The New Year started on a choppy note for global capital markets as a couple of “Black Swan” events buffeted risky assets globally. The rapid technical break-down of Crude Oil and Copper followed by the Swiss National Bank’s (SNB) surprise removal of a 3-year CHF-EUR cap sent shockwaves through markets world-wide. While there is no way to identify the size of damage caused by SNB’s unexpected policy shift, we suspect the pain will manifest over time.

Despite these “Black Swans”, markets found their footing relatively quickly after the European Central Bank (ECB) did not disappoint with its much-anticipated quantitative easing program. As a result, the MSCI World Equity Index managed to pare its earlier losses of more than 3% to end the month down -0.65%. For the same period, the Bloomberg USD Investment Grade Composite Bond Index rose +1.92% on the back of a rally in the US Government Bond which saw the 10-year Treasury yield declining 42bps. The Continuous Commodity Index however tumbled -5.13%.

Looking forward we expect rising volatility to feature prominently in the year ahead, though we must confessed that we were a little surprised by the sharp rise in the volatility of various asset classes in this early part of the year (please see chart below).


The return of volatility is largely the result of a policy-divergent world that we are currently confronting with. Shifts in monetary policy has historically generated rising volatility. As highlighted in our final investment letter of 2014 (published in early December 2014), "***The obvious risk in such a policy-divergent world would be a sharp appreciation of the USD in the midst of a lacklustre-growth world. A strong USD would put further pressure on commodities and exacerbate the current dis-inflationary situation***". Since then, the US Dollar Index (DXY) has rallied a further +7.30% and broke the technically important level of 90. Though DXY looks over-bought in the near term, there is sufficient momentum to push it higher (please see chart below).

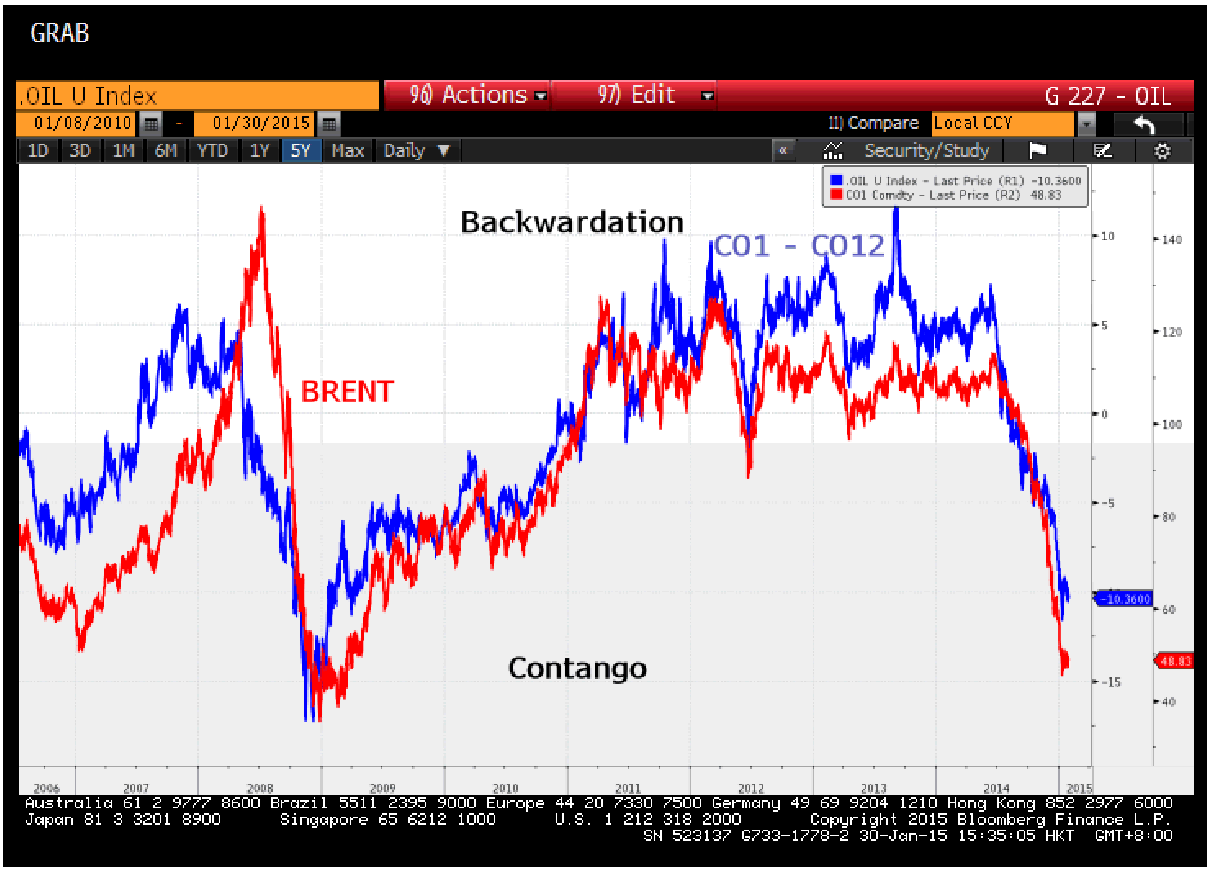

Having said that, it is interesting to note that Gold has performed well in January with a gain of +6.21% (please see chart below). This is despite an environment of strong dollar, weak commodity market and rising disinflationary pressure. There are several possible reasons behind the precious metal's rally. First, investors are increasingly losing faith in central banks, especially after ECB signalled its intention to join in the QE party. Also several central banks have pushed interest rates into negative territory, making the opportunity cost of holding gold more palatable. Finally, it is also possible that investors are seeking shelter in safe havens.


And this flight to safety is also evidenced in the G3 sovereign bond markets where long bond yields of Germany, Japan and US declined sharply in January (please see chart below). What is disconcerting is that the consistently falling yields seems to signal a lack of confidence in the growth outlook of the global economy.

Having said all these, in a year where we expect rising volatility, strengthening USD, increasing disinflationary threat (especially against the backdrop of a highly leveraged world) and scarce global growth, it is essential to maintain a diversified portfolio. In the fixed-income space, we favour high-grades over junks. This is especially so since the credit spread between quality and not-so-quality bonds seems to have bottomed (please see chart below).


As for equity, we prefer companies that offer growth at reasonable valuations especially against the backdrop of stagnant global growth. In the developed markets, European equity should benefit from ECB's QE program. As for emerging market space, we favour markets where central banks are on an interest rate reduction path and where governments are implementing reforms. Countries in this camp include China, India and possibly Korea as well as Indonesia.

Finally in the commodity space, we reckon that crude oil is trying to find a bottom after the almost 60% decline over the past 6 months. While the near-term supply-demand condition remain unfavourable, we suspect most of the bad news has been discounted. In addition at current level, oil is oversold. Meanwhile the oil contango has deepened to levels last seen in early 2009 (please see chart below).




*Source: Bloomberg, CLSA, UBS*

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