



**Analyst**

Liang Shibin  
+6565311516  
liangsb@phillip.com.sg

## May(be) a Break Time For Equities?

### Executive Summary

- **Equities – Market was boosted by positive earnings results and a continuing decline in the U.S. dollar; Trend may reverse in May as quantitative easing approaches termination.**
- **Commodities – Silver prices had a spectacular run, eyeing the 1980s all-time high at US\$50.35/Oz.; Oil prices were spurred by speculators rather than supply shortage.**
- **Fixed Income – European members are pondering upon the possibility of restructuring on Greek debts; U.S. government triple A rating under threat.**

### Equities – Happy Hours in April

Global stock markets finished up strongly during the month of April. Korea had a strong rally, up almost 9.2 percent. In Indonesia, the Jakarta Composite Index led the way up 7.8 percent, breaking its 52-week high (See Table 1 below).

On the U.S. equities, the market was boosted by the continuing decline in the U.S. dollar, which is now down over 6.5 percent for the year. The U.S. earnings continued to surprise to the upside as the U.S. major indices push through recent highs. As of the week ending Apr. 24, the Dow closed at 12,505.99, its highest level since June 2008 and 91% above its March 2009 low.

In terms of corporate performance, Standard & Poor's (S&P) estimated earnings of US\$96.69 for the S&P 500 equities this year, putting its P/E at slightly under 14. This is in addition to a series of positive earnings surprises on the U.S. equities during the month of April. Despite the market optimism, we are turning slightly negative for the month of May. The proposed end of the US\$600 billion quantitative easing (QE) may prove a challenge to the equities bulls.

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

Country	Index	Apr. 21	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
Korea	KOSPI Index	2186.92	9.16 ▲	5.65 ▲	16.66 ▲	2195.56	1532.68
India	BSE Sensex 30 Index	19470.98	8.91 ▲	2.23 ▲	-2.02 ▼	21108.64	15960.15
Indonesia	Jakarta Composite	3794.76	7.84 ▲	12.29 ▲	5.76 ▲	3794.76	2502.05
Singapore	Straits Times Index	3165.80	6.11 ▲	-0.59 ▼	0.07 ▲	3313.61	2648.15
Hong Kong	Hang Seng Index	23896.10	5.34 ▲	0.08 ▲	1.04 ▲	24988.57	18971.52
Japan	Nikkei 225	9658.35	4.91 ▲	-6.00 ▼	3.01 ▲	11213.45	8227.63
Europe	Euro Stoxx 50 Pr	2921.43	4.61 ▲	-0.20 ▼	2.45 ▲	3077.24	2448.10
United States	S&P 500 Index	1330.36	4.00 ▲	3.91 ▲	12.92 ▲	1344.07	1010.91
China	Shanghai Composite	3007.04	3.37 ▲	10.74 ▲	0.79 ▲	3186.72	2319.74
Malaysia	FTSE Bursa Malaysia KLCI	1531.02	1.47 ▲	-1.06 ▼	2.68 ▲	1576.95	1243.86

*Asian equities outperformed during the month of April. U.S. equities were boosted with a series of positive earnings results.*

Source: Bloomberg, as of 21 Apr 2011



**Quantitative Easing II – Japanese Lesson**

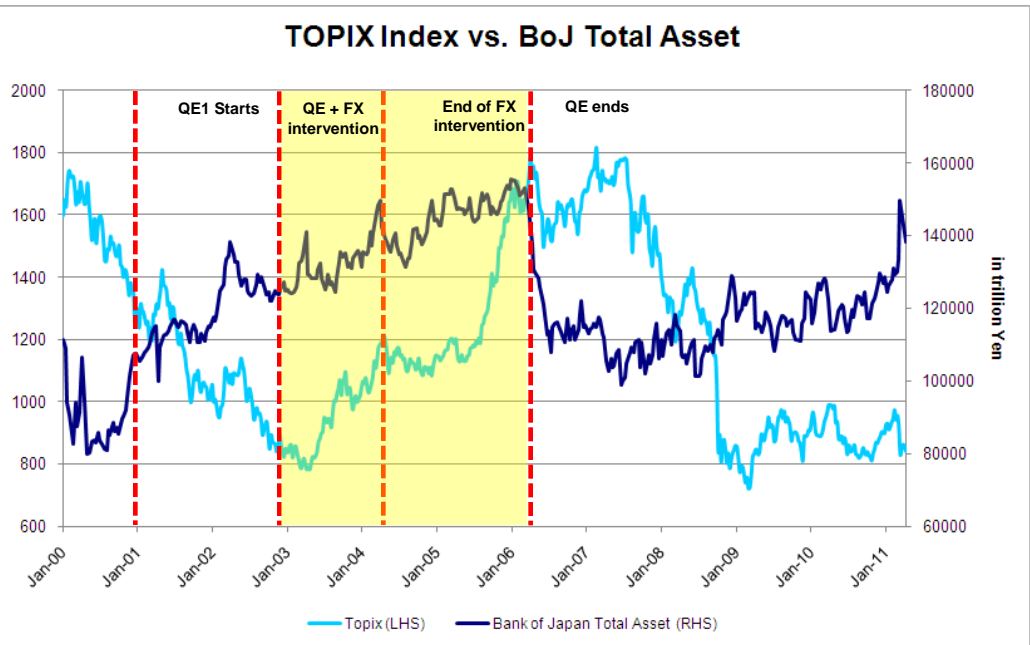
Generally speaking, QE affects the economy through changes in interest rates on long-term government bonds and other financial instruments. QE involves large-scale asset purchases by the central bank, resulting in downward pressures in interest rates on long-term Treasury securities. As interest rates fall, new business investments should bolster economic activity. However, there are evidence that the recent QE2 may have brought along unintended consequences through risky assets’ price inflation.

To recall, the second round of QE began in November 2010 and is scheduled to conclude coming end of June 2011. Since the start of QE2 program, the Dow Jones Industrial Average Index is up more than 11 percent. In fact, this positive correlation in equity rally following a non-traditional monetary policy in the form of QE is nothing new. The Japanese lesson with its QE experiment in 2001 offers valuable insights (See Chart 2 below).

Bank of Japan (BoJ) launched its previous QE program on Mar 19, 2001 and the Topix went on to make fresh high on May 7, rallying almost 16 percent. Following which, the Topix index slid 45 percent to just over 780 by end Apr 2003. The low for the Topix in 2003 followed shortly after the BoJ combined QE with FX intervention. The Topix rolled over in 2004 when FX intervention ended and again in 2006 when QE ended.

No doubt, the major equity markets may be in a definite optimistic tone at the moment. Proponents argued that earnings will continue to pick up with valuations still supportive. However, if we can put across the case that the recent equity run-up as a “risk-on” play, there is a high probability that the scheduled winding down of QE2 in June will signal the start of a sell-off in equities. To justify this claim, we will look into the margin debt levels on New York Stock Exchange (NYSE) next.

**Chart 1: Japanese Equities Rallied on QE (2003-2006)**



Source: Bloomberg, as of 21 Apr 2011

*The Japanese lesson with its QE experiment in 2001 kick-started a rally in equities which ended in 2007.*



**Quantitative Easing II – Risk On Signals Can’t Lose**

The QE2 had potentially sparked an escalating level of speculation in the equity space. According to the NYSE’s margin data, the debit balances at margin accounts is rising to new recent highs. The latest reading from end-March points to more than US\$315 billion of margin debt, only US\$65 billion away from its all-time highs (See Chart 2 below).

The current level of speculative fervor is consistent with that during the dot-com bubble in late 1990s and the Lehman credit crisis previously. The “risk on” environment has, to some extent, resulted in a “can’t lose” environment where investors believe that equities can keep up with the upward momentum.

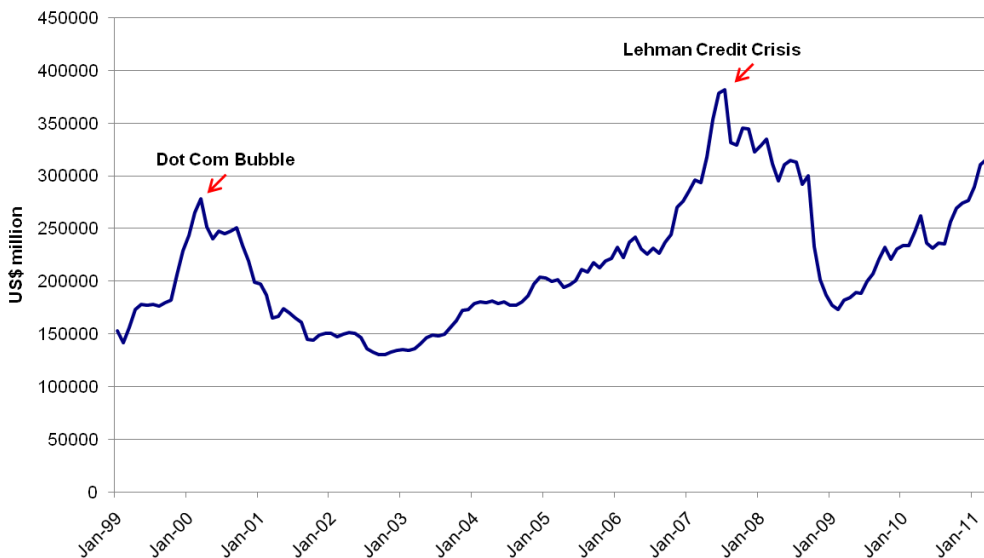
A speculative-led rally in the equity market is worrying. The unwinding of massive amount of leverage within the equity will generate further sell-offs. With reference to Chart 2, the potential level of margin debt unwinding sits at more than US\$50 billion as compared to a year earlier.

Perhaps, the final part of the equation is are we near the end of this quantitative cycle? Based on the cumulative total of par value accepted by New York Fed Reserve, more than US\$560 billion out of the total US\$600 billion QE program has already been implemented so far (as of Apr. 21). We are not there yet, but close.

Finally, if we look back at last year for guidance, the Greek and European crisis sparked a sell-off during the month of May. Back then, bad news filled the headlines. As the old market adage goes, the prospect of “selling in May and going away” may not be too bad should a correction occurs. Though we do not think that equities will go down right away, we are uncomfortable with the level of inherent risk generated by the increasing margin debts at the moment. Longer term, we remain bullish, as the profit cycle recovery looks solid.

**Chart 2: Margin Debt at Speculative Levels**

**NYSE Margin Debt (US\$ in millions)**



*Margin debt on the NYSE is at speculative levels, comparable to the previous Dot-com bubble, funded by the excess liquidity from QE.*

Source: Bloomberg, as of 21 Apr 2011



**Commodities – Speculation Driving WTI Crude Oil**

Global crude oil prices have risen significantly since August last year. In fact, crude oil prices are currently at their highest level since 2008. As mentioned in the earlier reports, the recent rise in crude prices can be attributed to the risk premium built in as a result of the disruption of crude oil exports from Libya and continuing unrest in other Middle East and North African (MENA) countries.

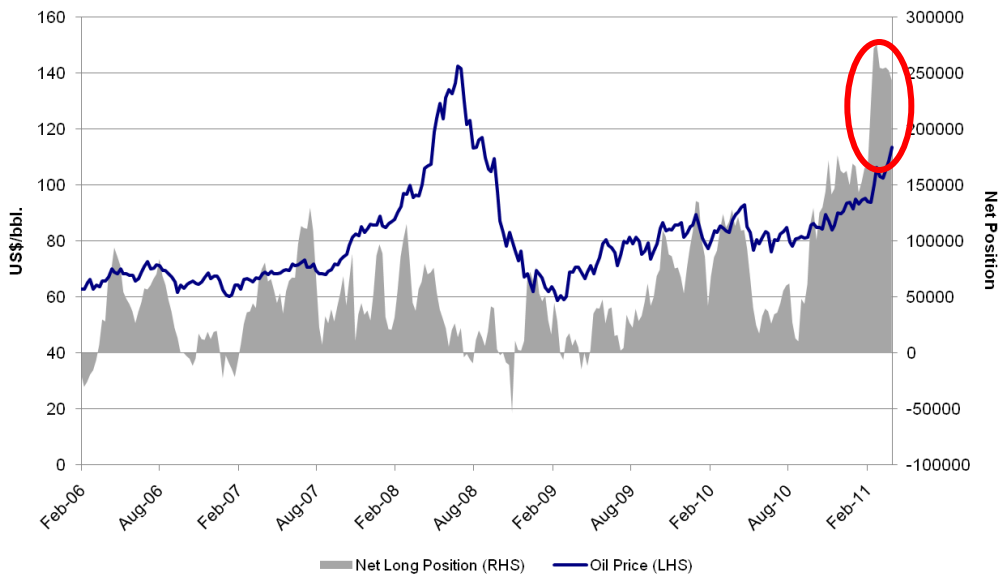
However we note that oil demand appears to be a lackluster. According to International Energy Agency, the growth in world oil consumption slowed to 2.6 percent in the first quarter of 2011, compared with 4.1 percent in the final three months of 2010. At the same time, oil demand is expected to grow at a mere 1.6 percent this year, largely in line with the 1.7 percent average annual increase recorded between 2001 and 2007.

At the same time, there are also concerns that a slowdown in Europe will put a dent on oil demand. Financial Times reported that overall European oil demand was flat in the year to February, while member countries saw considerable falls, with Britain recording a 3.1 percent decline and France 3.7 percent.

There is a possibility that the recent spike in oil prices was driven by the speculation rather than fundamentals. We note that non-commercial participants on the NYMEX WTI futures contract continued to scale up net buying positions (See Chart 3 below). Net buying interest on futures had picked up heavily, potentially buoyed by the implementation of QE2 and the Middle East unrest which followed. In the latest weekly data released by the CFTC, non-commercial length on futures increased to 243,261 contracts, from 149,466 contracts in the first week of January. However, we view that the fundamental drivers for higher oil prices are absent currently and will be negative on the oil prices outlook in the medium term.

**Chart 3: Oil Is A Pure Speculation Play?**

**Oil Futures Speculation**



*There is high level of market speculation on oil prices at the moment. Key resistance broken at US\$110/bbl. for WTI Crude.*

Source: Bloomberg, as of 21 Apr 2011



**Precious Metals – Spectacular Silver**

With reference to the macroeconomic environment three decades ago, the surge in precious metals’ prices looks similar to where we are today. Today, the U.S. economy is still trying to achieve sustainable economic growth (without government intervention) and fears of rising inflation is rampant globally. To complete the equation, we have a weakening U.S. dollar.

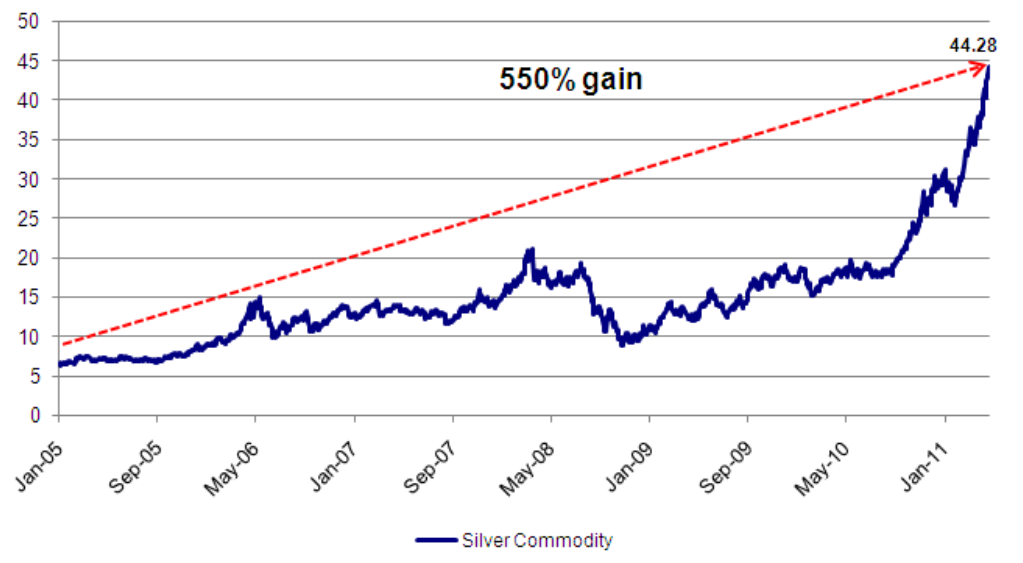
We remain constructive on precious metals in the medium term. To illustrate, the fundamental drivers for precious metals remain compelling. 1) China, along with other emerging economies, may be exploring alternatives to diversify their foreign-exchange reserves, which are in trillions of (weakening) U.S. dollar. 2) A recent article in the Financial Times reported that record physical silver sales have been recorded at the world’s leading mints over the past several quarters. 3) Investment demand for silver climbed 40 percent to a record in 2010, GFMS Ltd. said in an April report published by the Washington-based Silver Institute. Assets held in exchanged-traded products rose to a record 15,509.54 metric tons on April 12, data compiled by Bloomberg from four providers shows.

In short, we believe that investors will continue to look to alternative assets for wealth preservation as worries persist about the outlook for inflation and currency value.

Near term, we believe that the recent price rise should slow given the strong upward acceleration over the last few weeks. However, we do not see the uptrend in prices of precious metals reversing at the moment. The rise in the silver commodity since Jan 2005 stood at 550 percent (See Chart 4 below). So far, silver posted the biggest gain in 2011 among 19 raw materials in the Thomson Reuters/Jefferies CRB Index. As a guide, silver reached a record US\$50.35/Oz. in January 1980 as the Hunt Brothers tried to corner the market.

**Chart 4: Have You Seen Silver Prices Lately?**

**Silver Commodity since 2005**



*COMEX silver is trading at a level not seen since the 1980s downturn. A powerful run-up since the start of 2009.*

Source: Bloomberg, as of 21 Apr 2011



**Fixed Income – Europe Is Fracturing**

It may be an understatement that the European debt crisis is getting out of control. The Greek government 2-year bond yield crossed the 20 percent mark upon rumours of restructuring (See Chart 5 below). With an interest rate substantially higher than its nominal GDP growth, the Greek debt level is likely to pile up. Market is pricing in certain form of Greek debt restructuring in the near term. Majors banks, holders of the failed debt and the European taxpayers may have to burden the losses.

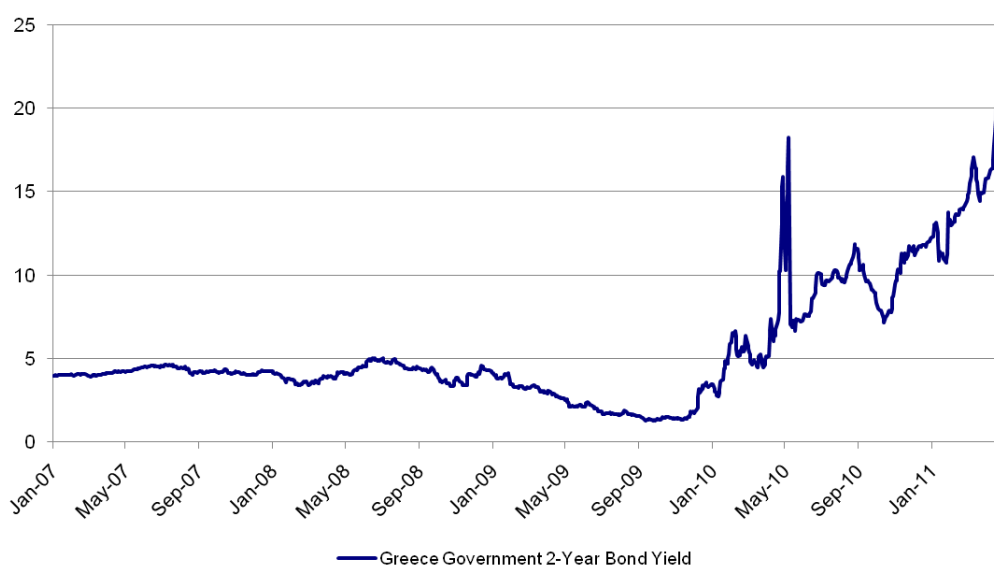
A member of German Chancellor Angela Merkel’s council of economic advisers, Lars Feld, mentioned that Greece should restructure its debt sooner than later. Europe’s statistics agency reported that Greece’s 2010 budget deficit was more than a percentage point wider than initially estimated. The shortfall was 10.5 percent of GDP, compared with the 9.4 percent reported in February. According to Bloomberg, with a debt standing at 150 percent of gross domestic product, Greece may have to pay as much as 9 percent of its GDP in interest.

Market is fearful that a debt restructuring by any euro country could trigger a banking crisis resembling the collapse of Lehman Brothers Holdings. European banks are exposed to highly indebted countries.

In fact, “contagion” is the fear word right now. With Ireland and Portugal already well down the path towards bailouts, Spain looks to be on the bailout watch list next. As previously observed, with every bailout comes a reiteration that it will be the last. Unfortunately, the debt markets are showing less faith time and again with the observed spike in yields. It seems that Spain and even Italy could well be the next victim. The market ponders who’s next. Increasingly, the fractures in the European system may become more prominent as divergences in real interest rates persist while varying political interests are at stake.

**Chart 5: Greek 2-Year Yields Hit 20 Percent on Restructuring Rumors**

**Greece 2-Year Government Bond Yield**



*Greece 2-Year government bond yield hits 20 percent as market is anticipating a possible restructuring as early as next month.*

Source: Bloomberg, as of 21 Apr 2011



**Fixed Income – The Unthinkable U.S. Default**

On Apr. 19, credit rating agency S&P downgraded U.S. outlook from stable to negative, stating that “we believe there is a material risk that U.S. policymakers might not reach an agreement on how to address the medium and long term budgetary challenges by 2013.” The S&P rating agency also warned that the U.S. government could lose its AAA rating. U.S. budget deficit is 10.6 percent of its GDP, the highest among other major AAA rated countries.

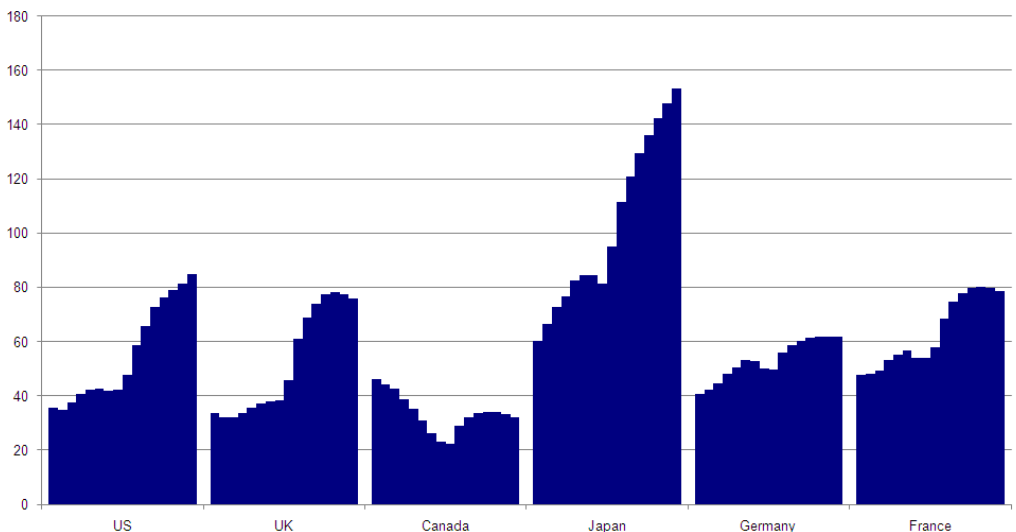
Historically, the U.S. has never defaulted on its debt. Throughout the past decade, the U.S. debt ceiling had been raised ten times. To point out, hundreds of billions of dollars in recession fighting spending by both Bush and Obama contributed to the sharp rise in the U.S. debt level since 2008. As a guide, the U.S. debt was US\$9 trillion in late 2007 before the start of the Great Recession and it stood at the US\$14 trillion mark today.

On the economic front, the U.S. economy is still reeling from high joblessness, a battered housing market and sustainable economic growth is not quite in place yet. To have a massive cut in government spending will be detrimental to the economy at the moment. Therefore, it will be a fiscal challenge for the U.S. policymakers should the debt ceiling not raised.

At the moment, we believe that the U.S. political leaders will muddle through amidst the political clashes between the Democrats and Republicans. Debt ceiling is almost certainly going to be raised to avoid economic chaos. It would be disastrous if the U.S. starts missing interest or principal payments. The U.S. has long been the global standard for financial stability and creditworthiness, with Treasury securities seen as a fail-safe investment. Nevertheless, the debate over the debt ceiling and the S&P near term downgrade will probably be an unwelcome noise to the market but not for long.

**Chart 6: Living Dangerously on High Debt Burdens**

**Net Debt as % of GDP of Advanced Economies (2000 - 2015\*)**



\* IMF forecast (2010-2015)  
 Net debt is calculated as gross debt minus financial assets corresponding to debt instruments. These financial assets are: monetary gold and SDRs, currency and deposits, debt securities, loans, insurance, pension, and standardized guarantee schemes, and other accounts receivable.

Source: International Monetary Fund, as of 21 Apr 2011

*Advanced economies are struggling with high levels of debt as their GDP growth could not catch up with the pace of debt increase.*



### **GENERAL DISCLAIMER**

This publication shall not be reproduced in whole or in part, distributed or published by you for any purpose. Phillip Securities Pte Ltd shall not be liable for any direct or consequential loss arising from any use of material contained in this publication.

This publication is solely for general information and should not be construed as an offer or solicitation for the subscription, purchase or sale of the securities, and specifically funds, mentioned herein. It does not have any regard to your specific investment objectives, financial situation and any of your particular needs. Accordingly, no warranty whatsoever is given and no liability whatsoever is accepted for any loss arising whether directly or indirectly as a result of any person or group of persons acting on such information and advice. Unit Trusts distributed by Phillip Securities Pte Ltd are not obligations of, deposits in, or guaranteed by, Phillip Securities Pte Ltd or any of its affiliates. No action should be taken without first viewing the details in a fund's prospectus. A copy of the prospectus can be obtained from Phillip Securities Pte Ltd or online at [www.eunittrust.com.sg](http://www.eunittrust.com.sg). Past performance is not necessarily indicative of future returns. Investments in unit trusts are subject to investment risks, including the possible loss of the principal amount invested. Investors should note that the value of the units and income from the fund may rise as well as decline. Investors should also note that there are limitations whenever performance is stated or comparison is made to another unit trust or index for any specific period as no funds or indices are directly comparable.

This publication should not be relied upon as authoritative without further being subject to the recipient's own independent verification and exercise of judgment. The fact that this publication has been made available constitutes neither a recommendation to enter into a particular transaction nor a representation that any investment product described in this material is suitable or appropriate for the recipient. Recipients should be aware that the investment products described in this publication may involve significant risks and may not be suitable for all investors, and that any decision to enter into transactions involving such products should not be made unless all such risks are understood and an independent determination has been made that such transactions would be appropriate. Any discussion of the risks contained herein with respect to any product should not be considered to be a disclosure of all risks or a complete discussion of such risks.

Whilst we have taken all reasonable care to ensure that the information contained in this publication is accurate, we do not guarantee the accuracy or completeness of this publication. Any advice contained in this publication is made only on a general basis and is subject to change without notice. We have not given any consideration to and have not made any investigation of the investment objectives, financial situation or particular needs of any specific person or group of persons as we are not in possession of any such information. You may wish to seek advice from a financial adviser before making a commitment to purchase the investment products mentioned. In the event you choose not to seek advice from a financial adviser, you should consider whether the investment product is suitable for you. Any unit trusts mentioned in this publication is not intended for U.S. citizens.

### **DISCLOSURE OF INTEREST**

Statement pursuant to section 36 of the Financial Advisers Act - Phillip Securities Pte Ltd, its directors and employees may have interest in the securities recommended herein from time to time, and its associates and connected persons may also have positions from time to time. Opinions and views expressed in this report are subject to change without notice.

PhillipCapital is a group of companies who together offer a full range of quality and innovative financial services to retail, corporate and institutional customers. Member companies in Singapore include Phillip Securities Pte Ltd, Phillip Securities Research Pte Ltd, Phillip Financial Pte Ltd, Phillip Futures Pte Ltd, Phillip Trading Pte Ltd, Phillip Capital Management (S) Ltd, CyberQuote Pte Ltd, International Factors (Singapore) Ltd and ECICS Ltd.

Information on any and all independent PhillipCapital members and the respective financial services they offer can be obtained through the following website – [www.phillip.com.sg](http://www.phillip.com.sg). Members can otherwise be identified by their authorised use of PhillipCapital brand name along with their own name in their documentation and literature.