# AMG Market Commentary

**January 2011**

## 2011 – Global economy and financial markets to stay in the up trend

In the last year, we were very positive about the emerging markets and held a negative view on the sovereign bonds of the major economies. While year 2010 is gone, we now see that emerging markets had performed well. MSCI Emerging Market Index was up by 17.4%, out-performed the MSCI All Country World Index by 7%. But, Hong Kong, China and Brazil market were obviously lagging behind. The Shanghai A share index dropped by 14%, Hang Seng Index gained only 5% and Brazil BOVASPA Index only edged up by 1%. And for the sovereign debt, the European debt problem had triggered the flight for safety in the middle of the year. But at the year end, medium to long term Treasuries bond yield started to shot up as the Fed adopted the second round of quantitative easing and U.S. retail sales picked up. For the whole year, investors were had earned 5% from 10 years Treasuries issue. It is very decent indeed and in fact better than what we expected.

So now, we are going to look at the market environment again and give you our thoughts about where investment opportunities lie.

We would sum up the market environment in the 5 points below.

1. Liquidity is still ample
   The major central banks are keeping monetary policy very loose. The U.S. Fed has extended its asset purchase program to Jun 2011 and U.S., Europe, U.K. and Japan are all holding their policy rate at historical low. With such a loose monetary environment in the major economies, we can expect liquidity will still be readily available.
2. Global economy and corporate profits continues to grow
   U.S. economy is widely expected to go faster this year as private consumption started to pick up in the second half of 2010. And the emerging countries are also expected to keep getting on well. Supported by the U.S. and emerging countries, the global economy shall have its third year of expansion. Besides, corporate profit is also expected to expand. Consensus estimates shows that double digits EPS growth is expected for U.S., European markets as well as the emerging markets e.g. BRIC countries and Korea.
3. Valuation for stock markets is reasonable
   PE ratios are close to long term average for the stock markets, only a few of them e.g. Brazil, Indonesia are slightly above the average. In no way, we can say stock markets are overheated.
4. Sovereign bond yield started to go up
   Despite that the major central banks took no action on interest rate, the bond yield for medium to long term sovereign debt started to jump up late 2010. Behind the scene was the adoption of more quantitative

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easing by the Fed. And U.S. stocks kept moving up while the bond yield shot up, we would say the market is signaling an expected return of inflation rather than worries about public finance for America.

5. Divergence in policy directions among different countries
   Divergence in the pace of recovery led to a divergence in policy directions. Generally speaking, the emerging economies had pulled themselves out of recession on strong consumption and investment demand. They are now troubled by inflation and therefore their government tends to tighten their monetary policies. But, the major economies are still struggling and their government tends to keep policies easy. The difference in policy directions makes emerging markets more susceptible to policy risk.

In sum, the global economy and corporate profits are expected to expand again in 2011, and private consumption in U.S. shall be an important source of growth. Also, liquidity is expected to be ample as the Fed is going to inject more capital into the market. So, the environment seems to be quite favourable for the risky assets.

For 2011, our preference lies with the following markets and asset classes.

1. Commodities
   Stronger growth in U.S. and global economy and the loose liquidity conditions are expected to help commodities prices. And within the group, shortage in supply for copper shall continue and we would expect copper to go up further despite it is now near the historical high.
2. Emerging countries stock markets
   Strong growth potential makes emerging market keenly sought after by investors. Fund flow statistics by EPFR showed that net fund inflow into emerging markets equity fund amounted to USD 920 billion, which is a new record high. Although emerging markets are clouded by inflation problem and risk of policy tightening, we believe that corporate profit is the key for stock market movement in longer term so we remain bullish with emerging markets equity.
3. U.S. stocks
   U.S. companies are also performing well, it is widely expected that U.S. corporate earnings will be very close to the record high set in 2007. And double digit growth shall be reported for 2010. At the back of the high expectation is the strong demand in overseas markets and higher private consumption in the United States. In addition to strong profits growth, fund flow is also turning more favourable for U.S. stock market. Fund flow statistics by EPFR showed that net fund flow has reversed for global equity fund in 4Q 2010. Net inflow amounted to USD 28.4 billion.
4. Information technology sector stocks
   The IT sector was among the strong performers last year. NASDAQ index gained 17.5% higher than the 13% upside for S&P 500 index. Besides higher corporate investment in equipments and software, gains on strong emerging market demand enjoyed by dominant players such as Apple and Microsoft also added to the edge of information technology sector.

**US : Positive**

Private consumption growth gained speed quarter after quarter last year. It was an encouraging change for the U.S. economy. And the good news here is that the Bush tax credits was extended for 2 years, it was a favouarble change for U.S. consumption and growth forecast was raised as a result. Relative strong growth prospect and supportive government policies made U.S. the best performer among developed markets.

And for the policies, U.S. government is the most aggressive among all in policy stimulation. Last November, the Fed added USD 600 billion to the asset purchase program and extended the operation to Jun 2011. And it made clear that the recovery of the job market is the single most important factor in its decision for policy exit. And a look at the job data showed that there could still be some way to go before U.S. can start its policy exit. In the third and fourth quarter of 2010, around 100,000 jobs were created every month in U.S.. The job market is recovering, yet the speed it too slow to make a significant improvement to the unemployment.

**Europe : Neutral**

Last year, the divergence in economic and stock market performance reminded us about the differences among the members in Euro zone. Supported by strong exports and industrial production, growth in Germany was very

decent indeed. But, it has been a rough year for the periphery European countries. Their government were squeezed by soaring cost of financing and forced to adopt aggressive budget cuts and raise taxes, and tightening of government budget just added to the risk of recession. The difference between Germany and peripheral Europe shall still be very obvious in the coming year.
The European debt crisis remains unresolved. Greece, Ireland, Portugal and Spain all needed at least a few years to fix their public finance and stop the debt problem from worsening. Moreover, Spanish and Portuguese sovereign bond yields are not coming down. High cost of financing is still an acute problem for them. So, the European debt problem shall remain a significant risk factor for global economy and financial markets for the coming year.

**China : Positive**
Investors have very good reason to feel disappointed about Hong Kong and China stock markets for last year. The Hang Seng Index advanced only by 5% while Shanghai A shares Index lost 14%. But in fact, business performance of the Chinese companies was not bad. Total operating profits grew by 49% compare to 2009 for the first 11 months in 2010 for the state owned enterprises. From value perspective, higher corporate earnings means the values of stock went up. And obviously it was not fairly reflected by the poor market performance. We would argue that the divergence in corporate earnings growth and stock market performance means that Hong Kong and China markets are giving better value to investors.
On the other hand, the Chinese government has turned to tightening policy to confront mounting inflation pressure. So, the reference interest rates, the required reserve ratios as well as the exchange rate of RMB shall be going up. The risk of more policy tightening and shortage of liquidity will stay here with Hong Kong and China market.

**Emerging Markets : Brazil : Positive, Russia : Positive**
Ms Rouseff, the new Brazilian President, come into office on 1 Jan. For her, the top priority is to trim down budget spending to keep national debt from swelling. Besides, deterioration of international payment balance is another problem for Brazil. An inflated currency eroded the competitiveness of Brazilian industrial production overseas while imports kept growing on strong domestic demand. For 2010, the current account deficit expanded to 2% of GDP. Hurt by the uncertainties, Brazilian stock market ended last year flat. Still, it did not mean there is no opportunity for investment. As a major exporter of commodities and agricultural products, Brazil should benefit from strong price and demand for them. A good example was Vale, one of the top 3 mining companies in the world. The shares of Vale shot up 46% in 2010.
Being a laggard in the global recovery, Russia was out of the mind of many investors. But, a turnaround in domestic consumption, investment and bank lending occurred in the second half of 2010. Together with strength in oil price, the improvement in Russia economic conditions helped RTS index to achieve more than 20% growth. This year, the Russia market shall continue to do well as it continue to recovery. And relative low valuation also makes Russian market attractive. Despite the strong growth last year, Russia stock market is trading at around 8-9 times PE.

**Commodities : Positive**
Commodities prices are expected to benefit from continued economic growth and excess liquidity. And among the industrial metals, demand and supply condition is the most favourable for copper. Thereby, we still look for more upside for copper. Beside, precious metals have become keenly sought after by investors. Gold price has climbed above the 1,400 dollar mark. Silver price has gone up above USD 30 an ounce also. In year 2010, silver price gone up by more than 80%. For now, investment demand and investors' enthusiasm are driving precious metals prices. Chances are precious metal may have further upside, but their prices are expected to become more volatile.

**Hedge Fund : Neutral**
Last year, the average return for hedge fund was very similar to global equity markets. Barclay Hedge Fund Index reported 11.74% gain for whole year 2010.

**Government Bonds : Negative**
After the Fed adopted the second round of quantitative easing in Nov 2010, yields on 10 years and 30 years

Treasuries bonds turned up sharply. Lately, the yields for 10 years and 30 years Treasuries rose to 3.4% and 4.4% respectively. The Fed offered 2 explanations for the rise in Treasuries bond yield. The first one is that expectation for long term inflation rose. And the second one is investors became worried about the financial situation of the U.S. government. Our observation is that U.S. stock rallied while Treasuries bond yield shot up. And at the same time, fund flow has turned positive for U.S. equity fund. So, Investors are not losing confidence in U.S. and it seems market performance is more supportive for the explanation by higher inflation expectation. Given inflation expectation has gone up, we expect capital flow to be headwind for Treasuries issues in the coming year.

**Things to Look Forward :**
Global financial market is still facing lots of uncertainties e.g. European debt problem, high inflation in emerging markets and there could be more volatility. But, corporate profits and global economy shall continue to do well and liquidity condition shall be favourable too. We are looking forward to rising stock markets as we believe corporate earnings is the most important factor for determining stock market trends.

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

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