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The last hurrah for the year

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THE RECENT RATING UPGRADE ON Malaysia by Standard & Poor's is just the kind of thing the Kuala Lumpur Stock Exchange needs. The ensuing reaction to the upgrade saw the KLSE's Composite Index (CI) hitting a 16-month high of 759.62 points on Oct 8.

The Standard and Poor's upgrade is now being seen as one of the factors behind an increased optimism that the fourth quarter of the year would be just as exciting as, if not more than, the last one-and-a-half quarters.

For starters, analysts are predicting the Standard and Poor's upgrade will translate into greater foreign fund participation in the KLSE. As has been often said, the lack of foreign fund participation in our market (since the 1997 financial crisis) is seen as the missing piece needed to take our market to the next level.

Hence it is not surprising that in the last quarter, the market's run-up was driven mostly by local money - both retail and institutional interests. It is also interesting to note that the market's run-up has been based a lot on 'theme and concept' plays.

First it was oil and gas stocks and then it was companies involved in water production. Investors' attention also went to stocks on the MESDAQ Market and initial public offerings that made their debuts on the KLSE. Undervalued second and third liners were also a favourite.

What would foreign funds buy?

The question to ask is: if, as indicated by analysts, foreign funds would slowly be attracted to the KLSE, egged on by the good news of the Standard & Poor's upgrade, then what would foreign funds be interested in picking up?

It has become a rule of thumb, note analysts, that foreign funds are likely to concentrate their investments on index-linked and 'big cap' stocks.

Although foreign fund participation in the local market has been rising the last few months, it is still at a low level. Foreign portfolio investments registered a net outflow of RM6.5 billion in 2002 and RM1.3 billion in the first half of 2003. Numbers released by the Ministry of Finance point to this as well.

Out of the total value of KLSE transactions of RM164.3 billion for January-July 2003, only about RM44.9 billion or 27.3% were accounted for by foreign investors. 'This is a far cry from over half the total transactions during the pre-crisis years,' reminds an analyst.

He expects their participation to increase gradually once the political transition takes place at the end of October when Datuk Seri Abdullah Ahmad Badawi takes over the reins from Prime Minister Datuk Seri Dr Mahathir Mohamad. While a smooth power transition is widely expected, analysts say the event is significant as it erases the political succession uncertainty that would otherwise hurt the stock market.

Room for growth for KLSE CI

At present, the KLSE CI still lags behind most of its regional peers, with the exception of South Korea and the Philippines. This means there is still upside to the local market, as our valuations remain undemanding compared to other Asian bourses.

Furthermore, it is widely accepted that because of the weakness in the US dollar, there is likely to be a flow of investment money out of dollar-based assets into Asian currency-based assets. As such, analysts believe some foreign funds are likely to find their way to the local market in the fourth quarter, given our attractive fundamentals.

So what are our attractive fundamentals? For one, Malaysia's economic growth is expected to be at 4.5% this year and 5.5-6% next year. That

should be coupled with the stock market's earnings yield of 7.4% for 2004. In contrast, returns are less than 4% on risk-free instruments like fixed deposits. Therefore it is only natural for investors to shift their money into equities. Moreover, Malaysian bond prices have peaked and are likely to come under pressure as global economic recovery prospects improve.

Hence analysts are confident that at current levels, the downside risk of the equities market is quite limited. Historically, the fourth quarter has always given better returns (than the rest of the year), averaging about 10%.

Still, although everyone would like to see more foreign participation in the market, analysts reckon that for the fourth quarter, it is going to be domestic players who are going to be driving the market. 'Local players still have a relatively high cash position and we expect to continue reducing their cash holdings going forward,' notes the report of one research house.

Greater retail participation is expected, as always, in the run-up to the next general election that can be held any time before November next year. The previous two elections suggest market activities tend to pick up a few months before the big event. This being the case, the market's performance is likely to be centered on second and third liners and rotational theme plays as against index-linked stocks. Politically-linked stocks will also feature more prominently as talk of an early election intensifies.

Valuations of oil and gas stocks are already stretched and for the run-up to be sustainable, analysts say it has to be followed by the award of sustainable contracts, which should translate down to earnings to justify the rich valuations.

Some water stocks, on the other hand, are still trading at reasonable valuations and could potentially trend higher.

To capitalise on the improved sentiment, some analysts anticipate an increase in the number of corporate mergers and acquisition activities and this should boost stocks on the KLSE. Investors will of course not go wrong if they stick to the fundamentals - to look for stocks that can generate growth and have earnings visibility.

The listings of Astro and Felda is also expected to create strong interest in the market. Astro, the only pure pay-TV company in Malaysia, is likely to get strong institutional interest, given the company's sizeable customer base, strong management and growth potential.

While large IPOs in the past have tended to sap liquidity from the stock market, analyst say the Astro IPOs is not likely to do much damage to the market's liquidity position simply because there is ample liquidity in the banking system. Furthermore, the retail portion of the IPO is small. Observers also say that the success of the Astro listing will also be seen as a test of the how well the local stock market will perform in light of the impending changing of the countries political leader.

With growing optimism in the world economy and expectations of external uncertainties abating, some analysts think the upside risk, that is, the risk of missing the market's upturn, is higher than the downside risk at the moment. That means the target of hitting the 800-point level by year-end could be easily achieved.

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