ARECA CAPITAL

flash

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NAVIGATING OPPORTUNITIES

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Dear Investors,

If we can summarise the 1st half of 2023, it is still one wrought with continued uncertainties (timing of the Fed pivot, China's economy etc). There's generally been much negative sentiment over the past couple of years. Nonetheless, there are reasons to remain optimistic.

In this edition of Flash, Edward and I share our market insights on equities and fixed income for the second half of 2023.

Cloudy and rainy days will not last forever. We believe that patience, agility and the ability to position ourselves strategically are crucial to seizing the sunny days when they come.

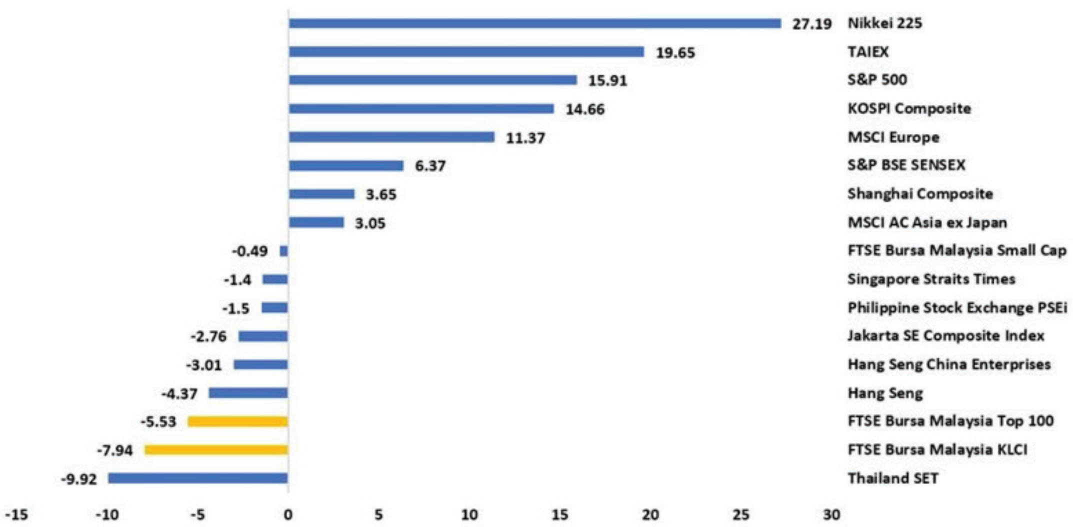
Stay invested. Happy reading!

Danny Wong
Chief Executive Officer
Areca Capital Sdn Bhd

REVIEW AND OUTLOOK

Equity Market Review - A Tale of Two Halves Again?

Chart 1: Equity Market Performance (January - June 2023)



Source: Lipper. Data as of 30th June 2023.

The first half of this year witnessed developed markets outperforming emerging markets, with Japan, Taiwan, and the US market taking the lead. One of the key factors contributing to this trend was the strengthening of the US dollar, largely influenced by the Federal Reserve's rate hike decisions.

The US Federal Reserve, in response to rising inflationary pressures and improving economic conditions, embarked on a path of swiftly raising interest rates. The expectation of higher rates in the US attracted global investors seeking better returns and led to an increase in demand for the US dollar. As a result, the US dollar strengthened against other currencies, providing a boost to US equity markets.

Another key factor is the advent of AI and ChatGPT, which ignited a chase for stocks related to the AI theme. As a result, developed markets with a higher concentration of leading-edge technology exposure, such as Japan, Taiwan, Korea and the US, topped the chart as market leaders.

In contrast, emerging markets faced certain challenges during this period. Factors such as rising inflation, currency depreciation, and geopolitical uncertainties affected investor sentiment. Some emerging economies experienced slower economic recoveries and struggled with weaker than expected China reopening demand, particularly countries that are reliant on a revival of Chinese tourists' visitations.

Additionally, the prospect of higher interest rates in the US triggered capital outflows from emerging markets as investors sought safer investment opportunities in developed markets. The combination of these factors contributed to the underperformance of emerging market equities compared to their developed market counterparts.

However, it is important to note that market dynamics can shift rapidly, and we are seeing some signs that the workings underpinning such a shift are falling into place. Changes in interest rate expectations and their resultant effect on currencies, economic and policy developments will continue to influence market performance and present new opportunities for investors.

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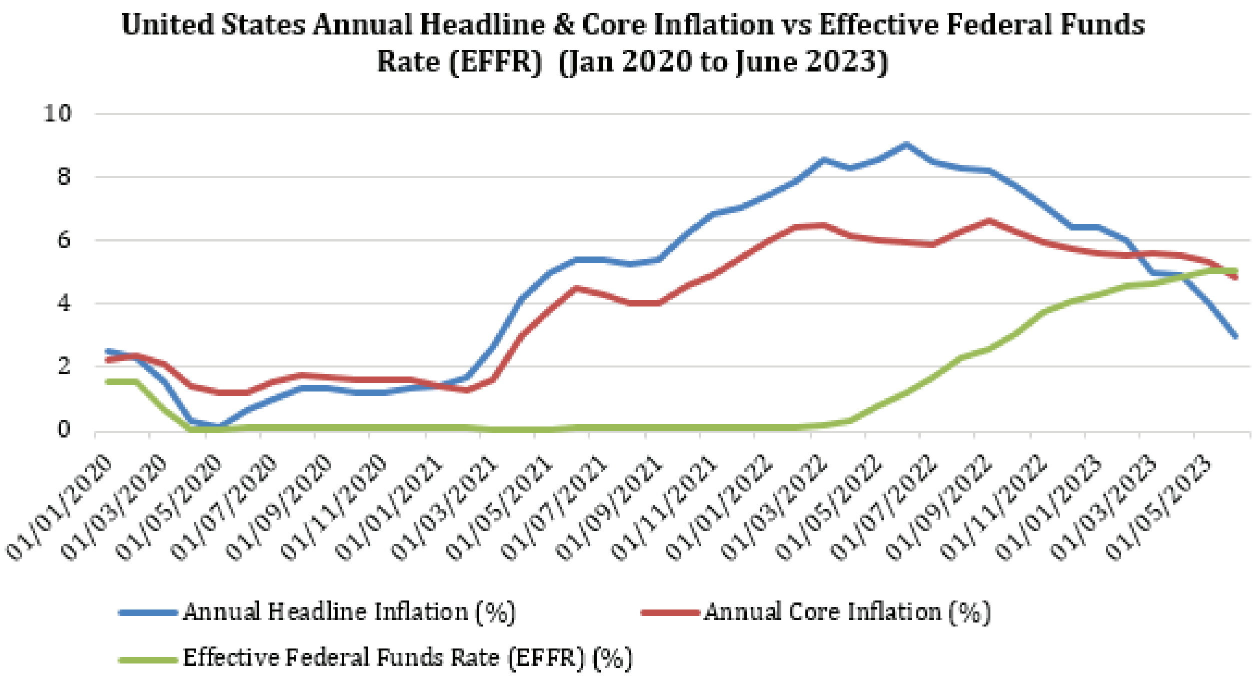
Equity Market Outlook - Reiterating Our View



Source: Bloomberg

There is a possibility that emerging markets, including Malaysia, could gain favour in the second half of the year.

We continue to hold on to our views—the US inflation rate may reach its peak, leading the Federal Reserve to pause on further interest rate hikes (refer to chart above). Such a development could potentially result in a reversal of the US dollar's strength, which could benefit emerging markets.

As market sentiment adjusts to a more accommodative monetary policy stance, investors may seek opportunities in emerging economies, including Malaysia, presenting a potential turnaround in performance. However, it is important to note that market conditions are subject to various factors and can evolve differently than anticipated. Monitoring economic indicators and policy decisions will be crucial in assessing the trajectory of emerging markets going forward.

There are three significant catalysts that could positively impact Malaysia's market outlook. Firstly, the easing of political uncertainty with the conclusion of state elections is expected to contribute to a more stable environment for economic growth. The resolution of political issues can instill investor confidence and attract both domestic and foreign investments. Secondly, the potential return of foreign investment flow holds promise for the market, particularly as foreign holdings have reached their lowest levels since the global financial crisis (refer chart below). This presents an opportunity for foreign investors to re-enter the market, potentially driving capital inflows and bolstering market performance. Lastly, the market's attractive valuation, currently trading below its 5-year mean level, indicates potential undervalued opportunities for investors. The combination of these catalysts—political stability, the potential rebound of foreign investment flows, and an attractive market valuation—positions Malaysia's market favourably for the second half of the year.

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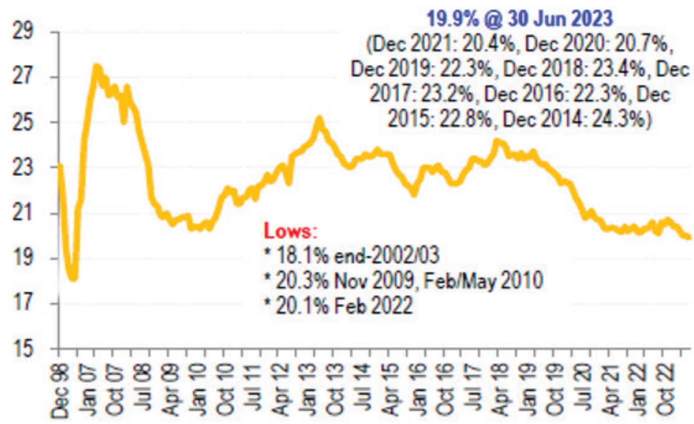


Source: Maybank IB, Bursa Malaysia

The China/Hong Kong markets present several catalysts that could shape their performance in the coming months. Firstly, the potential easing of regulatory pressure in China could have a positive impact on market sentiment. Recent regulatory measures aimed at various sectors have created uncertainty among investors, but as the regulatory landscape stabilises, it could restore confidence and attract renewed interest. Easing regulatory pressures are anticipated as authorities seek to strike a balance between oversight and market development.

Secondly, the current market valuation of China/Hong Kong stocks appears relatively low, offering potential opportunities for investors seeking undervalued assets. The market's attractive valuation may entice bargain hunters and value investors to enter or increase their positions, potentially driving an upward trend in prices. In our view, investors may be overly bearish on these assets.

Lastly, the potential return of foreign investors to emerging markets, including China and Hong Kong, could be influenced by the peak in US dollar strength. As the US dollar potentially weakens, it may make investments in emerging markets more appealing, leading to increased foreign investment flows into these markets.

While these catalysts present opportunities, it is important to note that the China/Hong Kong markets can be subject to volatility and unique risks. Investors should carefully assess the evolving regulatory environment, geopolitical dynamics, and market conditions before making investment decisions. Tensions, trade disputes, and global policy changes can significantly impact investor sentiment and introduce market volatility. Staying informed about geopolitical developments and adopting a diversified investment strategy can help mitigate the risks associated with such factors. A diversified approach and thorough research are essential for navigating these markets successfully.

Conclusion - View with a long-term lens, not short-termism.

Emerging markets, such as Malaysia and China/Hong Kong, offer enticing prospects for investors seeking long-term growth. Political stability, attractive market valuations, easing regulatory pressures, and the potential return of foreign investment flows shape the market outlook. Although certain conditions may be 'postponed' in the meantime, patience is a virtue. Our thesis at the start of the year remains.

For investors, portfolio diversification remains a key part of navigating market uncertainty and volatility. Having an appropriate asset allocation would allow investors to navigate these markets more effectively and position themselves to capitalise on emerging opportunities. The evolving landscape of emerging markets does present the potential for investors to achieve their financial goals and participate in the growth of these dynamic economies.

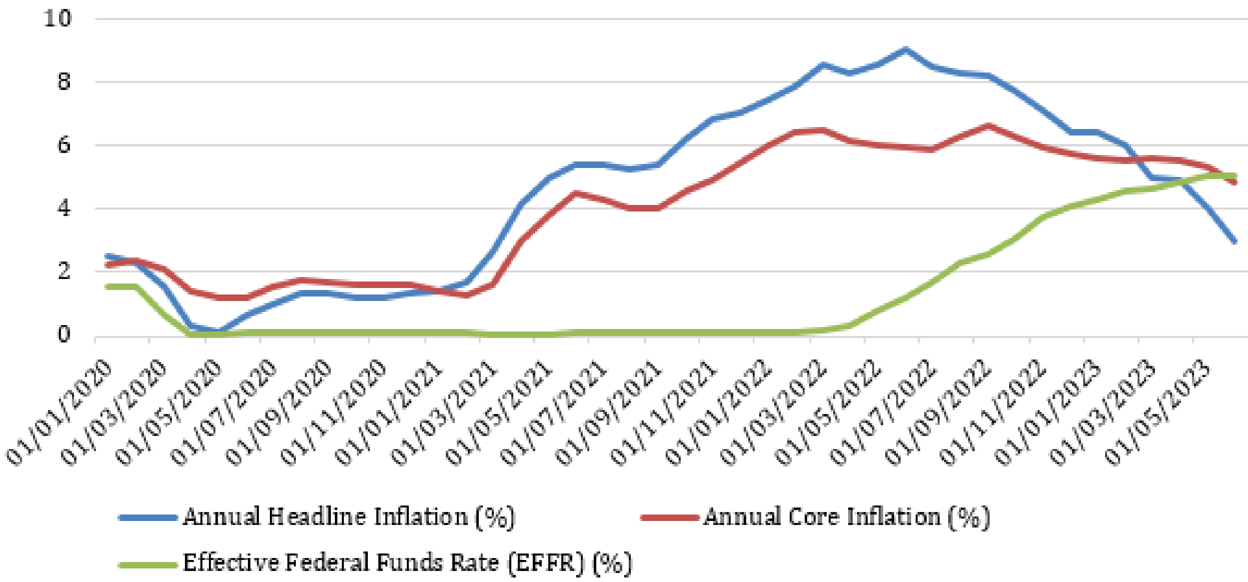
FIXED INCOME
MARKET REVIEW & OUTLOOK
BY EDWARD ISKANDAR TOH

Interest Rates Are Peakish

Are we there yet? Will the Fed continue to raise interest rates or are we nearing the end of the hike cycle? These were the questions I posed at the beginning of 2023. Since then, the United States Federal Reserve (Fed) has slowed its rate hikes, opting for 25 basis points (bps) hikes in its February, March and May meetings instead of the 75 bps increases enacted in late 2022. In total, the Fed increased its Effective Federal Funds Rate (EFFR) by 500 bps over 15 months. 113 bps in the first half of 2022, 289 bps in the second half of 2022 and decelerating to 98 bps in the first six months of 2023.

The US annual inflation rate continued to fall for 12 consecutive months since its peak of 9.1% in June 2022, with the latest consumer price index (CPI) falling to 3.0% in June 2023. Importantly, core inflation has trended down from its peak of 6.6% in September 2022 to 4.8% in June 2023 while the personal consumption expenditure price index (PCE) similarly eased from its peak of 7.0% in June 2022 to land at 3.8% in June 2023. The Fed's hawkishness has effectively guided inflation steadily downward. With the Fed finally pausing its rate hikes in June, the latest data also increases the chance that the Fed is nearing the very end of the current rate hike cycle.

United States Annual Headline & Core Inflation vs Effective Federal Funds Rate (EFFR) (Jan 2020 to June 2023)



Source: Bloomberg

US Economic Outlook

So what is next? The 2-year and 10-year US Treasury (UST) yields started to invert in July 2022, hitting the deepest levels since 1981 at -106 bps in June 2023. A yield curve inversion typically signals an economic slowdown. Since 1978, the time gap between the initial yield curve inversion and the estimated start date of an economic slowdown has ranged between 12 to 18 months.

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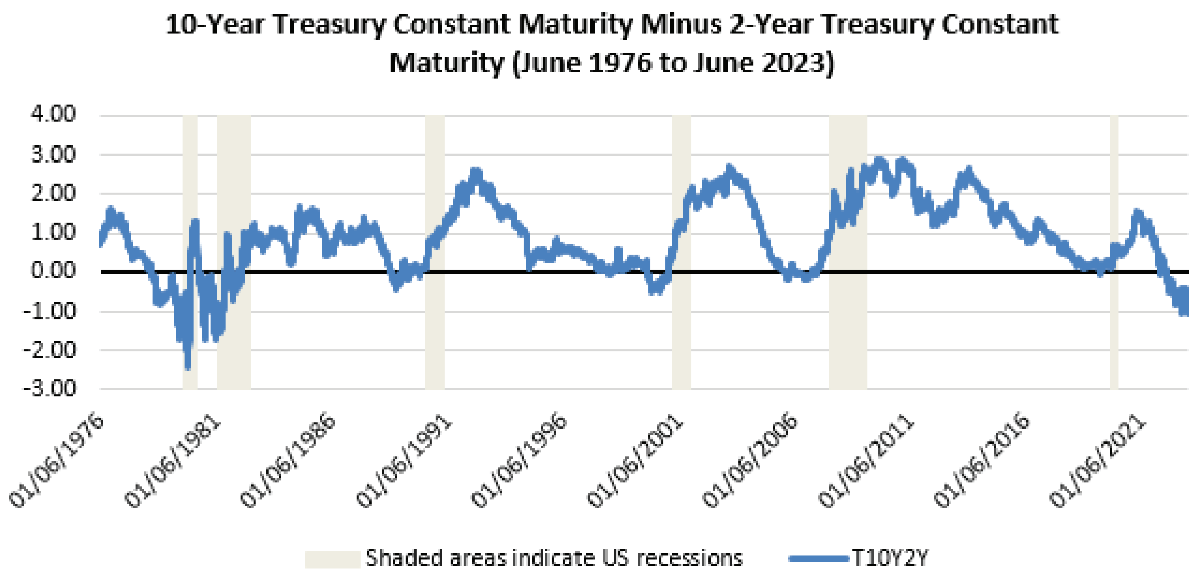


Source: Federal Reserve Economic Data (FRED)

If an economic slowdown does occur towards the end of 2023 or early 2024, the question is whether it will be a short and sharp slowdown or a long but shallow one. There are hints that the US might enter a soft landing slowdown instead. In its June 2023 Global Economic Prospects, the IMF expects US growth to weaken through 2023 and early 2024 (Real GDP Growth 2022 estimate: 2.1%, 2023 forecast: 1.1%, 2024 forecast: 0.8%). This is mainly the result of the lagged effects of the sharp rise in policy rates.

Impact on Malaysia

On the home front, China and the US represent Malaysia's largest and 3rd largest trading partners in 2022. With the potential slowdown in the US economy and the less-than-stellar recovery in China, Malaysia's road to recovery post-pandemic may hit some bumps.

The IMF earlier estimated Malaysia's real GDP growth to be at 8.7% before reducing to 4.3% and 4.2% in 2023 and 2024 respectively, below its 10-year average GDP growth in 2019 of 4.7%. Malaysia's inflation continues on a downward trend from its peak of 4.7% in August 2022 to 2.8% in May 2023. With less than exciting expected GDP growth and relatively contained inflation, the chances of further interest rate hikes by Bank Negara Malaysia (BNM) are less than slim.

Our Strategy

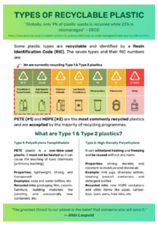
We will continue to hold moderate to long-duration bonds, which would enable us to gain from and capture any potential interest rate cuts while also maintaining liquidity on interest rate hike risks. We would also favour stronger credits as opposed to high-yielding ones.

Our Sustainability Initiatives & SRI 2023

Our Sustainability Initiatives

At Areca, we are making an effort to reduce single-use plastics such as plastic drinking water bottles, cutlery, straws, food containers and disposable bags and encourage the recycling of Type 1, 2, 4 and 5 plastics.

Furthermore, we also kicked off our energy conservation initiative by turning off lights when not in use. Let's all play our part in protecting our environment.



Sustainable And Responsible Investment (SRI) 2023

We are delighted to announce our continued support as the Platinum Sponsor for the Sustainable And Responsible Investment (SRI) 2023 Virtual Conference, "Join The Race For Sustainability: Empower Your Company At SRI 2023" organised by the Securities Industry Development Corporation (SIDC). The conference was held on the 21st - 22nd of June 2023.

Our CEO, Danny Wong, was also a panellist in the session on "Investors' Stewardship Priorities".

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