Focal Points

Investment & Trading Ideas

June 2, 2010
Research Comment
Quantitative/Technical Research

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Go to Cash: Facts and Fiction

- Our call is to go to cash, or cash-like instruments to the maximum of your mandate. Consider this our third and final warning/escalation. See Focal Points of May 16 and April 22 for the forerunners.
- Our view is based on the past and present state of the market (facts), and on what we see as the near-future condition of the market, which until it is fact, will be regarded by the naysayers as fiction.
- The risk for an asset manager is that he/she considers the current state (facts) of the market as fictitious, or irrelevant.
- We detail the conditions (facts), and have made our decision on where we see these conditions leading us (fiction until proven fact).
- By our standards, this Focal Points piece is lengthy. We wanted it to be as detailed as reasonably possible, and we do so at the risk of obfuscation.
- Our message of escalated concern may be summed up by one simple statement: **If Asian credit moves with European credit, and the European credit story is not over, then the whole notion of Asian-led global growth goes out the window, as we will see capital flight away from Asia and out of risk assets in general**. The pages that follow merely put the meat on the bones of this statement.
- Our key figure, and current statement of risk, is that **global equity markets follow the Asia dollar index** (Figure 1). It was not always this way, nor will it always be this way, but while it is this way, we pay attention.

Figure 1: S&P 500 Index and the Bloomberg-JP Morgan Asia Dollar Index (ADXY)

Source: BMO Capital Markets, Bloomberg, Thomson, Markit

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AsiaDoom: What it is, and What It Says

Moves in Asian sovereign default risk are now well correlated to moves in Western European sovereign default risk. This is fact – Figure 2.

China needs to grow for the sake of social stability (a standard PBOC **fact** line).

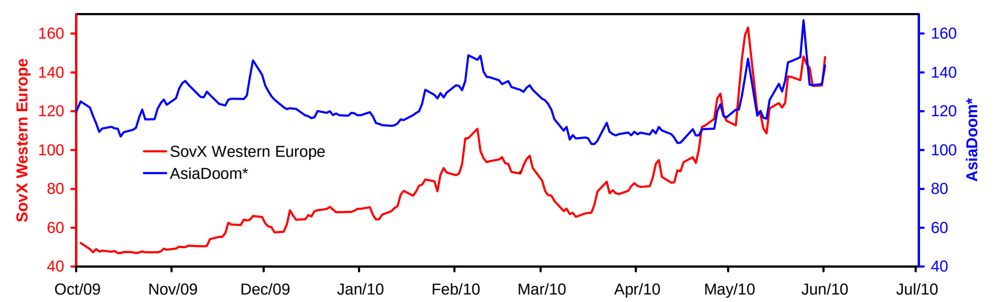
S&P mentions that Bank for International Settlements and the IMF estimate that cross-border lending by European banks to Asia is more than half a trillion dollars.

European bank default risk is of course tied to European sovereign default risk. In Figure 2, we just take out the conduit of risk – European banks – and equate the two continents.

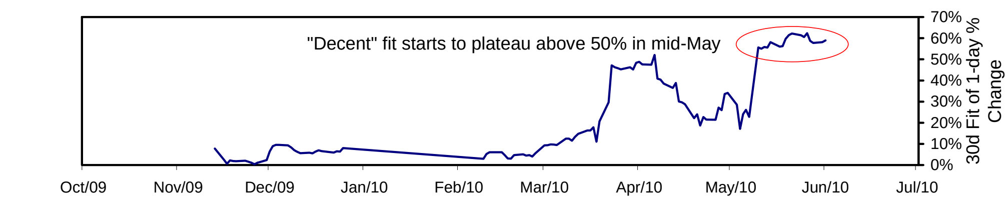
Asian growth needs to be funded, and yet escalating sovereign default risk has resulted in the closure of funding markets.

We created our "AsiaDoom" index to highlight this specific risk for our clients. AsiaDoom is a basket of six Asian Sovereign Credit Default Swaps. It is available on Bloomberg and updates in real time.

Figure 2: AsiaDoom and Western European Default Risk

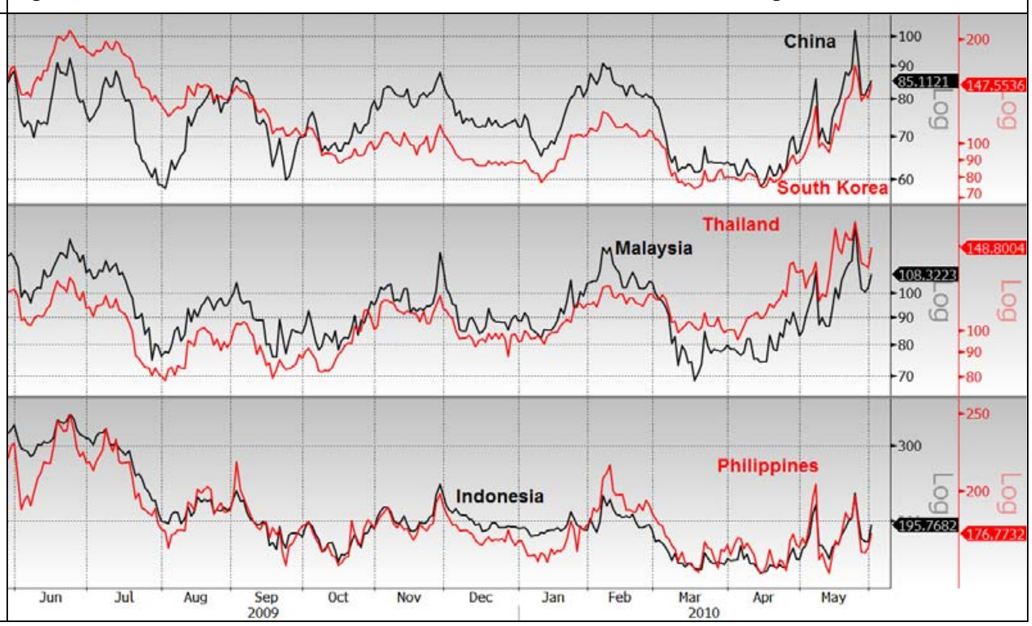


*AsiaDoom is a basket of six sovereign credit default swaps (China, South Korea, Malaysia, Thailand, Philippines and Indonesia)



- Our AsiaDoom indication of Asian Sovereign default risk is an equal-weighted basket of six 5-year sovereign credit default swaps (Figure 3):
  - China
  - South Korea
  - Thailand
  - Malaysia
  - Indonesia
  - Philippines

Figure 3: Constituents of Our AsiaDoom Indicator of Asian Sovereign Default Risk



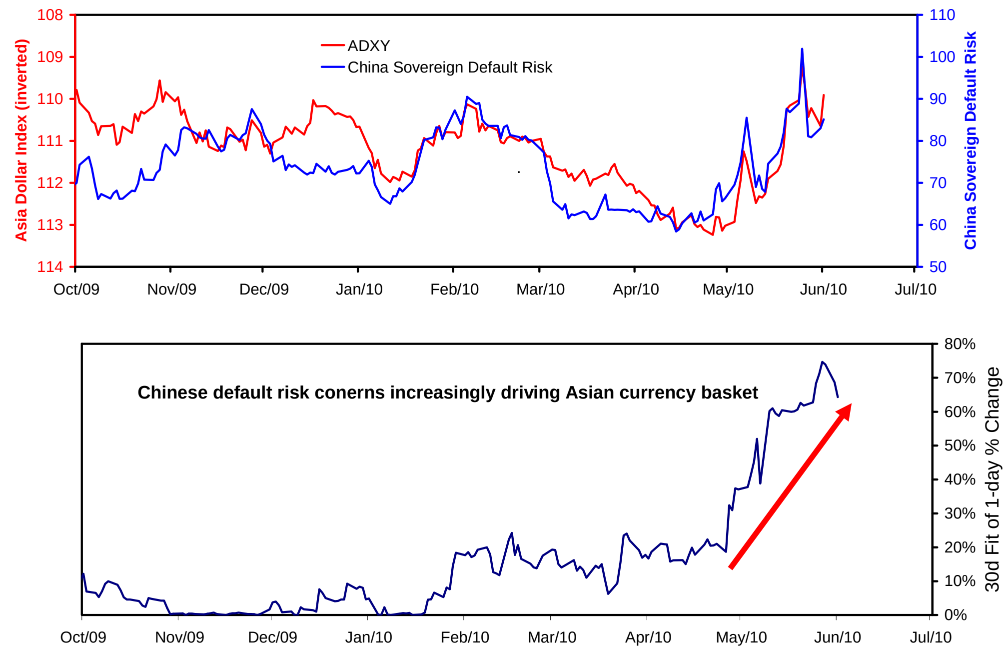
Default Risk Drives the Asia Dollar Index

The Asia Dollar Index (ADXY), as we highlight in Figure 1 is a key barometer for the equity market strength/weakness. The fact that the fit to equities is so good is a statement that the equity market is fixated on the Asian growth story. This is fact. How long this relationship lasts is an open question (fiction), but while it lasts, we heed its message.

ADXY is a trade-weighted basket of 10 of the most active traded currency pairs valued against the U.S. dollar. Those without a Bloomberg terminal can get updates on the ADXY here.

- The Chinese Renminbi has the largest weight in the ADXY (34%). As this currency cross is managed against the U.S. dollar, it effectively does not move the ADXY. The real story is that China is the greatest mover of the ADXY, not through the currency, but rather through Chinese sovereign default risk – Figure 4.

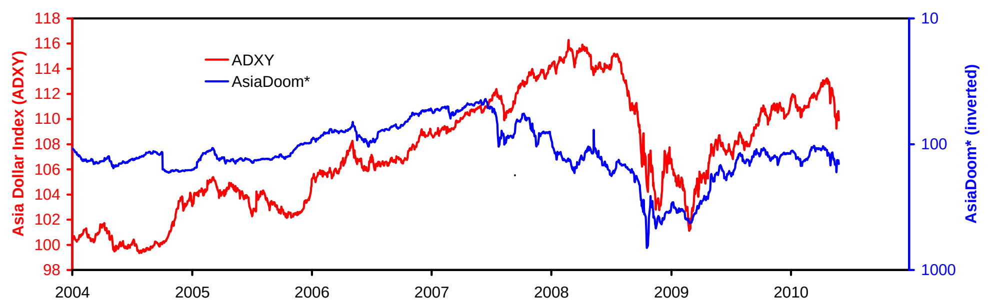
Figure 4: China Sovereign Default Risk and Asia Dollar Index



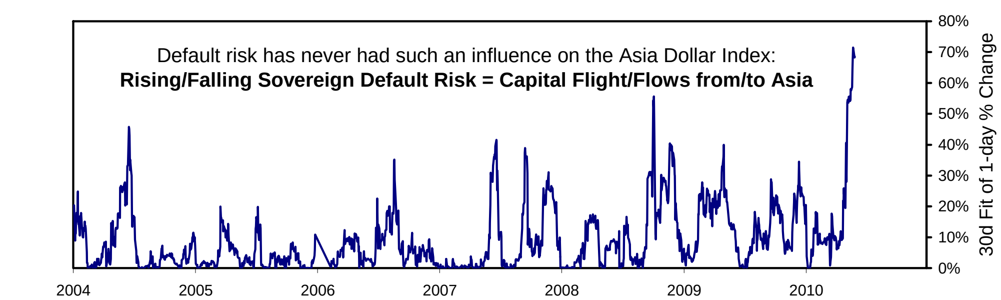
- The current fit of moves in the Chinese sovereign default risk to the moves in the ADXY is very good. This is also true for sovereign default risk of Indonesia, Vietnam, South Korea, Philippines, and to a lesser degree Malaysia and Thailand. This is fact.
- While the fit of these moves is high, one should conclude that:

Rising/**Falling** Sovereign Default Risk = Capital **Flight**/**Flows from**/**to** Asia

Figure 5: AsiaDoom and Asia Dollar Index



*AsiaDoom is a basket of six sovereign credit default swaps (China, South Korea, Malaysia, Thailand, Philippines and Indonesia)



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Asian Sovereign Default Risk and Commodities

The relationship of Asian sovereign default risk (AsiaDoom) and European Sovereign default risk (SovX Western Europe) is relatively new.

Newer still is the fit of AsiaDoom to crude oil, which is still building – Figure 6.

As long as this relationship continues to firm and/or hold, the key statement grows to include commodities in that:

Rising/**Falling** Sovereign Default Risk = Capital **Flight**/**Flows from**/**to** Asia = **Bear**/**Bull** case for crude oil.

Figure 6: AsiaDoom and Crude Oil

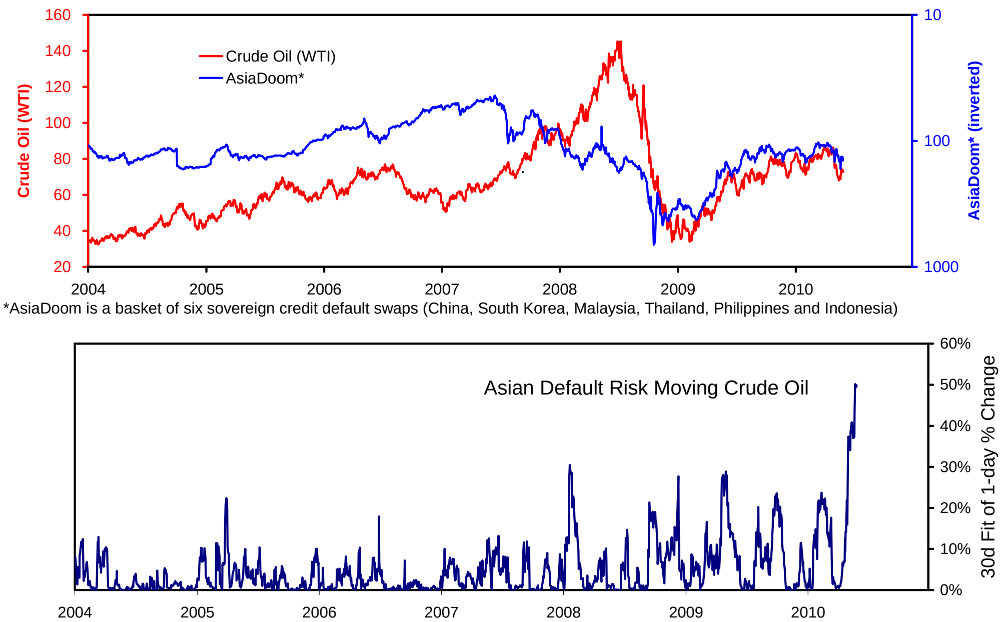
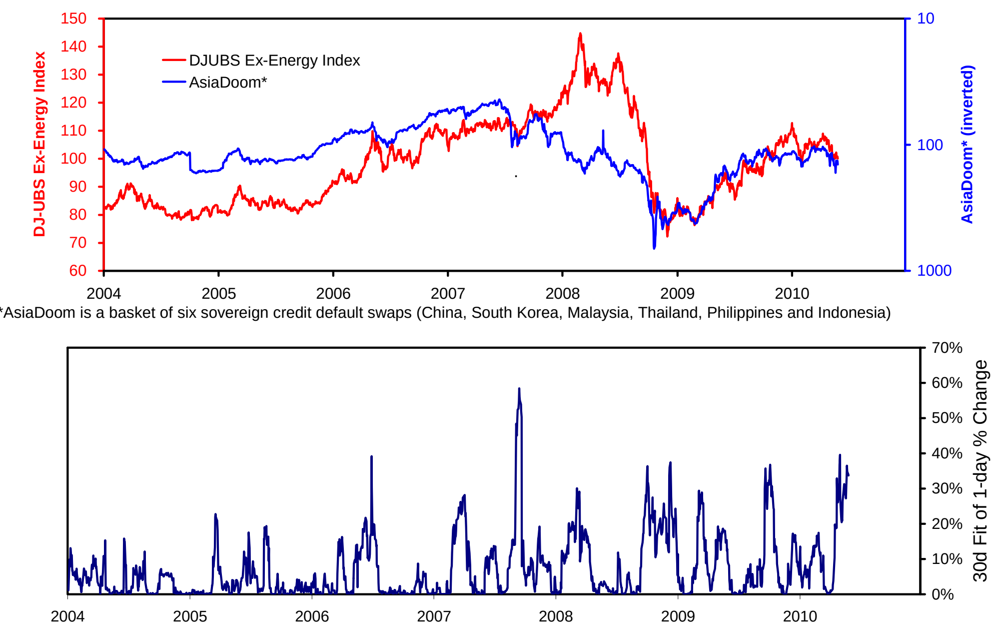


Figure 7: AsiaDoom and DJ UBS Ex-Energy Index

- The relationship of AsiaDoom to non-energy commodities has not yet broken out to a new high, though the fit is still decent and will be watched.



Asia March 2009 Versus Asia June 2010

- Our March 2009 quarterly update article was entitled "In Future Growth We Trust." Our conclusion a little over a year ago was:

The default risk of financial institutions is as great now as was the case during the Bear Stearns takeover and Lehman Brothers failure. In the months ahead, more banks will have deposited toxic assets into bad banks and/or government guarantee programs, effectively de-risking the corporations at the expense of the state and current shareholders who will see their stakes diluted.

Despite this tumultuous environment, there are signs that both supply and demand dynamics are helping commodity prices to stabilize. Default risk of commodity-sensitive states and corporations is easing. There is a sense that value in the globally fungible and economically sensitive non-paper entities has been found. Oil and copper are not as glamorous as gold, but regardless, the Chinese, in countercyclical fashion, are stockpiling these (instead of gold). Stamped on each barrel of oil and bar of the red metal is "in future growth we trust."

- Fast forward to June 2010 and we see:
  - Rising North American Investment Grade default risk, currently at about half the level seen during the peak of panic (December 2008).
  - French banks depositing toxic Greek waste upon the ECB, much to the chagrin of the top runners up (Herr Axel Weber and Signor Mario Draghi) to take the ECB helm from a rather pliable Monsieur Jean-Claude Trichet.
  - A Greek finance minister ready to tap the bond market in July because he thinks "We'll be able to access markets, because we have no doubt we can," even though the ECB distorted pricing of the PIIGS market is being described the same day as a "zombie market."
  - Sovereign default risk among the largest size and highest growth states (China, South Korea, Thailand) is rising (Figure 3).
  - Default risk among major commodity producers is rising (updated each and every day in our Relative Strength Filter).
  - The Asian Real Estate market is in decline (Figure 8).
  - Stockpiling of gold is a much more popular sport.
- In short, the "*in future growth we trust*" lasted about a year.
  - Distrust is the new black.

Figure 8: Relative Strength/Technical Profiles of Large Cap Asian Real Estate Stocks

	Company					Decile			Pricing		Rel Strength vs Gbl 1200						Technical Attributes							
	Name / Link to RS Chart	Symbol & CoWeb	News	Ctry.	Sub Industry	Group RS	LT RS	GBL RS	Chg (%)	MktCap US$mm	Chg Last Day	Reward/ Risk vs. Market	Reward/ Risk vs. Sector	Trend Slope	RS Hi (Mo)	RS Lo (Mo)	%Chg wrt 50 Day MA	Chg wrt 50 Day MA Trend	%Chg wrt 200 Day MA	Chg wrt 200 Day MA Trend	Boll Band	RSI X-Over	RSI Dly	RSI Wkly
1	CapitaLand Limited	CAPL SP	N	Singa...	REstDvAct	10	5	10	-1.7%	18,358		💣💣💣💣	💣💣💣💣	-50%			-7%	Below Falling	-10%	Below Falling	BELOW		37	43
2	Poly Real Estate Group Co Ltd	600048 CH	N	China	REstDevl	10	1	10	-3.0%	7,182		💣💣💣💣	💣💣💣💣	-100%			-18%	Below Falling	-36%	Below Falling	BELOW		39	35
3	DLF Ltd	DLFU IN	N	India	REstDvAct	10	6	10	-2.1%	9,753		💣💣💣💣	💣💣💣💣	-82%			-11%	Below Falling	-24%	Below Falling	BELOW		40	43
4	CapitaMalls Asia Ltd	CMA SP	N	Singa...	REstOpCo	7	8	10	0.5%	5,801		💣💣💣	💣💣💣	-43%			-3%	Below Falling			ABOVE		50	48
5	New World Development Ltd	17 HK	N	Hong...	REstDvAct	10	4	10	-2.3%	6,088		💣💣💣	💣💣	-38%			-14%	Below Falling	-21%	Below Falling	BELOW		35	42
6	Henderson Land Developmen...	12 HK	N	Hong...	REstDvAct	10	2	10	-0.1%	12,758		💣💣💣	💣💣💣	-26%			-8%	Below Falling	-12%	Below Falling	BELOW		46	49
7	China Resources Land Ltd	1109 HK	N	Caym...	REstDevl	10	1	9	-5.2%	9,023		💣💣	💣	-37%			-7%	Below Falling	-16%	Below Falling	BELOW		46	48
8	China Overseas Land & Invest...	688 HK	N	Hong...	REstDevl	10	1	9	-4.7%	15,356		💣💣	💣	-27%			-6%	Below Falling	-10%	Below Falling	BELOW		45	52
9	Shimao Property Holdings Ltd	813 HK	N	Caym...	REstDevl	10	1	9	-3.3%	5,132		💣💣	💣	-35%			-9%	Below Falling	-17%	Below Falling	BELOW		46	48
10	Kerry Properties Ltd	683 HK	N	Berm...	REstDvAct	10	4	9	-2.2%	5,856		💣💣	💣💣	-20%			-15%	Below Falling	-18%	Below Falling	BELOW		33	39
11	Sun Hung Kai Properties Ltd	16 HK	N	Hong...	REstDvAct	10	2	8	-1.6%	33,352		💣	★	-12%			-9%	Below Falling	-10%	Below Falling	BELOW		40	46
12	Wheelock & Co Ltd	20 HK	N	Hong...	REstDvAct	10	3	8	-0.7%	5,399		💣	💣	-13%			-10%	Below Falling	-11%	Below Falling	BELOW		42	46
13	Cheung Kong Holdings Ltd	1 HK	N	Hong...	REstDevl	10	3	8	-0.6%	26,222		💣	★	-5%			-9%	Below Falling	-9%	Below Falling	BELOW		35	38
14	Sino Land Co	83 HK	N	Hong...	REstDevl	10	4	8	-2.2%	7,883		💣	💣	-9%			-12%	Below Falling	-13%	Below Falling	BELOW		35	43
15	Swire Pacific Limited	19 HK	N	Hong...	REstDvAct	10	3	7	-2.9%	9,700		💣	★	-4%			-7%	Below Falling	-7%	Below Falling	BELOW		41	41
16	Wharf Holdings Ltd	4 HK	N	Hong...	REstDvAct	10	2	7	-1.3%	13,538		💣	★	-3%			-9%	Below Falling	-6%	Below Rising	BELOW		45	51
17	Hang Lung Group Ltd	10 HK	N	Hong...	REstDvAct	10	1	7	-1.3%	6,397		★	★★	0%			-7%	Below Falling	-4%	Below Falling	BELOW		42	40
18	Hang Lung Properties Ltd	101 HK	N	Hong...	REstDvAct	10	1	7	-0.7%	14,508		★	★	2%			-8%	Below Falling	-6%	Below Rising	BELOW		43	43
19	Link REIT	823 HK	N	Hong...	RetailREIT	1	4	7	0.2%	5,314		★	★	3%			-2%	Below Falling	2%	Above Rising	BELOW		44	43
20	City Developments Ltd	CIT SP	N	Singa...	REstDvAct	10	4	6	-0.8%	6,500		★	★	5%			-6%	Below Falling	-5%	Below Rising	BELOW		38	48
21	Hongkong Land Holdings Ltd	HKL SP	N	Berm...	REstOpCo	7	3	4	0.4%	10,797		★★	★★★	14%			-4%	Below Falling	3%	Above Rising	BELOW		45	52

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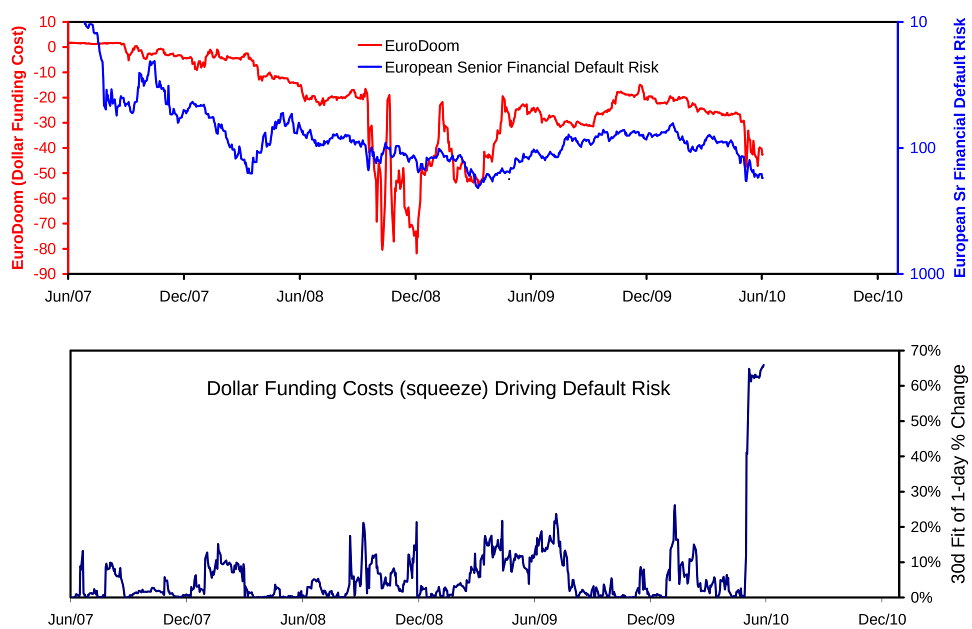
European Credit Risk Story Is Not Over

Figure 9: Lyxor ETF DJ STOXX 600 Banks vs. S&P Global 1200

European banks continue to be consistent market underperformers (Figure 9).

Figure 10: EuroDoom and European Senior Financial Default Risk

- As sovereign debt default concerns weigh upon European financials, their funding costs become squeezed. This pressure is observed in real-time via our EuroDoom indictor (available on Bloomberg), which is a blend of Euro-Dollar basis swap contracts.
- We detailed our EuroDoom indicator in our May 26 Focal Points and our May 26 Relative Strength Filter. A BIS paper explains how these swaps are a superior barometer (to Libor) as an indication of corporate stress, as it is priced from a broad universe of dollar demanding companies.
- The utility of EuroDoom is that moves in dollar funding costs are becoming increasingly more important as an indication of European financial default risk – Figure 10. Those who say that the level of Libor-OIS is small and insignificant have not seen this uncomfortable relationship.



European Corporate Credit Watch - Another Blast From the Recent Past

- We continue to see growing signs of stress among the riskiest of European diversified banks (Figure 11).
- We continue to see the less risky, but more interconnected, banks move toward a state of inversion (Figures 12, 13).

▪ Back on May 26, 2008, we wrote in our daily note entitled "Something Is Rotten in the State of Denmark":

  o *If LEH were an island onto itself, we would not care. Because it is one of those "too interconnected to fail," we are left to watch and worry.*

▪ What we were watching was the inverted credit curve of Lehman Brothers.

▪ Six weeks earlier, on April 10 we were asking if we should equate negative yields on U.S. T-bills with the sharp decline of Lehman Brothers. The answers are not always glaringly obvious. The clues, however, are there for those who observe and connect the dots.

Figure 11: European Diversified Banks; Sorted by 5- Year Credit Default Swap

	Company Name	Country of Incorporation	Equity Ticker	MktCap (US$)	5-yr CDS	%Chg CDS Yesterday	%Chg From 52w Hi	%Chg From 52w Low	1-yr/ 5-yr CDS
1	EFG Eurobank Ergasias SA	Greece	EUROB GA	$2,564	822	2%	8%	433%	**116%**
2	Alpha Bank AE	Greece	ALPHA GA	$2,897	801	0%	11%	454%	**147%**
3	National Bank of Greece SA	Greece	NBG US	$7,133	784	-1%	12%	509%	**144%**
4	Piraeus Bank SA	Greece	TPEIR GA	$1,646	769	2%	20%	385%	**146%**
5	Espirito Santo Financial Group SA	Luxembourg	ESF PL	$1,363	695	3%	7%	155%	**101%**
6	Allied Irish Banks PLC	Ireland	AIB US	$1,383	692	2%	17%	76%	90%
7	Banco Espirito Santo SA	Portugal	BES PL	$4,539	674	4%	6%	359%	**103%**
8	Banco Comercial Portugues SA	Portugal	BCP PL	$3,677	465	7%	18%	584%	**106%**
9	Banco BPI SA	Portugal	BPI PL	$1,724	446	3%	11%	514%	**104%**
10	IKB Deutsche Industriebank AG	Germany	IKB GR	$515	361	3%	48%	37%	92%
11	Finansbank AS	Turkey	FINBN TI	$5,228	344	2%	34%	28%	67%
12	Banco Popular Espanol SA	Spain	POP SM	$6,760	333	2%	20%	141%	96%
13	Dexia SA	EN-Belgium	DEXB BB	$7,546	317	5%	0%	98%	79%
14	Bank of Ireland	Ireland	IRE US	$2,473	305	2%	23%	98%	77%
15	Banco Sabadell SA	Spain	SAB SM	$5,070	302	5%	23%	132%	92%
16	Akbank TAS	Turkey	AKBNK TI	$19,474	290	1%	19%	34%	69%
17	Turkiye Is Bankasi	Turkey	ISCTR TI	$13,827	284	3%	27%	11%	69%
18	Bankinter SA	Spain	BKT SM	$2,686	282	2%	18%	96%	85%
19	OTP Bank Plc	Hungary	OTP HB	$694	246	0%	61%	2%	**101%**
20	Banco Bilbao Vizcaya Argentaria SA	Spain	BBVA US	$37,480	240	11%	13%	260%	87%
21	Royal Bank of Scotland Group Plc	U.K.	RBS US	$38,809	219	7%	6%	115%	82%
22	Lloyds TSB Group PLC	U.K.	LYG US	$55,887	213	4%	6%	113%	78%
23	Banco Popolare Societa Cooperativa	Italy	BP IM	$3,447	211	5%	10%	172%	84%
24	UBI Banca	Italy	UBI IM	$5,679	208	-2%	16%	160%	88%
25	*Banco Santander SA*	*Spain*	*STD US*	*$80,889*	*207*	*12%*	*18%*	*220%*	*87%*
26	Natixis	France	KN FP	$12,863	192	2%	35%	90%	84%
27	Raiffeisen Intl Bank Holding AG	Austria	RIBH AV	$6,463	184	2%	41%	29%	55%
28	Credit Agricole SA	France	ACA FP	$24,736	182	10%	19%	192%	77%
29	Banca Monte dei Paschi di Siena SpA	Italy	BMPS IM	$6,024	180	6%	14%	229%	79%
30	UniCredit SpA	Italy	UCG IM	$39,204	179	8%	16%	160%	79%
31	Barclays PLC	U.K.	BCS US	$52,542	170	8%	6%	139%	79%
32	*Societe Generale*	*France*	*GLE FP*	*$30,953*	*153*	*6%*	*26%*	*150%*	*77%*
33	BPM	Italy	PMI IM	$1,739	148	3%	4%	214%	73%
34	Intesa Sanpaolo SpA	Italy	ISP IM	$30,491	148	7%	20%	236%	76%
35	Commerzbank AG	Germany	CBK GR	$8,321	135	4%	23%	156%	72%
36	KBC Groep NV	EN-Belgium	KBC BB	$13,786	134	1%	49%	37%	71%
37	BNP Paribas	France	BNP FP	$66,653	123	5%	25%	158%	69%
38	HSBC Holdings PLC	U.K.	HBC US	$159,793	119	1%	4%	109%	65%
39	Nordea Bank AB	Sweden	NDA SS	$33,391	114	-1%	45%	38%	66%
40	Swedbank AB	Sweden	SWEDA SS	$8,441	110	-5%	66%	10%	60%
41	Skandinaviska Enskilda Banken AB	Sweden	SEBA SS	$11,239	109	-9%	45%	17%	73%
42	Standard Chartered PLC	U.K.	STAN LN	$49,864	104	5%	38%	82%	64%

Figure 12: SocGen: Equity (top) and CDS Curve (Black)

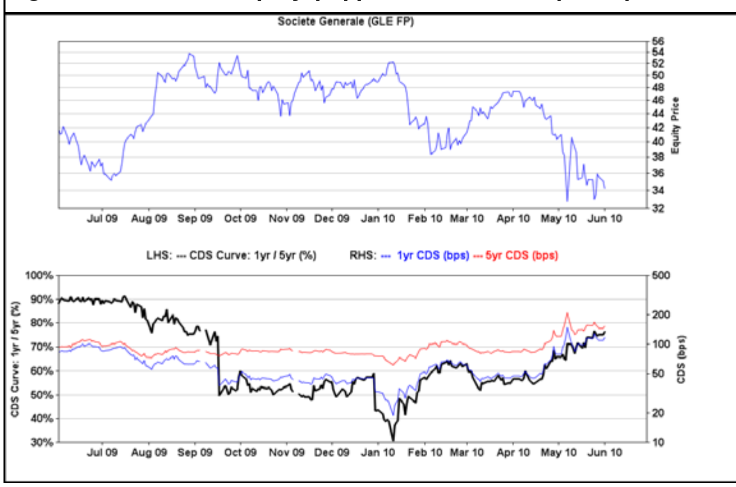
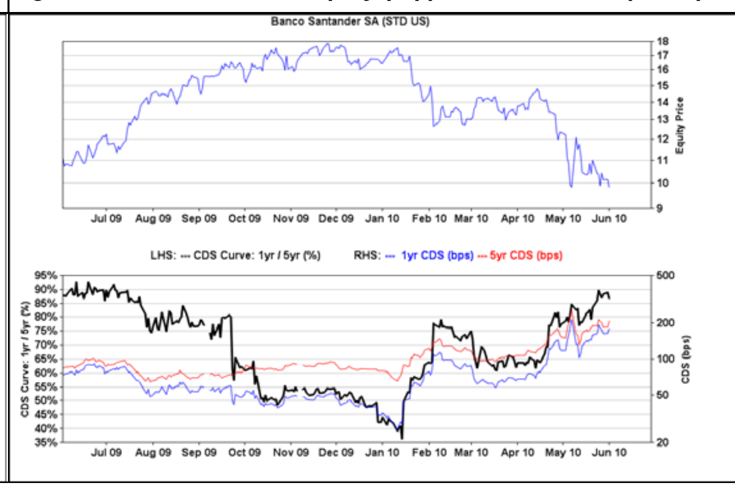


Figure 13: Santander SA: Equity (top) and CDS Curve (Black)



Sleep at Night Test: Can You Tell The Difference Between SocGen and BofA?

- The Canadian equity market has a 26% weight in energy, and a 33% weight toward non-gold resources.
    - The primitive, but increasingly decent fits between moves in Asian Sovereign default risk (AsiaDoom) and moves in oil (Figure 6) should help to define why resource bulls are currently on the wrong side of the market.
- What about U.S. investors, where resources make up only 14% of the S&P 500 Index?

- Can you, without looking at the labels, distinguish between a [SocGen with substantial Greek exposure] (assuming the ECB has not yet hoovered it all up), and a garden variety, too interconnected to fail, U.S. bank like Bank of America (Figure 14)? How about JP Morgan (Figure 15)? How about these U.S. banks and Santander SA – Figures 16, 17? If not, then you should not really trust the broad U.S. equity market.
- **Unfortunately, we have banks that are too interconnected to fail, and yet in Europe, the policy makers are too disconnected to yield comfort.**
- Banks, evil as they are portrayed, are conduits for funding.
    - [Funding markets are shut].
        - Shut means no bid.
            - No bid markets ≠ happy markets.

Figure 14: 5- Year CDS: SocGen and Bank of America

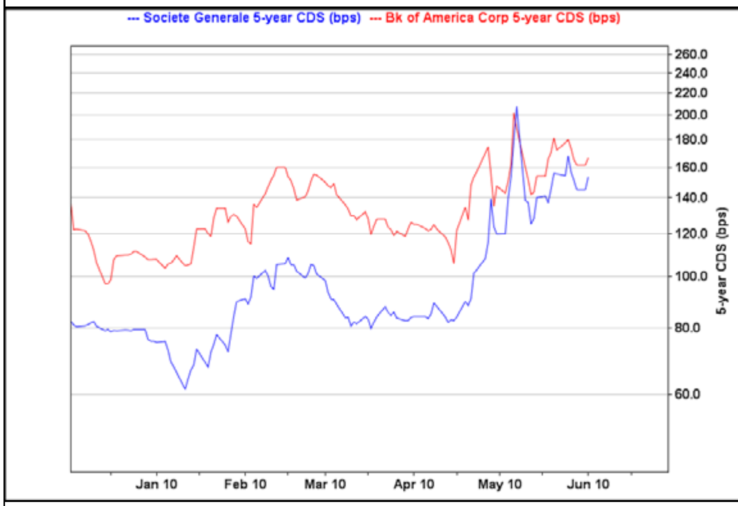


Figure 15: 5- Year CDS: SocGen and JP Morgan

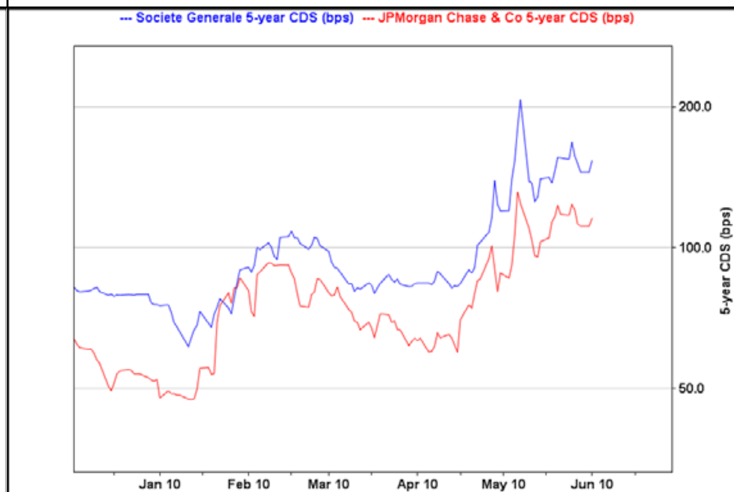


Figure 16: 5- Year CDS: Santander and Bank of America

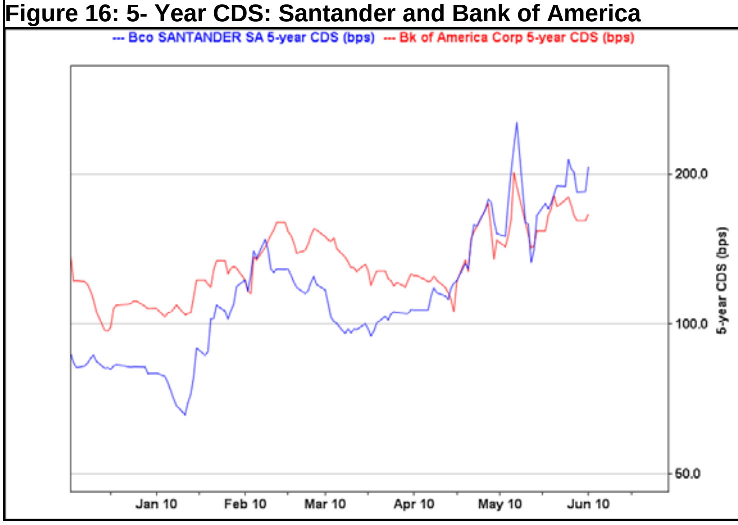
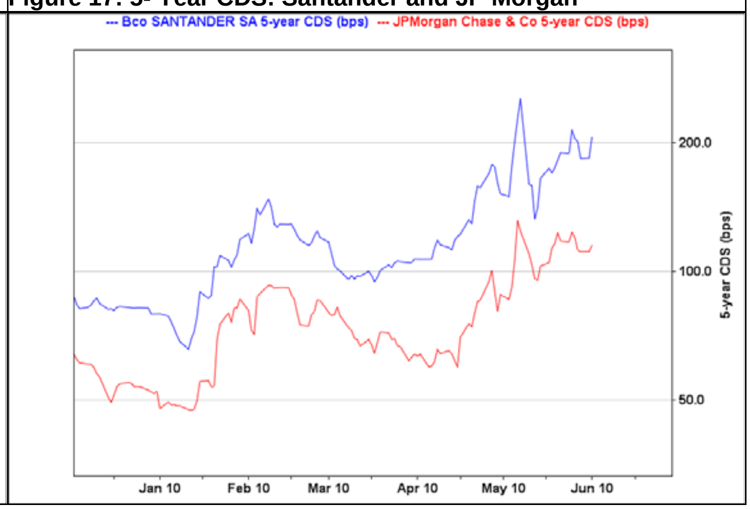


Figure 17: 5- Year CDS: Santander and JP Morgan



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Distribution of Ratings (Mar. 31, 2010)

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Buy	Outperform	32.9%	13.1%	36.4%	39.4%	47.9%	53%
Hold	Market Perform	63.2%	11.9%	63.6%	55.3%	48.5%	41%
Sell	Underperform	3.9%	0%	0%	5.2%	3.6%	8%

* Reflects rating distribution of all companies covered by BMO Capital Markets Corp. equity research analysts.
** Reflects rating distribution of all companies from which BMO Capital Markets Corp. has received compensation for Investment Banking services as percentage within ratings category.
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**** Reflects rating distribution of all companies covered by BMO Capital Markets equity research analysts.
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Ratings and Sector Key

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OP = Outperform - Forecast to outperform the market;
Mkt = Market Perform - Forecast to perform roughly in line with the market;
Und = Underperform - Forecast to underperform the market;
(S) = speculative investment;
NR = No rating at this time;
R = Restricted – Dissemination of research is currently restricted.

Market performance is measured by a benchmark index such as the S&P/TSX Composite Index, S&P 500, Nasdaq Composite, as appropriate for each company. BMO Capital Markets eight Top 15 lists guide investors to our best ideas according to different objectives (Canadian large, small, growth, value, income, quantitative; and US large, US small) have replaced the Top Pick rating.

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Prior BMO Capital Markets Ratings Systems

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