AMG FINANCIAL GROUP 安柏

AMG Market Commentary

August 2014

Will US$ Continue Its Uptrend In The Coming Years?

The US$ has recorded a strong rebound in the past few months. Against EUR, it is trading at a 1-year high. Against Japanese Yen, it is trading at the highest level since 2009. Apart from EUR and Japanese Yen, it has also recorded a substantial appreciation against most of the other currencies.

US$/ EUR

Source: Bloomberg

Japanese Yen/ US$

Source: Bloomberg

Based on the US$ Index, the value of US$ has appreciated more than 5% in the past 2-3 months. It was one of the best-performance periods for US$ in the past few years.

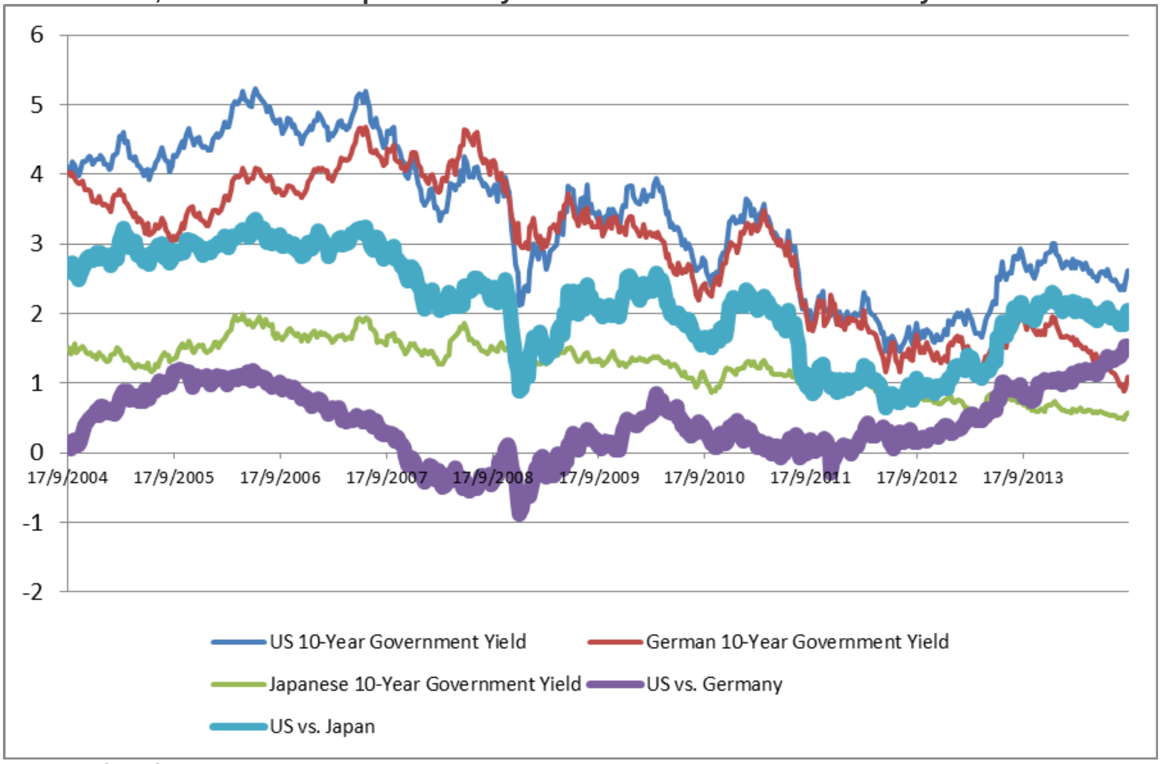
US$ Index

Source: Bloomberg

The reason behind the recent US$ appreciation

The US$ has recently recorded a sharp appreciation because many investors have expected that the outlook for the monetary policy in U.S. will be significantly different to the monetary policy in EU and Japan in the coming 1-2 years. Many investors have expected that the U.S. Fed will continue to taper its monetary policy in the coming 1-2 year (e.g. the Fed has started to reduce its monthly bond purchases in the beginning of this year and it will possibly be ended in Oct; besides, it is highly possible that it will start to increase its target interest rate next year). On the other hand, it is almost sure that ECB and BOJ will maintain their current ultra-loose monetary policy and may even impose a more expansionary monetary policy to further stimulate the economic growth. As a result, many investors have expected that the interest rate differentiation between U.S. vs. EU and Japan will become wider and wider in the coming 1-2 years and it will be a positive factor to US$ (vs. EUR or JPY).

Yield for US, German and Japanese 10-year Government bond and their yield differentiation



Source: Bloomberg

Moreover, the recent substantial appreciation of US$ was also due to the unstable geopolitical environment existing around the world. For example, the political issue in Ukraine has led to a wrestle between U.S., EU and Russia. The unrests in Middle East have also been intensified as the fight between Israel and Palestine has continued and the risk from The Islamic State has continued to accelerate. Being a traditional safe-haven currency, the US$ has thus benefited from the existing of these unstable factors.

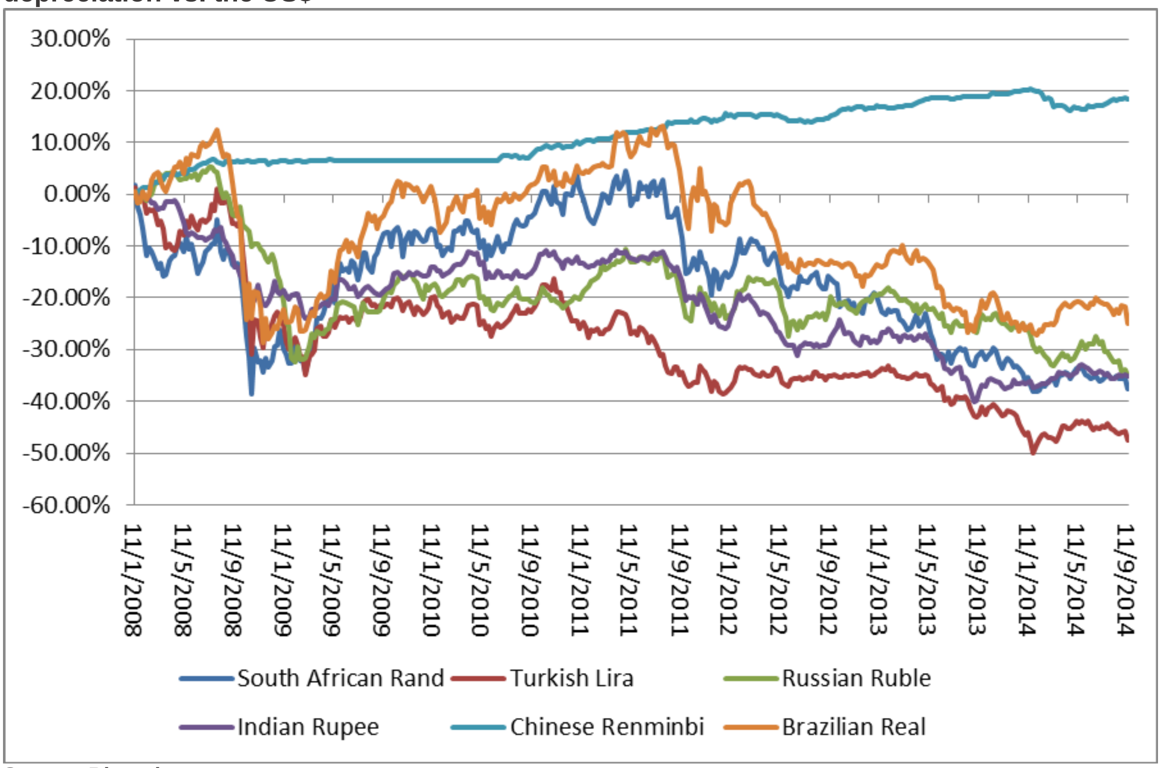
We agreed that it is more than enough factors to support the US$ to continue its uptrend in the coming 1-2 years (e.g. the yield differentiation will continue to favor the US$). However, we think that it may only be limited to US$ vs. the developed market currencies, such as EUR, JPY, CAD, AUD or NZD. We think that the US$ may not have another sharp appreciation against the emerging market currencies. It is because most of the emerging market currencies have already depreciated a lot (vs. US$) in the past few years. For example, except RMB, the currency from BRIC countries have dropped 20-40% against the US$ since 2008. In contrast, most of the developed market currencies have appreciated a lot vs. US$ during the same period. For example, the AUD has recorded the lowest value at US$0.6/ AUD in 2008 but has rebounded and skyrocketed to almost US$1.1/ AUD in 2011 and 2012 (significantly above the 20-year average of US$0.77/ AUD). Even at this moment, the AUD is still trading far above the long-term average. Thus, we will not feel any surprise if these developed market currencies will have a significant correction once the U.S. Fed has started its interest hike cycle.

Australian Dollar/ US$

Source: Bloomberg

As mentioned above, unlike most developed market currencies (had a sharp appreciation vs. US$ in the past few years), most emerging market currencies did record a depreciation vs. the US$. Thus, even though the U.S. Fed may start the interest rate hike next year, we believe that the impact to the emerging market currencies will be relatively minimal. First of all, it is because the emerging market currencies have not enjoyed any appreciation during the past few years (as a result of the zero interest rate policy implementing in U.S.). Besides, if comparing to the developed markets, the interest rate in most emerging markets are much higher, like 8-12%p.a.. Thus, even though the Fed may start to raise the interest rate next year, the interest rate of most emerging markets is still significantly higher than the interest rate of U.S..

Performance since 2008: Except RMB, most of the emerging market currencies have recorded a sharp depreciation vs. the US$



Source: Bloomberg

Economic Review and Market Outlook

U.S. Economy and Financial Market:

Any possible policy change from the U.S. Fed is still the hot topic in the financial world. In August, the FOMC minutes has led to a short-term fluctuation in the financial market. In the minutes, “some” members have mentioned that if the labor market conditions and inflation have converged toward the Fed’s objectives more quickly than expected, it might become appropriate to begin removing monetary policy accommodation sooner than most investors currently anticipated. It has led to investors to worry that the Fed may use the “minutes” to manipulate the market expectation (it will raise the interest rate soon).

Afterward, the speech from Janet Yellen in Jackson Hole has remained dovish and she has not mentioned anything about interest rate hike. Therefore, investors have calmed down and become less worried about a sooner than expected interest rate hike (apart from the dovish speech from Yellen, a worse than expected Nonfarm Payroll number recorded in August has also reduced the panic in the market).

U.S. Nonfarm Payrolls: There was only 142,000 nonfarm payrolls increase in August. It was significantly below the historical average and the market expectation.

Source: Bloomberg

We believe that even more Fed members have changed to support the interest rate hike, the majority still supported to remain the policy unchanged. The majority have shared a similar view from Yellen that the labor market is still not strong enough and thus an accommodative monetary policy is still appropriate in order to support the further improvement in the labor market. Besides, the inflation risk is still very minimal and thus the Fed does not need to rush to start the interest rate hike.

For the equity market, we believe that the market will consolidate at the current level. It is because the market has repeated the similar pattern in the past year. Usually, the market will take 3-6 weeks to consolidate after it has reached a new record. All in all, the fundamental factors are still very favorable and thus we are quite sure that the equity market can continue its uptrend and increase to a higher level after the consolidation has completed.

Dow Jones Industrial Average Index

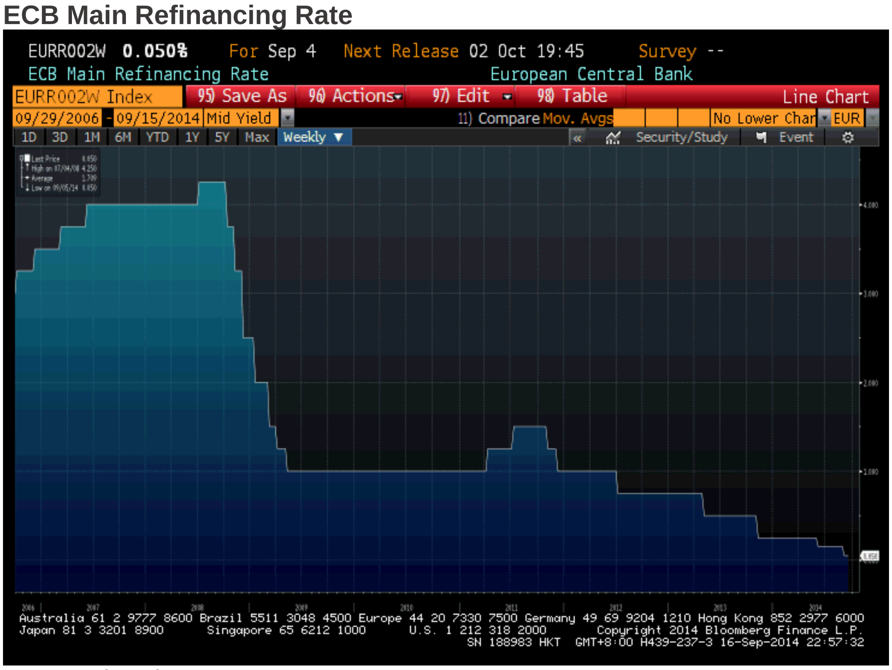
Source: Bloomberg

EU Economy and Financial Market:

ECB has continued to be the focus for the European financial market. It is because investors would like to know if ECB will introduce more stimulative policies to boost the economic growth in Europe (even though ECB has just increased its expansionary policy in June and Sept respectively this year).

As mentioned above, ECB has increased its expansionary policy in June and Sept. For example, ECB has lowered the target interest rate from 0.25% to 0.05%. It has imposed a negative interest rate to banks deposit in ECB (the negative interest rate has increased from -0.1% in June 2014 to -0.2 in Sept 2014). It has also introduced another round of targeted longer-term refinancing operations (TLTRO). In the TLTRO, ECB will provide low-cost capital to banks and the banks are required to provide more lending to the real economy (all sectors except financial and real estate). At last, it has also announced that it will purchase asset-backed securities from the market in order to inject more liquidity to the financial market and the real economy

ECB Main Refinancing Rate



Source: Bloomberg

The above policies have reflected that ECB is very committed to safeguard the economic growth and inflation within its desired level. In fact, ECB president Mario Draghi has repeatedly emphasized that ECB is ready to use additional conventional and unconventional (like QE in US) tools if needed to spur inflation and growth in the euro zone.

EU GDP

Source: Bloomberg

EU CPI

Source: Bloomberg

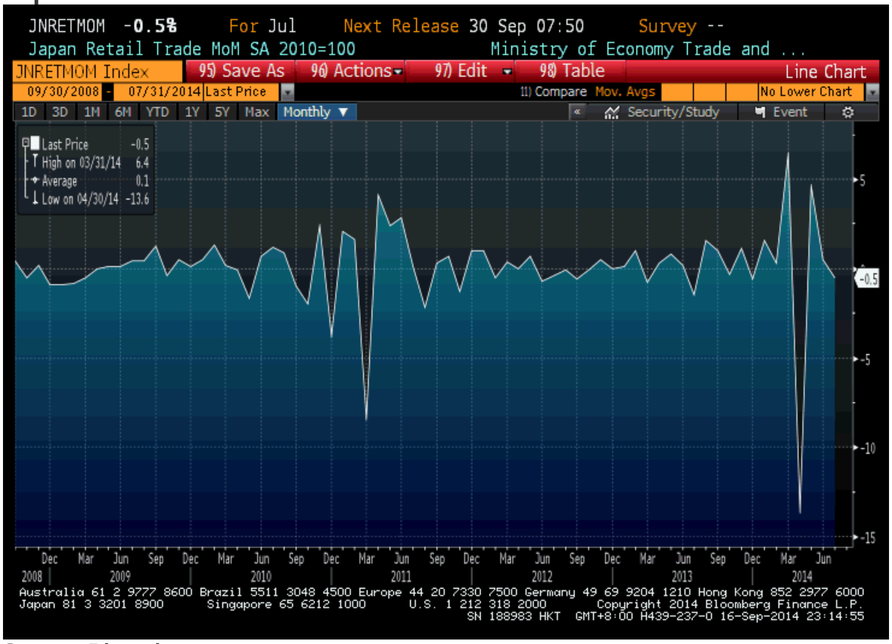
With the unlimited support from ECB and a better economic outlook (compare to the economic outlook in 2011 and 2012), we believe that the EU economy will not fall into another long-term recession (even though some recent economic data have shown that the economic momentum has slowed down recently).

Japan Economy and Financial Market:

As what we have predicted at the beginning of the year, the JPY has occurred another round of sharp depreciation in 2014. Starting from August, the JPY has depreciated from 102 to 110 (a depreciation of more than 7%) as more and more investors believed that BOJ will follow ECB to increase its expansionary monetary policy in order to stimulate the economic growth.

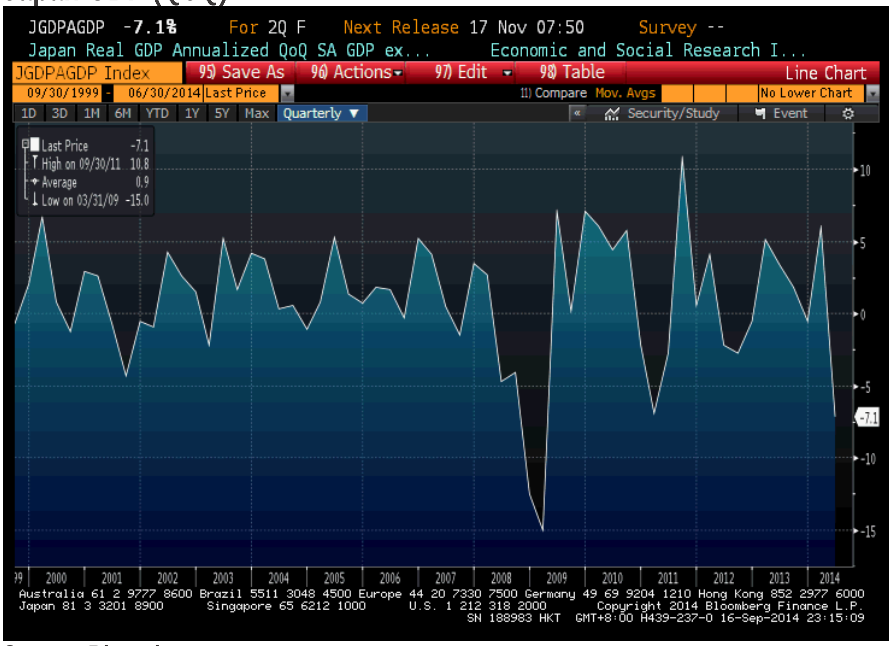
Although BOJ has maintained its policy unchanged (and also did not make any hints it have any intention to change the existing policy) in the past meetings, the deteriorating economic momentum is forcing BOJ to take action. First of all, the economy has started to slow down since the beginning of this year. In addition, the increase in sales tax since April 2014 has further weakened the economic momentum and led to a more substantial economic drawdown. For example, the retail sales has decreased 13.6% in April (due to the negative impact from the sales tax increase). The Q2 GDP has also been affected and recorded a -7.1% drawdown.

Japan Retail Trade



Source: Bloomberg

Japan GDP (QoQ)



Source: Bloomberg

Therefore, we believe that in the short-term future, BOJ will eventually follow ECB to increase its expansionary monetary policy to stimulate the economic growth. This will lead to another round of depreciation to JPY, but it will be a big positive factor to the Japanese stock market.

On the other hand, the Japanese Government has been urging the pension funds to change their investment style. Due to having a pessimistic outlook (to the economic growth as well as to the financial market), most of the pension funds invested most of their money into the Japanese Government bonds in the past. From now on, the Japanese Government would like the pension funds to be more aggressive and invest more money into the Japanese stock market and the oversea stock markets. As a result, it is expected that the pension funds will increase their investment in the Japanese stock market and oversea stock market. It will be a positive factor to the Japanese stock market. It is because if the pension funds increase their investment in the Japanese stock markets, it will directly increase the demand for the Japanese stocks. On the other hand, if the pension funds increase their investment in the oversea stock markets, it will increase the supply of JPY and will lead to a further depreciation of JPY (and a lower value of JPY will be a positive factor to the Japanese stock market).

China Economy and Financial Market:

The economic growth of China has remained at a relative low level in the past few months (the growth rate is low as we compare it to the average growth rate in the past 20-30 years [9%+]; however, the growth rate is surprisingly high if we compare it to the growth rate in US or EU). We expected that the economic growth in Q3 and Q4 will remain unchanged at around 7.5%. However, if we compare to last year, the number of investor who worried that the economy would happen hard-landing, has significantly decreased.

The stock market in China has recorded a significant rebound in the past two months. The Shanghai Stock Exchange Composite Index has increased more than 10% from 2,050 in July to 2,300 in September. However, we did not feel any surprise for the index to have such substantial increase in such short period of time. It is because after the years of sluggish performance (the Shanghai Stock Exchange Composite Index has dropped 35% from 2010-2013), the valuation for the stock market has dropped to a fair level or even at an undervalued level. Even without any positive news, it is not surprising for it to have a 10-15% rebound (as after the 10-15% rebound, the PE ratio for the stock market is still 11x only).

Shanghai Stock Exchange Composite Index

Source: Bloomberg

P/E Ratio (Shanghai Stock Exchange Composite Index)

Source: Bloomberg

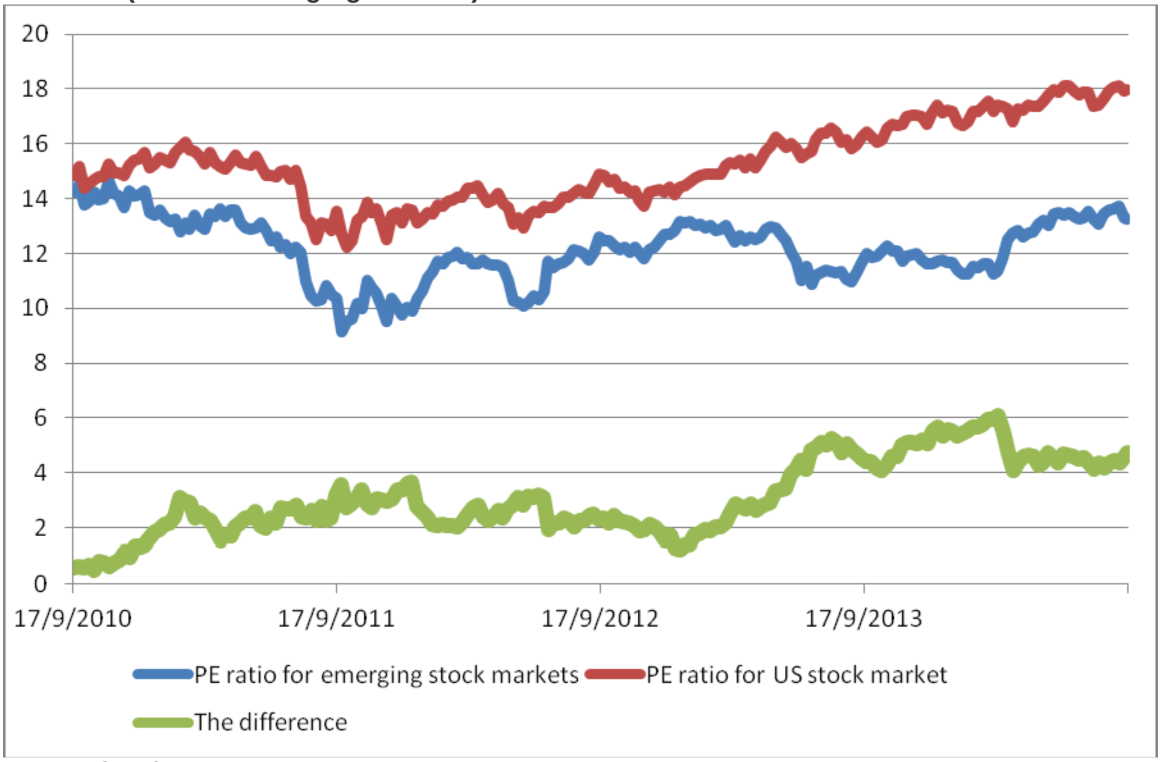
As what we have explained beforehand, the reason behind the recent stock market rebound was due to the optimism from investors that the China Government will continue to loosen its fiscal and monetary policy in the coming future in order to push the economic growth back to a higher level (apart from it, investors have also changed to have a more optimistic outlook to the stock market due to the coming launch of Shanghai-Hong Kong Stock Connect). They are expecting that a substantial stimulative policy will eventually occur and it will lead to a big push to economic growth as well as to the stock market.

In addition, one more favorable factor has been existed in the market recently. It was the huge capital inflows to the stock market from the mainland investors (as many mainland investors were attracted by the recent sharp increase in the stock market). In August, there were more than 170,000 investors to open their securities account in a single week and more than RMB 1 trillion to flow into the stock market (the amount is the largest since 2012). With such huge capital inflow, the market rebound has thus accelerated.

Economy and Financial Market in Emerging Markets:

Although there were rumors that the U.S. Fed may start the interest rate hike sooner than expected, it did not affect the investors' interest in the emerging markets. Most of the emerging stock markets have remained at the recent high level or risen further. However, it was not because there was any significant improvement happened in their economy. It was just because more and more investors have started to realized that the valuation for the emerging stock markets were very attractive, especially when they were compared to the developed stock markets. For example, the PE ratio for the U.S. stock market is 18x while the PE ratio for emerging stock markets is just 13x.

P/E Ratio (U.S. vs. Emerging markets)



Source: Bloomberg

We believe that the investors will continue to increase their portfolio weighting in the emerging markets. It is because due to the over-panic to the possible tapering from the U.S. Fed, many investors have excessively under-weighed their investment in emerging markets. Thus, in order to return their investment in emerging markets back to the normal level (or slightly over-weight), investors have to continue to flow in their capital to the emerging markets and it will be a positive factor to the emerging stock markets.

Commodity:

Crude Oil Price: The appreciation of US$ has led to the recent decrease in commodity price. For example, the NYMEX crude oil has decreased from US$98 at the beginning of August to US$95 now (in the meantime, it has dropped to near US$90). Apart from the impact of a stronger US$, we did see any material change in the fundamentals, such as any material change in global demand and supply for oil. In general, the demand and supply is still within the equilibrium level (or the supply is slightly more than the demand). We expected that market environment (any possible change in demand and supply) should remain neutral or slightly positive to the oil price. It is because we expected that the global economy will start to improve in 2015 and it will lead to an increasing demand for commodity. In short-term, the political unrests happened in different part of the world will continue to be a positive factor to the oil price and we are quite confident that the oil price will find its support at US$90.

NYMEX Crude Oil Price

Source: Bloomberg

Gold Price: Gold price is another "victim" of the recent US$ appreciation. The gold price has decreased from US$1,300 at the beginning of August to US$1,240 now (dropped more than 5%). Although the gold price has already technically over-sold, we expected that the gold price will remain weak in the coming few weeks. It is because we expected that the US$ will remain strong (especially against EUR and JPY) for a further while and thus it will continue to form a downward pressure to the gold price.

Gold Price

Source: Bloomberg

RICI Commodity Index

Source: Bloomberg

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

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