MARKET COMMENTARY

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This month, we discuss our positive view of the steel sector. We believe that this is not just a cyclical turnaround but a structurally positive cycle.

Our strong belief in this steel cycle is expressed through all our portfolios, both regionally as well as Malaysia.

CARTOON BY: HEDGEYE

OUR HOUSE VIEW

Cusp of a Break Up for Asian Equity Markets?

- Our central thesis from a year back was a potential multi-year bull market for Asian equity markets. Since then, we have come within a whisker throw of the top-end of a seven year horizontal trading range. In any multi-year market cycles, there remains the risk of mini-corrections, more so at an important inflexion point.
- Nonetheless, US Fed Janet Yellen's dovish testimony suggesting a potential pause to interest rate hike post a third hike by end 2017 has recalibrated market expectations that have become hawkishly concerning. There is no doubt that the emerging market asset class is the largest beneficiary of this 'Goldilocks' scenario.
- Our Asian economies are clearly on a secular recovery path. That said, high base comparison effects may create choppy moments in the second half of the year. Our longer-term positive view remains unchanged.
- Looking ahead, while mild corrections for the Malaysian equity market are expected in the second half of 2017 due to external noises arising from the US monetary tightening bias, weakness in crude oil prices, and hiccups from China's deleveraging process, market sentiment is expected to remain buoyant.

PERFORMANCE OF KEY INDICES

FIGURE 1

	AS AT 30.06.17	1 MTH (% change)	YTD 2017 (% change)	PER 2017
D. JONES	21,349.6	1.6	8.0	19.0
NASDAQ	6,140.4	-0.9	14.1	34.4
DAX	12,325.1	-2.3	7.4	20.3
KLCI	1,763.7	-0.1	7.4	16.5
USD / MYR	4.29	0.3	-4.3	-

SOURCE: BLOOMBERG (AS AT 30/06/2017)

RETURN OF THE IRON MAN

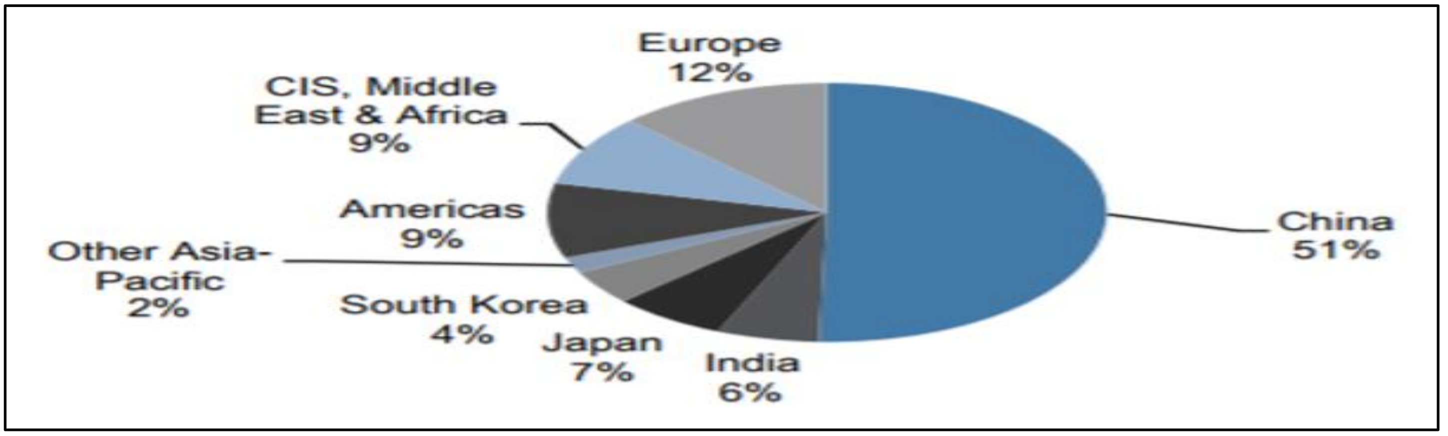
It seems an opportune time to revisit our bullish view on the global steel industry in light of two consecutive G20 Summits 2016 and 2017 focusing on steel overcapacity as a major concerning topic.

A Rewind to Our Positive Stance Adopted First in 2016

Leaders at the G20 Summit in Hangzhou 2006 accepted that overcapacity in "STEEL" (specifically named) and other industries is a global issue that requires a global response. It was proposed that a global forum would be formed that would seek a global solution for the "STEEL" (again specifically named) and report back to the G20 in 2017.

To us, the finger pointing rested squarely on China, which dominates 50% of the global steel production capacity. In short, China is under scrutiny and there is no escape. Especially, if China harbors ambitions of taking its place as one of the world's super economic powers.

FIGURE 2: GLOBAL STEEL PRODUCTION 2016



SOURCE: WSA, J.P.MORGAN

On hindsight, it is fair to say, China achieved its capacity cut target for 2016, a report card on show in 2017's G20 Summit Hamburg.

At G20 Summit 2017, Hamburg

The global steel overcapacity issue was again a hot-button issue in 2017's G20 Summit in Hamburg, not just the monitor on China, but also the rising tensions over US President Donald Trump's plan to use a Cold War-era law to restrict steel imports for national security reasons.

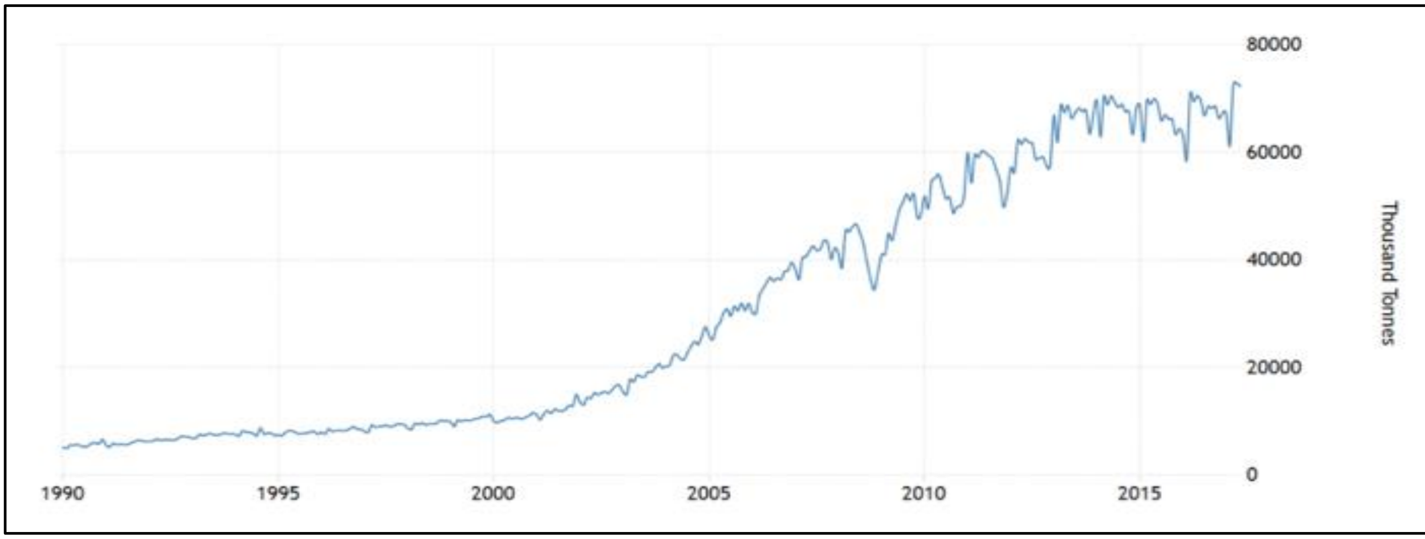
"The Global Forum on Steel Excess Capacity, to be facilitated by OECD, will develop concrete policy solutions by November 2017, which will serve as the basis for tangible and swift policy action, with follow-up progress reporting in 2018."

What is the Impact of China's Supply Side Reform?

At a dominant 51% of the world's steel production capacity, needless to say, conformance to capacity cuts will have a material impact on supply.

Firstly, it is clear from a longer-term perspective that the incremental steel capacity out of China, post WTO and her industralisation cycle, is likely to have plateau.

FIGURE 3: CHINA STEEL PRODUCTION

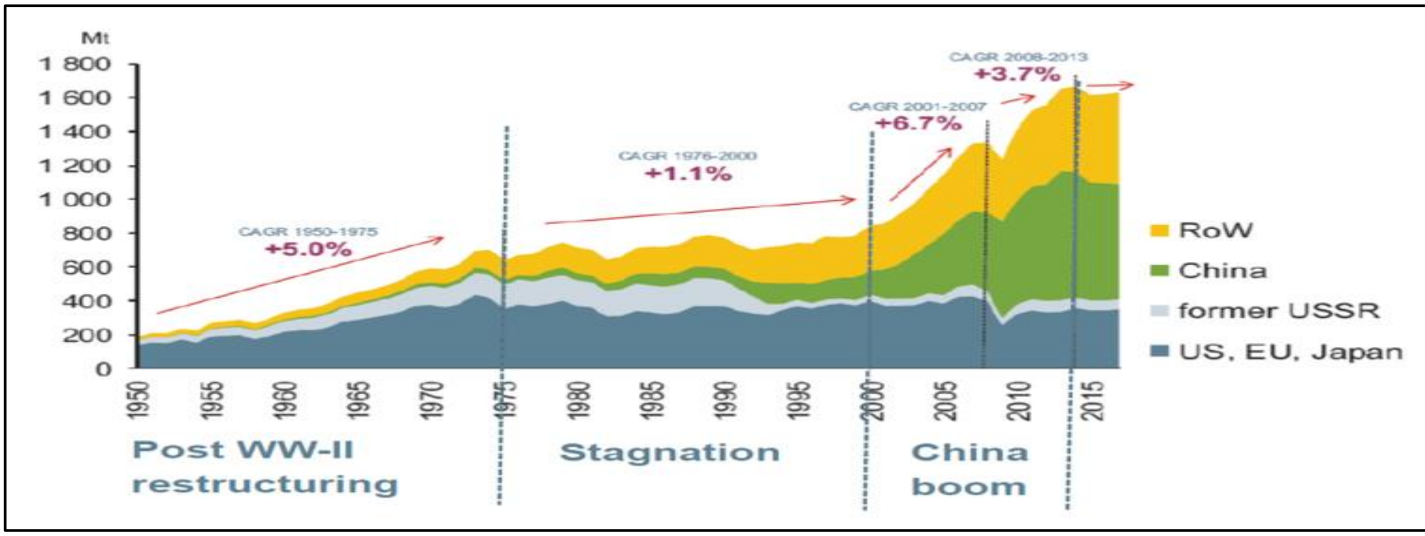


SOURCE: WSA

Can Demand Surprise?

With China's economic slowdown in recent years, much has been questioned about the sustainability of steel consumption in a country with excess steel capacity. We have reasons to believe that demand projections might be under-estimated.

FIGURE 4: EVOLUTION OF GLOBAL STEEL DEMAND (1950 – 2016)

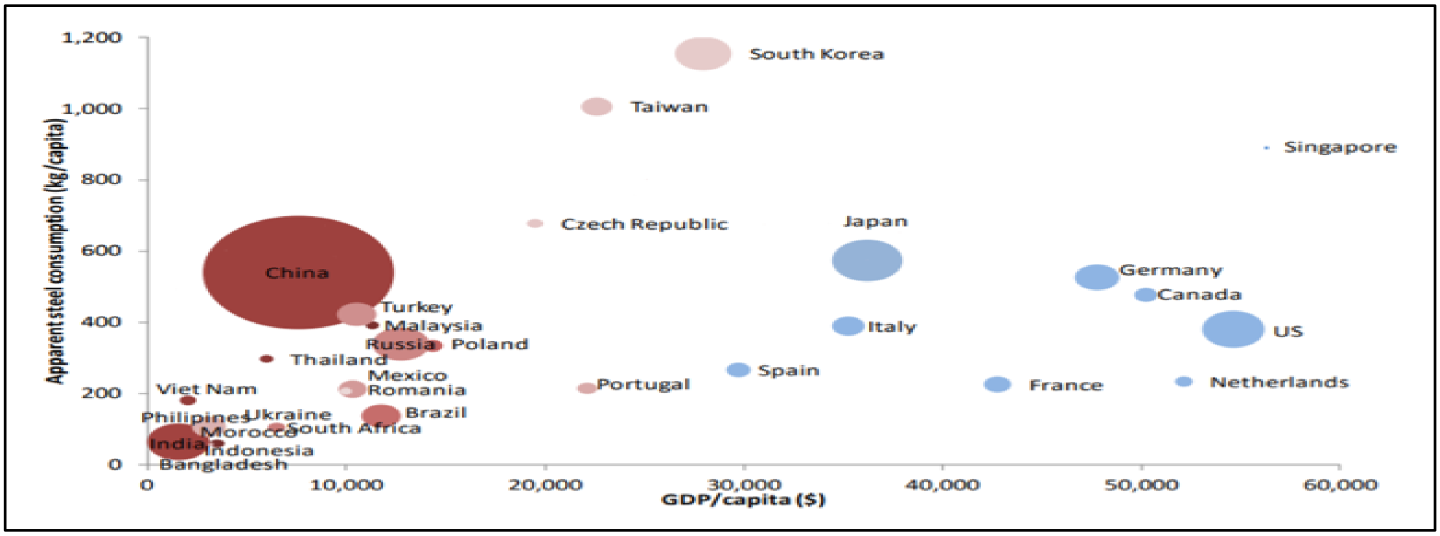


SOURCE: WORLDSTEEL (STEEL DEMAND IN CRUDE STEEL EQUIVALENT TERMS)

Looking longer-term, we draw parallels of China's One Belt One Road (OBOR) initiative to that of the US's Marshall Plan in post-World War Two rebuilding. The beneficiaries, while by no means the size of China, coming from an under infrastructured position, can be collectively a potential 'China' in size, replicating steel consumption during China's industralisation cycle from year 2000 to 2014.

And also if we compare the steel intensity of Korea and Taiwan, it is difficult to envisage a peak out in China so soon.

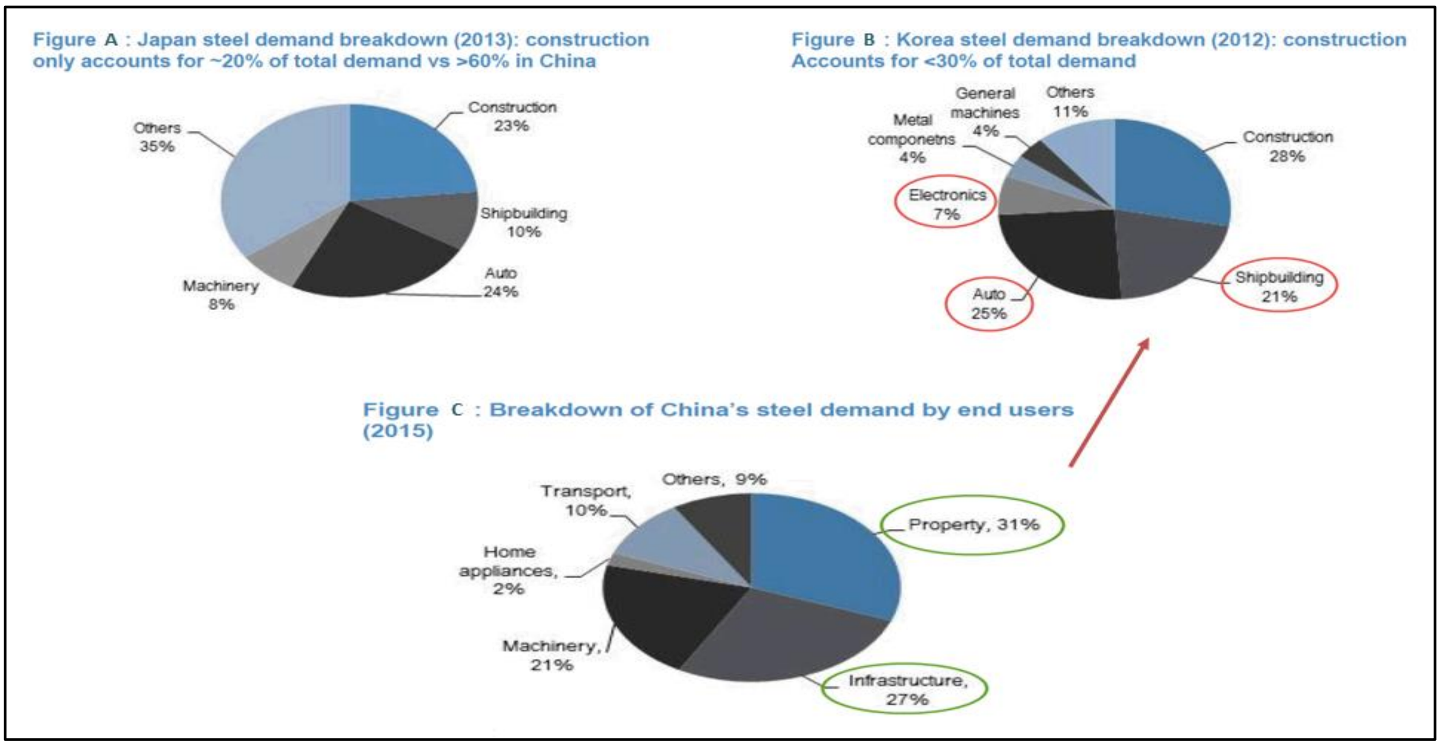
FIGURE 5: STEEL INTENSITY TO GDP & CONSUMPTION BY COUNTRY



SOURCE: WSA, CUSTEEL, DBS BANK

Even as the intensity for infrastructure and property plateau out for China, China's consumption mix will evolve towards the likes of Korea where Autos, Electronics, and other sectors take up the slack.

FIGURE 6: CONSUMPTION INTENSITY (COMPOSITION MIX)



SOURCE: KOSA, NBS, J.P.MORGAN ESTIMATES

<u>Do We Dare Dream an Undersupply Outlook?</u>

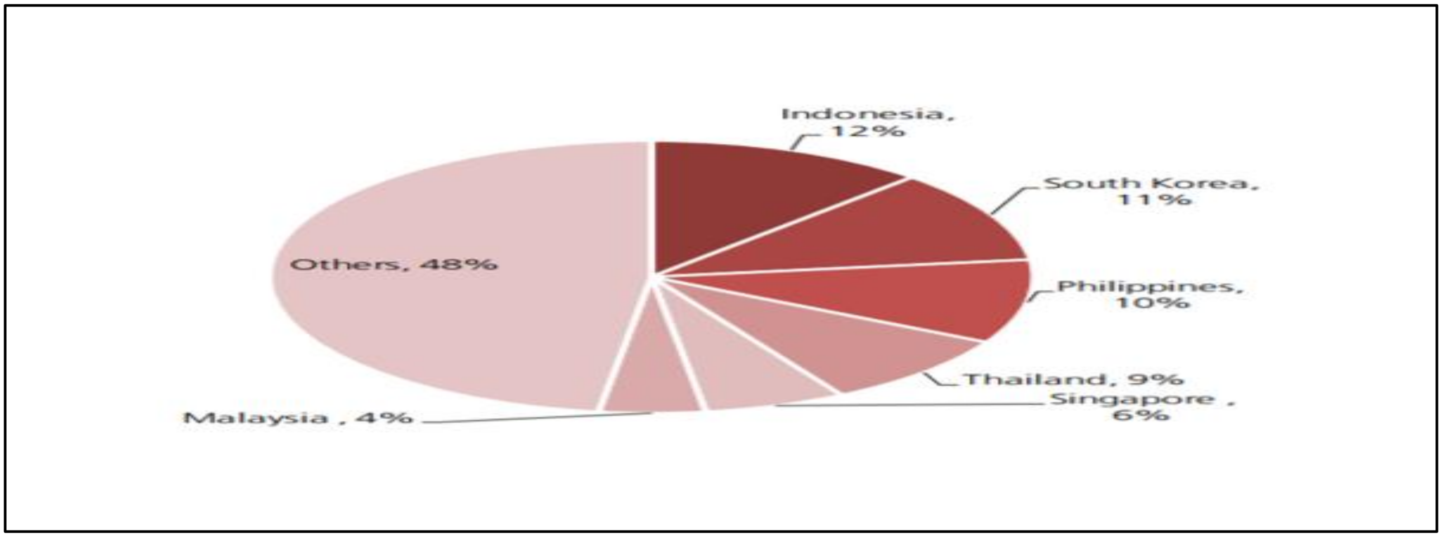
This "Dare to Dream" scenario could well explode on the combo of surprise upside demand when the largest steel producer in the world curtails capacity.

It will not be the China steel producers who benefit but the ex-China steel producers who suffered most that makes the sharpest turnaround in fortunes.

FIGURE 7: CHINA STEEL EXPORTS (MN TONS)

SOURCE: WSA, J.P.MORGAN ESTIMATES (CHINA STARTED TO FLOOD THE REGIONAL MARKETS IN 2013 – 2015)

FIGURE 8: BAR/ROD EXPORT DESTINATIONS (2016)



SOURCE: MYSTEEL, DBS BANK

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