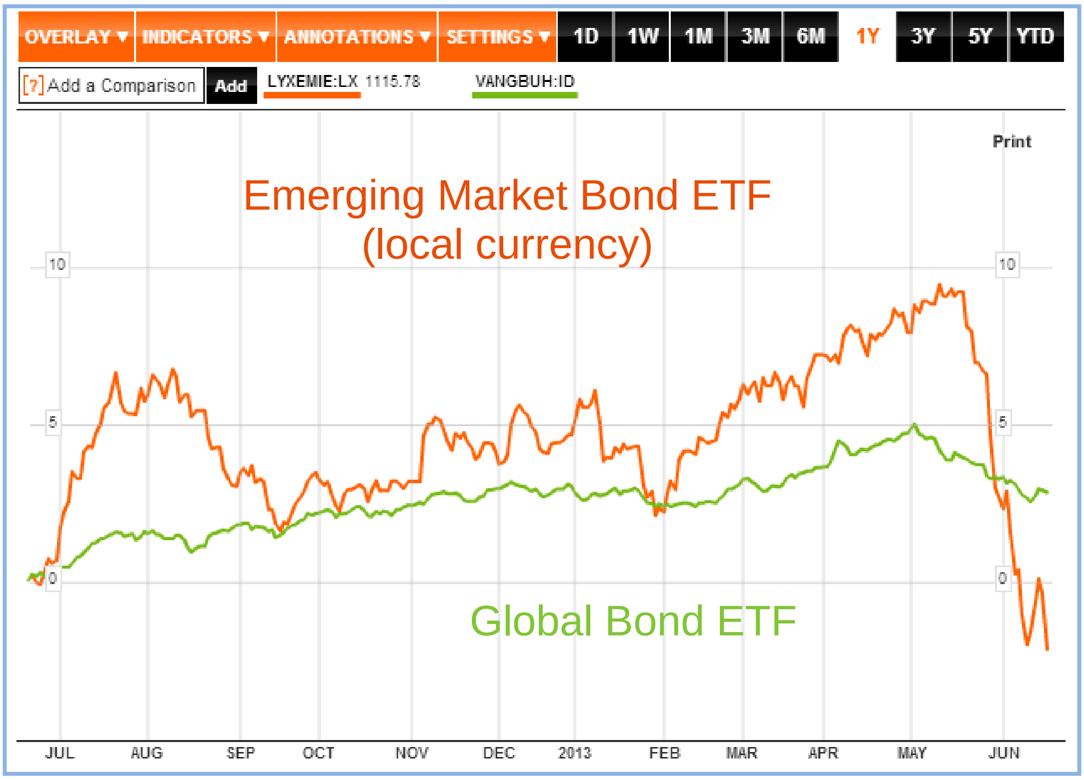
AMG 安柏 FINANCIAL GROUP

AMG Market Commentary

June 2013

Debt Overflow

In our December-2012 Market Commentary, our featured article begged the question: "Could Bonds be due a Rude Awakening?" In it, we'd looked into the torrid flow of investor money into all sorts of bond investments, from investment grade corporate to junk-rated corporate, and emerging market bonds denominated in either US dollar or local currencies. We were particularly concerned about questionable developments in the primary market – such as issuances of covenant-light bonds, corporate selling bonds to pay special dividends to major stakeholders, and the flood of new bonds with ever lenghening durations – which were all the rage at the time.



How things have changed in six months' time. There are no better words, nor need, to explain the turn of tide than the chart to the right. The chart, created from Bloomberg's public website, shows an emerging market bond ETF (exchange traded fund) denominated in local currencies and a global bond ETF denominated in US dollar over the latest one year period. While the global bond ETF has fallen since early-May and now barely clings to a positive return year-to-date, the emerging market bond ETF has plummeted and is now suffering negative return over the past year.

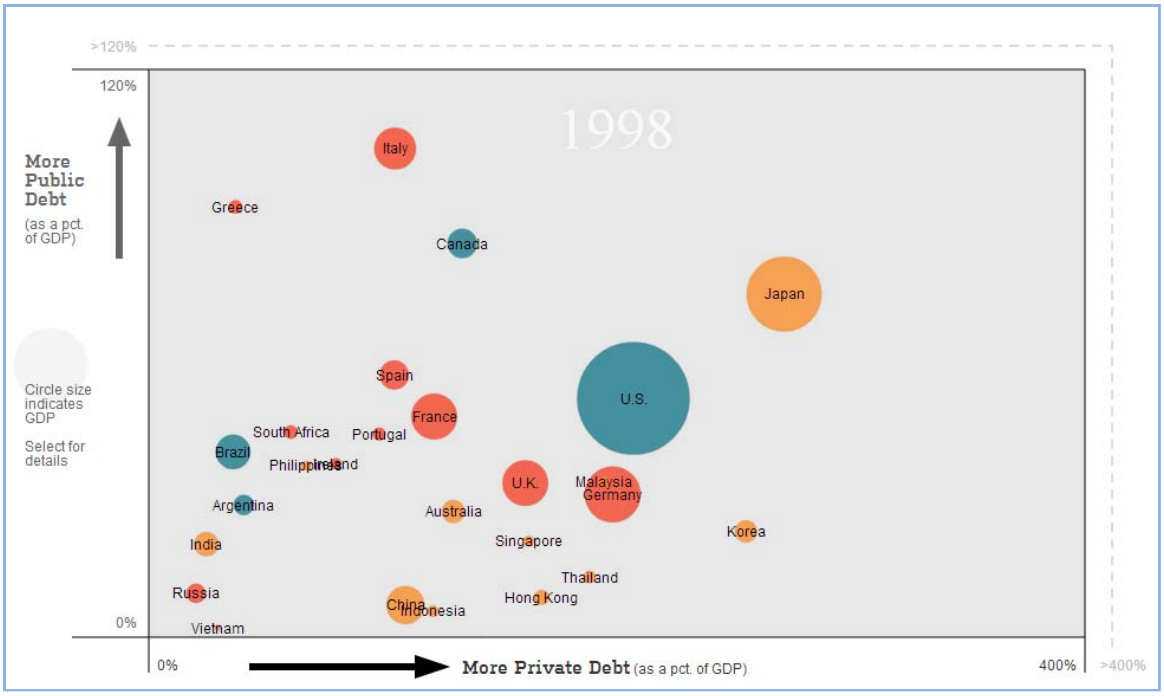
Whether this pull back is of temporary or longer term is hotly debated among investors and analysts. Our view is, and has been for an extended period of time, that bond prices have been mispriced (or specifically, overpriced) as investors are blindsided by cheap funding costs and abundance of liquidity, which are direct results of ultra loose monetary policies adopted by central banks around the world. This has encouraged and facilitated public and private borrowing to such extent that should leave anyone who care to look into it flabbergasted.

It so happened that The Wall Street Journal published a story a few weeks ago featuring some excellent charts that show how much debts have grown from 1998 to 2012 for various countries. The information contained in these charts are highly valuable and relevant that we felt it would be a waste not to share it with our readers/clients.

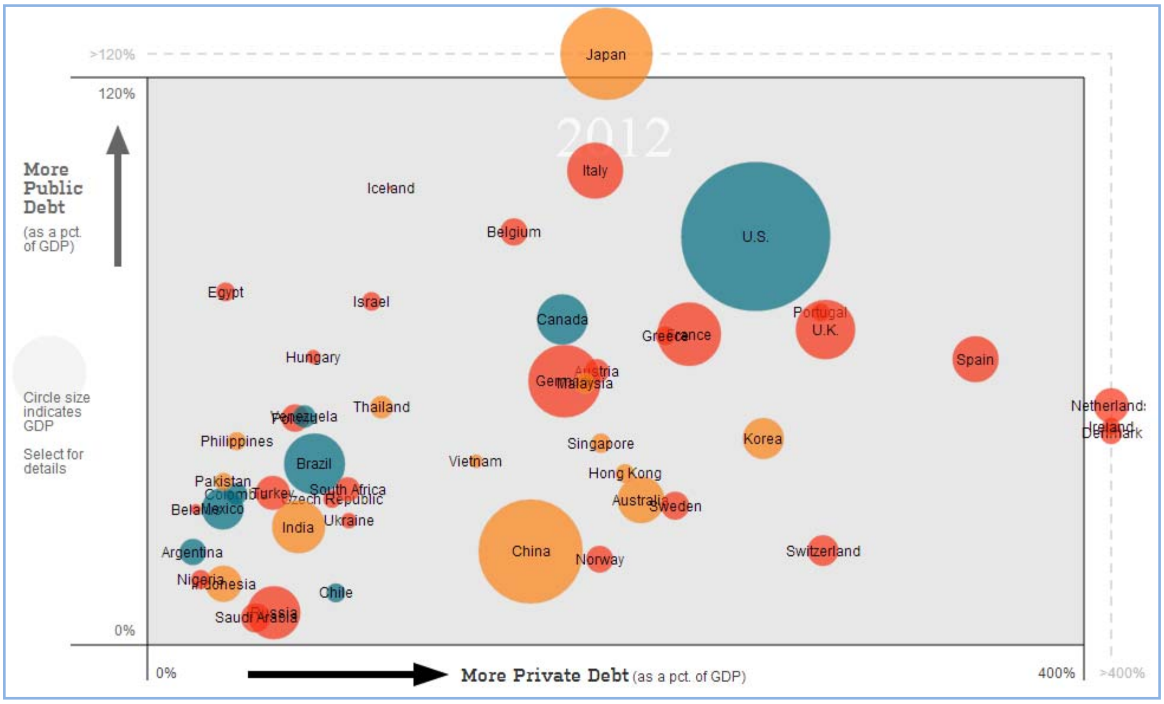
To better understand the chart, let us explain the different notations first. Each circle denotes an economy and the size corresponds to its GDP. Hence, the circle for U.S. is largest because U.S. is the largest economy in the world. The circles come in three colors: yellow refers to Asian economies, blue refers American economies and red refers to Europe, Africa and Middle-East. As for the two axises, the vertical axis measures the amount of public debt of an economy over its GDP, and the horizontal axis measures the amount of private debt of an economy over its GDP.

Now that we know how to read the chart, let's go back in time and look at the world's debt situation in 1998, which is the year Asian financial crisis struck and Russia defaulted on its debts.

Then we put up the chart showing the world's debt situation at end of 2012.



A lot can be observed by comparing the two charts. For instance, we can see how some of the economies have grown in size. In particular, back in 1998 China's GDP was smaller in size than Italy and perhaps only marginally bigger than Brazil. At end of 2012, China's GDP has grown to become the second largest after U.S..

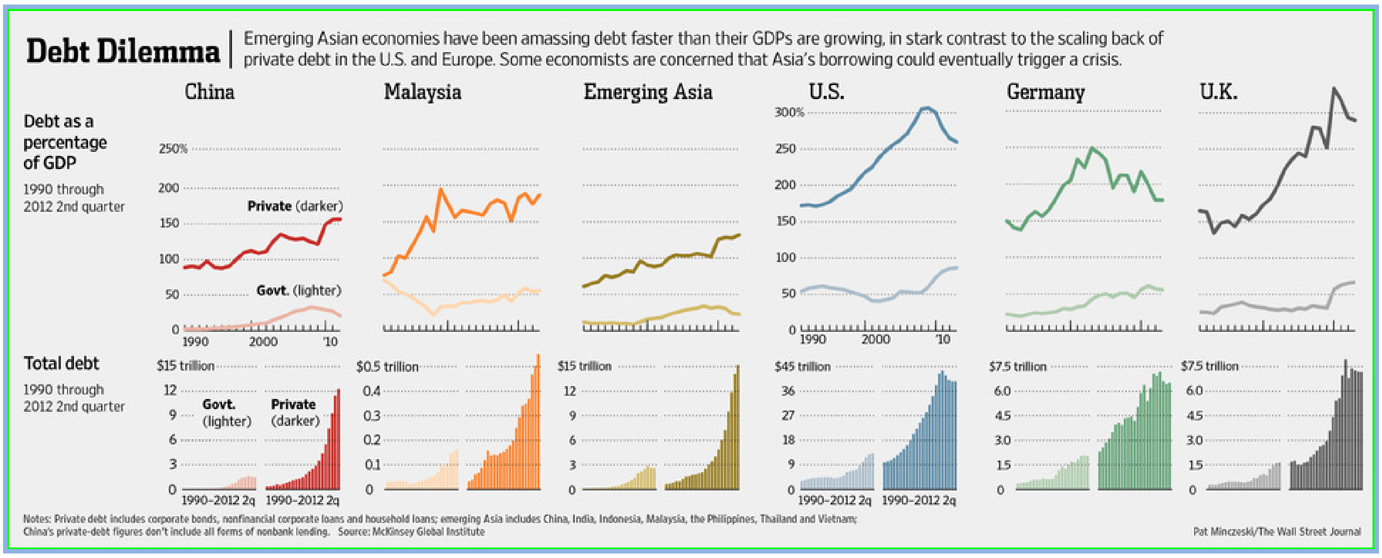


We can also see that almost all economies have taken on more debts, in both public and private forms, hence the circles have shift towards the upper right hand corner. In the case of Japan, private debt as a percentage of GDP has actually fallen (as corporate and household deleveraged) but its government has taken on so much debt to make Japan the most indebted country in the world in terms of public debt.

On the second chart, one should also noticed a lot more red circles are presented, meaning European, African and Middle-East countries have seen their economy and debt level grown. This development is reasonable given the emergence of the European Union and the euro currency since 1999. Thanks to a common currency and common interest rate set by the European Central Bank, previously smaller and weaker countries with lower credit ratings could borrow on far more advantageous terms. This mean a lot lower borrowing costs to EU members. Cheap credits are irresistible and hard to pass up, so Euro countries just loaded up on debt.

Among European countries, we can see that Italy has the highest level of public debt versus its GDP but three countries: Netherlands, Ireland and Denmark, are neck-to-neck having highest level of private debt versus their GDPs. And the level of debts is truly staggering. At over 400%, it's hard to imagine how household and corporate in these countries can pay down their debts within a reasonable period of time given the low growth nature of their economies. To make matter worse, this incredible challenge would become almost insurmontable when interest rate reverts and rise to more normal (or historical average) levels.

The last chart below shows how debts, both as a percentage of GDP and in absolute terms, have changed over time from 1990 to 2012 for selected countries. The upper chart shows ascending curves for China, Malaysia and Emerging Asia, meaning debts have been climbing more rapidly than economic growth. This contrast with the curves for U.S., Germany and U.K. which have been declining since the later part of last decade. This is the result of leveraging by households and corporate. Despite such effort, the level of debts remain unsustainable high. The real test for the heavily indebted economies will begin when the printing press starts to slow down…



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Market Review & Outlook

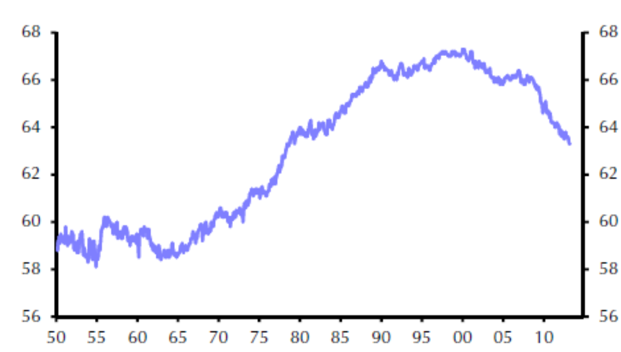
U.S.: Neutral

US EMPLOYMENT DATABANK										
	2012				2013					Implication for Payroll Growth
Labour Market Indicators	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**May[1]**	
Jobless Claims (Monthly Ave.)	376	367	406	359	353	356	343	358	347	Better
Jobless Claims (for week including the 12th)	379	384	451	366	350	348	334	355	363	Worse
Challenger Job Cut Announcements (SA)	37.2	52.3	50.9	34.2	30.1	48.5	57.2	38.0	-	Better
Help Wanted Online New Ads Index	1.93	1.98	2.01	1.98	2.10	2.00	2.06	2.40	-	Better
ISM Manufacturing Employment Index	53.7	52.3	50.1	51.9	54.0	52.6	54.2	50.2	-	Worse
ISM Non-Manufacturing Employment Index	52.0	54.8	51.4	55.3	57.5	57.2	53.3	52.0	-	Worse
ADP Private Payroll Employment Survey	105	148	276	209	177	198	131	119	-	Worse
CE Estimated Change in Payrolls[2]	100	125	75	175	150	175	200	125	175	
Consensus Forecast	120	120	100	150	160	150	190	155	163	
Actual Change in Payrolls	138	160	247	219	148	332	138	165	-	
Other Employment Report Data										**Consen. Fore.**
Unemployment Rate	7.8	7.9	7.8	7.8	7.9	7.7	7.6	7.5	7.5	7.5
Change in Household Employment	810	354	-51	28	17	170	-206	293	175	-
All Employees Hours Worked	34.5	34.3	34.4	34.5	34.4	34.5	34.6	34.4	34.5	34.5
All Employees Ave. Hourly Earnings (%m/m)	0.3	-0.1	0.4	0.3	0.1	0.2	0.0	0.2	0.2	0.2
All Employees Ave. Hourly Earnings (%y/y)	2.0	1.6	1.9	2.1	2.1	2.1	1.8	1.9	2.0	-

(1) Figures in blue are forecasts (2) Based on the CE econometric model of private payroll growth that includes effects from jobless claims, changes in temporary employment and the ISM employment indices.

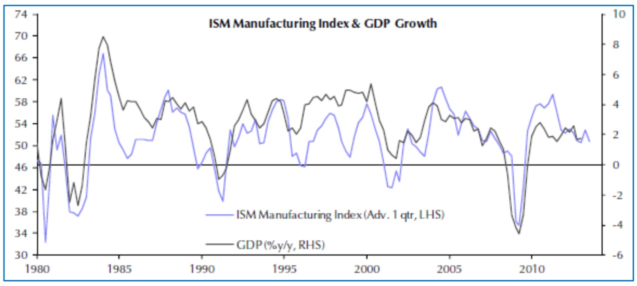
The participation rate actually began to trend lower more than a decade ago. The decline is largely because ageing baby boomers are now reaching retirement age. The jump in the number of discouraged persons not in the labour force suggests that at least one-third of the decline since 2008 is due to the weakness of the economy, i.e. cyclical factors.

CHART 1: PARTICIPATION RATE (%)



Source – Thomson Datastream

Whether those people will ever return to the labour force after being without a job for so long is unclear, however. The structural decline in the participation rate will also accelerate over the next decade. Under these circumstances, forecasting where the participation rate will be in one or two years' time is almost impossible. The problem for the Fed is that how many of these people eventually come back into the labour force will affect the timing of when wage inflation begins to rise.



Meanwhile, the decline in the ISM manufacturing index to a near four-year low of 49.0 in May, from 50.7, suggests that weak global conditions are weighing on US producers. While the manufacturing sector is suffering, however, other sectors of the economy, particularly housing, are strengthening.

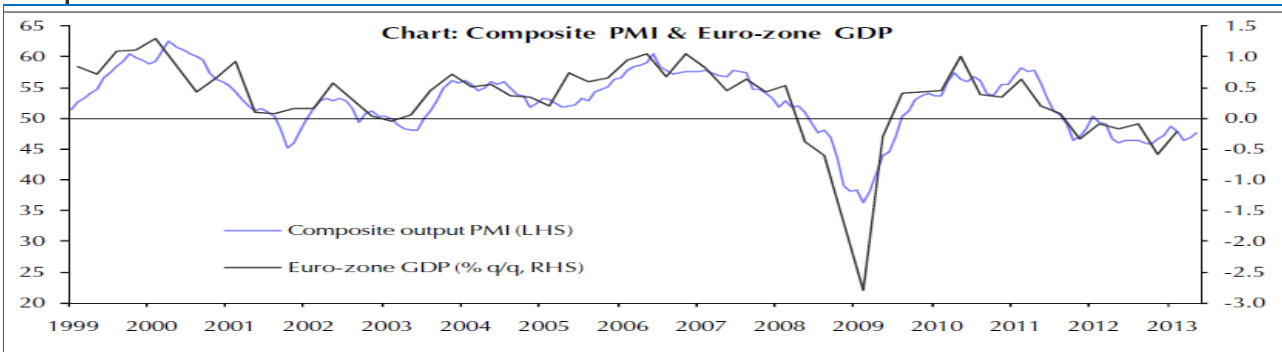
ISM MANUFACTURING SURVEY

	Overall Index	New Orders	Production	Employm't	Supplier Deliveries	Inventories	Prices Paid	Orders Backlog	New Exp'rt Orders	Imports
Mar	51.3	51.4	52.2	54.2	49.4	49.5	54.5	51.0	56.0	54.0
Apr	50.7	52.3	53.5	50.2	50.9	46.5	50.0	53.0	54.0	55.0
May	**49.0**	**48.8**	**48.6**	**50.1**	**48.7**	**49.0**	**49.5**	**48.0**	**51.0**	**54.5**

Source – Thomson Datastream

Although the drop in the ISM manufacturing index to below the 50 mark is disappointing, it does not suggest the wider economy is in danger of falling into recession. In the past, the level needs to be below 46 before a contraction in GDP growth is likely. Even then, the relationship needs to be treated cautiously because manufacturing is now a relatively minor part of the US economy, accounting for only 10% of GDP.

Europe: Neutral

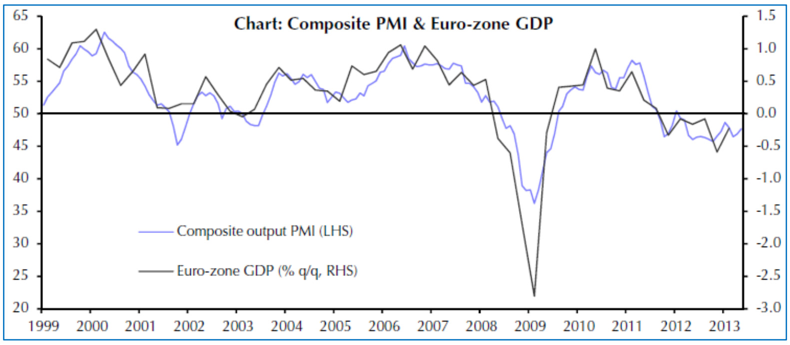


EURO-ZONE GDP (SELECTED COMPONENTS, % Q/Q UNLESS STATED)

	Real GDP q/q	Real GDP y/y	Household Consumpt'n	Gov. Consumpt'n	Investment	Domestic Demand	Exports	Imports
Q2 2012	-0.2	-0.5	-0.5	-0.3	-1.7	-0.8	1.6	0.4
Q3 2012	-0.1	-0.6	-0.2	-0.2	-0.9	-0.4	0.8	0.2
Q4 2012	-0.6	-1.0	-0.6	0.0	-1.4	-0.7	-0.9	-1.2
Q1 2013	**-0.2**	**-1.1**	**0.1**	**-0.1**	**-1.6**	**-0.3**	**-0.8**	**-1.1**

Source: Eurostat

Detailed GDP report showed the euro-zone economy contracted by 0.2% in Q1, which is the region's sixth successive contraction but an improvement on the 0.6% drop seen in Q4 last year. The annual growth rate in Q4 was nudged down a touch from the initial estimate of -1.0% to -1.1%.



The breakdown by expenditure components threw up few surprises. Reduction in the pace of GDP contraction was mainly due to improvement in household spending, which posted a 0.1% expansion after contracting in the previous five quarters. Nevertheless, spending is still down by more than 1% over the past year.

Other elements of growth showed few signs of improvement. The contraction in investment actually accelerated compared to Q4. And while overall net trade made a small positive contribution to growth, that was down to another fall in imports. Exports posted another quarterly drop of 0.8%.

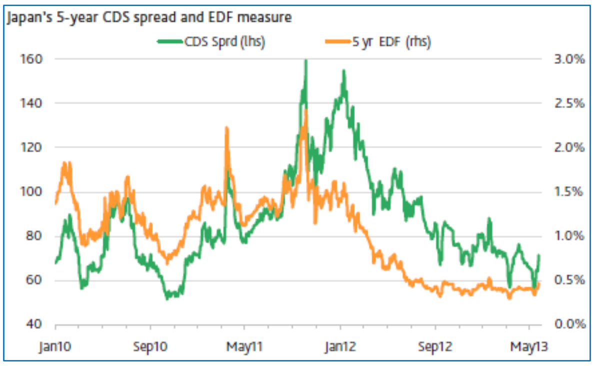
Japan: Positive

To say that Japan's financial markets experienced dramatic movements in the month of May would be an understatement. From the day Shinzo Abe took power in December, the Nikkei 225 index had at one point nearly doubled only to give back a big chunk last month. Still, from the low point last-December to end of May, the benchmark index has increased by more than 60%. Meanwhile, the yield on the 10-year Japanese government bond (JGBs) more than doubled from a low of 0.45% to 1.00% an intraday high.

Figure 1. Nikkei Index

FIGURE 2
Yield on 10-year Japanese government debt (%)

Japan's 5-year CDS spread and EDF measure



Since 2010, Japan's CDS-implied Expected Default Frequency credit measure has declined considerably, with the five-year metric being as high as 2.42% in October 2011. To be sure, this improvement has not been entirely issuer-specific, as EDF measures have declined for almost all sovereign issuers over the past year-and-a-half. Still, if Japan's new economic policies do not succeed, the country's CDS spreads will undoubtedly widen and its EDF measures to deteriorate.

Since becoming prime minister, Abe has launched an economic program consisting of three main planks (so-called three arrows). Firstly, Japan passed its largest government budget ever: ¥92.6 trillion. The country's budget deficits have already acted as a form of fiscal stimulus for two decades, so this is probably not what is making the difference right now. Furthermore, the country's high government debt load as a multiple of its GDP limits its ability to engage in fiscal stimulus.

Secondly, the Bank of Japan announced a new monetary policy program of both quantitative and qualitative easing, designed to achieve an explicit inflation target of 2% and a doubling of the monetary base within two years.

Finally, what is needed most is improvement in labor market flexibility and in corporate governance, as well as measures that undo corporate protectionism at the local level that is one of the causes of the stagnation of the economy. Such structural changes are much more difficult to implement than monetary and fiscal stimulus, but they are also much more necessary. That is to say, if this third arrow fails to hit its target, the first two arrows will result in no more than yet another of the many "false starts" seen throughout the country's two-decade slump.

China: Neutral

Exhibit 9: Summary of total social financing

RMB(bn)	May-13	Apr-13	Mar-13	Feb-13	Jan-13	Dec-12	Nov-12	Oct-12	Sep-12	Aug-12	Jul-12	Jun-12	May-12
Total Amount of Social Financing	**1190**	**1747**	**2549**	**1070**	**2544**	**1626**	**1122**	**1291**	**1646**	**1248**	**1052**	**1780**	**1143**
New RMB Loan	**667**	**793**	**1063**	**620**	**1072**	**454**	**522**	**505**	**623**	**704**	**540**	**920**	**793**
Retail Loans	382	372	382	121	471	204	241	146	334	283	184	275	214
- Short Term Loans	*153*	*141*	*211*	*-17*	*203*	*109*	*89*	*31*	*174*	*117*	*66*	*153*	*114*
- Medium/Long - Term Loans	*229*	*231*	*172*	*138*	*268*	*97*	*152*	*115*	*159*	*166*	*118*	*119*	*100*
Corporate Loans	285	420	682	499	599	240	282	359	293	421	356	649	576
- Discounted bills	*84*	*169*	*118*	*18*	*-34*	*-191*	*-37*	*-73*	*-217*	*131*	*153*	*34*	*232*
- Short Term Loans	*38*	*54*	*291*	*181*	*294*	*449*	*305*	*247*	*355*	*150*	*95*	*417*	*152*
- Medium/Long - Term Loans	*146*	*175*	*253*	*283*	*310*	*-15*	*-3*	*169*	*128*	*120*	*92*	*163*	*170*
New Loan in Foreign Currency	**36**	**85**	**151**	**115**	**180**	**149**	**104**	**129**	**176**	**74**	**7**	**104**	**30**
Off - Balance Activities	**184**	**609**	**879**	**143**	**997**	**736**	**253**	**311**	**561**	**144**	**188**	**489**	**115**
New entrusted Loan	197	193	175	143	206	208	122	94	145	105	128	79	21
New trust Loan	99	195	431	182	211	264	180	144	201	124	38	99	56
Banker's Acceptance Bill	-112	221	273	-182	580	264	-49	73	215	-85	22	311	38
Net Corporate Bond Financing	**217**	**190**	**386**	**145**	**225**	**207**	**182**	**299**	**228**	**258**	**249**	**198**	**144**
Non Financial Enterprise Equity Financing	**23**	**27**	**21**	**16**	**24**	**14**	**11**	**9**	**16**	**21**	**32**	**25**	**18**

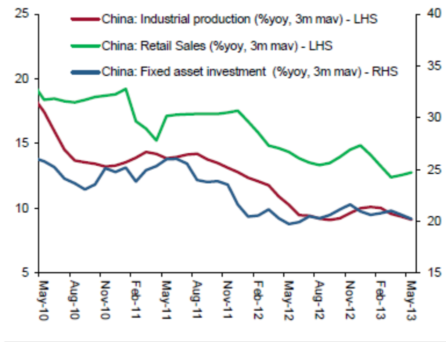
Source: PBoC, Credit Suisse

Industrial production grew by 9.2% YoY in May, weaker than the Bloomberg consensus of 9.4% and the 9.3% YoY growth in the previous month. For the first five months of the year, industrial production grew by 9.4%. On a sequential basis, IP expanded by 0.62% MoM (seasonally adjusted) in May, against the prior reading of 0.87%.

Retail sales growth improved mildly to 12.9% YoY in May from 12.8% YoY in the previous month. In real terms, retail sales growth was at 12.1% YoY. Sequentially, retail sales grew by 1.17% MoM on a seasonally adjusted basis. For January to May as a whole, retail sales grew by 12.6% compared to a year ago.

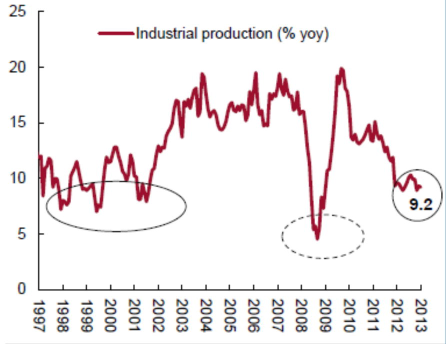
Food prices inflation softened to 3.2% YoY in May, against a prior reading of 4.0% YoY. Food inflation contributed 1.05% directly to headline inflation in May against 1.33% in April. Clearly, headline inflation continues to be dominated by movements of food prices.

Exhibit 2: Weakness across the board …



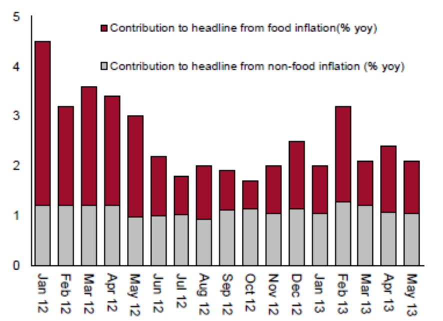
Source: NBS, Credit Suisse

Exhibit 3: … no sign of rebound



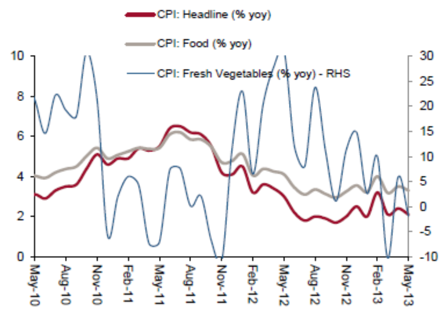
Source: NBS, Credit Suisse

Exhibit 5: Headline inflation dominated by food prices …



Source: NBS, Credit Suisse

Exhibit 6: … sharp fall in vegetable prices was the main driver for the month



Source: NBS, Credit Suisse

More recent data revealed pork prices picked up in the second half of May, specifically pork prices increased by 2.8% during the last ten days of the month. Should this development continue in coming months, this will exert upward pressure on headline inflation.

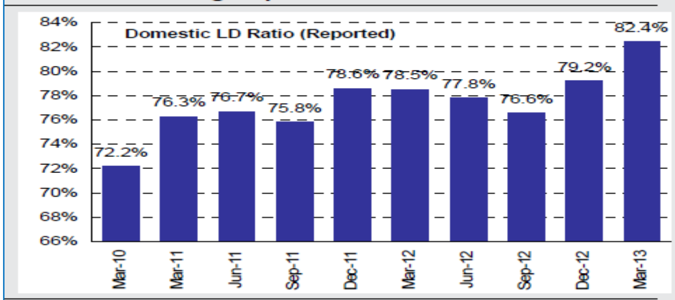
India: Neutral

The banking system Loan to Deposit ratio has stayed sticky at close to historically high levels of 77-78%. While loan growth has slowed to around 15% YoY, deposit growth has been even weaker at closer to 13%. The key reason is that real deposit rates (adjusted for CPI) are meaningfully negative. Banks will not see pick up in deposit growth unless real rates rise.

The Indian banks' LD ratio was even higher than the system at 82%. This explains the deposit rate hike by the banks in March 2013. Management said that for fiscal year 2014 it is targeting loan and deposit growth between 20-25%. With system growth likely to be between 12-14%, this implies that SBI will aggressively compete for deposits.

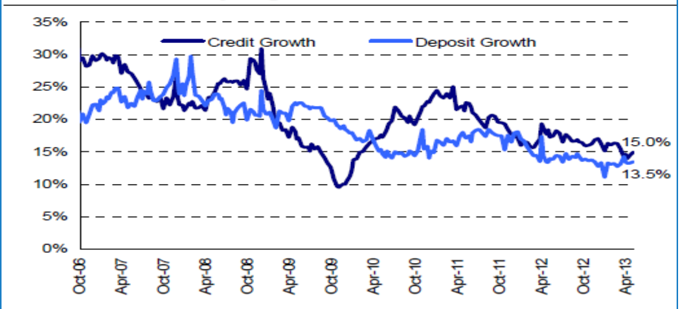
Since banks have migrated to a base rate system, lending rates are formulaically linked to deposit rates. Hence, the risk of lending rate cuts without deposit rate cuts is low. But if banks do cut the base rate without cutting deposit rates, NIMs will come under pressure at a time when provisions remain sticky at high levels and wage hikes are hitting earnings.

SBI – Domestic LD ratio has moved higher to 82%, compared to 79% in F3Q13 and 78% in F4Q12. This will make cutting deposit rates difficult.



Source: Company Data, Morgan Stanley Research

Indian Banks: Gap between credit and deposit continues to stay high



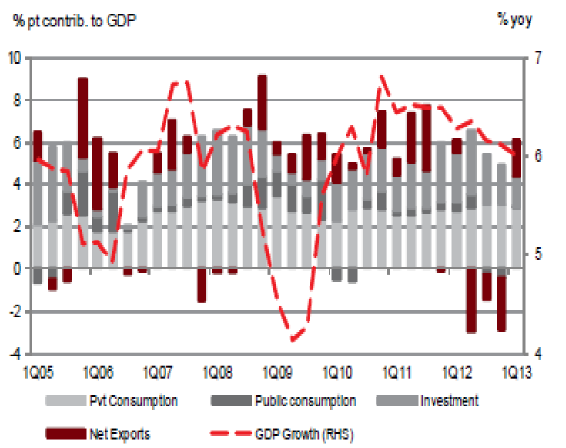
Source: RBI, Morgan Stanley Research

Unless rates are cut meaningfully or growth picks up sharply, asset quality concerns will remain high. In this backdrop quality names will continue to outperform over longer term period.

Asia Pacific: Mixed

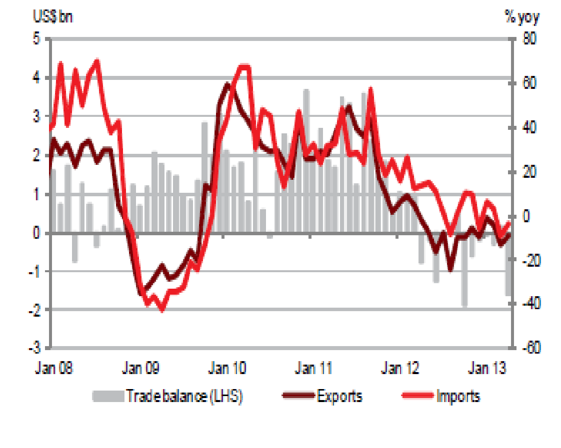
Real GDP growth of Indonesia eased slightly to 6.0% in 1Q13 from 6.1% in the previous quarter. The slowdown emanated from gross fixed capital formation, as a result of weaker investment in foreign machinery and transport equipment, which was a side effect of curtailed capex in the mining sector. Though net-export contributions turned positive in 1Q13, proposals by China and the EU to restrict the import of low-calorific-value coal and biodiesel respectively may slow the recovery in Indonesia's exports of the two commodities in 2013.

Figure 2: Real GDP growth eased slightly to 6.0% yoy in 1Q13



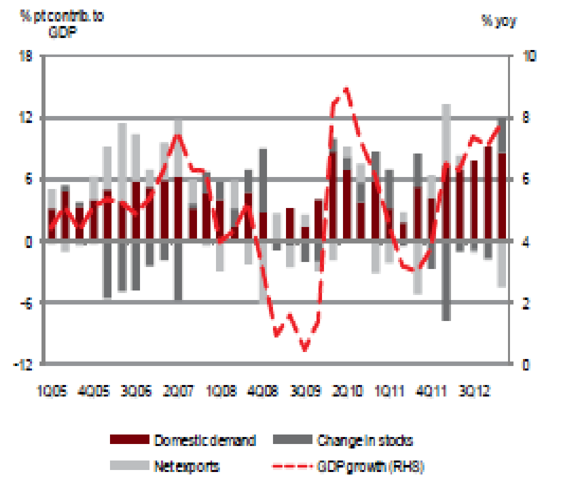
SOURCES: CEIC, CIMB RESEARCH

Figure 3: Import restrictions by China and EU may slow Indonesia's export recovery



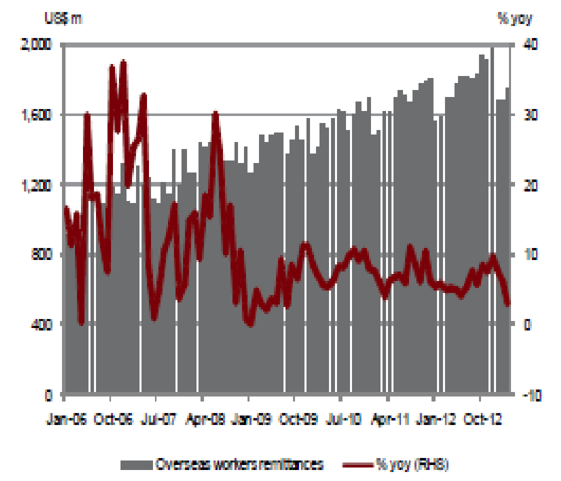
SOURCES: BPS, CEIC, CIMB RESEARCH

Figure 2: The economy expanded strongly by 7.8% yoy in 1Q13



SOURCES: CEIC, CIMB RESEARCH

Figure 3: Domestic demand fueled by overseas remittances



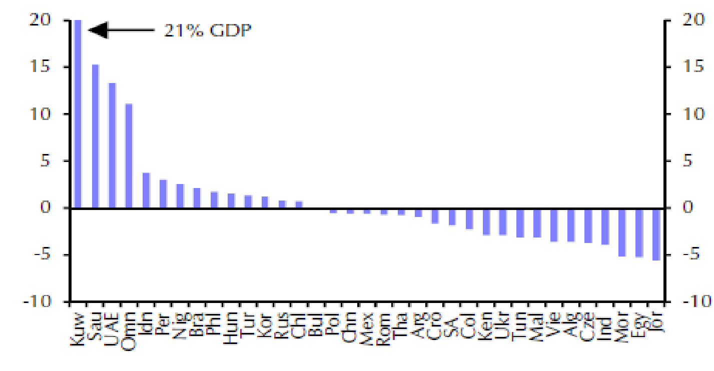
SOURCES: CEIC, CIMB RESEARCH

The Philippines' progresses in fiscal consolidation, strong external position and macroeconomic stability have earned it investment grades from S&P (in May 13) and Fitch Ratings (in Mar 13). Its budget deficit stood at 2.3% of GDP in 2012 (-2% of GDP in 2011) while its current account surplus was 2.8% of GDP (+3.1% of GDP in 2011). Still, the authorities would need to enhance the country's investment operational aspects to sustain foreign direct investments (FDIs). Measures could include easing restrictions on foreign ownership and streamlining the rules for business start-ups. Infrastructure spending via Public Private Partnerships is beginning to pay dividends.

Russia and Emerging Markets: Mixed

Emerging market (EM) governments have somewhat of a chequered history when it comes to debt. Indeed, according to Reinhart and Rogoff, EMs account for 126 of the world's 132 sovereign debt defaults since 1950. The past decade, which encompassed a global boom and bust, along with historically high commodity prices, has had a profound effect on EM debt dynamics.

Chart 1: General Government Primary Budget Balance (% GDP, 2012)

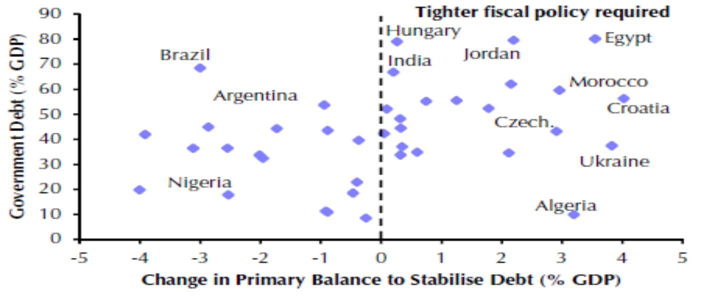


Sources – IMF, Thomson Datastream

If governments continue to run large budget deficits, then their overall stock of debt will rise. And while the effect of high public debt on economic growth is currently a hot topic of debate, there is little doubt that high public debt tests the patience of investors and can lead to macroeconomic instability.

Of particular concern are those countries in the top right hand corner in Chart 2 where the stock of debt is already high and the government has large budget deficit. For example, in Egypt, where gross debt is equivalent to around 80% of GDP, calculations suggest that fiscal policy needs to be tightened by 4-5% of GDP in order to prevent the debt ratio from rising even higher. That would almost certainly be the catalyst for a deep recession. High debt and large budget deficit also make Jordan vulnerable.

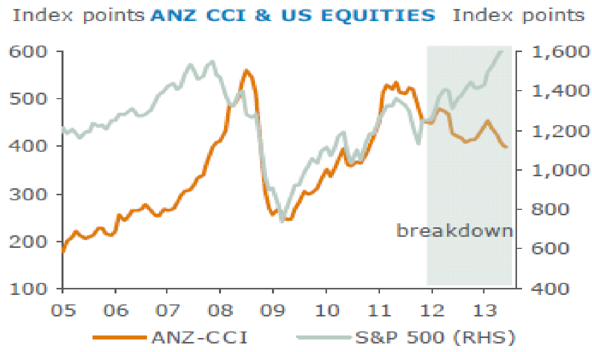
Chart 2: Change in Primary Budget Balance to Stabilise Debt & Gross Government Debt



Sources – IMF, Capital Economics

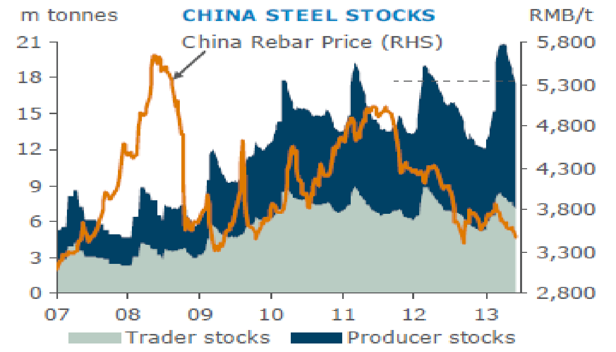
Commodities: Negative

FIGURE 3. GROWING MISMATCH BEWTEEN COMMODITY AND EQUITY MARKETS



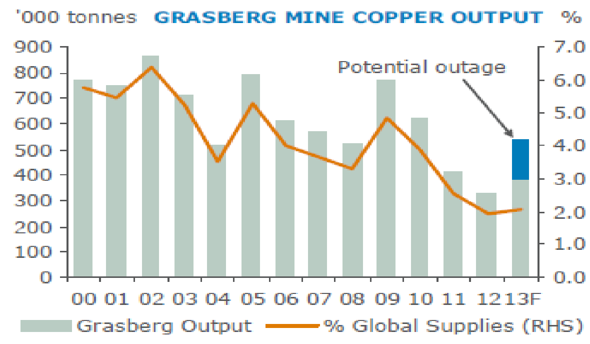
Sources: Bloomberg, CEIC, ANZ Commodity Strategy

FIGURE 4. CHINESE STEEL STOCKS FALLING OFF RECORD LEVELS, BUT STILL AT LAST YEARS PEAK



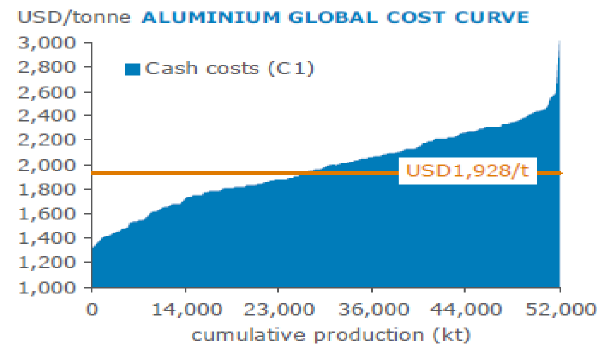
Sources: Bloomberg, ANZ Commodity Strategy

FIGURE 5. WORLDS SECOND LARGEST COPPER MINE (GRASBERG) OFFLINE FOR 2-3 MONTHS



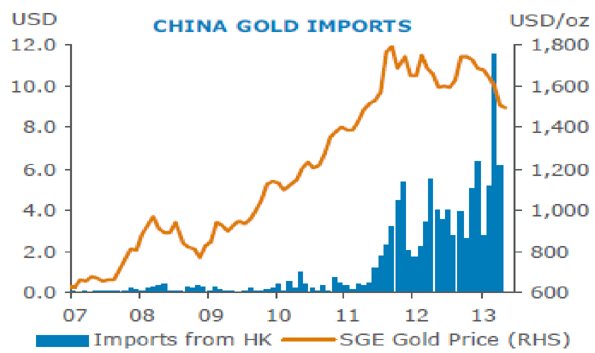
Sources: Wood Mackenzie, ANZ Commodity Strategy

FIGURE 6. ALCOA CUTS HIGH COST CAPACITY – POTENTIALLY MORE TO COME FOR OTHER PRODUCERS



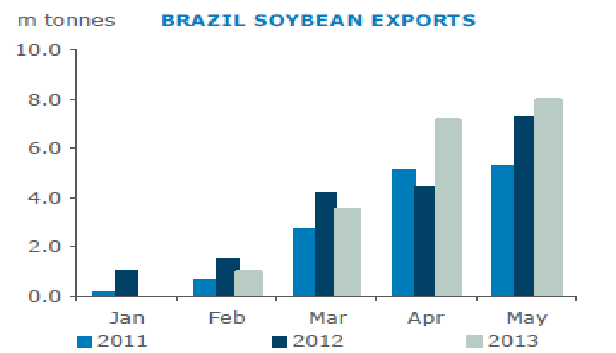
Sources: Wood Mackenzie, ANZ Commodity Strategy

FIGURE 7. CHINESE GOLD IMPORTS IN MAY DROP AS ATTRACTIVE ENTRY POINTS DIMINISH



Sources: Bloomberg, CEIC, ANZ Commodity Strategy

FIGURE 8. BRAZILIAN SOYBEAN EXPORTS – A SLOW START BUT RECORDS SET IN APRIL & MAY



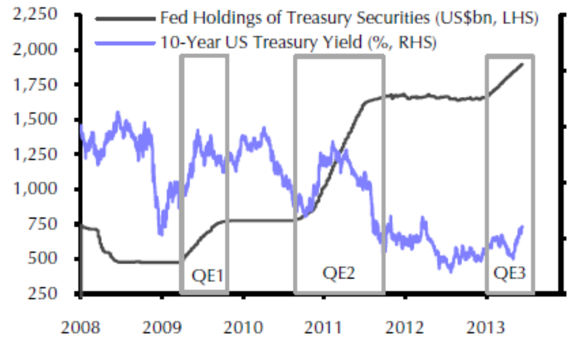
Sources: CEIC, ANZ Commodity Strategy

Commodities were weaker in May, as investors continued focusing on the weak run of China economic data. Expectations were again revised lower for China's economic growth prospects, while financial flows continued to favour riskier developed market assets such as US equities rather than commodities. Also a near-uniform fall in global inflation indicators pointed to markets largely removing the risk of a destabilising rise in global inflation.

Markets linked to China's steel industry were hardest hit, with iron ore and coking coal prices falling 18% and 6% respectively MoM. Precious metal markets also underperformed. But base metal prices benefited from a modest amount of short covering, after the extreme short positioning reached in April. Soybeans were the best performer in agriculture, rising 8%, as low US supplies forces domestic users to outbid export buyers.

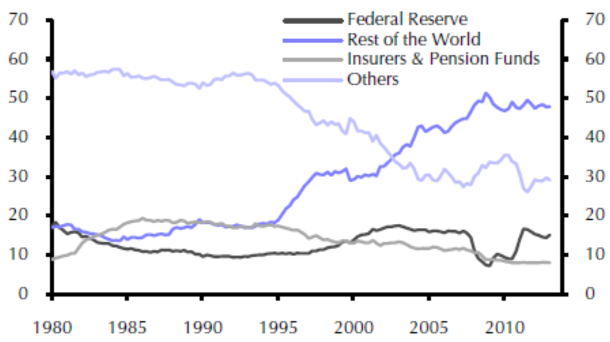
Bonds: Mixed

Chart 1: Fed Holdings & Treasury Yields



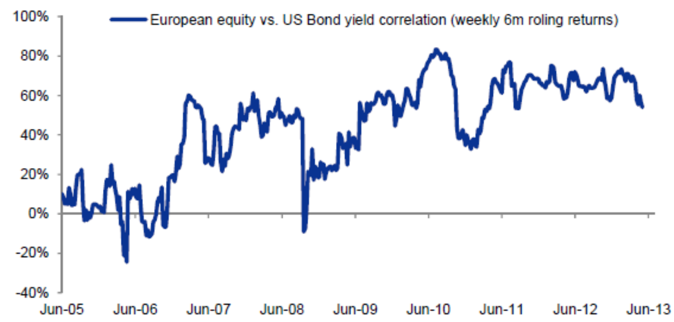
Source – Bloomberg

Chart 2: Ownership Shares Of US Treasuries (%)



Source – Thomson Datastream

Exhibit 3: ... the relationship holds for recent high-frequency data esp. with treasuries



Source: Datastream, Goldman Sachs Global ECS Research.

Total US public debt climbed by $673bn between the end of last September – which is the month in which QE3 was launched – and the end of May. Intra-governmental holdings increased $45bn, leaving other buyers and the Fed to soak up $628bn. The US central bank absorbed 38% of this amount, its holdings of Treasuries increasing by nearly a quarter in the process.

The Fed acquired more than 40% of the net increase in the stock of privately-held US government bonds in Q2 and Q3 2009, during QE1. And it absorbed more than the entire net increase during QE2. In neither case did the Treasury yields subsequently soar. This is because the end of QE dulled investors' appetite for risk, assuaged concerns about the inflationary consequences of expanding the monetary base, and was not accompanied by expectations of higher interest rates. It did not result in a reduction in the stock of assets held by the Fed either.

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

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