ZERO SUM GAME?

Analysts and fund managers say the current high oil prices herald both good and bad news.

By Prathaban V and Gurmeet Kaur

THESE are indeed worrying times. The economic barometer is pointing to a tough period ahead, with the rise in crude oil price causing uncertainty and being a concern for many.

However, it is music to the ears of those in the oil and gas sector. The industry has never been so flush with cash as now. But while companies like national oil company Petronas are raking it in, those in others sectors are reeling from the effects. Some say it will eventually be a zero sum game, where no one really benefits.

The good news is that domestic retail fuel prices are controlled. But how long can the government keep the price pressure at bay?

The rising oil price, mainly due to escalating tensions in the Middle East, has contributed to inflation and uncertainty in a number of economic sectors. All this has resulted in central banks looking to mitigate an anticipated slowdown.

According to the Malaysian Institute of Economic Research (Mier), escalating tensions in the Middle East are making matters worse as oil prices jump to US$78 per barrel.

'Persistently high oil prices have fuelled inflationary pressures in developed countries. To contain the inflationary threat, many central banks have raised interest rates,' it says on its website posting.

'The US Fed raised interest rates again in June 2006, at the expense of slower economic growth in late 2006 and 2007. This will have a dampening effect on the global economy, and Malaysia will not be insulated. Export demand could possibly be affected, leading to a moderation in the growth pace. Growth forecasts of many developed countries have been revised downwards in view of higher energy prices and tighter monetary policy,' Mier adds.

The Malaysian economy has been humming at 5.3% in the first quarter this year. However, inflation seems to have risen to 4.6% in April this year from 3.2% in January. So far, Bank Negara has increased its overnight policy rate twice – in February and April – to 3.5% from 3% in December last year.

Are all these signs that we should be prepared for more difficult times? Already, with the uncertainty in oil prices, cost of doing business is increasing.

Some predict that the rollout of the Ninth Malaysia Plan (9MP) projects would be a key stimulus to economic growth. We ask some analysts and fund managers for their views on the impact of the oil boom on the economy.

Imran Nurginias Ibrahim
Equity economist, MIDF Sisma Securities Sdn Bhd

With rising crude oil prices, what is your outlook on the economy and the stock market?

The rising crude oil price is not expected to directly impact the Malaysian economy as the government had promised earlier it would not revise the domestic fuel prices until next year. On the other hand, indirect impact on companies would potentially come from higher air freight; shipping and logistics charges and this will affect the cost of production.

Concerns over the future direction of the economy are going to keep production volume light in the coming months. Higher oil prices would curb overseas demand for our exports and hence gross domestic product growth.

Foreign demand for electric and electronic products is beginning to slacken. The expected slowdown of the US economy in the second half of this year would affect our exports. But we believe demand from other regions such as Europe and Asia could mitigate any adverse effects.

Given that Malaysia is a net oil exporter, high oil prices translate into stronger government budgetary positions. What remains crucial for Malaysia is the re-investment of petro-dollars into productive areas of the economy so that the oil boon translates into better earnings. Thus, the effective execution of the Ninth Malaysia Plan is vital in supporting overall economic growth via sustained expansion in government consumption.

Although we are concerned about the impact of higher inflation and interest rates on consumer spending and business investment, at the moment we maintain our growth forecast for this year of 5.7%. We believe a prolonged spike in oil prices would throw these forecasts out of tangent. We will review our GDP projection if the situation warrants it.

Crude oil prices are reaching highs of over US$75 a barrel. In your opinion, what is good and bad about the current price boom?

The good news is that it encourages people to conserve a non-renewable fuel. High oil prices are spurring efforts to discover and use alternate energy sources.

Rising oil costs are not necessarily bad news for all parts of the economy. Higher prices will encourage increased investment in the industry. Sustained high oil prices may also help, in the long run, to reduce dependency on crude oil. Nevertheless, in the long term, the crucial issues of demand-supply, speculative positions and geopolitical risks will have to be weighed to ensure more sustainable use of oil as a commodity.

What other factors will influence the direction of the economy?

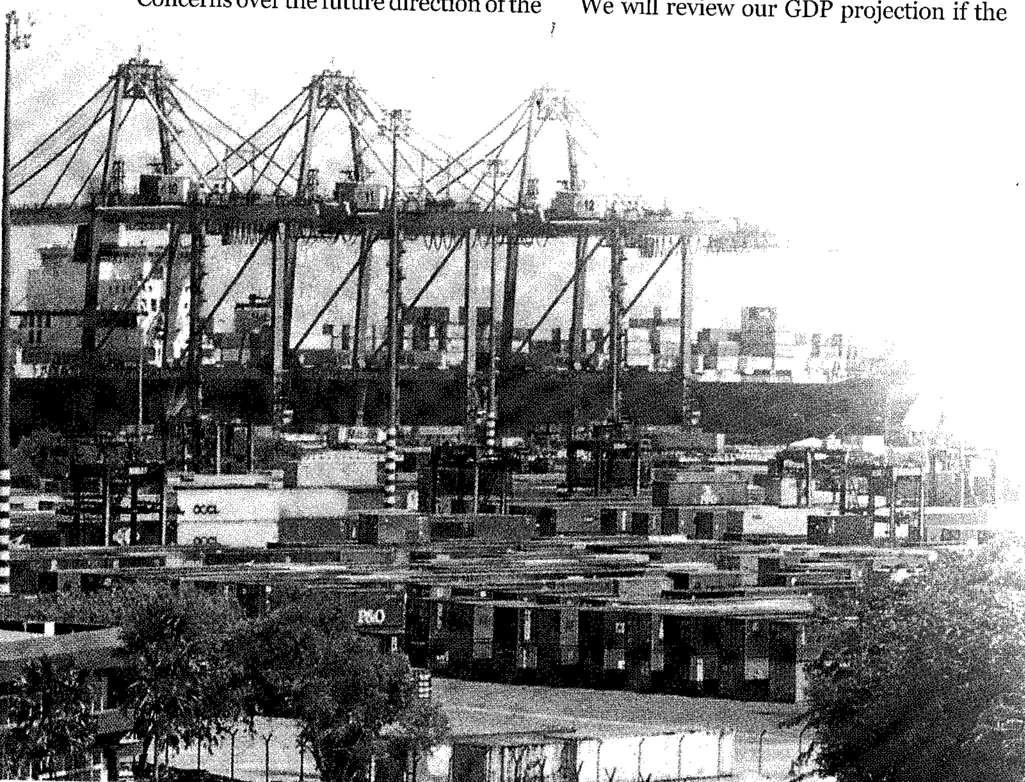
High oil and commodity prices, rising inflation and increase in interest rates remain the issues and challenges in sustaining growth.

Globally, the further escalation of oil prices hinges on the peaceful resolution of the Iran nuclear episode and stabilisation of the situation in Iraq. The Israeli attacks against militants in Lebanon have stoked fears of a wider Middle East conflict and possible oil-supply disruption.

Escalating oil prices and interest rates will have an impact on worldwide demand and dampen global economic growth. The weakening of the dollar and threats of further interest rate hikes to curb inflation could also result in a reduction in US demand, which could affect the global economy.

The challenge indeed is for Bank Negara as well as other central banks to orchestrate a managed slowdown. In doing so, the central banks must ensure that monetary and fiscal policies are rightly adapted to the changes in the economic landscape.

Our government is bullish on growth expectations for the rest of the year. However, as consumers begin to feel the pinch in terms of lower disposable income as a result of higher interest rates and fuel costs, we believe a slowdown is a natural result of the painful, but necessary



measures taken by the government since the start of the year.

Tan Teng Boo
Managing director, ICapital Bhd

With rising crude oil prices, what is your outlook on the economy and the stock market?

The US economy is slowing down. It is feeling the adverse impact of rising oil price and monetary tightening of the last two years. The sector that is feeling the brunt is the housing sector. In short, chances of a US recession in 2007 are rising.

The Malaysian economy may not be badly hurt by the US economy. Rising palm oil and crude oil prices would help to cushion the US slowdown. In addition, by 2007, many of the projects under the Ninth Malaysia Plan will be implemented, which will help the local economy. Overall, 2007 may not be that bad for Malaysia.

The stock market has held up well despite the rising oil price. Given the lack of substantial foreign funds participation, we expect it to continue to move up gradually, in a non-exciting, non-scary way.

Crude oil prices are reaching highs of over US$75 a barrel. In your opinion, what is good and bad about the current price boom?

The oil producers and the providers of services to the oil producers have not had it so good for a long time. Consumers are suffering and governments are scratching their heads over the ever-rising subsidies. The good side is this has helped to end deflation in countries like Japan; the bad side is it will bring about recession or a sharp slowdown in some countries. It is a zero sum game.

What other factors will influence the direction of the economy?

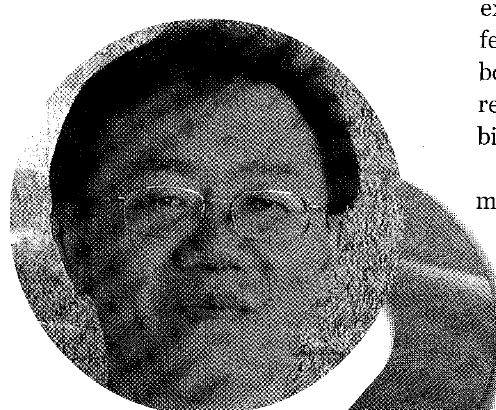
Whether it is interest rate or GDP growth or the Middle East crisis, the impact on the economy is being felt through rising oil price.

Have your projections for the stock market's Composite Index (CI) been revised?

No, our forecast remains the same. We see the CI possibly hitting 970 to 980 for the second half of 2006.

What are your favoured sectors and stock picks for the second half of the year?

Our stock picks are Lion Diversified, Padini, VADS, Tong Herr, Kumpulan Guthrie and United Malacca.



Lee Heng Guei
Head of Economic Research, CIMB Securities Sdn Bhd

With rising crude oil prices, what is your outlook on the economy and the stock market?

The on-going external uncertainties, arising from the elevated oil prices as well as slowing US economy, are expected to temper Malaysia's export growth. With the expected slowing exports, Malaysia's economic growth will hinge critically on sustaining domestic demand, underpinned by higher fiscal spending from the Ninth Malaysia Plan. We expect real GDP growth to expand by 5.3% in 2006 and 5.6% in 2007. During the consolidation phase, the economy will gradually build up momentum, making for more upbeat prospects in 2007.

Externally, most of the negative forces, especially the monetary tightening cycle for the global economy, have already materialised in 2006. We expect the US economy to continue expanding in 2007. This, together with sustained intra-regional trade, should support decent export growth. Domestically, domestic demand induced by the acceleration of public spending and private investment growth will boost growth prospects over the medium term.

Crude oil prices are reaching highs of over US$75 a barrel. In your opinion, what is good and bad about the current price boom?

High oil prices are a boon to net oil exporters, such as Malaysia. It translates into higher export earnings, boosting export income and consumption. The federal government's budget will get a boost from higher petroleum-related tax revenue. Petronas contributed RM41.7 billion to the government in FY2006.

The resurgence of the commodity markets can be a boon or bane to commodity-producing and exporting countries, depending on how the windfall gains are managed. This is because:

- Commodity prices can induce inflation. Commodity export booms tend to generate short-term increases in money creation and cause inflation. The rise in inflation is also partly due to higher cost of materials and energy, which is bound to pass from producers to retailers and, finally, consumers. In fact, commodity prices are found to be a successful predictor of inflation. If reinforced by excess demand (due to higher incomes), the second round of the inflationary spiral effect would set in.
- Higher commodity prices can lead to an excessive and prolonged appreciation of the real exchange rate.
- There may be a mismatch of government spending. Policymakers assume that the commodity price rises are permanent, boosting export earnings and government revenue. On

that basis, governments commit themselves to larger expenditure plans which fuel aggregate demand pressures. If the government bases its long-term investment programme on boom-time revenues, there is a risk of future budget deficits if the commodity price rises are short-term, as was the case in the longest and strongest commodity boom in the 1970s.

What other factors will influence the direction of the economy?

There are, of course, risks to the growth outlook. These are largely related to external factors, especially the sustainability of the US economy as monetary tightening may tip it into recessionary mode. Any hiccups in the US economy would have a dampening effect on Malaysia's exports of electronics.

Regionally, a severe slowdown of the China economy could act as a drag on intra-regional trade. The rise in global risk premiums due to the policy risks could set off an outflow of portfolio capital from the emerging markets, causing volatility in the foreign exchange and financial markets.

Global oil prices remain a wild card. Domestically, the policymakers must ensure the effective implementation of the Ninth Malaysia Plan projects as any delays would have a domino effect on the construction, manufacturing and services sectors.

Gerald Ambrose

Managing director, Aberdeen Asset Management Sdn Bhd

With rising crude oil prices, what is your outlook on the economy and the stock market?

As Southeast Asia's only net oil and gas exporter (Indonesia went back into deficit in oil production in June this year) the country should benefit overall. However, as one of the world's most open economies, with exports accounting for well over 100% of GDP, a drop in external demand caused by higher oil prices will negatively affect the economy.

Crude oil prices are reaching highs of over US$75 a barrel. In your opinion, what is good and bad about the current price boom?

Petronas is 100% owned by the government, which means a large chunk of the RM43 billion profit it made last financial year goes into government coffers. The government has chosen to spend a lot of that money on fuel and gas subsidies, which will help cushion Malaysia's corporations and individuals from some of the effects of higher oil prices.

This should help Malaysian manufacturers become more competitive than their unsubsidised foreign competitors and protect Malaysian citizens' disposable incomes, and therefore domestic demand. However, economic purists would argue that hardship drives efficiency and that Malaysia may therefore fall behind its neighbours.

What other factors will influence the direction of the economy?

Sentiment is an important factor, which is difficult to quantify. It is about a decade since the beginning of the Asian economic crisis and it is worth noting that some commentators are saying it is therefore time for another downturn. There is absolutely no logic to such a view, but it can affect sentiment.

Have your projections for the stock market's Composite Index (CI) been revised?

No. We never had a projection for the CI to change.

What are your favoured sectors and stock picks for the second half of the year?

Aberdeen picks companies according to the quality of management, transparency, consideration for minority shareholders and healthy balance sheets. These companies belong to no particular sector. Sectors which currently look most attractive top-down are:

a) Oil and gas: this could be the year in which the oil and gas sector delivers on its expectations.
b) Plantation sector: likely to benefit from a new source of demand.

INTER-PACIFIC RESEARCH SDN. BHD.

Inter-Pacific Research

With rising crude oil prices, what is your outlook on the economy and the stock market?

We are holding the real GDP for 2006 at 5.5%, which is 0.5% below Bank Negara's forecast. We expect the growth to remain broad-based, emanating from sustainable growth from exports and a modest growth in domestic demand emanating from the pump priming exercise, which would be more than sufficient to negate the slower private consumption spending caused by the erosion in real disposable income.

As for the market outlook, we remain fairly optimistic. In the near term, we expect it to remain bumpy, as liquidity is tight. However, over a longer horizon, we expect greater excitement, the market benefiting from pump priming activities coupled with a more stable interest rate environment.

Crude oil prices are reaching highs of over US$75 a barrel. In your opinion, what is good and bad about the current price boom?

We expect oil exporters, like Malaysia, to benefit from the surging oil prices. This would keep our current account in surplus. A surplus would tend to provide greater breathing space for the central bank in its monetary policy in relation to hiking of interest rates.

If oil price remains high, alternative by-products such as biodiesel would have greater opportunity to become a reality. Assuming Malaysia is successful in this area, it would become a new revenue generator.

The setback we fear most is cost-push inflation. We are experiencing this at the moment. Although the inflation risk may have been subdued, our primary concern is still on the issue of expectation of higher inflation emanating from cost-push as opposed to demand-pull.

What other factors will influence the direction of the economy?

Global risks remain high. Global economic growth is expected to moderate if not slow down in 2007, underpinned by the following:

- The US economy slowing down at a much faster pace than envisaged. In other words, the US economy could be heading for a hard landing. A slowing US economy represents a risk for the world economy, although it may not be as severe as it may have been a few years ago.

- The issue of global imbalances and the direction of the US dollar would continue to be a lingering concern. The US current account deficit is expected to grow due to a collapse in US net savings as opposed to an increase in investment.

- From the issue of deflation, we are now looking at the possibility of stagflation, apart from inflation. For instance, during the second quarter of this year, the US' real GDP grew by 2.5%, while its core personal-consumption index which excludes food and energy rose 2.9% in 2Q06, and the employment cost index was up 3.6% in 2Q06 from 2.4% in 1Q06. This could bring about policy confusion.

- Geopolitical risks such as the Middle East crisis, North Korean tension and the Iran nuclear issue. These issues could have a direct or indirect impact on the movement of global crude oil prices.

The effects of a moderate or slower global economic growth on our economy would be felt in 2007. We expect exports to grow at a moderate pace while consumer confidence would remain soft, in view of lower real disposable income and lack of positive wealth effect. Hence, the government's pump priming would become critical to contain the economy from slipping.

We expect the bulk of RM220 billion under the Ninth Malaysia Plan to be utilised in 2007 and 2008. The Visit Malaysia Year in 2007 would also provide some impetus. At the moment, we are looking at a 5.4% real GDP growth for 2007, based on the assumption that the global economy would expand by 3.6% in 2007.

Have your projections for the stock market's Composite Index (CI) been revised?

We have maintained a cautious outlook over the near term, expecting the market to be bumpy. However, over the longer horizon, we foresee the momentum to be better. Apart from benefiting from the pump priming activities, we expect flow of funds to improve, as investors would be looking for 'safe haven' markets. Also, the ringgit is expected to appreciate against the US dollar.

What are your favoured sectors and stock picks for the second half of the year?

For now, we like:

1. Oil and gas stocks: Wah Seong, KMN, Sapuracrest, Petra Perdana, Samudara.
2. Construction and building materials sector, which is poised to benefit from the 9MP projects which would be the catalyst for holding up the economy in 2007. Stocks: UEM World, UEM Builder, Naim Cendera, IJM, Gamuda, AZRB, CIMA.
3. Plantation stocks: Rimbunan Sawit, Imaspro.
4. Glove stocks: Kossan, Top Glove. mb