

Focus: More downside looming for risky assets

CIO Office

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- EU Summit proposals have unravelled amidst political turmoil in Greece and Italy
- Italian government bond yields surged, spreading contagion to Spain
- Euro area economy sliding into recession
- Technical indicators suggest bear market rally may be over
- We are reducing further our tactical weighting in equities

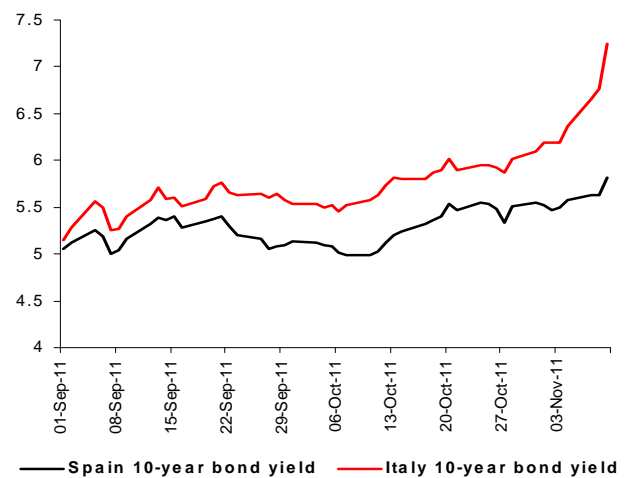
The bear market rally that started early October is over. The bear market that started early August is resuming – with the likelihood that prices will see new lows over coming months. The recent EU Summit package to prevent the widening and deepening of the Euro area debt crisis had started unravelling even before the ink had dried on the Summit Statement. And now Italy has plunged into political turmoil. Italian government bond yields have surged alarmingly over recent days, spreading contagion to Spain. Meanwhile, the Euro area economy appears to be slipping into recession. In the US, the likelihood that the economy might narrowly avoid a recession appears to have been fully priced by recent gains. In China, the central bank continues to hold back from monetary easing despite the weakening of the global economy. We are going further underweight on equities in our tactical asset allocation, with Asia ex-Japan bearing the brunt of the cut in weighting. Simultaneously, we are cutting our weighting in Asia ex-Japan bonds, shifting it to global bonds ex-Asia. While the long-term economic fundamentals of Asia ex-Japan remain superior, risk aversion will likely drive near-term underperformance for regional assets.

The trigger for this new bout of risk aversion – Greece and Italy descend into political shambles. After the EU Summit, we wrote of the “many potential stumbling blocks ahead” for the Euro area, including: “Market doubts over the ability of Greece, and indeed more importantly, Spain and Italy, to meet their fiscal reform targets, potentially triggering renewed attacks on government bond markets”. We also wrote about “the issue of Euro Area credibility” and how “in markets, sentiment can become reality.” The attacks on European government bonds have started again, driving Italian 10-year government bond yields above seven per cent. Where previously the concern was of contagion spreading to Italy, the situation now is of contagion flowing from Italy. (Figure 1)

Who's running Italy and Greece? Italian politics plunged into turmoil when Prime Minister Silvio Berlusconi failed to get a majority for what should have been a routine vote to ratify 2010 public accounts, signaling his loss of control over the Italian parliament. He has since announced his intention to resign after the approval of the 2012 Budget, possibly in a couple of weeks. But this now raises the prospect of early elections and a political vacuum in Italy over coming months. Similarly, Greece remains in

political limbo following Prime Minister George Papandreou's offer to resign, to make way for a new “unity government”.

Figure 1: Italian 10-year bond yields surged above 7%



Source: Bloomberg, as of 10 November 2011

So who's going to bail out Italy? It was always the European dilemma that indebted nations were seeking help from other indebted nations. The very act of helping other indebted nations could deepen the rescuers' financial woes. Besides, if markets turn to attack the rescuer nations, the rescuers could in turn be in need of rescue. This is how the situation has turned for Italy. With EUR1.9 trillion in debt, Italy is going to pose a massive challenge for other would-be Euro area rescuers both financially and politically.

Meanwhile, the global economy continues to weaken. Two months ago, we warned of false dawns. That is, there would be many false dawns before this bear market is over. US equities had been rallying on economic data that had come in less bad – not as bad as expected. They have also been given a boost by resilient corporate earnings growth, with upside surprises from reported earnings far exceeding disappointments. Nevertheless, the sustainability of the rally was always questionable. The broader, global outlook remained poor. Leaving aside the Euro area debt crisis, economic fundamentals remain fragile. The outlook for the US economy has improved slightly. That is, instead of a recession, what we might end up with could be just sub-par growth. But mind you, if the US avoids a recession, it would be by the narrowest of margins. Manufacturing continues to struggle at the breakeven point between expansion and contraction. Job creation has flat-lined, struggling to stay out of contraction. Even if the US economy avoids a recession, it will still feel a lot like a recession, with flat GDP and jobs growth. Meanwhile, the Euro area economy has deteriorated quite sharply over recent months, with both manufacturing and services in contraction. In the East, the good news is that the data coming out

from China continues to indicate a soft landing for the economy. The bad news is that policy makers have yet to show any commitment to monetary easing, despite the credit stress that appears to have built up amongst small and medium enterprises.

The bear market rally is over – time to cut risk further. Technical indicators suggest that the rally that started early October has exhausted itself. Risky asset markets are likely to push lower over coming months. Eventually, the Euro area governments will have to act to contain the contagion emanating from Italy. But much further damage may have to be inflicted on risky asset markets before Euro area leaders get

their political act together. And even when they do act, there will continue to be doubts on the effectiveness of their interventions.

We are cutting further our tactical asset allocation weighting for equities, taking them to further underweight. We are also reducing weightings for Asia ex-Japan bonds from overweight to neutral. Bouts of risk aversion usually result in underperformance for both Asia ex-Japan bonds and equities. The weightings will be switched over to global bonds ex-Asia. Meanwhile, with the S&P500 equities volatility index VIX spiking above resistances, investors may want to consider buying some portfolio protection through a proxy for VIX.

Q4-2011 TACTICAL ASSET ALLOCATION STRATEGY

ASSET CLASS	Q4-2011	Q4-2011 (REVISED)
EQUITIES	UNDERWEIGHT	UNDERWEIGHT
US Equities	Underweight	Underweight
Europe Equities	Underweight	Underweight
Asia pacific Ex-Japan Equities	Overweight	Neutral
Japan Equities	Overweight	Overweight
China Equities	Neutral	Neutral
Emerging Ex-Asia Equities	Neutral	Neutral
BONDS	OVERWEIGHT	OVERWEIGHT
Global ex Asia Bonds	Underweight	Overweight
Asia Ex-Japan Bonds	Overweight	Neutral
ALTERNATIVES	NEUTRAL	NEUTRAL
Global REITs	Underweight	Underweight
Commodities	Neutral	Neutral
Gold	Neutral	Neutral
Hedge Funds	Overweight	Overweight
CASH	NEUTRAL	OVERWEIGHT

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