



Equity Market Commentary

8 November 2010

Summary

QE2: Looking beyond the headlines

The markets expected it. Therefore, when the US Federal Reserve finally announced the second round of quantitative easing (“QE2”), the response from US markets was fairly muted, while concerns over economic prospects continue to linger.

Last week, the central bank said it would invigorate the economy by buying US\$600 billion more in Treasury bonds, on top of an expected US\$250 billion to US\$300 billion in Fed purchases over the same period from reinvesting proceeds from its mortgage portfolio.

The concern, however, is that the exercise is likely to only have a modest impact on US economy. A key risk is that the wealth and portfolio rebalancing channel could see capital flowing elsewhere instead of the US, implying that the US economic recovery could remain slow, while inflation will continue to languish in the medium-term. Additionally, QE2 raises the spectre of further asset bubbles elsewhere in the world.

In light of the current market developments, we recommend that investors stay with equities, as we believe the asset class should potentially outperform thanks to the combination of attractive valuations, strong corporate earnings, and the injection of further liquidity into the system.

Additionally, the latest economic indicators suggest that we are still in the reflationary stage of the economic cycle – a phase where stocks have historically been the top performer. All of which means there remains significant upside in equities, especially in Emerging Markets which is structurally in far better shape than the developed world.

Meanwhile, QE2 should provide further upside for commodities, and especially for gold. We think there is probably more room for regional currencies to strengthen further.



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Looking beyond the headlines

The markets expected it. And so did the analysts and commentators. Therefore, when the US Federal Reserve finally announced the second round of quantitative easing ("QE2"), the response from US markets was fairly muted, while concerns over economic prospects continue to linger.

Last week, the central bank said it would invigorate the economy by buying US\$600 billion more in Treasury bonds, on top of an expected US\$250 billion to US\$300 billion in Fed purchases over the same period from reinvesting proceeds from its mortgage portfolio.

The fresh injection now involves buying about US\$75 billion a month in long-term government bonds through the middle of 2011 – close to the consensus of US\$100 billion in monthly purchases of US Treasuries for a total of US\$500 billion. The idea is for cheaper loans to get people to spend more and stimulate hiring. Following the announcement, US markets posted modest gains, as most had priced in the Fed's move for weeks. Both the Dow and S&P500 ended last Wednesday's trading up 0.24% and 0.37% respectively.

The good news is that the US Federal Reserve now accords greater importance to cutting the unemployment rate (the latest statement reads that "the unemployment rate is elevated, and measures of underlying inflation are somewhat low"), compared with the September FOMC statement which did not explicitly address the level of unemployment.

The concern, however, is that the exercise is likely to only have a modest impact on US economy. In principle, liquidity-pumping feeds itself into the economy through a number of channels ranging from investment demand (via low interest rates), wealth effect or private sector portfolio rebalancing.

With interest rates already so low, the fresh monetary stimulus hopes to reduce the risks of deflation, and thus stimulate corporate investment spending. But a key risk is that the wealth and portfolio rebalancing channel could see capital flowing elsewhere instead of the US, implying that the US economic recovery could remain slow, while inflation will continue to languish in the medium-term.

Risk considerations

Additionally, QE2 raises the spectre of further asset bubbles elsewhere in the world. Already, property prices and high-yield assets in Asia have chalked up strong gains since the first round of US liquidity drive, and the fear is that prices may spiral into bubble territory if the world is flooded with more greenbacks.

In this connection, it is worth noting that the series of money injection has already given rise to a so-called US dollar-funded carry trade. The irony is that should QE2 succeed in lifting inflation and growth in the US (thus stoking fears of tightening later), the end-result could be a painful adjustment for Asian market due to the global liquidity volatility.



We are still bullish on equities

So what do all these mean for the average investor? In light of current market developments, we recommend that investors stay with equities, as we believe the asset class should potentially outperform thanks to the combination of attractive valuations, strong corporate earnings, and the injection of further liquidity into the system. Indeed, the upside could be even greater, since equities have underperformed commodities and fixed income at this leg of the cycle, and we believe that is set to change in the months ahead.

Additionally, the latest economic indicators suggest that we are still in the reflationary stage of the economic cycle – a phase where stocks have historically been the top performer. All of which means there remains significant upside in equities, especially in Emerging Markets which is structurally in far better shape than the developed world.

Meanwhile, QE2 should provide further upside for commodities, and especially for gold. These range from rising inflation expectations, the longer-term direction of the US dollar, low real rates – all of which are bullish for silver and gold.

In currencies, the greater greenback supply should exert further pressure on Emerging Market currencies to appreciate and for regional governments to tighten monetary policy to stave off asset bubbles or tighten quantitatively. Already, India and Australia have chosen to hike rates, while Jakarta is mulling options to extend debt holding period. We think there is probably more room for regional currencies to strengthen further.



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