Market Update – May 2012

The political impasse in Greece has rocked the global financial markets again in recent weeks and cast uncertainties over the future of the Euro area and the monetary union.

Over the past two years, Greece has repeatedly stated its intention of wanting to stay in the Euro area. But at the same time, it has systematically watered down the adjustment requests and deliberately postponed the adjustments. The latest election result has again indicated that Greeks have strong reluctance to continue the current drastic austerity measures. The austerity measures are imposed in exchange for the aid from the European Union, European Central Bank (ECB) and International Monetary Fund (IMF). With no political parties able to unite force with others to form a coalition government, a re-election has to be held. A care-taker government was sworn in on 17 May 2012 until the re-election, likely to be on 17 June 2012, is over. In the mean time capital flight from Greece continues.

The market is clouded with uncertainties on the future of not just Greece but the entire Euro area. A Greece exit from the monetary union was seen as an absurdity as the break-up cost is way too high. But now it is seen as a high probability scenario that politicians, central banks, financial markets and corporate treasuries round the globe cannot ignore.

To put things in perspective, the weight of the Greek GDP is only about 2.0%[1] of the Euro area's GDP. If Greece were to exit the monetary union and default on its debt, it would potentially cost European tax payers about €225 bn[2]. This can be absorbed by the Euro area although it is painful. The pain to Greece is much bigger in comparison. Greek Drachma may fall by 40% to 50% or even more. Its GDP could fall easily by 20% or so.

Nevertheless, the wider concern remains the domino knock-on effects in other peripheral countries, resulting in potential bank-runs in countries such as Ireland, Portugal, Spain and Italy, further widening of sovereign spreads and risks to the global economy.

We expect further monetary policy to kick in if the situation were to worsen further. Significant measures are required to establish fiscal sustainability over the medium. Recent elections have shown a popular swing against austerity measures and the Euro area is reconsidering how to achieve a suitable balance between austerity and growth

The probability of Greece leaving the monetary union has risen significantly. With negative impact from Greece's departure being significant, G8 has strongly urged Greece to stay in the Euro zone. Germany, the main driver of austerity push, will be pressured further to soften its stance. Eventually Germany will have to give in.

On a more encouraging note, growth in the US continues. For example, industrial production rose 1.1% in April, the biggest gain since December 2010. The gain in April was above expectations and was strong across the broad. While the pace of recovery remains weak, unemployment rate has fallen from a high of 10% to 8.1% as of April 2012.

Given the European uncertainties, risky assets including equities are expected to come under pressure and government bonds will be well bided. We are underweight equities currently. Nevertheless, the fundamentals in Singapore have remained strong. Historical records have

[1] Source : World Bank, as of 2010
[2] Source : UBS, 18 May 2012

shown that the Singapore stock market emerged strongly after each crisis, eg, Asian currency crisis, burst of Nasdaq bubble, SARS, and Lehman Brothers crisis. Therefore, investors should expect volatility in the coming months but take comfort in the strong long term fundamentals of the Singapore economy and stock market.

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