PERSPECTIVE

Malaysia's Crisis of Confidence

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One might say Malaysia has been facing a crisis of confidence this year as its currency (the ringgit) weakened to levels not seen since the Asian financial crisis in the late ’90s and its stock market declined amid a domestic political scandal as well as external shocks. We think Malaysia’s currency and equity market both may have become oversold and could be presenting attractive bargains for long-term investors. But the key question is: Can Malaysia turn things around? Its recently unveiled budget may offer some clues.

Prime Minister of Malaysia Dato’ Sri Mohd Najib bin Tun Haji Abdul Razak—who is also the country’s finance minister—recently unveiled the 2016 budget. Malaysia has been running a fiscal deficit, and the recent drop in crude oil prices hasn’t done the oil-exporting country any favors. The budget hinted of financial conservativeness, but at the same time, aims to selectively support economic growth during the current challenging times.

The government anticipates slowing growth in 2016, with gross domestic product (GDP) growth of 4%–5% year-over-year.[1] Operating expenditures are being reined in, while the implementation of the goods and services tax (GST)—a value-added tax levied on most transactions in the production process—should help Malaysia shore up its finances in the face of low crude oil prices. Overall, the fiscal deficit is expected to be kept in check at 3.1% of GDP for 2016.[2] I think this fiscal prudence will be important if Malaysia is to avoid a downgrade by debt rating agencies. Development expenditure is expected to expand slightly as outlined in the budget, and that bodes well for continued infrastructure spending, which would benefit the construction industry.

The government is also allocating further funding to the tourism sector, a logical move considering the attractiveness of the undervalued ringgit versus the US dollar. Measures were maintained to cool the property sector, which should continue to help keep prices in check and avoid a potential bubble that could spell catastrophe for the economy. No increases in taxes were announced on the brewery, tobacco and gaming sector, given that the GST was just introduced this year. On the whole, the budget looked to keep the deficit under control as Malaysia weathers the weakened economic environment.

Malaysia 2016 Budget: Five Priorities

1. Strengthening Economic Resilience
2. Increasing Productivity, Innovation, Green Technology
3. Empowering Human Capital
4. Advancing Bumiputera Agenda *(“Bumiputera” refers to the ethnic Malay and indigenous peoples.)*
5. Easing Cost of Living of the Rakyat *(“Rakyat” refers to the local population.)*

Source: 2016 Budget, Ministry of Finance Malaysia.

As a net exporter of commodities, Malaysia has been impacted by the low commodity price environment tied to weaker global growth. As the price of crude oil has collapsed since 2014, it has affected Malaysia's revenues; Malaysia has large industries involved in oil exploration and production. We would note that while some news headlines may have made the situation in Malaysia seem rather dire, its economy has continued to grow, sources of revenue have been more diversified in recent years than in the past, and its foreign reserves have remained relatively robust despite declining at various points this year.

While fiscal prudence and stronger commodity prices should help the country, one could argue that Malaysia will need to restore the confidence of its people in its government and of foreign investors in its markets to truly get back on track. According to various reports, the Malaysian government had reportedly directed a state-owned firm to invest more than US$4 billion in some of the country's depressed stocks, and allegedly, some other parts of independent state firms with overseas operations were directed to sell their investments and reinvest the proceeds in Malaysian equities. The country's main sovereign wealth fund also agreed to make such investments to rescue the stock exchange. Although this type of market intervention is not new nor is it unique to Malaysia, government intervention in the financial markets tends to heighten the uncertainty surrounding market behavior and can give foreign investors pause.

Corruption has also been a problem in Malaysia amid a scandal involving 1Malaysia Development Bhd (1MDB), which was established by Malaysia's prime minister to support long-term economic development in the country. Unfortunately, 1MDB has been subject to an investigation for misappropriation of some US$700 million of the funds. It has denied wrongdoing, and Najib Razak has said he is committed to full transparency in those dealings, but certainly, this type of news—which made international headlines—is quite detrimental. The silver lining in this case highlights the level of press freedom in the country, given that the attempts by the government to suspend certain newspapers and news websites were eventually revoked by Malaysia's High Court.

As host of the annual summit of the Association of South East Nations (ASEAN) that concluded in November, we are hopeful more positive news will emerge from Malaysia in the months to come.

Japan to the Rescue?

Continued quantitative easing in Japan, as well as Japanese foreign direct investment, should on the whole be beneficial for ASEAN countries, which include Malaysia. Japan is exporting not just capital but also technical expertise as it sets up factories in ASEAN countries to cater to the region's large and growing population. Thailand's automotive industry is a prime example, with a positive spillover effect driving the mushrooming of supporting industries. We believe this will be a continuing long-term trend as long as the return on invested capital for Japanese companies remains more favorable than reinvesting domestically.

Another positive factor we see for Malaysia and other ASEAN economies is a general orientation toward consumers, aided by a youthful demographic and a burgeoning middle class that has growing income to spend on discretionary goods. As investors in Malaysian equities, we are selective, and we favor consumer stocks because that is where we see growth in the long term in line with these trends. We have also been favoring smaller companies that we think have potential for growth, but that have been generally overlooked by other investors.

Despite favorable long-term dynamics, short-term flows are a different matter. Speculation that the US Federal Reserve is likely to raise interest rates in December should continue to dominate global investor sentiment and add to the market uncertainty and volatility we have seen in the second half of this year. Domestic issues and general uncertainty over the timing of a US interest-rate hike may be challenging in the short term for Malaysia, but we focus on long-term trends that we feel will prevail.

In the longer term, one of the positive aspects that can result from scandals or upheavals like the ones Malaysia has seen is that they often force change because the use of social media and the Internet makes them more transparent to the world. As a growing nation, Malaysia still has room for improvements and its people are realizing reform is needed, and that is good news, in our view. We will be eagerly watching its progress.

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What Are the Risks?

All investments involve risks, including possible loss of principal. Foreign securities involve special risks, including currency fluctuations and economic and political uncertainties. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. Smaller-company stocks have historically had more price volatility than large-company stocks, particularly over the short term.

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1. Source: 2016 Budget, Ministry of Finance Malaysia. There is no assurance that any estimate or forecast will be realized.

2. Source: Ibid.