NOMURA
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TOP DOWN

Our view

Credit conditions remain fragile despite low real bond yields and gradual balance sheet expansion at the Fed and the ECB. The lagging effects of high input costs continue to undermine central bank policy easing, while earnings estimates are beginning to reflect the slower economic activity. Investors will need to remain mindful of the extent of inventory build-up in emerging markets.

Anchor themes

- Global inflation continues to spike at both the headline and producer price levels. In contrast with the developed economies, there is an ongoing monetary tightening in Asia. Dollar strength continues to induce the liquidation of commodities.
- Emerging market valuations have moved into line with, or below, global peers. The deleveraging of the financial system is causing the velocity of money to decrease, creating secondary credit problems.

Market calls

We maintain our view that 3Q08 will be a period of capitulation in equity markets, as weak economic growth combines with poor investor sentiment to induce a liquidation of financial assets. Earnings forecasts are still being cut. On 7 August, we added a series of regional emerging market closed-end funds to our short-run basket on substantial discounts to NAV (relative to the respective listed stock markets). We also recommend (as we have for the past six months) a basket of telecom and high dividend yield stocks.

Blocked arteries

- Financial assets still in A&E ward
- How investors can implement our view

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① Financial assets still in A&E ward

Doctor: I have some bad news and some very bad news.
Patient: Well, might as well give me the bad news first.
Doctor: The lab called with your test results. They said you have 24 hours to live.
Patient: 24 hours? That's terrible! What could be worse? What's the very bad news?
Doctor: I've been trying to reach you since yesterday.

****

Patient: What should I do if my temperature goes up a point or more?
Doctor: Sell.

Source: Superiorjokes.com

"Arteries are blood vessels that carry blood away from the heart (as opposed to veins, blood vessels carrying blood toward the heart). The circulatory system is extremely important for sustaining life. Its proper functioning is responsible for the delivery of oxygen and nutrients to all cells, as well as the removal of carbon dioxide and waste products."
— Wikipedia.com

Investor sentiment remains poor, but this can only be expected given the psychology of falling markets. After four years of consecutive annualised returns, the prospect of further asset price declines is prompting some to question the long-term expected returns on equities. Deleveraging was never going to be pleasant — since the imbalances had been deemed "normal" for an economic cycle, the withdrawal symptoms were always going to trigger a much greater dislocation of expectations.

See the important disclosures and analyst certifications on pages 11 to 13.

While the financial economy tries to deleverage without causing collateral damage in the credit markets, the global real economy is showing more evidence of a rapid slowdown. Aside from rising geopolitical tension, global investors trying to depict the best-case and worst-case scenarios for equities will need to factor in the increasing likelihood of financial distress in the US credit markets couple with a sharp rise in delinquencies. For equity investors, with a synchronised slowdown gelling for Europe, the US and Japan (notwithstanding stronger-than-expected preliminary 2Q08 GDP data for the US), emerging markets have become the last bastions of growth.

With geopolitics making the headlines more than US financials, investors should be wary of the level of inventory accumulation in emerging markets (especially North Asia and China), given that inventory-to-shipment ratios in the developed economies remain relatively low

As we highlighted in a recent Strategy Notes, *If Guangdong coughs, do emerging markets sneeze*? (13 August), a significant part of China's growth is cyclical due to the nature of its outsourcing role in the world economy. In China and other emerging markets, consumption trends remain robust. Yet, with businesses in the western economies maintaining much lower inventory-to-shipment ratios (relative to previous cycles), inventories are more likely to accumulate if the growth slowdown proves to be sharper than expected.

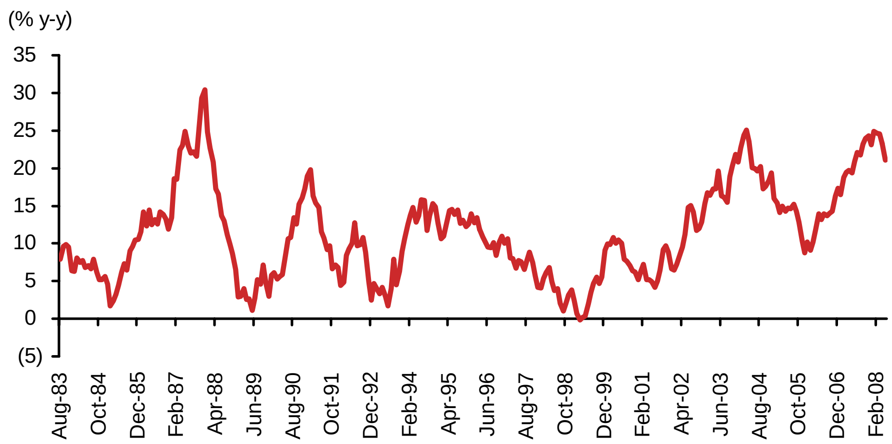
Wayward growth projections could lead to revised utilisation rates in North Asia

It should be remembered that while inventory accumulation boosts GDP in the short term, it borrows this growth from the future. Hence, with inventories still well behaved in the western economies (where auto companies have been quick to cut production), any misjudgement of prospective growth would lead to a painful readjustment of the utilisation rates of the North Asian “tigers”. It should be stressed that forward-looking purchasing manager indices (PMIs) will be critical for emerging market investors as the next two months represent the “peak” of the Christmas ordering season. Weaker PMIs alongside falling container rates ought to prompt investors to diversify their emerging market exposure even more.

② How investors can implement our view

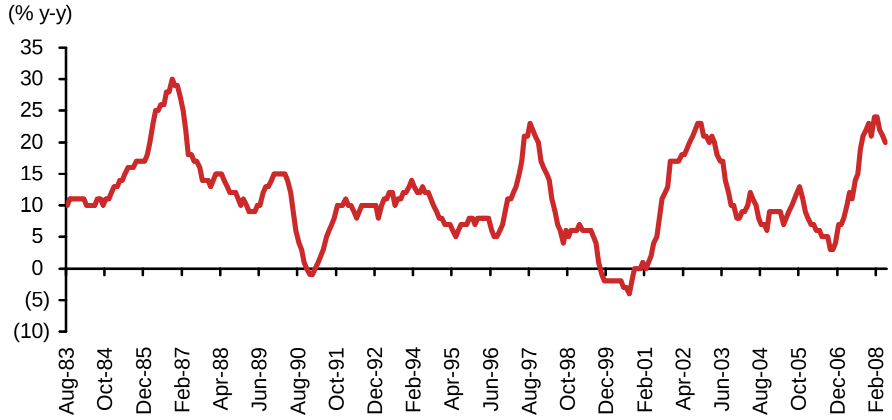
For some time we have regarded 3Q08 as a period of capitulation in equity markets, as weak economic growth combined with low investor sentiment causes a liquidation of financial assets. We recently added a series of regional closed-end funds to our short-run basket given their substantial discounts to NAV relative to the respective stock markets. We flag that earnings estimates continue to head south, and we still recommend (as we have for the past six months) a basket that contains both telecom and dividend yield stocks.

Exhibit 1. Global liquidity: US monetary base plus international reserves minus gold



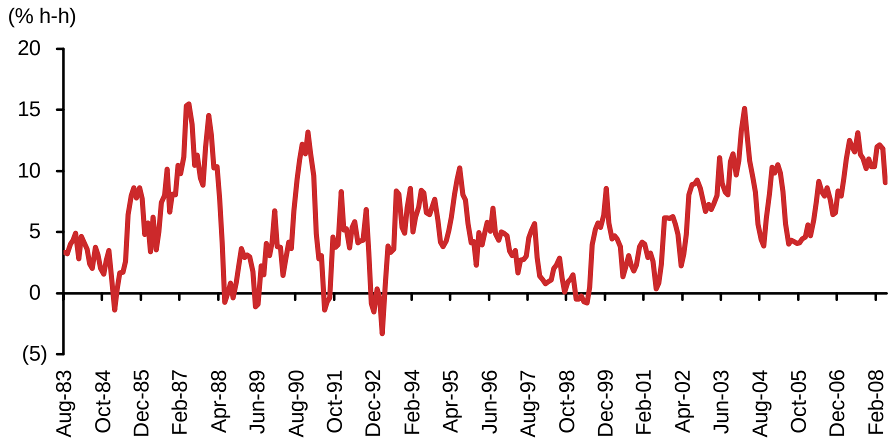
Source: CEIC data

Exhibit 2. Global liquidity: US monetary base plus foreign purchases of treasury bonds and notes (12-month moving average of y-y growth)



Source: CEIC data

Exhibit 3. Global liquidity: US monetary base plus international reserves minus gold — half-on-half growth (%)



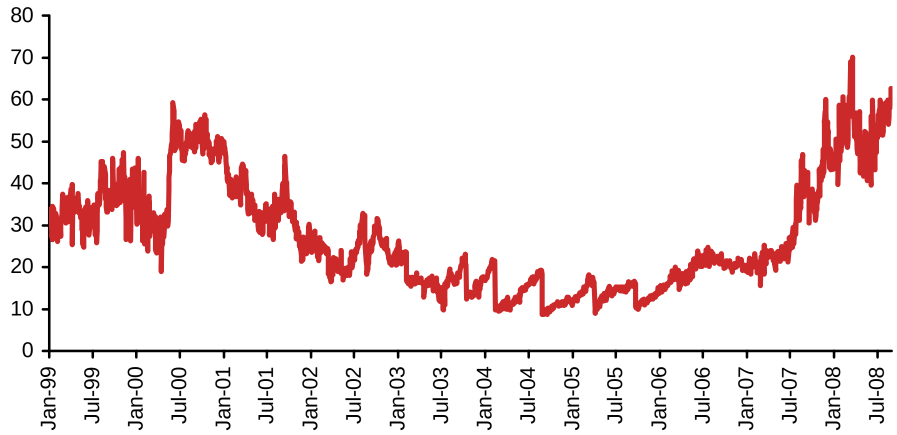
Source: CEIC data

Exhibit 4. US dollar SWAP spread ANN five years

Despite the abundant liquidity, credit spreads have widened noticeably….

Source: Bloomberg

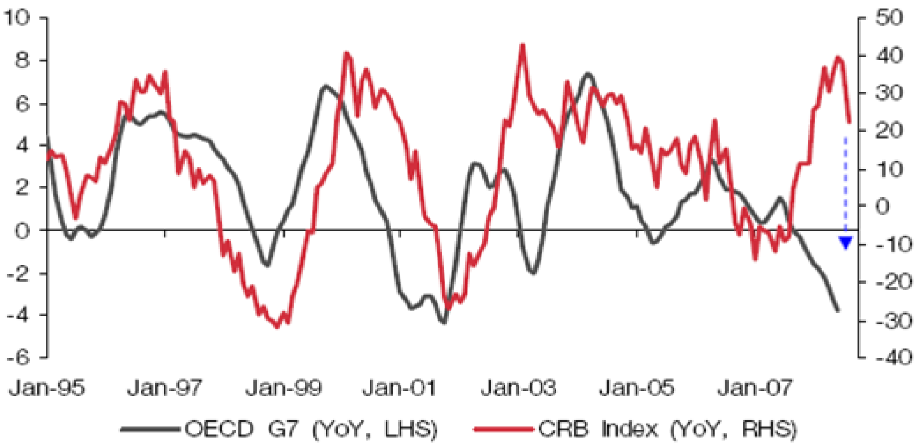
Exhibit 5. EUR SWAP spread five years



Source: Bloomberg

…suggesting that the financial system is still hoarding cash

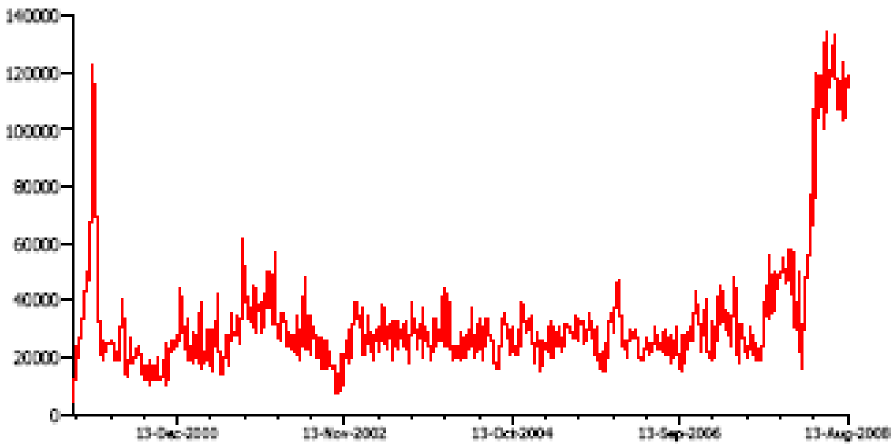
Exhibit 6. OECD lead indicator and CRB index



Source: CEIC data

Nomura's global quantitative team has flagged that the CRB is far removed from the OECD lead indicator; but since China, India and the Middle East are not in the OECD, this may not be a reliable gauge of overall demand

Exhibit 7. US Federal Reserve repo lending (US$mn)

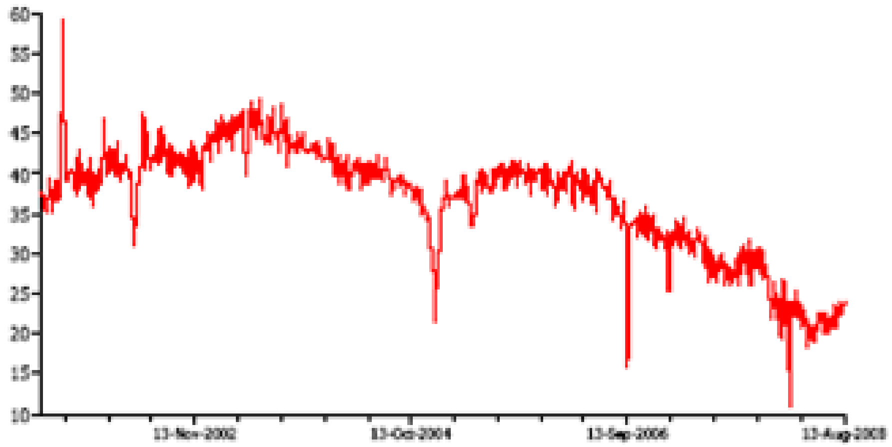


Source: CEIC data

The Fed continues to intervene in the money markets…

Exhibit 8. US Federal Reserve balance sheet growth (y-y %)

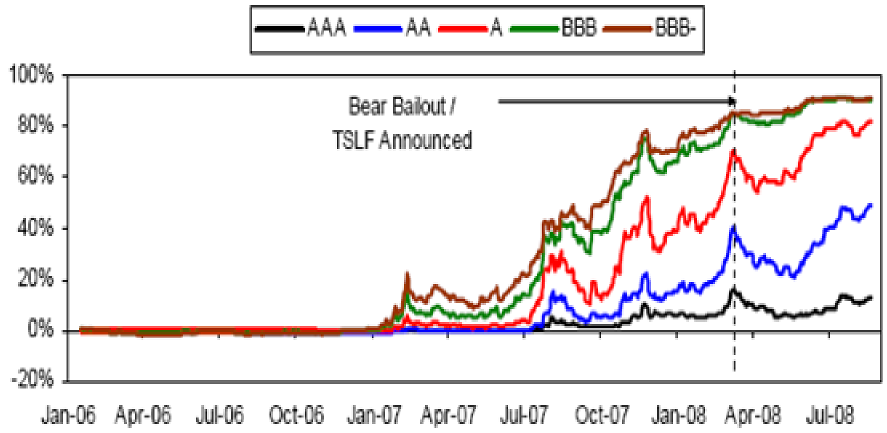
…and has begun to slowly expand the balance sheet



Source: CEIC data

Exhibit 9. ABX tranche % below par for 1H06 vintages

Asset conditions have seen no underlying improvement …



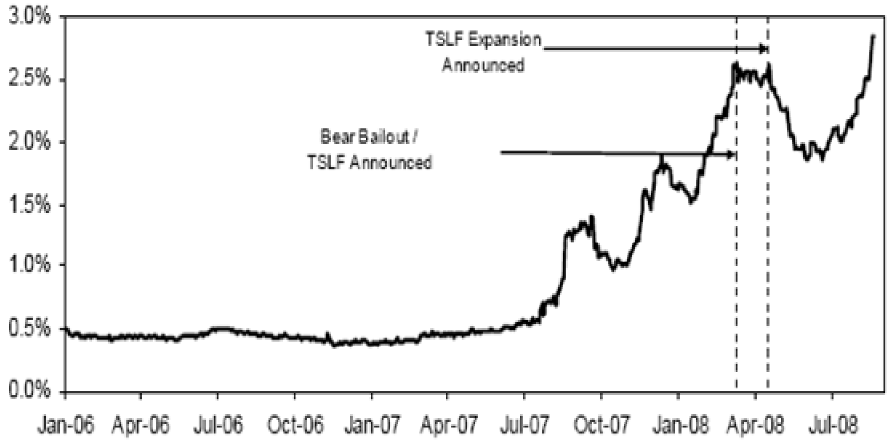
Source: Halkin, Markit

Exhibit 10. AAA corporate bid option adjusted spread

…hence financial asset prices appear to be stuck

Source: CEIC data

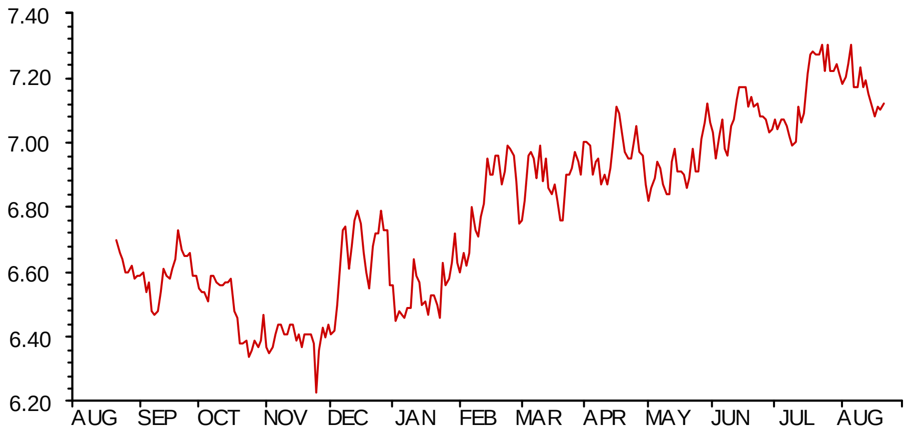
Exhibit 11. US credit card ABS index option adjusted spread



Source: CEIC data

Exhibit 12. US BAA corporate bond market (%)

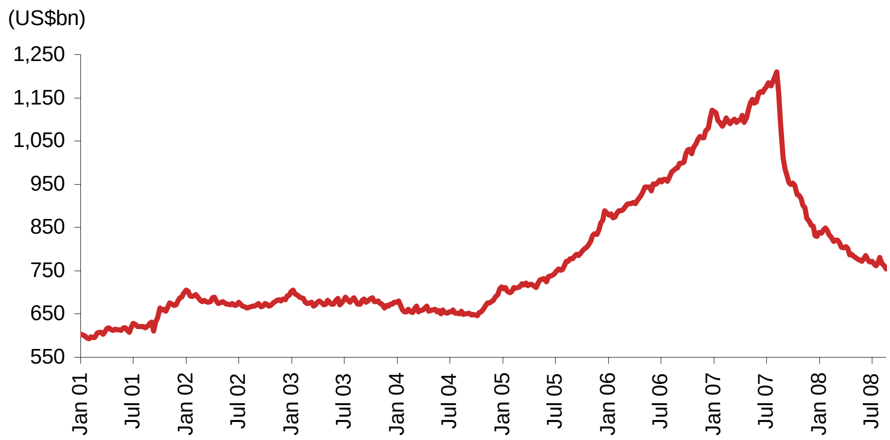
Indeed, long term corporate bond spreads are rising



Source: Datastream

Exhibit 13. Commercial paper (asset-backed) outstanding

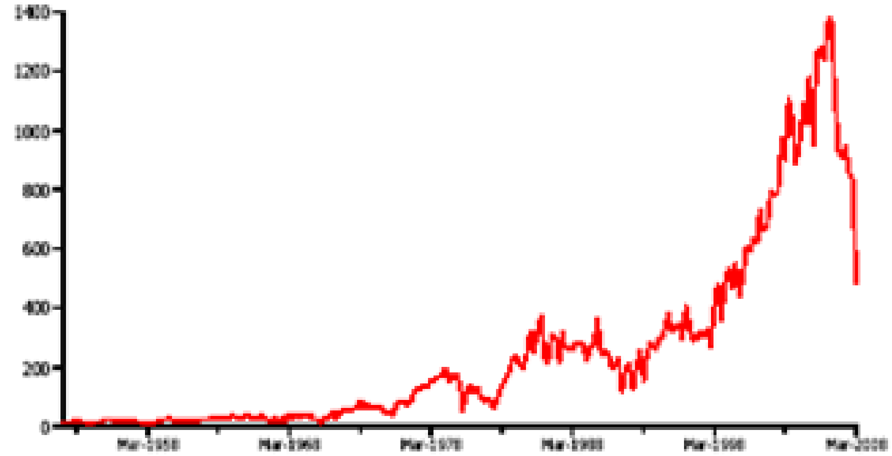
The commercial paper market (asset-backed) is dead



Source: Bloomberg

Exhibit 14. US: household borrowing (US$bn)

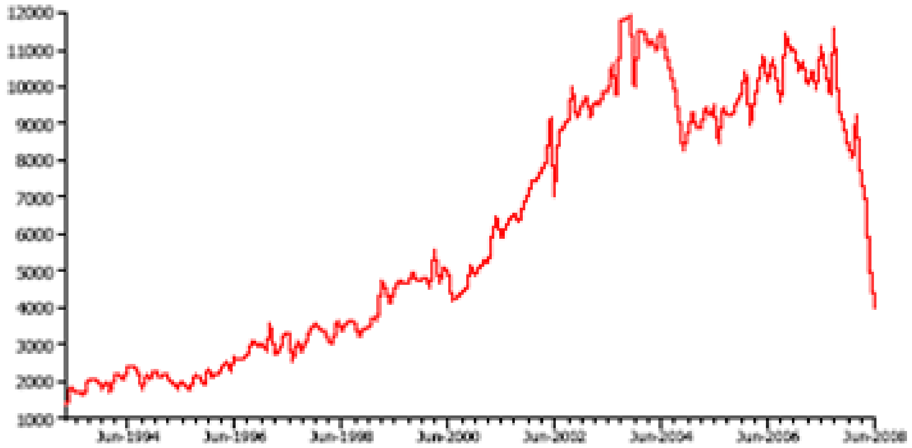
The tight credit conditions have restricted borrowing in the US…



Source: CEIC data

Exhibit 15. UK net lending (GBPmn)

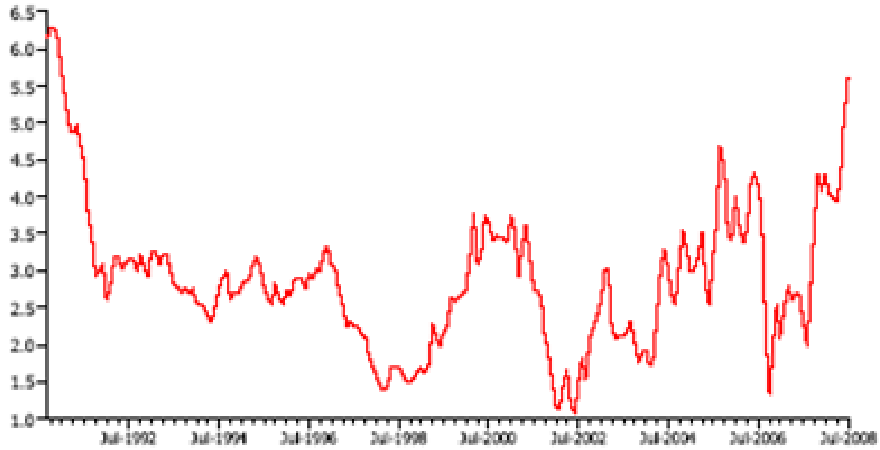
…and in the UK



Source: CEIC data

Exhibit 16. US: headline inflation

Meanwhile, inflation conditions remain aggravated...



Source: CEIC data

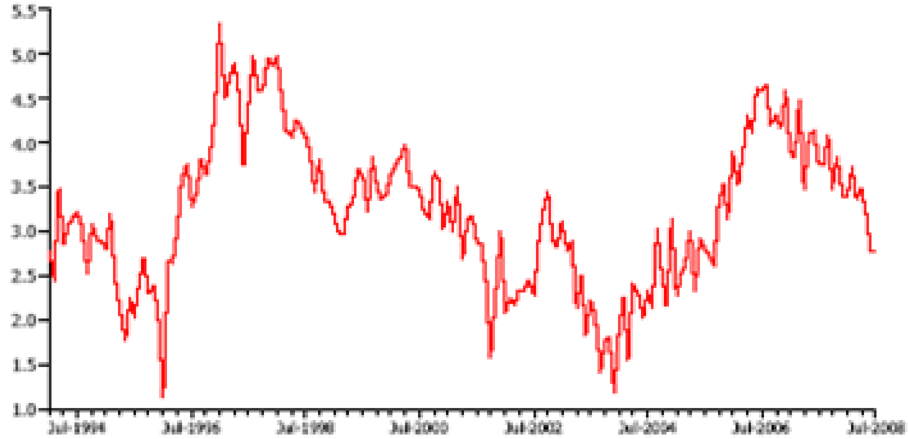
Exhibit 17. US employment growth (%)

...and employment conditions have deteriorated

Source: CEIC data

Exhibit 18. US nominal weekly wages (y-y %)

There are no signs of wage pressure in the US



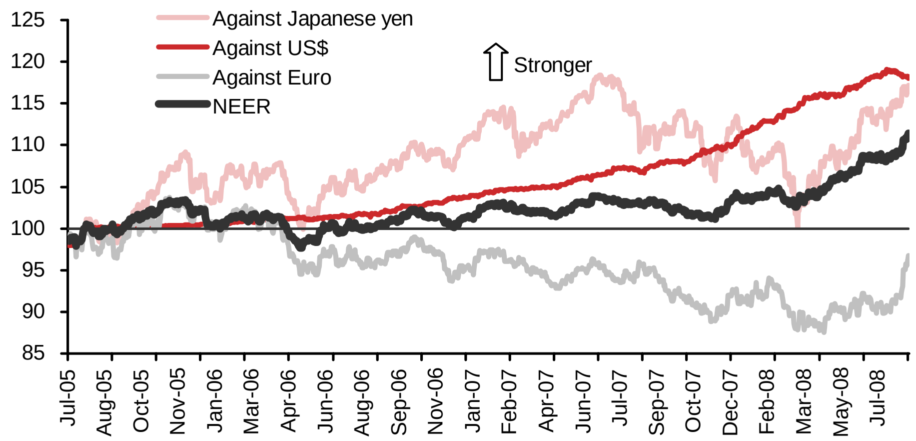
Source: CEIC data

Exhibit 19. US current account (US$mn)

The relative improvement in US exports along with a drop in US imports has improved the greenback's prospects

Source: CEIC data

Exhibit 20. RMB vs other currencies



Source: CEIC data

Meanwhile, the renminbi has stalled relative to the US dollar; on a normal trade-weighted basis it is still climbing

Exhibit 21. Developed world real yield (GDP-weighted)

Source: Bloomberg

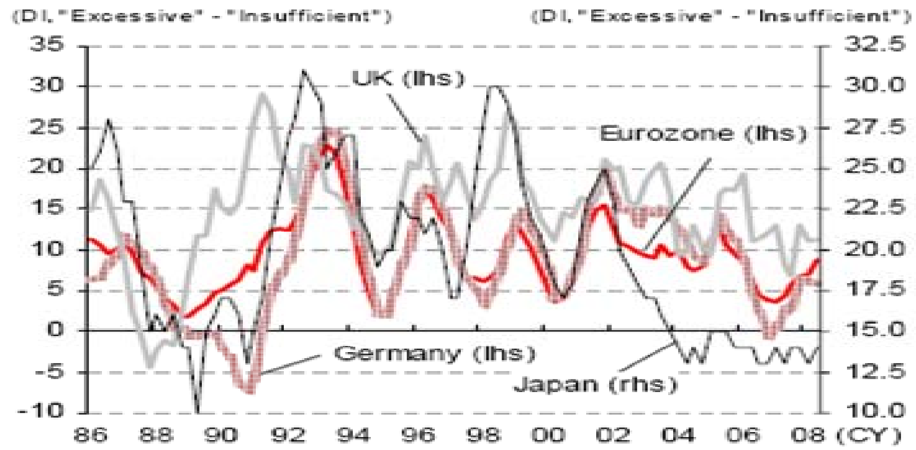
Global real yields continue to support financial assets

Exhibit 22. US: new orders minus inventories (ISM-derived)

Source: Bloomberg

There is no sign of an immediate rebound in US orders to overseas plants

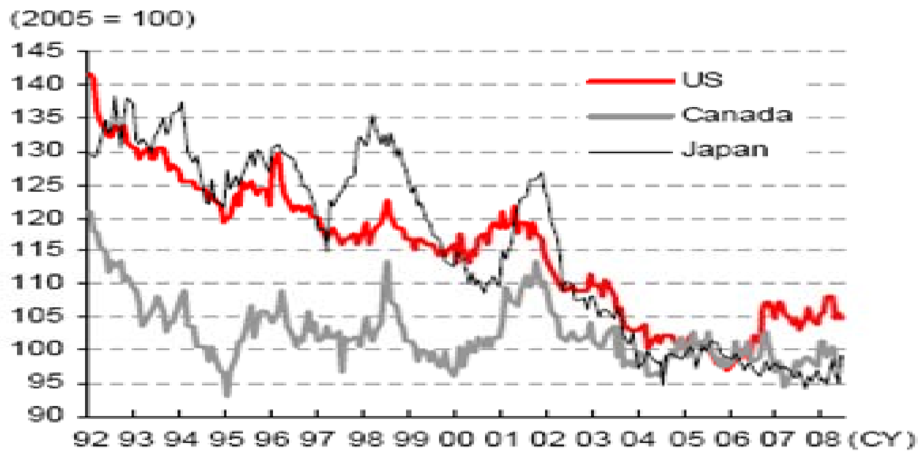
Exhibit 23. Companies assessment of inventories



Source: Nomura estimates, using Bank of Japan and EC Commission data

R. Sakagami, our UK-based Japanese economist, feels that inventory levels are manageable as companies appear to be prepared for a downturn…

Exhibit 24. Inventory-to-shipment ratios in Japan, US and Canada



Source: Nomura estimates, using Bank of Japan and EC Commission data

…and outside the US we see no dramatic increase in inventory-to-shipment ratios; our only concern is the possibility that inventory may be accumulating in Asia, particularly China

See Asia & Emerging Markets Strategy:
If Guangdong coughs, do emerging markets sneeze? (13 August, 2008)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Sources: Nomura International plc, Nomura Securities Co. Ltd. and Nomura International (Hong Kong) Ltd. as at 30 June 2008.

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