



Surviving a Panic Attack

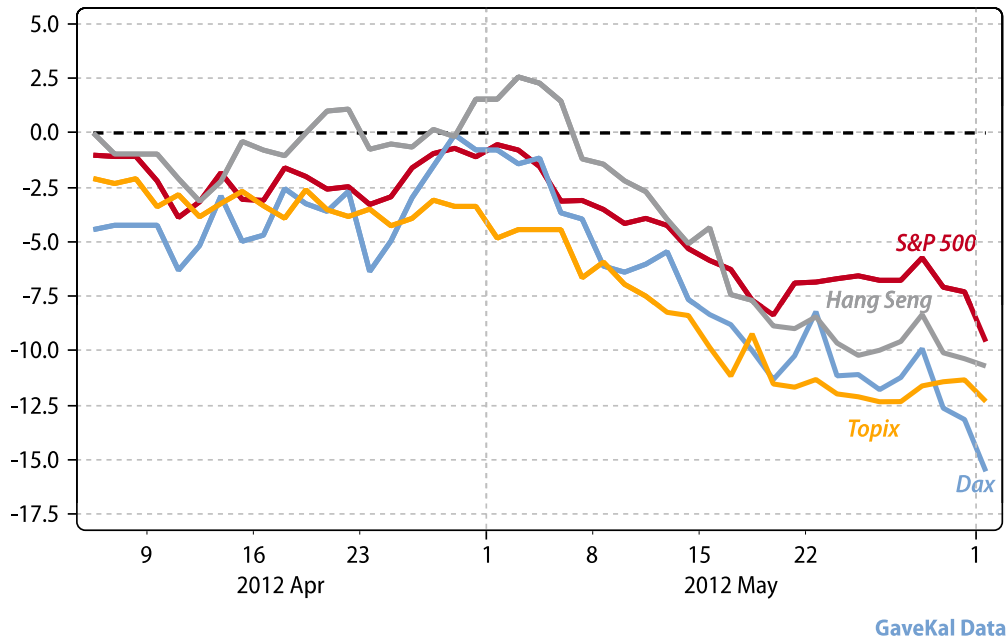
Summary

- Markets have been decidedly negative for the past two months and in recent weeks have begun to edge into panic territory. Investors are ramping up the selling of equities and piling into the long end of the safe-haven bond markets, where yields are now at a record lows. Behind the current wave of selling is the growing fear that Europe is moving towards a full-fledged bank run and that policy makers can do little to stem it.
- Until recently, we had hoped that a recovering US and China could act as a counterweight to the forces of disaster in Europe (see the previous [Quarterly Strategy Chart Book](#)). But given the disappointments in US employment data and Chinese industrial production, such hopes now seem unjustified.
- But even if the EMU breaks down, does this mean that we will get a “Lehman-on-steroids” moment? We are not convinced. First, through much of the developed world the corporate sector is very lean and highly cash flow positive (unlike in 2008). Second, most investors are cashed up (as evidenced by the massive valuation gap between equities and bonds), and would likely jump back into equities en masse if given a good reason to do so – in other words, much if not all of an EMU break-up is already priced in . Finally, we would not be so fast in writing off the Chinese and US economies, despite the poor recent data.
- In a panic, there are only two rational things to do: 1) join in the rush for safety, or 2) look for opportunities and redeploy capital as panics, by definition, create massive mispricings. The critical question, of course, is how deep are we in panic mode, and how much deeper can we get?

Equity markets have taken quite a beating

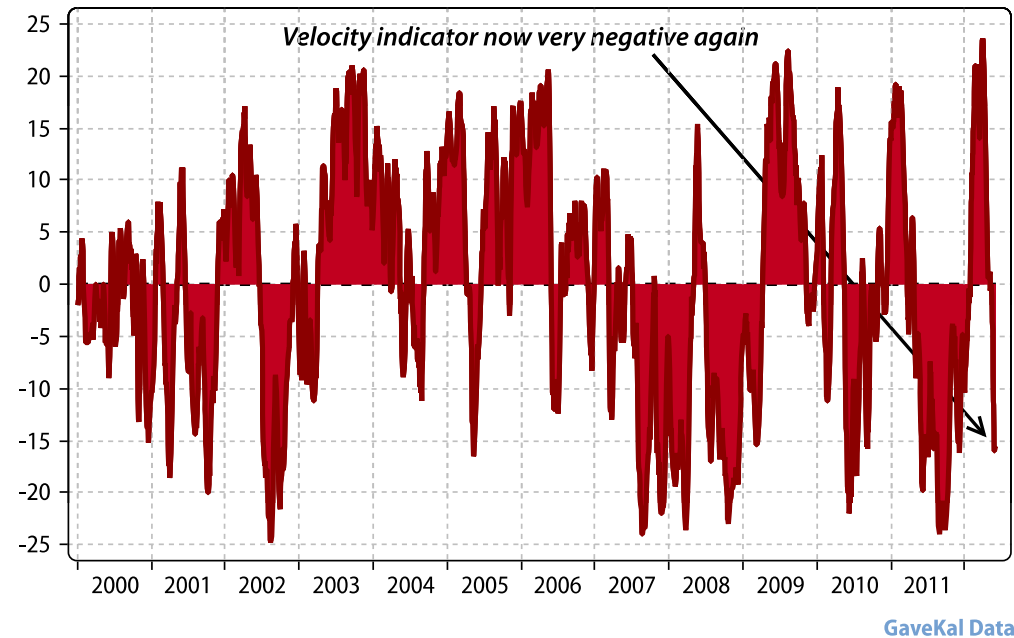
Equity markets have been suffering

Performance over the last two months



GaveKal velocity indicator

Combination of market-based spreads & fundamental data aimed at estimating risk appetite



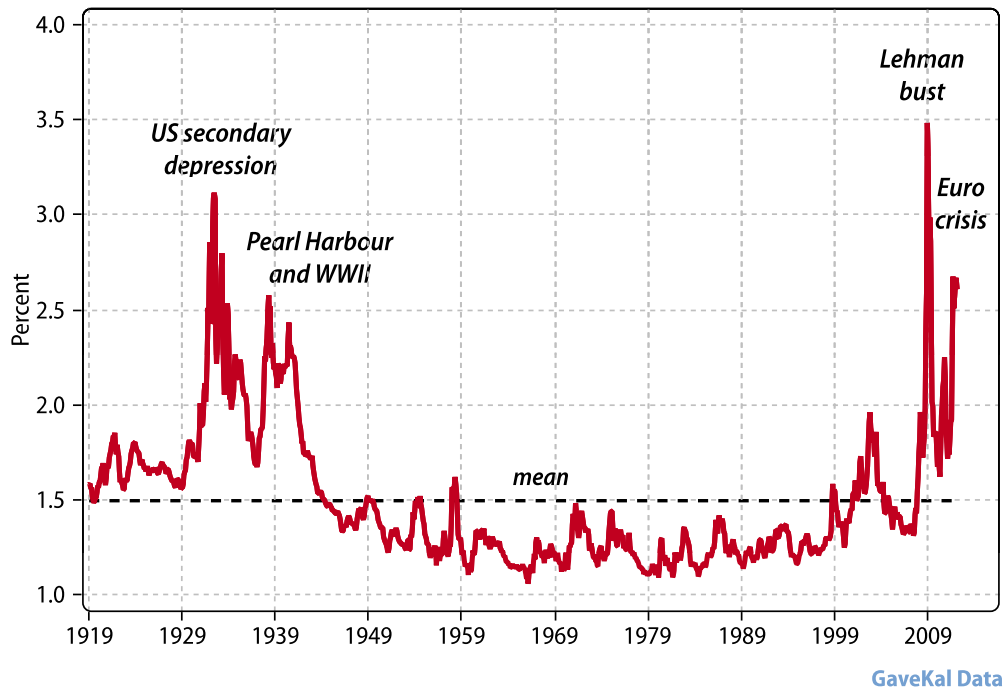
At the time of our last [Quarterly](#), equity markets had been on a tear, but bond markets had not really moved. We argued that equity markets were “right” and that the bubble in sovereign bond markets was getting long in the tooth.

However, since then, equities have rolled over; the World MSCI has shed -11% over the past two months.

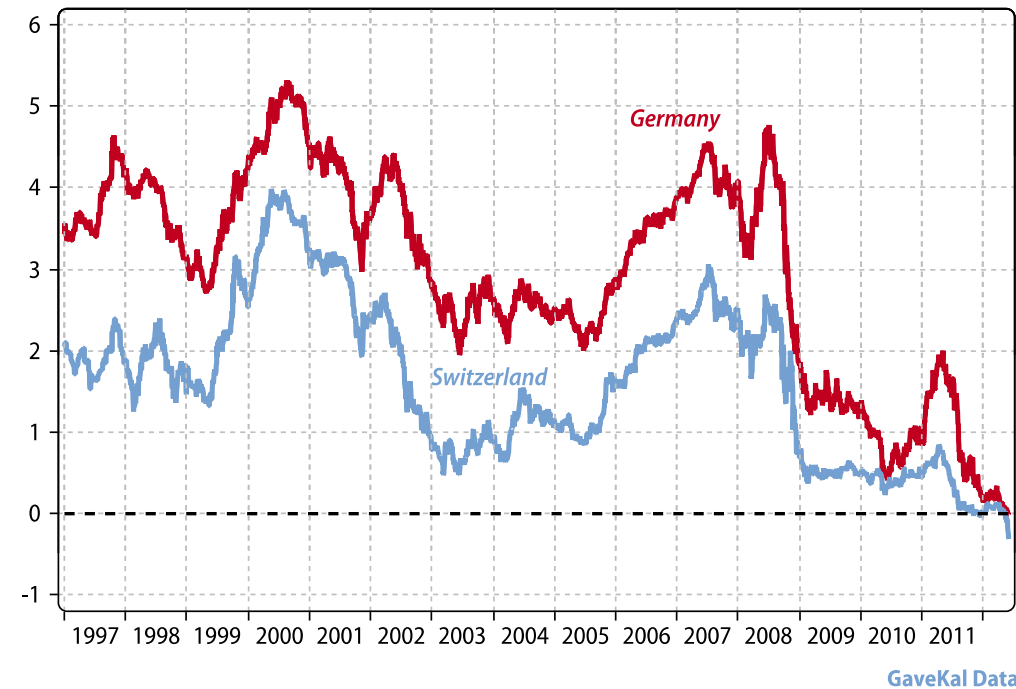
In addition, our main velocity indicator has once again turned profoundly negative, reflecting the new strains coming from the euro crisis and the deterioration of the European banking system.

We are now at panic valuations on safe haven plays

Ratio of US BAA yields to US 10-year government bond yields



Yields on 2-year government benchmarks



The move towards safe-haven fixed income has been breathtaking. In the US, the ten-year government bond yield is now at an all-time low of 1.47%.

In addition, the ratio between BAA yield and the US 10-year government bond implies a massive financial panic.

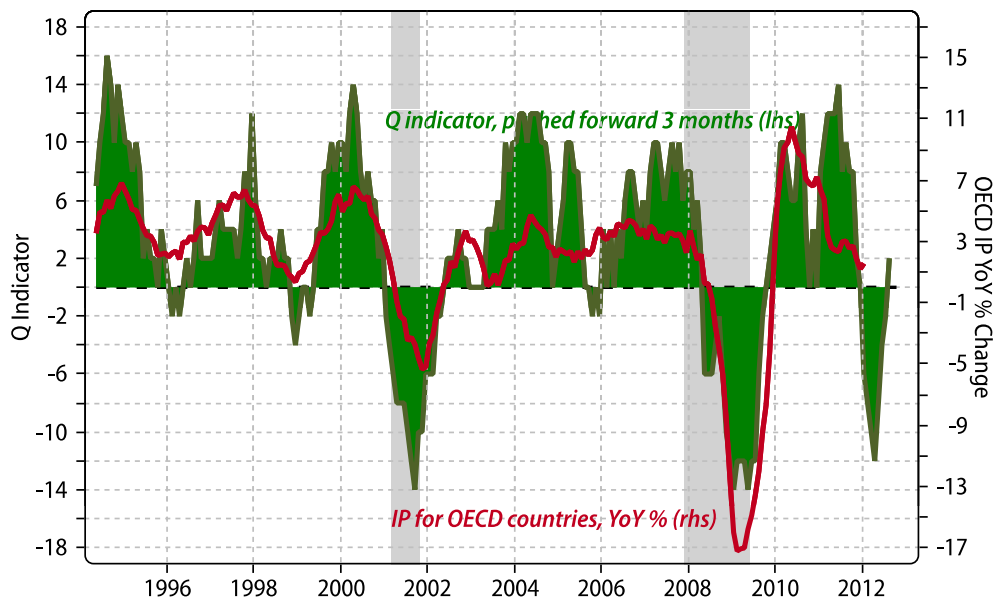
In Europe, the 2-year Swiss government bond is yielding an unprecedented -0.48%, and recently the German and the Danish 2-year yields have gone negative as well.

Historically, panics like these are opportunities to sell bonds and buy stocks. But timing is crucial, since a lot of money can be lost in two or three weeks of panic.

Meanwhile, our global growth indicators are improving

The GaveKal Q indicator

A monthly series of leading indicators and market prices that indicate global growth

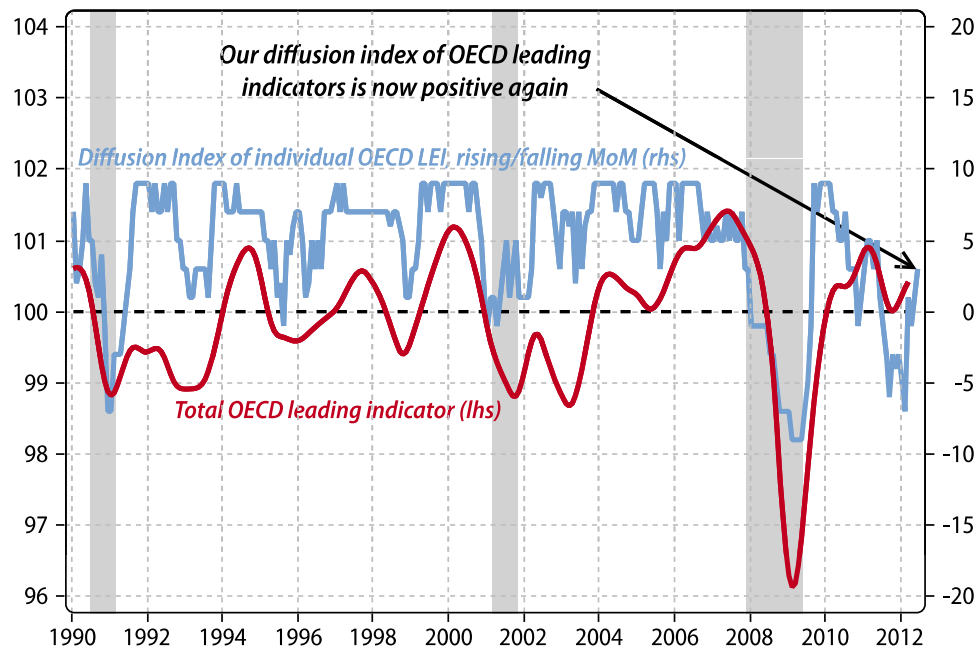


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While the economic data over the past two months has been coming in on the softer side, most of our forward looking indicators on growth are perking up.

Of course, one could also argue that the market is “right” and that our indicators are simply missing the storm ahead due to its exceptional nature (i.e.: Euro break-up). Still, another possibility is that markets are perhaps being overly bearish, perhaps because of the trauma of the 2008 shock?

Leading the OECD leading indicators



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Writing of Europe (since bad outcomes are basically mostly priced in by now), it seems that the main issue will be the balance between negatives and positives in the US and China.

In fact, even if a full-scale euro breakdown was to occur, the consensus view that a Grexit would trigger a Lehman*10-type event may prove erroneous. In fact, a number of us would argue that a breakdown of the euro should be welcomed, and not feared.

The Cyclical Bear Case

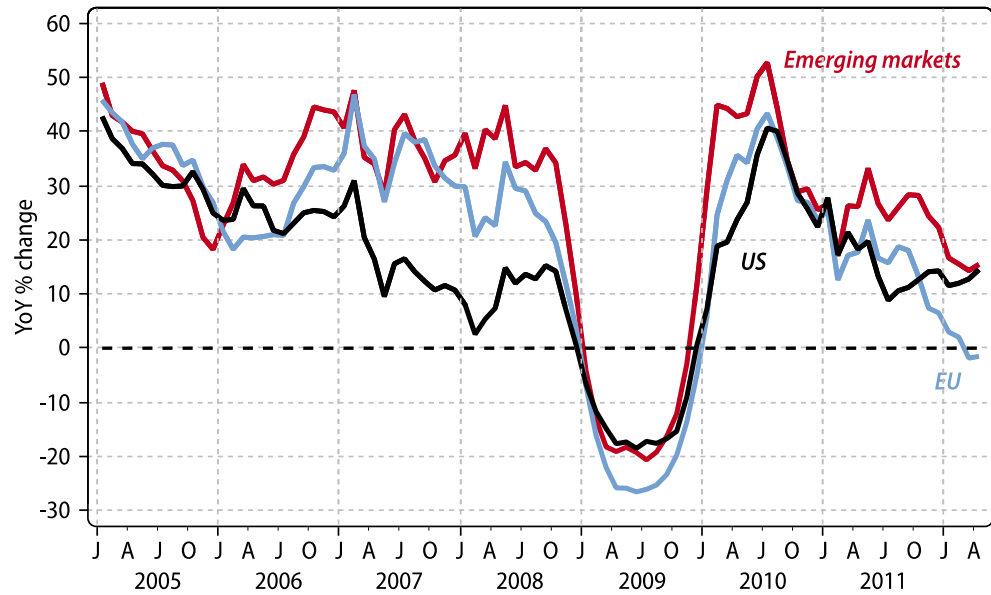
A laundry list of concerns

- **An EMU disaster.** First and foremost on every investor's mind is the potential for a near-term European accident. Most obviously, a Greek exit from the eurozone would likely trigger a devastating bank run, possibly ending the single currency altogether. Beyond Greece lies the other concerns of Spain's banking crisis and languishing Italian productivity.
- **Slowing Chinese growth and political turmoil.** Recent economic data out of China has been disappointing and the outlook is further muddled by a new phenomenon, namely political uncertainty.
- **Post-QE blues in the US.** The last few times the Fed has tried to exit its easing programs, the economy – and the markets – have rolled over. There is a risk that this happens again at the end of Operation Twist and recent data from the US has been more negative than earlier this year.
- **The fiscal cliff.** The US faces a severe fiscal contraction next year – the so-called “fiscal cliff.” Even if one thinks Congressional leaders will not allow the economy to plunge off this cliff, there is bound to be political theater and much gamesmanship as the US approaches another debt ceiling. This is likely to weigh on confidence, just as it did in 2011.

China's growth has disappointed

Europe is an increasing drag on China's export growth

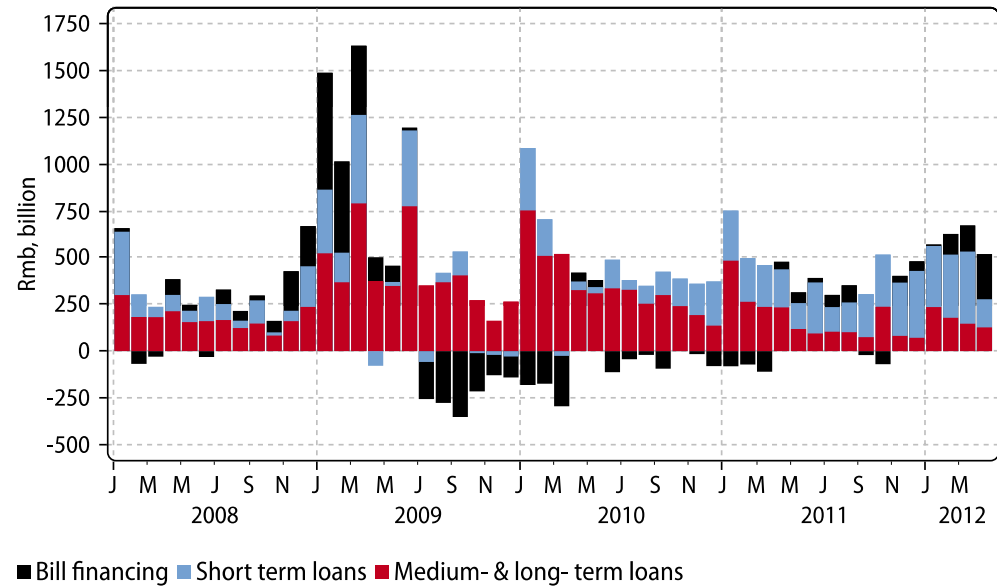
Exports by region, 3mma



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Lending growth is weak, as firms have less appetite for longer-term debt

New loans to non-financial corporations by type, monthly



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After some signs of stability in March, China's economic data for April was disappointing across the board, with an abrupt slowdown in industrial output, weak exports and signs of problems in the banking system.

We think the lending data points to problems both in the supply of and demand for credit. The banks' ability to lend is constrained by an increasingly fickle and high-cost deposit base, while firms' demand for credit is hurt by the slowing economy and banks' insistence on higher lending rates.

Both of these problems can be addressed, but 1H growth for China is likely to be subpar and it will be challenging for a rebound in 2H to push annual GDP growth to over 8%.

For investors, the worry about the Chinese story is compounded by recent political gyrations.

Triggering currency & fixed income doubts

Investment grade bond yield spread

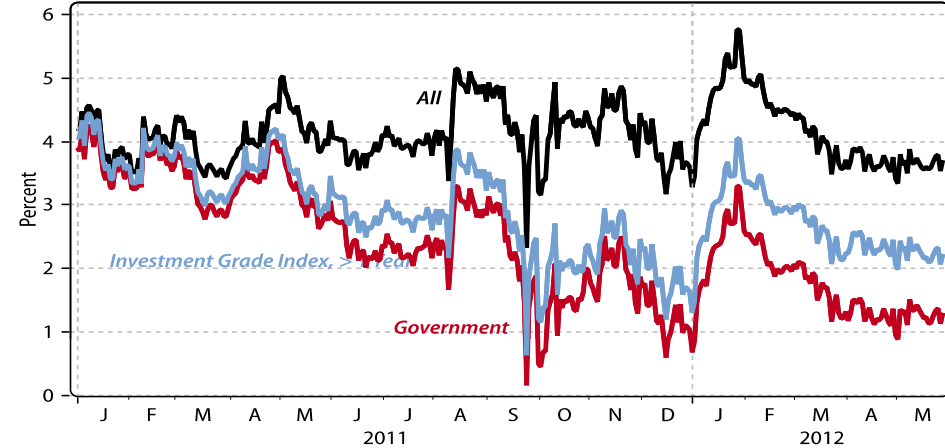
Dim sum bond yield minus global



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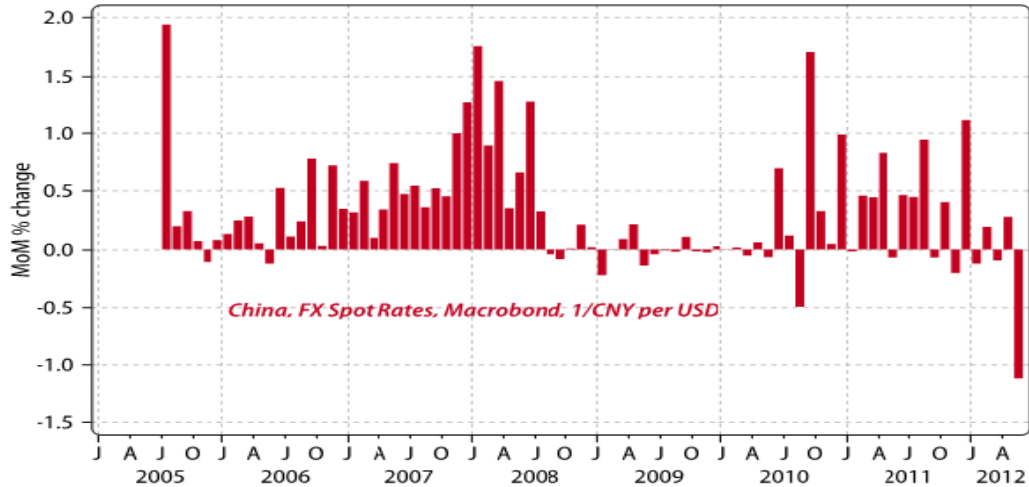
A proxy for expected CNH bond yield - effective yield + currency expectation

Merrill Lynch dim sum indices, adjusted for CNY 12m changes implied by NDR



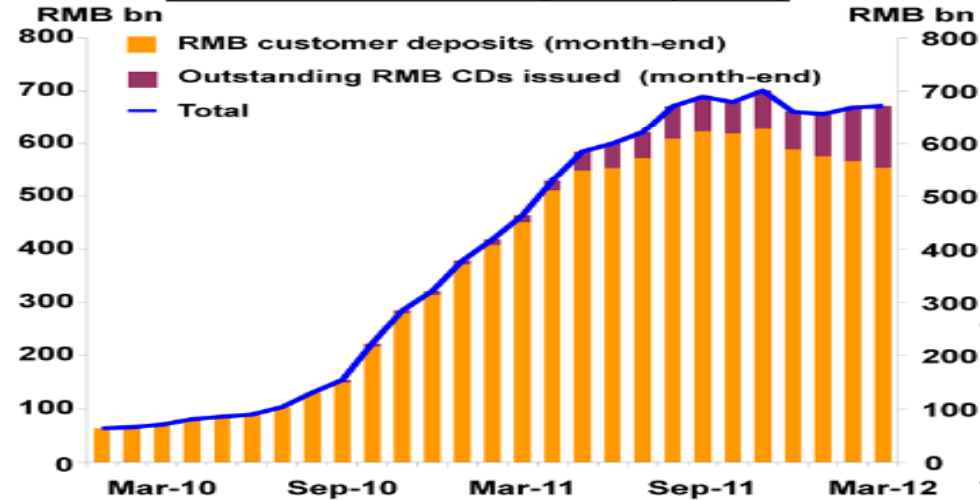
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The RMB has just seen the biggest monthly drop since depegging



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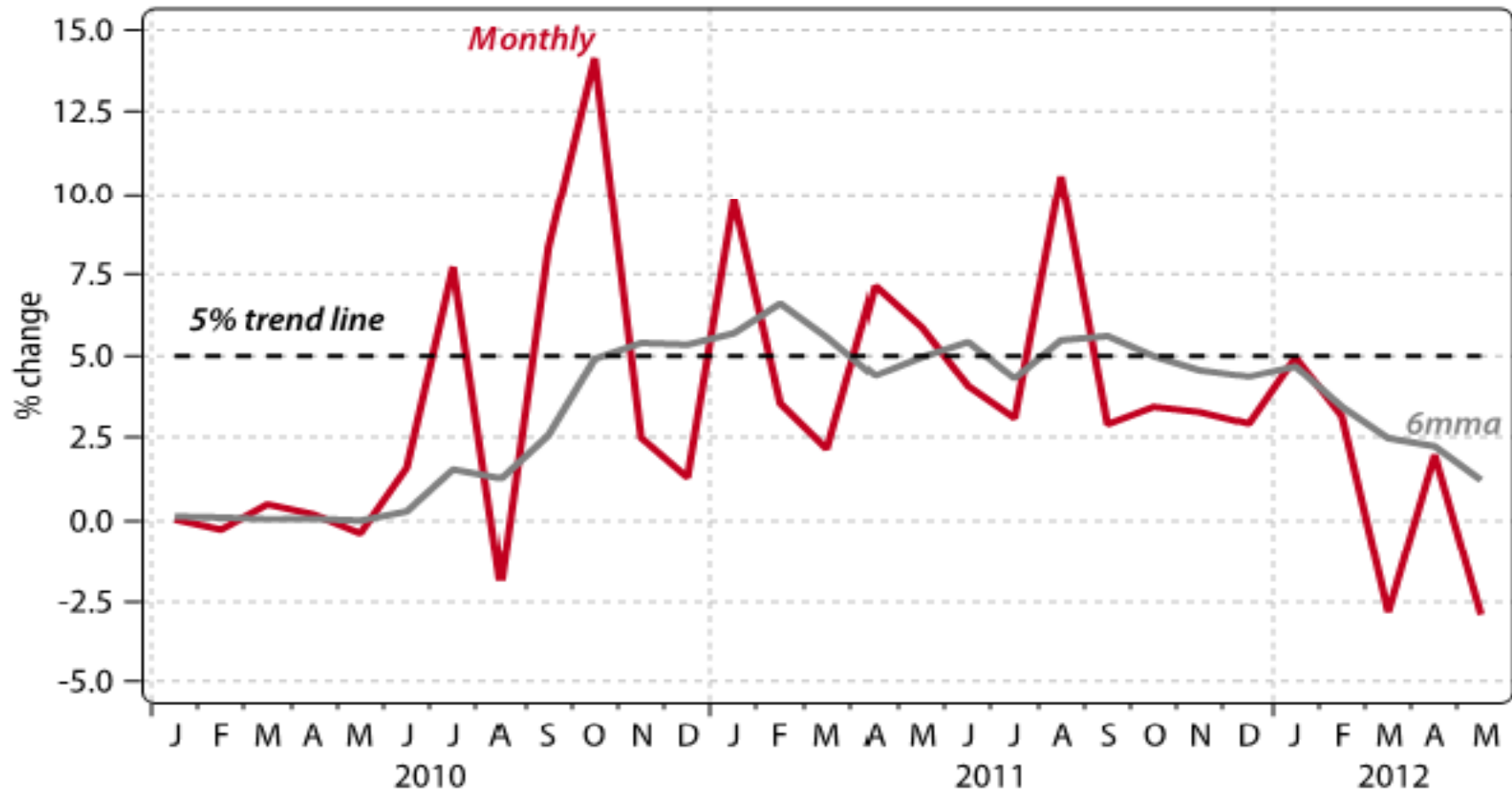
RMB customer deposits and certificates of deposit (CDs)



A change in trend or a buying opportunity?

China's currency has fallen off its trend of 5% appreciation

Annualized rate of change in CNY/USD exchange rate



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China's political uncertainty

2012 was supposed to see the playing out of a carefully-scripted handover of power from President Hu Jintao and Premier Wen Jiabao, to a younger generation of leaders. But this process, already fraught, appears to have been disrupted by the dramatic ouster and related scandals of party leader Bo Xilai.

Does this political turmoil mean that China will fail to respond to the current downturn? Simply, no.

- In political transition years, China's growth is more likely to accelerate than to slow, as local leaders try to make their area stand out. So the normal political dynamics are now working in favor of growth, not against it.
- The leadership's obsession with growth and stability is, if anything, heightened during transition years like 2012. So it is highly implausible that leaders would allow the economy to collapse while they fight over who-gets-what job. Economic problems are more likely to concentrate attention on making the necessary moves to support growth.

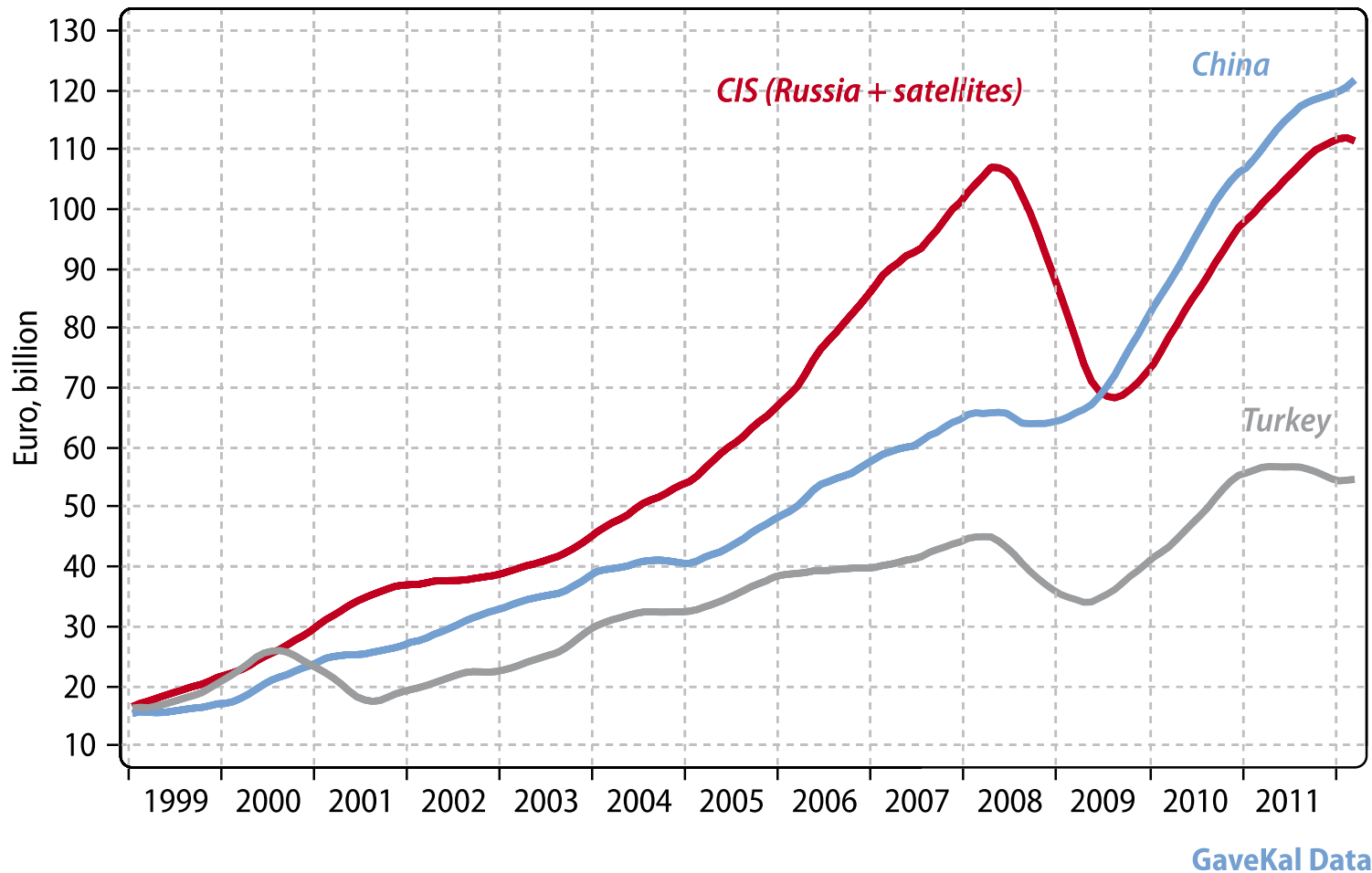
Does the uncertainty mean fewer structural reforms to support China's longer-term growth? Probably not.

- The consensus view was that 2012 would be dull, with important decisions put on hold for the next leadership.
- Yet there have been plenty of reforms this year: the financial reform pilot in Wenzhou, the widening of the USD/CNY trading band, a huge expansion of the QFII program, and more dividend collection from SOEs.
- This makes us cautiously optimistic that Bo's ouster may actually have smoothed policymaking. The deal to get rid of Bo unified the rest of the leadership, and could have helped bring consensus on other moves. Bo's departure also narrowed the range of views within the Politburo and reduced the need to placate his supporters. We thus think China can continue making progress on its reform agenda.

Russia's WTO membership is a boon to Europe and Asia

Russia and the CIS are crucial clients for the eurozone

Eurozone exports, rolling 12 months



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Russia's upcoming entry into the world trade body puts paid to fears that global economic woes would spark a wave of 1930s-style protectionism.

Exports to the CIS already account for 7% of total EMU exports, a weight similar to China's. After WTO entry, Russia's average import tariffs will decline from 9.4% to 6.4% on industrial goods and from 15.6% to 11.3% for agricultural goods.

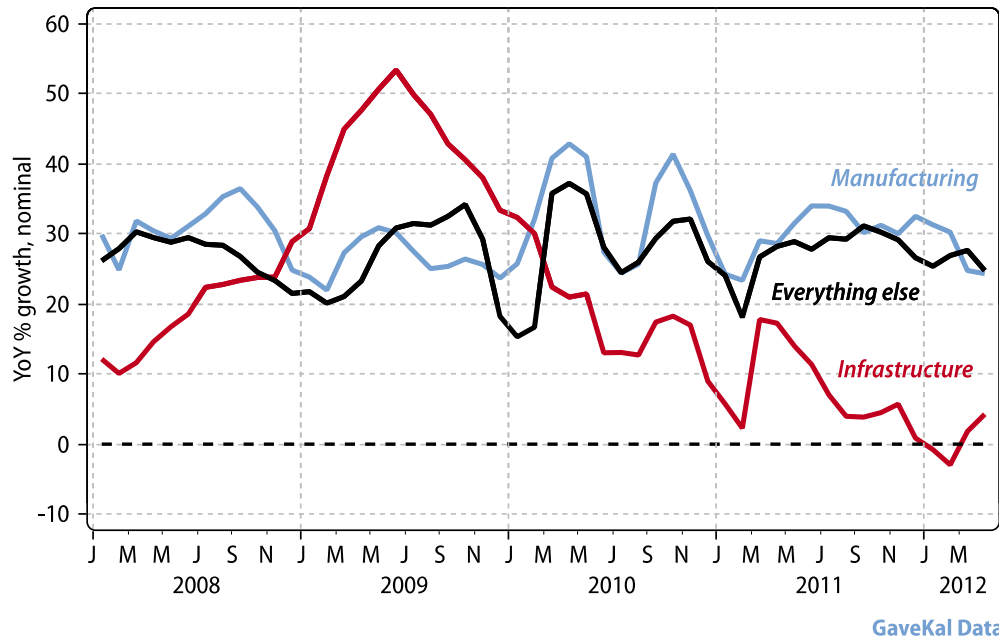
Ricardian growth potential will be unlocked in a wide range of sectors, with the potential integration of a cheap and well-educated workforce in the production process.

So at a time when Europe's great Ricardian project is threatened by the euro crisis, Russia's market opening provides comforting news.

More pro-growth policies in China

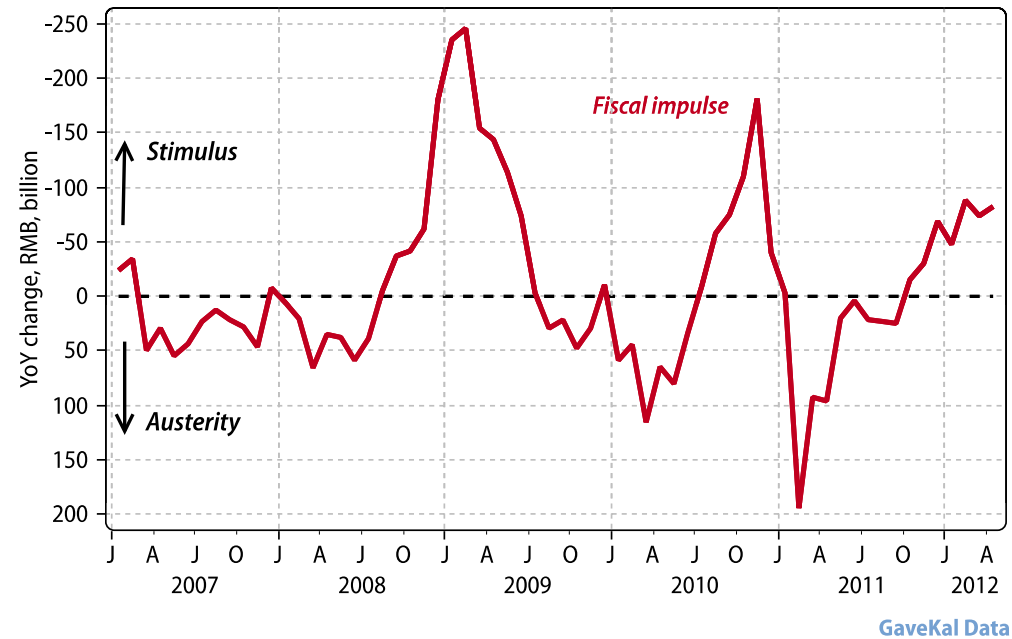
Infrastructure investment is picking up after a weak 2011

Fixed-asset investment by sector, 3mma



China has room to deliver additional fiscal stimulus this year

Change in general government budget balance, 3mma



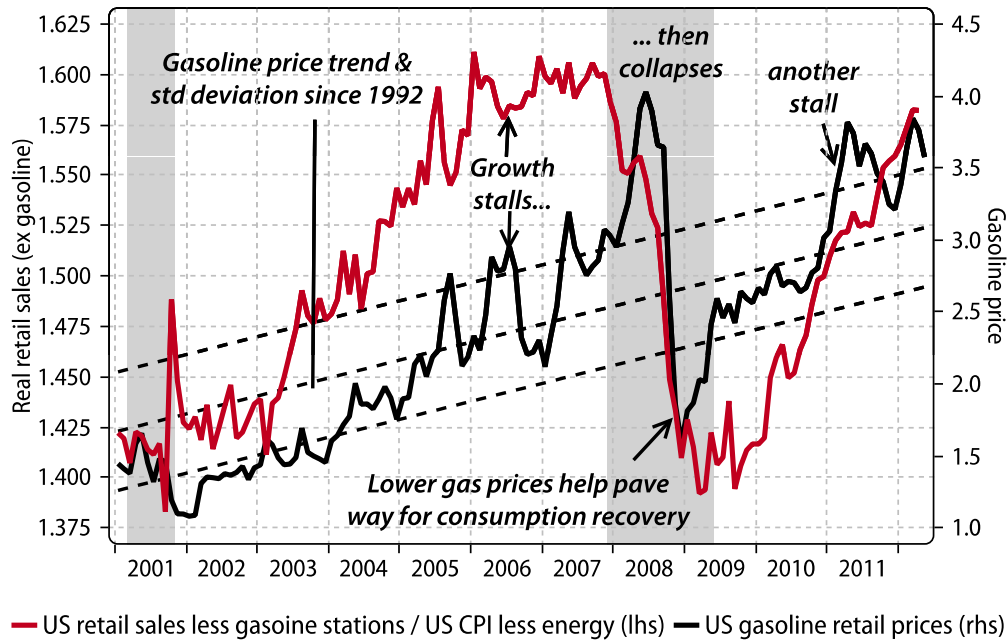
China's weak April data appear to have convinced the leadership to take a more decisively pro-growth stance. While the government has no desire to repeat the mega-stimulus launched in late 2008, it does have room to increase fiscal support generally, and infrastructure spending in particular.

The pace of project approvals has picked up in recent months, which should translate into more infrastructure investment in coming months.

The weak growth in infrastructure in 2011 lowers the bar for delivering growth in this sector in 2012. The government has also announced several corporate tax breaks as well as some subsidies for consumer spending on energy-efficient appliances and cars.

Oil prices are falling

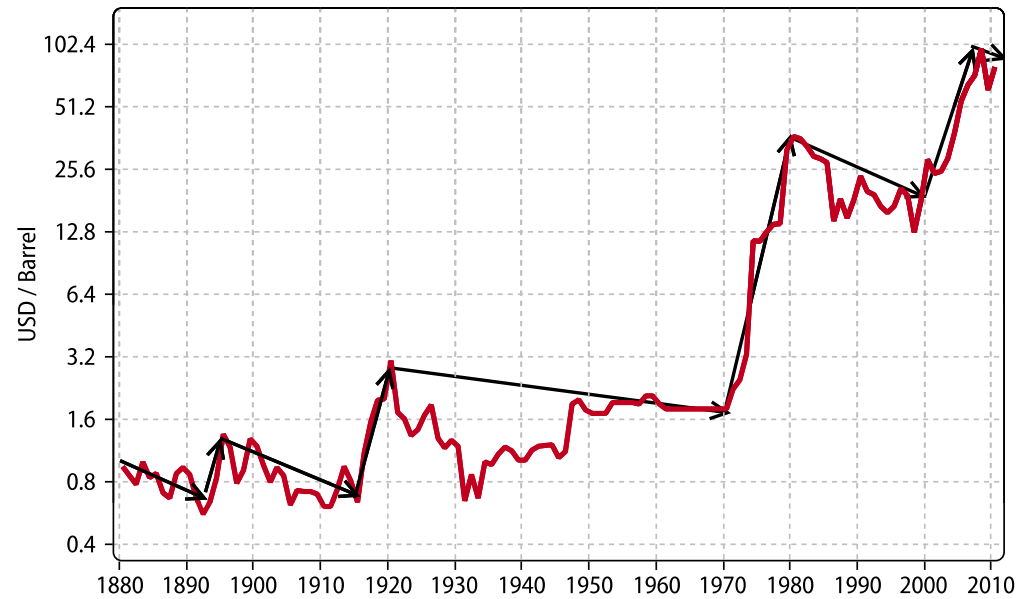
Consumers have done surprisingly well with higher oil; and now it is falling



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Oil prices move in long-term steps

Annual average crude oil prices since 1880



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It doesn't get talked about enough, but the rising oil price was a big factor behind the soft patches of 2010 and 2011.

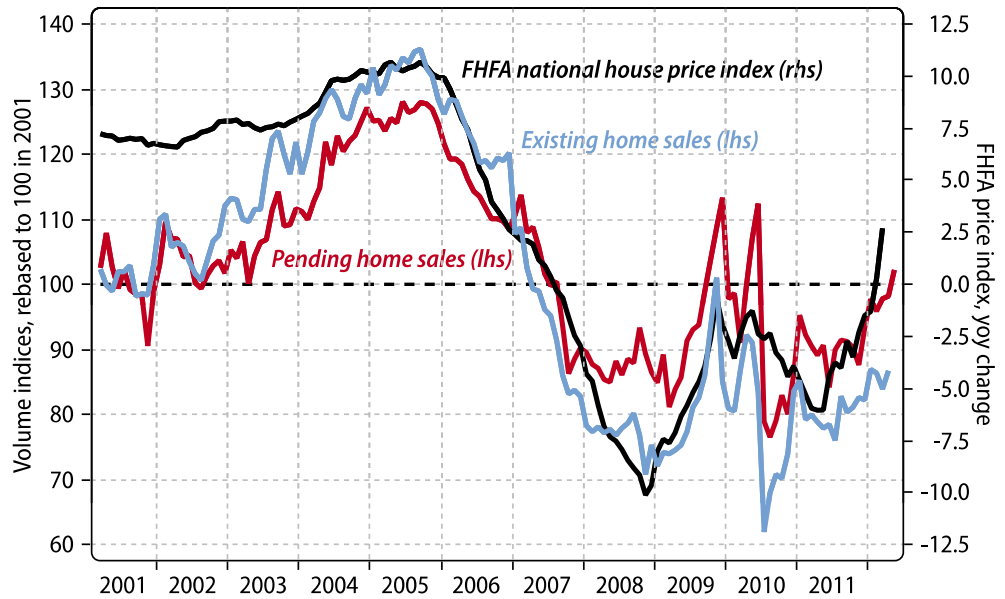
Now that oil prices are falling back, we should expect a commensurate improvement in economic activity. And aside from being an obvious kicker to growth, a falling oil price also means more liquidity gets released as less US\$ are tied up in oil inventories.

It is also important to remember that oil prices tend to move in long cycles. The past decade saw a very aggressive rise in the price of oil and we would not be surprised if the next ten years will be similar to the decade following the oil shocks of the 1970s.

US housing has turned a corner

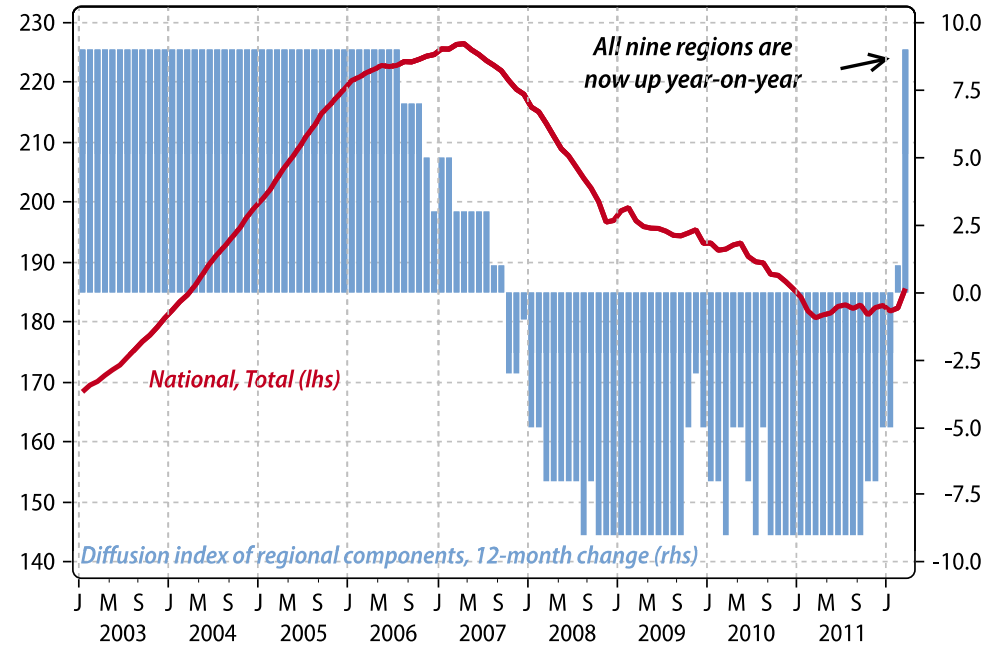
Confidence returning through higher volumes and rising prices

Sales volumes rebased to 2001 = 100; Pending homes sales lagged 2m



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The FHFA house price index and the regional diffusion index



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The recovery of the US housing market has picked up speed this year, led by sales volumes and now house prices.

Moreover, the recovery is getting more broad based and in March all nine regions in the Federal Housing Finance Agency were up on a year-on-year basis for the first time since 2006. And it is not just a base effect either, since all nine regions also saw monthly price gains.

The recovery should endure, as recent strong pending home sales data bodes well for future transaction completions. Mortgage availability should also improve as underwriters become more comfortable with collateral values.

While we do not expect a renewed housing boom, stable/rising prices will remove a noose from around consumers' necks and allow them to spend more, fuelling the broader economic recovery.

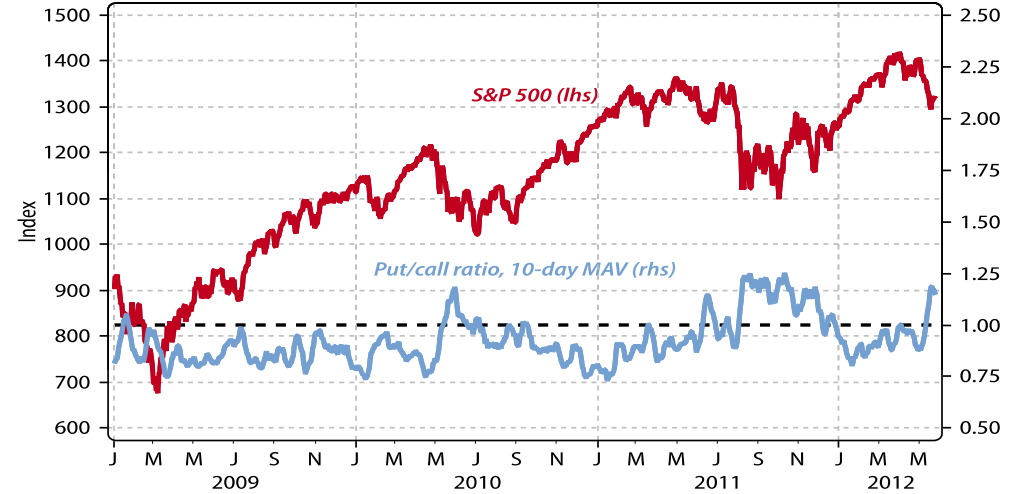
Markets have really capitulated

Hong Kong, Equity Indices, Hang Seng, China Enterprises Index, P/E Ratio



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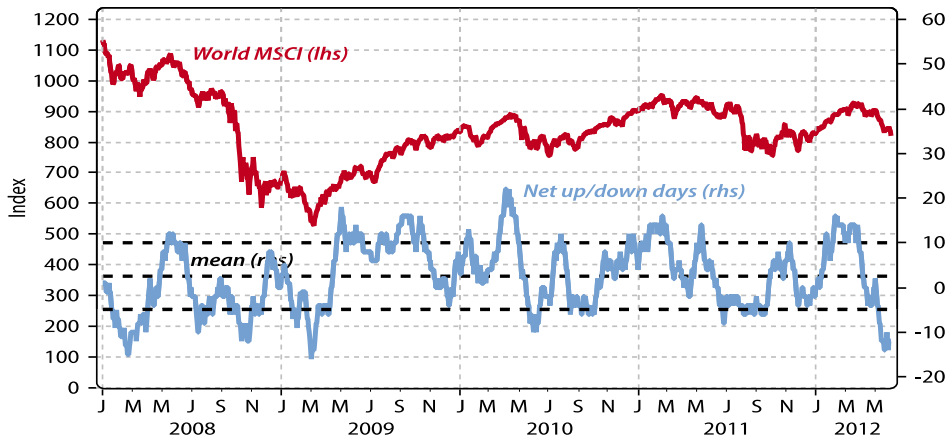
S&P 500 and the CBOE put/call ratio



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World MSCI and rolling net up days

Blue line: sum of up days minus down days over a rolling 40-day period



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As everybody is painfully aware, investors have been selling stocks very consistently over the past two months.

As a result, by most measures, the world's equity markets are now very oversold. Over the last 40 days, the number of down days outnumbered the number of up days by 14 – the worst record in more than three years.

Given the currently extreme low weightings towards equities and the extreme bearishness of investors, any potential turnaround on the markets could be very violent.

The structural bull case

Just as there are significant longer-term headwinds for the global economy, there are also some very interesting positive developments:

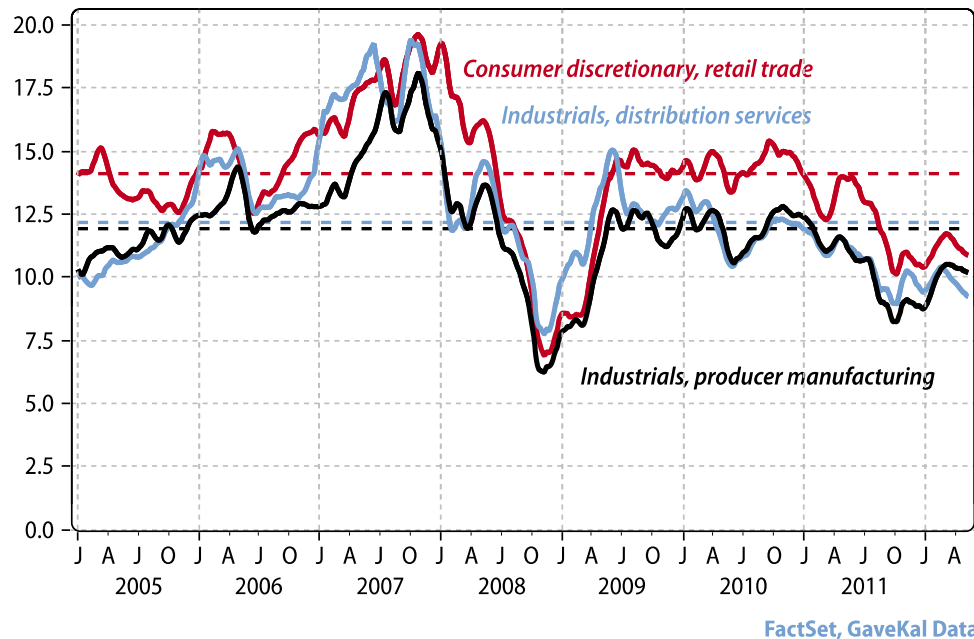
- **Chinese financial liberalization.** The Chinese leadership seems very committed to continued financial sector reform. This is a necessary step to unlock China's growth potential and is likely to yield big capital productivity gains (see [China's Path to Reform](#), [Land Reform](#) and [Weeks When Decades Happen](#)).
- **Chinese capital goods exports.** China's move into capital goods will make needed EM infrastructure investment easier and cheaper (see [Chinese Exports' Second Wave](#)). This is good news for all of Asia.
- **RMB internationalization.** A continued internalization of the RMB will lessen Asia's reliance on US\$ funding and the western banks, which should lower the region's risk premium. It will also help to speed up the financial reforms in China (see [Offshore RMB](#) and [Why Dim Sum Bonds Matter](#)).
- **Reversing of government expansion.** OECD government expansion has reached a peak. From here on, government's share of GDP is likely to trend down. This is good news for structural growth and for valuations (see [How the World Works](#)).
- **Political reform in Asia.** The opening of Burma, the anti-corruption fight in the Philippines, the death of Kim Jung III, the implementation of democracy in Indonesia... All around Asia, the political news is immensely supportive of higher asset prices.
- **Portfolio reallocation.** As commodity prices stagnate or reverse, a lot of the inflows to that sector will be reallocated to other assets. The same is true for bond flows, which have largely been driven by regulation and "fat-tail" risks. In sum, we are probably looking at a very big rerating of equities as an asset class (see our last [Quarterly Strategy Chart Book](#)).

Conclusion

Asian cyclicals and financials are trading at low valuations

Some Asia ex-Japan cyclicals are trading well below median valuations

Equally weighted indices; P/E (next 12m earnings); dotted lines show median

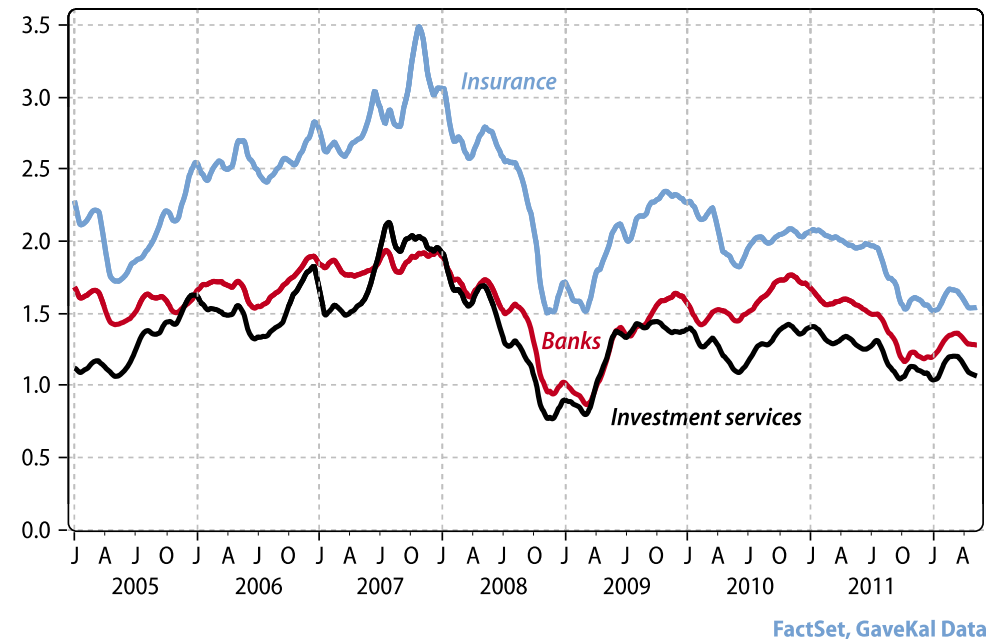


As could be expected, Asia ex-Japan cyclicals have sold off on global growth concerns. Despite the region's favorable long-term outlook, these sub-sectors now trade on 9-11x forward earnings.

These sub-sectors are a buy for any investor able to hold through the potential upcoming market volatility.

Valuations for Asia ex-Japan financials are getting close to 2008 levels

Equally-weighted indices, P/B, centered 1m ma



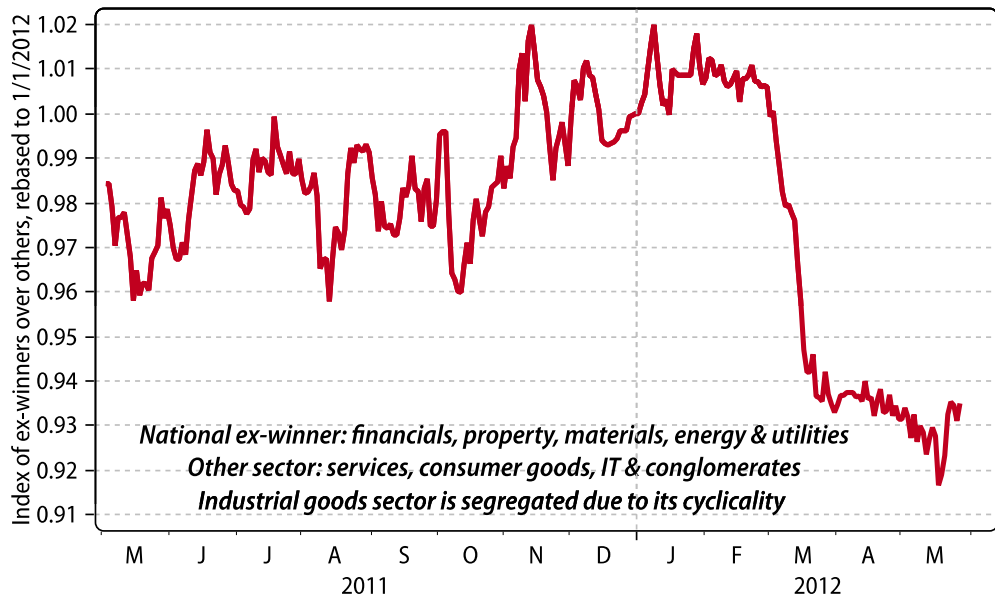
The valuation of financials has similarly contracted amid concerns of slowing growth and balance sheets' health. A similar argument applies: given that we are not overly concerned about the region's long term fundamentals and do not expect a large cyclical correction, these companies are a good long term buy.

Note that these indices exclude onshore Chinese equities, but include HK-listed and other offshore Chinese equities.

China: Winners and losers under pro-reform policies

National ex-winners will pay for China's coming reforms?

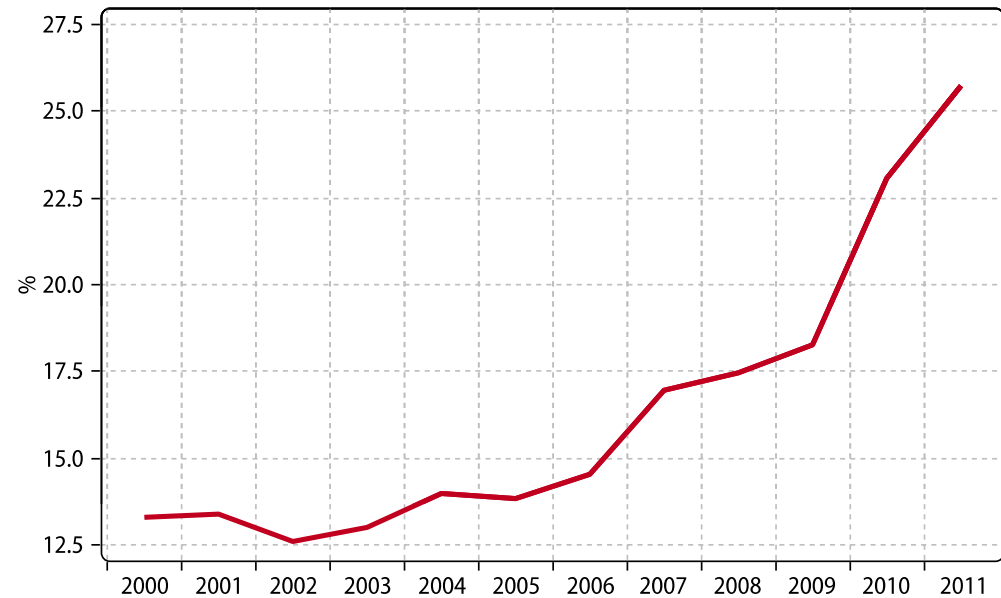
Relative performance of China's ex-winners vs other sectors (based on companies listed in HK)



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The shadow system is no longer a sideshow

Shadow finance as % of total outstanding credits



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There are always losers during any economic transformation. The interest groups that benefited most from the last decade of the Chinese growth story—SOEs, banks and property developers—are now being asked to pick up the tab for the reforms leading to the next round of growth.

Because they are so much less productive in their use of capital, SOEs will be forced to cede some ground to more efficient private firms.

Banks, in particular, will suffer from a revolt of the market against the old policy of financial repression. This is visible in the growth of “shadow banking,” which has led to greater competition for deposits between banks, and the beginnings of de facto interest rate liberalization and a rise of funding costs.

The combination of costlier deposits and deteriorating asset quality from the last stimulus will constrain banks’ capacity to keep lending.

Contact & Disclaimer

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