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## Hope for the Best, Prepare for the Worst

### Executive Summary

- **Equities** – The valuation cycle of U.S. equities may soon enter into a new structural down phase; European financials will require massive recapitalisation ahead.
- **Commodities** – We are positive on the outlook for gold. The neutral long-term trend provides a good support area at US\$1,550/Oz..
- **Fixed Income** – The extra yield demanded by investors to buy French bonds instead of German bunds is rising to its widest levels since the inception of Euro currency.

### Equities – A Year of Losses So Far

Although headlines continue to be almost uniformly bearish, sentiments are looking mixed at the moment. The latest AAI Sentiment Survey shows the bullish sentiment fell 3.8 percentage points to 36.0 percent. Bullish sentiment has now been below its historical average of 39 percent for 23 out of the last 27 weeks. On the other hand, bearish sentiment declined 1.8 percentage points to 34.6 percent. Bearish sentiment remained above its historical average of 30 percent for the 32nd time in the past 35 weeks.

Global equities were mostly down for the month of October. In particular, Thailand equities were down more than 11 percent as growing fears about severe flooding in central manufacturing zones raised concern about the country's economic output.

European equities recovered slightly from their hefty losses in August and September, up more than 6 percent on a monthly basis. Overall, we remain slightly bearish on the equities amidst the recent schizophrenic market behaviour.

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

Country	Index	Oct. 21	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Europe	Euro Stoxx 50 Pr	2271.77	6.14 ▲	-16.04 ▼	-22.24 ▼	3077.24	1935.89
Malaysia	FTSE Bursa Malaysia KLCI	1441.18	1.56 ▲	-7.96 ▼	-5.58 ▼	1597.08	1310.53
United States	S&P 500 Index	1215.39	1.11 ▲	-8.33 ▼	-8.64 ▼	1370.58	1074.77
Japan	Nikkei 225	8688.90	-0.60 ▼	-13.20 ▼	-10.29 ▼	10891.60	8227.63
India	BSE Sensex 30 Index	16936.89	-0.95 ▼	-8.46 ▼	-13.01 ▼	21108.64	15745.43
Indonesia	Jakarta Composite	3622.78	-2.02 ▼	-10.95 ▼	-4.69 ▼	4195.72	3217.95
Singapore	Straits Times Index	2694.01	-3.50 ▼	-14.16 ▼	-15.67 ▼	3313.61	2521.95
Hong Kong	Hang Seng Index	17983.10	-4.47 ▼	-18.21 ▼	-25.50 ▼	24988.57	16170.35
China	Shanghai Composite	2331.37	-7.23 ▼	-15.71 ▼	-22.97 ▼	3186.72	2315.90
Thailand	Stock Exchange of Thai Index	909.10	-11.70 ▼	-17.67 ▼	-18.09 ▼	1148.28	843.69

*Major equity markets are still down over the 3-month and 6-month basis. European equities were up 6 percent on a monthly basis.*

Source: Bloomberg, as of 21 Oct 2011



**U.S. Equities – A Dose of Realism**

Many believe that market valuations move in cycles, long term and short term. The long term valuation cycle may be a generational cycle influenced by psychological and demographical factors, lasting many decades. The short term cycle may last only a few years, occurring several times within a long term cycle. We believe that the valuation cycle of U.S. equities may soon enter into a new structural down phase from both the long term and short term perspective.

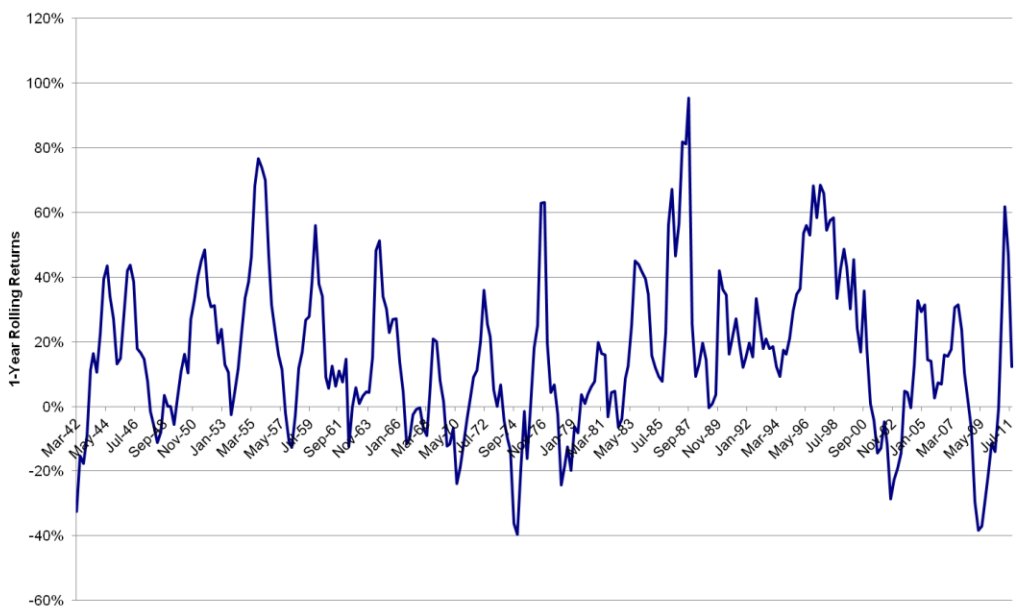
The demographic influence on the valuation cycle may have a negative impact on the U.S. equities moving forward. This is related to the aging of the baby boom generation (born between 1946 and 1964). As the baby boomers reach retirement age, they are likely to shift from buying stocks to selling their equity holdings to finance retirement. At the same time, the broader shift of age distribution in the U.S. population should have similar implications as well. In this sense, the long term valuation cycle down phase among the U.S. equities may be just starting to take hold.

The short term valuation cycle can be assessed using Professor Robert Shiller's cyclically adjusted PE ratio or CAPE. Accordingly, the historical average of the CAPE PE ratio for the U.S. S&P 500 should be closer to 16. Currently, the U.S. S&P 500 sits at a CAPE PE ratio of approximately 24, indicating overvaluation. The CAPE PE ratio takes into consideration the cyclical nature of the U.S. S&P 500's earnings and thus, implying a decline in future earnings from the current levels as well.

Lastly, Wall Street experts surveyed by CNN are largely "throwing in the towel" on hope for a U.S. stock market rebound. They now expect the U.S. S&P 500 to end the year below the year's start. Nearly half of the respondents expect the bullishness from earlier this year to fade. Chances of the usual fourth-quarter pick up (some regard as the year end rally) looks slim.

**Chart 1: Cyclical of U.S. Equity Market over the Past Seven Decades**

**Seven Decades of Bull and Bear Markets**



Source: Bloomberg, as of 24 Oct 2011

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**European Banks – Recapitalizations Ahead**

As mentioned in our previous report, European banks are currently facing a great deal of short-term funding squeeze. Also, EU leaders are pressing for the banks to increase core capital to 9 percent of risk-weighted assets from 5 percent over the next six months period. Given that the European banks are poorly capitalized at the moment, we do expect government-forced recapitalizations among major European banks in the near term.

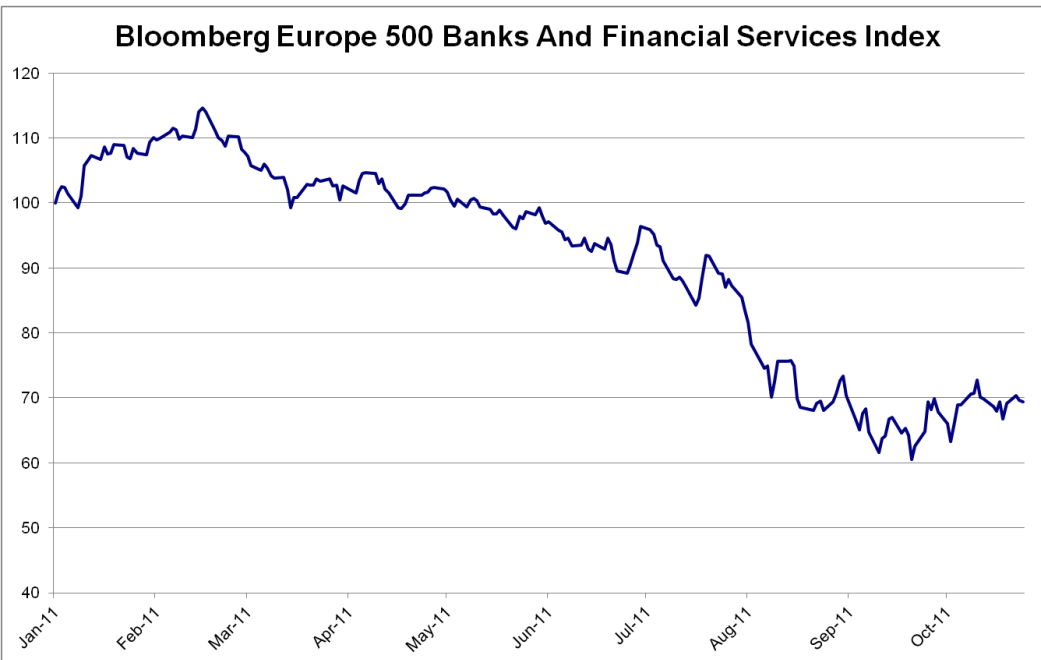
According to Bloomberg, banks in France, the U.K., Ireland, Germany and Spain have also announced plans to downsize their balance sheets by about €775 billion in the next two years to lower their dependence on short-term funding needs and leverage. As such, European banks are likely to curb lending and putting up loans and assets for sale. It is going to be a prolonged deleveraging process.

In fact, European banks are already cutting jobs at the fastest rate since the collapse of Lehman Brothers in 2008. 67,000 roles were eliminated so far this year. UK banks account for about 50,000 of those reductions.

The 46-member Bloomberg Europe Banks and Financial Services Index have fallen 31 percent this year, paced by Dexia SA, the Franco-Belgian lender that's being broken up after concern over its holdings of Greek sovereign debt blocked its access to short-term funding (See Chart 2 below). We do not think that the worst has arrived yet for other European lenders. The only viable option is for European policymakers to shore up confidence in banks quickly. Indecisiveness can be a curse.

The worst case scenario may be waiting in line for the Eurozone economy. Business bankruptcies and mortgage defaults (non-recourse) may rise as bank lending become inaccessible. If history is any guide, there will be negative domino effects and a vicious cycle will take hold. This does not bode well for the European equities overall.

**Chart 2: European Banks Are Treading A Thin Line**



Source: Bloomberg, as of 24 Oct 2011

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**Gold Commodity – Good Entry**

The near term direction of gold prices is likely dependent on how the European debt crisis will be played out. With investors still looking uncertain about the extent of contagion risk ahead of the G20 meeting, gold prices are likely to stay range-bound. However, we remain positive on gold over the medium to long term.

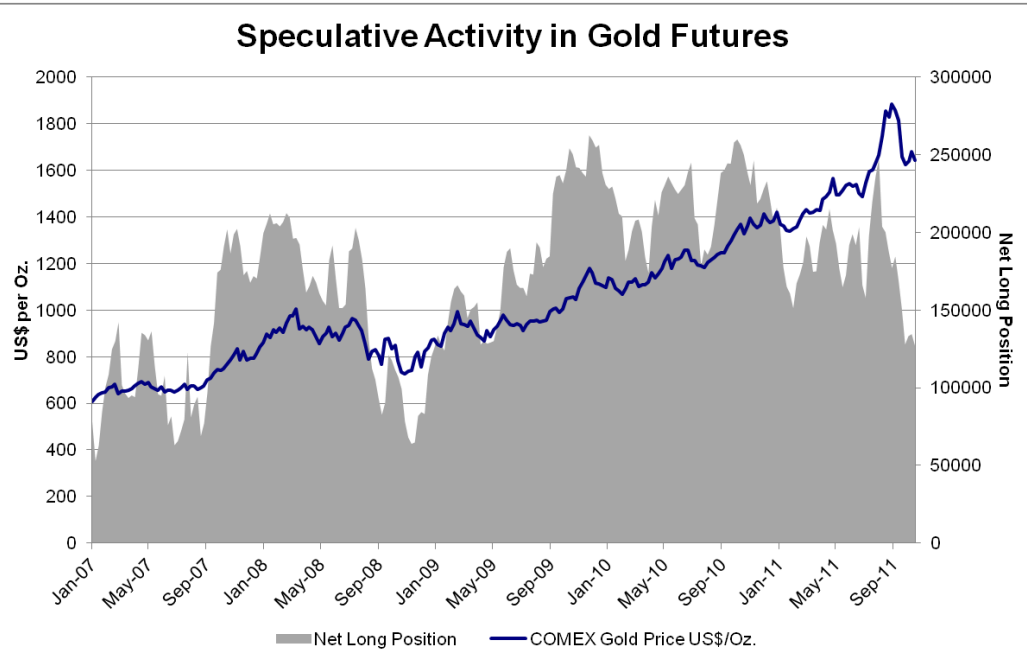
Global inflationary pressures will be one primary driver of higher gold prices. Based on latest inflation data, inflation will remain a key concern moving forward. In India, inflation exceeded 9 percent for the 10 straight months. The key food component of inflation in China rose as much as 13.4 percent year-on-year in September. At the same time, the euro-area inflation rate also inched up to 3 percent in September from 2.5 percent previously.

According to World Gold Council, worldwide central banks last year were net gold purchasers for the first time in two decades. Central bank and government-institution buying totalled 192.3 metric tons in the first half of 2011. Central bank demand is attributed to concerns about currency debasement as well as for diversification purposes.

Although gold is not intrinsically valuable, its production and overall supply is limited. Central banks in the developed countries are seeking to monetise trillions of dollars in public debt, causing potential currency debasement. As a fiat commodity currency, the value of gold is determined largely by its attractiveness relative to other fiat paper currencies. Given that investors are currently uncertain about the future value of most fiat paper currencies, gold will stay as an important hedge.

Over the long term, we are positive on the outlook for gold. After clearing the US\$1,900/Oz. mark previously, the now neutral long-term trend provides a good support area at US\$1,550/Oz., with the negative correlation against the U.S. dollar still intact.

**Chart 3: Speculative Activity is Down in Gold Futures**



Source: Bloomberg, as of 24 Oct 2011

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**Europe Debt Crisis – Possibility of a French Downgrade**

Just when the European Union is still figuring how to fix itself, Moody's Investors Service issued a warning that the French government debt metrics are now among the weakest of France's AAA peers. The potential for further contingent liabilities to emerge is also threatening the French government's AAA debt rating.

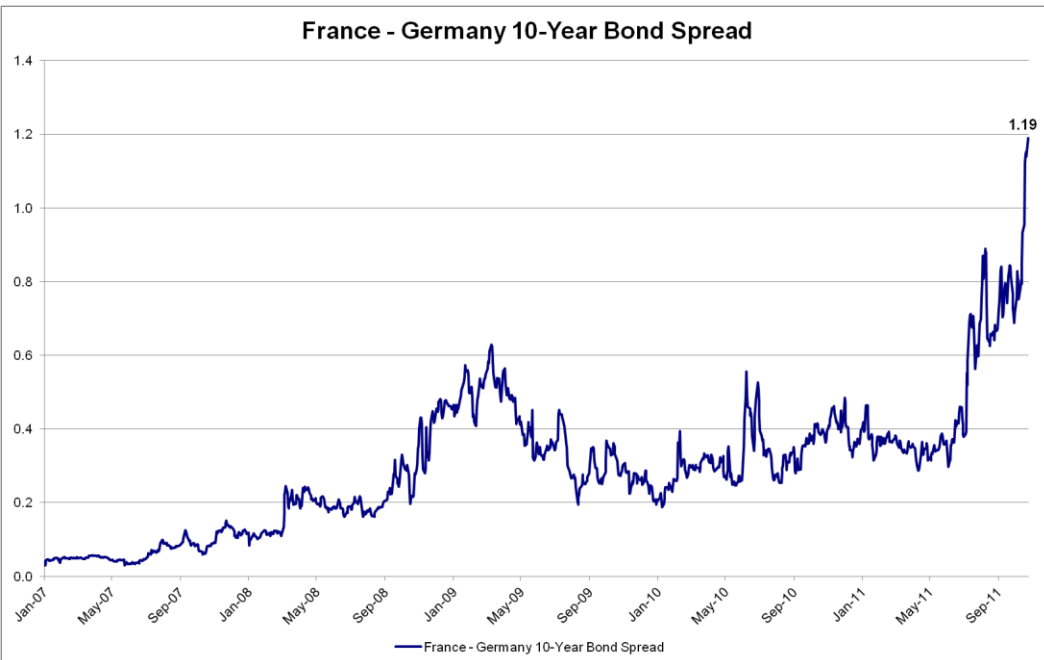
In the meantime, the stock prices of major French banks are experiencing heavy downside pressure. With a weakened banking system, the retail lending in France will be hit. This may bring down residential and business investment. As a result, the private sector will become financially stretched, with poor profitability and large borrowing requirement.

We feel that French government will have to start to take corrective measures in making the necessary economic and fiscal reforms. Recapitalisation of French banks will be high on the agenda as well. Tough and decisive measures will have to be taken to avoid an outright downgrade by the rating agencies.

On the positive side, it is still early to push the panic button. France's financial strength remain strong. Also, its fundamental GDP growth is supported by the high productivity, broad diversification and high private sector savings. The debt affordability remains comfortable. However, the French government now has less room for manoeuvre in stretching its balance sheet as compared to that in 2008.

The extra yield demanded by investors to buy French bonds instead of German bunds is rising to its widest levels since the inception of Euro currency. Investors are worried of a possible rating downgrade and its overall banking system as mentioned earlier. The 10-year French/German yield spread widened to 119 basis points as the yield on the benchmark 10-year French bond rose to 3.3 percent (See Chart 4 below). We feel that this may be the signal for the French policymakers to start acting before fear translates into paralysis.

**Chart 4: France-Germany 10-Year Government Bond Yields Spread Surged**



*Extra yield demanded by investors to buy French bonds instead of German bunds is rising to its widest levels Euro inception.*

Source: Bloomberg, as of 24 Oct 2011



**U.S. Debt-to-GDP Level – The 100 Percent Mark**

As reported by the U.S. Bureau of Economic Analysis, the U.S. Q2 GDP last stood at US\$15.012 trillion. This represents a mere US\$70 billion over the total U.S. debt outstanding, which is an all time low. At the start of 2010, the level of U.S. debt was US\$1.8 trillion below the level of U.S. GDP. Based on the upcoming Treasury bond issuance, the U.S. Debt-to-GDP ratio is likely to hit the 100 percent mark before the end of this year. The debt situation in U.S. looks to be in a bad predicament. (See Chart 5 below)

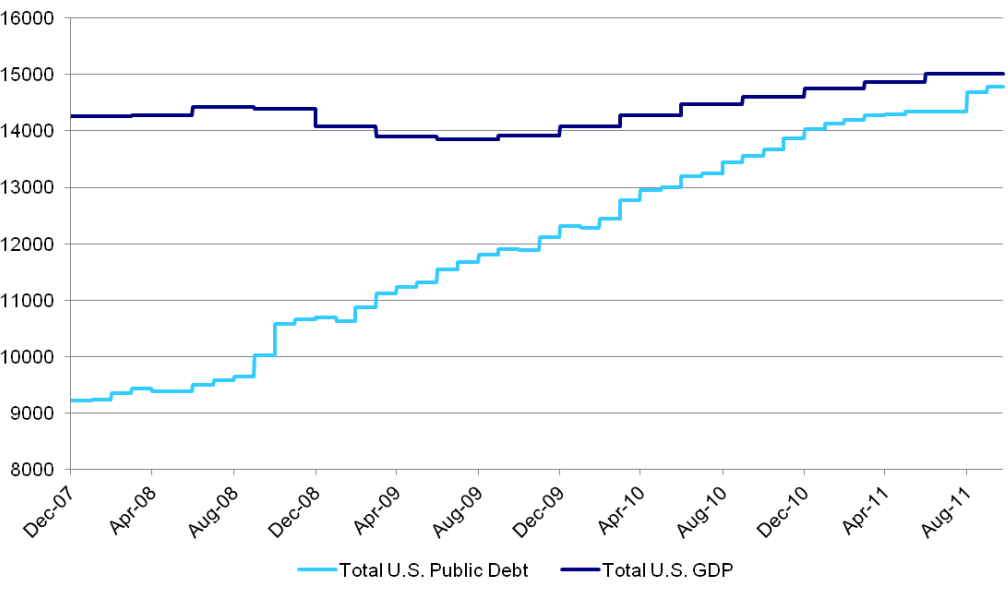
On the positive note, the current U.S. debt service burden on the national debt is low amidst the huge run up in the U.S. federal debt. This is due to the sharp drop in the average interest rate paid on the outstanding debt, standing at 2.9 percent as of Sept. 30. At the current level, the interest rates seem as low as it can go. In the event of rising interest rates, there will be problems in terms of market access and increase the rollover risk of maturing debt.

One possible “solution” is to extend the average maturity of the public debt, delaying the inability to roll over maturing debt. There are already evidence that the U.S. Treasury is increasing the average maturity of outstanding debt, from 50 months back in 2009 to 62 months today. In other words, the doomsday scenario has been postponed but not for long.

At the other end, the U.S. Federal Reserve may be planning a large scale asset purchase of agency Mortgage-Backed Securities (MBS) according to the Wall Street Journal. This is likely to increase the demand for MBS and reduce the effective yield, thus lowering the mortgage rates. The aggregate demand effect may add purchasing power of existing homeowners and stimulate consumer spending. However the truth is, we have seen very minimal incremental benefit to the overall U.S. economy based on previous experience with QE2. The health of the U.S. economy is getting immune towards monetary stimulus.

**Chart 5: Total U.S. Debt is Expected to Exceed Its GDP**

**Total GDP to Total Debt (in US\$ billions)**



*The U.S. Q2 GDP last stood at US\$15.012 trillion. This represents a mere US\$70 billion over the total U.S. debt outstanding.*

Source: Bloomberg, as of 24 Oct 2011



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