

# INVESTMENT OUTLOOK 2011

## FPA's Chief Investment Strategist Ken KHO Gives His Views For 2011



### SYNOPSIS

Year 2010 has been a challenging year with the performance of the asset markets punctuated by fears

over various issues. The most salient concerns have been the weakness of the US economy, the European sovereign debt crisis, and the recent Asian property bubble debate.

While the concern of a double-dip recession has receded, there are still issues regarding how governments especially those in the developed economies are going to sustain their growth prospects in the medium-term. The current strategy seems to centre on quantitative easing measures and these policies will not be sustainable in the long-term. The cooperation among governments is also very critical in this environment as monetary and fiscal policies in each country may have effect on others. In recent months, there have been accusations of currency undervaluation which have led to fears of "currency wars".

Against this backdrop, we analysed the fundamentals of the various geographic regions and sectors, and have developed the most appropriate asset allocation strategy. We will then highlight which respective asset classes we are positive on and which respective geographic markets and sectors one should invest in.

### EQUITIES

Global equity indices moved higher in 2010. We see prospects for further gains from here. We see equity markets moving in line with our earnings growth projections. Below we list our views on the various markets and highlight those that we like and the reasons for our preference.



### USA

The US economy is recovering, thanks to unprecedented macroeconomic policy stimulus, emergency financial stabilization

measures, and a modest cyclical upswing. The economy grew by 3.1% year-on-year(y-o-y) which translates to an annualized rate of 2 percent in the latest quarter. While investment in business equipment and software has been rising strongly lately, personal consumption

remains sluggish. Various reasons have been cited for this weakness. First, household net worth has deteriorated sharply as house prices have fallen by 25 to 30 percent over the past three years. Second, unemployment is high at 9.8 percent of the workforce. Third, banks are still reluctant to lend to consumers. On the other hand, private investment in software and equipment has rebounded strongly. Firms have also increased productivity, and unit labour costs have declined sharply. In the near term, fixed investment is likely to be the principal driver of domestic demand as inventory accumulation slows. The current account deficit is projected to remain at about 3.3 percent of GDP over the medium term—much lower than during the years leading up to the crisis—because the recovery in investment will be financed by strong private saving and improving fiscal balances. The most likely prospect for the US economy is for a continued but slow recovery, with growth expected to be far weaker than in previous recoveries. GDP growth is projected to be in the range of 2.3 and 2.6 percent in 2011.

However, there are still concerns with this forecast. Residential and commercial real estate markets have still not recovered. Further loan write-downs at banks could inhibit recovery of normal credit conditions. The sharp rise in government debt has increased vulnerability to financial market sentiment, although Treasury bond yields have fallen (though they have recently risen for various reasons) amid economic weakness, flight to quality, and expectations of additional government bond purchases by the Federal Reserve (Fed). Easing consumer price inflation, together with weak labour markets and relatively low consumption demand, point to a possibility of deflation. Amidst these concerns, the Fed has embarked on another quantitative easing program (QE2) amounting to US\$600 billion, with the aim to spur economic growth.

In addition, at some point, the US authorities will need to find a way to exit from extraordinary policy intervention without undermining the fledgling recovery. A key macroeconomic challenge is to ensure that the public debt is put on a sustainable path without jeopardizing the recovery. Currently, the general government deficit is projected to be about 10 percent of GDP in 2011, and gross general government debt will increase to about 110 percent of GDP by 2015. The huge prospective funding requirements may have implications for other economies. To the extent that 10-year Treasury bonds set a benchmark for other assets, market nervousness about the fiscal position of the United States could cause an international increase in interest rates. Further, because of the US dollar's role as a reserve currency and the importance of the US as a financial centre, shocks

to confidence in the US could cause an international increase in bond and equity risk premiums. As such, we are still underweight on the US equity markets and will continue to monitor the improvement of the economic indicators before making any change to our position.



## EUROPE

In the Eurozone, economic recovery is expected to continue, with modest employment growth from next year. GDP growth of around 1.5% is expected in 2011, increasing to 2% in 2012 as investment and consumer spending are expected to increase. This

will lead to improvement in the job situation. Thus, the unemployment rate is set to gradually decline to about 9% in 2011-2012. Export growth has also been improving especially exports from Germany and France. This is expected to spur industrial corporations into investing in new equipment. However, there is an uneven recovery across Europe, with some countries rebounding from the recession faster than others. This reflects differences in the size of the challenges faced by their economies and the extent of the export demand from other countries. For example, the labour market shows continued resilience in Germany, but in Spain unemployment is not showing any sign of abating from very high levels, owing to labour market rigidities and the collapse of construction. The sovereign debt turmoil also posed a threat to the recovery, with Greece and Ireland facing the greatest challenges. Moderate recovery is expected in Germany because weak growth is expected among its trading partners. In France, growth is projected to be modest, as private consumption is weakened by high unemployment and the withdrawal of stimulus measures. In Italy, the recovery is expected to be even more subdued, as a persistent competitiveness problem limits the scope for export growth, and planned fiscal consolidation weakens private demand. Constrained by fiscal and competitiveness imbalances, growth in Greece, Ireland, Portugal, and Spain is projected to be much lower. In the United Kingdom, domestic demand is expected to remain relatively subdued, particularly following the recent measures to cut the budget deficit. Nonetheless, growth is expected to range in the region of 2.3 to 2.5%.

The main upside to growth prospects are likely to come from higher-than-expected real activity in Germany, which is expected to lift growth in the European region, given the country's substantial trade and production linkages. Nevertheless, downside risks still loom large. In the near term, the potential for financial spill-over across sovereigns remains elevated in the euro area, particularly among peripheral economies. European banking systems are still heavily reliant on government support and are highly vulnerable to deterioration in the

real economy, sovereign shocks, and funding strains. In the medium term, the main risk is that fiscal and competitiveness imbalances in peripheral economies and insufficient action to tackle weak banks could lead to a protracted period of subpar growth and occasional crises. Against this backdrop, the policy challenge is to use the window of opportunity afforded by the unprecedented policy support to address underlying problems through national and European Union action. Establishing public debt sustainability has become a top priority for many European economies and current fiscal consolidation plans are going in the right direction. With the pick-up in economic activity and the deficit cutting measures being adopted by the various governments, the fiscal deficits are expected to be reduced in the coming year.

We remain positive on the European stock markets, and are currently recommending an overweight position. Eurozone Equities remain attractive with the Euro Stoxx 50's 12-month forward price earning ratio (P/E) at 10.55 times, 2010E price to book ratio (P/B) at 1.6 times and dividend yield at 3.78%. This compares very favourably with the 10-year German bond yield of 3%. Similarly, UK Equities are trading at 12-month forward P/E of 9.9 times and offer dividend yield of 3.38%.



## JAPAN

In Japan, fiscal stimulus and the rebound in global trade and strong demand from Asia have boosted output growth. An

export-led recovery and increase in consumer spending have underpinned recent economic growth. Exports have risen due to a stronger-than-anticipated recovery in the Western advanced economies and rising demand for capital goods from China. However, appreciation of the yen and the potential cooling of the U.S. economy may affect exports. The latest GDP growth reached 4.5% at an annualised rate. The bulk of the growth came from consumer spending, as the impending expiration of the eco-friendly cars subsidy program spurred purchases and the on-going Ecopoint program continues to stimulate spending. Real GDP growth is projected at 1.5 percent in 2011.

The Bank of Japan (BoJ) has also recently announced that it will further ease monetary policy by introducing a new fund supplying operation that aims to provide up to 10 trillion yen of funds at a fixed interest rate of 0.1%. The BoJ recognises the concern over persistent deflation and is willing to embark on quantitative easing. To achieve this objective, the BoJ has further set aside a 5 trillion yen pool of funds to purchase assets such as government bonds, corporate bonds and JReits.

The valuation of the stock market remains attractive with the current dividend yield at 2.24% versus the 10-year bond yield at 0.94%. The P/B is still trading at 1 time,

which is 30% below its 10-year average. The forward 12-month earnings yield of the Japanese stock index is 7.56%. We believe that the Japanese stock market would be a major beneficiary of the global economic recovery, with rising exports to the emerging economies in Asia.



## ASIA-PACIFIC EX JAPAN (APEJ)

The economies of advanced Asia have enjoyed a strong rebound. Their large manufacturing sectors have benefitted from the global rebound in trade. Growth performance is expected to vary across countries because of differences related to the various stimulus programs and private demand along with underlying economic and financial conditions. For example, a massive fiscal stimulus and credit expansion has boosted domestic demand in China. In India, low reliance on exports, accommodative policies, and strong capital inflows have supported domestic activity and growth. Prospects are, however, weak for economies at the lower end of the quality ladder in manufacturing exports and for those where there is macroeconomic and financial uncertainty, as in the case of Vietnam.

GDP growth is projected to be at a more sustainable rate of about 7 percent in 2011. For emerging Asia (which includes China, India and Indonesia), growth is projected at about 8 percent in 2011. A notable aspect of the outlook is that the large domestic-demand-driven economies—China, India, and Indonesia—are set to grow particularly rapidly and lead the Asian recovery. In China, GDP growth is projected to reach 9½ percent in 2011. This growth is expected to be driven more by private-sector demand. In particular, consumer growth should remain robust and increase as a share of GDP. This will be underpinned by strong labour market conditions and continued policy efforts to increase household disposable income. Sustained growth in retail sales and industrial production are expected to continue. However, there are likely to be tighter quantitative limits on credit growth and additional measures to cool off the property market.

The proposed implementation of the 12th Five-year plan in March is expected to call “for the establishment of a long-term mechanism to expand consumption, the optimization of investment structures, and quickened pace of the building of a new growth pattern that is jointly driven by consumption, investment and exports.” We expect China to focus on growing private consumption. The government has identified 3 new tasks to raise purchasing power. These are “to reasonably adjust income distribution, to increase the ratio of people’s incomes to the national income and the ratio of workers’ incomes in the primary distribution of national income.” With this plan, the government forecasts doubling

household income within the next five years.

The stock market is expected to be underpinned by healthy macro data and attractive valuation. In addition, the Chinese economy is expected to undergo structural adjustments which will be positive in the long run. However, there are concerns that high inflation may cause the policy makers to implement further measures such as increasing the reserve requirement ratio and interest rates.

In India, GDP growth is expected to reach 8½ percent in 2011. Private domestic demand is expected to remain strong, led increasingly by domestic demand. Robust corporate profits and favourable external financing will encourage investment. Consumption will be supported by strong labour market conditions and rising disposable income. In India, the current account deficit is projected to rise to 3 percent of GDP in 2010/11, as domestic demand remains strong. The rapid pace of domestic activity, evidenced by rapidly rising inflation, will see the central bank continue to increase the repo policy rate. The Indian stock market is currently underpinned by strong overseas fund flows and strong corporate earnings. However, concerns over valuation and inflation may limit gains in the coming year.

In Hong Kong, economic growth remains strong due to growth in external trade, in part due to the linkage with China. Unemployment rate has improved and domestic demand strength has exceeded expectations. The stock market is expected to be underpinned by weak US dollar and resurgence of IPOs.

In Korea, the latest quarterly GDP went up by 4.5% y-o-y on the back of strong private consumption, fixed investment and exports. However, there are signs of slowing exports growth and worries over inflation. The stock market continues to trade at attractive valuation relative to the historical average and the region. However, concern over potential tension with North Korea continues to worry foreign investors.

In Singapore, GDP growth is expected to moderate to 5.5% in 2011 but manufacturing & export, and services may surprise on the upside. Record low interest rates, together with ample global liquidity, are expected to fuel equity prices. With general elections likely by mid 2011, policy risk remains for property cooling measures and tighter labour immigration. Rising commodity and fuel costs are concerns but these may be mitigated by a strong Singapore dollar policy. The stock market is expected to be underpinned by improving corporate results and increase in tourist arrivals due to the new Integrated Resorts. With P/B of 1.78 times, the equity market is still attractive.

In Taiwan, economic growth is expected to slow down due to fading base effects, slower expansion in China and the likelihood of only modest growth in the industrial economies. Exports growth is expected to decelerate

on slower tech demand. However, the stock market will be underpinned by increase in listings by the Chinese companies on the Taiwan's stock exchange.

In Malaysia, private consumption will be the main driver of growth, in line with improvements in employment conditions and rural incomes. Private investment is likely to advance in response to structural reforms to boost medium-term growth. The Prime Minister has recently unveiled an Economic Transformation Programme (ETP) that includes 131 projects worth US\$444 billion to be implemented over 10 years. However, there is skepticism over the ability of the government to attract the required funds from the private investors. There is optimism over improving Malaysia-Singapore relationship, especially if the high-speed railway connecting Johor and Singapore were to materialize. The stock market is less attractive as compared to other countries in the APEJ region because of lower dividend yield and higher price-to-book value.

In Thailand, robust and broad-based growth is likely to move to a more sustainable pace in 2011, as stimulus policies are rolled back and export growth moderates. The Finance Ministry has revised upwards its economic growth forecasts due to strong GDP growth and robust exports. Consumer confidence also improved. However, political situation in the country remains a concern. Nonetheless, robust earnings, easing political tension and higher consumer confidence have underpinned the stock market. As a result, the Thai Baht has strengthened.

On valuation, P/B of the region is now at 2 times. Forward P/E is now at 12.9 times and the dividend yield is 2.93%. Valuations are still attractive and interest rates are low. The region's prospects will encourage more capital inflows. Capital inflows to Asia are likely to remain strong. These inflows will be driven both by cyclical and structural factors. Structurally, the higher medium-term growth prospects for the region, stronger policy fundamentals (including sound fiscal positions) and expanding local capital markets are leading fund managers and institutions to increase their allocations to emerging Asia. These factors will continue to favour our overweight position in the APEJ region.

## REAL ESTATE



In the US, residential investment remains severely depressed compared with that in past cycles. This has caused slow deleveraging for the household sector as

mortgages exceed the market values of the properties. Tax incentives did temporarily increase activity, but housing demand fell and prices receded after the recent expiration of these incentives. Although this was anticipated, the drop was larger than expected. Given the limited success of mortgage modification

programs and the shadow inventory from foreclosures and delinquencies, this has renewed fears of a double dip in real estate markets. Housing prices are likely to depend on the path of economic recovery. However, there are a few negative scenarios. Delinquency rates on commercial mortgage backed securities have recently reached record highs, and considerable amounts of commercial real estate debt will come due over the next few years. Resets on adjustable-rate loans are also looming on the horizon.

Refinancing options are limited, despite historically low mortgage rates. Renewed strain on credit conditions may materialize from loan losses due to delinquencies, which still may have not reached their peak, and higher capital and liquidity requirements in the context of new financial regulations.

Prices of the commercial properties in the US, however, have shown signs of bottoming. Prime rents are also stabilizing with medium term prospects supported by a sharp drop in the construction pipeline. However, real estate financing is not expected to show a considerable improvement for the wider market given the overhang of large volume of maturing real estate debt in 2011.

In the UK, London residential prices had been rising. Foreign buyers had been buying into residential properties and this has underpinned the top-end prices. This trend is expected to continue given the relative weakness of the sterling. Demand for rented homes has gone up due to more first-time buyers not being able to obtain mortgages.

In Japan, the vacancy rate for office space in Tokyo has been dropping although monthly rent has also been on the decline. New office vacancy rate has been dropping and this augurs well for the overall office market. The Real Estate Economic Institute cited that condominium sales in Tokyo remained favourable, judging from still low level of unsold units and high contract ratio. In addition, new condominium unit sales have been increasing. J-Reits' prices are expected to be supported by BOJ's purchase of J-Reits as part of its stimulus package.

In the Asia-Pacific region, several economies have experienced a rebound in real estate prices and residential investment since 2009. In many of the economies in this group, current price-to-rent and price-to income ratios are still above historical averages.

In Hong Kong and Singapore, economic fundamentals appear to provide support for the observed price increases, mainly due to strong growth prospects. However, in China some reports of speculative activity like rising vacancy rates in commercial property, sizable mortgage credit growth, and massive capital inflows, suggest that some of the urban real estate markets may be overheating. In some economies, the rebound in prices has been the result of policy measures put in place to help economic recovery. For example, in China,

tax incentives for home buyers and encouragement to banks to keep extending credit for real estate purchases coincided with the strong rebound in market activity. With the rebound in economic activity, some governments in the region have now introduced measures to cool the real estate markets. The Chinese government, for instance, deployed a range of regulatory tools, including increases in transaction taxes and stricter controls on lending. The government is expected to evaluate the impact of these measures over time and may introduce more measures if the real estate markets do not show restraint. China's residential property market prices turned around and began to grow rapidly during 2009, especially in several large and medium-sized cities. Meanwhile, mortgage loans grew at nearly 50 percent in 2009, raising mortgage debt from 10 to about 15 percent of nominal GDP in one year. The sharp increase in prices, coupled with unprecedented lending growth, has led many to question whether there is a bubble building up in China's property sector.

Recently, the IMF has done a study and the main findings are that house prices were not significantly overvalued in China as a whole. However, mass-market residential markets in Shanghai and Shenzhen and luxury residential markets in Beijing and Nanjing may be in the early stages of excessive price growth. Recent policy measures to cool down the markets unveiled by the government appear to have some impact on price growth. Given the awareness of the Chinese authorities of the risks posed by excessive property price growth, the threat of a housing price bust and consequent financial instability is not immediate. However, with structurally low real interest rates in the face of rapid income growth, no property taxes and lack of alternative investment possibilities, rapid property price growth in China may continue. As home ownership rises in this financial environment, the government will face a growing challenge to financial stability. Nonetheless, despite the property measures introduced by the government, property prices have continued to increase. In light of this, China has announced further measures such as restricting loans to the developers. In addition, the government is looking to implement property tax in the coming months and this may impact the market negatively.

In Hong Kong, property auctions continued to receive high bids from developers, indicating their optimism on the market. However, the government has announced various measures to curb rising home prices. On the commercial markets, there is expectation of an increase in office rents as banks demand more office space in the city.

In Singapore, private residential home sales continued to increase on a monthly basis despite the new policy measures implemented by the government. Residential home prices have also been rising though at a slower pace than that before the measures were introduced. Going forward, low to mid-end home prices may trade sideways given more government land sales and higher supply of Executive Condominiums (ECs). On the other

hand, we expect higher prices for high-end properties given the success of the rebranding of Singapore which would attract more foreigners to make purchases. On the commercial segment, prime office rents have picked up on the back of broad-based occupier demand. There is a potential Grade-A office supply shortage in 2013 to 2014 as more of the future supply has been pre-let and that there have been more conversions of older office buildings into residential blocks. Office investment deals have also been rising on the back of more acquisitions by both local and foreign institutions.

We remain positive on the Asia-Pacific real estate sector, especially commercial markets in Japan & Singapore and the high-end residential segment in Singapore.

## COMMODITIES



### GOLD AND BASE METALS

Gold price has been rallying due to inflationary concerns, risk aversion and the US dollar weakness.

The demand for gold is expected to increase as central banks are expected to turn net buyers of gold in 2011. Increase in gold prices has also been supported by investment demand. In the context of potentially rising supply of paper money in major economies, gold stands out as 'alternative currencies' as they are in limited supply and their 'zero yield' is not a major disadvantage versus (close to zero) interest rates in many developed economies. Gold may remain a winner from QE2, as the US dollar weakens and interest rates stay low.

For base metals, the prices of the base metals such as copper, iron ore have risen on the back of strong economic growth in China, leading to higher demand. Metal prices have responded strongly to improving expectations about prospects for the global economic recovery. Currently, the outlook for metal demand depends importantly on growth prospects in China, given the rapid rise of the Chinese economy's share in global demand over the past decade. Following a strong rise recently, related to significant macroeconomic policy stimulus, China's metal demand has now stabilized at a high level. Two developments are likely to restrain demand growth in the quarters ahead. First, the pace of growth in China may continue to moderate as the effects of stimulus wane and efforts to slow credit growth affect investment. Second, end users may choose to run down the inventories that were built up to support increased investment activities. Base metal stocks held in warehouses monitored by the Shanghai Futures Exchange have only just begun to decline from their recent cyclical peaks, with destocking in copper most advanced. On the other hand, there have been signs of recovering metal demand from advanced economies. However, the gradual pace of expansion suggests that emerging economies will remain the engine of demand growth. On balance, this suggests

that metal prices should increase modestly through the end of 2011.

We see more upside for base metals as fundamentals are supported by the prospect of physically-backed ETFs, strong emerging markets' demand and potential supply constraints. Supply issues have not played a major role in price changes in recent months. However, over the medium term, constraints on the growth of supply may become more important in determining market balances and prices. Deteriorating mine productivity and the impact of policies targeted at reducing the impact of metal smelting on the environment are among the most important constraints on supply. Inventory-to-use ratios increased during the recession and provide some buffer for shocks. However, they have begun to decline.

## OIL

We still see further upside for oil prices as a result of extended US liquidity, strong demand by emerging economies, and a nascent fall in US inventories. Oil prices have rallied due to weakness of the US dollar. The International Energy Agency (IEA) has upgraded its forecast for oil demand in 2011 to 88.5 million barrels per day (m b/d).

Oil supply is expected to remain tight as OPEC's spare capacity is expected to decline. OPEC has indicated that it will change its output ceiling of 24.845 m b/d if oil prices rise to \$100 a barrel.

Oil demand has strengthened more than expected, primarily due to stronger-than-projected global activity and an increase in Chinese oil demand above what would have been expected on the basis of activity. While demand has risen more than expected in advanced as well as emerging and developing economies, the latter still account for virtually all the growth in demand. Nevertheless, advanced economies still account for a relatively larger share of final oil consumption. Oil production edged up recently, almost matching the rise in demand. About half the supply increase is attributable to rises in total production outside the Organization of Petroleum Exporting Countries (OPEC). The turnaround in overall non-OPEC production reflected widespread gains, partly due to the incentives from high prices to ramp up production, including through greater use of enhanced recovery techniques where feasible. Favourable cost conditions on the oil services side have reinforced these incentives. Oil demand will continue to rise as the global recovery progresses, with the buoyancy determined in part by the strength of the expansion in activity. The recent build up of oil demand momentum in emerging and developing economies is likely to carry into 2011. While the momentum will put upward pressure on prices, oil futures data suggest that the extent of price pressure will remain limited. On the demand side, despite the likely rapid demand expansion in emerging and developing economies, global oil demand growth is expected to be moderated by stagnation or subdued increases in advanced economies. Such expectations are consistent

both with recent fuel efficiency trends and the estimated relationship between oil demand, activity growth, and real oil prices in advanced economies. Second, information on upstream investment projects analyzed by the IEA suggests that, under current execution plans, these projects will provide for a continued expansion in upstream production on the order of 1 percent per year. Though moderate, this pace of expansion can accommodate rapid demand growth in emerging and developing economies without substantial draws on OPEC spare capacity for much of the potential range of demand outcomes.

Under such relatively benign supply conditions, OPEC production policies would continue to remain an important factor in determining prices. In particular, the price path will depend on the target price at which OPEC members will accommodate an increase in their supply and the quota discipline among members. The main upside risks to this baseline picture of relative stability in the oil market come from the supply side, whereas on the demand side they seem limited to large upward surprises. Supply risk factors with the potential for a sustained impact are likely to come from obstacles to investment projects, for both new and replacement projects, although some geopolitical risks may also have a longer-lasting price impact. High oil prices and lower costs have helped keep capital expenditure at robust levels, supporting an unexpected increase in non-OPEC production despite ongoing declines in the North Sea and Mexico. However, the BP problem in the Gulf of Mexico has illustrated the risks involved in projects at new exploration. The production effects of the moratorium on new deepwater drilling in the US part of the Gulf will be small from a global perspective, as deep sea exploration and development elsewhere have continued. Nevertheless, expansion of this segment of unconventional oil production faces risks.



## FIXED INCOME AND CURRENCY

US monetary policy is expected to remain accommodative because of muted inflation, subpar growth, and lingering financial strain. The Fed has maintained the policy rate at a record low while signalling that conditions are likely to warrant keeping the rate at exceptionally low levels for an extended period. In light of larger downside risks, the Fed's recent decision to resume its purchases of government securities is appropriate. In the event that such risks materialize, policy responses could include a strengthened commitment to maintaining the ultra-low policy rate for an extended period and expanding asset purchases. Meanwhile, the Fed has been developing a well-diversified toolkit for managing monetary conditions, which will help facilitate monetary exit when needed. Currently, the loose monetary policy is expected to be maintained given that inflation is

projected to remain low ranging between 1 and 1.2% percent in 2011.

Nonetheless, upward revisions to economic forecasts, a favourable outlook for no tax hike, and improving consumer sentiment recently sent U.S. Treasury yields upwards. It is expected that yields to rise modestly throughout 2011, from current levels. The concern over inflation has been heightened recently by the announcement of further government bonds' purchase by the Fed as they implement the QE2 over the months ending June 2011. As a result of QE2, the USD has weakened against the major currencies and it is expected to stay weak.

In the Euro-zone, monetary policy is expected to remain very supportive for the near future. Inflation remains low because output gaps are large. Core inflation is projected to remain at about 1½ percent. Thus, it is appropriate to keep interest rates exceptionally low to help support the recovery by dampening the adverse short-term effects of fiscal consolidation on domestic demand.

Inflation in the UK, however, is expected to be higher and may reach 3.1%. Inflation has been rising at a faster rate than the 2% target set by the Bank of England (BOE). It is likely that when the economy starts to pick up, the BOE is likely to raise interest rates.

There are expectations that the IMF and ECB will step in to support the market in the event of default by any of the peripheral countries and that the purchase of government bonds by the ECB will continue. German Bund yields are somewhat cushioned and are likely to remain close to current levels unless the EMU bailout generates a big fiscal scare. UK Gilts are expected to trend higher given the inflationary trend.

We believe that the low growth, low inflation and low yield environment will be generally positive for credit. Monetary policy should remain extremely accommodative. Even with the signs that corporate deleveraging is fading, broad credit expansion is weak. This is likely to lead to excess demand for investment grade corporate bonds.

In the APEJ region, the government bonds have rallied on strong capital inflows and healthy fiscal balance sheets. Going forward, increase in bond prices will be tempered by potential interest rate hikes by the various Asian central banks. Recently, central banks in China, India, and Thailand have raised their interest rates and this trend may continue if inflation continues to increase significantly. Asian currencies have also appreciated against the US dollar due to foreign capital inflows looking for better returns and low interest rate environment in the developed countries. Fundamentally, Asian currencies will be underpinned by strong economic growth and high foreign exchange reserves. The rise in Asian currencies may, however, be tempered by the respective Asian governments as they may introduce measures to cap the currencies' appreciation on concern over the competitiveness of their exports.

In Singapore, rising inflation has caused the Monetary Authority of Singapore to widen and steepen the Singapore dollar (SGD) trading band, leading to a stronger currency. As a result, interest rates have fallen and this has supported the bond market. The demand for yields, especially those offered by the longer-dated bonds, have also continued to support the bond market. The prices of the short-term bonds have increased on safe-haven inflows and a strong SGD. The expectation of the US dollar to depreciate due to QE2 is likely to cause SGD to strengthen further.



## INVESTMENT STRATEGY

The 2011 performance of the asset markets would be highly dependent on policy measures that would be instituted by the various governments of the developed and emerging economies. The structure and nature of these measures will in turn be influenced by how the businesses and households would conduct their spending and purchasing patterns. If the spending is sustained, the governments may tighten their monetary policies. This may in turn affect economic growth. On the other hand, if the spending is weak, the various economies especially those in the developed world will have to embark on further quantitative easing programs. These may inadvertently cause fears of inflation in the longer run.

Our view is that growth will remain sustained and that governments will keep monetary policies loose for the first half of the year. Against this scenario, we will remain positive on Europe, Japan and APEJ. We will continue to monitor the situation in the US and when economic indicators like employment and consumer spending improve significantly, we may decide to overweight US equities. We remain positive on the Asian-Pacific property markets, especially commercial markets in Japan & Singapore and the high-end residential segment in Singapore. We still like the commodities sector given the expected demand from the emerging economies. In the fixed income area, we are overweight investment grade corporate bonds.

## POTENTIAL RISKS

While global growth is expected to be maintained, there are concerns of a few risks that may cause the growth to be lower than forecasted. These risks may materialise if the forecasts on scenarios like the sovereign crisis, oil price/commodities price movements and policy measures become more extreme than what we have predicted. These factors may cause a sharp global slowdown which may lead to a "double dip" in advanced economies and a low growth in the emerging and developing economies. We highlight below a number of situations that potentially may cause global growth to be affected.

## **(i) High inflation or deflation**

Inflation in advanced economies has declined by less than expected, considering the depth of the recession. For example, in the US, the drop in core inflation from 2008 to 2010 was about 1 percent, whereas the drop during the 1981–83 recession was about 4 percent. The weaker inflation response may reflect a variety of factors, for example, more credible inflation control, intensified losses in productive capacity, and downward wage and price rigidities. The improved credibility of monetary policy and its exceptionally strong response, together with temporarily low growth in potential output may be key explanatory factors. With strong credibility, medium- to long-term inflation expectations are much more stable than the actual inflation rate.

However, there are still looming concerns about the potential for high inflation in advanced economies. The QE2 policy embarked by the Fed has spawned many debates regarding its implication for long-term inflation in the US. In fact, long term rates have moved up recently, in part due to this concern.

Nonetheless, under present circumstances, deflation is the more pertinent risk. The reason is that risks to activity are clearly to the downside: households remain saddled with appreciable debt and the financial system remains vulnerable, thus expectations could put further downward pressure on prices and wages. How households will behave may depend on how policymakers reduce large public deficits. If there are drastic cuts in salaries, confidence may be shaken. Mistakes could cause a long period of deflation or low inflation and disappointing economic growth.

## **(ii) Growth prospects in advanced versus emerging economies**

Another concern is the apparent worsening of fundamentals in advanced economies, which may delay a robust pickup in private demand. Related to this is the extent to which emerging economies that have external surpluses can offset lower demand in advanced economies.

The latest crisis comes on top of an ongoing decline in advanced versus emerging economy growth rates. In advanced economies, this trend is being driven by a variety of fundamental factors, such as falling population growth. Developments in emerging economies have been quite different. As a group, emerging economies posted a string of impressive growth rates. Looking ahead, advanced economies face appreciably weaker prospects. The steep drop in business fixed investment during the recession has reduced manufacturing capacity and this suggests lower potential output. These lower estimates for trend output levels in advanced economies have significant policy implications. They imply that a large portion of fiscal revenue losses relative to pre-crisis revenue trends could be presumed permanent. In turn, this means that public expenditure programs would have to be scaled back (or taxes increased), or fiscal deficits and debt will continue to grow rapidly over the medium term. More fundamentally, capital and labour

will need to be reallocated from declining to expanding sectors, posing major social challenges. From a global perspective, the demand for imports by advanced economies will be below trends, in view of the high share of consumer durables and investment goods in trade. Emerging economies that relied heavily on demand from these economies will therefore have to rebalance growth further toward domestic sources to achieve growth rates similar to those before the crisis.

Emerging economies are unlikely to fully compensate for the lower demand from advanced economies over the medium term. In particular, recent developments in economies with excessive surpluses do not point to a significant acceleration in domestic demand relative to pre-crisis growth rates. Even in a best-case scenario, China will provide only a partial offset to the weaker demand from advanced economies, given the relatively small size of both overall Chinese consumption and Chinese imports of consumer goods. In addition, in many emerging Asian economies, investment in the services sector is still low. Policy efforts have been directed at allowing greater competition in infrastructure-related services, further opening the retail and financial sectors, and lifting restrictions on entry into social services, such as health and education. However, these will take time to bear fruit.

In addition, concerns about destabilizing currency appreciation and related losses of competitiveness have led key emerging economies to mainly accumulate reserves rather than to allow the nominal exchange rate to appreciate in response to trade surpluses and capital inflows. This is likely to slow domestic demand.

## **(iii) Escalation of the Euro sovereign debt problems resulting in contagion.**

The risks could come from political and social unrest in peripheral countries arising from the consequences of fiscal tightening, backlash from the stronger countries against fiscal transfers to the periphery countries, and escalating concerns of insolvency from peripherals spilling over to larger European countries which will be too large vis-a-vis the amount of liquidity facilities currently available. If events escalate towards an eventual debt restructuring resulting in European banks having to recognize losses on the back of their European sovereign debt exposure, this would create an environment that would prompt sharp risk aversion spilling over to the equity and bond markets especially those in the emerging markets including Asia. There are two major conduits of contagion to Asia. First, the financial linkages on volatility of capital flows prompted by global risk aversion and/or withdrawal of cross border bank claims from more exposed European banks would negatively affect certain Asian financial institutions like those in Korea and Indonesia. They look relatively more vulnerable to risk aversion given lower level of foreign reserve coverage (versus the short-term external debts) and the relatively high foreign ownership in equities and bonds. Second, the trade linkages may cause the Asian economies to have a major slow down if there is a sharper than expected Euro area growth decline. This will likely hit the more trade-dependent countries.