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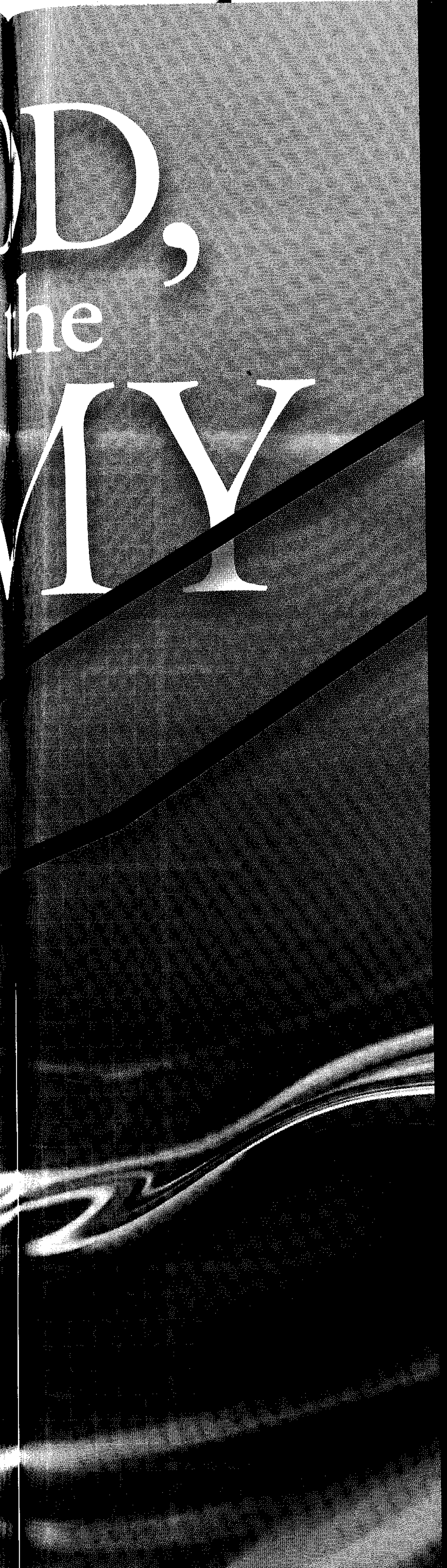
BESIEGED BY RISING COMMODITY PRICES, INTEREST RATES, INFLATION AND THE PROSPECTS OF A STRONGER RINGGIT, HOW WILL THE DIFFERENT STOCKS AND SECTORS FARE IN THE COMING MONTHS? DESPITE THE APPARENT PESSIMISTIC OUTLOOK, THERE ARE SOME BRIGHT SPOTS AND WINNERS TO LOOK OUT FOR.



BY JAMES S

'EVERYTHING seems to be going up but not disposable income and the stock market.' That is the lament being echoed from market players and the man-in-the-street nowadays.

The reasons are not difficult to fathom as interest rates and the prices of many goods and services continue to rise with no corresponding increase in salaries and wages.

But not everybody is suffering. If you are into commodities like base and precious metals, crude oil and soft commodities including crude palm oil (CPO) and rubber, you will be laughing all the way to the bank. These commodities have been enjoying their respective 'bull runs' for some time now.

It's also good news for the government as the record oil prices bring a windfall to national oil corporation Petroliam Nasional Bhd (Petronas)'s coffers – though it puts a strain on the consumers.

High crude oil prices wiping out subsidy savings

By guaranteeing no further rise in retail price of petrol and diesel until 2007, the government has committed itself to absorbing all further increases in the product cost of petrol, through the payment of subsidies to producers and retailers.

The problem is that the guarantee, made in February 2006 after the government raised fuel pump prices by cutting subsidies – a move it said would save it some RM4.4 billion – came at a time when crude oil prices were around US$61 a barrel.

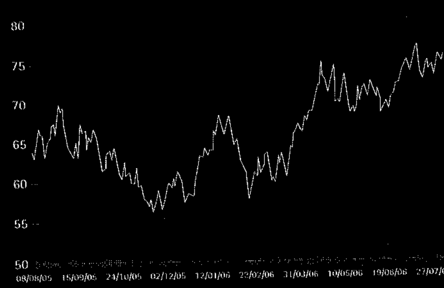
Currently, spurred by geopolitical uncertainties in Iran, North Korea and the Middle East hostilities, they are at an all-time high of US$78 a barrel *(see Chart 1)*, an increase of almost 30%.

According to a report by AmResearch Sdn Bhd, this means not only are the earlier 'savings' in subsidies of RM4.4 billion effectively wiped out but worse, the government may have to fork out more subsidies (additional RM3-4 billion) to keep the retail prices of petrol and diesel at current levels, cutting into its expenditure budget.

These additional subsidies could jeopardise the ability of the government to reduce its currently projected budget deficit of 3% of Gross Domestic Product (GDP) for 2006, it adds.

price performance chart

CHART 1: One-Year Light Crude Oil Futures Price Movement



Source: Bloomberg

Nonetheless, it's not all doom and gloom. According to OSK Research, record-high crude oil prices should translate into record-high earnings for Petronas as Malaysia is still a net exporter of crude oil.

As such, Petronas can pay high dividends to the government, boosting its revenue and ability to finance a more expansionary budget without undermining efforts to reduce the fiscal deficit.

In its end-March 2006 full-year results, Petronas reported revenue and net profit rising 21.8% and 22.6% to a record RM166.89 billion and RM43.59 billion respectively (compared with RM137.05 billion and RM35.6 billion respectively a year earlier).

Petronas said it sold Malaysian crude oil at an average US$61.60 a barrel in the latest fiscal year, up 37% from a year ago.

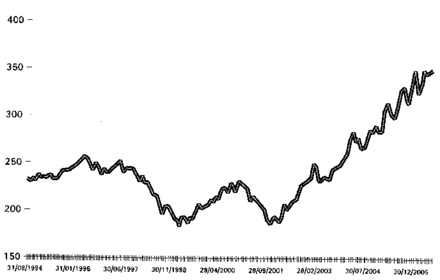
Chart 2 shows that most commodities are now at their multi-year highs as per the Reuters/Jefferies CRB Futures Price Index.

So who is not smiling? In that unhappy category would be property developers, retailers, and car manufacturers and dealers. The earlier reduction in petrol subsidy by the government and the rise in interest rates have helped to kick up domestic inflation and reduce disposable income of the masses.

Still, most analysts feel much would hinge on the oil prices, which would eventually determine the direction of any economy. Says Tan Teng Boo, managing director of Capital Dynamics Asset Management Sdn Bhd, 'Whether it is interest rate or GDP growth or the Middle East crisis, the impact on the economy is being felt through rising oil prices.'

price performance chart

CHART 2: Twelve-Year Reuters/Jefferies CRB Futures Price Index



Source: Bloombreg

Table 1: Average Selling Price of Gloves vs Latex

	FY03	FY04	FY05	FY06f	% increase (FY03-FY06)
Average selling price per 1,000 pcs (USD)	14.00	16.00	17.00	20.00	42.9%
Average latex price (RM/kg)	2.80	3.30	4.30	5.50	96.4%
% of latex cost able to pass down	42.9%/(96.4% x 0.55)				80.8%

According to most glove manufacturers, latex price is expected to average around RM5.50 for FY06

Source: OSK Research

Lee Heng Guie, economist at CIMB Group, says another worrying trend is the economies of the United States and China. 'Any hiccups in the US economy would have a dampening effect on Malaysia's exports of electronics. Regionally, a severe slowdown of the Chinese economy could act as a drag on intra-regional trade.'

Let us look at the impact of the higher prices of commodities such as sugar, steel and rubber, and the rising interest rates, on the Malaysian economy and its various sectors and stocks.

SECTORS LIKELY TO BE HIT BY RISING COMMODITY PRICES

Sweet turns sour

The rising price of raw sugar will impact the refining margin of sugar refineries owned by companies like Malayan Sugar Manufacturing Company Bhd and Kilang Gula Felda Perlis Sdn Bhd (respectively the subsidiary and 50% associate company of PPB Group) and Central Sugars Refinery Sdn Bhd (a fully owned subsidiary of Tradewinds (M) Bhd).

This is because the local retail selling price of refined or processed sugar is controlled and capped by the government. The price of refined or processed sugar in the domestic market is now RM1.20 per kg compared with the price of raw sugar of around RM1.36 per kg (using an exchange rate of US$1 = RM3.65).

Fortunately, the margin squeeze in a way has been mitigated by (i) discounts on bulk purchases by the Malaysian Government from raw sugar-exporting countries, (ii) forward purchase contracts at lower-than-current market prices (although future forward contracts will be more expensive if the current upward price trend continues), and (iii) the strengthening ringgit.

The bounce in rubber

As for the rising price of processed rubber (due to rising latex prices), it will impact the profit margin of rubber-glove manufacturers such as Top Glove Corporation, Supermax Corporation, APL Industries, Seal Polymer and Kossan Rubber Industries.

AmResearch says latex cost makes up about half the total production cost of rubber glove manufacturers. Rising latex prices have meant a 2%-5% increase in the cost of production of these players.

However, OSK Research in its report on the sector says the premium glove-makers should be able to pass down the increase in latex price to their customers. The research house says that for every 10% increase in latex price, the glove-makers should be able to adjust at least a 5% rise in their selling price to negate the impact.

According to OSK Research, the average selling price of latex examination gloves of Top Glove, Supermax and Kossan has already risen from US$14-US$15 per 1,000 pieces in 2003 to the current US$20-US$22, representing a 43% increase.

Table 1 shows that glove manufacturers have been able to pass down about 80% of the increase in their latex raw material prices to customers.

OSK Research expects latex prices to ease in the short term as the winter season of rubber tree is over and this will increase latex supply to the market. In addition, most industry players expect the rising rubber prices to ease next year as there is no acute shortage in the supply of natural rubber.

The recent hike in latex price has been fuelled by (i) increased demand for tyres from China, which currently accounts for 20% of the global consumption, and more importantly (ii) high crude oil prices.

Luckily, as mentioned earlier, local glove-makers have strong pricing power due to strong demand as a result of stringent regulations in medical standards for rubber gloves, and the fact that Malaysian companies control around 55% of the world market.

Consequently, the rising trend in rubber prices is still bearable for the industry thus far.

Metal shines but not all glitter

Analysts say higher gold prices are expected to adversely affect sales of gold retailers such as DeGem and Poh Kong Holdings. Although these companies usually sell their gold jewellery products according to prevailing market prices of gold, their sales would be affected by lower consumption amidst an increasingly competitive environment.

In the case of Poh Kong, for example, gold jewellery is the dominant contributor to its total revenue.

As for the higher base metal prices, higher aluminium and copper prices would affect companies like OYL Industries as these metals are used in the manufacture of copper pipes and aluminium casings used in the manufacture of air-conditioners.

Raw materials (aluminium, copper and steel) make up approximately 80% of the total cost of goods sold of OYL. Thus, any increase in such metal materials is likely to affect the company's gross profit margins.

An analyst who tracks the stock says OYL normally would not be able to fully pass on the cost increases to its customers as selling prices in the industry are usually fixed, and also because of the very competitive nature of the industry.

Even if they are able to do so, there would be a time lag and margins would still be squeezed in the interim period. The problem would get more severe if raw material costs keep going up without any respite (as is the case now).

Another company that would be adversely affected by higher aluminium prices is Aluminium Company of Malaysia (Alcom), which produces, among other things, aluminium finstock for air-conditioner manufacturers.

OBVIOUS WINNERS OF RISING COMMODITY PRICES

Amidst the downside of the rising commodity prices, there are also winners, such as the plantation players (especially oil palm planters), oil and gas companies, and steel producers.

For those planters with some rubber-planted areas, such as Kuala Lumpur Kepong, Golden Hope Plantations and Kumpulan Guthrie, they should also

Selective Winners and Losers in the Rising Trend of Commody Prices, Interest Rate & Currency

Commodity/Interest Rate/Currency	Affected sectors	Winners	Mixed	Losers
Sugar	Sugar Refineries	-	-	PPB Group & Tradewinds (Malaysia)
Rubber/Latex	Glove-makers	-	-	Top Glove Corporation, Supermax Corporation, APL Industries, Seal Polymer & Kossan Rubber Industries
Metals (Precious & Base)	Gold Retailers, Manufactures & Steel Sector	Choo Bee Metal Industries, Hiap Teck Venture, Tong Herr Resources, Prestar Resources & YLI Holdings	-	DeGem & Poh Kong Holdings; OYL Industries & Aluminium Company of Malaysia
Crude Oil	Oil & Gas Sector	KNM, Dialog, Samudra, Tanjung Offshore, Perisai & Petronas Gas	-	-
Crude Palm Oil	Plantation Sector	IOI Corporation, Asiatic Development & IJM Plantations	-	-
Interest Rate	Broad-based Economy & Equity Market	-	Banking & Insurance Sectors; Media Sector	Automobiles Sector, Consumer Sector; Building Materials, Construction & Property Sectors; Power & Telco Sectors
Ringgit	Broad-based Economy & Equity Market	Equity Market; Selective companies such as Tenaga, Telekom, AMMB Holdings, Hong Leong Bank, Maybank, RHB Capital, Star Publications, Sin Chew, Tan Chong Motor & Guinness Anchor		Glove Makers; Semiconductor Companies; Plantation Players; Contractors; Conglomerates; Shipping Companies; Airline Operators; Oil & Gas Sector

benefit marginally from the current high rubber prices.

Oil & Gas Sector

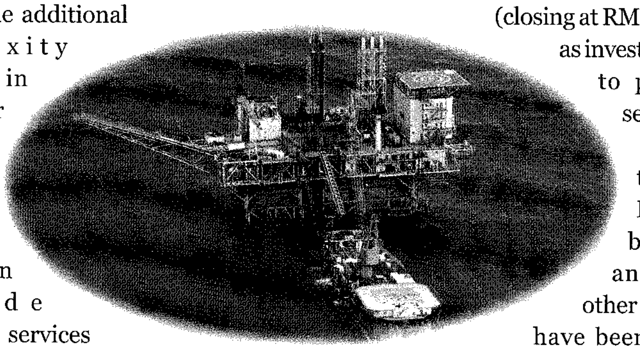
Apart from the impact of the Middle East tension and the threat to oil supply due to hurricane and other weather-related causes, OSK Research believes there would still be enough oil to supply the growing demand in the long run.

The research house expects a slew of contracts to be announced towards the 3Q and 4Q of 2006 after the Northern Hemisphere summer season.

As an indication, the exploration and production (E&P) spending for Malaysian waters has been steadily increasing over the years, demonstrating that more effort and money is being poured into the O&G sector, especially with prices being what they are, hovering around US$75 a barrel.

More interestingly, the proportion spent by foreign production sharing contractors (PSC) saw a jump as spending shifted more to deepwater fields. It is expected Petronas will take a backseat in the development of the deepwater fields, which will be spearheaded by overseas majors and independents such as Shell and Murphy.

Given the additional complexity involved in deepwater drilling, local oil and gas players which can provide supporting services to this area can expect to benefit from higher sales and margins.



Another point to note, according to OSK Research, is that the number of new exploration wells drilled has also been increasing over the last few years. As such, demand for drilling fluids and services to support developmental drilling should also continue rising.

With an expected 15-20 new drilling rigs in Malaysian waters over the next five years at a cost of US$200,000 per day for each rig, the rigs alone should require some RM4 billion of spending.

Add on an expected 65-70 new platforms, the larger of which can cost US$400 million and would require at least one marine support vessel each, it should be clear that O&G companies, as long as they maintain their costs, are in for a great time in the next four years at the least.

Meanwhile, for the downstream sector, after being quiet since 2002 when a number of foreign direct investments (FDI) shifted to China, a boom has now returned to Malaysia and Singapore with a number of large petroleum refineries or petrochemical projects being announced in the sector recently.

This will help the service providers that provide services or process equipment to these plants. With all these plus points, OSK Research is positive on the service-related companies in the sector, namely KNM, Dialog, Samudra, Tanjung Offshore, Perisai and Petronas Gas.

Plantation Sector

It is shiny days again for the sector, with the three-month benchmark CPO futures prices hitting a two-year high on Aug 2, closing at RM1,641 per tonne and spurring a run on plantation stocks on the local bourse.

Even laggard stocks such as Kulim (M) recently jumped to a nine-year high (closing at RM4.18 on Aug 3) as investors latched on to plays in the sector.

According to OSK Research, the biodiesel factor and rallies in other commodities have been supporting palm oil prices. Soyoil prices have risen to their highest level in a year at an equivalent of RM2,185 per tonne. In US dollar terms, soyoil's premium over palm oil is now at US$201.88, its highest since July 2004. Hence, the research house reckons that the rise in soyoil prices will spill over to palm oil as the huge premium will create a substitution effect.

As with CPO, the main cause of the surge in soyoil prices is also probably the demand for its conversion to biodiesel. The US currently has biodiesel capacity amounting to 1.283 million tonnes per annum and more are being constructed.

As such, with a similar situation developing in Malaysia, CPO prices should see further upside when biodiesel plants under construction come onstream in the next one to two years. According to an industry player, record-level crude oil prices will continue to limit any downside for CPO prices for now as high crude oil prices will encourage the use of biofuels.

OSK Research believes the up-cycle in CPO prices should last well into 2H2007. Although palm oil prices have lagged the rise in soyoil and rapeseed oil thus far, the research house believes it should make further gains in the months ahead to narrow the discount once inventory levels ease off.

Furthermore, it says, a surge in CPO prices seems inevitable given the upcoming biodiesel plants, which will create additional demand on top of current food usage, and cause a sharp reduction in inventory levels.

Most analysts are bullish on the sector and stocks favoured include IOI Corporation, Asiatic Development and IJM Plantations, although plays are also shifting to the lower and medium liners in the sector.

Steel Sector

According to OSK Research, after a year in the doldrums, the steel sector is set to shine following the recovery of steel prices and a major consolidation within the sector.

Of late, international steel prices have been on an uptrend as a result of re-stocking of steel products worldwide. In May, German, Japanese and South Korean steel millers agreed with iron ore miners for a 19% prices hike in iron ore, sending strong signals of firmer steel prices ahead.

Following the conclusion of Mittal Steel's acquisition of Arcelor, OSK Research also expects more M&A activities within the international steel sector soon. The consolidation of steel giants worldwide should help stabilise steel prices, thus reducing the volatility and profit margins in the industry.

On the domestic front, the research house believes the uptrend in steel prices will remain intact at least for the next two quarters and possibly beyond as well as (i) the domestic steel price is still lagging the international market by one to two quarters, (ii) dumping risk is unlikely as it is expected there will be another cut in export rebate for both long and flat products by the China Government as soon as July 2006, and (iii) demand is gaining momentum due to inventory replenishment and projects under the Ninth Malaysia Plan (9MP).

OSK Research says for the recent reporting season in May 2006, it already saw an impressive turnaround for most local steel companies.

The research house is bullish on the sector and steel companies such as Choo Bee Metal Industries, Hiap Teck Venture and Tong Herr Resources (*see story on 'Dancing with the Rising Prices' on page 16*), with Prestar Resources and YLI Holdings also being touted as good plays.

RISING INTEREST RATES – NO MORE EASY MONEY

Years ago, when the global markets were haunted by deflation worries, central banks of most countries adopted an easy money policy to keep interest rates low. However, this trend has been broken as central banks worldwide led by the US have been aggressively tightening monetary policies due mainly to inflation fears, triggered by rising crude oil and commodity prices.

Bank Negara itself has increased its overnight policy rate (OPR) from 2.70% to 3.50%, although its governor Tan Sri Dr Zeti Akhtar Aziz has conceded that the current inflation is more cost-push than demand-pull.

As opposed to rising commodity prices, rising interest rates have a wider repercussion on the economy. Generally, rising interest rates should have an adverse impact on the equity market. In addition, it would hurt domestic consumption spending. Companies that sell consumer products (both durable and non-durable) would face the prospects of weaker demand from consumers, because of either higher personal borrowing costs (such as mortgages or personal overdrafts) or the fact that consumers are discouraged from spending because of higher savings rates.

According to an AmResearch report, in an environment of rising interest rates, good stock investment choices include companies that have the ability to raise their product prices without worrying too much about its effects on demand. Such stocks could also be perceived as 'defensive stocks' given their ability to weather softer demand better than others.

Theoretically speaking, says the research house, companies command pricing power if they possess one or more of the following four factors:

- demand for their products and/or services is relatively inelastic;
- the company has strong branding power;
- the products or services provided by the company are essential products or services; or
- the company is in a monopolistic or oligopolistic industry structure.

However, in practice, suppliers or providers of essential goods and services, or companies with monopolistic structures, generally find themselves lacking pricing power because of government price control on such goods and services. Examples are the power and water utilities, airlines, postal services, financial services and land transport service providers.

That said, some of these providers of essential services, despite not having the freedom to raise their prices, enjoy inelastic demand. And a number of them, like Malaysia Airports, Malaysian Airline System (MAS), Pos Malaysia and Tenaga Nasional, are expected to get their tariff or price increases from the government in 2006 (as can be seen in the case of MAS and Tenaga recently).

These stocks will be winners in spite of potentially weaker consumer spending. *Chart 3* shows the pricing power of industries in the country.

Chart 3: Pricing Power of Industries In Malaysia

Pricing Power? Yes	No	Neutral
Food & Beverage	Airlines	Banking
Media	Construction	Casino
Tobacco	Insurance	Latex Glove
	Logistics	Motor
	Numbers Forecast	
	Pharmaceutical	
	Plantations	
	Power	
	Property	
	Retail	
	Shipping	
	Steel Products	
	Telecommunication	

Source: AmResearch

A CLOSER LOOK AT MAJOR SECTORS IN A RISING INTEREST RATE ENVIRONMENT

Automotive Sector

Most analysts agree it is very unlikely any single car manufacturer would have an advantage on pricing. Most companies maintain competitive pricing to maintain market share. Margins have also generally been squeezed by exchange rate volatility, high advertising & promotion costs and high raw material prices.

Nonetheless, AmResearch reckons that preferred and premium brands such as Honda, Toyota, Mercedes Benz and BMW might be able to maintain or even see a hike in their prices.

Even then, it would not be across-the-board but confined to the higher-end models (such as Toyota Camry and Honda Accord) and not the high-volume or mass-market models such as Toyota Vios, Toyota Avanza and the Honda City.

In its view, stocks that carry or distribute marques with branding power are Sime Darby (BMW), Cycle & Carriage Bintang and Hap Seng Consolidated (Mercedes Benz), Oriental Holdings and DRB-Hicom (Honda) and UMW Holdings (Toyota).

Banking Sector

Although banks in Malaysia tend to behave like a cartel – as evidenced by the recent almost uniform move by every commercial bank to raise their base lending rates (BLR) to 6.75%, which theoretically should be positive for their interest margin – the truth is that there is a lot of intense price competition among banks nowadays, especially since higher interest rates will cap consumer spending and hence loans growth.

As such, many banks are offering

sub-BLR rates for the first two or three years of a mortgage loan, and hire purchase loans that have effective interest rates lower than the bank's BLR.

And for the banking sector, competition is not just limited to lending rates but also in terms of promotions, particularly for credit cards, where customer acquisition and customer retention expenditures can be fairly costly.

Building Materials & Construction Sector

These sectors generally possess weak pricing power due to intense competition for both domestic and international jobs as well as pricing uncertainties and oversupply situation.

Nonetheless, with the recent announcement of 9MP projects, it seems there is a new optimism on the sector by analysts, with a higher order book potentially mitigating the impact of higher financing costs for the players.

Insurance Sector

Operation-wise, rising interest rates should not have a significant impact on the sector. The key event for general insurers in the country would be the proposed revision in the motor tariff structure.

If approved by Bank Negara, the new structure will have an overall positive impact on motor premiums earned by insurance companies. It is widely expected a new tariff structure will result in a net increase of between 10%-20% in overall motor premiums.

However, the waiting period has been long and there is still no word on the timeline for approval or announcement from Bank Negara. In any case, higher interest rates could still benefit insurance companies in the form of higher interest income for their investment portfolio. Note that most general insurers are heavily invested in short-term investment instruments.

Media Sector

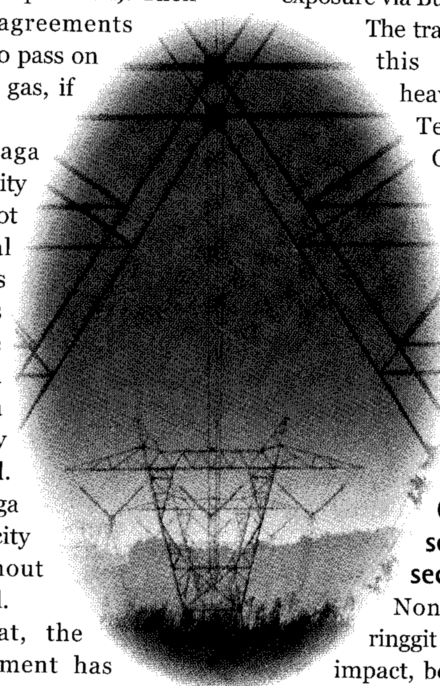
The sector is likely to be resilient as it fills a basic need. The only impact on media companies is most probably their financing cost. According to AmResearch, Star Publications, which owns the nation's leading English daily *The Star*, has a certain degree of pricing power in terms of advertising rates, due to its commanding position of 70% of the total English newspaper advertisement (adex) pie. This is due to its high readership of around 1.1 million, compared with *New Straits Times'* 318,000 and *The Sun's* 194,000.

Comparatively, Sin Chew Media Corporation is said to have less pricing power among the Chinese dailies as competition is more rife in the Chinese segment and the number two player in the segment, China Press, is also a lot stronger (unlike the English segment where *NST* is a distant second).

For the electronic broadcasting (television) segment, analysts say Media Prima also has a certain degree of pricing power given its monopoly of the private free-to-air TV station segment with its recent acquisition of the ntv7 group.

Power Sector

The companies that have pricing power in this sector are Malakoff and YTL Power (and hence, YTL Corporation). Their power purchase agreements (PPA) allow them to pass on the higher price of gas, if any.



While Tenaga monopolises electricity supply, this does not mean the national power utility has pricing power, says AmResearch. On the contrary, one could argue that Tenaga does not have any pricing power at all. This is because Tenaga cannot raise electricity tariffs without government approval.

Having said that, the Malaysian Government has recently allowed Tenaga to increase its electricity tariffs, and is also considering amending the PPAs to be more in favour of Tenaga.

The change in fortune of Tenaga has led to many analysts being bullish on the stock, at the expense of the PPA players like Malakoff and YTL Power.

Telecommunications Sector

Perhaps more than any other sector, this is one sector that is currently besieged by an intense price war. Previously, the price war was confined to the pre-paid segment but has now extended to the post-paid segment as well.

Thus, despite some branding power and being suppliers of what is almost an essential service, telco players definitely lack pricing power to pass on any higher cost to consumers at the moment.

RINGGIT TO THE RESCUE?

Good for the equity market

There is a school of thought that says while rising interest rates should adversely impact the equity market and various business sectors, it could also mean a stronger ringgit, which would attract foreign investment, especially of the equity portfolio kind.

According to CIMB Research, historical trends show that the performance of the Kuala Lumpur Composite Index (KLCI) is correlated with expectations of a ringgit appreciation as foreign funds seek exposure via Bursa Malaysia.

The traditional beneficiaries of this play are the super heavyweights like Tenaga, Telekom and Maybank. Other key gainers, according to CIMB, are Bumiputra-Commerce, Sime Darby and PLUS Expressways, due to their size and liquidity, which provide quick exposure for foreign investors.

Could be bad for selective business sectors?

Nonetheless, a stronger ringgit has various degrees of impact, both good and bad, on different business sectors. CIMB Research says the winners are likely to be companies with high foreign debts such as Tenaga and Telekom and industries that have high import costs such as automotive, media and brewery.

Losers, on the other hand, are (i)

Continues on page 31