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A year of two halves

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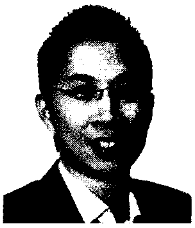

We believe 2014 could be a year of two halves with a more challenging first half due to quantitative easing (QE) tapering and a better second half as global growth momentum continues. We expect QE tapering to commence in the first quarter.

Recall in 2013 that when tapering expectations increased, there was an outflow of funds from emerging markets to developed markets and this caused the former, including Asia, to weaken. During the period of tapering fears from May to September 2013, Asean markets, such as Indonesia, Thailand and the Philippines, bore the brunt of the selldown while Malaysia was relatively flat.

We believe that a similar pattern could be repeated in the earlier part of 2014 when QE tapering appears imminent. When the expected selldown due to QE tapering happens, we will be looking for opportunities to accumulate in the local as well as regional bourses.

There is a general improvement in the macro data, especially in the US. The latest US manufacturing purchasing manager index is at a 31-month high of 57.3 (a figure higher than 50 indicates expansion). The housing and labour market has also been showing signs of improvement. Furthermore, there is also recovery in some countries in the eurozone.

Beyond the short-term impact of QE tapering, we believe that the improving outlook for the US and eurozone economies will eventually be positive for the growth prospects of Asian markets. Within Asia, markets such as Singapore and North Asia are more leveraged to the momentum in global economic growth. Valuation-wise, Asia ex-Japan is not demanding with a price-earnings ratio (PER) of about 11 times in 2014 compared with the historical mean of about 12 times.

Meanwhile, China has announced some reforms to be a market-driven economy. Although this could dampen some growth in the short term, there are benefits in the medium to longer term as efficiency would be enhanced. Execution is crucial and the positive reform momentum could help drive a re-rating for China, where valuations are trading well below the historical mean.

Within an Asean context, Malaysia looks relatively more attractive as it has less macro headwinds compared with Indonesia and political uncertainties compared with Thailand. Additionally, we expect Malaysia to perform relatively better (compared with other Asean markets) as QE tapering commences due to its defensive qualities and relatively low foreign shareholding.

One of the concerns about Malaysia is the country's fiscal position but recent announcements by the government, including the Goods and Services Tax and the rollback of subsidies for fuel and sugar would help allay some of those concerns. In the short term, this would have a negative impact on consumption. However, we think that it would be a case of short-term pain to achieve fiscal consolidation in the medium to long term.

Overall, we remain constructive on the local bourse due to favourable liquidity conditions, positive momentum from the Economic Transformation Programme (ETP) and better outlook for crude palm oil (CPO) prices.

In Malaysia, we like the construction, utility and tourism sectors. We expect the project newsflow from ETP to gain momentum and this is expected to benefit the construction sector. We also see opportunities in Sarawak construction-related plays like Cahya Mata Sarawak Bhd and Naim Holdings Bhd.

In utilities, we like Tenaga Nasional Bhd for its undemanding valuation and boost from the upcoming tariff increase. If Tenaga obtains the fuel cost pass-through mechanism, we see

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significant re-rating potential in the stock.

Passenger traffic growth in Malaysia has been robust and we expect this to continue, given competitive airfares, adequate infrastructure and the Visit Malaysia campaign. Brahim's Holdings Bhd, which has an airline food catering business, and Malaysia Airports Holdings Bhd are excellent plays on passenger growth, in our view. Unlike airlines, their earnings are far less vulnerable to fuel price increases.

Outside of the sectors mentioned above, we like Suria Capital Holdings Bhd. The port operator is a proxy for Sabah's economic growth. There is an earnings kicker from its Jesselton Quay project.

On the flipside, with costs expected to rise, we would be cautious on companies that have weak pricing power as their margins would be crimped.

The main investment risks include monetary stimulus being removed too fast or too much, affecting economic growth. We believe that the withdrawal of fiscal stimulus will be done gradually and not jeopardise the economic growth momentum significantly. We also need to keep an eye on the euro sovereign debt crisis and the health of the property and financial system in China. E