

A global diversification strategy is key

By Mark McFarland

THE collapse in oil prices in mid-2014 was supposed to usher in a period of rapid growth and better investment returns. The outcome, unfortunately, hasn't been quite as planned. While there have been periods when prices have risen with gusto (for example, China in 2014 and European bonds in 2015), there have been, however, periods when pessimism has held sway across asset classes. We are in a downturn at the moment, and despite expecting better prospects in the second half of the year, we are cautious about the near-term future.

The market sell-off that engulfed world markets in the first few months of the year was a general, but non-specific fear about growth prospects and default in US high yield bonds. Events since the UK Referendum on June 23 have been cathartic and are likely to be long lasting.

Although Asia, as a whole, is not deeply wedded to the UK, Asian markets are very sensitive to global growth, investment flows and US dollar interest rates. What happens next in Europe will be crucial for Asia's outlook in the next six months. It is worth remembering the old maxim that losing half your money means you have to double what is left to get back to all square.

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will automatically leave the EU, this is not true. The UK can decide if and when it wishes to trigger Article 50 of the Lisbon Treaty. Brussels cannot trigger a UK exit and it could easily offer concessions to keep Britain inside. Even if it does decide to leave, the UK will remain a fully-fledged member of the EU until its departure after the two-year notice period expires.

Nevertheless, Britain's long-term outlook and the level of support for holding other referendums in Europe will be important inputs into second-half 2016 investment decisions. It is very likely that the UK will skirt with recession, despite extensive support from the Bank of England and the European Central Bank.

It is also likely that the Brexit vote will add to uncertainty over cross-border trade and capital market flows across continental Europe. For that reason, the Brexit vote has made European markets a less attractive investment proposition.

HOW DOES IT IMPACT ASIA?

With sterling falling and capital seeking safe havens in US dollars and the Japanese yen, the implications for Asia are wide-ranging. Europe is a big player in world markets. It represents 17 per cent of global gross domestic product (GDP) when measured at purchasing power parity. World Trade Organization (WTO) data shows that the broad European Union accounts for about one-fifth of global



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trade in goods and services.

But the UK itself accounts for only a fraction of that number. Almost 60 per cent of the UK's trade is with the US and EU. A mere 7 per cent of UK trade is with China. For China, that is nothing. In other words, the outlook for Asia is dependent on uninterrupted trade with Europe, not the UK, and how the referendum affects global growth, if at all. Asian central banks, the US Federal Reserve and APEC treasury departments have considerable ability to stimulate growth if necessary.

The Peoples' Bank of China (PBOC) and the Bank of Japan (BOJ) have, for many years, opened swap lines to assist those requiring li-

quidity. And it's likely that the US central bank will be more cautious about raising interest rates. By the end of June, futures markets were offering a near-zero probability of a US interest rate increase in 2016.

WHAT TO EXPECT IN H2 2016

Assuming disruption continues as the UK negotiates the terms of its EU exit, the most appropriate strategy remains a mild preference for bonds over equities. Corporate and sovereign bonds in emerging markets have done well as inflation has fallen (for example, Indonesia) and currencies have stabilised. From here, the main strategy for the second half



continues to be:

- 1) finding value opportunities, and
- 2) trying not to de-risk portfolios so you miss out on the recovery when it finally comes.

That is best achieved by re-allocating equities: by taking from Europe and adding to equities in Asia-Pacific (India and Korea offer value and growth potential) and US equities for market depth. When there is an existential scare in markets, as there was in Europe in 2011/12, a higher proportion of US equities were warranted by virtue of its safe haven status. Also, holding gold as a hedge against geopolitical risk may be appropriate.

And in terms of Asian bonds and currencies, "lower for longer" US interest rates is positive for non-bank bonds and most likely for Asia currencies once markets respond to stimulus measures. Investing in Asia in the second half of the year isn't so much about diversification among local markets, but diversification in global terms into a region of the world where political risk has been falling over the last few years.

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