AMG Market Commentary

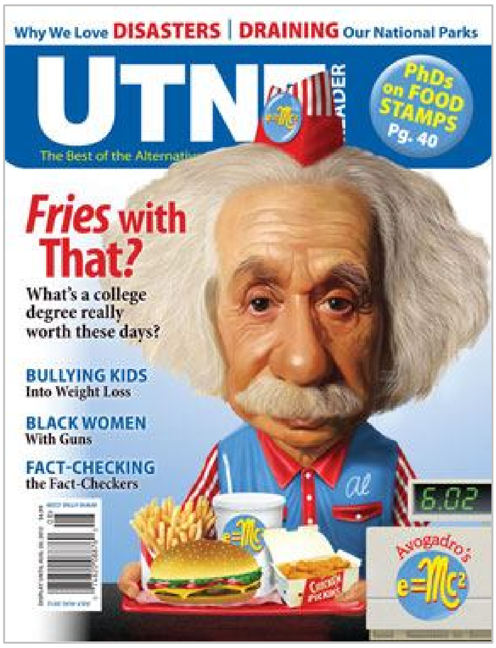
July 2012

Costs of Higher Education in the U.S.

Temperture has been stuck above 30 degree Celcius during day time for the past two weeks. I have been suffering and trying to fight off heat rush (熱痱) for about a week now. Friends and colleagues around are talking about and busily planning for family holidays. It's summer alright.

For graduating students, all examinations and thesis writings are done and completed. Many of them might be already in the midst of their long vacations to exciting foreign places. Even though it was well over two decades ago, I still remember vividly and fondly of my post-graduation back-packing trip seeing the World Expo in Vancouver, Canada. Ah, such happy time!

Inevitably, happy time ends and before long these newly graduates will have to confront the ever daunting task of job-seeking. While it's too early to say for sure how the situation in Hong Kong will fare for this year's graduates, it's fairly safe to bet it should be better than the situation in the U.S. and undoubtedly so in the Euro-zone. To begin with, university students in Hong Kong with outstanding government loans enjoyed highly flexible terms and low interest. Typically, the loan amount isn't excessive thanks to reasonably affordable tuition fees. In comparison, graduates in the U.S. are under tremendous pressure and having difficulty repaying student loans. This is the topic we wish to explore in this month's Featured Article.



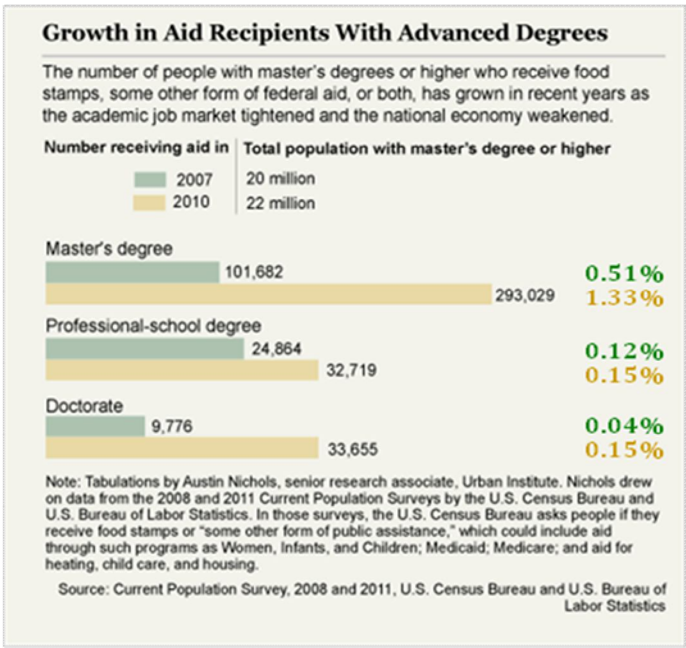
Last month, a report from the Federal Reserve Bank of New York found that as of end of March, outstanding educational debt in U.S. stood at US$904 billion, representing a 48% increase from US$611 billion at end of 2008. The amount has more than tripled in size since 2003, when the total amount was only about US$240 billion. More shockingly, the report found that student loans debt has surpassed credit-card debt as the second-biggest form of U.S. household debt in mid-2010.

In terms of delinquencies, the proportion of student loans that were 90 days or more overdue was 8.69% as of the first quarter (compare to peak of about 9.20% in late-2010). The delinquency rate was about 6% back in 2003. The report noted it is a higher delinquency rate than for almost any other form of consumer debt, including auto loans and home mortgages.

That report stirred this writer's curiosity. The high delinquent rate isn't hard to imagine given the anemic economy recovery in the U.S. and weak job market. The latest figure on average length of unemployment at 46 weeks, which is down about 10 percent from peak, speaks clearly how difficult it is for people with experience finding a new job. For fresh graduates with no working experience, the task is doubly challenging. Without any income, it is only reasonable they cannot repay their student loans. But to what extent are their indebtedness? Or to put it other way, how much debt outstanding do they owe? That calls for further investigation.

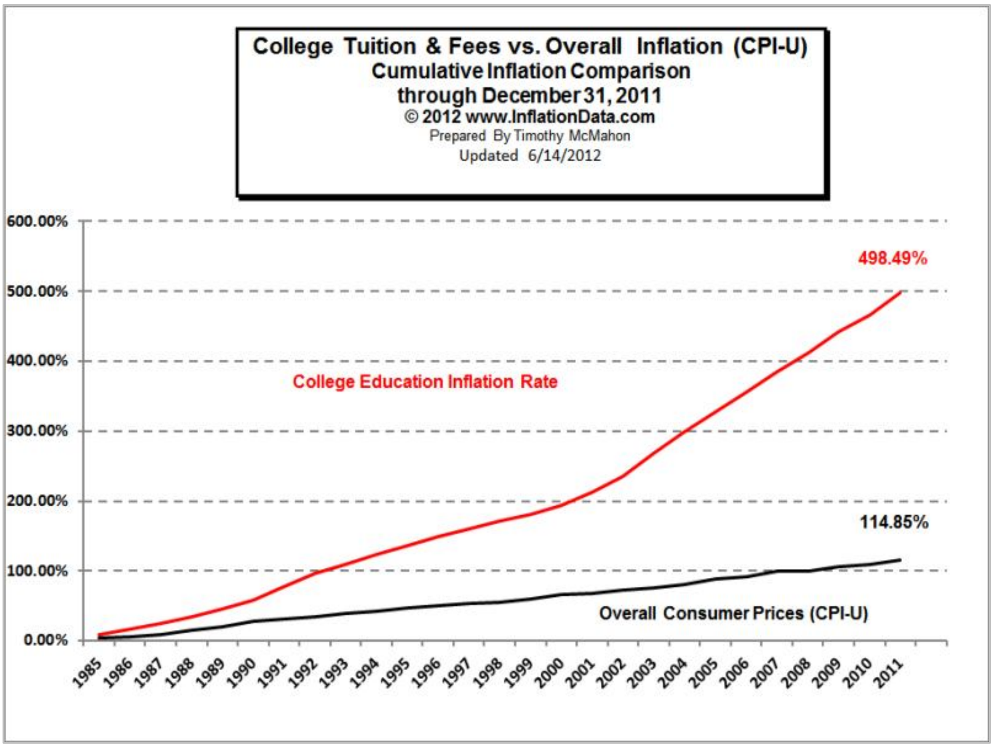
While surfing on the internet, this writer stumbled onto a magazine cover (shown at the bottom of the preceding page) depicting a cartoon figure of Albert Einstein dressed in uniform selling hamburger and french fries behind a cashier. A tag line on the right hand top corner of the cover says “PhDs on FOOD STAMPS” grabbed my attention. Digging further, it turned out it wasn’t a comical line.

According to the chart on the right, there were 22 million people in the U.S. with master’s degrees or higher at end of 2010. Of these, 293,029 master’s degree holders received food stamps and/or other forms of federal aid. 32,719 with profession-school degree were aid recipients. And 33,655 doctorate degree holders received aids. Looking at this number as a percentage of total population with higher education, which at 0.15%, may not seem alarming. However, the perspective is quite different when consider the rate of change over a short period of time.



Compare to figures at end of 2007, which is the year preceding the Great Recession, the number of people with master’s degrees or above has risen by about 10 percent. Yet the number of aid recipients with master’s degree nearly tripled, and the number of doctorate degree holders who relied on federal aids was nearly three-and-a-half times as that three years ago.

Those were grim and gut-wrenching statistics for graduates of higher educational studies, but let’s get back to our questions as to how did they get to such low point. Well, blame it on soaring costs of education. Throughout modern history and pretty much across all nations, except those countries whereby the government pays for all levels of education such as Brunei and Finland, costs of education have climbed much faster than general items. The chart below shows inflation in college tuition and fees compare to overall inflation (i.e., CPI) in the U.S. From 1985 to 2011, overall inflation has risen by 114.85% while higher education inflation surged nearly 500%! Readers with a keen eye might also notice education inflation ascended on a steeper slope since early-90s.



In 1992, the U.S. government introduced the Federal Stafford Loan, handing out government-backed student loans without parent income restrictions. The government’s intention was to help more Americans becoming more educated and a better chance to *pull ahead*, meaning getting higher paying jobs and climbing the social ladder.

The intention was good and indisputable, but with the government making it exceptionally easy for students to borrow massive amounts of money, colleges followed the lead by increasing their tuition rates. After all, it’s a freely operating market and price is determined by supply and demand. With rising demand for higher education, so goes higher price for it. Today the average undergraduate student loan debt is nearing US$20,000. Those who go on to graduate school often end up with an additional US$30,000. Law and medical students report an average accumulated debt (from years of undergraduate and graduate study) of US$91,700. Some estimates the cost of attending colleges will soar to US$120,000 by 2015. By the way, that figure apply to state universities. The costs for studying in one of the Ivy League (or similar grade private) universities are many times more.

The table to the right is taken from estimates provided by Harvard University to help potential students to calculate the Cost of Attendance for the 2012-13 school year. There's no dispute on tuition and most other figures, but the estimate on personal expenses seem a little low. For students attending Harvard, is it reasonable to expect they can get by on monthly personal expense of US$288? Besides, there is no mentioning on costs of textbooks and other study aids. Hence, *caveat emptor*.

Tuition	$37,576
Health Services Fee	$930
Student Services Fee	$2,360
Room	$8,366
Board	$5,264
Subtotal	**$54,496**
Estimated Personal Expenses	$3,454
Estimated Travel Costs	$0-$5,000
Total billed and unbilled costs	**$57,950 - $62,950**

In his new book *'The Price of Inequality'*, Nobel economist Joseph Stiglitz wrote "America likes to think of itself as a land of opportunity," …… unfortunately, today the "numbers show that the American dream is a myth … the gap's widening." Since 2008 "the top 1% of U.S. income earners captured 93% of the income growth…. **The clear trend is one of concentration of income and wealth at the top, the hollowing out of the middle, and increasing poverty at the bottom**."

It used to believe that education is the bridge that allows people at the lower rank to attain higher social status. Today, however, with costs of education shooting through the roof, unless the U.S. government does something about the system, education might be one of the reasons people got stuck at lower class.

Market Review & Outlook

U.S.: Neutral

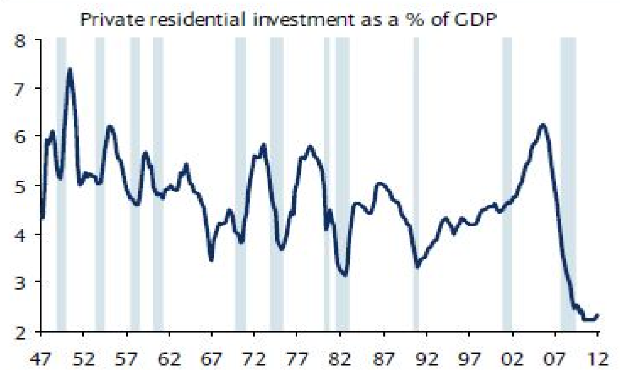
PMI of U.S. for June fell sharply to 49.7, the first under-50 reading since July 2009. There was a sharp reduction in the new orders component, down 12.3 to 47.8, the largest one-month decline since September 2011. However, the slide in the PMI could be just a catching-up with regional Fed indices. For a few months, the PMI had been consistently outperformed other regional indices, including the Philly and Chicago measures. Weaker external demand from Europe and Asia also contribute to falling ISM new orders.

FIGURE 4. ISM MANUFACTURING AND REGIONAL FED MANUFACTURING SURVEYS

Sources: Markit, Thomson Reuters Datastream, ANZ

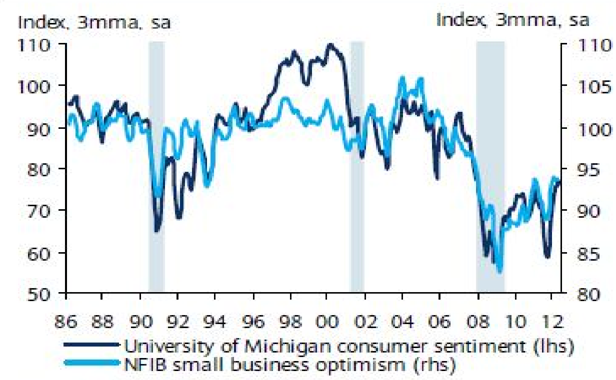
While there is widespread agreement that the pace of growth in U.S. is slow, some analysts go further and suggest that the economy is highly susceptible to falling into recession. There is least optimism about the housing market, the epicentre of the last recession. Residential investment as a share of GDP stands at 2.3%, up only slightly from the record low of Q3 2010. However, with new home inventories at a record low and falling, it's unlikely housing investment will be cut back significantly in coming quarters. In contrast, it is probable for investment sentiment to trend higher, along with job and income growth.

Figure 1: Residential investment spending near record low



Source: BEA, Haver Analytics

Figure 2: Consumer and business sentiment remain weak



Source: University of Michigan, NFIB, Haver Analytics

The FOMC meets next on July 31-August 1 and has tied further policy accommodation to the lack of "sustained improvement in labor market conditions". June marks the third straight month that monthly job growth below 100k. Monthly average job growth has slowed sharply in Q2 to 75,000 compared with 226,000 in the previous quarter. The June payroll report tilts the Fed toward further easing, but it may not be weak enough to compel the Fed to action at the July 31-August 1 meeting. Nonetheless, the 8.2% unemployment rate and the general softness of the job market remain worrisome and underscore the downside risks to the economic outlook.

The right hand table provides details of employment picture over the past few months which shows not all are negative. Employers are currently relying on a extended average workweek (34.5 hours per week in June vs 34.4 in May) to meet their production objectives, but with the workweek now near its average of the previous expansion any ramp up in production schedules may require more employees. Earlier, it has been reported industrial production increased 0.4% in June. Had all the increase in production implied by the longer hours been satisfied only with increased headcount, private payroll employment would have increased by an additional 325k. Other data may suggest potential new demand for production workers. Nearly all the 13k increase in employment in the goods producing industries was accounted for by supervisory employees. Increased hiring of managers tends to lead hiring of production workers, suggesting that a pickup in hiring of production workers may lie ahead. Another sizable increase in hiring of temporary workers (25k) may also point to more permanent hiring ahead. Temporary workers now account for about 2.3% of all private sector jobs, very close to the previous business cycle peak.

Figure 3: Employment report details

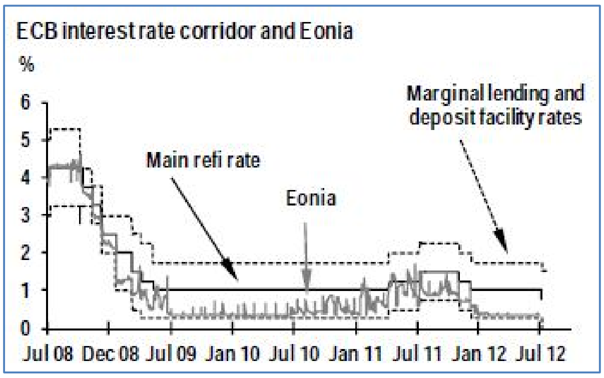
	6-Month Avg.	Feb-12	Mar-12	Apr-12	May-12	Jun-12
Total Payrolls	132845	132720	132863	132931	133008	133088
Change	**150**	259	143	68	77	80
Previous Est. Change	**197**	*259*	*143*	*77*	*69*	
Diffus. Index--Priv. Sect.	**62.0**	**62.2**	**63.5**	**58.1**	**59.8**	**57.9**
Diffusion Index – Mfg.	**61.9**	**63.0**	**69.8**	**55.6**	**53.7**	**51.2**
Private sector	**159**	254	147	85	105	84
Manufacturing	**26**	30	42	10	9	11
Construction	**-6**	-1	-14	-7	-35	2
Services (Priv)	**136**	218	119	81	126	71
Retail Trade	**3**	-15.2	-14.9	24.2	2.1	-5.4
Government	**-8**	5	-4	-17	-28	-4
Household Survey						
Employment	**271**	428	-31	-169	422	128
(Non-Ag. Priv. Employ.)	**395**	812	336	135	172	12
Unemp. Rate	**8.2**	8.3	8.2	8.1	8.2	8.2
Participation Rate	**63.8**	63.9	63.8	63.6	63.8	63.8
Establishment Survey						
Wkly. Hrs. (Production)	**33.8**	33.8	33.7	33.7	33.7	33.8
Mfg. Hours	**41.7**	41.9	41.6	41.7	41.6	41.7
Overtime	**4.2**	4.2	4.2	4.2	4.2	4.3
Avg. Hrly. Earn($)- all workers	**23.39**	23.34	23.37	23.40	23.44	23.50
% Change	**0.2%**	0.26%	0.13%	0.13%	0.17%	0.26%

Source: BLS; Nomura

Europe: Negative

The ECB cut all three of its policy interest rates by 25bp early in July. The main refinancing rate is now 0.75% and the deposit facility rate is at zero. The latter implies that short-term rates will decline to zero. As generally expected, no collateral easing or new LTROs were announced, but the door was left open.

ECB's latest actions are justified given that macro data have failed to improve. Mario Draghi admitted that effectiveness of the cuts was less than in normal times, given the segmented nature of financial markets and the high level of risk aversion (as reflected in low credit demand). In short, the ECB can help but cannot address all problems at their root cause.



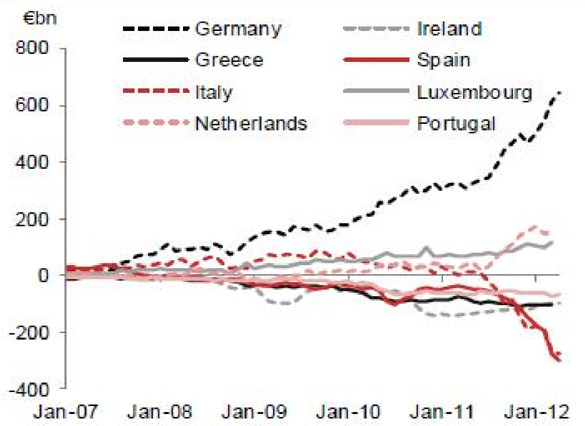
While it is possible for the ECB to move to a negative deposit facility rate or broad-based asset purchases, Draghi is concerned whether all parts of the region are able to cope with such moves. Below are potentials issues if ECB decide to significantly cut interest rate:

Technical considerations	Can all trading and payment systems handle 0% interest rates? Are there operational risks that some banks may not have the technical infrastructure in place to handle this? Markets have coped with negative Swedish and Swiss interest rates. Recently the Danish central bank stressed that it "has the instruments to handle potential negative interest rates".
ECB deposit facility becomes irrelevant	In the past, banks can move excess reserves from their ECB current accounts into the deposit facility, where these reserves could earn at deposit rate of 0.25%. Now that the deposit rate is cut to zero, there is no incentive for banks to use the ECB deposit facility, meaning excess deposits might be left in banks' current accounts.
Greater disintermediation in money markets	With money market rates close to zero, returns for lending in the interbank market may not be sufficient to compensate for counterparty risk. As such, market participants will need to borrow from the ECB instead. The end result would be more reliance on ECB borrowing and the ECB would increasingly become the sole provider of money market liquidity. This would prolong the ECB's exit strategy.
Delays balance sheet adjustment	Pushing interest rates to their de facto lower bound could signal that rates will remain low for a very long time. The ECB is aware that this could lead to new lending bubbles and may delay the inevitable deleveraging process.

The ECB cutting the deposit rate to zero has led to the closure of several European money market funds. This is because with rates at zero, these funds would have a negative yield after fees, which presents a significant obstacle to asset managers and investors alike. Indeed, some euro secured rates are already negative.

TARGET2 is an interbank payment system for the real-time processing of cross-border transfers throughout the European Union. The graph shows how the cumulative TARGET2 credits and liabilities are distributed across the euro area. It is clear that the TARGET2 is a zero-sum concept; the sum of all the imbalances is zero.

Figure 2. Target 2 imbalances



Source: National CBs and Nomura Global Economics.

In 2007, the TARGET2 imbalances were minimal, typically no more than +/- €70bn. But since the onset of the financial crisis in September 2008, the imbalances have continued to widen and accelerated in 2012. By March 2012, the Bundesbank had run up the largest credit (€616bn) followed by the Dutch central bank (€154bn), the central bank of Luxembourg (€115bn) and the central bank of Finland (€63bn). In contrast, the Banco de Espana and the Banca d'Italia, Central Bank of Ireland had accumulated the biggest TARGET2 overdraft (at €303bn, €279bn and €102bn respectively by April 2012).

Why have TARGET2 imbalances been rising since 2008? First, the financial crisis and the subsequent European sovereign debt crisis have increasingly shut out the periphery banking system from the interbank market. This means that private sector capital inflows into the periphery banking system have dried up. But the TARGET2 flows have partly substituted for the lack of private capital inflows. At the same time, parts of the periphery banking system are experiencing deposit flight prompting the ECB to step in as a lender of last resort and provide liquidity via its refinancing operations.

Japan: Neutral
Japan's economy might have reached a low-growth equilibrium. GDP grew at an average 1.23% rate during 1994-2007 compared with U.S.'s growth over the same period at an average of 3.1%. However, U.S. population grew 1% p.a. faster than Japan’s.

Some economists have lamented more aggressive monetary policies should be adopted to boost growth and, particularly, to eradicate deflation. But Japan’s weak growth could be more reflective of structural issues. One of them is the so-called “balance-sheet recession, meaning that Japan’s build-up of corporate debt in the 1980s during the triple bubble period was so extreme that it is inevitable that private-sector growth would be slow until debt come down. Another is Japan's failure to implement necessary structural reforms to open up new sources of growth. With much of the services sector constrained by rigid rules limiting competition and new entrants, there was little room to spur growth, especially with Japan’s large manufacturing companies is moving out to elsewhere.

Lastly, Japan has been in almost continuous deflation (falling core consumer prices) since 1998, with the general index down about 4% in aggregate. In contrast, CPI in the U.S. is up almost 40% over the same period. Japan’s debt overhang would have been easier to tackle with some inflation and perhaps the economy would have been more flexible and better able to signal new investment opportunities.

Figure 7: Japan’s bank lending is marginally positive
Loans and discounts y/y %

Sources: Bloomberg, Standard Chartered Research

Figure 8: Japan’s inflation expectations are rising
Breakeven inflation expectations 7Y

Sources: Bloomberg, Standard Chartered Research

China: Mixed

The People's Bank of China surprised markets by announcing on July 5 cutting the 1-year lending rate target by 31bp (to 6%) and the 1-year deposit rate by 25bp (to 3%), effective the following day. This is the second rate cut in a month, the previous move was on June 7, and continued an asymmetric rate cuts.

PBoC's latest move is in response to weak loan growth and soft investment activities. PMI for new orders have declined further in June to below 50-mark.

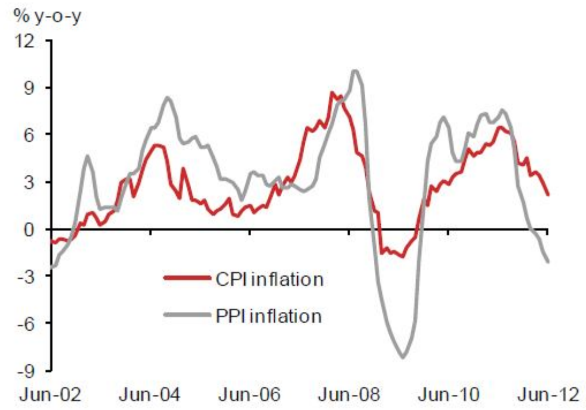
Further lowering of the lending rate floor (to 0.7x benchmark rate from 0.8x) is also a surprise, especially coming so soon after last month's adjustments. The minimum 1-year lending rate is now 4.2% (30% discount on benchmark rate of 6%), approaching the AA+ corporate bond yield of 3.89%.The asymmetric reduction between the lending and deposit rates could further shrink margins of banks. Profitability in the banking sector seems to have hit a major turning point.

Figure 1. PBOC Rate Change History

Benchmark lending rates (%)	20-Oct-10	26-Dec-10	9-Feb-11	6-Apr-11	6-Jul-11	7-Jun-12	6-Jul-12
6 month	5.1	5.35	5.60	5.85	6.10	5.85	5.60
1 year	5.56	5.81	6.06	6.31	6.56	6.31	6.00
1-3 year	5.6	5.85	6.10	6.40	6.65	6.40	6.15
3-5 year	5.96	6.22	6.45	6.65	6.90	6.65	6.40
Over 5 year	6.14	6.4	6.60	6.80	7.05	6.80	6.55
Deposit rates (%)							
Savings	0.36	0.36	0.40	0.50	0.50	0.40	0.35
3 month	1.91	2.25	2.60	2.85	3.10	2.85	2.60
6 month	2.20	2.50	2.80	3.05	3.30	3.05	2.80
1 year	2.50	2.75	3.00	3.25	3.50	3.25	3.00
2 year	3.25	3.55	3.90	4.15	4.40	4.10	3.75
3 year	3.85	4.15	4.50	4.75	5.00	4.65	4.25
5 year	4.20	4.55	5.00	5.25	5.50	5.10	4.75
Chg (bps)	**20-Oct-10**	**26-Dec-10**	**9-Feb-11**	**6-Apr-11**	**6-Jul-11**	**7-Jun-12**	**6-Jul-12**
6 month	24	25	25	25	25	(25)	(25)
1 year	25	25	25	25	25	(25)	(31)
1-3 year	20	25	25	30	25	(25)	(25)
3-5 year	20	26	23	20	25	(25)	(25)
Over 5 year	20	26	20	20	25	(25)	(25)
Deposit rates (%)							
Savings	0	0	4	10	0	(10)	(5)
3 month	20	34	35	25	25	(25)	(25)
6 month	22	30	30	25	25	(25)	(25)
1 year	25	25	25	25	25	(25)	(25)
2 year	46	30	35	25	25	(30)	(35)
3 year	52	30	35	25	25	(35)	(40)
5 year	60	35	45	25	25	(40)	(35)

Source: PBOC, Citi Research

Fig. 1: CPI and PPI inflation



Source: CEIC, Bloomberg, and Nomura Global Economics

Fig. 2: Sub-components of headline CPI inflation

	Weight* %	May % m-o-m	Jun % m-o-m	Jun average
Foodstuffs	31.0	-0.8	-1.6	-1.4
Tobacco and alcohol	3.4	0.2	0.1	0.0
Clothing	8.6	0.1	0.0	-0.3
Household items	5.6	0.1	0.1	0.0
Medicine and medical care	9.6	0.1	0.1	0.2
Transportation and comm.	10.4	-0.3	-0.5	-0.1
Recreation and education	14.0	-0.1	0.0	-0.4
Housing	17.4	0.0	0.0	0.1
Overall CPI	**100**	**-0.3**	**-0.6**	**-0.5**

The CPI basket is estimated based on the announcement by China's National Bureau of Statistics on 15 February 2011. June average refers to average m-o-m inflation in June over the period of 2005 - 2011

Source: CEIC, Bloomberg, and Nomura Global Economics

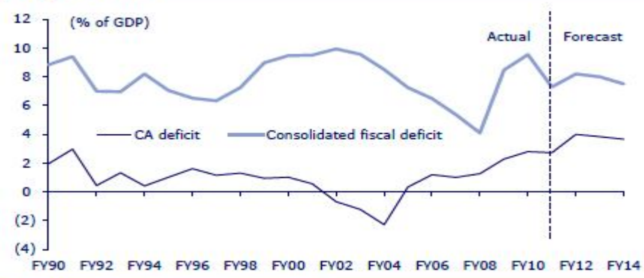
China's CPI dropped to 2.2% YoY in June from 3.0% in May. The sharp decline in inflation was partly driven by lower food prices, being the largest weighting in the CPI basket. Food price inflation slowed to 3.8% YoY from 6.4% in May, while non-food inflation remained unchanged at 1.4% in June. The decline in input prices for industrial producers accelerated to -2.5% in June from -1.6% in May. Lower PPI was driven by both weak domestic demand and lower commodity prices. The gap between output and input prices continued to widen, which helps profit margins for manufacturers. Lower inflation offers space for further policy easing ahead.

India: Negative

For about two decades, India has managed to grow rapidly despite deficits on fiscal and current account balances. The rationale has been that high capital inflows facilitate a stronger credit cycle, which in turn boosts GDP. However, the twin deficits have became unsustainably high and global capital inflows have turned more volatile and weaker.

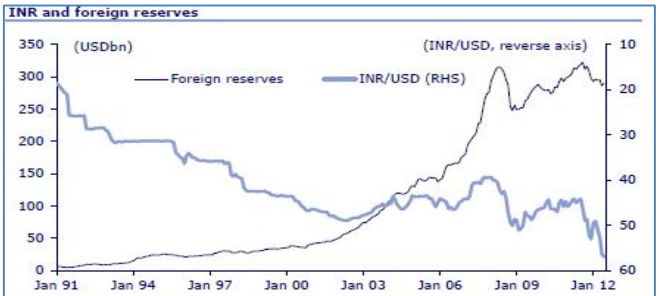
Since capital flows are more volatile than trade flows, the only effective nearterm sensible action is currency depreciation or, if the country has a pegged exchange rate, currency devaluation. Often, because currency weakness is viewed negatively, central banks fight the needed currency adjustment by running down foreign exchange reserves. This typically results in a decline in import coverage, worsens external liquidity ratios, and eventually still leads to currency devaluation.

Pesky twin deficits



Source: CLSA Asia-Pacific Markets, CEIC, RBI, MoF

INR and foreign reserves



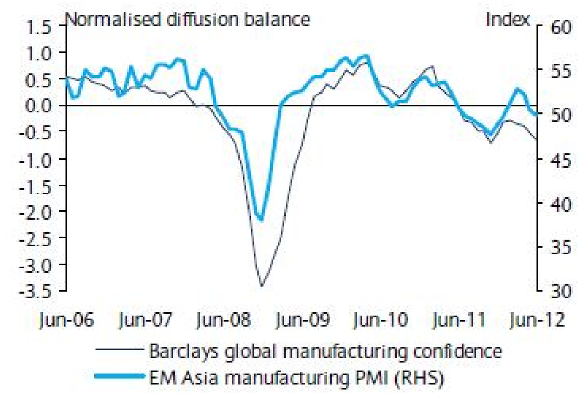
Source: CLSA Asia-Pacific Markets, Bloomberg, CEIC, RBI

To reduce impact from global factors, Reserve Bank of India might have to make several adjustments. First, the CA deficit has to shrink to a more sustainable range of 2-2.5% of GDP (from around 4% in FY12). Second, a much greater share of financing the CA deficit has to be long-term in nature and less reliant on risk-driven global capital inflows. And third, the RBI has to increase its stock of foreign reserves.

Asia Pacific: Mixed

The turmoil in Europe has caused global manufacturing confidence and new orders to deteriorate significantly in June, posing downside risks for Asia exports in coming months.The downturn in confidence may have been an overshoot due to heightened fears surrounding Europe. The risk to Asia's export machine has certainly risen, contrary to the better picture that emerged in the May export data across the region.

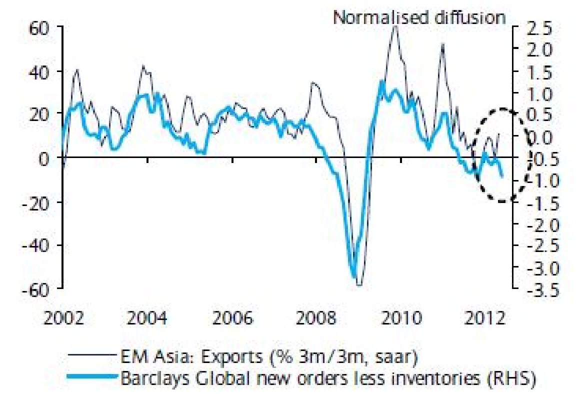
Figure 1: Asia PMIs also fell, in line with the US and Europe



Source: Haver Analytics, Barclays Research

Asia export growth so far this year has swung abruptly from negative to positive and back to negative again. This has been a result of volatility in China and to a lesser extent, India. Even after stripping out these larger countries, it is evident that export momentum for the rest of Asia has been on a downtrend since April, particularly in Korea, Singapore and Taiwan. In fact, only Thailand is bucking the downtrend, but that has been idiosyncratic and related to the resumption in production after last year's floods. Thus, the export rally in Q1 was simply pent-up demand due to easing shortages of automobile and electronic parts.

Figure 2: The small uptick in export momentum may not last

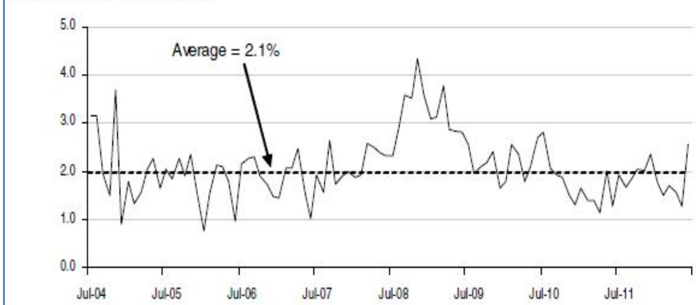


Source: Haver Analytics, Barclays Research

Not surprisingly, weak demand from Europe, which makes up 15% of total exports from Asia, has been a big drag. For the region as a whole, shipments to Europe were down 5.5% YoY in the first five months, and there is little evidence that the slump is bottoming. Korea has been the most affected, owing to its large exposure via vessel shipments. India, for which Europe is among the largest trading partners, has also suffered, but a large part is due to valuation effects. Growth in Asian exports has been supported by U.S. demand, up 9.4% YoY YTD, but these gains are at risk given the recent softening in U.S. indicators.

Meanwhile, cash levels at Asian funds are slightly higher than historical average. Average cash levels for Asia ex- Japan funds since 2004 are at 2.1% (% of AUM) compare to current cash levels which stand at 2.6%. This is about the same level as seen in July 2011, but well below levels of late-2008.

Cash levels in funds (Asia ex-Japan)

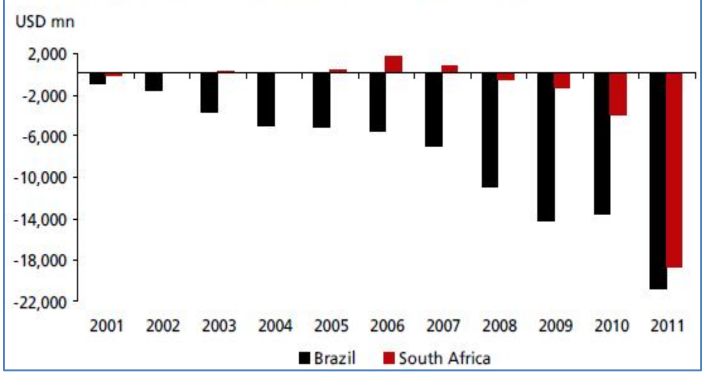


Source: EPFR, HSBC

Latin America: Negative

Thanks to China's insatiable demand on natural resources, Brazil has been enjoying sizable trade surplus. The chart on the right shows China's trade deficits against Brazil and South Africa. Brazil's exports to and imports from China grew at just about the same pace on average over 2001-2011, with exports mainly driven by primary commodities and precious stones (over 93% in 2010).

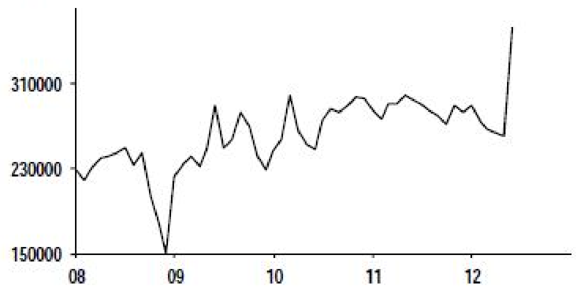
Chart 8: Deepening trade deficits with South Africa and Brazil



Increasingly, trade imbalance has been a point of contention between China and Brazil. Both sides have underlined the need to increase the value-added component of bilateral exports at the G20 meeting in Los Cabos, as a mean of relieving the imbalance. On the sidelines of the Rio+20 environmental summit, China and Brazil agreed on a US$29bn currency swap agreement.

Brazil: monthly car sales (Fenabrave)

Total sales sa



In view of weakening growth momentum, Brazilian government has been adding stimulus and there are some early indications that the credit channel has turned more active, suggesting a turning point might be near. Recent private sector sentiment seems to have improved, as indicated in the uptick in car sales in June. It could be an early sign of stronger household demand. Normalization in credit supply could further fuel the recovery in the next months.

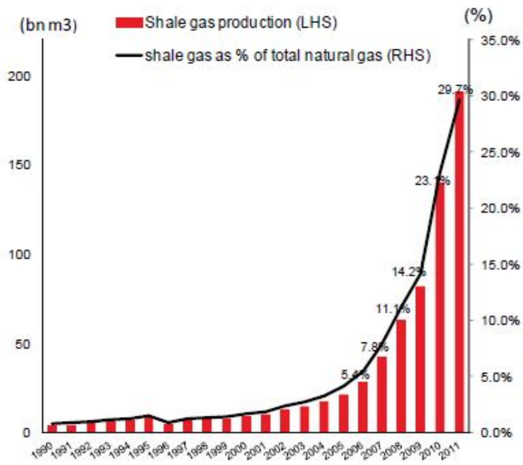
As for Brazil's neighbour, Argentina, which central bank (BCRA) recently banned the sale of USD in the formal FX market (at the official exchange rate) to individuals for sole purpose of savings. The authorities formalized what was previously being denied on a "de facto" basis. The measure serves to shield the government from lawsuits given that the arbitrary rejection of retail bids for USD was producing judicial demands against the state. It will force households to resort to the informal market to acquire USD, thus widening the parallel FX rate premium further (a large proportion of that demand was already channelled to the informal market).

BCRA's announcement carries four policy signals: (1) prioritizing BCRA reserves for external debt payments and imports; (2) unwillingness to devalue the official ARS; (3) tolerance for wide parallel FX premium and no interest in formalizing the de facto two-tier FX regime; and (4) pursuit of "pesofication" for domestic transactions like real estate purchases. The measure is being taken amid external cross-currents: on the positive side, the rally in prices of agricultural goods Argentina exports and decline in energy prices Argentina imports; and on the negative side, slippage in Brazil's demand for Argentine manufactured exports. The latter is highlighted by the contrast in June auto report between domestic sales, which slipped 1.6% YoY, and exports, which plunged 36.1% YoY.

Commodities: Negative

The U.S. shale gas revolution has led to the rapid substitution of natural gas for coal in the power sector. In Q1 2012, domestic demand for coal dropped 18.4% YoY, outpacing a 5.6% decline in national energy consumption during the same period. This essentially brought down the share of energy consumption by burning coal to a near 35-year low of 17%, against 22-23% over 2007-11, while the share of energy consumption of natural gas picked up markedly to 31%, from 23-24% over the same period.

Fig. 6: US shale gas production



Source: EIA, Nomura research

The ramp-up in shale gas production in U.S. has sent the price of Henry Hub natural gas to a near all-time low: the price was USD2.87/mmbtu as of June 27. According to Energy Information Administration (EIA), shale gas production in the U.S. jumped from 3.8bn cubic meters in 1990 to 191bn cubic meters in 2011, bringing the shale gas share as a percentage of total natural-gas production from 0.8% to 29.7% in the same period. The EIA forecasts U.S. shale gas production will reach 213.1bn cubic meters in 2012, for a gain of 11.6% YoY.

At the recently held McCloskey Coal USA conference, industry experts estimated that the coal market's share of power generation will decline from 31% in 2012 to 26% in 2020, equal to 40-50GW of coal plant retirements (15% of total) by 2018-2020. Coal power plants forecast to retire comprise 363 units and had total coal consumption of 65mt in 2011. Industry experts estimated that coal-to-gas displacement for 2012 would amount to 70mt, but with the potential for 50% of this figure to recover should gas moves above USD3.00/mmbtu.

According to Credit Suisse, aggregate non-OPEC oil production outside North America continues to undershoot. From the near-war conflict across South Sudan's new border with Sudan to the instability of Yemen and Egypt and the civil war in Syria, the destabilizing forces at work across the Mideast and Northern Africa continue to depress non-OPEC oil flows this year. More recently, labor issues are denting the production profile of Norway, which is a reliable North Sea giant. And growth is fading from erstwhile stalwarts such as Colombia, Brazil and Oman. Russia, meanwhile, recorded an output decline in June. Output from India, China and Australia remains far short of generally adopted national projections as well.

With some Australian miners now operating on extremely tight cash margins and DES ARA prices below the marginal delivered cost, demand for thermal coal has been better than many observers realised.

Credit Suisse also noted that recent thermal market commentaries have centred on weak demand. And that although inventories have built up rapidly in China, for example, on ample supply and relatively poor power generation, the broader picture is one of import records being set almost across the board. It is also argued that the imports of China and India are increasing steadily over the past few years which support the market price. Nevertheless, the surfeit of supply has swamped the market, pushing prices below marginal costs of production. As a result of this, miners are heading for a war of attrition, as those with squeezed or negative cash margins fight for market share and try to hold on, in the hope that others will cut before they do.

Hedge Funds: Mixed

Global financial market volatility remains elevated in June, despite the month ending on a note of optimism with regards to the European sovereign debt crisis. Financial markets were also dominated by concerns regarding bank trading losses, weak U.S. employment data and European elections. The Euro's rally against the USD towards end the month failed to avert a monthly loss, while bond yields in the U.S. ended the month modestly higher and high yield credit tightened. Global equity markets ended with broad-based gains, posting strong performance on the month's final trading day, with top contributions from financial sector, Spain & Italy and U.S. large-cap equities. Commodities experienced wide dispersion, with sharp declines in Oil, significant gains in Natural Gas & Agricultural and mixed performance across Metals. Hedge funds experienced mixed performance for the month, as Equity Hedge gains were offset by Macro declines. The HFRX Global Hedge Fund Index posted a decline of 0.30%, while the HFRX Absolute Return Index gained a fractionally 0.07%.

	Monthly Performance				Historical Performance		
	JUNE ROR	MAY ROR	YTD	INDEX VALUE (JUNE 29, 2012)	Last 12M	Last 36M (ann)	Last 48M (ann)
Global							
HFRX Global Hedge Fund Index	-0.30%	-1.69%	1.22%	1,122.95	-5.76%	1.39%	-3.89%
HFRX Equal Weighted Strategies Index	-0.39%	-1.22%	0.99%	1,109.73	-5.04%	2.08%	-3.33%
HFRX Absolute Return Index	0.07%	-0.24%	0.13%	947.75	-2.14%	-1.60%	-4.93%
HFRX Market Directional Index	-0.02%	-4.51%	-1.15%	1,010.02	-16.17%	0.23%	-5.83%
Equity Hedge							
HFRX Equity Hedge Index	0.52%	-3.07%	1.18%	1,012.31	-10.68%	-1.62%	-6.58%
HFRX EH: Equity Market Neutral Index	-1.46%	-0.44%	-4.96%	932.69	-10.18%	-2.51%	-3.59%
HFRX EH: Fundamental Growth Index	-0.26%	-3.60%	2.44%	1,443.50	-12.77%	1.30%	-3.59%
HFRX EH: Fundamental Value Index	0.93%	-1.92%	1.44%	937.29	-13.24%	-3.33%	-7.72%
Event Driven							
HFRX Event Driven Index	-0.57%	-2.01%	2.99%	1,346.30	-3.46%	2.21%	-1.41%
HFRX ED: Distressed Restructuring Index	-0.71%	-1.41%	3.04%	972.39	-5.89%	1.99%	-8.68%
HFRX ED: Merger Arbitrage Index	-0.54%	-0.21%	1.00%	1,508.61	-2.18%	2.87%	3.43%
HFRX ED: Special Situations Index	-1.04%	-2.34%	0.98%	1,082.72	-4.91%	2.31%	-2.42%
Macro							
HFRX Macro/CTA Index	-1.30%	0.36%	-1.81%	1,145.00	-4.55%	-3.80%	-6.17%
HFRX Macro: Systematic Diversified CTA Index	-3.92%	2.81%	-4.62%	1,565.63	0.07%	-0.09%	-0.44%
Relative Value							
HFRX Relative Value Arbitrage Index	-0.02%	-1.65%	2.13%	1,152.27	-3.31%	7.92%	-0.24%
HFRX RV: Convertible Arbitrage Index	0.75%	-0.65%	3.98%	681.18	-0.83%	9.05%	-8.64%
HFRX RV: Multi-Strategy Index	0.19%	-1.58%	2.06%	1,806.66	0.18%	11.15%	8.28%

The HFRX Equity Hedge Index posted a gain of 0.52% for the month, with gains in U.S. and European large caps partially offset by Asian and Equity Market Neutral exposures.

The HFRX Macro CTA Index posted a decline of 1.30% for the month, with weakness concentrated in Systematic Macro strategies only partially offset by gains from discretionary currency, commodity and fixed income exposures.

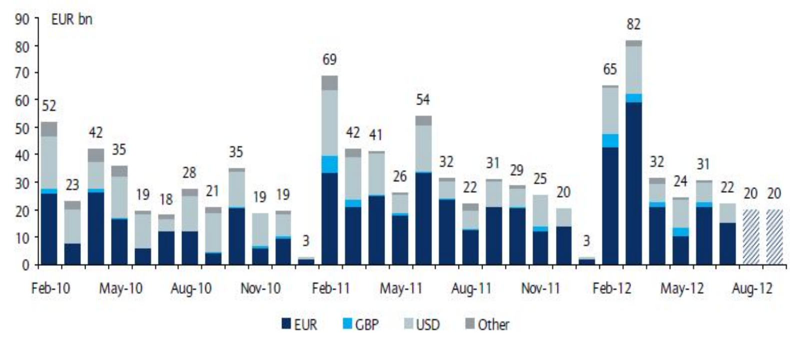
Relative Value strategies were narrowly changed for the month, with the HFRX Relative Value Arbitrage Index posting a decline of 0.02% as yields rose and arbitrage spreads tightened.

The HFRX Event Driven Index posted a decline of 0.57% for the month, paring YTD to +2.99%; gains in Activist strategies were offset by weakness in Distressed, Special Situations and Merger Arbitrage. T

Bonds: Mixed

Amid continued wariness among investors and demand for ‘risk-less’ yield, supranational, sub-sovereign and agency (SSA) issuers have exploit opportunities in the primary market and maintained their pace of fund raising. Total bond issuances among SSAs this year has been about EUR261bn. Even though we are nearing the main summer holiday season in Europe, the market still expect supply to continue in July and August. Somewhat with a twist is that future issuances may be more focused on USD, as appetite in the U.S. market seems to be buoyant and as supply in USD this year has been subdued.

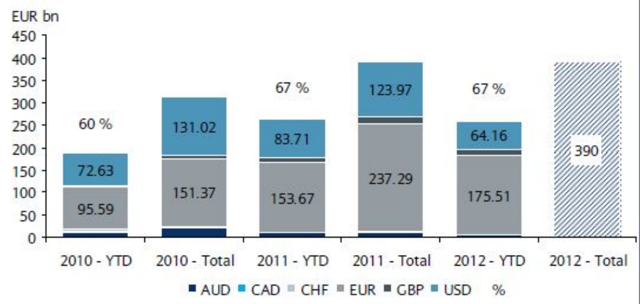
Figure 15: SSA total monthly supply by currency (€ bn)



Source: Barclays Research

Looking at the maturity distribution chart to the right, there are a couple of features worth noting. Shorter maturities, mainly up to 3 or maximum of 5 years, due to more difficult market conditions, have been dominated by issuers from peripheral countries and have seen less frequent issuance. On the other hand, there is strong demand from insurance companies and pension funds for very long-dated segment of 10+ years. European supranational issuers EFSF and EU have been active in this segment.

Figure 16: SSAs – YTD and total issuance comparison per currency for 2010, 2011 and 2012



Source: Barclays Research

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

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