21 August 2015 | Strategy

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Ringgit performance & FBM KLCI

Important for the Ringgit to regain course

KLCI: 1,577.41 points

2015 Year-end Target: 1,800 points (under review)

RINGGIT PERFORMANCE

Ringgit tracked major G7 currencies. During the past year, the Ringgit, Euro and Japanese Yen were gradually depreciating at an almost identical pace against the US Dollar. Therefore, either by design or by chance, the Ringgit had unofficially been 'pegged' against the Euro and Japanese Yen, which are major Group of Seven (G7) currencies.

Selloffs in Japanese Yen and Euro… Nevertheless, it is of note that during the review period until July this year, there were two main instances whereby the path of one of these three currencies diverged materially below the others (see Chart below). In both occasions however there were clear and direct monetary explanations to the divergences.

Selloffs in Japanese Yen, Euro and Ringgit (from August 2014 to present)

Source: Bloomberg, MIDFR; Note: Prices are normalized as of 31 July 2015

…due to monetary actions… Firstly, the Japanese Yen depreciated sharply beginning the last day of October 2014 pursuant to the announcement by Bank of Japan (BOJ) of an enlargement in the annual amount of its monetary stimulus to 80 trillion Yen. Secondly, the Euro got bashed down in March 2015 as the European Central Bank (ECB)'s quantitative easing program commenced.

…but were followed by eventual re-convergence. It must also be highlighted that, in both occurrences, the currency in question underperformed by up to 8%-points vis-à-vis the others but managed to regain its course thenceforth and duly re-converged within a span of circa 2 to 3 months.

The Ringgit's August selloff. Beginning August this year, as if taking turns, it was (and possibly still is) the Ringgit who came under intense selling pressure. The timing of the Ringgit selloff however seemed awkward as Malaysia's recent economic data have surprised on the upside with better than expected trade and GDP figures. Additionally, there were no recent major monetary actions from Bank Negara Malaysia (BNM) that may explain the sheer Ringgit decline.

We reckon the main sources of Ringgit's sharp decline in August were neither domestic monetary nor economic in nature, but arguably emanated from (i) the recent conflagration of domestic political rows involving both inter- and intra-party spats, as well as (ii) the surprise decision by People's Bank of China (PBOC), the China's central bank, to devalue its currency.

Extent of Ringgit underperformance matches earlier selloffs in Japanese Yen and Euro. It is notable that the magnitude of Ringgit relative depreciation has thus far matches the circa 8%-points underperformance of the earlier selloffs affecting the Japanese Yen and Euro. Hence, looking forward, we incline to imagine that the Ringgit would similarly regain its course and duly re-converge against the Euro and Japanese Yen within a span of circa 2 to 3 months.

It is important for the Ringgit to regain its course and re-converge, failing which it may unfavorably alter the nation's macro prospects and, by extension, the corporate earnings outlook. As stated in our Strategy note titled "FX, Funds, 1MDB and the Spring pullback" dated 18 June 2015, *"Provided that the prevailing foreign exchange (FX) dynamics [i.e. the unofficial 'peg' between Ringgit and major G7 currencies] continue on to prevail, in our view, the weakening of Ringgit against US Dollar would not in itself result in material derailment of the nation's macro outlook."* Hence any unfavorable shift in the FX dynamics would possibly result in macro derailment. In order to realize the re-convergence, we believe it may require (i) de-conflagration of the domestic political rows, as well as (ii) an end to the knee-jerk devaluations of China's Yuan.

WHITHER THE FBM KLCI

Follow the money. One of the basic investing strategies is to "follow the money". In the short-term, the word 'money' may mean the flow of market liquidity, while in the longer-term it is almost invariably refers to the underlying corporate earnings.

Secular view. We reiterate our assertion that empirical observations between earnings and price are conclusive with regard to the nature of their secular direct relationship. This is despite the ever present 'noises' from short-term price volatility which is influenced by market sentiment and other situational issues. Hence our assessment on the likely secular trend path of the FBM KLCI is highly dependent on the expected earnings growth performance during the next 12 to 18 months. At this juncture, the consensus 2016 FBM KLCI earnings still points toward a recovery whereby growth is expected to return to a healthy, and more normal, level of 9.01%.

Near-term view. Under the current rather fluid circumstances, it would be difficult to predict the timing of an eventual subsidence of the foreign liquidity outflows which began in earnest since early May this year and further intensified during the past weeks pursuant to the Ringgit selloff. Nonetheless, as explained in our Strategy note titled "Whither the FBM KLCI" dated 11 August 2015, we may take cue from the fact that *"…empirical evidences from the immediate past suggest foreigners tended to sell on rumor (Taper Tantrum) but turned buyer/neutral on fact (Actual Taper). As the foreigners are now selling on yet another rumor (Countdown to Rate Liftoff) hence, they may similarly turn buyer/neutral upon the fact (Actual Rate Liftoff). On this score, assuming the actual rate liftoff will take place in September, a repeat of past behavior may result in fairly supported equity market during the final quarter of 2015."*

Year-end 2015 FBM KLCI target under review. Pursuant to the ongoing result season, we have thus far raised our forward earnings estimates on only 3 companies from among the FBM KLCI constituents which have announced their results, but made cuts on 5 others while keeping another 7 unchanged. We thereby put our year-end 2015 FBM KLCI baseline target of 1,800 points (upper/lower range: 1,850/1,750 points) under review in view of the bigger tendency towards earnings cuts.

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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.