



Equity Market Comment

11 May 2010

Summary

Eurozone rescue package likely to help calm markets

Financial markets responded positively to the €750 billion stabilisation package announced by the Eurozone policymakers yesterday. MSCI Asia ex Japan was up 3%, Topix 1.3%, the S&P 500 4.4% and the Euro Stoxx 50 surged by 10.4%. Spreads in the European credit markets fell dramatically, with the benchmark 2-year yield on Greece's government bonds falling from 18% to 7%. The VIX volatility index dropped from 41 to 29. Only the Euro currency failed to rally.

The large package was welcomed by the market as it is large enough to more or less cover the €900 billion funding needs of Portugal, Italy, Ireland, Greece and Spain till the end of 2011. Although European interbank markets still show some signs of funding stress, we believe the risk of a liquidity crisis has receded significantly. The market also welcomed the announcement by the European Central Bank that it would buy both public and private bonds in the European market as this provides the market with a "lender of last resort".

The size of the rescue package is larger than what the market was expecting and is a clear attempt by the European policymakers to get ahead of events and not appear reactive. It also signals that the European policymakers are willing to do what it takes to stabilise financial markets and this has helped confidence.

Part of the aid package is dependent on the peripheral countries carrying out austere fiscal adjustments over the next few years and this process may or may not taken place smoothly. However, in our view, it is likely that markets have stabilised in the near term. Unlike the Lehman crisis, the European debt crisis does not appear to have caused a spillover into the global economy and we reiterate our positive stance on equities. Although concerns about China tightening continue to act as headwinds, especially for Asian markets, we still believe that the ongoing recovery in the global economy and in corporate earnings is likely to drive equity markets higher over the coming months.



Risk of liquidity crisis reduced

Financial markets responded positively to the €750 billion stabilisation package announced by the Eurozone policymakers yesterday. MSCI Asia ex Japan was up 3%, Topix 1.3%, the S&P 500 4.4% and the Euro Stoxx 50 surged by 10.4%. Spreads in the European credit markets fell dramatically, with the benchmark 2-year yield on Greece's government bonds falling from 18% to 7%. The VIX volatility index dropped from 41 to 29.

The €750 billion large package is made up of a €60 billion balance of payment facility (which is used to provide emergency funding), €440 billion in loan guarantees and €250 billion additional funding from the International Monetary Fund. The package was welcomed by the market as it is large enough to more or less cover the €900 billion funding needs of Portugal, Italy, Ireland, Greece and Spain till the end of 2011. A week ago, a €45 billion aid package had been announced for Greece, which would have covered Greece's financing needs for the coming three years. The problem was that contagion had emerged and the market was showing signs that it was not discriminating between Greece and the other peripheral Eurozone economies - Portugal, Italy, Ireland and Spain. The debt fundamentals of the other countries are not as bad as Greece's but their cost of borrowing was rising in tandem with Greece's. With this new package, the risk of contagion has been limited and although European interbank markets still show some signs of funding stress, we believe the risk of a liquidity crisis has receded significantly.

The market also welcomed the announcement by the European Central Bank (ECB) that it would buy both public and private bonds in the secondary European market. Unlike the US Federal Reserve and the Bank of England, the ECB did not engage in the purchase of bonds during the Lehman credit crisis. As recently as last Thursday, the ECB said during its monthly press conference that it had not discussed the buying of government bonds and this contributed to volatility in the market rising sharply. The ECB has not provided details of what they are planning to buy or how much they are planning to buy, but this fundamental change in the ECB's stance provides the market with a "lender of last resort", which is what the market wants. The purchase of the bonds by the ECB will however be a 'sterilised' form, i.e. they will withdraw liquidity in other areas to offset their purchases.

The size of the rescue package is larger than what the market was expecting and is a clear attempt by the European policymakers to get ahead of events and not appear reactive. It also signals that the European policymakers are willing to do what it takes to stabilise financial markets and this has helped confidence.

Euro currency likely to suffer

There was a small rally in the Euro yesterday but the currency has fallen back to its previous level, 1.27 against the US dollar. Since December last year, the Euro has fallen 15% against the US dollar and it is likely that downward pressure will remain on the Euro. The fiscal adjustments required by the peripheral countries are highly deflationary and wage pressures in most of Europe are likely to be subdued for a while as the labour markets even in the strong economies such as Germany are likely to fight to stay competitive. Subdued wage pressures will help keep a lid on inflation and give the ECB room to keep policy rates low for a while.



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More fundamentally, the recent financial turmoil and the political tensions have cast doubt about the viability of the Eurozone and its currency. The strength of the Euro in recent years had partly been driven by diversification of global foreign reserves away from the US dollar. The diversification process is likely to slow down or come to a halt as there is now a new risk premium in the Euro. The other factor weighing on the Euro is the ECB's pending purchase of bonds. Although the purchases will be sterilised, the ECB appears to be blurring the line between fiscal and monetary policy and this affects the "value" of its currency.

The concerns over the Euro are reflected in the price of gold. As risk aversion rose over the past weeks, gold rallied while the prices of other commodities declined. This is in contrast with what happened during the Lehman months when gold prices plunged alongside the other commodities. Since December last year, when the Euro began its decline, gold has risen 18% in Euro terms while remaining flat against the US dollar.

Remaining positive on Equities

Part of the aid package is dependent on the peripheral countries carrying out austere fiscal adjustments over the next few years and this process may or may not taken place smoothly. However, in our view, it is likely that markets have stabilised in the near term. Unlike the Lehman crisis, the European debt crisis does not appear to have caused a spillover into the global economy and we reiterate our positive stance on equities. Although concerns about China tightening continue to act as headwinds, especially for Asian markets, we still believe that the ongoing recovery in the global economy and in corporate earnings is likely to drive equity markets higher over the coming months.



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