STRATEGY

FBM KLCI 2020 Target: 1,320 pts

Fallout Phase Remains A Lurking Fear

KEY INVESTMENT HIGHLIGHTS

- **Market rebound (reaction phase) wholly expected, buoyed by 'flattening Covid-19 curve' and monetary/stimulus announcements**
- **But the magnitude of rebound exceeded expectation as the market seems to impute blue-sky scenario in regard to the post-lockdown economic recovery**
- **A point to note is that the rebound went into overdrive as the US Fed kicked off SMCCF hence it was arguably liquidity rather than fundamentally driven**
- **Rising financial conservatism among households and businesses may be counterproductive to economic recovery effort**
- **US Fed Chair warned that slow pace of economic recovery may turn liquidity into solvency problems**
- **A cue from China (already in post-lockdown) is that economic recovery may not be plain sailing**
- **We reckon the second downward thrust (fallout phase) may later emerge, possibly in the third quarter, as the fuller extent of economic and corporate earnings impacts of Covid-19 become manifest**
- **Another issue to revisit is the still unresolved US-China tensions**
- **Consensus FBM KLCI EPS20 slashed to 77.4 as of end-May (90.6 in mid-April)**

MARKET REBOUND (REACTION PHASE) WHOLLY EXPECTED

As highlighted in our strategy report titled The Bear Market Waves dated 24 March, a bear market empirically follows a 3-wave (down-up-down) pattern. Fundamentally, they can be classified as (i) trigger-(down), (ii) reaction-(up), and (iii) fallout-(down) phases.

In the prevailing case, the trigger was the Covid-19 pandemic (officially declared on 11 March) while the world's reactions came in the form of unprecedented city/nation-wide lockdowns (to flatten the Covid-19 curve) as well as further monetary easing (to address burgeoning liquidity issue) and larger fiscal stimulus (to provide more expansive backstop/lifeline to businesses and households).

In the same strategy report, we postulated that the equity market may have reached its midway bottom. As it turned out, in line with the general retracement of world's equity market, the FBM KLCI has since rebounded by more than 230 points.

The price retracement was buoyed by (i) flattening Covid-19 curve both internationally and domestically (i.e. the number of active cases in Malaysia is on a clear declining trend), and (ii) massive liquidity injections either directly or via interest rate cut as well as series of fiscal stimulus both internationally and domestically (i.e. the Malaysian government announced a series of stimulus totalling RM260b). Intermittently, claims of progress made on the development of Covid-19 vaccine also helped to excite the world's equity market.

MAGNITUDE OF MARKET REBOUND ABOVE EXPECTATION DRIVEN BY LIQUIDITY

It must however be noted that the magnitude of market retracement during the current reaction phase has surpassed our expectation. As stated in our strategy report titled FBM KLCI Cut On GDP Revision dated 14 April, we were targeting an upper consolidation target at 1,400 points (with a lower consolidation target at 1,250 points).

The FBM KLCI ended the month of May at 1,473.25 points (which was the level traded on 2 March, also the first workday of the current Prime Minister) hence effectively erased (i) all of the losses incurred after the 11 March Covid-19 pandemic declaration by the World Health Organisation (WHO), as well as (ii) all of the losses in reaction to the 9 March crash in crude oil prices due to production cut spat between Saudi Arabia and Russia.

Likewise, other international equity market indices also rebounded impressively. On Wall Street, the Dow Jones Industrial Average (DJIA) recouped the pre-11 March levels and a bit more. Meanwhile, the tech-laden Nasdaq Composite (with some constituents seen as beneficiary of the lockdowns) even managed to turn positive year-to-date and is now less than two percent off its all-time high level.

We reckon it is implicit in the prevailing buoyant world's equity market performance that (i) there will be no second (and subsequent) wave of Covid-19 infections, (ii) the Covid-19 vaccine shall be found (sooner than normally expected) hence rescinding the need for social distancing and its attendant adverse impacts on economic activities, and (iii) the economy is slated for a V-shape recovery after the lockdown is over with very limited fallouts on both the corporate and consumer fronts while social norms would quickly reverting back to the old normal.

The likely stimulant behind the implicitly optimistic (or even panglossian to some) scenarios may have emanated from the front loading of massive amount of liquidity by the US Fed as per its stated quest to do whatever it takes in dealing with the potential fallout from the Covid-19 pandemic.

Foremost, it must be highlighted that a never-been-done-before aspect of the above-mentioned liquidity program concerns the direct participation of the US Fed in the high-yield corporate bond market via the Secondary Market Corporate Credit Facility (SMCCF) and Primary Market Corporate Credit Facility (PMCCF).

In above regard, we argue that the correlative impact of the US Fed providing a backstop to the credit risk premium of corporate bond issues is manifested (albeit unintended) in the soaring valuation (which implies lowering of the required rate of return) of the equity market. After all, equity is akin to a subordinated perpetual bond (bearing cumulative residual coupon, plus the voting rights).

Thus it is interesting to note that the local equity market began to race ahead of our upper consolidation target at 1,400 points exactly a day after the US Fed kicked off the SMCCF on 12 May. The FBM KLCI advanced from 1,397 points on 13 May to 1,490 points on 1 June, while the DJIA jumped from 23,248 points to the 25,475 points during the same period.

LIQUIDITY MAY INFLUENCE VALUATION LEVEL BUT FUNDAMENTALS DICTATE TRAJECTORY

"Do not fight the Fed" (is a known market adage) as its financial firepower is technically unlimited. In dealing with Covid-19, the US Fed has made known its commitment (and well proven by its recent actions) to provide essentially unlimited liquidity to support the economy.

On above score, it should be highlighted that the total assets of the US Fed jumped by nearly USD3t during the past three months alone (from less than USD4.2t end-February to circa USD7.1t end-May). By comparison, it took several years (from August 2008 to November 2013) for the US Fed to expand its balance sheet by a similar dollar amount (from USD0.9t to USD3.9t) post-2008 crisis.

There is no dispute that the US Fed possesses the financial wherewithal to influence the valuation of risk asset prices. The SMCCF, among others, has arguably been successful thus far in raising the average tide level (as reflected by the soaring valuation) of world's equity market. In the case of FBM KLCI, it may have added between 50-100 points to our earlier upper consolidation target price level.

Having said the above, we must however take cognisant that the market is also subjected to both the high and low tides (i.e. the aggregate market forces which perennially assessing the forward fundamental dynamics) which we reckon even the forceful US Fed would not attempt to thwart. In other words, the secular trajectory of the equity market would always correspond to its underlying fundamentals, earnings in particular, either with or without the US Fed in the picture.

ANOTHER MARKET SELLOFF (FALLOUT PHASE) REMAINS A LURKING FEAR

Fundamentally, we believe the unfolding reality may differ from what the liquidity-driven market is currently implying.

Firstly, the WHO says that the Covid-19 could become endemic (i.e. the virus would never go away) thus the risk of subsequent waves of infections remain present until the society develops herd immunity. In fact, the director of the US Centers for Disease Control and Prevention (CDC) warns of a second Covid-19 wave to coincide with flu outbreak in the fall season.

Secondly, according to many health experts, the likely scenario is for a Covid-19 vaccine to be found and ready only by the middle of next year at the earliest. Hence the social distancing rules would likely remain in effect at least for the next 13 months. Another point to note is that none of the vaccine of the earlier types of coronavirus (e.g. SARS and MERS) was ever found.

Thirdly, a V-shape economic recovery could be achieved and sustained only if the virtuous economic circle of employment-consumption-revenue-investment-employment can be revived and safeguarded. However, without the Covid-19 vaccine, the economic consequence of social distancing rules on consumption and investment would remain a drag to output revival and growth in the foreseeable future.

Additionally, in the more immediate future, it is hard to imagine that despite the financial as well as psychological trauma (in the form of material loss of revenue and employment) brought about by the lockdowns and social distancing measures, the market could still be hopeful of very limited fallouts on both the corporate and consumer fronts. In fact, there are already emerging signs of heightened financial conservatism among businesses and households, a reactive behaviour which may prove detriment to the economic recovery process going forward.

On above score, it is notable that the US incomes and spending fell -2.0% and -7.5% respectively in March. Among the biggest decline was spending on autos. Consequently, US savings rate jumped to 13.1% (already the highest level in 39 years) and might rise even higher in the subsequent month. While this behaviour may seem reactive and fleeting, it could be counterproductive to the economic recovery effort if it became entrenched as consumption constitutes more than two-third of the US economy. However, it may well become entrenched for as long as jobs security remains a real issue.

Moreover, as alluded by the US Fed Chair Jerome Powell, a slower than desirable pace of economic recovery could turn what initially deem as liquidity problems into solvency problems among both the households and businesses.

A telltale sign that the post-lockdown recovery period is not expected to be plain sailing for the world economy can be glanced from the recent decision by China's authority to abandon (for the first time since 1994) an economic growth target for 2020. "This is because our country will face some factors that are difficult to predict in its development, due to the great uncertainty regarding the covid-19 pandemic and the world economic and trade environment," said Premier Li Keqiang.

[Like-minded video: Covid-19: Why the economy could fare worse than you think by The Economist]

Moving forward, possibly in the third quarter, we expect the equity market to encounter another wave of selling pressure, i.e. second downward thrust (fallout phase) as the real extent of economic/corporate earnings impacts of covid-19 become manifest.

In regard above, during both the current and ensuing quarters, the economic/corporate earnings data (i) may continue to deteriorate based on year-on-year basis, while (ii) the post-lockdown monthly sequential jump may quickly peter out as pent-up demand in the aftermath of the economic reopening is duly satisfied. During this period, we may see the next wave of selling in the equity market.

Lastly, since the onset of the pandemic, the market seems to be totally preoccupied with ongoing assessments of the battle against covid-19 that it risks ignoring other unresolved confrontations particularly the deteriorating US-China relations as well as geopolitical conflicts in the Middle-east and South China Sea, among others.

GDP 2020 ESTIMATE REVISED DOWN

As we had expected, Malaysia's GDP managed to escape contraction in 1Q20 and registered growth albeit at a significantly moderated pace of +0.7%yoy. On seasonally adjusted quarterly basis however, the economy fell -2%qoq, suggesting that recession is on the road.

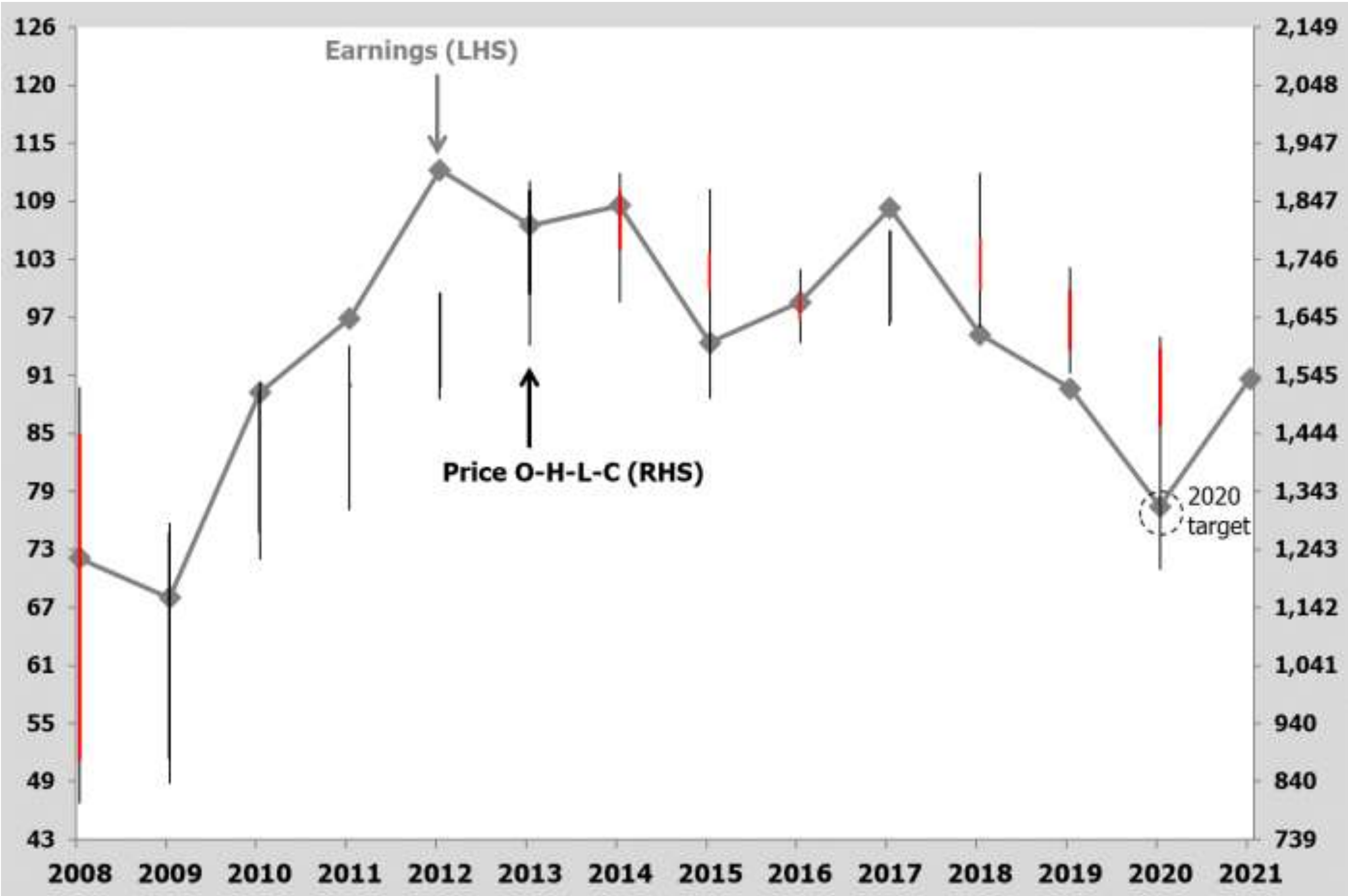
Looking ahead into 2Q20, the economy is anticipated to contract on annual basis with the extension of MCO in Malaysia and imposition of lockdowns in other key economies globally.

Based on the current developments and indicators, we revised our expectation for the Malaysian economy this year. We now expect the GDP to contract by -2.1%yoy in 2020, a downward revision from +1%yoy growth initially expected (vide Malaysian Economy Managed to Record Expansion in 1Q20 but More Pain Ahead).

Private consumption, the biggest driver of the economy, on top of private investment are foreseen to be significantly affected following extension of MCO and further influenced by deteriorating sentiments.

FBM KLCI 2020 TARGET CUT

It is also pertinent that (Bloomberg) consensus EPS forecasts for the FBM KLCI are under downward pressure as the forward earnings expectations were progressively trimmed to reflect the worsening business conditions. In this regard, the current year EPS20 estimate stood at 77.4 points in end-May (down from 90.6 points in mid-April and 95.6 points at the onset of the covid-19 crisis in early March).



As empirically demonstrated by the Earnings versus Price (Open-High-Low-Close) chart of the FBM KLCI, short-term equity valuation (i.e. price relative to earnings) may be influenced by multitude of factors (such as change in sentiment, macro performance, situational events as well as deluge or dearth of liquidity). However, the secular trajectory of the equity prices has almost always corresponded to the underlying fundamentals, earnings performance in particular.

Thus in line with (i) the diminution in consensus EPS20 estimate for the FBM KLCI to 77.4 points as of end-May, as well as (ii) the downward revision in our GDP target to -2.1% for this year, we thereby cut our **FBM KLCI year-end 2020 baseline target to 1,320 points** (from earlier 1,400 points) while, as a sign of near capitulation, raising our PER20 valuation target to 17.0x (from earlier 15.5x).

The revised valuation target equates to -0.5SD (standard deviation) of its 5-year (2014-18) historical average. It must be highlighted that despite the smaller valuation discount at -0.5SD (from earlier -2.0SD), it remains below the historical mean in anticipation of further downward revisions in the consensus forward earnings estimates as the full extent of Covid-19 impact on corporate earnings becomes manifest.

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MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
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.