US Macro, Asset Strategy

Buy Mortgage Backed Securities, high-yield US corporate bonds

Ng Weiwen

Products: ETF | CFD | Unit Trust

24 October 2012

Phillip Securities Research Pte Ltd

- **Index ETFs: (i)SPDR S&P 500 (SPY:NYSE), (ii)SPDR Dow Jones Industrial Average ETF (DIA:NYSE), (iii) Nasdaq PowerShares (QQQ:NASDAQ).**
- **Index CFD (Long/Short): (i) US SP 500 Index USD5 CFD, (ii) Wall Street Index USD1 CFD, (iii) US Tech 100 Index USD5 CFD.**
- **Unit Trusts (US-centric). Bonds: (i) Fidelity - US Dollar Bond A Inc -USD, (ii) Fidelity - US High Yield A -USD; Equities: Lion Global - Infinity US 500 Stock Index -SGD**
- **Table summary of US Asset Strategy Pg2, with equity sector preference via ETFs Pg 3.**

The US is increasingly evolving into a Jekyll and Hyde economy. The schizophrenia reflects households being more confident and increasing consumption expenditure, on the back of a firmer recovery in the housing market and notwithstanding elevated unemployment rate. By contrast, businesses are delaying investments in view of global slowdown as well as uncertainties shrouding the looming fiscal cliff.

While we expect some political gridlock over the fiscal cliff as well as the debt ceiling in view of a bipolar dysfunctional Congress, we do not expect the US economy to be dealt with a full-blown fiscal cliff. In fact, once these uncertainties clear, we should see a rebound in investment led by pent-up demand.

Looking ahead, market gyrations are likely the norm owing to constantly changing risk perception in view of unfolding political events as well as macro data releases. In such an environment, our key calls for the US market -which will perform well either in a risk-on or risk-off environment- are as follows:

- Long Mortgage Backed Securities (ETFs: VMBS:US) - the Fed is going to buy this at US$40b/mth indefinitely until the economy rebounds – which on the Fed's definition of 5-6% unemployment, which could take a while.
- Long high-yield US corporate bonds (ETF: HYG:NYSE) as US$ portfolios move out of treasuries and investment grade corporate to trudge further along the risk spectrum in search of yield.
- Long Treasury inflation-protected securities (ETF:TIP). Portfolios are loading up TIPs as inflation insurance in view of the open-ended nature of QE3.
- Long (i) iShares Dow Jones Select Dividend Index Fund (ETF: DVY) (~3.5% Div Yield), (ii) iShares S&P U.S. Preferred Stock Index Fund (ETF: PFF) (~5.7% Div Yield) which offer relatively attractive yield.

The S&P500 is just a whisker away from its cycle high. However, in view of the elevated uncertainties ahead arising from the looming fiscal cliff as well as unresolved issues on the EZ front, markets are faltering and struggling to make new highs. For the rally to sustain, apart from asset reflation via central bank easing, corporate earnings as well as macro fundamentals will need to improve.

We are underweight US equities despite "cheap valuations", on the macro risks highlighted above. In view of the massive stimulus by the government to prop up the economy, we are unsure of what the 'true' demand actually is. Hence, valuations might not actually be that cheap when considered from this angle.

Within the equity space, we prefer:

- Healthcare (XLV) - a defensive sector with high growth potential and broad-based demand.
- Financial (XLF) should also stand to benefit from increased mortgage lending (on the back of a housing recovery) and extremely low borrowing rates from the Fed.
- Homebuilders (XHB: NYSE) in view of the firmer recovery in the housing market.

We are neutral on Technology (XLK), Consumer staples (XLP), Consumer discretionary (XLY) and Energy (XLE). We have low conviction on Utilities (XLU), Industrials (XLI) and Materials (XLB).

We have yet to see a significantly weaker USD, notwithstanding the abundant global liquidity as well as reduced tail risks arising from the QE3-OMT announcements. Looking ahead, we expect the USD index (DXY) to remain soft (in a consolidation phase) - rather than an outright steep decline- on account of the following:

(i) relative outperformance of the US economy compared to other developed economies the EZ, UK and Japan.

(ii) possible spike in risk aversion -which would see safe haven flows into the Treasuries, thus temporarily supporting a stronger USD.

(iii) Furthermore, currencies should always be viewed from a relative basis. Specifically, central banks elsewhere might intervene to limit the near-term appreciation pressures on their currencies against the weak dollar.

With that in mind, our regional investors can assess whether there are currency translation gains -on top of capital gains- to be reaped from their US investments.

Summary of Our US Cross Asset Views

* Absolute Return: BL = Bullish ; N = Neutral ; BR = Bearish
* Relative Return: OW = Overweight ; MW = Neutralweight ; UW = Underweight

	Absolute Return/ Relative Return	Last Price (US$)	3 Month Total Return (%)	YTD Total Return (%)	Dividend Yield (%)	Dividend Freq
Treasuries						
iShares Barclays TIPS Bond Fund	N/OW	121.51	0.51	5.97	2.06	Monthly
iShares Barclays 10-20 Year Treasury Bond Fund	N/UW	134.28	-2.28	3.14	2.32	Monthly
iShares Barclays 20+ Year Treasury Bond Fund	N/UW	120.96	-4.65	2.45	2.84	Monthly
Mortgage-Backed Securities						
Vanguard Mortgage-Backed Securities ETF	BL/OW	52.70	0.44	2.69	1.98	Monthly
SPDR Barclays Capital Mortgage Backed Bond ETF	BL/OW	27.74	-0.20	2.13	2.93	Monthly
Corporate Bonds						
iShares iBoxx Investment Grade Corporate Bond Fund	N/MW	122.51	2.79	11.21	3.83	Monthly
iShares iBoxx $ High Yield Corporate Bond Fund	BL/OW	92.98	2.95	9.41	6.74	Monthly
Vanguard Long-Term Corporate Bond ETF	N/MW	93.19	1.61	11.53	4.27	Monthly
Index ETFs						
SPDR S&P 500 ETF Trust	N/UW	143.41	4.67	15.96	1.99	Quarter
SPDR Dow Jones Industrial Average ETF Trust	N/UW	133.10	3.73	11.43	2.42	Monthly
Powershares QQQ Trust Series	N/UW	66.02	1.18	18.45	0.93	Quarter
Dividend-play Equities						
iShares Dow Jones Select Dividend Index Fund	-	58.16	2.02	11.37	3.46	Quarter
iShares S&P US Preferred Stock Index Fund	-	40.04	3.42	17.68	5.71	Monthly

Source: Bloomberg, data as at close of 22 October 2012 US trading session

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Summary of Our US Equity Sector Views (See Pg 5-7 for details)

	Ticker	Last Price (US$)	3 Month Total Return (%)	YTD Total Return (%)	Dividend Yield (%)	Dividend Freq
Prefer						
Health Care Select Sector SPDR Fund	XLV	40.63	5.29	18.84	1.90	Quarter
Financial Select Sector SPDR Fund	XLF	16.11	10.84	25.43	1.64	Quarter
SPDR S&P Homebuilders ETF*	XHB	26.01	20.41	53.97	0.86	Quarter
Neutral						
Technology Select Sector SPDR Fund	XLK	29.49	1.10	16.38	1.51	Quarter
Consumer Staples Select Sector SPDR Fund	XLP	35.73	1.99	12.04	2.67	Quarter
Consumer Discretionary Select Sector SPDR Fund	XLY	46.43	5.54	20.58	1.45	Quarter
Energy Select Sector SPDR Fund	XLE	73.46	8.06	8.19	1.64	Quarter
Low Conviction						
Materials Select Sector SPDR Fund	XLB	37.26	4.62	12.32	2.01	Quarter
Industrial Select Sector SPDR Fund	XLI	36.69	4.03	10.74	2.17	Quarter
Utilities Select Sector SPDR Fund	XLU	37.01	-0.23	6.17	3.87	Quarter

* not a sector fund but one of our preferred ETFs
Source: Bloomberg, data as at close of 22 October 2012 US trading session

MACRO OUTLOOK

QE3 was a game-changer...

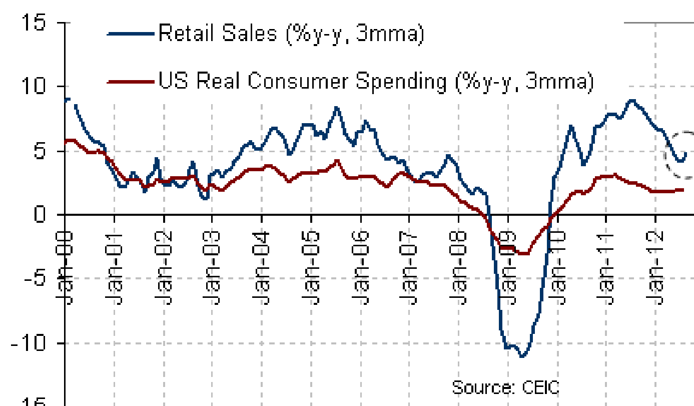
- Bernanke launched QE3 during September, sending equity markets surging to multi-year highs. We -along with markets- have been expecting QE after the dovish stance reflected in the Aug FOMC minutes as well as hints dropped by Bernanke at the Jackson Hole symposium, and our view was that it will be a close call for Sept FOMC. While the nature of this round of QE is unprecedented, it is consistent with what we have guided in our morning commentary.

- Specifically, the expanded asset purchase program will be (i) open-ended and (ii) new purchases will entirely comprise of mortgage-backed securities (to the tune of US$40bn/mth). Furthermore, (iii) the current low rate guidance will be extended into 2015. Notably, the accommodative stance hinged on the labour market improvement and had a tinge of "Evans rule" flavour in it. The FOMC statement explicitly said *"If the outlook for the labor market does not improve substantially, the Committee will continue its purchases of agency mortgage-backed securities, undertake additional asset purchases, and employ its other policy tools as appropriate until such improvement is achieved in a context of price stability."* Looking ahead, while we do not expect major monetary policy announcements prior to the Nov elections, the positive impact from the Sept FOMC decision extends well beyond.

- What impact will the Fed's latest move have on the economy? First, by focusing the new asset purchases on MBS only (rather than including Treasuries), it will effectively lower the private cost of mortgage borrowing and provide a direct boost to the economy. Second, by hinging the duration of this asset purchase on the economic outlook (more specifically the labour market) rather than a date (as per past practices), it will ensure that financial conditions remain accommodative when necessary, thereby providing an essential confidence booster to businesses and consumers.

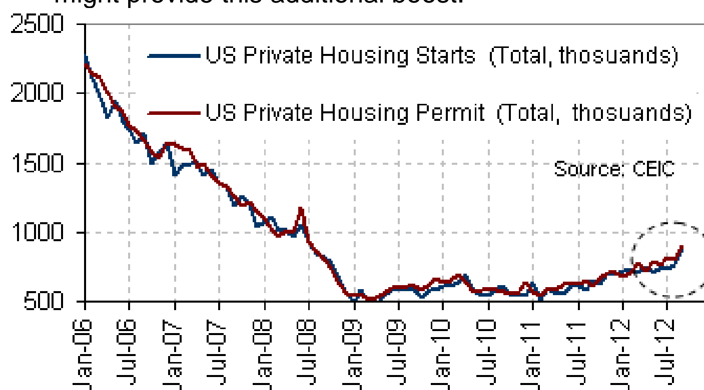
Retail sales have increased along with a rise in confidence

- Thus far, it seemed that QE3 is working through the economy via 2 channels: (i) asset reflation (wealth effect via gains from the equity market) and (ii) confidence. With regard to the latter channel, increased confidence (as reflected by recent gains in the University of Michigan consumer sentiment index) might translate to higher consumption spending which could provide a much-needed boost to the sluggish economy. Already, there are some signs of this. Retail sales surged 1.1% m-m in September, following revised gains of 1.2% in the preceding month, largely due to an increase in electronics purchases (iPhones). Thus, we look to more positive months of gains in retail sales to confirm whether the Fed's assurance of maintaining accommodative monetary policy for an extended period of time will continue to spur consumption spending amid a sluggish labour market.



Housing market is showing signs of a turnaround with inflation relatively benign

- We see some signs of stabilisation in the housing market, especially with the rise in housing starts. But this housing rebound has not been able counter the broad slowdown – yet. Though QE3 - with its focus on MBS- might provide this additional boost.



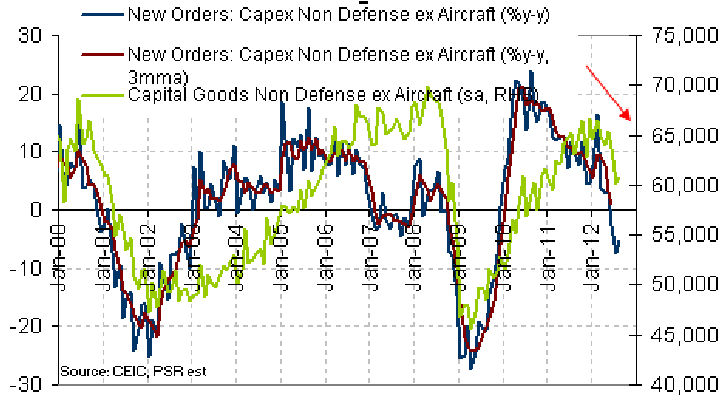
- Inflation has remained relatively benign, though much of the recent rise has been attributed to higher energy prices. The PCE deflator- the Fed's preferred gauge of inflationary pressures- rose 1.5% in August while the consumer price index for urban consumers rose 2.0% in Sept.

- But we caution that inflation expectations have risen with most major central banks easing, along with the open-ended nature of QE3 as well as 'unlimited' scope of OMT.

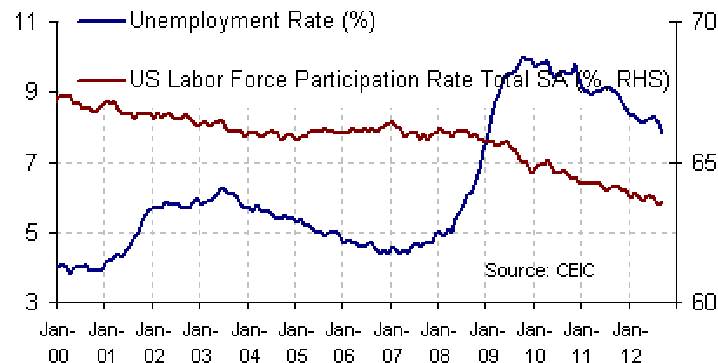
- Nonetheless, we expect the Fed to allow inflation to run above the official target of 2% if need, in an attempt to address the considerable slack in the economy as well as elevated unemployment rate via massive monetary easing.

But capex cycle has peaked and unemployment still remains elevated...

- In the US, the slowdown in investment cycle portends an end to the business cycle. Capex cycle has peaked with new orders turning negative and manufacturing new orders continue to slump.



- Unemployment has also remained elevated with jobs simply not created fast enough. Increasingly, frustrated job seekers have given up looking for a job, which translated to a declining labour force participation rate.



- **We forecast real GDP growth to come in at 2.0% in 2012 and 1.8% in 2013.** But should the downside risks - detailed earlier- materialize, growth could come in lower. **Consumer price inflation is expected to rise 2.3% in 2012 and 2013.** Still, we think that there are upsides to this inflation forecast, especially if inflationary expectations come unhinged and commodity prices surge (on the back of speculative demand, geopolitical tensions, stronger-than-expected recovery in global demand).

Downside risks still persist

- The US economy is confronted with challenges on the domestic as well as external fronts. On the external front, an escalation of financial stress in the eurozone might result in an environment of risk aversion. In such an environment, US might once again see safe haven flows which would lend support to low bond yields. However, the USD might face appreciation pressures which will then dampen exports amid sluggish global trade.

- Domestically, a looming fiscal cliff awaits. The fiscal withdrawal threatens to weigh on US GDP growth and could tip the economy into a mild recession if it is not adequately addressed and if gridlock ensues amid a bipolar dysfunctional Congress.

- Specifically, expiring tax provisions as well as automatic spending cuts of around US$600 bn could easily push the US down the fiscal cliff.

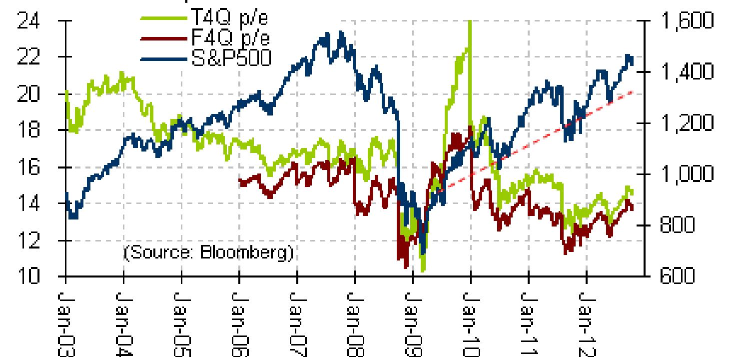
- Furthermore, total debt is fast approaching the statutory borrowing limit of US$16.394 trillion which will likely be breached by the end of this year. Thus, Congress need to raise the debt ceiling in a timely manner and make substantial progress on medium-term fiscal reforms. Political brinkmanship over this matter would risk Moody's -following S&P footstep of stripping the US of its triple-A rating.

ASSET STRATEGY

UNDERWEIGHT (US) EQUITIES

- We are neutral on equities as an asset class. While it's hard to be bearish on global equities on a 3 month horizon owing to the positive sentiment from QE3-OMT, we think one can't be outright bullish either in view of the divergence between markets and economics.

- Will markets recover from its QE-induced overhang? The S&P500 is just a whisker away from its cycle high. However, in view of the elevated uncertainties ahead arising from the looming fiscal cliff as well as unresolved issues on the EZ front, markets are faltering and struggling to make new highs. For the rally to sustain, apart from asset reflation via central bank easing, corporate earnings as well as macro fundamentals will need to improve.



- **Underweight** US equities despite "cheap valuations", on the macro risks highlighted earlier. In view of the massive stimulus by the government to prop up the economy, we are unsure of what the 'true' demand actually is. Hence, valuations might not actually be that cheap when considered from this angle.

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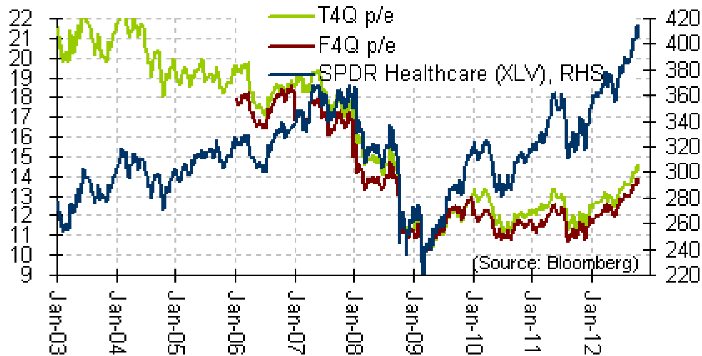
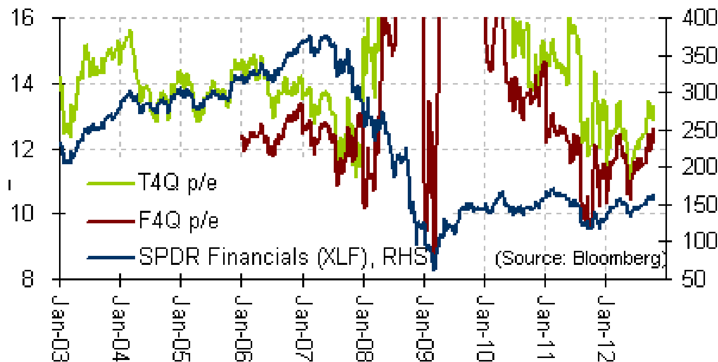
- We maintain a defensive bias in our equity sector recommendation. Some defensive sectors are potentially overvalued: **Consumer Staples (*XLP*), Utilities (*XLU*)**. Instead, we recommend **Healthcare (*XLV*)** - a defensive sector with higher growth potential and broad-based demand. ***Financial (XLF)*** should also stand to benefit from increased mortgage lending (on the back of a housing recovery) and extremely low borrowing rates from the Fed.

We **prefer**:

- **Healthcare (XLV)**. We like healthcare especially after greater certainty over the Affordable Care Act which has been ruled constitutional and would be extended to millions of Americans who would otherwise be uninsured. Furthermore, valuations are still below the historical average of T4Q P/E +20x. However, we caution that in US fiscal consolidation plans, healthcare (particularly medicare) spending could be slashed, dulling the allure of the sector.



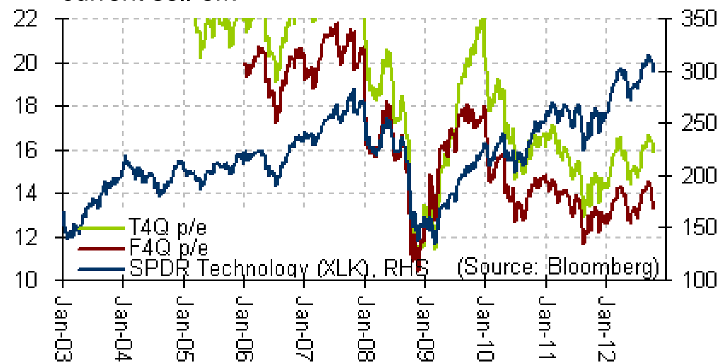
- **Financials (XLF)** could benefit from a generous spread between the relatively higher rates they lend out to corporates and the rock bottom rates they borrow from the Fed. Furthermore, with the housing market showing signs of turning around the corner and mortgage rates falling, banks could benefit from a resurgence in mortgage demand and rid foreclosed properties from their balance sheets.



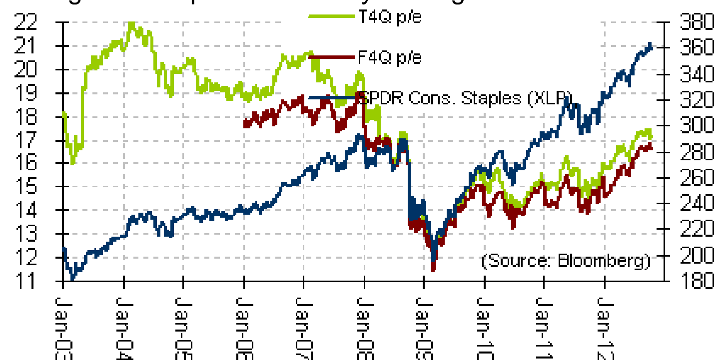
- **Homebuilders (XHB)** should continue to benefit as the recovery in the housing market continues to gain traction.

We are **neutral** on:

- **Technology (XLK)**. Major tech heavyweights such as IBM, Microsoft, Intel as well as Google have recently reported disappointing earnings. In the near term, the sell-off in tech is likely to persist until there is greater clarity on the fiscal front. Nonetheless, we wish to highlight that the tech sector is likely receive a boost from a potential uptick in technology spending (in equipment and software) in a broader productivity push when companies ramp up capital spending amid accommodative monetary conditions and after uncertainties over the fiscal cliff clear up. In such an event, **we might revisit our rating on tech with an upgrade** only after tech has bottomed out following the current sell-off.



- **Consumer staples (XLP) and Consumer discretionary (XLY)**. These two defensive sectors have enjoyed a strong rally of late and would continue to do so should risk aversion set in, owing to a possible escalation of crisis on the G2 sovereign debt crisis. However, (i)a swing to risk-on mode owing to accommodative monetary conditions as well as (ii) rising agricultural prices are likely to weigh on these 2 sectors.



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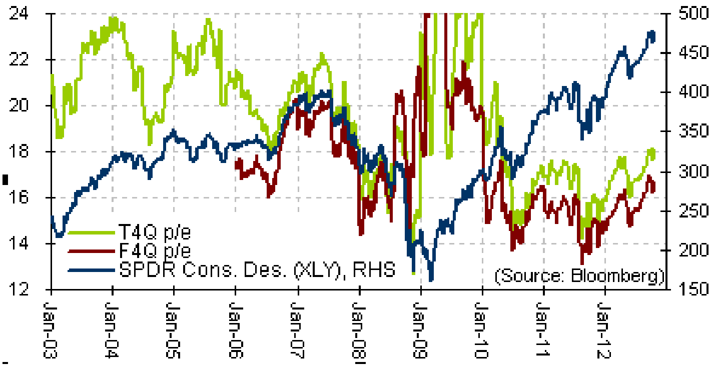
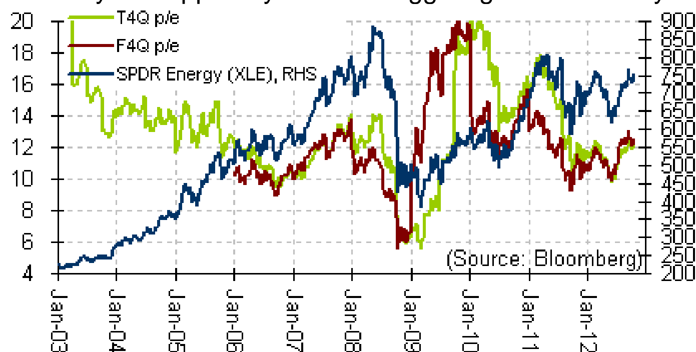
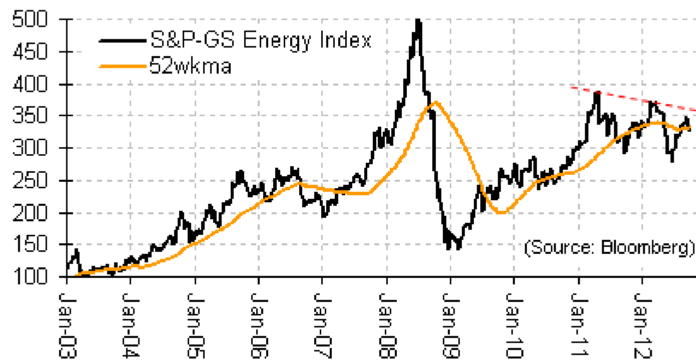


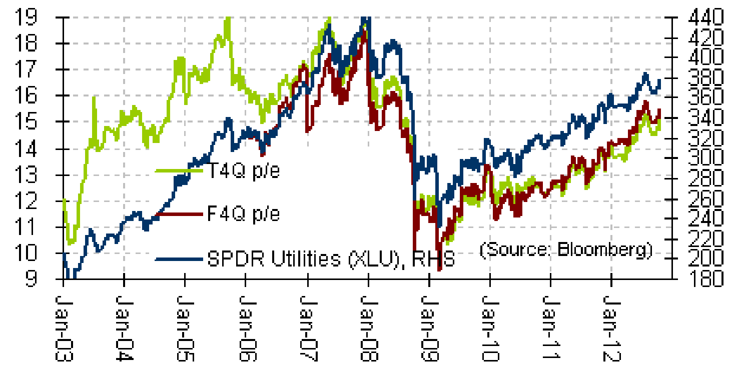
- **Energy (XLE)**. While energy will likely receive support from an easing bias as well as upsides owing to supply threats arising from geopolitical tensions, any gains will likely be capped by the still sluggish global economy.



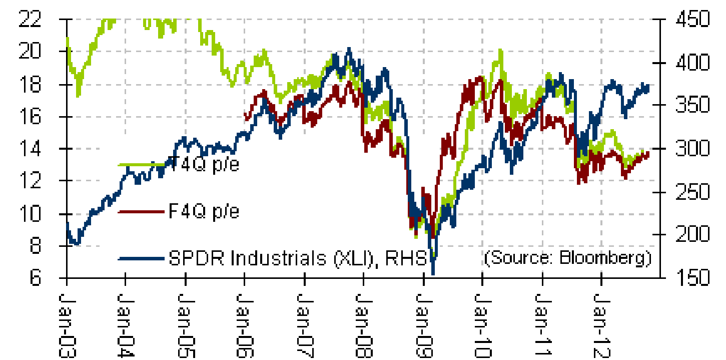


We have **low conviction** on the following:

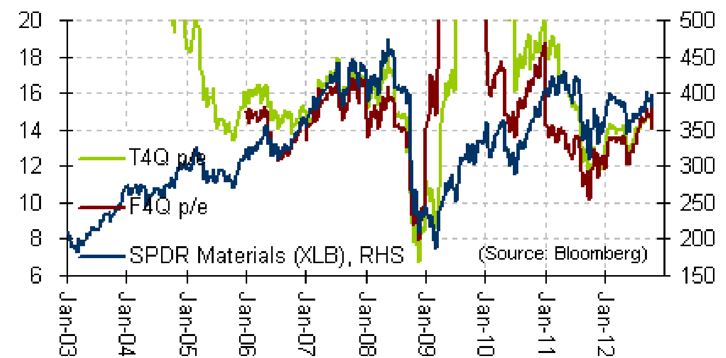
- **Utilities (XLU)**. With market chasing yields for some time, valuations have been overstretched. Furthermore, if the economy does rebound and risk appetite improves, utilities - a defensive sector- would take a beating. Conversely though, if uncertainties over the looming fiscal cliff as well as EZ sovereign crisis rise, defensives such as utilities could enjoy further upsides- though it is likely to be limited.



- **Industrials (XLI)**. Most economic bellwethers -such as FedEx, 3M- are part of this classification and they have either slashed profit forecasts or warned of a sluggish economic outlook ahead. Furthermore, sluggish manufacturing activity (as reflected by the US ISM index) as well as the prospect of fiscal austerity in the G2 economies do not bode well for the industrials sector.



- **Materials (XLB)**. We have low conviction on materials on account of sluggish external demand as well as China's insipid policy response to its economic slowdown in a broader bid to restructure towards domestic demand.



- Should investors not be able to stomach wild swings in equity markets or do not have a directional view on the markets, they might consider entering long positions (on weakness) the following bond-like equity ETFs that offer attractive dividend yields :
  (i) **iShares Dow Jones Select Dividend Index Fund (DVY: NYSE)** (~3.5% Div Yield)
  (ii) **iShares S&P U.S. Preferred Stock Index Fund (PFF: NYSE)** (~ 5.7% Div Yield)

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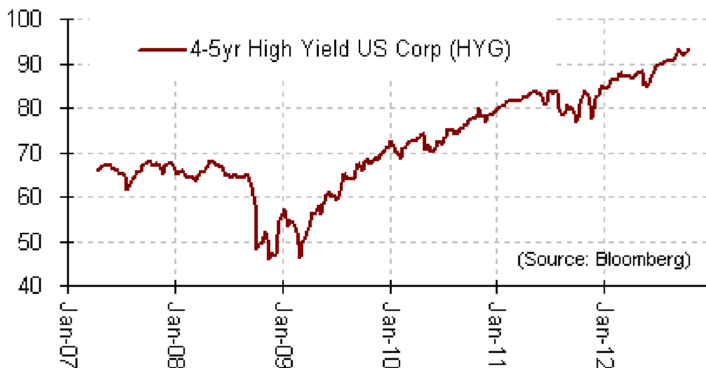
OVERWEIGHT BONDS

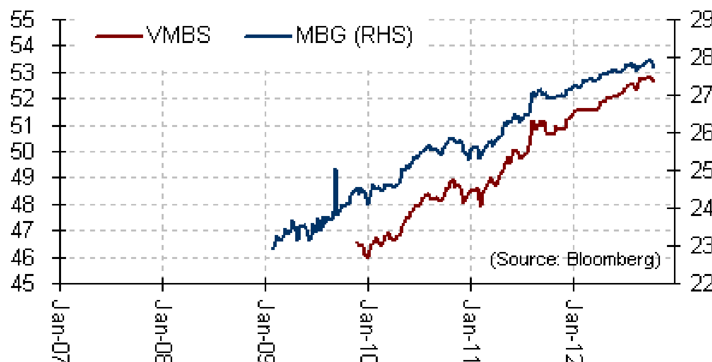
- Global risk on or risk off, portfolios will have to explore beyond traditional safe havens - which yield too low to protect purchasing power and have doubtful credit ratings. We reiterate our main investment theme, which is long EM/Asia Debt (**Asia Bond ETFs: N6M:SGX, N6L:SGX, O9P:SGX | EM Bond ETFs: EMB:US, LEMB:US, EMHY:US**) –EM nations on the other hand have nominal GDPs compounding faster than debt and +3.5% yields to boot, and are likely to increasingly feature as core-fixed income holdings. Interestingly both US$ and LC denominations are on strong uptrends as US$ portfolios diversify their US$ holdings to include EM/Asia.

- On the back of easing by major central banks QE3-OMT, we expect interest rates to remain low for a considerable period. Such environment will drive investors' appetite for yield plays. What are some opportunities in the US market?

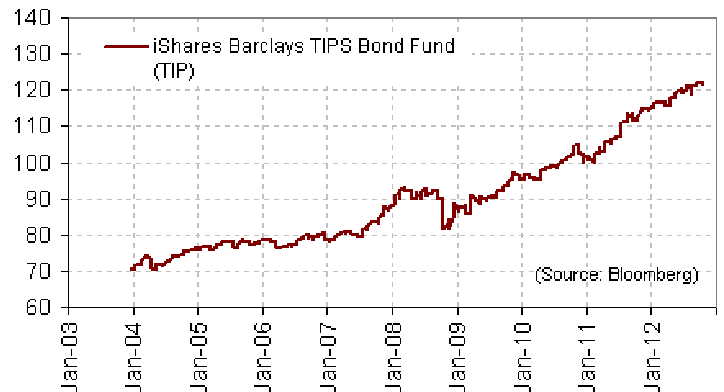
- On the fixed-income asset class, we are **OW high-yield US corporate bonds** (ETF: **HYG:NYSE**) as US$ portfolios move out of treasuries and investment grade corporate to trudge further along the risk spectrum in search of yield.



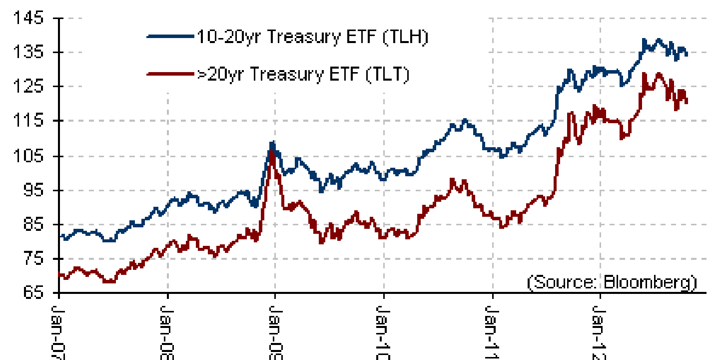
- We are also **OW Mortgage Backed Securities** (ETF: **VMBS:US**) - the Fed is going to buy this at US$40b/mth indefinitely until the economy rebounds and the labour market outlook improves substantially – which on the Fed's definition of 5-6% unemployment, which could take a while.

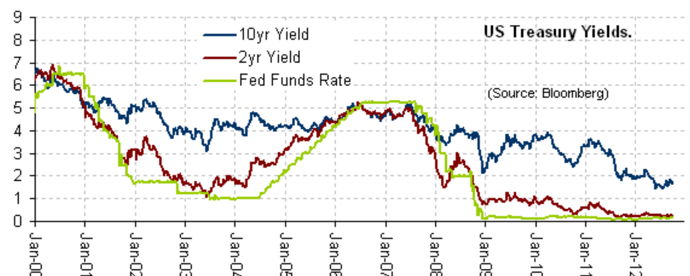


- Long **Treasury inflation-protected securities** (**ETF:TIP**). Portfolios are loading up TIPs as inflation insurance in view of the open-ended nature of QE3.



- We are **UW US Treasuries** (ETFs: **TLH:NYSE, TLT:NYSE**) and MW US Investment Grade Credit (ETFs: **VCLT:NYSE** and **LQD:NYSE**). US Treasuries took a beating with the QE3-OMT inducing risk-on appetite. Furthermore, treasuries are not the primary target of the Fed's QE3. We have low conviction on treasuries and so underweight them. But we caution in view of the fiscal challenges ahead for the G2 economies, the mood could easily swing to risk-off mode and we will see once again safe-haven flows into the Treasuries.





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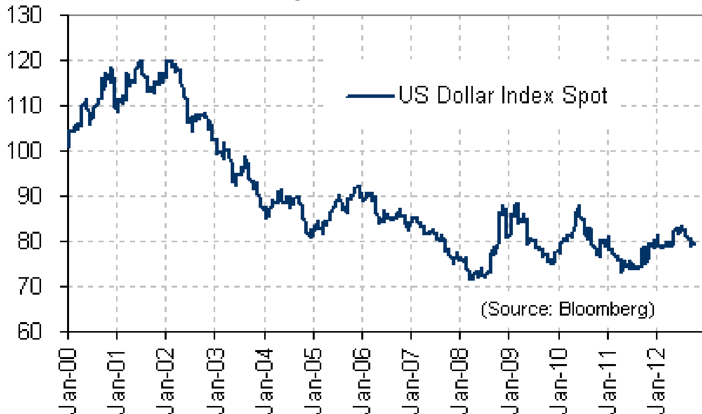
CURRENCY OUTLOOK

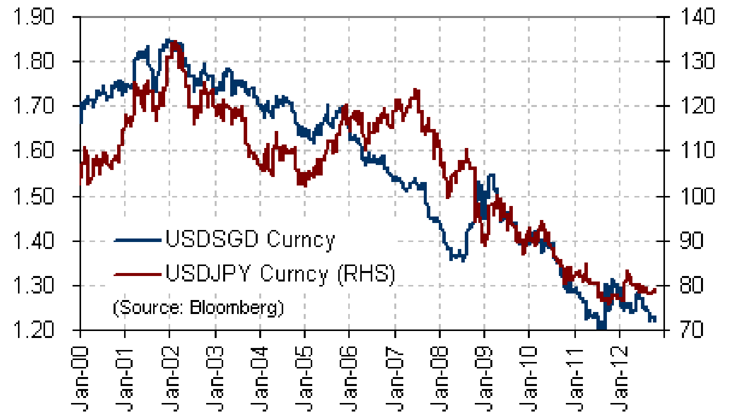
We have yet to see a significantly weaker USD, notwithstanding the abundant global liquidity as well as reduced tail risks arising from the QE3-OMT announcements. Looking ahead, we expect the USD index (DXY) to remain soft (in a consolidation phase) -rather than an outright steep decline- on account of the following:

(i) sluggish growth prospects elsewhere. Specifically, developed counterparts EZ, UK, and Japan are likely to underperform the US.

(ii) possible spike in risk aversion -which would see safe haven flows into the Treasuries, thus temporarily supporting a stronger USD.

(iii) Furthermore, currencies should always be viewed from a relative basis. Specifically, central banks elsewhere might intervene to limit the near-term appreciation pressures on their currencies against the weak dollar.





- Let us dwell a bit on the outlook for the USDJPY as well as the USDSGD for the benefit of our Japanese as well as Singapore clients.

- **USDJPY**. We expect the yen to remain soft in view of (i) possible BoJ intervention amid concerns that a stronger yen hurt the competitiveness of domestic exporters as well as (ii) relatively loose BoJ monetary policy which will likely limit gains. Recently, Japan announced plans of a 200bn Yen fiscal stimulus. Consensus USDJPY year-end est : 79

- **USDSGD**. We expect the SGD to be strong against the dollar. At the recent Oct Monetary Policy Statement, MAS stood pat- maintaining the slope, width of the policy band and the level which S$NEER is centered. As we have guided previously, we did not rule out the possibility of MAS standing pat in a bid to anchor inflation expectations and fend off QE3-induced capital inflows inflationary pressures. Furthermore, the SGD is one of the few attractive safe havens available, buoyed by strong macro fundamentals. Consensus USDSGD year-end est: 1.22

Important Information

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