

A good time to rebuild exposure



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On currency, we expect the US inflation data could provide much needed relief to the ringgit. We think there is some room for the ringgit to strengthen if the market pricing of the Fed rate hike is diminished.

THERE have been two surprises for the financial markets this year. The US economy has been more resilient than expected; and China's economic reopening has been very underwhelming. The American economy, fuelled by a resilient labour market and strong consumer demand is doing well despite the fastest interest rate increase over the last 40 years.

That left most investors, who were expecting the US to enter a recession in the 2H 2023, surprised. The strength in US consumers has been driven by high excess savings and a tight labour market. About 90% of US mortgages are also on fixed rates, hence the impact of higher interest rates is not as severe compared to other parts of the world.

China's economic reopening, on the other hand, has seen weak consumer sentiment and a sluggish property sector.

Against this backdrop, the growth outlook for the 2H 2023 remains uneven across various major economies. The global purchasing managers index (PMI) reveals a contrasting trend between services and manufacturing sectors, with services showing expansion while manufacturing remains in contraction.

This pattern is not surprising, considering the pent-up demand for services like dining out and tourism, whereas consumer spending shifted towards goods during lockdown periods.

However, things can change. The US growth is expected to decelerate as the cumulative and delayed effects of the Federal Reserve's (Fed) interest rate hikes broaden out.

The excess savings from consumers has also been gradually drawn down. Current labour market indicators, economic data and the inverted US Treasury curve suggest that the US could enter a shallow recession in the 1H 2024.

A deeper recession also cannot be ruled out if the Fed continues to hike interest rates aggressively.

On the other hand, China's economy may see more policy support being announced to spur growth and support its property sector in 2H 2023.

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After embarking on a rampant fire-fighting exercise to douse price pressures, the Fed's long-battle against inflation looks to be almost over. The latest inflation numbers could give the Fed some breathing room as it may show that its policy is having the desired effect of successfully lowering down inflation, while maintaining strong economic growth.

The CPI reading for June came in at 3% y-o-y which is in stark contrast to 9% y-o-y back in June 2022. We believe that US inflation has peaked and there has been significant decline on the headline CPI.

This has mainly been driven by a sharp fall in energy prices and weaker demand for goods. Stripping out volatile food and energy prices, core CPI rose 4.8% y-o-y and 0.2% m-o-m which was below expectations. Investors had anticipated June core CPI to increase 5% y-o-y and 0.3% m-o-m.

Nonetheless, the core inflation figure is still running well above the Fed's 2% target. One of the major components of CPI has been shelter costs, which has not come down meaningfully. The shelter index rose 0.4% last month and was up 7.8% on an annual basis.

That monthly gain accounted for 70% of the rise in headline CPI. The Fed expects the inflation rate to continue falling, particularly as shelter costs ease.

During the pandemic, interest rates were at historically low levels and were then jacked up rapidly. This did not only reduce housing demand, as intended by the Fed, but also significantly constrained supply by effectively locking owners in their proper-

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ties, preventing them from listing their homes for sale.

At its recent FOMC meeting in July, the Fed moved to raise interest rates by another 25 bps which was mostly priced-in.

However, expectations are that this would be the last increase as the Fed pauses in its September's FOMC meeting to allow the series of aggressive interest rate increase of over 500bps to filter through the economy.

For the Fed to end its rate hike cycle, it would need to see core inflation trending much closer to its 2% target and for labour market conditions to ease in the 2H 2023.

In Malaysia, we expect growth to moderate in 2H 2023 on the back of a deceleration in global growth and a high base effect in 1H 2023. We think Malaysia's GDP growth will come in at about 4.5% to 5.0% in 2023 after a very strong 8.7% growth rate in 2022.

Similarly, exports growth could come in lower at 2.0% to 3.0% for 2023 vs 14.5% last year. This decline can be attributed to multiple factors, including the base effect from the high growth of the previous year, the overall slowdown in the global economy, challenges faced by the electronics industry and the downturn in commodity prices.

The commodity and manufacturing sector remains weak, while tourism and travel-related services should perform well. We also expect a sustained recovery in private sector investments.

The US inflation data could provide much needed relief to the ringgit. There is room for the ringgit to strengthen if the market pricing of the Fed rate hike is diminished (due to

lower inflation or weaker job data). Another potential catalyst for the local currency could come from a stronger yuan, which may be driven by the announcement of bolder stimulus measures by Beijing. Given these factors, we anticipate a trading range of US\$1:RM 4.40-4.70 for 2H 2023.

The risks to inflation do appear to be balanced from a local setting, though this will be subject to changes in subsidy policies as the government moves to rein in debt and narrow its fiscal deficit.

Bank Negara Malaysia (BNM) is expected to maintain the overnight policy rate (OPR) at 3.0% for the rest of the year, keeping its eye on other financial market developments.

Given how much bond yields have risen over the last two years, we have increasingly turned more constructive on the outlook for bonds.

With the US interest rate hike cycle likely at its tail-end in 2H 2023, bonds are in a sweet spot for investors seeking attractive returns. This favourable backdrop becomes even more pronounced as we enter the next rate cut cycle in 2024 and beyond.

For government bonds, there are attractive opportunities in US and Australia which is much closer to the end of its rate hike cycle. The same goes for emerging markets including Asian local currency bonds as most central banks are done with their rate hikes.

When it comes to credit, we prefer investment-grade (IG) over high-yield (HY) bonds. Both US and Asian IG bonds offer attractive yields ranging from 5% to 7%, allowing investors to achieve decent returns without excessive credit risk.

While Asian HY bonds are currently trading at discounted prices primarily due to the distressed property sector in China, we anticipate a gradual recovery in property sales over time.

In the local bond market, there is likely to healthy demand for domestic government bonds from foreign investors as seen in the strong bond inflows YTD. The same can be said of major local institutional investors.

Recent domestic corporate bond issuances have garnered strong interest from investors due to the attractive yield. Moreover, it is worth noting that the supply of corporate bonds has been relatively lower compared to previous years, and that should provide strong technical support.

Inflection points in markets are pointing towards a more favourable environment for fixed income.

While timing market opportunities precisely can be challenging, a global portfolio that is diversified across the bond spectrum including duration, credit quality, sector and country exposure can help investors reap an attractive risk-adjusted return.

With the convergence of these factors, now may be an opportune time for investors who have been on the sidelines to gradually rebuild exposure.

They could harness yields to generate a stable income stream as well as earn potential capital gains.