



Aktia EMD Trip Notes

Southeast Asian Investor Trip

View from Thailand, Bangkok

Aktia

Southeast Asian Investor Trip

Jakarta, Indonesia

- We visited Malaysia, Indonesia and Thailand, where we attended several meetings with policy makers and economic experts.
- Indonesia and Malaysia have enjoyed cyclical tailwinds thanks to high commodity prices, whereas tourism-dependent Thailand has been lagging behind its Asian peers.
- China reopening is supportive for the trio, yet Thailand may harvest the biggest benefits given the possible boost to its tourism.
- In Malaysia, the new government will most likely face challenges and fiscal consolidation efforts may prove to be difficult, especially the subsidy normalization. In Thailand the general elections are expected to be held in early May with status quo anticipated to continue, despite opposition parties have made gains in polls.



Malaysia

- The cyclical picture of the economy has been strong during the last quarters as Malaysia has emerged from the corona pandemic. The robust rebound (2022 GDP growth close to 9%) has been driven by domestic demand. Fiscal support, which has included energy subsidies and transfers, and the boost from reopening has helped the service sector in particular. The external sector has been supported by elevated palm oil and coal prices, but also by semiconductor exports. Unlike many other Asian EM countries, Malaysia is a net exporter of energy, so its economy has been better positioned to face high energy prices than its regional peers.
- Cyclical tailwinds are likely to recede in the coming quarters. Some see that labour market strength has started to abate. Malaysia's growth is also expected to cool down to 3–4 % in 2023 on the back of a less accommodative fiscal side, normalising domestic demand and weaker external demand for both commodity and manufacturing exports. The higher GDP base will have a negative impact on the growth rate, too. As Malaysia accounts for around 7% of global semiconductor production, the non-commodity cycle matters too; and especially the demand coming from the US.
- The central bank has hiked rates, but this move is seen as more of a monetary policy normalisation rather than an outright tightening. The monetary policy stance was still seen as accommodative, but on the other hand inflation has shown signs of peaking and is expected to ease on the back of a fading reopening boost and a less accommodative fiscal stance. The government is moving towards cutting subsidies – bringing some potential upside pressure on inflation – but many seem to expect the subsidy normalisation to be postponed to next year.
- Last year, Malaysia's current account surplus, driven by high prices of key export products, did not offer much support to the Malaysian ringgit (MYR). One explanation for the weakness was seen to be Malaysian exporters' willingness to keep their export earnings in dollars in order to benefit from the USD rally. That said, it has not been just a matter of willingness but ability too, as the central bank has eased FX conversion rule for exporters. In addition, the high correlation to CNY has likely played its own part in the weak MYR story. Both aforementioned factors may become less of a drag for the MYR in the coming months paving the way for more neutral outlook for the currency.



Malaysia's growth is also expected to cool down to 3–4 % in 2023 on the back of a less accommodative fiscal side, normalising domestic demand and weaker external demand for both commodity and manufacturing exports.

Malaysia

- The general elections held in November were tight and led to a hung parliament for the first time in Malaysia's history. After failed attempts to form a government, the centre-left PH coalition led by (now PM) Anwar Ibrahim succeed in securing enough seats with the support of a rival coalition, BN, which finished third in the elections. Overall, it was pointed out that the election results suggest that Malaysians' values and attitudes seem to be now more Islamic than before, as the support for the Malaysian Islamic party PAS (which is part of the Perikatan National coalition) continued to rise. The party has softened its conservative image, which may have helped to gather votes. However, the key driver of the success for the PAS seems to be the state of economy rather than religion. The PAS succeeded to win votes from the people who have faced a weaker economic situation due to the corona pandemic, and overall, its performance was the strongest in the poorer regions. Interestingly, although PAS has gained on the back of economic issues, it was said the party does not have a clear economic plan, unlike other parties.
- Political stability has not been a strong suit for Malaysia during the past few years, and unsurprisingly, the new government coalition will face several challenges. First, some noted that the cabinet lacks experience which may bring some additional layer of uncertainty, at least at early stages of the term. Also, governability issues may arise from PM Anwar Ibrahim's dual role as the head of the government and finance minister. Secondly, the fact that no party or coalition was able to achieve a dominant role in parliament can pose some challenges for decision making. Third, some argue royal families can now be more assertive in business and politics. Another factor that could weaken the government are the UMNO party elections in March as government stability is underpinned by the UMNO's support.
- Some argue that populism has gained traction in Malaysia and the fiscal outlook has become less anchored. Fiscal consolidation is expected to take place this year, albeit with a modest pace. The fiscal deficit of 5.5% of GDP (6.2% in 2022) was seen as a market neutral outcome. Overall, there are still some key unknowns both on the expenditure and revenue side, namely energy subsidies and tax hikes. Based on the meetings, we got the impression that both items are not likely to be on the government's agenda this year. The energy subsidies are a major drag on the fiscal side, with costs estimated at around 3% of GDP. Public debt is currently close to the statutory debt ceiling level (65% of GDP) which was increased from 55% during the pandemic. Given the current fiscal outlook, the government cannot bring the debt ceiling back to pre-Covid levels. It will be extended further over the mid-term, even though the debt-to-GDP ratio is expected to stabilise and decrease over the coming years. Some expressed concerns about the budget policy, criticising it as being pro-cyclical. Also, several pension fund withdrawals have weakened the pension system thereby adding contingent liabilities.
- **Our view:** In the EM Local Currency Strategy, Malaysia is one of the top holdings given the country is net energy exporter, contrast to many other Asian economies. Despite the volatility in the politics in recent years, we think country's fundamentals are still solid and stand out positively among EM. As Malaysian local currency fixed-income markets have low volatility compared to other EM countries, we think it offers defensive characteristics to the portfolio amid still high global uncertainty.

Indonesia

- The economy has shown resilience amid the corona pandemic and a challenging global market environment. In 2022, GDP growth settled above +5% (after +3.7% in 2021), thanks to high commodity prices for key exports (coal and palm oil) with positive spillovers to domestic demand. However, despite the decent recovery, growth was still viewed to be below its potential rate. As is the case in many other countries, Indonesian growth is expected to slow down this year.
- The main short-term growth drivers – and key downside risks – are lower palm oil and coal prices, although China's earlier-than-expected reopening may offer downside protection through export demand, FDI flows and tourism. Also, it was pointed out that domestic consumption has been supported despite cuts in energy subsidies, so growth has been holding well.
- Overall, Indonesia's macroeconomic management is seen to be strong, but structural bottlenecks exist. Some say that with right structural reforms the potential growth could be lifted to as high as the 7–9% range. One clear focus area on the reform side is to find ways to improve tax collection, as Indonesia's tax-to-GDP ratio is currently low, which limits public investments. The taxation harmonisation law (passed in 2021) was not seen as a game changer, although it has had several implications, such as an increase of VAT, overturning a plan to cut the corporate tax rate and lift tax rates for wealthy individuals. In terms of implementation, things have not been all positive as the government has put the carbon tax on hold. Some view that the carbon tax is politically far from ready to be implemented, and it is not going to happen before the next elections in 2024.



Indonesia

- Another structural weakness in Indonesia is the underdeveloped banking sector compared to its peers. Indonesia has a relatively low credit-to-GDP ratio and a high level of savings that could be translated into private investments if the intermediation mechanism would be strengthened.
- Looking at things over the longer term, the green transition can be painful for Indonesia as its electricity generation relies on coal, and the country is a fossil fuels exporter. During the trip there was lot of talk about new growth engines; the full electric vehicles (EVS) supply chain being one. At least the starting point is good, as the country can utilise its ample mineral resources. Also, it is seen that Indonesia has the right skill set given Asian automakers have been there for several years. In fact, Hyundai has already launched a new plant that will produce the country's first locally assembled electronic vehicle (for domestic markets). There has also been talks within the company on whether Indonesia could serve as an export hub to Asia.
- Overall, with right policies Indonesia could benefit from the global green transition as it holds more than 20% of global nickel, which is a key component of batteries that are used in electronic vehicles. It also has significant reserves of cobalt. In order to increase industrial down-streaming in the economy, Indonesia has a policy of using export bans to attract FDIs. Despite some positive evidence of FDI inflows in the nickel sector, this export policy was seen to be driven by protectionism and, in fact, not really working for attracting foreign investments, as other challenges in the business environment need to be resolved first. Some experts noted that the export policy has a strong support in the country, it will continue no matter who will be the next president after the 2024 elections.
- Despite structural weaknesses in fiscal accounts, over the short term things have gone well: the fiscal deficit of 2.4% of GDP last year was seen as an achievement (the deficit target was 3.9%, 4.6% in 2021) with the budget already below the fiscal deficit ceiling target (3%). High commodity prices have certainly helped fiscal consolidation, with revenues outperforming and surging around 30% compared to last year. The energy subsidy cuts have played a part, too, so it is not just about commodity price tail winds. On the external balance side, high commodity prices have been supportive as 2022 marked the second surplus year in a row, after several years of deficits.



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Indonesia

- The government ended 2022 with a large cash balance, so the borrowing needs may not be that excessive now, which is highly welcome for the local government bond market, especially given that Bank Indonesia (BI) ended its bond buying programme (i.e. the burden sharing programme) last year. On the positive side, the demand from foreign investors has recently been strong: the IDR government bond market has been recording net inflows now three months in a row, after several months of net outflows. Due to outflows during the pandemic, the foreign ownership is now at historically low levels at 15% of the outstanding rupiah government bonds (39% at the start of 2020). The burden sharing programme, that was in use during the corona pandemic, raised some questions among investors. According to the central bank, it could repeat the programme in the future, but that would require extraordinary market conditions – otherwise the move would mean a loss of creditability for the central bank.
- When it comes to inflation, the central bank seems to have done the bulk of its rate increases (cumulatively +225bps since August). It was expected that the BI will continue to focus on managing the government bond market, i.e. keeping the interest rate differential high enough to attract foreign capital flows and maintain financial stability. The BI is expecting CPI to ease back to its target range (3% +/-1%) in the latter part of the year. True, inflation seems to have peaked, but some think price pressures could be stickier than the BI anticipates, given inflation expectations have shifted higher and pass-through from producers to suppliers has increased.
- **Our view:** We expect Indonesia's growth to be strong and ongoing structural and regulatory reforms will improve business and investment climate, providing catalyst for medium-term growth. The strong fiscal performance and the return of foreign investor flows has, in our view, alleviated concerns on the IDR government bond market stability, now that the central bank has ended its bond purchase programme. In our EM Local Currency Strategy, Indonesia is currently our biggest off-benchmark position. In our Hard Currency Strategy Indonesia is among the top holdings.



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Thailand

- The past few years have been especially challenging for Thailand, given the corona pandemic and the country's high reliance on tourism. Real GDP is still clearly below pre-pandemic levels despite services catching up on the back of a global reopening and the recovery in tourism. On the positive side, China's recent reopening could offer an additional boost to tourism and alleviate risks if global recession fears materialise. Also, lower energy prices are highly welcome as Thailand is one of the biggest energy net importers in EM. Unlike in Malaysia and Indonesia, Thailand's growth is expected to strengthen this year as things normalise.
- The biggest single event this year is the general election held in May. Interestingly, the Thai political landscape has shown some changes during the past few years as there are now more parties competing for seats in parliament. The key takeaway from the meetings was that even though political opposition is set to make gains, the most likely scenario is that the incumbent PM (Prayuth Chan-ocha who led the military coup in 2014) will continue as the head of the government. So, the status quo continues. According to the constitution, the senate (250 seats) will be named by the junta, which in practice gives the army the upper hand in nominating the next PM. The opposition, even though being popular, has limited chances to get in power.
- Some think the issues during the pandemic may not shape the election outcome as much as one could think – the post-covid recovery is more important in voters' minds, and that will benefit Prayuth. High inflation was not seen as an election topic. Also, some see that the incumbent PM will gain support due to the very popular food programs launched during the pandemic, although he has not been very active in "marketing" this achievement.
- Elections are set to be fairly contested, and it is expected that no single party will be able to win a simple majority in the parliament and political parties will have to find common ground. Some seem to think that no matter what the election outcome is, populist policies will continue. More importantly, it is difficult to see that Thailand will see reforms addressing its long-term structural issues, such as ageing population, low level of economic diversification, low-skilled labour force and lack of new growth engines
- The Thai baht was under significant stress during the corona pandemic. A deteriorating external balance (due to loss of tourism revenues and high energy prices) has certainly played its part, but in a sense, there has also been bad luck. Before corona the authorities liberalised FX markets, which, in turn, exacerbated the violent moves in the baht. As the economy has gone through a stress period, things now look much more constructive for the currency.

Thailand

- The central bank of Thailand (BOT) was seen to be behind the curve, keeping rates below Taylor rule consistent levels. Some also noted that the BOT has now focused more on core inflation, rather than headline inflation, which saw its peak levels in October at close to 8% YoY (BOT's target range 1–3%). The strong rebound in the baht has made it easier for the BOT to defend its slow approach. If the currency continues to gain, it could even limit further rate hikes (policy rate now at 1.50%) and policy makers could leave the terminal rate below 1.75–2.00% which was seen as a consensus call. Also, financial stability concerns stemming from rate hikes is something that worries the central bank, given household debt is an issue, and currently there are now signs of deleveraging.
- The government's borrowing needs peaked in FY2021 due to loss of revenues but also due to covid-related spending. The current budget does not include any more covid spending, but borrowing needs are still roughly 90% above 2019 level. Of the total borrowing needs in FY2023, roughly one third is new borrowing in order to fill the budgeted deficit. As a result of the pandemic, the refinancing needs are still elevated – roughly double compared 2019. Over the next three years, 35% of the public debt is maturing as during the crisis the issuance was mostly done on the short end of the curve due to weak demand in bonds. The demand picture was seen to normalized, but on the other hand the pace of fiscal consolidation was seen as gradual.
- **Our view:** Thailand has one of lowest nominal yield levels in EM, and as such, in the Local Currency Strategy we have had zero weight in the country for several years. The cyclical picture has turned to be more constructive for Thailand, but we think the risk reward is still poor.



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