Investment Insights

Monday, 12 August 2013

Equity Markets Consolidate; Search for Next Driver

SUMMARY

- **Developed markets equities consolidate as 2Q earnings season draws down**
- **Better-than-expected China macro data suggests economy is stabilising; stimulus measures taking effect**
- **Too early to be upbeat on China stocks; lingering concerns over shadow banking and non-performing loans**
- **Gradual macro outlook rebound in Europe**
- **37% of companies in Brazil and Mexico report positive earnings surprise; Latam stocks not looking good**

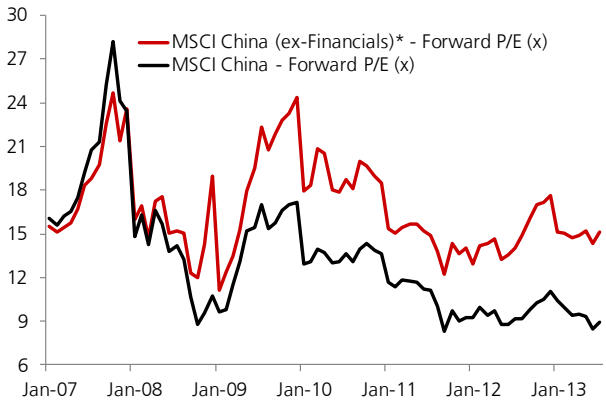
The US equities uptrend could pause as investors search for new drivers. There was relatively little data of importance last week so US stocks traded sideways or were a tad weaker. Some range-trading could continue on profit-taking against the backdrop of the end of the earnings season. Meanwhile, commodity-related plays bounced as the latest Chinese macro data came in better than expectations, suggesting that the economy might be stabilizing on recent stimulus measures. However, it is too early to pop the champagne on China-related investments as there are still quite a few structural issues overhanging the markets. Indeed, other Asia ex-Japan markets and emerging markets in general continued to perform poorly last week on a range of economic concerns.

Developed markets equities consolidate as earnings season draws to a close. Global equity markets were largely flat last week in the absence of major news flow and economic data releases. MSCI World dipped 0.4% on a USD-based total returns basis, led by declines in US and Japan equities. The two markets lost 1.7% on average, unsurprising after strong gains since the onset of the year. And with the curtains coming down on 2Q earnings season close and September historically volatile, further consolidation is expected in the weeks ahead.

What dominated headlines last week was a series of bright macro data from China. Exports rose 5.1% on-year in July, markedly higher than the 2.0% gain that analysts were looking at (Figure 1). Apart from robust exports, China also posted positive industrial production, fixed asset investment and money supply data for July. Commodity prices rallied in the wake of the positive numbers with the Thomson Reuters/Jefferies CRB Commodity Index gaining 0.6%. Industrial metals such as aluminium and copper led the gains, increasing 3.4% and 3.9% respectively on rising optimism that China's economy may have bottomed. Benchmark Nymex crude oil prices however declined 0.9% and this was partially offset by a 0.2% gain in gold as the latter

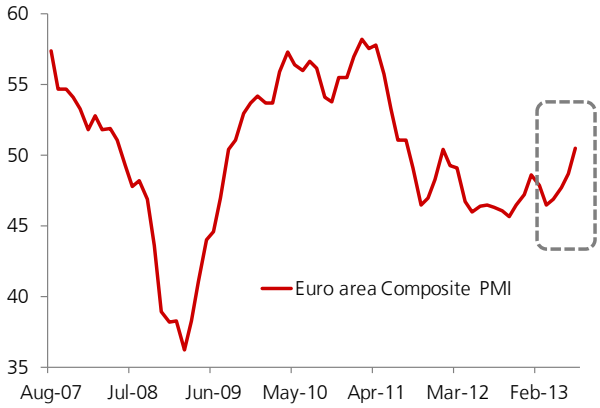
Fig1: China's Export Growth Bottoming

Fig2: China's Cheap Valuation Due to Financials



*Based on simple average of remaining sectors

Fig 3: Better-than-Expected Euro Zone PMI in July



Source: Bloomberg, DBS CIO Office as of 9 August 2013.

rebounded on dollar weakness. For currencies, the US dollar index (DXY) declined 1.0% due to losses against the currency-majors and commodity currencies. The Australian dollar (AUD) gained 3.4% against the greenback despite a Reserve Bank of Australia (RBA) decision to cut its benchmark rate by 25 basis points to a record low of 2.5%. A slight change in the RBA's policy statement tone lifting sentiment. The central bank didn't say if the inflation outlook provided scope for further easing while strong China data also boosted the AUD. China is Australia's largest trading partner.

Recent data suggests the China economy is stabilizing. Last week's data dump from Beijing beat expectations, suggesting that the economy is stabilising. Apart from robust trade numbers, industrial production in July also exceeded expectations with a 9.7% on-year gain. This came on the back of a strong rebound in the production of steel, non-ferrous metals, cement and power. Power production, a widely followed proxy for the level of economic activity, gained 10.2%, the highest since February 2012. Fixed Asset Investment, a key driver of GDP growth, grew 20.1% and beat consensus estimates. On the monetary front, money supply (M2) grew 14.5% on year while new Yuan loans came in at CNY699.9 billion, beating an estimate of CNY640.0 billion.

The rebound in economic momentum likely reflects the positive impact of a series of stimulus measures to prevent growth from deteriorating sharply. To date, the government has already announced a series of "targeted" mini stimulus measures ranging from railway construction to tax cuts for small businesses. In addition, the administration has also set long-term GDP growth of 7% as the minimum tolerable level. Meanwhile, inflation in China remains benign with CPI at 2.7% in July, significantly below the 3.5% "cap" as set by the government. This provides ample room for policymakers to loosen monetary policy and undertake more smaller-scale stimulus measures.

Structural overhangs remain in China. Despite the data suggesting stability or even a possible turnaround in China, it may be too early to expect equities to turn too. While commodity prices (especially base metals) and commodity-related currencies cheered the better-than-expected data, the reaction from China equities was mixed. The MSCI China lost 0.7% for the week although the Shanghai Composite edged up slightly. Commodities and commodity currencies did better. The AUD/USD gained 3.4% and the London Metal Exchange Index (LMEX) picked up 3.8% during the week.

The MSCI China was weighed down by performances of financials, healthcare and utilities. Last week's price action in China suggests two things: 1) the pullback in healthcare and utilities implies that portfolio allocators are still paring their exposure in defensive sectors as valuations remain steep (both sectors trade at average price-to-book (P/B) multiple of 2.3x, a 64% premium relative to the broader market). 2) the weak performance of Chinese financials reflects lingering concerns over the state of shadow banking and non-performing loans. The central government has begun to address these issues, but investor confidence is still lacking.

An often-cited argument for the Chinese market is that valuations are cheap at 8.9x forward price-to-earnings (P/E) ratio, which represents a 22% discount to the region. But once the financial sector is removed, China's forward price-to-earnings (P/E) multiple is actually higher at 15.4x (based on simple average of remaining sectors) (Figure 2). Institutional investors are staying away from Chinese banks, meaning it will be difficult for the index to sustain a rally.

European economic outlook brighter. The economic situation in Europe continues to display gradual improvement. The euro area composite purchasing managers' index, or PMI, came in slightly better-than-expected at 50.5 in July (Figure 3). Separately, industrial production in Germany also beat estimates with a 2.0% on-year gain in June compared to consensus expectations of -0.3%. The European swing began late last year, and this data is a continuation of that. The same was seen in Italy, which was one of euro zone's worrisome areas last year when it was gridlocked politically. Second quarter GDP declined by a lower-than-expected 0.2% on quarter while industrial production expanded for a second consecutive month, on-month.

Latam 2Q earnings not looking pretty. Unlike earnings in the US and Japan suggesting a recovery, the same cannot be said for the Latin America (Latam) markets. Earnings for Brazil and Mexico, its two largest economies, show that. In Brazil, slightly more than half of the companies have reported their numbers and only 46% were higher and above consensus. The outlook was particularly dire in the financials, consumer staples and industrials space. It was the same for Mexico, where only 27% of the 94% who have reported earnings in total surprised on the upside. The earnings data reinforces our cautious stance on emerging markets equities. As we progress through the second half, we expect corporate earnings growth to drive the next up-leg for equities and developed markets equities are looking better on this front.

Asian Insights Feature

Japan: Slower China Does Not Spell Trouble

A possible slowdown in China will more or less counteract the short-term positive effects of Abenomics, but the overall impact is expected to be limited. GDP growth forecasts are maintained at 1.8% in 2013 and 0.9% in 2014.

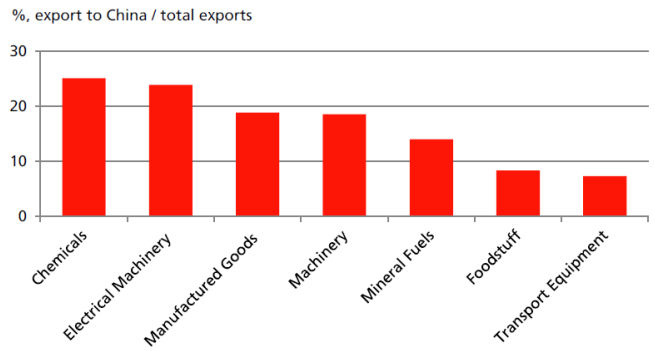
Admittedly, Japan's trade and investment exposure to China is not small. China has overtaken the US to become Japan's largest export market after the 2008 global financial crisis (18% in 2012.) China is Japan's second-largest foreign direct investment (FDI) destination, just after the US. Japanese firms hold a cumulative JPY8 trillion investment in China, equivalent to 9% of the country's total position of outward FDI. In addition, China is Japan's third-largest source of tourists, after Korea and Taiwan. China contributed to 17% of all tourists arrivals last year.

Even so, the macro impact of a China slowdown on Japan should still be limited. Firstly, Japan's reliance on external demand is not high. The share of goods exports in real GDP terms is only 14% in Japan (2012 statistics), compared to 180% in Singapore, 64% in Taiwan, and 47% in South Korea. Tourism as a percentage of GDP is negligible, at only 0.2%.

Secondly, Japan's exports to China have already deteriorated since late last year (-1.4% on-year on average in Jan-May 13), and tourist arrivals from China have fallen sharply (-26.4% on-year in Jan-May 13) as a result of territorial disputes and cooler diplomatic relations. Room for further export / tourism weakness appears limited.

Third, the yen's depreciation since end 2012 is expected to continue to help Japan's exports and tourism in the next 6-12 months, with a time lag. Tourist arrivals from other countries such as Korea and Taiwan have surged strongly in the first five months of 2013 (38.1% on-year, 45.4% on-year respectively). Goods exports to the US (10.9% on-year) and other non-China markets have been faring well. The US is likely to regain its status as Japan's largest export market this year.

Japan's export dependence on China by sector



Source: DBS Group Research

Furthermore, the Bank of Japan has been in easing mode since the 2008 global financial crisis, and has entered a "new era of quantitative and qualitative easing" since April this year. As one of the three pillars of Abenomics, monetary easing is aimed at beating deflation and pulling the economy out of the vicious cycle of falling prices and falling demand.

We don't anticipate a significant impact of China slowdown on Japan's overall economy and thus on monetary policy.

That said, additional easing remains possible next year. The BOJ's medium-term economic forecasts, especially price forecasts (1.3% for FY2014 and 1.9% for FY2015, excluding consumption tax hikes) appear too sanguine. Delivering the commitment of 2% inflation target in a two-year timeframe will be a challenge.

As far as the external balance is concerned, we expect the current account to continue a cyclical recovery in 2013-2014, aided by a weaker yen. The risk of portfolio capital outflows triggered by a China slowdown will be limited, in our view. JPY bonds are still seen as a safe asset.

China is the third-largest foreign investor in the JPY bond market (13% of total JPY bonds held by foreigners). These holdings are long-term investments, which mainly come from China's central bank with the aim of foreign reserve diversification.

As for Japan's net international creditor position, its outward portfolio investment is small in China (0.3% of total portfolio investment assets) and Asia (2.7%), but large in other emerging markets in Central and South America (19%).

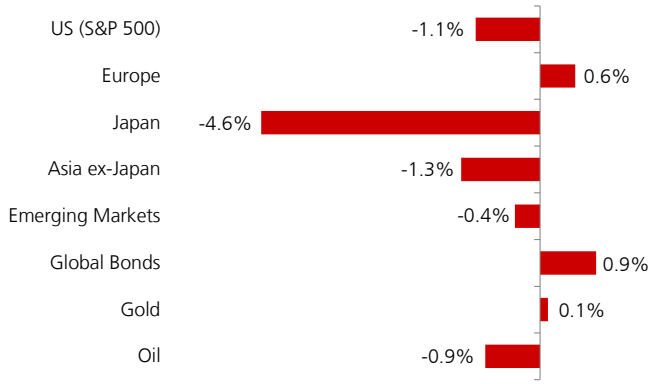
The latter is vulnerable to the risk of China slowdown, as that potentially curbs global demand for commodities. Possible funds repatriation to Japan from overseas emerging markets would help support Japan's balance of payments.

Source report: DBS Group Research. Asia – Impact of a Slower China. 2 August 2013.

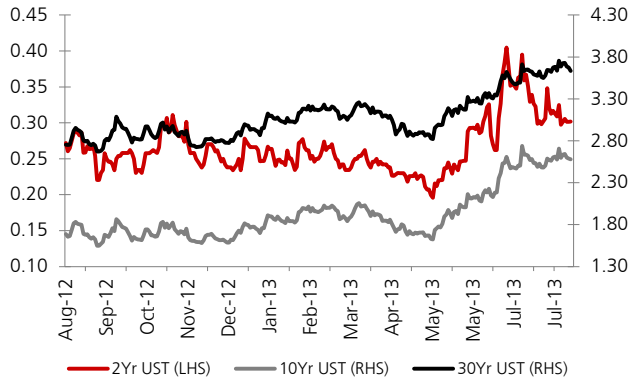
Summarised by DBS Group Wealth Management /CIO Office. An edited version appeared in 12 August 2013's *Market Snapshot.*

Economic & Market Data Monitor

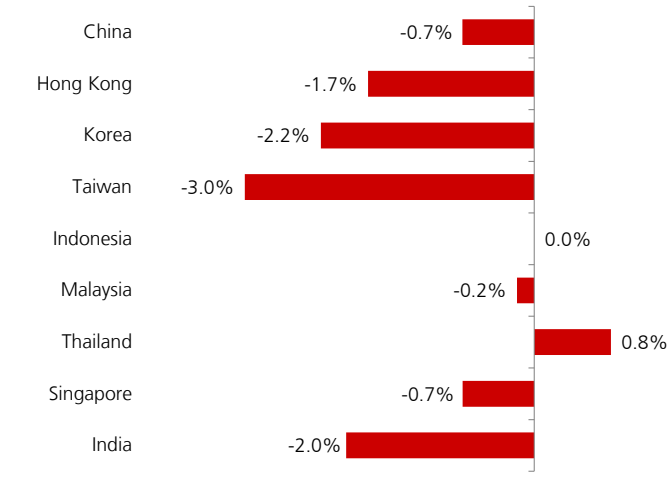
Leading Global Returns



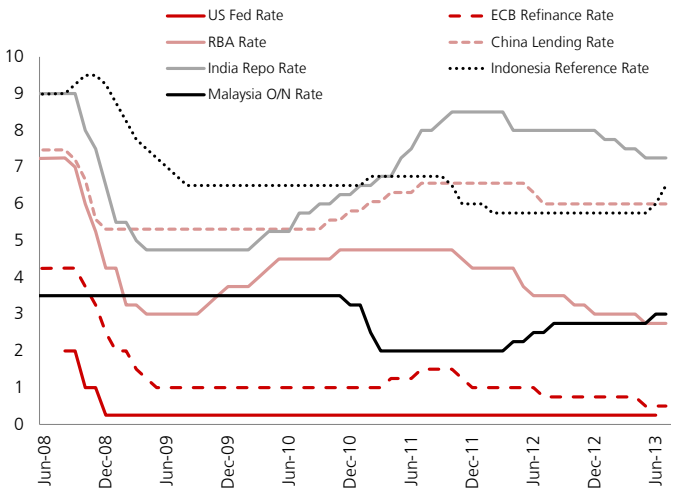
US Treasury Yields (%)



Asia Country Returns



Key Benchmark Rates (%)



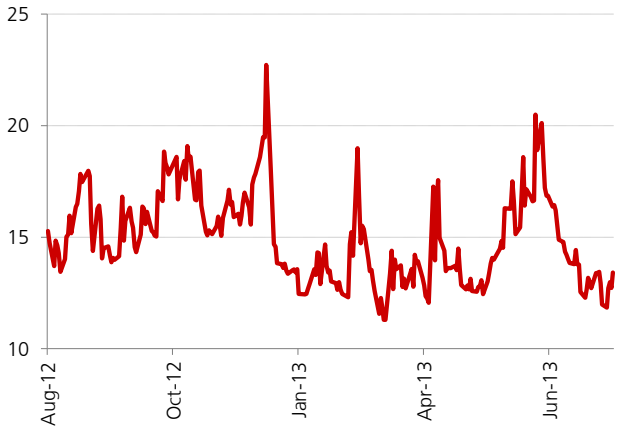
Key Forward PE & Earnings Growth

	YTD Returns	Fwd P/E 2013	10-Year Average	Earnings Growth 2013
US (S&P 500)	18.6%	16.8	14.0	6.8%
Europe	9.4%	37.2	12.1	1.9%
Japan	32.7%	23.8	16.3	59.1%
Asia ex-Japan	-6.3%	11.6	12.1	15.4%
Emerging Mkt	-9.8%	10.7	10.8	10.2%
Global Bonds	-2.6%	n.a.	n.a.	n.a.
China	-9.2%	8.5	12.0	11.0%
Hong Kong	-3.7%	10.0	13.1	10.2%
Korea	-5.8%	9.4	9.5	23.3%
Taiwan	2.0%	18.7	13.9	36.1%
Indonesia	7.5%	15.0	13.5	15.4%
Malaysia	5.4%	16.8	14.0	-0.7%
Thailand	2.9%	13.3	10.4	18.8%
Singapore	2.0%	13.4	13.9	0.5%
India	-3.3%	14.9	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 9 August 2013.

Volatility (VIX Index)



In The Coming Week

12 Aug 2013	Event	Period	Survey	Actual	Prior
SI	GDP (YoY)	2Q F	3.50%	3.80%	3.70%
JP	GDP (QoQ, saar)	2Q P	3.60%	2.60%	4.10%
JP	Industrial Production (MoM, sa)	Jun F	--	--	-3.30%
IN	Industrial Production (YoY)	Jun	-1.10%	--	-1.60%
13 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
JP	Machine Orders (MoM, sa)	Jun	-7.00%	--	10.50%
PH	Exports (YoY)	Jun	7.00%	--	-0.80%
US	Import Price Index (MoM)	Jul	0.80%	--	-0.20%
US	Retail Sales Advance (MoM)	Jul	0.30%	--	0.40%
EZ	Industrial Production (MoM, sa)	Jun	0.90%	--	-0.30%
14 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SK	Unemployment Rate	Jul	3.20%	--	3.20%
IN	Wholesale Prices (YoY)	Jul	4.83%	--	4.86%
EZ	GDP (QoQ, sa)	2Q A	0.20%	--	-0.20%
15 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SI	Retail Sales (YoY)	Jun	3.80%	--	3.20%
US	CPI (MoM)	Jul	0.20%	--	0.50%
US	Initial Jobless Claims	Aug-09	3000K	--	3330K
US	Industrial Production (MoM, sa)	Jul	0.30%	--	0.30%
ID	Bank Indonesia Reference Rate	Aug-15	6.50%	--	6.50%
16 Aug 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SI	Non-oil Domestic Exports (YoY)	Jul	-3.00%	--	-8.80%
HK	GDP (YoY)	2Q	3.20%	--	2.80%
TA	GDP (YoY)	2Q F	--	--	2.27%
US	Housing Starts	Jul	905K	--	836K
US	Univ. of Michigan Confidence	Aug P	85.5	--	85.1

Source: Bloomberg News. Data as of 12 August 2013. Note: DBS Group Research (DBS)

IN THE COMING WEEK

Singapore's non-oil domestic exports are expected to decline 3.0% on-year in July, less than the 8.8% fall a month ago. Also on tap: retail sales data.

Taiwan, Hong Kong and the Euro zone will announce their 2Q-13 GDP figures this week.

Indonesia's central bank will meet this week. Consensus expects the benchmark rate to stay steady at 6.50%.

Philippines' exports are estimated to rebound to 7.0% on-year growth in June from a 0.8% contraction a month ago.

In the US, focus will be on housing and manufacturing data releases. Consumer confidence figures will also be on tap.

In Review

- **China's** non-manufacturing PMI survey reading rebounded to 54.1 in July, up from 53.9 in June. A reading above 50 indicates expansion. Exports gained 5.1% on-year, rebounding from a fall in June, the first in 17 months. Imports jumped 10.9% on-year, more than five times what analysts were expecting. Industrial output grew 9.7% on-year in July, topping expectations for a 9.0% increase. Retail sales rose 13.2% on-year while fixed asset investments, an important driver of economic activity, rose 20.1% on-year. Consumer prices steadied at 2.7%, the same as a month ago. Producer prices fell 2.3%, less than a 2.7% fall in June.
- Elsewhere in North Asia, **Taiwan's** exports rose 1.6% on-year in July, less than the 4.9% increase expected. Overseas shipments account for more than 60% of the island's GDP.
- **Japan's** GDP grew 2.6% on-year in 2Q-13 after growing 3.8% a quarter ago. The Bank of Japan kept monetary policy steady at its latest meeting. The central bank also maintained its assessment of the economy after revising it upward in July.
- **Malaysia's** exports in June fell 6.9% on-year, declining for the fifth consecutive month, as tepid demand from the US, China and Japan hurt shipments of palm oil and electronics products. Industrial production gained 3.3% on-year in June, boosted by robust manufacturing sector. Meanwhile, the final reading for **Singapore's** GDP indicated a 3.8% on-year growth in 2Q-13, slightly faster than the initial reading of 3.7%.
- Inflation in the **Philippines** slowed to 2.5% on-year in July, the lowest in nearly four years, as utilities and select commodities prices fell. In response to the data, the country's central bank said it has enough room to adjust monetary policies to address shifts in investor sentiment or changes in economic outlook.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 12 August 2013.

Prepared by the CIO Office

Chief Investment Officer
Lim Say Boon

Investment Strategy
Manish Jaradi
Jason Low

Investment Communications
En-Lai Yeoh
Michele Lee
Zita Setiawan