CIO Message

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"2008 was a year many investors will remember, or rather, prefer to forget. The massive flight to government bonds, the sharp plunge in credit and equity markets, the enormous swings in currencies, the precipitous rise and decline in commodity prices have left many investors dazed and bruised."

Owning "safe" assets and shunning "risky" ones were the main investment decisions of 2008. What lies ahead for 2009? Are we likely to see more of the same or is the worst over? These are the questions most investors would ask.

Experienced investors rarely take a chance to predict the precise point when equity markets turn. What they can mostly see are signs of a bottoming phase, when the market is trying to find a floor. The market will make several attempts to break out but will periodically dive back down again and re-test the lows. The signs are that we could currently be in a bottoming phase, a process which is typically drawn out over a number of months.

Every cycle is different but in this round, the degree of uncertainty over the economy and corporate earnings is far higher than normal. And uncertainty makes markets volatile. The VIX, which measures implied volatility on equity markets, was above 40 at the end of December 2008. This is a great improvement from the 80+ readings we saw at the peak of the crisis on Wall Street but it is still sobering to note that VIX at this level is what it was during the Long Term Capital Management (LTCM) crisis in 1998. The problem with this sort of volatility is that it tends to keep long-term investors on the sidelines and delay the recovery of equity markets.

What the market is looking for are signs that the global economy is not going to enter into a deep, prolonged deflationary slump similar to the Great Depression in the 1930s or some modern version of it like what Japan experienced in the 1990s. The first clues of this are likely to come from the credit markets. If corporates can raise capital at rates that are not punitive, it would be an important signal that the credit crunch is receding. And when credit markets rally, equity markets will almost certainly follow suit.

Overcoming a credit crunch is not easy. Credit contractions by their nature have vicious in-built downward spirals and policymakers need to intervene to short-circuit the process. Central banks have all cut interest rates aggressively but in a situation where banks are unable and unwilling to lend, lowering official interest rates has limited effect. The US Federal Reserve has now turned to an unorthodox monetary policy by forcing down private sector borrowing rates. There are some hopeful signs that "quantitative easing" is beginning to work, for example, US mortgage security yields have begun to decline and US mortgage refining activity has risen.

Consumers, and also businesses, are nevertheless going to be restrained in their spending for some time and governments have to make up for the fall in demand. The new US administration under Mr. Barack Obama comes into office in January and the market would welcome the announcement of a meaningfully large stimulus fiscal package. In the developed economies, fiscal outlays in recent years have been centred on defence spending but the overwhelming theme now is infrastructure. The global shift from consumer to government spending will be manifested in financial markets in the coming months.

In Asia, the focus is on China. China possesses both the political will and the financial firepower to boost its economy. China's economy is suffering from two different challenges. One is the slowdown in its export sector, which is driven by US consumer demand. The other weakness is its property market, which was over-heating and has now slumped. The government has announced large infrastructure investment plans to create employment and a series of measures is also being introduced to revive the property market.

Compared to the Great Depression and the experience of Japan, policymakers have responded to this crisis with a great deal more speed and urgency. It is too late to turn around the downward momentum of the global economy and the recession ahead will be painful but we are optimistic that the policymakers will succeed in averting a deep and prolonged economic slump.

Investors are liable to stay pessimistic and skeptical given the developments in the past few months but from a risk-reward perspective, things are very different from what they were a year ago. Markets have fallen so far that it is impossible to ignore valuations. For investors with time on their side, those with a medium-term investment horizon, we believe that equity and credit markets are offering genuine value.