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Long DM, Short EM?

Stodgy old developed stock markets in the U.S., Europe and Japan have had a strong run the past few months, while flashy emerging markets have not exactly rung in the new year so happily. The question is: will the divergence continue?

According to media and newswires reports, Asian markets are being abandoned in recent weeks in favor of the US and European markets because of the following reasons: 1) developed markets do not having the same interest rates risks as Asia; 2) the recovery in developed markets, especially in the US, is expected to become more entrenched this year; 3) since equity markets bottomed in Mar09, Asian markets have rallied much more compared to developed markets and thus, the latter deserves more attention.

Let's hear some professional comments:

On the pro-developed market side, take Paul Marson, chief investment officer of Swiss private bank Lombard Odier. According to a recent note, he's telling clients to "rotate away from emerging market bonds and equities in favor of developed market assets." His basic thesis is that emerging markets will be busy tightening monetary policy to fight inflation, while developed markets can keep monetary conditions loose for awhile.

But could it be too late?

Citigroup analysts Geoffrey Dennis and Jason Press say in a research note that emerging market underperformance "should end soon." Emerging market inflation fears will "flatten off" in coming months as rate hikes take hold, they note. On valuations, average emerging market stocks are trading at a 10% discount to developed market stocks on a forward price-to-earnings ratio. And Citi calls it "unusual" in a general up market for emerging markets to underperform developed markets. They are sticking to their guns, calling for 30% gains in emerging-market stocks this year.

We agree with Citi & expect that inflationary pressure will ease in the second half year. According to the update from World Meteorological Organization (WMO) on 25 January, the strength of current La Nina's event is likely to decrease during the course of the following four months. Besides, the Australian Bureau of Meteorology stated that the event's peak has gone. Table 1 shows some forecast from 7 reputable meteorological models.

The Australia's flooding is partly as a result of the La Niña weather pattern. La Niña is a coupled ocean-atmosphere phenomenon that is the counterpart of El Niño as part of the broader El Niño-Southern Oscillation climate pattern. During a period of La Niña, the sea surface temperature across the equatorial Eastern Central Pacific Ocean will be lower than normal by 3–5 °C. The name La Niña originates from Spanish, meaning "the girl", analogous to El Niño meaning "the boy".

We expect food price go up, but the parabolic rise like last year is less likely to repeat. Inflation will maintain at high levels but the growth rate seems moderating.

Asian economies had led the global recovery since March 2009. This structural change of stronger Asian growth compared to the developed economies is expected to continue in the mid-long term. We believe that the current 'sell emerging, buy developed' markets play should not extend for long. This is because in economic recovery terms, developed markets are merely trying to play 'catch-up' with Asia. If their recovery hopes come true, than it will only be a matter of time before the same interest rates woes that is affecting Asia now, hits them. It may just be a matter of time before a balance is struck and the rate of outflow from Asia stabilizes.

MODEL/GROUP	Forecast Start Date	1 – 3 Months (Feb 11 to Apr 11)	4 – 6 Months (May 11 to Jul 11)
<u>POAMA</u> Australian Bureau of Meteorology	31 January	Neutral	Neutral
<u>System 3</u> ECMWF (EU)	1 January	Cool/Neutral	Neutral
<u>GloSea</u> UK Met Office	1 January	Cool/Neutral	Neutral*
<u>CFS</u> NCEP (US)	30 January	Cool	Cool/Neutral
<u>CGCMv1</u> NASA Goddard GMAO (US)	1 January	Neutral	Warm
<u>JMA-CGCM02</u> Japan Met. Agency	1 January	Neutral	Neutral/Warm
<u>KMA-SNU</u> Korean Met. Administration	1 December	Cool	Neutral

*Model forecast is run only until the end of June

Sources: *Australian Bureau of Meteorology*

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