



Equity Market Comment

21 May 2010

Summary

Risk aversion returns on continued uncertainty and volatility likely to continue for near term

Equity markets appeared to be stabilising last week with the €750 billion Eurozone debt rescue package but the unexpected ban on short selling by the German authorities has resulted in another hit to investor confidence.

One reason why the short selling announcement was received negatively by the market was because it was a unilateral move by Germany. This signaled to the market that Eurozone policymakers are not coordinated – something which the market is clearly looking for at the moment. The inclusion of 10 German financial stocks under the short selling ban also led to speculation that the German banks may suffer losses from their holdings of European peripheral sovereign debt.

In the past few months, risk aversion has driven by policy uncertainty not just in Europe but also in China, where tightening on the property market has been more aggressive than expected. Markets are however now beginning to price a downturn in the real economy. Investor confidence has been extremely fragile after the shock of Lehman and the market has become swift in discounting “tail” risks. The development of events in the Eurozone is leading the market to draw parallels with what took place in the US in 2008 - the rescue of Bear Stearns, the collapse of Lehman, the Troubled Asset Relief Program (TARP) rescue and the final spillover into the real economy.

We do not believe we will see a repeat of what happened after Lehman. For one, we believe the policymakers have learnt the lessons of Lehman and are unlikely to make a similar policy error. Also, the global business cycle is at a different point compared to September 2008 when the Lehman episode occurred.

Fear can however be self-fulfilling and there is a risk that business and consumer confidence is meaningfully affected if markets stay volatile, resulting in another pullback in spending and hiring. We have been sanguine about the recovery of the global economy and the concomitant recovery of corporate earnings but recognise that spillover risks are rising.



German ban on short selling reignites uncertainty

Equity markets appeared to be stabilising last week with the €750 billion rescue package announced for the peripheral Eurozone economies but the unexpected ban on short selling by the German authorities has resulted in another hit to investor confidence.

The ban, announced on 18 May, restricts

- Short selling of European government bonds listed on German domestic exchanges
- Naked credit default swaps (CDS) on European government bonds (i.e. trading the CDSs if you do not own the bonds)
- Short selling of 10 German financial stocks

The actual impact of the ban is likely to be limited as the restriction is only effective in Germany while the securities and CDS contracts are traded on other markets outside Germany. One reason why the short selling announcement was received negatively by the market was because it was a unilateral move by Germany. The other Eurozone members, including France, criticised Germany for not consulting them beforehand. This signaled to the market that Eurozone policymakers are not coordinated in their policy response – something which the market is clearly looking for at the moment.

One possible reason why Germany did what it did was because six members of the Merkel coalition government had indicated that they would be voting against the rescue package (the voting takes place on 21 May) and Angela Merkel was attempting to win the support of the left. The strong disgruntlement of the German public over the bailing out of the peripheral economies is another risk for the market.

The inclusion of 10 German financial stocks also led to speculation that the German banks may suffer losses from their holdings of Greece, Italy, Ireland, Spain and Portugal government bonds. This is also a concern of the market. While the rescue package takes care of the liquidity problem i.e. the governments of Greece, Italy, Ireland, Spain and Portugal will be able to roll over their debt over the next two years, it does not solve the solvency issue and some of the debt, in particular Greece's, may eventually need to be restructured. German banks, together with French banks, have the largest exposure to the government bonds of the peripheral Eurozone countries.

Spillover risks are rising but we do not expect another major economic downturn

In the past few months, risk aversion has driven by policy uncertainty not just in Europe but also in China, where tightening on the property market has been more aggressive than expected. Markets are however now beginning to price a downturn in the real economy. Leading cyclical indicators such as the price of copper and the Australian dollar have declined sharply over the recent weeks. Investor confidence has been extremely fragile after the shock of Lehman and the market has become swift in discounting "tail" risks, i.e. what is of low probability. The development of events in the Eurozone is leading the market to draw parallels with what took place in the US in 2008 - the rescue of Bear Stearns, the collapse of Lehman, the Troubled Asset Relief Program (TARP) rescue and the final drastic spillover into the real economy.



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