ARECA CAPITAL

ARECA'S PLAYBOOK FOR 2024

Areca Capital Sdn Bhd, a fast-growing fund house with assets under management of over RM4.1 billion (as at Oct 23), has deployed most of its cash in the markets in anticipation of a strong rebound in the bond and equity market next year.

CEO Danny Wong says now is the best time for investors to deploy their cash when the overall price still remains relatively low, if they have the holding power. The next opportunity would come knocking only a long time after.

"2024 will be another year of opportunities. Those who don't enter the market now might have to wait for a while for the next. It is very rare to see interest rates increase by over 5% in a year. It hurts investment performance, but also presents good opportunities. It is again, a very rare occasion," he emphasises.

In 2022, the equity markets did badly and bonds were fine, but were not fantastic. This year has been better, but not without surprises, among which were the higher-than-longer inflation and interest rate and the recent war that broke out between Israel and Hamas. Still, the market rebounded from last year's low, albeit weaker than expected.

Next year is expected to be a great year. Wong sees light at the end of the tunnel. "Next year should be a better year. I was positive about 2023. This year, I turn bullish on 2024," he says.

Areca Capital has a few tricks up its sleeve to tap next year's markets. They are a blend of long-term, value and tactical play, which sees the firm investing in sectors such as property, gloves and tourism, among others.

As for the bond market, the firm launched an interesting product that utilises the leverage facility to extract better returns from the Malaysian Government Securities (MGS), while another product uses leverage to invest in the Singapore-listed real estate investment trusts (REITs), which is deemed a proxy to bonds by investors.

Investors with a higher-risk appetite can explore the investment grade, local currency bond space, he adds.

Will the firm overweight bonds or equities next year? The firm likes both, says Wong. "If our expectation is correct, both will perform well."

A SOFT LANDING, OR EVEN 'NO LANDING' IN THE US

A stronger 2024, especially in the Malaysian markets, could be underpinned by a few factors.

For one, Wong expects the US Federal Reserve to finally lower interest rates next year as inflation has cooled and the Fed has already achieved a large part of its inflation targets. This is while the US economy is still humming along and remains rather strong.

"I think the Fed has achieved its objective of bringing down inflation, yet without hurting the economy by causing severe job loss. So far, I would say they have done a good job.

"All this gives us the impression that the US has a very low chance of entering a recession next year. It's likely to be a soft landing, or even 'no landing'. That's our expectation," he says.

Wong's view on continuously slowing inflation is partly supported by a news report published by Reuters on Dec 4. The report cited that the New York Fed's Multivariate Core Trend (MCT) inflation reading for October stood at 2.6% from September's 2.88%.

The MCT index is designed to gauge inflation persistence and how broadly price pressures are changing through 17 core sectors of the Personal Consumption Expenditures Price Index. The higher the index, the more inflation is likely to persist.

The same report mentioned that the higher level of MCT relative to its pre-pandemic average "is in large part due to the sector-specific trends in housing and services ex-housing".

Wong is also of the view that the US dollar is now at one of its strongest points and is likely to "normalise" against the ringgit once the US interest rates fall. "The ringgit may come back once the Fed starts lowering interest rates," he says.

Meanwhile, as investors shift their sights on the Malaysian market, they will realise that its valuation remains very low.

"The Malaysian market has been down for some time, which is not without good reasons. One of them being our [corporate] earnings have also been down, though not as steep as the fall in prices. This makes the PER (price-earnings ratio) more attractive.

"At one point, our market was valued at two standard deviations (SD) below the mean. It has recently recovered to about 1.5 SD. But from a longer perspective, it is still cheap."

Wong says the FBM KLCI has been one of the worst-performing main indices in Asia-Pacific this year, just better than Hong Kong and Thailand. But the tables could turn next year with the strengthening ringgit and attractive valuation.

"If global asset managers were to take profit from the US markets, they would have to move their gains somewhere and place them in a market with better potential. Malaysia is one of them in the Asia-Pacific region," says Wong.

Wong also likes the local market as political risk seems to have subsided quite substantially recently. "Political risk stands out when foreign investors want to invest in the local market. But it seems like the risk has reduced by a lot. It seems that the unity government can last, and hopefully, for another one to two more terms.

"As another 'Sheraton move' seems unlikely, the government can really focus on improving the country's economy. This gives us the confidence that major infrastructure projects will continue being implemented, which will have a spillover effect into other sectors," says Wong.

REVEALING PART OF ITS PLAYBOOK

As the firm anticipates that the global economy will enter into a different regime where the Fed is likely to lower interest rates, causing the USD to weaken against emerging-market currencies, Areca Capital has also tweaked its playbook for better returns.

The firm has started looking at value counters and implementing some tactical plays. It has also stopped adding on more bets to the exporters this year and shifted its focus to domestic-focused businesses.

Wong says the firm adopts some "value" plays by investing in companies in undervalued sectors, but with strong fundamentals. The property sector is an example.

He says the sector has been under-owned by the market for a long time, and it is ripe for picking. Property companies with solid fundamentals and good prospects could see their share prices rally when more good news starts emerging.

A property company based in Puchong, Selangor, is one of the firm's key holdings that has performed quite well under such a strategy. The company has a strong balance sheet and a large land bank. But it is trading at below 0.5 times book ratio only, which is very cheap.

As at Dec 6, the counter was up about 60% from the beginning of the year, partly due to the completion of its commercial property in Singapore, which could boost its annual income significantly.

However, could most companies in the property sector be a "value trap" where prices remain low and undervalued for a long time and do not rebound?

"We think there is definitely risk in the sector. But the companies we selected are the better bets. If some of the good plans are being executed and positive news starts coming out, people will eventually see that they are under-owned and start buying into them. What they need is just a catalyst and their share prices could rally," says Wong.

Areca Capital holds a "neutral" view on the property sector, but has positioned itself for several value plays within it.

The firm also favours the glove sector, which is deemed another value or tactical play. The reasoning behind these investments is similar to that of the property sector as some companies have very strong balance sheets, but are under-owned by investors due to the bearish market sentiment.

For instance, a glove company can have cash that is equal to 60% of its market capitalisation, which represents a very attractive investment opportunity to Areca Capital, as long as its losses are not significant and continue to narrow.

"It means you're buying into a glove counter that apart from assets [has] half of its market cap in cash. You're only exposing yourself to higher risk on one-half of your investment. The only worry is that the company could burn through its cash due to losses. But if the losses are narrowing, it's a sign that you go in," says Wong.

The firm also favours the tourism sector for tactical play as tourist arrivals to the country continue to recover next year, he adds.

Areca Capital is also a big believer in the local semiconductor and manufacturing industry, on the back of the ongoing developments in artificial intelligence (AI), big data, electric vehicle trends and more.

About one-third of the firm's overall portfolio is invested in both sectors, says Wong.

Demand for semiconductor products and services would take time to recover to the previous levels, but it will continue to grow and do well in the longer term. In the shorter term, it has received a boost from the launch of the Hua Wei Mate 60 Pro, which uses seven nanometre chips manufactured in China, and Apple's iPhone 15.

"We thought the industry would have a meaningful recovery in the second half of this year, but it has been delayed. We can see some signs of recovery in the third quarter."

Yet, the firm has not allocated too much additional capital into the sector this year. Instead, it took some profits and invested them in some big-cap companies and others with a stronger presence in domestic businesses.

"We took profit from some semiconductor companies. We re-focused on other sectors by assuming that economic recovery will continue locally," he says.

Malaysian exporters are going to be hurt by a strengthening ringgit once the Fed cuts interest rates. But as long as there is no major fluctuation, they should still be doing fine. "We hope the ringgit, dollar won't have major movements," says Wong.

"We think that the bond market will see a very good recovery next year. But we don't want to take credit risk. So, we invest in MGS and leverage it."
— Wong

LEVERAGING MGS AND SINGAPORE REITS FOR ENHANCED RETURNS

Commenting on bonds, Wong says investors can start looking at investment-grade bonds that provide them with attractive yields, which is possible to find as the Fed rates remain high.

However, he cautions investors to be aware of credit risk, which means the risk of borrowers unable to repay their loans. While a recession in the US might not happen, the risk of a higher number of business failures remains.

"Be careful about credit risk. Try not to touch high-yield or junk bonds. Cash flow-wise, they might not make it if things get worse moving forward," he says.

Investors with a higher risk appetite, however, can start looking at local currency bonds in the emerging markets if they have a clear and strong view on specific currencies. These currencies are expected to strengthen against the USD when the Fed starts lowering rates.

On the local front, Wong says Areca has several products that allow investors to capture the potential upside of the bond market. This includes the Areca Focus Leverage Fund 2 (AFLF2) that applies leverage to invest in MGS.

The fund has made a return of about 6% as at Nov 30, 2023, according to Wong.

What the fund does is that it purchases MGS and pledges them to a bank as collateral for a loan. The firm then reinvests the loan back into other tranches of MGS, which makes it a leverage product.

"We think that the bond market will see a very good recovery next year. But we don't want to take credit risk. So, we invest in MGS and leverage it.

"For illustration purposes, let's say we buy RM100 million worth of MGS and pledge it to the bank for RM200 million worth of loans. Then we buy more MGS with the money, and get a total exposure of RM300 million to MGS.

"Of course, the loan comes with an interest rate of about 4.2%, which is slightly higher than the MGS yield of about 4.1%. So, for every RM100 million, we lose a bit of money. But it's fine.

"Assuming the rate cut is happening next year, the [flexible] loan rate will come down while the yields stay. And bond prices may go up as interest rates come down. We can make three-times return from the rise in bond prices with leverage. As long as the rates go down, we gain," says Wong.

Based on its product highlight sheet, the AFLF2 is a wholesale fund launched on Dec 30, 2022. It has a minimum initial investment of RM50,000 and minimum additional investment of RM10,000.

Another product that investors might want to look at is the Areca REIT Leverage Fund (ARLF) that applies a similar leverage strategy as the AFLF2. While both are different asset classes, REITs are often seen as a proxy to bonds.

The fund invests in and acquires REITs listed on the Singapore Stock Exchange, pledges them to the bank for a ringgit loan and reinvests the loan in those REITs. The fund does not hedge its currency, adds Wong.

"We are very cautious about other currencies. But based on historical data, the Singapore dollar has appreciated against the ringgit over the long term. The direction over many years has been pretty clear. So, we don't hedge our currency exposure for the fund. As the SGD continues to appreciate against the ringgit, it will benefit us," he says.

He adds that the strengthening of the SGD against the ringgit is partly due to the design of the city state's exchange rate policy that takes inflation into account.

According to the official website of the Monetary Authority of Singapore, the value of the country's exports and imports of goods and services in a year is more than three times the value of what is produced in its economy. Singapore imports most of its basic needs, such as food, energy and raw material, with about 40 cents out of every dollar spent going to imports. At the same time, a lot of goods and services in Singapore are exported to the world.

"For such an 'open' and 'small' economy, the exchange rate has a greater influence over domestic inflation than the interest rate. The exchange rate is used to convert prices of imports that are in foreign currencies to Singapore dollars, which is ultimately what consumers here pay," writes the MAS.

As such, when inflation rises in Singapore, which happens in most of the years in line with its economic expansion, the SGD is engineered in a way that it would strengthen against a basket of foreign currencies, including the ringgit, so that the imported prices of goods are lower.

Underpinned by a positive view on the Malaysian markets next year, Wong says Areca Capital has deployed most of its cash into the market. What it needs now is patience to reap the benefits when the time comes.

"We used to hold some cash, as high as 30% at one point. Now, we have deployed more than 90% into the markets," says Wong.