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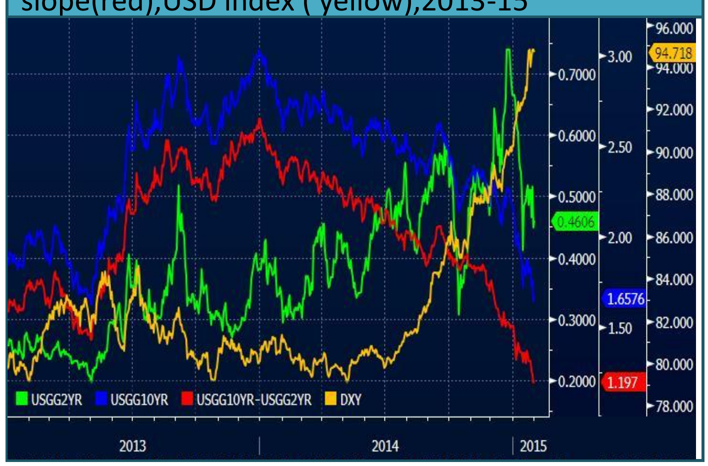
Suggested asset allocation at a hiatus stage

Summary	Investment Conclusions
Investors are faced with an ever-increasing series of trends and policy decisions which are totally contradictory. The Fed gears up for hikes, despite mediocre GDP performance, while Canada, Denmark, PRC, India, and Singapore and, yes, even Russia, all cut rates or loosen up futher. Never mind,of course, the on-going mega loosening by the ECB and BoJ. On top of that, deflationary pressures will stay- weak prices in nearly all soft and hard commodities and oil- and a uniformly strong USD which keeps the UST 2Y and 10Y yields falling rather than rising. Add on "minor" inconveniences such as Greece, and "Voila" a mess in which to try to make money.	A few Asian equity markets, India, the Philippines and Thailand, have outperformed, so far, the G3 markets continuing this trend since 2014. Thailand is less supported by its macros than the other two, which we continue to prefer. We are getting more uncertain about the outperformance of the USD, especially as the case against the Fed hiking this year gathers strength. Once it is clear that the Fed will not hike, then a "global" reversal may well take place, and not just with the JPY and EUR strengthening. Therefore we stay clear of UST positions.

The awkard mixture: The USD and the Fed

Chart 1 tells a complicated story. First, 10Y UST yields (blue) have been consistently declining since the end of 2013 despite the repeated intention of the Fed to hike rates at some stage. The 2Y UST yields have shown a rising trend. There have been bouts of uncertainty, especially after October 2014 when the markets took, once again, fright over the expected Fed hikes and reacted in exactly the opposite direction, yields went down and stayed down since then. The yield curve slope (red, 10Y-2Y UST) has been registering a flattening trend consistent with a tightening monetary policy and absence of inflation fears. So far so good, except for the persistent decrease of the 10Y yields, and now of the falling 2Y yields as well, all of which contradict the Fed's intentions to see rates rising across the spectrum. The flattening yield curve, on its own, is not in conflict with all this once its component parts are examined separately. Next we turn to the strengthening USD (yellow, the trade weighted USD index) which offers as an additional explanation. As the markets are convinced that the Fed will hike, while other rates across developed and developing economies are falling, funds are switched into the relatively higher yielding USD thus strengthening the currency and keeping UST yields down. A symmetrical argument will now point out that once markets are not convinced of an imminent Fed hike, then presumably the USD will become less desirable and this may also cause the UST yields, perversely, to rise despite the Fed not hiking. There is the added issue that the stronger dollar hurts the earnings of S&P 500 firms whose half of all their earnings come from overseas. Exports, although a small % of US's GDP, 13.5%, can contribute to GDP growth and now they are not. Import prices are also kept low thus keeping inflation low against the Fed's wishes.

Chart 1:UST 10Y,2Y(blue,green),Yield curve slope(red),USD index (yellow),2013-15



Source: Bloomberg

Asian equities: To the rescue ?

Chart 2 shows that three Asian equities markets have been outperforming both the US and Japanese markets since the start of 2014 till now, even if the returns are calculted in USD terms. Of these three markets, **India** now stands out for three reasons.First,the RBI has now started cutting rates as its inflation goals are being reached.Second, the low oil prices have given a fiscal boost by allowing the state to cut its expensive oil subsidies, and third, the Modi administration is still generating strong expectations of reforms and liberalisation.The market is not too expensive even in terms of developed markets (See Fact Box). **Philippines** is now charging ahead as the most expensive Asian market.The macro picture is most encouraging, with GDP growth accelerating from 5.3% yoy in 3Q.14 to 6.9% in 4Q.14, while inflation is decelerating helped by falling oil and food prices. Last but not least, the external balances remain healthy helped by remittances from workers overseas. The government is renewing its infrastructure investment initiatives helped by its ratings of investment grade. **Thailand's** macros, however, have weakened considerably,with GDP growth during 2014 nearly static and with a poor outlook for 2015.The results of efforts by the military government to reactivate investment have yet to appear and consumer spending remains subdued. Rate cuts by the central bank have been supportive but will not revive GDP growth on their own. The market is not cheap and is hard to see where earning growth will come from in 2015.

FACT BOX: Equity valuations-not cheap

Stock Index	12M P/E	12M P/B
S&P 500	16.5	2.5
Nikkei	18.8	1.7
Euro50	14.2	1.4
Shanghai	11.6	1.6
Mumbai	17.0	2.9
Thailand	15.0	2.0
Philippines	19.0	2.8

Source: Bloomberg

Chart 2:Stock indices: 2014=100 (*)

Source : Bloomberg

The Fed, ECB and BoJ and asset allocation

The markets will continue to be buffeted by the growing doubts that the Fed will hike thus putting in jeopardy the expectations-driven rally in UST, however much counter-intuitive this might be. Investment in fixed income assets still pursues high yields but with ambivalent attitudes to equities thus blurring the old distinction that risk-on meant higher rates and high stock prices, while risk-off meant lower yields and a stronger USD. Our position is simple. Till the Fed makes clear that it will not hike, equities will stay volatile and this will continue to encourage flows to UST and so to the USD. Once the Fed hike has been either expectation-wise or officially postponed to 2016, then equities will return to favor, and UST yields may rise while the USD weakens. Meanwhile, the now decade-old decoupling of Asian rates from the USD rates will support equities in Asian economies which can combine good macros prospects with falling rates. India and the Philippines are such two markets, much less so now Thailand.

(*)S&P(red),Nikkei (yellow),Mumbai (green),Philippines (brown), Thailand (violet)

Andrew Freris (writing completed 2/2/2015)