Irrational Divergence for Malaysia

Commentaries: Q2, 2023 (April to June 2023)

Return (%)	June 2023	2Q 2023	Year-To-Date	Since Inception (TSF: Nov 22)	Since Inception (PM: Apr 22)
Tradeview Sustainability Fund (TSF)	-0.4%	-4.0%	-1.0%	-0.3%	N/A
Discretionary Private Mandate (PM)	1.6%	-0.6%	3.7%	N/A	8.2%
FBM KLCI Index	-0.8%	-3.2%	-7.9%	-5.0%	-13.4%
FBM 100 Index	-1.1%	-2.7%	-5.5%	-1.7%	-10.7%
FBM Small Cap Index	0.1%	-2.7%	-0.5%	3.4%	-10.8%

The themes in the first half of 2023 were still the rising interest rates, geopolitical risks, recession fears, local political instability, and Ringgit weakness. Furthermore, the disappointing company reporting season in April and May impacted investor sentiment. The FBMKLCI experienced a decline of 3.2% in 2Q23, placing it just behind Thailand (decline of 8.2%) as the second worst performing market in ASEAN. However, the situation took a different turn when compared to developed markets such as the US, Korea, Taiwan, and Japan. These markets all registered positive performances in 2Q23. The dominance of tech megacaps in the broader stock market, along with the rally of AI-related investments in the US, propelled tech-heavy markets and indices into the bull market territory. Despite experiencing a banking crisis in March, which led to the collapse of Silicon Valley Bank and Signature Bank in the US, as well as the acquisition of Credit Suisse by UBS in Switzerland, the US showed surprising economic resilience. This was evident in the decline of new jobless benefit claims, better-than-expected employment data in May, retail sales growth, and a surge in housing starts. The persistent strength in the labor market continues to support economic growth and wage increases but also fuels inflation. Consequently, the Federal Reserve has indicated the likelihood of more interest rate hikes in the future to address inflationary pressures, posing a risk to equity market for the remaining months of 2023.

The recent weakness in the Ringgit has been a major topic of discussion locally. Ringgit weakened by around 5.6% against USD in 2Q23. This weakness is attributed to several factors, including the significant difference in interest rates compared to the US, the decline in oil prices, the depreciation of the Chinese Yuan, and local political instability. This also explains the continuous outflows of foreign funds in 1H23. However, it is believed that the weak ringgit is partially a result of USD strength, which may peak soon as the Fed pauses rate hikes. This could lead to an inflow of funds back into Malaysia, as the currency may be perceived as undervalued.

One near-term risk to consider is certainly the upcoming state elections slated to be held on 12th August 2023, which contribute to political uncertainties and has been the major reason for domestic market's weakness. The elections are expected to dominate the first half of 3Q23, and the market may remain sluggish until clear results are seen post-elections. After that, there is hope for a recovery as the political risks will be behind us.

Despite these challenges, there are several reasons to focus on Malaysia. The country stands to benefit from the US-China trade diversion, potentially attracting foreign investments that create job opportunities for local businesses. Malaysian market is also dependent on China's potential economic recovery in 2H23. Furthermore, our local economy is not expected to fall into recession and is relatively better off compared to developed economies that see such lingering fear.

In economic terms, a rising interest rate implies higher repayment costs for corporates and households as well as increased credit risk for banks. This leads to slower corporate earnings growth, reduced investments, muted personal consumption, and ultimately slower economic growth. The question then arises: should these risks be considered now? Looking at the solid performance of the US stock market in 1H23, it seems that these risks are not being fully considered. However, with valuations stretching to new highs and the rally potentially becoming euphoric, it is believed that the current rally may not be sustainable, as it is based on future earnings potential that has yet to be realized. The thematic push of AI reminds us of the thematic push of EV in 2021.

Considering all these factors, a cautious investment strategy is warranted to protect capital from any unexpected market shocks, which could potentially be systemic. However, this cautious approach may come at the cost of foregoing immediate near-term gains, which are driven by momentum and rich valuations.

In terms of stock selection, we continue our focus on companies with strong balance sheets, low to no-debt (preferably with net cash), capable of weathering the rising interest rate environment and avoiding margin compression from higher financing cost. It is important that these companies have positive free cash flow, indicating that their capital expenditure is covered by operating cash flow without the need for additional borrowing.

Given the current state of the market, characterized by high levels of uncertainties and volatilities, it is increasingly challenging to make short-term projections. Hence, we maintain a balanced approach, including both dividend yielders for downside support and growth-oriented names that could benefit from the potential recovery in China's economy, as well as rerating of the local stock market. The underperformance of the tech and industrial production sectors year-to-date compared to other sectors presents an area that merits closer examination as we move into the second half of 2023.

Sincerely,

Tradeview Capital