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FBM KLCI

Rate hike and its implications on the stock market

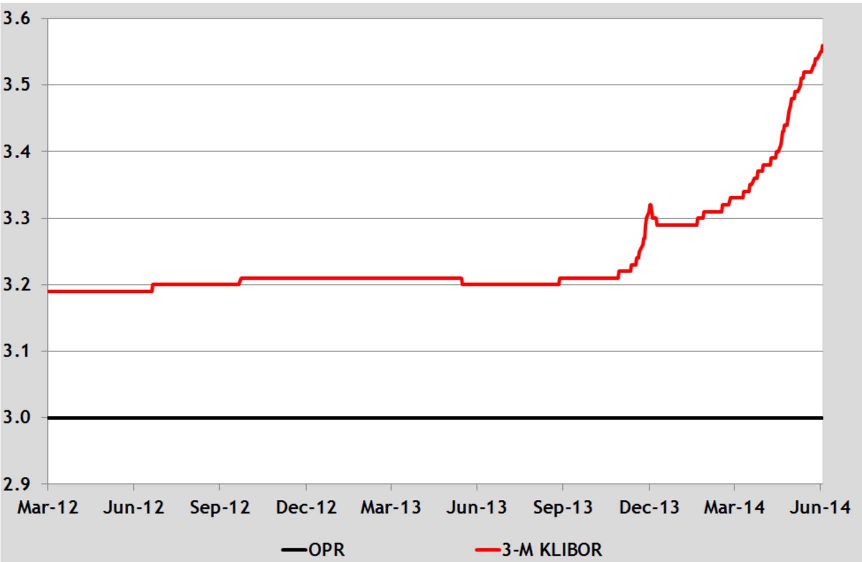
KLCI: 1,892.50

(2014 Year-end Target: 1,900 points)

- **BNM signals an imminent hike in interest rates…** In BNM's Monetary Policy Statement dated 8 May 2014, the central bank appears to proclaim its readiness to act. Some of the key phrases, most notably (i) "current monetary and financial conditions could lead to a broader build up in economic and financial imbalances", and (ii) "the degree of monetary accommodation may need to be adjusted", are arguably pointing towards an imminent hike in the overnight policy rate (OPR). On the other hand, recall its prior Monetary Policy Statement on 6 March which contained more passive phrases such as (i) "continue to monitor for signs of destabilising risks of financial imbalances", and (ii) "will continue to evaluate". Thus the BNM may decide to hike perhaps as early as during the next MPC meeting on 10 July 2014

- **…which the interbank money market thinks is a foregone conclusion.** Among all financial markets, the interbank money market is perhaps the most sensitive towards any movements and changes in the direction of short-term interest rates. While the price impact of possible rate hike on the equity market is hitherto unapparent, the reaction of interbank money market is clear and resolute. As at end-June, the 3-month KLIBOR was trading at 3.55% or 55bps higher that the OPR. In the past, the 3-month KLIBOR normally traded at circa 20bps above the benchmark overnight rate. Hence we may imply that the interbank market participants have (i) fully priced-in a 25bps OPR hike in the near future, and (ii) accorded a 40% possibility of another 25bps hike later.

3-M KLIBOR vs OPR

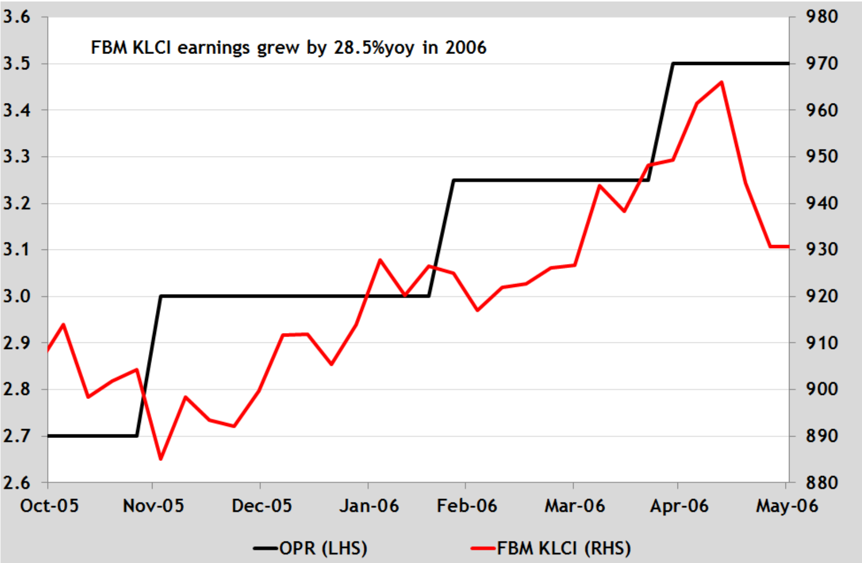


Source: Bloomberg, MIDFR

- **Equity market generally reacts negatively especially to multiple rate hikes.** The next question is on the possibility of a series of hikes. While one rate hike is arguably expected by the market, the subsequent ones are either not fully or not even priced-in. Thus the main impact on stock market sentiment pursuant to a rate hike may largely stem from the uncertainty over the possibility of further increases in the benchmark interest rate. It is well documented that equity market generally reacts negatively especially to multiple rate hikes as it dampens price performance due to the rising adverse effects of greater required return and higher cost of financing.

- **But the series of OPR hikes in 2006 and 2010 failed to dampen equity prices…** Having said the above, some recent empirical evidences on the relationship between interest rate hikes and equity price performance actually went against the established expectation. For example, when OPR was raised 3 times from 2.70% to 3.50% between late November 2005 and April 2006, the FBM KLCI had in fact advanced from circa 900 points to 970 points levels. And again when another series of OPR hikes from 2.00% to 2.75% were made between March and July 2010, the FBM KLCI rose from around 1,250 points to 1,350 points levels.

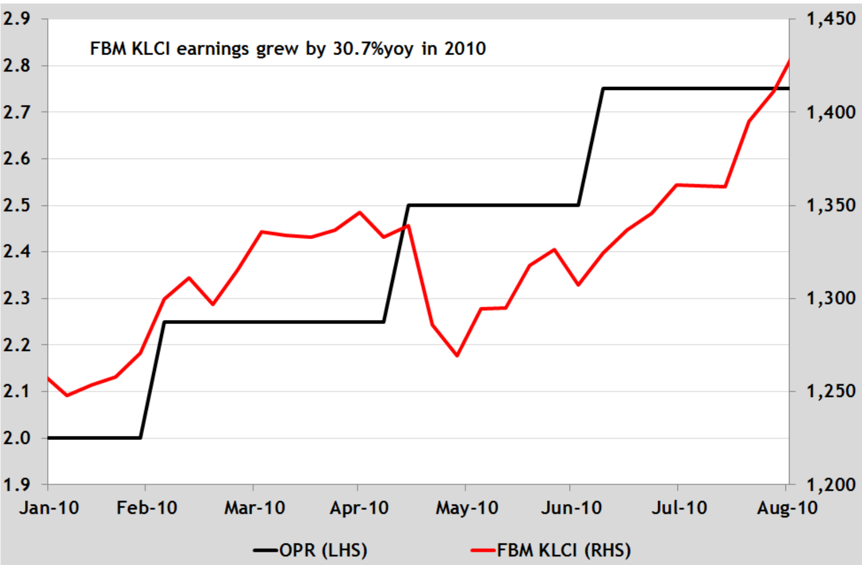
Interest rate hikes and Equity price performance: 2006



Source: Bloomberg, MIDFR

- **…as FBM KLCI earnings growth then was** buoyant. The bewildering price behaviors were actually supported by a valid fundamental reasoning. As during both years in 2006 and 2010, the earnings growth of FBM KLCI turned out to be exceptionally buoyant at 28.5%yoy and 30.7%yoy respectively. Hence the huge earnings leaps were more than enough to counteract the dampening effect of higher required return among investors pursuant to the respective hikes in interest rates.

Interest rate hikes and Equity price performance: 2010



Source: Bloomberg, MIDFR

- **Forward earnings growth is now rather subdued…** However, the prevailing consensus earnings growth estimates for current year and next are relatively subdued at 6.3%yoy and 9.8%yoy respectively. On top of that, earnings sentiment has been rather soft as evident by a spate of downward revisions since early this year.

FBM KLCI: Consensus earnings estimates

	EPS	YoY (% Change)
2014	111.49	6.3
2015	122.37	9.8

Source: Bloomberg, MIDFR

- **…hence may see negative price impact over rate hikes.** Therefore, without sizable earnings growth as a countering force, we may see negative market reaction to rate hikes as it dampens price performance due to the rising adverse effects of greater required return and higher cost of financing. Thus we believe, under current scenario and without massive upward earnings revisions going forward, the equity market would not be able to sustain a series of hikes in interest rates.

- **Reiterate FBM KLCI 2014 year-end top-down target at 1,900 points.** Hence we reiterate our FBM KLCI 2014 year-end target of 1,900 points, which is equivalent to 17.0x PER multiple of 2014 earnings.

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STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >15% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >15% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -15% and +15% over the next 12 months.
SELL	Total return is expected to be <-15% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >15% 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.