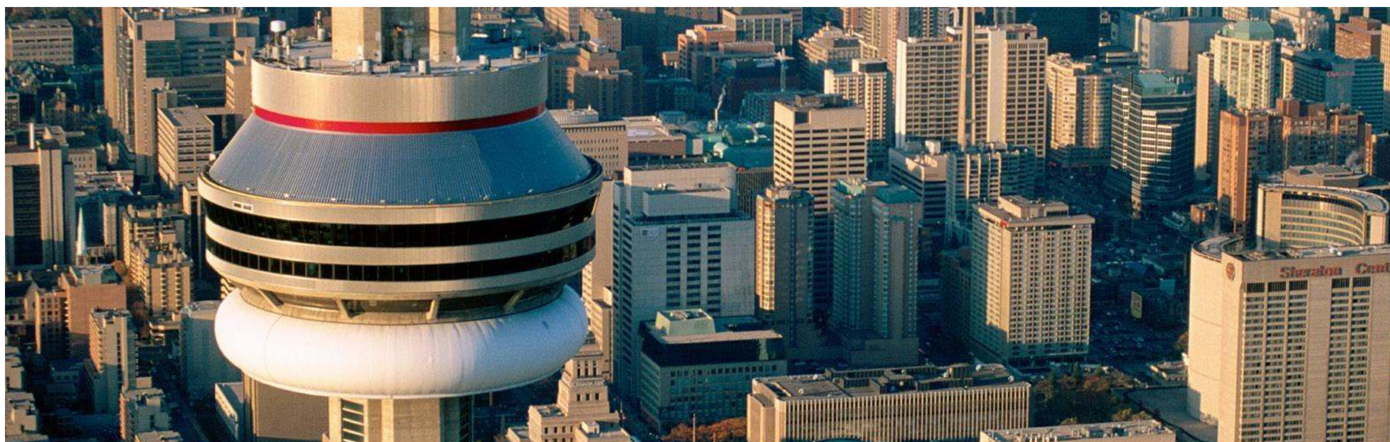


AMG Market Commentary

December 2011

European Bank Woes Deepened

It finally happened. For weeks, we have been waiting to see when the yield on Italy's 10-year government bonds would cross the psychologically important 7%-level. The breach took place in early-November and in the days that followed there was a tussle between sellers and the European Central Bank, which apparently was the sole buyer in the market. Yield bounced around that 7%-level like children jumping the rubber band rope (跳橡筋繩). In the end, ECB succeeded in defending the line with yield backed down below 7%, and remains so as of this writing. But as the Chinese saying goes, 'A new wave rises even before the prior one subsides (一波未平一波又起). ' Before ECB can breathe a sigh of relief, yield on 10-year Spanish government bonds was rising fast. In mid-November, when Spain auctioned a new batch of 10-year bonds, they fetched yields that were just a hair below 7%. Yields on existing 10-year bonds immediately jumped and ECB had to open its spigot again to fight another fire.

€10 billion=$13.46 billion
Source: Royal Bank of Scotland

Since ECB began its buying of government bonds of fragile euro-zone countries – initially that of Greece, Ireland and Portugal, but since July also expanded to Italy and Spain – total purchase has reached €190 billion, according to a recent tally by Wall Street Journal.

While all eyes are fixated on whether ECB will assume a more prominent role (and some bet this will be the ultimate outcome) in this European sovereign debt saga, that is to act as the last resort of backing all government bonds, we have noticed a great deal of activities happening in the European banking sector that warrant closer attention.

In recent weeks, a host of European banks have announced their latest earning results. Without any ambiguity and almost without exception, bank executives unequivocally talked of bleak and challenging operating environment for the recent past and for the future. The term 'paradigm shift' is fast becoming a cliché among European bankers.

Capital Calls

UniCredit's $10.32 billion share sale, announced Monday, becomes the ninth-biggest such 'rights offering' by a bank since 1999

Value, in billions	Issuer	Date
$24.30	RBS	April 22, 2008
23.27	RBS	Oct. 13, 2008
22.48	Lloyds TSB	Nov. 24, 2009
19.57	HSBC Holdings	March 2, 2009
19.21	Fortis	Sept. 21, 2007
15.38	UBS	May 22, 2008
13.96	Deutsche Bank	Sept. 20, 2010
12.78	HBOS	Oct. 13, 2008
10.32*	**UniCredit**	**Nov. 14, 2011**
9.31	Crédit Agricole	June 4, 2008
9.28	Santander	Nov. 10, 2008

*Current value

Source: Dealogic

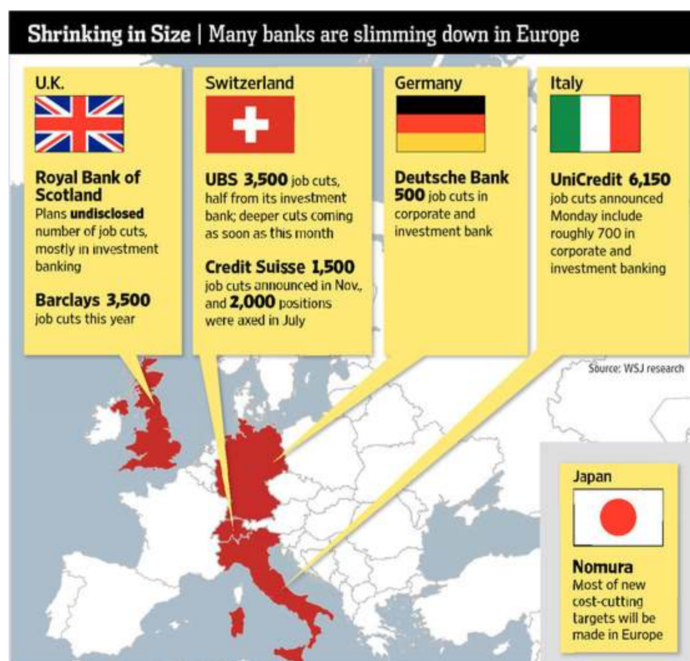
What these bankers refer to is the enactment of Basel III requirements that were developed and agreed by members of the Basel Committee on Banking Supervision in response to the deficiencies in financial regulation as revealed by the global financial crisis in 2008. Under Basel III, banks need to set aside more capital to meet higher adequacy ratios and there will be new regulatory requirements on bank liquidity as well as bank leverage. And in an attempt to pacify jittery capital markets and disgruntled investors, European government officials decided to move forward the timeline of enacting Basel III from the original start date in 2013 to mid-2012.

This sent bank executives scurrying looking for ways to meeting toughened capital requirements. There are several ways to do so: (1) raise capital by issuing securities in private or in the public market; (2) raise capital by

selling off assets or non-core businesses; (3) scale down balance sheet by trimming operations and liabilities; and (4) trim lending or pre-arranged yet unused credit lines.

Banks in Europe are utilizing all possible options. On the day UniCredit SpA of Italy, which is the nation's largest banking institution, announced its latest results, it also announced plan to sell about €7. 5 billion of newly issued stock to existing investors early next year. This is the third time since 2008 that UniCredit has raised new capital, with a total of €7 billion being raised in 2008 and 2009. In late-October, the European Banking Authority said dozens of banks needed to come up with an additional €106 billion in capital by next June. Hence, investors should prep themselves for more capital raising announcements in the months ahead.

At the same time, various banks have announced broad-based retrenchment in operations and reduction in head counts. In the case of UniCredit, it plans to scale back its investment-banking business, shrink its Eastern European operations and cut roughly 6,150 jobs by 2015. That includes an 8% staff cut in its investment-banking division, which has big London operations. On Nov 17, new permanent Chief Executive of UBS AG, Sergio Ermotti, outlined the Swiss bank's long-anticipated strategy to shrink its investment bank. This entails reducing its risk weighted assets, or RWAs, allowed to the investment bank by 50%, exiting its asset securitization business and scaling back its long-end rates businesses, and cutting global staffing levels in the investment bank to just under 16,000 from its current 18,000 level. Another Swiss bank, Credit Suisse Group, has also embarked on a similar strategy, announcing additional job cuts that raise the total of positions to be eliminated to 3,500, and also said it will shrink its fixed-income business to free up capital.



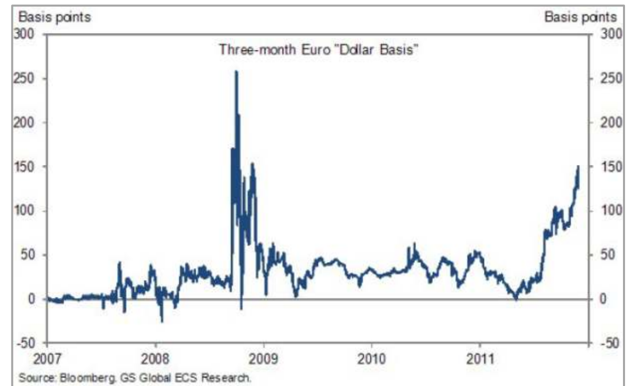
European banks are also pulling back lending in foreign markets. In October, France's BNP Paribas SA backed out on a commitment to provide its share of as much as 15 percent in a syndicated loan for an Australian media company, forcing the rest of the syndicate to fill the gap. And recently, Italy's UniCredit and Germany's Commerzbank have both pledged to cut their lending activities outside of their home markets.

In the past decade, European banks have aggressively extended their footprint in emerging markets, helping European companies winning businesses by providing commercial or trade loans. From 2005 to the middle of 2011, lending by euro-zone banks to emerging markets amounted to U.S.$2. 4 trillion, according to the Royal Bank of Canada and the Bank of International Settlements. Their retreat would impact businesses operating in emerging markets in Asia to Eastern Europe to Latin America, though in various degrees.

In the right-hand corner chart that was cropped from Wall Street Journal, we see how emerging markets in different parts of the world depend on euro-zone banks for lending and financing. In terms of region, generally speaking, companies and economies in Eastern Europe will bear the biggest impact, followed by Latin America and Russia, and then to lesser extent Asia.
Although Asian economies as a whole does not heavily rely on European banks for financing needs, recent trade data from Singapore to Taiwan to South Korea are starting to show slowdown and even negative growth due to waning demand from Europe and U.S.. We need to watch out if the current pull back in European bank lending morph into a full-blown credit crunch similar to the one after Lehman Brothers collapsed in 2008. Global economy is still recuperating from the last financial tsunami with many nations, emerging as well as developed ones, ill afford to confront another recession.

Market Review & Outlook

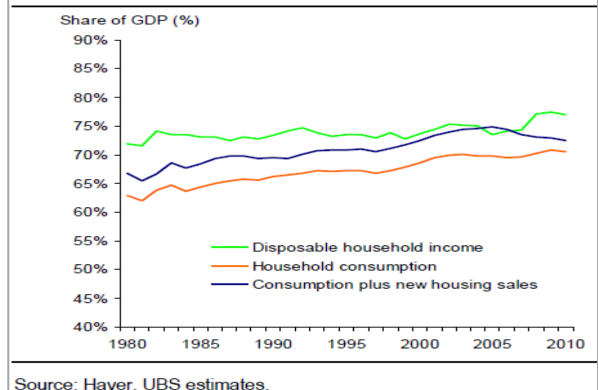
US: Negative



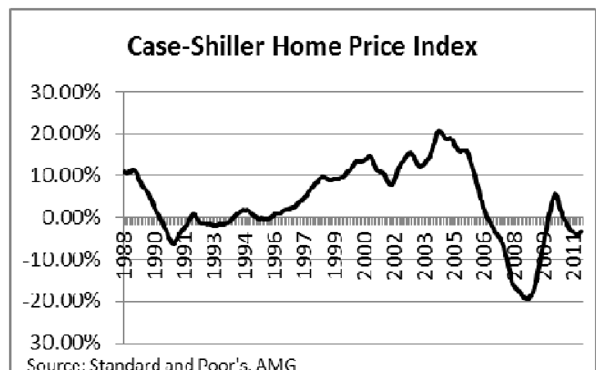
Six central banks, led by the Federal Reserve of U. S. and included the European Central Bank, Bank of Canada, Bank of England, Bank of Japan and Swiss National Bank, cut borrowing costs in borrowing dollars overnight in the swap markets in a surprised announcement at end of November. The news sent equity markets around the world soaring. As can be seen in the right hand chart, the 3-month Europe “dollar basis” has risen significantly since August and reached a post-crisis high in November. By trimming finance cost in overnight market, the USD has softened and investors regaining their risk appetite. This has also encouraged European sovereign bond buying and facilitated PIIGS countries, as well as banks, financing.

However, it is too early to say whether efforts by the 6 central banks can ease liquidity tension in the global banking system with long-lasting results. As yet, a concrete and generally acceptable solution for the European sovereign crisis remains illusive. Investors should pay close attention to the summit meeting of Euro zone leaders taking place on Dec 9.

Turning our attention to the U.S. property market, some people have been wondering why property prices are still declining and how come this has dealt such a significant and lasting impact on the real economy in the U.S..



The chart on the right provides some clues this question. It displayed the changes in income and spending behavior amongst American households over time. These are expressed as a share (in percentage) of U.S. GDP. From 1980 to 2006, housing prices kept climbing which led to rising consumption relative to income and net savings. The implication is that American home owners are increasing exposed to financial swings in the property market during this period with the decrease in household savings. When the bubble finally burst, home owners are stranded owning huge amount of debts.



The chart on the right shows the annual percentage change of Case-Shiller Home Price Index in constant-quality prices. Except for a briefing period in 2009, U.S. property prices are still dropping and they are a far cry from the pre-crisis peak levels. With property price still trending downward, it is hard to be optimistic for a full scale recovery in consumer confidence and personal consumption. Not to mention that American households, perhaps with the exception of the top 1% income class, are still fixated at deleveraging.

Europe: Negative

Pressure has been escalating in Europe for its leaders to come up with a real solution to end the two-year and running sovereign crisis. One only has to look at the surge in demands at the ECB lending window by European banks, these banks’ rush to shed assets and curtail lending, and the drop in M3 money supply in October.

Gross financing requirements of Austria, Belgium, France, Italy, the Netherlands and Spain are estimated to exceed €2trn till end of 2014. Just between Italy and Spain, they need to jointly raise around €10bn each week in 2012 and 2013. Bond market kept its pressure near the boil, with Italian bond yields across most maturities topping 7% and Spanish yields just shy of the 7%-level at late November. High refinancing costs impede the already dismal recovery in Italy and Spain.

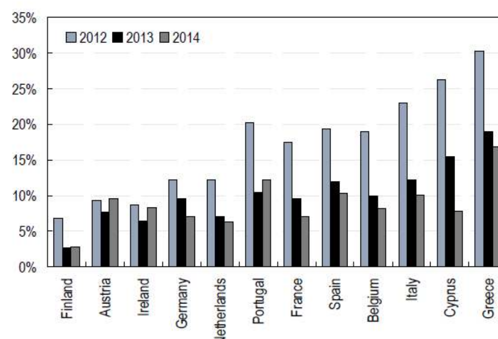


Figure 2. Selected Countries – General Government Gross Financing requirements (% of GDP), 2012 – 2014F

Note: Budget deficit (IMF forecasts for Ireland, Austria, Finland, Citi forecasts for all others) plus bond and bill redemptions. Greek/EFSF programmes are not reflected.
Source: Bloomberg and Citi Investment Research and Analysis

After deducting all commitments to Ireland, Portugal and the second Greek aid program, the European Financial Stability Facility (EFSF) has less than €300bn of ammunition. Even after passing the revision to allow EFSF to take over buying sovereign bonds (from ECB), it would run out of money in a matter of months just to support Italy and Spain. This would disable EFSF to expend on secondary market purchases or on bank support. Consequently, trimming finance cost is thus an important first step in coping with current distress.

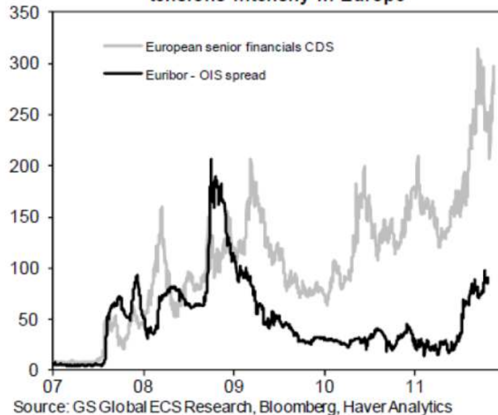
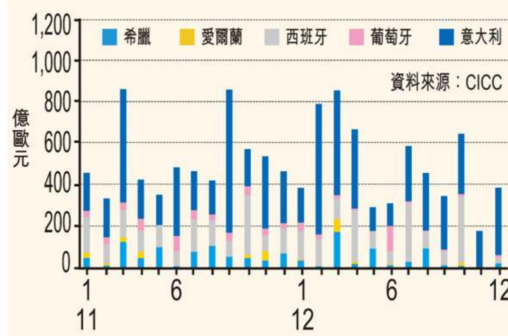


Chart 3: Bank CDS and money market tensions intensify in Europe

Source: GS Global ECS Research, Bloomberg, Haver Analytics

Evidence indicating tight liquidity in Europe's banking system is shown on the right chart. Widening Euribor–OIS spread shows rising re-finance cost in capital market, and rising European senior financials CDS indicates increasing fear of failure for some, if not all, European banks.

Diminishing market risk appetite in bond auction squeezes fair value of banks' bond holdings. When the time comes for banks to report annual results, they would reveal huge drop in asset values on their balance sheets and likely shock investors. Investors also need to be aware that as banks need to meet more demanding capital adequacy requirement, they would likely deleverage by selling off risky assets. According to Europe Banking Authority, EBA, the shortfall by European banks to fulfil capital adequacy requirement could exceed €106 billion.



We can also see mounting pressure due to the onslaught of sovereign debts maturing in Q1 of 2011 (see right chart). By that time, demand in capital will surge and cause more rattle to global markets to the extent of triggering another recession. The linkage between the rise and fall in refinancing needs and global equity market is supported by this year's experience if we examine the chart closely. Peak maturing months in March and September were accompanied with sharp sell offs in equity markets. If this relationship holds, next quarter would be a critical time for this crisis. Thus, investor needs to be cautious in making investment decisions involving the Europe zone, unless European leaders and/or the ECB can come up with effective means to support in-debt countries.

There is consensus situation in the Euro-area is nearing a critical stage. More and more observers believe that the ultimate solution would be a political one. At the moment, the two possibilities are either the disintegration of the Euro or moving the monetary union into fiscal which means mutualization of debt. The market increasingly sees the latter as the more likely outcome. Given the huge uncertainty and associated costs, probability of dissolving the European Union is quite low.

Japan: Neutral
Japan's exports and industrial production, which are major drivers of the economy, will likely remain stagnant through mid-2012 due to lacklustre demand in overseas markets.

The right chart compares the order/inventory gap in China's manufacturing PMI and Japan's export to China. It shows that the order/inventory gap in China slightly led Japan's export. With the inventory/order gap continued falling in October, and unlikely to return to strong growth any time soon, it would be difficult for Japan's export to regain momentum.

In addition, further financial strains could tip the Euro area economy into recession in the current quarter. Meanwhile, the surge of the yen against the Euro in the past few months is also aggravating Japan's export situation. Against such an external backdrop, Japan's export may be continued hamstrung through mid-2012.

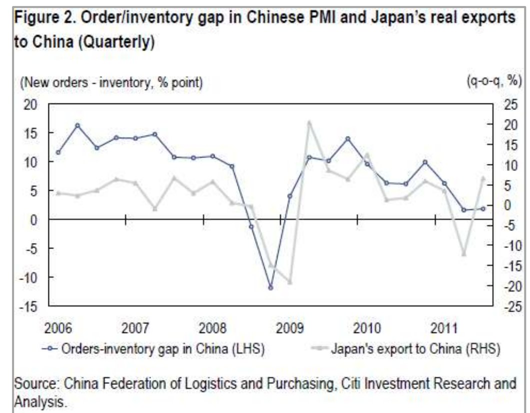


Figure 2. Order/inventory gap in Chinese PMI and Japan's real exports to China (Quarterly)

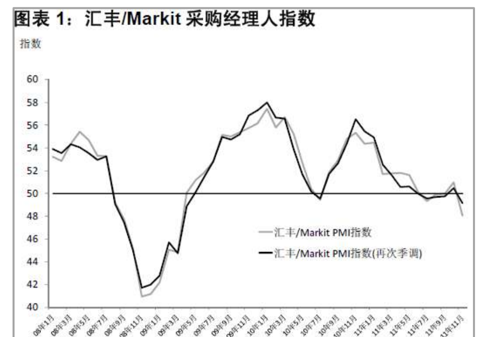
Source: China Federation of Logistics and Purchasing, Citi Investment Research and Analysis.

Despite the above, not all factors are pessimistic. There is increasing demand, from both public and private sectors, for rebuilding after Tohoku earthquake which is likely to boost the Japanese economy. The supplementary government budget bill to fund reconstruction, as well as residential investments, should buoy economic activities by around next spring. Consequently, we maintain our moderate view towards Japan.

China: Mixed

In an apparently co-ordinated, yet no officials has admitted, move with other central banks, China surprised the market by trimming the reserve redeposit ratio (RRR) 25 basis points at end of November. The timing is much earlier than market consensus, which was expecting the move by late December. The early than expected announcement is widely seen as a concerted response to calm investors; however, it also signifies the extent of a rapidly deteriorating domestic economy.

Two days after the announcement of reducing RRR, the official PMI for November was said to be 49, which is the first time below 50 (a figure below 50 reveals manufacturing is contracting) since the financial crisis in 2008.



Earlier on, the HSBC/Markit PMI also surprised on the downside, drastically dropping 3pp to 47. 7 in November. The low reading is in line with market expectation for continuously weakening demand in China. Furthermore, the sharply weaker reading may signify weakening sentiment towards China's property market is spreading to infrastructure investments and related sectors like steel, cement, and so on.

Premier Wen Jiabao mentioned earlier in November the need of "timely and adequate fine tuning in proactive manner", indicating Beijing government is more inclined to the idea of measured easing in some areas of the economy. Already, the government has introduced selective easing measures to cushion the slowing economy, including a pickup in credit growth in late October and early November, and some measured cut in discretionary RRR for rural banks. The key question for investors undoubtedly is: Is this the end of monetary tightening cycle and its implication to China's stock markets?

Some observers, we included, believe China's M1 money supply growth is a concurrent indicator, even leading to some extent, of domestic equity markets. The graph on the right shows the long term moves of China's M1 growth and the Shanghai Composite Index and Shenzhen Composite Index. For the past 15 years, the bottom of M1 lies somewhere between 7% to 10%. The October figure is 8. 9% which could mark a bottom. Additionally, some might also consider the quasi–money, which is the value of (M2 – M1). This measures how much money is not in circulation but represent potential purchasing power of an economy. Positive value of quasi money means market is too hot and vice versa. Investors may watch out for the sign to go from positive to negative.

Emerging Market: Negative

Table 4: Consensus EPS estimates and revisions since the beginning of 2011

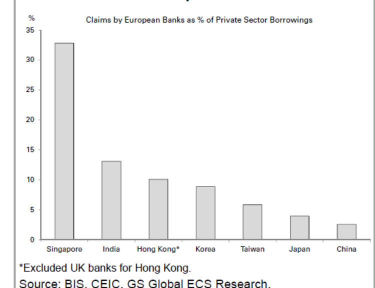
Index	Actual		Current Consensus EPS			Consensus EPS beginning of this Year			Revision in Consensus EPS (%)		
	09	10	11E	12E	13E	11E	12E	13E	11E	12E	13E
EM	**65**	**84**	**92**	**103**	**115**	**98**	**112**	**130**	**(6.9)**	**(8.7)**	**(11.6)**
EM Asia	**23**	**32**	**34**	**39**	**45**	**38**	**43**	**49**	**(8.4)**	**(9.0)**	**(8.4)**
Latam	**280**	**324**	**340**	**386**	**420**	**381**	**427**	**514**	**(10.7)**	**(9.6)**	**(18.3)**
EMEA	**27**	**34**	**41**	**43**	**47**	**40**	**47**	**51**	**0.7**	**(6.9)**	**(6.8)**
Brazil	16302	21094	22360	24193	25442	22610	25194	26230	(1.1)	(4.0)	(3.0)
Chile	248	313	319	368	431	339	384	367	(6.1)	(4.2)	17.5
China	3.76	5.21	5.79	6.46	7.32	5.62	6.53	7.53	3.2	(1.2)	(2.9)
Czech	34	34	29	31	33	33	34	34	(12.3)	(9.1)	(2.9)
Hungary	106	114	113	130	158	132	162	185	(14.7)	(19.6)	(14.6)
India	34	42	47	54	62	51	60	75	(8.2)	(10.4)	(17.6)
Indonesia	220	270	325	374	432	320	369	441	1.6	1.1	(2.1)
Korea	34	48	53	60	68	57	64	68	(6.2)	(6.5)	0.2
Malaysia	25	33	35	39	44	37	42	42	(6.6)	(6.2)	3.1
Mexico	1761	1553	1901	2352	2691	2241	2538	4666	(15.2)	(7.3)	(42.3)
Peru	68	93	126	140	141	128	135	115	(1.7)	4.0	22.8
Philippines	33	43	46	52	57	47	54	56	(2.0)	(4.4)	0.8
Poland	111	145	187	178	181	161	176	175	15.9	0.9	3.7
Russia	92	135	171	163	179	139	160	179	22.6	2.1	0.4
S Africa	43	51	63	81	90	66	78	86	(4.6)	4.2	5.3
Taiwan	11.0	20	16	19	24	24	27	26	(34.1)	(26.6)	(7.3)
Thailand	23	31	36	41	46	33	39	46	8.3	6.2	0.1
Turkey	74702	87052	80263	92705	105257	92606	104566	118525	(13.3)	(11.3)	(11.2)

Source: MSCI, Datastream, IBES, J. P. Morgan, 25 November 2011

As we progress towards year end, most investment banks are adjusting their EPS estimations of emerging markets. Overall, consensus earnings for emerging markets have been trimmed. The above table compared latest estimations and how that compare to that at the beginning of the year. In particular, Taiwan, Hungary, and Mexico have been adjusted downward significantly. The common aspects of the said countries are that their domestic economies are relatively small in size and heavily depending on export revenue from developed countries.

In respond, a number of emerging economies have already trimmed interest rate. Easing monetary policies in 2012 is likely to be supported by stimulative budgets in a number of countries as governments attempt to underlie economic growth. In Asia, Bank Indonesia and Royal Bank of Australia led the current rate cut cycle, and others are expected to follow before long. Expectation is high for Thailand and India to be next in line to trim policy rate, the latter boosts interest rate level that is close to pre-crisis level.

Exhibit 3: AEJ exposed to EZ bank financing issues—China least impacted

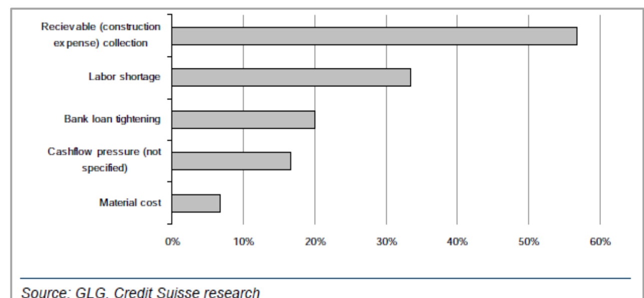


*Excluded UK banks for Hong Kong.
Source: BIS, CEIC, GS Global ECS Research.

On the other hand, it is expected that most European companies will announce lacklustre financial results in the first quarter next year. The huge exposure of European banks to Euro zones sovereign debts poses sizable liquidity threat for these banks. In order to meet capital adequacy requirements of Basel III, Euro zone banks would need to trim down their leverage considerably. Graph on the right shows the degree of AEJ (Asia ex Japan) private sector borrowings being exposed to Europe zone bank financing.

Commodities: Negative

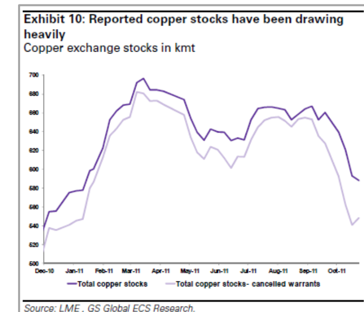
In previous market commentaries, we have explained our worries on the impact to commodities prices in the event of significant correction (or contraction) in China's property market. Recently, Credit Suisse published its findings about major business challenges for construction companies in the next six months.



Source: GLG, Credit Suisse research

They found that the biggest concern for construction companies pertains to account receivable from developers. 80% of surveyed construction companies said their clients continued to delay payments. The survey also found that developers had slowed down construction progress on projects already started. These findings generally are in support of our concerns. This hardens our expectation for demand on building materials to fall with a strong and negative impact on prices, given China government's insistence to continue property market suppressing policy and the likelihood of, though not inevitable, China's economy suffering a hard landing.

Exhibit 10: Reported copper stocks have been drawing heavily
Copper exchange stocks in kmt



Source: LME, GS Global ECS Research.

Our concerns notwithstanding, commodity prices have rebounded 15% since early October. A driver of such performance has been the tightening of physical fundamentals. Current U.S. total petroleum inventories are well below the 5-year average. In addition, copper exchange stock levels are declining fast in Asia after months of stability. Low levels of inventory provide support to commodities prices, and in the event Europe pulls through with delivering a workable solution to its sovereign crisis and a global recession is avoided prices could climb further.

Hedge Fund: Mixed

European leaders displayed firmer commitment to resolving the sovereign debt crisis in October prompted a rebound in hedge fund performance for the month. With improved sentiment and a return of liquidity in the market, this has created a profitable environment for most hedge fund strategies. Risky assets rallied, significantly outperformed safe-haven instruments. The Dow Jones Credit Suisse Hedge Fund Index (the "Broad Index") reported a gain of 1. 73% for October. Dedicated Short Bias and Managed Futures are the only two strategies generating negative results in October.

	Oct	YTD	Avg. Annualized Performance*	Annualized Vol.*
Dow Jones Credit Suisse Hedge Fund Index	**1.73%**	**-1.53%**	**8.86%**	**7.65%**
Convertible Arbitrage	1.18%	1.10%	7.55%	7.01%
Dedicated Short Bias	-9.59%	2.34%	-3.51%	17.06%
Emerging Markets	3.70%	-3.43%	7.61%	15.05%
Equity Market Neutral	2.76%	4.90%	5.13%	10.46%
Event Driven	2.56%	-7.38%	9.40%	6.38%
Fixed Income Arbitrage	0.14%	3.78%	5.23%	5.81%
Global Macro	0.18%	6.01%	12.22%	9.85%
Long/Short Equity	4.45%	-5.08%	9.42%	10.00%
Managed Futures	-5.06%	-5.11%	6.00%	11.82%
Multi Strategy	2.05%	2.61%	7.97%	5.43%

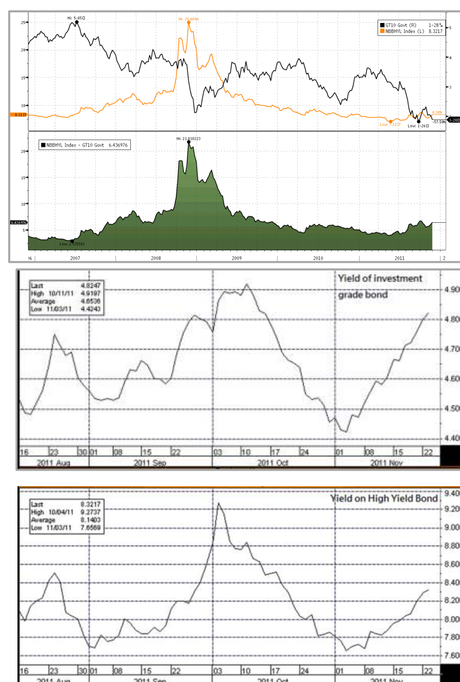
*Average annualized Index data begins January 1994. Source: Credit Suisse Hedge Index, LLC.

Dedicated Short, with a positive gain in September, is reasonable to suffer as a consequence of sharp rebound in global equities, while poor performance of Managed Futures is largely due to losses from trend following programs.

Long/short equity, emerging markets, event driven, and distressed were top performers in October. However, on a year-to-date basis, equity- and credit-based strategies remain in negative territory. Meanwhile, global macro managers and fixed income arbitrage managers posted modestly positive returns, while convertible arbitrage and multi-strategy managers benefited in part from their equity and credit components.

Bonds: Mixed

Among the biggest news of the month is that Fitch Ratings revised U.S. outlook to negative, though it affirmed the long term foreign and local Issuer Default Ratings (IDRs) at "AAA". This somehow alleviated anxiety among U.S. bond holders as market afraid of Fitch following moves by Moody's and S&P. Those two rating agencies stripped the U.S. of the coveted "AAA" designation earlier. While some critics argued Fitch's announcement has no impact to the USD given its stature as the preeminent preserve currency, the fact that Fitch maintained the "AAA" rating provided some support for Treasuries. We should point out that a negative outlook indicates a slightly greater than 50% chance of a downgrade over a two-year horizon.



As we stated last month, yields of investment grade bonds have been quite stable at about 4. 5% throughout the year, with the spread against comparable Treasuries widening mainly due to surging Treasury prices. Similar argument also applies to high yield bonds.

* Unless otherwise stated, all figures and informa tion are collected from WSJ, Bloomberg or Haver Analytics.

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