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Equity Bulls Climbing A Wall of Worry

Executive Summary

Equities – We believe that equities are supported by the ongoing QE2 at the moment, defying Middle East unrest and Japan's woes; The uptrend in equities may not be sustainable through June.

Commodities – Apart from QE2, commodity prices have been supported by the rise in world industrial demand since 1998; Gold broke new record high and silver is at its highest since 1980.

Fixed income – Headlines hit Portugal as the country is on the verge of an EU bailout; Fed Reserve funded 62.5% of U.S. budget deficit in Q42010. The question is who will fill this gap after June.

Equities – Slight Positive Mood in April

Global stock markets had a volatile month during the month of March, following Japan's woes and unrest in the Middle East and Libya. The threat of disaster from the damaged Fukushima nuclear power plant sparkled a massive sell-off in equities during middle of the month. Shortly after, investor's anxiety and the sell-off reversed course and equities regained part of their losses. According to the Ministry of Finance in Tokyo, foreign investors bought US$11 billion in Japanese stocks in the week through Mar 18, the most since comparable records began in 2005. Globally, the MSCI World Index rose for seven sessions in a row, the longest advance since September last year.

Across the Asian region, the best performing equity market was India, up more than 7.6% over the one month period. Japan equities were still down 10.9% over the month. The Nikkei 225 index made a 52-week low on Mar. 16. European and U.S. equities underperformed in the month of March while the Chinese equities outperformed over the six month period, up more than 13.2%.

Asian equities were mostly up on a monthly basis. Indian equities rebounded while Japan equities suffered as a result of the triple calamity.

Table 1: Selected Equity Stock Market Index Returns

Country	Index	Mar. 29	1-mth % gain/loss	3-mth % gain/loss	6-mth % gain/loss	52 week High	52 week Low
India	BSE Sensex 30 Index	19191.39	7.68 ▲	-5.26 ▼	-3.83 ▼	21108.64	15960.15
Korea	KOSPI Index	2072.13	6.85 ▲	1.40 ▲	11.02 ▲	2121.06	1532.68
Thailand	SET Index	1036.26	4.89 ▲	0.16 ▲	6.87 ▲	1056.44	714.66
Indonesia	Jakarta Composite Index	3580.19	3.17 ▲	-3.22 ▼	2.42 ▲	3789.47	2502.05
China	Shanghai Composite	2955.37	1.73 ▲	7.41 ▲	13.20 ▲	3186.72	2319.74
Singapore	Straits Times Index	3053.68	1.43 ▲	-4.81 ▼	-1.69 ▼	3313.61	2648.15
Hong Kong	Hang Seng Index	23063.14	-1.18 ▼	0.41 ▲	3.06 ▲	24988.57	18971.52
United States	S&P 500 Index	1310.19	-1.28 ▼	4.00 ▲	14.45 ▲	1344.07	1010.91
Europe	Euro Stoxx 50 Pr	2914.76	-3.26 ▼	2.59 ▲	5.89 ▲	3077.24	2448.10
Japan	Nikkei 225	9459.08	-10.97 ▼	-8.56 ▼	-1.05 ▼	11408.17	8227.63

Source: Bloomberg, as of 29 Mar 2011

Quantitative Easing III – Don't Bet on It

Despite the nuclear situation in Japan, spreading unrest in the Middle East and longstanding debt issues in Europe, markets performed generally well in the month of March. To a great extent, we believe that equities have been supported by the ongoing QE2 at the moment.

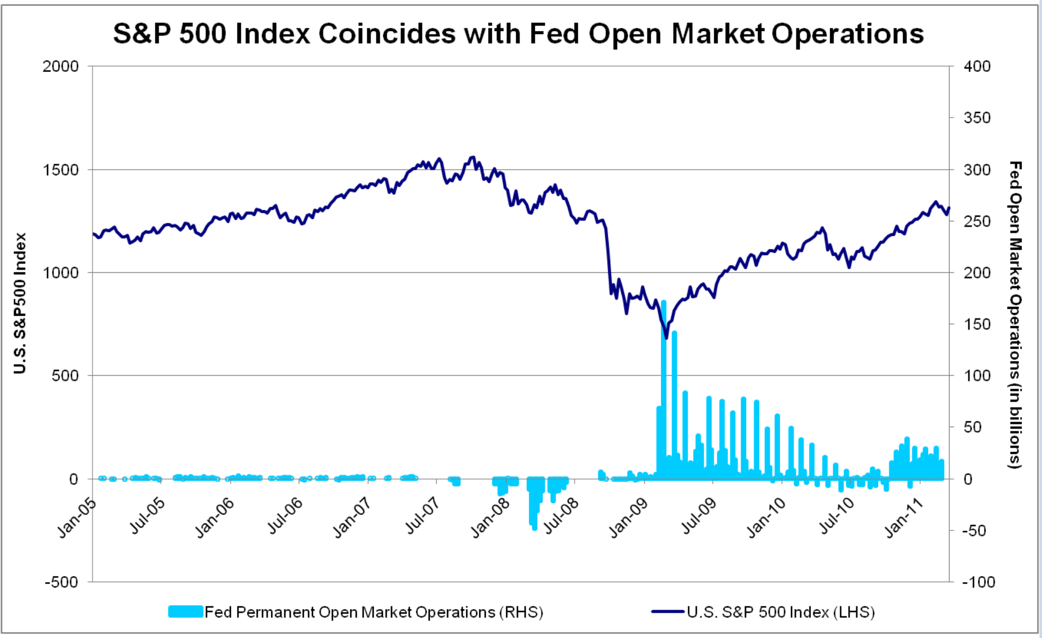
From Chart 1 below, the implementation of quantitative easing coincides with the uptrend in the U.S. equities since early 2009. However, as we get closer to the end of QE2, there may be implications that the uptrend in equities is not sustainable. Investors will be pondering upon what will be next for the equities after June and an eventual drop in liquidity may also hit the market negatively. As such, the equities are likely to lose steam gradually as June approaches.

We believe that further extraordinary monetary stimulus is unnecessary for now. On one end, inflationary pressures are mounting in some countries helped by extreme spikes in food and textile commodities. On the other end, U.S. Fed Chairman Bernanke mentioned that the "risk of deflation has become negligible." Therefore, we do not think that QE3 is in the pipeline at the moment.

On the contrary, a recent CNBC poll showed that one-third of portfolio managers are positioning bullishly for a possible QE3. It seems that some portfolio managers are overweight on equities in hope of a subsequent QE3. They misinterpreted that the Fed's aim of the QE2 is to boost the economy and not the equity markets. Once the U.S. economy gets back on track, further stimulus is unlikely.

Nevertheless, there may be still optimism going into the month of April. Historically, since 1950, April was one of the best month for Dow Jones Industrial Average Index (average 2.0% gain over the month). Together with the QE2 still in effect, we expect April to be a fairly positive month for equity.

Chart 1: Policy Has Driven Markets Over the Past 2 Years



Source: Bloomberg, as of 25 Mar 2011

To a certain extent, quantitative easing policy has successfully drove the S&P 500 Index higher.

Japanese Equities – Volatility and Opportunity *(Excerpt from Market Insight)*

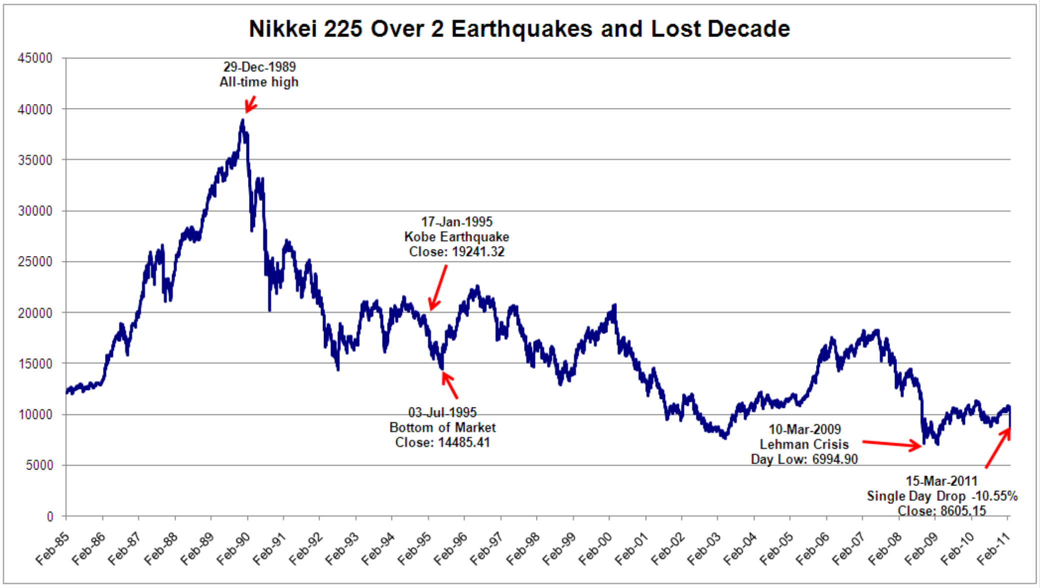
Japanese equities took a big hit, as the Nikkei 225 Index tumbled 20% from its Mar. 9 high to an intra-day low on Mar. 16. It was the worst decline over such a short time frame since the 1987 crash. Implied volatility on the Nikkei soared from 21 to 70 — within striking distance of the 92 peak reached after Lehman collapsed.

We feel that the Japanese equities are trading at an attractive valuation. The current stock prices value Japan’s companies at 1.23 times book value. In contrast, the MSCI World Index is priced at more than twice book value, double what it is in Japan. Accordingly, Wall Street Journal reported that on a 10-year cyclically smoothed basis, the Nikkei 225 Index is trading at a Price-to-Earnings multiple of 14.5 times, which is about the cheapest the market has been in over 40 years. The report also pointed out that the Japanese and United Kingdom equity market capitalization levels are roughly the same but global mutual funds and ETFs have 25% less of their assets in Japan.

To a large degree, we feel that this crisis has been priced into the stock prices in Japan. The panic sell-off on Mar. 16 was an example of such extreme behavior whereby market reacted irrationally in the form of indiscriminate selling. In fact, the media itself has successfully portrayed the worst outcome of a nuclear mishap to the masses. Despite this, we feel that the situation in Japan may turn out to be less than catastrophic.

With reference to previous market downturn, marginal buyers will enter the equities market as marginal sellers begin to diminish. Chart 4 below shows that Nikkei 225 is still some way off its all time peak. Therefore, we expect the crisis to be a good opportunity to invest in Japanese equities for the medium to long term. Short term volatility is likely to be here to stay with ongoing media reporting on the extent of the nuclear disaster. However, with the BOJ pledging almost unconditional support to Japan’s financial markets’ stability, investors can be hopeful.

Chart 2: Nikkei 225 Over 2 Earthquakes and Lost Decade



Source: Bloomberg, as of 23 Mar 2011

The Nikkei 225 Index remains 75% down from its all-time high in 1989, as of close on Mar. 23.

Commodities – Target for WTI Crude Oil Remains at US$110/bbl.

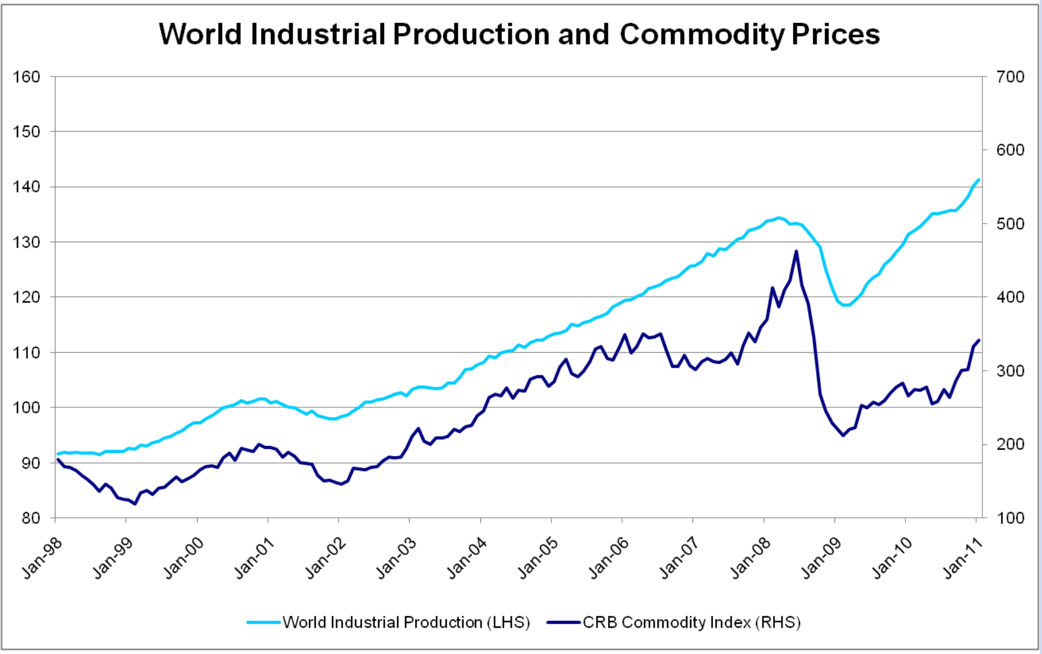
Escalating conflict in Libya since the implementation of the “no-fly” zone continues to pressure crude oil prices higher. The political tension mounts in Saudi Arabia (world’s top oil exporter) but any possibility that the Saudi Kingdom will end up looking like Libya remains low at the moment. Prior to the unrest, Austria, Ireland and Italy received over 20% of their imported oil from Libya. In the short term, Libya’s oil exports will remain nonexistent for many months as Saudi Arabia aims to fill the production gap.

Though we take note of the supply disruption at the moment, inventory level remains healthy. As Qatar's deputy prime minister and former oil minister noted, "The disappearance of the Libyan production hasn't really affected supply and demand, because we see compensation from other sources. When I look to the inventory, I see that the inventory is very high, over 60 days.”

Also, forthcoming reconstruction projects in Japan present potential demand for conventional energy resources (liquefied natural gas etc). However, we believe that the mentioned factors have been largely priced in. Our price target for WTI crude oil remains at US$110/bbl., but we do not rule out an upside scenario.

The recent spike across commodity prices coincides with the launch of the US$600 billion quantitative easing from the Fed Reserve. At the same time, commodity prices are also largely supported by the rise in world industrial production since 1998 (see Chart 3 below). We view that the fundamental drivers of demand for commodities are likely to persist over the long term. Therefore, we do not foresee a sharp decline in commodity prices in the near term. The commodities inflation is long supported by the rise in global industrial demand and the QE2 was probably the underlying catalyst.

Chart 3: Did The Fed Created A Commodity Boom



Source: Netherlands Bureau for Economic Policy Analysis, Bloomberg, as of 25 Mar 2011

The rise in commodity prices was largely in line with the rise in global industrial demand.

Gold – Higher Highs Ahead

COMEX gold prices set a new record high (yet again) of $1445/oz. on Mar 7 as protests and unrest in the Middle East and North Africa together with bouts of risk aversion sent gold prices higher. At the same time, silver is at its highest since 1980. The safe haven role makes gold and silver attractive for safety-seeking investors looking for a tangible store of value amid the turmoil.

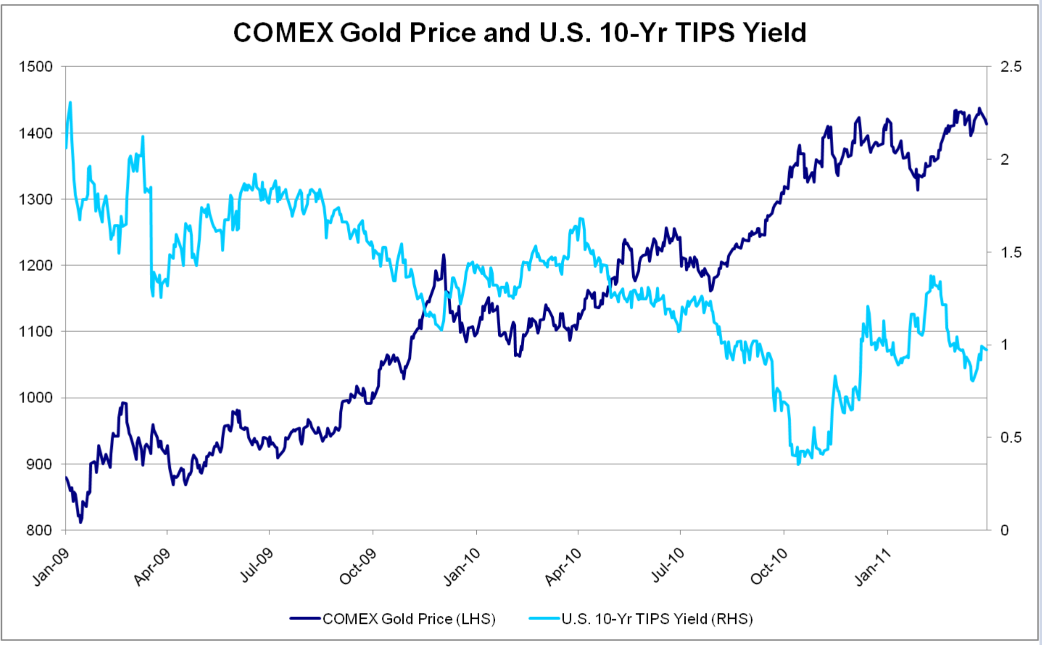
From Chart 4 below, the two-year uptrend for gold prices stays intact. Quantitative easing since early 2009 has caused many investors to sought safety from fiat currency risk and soaring deficits. As mentioned in our previous reports, there is no bubble forming in gold prices, not yet.

Moving forward, the Middle East uncertainty, combined with a resurgence of sovereign debt fears could provide the catalyst for gold to move higher. Peripheral nations in Europe are likely to seek further bailouts and there is little that can be done to quell the ongoing debt crisis. The region's new permanent bailout mechanism for the European Stability Mechanism stood at €700 billion (€620 billion in callable capital and €80 billion in capital paid in by member states, effective July 2013).

Also, we noted that the 10-year U.S. TIPS yield stayed below 100 basis points, indicating risk of inflationary pressure persists. Historically, the decline in 10-year U.S. TIPS yield is associated with a rise in gold prices (See Chart 4 below).

On the fundamentals, Chinese and Indian jewelry demand reached a record in 2010, according to the World Gold Council data. Physical bar purchases globally climbed 63% to 204.7 metric tons in the fourth quarter, with Asia accounting for most of the buying. Overall, we expect gold prices to move higher throughout 2011.

Chart 4: Inverse Relationship Between Gold and U.S. TIPS Yield



Source: Bloomberg, as of 29 Mar 2011

Gold enjoyed a good upward trend since 2009, trading inversely with the 10-year U.S. TIPS yield.

Fixed Income – Time's Up, Portugal

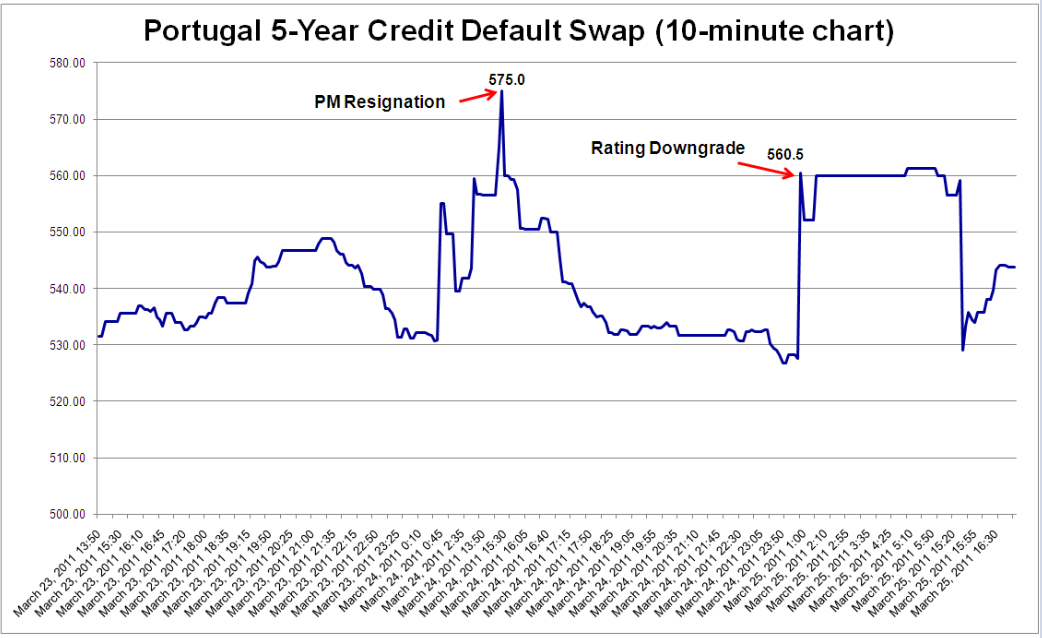
In the latest development of the Europe debt crisis, Portugal was back in the news after its Parliament rejected the government's austerity plan which led to the resignation of the PM. Standard & Poor's and Fitch downgraded Portugal's credit ratings by two notches and warned about further downgrades. The collapse of Portugal's government resulted in increased political uncertainty, hurting market confidence and potentially raising refinancing risk. With the yield on 10-year Portugal government bonds pushed over 7.5%, the Eurozone will most likely have to offer below market "bail-out" rates to Portugal, while trying to figure out how to handle this never-ending mess. Time is running out for Portugal as the market is losing confidence. The Portugal's sovereign CDS widened to 575 basis points before coming down (See Chart 5 below).

According to initial estimates, the European Financial Stability Mechanism, the European Financial Stability Facility and IMF assistance should be sufficient to cover the peripheral governments' financing needs going into 2012.

European nations have spelled their commitment time and again that they will continue to back the Euro. However, the economic numbers are not helping much to instill confidence in the statement. Spain, one of the core members, is struggling with a 20% unemployment rate and its recovery is now hurt by higher oil prices.

Lastly, we saw recent inflation in United Kingdom hitting 4.4% while the economy is contracting. Its economic growth forecast for 2011 was also lowered. There could potentially be a prolonged period of stagflation for the United Kingdom. Overall, full economic recovery appears to be farfetched at the moment. Although we are downplaying the outlook on European sovereign debts at the moment, we believe that there are still opportunities in the Asian corporate bonds with short duration (Refer to Focus of the Month for more details).

Chart 5: Portugal CDS hits 575bp on PM Resignation & Downgrade



Source: Bloomberg, as of 29 Mar 2011

Portugal 5-Year CDS spikes as the market is expecting Portugal to seek bailouts in near term.

Fixed Income – Fed is Funding U.S. Deficit; Only till June

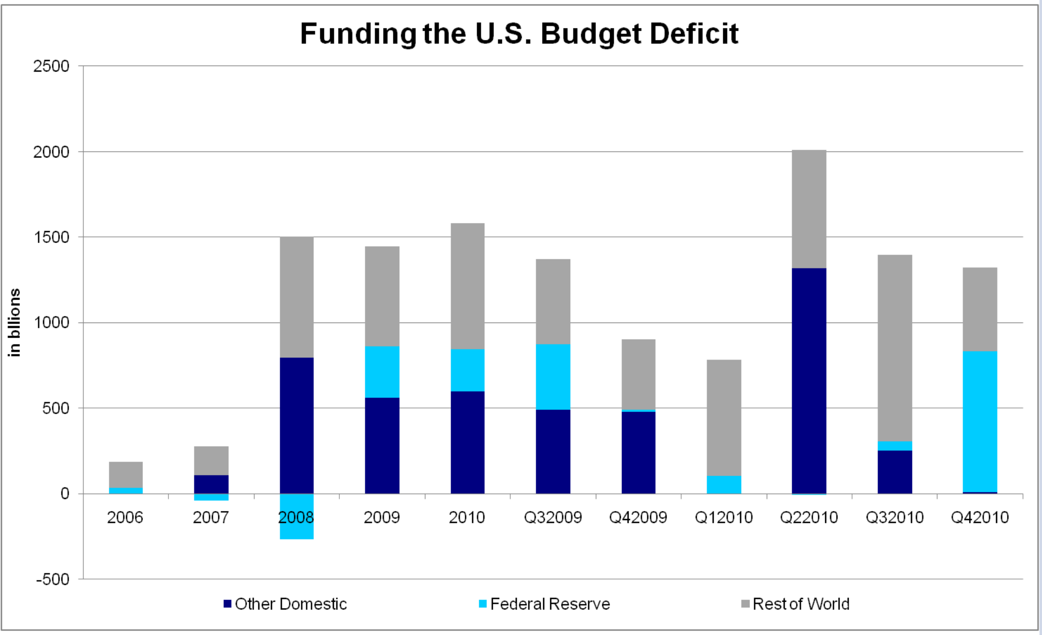
On the U.S. Treasuries, the Fed Reserve is sticking to its plan of buying Treasury bonds to suppress interest rates and underpin growth. The Fed's presence as a bond buyer is important given that Japan's disaster had the market speculating whether the country could sell some of its US$886 billion in Treasury holdings.

Down the road, two underlying economic factors may be potentially detrimental to Treasury bond investors. Firstly, yields on the Treasury bonds are likely to increase sharply as inflation pressures build on food and energy costs rise. The U.S. consumer price index jumped 0.5% in February, the biggest monthly increase since Jun 2009. Secondly, the recovery in the U.S. economy is deemed to be gaining decent momentum (lest the housing) and this could provide further downward pressure on the Treasury concurrently.

Many believe that the intent of quantitative easing is to generate new private sector lending, job creation and eventually a self-sustainable economic expansion. In another perspective, to kick start inflation in U.S. as soon as possible. Although some may argue that the quantitative easing policies merely cover up the other symptoms of an unhealthy economy. It remains debatable whether it is possible to cure a debt crisis with more debt.

The U.S. budget deficit was largely funded on an unprecedented scale by the Fed Reserve since the start of Q42010 (See Chart 6 below). With the QE2 coming to an end in three months time, there are certainly concerns who will be filling the gap left behind by the Fed Treasury purchases. Yields will have to go much higher to generate buying interest from the private sector. Higher yields will be detrimental to the housing mortgages in particular. To put in another perspective, the Fed will have something to worry about come Jun. 30.

Chart 6: Fed Reserve Funding U.S. Budget Deficit at Unprecedented Scale



Source: Fed Reserve, as of 25 Mar 2011

The Fed Reserve funded more than 62.5% of the deficit in Q42010; Foreign investors made up 36.8%.

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