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## Game On, This Is Going Down To The Wire

### Executive Summary

- **Equities – Markets in China and Europe are undergoing P/E contraction as investors place higher emphasis on macroeconomic events more than ever.**
- **Commodities – The ongoing saga of the US\$14.3 trillion U.S. debt ceiling is going to mark the next significant move up in Gold prices.**
- **Fixed Income – In cases whereby the PIIGS government bond yields (10-Year) surge past the 6 percent mark, they continue higher with no signs of reversal.**

### Equities – Good News and Bad News

The sovereign debt crisis in Europe took a temporary positive spin in the month of July following a new round of bailout on Greece. On the other end, the deadlock on the debt ceiling between the Republicans and Democrats continues in Washington. The stalemate may cost U.S. its triple A rating, adding US\$100 billion a year to U.S. government costs while dragging down economic growth, according to Wall Street bond dealers.

Overall, global equities put in a good performance in the month of July. Southeast Asia equities continued to outperform with Thailand leading the pack, up more than 9.4 percent in July. Japan equities rebounded strongly from the earlier trio of disasters, gaining 5.2 percent on a monthly basis. (See Table 1 below)

Moving forward, we continue to be positive on Southeast Asia equities and underweight European equities. We feel that the macroeconomic environment will be especially relevant in months to come. The outlook for equities in China and India will be challenging as their P/E ratios look to continue to trend lower.

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

Country	Index	Jul. 22	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Thailand	SET Index	1120.08	9.40 ▲	1.34 ▲	11.28 ▲	1120.32	824.98
Indonesia	Jakarta Composite	4093.27	7.10 ▲	7.69 ▲	21.12 ▲	4101.73	2959.75
India	BSE Sensex 30 Index	18712.02	6.62 ▲	-4.54 ▼	-1.55 ▼	21108.64	17295.62
Japan	Nikkei 225	10132.11	5.22 ▲	4.65 ▲	-1.39 ▼	10891.60	8227.63
Russia	MICEX Index	1725.63	5.21 ▲	-3.81 ▼	-1.25 ▼	1865.25	1328.18
China	Shanghai Composite	2770.79	4.58 ▲	-7.96 ▼	2.04 ▲	3186.72	2522.20
Singapore	Straits Times Index	3178.94	4.47 ▲	-0.49 ▼	-0.18 ▼	3313.61	2910.21
United States	S&P 500 Index	1343.80	4.40 ▲	0.48 ▲	4.71 ▲	1370.58	1039.70
Malaysia	FTSE Bursa Malaysia KLCI	1564.89	-0.16 ▼	2.77 ▲	1.13 ▲	1597.08	1332.92
Europe	Euro Stoxx 50 Pr	2785.82	-0.33 ▼	-5.12 ▼	-6.22 ▼	3077.24	2560.00

*Southeast Asia equities continued to outperform with Thailand equities gaining more than 9.4 percent over the 1-month period.*

Source: Bloomberg, as of 22 Jul 2011



**Contract and Expand: P/E Ratio Looking Meaningful**

The Price-to-Earnings ratio (P/E) measures the amount of money investors are paying for a company's earnings. In the simplest form, companies that post higher earnings will have a lower P/E than their benchmarks and are deemed undervalued on a relative basis. However, benchmark P/Es are dependent on various business cycles as well as market sentiments and is seldom a constant.

We feel that there is a possibility we may be entering a prolonged period of P/E decline for some of the equity markets. In periods of declining P/E otherwise known as P/E contraction, investors demand more earnings for each dollar of share price they are willing to pay.

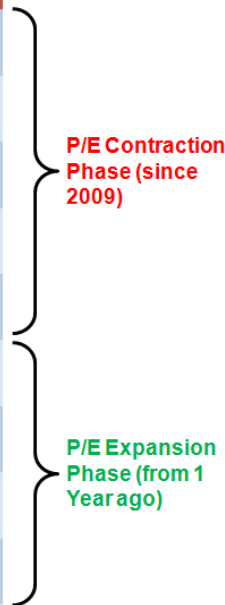
We remain negative on markets such as India, China and Europe where their P/E multiples have been on a downtrend. The P/E contraction for these markets took place since 2009 and is taking its toll on the equities' performance in these countries. We can attribute key underlying factors to be the negative market sentiments and economic uncertainty in these markets. (See Table 2 below)

On the contrary, the P/E multiples among various Southeast Asia equity markets are in an expansion mode as we continue to be overweight in this region. Supported by strong fundamentals, the Southeast Asia economies are experiencing exceptional growth rates, surpassing many other developed nations. To point out, equities in the P/E expansion phase markets have outperformed those struck in the P/E contraction phase over the most recent 1-year period.

Moving forward, macroeconomic events are likely to stay relevant. A stock is priced based on its future earnings, discounted against uncertainty (risk). With an uncertain economic landscape, P/E multiples may continue to contract in places like Europe as the discount factor becomes larger. We would expect stock prices in these geographical places to rise at a slower pace than earnings growth (if any).

**Table 2: P/E Contraction and Expansion in Selected Markets**

Country	Current P/E	P/E 1-Year Ago	P/E 2-Year Ago	1 Year % Return
Hong Kong	11.77	12.87	21.48	9.01
China	15.42	17.58	35.78	8.13
India	16.90	17.61	18.83	4.51
BRIC	10.55	14.27	15.22	5.67
Europe	11.09	11.95	25.16	6.43
Malaysia	17.37	17.05	20.04	17.14
Indonesia	18.66	16.95	31.18	35.82
Thailand	14.41	12.86	24.12	34.58
Philippines	15.83	11.58	14.67	31.14



*Markets such as Europe and China are undergoing P/E contraction while the P/Es for Southeast Asia equities are expanding.*

Source: Bloomberg, as of 22 Jul 2011



**Chinese Banks – Mounting Bad Debt Worries**

In our previous month report, we mentioned about the renewal write-downs in residential mortgage-backed securities hitting hard on the U.S. banks. Equivalently, we are starting to be fearful of a sharp increase in write-downs on the debts or loans issued by the Chinese lenders.

In China, the ballooning local governmental debt is a priority concern. According to Moody's, China's National Audit Office (NAO) may have understated the debt load of local governments by RMB3.5 trillion and that up to 75 percent of this could end up going bad. In short: 10 percent of China's GDP may be in the form of bad debt.

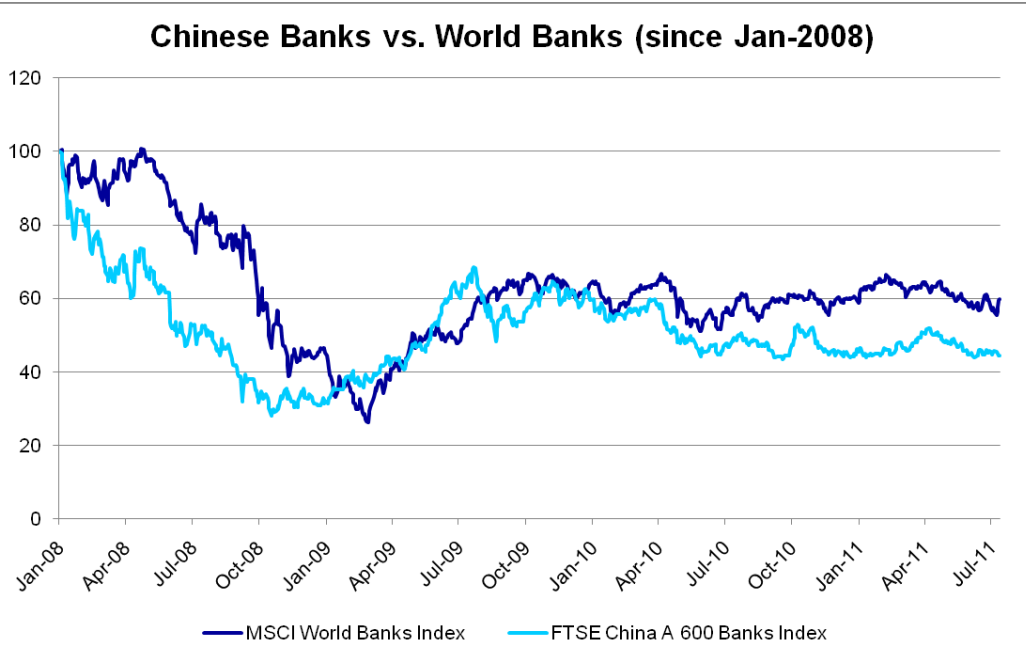
Assuming that the total estimates of local governmental debt stood between RMB15.5 trillion and RMB 20 trillion is correct, the interest payments will be unsustainable in the foreseeable future given the current tight credit conditions and rising interest rate environment in China.

Credit and monetary tightening in China have also led to increased lending outside the formal banking system. Underground lending has become a vital source of credit to privately-owned small and medium enterprises, which find it difficult to borrow from the state-dominated formal banking sector.

According to a research released by Financial Times, non-performing loans at 50 underground banks surveyed in seven provinces have been climbing steadily since early 2011. In April, May and June, the proportion of underground lenders reporting a rise in bad loans from the previous month were 22 percent, 19 percent and 15 percent respectively.

We feel that the debt concerns in China may continue to pose a negative outlook for the listed Chinese banks. Although the Chinese banks recovered many months ahead of their global peers during the credit crisis, they have been underperforming since the start of 2010. (See Chart 1 below)

**Chart 1: Chinese Banks are Underperforming Relative to Global Banks**



Source: Bloomberg, as of 22 Jul 2011

*Rising bad debts in China may be a problem too big to ignore and Chinese banks are likely to come under pressure.*



**Precious Metals – Gold Trends Higher Amidst Europe and U.S. Debt Talks**

We feel that the ongoing saga of the US\$14.3 trillion U.S. debt ceiling is going to mark the next significant move up in gold prices. The pending debt deal, be it substantial or meager, temporary or permanent, is likely to put further downward pressure on the value of the U.S. fiat currency.

Raising the debt ceiling or not, the outcome is likely to be negative for the U.S. dollar currency in the long run. Few investors will be convinced that the U.S. government has, after all, the urgency to rein in spending and cut its deficit. In fact, we believe that a weak dollar may help to improve the U.S. fiscal position.

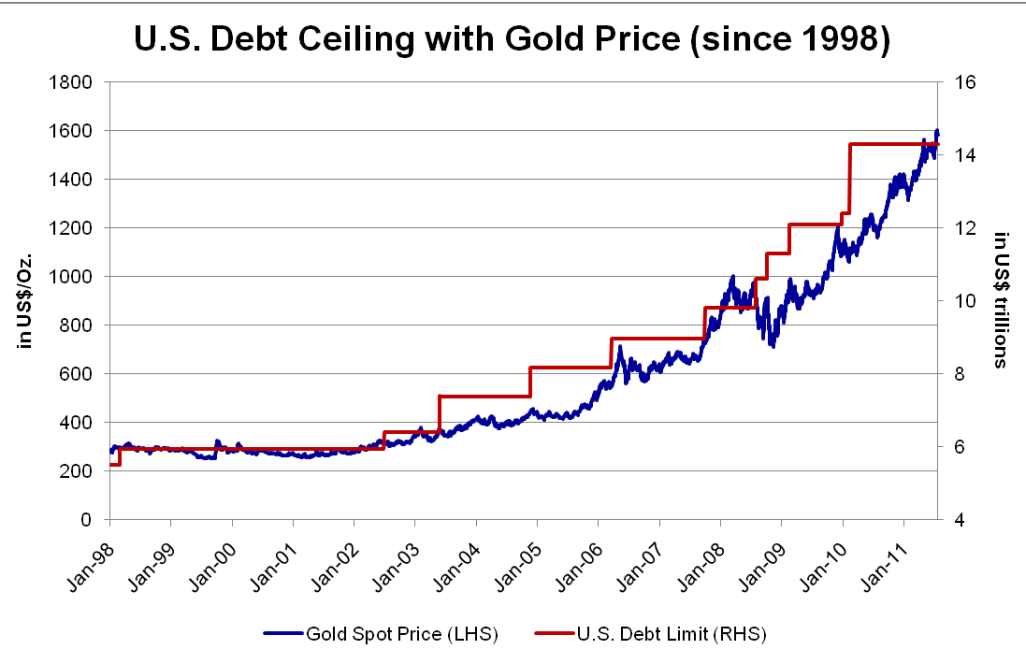
In the event that the debt deal is not reached, a partial government shutdown or potential Treasury default will put gold as the next best safe haven play. According to Reuters, the Federal Reserve (Fed) is actively preparing for the possibility that the United States could default. The Fed effectively acts as the Treasury's bank and clears the government's checks to the U.S. citizens from social security recipients to government workers.

According to Bloomberg, above-ground gold stocks last stood at an estimated 165,000 tons, which translates into about US\$8 trillion at current price. By comparison, the amount of U.S. debt held by the public stood at US\$9.75 trillion, doubling from five years earlier.

To illustrate further, gold prices have been positively correlated with the U.S. debt limit since 1998. Gold is up more than 490 percent in the last 10 years as the U.S. debt limit is raised by a good 10 times over the same corresponding period. (See Chart 2 below)

The recent price movements are positive. In the month of July, gold registered 11<sup>th</sup> consecutive day of gains, the longest run since 1980. Despite making a new all-time high of US\$1,624.07/Oz. on July. 25, we expect further upside ahead.

**Chart 2: Positive Correlation Between U.S. Debt Ceiling and Gold Price**



Source: Bloomberg, as of 22 Jul 2011

*Gold prices have been positively correlated with the U.S. debt limit since 1998, gaining more than 490 percent in the last 10 years.*



**Fixed Income – Risks Associated with Chinese Corporate Bonds**

The growth of the Hong Kong’s renminbi denominated bonds (Dim Sum bonds) over the last four years picked up great pace in the last few quarters. In many instances, Dim Sum bonds are issued by a Chinese-related entity (majority in the form of special purpose vehicle) in Hong Kong. This form of securitization enables offshore investors to gain exposure to the Chinese currency in Hong Kong.

According to Financial Times, the Dim Sum bond market has already seen more deals done this year than in the whole of FY2010. At the same time, we saw the actual number of high yield issuances outpacing market’s expectation by a significant margin. Amidst the recent hype, we feel that a sudden surge in the Dim Sum bond supply could bring along potential undesirable risks to investors.

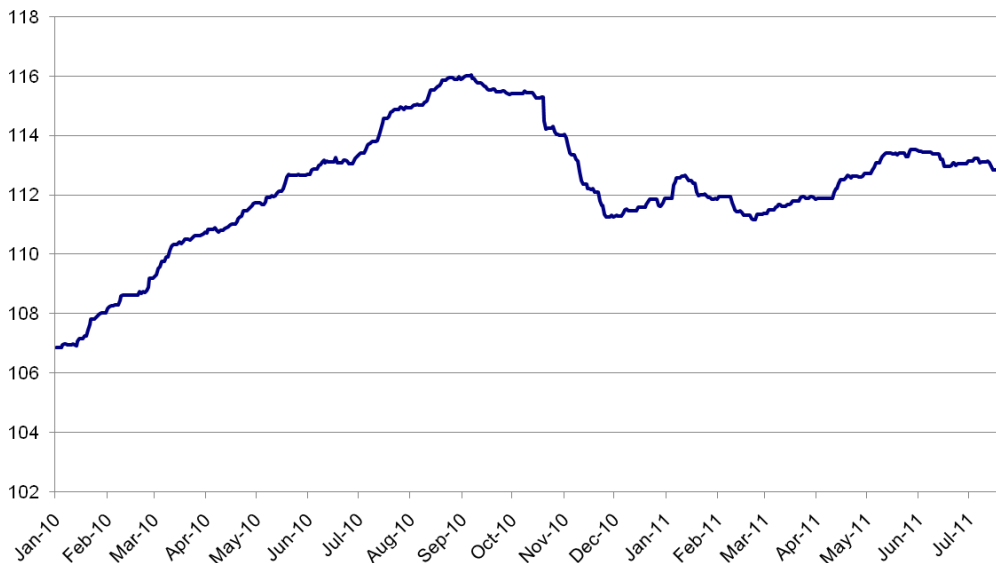
Given its special purpose vehicle structure, bond investors may have limited legal recourse against the underlying company should there be any form of voluntary default. Dim Sum bonds are regarded as subordinated as compared to the onshore bonds or bank loans. From this perspective, a higher default risk premium should be associated with Dim Sum bonds, a fact often ignored by investors.

In particular, investors should be concerned with the lax corporate governance and many preceding default examples. To recall, the bankruptcy of FerroChina in 2008 saw onshore creditors claiming a partial cash recovery while offshore creditors were left empty-handed. More recently, a series of accounting frauds among the Chinese companies further highlighted lax corporate governance in the Mainland.

Lastly, more than 90 per cent of Dim Sum bonds are issued with a two to three years maturities. This may bring upon a considerable wave of refinancing come 2013 and 2014. As a result, future spike in the interest rates may send many of these issuers into refinancing difficulties. We expect the hype in the Dim Sum bonds space to cool off in the near term.

**Chart 3: Weakness in Chinese Corporate Bonds**

**ChinaBond Corporate Bond Total Return Index**



*After peaking in the third quarter last year, Chinese corporate bonds are down more than 3.0 percent since then.*

Source: Bloomberg, as of 22 Jul 2011



**European Debt Crisis – The Magical 6 Percent Mark**

In what could be the greatest irony in modern history, the inspiration for the euro symbol came from the Greek epsilon, to certify stability. As far as the euro currency is concerned today, stability is no longer a given.

The most recent round of PIIGS bailout represents the sixth time in 18 months that European leaders have put together a “kick the can down” solution to the crisis. Despite the temporary relief in the market, we remain negative on the region’s outlook.

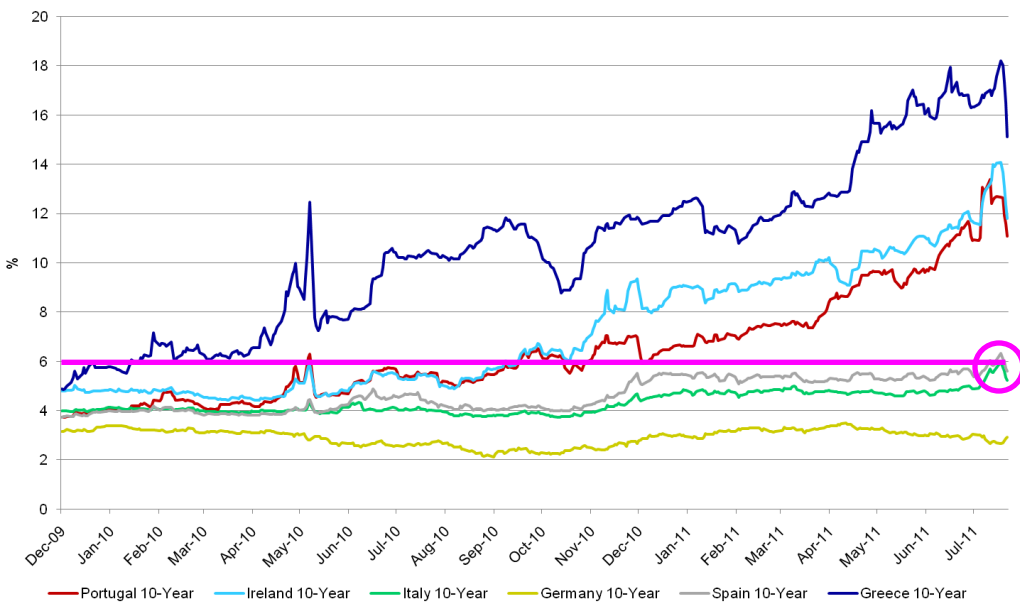
The austerity measures are likely to divert more of the debtor nations’ national incomes to the country’s debt service. This will result in less income translating to spending, further lowering the present growth rate. In fact, solutions to the debt crisis present in the form a self-reinforcing feedback loop of economic contraction.

At the same time, we believe that the banking sector in the peripheral nations will be hit hard once the contagion begins. According to a Wall Street Journal report on the latest round of European banks stress test, banks in Spain and Italy are holding PIIGS-related commercial and retail loans in the amount exceeding US\$3.4 trillion. The mammoth debt held by the Spanish and Italian banks are in the form of loans and other debt issued to institutions and individuals in the peripheral nations. As compared to the widely mentioned PIIGS sovereign debt exposure, the debt implosion of private sector will be a much bigger time bomb.

Lastly, there is an interesting observation on the PIIGS 10-year sovereign bond yields. The 6 percent mark appears the magical number to overcome. As depicted below, in cases whereby the PIIGS government bond yields surge past the 6 percent mark, they continue higher with no signs of reversal. The worrying fact came in July: 10-year bond yields on Spain and Italy briefly touched the 6 percent mark before coming off. The world is watching. (See Chart 4 below)

**Chart 4: PIIGS 10-Year Bond Yields (The Magical 6 Percent Mark)**

**10-Year Yields on PIIGS Signal Continual Headwinds**



*In cases whereby the PIIGS government bond yields surge past the 6 percent mark, they continue higher with no signs of reversal.*

Source: Bloomberg, as of 22 Jul 2011



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