AMG FINANCIAL GROUP 安柏

AMG Market Commentary

October 2014

Strong Dollar Effects to Investors

In last month investment report, we have discussed our view for the dollar trend in the next 1 to 2 years (We said that following the changing monetary policy, the dollar would sustain its strength against most developed market currencies, such as EUR, JPY, and NZD; but against emerging market currencies, it would initially have a short-term appreciation and then would change to neutral or slightly depreciation in a medium-to-long term perspective. It is because the value of most developed market currencies has been largely increased in the past few years, but on the other hand, most emerging-market currencies have depreciated during the same time. Therefore, the further downside room should be limited for most emerging market currencies). Today, we will explain how our investments will be affected if the strong dollar continues in the coming 1-2 years.

First, investors should figure out what kind of investors you are. What we are referring to here is whether you are a US$-based investor, a EUR-based investor, a JPY-based investor, or other currencies-based investor. It is because the surging dollar may have different influences on different currency-based investors. Some US$-based investor may misunderstand that a strong dollar will effect positively on their investments. However, it is a totally wrong idea! It is because if you are a US$-based investor, the value of your non-US$ asset will drop (in terms of US$) because of the rising dollar. For example, an investor has bought a Korean Equity Fund one year ago. Assuming the Korean stock market remained unchanged in the past one year (the value of the stocks holding in the fund portfolio also remained unchanged), the fund value will still drop (in terms of US$) if the dollar has appreciated against KRW in the past one year (however, such issue may not happen for EUR or JPY-based investors as both EUR and JPY may depreciate against US$, same as KRW at the same time).

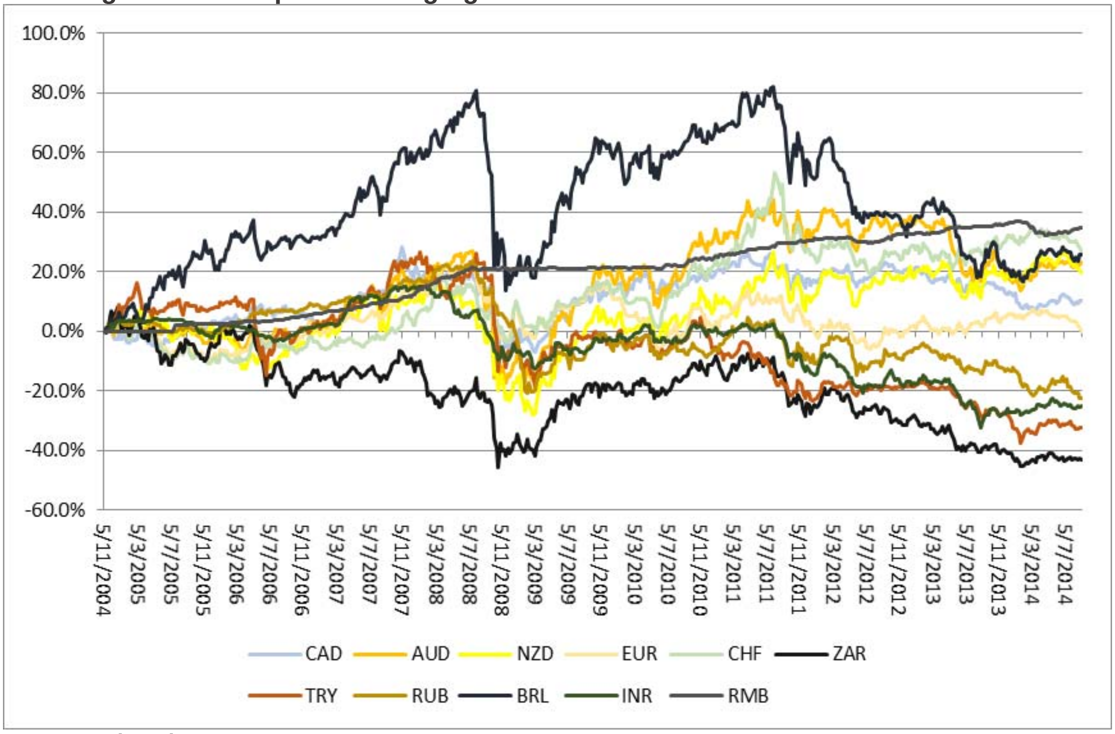
Thus, if you forecast the dollar will continue to appreciate sharply (like what was happened in the last quarter), you should be alert to the possible effects of the strong dollar and review your investment portfolios to see if any portfolio adjustments are needed.

Dollar Trend Forecast

As mentioned above, we believe the dollar will continue to rise up against most developed market currencies in the next 1-2 years. However, we are quite sure that the appreciation will not be as dramatic as what we have seen in the last quarter (the dollar has appreciated more than 8% in the past three months). Nevertheless, since the dollar will still be moving up against most developed market currencies, we suggest investors (if he/she is a US$-based investor) to reduce their investment exposure on these developed countries.

On the other hand, in a medium-to-long term perspective, we do not think the dollar will occur a significant appreciation against most emerging market currencies despite the dollar has just recorded a quite substantial appreciation against emerging market currencies in the past few months. It is because most emerging market currencies are already trading at their historical low now. Thus, we suggest investors can keep, or even slightly increase their investment exposure on emerging markets.

Dollar against Developed & Emerging Market Currencies in the Past Years



Sources: Bloomberg

Why Strong Dollar Suppress Stock Market?

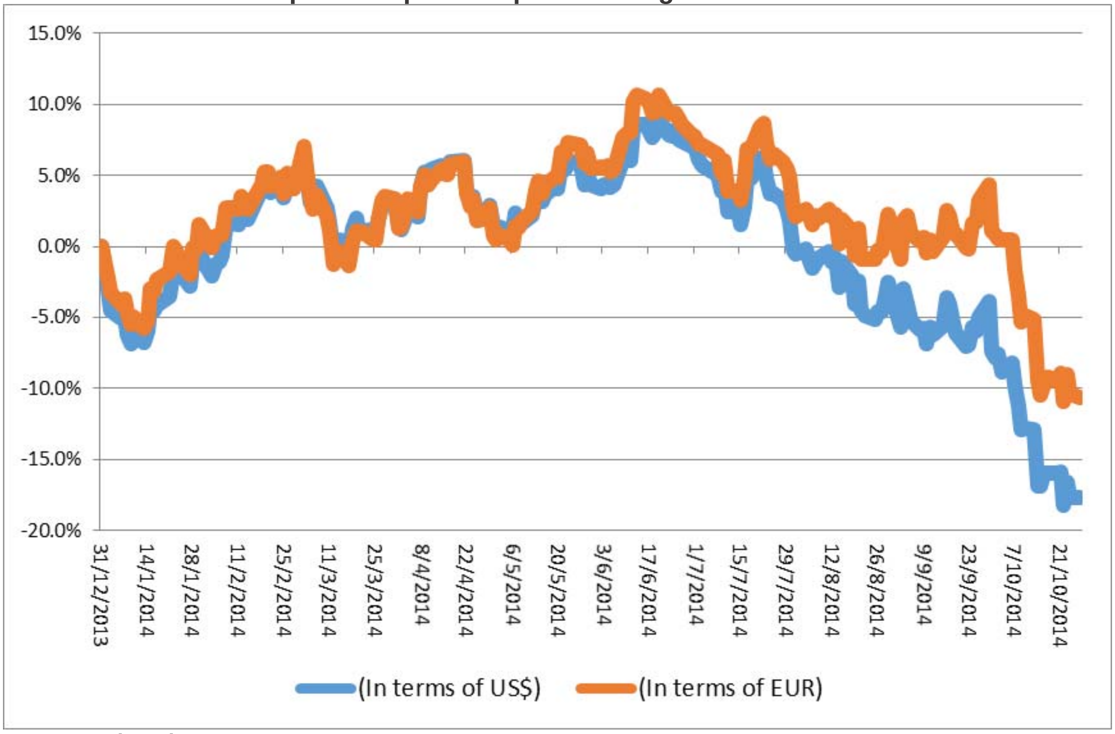
If the dollar just slightly rose up, it would not have much influence to the stock market. The stock markets have been under pressure in Sept and early Oct because the US dollar has rapidly risen up in the last few months.

One of the reasons for the surging dollar suppressing the stock market is that the U.S. companies' profits have been negatively influenced by the appreciation of the dollar. Even though U.S. is the largest economy and the largest consumer market in the world, many U.S. companies do not just focus their business in US. Indeed, they have extended their business to every corner of the world. As a whole, these overseas earnings have been a significant percentage of their overall earnings. For example, more than 30% of the earnings of the S&P 500 companies are coming from offshore business. The growth rate of these earnings (measured in US$) will decrease if the dollar has appreciated. It is because for a non-US dollar earning from abroad, the amount (in terms of US$) will be reduced if the US$ goes up. Taking the Q3 U.S. corporate earnings as an example, before the recent sharp rise of the U.S. dollar, investors had generally perceived an 8% increase on corporate earnings. Now, the expectation has been adjusted downward to 5% considering the negative effect of the rising dollar. However, we think that the stock market drawdown happened in late Sept and early Oct has to some extent overstated the negative impact to the earnings growth. We agree that the rising dollar will have a negative impact to the corporate earnings. However, the negative impact should be limited to 2-3% (but the stock market has corrected almost 8%), especially considering that some U.S. corporate have announced their earnings results and the negative impacts were not as severe as what investors have expected.

Why Strong Dollar Suppress Commodity Market?

Because most commodities are quoted in U.S. dollars, the appreciation of the U.S. dollar will increase the commodity prices (in terms of US$ for non-US dollar consumers and investors). The rising prices crimped the demand for commodities outside of the United States, which leads to the fall on commodity prices. Thus, a stronger dollar will often cause short-term or even medium-to-long term pressure on commodity prices.

NYMEX Crude Oil: the price drop is sharper counting in dollars than euros



Sources: Bloomberg

Will the Influences Last Long on Stock and Commodity Markets?

We believe the previous drop on stock market has fully priced-in or even overly priced-in the negative effects of the rising dollar. Even though a stronger dollar is an unfavorable factor to the earnings growth of some U.S. corporate, a stronger dollar will benefit some non-US corporate, for instance, some Asian export companies aiming U.S. as their sales market. It is because a strong dollar will make their export price more attractive. Therefore, for the global stock market as a whole, the strong dollar will not be a one-sided factor. However, investors need to understand the pros and cons and take the advantages of the rising trend by choosing the appropriate assets and regions.

On the other hand, the effects of a stronger dollar on commodities are believed to be more substantial and possibly last longer. As we mentioned above, the strong dollar effect will increase the commodity prices (for non-US dollar consumers and investors), then decrease the demand outside of America, and finally lead to a fall on commodity prices. Thus, in the next 1 to 2 years, the demand for commodities from the developed markets is expected to be suppressed, and it may limit the upside potential for the commodity prices. However, “US dollar value” is not the only factor that influences commodity prices. Economic outlook should be taken into consideration as well. Even though it is possible that the global economy may fall back a bit in a short term, we believe that the global economy will sustain a favorable outlook in 2015. As a result, we should not feel too pessimistic on commodities (especially the commodity prices have dropped about 20% in the past few months).

How to Adjust the Investment Strategies

As we believe in the next 1 to 2 years, the U.S. dollar will keep being strong against most developed market currencies (but will remain the same or drop down a bit against emerging market currencies), investors may consider to allocate more investment weightings on emerging markets while reducing the investment weightings on developed markets. Besides, it is expected that the commodity prices will be weak in a short-term as the stronger dollar effect is expected to be relatively significant and last long on commodity. We do not expect the commodity will change to very bullish in 2015. Thus, Investors should prepare to hold it as a long-term investment (however, it is a good timing to start a regular investment for commodity as the price is at a very attractive level now) before they want to invest on commodity.

Economic Review and Market Outlook

US Economy and Financial Markets:

Even though there has been substantial fluctuation in the U.S. financial markets in the past few weeks, the U.S. economy has not seen occurring any obvious downturn. For example, the U.S. Weekly Initial Jobless Claims stays below 300 thousand; U.S. Monthly Industrial Production shows 1% growth in Sept (the highest growth since

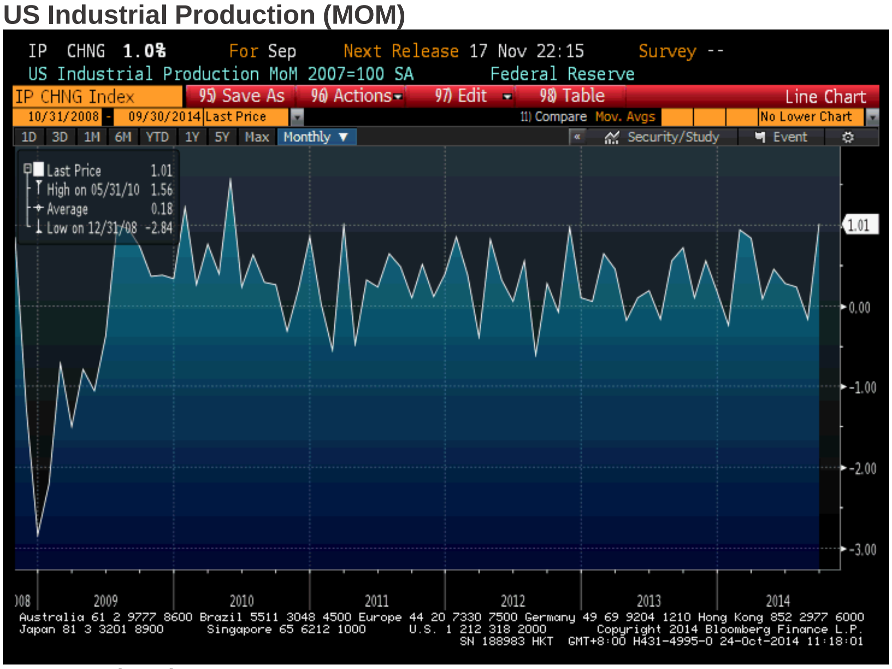
May 2010); U.S. PMI Manufacturing Index points at 56.6 (far higher than 50, the watershed between expansion and

contraction). The relatively disappointing data is the U.S. Factory Orders and Retail Sales. However, both of them are relatively volatile figures, which one single month underperformance is not sufficient to prove any severe downturn or risk of downturn has appeared in the U.S. economy.

US Weekly Initial Jobless Claims

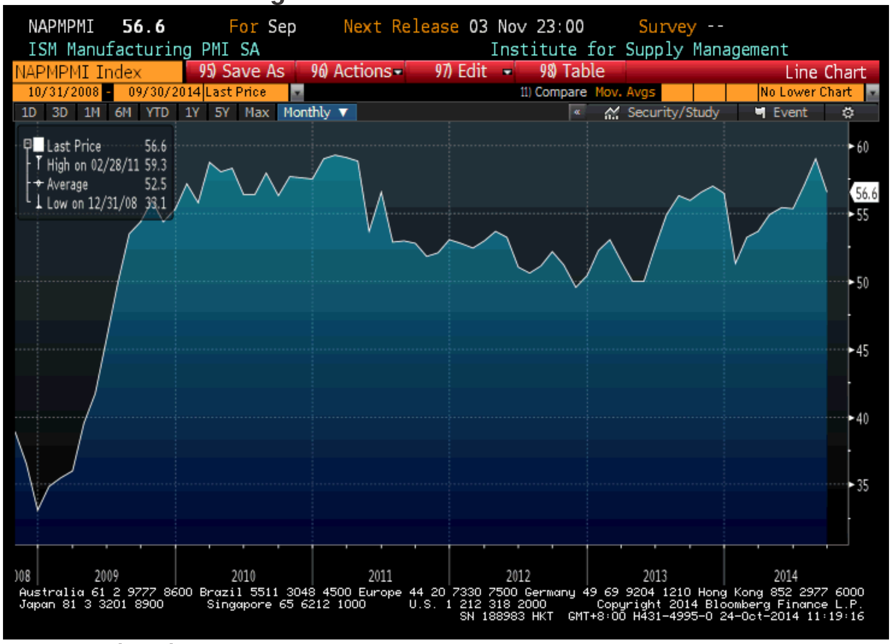
Sources: Bloomberg

US Industrial Production (MOM)



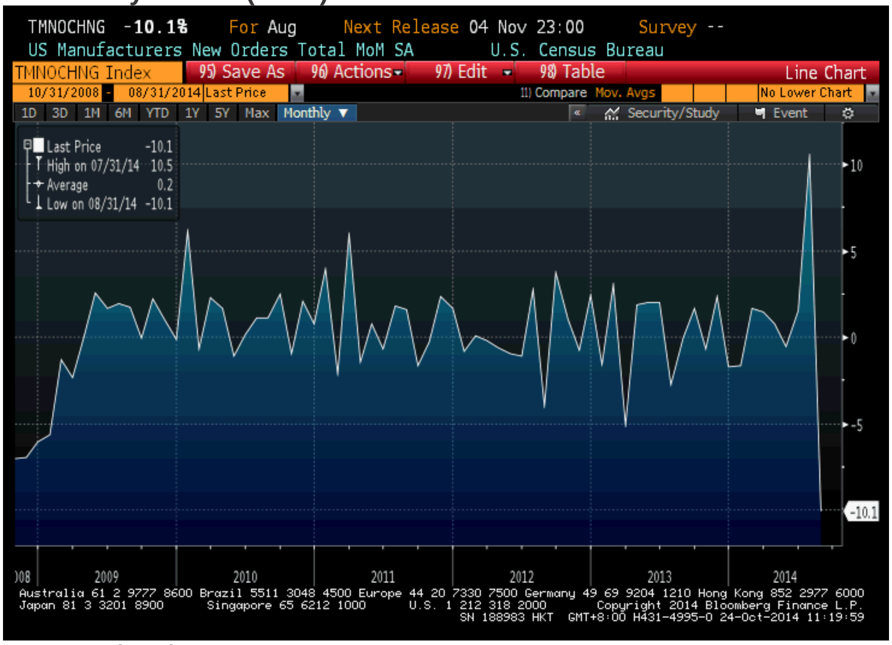
Sources: Bloomberg

US PMI Manufacturing Index



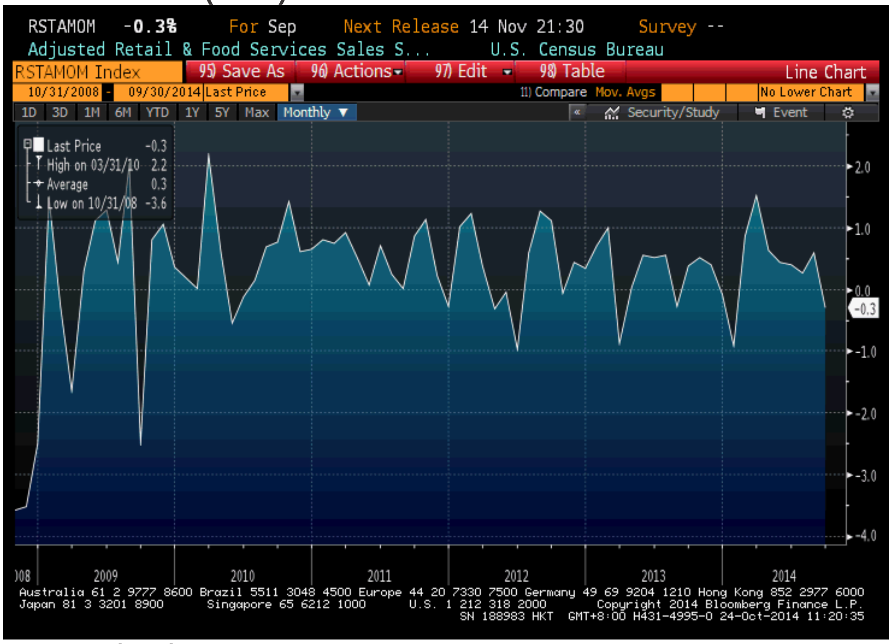
Sources: Bloomberg

US Factory Orders (MOM)



Sources: Bloomberg

US Retail Sales (MOM)



Sources: Bloomberg

After experiencing a sharp decline at the beginning of October, the U.S. stock market sees support from the bottom in recent days. The stock market has rebounded from the bottom because investors have realized that the U.S. economy outlook is staying to be positive and the company earnings are not affected by the rising dollar as severe as expected (to put it simply, investors were over panic and the stock market was oversold). For example, due to a rising US$, investors have lowered the forecast for Q3 U.S. corporate earnings from growth of 8% to 5%. However, most earnings reports have shown that the negative impact was not as severe as expected. There are more than 70% of the companies showing better-than-market-expectation earnings.

Dow Jones Industrial Average Index

Sources: Bloomberg

EU Economy and Financial Markets:

The policy decision from ECB continues to be the focus of the market. Mario Draghi, the ECB president, announced the details of the Asset-backed Securities and Covered Bond Purchase Programmes to the public during the ECB regular meeting on 2nd October. Draghi declared that the ECB would start the asset purchases by the end of Oct. Besides, it is expected that the programmes will last for two years, targeting to resume the ECB balance sheet to the levels seen in 2012 (if so, ECB will add about 1 trillion euros to its balance sheet).

ECB Balance Sheet

Sources: Bloomberg

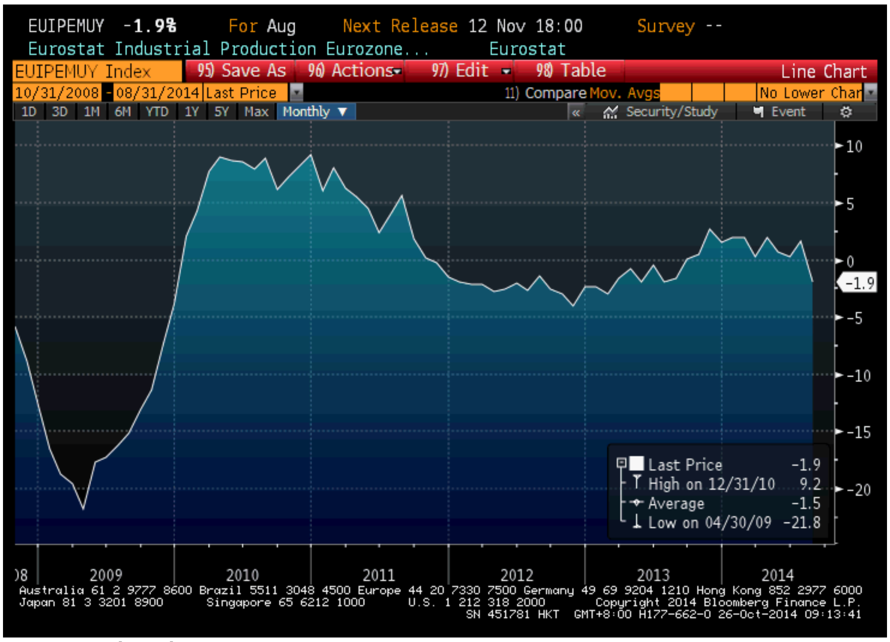
We believe that even though the scale of the asset purchases by ECB may not meet investors' expectations (some investors felt disappointed when ECB has announced the programme size), the policy is essentially beneficial to the economy and the stock market. In fact, the ECB has shown its strong determination to save the economy and prevent deflation. Though the scale of the asset purchases might not be large enough to convince every investors of ECB's capability, this piece of news is believed to eventually have positive effects on the stock market.

Economic statistics reflect that the momentum for European economic growth is slowing down. For instance, the EU PMI Manufacturing Index is 50.7 in October, much lower than 54 recorded at the beginning of the year. In addition, the EU Industrial Production also drops from +1.9% at the beginning of the year to -1.9% in August. However, even though the recent economic statistics have shown drop-falls, we are still confident to the EU economy. First, it is nothing but normal for the economic statistics showing some short-term downturns as the EU economy has just revived from the recession since Q3 2013 (EU economy has suffered recession during Q1 2012 – Q3 2013) and the economy still contains many instabilities. Second, as we mentioned above, under the reinforcement of the monetary policy by ECB, the EU economy would not be too bad.

EU PMI Manufacturing Index

Sources: Bloomberg

EU Industrial Production

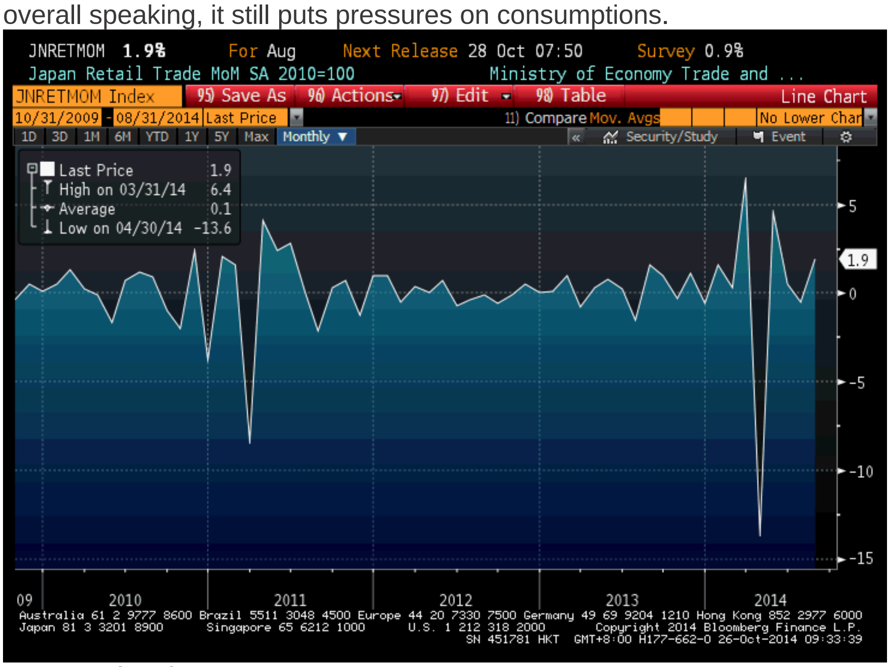


Sources: Bloomberg

Japan Economy and Financial Markets:

Japan's economic momentum has remained relatively weak. One of the reasons is that the economic structural problems are still unsolved. At the beginning of 2013, Abe's stimulus policy did bring a warm breeze to the Japanese economy. However, after 12-18 months, the stimulus effect of Abe's policy has barely left. Moreover, the rise of consumption tax starting from this April has harmed consumer sentiment and further struck the economic growth momentum.

Japan Retail Trade (MOM): the negative effect from the rise of consumption tax has been diminishing. However, overall speaking, it still puts pressures on consumptions.



Sources: Bloomberg

As affected by the external unstable factors, plus the appreciation of JPY, the Japanese stock market has recorded a more than 10% drop in early Oct. However, we are still confident to the Japanese stock market. It is because we believe that the most supportive factor to the stock market – the depreciation of yen, will continue in the next 6-12 months. We think that there is a great chance for JPY to stay around or even below JPY110/ US$.

Apart from that, the pension fund reform will also be a favorable factor to the Japanese stock market. Under the government's pressure, many Japanese pension funds have already started to change their investment strategies, turning from extremely conservative (having almost all Japanese government bonds in their portfolio) to moderately aggressive (increase their investment in Japan and overseas stock markets). This will bring huge supports to the Japanese stock market as it will directly increase the demand for Japanese stocks and keep JPY weak (and a weak JPY will be a favorable factor to the stock market).

Based on the statistics announced by Bank of Japan, the public pension funds, including the Government Pension Investment Fund (GPIF), have sold net JPY 1.1 trillion (about US$ 10.14 billion) long-term Japanese bond from April to June, and bought net JPY 393 billion Japanese stocks. We believe that such kind of capital inflows to the stock market will continue for a while in the future.

Japan Nikkei 225 Index

Sources: Bloomberg

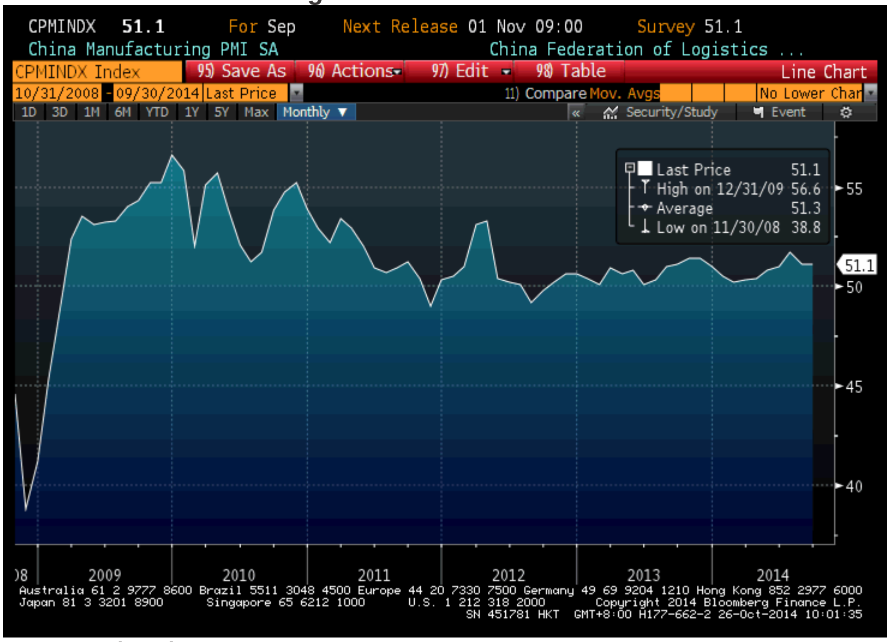
China Economy and Financial Markets:

China's economic growth in the 3rd quarter this year is 7.3%, lower than the 2nd quarter, but higher than the market expectation (7.2%). However, the economic growth momentum has remained at relatively weak levels as the economic and financial reforms have continued. Both the economic and financial reforms will continue to have constraining effects on the economic growth. Thus, we believe that the economic growth of China will remain at a relatively weak level (around 7% - 7.5%) in the short term future.

China GDP (YOY)

Sources: Bloomberg

China PMI Manufacturing Index



Sources: Bloomberg

Even though both Hong Kong and Mainland China stock markets have suffered some fall backs recently, the losses were way less than other regions. One of the reasons is that investors have remained quite optimistic the Chinese government is going to release a series of economic stimulus policies, such as further relaxing the constraints on real estate market, increasing the money supply by lower the required reserves or directly inject the capital to the banking sector).

Shanghai Stock Exchange Composite Index

Sources: Bloomberg

Hang Seng Index

Sources: Bloomberg

<u>Emerging Market Economies and Financial Markets:</u>

Last month, the emerging stock markets have also been affected by the global stock market correction. The MSCI Emerging Markets Index dropped about 12% from 1100 to 850 in the past one month. Apart from the drop appeared in the stock markets, the emerging market index was also struck by the fall of emerging market currencies as well.

MSCI Emerging Markets Index

Sources: Bloomberg

JPMorgan Emerging Markets Currency Index

Sources: Bloomberg

However, we believe that investors do not have to worry too much as the recent adjustments happened in the emerging stock markets were mainly caused by the external factors. It did not have any significant negative change in the fundamentals of the emerging markets. Besides, we also believe that even the US$ may continue to appreciate in the upcoming 1 to 2 years, the rising of the dollar will only appear against the developed currencies. The rising space will be limited against emerging markets currencies (thus, the emerging stock markets will not be significantly affected).

<u>Commodities</u>

Oil price: As most commodities are priced in US$, the commodity prices being suppressed is nothing more than normal under the rising dollar trend. Oil price is not an exception. The NYMEX crude oil price has dropped about a quarter from $105 in June to recent $80. Apart from the rising dollar, the cause for the suppressed price also includes investors' worries that the possible global economic slowdown in the next year will further worsen the oversupply situation in the oil market (especially when the largest country for oil production, Saudi Arabia, announced recently that it did not have any planning to reduce oil production, and would lower the export price in order to protect its market share in the oil export market).

However, we think even though the global economic growth may really slowdown in next year, we are quite confident that the slowdown will be just very minimal and the demand for oil will not be hurt that much. Therefore, we think the current oil price has been overreacting to the negative factors. Besides, Q4 has always been the peak for oil demand, oil price has a chance to bounce back from the current bottom.

NYMEX Crude Oil Price

Sources: Bloomberg

Gold: Similar with crude oil, the recent rising dollar also put pressures on gold price. To non-US dollar consumers and investors, the price for gold has been moving up following the stronger dollar (even if the price for gold in dollars remains unchanged, the price quoted in other currencies will move up because of the appreciation of the dollar). Thus, the demand for gold will be decreased. The rebound of gold price in the beginning of Oct was mainly driven by safe-haven positioning caused by declining stock market. We do not believe it can last long and the outlook for gold is still relatively bearish.

Gold Price

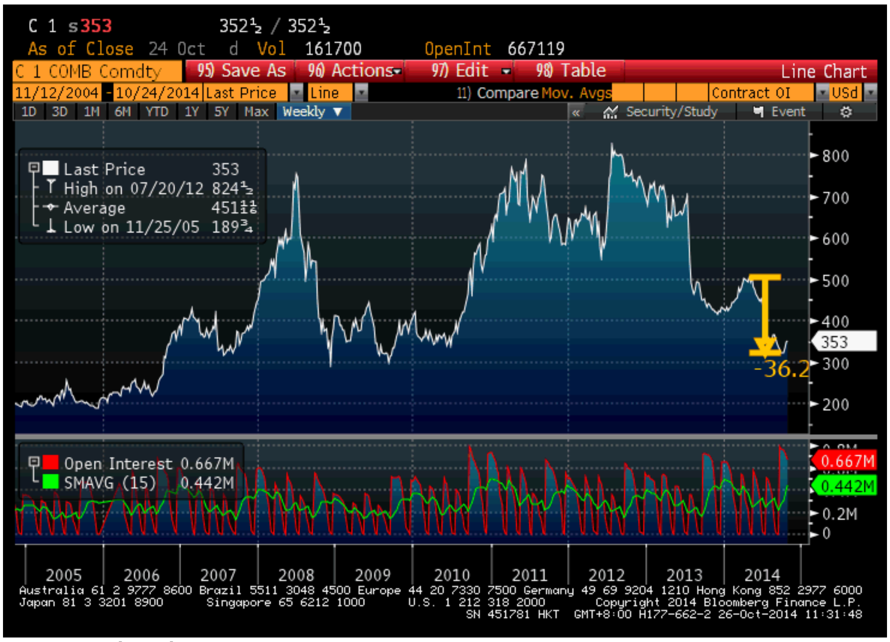
Sources: Bloomberg

Agricultural Products: We believe that it is time to invest in some agricultural products such as wheat and corn. The reason is quite simple and clear. The cycle for most agricultural product price fluctuation generally takes around 6 to 9 months. It is because producing agricultural products require relatively shorter time. If farmers see price falling for a certain kind of agricultural product, they will reduce their planation on that agricultural product and try to grow more profitable things. However, if every farmer does the same, the market supply for that product will shrink after 6 to 9 months, which in return helps the product's price to rise again. For the same reason, if the price for a certain kind of agricultural product moves up, farmers will use more lands to grow it. If every farmer does the same, the price will decline months later as the market supply increases sharply. Indeed, the prices for many agricultural products have dropped more than 30% since the beginning of April and the falling trend has been lasting for more than 6 months.

Wheat Price

Sources: Bloomberg

Corn Price



Sources: Bloomberg

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

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