

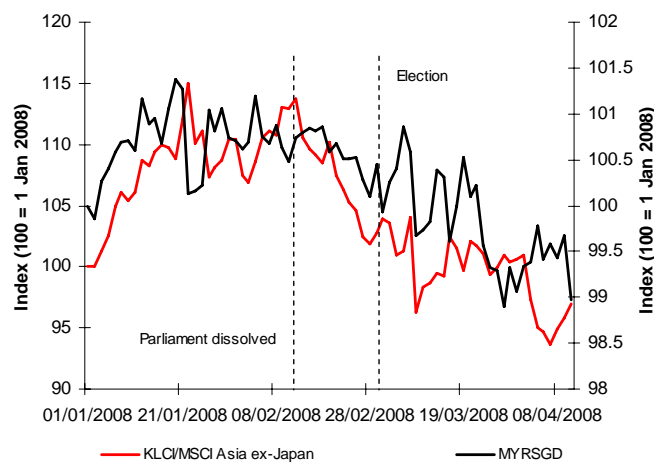
## Never ignore the risks

Thursday, May 03, 2012

Anticipation of a general election has been rampant in the public in the past few weeks, with the latest move by the government to implement a minimum wage in the country regarded to be another hint that we are getting closer to an early election in Malaysia even though the ruling coalition has until 2013 before they are legally required to dissolve the parliament. Early in April, comments by the Election Commission Chief suggested that the polls may be conducted in June or July, which means that the parliament may be dissolved anytime this month, given that elections will need to be held up to 60 days after the parliament has been dissolved. While a recent public poll done by the Merdeka Center has put PM Najib's popularity to have improved to 69% (from 59% in August 2011), the rather chaotic outcome of the Bersih 3.0 demonstrations held last weekend highlights the potential event risk .

Looking back to the March 2008 election, the unexpected outcome that had seen the ruling Barisan Nasional (BN) only winning 63.1% of the parliamentary seats or 50.3% of the popular votes triggered about 10% intra-day loss in the KLCI and about 1% drop in the value of the MYR. This impact is consistent even after measuring the performance of the KLCI relative to the MSCI Asia ex-Japan, and the MYR relative to the SGD, as seen in the graph below. Interestingly, however, the performance of both the KLCI and the MYR had been lackluster once the parliament was dissolved in mid-February 2008, indicating presumably that caution had prevailed even before the election results were announced.

Impact from the 2008 election



Source: Bloomberg and OCBC Bank

While it remains to be seen if we would observe a similar pattern in the market this time around, what is more important is to note the fact that the upcoming general election has just added another concern to the growing list of risks for the Malaysian market. Several interesting things have surfaced in recent months, including Fitch's

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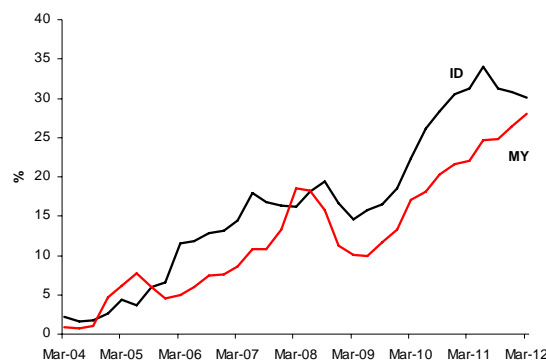
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cautionary note on the high level of fiscal spending in Malaysia. Earlier in the year, we had also noted that while Malaysia's growth has outperformed our expectation for Q4 2011, it is important to know that high fiscal spending (in excess of +20% yoy in H2 2011) has been a major driver of the economy. At about 5.0% of GDP, Malaysia's fiscal deficit stood at the highest in Asia for 2011, even if it was an improvement from the 5.6% level recorded for 2010. Similarly, at about 55% of GDP, Malaysia's debt-to-GDP ratio currently stands among the highest in Asia, only below that of India or the Philippines. It is hardly surprising then to see the credit rating agencies closely watching development on fiscal spending going forward, even if it is important to note that we don't expect any change in Malaysia's credit rating anytime soon.

Should there be growing unease about Malaysia's fiscal situation, there is a threat of some potential reversal of fund flows, which have been robust since 2009. In fact, while the threat of a sudden reversal of foreign fund flows has been mainly associated with Indonesia since end-2011, it should not be forgotten that foreign ownership of local currency government bonds in Malaysia has increased significantly since early 2009. As of Q1 2012, foreign ownership of government MYR bonds stood at about 28% of total outstanding bonds, comparable to the 30% seen in Indonesia. Unlike Indonesia though, Malaysia has so far not seen any marked reversal of this foreign fund flows in the bond market.

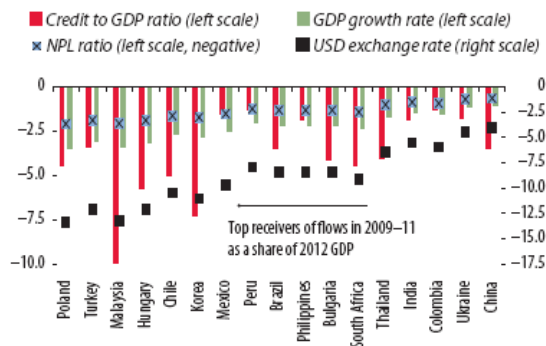
**Foreign ownership of local currency government bonds**



**Source: IMF Global Financial Stability Report April 2012**

Additionally, it is interesting that the IMF expects Malaysia to be among the economies most at risk from the de-leveraging process expected among European banks going forward. An abrupt reversal of foreign bank and portfolio flows would lead to a contraction in credit and loan quality, as well as hurting the local currency and growth prospects. In the IMF simulation, Malaysia (and the MYR) is seen to be among the most vulnerable, not only in Asia but in the entire Emerging Market space.

**What happens when flows of 2009-2011 reverse?**



**Source: IMF Global Financial Stability Report April 2012**

In the most immediate future, the release of Malaysia's Q1 2012 GDP data later this month is likely to inject some positives in the market, as growth is likely to have outperformed market expectations on the back of the better than expected exports growth in the period. As it is, we have also recently upgraded our 2012 GDP growth forecast from 3.8% to 4.2%, while seeing some signs that domestic demand has continued to be fairly constructive for the medium growth prospects. Nonetheless, current risks for the Malaysian economy go beyond the headline economic numbers alone, especially with regards to the still relatively high fiscal spending growth in the economy.

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