Investment Strategy

Bracing the Headwinds

FBMKLCI	1,542.94
Target	1,712.00 ↔

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Malaysia's 4QCY19 GDP of 3.6% revealed yesterday was well below our expected 4.0%. With the 1QCY20's Covid-19 tainted projection looking vulnerable to cuts, we lower our 2020 GDP growth forecast from 4.3% to 4.0%. And so, with the raised probability of another 25 bps OPR cut, plunging tourist arrivals and general sluggishness in retail spending, the view looks challenging for our stock market. We are almost certain to lower our 1,712 FBMKLCI target soon after the conclusion of the 2019 earnings season at this month-end. At the current level, the market is implying almost zero EPS growth for 2020 – a dire scenario against our current 7.5% growth estimate. On a lowered EPS growth of 4.5% - this being a preliminary figure -, the KLCI should find a fair value at 1,598: Our picks for the rebound are GENTING (OP; TP: RM7.00), AIRPORT (OP; TP: RM9.90), PADINI (OP; TP: RM4.00), KLK (OP, TP: RM32.90), GENM (MP; TP: RM3.30) and TAKAFUL (OP; TP: RM6.85).

Poor 4QCY19 GDP adds to gloom: In our strategy piece "This Too Shall Pass", we raised the point that the current virus crisis could take the market down to 1,480 drawing on the experience of an 8.4% peak-to-trough sell-off during the SARS crisis of 2003. The disappointing economic prognosis from yesterday's 4QCY19 GDP number and the ensuing street downgrades could well be the catalysts that accelerate the sell-off to sub-1,500.

Low agriculture output cuts both ways: According to Bank Negara, "growth was affected by supply disruptions in the commodities sector" that affected market sentiment. There are really two forces at work here; First is the concern that the underlying economy was weaker than expected even before the impact of Covid-19 set in (as revealed by the sluggish 4QCY19 GDP) and second, the adverse impact of Covid-19 itself. The weakness in 4QCY19 should be seen in the context of a very poor performing agriculture (-5.7%) and mining (-2.5%) sectors. Largely to blame for agriculture was the lower output of palm oil. Data released by MPOB revealed that production fell 16.9% YoY and 13.6% QoQ in the 4QCY19 to 4.67m tonnes. While not exactly encouraging, do not forget that it is because of falling output – this being the lagged impact of dry weather and low fertiliser application on yields - as well as the disincentive amongst smaller, less cost-efficient planters to harvest (when prices were below RM2,400/tonne) which led to sharply lower inventory levels and a recovery in CPO prices beyond RM3,000. As the plantation sector's stock prices are far more correlated to CPO prices than they are to output, this bugbear to GDP is actually a positive for plantations.

Covid-19 won't be around long: We see the Covid-19 impact as transitory in nature. The casualties in terms of deaths and confirmed cases so far remain concentrated within China (see table below – data as at 11 Feb 2020) whereas cases outside China accounted for just 1.1% of total. In the SARS experience, markets actually rebounded around the time when the number of daily cases peaked. With Covid-19, while experts have been hesitant to call a peak, it does appear the daily new cases are trending lower from the current peak of 4th February (see bar chart). While it must be said that it has resulted in extended post-CNY factory/establishment closures which disrupted the supply chain, work is returning albeit gradually.

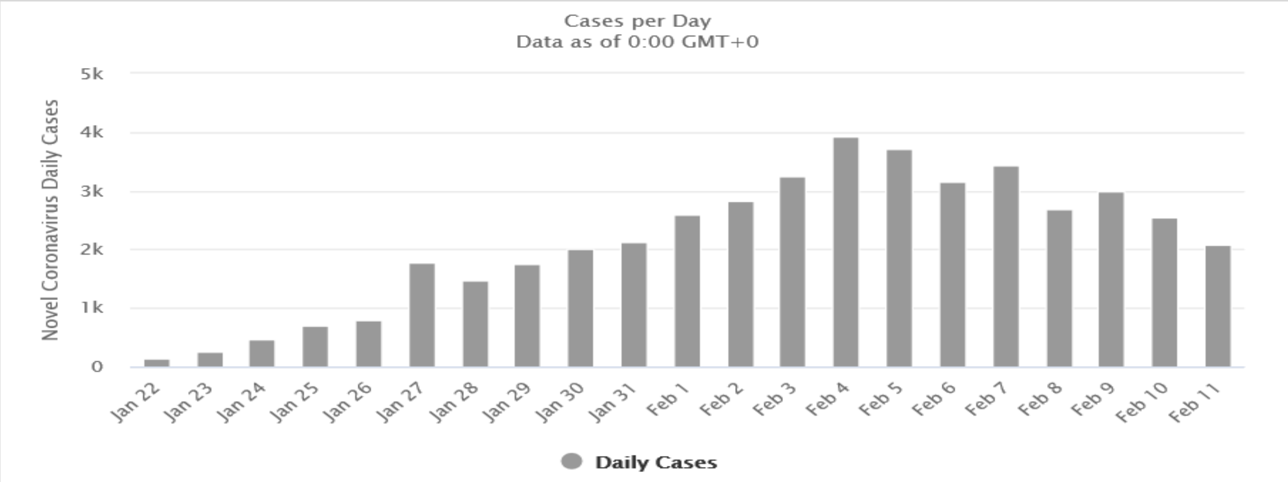
Covid-19 Statistics

Country	Total Cases	Total Deaths	Total Recovered
China	44,653	1,113	4,740
Japan	203	0	4
Hong Kong	49	1	0
Singapore	47	0	9
Thailand	33	0	10
South Korea	28	0	4
Malaysia	18	0	3
Rest of World	140	1	24
Total	**45,171**	**1,115***	**4,794***

Source: WHO

**The overall mortality rate so far is 2.5% and recovery rate is 10.6%*

Daily New Cases

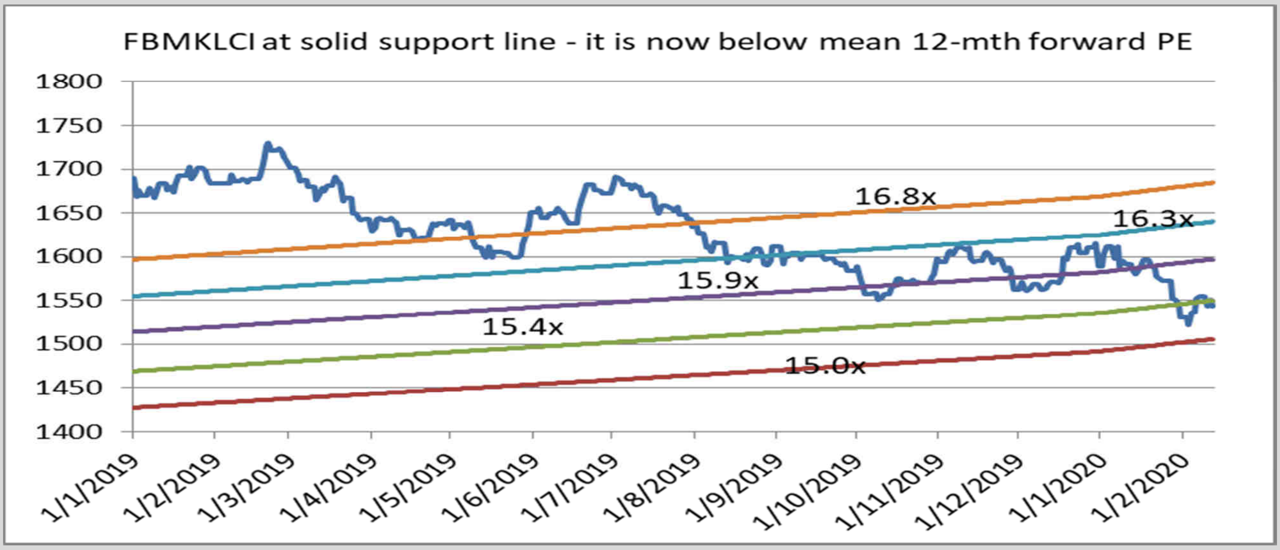


Source: WHO

Direct impact on Aviation, Casino, Retailers and secondary impacts on Banks: Among sectors most vulnerable to the current weakness are banks (which makes up 36% of the FBMKLCI by weight and over 40% by earnings) as OPR gets cut another time and concerns grow over a potential rise in credit charge. Others that are more directly impacted are tourism and retail/consumer plays which are likely to recover as sharply as they have fallen. Top picks here would be GENTING (OP, TP: RM 7:00) and GENM (OP, TP: RM3.30). AIRPORT (OP, TP: RM9.90) and AIRASIA (MP, TP: RM1.33) are BUYs for the lion-hearted.

Our near-term preliminary target for the FBMKLCI is 1,598. We look forward to the end of the 4QCY19 earnings season on the 29th Feb, after which we are almost certain to trim CY20E EPS on account of a poor outlook for 1QCY20. For long term investors, the determiner of the FBMKLCI target at the end of this year is CY21 EPS which would have little to do with Covid-19. However, shorter term investors would want to know where the KLCI should sit now in the midst of the current turmoil. **At the current KLCI level of 1,542 points, the implied EPS for CY20 (based on applying the mean 15.9x PE to 12-month forward EPS) is 95.4 which is 7% lower than our current expectation of 102.4. This also suggests zero EPS growth in CY20 over CY19.** This, in our view, reflects too dire assumptions given that stocks directly impacted (Genting, GenM and Airport) in aggregate account for just under 9% of KLCI's earnings. The larger sectors with bigger earnings impact would be the banks (accounting for nearly half of KLCI's earnings) followed by plantation, by the sheer magnitude of 65% growth. If we cut the banking sector's EPS growth from 3% to 0%, factoring the impact of another 25 bps cut and cut our average CPO price assumption from RM2,700 back to RM2,400 (2019 average), the FBMKLCI EPS growth would reduce from 7.5% to around 4.5% (as a result of trimming our CY20 EPS from 102.4 to 99.5). On this lowered EPS, the FBMKLCI currently sits on 15.4x 12-month forward EPS which is one standard deviation below the 5-year mean PE (see below). Our preliminary target of 1,598 is based on 15.9x (5-year mean) on the above described reduced EPS.

FBMKLCI and SD Levels



Source: Bloomberg, Kenanga Research

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Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM : A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM : A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM : A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT : A particular sector's Expected Total Return is MORE than 10%
NEUTRAL : A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT : A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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