

## Markets overly bearish on Asian stocks

In recent weeks, the financial markets saw a renewed bout of volatility on fresh spate of bad news out of the Euro zone and United States (US). Since last month, investors globally were spooked by talk that Greece may be booted out, and the repercussions that would have on some major European banks, most notably BNP Paribas and Societe Generale.

Additionally, there were fresh fears of a double dip, as certain manufacturing surveys (ISM, Europe's PMIs and HSBC Markit China) pointed to serious slowdown ahead even not contraction. Not surprisingly, most investors rushed for exits, and yesterday was no exception. Asian stocks were pounded from the opening bell, and by lunch time yesterday, Nikkei 225 had lost 1.74%, while South Korea's Kospi plunged 1.33%. Taiwan, Hong Kong, Singapore and Jakarta also bled with losses of close to 2% or higher.

While we are cautious on equities at the moment, we believe that the sell-down on Asian stocks may have been overdone. Although it is true that the macroeconomic outlook has clearly worsened from the previous quarter, it is clear that Asia is still in a fundamentally stronger position than its developed counterparts. Therefore, Asian equities may well be better-positioned to weather a slowdown compared with other markets. Additionally, as inflation starts to taper (and there are already signs of that), there is a chance that policy makers may have more headroom for additional stimulus measures to shore up their economies.

Furthermore, markets appear to have already priced in a recession in the next two quarters (using the Lehman's episode as a comparison), and we need a banking sector blow-up to justify more downside. Indeed, there are a number of reasons for a sluggish recovery scenario rather than a full-blown contraction. First, US corporate profits as a percentage of GDP are at record highs, and they point to healthier corporate standing than what a number of investors will recognise. In recent comments, the US Federal Reserve (Fed) noted that the US economic fundamentals were not as weak as what most perceived, and there is a chance that things may improve going forward.

Also, the Fed's Operation Twist to lower the longer-end rates will certainly help to lower business costs and, given sufficient time, should help lift business activity in the US. We also note that the economic data has started to be less disappointing, which means that fears of a recession may have been overblown.

Still, we recognise the greater macro risks in the horizon, ranging from the sovereign problems in Europe, its impact on the European banking sector, and possibly worsening sentiments and activity levels in the US. Meanwhile, growth outlook in the Emerging Markets has moderated, countries such as China and other Asean economies reported slower PMI readings. These trends are broadly consistent with the deterioration in the G10 outlook. Although we do not expect export growth to collapse to anywhere near the level seen in the fall of 2008 and spring of 2009, the weaker growth profiles for the US and Europe clearly point to more headwinds to orders and production.

For this reason, we had earlier in June 2011 moved to a neutral position in equities, and as of early August we recommended an underweight in the asset class. In an environment of slow growth, equities typically do not do well. 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.

We upgrade fixed income to overweight on possible rally in safe haven assets in times of macro uncertainty. Within the asset class, we 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 also 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 high grade corporate bonds attractive as the risks of defaults are not very high.

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