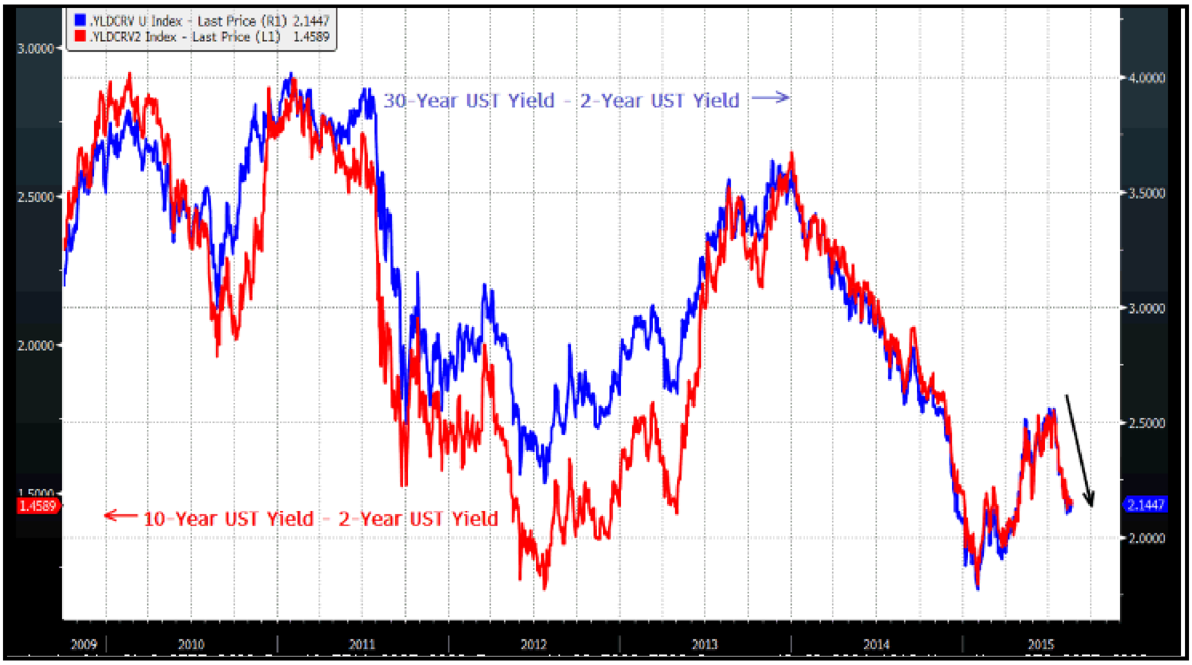
View from Bond

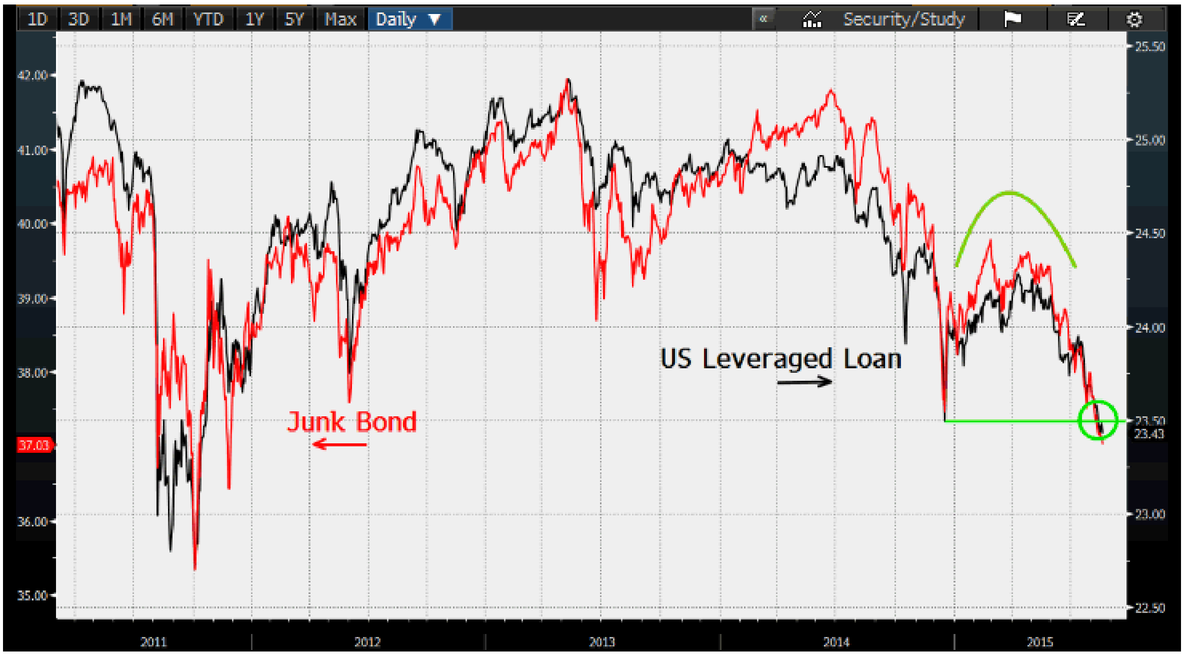
Readers who have followed our monthly Investment Letters would have realized that we have become increasingly cautious on risk assets as the traditionally volatile summer months approached. While acknowledging that the world is still flush with liquidity, we have become particularly concerned about the valuation of US equities, the sustainability of US corporate earnings growth and the deteriorating technical conditions of the market.

The recent developments in the bond markets have further heightened our nervousness for risk assets (specifically equities), especially when the fixed-income market has had a better predictive track record.

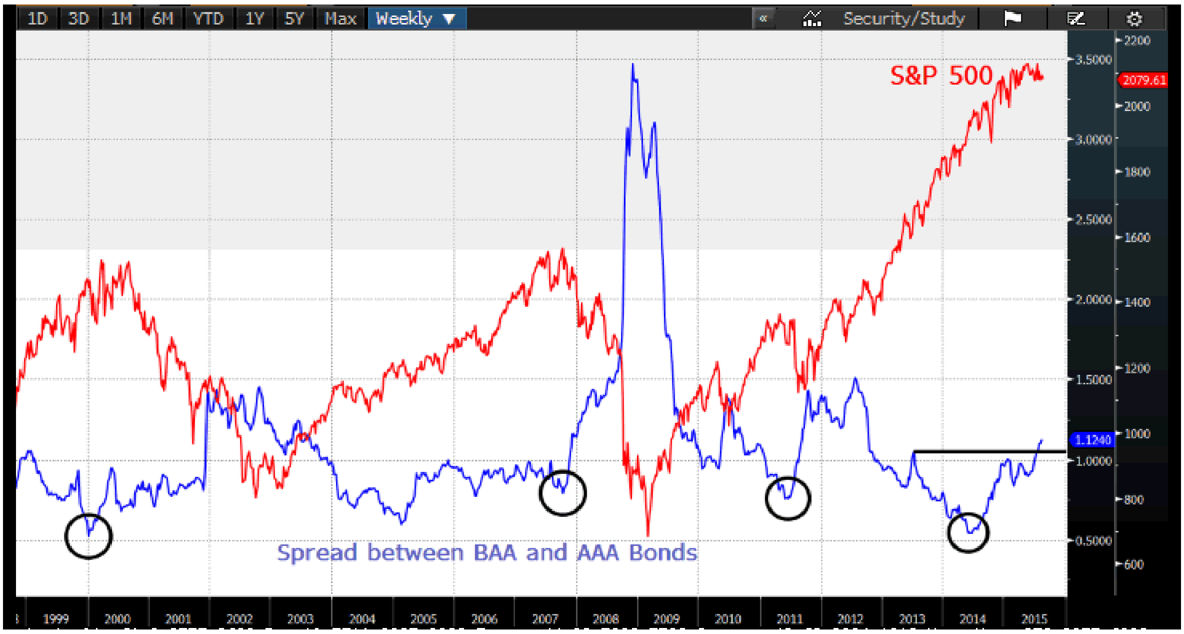
It is interesting to note that contrary to expectation the US' yield curve has flattened again from mid-July (please see chart below) amid rhetoric of an imminent interest rate lift-off by various FED governors.



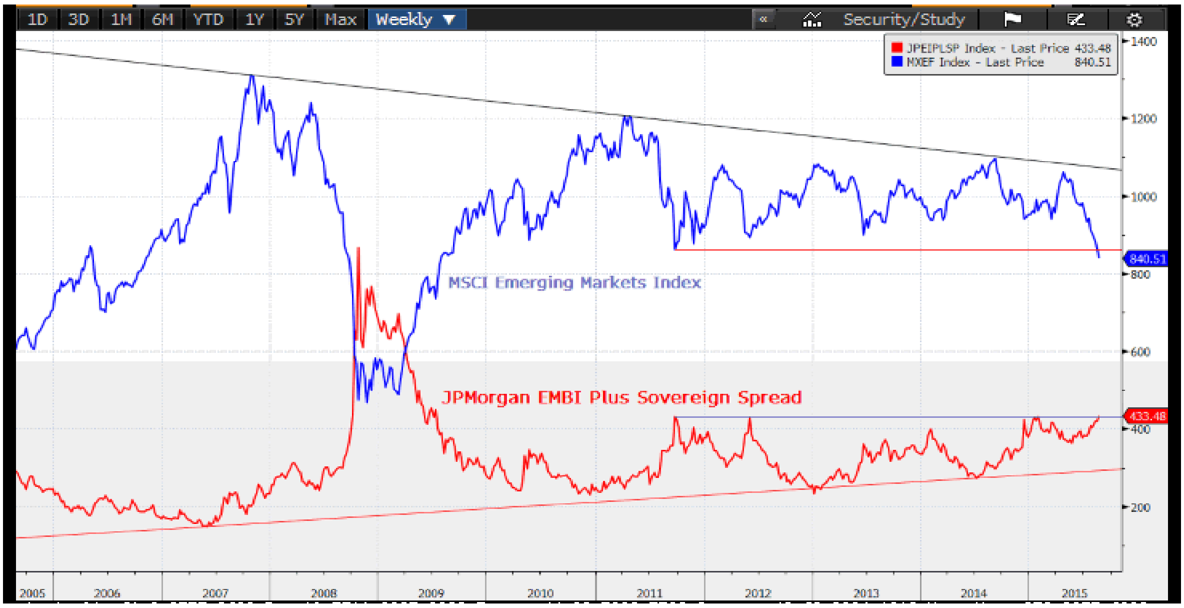
In addition the speculative corners of the US fixed-income markets, namely the US leveraged loan and junk bond markets have also demonstrated renewed weakness and broke their respective supports (please see chart below).



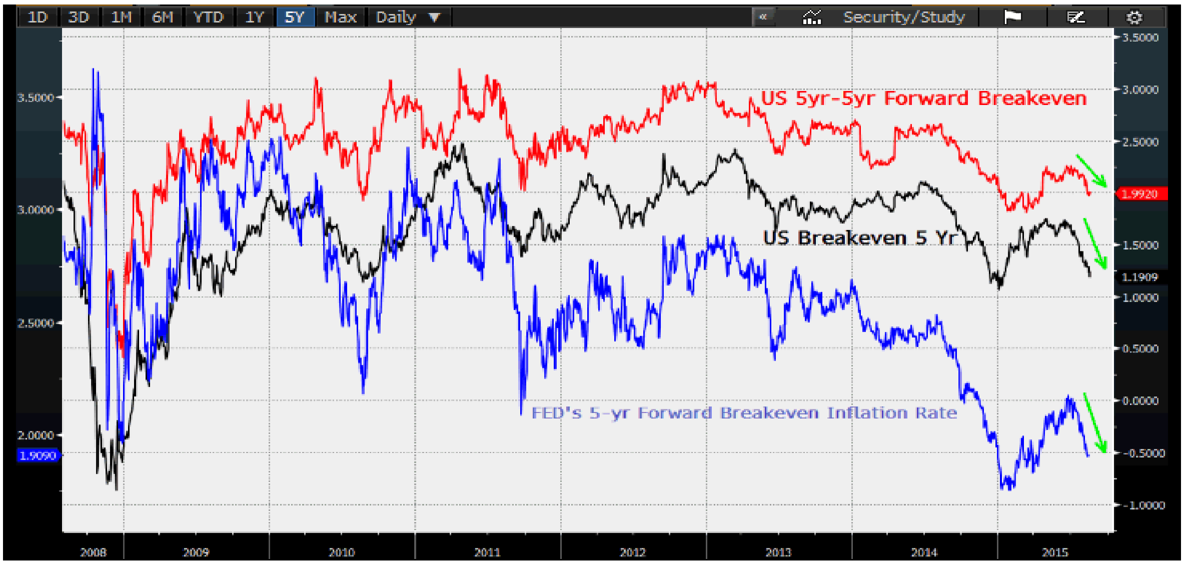
On the corporate front, investors are getting more discerning and demanding higher compensation for taking on risk. Hence the spread between Moody's AAA-rated and Baa-rated issues has widened. Historically when this spread bottomed out and widened, it has negative consequences on equity market (please see chart below).



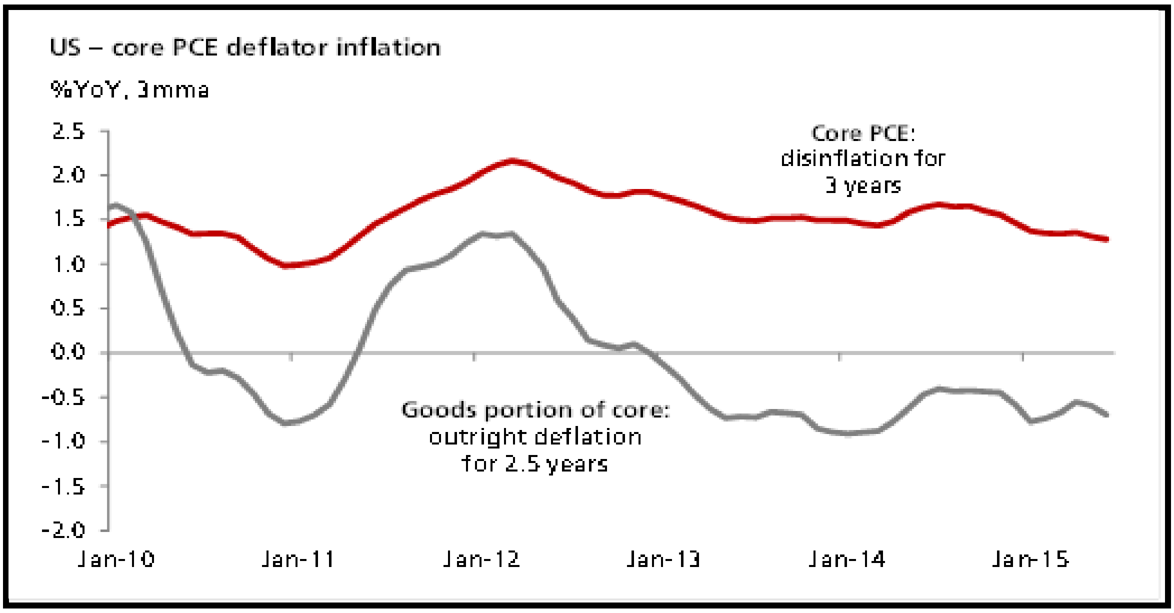
In the same vein, the sovereign spread of the Emerging Markets debt instruments has widened over the last 3 months. Similar to the above, a further widening of this spread would have an adverse impact on Emerging Markets equities (please see chart below).

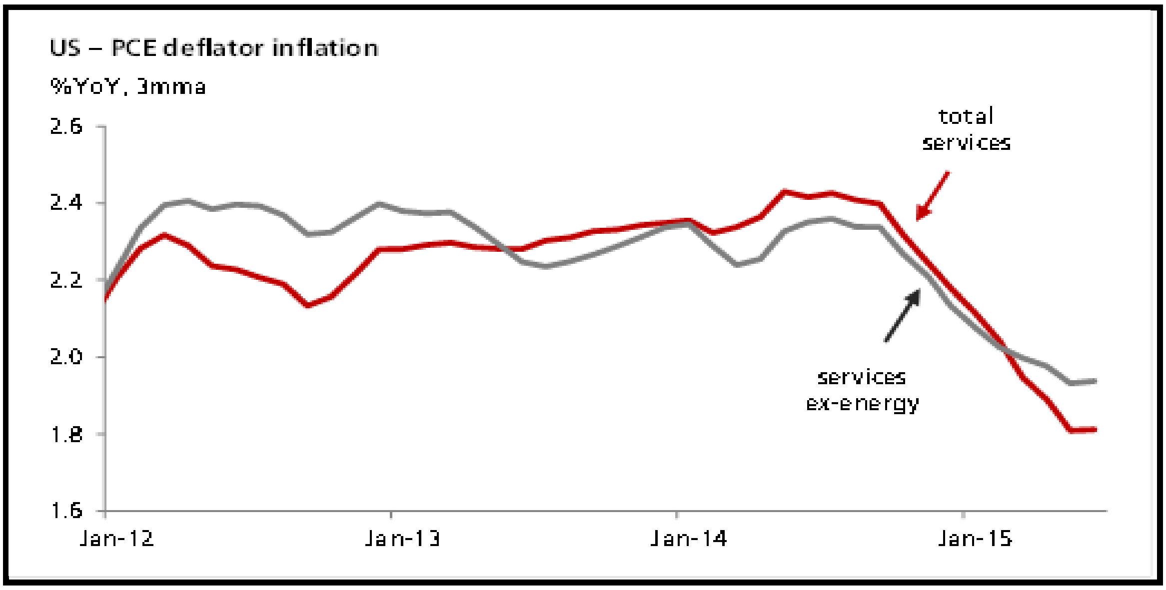


While FED Chairlady Yellen has repeatedly assured the market that a hike in the FED Fund rate is very much “data-dependent”, recent economic data especially those on inflation should make the decision to lift the benchmark interest rate a difficult one. Apart from the core Personal Consumption Expenditure Price Index (PCE) which remains lackluster, the inflation expectation as per predicted by the bond markets has turned lower again (please see chart below).



The disinflationary pressure that the US experiences is certainly more than those induced by the collapse of commodity prices. The goods portion of the core PCE Index has been in deflationary territory for the last two-and-a-half years and the services portion has also experienced disinflationary pressure over the last one year (please see charts below).





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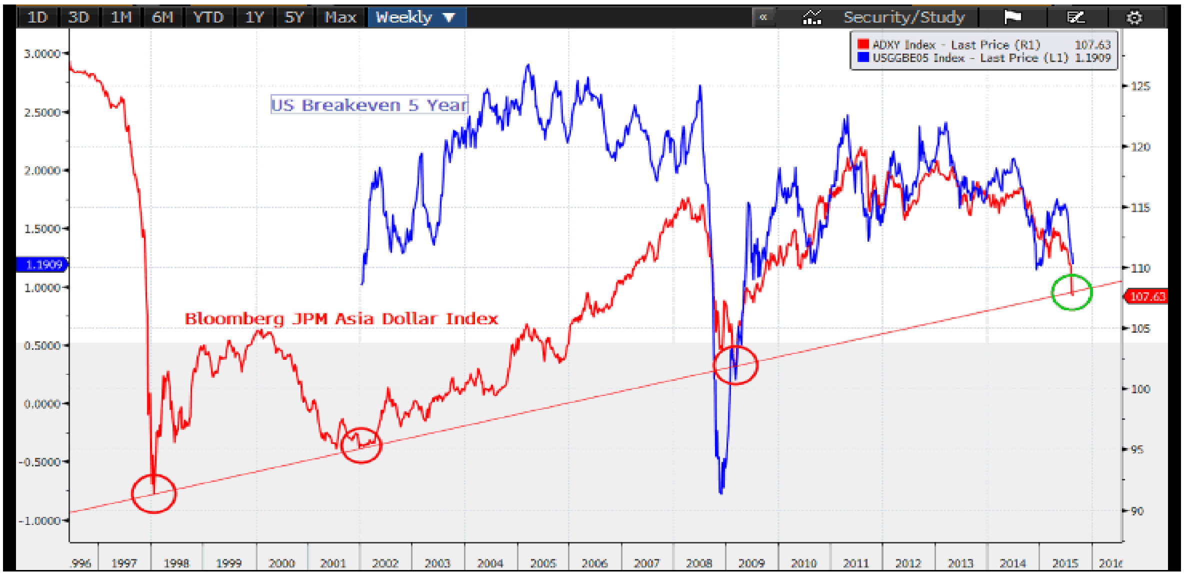
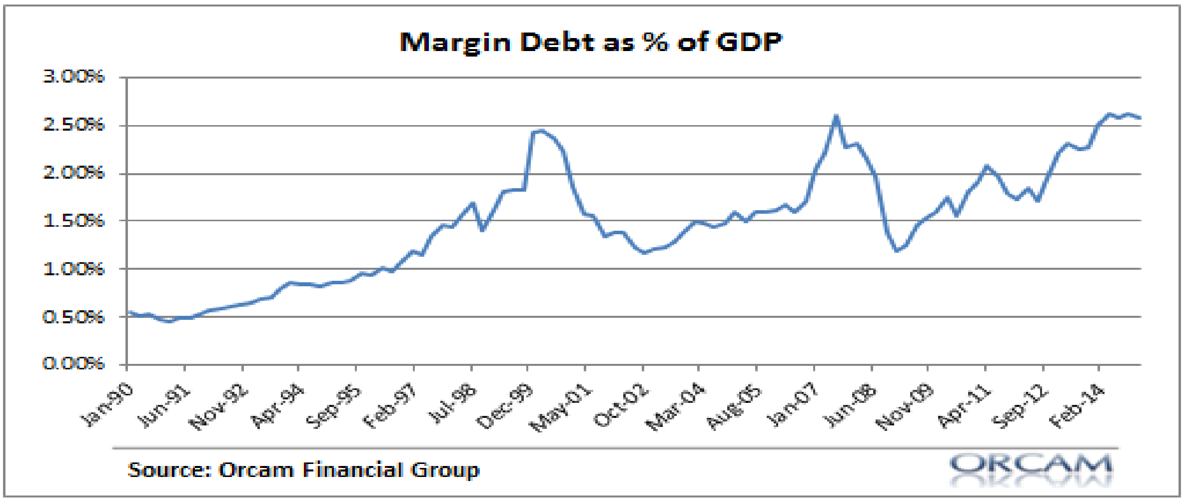
To make matter worse, the recent weakness in Asian currencies could potentially keep US disinflationary pressure intact (please see chart below).



Risk sounding like a broken record, we continue to find US equity market expensive. Having cited several valuation models in our previous Investment Letters, here we highlight the model made famous by Mr. Warren Buffett which has just flagged that the US equity market has entered expensive territory (please see chart below).

In addition, the ratio of margin debt to US GDP has reached levels which previously marked the peaks of the US equity market (please see chart below).



Finally the breadth of the New York Stock Exchange Composite Index continues to deteriorate. Thus only 39% of stocks listed on the NYSE are trading above their 200-day moving average (please see chart below). Such narrowing of market breadth suggests that the bull market is matured and increasingly vulnerable to correction.

Source: Bloomberg, CLSA, DBS, Orcam, Wilshire Associates, Zero-Hedge

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