



Equity Market Commentary

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Summary

Irish contagion appears remote for now

Credit turmoil in the Euro zone has once again come to the fore, as financial markets fix their attention on the rapidly deteriorating public finances in Ireland.

The flashpoint this time around is the staggering €45 billion that the Ireland may incur as it tries to shore up the country's crippled banking system. The bailout will swell Ireland's deficit this year to a staggering 32% of economic output from an initial estimate of 12%, the biggest in post-World War II Europe.

So far there has been limited evidence of the troubles in the periphery economies affecting the larger economies. In summary, we think that the risks that the markets recovery could be derailed by an economic contagion arising from the recent events in Ireland appear manageable.

Euro area's economies are now far stronger than a year ago, and the bloc's third quarter GDP growth of 0.4% from three months ago shows that the recovery remains on track. Additionally, the global banks have emerged from the last financial crisis in far better shape, and that should cushion any impact from any fallout from an Irish default. Therefore, we believe that the broader economic and market recovery stories remain intact.



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Markets spooked by fears of Irish contagion in the Euro zone

Credit turmoil in the Euro zone has once again come to the fore, as financial markets fix their attention on the rapidly deteriorating public finances in Ireland.

The flashpoint this time around is the staggering €45 billion that the Ireland may incur as it tries to shore up the country's crippled banking system. The bailout will swell Ireland's deficit this year to a staggering 32% of economic output from an initial estimate of 12%, the biggest in post-World War II Europe.

Accordingly, premiums on five-year insurance against Irish default spiked up 27 basis points to 620 basis points last Thursday, while five-year credit default swap (CDS) spreads on Portugal and Spain – the other two fiscally weak Euro zone economies – shot up more than 10 basis points as investors rushed for the exit.

But knee-jerk sell-off aside, the top issue in investors' minds now is the form that a new debt crisis mechanism, which replaces the existing European Financial Stability Mechanism (EFSM), will take when it kicks in by 2013. Investors fear that the new regime called "Sovereign Debt Restructuring Mechanism" (SDRM) may impose restructuring on troubled debts either by lengthening maturities on existing bonds and/or a haircut on their value.

The proposal has met with some opposition in the EU, and it is unclear how it will pan out. But even if restructuring is on the cards, our view is that the risks of a wider economic contagion arising from the latest debt turmoil should be manageable for the reasons discussed below.

Economic channel

Broadly speaking, there are two transmission mechanisms through which an Irish sovereign default can impact the Euro area or the rest of the world.

The first is the economic channel of consumption and trade, while the second takes effect via the credit markets.

The periphery economies suffer from the deep problems of budget deficits, trade deficits and low productivity. Additionally, the looming fiscal austerity (€15 billion savings until 2014 in Ireland's case) should have a visible drag on its economic growth ahead. However, it is worth noting that PIGS (Portugal, Ireland, Greece and Spain) collectively accounts for just 20% of Euro area's GDP (Gross Domestic Product), against the 70% taken up by the core (Germany, France and Italy).

So far there has been limited evidence of the troubles in the periphery economies affecting the larger economies.

Germany's PMI – a barometer of manufacturing activity – rose to 56.6 in October from 55.1 in September, while Germany's Ifo business climate index climbed to 107.6 from 106.8 in September – its highest level since May 2007. In addition, Euro area's third quarter real GDP increased by 0.4% quarter-on-quarter, led by Germany (0.7%), France (0.4%) and Italy (0.2%). Meanwhile, the United States' economic data has been improving, as October's ISM, which is a measure of how well the manufacturing sector is doing, came in at 56.9 with continued growth



signals from production, orders and employment. In China, the purchasing managers' index rose to a six-month high of 54.7 in October, from 53.8 in September, highlighting the strength of the world's second largest economy. Markets had expected the index to fall to 52.9 in October.

Credit channel

Investment markets are concerned that an Irish default may unleash another credit crunch, similar to what transpired in the wake of the Lehman collapse two years ago. This can happen if foreign banks pull their funding out of Ireland on lack of confidence. But the European Financial Stability Facility (EFSF) is designed to cushion this event (ECB's repo operations is ensuring sufficient liquidity in the system). Dublin has also already raised enough money to finance its spending needs until next summer. Additionally, the situation in Portugal is not nearly as dire as the Greek situation was in spring. Although both might have to borrow from the €440 billion EFSF to shore up their finances eventually, there is no immediate pressure to do so.

A key concern is the high degree of reliance on foreign investors to absorb new issuance, as some 85% of Irish government debt is foreign owned, while the equivalent figure for Portugal is 80%. However, as the figure is much less for other peripheral countries, this lends some stability to the system.

For now, inter-bank lending also appears little unaffected by Euro zone's latest troubles. The TED spread (the difference between the rates that banks charge one another for short-term loans and Treasury debt) is a key measure of risk aversion and it jumped to 4.63% amid the credit seizure in 2008. Last week, the spread reached a mere 0.16% - down from the 0.18% seen early this month and certainly far from those panic levels seen two years ago.

Furthermore, the major global banks have headed into this period of turmoil with a much stronger balance sheets and liquidity than previously, thus cushioning the impact of any debt fallout.

Broader economic and market recovery stories remain intact

In summary, we think that the risks that the markets recovery could be derailed by an economic contagion arising from the recent events in Ireland appear manageable.

Euro area's economies are now far stronger than a year ago, and the bloc's third quarter GDP growth of 0.4% from three months ago shows that the recovery remains on track. Additionally, the global banks have emerged from the last financial crisis in far better shape, and that should cushion any impact from any fallout from an Irish default.

Over the longer-term, the Euro zone will also be a beneficiary of healthy global and emerging market growth. In our view, emerging markets should continue to contribute significantly to global growth and the Euro zone is a key market for imports of machineries and equipment, services and finished goods. Therefore, we believe that the broader economic and market recovery stories remain intact.



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