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A quiet opening, but steady ascent

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While we expect relatively subdued corporate earnings growth amid tight global and domestic fiscal spending, there continues to be ample domestic liquidity that should keep the FBM KLCI slightly ahead of its historical average valuation. Just as in 2013, the FBM KLCI's gradual ascent should be characterised by relatively low trading volatility, barring occasional spurts amid hopes of a faster global economic recovery, and sputters tied to the expected tapering of the US Federal Reserve's quantitative easing programme.

We expect the market to reach the 1,900 level at year-end, pegging it at 15 times prospective price-earnings ratio (PER), just above the historical average PER of 14.6 times (note that our target FBM KLCI excludes Tenaga Nasional Bhd, which is pending coverage). The valuation premium reflects expectations of better economic growth beyond 2014 and the absence of political uncertainty. Overall, we expect the FBM KLCI to mostly trade within the 1,740 to 1,960 range based on -0.5 standard deviation (SD) to +0.5 SD to historical mean PER valuations.

Slowdown in domestic consumption

While Malaysia's gross domestic product (GDP) growth is expected to improve by between 5% and 5.5% next year (2013F: between 4.5% and 5%), led by an improvement in the external sector, domestic private consumption and investment growth are likely to moderate.

The economic highlights for 2014 include flat government fiscal spending, a reduction in subsidies, a modest hike in interest rates, a final nationwide implementation phase of minimum wages (extended to small and medium enterprises) and the full impact of Bank Negara Malaysia's measures to cool personal and property borrowings. We predict a more subdued domestic consumption trend as a result of a lower economic multiplier from public spending and the inflationary effects of subsidy reductions.

Inflation will remain elevated through to 2015 with further subsidy rationalisation and with the implementation of the Goods and Services Tax (GST) in April that year. Meanwhile, our economics team expects a modest 25 basis point hike in the overnight policy rate to 3.25%.

While corporate earnings are poised to stage a recovery from 2013's paltry 2% growth, earnings growth may still fall short of our expectations. In fact, the recent quarterly financial results prompted cuts in our earnings forecasts. Currently, we expect corporate earnings to grow 11.3% and 11% year on year in 2014 and 2015 respectively.

Strategy: A quiet opening game, followed by multiple strategies during the middle game

While we advocate being fairly defensive at the start of the year, we expect market conditions to still favour various thematic themes as the year unfolds. This will aid in stock picking, which has become more crucial since the second half of 2013 as most large caps now trade within their respective fair value ranges. Effective investment themes include: (a) capital management plays via business trusts and emerging real estate investment trust beneficiaries; (b) varying opportunities in the oil and gas sector; (c) mega infrastructure projects that benefit the construction sector; (d) power sector — formulation of incentive-based



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regulation; (e) Sarawak Corridor of Renewable Energy beneficiaries; (f) mergers and acquisitions (M&A) and corporate restructuring; and (g) beneficiaries of the creation of an environmental, social and governance fund.

Promoting the pawn: Focus on small/mid caps

With rising support from local institutional funds and retailers, some small/mid caps are still expected to deliver princely returns. Retail investors, in particular, have heavily sold down Malaysian equities this year (RM6.3 billion up to November) and will seek exposure in the cheaper small/mid caps. Despite the FBM Small Cap Index's 36% year-to-date rise, the index still trades at around six times PER below large caps' PERs.

Besides this, we expect good investor traction for selected laggards and M&A plays

Among the notable large cap laggards this year are most plantation companies, Telekom Malaysia Bhd and Top Glove Corp Bhd. While these stocks are only rated "hold", they could provide outperformance during selected periods.

We are "overweight" on the construction, gaming, plantation and telecommunications sectors and the oil and gas drilling and production segment. The oil and gas sector still promises a myriad of interesting thematic investment opportunities. Rising crude palm oil prices should allow the plantations sector to at least relatively outperform the market, if not, deliver respectable capital appreciation.

Continue to "underweight" the automobile sector as consumption of big-ticket items may fall as domestic consumption sputters. Despite the many measures imposed by the government, we are "market weight" on the property sector as 2H2013's underperformance suggests limited downside.

Our top picks are large caps DiGi.Com Bhd, Gamuda Bhd, Genting Bhd, Malayan Banking Bhd and SapuraKencana Petroleum Bhd. Situational plays include IOI Corp Bhd, ahead of the listing of its property division, and IJM Corp Bhd while Axiata Group Bhd is another notable large cap "buy".

Our favourite mid and small caps include oil and gas companies Barakah Offshore Petroleum Bhd, Perisai Petroleum Teknologi Bhd and Uzma Bhd and also MPH Capital Bhd.

Not rated stocks that should continue to gain investor traction include large caps Tenaga Nasional and deep value stock MMC Corp Bhd and small/mid caps Hong Leong Industries Bhd, Yinson Holdings Bhd and RGB International Bhd.