

COMMENTARY

## Markets set for further recovery next year

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This year was a confounding one for many market observers, as bulls and bears alike had various periods of vindications and setbacks.

While the bulls and bears fought it out in the media, investors were left to puzzle over the unique cocktail of events from central bank intervention, rescue packages, fickle views on inflation and deflation that dominated the headlines.

Was America in danger of a Japan-like dive into deflation or was hyper-inflation around the corner? Was the euro zone about to unravel or would emerging markets save the day?

That the recovery path was bumpy did not come as a surprise. But what especially spooked global investors were the new crises that came to the fore, such as the Greek and Irish fiscal woes, fresh fears of deflation in the United States, and then concerns of sharp policy tightening in China which briefly threatened the recovery prospects of the developed world.

As such, risk-averse investors could be forgiven for staying on the sidelines due to the lack of clarity on the macro front.

But fortune favours the bold. And the reality is that those investors, who were intrepid enough to ride out the volatility, were able to reap attractive returns by buying quality assets at discounted prices.

This is especially so for those who bought into the healthy Asian and Latin American stocks which outperformed their developed peers in the first year of recovery. The fact is, these counters have benefited from the favourable backdrop of low national debt, healthy banking systems and strong external positions in their home countries.

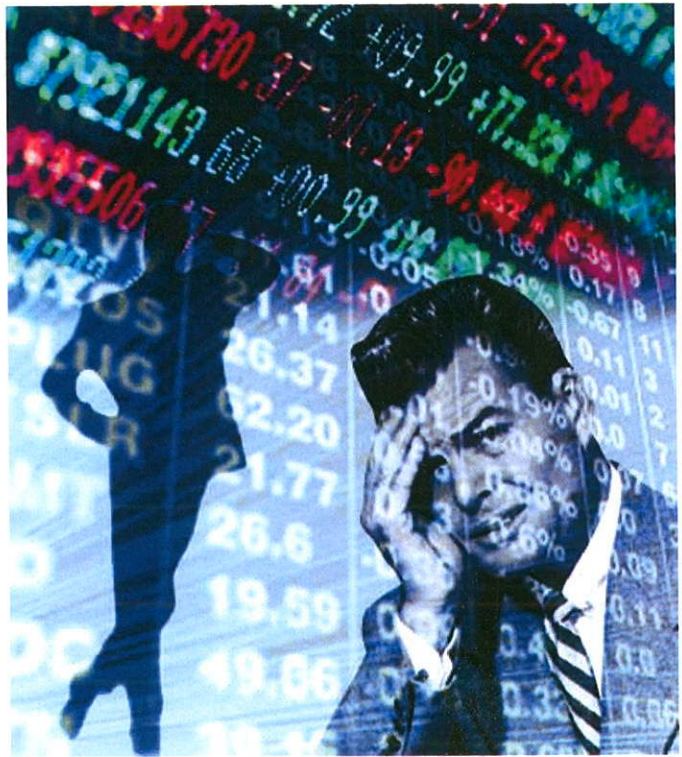
In terms of asset classes, as of Dec 7, all major asset classes have generated positive returns this year, with commodities generating the highest return of 11.7 per cent. Equities and bonds returned 7.5 per cent and 6.6 per cent respectively.

As we enter 2011, we think investor fears about double dips are dissipating. Economic data continue to show that the global economy has already gained a firm footing on the recovery path, with growth expansion in store for the next 12 months.

For example, the latest economic data from the US show that the overall tone of the job market continues to improve, while manufacturing activity gains traction. The implication is that US economic activity should improve, supported by the extremely accommodative credit conditions in the new year.

A look at developing Asia tells a similar story, as fast-growing economies such as China and India reported strong economic results throughout the second half of this year. There, most leading indicators are still pointing to a positive macro backdrop, despite the threat of rising inflationary pressures in several countries.

With growth already at or above the long-run levels in many emerging markets, we believe the US economy should follow suit and that growth prospects



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should improve. As capital market conditions continue to remain stable, and we believe that there is a strong case for our view that the world economy is not about to slip into a double-dip recession. In fact, we think that economies like the US should outperform market expectations.

Nonetheless, a trilogy of macro risks has dominated market sentiments in recent weeks — an overhang that investors will still have to contend with, going into 2011.

A key near-term risk in the emerging markets investment theme is the possibility of policy tightening as the price pressures in emerging market countries continue. Additionally, some countries in Asia may also implement capital controls to slow the inflow of hot money into their fixed income markets.

Against this backdrop, if our assessment is right, this means that equities will perform well in the months ahead, as the asset class thrives in a non-inflationary growth environment.

US equities are likely to outperform in the first half of next year as economic growth strengthens. We still favour emerging market stocks over the next 12 months owing to the strong economic

fundamentals, corporate earnings and reasonable valuations.

We remain underweight on fixed income but believe that high-yield fixed income instruments may do well, owing to a potential upside economic surprise in the US. This is because high yield spreads over investment grades and may tighten with the market prices in the improved economic environment.

The clear commitment of the US Federal Reserve and other central banks towards supporting economic growth means we are overweight on commodities. While the Federal Reserve's recent announcement of additional monetary liquidity measures is designed to fight deflationary pressures in the US economy, leakage of this stimulus into developing markets can be expected to boost growth prospects for the global economy.

The pro-growth bias of policy-makers should see both a continuation of low US interest rates and an increase in inflationary pressures, with commodity prices strengthening as a result. ■

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