AMG Market Commentary

December 2010

European debt problem shakes the market again

Ireland reached an agreement with EU and IMF on rescue loans on 28 Nov, and it became the second nation to ask for help. According to the agreement, Ireland gained access to EUR 67.5 billion external aids at an average cost of 5.8% p.a. In addition, the Irish will also make EUR 17.5 billion available from the pension assets and government cash reserve. So, total amount of capital commitment adds up to EUR 85 billion, which covers about 70% of estimated refinancing needs for the Irish government and the major banks till the end of 2013. So, the pressure on Ireland government financing is greatly reduced in the short-term.

But, the assistance agreement for Ireland did not stop the contagion. Rather fears about a domino effect for financial bailout arose. Yields on Portuguese and Spanish government debt continued to spiral up. Take 10 years sovereign debt as an example, the yield went as high as 7.25% for Portugal and 5.26% for Spain. It was more than 3% and 1.5% higher compare with those in early 2010. It showed that demand for their bonds dried up. If the problem persists, it would threaten the ability for the Iberian countries to stand on their own feet.

To stem the contagion, the ECB and Spanish government took action to sooth market sentiment. Spanish government announced that it will seek to raise EUR 19 billion from the sale of a non-controlling stake in the nation's airport and lottery operator. And the ECB says that it will continue to meet all short-term loans request till Apr 2010 to secure the access to short-term funding for banks in Europe. Moreover, it is reported that the ECB is buying European government debt including Portuguese and Irish government bonds heavily in the market to keep the bond yield from shooting up.

The initial reactions in the market showed that the action of ECB helped to arrest the fears of contagion. Sovereign bond yields for Spain, Portugal, Ireland, Greece as well as other European nations fell significantly. It could help to stabilize the financial markets. Yet, we must stress that the European nations still need to deal with their problem such as poor fiscal discipline, lack of competitiveness and growth in order to resolve the debt problem. So, the European debt problem may be contained for now, but not coming to an end.

US : Positive

Latest figures show that retail sales and industrial production is performing well. Statistics of the National Retailer Federation showed that retail sales amounted to USD 45 billion, up 6.9% compare to last year for the Thanksgiving holidays. And the ISM manufacturing PMI reached 56.6 in Nov 2010, showing that U.S. industrial production is also on an uptrend.

But, the poor job figures took us by surprise. According to the Labour Department, non-farm payroll rose barely by 39,000. It is a significant setback from the addition of 175,000 jobs reported last month. And the unemployment rate rose to 9.8%. Weakening job market is undoubtedly a serious threat to U.S. recovery. But, the official job figure was grossly contradictory to the other statistics. Last week, the ADP job report showed that hiring in U.S. has reached a high point in the last 3 years. And the employment sub index for both manufacturing and non-manufacturing PMI also showed improvements. Thereby, we would wait for the revised figures to deter if the job market is really turning down again. As a matter of fact, significant upward revisions were seen in the job figures for the last 3 months. And we would not be surprised if that happen again for Nov 2010.

Europe : Neutral
Concerns about the debt issue continued, Spain and Portugal came into market focus after Ireland received it bailout package. And the situation of Spain is of much higher importance as it could dry up all available funding in the ESFS if a bail out is needed.
For Spain, sovereign debt isn't as big a risk as the other European nations. Spanish sovereign debt is currently about 60% of its GDP, still not an alarming level. And the government is staying ahead of the schedule for deficit reduction. So, we can say that Spain is in a much stronger position to handle its public debt compare to its neighbor. But, the uncertainty with Spain is in the banking sector. Just like their Irish counterparts, the Spanish banks are severely hurt by the bursting of a real estate bubble. Yet, the progress for revaluation of troubled assets and restructuring of the bank sector is still very slow. Re-capitalization and restructuring of the banks will cost the Spanish government and remains an unknown for Spanish debt problem.

China : Positive
Manufacturing PMI rose to 55.7 in Nov 2010. The index has risen for 4 months in row. Clearly, it has picked up away after the slow down between Apr and July. The importance here is that momentum in retail sales and fixed asset investment were always strong for China, industrial production was the only sector that showed signs of slowdown. Now that industrial production picked up again. It means that sustainability of Chinese economic growth is out of question.
On the policy front, the central government announced that the overall direction of the monetary policy will be "prudent" for the coming year. It reflects the tendency to tighten from "relatively loose" stance. And we can expect tightening to come in form of lower loans quota, higher required reserve ratio and higher interest rates. Still, it is not expected to lead to pro-longed declines in stock market as long as corporate profits stay firmly in a growth trend.

Hong Kong : Positive
Hong Kong government acted swiftly to fight against speculation in residential properties. Last month, punitive stamp duties on sales of residential property within 2 years from the date of purchase is announced and adopted with immediate effect. Extra tax up to 15% of the sales prices will be levied. Following the adoption of the new tax, market turnover for second hand homes declined significantly while price adjustment is relatively mild. It seems that the market is digesting the measures and it will take some time before the actual impact can be seen.

Emerging Markets : South Korea : Positive
The dust has yet to settle down for the artillery battle in the Korean Peninsula. South Korea and U.S. performed joint military drills near the disputed border, and it nerved North Korea. Still, we would regard it as a show of military muscles to deter North Korea away from armed attack of its Southern neighbor. On the other hand, China is urging for the re-opening of the six parties talk to resolve the issue in a diplomatic way. We believe that the efforts of China will finally pays off as a full scale war is in no one's interest after all.

Commodities : Positive
Investors' enthusiasm in gold grows with the recent changes in market. Both ECB and the Fed seem to be inclined to more policy support than tightening. For ECB, it is buying more of the sovereign debt to contain the debt problem. And for the Fed, Chairman Ben Bernanke said in an interview that it may add to the quantitative easing operation to help the U.S. economy. As the major central banks go further on liquidity pumping, it adds to the need for gold investment.
Besides gold, crude oil is also performing very well. WTI crude price is approaching USD 90/barrel in the early dates of December 2010 as extreme cold reached Europe and Chinese industrial production revived.

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Hedge Fund : Neutral
Barclay Hedge Fund Index rose 0.74% last month, and the cumulative gain for year 2010 went up to 7.09%.

Government Bonds : Negative
Traditionally, government bonds of European and North American nations were considered safer when compared to emerging market bonds. Still, the European debt problem exposed the weakness for some Eurozone members. Government bond yields for some nations such as Greece, Ireland and even Portugal and Spain are now higher than that of South Korea, Brazil. It showed that investors are now more concerned about the financial strength of the individual issuers and the line between developed countries debt and emerging market debt is getting blurred.

Things to Look Forward :
The debt problem heat up in Europe again, Ireland became the second nations to ask for bailout. Portugal and Spain are in the hot seat now as their bond yield shoots up. Contagion effect of the debt problem is becoming a more serious threat to Europe. In order to contain the problem, it is expected that the European governments will add to the rescue efforts.
Besides Europe, the economic conditions and potential policy changes especially about asset purchase in U.S. will also be watched by investors.

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

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