AMG FINANCIAL GROUP 安柏

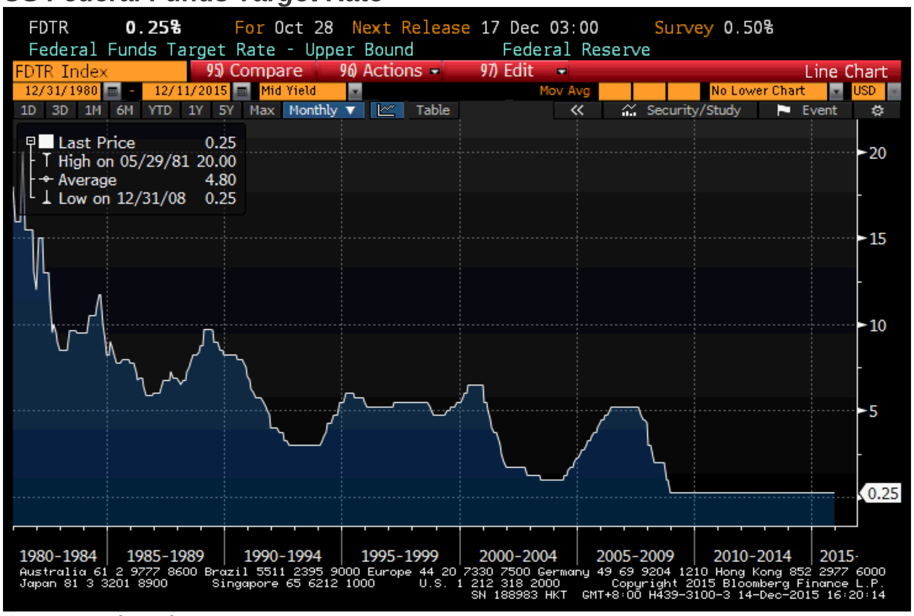
AMG Market Commentary

14 December 2015

The Recent Poor Performance in HK Stock Market: Was Due to Worry on CNY Devaluation, More than Due to Fear of US Interest Rate Rise

The US Federal Reserve will hold the last FOMC meeting this year on 16 December 2015. The market has expected that the Fed would start the interest rate raise in this meeting and put an end to the zero-interest rate policy, which has been implemented in the past seven years.

US Federal Funds Target Rate



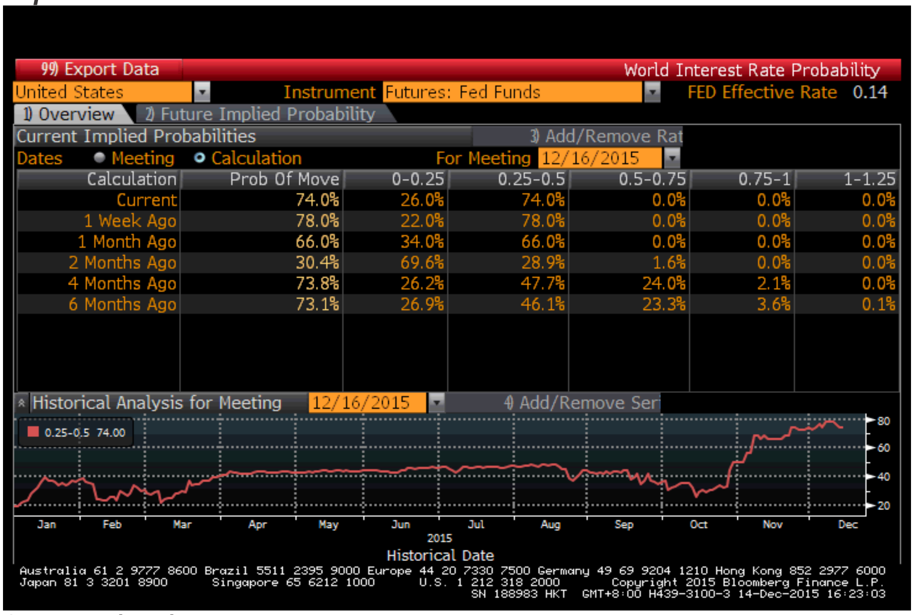
Sources: Bloomberg

Some investors would be afraid that the interest rate raise could make investments on stock market less attractive as the interest rate raise may lead to a downward pressure to the PE ratio. Thus, the interest rate raise may be a negative factor to the stock market. However, we believe that the interest rate raise will not lead to huge negative effects to the economy and the financial market. It is because most investors have been fully aware and prepared for the hike as the Federal Reserve has started to manage the expectation for the public for more than a year. Besides, we are quite sure that even though the Fed will continue to increase the interest rate in 2016, the speed of the following interest rate increases will be slow, and the range of the increases will be moderate. The monetary policy of the US, as we expect, will continue to maintain at a relatively easing level in the next year.

Investors Were Well Prepared for the Interest Rate Increase

Both the futures market and the market survey showed that investors had believed there is 74% possibility that the Fed will raise the interest rate on 16 December 2015 and the increase will be 0.25%. Although it is still a chance that the Fed may surprise the market and remain the interest rate unchanged, the results above have proved that investors were well prepared for the interest rate increase. At least no one would be shocked by the interest rate increase in December.

Implied Probabilities for Interest Rate Increase in December 2015



Calculation	Prob Of Move	0-0.25	0.25-0.5	0.5-0.75	0.75-1	1-1.25
Current	74.0%	26.0%	74.0%	0.0%	0.0%	0.0%
1 Week Ago	78.0%	22.0%	78.0%	0.0%	0.0%	0.0%
1 Month Ago	66.0%	34.0%	66.0%	0.0%	0.0%	0.0%
2 Months Ago	30.4%	69.6%	28.9%	1.6%	0.0%	0.0%
4 Months Ago	73.8%	26.2%	47.7%	24.0%	2.1%	0.0%
6 Months Ago	73.1%	26.9%	46.1%	23.3%	3.6%	0.1%

Sources: Bloomberg

<u>Investors Change Focus to Fed's Medium-Term Policy Trend (Rather than Just When to Start the Interest Rate Hike)</u>

Investors have changed their focus from when to start the interest rate hike, to the medium-term policy trend. For example, will the Fed continue to increase the interest rate in 2016? How will the speed and the range of the increase be? We believe the speed and range of interest rate raise will be slow and moderate, if we compared it with the previous increasing cycles. It is because the Fed does not need to rush to raise the interest rate as the inflation pressure is still very low. The current CPI data shows that the general price level does not have a significant upward pressure. In contrast, it has recorded several drawdowns during the past year. In addition, it is believed that the Fed has to take some time to observe the economic condition after the first interest rate increase, in order to avoid raising rate too fast will hurt the economic growth momentum. Therefore, we believe the Fed will continue to raise interest rate in 2016 in order to indicate the economic momentum is still strong. However, the speed and the range of the interest rate increase will be slow and moderate. It is very likely that the Fed will increase the interest rate four times and by 0.25% each time in 2016, which means the Federal Funds Target Rate will be 1.25% at the end of 2016.

<u>US CPI (YOY)</u>

Sources: Bloomberg

At least in 2016, the US monetary policy will still maintain at an easing level, which is supportive to the economic growth. On the one hand, as mentioned above, the Federal Funds Target Rate will maintain at the relatively low in 2016 (we expect the rate will increase to 1.25% at the end of 2016, which is still significantly below 2.62% - the 20-Year average for the Federal Funds Target Rate). On the other hand, the Fed has made it very clear that it will keep its balance sheet unchanged (currently at US$ 4.5 trillion) for a certain period of time in the future, which means the money supply will continue to be abundant, at least in 2016.

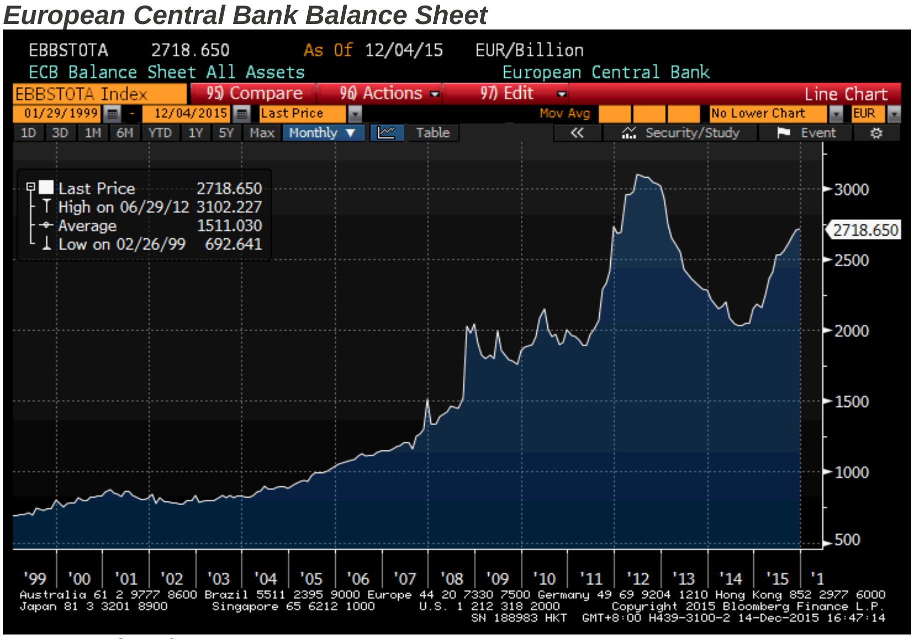
US Federal Reserve Balance Sheet

Sources: Bloomberg

EU, Japan and China Will Continue Policy Easing in 2016

As mentioned earlier, we do not think the US monetary policy will turn tough in any short term. In the meanwhile, the central banks of EU, Japan, and China will continue to implement easing monetary policies, which could offset the liquidity decrease caused by the interest rate increase in the US. The ECB (European Central Bank) has just enhanced the QE at the beginning of December, though the market was disappointed by the scale of the enhancement. The BOJ (Bank of Japan) might not enlarge the QE in short term. However, the annual money supply target of JPY 80 trillion has already set a record in history. Similar to ECB, the PBOC (People's Bank of China) is anticipated to further expand the easing policy, such as decreasing the interest rate and required reserve ratio continuously, to stimulate the economic growth. Therefore, even though the interest rate in the US will continue to increase in 2016 (but in a slow and moderate way), the global monetary policy in general is still very easing, and the global monetary supply is still very abundant!

European Central Bank Balance Sheet



Sources: Bloomberg

Bank of Japan Balance Sheet

Sources: Bloomberg

China Required Deposit Reserve Ratio

Sources: Bloomberg

China 1 Year Benchmark Lending Rates

Sources: Bloomberg

<u>HK Stock Market Is Scared by CNY Devaluation, Not by Fed Interest Rate Raise</u>

In the past few weeks, the Hong Kong stock market has underperformed (HK stock market has been going downward no matter whether the US stock market is up or down). Apart from the impact of the adjustment of the US stock market (the US stock market has just dropped a few days ago and only dropped a little bit), the underperformance was mainly due to investors' worry that the CNY might devalue significantly in 2016.

Investment market has been worrying about the possible significant CNY devaluation since a year ago. Because of the slowing economic growth, the declining export and the expected interest rate differential between US and China (as US will raise the interest rate while China will lower the interest rate in 2016), the market has believed that the CNY has been under devaluation pressure. In August, this expectation became even stronger because the Chinese government suddenly devalued the middle exchange rate of CNY. As a result, the Hong Kong stock market had dropped more than 15% in just two to three weeks. Then, the stock market has been stabilized after the Chinese government actively intervened and stabilized the CNY market. However, since the CNY has successfully been included in the SDR basket in the beginning of December, rumors of substantial CNY devaluation have again been spread among the market as many investors have worried that the Chinese government would stop to intervene and support the CNY price as what it did in August as the CNY has already included in the SDR. As a result, the Chinese government does not need to maintain the stability of CNY and can let the price of CNY fall freely. There are so many speculations about CNY in the market now. Many people think CNY might devalue 10-15% in the coming year, which is a negative factor pressing down the stock market of Hong Kong again.

Hang Seng China Enterprises Index

Sources: Bloomberg

CNY Devaluation is Possible, But 10% in Short Term is Too Much!

To be honest, the Chinese government may also want to devalue CNY because currency devaluation could help to boost export and stimulate economic momentums. However, is it practical/ feasible for the Chinese government to substantially devalue CNY in short term? We do not think so! If the CNY price slumps, the chaos in August will reappear: significant capitals fleeing out of China, Asian currencies competing to depreciate; stock markets collapsing in Hong Kong, and even in the whole Asia. Not only will the entire Asian financial market become volatile (if not properly handled, it is possible to trigger another financial crisis in Asia), the stability of Chinese economy will also be reversely affected. This is definitely not the Chinese government wants it to happen.

We believe that, in the next six months, it is possible for CNY to devalue 2-3%, but definitely not 10%, like what the market has anticipated now. Therefore we think the current stock market has over-reacted to the possible CNY devaluation. We think investors will eventually find out that CNY did not devalue as much as they worried and the stock market will be able to rebound like it did in October. (However, investors might need time to realize that they should not have to worry too much about the CNY devaluation.)

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

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