flash

Issue 20 : July 2020
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Every Cloud Has A Silver Lining

FROM THE DESK OF DANNY WONG

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Dear Investors,

The year 2020 had begun with a dramatic turn of events, bringing on a series of troubling times, including the COVID-19 pandemic that had caused the largest impact on the world and all its aspects over the first half of the year. The Malaysian market also had its fair share of bearish outcomes over the phases of the Movement Control Order imposed throughout the nation.

As a team, Areca Capital had taken a very different approach to bring out the silver lining in every cloud that came our way, drawing great opportunity in trying times. In this volume of Flash, Edward and I share our views and insights on how we kept our heads above water and brought out the best of what the year 2020 had to offer.

Happy Reading!

Danny Wong
Chief Executive Officer
Areca Capital Sdn Bhd

MARKET REVIEW AND OUTLOOK FOR 2H 2020

BY DANNY WONG

REVIEW AND OUTLOOK - Date: 10th August 2020

As the pandemic rampages through the world, for a period of several months, major economies have literally been brought to a stand-still. Much has already been said of its devastating impact on global economies, financial markets and the man on the street, so let us not dwell on those but instead, look forward to what's ahead – from an equity investor's perspective.

We believe the worst of the economic impact is probably behind us e.g. PMIs are improving across the world. At this stage, it is important to draw a line between the current situation we are facing with past financial or even economic crises. It is not a problem of confidence, but a situation where producer can't produce, sellers can't sell and buyers can't buy. In other words, during the lockdown, you are not able to go out for dinner with your friends or even splurge at your favourite shopping malls not because you cannot afford to, but it is because you simply can't, due to the imposed MCO. As lockdowns are slowly being lifted across the globe, we see economic engines start to get re-invigorated.

As earnings season kick in for Corporate Malaysia, many are left fearing the worst. After all, the 2nd Quarter inevitably captures the full impact of the lockdown. We are keeping a close eye on the corporate reporting but in our view, 2Q GDP and corporate reporting should be the worst for 2020. We are looking forward to better numbers in the 2nd half of the year. There will be reprieve seen in the 3rd and 4th quarter numbers as the economy starts recovering from the effects of the coronavirus and lockdown.

Much to everyone's surprise, the local stock market benchmark-KLCI-has rebounded strongly. It is in now one of the best performing in ASEAN with a year-to-date (YTD) return of -1.5% at the time writing. Two sectors have led the way. Technology gained circa 40% YTD. But even this stellar rise has been overshadowed by the healthcare's whopping more than 200% increase, powered by the glove stocks. We have thankfully made the correct sector calls and positioned early for those.

As we navigate through the 2nd half of the year, we expect the trade war to be a lingering theme. However, as the largest and 2nd largest economies of the world trade barbs at each other, ignore the noise and focus instead, on the fundamentals. We would prefer to look at ways we could capitalise on the situation. For example, our local Technology sector is, in fact one of the beneficiaries from the trade war as both US & China build their own capacities and value chain.

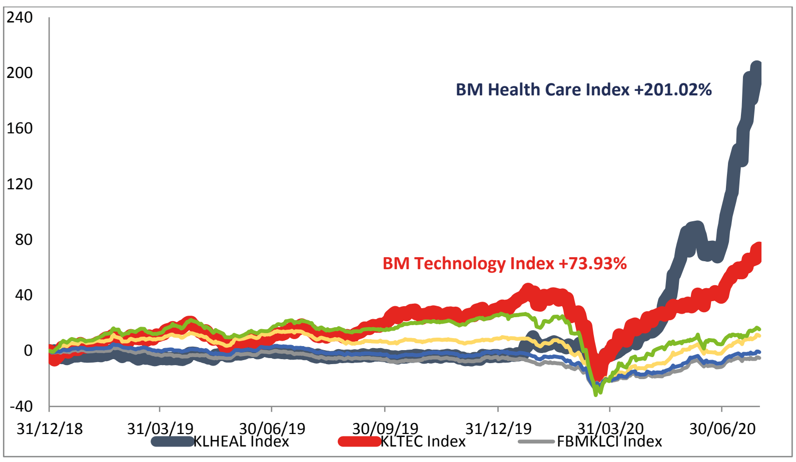
However, as markets continue to roar ahead, the worry is that if both the Healthcare and Technology's run eventually fizzles out, this would cap potential gains in the equity market. Not necessarily, in our view. We foresee some rotational play once the market is confident that there would be no more large-scale resurgent 2nd or 3rd wave cases – whether here or even globally. In other words, when investors are convinced that the worst has indeed, passed. The founding of a vaccine could, for example, catalyse this sector rotation.

Even as we speak, global central banks and governments continue to pursue easy monetary policy and massive fiscal stimulus programmes. In May, Reuters estimated that there have been $15 trillion worth of stimulus unveiled by the major economies. To put that into perspective, it equates to 17% of a $87 trillion global economy in 2019. In short, markets are awash and flushed with liquidity. This will continue to support and sustain the interest in equities. After all, with interest rates hovering at record low levels, where will the big banks and institutional investors go?

No doubt, there are some businesses or sectors that have been badly affected by pandemic but at the same time, there are also others that have benefited from that. We will continue to position ourselves ahead to take advantage of any prevailing opportunities. Within the potential rotational play theme, there are sectors that offer deep value in terms of valuation such as tourism/casino, banks, consumers and energy. We think that certain themes such as the future-proof theme with technology will continue to remain very relevant.

In our view, opportunities are ever-present if you know where to look – and even more so during a crisis.

Bursa Malaysia Health Care & Technology sectors outperformed benchmark KLCI by wide margin



Source: Bloomberg, extracted on 10 August 2020

Fixed Income
Market review & outlook
By Edward Iskandar Toh

The last six months has presented us an experience of a lifetime that very few could have imagined. A global lockdown of sorts to combat this scourge of a viral pandemic; so broad and deep has its impacts been that habits, lifestyles and paradigms shifts are occurring as we currently adjust and adapt.

Social norms, human relations and economic activities have been rudely jolted to the core that many believe can never return to what life was before.

By now, I believe everyone from all corners of the world would feel somewhat besieged by what appears to be bleakness of prospects ahead. The moment one turns on the television or radio or chance upon a newspaper, we would be overwhelmed by constant news of infections and deaths. There is almost no escape.

However, amidst the gloom, ironically fixed income markets enjoyed a fairly robust and fruitful year thus far as they benefit from the necessary drastic reduction in interest rates.

We began the year with the lockdown in Wuhan, the initial epicenter, where patient zero probably originated. I recall then that the world was complacent and thought that it would never happen to us. Then it began to spread to neighbouring countries, most in Asia took the conservative stance and emulated China in varying degrees of human mobility restrictions, thanks in part to our experience with recent epidemics. Meantime, western democracies watched and blamed. When the epicenter shifted to Europe, things became serious. Heart wrenching stories and videos of painful choices to be made by healthcare personnel on their patients surfaced. Meanwhile, the US watched and pointed their finger at others and thought that it would never come to their shores. Lo and behold, the first recorded patient in the US in January did not stir much attention. Even after the World Health Organisation (WHO) declared this a pandemic and a global emergency, the US remain preoccupied with politics. Until today their pandemic handling is in disarray with little coordination. The epicenter of spread shifted to the US in March. To date, almost 5 million have been infected with the virus in the US; almost a quarter of total global infections; and more than 150 thousand deaths. It now even appears highly irresponsible of the US to perpetuate the survival and continued spread of the virus while deflecting responsibility onto others. Similar to their concocted trade war with China that has dragged on for almost two years; the US are displaying a behavior akin to a fading superpower grasping at straws to stay above while attempting to suppress the rise of others.

Global central banks and their respective governments reacted promptly and necessarily by bringing out the cheque books and reducing borrowing costs. Fiscal discipline was thrown out the window with significant stimulus packages introduced to provide direct and indirect assistance. Interest rates were floored to soften the devastating effects of ravaged economies by reducing cost of borrowings.

Initially all long term government bond yields tracked central bank moves and yields were pressed down as the expectation of hampered growth filtered through. In March the reverse happened as knee jerk reactions by fund managers to convert assets into cash as quickly as possible and to bring them back to home base caused widespread sell off resulting in higher yields across the board. Emerging markets suffered a swift rush for the exit by foreign fund managers. Local investors and fund managers followed suit and hence the negative crunch by most fixed income funds.

The virus spread continued, economies shutdown, businesses closed, growth plunged and unemployment surged. Before long, the reality set in. Data pointed to retardation in economic numbers. Investors returned to fixed markets and flattened the yield curve.

The curious question now is: what is next? We are all hopeful for a vaccine or a cure to be discovered. The optimistic timeline of that is mass production of vaccines for them to be safely administered by end of this year or early next year.

With the widely speculative timeline in mind, we look for signs that may lead to a reversal of interest rates trend. Statistically, data will naturally turn positive by second half of next year when compared to the low base produced this year as restrictions loosen and commercial activities return. There is a chance sentiment will change by then. When sentiment turns upwards, confidence will translate to spending and in turn potential or expected inflation.

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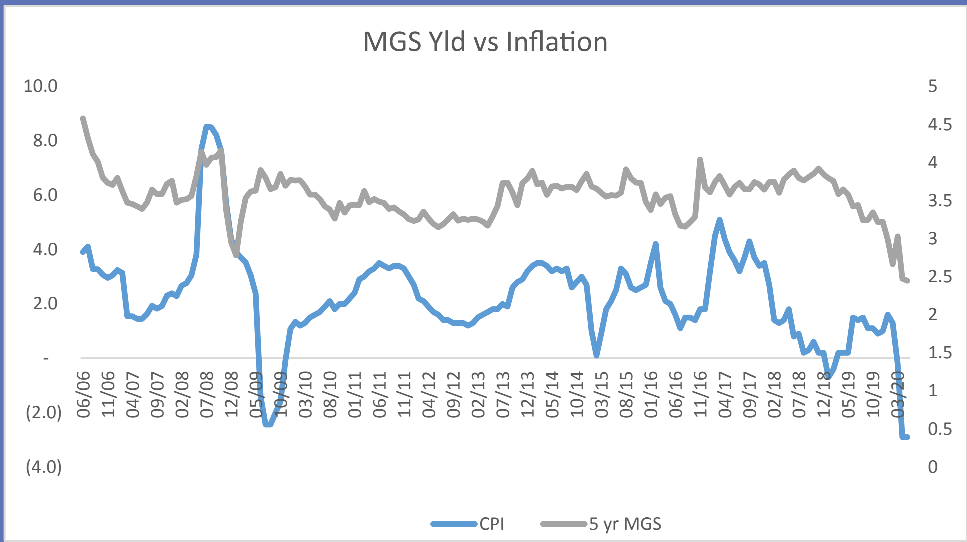
The one concern that usually spook central bankers is inflation.



The chart above plots Malaysian inflation (measured by Consumer Price Index) against 5 years Malaysian Government Securities (MGS) (benchmark with the deepest liquidity) for the last 15 years. Although correlation is a mere 0.3, it remains uncannily in sync. One can note from the chart that rising inflation can instigate higher yields. With limited room for rates to go down further, a conservative strategy would be to ride out this period of low interest rates environment by targeting duration that straddles past the start of the turn up in yields. This will help us climb up the yield curve as rates rise gradually in the future.

To some the impact of this unprecedented event has been devastating and permanent, to others it was an opportunity or enforced change. We may one day look back at 2020 covid-19 pandemic as a cursory read in Wikipedia or just a fleeting interjection, but for now we must stay safe and healthy and wait for this phase to pass. This could turn out to be the nudge towards the fourth industrial revolution afterall. Our survival instincts drives us to cope, adapt and excel. Much like our investments, we look forward to meander through this in the most successful way possible.

What?! This is the Fifth Parcel I've Received Today

Written by:

INVESTMENT TEAM

Since the outbreak of Covid-19 pandemic, it has forced almost every government in the world to enforce drastic measures. In Malaysia's case we implemented the Movement Control Order (MCO). Other countries also rolled out other similar measures in nature around the globe.

In the aftermath of the lockdown/MCO, the reality is that we will be seeing a different world. In this case, the most obvious one being the changing behaviour of the people, which in turn is accelerating digital transformation - be it the way of life or in workplace. In this section, we will examine the direction our society is heading post Covid-19 in order to better equip ourselves for these trends going forward.

GrabFood is here!

Can you relate to a situation where you decided to tune in a delivery platform to order your very first food delivery for dinner because you were bored (not because it was not delicious) with your wife's cooking during the MCO?

Maybe recently you found yourself seeing the postman more frequently. You realised everyone in your house has been busy sliding their phones, and before you know it, you find yourself busy collecting parcels.

Yes, you are not alone. E-commerce is getting prevalent. We do recognise that this is not something new, but covid-19 crisis has accelerated a change in shopping habits in a much more meaningful way.

We are all creature of habits, our consuming behaviour are well entrenched in our daily life. After all, why bother to change if I have been doing it alright, all this while? The MCO has forced us to try and take up new habits in view of safety and convenience. As people are realising the benefits that e-commerce can bring to their life, these new shopping behaviour are likely here to stay.

My Mother is Using Zoom!

I am sure (yes, I am very sure) everyone must have used, or at least heard of Zoom since MCO. Listed on NASDAQ in the US, this legendary company's share price doubled within 3 months at its peak since the virus outbreak.

It is human imperative to communicate. In light of social distancing, we are all learning new ways to connect, sparking the adoption of remote technology for work, entertainment and learning alike. As of writing this, my mother was using Zoom to learn dancing with her group of friends. This is a phenomenon that I would never had imagined before.

For business, the implications have been profound. Larger corporates to small-medium enterprises are definitely accelerating digital transformation to enable the Work-From-Home (WFH) process. This will not only be carried out as risk management against future threat of pandemic, it could well stick due to the benefits of remote technology in term of cost, speed and flexibility.

This will raise the demand of cloud computing, data storage and cybersecurity simultaneously. These trends might actually accelerate the demand for 5G to ensure mass web-communication without any latency and lag issue.

On the flip side, businesses also may be less reluctant to invest in swanky new offices and the CBD address since the space & location of the offices will be less important when employees are allowed to WFH. This likely will have negative implication on the office developers and operators.

Microwave your cash

Recall the recent news about a Korean man microwaving his money to disinfect it of Covid-19? This was likely due to the reports that there are chances of being infected through handling cash. People is likely to shun cash payment and shift to paying via electronic means such as e-wallet and online banking alike. After all, public health experts are urging businesses to stop using cash in an effort to limit spreading of virus.

Notwithstanding that, the ultimate driver that is accelerating the shift toward cashless society is the boom of e-commerce, which we have talked about above. Even in countries where online sales had been previously sluggish has seen remarkable growth in this space. Online shopping is tied with digital payment to make shopping experience seamless. As people shop online, digital payment would likely be ingrained in their spending behaviour. The people will bring this payment behaviour from online to offline shopping such as in physical stores.

Even before Covid-19 hit, Malaysia government has been trying to bring Malaysia toward a cashless society due to the paramount benefits of digital payment. While only about 20% of total payment in Malaysia are cashless transaction, the pandemic will serve as a catalyst for change toward cashless when cash would no longer be accepted as a means of payment. Even as we speak, the Penang government aims to adopt the e-wallet transaction. They are setting a June deadline for their public markets to go cashless.

Conclusion

The Covid-19 pandemic is not only a health crisis of immense proportion, its implication on businesses and industries is disproportional. Underlying this implication is a permanent restructuring of the global economic order.

On one side, the impact of pandemic induced change of behaviour is and will be catastrophic to many businesses. Some may experience a short-lived impact whilst the other will be affected permanently. For example, the lasting changes to consumer attitudes toward physical distance may point toward a change of dynamics between transportation modes. That means the deep and immediate demand shock of airline industry will likely take a longer than expected recovery period. Businesses will need to figure out how to operate in this new "normal". Perhaps, they should revise their business model, go online or omni channel.

On the opposite, technology and digital related business alike are the biggest winners. Today, out of the 10 largest market capitalisation companies, 7 are dominated by technology companies. These including Microsoft, Amazon, Facebook, Tencent and etc. As the world is moving towards more advanced technology and digitalisation, we will likely see the market capitalisation gap between technology and traditional companies to continue to widen.

With this in mind, the implication for investors are likely to take note that Investments from private and public markets will flow into technology sector.

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Returning to "New Normal"

Written by:

INVESTMENT TEAM

The Covid-19 pandemic, by and large brought with the risks that many companies and businesses are unaware of or neglected, once and for all. As we mentioned – Covid-19 is a demand and supply shocks, hence the disruption is paramount. A shock of this scale will create a drastic shift in the way businesses have traditionally operated.

As the lockdown/movement restriction begins to ease globally, many business leaders are navigating through the fog of uncertainty and thinking about how to operate in the "new normal". While how exactly this crisis evolves remains to be seen, we believe the following developments will likely be the new norm and practices of businesses.

Global Supply Chain Restructuring

The different timing and scale of COVID-19's impact around the world mean the global supply chains that cover multiple geographies now face disruption in a variety of different ways. Companies in industries that rely on global supply chain, are finding themselves vulnerable because they cannot get the parts they need. Even one small missing link can have crucial repercussions. In the auto sector, for example, a missing tyre would hinder the whole production of a complete vehicle.

Hence, there is a potential restructuring of global supply chain. Here are a few developments that we will likely see Post COVID-19:

• Companies may diversify their global supply chain across more countries to mitigate risk of disruption

• Potential of re-location of strategic suppliers and sourcing closer to production

• In a more extreme case, there might even be a re-localisation of production closer to end demand/user locations to fulfil self-sufficiency (reversal of globalisation?)

Even before COVID-19 hit, there were sign of protectionism emerging around the world. Within this context, we believe China, being the global factory would likely see some changes in her role in the global supply chain.

The COVID-19 crisis has shone a light on the over dependence on production in China. Perhaps going forward, we will be seeing situation like – China for China, others for outside China. This means, while the supply chain remained in China will be focused on producing for local market, many companies are likely to move out their supply chain from China to cater to markets other than China.

Supply Chain Management

For the same reason, we believe something are poised to change at the businesses' operating level. Companies will devise ways to incorporate operational resiliency through redundancy.

Perhaps supply chain built on Just-In-Time inventory sourcing may well have to be revisited, given the way many have been disrupted. Companies have come to realise that continuity of supply is just as important as cost and speed to market. In this case, companies will want to build inventory buffer.

Companies will also look at building redundancy in term of their procurement and sourcing. Identification of more suppliers will be inevitable. Instead of having a few tier 1 suppliers, companies may include tier 2 or even tier 3 suppliers to avoid future supply chain disruption.

Automation and Digitalisation

The consequences of lockdown restriction has provided businesses a better sense of what can and cannot be done in their traditional processes. One implication has to do with the unavailability of labour. With this comes the understanding of adoption of technology to drive productivity.

In the backdrop of the contact free economy, automation and digitalisation will be even more relevant. Manufacturing businesses will be embarking on automation and digitalising control & monitoring of such automated machines via AI and IoT. The needs for transmission speed means 5G would be the key enabler for such process to be seamless. As we discussed earlier, Work-From-Home will be a new norm. Businesses will also improve visibility across end-to-end supply chain via these advanced technologies.

In short, businesses are doing more with less, the COVID-19 is forcing both the pace and scale of operation and workplace innovation. In fact, Industry 4.0 is no longer a dream and COVID-19 is accelerating the transformation globally. It is becoming possible to imagine a world of business, from supply chain to production floor and finally to the hands of individual consumers, in which human contact would be minimal.

Conclusion

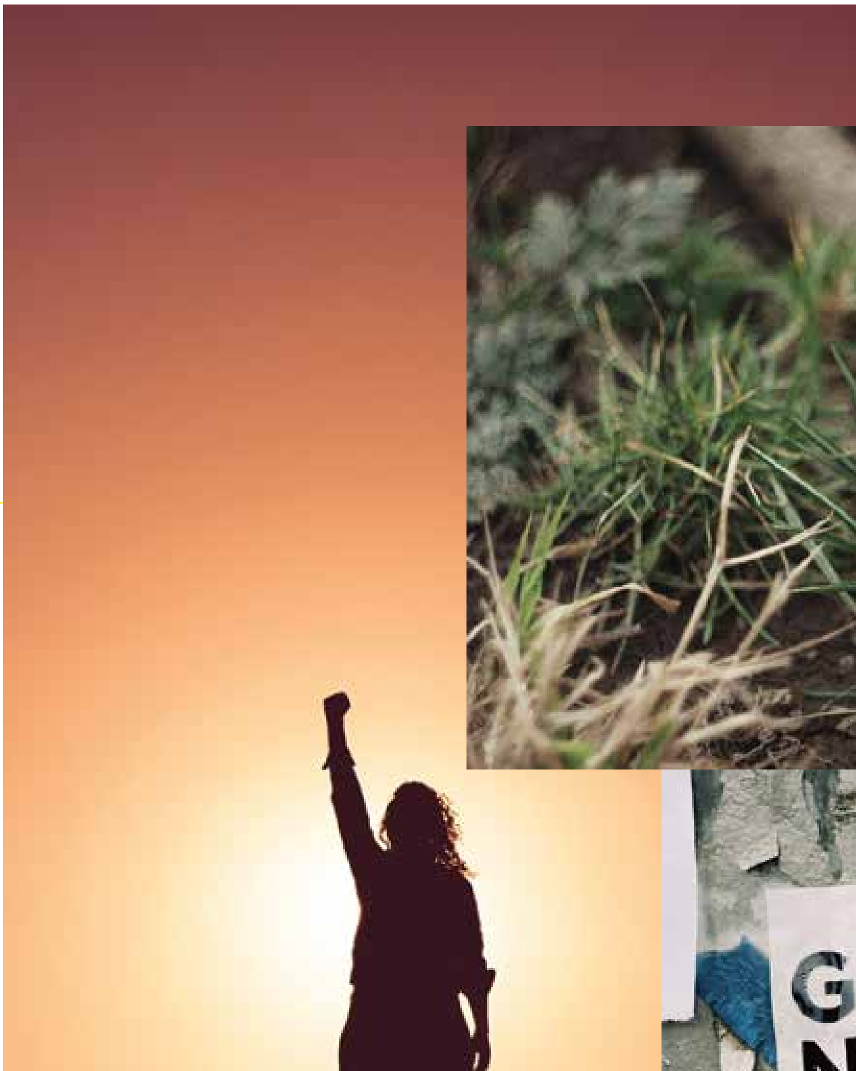
Implicitly, this crisis is revealing not just threats but opportunities to businesses globally. Take the above mentioned example, many would deem that the needed redundancy in supply chain management as well as automation would end up raising the capital of operating a business. For the astute business owners or management team however, these are opportunities. If implemented successfully, it will build a stronger foundation for growth in the years to come.

For now, while near-term survival may be the agenda for most businesses, what differentiates a first class business? In our view, it is one that will always figure out how to operate in new ways in order to come out of the crisis better than the competition. For this, the key lies within how resilient the company is in absorbing a shock while responding to changes confronting the industry it operate within.

The famous geologist and biologist Charles Darwin once quoted – "It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change."

APPROACHING A NEW ERA

In uncertain times, the future is not always bleak. As we focus on the times ahead, we can look forward to an ever changing advancement in our way of life.!



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