Global Macro & Markets

No more safety net (for now)

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Phillip Securities Research Pte Ltd

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MSCI Asia ex-Japan: 511 | FSSTI: 2946 | S&P500: 1389.7

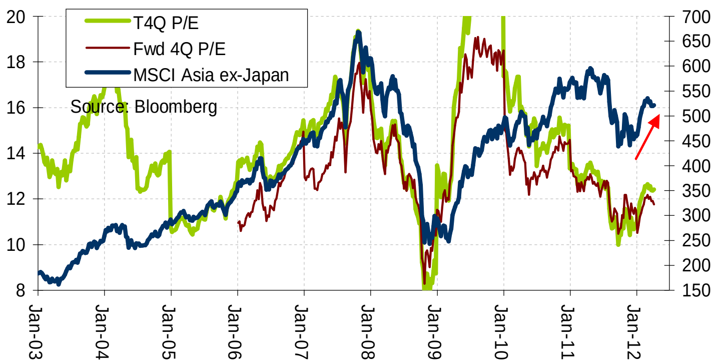
At the beginning of the year, the global economy was fairly resilient despite the EZ debt crisis. Once ECB LTROs removed immediate meltdown risks, markets, with expectations already crushed, took whatever scraps of good economic data and rallied on hope. On 3rd Jan 12 (see Morning Notes) we turned positive on equities, but only in the short term, as output got less bad, we rode a wave of ECB liquidity, and had the positive threat of QE3.

But now the easy gains have gone, with macro risk from Spain arising, and the policy safety net – the positive threat of QE3 – having been perceived by the market to be removed for now, the onus is on economic data to be much more robust to drive markets higher. Main economies US, EZ and China are however more likely to prove subdued, while central banks still lack room to stimulate. On 5th April Morning Notes, we advised taking some profit. We still hold this view as near term downside risk outweighs upside risks.

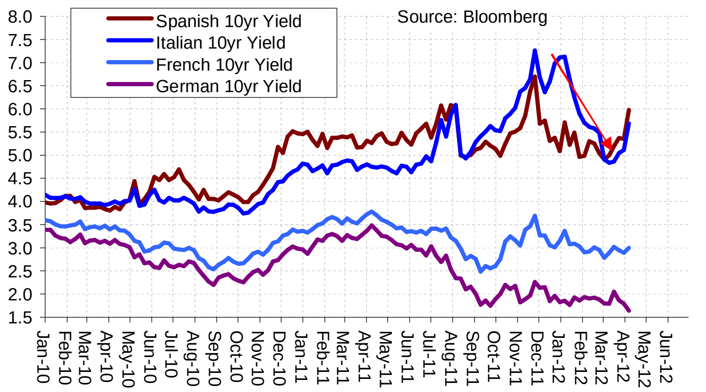
After this correction/consolidation period, we could still have another move higher yet, as weak growth could relieve inflationary pressures to a point where central banks loosen. In addition, a fiscal loosening announcement from China, remains a possible catalyst. Negative catalyst would be Spain, which is becoming a macro risk on fiscal woes. We may need ECB intervention again.

Should we have a rally again after this correction, markets could then find it challenging again in 4q12 as 2013 sees economic headwinds building in the form of large scale fiscal withdrawals in the west, amid low US real disposable income gains. Technically, the larger trend is still downward, as can be seen by the MSCI Asia ex-Japan putting in its 3rd lower high. Bucking the trend is ASEAN 3, of which we are overweight Indonesia and Thailand.

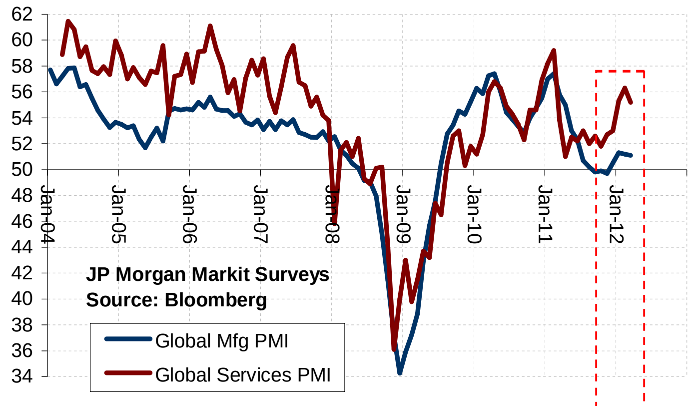
Equities rallied over 1q12 (red arrow) …



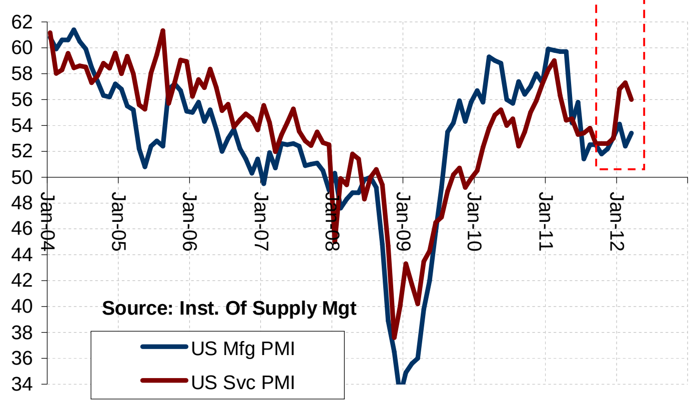
… as ECB long term refinancing operations brought yields down to manageable levels, averting potential meltdown…



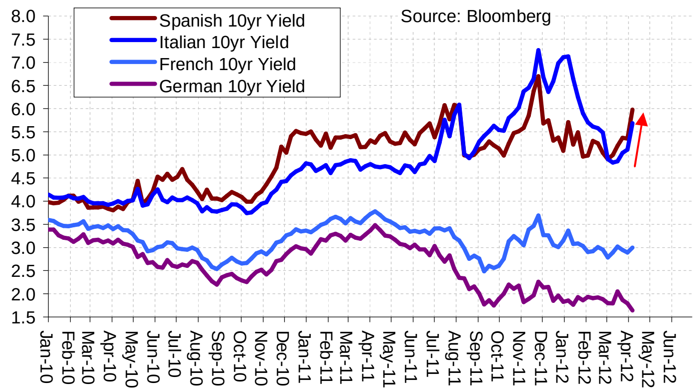
… which allowed the global economy to regain footing, and re-accelerate…



… mainly due to a resurgent US



But the EZ debt crisis is rearing its ugly head again as Spain struggles to contain its burgeoning debt-GDP ratio (68.5% 2011, 79.8% 2012f) on worsening recession and spending cuts feeding back into the economy due to ambitious deficit-GDP targets (8.5% 2011, 5.3% 2012f, 3% 2013f). Yields are clearly rising again – watch this space for Macro Risk (and more ECB intervention).

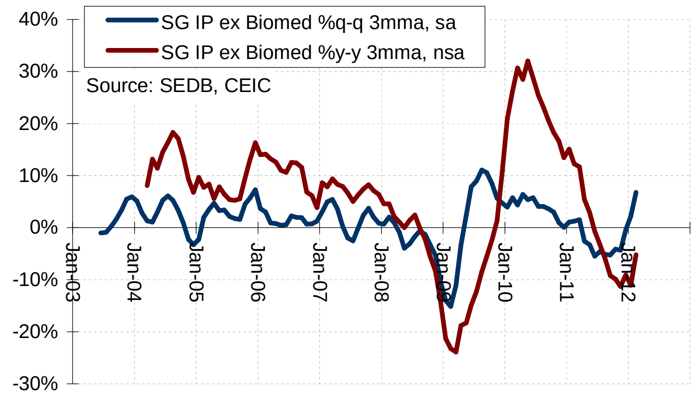


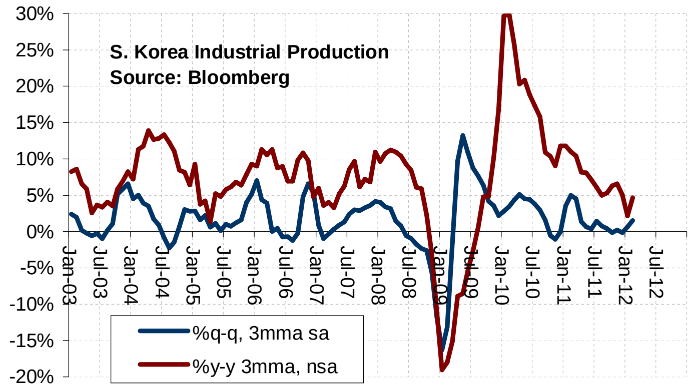
Also, the policy safety net of QE3 has been perceived by the market to be temporarily removed for now. In the last FOMC meeting, QE3 saw only 2 supporters out of 10, according to the released minutes, with 1 member believing that the fed funds rate would have to be raised well before end-2014 (quotes below).

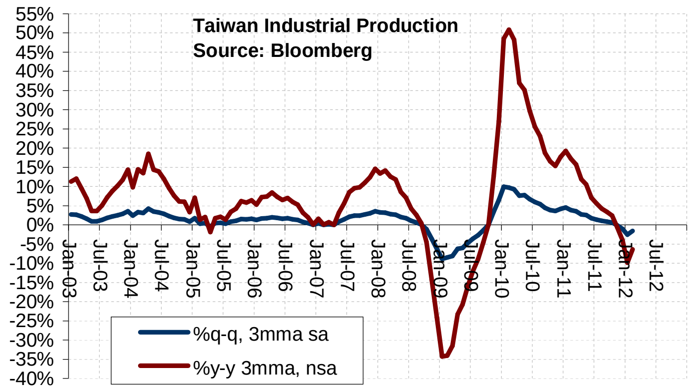
"In contrast, one member judged that maintaining the current degree of policy accommodation much beyond this year would likely be inappropriate; that member anticipated that a tightening of monetary policy would be necessary well before the end of 2014 in order to keep inflation close to the Committee's 2 percent objective. The Committee also stated that it is prepared to adjust the size and composition of its securities holdings as appropriate to promote a stronger economic recovery in a context of price stability. A couple of members indicated that the initiation of additional stimulus could become necessary if the economy lost momentum or if inflation seemed likely to remain below its mandate consistent rate of 2 percent over the medium run." (FOMC minutes 2012-3-13)

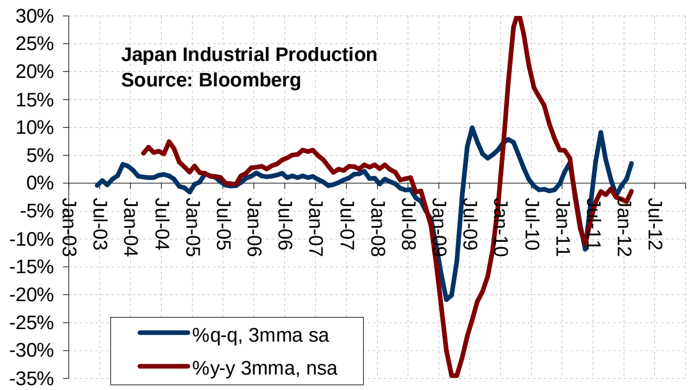
Although this by no means concludes that QE3 is removed as a policy option, a less dovish statement than before has altered the market's *perception,* that QE3 can no longer be counted on to support markets in the near term. Hence the onus is now on economic data, earnings, to outperform strongly to warrant further upside.

But US 1q12 economic resurgence largely masked a much weaker rebound across the rest of the world: Asia's rebound has been rather weak, from Singapore, Korea, Taiwan, to Japan…

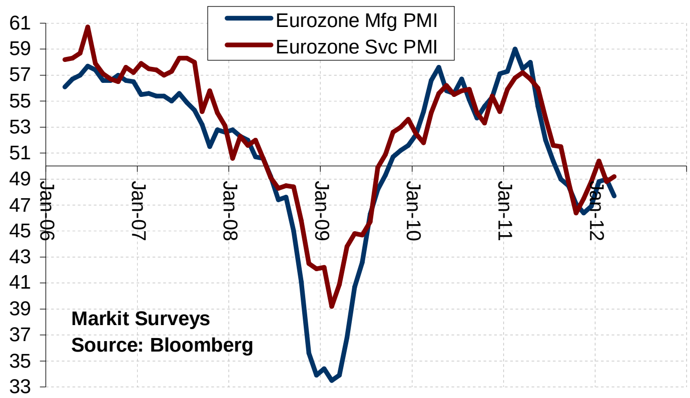






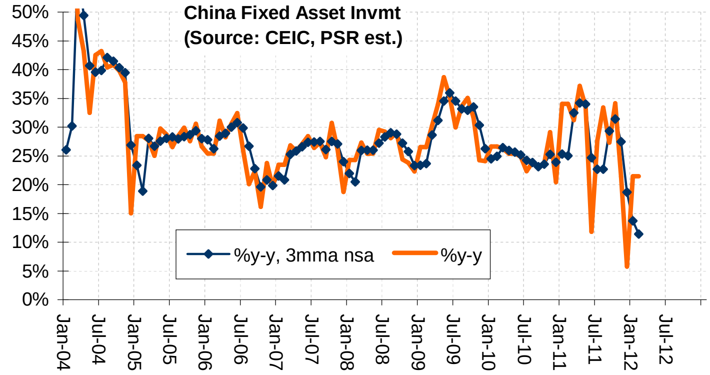


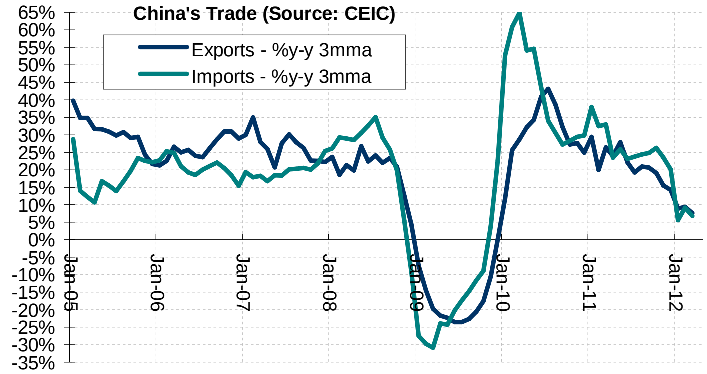
… as main markets the EZ remains recessionary…

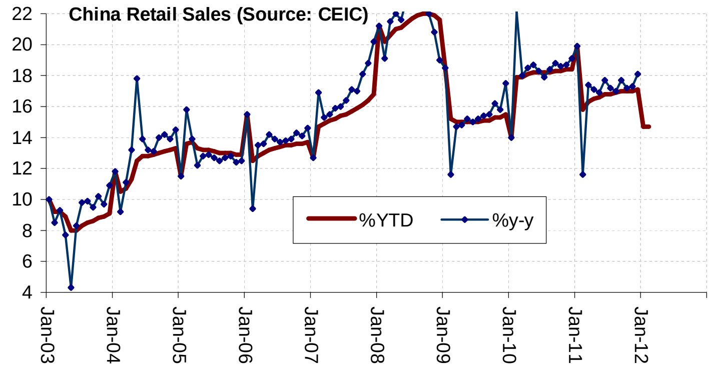


… and China continues to slow on all fronts: slowing investment and exports could now be joined by consumption

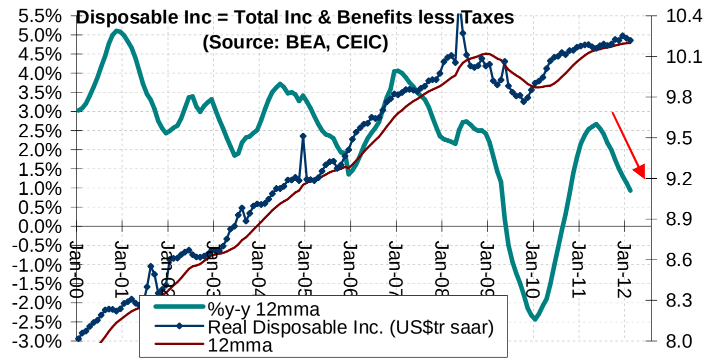
– retail sales was very much below expectations for Jan-Feb12.



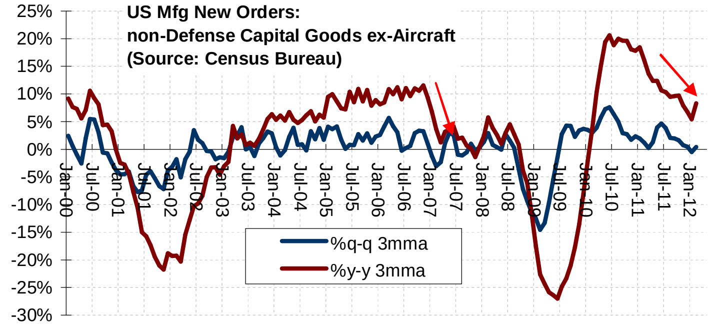




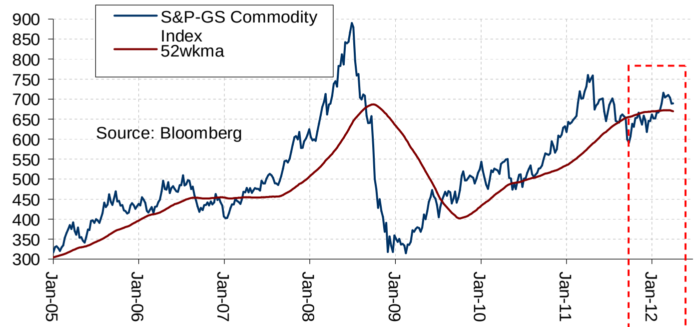
Although the US has outperformed, we are still not as optimistic as the consensus for a +2.2% US recovery, due to below trend and decelerating real disposable income growth (green line, red arrow) – which we believe is a much better gauge of consumption sustainability…

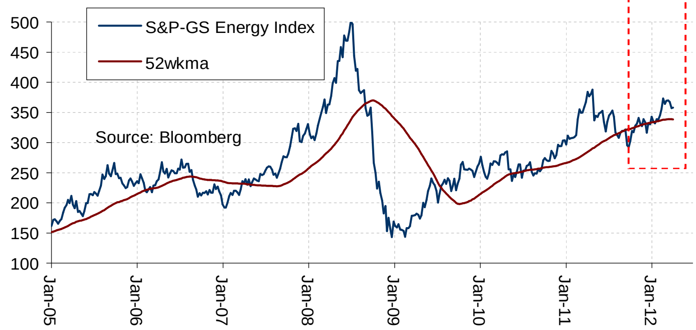


… and US core-orders for capital investment is also on a slowing trend.



Central banks on account of resilient crude prices (red box) are mostly likely to stand pat (table below), balancing downside risks to growth with upside risks with inflation – in plain English, this means although they would like to loosen to stimulate, they can't for the near future.





	Growth Outlook	Inflation Outlook	Monetary Policy
US	slowing	moderating, upside risk	stand pat
EZ	recession	upside risk	stand pat, bit hawkish
China	slowing	moderating, upside risk	room to cut RRR
S.Korea	moderate rebound, downside risk	moderating, upside risk	stand pat, bit hawkish
Taiwan	moderate rebound, downside risk	moderating, upside risk	stand pat, bit hawkish
Singapore	mild rebound, downside risk	upside pressures	S$NEER appreciation stance
Indonesia	robust, domestic drivers	moderating, upside risk *	stand pat
Thailand	V-shape, domestic drivers	upside pressures	stand pat, bit hawkish
Malaysia	robust, domestic drivers	moderating, upside risk	stand pat, bit hawkish

Source: PSR's view, Central Bank Policy statements
* as the fuel price hike could return on rising crude

As such, **we advised on 5th April Morning Notes to take some profit**: *"It is probably prudent now to take some profits, in view of macro risk rising from Spain, and the Fed removing in the short/medium term the QE3/Twist2 safety net from the market."* **We continue to hold that view, especially for the STI, Hang Seng, and S&P500, as near term downside risk outweigh potential upside risk.**

On the bright side, after this correction/consolidation, we are of the view that we may still yet have another intermittent rally in Asia (before 4q12), as weak growth could bring down inflation/crude prices to a point where central banks feel comfortable enough to loosen. In addition, China may still do a sizeable fiscal policy announcement as hard landing risks rise, this could catalyze a rally. Spain poses significant downside risk to this thesis, but the ECB could intervene to save the day.

By 4q12 though, we have to point out that markets would then be faced with a new and big challenge: on 1st Jan 2013, two major fiscal tightening events occur – stimulus withdrawal by the US to the tune of over US$500b (table below)…

Deficits or Surpluses Projected in CBO's Baseline

(Billions of dollars)	**2011**	**2012**	**2013**	**2014**	**2015**
Revenues	2,302	2,523	2,988	3,313	3,568
Outlays	3,598	3,601	3,573	3,658	3,836
Total Deficit	**-1,296**	**-1,079**	**-585**	**-345**	**-269**
Net Interest	227	224	231	247	282
Primary Deficit (-) or Surplus[a]	-1,069	-855	-354	-98	14
Memorandum (As a percentage of GDP):					
Total Deficit	-8.7	-7.0	-3.7	-2.1	-1.5
Primary Deficit (-) or Surplus[a]	-7.1	-5.5	-2.2	-0.6	0.1
Debt Held by the Public at the End of the Year	67.7	72.5	75.1	74.8	72.6

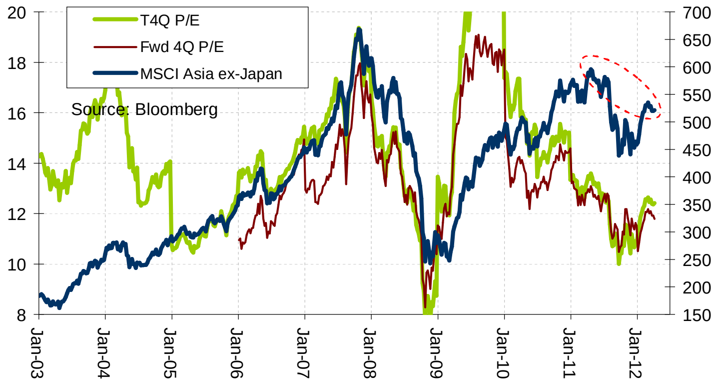
Source: Congressional Budget Office.

… and the Eurozone's New Fiscal Compact. Even if EZ members slash spending this year to prepare for criteria (3) in 2013, most will still fail criteria (4). Lacking growth, slashing spending is still likely to be the main option in 2013.

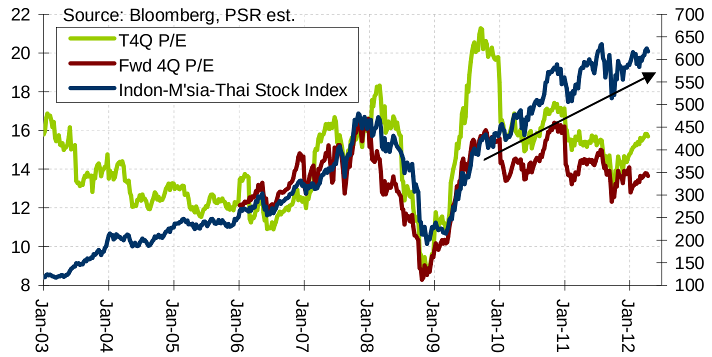
EUROZONES' NEW FISCAL COMPACT

(1) Members fiscal budgets to be surplus or balanced
(2) If Annual Structural Deficit > 0.5% of Nominal GDP, then automatic corrections (to be constitutionally enshrined) to kick in
(3) If Deficit / GDP > 3%, then:
    a. Possible sanctions by Members
    b. A "partnership" with EC for structural reform
    c. This is called the "Excessive Debt Procedure"
(4) If Gross Debt / GDP > 60% but Deficit GDP < 3%, then:
    a. Will be required to annually reduce debt burden at the rate of: (Current Debt / GDP – 60%) / 20
    b. If not, will be placed under "Excessive Debt Procedure"

In some sense, we wish to point out that markets may already be cognitive of this challenge – Asia excluding ASEAN 3 has made a 3rd lower high (red ellipse), technically then, the larger trend is still down. This is true for the STI, the Hang Seng, the HSCEI, the KOSPI, the TWSE, the Nikkei and the ASX. 4q12 going into 2013 will be interesting to say the least.



Although not immune to such external risks, bucking the trend above is the ASEAN 3: Indonesia, Thailand and Malaysia have much stronger economic stories driven by domestic demand, and their larger trends are still positive (black arrow). **Our current regional strategy is Overweight Indonesia (Regional Strategy 2012-3-29) and Overweight Thailand (Monthly SET Strategy 2012-4-5, Regional Macro 2012-4-5).**



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