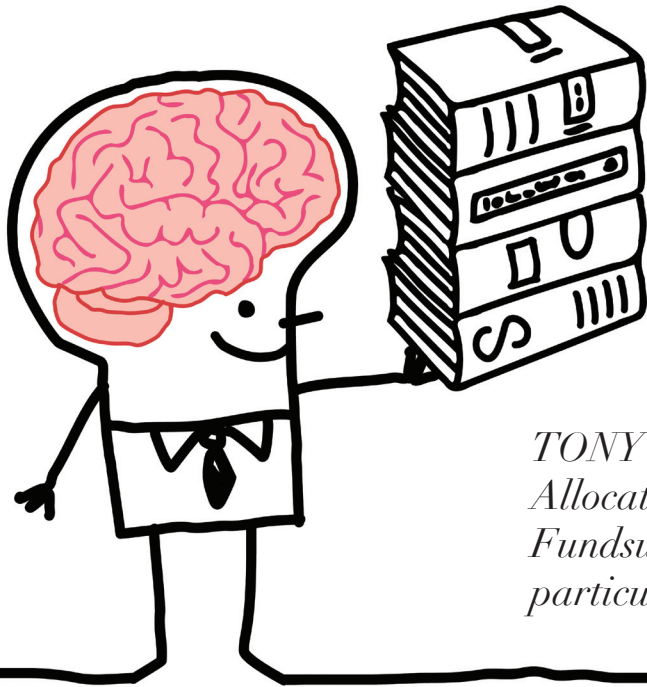


The Asset Allocation Answer To Inflation



TONY RAZA, Senior Director, Head of Asset Allocation at UOB Asset Management, shares with Fundsupermart his views on asset allocation after a particularly turbulent start to 2011.

BY FUNDSUPERMART CONTENT TEAM

Which asset class should investors overweight and which should they underweight? Tony Raza, Senior Director, Head of Asset Allocation at UOB Asset Management shares his outlook for the different asset classes and what investors should do if they are worried about inflation.

FUNDSUPERMART (FSM): How have the respective asset classes perform since the start of 2011?

TONY RAZA (TR):
EQUITIES

Since the start of the year, equities have generated a return of 4.9% as at 5 April 2011. We recommended an overweight on the asset class at the start of the year, with a specific preference for US equities. During the quarter, the equity markets saw a major tactical rebalancing in favour of US stocks, even as

concerns of inflation and tightening weighed down on emerging Asian stocks. For the second quarter of 2011, we believe that the macro environment remains conducive for risk assets, but also recognise that the list of tail risks may possibly shorten any market rally. As a result, we are now recommending a slight overweight on equities.

FIXED INCOME

As of 5 April 2011, bonds generated a year-to-date return of -0.2%. We continue to be bearish on this asset class, as the threat of policy tightening will be a major headwind in the fixed income segment. Additionally, there is the spectre of the end of the second quantitative easing (QE2) programme in June this year, which may drive Treasury yields up. Government bonds look especially vulnerable, and we are underweight on sovereign issues.

Within the fixed income asset class, corporate credits are still our preferred instruments.

Even as we remain fundamentally positive on stocks, we see relative value in corporate credits over their sovereign peers.

COMMODITIES

Commodities were the star performers in the first quarter, with a year-to-date return of 9.4%. The asset class did well due to the liquidity in the financial system, inflationary pressures, and unrest in the Middle East. In particular, oil trended higher on fears of supply disruption in Libya. Current headwinds to commodity demand include policy measures to cool the Chinese economy and credit troubles in the Eurozone.

In the second quarter of the year, we see upside in oil, and also retain our overweight on gold. We have a neutral position in bulk commodities, but recommend an underweight on base metals. Concerns over further Chinese domestic rate hikes have delayed the expected re-stocking for key commodities such as iron

ore, coal and copper. Sentiment will only improve with much stronger import data or from clear activity from the ambitious low-income housing program. To date, the launch of Base Metal Exchange Traded Funds (ETFs) has had a negligible effect on base metal prices.

FSM: Within equities, which regions demonstrate the most and least conviction?

TR: We are positive on US and Asia-Pacific (ex-Japan), as valuations remain reasonable, with growth upside to boot. The developed market data that remain strong includes industrial production, Institute for Supply Management (ISM), German Ifo Business Climate Index and US job data. However, there have been a couple of hints of slowing trend data in the US as the confidence numbers and durable goods orders disappointed in February. We are still sanguine on Asia-Pac (ex-Japan), owing to our belief that China will succeed in pulling off a soft landing.

We are still bearish on prospects in Japan, and the recent Japan earthquake may weigh down on sentiments further.

FSM: Within fixed income, which sectors demonstrate the most and least conviction?

TR: As mentioned earlier, we are more positive on corporate credits as they are expected to benefit from the supportive business environment. In particular, we still prefer the high-yields over the investment grades, as we believe that supportive macro backdrop lends further upside to high yield instruments compared with investment grades.

In terms of geographical calls, we are overweight emerging markets over developed markets. In particular, we stay overweight in Commonwealth of Independent States (CIS, a regional organisation of former Soviet Republics) and Middle East; maintain market weight in Latin America and Asia; and are underweight in Africa and Eastern Europe. We prefer more of the fundamentally strong local currencies bonds and would keep

duration relatively short to limit the impact from rate tightening.

In contrast, we are bearish on the outlook for government paper. In particular, we are still cautious on Europe, as the European Central Bank (ECB) may hike rates followed by United Kingdom (UK). Also, the markets may be disappointed again by the lack of comprehensive measures to address the credit problems. In all likelihood, Portugal will be the next to be bailed out and Spain will muddle through.

FSM: What commodities are you particularly overweight and underweight on?

TR: Within the energy segment, we recommend overweight on crude oil and a neutral position on natural gas. Fears of disruption to Middle East supplies have caused a spike in near-term spot prices, and lead to higher prices for international crude such as Brent relative to US benchmarks such as West Texas Intermediate.

However, underlying demand is also strong, with agencies such as the International Energy Agency (IEA) forecasting that 2011 will be a record year for demand. Crude oil inventories have now moved to normalised levels, at the same time as OPEC's ability to provide spare capacity is being questioned. While US natural gas prices remain depressed due to strong growth in shale gas production, liquefied natural gas (LNG) prices remain robust.

We retain our overweight position in gold which we expect to benefit from investor concerns about the unknown consequences of prolonged monetary stimulus on future inflation and currency stability.

We continue to be underweight in agriculture. This is despite the fact that prices for key commodities such as corn, wheat and soybean have continued to strengthen over the past quarter due to poor weather conditions. We expect weather-related shocks to abate over the coming months, and note that farmers are taking advantage of current high prices by increasing plantings for the 2010/11 harvest.

FSM: From a portfolio perspective, which asset class will you advise investors to overweight and underweight on?

TR: We continue to overweight equities and commodities and underweight fixed income investments. This would be consistent with the sectors that outperform at the current stage of the business and investment cycle.

However, as there is an unusual number of risks weighing on investment markets such as the risk of rising food and energy prices, the end of QE2, sovereign credits and conflicts in the Middle East, we would suggest only small overweights until there is greater clarity.

FSM: 2011 thus far has been rather turbulent both politically and in the financial markets. Do you see this turbulence continuing and how can investors protect their portfolios against such volatility?

TR: We would characterise the base case of the current environment as being very attractive as economic momentum, corporate profitability growth and valuations are attractive. But it is also an unusually turbulent period with a fairly large number of risks overhanging markets. We think that investors should stay invested but be balanced. This is not a time to take big bets in any one area.

FSM: How should investors position their portfolio in terms of asset allocation if they are concerned about inflation?

TR: Fixed income investments suffer the most in inflationary environments. Equities tend to be mixed. Strong companies tend to maintain their market positions, pass on costs and can perform well in inflationary environments. We also think property companies and REITs should hold their value better. Finally precious metals are traditionally a strong performer during inflationary periods. **FSM**

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