MAREKT REVIEW

JULY 2011

Many Asian markets registered a relief rally in July following the adoption of Greece’s austerity package but was hit at the start of August by two adverse external factors: (i) Eurozone sovereign debt pressures widening from peripheral economies like Greece to core economies like Italy; and (ii) a more constrained fiscal environment in the US following intense political bickering over the nation’s fiscal position and its debt ceiling. Deteriorating conditions in both the Eurozone and the US quickly soured the sentiment not only for equities in Asia but also globally.

In the near term, the volatility in Asian markets is likely to continue, with fear and uncertainty overtaking fundamentals in coming weeks. Market volatility should indeed rise given that the possibility of meeting the current consensus earnings or economic forecasts has not only declined but has also widened considerably, in our view. With appetite for risk assets quickly diminishing, the weak sentiment in Asian equity markets should further deteriorate in the near term given that, at the time of writing, US debt has just been downgraded from its AAA rating to AA+ by Standard & Poor’s.

While we had earlier recognised that the Eurozone had simmering sovereign debt issues to grapple with, particularly the solvency of Greece and Portugal, we also believed that these problems had been temporarily postponed—but only if capital markets remain stable and economic growth holds up. Unfortunately, following the recent sell off in the larger Eurozone sovereign debt markets and global equity markets, countries like Spain and Italy are now faced with the economic repercussions of a negative wealth impact from severely lower equity prices for private investors and sharply higher borrowing costs for the public sector—a case of large capital flows dictating economic fundamentals.

Research from the Centre for European Policy Studies (“CEPS”), a think tank based in Brussels that undertakes research on the challenges facing Europe, highlighted that a nation’s nominal GDP growth rates, its long-term nominal interest rates, and its initial debt-GDP ratio are key factors determining the sustainability of this latter ratio. With a negative wealth effect potentially slowing down GDP growth and borrowing costs now rising at an alarming pace for larger Eurozone countries, there is speculation that Spain and Italy’s debt-to-GDP may spiral to a much higher level. Fears of sovereign debt contagion spreading from peripheral to core European economies can be seen by the spreads of 5-year credit default swap (“CDS”) of Italy and Spain which rose to 386.82 basis points (a record for Italy) and 407.61 basis points, respectively. In comparison, Greek CDS spreads are currently at 1,690 basis points while Germany’s is at 74.24 basis points. Fears have spilled over to the Eurozone’s banking system which holds the sovereign debt not just of Greece and Portugal but also of Italy and Spain. European banks have started hoarding cash in early August with about €105bn parked at the ECB’s overnight deposit facility, the highest levels since February 2011.

At the same time, the US is now faced with a more constrained fiscal policy response. Loose US monetary policy has already proven to be impotent with unemployment still hovering around the nine per cent mark over the last few months and private sector demand has languished. Not surprisingly, investment bank Goldman Sachs reacted by trimming their US 2011 GDP growth from 1.8% to 1.7% and slashing their 2012 GDP growth projection from 3.0% to 2.1% to reflect weaker domestic growth and the lack of policy flexibility available to US policy makers.

On a more positive note, there is a silver lining in the current turmoil. First, the ECB has, on 4 August, responded by resuming its Securities Markets Program (SMP), a programme of buying Eurozone sovereign bonds to ensure that the market is functioning smoothly. At the end of the first week of August, there were reports that the ECB had been buying Irish and Portuguese sovereign bonds. The ECB had previously suspended the SMP for about five months. It should be noted that, in principle, the ECB has no constraints on its ability to purchase sovereign debt.

Second, Asian policy makers have been tightening since 2010 and with the current concerns in the Eurozone and the US as well as slower growth in the region, inflationary concerns are likely to abate and there is then the ability to adopt more accommodative policies. The price of crude oil, as measured by WTI benchmark, has come down from a recent high about US$114 to US$87 currently—a decline of over 20%. Regional economic growth had already been slowing down as we had alluded to in earlier reports. China, for example, has seen a steady decline in its PMI. July PMI was 50.7 points, down from 50.9 points in June and 53.9 points in December.

Third, Asian economies are fiscally much stronger than the Eurozone and the US. Yes, Asia may suffer a large demand shock from the current weakness in the developed economies of the Western world but it would also rebound faster and have the ability to pump prime their economies if external conditions deteriorate further.

Against this backdrop, markets that may weather this period of turmoil better would be those that have larger domestic markets and less exposure to the end consuming markets in the US and Eurozone. In the current market turmoil, we would seek to be selective and opportunistic. We continue to see value in auto parts, selected financials, infrastructure, and oil & gas. From a country perspective, we continue to like China and Hong Kong. China has been ahead of other Asian countries with their policy responses and offer the best valuation relative to other regional markets. Taiwan and Korean markets are likely to suffer more, dragged down by their high exposure to the exporters.

Source: Pheim Unit Trusts Bhd