AMG FINANCIAL GROUP 安柏

AMG Market Commentary

May 2012

Bernanke's View on Inflation Could be Wrong

What? How preposterous? Who are we to challenge the view of the Chairman of the U.S. Federal Reserve, the distinguished Dr. Ben Bernanke? Well, with all due respect, we have looked long and hard into this subject before mustered enough courage to speak out. So at the very least, allow us to lay down our observations.

U.S. Core PCE Inflation Rate (2002.05 – 2012.02)

The Fed Chairman has in numerous occasions defended the record low interest rates and unprecedented quantitative easing measures adopted by the Fed since 2009. His rationale primarily falls on two points: (1) the U.S. economy is operating at well below capacity especially in view of the still-high unemployment rate; and (2) core inflation remains well contained and below the bank's target of 2 percent. Since 2000, the preferred measure by the Federal Reserve of core inflation in the United States is the core Personal consumption expenditures price index (PCE). The latest available figure is 1.90% for the month of February, little changed from January's and last-December's readings. However, this is more than doubled from the low of 0.93% recorded at the end of 2010 (see above chart).

Bernanke's unguarded outlook on inflation is partly based on the view that high energy and commodity prices are transitory and would likely moderate given the murky global economic backdrop. While we share Bernanke's view on easing commodity prices going forward, that factor alone may have fairly limited effect on U.S.'s core inflation. To better understand this, just consider the latest Consumer Price figures for the month of April. The nominal CPI figure is unchanged from March, but core CPI (which excluded the volatile food and energy components) climbed 0.2% month-on-month and 2.3% year-on-year. What drove up core prices were shelter costs, owners equivalent rents, education costs, medical services and public transportation costs. These costs are more sticky in nature and have a tendency to pile on once such increases ingrain onto consumer's mindset or expectation.

The way we see it, global inflation is on a long-term upward trajectory and the flare up in developing countries may surprise many. But wait, isn't economic slowdown and inflation at odds of one another, that slower economic growth should dampen inflationary pressure rather than fueling it? Well, yes and no. In more normal economic periods and when market and pricing mechanism are free to adjust themselves, slower economic growth should exert downward pressure on prices. The problem is that we are living in 'abnormal' economic times with central bankers flooding markets with cheap money and politicians blocking structural changes in labor, housing and retail markets that are necessary to restore balance and growth.

Before we go any further, it may be useful showing long term charts on some key energy products and base metals to highlight their cyclical nature. The first chart on Nymex natural gas price should not come as a surprise as we have discussed at lengths a few months ago about the dawn of the Age of Shale. Production of shale gas is expected to increase for years to come and that would lead to lower prices. In comparison, crude price has stayed remarkably firm but has started fallen rapidly in the last week or so. We expect Nymex crude prices may have further to fall with more and more exploration companies in the U.S. drilling for shale oil since late last year. This and the production of crude oil in Iraq recently fully restored to before the downfall of Saddam Hussein should also put downward pressure on Brent prices.

Energy prices

Nymex Natural Gas, future prices (1990.04 – 2012.03) (log scale)

Nymex Crude Oil, future prices (1983.03 – 2012.03) (log scale)

As for base metal prices, their decade long rallies could be at the cusp of turning now that years of investment to expand production finally yield results just as economic growth in Europe and China hit a snag. Due to extended time lags embedded in the mining industry, and couple this with the fact that miners have accumulated mountainous of debts over the years, they will have to keep digging and selling even in the face of softening prices. Such inelastic mechanism could lead to multi-year downward adjustment in metal prices.

Base metal prices

LME Copper, spot prices (1986.04 – 2012.03) (log scale)

LME Zinc, spot prices (1989.01 – 2012.03) (log scale)

LME Nickel, spot prices (1987.01 – 2012.03) (log scale)

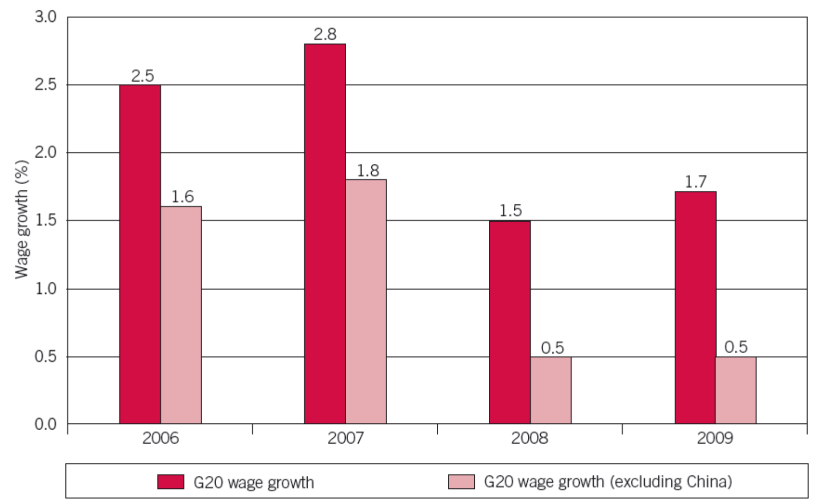
LME Tin, spot prices (1989.06 – 2012.03) (log scale)

Once again, this view of lower commodity prices seems to run against our prognosis for higher inflation. At the very least, inflation in China cannot possibly on the rise given the nation being the biggest buyer and user of many such resources. Well, not necessarily. Looking at China's historical CPI figures (see nearby chart), there was a period of soaring inflation between 1990 and 1995. Year-on-year change in CPI skyrocketed from low single digits to high twenty percent. Yet if we look at base metal prices during those years, we see that they were generally on a down trend. Hence obviously, something was at play back then that drove up inflation. The culprit, as it turned out, was surging food prices, as shown by the orange line on the same chart. Back in those early days of China's capitalist experiment, food was a major constituent in the calculation of domestic consumer prices. Even today, the food component is a key determinant of CPI albeit taking on a smaller role after the basket was revised a couple of years ago.

China CPIs (1990.01 – 2012.03)

Going forward, other factors will be more influential in driving the ups and downs of China CPI. One of these factors with growing prominence is labour cost or wage growth.

Wage growth in G20, 2006–09 (year-on-year % changes, real terms)

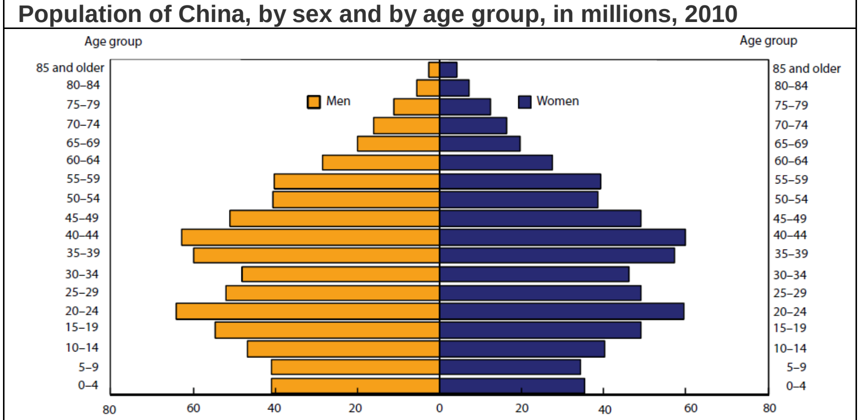


To be sure, China's cost of labour has been growing rapidly for years as any businessman operating in the mainland can attest. This is demonstrated in the right-hand chart (compiled by the International Labour Organization) that compares wage growth in the G20 nations with and without China. In the four years between 2006 and 2009, G20 wage growth with China is about one percentage point higher than that without China. This difference held steady, even widened further, during the financial tsunami of 2008-09, meaning wages in China kept rising unabatedly at a time when other economies tumbled.

Since the end of 2010, in the wake of broad scale labor shortages (particularly in cities and towns along coastal provinces), a spate of strikes and surging inflation, minimum wages have been rising throughout China. Premier Wen Jiabao has pledged that the government would raise salaries of low-income groups and minimum living allowances to ensure fair income distribution. The central government has also been encouraging wage hikes in the hope of boosting consumer spending and reducing the economy's reliance on exports. In fact, boosting people's incomes is one of the major tasks for the nation in its current five-year economic plan that ends 2015.

Apart from central government's initiative, China's rapidly aging population and workforce also play an important role in driving up wages. The shape of China's age distribution (right chart) resembles closer to that of Japan than a typical developing country, which tends to have a much wider base to reflect higher birth rate and younger population. Because of China's low futility rate and early age of retirement, its labour pool is shrinking fast. According to the national census, for the year 2010, 12.9 million fewer people came of working age than a decade ago. At the same time, 21.6 million more people retired from the work force.

Population of China, by sex and by age group, in millions, 2010



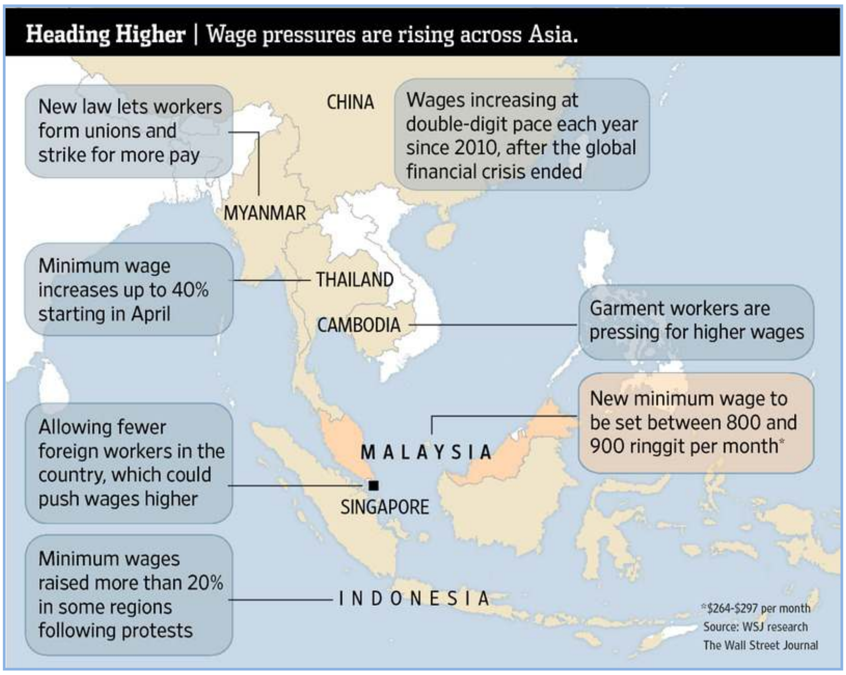
NOTE: Data were compiled by the U.S. Census Bureau from public and private data sources. Values for 2010 are estimated on the basis of sampling done in previous years.

SOURCE: U.S. Census Bureau, International Database, **www.census.gov/ipc/www/idb/**

A shrinking work force, coupled to a fast growing economy (by global standard), it is only natural for wages to keep rising. Some economists believe recent pace of wage gains may not last for long, as high labour costs will accelerate the process of industrial restructuring with more and more companies moving to more technologically advanced, that is more capital intensive and less labour intensive, methods of production. While there are already signs some companies are spearheading such transformation, weak global demand and tumbling profits in the industrial sector is prohibiting the less well-capitalized firms to follow suit.

Some analysts think that the wage lift may lead to factory closing and layoffs in certain industries where companies with increased labour costs are losing orders to competitors in the Asia region. The fact is, it is already happening. For the past few years, suppliers seeking to out-source work have looked beyond China to Vietnam, Indonesia and even Thailand to find the best mix of price and quality for manufacturing.

In turn, rising orders and exports have pushed up wages within the region. Moreover, Chinese government's policy to hike minimum wages has emboldened workers from various nations to demand similar treatments. In the past year, countries from Vietnam to Cambodia, and Thailand to Malaysia have enacted minimum wage hikes of well over double digits (see right chart).



Source: WSJ.com

While such wage increases are happening in Asia, higher costs will inevitably pass through and lead to higher prices when products appear on store shelves in the U.S. and other countries. Bernanke may get a feel of this when he and Mrs. Bernanke next shop for clothes, among other things that are made in and imported from Asia. Perhaps then, he may reconsider his prognosis of low inflation.

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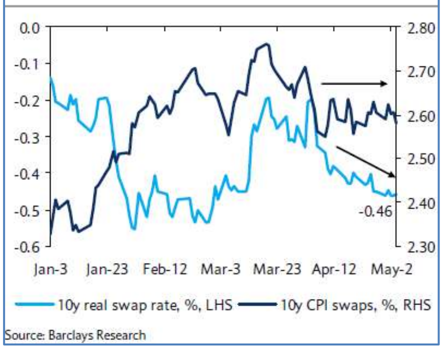
Market Review & Outlook

US: Neutral

A notably change in the latest Federal Open Market Committee (FOMC) statement, compare to previous version, is it noted that inflation "has picked up somewhat". The Fed's updated view on inflation notwithstanding, market remains hopeful for a third round of quantitative easing, also known as QE3, at the next FOMC meeting in June. Views from the swap market are for inflation to steady at about 2.6% (as per the dark line in the right hand chart).

Figure 2: Market expectations of additional stimulus have increased



At the same time, FOMC continue to characterize the U.S. housing market as depressed, but that there is "some signs of improvement". In March, new single-family home inventories dropped to 144,000 or equivalent to 5.3 months of supply at the current pace of sales. This compares to pre-crisis supply-to-sales average of 4.5 months. An uptick in single family housing starts could be yet another sign that U.S. housing has turned the corner recently.

Figure 3: New home inventory continues to move lower…

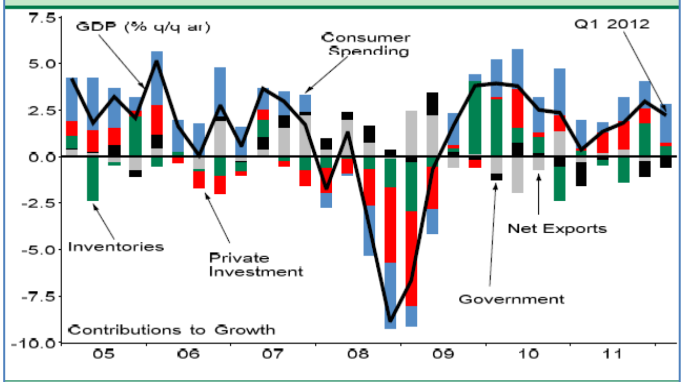
On the other hand, multifamily housing starts have been trending higher for a while in response to firming rents and the migration of former homeowners into the rental space.

To some, the Q1 GDP figure was quite disappointing. Not only the headline reading came in below expectations, it also reversed the uptrend in the past three quarters and might signal a turn for slower growth ahead. Although final sales and inventory contributed 1.6% and 0.6%, downside surprises from business fixed investment, government and foreign trade drag down the overall measure. For instance, oil and gas drilling, which had been running exceptionally strong in prior quarters, saw significant slowdown and thus pulled down business fixed investment.

Annualized percent change from previous quarter	2Q-11	3Q-11	4Q-11	1Q-12
Real GDP (chain-weight)	**1.3**	**1.8**	**3.0**	**2.2**
Final sales	1.6	3.2	1.1	1.6
Final domestic demand	1.3	2.7	1.3	1.6
Consumption	0.7	1.7	2.1	2.9
Business Investment	10.3	15.7	5.2	-2.1
Structures	22.6	14.4	-0.9	-12.0
Equipment and Software	6.2	16.2	7.5	1.7
Residential investment	4.2	1.3	11.6	19.1
Change in inventories (05$)	39.1	-2.0	52.2	69.5
Net exports (05$)	-416.4	-402.8	-410.8	-410.1
Exports	3.6	4.7	2.7	5.4
Imports	1.4	1.2	3.7	4.3
Government purchases	-0.9	-0.1	-4.2	-3.0
GDP Chain Price Index	**2.5**	**2.6**	**0.9**	**1.5**
Core PCE Price Index	2.3	2.1	1.3	2.1

Source: Bureau of Economic Analysis

Chart 1: GDP Growth Softened in Q1



Source: Reuters EcoWin Pro

Europe: Negative

Euro-area manufacturing PMI declined from 47.7 in March to 45.9 (revised down from 46.0) in April, reaching the lowest level since June 2009 and the ninth month below 50-reading in a row. Job losses accelerated to the sharpest rate in 28 months, with the employment component at 47.6 in April from 48.7 previously.

There are still no signs of an imminent turnaround. New-orders-to-inventory ratio, which is a forward-looking indicator, continued to fall from 0.92 in March to 0.89 in April, implying production is likely to remain low in May if not deteriorate further. Weak new orders will continue to weigh on feeble job markets and hence domestic demand. Positive developments in the U.S. and China failed to offset sharp slowdown of intra euro-area trade, with the new export component came in at 46.2 in April from 48.4 in March.

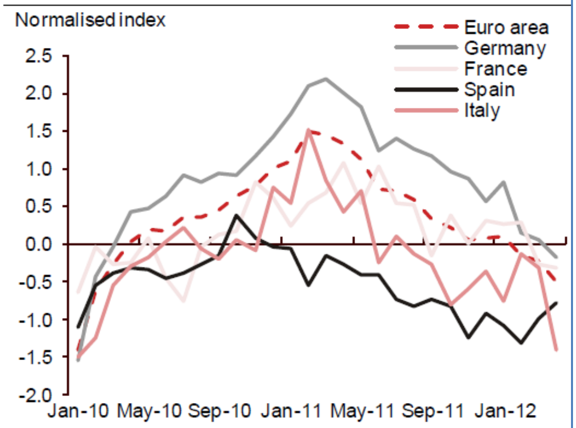
Below country breakdown shows most countries saw big contraction in the manufacturing sector since December.

Figure 1. Manufacturing PMIs across the euro area

	Apr.	Mar.	Long-term average	Note
Germany	46.2	48.4	52.4	33-month low
France	46.9	46.7	52.2	2-month high
Italy	43.8	47.9	51.0	6-month low
Spain	43.5	44.5	50.3	34-month low
Netherlands	49.0	49.6	51.7	3-month low
Ireland	50.1	51.5	51.0	2-month low
Greece	40.7	41.3	50.5	2-month low
Euro area	45.9	47.7	51.8	33-month low

Source: Datastream and Nomura Global Economics.

Figure 2. Employment component in the manufacturing PMIs



Source: Datastream and Nomura Global Economics.

The eye of the storm in Europe has shifted to Spain, with the country's sovereign bond yields surging to highest levels since late last year. This is raising concerns about the effectiveness of the two LTROs with the ECB dishing out close to €1.1 trillion of low interest 3-year loans. Looking at the schedule of bond issuances for the next two months (right table), there is likely to be about €79bn of liquidity draining from the market. Such massive issuance will exert considerable pressure on the market.

Apart from €11.5bn of sovereign debts to be issued by the Spanish government, the Spanish banking sector needs to raise €53bn to fund bond maturities in 2012.

Figure 3: Estimated euro area cash flows in May and June (€bn)

May and June	Gross Issuance	Redemptions	Coupons	Net Issuance	Net Cashflow
Germany	30.0	19.0	0.6	11.0	10.4
France	33.4	0.0	0.0	33.4	33.4
Italy	32.5	4.7	6.4	27.8	21.4
Spain	11.5	0.0	0.1	11.5	11.4
Belgium	6.0	0.2	0.3	5.8	5.5
Holland	11.0	0.0	0.0	11.0	11.0
Portugal	0.0	10.2	1.9	-10.2	-12.1
Finland	1.0	0.0	0.0	1.0	1.0
Austria	3.4	0.3	0.2	3.1	2.9
Greece	0.0	3.8	1.9	-3.8	-5.6
Ireland	0.0	0.0	0.3	0.0	-0.3
Eurozone Aggregates	128.8	38.2	11.7	90.7	79.0

Source: Barclays Research

According to data from the European Central Bank (ECB) and estimation from Credit Suisse, Spanish banks took down a massive 47% of the February LTRO. Together with last December's LTRO last year, Spanish banks have gotten a net of €202bn of LTRO funding. Their balance on deposit at the ECB currently stands at €89 billion, an increase of €73 billion since before the December LTRO. Between December and February, Spain's banking industry as a whole has experienced deposit flight of €23 billion and purchased €62 billion of government bonds.

Exhibit 7: Destination of Spanish LTRO funding: a large amount remains on deposit at the ECB

Breakdown of €202 billion net LTRO take-up by Spanish banks

Source: Credit Suisse, Bank of Spain, ECB
Bank deposit flight and government debt purchase data are for Dec – Feb; March data are not yet available

In its April Fiscal Monitor, the IMF has updated forecasts on fiscal balance and gross financial needs of select advanced economies. A summary is presented in the below table.

Governments in France and Italy are complementing recent fiscal packages with measures aimed at boosting growth. In France, starting October 1, a "social VAT," also known as fiscal devaluation, will reduce the labor tax wedge, offset by increases in the value-added tax and taxes on capital revenue. As noted in the September 2011 Fiscal Monitor, such a reform can reduce the cost of exported goods (through lower labor taxes) and increase the relative price of imported goods to consumers (through the higher VAT), much like a currency devaluation. In Italy, reforms in the areas of product market liberalization, infrastructure investment, and administrative simplification have been introduced, and the government has submitted to parliament a package of reforms aimed at making the labor market more flexible.

Table 1. Fiscal Balances, 2008–13

(Percent of GDP, except where otherwise indicated)

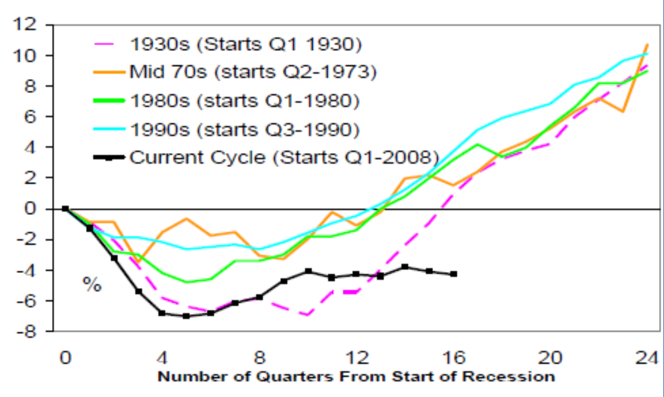
					Projections		Difference from September 2011 *Fiscal Monitor*		
	2008	2009	2010	2011	2012	2013	2011	2012	2013
Overall balance									
Advanced economies	–3.7	–8.9	–7.7	–6.6	–5.7	–4.5	0.1	–0.3	–0.4
United States	–6.7	–13.0	–10.5	–9.6	–8.1	–6.3	0.1	–0.2	–0.1
Euro area	–2.1	–6.4	–6.2	–4.1	–3.2	–2.7	0.1	0.0	–0.2
France	–3.3	–7.6	–7.1	–5.3	–4.6	–3.9	0.6	0.1	0.1
Germany	–0.1	–3.2	–4.3	–1.0	–0.8	–0.6	0.6	0.3	0.2
Italy	–2.7	–5.4	–4.5	–3.9	–2.4	–1.5	0.1	0.0	–0.4
Spain	–4.2	–11.2	–9.3	–8.5	–6.0	–5.7	–2.3	–0.9	–1.3
Japan	–4.1	–10.4	–9.4	–10.1	–10.0	–8.7	0.2	–0.8	–0.9
United Kingdom	–4.9	–10.4	–9.9	–8.7	–8.0	–6.6	–0.2	–0.9	–1.5
Canada	0.1	–4.9	–5.6	–4.5	–3.7	–2.9	–0.3	–0.5	–1.0
Others	1.9	–1.0	0.1	0.7	0.7	1.5	0.2	–0.4	–0.1
Emerging economies	–0.4	–4.8	–3.6	–2.2	–2.1	–2.1	0.5	0.1	–0.2
Asia	–2.2	–4.7	–3.9	–3.3	–3.2	–3.0	0.1	–0.5	–0.7
China	–0.4	–3.1	–2.3	–1.2	–1.3	–1.0	0.3	–0.5	–0.9
India	–7.2	–9.8	–9.2	–8.7	–8.3	–8.2	–0.6	–0.8	–0.8
ASEAN-5	–0.5	–3.3	–2.1	–2.2	–2.3	–2.4	0.6	0.3	0.1
Europe	0.6	–6.2	–4.4	–0.5	–1.0	–1.3	1.5	1.2	0.8
Russia	4.9	–6.3	–3.5	1.6	0.6	–0.3	2.7	2.7	1.9
Latin America	–0.7	–3.6	–2.9	–2.4	–2.1	–1.9	–0.1	0.1	0.0
Brazil	–1.4	–3.1	–2.8	–2.6	–2.3	–2.4	–0.1	0.5	0.2
Mexico	–1.1	–4.7	–4.3	–3.4	–2.4	–2.2	–0.2	0.4	0.3
Middle East and North Africa	–0.4	–2.5	–3.5	–5.7	–5.4	–4.9	0.0	–0.6	–0.6
Low-income countries	–1.2	–4.0	–2.9	–2.5	–3.0	–2.5	0.6	–0.1	0.0
Oil producers	5.9	–3.0	–0.8	2.1	2.4	1.6	1.9	2.4	1.8
G-20 economies	–2.7	–7.6	–6.2	–5.0	–4.4	–3.7	0.3	–0.1	–0.3
Advanced	–4.3	–9.6	–8.2	–7.2	–6.3	–5.0	0.1	–0.3	–0.3
Emerging	–0.2	–4.8	–3.5	–2.2	–2.1	–2.2	0.4	0.1	–0.2

In Spain, the government has announced in the budget for 2012 measures complementing the fiscal consolidation package of end-2011, in an effort to reach overall deficit target of 5.3 percent of GDP for 2012. The new deficit target understandably aims for a very large consolidation and is broadly appropriate, although a slightly more moderate adjustment that better accommodated cyclical developments would have been preferable.

In Ireland and Portugal, tax increases, revenue enhancing measures, and expenditure cuts are being introduced to maintain the committed path of deficit reduction over the medium term.

In the U.K., the Office for National Statistics announced that GDP fell 0.2% in Q1 2011 and non-oil GDP fell 0.1% QoQ in Q1, after falling 0.3% QoQ in Q4 of last year. Hence, the statistics put the economy back into a technical recession (generally defined as two consecutive quarters of negative growth). The Q1 non-oil GDP level is 4.3% below the pre-recession peak of 3.7% in Q1 2008.

Figure 1. UK — Cumulative Change in Real GDP From Start of Recessions, 1930-2012 Q1



Sources: ONS, NIESR and Citi Investment Research and Analysis

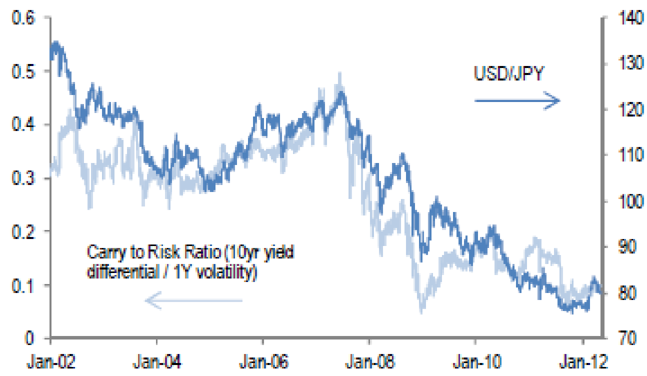
Some reports claim that this could be the worst recession/recovery cycle in U.K. for the past 80 years. As shown in the right hand chart, we can see that in all of the previous recessions, real GDP in U.K. would have surpasses pre-recession peaks after 16 quarters. The current cycle is starkly different with the economy underperforming due to fiscal drag, high household debts, the EMU crisis and poor credit availability.

Japan: Neutral

For years, the Japanese yen is the most common major currency borrowed for conducting carry trade due to the nation's close-to zero interest rate charges. This was true until 2007. Since the financial crisis, almost all major countries have substantially slashed their interest rates to stimulate economy. The charts nearby compares the carry to risk ratio, which is calculated by 10-year sovereign bond yield differential divided by 1-year volatility of the currency, to the USD/JPY exchange rate. Current risk adjusted return in doing carry trade through borrowing USD and EUR is almost 1/5 and 1/7 respectively to their peak during 2005 and 2007. Thus, the thin risk adjusted return produce little incentive for investors to use the yen for carry trades while bearing the risk of a stronger JPY.

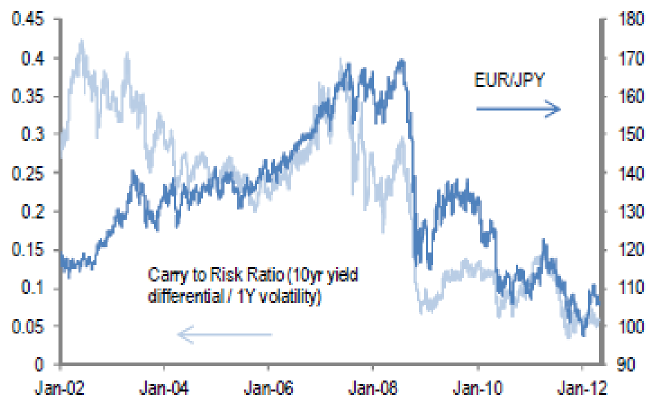
Meanwhile, CPI in Japan has returned to positive territory and should it hit the set target of 1% by Bank of Japan, it will take away one argument for BoJ to conduct further quantitative easing.

Chart 1: Carry to Risk Ratio and USD/JPY



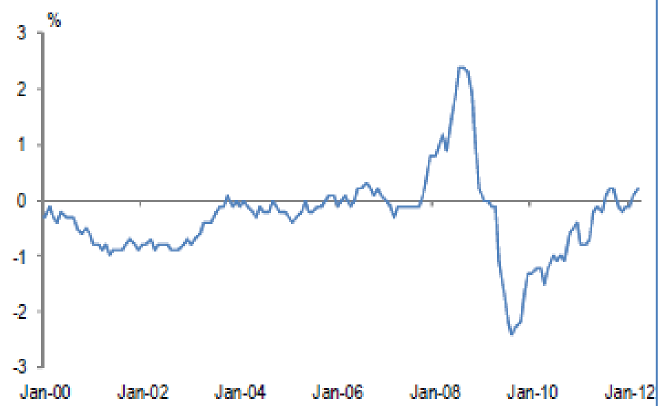
Source: J.P.Morgan

Chart 2: Carry to Risk Ratio and EUR/JPY



Source: J.P.Morgan

Chart 3: Japanese core CPI growth (oya, %)



Source: Ministry of Internal Affairs and Communications

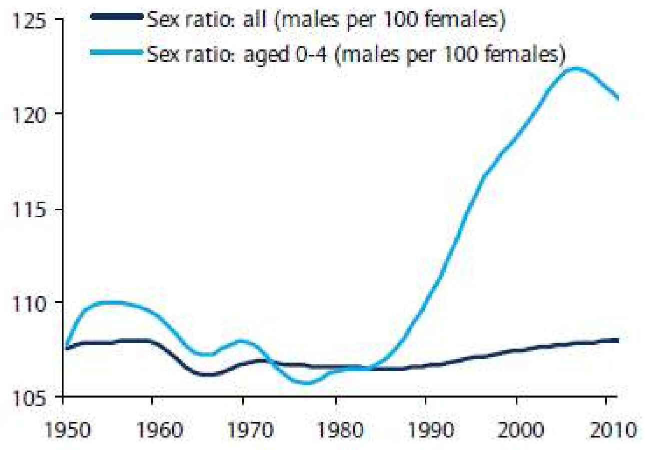
China: Mixed

According to the World Bank, China is the fastest aging major emerging nation in the world as a direct result of its one-child policy instituted in 1978. China's fertile rate has sharply contracted over the past decades, fallen to 1.8 in 2000 from 5 in the 1970s. Moreover, the policy has brought imbalances in its population's gender mix, changes in dependency ratio and rapid emergence of labour shortages. Looking forward, China faces many challenges in the form of slower GDP growth, higher inflation, higher average salary and reduced savings. At the same time, China will see greatly increased domestic consumption and the need for upgrading of production technologies.

The chart below shows the gender imbalance with the boy/girl ratio soaring since 1980s. In the not-too-distant future, there will be many unmarried men which may cause social instability and inflict enormous social cost to the economy. China's rapidly aging population will see depleting surplus of labour pool in the countryside and urban wages soaring, thus hurting economic growth and competitiveness.

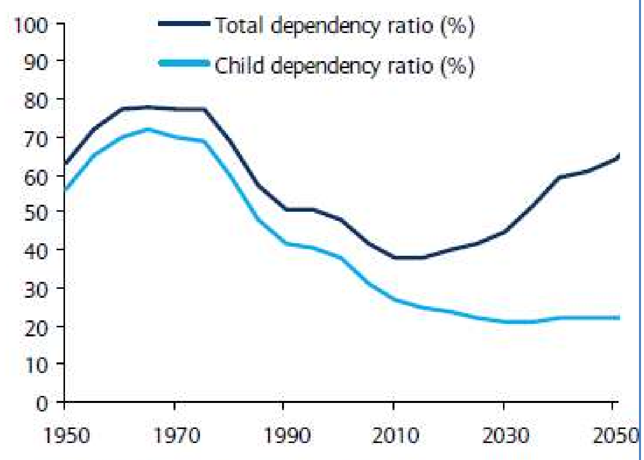
An aging population also means higher healthcare and pension costs, which could eat into resources available for making investment. Fortunately, the China government owns a huge amount of state-owned assets to cover its liability. The World Bank suggests the China government can liquidate assets to support its welfare system. But in exchange, the China government would need to forgo its monopolistic position.

Figure 1: Sex ratio at birth has reached 120 boys per girl



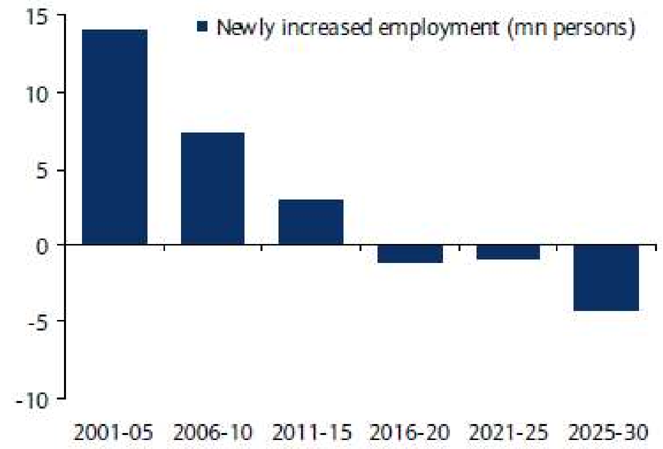
Source: Haver Analytics, Barclays Research

Figure 2: Dependency ratio vs child dependency ratio



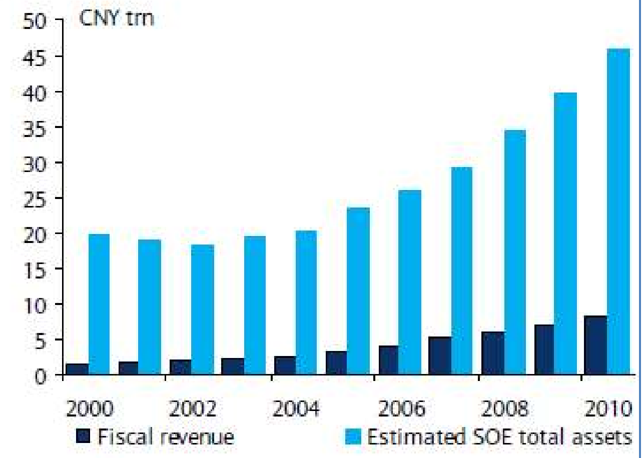
Source: Haver Analytics, Barclays Research

Figure 3: Annual increase in new workers



Source: Hu Ying (2010), "demographic changes in '12th Five Years Plan' Period and Prediction for Population Development", in Cai Fang ed. China Population and Labour Report in 2010, Social Science Literature Press.

Figure 4: SOEs – a massive asset base

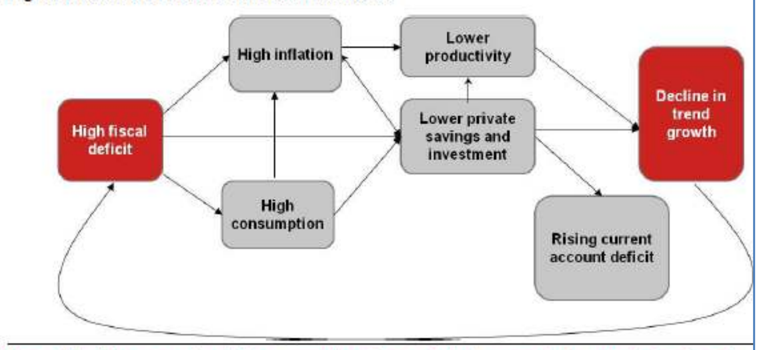


Source: CEIC, Barclays Research

India: Negative

Despite having one of the highest interest rates in the Asia region, India has not been too successful in curtailing inflationary pressure. The chart on the right produced by Nomura helps to explain India's structural problem. We can start from the very left that is India's high fiscal deficit. Such large fiscal deficit tends to fuel inflationary pressures by widening the consumption-investment gap. The country's long-time practice of subsidizing oil prices and expansion in inclusive growth schemes (without augmenting investment) increased consumption demand to unsustainably high levels.

Fig. 6: Reasons for India's structural weakness



Note: Global factors such as high commodity prices and slowing potential growth in developed economies are also responsible for high domestic inflation and slower growth. The above chart excludes that channel for simplicity.
Source: Nomura Global Economics.

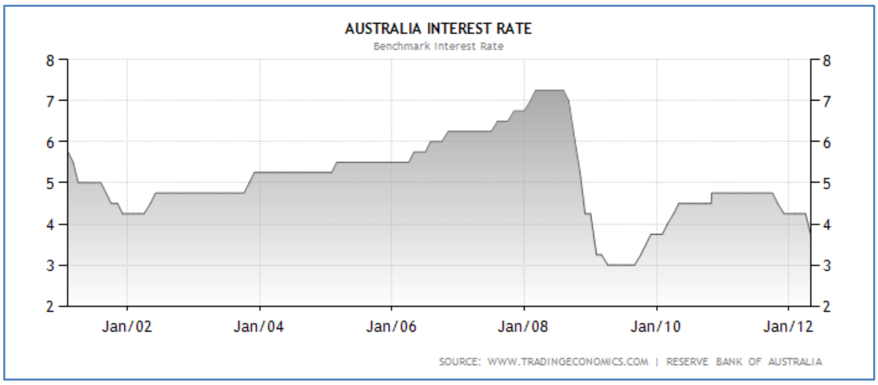
Since the RBI responded to these demand-side inflationary pressures by tightening interest rates, the burden of adjustment has fallen disproportionately on investments, and more so on private investment, which is more efficient than public investment but is being crowded out by the large fiscal deficit.

In the face of rising demand and limited production, a higher minimum support price (MSP) of food crops has fuelled food inflation. Demand is increasing faster now than during 2003-07 because the middle class is approaching key income threshold, at which demand for consumer durables and higher-protein food takes off. Since nearly half of the consumer basket is comprised of food prices, this has led to an unmooring of inflation expectations. Also, the rural employment guarantee scheme, where wage hikes are linked to CPI inflation, has set a floor on rural wages and exacerbated labour shortages. In the end, this has reinforced the wage-price spiral.

Asia Pacific: Mixed

The Reserve Bank of Australia cut the cash rate by a larger-than-expected 50bp to 3.75%. The outsized cut is supported by a notable fall in Q1 inflation which undershot expectations. The RBA also notes that despite some forecasters revising their global outlooks higher, it sees below-trend output. Europe also remains a potential source of adverse shocks for some time yet. While wholesale funding costs have fallen at the margin over recent months, funding for Australian banks remains elevated comparing to mid-2011. The pass-through over these funding costs amounts to around 20bp of tightening so far in 2012, which could explain a cut of this magnitude.

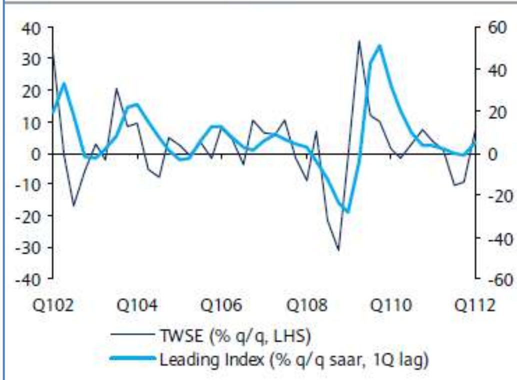
In reference to domestic economy, the RBA notes that credit demand remains modest and that while housing prices have shown some signs of stabilising, they remain subdued. The RBA references conditions in December 2011 in its decision to cut rates by 50bp. At that meeting, the RBA reduced rates by 25bp, but stated "output growth has been close to trend, with demand growth stronger than that". Clearly with the recent surprisingly low inflation print and the potential for forecasts for growth to be lowered, a more stimulatory position was desirable.



Thanks to improvement in the petrochemicals complex and the electronics sector, Taiwan's industrial production rose 5.2% QoQ on a seasonally adjusted annualized rate in Q1 2012, its first increase in nearly a year. Supply disruption caused by closure of local refineries for maintenance last May is on the mend and new orders from U.S. remain robust in recent quarters. The recovery may persist as the global shortage of hard-disk drives (as a result of last year's flood in Thailand) is expected to end in Q2, paving the way for a recovery in production of PCs and panels.

Taiwan's trade volume with China has steadily grown during the past two decades. China has now the largest trade deficit against Taiwan among all trading partners. These days, importers and exporters in Taiwan are actively settling their trades with China in RMB from Hong Kong. As of January 2012, 2.6% of RMB settled trade is between China and Taiwan. The Renmibi and China government policy thus have ever greater influence of Taiwan's economy.

Figure 1: Taiwan likely to emerge from recession in Q1

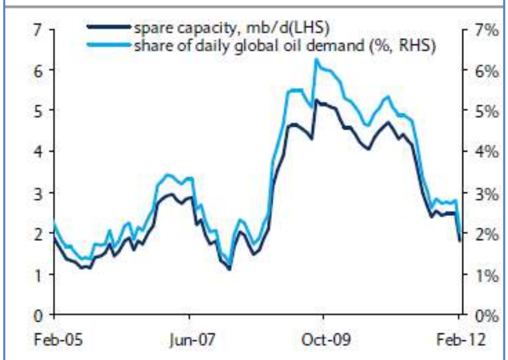


Source: Haver Analytics, Barclays Research

Commodities: Negative

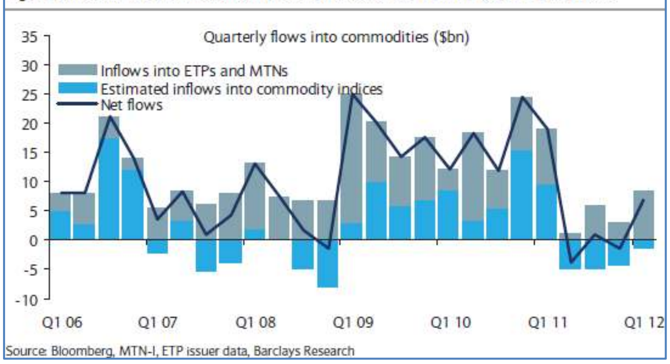
Crude oil prices remain well supported by growing demand by non-OECD countries. China's economic growth has slowed but demand stays strong as the country continues building up its strategic oil reserve. At the same time, OPEC's spare capacity remains low. As shown in the right hand chart, spare capacity has fallen to early-2008 levels. Separately, EU's sanctions on Iraq will be fully implemented on 1 July, which might further limit global supply. To ease concerns of supply disruption, Sandi Arabia has vowed to plug any shortfall by turning up its spare capacity. Some analysts said output of Saudi Arabia was running at 10mb/d for two consecutive months. There are doubts that the world's biggest crude producing nation is able to produce above 10mb/d on a sustainable basis for the second half year of 2012.

Figure 38: OPEC spare capacity near early 2008 levels



Source: IEA, Barclays Research

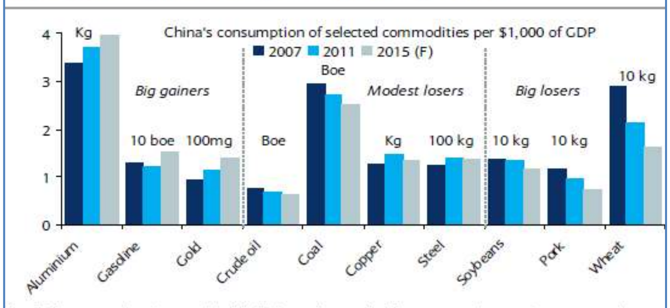
Figure 2: Inflows into commodities bounced back in Q1 12 with $6.9bn fresh flows



Source: Bloomberg, MTN-I, ETP issuer data, Barclays Research

After three quarters of tepid inflows, investment into commodities rebounded in Q1 2012 with a $6.9bn inflow. It was the strongest quarterly inflow in a year, though still far below the level in Q1 2011 (at $19bn) and the average quarterly inflow over the past five years ($11bn). The strength of Q1 inflows masks a large bias towards commodity ETPs and structured notes. In contrast, index swaps record a $1.5bn outflow over the quarter, the fourth consecutive quarter of outflow. Since Q1 2011, index swaps have had cumulative quarterly outflow of $15.9bn, but the pace of outflows have moderated in 2012.

Figure 1: Winners and losers from China's changing commodity appetite

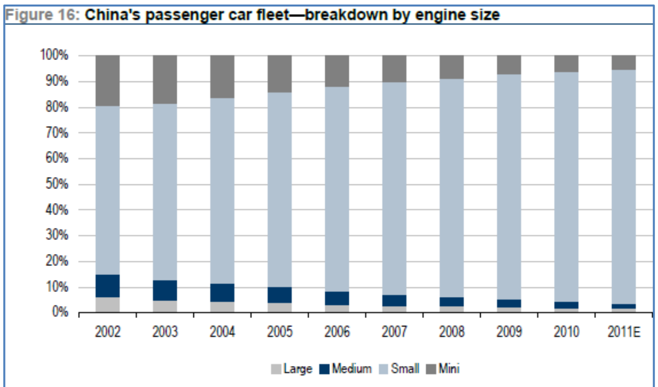


Note: Different units have been used (as labelled), in order to scale different commodities on the same vertical axis.
Source: Barclays Research

Earlier, we have said that China's target of slower GDP growth would see moderating fixed investment and higher domestic consumption. This could result in big shifts in future commodity demand. Accordingly, intensity of use is expected to decline for some industrial metals, with steel, copper and zinc the worst affected. Growth in overall demand on commodity may slow in the future, which is why we express our worries on the Australian economy.

In contrast, the intensity of using gasoline, palladium (used in vehicle catalysts), as well as nuclear, wind and solar energy will remain strong. For instance, despite exponential car population growth in the last decade China small passenger car population mix increased from 85% to 96%. Large passenger car population mix, on the other hand, decreased from 6.3% to less than 2% over the same period. As population of smaller cars grow faster, it would generate a demand on gasoline. The chart on the right is the estimation made by Barclays research team.

Figure 16: China's passenger car fleet—breakdown by engine size



Source: CEIC, Credit Suisse estimates

According to the World Silver Survey 2012 issued by Gold Fields Mineral Services, supply of silver has contracted faster than fabrication demand last year. Still, the market remained in excess supply of 5,000 ton. GFMS found mine supply continued to grow to yet another record as did scrap supply. Mine output was up by 1.4% at 23.7kt, boosted as a by-product from lead/zinc output as well as gold. Strong growth from countries such as Mexico and China offset losses in Peru, the US and Australia. On the demand side, despite robust growth of coin sales to fresh all-time highs, losses elsewhere led lower total demand. Industrial demand weakness at the end of the year swung the full year into negative growth while photography remained in structural decline.

Figure 7: Despite silver supply contracting further than demand, the market stays in surplus

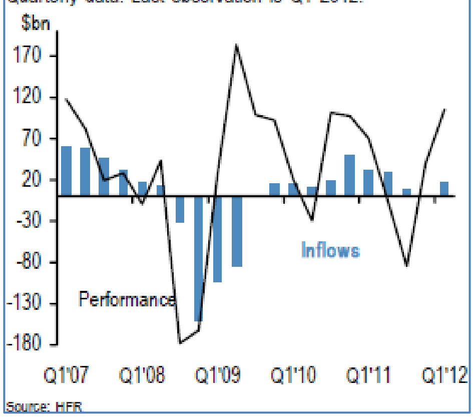
Source: Thomson Reuters GFMS, The Silver Institute, Barclays Research

Hedge Funds: Mixed

According to Hedge Fund Research, hedge funds saw $16bn of net inflows in Q1 2012, a considerable improvement from the $100mn outflows in Q4 of last year. This coupled with the strongest performance gains since Q2 2009 pushed total hedge fund AUM to around $2.1tr, a new record. Fixed income-based relative value strategies were the main beneficiary of the inflows garnering $12bn, whereas Equity Hedge strategies recorded net outflow of $3bn.

Chart 10: Hedge fund flows and performance

Quarterly data. Last observation is Q1 2012.



Source: HFR

Performance of different hedge fund styles were decidedly mixed in March. According to Credit Suisse, convertible arbitrage strategy benefitted from strong performance from the equity side while credit prices fell and spreads widened. Event driven strategy and fixed income strategy also posted positive performance. Interest rates markets in the U.S. and Europe continued to be guided by the perception of potential central bank action. As in previous QE interventions, further asset purchases would have numerous implications on fixed income markets, most notably in on-the-run vs. off-the-run bonds and cash vs. futures. Looking ahead, risks continue to be skewed toward higher Treasury yields given recent improvements in the U.S. labour market, elevated stock prices, and improved credit markets.

The weakest link is Managed Futures since the market experienced several reversals during March. Risk assets largely continued their upward moves during the first half of the month although momentum subsided in the latter half. Small gains in equities and energy were more than offset by losses in net long fixed income exposures, as yields rose significantly in U.S. Treasuries. While yields came down from their peak during the second half of the month, risk assets incurred losses for managers as these markets started tracing back.

	Mar	YTD	Avg. Annualized Performance*	Annualized Vol.*
Dow Jones Credit Suisse Hedge Fund Index	**0.05%**	**4.04%**	**8.83%**	**7.59%**
Convertible Arbitrage	0.55%	4.86%	7.65%	6.96%
Dedicated Short Bias	-1.35%	-13.08%	-4.09%	16.99%
Emerging Markets	-0.70%	6.02%	7.57%	14.93%
Equity Market Neutral	-0.15%	1.35%	5.06%	10.35%
Event Driven	0.79%	5.25%	9.37%	6.35%
Fixed Income Arbitrage	0.74%	2.94%	5.32%	5.75%
Global Macro	-0.43%	1.58%	12.05%	9.74%
Long/Short Equity	0.50%	7.19%	9.47%	9.94%
Managed Futures	-2.96%	-0.67%	5.88%	11.72%
Multi Strategy	0.45%	4.71%	8.01%	5.41%

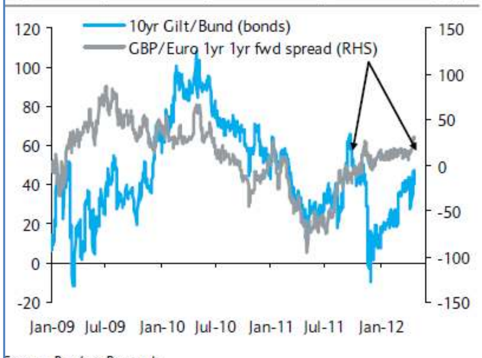
*Average annualized Index data begins January 1994. Source: Credit Suisse Hedge Index, LLC.

Bonds: Mixed

The Gilt market was swept by differing forces. The more hawkish than expected minutes from BoE and upside surprise on retail sales reinforced expectations that there would be no further extension of QE at the May MPC meeting. However, initial estimate of Q1 GDP of showed the U.K. economy suffered a technical recession.

Whether the market has fully priced in cessation of QE is not easy to judge but the 10yr Gilt/Bund spread has come under widening pressure. Given the retracement in gilt yields, the widening has primarily been about the strength of the Bund leg. The spread, currently at around 45bp, is close to where it was prior to the beginning of QE in October 2011. Nonetheless, an ending of QE with the Committee more concerned going forward about inflation should see yields come under cheapening pressure. In addition, there seems to have been waning overseas buying of the 10yr section. In the absence of BoE's buying program, the market will see positive cash flows for every month of the remainder of the fiscal year bar June 2012 and March 2013.

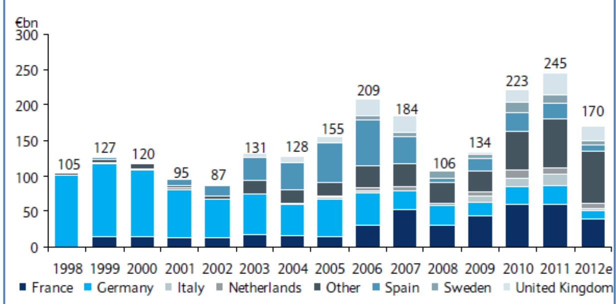
Figure 3: 10yr Gilt Bund spread close to pre-QE levels (bp)



Source: Barclays Research

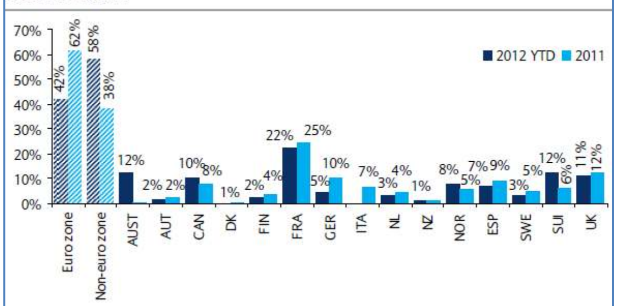
Covered bonds, historically a predominantly continental European debt instrument for decades, have seen more issuance outside the Eurozone than from within this year. Additionally, the share of European issuers has declined from historical levels. As worries in the Eurozone debt markets persist, issuance activity from selected Eurozone countries is likely to remain muted. This is further supported by the relatively high take-up in ECB's 3y LTRO in February by selected Eurozone countries. Covered bonds are debt securities backed by financial instrument. They are similar in many ways to asset-backed securities created in securitization, but holders of covered bond assets remain on the issuer's consolidated balance sheet.

Figure 1: Gross supply of benchmark covered bonds (EUR, USD, CHF, GBP, AUD, CAD) (EUR bn equivalent)



Source: Barclays Research

Figure 2: Gross supply of benchmark covered bonds (EUR, USD, CHF, GBP, AUD, CAD) – 2012 YTD vs 2011



Source: Barclays Research

The year-to-date covered bond gross supply, at €92.5bn, has been relatively strong, especially in light of the uncertain market conditions. Furthermore, given the record issuance volume in Q1 2011, it was expected that this issuance surge would not be repeated at the start of 2012.

The issuance activity year-to-date has been more sporadic and cautious. This applies particularly to the peripheral markets such as Spain, which saw the re-opening of the market in February. As the uncertainty around the Eurozone continues, the majority of the year-to-date issuance has in fact come from outside of the Eurozone. Indeed, 58% of year-to-date gross covered bond issuance originated from outside the Eurozone while in 2011, Eurozone issuers still represented 62% of annual supply.

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

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