AMG FINANCIAL GROUP 安柏

AMG Market Commentary

December 2012

Could Bonds be due a Rude Awakening?

In Hong Kong, sales of bond funds exploded this year. According to latest data from HKIFA, net sales (i.e., gross subscriptions minus gross redemptions) of all bond funds amounted to US$11,272.02 million as of end of October. This isn't far off from last year's record net sales of US$11,829.15 million.

Equally shocking perhaps, is that apart from balanced funds (which recorded aggregated net sales of US$1,853.43 million) all other major types of funds recorded negative net sales year-to-date. These included: equity funds (total), money market funds, equity index funds, hedge funds, guaranteed funds, fund-of-funds, and so on.

In terms of bond funds net sales as a percentage of all funds net sales, this figure came to 96.6% which is a new record high according to available data from the HKIFA website.

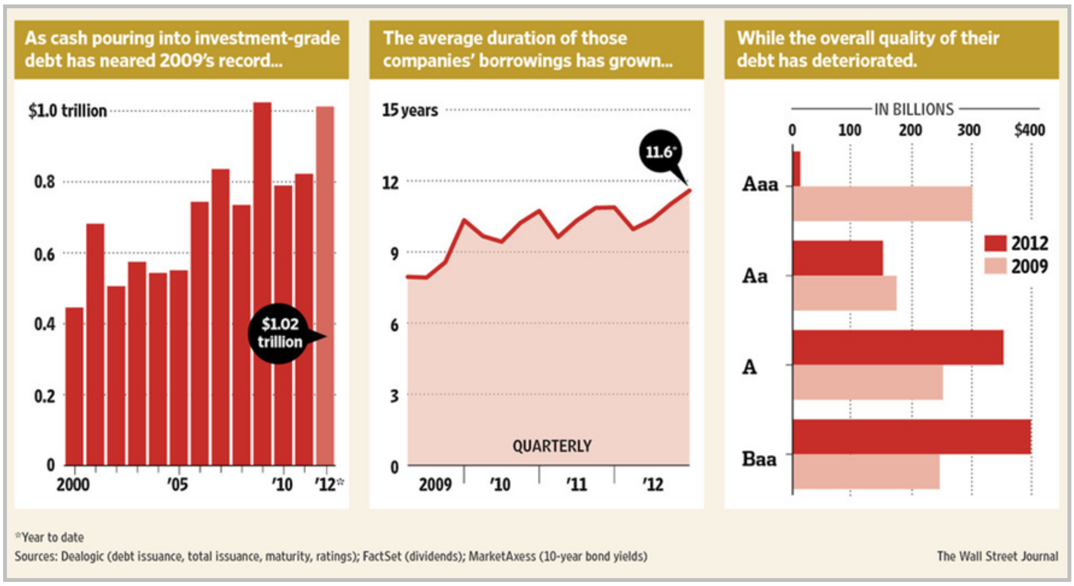
	Net retail sales by Hong Kong Investors (in US$Mln)									
Year	Global	Non-Global / Other	U.S.	Europe	Asia	Emerging Market	High Yield	Bond Funds Total	All Funds Total	% of Total
1999	n/a	n/a	n/a	n/a	n/a	n/a	n/a	75.07	1,463.23	5.13%
2000	n/a	n/a	n/a	n/a	n/a	n/a	n/a	(339.13)	1,394.99	N/R
2001	n/a	n/a	n/a	n/a	n/a	n/a	n/a	(40.50)	4,135.51	N/R
2002	121.67	196.38	738.76	n/a	n/a	n/a	n/a	1,056.81	4,603.13	22.96%
2003	(38.87)	498.98	705.13	n/a	n/a	n/a	n/a	1,165.24	3,238.72	35.98%
2004	63.70	(150.08)	(137.31)	n/a	n/a	n/a	n/a	(223.69)	2,640.02	N/R
2005	115.10	462.05	n/a	n/a	n/a	n/a	n/a	577.15	1,209.08	47.73%
2006	346.52	110.13	118.43	(46.65)	(44.19)	687.22	n/a	1,171.46	3,806.96	30.77%
2007	(179.44)	n/a	(206.24)	(128.59)	(47.17)	9.25	n/a	(552.19)	6,946.07	N/R
2008	187.38	n/a	34.62	(45.50)	198.53	(4.29)	n/a	370.74	(4,645.97)	N/R
2009	759.67	n/a	(22.55)	50.50	678.87	554.34	n/a	2,020.83	2,556.17	79.06%
2010	1,233.12	n/a	(18.02)	42.66	926.28	172.30	n/a	2,356.34	6,238.83	37.77%
2011	5,059.06	n/a	637.90	220.59	3,028.59	2,883.01	n/a	11,829.15	31,330.12	37.76%
2012 (till Oct. 31)	2,740.75	n/a	1,280.88	(54.08)	1,567.62	1,756.39	3,980.46	11,272.02	11,668.61	96.60%

Source: Hong Kong Investment Funds Association Sales & Redemptions Survey

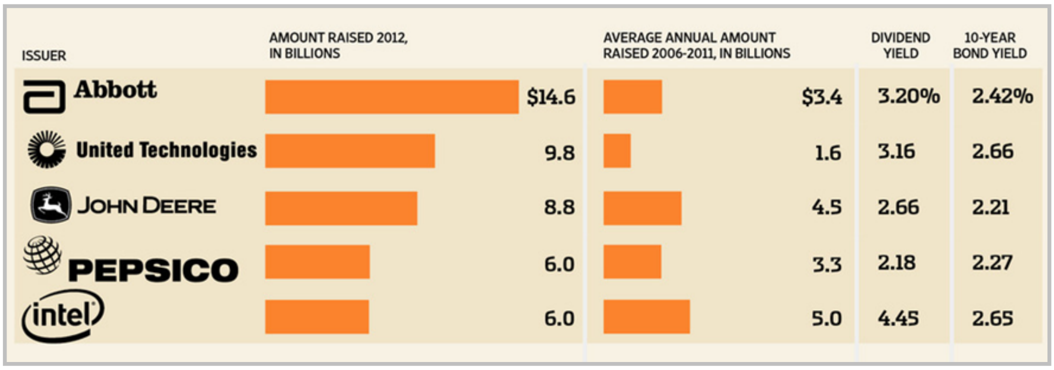
As an aside, working with the HKIFA compiled data leaves plenty to desire. To begin with, the data are presented in 'pdf' format and cannot be downloaded to an excel for easy number crunching or further analysis. Secondly, categorization of bond fund types is done in a haphazard manner and lack coherent, therefore making comparisons difficult. For instance, of all bond fund types this year, high yield bonds captured the biggest net sales amount. But there is no way to tell how much higher inflow is compared to last year because this figure was never broken out prior!

Even without year-over-year growth figures, the amount of net sales in high yield bond funds is staggering, making up more than 35% of total net bond funds sales so far this year. As for net inflows into bond funds in general, this is the fifth year whereby we see strong demand from retail investors. A question one has to ponder is: how long can and will this trend last?

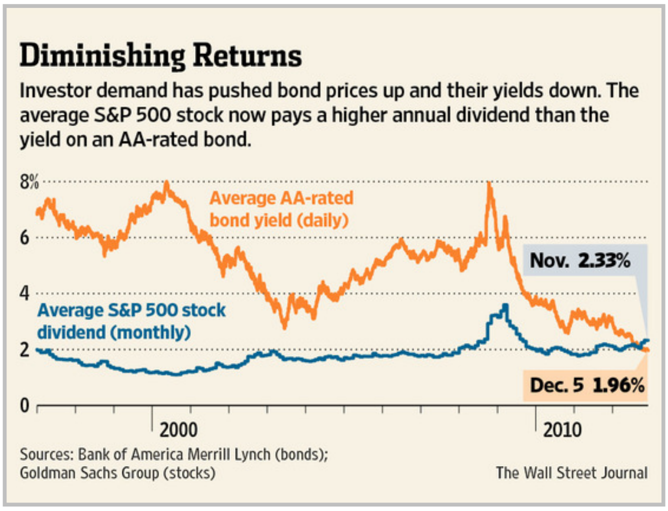
On the one hand, such 'quest for yield' behavior is understandable and indeed logical with interest rates around the global stuck at or near record lows. At the same time, the macro picture remains as uncertain as ever with all the talks about fiscal cliff in the U.S, a seemingly never-ending euro crisis that is destined to extend into a fourth year, and an incoming new prime minister in Japan who seems destine to push the nation's debt levels to the stratosphere. Such bleak outlook also prompt investors to seek shelter in the apparent safetyness of fixed income instruments. On the other hand though, there are flashing warning signs that the multi-year bull run in bonds could be running into exhaustion. We would like to talk about some of these warning signs herein below.



While the rush into bonds is a fairly new phenomenon here in Hong Kong, the movement has much deeper root in the U.S., as can be seen in the left-most chart (to the right). Investors were chasing for yield and safety in the form of investment grade corporate bonds in 2009, or the year after the collapse of Lehman Brothers. The demand subsided a bit in the two years that follow, but surged again this year. This is somewhat perplexing given the U.S. economy is in it fourth year of expansion, albeit at a pedestrian pace. Meanwhile, composition of newly issued bonds has changed. Average duration of new issues has grown significantly from less than 8 years in early-2009 to 11.6 years according to the latest tally. Quality of new issues has also deteriorated with majority of issuers rated single-A or Baa, and just a tiny portion carrying the highest Aaa rating. In short, more and more investors are buying into lower quality bonds with longer maturities at lower yields.



What is more is that investors looking for yield could get a better deal by buying shares of some of these listed companies. The table to the right shows a number of well known U.S. companies whose shares carry higher dividend yield than yields on their 10-year corporate bonds.



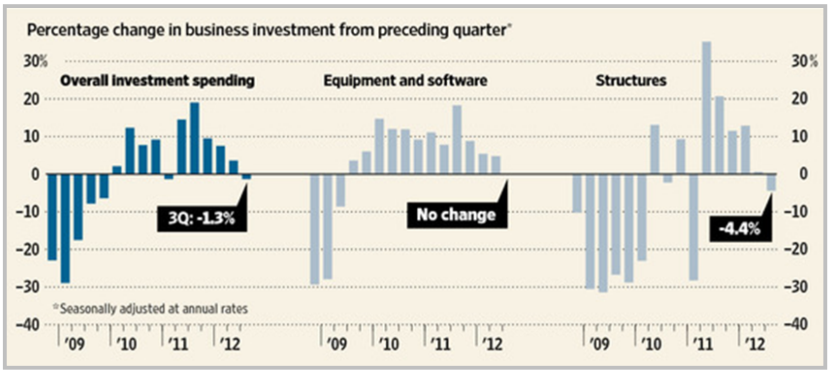
For those readers who may discard this as rare and exceptional incidences, the chart to the right should settle any dispute or disbelief for good. This chart shows the average dividend yield of companies that made up the S&P 500 Index at month end, and how this compares to the average yield of AA-rated bonds since 1997.

Over this 15-year period, AA-rate bond yield has (or perhaps more accurately to say 'had') been traded much higher than average dividend yield of the 500 largest listed companies in the U.S. Since 2009, spread between the two yields has narrowed precipitously. The two lines finally crossed about a month ago and the 'inverse' spread continued widening further.

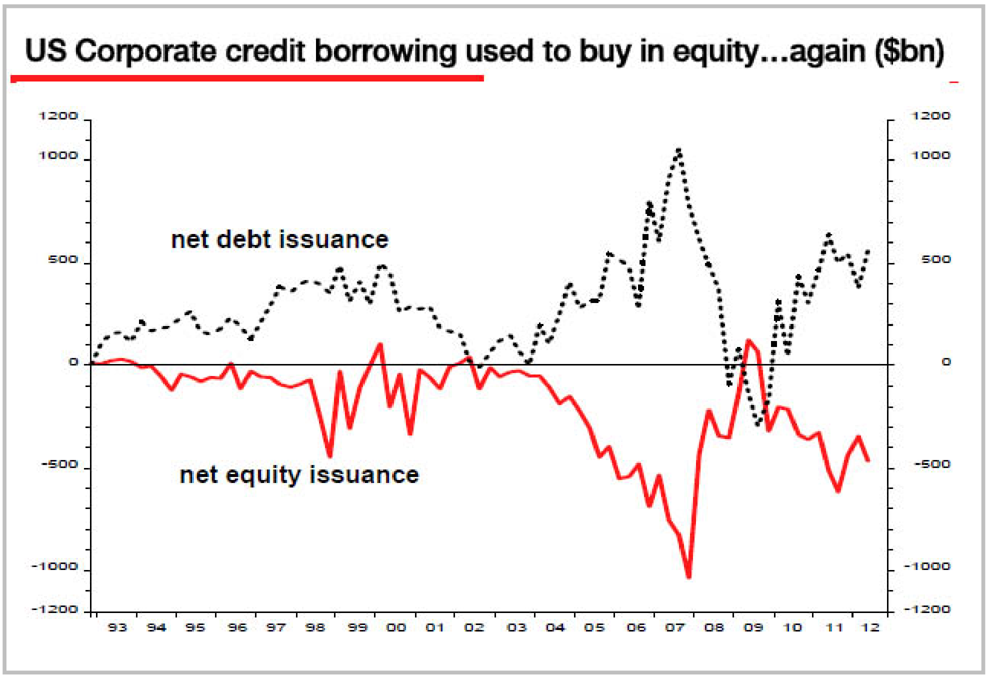
Let's pause for a moment to ponder the meaning of this inverse yield spread. According to common logic, and supported from empirical data, equities tend to outperform bonds in terms of capital gains over the long haul.

Because of this, there is less need to further incentivise investors to hold equities instead of bonds. On the contrary, companies issuing bonds need to offer higher yields to attract investors to buy their debts and forego higher potential (though uncertain) return provided by equities. Hence, the current inverse yield spread situation may suggest investors are so unsure and nervous about companies future prospects that they demand higher dividend yields to compensate for taking such risk. Alternatively, investors who flocked to these bonds despite the inverse yield spread are doing so blindly or unknowingly. A third explanation is that these investors are mandated to invest in high quality bonds exclusively, and they have been driven out of government bonds (some of which yield next to nothing) and into the only alternative which are investment grade corporate bonds.

So companies in the U.S. have been raising record amount of debts over the past few years. What are they doing with all this money? For sure they have not plowed the money into expanding businesses. As can be seen in the right hand charts, overall corporate investment spending has been trending downward since second half of last year. And judging from the anemic pace of job growth, companies didn't spend the money on hiring more people either.

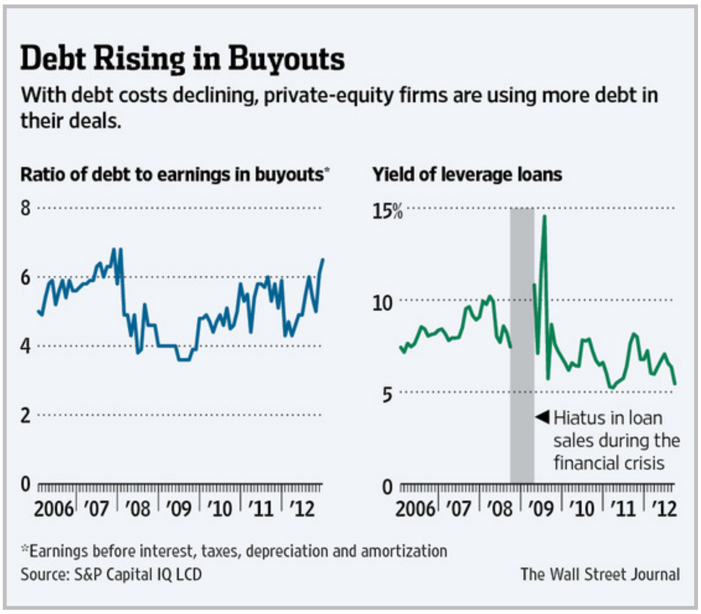


It turns out that considerable amount of the money raised via debt issuance could have been used for shares buyback. The chart to the right shows net debt issuance versus net equity issuance by U.S. companies since late-1992. We can see that since 2005, the amount of net debt issuance is almost equivalent to the amount of net equity relief via repurchases.



Source: SG, Datastream

Academia has been highly critical about the economic benefits of share buyback activities, claiming this is just a form of corporate accounting trick rather than generating any real gains to stakeholders and the economy at large. By reducing the number of outstanding shares, this boosts up earnings per share and reward shareholders. However, higher debt loads mean heavier burden to these companies and is detrimental to bondholders.



Another unhealthy development is the surge in the amount of debts used in corporate buyouts. Thanks to near record low yields and insatiable appetite of investors for high yielding bonds, private equity firms are borrowing more to fund acquisitions. Back in 2008/09, private-equity firms paid an average of 42% of the cost of large buyouts with their own money, also known as "equity," while borrowing the rest to finance their deals. In the past six months, this percentage has fallen to about 33%, according to Thomson Reuters, which is close to the 30% averaged in 2007. This means acquired firms are saddled with heavy debt loads. As shown in the right hand chart, the ratio of debt to earnings for acquired firms has been surging in the past year and rapidly approaching peak levels seen in late-2007 and early-2008, which incidentally marks the beginning of the last financial crisis.

The past few years have been kind to bond investors all over the world, with bonds offering both a safe shelter from the nauseous equity markets and handing out attractive returns at the same time. For bond investors in the U.S., they have enjoyed a remarkable long bull run that spanned over three decades with the origin dating back to former Fed Chairman Paul Volcker's quest to quell inflation. But all bull runs end somehow, and oftentimes inconspicuously. The way this writer sees it, there are sufficient signs that suggest the bull run in bonds have nearly ran the course. It is up to each investor to decide whether they wish to leave a little early but orderly, or to stay a little longer and then leave among the crowd when everyone rush for the exit.

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Market Review & Outlook

U.S.: Neutral

Although incoming data of U.S. are consistent with a moderate growth environment, markets remain preoccupied with negotiations between the political parties to resolve elements of the looming fiscal cliff. Legislative schedule for the remainder of the year is tight, making a comprehensive solution to problems difficult to achieve ahead of year-end. An agreement prior to year-end is possible but it is likely to be in a very limited scale.

A very tight legislative calendar

Date	Legislative calendar / event
Dec 14	Scheduled end of 'lame duck' House session
Dec 21	Potential extension of 'lame duck' House session
Dec 25 / Jan 1	*Christmas / New Year's Day holiday*
Jan 1	Expiration of tax cuts, provisions, unemp. comp. Affordable Care Act tax hikes
Jan 2	Imposition of sequestration
Jan 3	113th Congress convenes
Jan 20	Presidential Inauguration
Late Jan	2013 State of the Union address
Early Feb	President's budget introduced
Feb - Mar	Debt ceiling reached
Mar 27	Expiration of FY13 continuing resolution
Apr 15	FY12 tax return deadline

Source: Barclays Research

Given the tight legislative calendar and the two parties' gaping differences of opinion, current market observers think that policymakers will "go over" the cliff, raising questions about how quickly a resolution can be reached before serious damage is done to economic activity and financial markets. Some policymakers appear less worried about this outcome since they think the cliff is just a slope indeed, meaning economic damage will initially be limited while any equity market sell-off will only spur a resolution.

Figure 3: Employment details

	6-Month Avg.	Jun-12	Jul-12	Aug-12	Sep-12	Oct-12	Nov-12	
Total Payrolls	133478	133063	133244	133436	133568	133706	133852	
Change	139	45	181	192	132	138	146	*Net -49k from back revisions*
Previous Est. Change	137	*45*	*181*	*192*	*148*	*171*		
Diffus. Index--Priv. Sect.	**56.8**	**54.7**	**54.9**	**52.4**	**57.0**	**63.0**	**59.0**	*Broad job industry growth*
Diffusion Index – Mfg.	**48.4**	**50.6**	**48.8**	**43.2**	**43.2**	**56.8**	**47.5**	
Private sector	136	63	163	134	122	189	147	
Manufacturing	0	7	18	-13	-16	10	-7	*Hurricane interruptions*
Construction	1	4	3	3	-1	15	-20	*Ditto*
Services (Priv)	137	54	143	148	139	171	169	
Retail Trade	25	-9.0	3.2	18.1	36.6	50.9	52.6	*Early holiday hiring*
Government	3	-18	18	58	10	-51	-1	*State and local gains*
Household Survey								
Employment	163	128	-195	-119	873	410	-122	
(payroll concept equivalent)	139	-153	108	247	294	733	-398	
Unemp. Rate	8.0	8.2	8.3	8.1	7.8	7.9	7.7	*Fell for the "wrong" reasons*
Participation Rate	63.7	63.8	63.7	63.5	63.6	63.8	63.6	
Establishment Survey								
Wkly. Hrs. (Production)	33.7	33.7	33.7	33.6	33.7	33.6	33.7	
Mfg. Hours	41.6	41.6	41.7	41.5	41.5	41.5	41.6	
Overtime	4.1	4.1	4.2	4.1	4.2	4.1	4.1	
Avg. Hrly. Earn($)- all workers	23.56	23.50	23.52	23.52	23.60	23.59	23.63	
% Change	0.1%	0.30%	0.09%	0.00%	0.34%	-0.04%	0.17%	*Up 1.7% y-o-y*

Source: BLS, Nomura

Unemployment rate declined by 0.2 percentage points to 7.7% in November, reaching the lowest level since Dec-2008. Nevertheless, underlying details indicate the decline in unemployment rate was for the "wrong" reasons. Households reported job losses of 122k in November, while the labor force declined by an even larger 350k. These dynamics underscore why Bernanke has stressed that FOMC cannot gauge the health of the labor market on the unemployment rate alone. The loss of household employment likely reflects the BLS's conduct of the household survey one week earlier than usual, in the immediate aftermath of Hurricane Sandy. The share of workers reporting they were unable to work due to bad weather jumped much higher than a typical November.

Europe: Neutral

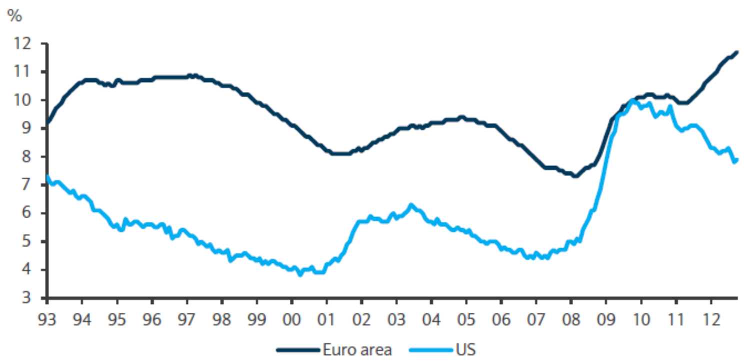
Authorities in the euro area are battling on three fronts: (1) fire-fighting to keep the crisis economies' adjustment programmes on track; (2) attempting to establish closer institutional ties to shore up support to the single currency;

and (3) boasting monetary support amid a broadening and deepening recession.

As smoke begins to clear regarding the Greek rescue, the Spanish crisis comes back into view. Spain's central government appears on track to meet its 4.5% deficit-to-GDP target for this year. Encouraging progress has been made both in increasing revenues and in cutting expenditure – even adding in the less fiscally disciplined regions.

Spain's on-going reluctance to request ESM assistance remains a point of contention. A request would open up the possibility of Outright Monetary Transactions (OMTs), lowering domestic interest rates and alleviating some of the financing pressures faced by public and private sectors. However, Spanish government appears reluctant to assume the stigma that would attached to a formal programme request, and unwilling to sign up to conditions that would commit it to reining in regional spending. The current state of affairs, in which market pressures are held at bay knowing that OMTs are ready for action, might be an equilibrium, but it is an uneasy one.

The euro area unemployment rate hit a new high in October



Source: Haver Analytics, Barclays Research

The schedule of debt issuance by European governments is mixed. Italy will issue as much as 12% less bond, reflecting a downward adjustment in its redemption profile. In contrast, supply in Portugal and Ireland may increase as they try to fund half their needs through the markets. Issuance in Austria is expected to increase noticeably as well due to its redemption profile.

Fig. 1: Euro area 2013 sovereign issuance forecasts (€bn)

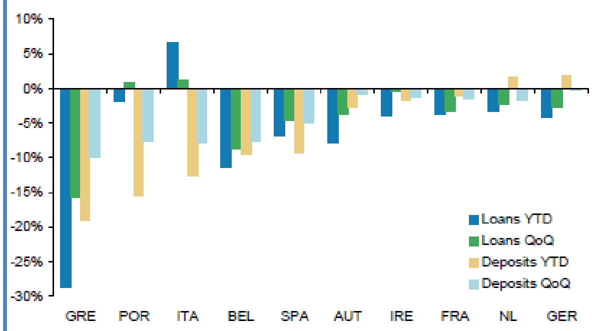
	Redemptions			Deficit			Funding needs			Diff.	Adjustment		Bond supply in €		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013F	2014F	2012	2013	2014
Austria	14	16	24	8	8	9	22	24	32	0	2	-2	22	26	30
Belgium	23	30	28	11	14	13	34	45	41	9	-4	-	43	41	41
Finland	7	7	7	2	3	4	9	10	11	2	-	-	11	10	11
France	105	106	121	90	77	76	195	183	197	7	10	10	202	193	207
Germany	160	157	139	4	6	13	164	163	152	21	-	-	185	163	152
Greece	21	10	15	14	12	11	36	22	26	-36	-22	-26	-	-	-
Ireland	6	6	8	13	13	9	19	18	17	-13	-9	-	6	9	17
Italy	199	158	173	46	49	44	245	207	217	-15	-5	-5	230	202	212
Netherlands	34	32	31	22	19	19	56	51	51	4	4	4	60	55	55
Portugal	14	6	14	9	9	7	22	15	21	-22	-7	-10	-	7	10
Spain	51	62	68	37	45	35	88	107	102	12	-17	-6	100	90	96
EA-11	633	588	628	255	256	240	889	844	868	-30	-49	-36	859	796	833

Note: Deficit refers to the general government fiscal balance with the exception of Italy and Spain, where it refers to the central government fiscal balance. Source: Nomura, National Treasuries, Bloomberg

One of the major risks to 2013's issuance profile stems from a potential weakening of market sentiment and demand for noncore debt, which could prevent the return of Ireland and Portugal to the market, force Spain to request a precautionary credit line, potentially leading to ESM/EFSF purchases in the primary market. Under severe stress some governments may also revise their issuance outlooks to shift a fraction of their planned medium-long term issuance into T-bills, providing lower duration risk, but raising rollover risk for themselves in the future.

Intra-Euro Area interbank lending and deposits underscores unwillingness to lend

YTD and QoQ changes (based on 4Q rolling average)

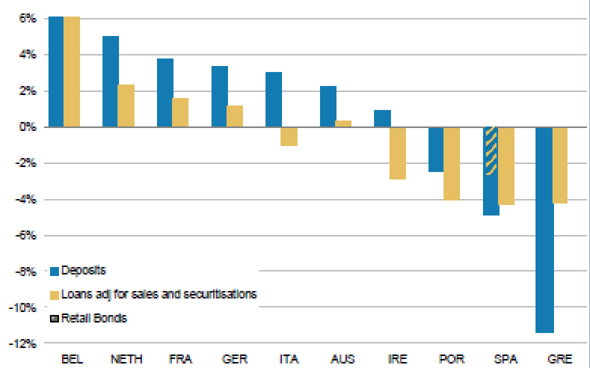


Source: ECB, Morgan Stanley Research.

Latest Q3 data from the ECB shows that intra Euro Area cross border lending and deposit taking remains acutely impacted by the on-going fragmentation of the banking sector. In particular, banks' willingness to lend to each other within the Euro Area has fallen significantly this year, with peripheral and core systems alike behaving in unison on the whole. Only German and Netherlands interbank deposit taking has been marginally positive YTD.

YTD lending and deposit flows underscore divergence

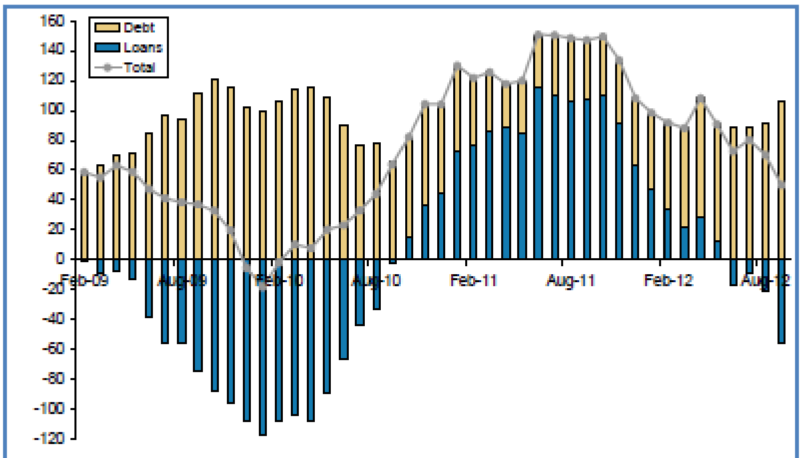
% change in deposits & loans YTD



Source: Morgan Stanley Research, NCB.

Looking at the banking system trends on a broader level, a metric that worth tracking is the banking system funding gap (lending – deposits), which can be interpreted as an indicator of cross border deleveraging. Looking across the total banking systems of the Euro Area, it is clear that net lenders to the system, such as Germany and France, continue to reduce their funding gaps. This trend is mirrored by Italy and Spain, which have seen their net borrowing from the system decline.

Latest corporate lending trends point to further core weakness in October, with Germany last month seeing its largest outflow since December last year (outflow of €4.2bn). From a growth rate perspective, however, the YTD fall in Germany has been gradual, while we note that in France there has been considerable reduction in corporate lending activity YTD, with loan growth at its lowest level since July 2010 at 0.2%. This chimes with the latest PMI and business confidence indicators in the core, which point to a further slowdown in corporate activity in Q4. In the periphery, corporate lending remains extremely weak, and in Spain, activity took another leg down to -6.5% from -5.8% in September.



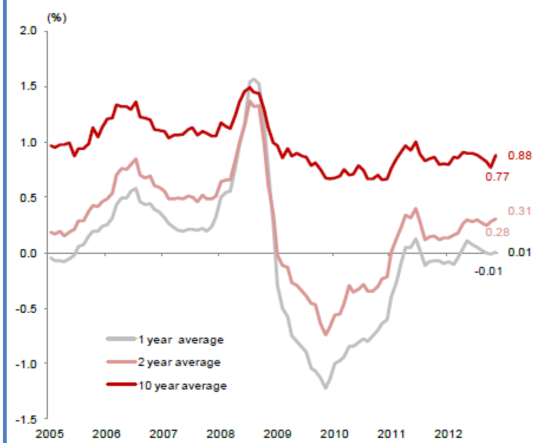
Source: Morgan Stanley Research, ECB

Latest data from the ECB shows corporate net issuance of debt securities in the past year stands at €106bn. However, whilst there has been an increase, many European firms are still reliant on bank lending, making it critical that this channel functions better and EU promotes policies supporting non-bank funding. But disintermediation is not true for firms in the periphery, where credit retrenchment has been greater than debt securities issued. Moreover, only a small fraction of firms actually have access to the capital markets as an alternative to bank loans – ECB's latest survey on access to finance of SMEs published in November show that only about 2% of SMEs use debt securities. Even among large German and French firms surveyed, less than 4% issue debt securities.

Japan: Neutral

There are probably two types of skeptics on the 'new BOJ' in the market: those who doubt whether the BOJ actually introduces higher inflation target and those who doubt whether the BOJ has a tool to achieve higher inflation. Inflation expectations based on the latest survey conducted by Nikkei Quick showed 10-year average inflation was expected to increase to 0.88% from 0.77%. While inflation expectations inched up during past month, they are still far below 2%, the target LDP leader Abe repeated he would share with the BOJ once the party takes power, as widely expected.

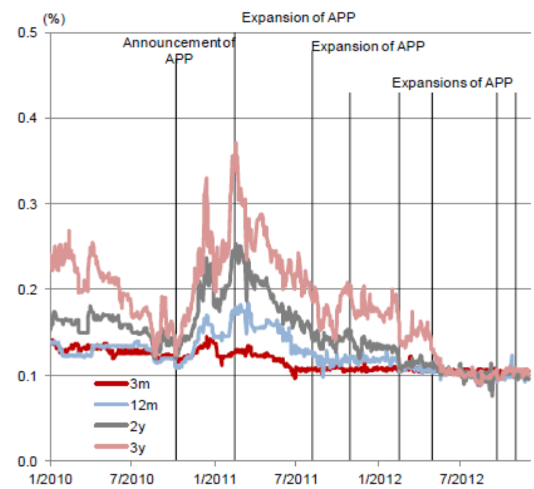
Fig. 1: Inflation expectations based on survey of bond investors



Source: Nomura, Nikkei Quick

42% of bond investors now expect an inflation target, instead of the vaguer current inflation goal, to be introduced, based on the same survey. 41% judged the possibility of an inflation target being introduced was around 50% and 18% judged it to be low. The survey result suggests bond investors are still not fully convinced that the BOJ will be forced to share a higher inflation target with government. However, as the LDP has clearly committed to raise the inflation target in its election pledge, the party is likely to put pressure on the BOJ to accept a higher target upon winning the upcoming general election.

Fig. 3: JGB yields

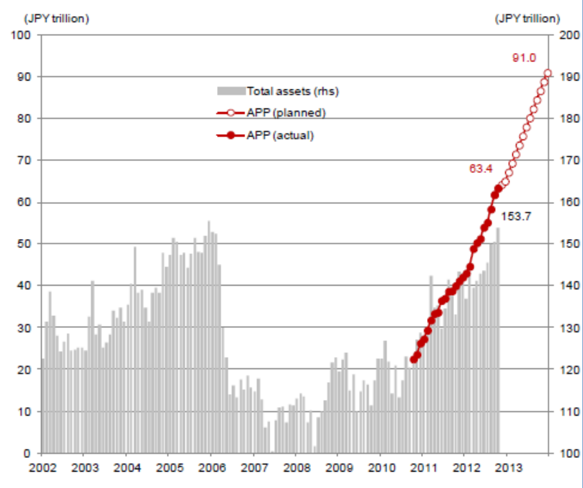


Source: Nomura, Bloomberg

At the same time, it is not clear whether 2% inflation is achievable for the BOJ in the near future. As Japanese yields shorter than 3yr which the BOJ is currently investing under the APP have reached 0.1%, a de-facto floor, the impact of previously adopted policies under Governor Shirakawa (APP expansion mainly focusing on JGBs) on the economy and JPY may not be significant. Other policy options, such as lowering IOER, extending the maturity of JGB buying under APP, and buying foreign bonds, have limitations or drawbacks from the BOJ's standpoint. It is not clear whether the BOJ can achieve a higher inflation target anytime soon, even after it is forced to seek higher inflation. Thus, skeptics of the latter type may have a point.

The timing of policy normalization should be later if the Bank seeks a 2% inflation target. The BOJ raised its policy rates twice in 2006/2007 and once in 2000. These are regarded as policy mistakes, at least in hindsight, but this type of policy mistake should be less likely under a higher inflation target while increasing the risk of overheating the economy and financial markets. As a result, the economy may become more responsive to positive shocks from foreign economies or domestically generated positive shocks, as the likelihood of premature policy tightening against the positive shocks would decline. Even if the Bank has no good tools to generate positive shocks to the economy by itself, it can increase the impact of any positive shocks on the economy under a higher inflation target.

Fig. 4: Assets held by the BOJ and size of APP



Source: Nomura, BOJ

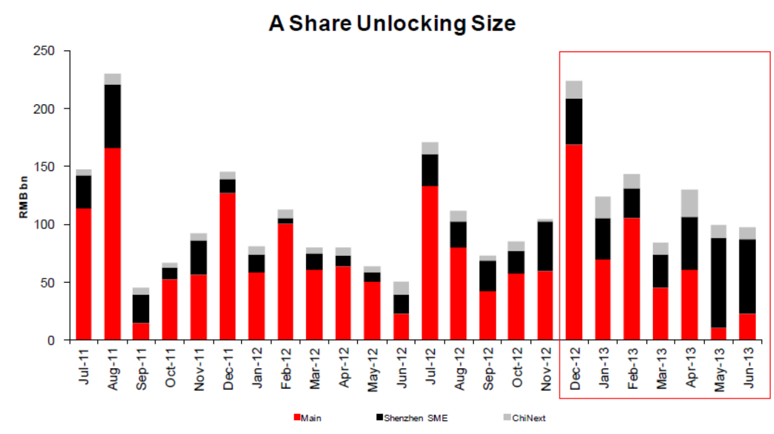
There are drawbacks. Risks of the economy overheating and asset price bubble would likely increase under the new framework. As Governor Shirakawa has frequently mentioned, Japanese inflation was below 2% when the economy was boosted by an asset price bubble in the late 1980s.

Nonetheless, recent politics surrounding the BOJ are clearly inclined to this decision, decreasing the risk of the BOJ cooling the economy too early while risking the economy and financial markets being overheated. The possible decision to introduce a higher inflation target should have implications on asset prices including JPY in the medium term.

China: Neutral

In China, investors and market observers are keening watching the flow of stock unlocking, with around Rmb250bn worth of shares scheduled for release in December 2012. Such events are mostly clustered on the ChiNext and SME exchanges. SME stocks account for the largest portion of share unlocking. What's new this time is the increased number of companies unlocking shares in ChiNext since ChiNext has existed for three years, exactly the length of the locking period for most non-traded stocks held by original shareholders.

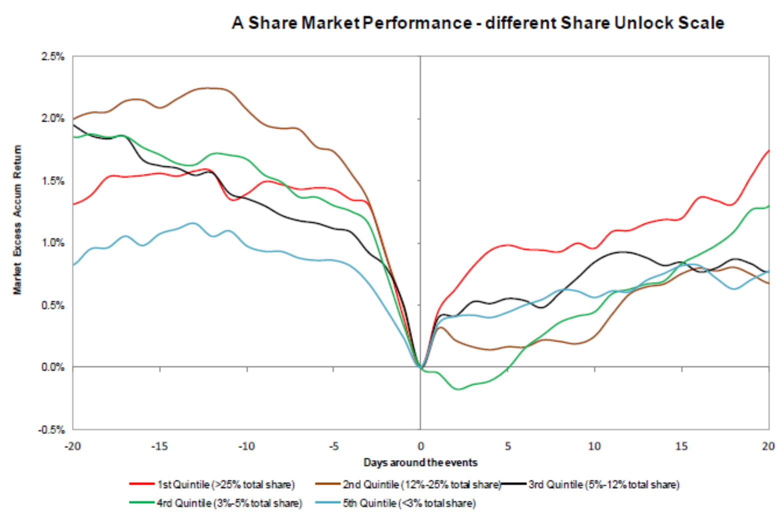
Fig 1 Market performance around Share Unlocking – different company sizes



Source: Wind, FactSet, Macquarie Research, December 2012

Historically, only 12.63% of the total "non-tradable" shares unlocked since China's share reform process began in 2005 have been subsequently sold. However, the mid- and small- cap board and the ChiNext board will face higher pressure from shareholders seeking to cash-out after unlocking.

Fig 4 Market performance around Share Unlocking – Different Share Unlocking scales



Source: FactSet, Wind, Macquarie Research, December 2012

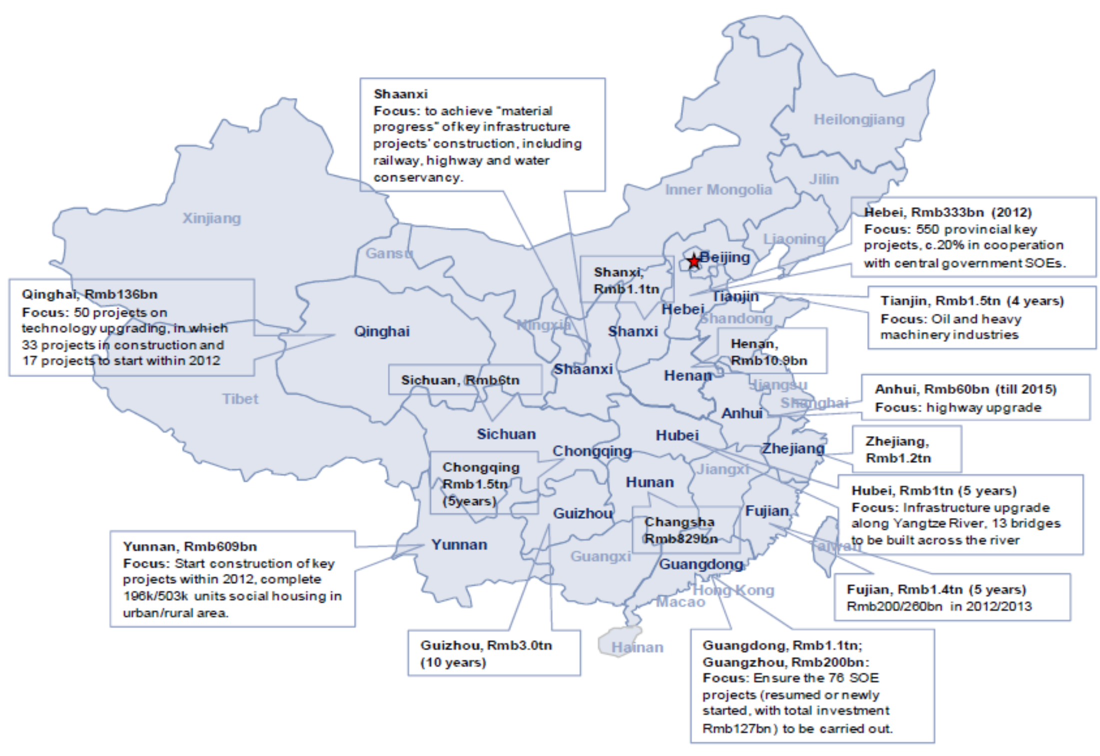
Unlike unlocked shares on the main boards, most of which belong to stable parent companies and thus are unlikely to be sold even after unlocking, those on the Shenzhen mid- and small-cap board and ChiNext are mainly held by founders, employees and private equity investors, who are much more likely to liquidate substantial portions of their holdings once unlocked.

According to ChinaVenture, in 2010 and 2011, a total of 50 private equity (PE) institutions cut holdings in 65 out of 291 unlocked A-share listed companies (or 22.3%) and cashed out shares valued at Rmb13.0bn. Some 35 of the 65 PE companies that decreased holdings were listed on Shenzhen's mid- and small-cap board and 26 were listed on ChiNext. The risk of reduction in holdings from PE investors (as well as from founders and employees) of already and yet-to-be unlocked stocks may cap the upside of the two markets.

The concern was somewhat alleviated by pledges from the managements of 36 ChiNext stocks at the end of September to hold back from selling stock in the following 2-6 months. However, primary investors of some other small-cap names cut positions right after the unlocking last month, rekindling investor fears. Research indicates that the underperformance is correlated to the size of the company - the smaller the company, the bigger the drawdown. On the other hand, underperformance is correlated to the size of share unlocking - the bigger the size of the share unlocking, the bigger the drawdown.

Exhibit 17: The ambitions of local government spending

Total investment of Rmb20 trn has been announced by 16 provinces and cities since May 2012



Source: Provincial and city level government websites, Hexun.com, NetEase Finance.,

Recent construction activity pickup since late-August (and subsequent commodities demand rebound) is driven mainly by restart of suspended infrastructure projects and acceleration of existing property projects.

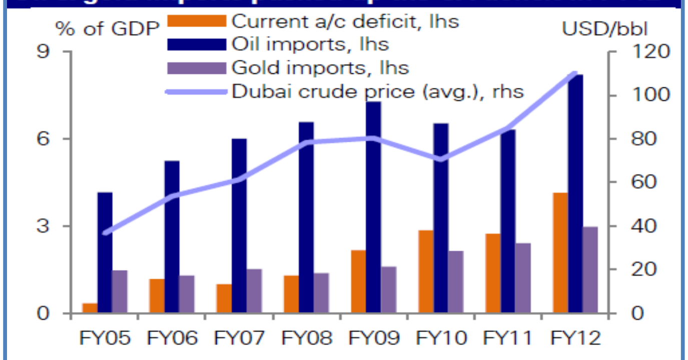
Despite the fact that both central and local governments have approved large number of new infrastructure projects, real starts weren't seen yet due to: 1) slower decision-making process amid government transition; 2) lack of adequate funding; and 3) lead time required to start large-scale projects. It is expected that strong construction activity may take place in March 2013 post the NPC meeting, even though some projects may still be struggling for funding.

India: Neutral

India's trade deficit has widened in recent months as exports growth has declined sharply while imports growth remained relatively firm, led by sharp increase in oil imports. The sharp increase of import growth growth has been led by strong performance in three of the most important categories – petroleum & crude products (18.3% of total exports), gems and jewellery (15.1%) and transport equipment (7%), as shown in the right-hand chart. The only exception is Drugs & Pharmaceutical sector (4.3% of total exports) which seems to be faring well thus far.

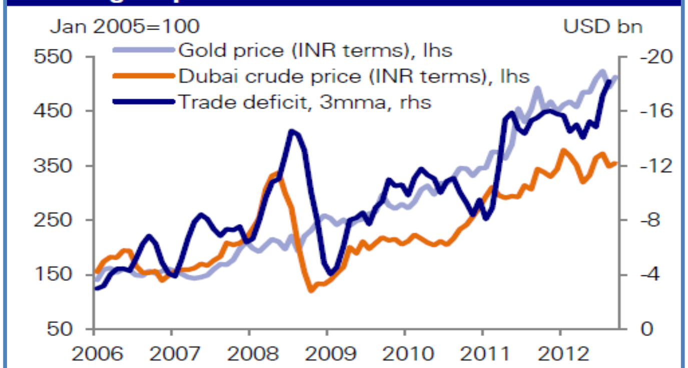
On the imports side, non-oil imports have slowed sharply, reflecting weak domestic demand; however, oil import (which constitutes about 30% of total imports) have started rising again in recent months. Worsening of trade deficit is occurring despite a sharp fall in gold imports growth, a key factor responsible for pushing up last year's current account deficit to 4.1% of GDP (despite robust exports and net invisibles outturn).

Oil & gold imports pushed up the CA deficit in FY12



Source: CEIC, Deutsche Bank

Oil and gold price in INR terms vs. trade deficit



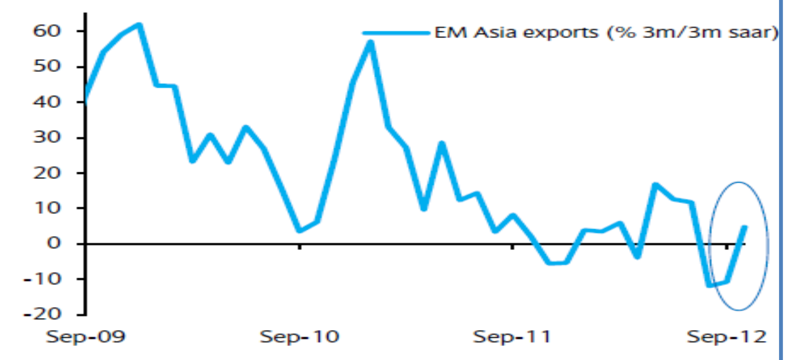
Source: CEIC, Deutsche Bank

As long as the fuel subsidy policy remains distortionary, it will be difficult for the authorities to bring down trade and current account deficits to comfortable levels. Similarly, unless inflation is tackled in a decisive manner, administrative measures are only likely to meet with temporary success in reducing gold imports.

Asia Pacific: Mixed

Trade data reported so far for EM Asia suggests a budding recovery in exports. With around 80% of the region having reported October data there appears to have been a shift from contraction in exports seen in the latter part of summer (exports fell 10% 3m/3m SAAR in September) to a sequential expansion of 4.7% 3m/3m SAAR in October.

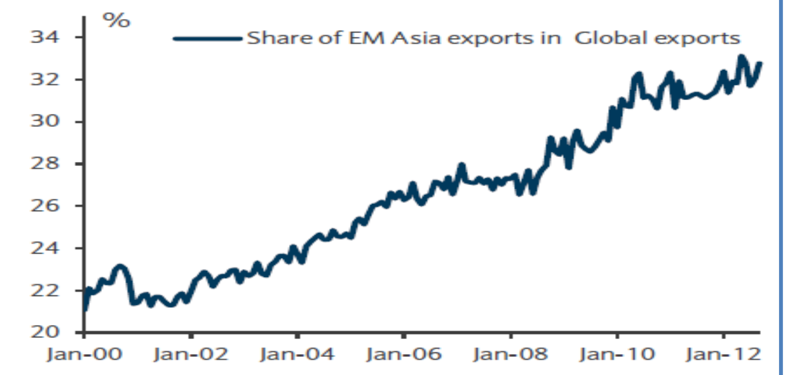
Export growth appears to be turning around



Note: Includes data for those reporting October numbers (China, India, Korea, Singapore, Taiwan, and Thailand). Source: Haver Analytics, Barclays Research

Despite weak external demand, EM Asia has benefited from its ability to continue to gain market share in various industries; the region's goods exports now account for 32.8% of total global exports.

Asia continues to gain global market share



Source: Haver Analytics, Barclays Research

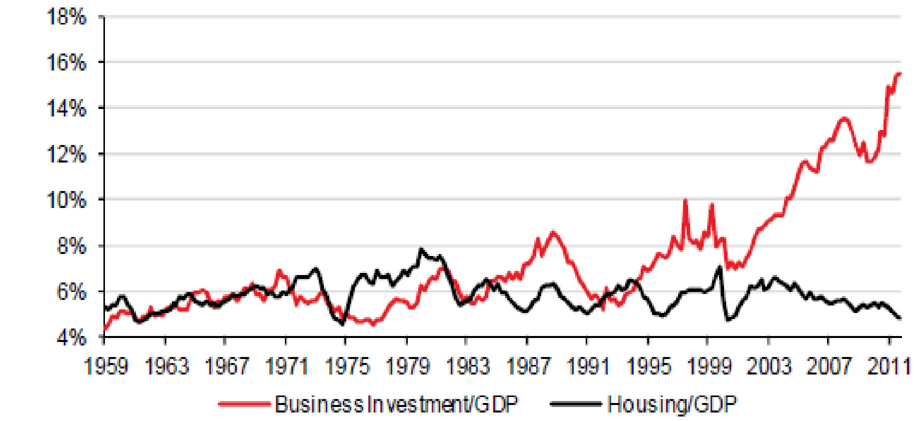
There has, however, been some variation in performance across the region. In Korea, exports finally began expanding in October (1.2% YoY) after spending much of the year in negative territory. Electrical and electronics exports were particularly strong, offsetting the drag from shipbuilding. This better trade performance, combined with a growing services surplus, helped drive Korea's current account surplus to record levels in October (USD5.82bn), with YTD surplus up 79% relative to same period in 2011.

Taiwan's exports had already begun expanding in September (up 10.4 % YoY), although some of that gain was given back in October due to softer sales of petrochemicals and electronics. In contrast, October data showed Singapore export momentum to be weak (contracting 1.2% MoM in October) and Indian exports continue to shrink (-1.3% YoY).

In China, which accounts for 45% of the region's exports, recent data has surprised to the upside. Weak sales to Europe have been offset by continued growth in exports to the U.S. and a significant improvement in sales to other parts of EM Asia (notably the ASEAN economies). This positive dynamic looks likely to be sustained in the near-term, with export orders component of the flash PMI moving into expansionary territory in October for the first time since April.

The Australian housing sector is moving into the spotlight now that it is clear RBA's contingency plans for the end of the mining boom rests on housing investment filling the void.

Fig. 25: Business and housing investment to GDP



Source: Datastream, Nomura research

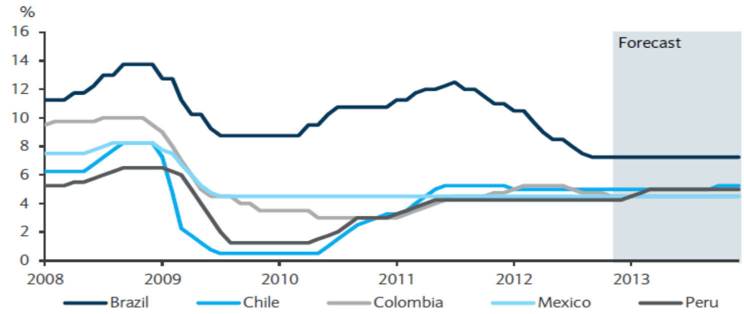
This is a questionable proposition for a number of reasons. Firstly, evidence so far is that households have not changed their attitude towards gearing. Credit growth is anaemic, and rate cuts have not changed people's mindset. Secondly, cuts to Victorian incentive schemes could offset increases in NSW. Thirdly, the mathematics is challenging. Business investment has been boosting GDP by as much as 7% compared with its pre boom baseline, whereas even a strong housing boom will only add an additional 2% of GDP, and then only for a couple of years.

Finally, established house prices are much cheaper than new house prices, so it will be particularly difficult to encourage new housing construction. The cost of delivering new plots has surged due to council charges, and labour and material costs.

Latin America: Neutral
The Brazilian Central Bank confirmed the end of the easing cycle by keeping the Selic rate at 7.25% with no bias in a unanimous decision. The Copom maintained the indication that keeping the current policy stance for a prolonged period of time is the optimal strategy to guarantee the convergence of inflation back to the target, even if in a non-linear manner. There are two main messages in this statement. First, that inflation will not necessarily return to the 4.5% midpoint of the target any time soon.

The second message concerns a broader policy objective the government is pursuing: lowering financing costs in Brazil. Hence, not only is maintaining the Selic rate at low levels key, but so is minimizing the use of interest rate hikes in the next tightening cycle by deploying other monetary policy instruments (using macro-prudential measures to limit credit expansion and even allowing for some exchange rate appreciation).

Most target rates in Latam have reached cruise levels (official monetary policy target interest rates, % observed and forecasts)



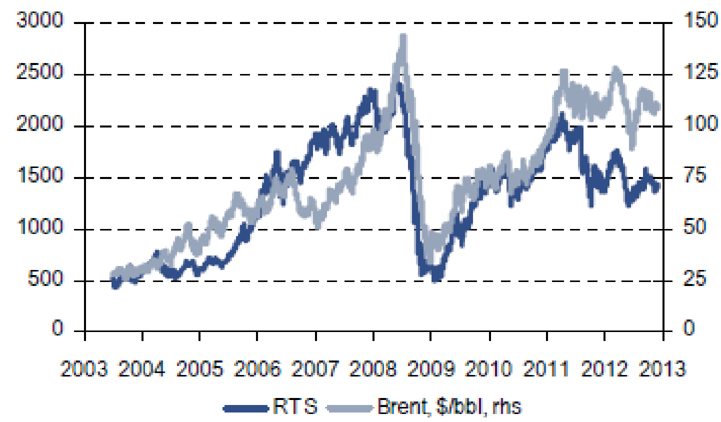
Source: Bloomberg, Barclays Research

Russia / Emerging Europe: Neutral
There are different drivers for Russia next year. Firstly, in contrast to the widespread market pessimism about reform in Russia, it is possible the current benchmarking drive to improve the investment attractiveness of Russia will continue, and will achieve a degree of success, within limits of the current system.

Besides, it is expected that more clarity on the Greenfield oil tax regime in light of the recent reassertion of state control over the sector with the agreed takeover of TNK BP. And there has been a series of corruption scandals in recent weeks, leading investors to believe they are part of a wider move to tackle the issue.

Potentially, this will lead to more stock-specific uncertainty before investors are persuaded that it ameliorates the investment climate sufficiently to encourage a re-rating.

Figure 11. RTS index and the oil price



Source: Datastream, Citi Research

The market infrastructure, such as ruble bond Euroclearability, the introduction of T+2 trading, IFRS accounting at Surgut, and the removal of GDR limits, might also brought positive changes.

Recently, the discount of RTS index to the oil price started the year at 35%, fluctuated all year between 30% and 40% largely dependent on investor perception of reform. It is possible that the discount can be narrow down next year.

For emerging Europe, we think investors should be cautious about event risks associated with each country. The following time table offers some reference.

	South Africa	Poland	Hungary	Czech	Baltics and Balkans
December	16-20th - Mangaung	Mid-month - Budget passed	10th - Budget passed Fitch downgrade mid-month (forecast)		Romania, 9th - Elections Romania, Budget passed after election
H1	Moody's and S&P downgrade again possible after Mangaung	Some risk of coalition switch from PSL to RPP or similar as reform agenda becomes fatigued	State-owned banking sector built Rate cuts to continue while EURHUF below 285 Watch for ECJ cases	CNB FX intervention (forecast) as next step of monetary loosening Coalition government may fall as further reforms are attempted	Bulgaria, Parliamentary elections
Q1	Eskom load shedding risk very higher	One or two rate cuts to finish off the cycle at 3.75-4.00%	IMF Article IV done sometime early in quarter Early FX debt issuance likely		
January	Downgrade by Fitch (forecast)	FCL runs out on 20th, expected to be renewed and possibly enlarged from current SDR19.2bn	FTT comes in start month	11-12th - Presidential election first round 25-26th - Presidential election run-off	
February	Start month - State of the Nation Address, long-run fiscal outlook document (perhaps including fiscal rule discussion) End month - Budget Current scheduling for Jacob Zuma's no confidence vote (we think likely to be earlier)		Announcement of new MNB governor		
March	Final rate cut (forecast, tentative probability) Round 2 of REIPP contracts signed		3rd - New governor takes over		Romania, SBA runs out on 30th, we think likely to have been extended by start 2013 for another two years but negotiations could stretch on in Q1 Serbia, SBA runs out on 28th, negotiations to extend difficult, but expected to conclude successfully
Q2	Wage round gets underway, violence increases, watch outside mining sector in particular, union roles		We see a risk Julia Kiraly resigns under new MNB governor		

April	REIPP hedges can begin for round 2, watch for DBSA funding announcements		EU convergence report - government policy reaction likely before		
May			EDP fine discussions continue in EC and Council		
June			Announcement of new deputy governors Theoretical date for FX deposits to run out		
H2	Second wage round with informal strikes possible in repeat of 2012 spurred on by non-traditional unions	BGK off balance sheet investment scheme should get underway Ratings upgrades expected			
Q3			Muni-debt write down, discussion with banks		
July			17th - New deputy governors take over		Croatia, Accession to EU start month
August					
September					
Q4	Round three of REIPP can occur mid-quarter together with hedging		EDP fine discussions at EU level intensify about 2014 budget Government takes additional policy reaction measures in 2014 budget as it progresses through Q4		
October	MTBPS end month				
November					
December		Budget finalisation	Budget finalisation	Budget finalisation	Budget finalisation
2014	Easter - Parliamentary elections; rate hiking cycle can occur mid-year as inflation goes up and rises out of target; Zuma handover to Cyril Ramaphosa possible	Shale gas may start to come on stream; tax comes into force; possibility that Poland joins ERM II	May - Parliamentary election	Easter - Parliamentary elections (latest)	Serbia, accession to EU mid-year? Possibility Bulgaria, Latvia and Lithuania join the euro - but 2015 more likely in our view

Source: Nomura

Commodities: Negative
Demand growth of crude has outpaced that of oil products this year as China begins to fill Phase 2 of its Strategic Petroleum Reserves (SPR). A similar trend had occurred in the past when the 1st Phase was being filled, aided also by new refinery projects having to stock up their own crude. Phase 2's capacity of 207mn bbl is more than double Phase 1's 76.8mn bbl which was completed between 3Q11-1Q12.

Coal demand is expected to rise because market is expecting China's industrial production to rebound. However, cheaper gas cost limits upside in LT coal price. In fact, coal is not the desired fuel due to its negative environmental impact, but its relatively cheap cost fulfills the need for electricity in Asia, especially for countries with a low electrification ratio, defined as a % of household or population with electricity supply, such as India (64%), ASEAN (72%) and Indonesia (71%). With the aim of achieving 95% electrification for Asia in year 2025, coal should continue to be the major fuel source for power generation.

Existing coal-fired plants will continue to support demand for coal, but new power plants will increasingly focus on gas, nuclear and renewable fuel sources following strong economic growth in Asia and increased emphasis for greener environment.

Status of Strategic Petroleum reserves (SPR)

Operator	Location	Capacity	Status	Completion
Phase 1				
Sinopec	Zhenhai, Zhejiang	32.7	Filled	3Q06
Sinochem	Zhoushan, Zhejiang	31.4	Filled	4Q07
Sinopec	Huangdao, Shandong	20.1	Filled	4Q07
CNPC	Dalian, Liaoning	18.9	Filled	4Q08
Phase 1 total		**103.1**		
Phase 2*				
CNPC	Dushanzi, Xinjiang	18.9	Filling in progress	3Q11
CNPC	Lanzhou, Gansu	18.9	Filling in progress	4Q11
CNPC	Jinzhou, Liaoning	18.9	Filling in progress	1Q12
Sinopec	Tianjin	20.1	Filling in progress	1Q12
CNPC	Shanshan, Xinjiang	39.0	Under construction	
CNPC	Jintan, Jiangsu	15.7	Under construction	
Sinopec	Zhanjiang, Guangdong	44.0	Planning	
CNOOC	Huizhou, Guangdong	31.4	Planning	
Phase 2 total		**206.9**		**2013**
Phase 3		**227.8**		**2016**
TOTAL SPR		**537.8**		

* Original plan for the second phase was 169mn b, but was revised to 206.9mn b. The additional capacity may mean pushback in timing

Source: Bloomberg, IEA, China Bureau of Statistics, Nomura estimates

Fig.12: Coal and gas price conversion

Coal (USD/t)*	Gas (US$/mmbtu)
US$40	1.67
US$50	2.08
US$60	2.50
US$70	2.92
US$80	3.33
US$90	3.75
US$100	4.17
US$110	4.58
US$120	5.00
US$130	5.42

Source: Various, DBS Vickers
**assuming coal at 12,000 Btus per pound or 6,672kcal/kg*

Fig.13: Construction cost of power plant

Coal	US$1.0 -1.5m/MW
Gas	US$0.4-0.8m/MW
Nuclear	US$2.0-4.5m//MW

Source: DBS Vickers, various

According to International Energy Agency, coal generates 42% of the world's electricity. Power plants are the largest user of coal and consume 68% of world coal production. If natural gas is included in the calculation, this would make up more than 80% of power production costs. Although concerns remain over the relatively "dirty" nature of coal when compared to gas and other renewable fuel sources, coal is by far one of the cheapest and most abundant sources of fuel in the world today, especially in the Asia.

Fig.14: Coal price trends- Newcastle FOB (US$/t)

Source: Bloomberg, DBS Vickers

Theoretically, coal price at US$90/t is equivalent to gas cost of US$3.75/mmbtu, which is much lower than the current gas cost of between US$10-15/mmbtu in Asia. Nevertheless, there has been switching of fuel sources from coal to gas in the U.S. due to the relatively low gas price of c.US$3.00/mmbtu, which is marginally lower compared to coal prices. Gas might over take coal as the major fuel source in Asia, if gas cost continues to fall to below US$5.00/mmbtu.

Hedge Funds: Mixed

HFRI INDICES - USD

	Monthly Performance		Historical Performance			
	Nov 2012 ROR	Nov 2012 Index Value	YTD	LAST 12M	LAST 36M (ann)	LAST 60M (ann)
HFRI Fund Weighted Composite Index	0.35%	10898.88	4.89%	4.42%	3.53%	1.36%
HFRI Equity Hedge (Total) Index	0.39%	15209.95	5.77%	4.80%	2.99%	-0.34%
HFRI EH: Equity Market Neutral Index	0.64%	4540.43	3.15%	3.48%	1.45%	-0.09%
HFRI EH: Quantitative Directional	1.41%	13330.80	7.20%	6.86%	3.22%	-0.88%
HFRI EH: Sector - Energy/Basic Materials Index	-1.49%	13280.18	-5.03%	-7.72%	-1.23%	-3.69%
HFRI EH: Sector - Technology/Healthcare Index	-0.16%	18595.35	5.23%	5.14%	6.21%	3.80%
HFRI EH: Short Bias Index	-1.70%	896.53	-15.49%	-15.48%	-12.86%	-7.41%
HFRI Event-Driven (Total) Index	0.66%	12092.56	6.46%	6.24%	5.63%	2.34%
HFRI ED: Distressed/Restructuring Index	0.64%	13169.90	7.73%	8.46%	6.75%	2.58%
HFRI ED: Merger Arbitrage Index	0.82%	6542.74	1.74%	1.84%	2.91%	2.62%
HFRI ED: Private Issue/Regulation D Index	-0.21%	5650.84	0.27%	-1.66%	6.09%	1.35%
HFRI Macro (Total) Index	0.00%	13843.36	-0.93%	-1.18%	0.42%	2.53%
HFRI Macro: Systematic Diversified Index	-0.29%	10696.26	-3.47%	-3.26%	-0.25%	3.74%
HFRI Relative Value (Total) Index	0.76%	9341.89	9.54%	9.95%	7.65%	4.87%
HFRI RV: Fixed Income-Asset Backed	1.09%	6376.40	15.93%	16.54%	12.33%	10.49%
HFRI RV: Fixed Income-Convertible Arbitrage Index	1.03%	6641.48	7.75%	8.24%	5.98%	4.16%
HFRI RV: Fixed Income-Corporate Index	0.64%	5786.96	9.64%	10.44%	7.78%	4.12%
HFRI RV: Multi-Strategy Index	0.62%	6391.34	7.00%	6.38%	6.53%	3.26%
HFRI RV: Yield Alternatives Index	0.43%	4322.21	9.60%	11.38%	10.22%	3.63%
HFRI Fund of Funds Composite Index	0.44%	4982.62	3.56%	2.99%	1.31%	-1.90%
HFRI FOF: Conservative Index	0.23%	4022.69	3.02%	2.68%	1.59%	-1.66%
HFRI FOF: Diversified Index	0.52%	4536.03	3.67%	3.16%	1.55%	-1.67%
HFRI FOF: Market Defensive Index	-0.53%	5534.15	-2.34%	-2.50%	-1.82%	1.19%
HFRI FOF: Strategic Index	0.53%	7977.26	4.39%	3.62%	1.30%	-2.58%
HFRI Emerging Markets (Total) Index	0.86%	14339.82	6.31%	4.13%	1.20%	-1.82%
HFRI Emerging Markets: Asia ex-Japan Index	1.67%	7672.47	7.91%	5.84%	0.01%	-1.87%
HFRI Emerging Markets: Global Index	1.40%	10398.35	6.34%	4.97%	3.12%	0.28%
HFRI Emerging Markets: Latin America Index	-0.88%	18029.02	6.10%	4.72%	1.35%	1.56%
HFRI Emerging Markets: Russia/Eastern Europe Index	-0.36%	12885.75	2.35%	-2.93%	-1.25%	-9.63%

HFRI INDICES - FX Hedged

	Monthly Performance		Historical Performance			
	Nov 2012 ROR	Nov 2012 Index Value	YTD	LAST 12M	LAST 36M (ann)	LAST 60M (ann)
HFRI Fund Weighted Composite Index - CHF	0.31%	8012.21	4.02%	3.47%	2.43%	0.17%
HFRI Fund Weighted Composite Index - EUR	0.32%	2481.39	4.34%	3.83%	3.18%	1.05%
HFRI Fund Weighted Composite Index - GBP	0.37%	15764.78	4.80%	4.36%	3.47%	1.40%
HFRI Fund Weighted Composite Index - JPY	0.34%	6133.67	4.72%	4.15%	3.29%	0.64%

The performance of HFRI FX Hedged indices reflect the performance of the underlying investments in USD as well as the foreign currency hedge associated with it. The return for the HFRI FWC EUR, JPY, CHF and GBP FX Hedged Indices are calculated by applying to the HFRI FWC Index(in USD) return and the cost of a rolling a hypothetical monthly foreign exchange contract on the relevant currency.

EH = Equity Hedge ED = Event Driven RV = Relative Value FOF = Fund of Funds

Hedge funds posted gains in November as equities traded in a wide intra-month range following the U.S. Presidential election and as global financial markets focused on U.S.'s fiscal cliff. The HFRI Fund Weighted Composite Index gained +0.35% for the month, posting its fifth gain in the last six months.

Relative Value Arbitrage (RVA) and Event Driven (ED) strategies were top contributors in November, with both index gaining +0.7%. RVA strategies remain the top area of hedge fund strategy performance YTD, with the HFRI RVA Index up +9.5% through November.

Event Driven strategies, which invest broadly across Merger Arbitrage, Distressed and Activist situations, posted the sixth consecutive monthly gain, benefitting from a strong M&A environment, as well as increased and special dividends announced ahead of possible tax increases.

Equity Hedge funds advanced +0.4%, with top contributions from Quantitative Directional and Fundamental Growth, which gained +1.4% and +0.8%, respectively. The HFRI Macro Index was essentially flat for the month, as gains in Currency, Discretionary and Active Trading funds offset declines in Commodity and Systematic Diversified CTA strategies.

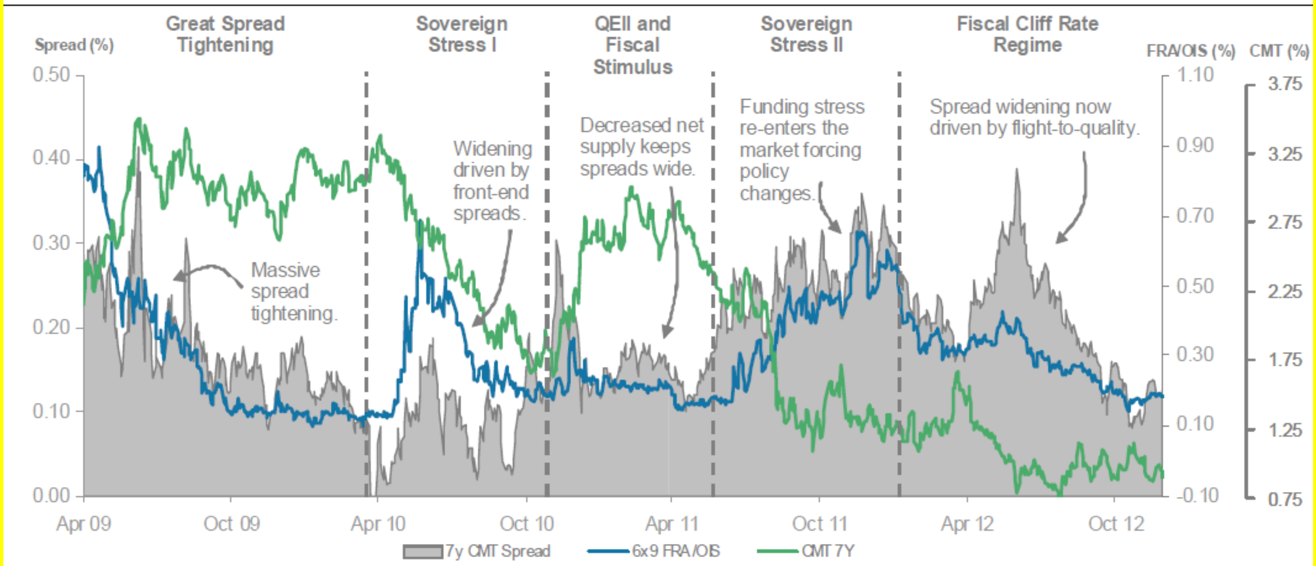
Emerging Markets hedge funds also posted their sixth consecutive gain as total hedge fund capital invested in Emerging Markets reached a record level, with the HFRI Emerging Markets Index gaining +0.9%. The HFRI Fund of Hedge Funds Composite Index also posted a gain of +0.4%, in line with the single-manager HFRI Fund Weighted Composite.

Bonds: Mixed

As risk events, fiscal and monetary policy, and the macroeconomic outlook change over time so do primary drivers and primary respondents of the market. To better understand the structural changes that have occurred in the larger rates market and their impact on spreads, the post-crisis history can be disected into five different regimes. These five periods range from the peak of the credit crisis to a period dominated by easy monetary policy and low economic growth expectations.

As Europe continues to struggle with sovereign debt issues, there will be episodes of flight-to-quality rallies in the Treasury market. As long as this is a possibility, there is the propensity for spreads to widen in a risk-off move, however it is hard to stay elevated in this low rate environment.

Five Post-Crisis Regimes and Impact on Swap Spreads



Source: Morgan Stanley Research

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

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