Investment Insights

Monday, 25 November 2013

US Equities Push Higher Despite Fed Taper Noise

SUMMARY

- **US stocks head up despite noise surrounding taper expectations**
- **Mixed back of US economic data continues**
- **Slight moderation in European and Chinese economic momentum**
- **Chinese reforms: beyond the initial sentiment boost, attention will turn to implementation**
- **Plunge in global demand for gold**

The uptrend in US equities continues, notwithstanding the market's rapid sentiment shifts over the timing of the expected "tapering" of US Federal Reserve's asset-purchase programme. Japanese equities meanwhile, appear to be resuming the uptrend from 1H-2013, after some five months of sideways consolidation. Even European equities – which had been treading water for over a month – could push higher on signals of more monetary accommodation from the European Central Bank (ECB). Meanwhile, the divergence between Developed and Emerging Market performance continues, with the latter trading weaker last week, possibly from ongoing concerns about the impact of the inevitable Federal Reserve asset-purchase drawdown on EM equities.

Looking beyond the Fed taper. Global risk assets traded lower early last week as the latest minutes release from Federal Reserve policymakers, known as the Federal Open Market Committee, were widely perceived as being "less dovish" than expected. The statement said some members of the FOMC "pointed out that, if economic conditions warranted, the Committee could decide to slow the pace of purchases at one of its next few meetings".

That reignited speculation of a December start of a trim in the US Federal Reserve's asset purchase programme, which now stands at USD85 billion a month. Fed Chair-designate Janet Yellen's recent testimony to Congress had skewed expectations of Fed policy to the dovish side. And it has set the market up for disappointment from less dovish Fed communications, such as the statement from last week. But what was perhaps more significant was that the early pullback in prices last week was very shallow. US equities rebounded late in the week to recapture lost ground, which could mean the market may be starting to switch off to the noise surrounding the "when and by how much" decision by the Federal Reserve to focus on likely longer-term developments, including: 1) continued growth in the US economy 2) the continuation of the near-zero Fed policy rate for another 1 to 2 years.

Mixed bag of US economic data continues. A series of better-than-expected economic data came out from the US last week and they included the preliminary Markit PMI, which improved to 54.3 in November from 51.8 on-month (vs. consensus forecast of 52.3), buoyed by improvement in new orders and component outputs. Initial jobless

Fig 1: US Inflation Remains Below Fed Target

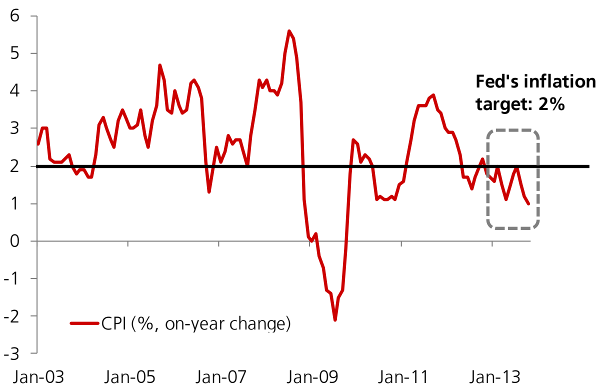


Fig 2: Relationship between HSCEI and Citi Surprise Index

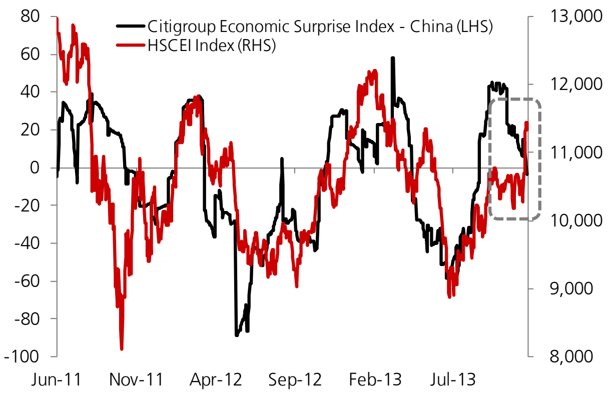
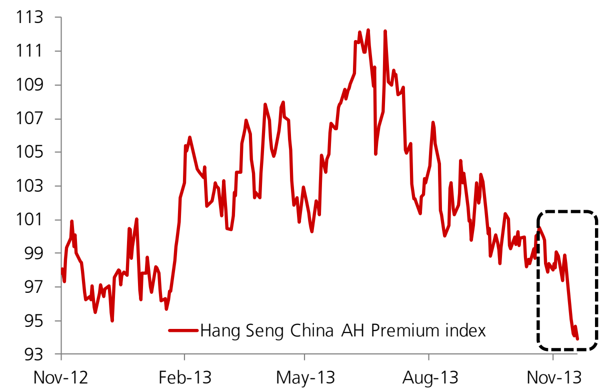


Fig 3: Pullback in Hang Seng China AH Premium Index



Source: Bloomberg, DBS CIO Office as of 22 November 2013.

claims also fell to 323,000 from 344,000 for the week ending 16 November. This was better than consensus expectations of 335,000. The improvement on the employment front may have helped consumer demand. Retail sales rose 0.4% on-month in October, beating a forecast of analysts expecting a 0.1% number.

The positive macro data was however, partially offset by softness on the inflation front. The Consumer Price Index fell 0.1% on-month in October, the first decline in six months. On an on-year basis, inflation remains subdued at +1.0%, substantially below the Fed's inflation target of 2% (Figure 1). Similar weakness was evident in manufacturing as the Philadelphia Fed Manufacturing index fell from +19.8 in October to +6.5 in November (vs. consensus expectations of +15.0) due to weaker gains in shipments, new orders and employment.

Slight moderation in European and Chinese economic momentum. The flash Purchasing Managers' Index for the Euro area fell to 51.5 in November from 51.9 a month earlier. On a geographical basis, the soft PMI print was mainly due to weakness in France, the bloc's 2nd largest economy, where PMI numbers for both manufacturing and services deteriorated. The same trend was evident in China, whereby the flash reading for the HSBC/Markit Manufacturing PMI moderated to 50.4 in November from 50.9 a month earlier. On a segmental basis, sub-indices that fell below the threshold between expansion and contraction of 50 included raw materials inventories, employment and new export orders.

While these are still early days, the moderation in economic momentum for these regions could be a drag on their respective equity markets, particularly for China. The Citigroup Economic Surprise Index (Figure 2) recently turned negative and this does not augur well for the outlook of Chinese equities, although this can still be mitigated by positive sentiment arising from recent reform announcements.

Divergence in views on Chinese equities between local and foreign investors. Recent reform announcements by the Chinese government boosted the Chinese equities market. The Hang Seng Composite Index (the 'H' shares market), which is invested mainly by foreign investors, has rallied, galvanized by expectations that upcoming reforms would lead to a re-rating of the market. By contrast, the Shanghai Composite (the 'A' shares market), primarily traded on by domestic investors, had been more subdued. The Hang Seng China AH Premium index, which measures the price premium of 'A' shares over 'H' shares, has since declined substantially to the level (Figure 3).

The divergence in trajectory suggests domestic investors remain skeptical over the recent reform commitments. On the other hand, the rebound in enthusiasm among foreign investors likely stems from a portfolio allocation view. That is, China is starting to look more attractive relative to other Emerging Markets, particularly those that face current account imbalances. Besides, China remains "under-owned" among institutional investors.

Chinese reforms: Beyond the initial sentiment boost, attention will switch to implementation. Beyond the initial sentiment boost from the reform announcements, the market's attention will likely soon switch to how these policies will eventually be implemented, and by extension, their likely impact on corporate earnings. The proposed reforms, such as changes to the 'one-child' policy, should bring long-term benefits to the economy. This in turn warrants a re-rating of the Chinese equity market. Currently, China trades at a 20% discount to Asia ex-Japan on a forward price-to-earnings (P/E) basis while Southeast Asian markets trade at a premium of 20%. A narrowing of this valuation gap is warranted as China progresses on the path of reform while Southeast Asia faces additional headwinds as the US Federal Reserve trims down and eventually exits quantitative easing.

However, the proposed reforms could also have negative earnings impact on some of the sectors. For instance, the proposed financial sector reforms, while positive for brokerages and insurance companies, could be negative for Chinese banks. Similarly, the recent pledge to fast-track the implementation of a property tax is intended to restrain demand. But it could also weigh on the earnings of property companies. The likely trajectory of Chinese equities from here will very much depend on the pace and method of implementation for some of these reforms.

Global plunge in gold demand reflects changing sentiment towards bullion. Global gold demand fell 21% on-year to 868.5 tonnes in 3Q-2013 as outflows from exchange-traded funds (ETFs) surged. The ETF inflow stood at 137.8 tonnes in 3Q-2012, but that turned to an outflow of 118.7 tonnes the last quarter. Demand from central banks also fell 17% on-year to 93.4 tonnes. On a geographical basis, consumer demand in India registered a huge decline of 32% on-year, although this was partly offset by an 18% gain in China.

The huge outflow from ETFs suggests a fundamental shift in sentiment towards the precious metal. Since the beginning of the year, ETFs have registered outflows every quarter, totalling 697.4 tonnes for 9M-2013. This contrasts sharply to inflows of 575 tonnes and 352 tonnes over similar 9-month periods in 2009 and 2010.

Asian Insights Feature

India: Caught in Fiscal Cross-Currents

An improving external sector and restrictions on gold imports are poised to narrow India's current account deficit this year. But things are not so rosy for fiscal balances.

We have said since the FY13/14 Budget that one of India's key risks this year is a reversal in fiscal consolidation efforts. And the evidence bears this out. Between April to September, the first half of the fiscal year, India's cumulative fiscal deficit has already reached 76% of the full-year target, a historical high.

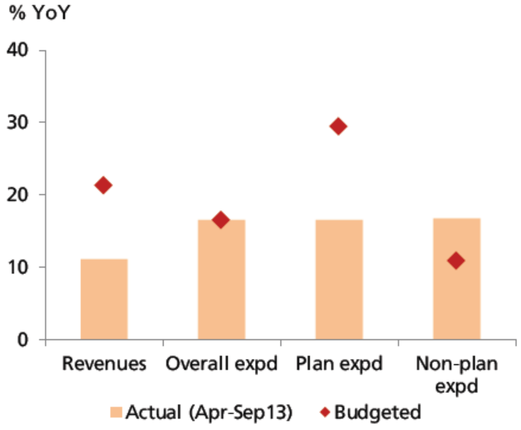
Most of India's spending has gone into non-planned components, which are unproductive. Non-planned expenditure has grown 16.6%, outpacing the budgeted 10.8% pace. Planned expenditure, which help productivity and growth, is running at just half the required pace.

Subsidies have been a significant drain, amounting to 2% of GDP. Even though fuel subsidies are budged to fall 30%, rupee depreciation could negate some of this improvement. Every 10% depreciation in the rupee vs USD could potentially raise the deficit by 0.25% of GDP.

Meanwhile, both tax and non-tax revenues have not impressed. And with growth slowing, investment weak and elections coming up, the odds of a tax increase are low. Divestment receipts could also hit roadblocks if equity markets are weak, depressing valuations and investor interest.

The budget's assumption of 13.4% nominal GDP growth also looks optimistic. Growth is more likely to come in at 10.5%. Our base case is that the FY13/14 deficit is poised to exceed the 4.8% of GDP deficit target by at least 50 basis points, sending it out to -5.3%.

Actual vs Budgeted Fiscal Variables



Source: DBS Group Research

So the evidence points to India potentially missing its deficit target. But the official stance is still that the targets will be met. Such rhetoric is not surprising, as policymakers are caught in the cross-currents of slow growth and upcoming elections, which call for a relaxation of fiscal consolidation efforts.

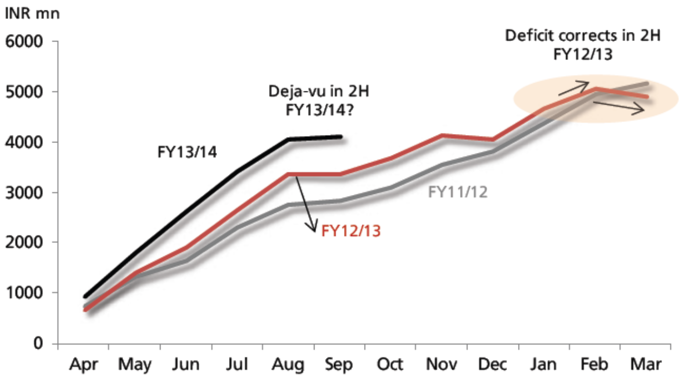
But as the miss of key fiscal targets ups the risk of a rating downgrade, we believe India's next course of action will likely be light on reforms and heavy on short-term fixes.

One such corrective action would be cutting expenditures. Last year, the government was able to cut spending enough to undershoot the FY12/13 fiscal deficit target, even though analysts widely expected an overshoot of 50-100 basis points. But that improvement was due mostly to cuts in planned spending, spending that usually contributes materially to growth. Where the axe will fall this time round is unclear, but if the fiscal deficit keeps at the current run-rate, it will overshoot the target by at least 50% by March 2014.

Routine austerity measures such as limiting foreign trips and cutting back on additional hiring are unlikely to result in meaningful savings. And the Finance ministry's proposed sizeable cuts in high-spending ministries, alongside a few flagship schemes have faced resistance.

But expenditure needs to be cut by about 2% of GDP to meet the deficit target. India's leadership has stressed that non-planned spending will be targeted. But the likelihood of this was undermined by the passage of the food security bill, reluctance to raise retail fuel prices by a bigger margin to lower subsidies, and the upcoming elections.

Build-up in India's Fiscal Deficit



Source: Datastream, DBS

The three main ratings agencies remain relatively sanguine about India's fiscal outlook, but the risks of rating action cannot be dismissed. S&P still has India on 'negative' outlook, though both Fitch and Moody's have a 'stable' outlook.

The agencies are likely to give Indian authorities the benefit of the doubt after they managed to meet last year's fiscal targets through action taken late in the year. The return of confidence in financial markets has also been encouraging. And the step-up in communication and follow-through action by the Reserve Bank of India has also reined in pessimism.

S&P recently expressed concern about the economy's public finance and lack of structural progress, but placed the burden to fix it on the next government that will assume office after May 2014.

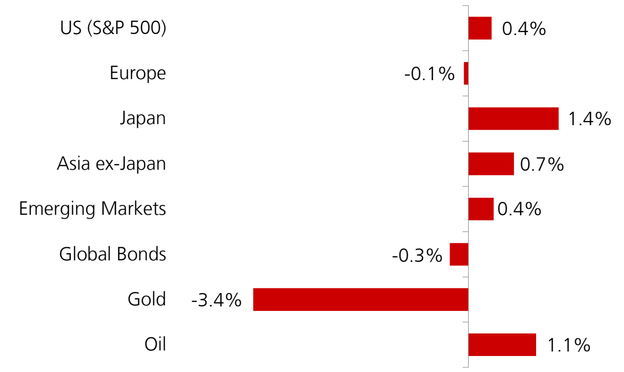
But there is little room for complacency. Developments will be monitored closely. Weak efforts to rein in the fiscal deficit, half-hearted reforms and/or weak growth could lead to ratings action much earlier than what is being priced in currently.

Source report: DBS Group Research. Economics: India – Caught in fiscal cross-currents. 18 November 2013.

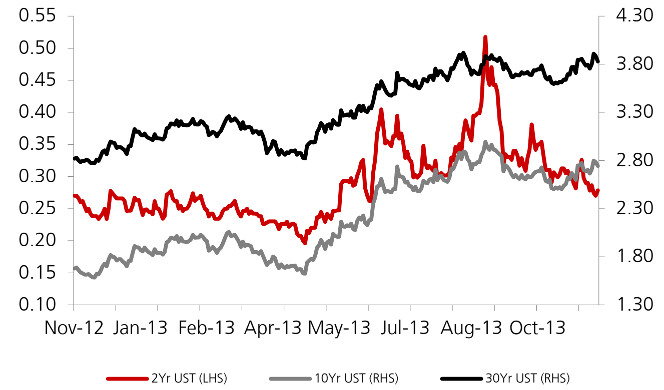
Summarised by DBS Group Wealth Management /CIO Office. An edited version appeared in 25 November 2013's *Market Snapshot.*

Economic & Market Data Monitor

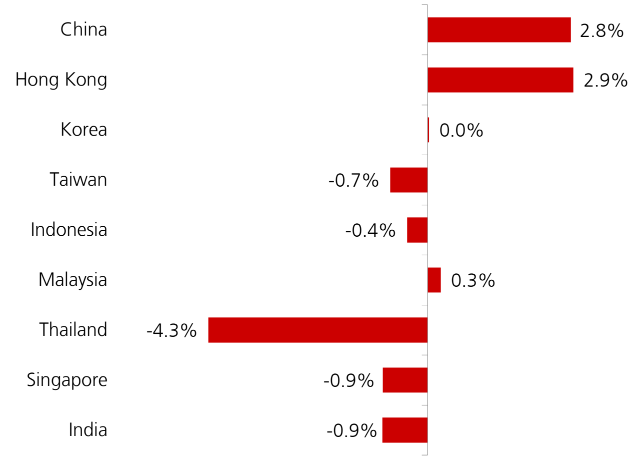
Leading Global Returns



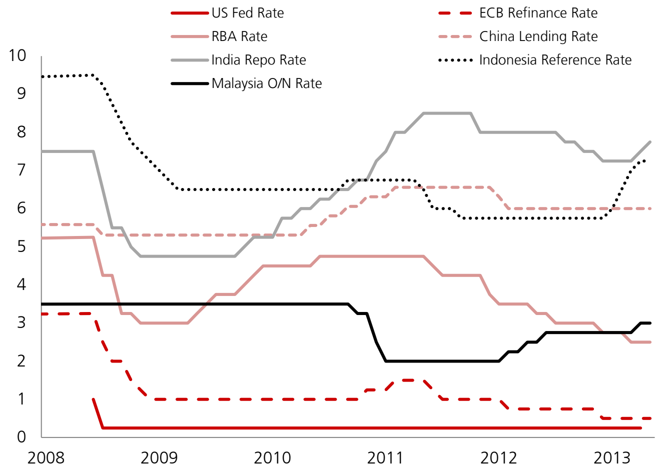
US Treasury Yields (%)



Asia Country Returns



Key Benchmark Rates (%)



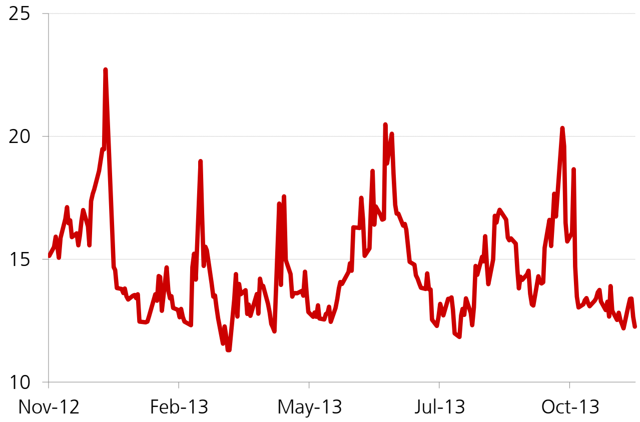
Key Forward PE & Earnings Growth

	YTD* Returns	Fwd P/E 2013	5-Year Average	Earnings Growth 2013**
US (S&P 500)	26.5%	16.3	14.0	4.6%
Europe (DJ Stoxx 600)	15.4%	15.1	11.9	39.7%
Japan (Nikkei-225)	48.0%	19.9	23.2	12.9%
Asia ex-Japan (MSCI)	0.3%	12.5	13.2	-2.4%
Emerging Mkt (MSCI)	-4.4%	11.7	11.8	3.2%
Global Bonds	-2.4%	n.a.	n.a.	n.a.
China (SHCOMP)	-3.2%	9.7	11.6	13.9%
Hong Kong (HSI)	4.6%	11.4	12.4	-5.5%
Korea (Kospi)	0.5%	10.0	10.7	16.0%
Taiwan (TWSE)	5.4%	16.0	16.5	46.6%
Indonesia (JCI)	0.0%	15.1	14.3	23.1%
Malaysia (KLCI)	6.3%	16.9	15.2	1.9%
Thailand (SET)	-2.4%	13.9	12.2	8.5%
Singapore (STI)	0.2%	15.0	14.2	-9.3%
India (Sensex)	4.1%	14.9	15.6	16.1%

* YTD refers to Year-to-date; Returns in local currency.
** Earnings growth based on local benchmark index, except for South Korea (MSCI Korea).

Source: Bloomberg, IBES, DBS. Data as of 22 November 2013.

Volatility (VIX Index)



In The Coming Week

25 Nov 2013	Event	Period	Survey	Actual	Prior
SI	CPI (YoY)	Oct	2.10%	--	1.60%
TA	Industrial Production (YoY)	Oct	1.00%	--	1.06%
US	Pending Home Sales (MoM, sa)	Oct	1.10%	--	-5.60%
26 Nov 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SI	Industrial Production (YoY)	Oct	9.20%	--	9.30%
HK	Exports (YoY)	Oct	6.50%	--	1.50%
US	Housing Starts	Oct	932K	--	--
US	S&P / Case Shiller Home Price Index	Sep	--	--	164.53
US	House Price Index (MoM)	Sep	0.40%	--	0.30%
US	Consumer Confidence Index	Nov	72.1	--	71.2
27 Nov 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
US	Initial Jobless Claims	23-Nov	330K	--	323K
US	Durable Goods Orders	Oct	-1.90%	--	3.70%
US	Univ. of Michigan Confidence	Nov F	73	--	72
28 Nov 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
HK	Retail Sales Value (YoY)	Oct	8.10%	--	5.10%
JP	Retail Trade (MoM, sa)	Oct	-0.80%	--	1.70%
PH	GDP (YoY)	3Q	7.10%	--	7.50%
TH	Manufacturing Production (YoY)	Oct	-2.70%	--	-2.90%
29 Nov 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SK	Industrial Production (YoY)	Oct	0.50%	--	-3.60%
TA	GDP (YoY)	3Q F	1.70%	--	1.58%
IN	GDP (YoY)	3Q	4.60%	--	4.40%
JP	Industrial Production (MoM, sa)	Oct	2.00%	--	1.30%
JP	CPI (YoY)	Oct	1.10%	--	1.10%
EZ	CPI (YoY)	Oct	0.80%	--	0.70%
EZ	Jobless Rate	Oct	12.20%	--	12.20%

Source: Bloomberg News. Data as of 22 November 2013. Note: DBS Group Research (DBS)

IN THE COMING WEEK

Singapore's industrial production is expected to gain 9.2% on-year in October. Also on tap: inflation numbers.

Taiwan, the Philippines and India will all release their GDP figures for 3Q this week.

Retail sales in Hong Kong may expand 8.1% on-year in October, faster than a 5.1% rise a month ago. The city will also release its trade data.

The US government will unveil weekly jobless claims, consumer confidence, housing starts, among others.

The Euro area will release the consumer inflation figures and jobless rate for October.

In Review

- **China's** home prices continue to skyrocket, with average new home prices rising a record 9.6% on-year in October, according to Reuters calculations. Beijing home prices pushed past 16%, Shanghai prices jumped 17.8% and Guangzhou and Shenzhen surged nearly 20%. Foreign direct investments rose 1.24% on-year, marking an increase for nine straight months. From January to October, FDI inflow recorded a 5.77% on-year increase. The preliminary reading for HSBC/Markit factory PMI for November fell to 50.4 from 50.9, staying in expansionary territory above the 50 threshold.
- **Thailand** cut its growth forecast for 2013 to 3% from an earlier 3.8%-4.3% projection in August. The National Economic and Social Development Board expects the economy to grow 4%-5% in 2014. GDP rose 1.3% in 3Q-13.
- Moody's upgraded its outlook for **Malaysia** to positive from stable, citing brighter prospects for fiscal reform after the country announced a consumption tax hike in 2015 and sharply cut its subsidies. Consumer inflation accelerated to an annual rate of 2.8% in October, faster-than-expected, owing to higher food prices.
- **Singapore's** Ministry of Trade and Industry said the economy grew 5.8% on-year in 3Q-13, beating expectations. The ministry also upped the full-year 2013 growth forecast to 3.5%-4.0%, and the 2014 forecast to 2%-4%.
- **Japan's** exports rose 18.6% on-year in October, helped by a weaker yen and a pick-up in global demand. The figure recorded its fastest gain since July 10. Imports also saw a sharp, larger-than-expected increase. As a result, trade deficit widened to JPY1.09 trillion. Meanwhile, the Bank of Japan maintained its massive monetary stimulus, as expected.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 22 November 2013.

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