

CapitalBeat



by Clement Chew

KLCI upcycle intact but expect a challenging H2

CAN the FBM KLCI sustain its 7% year-to-date rise? Are we in a new uptrend or will the stock market give up its gains?
Many investors are unsure of what is in store for the second half.

In my view, the KLCI's gains this year are sustainable. I believe we are in the early phase of a new upcycle. However, as valuations have become more expensive, the market is likely to consolidate, if not trade lower in the second half. After a consolidation, the market should be able to move higher.

My reasons are outlined below.

Bear markets come to an end

First, the KLCI is in a new upcycle. The longest correction in 30 years ended last year.

As *Graph 1* shows, there have been eight downcycles since 1987. The average duration of a downcycle was 12 months. The average decline was 37%. Typically, downcycles tend to be shallower and shorter than upcycles (see also *Graph 2*).

In the recent downcycle, the market fell by a modest 14%. However, the correction lasted for an unprecedented 29 months. The KLCI reached a peak of 1,886 (June 2014) and bottomed at 1,617 (December last year).

In contrast, the second-longest downtrend lasted for 18 months. This occurred during the 1997/98 Asian financial crisis when the stock market fell by 76% from its peak (February 1997) and bottomed out in September 1998.

The recent correction was unusual in terms of duration. Stock market cycles, including bear phases, must come to an end.

A new upcycle is underway

Second, market upcycles tend to last for some time. Since 1988, there has been seven upcycles (see *Graph 2*). The average upcycle lasted for 36 months. The average appreciation in these upcycles was 127%.

The current upcycle started last December. It is therefore only in its seventh month. In the last 30 years, the shortest upcycle was 11 months (2001-2002). The longest was 68 months (2008-2014).

Historical data would support the view that this upcycle has many more months to go.

Third, the street has revised up its earnings expectations for the market. This contrasts with previous years when analysts

were revising down their earnings estimates.

As *Graph 3* shows, analysts started to upgrade their forecasts in January this year. Consensus raised its forecast again in June after the first-quarter reporting season.

The KLCI's 2018 EPS integer has been revised up by about 7% from 107 (December 2016) to 115 (July). This approximated the circa 8% rise in the KLCI from the bottom (December 2016). In other words, positive earnings revisions have been a fundamental driver for the market's rally.

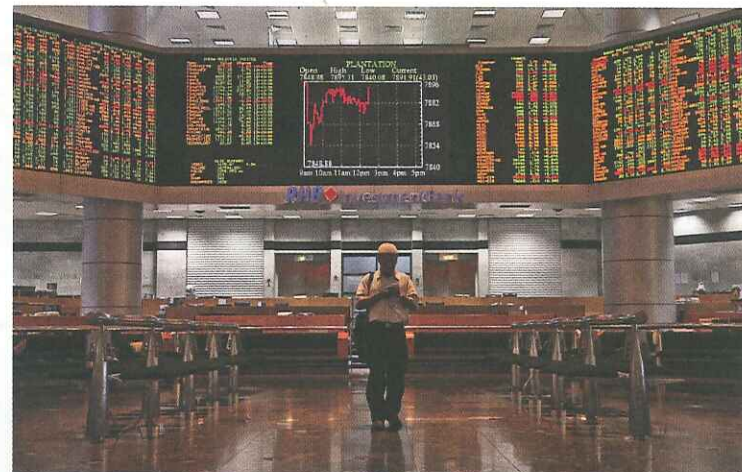
Furthermore, with a low base last year, we are likely to see mid-to-high single-digit market earnings growth this year. This contrasts with the flat-to-negative earnings growth in the last three years.

"The current upcycle started last December. It is therefore only in its seventh month. In the last 30 years, the shortest upcycle was 11 months. The longest was 68 months."

Funds flow

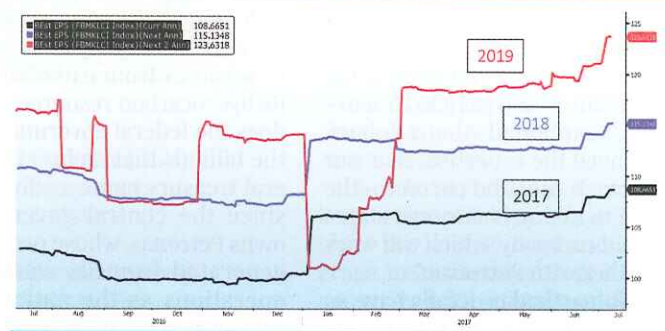
Fourth, foreigners remain significantly underweight in Malaysia. The foreign net inflow of RM10.2 bil in the first six months of this year may appear large. However, this is only 34% of the net outflow of RM29.7 bil that took place between 2014 and 2016.

The current interest in the country remains below the levels seen in the years after the global

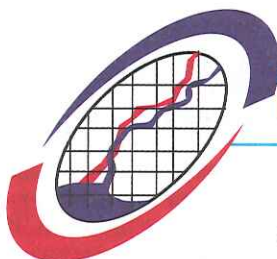


The KLCI is in a new upcycle which started in December

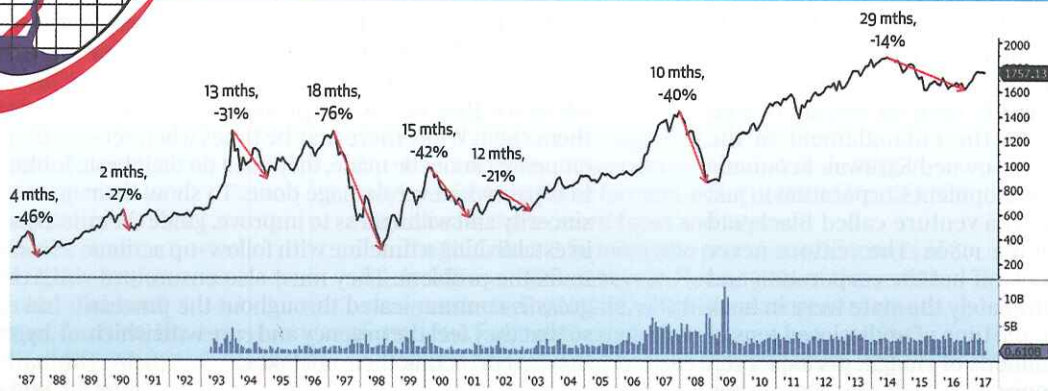
Graph 3: Consensus earnings estimates, KLCI



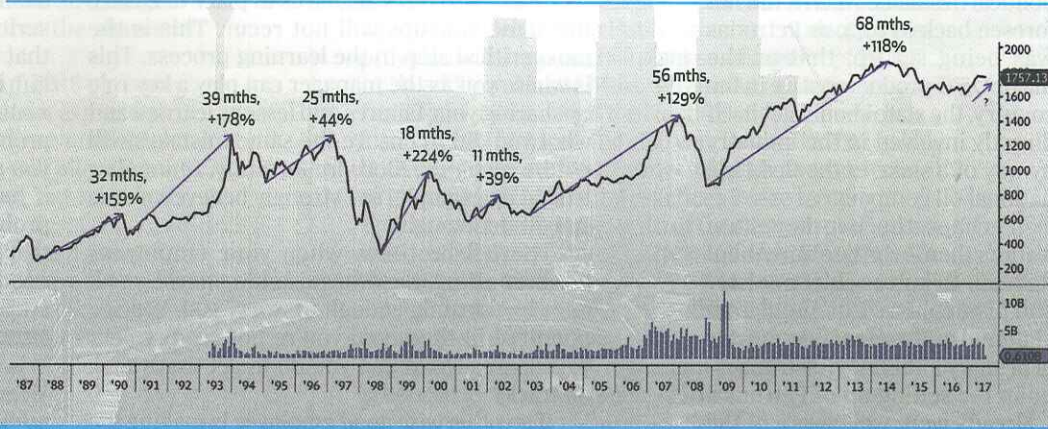
Source: Bloomberg



Graph 1: KLCI's downcycles in the last 30 years



Graph 2: KLCI's upcycles in the last 30 years



Source: Bloomberg and AISB

financial crisis.

This is corroborated by the foreign shareholding of 22.3% on Bursa at the end of last year. Even accounting for the foreign net inflow of RM10.2 bil in the first half, foreign ownership is not expected to be much higher than 21-22%. This is due to the 10% rise

in Bursa's market capitalisation from RM1.59 bil at end-2016 to RM 1.75 bil at end-June 2017. There is room for foreign ownership to increase if we consider that the peak in foreign shareholding was 27.5% in 2007.

A more challenging second half

The market is likely to see several headwinds in the coming months.

First, its 2017 PE multiple has risen to circa 16-17 times which is in line with its five-year mean of 16 times. Earnings will need to catch up before the market can move higher.

Second, the US Federal Reserve is expected to shrink its US\$4.5 tril balance sheet by Q4. This prompted the recent uptick in US bond yields. Higher US bond yields will put pressure on equity prices. It may also result in capital flowing out of emerging markets like Malaysia.

Lastly, we are getting ever closer to GE14. The issue is not the outcome but the uncertainty leading up to it. Markets dislike uncertainty and this will be an overhang for the KLCI. The general election must be called before Aug 24, next year.

In summary, the market's first-half rally had strong fundamental drivers. The upcycle remains intact. But for the next leg-up, the market will need to get through a few near-term challenges. **FocusM**

Clement Chew is CEO of Apex Investment Services Bhd. The views expressed in this article are his own and do not necessarily reflect the position of his company