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BY ADELIN PAUL RAJ

# CAN THINGS GET ANY WORSE IN 2023?

Despite the ongoing geopolitical tensions and monetary policy tightening, the Dow Jones Industrial Average and S&P 500 are trending upwards, but the FBM KLCI is down 7% year to date. As we enter the second half of the year, we look at which macroeconomic factors will continue to shape market dynamics.

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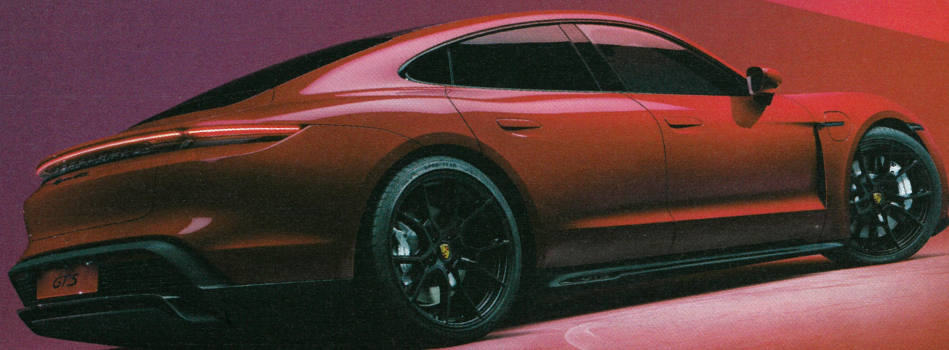
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## COVER STORY 2

# CAN THINGS GET ANY WORSE IN 2023?

## 6 THINGS TO WATCH OUT FOR IN 2H

BY LIEW JIA TENG AND KATHY FONG

Just like in 2022, financial markets continued to be impacted by the shockwaves from rising interest rates, geopolitical risks and recession fears in the first half of the year (1H2023).

Despite the chaos around the world, US equities have been on the rise — the Dow Jones Industrial Average is up 3% year to date (YTD) while the S&P 500 has advanced 15%. This is a stark contrast to the FBM KLCI, which has declined 7%.

The expression “a year of two halves” is commonly used by market commentators to describe a year that exhibits a significant change or shift in market dynamics and trends after the first six months. It implies that the two halves of the year differ substantially in terms of market performance, economic conditions and/or other relevant factors.

The question is, can things get any worse in 2023? What if this is not “a year of two halves” but a year of persistent difficulties?

To be fair, the FBM KLCI had a good start in January, gaining almost 2% in the first month of the year.

Then came the banking crisis in March, which saw the collapse of Silicon Valley Bank and Signature Bank in the US, as well as the acquisition of Credit Suisse by UBS in Switzerland. While the situation eventually calmed down, market sentiment was badly affected, resulting in many investors taking a cautious stance.

On a positive note, the recent run-up in the share price of Nvidia Corp — driven by demand for its artificial intelligence chips owing to the hype surrounding generative AI tools such as ChatGPT — contributed to the Nasdaq Composite Index’s 31% YTD gain.

As for economic developments, US Federal Reserve chair Jerome Powell has signalled the likelihood of more interest rate increases in the future to combat persistent inflationary pressures. While US equities have largely rebounded from their lows in March, Malaysian stocks did not follow suit.

With six states — Kedah, Penang, Selangor, Negeri Sembilan, Terengganu and Kelantan — heading to the polls, which are likely to take place in August, political uncertainties have been weighing on the local market. Meanwhile, the already weak ringgit is down 5% against the US and Singapore dollars.

Perhaps the only bright spot on the local corporate scene is the strong appetite for initial public offerings (IPOs), with 15 companies floating their shares on Bursa Malaysia in 1H2023. There are more companies in the pipeline going for listing over the next six months.

As we enter 2H2023, which macroeconomic factors will continue to shape market dynamics? What should investors do amid the market volatility?

### 1 THE HAWK IS NOT DESCENDING ANYTIME SOON

The Fed has been aggressively hawkish on interest rates since March last year. After 10 consecutive hikes over the past 15 months — the fastest series of rate increases in four decades — the US central bank finally paused its rate hikes at the Federal Open Market Committee meeting last month.

Two weeks ago, however, Powell affirmed that more interest rate increases are likely up ahead as “the process of getting inflation back down to 2% has a long way to go”.

Fed officials forecast another 50 basis points (bps) of rate increases before the year is over. That indicates two more hikes of 25bps each. The federal funds rate is currently at the 5%-5.25% range.

On the home front, Bank Negara Malaysia surprised the market by raising the overnight policy rate (OPR) by 25bps to 3% in May. While

most economists do not expect further OPR hikes by the central bank at the remaining three monetary policy committee meetings this year, certain quarters say Bank Negara cannot afford to keep interest rates at the current level, given the widening interest differential, hence another rate increase in 2H2023 is possible.

Pheim Asset Management Sdn Bhd founder and chief strategist Dr Tan Chong Koay opines that if the US keeps on increasing interest rates, Malaysia will need to follow suit. Otherwise, the ringgit will weaken further, triggering import inflation in the economy.

“Currently, the fed funds rate is already much higher than Malaysia’s OPR. On the business side, corporates will need to face rising borrowing costs and raw material costs,” he tells *The Edge*.

“With the rising interest rate, households could also face higher repayment costs while banks could experience higher NPLs (non-performing loans). Finally, this would affect corporate earnings growth and the country’s economic growth.”

Tan believes that if the market corrects sharply, there will be an opportunity for investors as value re-emerges. “We will focus on selecting companies that meet our investment criteria, such as robust earnings growth, low net gearing and good corporate management.”

Tradeview Capital Sdn Bhd CEO Ng Zhu Hann observes that the overall stock market’s performance since the start of the rate hikes has been on a continuous retreat. Besides, it is quite clear that even though the country’s economy remains resilient, the steep rate

increase trajectory has caused a significant outflow of foreign funds.

“This has also impacted ringgit strength, bringing our currency to record lows against the Singapore dollar and close to historical lows against the greenback,” he tells *The Edge*.

Ng points out that based on pre-Covid levels, there is still room for one more rate hike.

“In effect, for investors in the stock market, they must be willing to stomach another quarter of market weakness before things start to look positive. As for business, it is best to assess market conditions before taking any business risks unless one’s balance sheet is strong and cash flow is healthy,” he says.

Amundi Malaysia head of Asean equity Andrew San stresses that a company’s strong balance sheet is important in a high interest rate environment. Companies with resilient margins will carve out a strong position in their industries, while having capable and trustworthy managers at the helm will help them weather the storm.

“As local investment sentiment remains tepid amid global conditions that are now compounded by regional and local factors, we remain steadfast in advocating for having diversified exposure to good quality companies,” he says (see “Watching the ringgit as interest rate differentials widen” on Page 12).

### 2 MAY THE DUST SETTLE ON THE LOCAL POLITICAL SCENE

The outcome of upcoming state elections — which involve Selangor, Penang, Negeri Sembilan, Kedah, Kelantan and Terengganu — will set the stage for where the country is headed, including its economic policies.

Never before have state polls been such a critical event in Malaysia’s history, the results of which will be crucial to the country’s political stability — something that the business community and investing fraternity would want to see before making their next move.

“We believe investors are still waiting on the sidelines to have a clearer picture of the outcome of the state elections,” says Pheim’s Tan.

The state polls are expected to be held in the first half of August. Generally, there are three possible scenarios that politicians and political analysts believe could play out following the polls.

One possible outcome is Perikatan Nasional (PN) winning five states, except Penang, and receiving the mandate to rule Selangor, Negeri Sembilan, Kedah, Terengganu and Kelantan. While this is seen as the least likely scenario, no one would rule this out as PAS had outperformed all the other parties in the last general election (GE15) by winning 49 parliamentary seats.

The second scenario, which is the base case for many now, is that the Pakatan Harapan-Barisan Nasional (PH-BN) coalition captures the three states on the west coast, while PN takes control of Kelantan, Terengganu and Kedah.

Another scenario could be the PH-BN coalition winning a two-thirds majority in Selangor, Penang and Negeri Sembilan. On top of that, the alliance could win some seats in Kedah, although some quarters believe the likelihood of this is rather slim.

Kedah has a slightly bigger non-Malay population, of about 20% of the state’s population, than the less than 4% in Kelantan and Terengganu. In the three states on the west coast, non-Malays make up 36.4% of the population of Negeri Sembilan, 39.2% of the population of Selangor and 55% of the population of Penang.

Tradeview’s Ng comments that the biggest challenges plaguing Malaysia for the past five years have been political instability and

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## Be prudent in times of uncertainty

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the politicisation of issues at the expense of pragmatic policies. "I hope the state elections will be the final wave of political uncertainty in the country and all policymakers can focus on the work at hand to make the country a better place than before," he adds.

### 3 GEOPOLITICAL RISK IS NOT IMPROVING

Last week, Russia experienced a major security crisis following a rebellion led by Yevgeny Prigozhin, chief of the private military contractor known as Wagner. This rebellion was a challenge to President Vladimir Putin's authority and exposed potential weaknesses in his leadership.

Meanwhile, tensions between the US and China seem to have escalated again, with US President Joe Biden labelling Chinese President Xi Jinping a dictator, shortly after the visit of US Secretary of State Antony Blinken to Beijing, which had initially eased tensions.

These geopolitical factors have raised concerns about their impact on the global economy and financial markets due to supply chain disruptions.

MIDF Amanah Investment Bank Bhd research head Imran Yassin Yusof is of the view that the Wagner rebellion is "not an actual rebellion" and a "non-event" given that it has been resolved.

"It seems that things are going to be stable. What is important is whether Russia and Ukraine will get a negotiated settlement sooner rather than later. I think more or less it is status quo until we have some breakthroughs on the battlefield," he tells *The Edge*.

On Blinken's visit to China, Imran says, "It doesn't change anything", with Biden calling Xi a dictator. "We don't see any changes to the policy. There's no breakthrough. It is more of a long-term event."

Pheim's Tan says the geopolitical risks are not improving, which the market may not have fully discounted. "Many think Putin is losing his grip and credibility in Russia. Putin seems under pressure to regain his credibility and popularity, and things may get worse, especially if the nation has nuclear weapons. Meanwhile, the US-China tussle will continue even if a Republican wins the US presidential election next year."

Tradeview's Ng acknowledges that one of the main reasons global inflation has persisted for so long is due to the Russia-Ukraine war.

"Both countries have significant roles to play in the global economy and as the two large economies are suddenly taken out of the ecosystem, there is a vacuum that remains unfulfilled. Whether it is commodities such as oil, wheat, grain and natural gas, both countries are commodity-producing nations," he says.

On the US-China trade tensions, Ng says the impact is far-reaching as both are global economic powerhouses. "It is not possible to eliminate geopolitical risks from the equation but there is a need for the temperature to be dialled down a few notches in order for the focus to be on multilateralism and business diplomacy instead of threats to peace and harmony."

Nevertheless, Amundi's San believes that the uncertain and volatile times are ideal for building exposure to good quality companies, with valuations generally being more attractive.

"The key is to do your homework on companies to understand them and the level of their quality, while allowing you to build an inner confidence with these stocks to be able to act comfortably in a contrarian manner if and when buying opportunities are presented when the market is sold off," he says.



### 4 OTHER WILDCARDS, CHINA BEING ONE OF THEM

Malaysia, being an export-oriented nation and one that is largely dependent on foreign direct investment, is inevitably affected by any external headwinds, or tailwinds.

While most of the world are pinning their hopes on China being a powerhouse for the global economy, given that it has been a strong source of growth for nearly two decades, the country's pace of growth post-pandemic, however, has so far not been as robust as expected. China cut interest rates last month — a move that economists see as a stimulus measure but also as an affirmation of economic weakness.

The financial stress among China's debt-laden property developers does not help the country's economy, while consumer spending has shown signs of slowing, let alone the trade restrictions imposed by the US.

Furthermore, apart from Hong Kong and Thailand, the rest of the world has yet to see the arrival of Chinese tourists. Their spending splurge is expected to be a growth driver in many economies, particularly those counting on tourist dollars to spur growth.

The former head of the International Monetary Fund's China division Eswar Prasad was quoted by the media as saying that China's central bank, the People's Bank of China (PBOC), will need to further ease its monetary policy this year should the country's economic recovery continue to lose steam. He pointed out that the lack of clarity on the government's policy on the private sector has resulted in uncertainties.

"They [Chinese government] want the private sector to play a constructive role, but at the same time, do not want it to become too large and too powerful. And balancing that does create a lot of uncertainty in terms of the policy environment, which I think is holding back growth," says Prasad.

Amundi's San explains that while political uncertainty during the run-up to the state elections has weighed on market sentiment, the bigger driver of the FBM KLCI's recent negative performance, along with the weaker ringgit, has been due to the weaker-than-expected recovery in China.

"Given the considered approach currently

in how stimulus is provided by the Chinese government, along with the general weakness in global growth creating a feedback loop in the form of lower demand for goods from the world's workshop, any optimism on a strong post-reopening rebound in the Chinese economy would remain limited," he says.

After two decades of robust growth, it is now up to China's Xi to demonstrate to the world how a communist nation deals with an economic slowdown. And hopefully, his stimulus measures will help the global economy avoiding a prolonged downturn.

### 5 EASING OF COMMODITY BOOM

The prices of most commodities, from grain and milk to metals and crude oil, have retreated from their peak. This, at least, is one less factor fuelling inflationary pressures, although prices are still elevated compared with pre-pandemic levels.

Tradeview's Ng is of the view that the normalisation of oil and other commodity prices will help bring down inflation. He does not expect the margin squeeze to get more severe given the falling prices. This provides companies that were choked with escalating input costs some breathing space.

On the macroeconomic front, whichever direction crude oil prices are headed in could still be a cause for concern for Malaysia, being an oil exporter that heavily subsidises local petrol prices. The benchmark Brent crude price has been on a decline since June last year, falling 42% from the peak of nearly US\$128 a barrel and 13.4% year to date.

Lower oil prices would translate into less money being spent on the petrol subsidy. The average Brent crude price stands at US\$80 per barrel year to date, compared with US\$99.04 last year.

The Ministry of Finance estimated that the subsidy for petrol, diesel and liquefied petroleum gas (LPG) will be lower in 2023 at RM25.6 billion, nearly half the RM50.8 billion in 2022 but more than double the RM11.1 billion in 2021, when the average oil price stood at US\$70.92 a barrel.

By the same token, falling oil prices also mean less oil revenue, such as the Petroleum Income Tax paid by oil majors, for the government to replenish its coffers. As a result, the administration will face fiscal constraints

if it needs money to stimulate the domestic economy.

Besides, soft crude oil prices also put pressure on the ringgit, which is also regarded as a commodity currency given that Malaysia benefit largely from high commodity prices.

Pheim's Tan does not foresee a strong rebound in crude oil prices against the backdrop of recession risk in the US and Europe and softer-than-expected economic growth in China so far. He notes that from an investment perspective, utilities, transport and logistics, aviation and industrials are expected to benefit from the weaker oil prices, but not the coal mining, oil and gas and plantation sectors.

MIDF's Imran forecasts crude oil prices to hover at US\$70 to US\$80 per barrel. "We don't see it falling further, unless there is a recession. At the moment, Opec says demand looks quite good. I think it will support prices by cutting production if prices fall below a certain level," he says.

### 6 A RECESSION THAT KEEPS GETTING POSTPONED

As the saying goes, "When America sneezes, the world catches a cold."

Naturally, the growing likelihood of a US recession has raised apprehension about the potential ripple effects across the globe, including Malaysia.

Although the probability readings of a likely US recession are elevated, it is interesting to note that the projected timeline has been postponed several times. In Bloomberg's survey of economists, the projected "starting point" for the recession keeps getting pushed later — initially expected in 2Q2023 (during its November 2022 forecast) to 3Q2023 (January 2023 forecast) and now to 4Q2023 (May 2023 forecast).

"At the risk of sounding like an optimist, we reckon that these delays are an encouraging sign that a soft landing is still possible or even if the recession does strike, it could be a mild and swift one," says Hong Leong Investment Bank (HLIB) Research in a June 27 report.

Pheim's Tan highlights that corporate earnings growth, manufacturing activities, unemployment figures, housing starts and building permits, consumer sentiment — retail sales, durable goods orders — are good factors and indicators to track the health of the economy. "Businesses should be more cost-conscious in running their businesses, conserving more cash or reducing their gearing level, and take advantage of opportunities when they arise," he says.

Tradeview's Ng warns that the hawkish stance of central banks around the world may dampen consumption demand. And if they are not careful, it could bring about a recession and job losses in the process. "Businesses need to have standby cash for rainy days and hold back on major investments or capital expenditure, especially if it requires taking on significant loans, which will bring about higher financing cost. The important thing is to be prudent in times of uncertainty and only strike if the dark clouds of the economy dissipate."

Inter-Pacific Securities head of research Victor Wan says the outlook for 2H2023 does not appear to be rosy, judging from the external developments.

"Malaysia's trade with China has fallen, translating into lower exports. Things will deteriorate in 3Q. Some people think it will be at the end of the year, but I don't see that at this point. The second half will be more challenging than now," he says. ■