ARECA CAPITAL

flash

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FOCUS ON FUNDAMENTALS

CONTENTS

Dear Investors,

2019 so far turned out to be another trying period – trade wars, yield curve inversion etc. Thankfully however, our investing strategies have paid off. Read on as Edward and I share our thoughts in the equity and fixed income markets. As volatility increases, avoid getting distracted by the short term news-flow and headlines. Chaw Chern compares the facts between staying invested and market timing.

Again, we reiterate the need to stick to the fundamentals. Happy investing!

Danny Wong
Chief Executive Officer
Areca Capital Sdn Bhd

Market review and Outlook for 2H 2019

By Danny Wong

REVIEW AND OUTLOOK

The sirens from bonds, currencies and commodities are blaring louder. Markets are seemingly bracing for a global downturn as evident in the shocking appetite for safe haven assets. The world's pile of negative-yielding debt has swelled to a record level. In America, the curve has inverted—interest rates on ten-year bonds are now lower than on three-month bills—a strange situation that usually presages a recession. The safe-haven US dollar, Japanese yen and Swiss Franc are up against many other currencies. Gold is at a six-year high. Copper prices, a proxy for industrial health, are sharply lower. In spite of Iran's seizure of oil tankers in the Gulf, oil prices have fallen to $60 a barrel.

In view of the uncertainty caused by trade tension between US and China, along with the slew of weakening industrial production data and contractionary manufacturing purchasing manager indices, many people fear that a global recession is looming. Moreover, US is already having one of the longest economic expansions on record. With interest rates already so low, fiscal debt at towering level, the capacity to fight a recession is diminished.

Yet a recession is so far a fear, not a reality. The world economy is still growing, albeit at a slower pace than in 2018. Its resilience rests on consumers, especially consumption of services rather than manufactured goods. Jobs are abundant with unemployment rate at record low; wages are seen picking up; credit remains easy; and cheaper oil means there is more money to spend. More importantly, there has been little sign of the irrational exuberance that usually precedes a market slump. Investors are favouring stocks in defensive sectors like REITs, utilities consumer staples as well as capital-light internet and services firms that dish out strong profits.

Beyond the markets, central banks seem to be anxious too, and easing policy as a result. In July the Federal Reserve lowered interest rates for the first time in a decade as insurance against a downturn. Central banks in Brazil, India, New Zealand, Peru, the Philippines and Thailand have all follow suit in reducing their benchmark interest rates since the Fed acted. The European Central Bank is likely to resume its bond-buying programme.

For the cloudy road ahead, we are watching four notable developments closely. First, the trade negotiations between America and China. A proxy measure from JPMorgan Chase suggests that global capital spending is now falling. Because big investments by businesses are difficult to reverse, firms are reluctant to press ahead with them. If there is a genuine ceasefire and the uncertainty ease, business confidence will be restored, and the pent-up business investments will likely revive the stalling manufacturing output worldwide. Secondly, whether governments of world's major economies (particularly Germany) will begin to use fiscal stimulus to spur economic growth. They now appear to be over-reliant on the distortionary medicine of central-bank liquidity. And there are signs that this pain-numbing medicine has reach a level of diminishing effectiveness, just as a caffeine-dependent person requiring increasing shots of espresso just to stay awake. The third important development is whether a no-deal Brexit will transpire and the potential unintended consequences that might spill over to other global markets, given the highly connected nature of the London financial market. Lastly, whether the disruptive effect from the prolonged pro-democracy protest in Hong Kong will have extended impact on other markets, given Hong Kong's position as the key Asian financial market.

There are plenty of inconsistencies in the configuration of today's asset prices. When investors look back, the extreme anxiety in bond markets today may seem like a form of recklessness. The world is on the verge of Industrial Revolution 4.0, which will certainly raise human living standard and economic productivity level tremendously in the coming decade. Therefore, we are optimistic on the high growth potential of businesses in the coming decade along the themes of 5G & Internet of Things, machine learning, self-driving vehicles and etc. What is more, some of these great businesses are trading at attractive or reasonable stock valuation today given the backdrop of heightened market anxiety. When the clouds are clear, valuations of such businesses would almost certainly go skyward.

The case for Malaysia

It has been slightly more than a year since the new Malaysian government taken over the helm. Taking stock of how our stock market has performed over the one-year period since the 14th General Election, the benchmark KLCI Index (Large cap top 30) has languished by 12.4%, while the broader FBMEMAS Index has also fallen by 11.3%. The FBM Small Cap Index might appeared more resilient with a lesser decline of 9.7% during the same period, but it has actually taken a roller coaster ride. The Small Cap Index plunged sharply by 22.4% post GE14 until last year end, and then rebounded strongly by 15% until May this year. However, we cannot attribute our market's lacklustre performance on the change in government as the macroeconomic backdrop has also been far from rosy. External factors such as the lingering trade war also created plenty of uncertainties for businesses. Corporates earnings have also deteriorated over the period. In terms of sectors, the technology, telecommunication & media, energy, property and banks are among those which saw the poorest performance.

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Fundamentally, Malaysia's economy is still performing well. In fact, the 4.9% economic growth rate registered in the second quarter surprised the market positively. Our country's total trade and total exports growth have proved to be rather resilient compared to other ASEAN-5 countries, except Vietnam. Foreign direct investment in the Manufacturing, Services and Primary sectors has increased by 97.2% in first-half of this year compared to previous corresponding period. This illustrates our nation's competitiveness in attracting investments amid mounting global market uncertainties and trade war. Additionally, with Malaysian Ringgit hovering at around RM4.20/USD, and its status as an ASEAN nation with current account surplus stands Malaysia in good stead to attract foreign investment flows relative to other developing nations among the region, who are mired in twin deficits.

Navigating through the tempest in the second half of 2019 requires equanimity. Corporates' earnings have been dwindling for the fourth consecutive quarters due to ongoing internal & external headwinds. We think that corporate's earnings could have bottomed and likely to rebound in the second half of this year premised on: (1) The actual work progress and hence billings in the construction of the mega infrastructure projects that have been revived in the earlier part of the year; (2) many oil & gas services companies, who are still reporting losses in the first half, have received an influx of contracts from Petronas; (3) technology and industrial companies, who received reduced orders from clients in the first half owing to trade war uncertainty, have seen resumption of orders as production has to go on to prepare for typically robust new products launches in second half to capture the year-end festive demand. In addition, the key problem that many manufacturing businesses encountering-insufficient foreign labor-will likely be resolved in the second half, allowing local businesses to capture the pent-up demand and clear their orders backlog. All these will likely translate into corporate earnings improvement.

Conclusion

The lacklustre stock market so far this year offers long-term investors a great opportunity to invest at attractive prices. As the dust settles, fund flows could return to this part of the world – Malaysia could benefit with its huge current account surplus, still ample foreign reserves and defensive status.

In terms of investment strategy, we are investing into stocks deemed as oversold and cheap relative to their fundamental value, while being mindful of the potential rough patches ahead and adjust portfolio asset allocation level accordingly.

We continue to like exporters in the E&E sector, glove sector, selected companies within the Oil & Gas space or other companies with surplus in their foreign-denominated accounts.

Fixed Income
Market review & outlook

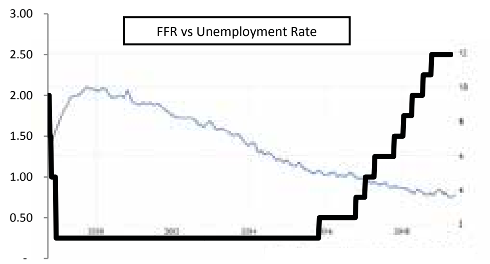
It is a wonder how the pendulum has swung from one where the market was expecting continuance of rate hikes to one that is now calling for rate cuts.

All economic elements and data suggest the US economy is growing sufficiently strong in an upward trajectory though tampered by a less rosy outlook.

It was just a little more than half a year ago when Jerome Powell declared that interest rates are still low and below neutral. As if in defiance of his President, he asserted firmly the independence of the Federal Reserve insisting that interest rates decisions are based exclusively on economic data and not subservient to political whims. "Our economy is currently performing very well overall, with strong job creations and gradually rising wages", Powell said at the start of December last year. He then raised Federal Fund Rates (FFR) for the fourth time in 2018 as market expected to 2.50%, leaving the dot plot pointing to expectations of 2 rate hikes in 2019. At that time, GDP for Q4 2018 recorded a decent 2.5%, Unemployment at 3.9% and Inflation just a tad below target at 1.9%. However, traders began to sense something amiss with benchmark 10 year US Treasury pressed down to close the year at 2.69%, but yet still above FFR. The spread between 10 and 2 years Treasuries began to narrow to just 11 bps, a level last seen in 2007. Negative spreads as history has them, are a phenomenon believed to precede the occurrence of a recession by between 13 and 24 months.

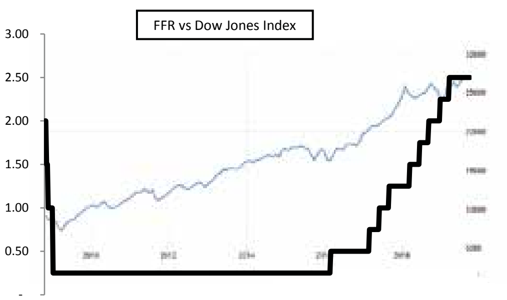
Fast forward six months to June 2019 and through four FOMC meetings thus far this year, the Federal Reserve Chairman kept rates unchanged at 2.50%, hailing the independence of the central bank while warning against policy yielding to short term political interests. Under constant twitter threats by President Trump denigrating the Fed Chairman for not easing interest rates; Jerome Powell; independence wavering, recently said: "Crosscurrents have reemerged raising renewed concerns about the strength of the global economy". Dot plot released in June pointed to a split between 'no more rate hikes' to 'possible cuts' for the rest of this year. GDP still grew at a healthy 2.7% and 2.3% for Q1 and Q2 respectively. Meanwhile, Unemployment hit a 49 year low at 3.6% in April but inflation stayed benign unable to break above 2% throughout the first six months of the year. Traders continue to push yields lower by buying up 10 year Treasury to below 2% in June, half a percent lower than FFR. Incidentally, 10/2 spreads remained narrow while the 30 year hovered just above FFR.

The following charts compare FFR movements against Unemployment Rate, Inflation and Dow Jones Index since 2008.



Downward trend in Unemployment provide basis for higher wages and a strong economy. Tightening policies are valid.

Inflation has struggled to breach 2%. This gives the Fed Reserve reason to hold back on hikes.



The stock market bull-run has been spectacular. Rate hikes have tracked its run.

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Economic data has not given a definitive reason for the turnaround in interest rates outlook. However, geopolitical upheavals and the ongoing trade war with China has been disruptive to global trade. Tariffs imposed by the US and the counter reaction by China since last July have led the IMF to downgrade global growth. Many analyst are beginning to price in a slowdown.

Although the Federal Reserve's justification may differ with that of the White House's, interest rates direction may just go the way Trump wishes for. Supported by low inflation, Powell has lately pointed to continued uncertainties caused by the unresolved trade rift with China and the impacts of tariffs imposed towards global trade as hints to imminent easings. Ramped up geopolitical risks in recent months and waning tax rate cut effects further reinforce the dovish tone. For Trump, he believes it is the high US interest rates that has kept US$ strong therefore negating the effect of trade tariffs which was imposed to address the lopsided trade imbalance with China.

Meanwhile, Malaysia endured a trying period in April with triple blow of negative news. Firstly, the Norwegian Sovereign Pension Fund withdrew investments in Emerging Market Bonds of which Malaysia is a part of. Then came the announcement that Malaysia is under negative watch for likely removal from the FTSE Russel Bond Index. Before the month was up, Moody's then called out Malaysia's intended RM6.3 bil bailout of FELDA as 'credit negative'. The market then prepared for a potential outflow some analyst predicted to be in the region of RM40 bil. At the end of April, BNM data shows foreigners were holding RM168.2 bil of domestic sovereign bonds or 22.1% of total outstanding compared to the highest level of 39.2% or RM242.7 bil back in July 2014. The 'bleeding' continued for another month. As it turned out, the change in US interest rates outlook benefited our markets with a larger positive carry. June saw an inflow of RM6.7 bil with the first half of 2019's net outflow of just –RM0.2 bil. Bank Negara, in line with the shifting global outlook on interest rates, then reduced OPR from 3.25% to 3.00%, lowering borrowing cost in the face of challenging times ahead in the May meeting. This further spurred the rush to safe havens assets like government issues and investment grades.

The US accuse many of currency manipulation, but they forget that their Quantitative Easing programs that began in 2008 which effectively stopped only in 2014 is a monetary policy tool that manipulates the market with a consequence of devaluing the US$. Now, the US who may potentially embark on a rate cutting phase, could unintendedly spark a currency war with 'race to the bottom' policies adopted by various nations. This would spiral into a spate of competitive devaluation with dire consequences if unchecked.

For bond investors, the inverse relation of rates and value would benefit holders. Strategically, our fixed income funds have been positioned likewise. Therefore, let us sit back and enjoy the ride for now.

Timing THE MARKET OR Staying Invested?

Written by:

WONG CHAW CHERN manager, private investment

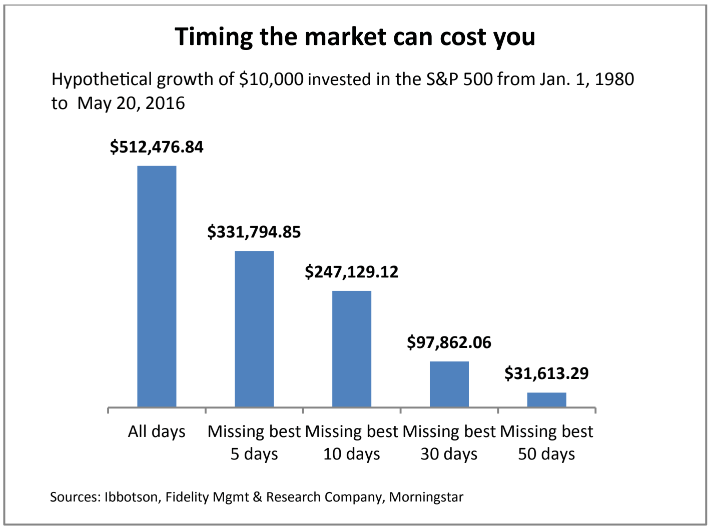
Addressing the giant elephant in the room, we are obviously with the staying invested camp. By focusing on our investment objectives and staying invested, it gives us an edge over the market timers who may be too distracted and affected by short-term news flow and headlines. But don't take our word for it, the numbers do not lie. Here are a few facts to pique your interest:

1. Missing the best days can be costly

Market timers have a tendency to switch in to equity market when they see an opportunity to make a quick buck. Having accomplished their goal, they will immediately switch out. They will run this playbook over and over again whenever opportunity presents itself.

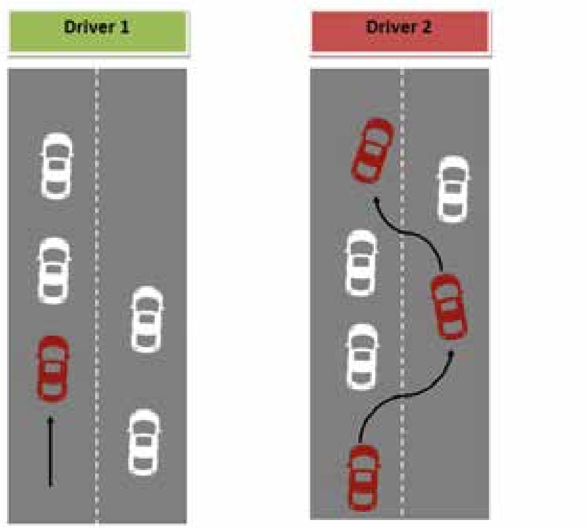
However, excessive movements in and out of the market can actually be counter-productive. As much as they are at risk of being caught out if the markets suddenly turn against them, they also risk missing out on the best days of a market rally.

Look no further than an analysis conducted in 2016 by Fidelity Investments and independent research firm, Morningstar. Just missing the five best days of the rally could mean the market timer's returns are only $331,794.84 compared to the investor who remained invested; whose returns come up to $512,476.84. This meant a difference of $180,682 or 54% more of what the market timer could have achieved, had he not tried to time the market.



We think an analogy can be found to differentiate investors from market timers. Referring to **Diagram 1**, both drivers are heading to the same location with similar traffic conditions. Driving style though, differs considerably. **Driver 1** patiently keeps in his lane while **Driver 2** weaves in an out, in an effort to get to the destination faster.

Diagram 1: Driving Style Analogy for Market Timers and Investors



Granted, **Driver 2**, may be able to get to his destination faster by a few minutes, but by moving out of lanes where he perceives to be slower and moving in to lanes where he thinks will give him a slight advantage, this increases his risk of being involved in an accident. This will come at the cost of his time and money, setting him back even further. Ultimately, will his actions be worth it? Can he truly beat the traffic?

2. Remain invested even through market volatility to generate superior returns

Fear is an inherent human emotion, so it's quite natural to assume that investors fear to hold on to their investments especially during what seems to be, market-moving events.

However, wise investment decisions are usually made without emotional interference. Besides that, the intensity and fervour of these market-moving events and other headline grabbing news usually die down after a couple of weeks.

Riding through short-term market swings isn't such an unacceptable proposition that some make it out to be. On the contrary, it can pay off to remain invested rather than switch out at the first sign of trouble.

3. Lessons to be learnt from successful investors

In order to achieve superior returns, successful investors have stayed invested throughout the market cycles, rode out short term volatilities and even looked to add more when market crashes presented them with bargains. Here are 4 famous investing gurus:

Investing Guru	Average annualized returns per year during period assessed	Quote
Peter Lynch	29.2% a year from 1977 to 1990 [1] (Fidelity Magellan Fund)	Invest in a business you understand.
Warren Buffett	20.8% a year from 1965 to 2017 [2] (Berkshire Hathaway)	I never attempt to make money on the stock market. I buy on assumption they could close the market the next day and not re-open it for five years.
Benjamin Graham	20% a year from 1936 to 1956 [3]	In the short run, the market is a voting machine but in the long run, it is a weighing machine.
John Templeton	15% a year from 1954 to 1992 [4] (Templeton Growth Fund)	The stock market is not a casino, but if you move in and out of stocks every time they move a point or two, or if you continually sell short… or deal only in options, or trade in futures, the market will be your casino. And, like most gamblers, you may lose eventually—or frequently.

Sourced from:
[1] – Investopedia, [2] –The Motley Fool, [3] –Forbes, [4] –Financial Times

Conclusion

You have to accept that you can never be the first or the fastest to react to the whims of the markets and the shifts in sentiment. Markets are notoriously hard to predict over the shorter term. A better way is to think ahead of the crowd; 2 or 3 years down the road. Pick a good stock or a better-managed Unit Trust Fund and hang on through the short term market trends. Let time do the heavy lifting for you. Superior returns can be generated by riding through market volatility and staying invested.

Meanwhile, the search for the best entry point may turn out to be futile. If investing in 1 lump sum into the equity market is something that concerns you, try investing systematically whether through Value Averaging or Cost Averaging. A disciplined investing strategy removes emotional biases from your decision making.

All of us are investing for a reason, be it for our eventual retirement or children's education. The time until the life goal spans many years. To put things in perspective, if you are a 40 year old adult and saving up for your children's education in university which is 10 years' away, day-to-day fluctuations in the equity market should not bother you at all. Invest for the long term and look at the bigger picture. If you keep thinking of the trees, you will end up missing the forest. Remember, it is time in the market, not timing the market.

The Edge Symposium 2019 and Collaboration with BOC HK Asset Management Limited

Areca Capital was the main sponsor for the Third Age Economy Symposium organised by The Edge Malaysia on 29th June 2019 at the Mandarin Oriental Hotel in Kuala Lumpur. The theme was "Turning Silver into Gold" – showcasing the huge opportunities as baby boomers find themselves retiring. As one of the speakers, Danny spoke about managing wealth in one's golden years.

Our company, Areca Capital Sdn Bhd is collaborating with BOCHK Asset Management Limited (wholly owned subsidiary of BOC Hong Kong (Holdings) Limited)
Our co-operation will provide Areca Capital's investors with access to Asian and Chinese High Yield Bonds. They can leverage on the experienced and award-winning investment team at BOCHK AM, which is in turn, supported by the expertise and extensive insight of the Bank of China Group.
Moving forward, our two companies will be exploring more potential tie-ups in distribution and other investment opportunities.
For the photo, individuals in the photo identified are as below:

Photo : Seated from left:Mr Zhang Min (CEO, Bank of China Malaysia),
Mr Shen Hua (CEO BOCHK Asset Management), Mr. Edward Iskandar Toh (CIO, Areca Capital) and Mr Danny Wong (CEO, Areca Capital)
Standing at the back is the Bank of China team
Location: Bank of China Malaysia Berhad
Date: 10 July 2019
Event: Signing of the Collaboration Agreement

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