AMG FINANCIAL GROUP 安柏

AMG Market Commentary

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The Recent Pullback In Stock Markets Was Just A Correction. The Medium To Long Term Uptrend Should Be Remained Unchanged.

Global stock markets have corrected in the past few weeks. It caused investors to worry that the market uptrend since 2009 may go to the end and the stock market will start a bearish cycle.

To be honest, the recent correction was just very small in size and should not be over exaggerated. Some investors were worried just because they were accustomed to the relative stable upward trend in the past years and forgot it is normal for stock markets to have ups and downs. For example, the Dow Jones Industrial Average was down just 4% from the recent peak. The MSCI Asia (ex Japan) Index and the MSCI Emerging Markets Index were also down only 4%. The European stock market has recorded a bigger decline but it was still less than 10%. Thus, the recent correction was just a normal market up and down and was very usual in the stock market. Therefore, investors should not feel panic about it.

MSCI World Index

Source: Bloomberg

The reasons causing the recent market correction

The recent market correction was mainly due to the geopolitical tensions and some market uncertainties. However, we are quite confident that most of them will not lead to lasting and severe impact to the global economic. Besides, their impact on the stock market should be short-lived.

The negative factors include:

1. The political conflict between US, EU and Russia: The conflict in the Ukraine has continued to worsen the relationship between US, EU and Russia. Russia has announced its anti-sanctions to US and EU after US and EU have launched two rounds of sanctions against Russia. The anti-sanction from Russia included

banning the import of agricultural products from US, EU and other Western countries. After the launch of the anti-sanction from the Russian Government, investors were worried that the struggle between US, EU and Russia will be further intersified and it will eventually lead to a significant impact to the global economy. However, we think that although several rounds of sanctions were launched against each other, they were still moderate in nature. It is because both (especially US and EU) are well understood that if they imposed a very harsh punishment again Russia, it would only lead to a more significant fight back from Russia and it will eventually hurt itself. Besides, we believe that some European countries may change to be less aggressive against Russia after Russia has announced the anit-sanction. It is because some European countries were afraid that if EU maintained the aggressive policy against Russia, it will lead to a significant negative impact to the European economy (as the anti-sanction from Russia would have a more harmful impact to the European economy). For example, EU has exported US$16 billion agricultural products to Russia in 2013 while US has only exported US$1.3 billion agricultural products to Russia.

2. US steps up air campaign in Iraq: Last week, the US Government has announced that in order to support the Iraqi Government against the anti-government rebels, it would start air strikes against the anti-government rebels. The air strikes have successfully destroyed some of the anti-government military forces and prevent them from conquering the capital city and other major oil facilities. Although the political situation in Iraq may remain uncertain for a certain period of time, we think that investors do not need to be too worried about it. It is because the situation in Iraq is still totally under the control of the US Government. On the other hand, as the global oil supply is still very abundant (relative to the global demand), the political uncertainty in Iraq should not lead to a sharp hike in oil price and thus will not lead to a severe impact to the global economic growth.

3. The bankruptcy of Argentina: We believe that the bankruptcy of Argentina will only have a very small impact, or even no impact to the global economy as well as the financial markets. Firstly, it is not the first time for the Argentinian Government to go bankrupt. The Argentinian Government has announced it would suspend its debt payments since Dec 2001. It has remained bankrupt in the past 12 years. Secondly, the Argentinian Government has gone bankrupt again just because it failed to reach a compromise with a few US creditors. In the past few years, the Argentinian Government has reached an agreement with most creditors to accept the hair-cut (reduce the principal by 70%). However, a few US creditors did not accept the hair-cut and requested the Argentinian Government to repay in full. Those US creditors finally sued the Argentinian Government and the US court judged that the Argentinian Government needs to return the full principal to the US creditors and prohibit the Argentinian Government to repay the other creditors before it has fully repaid the principal to the US creditors. As a result, the Argentinian Government cannot repay the money to the creditors as required and thus was forced to fall into bankruptcy again. Thus, the impact from the bankruptcy of Argentina should be minimal as i) it is not the first time for the Argentinian Government to go bankrupt; ii) the current situation is very different to the situation in 2001. In 2001, the Argentinian Government was lack of money and thus could not finance its debt. In 2014, the Argentinian Government is rich enough to finance its debt. It has become bankrupt just because it could not reach an agreement with a few creditors and thus make it failed to repay the remaining creditors on time (indeed, the Argentinian Government has transferred the needed money to its US bank account and ready to pay out to the creditors [those accepted the haircut]). Lastly, the bankruptcy of Argentina is just a single event. We do not see any signals that any neighboring countries have the same or similar fiscal problem.

Argentinian Stock Market Index: We did not see any significant impact from the bankruptcy

Source: Bloomberg

4. The banking crisis happened in Portugal: 1-2 months ago, investors were very concern about the financial health of BES – one of the largest banks in Portugal as its parent company could not finance its debt on time. Investors were afraid that the similar problem would be happened in BES and would lead to a banking crisis in Portugal or even in the whole EU. Last week, BES was proved to be at risk of insolvency due to a huge loss recorded in the last quarter. At last, BES was rescued by the central bank of Portugal. Although BES was eventually to be at risk of insolvency and assistance by the central bank was needed, we think that investors do not need to worry too much about this. It is because we believe that the problem of BES is just an individual event and it will not lead to another European debt crisis. Besides, we are quite confident on the European banking sector and we do not believe there is any substantial systematic risk existing in the European banking sector. In the past few years, ECB has done a lot to improve the financial health of the European banks. For example, it has applied a stress test to most big European banks to access their risk tolerance ability. In the stress test, it analyzed whether the bank has enough capital to tolerate the financial suffer if there is another economic recession or financial market crash. After the test, most of the banks have improved its financial health by increasing their capital through capital raising or earnings retention.

5. The outbreak of Ebola: Comparing to the above negative factors, we are more afraid about the possible negative impact from the outbreak of Ebola. We are afraid that it will cause significant impact to the global economy as well as the financial market. It is because the virus has been already out of control in Africa and it is possible to be spread out to other continent by the travelers. If the virus was really spread out around the world, it must lead to a significant impact to the global economic activities. As a result, it will also lead to a significant impact to the global financial markets. Thus, we recommend the investors to pay attention to the latest update about the virus and make any appropriate change to your investment portfolio.

   In conclusion, if the Ebola virus has not spread out and become a large-scale outbreak in the world (the worst scenario), we are quite positive that the recent market pull down will be just a short-term correction and the global stock markets can quickly regain its momentum and go to another record high. We suggest investors to make bargain hunting during the correction. Among various markets, we suggest to increase the investment on the European stock market as the recent correction was oversized and investors were over-worried to the negative factors.

Economic Review and Market Outlook

US Economy and Financial Market:

At the end of July, the US Government has announced the Q2 GDP growth figure which was up 4%. It has rebounded from the negative growth recorded in Q1 and is also better than the market consensus (3%). Although the GDP growth in Q2 is better than expected, we need to pay attention to the details. It is quite obvious that the strong growth in Q2 was just due to the extremely weak GDP performance in Q1. Thus, we cannot say that the US economy is really having a very strong growth. For example, the inventories have dropped significantly in Q1 and led to a negative GDP growth in Q1. However, the inventories have rebounded significantly in Q2 and led to an outstanding GDP growth in Q2. The inventories alone have contributed 1.7% growth to GDP in Q2.

US GDP Growth

Source: Bloomberg

The US Fed monetary policy has continued to be the hot topic in the investment world. In the past month, some investors have been worried that the Fed would start to increase the interest rate earlier than most investors have expected. They had such worry because the labor cost has recently increased at a faster rate and the increase was also larger than the market consensus. "Employment" is the major factor that Janet Yellen has been closely monitoring on deciding the interest rate policy. Janet Yellen has not started the interest rate hike yet because she thought that the current condition for the labor market was still far away from the full employment. She has repeatedly explained to the public that the labor market was still weak because the wage increase was still small (& the labor force participation rate was at a very low level; and the underemployment rate was still at a relative high level, etc.). Thus, some investors were very afraid that if the labor cost has continued to increase, Janet Yellen may change her mind and support to start the interest rate hike.

However, we are not afraid that Janet Yellen will raise the interest rate too soon. First of all, a single data is not enough to confirm whether the labor cost has really started to speed up or not. It will take at least a few months to observe the coming data and have the conclusion. Even though if it has confirmed that the labor cost was really speeded up, it has already been the end of 2014 or early of 2015. Then, it is almost indifference to the current market consensus that the Fed will start to raise the interest rate in Q2 or Q3 2015 (as the Fed may need a few months to prepare the rate hike after it has confirmed the labor market was strong enough to induce a rate hike). Besides, investors should not have a perception that it must be a bad thing for the Fed to raise the interest rate. Investors should regard rate hike as a good signal as it proved that the US economy has been fully rebounded and had a solid growth outlook. Otherwise, the Fed will not have the confidence to raise the interest rate.

EU Economy and Financial Market:

The European economy has shown a small slowdown during the past few months. For example, the Q2 GDP growth was flat (QOQ; in terms of YOY, the growth was 0.7%). It was a disappointing figure to most investors. Some investors have blamed that the economic slowdown was due to the negative impact from the recent political conflict between EU and Russia. We agree that the recent political conflict would have a negative impact to the EU economy. However, we think that the impact should remain minimal at this moment and the impact should not be exaggerated.

We believe that the recent economic slowdown was just a short-term fluctuation and was just a usual phenomenon, especially the EU economy has just recovered from the recession a few quarters ago. EU economy is still at the early stage of recovery and thus a short-term up and down is very common. Besides, most economic figures have still shown that the EU economy was still at the recovery stage and the uptrend has remained unchanged. Once again, we believe that the political conflict with Russia will not lead to a real and severe struggle between EU and Russia and thus its negative impact to the EU economy should be short-lived and minimal.

The ultra-loose monetary policy continued to be the most supporting factor to the EU economy as well as the EU financial markets. ECB has enhanced its expansionary monetary policy in June 2014. It is expected that the enhanced expansionary monetary policy will continue to support the economic growth and the stock market performance.

For the equity market, we think that the recent correction was excessive and over reflected the negative factors in the market. Thus, we suggest investors can bargain hunting at the current level.

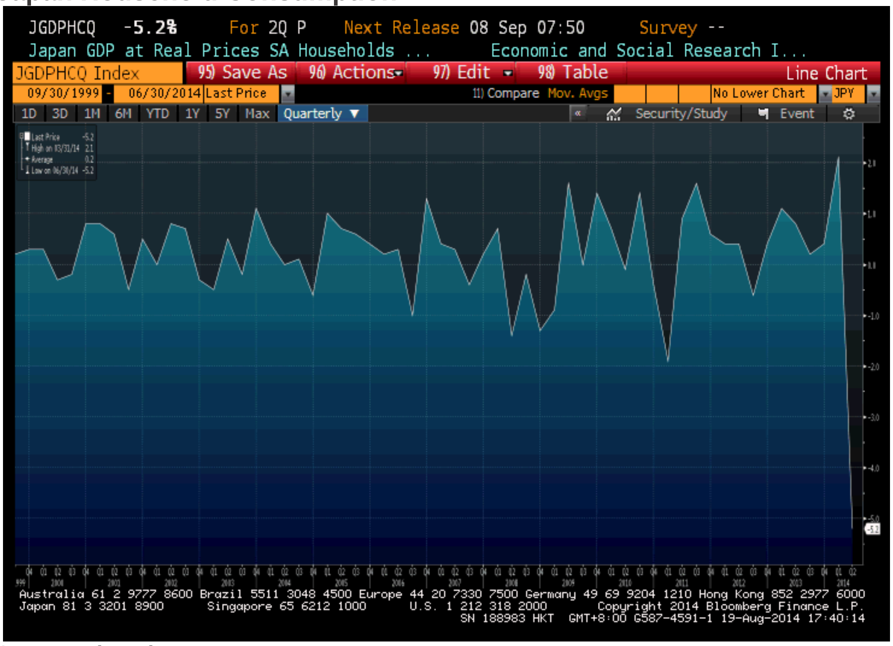
European Stoxx 50 Index

Source: Bloomberg

Japan Economy and Financial Market:

The Japan GDP has recorded a 6.8% setback in Q2. However, the setback was mainly due to the impact from the increase in sales tax starting from 1 Apr. Due to a higher sales tax, the consumer spending has reduced significantly in Q2 (consumer spending has decreased 5.2% in Q2). Although the GDP figures have been distorted by the impact from the increase in sales tax (it may not reflect the real economic situation as the increase in sales tax has forced the consumers to make an early consumption in Q1 and exhausted the consumption power in Q2 and the following quarters), it did not mean that there was no problems in the economy. It is obvious that the stimulative effect from the Abe's expansionary policy has been diminishing and there is a risk that the recovery since 2013 may go to the end. Thus, in order for Abe to maintain the ruling power, it is expected that Abe will launch another round of expansionary policies soon and if so, it will stimulate the economic growth and weaken the yen (having a lower value of yen) and benefit the stock market.

Japan Household Consumption



Source: Bloomberg

We believe that it is highly possible Abe will force the Bank of Japan to further loosen its monetary policies, such as to further increase the money supply to further stimulate the economy. If so, it will weaken the yen further and it may help the Japanese stocks market to increase to a higher level.

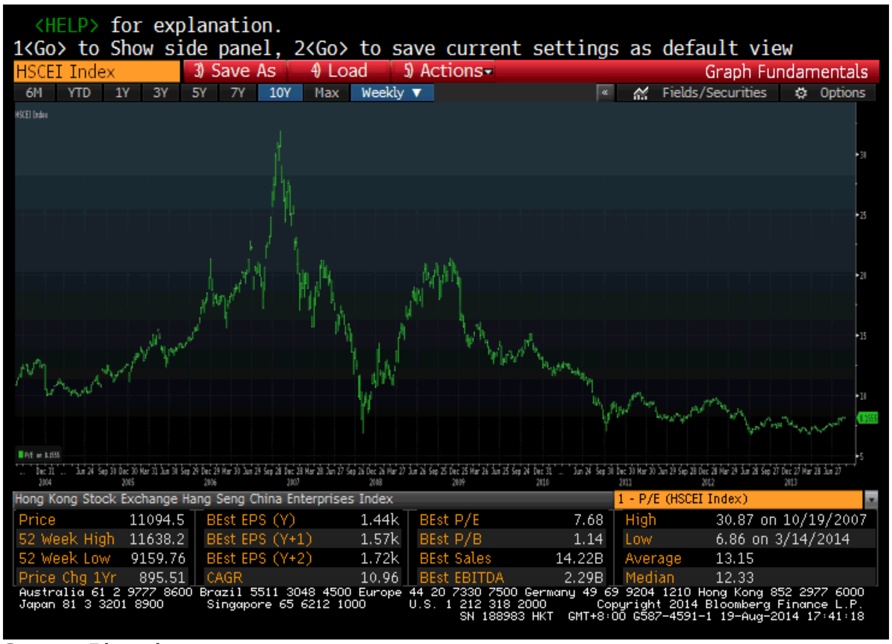
China Economy and Financial Market:

The economic growth for China has remained slowing during the past few months. However, it seems that the economic growth has found the bottom and the further downsize should be very minimal. The GDP growth was 7.5% in Q2 which was higher than the 7.4% growth in Q1. We believe that the economy for China will have a soft landing at GDP growth of around 7-7.5%. However, we expect that the GDP growth will remain slow in the coming 1-2 years and will not return to its previous high growth level (like 9-10% p.a.). We expect that the GDP growth will maintain at around 7.5% most of the time in the coming 1-2 years. It will not be able to bring any upside surprise to the investors.

For the equity market, the strong momentum has remained unchanged in the past month. It is because most investors were very optimistic the China Government will continue to launch more stimulative policies to support the economic growth. For example, they expect the China Government will launch more stimulative policies, such as the RRR (Required Reserve Requirement) reductions for some designated banks which have been announced in the past few months. If so, it will be good for the economic growth as well as for the stock market.

Attractive valuation remains the major selling point for China and Hong Kong stock markets. Even though the valuations have increased substantially in the past few months due to the recent market hike, the Hang Seng Index is still trading at 11x PE and the Hang Send China Enterprises Index is still trading at 8x PE.

P/E Ratio for HSCEI



Source: Bloomberg

Economy and Financial Market in Emerging Markets:

Over the past month, global capital has continued to flow into the emerging market and as a result, the emerging stock markets have continued to have a good performance. We remained our optimistic view on the emerging markets as their valuations are still at a very attractive level. The PE ratios for most developed stock markets have existed a substantially increase in the past years and their valuations are not as attractive as what they have been in 2009 or 2010. It is because the % increase in the stock market index in the past years has been much more than the % increase in the earnings of the index members. For example, the PE ratio for US S&P 500 index has increased from 13x in 2012 to 18x at this moment. In contrast, the PE ratios for most emerging stock markets have also increased during the same time. But their valuations are still at a relative attractive level. Using MSCI Emerging Market Index as an example, the PE ratio has increased from 10x in 2012 to just 14x at this moment. Although it has also increased a lot, it is still at a quite attractive level.

In fact, the recent capital flow into the emerging markets was more or less attracted by the low valuation for most emerging stock markets. Some Western investors have started to realize that the further upside for most US, European or other developed stock markets may be limited by their already demanding valuation. Thus, they have changed their focus to those markets with a more attractive valuation and better risk-reward profile, i.e. emerging stock markets.

YTD Performance: Emerging markets (white) vs. Developed markets (red); for the past two years, it is the first time that the performance for the emerging stock markets has outperformed the performance for the developed stock markets. We believe that the outperformance for the emerging stock markets will continue to happen

Source: Bloomberg

Commodity:

Crude Oil Price: The oil price movement in the last month has given a little surprise to investors. For example, the NYMEX crude oil price has dropped from US$105 to below US$100 (the price has dropped further to US$95 in Aug). Although it is quite usual for oil price to have a US$5-10 up or down, it was a little bit surprise to see the oil price to drop US$10 in the past month. It is because the political unrest in Ukraine, the new air strikes to Iraq from US and the fight between Israel and Palestine should have a positive effect on oil price (but in fact, the oil price has dropped). Of course, we can explain that the drop in oil price was mainly due to the sharp appreciation of USD. However, we think that it was not the full story. Nevertheless, we still think that the political uncertainties will remain a positive factor to the oil price. We think that the oil price can find the support at around US$95 and rebound to above US$100 in a short period of time.

NYMEX Crude Oil Price

Source: Bloomberg

Gold Price: The political uncertainties continued to be the major factor supporting the gold price. During the past month, investors were afraid that the political conflict between US, EU and Russia would further worsen. As a result, the gold price has increased to US$1,340. However, the political tension has calmed down a little bit and thus the gold price has corrected to around US$1,300.

We remained our pessimistic view on gold price (since the beginning of this year). We still think that the downside risk for gold is larger than the upside return for gold. It is because some previous favorable factors for gold have become neutral or even unfavorable to gold. For example, gold has become the favorite investment for some investors in the past years because investors were afraid that hyperinflation would exist soon. However, we did not see any significant inflation risk existed in the past years, even though the US Fed, ECB and BOJ have continued to increase the money supply. Besides, we also did not see any possible collapse of the currency system as worried by some investors in the past few years. Apart from this, a higher value of USD has also led to a further downward pressure to the gold price (recently, the USD has started to appreciate due to the expectation that the US Fed will start to raise the interest rate in 2015). It is because the gold price is denominated in USD. If the value of USD increases, the gold price will be more costly to non-USD investors and it will lower their demand for gold.

Gold Price:

Source: Bloomberg

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

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