CLSA GREED & FEAR

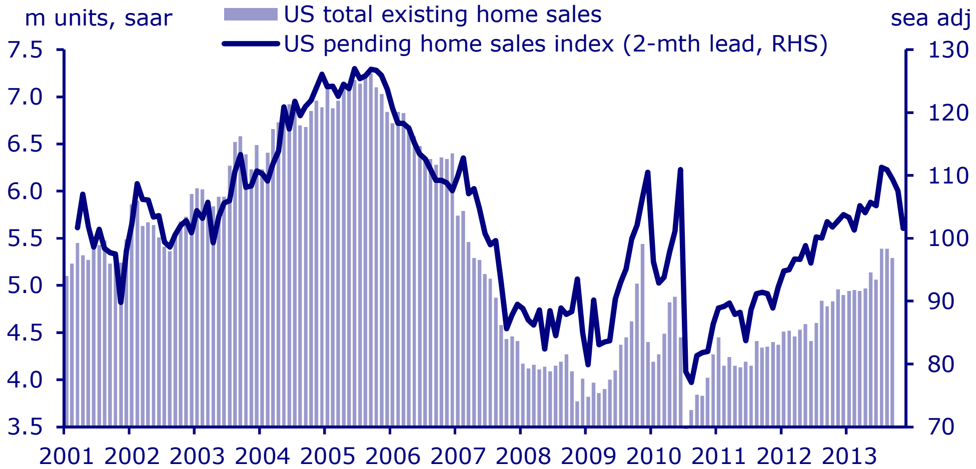
Christopher Wood christopher.wood@clsa.com +852 2600 8516

Shifting consensus

Washington

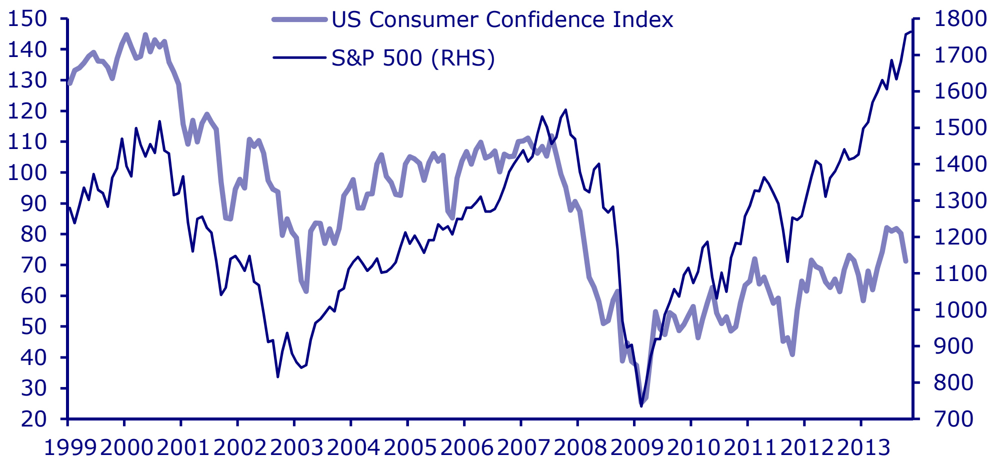
A second week in America and it is clear to *GREED & fear* that there is no real consensus among investors on the state of the American economy. In the first half of this year there was such a consensus with the belief that the economy was finally "normalising". This is no longer the case with the renewed weakness in housing triggered by the back-up in mortgage rates over the summer revealing fundamental fragility. Thus, the US pending home sales index, which measures existing home sales contracts signed but not yet closed, has declined for four straight months, falling by 5.6%MoM in September (see Figure 1). The index also declined by 1.2%YoY in September, the first year-on-year decline since April 2011.

Figure 1
US existing home sales and pending home sales index



Source: CLSA, National Association of Realtors

Figure 2
US Consumer Confidence Index and S&P500



Source: CLSA, The Conference Board, Datastream

Still if the bulls are not dominating the argument, it is also clear that the consensus is not capitulating to the bearish view, namely that deflationary pressures still dominate and that the American economy is due to weaken, not strengthen as hoped with the end of "fiscal drag". But where there is a growing consensus is the view that continuing trend real GDP growth around 2% is likely to lead to continuing balance sheet expansion at the current rate of US$85bn a month under a Yellen run Fed. The consensus is also of the view that continuing QE at this pace

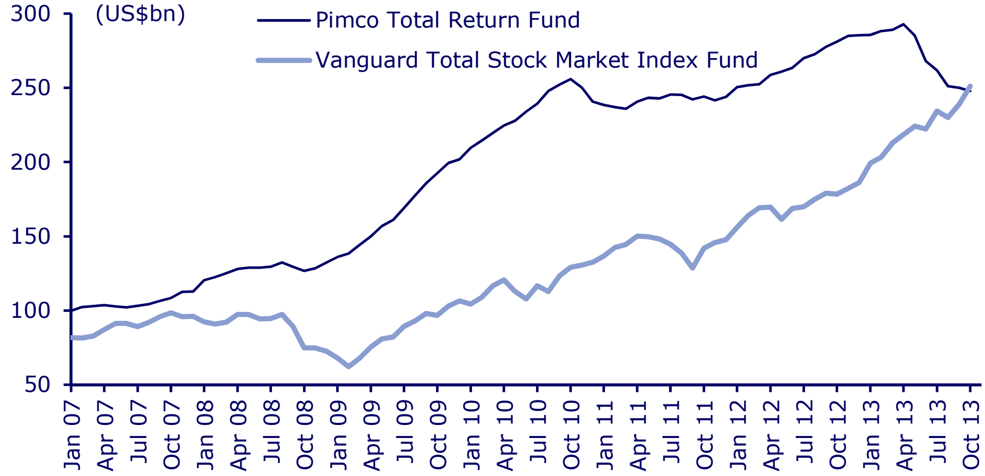
Christopher Wood christopher.wood@clsa.com +852 2600 8516

is likely to remain bullish for the stock market even if it means a continuing expansion of multiples in the absence of earnings growth. This is why any stock market pullback is likely to be bought and why the danger signal for a deeper correction has to be a parabolic move which has not yet happened. Meanwhile, the underlying fundamental risk posed by the current situation is the growing divergence between the S&P500 and US consumer confidence (see Figure 2). Thus, the Conference Board's US Consumer Confidence Index declined by 9 points to a six-month low of 71.2 in October, while the S&P500 rose by 4.5% in that month.

Still that divergence is not an issue actively being focused on by fund managers as they are more concerned about the professional issue of trying to outperform a rising stock market index. In this respect, it is interesting to note that a Vanguard index fund last month took over Pimco's flagship bond fund as America's largest mutual fund (see *Financial Times* article "*Pimco loses its fund crown to Vanguard as equities soar"*, 5 November 2013). Thus, the Pimco Total Return Fund's assets have declined by US$37.5bn so far this year to US$247.9bn at the end of October, while assets in the Vanguard Total Stock Market Index Fund have risen by US$65bn over the same period to US$251.1bn (see Figure 3).

Figure 3

Assets in Pimco Total Return Fund and Vanguard Total Stock Market Index Fund



Source: CLSA, Bloomberg

While it is natural that indexing should grow in popularity in a trending rising market, it is important to understand that indexing, otherwise known as "passive" investing, makes no fundamental sense for those who believe in free markets. On this point, *GREED & fear* was reminded of a saying by an old friend, the late and great Barton Biggs, who once described indexation as 'investor socialism'. *GREED & fear* does not believe in socialism and, therefore, also does not believe in indexation. Still *GREED & fear* will admit that in a tactical sense indexation can make sense in a trending market but the longer the bull trend has been running the greater the danger in doing what everybody else is doing.

Still returning to more near term issues, the increasing conviction that quanto easing is continuing, post the tapering scare, is the main reason for fund managers' reluctance to bet against the stock market. But this is predicated on the assumption that the Fed will be run by the doveish Janet Yellen and that the Fed governors will remain team players. *GREED & fear* makes this point because the politics of the Fed has become more important than usual given that there will be three empty seats in terms of the nine voting membership when Bernanke retires at the end of January. In this respect it is relevant to note that many of the Fed's members are not as doveish as Mrs Yellen and New York Fed President William Dudley. *GREED & fear* was also reminded this week that Paul Volcker's rate hikes in the late 1970s once occurred in the context of narrow four to three votes. Thus, on 18 September 1979, the Federal Reserve Board voted with a 4-3 split to raise the discount rate by 50bps to 11%. This is worth

Christopher Wood christopher.wood@clsa.com +852 2600 8516

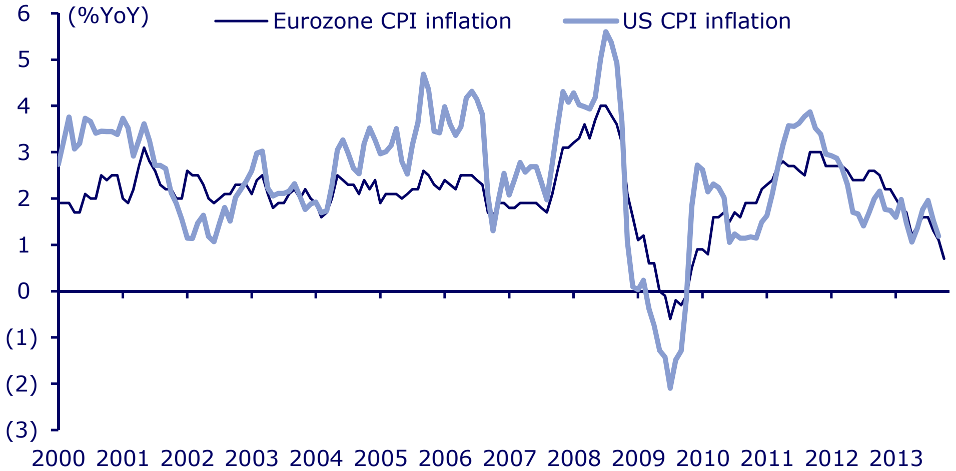
noting since a return to such contentious voting patterns would trigger a lot of investor angst and uncertainty, and would clearly not be bullish. Still *GREED & fear*'s base case is that Yellen will take charge once formally appointed and seek to ensure a common consistent line based on the "data dependent" view of quanto easing. That said, it should also be pointed out that this is an assumption which has not yet been proven with Fed governors continuing to sound off as "guests" on business TV shows. In that regard, *GREED & fear* has a recommendation for Janet Yellen. That is to bar central bankers from appearing on CNBC.

Meanwhile, it appears that there may be a new wrinkle to the "data dependent" view on quanto easing. *GREED & fear* refers to an article published in the *Wall Street Journal* yesterday and written by the Fed's favourite human tape recorder ("*Fed Study: Rate Peg Off Mark*", 6 November 2013 by Jon Hilsenrath). The article refers to a new Fed research paper written by William English, head of the Fed's monetary-affairs division, David Lopez-Salido and Robert Tetlow (*The Federal Reserve's Framework for Monetary Policy: recent challenges and new questions*, 5 November 2013), which argues that the Fed's unemployment threshold for triggering interest rate hikes would be more effective if lowered from the current 6.5% to "possibly" as low as 5.5%. If this happens, it will be a signal that the Fed is not yet willing to consider the argument that America's declining labour force participation rate is more structural than cyclical. The same article also refers to growing speculation that the Fed will put more emphasis going forward on forward guidance rather than asset purchases. *GREED & fear* has also heard talk that the Fed will move policy to a formal nominal GDP target.

Still amidst all this conjecture, the likely outcome is that if the nominal GDP is not met then quanto easing will accelerate not decelerate. In this respect the base case here remains, as discussed here last week (see *GREED & fear - The trap*, 31 October 2013), that the Fed is in a trap of its own making.

Meanwhile, Janet Yellen's view that deflationary pressures have been far from vanquished remains *GREED & fear*'s view, even if *GREED & fear*'s prescription on how to deal with these deflationary pressures remains the precise opposite of Mrs Yellen's. The financial markets have been reminded of the global deflationary backdrop over the past week by the sharp fall in Eurozone inflation. Thus, Eurozone CPI inflation fell from 1.1%YoY in September to a four-year low of 0.7%YoY in October, while US CPI inflation declined from 1.5%YoY in August to 1.2%YoY in September (see Figure 4).

Figure 4
US and Eurozone CPI inflation



Source: CLSA, ECB, Eurostat, US Bureau of Labour Statistics

Christopher Wood christopher.wood@clsa.com +852 2600 8516

The only surprise to *GREED & fear* about the Eurozone situation is that inflation in the Eurozone had not fallen more already. But sooner or later Flexible Mario will have to respond to the growing deflationary outlook. On this point, the ECB announced today a cut in its main refinancing rate by 25bps to a new record low of 0.25%.

The latest data out of the Eurozone is a reminder, if it was needed, that this is a deflationary adjustment in the Eurozone which is more bond friendly than equity friendly, just as it was in Japan, so long as investors assume, as they do for now, that the euro will remain in its present form. Meanwhile the latest American complaints about Germany's rising current account surplus, as expressed in the US Treasury's semi-annual currency report published on 30 October, will only make Germany less inclined to take the stimulatory action demanded by the "demand" obsessed neo-Keynesians. On this point Germans simply believe that they are a successful exporter because they make superior products. German exports of goods and services have risen from 22% of GDP in 1993 to 52% in 2012 (see Figure 5).

Figure 5

German exports of goods and services as % of nominal GDP

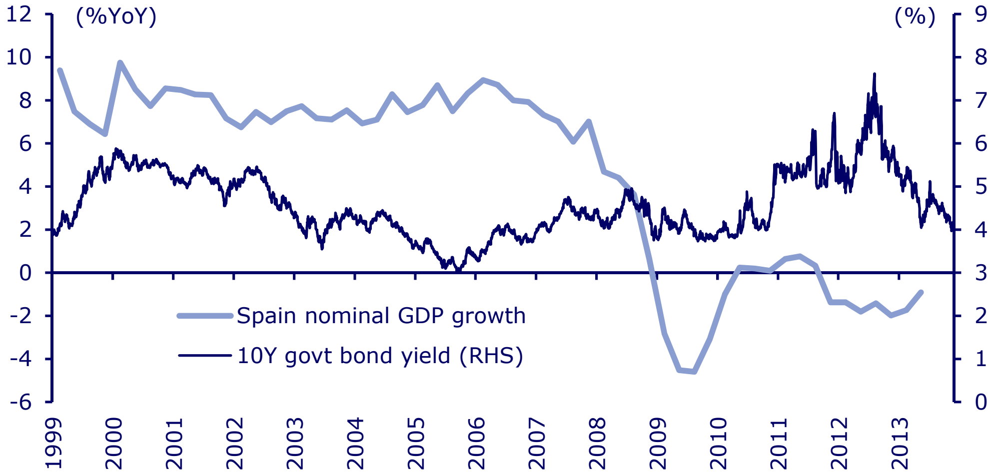
Source: CLSA, CEIC Data

Still this is not to say that Germany is not facing problems. The stronger euro, courtesy of the Eurozone's rising current account surplus, is a negative headwind; while soaring energy costs courtesy of Frau Merkel's precipitous decision to abandon nuclear energy by 2022 puts German industry at a competitive disadvantage, most particularly relative to America. The other point is that while Germany continues to resist for now further moves towards debt mutualisation in the Eurozone, the reality is that such debt mutualisation is likely to happen involuntarily, if not voluntarily, in response to future crises and related debt restructurings. That is so long as the political determination remains in Berlin to retain the euro and the Eurozone in its present construct. Indeed it is only a matter of time before this reality comes back to dominate market attention, given the deflationary backdrop, given the fact that periphery government bond yields remain above nominal GDP growth (see Figure 6) and given the upcoming stress test of European banks to be conducted by the ECB beginning this month. On this point, the ECB is in the conflicted position of being both the regulator of the banks and the lender to them, or as one investor put it to *GREED & fear* this week both the drug peddler and the enforcer of the "war against drugs". Investors should also not forget the other potentially incendiary issue of treatment of bank bond holders given the European finance ministers' laudable commitment to "bailing in" bank bond holders, at least at the subordinated debt level.

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 6

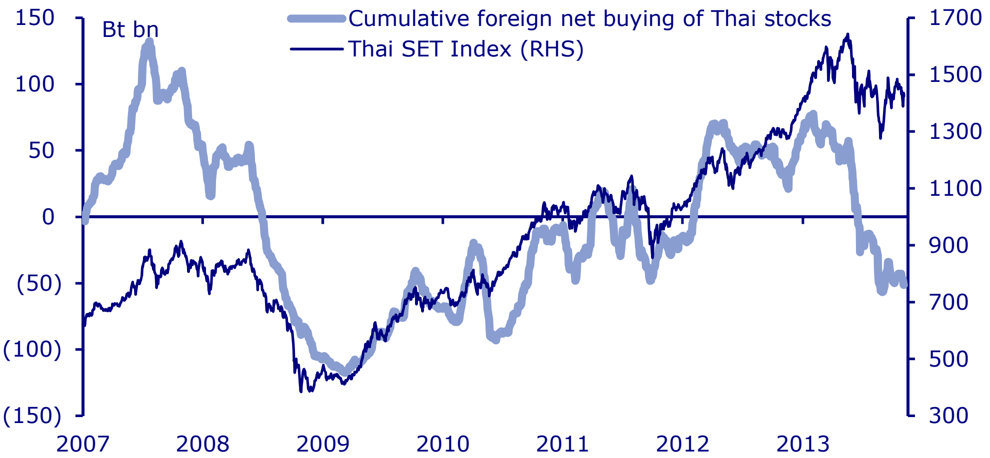
Spain nominal GDP growth and 10-year government bond yield



Source: CLSA, Bloomberg, Datastream

Figure 7

Thai SET Index and cumulative foreign net buying of Thai stocks



Source: CLSA, Bloomberg

Returning to more Asia focused issues, there have been some interesting developments in Thai politics of late. An attempt by the Yingluck government to get an amnesty bill through the legislature has backfired in the sense that it has triggered renewed anti-Thaksin demonstrations over the past week. While the demonstrations were not massive, they have seemingly been enough to cause the Yingluck government to back off for now. Note that the perceived effect of the amnesty bill would be to allow the exiled former Thai prime minister to be resolved of a criminal conviction paving the way for his return from exile. But for now the technical situation is that the amnesty bill has been passed by the Lower House but not been approved by the Senate.

What does Thaksin do now? *GREED & fear* saw the former Thai prime minister at close quarters in a Singapore hotel two weeks ago and he looked like the proverbial cat with the cream after seven years in exile; a state of being no doubt encouraged by the fact that his sister is Prime Minister of Thailand and his Pheu Thai Party is likely to win another general election if he decides to call his opponents' bluff and again calls an election, though one does not have to be held until July 2015.

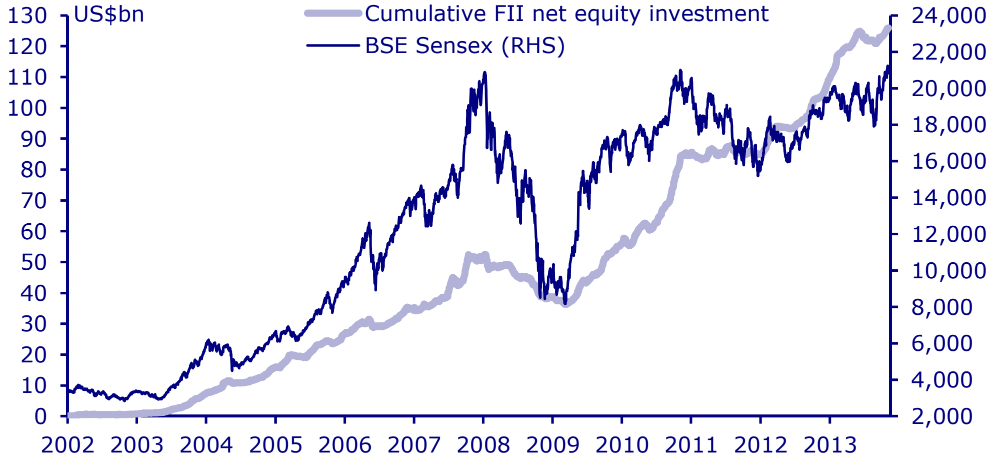
The amnesty bill strategy seems to be based on a hoped for deal, where Thaksin's return would be a *quid pro quo* for Democrat Party leaders like former Prime Minister Abhisit Vejjajiva being

Christopher Wood christopher.wood@clsa.com +852 2600 8516

let off charges relating to the killing of 91 red-shirt demonstrators in 2010. But if this is the hoped for deal, it appears that it is not happening as yet; which also means that the passage of the economically critical infrastructure bill may also be delayed. The draft Bt2tn infrastructure bill is now pending its second reading in Senate after passing the first reading in early October. Still *GREED & fear*'s base case remains that, sooner or later, Thaksin is coming back.

Figure 8

BSE Sensex and cumulative FII net buying of Indian equities



Source: CLSA, Bloomberg

The Indian stock market has staged a big bounce in the past 11 weeks. Thus, the Sensex has risen by 16% in rupee terms from a 11-month low reached on 21 August (see Figure 8) and is up 24% in US dollar terms. Part of this rally relates to the end of tapering neurosis but part also relates to growing hopes that BJP prime ministerial candidate Narendra Modi can win the pending general election which has to be held by May next year.

GREED & fear hears that opinion polls are now predicting the NDA coalition led by the BJP can now win between 187 and 195 seats in the general election. A test of Modi's momentum will be election results in four states which are due on 8 December. The BJP wave is apparently clear in 3 of these 4 state Assembly elections – Rajasthan, Madhya Pradesh and Chhattisgarh. The word is that Modi is profiting from the material aspirations of an estimated 150m new young voters as well as his campaign's classic one of social media.

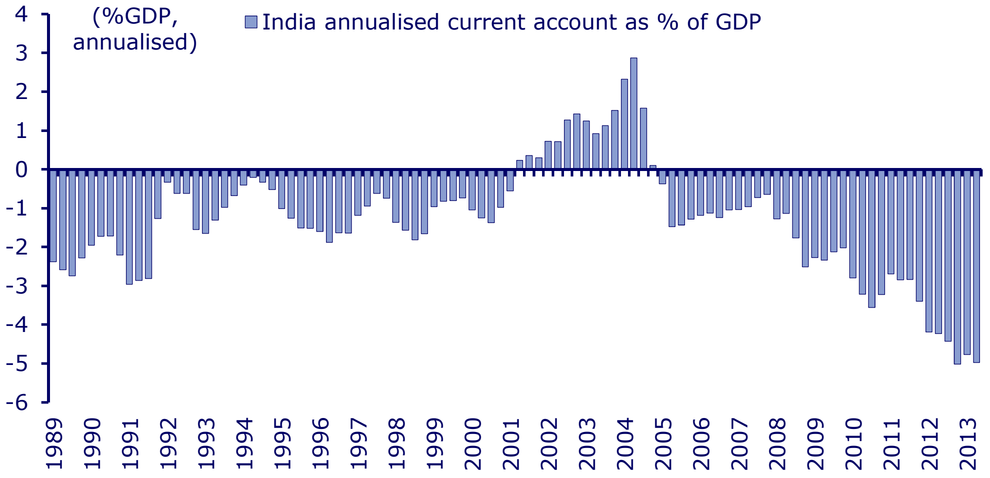
But perhaps more interesting than the polls, which are notoriously unreliable in India, Modi is reportedly to be drawing 6-8x the crowds that Congress' Rahul Gandhi has been attracting in the past few days. Indeed so eager are crowds to see the charismatic Modi *GREED & fear* has read recent news reports that they have even been paying to see him speak. Whereas normally in developing countries mobs are paid to attend such rallies.

If the Modi momentum is for real for now, the problem for him is that it is still six months from the national election. The reality is that his electoral prospects rise the greater the sense of economic crisis and the weaker the rupee. In this sense the stock market bounce and recent rupee stability is not in his political interest. Still the Gujarat chief minister should not be overly concerned since there remains no evidence of a turn in the investment cycle, and the current account deficit remains a large 5% of GDP (see Figure 9). This is why the recent stock market rally is on fragile ground. Still *GREED & fear* repeats the point that the stock market will have a dramatic rally if the BPJ candidate can achieve a viable majority, a prospect that was thought inconceivable a year ago. This is because business confidence will rise dramatically, and with it the chances of a new investment cycle. If BJP gets to between 190-200 seats on their own they will be in a strong position to form a viable coalition government.

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 9

India annualised current account as % of GDP



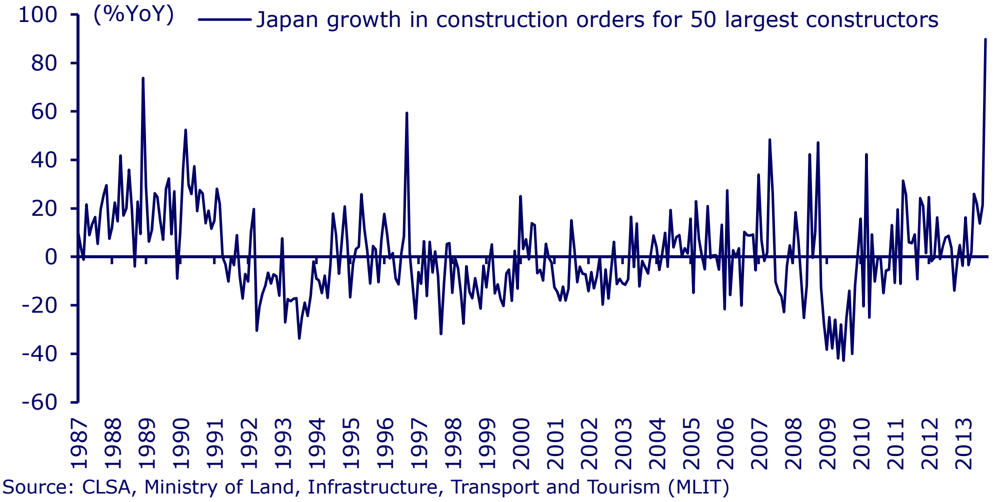
Source: CLSA, CEIC Data

Whether Modi can actually deliver on these massive expectations is, of course, another matter. But his track record in Gujarat is clearly enough to justify the current leap of faith on the part of many (see *GREED & fear – Wake up call arriving*, 31 May 2012). This is despite recent editorials in the *New York Times* and the pinko paper expressing concerns about his candidacy on account of the longstanding issue of an alleged failure to do more to stop a massacre of Muslims in 2002.

Moving on to Japan, the market consolidation continues. Still it is worth mentioning the latest construction data which is a signal that an infrastructure cycle is under way. Thus, construction orders for the 50 largest constructors surged by 89.8%YoY in September (see Figure 10), with domestic private construction orders up 127%YoY and public construction orders up 51%YoY. On that point, it is also worth noting that the construction stocks are now above the euphoric level reached post the Olympic news in September following a natural profit taking correction (see Figure 11).

Figure 10

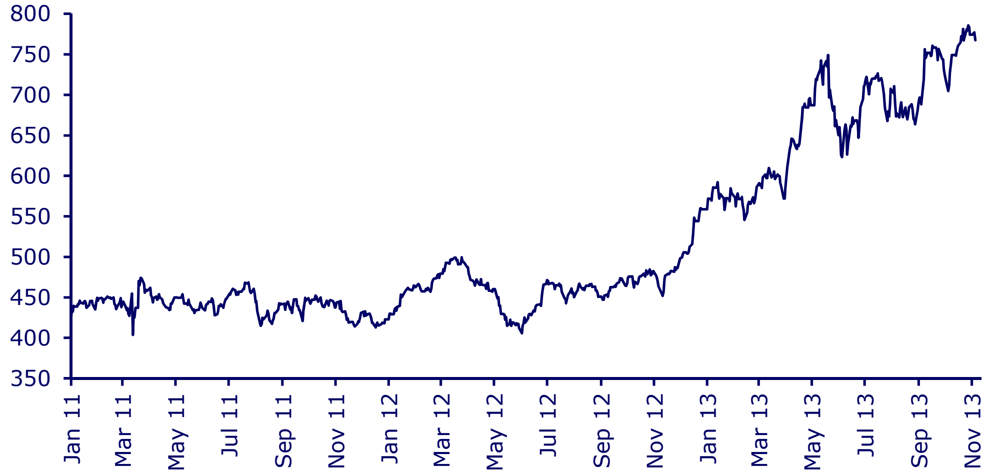
Japan growth in construction orders for the 50 largest constructors



Source: CLSA, Ministry of Land, Infrastructure, Transport and Tourism (MLIT)

Christopher Wood christopher.wood@clsa.com +852 2600 8516

Figure 11
Topix Construction Index



Source: CLSA, Datastream

GREED & fear continues to advise investors to stick with the Japanese story with the current consolidation trend representing healthy market action after the steep rally seen between November 2012 and May 2013 (see Figure 12).

Figure 12
Topix

Source: CLSA, Datastream

Christopher Wood **christopher.wood@clsa.com** +852 2600 8516

Research subscriptions

To change your report distribution requirements, please contact your CLSA sales representative or email us at cib@clsa.com.
You can also fine-tune your Research Alert email preferences at https://www.clsa.com/member/tools/email_alert/.

Key to CLSA/CLSA Americas/CA Taiwan investment rankings: BUY: Total return expected to exceed market return AND provide 20% or greater absolute return; **O-PF**: Total return expected to be greater than market return but less than 20% absolute return; **U-PF**: Total return expected to be less than market return but expected to provide a positive absolute return; **SELL**: Total return expected to be less than market return AND to provide a negative absolute return. For relative performance, we benchmark the 12-month total return (including dividends) for the stock against the 12-month forecast return (including dividends) for the local market where the stock is traded. We define stocks we expect to provide returns of 100% or higher including dividends within three years as "Double Baggers".

 Note: In the interests of timeliness, this document has not been edited.

The analyst/s who compiled this publication/communication hereby state/s and confirm/s that the contents hereof truly reflect his/her/their views and opinions on the subject matter and that the analyst/s has/have not been placed under any undue influence, intervention or pressure by any person/s in compiling such publication/communication.

CLSA group of companies (excluding CLSA Americas, LLC) ("CLSA"), Credit Agricole Securities Taiwan Co., Ltd. ("CA Taiwan"), CLSA/CA Taiwan's analysts and/or their associates do and from time to time seek to establish business or financial relationships with companies covered in their research reports. As a result, investors should be aware that CLSA and/or such individuals may have one or more conflicts of interests that could affect the objectivity of this report. Regulations or market practice of some jurisdictions/markets prescribe certain disclosures to be made for certain actual, potential or perceived conflicts of interests relating to research reports and such details are available at www.clsa.com/member/research_disclosures/. Disclosures therein include the position of CLSA, CLSA Americas, LLC and CA Taiwan only and do not reflect those of CITIC Securities International Company Limited, Credit Agricole Corporate & Investment Bank and/or their respective affiliates. If investors have any difficulty accessing this website, please contact webadmin@clsa.com or +852 2600 8111. If you require disclosure information on previous dates, please contact compliance_hk@clsa.com

IMPORTANT: The content of this report is subject to and should be read in conjunction with the disclaimer and CLSA's Legal and Regulatory Notices as set out at www.clsa.com/disclaimer.html, a hard copy of which may be obtained on request from CLSA Publications or CLSA Compliance Group (18/F, One Pacific Place, 88 Queensway, Hong Kong, telephone +852 2600 8888) and/or CA Taiwan Compliance (27/F, 95, Section 2 Dun Hua South Road, Taipei 10682, Taiwan, telephone +886 2 2326 8188). 05/08/2013