Investment Insights

Monday, 21 October 2013

After the Debt Ceiling, Focus Now Back on Fundamentals

SUMMARY

- **Focus back on economic and corporate earnings fundamentals**
- **Early US earnings season data shows 70% of companies beat expectations**
- **Eyes on upcoming economic data for signs of damage from partial US government shutdown**
- **Spending impact likely moderated by back payment of wages to furloughed government employees**
- **Any US growth loss may be offset by stronger China**
- **Expectations of a longer delay to reduction in US Fed's asset-purchase programme to support equities**
- **Future US debt negotiations should be less acrimonious as Republicans appear wounded**

With Washington's debt ceiling and budget brawl seemingly adjourned to early 2014, market focus shifts to economic data and earnings and the economic impact of the partial US government shutdown on the US economy. The early results of the current US earnings reporting season are encouraging, with 70% of companies reporting upside surprises. What little economic data that came out last week generally confirmed a continuation of moderate economic growth. Equities sentiment was also boosted last week by the stronger China GDP growth in the third quarter, which helped the Aussie dollar. In the end, to quote Shakespeare, the "sound and fury" of the US debt ceiling and budget battles "signified nothing" to markets. US equities were technically due for correction anyway in September. So, it corrected and it rebounded off an uptrend in early October, notwithstanding the approaching supposed "financial Armageddon". With the S&P 500 again approaching a trend channel technical resistance, it will probably correct a bit, before pushing higher again on improving economic and earnings fundamentals.

After the impasse, it's now back to fundamentals. In the end, the US debt ceiling row was reminiscent of that line from Shakespeare's Macbeth about "a tale told by an idiot, full of sound and fury, signifying nothing." There was lots of hyperventilating in the media, with breathless talk of an approaching "financial Armageddon". But the debt ceiling fiasco in the US ended in a whimper rather than a bang. It was as we had expected. The divided Republicans, who control one house in Congress that needed to give its approval to any borrowing authority, gave in at the eleventh hour to reopen the government until 15 January and a suspension of the debt ceiling until 7 February. A Congressional panel will now be required to produce a compromise US budget blueprint by 13 December. Sequestration, or automatic cuts in US government spending, will however remain. Market attention will now switch back to the economy and corporate earnings.

Fig 1: Market Now Expects First Rate Hike in Mid-2015

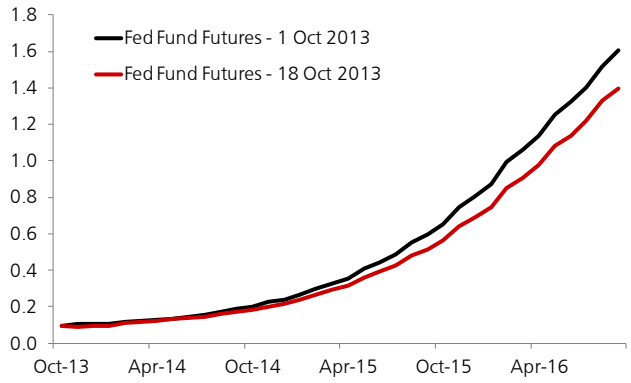


Fig 2: US Earnings Season Trending Well So Far

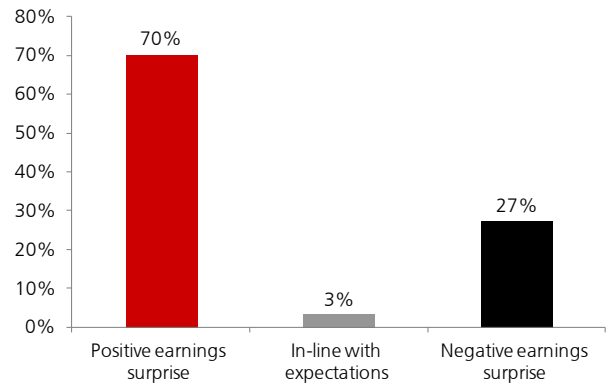
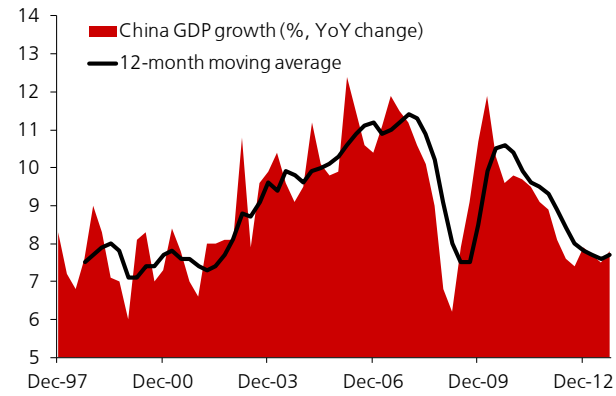


Fig 3: China GDP Growth On The Rebound



Source: Bloomberg, DBS CIO Office as of 18 October 2013.

Potential, modest loss of growth in the US could be offset by a stronger Chinese economy. Despite recent political uncertainties, there is no change in our view of continued, global economic growth driving a gradual shift of funds from bonds to equities. On the macroeconomic front, some deceleration in US economic growth is possible, given the reduction in government spending during recent shutdown. There could also be some impact to consumer and business confidence. But even that could be offset by retrospective payments of wages to government employees furloughed during the shutdown. Any modest easing in US growth (S&P estimates 0.6% was shaved off quarterly GDP from the closure) will likely be offset by improving growth momentum in China, which in 3Q registered 7.8% on-year economic expansion, This marks a reversal of China's first half slowdown as recent 'mini-stimulus' measures start to work their way through the economy.

Debt ceiling uncertainties are causing speculation on a further delay to Federal Reserve tapering. Because of growth uncertainties caused by the recent government shutdown, there are growing expectations that a reduction in the amount the US Federal Reserve pumps into markets under its Quantitative Easing (QE) programme might be postponed further to March next year. Market watchers will be looking toward data for greater clarity on the timing of the taper. The expectation of continued quantitative easing, to the tune of USD85 billion a month, over the coming months is supportive of equities.

Also, the deal struck in Washington means an immediate re-opening of government, limiting the damage to the US economy. But the overhang of the debt ceiling problem suggests a high likelihood of the Fed staying accommodative, pending a longer-term solution. Since the closure of government on October 1, the Fed Fund Futures curves show the market has now pushed back the timing of the first potential rate hike to around mid-2015 (Figure 1).

Earnings season results bullish for equities. The early results of the ongoing US earnings season show 70% of companies reporting positive earnings surprises (Figure 2). Further boosting positive sentiment were strong results from bellwether companies such as General Electric, which reported margin expansion and strong growth in its order book due to an "improving global business environment". In short, the reopening of the US government, encouraging 3Q earnings and a potential delay in QE tapering should provide a constructive backdrop for equities.

Recent data suggests modest US economic growth. The release of key US economic data had been delayed due to the recent government shutdown. Nonetheless, those released last week painted a picture of continued growth in the US economy. The Philly Fed Manufacturing survey came in better than consensus expectations at +19.8 in October. Separately, the Fed Beige Book release for the October FOMC suggests that "modest to moderate" economic expansion remains intact and the government shutdown will unlikely be a huge drag on the economy. In any case, to get a better sense of the US economic outlook, it is necessary to await post-shutdown data releases.

How will the 2014 fiscal and debt ceiling negotiations play out? The kicking of the debt ceiling can down the road means that markets will again be faced with the same political gridlock in Washington early next year. However, recent developments suggest that future debt ceiling negotiations will probably not be significant.

Markets appear to have discounted the "sound of fury" of the political battles in Washington as "signifying nothing". Unlike the debt ceiling negotiation in 2011, there were clearly no signs of market panic this time even as negotiations again went down to the wire. With the exception of some sharp moves in the short-dated US Treasury yields and credit default swaps, other asset classes hardly displayed signs of panic. Markets may have grown accustomed to and discounted frequent political bickering in the US.

Republicans weakened from this latest battle. The outcome of this latest debt ceiling battle was a major defeat for the Republicans and its noisy right-wing Tea Party movement. Prior to the standoff, the Republicans sought to remove funding for the Affordable Care Act as well as use the debt ceiling as leverage for budget negotiations. However, they failed on both counts. Instead, signs of internal disagreements have emerged while a recent Gallup poll shows that the Republicans' popularity rating has fallen to new lows. A shift away from the previous hard-line stance might be necessary if the party wants to improve its chances in 2014 mid-term congressional elections, where all 435 seats in the House of Representatives and a third in the Senate will be contested.

China appears to have turned the corner in 3Q. China reported GDP growth of 7.8% on-year in 3Q (Figure 3), improving on the 7.5% growth registered in the previous quarter. The rebound was driven predominantly by strong growth in Fixed Asset Investment as government stimulus measures start to work their way through the economy. While the latest data contradicts the government's long-term aim of rebalancing growth towards consumption, the GDP rebound nonetheless helps to allay market concerns of an imminent slowdown in China. Meanwhile, liquidity remains ample in the Chinese economy. New Chinese Yuan (CNY) loans stood at CNY787 billion in September (versus consensus expectations of CNY675 billion) while M2 money supply growth also came out in line with market expectations at 14.2% on-year in September.

Emerging Markets still facing challenges as an eventual US monetary exit stays in play. The recent Fed decision to hold off QE tapering, followed by the debt ceiling debacle in Washington, offered a temporary reprieve for Emerging Market (EM) assets. EM concerns took a backseat to the political farce in Washington. This, however, does not suggest these economies are out of the woods yet as tapering has only been postponed by months, not indefinitely. As long as upcoming macro data reaffirms that the damage inflicted by the government shutdown is limited and US economic growth remains on-track, market concerns over tapering and its impact on EM assets will resurface again.

Since the August EM sell-down, the currencies of current account deficit countries such as Brazil and India have rebounded substantially. However, the scope for further moves up is limited given that currency depreciation is a necessary adjustment mechanism for countries facing current account imbalances. Meanwhile, recent monetary tightening in some of these emerging markets will incrementally weigh on domestic demand and corporate earnings growth. Against this backdrop, headwinds for EM assets could resume after the recent reprieve.

Asian Insights Feature

Malaysia: Inflation to Crimp Housing Demand

Raising real property gains tax in and stamp duty in Malaysia could risk pushing house prices higher as sellers will try to pass on incremental costs to buyers and delay disposal - leading to even tighter supply. *DBS* expects property sales and price growth to soften given rising incoming supply and weakening demand as disposable income is dented by rising inflation. Tighter supply of building materials/labour as construction activity picks up for both infrastructure and property sectors from 2014 onwards could push up construction costs and possibly result in expensive delays.

Potentially tight supply of building materials and foreign labour in 2014-15 as construction activity peaks for both property and infrastructure projects could dampen developers' margins and lead to expensive penalty for late delivery. This could delay launches and push up property prices further. There is no property bubble but we fear an oversupply of KL office space, hybrid high-rise units and Iskandar Malaysia high-end condos.

House prices have proven to be resilient in the past, despite economic down-cycles and negative events, except for the Asian Financial Crisis. House prices have risen by 31% over the past three years, as residential sales value and volume hit record highs of MYR67.8 million and 272,699 units in 2012 (47% and 64% of overall property sales, respectively). The sharp price appreciation, however, were not across the board.

Despite the high property prices, we do not think there is an asset bubble because affordability remains high despite high house prices. Between 2009 and 2013, household income grew by 7.2% per annum on average (median: 8.1%), just short of the average house price growth of 9.4%. There is also support from Malaysia's high savings rate of around 35% and capital gains from the robust share and property markets (including refinancing).

We estimate even with a potential 50bps hike in interest rates in 2014, most households would still be able to afford to buy houses worth MYR650,000 per unit. We have assumed 5% income growth (in line with GDP expansion) and a more moderate 5% house price growth (given rising new supply against weakening demand). Every 100 basis point hike in interest rates would dent affordability by 11%. We note that the majority of Malaysia's property transactions are below MYR500,000 per unit (2012: 88%) and Malaysia still has the lowest house price-to-income ratio in the region at 5.3x (versus historical high of 7.8x).

What would kill Malaysia's property market, in our view, is if the government emulates Singapore's severe measures: imposing upfront stamp duty for buyers and sellers' stamp duty (irrespective of whether there was a profit). Such heavy-handed measures will not only drag down the already softer secondary market, but also turn away foreign investors (already small compared to other markets in the region).

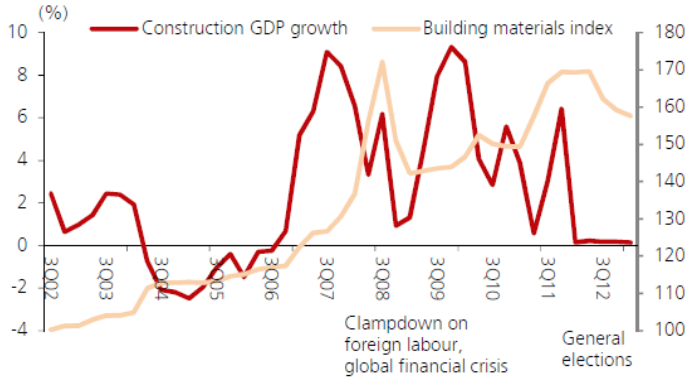
We believe Malaysia should segment and protect mass housing for locals (less than MYR1 million/unit) while liberalising high-end residential and commercial properties to attract high net worth individuals & foreign direct investments. The high-end segment contributed 45% of 2012 sales value despite only constituting 4% of volume.

While other countries in the region are restricting foreigners from buying properties, Malaysia should conversely open up as foreigners currently make up less than 5% of transaction volume. Property can be a new engine of growth for Malaysia in view of Iskandar Malaysia's potential to leverage on Singapore and Greater KL's significance within the Economic Transformation Program (targeting to attract 100 multi-national companies to set up operational headquarters in KL). A weaker Ringgit has also made Malaysian real assets more attractive.

We view positively the potential introduction of Goods & Services Tax by 2015, which could lead to lower personal and corporate tax rates. This should improve Malaysia's competitiveness in attracting FDI and talent along with stemming Malaysia's brain drain and rising investments overseas by local corporates. The immigration policy should also be liberalised further for deserving foreigners

We expect residential sales volume to contract by 5-10% p.a. over the next 2-3 years with slower GDP growth and lower disposable income due to rising inflation (as seen during sharp fuel price hikes in 2005-06 and 2008 of >60%). During periods of sharp inflationary spikes, house price growth tends to moderate. Inflation is set to spike, in our view, with the imminent introduction of Goods & Services Tax as early as 2015 and subsidy rationalisation to address Malaysia's widening budget deficit/high public debt. Fuel prices have already by MYR0.20 a litre or 10.5%, minimum wage is set to be implemented amid a weakening Ringgit that has fallen 13% against the USD over the past four months. Residential sales are starting to show signs of weakness with volume declining by 13% on-year in 1H13 while transacted value inched up by just 1% (supported by 9% increase in house price index).

Building Material Prices to Rise with Higher Construction Activity



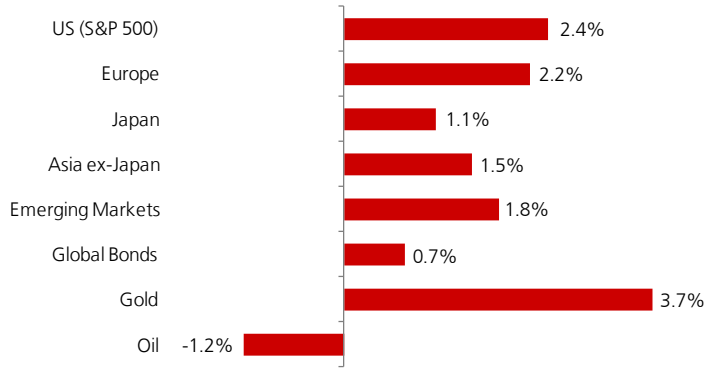
Source: Bank Negara Malaysia, Masters Builders Association Malaysia, DBS Vickers

Source report: DBS Group Research Equity. Malaysia Industry Focus: Delicate Balancing Act. 16 October 2013.

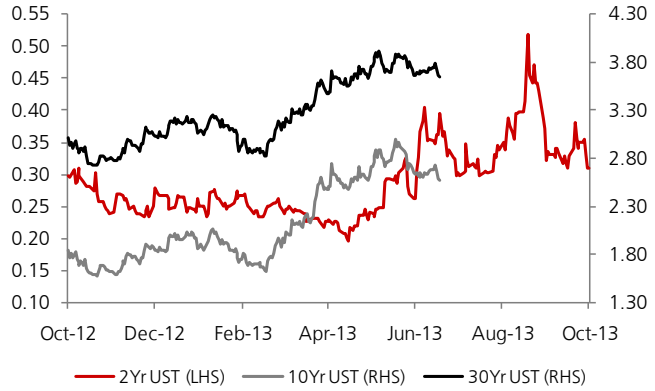
Summarised by DBS Group Wealth Management /CIO Office. An edited version appeared in 21 October 2013's *Market Snapshot.*

Economic & Market Data Monitor

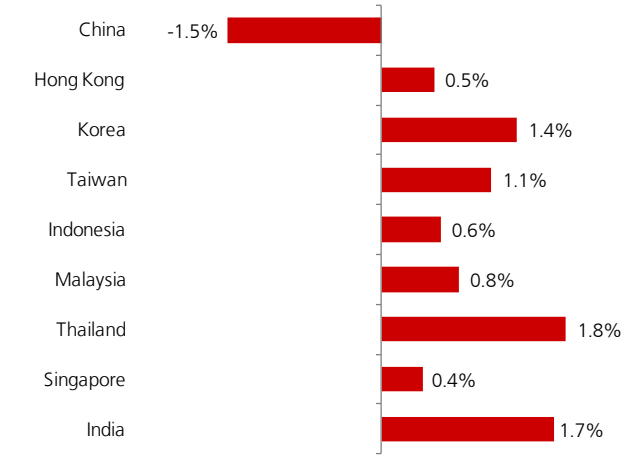
Leading Global Returns



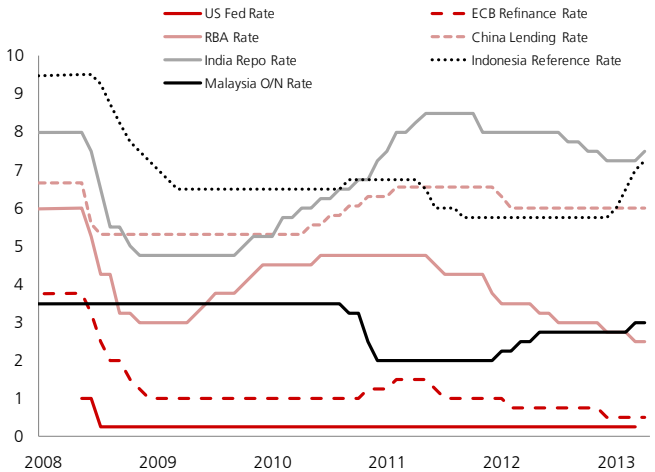
US Treasury Yields (%)



Asia Country Returns



Key Benchmark Rates (%)



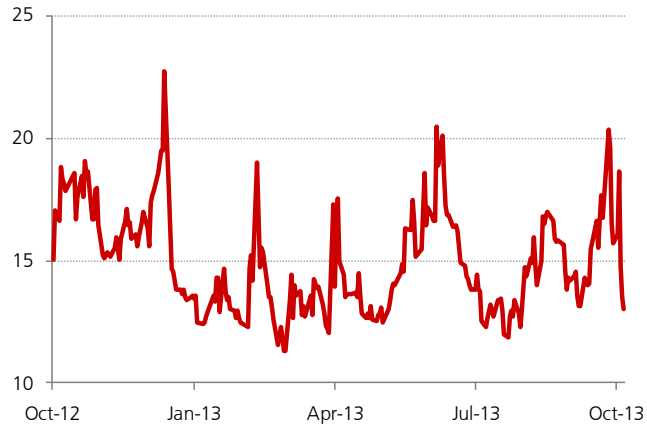
Key Forward PE & Earnings Growth

	YTD* Returns	Fwd P/E 2013	5-Year Average	Earnings Growth 2013**
US (S&P 500)	22.3%	15.8	13.9	6.1%
Europe (DJ Stoxx 600)	13.9%	14.6	11.8	41.4%
Japan (Nikkei-225)	40.1%	18.6	23.1	30.6%
Asia ex-Japan (MSCI)	2.3%	12.6	13.2	0.3%
Emerging Mkt (MSCI)	-1.2%	11.8	11.5	4.3%
Global Bonds	-1.4%	n.a.	n.a.	n.a.
China (SHCOMP)	-3.3%	9.7	11.5	19.3%
Hong Kong (HSI)	3.0%	11.2	12.4	-2.8%
Korea (Kospi)	2.8%	10.2	10.7	16.0%
Taiwan (TWSE)	9.6%	15.8	16.4	48.9%
Indonesia (JCI)	5.3%	15.9	9.9	17.9%
Malaysia (KLCI)	6.6%	16.9	15.1	0.1%
Thailand (SET)	6.7%	14.8	12.1	8.1%
Singapore (STI)	0.8%	14.9	14.1	-12.1%
India (Sensex)	7.5%	15.6	15.5	17.7%

* 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 18 October 2013.

Volatility (VIX Index)



In The Coming Week

21 Oct 2013	Event	Period	Survey	Actual	Prior
TW	Export Orders (YoY)	Sep	0.40%	--	0.50%
HK	CPI Composite (YoY)	Sep	4.40%	--	4.50%
US	Existing Home Sales	Sep	5.30M	--	5.48M
22 Oct 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
TW	Unemployment Rate	Sep	--	--	4.19%
CH	Property Prices	Sep	--	--	--
US	Unemployment Rate	Sep	7.30%	--	7.30%
US	Nonfarm Payrolls	Sep	180K	--	169K
US	Richmond Fed Manufacturing Index	Oct	--	--	0.00
US	Chicago Fed Nat Activity Index	Sep	--	--	0.14
23 Oct 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
SI	CPI (YoY)	Sep	2.00%	--	2.00%
TA	Industrial Production (YoY)	Sep	-0.45%	--	-0.70%
MA	CPI (YoY)	Sep	2.30%	--	1.90%
US	House Price Index (MoM)	Aug	--	--	1.00%
EZ	Consumer Confidence	Oct A	-14.5	--	-14.9
24 Oct 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
CH	HSBC/Markit Flash Manufacturing PMI	Oct	--	--	51.2
HK	Exports (YoY)	Sep	-3.10%	--	-1.30%
US	Initial Jobless Claims	18-Oct	--	--	359K
US	New Home Sales	Sep	425K	--	421K
TH	Exports (YoY)	Sep	--	--	3.90%
25 Oct 2013	**Event**	**Period**	**Survey**	**Actual**	**Prior**
JP	National CPI (YoY)	Sep	0.90%	--	0.90%
SK	GDP (YoY)	3Q P	3.10%	--	2.30%
SI	Industrial Production (YoY)	Sep	5.20%	--	3.50%
US	Durable Goods Orders	Sep	1.70%	--	0.10%
US	Univ. of Michigan Confidence	Oct F	--	--	75.2

Source: Bloomberg News. Data as of 18 October 2013. Note: DBS Group Research (DBS)

IN THE COMING WEEK

Consumer inflation in Singapore is expected to remain steady at 2.0% on-year in September. Also on tap: industrial production data.

South Korea's GDP is forecasted to expand 3.1% on-year in 3Q-13, slightly faster than the 2.3% growth last quarter. Also on schedule: industrial production.

Japan's inflation may stay steady at 0.9% on-year in September, still shy of the central bank's target of 2.0%.

The US is expecting a slew of data this week after a recent delay due to the 16-day partial government shutdown. On focus this week: labour and housing numbers.

In Review

- **India's** wholesale price index, which the country uses as a measure of inflation, rose to a seven-month high of 6.46% in September compared to 6.1% the previous month. This and the consumer inflation number are likely to play a major role in the central bank's end-October policy review. Meanwhile, industrial production rose weaker-than-expected at 0.6% on-year in August, slower than the 2.8% growth seen a month ago.
- **Singapore's** non-oil domestic exports (NODX) fell 1.2% in September from a year ago, less than the 3% fall expected. From August, NODX rebounded 5.7% after falling 6.6%. Weakness in electronics shipments continue to drag, but shipments to China and the US were strong. Retail sales in the city-state tumbled 7.8% on-year in August due to lower car demand.
- **China's** GDP growth picked up in 3Q to 7.8% on-year, in line with estimates. However, other data suggested the economy was slowing down last month. Aside from weak trade data, industrial output and retail sales figures all came in below August numbers, although they came in above consensus forecasts.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 18 October 2013.

Prepared by the CIO Office

Chief Investment Officer
Lim Say Boon

Investment Strategy
Manish Jaradi
Dylan Cheang
Jason Low

Investment Communications
En-Lai Yeoh
Michele Lee
Zita Setiawan