FUNDAMENTAL FLASH

2023 Mid-Year Outlook | Charting the Course

Prepared by AHAM Asset Management

It's been a bumpy 2023 with a flurry of events keeping investors on their toes. From banking turmoil, mysterious spy balloons and debt talks, markets have been on a whirlwind.

While conditions are expected to remain shaky, a turning point does seem closer at hand.

In our latest Fundamental Flash, we unpack the key investment themes that could shape the second half of the year.

Inflation Should Ease

After embarking on a rampant fire-fighting exercise to douse price pressures, the US Federal Reserve's (Fed) long-battle against inflation looks to be almost over. After 10 consecutive rate hikes of 500bps, we believe that the Fed is nearing, if not at the end of its current rate hike cycle.

Since reaching its peak of 9.00% in June 2022, headline inflation has eased to 4.00% in May 2023. However, core inflation remained relatively sticky at 5.30% as shelter costs remain elevated.

Nonetheless, we anticipate the presence of various disinflationary factors that could help quell price pressures.

Over the next 12 months, we expect inflation to maintain a downward trajectory as goods and energy prices stabilise. Furthermore, leading indicators like the Zillow rent index and home median sales price indicate a potential decline in shelter costs from its current y-o-y pace of 8.00%.

Flashpoints

- Inflation seen decelerating with the Fed maintaining Fed funds rate below 5.5% to achieve a soft landing.
- Current base-case is a mild recession as tighter monetary policy kicks-in. However, downside risks could exacerbate the slowdown.
- Waning USD strength will be a boon for Asian equities as Fed reaches the tail-end of its tightening cycle.
- Taiwan and Korea stocks well positioned to benefit from a recovery in the semiconductor space and advances in AI.
- Despite lagging behind peers, China equities warrant a closer look due to attractive valuations. Accommodative policies should also aid recovery.
- Reduced pressure on the MYR and increased political clarity are tailwinds for Malaysia. However, reforms must continue to attract FDIs and strengthen fiscal position.

At 5.25%, the Fed funds rate is already at a restrictive level. Assuming our inflation view pans out, we believe that the Fed funds rate will stay below 5.50%, which is roughly in line with the FOMC's median rate projection by end of this year.

We believe the Fed would err on the side of caution, preferring to maintain rates at this level instead of continuously hiking rates in order to achieve a soft landing. The key risks is if we see a wage spiral effect resulting in a much stickier or even a resurgence in inflation.

That being said, looking at the medium-term, our base-case is that of a gradual global slowdown as monetary policy filters through the real economy. We anticipate an increase in the unemployment rate coupled with the absence of a wage spiral. Consequently, this should lead to a gradual decline in inflationary pressures.

Mild Recession, But Caution Needed…

The case for a hard-landing recession appears to have been dwindled as the US economy maintains its resilience. Excess savings and unleashed demand post-pandemic helped to fuel the services sector, bolstering US gross domestic product (GDP). The labor market remained robust with the unemployment rate holding steady at 3.70%.

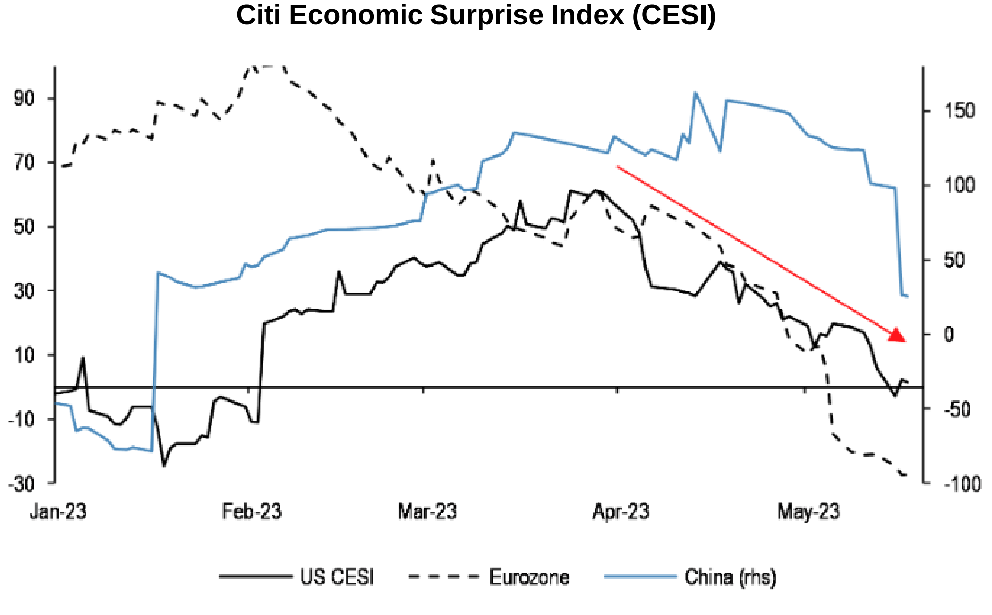
However, there are important signposts that bear watching. Companies are already trimming capital expenditure and work hours, with a slight increase in the unemployment rate. Additionally, regional banks are still facing pressure from deposit outflows.

Similarly, we are closely monitoring the commercial real estate loan sector as default rates are on the rise. Granted, these concerns are mitigated by a robust US housing market, characterised by low inventories and relatively low leverage in both the household and corporate sectors.

In the mid to long-term, we believe that the strength the US economy would start to dwindle and experience a gradual deceleration in the coming months, but a hard landing recession is not within our base-case. Instead, we anticipate a mild recession as the impact of tighter monetary policy begins to bite.

However, it is crucial to acknowledge the presence of various downside risks that could change our view on how deep or shallow this recession could go.

Graph 1: Economic activity is slowing



Source: J.P. Morgan Research, as of 21 May 2023

Bright Spots in Asia

It has been a mixed bag for Asian markets so far in terms of performance. The broader MSCI Asia Ex-Japan posted a gain of 3.20% *(Source: Bloomberg, as at 22 June 2023)*. Among the Asian markets, China experienced a decline of 6.70%, as tailwinds from its post-COVID reopening wanes. On the other hand, Taiwan and Korean notched impressive gains with both markets up 20% and 18% respectively.

Looking ahead, we expect market conditions to turn more conducive for Asia. With the end of the rate hike cycle nearing, the US dollar strength may subside and this may be a boon for Asian markets. Historically, the performance of Asian equities has been inversely correlated with the US dollar.

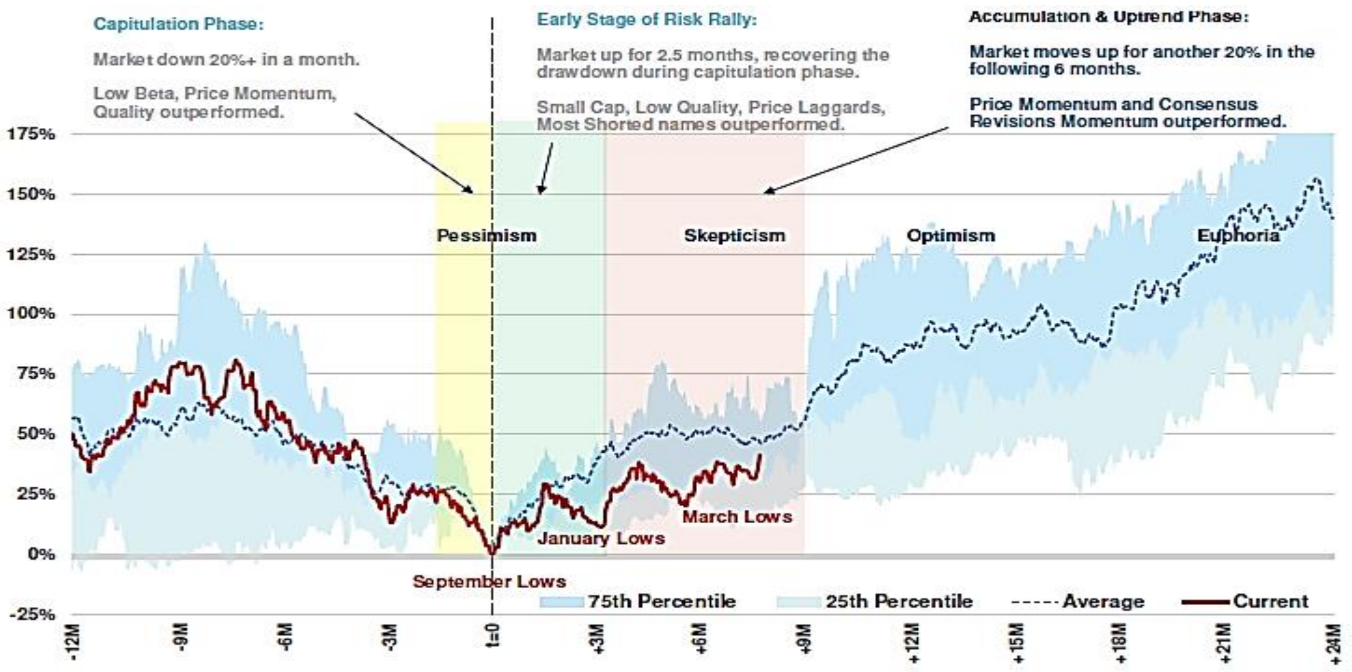
A prevailing environment of relatively lower interest rates in Asia should also set a favourable backdrop for companies in the region and help support higher growth rates and earnings. In contrast to developed markets, inflation has been more broadly benign in the Asian region with no need for the aggressive monetary tightening seen in the US and Europe.

For instance, the recent consumer price index (CPI) print for China was subdued at only 0.20% y-o-y, while the producer price index (PPI) plunged to -4.60% marking its lowest level since 2016.

For our portfolios, we like the consumption recovery theme as more countries start to see consumption patterns normalise post-COVID. This is also a structural theme driven by higher urbanisation rates and a rising middle-class as seen in countries like Indonesia and India, where we are positioned through banks and consumer stocks.

Additionally, we see opportunities in semiconductor companies as the sector is poised to reach a near-term cyclical bottom. The sector also stands to gain from the rise of spending in artificial intelligence (AI) which is still in its infancy but presents a multi-year theme with strong potential. Given the significant exposure of countries like Taiwan and Korea to the semiconductor sector, we believe they are well positioned to benefit.

Graph 2: Korea and Taiwan Driven by Semiconductor Bottoming Thesis



Source: FactSet, Morgan Stanley Research. Note: the chart shows historical average of memory stocks daily returns since 1995 (blue dotted line) vs. current cycle (red line).

Source: Morgan Stanley, as of 23 May 2023

China Still Worth a Look

Softer economic growth data has weighed on sentiment of China equities this year. However, attractive valuations do present attractive entry points to add exposure.

Valuations have experienced a notable decline over the past two years as reflected in the MSCI China index which currently trades at a price-to-earnings (P/E) ratio of 10.00x, below its 10-year historical average of 11.30x. Considering a potential normalization of the P/E ratio, we anticipate a favourable upside potential of around 13.00%.

While many other countries have been engaged in interest rate hikes, China has done the opposite by implementing rate cuts. This should filter through the economy and help spur a rebound. In the past month, there has been a growing recognition from Beijing that economic momentum has dwindled. This has prompted a shift in policy tone from Beijing on the need for more concerted stimulus measures.

Malaysia Awaiting Clarity

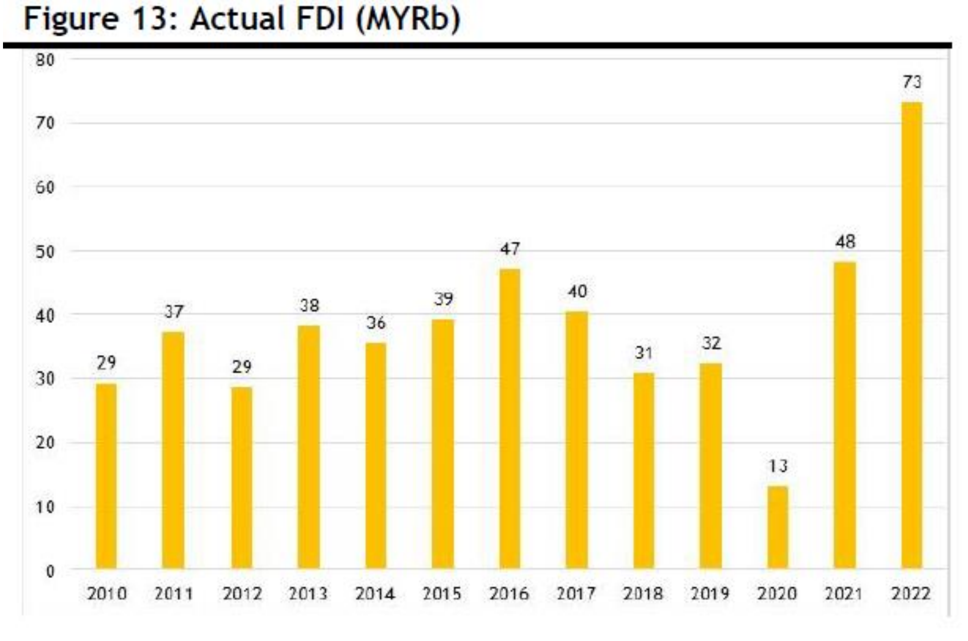
Foreign funds have exerted significant selling pressure on the Malaysian market this year, resulting in lacklustre performance. The market has faced challenges due to a weaker Ringgit and political uncertainty, which have hindered any substantial breakthroughs.

However, we anticipate a turnaround in the 2H'2023 following the conclusion of state elections, which will provide greater clarity on the stability of the unity government.

With a stable government and accommodative policies in place, we anticipate an increase in foreign direct investments (FDI), which will boost market sentiment and provide support to the Ringgit. Notwithstanding macro noises, the domestic economy continues to display resilience, as evidenced by its solid GDP showing.

Current valuations are also favourable with the KLCI being among the most attractively priced in the region and historically on a P/E basis. Once there is greater political clarity, we expect foreign outflows to reverse providing support to markets. Additionally, as the Fed nears the end of its rate hike cycle, there will be reduced pressure on the movement of the Ringgit.

Graph 3: FDI Is Key Given Tight Fiscal Space



Source: CEIC, Department of Statistics

However, it would be also important to see continuous reform measures to instil strong governance and fiscal discipline. The ongoing subsidy rationalisation is crucial in enlarging our fiscal buffers and narrowing our deficit. Alongside public expenditure, the government should continue to prioritise business-friendly policies to incentivise private sector investments which is an area that has shown progress under the new government.

Collectively, these measures will contribute to a stronger economy and a recovery in corporate earnings that serves as key catalysts for the local market.

On portfolio positioning, the bulk of our position is in quality large caps and these names are the prime beneficiaries when foreign flows return to Malaysia. Besides that, we favour healthcare sector which should see strong earnings growth driven by elective surgeries and medical tourism.

Bullish on Bonds

Bond investors would be sufficiently compensated from the yield carry, considering the upward adjustment in bond yields witnessed over the last 2 years. Investment Grade (IG) bonds, on average, offer yields ranging from 5% to 6% in USD, while yields hover around 4% to 4.5% in MYR terms. Furthermore, bonds have historically demonstrated resilience and tend to outperform in a decelerating growth environment.

As the Fed approaches the tail-end of its tightening cycle, we anticipate a potential stabilisation of bond market volatility. This would bolster the defensive attributes of fixed income as a valuable hedge against equity.

In our base-case scenario of a mild recession, we anticipate a continued rise in default rates. Consequently, our preference lies with Investment Grade (IG) bonds rather than High Yield (HY). Within the IG space, we favour sectors that have shown resilience during economic slowdowns and are less susceptible to geopolitical shocks.

We are wary of credits that are highly leveraged credits, as they face elevated risks associated with refinancing and repayment. We remain vigilant of such risks and prefer credits with more favourable risk profiles for our bond portfolios.

***