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Stay Low, Dead Cat Bouncing High

Executive Summary

- **Equities** – The financial world underwent three weeks of wild volatility and European officials will have little capacity for a massive bailout of European banks should it be necessary.
- **Commodities** – The gold bull run is not over yet although the near term upside may be limited after the recent parabolic swing. Our medium term target for gold is at US\$2,250/Oz..
- **Fixed Income** – Short-term funding stress is showing up in the spread between 3-month EUR LIBOR/forward rate agreement (FRA) and 3-month Euribor basis swaps.

Equities – No Place To Hide

The financial world underwent three weeks of wild volatility as downside risks increased significantly. Fears of the European sovereign debt contagion to France, Spain and Italy sent global investors scrambling for exit. In particular, European equities were the worst hit, tumbling almost 20 percent on a monthly basis (See Table 1 below).

According to Bloomberg data, global stocks lost more than US\$7.3 trillion in market value since Jul. 26. There is an increasing risk of a negative feedback loop between stock prices and the overall economy. The negative impact of both lower stock market valuations and lower business confidence may stall the economic recovery globally. A self-reinforcing cycle may take hold, eroding confidence and undermining markets, dealing a further hit to sentiment.

Local equities fell 13 percent over the 1-month period, pricing in the impact of a slowing global growth. The benchmark index fell to a 52-week low on Aug. 22, hitting 2680 before retracing the losses.

Table 1: Selected Equity Stock Market Index Returns

Country	Index	Aug. 23	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Philippines	PSEi Philippine SE Index	4375.39	-2.30 ▼	2.63 ▲	16.46 ▲	4563.65	3530.49
Thailand	SET Index	1069.16	-4.63 ▼	1.44 ▲	7.90 ▲	1148.28	881.87
Malaysia	FTSE Bursa Malaysia KLCI	1480.08	-5.43 ▼	-3.20 ▼	-2.05 ▼	1597.08	1396.41
Indonesia	Jakarta Composite	3864.51	-5.90 ▼	2.28 ▲	11.24 ▲	4195.72	3058.05
China	Shanghai Composite	2554.02	-7.82 ▼	-7.95 ▼	-10.78 ▼	3186.72	2437.68
Singapore	Straits Times Index	2769.27	-13.00 ▼	-10.97 ▼	-7.75 ▼	3313.61	2680.83
Japan	Nikkei 225	8733.01	-13.81 ▼	-7.69 ▼	-17.45 ▼	10891.60	8227.63
United States	S&P 500 Index	1123.82	-16.45 ▼	-14.69 ▼	-14.04 ▼	1370.58	1039.70
Financial Sector	MSCI World Financials	65.79	-19.76 ▼	-19.80 ▼	-24.57 ▼	90.30	65.69
Europe	Euro Stoxx 50 Pr	2224.07	-19.78 ▼	-20.41 ▼	-24.73 ▼	3077.24	2077.06

Southeast Asia equities were resilient in the latest stock market bloodbath, with Philippines and Thailand equities outperforming.

Source: Bloomberg, as of 23 Aug 2011



Global Equities – Braving Through The Storm

The August plunge had reduced the valuations of global stock markets to attractive levels (See Table 2 below). Headline risks were dominant and wild market swings were pervasive. We feel that it is unlikely to see the downtrend reversing in September and negative headlines will continue to spook investors.

The problems in U.S. and Europe are unlikely to be resolved quickly. The European debt issues and a probable double-dip U.S. recession will continue to heighten downside volatility in the near term.

More importantly, the market is experiencing elevated correlation among sectors and companies. This points to challenging times ahead for long-only fundamental investors. In highly correlated sell-offs, the market does not discriminate based on individual fundamentals, reducing the benefits of value investing. Stocks became commoditized and indistinguishable from one another.

For example on Aug. 8, every stock in the U.S. S&P 500 Index fell precipitously intraday, ending the day in the red. At the same time, the ratio of declining stocks to advancing stocks listed in U.S. was 77 to 1, a ratio not seen before in the past 80 years.

According to EPFR, U.S. equity funds had a fifth consecutive week of fund outflows as of the week of Aug. 19, their longest losing streak since January 2010. The sell-off is not only limited to U.S. equities. Outflows from emerging markets stock funds stood at US\$2.77 billion. Overall, equity funds saw US\$5.81 billion of outflows during the week itself.

At the present, it seems that the present market turbulence is unlikely to subside completely. Investors who choose to avoid the anxiety stemming from the market volatility are staying sidelines. On the other end, investors who are tempted to chase short-term price changes will have to stomach a higher level of risk.

Table 2: Market Valuations (Top: Cheapest) (Weighted Avg)

Country/Region	Dividend Yield	Price-to-Book	Forward PE	Current PE
Europe	5.37	1.01	8.01	9.28
Brazil	4.76	1.23	8.61	8.00
Singapore	4.11	1.36	12.81	7.94
Hong Kong	3.32	1.45	10.61	9.49
Asia Pacific ex Japan	3.48	1.60	10.79	11.40
Australia	4.99	1.73	11.18	14.37
Thailand	3.82	1.99	12.11	12.98
United States	2.29	1.84	11.26	12.29
Japan	2.15	1.13	14.42	16.47
Malaysia	3.83	2.26	14.56	16.47
China	1.91	2.14	11.75	13.98
Philippines	2.70	2.37	14.21	15.36
India	1.67	2.72	13.73	14.76
Indonesia	2.09	2.94	15.20	15.72

Source: Bloomberg, as of 23 Aug 2011

The August plunge had reduced the valuations of global stock markets with the European equities trading at par to book value.



European Banks – Too Big to Fail or Too Big to Bail

In Europe, bank stocks were clobbered as the Eurozone’s woes were aggravated by the inability of officials and politicians to end the sovereign debt crisis. On Aug. 10, France’s second-largest bank by market value, Société Générale, plunged more than 22 percent in a single trading day. Investors were nervy despite a renewed French government pledge to improve the country’s finances.

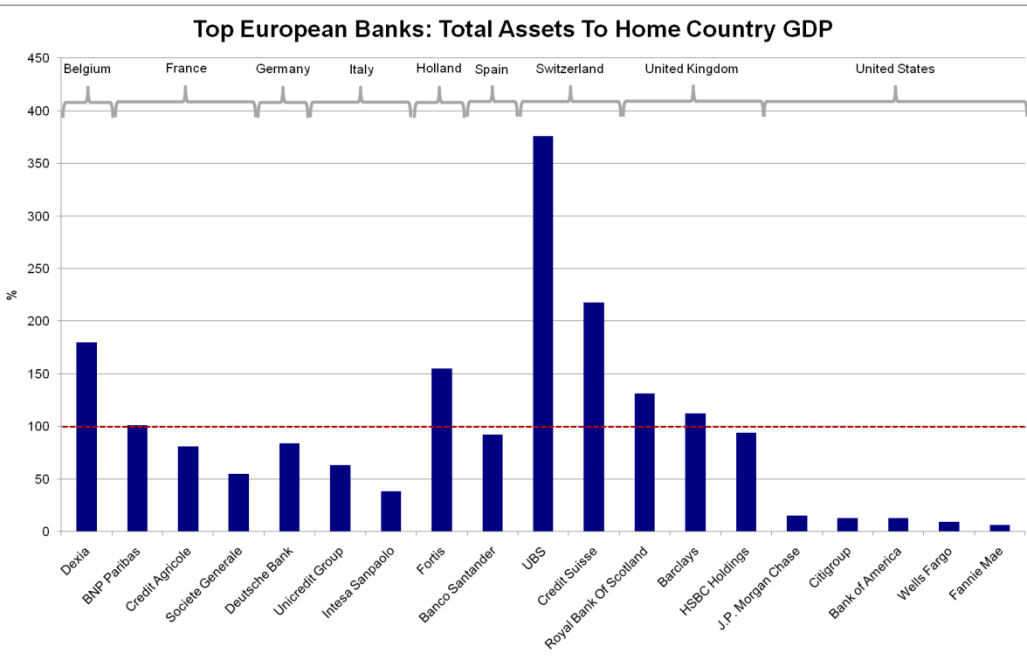
In the meantime, other European banks are taking on impairments to their earnings caused by the huge drop in the value of Greek bonds. A haircut to Greece’s debt may only be the start. The real deal comes when Italian and Spanish bonds must be written down as well.

It seems that the sovereign-debt crisis may be on the verge of implosion, dragging along the entire European banking system. To quantify, the relative size of European major banks’ assets were measured as a percentage of home countries’ total GDP. As shown below, a European bank may account for several multiple of its home country’s GDP. For instance, total assets in Dexia (Belgium) account for almost twice the country’s GDP (See Chart 1 below).

This is in contrast to the top 5 U.S. banks, whose total assets account for just half of the country’s GDP. In our view, European officials will have little capacity to launch any massive bailout of European banks should it be necessary. The concentration of bank assets among major European banks is posing a real systematic risk to the troubled region. In short, these European banks are too big to bail rather than too big to fail.

On the hindsight, major European banks (on their own) are unlikely to have enough capital to meet the expected losses from the peripheral nations’ debts. This may translate a liquidity problem into a full-blown banking solvency crisis. This sovereign debt crisis may probably be one of the biggest in human history.

Chart 1: Asset Size of European Banks Makes Them Too Big To Bail



Source: Bloomberg, as of 22 Aug 2011

European officials have little capacity for a massive bailout of European banks should it be necessary given the asset size of the banks.



Precious Metals – Medium Term Target for Gold at US\$2,250/Oz.

The attention on gold circles around inflation, fear, currency devaluation and other headline risks. We believe that the gold bull run is not over yet although the upside may be limited after the recent parabolic swing. Based on projection targets, we set the medium term target for gold at US\$2,250/Oz..

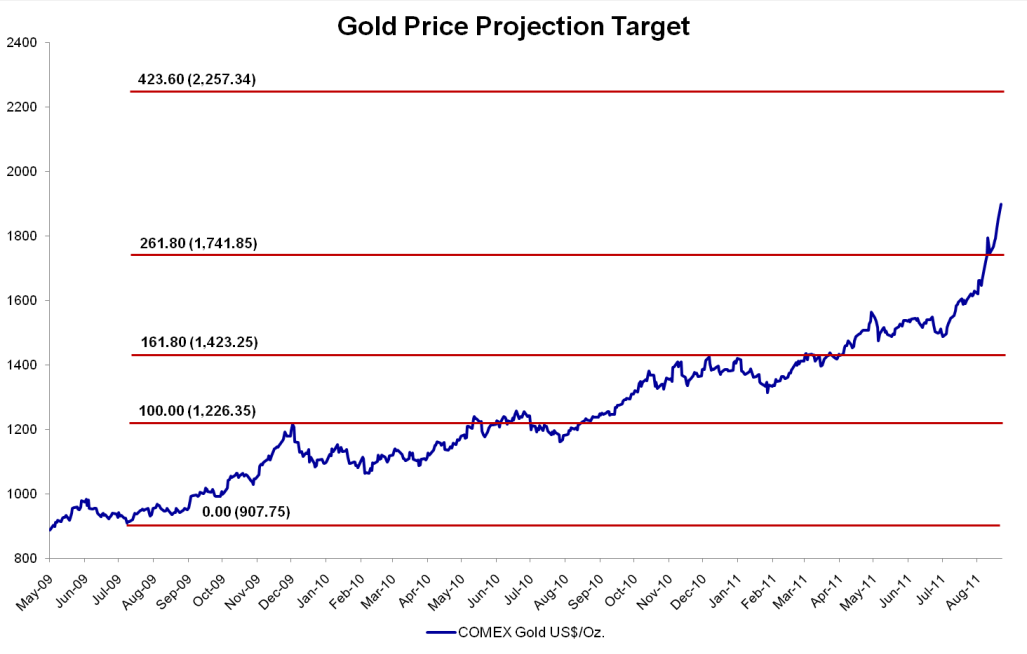
In an inflationary and deflationary environment, gold provides insurance against devaluation of countries' currencies and elevation of fear. We feel that many factors driving the meteoric rise in gold prices today were similar to those in the 1980s. Relatively, the real gold price is still below the high of US\$1,950/Oz. at today's prices seen in January 1980.

There are concerns that the gains in gold were excessive and resemble a bubble. However, based on historical experience, we feel that gold is still not in a bubble. The tech bubble in 2001 and oil bubble in 2007 saw prices rallying more than 3 to 5 times in a space of 5-year period before tumbling down. Over the past 5-year period since 2006, gold is up slightly less than 2 times. Therefore, we feel that this gold bull run is not over yet.

Currently, many drivers are at play in the gold rally. In particular, physical demand from China and India remains supportive. Together with other psychological drivers, it is strongly evident that demand for gold will stay pervasive. In short, gold is and will continue to be the safe haven.

Based on our projections, we believe that the next upswing should bring gold closer to the US\$2,250/Oz. level. Having broken through resistance at the US\$1,420/Oz. and US\$1740/Oz. levels previously, we do not think that there will be much resistance ahead till the US\$2,250/Oz. level. The near term entry level will be at the US\$1,740/Oz. support. This represents a 30 percent potential upside (See Chart 2 below).

Chart 2: Parabolic Swing in Gold Puts A Medium Term Target at US\$2,250/Oz.



Outlook for gold remains positive and our projection target is at US\$2,250/Oz.; US\$1,740 and US\$1,550 will be good entry levels.

Source: Bloomberg, as of 22 Aug 2011



Treasury Bonds – Misguided U.S. Policy

In the U.S., talks of further monetary stimulus is rampant and the recent debt ceiling debacle had made fiscal stimulus dead moving forward. We will be expecting the U.S. to shift towards a period of reduced spending and more limited forms of monetary easing.

Having said that, the U.S. economic outlook may turn murky for many months ahead. A weak U.S. economy will be supportive of Treasury bond investment, but not to our best liking.

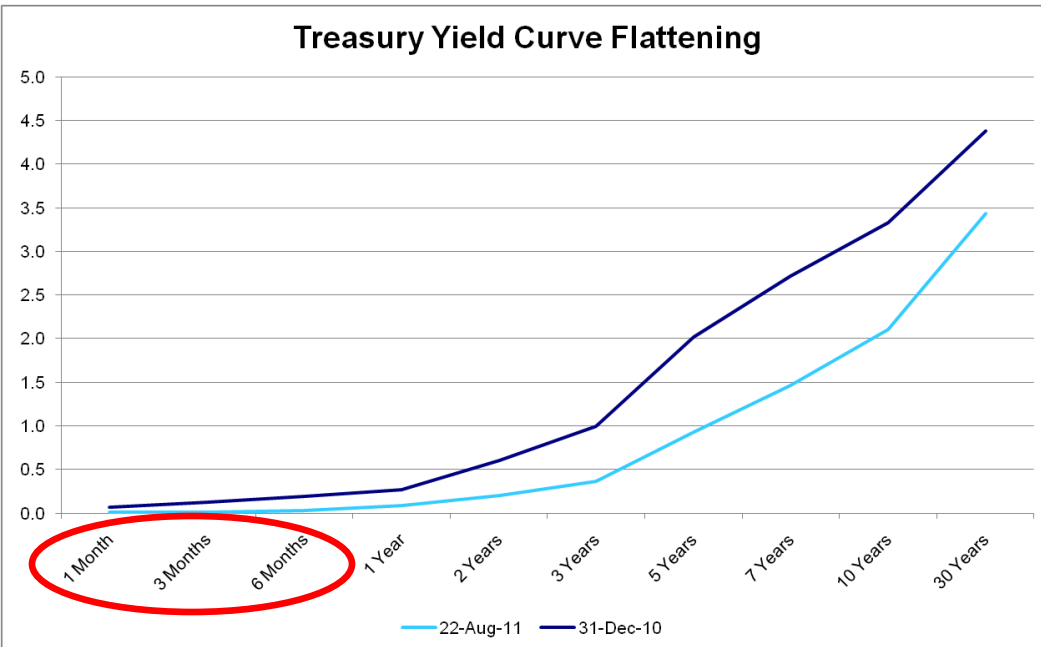
Treasury bonds appear to be the next best safe haven investment after gold (for now). Since 2007 following the collapse of the credit bubble, a massive deleveraging process on the household level took place. Today, U.S. bank lending remains lacklustre though U.S. banks are not short of reserves. With less credit availability, the market expects an underperforming economy.

Because of the ongoing deleveraging and weak economic outlook, we saw the 10-year Treasury bond trading at its lowest yield since 1937 and the 30-year Treasury yield is trading at levels not seen since the Lehman days. At the same time, the short end of the yield curve is trading at next to zero yield (See Chart 3 below).

As mentioned on several occasions, we are not optimistic about holding Treasury bonds for the long term. The U.S. debt level has been soaring over the past two years. With the U.S. government debt crossing 100 percent of its GDP and government receipts plummeting, bond investors should really reconsider the long term appeal of Treasury. The equation simply does not balance well.

If the U.S. today resemble the path which Japan took previously during its lost decade, yields are likely to stay next to zero for the next five to ten years. Both central banks have flooded the system with liquidity and soaked up the bad debts. What awaits may be a period of slow and gruelling economic growth.

Chart 3: Treasury Bonds Offer Little Investment Value at Current Low Yields



10-year Treasury bond is trading at its lowest yield since 1937 and the short end of the yield curve is trading at next to zero yield.

Source: Bloomberg, as of 22 Aug 2011



European Debt Crisis – Escalation of Funding Stress

Increasingly, the European sovereign debt crisis among the peripheral members may be on the verge of implosion. In particular, there will be rising funding challenges for European banks as sovereign concerns spill over to the banking sector.

As evident by the bond issuance volume in the term funding markets, European banks are facing increasing difficulty to meet their refinancing needs. The average monthly bond issuance by European banks in the first five months this year stood at US\$83 billion. Since the start of June, liquidity started to dry up and the average monthly bond issuance fell to US\$42 billion, representing a 49 percent decline in volume.

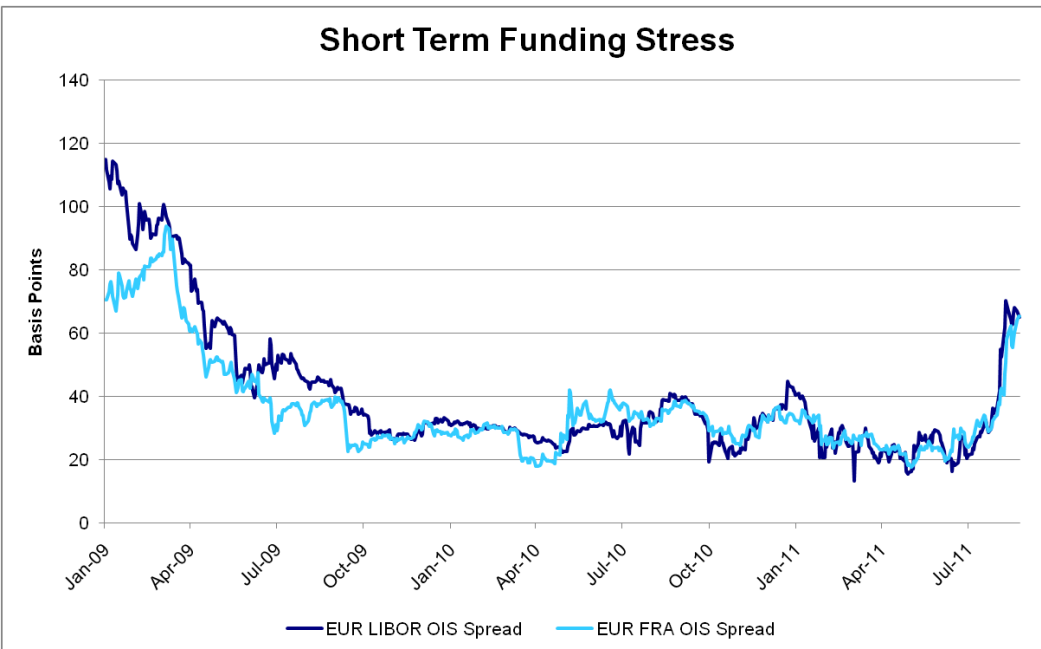
Secondly, short-term funding stress is showing up in the spread between 3-month EUR LIBOR/forward rate agreement (FRA) and 3-month Euribor basis swaps. The two spreads are seen as a bellwether for overall credit and liquidity conditions in the interbank market. Both indicators show the willingness of banks to lend money to each other.

Rising spread suggests growing level of risk aversion in the financial market. The two spreads widened to more than 60 basis points from 20 basis points at the beginning of Jun-2011. This spike coincided with the global financial market sell-off in the month of July and August (See Chart 4 below).

With the cost of funding hitting levels not seen for the most part of 2010, funding concerns may continue to be in the spotlight. This is further backed by the plunge in bond issuance volume in the term funding markets.

More worryingly, the fiscally challenged European nations may not have enough capacity to recapitalise the banking sector should a tail-risk systemic stress occur. Once again, it is an issue of too big to bail rather than too big to fail.

Chart 4: Credit Markets in Europe Showing Signs of Stress



Rising LIBOR-OIS and FRA-OIS spreads suggest growing level of risk aversion in the financial market.

Source: Bloomberg, as of 22 Aug 2011



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