

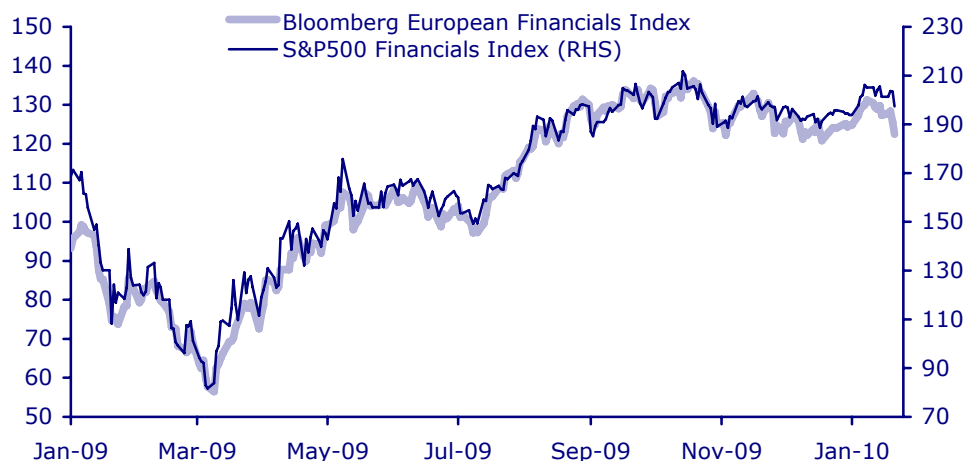
GREED & fear - flash

It has been a ridiculously long time coming. But President Barack Obama is finally reacting to the catastrophic political damage caused by the perception that the primary achievement of his administration thus far has been to bail out fat cats on Wall Street.

GREED & fear heard about the President's pending speech late last night Asian time just before sending out *GREED & fear* (*Pro cyclical speed bumps*, 21 January 2010). But the subsequent announcement merits further comment. Obviously, the devil will be in the details and the details are certainly not yet clear and will be the subject of much Congressional debate, not to mention frantic lobbying. Still there is the sense that fundamental reform of the financial sector is coming in the sense that real constraints will be put on the ability of banks taking federally insured deposits to engage in trading activities; though a key issue will be whether trading will be defined narrowly in the sense of purely proprietary trading or whether it will include taking positions against clients in order to execute trades. But whatever the exact details famous investment banks that obtained banking charters in the midst of the recent credit crisis story are likely to want to shed them if they want to retain their present business model.

Still for *GREED & fear* the real point is less the details than the new political reality. This is that a fundamental increase in regulation over finance in the West is coming despite the obvious power and wealth of the finance lobby. If so, it will undermine the assumptions of the consensus which had been assuming until yesterday that the 83-year-old Paul Volcker was too old and anachronistic a figure to influence the debate. In this respect Obama has smartly, albeit belatedly, sought out the advice of his one economic adviser with total credibility as a public servant. Remember that Volcker, who is due to speak at CLSA's AsiaUSA Forum in San Francisco on 1-4 March, is chairman of the President's Economic Recovery Advisory Board. Meanwhile, if the President wants to maintain the political momentum he should now change the rest of his economic team, all of whom are viewed as far too close to Wall Street.

Figure 1
S&P500 Financials Index and Bloomberg European Financials Index



Source: Bloomberg

All this may be "populist", to cite the "quality" press. But it is in fact sound public policy. *GREED & fear* used to write editorials calling for repeal of the 1933 Glass-Steagall Act when working for *The Economist* in New York in the late 1980s. But at the time a naïve *GREED & fear* had assumed that repeal of Glass-Steagall would occur in the context of capital markets where at least a certain modicum of market discipline would be allowed to prevail. *GREED & fear* never expected that investment banks with no depositors would be bailed out in such obscene fashion

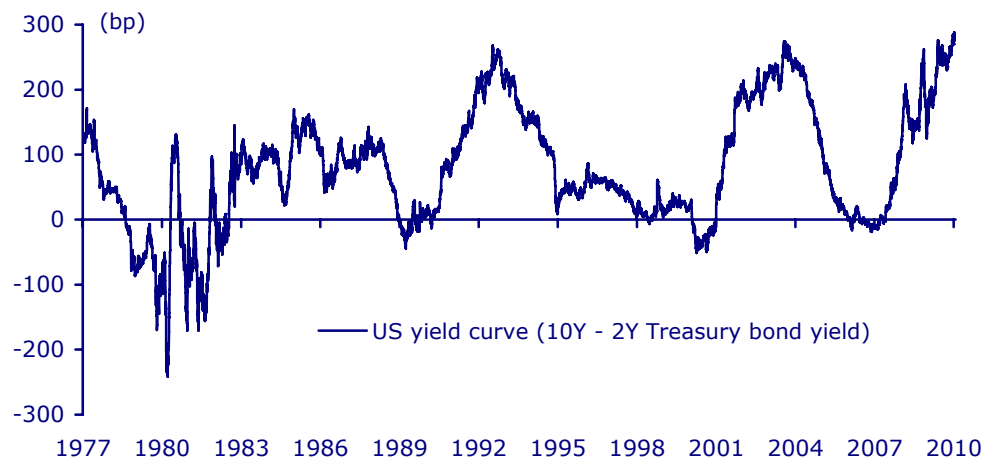
as happened in the recent past (save for Lehman Brothers) with bond investors taking no hair cut whatsoever.

The simple point is that there was never any case for repeal of Glass-Steagall, or indeed for financial deregulation in general, if the political process was not prepared to contemplate punishing commercial failure in the context of the financial services sector. This is also a point which can unite both Democrats and Republicans in Congress, which is why it is also interesting that Republican Senator John McCain and Democrat Senator Maria Cantwell introduced, as previously mentioned here (*GREED & fear - In favour of "narrow banking"*, 23 December 2009), a bill in Congress in December calling for a modern version of Glass-Steagall. For Democrats, bashing Wall Street and bankers in general makes total sense to appease their increasingly disgruntled "base". For Republicans, there is absolutely nothing free market about policies which socialise losses in the financial services sector which is why supposed free market paragon, Pipsqueak Pinball, was and is such a phony.

For a criticism from the political right of what has gone on in finance, investors are recommended to read an article published in yesterday's *International Herald Tribune* ("*Taxing Wall Street down to size*", 21 January 2010) by David Stockman, Ronald Regan's former director of the Office of Management and Budget. *GREED & fear* agrees with every word of this article but will quote just two sentences. "The US economy desperately needs less of our bloated, unproductive and increasingly parasitic banking system ... The banking system has become an agent of destruction for the gross domestic product and of impoverishment for the middle class."

Figure 2

US yield curve (10Y - 2Y Treasury bond yield)

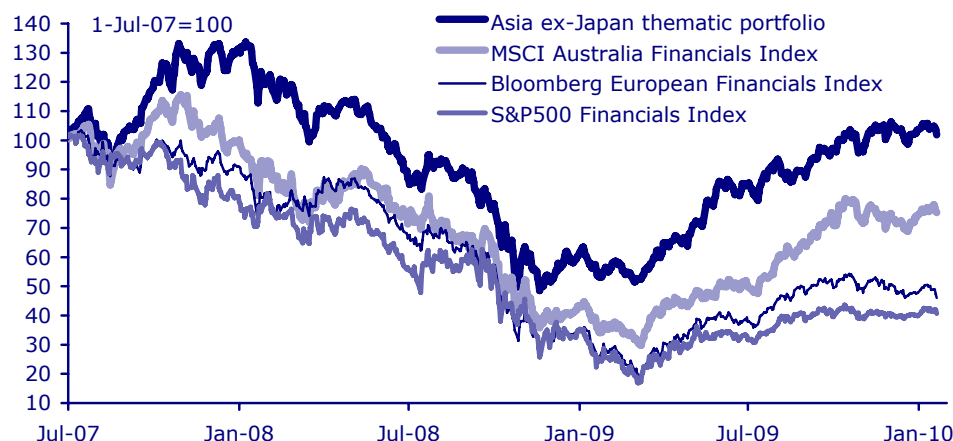


Source: Bloomberg

What about the market consequences? Obama's new policy initiative has clearly increased the risk that the Wall Street correction begins before the S&P500 reaches the 1200 level. Still the key point for *GREED & fear* is that investors who want to hedge their long Asian and emerging market exposure should continue to remain underweight or short the large Western financial stocks. It is true that some famous investors are long these stocks because of the easy profits now being generated by the significant steepening of yield curves which has occurred courtesy of Western central bank policy (see Figure 2). Still *GREED & fear* remains bearish on these stocks in the medium term. This is, first, because *GREED & fear* expects the yield curve to flatten in due course when investors realise the recovery in the West is not normal and government bond yields, as a consequence, decline. Second, in *GREED & fear's* view bulls on big bank stocks in America and Europe have been underestimating the regulatory reaction which is coming, which at a very minimum is likely to mean structurally lower returns on equity. This is because they are experts on finance, not politics.

Remember that if something is too big to fail it is too big to exist. That is something Joe Sixpack can understand even it remains a point hard to grasp for the sophisticates in New York and Washington and the rest of the Davos Crowd.

Figure 3

CLSA Asia ex-Japan thematic portfolio relative to Australian and Western Financials


Note: The portfolio has risen by 1.8% in US dollar terms since 1 July 2007, while US, European and Australian financials were down 59%, 54% and 25% in US dollar terms respectively over the same period. Source: Datastream, CLSA Asia-Pacific Markets

Key to CLSA investment rankings: **BUY** = Expected to outperform the local market by >10%; **O-PF** = Expected to outperform the local market by 0-10%; **U-PF** = Expected to underperform the local market by 0-10%; **SELL** = Expected to underperform the local market by >10%. Performance is defined as 12-month total return (including dividends).

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