8 January 2015 | Strategy

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FBM KLCI

The likely path in 2015

FBM KLCI: 1,709.18

***Revised* 2015 Year-end Target: 1,900 points**

(from 1,970 points)

We are cautiously optimistic… Our relative optimism on the local equity market is premised on a key assumption whereby crude oil price would rebound to a target average of circa USD75 per barrel. Recall that in our report of 17 November 2014 entitled, "Living in a World of Cheaper Oil", we projected new equilibrium levels of crude oil price and postulated a "sweet spot" price for Brent crude of USD75-80 per barrel. At around that target level, we reckon it would be, to borrow our chief central bank's words, "a plus to [Malaysia's] growth and inflation".

…as lower oil price is not a lose-lose situation for Malaysia… As a marginal net exporter of crude oil, we see the decline in price as essentially a massive wealth transfer to the domestic users (consumers and businesses) from the owner (Government of Malaysia) and producers (Petronas et al). Having said the above, it is noteworthy that sustained price decline at significantly below the target level may give rise to other concerns relating to fiscal, external balance and currency issues.

…thus the market pullback may be cyclical rather than secular. We do not believe that the equity market is at the cusp of a secular downturn but rather within the midst of a cyclical pullback. While the overall macro pictures may be slightly weakened due to fiscal and currency concerns, they are far from unravelling premised on the outlook on crude oil prices. In fact, we believe recent market reaction may have disproportionally discounted the potential impact of lower crude oil price on the nation's fundamentals.

The equity market is likely to resume on its upward trend… Furthermore, we opine that any secondary fallout from the slumping crude oil price shall be largely contained to among the major net exporting countries, e.g. no widespread contagion of Russian Ruble collapse. Hence we expect the FBM KLCI to resume on its upward trajectory soonest the crude oil prices regain its (still slippery) foothold.

Chart 1: FBM KLCI Secular Trend Channel

Source: Bloomberg, MIDFR

…but slower pace of crude oil price recovery… Going forward, while we expect crude oil price would recover to a target average of circa USD75 per barrel, however, the timing of price recovery may not be as swift as earlier thought. The main reason being the anticipated slowdown in crude oil output in reaction to the lower prices may not be as forthcoming.

…due to stubbornly high production attributable to hedges on output price… This is due to **(i)** the continued insistence by conventional crude oil producers to maintain their production levels despite lower margins, and **(ii)** rather unexpectedly, the ability of unconventional producers (especially the US oil shale companies) to continue on pumping at high levels as many are still shielded by their financial hedges, i.e. price insurance on their output. As recently remarked by a high official from an OPEC member country, "There are [US shale] companies which are hedged until the beginning of the year or until the end of the year, so we need to wait at least until the first quarter [of 2015] to see what is going to happen."

…may result in a more moderate FBM KLCI trajectory going forward. As stated earlier, any sustained price decline at below the target level may aggravate market concerns relating to the government's fiscal position, deterioration in external trade balance and relative weakness of the Ringgit. Hence consequent to the expected delay in the timing of crude oil price recovery, the pace of equity market upturn may also be similarly affected thus expect a more moderate FBM KLCI trajectory going forward.

Revised our FBM KLCI 2015 year-end target from 1,970 points to 1,900 points. While the pullback in crude oil price is not expected to result in wider systemic fallout, nevertheless it managed to trigger a re-assessment of market valuation hence the downward shift in FBM KLCI trend channel (see Chart 1). Technically, the FBM KLCI has given up the upper half secular channel and we do not expect it to revisit the lost territory anytime soon. Hence the FBM KLCI is henceforth expected to gravitate around the mid- as opposed to towards the upper-end of its lower half secular channel during the next 12 months. Thus we revised our FBM KLCI baseline 2015 year-end target to 1,900 points, with the upper and lower bounds at 1,950 points and 1,850 points respectively. Moreover, the new year-end target equates to PER of 16.37x or +0.74 standard deviation (SD) over its long-term mean (since 2006 to present).

Chart 2: FBM KLCI Price Book Value (PBV)

Source: Bloomberg, MIDFR

Potential downside would be limited to circa 1,700-1,650 points range. Insofar as the FBM KLCI downside is concern, apart from the expected earnings performance, the benchmark is also supported by its assets backing. Based on historical precedent, the FBMKLCI would not sustain at Price Book Value (PBV) of below 2.0x unless the economy is entering into a period of distress such as during the world's financial crisis of 2008/09 (see Chart 2). At PBV of 2.0x, the FBM KLCI equates to 1,690 points. Hence we expect potential downside to the benchmark would be limited to circa 1,700-1,650 points range.

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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.