inmyOpinion

investors should stick with developed markets.

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How markets react after a selloff often give us clues to future performance. We see different performance by various markets and asset classes, some recovering better while others continue to look vulnerable. In addition, we see the same factors - divergent policies and growth prospects - driving market performance. Upon consideration of the recent data, our conclusion remains unchanged. Despite "value" appearing in emerging markets after the selloff, developed markets are likely to outperform for the rest of 2013, with US and Japan expected to make new highs for the year.

On a peak to trough basis, the performance of developed markets diverged significantly from emerging markets. US equities continue to lead the pack, with Europe and Japan not far behind. Emerging market equities managed to eke out a recovery, although they have some way to go before recouping the losses. The worst performer is the Latin American market.

Figure 1: Recent Equity Market Performance

	May 2013 High	Recent Bottom	Current Price	% from May High
US	1669.16	1573.09	1695.53	-1.6%
Europe	293.43	265.06	291.12	0.8%
Emerging Europe	25.39	22.14	24.63	3.1%
Japan	15627.26	12445.38	14658.04	6.6%
Asia ex-Japan	60.96	51.66	56.29	8.3%
Emerging Markets	43.66	36.18	39.67	10.1%
Latin America	724.46	570.83	615.07	17.8%

A similar performance can be seen in the fixed income markets. High yield bonds, which are predominantly US junk bonds, were the best performer, close to recouping their losses. Their higher coupon is likely a factor for the quick recovery despite a re-pricing of interest rate risk. On the other end of the scale, we see emerging market bonds struggling to recover losses. Again, Latin American bonds are the laggards.

Figure 2: Recent Bond Market Performance

	May 2013 High	Recent Bottom	Current Price	% from May High
High yield Bonds	95.29	88.57	93.97	1.4%
Investment grade Bonds	121.55	111.12	115.45	5.3%
US Treasuries	108.76	100.52	102.74	5.9%
Asian Bonds	52.6	48.01	49.02	7.3%
Emerging market Bonds	120.76	103.27	111.53	8.3%
Latin American Bonds	26.49	22.56	24.31	9.0%

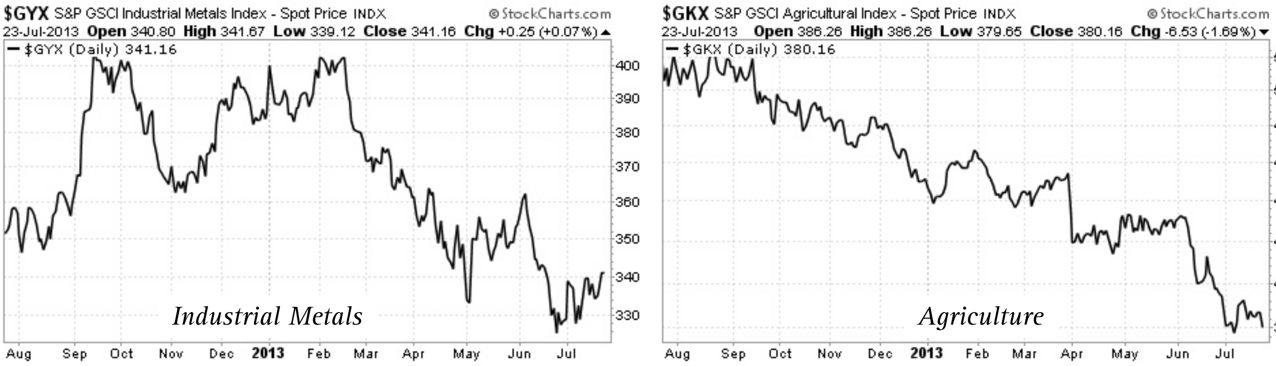
Fundamentally, the theme of developed economies outperforming emerging economies continues to play out. China's recent data shows the impact of restructuring the economy. Manufacturing PMI and industrial production continue to slow, while services and retail sales remain healthy. The July flash PMI report where the Chinese manufacturing sector remains in contraction for the third consecutive month again suggests that the trend is set to continue. Given the weak action from the Chinese equity markets, it should not surprise that data in the coming months will continue to be soft.

Figure 3: China Economic Snapshot	June	May
Markit Manufacturing PMI	48.2	49.2
Markit Services PMI	51.3	51.2
Industrial Output (% Chg)	8.9	9.2
Retail Sales (% Chg)	13.3	12.9

Figure 4: Chinese Stock Market In Long Term Downtrend

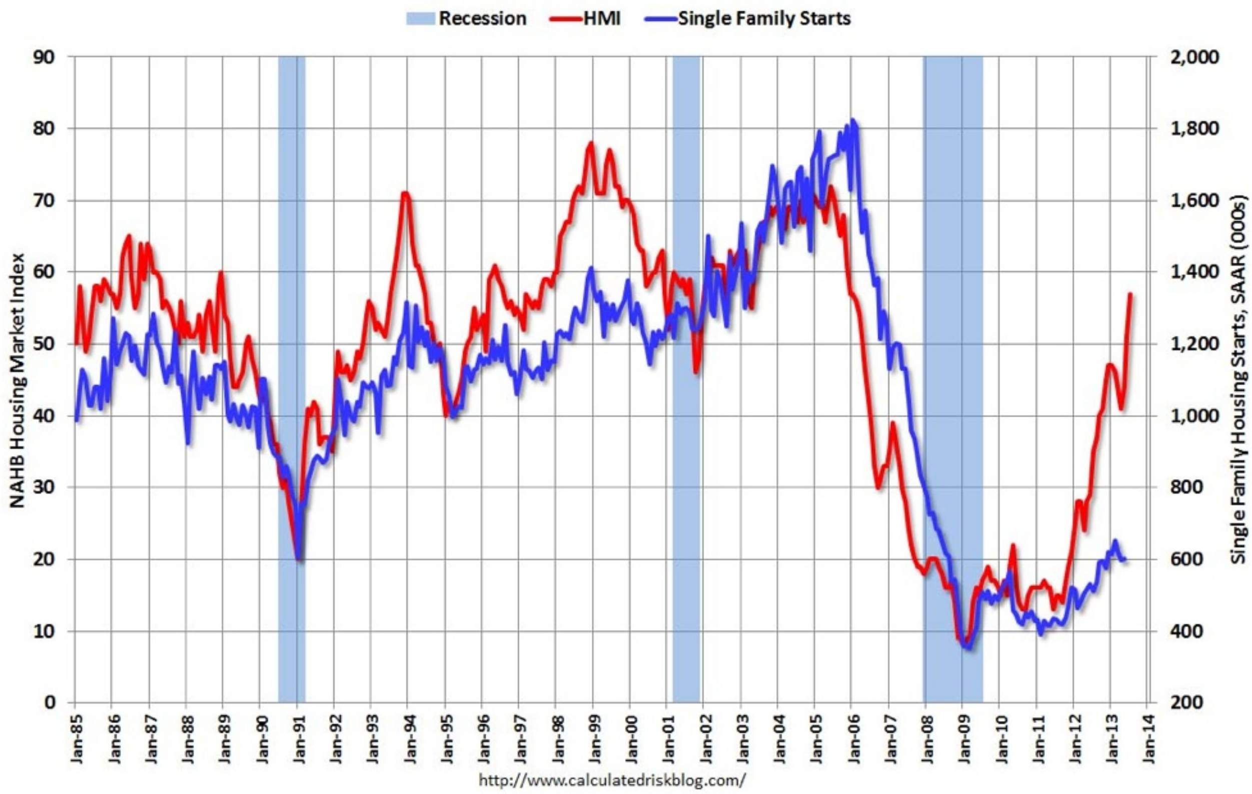
A weak China spells bad news for the emerging market economies. Commodity-based economies like Australia and Brazil have begun to experience the effects of lower consumption of commodities from China. As the Chinese economy restructures, commodity demand is unlikely to rise much, putting pressure on prices. Both industrial metals and agriculture prices have been in a downtrend since the start of the year. The ongoing price correction may have some way to go given that restructuring the Chinese economy is done not in months or quarters but in years.

Figure 5: Commodities Prices In Decline



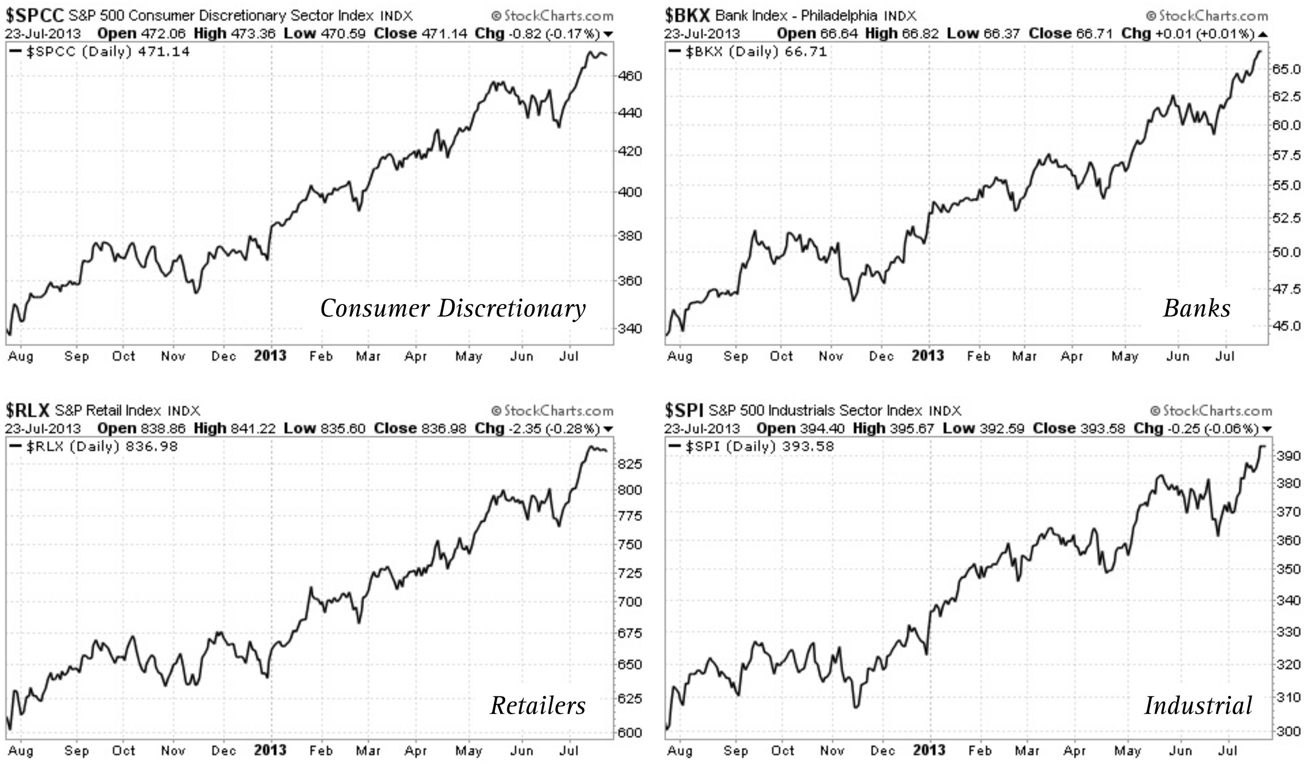
In the US, the data describes an economy that manages to sustain growth. Manufacturing remains in an expansionary phase with both the ISM and Markit's PMI above 50. Consumers are also opening up their wallets, as seen in vehicle sales rising in June. The housing market is also strengthening with the NAHB index, a measure of homebuilder's confidence, gaining for the third consecutive month and now at the strongest level since 2006.

Figure 6: National Association of Home Builders - Housing Market Index



These are reasons why US stocks are doing very well this year, with the S&P 500 up 19% so far this year. Various economic sensitive sectors, like consumer discretionary, banks, retailers and industrials, remain in an uptrend. Even fears of Fed tapering are not enough to put investors off as we saw huge inflows into US equity mutual funds[1] . The recent rise in interest rates should be seen as a sign of strength for the US economy, as opposed to weakness as seen in peripheral Europe. As the economic data continues to improve, the consensus will begin to pencil in higher and more sustainable growth numbers for the world's largest economy. Higher economic activity provides a conducive environment for earnings to grow.

Figure 7: US Economic Sensitive Sectors Making 52-week Highs



Speaking of earnings, the Japanese equity markets are currently enjoying an earnings driven rally, aided by a yen that has weakened around 20%. At the USD/JPY100 level, analysts are expecting strong earnings growth which will provide a tailwind for the Japanese stock market. The recent upper house election win for Prime Minister Abe further cement the view that structural changes are coming to Japan. While there are risk that he may face opposition from within his party where vested interest is involved, it is clear where Japan is heading. The sense of urgency to rejuvenate the economy as a means to counter the rise of China is rising, especially when conflicts appear to be on the rise[2]. Admittedly, Japan cannot just rely on exports alone to lift economic vibrancy. That is why policy announcements to increase the potential growth rate of the Japanese economy will be important to sustain the rally in Japanese equities.

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[1] U.S.-based stock funds gain $16.64 bln, most since early Jan. - Lipper 18 July 2013 Reuters

[2] Japan Says China Using Force to Try to Change Status Quo. 9 July 2013 Bloomberg

Figure 8: Weak Yen Improves Competitiveness

Figure 9: Nikkei225 Continues Its Rally

Europe deserves a special mention despite the poor growth outlook. It is after all the world's largest economic bloc, bigger than the US or China. When the European economy stabilises after many quarters of recession, it should be viewed as good news. The latest PMI reports confirm that given sufficient time, an economy adjusts itself via a recession to increase competitiveness. Spain's latest PMI finally ended a 25-month sequence of deteriorating operating conditions for her manufacturers by rising to 50. Overall the EU's manufacturing PMI has been improving over the past few months, signaling a potential end to the recession. This is probably why European equities have done well, on a relative basis, compared to say emerging markets. The former exceeded expectations by exiting a recession earlier, while the latter disappointed by its bleaker growth prospects. Also, the fact that European financials are holding up better than the market is another sign that Europe's stability is likely to last for a while longer.

Figure 10: Europe Outperforming Emerging Markets

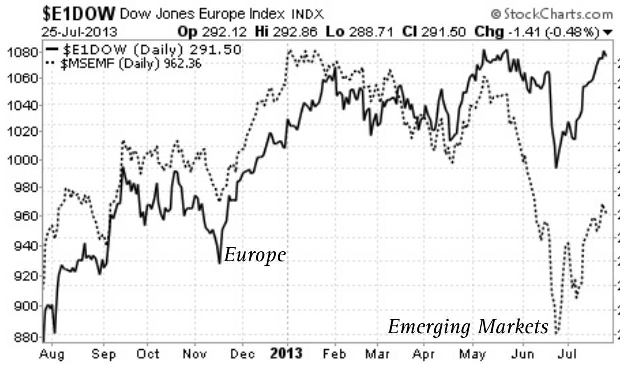

Figure 11: European Financials Holding Up

The remaining of 2013 is likely to be influenced by policy makers in the major economies. The Fed is seen by economists to begin tapering in September, adjusting its pace of bond purchase to US$65bn[3]. Markets have already priced in this action by sending 10-year Treasury yields up, even after Mr Bernanke clarified that tapering does not constitute a tightening in monetary policy. Investors need to understand that bond buying by the Fed is an attempt to influence long term interest rates. By reducing or stopping bond purchases, the Fed is allowing the market to decide the appropriate level of interest rates at the long end, depending on the market's expectations of economic growth and inflation. Higher growth expectations allow for higher rate of interest due to higher

[3] Bernanke Seen Slowing QE to $65 Billion in September. 24 July 2013 Bloomberg News

demand for credit. If 10-year yields continue to stay higher than levels seen in May 2013 after the Fed begins tapering, then the market is expecting a brighter economic outlook for the US.

Figure 12: Yields Are Higher Because Of Economic Improvement

Meanwhile emerging economies are left to deal with the outflow of liquidity as a consequence of the Fed's action. It does not help that the timing of the Fed tapering clashes with a weaker growth outlook for emerging economies. Fund flows out of emerging economies are forcing countries like Brazil, India and Indonesia to raise interest rates in an attempt to stem the sharp decline in their currencies. Monetary tightening while the economy slows will only exacerbate the slowdown further. Even countries that do not face significant outflows have to contend with lower growth as policy makers maintain a bias towards tighter monetary policy after years of credit fueled growth. Singapore is a prime example where the central bank continues to warn on excessive lending in the city state should interest rates rise significantly[4]. Tight monetary policy combined with weaker growth prospects is never a conducive environment for risk assets. Emerging market debt, having attracted a flood of foreign capital the past few years, is likely the riskiest asset class in a rising interest rate scenario.

Conclusion: Global equities, especially developed markets, have staged a remarkable recovery in July. As always, after a strong performance, a period of consolidation is expected as investors digest the current earnings reports and consider how monetary policy will play out in the months ahead. Our preference for US and Japan equities remains unchanged. They are well supported by better economic growth outlook and are beginning to become fashionable investment themes, just like emerging markets were ten years ago.

[4] Singapore central bank says rising household debt 'worrying' 23 July 2013 AFP

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