

# Asset Allocation Update


## *Summary*

*Given the recent changes in macro-environment, we will be revising our asset allocation to downgrade Equities to underweight and raise Fixed Income to slight overweight. We retain our overweight recommendation in gold. Within Equities, we overweight US stocks versus Emerging Market ("EM") equities. Within Fixed Income, we overweight EM corporate credits.*

*Our assessment is that the persistent spate of weak numbers is indicative of a more persistent slowdown rather than just a temporary soft patch. Previously, our base case outlook was for sub-par developed market growth, but at a level that could still be attractive for risk assets. However, we believe that the economic data pointing to growth is likely to come in at the lower end of the sub-par range at a level we would call a "stall" level of between zero and two per cent GDP growth, and this is likely bad for risk assets, though potentially more attractive for gold and fixed income.*

*We would also note that risks of recession and market anxiety of a new recession are increasing. Previously, we thought the economic recovery was enough to achieve improvements that would persist even through future austerity. But as expansion and job hiring faltered and austerity may come sooner than expected in the US, we think the risk that the US has not achieved "escape velocity" has increased significantly. Therefore, we would position our portfolios more defensively.*

*We are mindful of the risks of being too conservative. A bounce in data that does affirm that the economic weakness was only due to temporary factors would be very encouraging to markets – but at this stage we find a lack of evidence to support this hope. The Jackson Hole gathering which takes place later this month could be the first window for a potential Quantitative Easing ("QE3") announcement. At this stage, we think that we should expect a few more months of pain and increased anxiety of a new recession before QE3 would be introduced.*


## Key Changes

| | 3Q Strategy | Aug 2011 Update | Comment |
|---|---|---|---|
| ***Overall Asset Allocation*** | OW Commodities | OW Fixed Income/ UW Equities | The recent spate of weak macro numbers has stoked fears that US growth will be lackluster. This bodes ill for equities. |
| ***Equity Allocation*** | Neutral Equities | Underweight | Slow growth and even double dip fears are likely to weigh on markets over coming months. |
| ***Fixed Income Allocation*** | Overweight EM<br>Underweight Government Bonds | Overweight | Our base case of slow growth but not double dip makes fixed income corporate bonds attractive as persistent low rates are more likely. |
| ***Commodities*** | Positive on gold | Maintained | Gold to benefit from safe haven demand, and will benefit if inflation picks up as well. |

*OW: Overweight*
*UW: Underweight*

| Asset Allocation | 3Q2011 (update) Recommendation | Policy | 3Q2011 (original) Recommendation | Benchmark |
|---|---|---|---|---|
| **Equities** | **50%** | **Underweight** | **55%** | **55%** |
| ***Equities distribution*** | | | | |
| **US** | 44.5% | Overweight | 44.5% | 42.6% |
| **Europe** | 23.5% | Underweight | 24.0% | 25.6% |
| **Asia ex Japan** | 10.5% | Neutral | 11.0% | 9.9% |
| **Japan** | 6.5% | Underweight | 6.0% | 8.3% |
| **Australia** | 2.5% | Underweight | 2.5% | 3.4% |
| **Canada** | 4.0% | Underweight | 3.5% | 4.6% |
| **Latin America** | 6.0% | Overweight | 6.0% | 3.1% |
| **EMEA** | 2.5% | Neutral | 2.5% | 2.6% |
| **Fixed Income** | **40.0%** | **Overweight** | **35.0%** | **38%** |
| ***Fixed Income Distribution*** | | | | |
| ***Developed*** | 30% | Underweight | 30% | 70% |
| **Government** | 35% | Underweight | 35% | 71% |
| **High Grade** | 45% | Overweight | 35% | 21% |
| **High Yield** | 20% | Overweight | 30% | 8% |
| ***Emerging*** | 70% | Overweight | 70% | 30% |
| **Asia** | 31% | Neutral | 28% | 30% |
| **Latam** | 30% | Neutral | 33% | 33% |
| **CIS/EE** | 31% | Overweight | 31% | 27% |
| **ME/A** | 8% | Underweight | 8% | 10% |
| **Cash** | **3.0%** | **Overweight** | **4.0%** | **2%** |
| **Commodities** | **7.0%** | **Overweight** | **6%** | **5%** |
| ***Commodities Distribution*** | | | | |
| **Gold** | 50% | Overweight | 30% | 25% |
| **Base Metals** | 10% | Underweight | 15% | 20% |
| **Agriculture** | 20% | Neutral | 20% | 20% |
| **Energy** | 20% | Underweight | 35% | 35% |

*CIS/EE – Commonwealth of Independent States/Eastern Europe*
*ME/A – Middle East/Africa*

## Macro Review

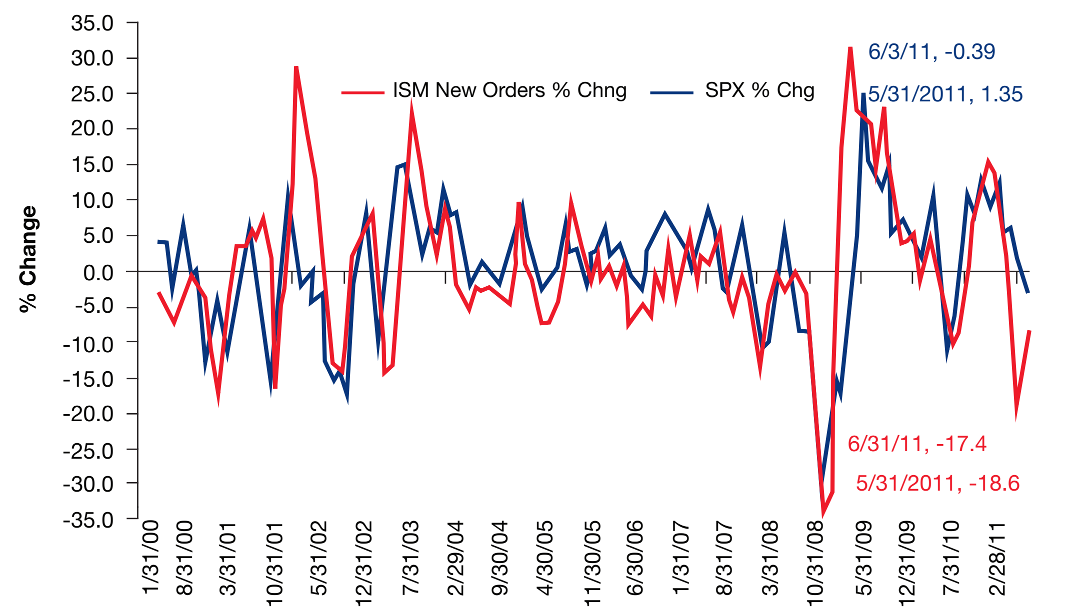
Global macroeconomic data have worsened with ISM, jobs and spending data largely disappointing. The employment component of the ISM survey pointed to further weakness in the US labour market, and this has coincided with the end of stimulus measures. Therefore, there is a possibility that the US economy may not be able to recover sufficiently before the US government starts withdrawing fiscal stimulus from the system.

In this environment, growth is likely to be lacklustre at fewer than two per cent – a rate which bodes ill for equities. We also note that the correlation between ISM and S&P 500 returns on a three-month rolling basis has historically been tight. Therefore, equities are certainly up against significant headwinds in the coming months.

| Shap Trajectory of Rebound | Implied GDP | UOBAM (last quarter) | UOBAM (current) | Consensus (current) | Market Implications |
|---|---|---|---|---|---|
| **Strong Recovery** | >3.5% | 10% | 5% | 5% | Positive, especially as policymakers are more focused on jobs than inflation. No real US policy headwinds until 2012. |
| **Weak Recovery** | 2-3.5% | 45% | 40% | 45% | Given low interest rates and global liquidity, risk assets will likely perform well even if the recovery is a slow recovery. |
| **Stall** | 0-2% | 35% | 45% | 45% | Bearish - post 1977-type markets (potentially bullish for Bonds and Gold depending on inflation) |
| **Double Dip** | <0% | 5% | 10% | 5% | Very bearish. |

Source: UOBAM estimates

We think that equity markets have to do more catching up with how badly the economic data has deteriorated. The chart highlights the strong correlation between the change is the US ISM surveys and the change in the markets and how there are more downside risks.




Source: UOBAM estimates

We are making a tactical call to keep our overweight US stocks, and funding that out of Asia (ex Japan) equities. While it seems perverse to sell Asia on US problems, we note that this would be typical market behaviour to sell higher beta markets first. The reason is that US stocks are operationally less leveraged to external environment, compared with European and EM stocks. Therefore, the risks appear less challenging for US stocks, compared with Asian markets.

## Fixed Income

Within Fixed Income, we still prefer Emerging Markets over Developed Markets, but we now recommend exposure to high grades instead of high yields. The macro risks have certainly heightened and therefore, the high-grade corporate names are probably the ones that are best positioned to weather the storm.

We would note that a “stall” projection of developed market growth would favour corporate bonds and a recession would favour government bonds. Since our base case is still for stagnant growth and not a recession, this makes corporate bonds attractive as the risks of defaults are not very high. Also, there will be very little risk of rising interest rates and the environment is likely to be fairly deflationary.

While we think the odds of a QE3 program to increase money supply is increasing, we still think that there is significantly more economic and market volatility to go through before the US Fed will resort to QE3. Criticism of the US Fed was so extreme after QE2, that markets are making the assumption that the US Fed will wait until markets are “begging” for QE3 before it acts this time.

## Commodities

We retain our overweight position in gold, on risk-aversion trades and central banks' demand. So far, the precious metal has outperformed all the major fiat currencies except for Swiss Francs, and there's room for further appreciation on central banks' buying.

Globally, the percentage of central bank's reserves held in gold averaged 10 per cent, with countries such as China holding just 2 per cent of its reserves in gold. As the US dollar and euro weaken, there is pressure on governments to buy more gold.

Furthermore, the low or negative real interest rates in many economies lend support to gold prices, and therefore, there is more upside than downside in buying the precious metal. Our year-end price target is US$1,750 per troy ounce, and we see signs of better performance among gold counters.

## Asian equities

In Asia, we are concerned about the slowdown in global growth, and therefore pared our exposure to export-oriented markets such as Taiwan and Korea. Already both countries have reported signs of export slowdown, and there could be downside further down the road.

In contrast, we now favour those countries with a strong domestic consumption story or play a defensive strategy by holding quality Singapore and South East Asian stocks. Within East Asia, some of the markets we like include Indonesia and Philippines and China. Although China is a major export powerhouse, our exposure there is primarily in consumer discretionary counters such as luxury goods and autos players. We also like the cement segment, but avoid steel plays and consumer staples. The country's Purchasing Managers' Index ("PMI") is still in expansion territory, while inflation looks set to moderate in the second half of 2011.

We are underweight in Thailand, even though we favour the banks. These banks enjoy high margins, even though most already have very high loan-deposit ratios.

In Singapore, the telecommunications sector looks increasingly attractive, as some of the players in that segment have been the top performers since the start of the year. There could be value in looking at some of the quality telecommunication names.

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