

**September 2013**  
**By Homiyar Vasania, CEO**

## The forces dampening the effects of QE tapering are kicking in

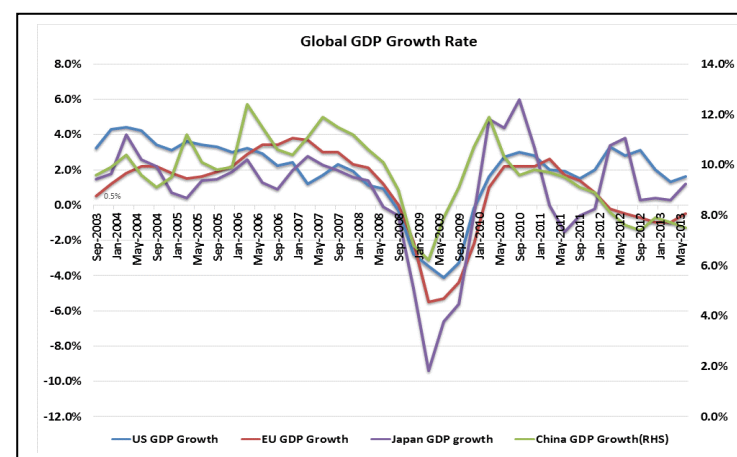
The selloff of certain kind of assets in the past four months has mostly been predicated on certain assumptions. The market's chain of thought has been: the US is growing well, the US labour market is improving, these are driven primarily by a recovery in the US property sector and hence the Fed has to start reversing the QE of the past few years. Add to this a stabilisation of Europe, Japan and China and it appears we have growth coming back. This is again a reason to reduce QE. Thus, the market expectation is that the losers would be the ones who benefited the most from QE, i.e. emerging markets and bond markets.

Now, our original premise of low growth globally is based on the fact that a tightening of liquidity will automatically lead to a reversal of a lot of factors supporting this growth and hence there will be a lower incentive to reverse QE. This factor reversal is starting to happen.

## The actual growth rebound is only marginal

Except for Japan, where there is a genuine belief in Abenomics leading to a growth rebound, the other economic blocks have only had a marginal rebound. In fact emerging markets are showing no rebound. The chart on the right shows the GDP growth trends in the four large global economic blocs.

Thus the incentive for the Fed to taper QE should be dampened.



Source: Bloomberg

## The US labour market and new job creation are not as healthy as they look

New job creation in the US has been looking poor and has surprised on the downside (see chart 1 on the right). In the last few months there have been strong downgrades to initial official estimates of new job creation. Unemployment numbers are slowly improving (see chart 2 below) but for the wrong reasons - more people are giving up looking for jobs, evidenced by US labour participation being at a 36-year low (see chart 3 below right). Hence the unemployment data looks better than it really is. The broad point is that the US labour market has hardly improved. The whole point of QE was to improve this; if this has not been achieved, why reverse QE in a big way?

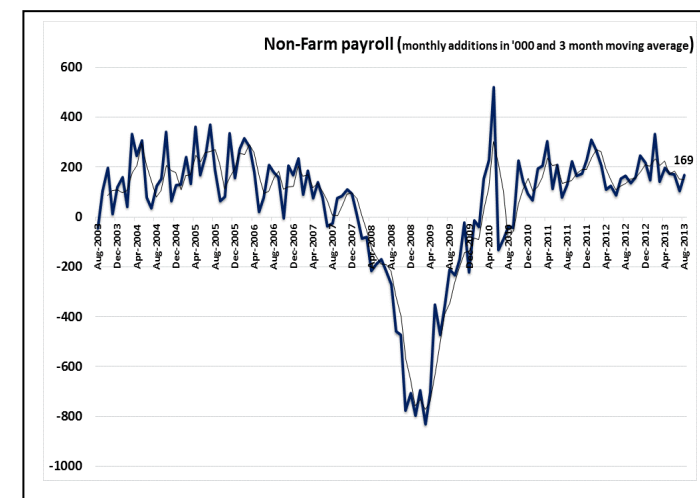


CHART 1

Source: Bloomberg

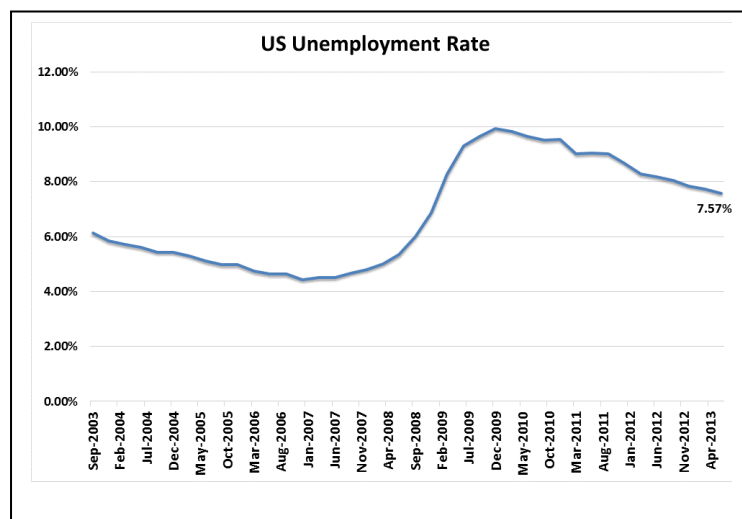


CHART 2

Source: Bloomberg

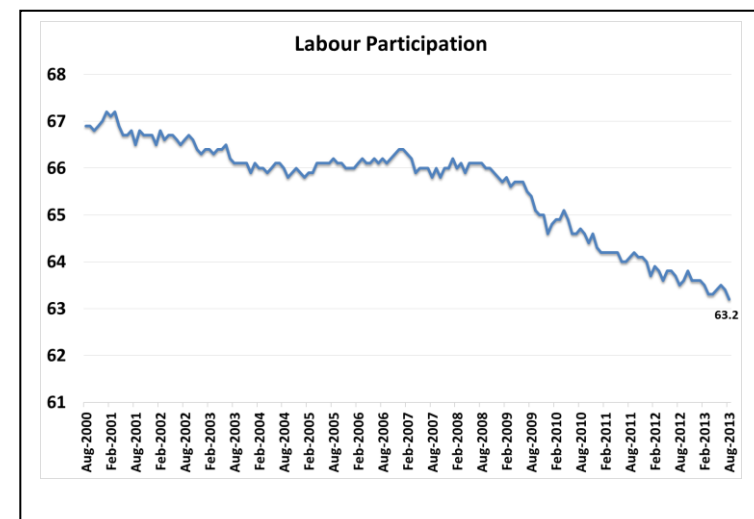


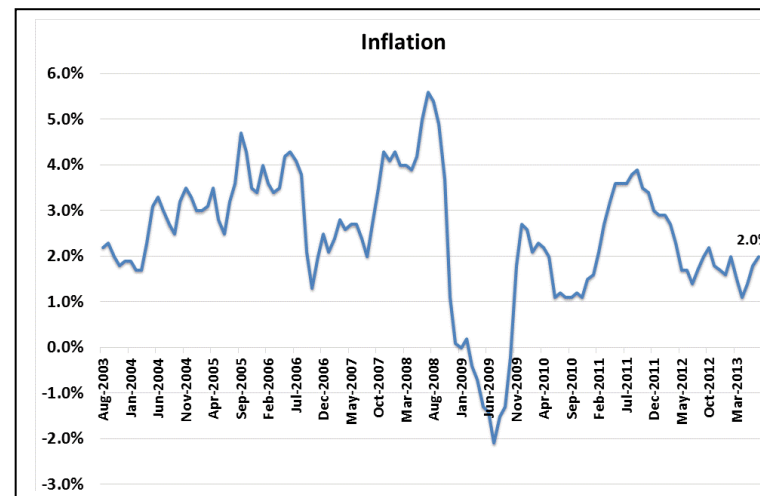
CHART 3

Source: Bloomberg

## US headline inflation is not yet a problem

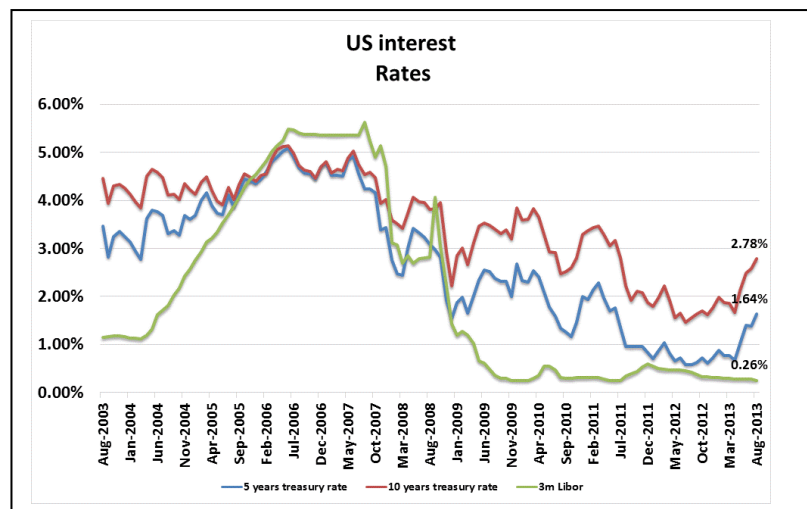
Inflation, which is normally a driver of a tightening cycle, is not yet a problem (see chart below).

Hence while the factors which were targeted by QE (i.e. labour market and GDP growth) have not improved significantly, pressures are building up to further dampen both these factors.



Source: Bloomberg

## Long term interest rates are shooting up



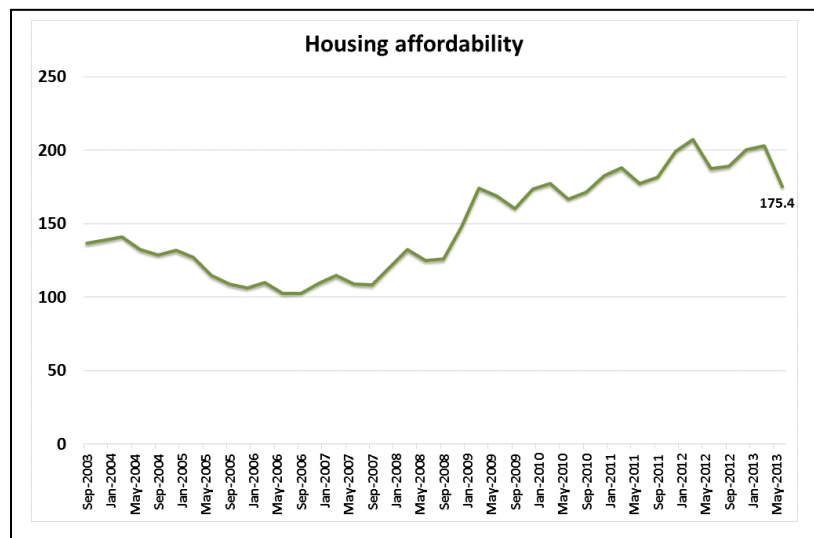
Source: Bloomberg

Much before the US Fed raises rates, the market-driven long term rates are already shooting up (see chart below). This has also been aided by emerging market central banks becoming net sellers of treasury bills (as they have to defend their weakening currencies). This increase in long term rates is happening at a time when the ratio of US government debt to GDP has doubled over the period 2009 to 2012. No one wants to consciously increase interest rates when one's debt has doubled. But that is what the market expects the US to voluntarily do.

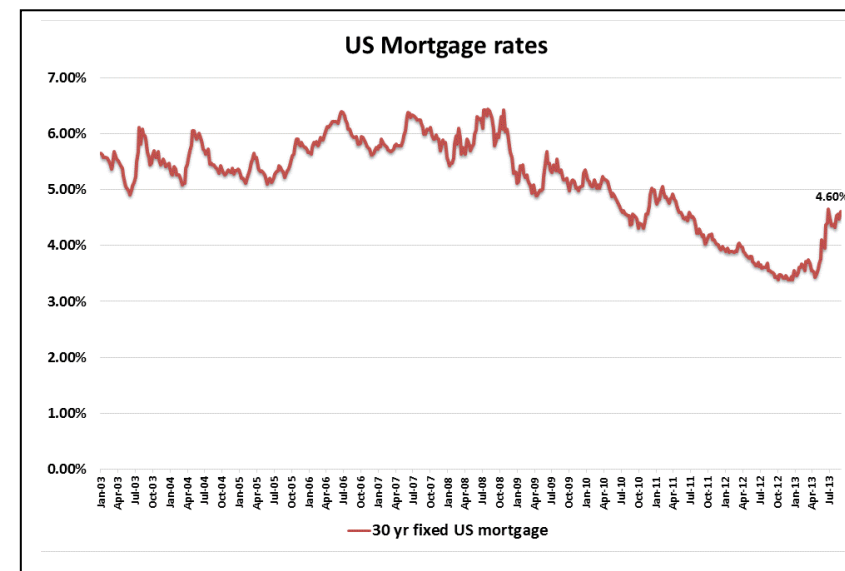
## The US housing market is suffering

30-year mortgage rates have spiked up (see chart on the right). Combine that with the sluggish US labour market mentioned earlier and it is not surprising that the US property market is suffering.

Consequently US housing affordability, which had improved dramatically since 2009, is coming off sharply (see chart below).

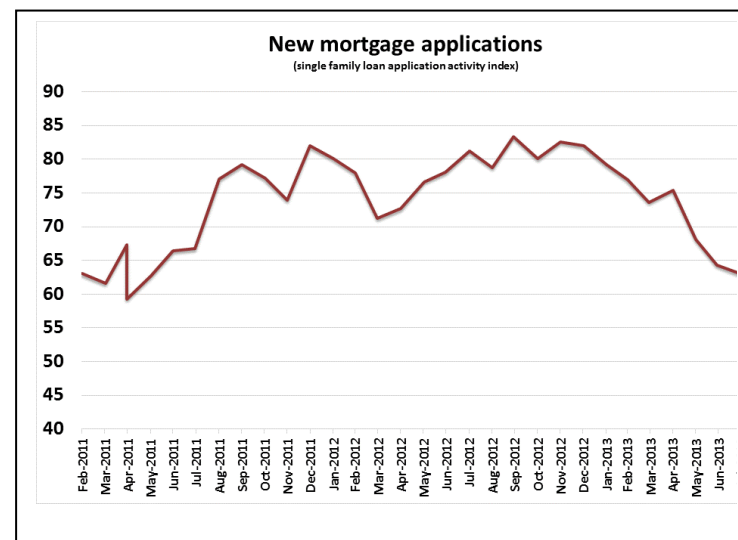


Source: Bloomberg

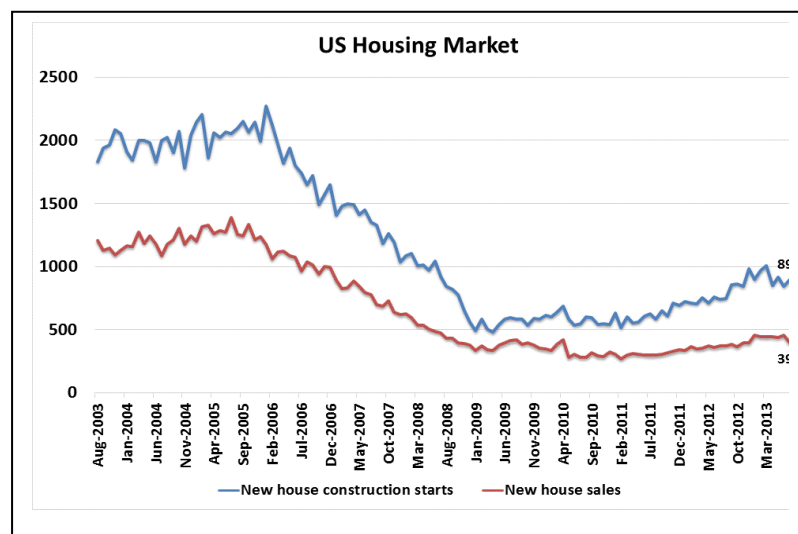


Source: Bloomberg

Mortgage activity (both refinance and new applications) is coming off very quickly and is reaching 2011 bottoms (see chart on the right). This is a precursor to slower housing activity.



Source: Bloomberg



Source: Bloomberg

New US housing construction starts are already 10% below the peak in March 2013. Sales are showing the first signs of coming off (see chart on the left). Though both these numbers are way below the 2007 peak, they already have headwinds building up against them.

The conclusion is that the US housing market is slowing down. This was one of the primary sources of the GDP growth rebound since 2009 and now that source is weakening.

## Conclusion

Though we do believe that the US long term interest rates are at the bottom of a 30-year cycle and they will need to go up, this will be a slow and arduous process and will not happen without a significant increase in inflation. Through all this, GDP growth will remain weak.

We therefore believe that there is a high likelihood of the QE tapering trade losing momentum.

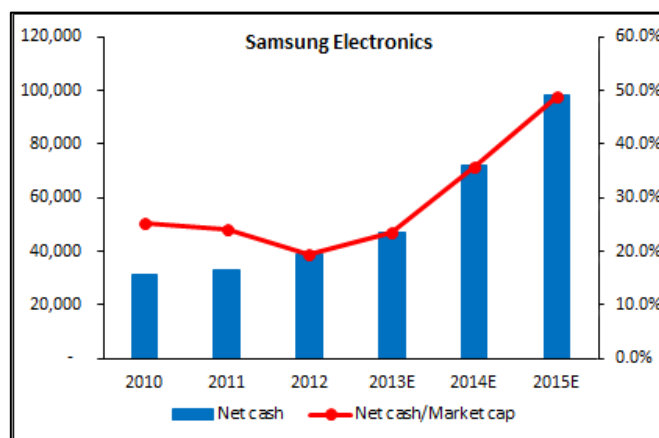
## Samsung Electronics: A typical example of our “Asian cash machine”

Samsung Electronics is one of the largest companies in the Asia ex-Japan and GEM universe. As global growth has moderated, deployment of cash generated for growth purposes has declined. Result: cash building up on the balance sheet. Samsung Electronics epitomises this. Cash-generation and its distribution are likely to be key points of debate in the near future and could well determine the future path of value creation for shareholders in many companies in Asia.

Annually Samsung is now generating free cash (operating cash flow minus capital expense) worth more than 12% of the current market capitalisation. By the end of this year it will have net cash worth 25% of its market capitalisation and this will grow to 50% of its market capitalisation by the end of 2015. This is a USD 200 bln market cap company sitting on USD 50 bln of net cash by the end of this year and generating about USD 25 bln of free cash every year. These are gigantic numbers. How we as investors benefit from this depends on what the management does with this cash.

This dynamic finds an echo in companies across the size and market-cap curve and throughout the economies of ASEAN and North Asia (India being the one exception). Managements’ key challenge will be to fashion a policy that distributes excess cash in the most tax efficient manner and yet have enough to fund future growth when the cycle turns up.

The chart below shows Samsung’s prodigious build-up in net cash likely over the next two years and its share of current market capitalisation.



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