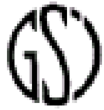


The Issues

May 2011

WHAT ARE MARKET ACTIONS TELLING US?

A recent *New York Times*/CBS poll showed nearly 80% of Americans feel the economy is stagnating or getting worse. The U.S. retail price of gasoline has jumped from $2.70/gallon a year ago to now over $4.00. Rises in the price of crude oil act like a tax: each US$10 increase takes away ~US$70 billion of spending power p.a. (~0.5% of GDP). In addition, there is a risk of rising U.S. long-term interest rates if the Fed stops purchasing bonds when QE2 ends in June.

Yet, despite these headwinds, Wall Street indexes have been hitting multi-year highs. What is the market telling us? Does it indicate excessive bullish expectations and, thus, vulnerability to disappointments? Or does it reflect a market that's been climbing a wall of worries, i.e., with negatives largely discounted and downside risks lower than otherwise?

Internal Market Dynamics Point to Caution

Internal market dynamics reveal a lot of caution among investors. In the U.S., the recent cost of three-month put options to sell the Standard & Poor's 500 Index is almost twice the price of calls to buy, the highest so-called "skew ratio" since July 2007 (Bloomberg data). While they have been adding to their stock exposures, many portfolio managers are also buying puts for protection, to hedge potential downside risks.

In Asia ex Japan, markets are also characterized by signs of caution. When more stocks rise than fall, market breadth expands, and vice versa. The cumulative advances to declines ratio is an indicator of the directional trend of market breadth. A rising trend line, plus active turnover, points to a good bull market. However, the charts below (Source: Bloomberg) all show poor market breadth across the region with trading volumes mostly in the low to moderate range.

Korea - Cum Advance to Decline vs. KOSPI

Chart 1

Taiwan - Cum Adv to Decline vs. TWSE

Chart 2

Hong Kong - Cum Adv to Decline vs. HSI

Chart 3

Malaysia - Cum Adv to Decline vs. KLSE

Chart 4

Thailand - Cum Adv to Decline vs. SET

Chart 5

Indonesia - Cum Adv to Decline vs. JCI Index

Chart 6

The charts for all six markets look similar. After the selloff in February/March, indexes have climbed back to near or slightly above levels at the start of 2011. However, in terms of internal market dynamics, more stocks are down than up vs.

the start of the year. Thailand showed the best (and only) market breadth during the April rebound, but not all lost ground has been recovered.

Most regional funds are benchmarked against the MXFEJ Index. At times of uncertainty, they tend to gravitate toward the main index stock constituents for relative safety—the psychology being “if markets move up, they will participate, but if markets decline, managers expect them to decline no more than the indexes.” As a result, the main market indexes outperform most active funds when overall market directions are unclear, as is the case now, as well in 2004 and 1H07.

Current State of Markets

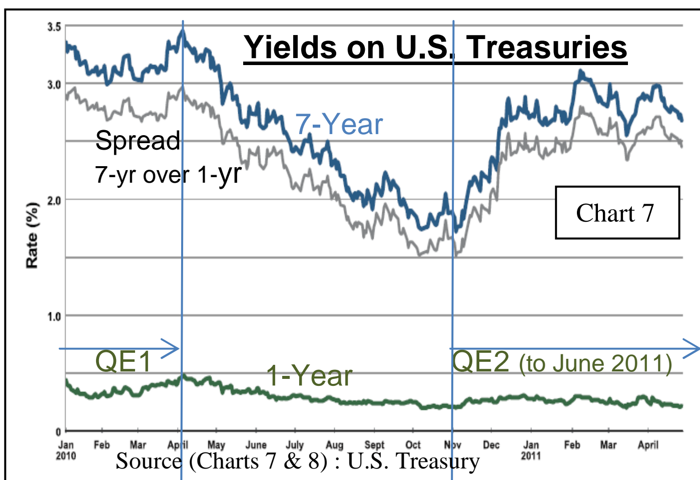
Up until October 2010, the U.S. equity market was concerned with a double dip. The onset of QE2 and monetary stimulus changed that psychology, and the ensuing rally in U.S. equities reflects the reversal of double-dip worries. As indexes rose, those underweighted in equities had to buy or risk underperformance. Yet, the high skew ratio, as discussed earlier, suggests many have taken on protection by using puts. Wall Street can best be described as a market climbing a wall of worries over the rate of recovery of the U.S. economy.

Whereas the U.S. is in an early phase of recovery, Asia ex Japan economies are in various stages of their business up cycles. Confronted with rising inflation and interest rates, investors started to lock in profits during the final months of 2010. Turmoil in the Middle East and the surge in oil prices led to selloffs in February/March. However, as Wall Street scored new highs, sentiment recovered in April. Relative-return investors, unsure about future overall market directions, have gravitated toward major index components to hedge their bets. Performance of the main stock market indexes masked weak market breadth as many more stocks are down than up vs. the start of the year. Markets in Asia are still marking time, waiting for clouds to clear over the world’s two biggest economies—the U.S. and China.

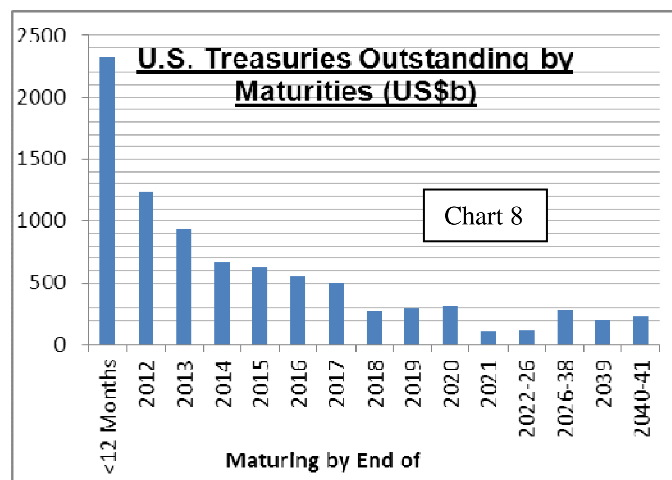
The Outlook: What Bond Yields Can Tell Us

US$600 billion of U.S. Treasury purchases by the U.S. Fed over eight months (QE2 ending June 2011) are equivalent to $900 billion annualized. The Fed has thus been monetizing ~56% of net new U.S. government bond issues to fund its US$1,600 billion annual deficit. During weekly bond auctions, the Fed has at times bought 80% net of purchases. That degree of intervention can distort prices and yields over the shorter term. With the Fed as a sizable buyer, bids from private sector investors, at current prices (and interest rates levels), are insufficient to cover 100% of the supply of bonds. Interest rates are thus lower than otherwise. The risk therefore exists that once the Fed stops making bond purchases (i.e., no QE3), yields may have to rise to higher levels to entice extra demand from investors to fill the gap.

Chart 7 shows that seven-year bond yields popped up to 3.5% at the end of March 2010 when the Fed ceased quantitative easing after QE1. Concern over the U.S. economy’s higher rates and fears about a double dip then drove a decline in seven-year bond yields from April through October 2010, i.e., a rise in bond prices without Fed buying. Note also how yields rose in 4Q10 when the Fed came in as buyer in QE2 as market expectations, driven by QE stimulus, shifted to a reacceleration of growth (and higher rates). Thus, while Fed actions may distort prices in the shorter term, over time, market expectations (and how they interpret Fed policy shifts) are the final determinant of bond prices and yields.



Source (Charts 7 & 8) : U.S. Treasury



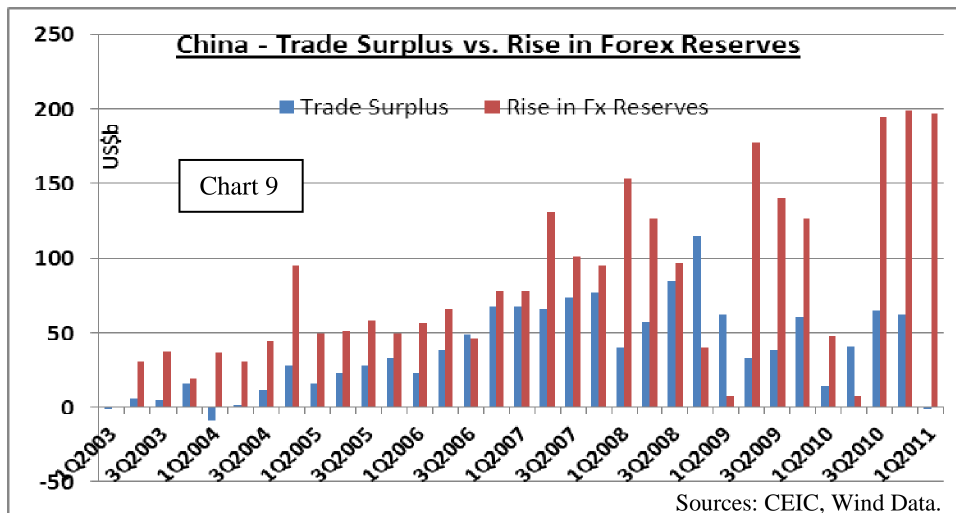
The size of the market in outstanding, longer-dated bonds is too big for the U.S. Fed to hold sway over prices and bond yields in the longer term. Out of the US$14.3 trillion of U.S. Treasuries outstanding, US4.6 trillion are non-marketable, held by intra-government entities. Of the balance of US$9.6 trillion, about US$2.2 trillion are four- to eight-year maturities and another US$2.2 trillion is spread over nine to 30 years. If bond investors expect the economy to continue to

gain strength, yields will rise (and bond prices will fall even with the Fed as a bond buyer). But if investors expect the economic recovery to stall, yields can drop, and prices can rise even without bond purchases by the Fed.

So, with 10-year bonds at 3.3%, what is the current yield curve telling us in terms of what bond investors think? We believe it suggests expectations of slow growth and probably no QE3. Bond investor expectations are thus at divergence with equity investors as the rally on Wall Street is riding on hopes of robust growth rates. If bond investors are right, Wall Street is still overly optimistic. Until recently, Wall Street expectations were for 4%+ growth. That has now been trimmed to nearer 3%. A bit more trimmings would be healthy. U.S. bond yields offer a sensitive indicator on growth expectations and sentiment surrounding the dollar, one of the more useful sign posts to gauge future market directions.

The Liquidity Situation in China

The quarter-on-quarter annualized growth rate in bank credit for 1Q11 is at 18.5%, still too high to suggest the central authorities in China have finally curbed bank lending successfully.



Sources: CEIC, Wind Data.

Part of the problem is the continual inflow of capital, which is keeping the banking system flooded with liquidity.

Chart 9 shows changes in China's holdings of foreign exchange reserves at the central bank vs. the trade account.

Trade surplus + other current account receipts + foreign direct investments normally make up the bulk of the rise in forex reserves under capital controls.

That relationship holds until end 2007, with trade surpluses as the key contributor.

Since 1Q08, the relationship has broken down and increasingly so. A fourth element, portfolio flows, has taken over as the major driver. In 1Q01, China had a small trade deficit, but forex reserves rose by nearly US$200 billion, on top of ~US$200 billion/quarter the prior two quarters (equivalent to 10.5% of GDP in total), a size too huge to be explained by foreign direct investments and other current account receipts. The data strongly suggest a sizable inflow of hot money seeking gains from appreciation of the renminbi, flooding the banking system and making the central bank's job tougher.

Much of these capital inflows would have been conducted by mainland Chinese companies with subsidiaries or operations abroad using exaggerated export receipts, intra-company transfers and loans, capital repayment or faked investments. The data suggest plenty of loopholes in China's capital control system and point to serious systemic failings of the central policy tools of monetary system management. This inflow of hot money will reverse at some stage, which can lead to liquidity tightening by more than policy design, a tail-end risk the market has not even talked about yet.

Economic liberalization has out-run China's political governance apparatus. The Communist Party at the center is finding it hard to manage and control the activities of tens of millions of party cadres spread all over China, whose priorities, more often than not, are to maximize their own interests, particularly near the end of their current five-year terms in office. This was what drove the credit bubble in 2009-10. New teams of managers are being appointed during 2011-12, and they will move quickly to clean house and make the mark they are now the boss. This is why real tightening will happen, and has probably only just begun. Those expecting an early end to tightening will likely be disappointed.

A slowdown in China does not bode well for the outlook on commodities producers in general but highly beneficial for users and positive for the inflation outlook. Our recent investment selections have been taking this scenario into account. For reasons as discussed above, markets are still in consolidation mode, and we are maintaining ~10% in liquidity.

The Net Asset Values GSI Asian Capital Growth—US$28.88 & The Long/Short Fund—US$25.94 (Apr 28, 2011)