Market review and Outlook FOR 1H 2018

By Danny Wong

REVIEW OF 2017

A synchronized growth in the major advanced economies ie U.S, Europe and China, spurred a recovery in global trade. This provided the tailwinds for corporate earnings growth and higher commodity prices.

In turn, this global economic upswing has benefited emerging countries like Malaysia. GDP growth has been strong so far this year. Malaysia achieved a 6.2% y-o-y growth in the 3rd quarter of 2017. Headline numbers indicate we are on more solid footing, with a recovery in oil prices, robust exports, improving foreign reserves and widening current account surplus.

In terms of the equities market, the global economic upswing has led to a revival in risk appetite. Equity markets rallied. In local currency terms, MSCI World advanced 21.6% while the MSCI Asia ex Japan soared 38.7%. Malaysia gained 9.4% while enjoying net foreign inflows worth of approximately RM10.6bil, the highest among the ASEAN countries. 2017 is the first year of positive inflow since 2013. The previous 3 years had seen a combined net outflow of RM26.1bil. Despite the first positive close in the last 4 years, our gains have paled in comparison with the rest of the world.

However, the Ringgit has been a bright spot. The local currency strengthened 10.9% against the US Dollar in 2017. At the time of writing, the USD/RM hovers around the 3.94 levels.

What to expect for 2018?

Can Malaysia, the laggard in Asia catch up in 2018? On the other hand, having seen such substantial gains in global and regional markets, are markets ripe for a pull back? We remain positive on the equities market on a mid-term outlook. Here's our take:

The overall macro outlook is still robust while leading indicators are still positive. Global trade growth and global manufacturing PMI are at their strongest levels in the past 6 years – and continue to trend higher. These indicate a better outlook ahead.

The gains seen thus far have been driven by selective sectors ie manufacturing, glove makers, technology etc. Corporate earnings growth have been reasonable but given the improving headline data and fundamentals in Malaysia, growth should eventually trickle down to become more broad-based. This will provide a boost to the business confidence and consumer sentiment.

The third, is the China factor. We view developments out of China as encouraging. The world's 2nd largest economy has moved away from their fixation with specific growth targets, unlike practices in the past. President Xi Jinping highlighted the focus on sustainable quality growth, the importance of developing an open economy as well as expressing support for deepening reforms. The One Belt, One Road initiative will further extend its influence in the Asian region. Malaysia is seen as one of the main beneficiaries of foreign direct investment (FDI) from the Chinese.

Beside that, according to an article published by The Edge, a UBS survey of Chinese companies showed that about 15% to 25% of large Chinese corporates are planning to invest in ASEAN – 90% of them have highlighted Malaysia as their preferred destination. (On another note, the same survey also showed that US companies find Penang attractive for their technology investments).

Last but not least, we have the election and oil prices. Malaysians have been waiting in bated breadth for the announcement of the 14th General Election, which must be held before August this year. Assuming there is continuity in policies, this will bode well for the market – removing a big uncertainty. Of late, Brent crude prices have managed to sustain above $60 per barrel. Over the past 6 months, prices have been steadily creeping up from the circa $45 per barrel to top the $70 level at the time of writing. The rebound in oil prices will undoubtedly provide a boost to our nation's finances.

Nevertheless, we do take note of the risks to our view. The issues of geopolitics and Trump's policies have been well-publicised, but what are the other risk factors investors should look out for?

The overvaluation in US markets has been a topic for some time. To look deeper into the US's rally, their gains have been mainly powered by the rise in FAANG stocks (Facebook, Amazon, Alibaba, Netflix and Google) For 2017 alone, Facebook, Amazon and Netflix rose by 53%, 56% and 55% respectively while Apple and Alphabet's Google rose 46% and 33% each. To put things into perspective, the FAANG, excluding Netflix, in terms of market capitalization are all in the top 10 of the S&P 500 index. Hence, the rise and fall of any of these giants can greatly influence the direction of the US markets. Over the past 5 years, the rally of the FAANG has been nothing short of spectacular. If there is a profit taking and in a huge way, sentiment can potentially take a hit.

After many years of easy monetary policy and fiscal stimulus, some major central banks are preparing for the inevitable – rate normalization. In 2018, the US Federal Reserve is expected to hike rates another 3 times, potentially bringing the Federal Funds Rate to a range between 2% - 2.25% by the year-end. They will also continue unwinding their $4.5trillion balance sheet. Across the Atlantic Ocean, the Bank of England has also hiked rates for the first time in a decade. Meanwhile, European Central Bank will commence a reduction in monthly bond purchases from€60bil to €30bil a month between January and September. Any overly hawkish or aggressive move will spook market participants.

We talked about the positive effects China earlier. But there are two sides to a coin. China is today Malaysia's leading trade partner, so the relevant question to ask is – If China sneezes, can Asia, or Malaysia for this matter, catch a cold?

We also think that inflationary risk should not be understated. Real interest rate (Interest rate – CPI) has been in the negative for the past one year. Inflation reduces our purchasing power, which gradually increases the cost of living. To put things in perspective, for every RM100,000 left un-invested with inflation running at 4%, the money will lose a value of RM4,000 every year. And the effects become even more pronounced over time. A lack of understanding of the need for returns net of inflation can lead to a faster-than-expected rate of capital attrition. For the average investor, it is imperative to achieve positive returns above inflation rate.

cont'd on page 1

Fixed Income

Market review & outlook

By Edward Iskandar Toh

UPSWING BEGINS

Fueled by low interest rates and ample liquidity, global economic recovery led by the US gathered pace in the second half of 2017. The International Monetary Fund (IMF) raised global growth outlook for 2017 to 3.6% from 3.5%. In the US, annualised 4Q2017 GDP grew at 2.5% y-o-y, marking 7 consecutive quarters of steady rise. In Europe, GDP grew steadily at 2.7% for 4Q. Meanwhile Japan, with the 8th consecutive quarterly growth in 4Q2017, enjoyed the longest streak of positive growth since 1989. In China, despite defending the Yuan and imposing capital controls, the 3rd largest economy (after the US and EU) grew 6.9%, beating projection of 6.5%. Much of these are due to years of quantitative easing programs in the US, EU and Japan which peaked at about US4.5 trillion from the US alone. Normalisation and scaling back of this artificially bloated balance sheet is now underway in the US.

Good economic news do not end there. US Unemployment rate is now at a 17 year low at 4.1% as at end December. Coupled with Trump's (only) major legislative victory in his inaugural year; the tax reform; the stock market reveled and pushed through umpteen new highs with year-end closing at yet another all-time high of 24,837. It is no surprise then the Federal Reserve raised Federal Fund Rates thrice in 2017 as expected to 1.5%.

However, this US presidency will not be normal without controversy. There were constant distractions in the form geopolitical risks emanating from tensions with Syria, Iran and North Korea, devastating natural disasters, internal government upheavals with regular bickerings and the ongoing investigation into Russian collusion in the US elections.

There was also the symbolic shift of global power from the West to the East. Withdrawing from the Paris Climate Accord and TPPA, the US has surrendered both climate and trade leadership roles to China; who are glad to further expand her global influence through their Belt and Road Initiative (Silk Route remake). This was evident in the red carpet treatment seduction of the praise-hungry US President when he backtracked from the lambasting he gave months earlier branding China a currency manipulator and stealing American jobs, instead heaped warm words of admiration towards China in what seem like a yielding and acknowledgement of who has the upper hand.

In Malaysia, inflation has kept above 3% throughout this year with December reading at 3.5%, an obvious result of higher average petrol prices. 3Q GDP growth advanced 6.2%, highest since 2Q 2014. For the year 2017, growth is expected to hit the upper range of official estimate of 5.2-5.7%.

There were three Monetary Policy Committee meetings in the second half of the year where Overnight Policy Rates were left unchanged at 3.00%. However, glaring changes in the accompanying statement in the November MPC meeting were seen as a hint for a potential rate hike in the near future. Recognising improved external and domestic economic data, BNM "may consider reviewing the degree of monetary accommodation". Massive gains in the MYR against USD was also noted towards the end of 2017. MYR strengthened 5.8% from 4.29 to 4.04 against the USD in 2H2017 on rate hike outlook, general weakening of the USD and strong growth expectation. This was aided by net inflow of offshore funds into our sovereign debt markets of RM12.6 bil in 2nd half versus a net outflow of RM21.9 bil in 1H2017. However, the Malaysian scene has largely been dominated by speculation of the 14th General Elections.

Inflation Watch

Looking ahead, there are a few indicators we have watch out for but none more important than inflation. The rise in prices of goods and services diminishes purchasing power of your currency. If its rate exceeds wage growth, it eats into disposable income and has a dampening effect towards consumption and growth as a whole. However, it is my opinion that the expectation of inflation may have a bigger impact as it curtails expense prematurely at an individual level or it instigates over eager aggressive rate hikes at a macro level which will suffocate the economy. Managing expectations of inflation as well as the appropriate level of antidote to be applied is crucial in the year ahead, both locally and the world at large.

The most direct and obvious tool is the counterbalance of inflation which is interest rates. Authorities have the ability to arrest the threat of rising inflation or stimulate it through raising or reducing rates at the critical junctures of economic cycles; or holding back while introducing other intervening forms. For instance, oil and other commodity prices affect cost directly. If crude oil price rise, so will refined oil which leads to higher petrol price. The Malaysian Government maintains the option of reintroducing subsidies if oil prices fluctuate too violently and avoid going the route of rates raising.

Another factor is the supply of government debts to be raised to finance budget deficits. Bank Negara Malaysia carefully spreads out quantity and tenures to smoothen and manage demand so as to avoid yield spikes.

	2015	2016	2017	2018
Budget Deficit	3.2%	3.1%	3.0%	2.8%
Net Required (RM'bil)	37.2	38.4	39.9	39.8
Maturities	55.3	47.3	67.2	62.8
Gross Issuance	92.5b	86.0b	107.1b	102.6b

From table above, supply is expected to be lower than last year while net issuance is stable. This allows for a gradual rate rise without upsetting demand.

Foreign inflows continue to play an important role in our domestic bond market. In 2017, there was a net outflow of RM9.2 bil of foreign investments in our sovereign debts. The lower net holdings of RM190.6 bil as well as a proportion of issued of 28.3% relieves some earlier nerves when it was at its highest in July 2014 with RM242.7 bil or 39.2% of total outstanding.

Rates outlook have turned somewhat hawkish as US/MYR interest rates differential has narrowed in recent months. It is imperative therefore that a measured and gradual rate rise occur. One 0.25% rate hike is imminent while a possible second is in the offing if growth momentum accelerates and excess demand forms. To shift benefit towards savers would be prudent when we have capacity to do so without stifling growth.

In the US, their dot plot suggests 3 rate hikes for the year. Anything more will appear aggressive or inflation is increasing faster than anticipated. Watch out for US Treasury yields spiking above 3% for the 10 year tenure as a hint.

Other flashpoints

The Middle East remains the hotbed of conflict. Trump's instruction to move the US embassy to Jerusalem from Tel Aviv gives legitimacy to Israel's claim and in essence may instigate an already tensed environment by throwing a spanner in the works of an ongoing peace negotiation. To complicate matters, the proxy war between the Saudis and Iran in Yemen, Iraq and Syria is not likely to end anytime soon.

It is also curious to wonder how the US deficit will be funded. The shortfall in government revenue as a result of the massive corporate tax cut will have to be plugged. There is a growing expectation of expense towards massive infrastructure rebuilding. The anticipated budget deficit blow out will likely be funded with increased US Treasuries. Logically, they will have to make purchasing them attractive. This can come in the form of weaker currency or higher interest rates. Other measures like increasing exports may not be an attainable option in the short term. A fundamental structural change in its economy is needed if they move in that direction.