

Invest Fair

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Markets have recovered dramatically since their lowest point in March, thanks to the influx of liquidity and relief that the spectre of another Great Depression has retreated. But how sustainable is this rally? Here are some experts who will speak at the InvestFair 2009 today. The fair is jointly organised by ShareInvestor and *The Business Times*.

Participants:
Kevin Scully, executive chairman and founder of NRA Capital
Terence Wong, senior vice-president and co-head of research of DMG & Partners Securities
Wong Sui Jau, fundsupermart general manager
Lorraine Tan, Standard & Poor's Equity Research director of research (Asia)

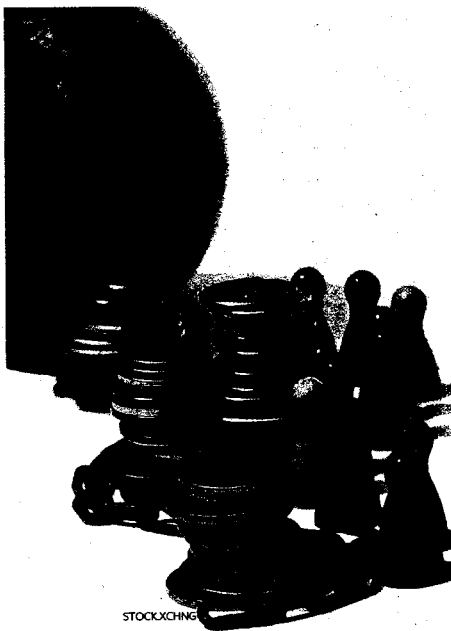
Highlights:
➤ Positive outlook for equities in the longer term, but expect near-term volatility
➤ Risk of premature withdrawal of liquidity; longer term risk of inflation and higher commodities prices
➤ Participants favour bank preference shares; properties in the core central region; cyclical stocks including banks and real estate

Q: Where does Asia and Singapore stand in the current macroeconomic cycle and how sustainable are the market rally and the green shoots of economic recovery?

Kevin Scully: Asia is still not a major consumption region in the global economy although it could grow in importance over the next five years. The current weakness in global demand from the US and EU will impact Asia and Singapore. However, a huge and globally coordinated pump-priming plan has stimulated many economies and lifted them off their lows. The key remains whether this will stimulate end-demand when the pump-priming ends. The pump-priming will start to strain national budget deficits if it is sustained over a prolonged period.

Terence Wong: The good news is that the worst is behind us (no big surprises there). The bad news is that the markets already got wind of it some five months back and the best gains may be behind us for now. Indeed, there has been a massive run-up in global stock markets and valuations are no longer cheap for most markets. Singapore, for example, is trading at about 17x P/E, some two standard deviations above the mean. In March this year, it was going for a mere 10x P/E, and offered a generous yield of over 5 per cent. In the long term, I am bullish on the market. In the interim, however, it is time to take a breather.

Wong Sui Jau: On a global basis, major economies are in recovery phase and Asia is no different. We have passed the trough and given the sharp contractions of various economies, it will not be surprising to see a strong rebound in growth in subsequent quarters. Leading indicators like purchasing managers indices (PMIs) are indicative of recovery, while most measures of economic conditions are generally showing improvement. Coupled with positive quarter-on-quarter growth in major economies like Germany and Japan



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Making sense of the rally

(and we do expect the US to deliver a positive performance in Q3), there is significant basis for a positive view on the global economy.

Given the rapid rebound in equity markets, the rally will undoubtedly see corrections as the market digests new data. Not all data will be positive and the market will react accordingly, but that will be part and parcel of climbing this wall of worry. However, the fact that there are still sceptics means that markets are not pricing in a return to normal conditions and thus there is a significant degree of undervaluation in equity markets.

Asian market valuations remain reasonable while its growth potential remains the highest compared to US, Europe and Japan. Even for the rest of the world, we expect a steady climb out of recession. We do not subscribe to the view that there will be a global depression similar to 1930s. Most markets are still well off their all-time highs. There remains significant upside to Asian markets.

Singapore is one of the markets we are most positive on within Asia. It has ample foreign reserves, its companies generally have strong balance sheets, and because it has diversified its economy, there are different avenues of growth which will all help to sustain the economic recovery.

The two integrated resort (IR) projects, plus many other projects will keep the construction sector busy over the next few

years, and their completion will help to further boost the Singapore economy. This, plus the low base of the fourth quarter of 2008 and first quarter of 2009 lead us to believe that Singapore should recover more strongly than developed countries like the US. We expect that 2009 and 2010 would surprise on the upside.

Lorraine Tan: The recent Q2 GDP data has largely been better than we originally anticipated and supports our view that the US economy should see recovery in Q4. While S&P economists expect data to bounce around the current subdued levels, we do believe the worst is over for Asia. Export data is gradually improving although still significantly below year-ago levels. The main drivers to the upside should come from the gradual recovery in global demand and continued regional government stimulus spending. We do expect a sluggish recovery for the US, however, with GDP growth of around 1-1.4 per cent next year and this is likely to weigh on Asian growth.

Q: What areas/risks give you the greatest concern in terms of the economy and corporate earnings?

Kevin: The key risks now appear to be a reversal or change in government macro policy. For example, a change in the very loose bank credit policy in China which generated close to US\$5-6 trillion in credit in the first six months of this year could

create other bubbles in the economy. The key seems to be what is the level of sustainable growth in exports in the second half of 2009 after the inventory restocking of Q2 2009 is over. Weak Christmas demand from the US and EU could revive retrenchment and corporate closures.

On the corporate earnings front, the better-than-expected Q2 2009 earnings came on the back of falls in revenue – the decline in revenue is consistent with weaker global demand while higher profits came from cost-cutting which is a one-off item. My sense is that there will be further consolidation of industries because very loose interest rate policies of the last two decades have led to misallocation of resources, as the cost of capital was too low. So with the world's overcapacity problems – we are likely to see the survival of the fittest and attrition of peripheral players. This, in time, will lead to a recovery in demand for the existing stronger players.

Terence: South-east Asia has been losing out to China in foreign direct investments over the past 15 years. I see two challenges for the region. First, how effectively will we be able to compete against China? I believe that we may see some interest return to the region in the coming years for geopolitical reasons. US firms may not want to put all their eggs in the Chinese basket. South-east Asia, with its established infrastructure and educated workforce, is a good alternative.



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Second, will we be able to diversify our economies, and be less reliant on exports? Singapore, in particular, is very susceptible to the booms and bust of global trade. The dependence on manufacturing will continue to be reduced over time. Manufacturing is very labour intensive, unlike the new industries that Singapore is building up, such as pharmaceuticals. When there are retrenchments in manufacturing, other key sectors may not be able to absorb the sheer numbers.

On the Singapore corporate earnings front, it is less of a concern for the listed companies, particularly the large caps, as most have diversified their earnings regionally or even globally. Take SingTel for example. A decade ago, practically all its revenue was derived from Singapore. Now, it is barely a third. It has built up a sprawling telco empire, from Australia to India, with over 262 million mobile customers – 58 times Singapore's population!

Sui Jau: A major risk is an early withdrawal of liquidity in the system if the US Federal Reserve and other central banks raise interest rates prematurely. Interest rates have to stay low as sentiment recovers for businesses to start spending again, and to prop up a weak housing sector in the US.

What happens in the US will undoubtedly impact Asian economies. The massive amounts of liquidity pumped into the financial system so far has not had an im-

act on core inflation numbers, which suggests little pressure on central banks to raise rates in the near term.

Another major risk globally and to Asia, in particular, is if an asset bubble forms in commodities and pushes prices, including oil, too high too fast. This would cut off the oxygen that Asian economies need just as they are recovering. It is still very early days yet in the economic recovery though. I would worry if oil prices push north of US\$100 per barrel, but we are still quite far from that.

Lorraine: Since this has been a global recession made worst by the US and UK financial crisis that started in September last year, we still see risks coming from continued defaults and further job cuts. US debt default rates and the unemployment will probably peak only next year in line with past recessions. Commercial real estate loans are a key concern for the US given that seven million jobs have been cut in the US, which means reduced need for office space. Given the relatively short-term nature of most of this debt, refinancing needs will be substantial over the next 12 months. Exposure to this debt is mainly with the smaller banks in the US, so we may not see the global contagion as we saw with the failure of Lehman Brothers, but insurance companies do have exposure to such debt.

We also see the risk of rising energy and commodity prices. Rising energy

and commodity costs rise, and inflation creep up, regional central banks may feel the need to tighten policy sooner than expected and while the economic recovery is still nebulous. Rising costs may also create margin pressures for companies at a time when demand is still weak. In the ongoing Q2 results season, we note that most companies are reporting better earnings as margins expanded due mainly to reduced costs. Topline growth has lagged. Cost-cutting is unlikely to be sustainable and the market has built in assumptions for revenue to rise next year and costs to remain benign. Any disappointment on this end could send markets lower.

Q: If you were advising a retirement portfolio for a middle-aged individual, age about 45, what asset allocation would you advocate in the light of the challenges arising from the crisis and from a long-term perspective, and why?

Terence: At 45, an individual is still relatively young and can afford to take risk. He or she can choose to invest 45 per cent in "safe" equities (including blue chips and Reits), 20 per cent in riskier equities (fundamentally sound small/mid caps), 20 per cent in bonds, and 15 per cent in cash. The risky component should be reduced with time.

Sui Jau: The crisis is a reminder that investors should always examine their risk appetites and investment horizons on an on-going basis. Investors often find themselves overly exposed to risky assets when markets are soaring and near a top, while being underinvested when markets are low. The strong market rally since stocks bottomed in early March also suggests that market timing is often futile; many investors took profits early on, only to see equity markets continue their relentless ascent.

Our hypothetical middle-aged individual should be looking at a balanced approach, with diversified holdings in both equity and bonds. The fixed income portion will be a drag on returns, but will serve to minimise downside risk and portfolio volatility. Such an asset allocation would normally have 50 per cent invested in equities through equity funds and 50 per cent invested in bond funds.

Investing through funds gives an added layer of safety as funds tend to be diversified as well, holding dozens if not more than one hundred securities. So, individual company risk is reduced.

Lorraine: We focus on equities and hence are not portfolio managers but we recommend that investors stay invested in around 60 per cent equities, 25 per cent bonds and 15 per cent cash. Of the equities portion, only up to 15 per cent should be in equities domiciled outside the investor's home country. Given that markets are still well below their prior peaks, we see being 60 per cent in equities to be reasonable at this juncture of the economic cycle.

Q: Where do you see the greatest opportunities in the near term and why?

Kevin: I expect financial markets to be

more volatile as the huge amounts of liquidity pumped into the system by central banks and governments is creating a liquidity bubble and possibly inflationary pressure if short-term interest rates remain near zero levels. I think equities look attractive but it's not time yet to pay a liquidity premium. So I would be looking at value growth plays with strong balance sheets, trading below book value and on single-digit PERs for stocks. I would also look at non-deposit yield plays. I like bank preference shares which can still generate running yields of about 5 per cent.

Currencies look to be volatile, especially the direction of the US dollar, bonds also look vulnerable because I expect central banks to start raising interest rates sometime early next year.

Terence: Equity will still provide the best upside. But I would advise investors to wait till the market corrects before entering in a meaningful way. I am also a great proponent of the "Remaking Singapore" story, and there will likely be good opportunities in the property front. But I am not talking about the shoe-box-sized 300 sq ft mass-market developments.

The recent run in the mass market has been overdone. In fact, some higher end apartments (in the core central region, or CCR) are selling at negligible premiums to the mass market, which goes against logic. While I believe mass prices are not sustainable, investors with cash may consider a bigger unit in the CCR, as it should be back in vogue in the next two to three years when expats return in a big way.

Sui Jau: We believe that there are near-term opportunities in global financials, which will react positively to better housing data. US financials are expected to benefit from a stabilising US housing market, given the huge amounts of mortgage-related debt on their books. Credit card defaults also appear to be stabilising, which suggests that the concerns over consumer defaults may not be as severe. Asia financials were sold down as the entire financial sector became the area to avoid in the wake of the Lehman Brothers crash.

However, these are generally well capitalised and do not have the kind of sub-prime-related loan problems that the US and European banks are faced with. In general though, the whole finance sector remains a key part of the global economy, and it will recover as the global economy recovers. The current price-to-book valuations for the financial sector remains cheap at close to one time price-to-book. And we expect earnings for the overall financial sector to surprise on the upside over the next 6-12 months. This is helped by the especially low interest environment globally right now, giving the banks a higher profit margin.

Lorraine: We focus mainly on equities – so our near-term recommendation is to pick up stocks in cyclical sectors such as energy, materials, banks and real estate on corrections but to temper this with holding some shares in defensive laggards (in Singapore, this would be some consumer staples and telecommunication stocks).