MARKET COMMENTARY

October, 2016 / Issue 15

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The Malaysian equity market has traded in a band, on a lower trajectory, reflecting the many macro concerns over its economy.

We believe that the upcoming Budget 2017 may be a potential turning point to turn more constructive towards our domestic equity market.

CARTOON BY: HEDGEYE

OUR HOUSE VIEW

Still Constructive Outlook For Asian Equity Markets

- In the horizon, potentially looms a number of 'Black Swans' events for the outperforming Asian equity markets. Nearer-term, the fate of Deutsche Bank remains a concern, with a contagion risk on the global financial system. Slightly further out, the US Presidential Election is the next danger, particularly an anti-Asia Donald Trump if he were to become President. Thereafter, we have to contend with a likely Fed rate hike in December followed by a potential hard Brexit in early 2017.

- The eventuality of any of these events will certainly have repercussions on Asia. That said, we remain of the view that any sell-offs should be seen as buying opportunities. We are at the cusp of a secular uptrend for Asian equity markets. The sustainability is well backed by domestic improvements; most importantly a stabilizing China economy but also supported by recoveries across most part of Asia. The upcoming third quarter earnings reporting season will be a very important sustaining driver for Asian equity markets.

- There are limited catalysts to re-rate Malaysia equity market in the 4Q 2016, we are maintaining our end-2016 FBM KLCI target of 1,660 based on the average 5-year PER of 16x. However, historical trend suggests strong 4Q 2016. Post 2008 crisis, the FBM KLCI has trended up in all the final quarters of the year, except 2014, when oil price collapsed.

PERFORMANCE OF KEY INDICES

FIGURE 1

	AS AT 30.09.16	1 MTH (% change)	YTD 2016 (% change)	PER 2016
D. JONES	18,308.2	-0.8	4.0	17.4
NASDAQ	5,312.0	1.7	4.9	31.2
DAX	10,511.0	-1.4	-2.2	23.8
KLCI	1,652.6	-1.5	-2.4	17.9
USD / MYR	4.14	2.1	-3.6	-

SOURCE: BLOOMBERG (AS AT 30/09/2016)

LOOKING BEYOND THE GOVERNMENT BUDGET

Cautious Yet Watching For A Turn

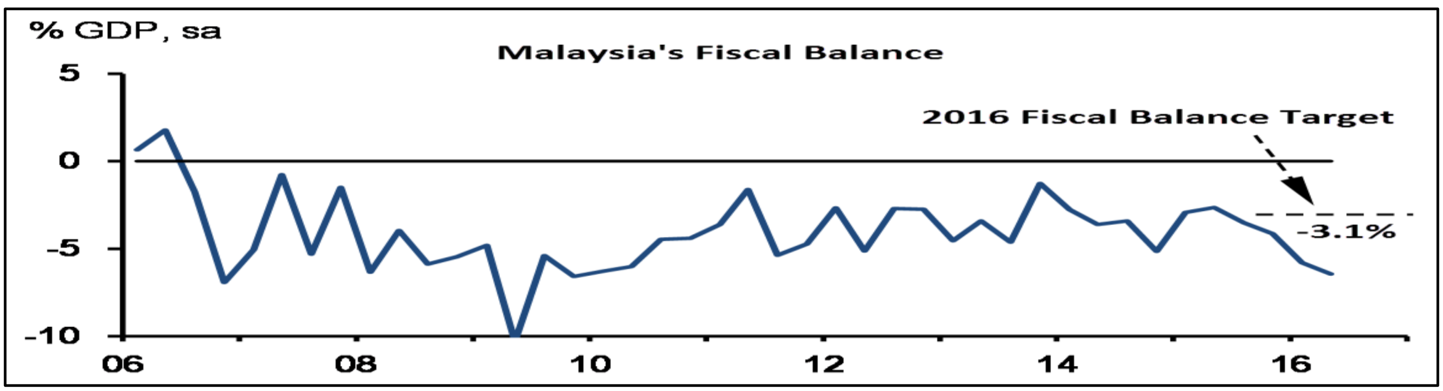
Our readers would know, through our newsletters, that we have been cautious on the Malaysian equity market due to the weaker economic fundamentals. Ahead of the delivery of Budget 2017, we will try to steer away from focusing on the "feel good" details, such as tax reliefs, measures to address the needs of the lower income group etc., which our readers are likely to have read from numerous research reports.

We want to do something slightly different. We would prefer to touch upon some of the fundamental aspects of a possibly realistic Budget and what it may mean for the equity market in terms of the potential upside that may come from exceeding managed expectations.

A Refresher Of The Year Past

The last year has been a difficult period for the Malaysian government. The Government has been forced by plunging crude oil prices into revising its Budget 2016, and yet, government revenue collection has still fallen short in the first half of 2016, resulting in a blow-out of the fiscal deficit to 5.6%, leading to growing concerns that government spending may have to be reined in for the second half of 2016 to manage the fiscal deficit, meaning that there is a risk of a further weakening of the economy.

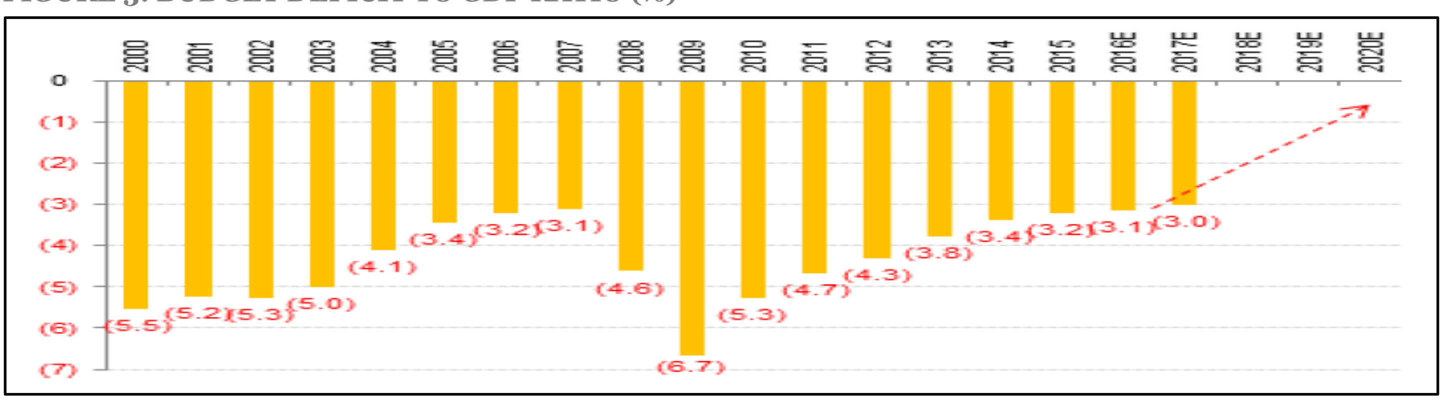
FIGURE 2: MALAYSIA'S FISCAL BALANCE



SOURCE: BNM, DOS, MOF, & J.P.MORGAN

However, it must be qualified that the fiscal deficit has been in much more precaurious positions in most of the yesteryears and the attainment of the 3.1% target would a credible achievement in light of the difficulties faced by Malaysia.

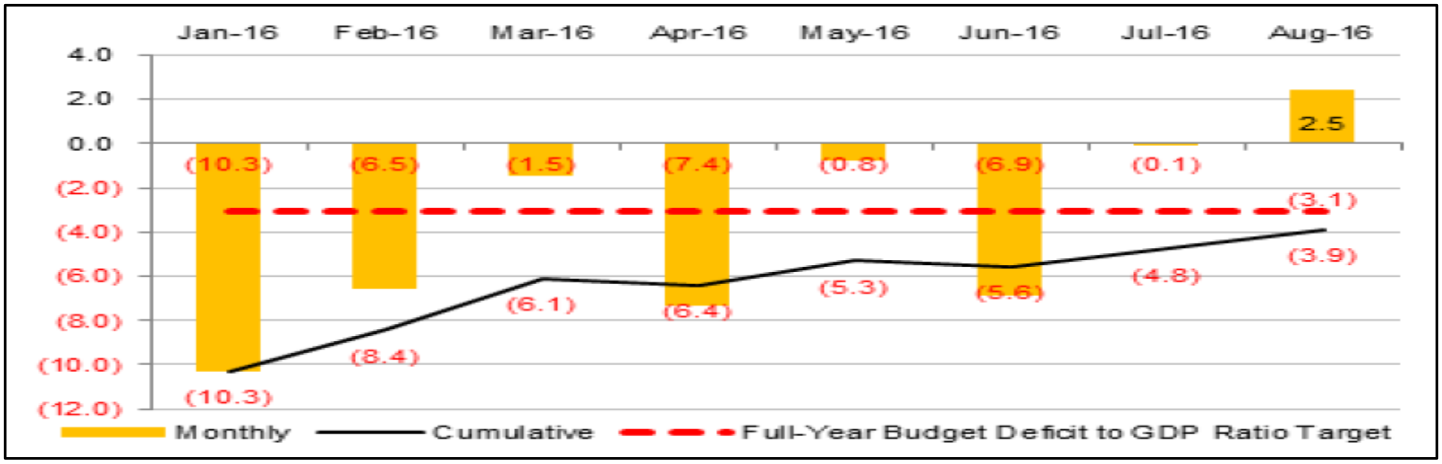
FIGURE 3: BUDGET DEFICIT TO GDP RATIO (%)



SOURCE: BNM, BUDGET 2016, MKE ECONOMICS RESEARCH

In fact, initial data from July and August have been very encouraging, resulting in a narrowing of the fiscal deficit to 3.9% YTD.

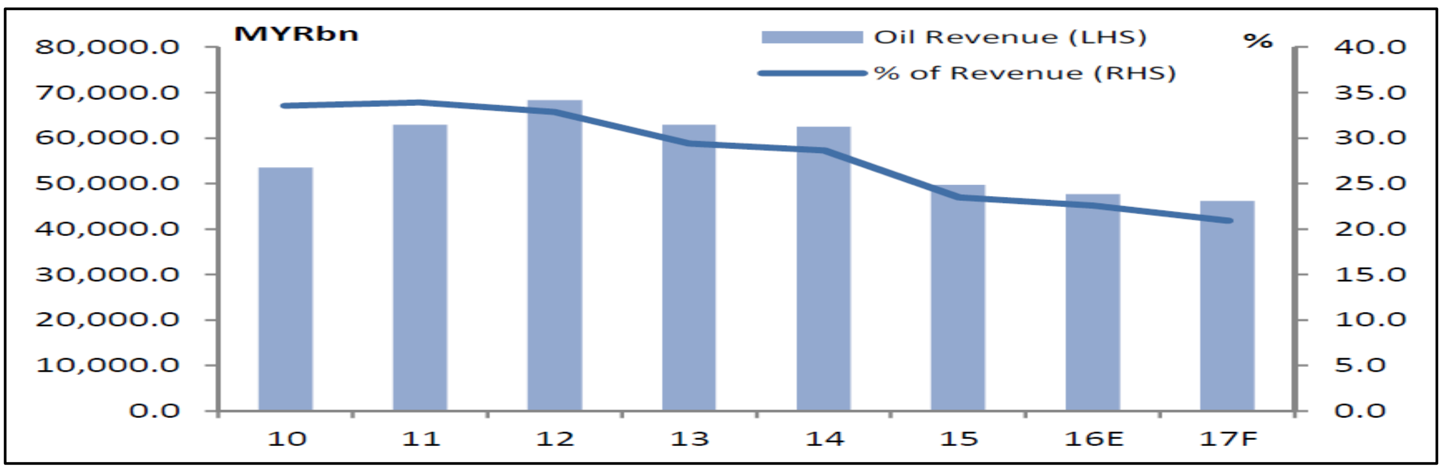
FIGURE 4: MONTHLY BUDGET BALANCE (2016, % OF GDP)



SOURCE: BNM, MKE ECONOMIC RESEARCH

There is optimism that the 3.1% fiscal deficit target can be achieved. The reason being that; (1) oil related revenue is some 25% of the total revenue collection, (2) the recalibrated Budget assumed a crude oil price between US$30-35 per barrel, (3) and crude oil price has traded largely between US$40-50 per barrel into the second half of 2016, and (4) the bulk of the Petronas dividends to the government, 62.5% of the total, will be paid in the second half of the year.

FIGURE 5: REVENUE FROM OIL



SOURCE: CEIC, MOF & RHB

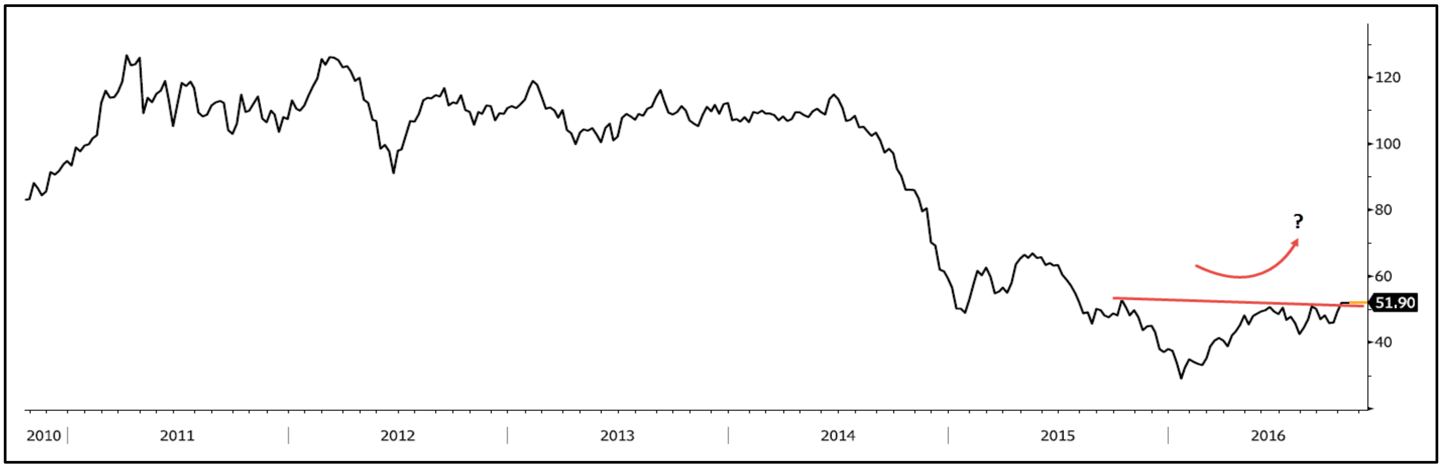
Managing Expectations To Surprise

We are of the view that given the circumstances, the Government is likely to be able to announce a Budget 2017 that will be marginally better than 2016, with the idea of a balancing act between maintaining fiscal prudence but yet able to support growth.

The concern is if the Malaysian government becomes overly expansionary, given the increasing noises of a possible early election, and therefore the need to pander to the voters.

However, if the government is realistic, and we have a positive view on crude oil price, a positive surprise on the Budget 2017 fiscal deficit target will then lend momentum for further expansionary moves in the future.

FIGURE 6: BRENT CRUDE OIL CHART (2010 – 2016)

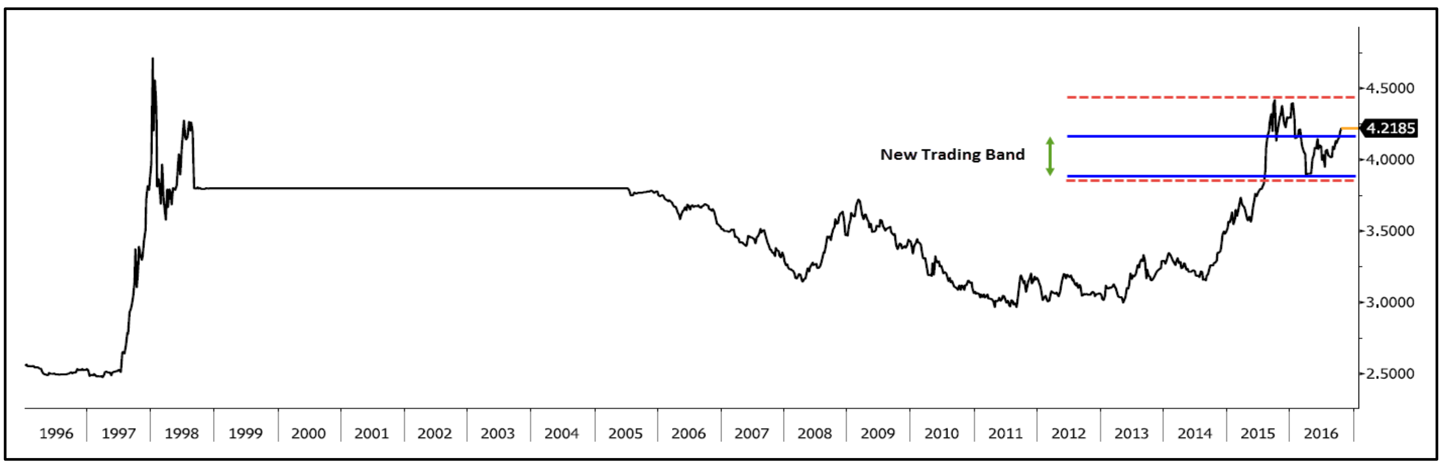


SOURCE: BLOOMBERG (AS AT 17/10/2016)

<u>The Virtuous Effects Of A Prudent Budget</u>

The Malaysian Ringgit has managed to held its own ground this year and we do expect that if the above scenario pans out, there is scope for stability, even if not a strengthening of the Malaysian Ringgit.

FIGURE 7: USD/MYR CHART (1996 – 2016)



SOURCE: BLOOMBERG (AS AT 17/10/2016)

This will provide Bank Negara the confidence to sustain an easy monetary cycle, which in turn will lift consumer sentiment.

We still expect Bank Negara to cut lending rate for a second time in its November 2016 monetary policy meeting. Real interest rates remain prohibitively high as inflation stays benign. Also, a reduction in the Statutory Reserve Requirement (SRR) is likely.

SELECTED HOLDINGS

FIGURE 8

STOCKS	BLOOMBERG TICKER	PRICE (RM)	PER 2016	EPS ($) 2016	GROWTH (%) 2016	P/BVPS 2016	DY (%) 2016
AXIS REIT	AXRB MK EQUITY	1.71	18.79	0.09	5.81	1.40	4.85
ELK DESA RESOURCES ***	ELK MK EQUITY	1.18	9.15	0.13	-10.42	0.64	2.75
KLCC STAPLED GROUP	KLCCSS MK EQUITY	7.83	18.47	0.42	3.16	1.10	4.45
YTL HOSPITALITY REIT	YTL REIT MK EQUITY	1.21	17.29	0.07	-12.50	0.99	6.58

*SOURCE: BLOOMBERG CONSENSUS DATA (AS AT 14/10/2016). *** DATA IS HISTORICAL (FY 2016)*

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