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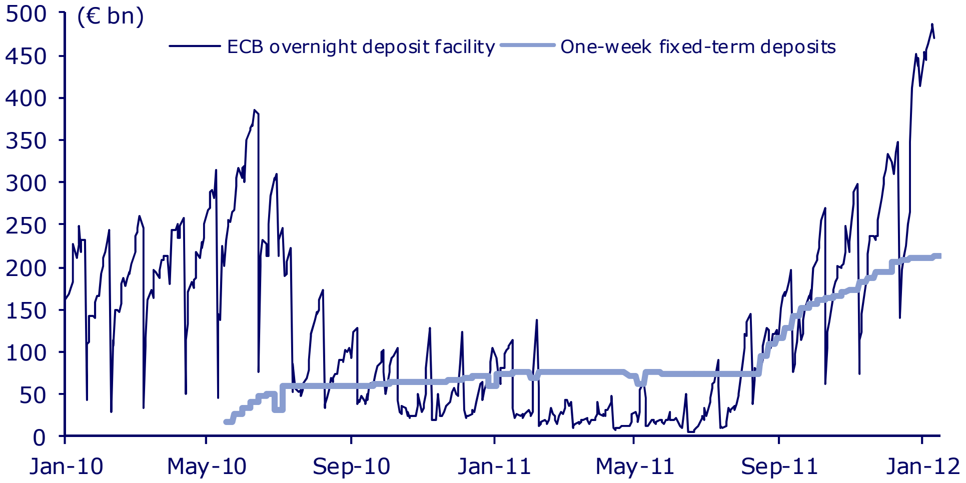
Sentiment wobbles

London

It is the New Year and hopes are, inevitably, that the current presumed consensus is too bearish. Still *GREED & fear* remains cautious and takes the view that the Eurozone will continue to dictate market moves day to day. The best hope for markets is clearly the liquidity enhancement provided by Mario Draghi's recent barrage of measures to help European banks. This is why it will be important to keep monitoring the ECB's overnight deposit facility to see if there is any sign of European banks putting their three-year funding to more "profitable" use, such as buying long-dated Eurozone sovereign bonds. On this point, European banks parked €470.6bn in the overnight deposit facility yesterday, after reaching a new record high of €485.9bn on Tuesday (see Figure 1).

Figure 1
ECB overnight deposit facility and one-week fixed-term deposits



Source: ECB

Still *GREED & fear*'s base case remains that hopes of a reactivated carry trade with Eurozone sovereign debt will prove short-lived since it would mean a complete reversal of European banks' recent efforts to reduce their exposure to Eurozone sovereign debt. Thus, as noted here last week, Eurozone monetary financial institutions' holdings of Eurozone general government securities have fallen from a peak of €1.67tn in October 2010 to €1.38tn in November 2011. There is also the issue that, with Frau Merkel backing down at the December EU summit on the principle of the private sector taking losses in the event of another Greek-like Eurozone default, the reality is that sovereign debt has now become riskier since the private sector will no longer be around to share the losses with taxpayers. For this reason among others risk aversion will return to hit Eurozone sovereign debt sooner or later, with *GREED & fear* retaining a preference for shorting French ten-year bonds as outlined here last week (see *GREED & fear – Reformulated outlook*, 5 January 2012).

The risk aversion will likely return because the attempt to agree a fiscal "compact" at the forthcoming EU summit due to be held on 30 January is surely bound to hit some setbacks. This is despite the fact that Frau Merkel said this week that the agreement on a fresh European treaty to reinforce budget discipline could be reached by the end of January with French President Nicolas Sarkozy adding that the treaty could be signed by 1 March.

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GREED & fear has obtained a look at a leaked third draft of the fiscal compact distributed to the EU member states on Tuesday with the title "Treaty on stability, coordination and governance in the economic and monetary union". The first impression is that the document is very much drafted under German influence, with a formal clause calling for the need to ensure that fiscal deficits do not exceed 3% of GDP and that government debt "does not exceed, or is sufficiently declining towards, 60% of GDP" – whatever that quite means. The draft rule also requires countries with government debt above 60% of GDP to reduce their debt at an average rate of 5ppts per year.

This latest revised draft also states that any contracting party which considers that another contracting party has failed to comply with any fiscal compact rule "may bring the matter before the Court of Justice of the European Union or invite the European Commission to issue a report on the matter." The draft also adds that the fiscal pact treaty is to be first adopted by the ratified euro member states and folded into European Union-wide rules within five years. It states that "within five years at most following the entry into force of this Treaty, the necessary steps shall be taken with the aim of incorporating the substance of this Treaty into the legal framework of the European Union".

Clearly all these targets can be broken, as they were under the former so-called "Stability and Growth Pact". Still in *GREED & fear*'s view the Germans are much more serious this time round which is why the first few months of 2012 will be dominated by the political attempt to push this through, raising the issue of how much resistance it will generate. Meanwhile, the forthcoming French elections are important because they have the potential to generate a lot of noise. This is not just because of the role of Marine Le Pen and her openly anti-euro National Front party, but also because Sarkozy's main rival, Socialist candidate Francois Hollande, appears to be against the sort of fiscal austerity implied by the Merkozy Plan. If elected, he would doubtless compromise on this stance since the French left, like the German left, is fundamentally in favour of more Eurozone integration. Still the French Socialists' anti-austerity stance has the potential to spook investors in French government bonds in coming months, even if the credit rating agencies do not do so with a downgrade.

Figure 2
French 10-year government bond yield

Source: Bloomberg

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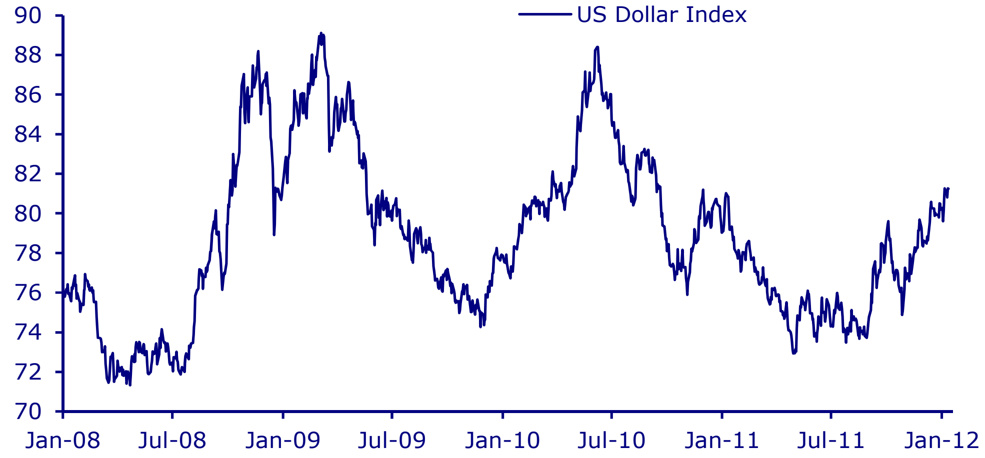
In London this week talking with investors, *GREED & fear* detects no obvious consensus on the Eurozone save for an acknowledgement that ECB actions on European banks have served to delay a Lehman moment. In this respect, sentiment is not as bearish as many suppose. There are also growing hopes that European banks will buy sovereign paper up to three years maturity, consistent with ECB funding. On the US economy, there is more optimism with many now questioning whether there will even be a third episode of quantitative easing. This greater confidence in the US economy, and therefore increased scepticism about QE3, is also presumably one reason behind the increased momentum behind the US dollar (see Figure 3).

Figure 3
US dollar index



Source: Bloomberg

Still if this is the sentiment, *GREED & fear* remains of the view that renewed quanto easing in America is coming sooner or later. This is primarily because of the extreme doveish mindset of Ben Bernanke but also because of the continuing view here that the credit multiplier is not functioning in America. On this point the best hope for a renewal of releveraging in the American economy must surely be a fundamental recovery in US housing. In *GREED & fear*'s view the best hope of short circuiting the current working through of excess inventory in US housing would be a sweeping policy of comprehensive mortgage debt relief. But such a policy remains hard to envisage this side of a US presidential election, though it would become a distinct possibility the other side of the November election if the Democrats end up winning both executive and legislative branches of governments. This is clearly a big *if*.

In the meantime, the Fed remains concerned about the housing market as is clear from its recent advice that Congress should be allowed the Fannie and Freddie to lose even more money to support housing! Thus, a Fed study on US housing market sent to Congress last week stated that "some actions that cause greater losses to be sustained by the GSEs in the near term might be in the interest of taxpayers to pursue if those actions result in a quicker and more vigorous economic recovery" (see Federal Reserve white paper – *The US housing market: Current conditions and policy considerations*, 4 January 2012). The report also noted that since early 2006 more than US$7tn in home equity, measured as aggregate home values less mortgage debt, has been lost with the home equity to disposable personal income ratio falling to a record low of 54% in 3Q11 (see Figure 4).

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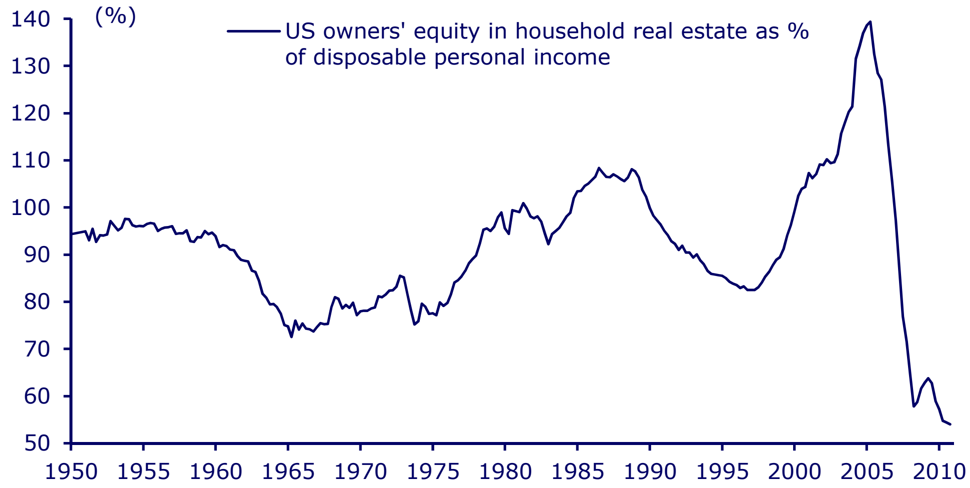
Figure 4
US home equity to disposable personal income ratio



Source: Federal Reserve – Flow of Funds Accounts

Returning to Asia, there has been much debate with investors this week about the exact timing of a China easing cycle. *GREED & fear*'s base case is that more meaningful action is likely to come in the second quarter by when it will be clearer that economic activity is slowing and inflation falling. Still the A-share market reacted positively this week to another signal that Beijing does not want the domestic stock market to fall any further. *GREED & fear* refers to news on Tuesday that prominent SOEs like Sinopec and Unicom have started to buy back their own shares. This follows the announcement in October 2011 that Central Huijin, the domestic investment arm of China's sovereign wealth fund, has started buying bank shares, an announcement re-iterated last week. The October announcement and the latest announcement were both made at around A share market lows (see Figure 5).

Figure 5
China CSI 300 Index

Source: Datastream

All this is an argument to add to China on weakness even if it does not constitute an outright easing signal. Meanwhile, if timing of easing of monetary policy and of policy towards the all-important property market remain the key issues for China, the key variable for India remains, in *GREED & fear*'s view, the currency. On this point, recent weeks have seen concrete evidence that the Indian authorities are now much more aware of the potential vulnerability of the currency and are desperate to prop it up. Thus, the government announced on 1 January that it has decided to allow Qualified Foreign Investors (QFIs), including foreign individuals, groups or associations but not FIIs, to directly invest in Indian equity market. But perhaps more

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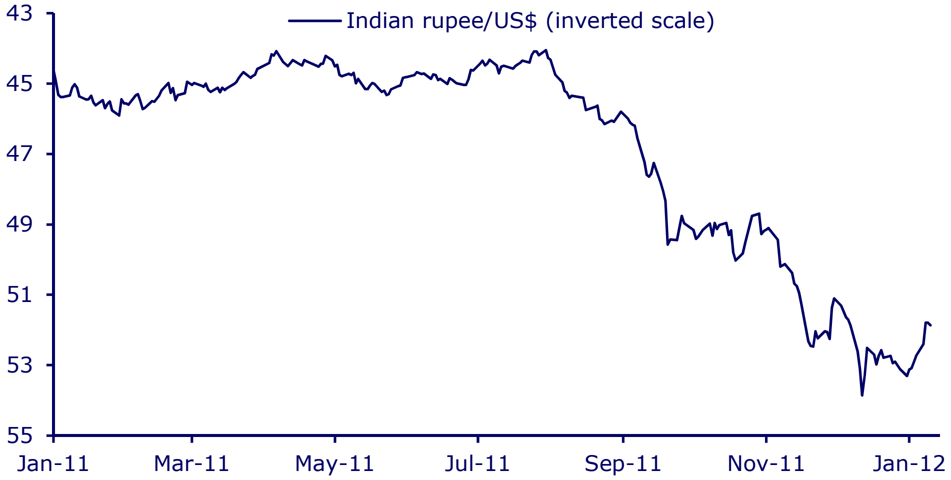
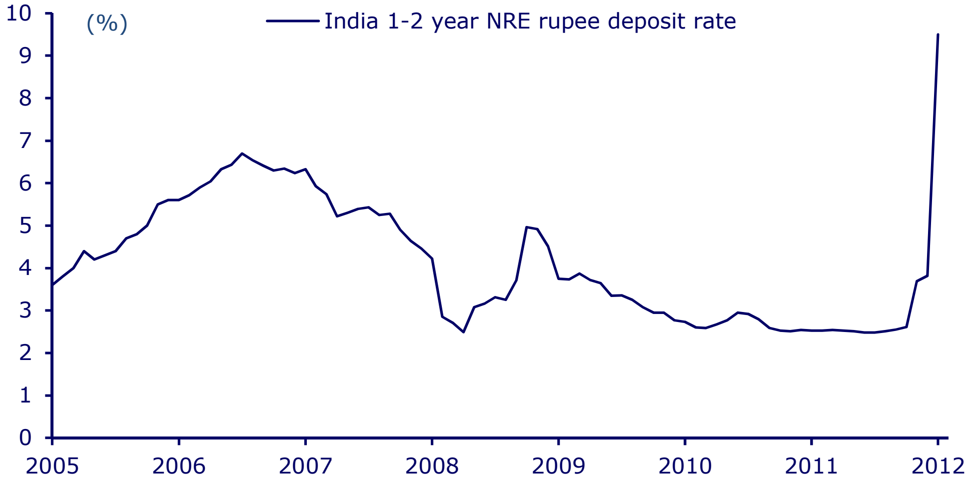
important was the deregulation of NRI deposits announced last month. The Reserve Bank of India (RBI) on 16 December deregulated the interest rates paid by banks on non-resident (external) rupee deposits and ordinary non-resident accounts. As a result, Indian banks are now offering NRIs one to two-year deposits at 9.5%, up from 3.8% in December (see Figure 7).

Figure 6
Indian rupee/US$ (inverted scale)



Source: Bloomberg

Figure 7
Interest rates on India 1-2 year non-resident (external) rupee (NRE) deposits



Source: CEIC Data, CLSA Asia-Pacific Markets

This yield is clearly attractive to always yield obsessed Indian savers. So, it will be interesting to see if they trust their own currency. These measures have in the near term boosted the currency, as has this week's decision to allow 100% FDI in single-brand retail. But *GREED & fear* still remains cautious given the combination of stubborn inflation and fiscal vulnerability in the context of slowing growth. The other problem is that currency vulnerability is clearly a constraint on the RBI's ability to commence an aggressive easing cycle.

Elsewhere in Asia, the most interesting news this week has been a High Court decision in Kuala Lumpur to end the long-running sodomy case against Malaysian opposition leader Anwar Ibrahim. *GREED & fear* interprets this as a sign that Malaysian Prime Minister Najib Razak wants to run as a reformer and that he calculated that the ongoing trial had the potential to undermine this image in the anticipated general election which is expected to be held in 2Q12.

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The stock market will want to see Najib win with a two-third majority. The ruling coalition currently controls 62% of parliamentary seats. An unlikely, but not impossible, opposition victory would be clearly bearish. But for now Malaysia's relatively high valuation is supported by the holding power of government-affiliated institutions who own an estimated 32% of the 30 stocks comprising the KLCI benchmark index. The CLSA Malaysia universe of 34 companies under coverage is trading on 13.8x 2012 forecast earnings and 2.1x 2012 book. This puts Malaysia at a substantial 32% valuation premium to the Asia ex-Japan region (see Figure 8).

Figure 8

CLSA Malaysia universe 12m forward PE premium to Asia ex-Japan

Source: CLSA Asia-Pacific Markets