

COMMENTARY

Way ahead for the third quarter

Investors should continue to go for equities with a focus on the US, emerging markets and Asia

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So far, this year has been a roller-coaster ride for most investors. Many are now probably confused as to where the markets are headed.

Global equity markets started the year strongly and then corrected sharply at the end of January as China started to tighten policies.

Then equity markets started to rally again, driven by increasingly strong economic data in the United States that resulted in the S&P 500 rising steadily by 15 per cent from February to April this year.

This was followed by the equity markets suffering a significant 10 to 15 per cent correction as a result of concerns in Europe.

The question is: Is it more of a typical mid-cycle correction buying opportunity, or the first hints of a looming double dip?

From our perspective, whilst we believe concerns over Europe are justified, we continue to be positive about the recovery in the global economic and investment cycle due to:

(1) Strong economic indicators;

(2) Strong monetary policy support from leading central banks;

(3) Strong corporate balance sheet and earnings prospects; and

(4) Potential return of investors back to equity fund following the redemptions of 2008.

We think the investment decision for the second half of this year really boils down to deciding if the world is going to double dip into another period of negative growth or not.

If otherwise, then monetary policy and zero per cent interest rates are likely to "drive" investment dollars into assets that

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offer growth even if that growth is sub-par compared to normal recoveries.

Also, if the economies are not double dipping, corporates will continue to find their funding rates to be as low as 3.5 per cent, which is a hurdle rate that almost any company can clear even in a slower-than-usual recovery.

For corporates, this implies increased mergers and acquisitions or business investment, either of which would be a positive sign for equity markets.

And finally for professional investors, as long as global economies do not double dip, then there will exist attractive "carry trades", where funds can borrow at such low rates that it is not difficult to find investments that can cover the costs of borrowing.

So what makes us believe there is not going to be a double dip?

Firstly, double dips are extremely rare. The only real case of a double dip was in 1982 when right after the 1980 recession the US Federal Reserve

Board hiked interest rates to 20 per cent to stamp out inflation once and for all.

Secondly, while there are structural problems with the financial system and de-leveraging, the multi-year recoveries in the 1930s and mid-1970s indicate that market can recover for extended periods of time even when there are structural problems.

Thirdly, economic indicators for the US remain quite strong as industrial production, manufacturing, confidence and employment all continue to recover. Even in Europe, these same trends remain healthy so far.

And, lastly, when we summarise the European crisis, it is quite clear the European Central Bank and International Monetary Fund have come up with a package that is enough to address the sovereign funding issues, and when we add up the fiscal austerity measures, it does not seem to have material impact on global growth.

We find that many of our clients are surprised that, after

the strong rallies of the past year, Asia and the US are still only trading at 11-12 times earnings with consensus forecast growth over the next couple of years in the range of 15 to 20 per cent a year.

Ultimately, we suspect much of the investment opportunity comes from the fact that investors are currently much more careful in analysing risks.

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This time, investors seem intent on not making the same mistake again, by pricing in discounts and pricing in double dip scenarios even when the evidence for it is fairly light.

The result is that corporates are growing earnings at healthy rates but reasonable valuations.

Thus, going into the third quarter of this year, we recommend investors to continue to overweight equities with a focus on the US, emerging markets and Asia.

While we would underweight fixed-income investments, we would relatively overweight emerging market bonds over government bonds. We would still hold gold which offers both a hedge and upside based on its own supply/demand imbalances. ■

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