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# After the year of two halves: Outlook, risks and opportunities for 2011

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Coming off the nadir of Lehman Brothers' collapse, global financial markets were soon troubled by a host of crises. With so many uncertainties amid an unstable environment, where should people be parking their money, and what are the risks? Where is the headwind coming from and where are the troubled spots?

Speaking in her personal capacity, Ong Guat Cheng, a senior portfolio fund manager at Fullerton Fund Management Company Ltd, gave her take on these wide-ranging, yet related issues at a recent Singapore Management University (SMU) seminar. Ong, with 13 years of investment experience, manages the Asian fixed income portfolios for Fullerton, a wholly-owned subsidiary of Temasek Holdings. She is a member of Fullerton's strategy and currency team implementing foreign exchange trading strategies, as well as tactical asset allocation decisions. The talk was organised by the Centre for Asset Securitisation and Management in Asia (http://www.smu.edu.sg/institutes/skbife/centres/casa/index.asp), part of SMU's Sim Kee Boon Institute of Financial Economics (http://www.smu.edu.sg/institutes/skbife/index.asp).

**Half full, half empty**

Ong noted that 2010 was a year of two halves. "The first half was marked by concerns over recession and a double dip, while the second half was a cyclical rebound." Up till now, the global outlook for 2011 is seemingly brighter. America, the world's largest economy, is riding a cyclical upturn. The Dow Jones Industrial Average is at its highest level in more than two years, and with 192,000 new jobs added in February, US unemployment rate has finally dipped below the 9% mark. Core EU members are also looking up. Germany, for example, grew by 3.5% last year – tepid by emerging Asia standards, but certainly not so for Euro-land.

However, positive indicators like these are being blunted somewhat by the combined effects of deleveraging in America, as well as increasing inflation in Asia, which might pose a major headwind for growth and asset market returns going forward. Inflation, for many Asian economies, while not yet hitting 2007-2008 levels, is nevertheless a growing concern. Due to the heavier weighting accorded to food in emerging Asia, relative to developed countries, food inflation is a major worry. According to JP Morgan's figures from December 2010, inflation of food prices for consumers in Asia was around 8%. Thus despite Asian companies reporting higher profits (and thus lending support to relatively cheap equities), the short term inflationary concern is a drag.

Still, Ong advocates a heavier allocation in equities relative to bonds. There are a couple of indicators lending support to higher share prices. For one, not only was there an uptick in global GDP growth in the last quarter of 2010, the JPMorgan all-industry purchasing manager's index (PMI) is also trending up. The PMI – a measure collated from surveying purchasing managers' views on business conditions across various economic sectors – is a widely-used indicator of manufacturing activity. The index indicates a global revival in new orders, keeping factories busy, and thus, by extension, can be interpreted as driving corporate earnings. Forecasts made by UBS from November 2010 put corporate profits at 15% growth this year, on the back of a 4% growth in global GDP. Equity prices, thus, should echo this.

**Structural USA**

In the US, capital expenditures have recovered and this appears to be holding up. In the longer term, however, the country still faces structural headwinds. Household debts remain high and fiscal deficit, as a percentage of GDP, indicates that more fiscal consolidation is likely further down the road. Then there are the political considerations. "Obama is moving closer to the (political) centre, spending more money to be popular," said Ong.

For now, despite some improvement, unemployment among Americans is still at a high level. Fullerton's own estimates is that to reduce the unemployment rate to 6.5% (from the 8.9% as of February), the US economy needs to grow 4.75% over the next 3 years. "Cutting back on leverage is negative for growth and contrary to what needs to happen for unemployment to come down," said Ong.

But, should high unemployment figures remain one of the biggest worries? Some analysts have pointed out that as the US economy works its way up, it is already undergoing structural changes, leading to higher structural unemployment and thus a higher natural rate of unemployment compared to before the crisis.

**US$100 oil – again?**

Meanwhile, Asia's economic growth has remained resilient, with positive trends in industrial production and retail

sales. Increasing domestic demand in China, India and Indonesia is supporting the underlying growth of these major Asian economies while reducing their dependence on exports to sustain growth.

However, to a certain extent, the growth story is vulnerable in several ways. For example, food and resource production might be affected by externalities like weather. Oil, the essential commodity, is again above the US$100 threshold, no thanks to the supply shock possibly arising from recent political unrest in the Middle East.

From Ong's perspective, "Libya's impact on the oil market is a bit exaggerated." The country pumps out around a million barrels a day. By contrast, Saudi Arabia alone, the key member OPEC member, has excess production capacity of 5 to 6 million. In short, it is easy to make up any shortfall from Libya. Nevertheless, having said so, the Kingdom is the key country to pay attention to; for should the political turmoil in the region spread wider, there is a real risk that oil prices could escalate, and that, probably, is what some quarters in the market worry about.

**China's growth**

China – with its recently affirmed status as world's second largest economy – is also a subject of much interest. Among the key issues keeping China watchers awake include stubbornly high inflation rates as well as a widening income gap. "Money creation has come off the 2009 and 2010 highs; it is now starting to pick up," said Ong. To cool the economy, the Chinese government has raised higher bank reserve requirement ratios, among other policy measures.

While there is a risk of a hard landing due to overly severe policies, Ong's take is that this is not too likely, as the Chinese government would want to balance their package of policy measures against the official growth target, which according to a February 28 announcement, is 7% per annum for the next five years – still a healthy growth rate by most standards.

China should not hog all the attention. Current stock market prices across regional bourses are adding to the Asia's attractiveness. Citing numbers from MXASJ (MSCI All Country ex Japan Index, made up of indices from 10 key Asian markets), the forward price to earnings ratio for Asian equities is estimated at 13.1 times. At this level, the ratio is below the historical band while trailing price to book ratios, and returns on equity for Asian equities, are above their historical averages.

**Keeping an eye on meltdowns**

Several systemic risks remain worldwide. For one, the EU and the International Monetary Fund (IMF) have set aside 750 billion euros to bail out the informal grouping of four risky EU members: Portugal, Ireland, Greece and Spain. However, even so, Ong noted that Greek bond yields are already priced for a potential default at some point in the future. On March 7, Moody's Investors Services slashed its ratings for Greece's sovereign debt by three more notches to "B1", sending it further away from investment-grade territory.

Meanwhile, Spain alone could account for 60% of the funds currently allocated for a bailout – perhaps large enough to tip the scale on whether or not the EU faces a systemic meltdown. European governments are aware that tough measures have to be introduced, where bitter medicine like higher tax rates have to be swallowed. However, these are clearly unpopular measures and thus, difficult to execute.

Across the Atlantic, the major risk for America is the crisis of confidence with a possible downgrade of its "AAA" sovereign credit rating, no thanks to its spreading red ink in both fiscal and current accounts. "The country as a whole is borrowing internally, and borrowing from the world. That is a concern," said Ong.

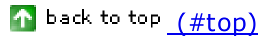
**Resilient greenback**

How was America able to get away with a downgrade thus far? It is the dominant global reserve currency, and there are no strong and clear alternatives at this point in time. With the on-going issues in the EU, central banks are wary about allocating too much of their reserves into the euro; and the Japanese yen, meanwhile, is on a structural decline. Due to the combination all of these factors, "rating agencies see that demand for the USD is structural -- you cannot run away from it," said Ong.

However in the longer term, should other potential reserve currencies emerge, namely China's RMB, it could chip away at the greenback's power. China is already allowing more flexible use of its currency outside China. The RMB has already been put on a measured path towards further internationalisation. For example, non-Chinese citizens can now open RMB-denominated accounts outside China in places like Hong Kong and Singapore. "This is actually an exciting development. China's currency demand will grow and gain greater importance on the international stage," said Ong.

Interestingly, even with the debt problems of America, the USD will not lose too much of its shine. Problems in other geographies, like in peripheral EU countries could bode well for the USD in the short term. This is because the USD remains the safe-haven currency for risk-adverse investors reacting to crises: when Lehman Brothers went under in 2008, and last year, when the EU sovereign debt problems stole the headlines. "The USD is still the base currency of

many international investors. In times of crisis, what do you do? You bring your money back. Given that your base is in USD, you buy USD, and you sell whatever currency you are invested in. So, the reality is that, the USD will still do well," said Ong.

 (#top)

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