



David Rosenberg
INSIGHT

The Fed has turned bonds and equities upside down

Stellar performance across most asset classes has been the norm until recently. Equity markets are up sizeably, and in some cases, like the S&P 500 and even the German Dax, have hit fresh all-time highs. Corporate bond markets are still offering decent returns as well, especially when measured against government bonds and cash.

Yet, in the past month, more than 60 per cent of the incoming US economic data have come in below expectations versus 34 per cent above expectations. Two months ago, only 42 per cent of data were disappointing and 53 per cent surprising to the upside.

The consensus was looking for 4 per cent US GDP growth for the first quarter; we got 2.4 per cent instead.

Estimates for this quarter are approaching a meagre 1.5 per cent annual rate. So it is safe to say that this latest leg in the risk rally does not have a lot to do with what is happening in the real economy.

The case for equities, in particular, lies much more in what the Federal Reserve and other central banks are doing, which is keeping short-term interest rates negative in real terms and making relentless incursions via quantitative easing.

In doing so, they are exerting a profound influence on the level of government bond yields, which in turn affects relative pricing in

all asset classes. Just in the past couple of months Bristol-Myers has come to market with a five-year note yielding just 1.06 per cent; Nike floated a 10-year offering at 2.27 per cent; Microsoft used its coveted triple-A ranking to issue five-year paper at 0.99 per cent; and Apple raised a record \$17bn in the debt market, with its three-year offering gobbling up at a microscopic 50 basis point yield.

In the stock market, a 2.3 per cent dividend yield on the S&P 500 looks juicy relative to the coupon available in the government bond market.

While there has been some reversal in recent weeks, the defensive segment of the stock market is up nearly 20 per cent so far this year versus just over 10 per cent for the cyclical in the largest outperformance in a good 15 years.

In addition, the average dividend yield on defensive stocks is now about 3 per cent – significantly higher than the yield on 10-year Treasuries and about in line with a generic triple B coupon.

Cyclical stocks command an average yield of only 1.8 per cent and you can see how income-hungry investors in the stock market are paying up for the yield characteristics: at a

price/earnings multiple of nearly 19 times, the defensives command a 20 per cent multiple premium over their economically-sensitive cousins. One can call them expensive, but another explanation is that the defensive dividend-payers are in a

continuum of being re-rated for their stability and yield characteristics in a world still fraught with an unusual amount of uncertainty and economic fragility.

That income theme may well be in its mature stage, but is still working out in an era of minuscule risk-adjusted rates and a soft global macro backdrop.

There is also a strong demographically-induced appetite for income, and in light of this, the most compelling case for shares is that the yield once so coveted in the bond market is being replaced by the yield available in the equity market.

Within the equity universe, net dividend increases totalled nearly \$15bn in the first quarter. Fully 944 publicly listed companies in the US sweetened their dividend policies compared with 677 a year ago, an increase of about 40 per cent. This remains a strong theme and crucial source of total return support.

Everything is ultimately priced off the Treasury yield curve – municipals, corporate credit, high yield, emerging market debt and even the equity market.

A sub-5 per cent generic junk bond yield is puny in absolute terms, but offers a 400 basis point pick-up over Treasuries, which may be appealing in terms of spreads and default rates stabilising near 3 per cent.

Similarly, a 2.3 per cent S&P 500 dividend yield hardly looks attractive on a historical basis, but again, relative to what you get in the bond market, it has not been this attractive since the late 1950s.

That is how the Fed has turned things so upside down and inside out. Investors in the Treasury market today are not there for the income, but for the prospective capital gain should yields decline. And when you look at the sectors that have done best this year on a risk-adjusted basis, they are the stodgy defensives for the most part that carry a 3.5 per cent dividend yield – investors are here not for the capital gain (although it is always welcome), but for the income.

Equities for income and bonds for capital gains. How fascinating.

David Rosenberg is chief economist and strategist at Gluskin Sheff

Windfall for short-term borrowers

Leveraged investors evade bond turmoil

Overnight interest rate falls to 0.05%

By Stephen Foley in New York

Leveraged investors who finance their holdings with short-term borrowings are reaping a windfall in lower funding costs, despite turmoil in the bond market caused by confusion over the Federal Reserve's next policy moves.

Very short-term US interest rates have been pressed lower, thanks to a combination of collateral shortages

and faith that the Fed will allow long-term rates to rise before returning to normal monetary policy and raising short-term rates.

While the benchmark 10-year Treasury rate hovered around 2.20 per cent yesterday, compared with 1.67 per cent at the start of May, the rate for collateralised overnight borrowing has fallen from 0.20 per cent to 0.05 per cent during the same period, according to an ICAP repo market index.

Banks, money market funds and many institutional investors lend money in the short-term debt markets to generate a small, safe return. Borrowers use

the markets to lever up portfolios, posting assets such as Treasuries and government-backed mortgage securities as collateral.

Repo and other money market rates are expected to stay low through the summer, holding down financing costs for institutional investors and easing the pain of price volatility in fixed income portfolios.

Long-term rates have risen since Fed officials signalled in mid-May that they could begin tapering monthly purchases of Treasuries and mortgages as early as this month.

Jim Lee, head of US interest rate derivative strategy

at RBS, said cash investors were finding collateralised lending opportunities in short supply. The US government's improving budgetary position has meant less issuance of Treasury bills, often used as collateral, and primary dealers have reduced their inventories of Treasuries.

"With the same amount of money looking for a home, that money needs to be lent at a lower rate," Mr Lee said.

Among the classes of investor to benefit from cheaper financing are mortgage real estate investment trusts (Reits). Participants at a KBW mortgage finance

conference last week said that, while the value of their portfolios had fallen because of rising long-term rates, the cost of financing portfolios remained low.

Kevin Grant, chief executive of CYS Investments, welcomed the prospect of an early end to Fed purchases of mortgages, which implied lower prices for future Reit investments, while the central bank remained committed to near-zero short-term rates.

Financial markets indicate that the first Fed rate increase will not come until December 2014.

"We are entering the sweet spot for this business

because the Fed is getting out of my sandbox. Whether it is three months, six months or nine months, I don't know. But I've got two years of visibility on my financing costs," Mr Grant said.

Alex Roeber, strategist at JPMorgan, forecast that Reits and other mortgage investors would continue to find financing plentiful and cheap.

"A big issue in financing markets has been, and continues to be, a relative scarcity of supply, relative to demand for places to invest cash," he said. "Cash investors would like to have more mortgages available."

Hong Kong stocks hit by China and Fed effect

News analysis

Currency peg to the dollar leaves the territory at the mercy of US interest rates, writes Josh Noble

On an especially clear night, the fireworks display that marks the end of each day at Disneyland is visible from the downtown offices of the Hong Kong Monetary Authority. The two institutions have a connection: both bring something American to Asia's financial capital.

Thanks to Hong Kong's currency peg to the US dollar, the territory has been at the mercy of US interest rates for decades, while remaining within an hour's smog-floating distance of China's economy.

Now hit by slowing Chinese growth and the prospect of a reversal in loose monetary policy in the US, Hong Kong's position helps explain why its equity market has been the worst performer this year, in Asia and in the developed world.

The main Hang Seng index has fallen 4.3 per cent year to date, and the Hang Seng China enterprises index – mainland companies listed in Hong Kong – has lost 11 per cent. Meanwhile, the S&P 500 is up 16 per cent, and the FTSE All World index has added 8.6 per cent.

Talk of the Federal Reserve tapering its asset purchases has led to revived volatility on global markets. But as the most accessible destination for

foreign capital in the world's fastest-growing region, Hong Kong has felt it more than most.

"Hong Kong does not have real control over its monetary policy. In theory it is, from a policy point of view, a colony of the US," says Jim McCafferty, head of research at CIMB. "[What happens to] the Hang Seng index is linked intrinsically to what's going on in the US."

Daiwa Securities estimates that \$130bn has flowed into Hong Kong since the first round of quantitative easing was announced in 2008. That has resulted in more than twice that amount of credit growth. Analyst Kevin Lai described tapering as a "margin call on Asia" and said Hong Kong was showing evidence of a "classic credit bubble".

The possible end of ultra-loose credit conditions has added to growing concerns about the state of the city's property market, which is heavily represented on the Hang Seng index. Fears of a rapid increase in property prices since 2008 – average housing costs have more than doubled – have already prompted the Hong Kong authorities to step in to limit lending in the sector.

But shares in the listed developers have taken a beating since Ben Bernanke's statement in late May suggested a possible rollback of Fed quantitative easing. Li Ka-shing's Cheung Kong Holdings has since lost 12 per cent, while Sun Hung Kai has dropped 11 per cent.

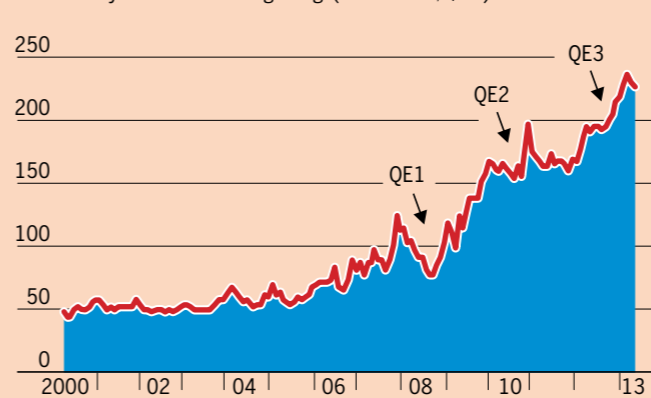
Due to restrictions on the mainland, Hong Kong is also where global investors



Construction equipment maker Zoomlion, listed on a mainland-focused index, is down more than 40 per cent this year Corbis

Hong Kong a magnet for US liquidity

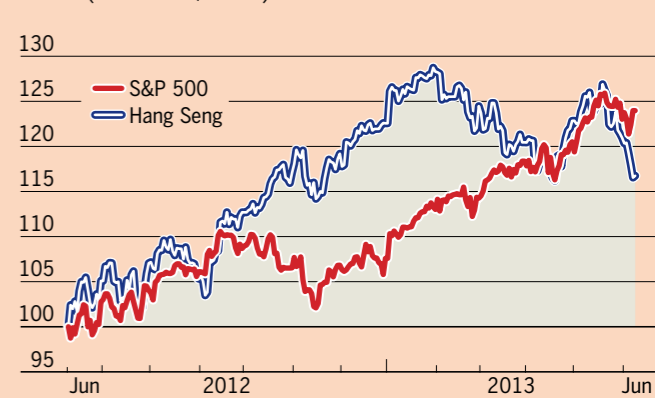
Total money inflows into Hong Kong (cumulative, \$bn)



Sources: Daiwa; Thomson Reuters Datastream

Hong Kong equities

Indices (rebased in \$ terms)



go to express their views on Chinese growth, and enthusiasm here also appears to be faltering. Data over the past few weeks have worsened, including trade figures released over the weekend, which revealed a collapse in exports in May. "Over the past few months the economic data has been pretty disappointing. It just shows that growth continues to be relatively weak," says Grace Tam, strategist at JPMor-

gan Asset Management. Companies listed on the mainland-focused Hang Seng China Enterprises Index have been hit hardest, with economy plays falling sharply. Zoomlion, which makes construction equipment, is down more than 40 per cent this year.

Another negative factor has been the reallocation into Japan during the Abenomics-driven rally, which began in November. Over the past six months many

investors have sold their holdings in Hong Kong, which is relatively liquid, to fund their moves into Japan.

Earnings have also been problematic. The slowing economy on the mainland has contributed to profit downgrades, which have outnumbered upgrades by a ratio of 2:1 in the past 22 weeks, according to CIMB research.

However, Hong Kong stocks might reappear on

the radar thanks to one thing: valuation. The Hang Seng now trades at 10.3 times forward earnings, compared with a five-year average of 12.6 times, while the FTSE All World index is at 13.7 times. But investors are yet to be convinced.

"The only advantage at the moment is valuation. On whatever measures, [the Hong Kong market] is now pretty cheap. But it could be cheap for the longer term," says Ms Tam.

Platts pricing head hits out at Brussels over oil inquiry

COMMODITIES

By Javier Blas in London

Platts, the price reporting agency involved in a European investigation into potential manipulation of oil prices, has launched a strong attack on Brussels, saying European regulators are conducting their inquiry in an opaque way.

Jorge Montepique, Platts global head of price reporting, told an oil industry conference in Kuala Lumpur that the European Commission had not provided the price reporting agency with any details about alleged manipulation.

"If the regulators are talking about transparency, why don't they start by being transparent themselves? If there is an investigation, make transparent what it is," he said. "We need as much transparency in government action as we need transparency in the actions by the industry."

Mr Montepique is the most senior executive at Platts dealing day-to-day with price reporting. He said: "If the objective of the investigation is transpar-

ency, then we will say why? We are already transparent. Then one starts thinking it has to be about something else".

The European Commission has proposed new rules on price reporting agencies, including making them liable for any information they provide and bringing them under national financial regulators.

Platts said that Mr Montepique was speaking in response to questions at his presentation at a public forum. The company added:



EU is investigating possible collusion over setting prices

"Platts confirms that it is complying fully with the EU review and that it shares the European Commission view that benchmarks should be robust, reliable and promote confidence in the marketplace".

Platts, a unit of New York-listed McGraw-Hill Financial, is the leading price reporting agency. Others include privately owned Argus and Icis, part of Reed Business Information. The price reporting agencies have in the past protested against what they regard as a push by regulators to oversee their activities.

In May Europe's leading antitrust authority raided oil majors Royal Dutch Shell, BP and Statoil in an investigation into the setting of oil prices. The offices of Platts in London were also raided.

The European Commission said that raids had taken place over concerns that "companies may have colluded in reporting distorted prices to a price reporting agency to manipulate the published prices".

www.ft.com/commodities
Twitter: @ftcommodities

Deutsche opens Singapore gold vault for wealthy investors

By Josh Noble in Hong Kong

Deutsche Bank has become the latest bank to tap the growing appetite for precious metals vaults, opening a safe deposit in Singapore capable of holding up to 200 tonnes of gold to meet storage demand in Asia.

The opening of the vault comes as banks seek to tap into rising demand from wealthy investors for direct access to physical bullion rather than holding exchange traded funds, futures and options on the metal.

Over the past two years, JPMorgan has reopened an old vault in Manhattan and built a facility in Singapore. Barclays, meanwhile, opened a precious metals vault in London late last year.

Mark Smallwood, Deutsche's head of wealth management in Asia, said investors globally were now paying closer attention to where their gold was stored, and that the new facility would help meet the changing demands of Asian investors.

"Until now, our private clients have traded and invested in significant amounts of gold through the London spot market and exchange traded funds," said Mr Smallwood. "There is a growing recognition among investors that they might want to have at least part of their allocation in physical bars."

'Asian clients like to make all their assets work very hard for them'

Mark Smallwood, head of wealth management, Asia

Deutsche's decision to locate its new vault in Singapore is a boost for the city-state's efforts to become the regional centre for gold trading. Last year, Singapore removed sales tax on gold investment in an effort to boost its role in the market.

Many Asian investors have used the recent falls in the spot price to load up on the precious metal. Fevered retail buying in April left many banks, jewellers and

even the Hong Kong gold exchange without enough stock to meet demand.

Deutsche Bank expected to see strong demand from wealthy clients looking to use physical gold as collateral for other trading activity, added Mr Smallwood.

"Asian clients like to make all their assets work very hard for them. Even though they may be holding gold for a potential catastrophic event, they recognise that it might not happen tomorrow," Mr Smallwood said.

The new facility will be located in the Singapore Freeport, already home to storage facilities run by auction house Christie's and wine investment manager Stamford Cellars.

Other banks, such as JPMorgan, already have gold vaults in Singapore, which are largely focused on institutional clients.

Demand from Asian investors has failed to spark a recovery in the price of gold. Since the beginning of April, the spot price has fallen 13.7 per cent. Yesterday, it was trading at \$1,381 a troy ounce.