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Equities still a good bet

Maybank Asset Management bullish on KLCI rebound moving forward as crude oil prices stabilise

by Dinesh Immanuel

LAST year was interesting in more ways than one. For Malaysians, it was painful as memories of three airline disasters continue to shock us. Then came the East Coast floods, which caused losses in the millions and untold loss and damage to property. Europe and Japan too continue to be in turmoil, while the Russian economy is teetering.

Despite the slew of bad news, more skyscrapers were built globally in one year than ever before. Rolls-Royce too sold a record 4,063 cars, its highest ever. Airline disasters also failed to rattle aircraft manufacturers, with both Boeing and Airbus having record deliveries and record new orders respectively.

In some ways, despite volatility in the stock markets, some yielded record performances. It was also a year for record stock market performances. Indices in the US hit all-time highs multiple times over the course of the year. Locally, the FBM KLCI hit its all-time high of 1,892.65 points on July 8, 2014. Unfortunately, it was downhill thereafter for the KLCI.

The second half of last year proved to be especially challenging. Declining crude oil prices and the sluggish economies in Europe and China cast a long shadow on the Malaysian economy and its capital markets. The KLCI fell over 10% from its all-time high. All this made it very difficult for fund managers seeking to derive value for their portfolios.

So in order to understand what strategies fund managers are employing moving forward and what market developments they are paying close attention to, we asked Maybank Asset Management Malaysia CEO Badrul Hisyam Abu Bakar.

Optimistic, Badrul is hoping that this year will be better than last year. "Surely 2015 has to be better," he says, setting the general tone in an exclusive email interview with ***FocusM***.

The following are excerpts:

FocusM: **What happened in 2014?**

Badrul: 2014 is a story of two halves, where the first half (H1) of the year was filled with bullish promising outlook while the opposite happened in the second half (H2). The bullish investment outlook also resulted in the KLCI closing at an all-time high of 1,892.65 points on July 8. However, soon after that, certain events and mostly external headwinds forced market participants to relook at valuations and reassess risks accompanying the equity market.

Foreign selling in anticipation of lesser liquidity (due to the third quantitative easing ending in October) continued to dampen our local markets, especially equities. The KLCI registered lower lows. The lowest point registered in December was 10.3% below last year's closing.

The already weak market sentiment was also affected by the retreat of crude oil prices, hence affecting our market's valuation. The year that was supposed to be stock picking turned out to be an asset allocation play towards the year end.

With the turn of events, the year-end (of 2014) was mainly associated with lower crude oil prices, with companies in the oil and gas (O&G) industries badly affected in this market. Some of the smaller and illiquid O&G counters have seen their market capitalisation erased by more than 50% with the fear that crude oil prices will continue to stay low for a considerable period of time.

Portfolios with overweight exposure in O&G stocks mostly underperformed, erasing all their outperformance during the first half of last year. However, blue chips in other sectors held up well. Some of the defensive and dividend-yielding stocks have gone up by more than 20% last year despite the negative returns of the main index.

Notwithstanding the negative impact on the portfolios' time-weighted rate of return (TWRR), our funds are still expected to achieve their respective required return on investment. This is mainly because we have realised most of the profits during the first half of last year. We also managed to ensure outperformance of the portfolios by overweighting fixed income exposure, which did not experience the severe selldown as compared to the equity.

Our fixed income mandates in general are less volatile. Our portfolios are structured to overweight credits to ensure sufficient yield enhancement, protecting against mark-to-market volatility in the Malaysian Government Securities (MGS) prices.

However, correction is inevitable. Considering that high crude oil prices which have market-inflated valuations, market participants may also have been in oversold position. They may have gone to the other extreme of 'over pessimism'. Hence, diligent preparation and market positioning for the eventual rebound is the key to ensure that portfolios enjoy optimum benefits and outperform this year.

What is your outlook for 2015?

The year 2015 will be welcomed with great hope as most market players had just left last year with a bitter taste. Surely, this year has to be better. Hence, we are excited in welcoming 2015 with renewed optimism in certain asset classes, recovery in sectors that were bashed down heavily last year and sectors that will still be resilient during the current volatile period.

In the near term, we believe investors should be in defensive and resilient sectors in H1 2015 pending recovery of oil prices. The main theme in H1 would be the overweight status of dividend yielders while still being defensive. We would also closely monitor the imminent recovery pattern of oil prices from its recent lows.

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>
> – Badrul

Beyond that, this year should provide more positive returns to investors as the country's economy is still in a good trajectory with expectation of 4% to 5% GDP growth and high single-digit corporate earnings growth. Our base case expectation of KLCI is at 1,826 points by year-end – a 5% upside. This is based on a 0.5 standard deviation of forward PE multiple of 14.5 times, which is quite reasonable, considering low expectation and sentiment of the market participants.

Which asset classes are expected to perform better in 2015?

For the past several years, since the market recovered in 2009, we were biased towards equity over bonds. This is based on steady earnings growth of corporates after the major correction in 2008. Our preference for equities is also due to fairly modest inflation, mainly as a result of generally accommodative monetary policy.

Bond yields are still low by any standard, especially in the wake of the impending US rate this year. With interest rates yet to normalise, we think that it is still too early to switch to fixed income, despite anticipated low inflationary risk. Notwithstanding our view to underweight fixed income, we are cognisant that fixed income remains an integral and relevant part of an investor's portfolio.

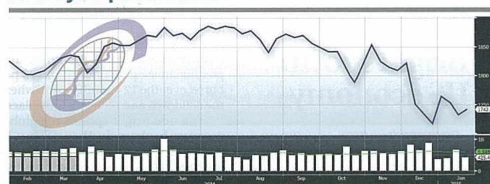
Hence, cushioning potential impact from the imminent US Fed Reserve rate hikes this year with higher yields from credits is a preferred strategy against holding government bonds, which seems relatively pricey at this juncture.

For Malaysian equities, a turnaround in the earnings revision cycle towards H2 this year should be a key catalyst for stocks valuations to revert to mean from their current low levels. Positive economic growth, low inflation and accommodative central banks should be a positive for (corporate) earnings. (This will positively impact) even laggard stocks which registered negative performance last year.

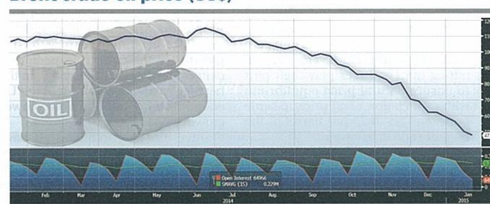
Modest and gradual interest rate hikes are likely to have a minimal impact on stock market valuations as expectation may not change aggressively. Stock picks remain with those companies possessing strong dividend policies and capital management, beneficiaries of infrastructure developments as they provide better earnings visibility. Selected O&G companies with medium term to long term earnings visibility, solid infrastructure and utilities players are in the buy list for alpha generation on recovery perspective.

With that, we believe that investors will be less pessimistic and should be more realistic when assessing investment options going forward. We hope this year will be a more fruitful year for our investors, with the three main factors that underpin our optimism this year are namely a recovery in O&G sector valuation, US recovery with less inflationary pressure, and further stimulus to contain the economic slowdown in Japan, China, and Europe.

KLCI 1-year performance



Brent crude oil price (US$)



Source: Bloomberg

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Bright spot in US economy

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What are the factors to be optimistic about the market?

Low crude oil prices may not last beyond six months. The O&G industry is now adjusting to cuts in capital expenditure for oil exploration and production activities and lower drilling permits for shale oil. The Saudi Arabian government has insisted on letting market forces play their part to ensure natural price equilibrium with expectation of oil price to settle between US$70-75 per barrel in the medium and long terms.

Some smaller high-cost oil producers, especially shale oil players will have to cut down or stop production due to the low crude oil price. The recent historic oil price low only lasted for a few weeks before rebounding and posting an average price of US$75 per barrel over the 12-month period where the selldown and recovery took place.

The one bright spot in the global economy has been the United States. In the US, consumers are the main drivers of growth. They are likely to stay positive this year since lower oil prices – hence lower household costs – may translate into higher consumer spending power. Real discretionary income will rise. Employers are on track to add the most jobs in coming years with GDP growth for the country expected to deliver above average numbers in the next few years. In some ways, the US economy may benefit from slower growth globally.

Investors in search of safety have poured money into US Treasuries. They helped hold down inflation and US loan rates. Lower rates, in turn, could fuel more home sales and construction this year. Consensus expectations are for a US rate hikes in mid-2015. However, muted inflationary risks due to the decline in commodity and oil prices may not push the Fed to raise rates.

The European Central Bank remains highly accommodative. It is committed to ensuring banking system in European Union (EU) is intact to avoid any systemic risk to all EU nations. Fairly positive bank stress test results recently should overwhelm banking sector concerns, which may translate into credit growth.

There is plenty of room for growth to bounce back in Japan even after slipping into recession in Q3 last year, and also in Europe too which only posted a marginal quarterly expansion also in Q3. China, too, may not be able to maintain consistent 7% GDP growth for the next few years.

However, as growth engines in all of these economies have faltered for much of last year, therefore this year is likely to be a year of recovery for them. FocusM