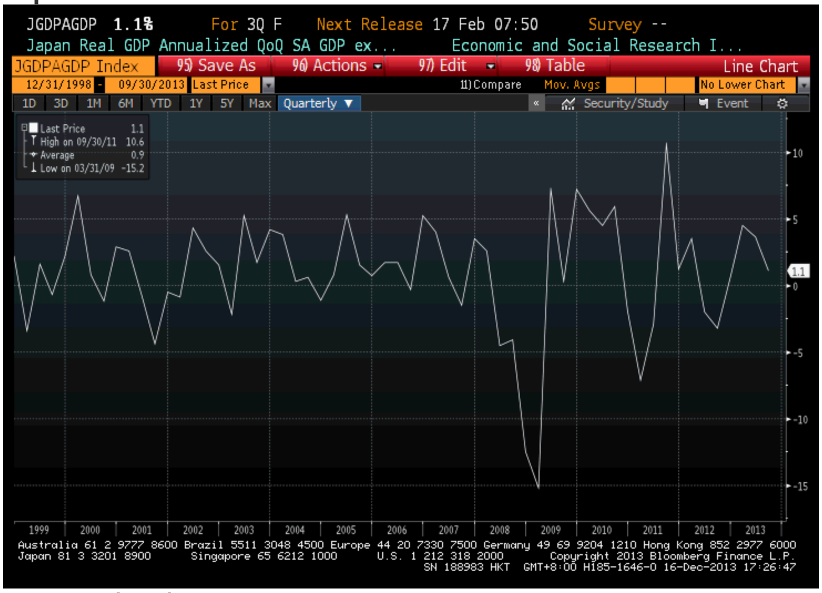
<u>Japanese Economy & Financial Market</u>

Recently, Japan announced its Q3 GDP growth and the growth rate is 1.1%, which is lower than 3.6% in 2Q and is also lower than market consensus of 1.6%. The most updated CPI figure is 1.1%. Although it is still significantly below the 2% target, price increase of 1.1% (YOY) is already a very good number for Japan as Japan has a long history of deflation problem.

For the next year, it is necessary for the Japanese government to continue relying on their QE to maintain the economic growth and having a positive growth in price level.

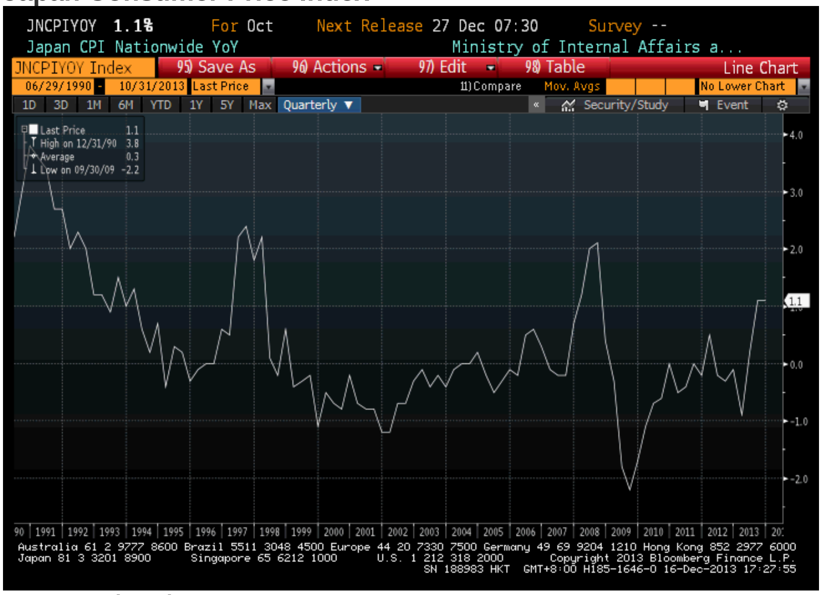
However, investors should pay attention to two possible negative factors in the next year. The first one is the planned increase in sales tax starting from April 2014 (increase from 5% to 8%). It may affect the personal consumption. The second one is the possible increase of Japanese government bond yield. If the bond yield really increases, it may affect the sustainability of the existing accommodative monetary policy.

Japan GDP Growth



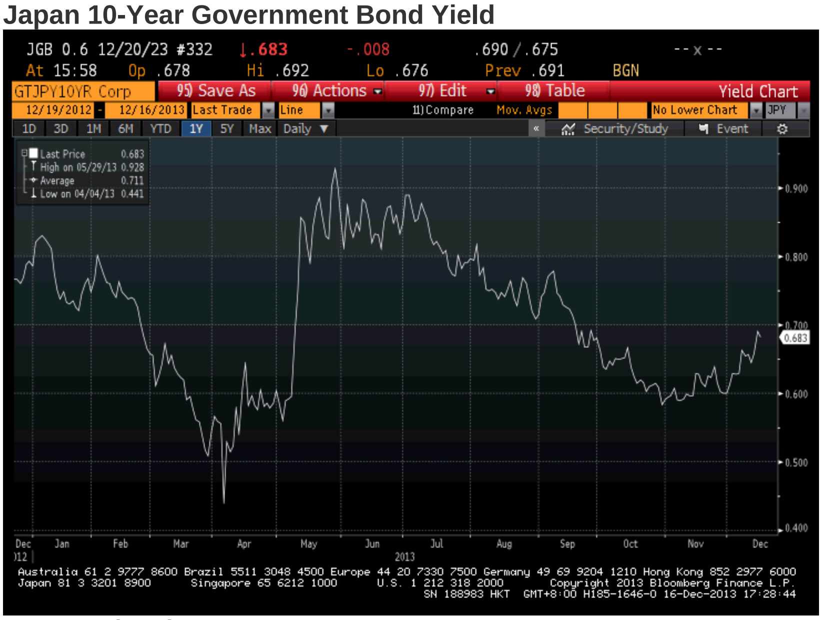
Sources: Bloomberg

Japan Consumer Price Index



Sources: Bloomberg

Japan 10-Year Government Bond Yield



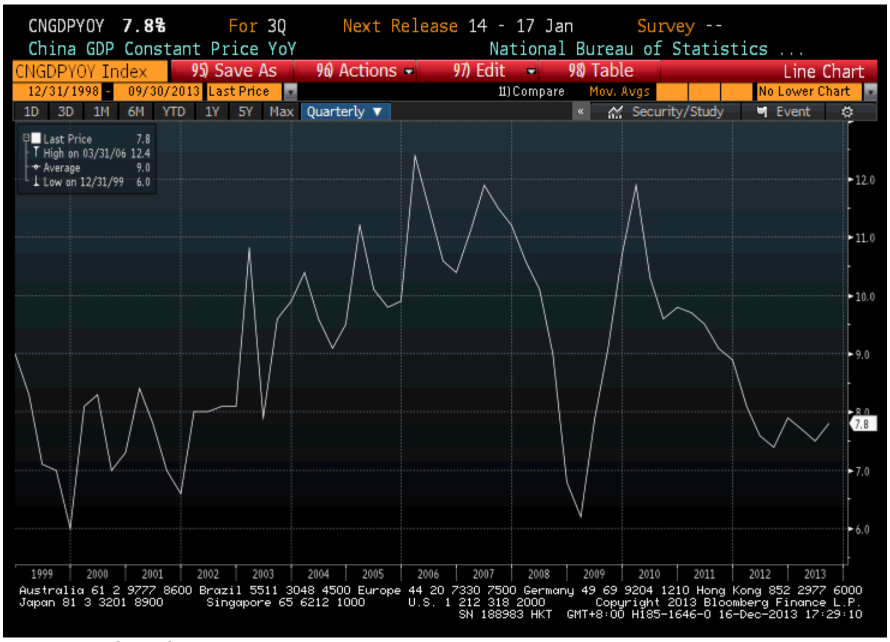
Sources: Bloomberg

China Economy and Financial Market

The economic growth has been rebounding from the bottom since Q3 2013. The GDP growth for Q3 is 7.8% (YOY), which is better than the 1st half growth of 7.6%.

For the coming year, we expect the GDP growth will remain at 7-8%. It is less likely to increase substantially because the China government has changed its economic target from pursuing “high growth” to “quality growth”. For example, the Central Economic Work Conference just held has emphasized the importance of “reform” and “innovation” and should consider the possible negative side-effect from economic growth. All of them show that the China government is willing to sacrifice some growth rate in order to improve the growth quality.

China GDP Growth



Sources: Bloomberg

Economy and Financial Market in Emerging Markets

There are two major factors negatively affecting the emerging markets in 2013. The first one is slowing economic growth and increasing price level. For example, Brazil and India is simultaneously suffering from slowing economic growth and increasing price level. It is difficult for their government to tackle because if the government increases the interest rate (to fight the inflation), it will lower the economic growth further. If the government lowers the interest rate (to stimulate the economic growth), it will push up the price level further. The second one is continuous capital outflow due to market fear from the possible tapering by the U.S. Fed. We expect the above two factors will continue to negatively affect the emerging markets in the 1st half of 2014.

Thailand, being one of the emerging markets, has suffered from political dispute recently. The political dispute has happened for almost a month. The dispute was caused by Yingluck Chinnawat as she proposed a law that is viewed as an important step to bring her brother, Thaksin Chinnawat, back to Thailand. However, we think that the proposed law is only the trigger point, rather than the underlying cause for the political dispute. The underlying cause is the long-term political struggle between Thaksin and the Democratic Party. Also, it is a fight between different social classes as well. In our opinion, we expect the dispute will continue for a certain period of time. It is because it seems that there is no room for both parties to compromise. The only turning point may be the Monarchs of Thailand come out and fix the argument. But the chance is very low at this moment.

Base on the risk consideration, we suggest reducing the exposure in Thailand or ASEAN Fund and switching to a Regional Asian Fund. We will switch the money back to Thailand or ASEAN Fund once the political situation becomes more stable.

Commodities:

Oil Price – The “risk premium” has decreased along with Syria Issue has been settled peacefully. It is because since June, the political issue in Syria has aroused investors' concern (afraid it may affect the supply of oil from Middle East) and pushed up the oil price. The oil price has broken the US$100 level and increased to US$110. However, since the political conflict in Syria has not resulted into any military affairs, investors become less worry and the so-called "risk premium" has reduced. If we just count on fundamentals, the oil price should trade at $90-100 for the coming few months because the demand is still not very strong as the economic growth is not very promising. We expect the oil price may test the $90 level again but we are confident that the oil price will have a strong support at $90.

Crude Oil Price

Sources: Bloomberg

Gold – we have a neutral or slightly negative view on gold. It is because we have seen a continuous capital outflow from the gold market. It is negative to the gold price. For example, the outstanding shares for SPDR Gold ETF has decreased significantly from more than 400 million shares in Jan 2013 to less than 300 million shares in Dec 2013. Although we have a negative view on gold, we expect the gold price may have a very short-term rebound in the beginning of next year because the uncertainty from the U.S. fiscal issue may lead investors becoming "risk averse".

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

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