Gearing Up For A Summer Top?

The "Sell in May" phenomenon was delayed this year as global equities saw a late selloff that wiped out an almost 2% gain in May. Triggered by uncertainty over the Greek debt talk, the MSCI World Equity Index declined -0.41% for the month. Going forward, the Greek drama is likely to dictate the direction of global markets. This is especially when Greece is facing a slew of debt repayment datelines throughout June till mid-July.

Meanwhile the strong out-performance of the MSCI Emerging Market Equity Index versus its Developed Market peer in the preceding month was reversed in May (please see chart below) as a -1.80% correction in the commodity space (led by oil), as well as the rising G3 sovereign bond yields weighed heavily on emerging market equities.

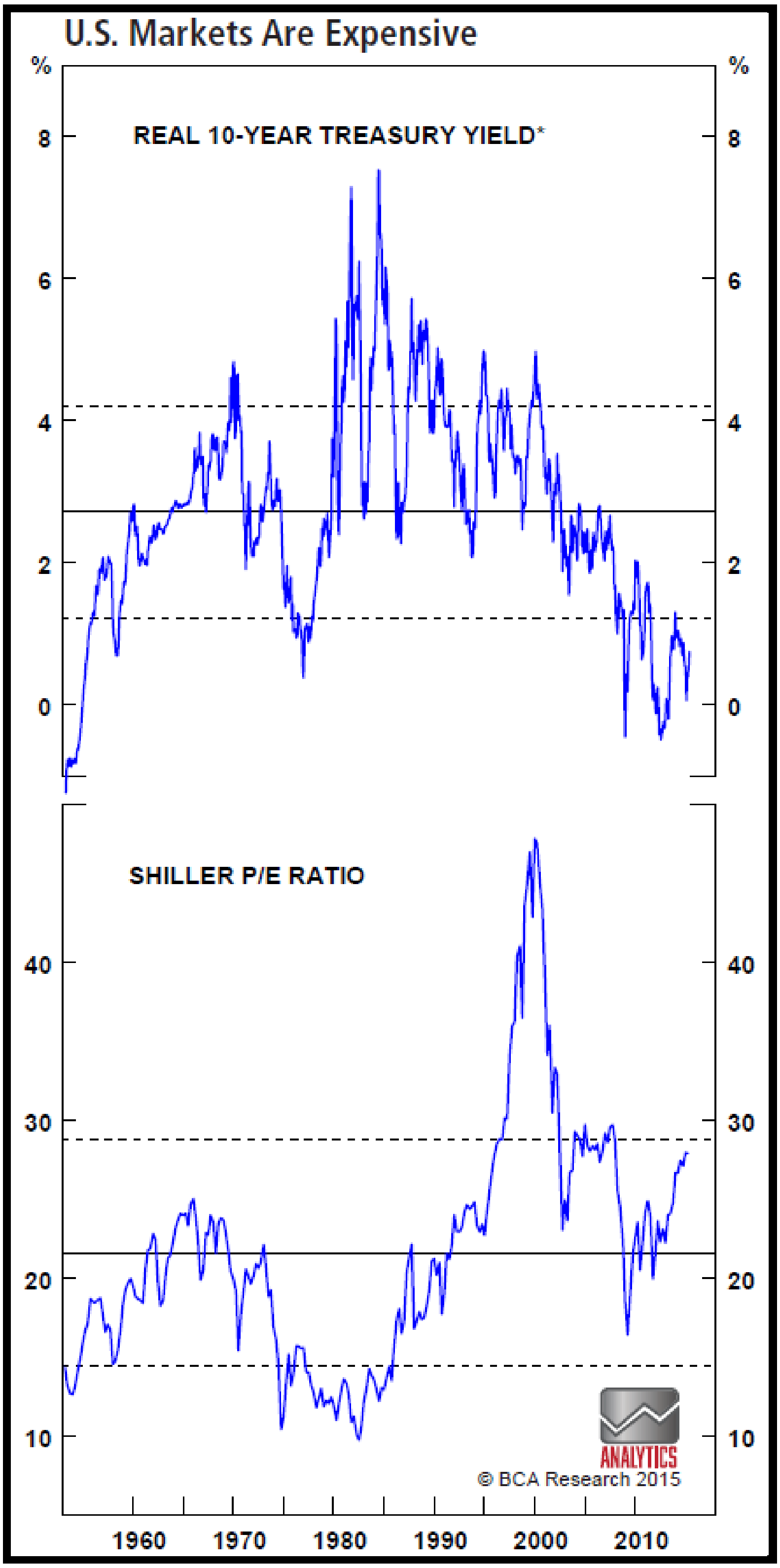
The bond rout which began in April continued apace (please see chart below) despite a generally soft global economic environment throughout May. As a result, the Bloomberg

USD-denominated Investment Grade Corporate Bond Index fell -0.82% for the month. While the recent bond selloff in the G3 economies has not adversely impacted developed market equities, a sustained rise in the risk-free rates certainly warrant caution.

Having said that it is interesting to note that in a central bank-distorted financial world, both US equities and US Treasury bonds have become "so overvalued" simultaneously for the first time since World War 2, according to a recent BCA Research report (please see chart below).

Hence US real long bond yield has surpassed one standard deviation below its historical average since World War 2. Concurrently the cyclically-adjusted price-earnings (CAPE) ratio of the US equity market has edged closer to one standard deviation above its historical average.

Accordingly historical evidence has suggested that the risk-reward of investing at such overvalued real bond yield and CAPE ratio has never been favourable over a 5-year and 10-year investment horizons.



T: +65 6590 0299 **F:** +65 6535 6255 **E:** enquiries@atlasam.com.sg
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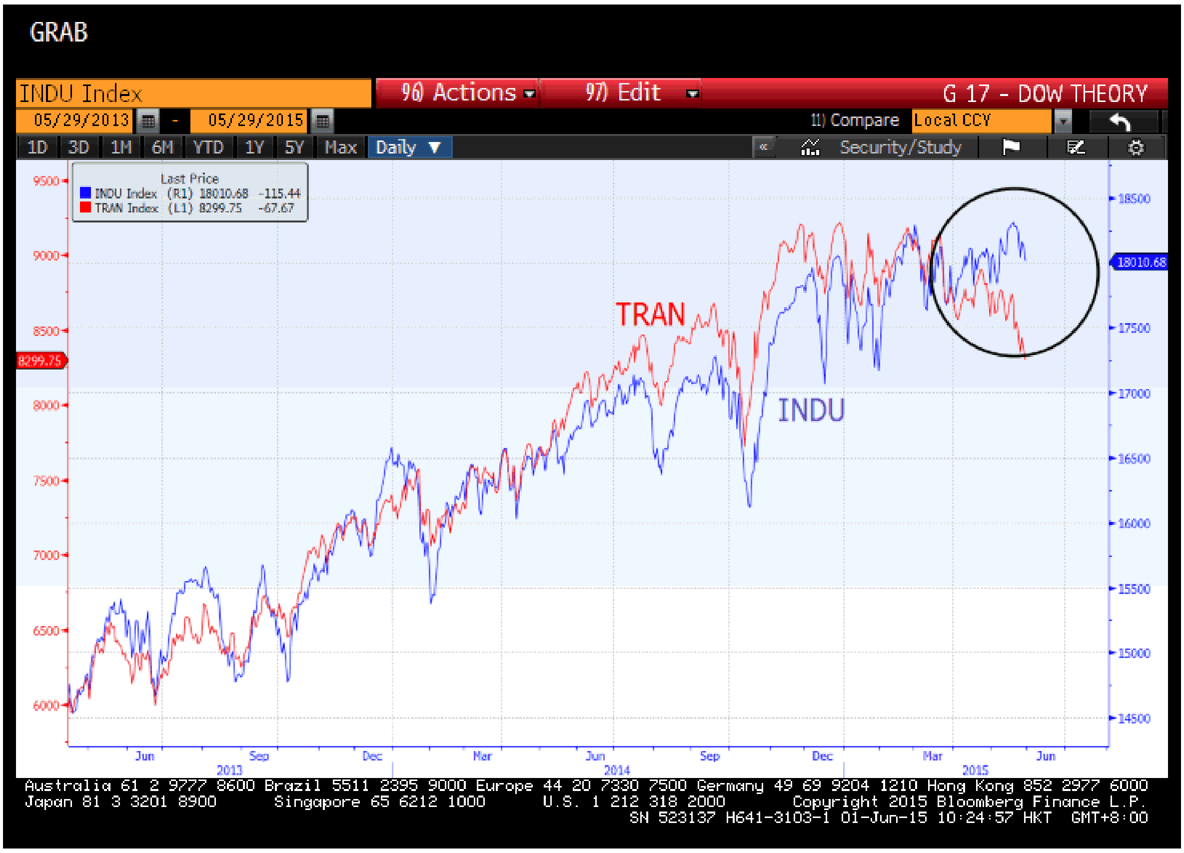
In addition, despite the recent record chalked up by the Dow Jones Industrial Average Index (INDU), the Dow Jones Transportation Average Index (TRAN) has fallen below important technical support levels to a seven-month low. The clear divergence between INDU and TRAN (please see chart below) is a non-confirmation on the new high set by the former, according to the Dow Theory. While such non-confirmation does not portend a major selloff, it does point to a potential peak in the making.



Meanwhile apart from the Dow Theory non-confirmation, the breath of the US equity market has also deteriorated even as the major US equity indexes scaled new heights (please see chart below). Hence the number of stocks advancing has started to lag the number of stocks declining, leaving fewer and fewer stocks to push the market index higher. From a technical analysis perspective, such divergence if sustained is never healthy.

Back in Asia, the world's second largest capitalized equity market continued to hog the limelight. The wild gyration exhibited by the Shanghai Composite Index (SHCOMP) largely reflected the greed and fear of a market driven largely by retail money and leverage (please see chart below). Hence the margin debt as a percentage of tradable market capitalization of the Mainland domestic equity market has reached an unprecedented high of 7.8%. This is way above US' margin debt to tradable market capitalization of 2.0%.

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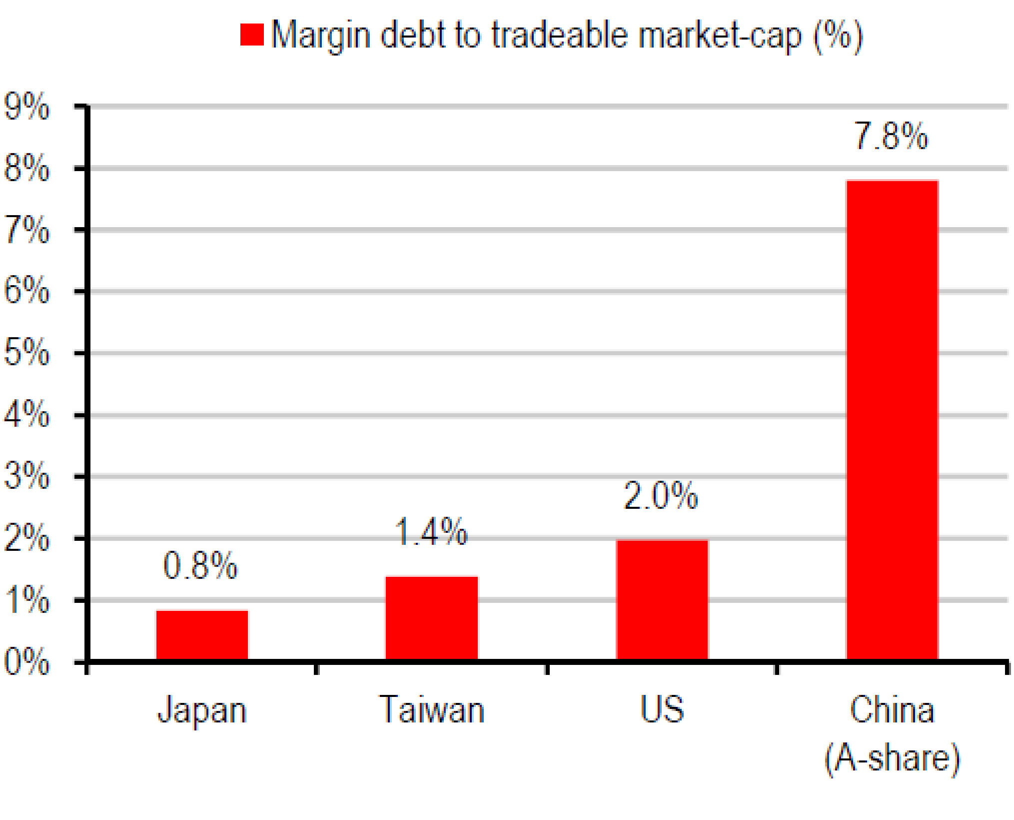
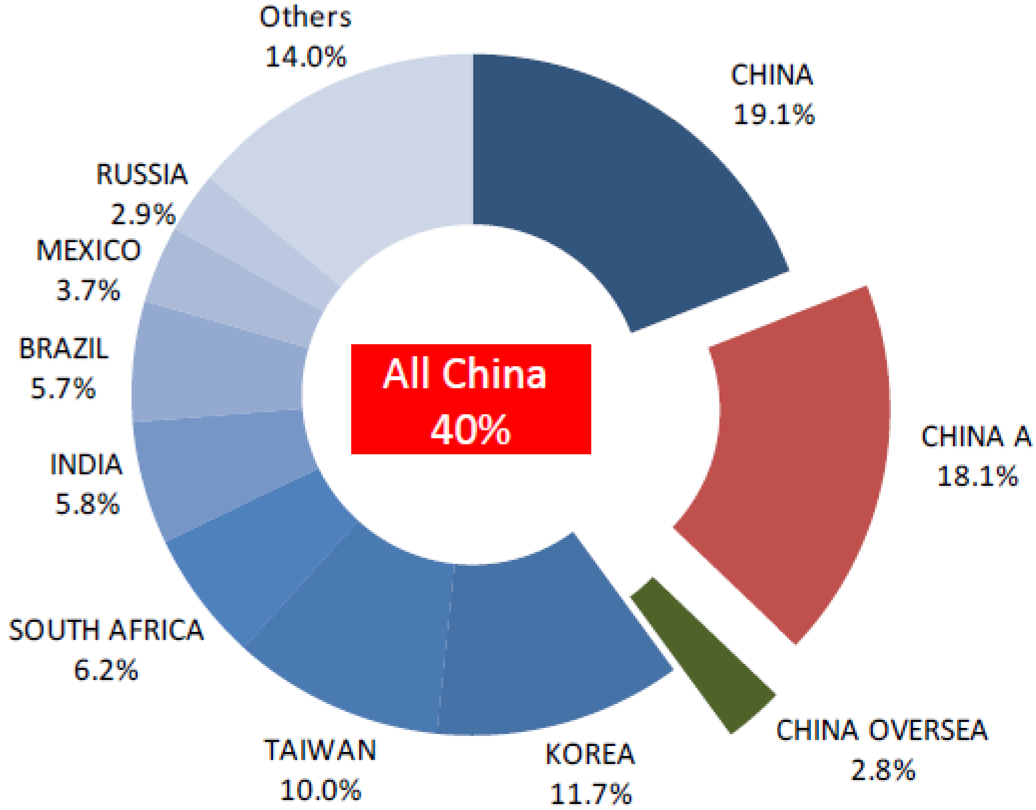


Source: Bloomberg, HSBC Equity Strategy

While the 6.5% single-day collapse of the SHCOMP on 28 May 2015 must have left many wondering if the “bad news is good news” phenomenon in China is sustainable, technically there could be another positive factor supporting China domestic A-share market in the near horizon. That is the potential inclusion of the A-shares into MSCI Emerging Markets Index. Currently, without the A-shares inclusion, Chinese equities already constituted 22% of MSCI Emerging Market. A potential A-shares inclusion which may be announced in early June would raise the weight of China to as much as 40% of the MSCI Emerging Market Index (please see chart below) and send benchmark-hugging fund managers to allocate more funds to China domestic equity market.

Hypothetical Weight of China A inclusion into EM



Data as of March 31, 2015. Based on the hypothetical scenario of full inclusion of A-shares into the MSCI Emerging Markets Index and the announced inclusion of overseas China (e.g. Baidu and Alibaba)
There is no suggestion here on if and when the inclusion will happen.

Source: Bloomberg, BCA, BoAML, CLSA, HSBC, LGT, MSCI, UOB Kay Hian

T: +65 6590 0299 **F:** +65 6535 6255 **E:** enquiries@atlasam.com.sg
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