LEAD STORY

Be careful of high valuations

BY LIEW JIA TENG

Last month marked the 10th anniversary of Bear Stearns' near-collapse, one of the first dominoes that fell before Lehman Brothers went bankrupt in the subprime mortgage crisis of 2007/08.

Economist Nouriel Roubini, the man who called the 2008 global financial crisis (GFC), had remarked that it was not a black swan event. Instead, there were tens of different signals that would eventually lead to a tipping point. (He defines a black swan event as an unforeseen incident.)

Interestingly, Wall Street took a beating recently, as US President Donald Trump announced plans to impose new tariffs on about US$60 billion of Chinese goods. China countered by threatening to impose its own tariffs on about US$3 billion worth of imports of US goods, including pork, fruit and wine.

The Dow Jones Industrial Average plunged more than 1,100 points on March 22 and 23 — a drop of 10% from the index's all-time high in January.

Note that before the US-China trade tensions erupted, concerns over rising interest rates and inflation from an overheated economy had already sent global stocks plummeting, with the Dow falling an ominous 666 points on Feb 2.

Now, is the steep decline in the Dow in recent months a wake-up call for investors? Are we seeing "signals" — as Roubini put it — that will eventually lead to the next crisis?

After all, financial crises seem to occur about once every decade. Recall 1987's Black Monday, the 1997/98 Asian financial crisis and the 2007/08 subprime crisis.

While they do not believe in the 10-year cycle, investment experts *The Edge* spoke to warn that investors should be careful at a time when stock markets are trading at high valuations.

Dr Tan Chong Koay, founder, chief strategist and executive chairman of Pheim Asset Management Sdn Bhd, says the pace of increase in their interest rates and market valuation as measured by their price-earnings ratios (PERs), need to be closely monitored. In addition, the extent of the trade war and the pace of global economic growth are also on his radar screen.

"Today, we can't deny that some of the big caps in Asean are definitely not cheap. Three to four years ago, some tech stocks were very reasonably priced, but most of them have now gone up. So we have a situation that we can safely say is not that cheap. If the US were to start a trade war, the global economy will experience a slowdown, so we have to be even more careful," he says.

Chong Koay, who oversees assets under management (AUM) of about US$300 million, highlights another big concern — the subscription and redemption of exchange-traded funds (ETFs) of index funds as large redemptions may cause a plunge in the market (see Chart 1).

"Global portfolio money flowing into ETFs and index tracker funds have grown exponentially in recent years and if investors are not careful, these could very well be the next financial weapon of mass destruction. ETFs and index tracker funds are so cheap to transact that, in times of great uncertainty, these instruments will be the first to experience capital flight. Once that happens, the domino effect will take over in the global financial markets," he warns.

Commenting on 10-year cycles, Chong Koay points out that the main causes are different in each market crash. For instance, Black Monday was mainly caused by increases in the interest rate within a short period of time in the US even though the economy was still performing well. The Asian financial crisis (AFC) occurred as a result of currency traders attacking the Thai baht's peg to the US dollar, which proved successful and caused the currency to be floated and devalued, he explains. As for the GFC, the global market was at record highs, but the economy was deteriorating, so it came down sharply eventually.

"All the crises are different. But today, we have a worryingly similar situation as 1987, where the economy looks good but the share prices have gone up so much," says Chong Koay.

"What could happen next is that central banks, being afraid of inflation, may raise interest rates higher and faster than anticipated. As a result, the whole market may plunge and all the assets and property prices would decline," he explains.

The 68-year-old, who has been in fund management for 42 years, adds that the growth and high valuations in the US are not sustainable. Hence, investors should consider trimming their stakes in the overvalued stocks.

"When there are more sellers than buyers, the market will go down. In fact, the market is already behaving as such in the last few weeks. The good thing is that the market did not crash, it went down but it rebounded a bit, so you still have a chance to get out, unless you don't want to."

Waiting for a volcano to erupt

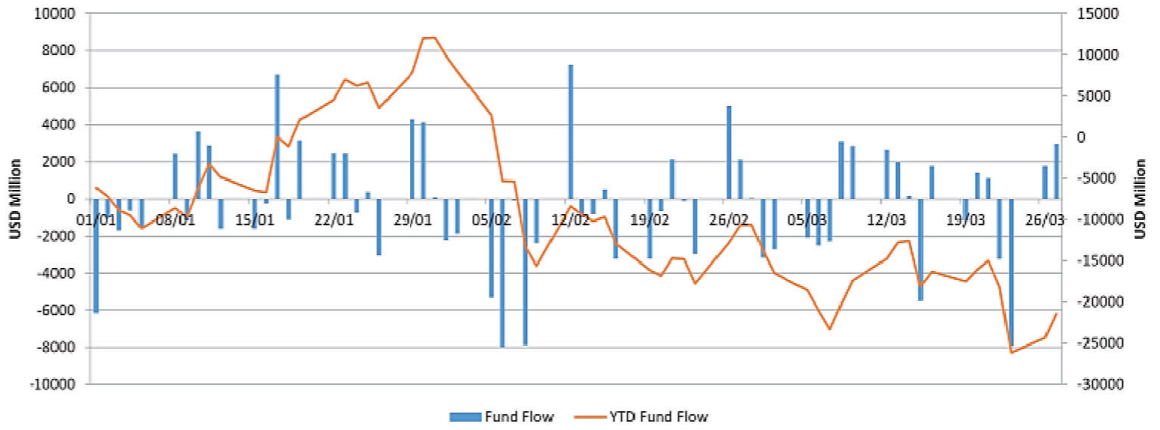
Datuk Seri Cheah Cheng Hye, founding chairman and co-chief investment officer of Hong Kong-listed Value Partners Group Ltd, says investors should be more cautious and diversified as global markets are trading at high valuations.

"I think investors should increase their defensive strategies. They may want to look at stocks that are cheaper or less exciting, but are capable of paying higher dividends. Perhaps it is also not a bad idea to buy some gold," he tells *The Edge*.

Cheah, 64, is a contrarian value investor who made Value Partners one of Asia's largest independent asset management firms with AUM of US$16.6 billion.

Cheah acknowledges that at some point,

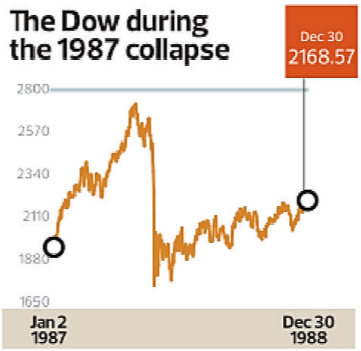
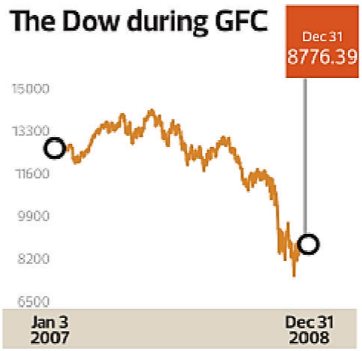
Chart 1: SPDR S&P 500 ETF Trust (US)



Cheah: I also look at the rear-view mirror, but my eyes are always on the front as much as possible

SAM FONG/THE EDGE

Chong Koay: If the US were to start a trade war, the global economy will experience a slowdown, so we have to be even more careful

SUHAIMI YUSUF/THE EDGE

Kim Khuat thinks the next financial crisis will be caused by the widening gap between the rich and the poor