AMG Market Commentary

October 2012

Markets Ascend Amid Bickering

Over the weekend of October 12-14, the world's top finance officials gathered in Tokyo, Japan for the annual joint meetings of the International Monetary Fund and the World Bank Group. According to official factsheet, ***The Meetings bring together central bankers, ministers of finance and development, private sector executives, civil society, and academics to discuss issues of global concern, including the world economic outlook, global financial stability, poverty eradication, jobs and growth, economic development, and aid effectiveness.***

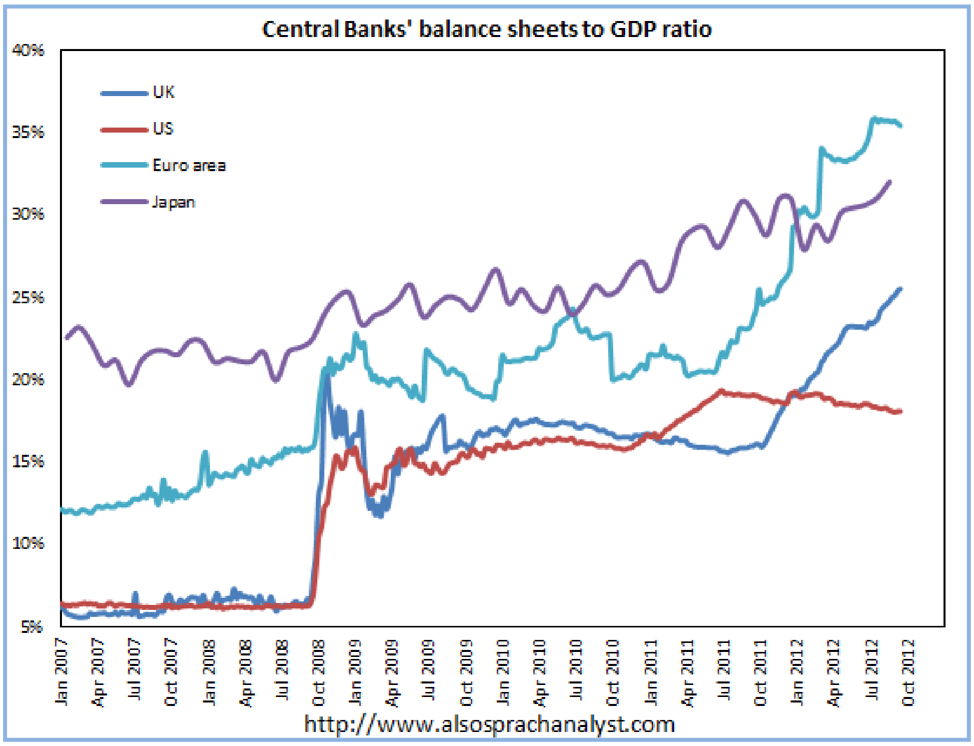
Those are certainly magnificent objectives, yet harboring the extent of superlatives in that more often than not words rang far louder than concrete agreements (let alone decisions) had typically resulted. This year is no exception. What was not lack of is economic babble from various high-powered attendees. An editorial opinion from Wall Street Journal wrote: *"Federal Reserve Chairman Ben Bernanke lectured that the world should welcome his dollar devaluation policy, no matter the upward pressure it puts on many other currencies. Brazil's foreign minister lectured the Europeans about their 'delayed reactions' to the crisis. The Europeans lectured the Americans about the looming 'fiscal cliff', and [U.S.] Treasury Secretary Tim Geithner returned the favor by lamenting the 'headwinds from Europe' hurting U.S. growth. The Japanese and Chinese glared at each another over contested islands, and the Chinese refused to send their most senior officials. Meanwhile, the poobahs at the International Monetary Fund lectures everyone about everything."* In short, there were plenty of bickering among attendees without reaching any tangible accord.

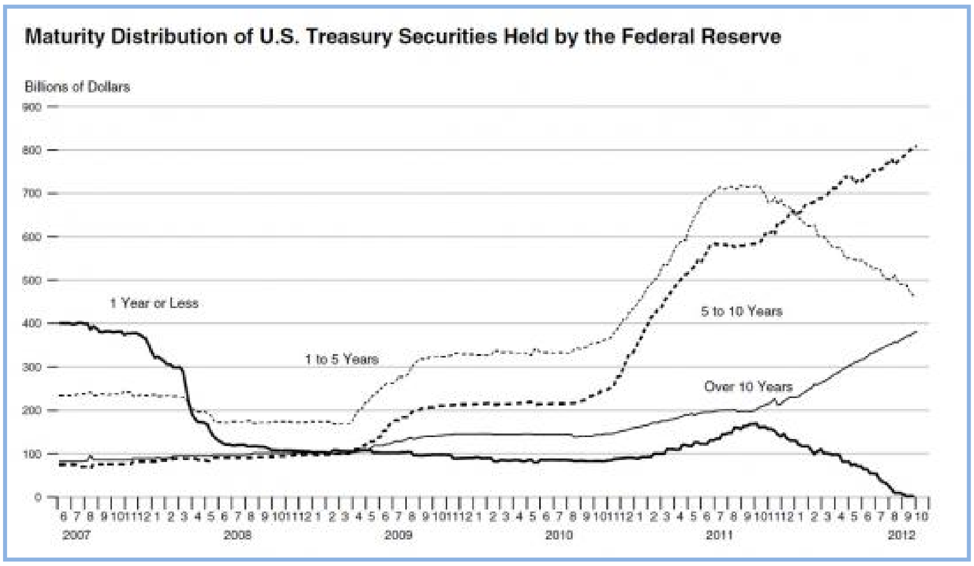
Country/Market	Index	One-year Return*
United States	DJIA	15.28%
	S&P 500 Index	17.60%
	Nasdaq Composite Index	14.86%
Canada	S&P/TSX Composite Index	1.23%
Brazil	Bovespa Index	10.70%
Mexico	Bolsa Index	20.55%
United Kingdom	FTSE 100 Index	6.38%
Germany	DAX Index	22.51%
France	CAC 40 Index	6.89%
Italy	FTSE MIB Index	-3.58%
Spain	IBEX 35 Index	-13.52%
Japan	Nikkei 225 Index	-0.53%
Australia	S&P/ASX 200 Index	6.80%
Hong Kong	Hang Seng Index	14.45%
China PRC	CSI 300 Index	-13.40%
South Korea	KOSPI	5.78%
India	S&P Nifty Index	11.03%

**Note: Local currency returns, as of end of Oct 15*

Amid all these squabbling, the never-ending Euro crisis and the impending fiscal cliff in the U.S., the above table showing latest 12-month returns of some of the world's major stockmarket indexes may surprise readers. As could be seen, most markets have performed positively in the past year, with more than a handful of them racking up double-digit gains. For example, the S&P 500 Index (SPX for short) is up about 18% in the past year, and gain so far in 2012 may make this the best calendar year return since 2009.

If the saying about "stock market being a mirror of a country's economic strength" holds true, does that mean the U.S. economy is far stronger than recent economic data imply? To that, we would advise investors to refrain from jumping to a quick conclusion. While the SPX's 116% advance since the market's trough on March-2009 was no small feat, this should be viewed against the various unprecedented and unconventional measures (namely, quantitative easing) the Federal Reserve has undertaken to boost liquidity and buoying asset prices. Moreover, the Fed is not the only central bank doing this.





The upper right-hand chart shows how balance sheets of the U.S. Fed, European Central Bank (ECB), Bank of England (BoE) and Bank of Japan (BoJ) have grown relative to their GDPs since 2007. Amazingly, despite the Fed's balance sheet growing from about US$800 billion before the financial crisis to just shy of US$2.8 trillion lately, in terms of GDP it is the least interventive among the major central banks.

On the other hand, it would be a mistake to think the Fed will have it easy when the time comes to unwind its colossal holdings of Treasury securities and mortgage-backed securities. The latter will continue to grow in size and proporation at a rate of $40 billion per month as stipulated by the Fed's QE3 purchase program.

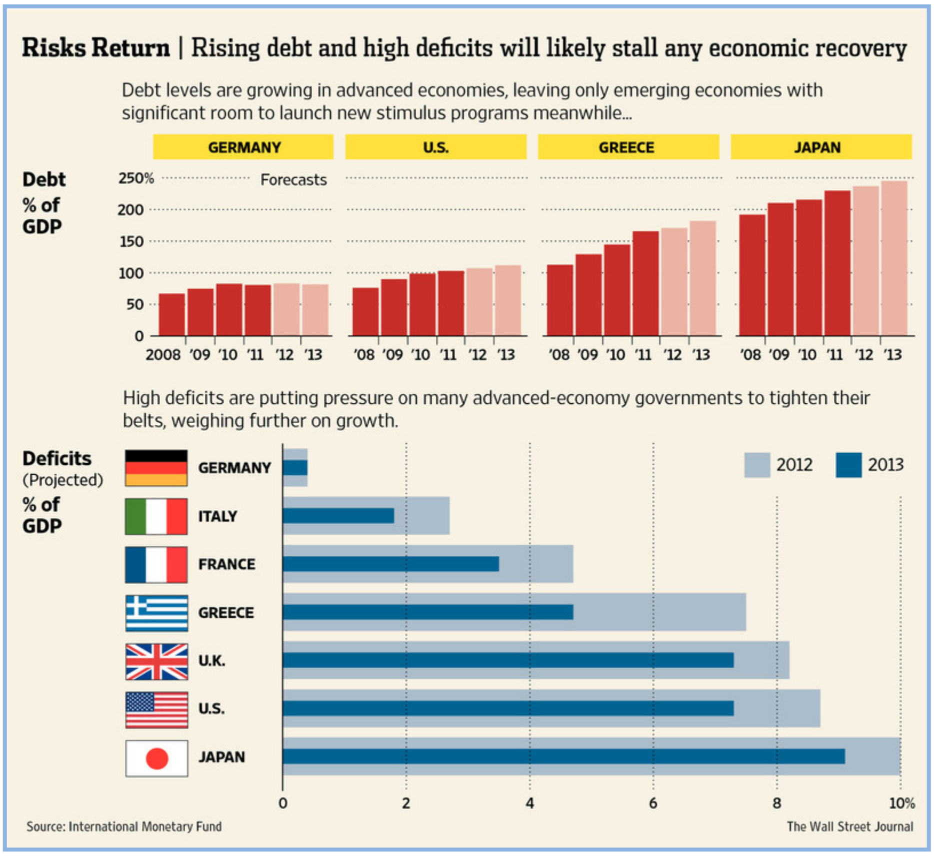
Apart from the sheer size of such holdings, it is equally important to consider what these securities consist of. The lower right-hand chart shows the types of Treasury securities held by the Fed and how have they changed over time. Before the financial crisis, the Fed used to mainly hold shorter-dated Treasury bills (with maturity less than a year) and Treasury notes (with maturity less than 5 years). As of late, the Fed hold almost no Treasury securities that mature within a year. In contrary, majority of its Treasury securities are maturing between 5 to 10 years, with a significant amount of them maturing in excess of 10 years.

If the Fed needs to unwind these longer-dated Treasury securities within a short period of time, this could potentially drive down bond prices, and hence cause a jump in bond yields. Alternatively, the Fed could stretch the selling period to minimize impact to market prices if it has the luxury to do so. Theoretically, it can be done. In practice though, no central bank has done this before so there's no precedence to observe or to be used as reference.

In addition to bloated central bank balance sheets, advanced economies also face the risks of high public debts and high fiscal deficits. This issue was clearly laid out by IMF Chief Economist Olivier Blanchard during the weekend meetings and graphically shown in the chart to the right.

Sometimes referred to as the "Twin Peaks", high debts and fiscal deficits will limit the ability for these economies to introduce further stimulus should their economies stumble again before long. At the same time, any new stimulus will likely be a lot less effective due to diminishing marginal return on same-old policies.

In his words, Blanchard says the global economy faces a really bad case of sickness that will take decades to resolve. His viewpoint echos ours.



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Market Review & Outlook

U.S.: Neutral

Exhibit 2

Quadrennial Presidential and Congressional Elections Since 1928

Presidential Elections Since 1928

Election Date	President Name	Incumbent Wins	President	Congress	Contested*	Gallup Margin**	Close Election***	Election Margin**
11/5/1928	Hoover		Republican	Republican	NA	NA	No	(17.4%)
11/7/1932	F. Roosevelt	No	Democrat	Democrat	NA	NA	No	17.7%
11/2/1936	F. Roosevelt	Yes	Democrat	Democrat	No	11.4%	No	25.0%
11/4/1940	F. Roosevelt	Yes	Democrat	Democrat	No	4.0%	No	10.0%
11/6/1944	F. Roosevelt	Yes	Democrat	Democrat	Yes	3.0%	No	7.6%
11/1/1948	Truman	Yes	Democrat	Democrat	No	(5.0%)	No	4.4%
11/3/1952	Eisenhower		Republican	Republican	Yes	(2.0%)	No	(10.8%)
11/5/1956	Eisenhower	Yes	Republican	Democrat	No	(19.0%)	No	(15.6%)
11/7/1960	Kennedy		Democrat	Democrat	Yes	1.0%	Yes	0.2%
11/2/1964	Johnson	Yes	Democrat	Democrat	No	28.0%	No	22.6%
11/4/1968	Nixon		Republican	Democrat	Yes	(1.0%)	Yes	(0.6%)
11/6/1972	Nixon	Yes	Republican	Democrat	No	(24.0%)	No	(23.6%)
11/1/1976	Carter		Democrat	Democrat	Yes	(1.0%)	Yes	2.0%
11/3/1980	Reagan	No	Republican	Divided	Yes	(3.0%)	No	(9.8%)
11/6/1984	Reagan	Yes	Republican	Divided	No	(18.0%)	No	(18.4%)
11/8/1988	G.H.W. Bush		Republican	Democrat	No	(12.0%)	No	(6.9%)
11/3/1992	Clinton	No	Democrat	Democrat	No	12.0%	No	5.6%
11/5/1996	Clinton	Yes	Democrat	Republican	No	11.0%	No	8.5%
11/7/2000	G.W. Bush		Republican	Republican	Yes	(2.0%)	Yes	0.5%
11/2/2004	G.W. Bush	Yes	Republican	Republican	Yes	0.0%	Yes	(2.4%)
11/4/2008	Obama		Democrat	Democrat	No	11.0%	No	7.0%

*Final Gallup poll within 3% margin of error.
**Democrat Less Republican
***Difference in popular vote is within 3%.

Source: Gallup, Factset, Morgan Stanley Research

There are no of statistical analyses and data mining with the clock ticking ever closer to the U.S. presidential election. The table above provides some interesting data of presidential elections since 1928. The final Gallup polls tend to be fairly accurate in predicting whether an election will be close or not. There have been 19 elections since 1936; 11 of these were decided by a "large" margin (more than 3 points), and in all of those elections the final Gallup polls had forecasted large margins. Only once was the Gallup poll completely inaccurate; in 1948 it predicted a Dewey victory but Truman actually won the election. In close elections the Gallup poll forecasts have been mixed. In 5 of the 8 elections where Gallup predicted a close race (within the margin of error of 3%), the actual tally was indeed close. Gallup predicted close elections in 1944, 1952 and 1980, but those elections were all decided at least 7 points.

The latest weekly Gallup poll suggests that the 2012 election will not be close, with Obama currently leading by 6 points, which is well above the margin of error. History also suggests that an Obama victory is more likely since only three incumbent Presidents, Herbert Hoover, Jimmy Carter and George H. W. Bush, have lost their re-election bid since at least 1900, while 10 incumbents have been re-elected.

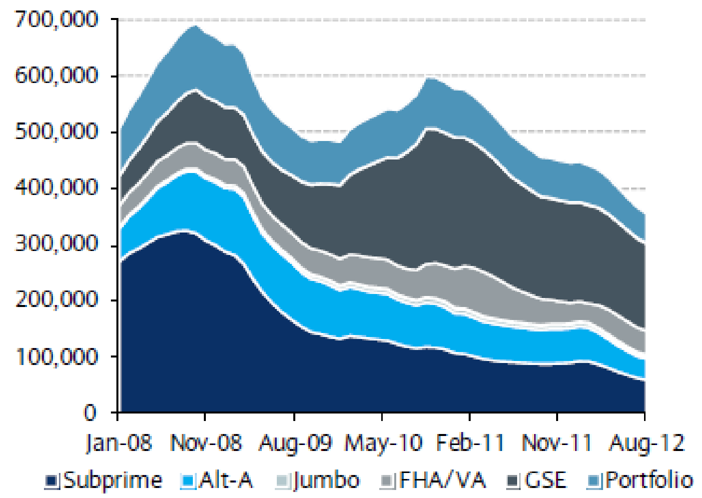
Figure 1: Election outcome probabilities

%	Obama	Romney
Democratic House and Senate	5.2	2.5
Republican House, Democratic Senate	35.8	17.3
Democratic House, Republican Senate	2.2	1.1
Republican House and Senate	15.0	7.2
Republican House, tied Senate	7.9	3.8
Democratic House, tied Senate	1.2	0.6
	67.4	**32.6**

Source: Intrade, Barclays Research

Housing has been a consistent bright spot for the U.S. economy this year, and general forecast is for home prices likely to surprise to the upside over the next few quarters for a number of reasons. Real estate inventory is at the lowest levels in five years, home prices look cheap-to-fair on a fundamental basis (though with wide regional variations) and U.S. home prices now have upside momentum. The latest week's Corelogic Home Price Index (HPI) report was the ninth consecutive month of positive seasonally adjusted price gain. August also brought further improvement to the foreclosure pipeline, with real estate inventory falling to 356K, the lowest level since August 2007. The U.S. housing market is at a point where much of the excess has been burnt off, one reason why prices could spring an upside surprise in the next few quarters.

Figure 3: REO inventory at lowest levels in 5 years



Source: CoreLogic LoanPerformance, GSE investor reports, MBA, FDIC, HUD, Barclays Research

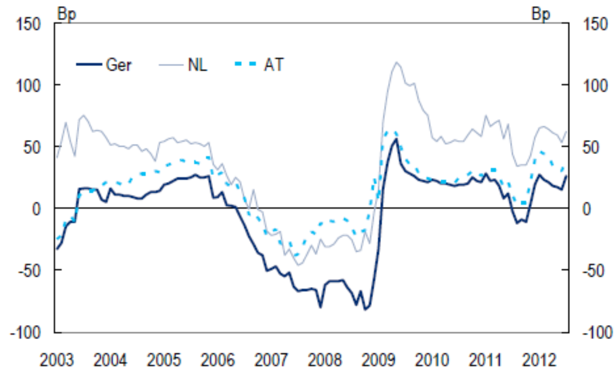
But investors should also exercise cautious against reading too much into such positive news on home prices. First, residential investment spending has already been helping the economy for the last few quarters (new home sales are up significantly over the last year from the lows of mid-2011) and the trend may not continue indefinitely. Second, many home-owners are still likely to stay underwater even if prices rise, say, 10 percent over the next couple of years (given how much prices have dropped from their peak). And finally, the ability of home-owners to tap home equity is more constrained than in the mid-2000s; mortgage lending standards are very tight and cash-out refinancing (i.e., how home-owners can tap into home equity) mortgages are rare. All in all, both the housing and the payroll data paint a picture of an economy that is growing in 2012 at a similar pace to 2011, without breaking out in either direction.

Europe: Neutral

July data show that banks in the core Euro countries have difficulties passing on the reduction in the ECB deposit rate to their own deposit holders. One indication for this is that the difference between the rate that banks offer to their clients for overnight deposits and the rate banks get from the ECB in the overnight deposit facility increased to the highest levels since the peak reached in early 2009, as a result of the global banking crisis.

For banks to compensate the costs of hoarding excess liquidity at the ECB, they may charge higher rates on their lending activity or to hold the excess liquidity in the form of cash (notes). The ECB's desired short-term effect of a negative deposit rate would be that, in order to prevent the penalty charge of storing access liquidity with the ECB, banks would decide to use excess liquidity to purchase assets or to expand their lending. However, even if banks would increase their lending activity, the reduction of the system-wide excess liquidity would be modest because of the low minimum reserve holding rate of 1%.

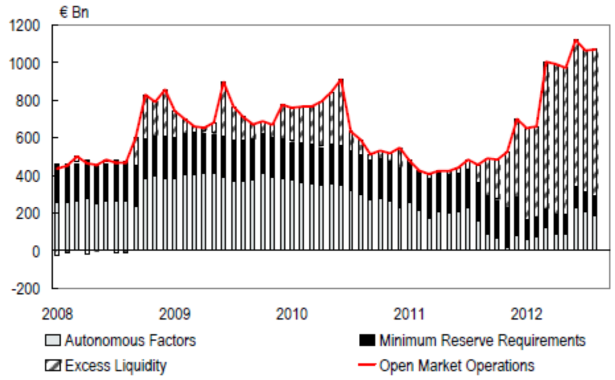
Figure 6. Core and Soft Core Countries – Spread between Rate for O/N Corporate Deposits vs. Rate for ECB Deposit Facility, 2003–Jul 2012



Sources: ECB and Citi Research

It is still uncertain whether the ECB will be able to get its desired effect from a negative deposit rate which would be an improvement in lending conditions particularly in respect of increasing transaction from core banks to periphery countries. Similar to the Danish Central Bank, the ECB might only be inclined to use negative deposit rate to reduce upside pressure on the currency. The ECB is unlikely to replace its "never pre-commit" policy by providing long-term guidance of low rates, as practiced by the Fed, to limit upside pressure on the currency.

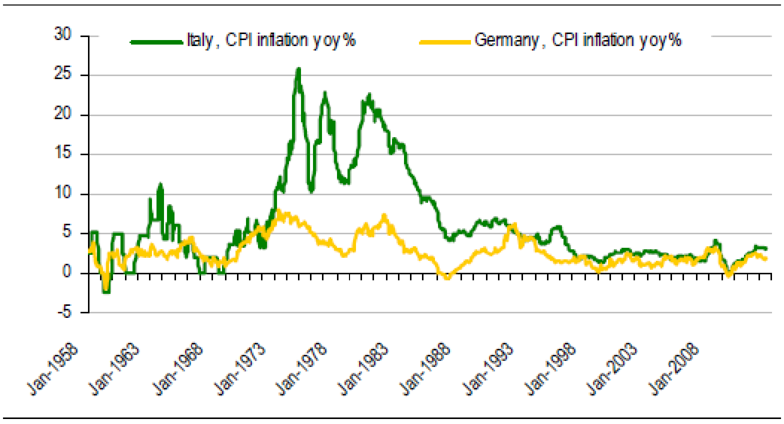
Figure 7. Euro Area — Open Market Operations and Excess Liquidity (EUR Bn.), 2008 – Sep 12



Sources: ECB and Citi Research

Many, especially in northern parts of Europe, fear that any solution to the euro crisis will involve inflation as a tool. If the euro zone inflation target remains at 'below or close to 2%' (the ECB's mantra) and, meanwhile, the periphery needs to turn more competitive, i.e., needs inflation rather close to or even below zero, this by definition means that inflation must exceed two percent in the core countries, mainly Germany. In a much-noticed speech in a Bundestag financial committee hearing earlier this year, the head of the Bundesbank economics department made it clear that his institution is very much aware of this. So if inflation above two percent is necessary and accepted as an unavoidable part of the overall solution even by Germany's austere central bank, it is particularly striking that Italian inflation is still hovering above Germany's.

Chart 3: Consumer price inflation in Italy and Germany, 1958-2012



Source: Haver, UBS

In the absence of room for deficit spending and the time it takes for structural reforms to generate growth, inflation provides an option to ease the pressure of fiscal tightening. This becomes even more important if we consider that the other realistic option, i.e., allowing for more time for fiscal adjustment in the periphery, is very unpopular among core-European politicians. So, this makes the absence of inflation look more like a threat than a relief.

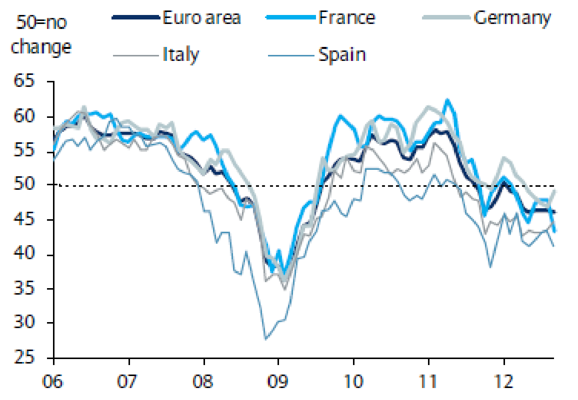
The fact that inflation could well work as a blessing rather than a curse in the near future of the euro area makes it even less reasonable to fuel worries of an 'Italianisation of central bank policies'. It is true that German savers have more reason to worry about inflation than private individuals in other countries, due to Germans' high savings but low exposure to real assets (housing, equities, commodities, etc). Yet it is also true that, on several occasions in the past, Germany has lived quite well with higher inflation for some time. In the aftermath of Germany's reunification, inflation ran north of 5%, without leaving long-term damage to its people's trust in the general solidity of monetary policy.

Composite PMI for the euro area fell to 46.1 in September, its lowest reading since June 2009. It has now been below 50 for 12 of the past 13 months. Although the manufacturing survey reported a slightly lower pace of decline, services activity contracted at its fastest pace for more than three years, emphasising the profound weakness in domestic demand. Looking at Q3 as a whole, the PMIs suggest that GDP growth might have been a touch weaker than the 0.3% QoQ contraction.

There are worrying signs that the contraction is broadening and deepening. France showed a particularly marked deterioration, with its composite PMI falling to level comparable to those of Italy and Spain. Although the composite PMI of UK remained above 50, the employment index fell sharply, suggesting that the prolonged stagnation in demand might finally impact the labour market. New car registrations data also emphasised the deterioration in confidence and demand. Registrations in the euro area's four largest economies fell 5.5% QoQ in Q3, hitting their lowest level in the history of the series (back to Q1 95). Again, the deterioration in France was striking (-7.7% QoQ), although it was surpassed by that in Italy (-9% QoQ).

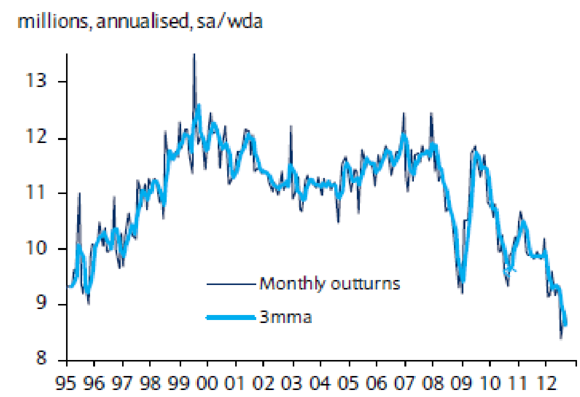
Undoubtedly, the worsening in European activity owes a great deal to the region's public finance crisis, both because the resultant fiscal tightening is a material drag on demand and because the threat of a major euro crisis has depressed sentiment. The goal of retaining, or re-attaining, credibility with financial markets has prompted more tightening measures to be announced. However, it is far from clear that the economic fundamentals will support further aggressive consolidation, and there are increasing concerns that the dreaded "doom loop" between the public finances and economic activity is spreading.

Figure 1: Composite PMIs show a broadening contraction



Source: Haver Analytics, Barclays Research

Figure 2: Euro area new car registrations have slumped

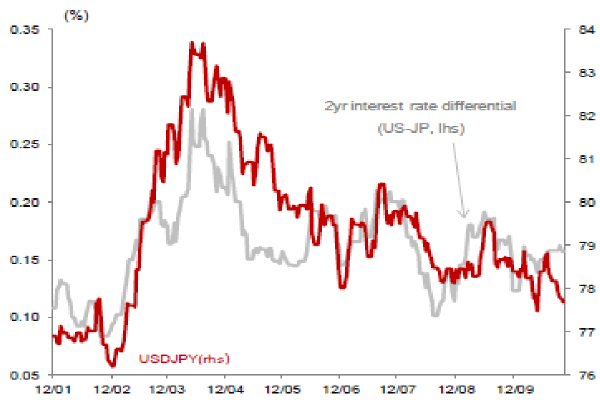


Source: Barclays Research based on national sources

Japan: Neutral

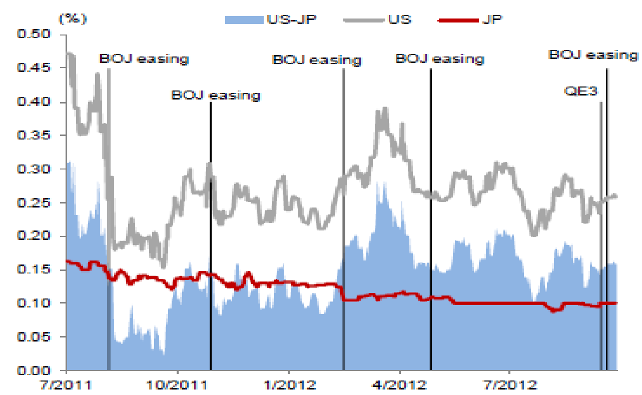
Right after the Fed announced the lateset round of quantitative easing (QE3), the BOJ decided to expand its Asset Purchasing Program. While USDJPY moved immediately after the announcement, the level of USDJPY changed little in the end. This is not surprising because a steady rate differential and an expected pace of balance sheet expansion both point to a steady USDJPY. Even though the correlation between the yield differential in the US and Japan weakened in 2H last year, partly due to Japanese intervention, the positive relationship has turned stronger again this year.

Fig. 1: 2yr rate differential (US-JP) and USDJPY



Source: Nomura, Bloomberg

Fig. 2: 2yr yields of US and Japan



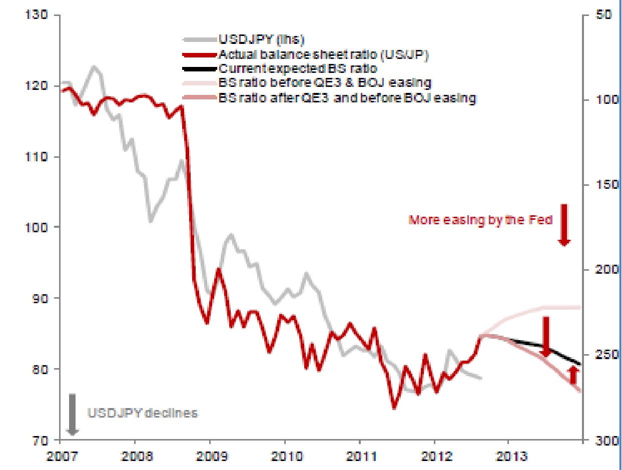
Source: Nomura, Bloomberg

A point to take note is that the latest easing by the Fed and BOJ had no meaningful impact on 2yr yields. Yields of JGBs shorter than 3 years to maturity were already close to 0.1%, the de facto lower limit under the current system. Even though the BOJ eliminated the lower limit for its JGB purchase operations at the same time as it expanded the APP, JGB yields will not decline significantly below 0.1% as long as the Bank sticks to offering 0.1% of interest on excess reserves (IOER).

The same is true for the U.S. As short-term yields had already declined considerably before the latest decision, limited room was left for the Fed to lower them further. The Fed's decision to purchase MBS but not Treasuries may also have contributed to the limited reactions of short-term UST yields.

Conceptually, private investors may purchase more risky assets including foreign assets as central banks continue supplying money by purchasing government bonds or other assets. In addition, as central banks hold more financial products, the risk of balance sheet deterioration rises, potentially raising inflation expectations and weakening the currency. Some analysts/investors may use the difference in pace of balance sheet expansion as a proxy of the aggressiveness of monetary policy easing and possible leakage into foreign assets.

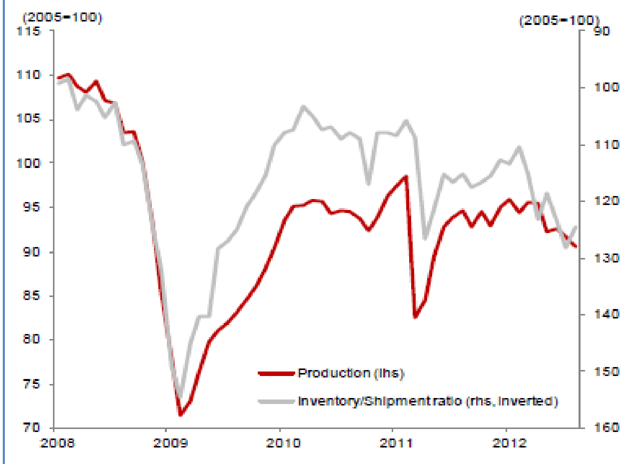
Fig. 5: Relative size of balance sheets of central banks (US/JP) and USDJPY



Source: Nomura, BOJ, Fed, Bloomberg

However, the correlation between the relative size of balance sheets and USDJPY has not been strong. In addition, it is not clear that the path of relative balance sheets influences FX as long as increased money is parked in low-risk domestic assets. Thus, the small difference in the pace of balance sheet expansion may not necessarily suggest a clear downtrend of USDJPY. If investors consider difference in size of nominal GDPs, the BOJ"s balance sheet expansion can be regarded as bigger than the Fed's.

Fig. 4: Production and inventory/shipment ratio



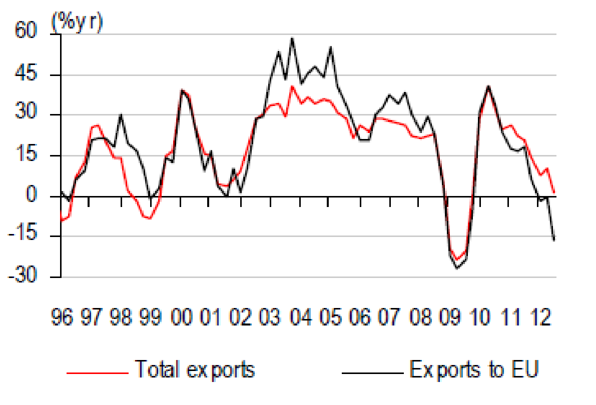
Source: Nomura, METI

Recent economic data suggest Japan's economy slowed in Q3, but the slowdown may not necessarily deepen in Q4. August production declined by 1.3% from the previous month, weaker than consensus expectation. Furthermore, firms plan to reduce production by 2.9% in September, suggesting weak production continues through Q3. At the same time, firms are planning for production to remain flat in October, suggesting production is likely to stabilize somewhat in Q4. The inventory/shipment ratio declined to 124.5 for the first time in four months and September manufacturing PMI slightly improved to 48.0 from 47.7. Export orders index of the manufacturing PMI, a leading indicator of real exports, also rose to 46.3, suggesting a slowdown in foreign demand eased lately.

China: Neutral

China has historically run trade surpluses with its major trading partners. In general, the impact of trade data may be most direct when looking at the FX market. A higher trade surplus will be seen as favorable for RMB appreciation expectations. But at the same time, China's persistent and even growing trade surplus would likely intensify political pressures and invoke threats of protectionism measures from its trading partners. Political sensitivity to stalling RMB appreciation is higher if the fall in trade balance is driven by weaker than expected exports versus stronger than expected imports, as the latter could be a sign of inflation concerns and keeping RMB strong may be used as a tool to tighten monetary conditions. However, a persistent trade deficit would change the overall perception of RMB's undervaluation and the extent in which policymakers can control it – it could be a sign of eroding currency competitiveness and would be negative for RMB.

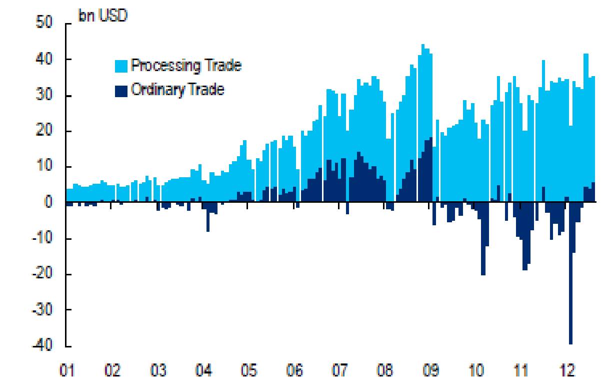
Chart 2. Export growth shrivels as Europe's woes bite



Source: CEIC, HSBC

China's trade can be broken down into process trade and normal trade. Process trade involves the importing of raw materials and components into China, where they are assembled and final products are exported. Most of China's trade surplus comes from process trade. In terms of ordinary trade, China actually runs a deficit. The share of domestic value added is high in normal exports (88-95%), but low in processing exports (18-26%), therefore, Chinese firms only receive a small portion of the price paid for final exported products.

Figure 6. China's trade is often broken down into process trade and normal trade

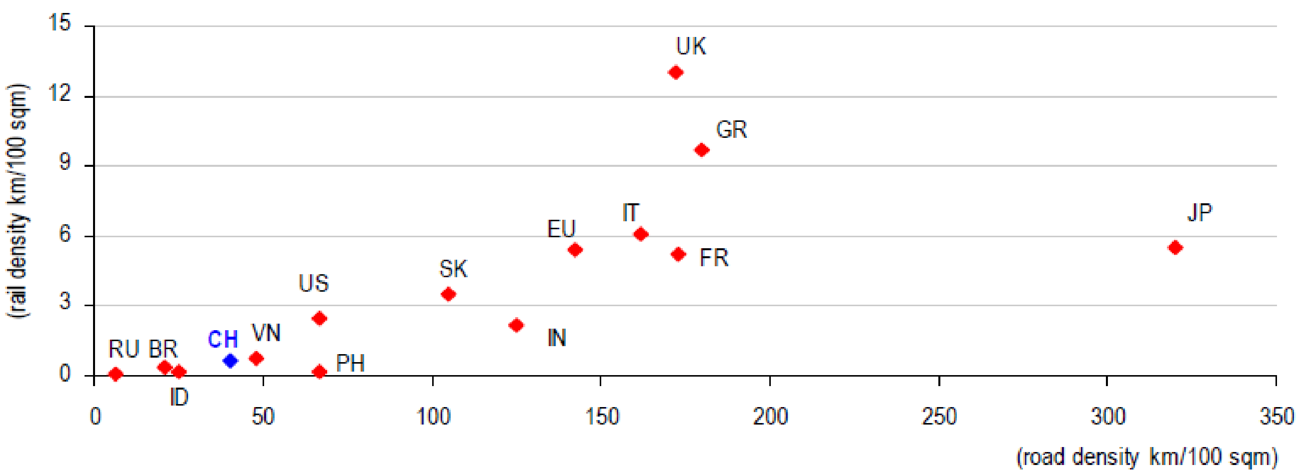


Source: CEIC and Citi Research

Although some observers criticize China is over-invested, there are arguments against such notion. Albeit China's high investment-to-GDP ratio, it still has room to grow its infrastructure network given the vast size of the market and low penetration level. Consider railway, the U.S. is similar in size to China but its rail network is twice as long as China's. Despite aggressive expansion as part of the RMB4trn stimulus package, China's rail network is still smaller than that of U.S. back in the 1880s. For roads, road density in relatively well-developed eastern China is 20% below OECD levels and poorer inland regions a long way behind. Furthermore, there are 100 Chinese cities with populations above 5m but more than 80 do not have subway system.

Beijing is speeding up the approval process for new projects, with a focus on subway systems in major cities. This is a step in the right direction as the Ministry of Finance's spending on transport – key for infrastructure – contracted 33% in August. This should bounce back in coming months as new projects start to materialise.

Chart 9. More infrastructure investment needed



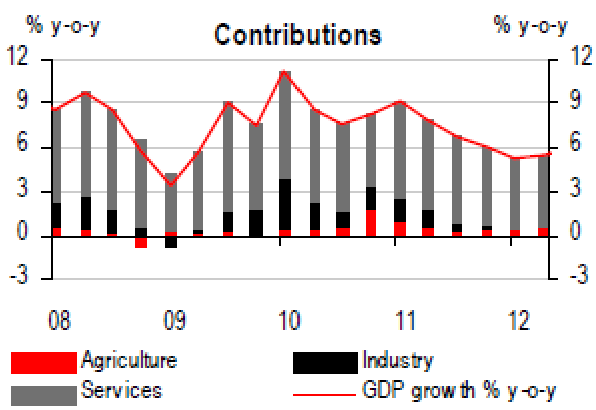
Source: World Bank, HSBC

India: Negative

India's economy has been gearing down over the past 18 months. In 2011-12, growth averaged 6.5% YoY and during the first quarter of this fiscal year, growth was even lower at 5.5% YoY (amid a slight improvement over the 5.3% YoY registered in the preceding quarter). This is a far cry from the 8%-plus pace India had accustomed to during the first decade of this century.

Slowdown has been evident across all sectors of the economy, but the main drag has been on manufacturing. It expanded at a meagre 0.2% YoY during the April-June quarter compared to an average growth rate of close to 8% during the past decade. On the demand side, slowdown over the past year has, in particular, been led by investment, although private consumption and exports have also slowed in recent quarters.

1. Growth has slowed across sectors

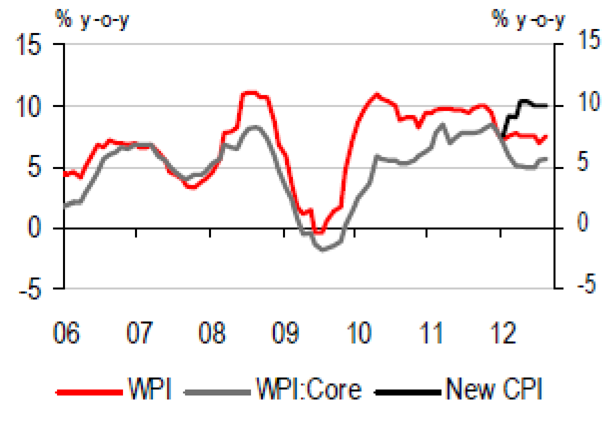


Source: CEIC and HSBC

The slowdown can be attributed to both external and internal forces, although the latter dominate. Exports have risen as a share of GDP and with nearly 50% of India's goods and services exports headed to the US and Europe, the slowdown in these countries has had an impact on both the manufacturing and services sectors.

In addition to the trade channel, the finance channel is an increasingly important source of external spill-over. Following the global financial crisis in 2008-09, India and other emerging markets were on the receiving end of large capital inflows. But these inflows have been weighed down over the past year by the rise in global risk aversion. Moreover, domestic sentiment in India has been hurt by the weaker global economic conditions and the associated higher level of uncertainty, thus dampening investment.

5. Inflation pressures have firmed recently



Source: CEIC and HSBC

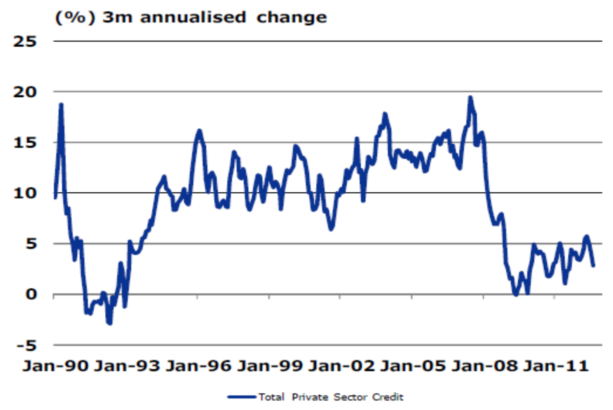
At the moment, the RBI has limited room to cut monetary policy rates. While inflation has declined since 2011, this can be attributed to food price base effects. Core inflation has also eased but remains elevated and persistent, and it has picked up again over recent months. The persistence and high level of inflation partly reflects the supply side is still struggling to keep up with demand due to lack of structural reform. Moreover, indirect tax hikes and depreciation of the rupee since last year have also added to inflation pressures.

There are other reasons that explain India's high inflation. Capacity remains tight because of the supply-led nature of the slowdown, which has left both food and non-food inflation structurally higher. This year's monsoons have so far delivered below-normal rainfall, although the situation has improved during latter half of the season. This is likely to lift food inflation in coming months. The recent decision to raise diesel prices and limit the supply of subsidised LPG cylinders to contain the government's subsidy bill will also lift headline inflation.

Asia Pacific: Mixed

After hitting a three-year high of 4.4% YoY, private credit growth of Australia in both sequential and annual terms eased in recent months and remains well below historical norm and current rate of nominal demand growth. By component, while the annual growth of housing credit and business credit has decelerated, the annual growth of personal credit remains near to a 30-month low. The poor figures highlight two very important trends.

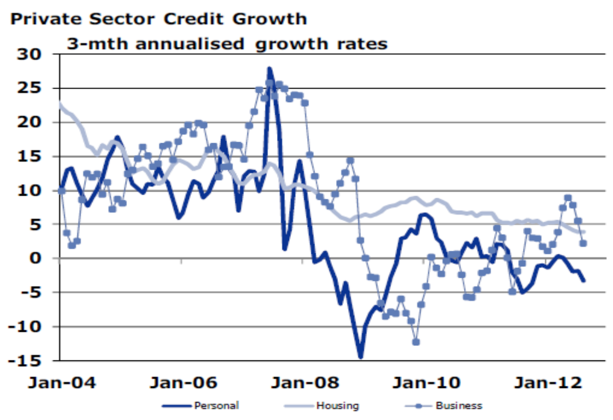
Exhibit 1: After recent improvement, credit momentum is slowing again



Source: GS Global ECS Research, RBA.

For households, there is still no clear sign yet that they have altered their strong preference to save rather than spend. Indeed, recent trends in household credit suggest this aversion to debt has, if anything, intensified. At 4.2% YoY, household credit growth is now below the 5%-plus growth in household income suggesting debt-to-income ratio is falling. Although lagged impacts of RBA's recent policy easing are still feeding through the economy, the outright stock of debt continues to constrain debt appetites. In combination with still weak consumer sentiment, the rising cost of essential spending, moderating income growth, and negative wealth growth (both equities and house prices), this suggests consumption will remain modest.

Exhibit 2: Business credit is the main driver of the slowdown



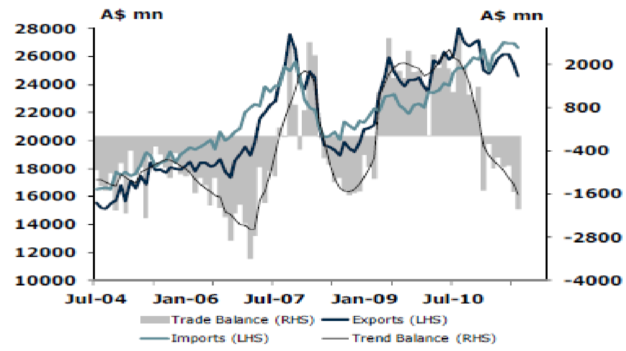
Source: GS Global ECS Research, RBA.

For business credit, recent RBA communications had been pointing to tentative signs of an improvement in housing markets and the acceleration in business credit as evidence that the first 75bp of the easing cycle was starting to gain traction. The 3-month annualised growth rate has slowed from 8.9% three months ago to just 2.2% lately. Clearly the point when the business sector is once again generating more normal rates of growth after an extended period of deleveraging and disintermediation is further out than the RBA had envisaged.

Australia reported trade deficit of A$2,027mn in August, relative to deficit of A$1,530 in June. Not only is the deficit worse than expected, there were major downward revisions to the recent history of trade balance. The downward revisions have intensified what was already a sharp deterioration in Australia's foreign trade position, highlighting the negative income shock which has started to cascade through the Australian economy.

Notwithstanding the large mining export-led deterioration in August's trade balance, trade details suggest that these data are far from factoring-in the full lagged impact of falls in bulk commodity prices in global markets. The impact will become apparent over coming months.

Exhibit 1: **Trade balance has deteriorated sharply**



Source: Australian Bureau of Statistics, GS Global ECS Research.

The size and pace of deterioration in Australia's bulk commodity export earnings highlights the sensitivity of nominal income to world prices, but also the level of the AUD, which in the current environment is proving unusually resilient, further erodes earning.

Exhibit 9: Key data

International trade in goods and services

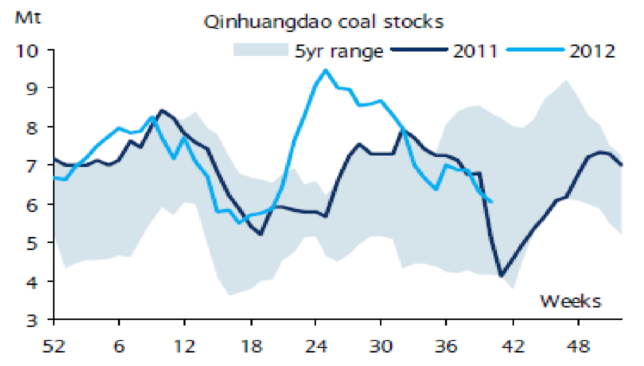
	Sep-11	Oct-11	Nov-11	Dec-11	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12
Trade Balance ($m)	1899	1157	988	1378	-1496	-207	-877	-571	-848	-791	-1530	-2027
- Trend	1869	1500	1029	543	-256	-524	-667	-789	-934	-1128	-1337	-1625
Monthly % ch. (seasonally adjusted)												
Total Exports	-3.4	-1.2	0.8	0.8	-7.9	-1.0	1.8	2.6	1.2	-0.2	-2.8	-3.3
Rural goods	0.7	1.5	0.5	-2.6	-4.6	-9.5	9.4	2.4	0.8	6.4	-4.3	1.3
Non-rural goods	-3.2	-1.1	-0.8	-0.9	-5.6	-1.3	0.3	3.8	0.8	-2.9	-1.1	-5.5
Services	-0.4	0.4	-0.3	-0.3	2.6	-2.7	1.8	-0.1	-0.6	1.0	0.4	1.2
Total Imports	-0.3	1.6	1.5	-0.7	2.8	-5.8	4.4	1.4	2.2	-0.4	0.1	-1.3
Consumption goods	-2.9	1.6	-1.7	4.6	2.5	-7.8	6.4	1.0	0.4	-1.5	0.3	1.9
Capital goods	3.9	2.0	5.2	-1.1	5.8	-3.8	1.7	4.4	5.1	2.7	-8.6	0.2
Intermediate goods	-1.3	-1.0	4.7	-2.4	2.4	-8.7	8.5	0.4	1.5	-2.9	4.2	-4.0
Services	-0.7	0.1	0.0	0.8	0.4	-1.1	0.8	1.0	0.3	1.4	3.4	0.9

Source: Australian Bureau of Statistics.

Commodities: Negative

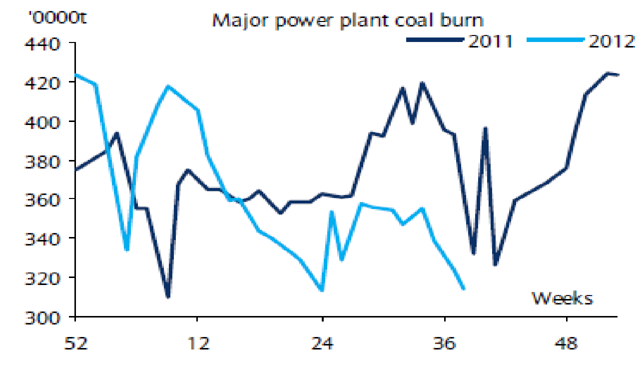
China's coal market remains soft despite substantial stock drawdown at the main domestic port at Qinhuangdao. First, the stock draw was primarily a pre-emptive effort by Chinese power plants to stock up ahead of holiday and a semi-annual maintenance of the Daqin railway, which is the main rail link for domestic coal to Qinhuangdao. The two-week long maintenance will shut the railway for 3-4 hours each day, which usually reduces coal shipment by 15-20% and could add up to a total loss of 1.5Mt. The 1Mt draw in Qinhuangdao stocks reflects the shift of stocks from ports to power plants. Second, while some power plants are reportedly running lower on coal stocks and increased purchasing, the overall stock-to-burn ratio is still high at major power plants in mid-September, at 27 days. Not surprisingly, continued economic softness has suppressed coal burn since Q2 2012, and there are no signs of a strong pickup yet. Burn will also remain soft during the holidays. Third, while the import arb window was finally shut for Australian coal in July, with buyers turning to more affordable domestic coal after prices corrected, has reopened after domestic prices recovered as a result. Imports from Indonesia are likely to remain strong, leaving the Chinese market well supplied. Domestic seaborne coal freight rates, which tend to lead Qinhuangdao spot prices, moderated in the last week of September, suggesting that the pre-emptive stock-building is coming to an end.

Figure 2: Coal stocks at Qinhuangdao have drawn sharply



Source: CCTD, Barclays Research

Figure 3: Coal burn is still soft at Chinese power plants



Source: CCTD, Barclays Research

Hedge Funds: Mixed

HFRX™ Indices *(UCITS compliant methodology)*

Daily HFRX Indices - USD

ON-LINE ACCESS TO ALL HFRX INDEX CONSTITUENT FUNDS VIA HFRDATABASE.COM

	Monthly Performance				Historical Performance		
	SEPT ROR	AUG ROR	YTD	INDEX VALUE (SEPTEMBER 28, 2012)	Last 12M	Last 36M (ann)	Last 48M (ann)
Global							
HFRX Global Hedge Fund Index	0.39%	0.51%	2.69%	1,139.19	2.20%	0.19%	-0.78%
HFRX Equal Weighted Strategies Index	0.15%	0.36%	1.97%	1,120.39	1.74%	0.99%	-0.84%
HFRX Absolute Return Index	-0.15%	0.27%	0.01%	946.65	0.13%	-1.22%	-3.98%
HFRX Market Directional Index	0.98%	0.82%	2.42%	1,046.54	-0.46%	-1.43%	-1.81%
Equity Hedge							
HFRX Equity Hedge Index	0.78%	0.84%	3.40%	1,034.44	2.52%	-2.60%	-2.88%
HFRX EH: Equity Market Neutral Index	-0.28%	-0.08%	-5.38%	928.58	-4.82%	-1.69%	-3.17%
HFRX EH: Fundamental Growth Index	0.71%	0.52%	3.62%	1,460.11	-1.01%	-0.50%	0.79%
HFRX EH: Fundamental Value Index	0.83%	0.71%	4.43%	964.93	5.51%	-3.89%	-3.86%
Event Driven							
HFRX Event Driven Index	0.67%	0.92%	4.90%	1,371.33	5.49%	1.20%	1.43%
HFRX ED: Distressed Restructuring Index	0.30%	-0.34%	3.45%	976.26	3.19%	2.19%	-7.49%
HFRX ED: Merger Arbitrage Index	-0.26%	0.16%	0.68%	1,503.91	1.76%	2.09%	3.66%
HFRX ED: Special Situations Index	0.89%	1.21%	3.19%	1,106.48	3.75%	1.20%	1.14%
Macro							
HFRX Macro/CTA Index	-0.52%	-0.02%	-0.89%	1,155.73	-2.83%	-3.03%	-3.42%
HFRX Macro: Systematic Diversified CTA Index	-1.75%	-1.54%	-4.75%	1,563.55	-7.32%	-1.11%	0.90%
Relative Value							
HFRX Relative Value Arbitrage Index	0.43%	0.20%	2.80%	1,159.91	2.91%	4.06%	3.13%
HFRX RV: Convertible Arbitrage Index	-0.26%	0.67%	5.62%	691.91	4.22%	4.94%	-3.31%
HFRX RV: Multi-Strategy Index	0.27%	-0.002%	1.77%	1,801.58	1.93%	6.10%	9.19%
Emerging Markets							
HFRX Emerging Markets Composite Index	-0.10%	0.54%	5.45%	1,988.24	3.17%	6.11%	8.11%
Concept							
HFRX Fixed Income - Credit Index	0.28%	0.52%	4.85%	1,823.87	5.08%	5.22%	8.38%
HFRX MLP Index	1.94%	1.77%	5.09%	1,550.14	15.78%	18.75%	n/a

Daily HFRX Indices - FX Hedged

ON-LINE ACCESS TO ALL HFR INDEX CONSTITUENT FUNDS VIA HFRDATABASE.COM

	Monthly Performance				Historical Performance		
	SEPT ROR	AUG ROR	YTD	INDEX VALUE (SEPTEMBER 28, 2012)	Last 12M	Last 36M (ann)	Last 48M (ann)
HFRX Equal Weighted Strategies CHF Index	0.12%	0.28%	1.40%	1,227.15	0.93%	0.21%	-1.72%
HFRX Equal Weighted Strategies EUR Index	0.12%	0.31%	1.70%	1,054.80	1.46%	0.92%	-1.10%
HFRX Equal Weighted Strategies GBP Index	0.16%	0.35%	2.00%	2,065.77	1.84%	1.08%	-1.04%
HFRX Equal Weighted Strategies JPY Index	0.12%	0.33%	1.75%	99,109.32	1.34%	0.75%	-1.06%
HFRX Global Hedge Fund CHF Index	0.34%	0.41%	1.98%	1,241.72	1.23%	-0.65%	-1.72%
HFRX Global Hedge Fund EUR Index	0.34%	0.45%	2.31%	1,060.65	1.80%	-0.06%	-1.33%
HFRX Global Hedge Fund GBP Index	0.39%	0.43%	2.51%	2,102.50	2.07%	0.32%	-0.94%
HFRX Global Hedge Fund JPY Index	0.35%	0.48%	2.48%	101,319.20	1.81%	-0.07%	-1.04%
HFRX Equity Hedge EUR Index	0.74%	0.79%	2.95%	983.92	2.04%	-2.88%	-3.42%
HFRX Event Driven EUR Index	0.63%	0.87%	4.54%	1,312.66	5.04%	1.05%	1.10%
HFRX Macro EUR Index	-0.53%	-0.07%	-0.99%	1,119.07	-2.80%	-2.97%	-3.34%
HFRX Relative Value Arbitrage EUR Index	0.39%	0.15%	2.51%	1,107.83	2.59%	4.01%	2.67%

The September performance of the HFRX Monthly Indices will be published on October 15.

HFRX Indices are designed to be representative of the overall composition of the hedge fund industry.

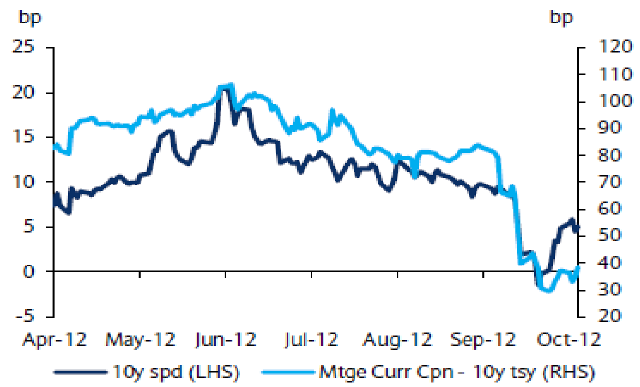
Equities posted gains in September, though gains were pared into month end on renewed European sovereign debt concerns despite stimulus measures by US, European and Japanese central banks. Equity gains were led by Cyclicals, Financials and Commodity sensitive sectors, with regional leadership from Asian and Emerging Markets. US Treasury yields rose for the month but settled off mid-month highs as the long end of the curve steepened and high yield credit tightened for the month. The Euro settled with monthly gains against the US dollar, though also pared into month end; the Pound posted similar gains while the Dollar strengthened against the Japanese Yen. Energies and Precious Metal Commodities diverged for the month with losses in Oil and gains across Aluminum and Silver; Natural Gas also posted a sharp increase. Hedge funds were positive in each month of Q3, with the HFRX Global Hedge Fund Index gaining +0.39% for September, while the HFRX Market Directional Index gained +0.98%.

The HFRX Equity Hedge Index posted a gain of +0.78 for September, the 4th consecutive month of gains, as equity markets rose across most sectors and regions, and positive contributions across Value, Growth, Energy, Technology and Emerging Markets exposures. The HFRX Fundamental Value Index gained +0.83%, with contributions from Consumer, Industrial, Financials and European equities. The HFRX Fundamental Growth Index posted a gain of +0.71% with contributions from Consumer, Telecom, Asian, Emerging Markets and US small cap exposures. The HFRX Market Neutral Index posted a decline of -0.28% for the month, with weakness in trading oriented EMN strategies.

Bonds: Mixed

Swap spreads have had an eventful few weeks. After trading in the double digits for most of the April-August period, 10y spreads collapsed shortly after the Fed announced QE3 that will focus exclusively on mortgages at a time when corporate swapped issuance had peaked. The fall in mortgage rates likely led to receding swap spreads as mortgage durations contracted, leading to receiving needs from convexity hedgers. However, they recovered swiftly towards the end of September, as there was a temporary lull in issuance and mortgages reversed course somewhat.

Figure 1: Swap spreads have widened after a dramatic tightening post QE3 announcement

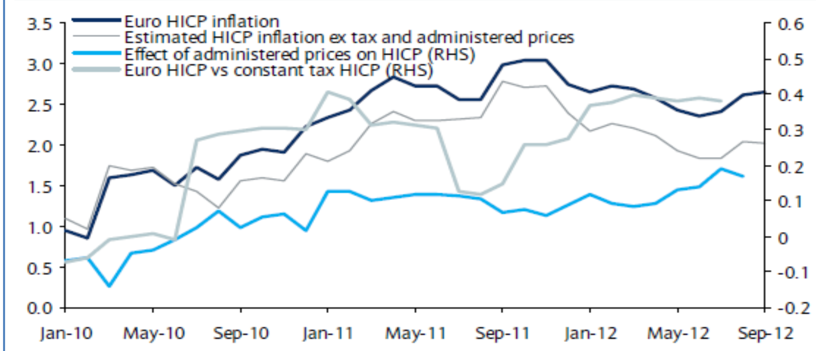


Note: Click chart to view dynamic data on Barclays Live.
Source: Barclays Live - Chart

With the September payroll report showing an unexpected drop in the unemployment rate, chances of a very large program being announced are small, but should that happens, there should not be too much of a reaction in spreads.

It is believed that the fiscal outlook drives swap spreads more than ongoing net issuance in any particular sector. If the US were to fall off the fiscal cliff, and it looked like gridlock made any resolution in the near term impossible, that would be reason for investors to expect spreads to widen because it would mean an actual reduction in treasury supply. Even if negotiations do not lead to a deal by December, the market will price in some chance of resolution within a few months.

Figure 1: Euro inflation very close to 2.0% allowing for taxes and administered prices



Estimated series is based on headline HICP inflation minus administered price and indirect tax gaps, not allowing for possible overlaps. August and September values are Barclays estimates. Source: Eurostat, Barclays Research.

In the introductory statement to the ECB press conference, President Draghi twice highlighted the importance of indirect taxes on inflation. They were part of the reason behind the increase in euro HICP inflation to 2.7% in September, and the only referenced upside risk for future price developments. There is a growing consensus on the ECB governing council that such price rises stemming from the need for fiscal consolidation should be looked through in considering the conventional elements of monetary policy. Spanish VAT hikes in September likely pushed the wedge between HICP and the Eurostat constant tax series close to its 2007 wide of almost 50bp (which was caused by the 3% German VAT hike), contributing to the 0.3pp upside surprise in the September euro HICP flash estimate. Allowing for indirect taxation and administered prices HICP inflation for September was around 2.0%.

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

For any comments, please send email to us at enquiries@amgwealth.com.

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