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***From the Chief Investment Officer's Desk*:**

Greece Fallout - Significant Events Unfolding Soon

by Lee Sook Yee

The Greek government announced a referendum to be held on 5 July on whether to say "Yes" or "No" to the creditors' proposal for bailout aid. The unexpected turn of events over the weekend is seen pushing Greece towards default as early as this evening (Tuesday, 30 June 2015) and an exit from the Eurozone.

The uncertainty over Greece will overhang market sentiment and the US nonfarm payroll report due for release on Thursday, 2 July could add further to market jittery. The direct beneficiaries for such risk aversion environment will be US dollar and Japanese yen. In Asia, negative sentiment will hurt currencies such as MYR and IDR which are already being weighed down by their own domestic issues, as well as more liquid currencies such as SGD. USD/MYR touched a high of 3.80 last Friday with Bank Negara reportedly in the market. However, we do not expect significant market distress in Asia at this point, unless the Greek drama turns into a global financial market contagion.

While the risk of Grexit is rising and the uncertainties increasing given that we are entering the territory of default and capital controls, we still think that the European authorities are both prepared and equipped to act to preserve the integrity of the euro in the face of market turbulence from Greece uncertainties.

With concerns over Greece default, the local bourse may continue its downtrend amid the negative sentiment. This is also due to the possible downgrade by Fitch Ratings on Malaysia's sovereign ratings. It is largely anticipated that Fitch will be making a decision today. Using 2013 as a reference point, the market dropped by some 5-6% following Fitch's decision to put the country's rating on negative outlook, but thereafter, the market rebounded sharply. The local bourse is now down by almost 4% YTD and the same could happen. Technically, immediate support is at 1660 points (the low of 2013).

Malaysia is arguably relatively defensive in the region given its low beta profile. Yesterday it dropped less than most other markets in the region (north Asia down ~3%) and Europe (down ~4%). This is because most foreign investors have already sold down previously and are very underweight on the Malaysia market. Based on recent data points, Malaysia's foreign equity ownership is now the lowest in ASEAN at 20% vs PH (23%), SG (29%) TH (31%), and ID (33%). Volume traded has also been light below MYR2.0bn in the last few weeks.

Due to its defensiveness and the likelihood that the market has discounted some of the bad news (the FBMKLCI is the second worst performing market after Indonesia within ASEAN), we believe downside risk is limited. We have locked in gains and reduced our investment levels across all funds since the beginning of May. Given the anticipated market volatility ahead, we will only slowly deploy excess cash to buy stocks both in the region and Malaysia especially when valuations become more compelling.

We continue to adopt a barbell strategy of holding a good balance of defensive stocks and beta/cyclical exposure, with the latter particularly focusing on the export-oriented sectors (like ICT and contract manufacturers) on the back of the MYR weakness. We also like sectors that remain the driver of GDP growth like construction and infrastructure plays, whilst selected small and mid cap stocks with good earnings prospects should also feature extensively.

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H-Shares Looking Attractive after Recent Correction

The SHCOMP index had corrected more than 20% from peak to trough on various reasons. First to note is that the market had staged a huge rally since Q4 last year, more than doubled to the recent peak level, partly spurred by leverage through margin financing to record high. Valuation appeared to be rich, with A-share large caps measured by CSI300 trading at PE 15x on 12-month forward basis, and non-financial as high as 21x.

Comparing to the H-shares market, the correction for HSCEI index of recent peak-to-trough of about 14%, not very far off from regional performance with JCI index (Indonesia) down 15%, Kospi index (Korea) down 10%, followed by Taiex index (Taiwan) down 9%, all quoted in US dollar terms. In contrary to A-share performance, HSCEI only staged a rally of 25% to its recent peak, before giving back some gains in the recent correction. On a YTD basis, HSCEI still showed a 6.5% gain.

In view of all this, we see potential downside risk for A-shares though potentially could be somewhat cushioned by government effort. For H-shares, given more attractive valuations with MSCI China only trading at PE 10.8x on 12-month forward basis, we see some upside in the next 6-12 months, but we do acknowledge that market likely to experience increased volatility. The heightened volatility would come from 2 fronts – namely the global market as we currently witness the uncertainty of Greece outcome, as well as volatility from the A-shares market. Despite all this, we see that the valuations remain attractive, especially after the recent correction. Recent easing on monetary front and stronger fiscal support by the government would likely to result in some positive impact to the economy with 2-3 quarters lag, which would be taken positively by the market if economic data in the next few months continue to see improving numbers.

We are currently about 38% invested in China/HK, from its recent high of 50% exposure as we took some profit during the market rally. We continue to favour North Asia markets like Taiwan and Korea with total investment about 20% of the fund. The remaining of the exposure is in Asean markets, coupled with highly cashed up position, and aiming to deploy during recent market weakness.

Note: The Kenanga Asia Pacific Total Return Fund is invested in the China market through the H-shares.

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