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2 January 2024

A Year Between Fear and Greed: Pivot Point or Bull Trap?

2023 saw a mixed year for the markets as we clawed our way up from the remnants of a sombre 2022. Generative AI became the overarching theme for alpha in global markets while the US Federal Reserve (Fed) hiked interest rates to 16-year highs, only to turn dovish in time for the year-end holiday season. China on the other hand falls short in attracting investors after lifting lockdown restrictions but goes full steam ahead with stimulus measures to prop up its economy. Malaysia also stepped forward with new policies, namely revolving around subsidies as well as taxes on capital gains and luxury goods. That being said, the year was not without its tragedies. Re-escalating Palestine-Israel tensions saw the loss of thousands of lives and prompted worldwide boycotts on certain brands. The year 2023 proved to be a rewarding year for some and a test of resolve for others.

Looking forward to 2024, we surmise the year to be a continuation of the recovery we have seen thus far due in part to a potentially dovish Fed, aggressive policies from China as well as a new ruler in line for Malaysia. These factors collectively set the stage for an exciting year, prompting us to delve into the salient questions that will shape our navigation through the coming months as below.

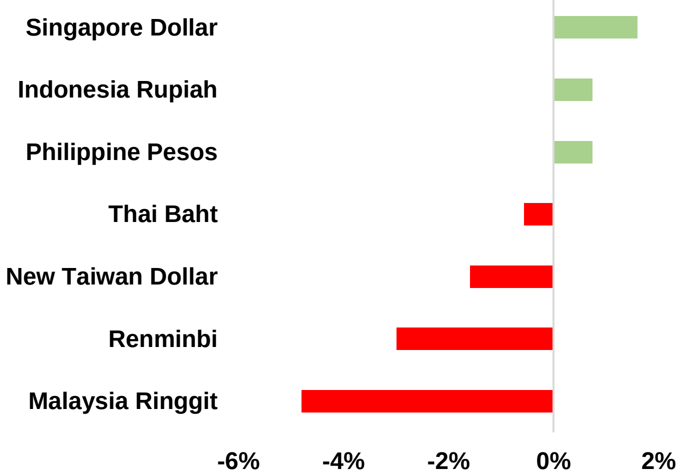
Q1. Peaking interest rates, is it 2024's most crowded trade?

At the beginning of 2023, the US 10-year treasury yield was 3.9% and the US Fed funds rate was forecasted to peak at 5%. At the time of writing, although US 10-year treasury yields are still far-off from reaching the Fed expectations of 2%, the US 10-year treasury yields fell below 4% after the Fed signaled a pause to the rate hike cycle in 2024 and potentially a fresh rate cut as early as March 2024.

After an elongated period of rapid policy tightening, we view the Fed interest rate policy will begin normalizing in 2024, signifying an inflection point by shifting from a 'higher for longer' view to a moderate pace before settling for a rate cutting cycle.

Plus, we also see US inflation rate declining faster than expected which has enabled the Fed to recalibrate its policy direction to avoid a hard landing scenario and ensure ample space for policy easing in case of a gloomy global growth outlook. That said, from a broader perspective, it appears that the Fed is now undertaking a proactive approach in finding a balance that encourages growth while mitigating some of the macroeconomic and geopolitical risks.

Fig. 1: Asian currencies 2023 performance against USD

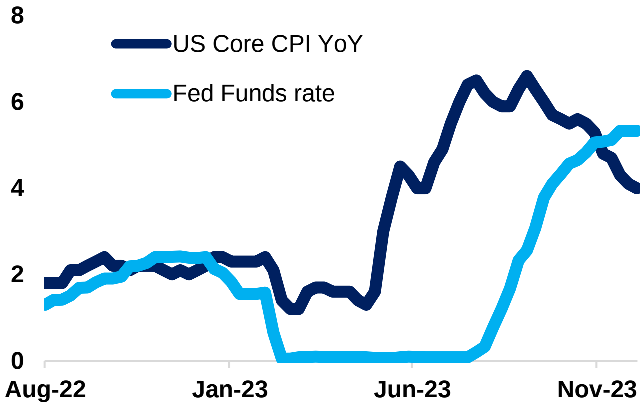


Source: Bloomberg, PCM 29 Dec 23

As such, we may therefore see emerging market currencies recover in 2024 after a majority of them experiencing a modest decline across the board in 2023 (**Fig. 1**). That said, we nonetheless expect the easing of US policy rates to remove the negative externality headwinds surrounding emerging market central banks despite some currencies exhibiting the unexpected reaction of a positive correlation to a weakening dollar.

Again, the key turning point for the Fed pivot will closely depend on a range of key economic indicators such as US economic growth, risk of a hard landing and whether or not inflation reaches Fed target of 2% in 2024 (**Fig. 2**). Other key events to closely watch in 2024 include the US Presidential election that may further raise investor concerns if a political impasse occurs similar to the US 2020 presidential elections, where yields continue to soar due to political instability risk.

Fig. 2: US Inflation rate and Fed Funds Rate



Source: Bloomberg, PCM Dec 23

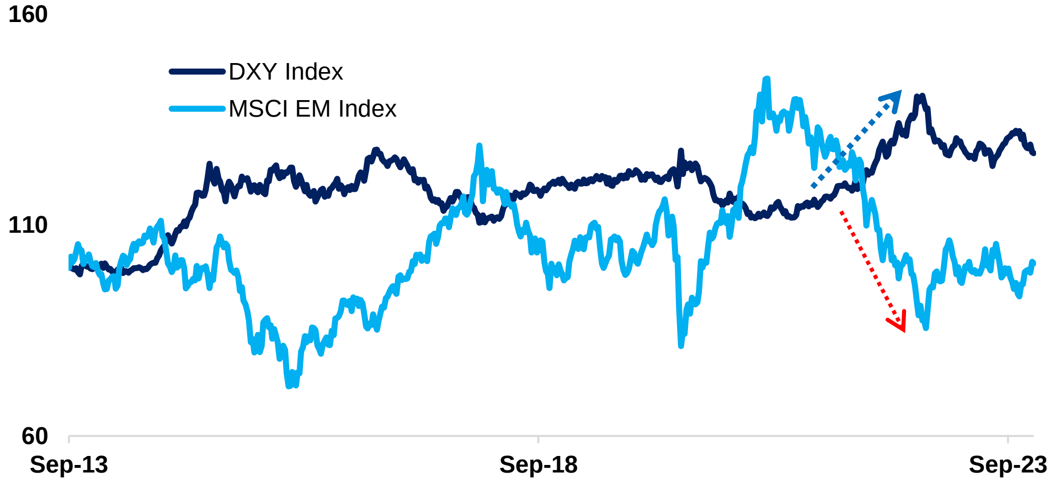
Q2. One man's loss is another man's gain. Who are the winners and losers of a weak US dollar?

The fall of interest rates expected in 2024 should be accompanied by lower financing cost. This could mean a more positive outlook for growth-oriented sectors and those that rely heavily on imports for production inputs, as market valuations for said sectors are severely impacted by the effects of higher interest rates.

We see tech, renewables, industrial manufacturing, infrastructure, consumer and oil & gas as industries that will be poised to benefit from the weakening of the US dollar. On the other hand, we expect export-oriented sectors to see tepid growth in earnings despite a stronger domestic currency. We expect furniture manufacturing, plantation and services will see a moderate growth in earnings.

Governments around the world that are burdened with large budget deficits and weaker macro fundamentals will see a temporary relief following the weakening of the US dollar, especially countries with a higher percentage of US denominated debt. Indeed, a weaker US dollar ostensibly allows them to have more fiscal policy flexibility to maneuver on government spending and debt servicing.

Fig. 3: MSCI EM Index performance against DXY



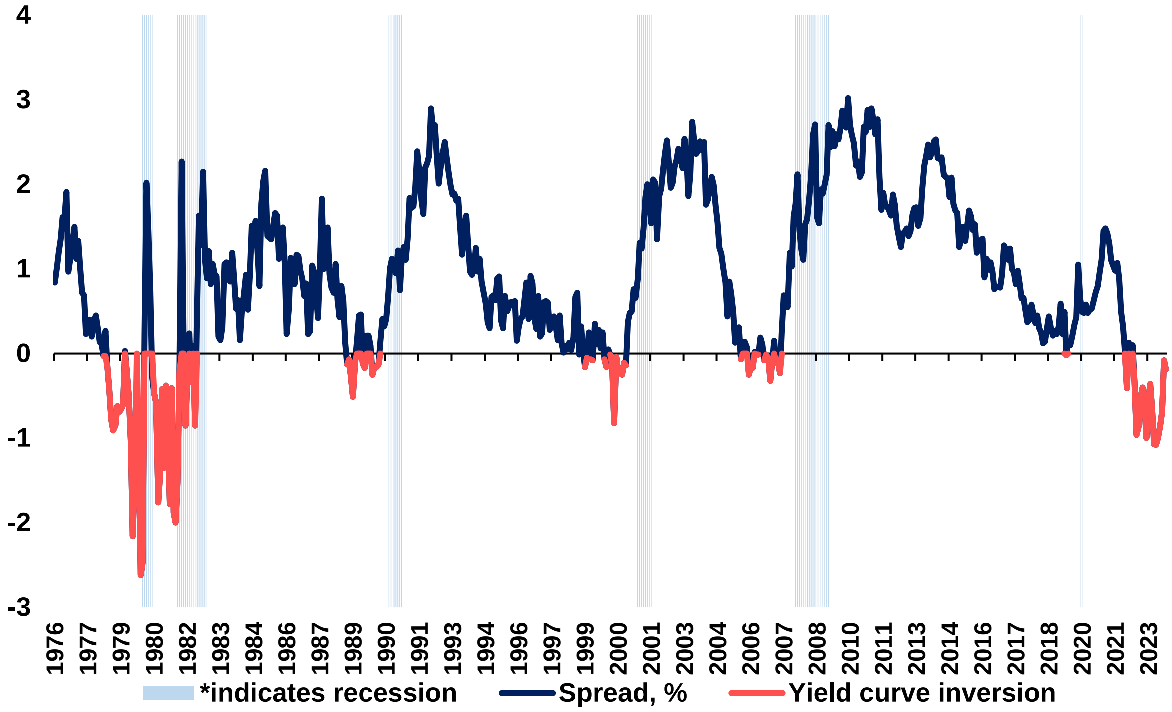
Source: Bloomberg, PCM Dec 23

We anticipate foreign inflow will return to emerging markets again after a sharp sell-off of both EM equity and bond markets amid the Fed's tightening cycle. In our view, historically the weakening of the US dollar drives capital allocation from developed markets to emerging markets as investors hunt for attractive yields which fit into their risk reward profile (**Fig.3**). Hence, a weakening US dollar may mean upside for emerging market asset classes supported by US policy easing and a normalizing yield curve.

Q3. The US Treasury yield curve has been inverted for quite some time. Is it a reliable predictor of a coming recession?

Yield curve inversions, a phenomenon where short-term yields on a risk-free asset (such as US Treasuries) are higher than the long-term yields of that same asset class, have preceded every single US recession since the 1950s. On average, an inverted yield curve will lead the start of a recession by 11 months on average. Referring to **Fig. 4**, notice that each time the 10Y-2Y yield spreads dip below 0, a recession eventually followed. An inverted yield curve's predictive ability can be explained by the shifting of money towards longer-term government bonds during policy rate hike cycles, bidding up the prices of these bonds and pushing down its yield. In this situation, yields on short term bonds will rise accordingly to policy rates while yields on long term bonds do not react as much. From a price perspective, prices of long-term bonds are much more sensitive to changes in interest rises compared to short-term bonds, which presents an opportunity for traders to profit from bond price appreciation when central banks cut their policy rates, which usually occur during recessions. A persistent inverted yield curve does not encourage long-term borrowing such as mortgage loans and eventually leads to a weaker economy.

Fig. 4: US Treasury spread (10Y-2Y) against recessionary periods 1976-2023



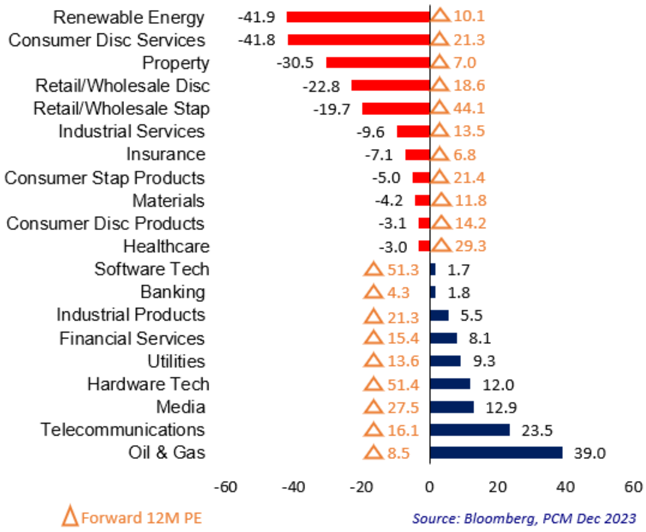
Source: Federal Reserve, PCM Dec 23

It has been 17 months since the yield curve inverted in July 2022 and we have yet to see signs of a recession in the US. Normalizing inflation, a healthy job market and a potentially dovish Federal Reserve could point to signs of a soft landing, if a recession occurs. However, based on past records, the longest lag between yield curve inversion and a recession was 24 months, being the lead-up to the 2008 global financial crisis. Thus, we should not rest on our laurels and start thinking we've steered clear of a recession. In fact, 24 months is not the upper limit. There is a first for everything and it is entirely possible we reach 30 months or more before the next recession comes. As prudent investors, we need to understand that the risk of a recession exists although empirical evidence suggests it may not be as substantial as some experts play it out to be. Even if markets come down, over the long term, the bulls have always beaten the bears and the markets have always managed to breakthrough pre-recession highs. Moreover, during recessions, US Fed have always reduced interest rates which helped to support the equity market.

Q4. China recovery has been uneven. Would the market return to pre-pandemic levels, and if so, what would be the contributing factors?

Despite efforts to stimulate the economy and revive the property sector, China post-pandemic growth remains subdued. The main drag on China stock market performance came from renewable energy, consumer discretionary services, and the property sector (**Fig. 5**).

Fig. 5: China Stock Performance by Sector (2023)

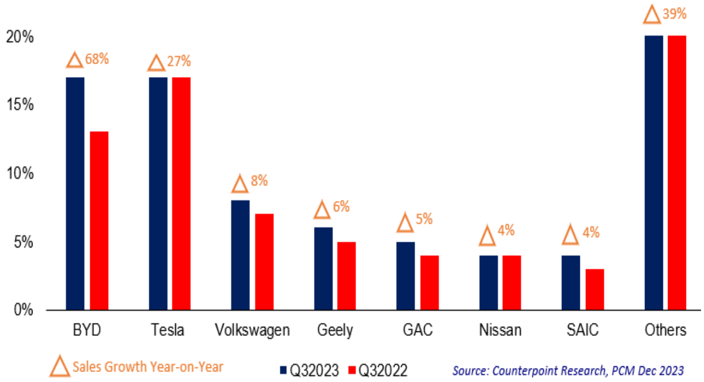


Source: Bloomberg, PCM Dec 2023

Many investors still focus on the property sector but neglect its rapidly growing digital economy, including areas such as Artificial Intelligence (AI), Electric Vehicles (EV), Renewables, Data Mining, Machine Learning, Cloud Computing, etc., which accounted for 41.5% of China GDP in 2022 according to China Academy of Information and Communications Technology. This is in line with the Digital China initiative outlined in China 14th five-year plan (2021-2025) that projected a growth of 25% in its data elements market. US restrictions on advanced chips critical to the development of AI tech as well as cutting-edge weapons also forced China tech giants to be self-sufficient in this area.

EVs have also been growing fast in China. As of 3Q2023, China remained the largest pure EV market globally, accounting for 58% of global market share versus the US' 12%. China EV brands also experienced significant growth in overseas markets in the same period, with a fourfold increase y-o-y, reaching 130,000 vehicles. (**Fig. 6**).

Fig. 6: Global BEV Unit Sales Share 3Q2023 vs 3Q2022



Source: Counterpoint Research, PCM Dec 2023

Despite multiple growth areas, China valuation remains attractive, with stock prices having fallen more than other markets, trading at -1.2 standard deviation below its 5-year mean (**Fig. 7**).

We expect more policy interventions and stimulus measures from the government and regulators to avert default in the property sector, including larger deficit spending by the government and further interest rate cuts in 2024. However, the focus is not on making it a pillar to support the economy. Separately, new growth areas have the potential to expand further in China, transforming the economic structure over the longer term. Digital technologies have been increasingly applied into a wide range of fields and have integrated with China real economy, as evidenced by increased digital business expenditures in enterprises that are expected to reach CAGR of 19.1% between 2023 and 2026 according to International Data Corp. These would drive China economy and market.

Fig. 7: Valuation by Market

	Current PE	Fwd PE	Fwd Earnings
US	21.9	18.1	12.4%
Europe	12.7	11.6	9.0%
UK	10.1	10.7	9.7%
APAC ex Japan	15.5	11.6	16.8%
China	12.1	9.2	15.3%
HK	9.1	7.4	12.8%
Taiwan	20.6	13.8	22.3%
Korea	16.9	8.8	27.9%
Japan	27.1	17.1	12.1%
Malaysia	13.3	12.4	9.9%

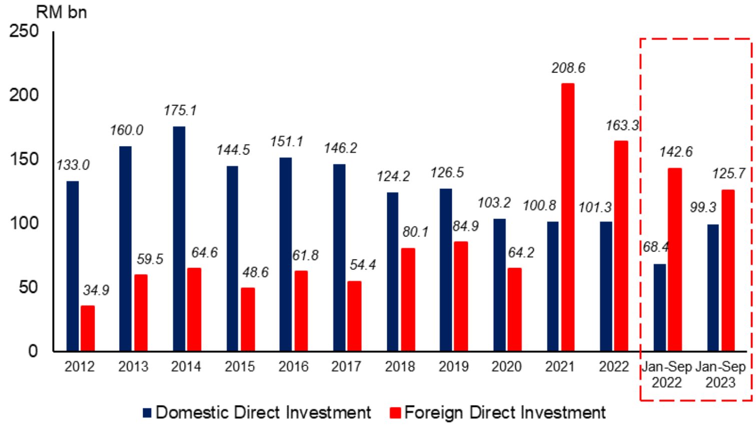
Source: Bloomberg, PCM Dec 2023

Q5. Could you provide insights into the factors that have led to the significant increase in Foreign Direct Investment (FDI) in Malaysia since 2021? Furthermore, is this upward trend sustainable in the long term?

Prior to 2021, Malaysia approved investment in foreign direct investment (FDI) has been lower than domestic direct investment (DDI). That could be attributed to an uneven state of global economic conditions post-2008 global financial crisis; weakening domestic economic growth; a weak investment climate including high regulatory and compliance costs and lingering uncertainty about policy transition as well as political instability.

FDI has outpaced DDI since 2021 (**Fig. 8**), benefitting from China-plus-one strategy for many multinational companies, resulting from US-China trade tension, Covid-19 lockdowns, as well as regulatory crackdowns on technology, education, property and tech sectors. The diversification of businesses from China is mainly in the electronics manufacturing services (EMS) sector evidenced by the securing of higher orders in the sector, especially data centre construction. Many of these companies are multi-national corporations diversifying away from China.

Fig. 8: Approved Investment in Malaysia



Source: MIDA, DOSM, PCM Dec 2023

In less than three years, Malaysia has drawn RM76bn in data centre (DC) investments and is expected to have an average annual growth rate of 16% from 2021 to 2026 according to Minister of Investment, Trade and Industry, Zafrul Aziz. Over 40 DCs are currently operational, each with a capacity ranging 100-150MW with some capable of reaching 500MW upon full completion. The developments in the pipeline are expected to add around 1,400MW of capacity.

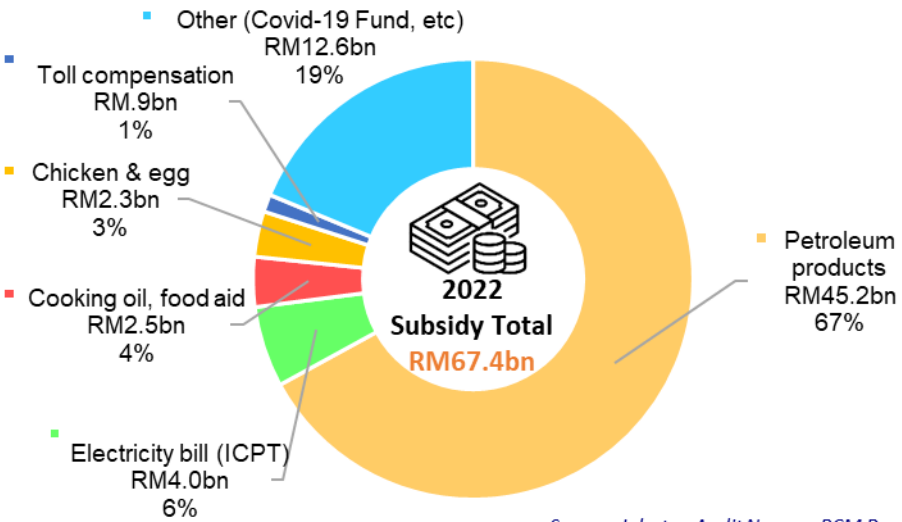
In 9M2023, approved investments were RM225bn (DDI 44% and FDI 56%) and exceeded FY23 target of RM220bn, a 6.6% increase vs 9M2022 of RM211bn and 1% higher than the 10-year average of RM222.6bn (**Fig. 8**). 70% of the approved investments is primarily in Electrical and Electronics (RM57.4bn), Information and Communications Technology (RM45.6bn) and Real Estate (RM44.4bn).

The momentum also comes from political stability after the formation of the Unity Government. We believe an improved policy outlook in Malaysia is likely to result in increased clarity and continuity of policies. The Malaysian economic growth will continue to be supported by domestic demand, improving labour market conditions and expected higher tourist arrivals from China, as well as continued implementation of multi-year investment projects.

Q6. The Malaysian Government paid RM67 billion in subsidies back in 2022 and is expected to be even higher in 2023. Will this trend continue in 2024 and how is the government handling this situation?

Subsidies have become part and parcel of any Malaysian's life, be it B40 to T20, or sole traders to big corporations. In fact, our history of subsidies dated way back to independence, where it was originally intended for rural development and production. The subsidies in Malaysia cover various core necessities such as petrol, electricity, food and others. Petrol subsidies consistently make up the biggest slice of our subsidy bill every year and as of 2022, subsidies for petroleum products, especially petrol and diesel, total a whopping RM45.2bn (**Fig. 9**) and is a 350% increase from the prior year at RM10bn. This poses a serious problem to our government finances, as Malaysia has been running a budget deficit ever since the 1997 Asian financial crisis and has been ranging from 3 - 6.5% of GDP since 2002. Moreover, blanket subsidies flowing to less deserving segments of the nation and leakages have been a point of debate for many years. In 2022, 53% of fuel subsidies went to the T20 group compared with just 15% to the B40 group while subsidised diesel leakages amounted to almost RM10bn.

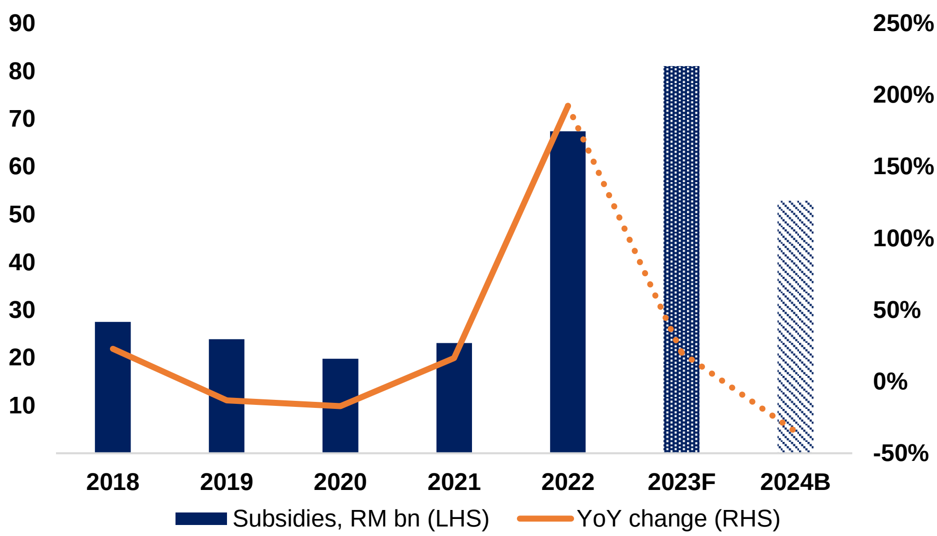
Fig. 9: Breakdown of Subsidies paid in 2022



Source: Jabatan Audit Negara, PCM Dec 23

On the other hand, the rollout of subsidies has done very well in controlling inflation. Despite supply chain woes and a subdued labour market as a result of the Covid-19 pandemic, Malaysia inflation peaked at 4.68% before dropping back down to healthy levels under 2% currently. This is in stark contrast with other ASEAN countries and even developed markets who are still combatting inflation to this day. However, generous subsidies are not without its fair share of troubles. Pundits argue that over-reliance on subsidies create undesirable knock-on effects which create a middle-income trap for citizens in the form of depressed wages. Low inflation disincentivises employers to raise wages while the race to keep exports and FDI competitive causes our currency to weaken.

Fig. 10: Malaysia subsidy spending 2018 – 2024 (Budgeted)



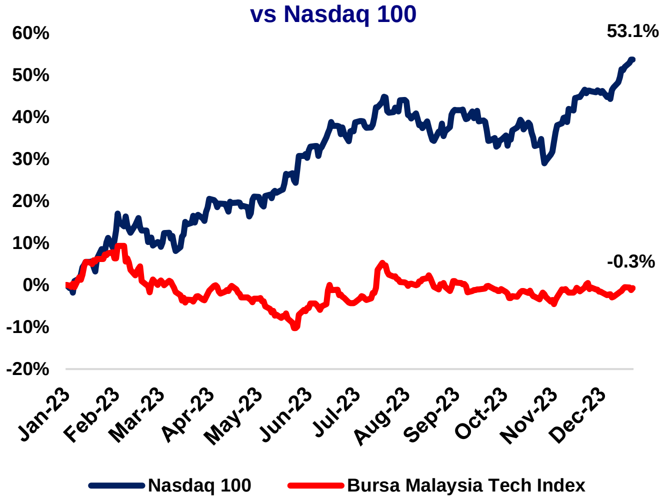
Source: Ministry of Finance, PCM Dec 23

Our government has pledged many steps to address these issues in 2024, primarily through subsidy rationalisation, cutting budgeted subsidies by 35% to RM53bn from 2023 forecasted amount of RM81bn, the highest subsidy bill in Malaysian history (**Fig.10**). In addition to the diesel subsidy rationalization announced in Budget 2024, the government had pronounced it will also rationalize petrol subsidies from 2H24 onwards. Based on what we have learned so far, the implementation method will be through targeted subsidies, utilising PADU, a centralised database to store personal information on citizens such as individual and household income and using that data to distribute target subsidies through a subsidy card. Although things are subject to change, we are positive on this direction and believe it will complement the targeted electricity subsidies implemented in 2023 and its expected revision in 2024. We are confident in Malaysia's ability to absorb the impact to living costs and subsequently create a more equitable environment where the government is more able to exercise optimal capital allocation.

Q7. The anticipated recovery in Malaysia Technology sector did not materialize as expected, and its pace has remained sluggish throughout 2023. Are there indications or prospects suggesting potential for a more robust recovery in 2024?

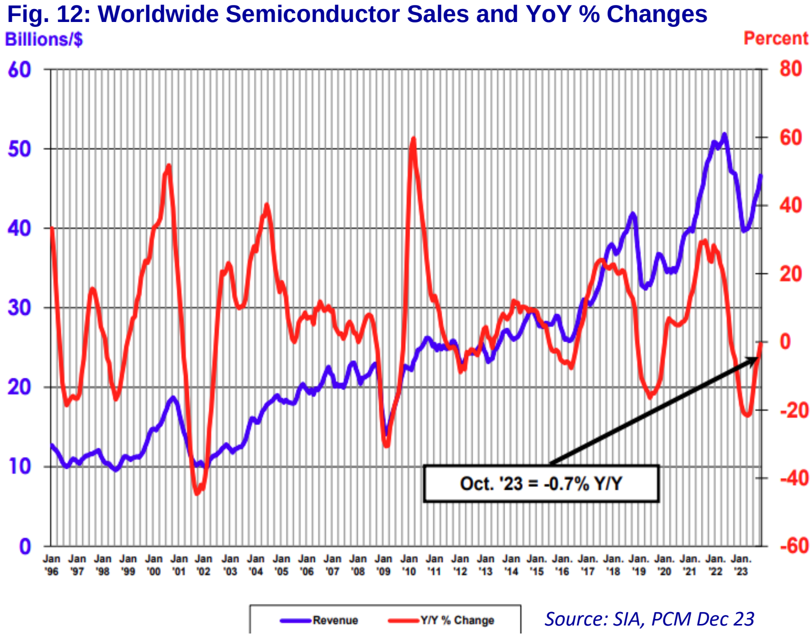
The Bursa Malaysia Technology Index slipped 0.3% in 2023, severely underperforming the Nasdaq which has surged 53.1% (Fig.11). The underperformance was mainly due to slow recovery in earnings and dim outlook from management guidance. The earnings were impacted by slow volume recovery in customer orders, elevated fixed costs from earlier expansions over the past 2 years, and higher input costs from electricity and wages. On the other hand, The Nasdaq's notable performance can be attributed primarily to increased optimism surrounding anticipated interest rate reductions, alongside a more positive projection for semiconductor recovery which is driven by a revival in consumer electronics and booming AI demand.

Fig. 11: 2023 Performance for Bursa Malaysia Tech Index vs Nasdaq 100



Source: Bloomberg, PCM Dec 23

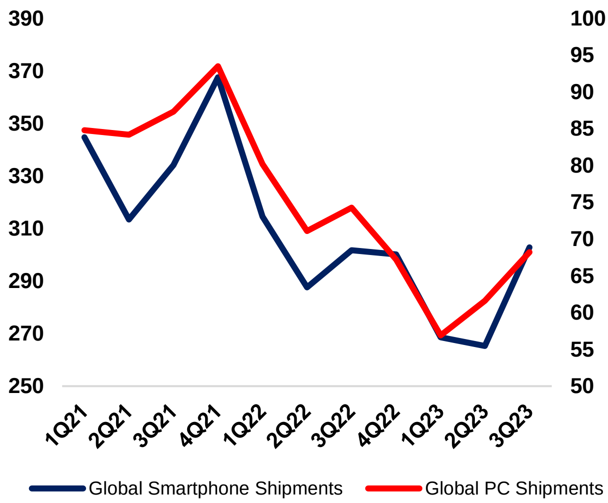
Fig. 12: Worldwide Semiconductor Sales and YoY % Changes



Source: SIA, PCM Dec 23

According to the Semiconductor Industry Association (SIA), global semiconductor sales have marked 8 consecutive months of MoM market growth (**Fig. 12**). SIA and IDC (International Data Corporation) have recently raised their global semiconductor sales forecasts which are projected to grow by 13.1% and 20.2% respectively, in 2024. The growth is attributed to inventory rationalization and heightened demand from AI server endpoint device manufacturers. Moreover, global smartphone and PC shipments sales in 3Q23 are also reflecting resurgence in demand for smartphones and PC (**Fig. 13**). Overall, Malaysian technology companies are experiencing a delayed recovery in our view. We expect the improvement to materialise as customer orders slowly recover moving forward, especially in the latter half of 2024.

Fig. 13: Global Smartphone and PC Shipments (mil units)

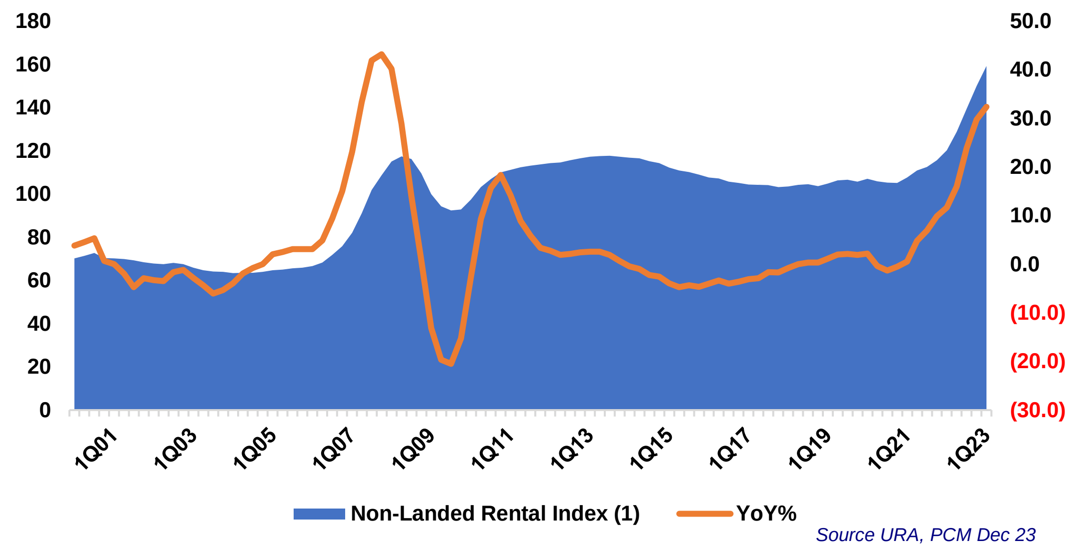


Source: IDC, PCM Dec 23

Q8. What key factors contribute to the optimistic outlook for Iskandar Malaysia (IM) development?

The property sector experienced a prolonged downturn from the aftermath of the 2014 property cyclical peak. Nevertheless, we believe that IM's prospects are underscored by the announcement of the JB-Singapore RTS station. This has instilled confidence and provided visibility on growth prospects in Iskandar Malaysia, boosted property prices around the RTS station to RM1,000-1,300k psf (on par with KLCC area). The recent unveiling of friendlier policies, including the Malaysia 2nd Home Programme as well as the special 15% income tax rate for eligible skilled workers in the special financial zone (Forest City), has positive influence on the Iskandar property market, attracting both local and international property investors and buyers.

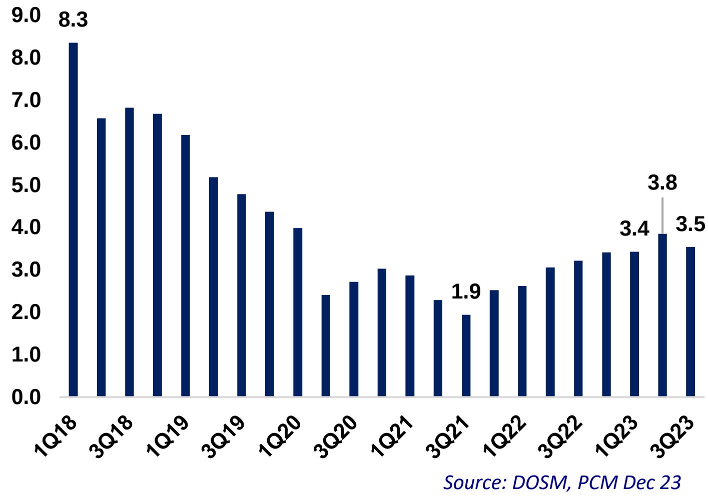
Fig. 14: Rental in Singapore surged post covid-19 pandemic



Apart from the positive news flow, rising rental rates in Singapore, coupled with the strengthening Singapore dollar, are becoming a push factor for Malaysians or expatriates working in Singapore to relocate to Johor, given the proximity and price differentials. High-rise rentals in Singapore grew 32% YoY in 1Q23 (**Fig. 14**), and the Singapore government raised stamp duty from 30% to 60% for foreign purchase of properties in Singapore from April 2023. Hence, we expect it will attract higher-income residents to relocate to Iskandar Malaysia, which will likely create a favourable demand for housing in IM.

The state of Johor has experienced a robust construction sector, with the value of construction-work-done reaching RM10.8bn in 9M23 (**Fig. 15**). As of 21 Dec 23, Johor awarded RM20.5bn worth of construction projects, closely trailing Selangor with RM25.4bn (**Fig. 16**). The burgeoning data centre industry in Johor, contributing RM51bn in 2022, is set to see an additional RM17bn investment in 2024. Beyond data centres, Johor remains attractive to both international and local investments, offering opportunities in Iskandar Rapid Transit, Bus Rapid Transit, mixed development TOD (transit-oriented development, High Speed Rail (HSR), LRT, and data centres within industrial parks.

Fig. 15: Value of quarterly construction work done in Johor (RM bn)



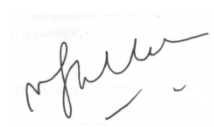
The collaborative of the Johor-Singapore special economic zone may encourage Singaporean companies to consider relocating a portion of their workforce to Johor. This possibility is reinforced by the positive discussions between the two governments, namely in adding ferry services and a potential new service between Puteri Harbour and Tuas near Forest City. The integration is anticipated to boost local consumption and contribute to the overall economic growth of the region.

Fig. 16: Contract Value Awarded as at 21st December 2023 (RM bn)

Source: DOSM, PCM Dec 23

Overall, we are optimistic about the current situation, with significant improvement observed in Johor, particularly around the RTS station at Bukit Chagar. The positive momentum is expected to continue, fuelled by ongoing and upcoming infrastructure projects, government incentives, healthy investment inflow and an attractive investment environment. We believe the completion of RTS and revival of HSR projects will continue to drive IM market growth, with long-term success driven by enhanced connectivity and convenience at the CIQ (customs, immigration and quarantine). With that, we anticipate a gradual rise in business activities and human traffic in Johor Bahru over the mid-to-long term. Notably, the upcoming appointment of the Johor Sultan as the next Agong is expected to further influence this sentiment.

For Phillip Capital Management Sdn Bhd



Nona Salleh
Executive Chairperson