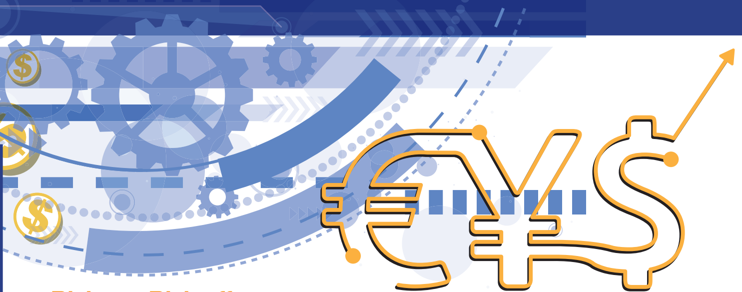
BY DANNY WONG



1H16 - USHERING IN ANOTHER PERIOD OF HEIGHTENED VOLATILITY

The year-end rally in equity markets unfortunately did not carry over to 1H16. Hints of improving risk appetite were thrown off the window as Chinese stocks were sold off heavily. The meltdown sent regional and global stocks into a tailspin. By April however, the outlook turned rosier as fund flows returned to Asia. Malaysia was one of the main beneficiaries, with investors classified as 'foreign' snapping up RM7.3billion worth of equities alone, in a ten-week buying spree. Improving conditions ie: recovery in oil prices, foreign fund inflow and Ringgit rebound meant that an anticipated rally could happen sooner than expected. Alas, it was not to be.

The old adage of 'selling in May' held true. The combination of disappointing global corporate earnings, Bank of Japan inaction and louder calls for another US interest rate increase ravaged risk assets. On top of that, we had to contend with a 1Malaysia Development Berhad (1MDB) default and a MSCI weightage cut towards the month-end. Year-to-date, KLCI lost 1.88% while the Ringgit, which saw a surge in April gave back most gains. Against the USD, after strengthening to a high of circa 3.84, the local currency have retraced to 4.05 amid the recent headwinds.

A scourge of recent times

Brent Crude oil was caught in a massive supply glut from 2014 and throughout 2015. However, the 'panic' phase is definitely over. Inventories are being drawn down while supply disruptions stemming from the Canadian wildfire and geopolitics in countries like Iraq, Nigeria and Kuwait capped production output. These factors have helped to lend weight to higher oil prices; Brent crude oil now trades around USD50 per barrel. Latest Organization of the Petroleum Exporting Countries (OPEC) reports pointed to oil demand exceeding its production for the first time in three years.

Brent Crude oil has rallied 31.58% this year but struggles to stage a clear sign of recovery. What gives?

We think that a major barrier to any sustained rally has been the strong greenback. A stronger US Dollar has historically weighed on commodity prices as they are priced more expensively. Brent Crude oil's next move depends on Federal Reserve Chairman, Janet Yellen's interest rate decision. However, in the event that crude oil embarks on another up-leg, we do not rule out the possibility of prices touching the USD80 level. The oil market is equally influenced by speculative activities as well supply and demand.

Missing-in-action

Consumers have bore the brunt of subsidy cuts, Good and Services Tax (GST) implementation, and the impact of the ringgit depreciation. The lower propensity to spend was observed through the Consumer Sentiment Index which plunged to its lowest since the Global Financial Crisis in 2008'. Fast forward fourteen months, we think that consumers have gradually become accustomed to the GST. Besides that, most purchases, which had been front-loaded ahead of the GST, are starting to finish, especially consumables like vitamins and household products. Combined with a low base effect, we could see a **rebound in consumer spending**.

We also think that corporate earnings will see a stronger 2H, underpinned by a rebound in consumer spending, cost-savings and low base effect. Following 2015's challenging business conditions, many companies have undergone cost-cutting measures in their capital and operational expenditures. One year on, they have come out leaner, meaner and stronger. A rebound in consumer spending should help top-line growth. The cost-saving effects will provide a further boost to their bottom-line. Having experienced an earnings recession over the last three years, we think that **corporate earnings may finally surprise on the upside**.

Risk-on, Risk off

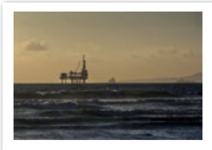
Continually monitoring global developments, we see two key risks for the market:

1) Frequency and magnitude of future US rate hikes - The Federal Reserve seems bent on raising rates at least once this year. The immediate question is when. We maintain our view that they should do it now rather than later. Investors hate uncertainty. The sooner the bearish overhang is removed, the faster regional markets can go on about their business. However, as things stand, it will likely be pushed forward until November/December

2) Brexit – At the time of writing, United Kingdom (UK) has voted out of the European Union (EU). The big fear is that if the stronger nations that have been propping up the singe-currency bloc taps out, where does this leave the peripheral EU countries? Nevertheless, the direct impact to Malaysia remains minimal and more likely to be felt over at Europe and UK. Although we saw some knee-jerk selling in risk assets immediately after the outcome, bargain hunting has elevated markets even higher compared to pre-Brexit levels.

That being said, Europe, Japan and China will continue their massive stimulus programmes as they look to prop up sagging growth. The excess liquidity is constantly in search of returns. As US stock valuations look increasingly expensive, this will drive them to look for other areas of growth. That usually comes from this part of the globe. Asia, as a whole has just endured its second round of selloff this year. As the dust settles, we see a buying opportunity for a six to twelve months window when the Asia ex-Japan Sentiment Index touches 0.5x Standard Deviation below mean. It now hovers 0.7x below mean.

So Malaysia, where do we go from here?



A potential oil rebound in 2H - Petronas projects that were previously put on the back burner could be revived. To recap, as much as RM50billion worth of jobs were deferred as the national oil company attempted to wait out weak oil prices. Oil & Gas (O&G) stocks were sold off heavily due to lack of contract visibility. This situation may reverse.

1Q Gross Domestic Product (GDP) expansion lies at the lower end of growth and we are anticipating lower 2Q GDP numbers. Going forward, the construction sector is expected to pick up the slack to support slowing domestic growth. Construction awards in 2016 are expected to reach a record high. The rollout of award packages under the Mass Rapid Transit 2 (MRT2), Light Rail Transit 3 (LRT3), RAPID and Pengerang will benefit the construction and basic materials sector, while being supportive of conditions in the labour market. The multiplier effect will also buoy the banks as companies embark on fund-raising activities. Moreover, in view of the slowing economic activities, Bank Negara Malaysia (BNM) is expected to relax policies even further. This entails more Statutory Reserve Requirement (SRR) or interest rate cuts.

For the nation, our recalibrated Budget 2016 was based on oil prices ranging between USD30-USD35 per barrel. Prices around that level then, strained government revenue. Malaysia was staring at a budget deficit that threatened to spiral out of control and a looming sovereign rating downgrade. Now, Brent crude oil trades around USD45 to USD50 and a further rebound in prices will help to brighten the outlook on the domestic economy. As the saying goes, a rising tide lifts all boats.

Political noise and 1MDB issues are definitely receding. Further strengthening of the Ringgit on the back of higher oil prices will help to shore up sentiment in local denominated assets. Although it will be a volatile ride throughout, we think that with oil prices at current levels, RM should trade close to 3.90 vs USD.

After the recent correction, valuation of the domestic market looks compelling. Malaysia's Price-to-book ratio dropped to 1.64x. To put things into perspective, during the last Global Financial Crisis it hovered around 1.47x. We have suffered two consecutive years of net foreign fund outflow amounting to RM26.5billion. Foreign holdings of domestic equity are relatively low now.

In light of all the positives mentioned, we retain our optimistic stance that 2016 will ultimately; turn out to be a better year compared to 2015.

2016 SO FAR...

Following the upbeat global outlook set forth after the first United State (US) rate hike in nine and a half years in December of 2015, markets took an unexpected volatile turn at the start of 2016.

The now-suspended circuit breaker installed to help limit volatility in China's stock market inadvertently became the catalyst for the opposite. Lower manufacturing and growth data provided further fuel. As the bell rang for the start of the year, a quick 5.0% drop tripped the first fifteen minute suspension. Upon reopening, a surge of selling broke the -7.0% level and caused a trading halt for the day within minutes. Three days later, following Bank of China's Yuan devaluation, their stock market swiftly hit -7.0% suspension marks again. The downward spiral continued till the end of the month culminating in a 22.0% decline at one point over 2015 close. The Dow Jones was not spared losing 11.0% at one point but recovered to -5.5% for the month. KLSE tracked the global stock markets slide losing 5.4% at its worst, hitting a four month low. Naturally, Brent crude oil price's corresponding fall from USD38 per barrel to USD28 in the same time frame in January was attributed some blame for these indices decline. Conversely, some may say; a result of recognition of global growth malaise.

Continued improvements in the US labour and housing data began to drag global sentiment upwards in Q2 although constant media focus on China's declining growth, growing debt to Gross Domestic Product (GDP) and worrying banking sector mitigated. At this juncture, this fund manager wishes to put things into perspective. China's GDP is the second largest in the world (if one excludes the European Union (EU)). With an annual growth rate of 6.7%, it cannot be deemed to be contributing to global slowdown. It is in fact propping up world growth especially if one compares with US's 2.1%. In fact, by mathematical constant growth rate projection, China would surpass the US by 2027 as the world's largest economy, which may explain the media harping and hounding.

Moving towards the end of Q2, attention turned to the EU. The 'Brexit' referendum carried out in the United Kingdom (UK) brought about a surprising result. So unexpected was the outcome that even the major betting houses got it wrong. Economically the UK forms barely 4.0% of global GDP. Trade with Malaysia is a mere 1.1%. Hence her exit's (though may be long drawn; over two years) impact may be minimal. However, it is now a question of resolve or even likelihood of geopolitical shift whether the other nations ponder their own membership in the EU in a possible contagion effect spill-over.

Amidst all these, global monetary policies have remained largely accommodative with several nations adopting Zero rates policy or even negative rates policy. Case in point is Japan, the EU, Denmark, Sweden and Switzerland. Japan went deeper into negative while the European Central Bank (ECB) dropped to zero with Quantitative Easing (QE) policies retained and expanded. Australia, India, Taiwan and South Korea also cut rates this half. Among our neighbours; Philippines and Indonesia followed suit while Singapore abandoned 'gradual appreciation' from their foreign exchange policy. With all the huffing and puffing, chest-thumping hawkish rhetoric from the US, the Federal Reserve found little justification for any rate hikes this year so far.

Domestically, Statutory Reserve Ratio was cut in January to ease liquidity tightness as Bank Negara Malaysia (BNM) saw some risks to growth developing. Interestingly, foreigners who rushed out our shores last year began trickling back. Foreign holdings of our sovereign debt stood at RM220.1 billion (34.2% of total issued) at the end of June 2016 compared to RM185.3 billion last September (at the peak of the 1Malaysia Development Berhad (1MDB) scrutiny). Although it is 10.0% away from the all time high of RM242.7 billion in July 2014, the trend is encouraging. This half also saw the changing of guard in Bank Negara Governor. Datuk Muhammad Ibrahim, a career central banker, took over the helm from the retiring Tan Sri Dr Zeti Akhtar Aziz, thus ensuring continuity of stable supportive policies.

...AND THE NEXT HALF...

Tiptoeing into the second half of this year, mixed feelings engulf us. Fresh off 'Brexit', the UK will have to renegotiate trade deals and arrangements with the EU and the world at large. Bilateral trade's agreements may come back in vogue and even benefit the Brits in contrast to en bloc trade agreements. In my opinion, the UK as a financial centre may still prevail while fears of imminent property price crashes in London may just be over exaggerated.

The US elections may throw up some surprises as well or at least its build up may make for an interesting and scary script.

As for interest rates outlook, with the US the only major power to be relatively upbeat on its economy, it is unlikely that an aggressive rate hike will ensue in an increasing connected and co- dependent world of business. If any, there may just be one rate hike towards the latter half of the year. As for ECB and Japan, their QE policies have ensured low to negative rates to prevail into next year. China however has ample room to reduce rates but more importantly would be their need to shift her economy to a more consumption based one and to address weakness in their banking system.

As for Malaysia, interest rates differential over the US and Singapore yields provide for some rate cuts opportunities. If need be, we may have up to 50 bps to cut this year for our Overnight Policy Rates while our Statutory Reserve Rate have the potential of one more cut following the surprise move in January.

Meantime, Brent crude oil prices seem to have found a sweet spot with price ranging between USD40-50 per barrel. Arguments of oversupply due to peak reserves in the US, slowing global growth and onslaught of supply from Iran have since dissipated. Noteworthy is that Malaysia's revised budget in January was based on oil price at that time which is circa USD35 per barrel. Hence, it augurs well for Malaysia's fiscal position with price trading 30% higher.

I have been tracking the relationship between oil prices and RON95 price at the pump since its 'liberation' from subsidies in December 2014. Sadly, I have found little consistencies in its basis of calculation and its applications. Comparing against cost after forex revaluations, the multiplier factor has ranged between 1.34 and 2.00 while if we go by margins, it has ranged between 52sens and 88sens. Not that we as consumers complain when prices are lower but the integrity and independence of a systematic formula is in question with suspicion of subsidy intervention as and when the authorities choose.

So the new norm of prolonged low (interest rates and growth rates) has now taken form and grip I believe. As long as the US's past three QE programs that pumped in excess of USD4.5 trillion into the system, Japan's ¥80 trillion annual bond buying program and EU's €80 billion monthly bond purchase activities continue to swirl in financial systems and artificially prop up asset values, there is reason to look over one's shoulder for the next crisis. In short, this may benefit local corporate bonds investors.