AMG Market Commentary

May 2014

The Recovery Of The Giant!

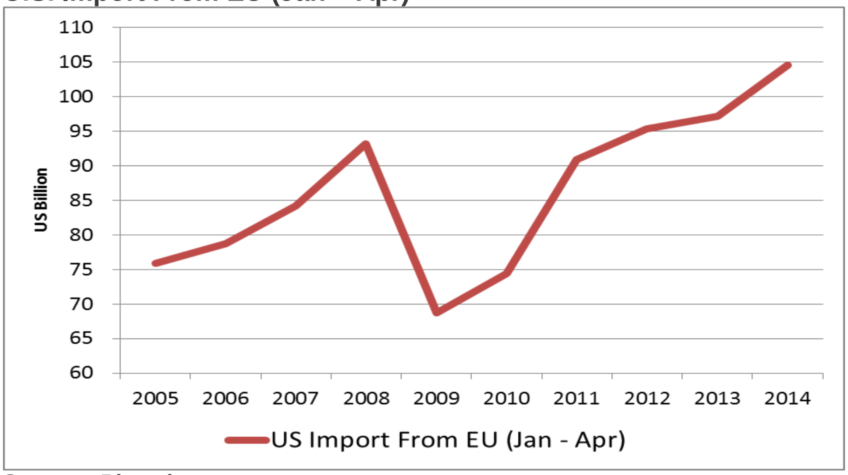
European Union (EU), although it has always been neglected by investors in the investment world (especially when we compare it to U.S. or China), it is the second largest economy in the world. Its GDP was more than US$12 trillion in 2013 (China is the third largest economy in the world with GDP of US$8 trillion in 2013).

After seven successive quarters of negative growth, EU GDP has returned to positive growth in Q4 2013. The GDP was 0.5% in Q4 2013. In 2014, the economic momentum has continued to improve. We believe such good momentum can sustain in the rest of 2014.

The economic recovery was due to both external and internal factors:

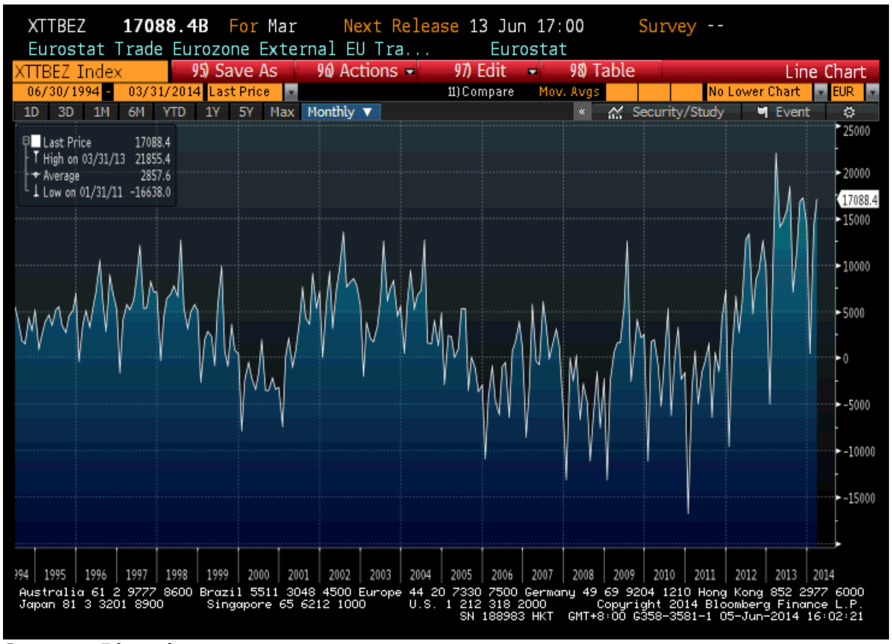
External Factors: Almost all the countries in the world were significantly suffered from the Financial Tsunami happened in 2008. As a result, it significantly hurt the demand for export from EU. However, as time goes by, some economies have been recovered (faster than EU) and their demand for export from EU has started to resume. For example, U.S. has imported US$104.5 billion from EU in Jan – Apr 2014. It has increased 8% YOY. Besides, since the EU economy is still relative weak, its growth in import is much less than its growth in export. As a result, its trade balance has been substantially improved and it was a significant factor for supporting the economic recovery.

U.S. Import From EU (Jan – Apr)



Sources: Bloomberg

EU Trade Balance



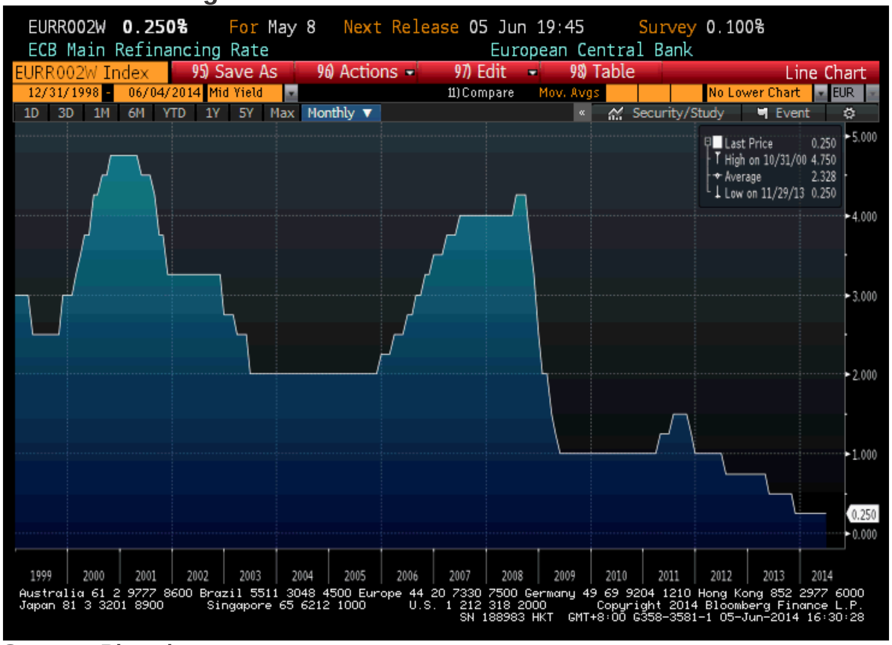
Sources: Bloomberg

Internal Factors: It includes a healthier government budget and a more expansionary monetary policy.

EU governments have a healthier budget now than in the previous years. In the past few years, EU countries were seriously suffered by the debt crisis. In order to recover investors' confident on the sovereign credit, most EU governments had to deeply cut their spending as well as to increase their revenue by raising tax. It was especially for PIIGS (Portugal, Italy, Ireland, Greece and Spain). Under a series of austerity measures, it has significantly affected the economic growth momentum. However, the budget problem has slightly improved (though it is still a problem for most EU countries) after a series of austerity measures have been implemented in the past few years. As a result, it allows some EU governments to lessen their fiscal tightening and it is supportive to the economic growth.

Apart from a healthier fiscal budget, a more expansionary monetary policy was a very significant factor for supporting the economic recovery. If you are familiar with the EU history, you should know that the current ECB was much different to what ECB was in the past decade. In the past, ECB only focused on price stabilization and did not concern anything about economic growth. For example, ECB was one of the few central banks started its interest rate hike cycle in 2011 (when the economy was still in the early stage of recovery). Indeed, the interest rate hike cycle was forced to stop in a very short-period of time as the economic growth has existed problem again. However, ECB has changed its policy stand since 1-2 years ago. It has changed to be more aggressive and more focus on promoting economic growth. For example, ECB has lowered the refinancing rate to below 1% in 2012 (it is the first time ECB has lowered the interest rate to below 1%). Besides, it has further reduced the interest rate to 0.25% in 2013. It was an important factor for supporting the economic recovery.

ECB Refinancing Rate



Sources: Bloomberg

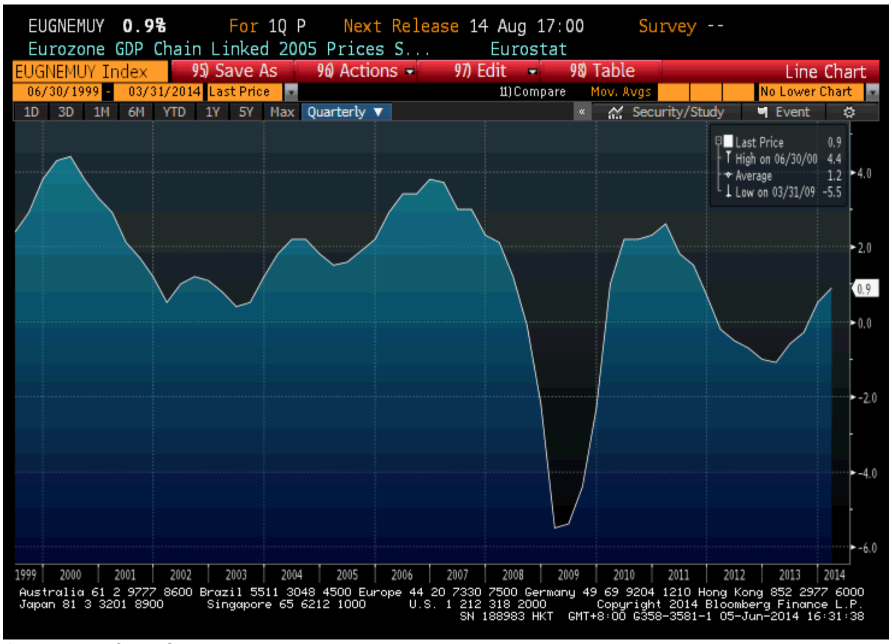
ECB has held its regular meeting today (5 June 2014). After the meeting, ECB has announced that it would further increase its support to the economy by:

- Further reduce the refinancing rate by 0.1% to 0.15%;
- Introduce a negative deposit facility interest rate (0.1%) to banks' excess reserve held in ECB;
- Conduct a new series of targeted longer-term refinancing operations (TLTROs) aimed at improving bank lending to the euro area non-financial private sector (exclude loans to households for house purchases). It is expected the amount will be up to EUR 400 billion;
- Prepare to purchase asset-backed securities in the open market (the details will be announced later)

The above policies were a record in the ECB history. First of all, it is the first time ECB has charged banks for holding excess reserve in ECB. It is also the first time ECB has purchased securities (if it was confirmed later) in the open market. All of the above have shown that ECB is committed to support the economic growth. We believe with the full support from ECB, the economic momentum in EU can continue to improve.

We forecast EU economy can have 0.5%-1% growth in 2014. Though it is very small in absolute term, it will already be a big improvement to EU as its economy has suffered severe recession in the past two years.

EU GDP Growth



Sources: Bloomberg

EU PMI Manufacturing Index

Sources: Bloomberg

EU Consumer Confidence Index

Sources: Bloomberg

Economic Review and Market Outlook

U.S. Economy and Financial Market:

The U.S. Government has recently released its revised GDP figure for Q1 2014. It was a bit surprise to the market that the figure has sharply reduced from 0.1% growth (announced in Apr) to the revised figure of 1% drawdown (the market consensus was a drawdown of 0.5%). However, the worse than expected GDP figure did not hurt investors' confidence on the economic outlook. It is because most investors regarded the GDP figure was a lag behind data. The data was talking about the economic momentum in Q1 2014 (but it is June now). Besides, most investors believed that the poor economic growth figure in Q1 was affected by some short-term negative factors which would not be repeated in the coming quarter. For example, a poor performance in construction sector and a lower inventory were the main reason causing a worse than expected GDP growth in Q1. However, the poor performance in construction sector was affected by the severe weather (affect the construction progress). On the other hand, a lower inventory in Q1 means it is highly possible that it will have a higher inventory in Q2. Last but not least, most investors believe that it will have a strong economic growth in Q2 (it is expected that the GDP growth can be as high as 3% in Q2).

U.S. GDP Growth

Sources: Bloomberg

For the U.S. stock market, it was continued to be supported by the solid economic outlook. However, it was constained by some resistance level formed in the past months. It is highly possible the market will continue to have the normal/ healthy consolidation (as the index has increased about 30% in 2013) and thus limit the further upside room.

Dow Jones Industrial Average Index

Sources: Bloomberg

The yield for 10-year U.S. Government Bond has dropped to below 2.5% last week. It was the lowest level in the past 11 months. The yield has dropped because investors were quite confident that the new Fed Chairman Janet Yellen will continue the loose monetary policy and will not rush to raise the interest rate. It is expected that she will start to raise the interest rate in Q2 or Q3 2015 but at a very slow speed. However, though the Fed may not rush to raise the interest rate, it will be soon to be in a hike cycle. Thus, we do not think that the bond yield can have a further significant drawdown.

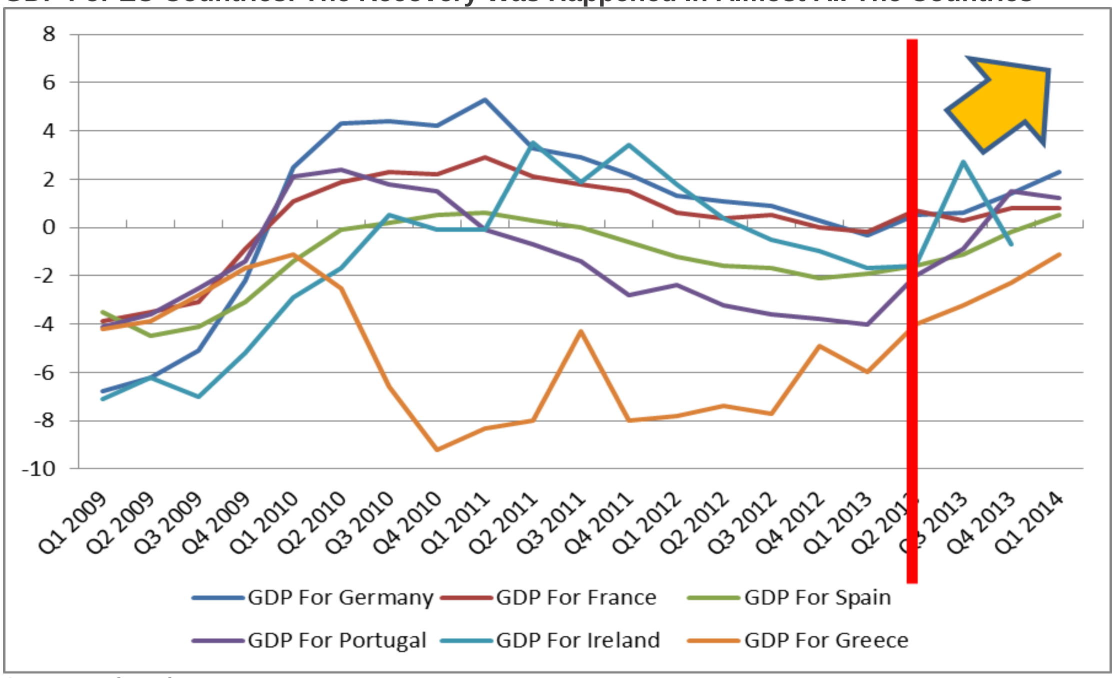
US 10-Year Government Bond Yield

Sources: Bloomberg

EU Economy and Financial Market:

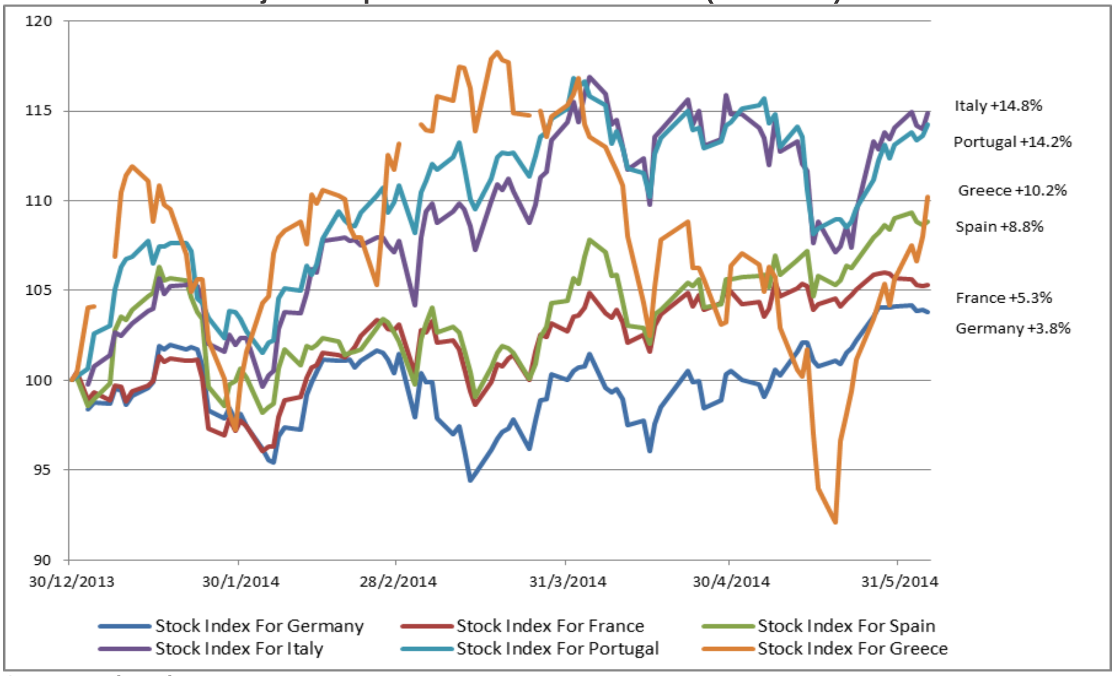
We are bullish on European stock market due to a solid economic recovery and a favorable monetary policy. Until now, the European stock markets had an outstanding performance in 2014. The Euro Stoxx Index was up 4.2%. The stock market performance was especially outstanding in those distressed economies, such as Portugal, Italy, Ireland, Greece and Spain. Their stock markets were pushed up by the momentum led by the economic recovery. We believe that these stock markets will continue to be significantly benefited by the continuous economic recovery. As a result, for aggressive investors, we suggest them to invest in funds having a higher exposure on PIIGS or funds having a small-cap mandate (as they will benefit the most from the economic recovery).

GDP For EU Countries: The Recovery Was Happened In Almost All The Countries



Sources: Bloomberg

Performance For Major European Stock Market Indices (TYD 2014)

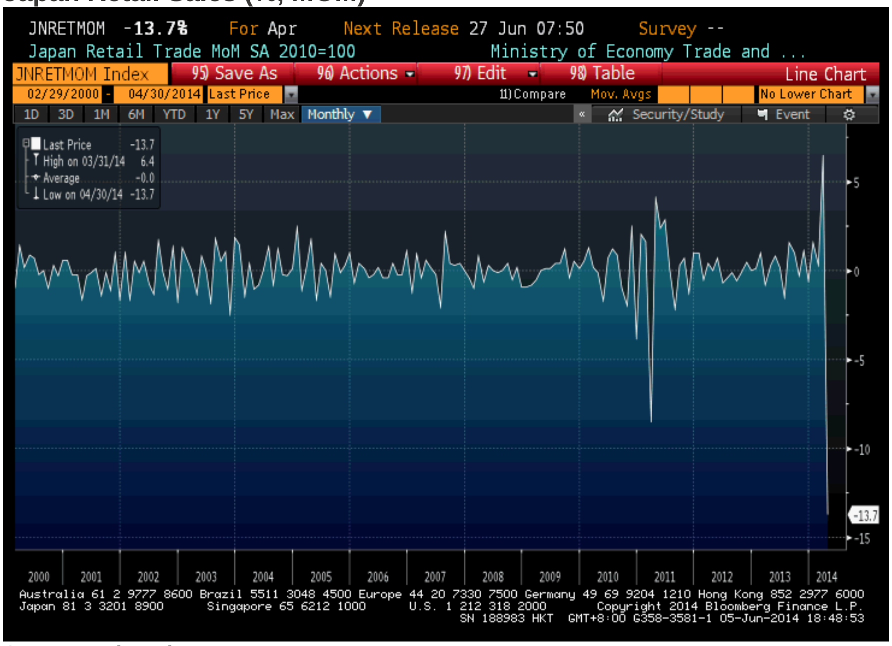


Sources: Bloomberg

Japan Economy and Financial Market:

Japan had a record drawdown in retail sales in April. The retail sales has dropped 14% (MOM). The drawdown was mainly due to the increase in sales tax (from 5% to 8%) starting from 1 Apr. In order to avoid paying a higher sales tax, many consumers have made their purchases in advance (to purchase before 1 Apr). Thus, the retail sales has increased 6.4% in Mar. The increase was very significant and it also pushed up the base for the comparison in Apr. Besides, a higher tax rate has discouraged people to purchase. It has also lowered the sales volume.

Japan Retail Sales (%, MOM)



Sources: Bloomberg

It is still not clear how the sales tax increase will affect the sales volume as well as the economic growth. We think that it will take at least a few months before the Japanese Government, BOJ or investors can have a clearer picture on it.

In sum, the economic outlook remains healthy at this moment. The Japanese Government has released the GDP figure for Q1 in May. It was up 5.9%. The CPI in Apr was up 3.4%. It is the biggest increase since 1991 (though it was exaggerated by the increase in sales tax rate in Apr). However, it was quite clear that the general price level has started to improve since 2013. First of all, the CPI has recorded positive gain in the past eleven successive months. Besides, the CPI has recorded over 1% gain in Jan to Mar this year. It was mainly due to the sharp depreciation of yen and the "imported inflation".

Japan GDP Growth

Sources: Bloomberg

Japan CPI Nationwide (%, YOY)

Sources: Bloomberg

The monetary policy from BOJ continued to be the dominant factor affecting the stock market in Japan. We expect BOJ will further increase its expansionary monetary policy in order to maintain the improving momentum. It will be a positive factor and can lead to another uptrend to the stock market.

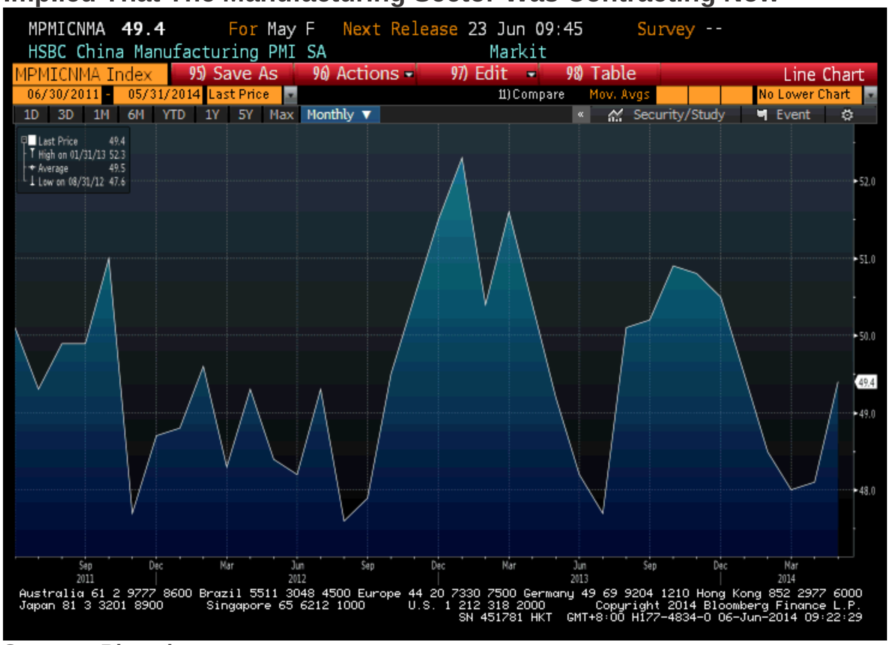
Japanese Stock Market Index

Sources: Bloomberg

China Economy and Financial Market:

It is an indisputable fact that the economy in China has continued to slow down. In May, most economic figures have continued to prove that the economy was still in a downtrend.

HSBC China PMI Manufacturing Index: The Index Has Been Below 50 For Five Successive Months. It Implied That The Manufacturing Sector Was Contracting Now



Sources: Bloomberg

As most investors think that it is almost impossible for the economy to have a sharp rebound in the short-term future, investors are hoping that the China Government will (& soon) act to support the economy as well as the financial markets. In fact, the China Government did not show any indication it will implement any policy soon to support the economy. We think that it was because the economy is not poor enough the China Government must need to do something.

The stock markets in China and HK has recorded a decent performance in May. First of all, the market has been rebounded from the bottom in Apr. Besides, there was a market rumor that some cities will relax its restrictions on the property market. As a result, the market was stimulated, especially for those property-related stocks. Furthermore, the China Government has said that it will lower the Required Reserve Ratio for those banks having substantial loans to agricultural sector or small enterprises. Although it did not mean that the China Government will lower the RRR for all banks, it is more than enough to have a short-term stimulative effect to the stock market.

Performance For Stock Market In China & HK (May 2014): [White: Shanghai Composite Index; Orange: Hang Seng Index]

Sources: Bloomberg

Economy and Financial Market in Emerging Markets:
India and Thailand has been the market focus in May,

India: After the 5-week election, a new Prime Minster was elected in India. As expected, the party led by Modi has won the election. However, it was a little bit surprise that the Modi party has won a majority in the parliament. It is the first time a single party has won majority in the parliament over the past 30 years.

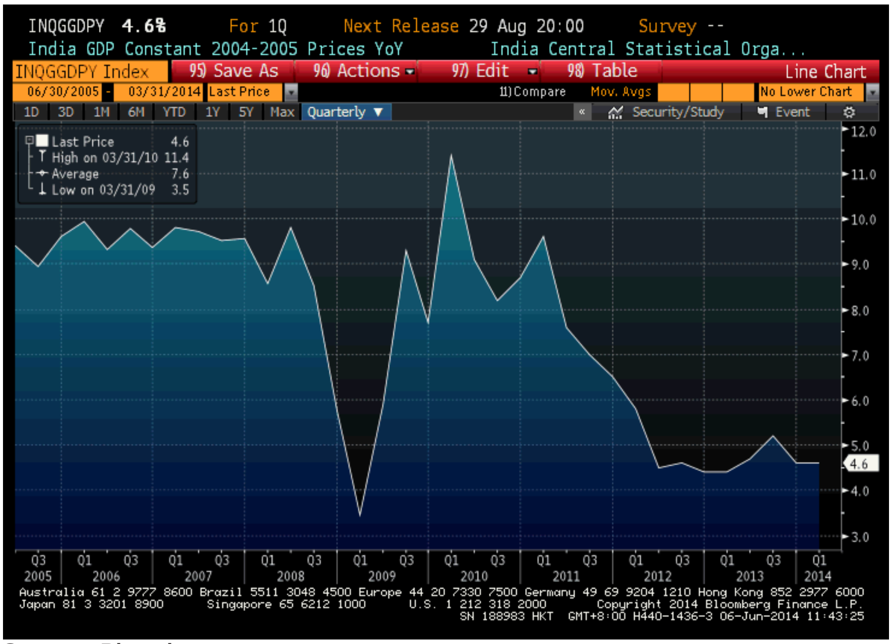
Investors are quite positive on the election result. Most investors expected that the new Prime Minister will significantly improve the efficiency of the government and promote the economic growth. Due to the optimistic view, the Indian stock market has skyrocketed in the past weeks and months. For example, the Indian stock market was up 25% in the past 2-3 months and up 10-15% in the past 2-3 weeks.

Indian Stock Market Index

Sources: Bloomberg

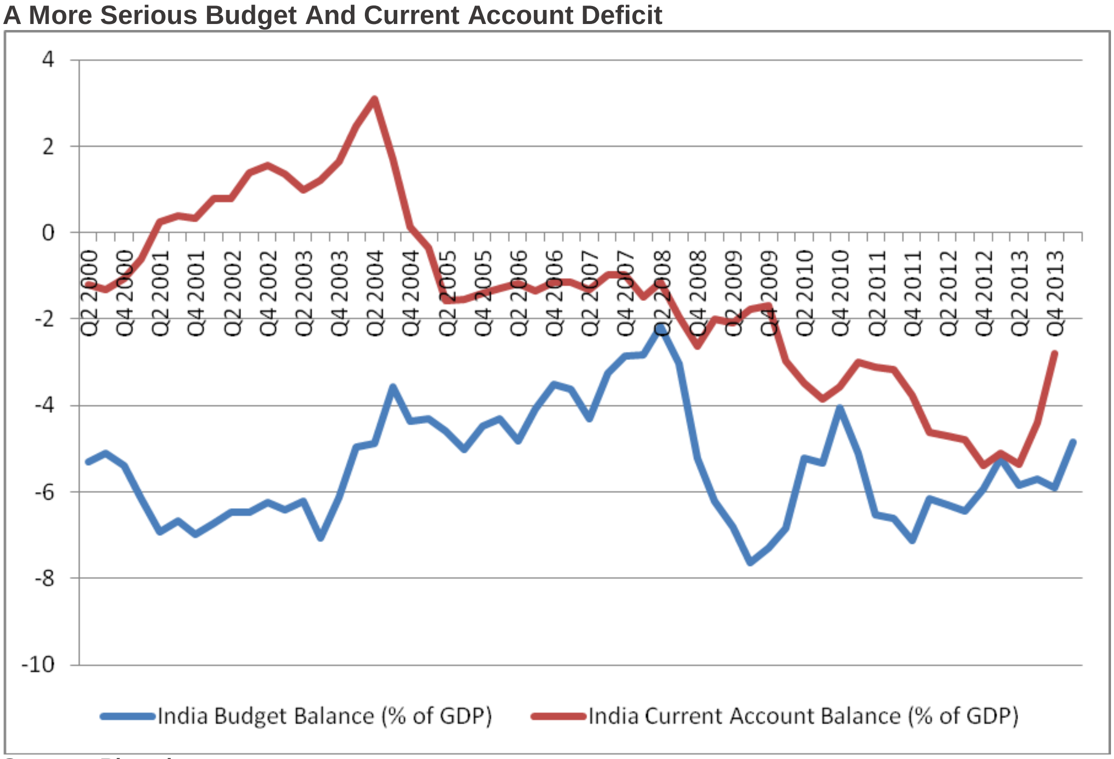
Although the Indian stock market is not very expensive (in terms of valuation; as it is just trading at 19x PE) at this moment, we are a little bit concern that the market may be overbought (as the market has been increased for more than 20% in just 2-3 months). It is because investors may overestimate the positive effect from the new Prime Minister. Even though the new Prime Minister may be able to improve the efficiency of the government and promote economic growth, it did not mean that he can solve all the structural problems existing now, such as the severe slowdown of economic growth, increasing budget and trade deficits, poor infrastructure and underdevelopment of manufacturing sector.

India GDP Growth



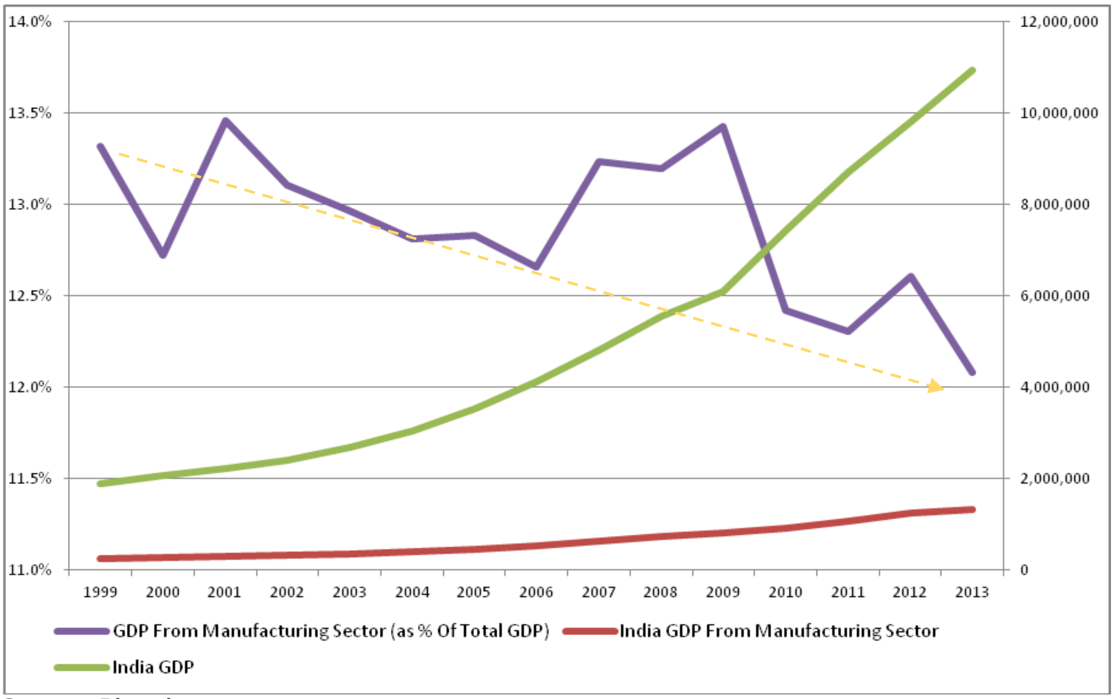
Sources: Bloomberg

A More Serious Budget And Current Account Deficit



Sources: Bloomberg

India Manufacturing Sector: Lack Of Development And Would Become A Bottleneck To Economic Growth In The Future



Sources: Bloomberg

Thailand: The Thai Military has launched a coup d'état on 22 May. The military leader has controlled the government and named himself as the temporary Prime Minister. He would continue to be the temporary Prime Minister until a new Prime Minister was elected. The military leader explained that the coup d'état was necessary to end the political instability and prevent the political stalemate worsening to military conflict or even internal war.

According to the latest announcement from the Thai Military, it is expected that a transitional government will be formed in Oct this year. Then, the Military will form a series of reconciliation and reform working groups in the country in order to listen the opinion from the public. It was also the first time the Military said that it may hold the election as soon as the end of 2015 as the Military needs time to restore the social order and implement the necessary reforms (before holding the election).

Although a coup d'état was happened, it did not have any significant impact to the Thai stock market. In contrast, the Thai stock market index has been increased after the coup d'état. First of all, it was because investors were used to the coup d'état happened in Thailand. It was already the "n" time coup d'état happened in the modern history in Thailand. Thus, investors were not surprised. Besides, investors may be happier to have the coup d'état, rather than keep on the political deadlock (as the political deadlock has seriously affected the normal economic activities). At last, some investors may think that the coup d'état can bring a new order to the country and also the economy.

Thai Stock Market Index

Sources: Bloomberg

Commodity:

Oil Price: The oil price has remained at about US$100-105 in May as the political unrest in Ukraine has continued to be a positive factor to the oil price. We expect the oil price will remain at US$100-105 in June.

NYMEX Crude Oil

Sources: Bloomberg

Gold Price: As what we have mentioned in the last report (Apr 2014), the positive effect from the political unrest in Ukraine (to gold price) has been diminishing (the sharp rise happened in Jan and Feb 2014 should not be repeated). Without the support from the safe-haven demand, the gold price was first consolidated at around US$1,300 and then corrected to around US$1,250.

In medium to long term, we remain our negative view on gold price as the capital has continued to flow out from the gold market and it will continue to be a negative factor to the gold price.

Gold Price

Sources: Bloomberg

Outstanding Shares For Gold ETF: It Shows That The Capital Has Continued To Flow Out From The Gold Market

Sources: Bloomberg

Hong Kong Government Will Issue The iBond Again:

It is expected that the Hong Kong Government will issue the iBond again in July. It is the fourth time the government has issued such kind of bond to the public.

Although the government has not yet announced the details, the detail of the sales should be as below:

- Issue amount: HK$10 billion;
- Years to maturity: 3 years
- Minimum purchase amount: HK$10,000
- Coupon: Fixed rate (1%) or floating rate (the arithmetic average of the year-on-year rates of change in Composite Consumer Price Index for the 6 most recent preceding months); whichever is the highest (paid semi-annually)

As the government will price the bond at par (HK$100; normally, the issuer will price the bond at above par if the demand for the bond is huge), with the above terms and conditions, the potential return for iBond is very attractive when compare to other existing HK government bond in the market (with the same years to maturity).

It is because the yield for a 3-year HK government bond is 0.68% at this moment. If you buy a 3-year HK government bond and hold it to maturity, you can gain 0.68%p.a. for 3 years. However, if you buy the iBond in IPO and also hold it to maturity, you can gain at least 1%p.a. (the fixed rate) for 3 years. Indeed, your annual return is highly possible to more than 1%p.a. as the CPI was at around 3-4% in the past 2-3 years. Thus, your return is highly possible to be 3-4%p.a. in the coming 3 years which is 3%p.a. more than you have bought a HK government bond.

<u>The Sales of iBond Is The Same as The Government Give Money to the Investors</u>
As shown above, the iBond was underpriced (refer to the IPO price) by the government. Therefore, it is always criticized by the public that the government has given money to the investors. Indeed, the bond price usually will be up 2-4% in the first trading day to reflect its real reasonable value. However, don't be too excited and hope to make a big gain in the iBond IPO. It is because it is always over-subscription and each investor can only get 2-3 lots (i.e. investment amount of HK$20,000-30,000).

$$\text{Reasonble Price For A Bond} = \sum_{t=1}^{T} \frac{Coupon\ Payment_t}{(1+IRR)^t} + \frac{Principal}{(1+IRR)^T}$$

Performance For iBond Issued in 2013: The Total Return Was About 9% In The Past One Year (4%Coupon Payment + 5% Price Gain)

Sources: Bloomberg

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

For any comments, please send email to us at <u>enquiries@amgwealth.com</u>.

AMG Financial Group
5/F, Guangdong Investment Tower, 148 Connaught Road Central, Central, HONG KONG
Telephone: (852) 3970 9531 Facsimile: (852) 3426 2650