AMG Market Commentary

October 2011

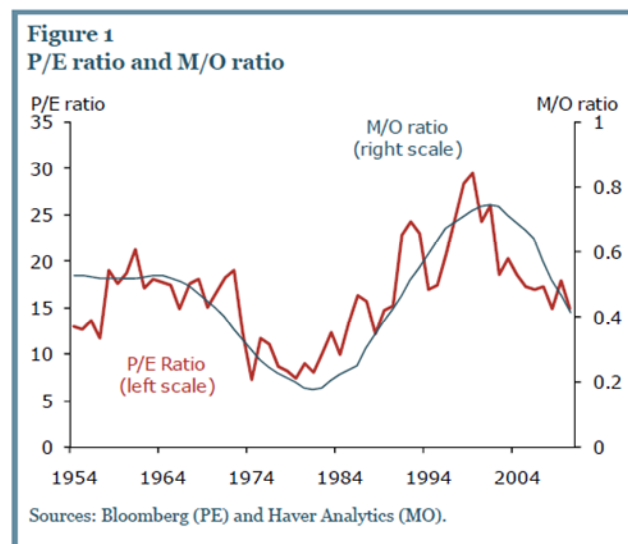
Age, Investing & Equity Valuations

In our September Market Commentary, we stated our expectations for a coming period of slower economic growth in the U.S. and how such a development will lower equity valuations and stock market performance for years to come. About a week ago, this writer came across a study conducted by researchers from the Federal Reserve Bank of San Francisco that looked into a key demographic trend in the U.S. – that is the aging of the baby boomers generation and its implications to equity values. Specifically, Zheng Liu and Mark M. Spiegel built a statistical model and found that the coming changes in age distribution could be a factor in holding down equity valuations over the next two decades.

To begin, the term ‘baby boomers’ refers to those who are born between 1946 (the year following the official end of World War II) and 1964. According to the U.S. Census Bureau, this is a large portion of the population, making up about 25%. Furthermore, given their ages baby boomers are people who are in their prime in terms of income, experience, wealth, spending power and social status. However, their ages also mean that they are gradually transitioning from work to retirement over the next twenty years. This transition would bring about behavioral changes to the way they save, spend and invest. The common logic is that as someone moves from the work place to retirement living, he or she would tend to save more, spend thoughtfully and invest prudently. With regards to investment, there is already evidence that baby boomers have diversified their asset portfolios by trimming down risky equities and adding to yield and dividend bearing asset classes.

To examine the historical relationship between demographic trends and stock prices, the researchers considered a statistical model in which the equity price-to-earnings (P/E) ratio depends on a measure of age distribution. They construct the P/E ratio based on year-end level of the Standard & Poor’s 500 Index adjusted for inflation and average inflation-adjusted earnings over the past 12 months. They measure age distribution using the ratio of middle-agers (40-49 years old) to the old-agers (60-69 years old). They call this the M/O ratio.

Figure 1
P/E ratio and M/O ratio



Sources: Bloomberg (PE) and Haver Analytics (MO).

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The chart titled Figure 1 shows how these two ratios moved for the period from 1954 to 2010. The researchers found that the two series are highly correlated, with a correlation coefficient of 0.61 during this sample period.

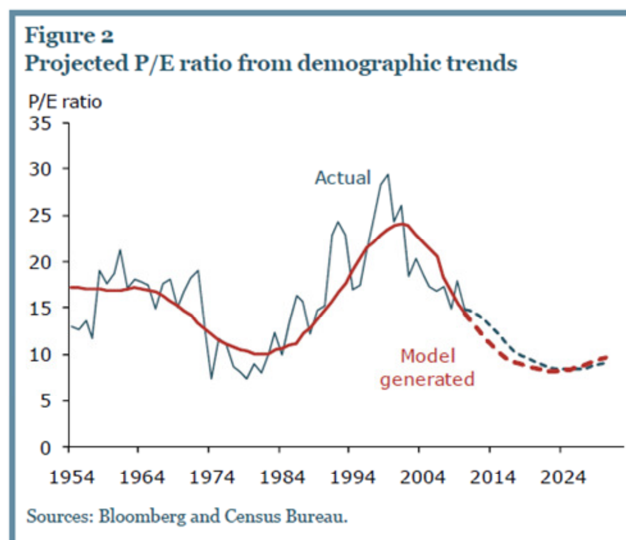


Figure 2
Projected P/E ratio from demographic trends

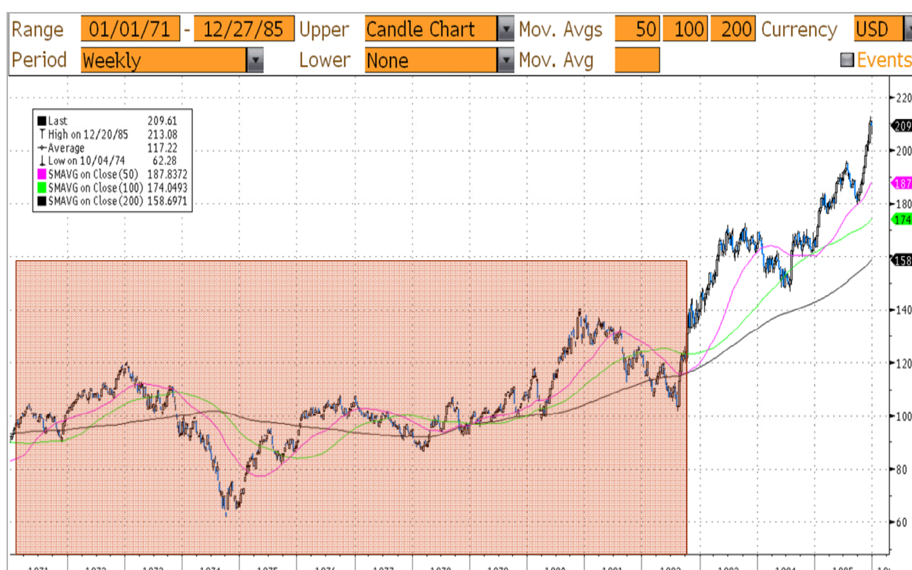
Sources: Bloomberg and Census Bureau.

With this encouraging result, the researchers next try to forecast the path of future P/E ratio based on predicted M/O ratio. They calculate the projected M/O ratio from 2011 to 2030 using projected population data by the Census Bureau. The finding is shown in Figure 2.

In short, P/E ratio is expected to decline persistently from about 15x in 2010 to about 8.4x in 2025, before recovering somewhat to about 9.1x in 2030.

The researchers were the first to acknowledge their model only examines a single factor, that is the M/O ratio or age distribution, and that there are numerous other factors that may drive demand for stock. For instance, the near record low levels of bond yields may drive more investors to move into higher risk equities.

In the event such grim forecast turns into reality, then what are investors supposed to do. We would like to bring back the S&P 500 historical chart from last month's publication to better explain. The shaded area corresponds to a period of depressed P/E ratios that averaged at less than 10x. It was a frustrating decade for most investors. Apart from the most deft market timers, it's easy to get caught and suffer big losses in such wildly whipsawing price movements.



While this is a treacherous market (or period) to trade, it is an ideal setting for investing on a regular basis, otherwise known as regular saving. By investing a fixed amount of money regularly, say once a month, not only investors can smooth out market volatility they can reap the benefit of lowering their average purchase price due to the 'dollar cost averaging' mechanism.

Assume we invest $1,000 each month. When the price of a security or asset (can be a stock, a fund, or ETF) is low, you would have bought more units. When the price is high, you would have bought fewer units. This is an automatic levelling system so that you would gather more cheap units and fewer expensive units. This also means your average cost is lowered because of the weight towards cheap units. Hassle-free investing made easy, now ain't that a beauty!

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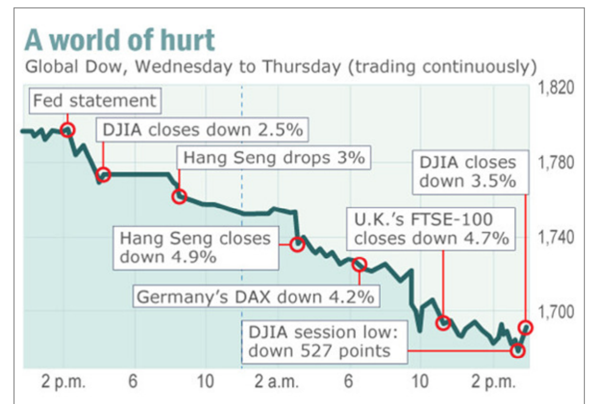
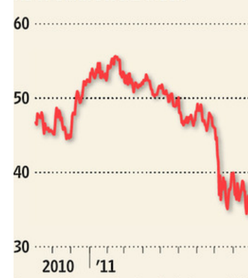
Market Review & Outlook

US: Negative



Instead of QE3, the two-day FOMC meeting that ended on Sept 21 resulted at a manoeuvre called Operation Twist. In short, the Fed will roll over US$400 billion worth of maturing bonds to longer dated Treasuries and mortgage-backed securities in an effort to further push down long-term interest rates. The hope is that this will drive down mortgage rates to encourage new mortgages and refinancing of outstanding mortgages. The ultimate objective is that American home-owners will spend the money saved from reduced mortgage repayments. That is, if things work according to the Fed's script. Unfortunately, investors clearly have different expectations and their disappointment is vividly shown in the relay of sell offs in global markets immediately following the Fed's announcement. The accompanied chart shows the continuous performance of the Global Dow Index on Sept 21 and 22, with references to daily returns of major equity markets around the world.

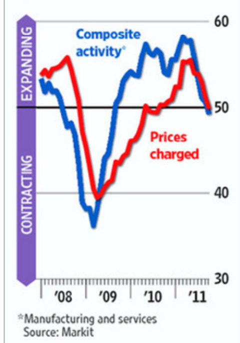


Sources: Thomson Reuters Datastream (KBW); Office of the Comptroller of the Currency

For the third quarter just ended, U.S. stocks suffered the biggest quarterly fall since the aftermath of the financial tsunami. Among the market's biggest losers are banking stocks, as investors fretted about their exposure to European bank debts. This can be seen in the performance of the KBW Bank Stocks Index (see chart to the right). As Europe wobbles, shares of J.P. Morgan Chase, Citigroup, Goldman Sachs, Bank of America and Morgan Stanley took deep dives.

In addition to outright lending exposure, investors are also concerned about the degree of derivatives exposures these banks have over their European counterparts. The situation is made even more difficult due to meager, non-uniform and often confusing information provided by banks. According to some measures, the five largest U.S. banks held approximately 96% of $332 trillion in face value, or notional, derivatives on a gross basis. Banks executives would be the first to point out their net exposure is far lower. But how low are they? It's almost impossible to find out. During Citi's second-quarter call, an analyst asked about the bank's gross and net exposure to troubled European countries. Citi CFO John Gerspach replied: "I don't think that the gross number is relevant."

Europe: Negative



*Manufacturing and services
Source: Markit

Euro-zone manufacturing sector contracted for the second consecutive month in September, according to data from Markit Economics. The final Markit euro-zone manufacturing purchasing managers' index fell to a 25-month low of 48.5 in September from 49.0 in August. Meanwhile, the region's composite PMI reading for September slid 1.5 points to 49.2, falling below the 50-mark for the first time since July 2009 (see chart to the right). The new orders component of the survey also declined, suggesting further weakness ahead.

At the time of writing, officials from the 'troika', namely the European Union, European Central Bank and the International Monetary Fund, have returned to Greece to check the progress of the country's austerity program to decide whether the next tranche of aid (valued at 8 billion euros) can be disbursed. According to Greece's own estimates, the country will not be able to pay its bills if the next tranche is not available by mid-October. With so much pending on the troika's decision, the Greek government reportedly said it may not be able to meet its deficit targets for this year and the next. The BBC reported that Greece's 2011 deficit is now expected to be 8.5% of GDP, falling short of a target of 7.6%. Deficit will be reduced to 6.8% of GDP In 2012, albeit still below the target of 6.5%.

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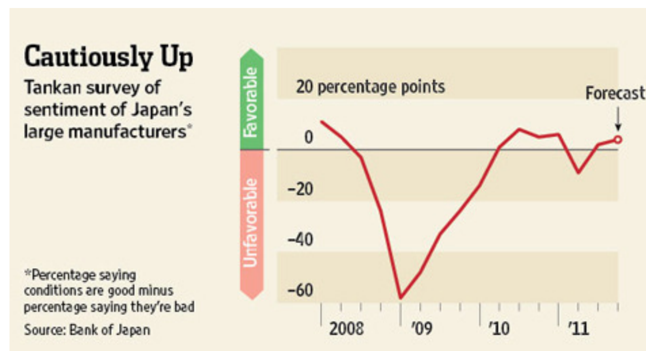
Japan: Neutral

Firstly, an update to the popularity of Japan's new prime minister Yoshihiko Noda. A month after Mr. Noda's inauguration, his support rating fell to 54.6% according to a Kyodo News poll. In comparison, it was at 62.8% last month, when the same poll conducted similar study just days after he took office. While the political front provides nothing to cheer about, sentiment among businesses improves in the latest three-month period. The Bank of Japan's closely watched tankan survey showed a rebound in corporate sentiment, with the headline index returning to positive territory for the first time since March, as production and exports returned to pre-quake levels. Industry-wise, sentiment among Japan's auto makers recorded the biggest improvement on record, jumping to positive 13 from minus 52 in June. This suggests the industry that was battered by a giant earthquake and a resulting tsunami in March is finally seeing its operations returning to normal. The Tankan index is calculated by subtracting the percentage of surveyed companies saying business conditions are bad from those saying they are good.

Emerging Markets: Negative



Investor sentiment on emerging-market stocks dived in the third quarter amid growing fears of global economic slowdown and financial contagion from the Europe debt crisis triggering a repeat of the financial tsunami of three years ago. The MSCI Emerging Markets Index plunged 23% over the quarter, compared to the 17% loss for the MSCI World Index which is a proxy for global stocks. Of the three main clusters in the emerging market universe, Eastern European and Asian markets suffered the worst tumult – the former due to economic and financial dependency on Western European countries, and the latter due to fears of China's economic growth faltering. In comparison, Latin American stocks outperformed the other two regions on a relative basis, thanks to their lower exposure to the aforementioned two problem areas. Most Asian markets suffered double whammies in September, namely took hits from steep losses in equity prices and currencies. In particular, the ASEAN markets, with their strong gains in the past few years and high degree of liquidity, are prime targets for profit-taking. There were also some concerns of some Asian countries depending on European banks for funding needs. If the European situation worsens, such funding could evaporate in no time at all. The nearby table from UBS provides a handy summary of the degree of dependency Asian markets rely on European lending.

	European Banks (EB)	Total Foreign Claims (TFC)	EB/TFC	Germany (G)	France (F)	G+F/TFC
China	221,520	593,879	37.3%	22,441	32,607	9.27%
Hong Kong SAR	386,086	612,733	63.0%	13,448	32,590	7.51%
Chinese Taipei	95,863	171,634	55.9%	11,083	14,705	15.02%
Singapore	200,539	354,913	56.5%	27,734	25,901	15.11%
North Korea	37	120	30.8%	23	14	30.83%
South Korea	174,399	358,803	48.6%	15,504	27,461	11.97%
Philippines	18,079	36,851	49.1%	2,402	3,572	16.21%
Thailand	28,097	94,396	29.8%	6,083	2,752	9.36%
India	150,765	317,672	47.5%	25,838	19,522	14.28%
Indonesia	46,852	109,361	42.8%	9,422	5,366	13.52%
Malaysia	59,107	142,174	41.6%	7,813	4,709	8.81%
Total	**1,381,344**	**2,792,536**	**49.5%**	**141,791**	**169,199**	**11.14%**

Source: BIS, UBS WMR, as of end-March 2011

Commodities: Negative

Copper, oil and palladium led a broad selloff in commodities in recent weeks, as fear grows that slowing global growth will have dire consequences for manufacturing, construction and other key parts of the world economy. Reports on manufacturing in China and the euro-zone — the two largest users of the industrial metal — contracted expedited the slump. The preliminary HSBC China Manufacturing Purchasing Managers Index fell to 49.4 in September from a final reading of 49.9 in August; a reading below 50 indicates contraction. The purchasing managers' index for euro-zone manufacturers stood at a two-year low of 48.4 in September, down from 49.0 the previous month.

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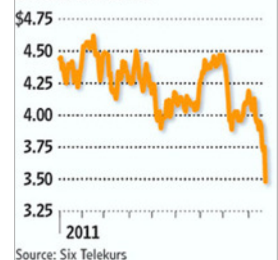
Collapse in prices of industrial base metals aside, the precious metal complex didn't fare too well either. In fact, towards end-Sept, prices of silver and gold were virtually on free fall suffering double digit percentage losses. The chart below shows year-to-date performance of ETFs that track gold and platinum prices against that of silver. The red line being gold, green line for platinum and blue line represents silver.

(from *finance.yahoo.com/charts*)



Hedge Funds: Mixed

Hedge funds generated negative performance in August but still outperformed global equities. The Dow Jones Credit Suisse Hedge Fund Index fell 2.30% for the month versus a loss of 7.69% for the Dow Jones Global Index. Among the 10 sectors that made up the Index, 3 posted positive performance in August with Dedicated Short Bias delivering the strongest performance, gaining 6.56% as short positions across equity markets proved profitable amidst broad market downturns. Global Macro also gained 1.91% as managers employed tactical trading strategies to navigate the high levels of volatility seen in August. According to Credit Suisse Index Co., LLC, the hedge fund industry saw an estimated US$4.77 billion in inflows for the month. Total industry assets at end of August are estimated at US$1.79 trillion.

Index	August 2011	July 2011	YTD
Broad Index	**-2.30%**	**0.69%**	**0.00%**
Convertible Arbitrage	-1.73%	-0.14%	1.72%
Dedicated Short Bias	6.56%	3.01%	4.37%
Emerging Markets	-3.15%	1.67%	0.63%
Equity Market Neutral	-0.89%	-0.18%	4.40%
Event Driven	-5.37%	-0.78%	-4.87%
Distressed	-4.41%	-0.26%	-1.69%
Event Driven Multi-Strategy	-5.98%	-1.07%	-6.78%
Risk Arbitrage	-0.92%	-0.77%	1.21%
Fixed Income Arbitrage	-0.27%	0.55%	3.82%
Global Macro	1.91%	2.53%	5.89%
Long/Short Equity	-4.44%	-0.41%	-4.12%
Managed Futures	0.25%	4.03%	0.74%
Multi-Strategy	-1.93%	0.61%	2.99%
Dow Jones Industrial Average	-3.96%	-2.05%	2.14%
Dow Jones Global Index	-7.69%	-1.66%	-6.07%

Bonds: Mixed

Partly due to the Fed's announcement of Operation Twist, but probably more to do with heightened risk aversion as worries about Europe's ongoing debt crisis ending disastrously, Treasury prices registered their biggest rallies since the 2008 financial tsunami. For the third quarter, yields on the 10-year benchmark Treasuries fell 122 basis points from 3.16% at end of June. At one point, yields of the 10-year T-note touched 1.68% which is the lowest ever on record. 30-year Treasury yields plunged 146 basis points in Q3, while yields on 2-year T-notes also tumbled to a record low of 0.15% intra-quarter and ended the quarter down 20 basis points from June. Government bonds issued by countries viewed as safe havens also gained strongly as investors fled from risky assets of all kinds. These include Japan, Germany, Sweden and Switzerland.

Outside sovereign bonds from developed countries, we see yields rising on investment grade corporate bonds and high yield bonds. Moreover, yield spread of high yield bonds over hi-grade corporate bonds is also picking up, which signals heightening risk aversion among investors. While the prevailing yield spread remains low, if the experience during the Lehman collapse in 2008 is any guide it could surge abruptly and significantly.

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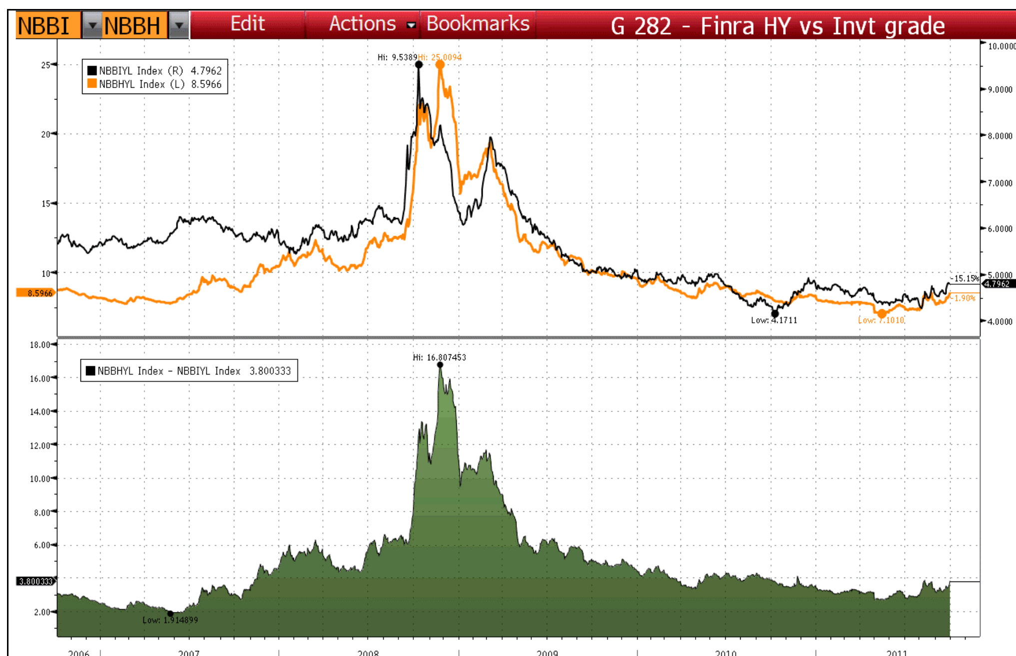

* Unless otherwise stated, all figures and informa tion are collected from WSJ, Bloomberg or Haver Analytics.

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