AMG FINANCIAL GROUP 安柏

AMG Market Commentary

26 August 2015

It Is Another Hard Time For Investors

Global stock markets have dropped sharply in the past few weeks, reflecting that investors are nervous about the possible collapse of the Chinese economy, or put in another way, the spread of economic problems from China to global, and the possible massive currency depreciation which once led to financial crisis in 1997.

Dow Jones Industrial Average has dropped 7.6% since August 1st (till August 26th). In the same time, German DAX Index and Hang Seng Index have plunged by 11.6% and 14.2%, respectively. Investors have been frightened by not only the size of the market slump, but also the speed of the market slump.

Global Stock Markets Slump

	Aug 1 – Aug 26	Highest in 2015 – Aug 26	YTD	P/E
U.S. Dow Jones Industrial Average Index	-7.9%	-11.1%	-8.6%	14.1x
Japan Nikkei 225 Index	-9.0%	-10.2%	8.2%	19.5x
German DAX Index	-11.6%	-19.0%	1.9%	15.7x
Hang Seng Index	-12.3%	-24.0%	-8.4%	9.4x
Hang Seng China Enterprises Index	-12.6%	-34.3%	-18.9%	7.1x
MSCI World Index	-8.4%	-10.7%	-5.4%	17.3x
MSCI Asia Pacific (ex. Japan) Index	-13.1%	-25.7%	-15.5%	10.5x
MSCI Emerging Markets Index	-12.6%	-26.2%	-17.6%	11.5x

Source from: Bloomberg

However, we think that investment markets have been dominated by pessimism currently, and thus have over-dropped, and over-reacted to the existing negative factors. Even though there is bad news around, the recent abrupt slump of stock markets still doesn't make sense.

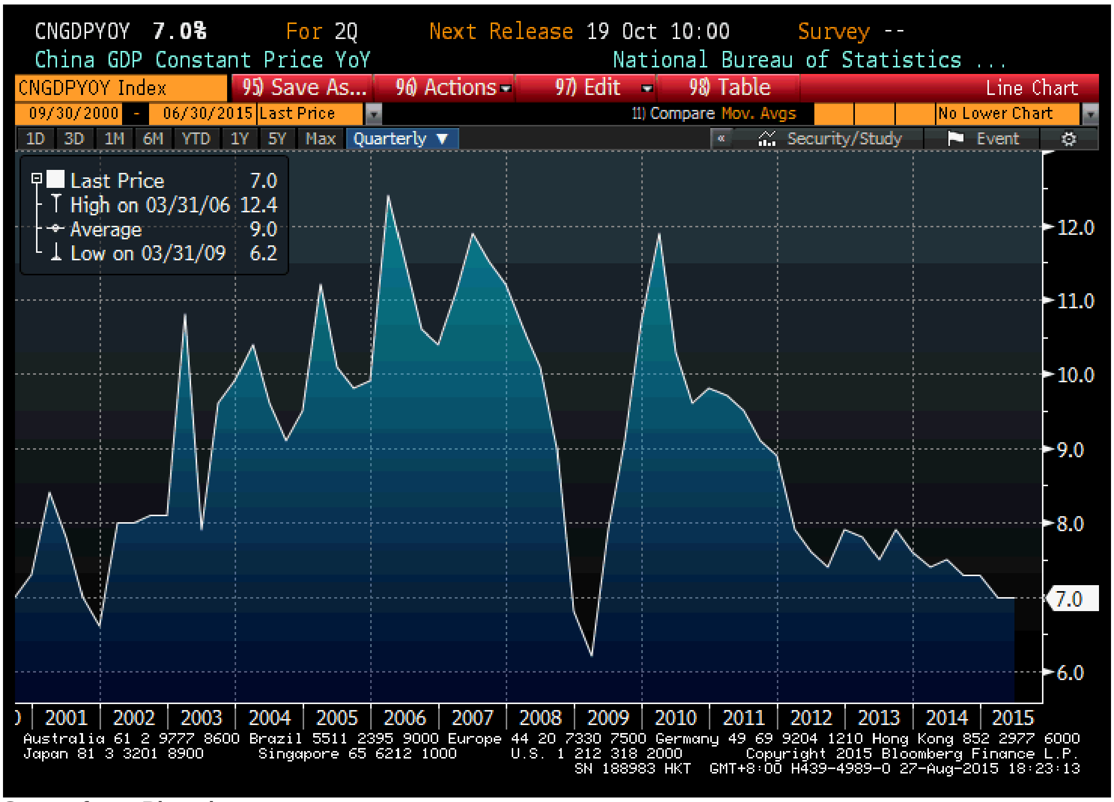
1. **<u>The slowdown of economic growth in China, though undeniable, does not mean the country is on the verge of collapse.</u>**

We have been pessimistic about the economic outlook of China for quite a long time simply because the slowdown of economic growth is inevitable.

First, the Chinese government has pushed the economic restructuring since the beginning of 2010. The reformation has spanned from the change of development focus among different industries (encourage the development of high-tech and high value-added industries, and discourage the development of low value-added and high pollution industries), to the broad shift of economic and monetary policies (try to reduce the reliance of economic growth on spending of infrastructure by the government or lending by the banking sector). Unfortunately, the side-effects of economic reformation are often hard to avoid, weakening the momentums for economic growth.

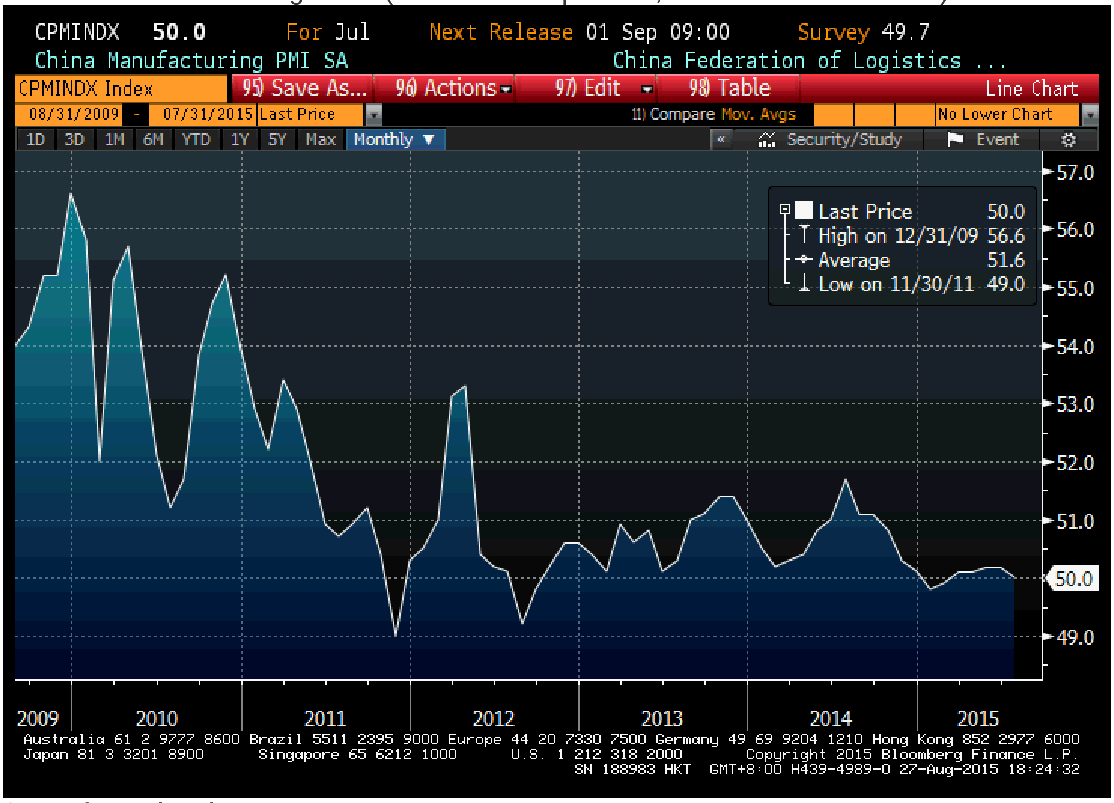
Second, the overcapacity generated by the "4 Trillion Policy" has caused serious troubles. In 2009, the government injected huge amount of money to the economy in order to avoid to be damaged by the financial crisis and maintain the economic growth. Large proportion of the capitals was eventually flowed to the property development or used to expand capacity. Neither developing property market nor expanding capacity was a bad decision by nature. However, because too many capitals were poured into the property development or industries which have already over-expanded, such as iron industry, it then has generated severe overcapacity problems. Relatively long time is needed to dissipate the negative impact of the over-investment. In terms of real estate market, ghost town - a place where has many new apartments built but not has enough people to live in - has appeared in some cities. In steel industry, because of the serious overcapacity problem, the price of steel dropped sharply, leading to less, if not negative, corporate profits in most steel companies.

China GDP Growth YoY



Source from: Bloomberg

China PMI Manufacturing Index (>50 means expansion, <50 means contraction)



Source from: Bloomberg

Apart from the economic restructuring, the Chinese economy is also influenced by other internal and external factors. Internal factors include the increasing of production costs, such as CNY revaluation, the rise of labor and land prices, and persistent low of consumption (The saving rate for average Chinese people is very high. It is because social welfare is insufficient, Chinese people have to save a lot for potential medical expenses or for retirement. Such high saving rate restrains the growth of domestic consumption). The external factors include that the relative weak economic growth of the U.S. and Europe since the financial crisis in 2008, dragging down the growth of import from China, and that the depreciation of emerging market currencies has reduced the competitiveness of the export industries in China.

We believe that the economic growth in China will remain slow in at least one to two years and is unlikely to revive in any short term. However, it does not mean that the Chinese economy or financial market will collapse or that another Asian financial crisis is coming.

Many people have believed that the pronounced depreciation of Asian currencies had resulted in the financial crisis in Asia in 1997. However, currency depreciation was just a sparking point, there were more underlying reasons behind that financial crisis. Asian countries at that time accumulated huge amount of outstanding debts, many of which were short-term debts and foreign debts. When the economy turned weak, those countries were immediately caught in liquidity problems as the capitals fled out of the emerging markets quickly.

Even though China also has relatively huge debts at present (if we include the hidden debts such as local governmental debts and bad debts hidden in the banking sector), China does not have many foreign debts or short-term debts. Even if CNY drops sharply, it is unlikely that the Chinese economy will be under tremendous and abrupt hit.

As mentioned before, many investors were very worried that massive bad debts were hidden and did not disclose to the public. We think it is possible that the amount of bad debts in the Chinese banking system could be ten times, or even twenty times, greater than the number announced officially. However, at least in the near future, we do not think it could lead to any financial crisis in China because Chinese citizens and corporations could not move money in and out of China freely under the current capital control. Even if they lose confidence on the financial system of China, the amount of money that could be legally transferred out of China is still quite small. Some money could be hidden in and transferred through illegal channels, such as fade trade, but the amount is still limited. For example, the annual total trade amount of China is around $5 trillion. If 10% of the total trade is fake, there is about $500 billion could flow through fake trade. As the deposits in banks have amounted to 130 trillion CNY, it takes more than 40 years for all the deposits to flee out of China!

Besides, China has accumulated $3.6 trillion foreign exchange reserves. The country's financial strength could not only maintain the confidence of Chinese citizens on the financial system and CNY, but also equip the government with one more tool to stabilize the market when it experiences short-term volatilities.

Therefore, even though we agree that the slowdown of the economic growth of China would continuously affect the global economy for a relatively long time, **we do not think** that the Chinese economy or financial system is on the verge of collapse. Though adjusting down from May's high is reasonable, it is not reasonable for the global stock markets (except A-share) to drop sharply to the current level. The recent market slump has over reacted to the negative factors in our point of view.

2. Will China spread economic weakness to global markets through CNY depreciation?

On August 11, the PBOC adjusted down the middle exchange rate of RMB by 1.9% (The middle exchange rate of RMB on August 11 was 611.62, but on August 12 it dropped to 622.98). In the following two days, the middle exchange rate dropped down further to 640.1. Up to now, the on-shore CNY middle exchange rate has dropped to 640.93, 3.2% cheaper than the price at August 11.

Middle Exchange Rate of RMB

Date	USD/RMB	Up/Down
2015-08-26	640.43	-0.09%
2015-08-25	639.87	-0.20%
2015-08-24	638.62	-0.00%
2015-08-21	638.64	+0.08%
2015-08-20	639.15	+0.08%
2015-08-19	639.63	-0.00%
2015-08-18	639.66	-0.00%
2015-08-17	639.69	+0.01%
2015-08-14	639.75	+0.05%
2015-08-13	640.1	-1.11%
2015-08-12	633.06	-1.62%
2015-08-11	622.98	-1.86%
2015-08-10	611.62	

Source from: State Administration of Foreign Exchange

CNY On-Shore Price

Source from: Bloomberg

In the past two weeks, investors have been worrying that the Chinese government might devalue CNY significantly, spreading economic weakness to other countries. If CNY slumps, it will not only turbulent the Chinese financial system, but also ignite a currency war in Asia in which every country will swings into currency depreciation, damaging the economy and financial system of the emerging market.

Even though the PBOC has explained the adjustment of CNY middle exchange rate as a way to strengthen the market's role in CNY pricing mechanism, it is quite clear the one possible reason behind PBOC's move is to boost up export and narrow the price differences between CNY and other Asian currencies. In the past two years, CNY has substantially appreciated against other Asian currencies which have depreciated pronouncedly.

However, we do not think the Chinese government would pronouncedly devalue CNY in short term.

First, though currency devaluation could benefit exports, the export industry in China is influenced even more by the increasing production costs which include the rising labor price and land price. For example, in the past ten years, the wage of manufacturing employees has risen up by more than 10% each year, increasing the production cost. If the Chinse government wants to stimulate export by CNY devaluation only, CNY might need to be devalued by at least 10-20%.

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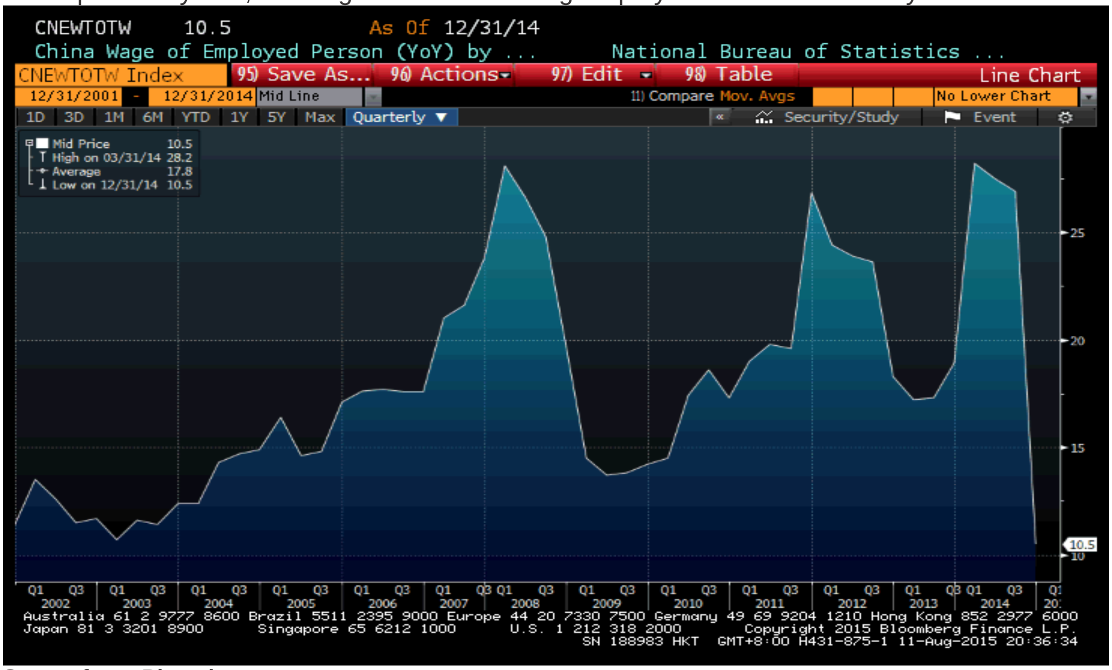


Source from: Bloomberg

However, will the Chinese economy and financial market be able to accept the negative impact from the devaluation (for example, the massive capital outflow)? What actions will other Asian countries take if CNY continues to devalue? We are almost certain that if the devaluation of CNY continues, other Asian countries will spontaneously depreciate their currencies. It could hardly help to boost up exports from China, but might severely undermine the stability of Asian economy and financial system.

Therefore, the Chinese government, as we believe, will not devalue CNY massively to boost up exports as such action will put the economy of Asia, or even the whole world, under huge risks. As we mentioned before, the devaluation of CNY does not equal to more exports because other Asian countries will depreciate their currencies as well. What's worse, the depreciation of CNY could undermine Asian economy and might trigger financial crisis like the one in 1997. Considering its own benefit, China will not take the risk. Therefore, investors have no reason to worry that China might spread economic weakness to other countries through massive currency devaluation.

The Chinese government will not hugely devalue CNY (for example, over 10%) because no one, not even China, could benefit from it.

3. <u>Emerging market is more prepared to defend against external shocks than ten or twenty years ago</u>

Investors also have concerns that the recent currency drop might damage the economy of emerging market and put the stability of finance market at risk.

Some small developing countries, from our point of view, may be threatened by the recent sharp currency drop. However, we do not think the emerging market in general is facing huge difficulties. To put it in another way, we do not believe that there is any possibility another Asian financial crisis will happen soon.

As we mentioned earlier, currency depreciation is only the sparking point. What really caused the financial crisis in 1997 were the unsustainable debts, especially the huge foreign debts and short-term debts, and the long-term structural imbalance - the continued trade deficit and government budget deficit. Today, both the debt level and the economic structure of emerging market countries are much better than those of 1997 or 2000. Emerging market is more prepared to defend against external shocks than before.

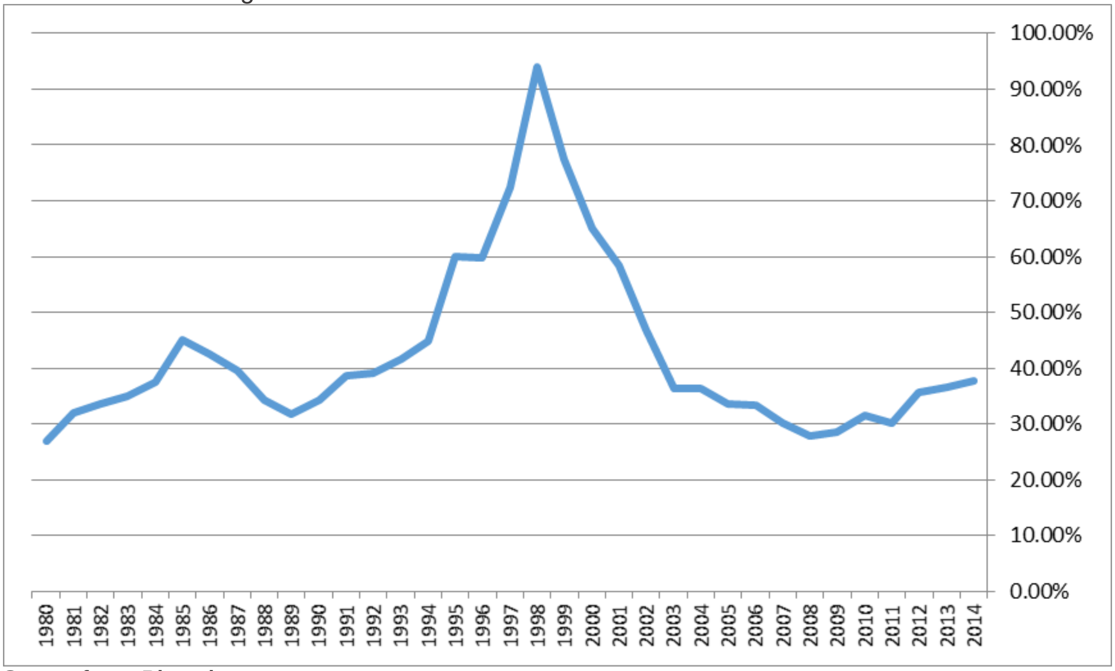
First, most emerging market countries have healthier debt structure. Both the short-term foreign debt to total foreign debt ratio and the total foreign debt to GDP ratio are much lower than those of 1997.

Most emerging market countries have healthier debt structure

	Short-term foreign debt/total foreign debt	Total foreign debt/GDP
Brazil	10%	30%
India	16%	23%
South Africa	24%	41%
Turkey	33%	49%
Russia	10%	29%
China	76%	8%
Thailand	28%	37%

Source from: Bloomberg

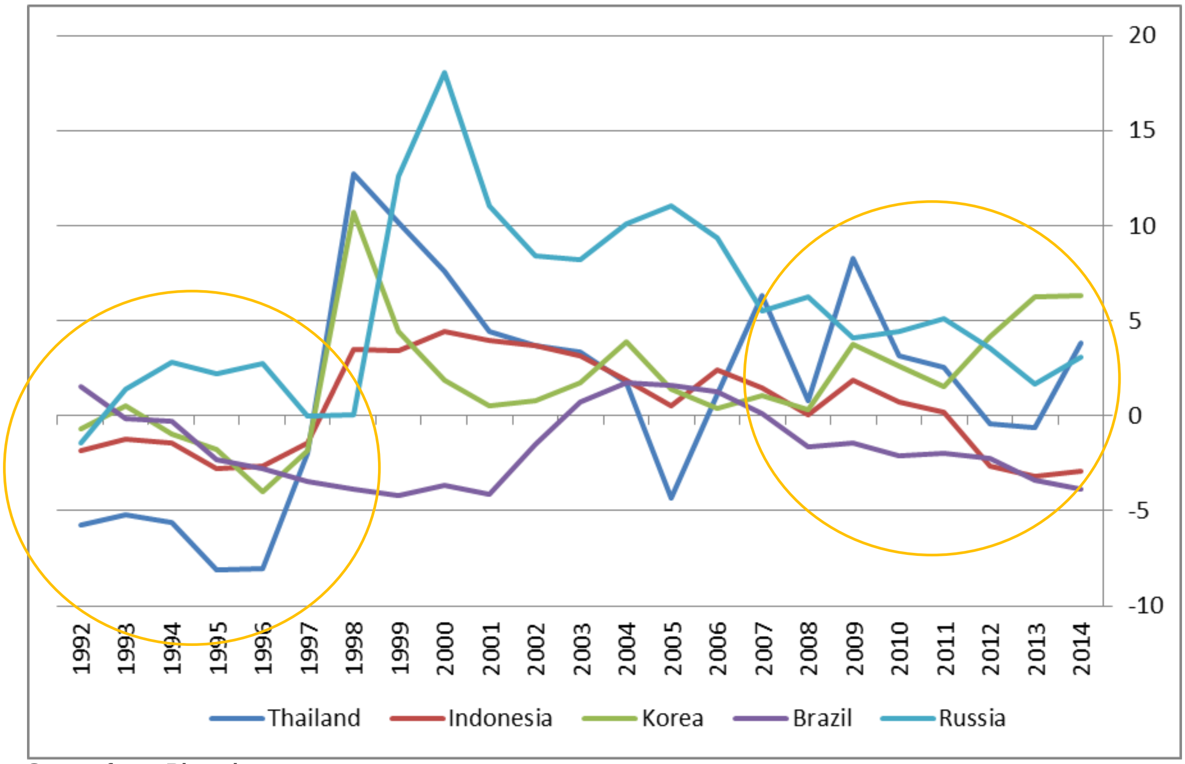
Thailand Total Foreign Debt/GDP Ratio



Source from: Bloomberg

Second, in 1980s and 1990s, most emerging market countries have recorded current account deficit for a long time, indicating more import than export in their foreign trade. Countries with trade deficit have had to borrow money and thus been exposed to more risks as the amount of debts have grown. However, the situation is much improved now. Even though some emerging countries have still recorded current account deficit, most have recorded current account surplus for a long time, indicating healthier situation in their foreign trade.

Current Account Balance/Deficit to GDP Ratio



Source from: Bloomberg

At last, most emerging countries have accumulated more foreign exchange reserves than they did in 1990s, better protecting themselves from external turbulence. Even though having large foreign exchange reserves does not guarantee the country to be indestructible in the global turmoil, it could help emerging market countries to defend against short-term external turbulence and thus decreasing the possibility of suffering another financial crisis.

Foreign Exchange Reserves in Billion USD

	2015	1996
United States	39.4	160
Germany	37.4	118
China	3,650	111
South Korea	370	34.1
Thailand	149	38.6
Indonesia	107	19.3
Brazil	187	59.6
Russia	313	16.2

Source from: Bloomberg (2015) & World Bank (1996)

Therefore, even though the risk of economic collapse exists in some developing countries, we do not think emerging market in general is facing high risk. In other words, we think another Asian financial crisis is a small probability event

Summary

Pessimism again dominates the market right now, reflected in the current stock market slump. Even though quite a few negative factors exist in the market, the fundamentals of current market are not significantly worse than those of a few months ago. However, the stock market has dropped from heaven to hell! The stock market drop is understandable, but, except A-share market which is still not cheap after the drop, stock markets should not have slumped to the current extremely low level. It is quite obvious that the market has been dominated by panic mood and thus over-dropped. We believe the stock market could strongly rebound from current level once investors are calm down.

Now is another test for investors. Could we remain calm during the current market slump and wait the short-term price drop over?

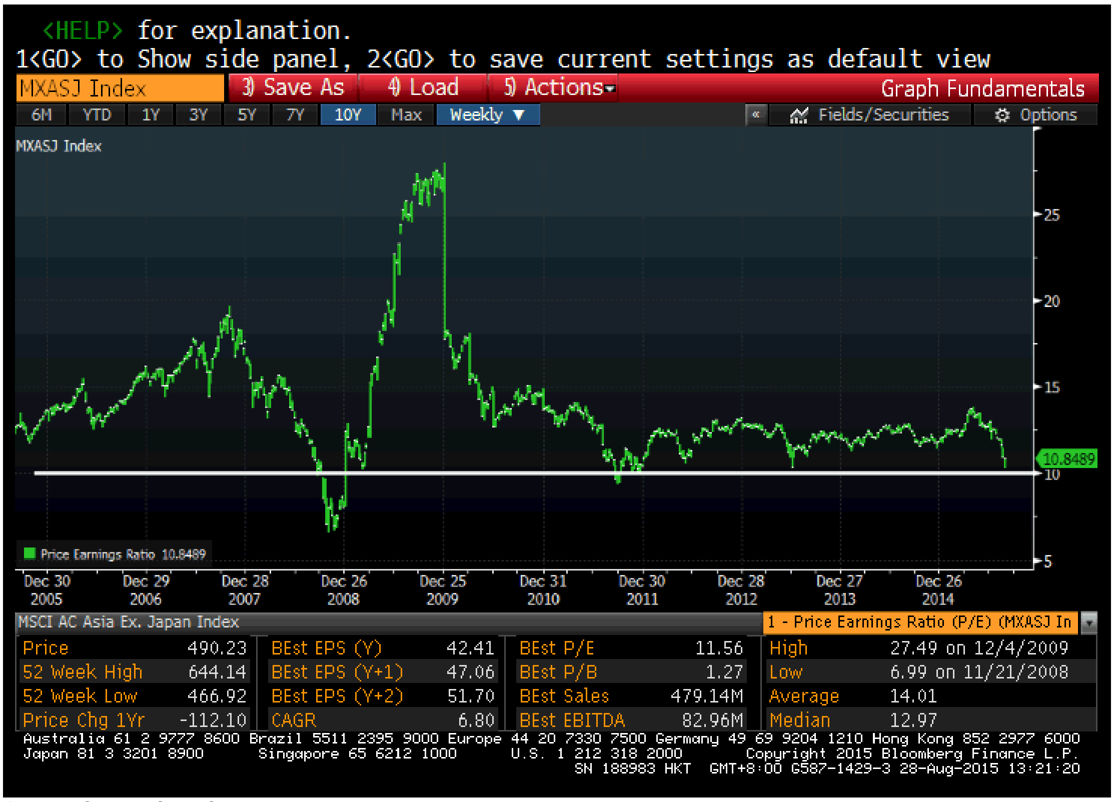
First, investors should understand that 10-20% fluctuation is quite often in stock market, usually once or twice a year. Instead of lead by the market mood, investors should figure out whether the drop of the market is caused by a real economic weakness or just by a panic mood. If the market is just dragged down by market panic, when the market panic is gone, investors usually regret that they didn't insist on buying in when the market was low.

Warren Buffett is considered one of the greatest investors of the world not only because of his unique investment strategy but also because of his psychological quality. Remember his well-known say?

"Be fearful when others are greedy and greedy when others are fearful."

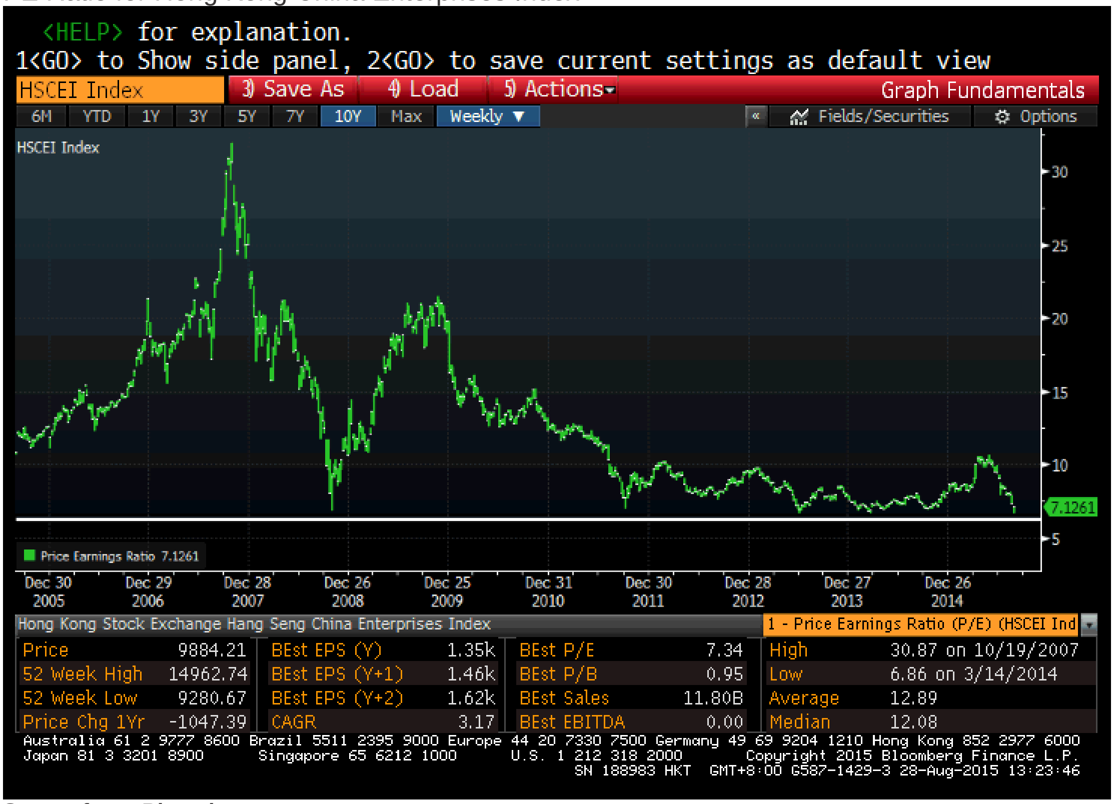
As investors have remained pessimistic on the economic outlook, the stock market might continue to fluctuate and test another low in the short-term. However, the current stock price is quite attractive if investors could hold for 9-12 months. For example, the Asian stock market is trading at 11x P/E, almost the lowest in the past ten years, except a very short period during the financial crisis in 2008. The P/E for Hang Seng China Enterprises Index is trading at only 7x, even lower than that of 2008.

PE Ratio for Asian Stock Market



Source from: Bloomberg

PE Ratio for Hong Kong China Enterprises Index



Source from: Bloomberg

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

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