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flash

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STAY THE COURSE



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Dear Investors,

Admittedly, uncertainty and storms are unavoidable. Therefore, when investing, it is crucial to stay the course and constantly have a long-term perspective. We persevere through the rainy days so that we can experience the sunny days and rainbows.

In this issue of Flash, Edward and I share our insights on the equity and fixed income markets for the second half of 2022. Also, Chaw Chern will talk about staying the course in volatility.

Stay invested. Happy reading!

A handwritten signature in black ink, appearing to read 'Danny Wong', with a stylized flourish at the end.

Danny Wong
Chief Executive Officer
Areca Capital Sdn Bhd

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REVIEW AND OUTLOOK

Global and Malaysia Review - A "Perfect Storm"

Navigating into the first half of 2022, a "perfect storm" was brewing. The initial resurgence of COVID-19 cases and geopolitics disrupted global supply chains and shipments. The imbalance between supply and demand caused worldwide shortages and commodity prices to surge. What started as cost-push inflation threatened to spill over to demand-pull inflation – spurring the Federal Reserve's (Fed) hawkish stance in quelling inflation.

At the time of writing, the US economy has experienced a technical recession as defined by two consecutive quarters of GDP contraction (Q1: -1.6%, Q2: -0.9%). The inverted yield curve (2Y-10Y) also suggests that an economic recession is up ahead, and this expectation is increasingly being priced into market valuation, as witnessed by the fall of key market indices, particularly those in the US, into bear market territory (e.g. 20% down from the peak).

The Malaysian economy expanded by 5.0% y.o.y in the first quarter of 2022, an increase from 3.6% in the previous quarter. This was largely supported by the easing of COVID-19 restrictions, normalisation of economic activities, and improving domestic demand. However, the country was not able to escape the global trend of rising inflation. Malaysia's annual headline inflation rate rose to a 1-year high of 3.4% in June 2022 from 2.8% in the preceding month and 2.3% in January 2022.

Global Outlook - Rough Seas Ahead in 2H22?

While the global economy will continue to recover, we will likely see a slowdown in GDP growth due to the risks of tighter global financial conditions, rising inflation, China's growth slowdown, the War in Ukraine, and geopolitical fragmentation. The IMF had cut down the global growth forecasts for 2022 to 3.2% in July 2022, a 0.4 percentage point lower than its previous forecast. As such, we foresee that volatility will be here to stay.

Chart 1: Commodities and Freight index are off their peaks



— Baltic Exchange Freight Index (LHS) — Bloomberg Commodity Index (RHS)

Source: Bloomberg. Data as of 4th August 2022

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Concerning the Fed's target to cool inflation in the US, we think that the inflation rate may peak soon, in the third quarter of 2022. We are already seeing signs of many commodity prices peaking in early June, and supply constraints are easing (Refer to Chart 1). Therefore, we think the inflation rate will likely top out soon, and it is unlikely that we will return to the high inflation regime of the 1970s. Given the softer outlook on economic growth ahead and the potential peaking of the inflation rate in the third quarter of this year, we reckon this gives the Fed some room to scale back on its aggressiveness to tighten monetary policy.

Domestic Outlook and Our Strategy - Navigating Through Bumpy Waves

We are of the view that much of the risk flagged earlier may have already been priced in by markets. While local companies on our radar remain fundamentally intact, they have been negatively affected by broader market sentiment. This will create an opportunity when the dust finally settles. Sentiment may change very quickly when the tide turns. In the meantime, we remain selective in our asset allocation and stock picks. 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:
Financials and consumer

Growth: Technology secular trend e.g.
(i) 5G/IoT;
(ii) Automation/AI;
(iii) Cloud computing remains intact.

The reopening of Malaysia's economy will continue to drive tourism and private spending, supporting corporate earnings momentum.

Malaysia's headline inflation rate has been relatively less severe compared to its regional peers.

- Partly because of ceiling/controlled prices and subsidies.
- Will we see even higher inflation in the second half of the year?
 - We are positioned with companies that have the pricing power to pass on costs to customers.

BNM is not expected to be as aggressive as its US counterpart.

- Rate hikes are usually beneficial to the banking sector.
 - Increase in net interest margins and subsequently their earnings.

The technology sector has been heavily battered in the first half of 2022.

- Bursa Malaysia Technology Index posted a disappointing return of -35.27%.
- Despite the negative connotations associated with tech stocks in a rising rate environment, we beg to differ.
 - It is important to remain selective and not throw the baby out with the bath water.

We expect the secular trends in technology to remain intact and grow in the long term.

- e.g. Demand for 5G-related services, AI, Internet of Things, and Electric Vehicles.
- This will drive secondary demand for the semiconductor industry to provide the required processing power and innovation.



China's Outlook and Our Strategy - A Dragon Among The Waves

Despite the noises in China, such as the technology regulation, COVID-19 lockdown in Shanghai and more recently, the mortgage issue, we remain long-term positive on the world's second-largest economy, particularly in its technology sector.

We believe China recognises the downside risks to its growth as it has started to cautiously re-open and support its economy, whether through a more dynamic COVID-19 policy or other fiscal or monetary measures. This is starkly in contrast with other major economies that are tightening instead.

Moreover, could we be approaching the tail-end of the "Common Prosperity" reforms in its technology sector? We expect that the easing of these reforms will continue in the long term as part of the Chinese government's broader long-term policies on self-sufficiency. An example of this is the "Domestic-International Dual Circulation" policy to reorient its economy by prioritising domestic consumption while remaining open to international trade and investment. Another example is the "Made in China 2025" policy to further develop its manufacturing sector, with one of the goals focusing on increasing the production of high-tech products and services.

We will be adopting a more active strategy in our China equity portfolios.

Conclusion - Looking Beyond The Horizon

The events that we went through in the first half of 2022 were part of what we call a "Perfect Storm". Looking ahead, we are cautiously optimistic about Malaysian equities. Our barbell strategy remains in place as we see value emerging. We remain long-term positive on China, particularly its technology sector, as its government has begun ramping up policy support for its economy, and we expect that the easing of "Common Prosperity" reforms will continue in the long-term.

Nevertheless, downside risks and uncertainties will be ever-present. Hence, we will continue to maintain our flexibility and agility while being cautious in our Asset Allocation, sectors, and stocks selection.

We urge all of our investors to stay the course with us, as we will weather this storm together. Better and sunny days are not too far away!

Source: From various compilations. The article was written on 5th August 2022.

FIXED INCOME MARKET REVIEW & OUTLOOK

BY EDWARD ISKANDAR TOH



Recession Ahead?

Wikipedia defines recession as a general decline in economic activity that is often accompanied by an overall contraction in spending. The widely accepted rule of thumb is that of 2 consecutive quarters of negative growth. This phase in the business cycle brings with it negative connotations of bleakness, despair and hopelessness. One easily imagines long lines at unemployment benefit welfare centres, or homeless shelters packed to the brim or even streets full of panhandlers. It is obvious then why nations' authorities and leaders are bent on avoiding that label attached to their legacy.

Six months ago, I wrote about the imminent inflation that would befall the US and the world over. However, I underestimated the fervour with which the media would go to town with it and the reaction of central bankers, especially that of the US. As if to make up for their lack of reaction early on when the first signs emerged last year, calling it transitory, the 180° flip saw the Fed Funds Rate raised thrice consecutively from 0.25% to 1.75%. The market continues to call for a further 75 to 100 basis point hike in July, fanned by the Fed chairman himself. The steepness of spikes matched only by the hyper-inflation and stagflation era of the late 70's to 80's post dismantling of the gold pegged USD currency.

Raising interest rates may be an effective tool to curtail inflation. However, rising prices can be a result of various factors. If prices rise because of strong demand exceeding supply, raising rates would be effective by causing borrowing costs to be expensive, discouraging spending while motivating savings. Demand would then slow until equilibrium is achieved. The reverse is true if the economy is sluggish and slow; dropping rates may be able to stimulate economic activity by lowering borrowing costs, disincentivising savings and raising demand with the aim of reducing excess supply.

The recent conundrum is complicated by the COVID-induced global slowdown. Since being declared a pandemic by the World Health Organisation in early 2020, the world ground to a halt for more than a year. Ever since vaccines were discovered and administered, humans have learned to live with the virus. Countries began reopening their borders and economic activity returned. The restart was uneven and chaotic in some cases, causing various levels of supply bottlenecks. The Russia-Ukraine conflict, which began early this year and China's strict zero-covid policy exacerbated matters by causing commodity price spikes and further supply chain disruptions. This high inflation currently experienced is thus largely contributed by supply structure issues. There are, of course, demand-driven factors like high wages, which were caused by labour squeeze post-lifting of mobility restrictions. The sudden boom in some economies waking from lockdown doldrums also caused a surge in general demand.

In response, the Federal Reserve went on a blitz to raise interest rates. To compound matters, they began the reduction in the US Treasury's balance sheet, further suppressing the volume and velocity of money in circulation, reversing the course of credit growth.

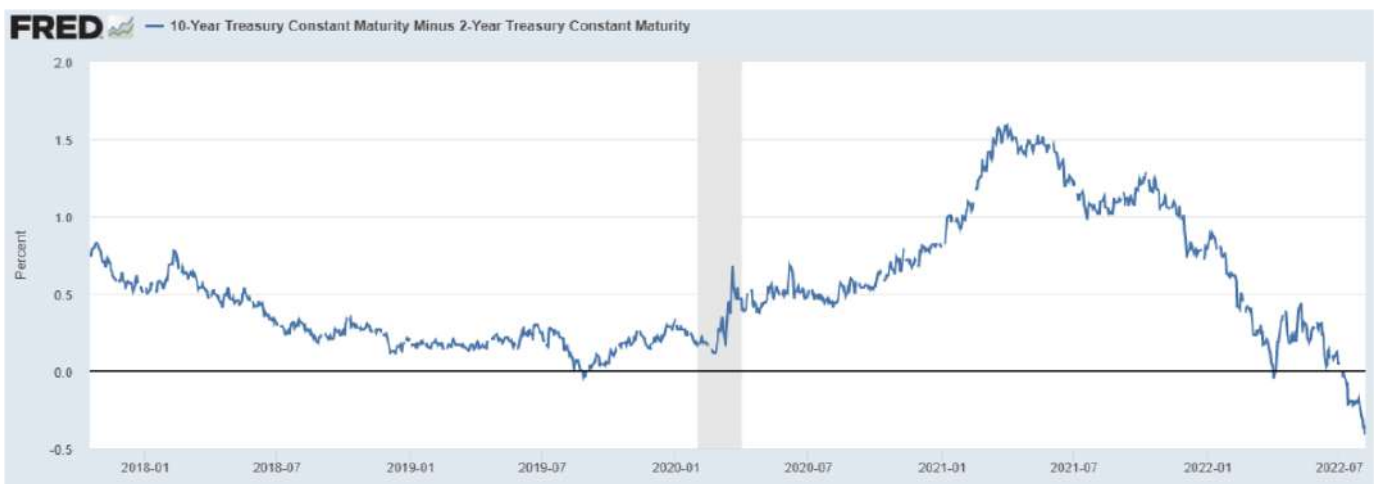
The drying up of liquidity and cheap money has now led the market to suspect the rate of increase may be too steep and too fast. Expectations are now building towards a slowdown which may tip into a recession. This has traders inverting the yield curve, a phenomenon where short-term rates are higher than long-term rates, as opposed to a normal, positively sloped yield curve where short tenures are lower than long tenures.

Although US Treasuries made its debut almost 100 years ago, records of 10/2 spreads (yield difference between 10 and 2-year Treasuries) date back only 50 years. Since then, there have been 6 official recessions declared. Each time it was preceded by a period of 10/2 negative spreads or yield inversions.

FIXED INCOME MARKET REVIEW & OUTLOOK (CONT'D)



1976 - Present



2018 - Present

Shaded area denotes recession.

Source: Federal Reserve Bank of St Louis.

Since the Fed Funds Rate was raised to 1.75% in June, the curve has inverted again.

Recession seems imminent. Many estimate a lag of between 16 to 18 months, as the historical average goes. However, cycles have become shorter as the effects of credit creation through numerous quantitative easings may have sullied normal cycles.

Interestingly, there has been increased activity on Wikipedia pages on Recession definition recently.

In Malaysia, our bond markets are less mature. With only about 50 years of history, spreads have only been monitored in the last 17 years. There has been only one brief occasion of an inversion between the short 3-month notes against 5 and 10-year MGS in 2007, insufficient to justify a signal. Anyhow, dips are part of the overall economic growth of a country. One can bemoan its challenges, or seize the opportunities that it presents. We choose the latter.

This piece is not meant to predict a recession but is a partial dig at those that are in denial of a recession, technical or otherwise, while they were previously quick to announce that of others.

STAYING THE COURSE IN VOLATILITY

BY WONG CHAW CHERN



Ever get the feeling of déjà vu? Looking back, we've been seeing a familiar scene play out in financial markets over the past 4 or 5 years. It has usually been a tale of two halves – the Jekyll or Hyde phases of the market. Which personality ultimately turns up in the first half (or second half) is usually unpredictable.

Looking ahead, the unpredictability and volatility will be something we have to learn to live with. The emergence of the pandemic, the damaging after-effects of supply chain issues, China's slowdown, war between Russia and Ukraine and rising tension between the world's super-powers were only some of them, to name a few. The question is how this translates to our investments and how we deal with its repercussions:

Making Sure The Plan Jives With Our Objective

We can't stress enough the importance of having a portfolio of investments. For most of us, these would comprise of investments like Fixed Income/Bonds, Equity, Fixed Deposits and even Properties. How these are allocated depends on the usual factors – Financial objective, appetite for risk and pursuant to any liquidity needs.

A mismatch occurs if 45-year-old Helen, aiming to live off her nest egg for another 40 years, puts a majority of her "investments" in Fixed Deposit and Cash, or if 30-year-old Sam, buying his first property next year, decides to put his down-payment money in Equity.

With her 40-year investment horizon in mind, a more appropriate investment allocation for Helen could be a 50-50 weight in Fixed Income and Equity.

Diversify Reasonably

What would make up the underlying components of the 50-50 basket for Helen? Given that she may not be well versed in financial markets, Helen could go about adding several Unit Trust Funds to her portfolio to have some form of diversification. Generally, each Fund would hold somewhere between 30-40 stocks or bonds for ample diversification. Therefore, a reasonable number of Funds for a portfolio of between RM1mil to RM3mil could be 5 to 6.

So no, Helen does not need to invest in 20-30 Unit Trust Funds. Owning too many similar Equity funds would not diversify away the risk of Equity investment. This is over-diversification or diworsification!

The reason for diversification is that, ideally, the asset classes move in the opposite direction of each other, e.g.: when one falls, the other rises. However, given how investments have moved in unison lately, even that may be a tall order. What is for sure, however, is that well-diversified portfolios would withstand market sell-offs better. These are usually ones with an appropriate allocation to Fixed Income and Equity instruments.

The main consideration to diversify is not to maximise returns, but rather, to achieve a more reasonable risk-adjusted return.

What Happens When There is Volatility or Market Sell-offs?

It is admittedly painful whenever our portfolio (and our money) takes a hit. Nevertheless, here is when having a plan and knowing the "why" that we invest in the first place is important.

Take a step back and review the actual objective of our investment. Taking Helen, for example, if she is ultimately investing for the next 40 years, any temporary fluctuations, such as over a period of 4 days, 4 weeks or even 4 months in equity prices, should not matter much to Helen. She has time in the market. What is crucial here is that Helen has a well-constructed plan in the beginning – and she sticks with it.

Many of us know this, but the question is, do we follow through on our plan? Or do most of us end up switching out or over-reacting at the first sign of "trouble"? Alternatively, what can we do?

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STAYING THE COURSE IN VOLATILITY

BY WONG CHAW CHERN



1. Filter or Turn Off The Noise

These days, information can be made available at literally the touch of a button. Technology offers the dissemination of information a level playing field, as it transcends borders and regions. In our view, it is by and large, a double-edged sword. There can be too much information, even for a professional investor to digest. What more for the individual investor?

If you are reading some financial news headlines, take a step back and look at the subject in question from a different perspective before coming up with your own reasoning. Moreover, the world has never been short of news, but bad news sells.

2. Re-balance Your Portfolio

For Helen's initial 50-50 portfolio, if her current allocation has diverged significantly, she can consider re-balancing the portfolio to its original weight. For example, over time, her Equity funds' growth may have outpaced the growth in Bond Funds, turning her portfolio to a 60-40 mix. It may be prudent for Helen to switch some of the Equity portion into Fixed Income portion to re-align it back to the initial 50-50 allocation.

Conversely, following a market sell-off, the reverse would be true; due to the fall in prices, Equity's overall allocation could fall to 40-60. Helen can now switch some of her Fixed Income allocation to buy Equity at a relatively cheaper price.

Being a disciplined strategy, re-balancing removes the emotional aspects from your investment decision-making. The selling and buying decisions are typically triggered by pre-determined factors, e.g.: time-based (quarterly, annually etc.) or target-based (if the equity portion crosses a certain percentage of the portfolio).

3. Deploying Cash – in Tranches

In fact, taking the glass as half-full, times of turbulence or volatility could be opportunities to add to your existing portfolio when prices are low.

Here is another harsh truth – holding out your investments in search of the best entry point may turn out to be futile. There is no perfect moment to invest in; there is no crystal ball to foretell any market rallies or to catch the market bottom. Even the professionals get it wrong in timing the market.

If you are too concerned about investing in one lump sum, try a staggered approach. Identify the amount of unutilised or excess cash you can spare, and you can deploy it through 2-3 tranches.

4. Cost Averaging

For some, even 2-3 staggered investments may be too concentrated. Try adopting a Cost Averaging strategy. It involves a fixed amount of money being deployed into the Target Fund at regular pre-set intervals. If the target is to ultimately deploy RM100,000 over a period of 10 months, you'll be looking at investing RM10,000 every month, consistently – regardless of prices and market conditions.

Whether it is through 2-3 tranches or a Cost Averaging approach, these methods remove much of the market timing risk and replace it with a more disciplined alternative.

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STAYING THE COURSE IN VOLATILITY

BY WONG CHAW CHERN



Conclusion - Persevere Through, Stay The Course

Despite all the negativity and bearish market sentiment around us, we have to remain level-headed. Moreover, we can't extrapolate what is happening today and project it into the future.



If your long-term goals are intact, stay the course. Don't rip out your investment portfolio just because of the peculiar temperaments of the market.

Maintain the Asset Allocation of your portfolio and avoid making any drastic moves unless they are warranted. Rebalance periodically and make small tactical adjustments when necessary.

Let time or even the professionals do the heavy lifting in growing your money for you, and most importantly, don't let the noise distract you from your ultimate objective.

SRI 2022 & THE EDGE THIRD AGE SYMPOSIUM 2022

We are pleased to be the Platinum Sponsor for the SRI 2022 Conference: Preserving The Climate Through Sustainable Business and Living, which was held on 22nd - 23rd June 2022, by the Securities Industry Development Corporation (SIDC). Furthermore, we are also delighted to be the Main Sponsor of The Edge Third Age Symposium 2022: Successful Ageing in a Post Covid World, which was held on 2nd July 2022 in Mandarin Oriental KL. Here are some highlights from the events:

SRI 2022



THE EDGE THIRD AGE SYMPOSIUM 2022



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