

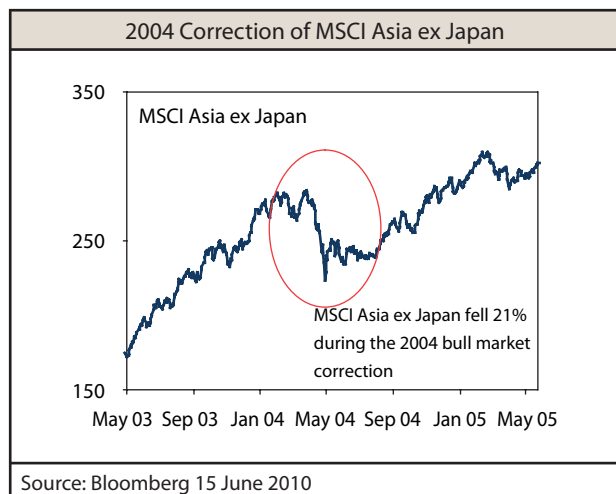
# Global Investment Strategy 3Q 2010

Contributed by UOB Asset Management

Equity markets continued to be marked by volatility in the second quarter of 2010. Investors remain troubled by the debt problems in Europe and their fears of a hard landing in China have grown stronger. The rise in risk aversion in financial markets has however not spilled over into the real economy and global economic indicators are still showing signs of a continuing recovery.

Although the ongoing volatility in financial markets raises the risk that business and consumer confidence will be affected, our view is that we are likely to avoid a double-dip recession. This is because the global economy is at a very different stage of the business cycle compared to 2008. Companies have not been hiring aggressively and business inventories have not been rebuilt. The degree of retrenchment we saw after the Lehman episode is therefore unlikely to be repeated.

**As we do not expect another recession, we believe the market is experiencing a bull market correction, akin to 2004, and that this is not the start of a bear market.**



The investment environment is however not exactly like 2004 as the cyclical picture is being complicated by structural problems, i.e. the large and growing fiscal deficits in the developed economies. As there is more uncertainty, the volatility in markets could last longer than normal.

Investors are likely to stay edgy until fears of a sovereign default in Europe are assuaged. More initiatives by the European policymakers and signs that funding stress in the interbank market is abating would help calm investors.

For China, it is likely that the government will continue to stay tough on the property market in the near term as the government has never reversed policy within three months of a major change. A signal that the government has seen sufficient evidence of property prices coming under control and that policy tightening is over would be welcomed by the market.

The market will also be focussed on economic data in the coming months to gauge if the recovery is sustainable or if the debt crisis in Europe has affected the real economy. Resilient economic data is likely to stabilise equity markets.

**We retain our Overweight in Equities and the Underweight in Bonds. We also stay overweight Commodities.** Within Equities we remain overweight the US, Asia and Latin America, and stay underweight Europe and Japan. In Fixed Income we continue to prefer Investment Grade bonds. In Commodities, we are overweight in Gold and Base Metals.

3 <sup>rd</sup> Quarter Asset Allocation				
		3Q 2010	2Q 2010	Change from 2Q 2010
<b>Equities</b> Remaining Overweight	<ul style="list-style-type: none"> <li>Real economy and corporate profits continue to improve.</li> <li>Interest rates are likely to stay low and this will</li> </ul>	60%	60%	-
<b>Bonds</b> Remaining Underweight	<ul style="list-style-type: none"> <li>Investment Grade corporate bonds are attractively valued and credit fundamentals continue to improve.</li> </ul>	30%	30%	-
<b>Commodities</b> Remaining Overweight	<ul style="list-style-type: none"> <li>Investment demand for Gold likely to stay firm as currency markets remain volatile.</li> <li>Base Metals supported by the recovery in global</li> </ul>	7.5%	7.5%	-
<b>Cash</b> Remaining Underweight	-	2.5%	2.5%	-

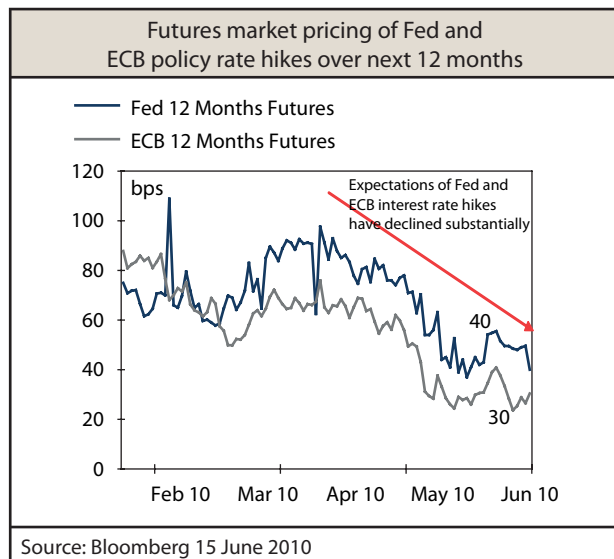
Source: UOB Asset Management

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### Retain overweight position in Equities

Although concerns about the debt problems in the Eurozone and China tightening will persist, we continue to think that the strength of the recovery in the US and the global upturn in corporate profits are likely to drive equity markets forward in the coming months.

Equity markets are also supported by the liquidity environment. The debt crisis in the Eurozone is likely to have delayed interest rate hikes by the key central banks, in particular the US Federal Reserve and the European Central Bank. At the beginning of 2010, the interest rate futures market was pricing about a 100bp hike by the Fed over the coming 12 months. This has fallen to only 40bps.



We make no changes to our allocations to the various equity markets. We stay overweight the US, Asia and Latin America and we have underweight positions in Europe and Japan.

The **US** economy has firmly bottomed and there are signs that the industrial recovery is broadening out. The housing market appears to have stabilised and the job market is improving. Having moved aggressively to manage costs during the downturn, the US corporate sector is poised to benefit from the gradual recovery in final demand. The US appears to be the first-in / first-out (FIFO) of the Developed Markets. Relative valuations and growth considerations prompt us to stay overweight.

In **Europe** financial conditions have deteriorated and fiscal headwinds may constrain growth. Consensus estimates for Eurozone growth continue to be reduced. Despite the fact that European valuations are amongst the cheapest in the world, structural concerns lead us to stay underweight.

In terms of **sectors**, in general we prefer the cyclicals over the defensives and have higher exposure to Technology, Consumer Discretionary, Industrials, Materials and Energy.

For **Japan**, while corporate profits are projected to rebound sharply in the current year and also next year, core operating performance leaves much to be desired. The recent strength in the yen has weighed on exporters. Corporate profitability still needs to recover further before we can justify further capital allocation. We are slightly underweight.

We are still overweight in **Asia ex Japan** but adopt a more defensive stance, focused on domestic consumption. China's moves to tighten monetary conditions to address an overheating property market and to reverse some of its prior stimulus have raised concerns. Strong upward wage adjustments put pressure on corporate profits and also add to inflation concerns.

**Latin America** continues to represent an attractive investment opportunity, underpinned by strong domestic growth. While there are some near term risks due to higher inflation, the central banks in the region, most notably Brazil, are generally ahead of the curve in fighting inflation. The region continues to offer strong long term investment opportunities for equity investors. We remain overweight.

### Retain underweight position in Bonds Developed Markets

**Government Bonds** enjoyed a rally in the second quarter as risk aversion rose further and there was a greater flight to safety. Although the bond yields in the peripheral Eurozone economies moved up sharply, this was more than offset by the rally in US Treasuries and German Bunds. UK gilts also rallied as the new coalition government has been vocal about reducing public sector debt. We maintain our underweight position in Government Bonds as we do not expect a double-dip recession scenario and believe bond yields will rise once risk aversion abates. Over the medium term, the strong headwind for government bonds is the large supply forthcoming as government deficits remain sizeable. Fiscal sustainability is clearly an issue with investors and there is a new premium on sovereign risk. We are overweight in the core Eurozone markets, and neutral in the US and the UK. We are underweight in Japan. We are long duration in the core European markets, neutral in the US and short duration in the UK.

We maintain our overweight in **Investment Grade** bonds. From a credit fundamental and valuation viewpoint, Investment Grade bonds have become more attractive following the selloff in May. Fundamentals continue to

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improve, with the recovery in earnings being an impressive one, balance sheets being repaired and interest coverage ratios rising. We prefer US to European names which are directly exposed to the macroeconomic problems in Europe. Sectors we like are Utilities, with their stable cash flows and strong credit profiles; Capital Goods, where cost cutting has been aggressive; Basic Materials and Energy, where balance sheets have been deleveraged via asset disposals and reduced capital spending; and the Insurance Sub-sectors where capital levels have improved and US Managed Care companies which are able to absorb the cost impact of the US healthcare reforms.

We have reduced our position in **High Yield** corporate bonds to an underweight due to the rise in risk aversion. High Yield, with their weaker credit profile and higher beta is more sensitive to macroeconomic and market risks. This is reflected in the underperformance of High Yield which posted negative return of -4.96% compared with -3.34% for High Grade during the recent selloff. We avoid sectors that are more vulnerable to regulatory, credit and M&A risks such as Financials, Media, Building Materials and Consumer Cyclical.

### Emerging Markets

We prefer **Emerging Markets (EM)** to the Developed Markets. Growth in EM will continue to outpace the Developed Markets but inflation risks appear contained as EM central banks are acting pre-emptively. Public debt levels in EM also remain low and this provides EM governments with fiscal flexibility. External debt levels in EM have also been trending down. However although the overall outlook is positive, investor appetite in the near term is likely to be dictated by events in Europe. Within Emerging Markets, we stay overweight Asia and Central/Eastern Europe and are underweight Latin America and the Middle East.

In the **Asia Fixed Income** market, we prefer High Grade to High Yield. Sentiment towards the Asian credit market is likely to remain weak over the next three months as more evidence emerges to indicate that China's economic growth is decelerating. With a flattening of the US government yield curve, Asian high grade corporate bonds also offer an ideal place for global funds to park investments. We prefer the Singapore and Hong Kong high grade names as these two countries are viewed as safe havens. We are underweight the Chinese property sector as it may continue to underperform due to policy risks.

Given the rise in risk aversion, we have now turned bullish on the long-end **Singapore Government Securities** (SGS). In particular, we like SGS 3.25% 2020 as its current

yield of 2.65% is 20-25 bps higher than its fair value yield. On the **Singapore Corporate** front we like AAA-rated Areit 1.6% 01/2017 (putable at par in 2015), which is currently yielding 3.0% or 215 bps higher than the five-year SGS.

### Retain Overweight position in Commodities

We hold our overweight position in **Gold**. The price of gold rose to a record high in June not only in US dollars but also in euro, sterling pound and Swiss francs. Gold is a major beneficiary of the sovereign debt crisis in Europe and the wider concern about growing government deficits in the developed economies. One key driver of the gold price has been flows into gold Exchange Traded Funds (ETFs).

We retain our underweight position in **Energy**. We are into the US summer driving season and the oil market traditionally looks at the strength of US demand for its direction. The rise in US gasoline demand should be positive but modest given that US consumers are still cautious. In recent years, gasoline demand from Asia, Latin America and the Middle East have also been important in driving oil prices and this demand has remained robust. Demand is however unlikely to drive prices in the near term as there is surplus refining capacity in the developed economies and China and India have also been expanding refining capacity. The ongoing worries about Europe and the potential downturn of the global economy are also likely to keep oil prices contained.

We retain our overweight in **Base Metals**. Base Metals sold off strongly in the second quarter but the strength of global manufacturing remains fundamentally positive for base metals. China's economy also continues to be firm and we believe the authorities are easing off their policy tightening given the ongoing problems in the Eurozone. Copper inventories in the London and Shanghai exchanges have also been declining.

We also retain our underweight position in **Agriculture**. Grain prices remain under pressure as weather conditions have been good and the latest report on US crop plantings indicate a high percentage of crops being in good/excellent conditions.

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