

# wealthline

## View from the top

Bull markets likely to survive in 2011

## In the know

Further steepening likely  
for US yield curve

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Exclusively for  
DBS Treasures clients

March 2011

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# From the CIO's Desk

## Cyclical recovery in equities likely to continue

The bull market in risky assets that started early 2009 will likely survive the coming year, notwithstanding the current weakness in equities. Yes, this will be an older bull and a little worse for wear.

But equity bull markets typically do not terminate after only 20-21 months. 38 months is the average length of bull markets since the Second World War, with more recent equity rallies lasting longer. The end of bull markets is usually associated with recessions, overvaluation, high cost of funds, or financial crises – or a combination of the above.

However, there is no recession in sight. Not in the United States where the steepness of the Treasury yield curve suggests there is only negligible probability of a double dip over the course of 2011, and certainly not in Asia ex-Japan.

Equity valuations in most markets remain modest, trading in the lower half of their cyclical ranges. The price gains over the past two years have been driven to a very large extent by earnings recovery rather than an expansion of valuation multiples. Even in Asia ex-Japan, despite massive outperformance, stock valuations are “mid-cycle” rather than “late cycle”. And the yield gap in the US – that is, higher equity earnings yields relative to investment grade bond yields – is larger than at any time over the past decade, suggesting that stocks are cheap relative to fixed income. The gap is even more glaring for equity earnings yield relative to US government bond yields (Figure 1).

## The power of “zero”

Yes, rates are going up in Asia ex-Japan. And there is a possibility of the US Federal Reserve hiking rates towards end-2011. But those hikes are off ultra low bases. The power of zero – that is, zero or near zero interest rates in many parts of the world, including the US, Japan, Singapore and Hong Kong – remains a powerful driver of investor behaviour. The choice is stark: Stay invested or face zero to negative real returns for cash.

The long-term objective of investing has been about staying ahead of inflation. The disinflation and outright deflation of recent years should not be seen as the “new normal”. Investors who had been looking at tame consumer price inflation numbers post the global financial crisis have been looking at the “wrong” inflation. In this part of the world, we have seen massive surges in asset prices – most notably property prices – even while consumer inflation remained flat. But more recently, even consumer inflation is turning up again in the fast growth economies of Asia ex-Japan, eroding real returns on cash. Even in the United States, inflationary expectations are gradually rising amidst massive quantitative easing. It is worth remembering that US inflation is now at a half century low.

## Euro area sovereign debt risk

Nevertheless, investors should moderate their expectations. This is a bull market approaching the end of its second year. Gains will be harder fought. There will be periodic bouts of risk aversion triggered by Euro area sovereign debt concerns. This leads us to the risk of the bull market being derailed by financial crisis – the most credible of the threats outlined above.

The Euro area sovereign debt problem could unfold in an erratic manner over the course of 2011. The market understands the vulnerabilities.

Ireland and Greece run government budget deficits of around 13–14% of GDP. They are around 11% for Spain and 10% for Portugal. As a result of this overspending, their governments have run up huge debts. Further, these economies rely on external financing, so they are subject to the harsh discipline of international markets. In financial markets, sentiment can become reality. If the markets aggressively sell down your debt, it drives up borrowing costs. And if governments are already overspending their budgets, sharply higher borrowing costs can only further undermine fiscal credibility. Yet, if they cut spending too deeply, they will shrink their economies and tax bases. Once economies are caught in the downward spiral of ballooning debts, sharply higher interest charges and shrinking economies, the line between illiquidity and insolvency becomes a very thin one.

This is a tough call. But the Euro area sovereign debt crisis is unlikely to spiral into a global, systemic crisis as with Lehman Brothers. The EU, IMF and the ECB understand the stakes are high. They understand the impact of sovereign debt defaults on the European banking system. They have little choice but to buy the sovereign debt of the PIGS (Portugal, Ireland, Greece and Spain). Indeed, the ECB has yet to really stretch itself in bailing out the PIGS sovereign debt.

If pushed into a corner, the ECB could engage in “unsterilised” intervention in the government bond markets and print Euros to monetize the debt. So far, the ECB has shunned quantitative easing, choosing to sterilise their purchases of the PIGS sovereign debt. Yes, the Euro currency would be aggressively sold down if the ECB embarked on quantitative easing. But economically, that may not be a bad thing for the Euro area as debt crises typically require massive currency devaluation to restore competitiveness.

## Stronger Asian fundamentals should prevail over inflation

While the Euro area is struggling with debt deflation, Asia ex-Japan has to deal with the threat of inflation.

The story for Asia ex-Japan equities is one of divergence told in three chapters. The first chapter has already played out. In the early stages of the global economic recovery, Asia ex-Japan diverged from the West with earlier and more robust economic rebounds. Our markets were rewarded with large capital gains, with some approaching or even exceeding 100 per cent recovery of the losses from the peaks of 2007.

The second chapter is currently being played out. The strength of Asian ex-Japan economies is now restraining our equity markets. While the US remains in quantitative easing, Asia ex-Japan has gone into policy tightening mode. The fear now is of rising inflation and higher interest rates.

But the final chapter, which is likely to be played out later in 2011, should see Asian ex-Japan equities again being rewarded for their superior economic fundamentals. Before end of the year, the markets are likely to look ahead – past the rate hiking cycle in the region – towards still resilient growth and superior fundamentals.

## Chinese demand growth to continue to drive commodity prices

Commodities are likely to push higher through the course of the year, possibly even outperforming equities. Asia ex-Japan equities are struggling because of the fear of interest rate hikes. But those interest rate hikes are the result of robust economies. And strong economies drive growth in consumption of commodities. Investors should continue accumulating commodities as China “plays” and as hedges against higher US inflation one to two years down the line.

Gold, having doubled over the past 26 months, is likely to continue correcting in 1Q 2011. But the correction is likely to be shallow given the likelihood of a multi-year decline in the value of the US Dollar. Gold has very low correlations against other asset classes. Investors should consider gold as a diversifier in their portfolios and as a US dollar hedge.

For the coming quarter, I would keep a neutral weight for equities, underweight bonds in view of rising yields, and overweight alternatives, particularly commodities. Within equities, I would put Asia ex-Japan on neutral weighting and overweight US equities on continued economic recovery in the face of quantitative easing and near zero interest rates.

## Asian currencies should continue to strengthen against the USD

The US dollar could continue to strengthen against the Euro in the early months of 2011 – on both Euro area sovereign debt fears and rising US Treasury yields. But beyond that, the Dollar is likely to weaken again on quantitative easing. Asia ex-Japan currencies should make further, moderate gains against the Dollar over the course of 2011 on the back of its stronger economies.

The author is Lim Say Boon, the Chief Investment Officer for DBS Bank

Figure 1: Modest global equity valuations

MSCIAC WORLD -12MTH FWD P/E RATIO

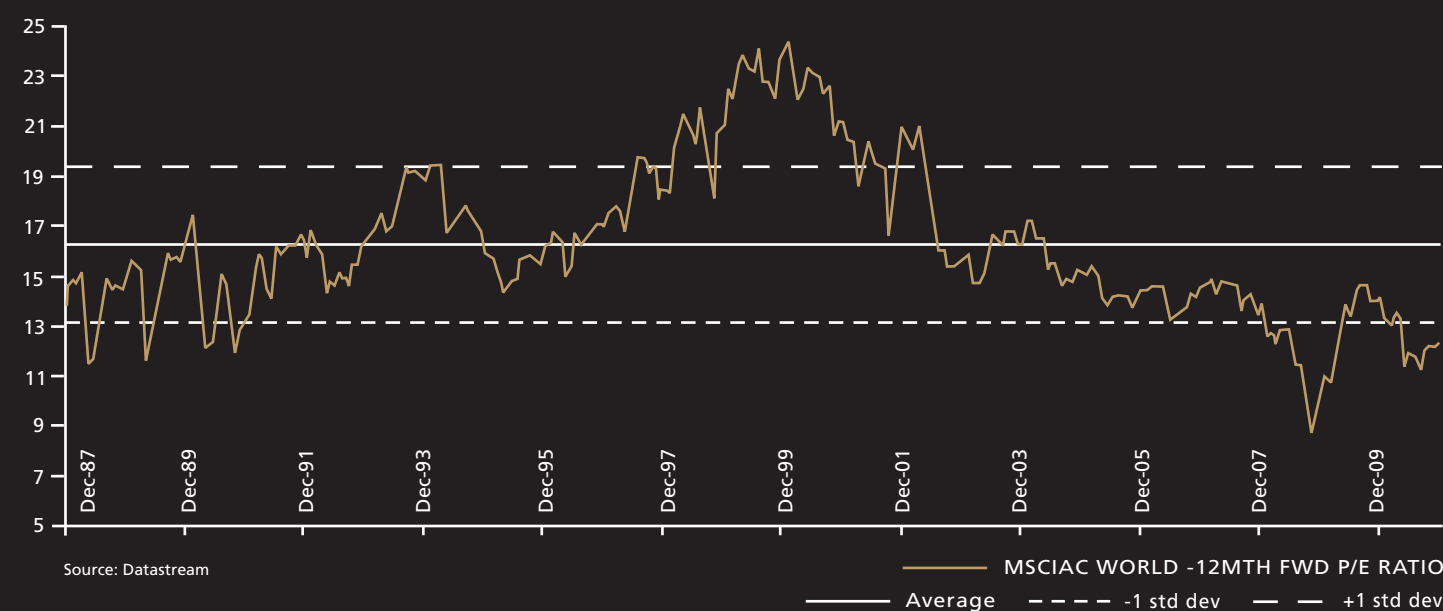
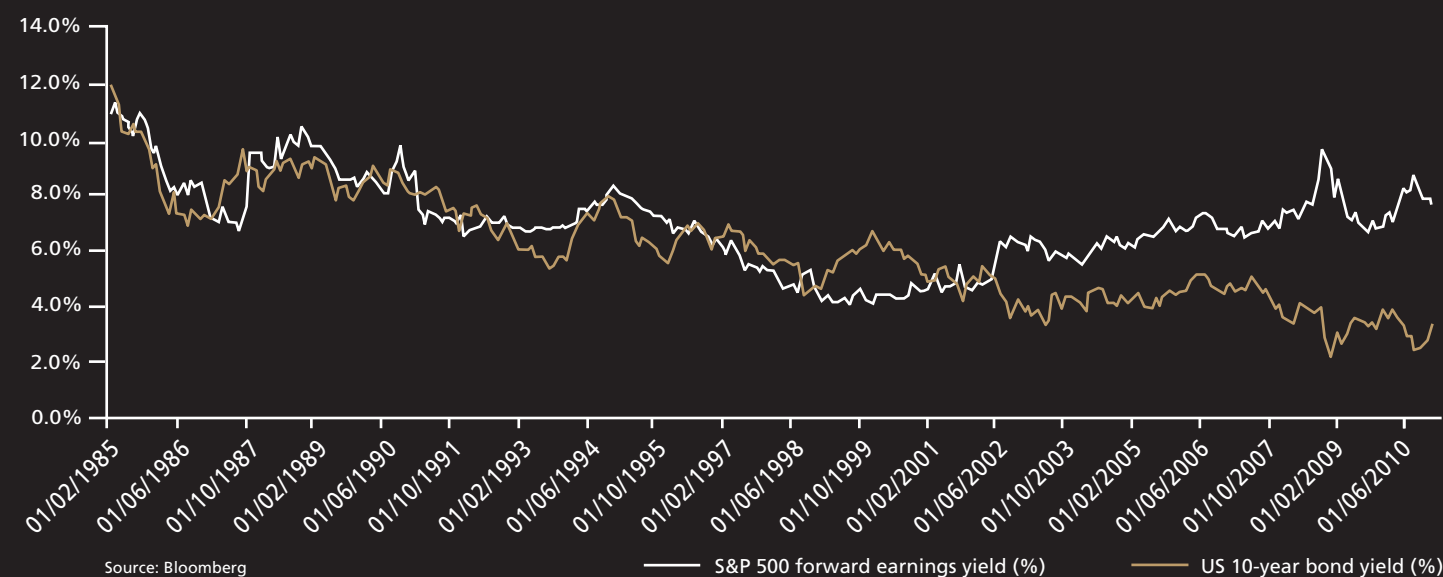


Figure 2: Equities undervalued relative to bonds



# Further steepening likely for US yield curve

The recovery efforts in the United States look set to continue into 2011 as the Federal Reserve ponders over its range of options available to help boost economic growth. The country has been trying to kick-start its economy through quantitative easing, more specifically debt repurchasing programmes designed to stimulate growth. While recent economic data proved encouraging, there are still various concerns over the vital signs and indicators that the US recovery has fully taken flight.

In this article, we will explore some insights regarding the economic situation and ongoing recovery efforts in the US, as well as how bond yield curves are impacted by the situation.

## Strong Consumption Demand in 2010 leading to 2011

One of the key themes of the recovery efforts in the US has been its accelerating consumption demand, as it drives other demands.

A report by DBS Group Research (DBS) on the US economy titled "US: Is labor recovering or not?" written in December 2010 highlighted that the economic condition in the US is still fairly robust. For instance, retail sales growth has accelerated to a 10-year high of 7.9% year-on-year in December 2010. Total real consumption grew 2.8% in 3Q 2010 compared to 2.2% in 2Q 2010 and is expected to grow at its long-run average rate of 3%. Growth in business investment has been doing similarly well, averaging 14% quarter-on-quarter growth in 2Q and 3Q 2010. However, we believe that business investment growth will moderate to 8% in the coming quarters. At such a rate, growth still remains reasonable.

The focus this year, as a result of 2010's aggressive recovery efforts and strong demand affecting the US trade balance, will be on the US government's fiscal position.

Even if the government budget deficit stays stable and ranges from US\$500 – 700 billion from 2011 to 2020, outstanding debt would increase by 6 – 7% on an annualised basis for the next ten years. These are based on figures from the Congressional Budget Office shown in Figure 2.

Figure 2: America's debt challenge (USD billions)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Outstanding debt at the beginning of the fiscal year	7,272	8,863	10,129	11,022	11,795	12,498	13,287	14,171	15,068	15,969	16,962
Government Budget Deficit		1,066	665	525	438	507	585	579	562	634	685
Interest on outstanding debt (assuming average coupon = 2.25%)		199	228	248	265	281	299	319	339	359	382
Outstanding debt at the end of the fiscal year	8,863	10,129	11,022	11,795	12,498	13,287	14,171	15,068	15,969	16,962	18,029
Annual growth in outstanding debt (%)		14.3	8.8	7.0	6.0	6.3	6.6	6.3	6.0	6.2	6.3

Source: Congressional Budget Office, Bloomberg and DBS Group Research (as of Jan 2011)

## Possibility of a credit downgrade

Two major credit ratings firms, S&P and Moody's, have warned that the US would need to find a way to reverse the rising debt-to-GDP ratio, or risk a possible downgrade of its credit ratings. The US currently has the highest possible credit rating and stable outlook at both raters. US national debt currently stands at \$14 trillion and rising, and they will have to pay in excess of \$200 billion a year just to service it.

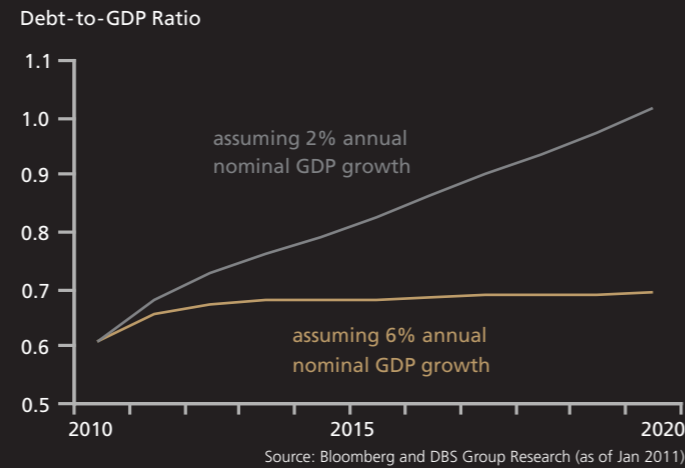
Another factor that comes into play is the debt limit it has set for itself. Congress has set the limit at \$14.3 trillion, and they are only \$335 billion away from the ceiling, with Treasury Secretary Timothy Geithner estimating the ceiling would be reached between 31 March 2011 and 16 May 2011.

Federal Reserve Chairman Ben Bernanke, in his testimony before the Senate Budget committee on January 7, warned that "an important part of the federal budget deficit appears to be structural rather than cyclical; that is, the deficit is expected to remain unsustainably elevated even after economic conditions have returned to normal". He further cautioned that the high rates of government borrowing would both drain funds away from private capital formation and increase foreign indebtedness, with adverse long-run effects on U.S. output, incomes, and standards of living".

In 2010, monetary and fiscal stimuli helped allay the chief concerns – economic recovery and the threat of a double-dip recession. This year, the tools utilised in 2010 – monetary and fiscal stimulus measures have resulted in new worries. Markets will be concerned about whether growth rates would be fast enough to bring the unemployment rate down and to allow the government to reduce its alarming budget deficit.

Concerns are mounting that nominal growth would not be fast enough to keep the debt-to-GDP ratio stable. These concerns in turn may also potentially drive a repricing of the risk premium on government bonds. The US economy would need to grow 6% nominally for the debt-to-GDP ratio and debt service burden to be stable, given projections made by the Congressional Budget Office, as shown in Figure 1 below.

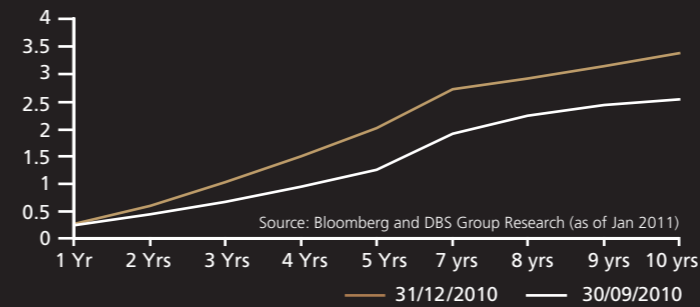
Figure 1: America's Debt Challenge



## US treasury yield curve is likely to steepen

The 2-year and 10-year Treasury curve steepened considerably in 4Q 2010. In the last three months (30 September 2010 – 31 December 2010), 10-year yields have increased 70 basis points relative to 2-year yields, and the yield spread currently stands at 270 basis points, as can be seen from Figure 3.

Figure 3: US TREASURY AND BOND YIELDS



Some of the steepening effect can be put down to a realignment of economic fundamentals. The monetary and fiscal stimulus packages put in place by the Federal Reserve have helped to improve economic sentiment, lessening the likelihood of a sharp slowdown and deflation and putting pressure on bond prices. This appears to be the main reason why the steepening has occurred. With expected GDP growth rates of 2.6% and annual CPI inflation of 1.5% in 2011, 10-year Treasury yields should definitely be higher than the extremely low levels they are currently at.

The bond market may also be pricing in inflation or a greater credit risk premium as we expect the market to be increasingly driven by the debt concerns in 2011, compared to 2010.

We believe that the US economy will achieve between 2.5% to 3% real GDP growth in 2011, aided by the latest round of stimulus measures, while unemployment rate should continue to fall. The unemployment rate improved to 9.4% in December 2010, the lowest level since May 2009 and the biggest fall in more than a decade.

As the government deficit will remain elevated, total US marketable public debt (Treasury securities outstanding) will rise to US\$9 trillion in 2011, from US\$4 trillion in 2007 and US\$8 trillion in 2010. The 2-year/10-year Treasury spread should steepen to a new high, above 300 basis points, as nominal growth will not be strong enough to ease the concerns mentioned – high debt levels

and a possible downgrade in credit rating. Investors will look to seek higher risk premiums for holding longer dated maturities, driving yields up and prices down. 10-year Treasury yields are likely to trade between 3% and 3.5% in the coming months with risks tilted towards higher yields, and end 2011 above 4%.

Investors sensing an upturn in economic prospects will gradually sell out of longer term bonds, moving into the equities market. Bond prices, which move inversely to interest rates, would start to dip, while the equities market should see higher trading volumes as investors move funds in amidst buoyant expectations.

The factors mentioned above could possibly unnerve markets, causing a sharp rise in the yields that dampens investors demand to hold US Treasury securities. In our view, these factors, aligned with economic growth and inflation, should all imply upward pressures on yields.

## What a steepening yield curve means

In summary, pricing in of inflation, possibility of a downgrade adding on to the risk premium that investors would demand, and a reasonable pace of economic growth are the three key reasons why the 2-year to 10-year yield curve is steepening and may continue to steepen going forward. But what does a steepening yield curve mean?

The yield curve tracks the relationship between the yields of short maturity bonds and longer maturity bonds and provides insights into investor sentiment. A steep yield curve traditionally provides incentive for investors to borrow short-term in order to invest in long-term projects, as short-term rates are much lower while long-term rates are higher. It also allows for economic growth as banks and other lenders become more willing to lend in expectation of repayments at higher long term rates. This generally bodes well for banks who borrow short term in the form of client deposits and lend long term to generate profits.

In general, with steep yield curves being good indicators of improving economic sentiment and growth, there is also less fear of the US slipping back into recession.

The author for this article is from the Investments & Market Advisory Team in DBS Bank.

# DBS Treasures celebrates with a night to remember



Pearlyn Phau, Managing Director and Regional Head of DBS Treasures, addressing guests

Without the support of our clients, DBS Treasures would not be where we are today. With that in mind, 120 DBS Treasures clients, staff and business partners were invited to The Gallery at Grand Hyatt Hotel on 8 December 2010 to end the year on a high note. The appreciation dinner celebrations started with a cocktail session, where light canapés and champagne were served. Clients also had the option of having their pictures taken at our photo booth, which were then developed instantly for them to take home as mementos.

Before the dinner commenced, guests were greeted with a welcome speech by Ms Pearlyn Phau, Managing Director and Regional Head of DBS Treasures. This was followed by a sumptuous five-course fusion treat specially prepared for every guest. Throughout the evening, clients were entertained by accomplished jazz/bossa and samba singer, Dawn Ho and the Indigo band. They performed moving renditions of "It had to be you", "Come rain or come shine", before ending with Christmas carols as the night drew to a close.

Before we finally called it a night, a toast was raised by Pearlyn, with a parting note to health, wealth and happiness for everyone.

(continued on back page)

# A DBS Treasures Exclusive

The Raffles Grand Hotel d'Angkor, Siem Reap and the Raffles Hotel Le Royal, Phnom Penh are iconic examples of Art Deco and French colonial architecture from the late 1920s.

Each is nestled in a tranquil location – Raffles Grand Hotel d'Angkor faces the delightful Royal Gardens while the Raffles Hotel Le Royal is just a short distance from Wat Phnom.

Both hotels indulge you in a level of service and style that are unmatched anywhere in Asia, while the restaurants and bars have mouthwatering local and international cuisine paired with wine lists that are comparable to some of the finest establishments in Paris.

## Raffles Grand Hotel d'Angkor, Siem Reap



Accommodation of your choice at 20% off the best available rate, with a host of privileges:

- Daily Champagne buffet breakfast at Café d'Angkor
- 24-hr Cambodian Butler service for all guestrooms
- Daily local newspaper
- Unlimited bottled drinking water, replenished daily
- Amrita Spa bathroom amenities
- Daily turndown service
- 24-hr High-speed wireless internet access in room and public areas
- Signature mocktail and cold towel upon arrival
- Daily fresh fruit platter in the room
- Access to Amrita Spa, Jacuzzi, Steam Room, Sauna, Gymnasium and Swimming Pool

### Complimentary Evening Activities from 7.15 – 7.45pm

- **Mon & Fri** - Wine tasting at Restaurant Le Grand's wine cellar
- **Tue & Sat** - Signature cocktail tasting at the Conservatory
- **Wed & Sun** - Local cultural display and lotus flower activities
- **Thu** - Classical dance at hotel lobby



## Raffles Hotel Le Royal, Phnom Penh



Rates start from US\$215 per room per night inclusive of:

- Complimentary round-trip airport transfers in a Mercedes E-280 Class
- 55-minute massage for two (choice of Aromatherapy, Swedish or Traditional Khmer massage)
- Complimentary buffet breakfast at Cafe Monivong
- Early check-in and late check-out subject to availability
- 24-hr High-speed wireless internet access in room and public areas
- Signature mocktail and cold towel upon arrival
- Daily fresh fruit platter in the room
- Access to Amrita Spa, Jacuzzi, Steam Room, Sauna, Gymnasium and Swimming Pool



To make a reservation at either hotel:

1. Singapore & Hong Kong toll free number 001 800 1723 3537
2. For bookings at Raffles Hotel Le Royal, Phnom Penh: telephone +855 23 981 888 or email [bookus.phnompenh@raffles.com](mailto:bookus.phnompenh@raffles.com)
3. For bookings at Raffles Grand Hotel d'Angkor, Siem Reap: telephone +855 63 963 888 or email [bookus.siemreap@raffles.com](mailto:bookus.siemreap@raffles.com)

**Promotion Period: 1 March 2011 – 31 May 2011, please quote DBS Treasures Exclusive promo code PDBT when making reservations.**

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