

ALL THAT DOOM & GLOOM

4 Journal (2Q 2018, July)

By Lee Sook Yee

Fiscal consolidation measures, institutional reform and strong consumer sentiment likely to drive market rebound in Q4 2018 despite short-term capital outflow and policy uncertainties.

The aftermath of the 14th general election (GE14) has not been kind to the local equity market or the broader Malaysian capital markets. The consensus among market observers is that Bursa Malaysia is still reeling from a sharp correction period stemming from foreign selling, policy uncertainties and the review of mega projects. Recall that investors were initially shocked by the revelation of gargantuan government debts (in excess of RM1 trillion) as well as the zero-rating of goods and services tax (GST), which would remove a major source of the government's revenue.



This concern was later alleviated when the Finance Ministry announced that GST would be replaced by sales and services tax (SST) which, when coupled with cost savings from plugging wastage (stemming from abuse of public funds) as well as leakage (from graft), would eventually maintain the fiscal deficit target at 2.8%. Moreover, the rise in global crude oil prices (currently US\$70/barrel on average, up from the US\$52/barrel figure projected under Budget 2018) would probably entail an additional RM5.4 bil in oil-related revenue (every US\$1/barrel increase equals a gain of about RM300 mil). In all frankness, attributing the current soft state of the local bourse solely to the unprecedented GE14 outcome in which the 'untested' Pakatan Harapan coalition emerged triumphant is very much an overstatement.

This is a given as market movement is influenced by a culmination of other internal factors – not to mention having to absorb various external shocks – along the way. Not helping was the poor showing of first quarter (1Q 2018) corporate reporting results. The reports, which were made available end-May, revealed that 35.7% of corporates missed their earnings expectations, which was the highest such figure reported in six quarters. Another 45% of corporates suffered downgrades in estimates following earnings disappointments. A few external developments further exacerbated the already bearish sentiment in Bursa Malaysia. Fresh from the second interest rate hike, the US Federal Reserve has projected two more hikes (previously one hike) in the pipeline for the remainder of 2018.

Elsewhere, lingering uncertainty over the US-China trade dispute and rising eurozone instability is likely to pressure the performance of emerging markets in the near term. The convergence of all these negatives

dragged the FBM KLCI down to 1,740.62 points by end- May 2018 (with a year-to-date return of -3.13%). What is intriguing, however, is that Malaysia is not alone enduring in market corrections. The recent strengthening of the greenback has put emerging markets in a tight spot as they are unable to hold their currency valuations in global trade. Likewise, a higher US dollar-induced domestic sell-off in bond markets by foreign investors has put most emerging markets under pressure. This explains why, notwithstanding the substantial outflow of foreign funds in recent times, the year-to-date outflow (as of 15 June) from Malaysia of RM4.23 bil net (US\$1.06 bil) is still deemed the lowest among its ASEAN peers, namely Thailand, the Philippines and Indonesia (Source: MIDF Research's Weekly Fund Flow report). In a similar light, volatility is also evident in the Malaysian debt securities market whereby recent outflows have slashed share of foreign holdings to the lowest in eight years (since June 2010) to 14.2% (April: 15.2%), according to Kenanga Research.

HOLISTIC DEVELOPMENT

Very broadly, the domestic market is experiencing what can be regarded as the “short-term pain for long-term gain” syndrome. The revelation of negatives left from the legacies of the previous government could be likened to the “kitchen sinking” exercises typically adopted by corporates.

In practice, “kitchen sinking” refers to the provision of major negatives and impairments in a corporate's earnings which usually lead to losses. Corporate which goes through a massive “kitchen sinking” exercise could start the next chapter on a better and healthier position. We are hopeful that after the recent outpour of negative news, and having undertaken various institutional reforms, the government will look into additional measures to stimulate the domestic economy. We believe the government will explore new infrastructure projects by emphasising cost efficiency, which may include a scaled-down version of the previously proposed Mass Rapid Transit Line 3 (MRT3) or the Kuala Lumpur-Singapore High Speed Rail (HSR). Elsewhere, the government is also likely to focus on smaller development projects such as schools, hospitals, roads and drainage in line with the promotion of social-economic benefits to the community.

Meanwhile, private consumption is expected to remain robust with the removal of GST, which revives consumer buying sentiment. Following the implementation of zero-rated GST effective June 1 for a three-month period prior to SST implementation, automotive companies are already enjoying strong bookings

BASIS OF THE RM1 TRILLION NATIONAL DEBT

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Source: Ministry of Finance

and sales with many models already reported to be out of stock. So long as the government continues to focus on measures towards fiscal consolidation, the risk of Malaysia's sovereign rating being downgraded is low, given international rating agencies are likely to

consider these consolidation efforts. Likewise, rating agencies are very unlikely to downgrade Malaysia's sovereign rating until a revised Budget for 2019 is unveiled by the new government on 2 November.

Moreover, the government debts are largely denominated in the ringgit, with only 3% denominated in foreign currency. Although foreign holding of Malaysian government securities amounted to 41.9% as of end-May, there is sufficient domestic liquidity to absorb any outflow of funds given Malaysia's fairly well developed asset management and insurance industries. In all fairness, the current state of both the equity and bond markets cannot be an accurate barometer of how the broader Malaysian economy will perform over the medium to longer term.

In the light of a slew of revelations made in the name of competency, accountability and transparency (CAT) – with the ultimate motive of cleaning up a humongous sum of financial burdens inherited from the previous government – the country can be perceived to be in good hands given its finances will not be allowed to bleed any further. One effective measure to boost investor confidence in the Malaysian economy has been the shake-ups involving politically-linked head honchos ranging from key public service office bearers to government-linked companies (GLCs).

The services of controversial attorney-general (AG) Tan Sri Mohamed Apandi Ali were terminated following the appointment of Tommy Thomas to replace him. Treasury secretary-general Tan Sri Dr Mohd Irwan Serigar Abdullah was transferred out of his position and was placed under the Public Service Department till 13 June when his shortened contract expired.

Bank Negara Malaysia governor Tan Sri Muhammad Ibrahim has tendered his resignation after just two years of a five-year term, amid criticism that the Barisan Nasional-led government had used funds from the central bank's recent land deal to pay for debts associated with 1Malaysia Development Bhd (1MDB). Following in Muhammad's footsteps is Telekom Malaysia Bhd's managing director and group CEO Datuk Seri Mohammed Shazalli Ramly.

Also intriguing is Dr Mahathir's revival of his Look East Policy, which can perhaps be deemed as striking an equilibrium in Malaysia's over-dependency on China's economic prowess (as can be witnessed in mega-infrastructure projects) while serving as an impetus to woo Japanese investments into Malaysia. There has also been a positive response to Prime Minister Tun Dr Mahathir Mohamad's request for a yen loan.

INVESTMENT STRATEGIES

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On the same note, we are not keen to change our strategies each year, given such a move is simply not logical; as unexpected incidents or geopolitical events happen pretty frequently, we have to rely on a consistency in our evaluation processes to help us ride those market highs and to weather the lows. For

Measures to Increase Revenue/ Reduce Expenditure/Lower Public Debt

- Rise in global crude oil prices (currently US\$70/barrel on average, up from US\$52/barrel projected under Budget 2018). This would entail an estimated RM5.4 bil increase in oil-related revenue (every US\$1/barrel increase equals a gain of about RM300 mil).
- RM5 bil from higher dividend payouts by GLCs, notably Khazanah Nasional Bhd, Bank Negara Malaysia (BNM) and Petronas (which is expected to contribute RM3–RM4 bil, or an estimated increase from RM19 bil in Budget 2018 to about RM22–RM23 bil this year).
- RM10 bil from an expenditure review which encompasses downsizing, delaying and abolition of overlapping and non-urgent programmes or projects.
- Defer or terminate the RM55 bil East Coast Rail Link (ECRL), whose contractor is state-owned China Communication Construction Co Ltd, while the loan is from the Export and Import Bank of China.
- Scrapping or shelving both the RM110 bil (with interest added) Kuala Lumpur-Singapore High Speed Rail (HSR) and the RM40–RM45 bil Klang Valley Mass Rapid Transit Line 3 (MRT 3 or Circle Line) despite the government having to shoulder a RM500 mil cancellation penalty for the former.
- Redefining the meaning of foreign direct investments (FDIs) and technology transfers from abroad.

Source: Media reports, MoF statements

investment themes, we believe the GLC reform theme will continue with the new government focusing on institutional reform by shaping better corporate governance.

Banks are likely to benefit from improved optimism on the economic outlook spurring higher consumer spending and private investment. Likewise, the consumer sector is expected to get a lift from the abolishment of GST. The oil & gas sector will benefit from firmer oil prices and the gradual recovery of capex spending by Petronas. We also look forward to stronger corporate earnings growth for the next one to two years, to be underpinned by solid gross domestic product (GDP) and private consumption growth.

Finally, the roll-out of comprehensive fiscal plan to address the country's fiscal consolidation could be a re-rating catalyst for the market and currency in the medium to long-term. These are the key investment themes that we are watching and intend to leverage on in the future. Our projection is that the benchmark FBM KLCI will stay volatile in the near term before staging a meaningful rebound towards the final quarter of 2018. In fact, investors would have a clearer picture of new government policies after the 100- day 'in-office' period and upon the tabling of the 2019 Budget on 2 November.

ENDS

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Article Source:

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ECONOMICS

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