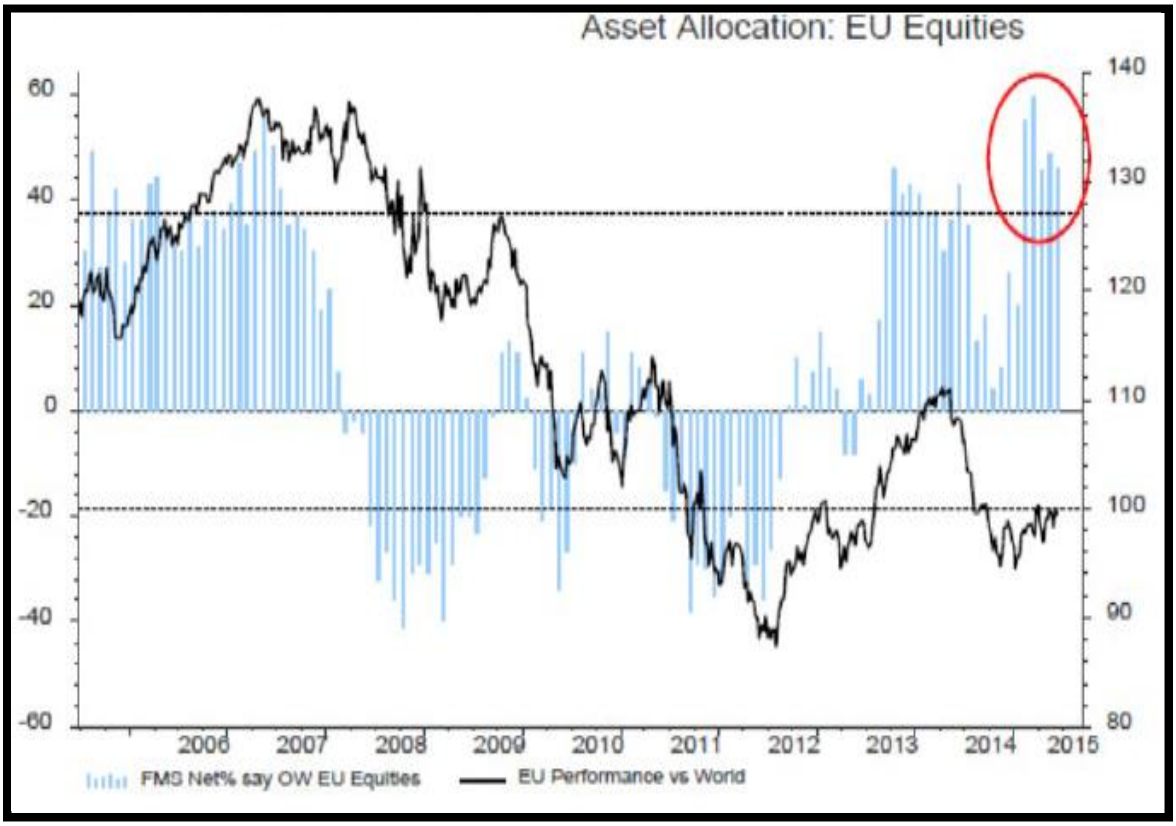
Into The Danger Zone

The local newspaper's headline on the Greek drama read, "Greek crisis enters dangerous phase" after Prime Minister Tsipras' talk with the country's creditors failed. For too long, investors have been lulled into thinking that the creditors will blink and give in to the demand of Greece (again!). Investors have been complacent and remained overweight in European equities (please see chart below) despite the potential uncertainty pose by Greece. Thus when the plot of the 5-year old story turned out differently, investors were caught off guard and fled for the exit.



As highlighted in our previous letter, Greece dictated investors' sentiment and direction of global financial markets for most of the month. The FOMC's assurance of a "gradual" approach to any potential rate hike and China Central Bank's cut in both benchmark interest rates as well as the reserve requirement ratio became side shows and failed to mitigate the sell-off in risk assets.

For the month, the MSCI World Equity Index declined -2.53% while the Bloomberg USD-denominated Investment Grade Corporate Bond Index fell -1.63%. Despite the Greek saga, yield on the 10-year US Treasury climbed +23bps to end the month at 2.35%, though off the intra-month high of 2.50%. Meanwhile commodities performed well with the Continuous Commodity Index chalking up a monthly gain of +2.93%.

Having said that it is important to note that Greece is too small to have a material impact on the world economy and the global financial markets. Nevertheless against a background of high valuation and risk assets that are priced for perfection, any source of uncertainty is bound to affect sentiment and trigger negative knee-jerk reaction. Hence while the European Financial Credit Default Swap spread spiked, it is still way below the levels seen in the past crisis (please see chart below).

Across the Atlantic, bond yields continued to edge higher despite the Greek saga. The bond rout which began in April saw yield on the 10-year US Treasury moving up +43 basis points in the past 3 months, resulting in a first quarterly loss for US Treasuries since 2013.

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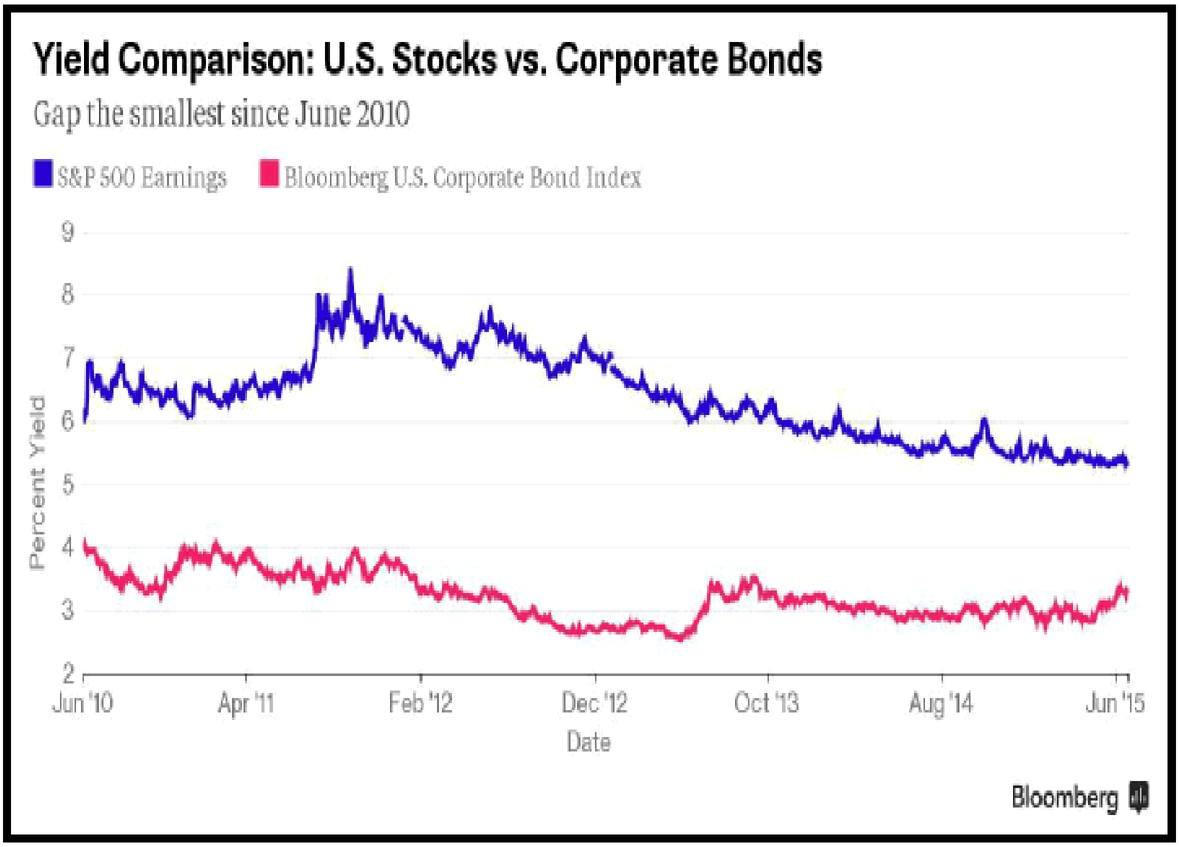
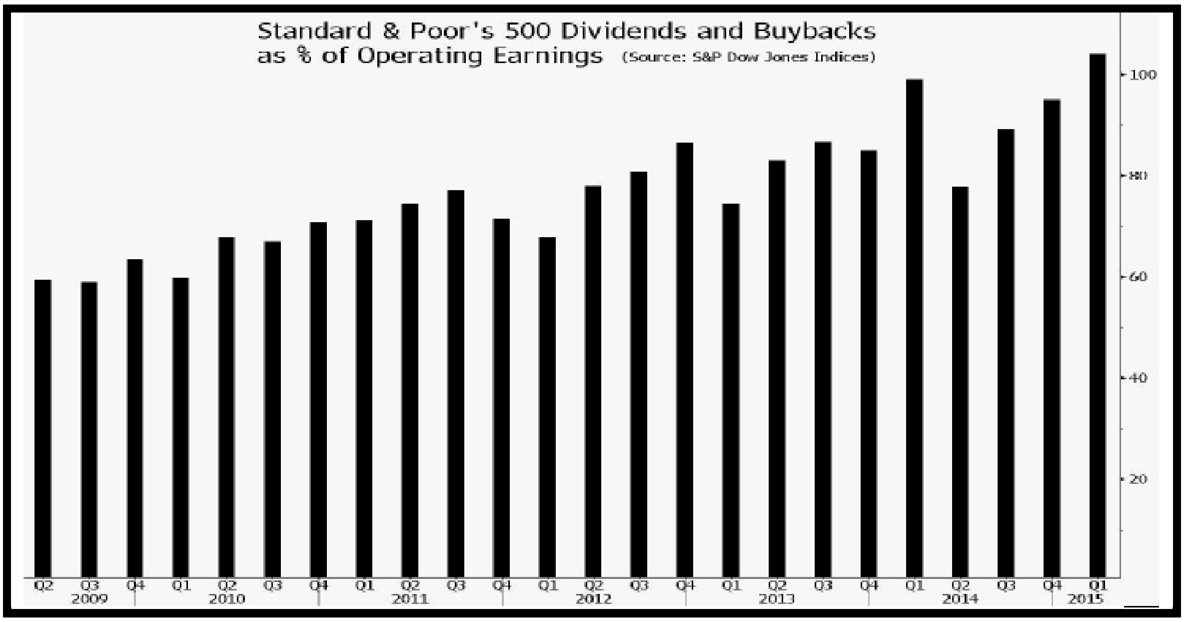
The sequential rise in US corporate bond yields narrowed the spread between the rates US corporates pay and the earnings yield for US equity. As a result, the yield gap that US equity commands over US corporate bond has tightened to the narrowest level since the equity bull market began five and a half years ago (please see chart below).



Meanwhile the latest data from S&P and Dow Jones Indices suggested that the combined amount of share buybacks and dividends handed out by companies in the S&P 500 Index has surpassed the total operating earnings these companies made in the first quarter of the year. Specifically these S&P 500 companies have spent USD144.1 billion and USD93.6 billion on share buybacks and dividends respectively. As a result the combined buybacks and dividends has reached 104% of S&P 500 companies' operating earnings (please see chart below).

The last time this ratio surpassed 100% was in the second quarter of 2007 and it went on to a record high of 156.5% in the fourth quarter of 2007, just before the last bull market ended.



At the same time, US Corporate Profits relative to GDP seem to have peaked (please see chart below)…

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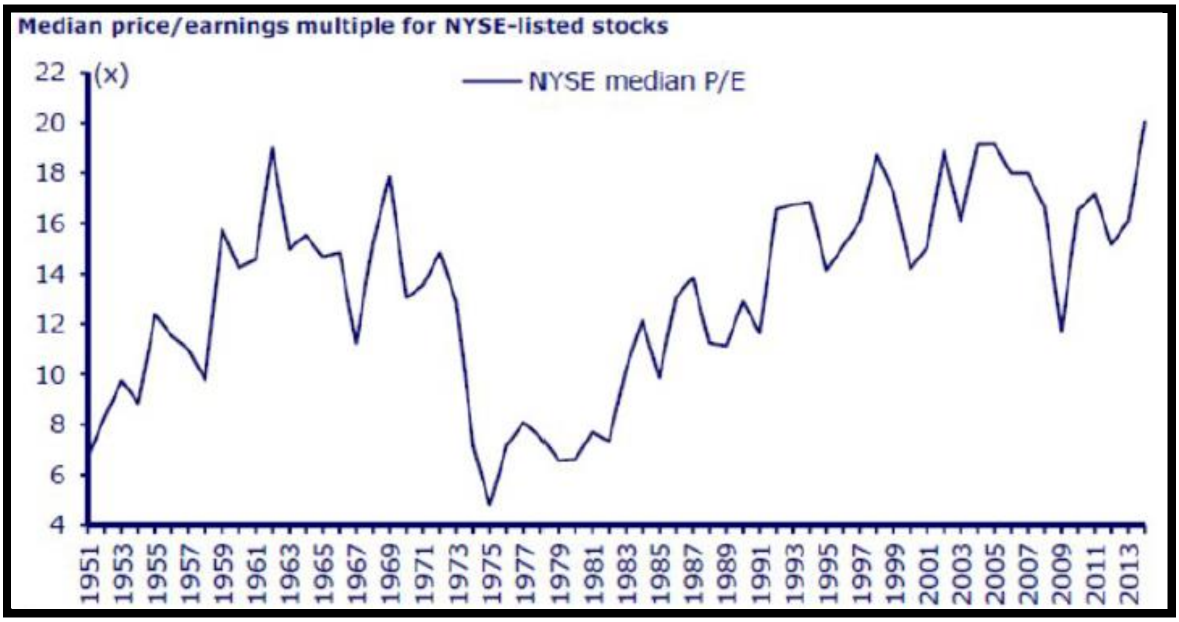
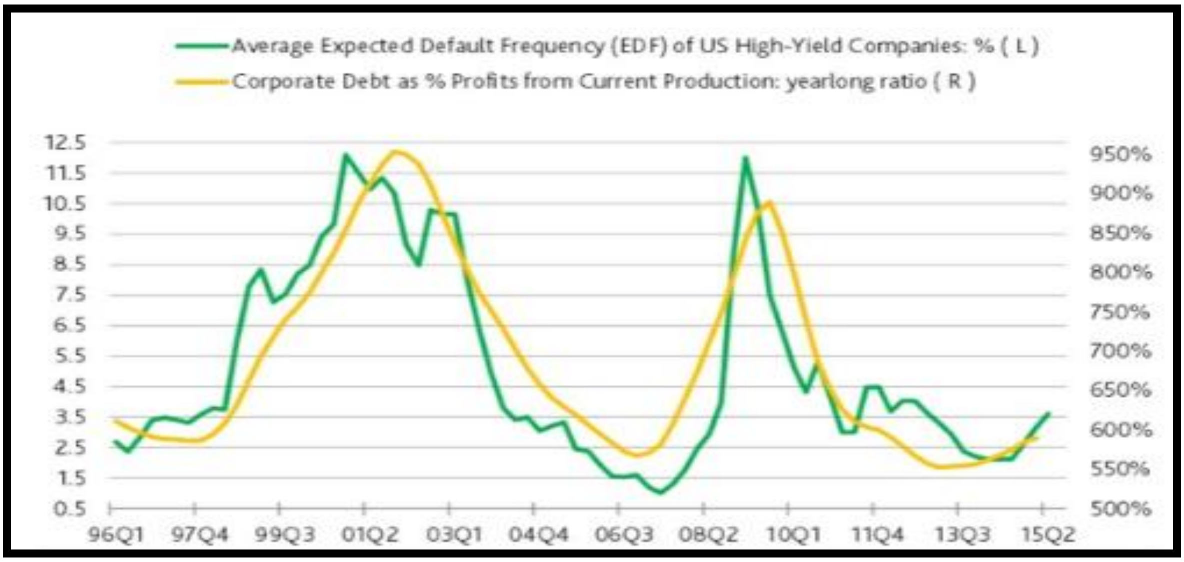
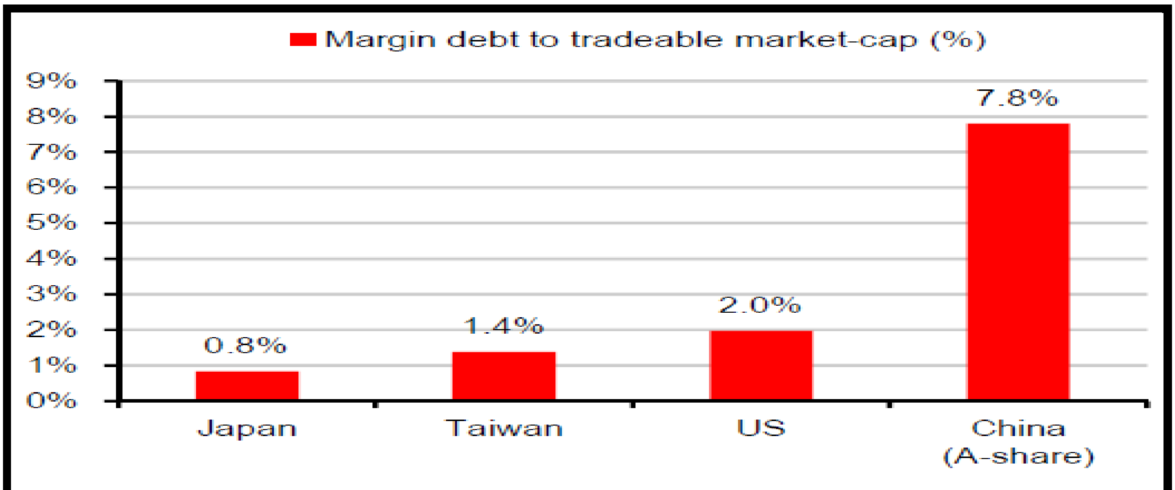
…while valuation of US equity is at record high (please see chart below).



In the bond space, it is interesting to note Moody's recent caution that speculative bonds are "in a dangerous zone" as default risk rose to levels last seen in end-2012 (please see chart below) despite the loose monetary policies around the world.



Back in Asia, the world's best performing equity market (year-to-date) has finally succumbed to the gravity of fundamentals and entered bear market territory. Having chalked up record margin debt (please see chart below), the Chinese bourse certainly needs to let some air out.



Source: Bloomberg, HSBC Equity Strategy

Historically the average decline for the Shanghai Composite Index during a bear market advance is around 36.6% (please see table below), suggesting that it may be too early to bottom fish.

Shanghai Composite: Average Bear market advance of 112%

Date	SHCOMP	Date	SHCOMP	% Declin	Duration (week	Gap (yrs
22/02/1991	134.87	16/05/1991	105.77	-21.6%	11.86	
25/05/1992	1,421.57	17/11/1992	393.52	-72.3%	25.14	1.03
15/02/1993	1,536.82	29/07/1994	333.92	-78.3%	75.57	0.25
13/09/1994	1,033.47	28/02/1995	549.26	-46.9%	24.00	0.13
22/05/1995	897.42	22/01/1996	516.46	-42.5%	35.00	0.23
12/05/1997	1,500.40	23/09/1997	1,041.97	-30.6%	19.14	1.30
3/06/1998	1,420.00	17/08/1998	1,070.41	-24.6%	10.71	0.69
16/11/1998	1,293.74	18/05/1999	1,059.87	-18.1%	26.14	0.25
29/06/1999	1,739.21	27/12/1999	1,345.35	-22.6%	25.86	0.12
26/06/2001	2,233.59	22/01/2002	1,358.69	-39.2%	30.00	1.50
8/07/2002	1,732.93	3/01/2003	1,319.87	-23.8%	25.57	0.46
15/04/2003	1,631.47	18/11/2003	1,316.56	-19.3%	31.00	0.28
6/04/2004	1,777.52	11/07/2005	1,011.50	-43.1%	65.86	0.38
16/10/2007	6,092.06	4/11/2008	1,706.70	-72.0%	55.00	2.27
4/08/2009	3,471.44	5/07/2010	2,363.95	-31.9%	47.86	0.75
8/11/2010	3,159.51	5/01/2012	2,148.45	-32.0%	60.43	0.35
2/03/2012	2,460.69	30/11/2012	1,980.12	-19.5%	39.00	0.16
6/02/2013	2,434.48	27/06/2013	1,950.01	-19.9%	20.14	0.19
Average				**-36.6%**	**34.90**	**0.61**

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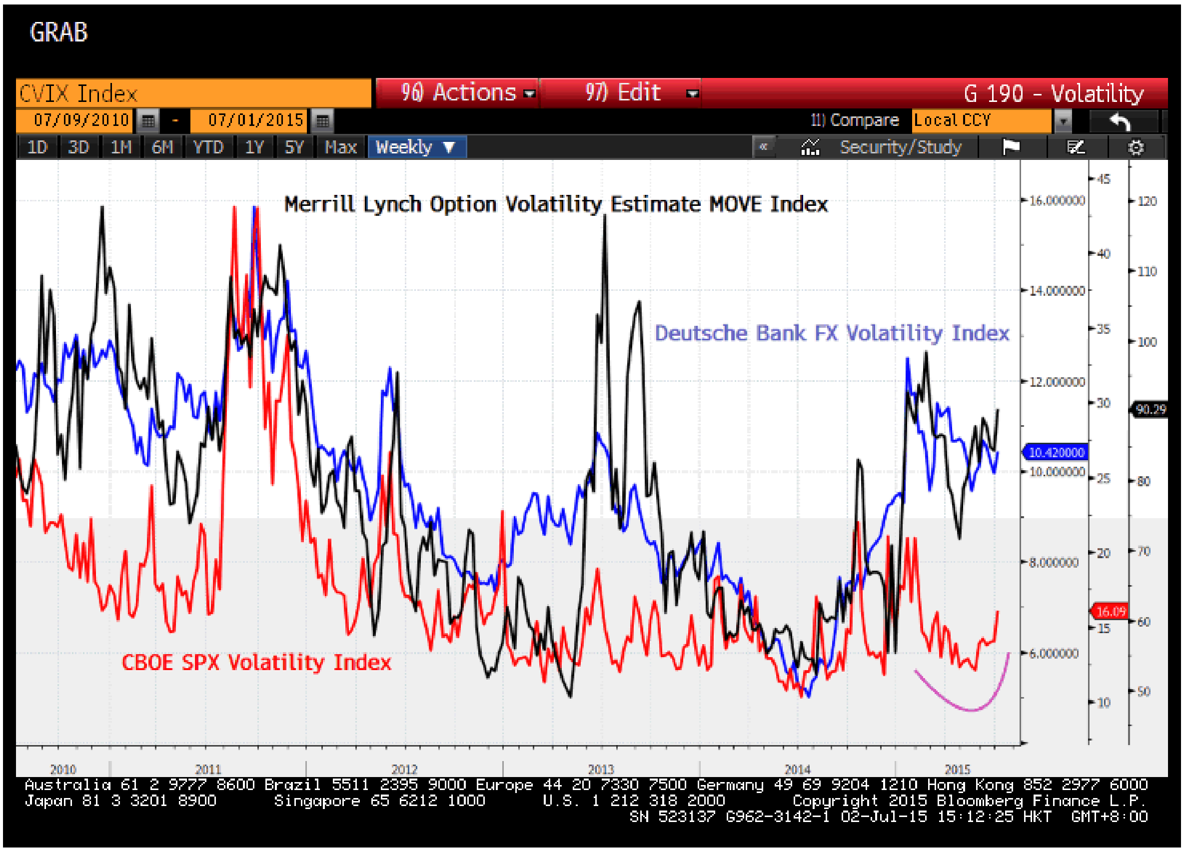
Looking forward we expect financial markets to remain volatile (please see chart below) for the rest of the year as major central banks' policies diverge.



The recent upward pressure on long bond yields and the potential hike in benchmark rate by the FOMC point to higher cost of money. Against the backdrop of softening earnings growth and rich valuations, the risk-reward dynamic is set to change going forward. Hence, this is not the season to accumulate risk aggressively.

Source: Bloomberg, BCA, BoAML, CLSA, High Net Worth, HSBC, MSCI, S&P and Dow Jones Indices

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