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Tapering likely to cast long shadow on global markets next year

FocusM speaks to two locally-based fund managers to understand their strategies for 2014

by Dinesh Immanuel

THE possible impact of the tapering of the US government's economic stimulus package will likely continue to feature prominently in local and global markets.

According Maybank Asset Management Group Bhd (Maybank AM), the continued debate on the US government's tapering strategy will continue to cast its long shadow on local and global markets. "More importantly, potential quantitative easing (QE) tapering by the US Federal Reserve remains a big overhang to global asset markets and [the] KLCI is not immune to this," says Maybank AM CEO Nor' Azamin Salleh.

Scotland-based Aberdeen Islamic Asset Management (AIAM) Malaysia CEO Gerald Ambrose agrees that the QE's removal will be a major impact. "The main risk I see for this year is the removal – or even the threat of the removal – of quantitative easing (QE) in the US. I do believe that the side effects [of the removal of] QE is almost desperate search for higher returns in emerging markets," says Ambrose.

Asset managers have a tough job of navigating both global and local economic challenges to make the right investment decisions. As of June 30, according to the Securities Commission, there are 81 fund management companies in Malaysia with some RM555 bil in assets under management. As such, asset management houses have a significant impact in playing and riding the market, be it equities or the fixed income market.

In an email interview, ***FocusM*** corresponded with Nor' Azamin Salleh and Gerald Ambrose to better understand their perspective on the Malaysian economy.

Maybank AM and AIAM, which together manage some RM29 bil worth of assets, share their thoughts on how the markets have performed in 2013 and what's in store moving into 2014. They share each of their asset house's investment portfolios for 2013, the global and local economic risks faced, challenges overcome, and their strategies in the year to come.

Has your investment strategy in Malaysia changed over the course of the year?

Azamin: Maybank Asset Management's investment strategy in Malaysia in early 2013 was to overweight sectors that would benefit from pump-priming via the Economic Transformation Programme (ETP) and as well as conducive credit and accommodative liquidity environments such as the banking, construction, oil and gas, and property sectors.

Year-to-date, these themes have played out reasonably well. However, more recently, the government has responded via various measures to manage the priority of growth in view of rapidly declining current account surpluses as well as pockets of over-exuberance in the property sector. As such Maybank AM has positioned itself to underweight the property sector and selectively choose construction players that will benefit from 'prioritised' pump-priming programmes.

Azamin ... we will selectively choose construction players that will benefit from 'prioritised' pump-priming programmes

Ambrose: Aberdeen Asset Management's investment strategy for 2013 is exactly the same as it has been for the past 30 years, where we employ the same stringent quality criteria in selecting investment opportunities and managing our existing investments.

How does your investment strategy pan out moving into 2014?

Azamin: The Malaysian economy is expected to grow at a decent pace going into 2014, despite having to bear the brunt of rising electricity prices following the recent tariff hike. More importantly, potential quantitative-easing (QE) tapering by the US Federal Reserve remains a big overhang to global asset markets and the KLCI is not immune to this. Maybank AM is reasonably confident that the Fed is fully aware of the reaction to its unwinding policy and as such, any tapering would be carried out in a gradual manner in response to the underlying strength of the US economy. As we speak, the market has already begun to price in this possibility.

Ambrose: As Aberdeen's investment process does not involve top-down analysis, the macroeconomic outlook is not really a factor for us. Nevertheless, it is becoming more difficult to find companies on Bursa Malaysia which really meet our valuation criteria as there has been quite a market re-rating all over the world, possibly caused by loose monetary policy worldwide.

What sort of risks do you foresee markets facing in 2014?

Azamin: In terms of equity markets, the key macro risks here would be the impact of the Federal Reserve monetary policy on Asian currencies and foreign exchange, which could result in spillover effects in the equity markets, and global growth falling short of expectations. For Asian markets, earnings growth has to come through in order for the markets to outperform. While Maybank AM expects markets to be volatile during this period [in the near term], there would be opportunities for bottom-up stock picking. This is where Maybank AM's bottom-up focus would come to the fore in 2014.

As for fixed income markets, we end 2013 with the Federal Reserve deciding to initiate QE tapering on Dec 18. Maybank AM has been expecting QE tapering since early 2013 given the progressively improving key US economic data. Going into 2014, concerns remain with the speed and scale of the implementation of the tapering as well as the market reaction to it. In addition to the decline in Treasury bond-buying by the Federal Reserve post-tapering, there is ongoing momentum of fund flows rotating from fixed income into equities. The risk is this rotation may turn into a longer lasting trend as reflected by previous multiyear bond inflow and multiyear equity outflows in the past six years. This rotation may bode well for equities as seen in the new highs in US equities and likely to be negative to US Treasuries.

Ambrose says it's becoming more difficult to find companies on Bursa that meet Aberdeen's valuation criteria

These factors collectively set the backdrop for a net decline in demand for US treasuries and bonds in general, which may spill over into the Malaysian market as seen recently in the redemption by foreign investors in Malaysian government securities (MGS), albeit more limited in the domestic corporate bond market. While this would likely cause market impact, the economic impact to Malaysia is generally expected to be positive due to the improving global economic climate and expectation of stronger exports fuelled by a recovery in the developed economies.

Ambrose: The main risk I see for this year is the removal – or even the threat of the removal – of QE in the US. I do believe that the side effects (from the removal of) QE is an almost desperate search for higher returns in emerging markets which is often in the form of the "carry-trade", where an investor borrows a lot of US dollars or [Japanese] yen and converts them into emerging market currency assets which offer a higher return. [The risk is] that our currency, our sovereign bonds, and our equities could suffer a sharp correction if this "carry-trade" is suddenly reversed.

How do you see the bond market performing in 2014?

Azamin: Maybank AM is an active investor in the Malaysian bond market, being a manager of one of the largest financial bond funds, which we have positioned for any potential sell-off by lowering the risk in terms of duration to below four years and increasing cash buffer to above 15% to take advantage of more attractive bonds from the new issuance market as well as to mitigate redemption risk.

In 2014, we expect the corporate bond market to continue to achieve positive returns of 3-5%, depending on the influence of the Federal Reserve QE tapering as well as negative fund flows. The return range for domestic corporate bond is expected to be more stable vs government bonds due to the lower foreign ownership of about 9% of all corporate bonds as compared to about 43% for government securities. Within domestic corporate bonds, we find that there is better value in the new bank subordinated papers rated at AA2 or above, which at about 4.7-4.8% yield for a five-year bond, is well above similar-rated non-bank papers of similar rating and maturity, which would generally be below 4.2%.

Ambrose: Aberdeen has a significant amount invested in Asian local currency bonds for its clients, much of it in Malaysian government securities. The yield on the long end of these securities has been volatile and could continue to be so if "hot" money rushes out. Nevertheless, we are more of a long-term investor and take a bottom-up view of bonds as we do for equities.

What are your views on potential risks in Malaysia's economy?

Azamin: Malaysia has always been a pro-growth nation and we expect this to continue with some fine-tuning to the overall competitive structure of the economy; for instance, gradual unwinding of unhealthy subsidies that we have seen in recent times on the price of petrol and electricity. In the short term, the economy will have to deal with a higher level of inflation but this will be at the benefit of putting the house in better order over the medium term in terms of our fiscal budget, current account balance, and sustainable government and household debts.

Ambrose: God has been kind to Malaysia so far in that we have had no earthquakes, tsunamis or typhoons, no coups, no real street riots, no 'yawning' deficits, and for this we should be thankful but not over-relaxed. For it is the latter which could be our Achilles' heel.

How does your investment strategy in Malaysia differ from that in other markets in the region?

Azamin: There is essentially no difference in the investment approach in Malaysia versus other markets in the region. The minor difference in Q4 2013 is that Maybank AM is slightly more overweight on equities in Malaysia versus the rest of the region given that the Malaysian market is well-supported by domestic liquidity.

Ambrose: Aberdeen's investment strategy is exactly the same all over the world. However, our investment process might produce different portfolios in different markets, for example, a small island republic like Singapore tends to have more service exporters while Thailand might have more stocks exposed to the automotive industry. FocusM