



**Analyst**  
**Hillary Ho Li Ling**  
+6565311517  
hillaryho@phillip.com.sg

## ECONOMIC UPDATE

### Executive Summary

**United States:** At this moment, economic condition has not deteriorated to an extent where support from the government becomes necessary. It's normal for economic activities to pull back after the initial stage of recovery. We maintain our belief that a sub-par recovery will persist.

**China:** Softening of the Chinese economy and acceptable inflation levels will allow the government to temporarily shelve any tightening measures.

### United State: Hope for more stimulus

Recoveries around the world are looking less certain than they did a few months ago and this has prompted a new round of calls for additional expansionary policy. How necessary are these stimulus? Can the economy sustain without further incentive from the government? In this report, we examine to what extent is further stimulus necessary at this point in time.

The headline number of many data sets is no doubt important. However, it can be the underlying components of reports that tell the more accurate story. The latest report on ISM manufacturing index signaled that economic activity in the manufacturing sector expanded in July for the 12th consecutive month and the overall economy grew for the 15th consecutive month. The purchasing manager index stood at 55.5 percent in July, a decline of 0.7 percentage point from June. This marked the third consecutive decline after the index hit a peak of 60.4 percent in April this year. Employment, supplier deliveries and inventories improved during the month. The prices that manufacturers paid for their inputs were slightly higher but stable. However, new orders, which show what future activity may look like, fell back on the manufacturing side to a one-year low, though it's still in the expansionary territory at 53.5.

A study of past recessions (as defined by the National Bureau of Economic Research) shows that it is normal for growth momentum to fade after the initial recovery phase. This is illustrated in the figure below. Areas shaded in grey represent periods of recession. It is shown that growth typically declines after the economy emerge from recession.

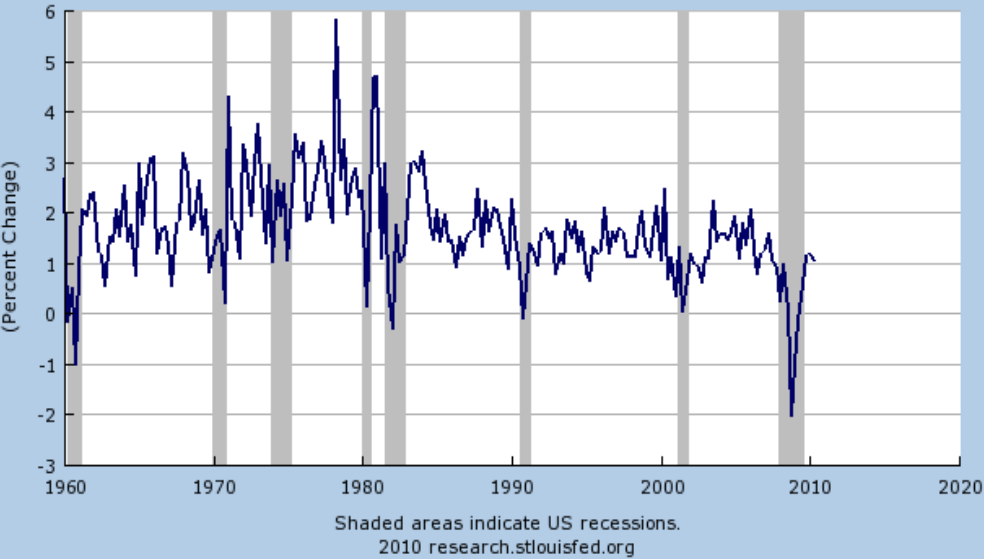
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**Figure 1: US Gross Domestic Product**

Gross Domestic Product, 1 Decimal (GDP)  
Source: U.S. Department of Commerce: Bureau of Economic Analysis



Source: 2010 research.stlouisfed.org

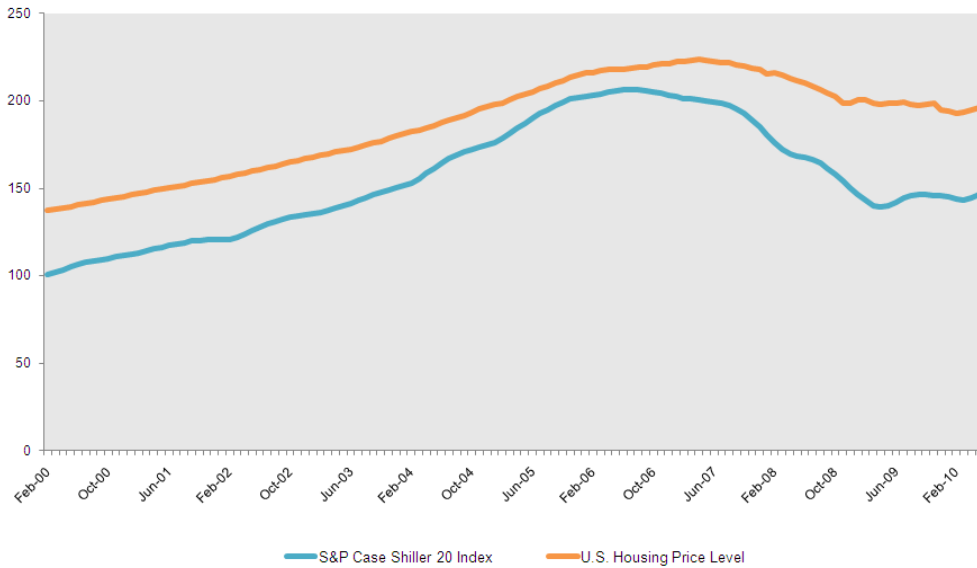
We once again examine the factors that are crucial for the economy to self sustain (i.e. factors that affect consumption levels). On the housing front, data has been distorted by the expiration of the federal homebuyer tax credit, but that distortion should be fading, and June pending home sales still fell 2.6 percent. While much better than the 29.9 percent decline we saw in May immediately after the tax credit expiration, it still missed expectations of a positive reading. Meanwhile, in terms of supply, the number of unsold homes in the market and the vacancy rates have continued to rise, suggesting that supply fundamental has deteriorated further. The combination of a decline in sales and a rise in the number of homes up for sales has boosted the excess inventory. At current rates of sales, in June it would have taken 8.5 months to clear all the unsold homes on the market, up from 8.0 in May. In view of an ample supply of houses in the market and the lack of stimulus to spur demand, it seems unlikely at this moment that housing prices will rise substantially.

*On the housing front, an ample supply of houses in the market and the lack of stimulus to spur demand, suggests that housing prices are unlikely to rise substantially in the near term.*



**Figure 2: Housing Prices**

### Housing Prices



Source: Bloomberg, May 2010

In our previous report, we have mentioned that housing price levels very much influence the financial position of households. In turn, this affects individual's willingness to consume. There is interdependence between the two variables. As such, with housing prices unlikely to rise substantially, consumption will inevitably be affected to a certain extent. Despite so, all hope is not lost as current housing prices as measured by the Case-Shiller 20-City price index is still 4.6 percent above the trough. Therefore, while prices seem to be heading south, it is probably no cause for alarm.

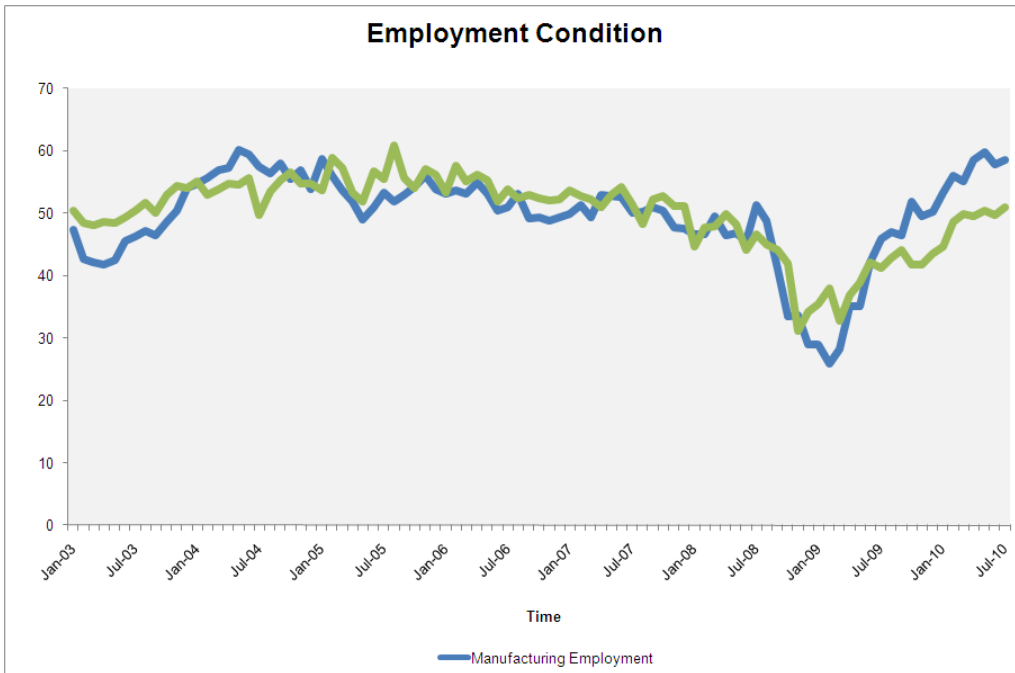
Persistently high unemployment rate continues to garner attention on Wall Street. While unemployment rate remained at 9.5 percent, July labor report showed private payroll rose by 71,000, though still relatively anemic. It is also encouraging to note that the average workweek ticked up to 34.2 hours from 34.1 hours in June. There is hope on the labor horizon as leading indicators continue to show improvement. For instance, the employment component on the ISM Manufacturing Index rose to 58.6 from 57.8 and the same indicator in the non-manufacturing report rose to 50.9 from 49.7, indicating expanding employment in the service sector.

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**Figure 3: Employment**



Source: Bloomberg, July 2010

Hence, at this moment, economic condition has not deteriorated to an extent where support from the government becomes necessary. As mentioned earlier, it's normal for economic activities to pull back after the initial stage of recovery. Indeed, in the minutes of the latest policy meeting, Federal Reserve officials said further central-bank action might be necessary if the economic outlook "were to worsen appreciably". We maintain our belief that a sub-par recovery will persist. Nonetheless, we will continue to watch for indicators that will signal a change in tide.

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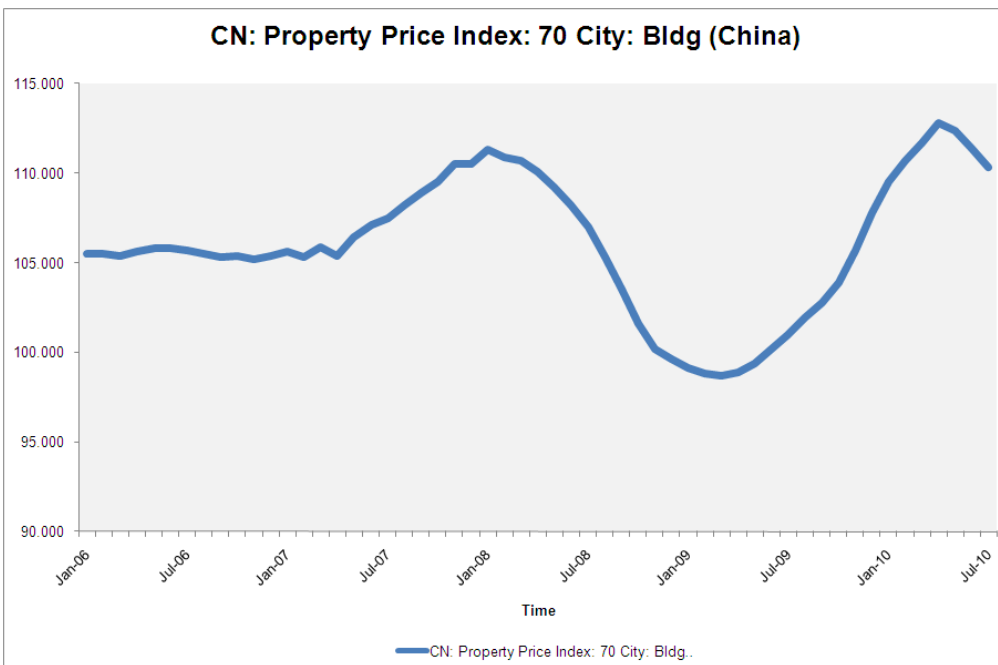


### China

We maintain our focus on the property market as we think this is an area, which will continue to gain traction from the Chinese government in the near term. The government's efforts to curb speculation continue to be met with some success. Chinese property prices measured by the 70 city property price index declined for the third consecutive month. The index, which stood at 111.40 in June 2010, fell by close to 1 percent in July to close at 110.30. The magnitude of decline is once again larger relative to the month before. Despite so, from a year ago, property prices are still higher by approximately 9 percent.

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**Figure 4: Property Price Index**



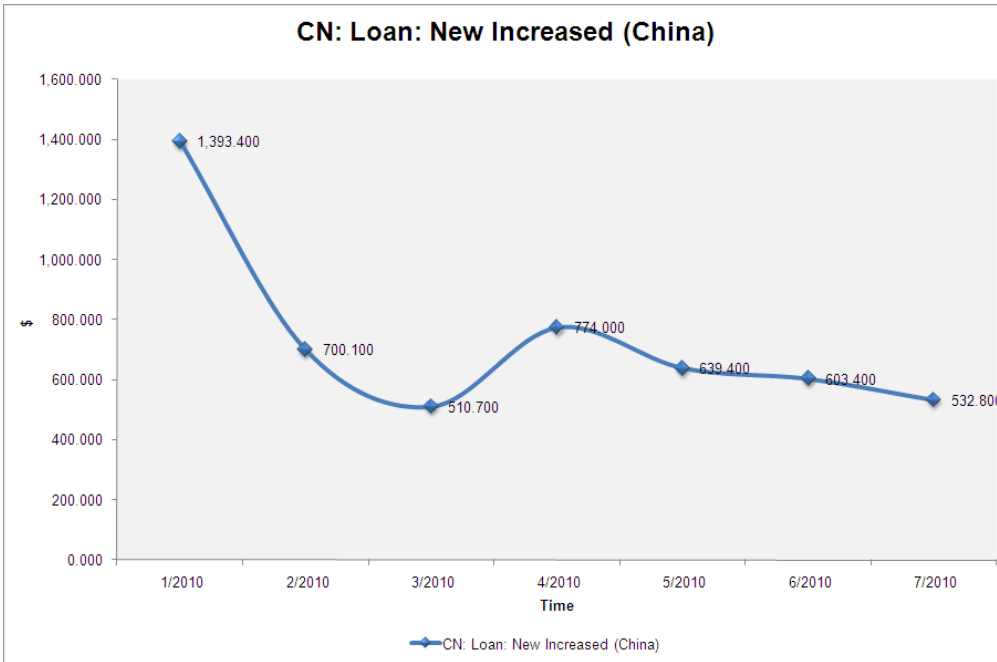
Source: CEIC. As of July 2010

Meanwhile, the rate of growth of new loans continues to decline for the third consecutive month in July. The cumulative amount of new loans granted till date is approximately RMB 5.2 trillion. We mentioned previously that to keep the total amount of loans created to RMB 7.5 trillion, the amount of loans granted on a monthly basis should not exceed RMB 463 billion for the rest of the year. Once again, the rate of growth has exceeded the “permissible” amount.

*Once again, the rate of growth has exceeded the “permissible” amount.*



**Figure 5: New Loans**



Source: CEIC. As of July 2010

In other aspect of the Chinese economy, consumer price inflation registered a sharp rise in July. Consumer price index rose 3.3 percent in July from a year earlier. We do not think that the sudden turnaround in prices should be a cause for concern. This is so as the rise in prices was due to a surge in food prices following severe flooding. Food prices rose by around 1.5 percent in July relative to June after four consecutive months of decline. Non-food prices on the other hand are at a low and steady level.

Industrial production is still on the decline. Output growth dropped 13.4 percent year-on-year, down from 13.7 percent in June and 16.5 percent in May. Some of the decline is due to the relative strength this time a year ago and some to the gradual winding down of stimulus-linked investment. The government campaign against property market speculation also seems to have triggered a sharp fall in output growth from heavy industry.

Although property price levels and loan growth rate remain above the government's targets, they have nonetheless ease from the top. Softening of the Chinese economy and acceptable inflation levels will allow the government to temporarily shelve any tightening measures.

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**Analyst**  
**Liang Shibin**  
 +6565311516  
 liangsb@phillip.com.sg

## CHOOSING THE RIGHT PLACE TO BE IN

### Executive Summary

**Equities** – Global equities were up as Greater China equities outperformed significantly, China on track to become the second biggest equity market.

**Commodities** – Wheat prices spiked on supply shock. Commodities are likely to experience short term strength on non-commercial traders' positioning.

**Fixed income** – The strong upward momentum in Treasury bonds continued as yields are likely to stay near historical lows; Asian bond market shines.

### Equities – The Chinese Dragon Awakes

We saw a positive monthly performance among global equities in August. In particular, the China benchmark index rose a stuttering 10% over the one month period. Greater China equities were the top 3 best performing markets on bargain hunting as valuations on the region's equities were below their 3-Year and 5-Year average (as mentioned in the prior month report). Weak economic numbers and a stronger yen continued to take a beating on the Japanese equities, sending the Nikkei 225 down more than 10.4% over the 3 month period. On the Southeast Asia equities, the FTSE Malaysia KLCI broke its 52 week high during the month (See Table 1 below). Nonetheless, we still favour the general valuations on Thailand, South Korea and Singapore equities. The Price-to-Book ratio on these 3 markets stood at approximately 1.6, as compared to the other Asian counterparts at 1.9. Strong earnings growth projections put the forward Price-to-Earnings ratios on these 3 markets at an average of 12 whereas countries such as India were trading at a forward Price-to-Earnings close to 17.

**Table 1: Selected Equity Stock Market Index Returns**

Country	Index	Aug. 17	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
China	Shanghai Composite	2667.97	10.05 ▲	4.22 ▲	-11.60 ▼	3361.39	2319.74
Hong Kong	Hang Seng Index	21071.58	4.06 ▲	6.88 ▲	2.62 ▲	23099.57	18971.52
Taiwan	Taiex Index	7949.39	3.72 ▲	4.61 ▲	6.82 ▲	8395.39	6629.10
Malaysia	FTSE Malaysia KLCI	1379.29	3.19 ▲	3.37 ▲	9.55 ▲	1381.02	1153.97
Indonesia	Jakarta Composite	3052.60	2.01 ▲	8.27 ▲	18.26 ▲	3104.08	2235.39
U.S.	S&P 500 Index	1079.38	1.36 ▲	-5.06 ▼	-1.83 ▼	1219.80	978.51
India	BSE Sensex 30	18123.06	0.93 ▲	7.65 ▲	10.31 ▲	18309.25	14684.45
Korea	KOSPI Index	1752.95	0.83 ▲	6.14 ▲	7.71 ▲	1797.42	1519.40
Singapore	Straits Times Index	2931.30	-0.89 ▼	3.44 ▲	4.91 ▲	3043.28	2521.36
Japan	Nikkei 225	9165.96	-2.58 ▼	-10.45 ▼	-11.07 ▼	11408.17	9065.94

*Major global equities were mostly up on a monthly basis. Greater China equities were among the top performers.*

Source: Bloomberg, as of 17 Aug 2010



As recent as the third week of August, China officially overtook Japan as the world's second biggest economy. A glance at where the Chinese equities market stood in relative size to the overall global equity markets, China was getting very close to become the second biggest. As shown below in Table 2, Japan's stock market capitalization is currently 7.97% of world market cap with China trailing behind at 6.89%. Five years ago, Japan accounted for 10.34% of world market cap, while China accounted for just 1.10%. In a space of half a decade, China's domestic equities had the biggest growth percentage of world market cap, spurred by its fast-growing economy. It would not be a surprise if China make it to the second spot over the next couple of years.

In terms of performance, the Shanghai Stock Exchange Composite Index plunged 27% in the first half of the year, compared with 7.6% for the S&P 500. Since then till date, the Chinese benchmark had outperformed its U.S. equivalent, 12% to 4.2%. China's equities were trading near its three-month high at the time of writing.

Nevertheless, the near term upside on global equities is likely to be capped by continuing weak economic numbers from the United States. In particular, the market action on the U.S. S&P 500 Index was pointing to the downside. On the 11 Aug 2010, 9 U.S. stocks declined for each that gained as 90% of trading came from falling shares (the 10<sup>th</sup> such session since April'10). Further possible corrections on equities could get brutal if major support levels do not hold.

**Table 2: Country % of World Market Cap**

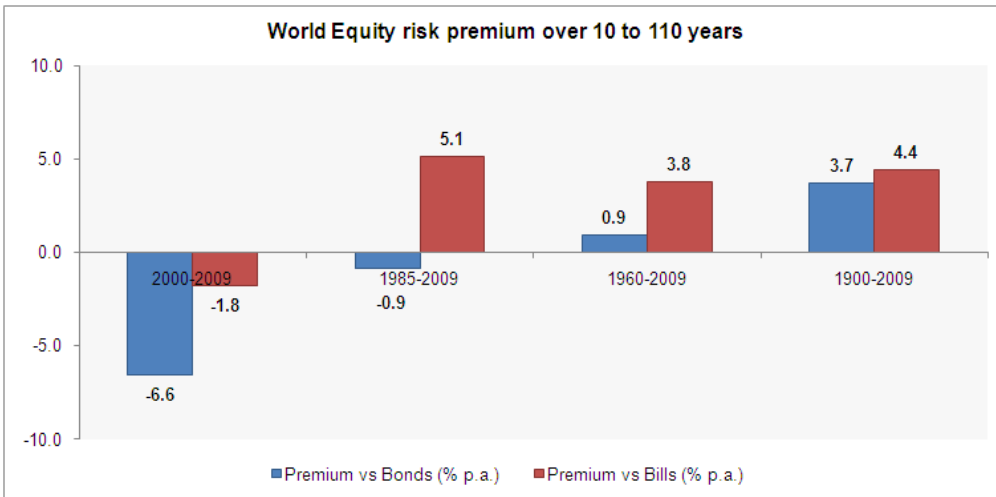
Country	% World Mkt Cap	5 Years Ago
United States	29.7	39.9
Japan	7.97	10.34
China	6.89	1.1
United Kingdom	6.72	7.85
Hong Kong	4.97	2.56
Canada	3.74	3.07
France	3.55	4.72
India	3.22	1.25
Brazil	2.84	1.04
Australia	2.67	1.79
South Korea	1.97	1.42
Taiwan	1.72	1.29
Russia	1.2	1
Singapore	1.11	0.63
South Africa	0.94	0.7
Malaysia	0.77	0.49

*China has had the biggest growth in percentage points, while the US has had the biggest fall. Hong Kong, India, and Brazil have seen pretty big increases in share, while the UK, France, and Japan had all lost the most ground after the US.*

Source: Bloomberg, as of 17 Aug 2010



**Chart 1: Equities Risk Premium over Bonds and Bills**



Source: Credit Suisse Global Investment Returns Sourcebook 2010

Since 2000, bonds beat equities by 6.6% per year. The world equity risk premium over global bonds had been negative since 1985.

The capital asset pricing model (CAPM), one of today’s renowned financial model, illustrated how securities were priced in a manner which reflect the reward-to-risk ratio in relation to that of the overall market. At the same time, the equity risk premium component within the model demonstrated that equities should generate a higher expected return over bonds given its higher risk nature.

A recent publication from Credit Suisse based on 19 major country’s indices suggested that the conventional risk and return tradeoff had become distorted in recent years. We observed that world equities (higher risk) had failed to generate positive historical risk premium over bonds (lower risk), probably over the last 25 years (See Chart 1 above). Chart 1 showed that, since 2000, world equities underperformed world bonds by 6.6% per year. In short, bonds do outperform equities even in the medium to long term. The conventional investment theory that riskier assets will bring about higher returns over time had just been proven to be not entirely true.

As a food of thought on the above findings, the new investment landscape today had become a different arena for individual investors compared to few decades ago. Traditional buy on hold strategy (passive management) may not make sense in the current context given the asymmetrical risk and return profile (potentially skewed towards the downside) in equities. As evident in the recent Lehman crisis, the unprecedented losses suffered in equities did effectively wiped out the many years of positive returns in space of months (*The Black Swan Theory*). In this case, performing an active management strategy by doing active reallocation/rebalancing between asset classes may be the better alternative in portfolio management moving forward.

Also, investors should take into account the length of holding periods on their investments. It is irrational to assume an investor to be prepared to stay invested over a century long. Therefore, even if equities do outperform bonds over the next 100 years period, it should be of little concern to equities investors if equities are going to continue to underperform bonds over the next couple of decades.

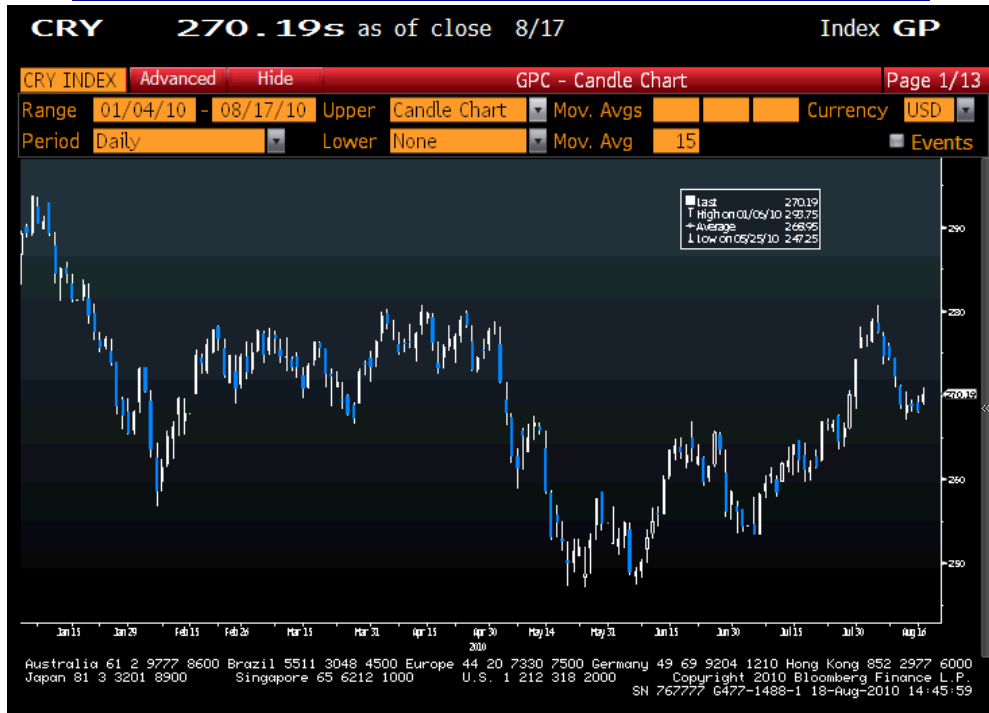


### Commodities – Non-commercial on the long side of Commodities

The grains commodities (in particular wheat) registered a sharp rise in prices following news that Russia imposed a ban on its wheat exports as the country's wheat crop deteriorated. The release of the Commodity Futures Trading Commission weekly data showed the short covering by non-commercial traders sent the wheat prices to their highest level since September 2008. However, wheat yield stood at 46.0 bushels per acre, above the five-year average of 37.7. The run-up in wheat prices looked overdone and prices are expected to moderate.

From Chart 3 on the next page, since the start of July this year, we noticed a reversal in the net non-commercial (a proxy for hedge funds) long position on 13 commonly traded commodities futures. The previous round of spike in the net non-commercial long position came in September'09 and it coincided with a subsequent 14.7% rise in the CRB Commodity Index. We expect general commodities prices to experience short term strength in the month of September.

**Chart 2: Performance of CRB Commodities Index (Y-T-D)**



General commodities had been weak since the start of the year, with the benchmark index down 6.6% Year-To-Date.

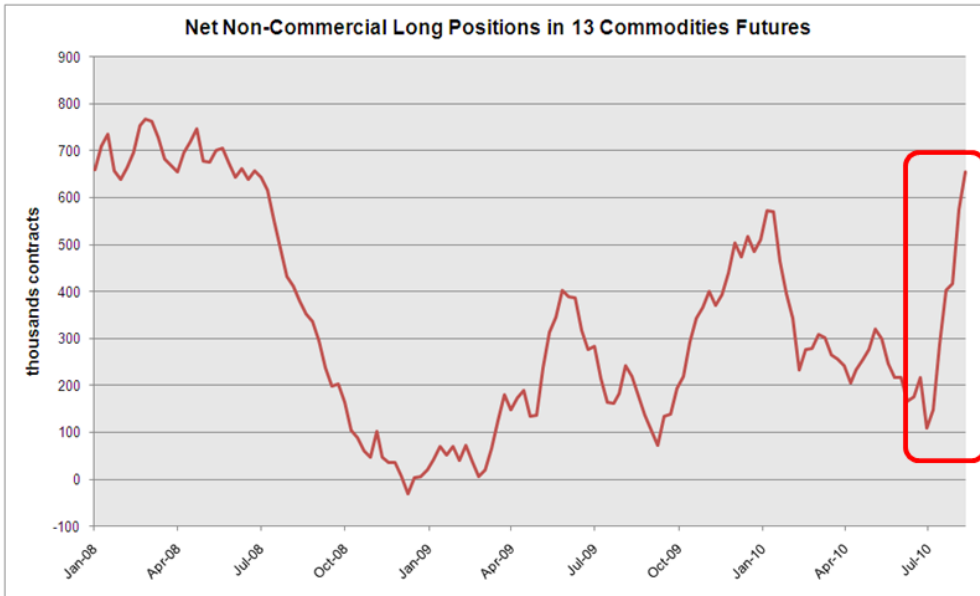
Source: Bloomberg, as of 17 Aug 2010

Safe-haven buying of gold had been holding steady as physical demand had created a soft floor for prices. Based on the Bloomberg World Trend and Reversal analysis, we noticed that the underlying trend in the gold metal prices was towards the upside (See Chart 4 on the next page). This was in stark contrast with the expected near-term weakness in the equities and the oil commodities, as reflected in the diagram.

Given that recent deflationary fears continued to dominate the recent headlines, gold should continue to take the center stage at least in the near term. More money printing would add to the attractiveness of gold, given the investors' perception that gold is the enemy of paper currencies.



**Chart 3: Hedge Fund Positioning on a Rising Trend**



Hedge funds were taking the long side of general commodities futures contract, the highest since start of the year.

Source: Bloomberg, as of 17 Aug 2010

**Chart 4: World Trend and Reversal – Stick With Gold**



Underlying trend in gold metal is likely to remain up as investors remained divided on global equities.

Source: Bloomberg, as of 18 Aug 2010



### Fixed Income – Treasury Bond Bubble (Unlikely)

Market players turned uneasy since the start of the second quarter on the back of near historical low U.S. Treasury yields. Reports were claiming that the “Greatest Bond Bubble” was in the making. As a recap, a “bubble” occurs when market forces combine to generate a highly unstable position. The causes of a “bubble” can be many – though primarily psychological. No doubt that a 10 year U.S. treasury at 2.6% might not be the world’s greatest bargain, we beg to differ that there is an ongoing “bubble” in the U.S. Treasury bonds.

We believe that any possible collapse in Treasury bond prices had been overstated. Although the fear of rising interest rates may be legitimate, a bear market in bonds is different from a bear market in equities in terms of magnitude. Historically, the worst 12-month return for U.S. bonds since 1926 was -9.2%, while the worst 12-month return for U.S. stocks was -67.6% (12 months ended June 1932). From another perspective, the worst calendar year for the bond market was 1994, due to an unexpected upward shift in interest rates. That year, the bond market returned -2.9% (in 1995, the bond market returned 18.5%). On the other hand, the U.S. S&P 500 Index lost more than -2.9% (single day loss) in 27 individual trading days back in 2008.

Fundamentally, the Fed Reserve is still tackling weak employment, less than optimal industrial capacity utilization, falling home prices and a high historical private sector debt level. Any chances of rate hike should be the last thing expected from the Fed Reserve. On that note, the long term chart on the Treasury bonds remain positive since breaking out in April this year (See Chart 5 below).

### Chart 5: Barclays 7-10 Year Treasury Bond Index – Weekly Chart



*The weekly chart of the 10-Year Treasury showed a strong uptrend. Price is moving up in the outer band of the grey bollinger bands and had yet to correct outside this upper band.*

Source: Bloomberg, as of 18 Aug 2010

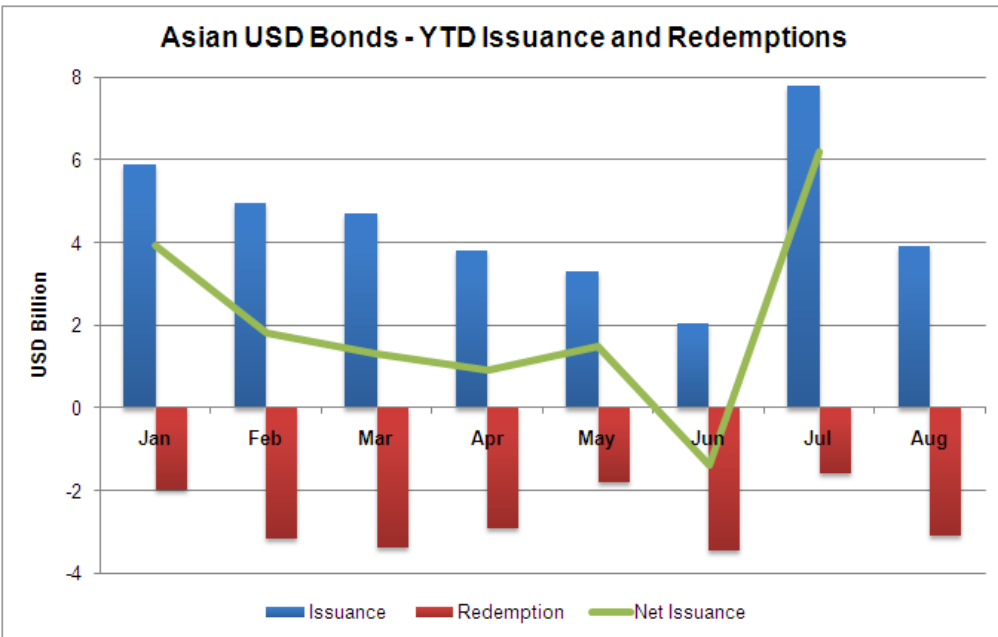


On the Asian front, Year-To-Date net issuance on Asian USD bonds remained upbeat (See Chart 6 below). On a whole, Asia ex-Japan sales in G3 currency rose to \$39.5 billion this year from \$34.6 billion in the same period of 2009, according to data compiled by Bloomberg. Total issuance climbed to a record \$56.7 billion last year as credit markets recovered from the collapse of Lehman. The growing supply of Asian bonds had been met with a strong Year-To-Date fund inflows of approximately US\$7.6 billion into Asian bond funds, as the market appetite for Asian bonds picked up strongly.

On the Asian currency front, Malaysia’s Ringgit, Indonesia’s Rupiah and China’s Yuan are among the 10 best-performing emerging-market currencies this year. The fundamental strength in the Asian currencies was supported by the massive accumulation of US\$5 trillion of foreign-exchange reserves. Yields were relatively attractive with the 10-year government bonds yield 3.72 percent in Malaysia, 4.60 percent in South Korea and 7.93 percent in Indonesia, compared with 2.56 percent on U.S. debt (as of 20 August 2010).

For the month of September, the general upside on global equities is likely to be limited. On the commodities front, the spike on net non-commercial long positions on 13 frequently traded commodities futures contract should bring about a short term strength to general commodities’ prices (we remained bearish on wheat prices as the supply shock rally seemed overdone). There are bright spots in the fixed income space and in particular, the growing size of the Asian bond market is likely to be a major talking point moving forward.

**Chart 6: Asian Bonds Market – A Growing Market**



Source: Bloomberg, as of 17 Aug 2010

*Asian borrowers were raising money for expansion and are growing their businesses at a faster rate than companies in the U.S., putting the money to work more effectively.*



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