AMG Market Commentary

August 2012

An 'Irrational Exuberant' Rally in the U.S.?

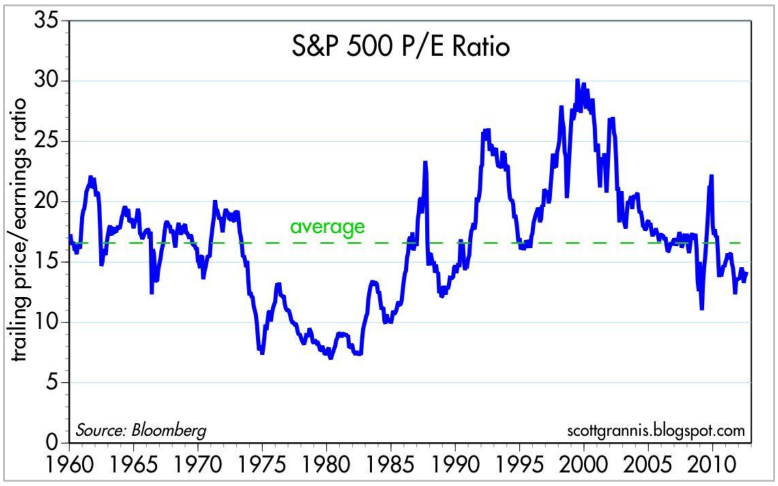
Some words are forever remembered, such as "***irrational exuberance***". The phrase was used by the former Federal Reserve Board Chairman, Alan Greenspan, in a speech given at the American Enterprise Institute in December of 1996. Backed then, there was widespread buoyancy in global financial markets. Russia's Boris Yeltsin was re-elected President after a two-round elections held in June and July that year. Investors embraced Yeltsin's victory over Communist challenger Gennady Zyuganov. Foreign direct investments poured into Russia's banking and energy sectors. The same year, China's ex-Premier Zhu Rongji introduced the Banking and Financial Reform. As a direct result, over 120 shareholding medium and small-sized commercial banks have been set up or reorganized, channeling deposits from the public to help financing private enterprises for investment, and also lending money to municipal and regional governments and state-owned companies. In the U.S., the Dot-com bubble was gearing up for its meteoric multi-year rally to the stratosphere.

Stock markets, almost everywhere, were reaching new heights and investors were wandering in dreamland. Then, the music stopped. In July 1997, the curtain to the Asian financial crisis was raised when Thailand's government was forced to float the Thai baht after weeks of precipitous fall. That triggered a domaino effect as one Asian country tumbled after another. A year later in August 1998, the Russian government devalued the ruble and defaulted on its debt. The crises in Asia and Russia sent currencies and stocks plummeting, and economies contracted convulsively. Asian economies recovered rapidly as sharply lower currencies attracted the return of foreign money, and Russia saw its good fortune returned thanks to surging oil prices during 1999-2000. Just as investors breathed a sigh of relief, the Dot-com bubble burst in March 2000. With that, global stock markets went into tail-spin yet again.

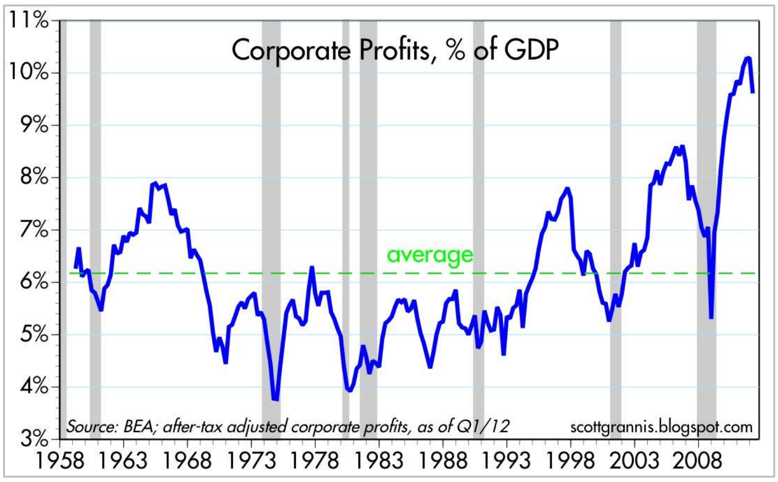
So why are we talking about the phrase and bringing back such horrid memory, here and now? The European debt crisis is in its third year with no end in sight. BRICs, darlings among investors in the past few years, have lost their glitters. Over in the U.S., property prices remain over a third below the peaks of 2006 and unemployment rate is stuck above 8% for the sixth year. What does the current economic backdrop has to do with the phrase irrational exuberance, readers might be wondering?

The right hand chart showing comparative performance of the three leading U.S. stock indices over the past five years helps to explain our concern. As can be seen, both the Dow Jones Industrial Average and the S&P 500 indices have climbed back to levels 5 years ago, and the Nasdaq Composite well surpassing that. In fact, the S&P 500 Index is just 11% from its all-time intraday high and the Dow Jones is only slightly over 7% away from its. Given the current economic backdrop, we cannot help but wonder whether investors are once again basking under the imagined sun in la-la land.

Granted, the U.S. stock market isn't priced at skyhigh valuation. In fact, looking at the price-earning chart to the right, the S&P 500 Index is valued at well below its long-term average. Having said that, it does not mean the P/E ratio cannot go lower. For about 15 years, from just before mid-70s to late-80s, the S&P 500 never traded above a multiple of 13x, which is lower than where it is today. That period encompassed three recessions (in 1974, 1980 and 1982) and was notable for frequent leadership changes in the U.S. – with Richard Nixon, Gerald Ford, Jimmy Carter and then Ronald Reagan took turn occuping the White House.



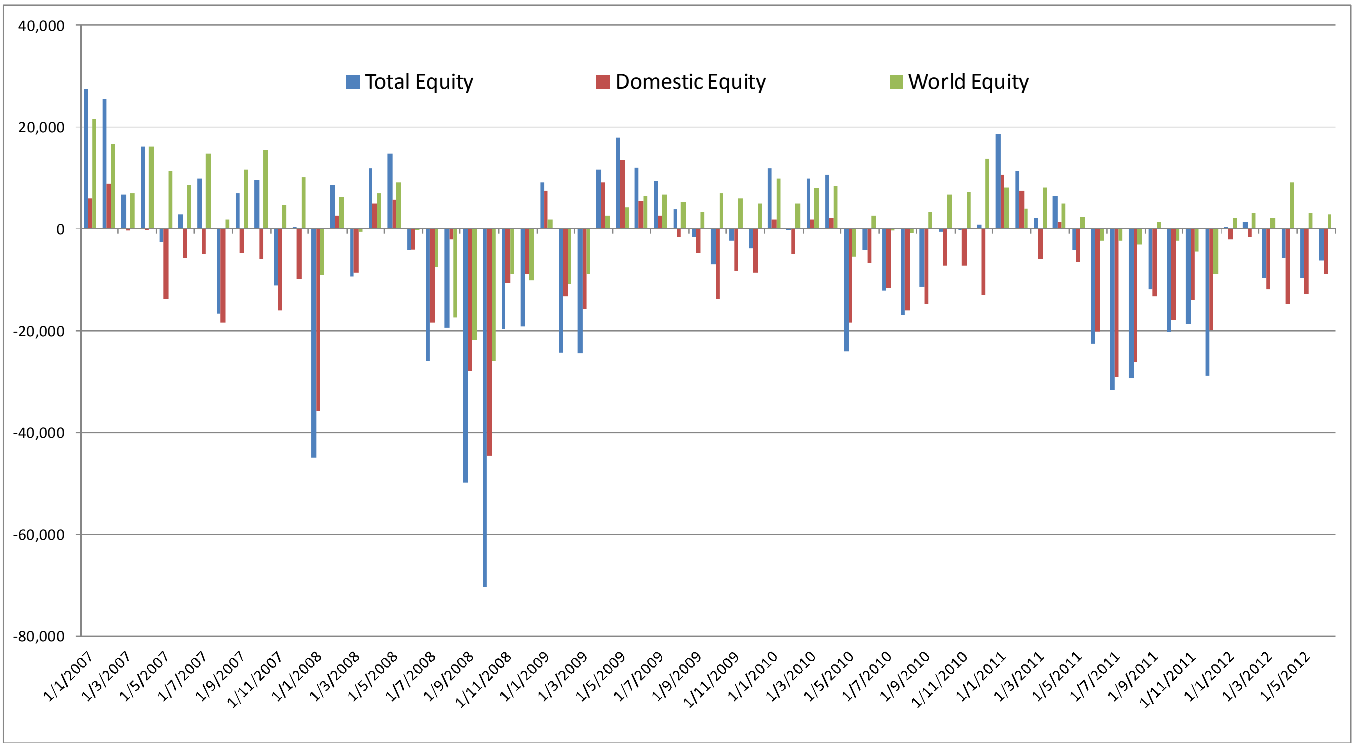
It was an extraordinary period in another sense. To the right is a chart showing corporate profits as a percentage of GDP in the U.S.. We can see that the above-mentioned period also correspond to a period of relatively low corporate profits. This is in stark contrast to where we are as corporate profits as a percentage of GDP is at or near the highest level since record begins. Does this not support the notion that the stock market should be trading at significantly higher multiples than is now? Instead of answering that question, we prefer to consider the flip side of it, that being given corporate profits already at such lofty percentage of GDP, how likely is it to extend further to the upside? And should this trend starts reversing to the long-term mean, what implication might this have on share prices? Our concern is that if a period of rising corporate profits failed to boost stock valuations, when corporate profit growth ultimately slows it would only weigh even more on valuations.



Another concern that we have is the three-year rally has not seen a commensurated increase in stock market volume. The table below shows daily average trading volume (in shares) on various exchanges in the U.S.. It's plain to see that most exchanges witnessed peak volume in 2009 and have since experienced gradual decline.

U.S. Stock Market Volume ***(Daily Avg., Mln. of Shares)***						
	NYSE	**AMEX/ARCA**	**NASDAQ**	**BATS**	**DirectEdge**	**Pink OTC Markets**
2007	2,110.90	228.90	2,132.00	297.70		3,053.34
2008	2,609.40	459.30	2,259.30	852.90	402.59	2,275.90
2009	2,181.13	449.51	2,224.75	1,014.28	1,074.62	5,213.19
2010	1,764.00	346.20	2,191.60	861.33	1,059.31	6,976.77
2011	1,511.60	350.40	2,041.80	814.59	879.92	4,583.71
2012 YTD*	1,218.80	243.50	1,783.40	769.06	751.67	3,563.86
% Change YTD (YoY)	-17.7%	-20.4%	-11.9%	-5.90%	-12.92%	-41.79%
Source: Securities Industry and Financial Markets Association (SIFMA) (As of end of June 2012)*						

The drop in transaction volume coincides with data on equity fund flows. Based on latest data from Investment Company Institute (ICI.org), we composed the below chart that shows monthly money flow into various equity funds since January 2007. The chart shows that investors began moving money out of domestic equity funds even before the financial tsunami. The pace of redemption quickened throughout 2008 as the economy plunged into a severe recession and stock market plummeted. But surprisingly, investors continued pulling money out of equity funds throughout the past three years, despite a recovering economy and sharp rebound in share prices.



Source: ICI.org

If investors are wary about the health of the stock market, a logical thought would be for them to switch into lower risk asset classes. That notion is partially supported by net new cash flow data from Securities Industry and Financial Markets Association. As we can see from the below table, money has been flowing into hybrid funds (otherwise known as balanced funds) and bond funds in particularly. But other data raised an even more serious and mind-boggling question. Specifically, there have been substantial outflows from money market funds every year since 2009. The outflow from money market funds dwarfs combined inflow from other funds to drag total mutual fund assets lower for the fourth year counting. This begs the multi-billion-dollar question: where have all the money gone into?

U.S. Mutual Fund Net New Cash Flow *($ Billions)*					
	Equity	**Hybrid**	**Bond**	**Money Market**	**Total Assets**
2007	95.60	22.20	108.60	661.50	887.90
2008	-237.70	-21.70	33.00	631.70	405.20
2009	-11.00	22.00	374.90	-539.40	-153.50
2010	-24.30	22.10	244.80	-524.20	-281.50
2011	-128.20	26.10	119.10	-123.50	-106.40
2012 YTD*	-6.30	0.50	16.20	-46.40	-35.90
Source: Securities Industry and Financial Markets Association (SIFMA) (As of end of June 2012)*					

We suspect money redeemed from money market funds has gone into financing household consumption. Even as the U.S. economy recovers and more jobs have been added, wages have remained flat. When adjusted for inflation, real income has actually seen negative growth. In our view, Americans have digged into their money market piggy banks (which is a form of savings) to help sustain their expenditure. With aggregate assets of money market funds at US$2,514 billions at end of June, there isn't a bottomless reservoir to keep feeding consumption. This is one reason that keep us alert of the U.S. economy and the longevity of the stock market's rally.

Market Review & Outlook

U.S.: Neutral

Under current law, the U.S. federal government is scheduled to implement a fiscal tightening of unprecedented severity at the start of 2013. This is mostly attributable to the roll-off of over $400 billion of tax cuts and more than $200 billion of spending declines, and in total approaches about 5% of GDP. This would be a historically unprecedented one-year reversal in fiscal support for the economy. The most similar occurrence was a 3% fiscal tightening in 1969 that presaged a recession later that year following robust growth of 5% in 1968.

Thus, unless Congress acts to block the so-called sequestration, it is expected the fiscal cliff would thrust the U.S. economy into recession next year. But how will fiscal cliff impact credit markets and the fixed income market?

For the municipal market, as tax revenue are highly correlated with the level of economic activity, which is intuitive given that they are derived from economic production (income & sales tax) and wealth (property tax). Accordingly, a fiscal cliff-led recession would result in tax revenue weakness.

If the fiscal cliff scenario were to materialize, credit spreads between treasuries and investment grade corporate as well as municipals may widen significantly for three reasons. Firstly, spending reductions reduce growth. Secondly, earnings may shrink. Lastly, investors switching to risk-off trades may flock to Treasuries, pushing yields lower.

To the right is a timetable of important dates and political events leading up to the time when fiscal cliff kicks in for those who wish to follow the development closely.

As at August 3, a total of 393 companies, or 85% of the S&P 500 market cap, have reported 2Q12 results. Of these, 43% have topped revenue estimates and 71% have topped earnings estimates. Aggregate earnings results have exceeded estimates by 4%, and revenues have beat by 0.2%. Blended revenue growth is 1% and earnings growth is 5%. Excluding the energy sector, revenue growth is 4% and earnings growth is 10%. Blended margins are up 43bps YoY, down 7bps excluding Energy and Financials.

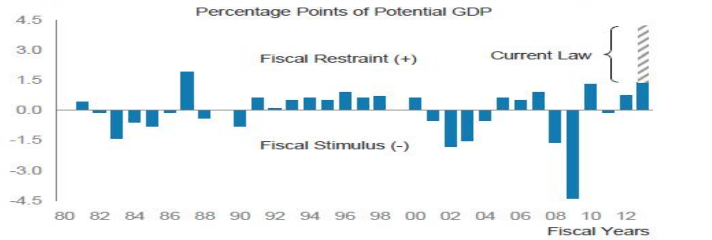
Fiscal Roadblocks: Lower Spending, Higher Taxes

Sizing up the Cliff: Estimated Impact of Selected Fiscal Policies

	Annualized Run Rate ($ Bln)
Bush tax cuts and AMT fix	$320
Payroll tax cut	$115
Spending cuts under Budget Control Act	$95
Extended Unemployment Benefits	$50
Investment Tax Incentives	$40
Medicare Tax Increases	$25
Doc Fix	$20
Total of Major Items	**$665**

Source: Morgan Stanley Research

Fiscal Cliff Could Cost Nearly 5% of GDP in 2012



Source: Morgan Stanley Financial Conditions Index

The Fiscal Cliff | **Timeline for Action (or Inaction?)**

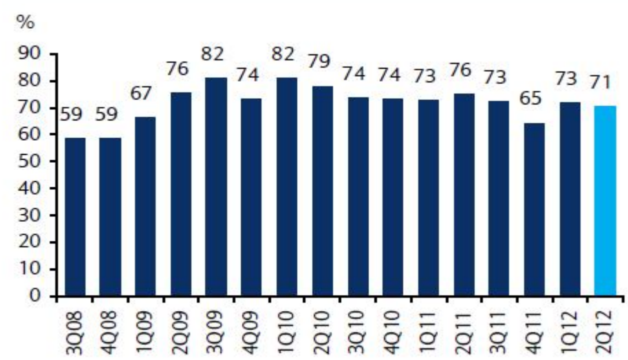
October 1, 2012	New fiscal year begins (budget appropriations legislation or continuing resolution required to avoid a govt shutdown)
November 6, 2012	Election Day
Mid-November, 2012	Congress expected to reconvene for lame duck session
January 1, 2013	Bush-era tax cuts expire, payroll tax cut expires, spending sequester triggered, etc.
January 3, 2013	113th Congress convenes
January 20, 2013	Presidential inauguration
Mid-February, 2013	Debt ceiling hike required [1]

Figure 1: Revenue and earnings surprise

Sector	Revenues, Surp % 1Q12	Revenues, Surp % 2Q12	Earnings, Surp % 1Q12	Earnings, Surp % 2Q12
DIS	0.4	(0.8)	6.5	2.9
STA	0.9	0.2	3.5	1.2
ENR	2.3	4.0	(2.3)	(0.1)
FIN	1.7	0.0	8.9	10.9
HLC	1.3	(0.3)	2.9	5.3
IND	1.2	(0.2)	6.5	6.0
TEC	1.7	(0.7)	8.7	2.0
MAT	0.8	(2.4)	8.5	(1.6)
TEL	0.1	0.1	13.4	3.7
UTL	(5.9)	(5.8)	(1.8)	6.1
SPX	1.1	0.2	5.4	4.0
SPX ex-FIN	1.0	0.3	4.6	2.7
SPX ex-ENR	0.8	(0.6)	6.6	4.7
SPX ex-FIN,ENR	0.7	(0.7)	6.0	3.3
SPX ex-AAPL	1.0	0.2	4.6	4.0

Source: FactSet, Barclays Research
Note: Actual results relative to consensus estimates (actual / estimates -1)

Figure 2: Percent of companies exceeding estimates



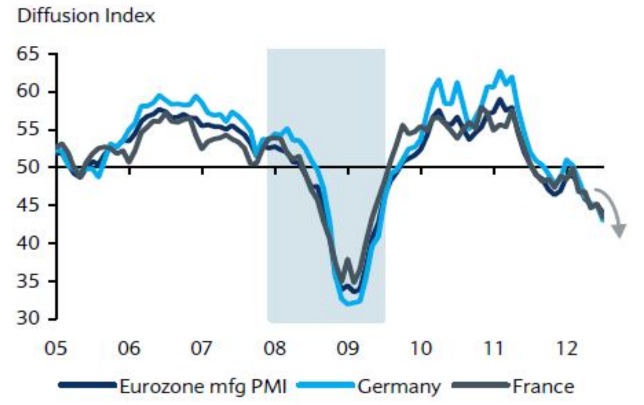
Source: FactSet, Barclays Research
Note: Number of companies that beat estimates as a percentage of total

Europe: Negative

In June, signs of stabilization emerged in the European core (e.g., Germany, France, The Netherlands). Inventory proxies and new orders bounced, but export orders continued to fall. In July, however, all three measures deteriorated. Meanwhile, the periphery (Italy and Spain) remained in a sharp downtrend in June. In July, the periphery PMI headlines, inventory proxy and new orders stabilized, but it could be a false dawn (similar to the core in June). Given the looming Spanish tax hike and elimination of mortgage interest deduction (something that makes sense in the long run but perhaps not in the middle of a housing collapse), it is highly suspicious that the situation is stabilizing.

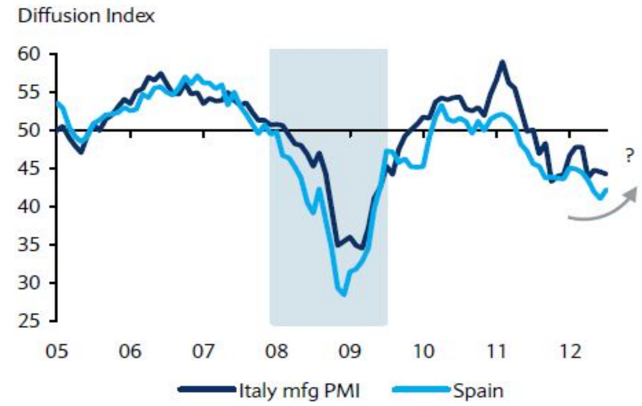
There is growing concern about the fiscal situation of Spain’s 17 autonomous regions as rumours had that some of them are on the edge to request financial aid. These regions are quite diverse in many respects, and enjoy a comparatively high degree of autonomy, which is anchored in the Spanish Constitution enacted in 1978 (Spain is a unitary, not a federal state, just a much decentralised one). Some of them, including the Basque Country, Catalonia, and Galicia, have their own local languages, which are also spoken beyond their perimeters.

Figure 1: In June, signs of stabilization emerged in the European core, but in July there was further deterioration



Source: Markit, Haver, Barclays Research

Figure 2: The periphery remained in freefall in June. In July, the PMI headlines, stabilized, but it could be a false dawn



Source: Markit, Haver, Barclays Research

Figure 2. Spain – Autonomous Regions, 2011

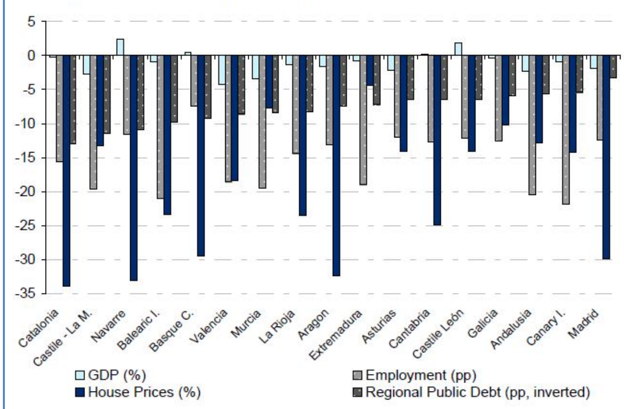
Community	Population		GDP		GDP per Capita		Regional Govt Gross Debt			Regional Govt Balance		
	TH	% of total	MM Eur	% of National	TH Eur	% of National	MM Eur	% of reg GDP	% nat GDP	MM Eur	% of reg GDP	% nat GDP
Andalusia	8,271	17.9	145,452	13.6	17.6	75.6	15,373	10.57	1.43	-4,716	-3.2	-0.4
Aragon	1,316	2.9	34,098	3.2	25.9	111.4	3,731	10.94	0.35	-978	-2.9	-0.1
Asturias	1,055	2.3	23,175	2.2	22.0	94.4	2,242	9.68	0.21	-843	-3.6	-0.1
Balearic Islands	1,093	2.4	26,859	2.5	24.6	105.6	4,479	16.68	0.42	-1,069	-4.0	-0.1
Canary Islands	2,107	4.6	41,733	3.9	19.8	85.1	3,779	9.06	0.35	-734	-1.8	-0.1
Cantabria	578	1.3	13,290	1.2	23.0	98.8	1,301	9.79	0.12	-533	-4.0	0.0
Castile and León	2,484	5.4	57,491	5.4	23.1	99.5	5,557	9.67	0.52	-1,489	-2.6	-0.1
Castile - La Mancha	2,045	4.4	37,979	3.5	18.6	79.8	6,287	16.55	0.59	-2,790	-7.3	-0.3
Catalonia	7,303	15.8	200,323	18.7	27.4	117.9	42,000	20.97	3.91	-7,418	-3.7	-0.7
Valencian Community	5,001	10.8	102,942	9.6	20.6	88.5	20,832	20.24	1.94	-4,657	-4.5	-0.4
Extremadura	1,083	2.3	17,491	1.6	16.1	69.4	2,045	11.69	0.19	-812	-4.6	-0.1
Galicia	2,732	5.9	57,678	5.4	21.1	90.7	7,381	12.80	0.69	-2,530	-4.4	-0.2
Madrid	6,372	13.8	189,432	17.6	29.7	127.8	16,572	8.75	1.54	-4,231	-2.2	-0.4
Murcia	1,471	3.2	28,169	2.6	19.1	82.3	3,055	10.85	0.28	-1,237	-4.4	-0.1
Navarre	623	1.4	18,726	1.7	30.1	129.2	2,725	14.55	0.25	-348	-1.9	0.0
Basque Country	2,128	4.6	66,575	6.2	31.3	134.4	6,798	10.21	0.63	-1,687	-2.5	-0.2
La Rioja	313	0.7	8,171	0.8	26.1	112.3	960	11.74	0.09	-131	-1.6	0.0
Total	46,125		1,073,383		23.3	100.0	145,118	13.52	13.52	-36,203	-3.3	-3.3

Note: Excessive Deficit Procedure (EDP) measures for government gross debt and government deficit

Source: Bank of Spain, INE, Ministry of Finance and Public Administration and Citi Research

More generally, these regions differ widely in terms of their landmass, population size, size of regional economies, and their levels of prosperity. The four largest regions (Andalusia, Catalonia, Madrid and Valencian) account for 58% of Spain's total population and just under 60% of national GDP. GDP per capita in the richest region, the Basque Country is more than a third above the national average and almost twice that of the poorest region, Extremadura. Madrid, Navarra and Catalonia also have levels of GDP per capita substantially above the national average, while Andalusia, Murcia and the Canary Islands are relatively poor.

Figure 3. Spain – Autonomous Regions Change in Macro Indicators, 2007-latest



Note: pp stands for percentage points. Latest values correspond to Q1 2012 for house prices, unemployment, and regional debt. GDP values correspond to growth rate between 2008 and 2011 due to data availability.

Source: Bank of Spain, INE and Citi Research

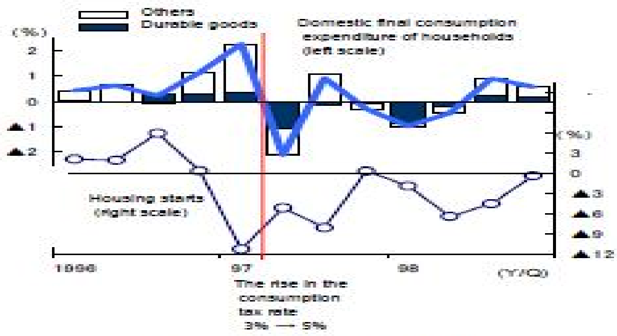
Administration and responsibilities are devolved to the regions to quite a large extent in Spain, and the degree of decentralisation has increased substantially over the past two decades. These regions accounted for 28% of general government and 29% of public expenditures in 2010. The regional governments receive a fixed percentage of certain taxes collected by the central government (50% of VAT, 50% of personal income tax, 100% of electricity taxes, 58% of alcohol, gas and tobacco levies). In addition, regional governments have legal authority to increase the rate of personal income tax paid in the region and to levy certain other taxes (including asset transaction tax, stamp duty, inheritance tax, transport tax, tax on the sale of certain hydrocarbons, gambling tax and fees related to particular services, e.g. tuition fees). Furthermore, the central government provides additional transfers, particularly to the poorer regions to reduce regional disparities in public spending and living standards. The Basque Country and Navarra are subject to the 'foral regime' according to which they levy their own taxes and transfer a subsidy to the central government. Catalonia has at times pushed for being granted the same rights and there were media reports in recent days that it may strive to do so again in the next months.

Japan: Neutral

If consumption tax rate is raised from 5 per cent to 8 per cent in April 2014, economic activity in the second half of FY2013 to March 2014 will likely have a considerable upswing due to rushed demand. A similar phenomenon took place when the consumption tax rate was last raised in FY1997. Private consumption expenditure and housing starts increased significantly in FY1996.

However, economic activity in FY2014 may suffer a reactionary decline after the rate is raised. Further, price increased after the consumption tax rise will lower the growth rate of private consumption expenditure due to reduction in purchasing power of households.

Figure 8-1 Rushed Demand and Reactionary Fall due to Consumption Tax Rise



Source: The Cabinet Office, The Ministry of Land, Infrastructure and Transport.

According to the Japan Research Institute's macro model simulation, real GDP growth rate in FY2014 is estimated to be lower by 0.9 percentage points.

Moreover, it is highly likely that financial burden on households will further increase because the government is expected to have to increase revenues for reconstruction from the earthquake and nuclear disaster as well as rebuilding of public finance.

As the period during which income tax is raised for reconstruction was decided to be 25 years, the financial burden on households per year will not be excessive. However, the abolition of tax exemptions for dependents, and a rise in pension premiums will exert a heavy financial burden on households.

Figure 8-2 Estimate on the Effect of Consumption Tax Rise in FY 2014 on Demand in FY2014 <5% → 8% in April 2014>

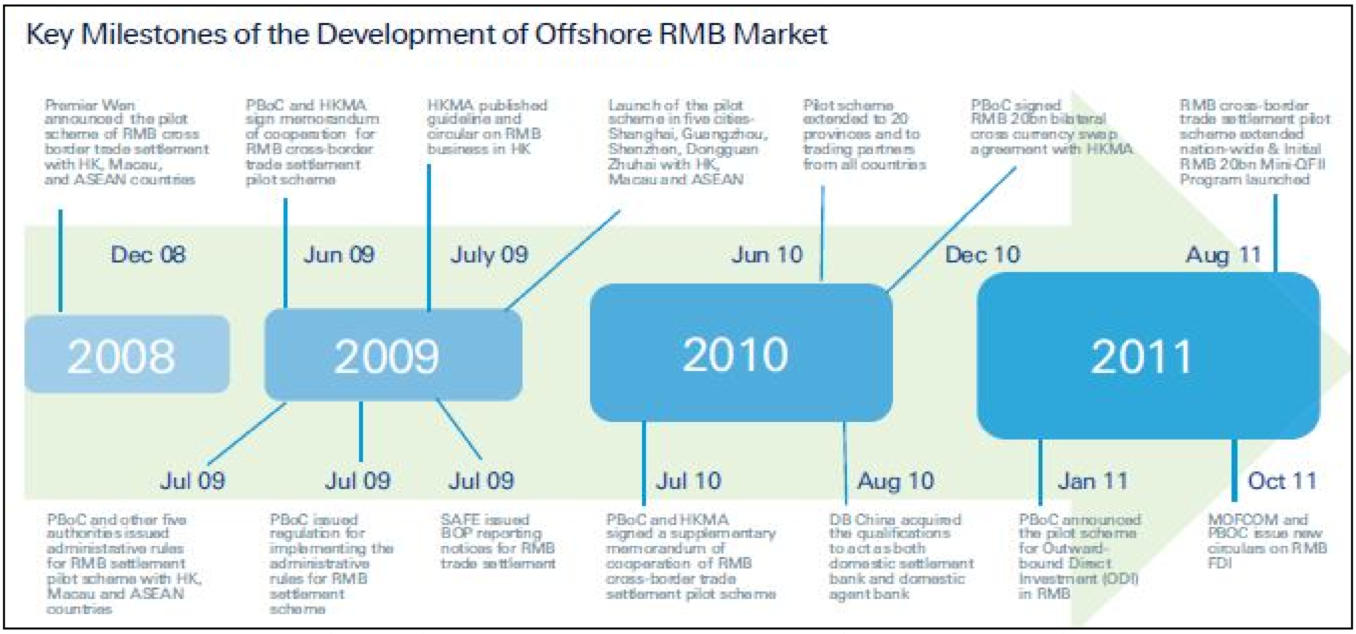
(% points)

Real GDP	- 0.9
Real private consumption expenditure	- 1.5
Housing starts	- 2.0
CPI	+ 2.2

Source: Macro model simulation by The Japan Research Institute, Ltd. based on the data of The Cabinet Office.
Note: The difference from the scenario of no rise in the consumption tax rate in FY2014.

As a result, net benefit to households is expected to decrease by about 1 trillion yen from the previous fiscal year in FY2012, and about 0.5 trillion yen in FY2013. The decrease in net benefit is predicted to be a downswing factor to private consumption expenditure through a decline in the disposable income of households.

China: Mixed



In the process to liberalize China's fiscal account, internationalization of the RMB is one of the crucial steps. Recent data reveal that more and more trade is being settled by RMB, indicating increasing popularity of the currency in the global market. How does this affect investors? It will reduce FX hedging costs for inward/outward investment, and lower transaction costs for foreign companies operating in or buying from China, just to name a couple.

For domestic banks, this means greater investment choice and yield opportunities for CNH deposits. For SMEs, they will be able to hedge RMB exposure as its use in international trade increases and a diversified and competitive source of financing. It also provides broader access to onshore buyers and suppliers and lays the path for gradual RMB appreciation and eventual capital convertibility.

China's balance of payments (BOP) fell to a quarterly deficit of US$11.8bn in Q2. This is the first BOP deficit for China since 1998 – and the first time international reserves have fallen on a quarterly basis, excluding valuation effects from exchange rates and asset prices.

China's current account surplus rose to US$59.7bn in Q2 from US$23.5bn in Q1, but it was offset by a record-high US$ 71.5bn deficit of capital flow. Net foreign direct investment (FDI) inflows fell to US$38.6bn from US$48.9bn in Q1, while other items in capital and financial accounts saw a record-high collective net outflow of US$110bn in Q2.

The job market in China remains strong. The ratio of job vacancies to applicants in China fell to 1.05 in Q2 from 1.08 in Q1, but remained above the breakeven point of 1.0 for the seventh consecutive quarter. This suggests that unemployment is not a problem despite GDP growth slowing to 7.6% in Q2.

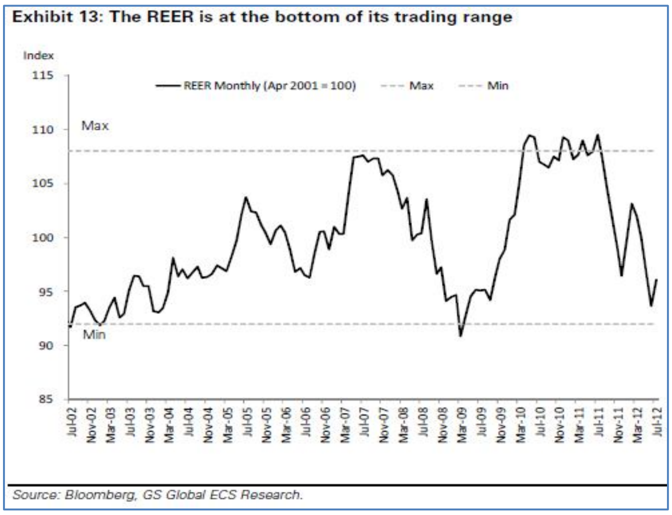
The tight labour market is indicative of GDP growth that is not far below its potential. However, we still expect policy easing to push up Q4 GDP growth by more than 1 percentage point from Q2, which would widen the output gap and drive up inflation.

Industrial production growth dropped to 9.2% in July from 9.5% in June. On a seasonally adjusted MoM basis, IP growth slowed to 0.66% from 0.74% in June. The slowdown was likely driven by inventory destocking and a slowdown in exports, as the PMI finished goods inventory index dropped sharply to 48 in July from 53.2 in June, and both Korea and Taiwan export data released earlier in August surprised on the downside. The weak IP data are indicative of downside risks to July export data which are expected on 10 August.

Fixed asset investment (FAI) growth was flat at 20.4% in July. FAI growth in real terms rose as producer price inflation (PPI) dropped sharply to -2.9% in July from -2.1 in June. Retail sales growth slowed to 13.1% from 13.7%, which was partly driven by price effects as CPI inflation dropped to 1.8% from 2.2% in June.

India: Negative

The INR remains vulnerable in the near term due to a weak balance of payments (BOP), exacerbated by the negative supply shock due to poor monsoon so far.



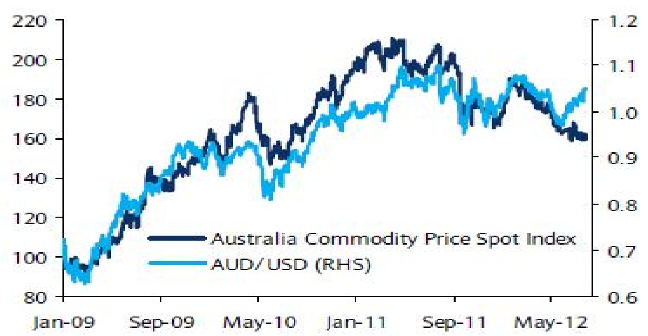
However, we can be more sanguine about the current account deficit and the INR on a 6-12 month basis due to sharp rupee depreciation helps to improve competitiveness, and the composition and direction of India's exports driven more by emerging markets.

Further, the INR has fallen close to the bottom of its trading range on a REER basis, the BOP is being funded on an annual basis, and the RBI has a preference to intervene to stabilize the currency, as well as measures it has taken to increase capital inflows. While there are clear risks for further trade-weighted depreciation of the INR, it is optimistic for the currency in the medium term.

Asia Pacific: Mixed

AUD has appreciated in the past two months which surprised many bearish investors. If viewed against the backdrop of generally weaker commodity prices, the recent rally in AUD/USD looks overextended. To wit, prices of iron ore and coal have fallen 15% and 2.5% in the past two months. Together, the two commodities make up about 45% of total Australian merchandise exports. Moreover, fragile global economic activity, as indicated by deteriorating manufacturing figures, suggests limited commodity price gains near term.

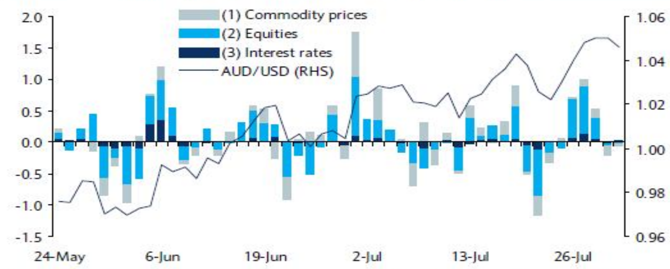
Figure 2: Australia commodity prices and AUD/USD



Source: Bloomberg, Barclays Research

So why is the AUD's recent strength? Possible explanations include recent improvement in global risk appetite, gains in global equities, and current market focus on extensive stimulative measures from major central banks to avert Europe's debt crisis and to boost economic growth.

Figure 1: AUD short-term drivers (contribution to daily change, pp)



Note: Factor definitions are as follows: 1) Change in Commodity Research Bureau (CRB) commodity price index; 2) Change in MSCI index and change in performance of ASX 200 relative to MSCI index; 3) Change in 3m AU-US interest rate differential, relative change in steepness of AU 1y-3m curve vs US curve, and the relative change in steepness of AU 10y-1y vs US curve. Source: Barclays Live

The recent flooding which has submerged large parts of Manila, causing much of the capital city and surrounding area to shut down, has prompted many to make reference to the Ketsana-Parma Tropical storm which swamped 80% of Metro Manila in 2009. That disaster caused nearly USD 200bn worth of estimated damage in assets and output (2.5% of GDP), according to the UN.

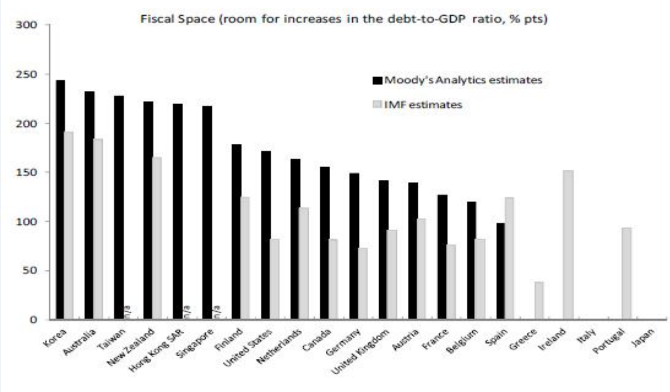
As it stands, damage from the current flooding is likely to be significantly smaller. The current disaster has affected 1.2mn people in total with about 80,000 of those in Metro Manila (versus Ketsana-Parma's 10mn people). In light of the devastating floods in Thailand, which wiped out about 3% of GDP in 2011, it is also worth comparing the concentration of economic activities in the capital region of the Philippines with the equivalent area of Thailand. The right chart shows that the concentration is higher in Thailand than in the Philippines – Bangkok and vicinities account for 41% of Thailand's GDP, whereas the share of Metro Manila stands at 35%.

Exhibit 5: Philippines: Share of the capital region's GDP, manufacturing and service output (% of the national total)

Source: CEIC, Credit Suisse

Nevertheless, concentration of economic activities in the Manila region is still high in absolute terms. As a result, should the current floods continue to affect the capital, the economic (and social) damage could increase substantially.

Exhibit 6: Korea has a large fiscal space



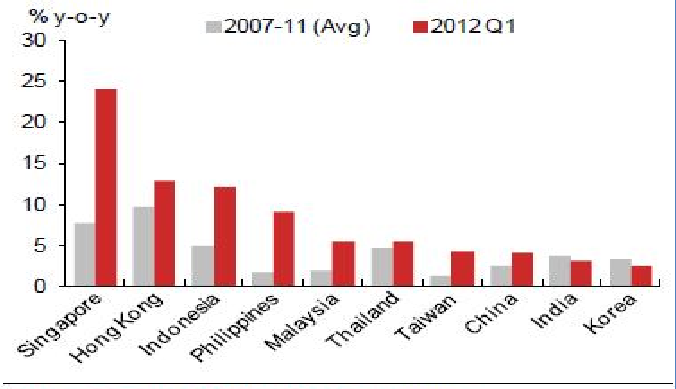
Source: IMF, Moody's Analytics, GS Global ECS Research.

In the event of further deterioration of the global economy in 2H2012, Korea has enough policy room to ease. A primary policy tool is likely to be fiscal stimulus, deregulation and financial sector policies rather than further interest rate cuts. First, fiscal spending tends to have more immediate impact than rate cuts. Second, Korea has a large fiscal space, one of the highest according to the IMF and Moody's, estimated at 217 percentage points of GDP on average although the figure should not be taken literally due the theoretical nature of the estimate (see right chart). In comparison, with policy rate already near its historic low, aggressive rate cuts would eventually translate into further household leverage, making it difficult to raise interest rate when inflation pressure flares up in the next economic up-cycle. Finally, fiscal or financial sector policies would be relatively easier to target beneficiaries such as low income families, small companies, small office and home offices (SOHO) in need of temporary liquidity support.

Although Euro sovereign debt crisis is still a major hazard to the Asian region, Pan-Asia economies remain stronger than those in the Europe. For instance, there are supportive fiscal policies in place in these countries. Pre-election spending in Malaysia, flood-related reconstruction spending in Thailand and government spending on social and economic services in the Philippines are all putting money in the hands of consumers. In China, local government stimulus is aimed at investments which will likely have a spill over effect on consumption, as stronger demand pushes up corporate and household incomes.

In addition, credit growth remains strong and substantially outpacing nominal GDP growth in Singapore, Hong Kong, Indonesia and the Philippines. Loose monetary conditions continue driving domestic demand. Residential property prices in Singapore and Hong Kong remain elevated, hence creating positive wealth effects for consumers. Even in China, property prices appear to have bottomed. Therefore, private consumption demand should remain resilient in Asia.

Fig. 3: Domestic credit less nominal GDP growth



Source: CEIC and Nomura Global Economics.

Latin America: Negative

Brazil's CPI (IPCA-15) rose 0.33% MoM in the month through mid-July, accelerating from a rise of 0.18% MoM (+5% YoY) in mid-June; this was above expectations of +0.18% MoM and was due to higher food prices.

Annual inflation rebounded to 5.24% from 5.0%, rising for the first time in ten months. Given the pickup in food prices, CPI inflation is unlikely to converge to the midpoint of the central bank’s inflation target (4.5%) in the near term.

Figure 27. Industrial Production and Retail Sales (Y/Y)

Source: National Sources, Datastream and Citi Research

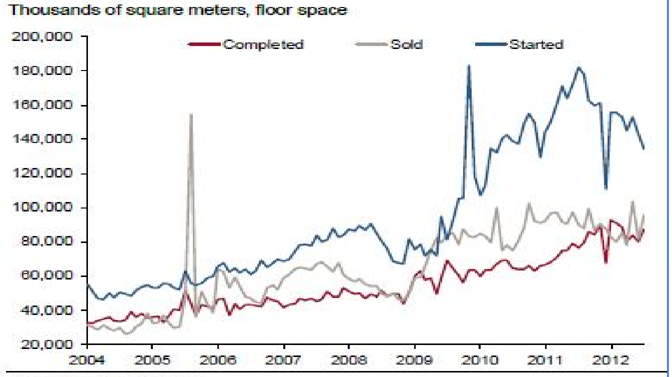
Commodities: Negative

Investors in the commodity sector are focusing on industrial production growth, especially of that in China and India. In July, China industrial production grew at around an 8.2% annualized pace, a slightly slower pace than that seen in June and weaker than market consensus.

At the same time, July real estate data suggest sales and construction completions have improved while new development activity continues to slow, with land purchases and construction starts declining. Commodity floor space completed was the highest since March (on a seasonally adjusted basis) and sales were strong, rebounding back to near the peak in May. However, floor space started continues to decline, hitting the lowest point year-to-date. Land purchases were even more depressed, fallen to the lowest point in over a decade.

Exhibit 4: Housing sales are improving, but starts continue to weaken

Thousands of square meters, floor space

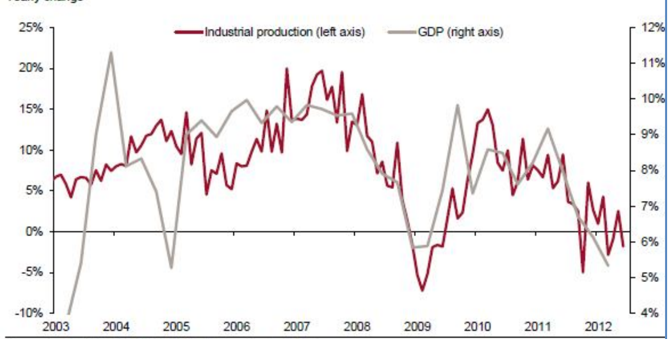


Source: NBS, Credit Suisse

Such breakdown in activity should be helpful to developers that are facing cash squeeze, but is negative for commodity demand in the short term, and will also put local government revenues under even more pressure as they are heavily dependent on real estate development and land sales.

Exhibit 8: Indian IP still weaker

Yearly change

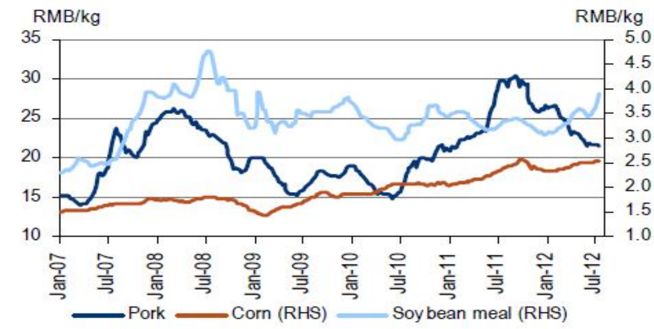


Source: the BLOOMBERG PROFESSIONAL™ service, Credit Suisse

While China is stabilizing, economic data from India remains quite weak. Total output fell 1.8% in year-on-year terms. This round of contraction is comparable to the country’s worst quarter-on-quarter contraction in industrial production since January-March 2009, when the global financial crisis was still unravelling. There have been a lot of speculations whether the worst drought in decades in the U.S. will pose inflation threat to China. Fact is, China is mostly self-sufficient in major grains, namely rice, wheat and corn – net imports (as percentage of apparent consumption) were 0%, 0.7% and 0.8%, respectively, in 2011. Major grain import is soybean. Imports account for about 80% of China's soybean consumption and 43% of those imports are from the U.S.. As imports account for just 9.5% of total grain consumption, China's domestic grain prices are largely determined by domestic conditions, and not global prices. For example, rice prices outside China surged 50% in 1H08 (from end-2007 to June 2008), but China's rice prices only rose 4% in that period.

Chart 1: Corn prices in China and US are not so strongly correlated

Chart 5: The link between short-term pork and grain prices is weak



Source: CEIC, BofA Merrill Lynch Global Research.

Luckily for China, grain production has been increasing for eight years in a row, helping it accumulate large state reserves. Unlike the U.S., China's weather has been fair this year. So far this year, China's summer crops (25% of annual production) increased 2.8%. In July, weather conditions for grain production were slightly worse than historical average, with more rain in many parts of China. This might have some impact on autumn crops (70% of annual production). However, the weather improved in early August, and China will most likely have a relatively fine autumn crop this year.

One major transmission channel from surging corn/soybean prices to China's inflation is pork prices. In China, corn and soybean meal make up 60% and 20% of feed grain for pigs respectively, and feed accounts for about 60% of total costs of rearing a pig. However, China has its unique pork price cycle. In the long term, pork prices should be determined by the level of raw material prices and labour costs, but in the short term, pork prices could overshoot and undershoot its fair value by a wide margin due to oversupply or shortage.

Hedge Funds: Mixed

HFRX Global Hedge Fund Index

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
1998	(0.46)	1.49	4.20	(1.86)	(0.52)	1.60	2.00	(1.76)	(0.57)	1.54	2.92	3.88	12.94
1999	5.49	(2.57)	2.89	4.99	(1.28)	2.39	(0.60)	0.14	0.47	1.20	5.36	5.84	26.66
2000	0.95	5.95	1.55	(3.85)	(0.07)	0.52	(0.44)	3.58	(0.22)	(0.95)	1.78	5.03	14.29
2001	2.14	0.09	2.20	0.05	(0.01)	0.38	0.68	1.47	0.27	1.42	(0.66)	0.36	8.67
2002	0.12	0.19	2.08	0.65	0.41	(0.27)	(1.45)	0.74	(0.02)	0.09	1.34	0.80	4.72
2003	1.27	0.67	0.47	1.83	2.72	0.86	0.37	0.79	0.71	1.06	0.13	1.79	13.39
2004	1.13	0.44	0.25	(1.23)	(0.62)	(0.17)	(0.92)	(0.25)	0.75	0.16	1.92	1.24	2.69
2005	(0.95)	0.88	(0.97)	(1.76)	0.14	0.91	1.67	0.43	1.11	(1.85)	1.69	1.48	2.72
2006	2.45	0.17	1.15	1.15	(1.31)	(0.49)	(0.57)	0.76	0.50	2.02	1.54	1.58	9.26
2007	1.50	(0.21)	0.28	2.21	2.55	(0.07)	(0.93)	(2.55)	1.28	2.82	(2.41)	(0.14)	4.23
2008	(2.06)	1.77	(2.46)	1.20	1.44	(0.83)	(2.82)	(1.28)	(6.90)	(9.35)	(3.04)	(1.22)	(23.25)
2009	1.10	(0.38)	(0.03)	1.61	3.15	0.04	1.59	1.25	2.22	(0.06)	1.66	0.55	13.40
2010	(0.02)	0.26	1.38	0.80	(2.64)	(0.94)	1.23	0.17	1.72	1.12	(0.27)	2.36	5.19
2011	0.56	0.73	(0.88)	0.47	(1.39)	(1.59)	(0.11)	(3.47)	(2.99)	0.81	(0.87)	(0.42)	(8.87)
2012	1.72	1.42	(0.02)	0.12	(1.69)	(0.30)							1.22

Benchmarks B1: MSCI Indices US$ World Index; B2: S&P 500 w/ dividends; B3: Barclays Capital Government/Credit Bond Index

Risk/Return	Index	B1	B2	B3
Geo. Avg. Monthly	0.44	0.16	0.34	0.54
Std. Deviation	1.94	4.87	4.76	1.34
High Month	5.95	10.90	10.92	4.83
Low Month	(9.35)	(19.04)	(16.79)	(4.53)
Annualized Return	5.39	1.93	4.22	6.70
Annualized STD	6.72	16.87	16.48	4.65
Risk Free Rate	2.57	2.57	2.57	2.57
Sharpe Ratio	0.43	0.05	0.18	0.87
% of Winning Mo.	63.79	55.17	59.77	67.24
Max Drawdown	25.21	55.37	50.92	5.93

Regression	B1	B2	B3
Monthly Alpha	0.39	0.35	0.40
Monthly Beta	0.25	0.22	0.10
Mnt. R-Squared	0.38	0.30	0.00
Correlation	0.62	0.55	0.07
Up Alpha	1.00	0.63	1.15
Up Beta	0.11	0.16	(0.44)
Up R-Squared	0.04	0.08	0.05
Down Alpha	0.19	0.20	0.79
Down Beta	0.24	0.21	0.73
Down R-Squared	0.24	0.13	0.08

Returns	Index	B1	B2	B3
1 Month	(0.30)	4.93	4.12	(0.02)
3 Month	(1.86)	(5.81)	(2.75)	2.70
6 Month	1.22	4.49	9.48	2.79
1 Year	(5.76)	(7.17)	5.43	9.27
2 Year Ann.	(0.90)	8.94	17.38	6.55
3 Year Ann.	1.39	8.63	16.39	7.77
5 Year Ann.	(3.72)	(5.06)	0.22	7.33
7 Year Ann.	0.08	1.05	4.09	5.88
10 Year Ann.	1.56	3.13	5.33	6.21
Since Incept.	5.39	1.93	4.22	6.70

Hedge funds posted gains for the second consecutive month in July as Macro CTA managers captured strong trending dynamics across multiple asset classes, pushing the HFRI Macro Systematic Diversified Index to a gain of 2.8%. The HFRI Fund Weighted Composite gained 1.1% in July, the strongest monthly performance since February, with positive contributions from Relative Value Arbitrage (RVA), Equity Hedge (EH) and Event Driven (ED) strategies complementing the Macro gains. The HFRI Emerging Markets Index gained 1.1%, also the strongest month since February, while the HFRI Fund of Funds Index advanced 0.7%, ending three consecutive months of declines.

Macro hedge funds benefitted from volatility and strong trending behaviour across multiple asset classes in July, with the HFRI Macro Index posting a gain of 1.9%. Thanks to significant positive contributions from agricultural and metals exposures, commodity-focused strategies gained nearly 2.0% for the month. Currency-focused funds also posted gains, with many funds having reduced profitable short Euro positions in recent weeks, moderating aggregate industry short Euro exposure. Falling yields and spread tightening benefitted both Relative Value Arbitrage and Macro strategies, with the HFRI RVA Index gaining 1.5% in July, bringing YTD performance to 5.8%, the strongest area of industry performance. Fixed income-based RVA performance was also driven by strong sub-strategy gains across Asset-Backed and Yield Alternatives exposures, with these gaining 2.3% and 2.5%, respectively.

The HFRI Equity Hedge Index gained 0.6% in July, led by contributions from Quantitative Directional and Energy/Basic Materials funds, with these gaining 1.7% and 2.1%, respectively. Event Driven also posted positive performance for the month of 0.3% in July.

Bonds: Mixed

The noise for QE3 is becoming louder and louder. By comparing implied allocation of the purchases across various maturity buckets with the actual allocation of the previous QE operations, it may be possible to predict the likely movement in the bond market. From QE1 to QE2, the biggest shift was in favour of 10-yr issues, away from the front and back ends of the curve.

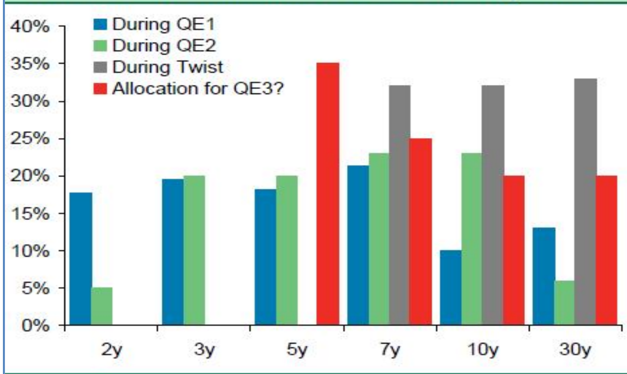
Anticipating QE3, some analysts use the 40% target as a guideline, then the most visible shift will be in favour of 5-yr. Allocation into the 7-yr and 10-yr segments will be roughly in line with QE2, while the 30-yr should enjoy a bigger allocation than in the first two QE programs. Expected purchases in the 5-yr area are yet another reason why investors should consider a core, long position in this sector.

One way to gauge the size and share of foreign inflows into Asia government bonds is to look at the cumulative increase in foreign holdings in four of the most open regional bond markets: Indonesia, Korea, Malaysia and Thailand.

According to ADB data, over the seven-year period 2005-2011, foreigners cumulatively purchased USD118bn, or 30% of the cumulative USD389bn increase in total holdings in these markets.

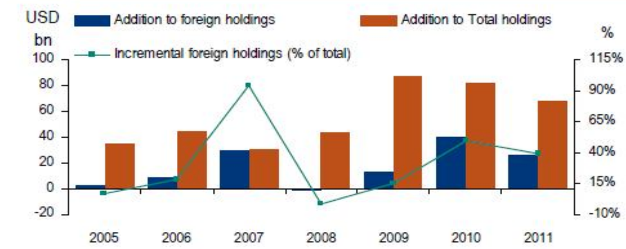
In fact, in 2007 foreigners absorbed 95% of the additional bond in these markets. Foreign absorption surged again in 2010 to 50% of the incremental supply, spurred by monetary stimulus in the developed markets that increased demand for emerging market assets, before falling to 39% in 2011 as QE2 ended.

Chart 4: Fed Allocations Across the Tsy Curve



Source: BNP Paribas

Chart 9: Foreigners absorbed 39% of the increase in total outstanding* in 2011, down from 50% in 2010



Source: BofA Merrill Lynch Global Research; ADB; Note: *the increase in total outstanding in Indonesia, Malaysia, Korea and Thailand

Table 3: Annual increase in total outstanding vs Annual increase in foreign holdings (in parentheses) of Key Asian bond markets

	Indonesia	Korea	Malaysia	Thailand	Total	Δ foreign holdings (% of Δ total)
2005	0 (2)	28 (0)	3 (0)	4 (0)	35 (2)	7%
2006	2 (3)	32 (3)	5 (2)	5 (0)	44 (8)	18%
2007	6 (2)	12 (23)	8 (4)	4 (-1)	30 (29)	95%
2008	4 (1)	27 (-3)	11 (0)	2 (1)	43 (-1)	-2%
2009	6 (2)	53 (6)	15 (4)	13 (1)	87 (13)	15%
2010	7 (10)	56 (16)	11 (11)	8 (4)	82 (40)	50%
2011	9 (3)	43 (10)	14 (9)	1 (4)	68 (26)	39%

Source: BofA Merrill Lynch Global Research; ADB

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

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