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THEMATIC REPORT | To Cut or not to Cut: Malaysia's Monetary Policy & the Impact to the Banking Sector

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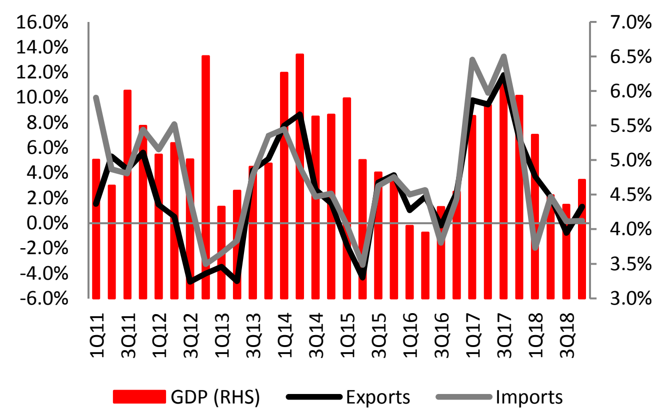
KEY HIGHLIGHTS

- **Conditions for an OPR cut have yet to be met at this juncture**
- **GDP growth in 4Q18 exceeded market expectations. For 2019, expect tepid 1Q19 growth but will recover 2Q19 and 2H19**
- **Deflation in Jan-19 and Feb-19 was due to cost factor (fuel) and not due to slowdown in demand. Meanwhile, labour market remains strong**
- **OPR cut only if GDP falls below 4% level**
- **Base case scenario; still POSITIVE on Banking Sector**
- **Any OPR cut will compress net interest margin but this will later normalized**
- **Expecting an average of -3% decline in our full year earnings estimates of banks under our coverage**
- **Still room to manoeuver in the banking sector if there is OPR cut**

A LOOK AT MALAYSIA'S MONETARY POLICY

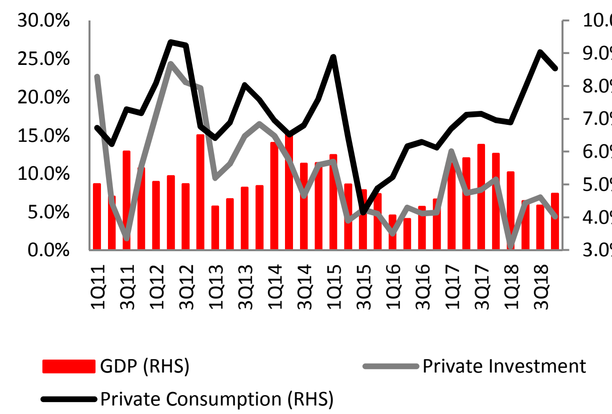
Setting the scene; GDP growth in 4Q18 exceeds market expectation. Before we delve into our analysis of Malaysia's monetary policy, we opine that it is worth recalling the background scenario. Recall that Malaysia's GDP growth expanded by 4.7%yoy in 4Q18, above market expectations of 4.5%yoy. Similarly, for the full year of 2018, Malaysia's economy expanded by 4.7%. The 4Q18 GDP growth was the fastest GDP expansion since 1Q18. The recovery of economic growth in 4Q18 was expected, contributed by the improved performances of external trade, industrial activities and sustained solid domestic demand. From the supply side, services and manufacturing sectors contributed 3.8% and 1.1% respectively. We opine the solid GDP growth was mainly due to external factors particularly receding trade war effects and modest recovery in mining sector especially crude petroleum and LNG. Moderating inflationary pressure, strengthening domestic demand and accommodative economic policies are expected to be the major drivers for GDP performance in the 2019.

Chart 1: GDP vs External Trade (YoY%)



Source: CEIC, MIDFR

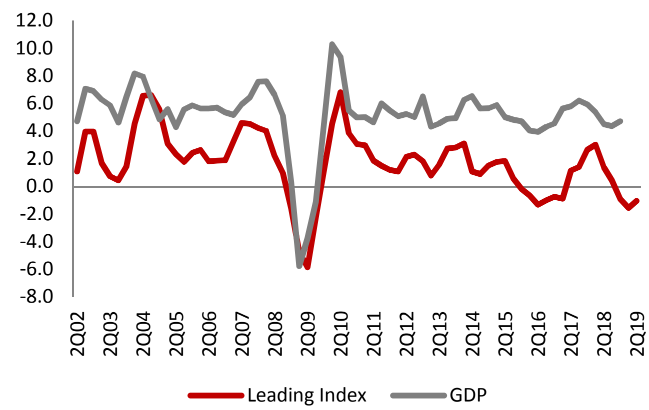
Chart 2: GDP vs Private Sector (YoY%)



Source: CEIC, MIDFR

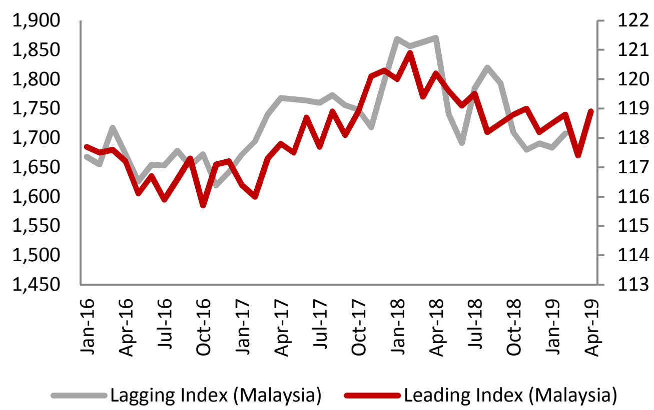
Expecting tepid growth in 1Q19 but modest recovery in 2Q19. Moving into our economic expectations in 2019, based on the latest leading index, we expect tepid economic growth in 1Q19 with slight recovery in 2Q19. The index inched up to a 5-month high at 118.9 in Feb-19. Weak growth in 1Q19 was mainly due uncertainties over the trade negotiation between the US and China. This was in tandem with the pessimistic trend reflected by the Nikkei Manufacturing PMI for Malaysia, registering below 50 points for five consecutive months since Oct-18. However, we foresee a steady recovery towards 2Q19 and also 2H19 amid gradual pick-up in commodity prices, strong domestic demand and receding trade war effects. Brent crude oil price have improved steadily since Jan-19 at an average of $60.50pbd and latest in Mar-19 at $66.70. Global demand is expected to recover particularly if the US and China eventually strike a trade deal. On local front, full-employment condition and shallow inflationary pressure are key supporting factors of the domestic demand. In addition, further announcements on government-related infrastructure projects would engender positive sentiments aiding to the economic growth.

Chart 3: GDP Growth vs Leading Index (YoY%)



Source: CEIC, MIDFR

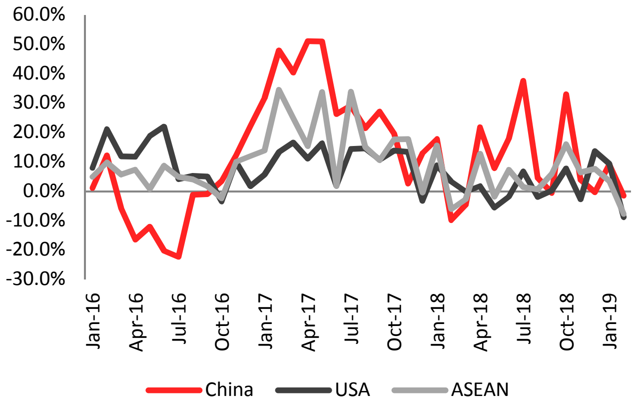
Chart 4: KLCI vs Leading Index



Source: CEIC, MIDFR

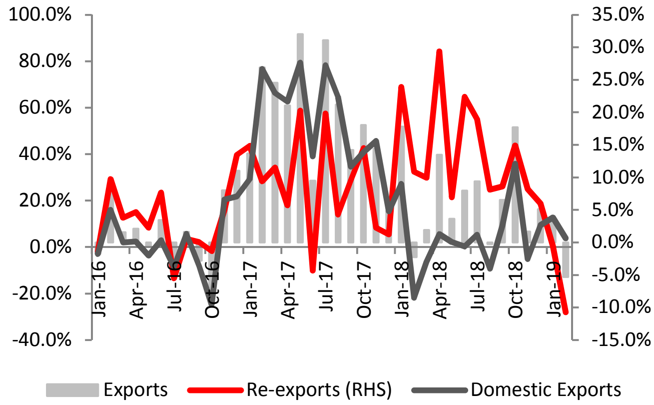
CNY holidays affected trade performances. Exports dropped 5.3%yoy in Feb-19, the lowest in more than 2 years primarily due to a short calendar month on top of long Chinese New Year (CNY) holidays. Meanwhile, imports fell more than exports at 9.4%yoy. During this holiday, all Chinese factories were shut down with most of them closed one or two weeks prior to the festive holidays. As the celebration put a halt to mass production, it disrupted global supply chain resulting in a weak trade performance. All sectors recorded a negative exports growth: agriculture (-13.7%yoy), manufacturing (-4.3%yoy) and mining (-5.5%yoy). Despite the poor exports and imports figures, trade surplus maintain above RM11b in Feb-19. On a monthly basis, both exports and imports contracted by 22% and 24.8% respectively. On a side note, risks resulting from US-China trade spat to the global economy remain as the duo have yet to sign any agreement.

Chart 5: Exports Growth (YoY%) by Major Destination



Source: CEIC, MIDFR

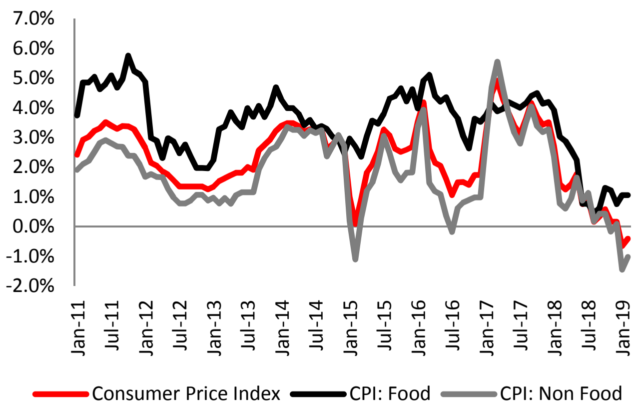
Chart 6: Total Exports: Domestic vs Re-exports (YoY%)



Source: CEIC, MIDFR

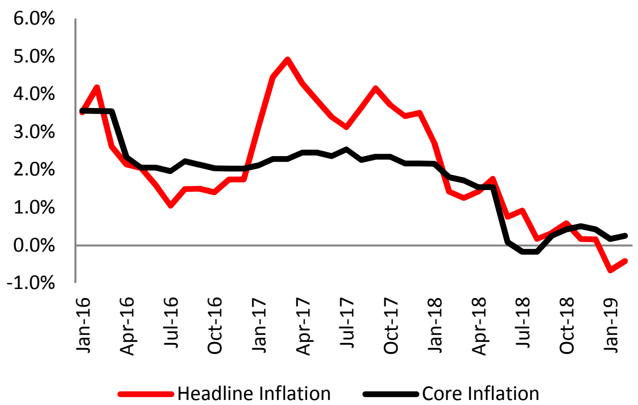
Deflation due to cost factors rather than demand. Consumer price index contracted -0.4%yoy in the second month of 2019 continuing the deflationary trend. The deflationary pressure came mainly from the transport component. Transport prices continued to drop by -6.8%yoy in Feb-19, registering four-consecutive months of negative growth. In contrast, food inflation which accounts for 29.5% of the CPI weights remains on positive growth, at 1%yoy in Feb-19. Malaysia is a net importer of food. Based on latest data, Malaysia recorded RM1.3b trade deficit for food in Feb-19. Imports of food grew stronger than exports, 6.2%yoy against 3.3%yoy during the month. Henceforth, the widening gap indirectly affects food inflation to stay at high-side and expected to be the key driver of overall inflation in 2019. Meanwhile, core inflation improved marginally by 0.3%yoy. Looking ahead, we believe that Malaysia's consumer inflation is likely to stay low following the lower capped prices of RON95 and Diesel at RM2.08 and RM2.18 per litre. Nevertheless, demand-push factor remains firm amid stable job market and steady wage growth.

Chart 7: CPI: Headline vs Food & Non-food (YoY%)



Source: CEIC, MIDFR

Chart 8: CPI: Headline vs Core (YoY%)

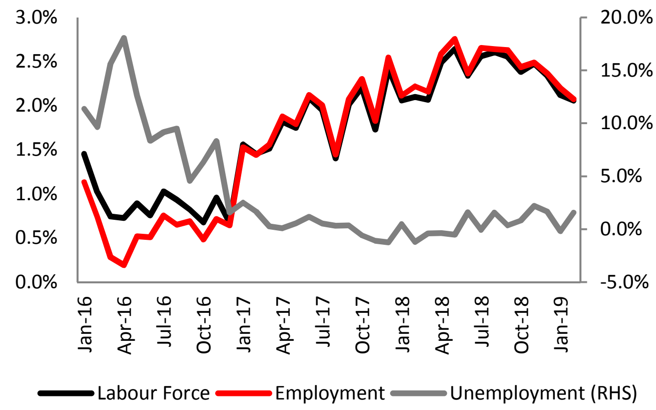


Source: CEIC, MIDFR

Labour market remains strong. Labour force growth was maintained at 2.1%yoy in Feb-19. Employment growth inched down to 2.1%yoy while jobs added in the economy recorded at 34.0k. Meanwhile, the number of unemployed increased 1.6%yoy. Nevertheless, growth in both labour force and employment continue to outpace unemployment growth for the last 24 months since Mar-17. Total job vacancies in Jan-19 recorded at 106.8k which is higher than the prior month and above 2018's average of 91.3K. Nevertheless, Malaysia's job vacancies are mainly dominated by low-skilled type of jobs. For instance, 72.0% of job vacancies in Jan-19 were for elementary occupation and 15.3% for operators while the remaining 12.7% for medium and high-skilled jobs.

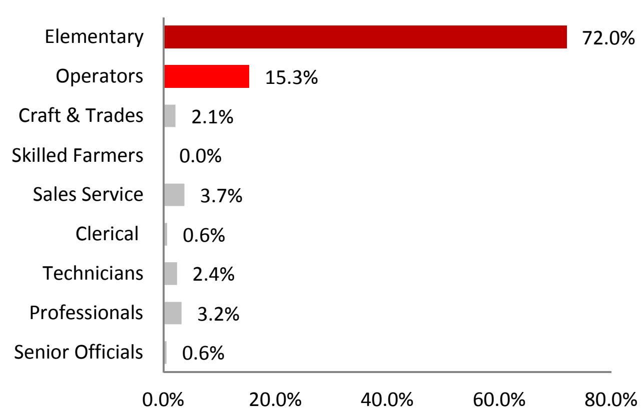
Taking the context as a whole, job market remains stable and reflects healthy development of Malaysia's economy and provides solid support to domestic demand.

Chart 9: Labour Market Key Indicators (YoY%)



Source: CEIC, MIDFR

Chart 10: Share of Job Vacancies by Type (%) in Jan-19



Source: CEIC, MIDFR

OPR to stay at 3.25% in 2019. While the macroeconomic indicators are showing moderating signs especially at the global front, we expect Malaysia's GDP growth to remain solid this year. We had observed a slowdown in external trade, industrial production and manufacturing sales performances in 2018 as compared to 2017. The moderating external trend is anticipated to continue into 2019. Nevertheless, our optimism of Malaysia's GDP are buoyed by robust domestic spending, continuous pick-up in commodity prices and stable labour market. We reiterate our 2019 forecast of GDP growth at 4.9%. Based on our expectations that major macroeconomic indicators to remain stable, we opine that a change in monetary stance is not required at this juncture. This is to ensure that there would be no adverse impact that could affect the trajectory of Malaysia's domestic growth. Furthermore, the US has indicated that it will hold interest rates at current level for the rest of 2019. Since there will be less pressure from both domestic and external fronts, we anticipate that Bank Negara will maintain the OPR at 3.25% in 2019.

Hypothetical scenario; OPR cut if GDP growth below 4%. We opine that BNM will only consider for a rate cut if the GDP growth hit below 4%yoy. The last time BNM cut the key interest rate was in July-16, the fourth MPC meeting of 2016. Prior to that, the central bank lowered the benchmark rate in Feb-09 in response to the 2008/09 global financial crisis. The 2016's cut was due to increasing downside risks on the external front which weighed on growth. Then, the economy grew by 4.1%yoy in 1Q16, moderated sharply from 4.7%yoy in the previous quarter which prompted a rate cut. In that quarter, trade surplus was recorded at RM23.9b (4Q15: RM30.6B). In comparison, based on the latest data, GDP growth and trade surplus in 4Q18 have been recorded at 4.7%yoy and RM34.8b respectively.

OPR cut might cause Ringgit's depreciation. As of Mar-19, Ringgit averaged at RM4.09, higher than 2018's average of RM4.03. Lower interest rates tend to be unattractive for foreign investment, reducing the demand for and relative value of the currency. Given that other factors determining the value of Ringgit such as political and policy stability are still in a flux, we believe that trimming the rate might not be the right move at this juncture as it will result in further depreciation of Ringgit.

Current Ringgit's depreciation is temporary. The warning of excluding Malaysia from the World Government Bond Index (WGBI) would only affect the Ringgit and financial market temporarily. We opine the Ringgit to rebound underpin by solid macroeconomic fundamental, sanguine global demand and steady pick-up in commodity prices. In addition, we believe the government will fulfil the WGBI eligibility criteria in order to avoid risks of capital flight and further Ringgit depreciation.

IMPACT TO THE BANKING SECTOR

Scenario 1: Base Case

No change to the banking sector's POSITIVE outlook. As we do not foresee any OPR cut this year, we opine that the outlook for the banking sector remains positive at this juncture. We continue to be cautiously optimistic of the sector to continue its solid performance in 2019. We believe that the banking sector will be able to maintain its earnings potential. This is premised upon our expectations of (i) continued loans growth, (ii) less pressure on net interest margin (NIM) compression, (iii) downtrend in cost, and (iv) solid asset quality leading to stable credit cost.

Loans growth will continue to be robust with moderation due to high base effect. We expect a slight deceleration in loans growth for 2019, to +4.7%yoy. However, this will not be due to any significant shift in loans demand but due to the high base effect. We opine that the major contributor for loans growth will still be the mortgage segment. We believe that loans for the purpose of purchasing residential homes will come in circa +7.5%yoy higher as at end 2019. We observed that affordable home ownership is still very much in demand. We also believe that business loans will remain solid especially in the SME segment. According to Bank Negara Malaysia 2018 Annual Report, loans disbursed to SMEs made up 38.6% of total business loans disbursed in 2018, up from the 2013 to 2017 average of 37.3%.

With status quo remains, pressure on NIM compression should ease. The banking sector saw NIM compression in 2H18 that stemmed from deposits competition as a result of expectations of the implementation of Net Stable Funding Ratio (NSFR) requirement in 2019. This compression was moderated by the OPR hike in the early parts of 2018 but the boost soon normalized. However, the NSFR implementation has been moved to 2020. As a majority of banks have met this requirement, we do not expect a repeat of the intensity of the deposit competition as there will be no pressing need.

Scenario 2: OPR cut

Margin compression in the short term. While there will be no OPR cut in our base case, we have estimated the potential impact of a hypothetical situation of an OPR cut. Where we observed the OPR hike providing a short term boost to NIM last year, there will be a reverse in the event of an OPR cut. This is due to the fact that there will be a near-immediate downward adjustment to loans and financing which has a floating rate. The floating rate loans, on average, contributed circa 78.3% of total loans book of banks under our coverage as at end 2018. We note that previous OPR cut had translated into a decrease of -12bps in Base Lending Rate the following month.

However, NIM will eventually normalise. While NIM will be impacted by the lower lending rate, it the case of an OPR cut, we expect it will normalise within 2 to 3 quarters. This is due to the fact that cost of fund will also decrease, in particular adjustment to the fixed deposit rates which had been contracted before the OPR cut. Also, based on market conditions, banks may not fully translate the full quantum of the OPR cut to borrowers and savers.

Table 1: Banks' Percentage of Floating Rate Loans & Casa Ratio as at end Dec-18

Banks	Percentage of floating rate loans	CASA ratio
Maybank	71.6%	35.1%
Public	77.6%	26.4%

Banks	Percentage of floating rate loans	CASA ratio
CIMB	84.1%	33.4%
Hong Leong Bank	80.7%	24.8%
RHB	85.7%	25.9%
AMMB	74.3%	20.7%
BIMB	91.0%	30.4%
Alliance Bank	89.9%	38.1%
Affin	67.2%	17.6%
Average	*78.3%*	*30.0%*

Source: Company, MIDFR

Banks with higher floating rate loans will be impacted the most. We opine that with a short term pressure to NIM, earnings for banks will be negatively affected. Assuming an OPR cut at the start of a financial year, we estimate an average of -3.0% decline to the earnings of banks under our coverage when compared against our previous forecast. We expect banks with higher floating rate loans to be impacted the most. As such, we believe that **BIMB Holdings Bhd (BUY, TP: RM4.85)** and **Alliance Bank Malaysia Bhd (BUY, TP: RM4.75)** will see a higher drag to its earnings as its floating rate loans comprised 91.0% and 89.9% of its loans book respectively. Meanwhile, we expect less muted impact for **Maybank (BUY, TP: RM11.40)** due to more geographically diversified loan exposures and **Affin Bank (BUY, TP: RM2.70)** due to less exposure in floating rate loans.

Table 2: Estimated Impact of Hypothetical OPR Cut on FY19/20 Earnings Forecast of Banks

Banks	FY19/FY20 Net Profit forecast Pre-Hypothetical OPR cut (RM m)	FY19/FY20 Net Profit forecast Post- Hypothetical OPR cut (RM m)	Change
Maybank	8,591	8,377	-2.5%
Public	5,701	5,564	-2.4%
CIMB	4,991	4,822	-3.4%
Hong Leong Bank*	2,927	2,819	-3.7%
RHB	2,500	2,399	-4.1%
AMMB*	1,401	1,360	-2.9%
BIMB	687	659	-4.1%
Alliance Bank*	609	575	-5.6%
Affin	559	549	-1.8%

* denotes impact on FY20 earnings of banks as FYs of these banks end on Mar/June. For the rest, the impact will be on FY19 earnings

Source: MIDFR

Potential booster for loans growth. One of the possible upside from any OPR cut will be a boost to loans growth due to higher loans demand. This could be due to borrowers taking advantage of the better rates. However, we do not believe that the steep upswing in loans demand as loan affordability will continue to be a determinant.

Manoeuvring a potential OPR cut. While our analysis of an OPR cut is based on a hypothetical situation, we believe that there are still room for an investor to manoeuvre to moderate its impact. We believe that investors could consider banks with low exposure in floating rate in its loans book, have a geographically diversified loans book and offer solid dividend yield. Applying these criteria, we opine that Maybank is a good candidate. We have a **BUY** call with **TP of RM11.40** for **Maybank**.

Back to the base case

Maintain POSITIVE. We reiterate our cautious optimism for the banking sector this year. As we mentioned, we believe that banks will be able to continue its earnings momentum at current juncture despite the pressure on margin. This is due to continued loans growth. Meanwhile, stable asset quality will contain banks' provision levels. With the recent sell-off on banking stocks, we view that most banks under our coverage are currently undervalued. As we do not expect any change in the fundamental of the banking sector, we opine that the current price levels of banking stocks present a good opportunity to investors. Hence, we reiterate our POSITIVE view on the sector. Given the current market conditions, our top picks for this sector are **Maybank (BUY, TP: RM11.40)**, **CIMB (BUY, TP: RM7.55)** and **Public Bank (BUY, TP: RM27.15)**.

Table 3: Peer Comparison For Malaysian Banking Stocks

	Rec.	Price @ 17/4 (RM)	TP (RM)	EPS (sen)		PER (x)		Net DPS (sen)		Net Div Yield (%)		BV (RM)		PBV (x)	
				18	19	18	19	18	19	18	19	18	19	18	19
Maybank	BUY	9.00	11.40	75.9	76.2	11.9	11.8	59.0	59.0	6.6	6.6	7.1	7.3	1.3	1.2
Public Bank	BUY	22.60	27.15	147.6	151.0	15.3	15.0	72.0	73.0	3.2	3.2	11.2	12.0	2.0	1.9
CIMB	BUY	5.05	7.55	50.0	49.0	10.1	10.3	26.0	25.0	5.1	5.0	5.6	5.7	0.9	0.9
RHB Bank	BUY	5.79	6.10	62.4	67.7	9.3	8.6	20.0	20.0	3.5	3.5	6.3	6.5	0.9	0.9
Hong Leong	NEUTRAL	20.00	20.30	135.8	143.1	14.7	14.0	49.0	50.0	2.5	2.5	12.5	13.4	1.6	1.5
AMMB	NEUTRAL	4.44	4.50	45.4	46.6	9.8	9.5	18.0	18.0	4.1	4.1	5.6	5.8	0.8	0.8
Affin	BUY	2.18	2.70	29.0	29.0	7.5	7.5	5.0	7.0	2.3	3.2	4.7	4.9	0.5	0.4
Alliance	BUY	4.00	4.75	37.0	39.8	10.8	10.1	17.0	18.5	3.7	4.4	3.6	3.7	1.1	1.1
BIMB	BUY	4.51	4.85	42.0	42.3	10.7	10.7	16.0	18.0	3.5	4.0	3.2	3.5	1.4	1.3
Average				**69.5**	**71.6**	**11.1**	**10.8**	**31.3**	**32.1**	**3.8**	**4.0**	**6.6**	**7.0**	**1.2**	**1.1**

DISCLOSURES AND DISCLAIMER

MIDF AMANAH INVESTMENT BANK : GUIDE TO RECOMMENDATIONS	
STOCK RECOMMENDATIONS	
BUY	Total return is expected to be >10% over the next 12 months.
TRADING BUY	Stock price is expected to *rise* by >10% within 3-months after a Trading Buy rating has been assigned due to positive newsflow.
NEUTRAL	Total return is expected to be between -10% and +15% over the next 12 months.
SELL	Total return is expected to be <-10% over the next 12 months.
TRADING SELL	Stock price is expected to *fall* by >10% within 3-months after a Trading Sell rating has been assigned due to negative newsflow.
SECTOR RECOMMENDATIONS	
POSITIVE	The sector is expected to outperform the overall market over the next 12 months.
NEUTRAL	The sector is to perform in line with the overall market over the next 12 months.
NEGATIVE	The sector is expected to underperform the overall market over the next 12 months.