AMG Market Commentary

December 2014

Global Economy and Financial Markets Outlook for 2015

A few days later, 2014 will end. The financial market, going through waves and storms, has finally tide over this year.

The US stock market remains the robust trend and continuously hits record highs. The Eurozone stock markets, even though were troubled by weak economy and deflation risks, and experienced some deep change, has eventually risen up. The performance of emerging markets wasn't astonishing. However, capitals have been streaming back again compared with last two years. The time for emerging markets to soar is expected to be closer and closer.

Global Equity Market Performance

Equity Market Index	Year-to-date (as of Dec 11)
U.S. Dow Jones Industrial Average Index	6.1%
Brazil IBOVESPA Index	-5.1%
FTSE 100 Index	-4.4%
France CAC Index	-1.9%
German DAX Index	2.7%
Japan Nikki 225 Index	5.9%
Australia ASX200 Index	-2.2%
Hong Kong Hang Seng Index	0.0%
China Shanghai Securities Composite Index	38.2%
MSCI World Index (count in US dollars)	2.2%
MSCI Asia Index (count in US dollars)	2.2%
MSCI Emerging Market Index (count in US dollars)	-4.3%

Data Source：Bloomberg

The performances of national bonds remain firm. The main reason is the global central banks still hold relatively low interest rates. For example, the United States 10-year bond yield is 2.2%, and German 0.7%. On the other hand, corporate bonds investments finally show fair adjustments. In the past few years, the yield spreads are getting to a level which is far too narrow and illogical. The widen yield spread doesn't infer any danger in our economy. We think the reason behind the adjustments is simply that the previous spread level could not last long.

US Yield Spread

Source : Bloomberg

The only significant change in 2014 is the strong dollar. Stimulated by the good news such as continuous recovery of the U.S. economy and Fed's finishing asset-buying, the dollar ending years of weakness trend has turned surprising robust. Take the US dollar index as an example, the dollar surged up 11% in only five months. The most miserable victim of the strong dollar must be the commodity market. As most commodities are priced in dollar, prices for commodities plunged sharply after the dollar appreciation. Not only the commodities, for dollar investors, the values of most non-dollar assets (priced in dollar) are also pressured.

US Dollar Index

Source : Bloomberg

RICI Commodity Index

Source：Bloomberg

<u>2015 Global Economic Outlook –</u>

We believe the global economic will not counter any serious problem and will keep growth, though in a slow speed, in 2015. Investors have been held concerns for the coming years, such as European economy might step in recession again in 2015, some emerging markets might struggle to keep economic growth. However, we believe that these worries are unnecessary. The economic outlook is not carnival exciting. But it is not bad either, especially not when the United States has been showing steady economic growth, and China has already started easing its tightened monetary policy to maintain economic momentums.

On the other hand, global central banks will continue to implement easing monetary policies in 2015, which will benefit economic growth. Even though the Federal Reserve will likely to raise interest rate after the middle of 2015, we believe the speed and the range of interest increase will be gradual and moderate. Besides, the European Central Bank and the Bank of Japan will pick up what the United States is about to end and keep implementing super easing monetary policies. The ECB has just purchased one trillion euro asset-backed securities this October. Around the time, the BOJ raised its monetary supply increase target from 70 trillion yen per year to 80 trillion per year. Another point is, the Chinese government has just started to relax the tightening policy which has been implemented in the past few years. This action will probably help to stimulus China’s economy.

<u>2015 Global Financial Markets Outlook–</u>

Stock market: We believe the stock market will continue the upward trend in 2015, though possibly show higher volatility than 2014. First, global central banks pushing easing monetary policies will continue benefit the stock markets. Even though the Federal Reserve has already stopped buying new assets and will likely to increase interest rates in the middle of 2015, it still provides enough liquidity to the market. Up till now, the Federal Reserve has kept 4.5 trillion US dollar, four times more than the amount in 2008 before the financial crisis happened, on its balance sheet. We believe that the Federal Reserve will keep the balance sheet at its current scale and won’t reduce monetary supply.

US Federal Reserve Balance Sheet

Source: Bloomberg

Second, we don't think there will be any economic chaos next year, which will create a positive environment for stock markets.

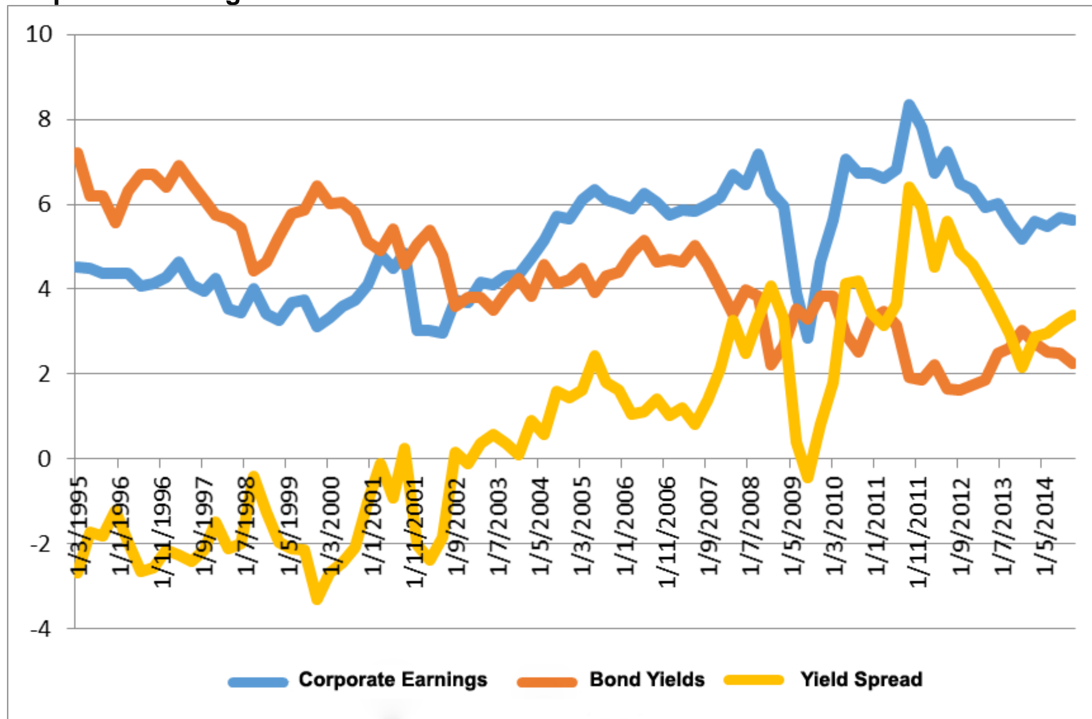
In terms of the stock values, even though the P/E ratios of the U.S. and European stock markets are no longer low, corporate earing ratios are still attractive compared with bond yields. We believe investors' money will still be attracted to stock markets from bond markets, thus stimulus stock markets. (Investors need to find something that can generate profits since bond investment doesn't have much potential anymore.)

P/E Ratios for Global Major Stock Markets

	P/E (as of Dec 24, 2014)	10-Year Average
U.S. Dow Jones Industrial Average	16.1x	15.3x
UK FTSE Index	18.8x	19.2x
German DAX Index	17.4x	16.8x
Japan Nikkei 225 Index	21.8x	21.2x
HK Hang Seng Index	9.8x	13.0x
China Shanghai Securities Composite Index	14.2x	19.3x
MSCI World Index	17.9x	16.9x
MSCI Asia Index	12.2x	13.9x
MSCI Emerging Markets Index	12.9x	13.3x

Source: Bloomberg

Corporate Earnings vs Bond Yields



Source: Bloomberg

Bond: Compared with stock markets, the bond markets seem much less impressive. First, investors need to know where the profits of bond investments come from. Returns on bond investment on the one hand come from the bond yield; on the other hand depend on the price change of the bond itself. Market interest rate negatively correlates the bond price. Therefore, the bond price will go up when the interest rate drops and vice versa. In the past few years, thanks to the continuously dropping market interest rates chopped by global central banks' easing policies, the bond market has enjoyed "five golden years". However, it has to say goodbye to the golden time for the next few years. Most of the countries are having historical-low bond yields. The space for further yield rate drop barely exists. What's worse, the bond price might be pressured as the United States is expected to raise interest rates and the global bond yields are likely to increase. Thus, this year will not be a good year for bond markets.

U.S. 10-Year Bond Yield

Source: Bloomberg

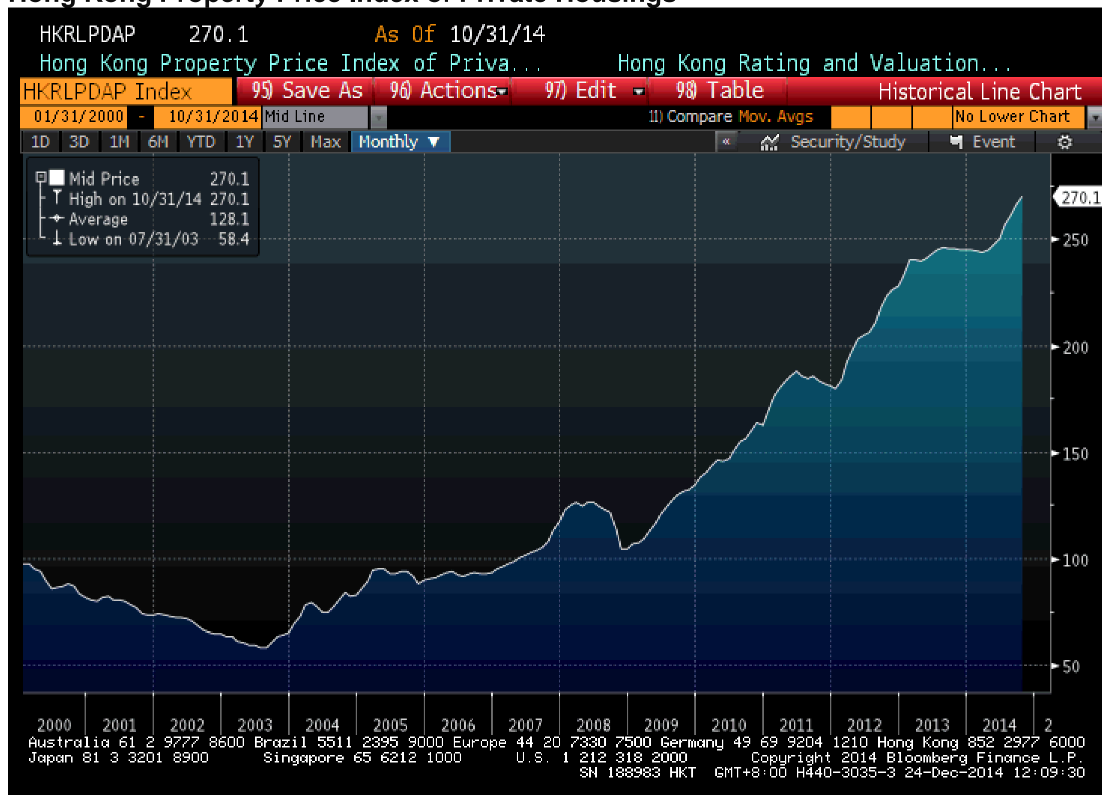
German 10-Year Bond Yield

Source: Bloomberg

Real Estate: Different countries are faced with different property markets, which is why our discussion will only focus on our views toward Hong Kong and U.S. property markets.
For the Hong Kong real estate market, we believe the price will still be relatively high in 2015 as it gains support from the current low mortgage rates. Even though the United States will very likely increase interest rates (and because of the linked exchange rate system, Hong Kong's interest rates have to follow Uncle Sam's step), it will not crush down housing prices as the speed and the scale of the interest raise will be gradual and moderate. However, we don't think the price will move up further. The price raise was not supported by any substantial wage

increase for Hong Kong citizens, but stimulated by the mortgage rates drop and offshore purchase surge. We don't believe the distorted situation will last long. Hong Kong real estate market might show deep adjustments when the U.S. substantially raise the interest rates (probably in 2016 or 2017).

Hong Kong Property Price Index of Private Housings



Source: Bloomberg

Unlike Hong Kong, the real estate market in the United States is still struggle for recovery. When the financial tsunami caused by property and credit bubble struck America in 2008, the housing market was even more damaged than the financial industry. Compared with the pre-crisis period, the housing sales volume in 2009 almost lost 50%, the housing prices more than 30% (You should know that the real estate markets in the United and Hong Kong are quite different. First, in America, most of the houses are owner-occupied. Speculators aren't much. Second, the median price for housings in the U.S. is only around 220 thousand USD, 160 thousand counting the 30% drop, which is only a little bit more than one million HKD), and the foreclosure rate was up to 10%. However, the environment for real estate market has much improved today thanks to the recovery of the U.S. economy. The average economic growth for the first three quarters is 2.5%. The number is likely to be around 2.5-3% in 2015. On the other hand, the unemployment rate dropped to 5.8% from the peak of 10%. Economic recovery together with the improving labor market helps the real estate market fight back from the bottom. We believe it will continue this trend in 2015, even though the United States is likely to increase interest rates.

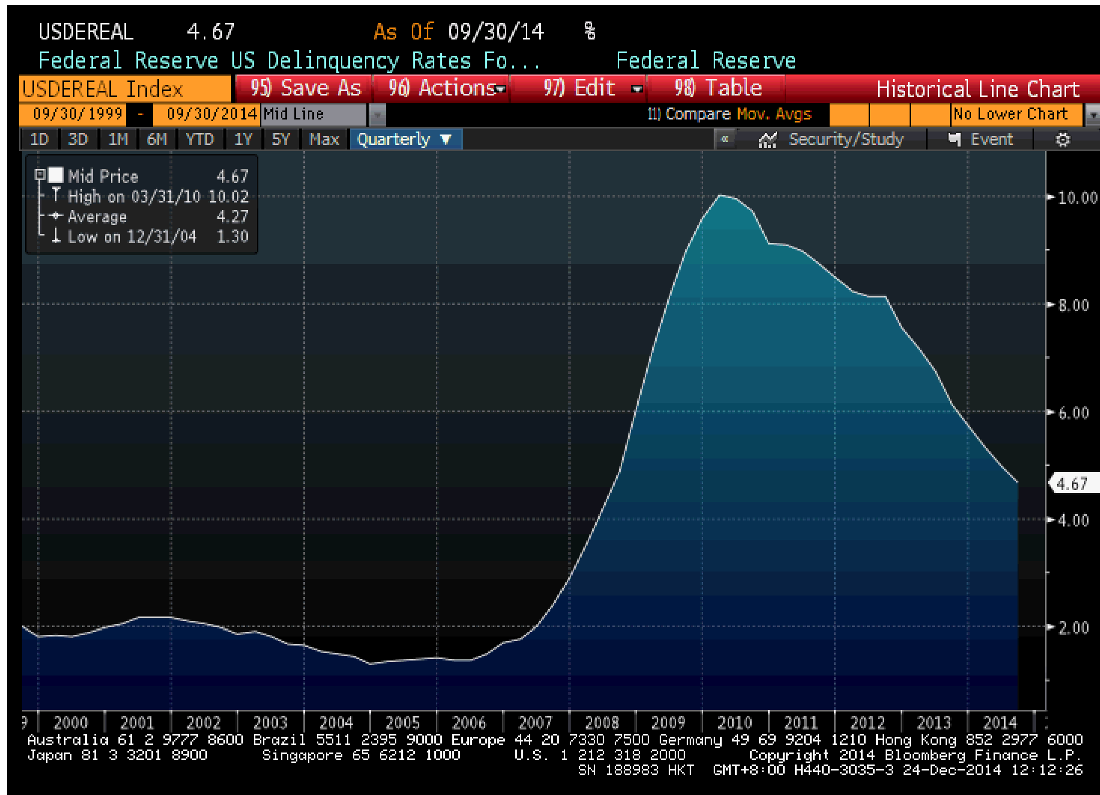
U.S. Existing Homes Sales

Source: Bloomberg

US Existing Home Sales Median Price

Source: Bloomberg

U.S. Foreclosure Rate

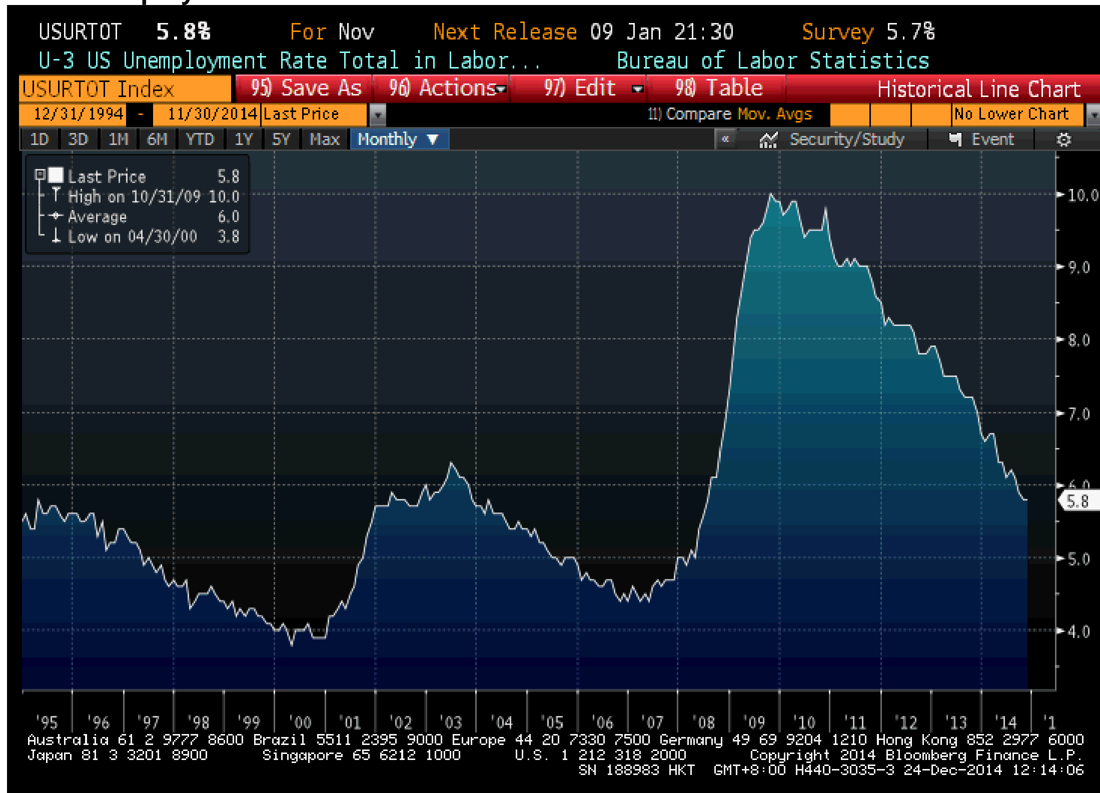


Source: Bloomberg

US Economic Growth

Source: Bloomberg

U.S. Unemployment Rate



Source: Bloomberg

Commodity: The under-expectation economic growth keeps pressing down commodity prices. We hold positive view on the economic growth on 2015. However, the growth will not be enough to drive up the commodity prices. In the past two to three months, we saw commodity prices (especially oil prices) hunting for bottom. One of the reasons behind this is that investors worry about the downward risk of the economic growth next year causing serious drop on demand for commodities. (Dollar surge in the past few months is another reason.) Even though we agree that the risk for negative growth does exit, we don't think the growth rate will turn out too bad. The commodity market has over priced-in the negative factors and dropped out of the track. We believe the commodity prices will bounce back from the bottom in three to six months.

New York Crude Oil Price

Source: Bloomberg

Market Review and Outlook

U.S. Economy and Financial Market： The U.S. economy shows continuous and reliable growth. The third quarter recorded 5% growth after the final review constituting two quarters in a row with more than 4% growth rate, which had never appeared since 2003. Even though the high growth rate is unlikely to last long, it is a good sign.

U.S. stock market showed adjustment in the middle of the December because investors worried about the possible sluggish economic growth next year. Later, the Chair of the Federal Reserve, Janet Yellen, said after the meeting that the Fed was unlikely to raise interest in the first quarter of 2015, and even if it started to increase interest rate, the Fed will raise it with “patience”. Yellen’s announcement has eased the nerves of investors. If her words are followed by actions, it will benefit the stock market.

In 2015, we expect the U.S. will maintain stable and healthy economic growth, and the stock market will likely to show high one-digit percentage growth.

Eurozone Economy and Financial Market: Eurozone economic might still be unstable. However, the active actions taken by the ECB might prevent the economy from deeper struggling. In the past few month, the ECB has launched a series of easing monetary policies, such as lower the target interest rate to near zero level, implemented negative interest rate to the deposits in the central bank so that banks will incline to lend money to the corporates or consumers, launched another round of LTRO to provide low-cost funds to banks that agreed to lend more, and made commitments to spend one trillion euro on purchasing asset-backed equities from the market. The scale of the fore mentioned policies might not be as large as those implemented by the U.S. government, but it is unprecedented in the European history. We believe it will provide substantial support for the European economy and the stock market.

Europe stock market has fully recovered in November and December after the slump in October. The changed occurred not because of any exciting news appeared, but because investors finally realized that the European economic outlook isn’t as disappointed as previous expectation. We believe the super easing policy implemented by the ECB will be the backbone for Europe stock markets next year.

MSCI Europe Index

Source: Bloomberg

Japan Economy and Financial Market: In order to safeguard the administrative power, Japan's Prime Minister Shinzo Abe held an early parliament election hoping to enhance the acknowledgment for Abe's policy through polling. Obtaining 2/3 of the seats, the ruling coalition leading by Abe has again seized absolute control of the parliament. We think the election result will benefit Abe to continue his easing policy and even accelerate monetary supply increase (by pushing BOJ raise the monetary supply increase target again) and then use yen devaluation to tackle inflation problem and stimulate economy.

Winning the election will benefit Abe to delay increasing consumption tax. This April, Japanese government increased the consumption tax from 5% to 8%, striking the momentums for domestic consumption. Last but not least, the election result is also in the advantage of driving retirement pension funds to change investment strategy from focusing on Japanese bonds to increasing weights on domestic and abroad equities.

All the reasons mentioned above could stimulate Japanese stock market. However, the devaluation of Japanese yen compromises the investment return on Japanese equities. Investors might as well allocate capitals on some hedged Japanese equity funds.

Bank of Japan Balance Sheet

Source: Bloomberg

Japanese Stocks (white) vs. Japanese Yen (orange)

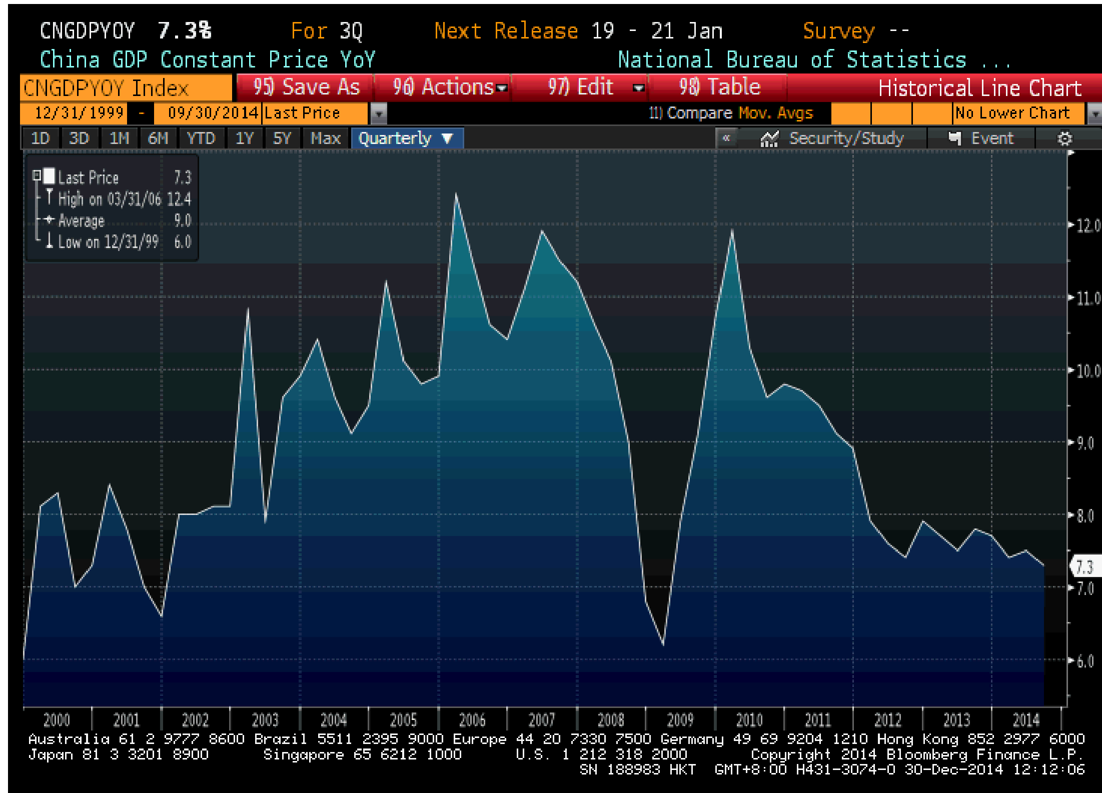
Source: Bloomberg

China Economy and Financial Market: Investors continue to show their excitement on the Chinese government's easing policy, thus heat up the stock market.

We already said early this year that the Chinese government would change the tightening policy to a more easing one. The main reason is that the Chinese government realizes that the economic growth has showed down to the alerting line and changes need to be made in case of a hard landing for China's economy. The average economic growth of the first three quarter is only 7.4%, the slowest since after the financial tsunami and close to the 7% alert

line. Even though chatter around said that Chinese government will tolerant the economic growth slowing down to 6% for the sake of long-term reformation, we don't think new leadership will risk it as it harms the social stability and challenges the ruling authority of the leading group if the economic growth falls out of the track.

China GDP Growth



Source: Bloomberg

Therefore, we believe China's economic growth will not sharply move up or down, but stay around 7% in 2015.

The stock market, stimulated by the Chinese government's easing policy, will keep winning the eyeballs of investors. In the past few years, China's stock market was ignored by most investors because of the continuous slowing economy and the tightening policy pushed by the government, causing the drop of P/E ratio from 20 to less than 10 at the beginning of this year. Even though the astonishing surge in the past few months has pushed back the P/E ratio to 15, China's stock market is still on a reasonable track as long as P/E is still lower than 18. Therefore, we think China's stock market could still move up 20%.

P/E Ratio for China's Stock Market

Source: Bloomberg

<u>**Emerging Market Economy and Financial Market:**</u> Some emerging market countries are strike by the sluggish economy. Two of the big emerging countries, Brazil and Russia, need to be prepared with poor domestic economic performance. Let's talk about Brazil first. We were not fond of investing on Brazilian market since years ago because its economy development has been lack of direction and competitiveness. The current government failed to convince investors of their capability for bringing a brighter economic outlook to the country. Besides, the World Cup has already eaten up many of the capitals which were supposed to enhance the country's infrastructures. Brazil will not have enough resources for economic development after exhausting fortunes again on a splendid 2016 Olympic Game.

Obviously, Russia is doomed to suffer in 2015. The negative influence of political confrontation with the Western World has emerged. (Corporation financing has been blocked by western countries.) What's worse, the drastic fall of oil prices has made the situation even more desperate for the country that heavily depends on oil and gas production and export. The Financial Minister of Russia has already indicated that Russia will step into recession, a possible 4-5% fall back, in 2015.

For other emerging markets, we believe the economic growth next year will be similar compared with 2014, and may even outperform a little. The main reason is that the dollar surge in 2014 negatively affected almost all investments on emerging markets. Even though the dollar might continue to move up in 2015, we don't believe it will appreciate as much as it in 2014. Another reason is that the continuous recovery of the U.S. economy will be helpful for further stabilize the global economy, and thus encourage investors to allocate more capitals on emerging markets.

Dollar Surge Press Down Emerging Markets (Red: Dollar Index, Yellow: Emerging Markets Index)

Source: Bloomberg

Commodities:

Oil price: During the last two month of 2014, the oil price continuously hunts for bottom. The New York Crude Oil has dropped 40% compared with the price four months ago to below 55 USD. An almost 50% drop has clearly overpriced-in the negative factors, even though the bad news exists. On the one hand, the dollar, which will cause the opposite move of oil price, has only appreciated 12%. On the other hand, even though the economic growth next year might not be as good as that in 2014 and the demand growth might fall short of our expectation, it doesn't mean the economy will walk out of the growing trend and step into recession. Investors shouldn't be easily spooked by IMF slightly turning down their expectation of economic growth from 4% to 3.8%. Some investors think the shale oil production in U.S. has increased the oil supply and reduced their demand for importing oil. But the United States has been exploiting shale oil for a long time. Why the factor didn't bother investors four months ago suddenly becomes an obvious reason for causing the 50%-drop chaos.

Therefore, we think crude oil (and other industrial commodities) has been oversold. We have been added up the weights on commodity funds in our portfolio for one to two years investment.

Gold Price: In the past two year, the gold price has maintained around 1150 to 1200 USD. We are still not attracted to this price because the factors that drove up the gold prices have completely changed. The US dollar didn't depreciated any more. The monetary system didn't crush by the central government launching massive quantitative easing policy. The financial market has been more and more stable and thus lower investors' demand for safe harbor. Capitals has been streaming out of the gold market, which further press down the gold price

Distribution Amount for Gold ETF

Source: Bloomberg

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

Important Note & Disclaimer:
This document has been prepared mainly as information for internal professional advisers and nothing contained in this document should be construed as an invitation or an offer to invest or a recommendation to buy or sell any particular security or to adopt any investment strategy. Although the information provided in this document is obtained or compiled from what we believe to be reliable sources, AMG Financial Group Limited and its affiliates and the author cannot and does not warrant, guarantee or represent, expressly or impliedly, the accuracy, validity or completeness of any information or data made available to the recipients of this document for any particular purpose and no liability in respect of any errors or omissions is accepted by AMG Financial Group Limited or its affiliates or any director or employee of AMG Financial Group

Limited or his/her affiliates or the author. The author's views are subject to change without notice to the recipients of this document. Past performance is not necessarily a guide to future performance, the value of any investment and the income from it can rise as well as can fall as a result of currency and market fluctuations. The recipients of this document should seek for professional advice if they are in any doubt about any of the information contained herein.

For any comments, please send email to us at enquiries@amgwealth.com.

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