Three investment themes — stimulus, development corridors and defensives

A report by **OSK Research**

Although we believe the KLCI is already fairly valued, having run past our 2009 KLCI fair value of 1,040 points, we continue to see opportunities to trade in the current market given the positive sentiment and ample liquidity.

In line with previous rebounds, we see the KLCI possibly rallying some 10% more before the inevitable retracement. We recommend a three-pronged strategy focusing on the beneficiaries of the stimulus packages and development corridors while stocking up on defensive counters ahead of the retracement. Our Top 10 picks are therefore mainly from the construction, steel and oil and gas (O&G) sectors, with a sprinkling of defensive plays.

Slightly more optimistic on 2010 numbers

We are currently overweight on seven sectors, namely consumer — food, gaming, O&G, rubber gloves, steel, technology and utilities, reflecting our forecast growth in 2010 earnings.

L-shaped global recovery

The global economy appears to be stabilising from the worst, but a firm recovery is yet to be tested because there are still a lot of uncertainties in sight. Overall, we expect an L-shaped global recovery.

Potential surprises in the upcoming Budget 2010

Hopefully, the budget will further boost growth for 2010 despite a widening budget deficit, given that it will be exceptional spending in exceptional times. Overall, we maintain our forecast that the economy will contract by 3% in 2009 and slightly rebound to a 2.5% growth in 2010.

Strategy: More room to trade

A combination of economic uncertainty and high liquidity

With the still cloudy picture for the economy, we are maintaining our view that the market is fairly valued at our 2009 KLCI fair value of 1,040 points. However, as the financial systems are flush with liquidity given the fiscal and monetary policies of governments worldwide, we think there is still some upside until our 2010 fair value of 1,150 points is reached.

However, if the KLCI were to approach 1,150 points, it will trigger our sell call. In this section, we will argue why we think the market will still rally a bit more before undergoing a significant retracement.

History repeats itself

In our 2009 Market Outlook published in November 2008, we had highlighted that based on our analysis of the KLCI in the bear markets of 1987-1989, 1997-1999 and 2000-2001, we noted that the KLCI had averaged a 50% drop from its high over a period of 15 months.

With regard to the current bear market, assuming our interpretation is correct that the worst of the bear market is over, the KLCI fell for 14 months from January 2008 to March 2009, down some 45% from 1,524.69 to 842.63 points, coming surprisingly close to our earlier projection.

Therefore, to gauge how far this rebound can carry itself, we again take a similar look at past historical performance.

Our analysis indicates that the DJIA should rally a further 6% from its current level and that the rally can last until the second half of July. On the Malaysian front, our analysis based on historical trends indicates that the KLCI can rally up to 1,190 points (another 12%) in the month of July before a retracement sets in. As such, we feel that there is still room to trade in the local market.

Stock market trades ahead of the economy

The stock market traditionally trades ahead of the economy. With most economists expecting the 1Q09 GDP contraction of 6.2% to have been the worst, the remaining quarters should see an improving economy although year-on-year (y-o-y) contractions may be registered up to 4Q09.

The KLCI tends to bottom out one quarter ahead of the worst contraction experienced by the economy.

As such, given our anticipation that y-o-y GDP contraction will steadily improve over the next two quarters before registering a y-o-y growth in 4Q, we see the market resuming on a general uptrend. However, the KLCI appears to have run ahead of fundamentals in this case as the recovery in the economy is expected to be a lot more gradual than the rally in the KLCI would seem to suggest.

A new government keen to prove itself

With Prime Minister Datuk Seri Najib Razak sworn in on April 3, expectations have run high among investors of his first 100 days in office. With the 100 days ending on July 11, we expect more stimulus from the new administration to get the economy back on track.

For 2H2009, we expect:

- Further liberalisation measures for the Malaysian capital market.
- Contracts for the LRT extensions.
- Contracts for the Gemas-JB double tracking.
- Contracts for the Bakun energy transmission grid.
- Contracts for the Pahang-Selangor water transfer project.

All in all, we expect an exciting next two or three months when contract news flow peaks. Subsequently, we expect the country to get down to executing the contracts and the news flow to dry up. This jives with our view of a further short rally in the market before a retracement.

A retracement inevitable

Just as we see the KLCI rallying a little more towards the 1,150 level or even possibly the 1,200 level, we also feel it is inevitable that the market will retrace.

Firstly, looking at the historical performance after the rebound, the KLCI retraced an average of 15% in all three previous periods. If we apply our 1,190 points rebound target, the KLCI may retrace to the 1,007 point-level.

Secondly, based on the GDP outlook, we note a difference between 1999/2002 and the current outlook. In the previous two periods, recovery in GDP was swift (1999 — rebound from -11.2% in 4Q08 to 4.8% by 2Q09, 2002 — up from -0.4% in 3Q01 to 2.7% in 1Q02).

However, for the current period, we see Malaysia's GDP still contracting by -5% and -2% in 2Q09 and 3Q09 respectively after the -6.2% contraction in 1Q09. As such, although there is a recovery, with the economy still contracting, we feel that valuations have run too far ahead of fundamentals.

No need to play catch up

Some have argued that institutional investors remain under invested and foreign investors have yet to make a comeback to the Malaysian market, both of which we believe are correct, and therefore will help bolster the KLCI to greater heights.

While we believe the KLCI can still run ahead on short-term positive sentiment, we also feel that most institutions will hold out for the expected retracement before re-entering the market in a big way.

At the same time, we feel that there is no particular reason for the KLCI to play catch-up to regional markets. While the KLCI has definitely underperformed in 2009 as shown in the figure, based on returns since January 2008, the KLCI is still outperforming the MSCI Asia ex-Japan index given its outperformance in the bear market of 2008.

Benchmarked against January 2008, the KLCI is still outperforming the MSCI Asia ex-Japan by 9% and looking at past historical performance, we do not see any reason for the KLCI to play catch-up. Instead, we see the upcoming retracement as the factor behind an eventual narrowing of the gap between Malaysia's performance and that of its peers as we should again outperform in any downturn.

A bit more upside, then it's time to sell

As such, based on our arguments above, we maintain our view that the KLCI has still some room to rally, perhaps to the 1,190-1,200 range. Nonetheless, we expect a retracement subsequent to that rally that could well take the KLCI back to the 1,000-point level.

As such, we advise trading the market at the moment, with our investment ideas highlighted on the subsequent section. If the market were to retrace earlier than expected, we would recommend strong buying at the 950-point level.

Otherwise, we would call a sell if the market approaches 1,150 points to derive an opportunity to exit before the inevitable retracement.

Investment Ideas/Stock picks

Based on our view that the market has a little more to rally before retracing, we identify three investment strategies that will allow investors to benefit from the trading nature of the market and the emerging buying opportunities after the retracement. The themes are: stimulus package theme, development corridor and defensives.

For 2H2009, we recommend a three-pronged strategy, focusing on: (1) Stimulus package beneficiaries, (2) Development corridor beneficiaries, and (3) Defensive stocks. Our top buys, therefore, reflect our investment strategy. For 2H2009, we are choosing a more balanced mix of aggressive and defensive stocks.

Stimulus package beneficiaries

With the stimulus packages pouring money into infrastructure development, we see demand for building materials such as steel and cement recovering. On the local front, the government seems committed to awarding a number of key construction contracts such as the double-track rail project down south, the LRT extension lines and the Bakun energy transmission grid.

We also believe the government will spur Petronas to resume its capex on O&G-related infrastructure, especially since oil prices have recovered to above US$60 (RM211.80) per barrel. As such, the sectors that will benefit from the stimulus package theme are steel, construction and oil & gas.

Top buys — Big caps

Stock	Price RM^	Fair Value RM	Mkt Cap RM m	PER (x) FY1	PER (x) FY2	FY1 DY %	P/NTA (x)	Rating
Axiata	2.39	2.70	20,183.9	17.5	12.9	0.0	0.8	Trading buy
Resorts	2.85	3.25	15,237.0	12.6	12.1	2.5	1.8	Buy
MMC Corp	1.93	2.39	5,877.0	13.4	10.8	1.3	-2.6	Buy
WCT	2.19	2.70	1,707.0	12.2	14.0	2.5	1.2	Trading buy
Wah Seong	1.87	2.58	1,263.7	9.7	8.4	4.1	1.8	Buy

Source: OSK Research

Top buys — Small caps

Stock	Price RM^	Fair Value RM	Mkt Cap RM m	PER (x) FY1	PER (x) FY2	FY1 DY %	P/NTA (x)	Rating
QL Resources	2.80	3.68	1,058.3	9.5	8.1	3.6	2.2	Buy
Lion Industries	1.30	1.90	925.6	n.m.	3.2	0.0	0.3	Buy
Alam Maritim	1.41	1.95	694.9	6.9	6.5	1.1	0.9	Buy
Sino Hua-An	0.515	0.66	589.2	17.5	5.1	2.3	0.8	Buy
Mudajaya	1.51	1.90	561.0	8.9	6.0	1.0	1.9	Buy

Source: OSK Research

Among OSK Research's top picks

Petronas Gas (Defensive) Price – RM9.80 Fair value – RM11.10	Downgraded to Neutral after its poor 3QFY09 results in February. Subsequently upgraded back to a Buy in May after the company secured better tariff rates. Price has been flattish, underperforming KLCI. Fair value – RM10.80
IOI Corp (Aggressive) Price – RM3.10 Fair value – RM4.22	Downgraded to Take Profit in early Jan as price surpassed its fair value (RM4.26). Price retraced and subsequently rallied ahead as CPO prices climbed. Currently a Sell Call. Fair value – RM3.40
Tanjong (Defensive) Price – RM11.80 Fair value – RM18.60	Maintained as Buy call. Price has appreciated but underperformed the KLCI due to its defensive nature. Fair value – RM18.60
KFC (Defensive) Price – RM6.95 Fair value – RM7.70	Maintained as Buy call. Price has remained flattish due to its defensive nature. Fair value – RM8.30
QL Resources (Defensive) Price – RM2.40 Fair value – RM3.90	Maintained as Buy. Price has appreciated but still underperformed KLCI. Fair value – RM3.68
KPJ Healthcare (Defensive) Price – RM2.80 Fair value – RM5.00	Maintained as Buy. Price has appreciated but still underperformed KLCI. Fair value – RM4.00

Source: OSK Research

Development corridor beneficiaries

While we still do not see much progress for the Northern Corridor Economic Region (NCER) and the Sabah Development Corridor (SDC), we feel that the outlook may be different for Iskandar Malaysia (Iskandar), the East Coast Economic Region (ECER) and the Sarawak Corridor of Renewable Energy (SCORE).

The ECER will benefit from the new Terengganu Investment Authority (TIA) which will oversee the development of the state's infrastructure. We see construction and O&G players benefiting here.

For Iskandar, Malaysia's warming ties with Singapore could potentially spur investments from the island republic, which is a shot in the arm that Iskandar needs given the troubles plaguing the Middle East investors it was previously courting.

While property players stand to gain from Iskandar, we retain the view that the sector is overvalued and instead see construction (MRCB) and utilities (MMC) as the segments which could benefit.

Finally, for SCORE, we believe that the delay in investment in infrastructure projects such as the aluminium smelter in Samalaju due to the global credit crunch will generally ease and with the warming of ties with China, Chinese companies could potentially invest in resource and energy-rich Sarawak. Construction companies should benefit while local utility company Sarawak Energy could finally secure funding for its dams. The building of the Bakun grid would also benefit Tenaga Nasional. As such, the sectors that should benefit from the development corridor theme are O&G, construction and utilities.

Defensive beneficiaries

Our final theme is based on our view that a retracement is inevitable. As and when such a pullback occurs, investors will want to switch back to safe haven stocks. Our favourite sectors among defensives include gaming (given the cash rich or strong yield nature of the companies here), utilities (which will benefit from a gradually recovering economy), consumer — food (a resilient sector during downturns) and rubber gloves (with the H1N1 influenza pandemic still a threat).

While the gaming, utilities and consumer-food sectors have seen lacklustre performance in the recovering KLCI, the rubber glove sector has outperformed due to recognition of its undervalued companies and on healthcare fears such as the H1N1 influenza.

We believe that a retracement will benefit the stocks with a defensive theme including the utilities, gaming, consumer and rubber glove sectors.

Within each of these sectors, there are a number of key buys which include large and small caps. We also like a number of big cap buys within the telco and banking sectors.