Multiple Factors Probably Drive Decline in KLCI, Few Opportunities for 2017 Turnaround

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Few catalysts remain in 2017 for Malaysia's Kuala Lumpur Composite Index (KLCI)—a capitalization-weighted index of the 30 largest companies on Bursa Malaysia's Main Market—to reverse its downward trend that began in June. After gaining more than 9% and closing at its year-to-date high of 1792.35 on 14 June, the KLCI has dropped 3.9% to 1721.66 as of its closing on 17 November—ceding approximately 47% of its year-to-date gains.

- From 14 June to 17 November, average daily volume on days the KLCI declined exceeded the average daily volume on days the KLCI advanced, 110.28 million to 100.33 million, based on a review of daily volume data from investing.com, underscoring the general bearish sentiment of the market. For comparison, from early January through 14 June, average daily volume was greater on days the market increased than days it decreased, 148.67 million to 130.43 million.

- Foreign investors, who had been net buyers of Malaysian equities from January through July, have been net sellers in August, September, and October, with net outflows of MYR 241.9 million, MYR 737.3 million, and MYR 226.3 million, respectively. Net outflows have continued in November, with foreign investors most recently selling MYR 297.1 million the week of 13 November, according to MIDF Amanah Investment Bank, as reported in The Edge Financial Markets.

- Throughout the year, the KLCI generally has underperformed its peers in Southeast Asia, gaining 4.87% year-to-date through 17 November. This exceeds only the Lao Securities Exchange index, which has gained 0.95%; the Cambodia Securities Exchange index, which has declined 7.74%; and the Myanmar Stock Price index, which has fallen 19.15%.

Several economic developments in Malaysia since June probably contributed to the KLCI's downturn. More recent losses in the KLCI also may be related to modest declines in some regional and global indices.

- Second quarter earnings for Malaysian companies, which businesses released primarily from July to September, revealed few positive surprises and reflected soft domestic consumption, according to The Star Online.

- On 9 November, Bank Negara, Malaysia's central bank, indicated it might raise its benchmark interest rate in 2018 from its current level of 3%, due to the strong domestic and global economy, according to its press release. Inflation also has risen, increasing 4.3% year-over-year in September, according to the Department of Statistics Malaysia; further climbs in inflation

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could support the bank's position to increase rates.

- The Malaysian Ringgit has gained 7.96% relative to the US Dollar year-to-date through 17 November—second in Southeast Asia to only the Thai Bhat's rise of 9.17%—which could put pressure on the country's exports. The Ringgit has room to appreciate further—Malaysia's central bank governor on 17 November indicated the currency remains undervalued—particularly if the Malaysian central bank begins to raise rates.

- Over the past two weeks—from the close on 3 November through the close on 17 November—the KLCI declined 1.1%, while the Philippine Stock Exchange index was down 0.8%, the S&P 500 was down 0.3%, and the Nikkei was down 0.6%.

Recent Developments Insufficient To Halt Decline

Economic growth that has topped expectations in consecutive quarters and the unveiling of the government's 2018 budget have not stemmed the KLCI's decline, suggesting investors are looking beyond these developments.

- Malaysia's central bank on 17 November announced third quarter gross domestic product (GDP) growth of 6.2%, which far exceeded the median estimate of 5.7%, according to Bloomberg; this follows second quarter GDP results that also surpassed expectations. The economy's strong GDP probably increases the likelihood of a rate hike in 2018 and establishes a high benchmark for next year's growth.

- In late October, Malaysia's Prime Minister Najib Razak revealed the country's budget for 2018, which some analysts assessed could propel the KLCI to 1,850, according to The New Straits Times. The budget provided tax cuts for some consumers, but it may have disappointed investors because it did not include tax cuts for companies, which have faced higher costs from the implementation of minimum wages and the removal of energy subsidies, according to Bloomberg.

Malaysia's third quarter corporate earnings season currently is underway and probably presents the best opportunity for the KLCI to reverse its second-half of 2017 downtrend, were results to beat expectations. Moreover, recent leading indicators do not suggest an acceleration in the economy.

- At 25 September, the KLCI closed at 1769.14 and traded at 16.5x its estimated price to earnings (PE) ratio, with a fair PE value of 16x, according to iFast Financial. Using the KLCI's closing price at 17 November of 1721.66 yields an implied PE of 16.05x, which suggests the index is fairly valued at its current levels.

- The Nikkei's Manufacturing Purchasing Manager's Index for Malaysia declined in September and October to 49.9 and 48.6, respectively, according to The New Straits Times, which suggest a contraction in manufacturing. Additionally, Malaysia's Consumer Sentiment Index and Business

Conditions Index both declined in the third quarter, according to the Malaysian Institute of Economic Research.

Looking into 2018, Malaysia's economy is positioned for strong growth—the International Monetary Fund forecasts its GDP to reach 4.8%, and its economy should be able to withstand the impact from probable rate hikes in the US and elsewhere, according to Bloomberg—but political and economic issues could arise that temper its expansion. Additionally, some projects underway that should boost the economy, such as China's "One Belt One Road" (OBOR) initiatives, probably will not provide tangible economic benefits until their completion.

- National elections, which must be held before September of next year, historically have led to improved consumer and business sentiment, according to Morgan Stanley, as reported by CNBC. Uncertainty over when the government will call elections, however, as well as potential political unrest—the opposition has increased its rhetoric against the government, to include a two month "roadshow" that concluded in October with a protest of thousands, according to Reuters—could soften the typically positive economic impact of elections.

- On 17 November, Bank Negara Governor Tan Sri Muhammad Ibrahim stated that significant supply surpluses in the Malaysian property sector pose a significant risk to the Malaysian economy. The number of unsold residential properties have reached a decade-high and the office vacancy rate in the Klang Valley—an area that includes Kuala Lumpur and its adjoining cities and towns—is projected to reach an all-time high of 32% by 2021, according to The Edge Financial Markets.

- An economist at Capital Economics stated in mid-November that consumer spending probably could not maintain its current pace due to the level of household debt in Malaysia, according to Nikkei Asian Review. Domestic demand is a key driver of the Malaysian economy, according to Bank Negara.

- Malaysia has a number of infrastructure projects underway or scheduled via China's OBOR initiative—notably, the East Coast Rail Link, which will bridge Malaysia's east and west coasts—that when completed should provide operational efficiencies and new economic opportunities. Until then, however, the spending on these projects probably will benefit primarily Chinese companies because foreign contractors can execute as much as 70% of the work, according to The Sun Daily.