Bank Negara Has No More Excuses to Avoid the Long-Delayed Rate Cut, Unlocking Value

By Prasenjit K. Basu, Chief Economist

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EXECUTIVE SUMMARY

With its labour force estimated to be growing 2.6% annually -- and likely augmented by more foreign workers -- Malaysia's real GDP growth rate of 4.7% in 2018 was disappointing, especially given the strong 14% export growth during the year. The failure of Bank Negara Malaysia (BNM) to cut the OPR (official policy rate) was a major factor hindering domestic demand (particularly fixed investment spending). The global semiconductor cycle began to turn down by November 2018, and Malaysia's exports have consequently contracted in 1Q 2019.

With the abolition of the GST soon after the PH government took office, CPI inflation has been consistently below 1% YoY since June 2018, and averaged -0.3% YoY in 1Q 2019. In the face of deflation, Malaysia's real interest rate of +3.5% (the highest in more than a decade) has deterred real investment spending (which grew just 1.3% YoY in 2H 2018). With the fiscal deficit contained at 3.7% of GDP in 2018, and the current account surplus at a comfortable 2.4% of GDP in 2018 -- and likely to be above 4.5% of GDP in 1Q 2019 -- we expect Bank Negara to cut the OPR by 25bp on 7th May, and to cut it further by at least another 25bp in 3Q 2019.

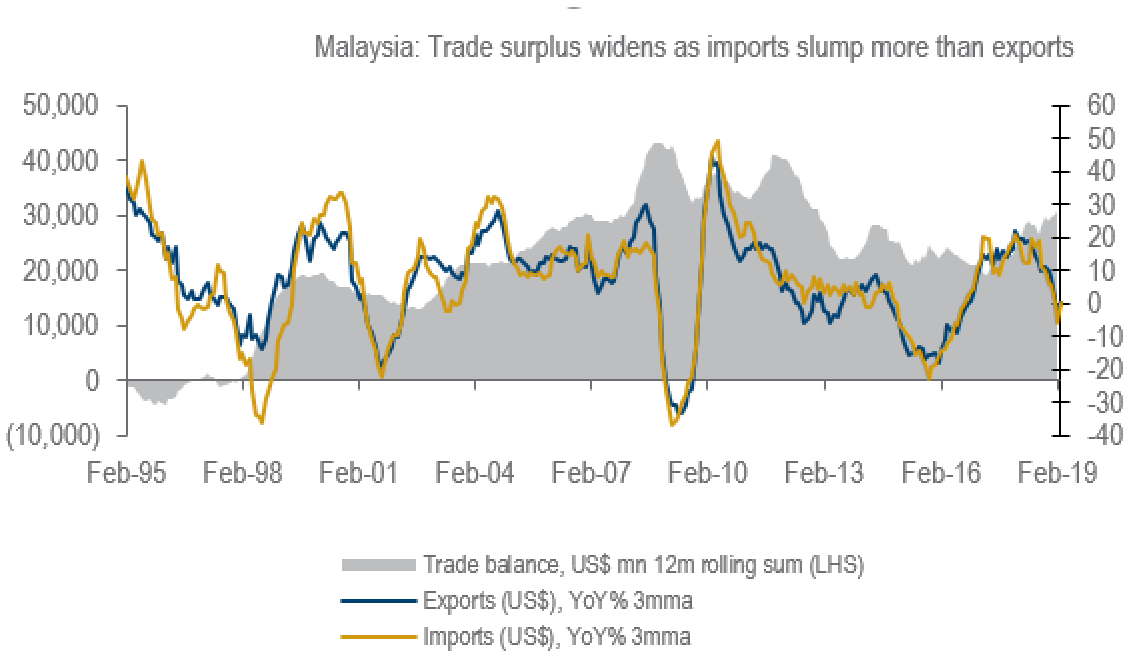
The rate cut should spur a modest investment-led recovery to over 5% real GDP growth in 2H 2019 (after a likely moderation to 4.4% YoY growth in 1Q 2019), and should also provide a fillip to the stock-market, which has seen a big sell-off in the large-caps over the past year (making the KL index one of the worst-performing stock-markets in the world in the year-to-date and over the past 12 months). Lower interest rates will particularly boost the heavily sold-down GLCs (from both the Khazanah and PNB stables, whose stock prices have fallen as the former in particular has been gradually reducing its stakes, for instance in Tenaga last month). In light of the rate cuts to come, we are Bullish Malaysia, and would in particular recommend the large-cap GLCs, led by Maybank (with an attractive dividend yield of 6.2%) and TNB (with a dividend yield of 4.3%). The latter does face some headwinds from regulatory uncertainty (as its near-monopoly on transmission and distribution could be eroded over time), but its stock price should have scant further downside after the recent sell-off, and its bond-like characteristics make it attractive in a falling interest-rate environment.

DETAIL

CPI inflation in Malaysia has been most notable by its absence over the past 10 months, ever since the new PH (Pakatan Harapan) government abolished the GST -- thereby reducing retail prices across the board. CPI inflation has been consistently lower than 1% YoY since June 2018, and yet Bank Negara Malaysia (BNM) has left interest rates unchanged at +3.25%, having raised the OPR to that level in January 2018. That rate hike worked almost immediately, helping to bring headline CPI inflation below 2% YoY by February 2018, levels that it remained at until the May 2018 election, before receding sharply further in June and beyond. In January-February 2019, Malaysia experienced deflation (-0.7% and -0.4% YoY), and CPI inflation was barely positive at +0.2% YoY in March 2019.

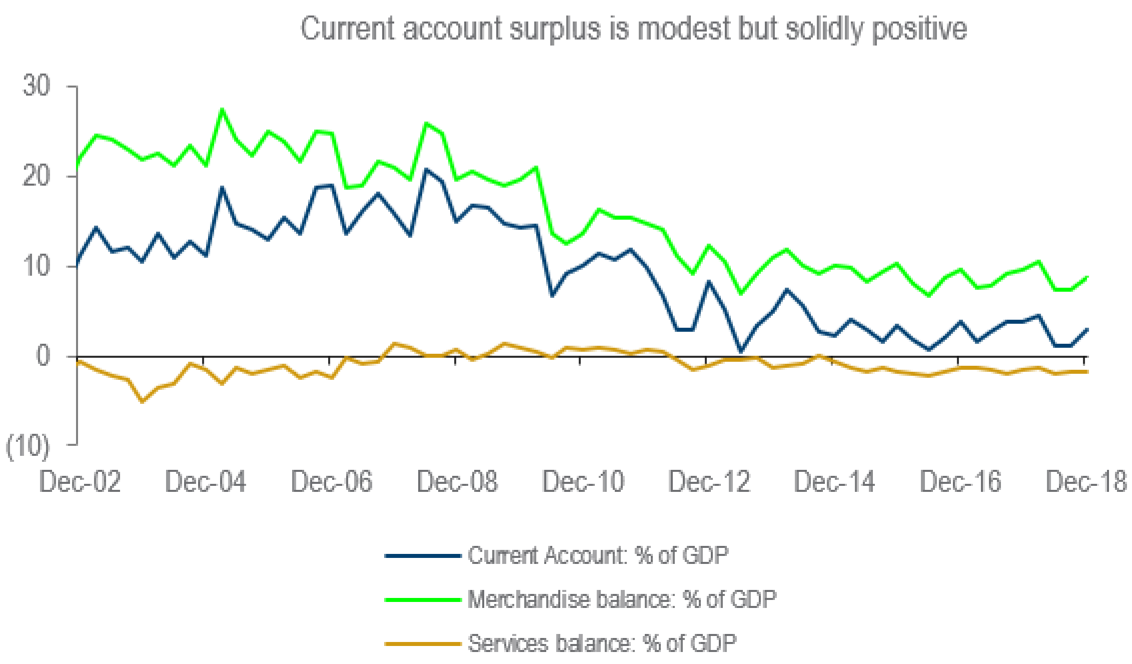
Sources: REAL-Economics.com, based on data from Trading Economics

Exports (+14.1%YoY) outpaced import growth (+12.2%) in 2018; and in 1Q 2019 too, exports declined less (-4.8% YoY) than imports (-6.9% YoY), boosting the trade surplus. Malaysia's exports grew 14.1% YoY in 2018 (decelerating only slightly from 14.7% in 2017 amid strong global electronics demand). But export growth had begun to run out of momentum in November-December 2018 (to +2.1% YoY) as the electronics/semiconductor cycle turned downwards -- and exports *declined* 0.8% YoY in January and -9.2% YoY in February 2019. Imports, however, had begun to decline earlier and faster -- falling 1.3% YoY in December 2018, -2.9% in January and -13.2% YoY in February 2019. In March 2019, exports declined 4.8% YoY and imports declined 4.6% YoY (in US$ terms; the official figures are reported in MYR-terms, but we convert them to US$, to be consistent with the rest of the world). For 2018 as a whole, exports outpaced import growth (+12.2% YoY), and the trade surplus widened as a consequence to US$29.9bn in 2018 (from US$24.56bn in 2017). The deteriorating semiconductor cycle caused Malaysia's headline exports to decline 0.8% YoY in January and -9.2% YoY in February 2019 -- but imports declined even more, by -2.9% YoY and -13.2% YoY respectively in the two months. Consequently the 1Q 2019 trade surplus this year was US$9bn (up from US$8.5bn for the same quarter in 2018).



Source: REAL-Economics.com, based on data from Trading Economics

Current account surplus was 2.3% of GDP in 2018; likely to be over 4.5% of GDP in 1Q 2019. The current account surplus had shrunk to 1% of GDP in 2Q and 3Q 2018, but widened to 2.9% of GDP in 4Q 2018. Given the widening of the trade surplus in 1Q 2019, the current account surplus in 1Q 2019 is set to exceed the 4.4% of GDP in 1Q 2018 -- and will likely rise to more than 4.5% of GDP in 1Q 2019. The strength of the current account is another argument for



Source: REAL-Economics.com, based on data from Department of Statistics, Malaysia

Real GDP growth accelerated only slightly to 4.7% YoY in 4Q 2018, after moderating to 4.5% in 2Q 2018, and 4.4% YoY in 3Q 2018 (from 5.4% in 1Q 2018). The key factor holding back growth was fixed investment spending -- which grew an anaemic 0.3% YoY in 4Q 2018, and 2.3% YoY in 3Q 2018. The abolition of the GST (Goods & Services Tax) as promised by the new PH government provided a huge fillip to private consumption spending (+8.8% YoY in 2H 2018), but required some restraint in government spending (which increased 4.6% YoY in 2H 2018). The abolition of GST caused a sharp one-off decline in consumer prices, but this was not passed on in the form of an interest rate cut -- and the sharply higher real interest rates constrained domestic investment spending. Real GDP growth in 1Q 2019 is likely to be below 4.5% YoY -- held back by a further weakening in industrial growth (as evident in the decline in exports during the quarter), but helped by surging palm-oil output, which would have boosted the agriculture sector and buoyed private consumption spending.

In the face of CPI *deflation* in 1Q 2019, coupled with a wider current account surplus (2.4% of GDP in 2018, likely over 4.5% of GDP in 1Q 2019) **and a well-contained fiscal deficit** (3.7% of GDP in 2018), **we expect Bank Negara to cut the OPR by 25bp at the next policy meeting on May 7th, and a further 25bp in 3Q 2019**. With some of the uncertainty over Malaysia-China ties finally resolved -- including a massive 33% reduction in the cost of the East Coast Rail construction project that China was to lead (including restraints on the use of mainland-Chinese workers, implicitly greater involvement for Malaysian contractors) -- capital flows from mainland China are likely to recover somewhat in 2H 2019. Malaysia's KLCI has been one of the worst-performing markets in Asia over the past 12 months, with the GLCs (government-linked companies) in the Khazanah or PNB stable -- including Maybank, Tenaga Nasional, CIMB, Sime Darby, Telekom Malaysia, Axiata -- among the worst performers in the year-to-date.