

SMART MONEY

GLOBAL INVESTOR CHRIS WRIGHT

Time to search out the next best bet

After six years in which Australian shares have outperformed global equities, long-term trends (and a bit of common sense) dictate that the pendulum is due to shift – if not immediately, then soon.

But where to go? The world's a big place and the outlook varies dramatically from region to region.

Any discussion of global outlooks has to start with the United States: for a start, most global equities funds in Australia allocate about half their funds to the US stockmarket, and secondly, the US economy has a direct influence on almost every other economy on earth, Australia's included.

The picture doesn't look great. State Street Global Advisors expects gross domestic product (GDP) growth of only 2.2 per cent in 2007; chief economist Christopher Probyn calls it "a good year to wager against the economy".

But, like many of his peers, he expects what he calls a soft landing – a euphemism economists use for a slowing of growth that doesn't trigger a recession, high inflation or high interest rates.

"After all, business investment remains robust, the drag from international trade is waning, and the spillover from housing to consumer spending should be limited by tight labour markets, solid income growth and healthy household balance sheets," he says.

The oil price is an issue here; the recent softening in this market increases the chance of a soft rather than a hard landing.

All this suggests a US sharemarket that doesn't shoot the lights out but doesn't fall through a trapdoor either.

"Stocks still have a way to run," Probyn says. "Of course, they will run further faster if the Fed delivers some rate cuts."

Hans Kunnen, head of investments markets research at Colonial First State, has a similar line of reasoning but a more optimistic view.

"If official US interest rates fall and their economy continues to grow, the US market could well get excited," he says. "The rest of the world would most likely follow and, as long as earnings grow or are maintained, that would not be a bad thing."

Kunnen notes the huge influence mergers and acquisitions worldwide are likely to have on sharemarkets. "The takeover frenzy seen in Australia is not unique," he says. "Takeover activity is rampant around the globe."

Nothing pushes up share prices quite like a round of takeover tilts, and if the behaviour of 2006 continues in 2007, then markets should climb strongly regardless of the broader economic rationale.

As in Australia, this trend is being driven by the extraordinary muscle of private equity firms around the world. Qantas is a big deal, but private equity investments three times the size are happening in the US with reasonable frequency now, and audacious jumbo bids are commonplace in Europe and Japan too.

Western Europe

Europe was for years a profoundly disappointing place for Australian investors. Your correspondent, who

WORLD IS YOUR OYSTER

Best Japan funds

	1yr %	3yr % pa	5yr % pa	7yr % pa
Goldman Sachs JBWere Japan Fund	-0.48	9.47	0.94	-5.01
INVESCO Asian Share Fund	-3.56	15.77	5.26	-5.18
Platinum Japan Fund	-5.18	17.01	14.39	9.28

Best Asia funds

Fidelity China Fund	86.75	NAv	NAv	NAv
Challenger China Share Fund	67.76	NAv	NAv	NAv
Premium China Fund	47.97	NAv	NAv	NAv

Best world growth funds

K2 Select Inter Absolute Return	32.98	NAv	NAv	NAv
MFS Hedged Global Equity Trust	20.47	NAv	NAv	NAv
Zurich Hedged Inter Share Fund	19.22	NAv	NAv	NAv

had the bright idea of putting a slab of money into a Europe mutual fund at the time of the euro's inception, believing it to herald a new era of corporate growth, needed five years to get his money back. But lately, Europe (including the UK) has started to look a lot better.

"The European consumer is finally spending money, which is leading the economic union out of the doldrums," Citigroup Global Wealth Management chief investment officer Paul Guidone told his private banking clients in a recent note. "Meanwhile, European business confidence has reached heights not seen in half a decade." Nevertheless, Citigroup as an institution predicts that economic growth, which hit 2.7 per cent in 2006, peaked then and will fall back to 2 per cent in 2007. For the UK, it predicts a slip back from 2.5 to 2.2 per cent.

Be that as it may, it doesn't necessarily make Europe a place to avoid for investment. The 21 per cent rise in the MSCI Europe Index (in local currency) in 2006 was far better than a 2.7 per cent GDP growth rate would necessarily suggest. "Secular shifts in Europe and Japan are under way," notes Georgia Bush, an economics researcher in Guidone's team. "New entrants into those markets, including activist hedge funds and private equity managers, are pushing change in corporate management and the business environment. Government policy makers are recognising that

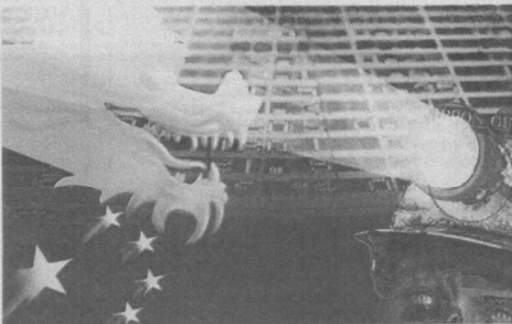
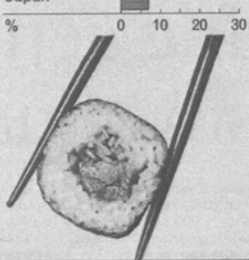


Photo-illustration Peter Riches

MSCI index performance (including dividends) as at Dec 29, 2006

Region	%
Emerging Asia	27
Australia	27
Euro	27
US	27
Japan	27



Source: Morningstar, MSCI

'Our view is that China's rapid growth is sustainable.'

domestic companies need to compete in the global marketplace. And managers are becoming more responsive to shareholder interests." She argues Europe will remain attractive in 2007.

Japan

Japan, though, behaved quite differently to Europe last year. While many were unenthusiastic about Europe's potential and were pleasantly surprised, in Japan the reverse was true: people finally accepted that Japan was back in business and so put money in, only to find that the market stayed relatively flat, rising about 8 per cent.

It's worth recapping the reasons people were enthusiastic about Japan originally, though. There's no longer much question that Japan has emerged from recession: every indicator you can bring to mind supports the view. Companies are more profitable, banks are better capitalised, the consumer is spending more and property prices are climbing. Last year may perhaps have been a necessary pause for breath after a terrific run in the Tokyo stockmarket the previous year, and by world standards Japan today looks relatively cheap. The 12-month forward P/E for the Japan MSCI index is 17, compared with a 15-year historical average of 34.

Merrill Lynch is among the believers. "Japanese stocks are poised to recover in 2007, in our view," says a report, citing consumer demand as a driver. "Corporate earnings are poised to benefit from improved terms of trade, rising productivity and the return of moderate pricing power." Merrill likes "domestic demand-oriented laggards" best, such as banks and retailers, as well as industrial electronics and car companies.

If there has been a question about Japan lately, it has been about succession. Most of the good news in terms of economic and market behaviour came under the tenure of the Koizumi government, replaced by Shinzo Abe in 2006.

However there has been little sign of a change in policy to go with the change of government.

Asia

The rest of Asia performed exceptionally well in 2006: the MSCI Asia ex-Japan Index rose 27 per cent in 2006, driven in particular by strong growth in China and India. The big question about Asia is how it will perform if the US weakens. In previous years, the two were closely linked: US recession equalled misery in Asian markets. But as intra-Asian trade has grown, the reliance on American economic largesse has eased. How much, we might find out this year.

Credit Suisse took on this idea when it addressed its private banking clients in December. "We believe that this theme [decoupling of Asian growth from the US risk of slowdown] will play out in the next 12 months when increasing evidence shows that the growth outlook of Asia is becoming more dependent upon demand from the emerging world in a less US-centric global economy," the Swiss bank said. Asian exports were resilient in 2006 despite signs of a US slowdown.

So where to go? Credit Suisse's multimillionaire private client customers have been advised to overweight China, Japan, Taiwan, Korea and Singapore; be particularly bullish on Asian financial stocks and the tech sector; be neutral on Hong Kong, Malaysia and Thailand; and be underweight on Indonesia and – guess where? Australia. A few specific investment ideas, for those of a daring bent, include Nidec Corp in Japan, Daewoo Shipbuilding and Marine in Korea and China Netcom (listed in Hong Kong).

Merrill Lynch is equally excited about Asia, expecting China and India to lead the way "although at a slightly less torrid pace" than last year. Its key investment themes for the region in 2007 include being overweight on Japanese equities; overweight banks in Asia, especially in Korea, Pakistan and Singapore; and underweight Indian equities, despite the bank's expectation of economic growth from India. "We remain positive on India's economy, but are worried about the outlook for the market," Merrill says. "Earnings growth should slow, as interest rates rise, commodity prices fall, and high capacity utilisation limits volume expensive." More to the point, India is expensive: it's trading at 18 times forward earnings, very high for an emerging market.

But when most investors look at Asia, what they're really thinking about is China. That's what happens when a country grows by more than 9 per cent a year for a quarter of a century. Last year was one of the few in recent memory when that economic performance was mirrored by the stockmarket, which was one of the best performers in the world (it lagged Russia, but then putting your cash into Russia makes Chinese equities look like US Treasury bonds). The decision to make on China is: is this sustainable? And am I going to be buying in just as the bubble bursts?

"Our view," says Shane Oliver, head of investment strategy and chief economist at AMP Capital Investors, "is that China's rapid growth is sustainable and that it has a long way to go. This will create enormous opportunities for investors."