AMG Market Commentary

June 2009

Strong capital flow prop up asset prices

Amid the last 2 months, stock markets had the best performance since the financial tsunami. On the down side, USD and Treasuries bond were beaten down hard. Clearly, investors are pulling back from safe assets and starting to risk their money for higher return.

Return on stocks, commodities and even currencies were tempting. But, it was mainly the result of strong capital flow rather than strong fundamental conditions.

Since late 2008, major central banks such as Fed, BOE, BOJ adopted quantitative easing one after one. It meant that they are pumping large amount of liquidity into the banking system. Ample amount of money in banking system not only pushed down short term interest rates, but also resulted in strong incentive for investors to take risk for higher return.

However, rally on hot money could hardly sustain if improvement in fundamental conditions did not follow. Last month, we mentioned that housing, manufacturing PMI and credit market also showed a moderation in decline in U.S. But, the job market lagged behind.

In May, the job market showed significant improvement toward stablization. Non-farm payroll statistics showed that 345,000 jobs were trimmed. It was much lower than over 500,000 job cuts in April and the smallest number of job lost in 8 months. It confirmed with the above mentioned figures that the economy has yet to touch bottom, but the worst of the slump could be behind us.

All in all, more and more evidence indicate that the worst time for this recession is past. Still, we reiterate that chasing in after the hot money driven rally is not desirable. Buy on dip should be the right way to handle the market.

US : Neutral

Fed policy rate decision came back into market focus again. This time, the market is speculating whether the Fed will lift interest rate later in the year. However, the speculation is pre-mature and the chance for it actually happens is still low when U.S. economy had yet to start recovering and low interest rate is needed to help fighting recession.

EU : Neutral

Political risk is rising with U.K. Prime Minister, Gordon Brown is struggling to stay in power. His authority is seriously damaged by the expense scandal which has caused 3 of his cabinet member to step down so far. And,

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the bitter defeat of Labour Party in EU election added to his pressure. Though that Brown insisted in handing on to his position, the struggle has already weakened his administration. Without strong leadership, it would be very difficult for U.K. to fight the economic hardship.

China : Positive
Liquidity flooded Hong Kong's banking system. The interbank balance rose to over HKD 250 billion, it was more than 10 times higher than long term average. It showed that hot money rushed into the territory. It was favourable for short term market performance. But, it did not mean the fundamentals have improved.

Emerging Markets : Positive
Emerging markets continued to benefit from strong liquidity inflow and higher incentive to take risk. India, Brazil, Russia, Korea all reported strong gains since March. But, similar to China, the rally was overdone as capital rushed out from U.S. for higher return. They are posed to adjust when capital flow reverses.

Commodities : Positive
Commodities was another asset class which benefited from the signs for economy recession to ease and capital outflow from Treasuries bonds and USD. Crude oil approached USD 70/barrel while gold breached USD 980/ounce in May. But, lately they met resistance as USD bounced back a bit.

Hedge Fund : Neutral
Hedge funds had a strong showing as asset prices bounce back. According to Barclay Hedge, hedge funds as a group rose 5.69% in May. It made the YTD return to go up to 10.59%. Just like the equities market, the darkest period for hedge fund should have been over.

Government Bonds : Negative
Sovereign bonds of developed countries became the villain. Quantitative easing and high budget deficit meant that U.S., U.K. and Japan are going to borrow and print money in huge amount. The higher supply of government bonds drove up bond yield. For example, 10 years U.S. Treasuries bonds now yield more than 3.8%. But it did not change our negative view on high-grade government bonds. For us, it meant that bond yield was going back to normal level only.

Things to Look Forward:
Capital flow is the major drive for current rally in stock markets. Since investors' capital are flowing from U.S .Treasuries to other assets classes and currencies, the rebound of USD would be a sign for capital flow to reverse and also a sign for adjustment in assets prices to come.

* All figures and information are collected from Bloomberg.com & Barclay Hedge.

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