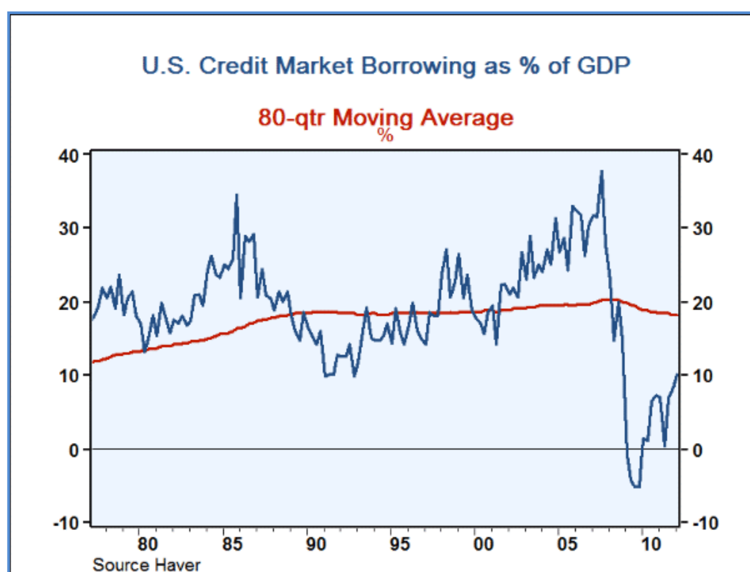
AMG Market Commentary

June 2012

Another Look at U.S.'s New Normal

The term 'New Normal' is famously used by the two CIOs of PIMCO, Mohamed El-Erian and Bill Gross, to portray a new global economic setting as an aftermath of the 2008 financial crisis. Simply put, it describes a world of muted economic growth particularly in the western societies, elevated unemployment for an extended period of time and deleveraging by public (government) and private account (corporate and household). The scenario is so unpalatable that few would like to see or wish to believe in. The notion has also been regularly challenged, and the duo from PIMCO have engaged in countless debates with critics to defend their stance. Is this notion of New Normal for real or for a laugh? We will take a closer look into it this month.

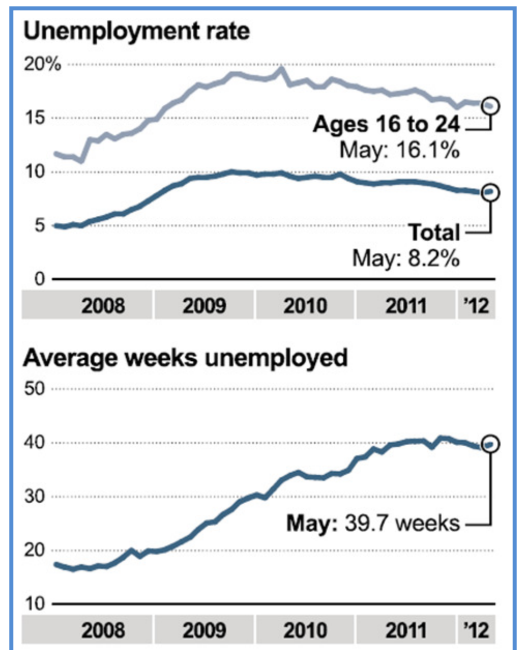
It was shy of three months four years ago (or Sept 15, 2008 to be exact) that Lehman Brothers, then the fourth largest investment bank in the U.S., filed for Chapter 11 bankruptcy protection. That event triggered the financial tsunami which in turn led to the worst recession the world has seen since the early-30s. Remarkably, global capital markets survived after experiencing a brief period of near-meltdown and global economy returned to growth by late-2009/early-2010. Looking at some of the recent news headlines, it almost seems the incident four years ago was nothing more than a bad dream. Bank of Canada reported that total debt-to-household income ratio for Canadians have reached new record high surpassing their southern neighbors. Dallas Fed's Annual Report found that at end of 2010, the five biggest banks in the U.S. collectively holds more than 52% of industry assets versus 17% back in 1970. The same report also showed the top 10 Wall Street banks own assets that are valued at more than 50% of America's annual gross domestic product (GDP). According to Bank of International Settlement (BIS), as of June 2011, global derivative gross exposure increased by US$107 trillion to a staggering US$707 trillion, a new record high. Closer to home, property prices in Hong Kong have nearly doubled from levels in 2007 and more than quadrupled from the low point in 2003. Did someone say deleveraging? Is this a joke or what?!



While there are no lack of pockets of exuberance in financing and asset prices, there are also signs of pull back in outstanding credit in other areas. This is evidenced in the right-hand chart which shows credit market borrowing in the U.S. as a percentage of GDP over a near three-decade time span.

We would like to point out three observations from the chart. Firstly, from the mid-70s all the way to just before the financial tsunami, Americans have been taking on more debts than they collectively produced. This is exemplified by the two periods being 1980-85 and 1992-2007. Secondly, this pattern was finally broken by the steep contraction in credit outstanding during the last recession. The decline was so deep and extraordinarily that it even reversed the uptrend of a 80-quarter (i.e., 20-year) moving average. To use an analogy, this is like turning a 40-foot flat-bed trailer on a dime! Even the multi-year contraction of credit in 1986-91 was only able to flatten the uptrend for a while. Thirdly, the rebound in credit since two years ago remains far below the long-term average. Whether this is due to voluntary or involuntary reasons (e.g., banks foreclosing on properties), it serves as empirical proof of deleveraging among U.S. households.

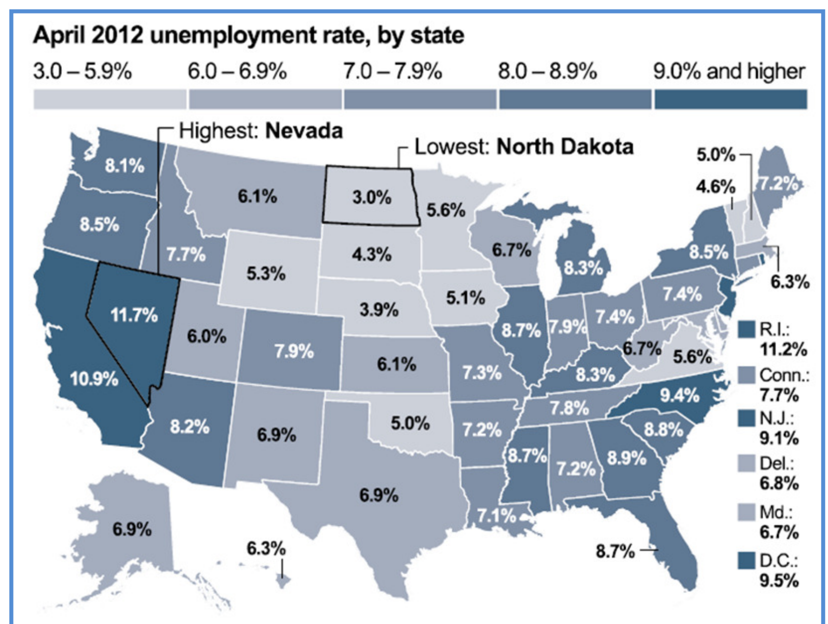
The second aspect of New Normal, i.e., extended period of elevated unemployment, is also well supported by the charts to the right. The upper chart depicts the headline unemployment rate in the U.S. (at 8.2%) as well as the unemployment rate of young Americans between age 16 to 24. Both rates remain significantly higher than levels before the financial crisis and despite the economy is more than three years in expansion cycle, improvement has been painfully slow. The lower chart shows for those Americans who are unemployed, they have been out of work for an average of nearly 40 weeks. This is a far cry from the average reading of about 16 weeks before the financial crisis. An added worry for these long-time unemployed is that the longer they are out of the labor market the more difficult for them to get back in. Meanwhile, the emergency jobless benefit programs are gradually winding down so these people will have to look for other means of, such as familial, financial support.



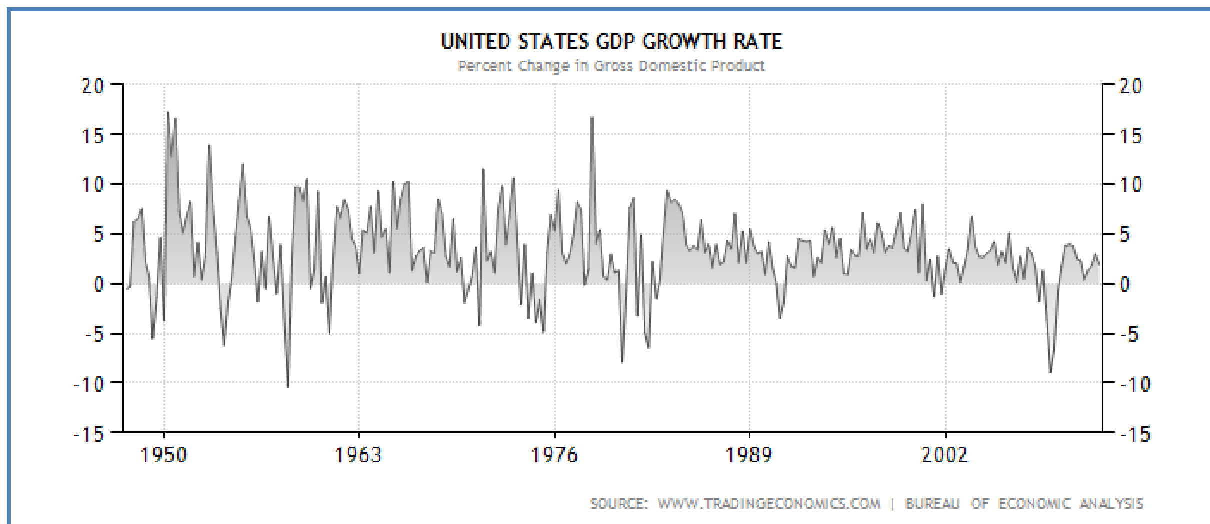
The grindingly slow improvement in the job market is both embarrassing and perplexing to President Barrack Obama, who is getting ready to launch his re-election campaign, as much as to Federal Reserve Chairman Ben Bernanke. Despite firmly nailed the Fed Funds rate at the current record low of 0 - 0.25% since late-2008, two rounds of quantitative easing and two rounds of so-called Operation Twist maneuvers (the second *Twist* was announced just days ago on June 19), the pace of job creation has consistently trailed the rate of population growth.

Even when jobs are created, they may not have as big a bang-for-the-buck effect to the economy as in previous cycles. This is due to shifting economic drivers.

The chart to the right shows the latest unemployment rate by state. We can see that the states with higher unemployment rate are located on the West Coast and East Coast as well as the so-called Heartland (or Mid-east region), whereas those with lower unemployment rate are located in the Northern region. The job boom in the Northern region, including North Dakota which boasts the lowest unemployment rate, can be explained by the rapid growth in shale energy. As we have reported in an earlier Commentary, some townships in North Dakota have unemployment rate as low as 1%. The energy boom in those areas has created good paying, albeit not-so-glamorous, jobs by the thousands. This is certainly wonderful development for the economy in those areas, but it should be noted that those regions have comparatively small populations and scale of economy. The real heavyweights, in terms of population and GDP, and hence significance to national growth, are states scattering along both coasts. The West has been known for its concentration of high tech manufacturing and software development companies. The East is known for its high density of financial and other tertiary industries. Because the social and industrial fabrics are more closely knitted in the East and West Coast, a job created here will have a higher multiplier effect than one created in the more remote and detached region.



The third aspect of New Normal is subdued economic growth. For that, we present the below long-term chart showing annual rate of U.S. GDP growth since 1947 (shortly after WWII). It is easy to see that pace of growth has moderated over this span of six and a half decades. One might argue that due to the U.S. economy's huge size, it is at a disadvantage due to high base effect. Moreover, it is typical for matured economies to grow at more temperate pace. Both arguments have some validity in them. So couldn't this also be part of the reasons that explain the New Normal?



After all, New Normal does not have to be something that is totally foreign but a natural and inherent evolution of the U.S. economy. Looking from this angle, it may be easier to accept and embrace the new economic backdrop. And more importantly, to be better able to cope with and adjust to the implications that it brings.

Market Review & Outlook

US: Neutral

May's job statistics came in broadly weaker than expected. Not only the gain of 69,000 in payroll was well below consensus, the figures for the previous two months were revised downward. Moreover, average workweek posted an outright decline while average hourly earnings showed the slightest rise possible. Based on the drop in manufacturing hours, industrial production for the month of May could register a decline when it is due for release. Finally, the unemployment rate ticked up to 8.2%.

	Feb-12	Mar-12	Apr-12	May-12
Nonfarm Payrolls (Chg, 000s)	**259**	**143**	**77**	**69**
Manufacturing	30	42	9	**12**
Construction	-1	-14	-5	**-28**
Retail Trade	-15	-15	27	**2**
Prof & Bus Services	89	18	37	**-1**
Temps	50	-13	13	**9**
Government	5	-4	-10	**-13**
Other	151	116	19	**97**
Average Workweek (hours)	34.6	34.5	34.5	**34.4**
Manufacturing	40.9	40.7	40.8	**40.5**
Aggregate Hours (% chg)	0.5	-0.1	0.0	**-0.2**
Manufacturing	0.2	-0.1	0.2	**-0.6**
Average Hourly Earnings (% chg)	0.2	0.2	0.1	**0.1**
Unemployment rate	**8.3**	**8.2**	**8.1**	**8.2**

Source: Bureau of Labor Statistics

A bright spot offered by a separate report showed a jump in the labour force participation rate and an accompanying rise of 422,000 in the household survey measure of employment.

Jobless claim data released by the Department of Labor showed the four-week moving average of initial claims for unemployment risen to 375,000 from 371,000 at end of May, but was 10,000 below the pace a month ago. Historically, there is oftentimes a seasonal rise in employment during the spring months but this jump might be smaller than usual given last year's mild winter could mean more workers remained employed and hence tamer improvement for this year.

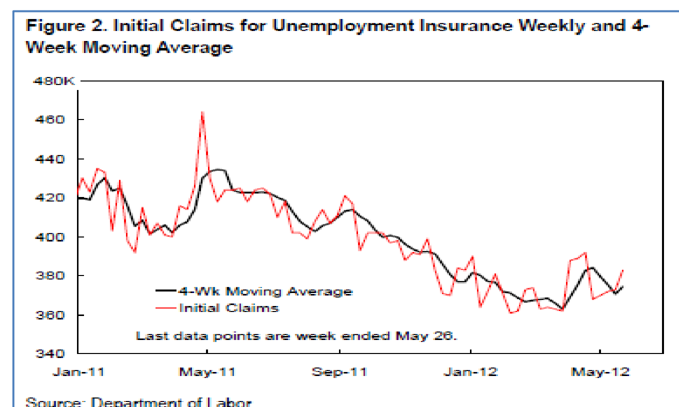


Figure 2. Initial Claims for Unemployment Insurance Weekly and 4-Week Moving Average

Source: Department of Labor.

Europe: Negative

The outcome of Greece's election on June 17 and the topic of 'Grexit' are key concerns with global ramifications. In the event Greece exits from EU and were to restructure or default on its outstanding debt, the debt dynamics would be very different from the 'voluntary' hair-cut forced upon private creditors a couple of months ago. As of now, over half of Greece's public debts are official loans from the EU and IMF, and much of the remainder is held in the domestic banking system and by the ECB.

Figure 4: Holdings of Greek public debt

	Before PSI	Post PSI, end 2012
IMF loans	20	28
EU loan package 1	53	74
EU loan package 2	0	88
ECB SMP + Investment portfolio	55	46
T-bills	15	15
Sub total 1	143	251
Banks (o/w Greek banks c.EUR40bn)	70 (40)	22 (13)
Insurance	10	3
Central banks/official institutions	38	12
Other investors (real money, etc)	70	22
Greek Social Security fund	18	6
Sub total 2	206	0
New exchange bonds from PSI	0	65
Total Greek debt	349	316

Source: Barclays Research

Debt held by the domestic banking system cannot be written down without breaking the banks and requiring a government-financed bank recapitalization. And official creditors including the ECB have so far resisted a restructuring of Greek obligations that they hold.

Figure 2: Foreign Bank Claims on Greece

End-December 2011	European banks	France	Germany	Italy	Spain	Switzerland	UK	US
Foreign claims	90,473	44,353	13,355	2,186	969	1,940	10,537	4,455
Public sector	21,929	6,502	6,749	773	302	168	1,759	725
Banks	3,167	223	759	146	39	476	1,005	672
Non-bank private sector	65,295	37,628	5,847	1,266	627	1,256	7,772	3,058
Other potential exposures	29,032	6,901	3,779	1,790	417	1,406	11,825	46,231
Derivatives contracts	6,548	1,545	470	462	172	505	2,953	907
Guarantees extended	15,835	3,692	2,818	280	24	155	8,199	44,831
Credit commitments	6,649	1,664	491	1,048	221	746	673	493

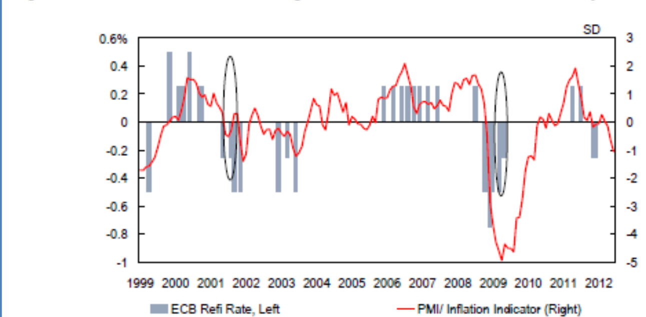
Source: Bank of International Settlements, valuations at EUR prices at end-December 2011

For private creditors, European banks are most exposed. Even so, Euro-zone's exposure to Greek private sector debts is substantially smaller than that to the Greek government. Much of this exposure is for non-bank private sector (EUR65bn). But even for France, the most heavily exposed single country (EUR38bn), the exposure is not large enough to pose a systemic threat.

Although ECB left interest rate unchanged at the last meeting in early-June, given the sharp drop off in the composite PMI and the EU Commission Economic Sentiment Survey in May, it is likely that ECB would open the door for additional non-standard stimulus measures and lower rates in Q3 or even as early as July.

Historical evidence shows that ECB rate actions closely follow the PMI/ inflation indicator. As all evidence point to continuation of the deteriorating trend, further cut in interest rate in Q3 should not be ruled out.

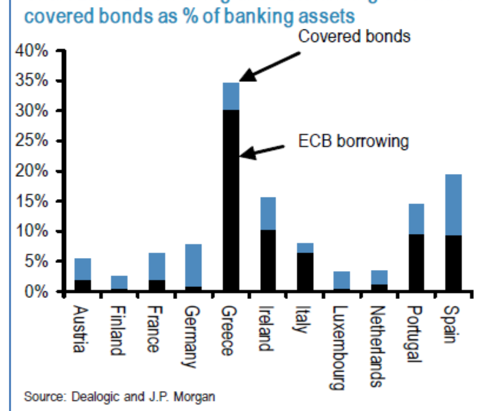
Figure 2. Euro Area — ECB Rate Changes and PMI/Inflation Indicator, 1999–May 2012



Sources: Ecowin and Citi Investment Research and Analysis

Net issuance of unsecured bank debt in Europe is diminishing rapidly. Year-to-date, €150bn of unsecured bank debt has been withdrawn in Europe, surpassing 2011's total withdrawal of €130bn. Both years are a lot worse than 2008 when European banks were forced to retire €13bn of unsecured bank debt. The shift away from unsecured to secured bank debt appears to be undermining bail-in plans which could become self-defeating unless a minimum requirement of unsecured bank debt is imposed.

Chart 2: ECB borrowing and outstanding amount of covered bonds as % of banking assets



Source: Dealogic and J.P. Morgan

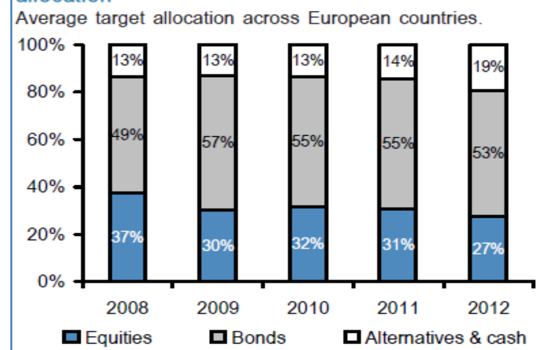
Increasing issuance of secured bonds coupled with rising borrowing from the ECB paint a problematic picture in the European bank sector in terms of subordination of unsecured creditors. The chart on the left shows that after Greece, Spain has the most problematic banking sector from this perspective where 20% of assets are encumbered via covered bond issuance and ECB borrowing.

According to the latest European asset allocation survey by Mercer, pension funds continued reducing their target equity allocations and increase their target allocations to alternative investments. At the same time, in view of extremely low government bond yields levels, allocations to bonds have also fallen.

Average target allocation to alternatives currently stands at 15%, including 8% in property. The remainder is heavily weighted towards hedge funds and emerging market debt. Hedge funds investing across asset classes are by far the most popular. Target cash allocations have also risen, now at 4% up from 3% in last year's survey.

Chart 8: European pension fund target asset allocation

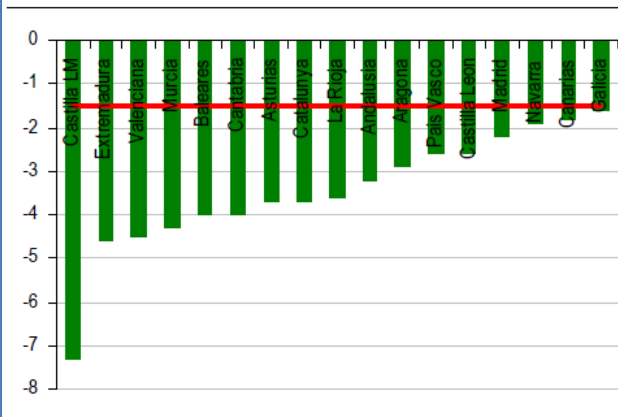
Average target allocation across European countries.



Source: Mercer, J.P.Morgan

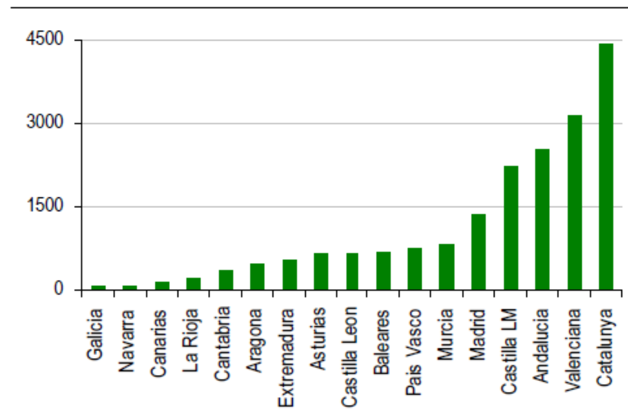
With each passing day, investors are more concerned about the situation in Spain, and the financial well-being of its autonomous regions. The chart below shows the Spanish government might be in despair to achieve the target of shrinking deficit to less than 1.5% in some regions. Five regions account for most of the needed adjustment (72%), they are Madrid, Castilla La Mancha, Andalucia, Comunitat Valenciana and Catalunya. These regions' deficit swelled partly due to substantial increase in health-related expenditure accumulated in previous years. These are one-off expenses and therefore will not weigh on this year's deficit. Netting them out, the needed adjustment is more manageable but still very ambitious.

Chart 1: Regional deficits as % regional GDP



Source: Spanish regions' consolidation plans

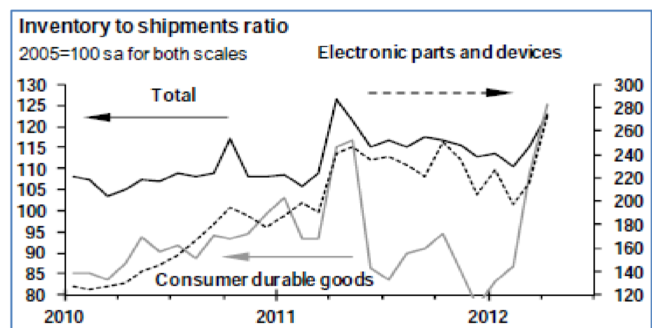
Chart 2: Needed fiscal contraction, € mln



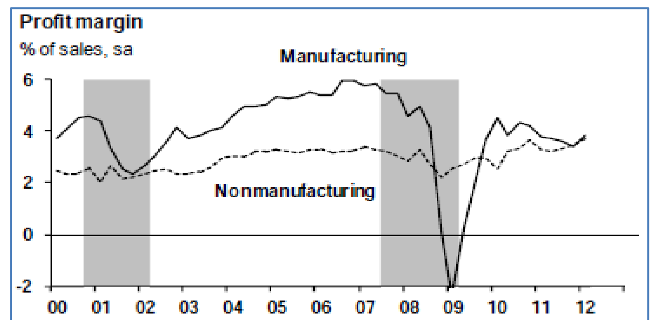
Source: Spanish regions' consolidation plans

Japan: Neutral

In Japan, the inventory to shipments ratio surged 6.6% in April after a 4.4% rise in the prior month, leaving it at its highest level since April last year, a month after the 3-11 Tohoku earthquake. Among all categories, the rise in durable consumer goods and electronic parts and devices is particularly notable.

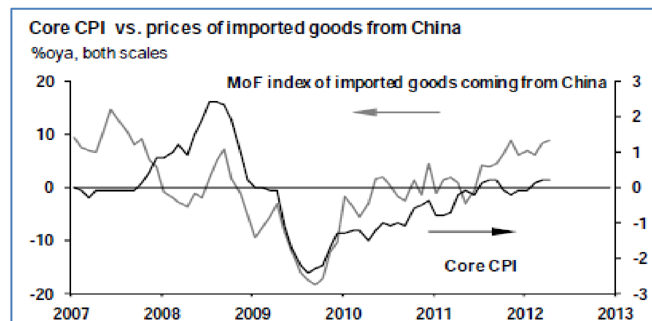


Q1 corporate profit was strong across different industries, rising 43.5% annually after a 7.4% gain in Q4 last year, mainly driven by manufacturing (89.8%). This came on the back of a 5.2% increase in sales, but profit margins also expanded for both manufacturing and nonmanufacturing sectors which is more encouraging.



However, some observers pointed out the outlook for profits could be in doubt given the yen's sharp rise recently. A stronger yen reduces overseas earnings when translates back into local currency. Also, there is question about sustainability of the strength of nonmanufacturing sector, especially when the fiscal stimulus effect from the rebuilding process begins to fade.

Bank of Japan (BoJ) Governor Shirakawa noted in a recent press conference that China's double digit wage inflation will likely raise Japan import prices, and accordingly, the CPI.



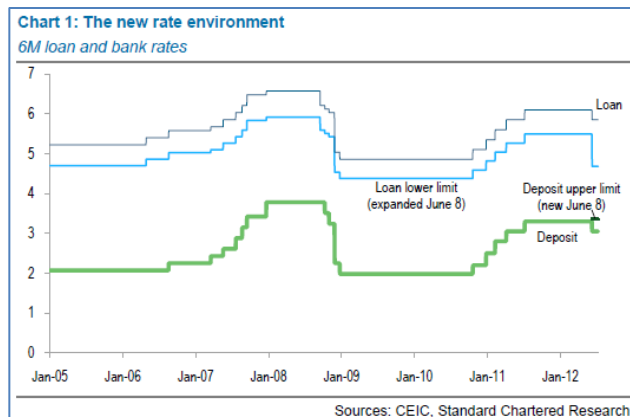
Dissenters argue that import prices do not have much impact on consumer prices in Japan. In addition, changes in prices of imported goods from China only have a partial impact to overall import prices in Japan. China accounted for 21.5% of total nominal imports to Japan in 2011.

China: Positive

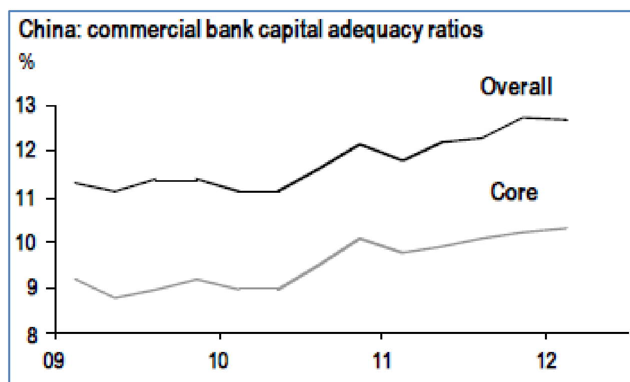
The People Bank of China (PBoC) announced the evening on June 7 a 25bps cut to both the benchmark lending and deposit rate. The new one-year benchmark deposit and lending rates are now 3.25% and 6.31%, respectively.

The first rate cut since Dec 2008, it sent a strong signal that the government is turning more active in supporting demand and stabilizing growth.

Perhaps more significant than the quarter point cut is PBoC allowing banks more flexibility in rate setting: deposit rates can float upward by as much as 10% (no upward floating before) and lending rates can float downward by as much as 20% (from 10% before). This is generally viewed as an important step in the direction of interest rate liberalization. Recent policy easing measures, including subsidies to promote sales of energy efficient appliances, may support for stronger economic growth in the second half of the year.



The State Council announced a new timetable for the implementation of Basel III regulatory framework in China. The original plan was for phasing in of higher capital adequacy ratios on January 1, 2012, and to be completed before end-2013 for systematically important banks (SIBs) and before end-2015 for other banks. Under the new timetable, Chinese banks will start to implement Basel III on January 1, 2013, and to be completed before January 1, 2019. Market welcomed the announcement for several reasons.



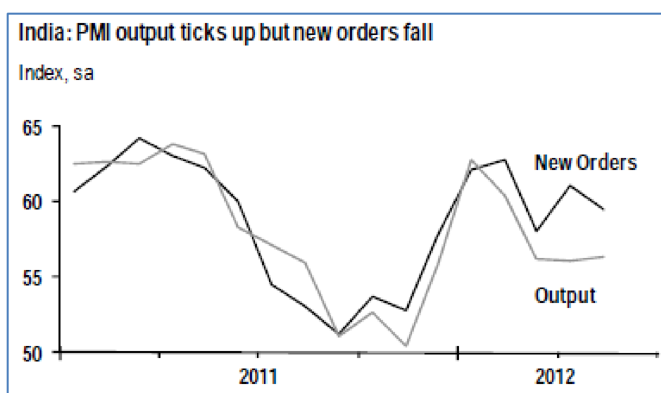
Firstly, the postponement of Basel III implementation is in line with the macro perspective of capital regulation, i.e. capital requirements should be stricter in economic upturns but relatively lenient in economic downturns. It allows banks to focus on supporting growth this year. Indeed, the State Council stated explicitly that the schedule of the transition period should help ensure reasonable growth in bank loans.

Secondly, China Banking Regulatory Commission (CBRC) can assign the risk weights of specific loans to support industry policies. In particular, SME loans and household loans receive favourable risk weights, which is supportive to the government's efforts to support household consumption and the SME sector.

Thirdly, despite the postponement, eventual implementation of Basel III will help Chinese banks to build up loss-absorption capacity and to improve risk management system. It is worth mentioning that the China version of Basel III is stricter than the international standard, by requiring higher core tier-1 capital adequacy ratio (5% vs. 4.5%) and a higher leverage ratio requirement (4% vs. 3%).

India: Negative

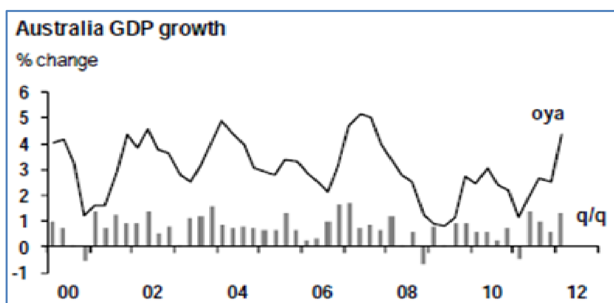
The latest manufacturing sector data brought no cheers to the market, with May's manufacturing PMI essentially unchanged, at 54.7 versus 54.8 the previous month. The PMI has been stuck in a tight range over the last three months.



The flat lined PMI, however, concealed divergent trends in the details. While the output index rose to 56.4 in May from 56.1, new orders moderated appreciably to 59.6 from 61.1. However, it mustn't be forgotten that this was on the back of last month's surge in new orders and so this component figure is not as bad as it look.

Asia Pacific: Mixed

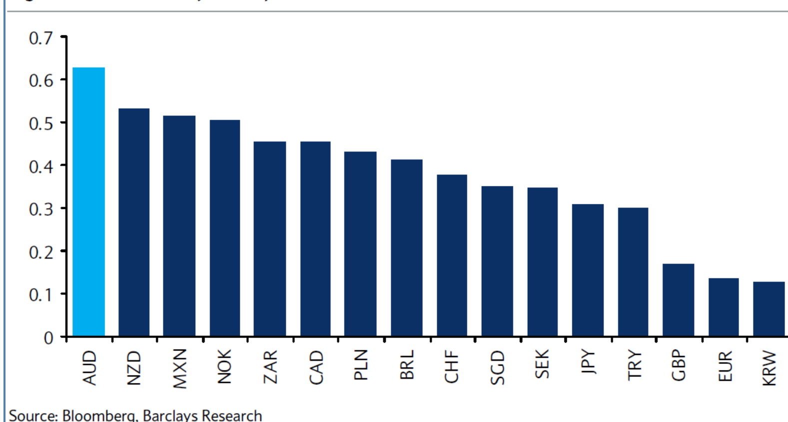
The Reserve Bank of Australia cut interest rate for a second straight month while the latest national accounts data revealed the economy grew at its fastest pace in more than four years (see chart to the right). The RBA's decision to ease policy appears counterintuitive to some. However, the national accounts may only be strong due to last year's low base while revealed little about



contemporary trends in the economy, which generally are weaker than in the March quarter. Indeed, days later, the jobless rate pushed back up above 5% in May, despite strong gain in payroll.

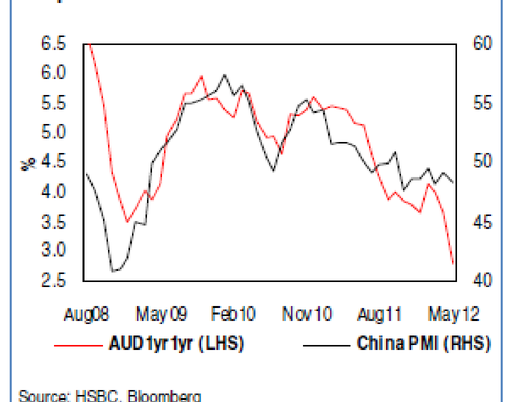
New researches confirm the ever closer relationship between

Figure 3: FX sensitivity to surprises from China PMI



Source: Bloomberg, Barclays Research

Figure 2: Falling China PMI drives front-end AUD swap rates lower



Source: HSBC, Bloomberg

Australia and China. For example, front-end AUD swap rates, Aussie dollar and Chinese imports from Australia exhibit strong linkages with China's economy. Using monthly data over the past three years, a regression analysis performed by HSBC found a correlation of 0.82 between HSBC's China PMI and 1yr AUD IRS. As such, disappointing China PMI data over past seven months has led to more entrenched expectations of a slowing Chinese economy and a subsequent decline in front-end rates. According to Barclays Research, the relationship between AUD and China PMI is 0.62. This indicates that if China can prevent the economy from hard-landing, the AUD can be stronger even amid sliding commodity prices. At the same time, Barclays point out the Aussie dollar has the closest relationship with the China PMI amongst all other currencies.

ASEAN: Mixed

Indonesia posted a trade deficit of US$0.64 billion in April, which is much weaker than expectations. The latest figure prompted a downward revision in the full-year BoP-based trade balance to US$19 billion from US$30 billion previously. This in turn reduces the full-year BoP position to a deficit of US$8.0 billion from a previous forecast of a US$2.3 billion deficit. The weakened balance of payments position has also led to a weakening in the FX rate.

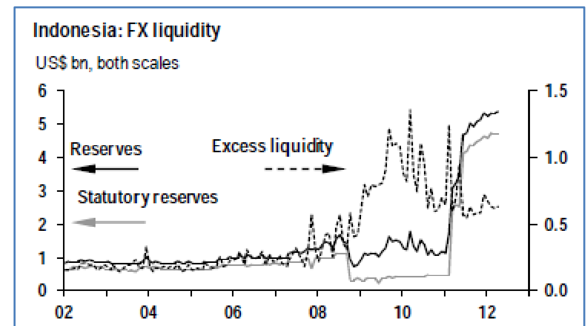
Indonesia: coal, LNG, and CPO exports and trade balance

	3Q10	4Q10	1Q11	2Q11	3Q11	4Q11	1Q12[1]
1. Coal (US$ bn)	4.4	5.0	5.5	6.5	7.1	8.1	6.4
Volume (MT)	68	76	76	86	90	101	82
Price (US$/T)	64.8	65.8	72.0	76.0	78.9	80.0	77.3
2. LNG (US$ bn)	2.8	4.4	3.8	6.9	6.8	5.3	5.5
Volume (MT)	6	12	7	10	9	8	8
Price (US$/T)	477	377	567	664	733	678	716
3.CPO (US$ bn)	4.3	5.9	3.6	6.0	5.1	5.6	5.0
Volume (MT)	5.3	5.8	2.9	5.1	4.6	5.8	4.9
Price (US$/T)	812	1023	1234	1175	1103	968	1031
a. Total (1+2+3)	11.5	15.4	12.9	19.5	19.0	19.0	16.9
b. Trade bal.	3.9	8.6	6.6	8.4	7.2	3.9	2.8
c. Trade bal. (b-a)	-7.6	-6.8	-6.3	-11.0	-11.9	-15.1	-14.1

1. Based on average of Jan-Feb data

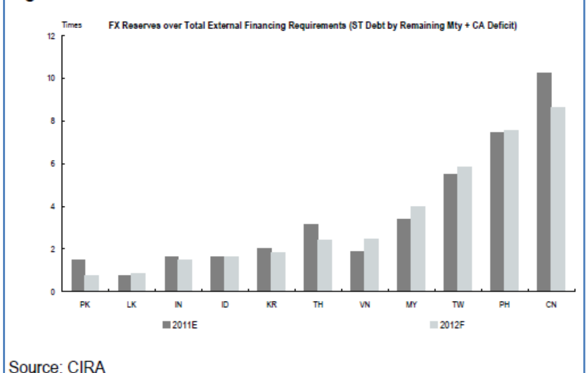
Aside from the balance of payments, inflation in May came in as expected. Some research suggests that the recent decline in oil prices will postpone the expected hike in domestic subsidized oil prices, which will alter the 2H12 outlook for inflation and policy rates.

Indonesia: FX liquidity



In response to the weakness in the FX rate and also to counter the fragmented FX liquidity in the banking system, Indonesia authorities set up a deposit taking facility that will accept US$ liquidity, ostensibly to redistribute liquidity in the banking system with the central bank as the conduit. The move to open the FASBI (Fasilitas Simpanan Bank Indonesia) to US$ would be one way to provide a conduit—by establishing Bank Indonesia as a central counterparty—for a more even redistribution of liquidity.

Figure 10. FX Reserve Ratios – Some Have More Ammunition

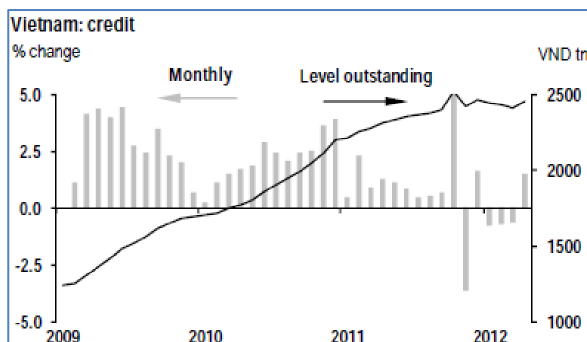


Source: CIRA

Amidst the sensitive and uncertain global environment, there is exacerbating risk of FX weakness when a country is highly reliant on portfolio flows to cover its external funding gap (large current account/basic balance deficit). For such a country, it has little capacity to mitigate FX volatility because FX reserve coverage is not "bullet proof", and excessive FX volatility is a concern given sizeable net external debt or sensitivity to FX pass-through on inflation. In Asia, this is most evident in Sri Lanka. This helps to explain the aggressive use of policy tightening measures of Sri Lanka since February to try to narrow the current account deficit and stabilize the currency amid inadequate FX reserves and relatively high external debt.

External imbalances also represent significant constraint for monetary policy in India. The private sector in India is a net external debtor but, more importantly, the inflation pass-through of rupiah weakness is relatively high, and could complicate inflation management. At the margin, this may also be increasingly a constraint in Indonesia – while not as vulnerable as the other two, Indonesia as a whole is a small net external debtor and does not have bullet-proof reserve coverage. Fitch estimates Indonesia's FX coverage at about 10% of GDP in 2011. In respond, the nation recently signalled intention to allow medium-to-long term bond yields to rise in order to attract inflows into the local markets.

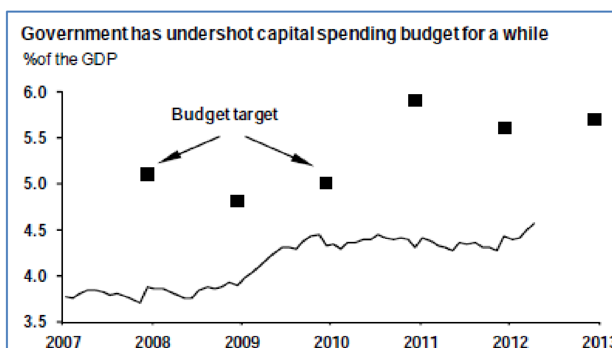
Easing of policy rates has been the main operating tool through which the State Bank of Vietnam works to stimulate economy this year. But recently, the government has begun to encourage credit growth as well. In April, credit expanded for the first time this year, and it will likely pick up in coming months. One notably absent aspect of this easing cycle has been a weakening of the Dong (VND) as another way to loosen monetary conditions.

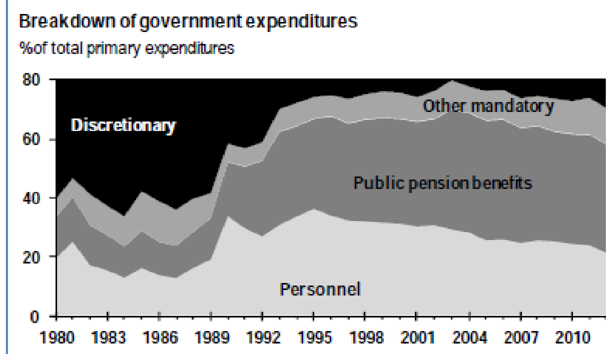


While lower policy rates have translated into lower market rates, the transmission mechanism is poor. To get a better sense of monetary conditions in Vietnam, credit and VND changes must also be taken into account. The gain in April's credit was attributable to government intervention in encouraging banks lending.

Latin America: Mixed

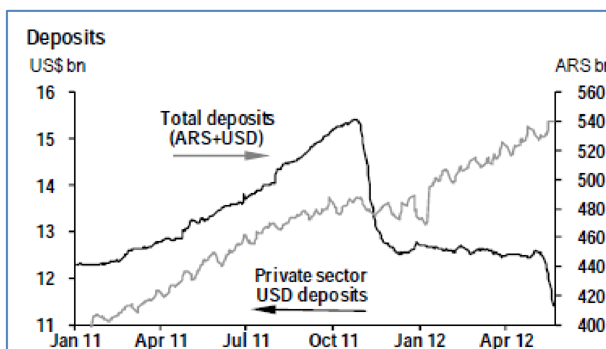
The state-owned Brazilian Development Bank announced a new round of interest rate cuts in its subsidized working capital lines to 6.0%-8.0% from 9.5%-10.0% while the average rate for those lines in the market is roughly 23%. The measure aims to stimulate private sector capex. On public investment, the decision was to speed up execution of existing infrastructure programs that have lagged behind schedule rather than impacting the primary surplus target. Apparently, the government will reduce the primary surplus target only in an emergency provoked by a global credit crunch. However, even the acceleration of government infrastructure spending already budgeted is not an easy initiative.





Indeed, execution of infrastructure projects has underperformed budget targets over recent years, a phenomenon that could be related to the inflexibility of the federal budget. With most of budget expenditures being mandatory (payroll, pensions, and other mandatory spending), any fiscal adjustment or disappointment with tax revenues is borne by a reduction in actual investment spending. President Rousseff should force an acceleration of much needed public investment this time and help to reignite short term activity.

The withdrawal of U.S. dollar deposits in Argentina from the banking system appears to be ongoing. It is an unintended consequence of the increased restrictions faced by the general public to access U.S. dollars at the official exchange rate (as a proportion of wage income and for traveling abroad). Although deposits are not affected by the measures, depositors associate them with increasing risk of future measures.



However, U.S. dollar deposits in local banks are a small fraction (less than $10.9 billion or 10% of total) of overall bank deposits and largely lie idle as U.S. dollar banking system reserves (estimated at $6.4 billion) at the central bank. Furthermore, total banking system deposits have continued to increase as peso deposit growth more than offset U.S. dollar deposit outflows.

Commodities: Negative

New U.S. sanctions against Iran will go into effect at the end of this month. These sanctions effectively block Iranian oil exports to countries that do business with the United States by imposing penalties on those engaging in transactions with the Iranian central bank.

These sanctions allow the U.S. President the power to grant waivers for countries promising to significantly reduce their purchases of Iranian crude oil. Typically, countries have been granted waivers in return for promising to reduce their purchases by about 20%. Among non-EU countries, only Japan has been granted a waiver. However, South Korea, Turkey, India, Taiwan, Sri Lanka and South Africa have all reduced or have promised to reduce their imports from Iran and are seeking waivers.

Exhibit 3: ... however, the policy risk to Iranian exports remains as US and European sanctions come into effect
Thousand b/d

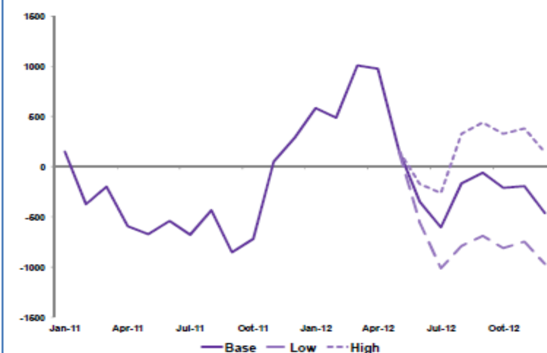
	2011 average	April estimate	2012 May - Dec		
			base case	low case	high case
Japan	305	189	215	24	290
South Korea	229	250	190	19	220
Turkey	185	107	145	13	142
China	557	390	594	650	531
EU	593	68	9	9	387
India	353	350	315	315	350
Taiwan	33	33	30	19	33
Sri Lanka	39	24	30	14	37
South Africa	98	70	77	39	95
Total exports	**2,392**	**1,481**	**1,605**	**1,101**	**2,085**

Source: IEA and Goldman Sachs Global ECS Research.

European Union sanctions are scheduled to go into effect on July 1. These sanctions consist of two main components: EU embargo and the prohibition on EU insurers from covering oil tankers carrying Iranian crude oil. In 2011, EU countries imported almost 600,000 b/d of Iranian crude oil. With the embargo coming into effect, those imports are falling to zero. The prohibition on EU insurers for providing coverage to oil tankers that carry Iranian crude oil after July 1 is also having a strong impact on Iran's exports. Around 90% of the world's tankers are insured via insurance pools or use reinsurance from EU companies, making the ability to obtain tanker insurance increasingly difficult. For example, Japan's imports from Iran fell to 190,000 b/d in April, almost 40% below 2011 levels, or double the reduction Japan pledged to obtain a waiver from U.S. sanctions. South Korean refiners have warned that they would need to suspend imports of Iranian crude altogether if no solution for insurance is found by July 1.

Among Iran's major crude oil customers, only China seems to be largely unaffected by the U.S. and EU sanctions. Despite the slight decrease of crude import at the beginning of the year, China ramped up its imports to 390,000 b/d in April from 254,000 b/d in March. It is expected that China will continue to increase its imports if sanctions go into effect, absorbing some of the Iranian crude that is displaced as a result of the U.S. and European sanctions.

Exhibit 4: We expect the world oil market to shift into a seasonally-adjusted deficit as demand picks up in 2H12...
Thousand b/d, 3-month moving average, OECD and Saudi onshore inventories and oil at sea

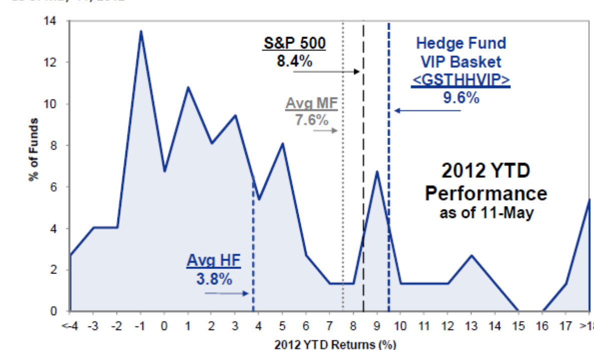


Source: IEA and GS Global ECS Research.

While the U.S. and EU sanctions are only going into effect at the end of June and beginning of July, the supply side of the oil market this year has been driven to a large extent by the anticipated effects of the sanctions. In Q1, the world oil market supply-demand balance was in surplus as Saudi ramped up its crude oil production to 30-year highs in order to prepare for offsetting the loss of Iranian crude oil to the market.

As the impact of U.S. and European sanctions come to bear on Iran, the loss of Iranian crude oil has returned the oil market to balance. Some observers expect the oil market will soon shift into a seasonally-adjusted deficit in 2H12 as demand picks up seasonally. The preliminary inventory data for May support the view that the oil market is tightening, in particular Japanese oil inventories appear continued building up.

Exhibit 7: Distribution of 2012 hedge fund performance
as of May 11, 2012



Hedge Funds: Mixed

The typical hedge fund generated YTD return of 4% through May 11 compared with 8% gains for both the S&P 500 and the average large cap core mutual fund. The standard deviation of all hedge fund returns was 7 percentage points, so two-thirds of hedge funds have generated YTD returns between -3% and +11%. Distribution of returns (right hand chart) provides more perspective than a single point estimate. More than 50% of hedge funds have generated YTD returns between -2% and +4%. 19% have returned more than 8.4%, outperforming the S&P 500, while 7% have returned 15% or more. 69% of funds had positive returns.

Hedging on equity exposure continues to drag on performance. Despite success with leading long positions, short stock selections have handicapped hedge funds so far in 2012. Hedge funds' net long exposure rose to 49% in 1Q 2012 vs. 46% at the end of 4Q 2011, just short of returning to the 50% net long exposure in December 2010.

Hedge fund strategies have mixed results. The average equity long/short fund has returned 4% YTD, versus an average of 0% for global macro funds and 10% for event-driven/relative value funds. Distribution of equity long/short fund returns YTD is much wider than for global macro funds but lower than for event-driven funds. About 24% of equity long/short funds posted negative returns through May 11 while 13% of funds returned more than 10%. However, almost 60% of global macro funds posted negative returns, and none returned more than 10%.

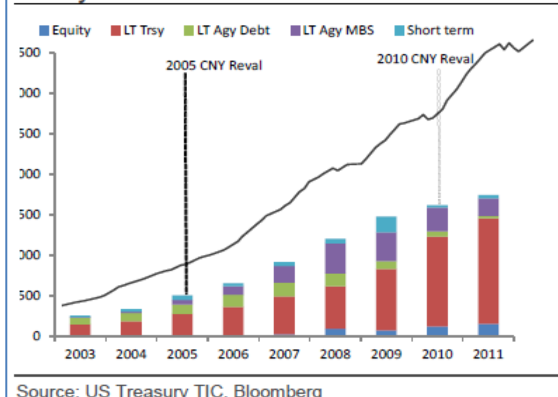
Bonds: Mixed

China's buying of long-term USD securities has undergone multiple regime shifts over the past several years. China became a large buyer of U.S. Agency debt, both debentures and MBS, after 2006. However, the 2008 financial crisis completely changed the mind-set and China switched back to investing most of its USD reserves in USTs, winding down its agency debenture portfolio as the implicit government guarantee was called into question. China also let its agency MBS portfolio start to roll off.

Since 2007, some of the increase in FX reserves also found its way into U.S. equities, likely driven by the allocation towards sovereign wealth fund investments. With recent Treasury International Capital (TIC) data showing China's slowdown in UST purchases, the annual data shown in the figure on the right shows that between 2010 and 2011 China was still a net buyer of USTs to the tune of almost $200bn. Moreover, China may be more open to the usage of futures and derivatives.

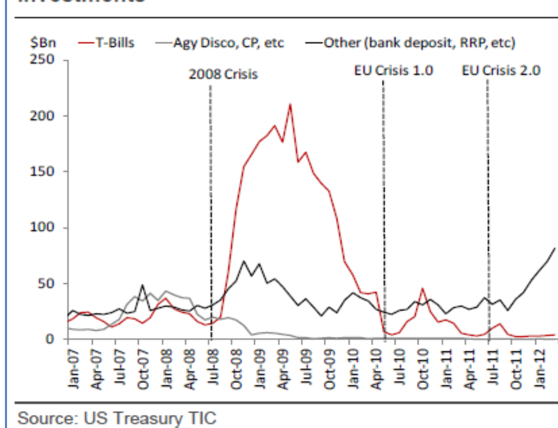
In the earlier part of the last decade, China maintained about 10% of its USD portfolio in the front end of the U.S. Treasury curve. During the conundrum years, front-end holdings fell to about 5%, but spiked right back up during the global financial crisis of 2008.Recently China extended out the curve for yield pick-up, such that the front end now accounts for just 2% of China's total USD portfolio. Also interesting is the shifting composition of China's front-end exposure. Like the allocation out of long-term Agencies into USTs, there is a similar move out of short-term Agency securities into Treasury bills. The flight-to-quality episodes of mid-2010 also saw an uptick in T-bills while in the EU crisis since summer 2011 there has been a sizable inflow into the "other" category captured by the TIC report, while T-bill allocation stayed low. "Other" mostly consists of bank deposits and reverse repos, albeit with no detailed breakdown available on a country level.

Figure 2. China's holdings of long-term US securities vs. FX reserve accumulation: Shifting to mostly USTs



Source: US Treasury TIC, Bloomberg

Figure 3. China's holding in short-term USD investments



Source: US Treasury TIC

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

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