A QUESTION OF WHEN, NOT IF

Possible positioning from the expected US rate pause

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KEY HIGHLIGHTS

- **A lot of the optimism and disappointment in the market this year still revolves around the US Fed and its interest rate decisions.**
- **Presently, the main cues coming out of Wall Street suggest Fed pause likely in upcoming June meeting.**
- **On balance, despite the prevalent fears of a forthcoming recession, we posit the risk asset markets (and equity in particular) are tilting toward the upside in the short to medium term.**
- **The intervening period between the end of US Fed rate hikes and a looming recession could prove attractive for equity pricing.**
- **Meanwhile, the strong dollar persisted as Fed yet to end tightening cycle. However, we opine the Ringgit remained undervalued.**
- **With BNM having raised OPR to pre-pandemic level of 3.00%, we foresee the policy rate will kept unchanged.**
- **We forecast the Ringgit to average RM4.26 this year.**
- **For the equities market going forward, we do not expect the underperformance of FBM KLCI stocks to persist and expect it to regain vigor post-Fed pause.**
- **We maintain our FBM KLCI end-2023 target at 1,590 points or PER23 of 15.3x, and maintain our FBM70 end-2023 target at 15,000 points or PER23 of 18.3x.**

EQUITIES MARKET

US rate pause – a question of when rather than if. A lot of the optimism and disappointment in the market this year still revolves around the US Fed and its interest rate decisions. Although there were other events such as banking turmoil in the US and Europe, and US government debt ceiling, it was mostly short termed. The main interest has been in US Fed action where earlier optimism of a pause faded as inflation remained stubborn. However, we believe that the question is when will rather than if the US Fed pause its rate hikes. Keeping consistent with our investment thesis for this year, we opine that the pause should cause some boost to markets.

Fed pause likely in upcoming June meeting. Presently, the main cues coming out of Wall Street are (1) inflation pressures are ebbing, and (2) the US Fed is likely to pause its rate hike in the upcoming June meeting (with the interest rate futures market implying circa 70% probability, as of writing) hence a terminal rate of 5.25%.

Bullish window on equity. On balance, despite the prevalent fears of a forthcoming recession, we posit the risk asset markets (and equity in particular) are tilting toward the upside in the short to medium term. In fact, empirically, the intervening period between the end of US Fed rate hikes and a looming recession could prove attractive for equity market.

Period between end of hikes and looming recession attractive for equity market... The intervening period between the end of US Fed rate hikes and a looming recession could prove attractive for equity pricing principally due to the unwinding or subsiding pressure on equity required return (as the upside risk diminishes) with the end of rate tightening cycle. Moreover, macro performance and equity earnings remain somewhat resilient as the anticipated recession has yet to fully manifest.

DJIA and FBM KLCI: Big Rally post rate pause in 2006

Source: MIDFR, Bloomberg (G709)

...such after mid-2006. A potent bond market signal of a looming recession emerged in January 2006 with the inversion of 10Y-3M UST yield curve spread. The yield curve inversion (YC Invert) occurred as a consequence of an aggressive series of rate hikes totaling 425 basis points (1.00% to 5.25%) from June 2004 to June 2006. However, the equity market began to rally with the DJIA climbing from 10,700 points level in July 2006 to 13,500 points level a year later. Thenceforth, it rose further to pre-GFC (Global Financial Crisis) record of 14,100 points level in October 2007. Domestically, the FBM KLCI was also advancing from 900 points level in July 2006 to 1,300 points level a year later. Subsequently, it climbed further to pre-GFC record of 1,500 points level in January 2008.

DJIA and FBM KLCI: Rally post rate pause in 2023?

Source: MIDFR, Bloomberg (G710)

Expect a repeat in 2023... The UST bond market is again signaling an imminent recession with the inversion of 10Y-3M yield curve spread in October 2022. The YC Invert occurred as a consequence of an aggressive series of rate hikes hitherto totaling 500 basis points (0.25% to 5.25%) from March 2022 to May 2023. Meanwhile, most of the world's equity markets (namely the US, Europe, and advanced East Asia) have been progressively rebounding off their 52-week lows in the final quarter of last year (see list below) arguably in reaction to the Fed pivot late last year and in anticipation of a Fed pause this year. Going forward, we reckon the upward momentum would intensify, especially after the Fed pause potentially in the upcoming June meeting.

…with emerging ASEAN region playing catchup. In contrast, the equity markets of emerging ASEAN region duly rebounded late last year but subsequently lagged particularly since the onset of US and Europe banking turmoil in March this year (see list below). Nonetheless, going forward, we reckon the upward momentum would resume, especially after a Fed pause potentially in the upcoming June meeting, with international funds rotating into emerging ASEAN on weaker US Dollar and attractive valuation.

Performance of world's equity markets since 4QCY23:

S&P500 (US Benchmark)

- Upward trend beginning October last year.
- Maintained upward trend despite the onset of US and Europe banking turmoil in March.
- Registered year-high level in June and expect upward momentum to intensify post-Fed pause.

Source: TradingView

STOXX600 (European Benchmark)

- Upward trend beginning October last year.
- Maintained upward trend despite the onset of US and Europe banking turmoil in March.
- Registered year-high level in May and expect upward momentum to sustain post-Fed pause.

Source: TradingView

NIKKEI (Japan Benchmark)

- Maintained upward trend despite the onset of US and Europe banking turmoil in March.
- Registered year-high level in June (which equates to 33-year high)
- Expect upward momentum to sustain post-Fed pause.

Source: TradingView

JCI/SET/STI (ASEAN Benchmarks)

- ASEAN benchmarks namely Jakarta's JCI, Bangkok's SET and Singapore's STI lagged other regions (namely the US, Europe, and advanced North Asia) from March onwards since the onset of US and Europe banking turmoil.
- Expect these markets to play catch up post-Fed pause (with funds rotating into emerging ASEAN region on weaker US Dollar and attractive valuation).

Source: TradingView

FBM KLCI (Malaysia/ASEAN Benchmark)

- Upward trend beginning October last year.
- Its trend turned south from March onwards since the onset of US and Europe banking turmoil.
- It is notable the FBM KLCI is too heavily weighted in banking stocks (more than 40%).
- Expect banking stocks to play catch up post-Fed pause (with subsiding concerns over valuation of bank assets).
- Expect FBM KLCI to play catch up with more broad-based buying post-Fed pause (with funds rotating into emerging ASEAN region on weaker US Dollar and attractive valuation).

Source: TradingView

FBM70 (Malaysia Mid-cap)

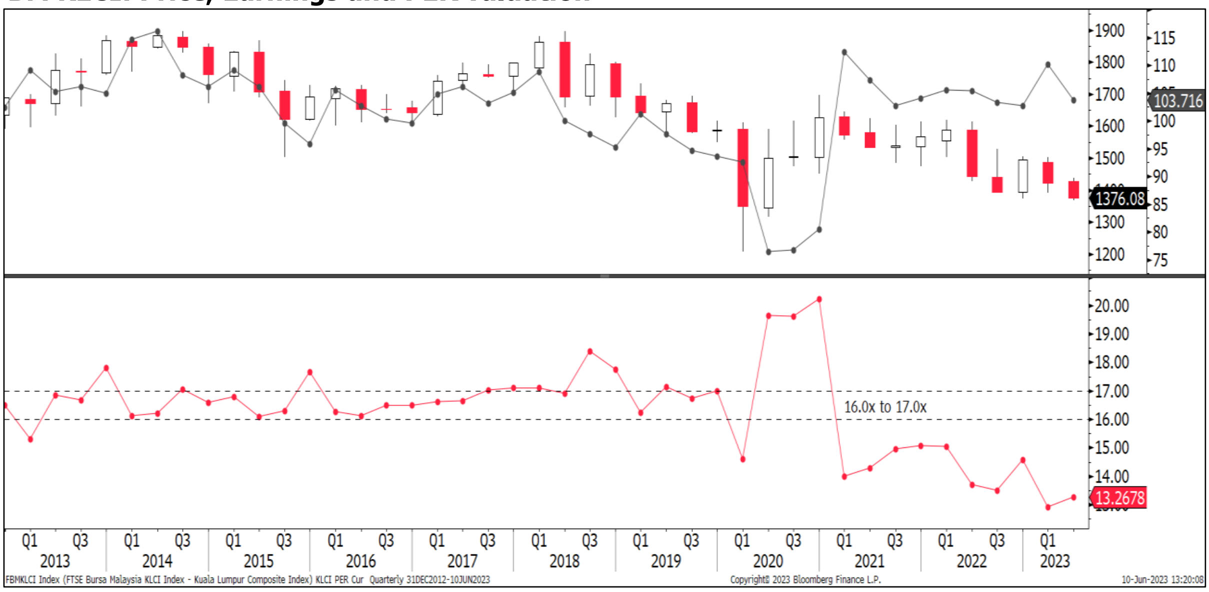
- Upward trend beginning October last year.
- Mid-cap FBM70 maintained its upward trend (in contrast to main benchmark FBM KLCI) despite the onset of US and Europe banking turmoil in March.
- Registered year-high level in April and expect upward momentum to sustain post-Fed pause.

Source: TradingView

FBM70 is leading thus far this year. As of end-May 2023, the year-to-date price return of FBM KLCI stood at -7.2%. In contrast, the mid-cap FBM70 index registered a year-to-date return of +4.9%. The heavyweights were bogged down mainly by price underperformance of Financial Services as well as commodity-related Industrial P&S (namely Petronas Chemicals and Press Metal) and Plantation stocks. The former sector was impacted by banking turmoil in the US and Europe while the latter by lower commodity product prices.

Expect FBM KLCI to regain vigor post-Fed pause. Nonetheless, going forward, we do not expect the underperformance of these heavyweight stocks to persist. Firstly, the banking turmoil in the US and Europe is arguably a consequence of the rapid rise in interest rates during the past year. As the US Fed is anticipated to pause in the upcoming June meeting, we can thenceforth expect to see some recovery in both the valuation and earnings expectation of banking stocks. Secondly, we reckon the softening commodity price trend is presaging a slowdown in economic activities which is also arguably a consequence of the rapid rise in interest rates during the past year. Likewise, we can expect to see some improvement in both the valuation and earnings expectation of commodity-related stocks post-Fed pause.

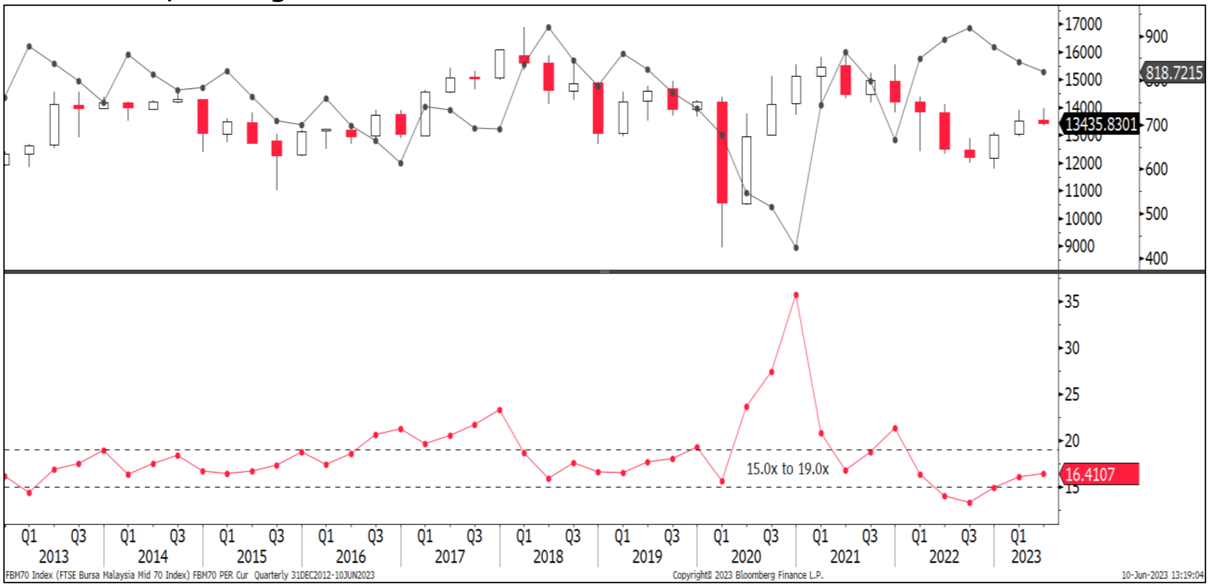
FBM KLCI: Price, Earnings and PER valuation



Source: MIDFR, Bloomberg (G658)

Maintain FBM KLCI end-2023 target at 1,590 points. At PER23 of 13.3x, the FBM KLCI is currently trading at depressed valuation (vis-à-vis its historical range of 16.0x to 17.0x). However, we expect its valuation to revert higher during the latter part of this year supported by the reasons stated above and buttressed by the continuing general macro growth. Hence, we maintain our **FBM KLCI end-2023 target at 1,590 points** or **PER23 of 15.3x**.

FBM70: Price, Earnings and PER valuation



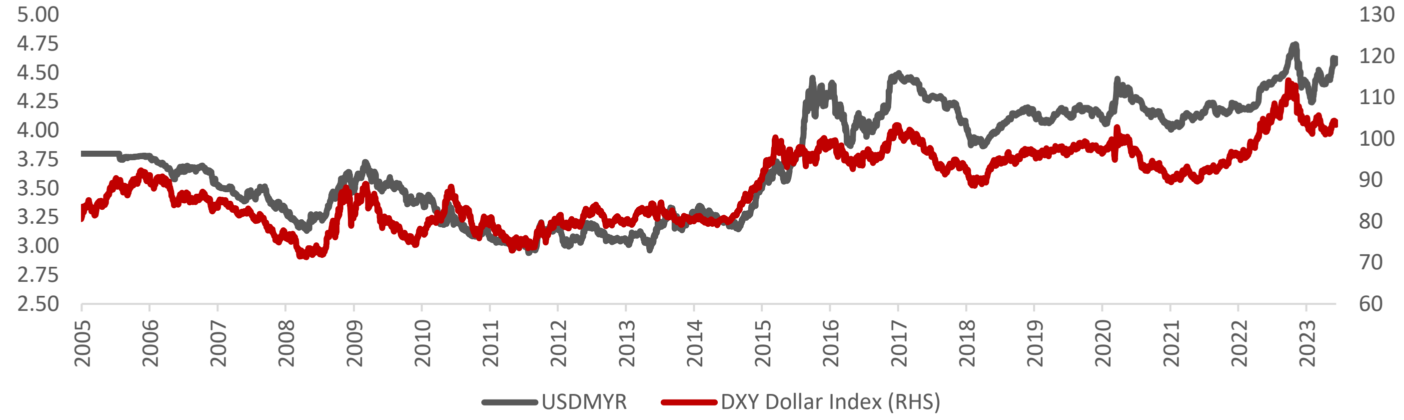
Source: MIDFR, Bloomberg (G715)

Maintain FBM70 end-2023 target at 15,000 points. At PER23 of 16.4x, the FBM70 index (which represents mid-cap stocks) is currently trading within its historical valuation range (of 15.0x to 19.0x), albeit in the lower half. Nonetheless, when compared to the big-caps, the mid-cap stocks performed better thus far this year both in terms of valuation and year-to-date price return. Going forward, we expect the market valuation of FBM70 to improve further supported by macro and corporate earnings growth as well as the end of interest rate tightening cycle. We maintain our **FBM70 end-2023 target at 15,000** points or **PER23 of 18.3x**.

CURRENCY

Strong dollar persisted as Fed yet to end tightening cycle. Revised views for further hikes by the Fed and several other developments have caused the US dollar to continue strengthening against other currencies. The stubbornly elevated inflation shifted market opinions to expect a delayed pause by the Fed, and no more expectations for rate cuts latter this year. In fact, market expectations seem to be more in agreement with the Fed's indication to keep fed funds rate at high levels until inflation clearly trending lower towards the Fed's 2% longer-term target. Although the greenback weakened after mid-Mar-23 as market sentiment improved after the prompt actions by authorities in the US and Europe to contain the risk of a wider banking turmoil, the dollar appreciated again in May-23 until the US government agreed to suspend its debt ceiling for 2 years until early Jan-25. Despite the fluctuations in DXY index this year, the US dollar was broadly unchanged as of last Friday (9 Jun 2023) against the level at end-2022.

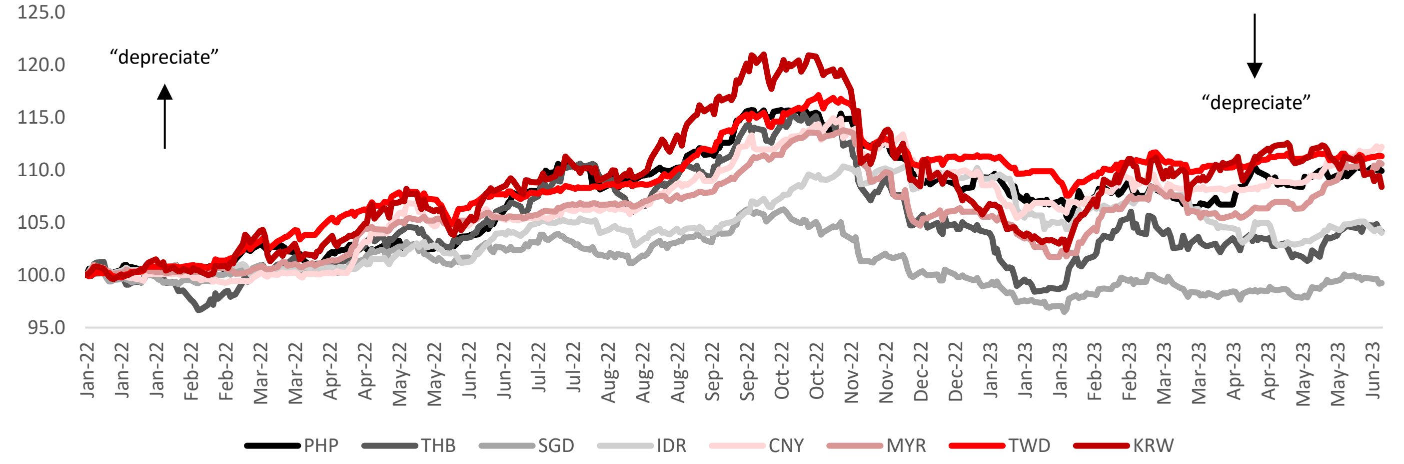
Chart 13: Ringgit vs. US Dollar (DXY) Index



Source: Bloomberg, MIDFR

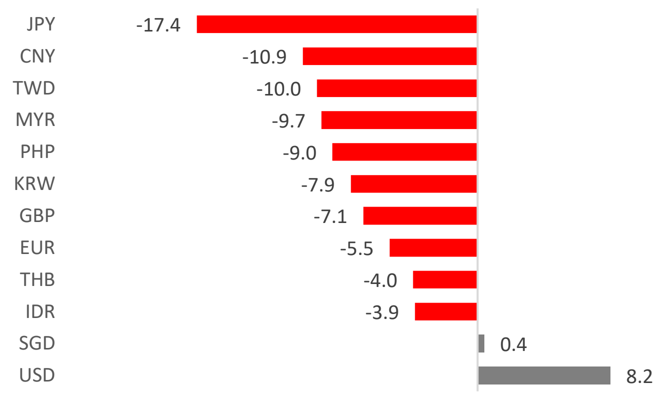
YTD ringgit was among worst performing currencies after JPY. While the dollar index remained unchanged on year-to-date basis, ringgit on the other hand has been among the worst performing currencies, only second after Japanese yen. As market priced in delayed pause by the Fed and fears on global growth outlook (with the debt ceiling talks and consumption-led recovery in China), ringgit practically reversed its appreciation and fell back to lowest level since Nov-22, and hovered around RM4.59-4.60 in the past couple weeks. This translated into -4.5% depreciation of ringgit, second after -5.9% decline in yen. Other regional currencies also weakened year-to-date at slower pace between -0.3% to -3.3%.

Chart 14: Regional Currencies Performance vs. USD in 2022-2023 (3 Jan 2022 = 100)



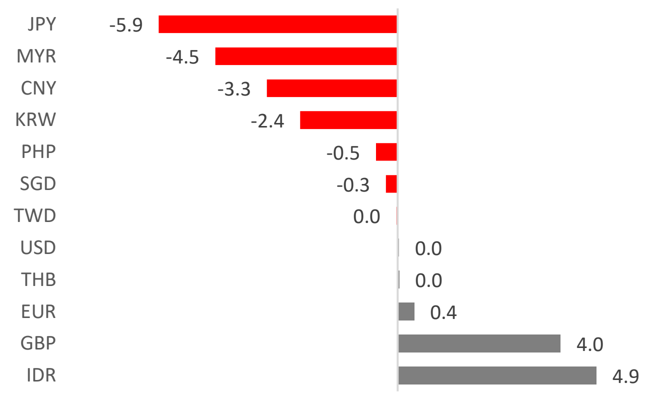
Source: Bloomberg, MIDFR

Chart 15: % Change for Selected Currencies vs. USD from end-2021 to end-2022 (%)



Source: Bloomberg, MIDFR

Chart 16: Year-to-Date % Change for Selected Currencies vs. USD from end-2022 to 9 June 2023 (%)



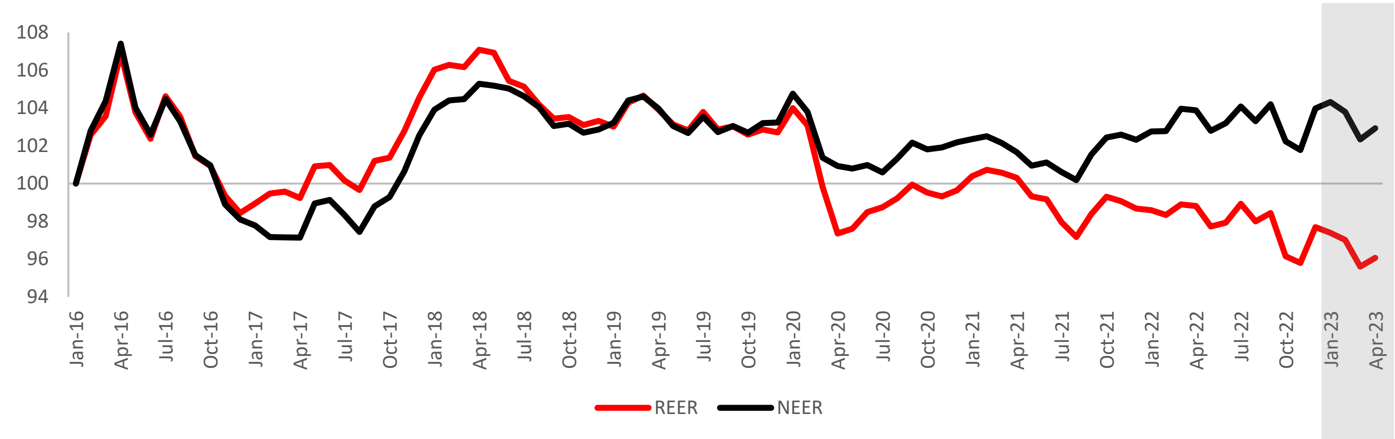
Source: Bloomberg, MIDFR

Weaker-than-expected data dragged down ringgit… Although we earlier anticipated growth fundamentals to be more in favor of ringgit (to strengthen), we noticed recent weaker-than-expected economic data and low commodity prices led the ringgit to weaken more than other currencies. Among the discouraging releases include: sharper-than-expected decline in exports (and downward revisions to external trade outlook), subdued global manufacturing activities, and limited boost from China's post-reopening recovery.

…and from other factors too. Nevertheless, the widened interest differential (i.e. US fed funds rate vs. OPR) is another key factor that had caused outflows of funds from Malaysia and foreign selling of ringgit-denominated assets. On another note, we believe other factors like changing sentiment in local markets and recent developments surrounding domestic issues led to outflows of foreign funds and consequently ringgit to weaken.

Ringgit remained undervalued. The real effective exchange rate (REER) fell further below 100 (as shown in chart 6), indicating the ringgit exchange rates remained undervalued even after two years of post-pandemic recovery. The decline in REER not only worsened ahead of the Fed initiated its aggressive rate tightening, but it also resumed again after a temporary reversal late last year (when market expected the Fed to pivot and eventually stopped its policy tightening). However, the delayed pause and therefore more hikes by the Fed not only supported the US dollars, but also caused ringgit's REER to deteriorate further going into 2023. In contrast, analyzing the ringgit's effective exchange rate on nominal basis (NEER), the local currency was roughly unchanged with the NEER averaging 103.4 in Jan-Apr 2023 (average 2022: 103.2). In other words, NEER suggests a more stable ringgit valuation despite the fluctuations and weakening against selected currencies such as major currencies i.e. USD, EUR and GBP as well as most regional currencies such as IDR, THB and SGD.

Chart 17: Ringgit's NEER and REER (Jan-16 = 100)

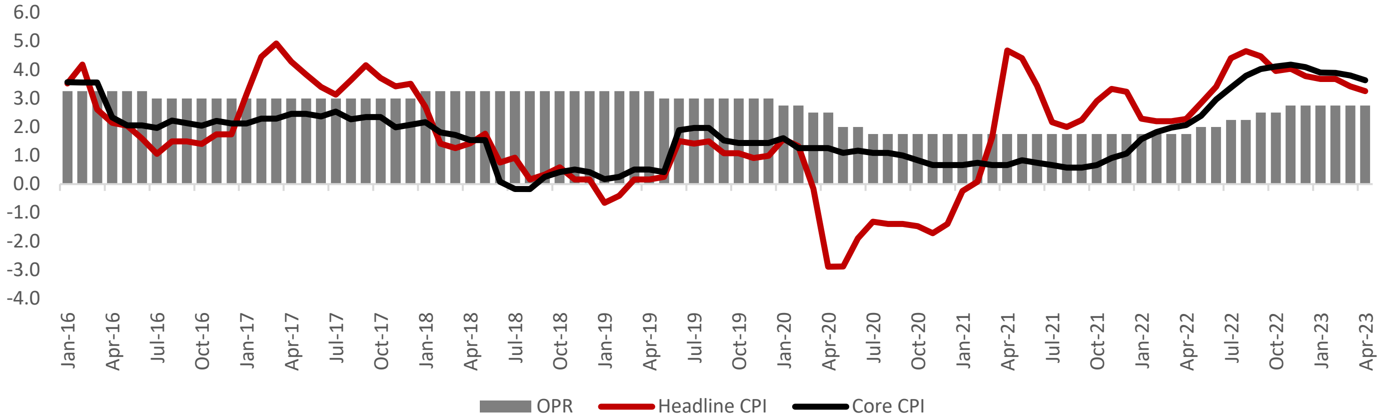


Source: Macrobond, MIDFR

External uncertainties will limit ringgit appreciation. Despite the robust and sound economic fundamentals on the back of sustained growth in domestic demand, positive job market, and continued trade surplus, we noted ringgit had weakened due to greater influence from external developments. Apart from changing fund flows, ringgit has been constrained by revised view on the Fed's future policy direction, concerns over global growth (e.g. less encouraging China's economic recovery and US debt ceiling issues), and relatively lower commodity prices. If the strong dollar narrative continues, positive growth fundamentals will have limited effect to support ringgit outlook.

OPR to stay at 3.00%. With BNM having raised OPR to pre-pandemic level of 3.00%, we foresee the policy rate will kept unchanged. We opine inflation (which has not been as high as in other countries) will continue to moderate and BNM will keep its focus on sustaining growth. In addition, improved supply and reduced cost pressures shall keep inflation under control. Nevertheless, high demand pressures, given the core inflation persistently exceeding headline inflation, is one of the upside risks to OPR outlook.

Chart 18: OPR (%) vs. CPI Inflation (YoY%)



Source: Bloomberg, MIDFR

Risk-on sentiment to support more flows to EMs. Taking into account Fed to pause later this year and no rate cuts despite the US experiencing below-trend growth, we foresee fund flows to return to the emerging markets. At least we noticed US dollar has depreciated in the past 2 weeks as risk-on sentiment improved after the passing of bill on US debt ceiling suspension. This supports more positive outlook for EM currencies as Fed is expected to maintain its fed fund rate at current high levels.

Ringgit to average RM4.26 this year. Ringgit will also gain from increased foreign flows, in addition to no further widening in interest differentials. Looking at the depreciation of ringgit vis-à-vis US dollars so far, we had recently revised our FX outlook for ringgit to average at RM4.26 this year (previous forecast: RM4.20). Although this points to a slower appreciation than previously forecasted, it will still be stronger than average RM4.40 recorded last year. Given the sharp fluctuation in ringgit movement, we still assume ringgit could move towards RM4.00 by year-end as economic growth will be sustained and anchored by growing domestic economic activities.

STOCK SELECTION

ASEAN benchmarks underperformed, possibility of catch up. With SEA benchmarks (including Malaysia) underperforming vs. advanced markets, we believe that there is a possibility that these markets will play catch up after the US rate pause. As for Malaysia, the FBM KLCI have underperformed, while FBM 70 have more or less moved in tandem with more advanced markets.

Underperformance of FBM KLCI can be observed in MIDF Research stock universe. The underperformance of FBM KLCI and the performance of FBM 70 can be observed in MIDF Research stock universe. Highlights as follows:

- From MIDF Research stock universe, there are 60 **BUY** calls. Out of these 60 stocks, 37 (61.7%) have registered gains this year.
- Out of the 60 **BUY** calls, 15 are FBM KLCI component stocks, and out of this 15 FBM KLCI stocks, only 4 have showed gains (26.7%) thus far this year.
- Out of the 60 **BUY** calls, 45 are non-FBM KLCI component stocks. Out of this 45 non-FBM KLCI stocks, 33 have showed gains (73.3%) on a year to date basis.

	No. of BUY calls	No. with YTD gains	%
Total no. of stocks	60	37	61.7%
FBM KLCI stocks	15	4	26.7%
Non-FBM KLCI stocks	45	33	73.3%

Source: Bloomberg, MIDFR

Underperformance provides trading opportunities. We believe the underperformance of the FBM KLCI comparative to more advanced markets provide investors with trading opportunities. This is premised on the expected rate hike pause by the US Fed which will boost risk asset valuation. In fact, as we have discussed, advanced markets are already manifesting this in our opinion.

Worth looking at FBM KLCI stocks that have underperformed thus far this year. As we believe that the FBM KLCI will rebound from its current low in 2HCY23 following the US Fed rate pause, we have selected stocks in our universe that have underperformed thus far this year. In addition, we highlight selected stocks in FBM 70 which have also underperformed as a possibility for investors take advantage on the upward trend of the FBM 70 index.

Selected Stock Recommendation

Name	Rec.	TP (RM)	Price (RM) at		%YTD	% Exp. Capital Appreciation
			29/12/2022	8/6/2023		
FBM KLCI Stocks						
AMMB	BUY	4.03	4.18	3.57	-14.6%	12.9%
Dialog Group	BUY	3.28	2.42	2.08	-14.2%	57.9%
CIMB	BUY	5.92	5.66	4.95	-12.6%	19.6%
Public Bank	BUY	4.76	4.30	3.82	-11.1%	24.6%
Hong Leong Bank	BUY	24.91	20.33	18.66	-8.2%	33.5%
PPB Group	BUY	19.00	17.08	15.80	-7.5%	20.3%
Hong Leong Financial	BUY	22.79	18.33	17.30	-5.6%	31.7%
IOI Corp	BUY	4.89	3.99	3.77	-5.5%	29.7%
IHH Healthcare	BUY	6.57	6.05	5.73	-5.4%	14.7%
RHB Bank	BUY	7.58	5.50	5.29	-3.8%	43.3%
Petronas Gas	BUY	18.43	16.73	16.62	-0.7%	10.9%
Petronas Dagangan	BUY	24.52	21.44	21.46	0.1%	14.3%
MISC	BUY	8.16	7.20	7.23	0.4%	12.9%
Malayan Banking	BUY	9.28	8.44	8.62	2.1%	7.7%
KL Kepong	BUY	26.00	21.17	21.70	2.5%	19.8%
FBM70 Stocks						
S P Setia	BUY	0.71	0.61	0.52	-14.0%	36.5%
Alliance Bank	BUY	4.00	3.70	3.36	-9.2%	19.0%
Bursa Malaysia	BUY	7.30	6.54	6.22	-4.8%	17.4%
AEON Co.	BUY	1.50	1.33	1.30	-2.2%	15.4%
My E.G.	BUY	1.00	0.86	0.84	-2.0%	19.0%
IJM Corp	BUY	1.93	1.56	1.61	3.2%	19.9%

Source: Bloomberg, MIDFR

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +10% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% 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.
ESG RECOMMENDATIONS* - source Bursa Malaysia and FTSE Russell	
☆☆☆☆	Top 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆☆	Top 26-50% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆	Top 51%- 75% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆	Bottom 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell

* ESG Ratings of PLCs in FBM EMAS that have been assessed by FTSE Russell in accordance with FTSE Russell ESG Ratings Methodology