

Investment Insights

Monday, 22 July 2013

Moderate Growth with Monetary Accommodation Theme Returns

SUMMARY

- **Market takes a “dovish” view of Ben Bernanke’s statements**
- **Generally strong corporate earnings further support sentiment towards US equities**
- **Cyclicals likely to do better as US economic recovery gathers pace**
- **Prime Minister Abe consolidates power in Japan – bullish equities, bearish Yen**
- **China liberalises lending rates while India defends currency**

The US equities market’s mood has swung back towards belief in moderate economic and earnings growth with continuation of low interest rates and yields. Some of that would have been simply the US market reversing its over-reaction to the risk of earlier-than-expected tapering of quantitative easing (QE). But dovish communication from Federal Reserve Chairman Ben Bernanke and a mixed bag of data helped reinforce the message that the timing of QE tapering is by no means pre-determined. US equities also got a boost from generally strong 2Q earnings reports to date.

In Asia, Prime Minister Shinzo Abe’s Liberal Democratic Party and its ally, the New Komeito Party won the Upper House election over the weekend. This should keep sentiment towards Japanese equities positive and continue to pressure the Yen downwards. In China, the big story was further interest rate liberalization. While there is unlikely to be any immediate economic impact from the removal of the floor for lending rates, the symbolic move could support market sentiment on the argument that the Government is moving in the right direction – towards market-oriented reforms.

Nothing new in Mr. Bernanke’s statements but the market perceived it as “dovish”. The uptrend in global risk assets continued last week. In the US, a major news event was Federal Reserve Chairman Ben Bernanke reiterating that monetary tightening is still some time away, which pulled market sentiment back from its over-reaction to fears of earlier than expected QE tapering. There was nothing of major significance in his semi-annual testimony to Congress that he hadn’t said before. But the balance of his statements and the emphases he gave were perceived by markets as more dovish than previous statements.

The key message was that tapering and eventual exit from QE is “data-dependent”. Mr. Bernanke said that the Fed could start tapering QE later this year and conclude by mid-2014. But he repeated the mantra that this is data-dependent and includes growth picking up over the next several quarters and inflation moving towards “our 2 per cent objective”. That is, the data is not restricted to labour market numbers. Asset purchases are “by no means on a preset course”; he also outlined

Fig1: Higher Valuation for US Non-Cyclicals to Cyclicals

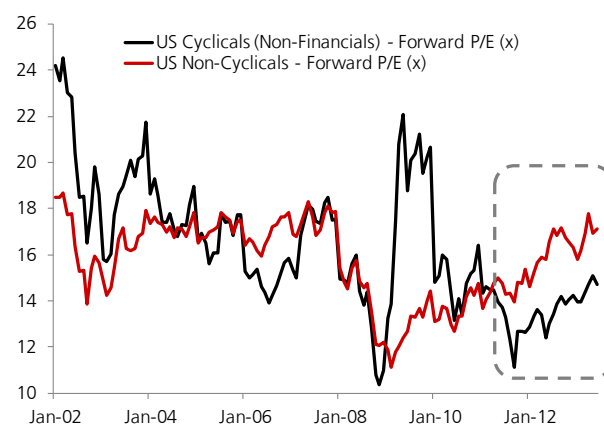


Fig2: Nikkei Rally on JPY Weakness

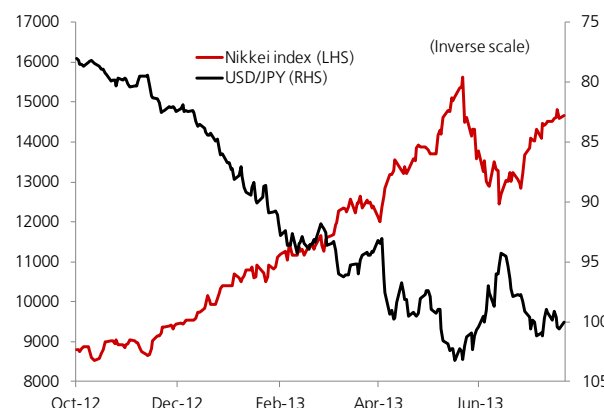
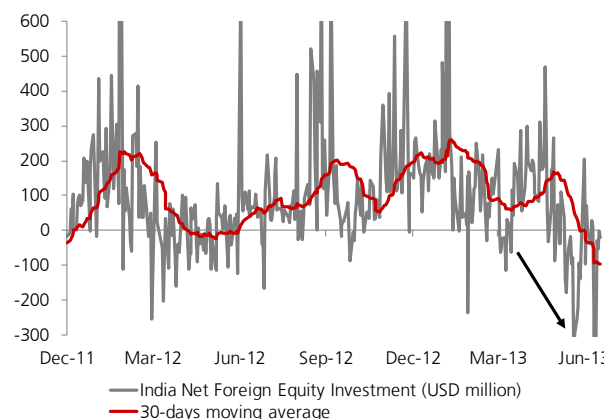


Fig 3: India: Net Outflow of Foreign Equity Funds since June



Source: Bloomberg, DBS CIO Office as of 19 July 2013.

a range of negative scenarios that could see the Fed keeping the current asset purchases “for longer”.

Mr. Bernanke also stressed that monetary policies could stay accommodative even after the unemployment rate fell below the 6.5% threshold, if this fall is due to “cyclical declines in the labour force participation rate rather than gains in employment”.

Fed reassurance lifts equities, bonds. The promise of ongoing central bank support lifted equities in both developed and emerging markets. Global financials paced the gains, buoyed by positive earnings from major US financial companies. The benchmark 10-year US Treasury yield fell 10 basis points (bps). Within commodities, the Thomson Reuters/Jefferies CRB Commodities index traded higher, driven mainly oil price which gained on the back of lower OPEC output in June and a stronger demand outlook as refineries return from maintenance.

Generally strong corporate earnings helped boost US equities. To date, 21% of the companies on the S&P 500 index have reported their 2Q numbers. And from that, 73% exceeded consensus estimates. The outlook was particularly upbeat among financials as 80% of the companies reported positive earnings surprises, including Morgan Stanley, JP Morgan and Goldman Sachs. Since July, the financial sector has gained 6.5% in total returns (vs. 5.7% for US cyclicals and 5.5% for the broader market).

Mixed US data suggests continuing patchy, moderate growth. US headline inflation came in above market expectations (0.5% rise in June versus consensus of 0.3%), driven largely by volatile gasoline prices. Core inflation rose more moderately at 0.2%. Meanwhile, initial jobless claims came in lower than expected while the Philadelphia Fed’s gauge of factory activity beat expectations with a 19.8 reading (consensus estimate: 8.0). Other data maintained the theme of patchy, moderate growth: Housing starts and retail sales came in weaker than expected. Indeed, housing starts fell nearly 10% month-on-month in June.

Play the US recovery via cyclical stocks. The recent slew of US macro data reinforces our view that the economy is on the cusp of a sustainable recovery. Upbeat 2Q earnings from financials and industrials suggest that cyclical sectors are poised to outperform non-cyclicals as investors rotate their allocations to sectors that are more geared to the macro recovery story.

In a typical economic up-cycle, growth stocks with strong earnings outlook are expected to outperform, driven by a combination of earnings per share (EPS) growth and rising valuation multiples. Currently, US cyclical stocks (non-financials) are trading at forward price-to-earnings ratio (P/E) of 14.7x, which is below the long-term average of 16.2x and the 17.1x for non-cyclicals (Figure 1). However, as the macro picture and corporate earnings continue to surprise on the upside, valuation multiples for cyclicals should expand. This is due to growing willingness of investors to pay a premium for growth. Another group of beneficiaries of the economic up-cycle should be companies with high operating leverage, given their ability to generate more profit from additional sales as operating margins expand.

LDP wins decisive victory in Japan’s upper house election. In a widely anticipated outcome, the Liberal Democratic Party (LDP) and its partner, the New Komeito party, won 76 out of the 121 seats contested in the upper house. This election outcome ensures that Japan will no longer have a split Parliament as it allows the

coalition to control both houses of parliament for the first time since 2007. The result also reflects public endorsement of Prime Minister Shinzo Abe’s expansionary economic policies that have thus far boosted Japan’s export competitiveness through a weakening of the Japanese Yen (JPY). It has also triggered a 40% rise in the Nikkei year-to-date (Figure 2). Now, with the latest electoral victory, the coalition is widely expected to embark on the next phase of its economic strategy, focusing on structural reforms. This electoral victory will likely support sentiment towards Japanese equities and continue to weaken the Yen.

China moves on interest rate liberalization. The People’s Bank of China (PBoC) announced last week that it would remove the lending rate floor for commercial interest rates with effect 20 July. Only mortgage loans will not be subject to this new ruling. The previous floor was set at 30% below the benchmark lending rate. However, the 10% cap on deposit rate ceiling was retained. The PBoC said the implications of such a move were much wider and it would proceed with greater caution on this front.

The latest policy move represents another financial reform in China. Further, the removal of the lending rate floor represents, at least in theory, monetary easing as it could potentially result in lower borrowing costs for the corporate sector. In reality, the immediate impact for companies is limited given that the 30% discount has rarely been used. As such, we do not expect much negative impact on the net interest margins (NIMs) of Chinese banks at this stage. On balance, although only symbolic in nature at this stage, the latest policy move nonetheless could be seen in the market as a signal of political will for financial liberalization.

India: A sea of troubles. The Indian rupee (INR) has depreciated 7.9% against the US dollar since the start of the year as the current account deficit, weak balance of payments and shrinking foreign currency reserves continue to trouble the economy. India’s current account deficit reached 4.8% of GDP in FY2013 – the highest in Asia. On the other hand, its holdings of foreign currency reserves constitutes only 5.2 months of imports. Now, as the US moves to towards QE tapering, India could be vulnerable if cheap liquidity is withdrawn from emerging markets. Since June, India has seen outflows of USD2.8 billion from the domestic equity market, compared to inflows of USD15.1 billion during first five months of the year (Figure 3).

In an effort to stem further weakening of the rupee, the Reserve Bank of India (RBI), in a surprise move last week, announced a series of measures to tighten INR liquidity. While the steps undertaken have since stemmed the slide in the INR, it could come at some cost to India’s economy as growth remains weak. Industrial production fell by 1.6% on-year in May while the April number was also revised lower. Longer-term, the rise in interest rates could weigh on the broader economy, in turn resulting in higher non-performing loans (NPLs) in the domestic banking sector. Indian equities continue to face substantial headwinds while catalysts remain wanting.

The week ahead. The US releases its new home sales and durable goods orders numbers for June this week, expected at 481,000 and 1.0% on-month respectively. In Europe, M3 is expected to grow 3.0% on-year while the PMI Composite is slated to improve from 48.7 in May to 49.1 in June. In Asia, China’s flash HSBC manufacturing PMI is expected to rebound to 48.5 in July, showing some reprieve. Concerns over the country’s economic weakness have already triggered a sell-down in Chinese equities.

Asian Insights Feature

CNH: PBoC Relaxes Rules for CNH Crossborder Activities

On 10 July, the People's Bank of China (PBoC) announced a series of measures aimed at simplifying renminbi (CNH) cross-border transactions. We highlight three key measures and the respective implications to the market.

1. Based on the basis of 'know your customer', 'know your business,' and 'due diligence', banks in the mainland can process CNH cross-border trade settlement for their corporate clients before verifying the documentary proof of underlying trade transactions.

Before the new model was introduced, companies had to process multiple cross-border CNH payments separately for regulatory oversight purposes, resulting in transaction costs and a lack of central monitoring. Domestic banks were also frustrated as this was time-consuming and labour intensive.

To address these concerns, a new scheme — gross-in/gross-out arrangement — was introduced. Companies can now consolidate all incoming CNH transactions made in different time periods into a single transaction. All outgoing CNH payments can be consolidated into another. This centralized approach to cash management significantly reduces the exchange rate exposure and optimises liquidity management for the company. It also sets a precedent for other foreign corporates to adopt the CNH in international trade.

There is some worry that efforts to promote the international use of the CNH are dependent on appreciation expectations. We do not share this view, and believe cost advantage is the main driver fuelling the growth of CNH use. The use of CNH can lower FX costs and risks for corporations trading with China. Such companies can also enjoy price discounts offered by some Chinese companies. Currency appreciation / depreciation might be less relevant from a supply chain perspective.

2. Non-financial companies can use the CNH fund held within their organizations in China to extend loans to their overseas affiliates.

With a more balanced CNH inflow and outflow via the trade channel, there was a need to develop other avenues to replenish the offshore CNH liquidity pool. This requires the mainland to expand the focus of CNH reforms from current account to capital account convertibility.

The latest initiative allows onshore non-financial companies to better utilize excess CNH liquidity to fund related offshore business, which is consistent with the "Going Out" strategy promoted by the central government. The new rule also encourages overseas M&A activity, especially to promote CNH outward direct investment (ODI), which has lagged behind its inward counterpart (Chart).

3. Non-financial companies that plan to issue CNH-denominated bonds in the offshore market can set up a special deposit account at a domestic bank to keep the remitted proceeds raised via the bond issuance.

The latest arrangement complements the existing regulatory framework governing offshore CNH bond issuance by Chinese corporates. Facilitating the development of the offshore CNH bond market has been part of Beijing's effort to liberalize the mainland

lending environment, which is currently dominated by indirect financing (bank loans, policy rates) rather than direct financing (bond issuance, market rates).

Nevertheless, the latest policy change would not induce a significant increase in Chinese corporate bond issuance in the near term. Specifically, no changes have been made regarding the remittance process and usage of proceeds. According to the current regulations, proceeds need to be deployed mainly in fixed asset investments, and must comply with the country's macro-control policies, industrial policies, foreign capital utilization, and foreign investment policies.

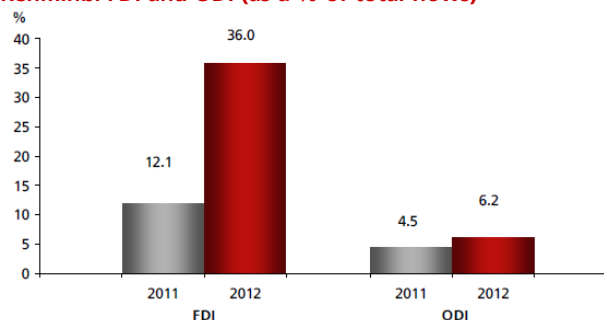
Of equal importance, offshore funding costs have become comparable to onshore ones. Since June, the weakening CNH appreciation expectation amid moderating mainland economic activities has already pushed offshore bond yield sharply higher.

The recent liquidity squeeze onshore will possibly generate more interest among Chinese companies for borrowing from Hong Kong banks. The resulting higher offshore funding costs might in turn dampen the appetite for issuing offshore CNH bonds in 2H13.

In conclusion, the latest policy changes highlight Beijing's determination to allow the CNH to play a role commensurate with China's economic power. That said, the regulator is also wary of potentially destabilizing capital flows.

For example, the new rules state that the amount of the cross-border CNH loan repayments cannot exceed the original principal plus the interest and related taxes and fees. Cash raised through offshore bond sales must be strictly used for the purpose described in the prospectus.

Renminbi FDI and ODI (as a % of total flows)



Source: DBS Group Research

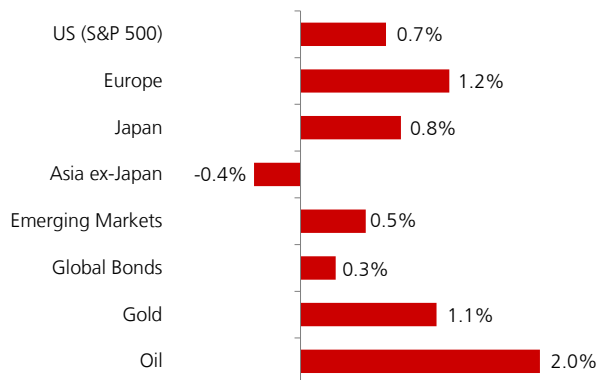
Meanwhile, local branches of the central bank must conduct regular off-site inspections on all cross-border activities to prevent potential risks. All these measures facilitate real flows of CNH funds while maintaining the bulwark against speculative flows.

Source report: DBS Group Research. Economics. CNH: PBoC relaxes rules for RMB crossborder activities. 12 July 13.

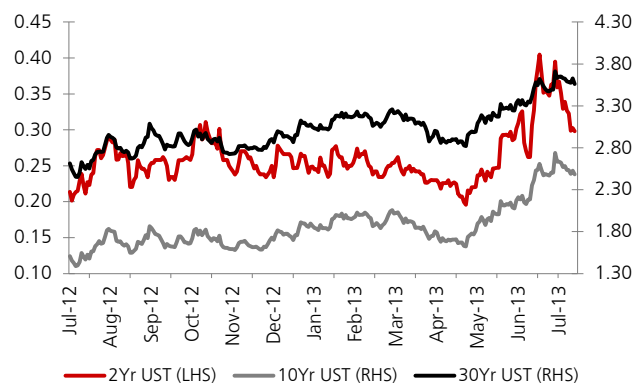
Summarised by DBS Group Wealth Management /CIO Office.
An edited version appeared in 22 July 2013's *Market Snapshot*

Economic & Market Data Monitor

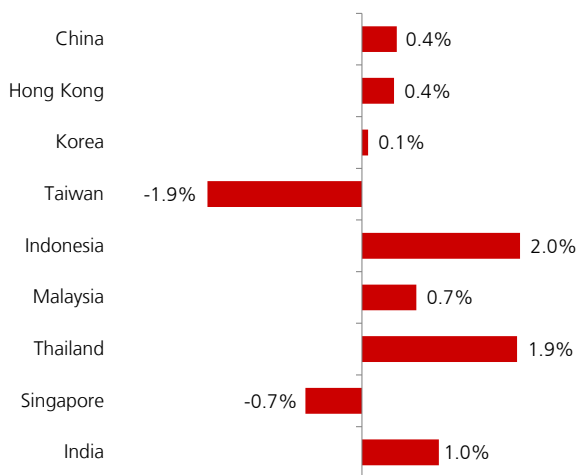
Leading Global Returns



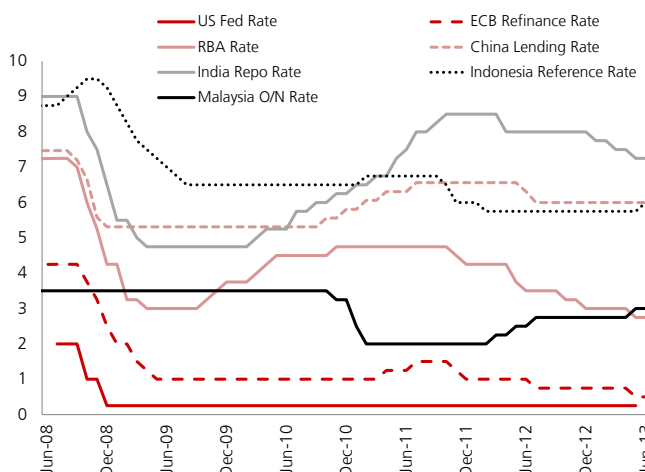
US Treasury Yields (%)



Asia Country Returns



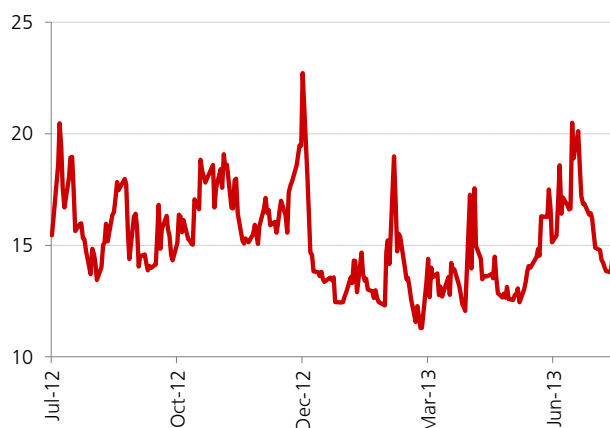
Key Benchmark Rates (%)



Key Forward PE & Earnings Growth

	YTD Returns	Fwd P/E 2013	10-Year Average	Earnings Growth 2013
US (S&P 500)	18.6%	16.8	14.0	6.8%
Europe	7.2%	36.4	12.1	1.9%
Japan	41.0%	25.3	16.3	59.1%
Asia ex-Japan	-6.1%	11.7	12.1	15.4%
Emerging Mkt	-9.9%	10.5	10.8	12.0%
Global Bonds	-4.1%	n.a.	n.a.	n.a.
China	-11.8%	8.2	12.0	11.0%
Hong Kong	-5.7%	9.8	13.1	10.2%
Korea	-6.3%	9.4	9.5	23.3%
Taiwan	4.7%	19.2	13.9	36.1%
Indonesia	9.4%	15.2	13.5	15.4%
Malaysia	6.4%	16.9	14.0	-0.7%
Thailand	6.5%	13.8	10.4	18.8%
Singapore	1.5%	13.3	13.9	0.5%
India	3.7%	15.9	14.8	10.7%

Volatility (VIX Index)



^ YTD refers to Year-to-date; Returns in local currency. Earning figures are as of 4 July 2013.

Source: Bloomberg, IBES, DBS. Data as of 19 July 2013.

In The Coming Week

22 Jul 2013	Event	Period	Survey	Actual	Prior
TA	Unemployment Rate (sa)	Jun	4.19%	--	4.19%
TA	Export Orders (YoY)	Jun	0.80%	--	-0.40%
HK	CPI (YoY)	Jun	--	--	3.90%
US	Chicago Fed Nat Activity Index	Jun	--	--	-0.3
US	Existing Home Sales	Jun	5.27M	--	5.18M
23 Jul 2013	Event	Period	Survey	Actual	Prior
SI	CPI (YoY)	Jun	1.60%	--	1.60%
TA	Industrial Production (YoY)	Jun	2.60%	--	-0.07%
US	House Price Index (MoM)	May	0.80%	--	0.70%
US	Richmond Fed Manf. Index	Jul	6	--	8
EZ	Consumer Confidence Index	Jul A	-18.4	--	-18.8
24 Jul 2013	Event	Period	Survey	Actual	Prior
CH	HSBC Flash Manf. PMI	Jul	48.5	--	48.2
JP	Exports (YoY)	Jun	9.60%	--	10.10%
US	New Home Sales	Jun	481K	--	476K
US	MBA Mortgage Applications	19-Jul	--	--	-2.60%
EZ	Manf. PMI	Jul A	449.0	--	48.8
25 Jul 2013	Event	Period	Survey	Actual	Prior
SK	GDP (YoY)	2Q P	1.80%	--	1.50%
HK	Exports (YoY)	Jun	2.50%	--	-1.00%
PH	Imports (YoY)	May	--	--	7.40%
TH	Exports (YoY)	Jun	1.50%	--	-5.25%
US	Initial Jobless Claims	Jul-19	--	--	334K
US	Durable Goods Orders	Jun	1.00%	--	3.60%
26 Jul 2013	Event	Period	Survey	Actual	Prior
SI	Industrial Production (YoY)	Jun	-4.30%	--	2.10%
JP	National CPI (YoY)	Jun	0.10%	--	-0.30%
TH	Manufacturing Production (YoY)	Jun	--	--	-7.80%
US	U. of Michigan Confidence	Jul F	84.0	--	83.9

IN THE COMING WEEK

Singapore's inflation is expected to remain steady at 1.6% on-year in June. Also in focus: industrial production figure for the same month.

Economists estimate South Korea's GDP to grow 1.8% on-year in 2Q-13, slightly faster than 1.5% expansion a quarter ago.

China's HSBC Flash manufacturing activity index is expected to rebound in July, though it is likely to stay in contractionary territory.

Thailand, Taiwan, the Philippines, Hong Kong and Japan will all release trade figures this week.

Source: Bloomberg News. Data as of 19 July 2013. Note: DBS Group Research (DBS)

In Review

- **China's** GDP growth came in at 7.5% in 2Q-13, matching analyst expectations. Factory production rose 8.9%, its slowest since 2009. Premier Li Keqiang said a balance between long-term structural reforms and short-term economic growth targets is required. June's housing prices showed on-year price growth remained elevated, indicating the government's property measures will stay tight.
- **Singapore's** non-oil domestic exports fell 8.8% on-year in June, slightly weaker than our expectations for a 8.5% figure, though it clearly missed the Bloomberg median forecast of 5.4%. Electronics shipments fell 12.4% after falling 13.2% in May. Pharmaceuticals failed to provide support, falling 35.4%. Retail sales grew better-than-expected at 3.2% on-year in May.
- **India** raised foreign direct investment ceilings for nearly 13 key sectors, which should provide the private sector incentives to seek offshore partners. Meanwhile, the central bank raised two short-term rates, alongside a few other measures to tighten liquidity conditions and curb currency volatility. The country's wholesale inflation accelerated to 4.86% on-year in June, still within the Reserve Bank of India's tolerance zone. The pace was slower than economists' estimate of 5.0%.

Source: Bloomberg News, Dow Jones Newswires, Thomson Reuters. Data as of 19 July 2013.

Prepared by the CIO Office**Chief Investment Officer**

Lim Say Boon

Investment Strategy

Manish Jaradi

Jason Low

Investment Communications

En-Lai Yeoh

Michele Lee

Zita Setiawan

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