

## FUNDAMENTAL FLASH

# Newsflash | Malaysia State of Emergency: Market Views

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Prepared by Affin Hwang Asset Management

### State of Emergency

Reports abound that the Prime Minister Tan Sri Muhyiddin Yassin (PM) has proposed a state of emergency. The Yang di-Pertuan Agong (YDPA) and the Conference of Rulers will be meeting to discuss such a proposal following on from a royal audience last Friday with the PM. Should the YDPA decide to declare a state of emergency, the administration of the country will be managed by the executive, and Parliament could be suspended. We discuss the implications of such a move and how it could impact both the local equity and bond markets.

### More political stability?

Given the recent escalation of political instability in Malaysia, it could be argued that this move may in fact provide what is required i.e. political stability for the nation to fight the COVID-19 pandemic, and a more effective government without the unnecessary politicking.

However, many political commentators believe that the real reason for calling a state of emergency is due to the government's fear of not being able to pass the Budget 2021 when it is slated to be tabled on 6 November, which would result in the dissolution of Parliament and pave the way for snap elections.

### Flashpoints

- A state of emergency declaration may provide some form of stability in the short-term especially concerning policy implementation
- Though, if left unchecked and prolonged, it is harmful to the country's democratic process and governance
- Snap elections are unlikely to solve the impasse possibly even leading to a hung parliament
- Both equity and bond markets could see some knee-jerk selloff led by foreign outflows if this event materialises
- However, ample domestic liquidity and low interest rates should limit downside

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But as the country reels from a third wave of the COVID-19 pandemic, there is fear that this could lead to even higher cases, as seen from the Sabah state election.

Even if a snap election is called, we may end up with a hung parliament with no clear majority. In short, there doesn't seem to be a good outcome from these various scenarios.

So, would a state of emergency lead to more political stability that would provide more confidence to financial markets?

As an immediate response, we expect foreign investors to be spooked by this development thus leading to more portfolio outflows. Business and consumer sentiment should deteriorate further. However, this could change and improve if the PM can convince the public that this is an interim measure and short-lived with the aim to rein in COVID-19 and that they will continue to govern sensibly.

### **Credit Rating Impact**

International rating agencies such as Fitch and S&P have placed Malaysia on an 'A-' negative outlook in their April and June 2020 reviews respectively. However, the rating agencies have stated that downgrade pressures could arise if there is weaker commitment to fiscal consolidation that leads to faster accumulation of debt, or a deterioration in political stability and governance such that policymaking becomes materially less predictable.

S&P expects Malaysia's debt to GDP ratio to surpass 60% in 2020 and 2021 as the economy contracts in the midst of the pandemic. Moody's credit rating for Malaysia was last set at 'A3' with a stable outlook, but warned in August that the nation's debt burden is significantly higher than other countries with a similar 'A' sovereign credit rating.

Although we do not expect an immediate downgrade by rating agencies if this event materialises, we believe that downgrade risks have risen as the country's debt metrics and political stability have been deteriorating. Rating agencies would be closely watching this political development as this signals deterioration of governance and democracy. They will also be looking at Budget 2021 fiscal targets, and would want to see commitment to fiscal consolidation over the medium term, even if the federal budget is more expansionary.

On the flipside, rating agencies also recognise that even as debt level rises, our deep domestic capital markets and high savings provide a stable funding pool for government debt, which partly offset these fiscal weaknesses.

### **Bond Market Reaction**

We expect a knee-jerk selling of bonds next week if a state of emergency is declared, led by foreign portfolio outflows. Furthermore, investors are positioned cautiously ahead of the planned Budget 2021, as well as Bank Negara Malaysia's (BNM) policy meeting and the US Presidential election in early November.

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If the planned federal budget is more expansionary than what the market anticipates (fiscal deficit of 6% of GDP), this could lead to a further sell-off on the back of higher government bond supply in 2021.

On the other hand, we expect BNM to cut the overnight policy rate (OPR) by another 25bps in its November Monetary Policy Committee (MPC) meeting to keep interest rates low to support economic activities. These should keep a lid on bond corrections to within 10-20bp from current levels.

Over the medium-term, we still believe that the current low interest rate environment, ample liquidity pool and the flight to safe haven assets amidst economic uncertainties would be supportive of the domestic bond market.

### **Impact on Ringgit**

Portfolio outflows and weakened confidence would lead to a weaker Ringgit outlook, especially against regional currencies. As for the USD/MYR, we expect the Ringgit to trade between 4.20-4.30 in the near term if this event materialises.

### **Equity Perspective**

By removing one of the three overhangs in the market (i.e. political quandary, weak economy and COVID-19 health crisis), such a move could ultimately be good for the economy and equity market.

For the economy, it could provide stability in terms of policy and implementation. It should also provide some stability to the ever-changing leadership positions at government-linked companies (GLCs) that form a large part of the economy.

The alternative scenario is that we have an election during a health crisis, with the likely result of a hung parliament that does not resolve any of the issues, but instead wasting time and resources. Similarly, it could lead to the formation of yet another unstable coalition government with a slim majority that is subject to the same uncertain future. Ideally, the government could follow up with some form of stimulus plan as the goal is to revive the economy.

The economy does need a higher velocity of activity to counter the negative sentiment from this political change. As investors grapple with the new situation, markets might first have a short-term sell-off. We do note that there is ample domestic liquidity and that low interest rates tend to moderate any sell-down.

Nonetheless, there are segments we are concerned about. Companies with high foreign shareholdings might face more selling pressure. We think foreign funds might not take too kindly to the suspension of the democratic process. This was what happened during the 2014 Thai military coup which saw heavy foreign selling prior to the coup due to the political impasse, then followed by shallow but sustained selling post-coup.



Higher foreign selling naturally leads to a weaker Ringgit. Exporters should benefit. We are also cautious on GLCs; in case they are tasked to do more national duty to help alleviate the soft economy. Stocks that have performed strongly might also face higher than normal selling pressure as some segment of the investing community lock-in gains on the back of this unusual event.

Two sectors that could benefit are e-government linked players and contractors. Award of e-government contracts were held back by political instability. The government might pump prime the economy through more construction projects. We need more evidence of this before committing.

We will await further developments over the next few days to see if we need to change our portfolio strategy. Our funds are 15%-20% cashed up at this point. We are inclined to buy into a market sell down.

Meanwhile key milestones to watch for are composition of the emergency council members (to see where alliances lie), the proposed federal budget as well as the response of foreign investors and opposition parties.

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