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December 2018

Monthly Commentary

Malaysia update

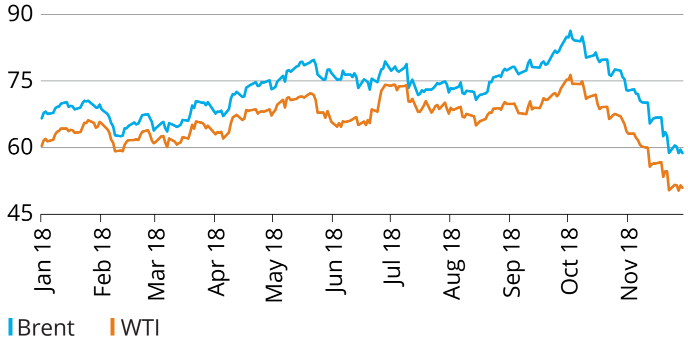
- Malaysian equities slip on lower oil prices, weaker GDP growth and muted earnings
- Oil and gas stocks hurt by lower oil price, but signs of capex rebound
- Bank holdings perform well on solid earnings
- Most consumer stocks benefit from temporary tax holiday

Market review

Malaysian shares struggled in November, underperforming most other regional benchmarks as foreign fund withdrawals continued. The new government's first Budget failed to lift the market, while sentiment was further dented by falling oil prices, weaker growth and a disappointing earnings season. Energy and technology stocks suffered the heaviest falls.

Slippery slope

Oil price (US$)



Source: Bloomberg, November 2018

Economic growth moderated to an annualised 4.4% in the third quarter, a two-year low, driven by weaker exports, although private consumption remained solid. The central bank left its policy rate unchanged at 3.25%. It said that an escalation of the global trade war and continued weakness in the mining and agricultural sectors could hinder the economy, but GDP growth should remain steady in 2019.

Oil prices: boom and bust

The oil and gas sector lagged in November, as oil had its weakest month in more than a decade. The international benchmark, Brent, slipped by over 20% from its October peaks to US$58.71 at end-November. Prices declined after the Trump administration surprisingly granted waivers from Iran oil sanctions to several countries, swelling US stockpiles and lowering demand forecasts, which triggered concerns of a supply glut. President Trump's pressure on Saudi Arabia also cast doubt over OPEC's ability to control output.

Several energy holdings fell as a result, including tank terminal operator **Dialog**, as its upstream businesses are likely to be hurt. Bearing this out, Dialog's September-quarter earnings were bolstered by higher contributions from its upstream segment in the rising-oil-price environment, as well as increased terminal activities. We topsliced the company as a result.

Also declining was energy services provider Bumi Armada, after it posted a 503 million ringgit quarterly net loss on the back of two significant non-cash impairments. More worrying was that revenue from its offshore marine services division declined from the previous quarter, despite improving utilisation rates, making it an outlier compared to its peers. Its debt issues also limit its upside catalysts, and given this negative outlook, we divested our position.

On the whole, we are seeing signs of a rebound in capital expenditure in the energy sector, and there are several companies with solid balance sheets that is supportive of upcoming growth. Given this more positive outlook, we established a position in **Velesto Energy**. The company provides drilling and oilfield services, and has a prominent position in Malaysia. We believe the company is well-positioned to gain in the current environment, due to our view that the rig cycle is at the early stages of a recovery, and that drilling activity could improve in 2019. This, coupled with rising utilisation rates, will drive Velesto's earnings higher. Meanwhile, its balance sheet appears healthier following its restructuring, while it generates comfortable cashflows to service its existing liabilities.

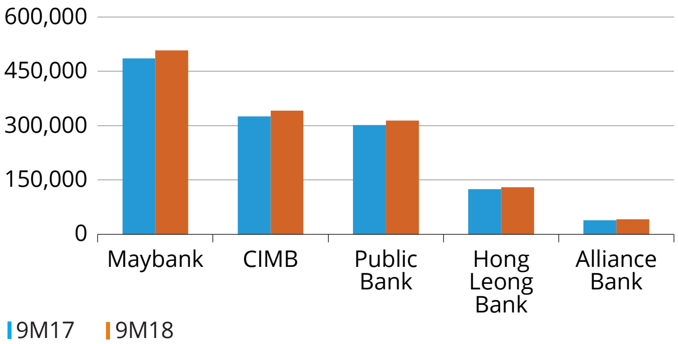
Banks: stable amid challenges

Most of our bank holdings continued to perform well relative to the domestic benchmark, with quarterly results that mostly met our expectations. **Hong Leong Financial Group**'s (HLFG) profits rose by 11%, on the back of decent numbers from its **Hong Leong Bank** subsidiary, and improving profitability from its insurance business. **Alliance Bank** saw traction in risk-adjusted-return loans, which underpinned margin expansion. We think that this, along with reduced costs from its lower tech spend, should drive better earnings. **CIMB Group** similarly enjoyed a better quarter, with net profits increasing by 4% from a year ago on improved performance from its consumer banking business. Encouragingly, profitability at its Indonesian business also picked up.

However, **Maybank**'s quarterly profits fell year-on-year as non-interest income remained weak. **Public Bank**'s profits also shrank, hurt by slowing loan growth and intensifying competition on deposits. That said, valuations remained supported by management's good track record and stable asset quality.

Loans still growing

Total loans of Malaysian bank holdings (RMmn)



Source: Company data, November 2018

We think the operating environment for the sector remains uncertain. Most lenders' net-interest margins contracted due to higher competition, while non-interest income growth moderated amid muted capital markets. We think this could pressure banks' profitability. Nevertheless, there are some positive signs: loan growth is expected to remain solid, asset quality looks steady, and our holdings are still well-capitalised.

Tax holiday boost for consumer stocks

Third-quarter results from our consumer holdings were generally positive, as they benefited from the temporary tax holiday following the government's decision to abolish the Goods and Services Tax. Retailer **Aeon Co**'s improved profitability from its retailing segment was underpinned by higher revenues from its newly-opened malls and a better product mix. However, operating profit growth from its property-management division declined, owing to higher promotional expenses. Overall, the results met our expectations, and reflected the company's more efficient operations, especially its retail business. However, we are still wary about its prospects, given intense competition and expectations for higher operational expenses due to the SST.

Carlsberg Malaysia and **Heineken Malaysia** both reported higher revenues and margins, on the back of front-loading activity ahead of the implementation of the new sales and services tax (SST). While the brewers' fourth-quarter numbers are expected to moderate due to the impact of the SST, a more effective crackdown on contraband beer remains a long-term driver for both companies' share prices. Consequently, we added to Heineken Malaysia, due to its attractive valuations.

What we've been busy with...

In addition to the abovementioned portfolio adjustments, we topped up recently-initiated government e-services provider **My EG**, due to its positive outlook. We also took advantage of share-price strength to topslice **Allianz**, **Oriental Holdings**, **Panasonic Manufacturing Malaysia**, **Shangri-La Hotels** and **United Plantations**.

We also reduced our exposure to developer **SP Setia**, as we think its prospects remain challenging. Its recent results were weaker than expected, with lower revenue and higher costs from the front-loading of construction for new developments, leading to lower margins. While its valuations appear attractive, we think that the soft property market, weak earnings forecasts and the delayed sale of the commercial phase of its Battersea project in London likely suggest a lack of near-term catalysts that could boost its share price.

Note: Any changes refer to those of our model portfolio, which is the basis for actual portfolios we manage that have similar investment objectives. However, there might be minor variations, so the comments may not apply to all portfolios.

Outlook

Malaysian stocks are likely to remain volatile as investors continue to price in policy risks. There is still uncertainty over the impact of the government's policies, with its maiden Budget likely to support consumption but potentially setting back fiscal consolidation. Renewed oil-price swings would be another strain. Markets also remain susceptible to a familiar checklist of external worries, including tightening monetary conditions, softer global growth and heightened trade tensions. That said, the China-US trade friction could also create opportunities, with sectors such as furniture and electronics manufacturing benefiting as global customers look for alternative supply. The longer-term outlook is also encouraging. Spending cuts and higher dividend contributions from state-linked corporations will help pare the country's debt, macroeconomic fundamentals and external finances remain resilient, while domestic demand should continue to sustain economic momentum. With valuations reasonable, we believe the market still offers attractive investment opportunities, and remain focused on unearthing quality companies with compelling long-term prospects.

We hold the companies highlighted.

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