AMG Market Commentary

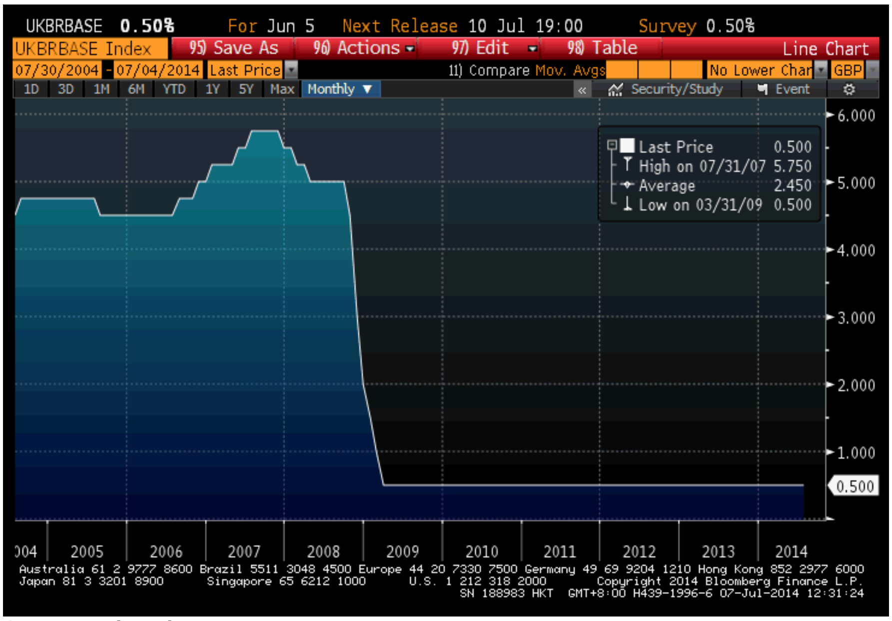
June 2014

No Need To Worry, The Global Rate Hike Is Still Far Away

Recently, the BOE Governor has said that BOE may lift the interest rate sooner than markets expected. After the speech, the financial market has immediately priced in the possible interest rate hike and investors expected that the BOE will start raising the interest rate at the end of this year. It will be the second developed country (after New Zealand) to begin the interest rate hike cycle.

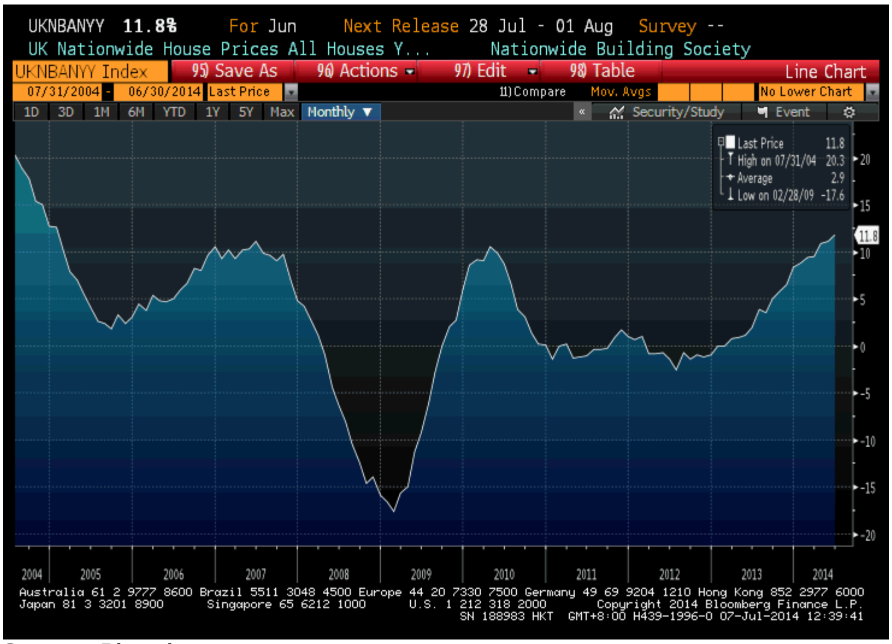
However, unlike New Zealand, it is not the intention of BOE to raise the interest rate. From BOE's point of view, it did not want to raise the interest rate as it wants to keep the rate low to support the economic growth. It has to raise the interest rate because it needs a higher interest rate to cool down the property market as the property price has heated up in the past months.

BOE Official Bank Rate



Sources: Bloomberg

UK Nationwide House Price YOY



Sources: Bloomberg

On the other hand, the U.S. Government has announced the job data for June last week. Both Non-farm Payroll and Unemployment Rate were much better than the market expectation. For example, Non-farm Payroll has increased to 288k which has increased substantially from the previous month (from 224k in May) and also substantially better than the market expectation (215k). As a result, some investors were afraid that the U.S. Fed may speed up the tapering. Investors expected that the U.S. Fed may raise the interest rate as soon as Q2 2015, rather than the previous forecast of Q3 or even Q4 2015.

U.S. Fed Fund Target Rate

Sources: Bloomberg

Same, we are not too worried that the U.S. Fed will significantly speed up its tapering. It is because the U.S. Fed has the same mentality as the BOE. Both of them do want to maintain a very low interest rate in order to support the economic growth. Thus, we are not afraid that the U.S. Fed will rush to raise the interest rate. Besides, we are also assured by the speeches from Janet Yellen that she has maintained her dovish stance after she has become the Fed Chairman. She has emphasized again and again that she will not push the Fed to raise the interest rate as the U.S. labor market is still not strong enough, especially the labor force participation rate is at a historical low level and the underemployment rate is at a relative high level.

US Labor Force Participation Rate

Sources: Bloomberg

U.S. Underemployment Rate

Sources: Bloomberg

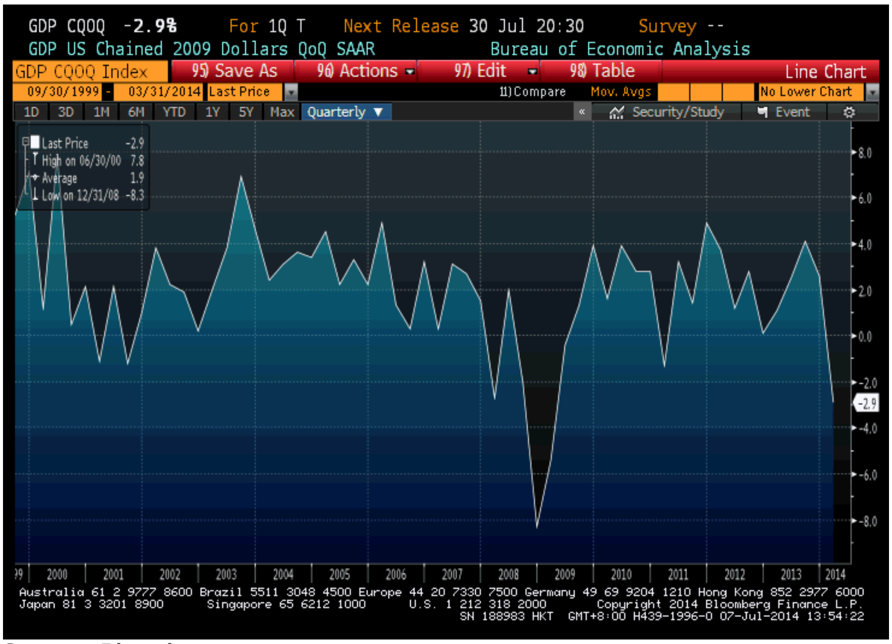
Therefore, although the BOE may start to raise the interest rate by the end of 2014, we are quite confident the BOE will only raise the interest rate gradually and small in size. It will be very different to the previous interest rate hike cycles which the central banks have raised the interest rate quickly and significantly. It is because the BOE itself does not want to raise the interest rate.

The other two economic powers – EU and Japan, it is expected that they will maintain their loose monetary policy in a certain long period of time. For EU, the ECB has just enhanced its expansionary monetary policy in June. For Japan, although BOJ did not have any actions in the past few months, it is highly possible that it will follow EU to enhance its expansionary monetary policy in a foreseeable future.

Economic Review and Market Outlook

U.S. Economy and Financial Market:
Economic data have become the major factor affecting the financial market last month. For example, the US Government has released the final estimation for Q1 GDP on 25 June. The GDP growth result was significantly below the market expectation. The GDP growth was revised downward to -2.9% (from -1% in the previous estimation).

U.S. GDP Growth



Sources: Bloomberg

The -2.9% is the first GDP drawdown since 2011. It is also the biggest drawdown since Q2 2009. Although such poor GDP figure should lead to market to worry about the economic growth, investors were surprisingly calm and regarded it as an individual case only. Most investors believed that the ugly GDP figure in Q1 was affected by the severe weather and the seasonal decrease in inventory. It will not be repeated in Q2 and the rest of 2014. They expected that the economy will resume to positive growth in Q2 and the GDP growth may be as high as 3% in Q2. In this regard, we share the same view as we did see a very solid economic momentum from most of the economic data released in the past months. We believe that the negative GDP in Q1 is just a temporary issue and will not continue in Q2 or the rest of 2014.

As what we have mentioned above, most of the economic data released in the past months have shown the economy was growing at a solid pace. For example, the labor market data were strong in the past months. Last Thursday, the U.S. Government has released a series of labor market data. Although the Labor Force Participation Rate and Average Hourly Earnings have remained flat, the Non-farm Payroll and Unemployment Rate have improved significantly and were much better than the market consensus.

U.S. Non-Farm Payroll

Sources: Bloomberg

U.S. Unemployment Rate

Sources: Bloomberg

U.S. Average Hourly Earnings

Sources: Bloomberg

Although the labor market data were very outstanding, it did not have any stimulus to the stock market. It is because investors were afraid that a too good labor market data will push the U.S. Fed to speed up the tapering and it will lead to a negative impact to the stock market. On the other hand, the better than expected labor market data did not cause any panic in the stock market as stated above. It is because before the release of the data, Janet Yellen has repeatedly emphasized the U.S. Fed will not just focus on the unemployment rate in determining the right timing for raising the interest rate. It will consider a series of data, such as labor force participation rate, underemployment rate, hourly earnings, etc.

EU Economy and Financial Market:

ECB has enhanced its expansionary monetary policy in June. Although it is difficult to assess its efficiency at this moment, we are quite sure that it will create a positive impact to the economy as well as the financial market.

For example, although the target interest rate has just decreased from 0.25% to 0.15%, it is still a positive factor to the economic growth. It is because a lower interest rate can encourage consumption and investment. Besides, after the ECB's action in June, both consumers and investors believed that the extremely low interest rate environment will last for a longer time. It will also encourage the consumption as well as the investment.

The European stock market was stimulated by the ECB action and has recorded an outstanding YTD performance. Most of them are now trading at their highest level since the Financial Crisis happened in 2008 or even at their historical high.

	YTD Performance %
EURO Stoxx 50	8.17%
MSCI Euro	7.95%
Germany DAX Index	4.78%
France CAC Index	7.15%
Italy Stock Market Index	16.25%
Spain Stock Market Index	14.20%
Portugal Stock Market Index	9.32%
Ireland Stock Market Index	6.86%
Greece Stock Market Index	7.34%

Sources: Bloomberg

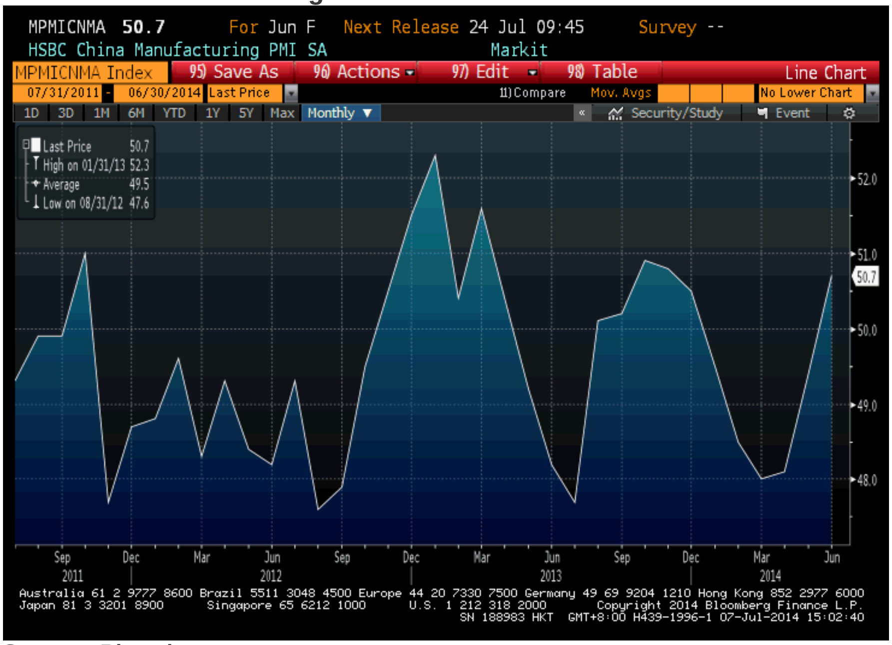
Japan Economy and Financial Market:
Prime Minister Shinzo Abe's Cabinet approved a reinterpretation of the country's pacifist postwar constitution that will allow the military to help defend allies and others "in a close relationship" with Japan under what is known as "collective self-defence". The reinterpretation has violated the norms from the previous government leaderships that Japan can only exercise the right of self-defence after the country itself was being attacked. It is regarded that the reinterpretation is a preparation for the Abe-led government to send troops abroad in the future as it has cleared all the obstacles from the Constitution.

The Abe’s move has immediately drew sharp criticism from the neighboring countries. Besides, most of the Japanese were also strongly opposed. About 2,000 people protested outside Abe's office, saying that any changes to the constitution should be made through a public referendum, not simply a Cabinet reinterpretation. The 1947 constitution says the Japanese people "forever renounce war as a sovereign right of the nation". The latest polls show that 67% of Japanese people are opposed the Cabinet reinterpretation and 56% of Japanese people are opposed to any form of way to lifting the ban.

We believe that the move from Abe will lead to instability to the political environment. Although the move may strengthen the support to him from the radicals, he will lose the support from the moderates. The move may thus lead to instability of his leadership. In order to safeguard his leadership, he needs to have a good performance in the economic growth. As a result, we expect Abe will do whatever he can to push up the economy, including but not limited to forcing BOJ to adopt a more expansionary monetary policy.

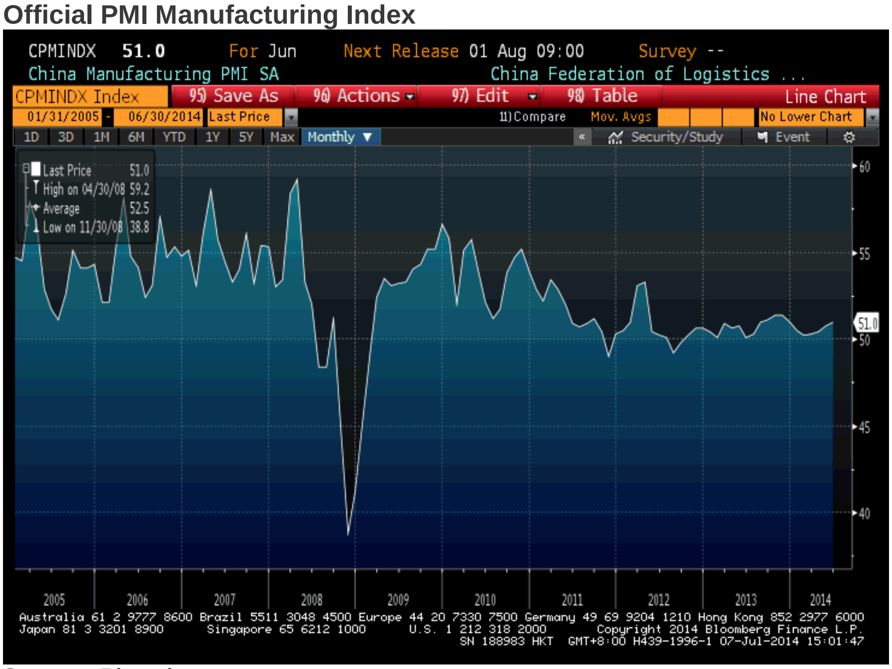
China Economy and Financial Market:
The economic momentum seems to be strengthened last month. However, it is difficult to confirm the trend at this moment as there were not enough positive data to support such conclusion. Nevertheless, it is still a good news as it was seldom to have such positive economic data in the past 1-2 years. For example, both Official PMI and HSBC PMI Manufacturing Index have rebounded from the low level in the previous month. Besides, both of them were above 50 which implied that the manufacturing sector is expanding.

HSBC PMI Manufacturing Index



Sources: Bloomberg

Official PMI Manufacturing Index



Sources: Bloomberg

Apart from an improving economic momentum, investors were also focus on any possible expansionary actions from the China Government. Some investors were expecting that the China Government will loosen its fiscal and monetary policy in order to maintain the economic growth at the desired level.

In the past month, the China Government has lowered the Required Reserve Ratio for some banks. Although the China Government just provided the reduction for those banks with substantial loans to rural development or small enterprises (not all the banks can enjoy the reduction), it has shown that the China Government is willing to provide the support if it is necessary. Besides, it also leads more investors to expect that the China Government will provide more support for the economy in the short-term future.

As more investors were expecting the China Government will soon provide more support for the economy, the stock market has thus increased recently. For example, the Hong Kong Hang Seng Index is trading at 23,500 at this moment which is near the 52-week high. Although we are very positive to the long-term outlook of the Chinese stock market, we have turned to be more cautious at this moment as the short-term upside may be limited due to the lack of further good market news (The economic momentum may improve further but we do not think that the economic momentum can have an substantial improvement within a short period of time. Besides, we do not expect the China Government will implement any substantial expansionary fiscal or monetary policies, unless the economy has suffered a severe drawdown). Thus, if the HK stock market has further increased and reached 24,500, we may start to trim down our position on the China Equity Fund. We may keep the cash and wait for another buy opportunity.

Hong Kong Hang Seng Index

Sources: Bloomberg

Economy and Financial Market in Emerging Markets:

Although the performance for most emerging markets has remained volatile in the past 6 months, the situation has started to change recently. Besides, investors have started to invest in these markets. According to the statistics from Bloomberg, investors have piled almost US$ 11 billion into developing –nation exchange-traded funds listed in the U.S. last quarter. It is the most since 2012.

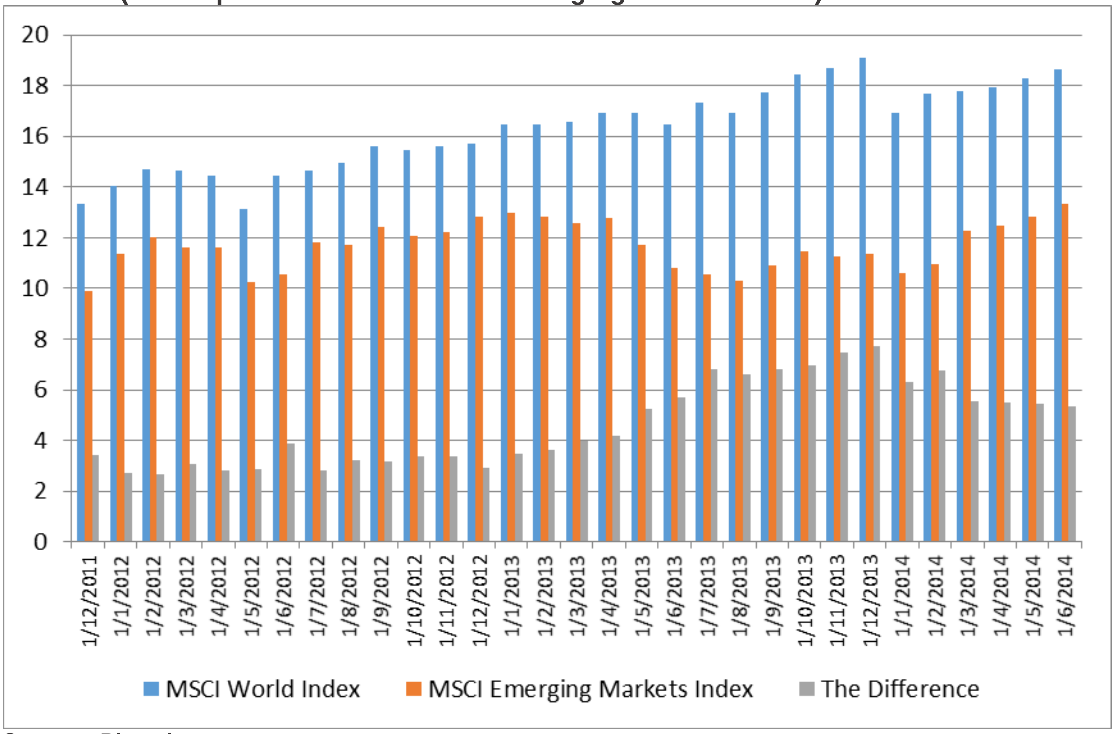
As a result, most emerging stock markets have recorded an outstanding performance last quarter. For example, MSCI Emerging Markets Index was up 5.6% in Q2 2014 which was the biggest quarterly gain since Q4 2012. Besides, it is also the first time the Emerging Markets (MSCI Emerging Markets Index) has outperformed the Developed Markets (MSCI World Index) since 2012.

MSCI Emerging Markets Index

Sources: Bloomberg

The Emerging Markets had such outstanding performance in Q2 because investors have changed their risk appetite and were willing to take more risk. In the past 1-2 years, investors tended to be more risk-averse and had a pessimistic view on most emerging markets. They were afraid that if the U.S. Fed really started to raise the interest rate, the emerging markets would suffer significantly. Indeed, even though the Fed has started tapering for more than 6 months, most emerging markets were fine and no substantial suffering has happened due to the U.S. Fed tapering. As a result, investors started to realize that they were over worried and started to be more confident to the emerging markets investment. On the other hand, investors have increased their exposure in emerging markets because the valuation for emerging markets is much lower than the valuation for developed markets. For example, the PE ratio for MSCI Emerging Markets Index was 10x and for MSCI World Index was 13x at the beginning of 2012. Two years later (as of Feb 2014), the PE ratio for MSCI Emerging Markets Index has increased to 11x but the PE ratio for MSCI World Index has increased to almost 18x. The difference has significantly enlarged from 3x to 7x. Besides, as the valuation for most developed stock markets (in absolute term) are not low now, it also leads some investors to shift their investment from developed markets to emerging markets (at a much cheaper price).

PE Ratio (Developed Stock Markets vs. Emerging Stock Markets)



Sources: Bloomberg

Commodity:

Crude Oil Price: The political situation in Iraq has undertaken Ukraine to be the most important factor affecting the short-term oil price. The political unrest in Iraq has intensified since the early June. The anti-government forces have captured some of the cities and there was a risk that they may control the Baghdad soon. As a result, the oil price has increased from US$102 to US$108. Afterward, the oil price has dropped back to US$103 as the political unrest in Iraq has not worsened. However, we expect that the political unrest in Iraq will remain a positive factor to the oil price for a certain period of time.

If we compare the effect from the political unrest in Iraq and Ukraine, the effect from the political unrest in Iraq will be much greater than the effect from the political unrest in Ukraine. It is because Iraq is more important to global oil supply than Ukraine is. For Iraq, it is the 6th largest oil exporter in the world which exports crude oil of 2.2 million barrel per day. It is about 5-6% of the global total crude oil export. Besides, Iraq is located at the center of the whole Middle East. If Iraq was eventually controlled by the anti-government forces, the political unrest may be spread to other countries in the Middle East and it will lead to a risk to the global oil supply (as altogether, Middle East countries have exported crude oil of over 20 million barrel per day, which is about 1/2 of the global total crude oil export).

In front of the anti-government forces, the Iraq's Government was too weak and assistance from other country is needed. However, it is very unlikely that U.S. Government will give out its hand to Iraq again. It is because most of the U.S. people are weary of war and will not agree the U.S. Government to join the battlefield again. Besides, the U.S. Government also does not want to fall into the trap in Iraq and create another financial and political burden for itself. Without the help from the U.S. Government, we expect the Iraq's Government is not able to suppress the anti-government forces completely and thus the political unrest in Iraq will last for a quite long time. The political situation will remain unstable in Iraq and it will remain to be a positive factor to the oil price.

MYMEX Crude Oil Price

Sources: Bloomberg

Gold Price: The political unrest in Iraq has pushed up the gold price in the past few weeks. Like the price hike after the Ukrainian political crisis happened in Feb, the gold price has increased from US$1,250 in the early June to around US$1,320 in the end of June. We expect the political unrest will last for a quite long time and it will remain to be a positive factor to the gold price. However, we think that the gold price may be limited by US$1,400 and thus the upside potential is not very attractive at this moment.

Gold Price

Sources: Bloomberg

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

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