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Fitch downgrade bad for stockmarket

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People in the market are aware of the issue revolving around Fitch Ratings' downgrade, hence it did not result in any immediate implication.

The situation, however, is a temporary hiccup, say market observers

THIS week was a rough one for Malaysia. The stock market fell the most in seven weeks, the ringgit dropped to the lowest in three years and the yield of Malaysian government's 10-year debt paper increased to the highest point since January 2011. That reaction stems from Fitch Ratings downgrading its outlook for Malaysia's credit rating.

Market observers agree that the revised outlook is bad news for the stock market, but they also agree that the situation is a temporary hiccup.

The FTSE Bursa Malaysia KL Composite Index (KLCI) closed 1.25% or 22.46 points lower at 1,7772.62 on Wednesday. But on Thursday, the local bourse rebounded to close 0.3% or 5.2 points higher to 1,777.82. It continued its uptrend yesterday, advancing 0.26% or 4.69 points to 1,782.51 yesterday.

Inter-Pacific Research Sdn Bhd head of research, Pong Teng Siew tells *StarBizWeek* over the phone that there was a massive "knee-jerk" pullout by foreign funds in the equity market the day after the revised outlook by Fitch Ratings.

"On Wednesday, RM436.5mil foreign selling took place and it continued on Thursday at RM262.1mil," he says.

He explains while foreign investors are prone to a cash out their positions in the market, the situation is instead cushioned by the local investors.

Yet, the sell-off could represent a temporary hiccup because Malaysia's public finance (the reason for Fitch Ratings to downgrade its outlook) is considered old news, Pong notes.

He adds that people in the market are aware of the issue, hence it did not result in any immediate implication. "It would not hold the market from advancing".

Areca Capital chief executive officer Danny Wong says that the stock market will bounce back again because the country's strong economic fundamentals and corporate earnings are still robust.

"Those factors will drive the stock market to recovery," he adds.

He notes that the foreign investors may use the downgrade as a reason to exit Malaysia.

"There is a concern that the downgrading may affect foreigners to exit Malaysia in a big way," he says, noting that the impact could be minimal in the stock market but a greater concern for the bond market.

Public Finance

High debt levels have been a growing concern in recent years for the country, as the government's debt-to-GDP ratio is among the highest in South-East Asia.

Malaysia debt-to-GDP ratio is almost touching its ceiling limit of 55%.

The country's budget deficit had widened to 4.7% of GDP in 2013 from 3.8% in 2011, Fitch notes. It said the downgrade in its outlook was because it feels Malaysia's public finances are its "key rating weakness".

"I believe that the Government will pursue its target to reduce the budget deficit by 4% this year, or at least show a sign of reduction," says RAM Holdings Bhd chief economist Dr Yeah Kim Leng.

The ringgit has depreciated further to RM3.25 against the US dollar as the greenback strengthens.

CIMB Research in a report says the depreciation of the ringgit benefits exporters, such as plantation, rubber glove and semicon players, as well as those with foreign currency revenues.

"Malaysia's current account balance is expected to narrow to around 3% of GDP or lower this year," its chief economist Lee Heng Guie tells StarBizWeek.

Since the first quarter, the current account surplus had narrowed to 3.7% of GDP. In 2012, current account surplus stood at 6.1% of GDP compared with 14.4% of GDP in 2005 to 2010.

He adds that the downward pressure on the current account is due to the slowdown in export growth and an increase in imports as the domestic demand grows.

"Going forward, we expect two developments in the balance of payments to influence the direction of Malaysia's current account, which includes export earnings volatility and private investment growth picking up as a result of the Economic Transformation Programme implementation and import of investment capital goods for the construction, oil & gas and service sectors.

"The sustained inflows of private capital and a large war chest of foreign reserves will provide a strong buffer against the weakness in the current account," he says.

He notes a deterioration in the balance of payments should not be a cause for alarm. "It is the speed, magnitude and cause of deterioration that should warrant a pre-emptive action".

"Nevertheless, further erosion of the current account surplus and given that Malaysia also incurs persistent years of budget deficit, the emergence of 'twin deficits' if they materialise could flag investors' concerns about their sustainability and net external financing issues to bridge the gap. This underscores the urgency for the government to take remedial action to contain the budget deficit," he explains.

Response

On Thursday, Fitch Ratings head of Asia-Pacific sovereign Andrew Colquhan over a conference call said that a downgrade in Malaysia's credit rating is "more likely than not" over the next 18 months and 24 months, after cutting the Malaysia's outlook, highlighting a concern over the Government's commitment for fiscal consolidation and budget reforms step.

"It is difficult to see the Government pressing forward any of those steps after the general election," he says, adding that the rating could reverse if action was taken to address the fiscal issue.

Meanwhile, on Thursday, Prime Minister Datuk Seri Najib Tun Razak gave his assurance that the Government would address the concerns over the Fitch Ratings outlook in his budget speech this year.

"We have already put in place a fiscal committee, which is looking into some of this challenges that we face, and all these will be addressed shortly, especially in the forthcoming Budget," he said yesterday.

Budget 2014 is expected to be tabled on Oct 25.

Bank Negara governor Tan Sri Dr Zeti Akhtar Aziz says Malaysia has the capacity and capability to address its fiscal vulnerabilities in a gradual and sequenced manner.

"Malaysia still has time to do it, but of course it is now more urgent because the global environment has become more challenging," she said, adding that policymakers were putting emphasis on increasing national resilience and boosting its potential to sustain economic growth.

The Government has targeted to reduce budget deficit to 4% this year, 3.5% in 2014 and 3% by 2015.

Bond yields

The revised outlook by Fitch also pushed up the yield on the 10-year Malaysian Government Securities (MGS) to the highest since January 2011.

On Wednesday, the yield increased to 4.13% and remain above 4% on Thursday.

"The pullout by foreign funds started in June 2012 judging from the decrease in the foreign holdings in MGS to RM137.9bil in June from RM144.5bil in May.

"The downgrade of Malaysia's outlook by Fitch Ratings has compounded the impact as local bond market is still digesting what had transpired in the US Treasuries (UST) market on possible tapering of assets purchase programme by the US Federal Reserve," said Bond Pricing Agency Malaysia chief executive officer Meor Amri Meor Ayob in an email reply.

He says that the local bond market is sensitive to the spread between UST and MGS. "The UST yields have spiked up substantially for the past two months, so have the MGS yields".

"That being said, in the longer-term perspective, the MGS yields will depend on the health of the economic fundamentals, such as GDP growth, inflation outlook, current account balance as well as fiscal and monetary policy," he notes.

Zeti says there is not reason to overreact over the recent sell-off of Malaysian bonds.

She adds Malaysia is a highly open market and that it could cope with such volatility because its financial market is one of the most developed among emerging economies.