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THE PIVOT IS COMING

US Fed pivot engenders risk-on mode

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KEY HIGHLIGHTS

- **US Fed slowed the pace of its rate hike with the 50bps increase in its Federal fund rate in the Dec-22 FOMC meeting. Arguably with this, we can reason that we have seen the start of the awaited US Fed pivot.**
- **Economic indicators suggests that US Fed may be compelled to slower the pace, while market is pricing in 25bps rate hike in Feb-23 FOMC meeting, based on the interest rate futures market showing more than 95% probability.**
- **The weakness in US dollars continued in 2023.**
- **Despite the prevalent fears of recession, the world's equity market has been gradually gaining ground since October.**
- **On year-to-date basis, the mid and small caps have been leading the upward charge with midcaps FBM70 and FBM Smallcap recorded 5.7% and 8.5% gains respectively.**
- **On balance, despite the prevalent fears of impending recession, we posit the risk asset markets (and equity in particular) are tilting toward the upside in the short to medium term.**
- **We maintain our FBM KLCI end-2023 target at 1,700 points or PER23 of 15.0x.**
- **We believe that this may also be an opportune time for investors to consider mid-caps stocks.**

CASE POINTING TO A CONTINUING PIVOT

Waiting for the pivot from the US Fed, or have we seen that already? In response to the inflationary pressures, monetary authorities globally adopted tightening stance last year to curb price pressures and anchor inflation expectations. The most aggressive of these had been the US Federal Reserve (US Fed) which caused downward pressure on risk assets notably in the equity, bond and currency markets. Nevertheless, we had expected the US Fed to slower its pace of rate hike, initially in July-22, subsequently in Nov-22. However, inflation stayed stubbornly high and we saw a further consecutive 75bps hikes in those two meeting. Eventually, US Fed slowed the pace of its rate hike with the 50bps increase in its Federal fund rate in the Dec-22 FOMC meeting. Arguably with this, we can reason that we have seen the start of the awaited US Fed pivot.

Will the pivot continue? After the US Fed slowed its pace of rate hike in Dec-22, the question that we should be asking now is that; will this slowing of pace continue in the next FOMC meeting on 1 February 2023? Various statements by US Fed governors seems to suggest that might be the case. Market participants indicated the exact same view, based on the interest rate futures market showing more than 95% probability of just a 25bps rate hike in Feb-23 FOMC meeting.

Economic indicators suggests that US Fed may be compelled to slower the pace. For full-year 2022, the US economy grew +2.1%, far better than the FOMC's Dec-22 projection of +0.4% to 0.5%. Despite the ongoing talks and concerns about recession risk, the sustained GDP growth continued to be largely underpinned by growing consumer spending, which covers more than two-thirds of GDP. This was backed by still strong labour demand, despite aggressive policy tightening by the Fed last year. With prices remained elevated, we opine the US Fed will continue raise fed funds rate to ensure inflation eases further towards its 2% target. But the magnitude of hikes would be smaller at 25bps because based on the latest price data that released together with the 4Q GDP update, core PCE price inflation eased to +3.5%qoq during the quarter (3QCY22: +4.4%qoq).

Inflation continues to moderate. Mostly referred inflation rate by the US Fed continued on a moderating trend, reflecting softening domestic demand in the US economy. Core PCE inflation registered at +4.4%yoy in Dec-22, the slowest in a year. Even though global energy prices to stay elevated, the price level is predicted to be lower than last year's. Hence, inflation trend is expected to soften this year due to high-base effects. The effects of tightening monetary policy and softening global demand are gradually reflected especially in job market as well as income growth. Personal spending contracted by -0.2%mom in Dec-22, the largest decline in a year. Personal income increased by +0.2%mom, in line with market estimates. With this easing inflationary pressure, we foresee the Fed to further reduce its rate hike speed from 50bps to 25bps in the first FOMC meeting of 2023 and another 25bps in Mar-23. Market expectations are expecting the Fed's funds rate to pause at 5.00~5.25%.

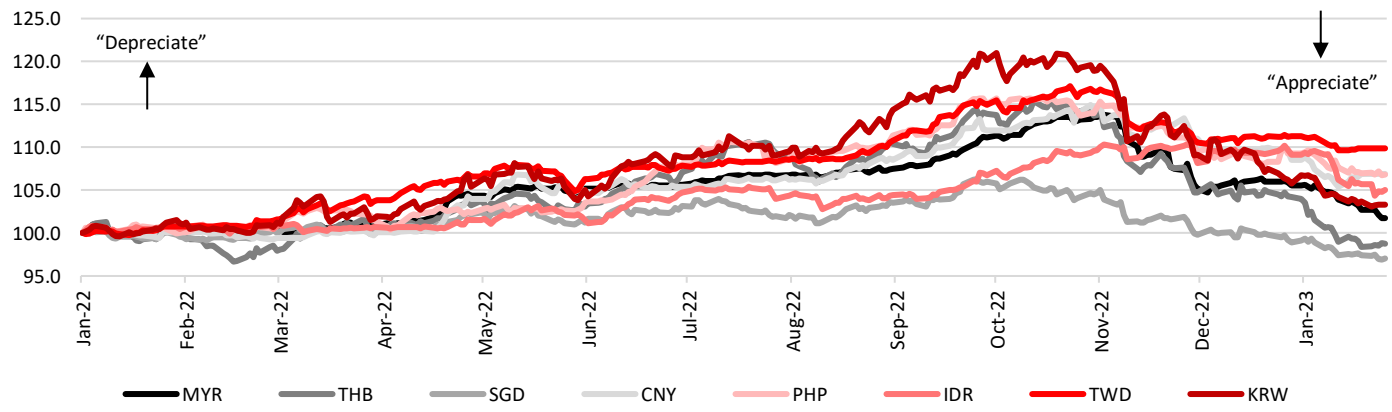
Job market is seen losing momentum. Even though jobless rate in the US at pandemic low 3.5% in Dec-22, the job market is seen losing momentum slowly. Non-farm payrolls increased by 223K in the last month of 2022, marking the lowest additional job gains in two years. We foresee further moderation in the non-farm payrolls in 2023 following the effects of tightening monetary policy, elevated input prices and cautious domestic demand. Hence this supports the thesis that the Fed will pull its handbrake by 1QCY23. Extension of rate hikes may derail the economy including job market outlook.

IMPACT OF THE PIVOT

Regional currencies appreciated from the lows in 2022, about two to four months ago. As market priced in the Fed's expected decision to pivot with slower rate hike in Dec-22, we noticed regional currencies and ringgit appreciated against the US dollars. This is in line with our expectation (as we described in our thematic report back in Aug-22) that FX trend will reverse and more in favour of EM currencies as demand for US dollars weakened particularly when market became more convinced that Fed will slow down the pace of its policy tightening. From growth differential, the improved outlook with sustained growth in domestic demand and reopening of China's economy will also boost demand for EM currencies. After reaching the lows between end-Sep-22 and end-Nov-22, regional currencies appreciated against the US dollar between +1.1% to +14.4%. The pace of reversal (i.e. appreciation) was the sharpest for Korean won, appreciating +14.4% between early Oct-22 to end-2022. Among ASEAN-5 currencies, Thai baht appreciated the most by +10.8% from mid-Oct-22 to end-2022.

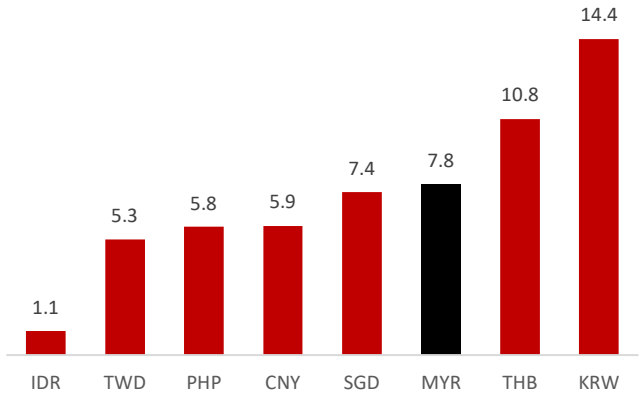
Dollar weakness continues in 2023. The weakness in US dollars continued in 2023 as recent update indicated easing inflation in the US, therefore supporting for smaller rate hike by the Fed. As a result, regional currencies continued to strengthen between +1.6% to +5.5% in the first four weeks of 2023 i.e. until 27th Jan. Singapore dollar and Thai baht both strengthened to level stronger than the start of 2021. We anticipate the growing demand for EM currencies will continue this year with the Fed to resume its slow tightening mode and then pause after raising fed funds rate to terminal rate of 5.00% at the FOMC meeting in Mar-23.

Chart 1: Regional Currencies Performance vs. USD in 2022-2023 (3 Jan 2022 = 100)



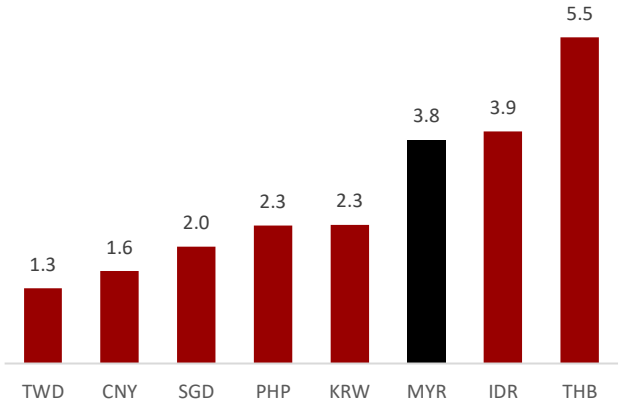
Source: Bloomberg, MIDFR

Chart 2: Appreciation of Regional Currencies vs. USD from 2022 lows to end-2022 (%)



Source: Bloomberg, MIDFR

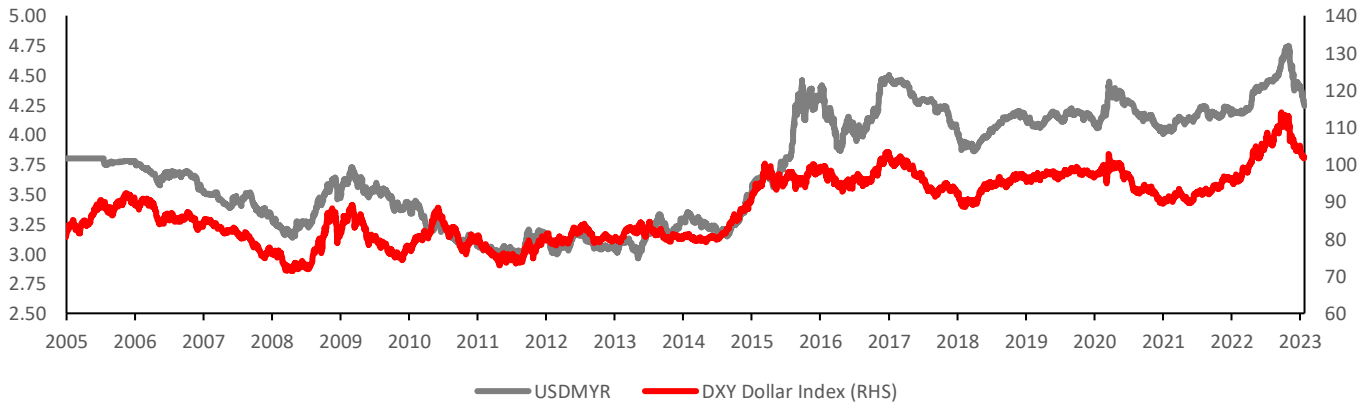
Chart 3: Year-to-Date Appreciation of Regional Currencies vs. USD in 2023 (%)



Source: Bloomberg, MIDFR

Ringgit appreciated at relatively faster pace… The +7.8% appreciation of ringgit vs. US dollar between early Nov-22 to end-2022 makes the local currency to be the third fastest reversal (i.e. appreciation) after Thai baht and Korean won. We opine this was driven by positive effect from expectations for the Fed to pivot and hence reduced demand for US dollars. Moreover, Malaysia's growth fundamentals look more encouraging as domestic spending looks strong, and business activities and labour market condition are projected to continue improving going into 2023. Apart from foreign flows, sustained current account surplus also supported demand for ringgit. So far this year, the continued appreciation of ringgit year-to-date until 27 January was also among the sharpest, strengthening +3.8% to RM4.244 from RM4.405 at end-2022. This places ringgit in third position after Thai baht and Indonesian rupiah in terms of year-to-date appreciation.

Chart 4: Ringgit vs. US Dollar (DXY) Index



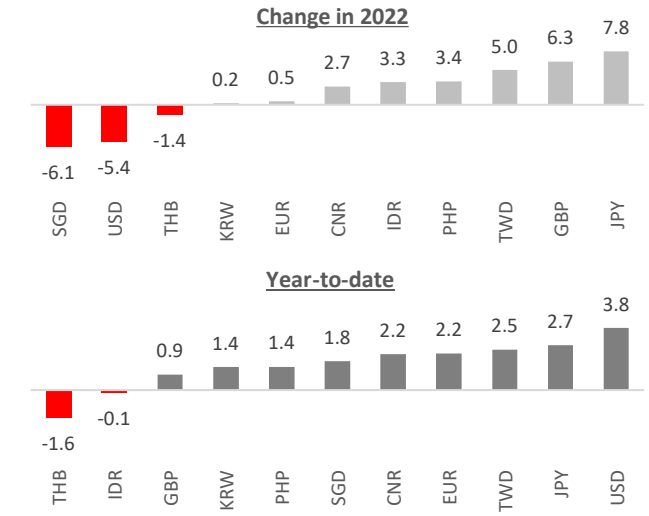
Source: Bloomberg, MIDFR

…thus strengthened against other currencies. Given the relative strength in ringgit and in particular the fast pace of appreciation towards end-2022, ringgit even strengthened last year against euro, pound sterling, and most regional currencies but weakened versus US dollar, Singapore dollar and Thai baht. As of 27 January 2023, ringgit closed at RM4.244 per dollar, the strongest rate in more than 8 months. When we compare against other currencies, ringgit appreciated further against most currencies except Thai baht and Indonesian rupiah. Looking at the reduced need for aggressive rate hike by the Fed and the stronger-than-expected strengthening of ringgit thus far, we update our ringgit forecast to appreciate faster towards RM4.00 by year-end and average around RM4.20 per USD.

BNM will continue policy normalization and raise OPR back to 3.00%. After the pause at the Jan-23 MPC meeting, we reiterate our expectations that BNM will continue with policy normalization towards pre-pandemic level. Although the decision to keep OPR unchanged at 2.75% for now was a surprise defying market forecast, we believe the recent sign of easing inflation and reduced supply pressures provide room for BNM to gauge the effect of previous OPR hikes on the overall economy. Nevertheless, reading the signal from Jan-23 Monetary Policy Statement, we conclude BNM will proceed to raise OPR towards 3.00% in 1QCY23 because core inflation remains elevated. Moreover, we expect the strength in domestic

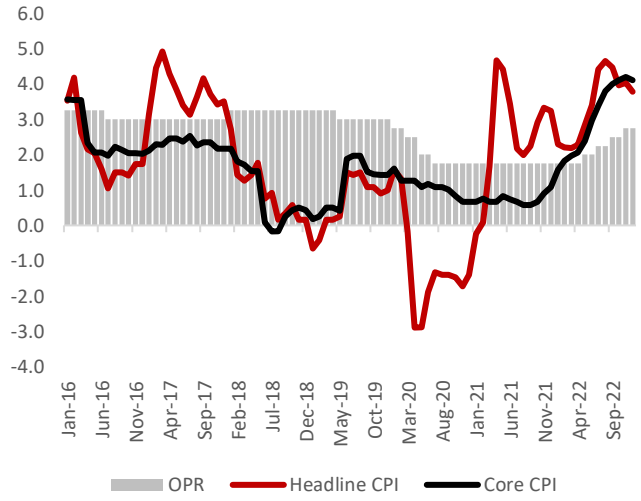
demand will continue to pose upward pressures on prices. With the Fed pivoting and then keeping high borrowing costs for some time this year, interest differentials and more favourable outlook for EM currencies add to positive factors supporting stronger ringgit.

Chart 5: Ringgit vs. other currencies in 2022-2023 (%)



Source: Bloomberg, MIDFR

Chart 6: OPR (%) vs. CPI Inflation (YoY%)

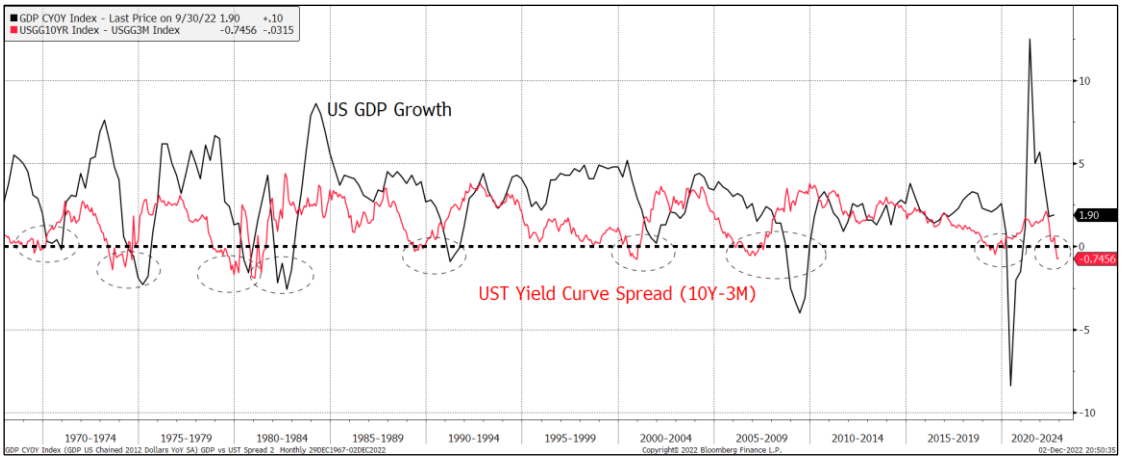


Source: Bloomberg, MIDFR

External factors would affect forex outlook. While we remain sanguine that growth and interest differentials and even broad weakness in the US dollars will be supportive of ringgit outlook this year, we believe several risks could influence ringgit performance. Safe-haven demand would be a possible trigger for stronger US dollar outlook, given concerns over softer global growth this year and concerns over recession risk. Should the decline in aggregate demand in advanced economies were to be deeper than expected, this could rebalance the flows of funds back into USD-denominated securities. Furthermore, a possibility of stickier downtrend in US inflation which could force the Fed to extend policy tightening to a longer period will also affect foreign exchange outlook. Meanwhile, as China's economic reopening will also support regional currencies this year, weaker-than-expected growth outlook in China's economic recovery will negative the region. In other words, a sharper slowdown in global and regional trade and investment outlook will also constrain growth outlook and therefore would be another downside risk as flows of fund into the region and Malaysia may be limited. On the domestic front, we are monitoring whether new measures and policy actions announced by the government including the re-tabling of Budget 2023 will provide additional positive points to ringgit outlook this year. In addition, if political stability can be maintained, this will also support for ringgit to appreciate this year.

10Y-3M yield spread at last inverted in October 2022. The aggressiveness of US Fed in raising the short-term policy rate has invariably resulted in the complete inversion of bond yield curve. Looking at various long versus short maturity spreads of the US Treasury (UST) issues, the last to invert was the 10-year against 3-month (10Y-3M) in late October 2022.

Chart 7: UST 10Y-3M Spread: Harbinger of Recession



Source: MIDFR, Bloomberg (G705)

US recession forthcoming between 1 or 2 years, empirically. It should be highlighted that the inversion of 10Y-3M spread serves as a potent signal of an impending economic recession, empirically within the ensuing 1 to 2 years. It correctly predicted all US recessions since at least the early 1970s. Hence, we can plausibly expect the US economy to be in a recession possibly in the final quarter of 2023 or by the final quarter of 2024.

Nonetheless, expectation of Fed pivot engenders risk-on mode. However, despite the prevalent fears of recession, the world's equity market has been gradually gaining ground since October while the mighty US dollar retreating since November 2022. The FBM KLCI climbed from a low of 1,370 points level in October to a tad below 1,500 points presently. Concurrently, ringgit has been strengthening swiftly against US dollar from 4.74 in early November to 4.24 level presently. We reckon the underlying dynamics began to shift arguably when the pace of US Fed rate hike was anticipated to be pared down during its recent December meeting.

Mid and small caps leading the charge thus far this year. On year-to-date basis, the mid and small caps have been leading the upward charge with midcaps FBM70 and FBM Smallcap recorded 5.7% and 8.5% gains respectively. Meanwhile, the heavyweight FBM KLCI advanced by mere 0.1%. The key heavyweight sectors particularly Plantation and Finance were major underperformers thus far this year. Meanwhile, Energy, Transport and Technology sectors were the notable outperformers. Similarly, the smaller caps have been outperforming on Wall Street. On year-to-date basis, the heavyweight Dow Jones Industrial Average (DJIA) lagged with 2.5% return vis-à-vis Nasdaq Composite which soared 11.0%.

Fed pause as early as after March meeting. Presently, the main cues coming out of Wall Street are that (1) inflation pressures are ebbing, (2) the US Fed is highly likely to normalize the pace of rate hike in its upcoming February meeting (with more than 95% probability as per the interest rate futures market), and (3) the US Fed is likely to pause its rate hike after the March meeting, implying a terminal fed rate of 5.0% (also as per the interest rate futures market).

Bullish window on equity. On balance, despite the prevalent fears of impending recession, we posit the risk asset markets (and equity in particular) are tilting toward the upside in the short to medium term. In fact, empirically, the intervening period between the end of US Fed rate hikes and the ensuing recession could prove attractive for equity market.

Period between end of hikes and looming recession attractive for equity market… The intervening period between the end of US Fed rate hikes and the ensuing recession could prove attractive for equity pricing principally due to the unwinding or subsiding pressure on equity required return (as the upside risk diminishes) with the end of tightening cycle. Moreover, equity earnings (and macro data) would remain buoyant as the anticipated (looming) recession is still either one or two years away.

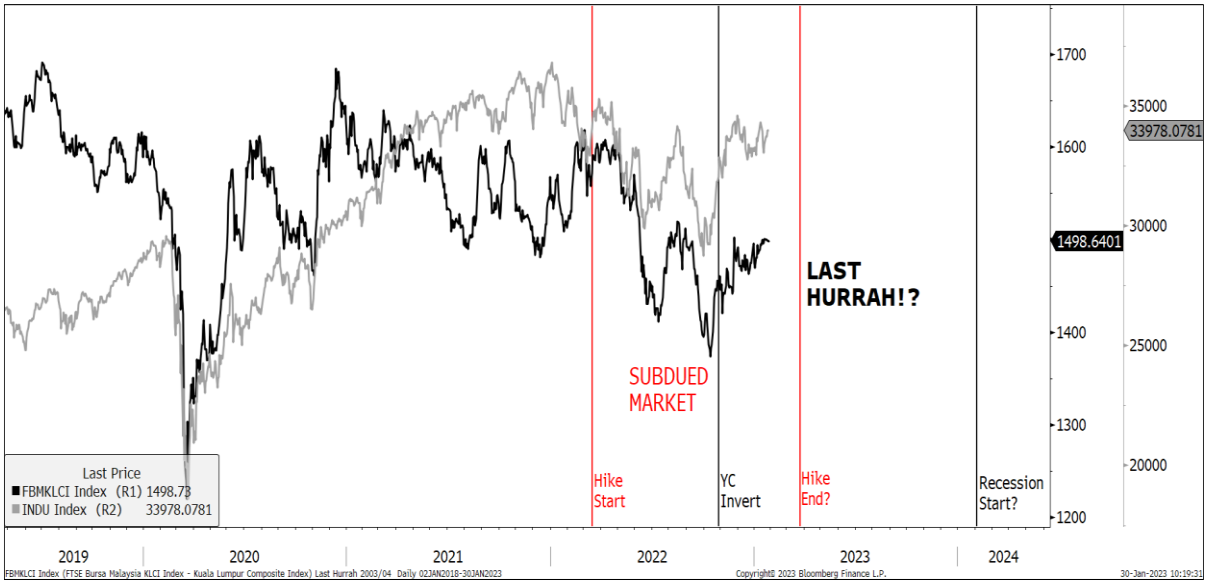
Chart 8: DJIA and FBM KLCI: Big Rally post rate pause in 2006



Source: MIDFR, Bloomberg (G709)

...such after mid-2006. The 10Y-3M spread first turned negative in January 2006 thus signalling a looming recession. The yield curve inversion (YC Invert) occurred as consequence of an aggressive series of rate hikes totalling 425 basis points (1.00% to 5.25%) from June 2004 to June 2006. However, the equity market began to rally with the DJIA climbing from 10,700 points level in July 2006 to 13,500 points level a year later. Thenceforth, it risen further to pre-GFC (Global Financial Crisis) record of 14,100 points level in October 2007. Domestically, the FBM KLCI was also advancing from 900 points level in July 2006 to 1,300 points level a year later. Subsequently, it climbed further to pre-GFC record of 1,500 points level in January 2008.

Chart 9: DJIA and FBM KLCI: Rally post rate pause in 2023?



Source: MIDFR, Bloomberg (G710)

A repeat in 2023? The 10Y-3M spread first turned negative in October 2022 thus signalling a looming recession. The YC Invert occurred as consequence of an aggressive series of rate hikes potentially totalling 475 basis points (0.25% to 5.00%) from March 2022 to March 2023. Nonetheless, the world's equity market has been steadily rebounding off its 52-week low in the final quarter of last year. We reckon, going forward, the upward momentum could gradually intensify especially upon a further Fed pivot in early February and ultimately a Fed pause potentially after the March meeting.

Maintain our FBM KLCI end-2023 target at 1,700 points. As earlier stated, despite the prevalent fears of impending recession, we posit the risk asset markets (and equity in particular) are tilting toward the upside in the short to medium term. This is view of (1) the unwinding or subsiding pressure on equity required return (as the upside risk diminishes) with the end of tightening cycle, and (2) equity earnings (and macro data) would remain buoyant as the anticipated (looming) recession is still either one or two years away. Hence, we maintain our **FBM KLCI end-2023 target at 1,700 points or PER23 of 15.0x**.

Opportune time to look at the mid-caps. While we expect that the FBM KLCI will eventually follow the prevailing risk-on trend, it is possible that it will need to wait for the confirmation of the pivot either via the 25bps hike expected on 1 February 2023 or the expected pause after the March meeting. In the meantime, the mid-caps stocks have already rallied based on this expectation as highlighted by the performance of the FBM70 thus far this year. We believe that this may be an opportune time for investors to consider mid-caps stocks.

Foreign investors net buying Technology and Energy. While overall foreign investors have been on a net selling position thus far this year, to the tune of -RM200.8m as of 27 January 2023, it has not been broad based as there are sectors seeing net buying position. The three largest have been Technology, Energy and Healthcare, amounting to RM72.8m, RM71.0m and RM63.3m respectively. We can infer that the foreign investors are focusing on the mid-caps and small-caps based on their investing behaviour.

Top ten picks amongst FBM70 stocks. We should note that four out of our overall top ten picks are FBM70 constituents. We also note there are several other stocks that are within our theme for this year (oil & gas and consumer related i.e. consumer, automotive and REITs) that are amongst the FBM70. In addition, we believe that there are a few stocks in the FBM70 that are worth a look. Below is our top ten picks amongst FBM70 stocks:

	Rec.	Price (RM) @ 30/1	Target Price	Price Return	Dividend Yield	Total Returns
Bumi Armada	BUY	0.57	0.80	40.4%	1.4%	41.8%
AEON Co.	BUY	1.35	1.81	34.1%	4.4%	38.4%
Fraser & Neave	BUY	24.22	29.70	22.6%	2.9%	25.5%
Sunway REIT	BUY	1.59	1.73	8.8%	5.8%	14.7%
Unisem	BUY	3.19	3.72	16.6%	3.1%	19.7%
Bermaz Auto	BUY	2.10	2.67	27.1%	6.5%	18.9%
Alliance Bank	BUY	3.59	4.36	21.4%	6.5%	28.0%
Gamuda	BUY	3.89	4.67	20.1%	3.1%	24.2%
Axis REIT	BUY	1.87	2.06	10.2%	4.3%	14.5%
Bursa Malaysia	BUY	6.78	7.60	12.1%	5.3%	17.4%

Source: MIDFR, Bloomberg

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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.
ESG RECOMMENDATIONS* - source Bursa Malaysia and FTSE Russell	
☆☆☆☆	Top 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆☆	Top 26-50% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆	Top 51%- 75% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆	Bottom 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell

* ESG Ratings of PLCs in FBM EMAS that have been assessed by FTSE Russell in accordance with FTSE Russell ESG Ratings Methodology