Kenanga Investors

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THE DECEPTIVE TRADE CONFLICT TRUCE

Focus Malaysia (12 January 2019)

By Ismitz Matthew De Alwis

- **Trump** must act more cohesively to settle the US-China trade dispute
- **Other** challenges to a global equity market rebound in 2019

If there is one wish the global investment fraternity has for 2019, it has to be for US president Donald Trump to act in a more gentlemanly manner in his decision-making process, particularly on issues with major global impact. Last year witnessed how the eccentric behaviour of the leader of the world's biggest economy brought about numerous rollercoaster rides time and again across equity markets worldwide. The global economic climate has been besieged with uncertainties of sorts in recent times with Trump's notoriety in declaring a 'deceptive' 90-day trade conflict truce – his most recent market-adverse stunt. On Dec 3, the already sluggish Dow Jones Industrial Index rebounded 250 points soon after Trump and his Chinese counterpart Xi Jinping agreed to a 90-day ceasefire in the trade war that has weighed heavily on global stock markets since mid-2018. But the joy was short-lived as Wall Street's enthusiasm for the US-China trade truce vanished 24 hours later (the Dow plunged 799 points or 3.1%) following Trump's costly tweet labelling himself as a "Tariff Man" in addition to the surprise and controversial arrest in Canada of Huawei's chief financial officer Meng Wanzhou at the behest of US authorities.

Prior to the truce, both economic giants had already been embroiled in tit-for-tat counterblows with China reciprocating every trade action initiated by the US, i.e. by releasing last August a list of American goods worth US$60 bil (RM246.66 bil) that Beijing intends to hit with tariffs in retaliation for Trump's plan to impose duties on US$200 bil in Chinese imports.

DOUBLE-EDGED SWORD

Given his reputation as a businessman extraordinaire – the first billionaire president in US history - Trump would be better off leveraging his business flair to rally economic growth, spread wealth or share prosperity across the globe. Instead, his key messages tend to circle around the usurping of American wealth by foreign economic forces. Ditching much of the legacy of his predecessor Barack Obama, the US has disassociated itself from the 11-member Trans-Pacific Partnership (TPP) which came into effect on Dec 30 with economic powerhouses in the likes of Japan, Canada, Mexico and Australia.

In line with his "America First" agenda to shrink the US trade deficit and overturn "decades of unfair trade deals that sacrificed our prosperity," Trump is adamant in re-negotiating free trade agreements at all costs to safeguard the US economy. China aside, Trump has also waged trade wars on all fronts vis-à-vis free trade animosity with neighbours Mexico and Canada (a revised North American Free Trade Agreement was sealed on Nov 30) as well as the European Union (with whom Trump declared the scale of hostility was “almost as bad as China, just smaller”).

The trade conflict situation is now akin to a double-edged sword. If it worsens with the Trump administration expanding tariffs, the global economy - emerging markets are not spared - is likely to be harmed given the huge size of the US trade with China. On the contrary, there are valid reasons for financial markets worldwide to rejoice if the dispute can be resolved soonest - or at least managed with utmost precaution.

RECORD-BREAKING FEATS

In all fairness, Trump should not be faulted as the sole protagonist for the under-performing global stock markets throughout 2018. On Dec 20, the Federal Reserve raised its benchmark interest rate for the fourth time in 2018 by a quarter-point to 2.5% but lowered its projections for future hikes to two in 2019. Then there was a downward revision to third-quarter gross domestic product numbers (by a mere 0.1% to 3.4%) as business spending weakened. Amid such developments, there were escalating concerns over continued signs of economic slowdown in both Europe and China that many investors feared would ripple over into the US. For the record, all three key barometers ended in the red in 2018 with the Dow retreating 5.6%, the S&P 500 (-6.2%) and the Nasdaq Composite (-4%). It was the worst year for stocks since 2008 and only the second year the Dow and S&P 500 fell in the past decade.

Ironically, Wall Street also achieved a few feats in 2018. Both the Dow and S&P 500 broke an all-time record of 26,828.39 points on Oct 3 (Dec 31: 23,327.46) and 2,930.75 points on Sept 20 (Dec 31: 2,506.85) respectively. The Dow also surged 1,086.25 points at the close on Boxing Day, presumably as a year-end window dressing exercise – the first time the benchmark index ever ended on a four-digit note in a single day. But 2018 will be remembered for its extreme volatility. The VIX volatility index spiked while the CNN Business’ Fear & Greed Index has been stuck in “Extreme Fear” throughout much of the year. The Dow has swung 1,000 points in a single session only eight times in its history, and five of those took place in 2018. Across the Atlantic, there is a high likelihood of Brexit triggering chaos in the UK with an adverse spillover effect on global financial markets.

Back in October, S&P Global Ratings warned that a “hard” Brexit would trigger a deep and lengthy recession in the UK – and the outlook increasingly points to such a no-deal scenario as the European Commission rolls out contingency plans and embattled Prime Minister Theresa May struggles to get the votes for the deal she negotiated.

LOCAL CHALLENGES

Back home, external concerns will continue to undermine investor sentiment in 2019 with the dearth of domestic drivers making it difficult for the Malaysian equity market to shine amid already pricier valuation vis-à-vis comparable developing peers.

Those uncertainties are further heightened by the volatility in crude oil prices (Brent crude closed 2018 at US$53.80/barrel after touching a four-year high of US$86.29/barrel on Oct 3), potentially weaker external sector and limited ability to pump prime domestically due to a commitment towards fiscal prudence. On the other hand, downside pressure on US economic growth stemming from waning fiscal stimulus and rising inflation, coupled with a potential reversal in the greenback’s strength, could encourage the outflow of funds – potentially in the second half of 2019 – into Asian markets that boast stronger growth prospects, both in terms of economy and corporate earnings. Regardless of pricier valuation, foreign investors are poised to nibble selectively into undervalued blue chips and fundamentally solid big and mid-cap plays as the earnings growth is expected to gain momentum in 2020.

Given the mixed signals, investors are advised to maintain a defensive view of the local equity market and probably pursue a bottom up strategy in 2019. Amid the anticipation of moderating growth for the Malaysian economy with minimal prospect of broad-based growth in the local stock market, an active management strategy with decent stock picking skill can spell success for investors. In the context of unit trusts, a little readjustment of one’s portfolio, i.e. switching from an FBM KLCI index-linked fund to a small sector fund may just do the trick. This is given the spread between the FBM KLCI and FBM Small Cap is trading at levels not seen in more than five years, suggesting an attractive valuation for the small cap sector in comparison with the benchmark index.

After registering superior returns in 2017 (+15.9%), the local small cap sector had reversed all its previous gains by posting 34% losses in 2018 in tandem with a bearish sentiment that had impacted equity markets locally, regionally and globally. Above all else, a bluer sky can be expected in the days ahead with the government having lined up various measures to strengthen the nation’s finances, and its structural reforms to address past shortcomings and boost competitiveness should be viewed in a positive light by investors.

Despite closing 5.91% lower at 1,690.58 points in 2018 (2017: 1,796.81) and posting a total foreign net outflow of RM11.65 bil (the largest yearly foreign net outflow since RM19.49 bil in 2015) as tracked by MIDF Research, the local bourse was Asia-Pacific ex-Japan’s fifth best performer behind India’s SENSEX (+6.02%), New Zealand’s NZX (+4.92%), Jakarta Composite Index (-2.54%) and Sri Lanka’s Colombo Stock Exchange All Share Index (-4.97%).

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Ismitz Matthew De Alwis *is the executive director and CEO of Kenanga Investors Bhd and president of the Financial Planning Association of Malaysia (FPAM).*

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Record-breaking feats

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Local challenges

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Traders on the floor of the New York Stock Exchange this week in the wake of the US-China trade conflict

How did the US stock markets fare in 2018?

INDEX	ENDED 2018	CHANGE IN 2018	CHANGE IN 2017	DECLINE FROM 52-WEEK HIGH
Dow Jones	23,327.46	-5.6%	25%	-13.4%
Nasdaq Composite	6,635.28	-3.9%	28.2%	-18.4%
S&P 500	2,506.85	-6.2%	19.4%	-14.8%

Source: Bloomberg