STRATEGY

FBM KLCI 2020 Target: 1,680 pts

Valuation expansion: Asia in footsteps of US/Europe?

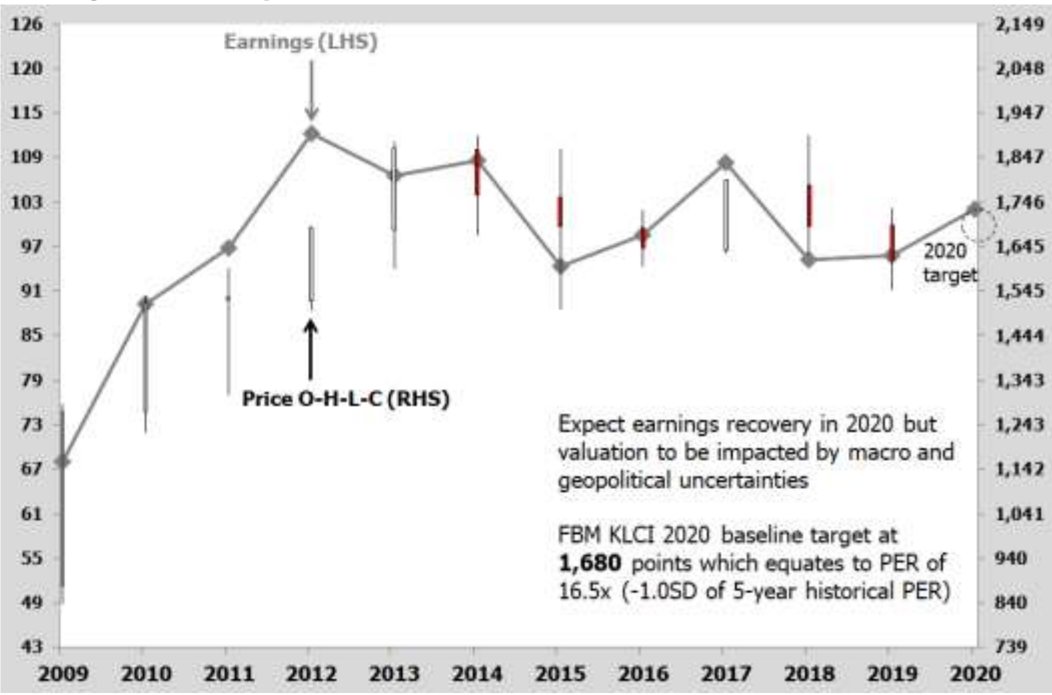
KEY INVESTMENT HIGHLIGHTS

- **Earnings growth rate expected to be measuredly positive at 6.4% in 2020**
- **Reiterate our FBM KLCI baseline target for next year at 1,680 points or -1SD historical PER**
- **Recent rally pushed up the valuation of US and European equity markets**
- **Valuation expansion is a bona fide (upside) risk to Asian equities going forward**
- **Burgeoning US monetary base may positively impact Asian currencies**
- **In turn, attracting funds eastward**
- **Hence benefiting Asian equities in 2020**

We begin our 2020 outlook commentary with the following remarks:

1. *Past observations of both earnings and price trends are conclusive with regard to their secular direct relationship amidst price range volatility engendered mainly by valuation-related factors as well as myriads of situational 'noises'.*
2. *Hence our forward assessments on the likely price path of the equity market during the coming period are largely the functions of expected earnings performance and valuation-related factors.*
3. *Our baseline year-end price target for 2020 is underpinned by forward earnings and pegged against historical valuation yardstick.*
4. *Nevertheless, we shall also deliberate on potential valuation-related 'tail' event that might influence the eventual price path.*

Earnings trend and price levels of FBM KLCI



Source: Bloomberg, MIDFR

EARNINGS

Going forward into 2020, the market consensus is anticipating corporate earnings growth to expand at a relatively faster clip as compared to this year. However, the forward growth rate is expected to be rather measured (despite the low-base from this year), which is in line with the tepid prevailing sentiment on macro outlook. In this regard, the FBM KLCI is forecasted to register a modest 6.4%yoy earnings growth next year.

Historical and forward earnings growth of FBM KLCI

Year	EPS	YoY (%change)
CY2020(F)	101.81	+6.43
CY2019(E)	95.66	+0.69
CY2018	95.00	-11.96
CY2017	107.90	+9.79
CY2016	98.28	+4.39

Source: Bloomberg, MIDFR

In the broader market, based on our coverage universe of 120 stocks listed on Bursa Malaysia as at early-December 2019, the aggregate earnings growth is forecasted at 8.9%yoy for the next financial year (FY). On sectoral basis, the Financial Services, Consumer Product & Services (P&S) and Industrial P&S are expected to contribute the largest quantum of incremental earnings while the Plantation, Consumer P&S and Industrial P&S sectors are anticipated to generate the highest growth percentages. Moreover, none of the sectors are expected to register negative earnings growth in the forward financial year.

Sectoral earnings forecasts (MIDFR Universe)

Sector	Current FY	Next FY	% Change
Construction	1,448.02	1,624.27	12.17
Consumer P&S	4,957.70	5,929.80	19.61
Energy	1,281.40	1,449.80	13.14
Financial Services	31,414.90	32,734.10	4.20
Health Care	2,482.70	2,899.60	16.79
Industrial P&S	4,729.43	5,783.06	22.28
Plantation	2,040.70	2,783.50	36.40
Property	2,001.10	2,136.10	6.75
REITs	1,970.70	2,081.70	5.63
Technology	608.50	699.10	14.89
Telco & Media	5,707.00	6,196.70	8.58
Transport & Logistics	3,536.80	3,722.10	5.24
Utilities	8,126.60	8,502.60	4.63
Total	**70,305.55**	**76,542.43**	**8.87**

VALUATION

We reaffirm the view that a key underlying dynamic of 2019 (and also next year) is the concurrent dovishness [particularly] among the world's three major central banks. Unlike in the previous year, we now witnessed a more concurring broad monetary policy stance by the US Fed, ECB and the PBOC (as well as, by extension, other smaller central banks including Bank Negara Malaysia). However, we also observed varying degree of aggressiveness thus far among the monetary authorities worldwide.

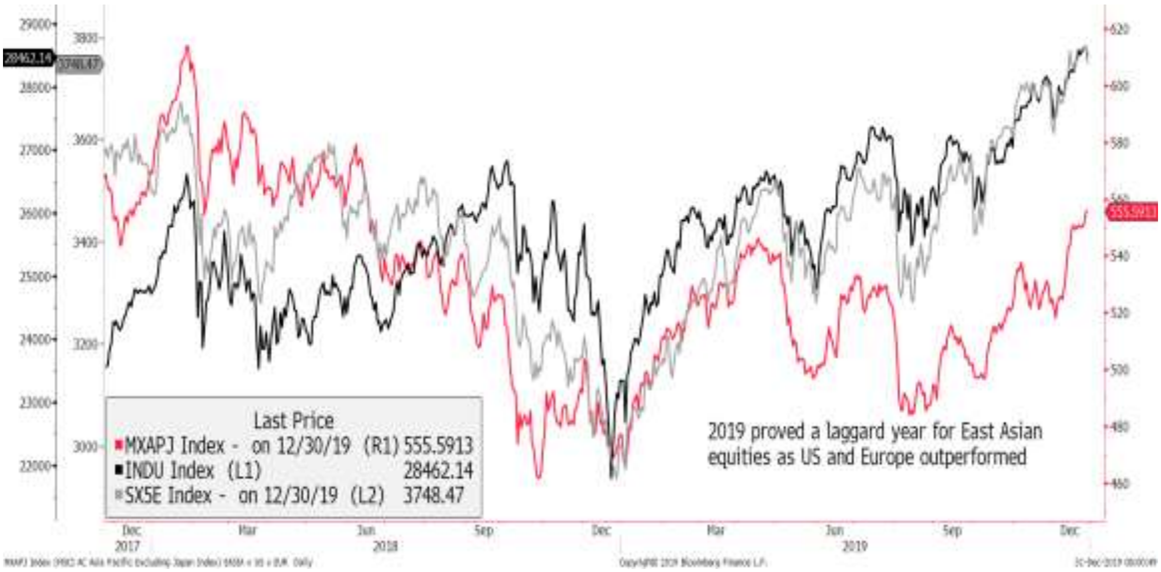
As amply stated in our earlier strategy reports, we must also again highlight that the potentially virtuous impacts of the easing monetary dynamic (i.e. burgeoning tide of world's financial liquidity) are not limited to buttressing the real economy but also [more immediately] towards the valuation of risk assets.

In the US, its relatively strong economic performance together with multiple rate cuts (totaling 75bps this year) helped to prop up the equity market. The DJIA and other key Wall Street indices made multiple new all-time highs this year and, as of ending December, were trading at circa record levels. Valuation-wise, its 12-month trailing PER expanded from 15.0x in late 2018 to nearly 20x at current juncture.

Whereas in Europe, with its major economies tethering on the brink of recession (e.g. Germany narrowly avoids technical recession in 3Q19), the ECB reacted by postponing an earlier planned timeline of rate hikes and instead announced the resumption of liquidity injections via TLTRO III program.

Its equity markets reacted positively arguably to the prospects of macro reflation as seen by the performance of its key equity indices. It is notable that, as of ending December, the Frankfurt's DAX was trading at less than 3 percent off its all-time high mark while Paris' CAC was hovering at post-GFC highs. Similarly, the European benchmark STOXX50 index was hovering near its all-time high levels. Valuation-wise, its 12-month trailing PER expanded from 13.5x in late 2018 to more than 20x at current juncture.

East Asia (MXAPJ) lagged US (INDU) and Europe (SX5E) in 2019



Source: Bloomberg, MIDFR

Meanwhile in East Asia, the response of its monetary authorities to the prevailing economic slowdown has been comparatively muted. In China, despite its GDP growing at multi-decades low, the PBOC has been especially measured in its monetary reaction.

In our previous 2019 Outlook (dated 17 December 2018), we envisaged that,

> *"The odds are rising for PBOC to take monetary countermeasures thus we could see a spate of rate cuts as early as in 2019. On this score, the liquidity injection may in turn be a positive catalyst to the China's equity market next year with a positive spillover effect on other emerging markets."*

What we had in mind then was the magnitude of expected rate cuts by the PBOC in 2019 would at least match the intensity of monetary easing in 2015 (i.e. 5 cuts totaling 120bps).

However, as it turned out, the China central bank has thus far (since the onset of US-China trade spat) decided to cut its LPR policy rate by measly 15bps in total. In this regard, we can argue that the underperformance of East Asian equities benchmark MSCI Asia-Pacific ex-Japan (MXAPJ) vis-à-vis its US (DJIA) and European (STOXX50) counterparts in 2019 can be partly attributed to the relative lack of aggressiveness in monetary policy reaction to the prevailing economic slowdown.

Going into 2020, assuming a baseline scenario in which (1) the US-China trade dispute fails to achieve full closure, and (2) the East Asian region continued to be beset by the relative lack of liquidity-induced macro reflationary prospects, we foresee a situation whereby equities valuation would remain depressed.

FBM KLCI: Historical PER

Source: Bloomberg, MIDFR

Under above circumstances, the FBM KLCI may see its valuation tapering towards the lower end of its historical range. Hence our baseline target for the FBM KLCI in 2020 is pegged to PER of 16.5x, which equates to -1.0SD (standard deviation) of its 5-year (2014-18) historical average.

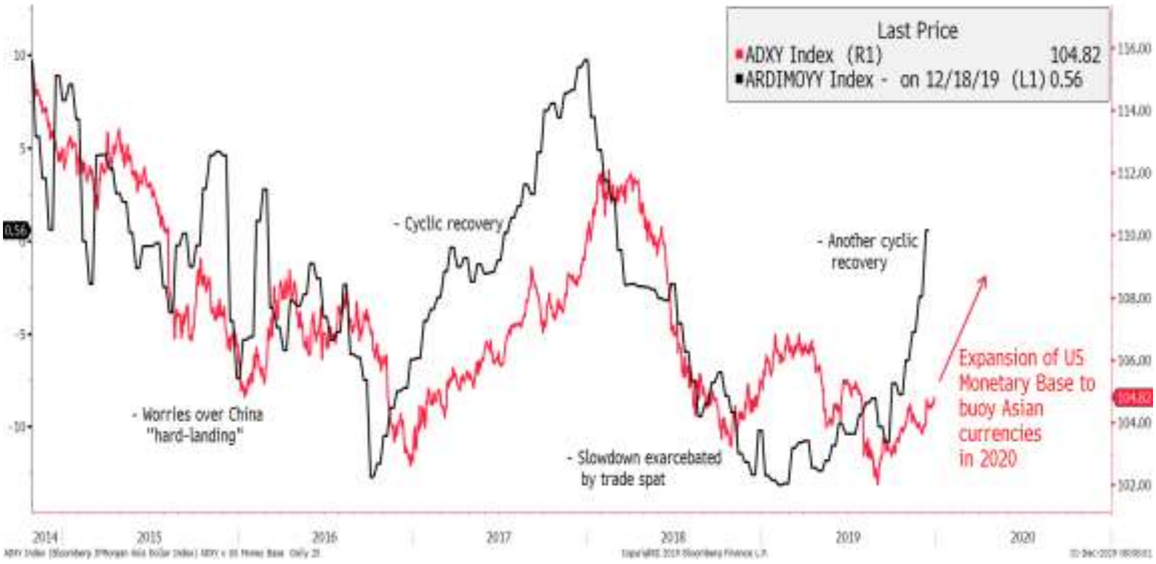
As the EPS for 2020 is forecasted at 101.8, we reiterate our year-end 2020 baseline target for the FBM KLCI at 1,680 points.

'TAIL' SCENARIO

While our official 2020 year-end target for the FBM KLCI is based on the baseline scenario in above, we cannot ignore the possibility of a 'tail' scenario transpiring. If the 'tail' scenario were to happen, we may see material valuation expansion which would catapult the FBM KLCI towards the higher end of its historical PER range. Under the 'tail' scenario, at +1.0SD and PER of 18.4x, the FBM KLCI may conceivably rise to 1,900 points (which equates to its all-time high level) in 2020.

Admittedly, the US Dollar is still very much the world's reserve currency and the foremost source of cross-border funding for both economic as well as financial activities worldwide. This reality can be glanced through the highly correlative relationship between the US monetary base and the Asian currencies (as represented by the ADXY index).

US Monetary Base versus Asian Currencies (ADXY)



Source: Bloomberg, MIDFR

As the US Fed carries on with its dovish monetary stance, we can expect to see continued expansion of its balance sheet. In this regard, we foresee the fledgling expansion of US monetary base to continue into 2020. Consequent to the continued expansion of US monetary base, it is not inconceivable to anticipate rising flow of (both economic and financial) funds eastward with positive impact on the performance of Asian currencies.

In our baseline scenario, as above stated, the East Asian region shall continue to be beset by the relative lack of liquidity-induced macro reflationary prospects. However, in the 'tail' scenario, the movement of funds eastward may help to underpin investors' sentiment over the prospects of liquidity-induced macro reflation in East Asia. On this score, the so-called economic 'green-shoots' are all needed to convince some investors that they are actually seeing light at the end of the tunnel.

As the rising US monetary base correlates with strengthening Asian currencies (arguably due to rising flow of funds eastward), we reckon the value of the Malaysian Ringgit would likewise be reinforced. In this regard, the FBM KLCI should similarly be bolstered as its performance, at least in the shorter-term, is correlated to the movements of Malaysian Ringgit against US Dollar.

FBM KLCI versus USD/MYR

Source: Bloomberg, MIDFR

Another aspect of the 'tail' scenario is the re-steepening of the bond [UST in particular] yield curve. On this score, it must be highlighted that the re-steepening of the yield curve is not the cause but rather a symptom of an impending equity 'melt-up' and a resultant valuation expansion in the equity market.

The re-steepening happens when the long-end of the UST curve begins to underperform the short-end. As the short-dated issues (i.e. 3- or 6-month) generally track the prevailing US Fed rate, a spate of policy rate cuts may lead to lower yields at the short-end.

Meanwhile, the longer-end of the curve is more influenced by investors' expectations on future growth and its attendant risks. On this score, heightened risks to economic growth would see investors flocking into the long-end of the curve, and vice versa.

As the monetary authorities feed the economy with financial liquidity (e.g. by cutting rates), with some policy traction, the resultant macro reflation would see money flowing out from the safety of longer dated UST into riskier assets. This would result in an upward yield pressure at the longer-end of the curve, hence its underperformance.

Nevertheless, the money rotation into riskier assets such as equities would results in price rally and resultant valuation expansion. This phenomenon is empirically prevalent especially toward the tail-end of a business cycle.

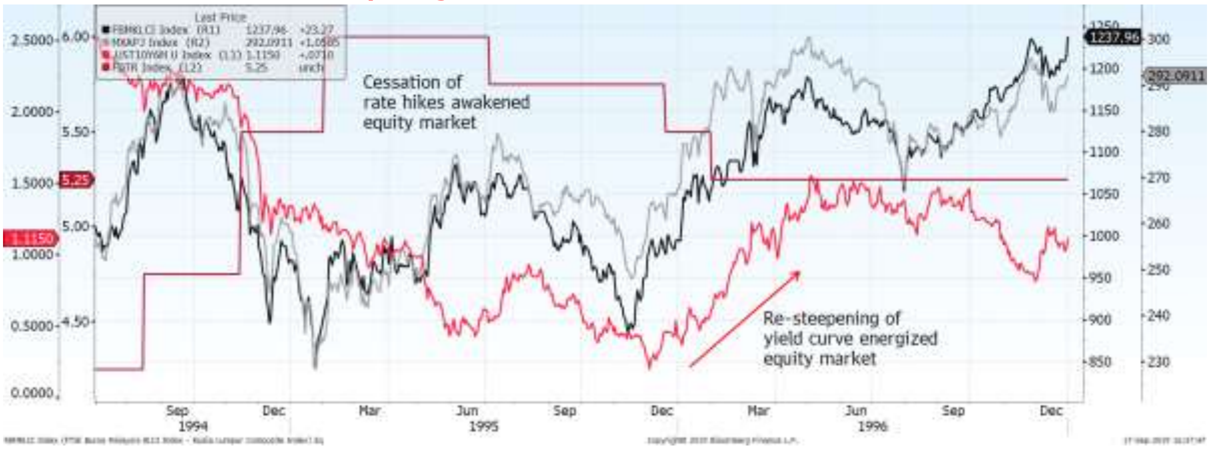
One business cycle ago, recall that the re-steepening of UST yield curve in 2007 coincided the so-called melt-up situation as evident by massive rallies in world's equity and other risk assets. On the local front, the FBM KLCI broke above 1,000 points resistance level and sprinted to a new all-time high of more than 1,400 points in 2007. Valuation-wise, the PER (12M trailing) of FBM KLCI expanded from 13.4x in December 2006 to 17.8x in June 2007.

FBM KLCI: Reaction to re-steepening of UST curve in 2007

Source: Bloomberg, MIDFR

Even earlier on, circa two business cycles ago, the re-steepening of UST yield curve in 1996 also signaled the melt-up state which saw the local benchmark catapulted from mere 900 points in late 1995 to more than 1,200 points in 1996. Valuation-wise, the PER (12M trailing) of FBM KLCI expanded from 16.5x in November 1995 to 21.8x in November 1996.

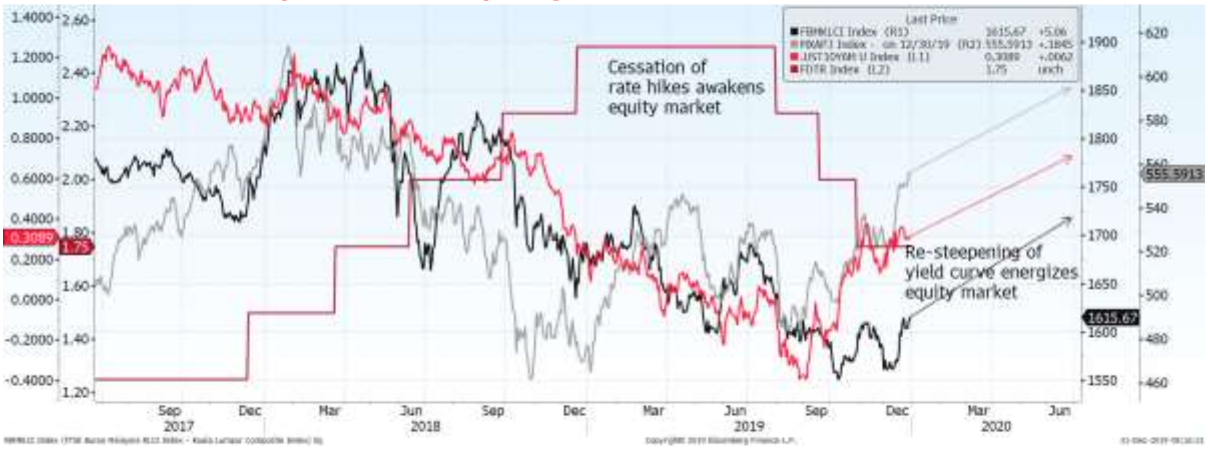
FBM KLCI: Reaction to re-steepening of UST curve in 1996



Source: Bloomberg, MIDFR

However, a successful (or failed) handover from liquidity-to-fundamentals, i.e. liquidity injections resulted in sustainably reflated fundamentals (or otherwise), can only be determined between one to a few years after the melt-up scenario. It must be highlighted that a failed handover would turn what initially deemed as a reflation rally into a "last hurrah" as transpired by the economic recessions in 2008 (worldwide) and earlier on in 1997 (east Asian region).

FBM KLCI: Reaction to potential re-steepening of UST curve in 2019/20 ?



Source: Bloomberg, MIDFR

In above regard, we should take cue from an earlier remark by the US Fed Chair Jerome Powell that the "business cycle has not been repealed." However, he also added that "there is no reason [yet] why this economy cannot continue to expand."

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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.