AMG Market Commentary

June 2010

Markets stabilized a bit, while budget cuts bring new challenge

Towards the end of May, financial markets took a breath from the landslide decline started by sovereign debt crisis in Euro zone. In the last 2 weeks, Euro stood at around 1.2-1.25 against the dollar. Stock markets indices and commodities prices also entered side way movement.

But, it did not mean the problems are gone. To contain the sovereign debt crisis, European governments announce new plans to cut fiscal spending and budget deficit. Without any doubt, it is the right way to fix the debt problem. But, it is not the right time now. European economies have barely turned up after the financial tsunami, and stable recovery is still far out of reach. Cutting government spending at this stage will hurt job market and domestic demand. Inevitably, their economies will slow down again. For nations like Greece, Spain and Portugal, they will probably get into the second leg of economic recession.

Fortunately, the major economies are still showing strong momentum. Recent data shows that private sector is lending stronger support to the U.S. economy. In Q1 2010, private consumption rose by 3.6%. It has accelerated for three quarters in a row. Moreover, change in payrolls number turned positive in recent months, it shall help private consumption in coming future. While for Europe, Germany and France are heading back to growth as they are driven by industrial production and exports. And a weaker Euro is a tailwind for their exports.

All in all, the major economies are lending support to the global economic recovery. But, the negative impact of budget cuts by European nations will kick in later this year. It will not only drag on the global economy, but also lead to more volatility in financial markets. For investors, it means that patience is needed before uncertainties will dissipate and more stable trends can be seen.

US : Positive

Recent data shows that U.S. is on track to healthy growth. In Q1 2010, U.S. GDP grew by 3.2%. The encourage part of GDP report was that private consumption and private investment kept up with strong growth. Private consumption was up by 3.6% and private investment rose 14.8% last quarter. Looking forward, the return of job growth shall help consumption and restocking is supportive for investments. So, private sector is expected to drive U.S. economy forward.
Besides, latest PMI figures show that business activities are very active. For May 2010, ISM manufacturing PMI edged down 0.7 points to 59.7 while the non-manufacturing PMI stayed unchanged at 55.4. The bright spot here is the employment sub-index, which is in expansion territory for both manufacturing and services industries.
But, on the negative side, government incentive for first time home purchase has expired in Apr 2010. The housing market may fall again while subsidy is removed and in turn hurts employment and consumption.

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Europe : Neutral
Impact of budget cuts is expected to be very different for the Euro zone members. The size of the budget cuts is largest in GDP terms for Greece, Spain and Portugal. As such, they are also expected to be most severely hurt and they probably will fall back to economic contraction. But, for Germany and France, strong export is driving industrial productions and overall economy. Despite the threat from slower European growth, their economies are expected to stay in expansion albeit at slower pace.

China : Positive
Despite the threat of slower growth in Europe, there will be no “U-turn” in policy. It is still tightening its grip on real estate prices. Details for the newly introduced property tax are coming out for the major cities e.g. Shanghai will charge property owners 0.8% of the property value per annum. While on the other hand, more support is given to boost domestic demand. Last week, the central government extended the subsidy for replacement of household appliance and announced the incentives scheme for renewable energy vehicles.

Emerging Market : South Korea : Positive
Investigation results for the sinking of “Cheonan” were released and North Korea took the blame. According to the report, “Cheonan” was sunk by North Korean torpedo. The announcement struck the nerves across the Korean border. Seoul vowed to take “stern action” while Pangyang warned of war if any retaliation is made. The tension shook South Korea stock market and it plunged some 4% on the day the report was released. But, the selling pressure dissipated quickly as all parties are trying to cool down the heat and military conflicts is perceived as unlikely.

Japan : Positive
Japanese Prime Minister Hatoyama resigned in the disputes over U.S. military base in Okinawa. He is the fourth Japanese PM to step down after Kozumi left in 2006. Naoto Kan, the current finance minister, is leading in the race to succeed Hatoyama. Mr Kan is well known for his preference for a weaker Yen to help Japanese exports. If his is elected PM, his may adopt policies to push Japanese Yen down faster. But, significant change in economic policy is not expected and Japan will still rely heavily on exports to drive its economy.

Commodities : Positive
Crude oil bounce back strongly while Euro took a breath from the slide, it went all the way up to USD 75 from USD 65. Nearly 20% rebound. While gold has little reaction, it just stayed at around USD 1,200 all the time.

Hedge Fund : Neutral
Hedge funds in general took a big hit in the last month. Barclay Hedge Fund index lost 2.63% in May 2010 and YTD return was trimmed to 1.74%. Equity Market Neutral index was the only strategy sub index to make a gain of 0.46%.

Government Bonds : Negative
Government bonds of U.S., Germany and UK continued to play the role of safe heaven and the bond yields become a good indicator of risk aversion now. Over the last 2 weeks, their bond yields retreated slightly. It showed that investors demand for safe heaven assets receded a bit.
But, on the other hand, fundamental changes shall lend support to the “safe” sovereign debt. Budget cuts by European countries are expected to result in slower economic growth and interest rate hikes will probably be delayed. As interest rate hikes are pushed farer away, bond prices shall stay high for coming months. In sum, bond yields for U.S., Germany and UK sovereign debt shall see more pressure to come. But, the delay in interest rate hike shall protect the bond prices from an abrupt collapse.

Things to Look Forward :
Huge budget cuts by European nations shall take its toll on global economic recovery. Still, it will take some time before the actual impact is shown. Although we do not expect a widespread recession, bad news about economic slowdown is expected to bring more volatility to the financial markets.

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

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