



Equity Market Comment

6 May 2010

Summary

Equity markets caught between cyclical recovery and structural concerns

Equity markets have been moving in a yo-yo pattern in recent days, rising on strong economic data and good corporate earnings but declining on concerns of the sovereign debt problems in Europe. Other developments which have also affected risk appetite include the continued tightening by the Chinese authorities and the proposed new “super tax” on mining companies in Australia.

Since the credit crisis, investors have been extremely cautious and swift in backing away from any sign of financial trouble. The continued doubts regarding the debt problems in Europe could keep financial markets edgy for a further period.

On their own, the problems of Greece are small in terms of their global impact as the Greek economy makes up less than 1% of global GDP. The risk is the contagion effect on the other highly indebted peripheral economies in Europe – Portugal, Spain and Italy. This is something we are monitoring closely.

Despite the rise in uncertainty, we however continue to stay positive on equities as leading economic indicators continue to be firm and the US labour market is likely to have entered a period of sustained job creation. And this is likely to continue to drive the recovery of corporate earnings.

Risk appetite affected by structural concerns

The problems over the financing of Greece’s government debt have continued to affect risk appetite. Over the weekend, the European Commission and the International Monetary Fund (IMF) announced a €110 billion aid package to Greece. There was momentary relief in financial markets but scepticism resurfaced on Tuesday and the yield on Greece’s two-year government debt has surged from 10.2% to 14.8%. The €110 billion package is expected to cover Greece’s financing needs for the next three years i.e. Greece’s two-year bonds should in theory be covered.

There are a number of reasons why the market does not believe that the Greece problem has been solved. Although the aid package reduces near term liquidity risk, the longer term issue of sustainability or solvency is being questioned. The aid package is conditional upon Greece fulfilling a major austerity programme and it is far from clear that the Greek population will accept the rises in taxes and cuts in employment and income. Strikes by public sector workers have been ongoing in Greece, with violence erupting in Athens yesterday. There is also doubt that the €110 billion package





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is sufficient to cover Greece's financing needs as it is based on the assumption that Greece is able to return to positive growth within the next few years. Countries which have large debt problems usually devalue their currencies as part of the adjustment process but Greece does not have this option as it is part of the Eurozone. The market has also been rattled by the news that the Greek government had hired Lazard investment bank for consultation. Lazard was involved in the restructuring of Argentina's sovereign debt when the country defaulted in 2001. A potential legal hurdle is the possibility that the bailout could be challenged in Germany in the constitutional court. A decision to hear the case would probably mean a suspension of Germany's contribution to the aid package.

Contagion is a risk

On their own, the problems of Greece are small in terms of their global impact as the Greek economy makes up less than 1% of global GDP. The bigger risk for market has been the contagion effect. Contagion is what happens when the market becomes indiscriminating in its treatment of different situations and the fears become self-fulfilling.

Since the problems with Greece surfaced, the cost of borrowing for the other highly indebted economies in the Eurozone – Portugal, Spain and Italy – has also been rising. Last week, Standard & Poor's downgraded its sovereign ratings of Portugal and Spain and the market has been spooked by rumours that Spain could also be seeking aid from the IMF.

The fiscal situations of Portugal, Spain and Italy, although difficult, are not as bad as Greece's. For instance Portugal which, after Greece, has been coming under the most pressure, has a deficit which is about half the size of Greece. Portugal's debt to GDP ratio is under 80% compared to nearly 120% in Greece. Portugal's near term financing requirements are also two-thirds that of Greece's. However Greece and Portugal are small economies (2.6% and 1.8% of Eurozone GDP respectively) whereas Spain and Italy are larger economies (11.7% and 16.9% respectively) and European banks have a significant exposure to the government bonds of Spain and Italy.

Continued tightening by China also weighing on sentiment

Equity markets have also been affected by the series of announcements by the Chinese authorities to rein in liquidity and cool down the property market. The latest announcement was another 50bp hike in the reserve requirement ratio over the weekend. Although the continued tightening by the Chinese authorities is not a surprise, the announcements continue to act as headwinds for equities, especially Emerging Markets. The market has also been dismayed by the proposed new 40% 'super tax' by the Australian government on the earnings of mining companies. Apart from affecting the earnings of mining companies, the tax is also likely to act as a brake on acquisition activity.

Cyclical recovery providing support to equity markets

Although there has been a lot to unsettle equity markets, markets have however also been responding to the continued strong flow of economic news and good corporate earnings. The latest April US Institute for Supply Management index rose to 60.4, the highest level since May 2004. Within the index, the components most indicative of growth were furthermore strong, with firm rises in the New Orders, Employment and Production components.



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Corporate earnings have also been supportive of equity markets. We are nearing the end of the first quarter reporting season for the S&P 500 companies and as at the end of last week, 51% of companies had reported earnings above consensus expectations. The initial stage in the recovery of earnings was driven by stringent cost cutting but rising sales are also now contributing to profits. The improvement in earnings is being seen across the board, led by Financials, Consumer Discretionary and Technology.

Remaining positive on Equities

Since the credit crisis, investors have been extremely cautious and swift in backing away from any sign of financial trouble. The rise in fiscal deficits in the developed economies is a medium term issue which is likely to surface from time to time. So far the most important government debt market – US Treasuries – has not been affected and US Treasuries have continued to act as a safe haven. Focus remains on the peripheral European economies and the continued doubts here could keep financial markets edgy for a further period.

Despite the rise in uncertainty, we however continue to stay positive on equities as leading economic indicators continue to be firm and in our view, the US labour market is likely to have entered a period of sustained job creation. And this is likely to continue to drive the recovery of corporate earnings.



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