6 February 2014 | Strategy

World equity market

Do not worry – it is climbing the wall

FBM KLCI: 1,785.88

(2014 Year-end Target: 1,900 points)

The world is transitioning to a more normal monetary as well as macro environment. The US Fed is slowly taking away the QE3 liquidity punchbowl with the pace of monetary normalization "tied to what happens in the economy". While the recovery in advanced economies has thus far been rather measured, nonetheless it is also uneven at times hence the transition process will not likely be smooth and predictable. This uncertainty may contribute to intermittent heightened volatility in the world's risk asset prices.

In our Strategy note dated 28 June 2013 (para 4&5), we alluded to the following outcomes in light of the normalizing monetary and macro environment:

> There are instances, principally during a period when the real economy is gaining on its recovery traction, wherewith the trend in equity prices might turn out to be flat and even scaling up against the backdrop of rising interest rates or of the perception thereof. This is due to positive numerator effect with regard to corporate earnings. In technical parlance, this situation could be dubbed as <u>the market "climbing the wall of worry"</u>. *[emphasis added]*
>
> Therefore, the QE3 taper may have brought heightened liquidity risk premium to the broad equity valuations. Nonetheless, despite the higher cost of capital denominator, expected rising income stream as a result of brighter economic conditions may, <u>all in all, be positive to equity secular pricing dynamics</u>. *[emphasis added]*

Scaling up the "wall of worry". Accordingly, major equity markets particularly in the US and Euro region scaled up the "wall of worry" with gusto as evident by spate of new all-time (US indices) and multi-year (Euro indices) highs in the final quarter of last year. Locally, the FBM KLCI too recorded numerous new all-time highs in the closing quarter of 2013.

In the same Strategy note (para 6), we also suggested that:

> Furthermore, during period when the market is climbing the proverbial "wall of worry", <u>volatility generally rises</u> due to the flare up in tug-of-war between the so-called optimists and pessimists elements in the market. *[emphasis added]*

Market ripe for meaningful correction after a hearty run. Thus after a gravity-defying performance in the last quarter, the US (and European) stocks which were overwhelmed by the optimists are now ripe for a meaningful correction. An exit trigger was provided by a limited contagion from some emerging economies (particularly those suffering from the twin deficits and, in some cases, coupled with domestic socio-political uncertainty) which are battling with currency depreciation due to heightened pace of liquidity withdrawals of late. Also, the recent below consensus US ISM-Manufacturing number provided the pessimists another exit opportunity that resulted in the Dow Jones Industrial Average (DJIA) shedding more than 300 points in a single day on 3 February 2014. In unison, the local benchmark dropped as well.

FBM KLCI is expected to remain on its secular upward trajectory. While the heightened volatility latterly could be unnerving, let us be reminded that the normalizing monetary and macro environment may, "all in all, be positive to equity secular pricing dynamics." Thus despite the recent volatility, we reiterate our view that the FBM KLCI is expected to remain on its secular upward trajectory at least until end of the year, supported by expectations of **(i)** gentler yet still robust domestic growth momentum, and **(ii)** brightening external economic conditions. Additionally, we do not expect the recent capital flight from countries suffering the twin deficits and domestic uncertainty would become out of control that it may result in a full-blown contagion to other emerging market currencies.

FBM KLCI entry point target at 1,750-1,700 points range... While remain positive on the secular trajectory of FBM KLCI, we however do not think the recent correction has played itself out just as yet. Hence, on the downside, we reiterate our view of the local benchmark support levels at between 1,750-1,700 points range.

…with market upside capped by liquidity, earnings, monetary and valuation factors. Although we do not expect the market to enter into a bear territory this year, nor do we expect the FBM KLCI to repeat its rather stellar performance last year. In our opinion, the following factors may put a cap to the prevailing above-mean market valuation going forward: **(i)** the incessant albeit generally measured withdrawal of foreign liquidity (pursuant to the commencement of QE3 taper) to continue on in the months to come, **(ii)** comparatively muted FBM KLCI expected earnings growth of circa 10% in 2014, **(iii)** market expectation of a hike in the OPR, and **(iv)** Malaysia's relatively weak albeit improving current account situation.

Reaffirm our FBM KLCI 2014 year-end target of 1,900 points. We reaffirm our FBM KLCI baseline 2014 year-end target of 1,900 points, with the upper and lower bounds at 1,980 points and 1,840 points respectively.

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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.