

Malaysia's Newfound Stability



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After four years of political turmoil, Malaysia's recent stability and steady growth are paving the way for its government to implement critical reforms, including the overhaul of costly fuel and power subsidies. As a key beneficiary of the China Plus One strategy, Malaysia is well-positioned for increased investments, particularly in its expanding data center sector, capitalizing on the ongoing "tech war" between the U.S. and China.

From its independence in 1957 until 2018, Malaysia enjoyed the political stability of being governed by just six prime ministers, until the \$4.5 billion corruption scandal at 1MDB (1Malaysia Development Berhad) led voters to oust the ruling party, United Malays National Organization. This upheaval then brought a rapid succession of four prime ministers in a mere four years. The 2022 elections marked a turning point with veteran politician Anwar Ibrahim rallying former rivals into joining a unity government comprised of 19 different parties. With the coalition now controlling two-thirds of parliamentary seats, the administration has a four-year window before facing major elections in 2028.

Malaysia has been a forgotten market among foreign investors for more than two and half decades. The former Asian tiger was once the largest Asian emerging market by weight in the MSCI index prior to the Asian Financial Crisis in 1997. Over the years it has struggled to regain its former glory, being overshadowed by larger Asian markets like China and India, and the tech prowess of both Korea and Taiwan. Even neighboring Indonesia drew more investor interest as it focused on "down-streaming" in its mining industry.

We believe Malaysia is worth another look. Political stability has encouraged much-needed reforms, while Ekonomi Madani, a 10-year development plan launched in July 2023, aims to reduce red tape, promote economic growth of regions outside Peninsular Malaysia and enhance the efficiency of government-related enterprises.

The country's \$400 billion economy has averaged 4.5% growth over the past two decades, doubling GDP (gross domestic product) per capita to around \$12,000. In the second quarter of 2024, GDP climbed to 5.9%, following a 4.2% rise

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in the first quarter. This economic momentum has spurred job creation with unemployment rates declining from the peaks seen during the COVID-19 lockdowns. The narrowing gap between labor costs and labor productivity, which had surged during the pandemic, is making Malaysia more competitive in the region.

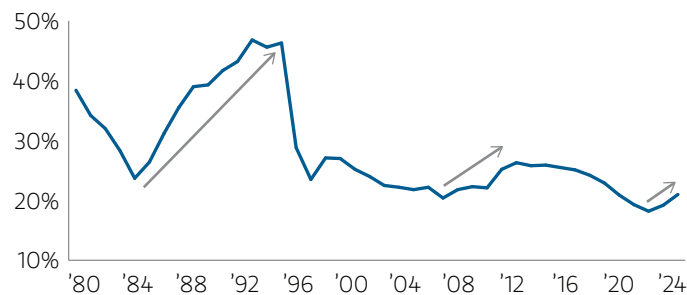
We expect inflation to remain under control, allowing Bank Negara Malaysia to hold its policy interest rate at 3%. We believe the central bank will be in no hurry to adjust its monetary policy and will hold rates steady for the remainder of the year.

Despite a slight dip in consumer confidence, retail sales and lending activity continue to gain momentum, indicating a resilient consumer base. Domestic consumption now accounts for 60% of GDP, up from 44% in 2008. Additionally, the government's plan to increase the salaries of 1.6 million civil servants by between 7% and 15%, starting in December, will further boost consumption growth.

DISPLAY 1

The Start of Malaysia's Third Investment Cycle

Gross fixed capital formation as a percentage of GDP



Source: Haver and Department of Statistics, Malaysia. As of 6/30/2024.

Budgetary discipline is at the forefront. Post-pandemic, Malaysia's fiscal deficit widened to 5.8% of GDP compared to 3.3% in the previous five years, elevating government debt to 64% of GDP from 52%. The Fiscal Responsibility Act (FRA), introduced last year, aims to lower the fiscal deficit to 3% of GDP and keep government debt levels to under 60% over the next five years. The law also requires annual development expenditure to be at least 3% of GDP.

Balancing fiscal sustainability and managing public discontent will be challenging, though. Subsidies peaked at 4.3% of GDP in 2023, accounting for almost 25% of total government expenditure. This year's budget projects a reduction in subsidies by over 30%. The government has already removed support from chicken and eggs and applied targeted subsidies on diesel

and electricity. The real test will come with the rationalization of RON95 (octane) gasoline prices, which accounted for around 60% of subsidies in 2023. To mitigate inflation spikes and political backlash, the increase in RON95 gasoline prices will likely be phased in, starting later this year or early in 2025.

In a positive turn for Malaysia's economic landscape, the country is witnessing a resurgence in foreign direct investment (FDI) after years of stagnation. Since 2021, Malaysia has attracted \$24 billion in data-related investments helping the country promote itself as Asia's data center hub. With affordable land, electricity and water along with a stable geological environment outside of earthquake zones, it has become an attractive destination for tech companies.

That should bolster Malaysia's ringgit, which historically appreciates against the U.S. dollar during investment growth periods. Further, efforts to repatriate funds by Government-Linked Investment Companies (GLICs), in which the state has a controlling stake, and private corporations should also support the currency.

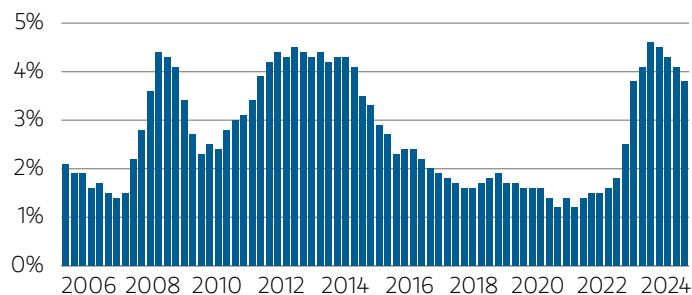
More investments should come from special economic zones. Johor, known as the southern gateway of Malaysia, is promoting the planned Johor-Singapore Special Economic Zone that will offer streamlined licensing, tax incentives and passport-free travel. Separately, the Forest City Special Financial Zone, also in Johor, aims to create a global finance hub tapping into Singapore's international financial market. A planned high-speed rail link connecting Kuala Lumpur to Singapore, will bring improved connectivity between the two nations.

Manufacturing remains central to Malaysia's economic strategy, contributing 23% to its GDP – higher than most emerging market countries – and accounting for over 80% of its exports. The first investment wave in the 1980s helped transform Malaysia from a commodity-based economy to a manufacturing-

DISPLAY 2

Reducing Subsidies Is Key to Malaysia's 2024 Budget

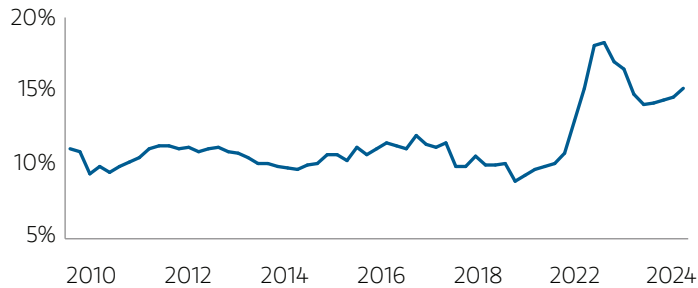
Government subsidies as a percentage of GDP



Source: Haver, Bank Negara Malaysia. As of 6/30/2024.

DISPLAY 3**Malaysia Is Attracting Significant Foreign Direct Investment Flows Post-Covid**

FDI Inflows as a percentage of GDP



Source: Haver and Bank Negara Malaysia. As of 6/30/2024.

based one. Penang, a key beneficiary of that early FDI, has attracted technology giants like Intel, Advanced Micro Devices and Hewlett-Packard. The state is now focusing on microchip design and wafer fabrication.

We believe Malaysian stocks are poised for their strongest year in over a decade, driven by improving industrial activity and resilient consumer spending. Equity market liquidity is improving, spurred by domestic institutional investors, particularly the GLICs. With macro fundamentals improving, there is a strong case for Malaysian equities to return to pre-pandemic levels.

But what could go wrong? Anwar's coalition needs to navigate a complex political landscape where compromise is essential. Although Anwar had flagged anti-corruption as a priority for his government, the administration has dropped graft charges against coalition members to ensure their loyalty.

The balancing act between economic future and political stability will be pivotal in unlocking the country's full potential. Structural reforms underway should the fiscal deficit and restore investor confidence. Anwar has four years before he must face the voters again. If he keeps doing the responsible thing, Malaysia's prospects look promising.

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