AMG Market Commentary

February 2011

The inflation problem of Asian countries

Stock markets of Asian countries started to underperform U.S. stocks market since the last quarter of 2010. For some countries such as India, Indonesia and China A shares markets, significant drawdown was seen. Their stock market indices all fell more than 10% from the peak made in late 2010.

Investors flee Asian stock markets on concerns about pressing inflation and the tightening of monetary policy. We can see from the table below that CPI is now much higher than a year earlier. While the Asian central banks have lifted the benchmark rates, they are falling behind the surge in CPI by far. So, the margin between inflation rate and benchmark interest rate in some countries such as China, India, Indonesia and South Korea widened and the real interest rates are deeper in the negative territory. The problem with prolonged period of negative real interest rate is that it will hurt depositors and steer capital towards investment and spending which in turn fuels further increase in inflation. To fight rising inflation, the Asian countries are now under higher pressure to lift their interest rates.

CPI and benchmark interest rate of Asian countries and major economies

Country / Region	CPI		Benchmark Interest Rate	
	Latest figure	Jan 2010	Latest figure	Jan 2010
China	4.60%	1.50%	2.25%*	2.75%*
India	8.33%	16.22%	5.50%	3.25%
South Korea	4.10%	3.07%	2.75%	2.00%
Taiwan	1.25%	0.26%	1.63%	1.25%
Singapore	4.60%	0.20%	NA	NA
Indonesia	7.02%	3.72%	6.50%	6.50%
Thailand	3.03%	4.10%	2.25%	1.25%
Malaysia	2.00%	1.30%	2.75%	2.00%
U.S.	1.50%	2.60%	0.00-0.25%	0.00-0.25%

Eurozone	2.20%	1.00%	1.00%	1.00%
UK	3.70%	3.50%	0.50%	0.50%
Japan	0.00%	-1.30%	0.00%	0.10%

Date source: www.tradingeconomices.com, www.bloomberg.com
* 1-year term deposits rate

But, the inflation problem of the Asian countries is complicated by ultra loose monetary policies of U.S. and Europe. Besides strong domestic demand, rising commodities and agricultural products prices are also driving inflation in Asian countries. As commodities prices keep on surging, the Asian central banks are fighting an uphill war to tame inflation.

And now, there is still some way to go before ECB and the Fed will lift the interest rate. Liquidity conditions will still be very loose and commodities price will likely keep soaring. Inflation in Asian countries has yet to reach its peak. So, the central banks in the region are still in tightening mode and more interest rate hike will come. Stock markets in the region will likely remain under pressure.

US : Positive

U.S. stock market kept rally on satisfactory corporate results and reassurance by the Fed to keep policy unchanged for some time. DJIA rose in 8 of the last 9 weeks.

Corporate profits beat consensus estimates again for the last quarter of 2010. According to reports by Bloomberg, more than 300 S&P 500 constituent companies have reported their earnings. And over 70% of them managed to beat consensus estimates.

And in the FOMC in Jan 2011, the Fed kept U.S. interest rate unchanged and at the same time reinstated that it will stick to the schedule for its asset purchase program. It means the Fed will not stop buying till Jun 2011. And the U.S. will see no tightening any time soon.

Europe : Neutral

ESFS, which was established to help Eurozone members, completed the first debt issuance with a success. The bids received amounted to EUR 27 billion, 5 times the target issuance amount of EUR 5 billion and the yield is 2.23%. It shows that market demand for ESFS bonds is high and it assured investors that the Eurozone would be capable of helping its members. Besides debt issuance, the ECB President Mr Trichent urged for more flexibility for ESFS. It ignited the debate to allow the ESFS to buy bonds directly in the market to bring down the yield and ease the pressure of the weaker members.

Concerns about the European sovereign debt problem receded again as ESFS made a big success with its debt issuance. Market sentiments improved dramatically on periphery Europe. FTSE MIB index rose 9.31%, IBEX 35 index jumped 9.61% and Athex Composite Share Pr jumped by 12.69% last month. Here, we urge investors to pay attention to the high debt level and the need to rein in fiscal deficit for these countries. Harsh fiscal tightening is still need for at least 2-3 years, and it shall hurt economic growth. Thereby, we think that the spectacular performance of peripheral Europe would be short-lived.

China : Positive

Bring the real estate market and inflation under control is the prime concerns for the Chinese government now. As such, it added to the austerity measures against real property speculations and bank lending. For the property market, the new measures include requiring local governments to set the annual target for property price changes, cutting the mortgage ratio for second home purchase to 60% and taxing residential property turnover with 5 years of purchase. Yet, Looking at what has been announced by Shanghai and Chongqing, the tax rate is between 0.5-1.2%. It is not very harsh in deed and the impact on property prices would not be substantial.

While for liquidity and money supply, the PBOC has shifted to dynamic reserve requirements as the main policy tools to control the growth in money supply. The difference that it may bring is that explosive growth in bank lending during the early part of the calendar year may not be seen again as the expansion of the bank's book with be more closely monitored during the year under the new mechanism. And liquidity conditions may be less volatile

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in the year.

Emerging Markets : Africa and Middle East : Neutral

The ousting of Tunisia president resulted in a wave of anti-government protests swiping across North Africa and Middle East. Now, Egyptian President Mubarak is facing fierce challenge from the people. Large scale protest are held in the major cities like Cairo, Port Alexandra and Suez, and the voice to demand for his resignation is getting louder and louder. Mr Mubarak has announced that he will not run in the Presidential election in Sep 2011, and it will be the end of his 30 years rule in Egypt. Still, the protestors are not satisfied and ask for his immediate exit. The political struggle has yet to settle down and the wave of anti-government protest has spread to other countries in the region such as Yemen and Jordan. There are still chances for political turmoil in Africa and Middle East to bring more volatility to the financial markets. Fortunately, the major oil producers and exporters like Saudi Arabia, Iran and Kuwait are largely unaffected. As long as the oil giants manage to stay away from the trouble, the real harm to global economy and financial markets will be limited.

Commodities : Positive

Investors continued to put more capital into commodities. And among them, agricultural products and industrial metals performed relative well so far in 2011.

Extreme weather and loose liquidity conditions are helping agricultural prices. Wheat, sugar and corn rose by around 5% in the first month of 2011.

And for industrial metals, copper and tin future hit historical high on the back of strong industrial demand and drawdown of inventory. Copper futures breached USD 10,000 a tonne.

For oil and gold, they started the year with a retreat. Yet, the geo-political tension in Middle East helped them to find support at around USD 85 and USD 1,300 respectively.

Hedge Fund : Neutral

Barclay Hedge Fund Index gain 0.04% Jan 2011. Barclay Convertible Arbitrage Index extended the lead among all strategies sub-index last month with a gain of 2.53%.

Government Bonds : Negative

Besides Asian countries stock markets, government debt is also being squeezed by rising inflation. Long term U.S. and German Bund yield rose sharply despite that the Fed and ECB have refrained from lifting interest rate. 10 year Treasuries yield rose to 3.4% and the German counterpart rose to 3.2%, both are 1% higher than the low made in 2010. While inflation expectation is still there, high grade government bonds are still unattractive to us.

Things to Look Forward :

Stock markets of the Asian countries are clouded by surging inflation and expectations for policy tightening. And it is widely expected that the inflation problem will get more acute as food prices and materials prices are still surging. Thereby, we expect the policy tightening cycle to continue and Asian stock markets will be under pressure for some time. Yet, they are still attractive long term investments with strong domestic demand and fair valuations. But, for the near future, we may need to watch for signs of moderation in their CPI and agricultural prices for them to pick up again.

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

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