AMG Market Commentary

August 2010

Status quo for Fed's easy monetary policy

In the last 2 years, government stimulation has been the driving force for recover and the Fed has boldly set up an asset purchasing program to inject capital into the financial markets. Now the U.S. is facing the risk of slowdown again, investors are watching closely at changes in quantitative easing by the Fed.

FOMC meeting for Aug 2010 touched on this issue. After the meeting, the Fed announced that it will maintain status quo for the asset purchase program. It will reinvest the principal invested when the current bond holding matures and put the money into 2-10 years Treasuries issues. Also, it has explicitly stated that asset size will be kept at current level, which is at around USD 2 trillion.

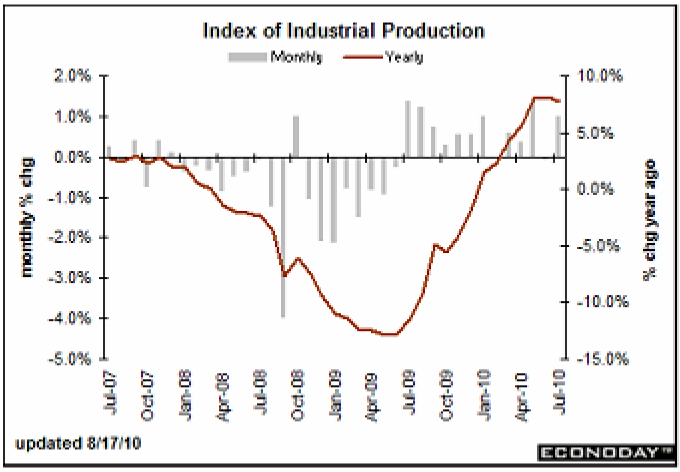
Given that no new capital will be thrown in, it is estimated that capital recycled by Fed would amount to around USD 10-20 billion a month. Direct impact of the asset purchase would be very limited. But, the extension of asset purchase program conveys an important message. It is that the Fed is still in extremely easy mode, obviously it will keep interest rate at zero level for quite some time. And expectation for prolonged period of low interest rate makes investors flocks to U.S. Treasuries and German Bund, which are perceived as the safest financial asset of all. The result is that bond prices for Treasuries and Bunds are pushed to very high level. Besides, the injection of liquidity would lead to higher turnover in financial markets. But, the global economy is clouded by a lack of private demand. Without a clear growth prospect, excess liquidity can only lead to more volatility but not helping the stock market to break out from range bounded movements.

US : Positive

Unsurprisingly, slowdown in economic growth is confirmed by recent data. The industrial production index for July 2010 showed a 7.7% growth in year on year comparison and retails sales also grew by 5.5%. Still, we can see from the graph below that growth momentum is flattening for industrial production while the declines in retail sales growth is even more obvious.

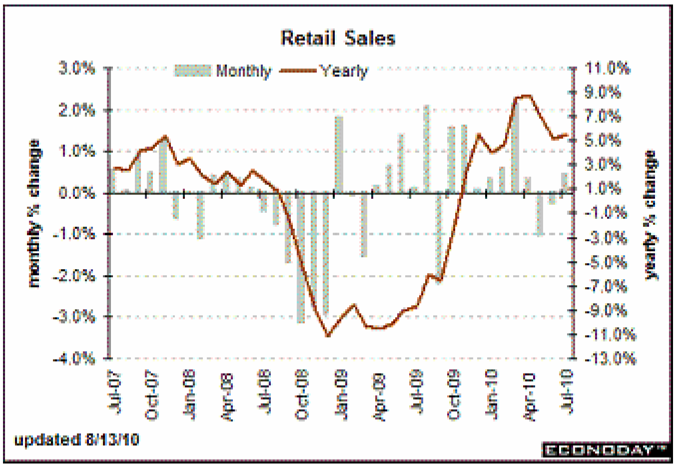
Slower economic growth is not going to help corporate profit and stock market performance. Still, we must state that we are heading to slower growth rather than recession. Moreover, stock market valuation is reasonable. Thus, we maintain that stock market will still go side way despite that the economic slowdown is getting more attention.

US index of industrial production



Source: Econoday

US retail sales



Source: Econoday

Europe : Neutral
European Central Bank commitee member Axel Weber openly urged the ECB to keep the emergence lending facilities through year end in order to help the bank meeting liqudity needs at the turn of the year. It seems that ECB is also very cautious in taking back the policies adopted to support the economy. So, we can expect that Europe will also be in a very easy mode for long time.
Rumors about Anglo Irish Bank is asking for bail-out again spreads, it is said that the Ireland government will buy another EUR 60 billion of problem asset from AIB. The rumors lead to renewed concerns about the cost of bail-out and financial stablity of European banks and governments. Yield spreads and CDS for the pheripery European nations jumps again and Euro fell sharply.

China : Positive
The Chinese government is taking more steps to help RMB to go global. It has announced that banks in Hong Kong will be allowed to invest into debt market in the mainland and start of forex trading for RMB against Malaysian Ringgit in domestic forex market. More investment channel for offshore holders of RMB and higher convertibility shall help making RMB more welcomed by overseas holders. For Hong Kong, the designated offshore center of RMB, our banking and financial industry shall benefit from the increasing usage of RMB.

Australia : Positive
While ballot counting is still in progress, thus far poll survey shows that neither the Labor Party nor rival conservative coalition of Liberal Party and National Party will win more than half of the seats in the Parliament. So, Australia will likely have a hung parliament. A hung parliament means strong resistance could often arise against government policy and hurt the government efficiency. In theory, it can hurt the economy. Still, Australia is being helped by strong external demand for resources and it can make up for the political problem.

Commodities : Positive
Commodities prices are also in side way movement. Gold prices rose again at the expense of the greenback and it went back up above USD 1,200. While crude oil fell on concerns about slower growth, it managed to stay above UDS 70/barrel.

Hedge Fund : Neutral
Up to the end of July, Barclay Hedge Fund Index rose by 2.08%. What we notice here is that out of the 2.08% upside, 2.03% was made in July 2010. It seems to us that the index was just brought up by performance in July and does not reflect persistent gains. Among different strategies indices, the fixed income instruments strategy

indices are leading the pack. Barclay fixed income arbitrage index rose 7.03%, Barclay distressed securities index made 6.70% and Barclay convertible arbitrage index gained 5.48% so far in 2010.

Government Bonds : Negative

Yield of U.S. Treasuries and German Bunds fell to historical lows. Dimmer growth prospect translates into tendency for U.S. and Europe governments to keep monetary policy as expansionary as possible. And example here is the extension of asset purchase program by the Fed. Other than economic growth, inflation is another important factor in the policy equation. Here, sluggish job market keeps the threat of inflation at bay. Thus, interest rates of U.S. and Europe shall remain at extremely low level for visible future. In other words, conditions are very supportive to “safe” investments such as Treasuries and the Bunds. Having said that, we still do not recommend buying into these issues as the return is far from fair not to mention attractive.

Things to Look Forward :

Selling pressure starts to arrive at the stock market while slowdown is getting more obvious and concerns about European debt revives on Irish bank bail-out. Again, it could bring us short-term adjustments, which could be sharp and deep. Still, we maintain that valuations of global stock markets are not high and the global economy is still expected to escape from double dip recession. So, we would take the adjustment as a buying opportunity. And we also have to mention that private demand is still very weak in U.S. and Europe, investors will likely need to wait patiently until companies and households start to spend before genuine growth can be seen in the global economy as well as the stock markets.

* All figures and information are collected from Bloomberg.com, Bespokeinvest & Barclay Hedge.

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