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THE YEAR WHEN A REBOUND IS IMMINENT

Smart Investor (December 2018)

By CS Cheah

The global economy is poised to be soft for the first half of 2019 before a turnaround can happen.

This year can be summed up as one of mixed fortunes for the global economy. While the US stock market has been a surprise package given its ability to stay afloat despite concerns over the bubble bursting, emerging markets are reeling from volatility amid a more hawkish US Federal Reserve policy, decelerating economic growth and the US-China trade tensions, among others. At home, the 14th General Election was a historic affair with underdog Pakatan Harapan pact emerging triumphant, thus getting the mandate to both administer and steer the Malaysian economy out of the doldrums. Insofar as the investment fraternity is concerned, the recently tabled Budget 2019 has provided some policy clarity, direction or even hint on how the first time- in-power government aspires to heal the wounds of the once Asian Tiger economy.

Amid uncertainties of sorts enveloping the global economy in recent times, one truly wonders whether there will be clearer skies in 2019. Or will 2019 remain turbulent? In short, what are the major obstacles/ challenges facing the Malaysian economy in 2019 and beyond? The following are views expressed by some prominent market players on the investment outlook for 2019:

KENANGA INVESTORS BHD CHIEF INVESTMENT OFFICER LEE SOOK YEE

Investors generally dislike uncertainty and have been cautious on the market given the roll-out of new taxes as well as changes in infrastructure plans that have negatively affected corporates, particularly the construction sector. While investors understand the government's intention to control spending, policy uncertainty and punitive taxes on businesses will discourage investment in the economy as businesses adopt a wait-and-see approach. Reduced investment will in turn lower economic growth and be negative for long-term development. As such, clear communication and consistency regarding policy direction and

intention are needed to encourage investors to return to the market. This includes reassurance from the government that it remains pro-business and has no qualms in rolling out policies that promote investment.

At the global level, two key risks that affected the market this year include the trade war and tightening global liquidity. As the trade war worsened this year, Malaysia was not spared as it is a highly open economy with China as a major trading partner. Secondly, emerging markets were also affected by tightening liquidity. Stronger growth and rising interest rates in the US attracted fund flows back and resulted in a stronger greenback. This reduced flows to emerging markets and triggered a liquidity squeeze with 'twin deficit' countries such as Turkey and Argentina suffering heavy currency depreciations given their reliance on foreign funding. Malaysia was not spared, given it is traditionally grouped alongside countries in the emerging market bloc. Nevertheless, the ringgit still outperformed regional currencies in view of Malaysia's current account surplus position.

Thriving on fundamentals

While it is usually true that there are opportunities in every crisis, it is critical to focus on fundamentals in order to determine the 'what' and the 'when' of investing. Although the US-China trade war has worsened significantly this year, there is still potential for President Donald Trump to initiate a classic 'deal' which would catalyse a short-term relief rally in the market. Considering Asian markets have corrected substantially, we think it is an opportune time to accumulate selected stocks which are trading at bargain prices (particularly those that will benefit from currency depreciation).

Nevertheless, we remain defensive over the medium-term as the US trade war can potentially be a long and drawn out affair given China is increasingly being viewed as a strategic rival in the US. There is increasing bipartisan support towards adopting a tougher stance on China and implementing non-tariff trade barriers. On the longer term, we would also look at companies that will benefit from potential supply chain relocation out of China into neighbouring countries.

That 2018 is shaping to be a highly challenging year has somehow brought down valuations and expectations for 2019. With the base and expectations being set lower, the probability for better returns has

thus increased. Specifically for Malaysia, 2019 will be year of gradual normalisation after having experienced major changes in 2018 both in terms of government and policy. As the new government finds its footing, we hope that a more stable business environment will translate into better returns for corporates. Globally, we remain cautious as the key risk of tighter liquidity and trade tension take time to play out. Thus, investors need to be more trading-oriented by buying on weakness and be disciplined in taking profits.

ALLIANZ MALAYSIA BHD CHIEF INVESTMENT OFFICER WONG SIEW LIN

It is inevitable that the entry of a new government would entail changes in administrative style and/or modus operandi. Given the country's fiscal constraints and the need for budgetary discipline, we believe the government has no better option but to optimise projects and/or implement targeted policies for the benefit of all stakeholders as well as to ensure long-term sustainability in certain sectors. Externally, headwinds such as the US-China trade tension, uncertainties over the pace of US Federal Reserve rate hike, reversal of global monetary easing, a slowdown in global and China's growth, a stronger greenback and heightened geopolitical tensions have weighed on emerging market assets. Market volatility has historically produced attractive long-term investment opportunities. However, investors need to remain vigilant given the highly uncertain and volatile environment. A full-blown trade war between the two largest economies in the world will have a negative impact on business and financial market sentiment. At worst, it could lead to a slowdown in global economic growth and heighten financial market volatility.

Foreign funds outflow

Foreign funds have been pulling out of emerging markets, including Malaysia. The bulk of the foreign outflows centred around May-June 2018 which could suggest that the sizeable sell-down was due in part to a near-term knee jerk effect on the back of the uncertainties that would normally arise from a government transition, more so this being the first in 61 years. Nonetheless, we opine that this is a somewhat transitory phase with a new phase of price discovery taking place soon, thus stabilising the outflow effect. The higher fiscal deficit of -3.7% in 2018 is a temporary diversion. The government has already outlined a plan to lower its budget deficit to -2.8% of gross domestic product (GDP) in 2021. It is imperative that the government reassures international rating agencies by following through with its fiscal consolidation plan. It is also noteworthy that the government has kept the current account balanced, i.e. with the government operating

expenditure funded through revenue instead of via increased debt. While foreign rating agencies such as Moody's and Fitch have recently raised concerns over Malaysia's elevated debt level, they also acknowledged efforts at being more transparent as credit positive on the country's profile.

We believe that the investment community will be relieved to note the absence of capital gain and inheritance taxes. However, the roll-out of selected taxes is a necessary evil and we do not doubt that they could impact certain pockets of investments. All-in-all, we would surmise that the taxes introduced are targeted and a requisite for long-term strengthening of Malaysia's fiscal position and social economic reform. In conclusion, 2019 is firming up to be a challenging year as market volatility is expected to remain elevated given the prevailing uncertainties both domestically and externally. Despite short-term volatility, Malaysia's long-term fundamentals remain intact. Investors should invest prudently in areas with good long-term growth prospects and avoid over-extending with excessive leverage.

FUNDSUPERMART RESEARCH ANALYST, JERRY LEE CHEE YEONG

As Malaysia is surrounded by numerous external headwinds such as the on-going US-China trade dispute, the tightening global liquidity and the slowdown in China's economic growth – coupled with mounting national debt internally – we believe Malaysia would depend more on the private sector to drive economicactivity in 2019. The country's high total debt and liabilities, which include government debt (RM725 bil), government-guaranteed debt (RM258.4 bil) and public-private partnership-related liabilities (RM82.3 bil), are among the government's main challenges.

Together with the widening fiscal deficit as well as the high reliance on oil-related revenue, we see a higher possibility of credit outlook downgrade (short to mid-term outlook) instead of credit rating downgrade (long-term outlook) by international rating agencies the likes of Moody's, S&P or Fitch. In order to prevent either credit outlook or rating downgrade, the government should reduce reliance on oil-related revenue to prevent the fluctuation in oil prices affecting the country's fundamentals.

Volatility and uncertainties aplenty

With the new government in power for the first time in 60 years, volatility and uncertainty are inevitable, prompting investors to shun the local equity market. Sectors such as plantation, materials, construction, gaming and telco have been negatively impacted by the latest government policies. We believe impact from new policies such as minimum wage or introduction of new taxes have already been factored into the recent stock market performance. Contrary to belief, we believe ASEAN economies might find some upsides from the escalated Sino-US trade tension on the longer term due to product re-location and trade diversion. Companies with manufacturing facilities in China would probably need to look for alternative sources and location to negate the effects of tariffs, hence ASEAN standing out as a beneficiary given its competitive labour cost and improving infrastructure. Looking at the foreign fund flow data, we observe that Malaysia is not the only market suffering from the strong foreign outflow (while foreign investors have sold RM10.37 bil of local stocks till Nov 16, Malaysia still has the second lowest foreign net outflow among four ASEAN markets monitored by MIDF Research).

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Internally, although the change in Malaysia's political landscape has brought about policy uncertainties which somehow triggered foreign fund outflow; this tends to be more short-term in nature as foreign investors await greater policy clarity from the new government. In our reckoning, the aggressive rate hike decision by US Fed which subsequently led to the strengthening of the greenback was one of the main reasons that contributed to the massive foreign outflow emanating from emerging markets in 2018. Frankly, we do not foresee lower volatility for 2019 as we believe the fore-mentioned external factors will continue to dominate headlines.

As such, we would advocate adopting a portfolio approach by staying invested as this allows investors to ride out volatile market periods with the potential to recoup losses and continue to make gains. For the Malaysian equity market, given the government's effort to support SMEs and the strengthening of the greenback, we believe investors can focus on small and mid-cap stocks for more profitable investment opportunity. In October, the local small- to mid-cap index slumped to a five-year low due to the global equities rout that affected investors' risk appetite. Hence, from the valuation front, the local small to midcap segment appears to be rather attractive with its fundamentals remaining intact.

AFFIN HWANG ASSET MANAGEMENT PORTFOLIO MANAGER LIM CHIA WEI

Emerging markets (EMs) started 2018 on a strong footing but subsequently weakened materially. Many were caught off-guard by how far the US-China trade dispute escalated, and how quickly EMs' economic growth slowed down. The slowdown began even before the negative impact of trade tariff took effect. There are three risks that stand out in recent times. The first is the event of a protracted and escalating geopolitical tension between the US and China. The geopolitical tension could evolve beyond trade to South China Sea territorial disputes. At this current juncture, we think the probability of such a bleak scenario is low. But it's something that we are keeping a close eye on. The second risk will be rising global bond yield in the US and its knock-on effect on global bond yield levels.

So far, rising bond yields have not created a significant problem. However, higher bond yields essentially make it more expensive for consumers to purchase property with a mortgage, as well as for businesses to fund their expansion through borrowings and for the government to fund fiscal spending. Those with excessive borrowings will find themselves squeezed in a rising bond yield environment.

The third risk will be sooner-than-expected US recession. In our view, a US recession is unlikely to take place in the next 12 months. But history has shown that it is hard to predict the timing of a recession. If the US were to go into recession, EMs would likely fall too. I wouldn't call these investment themes as such. But the current story could change some time in 2019. The current market narrative is “pessimistic EM sentiment”. I won't be surprised if the story changes in 2019 and market sentiment improves. History shows that the market eventually finds its bottom after pricing in all the risks. It is possible for EMs to find their bottom in mid-2019 and stage a rebound. However, it is important to emphasise that it is always hard to predict market sentiment correctly.

EMs still a decent asset class

EMs have been pressured in 2018 and will continue to face this pressure in 2019 as mentioned earlier. But it may not break Asian countries. Today, most Asian countries have stronger current account and much less foreign debt compared to 1997. So Asian countries are more resilient this time. The exceptions will be Indonesia and India. These two countries are more vulnerable due to their twin deficits. This time, it is the

non-Asian EMs that are more vulnerable. These include countries like Argentina, Brazil and South Africa which have a weak current account and rely too much on foreign debt. Over the long term, EMs will remain a 'decent asset class for global investors. All markets including EMs always have both sunny and rainy days. This year has been tough for EMs but it won't stay tough forever. For long-term investors, it will be beneficial to stick to their long-term asset allocation and sit through the down cycle.

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For long-term passive investors with holding power, sitting through the down cycle had worked out in the 2000 tech bust and 2008 Global Financial Crisis. It is likely to work out today and in the future. For active investors, the perennial question has always been 'when is the next global recession?' The US is in the late stages of an economic expansion. However, the current late-stage expansion can continue for another year or two. Based on current data, we don't expect a US recession in 2019. As such, I wouldn't be too pessimistic. However, it is hard to predict the timing of a recession and the consequential bear market. Investors should stay prudent, side with fundamentals and stick to recession-proof stocks.

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