Investment Insights

Monday, 16 September 2013

Market Tantrums to Rise as Taper Looms; Proof of Growth Spreads

SUMMARY

- **Market volatility heightened ahead of US Federal Reserve policy meeting**
- **US economic data probably strong enough for modest reduction in Fed's asset-purchase programme to begin this month**
- **Data improvement in the US, Europe, Japan and China are supportive of global equities**
- **Emerging Markets enjoying some respite but pressure on current account deficit economies unlikely to dissipate quickly**
- **Dollar strength could ease near-term on expectations of a dovish outcome at the coming Fed meeting but over the longer term, US Treasury yields could push even higher**

Market volatility will increase this week ahead of the closely watched two-day Federal Open Market Committee meeting mid-week. The news that Lawrence Summers is out of contention for leadership of the Fed has already pushed equities significantly higher and the US Dollar lower. Near-term, the USD could pull back further, particularly if the expected commencement of a reduction in Quantitative Easing fails to materialise. But more importantly than the market "noise", the economic data suggests that growth momentum is picking up everywhere from the US to Europe to China. This should support equities, notwithstanding a modest start to tapering in September. Meanwhile, tapering of QE could be medium-term bullish for the US Dollar if US Treasury yields continued to rise as a result. The ongoing rebounds in Emerging Market equities and currencies may be difficult to sustain. We are at a three-decade low in the US policy rate. And eventual rate normalisation will likely continue to be disruptive for EM economies with current account deficits.

Broad gains for equity markets as recent data supports a moderately optimistic outlook for global growth

Global equities registered another week of robust gains with the MSCI All Country World Index (ACWI) up 2.3% to return to May levels as recent data continues to support a moderately optimistic outlook for global growth. The gains were broad based. Developed Markets (DM) equities rose 2.1%, led by Japan and Europe. The relief rally in Emerging Market (EM) equities continued as sentiments were boosted by positive China macro data, cheaper valuations and expectations of a more dovish Fed following the recent non-farm payroll data disappointment. Indonesia and Turkey registered robust gains of 13.6% and 7.6% respectively.

Fig 1: EU to Register Largest Growth From 2012-2015

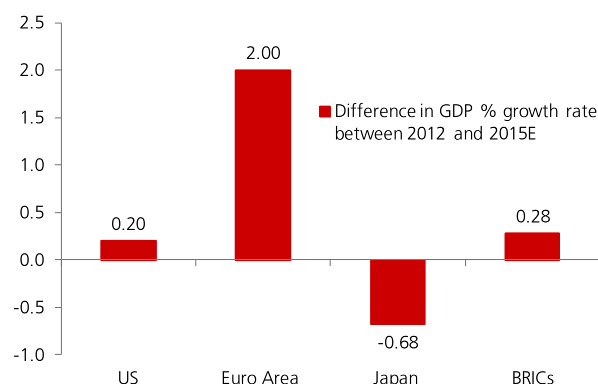


Fig 2: China Trades at 20% Discount on Forward P/E

Fig 3: Gold Prices on Decline Again

Source: Bloomberg, DBS CIO Office as of 13 September 2013.

Equities could grind higher post-FOMC announcement

This week, the key focus will be the post-FOMC statement and Chairman Ben Bernanke's press conference following his top policymaking huddle. While recent US data remains mixed, it is nonetheless strong enough for "tapering" to commence this month. Indeed, if the Fed proceeds with a "mild taper" – that is if it reduces its monthly securities purchases by USD10-15 billion – equities could actually push higher as sentiment is boosted on two fronts.

Firstly, the decision to proceed with "tapering" would suggest that the US economy was on the right footing and the Fed felt confident enough to reduce monetary stimulus. Indeed, recent US ISM and industrial production data suggest that the recovery is gaining momentum. Even on the employment front, while the August non-farm payroll data came in softer than expected, the longer-term trend supports that very argument.

Secondly, after months of speculation surrounding how and when the Fed will taper its QE program, its eventuality could represent the removal of a major overhang. EM assets that were sold down recently could experience some short-term respite while DM equities could also grind higher on the improving macro and earnings outlook.

European economic outlook improves

Europe's economic outlook is showing encouraging signs of recovery as GDP returned to expansion for the first time since 2010 while the Markit Economics August manufacturing PMI beat analyst expectations. There are still many structural challenges ahead for the European economy. But expectations and valuations are low, allowing room for the market to respond to upside surprises. Europe is possibly in a 'sweet spot' as it continues to benefit from ongoing economic recoveries in the US and China, with little threat of monetary tightening anytime soon.

MSCI Europe has rebounded 14.8% since its June trough. And the following factors could drive further price gains. Firstly, the Euro area is expected to register the largest rate of change in its GDP growth compared to developed economies and the BRIC nations between 2012 and 2015 (Figure 1). Secondly, European equities currently trade at 13.9x forward price-to-earnings (P/E), making it the cheapest developed market. Europe also trades at a 16% discount relative to its long-term price to book (P/B) mean. There could be further upside as the cyclical recovery in Europe gathers pace.

Economic data in Japan continues to improve

Japan's 2Q GDP growth has been revised up from a preliminary reading of +2.6% to +3.8% on-quarter as positive revisions were made to capital expenditure and public fixed capital formation. This, coming on the back of a stronger-than-expected core inflation reading in July, suggests that Japan could finally be emerging from deflation and low growth.

The recent growth momentum has in turn persuaded the administration led by Prime Minister Shinzo Abe to agree "in principle" to press ahead with the proposed hike in the sales tax from 5% to 8% next April. To soften the impact of this taxation hike, the government will at the same time implement a stimulus package worth as much as JPY15 trillion to support the economy.

North Asian outperformance against Southeast Asia and India likely to continue

The marked divergence in equities market performances between North Asia and Southeast Asia/India during the recent EM sell-down shows that investors are not indiscriminate in their withdrawal of funds from Emerging Asia with the end of QE at hand. Markets with strong foreign reserves and current account balances have weathered the storm much better relative to those that don't and we expect this distinction in performance to persist.

Paradoxically, from a portfolio positioning standpoint, the recent EM sell-down could prove to be a blessing for China if investors reallocate their funds from "weak EM" to "strong EM". China is arguably one of the strongest EM economies given its huge foreign reserves and low external debt. Recent PMI and industrial production data suggests that the Chinese economy is bottoming. And while the government is unlikely to unleash another round of massive stimulus, it is likely to do just enough to maintain growth at 7-8%.

Meanwhile, monetary conditions continue to improve with money supply (M2) growth coming in above expectations at +14.7% on-year /y in August. Valuations are attractive. China equities trade at a 20% forward P/E discount to the region (Figure 2). The upcoming Third Plenary Session in November could offer insights into crucial reforms that could boost market sentiment further.

On the other hand, the challenges facing Southeast Asia and India remain significant. The governments of India and Indonesia have since undertaken some steps to stabilise their current accounts and stem the declines in their currencies. For instance, Bank Indonesia (BI) hiked its benchmark policy rate by another 25 basis points last week after a 50 basis point hike on 29 August. And there are likely to be efforts by Indian policymakers to boost the economy's foreign reserves by encouraging Non-Resident Indian funds back into the country. These policy responses will buy some wriggle room but it is worth remembering that the Fed policy rate is sitting at the bottom of a 32-year secular decline. This is likely to have significant and difficult to predict implications for global fund flows. As long as EM economies run sizeable current account deficits, the risks remain.

Gold slides on "tapering" concerns and receding geopolitical tension in Middle East

Gold prices fell 4.7% last week to USD1,326 per ounce with the increasing likelihood a reduction in QE in turn reduces the attractiveness of gold as an inflation hedge (Figure 3). Besides, receding geopolitical tensions in Middle East have also reduced the safe-haven appeal of gold. While tapering drove gold prices lower, it however failed to boost the US dollar. The US Dollar Index (DXY) fell 0.8% as the greenback weakened against both the euro and British pound. The Thomson Reuters/Jefferies CRB Commodity index lost 0.8%, as a result of across the board declines in oil, gold and base metals.

Asian Insights Feature

Asia: Long-Term Money Is Staying Put

Capital flows have always been a two-way affair. When sentiment is strong, inflows push you up the mountain. When it's weak, they drag you out to sea.

The fact that Western central banks put interest rates on the floor five years ago and kept them there has only amplified the action – first, inward as Asia's V-shaped recovery took off in 2009 and 2010, then outward as the EU debt crisis erupted in 2011 and more recently, as fears over US Fed tapering have grown.

We estimate that in the two quarters ending June, some USD138 billion flowed out of the Asia-8*. Is that a lot? Surprisingly, no. Two years ago, USD152 billion flowed out when the European debt crisis erupted. When Lehman collapsed five years ago, USD350 billion left the region, which is 2.5x more than the current 'exodus'.

Quantitative easing (QE) and its tapering make a sexy story, but the fact is today's outflows rank only third in the standings, and that's just in the past five years.

If all of this money is flowing out of the region, when does Asia run dry? It doesn't. Today's outflows underscore the fact that there have always been two types of inflow: (i) short-run 'hot' money flows arbitraging differential rates and returns, and (ii) longer-term inflows seeking to profit from Asia's strong growth.

The hot money is now going home – or at least last week it was. The long-term money is staying put. And the long-term money is the bigger force.

Since the dot.com / hi-tech downturn ended in 2001, some USD2.4 trillion of capital has flowed into the Asia-10*. About USD500 billion flowed out temporarily in 2008/09 and another USD300 billion has flowed out since September 2011.

That works out to be USD1.6 trillion of long-term capital that has stayed in Asia, riding out the various global crises of the past 12 years. So for every dollar that comes in, 66 cents stay for the long haul. As capital flows go, that is a pretty good signal-to-noise ratio.

So much money is coming to Asia because this region is where the world's growth is being generated. And businesses want to be where the growth is. Asia and the US are now about the same size, with GDP of roughly USD16 trillion each. If the US grows at a 2.5% rate, it generates USD40 billion of new demand each year. But Asia grows at a 6.25% pace, maybe a bit faster. Asia generates USD1,000 billion of new demand every year.

Extend the thought to Europe. Many are encouraged by the fact that Germany returned to positive growth in 2Q13. That's good news, and a good reason to invest there. But if Germany grew at a 1.5% rate for the next 47 years, it would double in size. It would 'add' a new Germany to Europe's economic map by 2060.

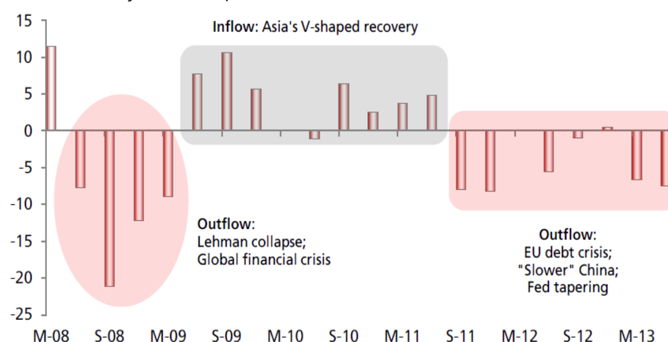
Asia, in contrast, 'adds' a new Germany every 4 years, right here in Asia. Five years hence, it will take only 3.5 years for Asia to add a Germany. By 2060, Asia will have put about 25 Germanys on the economic map. That's pretty staggering.

This is why long-term capital will continue to flow to Asia. Businesses and investors want to be where the growth is. Inflows will continue to flip-flop in the short-run and yes, Asia will make plenty of mistakes. But the shift in economic gravity is the biggest structural change underway in the global economy today.

Structural inflows will remain, and grow, long after today's hot and sexy but ultimately short-term outflows have become a footnote to the bigger picture.

Asia-8 Capital flows

(Balance of Payments capital account as % of GDP)



Source: Group Research

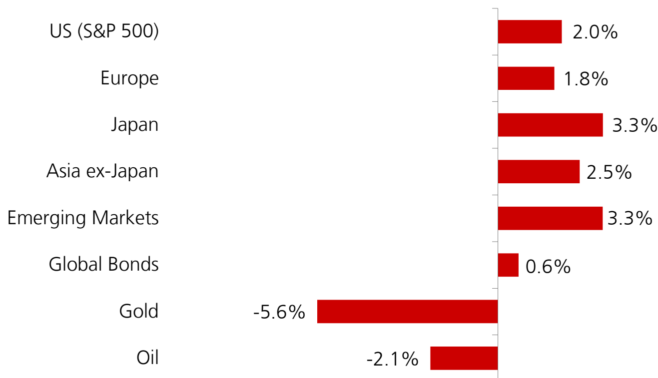
Notes: Asia-10 refers to China, Hong Kong SAR, Taiwan, South Korea, Singapore, Malaysia, Indonesia, Thailand, Philippines, India. Asia-8 refers to Asia-10 less India and China.

Source report: DBS Group Research. Economics-Markets-Strategy 4Q 2013. 12 September 2013.

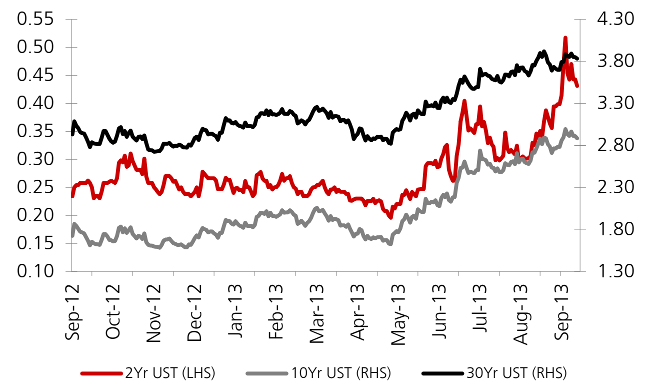
Summarised by DBS Group Wealth Management /CIO Office. An edited version appeared in 16 September 2013's *Market Snapshot*.

Economic & Market Data Monitor

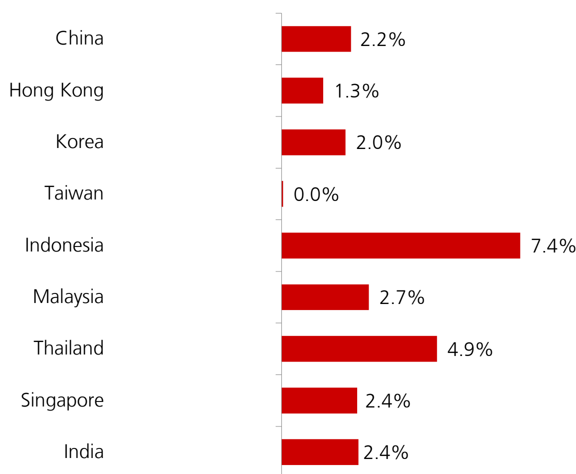
Leading Global Returns



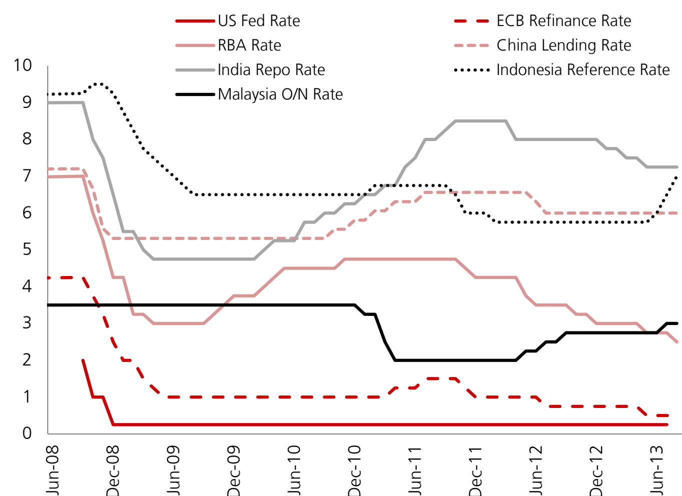
US Treasury Yields (%)



Asia Country Returns



Key Benchmark Rates (%)



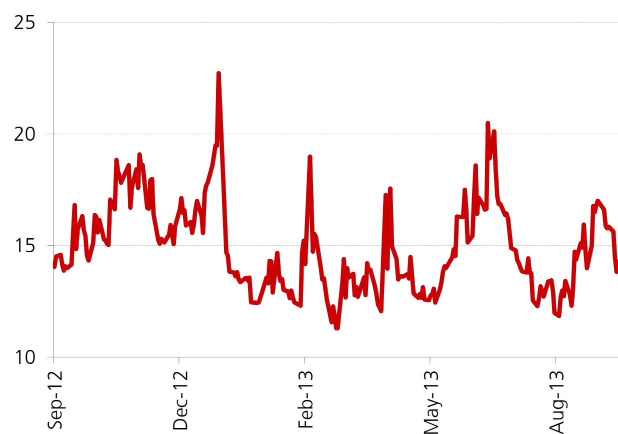
Key Forward PE & Earnings Growth

	YTD Returns	Fwd P/E 2013	10-Year Average	Earnings Growth 2013
US (S&P 500)	18.4%	16.8	14.0	6.8%
Europe	11.4%	37.8	12.1	1.9%
Japan	37.9%	24.7	16.3	59.1%
Asia ex-Japan	-2.8%	12.1	12.1	15.4%
Emerging Mkt	-6.5%	11.3	10.8	8.7%
Global Bonds	-4.2%	n.a.	n.a.	n.a.
China	-2.0%	9.2	12.0	11.0%
Hong Kong	1.1%	10.5	13.1	10.2%
Korea	-0.1%	10.0	9.5	23.3%
Taiwan	6.1%	19.4	13.9	36.1%
Indonesia	1.4%	14.1	13.5	15.4%
Malaysia	4.8%	16.7	14.0	-0.7%
Thailand	0.7%	13.0	10.4	18.8%
Singapore	-1.5%	12.9	13.9	0.5%
India	1.6%	15.6	14.8	10.7%

^ YTD refers to Year-to-date; Returns in local currency.
Earning figures are as of 4 July 2013.

Source: Bloomberg, IBES, DBS. Data as of 13 September 2013.

Volatility (VIX Index)



In The Coming Week

16 Sep 2013	Event	Period	Survey	Actual	Prior
IN	Wholesale Prices YoY	Aug	5.70%	--	5.79%
US	Empire Manufacturing	Sep	9	--	8.24
US	Industrial Production MoM	Aug	0.40%	--	0.00%
US	Capacity Utilization	Aug	77.90%	--	77.60%
17 Sep 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SK	PPI YoY	Aug	--	--	-0.90%
SI	Non-oil Domestic Exports YoY	Aug	2.20%	--	-0.70%
HK	Unemployment Rate SA	Aug	3.30%	--	3.30%
US	CPI YoY	Aug	1.60%	--	2.00%
US	NAHB Housing Market Index	Sep	58	--	59
18 Sep 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
CH	China August Property Prices	Aug	--	--	--
MA	CPI YoY	Aug	2.00%	--	2.00%
US	MBA Mortgage Applications	Sep-13	--	--	--
US	Housing Starts MoM	Aug	2.40%	--	5.90%
US	Building Permits MoM	Aug	-0.40%	--	2.70%
19 Sep 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
US	FOMC Rate Decision	Sep-18	0.25%	--	0.25%
US	Initial Jobless Claims	Sep-13	330K	--	292K
US	Philadelphia Fed Business Outlook	Sep	10	--	9.3
US	Existing Home Sales MoM	Aug	-2.50%	--	6.50%
20 Sep 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
IN	RBI Repurchase Rate	Sep-20	--	--	7.25%
EZ	Consumer Confidence	Sep A	-14.5	--	-15.6

Source: Bloomberg News. Data as of 13 September 2013. Note: DBS Group Research (DBS)

IN THE COMING WEEK

All eyes will be on the US' Federal Open Market Committee this week, as the Fed could announce a slowdown in its asset purchase programme. The recent mixed bag of data has called into doubt the pace and depth of taper. Also on tap in the US: manufacturing, inflation and housing data.

China reports property price data. Policymakers have worried about another property bubble building.

India wholesale prices, the central bank's main gauge of inflation, likely grew 5.65% in August. If revived, inflation pressures could keep the Reserve Bank of India from cutting rates this year to support growth. The RBI meets Friday.

In Southeast Asia, Singapore could see a pickup in non-oil domestic exports in August, while Malaysia releases consumer inflation numbers.

In Review

- **China's** string of positive data releases add to signs the Chinese economy may have rebounded more strongly in August. Exports rose 7.2% on-year in August, picking up pace from the 5.1% recorded in July and -3.1% in July. This translated to a bigger-than-expected trade surplus of USD28.6 billion. Industrial output rose 10.4% on-year in the same period, beating a 9.9% forecast. Retail sales rose 13.4%. Fixed asset investment in non-rural areas rose 20.3% in the first eight months this year. Consumer prices rose at a modest 2.6% on-year in August (vs 2.7% in July), while producer prices fell 1.6% (vs. 2.3% fall in July).
- The **Bank of Japan's** August meeting minutes showed policymakers are confident that the central bank's aggressive stimulus injections are working. Early Monday morning, Tokyo revised 2Q-13 GDP sharply up to an annualised 3.8% from an earlier 2.6% estimate. July core machine orders were flat on-month, but up 6.5% on an annual basis (missing a 7.7% forecast).
- In Southeast Asia, the **Philippines** reported exports rose 2.3% on-year in July, exceeding forecasts. An 11.2% rise in electronics shipments led August exports growth. The Philippines accounts for about 10% of the world's semi-conductor manufacturing services. **Bank Indonesia** surprised with yet another rate hike in an effort to battle a weak Rupiah and high inflation.
- **India** exports climbed nearly 13% on-year in August, shrinking the trade deficit to USD10.9 billion. Car sales rebounded 15% on-year in August, but the industry expects this to just be a breather, and forecasts a second consecutive year of lower automobile sales. Industrial production saw a surprisingly strong 2.6% on-year gain in July, beating estimates for a 0.5% decline. Consumer inflation eased to 9.52% on-year in August. Wholesale price inflation, the main gauge, is due Monday.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 13 September 2013.

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