Global Macro Asset Strategy - Update

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Downgrade High Yield fixed income to MW; Be mindful of downside risks amid this equity euphoria

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Products: ETF | CFD | Unit Trusts

4 March 2013
Phillip Securities Research Pte Ltd

Revised table summary of Asset Performance (Pg7) and Strategy (Pg8), with ETF and CFD instruments to trade the outlook

In this note, we update our views on high-yield bonds as well as country equities. Specifically we are:

- **(i) Downgrading EM-Asia high yield and US high yield debt to MW**
- **(ii) Waiting to upgrade US equities once US gets a handle over the fiscal uncertainties ahead**
- **(iii) Marketweight Japan as a weak yen is not the panacea for Japan's structural problems.**

Equity indices are at/near their respective cyclical highs. Amid this euphoria, it is tempting to throw caution to the wind. But the fact of the matter is - downside risks are still lurking at the backdrop, notwithstanding a brighter global macro outlook.

In this note, we flesh out 8 possible downside risks that could throw sand to the wheels, dampen risk appetite and bring the risk rally to a halt.

Having pointed these out, no change to our broad call of OW equities, MW bonds, MW commodities and UW gold. Equities are still likely to rally in a risk-on mood, punctured by intermittent episodes of pull-back in prices which offer an attractive opportunity to accumulate our OWs in CN,HK (on compelling valuations), PH, TH (resilient domestic demand) and SG (construction boom, attractive dividend yield).

8 RISKS ON THE HORIZON

Summary:

(i) It is tempting to shift our MW on US equities to OW, but fiscal uncertainties persist: the sequestration, the need to raise its US$16.4tn debt limit after 18th May, as well as absence of a medium-term deficit reduction deal

(ii) In the EZ, Italian's reform commitments are in doubt owing to a political impasse after the recent elections.

(iii) Then, there's the incipient risk of global inflation. Supply shocks arising from geopolitical tensions and weather-related disruptions might result in a run-up in commodity prices. Some ASEAN countries are also running inflationary policies like tighter labour and mandated wage hikes.

(iv) EMs are also confronted with the risk of an asset bubble, especially if credit expansion runs ahead of economic growth. An asset bubble -if burst- would have severe impact on the economy through the multiple feedback loops.

(v) Begger-thy-neighbour currency policies could lead to a full blown currency war.

(vi) A premature and/or not properly calibrated exit strategy from these LSAPs en route to normalisation might have a destabilising effect on both the economy and markets. Recall the Fed 1994 bond shock moment.

(vii) Incipient risk arising from a collapse of China's shadow banking system which comprised mainly of wealth management and trust companies will have ramifications across all sectors of the economy and markets.

(viii) Japan's new monetary and fiscal moves fails to revive the economy, which is actually in need of structural reform.

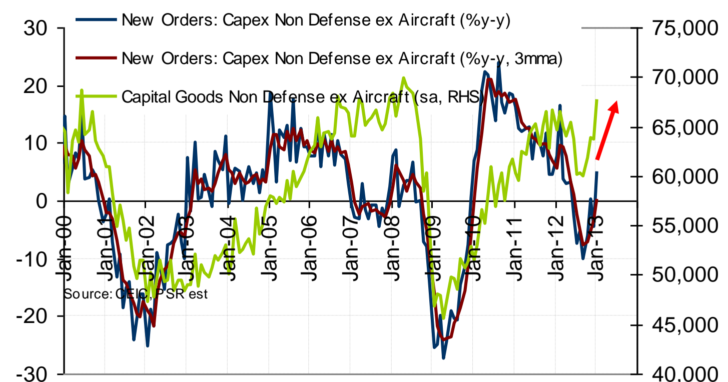
Details:

(i) Upside risk to our MW rating on US equities, but US fiscal uncertainties persist.

MSCI US (+6.7%) has outperformed MSCI World (+4.9%) ytd. We reckon the rally in US equities has underlying upside pressure on account of the following:

- (i) still-attractive valuation multiples compared to previous crisis levels,
- (ii) ongoing housing market recovery,
- (iii) capex rebound as businesses ramp up investments
- (iv) accommodative monetary conditions,
- (v) the shale gas and oil boom, as well as
- (vi) the EU-US free trade agreement (deal scheduled by end 2014 and expected to add 0.2ppts to US GDP)

Capex rebounded strongly after the fiscal compromise at the turn of this year, consistent with our guidance in our US Macro Strategy report (21st Dec 2012)



However, we are holding back the OW call mainly on political risk causing fiscal drag:

First, there is likely a lagged adverse effect of the payroll tax hikes on household consumption, amounting to an estimated 0.6%-pt drag on economic growth. While recent macro data suggests US consumers -in the face of the payroll tax hike- saved less to keep spending up, the question is whether consumers will continue to dig into

savings? Households could have saved quite a fair bit of early dividend payouts distributed last December, indicating a possible one-off payback effect. Thus, we will need to seek guidance from the upcoming February and March retail sales as well as household consumption/savings prints.

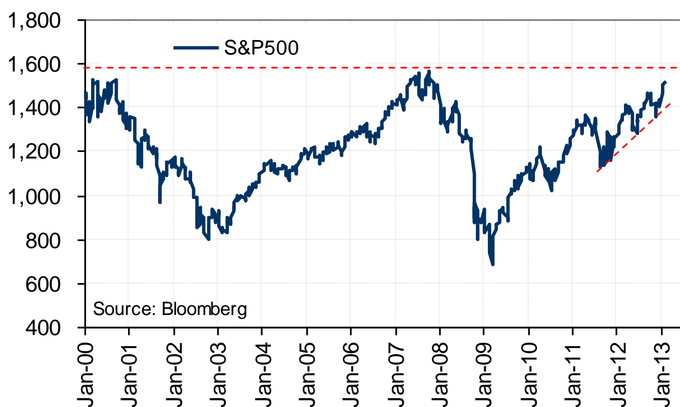
Secondly, the kicking in of the "sequester" of US$85 billion automatic and across-the-board budget cuts for the rest of this fiscal year, if not watered down going forward, shaves off another 0.6%pts of economic growth in real terms. **Despite the passed deadline, we are still cautiously optimistic that Congress might dampen the fiscal drag to some extent possibly via legislative changes as well as emergency appropriations in the coming weeks.**

Thirdly, there is the need to raise its US$16.4tn debt limit after 18th May. More critically, a medium-term deficit reduction deal is warranted.

Taking into account that the underlying economy has many upsides, on balance, we are revising downwards our real GDP growth for the US by 0.5%-pt to 1.7% for the whole of 2013.

Downside risk to our US 2013 GDP forecast is a sharper-than-expected fiscal drag. On the other hand, a strong-than-expected capex rebound would pose some upsides for growth.

While both the S&P 500 and DJIA are just a whisker away from their record highs, we reckon that without some action to reduce the sequester effects, both indexes will face strong technical resistance levels of 1575 (triple top) and 14200 (double top) respectively.



(ii) The EZ remains in a fragile equilibrium amid potentially destabilising political risk events as well as ongoing fiscal tightening.

At this juncture, it is unclear as to whether Berlusconi and Bersani can overcome their deep divide and form a grand coalition government. As we have mentioned previously in our commentaries, with Berlusconi in the government, Italian reform commitments are in doubt and this will jolt the fragile equilibrium that the EZ is at now. If markets start to doubt Italy's qualifications for OMT aid, borrowing costs (i.e. Italian 10yr bond yields) will continue to escalate to unsustainable level of around 7% and that will have negative ramifications for equity markets.

While the EZ has taken nascent steps with the banking union, much progress on a fiscal and banking union is still necessary for any effective solution of the EZ crisis. In recent months, the EU reached a landmark agreement on centralised supervision – main objective of breaking the link between weak banks and their government (sovereigns). Specifically, the ECB will start supervising the most important and vulnerable banks in the euro-zone. But to be more effective, we reckon that the ECB needs fresh powers to shut down ailing banks before they start to pose a systemic risk to sovereigns. Furthermore, we opine that significant fragmentation in financial conditions within the bloc is still likely to persist.

Then there also **incipient risks as well as potential risks lurking at the backdrop** that investors should be mindful of:

(iii) Global inflation. We have been MW commodities but OW equities to reflect that although the macro outlook has improved significantly from 2012, the recovery backdrop was still relatively weak, but as,too many portfolios were underweight stocks on the unexpected improvement in the global economy, equities therefore had the greater rate of change of expectations. This call proved correct (see Pg.7).

But we can't be complacent about inflation even in a low growth environment. Specifically two things: Geopolitical Risk, and Inflationary Domestic Policy in certain ASEAN countries.

Supply shocks arising from geopolitical tensions (particularly in the Middle East) and weather-related disruptions might result in a run-up in commodity prices which have remained relatively benign for now.

Closer to home in Singapore, amid an economic restructuring, we expect wage cost pressures to rear its ugly head, while cost pressures from private road transport and accommodation that hogged the headlines for most of 2012 will continue to persist.

In Malaysia, there are still upside risks to the inflation outlook - which is largely domestically driven.

(i) First, it is likely that subsidies for food (eg. flour, sugar, cooking oil) and fuel (diesel, petrol) – major drivers of headline inflation – will get scaled back after the 13th General Elections.

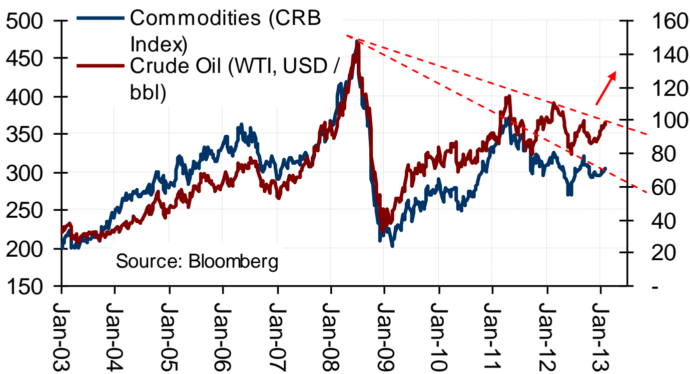
(ii) Second, minimum wage hikes. In May 2012, PM Najib introduced the minimum wage of RM900 for Peninsular Malaysia and RM800 for those in Sarawak, Sabah and Labuan. Most firms will have to start paying the minimum wage in six months, while small companies have a year to comply. As the wage hike is not premised on higher productivity, the upside risk to inflation is that the increase in

money could outpace the growth in output, firms which are able will likely decide to pass on the costs to consumers.

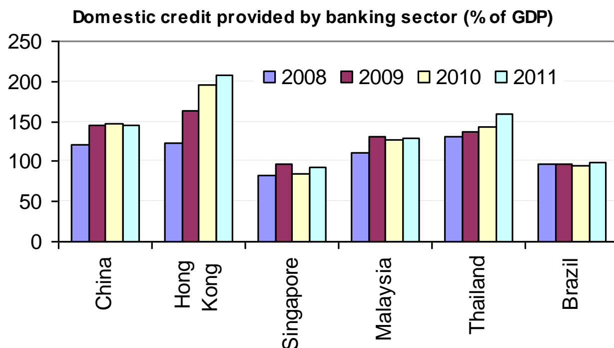
(iii) Third, the proposed goods and services tax –aimed to broaden the tax base- might be implemented after the 13th General Elections. This comes as the government needs to better manage public debt which is expected to rise from 51.8% of GDP in 2011 to 53% in 2012, just a whisker shy of the federal debt-to-GDP ceiling of 55%.

In Indonesia, there are also upside risks to inflation as the government will need to eventually scale back on fuel subsidies which has resulted in soaring costs of fuel imports, putting pressure on the current account balance and consequently weighing on the IDR.

CRB and WTI have not broken the downward sloping trendline yet, but on improving global growth, a breakout must be considered.



(iv) Credit bubble brewing in EM. There is also a risk of a credit bubble which we first highlighted in our Asean Macro Strategy report (dated 5th Dec). We are monitoring the accelerating credit growth in emerging markets (EM) such as ASEAN. Though credit expansion has been procyclical thus far, if credit expansion runs ahead of economic growth, an asset bubble might result which would have severe effect on the economy through the multiple feedback loops -if burst.



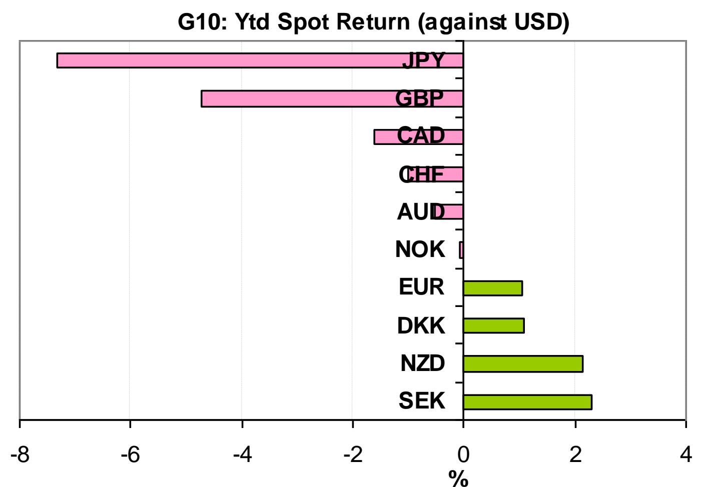
Source: World Bank, PSR est.

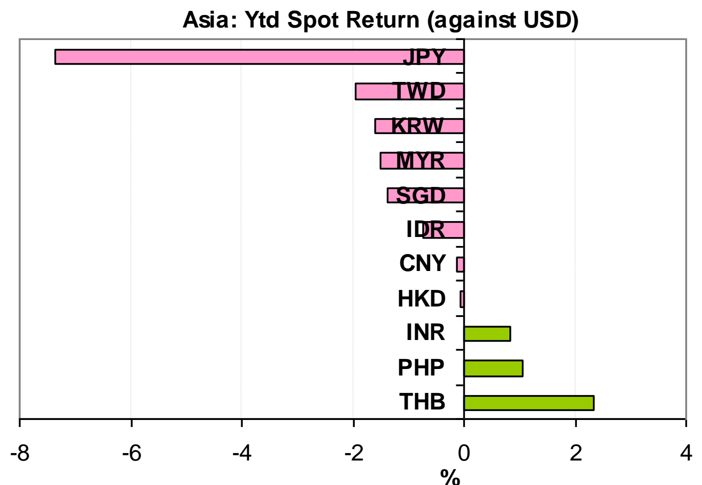
(v) Currency War which could trigger a race to the bottom for currencies. This risk is one that we first highlighted in our 4th Jan GMAS report. We –along with markets- view the absence of a specific censure against Japan in the recent G20 final communique as a tacit vindication of Japan's aggressive monetary policies.

Why would major central banks of advanced economies be keen to jump onto the bandwagon and engage in competitive depreciation? Well, it's the **'beggar-thy-neighbour'** effect that we saw in the 1930s currency war. A weak yen is being used as a tool with the objective of reviving Japan's sluggish export sector. This will ultimately compete reduce market share of exporters such as South Korea (Samsung, LG) particularly in the electronics segment, especially in this sluggish global demand environment where the pie simply isn't growing fast enough. This is why we think there are downsides to our current MW rating for South Korea.

Have the state of affairs escalated into a currency war'? At this juncture, we reckon not. Monetary easing by the G4 central banks is a response to support their respective sluggish domestic economies, and weaker currencies are a by-product. But having said that, it does not take much incentive (or rather dis-incentive) for major nations to engage in a full-blown currency war.

JPY weakened considerably against other majors and Asian currencies





Source: PSR, Bloomberg, 19 Feb 2013

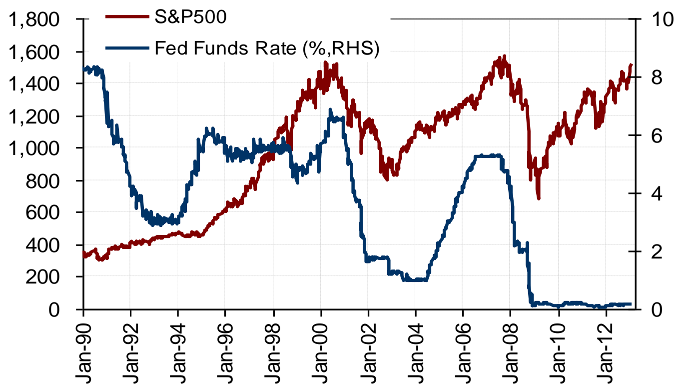
(vi) Policy mis-steps in the withdrawal from LSAPs. G4 central banks -namely Fed, ECB, BoE, BoJ- have also adopted unconventional monetary policies that have, to some extent, restored market's confidence and resusucitiated the global economy. But such balance sheet expansion by central banks will eventually suffer from diminishing returns. Furthermore, a premature and/or not properly calibrated exit from these LSAPs might have a destabilising effect on both the economy and markets, especially in view of the series of rate hikes to normalise interest rates.

At this juncture, these open-ended large scale asset purchases (US$85bn/mth) are likely to continue -at least for now- on account of a sluggish labour market and well-anchored inflation expectations as posited by Bernanke in his semiannual report to Congress.

But notably, the Fed in its Jan FOMC minutes hinted that large-scale asset purchases (LSAPs) to the tune of US$85bn/mth might be **scaled back or halted even before a substantial improvement in the labor market** (i.e. before reaching 6.5% unemployment target. Basically, the Fed is trying to avoid a disorderly exit strategy from LSAPs en route to normalisation.

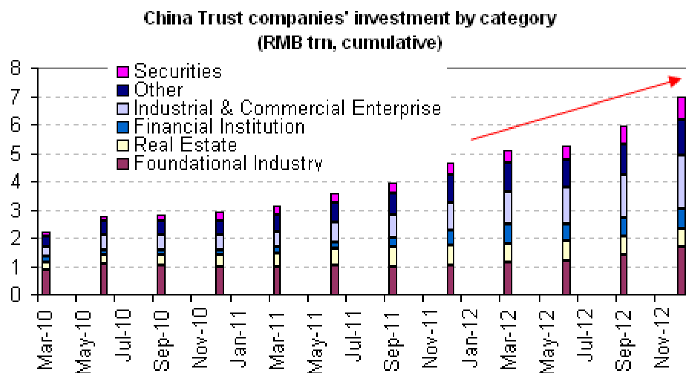
To be sure, an exit from the LSAP should signal a strengthening economy, in which case equities would rally even more (as a selloff in bonds under Fed withdrawal and a strengthening economy would entail a cycle out of bonds into stocks). But if the exit is too early, or judged by the market to be too early, both the economy could slow and equity risk-on be halted, as was the case in 1994. Recall that in 1994 the S&P500 bull run stalled that year as the Fed Funds soared 400bp between Jan94 to Feb95. Do note in this premature exit from loosening scenario, equity risk-on only stalled and resumed its climb in 1995 as the economy withstood the tightening. The end of LSAP therefore could cut either way, and depends much on the skill of the Fed's timing and reading of the underlying economy.

Note the sharp rise in interest rates from Jan94 to Feb95 merely stalled the bull run for a year as the exit from loose policy did not result in a weak economy. Will the Fed this time read the economy as well as in 1994?



(vii) A collapse of China's shadow banking system - which mainly comprises of wealth management and trust companies- will have ramifications across all sectors of the economy and markets. So essentially, the policy risk comes in the form of failing to manage non-bank credit growth, allowing it to spiral out of control.

Excessive credit growth in trust companies



Source: CEIC, PSR est.

(viii) In **Japan**, **failure to live up to the market's positive expectations**. The MSCI Japan has so far garnered an attractive return of 10.9% ytd. But our optimism for JP equities is a cautious one. Pencil in 4th April 2013. There is a risk that markets (especially those who shorted the JPY, i.e. went long the USDJPY, and went long JP equities) may be disappointed by the maiden monetary policy meeting (with the new incoming BoJ Governor as well as leadership) in view of high expectations of aggressive monetary easing already priced in.

Instead of finishing his term in April, BoJ Governor Shirakawa plans to resign the same time as his Deputy Governors in March. PM Abe has nominated Kuroda (dove) -a choice that is palatable to the opposition factions- as the BoJ Governor and Iwata (ultra-dovish) as one of his Deputies. While a renewed rally in USDJPY and consequently Nikkei might ensue on their appointment, markets might just as well "sell the fact". It is important to view this rally in perspective, the Nikkei has already run up quite a fair bit since mid-November, and has merely surpassed its 2011 pre-tsunami levels, now being very close to the major 12,000 resistance. Furthermore, while expectations of a weaker Yen -with USDJPY likely to test major resistance at 95 and even possibly 100- abound, yet again the fact that the Yen has stalled close to 95, could indicate a "sell the fact" event. Short term traders keep your stops tight.

Having said that, a positive outcome for the 4th April meeting means the Nikkei could slice through 12,0000 and challenge the 14,000 resistance level (attained in mid 2008 before the 2008/09 global financial crisis slump), this however, will depend very much on the meeting outcome.

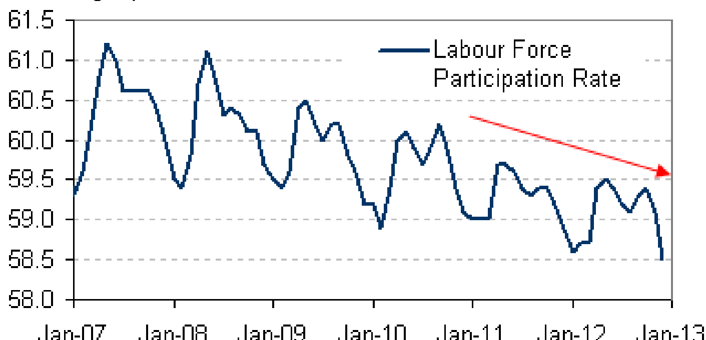
The Nikkei rally might still have legs, OW if 4th April policy meeting is positive

Source: Bloomberg, PSR est.

Looking beyond 14,000, we temper our optimism with regard to the Nikkei 225 over the longer term. This is because, notwithstanding aggressive monetary easing (possibly 2% inflation target and a commitment to open-ended easing from 2014) as well as fiscal pump priming under the Abe leadership, without other structural reforms (such as eliminating protectionism for certain domestic industries which breeds inefficient firms, as well as addressing its unfavourable demographics) we doubt a sustained revival of the Japanese economy. In addition, even if the Yen weakens considerably, it will merely increase the size of its energy import bill in view of a sharp increase in energy imports which have soared since the March 2011 nuclear accident.

In short, a weak Yen, cheap credit, along with massive fiscal deficits are not structural solutions to structural problems, which is what Japan really needs. The Nikkei 225 might therefore struggle to clear the 14,000 resistance level, even if monetary policy is ultra loose.

Unfavourable demographics is just one of the structural problems confronting Japan

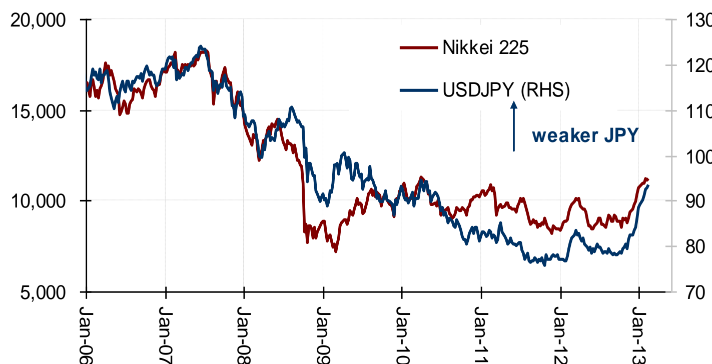


Source: CEIC, PSR est.

Furthermore, there is a significant possibility that Japan might be plagued with fiscal sustainability woes. If Japan tumbles down the hill with Abe failing to reflate the economy, these increased fiscal spending will merely add on Japan's ballooning debt burden and consequently portend downsides to its AA- sovereign credit rating.

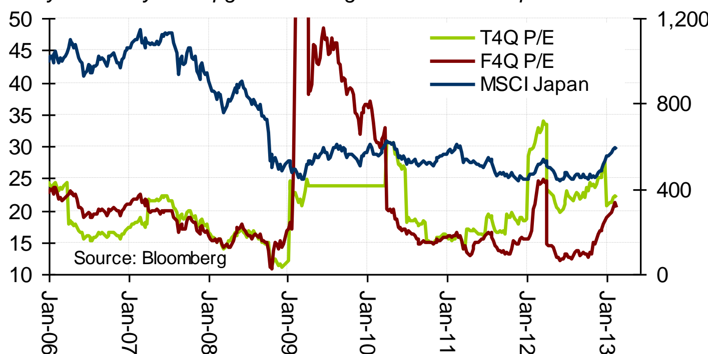
On a relative basis, we are still MW Japan in view of Japan's structural headwinds as well as the possibility that total returns when translated to US$, will be eroded – to a large extent- by a much weaker Yen.

Weak Yen bodes well for the Nikkei – particularly the Japanese exporters, but this will also cause its energy bill to rise



Source: Bloomberg, PSR est.

Analysts have yet to upgrade earnings forecasts for Japan Inc.



UPDATES TO OUR ASSET ALLOCATION STRATEGY

Despite these risks, we are still in risk-on mode. We define them so that investors and ourselves keep level headed and keep ourselves ready to be flexible in the event some combination of these risks realize themselves. **No change to our broad outlook of OW Equities, MW bonds, MW commodities and UW gold**. In terms of changes to the sub-category calls, there is upside risk to our equity calls on the US and JP, the only major change is that shortly we will formally downgrade HY debt to MW, to complete our progressive downgrade of bonds (see GMAS 24th Jan 13) on an improving global economy, upside risks to inflation, and too much money in bonds last year

EQUITIES (OW)

Our view that 2013 is the year for equities over bonds (see 4th Jan GMAS report) has been correct thus far as MSCI World registered a 4.9%ytd total return vs. bonds 0%ytd (see Pg.7).

- Upside risk to our MW rating on US equities. Look to OW if US mitigates the effects of the sequestration and

shows commitment to a medium-term deficit reduction deal.

- Assign MW rating on Japan equities. Weak Yen is not the panacea for Japan's structural problems. Weak Yen bodes well for the Nikkei but valuations suggest limited upside for Japan Inc. Look to OW if Japan shows signs of emerging from deflationary cycle with micro reforms.

Equity indices are hovering around their respective cyclical highs. In the near term, equities are still likely to rally in a risk-on mood, punctured by intermittent episodes of pull-back in prices.

Looking ahead, we recommend clients to buy the dips. Bouts of profit taking might occur intermittently during this rally which will result in pull-backs that offer attractive points of entry to enter equity markets –especially for those who have missed it.

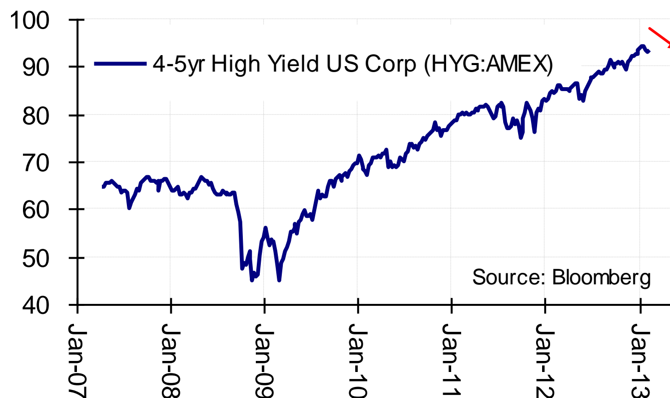
But it is important to note that the price of equities and bonds are increasingly an artificial construct - with interest rates being held hostage by the G4 central banks with their unconventional monetary policies.

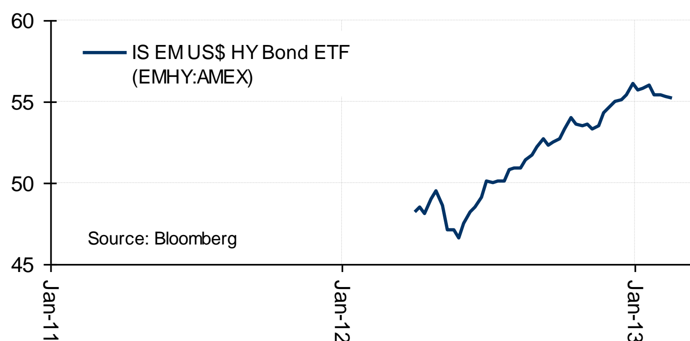
FIXED INCOME (MW)

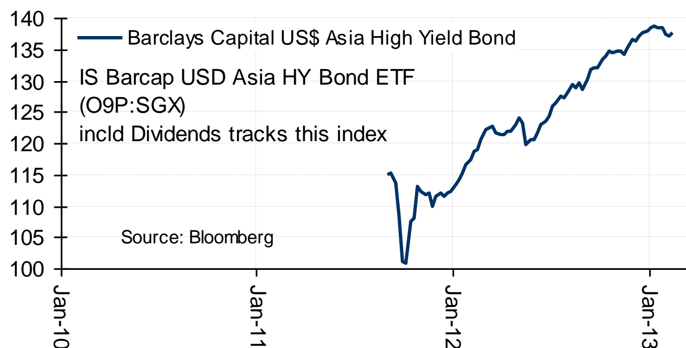
Recall that on the 24th Jan 13 we downgraded EM-Asia US$ and LC debt to MW. In this note, following from our 18th Feb morning commentary, **we formally downgrade US Corporate High Yield and EM-Asia High Yield fixed income (HYG.AMEX, EMHY.AMEX, O9P.SGX) from OW to MW on account of the following**:

(i) We believe the great rotation out of bonds into equities following better than expected global growth has long begun, and although HY generally trades in line with risk-on equity, we believe that…
(ii) the Market's relentless search for yield has resulted in the high yield space to be overcrowded and such desperation might have possibly resulted in some investors to overlook the significant credit risk that accompanies such products that are of relatively lower credit quality.
(iii) High-yield price returns have been flat. We reckon that there are better investment alternatives out there, such as equities.

Prices of High-Yield fixed income have peaked, warranting a downgrade to Market weight







Total Return	2012	2013	2013 rtn (ytd)	
Bonds				
US Treasuries	OW to UW 9th Oct	UW	-1.5%	correct
US MBS	OW	OW to UW 23rd Jan	-0.2%	<= downgrade
US Corp IG	OW to MW 9th Oct	UW	-0.3%	correct
US Corp HY	OW	OW to MW 28th Feb	1.3%	<= downgrade
EM-Asia US$ IG	OW	OW to UW 23rd Jan	-0.8%	<= downgrade
EM-Asia LC IG	OW	OW to MW 23rd Jan	0.8%	<= downgrade
EM-Asia HY	OW	OW to MW 28th Feb	0.6%	<= downgrade
simple average:	OW	MW	-0.01%	correct
Equities				
World	MW	OW	4.9%	correct
US	UW to MW 21st Dec	MW	6.7%	Possible Upside to MW call
EZ	UW	UW	2.9%	<= too pessimistic again?
Japan	-	MW	10.9%	Possible Upside to MW call
Korea	MW	MW	0.3%	Under Review - Downgrade UW
Taiwan	MW	MW	2.8%	correct
China (A)	OW 22nd Oct	OW	6.0%	correct (CSI 300)
China (H)	OW 22nd Oct	OW	-2.2%	Near-term weakness on possible property curbs
HK	OW 8th Oct	OW	3.8%	correct
SG	OW	OW	2.5%	correct
MY	MW	MW	-3.1%	<= reassess after elections
TH	OW	OW	3.1%	correct
ID	MW	MW	10.4%	Under Review - Upgrade OW
PH	OW	OW	13.8%	correct
India	UW	UW	-1.6%	correct
Commodities	UW	MW	-1.6%	correct
Gold	UW	UW	-4.4%	correct

OW = Overweight | MW = Marketweight | UW = Underweight

Source: PSR, Bloomberg (28 Feb 2013)

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	MW	HYG.AMEX / JNK.AMEX		
	EM US$ Govt	UW	EMB.AMEX		
	EM LC Govt	MW	LEMB.AMEX		
	EM US$ HY Corp & Govt	MW	EMHY.AMEX		
	Asian US$ Govt & Corp	UW	N6M.SGX		
	Asian LC Govt & Corp	MW	N6L.SGX		
	Asian US$ Corp HY	MW	O9P.SGX		
Equities (OW)	US	OW	SPDR S&P 500 (SPY:AMEX)		US SP 500 Index USD5 CFD (S&P500) / Wall Street Index USD1 CFD (DJIA)/ US Tech 100 Index USD5 CFD
	Europe	UW	SPDR Stoxx 50 (FEU:AMEX)		
	Australia	-	iShares MSCI Australia (IOZ:ASX)		
	Japan	MW	Nomura Nikkei 225 (1321.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$)**	STI SGD5 CFD / S'pore Index SGD20 CFD (SMSCI)
	Malaysia	MW	DBXT - MSCI Malaysia (LG6:SGX)		FBM KLCI MYR10 CFD
	Thailand	OW	DBXT - MSCI Thailand TRN (LG7:SGX)		
	Indonesia	MW	DBXT - MSCI Indonesia (KJ7:SGX)		Indonesia Index USD1 CFD (MSCI Indon)
	Phillippines	OW	DBXT - MSCI Philippines (N2E:SGX)		
	Vietnam	MW	DBXT - FTSE Vietnam (HD9:SGX)		
	India	UW	iShares MSCI India (I98:SGX)		India50 Index USD1 CFD (S&P CNX Nifty)
Commodities		MW	Lyxor Commodity 10$US (A0W:SGX)		
Gold		UW	SPDR Gold ETF (O87:SGX or GLD:AMEX)		

Important Information

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