Date: 24 July 2018

FENCING OFF MARKET FATIGUE

Focus Malaysia (21 July 2018)

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- **THE US** AS THE PROTAGONIST WITH A TRADE PROTECTIONISM & INTEREST RATE HIKE
- **EXTERNAL** SHOCKS TO PERVADE EMERGING MARKETS IN SHORT-TO MEDIUM-TERM

The adage "when America sneezes, the world catches the cold" has its origin in the aftermath of the Oct 29, 1929 Wall Street crash (a.k.a Black Tuesday) which has been deemed as the most devastating stock market crash in US history. A period of economic gloom permeated across the US and elsewhere across the globe. The ripple effect which brought about an era of Great Depression did eventually arrive at the then Malayan shores. Predictably, the tumbling passenger car sales in the US had dire consequences on the demand for rubber which was then Malaya's chief export. The US would hold on to that 'metaphoric' honour well into the new millennium until recent times when China's rapid ascent as the world's second biggest economy threatened to dethrone it as an economic powerhouse.

With both economic superpowers now pitted against each other in a tit-for-tat trade spat, the only logical diagnosis the world needs would probably be 'a double dose of flu vaccine' as an insulation against 'the contagion effect of the flu bugs.' As no economist as yet can foretell how devastating the impact from the ensuing battle royale will be to the global economy, it makes sense to view the duel from three varying degrees, namely, 'big battle,' 'medium battle' and 'small battle.' Notwithstanding US$100 bil (RM404.7 bil) of imports are at stake on both sides of the equation (the tariffs imposition came into effect 011 July 9), any tariff imposed by Washington on Chinese goods will be met with countermeasures of equal weight by Beijing.

An all-out trade war is expected to shave 0.25% off the gross domestic product (GDP) of both economies this year. However, things could get much worse next year with both countries seeing a reduction in growth of about 0.5% or more, according to DBS's chief economist Taimur Baig, who added that "considering China grows at 6%-7% and the US at 2%-3%, we believe the damage would be greater to the US than China." While this tends to illustrate a worst-case scenario, many market observers prefer to stick to the "medium battle" on the grounds that the trade dispute would eventually be a case of "words speak louder than actions" with both parties ultimately coming to terms with the severity of their punitive actions - a lose-lose battle not only for themselves but bringing global trade to its knees. For the proponents of 'small battle,' their view is that current concerns stem merely from policy wrong-footing, hence neither side is likely to wage a full-blown trade war which would impede precious growth momentum and aggregate demand.

EMERGING MARKETS IN DOLDRUMS

Many economists from near and far have acknowledged that Asia would bear the brunt of the US-China trade dispute which is touted as the biggest trade war in history given its economy is deeply embedded in China's supply chains. Taiwan is exposed to the highest risk, potentially shedding 2% of its GDP due to its reliance US demand through value-added contributions to China's exports, followed by Malaysia, South Korea and Singapore. One thing is for sure, however; that the US-China trade war is unlikely to affect the Malaysian economy in the scale of the Great Depression. Nevertheless, prolonged repercussions are inevitable should the US move beyond the current tariff exercise to another two rounds of protectionist measures worth US$200 bil each and China reciprocates. Ironically, the US is also a protagonist for unsettling economic stability in emerging markets (EM) on two fronts - its potentially third and fourth interest rate hikes this year on the back of a tightening labour market and rising inflation are poised to be another sentiment dampener for Malaysia and its regional peers.

Malaysia's palm oil could substitute US soybean in China

Such a possibility has heightened the likelihood of other influential central banks - notably, the European Central Bank and Bank of England - following suit, hence triggering an outflow of foreign funds in many EM economies. Doubtlessly, Bursa Malaysia posted a year-to-date (YTD) foreign outflow of RM8.06 bil for the week ended July 13 which offset 78% of the total inflow of RM10.33 bil last year, according to the MIDF Research weekly fund flow report.

Despite the unpleasant revelation, Malaysia still has the second lowest outflow among the four ASEAN markets monitored after the Philippines on a YTD basis (the other two being Thailand and Indonesia). This flight to safety measure could eventually boost the greenback at the expense of EM currencies (the ringgit could drift downward to RM4.20 per US dollar by end-2018 premised on the impending rate hikes in the US and severity of the trade war).

NOT EVERYTHING IS LOST

While there has been mixed reaction to the direction of crude oil prices stemming from concerns of China's retaliatory move to slap tariffs on imports of US crude oil and oil products, Malaysia's economic reform agenda will not be derailed as long as the pricing of Brent crude maintains its current range of US$75-US$77 per barrel. After all, this will provide a windfall to its Budget 2018's oil-related revenue forecast of RM37.7 bil which was based on a price assumption of US$52. Analysts have forecast that every US$10 rise in the annual average crude oil price could boost Malaysia's oil-related revenue by RM7 bil to RM8 bil.

This should bring some relief to the construction and infrastructure sectors which are languishing following the shelving, scrapping or renegotiating of exorbitantly-priced mega projects such as the Kuala Lumpur Singapore High-Speed Rail, the Mass Rapid Transit Line 3 (Circle Line) and the East Coast Railway Link. Likewise, the lacklustre state of Malaysia's crude palm oil (CPO) could see better days ahead as China's

25% retaliatory import tariffs on US soybeans is an opportunity for the palm oil industry to raise its exports to the world's most populous country. This is simply so as lower soybean imports from the US would create a shortfall of edible oil imports into China. For those dabbling in the equity market, the current disconnect between the fundamentals of stocks and their true value would present a good opportunity to amass quality counters at mouth-watering prices. However, bear in mind that the current soft price trend in Bursa Malaysia is likely to persist indefinitely - probably over the next three to six months - amid a slew of policy changes and reforms that may have a direct impact on the capital markets. To ensure that the reform initiatives spark long-term economic vibrancy, it is essential that they are farsighted, wholesome and followed through by the respective authorities or market regulators tasked with overseeing them.

Pedestrians and shoppers walk past a Gap Inc retail store in Shanghai as a trade war looms

Given that the implementation of the zero-rated goods and services tax (GST) implies a revenue shortfall of RM25.6 bil on a simple pro-rated basis (from a projected revenue of RM43.8 bil under Budget 2018), the deficit has to be properly patched up by the anticipated rise in oil revenue and a cut in government expenditure (by plugging various wastages and leakages), among others. Austerity measures to curb excessive remuneration of top executives of government-linked companies (GLCs) and government- linked investment companies (GLICs) or to purge heftily paid politically-linked appointees on their boards are expected to be market-positive from an investor's viewpoint on condition they are implemented wholeheartedly without fear or favour. After all, GLICs control about 40% of the entire market capitalisation of the local bourse through their stakes in various GLCs. Amid the RM1 tril national debt burden which stems from liabilities including debts incurred from the 1Malaysia Development Bhd scandal, it is worthwhile to remember that international rating agencies are keeping a close eye on the success of the government's fiscal deficit consolidation exercise.

In all likelihood, the second half of this year could see the restoration of business confidence with the tabling of Budget 2019 in November and the mid-term review of the 11th Malaysian Plan which will focus on ensuring that the country is able to sustain its foreign direct investments while investors continue to retain Malaysia as their favourite investment destination.

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Article Source:

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- **External** shocks to pervade emerging markets in short- to medium-term

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