ARECA CAPITAL

flash

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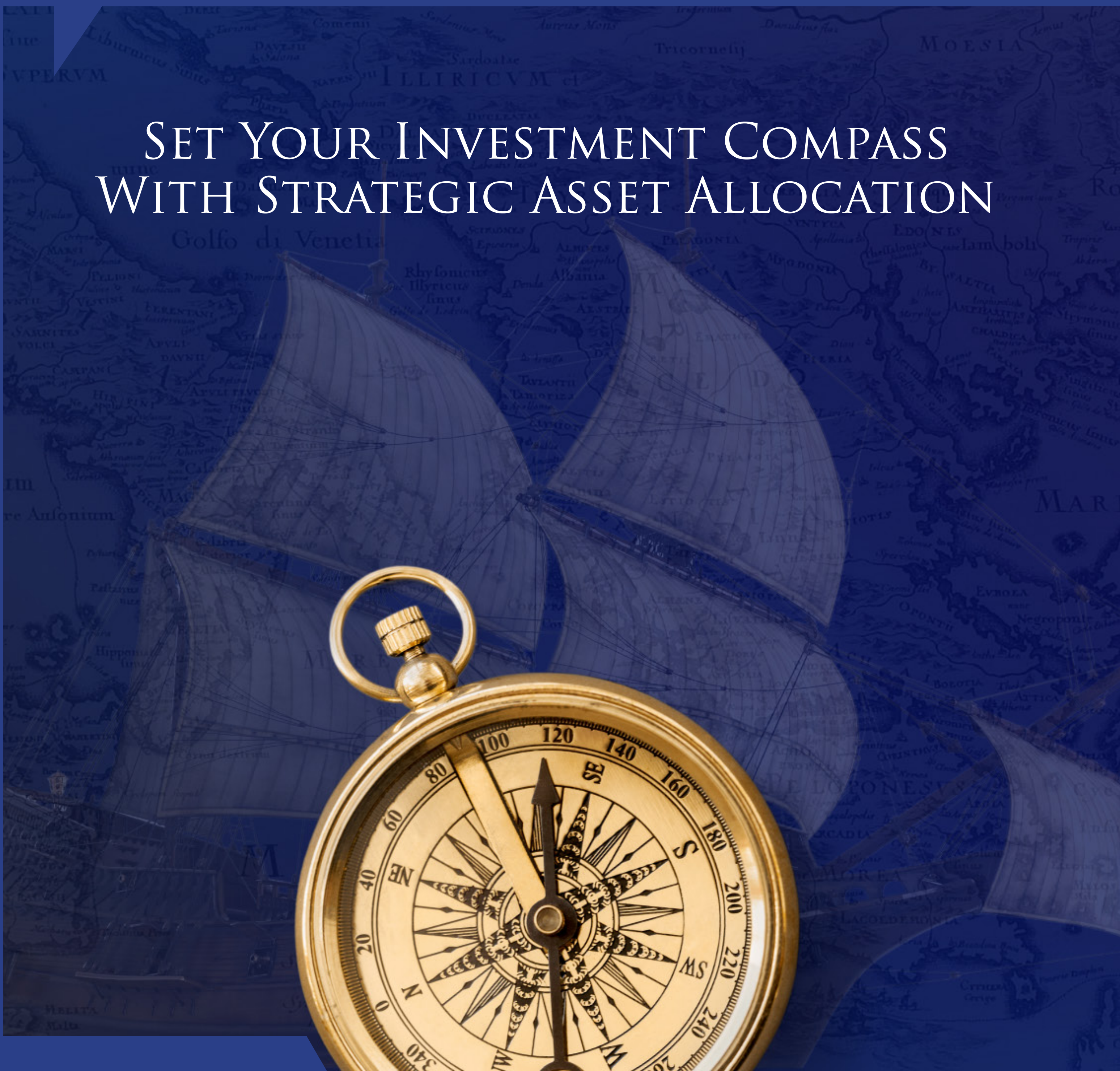
Set Your Investment Compass With Strategic Asset Allocation



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Dear Investors,

As we usher in the Year of the Rabbit, portfolio diversification will remain as highly relevant as ever. From an investor's perspective, your strategic asset allocation should be tuned towards your own needs and risk appetite.

We hope that our views will help you calibrate your investment compass for 2023. When times are tough, it is not just important to stay the course, but it may also present long-term opportunities along the way.

In this edition of Flash, Edward and I share our market insights on equities and fixed income for the first half of 2023, and Chaw Chern discusses the impact of inflation.

Stay invested. Happy reading!

Danny Wong
Chief Executive Officer
Areca Capital Sdn Bhd

Market Review And Outlook FOR 1H 2023

By Danny Wong

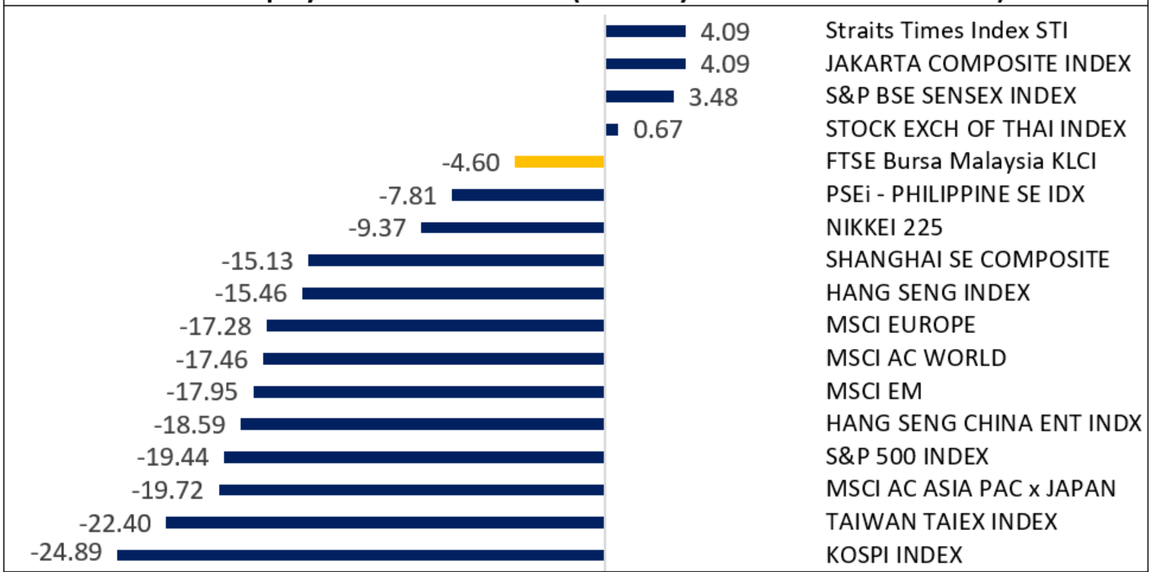
Review And Outlook

Global and Malaysia Review – 2022, A Volatile Year

What a year 2022 was. The global economy was plagued with many challenges. The COVID-19 pandemic's lingering impact on the global supply chain, supply disruptions and a surge in commodity prices exacerbated by the Russia/Ukraine war, and multidecade high inflation triggered a synchronised tightening of monetary policy across many advanced and emerging economies.

As such, 2022 has been especially volatile for equities. Only a handful of markets (Singapore, Indonesia, India, and Thailand) managed to generate a positive return, while most economies were in the red, including our very own FTSE Bursa Malaysia KLCI.

Chart 1: Equity Market Performance (1 January 2022 – 31 December 2022)



Source: Lipper (as of 31st December 2022)

The Malaysian economy expanded by 14.2% y.o.y in the 3rd quarter of 2022, an increase from 8.9% in the previous quarter. This was largely attributed to the lower base in the 3rd quarter of 2021. Nevertheless, the 2nd quarter also showed strong growth as the country eased its COVID-19 restrictions and reopened its international borders. The inflation rate, on the other hand, saw an increase from 2.3% in January to 4.7% in August before it started to decrease to 4% in November 2022. Even so, Malaysia's inflation rate, as of November 2022, was relatively lower than economies such as the Euro Zone (10.0%), United States of America (US) (7.1%), Philippines (8.0%), Thailand (5.6%), Indonesia (5.4%) and the Republic of Korea (5.0%).

Global Outlook – Is Growth Slowing? But on the bright side, are we nearing the end of the Fed's hike cycle?

The World Bank, in its January 2023 Global Economic Prospects report, projected that global growth will decelerate sharply to 1.7% in 2023. This will be the third weakest pace in nearly three decades, behind the 2009 and 2020 global recessions. As such, we expect volatility to persist, and we remain cautious about the downside risks that could cause a further slowdown in global growth. Nevertheless, China's reopening could provide support for global growth.

Meanwhile, in the US, its inflation rate fell to 6.5% y.o.y in December 2022, the smallest annual increase since May 2021. This indicates that inflation continues to moderate and we might see a less aggressive Fed in 2023. As much of the hikes

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(0.25% to 4.5%) have been implemented, we anticipate that the Fed's hike cycle is nearing its end with a slower pace of rate hikes, perhaps another 1 percentage point to go.

Malaysia Outlook and Our Strategy – Uncertainty Dissipates. Watch Out for Macro Factors.

Growth in Malaysia is projected at 4.0% in 2023, relatively higher compared to the projected growth of the global economy. Similar to our views in our previous Areca Flash (July - Dec 2022), we anticipate that much of the downside risks may have been priced in by the markets. The political uncertainty that plagued much of 2022 has been moderated with the conclusion of the 15th General Election and the formation of a Unity Government with a supermajority (two-thirds) in Parliament.

We believe that domestic companies in our scope remain fundamentally intact, and the macro outlook still dominates global downside risks. Our focus remains on the long-term outlook, not on market sentiment or short-termism. We will continue to employ our barbell strategy in our Malaysia portfolio.

Value (Reopening)	Growth
Domestic demand remains the key driver of growth in 2023. - Improvements in labour market conditions and income prospects. - Unemployment rate decreased to 3.6% in November 2022 from 4.3% in November 2021.	The technology sector has been heavily bashed down in 2022. - Bursa Malaysia Technology Index posted a disappointing return of -34.29%. Appetite for growth may resume once the Fed becomes less aggressive and hawkish. - But this won't necessarily affect the entire technology sector. - Important to remain selective on specific sub-segments within the sector.
Reopening of international borders. - Malaysia has seen a high rise in tourist arrivals since April 2022. - The reopening of China's borders in December 2022 may see an influx of Chinese tourists in 2023.	
BNM's stance remains accommodative and supportive of economic growth.	Similar to our views in the previous Areca Flash, we expect the secular trends in technology to remain intact and grow in the long term. - i.e. Demand for 5G-related services, AI, Internet of Things, and Electric Vehicles.

China's Outlook and Our Strategy – World's 2nd-Largest Economy Re-Opens

As a result of its COVID-19 restrictions, unprecedented droughts, and property sector stress, China's economic activity deteriorated considerably in 2022 (Table 2). This led to an estimated slow growth of 2.7% in 2022 by the World Bank, the weakest growth pace since the mid-1970s (excluding 2020).

However, China's growth is projected to improve to 4.3% in 2023, as its government has begun lifting COVID-19 restrictions in December 2022, thus allowing economic activity to gradually recover and release pent-up consumer spending.

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As such, we remain long-term positive about China (particularly in its banking and technology sectors), and as sentiment recovers, prices will start to reflect fundamentals. This can be especially seen in China's banks, whose 12-month forward dividend yield was at an attractive record high in October 2022 (Table 3).

<table>
<tr><th>Table 2: Industrial production, retail sales, export, and import growth in China</th><th>Table 3: 12m Fwd Dividend Yield</th></tr>
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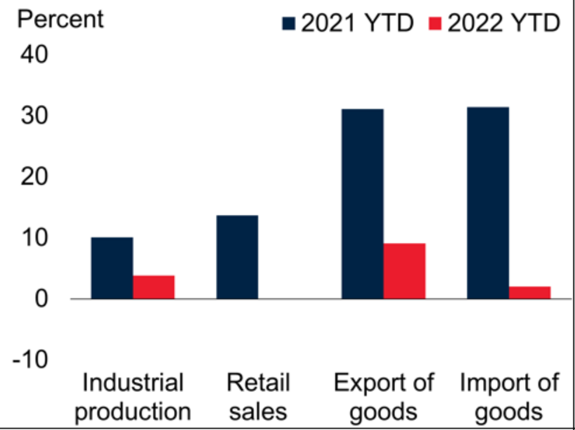

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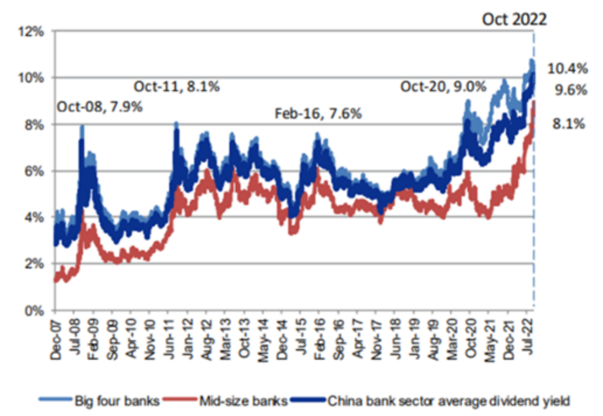

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<tr><td>Source: World Bank's Global Economic Prospects – January 2023</td><td>Source: CGS CIMB – 25th October 2022</td></tr>
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Ultimately, we tap into China's long-term plans and targets for achieving self-sufficiency. Plans such as the 14th 5-Year Plan, which emphasises innovation, dual circulation, and reforms to increase living standards, and the "Made in China 2025" policy, which emphasises further development in its manufacturing sector, are key drivers in the growth and development of its technology sector. Furthermore, we have seen that the regulatory overhang on its technology sector has largely been removed.

We have been taking a more active strategy in our China equities portfolios.

Conclusion – Opportunities in 2023

Looking into 2023, we might see a less aggressive Fed as the US inflation rate continues to moderate, which would be positive for sentiment on equities. We remain cautiously optimistic about Malaysian equities and agile for any changes. Our barbell strategy remains in place as domestic companies in our scope remain fundamentally intact and the macro outlook still dominates global downside risks. We remain long-term positive on China, as its economy has begun to recover from COVID-19 restrictions.

We are employing both top-down and bottom-up approaches in our asset allocation and stock picks, which enables us to not only identify promising sectors but attractive companies in unfavourable sectors too. Nonetheless, downside risks and uncertainties from 2022 may continue into 2023. Hence, we will retain our flexibility and agility while being cautious in our asset allocation, sectors, and stock selection. For investors, portfolio diversification is key.

Source: From various compilations. The article was written on 12th January 2023.

Fixed Income
Market Review & Outlook
By Edward Iskandar Toh

Are We There Yet?

Six months ago, I wrote about the hawkishness of the United States Federal Reserve (Fed) in raising interest rates and using quantitative tightening to combat multidecade high inflation.

Since then, the Fed has continued its crusade to kill inflation by aggressively hiking interest rates from 0.25% in March 2022 to 4.5% in its December 2022 meeting. In terms of the Effective Federal Fund Rate (EFFR), the Fed raised 425 basis points within 3 months (Table 1). The current rate hike cycle has been the most aggressive and fastest over the past 35 years, more than twice as fast as the Mar 1988 – May 1989 cycle and more severe than the Jun 2004 – Jun 2006 cycle.

Table 1: Current vs Previous Rate Hike Cycle

Period	Duration (Months)	Total Change in EFFR (Basis Points)	Change in EFFR per Month	Inflation Rate at Start of Cycle
Mar 1988 - May 1989	14	323	**23.07**	3.90%
Feb 1994 - Feb 1995	12	267	22.25	2.50%
Jun 1999 - May 2000	11	151	13.73	2.00%
Jun 2004 - Jun 2006	24	**396**	16.50	3.30%
Dec 2015 - Dec 2018	36	203	5.64	0.70%
Mar 2022 - Dec 2022	**9**	**425**	**47.22**	**8.50%**

Source: VisualCapitalist, Federal Reserve, U.S. Bureau of Labor Statistics

So, are we there yet? Will the Fed continue to raise interest rates, or are we nearing the end of the hike cycle?

Are Interest Rates Peaking?

The US inflation rate peaked at 9.1% in June 2022. The latest Consumer Price Index (CPI) Data shows that the inflation rate fell to 6.5% y.o.y in December 2022 from 7.1% in November. In line with market expectations, this marks the sixth consecutive month when the inflation rate slowed down but was still more than three times higher than the Fed's 2% target rate.

Several factors helped push inflation lower in the US. One factor is that global supply chain pressures, while still above pre-pandemic levels, have eased since mid-2022 and are returning to historical averages. This was largely attributed to lower transportation costs (Table 2), the normalisation of inventories (Table 3), and the cooling demand for goods.

As such, supply-side bottlenecks are expected to continue to ease in 2023 as economies worldwide continue to reopen their borders. This is especially encouraging as the world's 2nd-largest economy, China, ended its zero-COVID policy in December 2022 and began reopening its economy and borders. Additionally, the United Nations Black Sea Grain Initiative paved the path for a resumption of both Ukrainian grain exports via the Black Sea and Russian food and fertiliser to the global market, allowing for the stabilisation of food prices worldwide.

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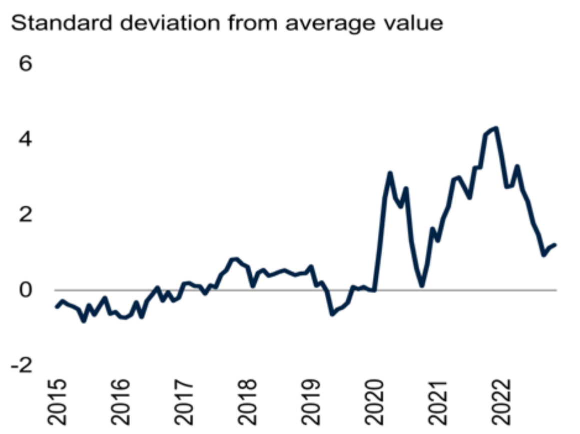
Another factor that helped push inflation lower is that the US Wages and Salaries growth rate has been decreasing from 11.4% in February 2022 to 5.28% in December 2022. This may indicate a slower rise in the cost of producing goods due to a rise in wages, pushing wage push inflation lower.

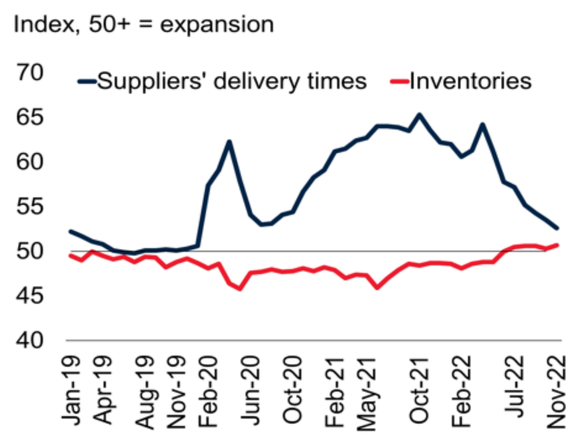
All in all, we might see a less aggressive Fed in 2023 as the inflation peak may be behind us and continues to slow. As inflation is still more than 3 times higher than the Fed's target, we can likely expect more rate hikes but at a slower pace, potentially until it reaches the peak expectation of 5% or near 5%.

Table 2: Global Supply Chain Pressure Index



Source: World Bank's Global Economic Prospects – January 2023
Last observation is November 2022.

Table 3: Manufacturing Purchasing Managers' Index (PMI) Subcomponents



Source: World Bank's Global Economic Prospects – January 2023
Last observation is November 2022.

Malaysia – Some Rates Upside But Limited

On our home front, in its assessment, Bank Negara Malaysia (BNM) expects that Malaysia's headline inflation has likely peaked in 3Q 2022 and will moderate thereafter. In its November 2022 meeting, BNM decided to increase the Overnight Policy Rate (OPR) to 2.75% to keep inflation in check but not curtail economic recovery. Despite pressure from interest differential and imported inflation, BNM monetary policy remains accommodative and supportive of economic growth with a measured approach in gradual rate hikes.

As inflation will likely remain elevated despite moderating, BNM may have a couple more hikes to go, depending on the government's subsidy policies, which we can catch a glimpse of in the tabling of Budget 2023 in February 2023. However, with the global slowdown ahead, the runway for rate hikes may be short.

Source: From various compilations. The article was written on 12th January 2023.

Inflation – The Silent Killer?

By Wong Chaw Chern

A bowl of prawn mee may have used to cost less than RM1 in the 70s, now prices can be north of RM10. In a span of 50 years, based on the estimated prices, that would work out to be a relative increase of 900%. This is what we call the inflationary effects. Simply put, inflation is the increase in the cost of goods and services over time.

Inflation reduces the real value of money. A reduced purchasing power will mean that "X" amount of money now will not be able to buy the same amount of goods in the future. Putting it in perspective, in a 4% inflation environment, what used to cost RM100 is going to cost RM148 in 10 years' time.

What are the main causes?

There are a few causes and types of inflation. Here, let's examine cost-push and demand-pull factors.

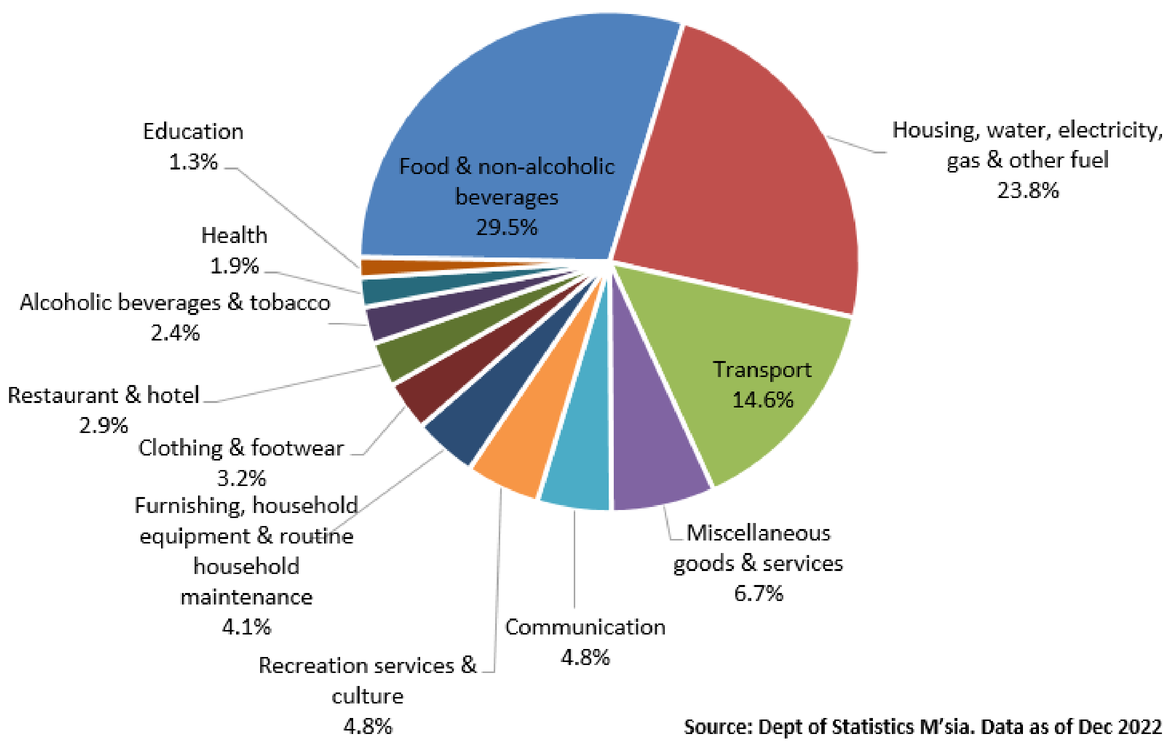
Cost-push inflation happens when businesses pass on costs to their customers to protect their margins. They may have raised the price of certain goods due to an increase in the price of a crucial component in producing the goods, e.g., a rise in labour costs, petrol, gas, or sugar.

Demand-pull Inflation occurs when the demand for goods increases to the extent that the existing supply is unable to catch up. When demand outweighs supply, prices increase. It is usually taken as a sign of a growing economy as consumers have more disposable income or experience increased consumer sentiment.

How is inflation measured?

The Consumer Price Index (CPI) is one of the broader measures to track inflation, measuring the average change in the price of a basket of goods and services.

Consumer Price Index Component Weight



Source: Dept of Statistics M'sia. Data as of Dec 2022

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The CPI is made up of 12 broad items, which are assigned their corresponding weights. A theoretical 10% increase in fuel price will have a +1.46% effect, on its own, on the CPI. This is based on the transportation component's weight in the CPI, which is 14.6%.

Inflation is expressed in terms of percentages. Hence, if the CPI is up 4% year-on-year, this would mean that prices are generally 4% higher compared to the previous year.

Since inflation reduces purchasing power, wouldn't it be better for us to have zero or negative inflation?

The opposite of inflation is deflation, which is characterised by a situation whereby the prices of goods and services are decreasing. Sounds like a good thing, no? Well, here's a short example:

In a deflationary environment, consumers will end up holding back on purchases. They believe prices will be even lower in the future, so what's the incentive to buy now? This creates a downward spiral in the economy. Due to a lack of demand and poor consumer sentiment, businesses end up making losses. They are not willing to stock up on goods as no one is buying. Factories cut excess production capacity. Eventually, workers will get laid off. This will eventually affect the banks as individuals and businesses default on their loans. In short, economic activity is effectively brought to a halt.

So as you can see, deflation is an even worse enemy than inflation. It is better to have a gradual and stable increase in the rate of inflation over time.

Why is it important to understand the effects of inflation?

Recall that inflation reduces your purchasing power, which means it gradually increases your cost of living. Secondly, money left uninvested eventually loses its value. With inflation running at 4%, every RM100,000 left uninvested loses RM4,000 in value each year. The effects become even more pronounced over time.

In order to at least keep up with inflation, we must invest!

Investing in equities can be an example of a hedge against inflation. Over the long run, you can expect companies' earnings to increase at least in tandem with or higher than the inflation rate. Investment in real estate or properties is another example. Most importantly, however, it is crucial to keep your investment portfolio diversified in accordance with your risk profile.

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, we should aim to achieve positive returns above the inflation rate.

We think that the inflation risk is a silent killer; one that you must not underestimate. It starts off as a thief in your wallet before eventually growing into a ravenous beast that eats away at your wealth if left unchecked.

Source: From various compilations. The article was written on 5th January 2023.

Roadshows 2022

Areca Capital is thrilled to have successfully concluded its “Set Your Investment Compass With Strategic Asset Allocation” roadshows across various cities in Malaysia last year end. The roadshows were held in Kuala Lumpur, Ipoh, Penang, Malacca, Johor, Kuching, and Kota Kinabalu and received a warm welcome from the local communities. These roadshows provided Areca Capital with a platform to engage with its stakeholders, share useful insights and outlooks on the market, and most importantly, to better understand the needs and aspirations of its clients. The response was largely positive and Areca Capital is grateful for the opportunity to connect with its clients on a more personal level. The roadshows have further solidified Areca Capital's commitment to delivering exceptional service and tailored solutions to meet the unique needs of its clients.

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