Global Macro Asset Strategy - Update

19 right and 4 wrong. And time to downgrade EM-Asia debt

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Products: ETF | CFD | Unit Trusts

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Phillip Securities Research Pte Ltd

Table summary of Asset Strategy Pg4 of report, with ETF and CFD instruments to trade the outlook

Our view that this is the year for equities over bonds (see 4th Jan GMAS report) seems correct as MSCI World posts a 7.4%ytd total return v. bonds 3.8%ytd (see Pg.3). Our views for equities are unchanged, but to reflect more strongly our view that 2013 is likely to be risk-on, we are refining our views on bonds in the EM-Asia segment, specifically we are:

- **(i) Downgrading EM-Asia US$ debt to UW**
- **(ii) Downgrading EM-Asia Local Currency (LC) debt to MW**
- **(iii) Maintaining OW on EM-Asia and US high yield (HY) debt**
- **(iv) Downgrading to UW US Mortgage Backed Securities**

On account of the following reasons: (1) EM-Asia bonds in the quality US$ space are trading at a premium (2) US$ depreciation versus EM-Asia currencies is likely entering a new structural phase (3) interest rate normalization is likely on improving growth (4) portfolios are much too overweight bonds from last year and a liable to rush back into stocks.

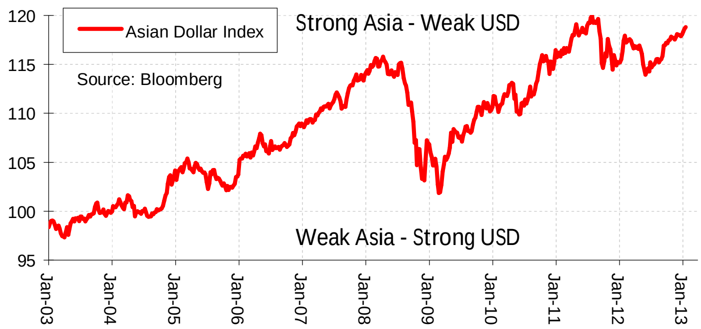
We also include a section reviewing our 2012 calls, which we note were mostly accurate: 19 right, 4 wrong.

Its old news that sovereign safe havens and US corporate investment grade have been expensive. The lament of yield repression goes on and portfolio managers have been forced to trudge further out into the risk spectrum in search for yield. Last year Asian and US HY debt were the best performers as managers plied the HY universe to boost yield return. But is this now a tired trade? Sovereign safe havens and US corporate investment grade have long entered expensive territory, but what about EM-Asia, the darling of last year? A quick check on valuations of current yield v. yield-to-maturities (stated on the iShares website), reveals the following:

- EM US$ debt: 4.21% > 4.01% (premium),
- EM LC debt 3.48% < 4.87% (discount),
- Asia US$ debt: 4.96% > 3.58% (premium),
- Asia LC debt: 2.89% < 3.43% (discount),
- Asia US$ HY debt : 7.24% > 6.15% (premium)

Thus we see US$ debt in overvalued territory, while LC debt still has some valuation room to move. HY is overvalued, but as a risk-asset it could still move higher in line with other risk assets like equities. When we check against the 2013 ytd total return performance (refer Table 1 Pg.3) we find that average returns for High Yield (HY) and Local Currency (LC) debt are indeed both outperforming US$ dent in the order of 7.8%, 3.9% and 3.7%. If we count the average appreciation of Asian currencies versus the US$ of about 0.5% this year (Fig.1), it would be 7.8%, 3.9%, 3.2%. See also Appendix 1 on structural weakness of the US$ v. EM-Asian currencies.

Fig.1 Asian currencies on an appreciation trend (+0.5%ytd)



Average returns for fixed income this year are 3.8% (Table 1, pg.3). MSCI World total return is running at 7.4%, in line with our view that this year will see a rotation out of bonds into equities as global growth improves, and macro tail risk is perceived to be under control (see 4th Jan GMAS for more details on why we prefer stocks this year, and which equity markets we prefer). Yet on the back of an improved growth outlook, it is also natural to assume a pickup in inflation and therefore interest rate normalization, which both represent further downside risk for bonds let alone the cycle out of bonds into stocks on better growth, earnings prospects, and portfolios being generally underweight equities last year. Policy has thus far been generally loose globally to hedge downside risks to growth given the macro risks we have been experiencing in 2011 and 2012. Thus far, we are not penciling in policy rate increases as growth is only just gaining traction and authorities will want it to solidify before considering tighter policy (Table 2, pg.3). But watch this space, suffices to say, risks for rate normalization are higher than not in a growth recovery context. And even if authorities stand pat, higher inflation itself represents a downside risk for bonds. Even now, we sense a gradual move from bonds to equities on the better growth outlook, thus inflation and tighter policy could provoke an avalanche out of bonds into equities.

In view of these downside risks: (1) over-valuation, (2) weak US$ v. EM-Asian currencies, (3) risk of inflation and rate normalisation, (4) portfolios much too underweight equities, we are downgrading the following:

- EM-Asia US$ debt from OW to UW on account of all 4 reasons
- EM-Asia LC debt from OW to MW on account of (3), and (4)
- EM-Asia HY debt maintained at OW as it's a risk asset despite (1) – (4), that said, if we do not observe continued positive chart trends, we will be re-considering the rating.

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How did our Ratings fare in 2012?

In reference to Table 1, Pg. 3, pretty good! We favoured fixed income which outperformed stocks (16% v 15.4%), and were rightly UW both commodities (-3.4%) and gold (-2.9%).

Of the 23 calls only 4 were "off", they were: US Mortgage Backed Securities (MBS) we got completely wrong (we thought OW on endless Fed QE when the market had already bought ahead long ago so much that there was nil upside), S&P500 & Euro Stoxx 50 we were UW for most of the year, we looked very clever mid-year when gains were given up but then stubbornly stayed UW (S&P500 upgraded to MW much too late in Dec) even after Aug12 when the ECB's OMT removed macro tail risks (a lesson in changing expectations – its so bad, less bad is fantastic)! India we were off as well, another case of changing expectations. Basically it was a classic case of being too sensitive to economic conditions and not sensitive to changing market expectations. We will be watching price action and trends much more closely this year. For the record, this business is an art and a science, of blending economics, valuations, technical analysis, expectations, and politics.

Of the other 19 calls where we got right, thankfully it was mainly our core ASEAN and CN-HK markets plus the calls to OW EM-Asia debt. Our move to OW China A-shares was timely, while our moves to OW HSCEI and the Hang Seng caught the second wave of big upward moves. We were right to MW Malaysia (politics) and Indonesia (weak Rupiah), and OW Thailand and Phillippines. Happily we were OW the STI which outperformed.

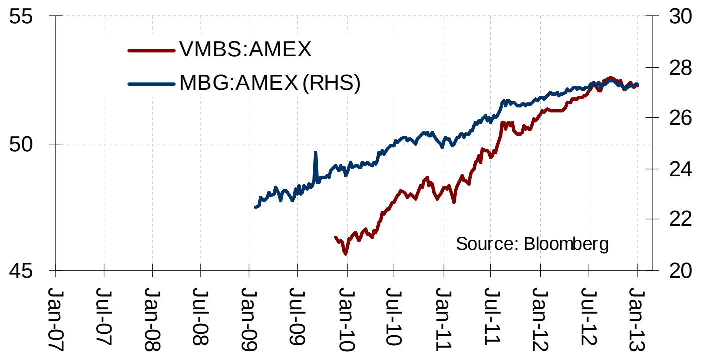
So there you have it. Now to cleanse ourselves of our last remaining "wrong" pick: we downgrade today Mortgage-backed Securities (MBS) from OW to UW as there is limited upside to prices of MBS ETFs (Fig.2) on account of the following:

(i) After Bernanke singled out the weak housing market as an obstacle to growth in Jan 2012, markets have been expecting future monetary easing to take the form of MBS purchases prior to Sept QE3. Thus, most of the expectations have been priced in prior to Sep12.

(ii) While the Fed has committed to purchase MBS to the tune of US$40b/mth till the labour market improves substantially, the Fed does not set the mortgage rate and is just one of the players (albeit a significant one) in the mortgage market

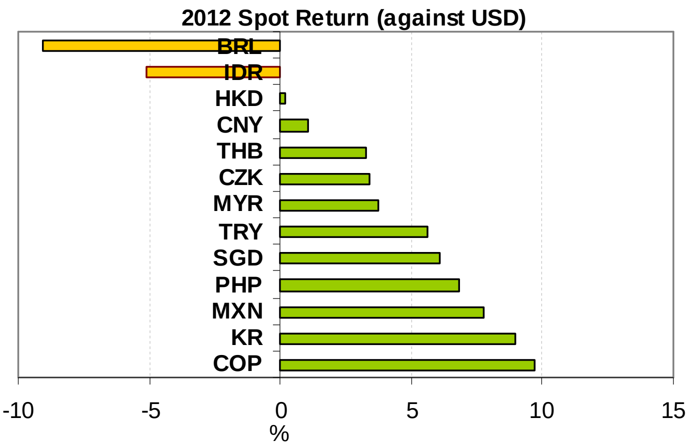
(iii) Premature withdrawal/termination of Large Scale Asset Purchases (which involved US$40bn MBS) might weigh on MBS prices. In fact we think the market to pricing some of this in after the last Fed minutes revealed apprehension on the effectiveness and lack of an exit strategy regarding MBS and Treasuries.

Fig.2: MBS chart looks like its rolling over?



Appendix 1: Structural Weakness in the USD

Weakness in the USD relative to Asia ex Japan currencies is likely to be structural in nature and is likely to persist in the near term on account of (i) relative growth differentials between the US and EM-Asia, (ii) risk-on environment and (iii) Fed running looser monetary policies than EM-Asian Central Banks. EM-Asia currencies -except BRL and IDR- have broadly outperformed the USD in 2012 and are expected to continue to do so in 2013 (see figures below).



COP: Colombian Peso; KRW: South Korean Won; MXN: Mexican Peso; PHP: Philippine Peso; SGD: Singapore Dollar; TRY: Turkish Lira; MYR: Malaysian Ringgit; CZK: Czech Koruna; THB: Thai Baht; CNY: Chinese Renminbi; HKD: Hong Kong Dollar; IDR: Indonesian Rupiah; BRL: Brazilian Real
Source: Bloomberg

TABLE 1.

Phillip Securities Research: Asset Allocation Strategy

Returns incl. Yield	**2012**	**2012 rtn**		**2013**	**2013 rtn**	
Bonds						
US Treasuries	OW to UW 9th Oct	7.0%	correct	UW	0.2%	correct
US MBS	OW	4.6%	wrong	OW to UW 23rd Jan	-0.2%	<= downgrade
US Corp IG	OW to MW 9th Oct	16.4%	correct	UW	2.8%	correct
US Corp HY	OW	19.8%	correct	OW	8.4%	correct
EM-Asia US$ IG	OW	19.5%	correct	OW to UW 23rd Jan	3.7%	<= downgrade
EM-Asia LC IG	OW	14.2%	correct	OW to MW 23rd Jan	3.9%	<= downgrade
EM-Asia HY	OW	30.4%	correct	OW	7.5%	correct
simple average:	OW	16.0%	correct	MW	3.8%	correct
Equities						
World	MW	15.4%	correct	OW	7.4%	correct
US	UW to MW 21st Dec	13.8%	shld have MW in Jun not Dec!	MW	8.6%	<= too pessimistic again?
EZ	UW	17.9%	wrong	UW	7.8%	<= too pessimistic again?
Korea	MW	12.7%	correct	MW	2.0%	correct
Taiwan	MW	12.2%	correct	MW	4.1%	correct
China-A	OW 22nd Oct	7.8%	timely!	OW	6.2%	correct
China-H	OW 22nd Oct	17.8%	caught 2nd move	OW	9.4%	correct
HK	OW 22nd Oct	26.1%	caught 2nd move	OW	6.9%	correct
SG	OW	23.5%	correct	OW	4.1%	correct
MY	MW	13.4%	correct	MW	0.7%	<= reassess after elections
TH	OW	29.6%	correct	OW	3.2%	<= too optimistic?
ID	MW	11.3%	correct	MW	4.8%	<= too pessimistic?
PH	OW	36.8%	correct	OW	6.4%	correct
India	UW	29.3%	wrong	UW	3.6%	<= policy risk…
Commodities	UW	-3.4%	correct	MW	2.3%	correct
Gold	UW	-2.9%	correct	UW	1.7%	correct

OW = Overweight | MW = Marketweight | UW = Underweight (Souce: PSR, Bloomberg)

TABLE 2.

Growth / Inflation	**2012f**	**2013f**	**Current Mon. Policy**	**Last Change & Outlook**
US	2.2% / 2.1%	2.2% / 2.0%	Fed Funds Rate: 0 - 25 bp	stand pat
China	7.8% / 2.2%	8.0% / 3.0%	PBoC Policy Lending Rate: 6.00%	-31bp Jul12, stand pat, room to cut
HK	1.2% / 3.9%	3.0% / 4.0%	US$7.8 peg since Oct83	stand pat
Singapore	1.4% / 4.7%	2.0% / 4.2%	maintain modest, gradual app S$neer	tighter Apr12, stand pat, inflation worry
Malaysia	5.0% / 1.7%	4.0% / 2.2%	O/N Policy Rate: 3.00%	+25bp May 11, stand pat, room to cut
Thailand	5.3% / 3.0%	4.5% / 3.5%	1 Day Repo: 2.75%	-25bp Oct12, stand pat, room to cut
Indonesia	5.9% / 4.5%	4.5% / 4.3%	O/N Rate: 5.75%	-25bp Feb12, stand pat, room to cut
Phillippines	5.5% / 3.3%	4.5% / 3.0%	O/N Reverse Repo: 3.50%	-25bp Oct12, stand pat, room to cut

Source: PSR Macro Analysts

Global Macro, Asset Strategy Team, Phillip Securities Research

OW = Overweight ; MW = Neutralweight ; UW = Underweight

Broad Asset	Sub-Asset	Rating	ETF		Phillip CFD
Bonds (MW)	US Treasuries	UW	TLH.AMEX / TLT.AMEX		
	US Mortgage Backed	UW	VMBS.AMEX / MBG.AMEX		
	US Corp	UW	VCLT.AMEX / LQD.AMEX		
	US Corp High Yield	OW	HYG.AMEX / JNK.AMEX		
	EM US$ Govt	UW	EMB.AMEX		
	EM LC Govt	MW	LEMB.AMEX		
	EM US$ HY Corp & Govt	OW	EMHY.AMEX		
	Asian US$ Govt & Corp	UW	N6M.SGX		
	Asian LC Govt & Corp	MW	N6L.SGX		
	Asian US$ Corp HY	OW	O9P.SGX		
Equities (OW)	US	MW	SPDR S&P 500 (SPY:AMEX)		US SP 500 Index USD5 CFD (S&P500) / Wall Street Index USD1 CFD (DJIA)
	Europe	UW	SPDR Stoxx 50 (FEU:AMEX)		
	Australia	-	iShares MSCI Australia (IOZ:ASX)		
	Japan	-	Nomura ETF Nikkei 225 (1329.JP)		Japan 225 Index JPY100 CFD (Nikkei 225) / Tokyo Index JPY1000 CFD (Topix)
	S.Korea	MW	DBXT - MSCI Korea (IH2:SGX)		
	Taiwan	MW	DBXT - MSCI Taiwan (HD7:SGX)		Taiwan Index USD20 CFD (MSCI Taiwan)
	China A shares	OW	CSI300 (83188.HK) / SSE 50 (JK8.SGX)		FTSE China A50 Index USD1 CFD
	China H shares	OW	HKCEI (2828.HK)		H Shares Index HKD5 CFD (HSCEI)
	HK	OW	Hang Seng (2800.HK)		Hong Kong 40 Index HKD5 CFD (Hang Seng)
	Singapore	OW	SPDR STI (ES3:SGX)	**CIMB ASEAN40 ETF (QS0:SGX for S$ or M62:SGX for US$)**	STI SGD5 CFD / S'pore Index SGD20 CFD (SMSCI)
	Malaysia	MW	DBXT - MSCI Malaysia (LG6:SGX)		FBM KLCI MYR10 CFD
	Thailand	OW	DBXT - MSCI Thailand TRN (LG7:SGX)		
	Indonesia	MW	DBXT - MSCI Indonesia (KJ7:SGX)		Indonesia Index USD1 CFD (MSIC Indon)
	Phillippines	OW	DBXT - MSCI Philippines (N2E:SGX)		
	Vietnam	MW	DBXT - FTSE Vietnam (HD9:SGX)		
	India	UW	iShares MSCI India (I98:SGX)		India50 Index USD1 CFD (S&P CNX Nifty)
Commodities		MW	Lyxor Commodity 10$US (A0W:SGX)		
Gold		UW	SPDR Gold ETF (O87:SGX or GLD:AMEX)		

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