

16/07/2002

Market outlook the lull after the storm

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AFTER weathering a storm of external events mostly arising from US corporate indiscretions, and a domestic shock or two, the market appears to be going into a quiescent phase. Still, expert opinion presents a strong case to remain invested and advises on where to fish in quiet waters

`SIX MONTHS AGO, WE WERE CONFIDENT the global situation was looking up. Now, we still maintain this view. In i Capital(r), we had forecast much earlier that the US economy and its equity markets would move in separate directions,' says Tan Teng Boo, managing director of licensed investment advisor Capital Dynamics Sdn Bhd, the publisher of the i Capital investment weekly.

Three weeks ago, Tan had undergone `a short spate of worrying due to May 2002 economic data.' Car sales, a good indicator of consumer demand, had declined in Europe and the US. And equity markets there had somehow not bottomed out despite months of correction.

At the time of writing, though, Tan seems ebullient again. `The US-led recovery appears to be intact. We still hold on to our forecast that the US economy would grow 3.5-4% in 2002.' As an engine of world growth, strong US economic growth is positive for the rest of the world, especially export-oriented economies where spillover benefits include higher corporate earnings, which should eventually be mirrored in the re-rating of stocks.

Ivan Tham, executive director of HLG Asset Management Sdn Bhd, is less sanguine on American recovery. According to him, economic recovery may not be as strong since housing starts and retail sales are already very strong, leaving little room for further expansion. `Capital spending is still down, manufacturing for new orders is not showing a clear trend and there's less than perfect visibility. Manufacturers are moving in just-in-time mode, which has become a critical priority in the US.

`As a result, inventory levels are still continuing to fall. This could indicate one of two things - there is still a lot of inventory rebuilding, or paradoxically, there is little rebuilding because of lack of confidence.'

But he adds more optimistically that, `In the long term, the continuing driving down of inventory levels will leave greater room for expansion and eventual pick-up. The Fed's 11 interest rate cuts are also pumping in liquidity, and eventually an adjustment will come through. As a bonus, Chinese imports of Asian goods are rising, and this helps cushion shortfalls in imports by the US, which is a big component in Asian economies.'

Although the prognosis for the US economy may be described as either fair or mixed, the same can't be said for US markets, which were battered again recently by the unveiling of WorldCom's massive accounting fraud in late June 2002. America's second-largest long-distance telecommunications company inflated its profits over five quarters to the tune of US\$3.8 billion, and analysts predict WorldCom's business failure will be three times the size of predecessor Enron.

Post-WorldCom rebounds on the US markets in early July were short-lived, demolished by Merck's confession that it too had overstated figures, by recording revenues that were never received. At the time of writing, US markets had reached their nadir since 1997.

The silver lining? Depressed US markets - and an increased risk premium for US assets - could be lucrative for the rest of the world. Trends indicate a possible decoupling of US stock markets from global bourses as panicked money seeks other safe havens. Possible refuge include Asian stock markets, as well as old-fashioned stalwarts such as gold.

Says Tham, 'Previously, the media played up American corporate governance too much. Now, we will find a lot of excesses coming home to roost such as Enron, Tyco, WorldCom. These are now starting to unwind. Historically, the US has traded at a premium because its clarity, transparency, and accounting standards were seen as being beyond reproach. Now, there is a narrowing of the risk premium gap. Investors are not willing to pay a huge risk premium. Why should we pay 40-50 times for an asset that I can get at 12 times in another market?

'There is a flight away from the US. Global asset allocations are down-weighting the US in favour of Asian markets - Japan, Korea, Taiwan and emerging markets such as Malaysia, Singapore and Thailand.'

Although such adverse conditions improve the chances of Asian market rallies, wild cards could still upset the deck. Global political stability or geopolitical risks still could cause tremors in investor confidence, similar to the panic unleashed by the Sept 11 terrorist attack. In particular, the hawkish foreign policy favoured by US President George Bush creates and exacerbates international faultlines.

'Politically, the issue of Bush and Saddam Hussein (with Bush wanting to oust Saddam) is extremely worrying. We do not know the impact of an all-out campaign, and such a campaign will be different from the war waged against Osama. The world branded Osama a terrorist, but the case of Bush versus Saddam involves one head of state gunning for another head of state. The issue will be different from pure terrorism, and we don't know the response from neighbours such as Saudi Arabia and Iran.

'On top of that, Iraq is a major oil producer, so the oil issue will also complicate matters. Maybe the Middle East Crisis will escalate from this. And if these events take place now, business and consumer confidence will be shattered,' states Tan. 'The worry is the non-economic part. If the non-economic situation does not worsen, there is a fair chance of the KLSE Composite Index hitting 850-900 by the year-end.'

Surf88.com is sticking to its 800-850 target for the KLCI, although it (this target) is likely to come slightly later and probably more cautiously as well. Tham won't predict indices, saying, 'My own philosophy is not to follow the indices because indices are formed from a small number of stocks, which makes them too narrow. Here, you just need to move three stocks to move the index.' Nevertheless, he adds, 'Since some main heavyweights have not performed, I don't think the market will touch 600 levels.'

Similarly, domestic political risk has now emerged as a third dimension in investment decisions linked to the KLSE. The Prime Minister's shock announcement on June 22 2002 rattled investors, and in tandem with WorldCom's revelations of accounting fraud, pushed the KLCI down to around 703 points in the following week.

Reasons Tham, 'His announcement came as a surprise. In the short term, the way it was presented spooked foreign investors since they're sitting so far away. Therefore, in the short term, the risk premium increases because of perceived political uncertainty.'

In hindsight, it had to happen some time. Wrote Surf88.com in a recent report, '...Succession is an ever-present issue, but one which had been relegated to the background amidst improved political stability.' Bringing the matter into the open, and addressing the issue with the PM overseeing the transition process, would be preferable to a sudden disruption, said

the online investment portal.

Tham concurs. 'Dr Mahathir's move towards retirement has freed up the succession issue. Now, it is time for Abdullah Badawi to show his solidity and to make things work. It is time for a new set of people to set up a structure and administrative policies, and there has to be a structure where there is a clear hand-over of power. Therefore, the announcement really settles the succession issue, which has always been lingering. However, the political situation will be affected by factors such as (possible) political infighting.'

The anticipation of elections may also play a role in the health of the KLSE. Says Tan in tongue-twisting fashion, 'Where the Malaysian election is concerned, if the external environment is favourable then the Malaysian election will enhance the favourableness of the economic scenario and the stock market. But if the external environment is non-favourable, then the anticipation of a Malaysian election will not have any impact on the KLSE.'

How long will investors have to wait before seeing upside? Tham says, 'The rest of 2002 will be down months featuring a very quiet consolidation phase. There should be a pick-up in the fourth quarter, latest in the first quarter of 2003, as clearer signs of economic recovery filter through, since financial markets as leading indicators tend to predict forward.'

Surf88.com sees support as the KLCI rebuilds its base, but the recent rebound is still 'tentative' as low volumes indicate lack of broad participation. But it recommends that 'investors with medium to longer-term horizons should bottom fish amidst consolidation, and ahead of the expected pre-budget rally in September 2002.' In the interim, says the investment portal, investors will need patience to ride the lull.

Given that the market is quiescent, Tham is taking the opportunity to shop. 'The market may under-perform in the short term but we may never catch the exact bottom, so we might as well give up short-term performance in order to catch the long-term wave. Some companies look very attractive. We would still recommend companies that show very strong balance sheets.' Surf88.com sees the correction as another opportunity for investors who missed the boat during the second-quarter rally, given that general economic and corporate fundamentals are still very much on the positive track.

Currently, says Tham, some companies look very attractive. Capital Dynamics' Tan, as usual, advocates value investing, zeroing in on stocks with strong balance sheets and preferably, barrels of cash. Tham warns against political stocks, even though elections may induce euphoria in such counters.

On a sectoral basis, Tham advises that investors cherry-pick in sectors slated to perform well. Currently, 'We're 80-something per cent invested in our sectoral funds.' According to Tham, construction will continue to bring in cashflows since order books are still strong. Surf88.com concurs, saying earnings impact from public pump-priming projects progressively awarded this year will only come through more meaningfully next year.

Oil palm still holds potential, say analysts, despite riding high over the past few months. Surf88.com writes, 'The rising likelihood of El Nino could well extend the bullish CPO price cycle by another year. Given that the 22% gain in CPO prices so far in 2002 would propel plantations' profit by significantly more (due to relatively high fixed cost), we believe the plantation index still has more room to go. In fact, we can still find many plantations and construction companies trading at compelling value.' Capital Dynamics advises investors to look out for pure plantation stocks with strong balance sheet and good dividends. Elsewhere, gaming stocks

are starting to look 'interesting', according to Tham. However, Surf88.com says gaming companies are experiencing flattish sales.

Tham believes NPLs still haven't peaked in the financial sector, but the rate of increase has slowed down. Surf88.com is more neutral on finance and would only 'cherry-pick' here since it believes some stocks have already reached fair values.

On tech, Tham says: 'It may be a bit early since we cannot see visibility. Nobody can definitely say recovery (in tech) is sure yet, but if things change, values will always appear.' However, Capital Dynamics' Tan is of the opinion that tech stocks should have strong balance sheets to play out the economic recovery. The caveat in tech? Despite signs of recovery in the semiconductor sector, some companies (such as AMD in the US) have announced that the sales outlook still isn't very promising.

Although some analysts remain bullish on the auto sector, Tan says that due to the uncertainties of AFTA, the risks associated with auto stocks are hard to quantify. 'If Proton does not do well, we don't think others companies associated with the manufacture of automotive parts and supplies will do well too.'

Given their views of the market, how heavily are they invested? Says Tham, 'We're 75-85% invested, and we might raise this to 90% if opportunities allow.' Over at Capital Dynamics, the long-term Capital Dynamics Section C portfolio 'is still heavily into cash, about 42%, because we haven't found a stock we like.' Capital Dynamics' medium-term portfolio is holding 26% cash.

Says Tham, 'We can't afford not to be invested because returns are better from equity market than from the artificially low cash market. Even if we were to look for dividend yields, if we were to go very defensive, we can get 5-6%. On a yield-gap basis, there is a strong argument to be invested in the equity market.'

But like any other investment, dividends must be approached with caution, because 'dividends can sometimes be paid out to milk the company,' says Tan.

Apart from dividends, some analysts have also advised investors to look out for buybacks. Nonetheless, investors must also examine corporate motives behind share buybacks, cautions Tan. On a positive note, buybacks can send the message that the company is confident in its own business. 'Assuming buybacks are based on conservative share valuations, buybacks can enhance shares depending on the purpose of the buyback. For instance if the shares are cancelled, earnings per share can go up. However, share buybacks may not necessarily lead to any positive conclusions,' he adds.

Apart from checking out mother shares, investors may want to consider derivatives such as warrants and ICULS, but keep an eagle eye on risk and potential returns. Notes Surf88.com in a recent report, 'We would reiterate caution over warrants with excessive premiums, as the high risks may not be commensurate with returns.' Agrees Tham, 'There is better value in the mother share at this juncture. Warrants still carry a very high premium and high strike prices on the average.'

If most warrants aren't warranted at this point in time, given large conversion premiums and soft trade in their mother shares, should investors consider ICULS? Might ICULS be a case of icing on the warrants?

Broadly speaking, Irredeemable Convertible Unsecured Loan Stocks (ICULS) are quasi-debt which typically pay an annual coupon over the tenure of the ICULS. Being irredeemable, the principal outlay for ICULS will not be repaid at maturity. Instead, the face value of the ICULS will be converted into new ordinary shares based on the stipulated conversion ratio, wrote Surf88.com in a recent report.

Just like warrants, investors looking at ICULs should be checking out

the health of the underlying mother shares, the remaining tenure of the ICULS and the conversion premium. The fundamentals of the mother share are important since both ICULS and warrants ultimately derive their value from the underlying shares. The remaining life of an ICULS affects value.

`All else being equal, both ICULS and warrants lose value over time with the approach of their expiry dates,' notes Surf88.com. Thus, the longer the tenure remaining, the better. Similarly, lower conversion premiums carry less risk. Another caveat - warrant holders have to fork out extra cash to convert their warrants into shares whereas ICULS are converted into shares at the stipulated rate. If warrants are out-of-the-money and not worth exercising, warrant holders end up with worthless paper at the end of the warrants' tenure, whereas ICULS holders would still gain mother shares in a similar situation.

ICULS' coupons could also be a sweetener and a cushion vis-a-vis warrants. `Given similar tenure and conversion premium, an ICULS would tend to be less risky due to the coupon income and also the conversion of principal at maturity, against warrants which provide no income and require additional outlay at maturity,' adds the investment portal.

The general preference for warrants could even work in favour of ICULS. `... In the Malaysian context, investors' penchant for warrants is such that they are often chased up to huge premiums, while ICULS lag behind at conversion discounts despite offering attractive annual coupons,' notes Surf88.com