AMG Market Commentary

November 2011

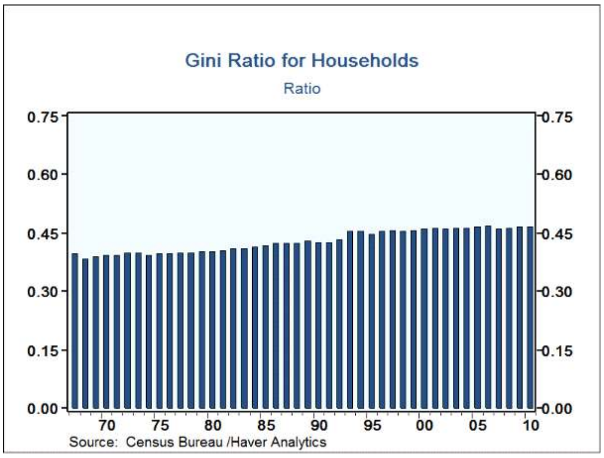
Wealth Inequality – A Growing Problem

It's seven weeks old and counting….. What we are referring to is the Occupy Wall Street movement, or OWS for short. Born on September 17 by a group of loosely organized ordinary people matching on Wall Street, the movement has since attracted global attention and similar "Occupy" demonstrations have been held in over 900 cities worldwide. In late October, the General Assembly of Occupy Wall Street has registered for tax exempt status in the U.S. In the beginning, there was no central theme or common ideology. Observers and government officials thought the crowd would disperse in a matter of days. But before long, the group arrived at something that more and more people can relate to. The slogan, "We are the 99%", refers to the difference in wealth between the wealthiest 1% and the rest of the population hit the heart of a growing problem, that is wealth inequality.

A couple of weeks ago, Donald Tsang, Chief Executive of the Hong Kong SAR, said at a post-policy address forum organized by The Hong Kong Federation of Youth Groups: The wealth gap between rich and poor is a fundamental problem that is shared by all capitalist societies. Some people interpreted and criticized that as the Chief Executive's reluctance to do more to help the needy. To us, Tsang's comment sounds a reasonable observation and triggered our interest to take a more in depth look at this topic.

A classic measure of equality or inequality in the distribution of income is the Gini Ratio, which varies from 0 where income is perfectly divided across the entire population of a community (or nation) to 1 where one person holds all the income.

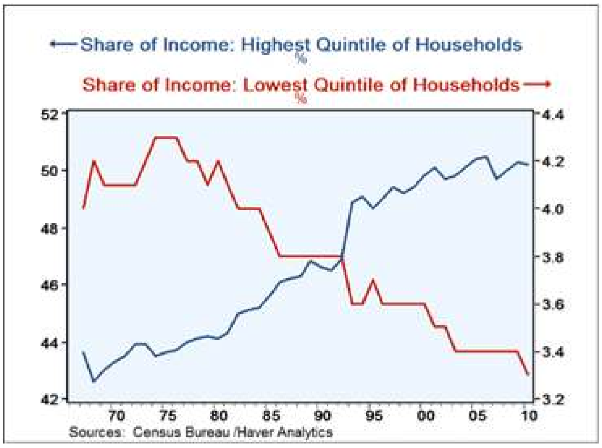
Gini ratios for households in the United States from 1967 through 2010 are shown in the right chart, which was composed by Haver Analytics based on data from the Census Bureau. The ratio rose from 0.386 in 1968 to 0.470 in 2006, and after a small drop in 2007 rose back up to 0.469 in 2010. While year-over-year changes are diminutive, they indicate a unambiguous and steadfastly shift toward more inequality in household income since the 1960s.



In addition to the Gini ratio, which only gives one reference point, we also examined the difference in take-home

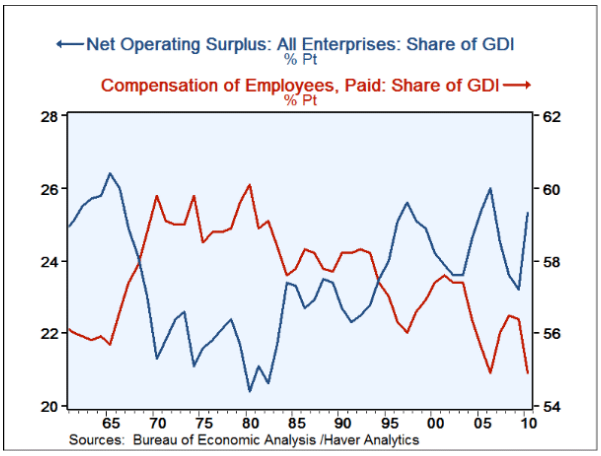
Important Note & Disclaimer:

income between the top-tier and bottom-tier households, and how this difference changed over time. The second chart shows the highest quintile's (i.e., top twenty percent of an universe or a community) share of income has risen over time and the lowest quintile fallen steadily.



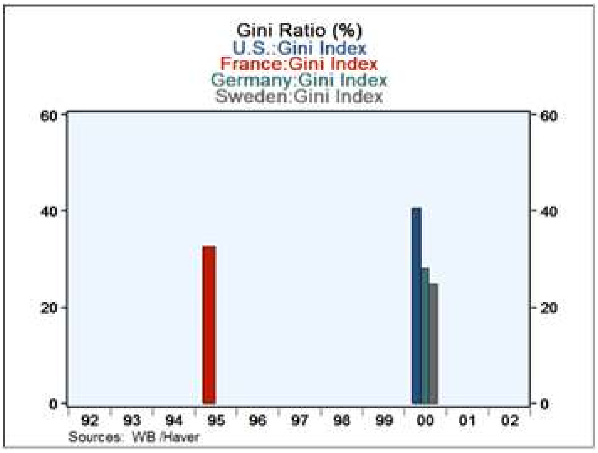
In the late-60s, the top-fifth of households took home just over 42% of national income. This has risen to 50% by mid-2000s. Over the same period, the bottom-fifth's share of national income has fallen from a peak of 4.3% at around mid-70s to just 3.3% in 2010. These data strongly support the notion that the "Haves" are getting an ever bigger slice of the income pie (albeit growing) while the "Have-nots" are being squeezed.

In the third chart, we look at the percentage of gross domestic income earned by businesses (in terms of operating surplus) and how much of this goes to employees. Here, the picture is a bit mixed as the ratios fluctuated in the past fifty years. But if we focus on the development from 1980 and onward, a clearer picture emerged and that is enterprises gained ground while employees' compensation shrank. What happened in the U.S. some thirty years ago that prompted this development? In our view, it's not something that took place in America, but somewhere at the reverse side of the globe, or specifically China.



In 1978, Deng Xiaoping launched what he called a "second revolution" that involved reforming China's moribund economic system and "opening up to outside world." The market-oriented economic reforms launched by Deng were described as "Socialism with Chinese Characteristics." Deng insisted the reforms were not capitalistic. Whatever Deng calls it, the reform he initiated has turned China into the largest manufacturing and exporting country, and overtook Japan to become the world's second largest economy since last year. For American businesses, the relentless shift to importing ever increasing amount of goods, in volume and variety, from China has translated to rising profits. At the same time, with more and more productions being taken place outside of U.S., fewer domestic workers are needed which led to loss of higher paying manufacturing jobs, thus hurting employee compensation.

Before we get caught into debating U.S.-China trade issues, let's look at Gini ratios of other nations. Because such ratios are not calculated by all nations regularly, we can only show the most recent data available. In the fourth chart, we compared France, Germany, Sweden and the U.S., with a scale of 0 to 100%. Sweden, as one might expect, has the lowest ratio. In 2000, the Swedish Gini Ratio was 25 compared with 28.31 for Germany and 40.81 for the U. S. The latest data for France is 1995 when it was 32.74.



Admittedly, Sweden is an oddball capitalist country. The CIA website has this to say "Sweden's long-successful economic formula of a capitalist system interlarded with substantial welfare elements......" Still, on that front, Mr.

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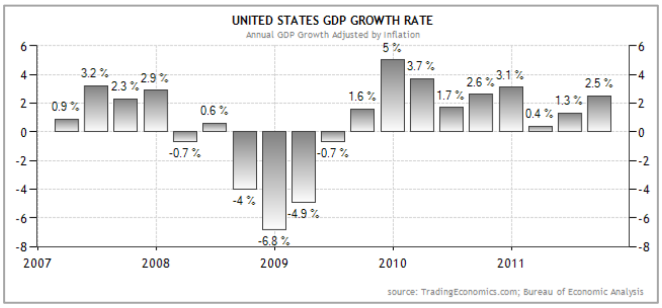
Tsang's comment isn't exactly correct.

Market Review & Outlook

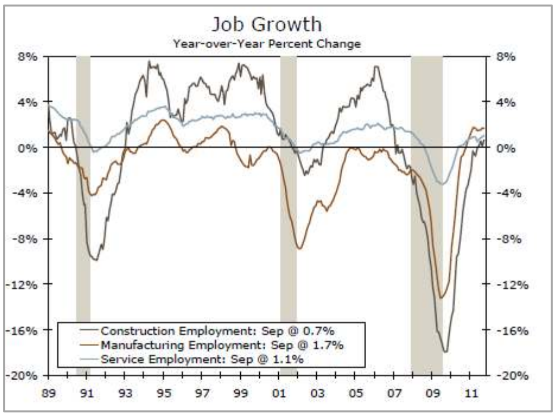
US: Negative

Recent economic data from the U.S. cheered investors. Third quarter GDP growth jumped 2.5%, a markedly faster pace from that of 0.4% in Q1 and 1.3% in Q2.

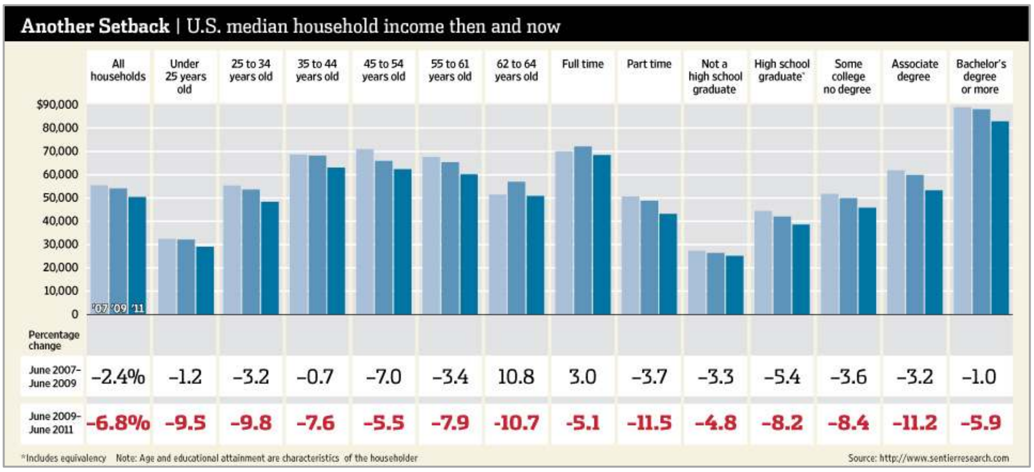


Early in the month, the Labor Department reported 103,000 non-farm jobs were added in September, and the figures for August and July were revised upward. As such, an average gain of 96,000 jobs was recorded for the past three months. Job gains were centered in professional services, education & health, information and construction. Despite the apparent weak property market, in excess of 10,000 construction jobs were averaged over the latest three month period. Local governments continue to shed jobs, which were largely expected.

The current recovery continues to generate far fewer jobs than many expected, and especially so when compared to the same point during the 1990 and 2000 expansions (see chart to the right). The ongoing under-performance of job gains reflects a longer-term structural change in what and how goods and services are produced in America.



Another sobering finding from an analysis of monthly Census Bureau numbers showed income of the median household declined 3.2% to $53,518 during the 2007-2009 recession, and fell a further 6.7% to $49,909 between June 2009 and June 2011. Income of the typical American household, adjusted for inflation and in 2011 dollars, has dropped well below the January 2000 level ($55,836). And as the below chart depicts, income fell across all age groups and educational achievements.

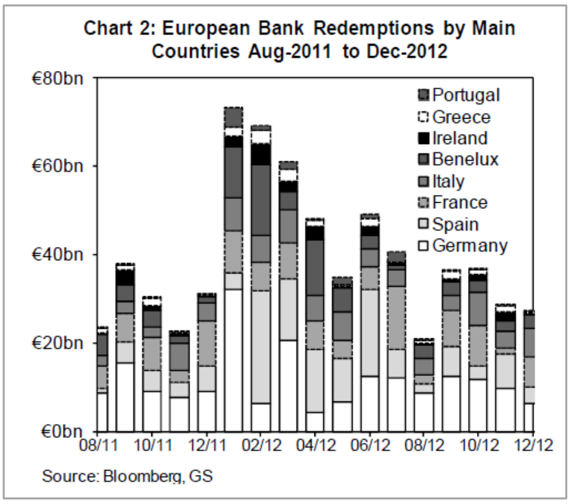


Amid the mixed economic picture, U.S. equities had a stellar month. An eleventh-hour proposal reached by EU leaders on slashing debts owed by the Greek government, recapitalizing banks and expanding financial firepower of EFSF (European Financial Stability Fund) set markets to full tilt rally mode. Both S&P 500 and Nasdaq Composite Index soared 11% for the month of October. The Dow Jones Industrial Average Index rose 9.5%, which is the third-largest monthly percentage gain in its 115-year history. How long can this rally last? Investor sentiment has swung from extreme pessimistic in late-September to generally optimistic in the last week of October, which from a contrarian angle is a cause of concern.

Europe: Negative

After a grueling meeting that extended into the wee hours on the night of Oct 26, or rather the morning of Oct 27, leaders of the 17 EU nations were congratulating themselves for reaching a "comprehensive package" to end the two-year-old crisis. Yet before they returned to their own offices the following week, markets already doubting this would truly be the last and final package. To begin, even with the proposed leveraging for EFSF, for up to €1 trillion in firepower, the size is not sufficiently large to withstand a run on Italy and Spain. Secondly, suggested bank recapitalization levels are based on what countries can afford, rather than what they should be. And thirdly, even after the 50% 'voluntary' haircut, Greece's debt levels would only be reduced to 120% by 2020, about the same level as Italy, and this is under the best case scenario.

Moreover, in reaction to the plan and new Basel III requirement on capital adequacy banks may consider shrinking their asset bases and get rid of risky assets instead of raising additional capital from the public. As a consequence of such actions, banks are calling back loans and dampening business activities.

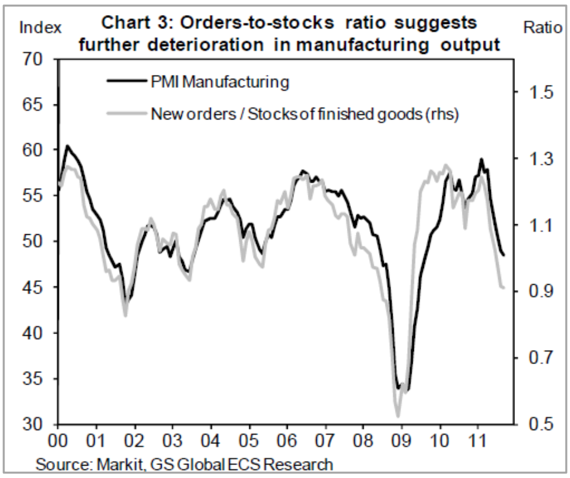


Indeed, higher wholesale funding costs have been seen across European banks. For peripheral economies alone, outstanding bank debts that will mature by the end of 2012 amounts to around €260 billion. Given the magnitude of these numbers, it is understandable that the rise in wholesale funding costs is raising concerns about the overall health of the European banking sector and risk of a systemic event.

The final Euro-zone Composite PMI number for September came in at 49.1, one-tenth below the flash estimate and first time dropping below 50 since July 2009. New orders were the weakest component within the Composite PMI, falling from 49.8 in August to 46.5 in September. Historically, this serves as a good short-term leading indicator, and raises the risk of a further contraction in the headline index over the coming months. The current pressures on banks, driven by uncertainty about the sovereign crisis) and the significant deterioration in the funding conditions they face, may have translated into weaker business confidence, with firms opting to 'wait-and-see' or cancel orders outright.

More and more companies across Europe are curtailing production or cutting costs. Below are recent announcements as reported in the Wall Street Journal:

- Truck maker Scania plans to pare production by as much as 15%, beginning in November.
- Volvo intends to scale back truck manufacturing next year.
- PSA Peugeot Citroën plans to suspend production at a plant in Slovakia. The company also said it would lay off 6,000 workers, mostly in France.
- Liquor maker Diageo restructured its European operation by centralizing certain functions and shifting investment away from Western European markets.



Important Note & Disclaimer:

Japan: Neutral

Industrial production growth remained moderate. Although auto industry supply chain has gradually normalized, the sector has been affected recently by the strong Japanese yen (JPY). Meanwhile, the recovery in electronics parts production remains anemic amid high inventory adjustment pressure and weakening global economic outlook.

The Bank of Japan seems powerless in putting a stop to the rocketing currency. Outlook of its economy is neutral for the balance of two different driving forces: sharp rebound after the March earthquake is driving the GDP rebound, but strong domestic currency as well as frail world demand weakens its export sector.

According to the Ministry of Finance, free cash flow at large Japanese companies have reached historic high. Yet at the same time, Japanese companies are capping capital expenditure despite improved earnings. As a result, holdings of cash and equivalent soared. Interestingly though, corporate debt outstanding has not come down at all. The reason behind this could attribute to Bank of Japan's zero interest-rate policy – interest rate is so low that companies have little intention to repay debts.

Although the strong Japanese yen undermines competitiveness of Japan's export, it lower the costs for Japanese companies making overseas M&A to expand their business. Figures on the right chart show rising values in M&A deals involving foreign target companies.

Figure 1. FCF for large companies in MoF's corporate statistics (ex. finance, insurance)

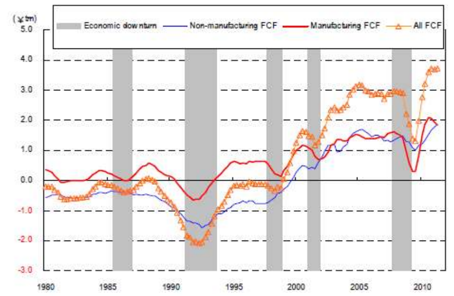


Figure 5. Holdings of cash and equivalents

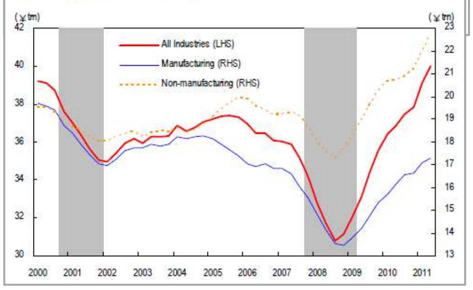
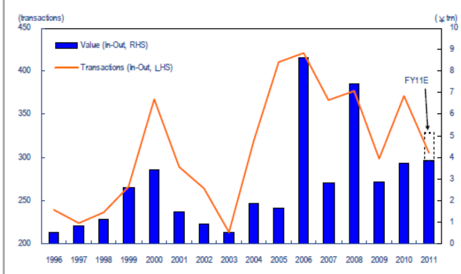


Figure 9. M&A involving foreign target companies

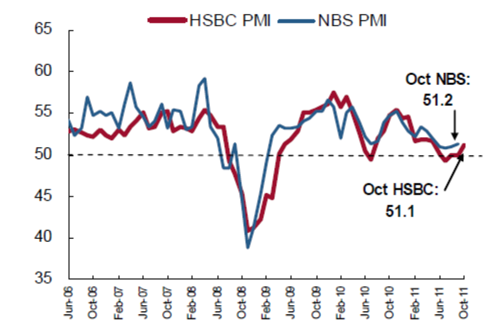


Notes: 1) 2011 data up to August. 2) 2011 estimate assumes pace of deals in Jan–Aug continues in Sep–Dec.
Source: MAAR, Citi Investment Research and Analysis.

China: Mixed

HSBC/Markit released the flash PMI reading for China for October, which rose to 51.1 from 49.9 (final) in the previous month. A number above 50 means business activity is expanding. This helps alleviate growing market concerns of "hard landing" in China and that the economy risks falling into recession. It is now expected China's GDP growth would bottom somewhere between 7% and 8%.

Figure 1: Flash PMI back above 50, but we still expect growth slowdown

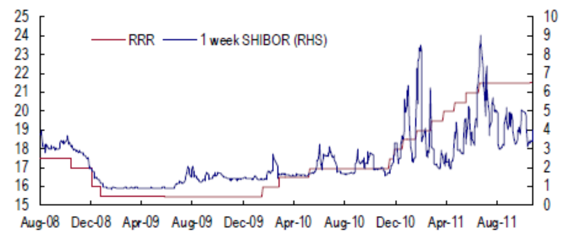


Source: NBS, CLIC, Markit Economics, Credit Suisse

China's 18-month-long monetary tightening cycle is reaching a critical point. China banks are reluctant to lend, even between banks, in face of strict regulation and record high reserve requirement ratios (or RRR). This is can be seen in the heightened Shanghai interbank overnight rate, also known as SHIBOR. Market participants are increasingly worried about insufficient supervision on shadow banking/lending activities. Wenzhou is now as well-known a place as Beijing or Shanghai as the name can be found in various media throughout October. Some estimated the size of shadow banking sector is in excess of 1,000 billion RMB. While that figure remains small compare to total outstanding bank lending, a rupture could have an adverse impact to the formal banking sector.

As for China's banking stocks, their outlook remain cloudy so long as tight monetary policy continues, which in turn depends on how inflation is faring. CPI number has been dropping for three months since peaking in June, and stood at 6.1% for the month of August. The National Development and Reform Commission (NDRC) estimated CPI would drop towards 5% by end of year. Investors will be watching closely.

Figure 1: China—RRR (large banks) at historical high of 21.5% has caused seven-day SHIBOR to double to around 4-5%



Source: CEIC, Credit Suisse estimates

Emerging Markets: Negative

After US$20.65 billion of net foreign selling out of Emerging Asia (ex-China) in August and September (see right most column in nearby table), there was US$745 million of net foreign buying up to the third week in October. Research shows that the Euribor-OIS spread has a very close relationship with emerging markets performance in the recent months. The spread seem to have peaked in early October, which may suggest/encourage investors returning to emerging markets. However, the crisis in Europe is hardly over yet so investors are advised to remain alert.

Figure 1: Net foreign buying in Emerging Asia (ex China), US$ Mn

	India	Indonesia	Korea	Philippines	Taiwan	Thailand	EM Asia ex-CN & MY
Monthly data							
Jan-11	-1,054	-444	567	-94	3,430	-942	1,463
Feb-11	-1,007	238	-3,103	-80	-3,277	275	-6,953
Mar-11	1,540	-258	862	79	-1,335	645	1,532
Apr-11	1,618	404	2,983	361	3,488	981	9,835
May-11	-1,480	-30	-2,281	71	-462	-553	-4,735
Jun-11	1,014	481	-664	30	-887	-884	-910
Jul-11	1,807	608	1,131	223	-2,155	1,255	2,869
Aug-11	-2,394	-992	-4,793	-124	-6,617	-1,408	-16,328
Sep-11	7	188	-1,290	-79	-2,602	-542	-4,318
Oct-11	-222	82	102	-21	219	584	745
Annual data							
2011 (YTD)	-171	278	-6,487	366	-10,198	-589	-16,800
2010	29,362	2,312	19,501	1,219	9,577	2,678	64,650
2009	17,176	1,303	24,386	408	15,611	1,110	59,994
2008	-15,674	2,893	-35,531	-1,060	-15,743	-4,845	-69,960

Last update: 21 Oct 2011. Source: Various stock exchanges, Credit Suisse estimates.

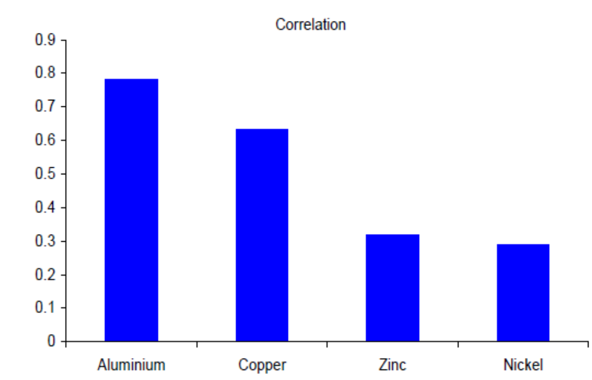
Two natural disasters hit emerging markets in October: an earthquake in Turkey and a worst-flood-in-decade in Thailand. For Thailand, Moody's Investors Service estimates damages resulted from the flood may exceed 200 billion baht (US$6.6 billion), or equivalent to 2 percent of GDP. Thailand central bank also lowered its growth forecasts from 4.1% to 2.6% this year. There is increasing odds of an interest-rate cut in the coming months to help stimulate Thailand, which is Southeast Asia's second largest economy.

During the month of October, India hiked its benchmark interest rates again but the Reserve Bank of India signaled they may pause further hikes. Other emerging markets also seemed to have reached the peak of interest rate cycle. In fear of drastically weaker economic growth in developed markets, Brazil and Indonesia have started trimming interest rates. Singapore has also adjusted its target exchange rate as a mean of monetary easing.

Commodities: Negative

There is a not-so-new joke within the financial circle that to be an analyst in commodities, one needs to speak Chinese (or Putonghua, being the official language of the People's Republic of China). As has been well documented, China accounted for nearly all of the growth in copper and iron ore demand over the past decade and 90% of the increase in global oil consumption. This explains the importance of understanding what drive the demands out from China in order to get a good grip on the direction of commodity prices.

Figure 2: Correlation between industrial metals prices & China housing construction



Source: Bloomberg Finance LP, Deutsche Bank

In China, the property sector has long been one of the biggest users of commodities, or more specifically industrial metals. Recent reports suggested property prices are showing signs of softening, a result of restrictive measures on property sales and mortgage lending, and also on the surge in completed units. The graph on the right shows that floor space under

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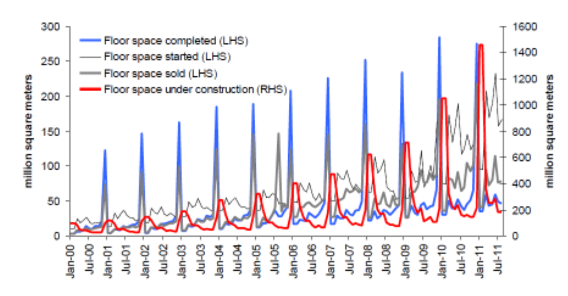
construction in China this year has exceeded floor space sold by a significant amount. On one hand, this is likely to exert more downward pressure on prices, and on the other hand this suggests slow down of property construction is highly probable come next year.

The CRB Raw Industrial Index has not rallied with other markets despite risk assets taking off in the past few weeks. In comparison, the GSCI index has rallied quite a bit off the bottom since early October. It appears recent buying has been highly speculative and selective, with raw commodity buyers staying mostly on the sidelines. Once risk appetite of speculators subsides, prices of industrial metals could see further weakness.

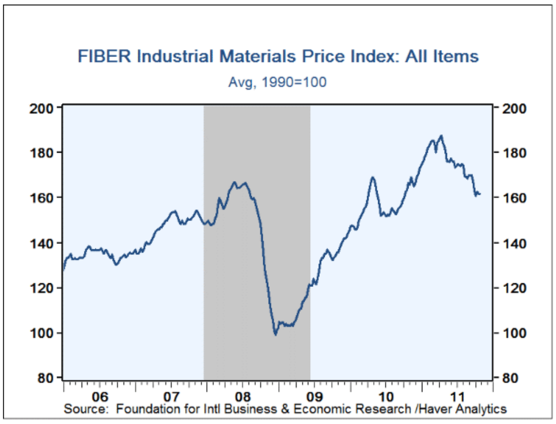
The latest price index from the Foundation for International Business and Economic Research (FIBER), which covers industrial materials prices, was at its lowest in twelve months. Year-to-year, the decline is a modest 2.9%, but since the April peak prices have fallen 13.6%.

Weakness amongst the FIBER index subgroups has been broad-based. Textiles prices were led lower by cotton which fell by nearly one-quarter YoY and have halved from peak early this year. Crude oil & benzene prices also fell with crude oil, though prices have been stabilizing recently. Prices in the miscellaneous group fell with lower lumber and rubber prices. Lumber prices recently have held up but rubber prices continued down. Prices in the industrial metals group continued their downward trends.

Fig 1 There is a questionably large degree of seasonality in the construction indicators



Source: NBS, Macquarie Research, October 2011



Hedge Funds: Mixed

European sovereign debt worries resulted in high levels of volatility and were disruptive to the majority of hedge fund strategies in September. These events ultimately translated into a loss of -3.20% for the Dow Jones Credit Suisse Hedge Fund Index (the "Broad Index") for September, the worst performance since November 2008. Dedicated Short Bias was the only strategy to post positive performance for the month due to steep declines in global equity markets.

Other hedge fund strategies saw various degree of declines. Global Macro and Managed Futures suffered fractional losses, which compared well against global

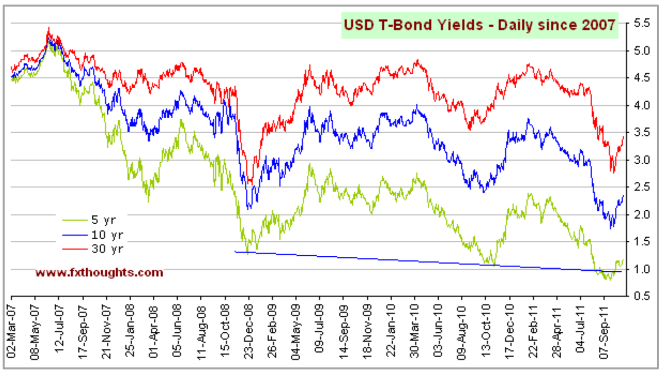
	Sep	YTD	Avg. Annualized Performance*	Annualized Vol.*	Current Sector Weights
Dow Jones Credit Suisse Hedge Fund Index	**-3.20%**	**-3.20%**	**8.80%**	**7.66%**	**100.00%**
Convertible Arbitrage	-1.77%	-0.07%	7.52%	7.03%	**1.53%**
Dedicated Short Bias	8.45%	13.19%	-2.97%	16.95%	**0.13%**
Emerging Markets	-7.47%	-6.88%	7.43%	15.07%	**7.22%**
Equity Market Neutral	-2.22%	2.09%	4.99%	10.47%	**2.21%**
Event Driven	-5.06%	-9.69%	9.29%	6.38%	**23.48%**
Fixed Income Arbitrage	-0.19%	3.63%	5.24%	5.82%	**6.60%**
Global Macro	-0.07%	5.82%	12.27%	9.87%	**20.15%**
Long/Short Equity	-5.22%	-9.12%	9.20%	9.99%	**19.64%**
Managed Futures	-0.78%	-0.05%	6.34%	11.78%	**5.99%**
Multi Strategy	-2.37%	0.55%	7.89%	5.44%	**13.04%**

Source: Credit Suisse Hedge Index, LLC.
*Average annualized Index data begins January 1994.

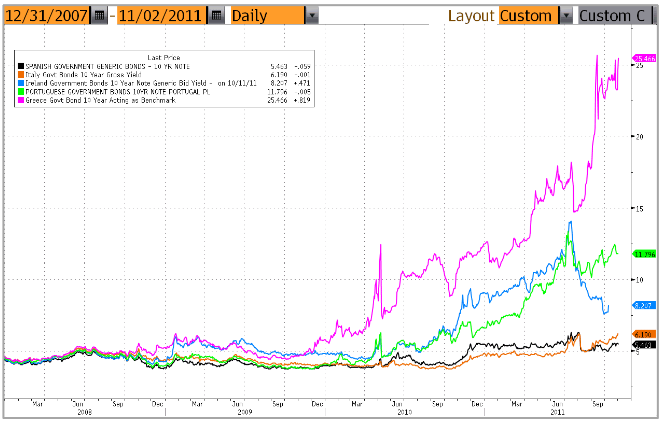
equities, thanks to relatively low long exposure and in some cases short exposure to equities. Multi-Strategy, Convertible Arbitrage and Fixed Income Arbitrage generally experienced mark-to-market losses on positions held. However, global stock markets registered strong rebound in October. It remains to be seen how different hedge fund strategies can cope with such acute turnaround.

Bonds: Mixed

'Risk-on trades' dominated the month of October, and this can be seen in the right chart. Investors switched back to risky assets from safe but low-yielding Treasuries, causing yields rising across bonds of various maturities.

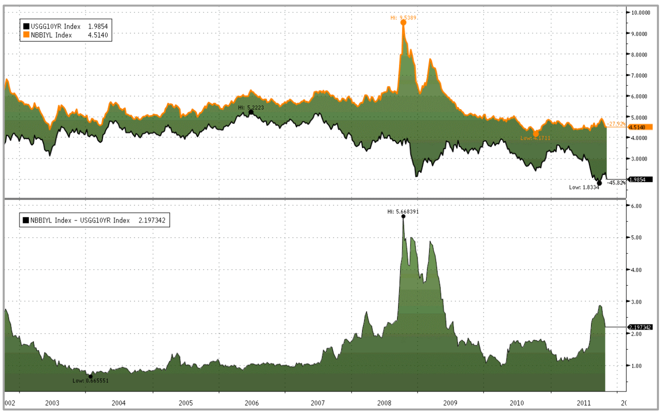


Yet, the situation in Europe is far from clear. Looking at yields on 10-year government bonds issued by the PIIGS countries, with the exception of Ireland, investor concern has actually heightened for Greece, Portugal, Italy and Spain. Yields on Greek bonds reaching new record highs notwithstanding, recent jump in 10-year Italian bond yields atop 6 percent should be closely monitored.



Since the start of the European sovereign debt crisis two years ago, that 6-percent on 10-year government bonds has been a threshold that cause a country to throw in the towel and seek help from EU and others (such as the IMF). Greece was the first to cross that line, followed by Ireland and Portugal. Should Italy, with total sovereign debt outstanding estimated to be €1.2-1.4 trillion, unable to hold the line, it could mark the endgame to the twelve-year euro experiment.

Turning our attention to corporate bonds, we noted yields have been quite stable for investment-grade holding at around 4.5% throughout the year. While the spread to 10-year Treasuries has widened since mid-year, this was due to falling Treasury yields.



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

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