

CIO MESSAGE

The first half of 2010 has been a roller-coaster period for investors, with equity markets making swings of 15% to 20% over the course of the six months as investors climbed the proverbial 'wall of worry'.

Markets have lacked conviction this year because investors are being pulled in two directions - one secular, the other cyclical. On the secular front, the market has become very sensitive to the large and growing level of government deficits in the developed economies. The crisis over Greece and the other indebted peripheral Eurozone economies is a manifestation of these concerns. However, the problem extends wider and the government deficits in Japan, the UK and the US could potentially become a focus of the market.

Behind the headlines surrounding the European crisis, there has however been the steady improvement of the global economy. The cyclical recovery has turned out to be stronger and faster than expected and the latest data still points to a continued expansion in economic activity. The return to growth is providing a sizeable boost to corporate profits, particularly as companies are enjoying exceptionally high operating leverage in light of the aggressive cost cutting they undertook during the recession.

It has not been easy for investors to weigh the secular concerns against the cyclical recovery. The question of sovereign risk does not fit easily into any conventional risk-reward framework. The €750 billion stabilisation package buys time for Greece and the peripheral economies but does not appear to change the underlying solvency risk. Investors are therefore either standing aside or asking for higher returns.

With investors demanding greater fiscal discipline from governments, the market has also begun to question the sustainability of the global economic recovery. The global economy was put back on its feet by unprecedented fiscal and monetary stimulus from policymakers. The recovery could falter if government spending is reined in while households in the developed economies are still deleveraging.

Whether the recovery is self-sustaining or not depends largely on the US labour market. If the US is back to creating jobs, US consumers will continue to spend, even if modestly. Then companies will continue hiring, rebuilding inventories and expanding capacity. So far, the signs we have seen are modestly encouraging. The private sector in the US has been

creating jobs since January this year, albeit at a slower pace than what the market was anticipating.

One important reason why we think we can avoid a double-dip recession is because the global business cycle today is at a different stage compared to 2008. The corporate sector has not rebuilt its inventories and hiring has been cautious and even if the European crisis begins to affect business confidence, it would be difficult to envisage a repeat of the extraordinary retrenchment we saw in the wake of the Lehman crisis.

If, as we believe, we are not about to fall into another recession, then equity markets are attractively priced. Because markets have been volatile, analysts have been cautious in revising their earnings estimates and equity multiples have compressed. The forward PE of the S&P 500 at 12.2x is close to the level where it was at the beginning of 2009, just before the market began its rally. This is similarly the case for MSCI Asia ex Japan, which is trading around 10.9x.

For Asian equity markets, an added headwind has been the policy tightening in China. The determination of the Chinese authorities to cool the property market has led to greater fears of a hard landing of China's economy. Property prices in China have finally begun to decline. If there are more convincing signs that prices are under control and inflation is not a problem, policy tightening in China is likely to ease. This would be a relief to Asian equity markets.

The one asset class which has clearly benefited from the uncertainty and volatility this year is gold. The price of gold in every major currency is at record high. Compared to equities and bonds, gold only makes up a tiny percentage of global portfolios and the small shift that has been occurring in asset allocations is the key reason why gold prices have risen. We have been advocating that investors consider some exposure to gold and gold equities to diversify their risk and this is something which we believe is worthy of consideration.

To sum up our view, while we expect markets to continue on its choppy course, we do not expect the global economy to enter another recession. We believe that the current phase of volatility is a bull market correction and not the start of a bear market. Therefore, we stay positive on equities.

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