

Summary

Equity market volatility is a bull market correction, not a resumption of bear market

Asian equity markets are suffering their largest correction since March 2009. The trigger was the hike in the reserve requirement ratio by the People's Bank of China in the second week of January. Risk appetite has also been affected by President Obama's proposed curbs on the trading activities of US banks. In Europe, there are fresh concerns about Greece's ability to repay its sovereign debt.

Equity markets usually suffer a correction at the first move by central banks to tighten. We had expected China to tighten ahead of the Fed because the rebound in China's growth has been stronger than expected and inflation risk was rising. The tightening has however come earlier than anticipated. In our view, China is unlikely to tighten to a point that its economy is derailed as global growth remains weak.

We view the decline as a bull market correction and believe that the equity rally can resume. We have however turned tactically more cautious and are scaling back our exposure to equities from an Overweight position to Neutral. The rise in policy uncertainty in both the Emerging Markets and the Developed Markets is likely to keep volatility relatively high for the near term.

We still see strong reasons for the equity market to move higher over the course of 2010. Support for equities comes from the continuing recovery of the global economy, improving earnings, the Fed remaining on hold, a large amount of cash still on the sidelines earning practically zero interest and the high free cash flow in the corporate sector.

After the rally in 2009, markets were no longer cheap and at the start of the year, Asia ex Japan was trading modestly about its long term averages. The correction is making the market more attractive and we believe that valuation support for Asia ex Japan could come in about 10% from today's levels. Our strategy is not to time the bottom of the sell down but we are looking for opportunities to increase our positions in the companies with good fundamentals.

Risk appetite affected by rise in uncertainty

Asian equity markets are suffering their largest correction since the lows of March 2009. MSCI Asia ex Japan has fallen by about 10% over the recent days, the trigger being the hike in the reserve requirement ratio (RRR) by the People's Bank of China (PBOC) in the second week of January. This was followed by the PBOC's request to some banks that lending be stopped for the remainder of the month. Risk appetite has also been affected by President Obama's proposed curbs on the trading activities of US banks. This came immediately after the Democrats suffered an unexpected defeat in the state of Massachusetts, a Democratic stronghold. To the market it appears that the Obama Administration is turning more populist in its policies. In Europe, there are fresh concerns about Greece's ability to repay its sovereign debt. Together, these developments have created a significant amount of uncertainty and equity markets have pulled back.

Volatility is common at the first tightening

We highlighted in our 1Q 2010 Quarterly Investment Strategy that the focus of the market in 2010 would be on policy changes. Equity markets usually suffer a correction at the first move by central banks to tighten. Asia usually tightens after the Fed has begun raising interest rates, but in this cycle we had expected Asia to tighten ahead of the Fed. We thought it was likely that the first to move would be China because the rebound in China's growth has been stronger than expected and inflation risk was rising. The move has however come earlier than anticipated.

In an earlier note, we commented that the hike in the RRR was a move by the Chinese authorities to rein in excess liquidity in the system. New loan growth in 2009 was over 30% and some of this appear to have leaked into the property and equity markets in China. The Chinese authorities are likely to be more comfortable with credit growth of under 20% a year, in line with nominal GDP growth. In our view, China is unlikely to tighten to a point that the economy is derailed as global growth remains weak. Nevertheless, the actions by the PBOC represent near term headwinds for the equity market.

Key difference is that the Fed is on hold this time

Over the last 20 years, during equity bull markets, Asia ex Japan has typically suffered periodic corrections of more than 10%. These corrections, if they come after a large run-up in markets, can be a little painful, like the 25% decline in 2004. MSCI Asia ex Japan however still ended 2004 up 15%. One important difference in this cycle is that the Fed and the other key central banks in the Developed Economies are not likely to tighten any time soon. This probably moderates the degree of tightening that Asian central banks will undertake and overall liquidity conditions are likely to remain accommodative.

The Fed being on hold also limits the extent to which the US dollar will strengthen. The US dollar has been pushed upwards in recent days because of the spike in risk aversion as the US dollar is a safe haven asset. The problems in Greece have also weighed on the Euro which further boosted the US dollar. The problems in Greece have also weighed on the euro which further boosted the US dollar. The US dollar could continue to stay relatively strong if US economic data surprises on the upside in the coming weeks. Another potential support for the US dollar is President Obama's proposals for a freeze on government spending. A strong US dollar has traditionally been a negative for Asian equities because its currencies are linked to the US dollar and tend to strengthen in tandem. Stronger currencies hurt Asian export sectors.

Bull market supported by earnings and liquidity

We view the decline as a bull market correction and believe that the equity rally can resume. We have however turned tactically more cautious and are scaling back our exposure to equities from an Overweight position to Neutral. The rise in policy uncertainty in both the Emerging Markets and the Developed Markets is likely to keep volatility relatively high for the near term.

We still see strong reasons for the equity market to move higher over the course of 2010. The global economy continues to recover and corporate earnings continue to improve. We are in the middle of the US fourth quarter reporting season and so far earnings have been surprising on the upside. The trough of the S&P earnings cycle appears to have been the third quarter of 2009. Consensus expects a 25% increase in US earnings in 2010, and 20% in 2011. The new regulatory proposals for the banks to curb their trading activities may affect the profitability of the financial sector but the non-financial sector is not directly affected. Asia ex Japan is expected to see 30% earnings growth in 2010 and 15% in 2011.

As mentioned, we believe the Fed will not raise interest rates for some time as inflation risk is low and the housing market is still fragile. Practically zero Interest rates mean that investors have a strong incentive to reallocate out of cash and money market funds. The dividend yields in some stocks now exceed their bond yields and present very attractive alternatives to cash. There is also high free cash flow in the corporate sector. This could be returned to investors, through dividends and share buybacks, used for corporate activities i.e. mergers and acquisitions, or to fund capital spending.

After the rally in 2009, markets were no longer cheap and at the start of the year Asia ex Japan was trading modestly about its long term averages. The correction is making the market more attractive and we believe that valuation support for Asia ex Japan could come in about 10% from today's levels. Our strategy is not to time the bottom of the sell down but we are looking for opportunities to increase our positions in the companies with good fundamentals.



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Contact Details

Address 80 Raffles Place UOB Plaza 2 Level 3 Singapore 048624
24-hour Hotline 1800 222 2228 (Local) • (65) 6222 2228 (International)
Fax (65) 6532 3868
Email uobam@uobgroup.com
Website uobam.com.sg

Regional Offices

Singapore

Institutional Investments
Dennis Siew
Senior Director

Retail Investments
Norman Wu
Senior Director

Regional Investments
Faizal M. Fazluddin
Senior Director

Alternative Investments
Chong Jiun Yeh
Executive Director

International Business (China)
Jasmine Lim
Senior Director

Brunei

Kamal Muhd
General Manager

Japan

Masashi Ohmatsu
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Lim Suet Ling
Chief Executive Officer

Taiwan

Juang San Tay
General Manager

Thailand

Vana Bulbon
Chief Executive Officer

BULL MARKET CORRECTION

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