WAYS TO PROFIT FROM QUANTITATIVE EASING 2: EQUITY AND BOND STRATEGY

By iFast Research Team

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Key Points:

- The Fed announced an initial US$600 billion asset purchase programme (QE2) which will be completed by the end of the second quarter of 2011
- Double-dip recession is not the chief factor for QE2. The Japanese history has told us QE2 aims at managing price expectations
- It is evident that the lack of credit creation mainly comes from the demand side, that is, consumers' unwillingness to borrow. QE would be ineffective when there is an absence of borrowers in an economy, as liquidity injected by the central banks cannot be circulated in the banking system
- While the effect of QE2 is still controversial, one thing is sure: markets are flushed with liquidity. Risky assets will benefit from the programme as excess liquidity will flow into the asset markets
- We identify three main investment trends amidst the QE period: 1. Risk-free asset will also be yield-free asset; Financial Institutions like pension funds and insurance companies which rely on the regular fixed income to maintain its cash flow will be battered; The low cost of borrowing would encourage investment which is a key positive catalyst for the re-rating in valuation
- For the bond market, we favour high-yield corporate bonds, Asian and emerging sovereign (EM) bonds on the back of attractive yields and potential capital gains from currency appreciation. We also expect investment-grade corporate bonds to outperform as they will likely be the targets of the Fed's asset purchase programme
- For the equity market, the emerging markets are likely to be the biggest winners, compared with the developed markets in the QE2. We think the Technology sector, the China A- and H-share markets as well as the Hong Kong market are high ROE players that are set for more upside. For value plays, Russia, Europe and the Technology sector look attractive. Lastly, investors looking for attractive yields may consider Taiwan and Europe markets.

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PART A:
BACKDROP OF QE2

The long-awaited details of the 2nd Quantitative Easing (QE2) announced earlier by the Fed were revealed in the FOMC meeting in November 2010. Market consensus on the size of QE2 programme is widely different, ranging from between US$500 billion to US$2 trillion. Some analysts even predicted that the Fed will not announce the maximum amount for the package. Finally, the Fed announced an initial US$600 billion asset purchase programme which will be completed by the end of the second quarter of 2011, a pace of about US$75 billion of assets a month. It could be argued that the details of the programme are roughly in line with the market's anticipation. QE2 is regarded as one of the most important decisions the Fed has made in the decade. Investors believe it is crucial for the bank to tackle several economic issues like high unemployment, deflationary threat, and, of course the biggest challenge – to maintain sustainable economic growth.

In this article, we will start by discussing the purpose of the QE2 programme, whether it can solve the ongoing economic predicament – the threat of a double-dip recession and a Japanese-style deflationary spiral. Afterwards, we analyse how QE in general change investment behaviour and its implication on investment strategy.

DOUBLE-DIP RECESSION IS NOT THE CHIEF FACTOR FOR QE2

In early September this year, some economists argued that the Fed will launch an additional QE programme to eliminate the threat of a double-dip recession, especially when there were concerns that GDP growth would be tepid in the second quarter that was much out of market's expectation. As domestic inventory is falling and the impact of fiscal stimulus receding, some forecasters claimed it is now the right time for the Fed to introduce a second round of QE.

However, we hold a different view. In a previous article US Economy: Moderate growth in 2Q 10 marks fourth straight quarterly expansion, our US specialist has explained that the main detractor to growth in second quarter was net exports, which subtracted 2.8% from the overall growth. Imports surged by an annualised 28.8% quarter-on-quarter, attributed to strength in the US dollar against euro. If we exclude the negative impact of net exports in 2Q 10 GDP growth data, the annualised growth rate would actually be 5.1%. It indicates that the US economic growth is not as slow as what the market thought.

TABLE 1: GDP COMPONENTS (ANNUALIZED Q-O-Q CHANGE IN %)

GROWTH (%)	2009 1Q	2009 2Q	2009 3Q	2009 4Q	2010 1Q	2010 2Q	2010 3Q*
Gross Domestic Product	*-4.9*	*-0.7*	1.6	5	3.7	1.7	2
Personal Consumption Expenditures	***-0.5***	***-1.6***	2	0.9	1.9	2.2	2.6
Gross Private Domestic Investment	***-42.2***	***-18.5***	11.8	26.7	29.1	26.2	12.8
Exports	***-27.8***	***-1***	12.2	24.4	11.4	9.1	5
Imports	***-35.3***	***-10.6***	21.9	4.9	11.2	33.5	17.4
Government Consumption Expenditures and Gross Investment	***-3***	6.1	1.6	***-1.4***	***-1.6***	3.9	3.4

Source: US Bureau of Economic Analysis
* Denotes official advance estimate

Notably, the euro has continued to rise against the US dollar since the third quarter 2010. It is widely expected that a weak US dollar will continue as the Fed enlarges the asset purchase programme or adopts step-up quantitative easing. We expect the negative contribution of net export to mitigate in the coming quarters.

In fact, investment flow, the main driver of the US GDP growth, remains strong. Gross private domestic investment had demonstrated strong double digit growth for the fifth consecutive quarter since the third quarter of 2009, and the most recent data for 3Q 2010 showed another strong 12.8% increase. Inventory restocking continued to go up considerably, while the GDP data indicated a turnaround for structures and residential investment.

Personal consumption expenditures (PCE) accelerated in 3Q 2010, gaining an annualised 2.6% (see TABLE 1) from 2Q 2010 and contributing 1.79% to the overall growth figure. Along with the recovery in overall GDP, PCE has posted five straight quarters of growth, with the latest quarter's 2.6% rate the quickest pace of expansion since 4Q 2006's 4.1%. It shows that a double-dip recession is not a major threat at this moment.

LEARN FROM THE JAPANESE HISTORY: QE2 AIMS AT MANAGING PRICE EXPECTATIONS

As a Princeton professor in the 1990s and a Fed official in 2000s, Ben Bernanke has long criticised the Bank of Japan (BOJ) that raising interest rate prematurely is one of the major reasons that have prolonged Japan's lost decade. In March 2001, 11 years after the crisis, the BOJ finally adopted Quantitative Easing by injecting 25 trillion yen into the banking system. In spite of the implementation, however, signs of a Negative Wealth Effect and the sluggish domestic demand created a strong deflation pressure in Japan. The country faced a protracted stretch of deflation as the Consumer Price Index (CPI) excluding food and energy was negative from 2001 to 2006.

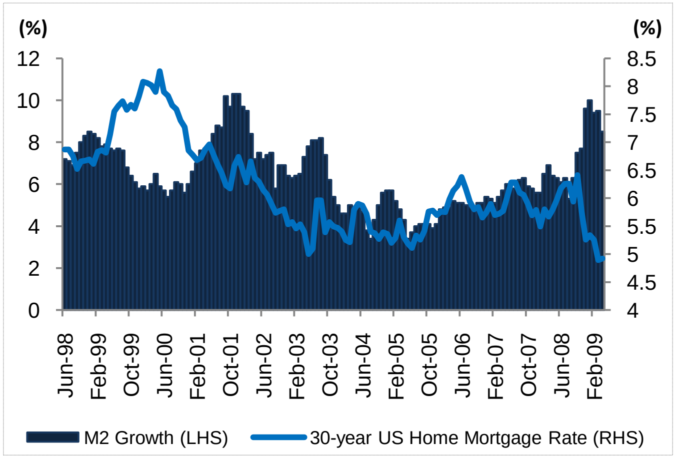
During that period, the required reserves averaged around 6 trillion yen, indicating that the 25 trillion yen asset purchase programme could result in hyperinflation if the domestic demand rebounded. Thus, the BOJ was very sensitive to any positive economic data. The bank mistakenly judged that inflationary risks would be present in greater measure than deflationary risks in early 2006. To stabilise the price of goods, the bank took a strong anti-inflation stance, which induced Japanese households to expect that prices will continue to fall. This was a self-fulfilling deflationary expectation.

In March 2006, the BOJ decided to stop its QE programme and it subsequently adopted a monetary tightening policy – 18 months before the core CPI actually turned positive. The policy change intensified deflation, so the original QE programme was unsuccessful in stimulating credit activities and economic activity.

Ben Bernanke argued that the Bank of Japan officials should have taken aggressive actions to manage expectations. He claimed that convincing households and businesses that deflation wouldn't persist would help to spur economic activity. Thus, he suggested the BOJ to set a price level target.

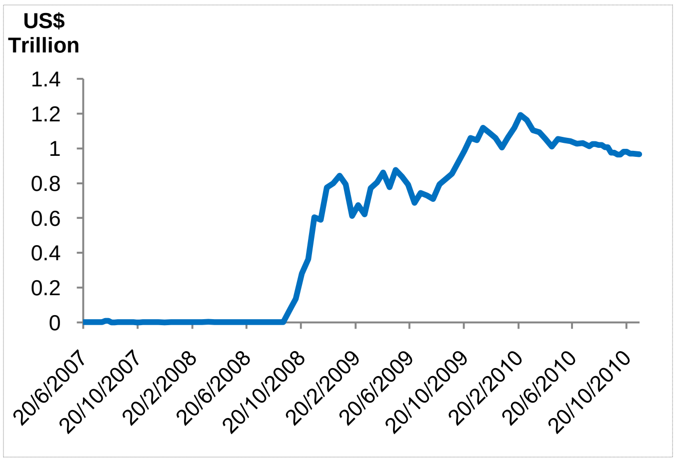
Tokyo's experience is a very good lesson for the Federal Reserve chairman. Today, he is ready to apply his

CHART 1: M2 GROWTH & US HOME MORTGAGE 30 YEAR FIXED NATIONAL AVERAGE



Source: Bankrate.com, Federal Reserve Bank Of St. Louis and iFAST Compilations

CHART 2: US DEPOSITORY INSTITUTION EXCESS RESERVES



Source: Federal Reserve and iFAST Compilations

theory on the US's economic problem. In 15 October 2010, Bernanke said that FOMC participants "generally judge the mandate-consistent inflation rate to be about 2% or a bit below". We believe the main purpose of additional QE is to manage expectations of the price level.

QE1 WORKS! HOW ABOUT QE2?

During the financial tsunami in 2008, banks suffered a substantial loss of capital from the toxic assets. The rising non-performing loans have also curtailed the banks' lending ability. They are less willing to lend due to the fears of counterparty risk, hence many companies are unable to get credit. Hence, the aim of QE is to increase overall money supply through deposit multiplication by increasing lending and reducing the cost of borrowing to stimulate the economy.

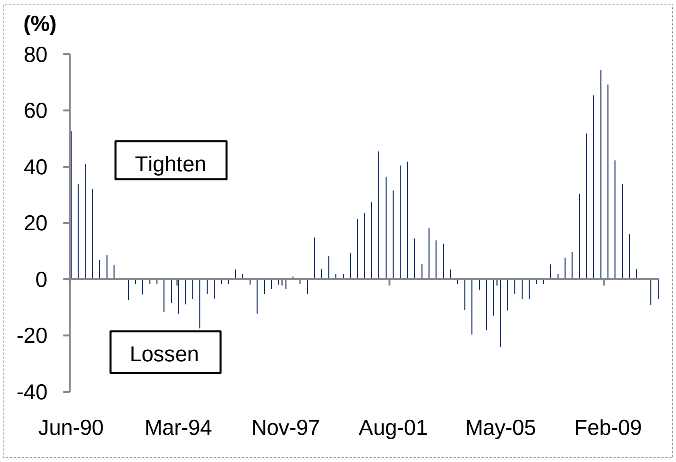
In order to ease off credit squeeze, the Federal Reserve engaged in quantitative easing (QE1) by purchasing MBS, agency bonds and US Treasuries. The action successfully lifted money supply (M2) and reduced the cost of borrowing (30-year US Home Mortgage Rate) as depicted in CHART 1. It helped to improve the money market and financial market conditions. Although the US economy remains lackluster, the Fed's initiative gave financial support to the companies that had financing pressures, preventing a large number of US corporate bankruptcies. It helped to avoid another Great Depression. In this perspective, we can conclude QE1 has been effective.

It is clear that banks are still unwilling to lend, as evidenced by the US$1.2 trillion of excess reserves (bank reserves in excess of the reserve requirement) (see CHART 2), Some economists and market commentators called for further QE to improve the situation. By injecting more liquidity into the banking system, the QE encourages banks to lend and thereby stimulate domestic demand. We agree that QE encourages banks to lend more, but it is evident that the lack of credit creation mainly comes from the demand side, that is, consumers' unwillingness to borrow.

According to the quarterly-conducted Senior Loan Officer Survey, banks have lowered underwriting standards and eased lending terms for commercial and industrial loans to large firms since 2Q 2010 (see CHART 3). It proves that the credit environment has been favourable to the large- and medium-sized firms since 2010. In addition, banks have also eased underwriting standards for small firms in 3Q 2010. It was the first time since 4Q 2006 that banks increased their willingness to make loans and ease standards for loans application for small-sized firms. This result shows that banks continue "a modest unwinding of the widespread tightening that occurred over the past few years". Thus, the unprecedented high level of excess reserves should not only be attributed to banks' unwillingness or inability to lend, because the latest survey result shows continuous improvement on the supply side of credit in the industry.

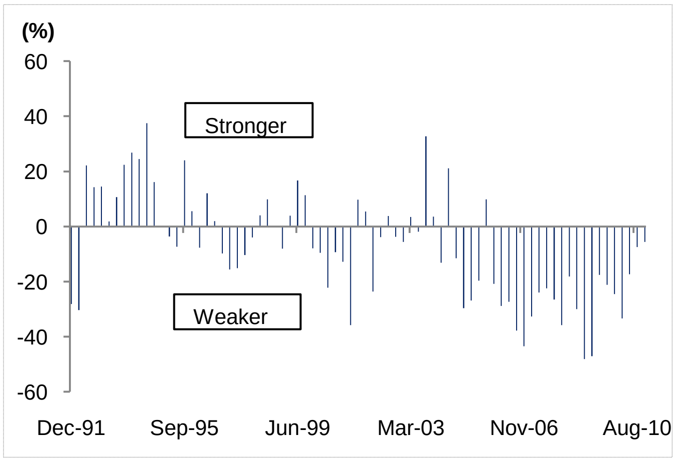
On the other hand, banks reported a weaker demand for commercial and industrial loans for all firms (see CHART 4). Reduction in financing needs for inventories and accounts receivable, reduction in business expansion, and the rise of internally generated funds are the major reasons for the weaker demand. Similarly, the

CHART 3: NET PERCENTAGE OF TIGHTENING STANDARDS FOR C&I LOANS FOR SMALL FIRMS



Source: Federal Reserve and iFAST Compilations

CHART 4: NET PERCENTAGE OF BANKS REPORTING STRONGER DEMAND FOR CONSUMER LOANS



Source: Federal Reserve and iFAST Compilations

majority of banks reported a decrease in demand for consumer loans.

This should not be surprising, because the sharp deterioration of corporate and household balance sheets has driven down the number of borrowers drastically. A company or household suffering from a debt burden will not borrow just because loans are becoming cheaper. However, QE would be ineffective when there is an absence of borrowers in an economy, as liquidity injected by the central banks cannot be circulated in the banking system. Thus, QE could probably only increase the monetary base (bank notes + coins). As a result, the money supply (M2, i.e.monetary base + demand accounts + saving accounts + time deposits + money market accounts) cannot grow and the economy cannot benefit from the easing progamme.

3 MAIN INVESTMENT IMPLICATIONS

While the effect of QE2 is still controversial, one thing is sure: **markets are flushed with liquidity**. **Risky assets will benefit** from the programme as excess liquidity will flow into the asset markets. We identify three main investment trends amidst the QE period, which forms our investment strategies for QE beneficiaries.

1. **Risk-free asset will also be yield-free asset:**
   The US$600 billion bond purchase programme, combined with the proceeds from its first quantitative easing programme (an estimated of $250 to $300 billion) to reinvest in longer-term government bonds, will put a strong downward pressure on yields across the bond market. The expected issuance of high quality bonds including US Treasuries, US government agencies bonds and US corporate bonds is around US$1.3 trillion.

2. **Financial Institutions like pension funds and insurance companies which rely on the regular fixed income to maintain its cash flow will be battered:**
   These companies need to generate adequate returns to fulfill the expected cash payout for policy holders or fund investors. The prolonged low yield environment makes it difficult to achieve the returns target and increases their incentive to invest more in riskier assets.

3. **The low cost of borrowing would encourage investment which is a key positive catalyst for the re-rating in valuation**:
   It would also shift investor's objective from *earning interest* to *reaping capital gain*.

On the basis of these three investment trends, we identify the beneficiaries of QE in the equity and bond sectors.

PART B: BOND STRATEGY

Apart from the US QE2 programme, the Bank of Japan (BOJ) had also announced further monetary easing measures in early October 2010 to safeguard its fragile recovery and to combat deflation. The "comprehensive monetary easing policy" includes a cut of the bank's overnight call rate to a range of zero to 0.1% and a new temporary 5-trillion-yen (US$60 billion) fund on its balance sheet to buy various assets, including Japanese government bonds.

Adam Posen, the policy maker of Bank of England (BoE), has commented that the decline in credit growth in the UK is similar to what Japan has experienced in the 1990s, and admitted the country's need for further QE through large-scale asset purchase scheme. The bond purchase programme in developed nations would continue to put a strong downward pressure on their government bond yields. This has already been evidenced by the multi-year low level of yields on developed sovereign bonds in the third quarter of 2010.

While the developed countries' sovereign fixed income looks unattractive, investors can still find alternatives with better yields. In the cover story of our 4Q 2010 magazine, we highlighted the beneficiaries under the theme *The Hunt for Better Yields Amid Low Interest Rates*. Under these themes, we like high-yield corporate bonds, Asian and emerging local currency sovereign bonds.

In the following, we briefly recap the rationale behind our picks.

INVESTMENT STRATEGY 1 – BUY HIGH-YIELD CORPORATE BONDS, ASIAN AND EMERGING SOVEREIGN (EM) BONDS

At this juncture, high-yield corporate bonds, Asian and EM bonds offer higher yields compared with the developed sovereign bonds. Since early January 2009, yield spreads between high-yield corporate bonds and Treasuries have narrowed sharply as investors priced in a recovery scenario, along the diminishing fear of rising defaults. Still, the current yield spread (453 bps as at 4 November 2010) is still remarkably wide compared to the historical spread of between 250 to 400 bps in a strong economic upturn. The wider-than-average yield spreads suggests that it is still not too late for investors to buy high yield corporate bonds.

TABLE 2: SOVEREIGN DEBT YIELDS

5-YEAR LOCAL CURRENCY SOVEREIGN BOND	YIELD AS AT 12 NOV 2010	MODDY'S CREDIT RATING
Brazil (4-year sovereign bond)	12.015%	Baa3
Colombia	6.58%	Baa3
Hungary	7.02%	Baa1
Indonesia	6.28%	Ba2
Malaysia	3.25%	A3
Mexico	5.456%	Baa1
Poland	5.4%	A2
South Africa	7.0%	A3
Turkey	7.57%	Ba2

Source: Bloomberg and iFAST Compilations

For Asian and EM local currency bonds, attractive yields and potential capital gains from appreciating currencies are likely to provide stronger returns for yield seekers. Numerous EM bonds are offering attractive yields (see TABLE 2). For example, Brazil's 4-year local currency sovereign bond offers investors one of the highest yields in the world, despite its strong economic fundamentals and investment-grade rating.

In addition, we expect interest rate normalisation in emerging markets to continue and real interest rates to climb up. The widening interest rate gap between emerging markets and developed nations suggests that Emerging Market currencies are likely to appreciate against developed market currencies.

However, we believe currency appreciation will slow down with increased volatility in some emerging countries. QE2 has risked currency wars as we noticed that a number of central banks have planned to intervene in the foreign exchange (FX) market. For example, the Korean government imposed a new FX regulation which tightens the banks' FX position to ease the volatility of capital flows.

Taiwan has also put restrictions on foreign investment on local fixed income products while Indonesia has

TABLE 3: CENTRAL BANKS' REACTION TO US QE2

Country	China	Hong Kong	India	Indonesia	Korea	Malaysia	Philippines	Singapore	Taiwan
FX Intervention	Heavy	Pegged by law	Light	Heavy since August 10	Heavy	Heavy since August10	Moderate	Intervention via managed	Heavy
Change in Policy Rates	+25 basis point	No interest rate policy	+100 basis points	No change	+25 basis points	+75 basis points	No change	No interest rate policy	+50 basis points
Capital Flow Regulation	Liberalise investments into interbank RMB bond market; ease outflow	None	Increase FII limits on government and corporate bonds	Impose 1 month holding period on SBIs	Tighten FX derivative limits for banks; possible tax on bonds	Liberalise FX rules to increase inflows	Easing dollar purchases without documentation; encourage outflows	None	Ban time deposits; put limits on foreign investment in local FI Instruments
Net Impact	2-way flows		Increase inflows	Tighten inflows	Tighten inflows	Increase inflows	Increase outflows		Tighten inflows

Source: Citi, Asia Macro and Strategy Outlook, 29 October 2010

imposed a one-month holding period on its bonds (SBIs). We expect more capital flow intervention from the authorities in the Emerging Markets if speculative capital continues to pour into the region. Thus, the pace and the magnitude of currency appreciation for countries that actively regulate their exchange rate and capital flow would be slower than market expectations.

We therefore recommend investors to position themselves in High-Yield, Asian and Emerging Market bonds.

INVESTMENT STRATEGY 2 – BUY BBB CORPORATE BOND

The FOMC reassured that it will regularly review the pace and the overall size of the asset-purchase program. It would adjust the program as needed to fulfil its employment and price levelgoals. It implies the Fed would expand the size and the asset class should the unemployment rate and inflation rate fall below the Fed's target. We expect the Fed to buy long-term Treasuries and other securities aside from the government bonds, especially corporate bonds.

Indeed, we can find some clues from the BOJ's recent action (see TABLE 3). While deflation persists and money-market rate remains low, the Japanese central bank is considering purchasing riskier assets to further reduce borrowing costs. To make a strong impact, the BOJ will likely purchase BBB-rated corporate bonds and a-2-rated commercial papers. It would be an unprecedented move because the central bank has limited its purchases to bonds rated A or above and a-1 commercial paper during the 2008 financial tsunami. This move is more effective than buying high-rated corporate bonds because it can help to lower the borrowing cost for the small-to-medium sized companies which struggle to find funding.

We do not expect the Fed to buy corporate bonds anytime soon, but the move is nonetheless anticipated. Such expectation will push investors to move out of their comfort zone and take a step further in the risk spectrum– to invest in investment-grade corporate bonds. We think BBB-rated corporate bonds which offer the highest yield among the investment grade bonds would be the beneficiaries. As at 12 November 2010, spreads for investment grade (205 bps) and high investment grade bonds (106 bps) are close to their historical averages. However, investors' preference is now skewed towards higher yield bond. Coupled with the potential corporate bond purchase by the Fed, there will be a strong support for the BBB corporate bond.

PART C: EQUITY STRATEGY

To move on, we present three strategies in equity investment against the backdrop of the QE2 as follows:

1. Looking for Quality;
2. Searching for Values; and
3. Hunting for Yields.

INVESTMENT STRATEGY 1 – LOOKING FOR QUALITY

In September, market sentiment shifted from worries over the sustainability of the US recovery to anticipation of QE2 from the Fed to revive the US economy. As we've addressed in the beginning, QE2 involves injecting more liquidity into the global economy.

In our view, one scenario would be money flows towards the into quality assets. In this session, we identify the best -quality equity markets to invest.

Strategy

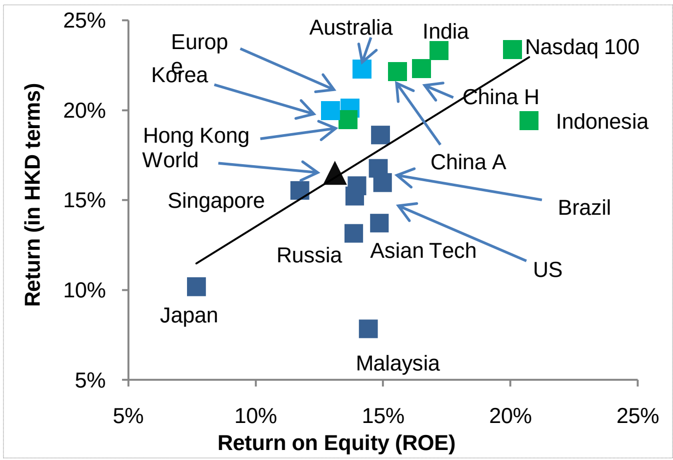
Return on equity (ROE) measures the efficiency of a company's equities in generating profits. Very simply, the higher the ROE, the better the company.

We notice that global equities have reacted favourably ahead of the Fed's announcement in November. We also note that the market favours high quality assets as evidenced by the strong performance of several high-ROE markets including Indonesia, India and both China A- and H-share markets, and the Technology sector (see TABLE 4) since September.

On the other hand, Hong Kong's Hang Seng Index registered a decent gain amid its relatively low ROE. If we take a closer look at the index, we would discover that the top performers are mainly Chinese financials, energy and materials sectors, which have a high ROE and collectively attributed to 47% of the index-point gain over the period.

While Hong Kong investors may find that Australia, Europe and Korea equity funds have also performed well over the period, it is worthwhile to note that much of the gain is from the currency, which means the stock prices have not gone up much. Therefore, their returns represented in local currency terms are not that

CHART 5: HIGH ROE PLAYERS LEAD THE PACK



Source: Bloomberg and iFAST Compilations
Returns between 31 Aug and 4 Nov 2010

attractive after excluding the currency gains.

At this juncture, investors may ponder whether these high-quality markets have priced in their higher ROEs as they have been lying above the trend line (as shown in CHART 5) since the recent rally. Nonetheless, we think there would be more upside for some of them.

1. We think the Technology sector represented by the **Nasdaq 100** can benefitted from more re-ratings as their corporate results have mostly beaten the consensus. As of 12 November 2010, among 80 of Nasdaq 100's companies that have reported their 3Q10 earnings, 67 (84%) of them outperformed market expectations. The better-than-expected earnings plus the better growth outlook are likely to fuel further earnings upgrade.
2. We think **China A- and H**-shares markets and possibly **Hong Kong's Hang Seng Index** are seeing more upside. While we graphically put a straight line in the chart to visualise the upward trend, the actual relationship may not be linear because high quality assets can be priced with a premium while low quality assets can be priced with a discount. Furthermore, valuations for these markets remain attractive and are well supported by robust earnings growth (we will further discuss in the next paragraph).

TABLE 4: GLOBAL EQUITY MARKETS RETURNS

Market Indices	Return on equity (ROE)	Performance since 31 Aug 2010		Impact from Currency Gains
		In HKD terms	In Local Currency (LCY) terms	
JCI Index	*20.7%*	*19.4%*	*17.8%*	*1.7%*
NDX Index	*20.1%*	*23.4%*	*23.8%*	*-0.4%*
SENSEX Index	*17.2%*	*23.3%*	*16.3%*	*7.1%*
HSCEI Index	*16.5%*	*22.3%*	*22.3%*	*0.0%*
SHSZ300 Index	*15.6%*	*22.1%*	*19.9%*	*2.3%*
SPX Index	15.0%	16.0%	16.4%	-0.4%
SET Index	14.9%	18.6%	13.0%	5.7%
BPRTECH Index	14.9%	13.7%	14.1%	-0.4%
IBOV Index	14.8%	16.8%	12.1%	4.7%
KLCI Index	14.4%	7.8%	6.3%	1.6%
AS51 Index	**14.2%**	**22.3%**	**7.7%**	**14.5%**
TWSE Index	14.0%	15.8%	9.7%	6.1%
ACASEAN Index	13.9%	15.2%	15.6%	-0.4%
***RTSI$ Index**	13.9%	13.2%	13.5%	-0.4%
SXXP Index	**13.7%**	**20.1%**	**7.8%**	**12.4%**
HSI Index	*13.6%*	*19.5%*	*19.5%*	*0.0%*
MXWO Index	13.1%	16.5%	16.9%	-0.4%
KOSPI Index	**12.9%**	**20.0%**	**11.5%**	**8.5%**
FSSTI Index	11.7%	15.5%	9.8%	5.7%
NKY Index	7.7%	10.2%	6.1%	4.1%

Source: Bloomberg and iFAST Compilations (as of 4 November 2010)
*RTS Index measured in the USD terms

INVESTMENT STRATEGY 2 – SEARCHING FOR VALUES

A value investor always considers both the quality and the price of the assets. There are three evaluation matrices to identify markets with good value:

a) Price to Book (PB) ratio vs Return on Equity (ROE);
b) Price Earnings (PE) ratio; and
c) Price/Earnings-to-Growth (PEG) Ratio

The PB – ROE Valuation Model

ROE measures how efficient a company is in generating profits from its equities. On the other hand, the PB ratio indicates the price an investor pays for the book value of a company. In a nutshell, PB ratio is the price you pay while ROE measures the quality of the goods that you buy. This model tells you the market with the best value.

As a rule of thumb, a high PB ratio usually goes with a high ROE. We compared the consensus PB ratio for 2011 and the average consensus ROE over the next two years. With these data on hand, we have generated a value line (denoted by the black line in CHART 6) which shows the relative attractiveness of global equity markets. Markets above the value lines are considered less attractive than average, while those beneath the value line are considered cheaper markets.

As shown in CHART 6, a few h markets with a high ROE are trading above the value line, suggesting they are comparatively expensive relative to their peers. In fact, earnings for the Technology sector have been revised up sharply, which have driven up its expected ROE. This is in-line with our earlier view that the **Technology sector is significantly overlooked**. In our view, after the recent rally**, the market will turn its focus to lower ROE markets with compelling valuations**. Located significantly below the line, these markets include **Russia, Brazil, Europe and Korea.**

Price Earnings (PE) ratio

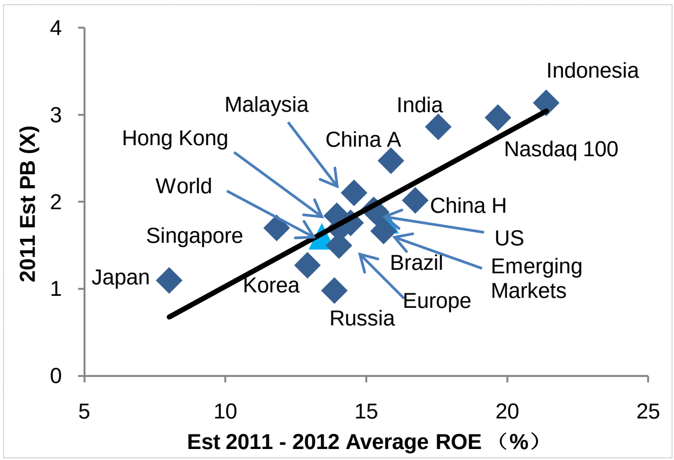
While PE ratios are a simple and straightforward way to judge the relative attractiveness of an investment, it is worthwhile to note that the *fair* PE ratio varies with the market and is largely affected by the underlying sector composition. For instance, the Russian equity market has been trading at a single-digit PE due to a huge exposure to the cyclical energy sector (market typically accords lower PE to cyclical sectors due to unstable profit outlook). Thus, it is premature to conclude that the Russian market is cheap just because of its significant valuation discount to its peers or to the global average.

To overcome these drawbacks, we compare the 2011 forecasted PE of major emerging markets with their historical 12-month PEs over the past ten years (with a few exceptions subjected to data availability, see notes under CHART 7). To reduce the impact of the extreme scenarios to our analysis, we have also made adjustments by removing outliers and choosing the median rather than a simple average to represent the mean. On a forward earnings basis, while the vast majority of equity markets are still trading below their historical mean, few markets' valuations are elevated in absolute and relative terms.

<u>Singapore, India and Thailand are not cheap anymore</u>

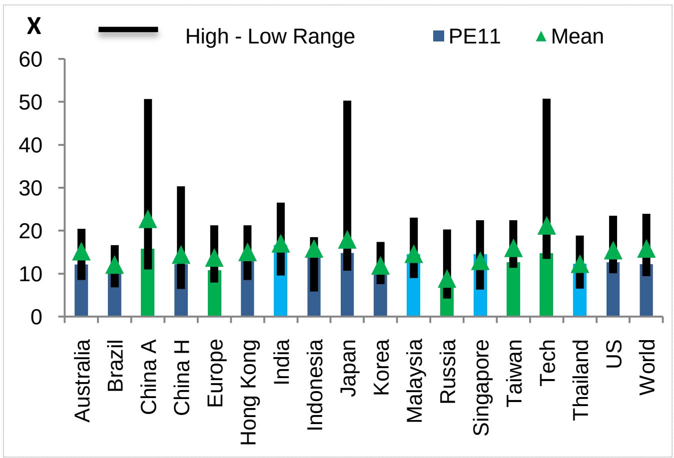
Notably, the Singapore, India, Thailand and Malaysia markets (as highlighted in red) are trading close to or above their historical mean. With the exception of Malaysia, we have recently downgraded the other three markets (See Why we're downgrading Singapore to 3.5 stars; We are now neutral on India ; Is it time to take profit on Thailand equity investments?). Despite the less attractive valuation in Malaysia, our Malaysia specialist has left the rating unchanged as the current valuation is still within a reasonable range during the boom market; the market consensus has underestimated the earnings of Malaysian companies, and the specialist also expects earnings upgrades when most Malaysian companies start reporting their 3Q10 performance by end-November.

CHART 6: RELATIONSHIP OF P/B RATIOS AND ROE OF GLOBAL EQUITY MARKETS



Source: Bloomberg and iFAST Compilations (as of 4 Nov 2010)

CHART 7: PRICE-EARNINGS RATIOS OF GLOBAL EQUITY MARKETS



Source: Bloomberg and iFAST Compilations (as of 4 Nov 2010)
Notes: Data between Sep 2000 to Oct 2010 with exception of Brazil's IBOV since 1 Jan 2001; China H's HSCEI since 31 Dec 2001; Europe's SXXP data since 31 Jan 2002; China A's CSI300 since 31 Dec 2004 and Singapore's Old Straits Times Index used prior to 10 Jan 2008; Adjustment made to calculate mean if necessary

<u>*Tech and Taiwan are still the bargain buys*</u>

In contrast, China A-Share, Europe, Russia, Taiwan, and the Technology sector (as highlighted in green) are still trading at a moderate discount to their historical means, suggesting more potential upside to their valuations. In particular, the Technology sector and the Tech-heavy Taiwan market are trading close to the low-end valuation and their valuation premiums have shrunk sharply.

During the last bull run in the period between 2004 and 2007, the Tech companies in S&P 500 were valued approximately 40% above the broad-based S&P 500 Index. The global financial crisis then depressed the premium and Techs were then valued at a 17% discount to S&P 500 in the fourth quarter of 2008 amid a panic sell-off. At present, not only is the Tech sector trading at a multi-year low, the high-growth S&P 500 Tech companies are trading close at par or even upside down against the broader S&P 500 (see TABLE 5). **Our Tech sector specialist think there is a mismatch between profit expectations and valuations in the sector**. Despite the recent rally, the sector remains an undervalued growth play.

Same case for the Tech-heavy Taiwan market - many Technology companies are trading at low double-digit or even single-digit PEs. **We think Taiwan's closer economic collaboration with mainland China can brighten up the island's long-term outlook and cause re-ratings in Taiwanese equities – Taiwan would soon be another growth play in the Greater China region.** Furthermore, with many Taiwanese companies expanding their operations into the mainland China, they can also benefit from the RMB appreciation.

Price/Earnings-to-Growth (PEG) Ratio

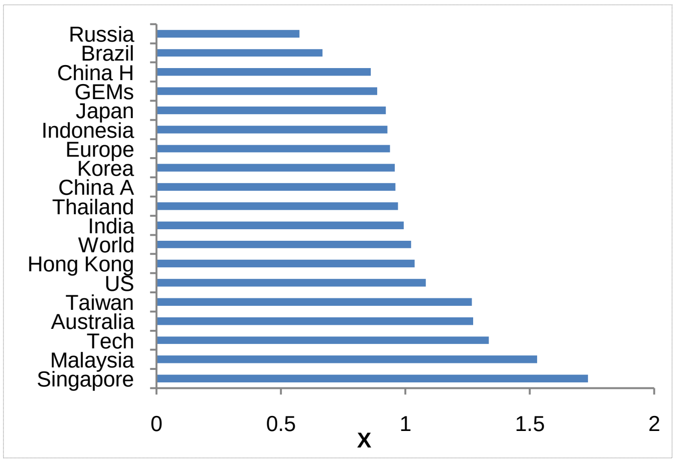
<u>Generally speaking, an investment with huge growth potential should be rewarded by a higher PE ratio. However, we may misjudge a favourable investment by its apparently high PE ratios.</u> The PEG ratio is a good gauge for valuations as it takes the earnings growth into account. <u>It helps us find a right balance between the growth outlook and the price we pay.</u> Simply, the lower the PEG ratio, the more attractive is the investment.

TABLE 5: THE MARKET DISCOUNTS TECH'S VALUATION PREMIUM

	FY10 PE	FY11 PE	FY12 PE
S&P 500 Information Technology	14.2X	12.9X	11.9X
S&P 500	14.4X	12.7X	11.2X
Premium / *(Discount)* to S&P 500	***(1.2%)***	1.7%	6.1%

Source: Bloomberg and iFAST Compilations (as of 4 November 2010)

CHART 8: PEG RATIO (2010 EST PE / CAGR 2011E - 2012E)



Source: Bloomberg and iFAST Compilations (as of 4 Nov 2010)

In our analysis, we computed the PEG ratio of various markets by dividing the 2010 forecasted PE by the Compound Annual Growth (CAGR) over the next two years (i.e. 2011 and 2012). As displayed in CHART 8, **Russia and Brazil stand out** amongst the peers.

To sum up, we think Russia, Europe and the Technology sector are the value picks.

INVESTMENT STRATEGY 3 – HUNTING FOR YIELDS

Traditionally, bonds are viewed as assets with stable cash flow stream. Over the past decade, central bankers of major countries persistently lower their key interest rates to fight against financial crises. In the recent one, the key interest rates in many countries have reached and remained at an ultra-low level for an extended period. This lowers the attractiveness of bond investments

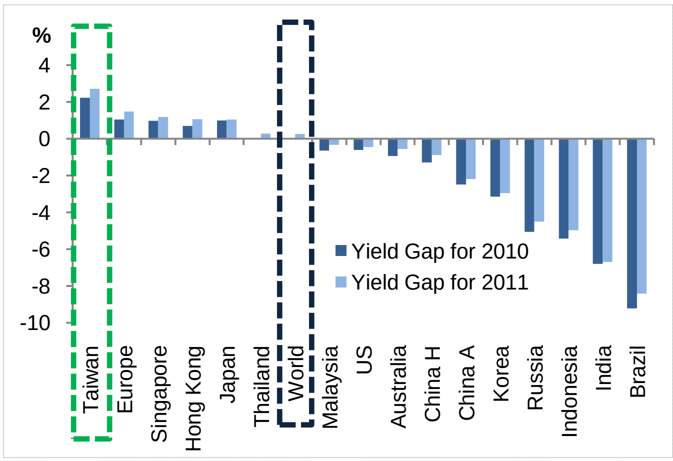
Even worst, the last QE which aimed at lowering the long-term bond yields has resulted in a flattening yield curve. In some cases, investors of government bonds (particularly developed market sovereign bonds) are not well-compensated, which means they are paid less for the risk they bear. Consequently, there have been calls for alternatives, e.g. in the high-yield equity markets. In the following, we analyse the dividend yield gaps as well as the dividend yield of global equity markets.

Dividend yield gaps

We computed the dividend yield gaps of the major equity markets by subtracting the market's corresponding 10-year government bond yield from its dividend yield. To make things easy, we look at the dividend yields on a pre-tax basis. As we have pointed out in our earlier article, dividend payment suggests a company's commitment in distributing part of the profits to its shareholders. It also tells whether a company is effectively earning real cash, rather than booking non-cash profits. From a valuation perspective, dividend yield gap model is more conservative than earnings yield gap model – companies seldom pay out dividends more than they have earned, and hence yield gaps derived from dividends are usually smaller than that from earnings. Similar to the earnings yield gap, the larger the dividend yield gap, the more attractive the equity market relative to the bond market.

Over the past few months, with global government bonds falling to a record low level, the dividend yield gaps of global equities have widened sharply. Notably, the consensus data reveals that **dividend yield gaps for the Taiwan and Europe markets are much wider than other global markets**. The conclusion suggests these two markets are of good value.

CHART 9: GLOBAL EQUITY MARKET DIVIDEND YIELD GAPS



Source: Bloomberg and iFAST Compilations (as of 4 Nov 2010)
Refer to TABLE 4 for the respective indices

Dividend yields

CHART 9 highlights one important point: Global equities are cheap. With reference to 2011 estimates, we note that the dividend yields of most major equity markets are below their historical mean (CHART 9). In our view, a low dividend yield has two possible implications: either the market is pricing an unfavourable outcome, or it undervalues the asset. In this case, the latter is a more likely scenario because corporate earnings have bounced back in the post-crisis recovery and are on the way to a record high. Thus, we think the chances for a double-dip recession are low.

Among the major markets shown in CHART 9, Australia, Europe and Taiwan offer good yield and are expected to yield over 3% next year. Moreover, the expected dividend yield for the Technology sector in 2011 is 68% above the historical average (0.74% vs 0.44%). Although the yield remains low in the absolute term, it tells how much the market has under-priced the sector on a relative basis.

Equally important, the dividend yield of global equities represented by the MSCI AC World Index are still trading below their historical mean (2.79% vs 2.33%), suggesting that global equities remain attractive despite the recent rally.

We recommend investors looking for attractive yields to consider Taiwan and Europe markets.

CONCLUSION: OPPORTUNITIES OR RISKS?

We hope the equity and bond strategies discussed in this article would give you a complete picture of the new market trend under QE2 and help you better position your portfolio. While you may be enticed to forgo the long-hold investment disciplines and become a liquidity follower, we would always advise you not to follow the crowd, nor to follow the capital flows. Our strategies discussed remain fundamental-driven.

In summary, we think both the bond and equity markets have interesting opportunities. For the bond market, we favour high-yield corporate bonds, Asian and emerging sovereign (EM) bonds on the back of attractive yields and potential capital gains from currency appreciation. We also expect investment-grade corporate bonds to outperform as they will likely be the targets of the Fed's asset purchase programme.

For the equity market, the emerging markets are likely to be the biggest winners, compared with the developed markets in the QE2. We think the Technology sector, the China A- and H-share markets as well as the Hong Kong market are high ROE players that are set for more upside. For value plays, Russia, Europe and the Technology sector look attractive. Lastly, investors looking for attractive yields may consider Taiwan and Europe markets.

TABLE 6: BOND AND EQUITY STRATEGIES THAT HELP INVESTORS PROFIT FROM THE QE2

OPPORTUNITIES	STRATEGIES
BOND	
Converging credit ratings and appreciating currencies	High-Yield Corporate Bonds, Asian and Emerging Sovereign (EM) Bonds
Fed's asset purchase programme targets	Investment grade corporate bonds
EQUITY	
Looking for Quality	Global Technology and China (A- and H-share markets)
Searching for Values	Russia, Europe and global Technology
Hunting for Yields	Taiwan and Europe

Source: iFAST Compilations

The Research team is part of iFAST Capital Sdn Bhd.