AMG 安柏 FINANCIAL GROUP

AMG Market Commentary

December 2013

Will the recent fire sale in Emerging Markets' currency eventually lead to a financial crisis?

Over the past 1-2 weeks, many emerging markets have suffered from a sharp depreciation in their currencies. The drop was so massive that it led to a market panic to emerging market investments.

The suffered currencies include Argentina peso, Turkish lira, South African rand and Russian ruble. All of them have suffered 8-35% depreciation in the past three months.

	% of depreciation in the past three months	
Argentina peso	35%	The lowest after 2001 (when Argentina was bankrupted)
Turkish lira	13%	Historical low
South African rand	12%	5-year low
Russian ruble	8%	4-year low

As the sell off is so severe, investors worry that it may even undermine the economic stability and lead to a financial crisis in emerging markets, like the Asian Financial Crisis happened in 1997.

The causes of currency depreciation in emerging markets

Although Argentina peso, Turkish lira, South African rand and Russian ruble were the most suffered currencies, some of them have their own unique problem and thus their situation may not be able to generally apply to other emerging countries.

For example, Argentina peso had the largest drawdown in the past three months. However, its big drawdown was mainly due to its FX and capital control implemented in the past years. It is because after Argentina has bankrupted in 2001, its government has imposed a strict control on it currency value and capital flow. Therefore, there were two exchange rates co-exist in Argentina – an official rate and a black market rate. As of 29 Jan 2014, the official rate is 8 peso to 1 US$. It is significantly deviated from the black market rate of 13 peso to 1 US$. Thus, once the government announced it will loosen its control on currency value and capital flow, the official rate depreciated sharply and move toward the black market rate.

Another example is South Africa. The long-lasting labor dispute has hurt the mining sector in South Africa. As mining is an important sector and contribute much to export as well as GDP growth for South Africa, the dispute has significantly affected the economic growth and the outlook. For example, the current account deficit was 6.8% of GDP last quarter which is much higher than the average (4.3%) after the financial crisis in 2008. As a result, South African rank was under pressure and sold aggressively by investors.

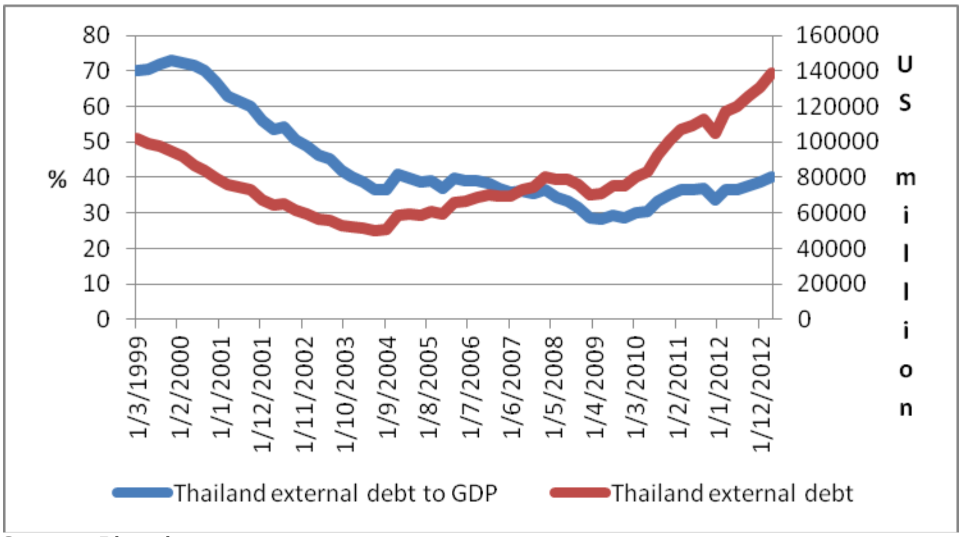
Although some of the negative factors were country specific (does not apply to other emerging markets), it does not mean that we believe emerging markets are lack of any drawbacks. Indeed, we expect many emerging markets will face an economic slowdown in 2014. For example, IMF has reduced its economic growth forecast for several emerging economies in 2014, such as reduce its GDP growth forecast from 3% to 2% for Russia and from 2.5% to 2.3% for Brazil.

Besides, many emerging economies will continue to suffer from rising inflation and deteriorating current account balance. And in order to fight the rising inflation, some of the emerging countries will increase their interest rate but it will further slowdown their GDP growth. For current account deficit, we are afraid that it will become a risk factor to the health of many emerging economies. It is because the deficit for most emerging markets is not very significant at this moment. But if the problem was not solved, it will be accumulated and eventually become a potential bubble.

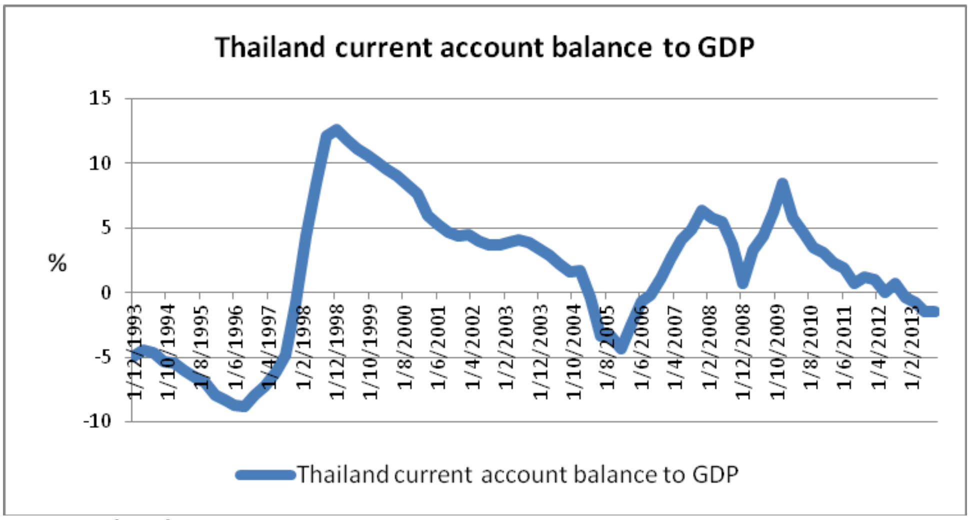
We believe the recent currency depreciation will not turn out to be another financial crisis

We are quite confident that the recent currency depreciation will not become another financial crisis. It is because we did not see any material bubble existed in the emerging markets. Being experienced in Asian Financial Crisis in 1997, the bankruptcy of Russia and Argentina in 2000 & 2001 and the US Financial Tsunami in 2008, most emerging markets have learnt the lesson and have changed to less aggressive when develop their economy, such as they are having a more healthy foreign debt level.

Using Thailand as an example, Thailand has borrowed aggressively to develop its economy in the 1990s. For example, the debt to GDP ratio was near 100%. Besides, it was running a current account deficit for successive years. As a result, the debt was too large that it eventually cannot afford. Eventually, the bubble burst and Thailand was seriously suffered during the Asian Financial Crisis in 1997. Today, although both debt level and current account deficit has been increasing in the past 1-2 years, they are still within the healthy range (especially if we compare them to the level in the 1990s). Similar case can be applied to most of the other emerging markets.



Sources: Bloomberg



Sources: Bloomberg

The economic strength has increased substantially in the past decades

At last, investors should not underestimate the economic power of most emerging markets. They have increased substantially in the past decades. For example, the foreign exchange reserve for most emerging countries has increased significantly in the past 10 years. Having a more amount of foreign reserve (especially for most Asian countries), it can help the emerging markets to be more capable to resist the external shocks. As of June 2013, China has the largest foreign exchange reserve in the world. It has almost US$ 3.5 trillion which is about 31% of the world total. Japan has the 2nd largest reserve holding in Asia. Its reserve is about 9% of the world total. Exclude China and Japan, all Asian countries have total reserve of US$ 2.2 trillion which is almost 20% of the world total. Apart from having the huge foreign reserve, they are having a more healthy financial including a more healthy external debt and current account balance.

US economy and financial market:

The economic data shown that the US economy has weakened a little bit since December 2013. For example, we have seen a disappointing non-farm payroll and home sales figure. Some investors were worried that the US economy may start to slowdown. However, we believe that US economy will continue to grow in 2014 though the growth rate may remain on 2%. Besides, the weaker than expected economic figure at the end of 2013 may be partly due to the extreme cold weather in Dec 2013. It has affected the private consumption, home purchases as well as the hiring plan.

US non-farm payroll

Sources: Bloomberg

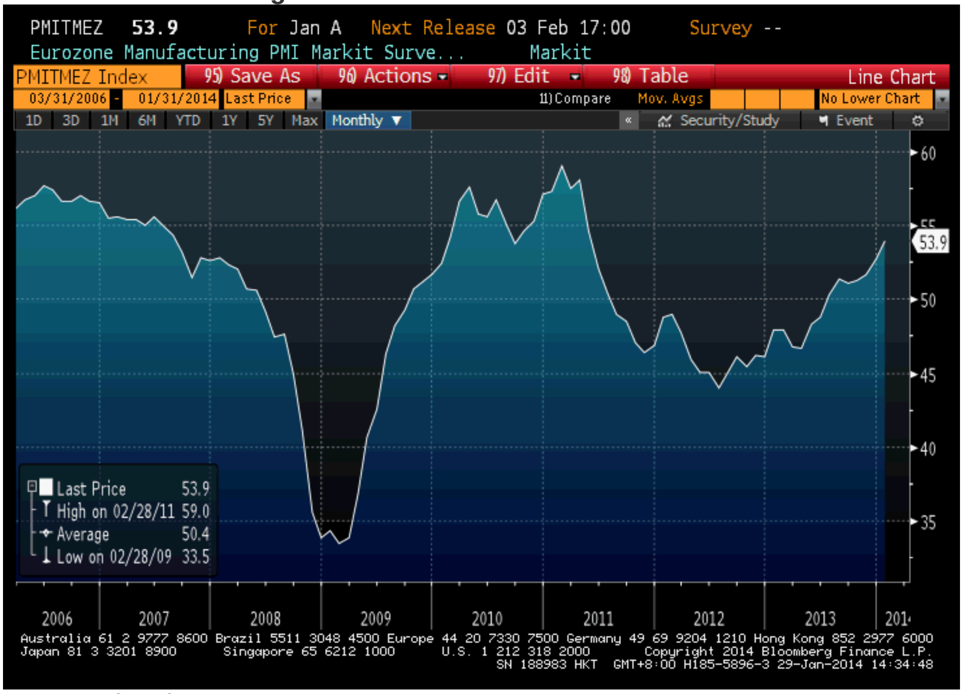
On the other hand, tapering from the Fed will remain a hot topic for 2014. However, we are not very worrying about it because the tapering is in a gradual speed and well-expected by the market. We expect the Fed will reduce its bond purchases by US$ 10 billion on every FOMC meeting this year.

Although most investors have already forgotten the Debt Limit issue, we would like to warn you that it can be a short-term shock to the stock market. It is because according to the old agreement, US government will reach its debt limit by the end of February 2014. However, until now, we did not see any progress in the Congress. Although we believe the Congress will eventually agree to raise the limit, the uncertainty may lead to a short-term fluctuation to the stock markets.

EU economy and financial market:

EU economy has continued to improve in the past month. For example, the PMI Manufacturing Index has increased from 52.7 to 53.9. The index has rise in 8 out of the last 9 months.

EU PMI Manufacturing Index



Sources: Bloomberg

Germany, being the growth driver in EU, has shown its economy continues to improve in the past months. We have seen a stronger growth in its factory orders as well as its industrial sector.

However, please don’t forget the negative effect from the debt problem. We expect most EU governments need to continue their fiscal austerity in 2014. That means most EU governments need to remain spending cut or increase their tax revenue. Both of them will have a negative impact to economic growth. Thus, although we believe EU economy will continue to recover from recession in 2014, we expect the GDP growth rate will be relative small, such as 0.5%.

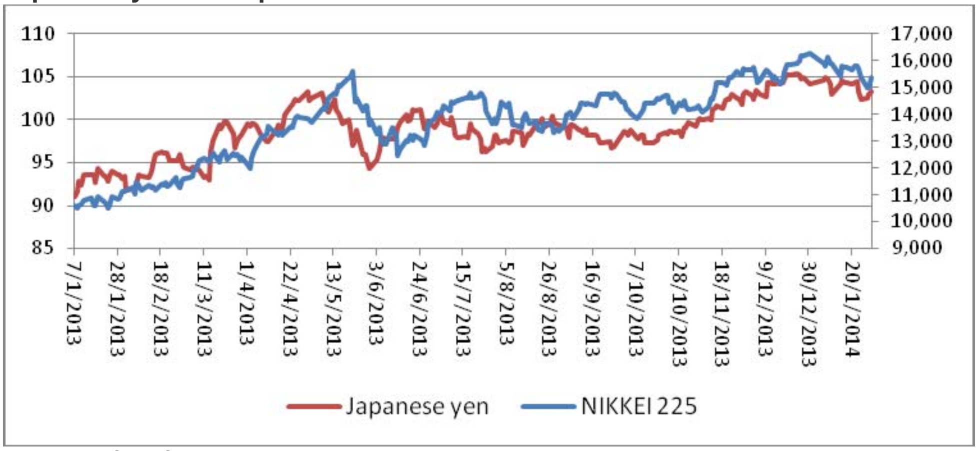
<u>Japan economy and financial market:</u>

The economic momentum has slowed down at the end of 2013. It was due to the diminishing effect from Abe’s quantitative easing. In fact, the quantitative easing proposed by Abe can only have a very short-term push to the Japanese economy. Its effect will not last long. It is because the quantitative easing will not solve those fundamental problems, such as lack of innovation and loss of competitiveness for most Japanese companies.

We believe that as the honeymoon period has passed, Abe will face the strong resistance against the reforms which many former Prime Minster wanted to be implemented and should be implemented. Without these reforms, the recent economic rebound will likely be short-lived.

The weak yen will remain the main supporting factor for the Japanese stock market. We expect Abe may force the BOJ to have a bigger amount of QE in 2014 in order to resume the economic momentum and to counter the negative impact from the planned GST increase in April. If so, we expect that it will lead to another uptrend to the Japanese stock market.

Japanese yen vs. Japanese stock market



Sources: Bloomberg

China economy and financial market:

There were two problems happened in the financial market in January 2014. First of all, the liquidity problem reoccurred. The 1-week SHIBOR has increased to over 6% from 4%. However, we are not very afraid of it as we believe that the Chinese Government is well prepared of it and it can easily solve the problem by injecting the extra money supply to the banking sector. In fact, once the BOC had injected about 400 billion yuan to the market, the SHIBOR has corrected significantly and resumed normal.

1-week SHIBOR

Sources: Bloomberg

The other problem is come from the Trust Product being sold by the banking sector. One of the Trust Products which will be expired on 31 Jan 2014 may not repay the principal to the investors. It is because the Trust has invested on a coal company which was collapsed. Although the involved amount is very small (3 billion yuan only), if it finally cannot pay the money back to the investors, it will be the 1st Trust Product being defaulted in the past decade. We think that the issue is good to the financial development of China because it will alert investors to study more before they really invest on this kind of product. Besides, it also reminds the China Government to increase the supervision and control of the market.

Economy and financial market for Emerging Markets

It is hard for most emerging markets in the past month. It is because most emerging markets have suffered a big drop in their currencies and caused high fluctuation in their financial markets.

However, we don't believe it will eventually become a financial crisis. It is because emerging markets are having a stronger economic power and become less leverage on growing their economies. As a result, the risk of having another financial crisis is much lower.

We expected the recent fire sale of emerging market currencies will continue for a while. However, most of the emerging market currencies are in a depressed level and were oversold. Thus, after the market panic, we expect most of them can have a rebound in the coming 6-12 months.

Commodity:

There was no any material change in the market during the last month.

Oil price: The oil price remains at US$ 90-100. The cold weather in Europe and US has increased the demand for heating oil and thus has a positive effect to the oil price. In 2104, we expect the oil price will remain ups and downs between US$ 90-110 and it is unlikely for it to have any breakthrough.

Gold price: Gold price has rebounded a little bit due to the risk aversion (investors were panic as emerging market currencies have suffered a freefall). However, we still maintain our neutral or slightly negative view on gold as the capital outflow from gold market continues. We will change our view only if we can see the capital outflow has been stopped (as the risk reward profile is not very attractive if the capital remains flow out from the market).

Gold price

Sources: Bloomberg

The outstanding shares for Gold ETF: continue to decrease

Sources: Bloomberg

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

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