AMG Market Commentary

March 2012

Changing Dynamics in the Global Auto Industry

The first time I visited the office of AMG Financial Group, I was fascinated by a poster that reads "Our Culture of CAR". Reading through the finer print, I realized it was an acronym for **C**ommunication, **A**ppreciation and **R**espect. The motto imprinted a deep mark in my head, not just because it makes a lot of sense to me but also because of my personal allure to car. Since I was a kid, probably still in primary school if I remember correctly, I have been interested in cars. About that time, my father brought his first car which was a second hand car from a friend. It was an Austin, an English brand that has long ceased. After I graduated from my MBA study, I joined a small brokerage firm in New York as analyst trainee. The big boss asked me if I have any particular industry of special interest and without thinking I replied the auto industry. This is also the subject I want to talk about in this month's Featured Article.

For decades, the U.S. was the biggest market in the world in terms of production and sales of automobile. American-made cars may not be the most prestigious, nor prettiest, nor safest, but they sell in big volumes thanks to the nation's deeply ingrained car culture, high affordability of cars compare to household income and cheap gasoline prices. The fact that it's a vast country with well constructed highways and under-built public transportation also encourage car ownership. Since the first gasoline powered automobile, made in 1891, the industry has gone through countless transformation and restructuring. In the early-Nineteenth century, there were hundreds of car making companies. During the Great Depression from 1929 to 1936, when unemployment rate hit as high as 25%, many auto makers went out of business. By the end of that decade, three brands came to dominate the entire market. Called The Big Three, they were (and still are) General Motors, Ford Motors and Chrysler.

Then came World War II, whereby all automobile production was halted as facilities were converted to producing war equipments and military vehicles. After the war, automakers scrambled to refurbish production facilities. With deep pockets, The Big Three were able to quickly ramp up production and in the following decade bought out many of the smaller firms and turned the U.S. auto industry into an oligopoly. Good times continued to roll until the first Oil Crisis in the early-70s. High fuel costs forced Americans to leave their land-yachts on the parkway, and unsold cars filled parking lots of auto dealers. The crisis created an opportunity for much smaller sized but a lot more stingy (in terms of oil consumption) cars made by the Japanese. There was a joke about the first ever Japanese car imported to the U.S.. Americans quipped you don't drive in them, but wear them on your feet to skate. Within a few years though, Japanese-made cars became so popular that Chrysler, the smallest of The Big Three, had to seek bankruptcy protection to restructure. In the 80s, then-President Ronald Reagan forced Japanese auto makers to accept a 'voluntary' quota on exportation of cars in order to save the domestic auto industry. Instead of playing the defense, the Japanese spotted a loophole in the policy and launched an offence, and that is to build cars within America.

Because these cars were made in the U.S., they are not considered exports and hence can circumvent the quota system. That turned a new page in auto making, which is shipping partly built cars and all necessary mechanical parts overseas for final assembly.

The strategy proved a huge success, and American-built Japanese cars continued taking market shares from The Big Three. By 2000, Japan overtook the U.S. to become the biggest auto producing nation when also counting foreign made vehicles. But as the Japanese brands were basking in success in conquering the U.S. and the world, an ungainly 3-door hatchback made in South Korea quietly entered the North American market. Called the Hyundai Excel, it was billed as the cheapest brand new car on the market in 1985. The first time I saw an ad about this car, I didn't know how to pronounce the company's name but I felt it was cute looking and very affordable.

It was a very humble export attempt of Korean-made car, but they followed the same tested and succeeded approach pioneered by the Japanese. Last year, Hyundai became the Top-7 selling auto brand in the U.S., behind GM, Ford, Toyota, Chrysler, Honda and Nissan. But more amazingly is that Hyundai outsold Toyota in Europe last year, thanks to the merger of rival Kia years ago and its early venture into Eastern European markets.

We said in the beginning that the U.S. auto market was the biggest in the world for a long time, but since 2009 it has been overtaken by China. The subprime mortgage induced financial tsunami resulted in what is popularly called The Great Recession to the U.S. economy. Annual auto sales plunged from a peak of ~17 million to just 10.38 million in 2009.

Calendar year	Production (in million units)	Growth
1992	1.00	-
1999	1.20	20.0%
2000	2.07	72.5%
2001	2.33	12.6%
2002	3.25	39.5%
2003	4.44	36.6%
2004	5.07	14.2%
2005	5.71	12.6%
2006	7.28	27.5%
2007	8.88	22.0%
2008	9.35	5.3%
2009	13.79	47.5%
2010	18.06	31.0%
2011	18.50	2.4%

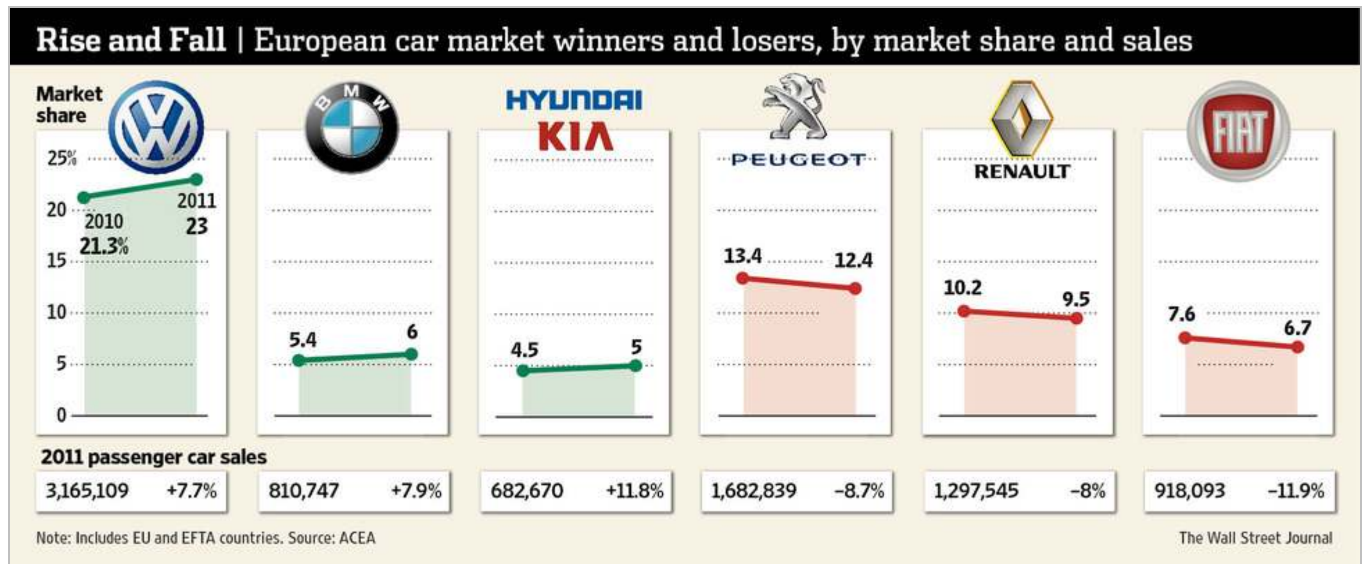
At the same time, China's auto industry was undergoing explosive growth as can be seen in the right-hand table. In response to the external shock from the U.S. recession, Chinese government launched a 4 trillion yuan fiscal stimulus package in late-2008. Part of the package was generous subsidy for first time car buyers and those who opt to switch their existing cars to more fuel efficient models. Chinese people embraced that policy in droves, pushing up auto production and sales by nearly 50% in 2009.

But as these subsidies expire one after another, sales growth slowed down dramatically. Last year, sales grew at the slowest pace since record began. The China Association of Automobile Manufacturers estimates passenger-vehicle sales growth of 9.5%, to 15.87 million vehicles for this year. Even with the growth in demand, the problem of over-capacity in the China auto industry is hard to ignore. The Chinese central government is plainly aware of this. In recent months, China has shifted its attitude, emphasizing consolidation and better use of existing capacity, and reducing its focus on drawing investment from overseas. The latter is highlighted by the disapproval of Ford's application for further expansion of production in the city of Chongqing. Another example can be seen in the announcement in late-February a list of vehicles from which government officials are allowed to purchase, whereby not a single foreign brand was on it. At the moment, overseas brands accounted for about 80% of official vehicle pool in China, with Volkswagen's Audi making up about one-third of government fleets, as estimated by Guotai Junan Securities Co. According to China International Capital Corp., a Beijing-based investment bank, government purchase of vehicles may worth about 80 billion yuan. Some analysts see this as a desperate measure by the Chinese government to give domestic auto makers a much needed helping hand.

In their defense, the Ministry of Industry and Information Technology said the list is preliminary and is open for public consultation until March 9. However, if approved it would create new headwind for premium European auto makers when their home markets are shrinking fast. According to the European Auto Manufacturers' Association, new car registrations in Europe has been falling every year since 2007. New car registrations for last year fell 1.7% from a year ago to just 13.3 million.

Sinking auto sales, intensifying price war and chronic overcapacity are weighing on Europe's auto makers to cut jobs, close plants and forge partnerships. According to estimates by Morgan Stanley, matching production to sales would require eliminating 1.5 million vehicles worth of annual production capacity—the equivalent of five assembly plants. However, throughout this time, only GM and Fiat have each closed one factory. With unemployment in

most European countries already at or near record high, governments are pressuring auto makers to preserve jobs, even that may mean heavy losses to the companies and their shareholders. The situation is particular dire for volume car makers in Europe such as Peugeot, Opel and Fiat whereby domestic sales account for up to 70% of total sales. On the other hand, premium auto makers, mainly German brands such as BMW, Daimler AG's Mercedes-Benz and Volkswagen's Audi, are thriving with record sales and profits thanks to strong global demand, especially in emerging markets including China and India.



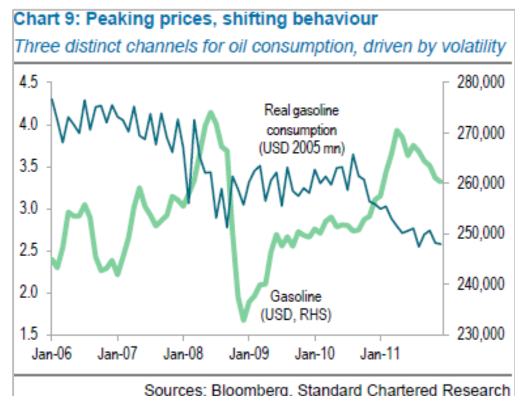
Despite at government's dismay, European auto makers appear decided to move ahead with restructuring plans. Early-March, GM and France-based Peugeot Citroen announced an alliance for pooling purchasing and sharing development cost of new vehicle platforms and parts. Together, the companies have production of 12.5 million vehicles and U.S.$125 billion in purchasing annually. GM will also acquire a 7% stake in Peugeot, which is Europe's second-largest auto group, to cement the alliance. In a separate unconfirmed news break, GM is said to engage in discussion with Fiat to combine parts of their European operations. These developments clearly indicate the mounting troubles in Europe's auto industry and the pressing needs for major change over.

Not too long ago, the world celebrated the centennial of the Ford Model T (a picture shown at the beginning of this writing), a four-wheeler introduced in 1908 as the first mass-produced automobile in the world. Its introduction brought open-road travelling to the middle-class and forever changed the auto industry. Over the past century or so, the industry had encountered numerous crises and undergone tremendous changes. As we stand, this test-and-survival cycle continues….

Market Review & Outlook

US: Neutral

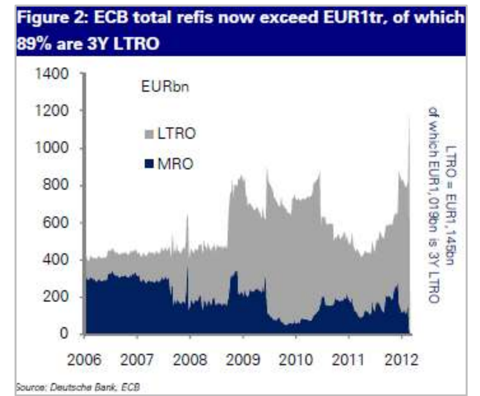
It has been found that after housing and unemployment, gasoline price is the third most concerned issue amongst U.S. consumers. According to Bloomberg, gasoline sales now account for 11.2% of total retail sales, up significantly from an average of 7.4% during the ten year period of 1992-2003. Meanwhile, gasoline prices were major drivers of inflation trend in the U.S. for the past 12 years.



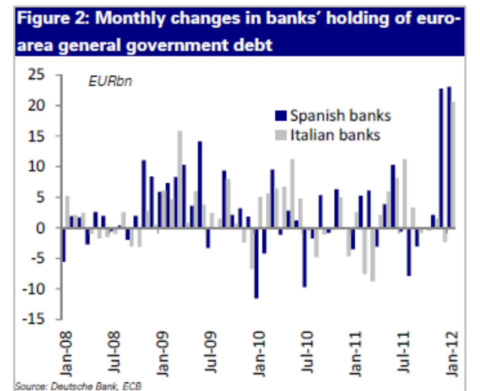
From a national level, actual consumption of gasoline has been on a gradual decline since 2005 (see right-hand chart). This decline in usage corresponds to rising gasoline prices. Despite reduced consumption, sharp increase in gasoline prices still take a big chunk out of the paycheck and squeezed disposable income of Americans. According to Standard Chartered Research, the 27% rise in gasoline prices between 2010 and 2011 has pushed down disposable income by 0.1%, even though nominal income has increased 3.4% over the period.

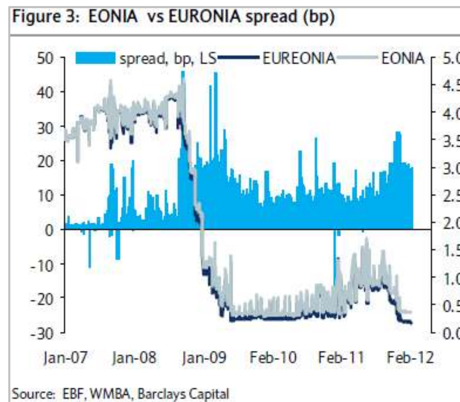
Europe: Negative

As a consequence of a second allotment of 3-year loan at 1% interest rate on 29 Feb, otherwise known as LTRO, liquidity outstanding and average maturity of the ECB liquidity operations have increased significantly. In the latest LTRO, ECB allotted €529.5bn of liquidity amongst 800 banks. At the previous LTRO, the take-up was €489bn amongst 523 banks. The primary objective of LTRO was to make sure of sufficient bank funding for this year and the next. For the second LTRO, acceptable collateral was broaden in order to allow small banks to be able to put up enough eligible collateral to apply for loans directly with the ECB.



Despite the boost in liquidity from LTRO, European banks are not likely to actively hand out medium and long-term loans, for fear of sudden liquidity crunch. As with the aftermath of the first LTRO, it is expected most European banks will engage in so-called 'sovereign carry trade' which involved banks buying up sovereign bonds issued by their own governments. This is so because domestic government bonds carry zero-risk weight according to typical Basel definitions, hence European banks wouldn't need to be concerned of selling such securities in the event they are required to increase their capital bases. The chart nearby shows the big jump in Spanish and Italian banks' holding of sovereign debts after the first LTRO.





The big increase in the number of participating banks in the second LTRO suggests many more small banks have participated. As a result, small banks have reduced need to borrow in the interbank market. The volume and index for EONIA (EURO Overnight Index Average) has thus reduced significantly, as shown in the chart to the right. At the same time, average maturity of ECB's refinancing operations has also increased between 300 days and 900 days. Longer maturity further improves liquidity condition because the need for rolling over has been lengthened when financing matures.

We can also look at a broad set of market based data to illustrate how Eurozone risk premium has compressed over the past three months. We use data from last November as peak reference points. As shown in the nearby table, Euribor-OIS spreads and government funding cost have more than reversed the increases seen in H2 2011 and even lower than average levels in H1 2011. EUR basis swap and CDS for European banks have yet to retrace to levels in H1 2011, but both measured have well recovered over 50% from levels last November. These data provide empirical proof that systematic risk has dropped as a result of recent political maneuvers by EU officials and LTRO as market sentiment improves.

Fig. 1: Eurozone Risk premium measures

Indicators	H1 average	Peak (late November)	Now	Risk premium compression
EUR basis swap (bp)	28	105	60	58%
Bank CDS (bp)	160	465	245	72%
Euribor-OIS spread (bp)	76	103	65	141%
ST government funding cost	2.24	3.56	1.02	192%
LT government funding cost	4.05	4.62	3.35	223%

Note: government funding costs are based on a debt-weighted Eurozone average, excluding Greece and Portugal, of the yield on government bonds. Source: Bloomberg, Nomura

On the other hand, bank loans to non-finance business have deteriorated significantly and nearly fallen back to the trough level in early 2009. In an attempt to circumvent the shortfall of bank capital, non-finance corporations have stepped the pace of securities issuance. This situation was similar to the period in the second half of 2008, only this time the market is a lot more difficult to raise capital. According to ECB data, back in Q4 2008, net flows of loans to the corporate sector fell to €19bn on average from €34.5bn in Q3. Duringthe same period, net issues of securities shot up to €67.4bn from €29bn. But this time, net issues of securities fell sharply behind.

Japan: Neutral

There are rising concerns in Japan whether the recent rally in oil price would negatively impact economic growth. There are some hopefully signs that Japan may not be severely hurt by the latest oil shock. Firstly, Japan has always been reliant on oil imports and over time has learnt to deal with expensive oil price. As the right hand chart shows, when measured by energy consumption over nominal GDP, Japan is now among the most energy-efficient economies in the world. Secondly, the Japanese yen has steadily appreciated over the past few years and thus provide a cushion as U.S.D-denominated oil price translates into fewer yen than before. Even so, ever-rising oil price and tight electricity supply would still weigh on those companies that are big users of electricity and oil products. These include trucking, shipping, airlines, railways, machinery, and construction.

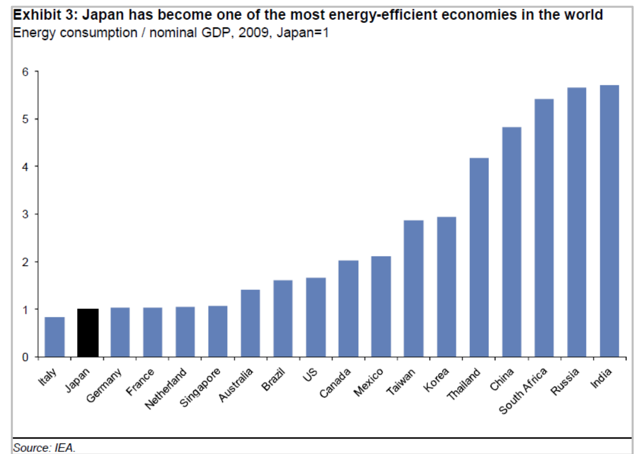


Exhibit 3: Japan has become one of the most energy-efficient economies in the world
Energy consumption / nominal GDP, 2009, Japan=1

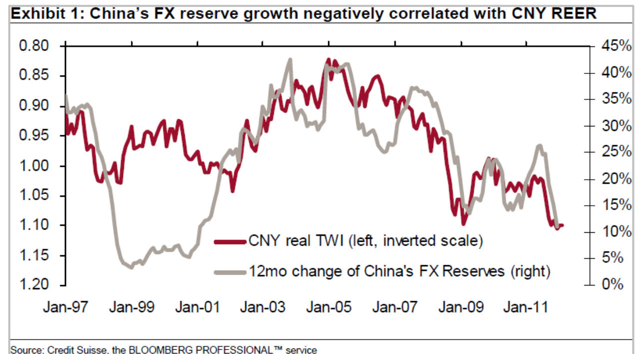
Source: IEA.

China: Neutral

There were a number of important changes in China's policy direction recently. Firstly, Premier Wen Jiabao trimmed GDP growth target for 2012 to 7.5%, down from the previous target of 8% which had held stable for a decade, and at the same time set this year's CPI target at 4%. This suggests the Chinese government is more tolerable for slower growth. On the other hand, the CPI target should leave sufficient room for implementing easier monetary policy.

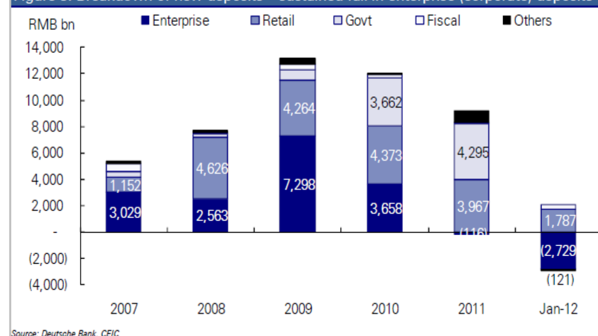
Secondly, China seems to have paused accumulating FX reserves lately. Although FX reserves are still up from a year ago, the growth rate has slowed markedly from the peak in August 2011. Fact is, FX reserves as a share of GDP and China's import coverage ratio have been trending downward over the past few years. As China's FX reserve growth is negatively correlated with CNY real effective exchange rate, there is less need for China to intervene in the forex market. Meanwhile, slower inflow of dollar may also lead to reduced urgency for China to diversify its reserves to other non-U.S.D currency denominated assets.

Exhibit 1: China's FX reserve growth negatively correlated with CNY REER



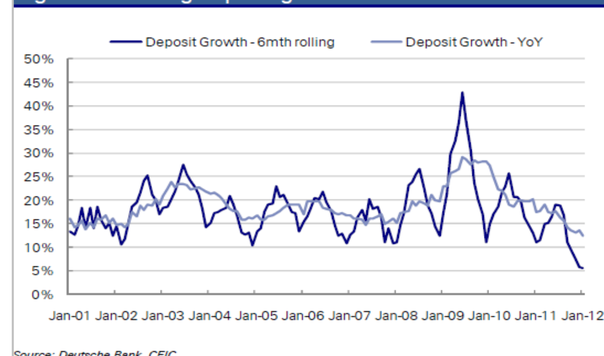
Source: Credit Suisse, the BLOOMBERG PROFESSIONAL™ service

Figure 3: Breakdown of new deposits – sustained fall in enterprise (corporate) deposits



Source: Deutsche Bank, CEIC

Figure 5: Slowing deposit growth



Source: Deutsche Bank, CEIC

It was more than six months since Premier Wen visited Wenzhou and a look at the deposit situation may help to provide a sense of the current health of China banks. As can be seen in the right hand chart, there has been a dearth of corporate new deposits in 2011. More specifically, net reduction in corporate deposits is observed, implying more funds have been withdrawn than deposited. Deutsche Bank attributes this phenomenon to two reasons. Firstly, corporate margin has decreased hence less income is available to be deposited. Secondly, companies have seen lengthened account receivables over the past year, leading to reduced cash corporate held.

India: Neutral

India's real GDP growth fell sharply to 6.1% YoY in Q4 2011 from 6.9% in Q3. It was also the lowest growth over a span of eleven quarters, mainly due to contraction in investment and a drop in net exports. High interest rate and an uncertain global economic backdrop aggravated the contraction in Indian exports. At the same time, domestic capacity constraints fueled demand for imports. Meanwhile, consumption sector, supported by both government and private sector spending, expands to crowd out investment.

Fig. 1: GDP growth by sectors

% y-o-y	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Real GDP (factor cost)	7.8	7.7	6.9	6.1
Agriculture	7.5	3.9	3.2	2.7
Industry	6.1	5.0	3.2	2.6
Services	8.7	10.0	9.3	8.9
By expenditure				
Real GDP (market price)	7.7	8.5	6.7	6.3
Private Consumption	8.0	5.9	2.9	6.2
Government	4.9	2.9	6.1	4.4
Investment	0.4	4.9	(4.0)	(1.2)
Exports	25.0	23.2	23.3	13.1
Imports	10.3	20.8	6.9	17.3

Source: CEIC and Nomura Global Economics

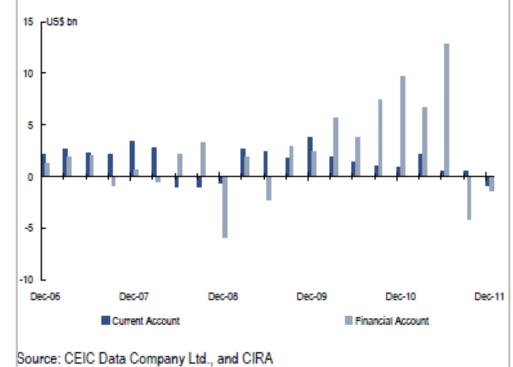
Figure 45. Core Inflation has eased, thus supporting the case for easing

Source: Office of the Economic Advisor, CIRA

Looking at sectors, agriculture's contribution to GDP moderated due to a drop in crop harvests. Industrial also eased as slowdown in mining overwhelmed higher construction output. Although services as a sector is the biggest driver of GDP growth, it too has dropped modestly from Q3's 9.3% to 8.9%. India currently confronts a challenging situation with still high inflation, wide current account deficit, heightened oil price and weak financial balances.

Following a drop of 160bp in inflation in December, core inflation further dropped 92bp in January. The outsized back-to-back drop in inflation may be attributable to high base effect from last year and seasonal factors in January. Conversely, non-food manufactured product inflation, which is a proxy for core inflation, has fallen to 6.7% from 8% which suggest inflation may stay below 8% in the near future. Easing inflationary pressure and slower GDP growth bolt well for further easing of repo rate by Reserve Bank of India.

Figure 55. The current account slipped into deficit in 4Q11

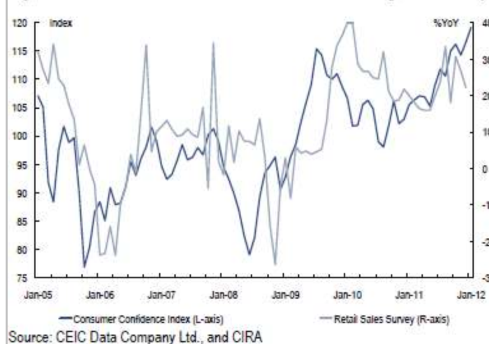


Source: CEIC Data Company Ltd., and CIRA

Asia-Pacific: Mixed

In another sign of the contagion effect of Europe's sovereign crisis and slowing economy, Indonesia's export growth slows further. January export to Europe has tumbled by -12%. Although export to China still registered double digit growth, oil and gas trade balance has been on deteriorating trend. Consequently, the current account balance has slipped into deficit equivalent to 0.4% of GDP in Q4 2011.

Figure 54. Consumer confidence rose toward all time highs in January

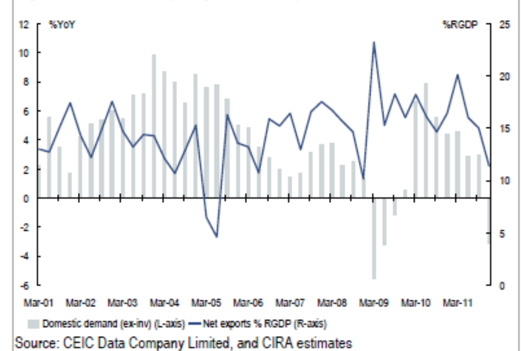


Source: CEIC Data Company Ltd., and CIRA

On a more positive front, reinvested earnings of foreign owned companies in Indonesia helped to sustain foreign investment at healthy level in Q4 2011. FDI inflows, as a percentage of GDP in 2011, have grown 2.1%, reaching the highest level in 6 years.

Meanwhile, domestic consumption appeared held up well amid consumer confidence climbed to record high.

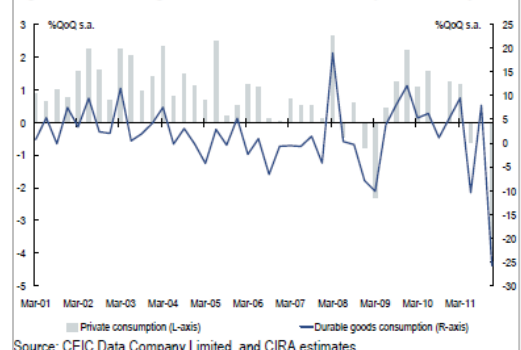
Figure 107. 4Q11 GDP plunged on net exports & domestic demand fall



Source: CEIC Data Company Limited, and CIRA estimates

Similar to Indonesia, Thailand's export also contract in the fourth quarter last year. As for other economic aspects, consumption fell a surprising 3% YoY, real private investments fell 1.3% YoY, while total public spending declined by 5.9% YoY. Durable goods consumption plunged by 21.8% YoY. For non-durable goods, such as food & electricity, they dropped 1.3%YoY hurt by artificial shortages/transport bottlenecks. However, due to rebounding consumption and increased private investment, consumer-driven growth will likely be overlayed with investment-led momentum in H2 2012. Construction activity stalled by floods previously and new private investment as well as recovery in tourist activity are also expected to be important driver to boost 2012 GDP with the time lag effect kicks in 6-9 months after last year's floods.

Figure 108. Durable goods demand to lead consumption recovery



Source: CEIC Data Company Limited, and CIRA estimates

In Korea, industrial production continues its downward trend over the past months. The pace of manufacturing growth more than halved to 2.9% in December 2011 from November's 6.1%. Meanwhile, inventories are stacking up as shipments slowed due to sluggish domestic and overseas demand. Service activities and consumer goods sales also lost momentum.

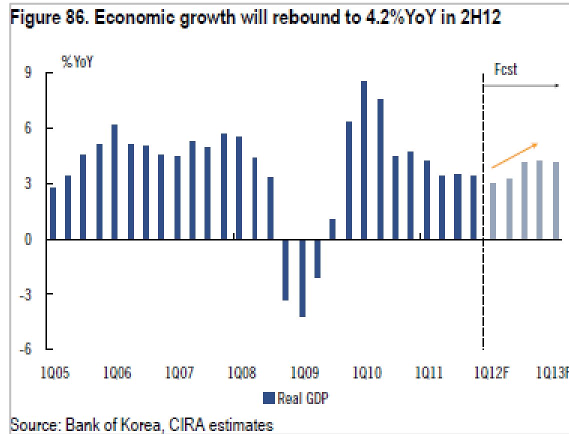


Figure 86. Economic growth will rebound to 4.2%YoY in 2H12

Source: Bank of Korea, CIRA estimates

With parliamentary election coming up on April 11, the ruling and opposition parties are calling for various policies that appeal to voters. Tightening regulation on large companies, imposing higher tax on corporations and the rich, and withdrawing income tax cuts have been proposed. The conservative ruling party, in particular, has deviated from its norm by seeking socialist policies. It goes without saying that welfare policies helps to ensure social stability, but overly generous policies could act as disincentives for business investment.

Besides political concerns, high oil price may also hurt economic growth. Similar to other Asian countries, Korea is subjected to the volatility of oil price. Net oil imports account for 6.4% of Korean GDP, somewhat less than Thailand's 8.9%. In order to support regular business activities, the Korean government may need to further cut tax on oil imports.

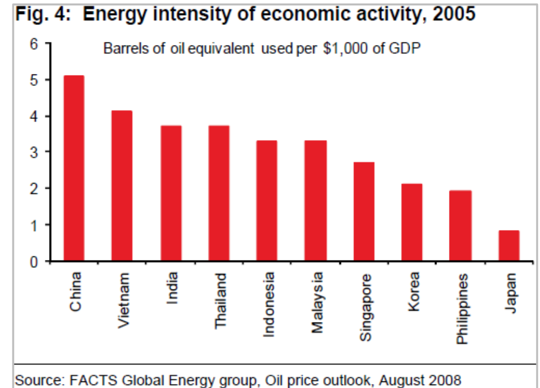


Fig. 4: Energy intensity of economic activity, 2005

Source: FACTS Global Energy group, Oil price outlook, August 2008

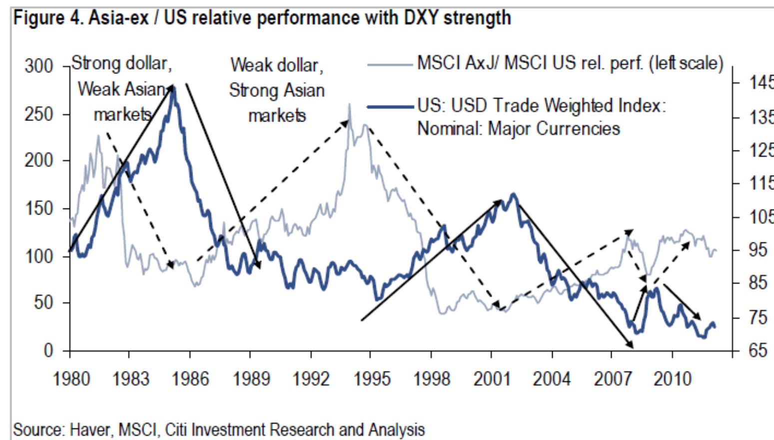


Figure 4. Asia-ex / US relative performance with DXY strength

Source: Haver, MSCI, Citi Investment Research and Analysis

Investors in Asia should pay attention to money flow and particularly the trend of the U.S. dollar. According to Citi's research team, the correlation between regional equity prices and the U.S.D has intensified from -0.29 to -0.47 in recent years.

Russia & Emerging Europe: Cautious

February PMIs across emerging European countries were broadly hovering above the 50-level, which is the dividing line for expansion and contraction. Still, the trend over the past year is unmistakably a declining one. That means while European banks have been reining in lending and undergoing deleveraging process over the past year, emerging European countries have been so far avoided falling into recession. Then again, there isn't a lot of buffer. Even for the larger economies, such as Turkey, Poland and Russia, PMI figures have slipped to barely above 50. For Central European economies, such as Hungary and Czech, PMI figures have dropped below 50 a few months ago and only just bounced back above. It is too early to say whether they can maintain in the expansion zone and for how long. Adding to the challenge these countries face is their double digit core. Political leaders in these countries have to carefully balance the risk of fighting inflation and sustaining GDP growth.

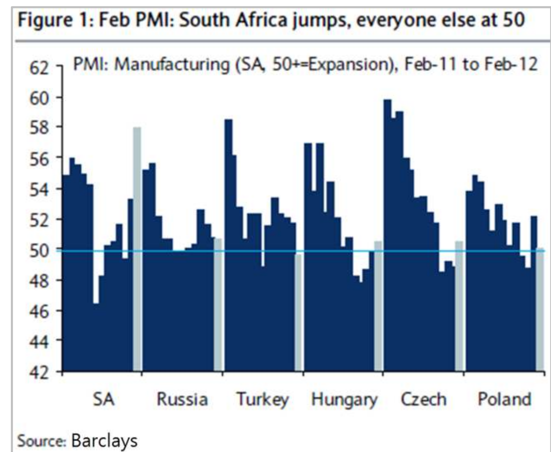


Figure 1: Feb PMI: South Africa jumps, everyone else at 50

Source: Barclays

Commodities: Negative

Escalating concerns over Iran's continued defiance against sanctions from the U.S. and Europe have led to questioning of implication of oil price spike on base metals prices. There are two opposing forces on metal from surging oil prices. The first one is cost push which relates to mining and refining metals. And the other one is potential reduction in global demand following higher oil prices. Empirical findings seem to support (as shown in

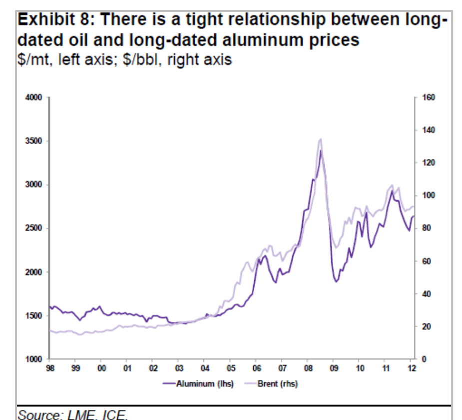


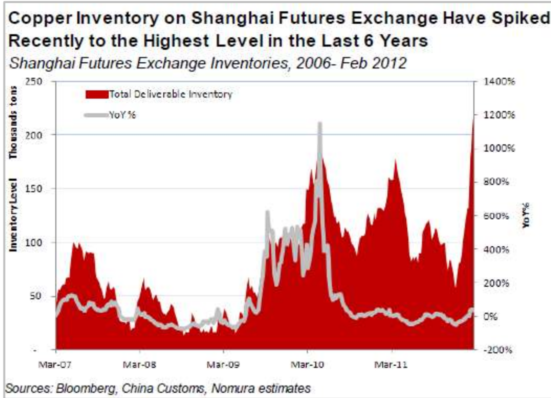
Exhibit 8: There is a tight relationship between long-dated oil and long-dated aluminum prices

$/mt, left axis; $/bbl, right axis

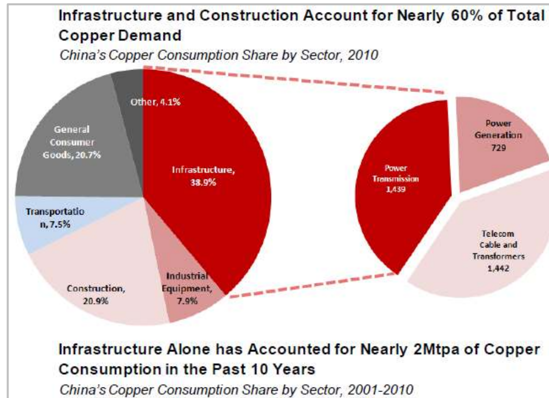
Source: LME, ICE.

the right hand chart) fairly strong correlation between oil price and base metals prices historically which is consistent with the cost-push argument.

While on the subject of metal prices, let's look at the right chart which shows refined copper inventory at Shanghai Futures Exchange has spiked dramatically lately to the highest levels since 2007. The big question is whether surging inventory corresponds to actual demand or for some other reasons.



Copper Inventory on Shanghai Futures Exchange Have Spiked Recently to the Highest Level in the Last 6 Years
Shanghai Futures Exchange Inventories, 2006- Feb 2012
Sources: Bloomberg, China Customs, Nomura estimates



Infrastructure and Construction Account for Nearly 60% of Total Copper Demand
China's Copper Consumption Share by Sector, 2010
Infrastructure Alone has Accounted for Nearly 2Mtpa of Copper Consumption in the Past 10 Years
China's Copper Consumption Share by Sector, 2001-2010

Generally, copper usage can be split into six types: infrastructure, construction, general consumer goods, industrial equipment, transportation and others. As the right hand chart shows, infrastructure and construction account for nearly 60% of total copper demand. On both fronts, it's hard to justify the recent surge in copper inventory. For instance, China government is proposing to build ultra-high voltage (UHV) lines that actually do not require copper. Furthermore, construction has cooled due to excess inventories and continued government efforts to curb property prices. In addition, we have been seeing slower demand growth for China's export in recent months. All of the aforementioned factors tend to weigh on copper price.

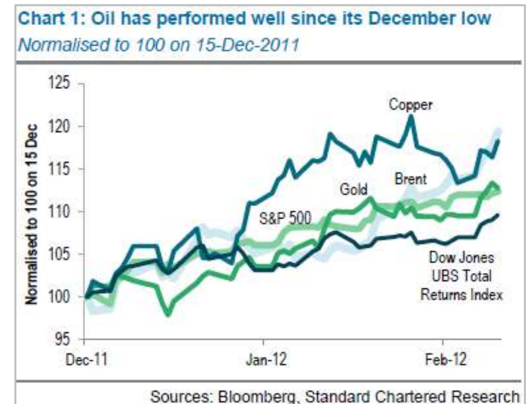


Chart 1: Oil has performed well since its December low
Normalised to 100 on 15-Dec-2011
Sources: Bloomberg, Standard Chartered Research

Now that the European sovereign crisis is quieting down somewhat, the flare up in oil prices became the primary focus as a threat to global economic growth. Some analysts see the heightened oil prices as "fear premium" induced by Iran which we have commented in earlier sections. While it is possible that genuine demand from the commercial side has been driving the ascent, there are signs that speculators are also at play. It has been reported that fund flows into oil ETF have increased by U.S.D 820mn since mid-December last year.

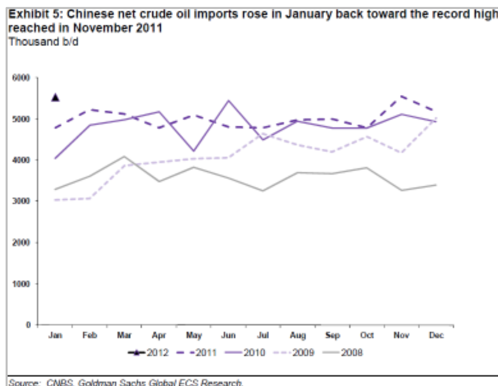


Exhibit 5: Chinese net crude oil imports rose in January back toward the record high reached in November 2011
Thousand b/d
Source: CNBS, Goldman Sachs Global ECS Research.

On the fundamental side, latest data released by the International Energy Agency (IEA) shows that non-OECD demand has been very strong. In China, the National Bureau of Statistics reported that the January import volume of crude oil is highest for the past 5 years. The reacceleration of oil demand from China has not been accompanied by non-OECD supply growth. Data from the IEA suggested that OECD oil inventories have built up only by 11.4 million barrels in January, well below the 10-year average of 26.3 million barrels. It rather surprises the market given the weakness in European economy, much warmer-than-normal winter weather in U.S. and Western Europe and reportedly robust rebound in Saudi and Libyan oil production.

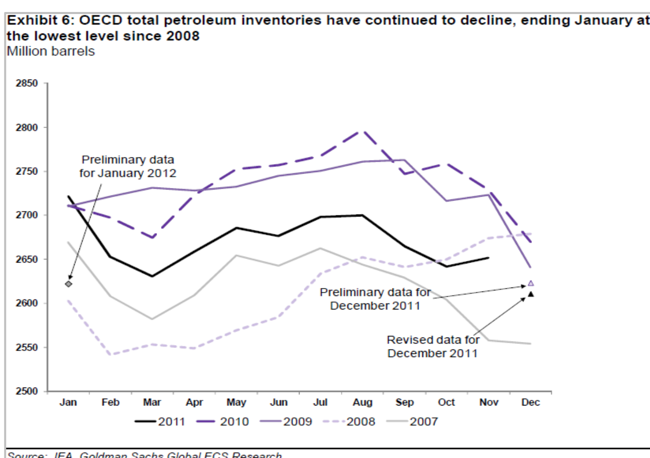


Exhibit 6: OECD total petroleum inventories have continued to decline, ending January at the lowest level since 2008
Million barrels
Source: IEA, Goldman Sachs Global ECS Research.

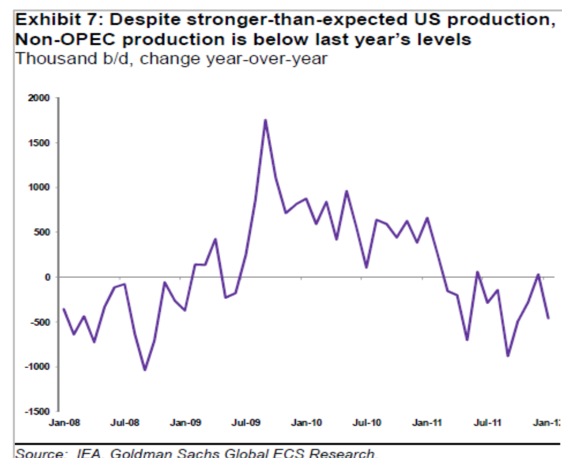


Exhibit 7: Despite stronger-than-expected US production, Non-OPEC production is below last year's levels
Thousand b/d, change year-over-year
Source: IEA, Goldman Sachs Global ECS Research.

Hedge Funds: Mixed

According to Hedge Fund Research, hedge funds posted their strongest start in a calendar year since 2000, with the biggest gains coming from strategies which underperformed last year. The HFRI Fund Weighted Composite Index gained 2.14% in February and near 5% when adding to January's performance. Equity hedge strategies, including sub-strategies of fundamental growth, value and energy, contributed the most to HFRI's performance.

Thanks to contributions of distressed/restructuring and private issue/regulation strategies, the HFRI Event-driven (total) Index also posted good performance in February and YTD. Not to be outdone, fixed income-based Relative Value Arbitrage funds gained +1.7% in February (+3.6% YTD) as spread tightening and strong liquidity contributed to Arbitrage gains. Macro funds have also posted gains despite the volatile commodity and amid trending environment.

February 2012

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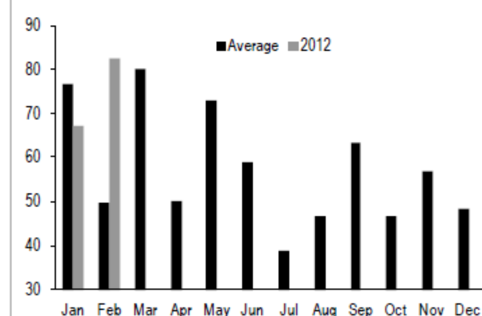
HFRI INDICES	February 2012 ROR	February 2012 Index Value	Total Return YTD	Total Return 1 YR	Total Return 3 YR	1 Year STD*	1 Year ShR**	3 Year Annualized ROR	3 Year Annualized STD*	3 Year Annualized ShR***
HFRI Fund Weighted Composite Index	2.14%	10904.37	4.95%	-2.18%	33.26%	7.50%	-0.26	10.04%	6.86%	1.42
HFRI Equity Hedge (Total) Index	2.99%	15374.78	6.93%	-3.71%	39.04%	11.32%	-0.28	11.61%	9.75%	1.17
HFRI EH: Equity Market Neutral Index	1.12%	4510.67	2.54%	-0.90%	5.40%	4.78%	-0.18	1.77%	3.15%	0.54
HFRI EH: Quantitative Directional	3.29%	13166.63	5.95%	-3.50%	30.77%	10.03%	-0.31	9.35%	8.48%	1.09
HFRI EH: Sector - Energy/Basic Materials Index	0.80%	14727.03	6.06%	-15.56%	45.86%	18.42%	-0.83	13.41%	16.03%	0.86
HFRI EH: Sector - Technology/Healthcare Index	1.41%	18458.14	4.42%	2.33%	46.01%	7.47%	0.34	13.45%	7.31%	1.76
HFRI EH: Short Bias Index	-7.61%	930.12	-12.32%	-8.85%	-49.02%	13.02%	-0.65	-20.12%	13.62%	-1.57
HFRI Event-Driven (Total) Index	1.89%	11883.01	4.56%	-1.85%	43.00%	7.59%	-0.22	12.66%	6.79%	1.78
HFRI ED: Distressed/Restructuring Index	0.89%	12586.21	3.18%	-1.84%	45.93%	7.27%	-0.23	13.43%	6.83%	1.87
HFRI ED: Merger Arbitrage Index	0.91%	6534.57	1.61%	1.75%	19.95%	2.34%	0.74	6.25%	2.42%	2.48
HFRI ED: Private Issue/Regulation D Index	1.45%	5848.91	3.78%	1.90%	20.70%	5.12%	0.38	6.47%	6.32%	1.01
HFRI Macro (Total) Index	1.22%	14322.39	2.44%	-2.30%	11.00%	5.07%	-0.44	3.54%	5.36%	0.66
HFRI Macro: Systematic Diversified Index	1.09%	11244.82	1.51%	-2.54%	6.35%	8.21%	-0.28	2.07%	7.92%	0.28
HFRI Relative Value (Total) Index	1.67%	8831.33	3.56%	1.61%	41.72%	4.24%	0.39	12.32%	4.43%	2.63
HFRI RV: Fixed Income-Asset Backed	1.43%	5674.56	3.14%	6.53%	50.55%	2.75%	2.30	14.61%	3.26%	4.20
HFRI RV: Fixed Income-Convertible Arbitrage Index	2.01%	6477.05	5.00%	-2.71%	68.61%	6.83%	-0.38	19.02%	9.18%	1.94
HFRI RV: Fixed Income-Corporate Index	1.29%	5449.72	3.30%	1.34%	51.28%	5.59%	0.26	14.80%	5.75%	2.43
HFRI RV: Multi-Strategy Index	2.41%	6183.46	3.52%	-1.13%	38.42%	3.81%	-0.29	11.45%	4.82%	2.26
HFRI RV: Yield Alternatives Index	2.23%	4169.47	5.83%	7.56%	50.36%	8.92%	0.86	14.56%	6.87%	2.01

Bonds: Mixed

U.S. Treasury Department released its annual survey, detailing the extent of U.S. securities being held by foreign entities. The report shows overall pace of foreign buying was solid before Q2 2011 and peaked at Q3 2011. After which foreign buying began to slow. More significantly, China who overtook Japan as the largest holder of U.S. government securities since 2010 has changed from a net buyer of Treasuries to a net seller in H2 2011.

Exhibit 3: High grade issuance in February was nearly double the 10-year average

Average gross issuance by calendar month over 2002-2011, versus 2012; $bn



Source: Thomson Financial, Bloomberg, and J.P. Morgan

Exhibit 11: The US Treasury lost its largest client in 2H11

Average monthly net purchases of Treasuries (bills and coupons) for the top 10 Treasury holders at the end of 2011; $bn

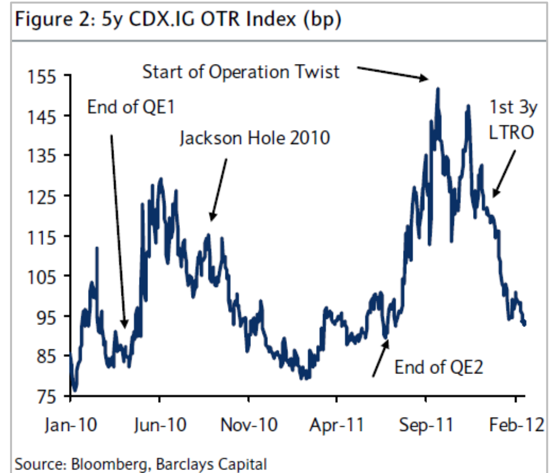
Country	Jun'09-Jun'10	Jun'10-Jun'11	3Q11	4Q11
China, Mainland	16	16	-12	-39
Japan	8	7	34	25
Brazil	1	4	3	0
Taiwan	3	0	7	4
Luxembourg	0	2	2	8
Russia	2	-1	-1	0
Switzerland	2	1	13	-5
Belgium	1	4	14	1
Hong Kong	3	-2	0	3
United Kingdom	1	4	-6	-2

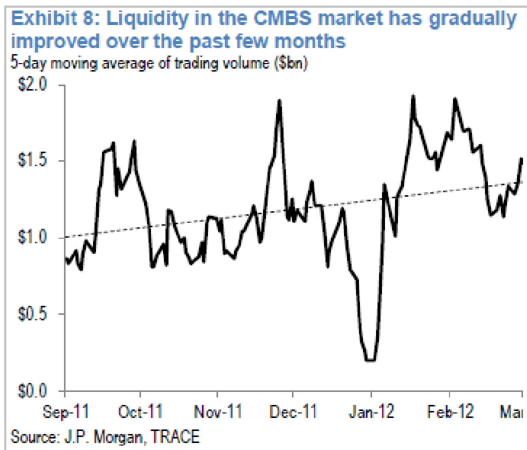
Source: Treasury TIC

Specifically, China sold U.S. Treasuries during both Q3 and Q4, for a net amount of -U.S.$12bn and -U.S.$39bn respectively. This is the clearest sign that China is diversifying its foreign reserves into other assets. Luckily for the U.S., selling by China was more than covered by buying from Japan. However, buying by Japan is not expected to be able to stay at such lofty level for long, given their weakening trade account balances. Should China continue to underweight U.S. Treasuries, there could be some downward pressure on Treasury prices going forward.

At the same time, Chinese investors have also net sold U.S.$80bn of U.S. agency MBS from a peak of U.S.$369bn in 2008. Although Treasury International Capital System acknowledges that there exists tracking error in the fund flow estimates and position survey, it is quite apparent that foreign investors are no longer active buyers which suggest possibly weakening demand for agency bonds.

Thanks to successive quantitative easing from the U.S. Fed and ECB, CDS on peripheral European sovereign bonds and French banks have receded to early August 2011 level. This is illustrated in the right hand chart.





Subsequently, there have been plenty of activities in the primary markets. For instance, issuance of U.S. high grade corporate bonds in February was nearly double the average over the previous ten years. At the same time, market liquidity of commercial mortgage backed securities (CMBS) continues to recover in the first quarter this year.

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

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