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Out of the depths, into the light

REVIEW 2003: A TURNAROUND YEAR for the market

IT was a year of ups and downs that tried the patience of investors but in the end rewarded them with a long-awaited bull run. It was a historic year with war, disease and then hope for a nation entering a new political era. The KLCI closed the year at 793.94 slightly above our fair value of 770. In tandem with a recovery in global markets after a three-year losing streak, the KLCI posted a gain of 22.8% in 2003, the highest annual gain since 1999, but one that still paled in comparison to regional markets like Thailand (117%) or even Singapore (32%). Nevertheless, significant gains were made on the Second Board and MESDAQ Market (see Table 1)

The year began with a spurt upon the arrival of Valuecap but the market was soon bogged down for five months in the uncertainties of the war in Iraq and then SARS closer to home. The economic stimulus package announced on May 21 was the turning point, sparking a KLSE rally to a year high of 818 on Nov 3.

Sentiment was supported by fervent retail activity that chased up highly profitable IPOs, oil and gas stocks and other lower liners. The sovereign rating upgrade by Standard & Poors on Oct 8 kept the rally intact but the KLCI subsequently pulled back despite a smooth leadership transition as Tun Dr Mahathir Mohamad handed over the nation's leadership to Dato' Seri Abdullah Ahmad Badawi. The KLCI then traded within the 760 to 800-point band as the market dwelled on the double tracking rail imbroglio but a two-week window dressing period managed to close the KLCI for the year at 793.94

AN ELECTION YEAR: SIGN OF GOOD TIMES AHEAD

The improving economy, expected to grow at 4.8% in 2003, supported last year's market rally and will continue to do well this year since we expect a 6% GDP growth for 2004 as exports growth accelerate and domestic consumption takes on a larger positive role. Signs of a real US economic recovery, which posted a two-decade high GDP growth of 8.2% in 3Q03, lends credence to a sustained growth for Malaysia.

The year starts on a optimistic note as investors now look forward to a Chinese New Year rally which we believe this time around will be aided by with the appointment of Dato' Sri Najib Tun Razak as Deputy Prime Minister and a minor cabinet reshuffle, the stage is now set for an election, most likely in the first quarter. If so, then a possible date could be during the school holidays from March 13-21 which conveniently also has a non-working Saturday.

Elections will also be held in many other countries this year ( see Table 2), most notably in the US but in Asia alone, Thailand, Taiwan, India, the Philippines, Indonesia and South Korea will go to the polls. Election years tend to see higher government spending to stimulate growth and the excitement created from retail activity lends support to a potential rally.

The Barisan Nasional is intent on reversing the less-than-stellar performance in its previous outing (Table 3) and we reckon it is likely to do so with a rejuvenated leadership under Dato' Seri Abdullah. That optimism, we believe, will be an added catalyst for the market. Even then, historically, general elections in Malaysia have been positive for the market.

Tracking the KLCI since the 1978 general election shows that the one-

month period before election gave on average a slim 1% gain but a more significant gain of 5.8% a month after the elections, for a total of 8.4% two months around the election. Bear in mind that the 1990 election was adversely affected by the first Gulf War.

#### LIQUIDITY DRIVING THE MARKET

If the improving strength of the economy is the reason to invest and the election is the catalyst for the market, then it is the ample liquidity that will provide the market with the capacity to make further gains. Liquidity, estimated at RM87 billion at end 2003, has risen 62% since the previous year and with interest rates remaining low, equity investing becomes an attractive option.

Additionally, expanding external reserves, which stood at RM44.9 billion as at end 2003, that in part has been helped by rising portfolio funds, can be expected to rise further. However, being averse to political risk, we believe most foreign investors would only be persuaded to enter the market after the election, unless an unusually robust rally is too tempting to miss.

#### RISK MAINLY TOWARDS SECOND HALF OF THE YEAR

The local economy's recovery is still heavily reliant on the performance of the US and to a lesser extent, other global economies. If the US economic juggernaut goes off track, expanding significantly slower than the expected GDP growth of 4.4% for 2004 and if Europe and Japan begin to falter, then falling external demand could dent Malaysia's recovery process.

Rising interest rates is also a visible risk. Fortunately, despite England's and Australia's recent rate hikes, the US stance to maintain rates for the near future puts less pressure on the local front, at least for the first half. But an expected 4Q04 rate hike in the US could cap the local market during the second half.

In addition, a downward spiral of the US dollar could loosen the ringgit peg, creating uncertainty for foreign investors, though we believe a depeg of the ringgit to be remote. Nevertheless, other non-economic risks could emerge to dampen the local market: the reappearance of SARS, rising terrorist activity and preponderance of natural disasters.

#### VALUATIONS ARE UNDEMANDING

The KLSE still trades at undemanding valuations from a historical perspective. The market's PER of 14.3 times for 2004 represents the lower end of the trading range of 12-20 times in the post-Asian crisis period (Chart 2). That places Malaysia at a reasonable fourth most expensive in PER terms among regional markets (Table 5).

Despite last year's 23% gain, we expect our forecast earnings growth of 12.7% for 2004 to be sufficient to support further upside for the local market. In fact, further earnings upgrades could keep the market sustained at even higher levels and this has been evident since mid-2003.

Positive earnings revisions as represented by the ratio of consensus buy recommendations as a percentage of holds and sells has been rising across the region since it bottomed around June to September 2003 (Chart 1). We expect this bullish indicator, which bottomed in June for Malaysia, to persist in its positive trend, hence adding credence to a more buoyant market for 2004.

As the market rises on the back of an economic recovery and fuelled by positive investor sentiment, we expect the market to trade at a higher PER of 17 times in 2004. As such, we arrive at the KLCI fair value of 944 based on our current earnings growth model. An even more optimistic scenario, though not altogether impossible, would be a surge towards 18 times earnings which would raise the KLCI to the magical 1,000 level.

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