



Summary

Policy uncertainty keeps equity markets volatile *Debt problems in Europe weigh on risk appetite*

Equity markets continue to be volatile with the focus of the market currently on Greece's large debt problem. The credit default swap spreads on Greek sovereign have widened out to levels higher than was seen during the worst months of the global credit crisis. Greece is part of the Eurozone and the current dilemma for the Eurozone authorities is between the systemic risk of not bailing out Greece and the moral hazard that the other highly indebted economies in the Eurozone (Portugal, Spain, Ireland and Italy) will not reduce their fiscal deficits if Greece is bailed out. We expect the Eurozone policymakers to place the systemic risk over the moral hazard and that a solution will soon be found for Greece.

One consequence of the problems in Europe is that the euro has fallen against the US dollar. All other things being equal, a strong US dollar typically creates a headwind for equity markets. This upward move of the US dollar has furthermore come at a time when equity markets are undergoing a correction triggered in January by China tightening its monetary policy.

The current weakness in equity markets is within the range of typical bull market corrections. The average bull market correction of the S&P 500 since the 1930s has been 15% and so far the S&P has declined 9.3% since the middle of January. MSCI Asia ex Japan is currently down 12%. During the 2003-2007 bull market, there were 10 corrections in Asia ex Japan which were in excess of 10%.

For now, we stay tactically cautious and maintain our neutral position in Equities. We see risk aversion as being driven by policy uncertainty and we believe equity markets should be able to resume their advance once there is more clarity over policy moves. Fundamentally, the global economy continues to recover and corporate earnings are likely to improve over the course of 2010. The key central banks in the Developed Economies are also likely to keep interest rates very low for some time and this should continue to lead funds to be reallocated out of cash and money market funds.

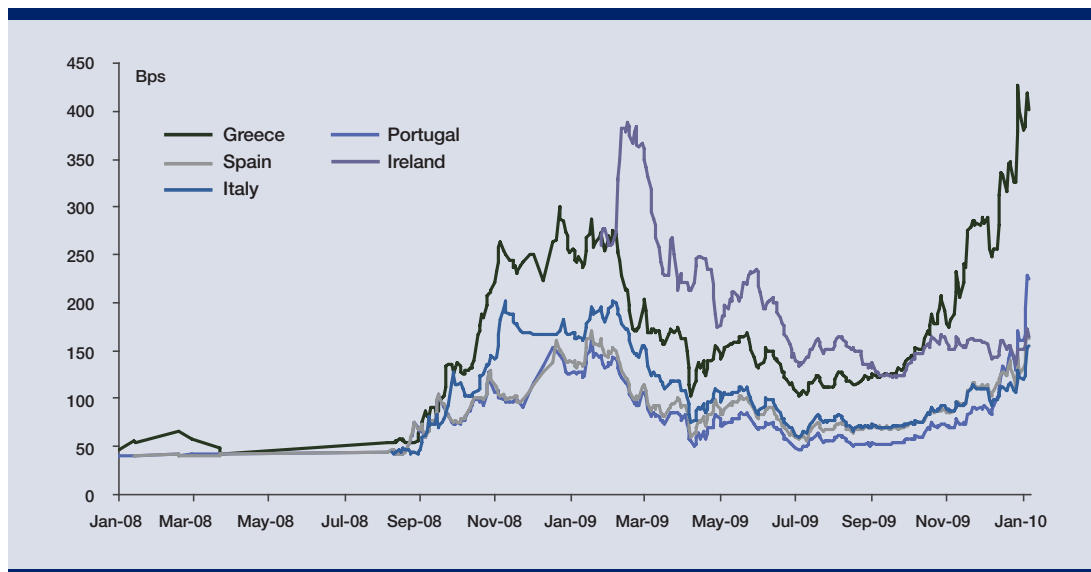


Concerns about systemic risk likely to prevail over moral hazard

The problem with Greece is its very high fiscal and current account deficits. In 2009, Greece's fiscal deficit was 12.7% of GDP and its sovereign debt was 113% of GDP. Its current account deficit is running at around 12% of GDP. In January, the Greek government presented its stability plan to reduce its fiscal deficit, in theory to 2.8% of GDP in 2012. To achieve this, the Greek government would have to cut spending as well as increase tax receipts. Expenditure cuts would come from freezing public sector salaries and employment. A rise in tax revenue would be obtained by raising taxes on alcohol and tobacco, removing tax exemptions and combating tax evasion.

The European Commission approved the budget proposals last week but the market viewed the matter with considerable scepticism. Credit default swap (CDS) spreads on Greece's sovereign debt, which had been rising for several months already, spiked to their highest levels the day after the European Commission accepted Greece's budget. CDS spreads measure the cost of insuring against the risk of default and a widening of spreads means the market believes that is a higher risk of Greece defaulting on its debt.

Five-year Credit Default Swap Spreads (Greece, Portugal, Spain, Italy and Ireland)



Source: Bloomberg, 8 February 2010

The market is sceptical because the budget proposals by the Greek government amount to the government reducing its fiscal deficit by 9.5% in just three years. An adjustment of this size and speed is rare because of the tremendous amount of stress it would impose on the economy. The questions are whether such an ambitious plan could actually be executed and whether it is politically achievable. Greece's biggest union approved a second mass strike this month and tax collectors staged a 48-hour walkout last week. In sum, a lot of room exists for disappointment.

As the market dwelled on Greece's problems, a contagion effect developed and the government bonds and the sovereign CDSs of Portugal and Spain also suffered. These countries likewise have



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large fiscal deficits. There was even a widening of spreads seen in other highly indebted countries outside the Eurozone, such as Argentina and Kazakhstan. The return of risk aversion also spilled over to the equity and credit markets.

Investors are staying cautious because the European Commission has not made it clear what it would do should Greece fail to refinance its debt which is due over the coming few months. Greece has EUR 25 billion sovereign bonds which are due for redemption this year, EUR 16.6 billion of which will be in just two single issues this coming April and May. The dilemma for the European Commission is that there is systemic risk if Greece defaults but moral hazard risk if Greece is bailed out. There is systemic risk because a significant amount of Greek bonds are held by European banks and there would also likely be a domino effect in the bonds of the other highly indebted Eurozone economies. The moral hazard if Greece is bailed out is that the other highly indebted Eurozone economies (i.e. Portugal, Spain, Ireland and Italy) will have less incentive to reduce their deficits.

Our view is that the Eurozone policymakers will place the systemic risk over the moral hazard risk and that a solution will soon be found for Greece.

Eurozone problems have caused the US dollar to strengthen

One consequence of the problems in Europe is that the investors have been selling Euro-denominated assets and this has led to a fall in the euro against the US dollar. All other things being equal, a strong US dollar typically creates a headwind for equity markets. This upward move of the US dollar has furthermore come at a time when equity markets are undergoing a correction triggered in January by China tightening its monetary policy. As we have highlighted previously, equity markets typically undergo a correction at the initial phase of monetary tightening. Equity markets have also been shaken by President Obama's recent proposals to limit the trading activities of US banks, which could potentially affect their earnings.

More clarity on policy would help risk appetite recover

The current weakness in equity markets is within the range of typical bull market corrections. The average bull market correction of the S&P 500 since the 1930s has been 15% and so far the S&P has declined 9.3% since the middle of January. MSCI Asia ex Japan is currently down 12%. During the 2003-2007 bull market, there were 10 corrections in Asia ex Japan which were in excess of 10%.

In the current cycle, one potential recurrent source of volatility is likely to come from the government bond markets and the currency markets, which is closely related. Governments responded to the global financial crisis by injecting an unprecedented amount of monetary and fiscal stimulus into the market and the governments now have to move towards an "exit". The problems in Greece is partly due to the fact the European Central Bank has indicated that it is gradually closing its financing window. The current situation also highlights the risk that lies in the bonds of highly indebted governments.

In terms of investment strategy, we stay tactically cautious and maintain our neutral position in Equities for now. We see risk aversion as being driven by policy uncertainty, in the Eurozone, China and the US, and we believe equity markets should be able to resume their advance once there is more clarity over policy moves. Fundamentally, the global economy continues to recover and



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corporate earnings are likely to improve over the course of 2010. The key central banks in the Developed Economies are also likely to keep interest rates very low for some time and this should continue to lead funds to be reallocated out of cash and money market funds.

GREECE'S DEBT PROBLEM



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