Christopher Wood christopher.wood@clsa.com (852) 26008516

Bullet dodged

Lugano

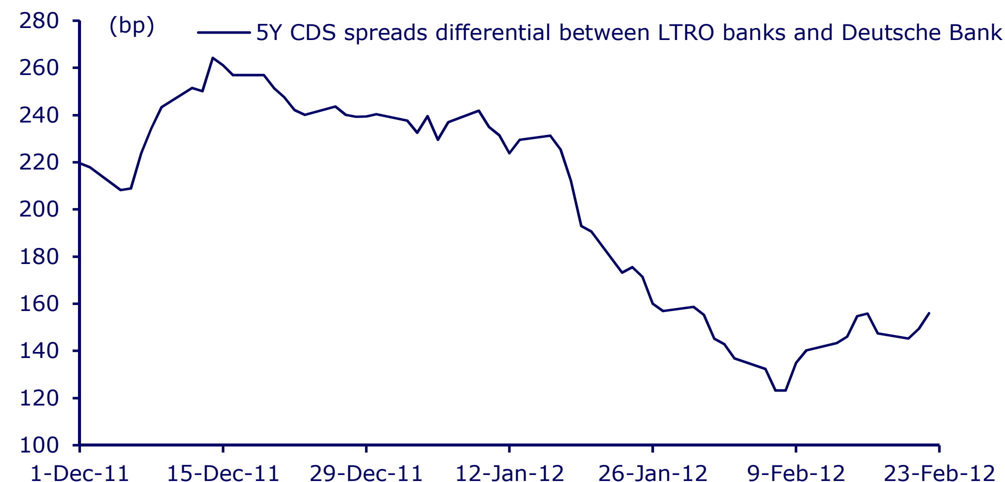
The Greek bullet has been dodged for now though the scheduled April elections in Greece remain an obvious stumbling block. Accordingly, *GREED & fear*'s base case remains with the "risk on" trade which means that any pullback in equities should be bought. A potential moderate disappointment for the markets may be that the LTRO-2 is not quite as large as previously expected because of the apparent reluctance of the big German and French banks to be seen taking up the carrot of generous ECB funding. For this reason the amount raised may be less than the €500bn-1tn previously guesstimated.

Still this will not be enough to end the "risk on" rally since those banks that really need the funding, or the profits from the carry trade like the Italian and Spanish banks, seem likely to participate again. Meanwhile, it is a telling sign of improving market conditions that Italian bank Intesa Sanpaolo was able this week to issue an €1bn unsecured bond with a five-year maturity, following its successful issuance of €1.5bn in unsecured 18-month bond at the end of January. Such longer term funding would have been impossible prior to the LTRO.

It also continues to be clear that Flexible Mario would like all the major European banks to take advantage of the LTRO. Indeed the ECB stance towards the banks is increasingly likely to be either take funding from the LTRO or raise equity, rather than the other option of pursuing deleveraging and balance sheet contraction. While, as previously noted here, it is also likely that the European Banking Authority (EBA) will come under growing pressure to relax its capital requirements even if nothing specific appears to have been announced yet.

Figure 1

Differential between LTRO banks' and Deutsche Bank's 5Y CDS spreads



Note: Average 5Y CDS spreads of Banco Santander, BBVA, UniCredit and Intesa Sanpaolo minus Deutsche Bank CDS spread. Source: Bloomberg, CLSA Asia-Pacific Markets

In a further demonstration of Flexible Mario's extreme flexibility, it is also worth noting that in its recent relaxation of collateral standards the ECB has allowed national central banks to set individual collateral rules tailored to meet individual countries' banking systems' particular funding needs. A very informative article on this was published in the *European Wall Street Journal* last Tuesday (*"ECB allows diversity of collateral rules"*, 14 February 2012). Thus, by way of example, the Bank of France will accept assets denominated in US dollars reflecting French banks' large pool of dollar assets.

One consequence of this so-called "balkanisation" of the Eurozone financial system is that all collateral is not created equal. This is, of course, the exact opposite direction of the current

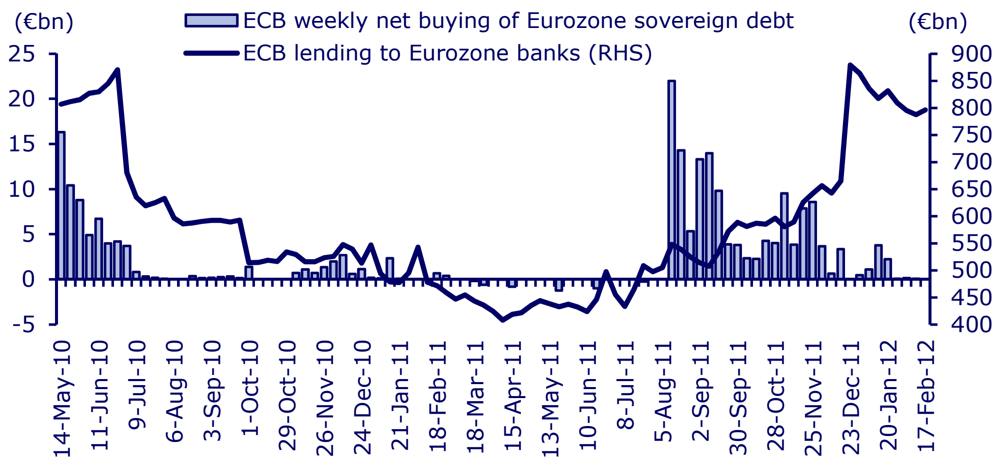
Christopher Wood christopher.wood@clsa.com (852) 26008516

efforts to move Euroland towards greater fiscal integration. Still Flexible Mario is, clearly, a believer in "needs must" to the delight for now of owners of risk assets.

Meanwhile, the longer term issue raised by the LTRO is that certain banks may become hooked on ECB funding. This is presumably why certain major European banks do not want the perceived stigma of being seen to be dependent on ECB *largesse*. The issue here is whether markets will make a distinction between those banks reliant on ECB funding and those which are not. This appears to be happening. Thus, the differential between the five-year CDS spread of Deutsche Bank and the average CDS spread of Banco Santander, BBVA, UniCredit and Intesa Sanpaolo has widened by 33bp to 156bp since bottoming on 7 February prior to the ECB monetary policy meeting and a European finance ministers' meeting on 9 February (see Figure 1).

Figure 2

ECB weekly net buying of Eurozone sovereign bonds and lending to Eurozone banks



Source: ECB

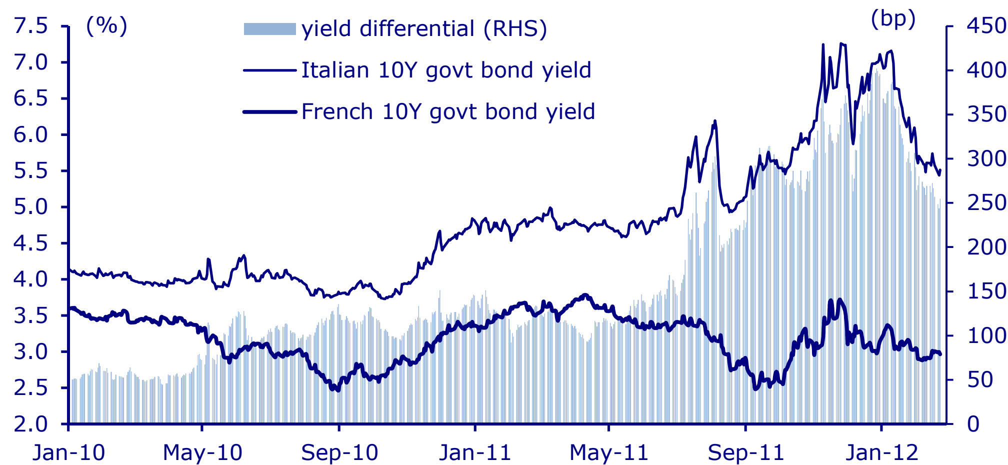
The fundamental improvement in Europe's credit markets is also clear from the fact that the ECB has of late been able to reduce massively its buying of sovereign debt. Thus, the ECB did not buy any Eurozone government bonds last week for the first time since early August 2011, after buying a mere €59m in the previous week (see Figure 2). Nowhere is this improvement in sentiment more evident than in Italy where the 10-year government bond yield is now "only" 5.51%, down from a peak of 7.26% reached in November (see Figure 3).

GREED & fear has been in Italy this week and there is no doubt that sentiment has improved dramatically. The key reason for this is that the Mario Monti-led technocratic government is seemingly achieving concrete results. Thus, it has already secured fundamental reform of the pension system for both the private and public sectors which effectively means that, starting in 2022, people cannot retire until the age of 67. Moreover, the reform was achieved without major strikes reflecting the popular support for the current government.

The next goal of the Monti government is labour market reform, which would free up employers' ability to hire and fire. The deadline for this potential landmark reform is the end of March and *GREED & fear* hears that the likelihood is that it will pass. The good news in this respect is that the next general election is not due to be held until April 2013 while Monti is being careful to remain neutral of the political parties. A lot of structural reform can be implemented in a year if popular support is maintained.

Christopher Wood christopher.wood@clsa.com (852) 26008516

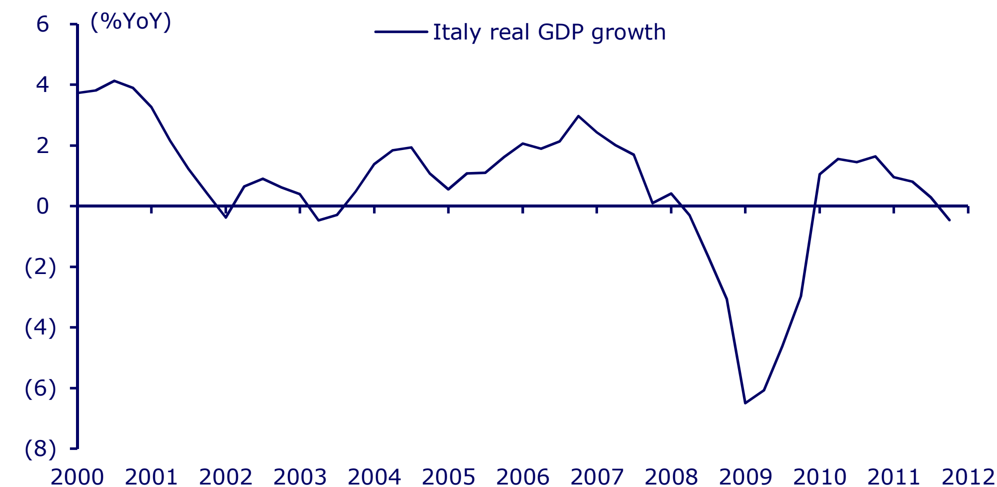
Figure 3
Spread between Italian and French 10-year government bond yields



Source: Bloomberg

For this reason *GREED & fear* is happy to stick with the long Italian 10-year / short French 10-year trade first recommended here on 5 January (see *GREED & fear – Reformulated outlook*, 5 January 2012). This has the potential for even greater spread contraction than has already occurred. Thus, the spread between the 10-year Italian government bond yield and the 10-year French government bond yield has fallen by 119bp since 5 January to 255bp, and is down 150bp from the peak reached in November (see Figure 3). There are two reasons why. First, the French are as yet nowhere near embracing the structural reform Italy has begun to do because the country has, first, to go through a divisive electoral contest on 22 April and 6 May. Second, Italy is a major part of the global fixed income index. Thus, Italy accounts for 5.5% of the Bloomberg/EFFAS Global Bond Index. So benchmark orientated investors are being forced to buy back Italian bonds which they sold last year as the rally's momentum intensifies.

Figure 4
Italy real GDP growth



Source: CEIC Data

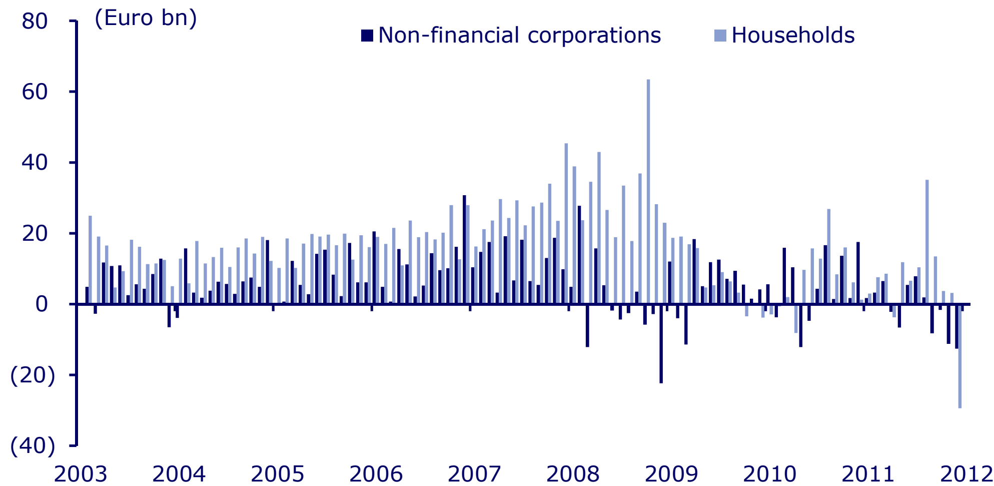
Meanwhile, none of the above means that Italy will avoid an economic contraction this year. Italy's real GDP declined by 0.7%QoQ and 0.5%YoY in 4Q11 (see Figure 4), while the consensus forecasts a 1.3% contraction this year. In this sense, the process of structural reform impacting the real economy will take time. That is why the key prerequisite is continuing popular support conferring legitimacy on the Monti government. Meanwhile, a clue to the LTRO's success, or lack of it, in helping the real economy rather than the banks' funding needs will only come with the next release of the ECB's quarterly survey of credit conditions.

Christopher Wood christopher.wood@clsa.com (852) 26008516

This is not due until 25 April. The other critical area to watch is deposit flows. Remember that in December the Eurozone saw deposit outflows. Thus, Eurozone household deposits included in M3 fell by €29.4bn month-on-month in December on a seasonally adjusted basis, the biggest monthly decline since the data series began in 2003. While deposits placed by non-financial corporations also declined by €12.5bn month-on-month in December and are down 1.0%YoY (see Figure 5). The next data on this critical area is due on 27 February.

Figure 5

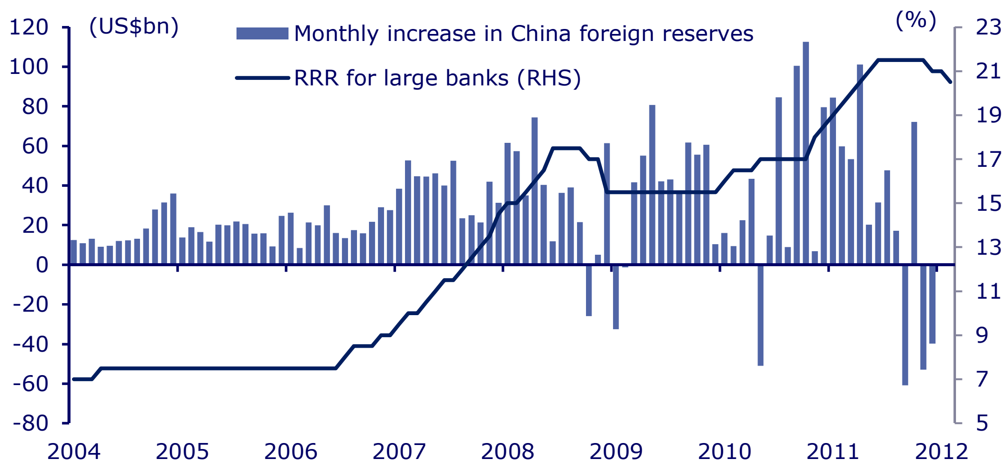
Monthly flows in Eurozone M3 deposits placed by households and corporations



Note: Eurozone deposits included in M3, seasonally adjusted. Source: ECB

Figure 6

Monthly increase in China foreign reserves and reserve requirement ratio for large banks



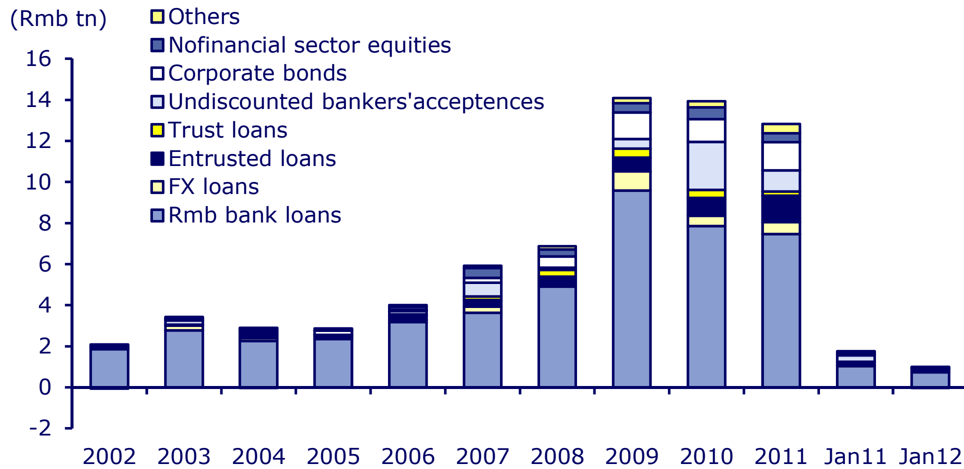
Note: Foreign exchange reserves data up to December 2011. RRR up to February 2012. Source: PBOC, CEIC Data

Returning to Asia, the failure of the Shanghai A-share market to generate more excitement from the latest 50bp cut in the reserve requirement ratio (RRR) on Saturday is instructive. The lack of a reaction suggests that the main motive of the move, as discussed here before, is to offset recent capital outflows. Remember China's foreign exchange reserves fell by US$92.6bn or 2.8% in the last two months of 2011 (see Figure 6). As a further sign of the lack of liquidity easing, the latest "social financing" data from the PBOC, which is now issued monthly, shows a continuing sharp contraction in the rate of overall credit growth. Remember "social financing" is the PBOC's data series for measuring credit growth in the so-called "shadow banking system", a description which by the way is misleading given that the mainland regulatory authorities are well aware of it. Thus, social financing in January fell by Rmb800.1bn, or 46%YoY, from January 2011 to Rmb955.9bn (see Figure 7).

Christopher Wood christopher.wood@clsa.com (852) 26008516

Figure 7

China total social financing volume

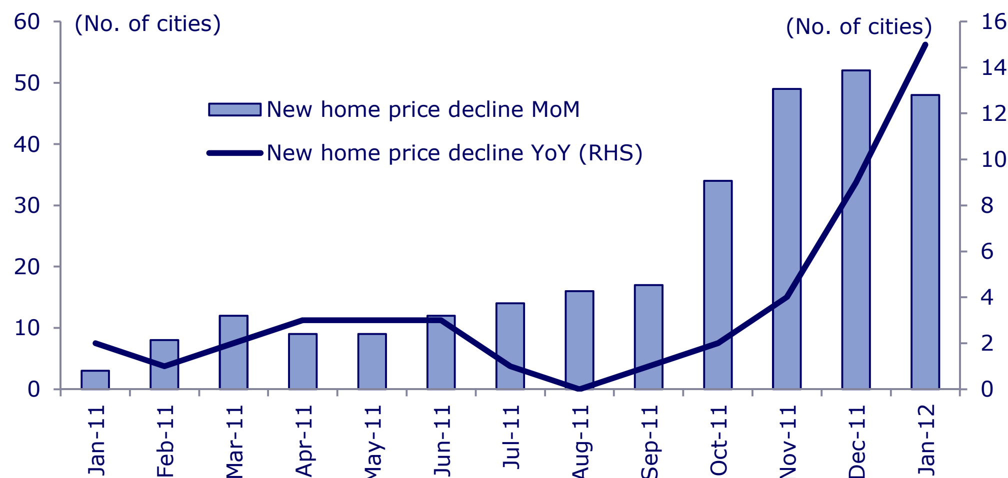


Source: PBOC, CEIC Data, CLSA Asia-Pacific Markets

The key issue for Chinese equities remains when incremental easing begins. In his latest "Sinology" report, CLSA's China macro strategist Andy Rothman argues that it is likely that the Communist Party will declare victory in its campaign against rising residential property prices at the National People's Congress scheduled to begin on 5 March (see CLSA research *Sinology – China Property: Easing still expected*, 20 February 2012). Rothman's view is that there is now sufficient evidence of property market weakness to allow the PRC leadership to take this stance. Thus, the National Bureau of Statistics (NBS) reported on Saturday that new home prices in 48 of the 70 cities surveyed fell month-on-month in January. While 15 cities saw new home prices decline year-on-year, up from nine cities in December (see Figure 8). This is also the first time since the data began in January 2011 that none of the 70 cities reported month-on-month increases in new home prices. CLSA's China Reality Research (CRR) also reported this week that property prices in 120 CRR-tracked residential projects in 40 2nd and 3rd tier cities declined by 0.4%MoM and 2.5%YoY in January (see Figure 9 and CRR report *Property Monthly – Still sluggish*, 20 February 2012).

Figure 8

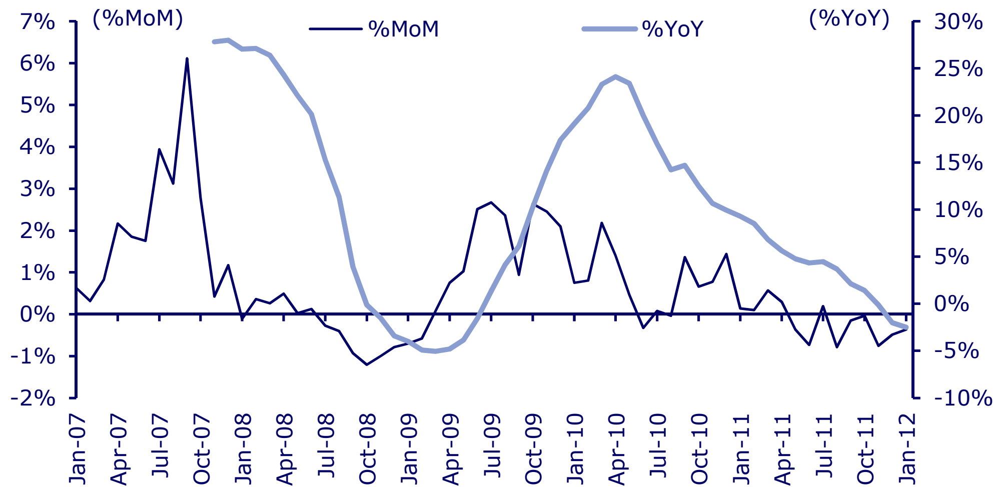
Mainland cities with new home price decline (NBS survey of 70 cities)



Note: Based on newly constructed commodity residential properties in 70 major cities surveyed by the NBS. Source: National Bureau of Statistics (NBS)

Christopher Wood christopher.wood@clsa.com (852) 26008516

Figure 9
CRR Property Price Index



Note: Based on average selling prices at the 120 for-sale residential projects in 40 2nd and 3rd tier mainland cities tracked by CRR. Source: China Reality Research (CRR)

Figure 10
MSCI China relative to MSCI AC Asia Pacific ex-Japan Index

Source: Datastream, CLSA Asia-Pacific Markets

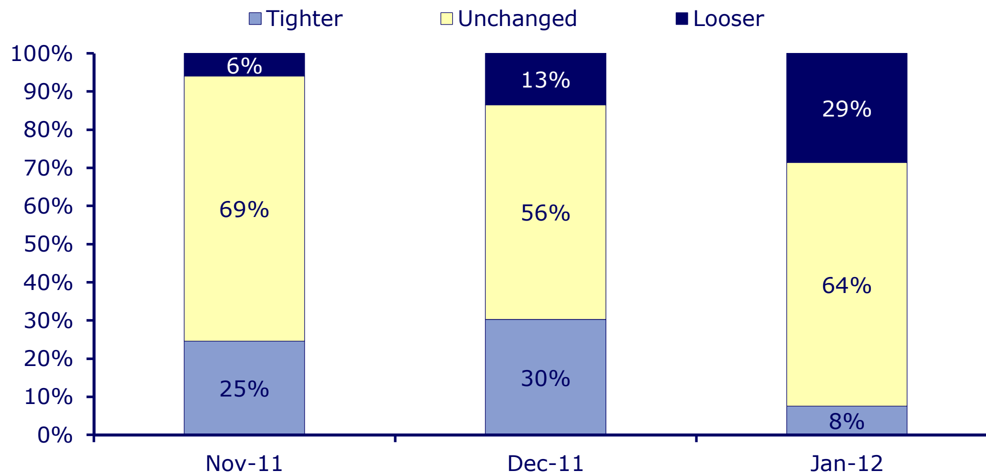
The commencement of incremental easing on residential property by the middle of this year also remains *GREED & fear*'s base case. This is why the overweight on China in the MSCI Asia Pacific ex-Japan relative-return portfolio is maintained (see Figure 13). Still if such easing is not forthcoming it will have been wrong to have maintained this overweight. Meanwhile, in what could be interpreted as a first hint of easing, it is interesting to note that 29% of property sales managers surveyed told CLSA's China Reality Research last month that mortgage availability had improved month-on-month, up from 13% in December and only 6% in November (see Figure 11). It is also a potentially encouraging signal that Shanghai announced this week that non-locals living in the city for more than three years would be allowed to buy a second home.

The other point to note about China is that recent developments in the political leadership in China potentially create a reason for easing to be brought forward. *GREED & fear* refers to an article published in the *South China Morning Post* this week ("*The plot thickens*" by Shi Jiangtao, 22 February 2012). Investors should keep a close eye on the Shanghai A-share market which, from a technical perspective, last week broke above its 100-day moving average (see Figure 12).

Christopher Wood christopher.wood@clsa.com (852) 26008516

To increase the beta on the China bets in the Asia ex-Japan long-only portfolio, the investment in China National Building Material will be increased by three percentage points by removing the investment in Shandong Weigao (see Figure 14).

Figure 11
Property sales managers reported that mortgage lending was tighter/looser compared with previous month



Note: Based on the 120 CRR-monitored for-sale residential projects. Source: China Reality Research (CRR)

Figure 12
Shanghai Composite Index

Source: Bloomberg

The lunacy of political correctness in the Western world becomes ever more extreme with *GREED & fear* reading this week that Britain's "Culture Secretary" is concerning himself with the important public policy issue of professional footballers being free to "come out". Still the PC movement can also have practical commercial consequences. Nowhere has this been more ever evident than in the "global warming" hysteria and the resulting mushrooming of businesses dedicated to profiting from the taxpayer-funded subsidies set up to cater to this hysteria.

If "global warming" is one element of environmental hysteria, another related one is Euroland's aversion to hydraulic fracturing. This is based on the "global warming"-driven alternative energy lobby's justifiable concerns that shale gas offers a profound threat to its existence. On this point, an excellent article in the *European Wall Street Journal* this week (*"Europe can't ignore shale gas"* by Alan Riley, 21 February 2012) highlights the long-term risk Europe is running in turning its back on the energy revolution likely to be ushered in by shale gas. For example, the article raises the issue of the long-term viability of Europe's chemicals industry which uses hydrocarbons as a feedstock and fuel. The other point is that with the US likely to

Christopher Wood christopher.wood@clsa.com (852) 26008516

become, sooner or later, no longer dependent on imported energy, will Washington still be willing to pay for policing the Persian Gulf.

These may be long-term issues. But they are valid nonetheless. Certainly, any development that reduces the West's dependence on the Middle East for energy can only be good news.

Figure 13

CLSA Asia Pacific ex-Japan asset allocation

	MSCI AC Asia Pacific ex-Japan weightings 8-Feb-12	CLSA recommended weightings 9-Feb-12	Mismatch from current benchmark
Australia	25.3%	10.0%	-15.3%
China	18.5%	23.0%	4.5%
Hong Kong	8.2%	7.0%	-1.2%
India	7.0%	9.0%	2.0%
Indonesia	2.8%	6.0%	3.2%
Korea	15.3%	17.0%	1.7%
Malaysia	3.4%	4.0%	0.6%
New Zealand	0.3%	0.0%	-0.3%
Philippines	0.8%	6.0%	5.2%
Singapore	5.2%	4.0%	-1.2%
Taiwan	11.2%	9.0%	-2.2%
Thailand	2.0%	5.0%	3.0%
Total	100.0%	100.0%	--

Source: CLSA Asia-Pacific Markets

Figure 14

Asia ex-Japan thematic equity portfolio for long-only absolute-return investors

Australia gold mining	8%	Newcrest Mining
China cement	8%	China National Building Material
China internet search engine	6%	Baidu
China internet company	5%	Sina
India consumer	7%	Titan Industries (3%), Godrej Consumer (4%)
India banks	5%	HDFC Bank
India infrastructure finance	4%	IDFC
India internet play	4%	Info Edge
India property	4%	Godrej Properties
Indonesia autos	4%	Astra International
Indonesia banks	4%	Bank Central Asia
Indonesia cement	4%	Indocement
Korea autos	3%	Hyundai Motor
Korea electronics	5%	Samsung Electronics
Korea internet search portal	3%	NHN Corp
Malaysia property	3%	UEM Land
Philippines banks	5%	Security Bank
Singapore dividend play	5%	StarHub
Taiwan dividend play	8%	Chunghwa Telecom
Thailand consumer	5%	CP All

Note: Readers should refer to the relevant CLSA research reports for detailed analysis & disclosures.
Source: CLSA Asia-Pacific Markets

Christopher Wood **christopher.wood@clsa.com** (852) 26008516

Key to CLSA 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.

CLSA changed the methodology by which it derives its investment rankings on 1 January 2012. The stocks covered in this report are subject to the revised methodology. We have made no changes to the methodologies through which analysts derive price targets - our views on intrinsic values and appropriate price targets are unchanged by this revised methodology. For further details of our new investment ranking methodology, please refer to our website.

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