AMG Market Commentary

September 2011

Pitfalls of Looking into the Hourglass

For those who are less familiar with the phrase, “Looking into the hourglass” means looking back in history. We practice this all the time, both casually and scientifically. Take the example of weather forecasting. Not too long ago, there was a common saying that ‘To trust the weather guy one might as well ask the blind for direction.’ This says a lot about the difficulty of forecasting weather years ago. Nowadays, with the help of satellites covering nearly every corner of the world on a continuous basis and the availability of supercomputers, weather forecasting has become highly scientific. A few months ago when I visited relatives in New York, one of them showed me a screen on his iPhone with precise weather forecasts by the hour. Whoever is making that kind of forecasts is surely gutsy and highly confident about his forecasting models.

Now consider the recent tropical storm Irene that swept through several states along the Eastern coast of the United States. All predictions were the storm will be a severe one that may cause tens of billions dollars worth of damage. U.S. President Barack Obama returned to Washington in the middle of his family vacation so that he can stay on top of things when the storm make land fall. The Mayor of New York, Michael Bloomberg, ordered 300,000 people to leave their homes for higher grounds. As Irene moved over the New York state, shops were closed and streets were deserted, but most people said they could hardly feel a thing. “Like a whisper” was the most common response when people were asked by media how they felt about the storm.

Some readers might be already groaning: what have all these weather forecasting talks to do with financial markets and investing? Quite a lot, actually. Economists use historical events to predict the future and analysts use companies’ past results to predict their future earnings and hence share prices. While their approach and methodologies may be meticulously scientific, the accuracy of their forecasts is not guaranteed. This is particularly so if there are faults in their assumptions.

A recent survey among U.S. analysts found that most of them remain highly optimistic about corporate earnings growth for the second half of this year. Based on their expected earnings for S&P 500 companies, price-earnings ratios (PERs) for the index is less than 13 times multiple. This is near the bottom of a range that spans over the past twenty years. The conclusion from these analysts is that U.S. equities are way undervalued and should see significant upside from here. But is the assumption of looking back to the past two decades meaningful or appropriate? Lately, more and more strategists who look at macro events are having doubts. A growing number of them suggested perhaps a comparison to the period from early-70s to early-80s might be more relevant.

These strategists argued that an extended period of disinflation since early-80s has allowed global interest rates to

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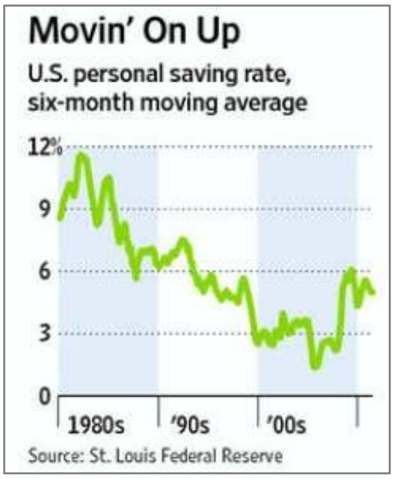
drop steadily over time to near record low levels. As such, this had encouraged governments, companies, and households to borrow ever more in the face of ever lowering costs. And now, nations and individuals found themselves being swamped in the sea of debts. Reluctantly but irrevocably, governments and households have to reduce their debt levels by cutting spending.


Movin' On Up

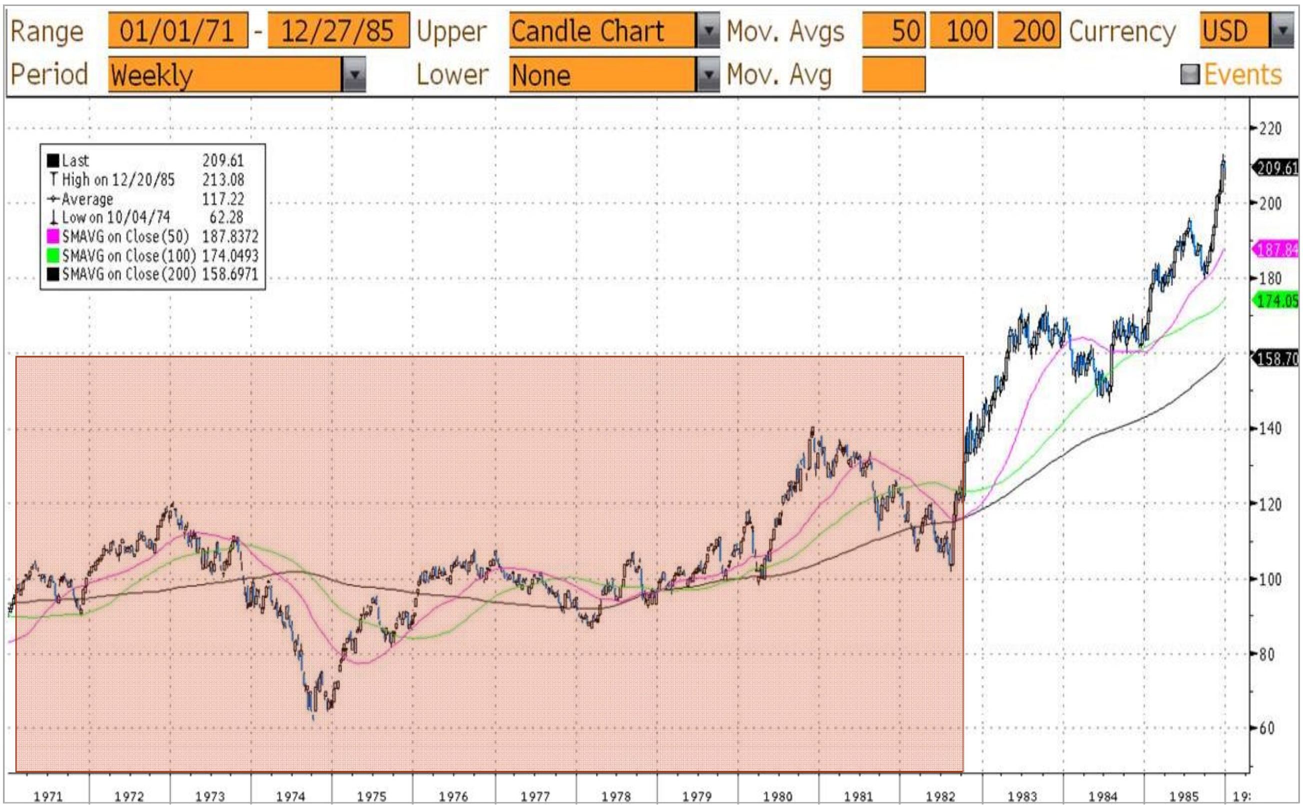
U.S. personal saving rate, six-month moving average

Source: St. Louis Federal Reserve

The chart to the right shows saving rate of American household since 1980. Notice how during the abovementioned period of disinflation and declining interest rates personal saving rate also dropped progressively. This is the era of consumerism, whereby Americans spent beyond their means. Then came the financial tsunami in 2008, which was no less a wakeup call. Since then, Americans re-learn the virtue of “saving for the rainy days” and saving rate made a sharp turn to the upside. With an uncertain economic outlook and even bleaker job market, Americans are expected to remind watchful about spending and could save even more. Given that seventy percent of U.S.’s economic growth depends on personal spending, it would be hard pressed for GDP growth to accelerate in a big way.

Another cloud hanging on the horizon is the talk of government spending cuts as a mean to reduce budget deficit. Invariably, this would further dampen growth as government enacts various cost cutting measures.

This patchy and slow growth outlook is highly reminiscent of the period during the early-70s and early-80s. Below is a chart from Bloomberg showing the S&P500 Index with the just mentioned period highlighted. It was a tightly range-bounded decade producing low single-digit annualized gain.


Range 01/01/71 - 12/27/85 Upper Candle Chart Mov. Avgs 50 100 200 Currency USD

Period Weekly Lower None Mov. Avg Events

■ Last	209.61
T High on 12/20/85	213.08
+ Average	117.22
⊥ Low on 10/04/74	62.28
■ SMAVG on Close(50)	187.8372
■ SMAVG on Close(100)	174.0493
■ SMAVG on Close(200)	158.6971

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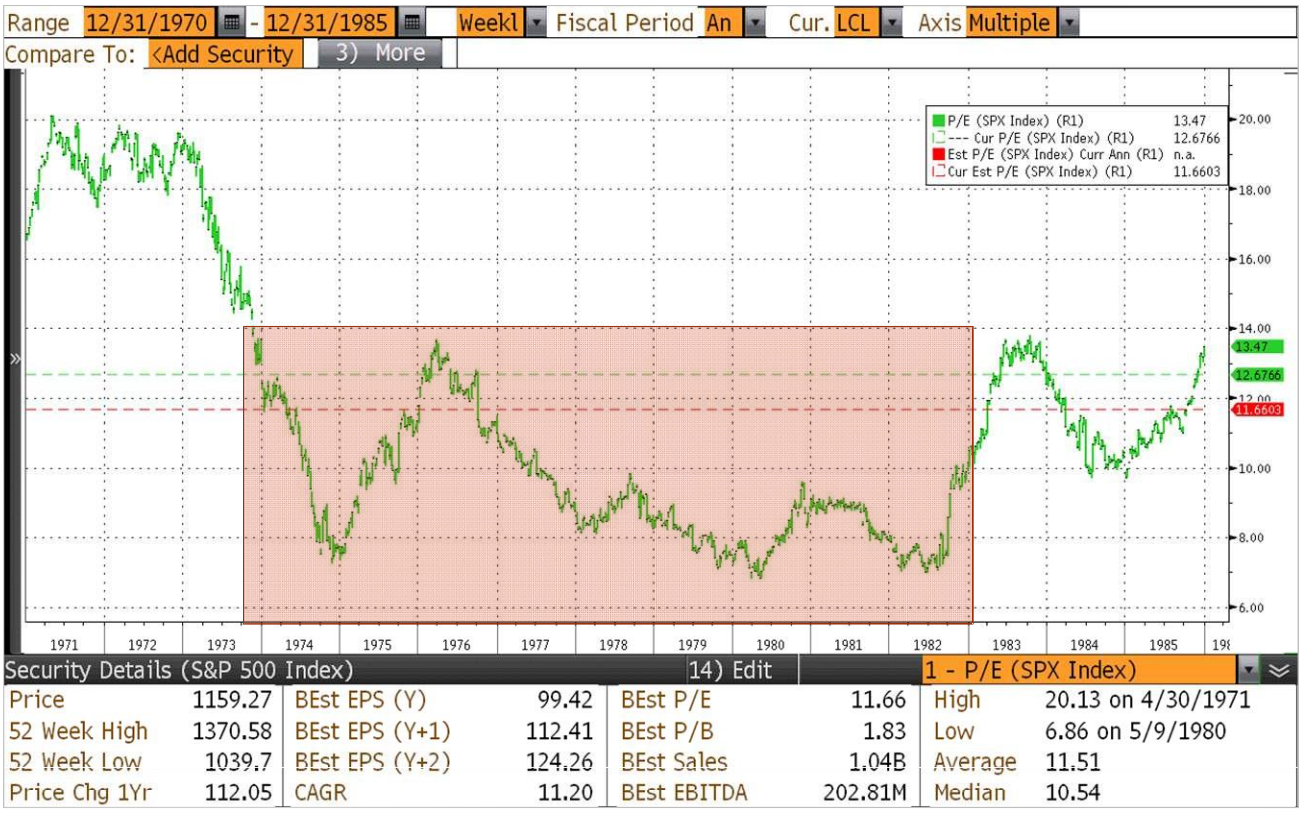
What about stock market valuation during this period? The below chart, also from Bloomberg, shows PERs of the S&P500 Index fell from 20x in the early-70s to below 7x by end of 1974. Furthermore, between 1973 and 1983, PERs never exceeded 14x. For an extended period, PERs were stuck at single multiples.


Range 12/31/1970 - 12/31/1985 Weekl Fiscal Period An Cur. LCL Axis Multiple

Compare To: <Add Security 3) More

P/E (SPX Index) (R1) 13.47
--- Cur P/E (SPX Index) (R1) 12.6766
Est P/E (SPX Index) Curr Ann (R1) n.a.
Cur Est P/E (SPX Index) (R1) 11.6603
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14.00
13.47
12.6766
12.00
11.6603
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Security Details (S&P 500 Index)			14) Edit			1 - P/E (SPX Index)	
Price	1159.27	BEst EPS (Y)	99.42	BEst P/E	11.66	High	20.13 on 4/30/1971
52 Week High	1370.58	BEst EPS (Y+1)	112.41	BEst P/B	1.83	Low	6.86 on 5/9/1980
52 Week Low	1039.7	BEst EPS (Y+2)	124.26	BEst Sales	1.04B	Average	11.51
Price Chg 1Yr	112.05	CAGR	11.20	BEst EBITDA	202.81M	Median	10.54

Needless to say, it's a frustrating era for investors because there were few stretches of sustainable and meaningful gains. It would take the most brilliant market timer to be able to score against such a market backdrop. But then again, there is a simple tool to take advantage of this maddening period that is 'dollar cost averaging'. This concept is the backbone of regular saving schemes. While most investors would undoubtedly have heard of this concept, it may be as good a time as ever to have a refreshment course with your investment advisor.

Immediate Market Outlook

US: Negative
Federal Reserve Chairman Ben Bernanke is truly a master with words, or more appropriately a master without words. With all eyes and ears waiting for further stimulus policies at his appearance in the recent Jackson Hole event, all that he said was to have more in depth discussions with other board members in the next FOMC meeting in September that will be extended for an extra day (which will take place Sept 20 and 21, specifically). Without giving any promises or commitments, market participants made up their own assumptions to spur a roughly 10% rebound in the major indexes in about a week's time. However, we have to caution that the rebound was accompanied by reduced daily trading volume and based on hopes of the Fed being able to come up with some miracle resulting policies. A rally that is built on hope should not be relied upon.

Europe: Negative
European markets seem to have calmed down after a tumultuous summer. This may be the result of the ECB's

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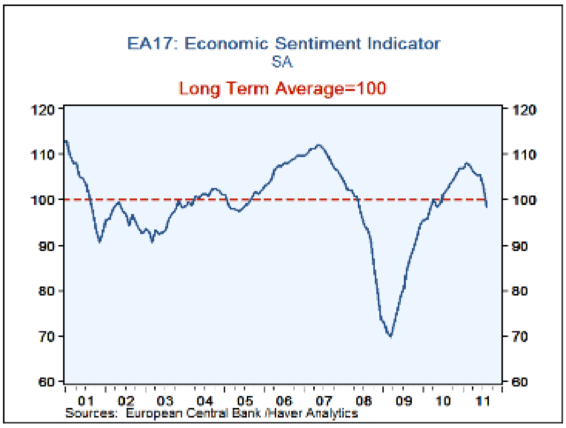


renewed purchase of government bonds issued by Italy, Spain and other Euro members in trouble. The short-selling bans adopted by various European countries may have also artificially forced down trading activity and share price volatility. Such short-selling bans were enacted during the 2008 financial tsunami with limited effect.

There are already signs that more and more banks in Europe are turning to ECB for short term funding needs. The passage through calm waters may only be a temporary respite. The latest economic sentiment indicator for the Euro-zone's 17 members showed further decline since February this year.

Japan: Neutral

Japan's parliament elected a new prime minister to replace Naoto Kan whom resigned on Aug 26. The 54-year-old Yoshihiko Noda, who served as finance minister under Kan, was elected with 308 out of 476 votes. Noda will be Japan's sixth prime minister in five years. While it is too early to tell if the new Prime Minister will be more successful in tackling the nation's many problems, there may be a honeymoon period before and shortly after the inauguration.

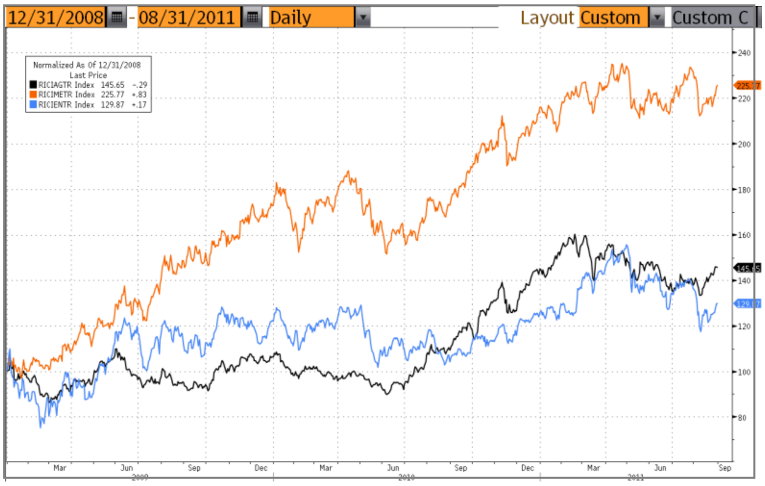
Emerging Markets: Mixed

Emerging markets are always a mixed bag and difficult to make a single assessment. But if there is one thing that is common to most emerging markets these days, it is the rising trend of inflation. Countries facing more acute inflationary pressure, such as India, China, and Vietnam, are still on a monetary tightening mode. Other countries with subdue price pressure are taking a wait-and-see attitude. Another common head wind sweeping across emerging markets is slowing economic growth in the developed nations of the U.S. and the Euro-zone. This will likely weigh on future economic growth as most emerging markets remain depending on developed countries buying their exports, from raw materials to intermediate to finished goods. On the other hand, many emerging markets have suffered steep losses in recent months and low valuations could attract bottom-fishing buying from investors.

Commodities: Negative

The accompany chart to the right shows the three sub-indexes to the Rogers Commodity Composite Index (or RICI) – the orange line denotes the metal complex, black line represents agriculture, and blue line stands for energy. Year-to-date, both the agriculture and energy complexes have displaced clear downward trends while the metal complex stays near peak levels, thanks to strengths in precious metals prices.

Since August, all three sub-indexes turned higher. On the surface, this is difficult to apprehend as recent economic data from the U.S. and Europe almost unequivocally suggest slowing economic growth for rest of this year and well into the next. There are some evidences that hedge funds and prop desks were behind the buying when we look at the significant increase in long futures positions held by such entities. Despite the latest uptick, commodity prices may see further weakness when investors refocus on the lethargic fundamentals of the



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developed economies.

Hedge Funds: Mixed

Sharp corrections in most equity markets in the past months have been rewarding to short-biased hedge funds. This is quite a turnaround from earlier this year, and indeed the past two years, when global equity markets were experiencing strong rallies. Global macro hedge funds have also performed well in the past month and year-to-date, benefitting from long bets on gold, Treasuries and currencies (against the USD). Emerging market hedge funds, whereby the majority of them held long-biased positions, have suffered sizable losses in recent months with many such markets plunging in excess of twenty percent from this year's peaks to place them into bear market territory.

It's been a mixed showing for CTA funds. Funds that focus on commodities and currencies, and those that trade on short trend signals, are faring better. Broadly diversified funds and those that trade on longer term trends have done less well and some have suffered losses year-to-date. As market outlook continued mire in great uncertainty, broadly diversified CTA funds could see more challenging trading environment ahead.

Bonds: Mixed

Despite a downgrade from Standard & Poor's, U.S. Treasuries remains a de facto safe haven in times of market turmoil. This is vividly demonstrated as yields on 2-year and 10-year Treasuries set new record lows, with the former currently yielding around 0.2% and the latter just over 2.1%. Another way to talk at this is investors are so pessimistic about the future that they are willing to lend money to the U.S. government at a paltry rate of 0.2% for the next two years. At the same time investors are pouring into safe haven bonds, they are exiting from higher risk emerging market bonds and junk bonds. In the near term, these trends may continue. But sooner or later, investors would start to question the sanity of lending money to hugely indebted nations; even that nation is the United States of America. At the same time, attractive yields offered by selected emerging countries, especially in Asia, might begin to look more appealing.

Things to Look Out for:

We are almost done with the Q2 earnings reporting season, and while most companies have surprised analysts on the upside an ever-increasing number of them held decidedly cautionary outlook for the second half and next year. Many companies are becoming more careful on their hiring plans, that is if they are still hiring at all, and reining in capital spending. This adds another dark cloud to the already gloomy macro outlook. Investors are advised to take precaution and look for ways to weather-proof their portfolios.

* All figures and information are collected from WSJ, Bloomberg or Haver Analytics.

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