AMG Market Commentary

October 2010

Quantitative easing 2.0

Policy stance for the U.S. Federal Reserve has seemingly turned in favour of more easing again as the U.S. struggles with painstakingly high unemployment and weak demand. The Fed made it clear that it is ready to provide more stimulus in the minutes of the last FOMC meeting. So, the second round of quantitative easing since 2008 seems inevitable now. It is widely expected that the Fed will announce the adoption of QE 2.0 after the FOMC meeting on Nov 3.

At the moment, we are still waiting for the details of the plan. What we expect is that the Fed will spend the extra money in small blocks over a period of time to keep the yield for U.S. government debt low. And it will also adjust the plan according to economic and market conditions. The good point about the plan is that it will allow the Fed more flexibility to expand or shrink the operation and claims the market concerns about whether it will give sufficient support to the market.

As for the financial markets, the extra liquidity is expected to add to the capital flight to commodities and equities markets and bonds of emerging economies. According to EPFR, net fund inflow into emerging market equities funds in year 2010 has reached USD 60 billion up to 6 Oct 2010. And the net fund inflow is expected to reach a new record for the whole year. Now, U.S. is ready to inject more liquidity into the market, and we expect more capital to rush into the risky assets. And we cannot rule out the risk of asset bubble. But, we would argue that the stock markets are generally close to historical average in terms of valuations. There is hardly any sign of asset bubble. Thereby, we still expect asset prices to go up further as the Fed injects more liquidity into the market.

US : Positive

U.S. GDP grew by 2.0% in the third quarter of 2010, it was even faster compare with 1.7% growth reported for the previous quarter. Detailed figures show that personal consumption, corporate inventory and software expense continued to support the economic growth. And among all factors, private consumption contributed 1.75% of the overall growth and it was the single biggest contributor to the GDP growth. So, private consumption remains the determining factor for the prospect of U.S. economy and for private consumption, the pace of recovery of job market is crucial.

Payroll figures for the past few months showed that the public sector is laying off people as the temporary hiring for the U.S. Census is terminated. Private payroll becomes even more important now. And private payroll has kept growing at a very slow pace since April 2010 and we expect that the slow recovery will continue. The point is just that private hiring will need to speed up to bring down the unemployment.

Europe : Neutral

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Although the debt problem for the peripheral Europe countries is no longer headline news, it does not mean the problem has been solved. Bond yields for government debt of Greece and Ireland shot up again lately as the Irish government is paying more to save the banks. Still, market reaction is just very mild so far and the stock market did not drop much on the news.

China : Positive

PBOC lifted the interest rates for savings and lending in China while everybody is having his eyes on the Fed. As for China, the increase in interest rate is well justified as the economy is roaring, inflation is getting higher and signs of overheating were seen in bank lending and property market. So, it is no surprise that the Chinese government tries to rein in the asset bubble with higher interest rate. And we think that it is the start of the interest rate hike cycle for China and the PBOC shall continue adding to the interest rate in coming quarters.

What made the interest rate hike special to us is the magnitude of change, this time the PBOC lifted the rates by 0.25% instead of the conventional move of 0.27% in China. We think that this is another action of the Chinese government to bring the financial system of China in line with global practice.

Japan : Neutral

Facing the pressure of higher Yen exchange rate and deflation, the Bank of Japan announced that it will make another round of quantitative easing in which JPY 500 billion will be invested. But, it failed to stop the Yen from rising. In fact, there is very little the Japanese government can do to fight against rising Yen now.

Commodities : Positive

Falling USD helped to drive commodities prices again. Gold price went over USD 1,300/ounce and crude oil climbed back to USD 80/barrel.

Hedge Fund : Neutral

Barclay Hedge Fund Index had the best monthly performance in 2010, the index rose 3.54% in Sep 2010. At the back of the strong performance was a very strong rally in equities markets. And it explained why the Barclay Equity Long Bias Index was the best strategy sub-index among them all, the Barclay Equity Long Bias Index gained 5.9% last month.

Government Bonds : Negative

The tendency for the Fed to make more quantitative easing implied that it is getting even farer away for interest rate hike. So, we would expect the yield of the Treasuries issues to stay low despite volatility may be seen. Besides bringing down unemployment, the Fed has also expressed the intension to bring inflation back up to its long term policy target at around 2%. Though that the chance for inflation to come back in near future is not high, but it shall hurt the bond prices when it actually revives later. We would suggest investors who are holding the Treasuries bonds to keep any eye on the inflation risk.

Things to Look Forward :

Besides the direct impact of making liquidity more readily available in the market, it is also expected to weigh on the dollar as more USD comes into the market. The question here is whether central banks of Europe, UK and Japan will expand their own asset purchase to combat against appreciation pressure.

While on the other hand, the emerging markets and resources exporters like Australia and Canada are facing the risk of asset bubble as capital keeps flowing in. The reactions by their government may also affect the financial markets.

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

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