The New Year's Rally

Asset Allocation Update: Overweight equities and commodities, underweight bonds and cash

We started the year with a neutral position in equities and we highlighted that this year offers both the chance for significant double digit gains as well as the risk of double digit losses largely depending on how successful Europe is in refinancing the large amounts of sovereign debt that mature in 2012. Since the start of the year, the bond auctions have been very successful and economic data around the world has steadily improved. In the light of the recent developments, we have switched back to an equities and commodities overweight and underweights in bonds and cash.

In January 2012, equity markets across the world have largely rebounded from the lows seen last year. Also, gold and most commodities have performed well while bonds have held their own. The S&P 500 has crossed the 1,300-point level, while the Dow continued to march upwards, nearly touching a four-year high last set in May 2008. Even in Singapore, we have seen the benchmark Straits Times Index gained ground to cross the 2,900-level, while gains were also seen elsewhere in Asia.

The broad-based market rebound has been strongly supported by the bank liquidity facility arranged by the European Central Bank late last year. This Long-Term Refinancing Operation (ie "LTRO" the acronym that will soon be as famous as "TARP" and "QE2") created an injection of nearly half a trillion euros of three-year ECB funding in December 2011 and has helped to ease up funding stress across the sovereigns and stabilized the capital markets on the continent.

Since the money injection last December 2011, the three-month spread between Libor rates and overnight index swap rates has narrowed and may continue to do so as the central bank is set to offer another round of three-year loans later this month.

In our view, the effect of such a development on the asset markets is significant, as it removes a major overhang that weighed down on markets for almost the whole of last year. If credit availability is no longer a major issue, that will pave the way to yields to decline, in which case, fears over European banks' solvency will also retreat somewhat.

The second round effect is that liquidity relief after a credit crunch often results in higher asset prices in the short to medium term via portfolio rebalancing channel or higher risk appetite as activity picks up. An equivalent episode would be the period post the second round of quantitative easing in the US, where risk markets posted sharp rallies which was then followed by steady improvement in economic data.

Sovereign debt levels remain a big problem in Europe and will require significant and painful actions over many years to bring the debt burdens back to more reasonable levels. And while the LTRO may help contain the European situation from erupting into a Lehman like shock, it certainly does not exempt Europe from the tough fiscal austerity that will last years. The politics of such pain will continue to pose significant tail risks.

Nevertheless, we believe that markets can still post a steady recovery so long as there's stabilisation in credit markets, coupled with improvement in overall economic activity and fiscal progress made in Europe. And recent developments certainly point in that direction.

For example, the economic conditions in the US have clearly improved as seen from the latest jobs and ISM numbers. Weekly jobless claims have been south of 400,000 level for over a month, while nonfarm payrolls beat survey estimates with a 200,000 print in November 2011. Latest ISM readings showed that new orders continued to be strong – a print of over 57, as headline figure recorded an expansion. In Asia, we have seen the purchasing managers' indices for India, China and Taiwan improved even as fears about a China hard landing abate.

While the "headline" risks out of Europe remain (markets may unravel if there's a serious failed bond auction), or if the Greek default process becomes "disorderly", we see signs that the liquidity improvement is helping to ease panic conditions and there has been a gradual improvement in economic data. To us, the developments suggest that the recent market rallies may have more legs to it and we have raised our weightings to equities and commodities accordingly.

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