2 April 2012

INVESTMENT OUTLOOK – 2Q-2012

Dear Valued Client,

An overdue correction in global equities is likely in 2Q-2012. And with that, other risky assets – most notably industrial metals and currencies sensitive to global growth – could also see pullbacks.

Equities, which we rated at the start of the year the "best asset class" for 2012, continue to be attractively valued, despite significant gains over 1Q-2012. Valuations in many markets are still at the lower end of their cyclical ranges.

The threat of a sovereign debt meltdown in the Euro area has diminished dramatically as a result of the European Central Bank's Long Term Refinancing Operation (LTRO). Meanwhile, the US economy continues to grow, albeit at a modest rate. And China's economic slowdown remains moderate, with a lot of room for policy stimulus, given easing inflation.

But near-term, equities markets appear technically overbought, with the likelihood of a correction over the coming quarter.

Apart from some profit taking after a massive rally, other triggers for this expected correction are likely to include disappointment of heightened expectations of the US economy, stubbornly high crude oil prices and jitters over the possibility of a "hard landing" as the Chinese economy cools.

But we would regard a correction as a buying opportunity for longer-term investors. Beyond any near-term pullback, equities are likely to resume the uptrend from the final quarter of last year.

In Asia, the most important single driver of investor behaviour continues to be near zero to deeply negative real interest rates. There is a hunger for returns/yields that is likely to drive investors back into risky asset markets on corrections.

Asian credits, which have also been rallying in tandem with equities on improved risk appetite and inflows, are also vulnerable on a significant correction in risky asset markets. But beyond any short-term spread widening, we remain positive on Asian credits on continued economic and earnings growth.

In commodities, the price of crude oil is likely to be supported above US$95 per barrel on the combination of continued geopolitical tensions surrounding Iran and tightening spare production capacity. But the flipside of that is industrial metals could weaken further on fears of high oil prices choking off global economic growth.

Gold remains on a long-term uptrend while it continues to hold above its 55-week moving average, which is currently around $1638 per ounce. And while gold has made massive gains since 2008, global excess liquidity remains supportive of yet higher prices.

The major currencies are likely to remain in a range, with a bias towards US dollar strengthening in 2Q-2012. The standout is the Australian dollar, which looks particularly vulnerable, not just against the US dollar but also against Asian currencies. However, as with equities, longer-term investors should look to accumulate the Aussie on the pullback on the likely resilience of the Chinese economy and its demand for commodities.

Thank you for investing with DBS.

Lim Say Boon
Chief Investment Officer
DBS Bank

Equities

Correction is long overdue. Underweight (3 months), Neutral (12 months)

Bonds

Remain positive Asian credits on economic and earnings improvements. Overweight (3 months, 12 months)

Commodities

Crude oil resilience could hurt industrial metal prices. Neutral (3 months, 12 months)

Currencies

Range trading amongst major currencies with a bias towards US dollar strength.

EQUITIES

The global equities bull market that started early 2009 has stood out in historical terms for the extent of its wild "mood swings" – with international equities (the MSCI AC World Index) declining 18% and 26% from mid-April to early July 2010 and 3Q-2011 respectively. Indeed, in technical terms, most major stock indices entered bear market territory in 2011. But by the same definition, the index is back in "bull market mode" with a 28% gain from its October 2011 low. For an equivalent swing, we would have to go back to the second half of 1998, which saw the S&P 500 fall 22% amidst the Russian debt crisis, only to push sharply higher over the following 2-3 years.

The world has found itself caught between three powerful, conflicting forces. The West is still struggling with the legacies of the global financial crisis – that is, slow growth and structural dysfunction associated with deleveraging and high levels of indebtedness at both the household and government levels. But government intervention has unleashed a sharp burst of monetary expansion, most prominently symbolised by so-called "quantitative easing" in the US and "long-term refinancing operations" in the Euro area. Meanwhile, the demographic-driven structural changes in Asia ex-Japan continue to drive high levels of fixed asset investment and consumption growth, fuelling inflation.

An important consequence of these forces for investors has been plentiful, cheap money in many parts of the world amidst rising consumer and asset price inflation. This translates into negative real interest rates and desperation amongst investors to stay ahead of rising prices. Singapore and Hong Kong are prime examples of this phenomenon. (Figure 1)

There remains much to worry about in the global economy. The European debt crisis has not been resolved – the European Central Bank's (ECB's) LTRO has merely bought some time for the highly indebted states of the European periphery to restructure their economies and public finances. And US growth will struggle to keep up with its long-term trend level.

But at the same time, investors suffering negative real interest rates are anxious to buy on corrections. And valuations are attractive – with some markets' price–to-book (PB) and price-to–earnings (PE) ratios close to the post-Lehman lows of 2008-2009.

The push and pull of these opposing forces will continue to feed volatility in equities markets over the coming year. And indeed, we see technical signals that tell us a correction in equities is likely in 2Q-2012, hence our underweight position for equities over the next few months.

But in this environment, investors should differentiate between performance horizons. The traditional 3-month tactical asset allocations are useful only for those who are anxious to account for the performance of their portfolios on a quarterly basis. But in an environment prone to unpredictable mood swings, attempts to forecast the near-term direction for equities have frankly become difficult.

Figure 1: Negative real rates fuel demand for equities

Source: Group Research, CIO Office, data as of end March 2012

Investors with a longer-term horizon should focus on the time-tested strategy of "buying good, buying cheap and hanging on". Spotting quality stocks is a matter of research and quality advice. Buying cheap is a matter of valuation – and those valuations are often compelling at the moment. Hanging on is a matter of investor discipline.

Notwithstanding the rally of the past few months, equities generally remain attractively valued, with much of the gains reflecting only earnings growth, rather than expansion in valuation multiples.

More cautious investors might want to consider high dividend paying, low beta (meaning less volatile) stocks denominated in their local currencies.

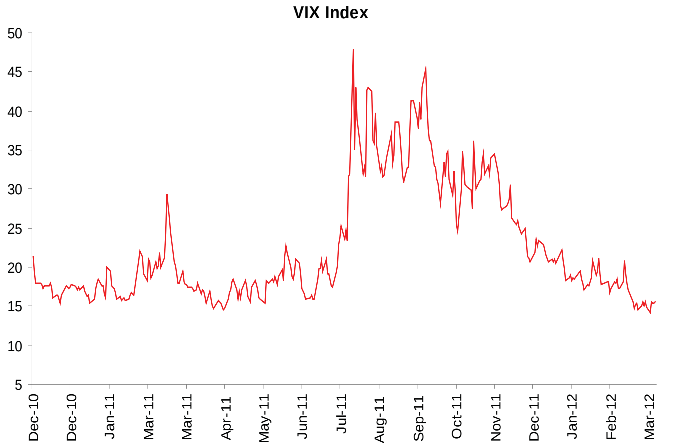
On a 12-month time horizon, we are more upbeat about equities, with a neutral rating, expecting further gains, even from current levels.

BONDS

As outlined earlier, Asia ex-Japan has found itself in a world where rapid growth and inflation in the East sits uncomfortably with low growth and structural dysfunction in the West. The former demands a more aggressive approach towards investment risk/returns to stay ahead of rising consumer and asset price inflation. The latter requires caution even as investors race against rising prices.

So it is about striking a balance between risk and hedges.

Figure 2: Volatility eased but likely to return in 2Q-2012



Source: Bloomberg as of end March 2012

Yes, we recognise that equities offer far better value today. Indeed, the yield gap between equities earnings yields and government and high-grade corporate bond yields is very large in historic terms.

But volatility has merely retreated temporarily and not disappeared. Indeed, equities market volatility, as measured by the VIX index, appears under-priced at current levels, and vulnerable to upward spikes. (Figure 2) Triggers for a return of volatility could include renewed concerns over Euro area sovereign debt, disappointments in US economic data, and fears of a hard landing for the Chinese economy. So we remain overweight bonds as a portfolio diversifier.

Over the coming quarter, we are maintaining our strategy of protecting capital through high grade credits. But we would seize opportunities in market volatility to move into better quality, high yield credits to improve longer-term returns. That also means using any pullbacks in risk appetites and spread widening to take on more weight in Asia ex-Japan credits at the expense of global ex-Asia bonds.

Among high grade corporates, we continue to see relative value in defensive credits, particularly those in infrastructure/utilities, the power/energy sectors, and in some Hong Kong and India issues.

Among high yielders, we see relative value in the better quality high beta credits, particularly those in the high B straddling BB range. We would buy them on dips.

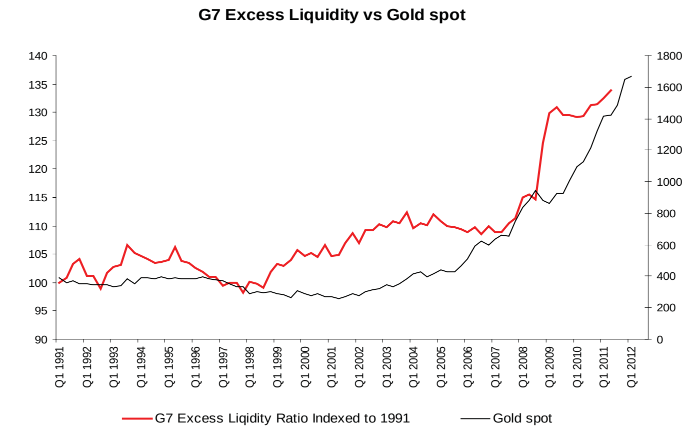
For Chinese property credits, the operating environment is likely to remain challenging over coming months. But headwind regulatory risks have diminished. And property developers with established brand names, good project locations, diversified asset portfolios in cities that are less exposed to stringent regulatory policies, low cost land-banks, and better access to alternative funding are likely to outperform.

COMMODITIES

The broad commodities market – mirrored by the Reuters/Jefferies CRB Index – has dramatically lagged the recovery in the MSCI Asia ex-Japan equities index from their respective October 2011 lows. This is troubling given that commodity prices should reflect sentiment towards economic growth in Asia. Even more troubling has been the sharp drops in the index in March.

Commodities are likely to struggle with some of the same factors expected to overhang equities in 2Q-2012. They include potential disappointment with US economic data and renewed Euro area turbulence possibly focusing on Spain and Portugal.

Figure 3: Global excess liquidity driving gold prices



Source: Bloomberg and Datastream, data as of end March 2011

But in addition, the commodities market could be weighed down further by fears of US dollar strength in 2Q-2012 and foot-dragging by Chinese policy makers on monetary policy easing.

Meanwhile, oil prices may have overshot on the upside on fears of a war involving Iran. Of course, an outbreak of war would likely send crude oil prices through the proverbial roof. But to date, it has been all sabre rattling with no swords yet seen leaving the scabbard. It is probably true that even in the absence of acute tensions, the ever-present threat of geopolitical tensions involving Iran – coupled with tightening spare production capacity – should keep crude prices (West Texas Intermediate, WTI) supported around $95 per barrel. But nevertheless, that would still involve significant price downside from current levels.

Industrial metals are likely to weaken further in 2Q-12 on fears of Chinese policy "overkill".

But we do not see a hard landing for China. And there is plenty of room for policy manoeuvre if it becomes evident that China's economic growth is decelerating sharply. We would be buyers into industrial metals on the likely correction.

Similarly, we would be buying into a correction on crude oil prices given that supply constraints and geopolitical tensions are likely to return as concerns.

Gold is trading just above a long-term support level at its 55-week moving average which is currently at around $1639 per ounce. If it breaks this support level – as it did in 2008 – we could see accelerated losses. Otherwise, we expect that aggressive global monetary expansion should push gold higher over the coming year towards $1950 per ounce and possibly even $2000 per ounce. (Figure 3)

CURRENCIES

Our long-standing theme of rotational weakness amongst the major currencies remains valid. But in this game of swings and roundabouts, what the US dollar lost in the first quarter, it could pick back up in 2Q-2012, as risk appetites wane.

But apart from the risk-on/risk-off cycle, the fundamental dynamics of the Euro and the dollar are evolving. The relative strength of the US economy and the diminishing expectations for another round of quantitative easing stand in contrast to the EUR1 trillion of cheap liquidity pumped into European banks by the ECB in less than three months.

And while the ECB's LTRO prevented a meltdown in the Euro area, the problems have not gone away and require a significantly weaker currency to restore competitiveness.

The Australian dollar (Aussie) has already started retreating quite quickly from its recent highs against a range of currencies. The Australian economy is slowing with growing concerns over tentative signs of a pick up in unemployment. Meanwhile, the housing market continues to soften with early signs of mortgage stress. Although the Reserve Bank of Australia had gone on hold on rates, the rate cutting cycle is unlikely to be over just yet. Concerns over slower growth in China will also weigh on the Aussie over coming months.

Broad US dollar strengthening in 2Q-2012 could also weigh on Asia ex-Japan currencies. But losses among the regional currencies against the US dollar could be moderated by stubborn inflation in the region. Given that inflation hasn't eased as fast as some expected last year in some countries, there is a possibility that Asian central banks could go slow on rate cuts.

2Q-2012 Tactical Asset Allocation Strategy

VIEW	3 MONTHS	12 MONTHS
EQUITIES	**UNDERWEIGHT**	**NEUTRAL**
United States	Neutral	Overweight
Europe	Underweight	Underweight
Asia Pacific ex-Japan	Underweight	Neutral
Japan	Overweight	Overweight
Emerging Markets	Underweight	Neutral
China	Neutral	Overweight
BONDS	**OVERWEIGHT**	**OVERWEIGHT**
Global ex-Asia	Overweight	Neutral
Asia ex-Japan	Neutral	Overweight
ALTERNATIVES	**NEUTRAL**	**OVERWEIGHT**
Property	Underweight	Neutral
Commodities	Neutral	Neutral
Gold	Neutral	Overweight
Hedge Funds	Overweight	Neutral
CASH	**OVERWEIGHT**	**UNDERWEIGHT**