AMG Market Commentary

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Sovereign debt issue in Euro zone

Collapse of investor's confidence choked off the plan for Greece to stand on its own feet. As investors flee from its debt, borrowing cost escalated. Take the 2 years bond as an example, the yield once went above 20%. And the Greek government finally asked EU and IMF for help. In an attempt to stop the contagion of sovereign debt crisis, EU and IMF expanded the rescue package to EUR 110 billion and extended the tenor to 3 years.

However, it failed to stop the turmoil in financial markets. Market focus turned other Euro zone members with high national debt and budget deficit, namely Portugal and Spain. Prices of their government bonds slipped and investors started a sell-off for risky assets e.g. stocks, commodities and high yield currencies.

So, is Portugal or Spain really going to default? We would say not now, at least. Debt to GDP ratio stands at around 60% for Spain and around 80% for Portugal. If interest rate is kept low, they can still finance the debt at a cost of 3-4% of GDP, which is still financially bearable. Their problem is high deficit. For year 2009, the fiscal deficit for both Portugal and Spain were close to 10% of their GDP. If it is not trimmed down, they will be in real trouble in 3 or 4 years time. The good thing here is their government fully acknowledges the risk and they has put in place plans to bring government budget under control. That said, it will take years to fix the problem and insufficient to bring back investors' confidence.

In the last few months, European Commission and European Central Bank showed a reluctance to step in to defend the currencies and the weaker members. But it has changed. On 7 May 2010, European Commission vowed to set up a mechanism to defend the Euro and has submitted it for decision to FINCON 2 days later. The new proposal by European Commission is a pledge by the Euro zone members to provide up to EUR 500 billion loans to members in need and IMF agree to add another EUR 250 billion. In addition, ECB and central banks of the member nations have started to purchase sovereign and corporate debt in market to ensure the confidence problem will not turn into a liquidity quench.

The EUR 750 billion pledged for financial aids would be sufficient to finance around 75% of the estimated re-financing needs for Greece, Portugal, Spain and Italy altogether. The new package should be enough to help them avoid falling into default risk in near future and avoid the spread of sovereign debt crisis in the region. Besides, the massive plan showed to market that the European nations are determined to defend their common currencies and stop the sovereign debt crisis. It shall help on investors' confidence.

US : Positive

Despite that U.S. stock market fell on the sovereign debt issue, economic development and corporate results were

in fact very good.
Latest figures showed a rosy picture for U.S. economy. Las t month, the PMIs for manufacturing industries, non-manufacturing industries and non-farm payrolls all reported the best figures in last 3 years. In Apr 2010, ISM manufacturing PMI rose to 60.4 while the non-manufacturing PMI stood at 55.4. And non-farm payroll reported an increase of 290,000 jobs. The figures showed that activities in manufacturing and services industries are gaining traction and employers are starting to hire. All points to better prospect for U.S. economy.
Corporate results were also spectacular. Up to 30 Apr 2010, around 68% of the earnings reports were above estimates. And if we look through the corporate results by sector, we will see that consumer discretionary, information technology and materials which are all cyclical in nature, are doing better than generally markets.

Europe : Neutral
UK election results were revealed. The much feared "Hung Parliament" situations came true. The Conservatives won 306 seats in the Parliament, but failed to get 326 seats required to claim control. In other words, UK will have a union government, which is often weakened by quarrel within the government. Investors worries that without an efficient government, it would be very difficult for UK to stimulate its economy and bring budget deficit under control. As a result, Sterling pound came under pressure.

China : Positive
China stock market has been clouded by the central government tightening policy to rein in explosive increase in bank lending and curb speculation in real estate for months. And the outbreak of sovereign debt problem exaggerated the decline in Hong Kong and China market.
But, Chinese economy continued to growth quickly. In Q1 2010, GDP growth rose to 11.9%. Not only the headline figures kept up with strong growth, the components were also doing well. Domestic consumption and industrial production grew nearly 20% while the growth fixed asset investment slowed a bit to 26.4% from above 30% in previous quarters.

Commodities : Positive
Commodities prices were also dominated by sovereign debt issue. Crude oil fell sharply to USD 75/barrel while gold prices was pushed to 1,200/ounce as investors seek for safety. At 1,200, gold price is a bit over-valued and we expect it to retreat when market calms down.

Hedge Fund : Neutral
Barclay Hedge Fund index gained 1.32% in Apr 2010. Besides improvements in performance, cash flow conditions are also getting better for hedge funds. According to Barclay Hedge, the net capital inflow to hedge funds amounted to USD 7.6 billion.

Government Bonds : Negative
Risk aversion rose on the sovereign debt issue, U.S. Treasuries, UK gilt and German Bund became the safe heaven of choice. While capital rushed in the bond yield dropped, 10 years U.S. Treasuries yield went down to 3.5% and that for German Bund fell to 2.7%. Similar to gold, their prices are elevated by capital flow linked with flight to safety. And we maintain our positions that government bonds of the major countries lacked attractiveness and do not recommend chasing in at current price level.

Things to Look Forward :
While financial markets are still very volatile, we are happy to see European Commission stepping in to stabilize the market. The size of proposed stabilization plan amount to EUR 750 billion, which should be sufficient to meet the re-financing needs of the Euro zone members for the next 1-2 years and it should help a lot in contain the sovereign debt crisis. We expect financial market to calm down gradually and stock market performance shall improve.

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

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

AMG 安柏
FINANCIAL GROUP

AMG Financial Group
5/F, Guangdong Investment Tower, 148 Connaught Road Central, Central, HONG KONG
Telephone: (852) 3970 9595   Facsimile: (852) 3426 2650