

COMMENTARY

Commodities are likely to outperform in the next quarter

The first quarter of 2011 was filled with major environmental, economic and social challenges from around the world. What are the potential investment opportunities and challenges investors should look out for in this market environment? **TONY RAZA** shares his asset allocation views for the next quarter of the year.

FIRST QUARTER 2011 REVIEW

The global macro environment in the first quarter of this year has been a "tug of war" between attractive economic momentum and reasonable evaluations versus a growing list of risks such as oil prices, European sovereign credits and natural disasters. On a global basis, risk assets such as equities and commodities have continued to perform well as the economic momentum trumped the growing concerns.

Geographically, we saw Asian stocks and developed markets (DM) start the year with healthy performance. As the double-dip fears eased and the recovery strengthen in the developed markets investors became more willing to accept equity risks.

However, the emerging market (EM) performance faded, as global investors grew increasingly concerned about potential inflationary pressures and, in particular, the extent to which central banks policy changes will affect economic growth. The concerns are particularly acute in fast-growing emerging Asian economies such as China and India, where growing wealth is putting significant pressures on food and energy resources.

The concern among investors is that overly aggressive rate hikes may disrupt

the global economic recovery, which gained traction only late last year. There is also the perennial fear among some that the spurt in prices may be a sign of late stage inflationary cycles. If true, the implication is that fast-growing economies may slow down much earlier than expected.

These worries set off a significant tactical shift away from EM that were most prone to inflation pressures and rate hikes. Countries that saw a major reversal of flows include India, Indonesia and Thailand, as global funds shifted their focus to countries such as the United States and Europe with better risk-return profiles.

Meanwhile, oil set a year-high on stronger global economic and geopolitical instability in the Middle East. Late last year, developed market economies showed signs of significant improvement in economic momentum, while threats of chaos and political vacuum in troubled states such as Libya and Bahrain have sent oil prices higher. In the latter case, the concern was that the social unrest in these resource-rich countries might result in oil supply disruption in the months ahead.

However, despite these economic threats, it is clear that industrial growth, consumer spending and job markets in the US continued to improve. For example, the latest economic data from the US show that overall tone of the job market continues to improve, while manufacturing activity gains traction. The implication is that the US economic activity should improve, supported by the extremely accommodative credit conditions in the coming quarters.

With many leading indicators above their two-year levels, we believe that the global economy has gained a firm footing, and is steadily charting its course through an expansion phase.

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ASSET ALLOCATION POSITIONING IN SECOND QUARTER OF 2011

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Additionally, the combination of unique tail risks ranging from Libyan turmoil and further rise in oil prices mean that gold may put up the occasional rally. We also like bulk commodities, copper and uranium.

Although we remain fundamentally sanguine on equities as a whole, we expect EM to continue to face the overhang of inflation until data peaks, possibly around mid-year. If markets get confirmation of inflation peaking after the food spike, then we believe that EM will outperform DM in the latter half of the year. Fundamentally, EM still enjoys stronger economic fundamentals when compared to DM — a trend which is unlikely to change in the medium-term. Within EM, we prefer the domestic growth story, and, therefore, recommend overweight in China and Indonesia. In contrast, we will underweight export-driven economies such as South Korea and Taiwan.

We remain underweight in fixed income, as the end of second round of quantitative easing (QE2) programme in June this year is likely to drive rates up and this bodes ill for US Government bonds. Additionally, higher inflation typically hurts returns on fixed-rate instruments and, therefore, creates a headwind for fixed income in the current phase of the economic cycle. ■

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