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Can the Water Rabbit Emerge Unscathed from the Recession Hole?

As predicted, the 2022 Water Tiger year was filled with unforeseen changes and surprising developments ranging from the outbreak of the Covid-19 Omicron variant, Russia's invasion of Ukraine creating wreak havoc to the commodity markets with sky high prices that led to inflation concerns, Fed Funds rates raised as high as 75bps sparking concerns of US recession risks and China's zero-Covid policy with strict lockdowns that exacerbated supply chain woes. Consequently, most regional equity markets ended the year in the negative territory.

Based on Chinese horoscope, 2023 is the year of Water Rabbit and is predicted to be a year of hope. Hence, will the Water Rabbit bring us what we lacked in 2022, which is peace and success, as we navigate through the looming global recession? Some of the pertinent questions in the mind of investors are shown below.

Q1. a) Has the multiple decades of high inflation in the US past the peak?

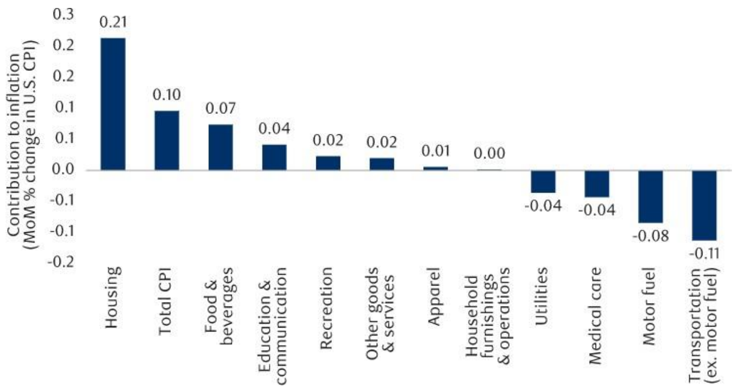
Although the CPI readings have been coming down y-o-y for five consecutive months, the core CPI did not seem to reflect the same trend. A detailed look into the breakdown of the CPI components, revealed that the shelter CPI (see ***Figure 1***), which contributes one third to the headline CPI has emerged as a major contributor (see ***Figure 2***). Since the US Bureau of Labor Statistics (BLS) measures owner-occupied housing inflation through surveys of renters on the cost of lease they currently pay; and because the typical lease contracts tend to lock in rents for 6 - 12 months, any survey of current tenants, will reflect rents that were prevalent when the leases were signed, instead of the rents today. Hence, the CPI shelter is a lagging indicator that lags the actual scenario for 6 months or more. Zillow Observed Rent Index, which is a high frequency rental ask prices index has showedsign of easing since Sep 2022.

Figure 1: Weightage of CPI Components (%)

Components	CPI Weightage (%)
Shelter	32.7
Food	13.7
Energy	8.1
Medical care	6.8
Transportation	6.0
New vehicles	4.1
Used cars & trucks	3.7
Others	24.9

Source: BLS (Dec 2022)

Figure 2: Contribution to Inflation by Components in Nov 2022 (%)



Source: BLS, Mactobond, RBC GAM (Dec 2022)

In ***Figure 3***, it is shown that during the high inflationary era (1970 - 1980), the headline CPI peaked before the core CPI. Surprisingly, there was even a period of time when the core CPI was higher than the headline CPI, an indication that the highly fluctuating food and energy prices declined significantly on a y-o-y basis. Noticeably, this occurrence happened when the red-hot inflation began to cool. Therefore, any signs of a sharp downturn in energy and food prices serve as a signal of disinflation moving forward. As the headline CPI continues to decline y-o-y due to higher base, both inflation measures will converge eventually. Once this happens, the already cooling rental ask prices will start tofeed into the lagging

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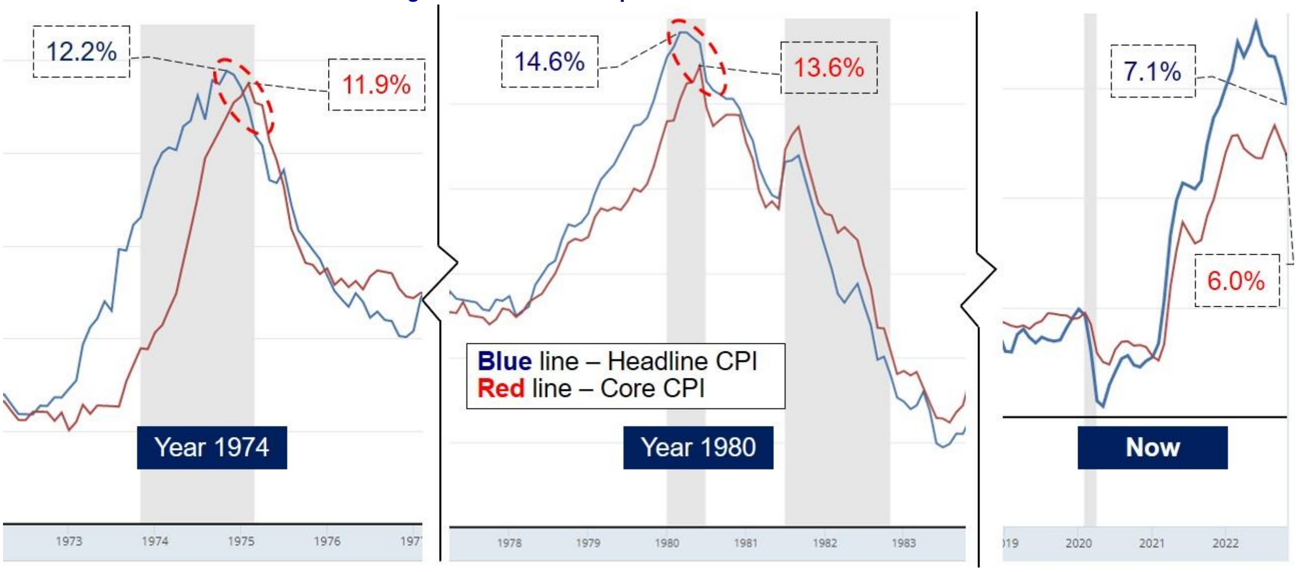
shelter CPI and by that time, we can argue that the Fed's top priority to tame inflation is successful in high confidence. On a positive note, the Fed is not far from that goal asenergy prices have been falling sharply whereas the food prices are waning since Jul 2022.

Figure 3: Headline CPI peaked before the Core CPI



Source: FRED, PCM (Dec 2022)

b) In response, the Federal Reserve is implementing one of the most aggressive monetary tightening in order to tame the "red hot' inflation. How will the terminal rate progress in 2023?

The target rate has been revised upwards multiple times due to stronger than expected job data, which is supportive of a more aggressive rate hike, hence this led to larger correction in risky assets. The current target range still implies a negative interest rate in real terms, even with an optimistic view on inflation expectations. A negative real interest rate will not slow demand growth, which means thatmore stringent monetary policy is required to ease pressure on resources to reduce goods prices. As Mr. Powell explained recently, three decisions shape the path of the policy rate: How fast to raise it? How high to go? And how long to stay at that elevated level? The big debates of 2023 are now underway. In the recent economic projection, the Fed has revised its 1-yr interest rate projection to 5.1% from 4.6%, and yet traders have been pricing in rate cuts as early as Nov 2023. At a median rate of 4.38% (see ***Figure 4***), we are approaching the market-trading rate and the Fed guided projection. Hence, 2023 is slated to be the year of pivot in interest rate.

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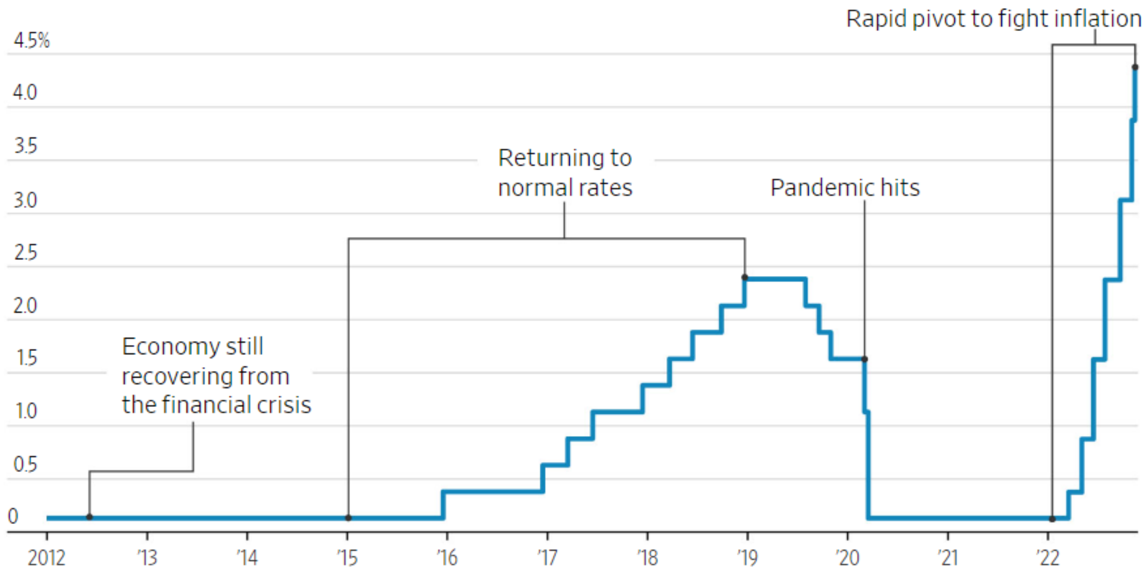
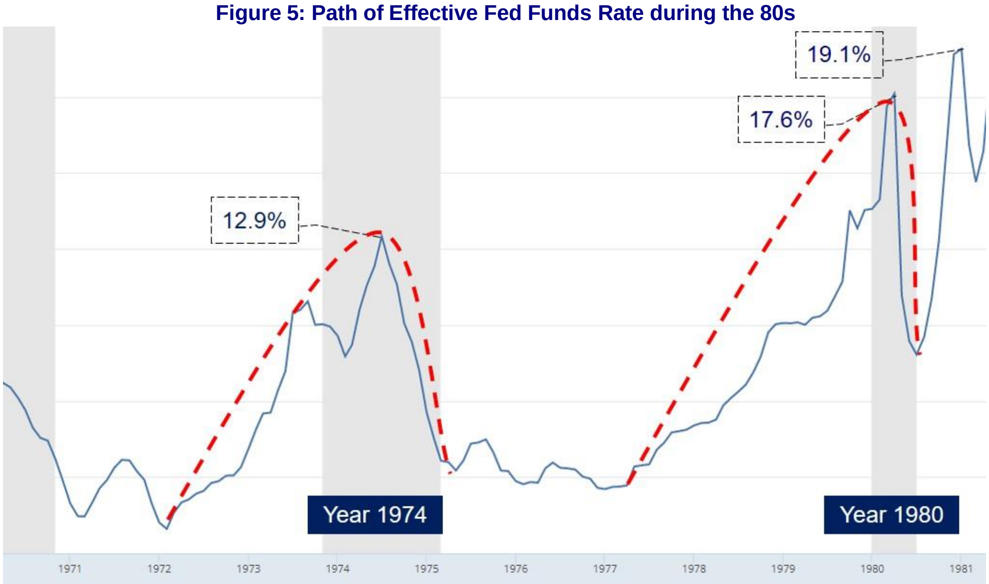
Figure 4: Path of Fed Target Rate



Source: FED, extracted from WSJ (Dec 2022)

Historically, monetary tightening as a result of elevated inflation has never been sustained. This is because the excessive rate hikes to cool inflation often prompt the Fed to act in a hurry, resulting in overtightening. The surge in borrowing costs then dampen the demand for everything, causing an economic slowdown. In 1974 and 1980, not only the high inflation resembled a parabolic shape (see ***Figure 3***) the path of Fed Funds Rate progressed in a similar manner (see ***Figure 5***).

Figure 5: Path of Effective Fed Funds Rate during the 80s



Source: FRED, PCM (Dec 2022)

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Q2. As China eases its Covid-19 restrictions so what is the way forward for the Chinese economy?

The role of China, in the face of an imminent global recession in 2023, is crucial, as a faster than expected durable reopening from Covid-19 restriction would be a positive factor and help offset someof the downside drivers for 2023. Hence, this could benefit global and Asian outlook. The path of recovery will clearly be bumpy with 1Q23 will likely to be marred with a lot of noise and negative headlines, as cases are likely to surge, leading to unfortunate deaths and hospitalisations, if experience of some other countries is a guide for what to expect in China.

Figure 6: Domestic policy turned more proactive in periods of negative export growth

Source: Bloomberg

Since 2008, Chinese equities have had three such twin negative periods over Dec 2008 to Nov 2009, Jan 2015 to Aug 2016 and Aug 2019 to Jun 2020 (see ***Figure 6***). In all three periods, policy actions turned more proactive in response and helped equity index returns (see ***Figure 6***). In fact, China's valuation appears compelling (see ***Figure 7***). Given the importance of net export in driving China's GDP growth and current account surplus being critical in supporting the foreign exchange, when the export cools, Chinese policymakers have tended to respond with stimulus to boost demand for credit and to revive aggregate demand.

Figure 7: MSCI China 12-month forward PE

Source: WIND

Overall, we expect China's outlook to improve more materially in 2H23 as we anticipate further flow-through of the stimulus measures to be positive for the economy with a helpfulstabilisation of the property market. We believe the property sector is likely to bottom out and stabilise, given the authorities unveiled the long-awaited rescue package at the end of 2022, which appears to be the biggest supportive move to the sector in the two-year deleverage campaign.

Q3. With escalating geopolitical tensions add to in the near-term uncertainty, how will this affect the stock markets?

The geopolitical relations and economic landscape between the US and China deteriorated when Trump initiated the US-China Trade War in Jul 2018 over the allegations of unfair China economic policies that induced US prolonged massive trade deficits with China. Trump imposed levies on importsfrom China and export controls particularly on high-tech products to China amid heightening national security concerns. China retaliated with additional tariffs on US imports and cancelled US agricultural purchases. Consequently, China achieved the weakest industrial output growth in May 2019 while US overall deficits peaked ironically since 2008 during Trump's presidency.

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In Oct 2022, Biden announced export restrictions on all advanced American computer chips and chip-making tools to China, further crumbling the fractured bilateral relationship. The sweeping embargoes aimed to obstruct the technological transformation in China exacerbated the challenging operating environment for chipmakers and provoked further selloffs in the tech sector. Being the topmost prominent chipmaker, Taiwan is sandwiched between its major export partner China and its main military ally US. Given the rising military pressure from China over the island's sovereignty disputes, Biden gave assurance to defend Taiwan against China's invasion due to Taiwan's dominant status in US semiconductor supplies. Nonetheless, its silicon shield could eventually be not functional as the US has been actively cutting its supply reliance on Taiwan. The battle between the two superpowers is propelled by nationalism to defend their geopolitical and economic supremacy rather than economic facts.

Following Russia's invasion on 24 Feb 2022, the financial markets tumbled and the crisis triggered shifts to safe haven assets such as gold and government bonds. Despite recovering within a few weeksafter the invasion, equity markets continued to trend downward amid aggressive US tightening monetary policies. The military tensions exerted additional inflationary pressure specifically in the Eurozone when commodity prices skyrocketed due to supply chain bottlenecks. To revenge against Western sanctions, Russia being the commodities powerhouse, tightened its supply of essential commodities and posed threats to energy and food security given the world's heavy reliance on Russian gas and grains.

The growing geopolitical turmoil undoubtedly accelerates the reshoring and deglobalisation progress, which could distort global production and trade patterns, making every country worse off. Still, the deglobalisation movements provide supply chain diversification in the future, mitigating the potential concentration risk. After all, the stock market downfall that emerged from the geopolitical hostilities provides good opportunities to accumulate undervalued stocks with solid fundamentals and growth potential in the long run.

Q4. As a result of US aggressive rate hikes, is recession on the way?

As the global stock markets just finished celebrating the super rally, brought about by the unlimited quantitative easing with a near-zero interest rate due to Covid-19, investors are now being asked to pay the price. In the wake of the fastest economic recovery in history during the last two years, the economy spending had turned into a position of enormous surplus demand. Due in part to the afore- mentioned economic circumstances and in part to the supply chain distortions as well as the Russia- Ukraine war, inflation reached its frothiest peaks in a generation. The uncontrollable inflation rate prompted central banks worldwide to implement their most aggressive monetary tightening in decades. Almost all markets responded with a great deal of resentment. On the other side of the world, the Chinese economy encountered one of the most significant structural and cyclical hindrance due to the nation's zero-tolerance stance on Covid-19.

In 2022, we went through a unique year where positive economic news was seen unfavourably by the stock market because it was assumed that inflation would be high for a longer period and that central banks would need to hike interest rates by a greater magnitude. This relationship has again reverted to where good economic data is welcomed by the stock market and poor economic data is not. Now, it seems reasonable to think that the stock market has now pivoted from fretting exclusively about inflation to incorporating growth concerns:

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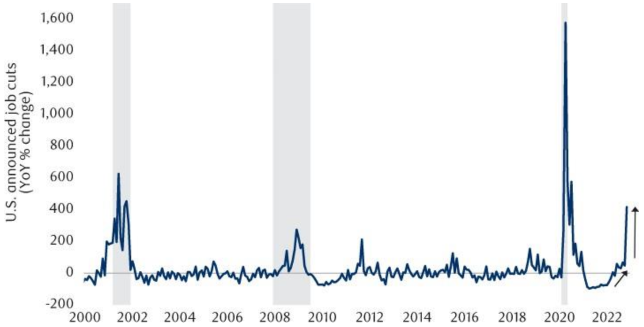
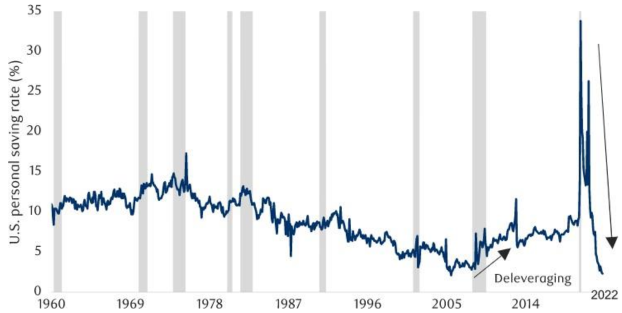
1. Led by tech sector, layoffs are accelerating (see ***Figure 8***)
2. Personal saving rate has dipped to the lowest level in decades (see ***Figure 9***)
3. Contraction in manufacturing activities has begun (see ***Figure 10***)
4. US is likely to enter into recession (see ***Figure 11***)

Figure 8: US Job Cut are Picking Up



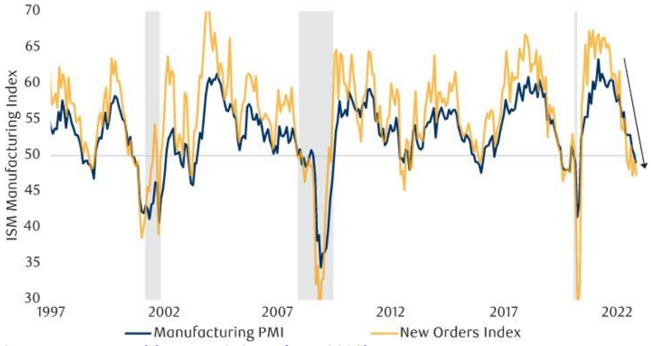
Source: Extracted from RBC GAM (Nov 22)

Figure 9: US Personal saving rate approaches record low



Source: Extracted from RBC GAM (Nov 22)

Figure 10: Manufacturing activities are in Contraction



Source: Extracted from RBC GAM (Nov 2022)

Figure 11: RBC GAM's Recession Checklist

Signal	Indicating recession?
2yr-10yr curve inverts	Yes
3m-10yr curve inverts	Yes
Fed short-term curve inverts	Yes
Oil shock	Yes
Financial conditions tighten	Yes
Jobless claims jump	Yes
Monetary tightening cycle	Likely
Google "recession" news trend	Likely
RBC GAM recession model	Maybe
Duncan Leading Indicator falls	Maybe
Unemployment increase	No, but may be turning

Source: RBC GAM (Nov 2022)

It seems convincing that "soft landing" is most likely not the base case for 2023. However, we think that the chances of a deep recession such as the like of subprime mortgage crisis is unlikely for the following reasons: 1) the US financial system is currently in far better health than it was during previous economic downturns; 2) balance sheets for businesses and consumers remain strong, which is preventing further economic downturn; 3) majority of the corporate debts secured during the Covid-19 were at a very low fixed rate; 4) American consumers are flushed with more than USD1tn of stimulus- derived savings, as well as their lowest household debt relative to gross domestic product in two decades; and 5) while prices for goods and services will ultimately start to decline, salaries are not expected to follow suit, giving consumers additional purchasing power.

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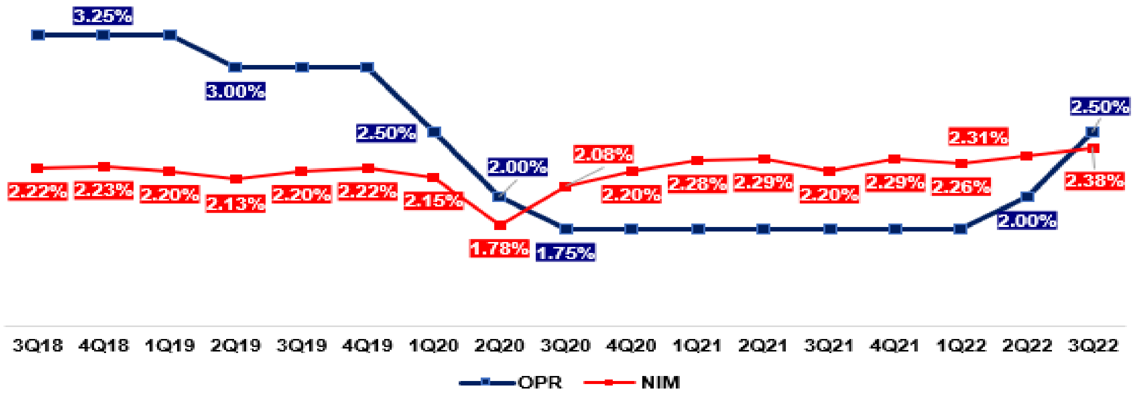
Q5. How much more will Bank Negara increase the Overnight Policy Rates in 2023 and how will this impact the banking sector?

To recap, Bank Negara of Malaysia (BNM) raised the overnight policy rate (OPR) by 25bps each in Jul, Sept and Nov 2022 to 2.75% in order to manage inflationary pressures and seek protection for the value of the Ringgit. This was mainly driven by continued aggressive hike in the US interest rates and expectations of a higher terminal rate in the US, which have contributed to a persistently strong USD. At this juncture, the median estimate for the Fed Funds Rate by the end of 2023 rose to 5.1%. This suggests about 75bps worth of rate rises still to come. Nevertheless, the recent strengthening of the Ringgit may ease some pressure for BNM to remain as aggressive, we think persistent inflationary pressure and normalised economic performance may take precedence. Overall, we expect the BNM to implement another 1-2 OPR hikes with 25bps each in 2023, bringing the OPR back to pre-pandemic level of 3.00-3.25% and to remain at this level until end-2023. We view that this reflects the shift in monetary policy stance from "accommodative" to "neutral" rather than "restrictive" as BNM seeks to strike a balance between addressing inflation and supporting growth.

Rate hikes generally have a positive short-term impact on banks, as their floating-rate loans are larger than fixed deposits. It usually takes on average about 3-6 months for funding costs to normalise in the event of interest rate adjustment. Hence, banks' net interest margins (NIMs) expanded by up to 12bps between 1Q22 and 3Q22, to an average of 2.38% (see ***Figure 12***). In 2023, the estimated impact to banks' NIMs will be 1-4bps improvement for every 25bps increase in OPR, which translates to roughly a 2-3% enhancement in earnings. However, the positive impact from OPR hikes could be partly diluted by higher-than-expected cost of funds from a pick-up in the deposit competition.

Figure 12: Historical Quarterly OPR vs. NIM



Source: BNM & Banks

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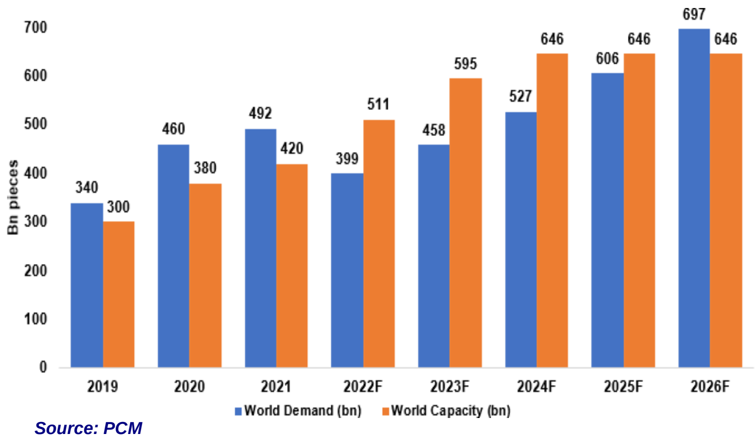
Q6. Will gloves stocks stage a comeback having charted sharp price decline since 2021? Is it the time to invest in gloves stocks now?

Figure 13: World Glove Demand and Capacity



Source: PCM

The top 4 glove makers (Hartalega, Supermax, Kossan and Top Glove) have always been the market darlings for the last decade as their share prices surged approx. 1,638% due to the rising awareness of healthcare-related infections and Covid-19 pandemic in 2020. As such, global gloves demand spiked from 350bn in 2019 to c.500b pcs (see ***Figure 13***). The surge in demand during the pandemic had caused an undersupply of gloves, resulting in a multi-fold increase in average selling prices (ASPs). That was a wonderful period for shareholders who saw their returns multiplied within a short period of time. It, however, did not last long. The abnormally high profitability encouraged existing players to expand their capacities and because of the relatively low barrier to entry, new entrants also jumped into the bandwagon. As a result of the rapid capacity increase, there was an imbalance in the supply-demand. With the discovery of vaccine for Covid-19 and mass vaccination globally, the demand for gloves began to subdue and thus the ASPs fell below pre-pandemic levels. Considering that glove makers are now trading well below their average share prices in 2019, is this a good time to accumulate their shares?

We are of the view that the worst is yet to come for the industry's supply-demand as the blended ASP is currently at c. USD20–22 per/1k pcs, similar to pre-pandemic levels. In 3Q22, the q-o-q decline in ASP eased to a low single digit, suggesting the ASP may have bottomed. Despite the ongoing glove price war led by Chinese producers, we expect ASP moderation to slow or stabilise q-o-q. Nonetheless, China players, Intco Medical and Bluesail Group reported EBIT losses in 3Q22, indicating that the current ASP levels are unsustainable. With the upliftment of China's "zero-Covid" policy and reopening the border, the sudden spike in Covid-19 cases in 4Q22 may hasten replenishment. According to Bloomberg, 37m of people in China caught Covid-19 in a single day last week. However, based on the latest results takeaways, glove makers indicated the absence of restocking. As such, we maintain our FY22 glove demand assumption of 399b pcs (-19% y-o-y).

Overall, we believe the outlook for the glove sector supply is bleak. Since the local rubber gloves industry is now running at low utilisation rate between 30 to 40%, the top 4 producers had delayed theirnew production capacity expansion until 2023. At the same time, the Chinese producers are also facinga similar trend with less than 50% utilisation. Consequently, we anticipate that glove makers will remain cautious before commissioning any new production lines. Hence, we are anticipating a flat growth rate in global supply for 2023. On a positive note, as at end 3QCY22, all glove companies Supermax, Hartalega, Kossan and Top Glove are backed by strong net cash positions of RM2.9b, RM2.4b, RM1.3b and RM0.4b, respectively. This would support cashflow requirements in the longer term, while we believe that the efforts by glove companies to slow down their CAPEX plans could also help to preserve capitals.

Q7. After 2 years of strong gains, investors have been fleeing high-growth Malaysian tech stocks in 2022 as demand for pandemic-induced consumer electronics devices faded after pandemic boost and amid recession fears. Does this imply the end of super cycle for the technology sector?

Figure 14: FBM KLTEC Index

Year 2022 had been a turbulent year for theMalaysian technology (tech) sector with the FBM KLTEC Index down 34.3% (see ***Figure 14***) on concerns of hard landing on the semiconductor industry. Nonetheless, most local tech companies continue to expand their capacities though at a moderated rate. We understand that more floor space is needed in preparation of potential onboarding of new projects. This is because the on-goinggeopolitical tension between the US and China has driven upstream multinational companies (MNCs) from both countries to resort to new suppliers or diversify their manufacturing facilities to other regions especially ASEAN including Malaysia with the intentions of supply chain diversification for cost-saving purposes as well as part of their risk management strategy.

While we acknowledge the current semiconductor down-cycle may continue, we note that most tech companies have built up strong cash piles over the years, with most of them being in net cash position (see ***Figure 15***). As such, we believe the current expansions would not pose significant risk to the cash flow liquidity of the local tech companies.

Figure 15: Net debt/ (cash) position of tech companies

Company Name	Net Debt/ (Cash)	Net Gearing
Semiconductor/ Semincon services	RM (m)	(%)
Inari	(1,956.0)	Net Cash
Globetronics	(195.1)	Net Cash
MPI	(745.2)	Net Cash
Unisem	(61.6)	Net Cash
Vitrox	(220.8)	Net Cash
Pentamaster	(476.1)	Net Cash
Greatech	(300.7)	Net Cash
MI Tech	(299.3)	Net Cash
Aemulus	(19.2)	Net Cash
KESM	(162.0)	Net Cash
SFP	13.9	18.6
MMSV	(44.5)	Net Cash
Dufu	(67.0)	Net Cash
JF Tech	(78.9)	Net Cash
EMS		
SKP	(65.1)	Net Cash
VSI	325.2	14.8
PIE	(8.2)	Net Cash
JHM	34.1	13.7
Aurelius	38.0	10.6
Uchi Tech	(181.8)	Net Cash

Source: Companies

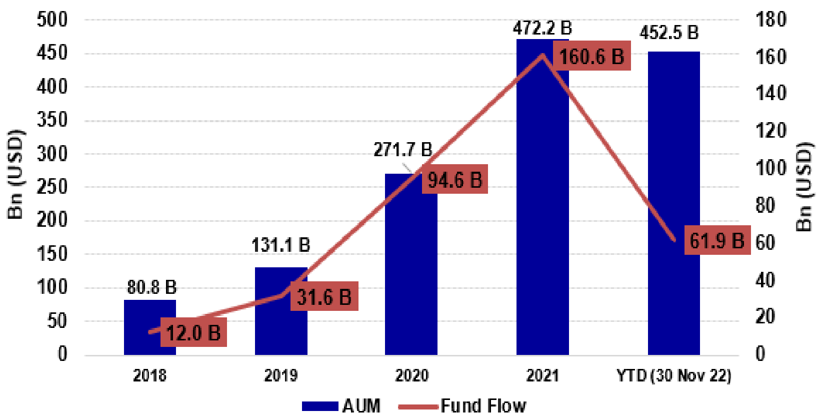
We believe that long-term growth prospects of most companies in Malaysia, which are predominantly back-end, equipment making and electronicmanufacturing services (EMS) companies, are intact. This is driven by the expansion of supply chains in ASEAN as they are repositioned away from North Asia (for instance Foxconn, Tesla, Infineon) and the expansion of foundries in ASEAN (for example Intel, GlobalFoundries). In fact, MNCs such as LAM Research, Infineon, Intel, ams OSRAM and Micron are investing more capital to expand their capacity in Malaysia to support these MNCs.

With all kinds of things are becoming digital and the trend toward digital transformation, that ischanging the very nature of business models has gained momentum during the pandemic. Hence, we expect capex in response to changes in the industry structure backed by digitalisation and carbon neutrality to continue to drive growth in the future. The increasing adoption of semiconductor components in the automotive industry as well as the fast-growing medical device segment could proveto be the next growth drivers in coming years. In terms of macro trend, we continue see growth potential in global migration towards 5G, increasing popularity of EV/autonomous driving, adoption of automation in progression towards Industry 4.0, high-performance computing as well as IoT and AI.

Q8. ***With ESG investing has become an increasingly important part of the investment process, how does ESG affect investors' decisions?***

All along many investors have been taking ESG into considerations in their fundamental investment analysis by including regulatory developments, reputational risk or megatrends in their assessments. Despite merely making up nearly 4% of the global ETF assets, ESG ETFs contribute more than 10% of the USD1.2tn global ETF flows and the trend is expected to continue (see ***Figure 16***).

Figure 16: Annual AUM and Fund Flows of Global ESG ETFs



Source: Bloomberg

Investors today are enthusiastic about using their money to create a difference. An increasing number of investors believe that companies that perform well in ESG are less risky, better positioned for the long-term and more resilient to uncertainties. Currently, several pressures, especially regulatory ones, create a market condition necessary for rapid sectoral change. A good example would be the energy sector, where stakeholder pressures induced movements on carbon reduction and the restructuring of assets toward lower-carbon alternatives. As ESG investors prioritise moral value over economic value, they believe that harming the environment in order to create wealth is unethical and would view this circumstance as unfavourable. ESG analysis can be a useful complement to traditional investors' fundamental financial analysis.

ESG investing would also affect the investment horizon of a company. As ESG factors are typically long-term drivers of return, they generally do not fit well with short-termism, which emphasises excessively on corporate leaders, maximising shareholders' return and financial results. In fact, ESG is rather on a long-term value creation. As such, an investor with ESG principles in mind would be more concerned in good corporate governance, which would only be reflective over a long period rather than in the next quarter. This effectively changes the time periodicity expectations of an investment for an ESG investor. Overall, companies that prioritise ESG issues and realign themselves to the stakeholder capitalism agenda may have a competitive advantage over those that just strive to maintain business as usual.