



# PHILLIP SECURITIES PTE LTD

## Unit Trust – Asset Class Update

21 Oct 2010

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## BULLS WON ; DOES TREASURY YIELDS MAKE SENSE?

### Executive Summary

**Equities** – Global equities continued to perform strongly while possible fresh round of U.S. quantitative easing will be a further boost to credit growth and investment activities in the East.

**Commodities** – Sugar commodity outperformed on a monthly basis; gains in general commodities mainly due to weakness in the dollar.

**Fixed income** – The ratio between 30-Year and 10-Year Treasury yields traded at record high on the back of possible new round of quantitative easing from the Fed. 5-Year TIPS trading at negative real yields.

### Equities – The Quantitative Easing Story

October continued the September's brisk advance for the equity markets. We saw the U.S. S&P 500 Index gaining more than 5 percent for the month (See Table 1 below), closing on 18<sup>th</sup> Oct strongly at 1184.71. From their recent lows in late August, U.S. stocks have rallied nearly 13 percent. Based on the recent performance, we may be entering one of the best season for stocks in the calendar year. Three big forces may be behind the recent broad based equity rise — earnings season, the U.S. midterm elections, and the Federal Reserve's moves to further easing.

At the same time, China's stocks entered a so-called bull market on Oct. 11 as the benchmark index spurred a 20 percent rebound off this year's low. We continued our positive call on Chinese equities. The recent move from the central bank in boosting the benchmark one-year lending rate to 5.56 percent from 5.31 percent and deposit rate to 2.5 percent from 2.25 percent was the nation's first interest-rate increase since 2007. This will help tame inflation and contain asset bubbles.

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

Country	Index	Oct. 19	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
China	Shanghai Composite	3001.85	15.51	21.27	0.72	3361.39	2319.74
Hong Kong	MSCI Turkey	1032996.00	9.98	21.24	22.39	1040537.25	654235.06
Hong Kong	Hang Seng index	23763.73	8.16	18.28	11.02	23866.87	18971.52
Thailand	Stock Exch of Thai	988.23	7.00	19.01	36.07	999.51	666.81
Indonesia	Jakarta Composite	3582.32	5.84	20.39	26.12	3645.61	2235.39
Asia Pac ex Jap	MSCI Asia ex Japan	547.15	5.83	16.60	11.20	558.01	425.24
United States	S&P 500 Index	1184.71	5.25	10.59	-1.07	1219.80	1010.91
Singapore	Straits Times Index	3191.78	3.75	8.36	7.80	3220.71	2605.10
Malaysia	Bursa Malaysia KLCI	1485.13	1.24	11.38	11.94	1503.82	1224.37
Japan	Nikkei 225	9539.45	-0.90	1.39	-12.55	11408.17	8796.45

Source: Bloomberg, as of 19 Oct 2010

*Major global equities were mostly up on a monthly basis. Japan equities continued to be a laggard.*



### Credit Growth a Boost to Asia Pacific ex Japan Equities

There were market talks on the massive international capital flows to the Asian continent as a result of the easing policies from the West. Historically, data from CEIC research showed a total net capital outflow of USD149billion during the 2008Q3 – 2009Q1 period (USD78billion in Q4 alone). However, in the second half of 2009, investors saw the largest ever capital inflows (in USD terms) back to the Asian continent as the region’s recovery strengthened. Till date, the net inflows as of mid-2010 had more than made up for the earlier outflows in 2008-09.

Importantly, the data from CEIC also showed that most of the capital coming back to Asia is through bank lending, generating excessive credit growth. Countries such as Hong Kong, India and Indonesia enjoyed more than 20 percent credit growth on a year-on-year basis. That being said, this complicated monetary policy in a region where most central banks are trying to at least “normalize” monetary conditions if not actually tighten credit (The People’s Bank of China being the latest central bank to raise interest rate as mentioned earlier). In our opinion, a possible second round of quantitative easing in the United States would further result in massive amount of “hot money” pouring into the Asia region, finding their way to high yielding assets such as properties and equities.

The credit growth had actually boosted the performance of Asia-Pacific ex Japan equities to a certain extent over the past year with countries such as Indonesia and Philippines gaining more that 40 percent (See Table 2 below). At the same time, the 1-Year performance on the U.S. S&P 500 Index and the European blue chips were less than convincing on a relative basis. From the valuation angle, Asia Pacific ex Japan equities were sitting at a reasonable Price-to-Earnings ratio of 15 and a Price-to-Book value of slightly over 2.

Moving forward, a near-term peak is going to be expected in early November as global equities entered into overbought region. Buying Asia-pacific ex Japan equities on a near-term dip may offer an attractive investment opportunity.

**Table 2: Stock Market Boom in Asia**

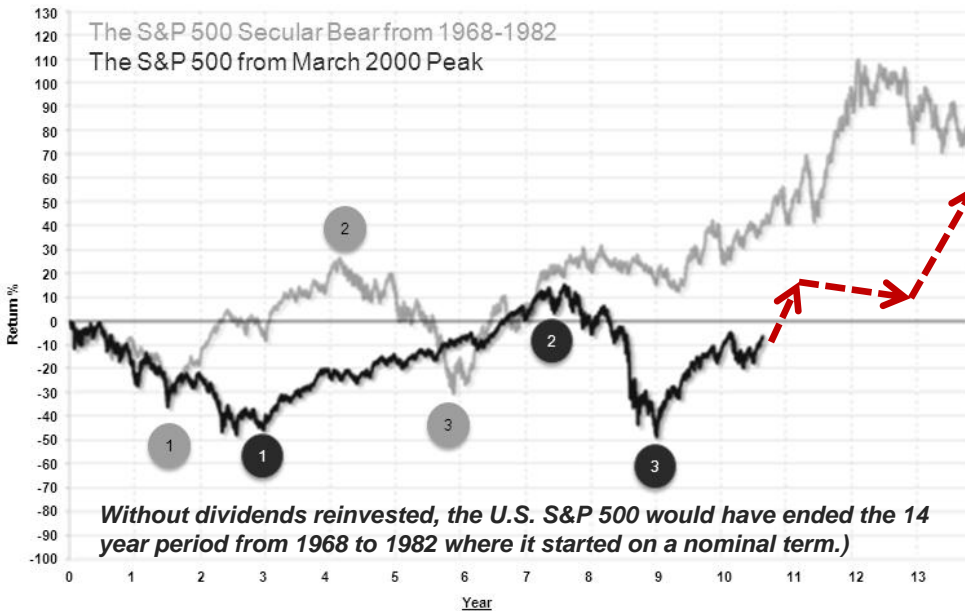
Index	3 Mth %	1 Yr %
Hang Seng Index	18.28	7.04
Jakarta Composite Index	20.37	42.03
BSE Sensex 30 Index	12.75	16.81
Shanghai SE Composite	21.27	-1.20
Straits Times Index	8.36	17.69
Kospi Index	7.24	12.63
PSEi - Philippine SE Index	22.40	42.94
Taiwan TaieX Index	5.18	3.80
FTSE Bursa Malaysia KLCI	11.41	17.77
Stock Exch of Thai Index	19.03	35.21
MSCI AC Asia ex Japan	16.60	15.52
S&P 500 Index	10.59	7.91
Euro Stoxx 50	8.27	-3.22

*A surge of capital is flowing into Asia emerging markets through credit growth and bank lending activities, bringing about the outperformance in Asian equities.*

Source: Bloomberg, as of 19 Oct 2010



### Chart 1: Nominal Comparison-Total return (dividend reinvested)



Source: Bloomberg, as of 19 Oct 2010

Chart 1 above compared the two secular bear markets in recent history on a total return basis (with dividends reinvested). The two periods identified are from Nov 1968 to Aug 1982 and Mar 2000 till date. Some market participants seemed to believe that price action tended to repeat itself because investors collectively tend towards patterned behavior, especially when it comes to the argument for technical analysis. From the chart above, we aligned the two bear troughs labeled number 1 and 3 and the peak identified by number 2.

To recall, the earlier secular bear market was a period of stagflation that started with the 1973 oil embargo as the stagflation bear pushed the U.S. S&P 500 Index to its bottom as shown by the trough highlighted in light grey number 3. Today, the economic environment in terms of inflation rates, dividend yields, federal debt, average GDP etc are radically different from the 1970s. However through another perspective, we realised that the corporate sectors were hoarding a high level of cash then and now to be given out as dividend/stock buyback or reinvested through capital expenditures. Therefore, investors should be inclined to focus more on a dividend play strategy in the medium-to-long term as the patchy economic recovery would have caught out the aggressive ones, while leaving the most conservative ones underperforming. On top of that, companies that had adopted a steady dividend payout policy were most likely to continue to do so year in and year out as stockholders viewed the payout as a form of steady cash flow.

As such, we are inclined to believe that history may after all be a guide for United States equities moving forward. From the chart above, one would tend to believe that the outlook on the U.S. equities will be they are likely to experience another leg up in the very short term and remain range-bounded for the next couple of years, before making new highs again.

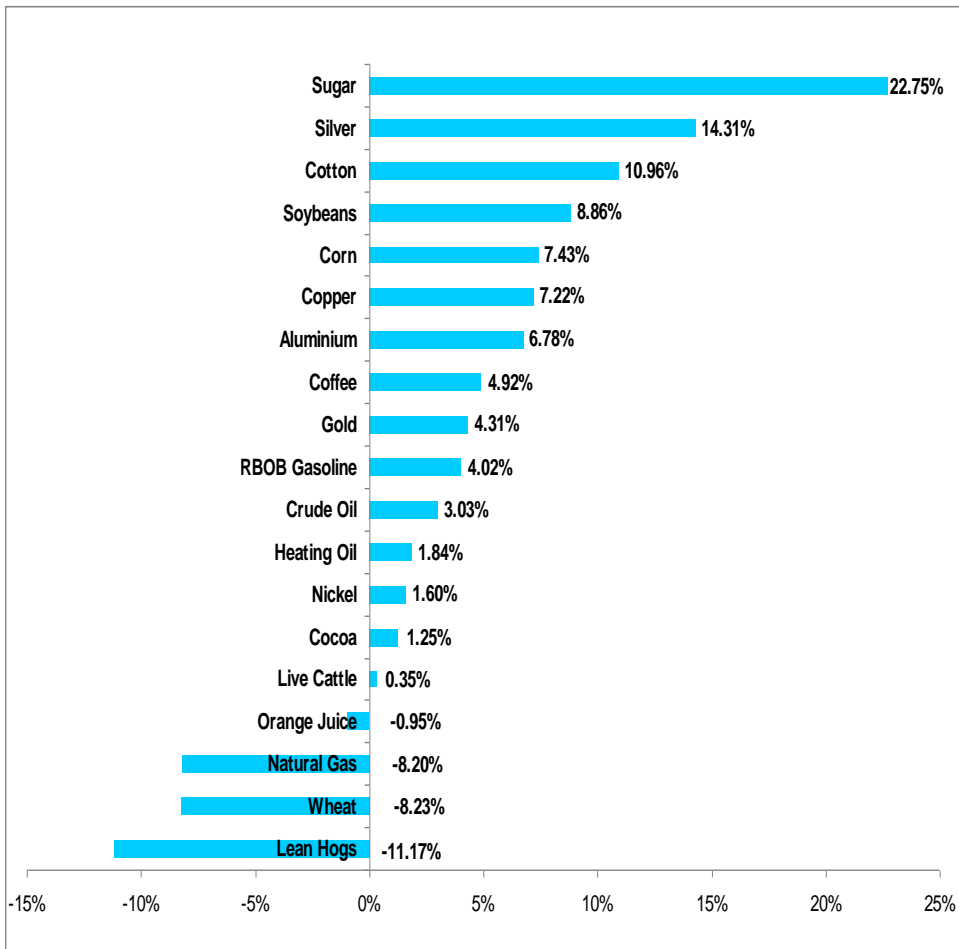
*The nominal total return mega-bear comparison on index prices with dividends reinvested between the 1970s and 2000s.*



### Commodities – Fundamentals and the Dollar

The Thomson Reuters/Jefferies CRB Commodities Index gained 4.77 percent in the one month period ending 20 October 2010 and 1.26 percent year-to-date. Most commodities experienced gains as we witnessed 15 gainers and 4 decliners as shown in Chart 2.

**Chart 2: Commodities 1-Month Return**



Source: Bloomberg, as of 20 Oct 2010

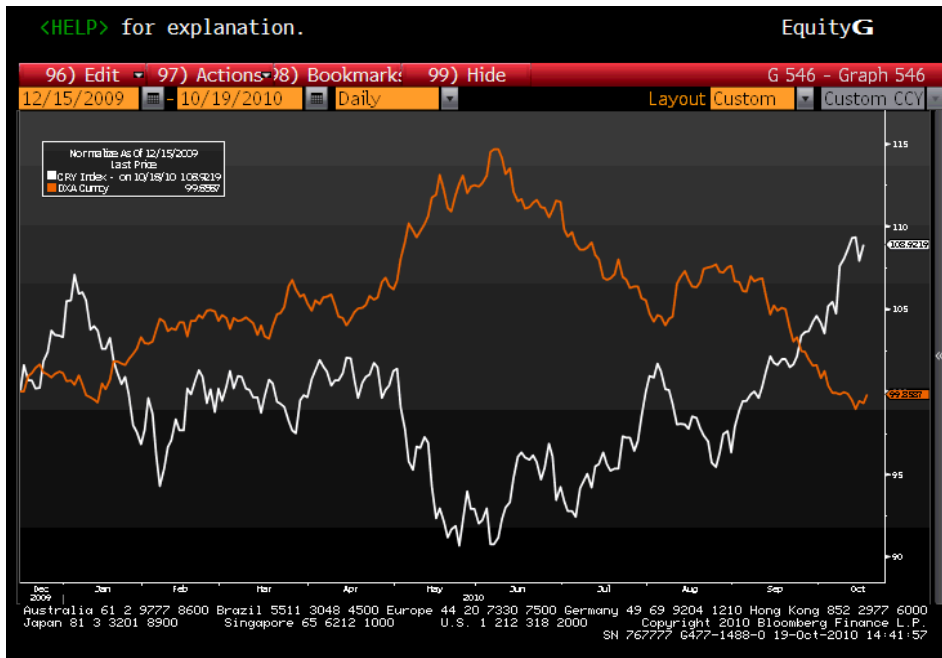
### Commodities – Dollar

The market were expecting Quantitative Easing II (QE2) by the US Federal Reserve to result in a weaker dollar as investments fled from the low interest environment into emerging market equities, foreign exchange and commodities. Historically, there is an inverse relationship between the USD and the Thomson Reuters/Jefferies CRB Commodities Index as shown in Chart 3. Therefore, despite the impressive gain in commodities in the past month, much of the recent gains in commodity market could be on the back of a weaker US dollar.

*Most commodities had strong positive returns in the one month period ending 20 October 2010.*



**Chart 3: CRB Commodities Index vs Dollar Index (Normalised)**

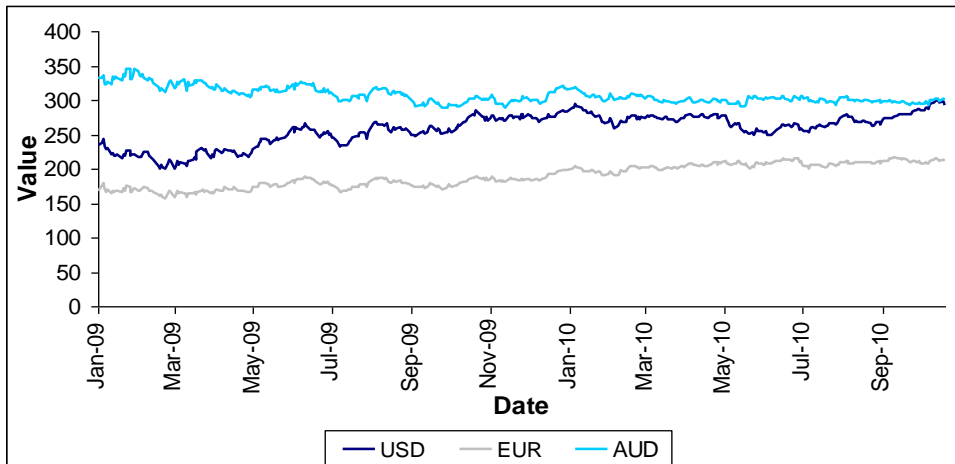


*There is negative correlation between CRB Commodities Index and Dollar Index.*

Source: Bloomberg, as of 20 Oct 2010

We noticed that despite the strong negative correlation between US dollar and commodities price, the CRB Commodities Index priced in other currencies are pretty much flat as shown in Chart 4. The CRB Commodities Index based in the Euro dollar has a less steep increase and that based in the Australian Dollars actually witnessed a decline in price. Although the one-month return for the Commodities Index was a stunning 4.77 percent in US dollar term, the return is 2.01 percent and -0.84 percent when priced in Australian dollar and Euro dollar respectively. This substantiates the view that the commodities rally in the last month was largely due to the effect of the decline in value of the US dollar.

**Chart 4: CRB Commodities Index Based in Various Currencies**



*Commodities price in EUR has less impressive return and that in AUD has negative return over the last 6 months.*

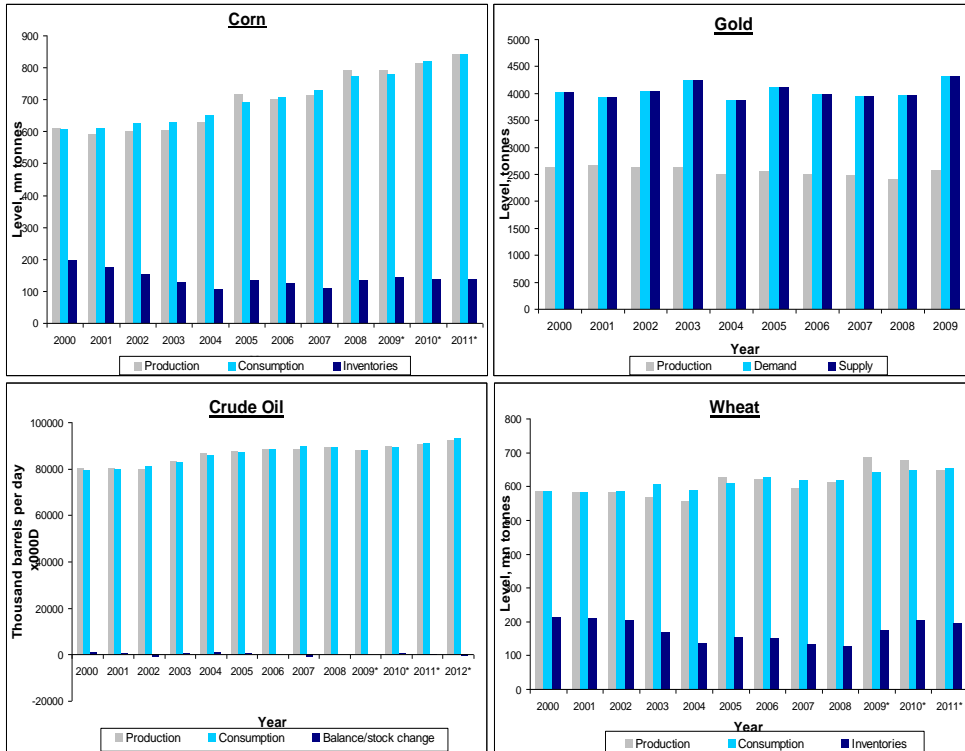
Source: Bloomberg, as of 20 Oct 2010



### Commodities – Supply and Demand

Next, a look at the supply and demand of various commodities showed that the fundamental driving factors of commodities prices had not changed much throughout the years. Despite the increase in demand noted in the commodities in recent years, the supply and demand usually balanced out in the years as shown in Chart 5.

**Chart 5: Commodities Supply & Demand**



Source: BMI, as of 19 Oct 2010

### Commodities – Speculative Activities

Since the fundamentals of the commodities market had not changed significantly, what we deemed as the driving force behind the price movement were speculative activities. For example, investment demand had greatly increased for precious metals due to weakness in the dollar and potential of QE2. However, as the precious metals' prices rises, their fundamental demand from jewelry makers and other end users could decline. Therefore, one main concern for the precious metals prices is that the investment demand alone will be insufficient to bridge the gap between fundamental demand and supply, so any risk of decline in the precious metals' prices could cause a downward spiral of prices if speculative investors start selling their positions.

In conclusion, we feel that the rally last month was largely due to speculative activities and the weak dollar and we expect to see a correction in the commodities market in the coming month.

*Commodities generally have increase in recent years, but demand and supply are generally balanced throughout the year.*



### Fixed Income – Does a negative yield makes sense?

With the economy growing too slow and unemployment rate too high, the U.S. Federal Reserve Chairman Ben S. Bernanke increased speculation that the central bank was likely to prepare a second round of so-called quantitative easing through bond purchase program. In particular, this had provided a further boost to the Treasuries and at the same time hitting the dollar hard, sending the dollar index basket down 8% from its previous peak.

The 10-Year and 30-Year Treasury securities were considerably higher for the month, bringing the respective yields to a new low this year. On this note, this had actually prompted questions over how much stimulus has already been priced in on the Treasuries. The extra yield investors demand to hold 30-year notes over 10-year notes, increased to one of the highest level in recent history at 1.42 percentage points on Oct. 19.

From Chart 6 below, the ratio between the 30-Year and 10-Year US Treasury yields is currently trading at an all-time high. With the ratio broken out to uncharted territory, the yield curve is at its steepness in recent history. Steep yield curves were typically considered conducive to economic growth but this time round, the shape and steepness of the yield curve is becoming artificially distorted.

In our opinion, it could be the case that the 10-Year Treasury may have ran ahead of itself on this event. The question regarding a second round of quantitative easing by the Fed is tilted towards the “when” rather than “if”. This current wave of bullish market sentiment on Treasury bonds had made some investors concerned about a possible pullback on the Treasury bonds. The question in line is, after the second round of quantitative easing, what’s next?

### Chart 6: Long End of the Yield Curve Keeps Getting Steeper



*The long end of the yield curve became steeper (during the period highlighted in yellow) as the market digested the effects of Bernanke introducing the QE2.*

Source: Bloomberg, as of 19 Oct 2010

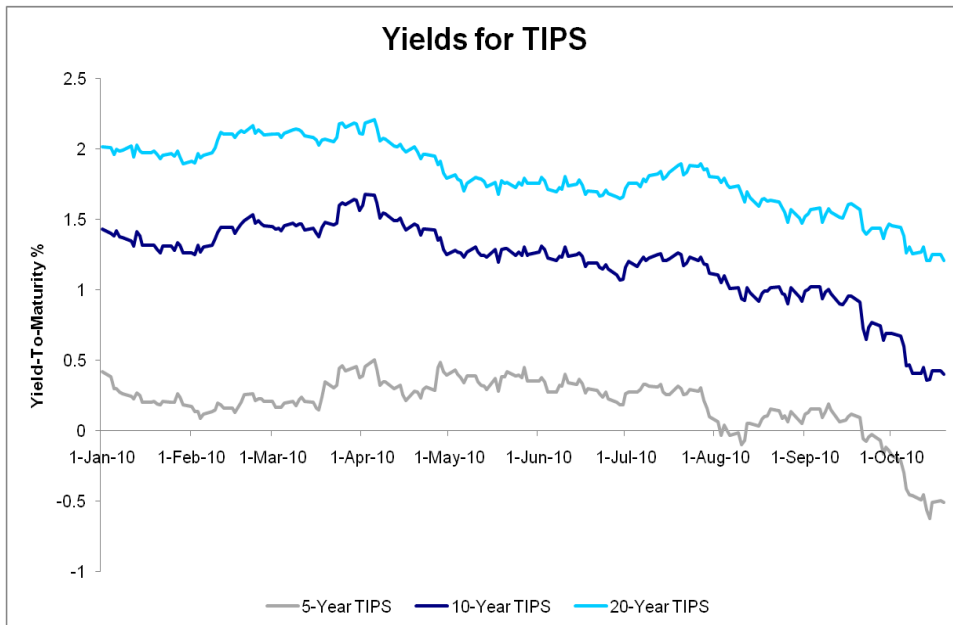


We were further concerned about the outlook on the U.S. bond market when the yield-to-maturity on the 5-Year Treasury Inflation Protected Securities (TIPS) turned negative for the first time on Aug. 10. From Chart 7 below, the observation was that the one day dip into negative territory for the 5-Year TIPS on the Aug. 10 had been followed with a series of negative real yields for the 5-Year TIPS that commenced on Sept. 28. The decline in the yield was also observed on the 10-Year TIPS and 20-Year TIPS.

A negative yield-to-maturity implied that investors would be making an investment loss if he chose to hold the bond to maturity. In short, it does not make any investment sense for the investors unless they are speculating that the bond securities would make them a significant capital gain prior to maturity. On this note, the return/risk characteristic became further complicated given that the coupon payments and bond's face value is inflation protected (par value rises with inflation).

In this case, there could be two possible explanations for the above observation. Firstly, this may spell a high level of speculative activities in the Treasury market at the moment. Speculators were betting that the second round of bond purchase program from the Fed will further drive the TIPS yields lower, giving them a capital gain advantage prior to the TIPS maturity. Secondly, future inflation expectation may be lingering as market participants anticipate the current negative yield-to-maturity will be offset by an increase in the par value. However, given that the general U.S. economic data was less than convincing as many would have observed, the latter scenario is more subtle. Therefore, in our opinion, the former seemed the likely scenario.

**Chart 7: Negative Yield-To-Maturity on 5-Year TIPS**



Source: Bloomberg, as of 19 Oct 2010

*Negative yield-to-maturity on the 5-year TIPS implied short-term speculative activities and/or escalating long term inflation concerns.*



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