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A CASE TO APPRECIATE THE RINGGIT

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Factors that may see Ringgit appreciation in 2HCY22

KEY HIGHLIGHTS

- **Since 2022 is a post-pandemic year, pace of monetary policy normalization varies across countries, mainly to balance between economic growth stability, currency fluctuation and inflation target**
- **Fundamentally, Ringgit is on strong footing underpinned by firming domestic demand, robust external sector and elevated global commodity prices**
- **Thus far, the recent weakness in Ringgit was primarily due to the effect of the broad strength in USD**
- **With the US Fed expected to slow down the pace of its policy tightening towards the end of year, we foresee less support for US dollars to strengthen further**
- **Based on real effective exchange rate (REER), Ringgit remains undervalued**
- **Appreciation of Ringgit to ease food inflationary pressure**
- **The depreciating Ringgit against US dollar proved a blow to the pace of foreign inflow**
- **Nonetheless, we are seeing improvement in the foreign fund flow since mid-July**
- **Maintain FBM KLCI year-end 2022 baseline target of 1,600 points**

BACKGROUND

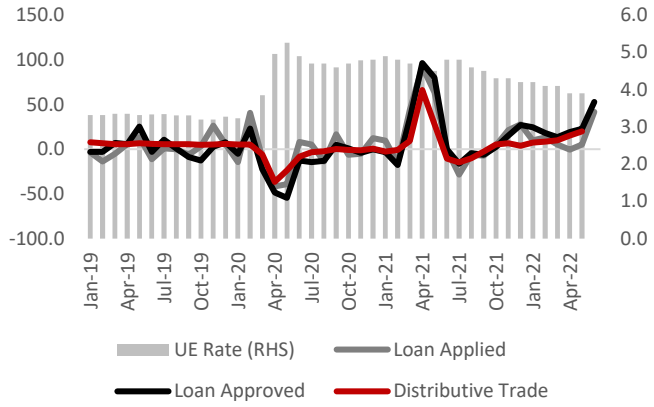
Currency valuation in the environment of tightening monetary policy. In post-pandemic era, most economies start to normalize or tighten monetary policy rate amid improving domestic economic activities and rising inflationary pressure. The US Federal Reserve is set to end its funds rate at 3.50% by end of this year, higher than 2.50% in 2019. Bank of England further raised its interest rate to 1.75% in Aug-22, the highest since 2009. The European Central Bank also surprised the global financial market after raising its interest rate from 0.00% to 0.50% in Jul-22, the first-rate hike since 2011. Reserve Bank of Australia and Reserve Bank of India are also seen tightening interest rates higher than 2019 levels by end of 2022. The faster pace of the Fed's tightening monetary policy had caused strong appreciation of the US dollars and directly suppressed other currencies. Since 2022 is a post-pandemic year, pace of monetary policy normalization varies across countries, mainly to balance between economic growth stability, currency fluctuation and inflation target. In addition, every country reopens domestic economy at different time, hence affecting growth trajectory and monetary policy normalization path.

A CASE FOR RINGGIT APPRECIATION

FUNDAMENTAL POINT OF VIEW

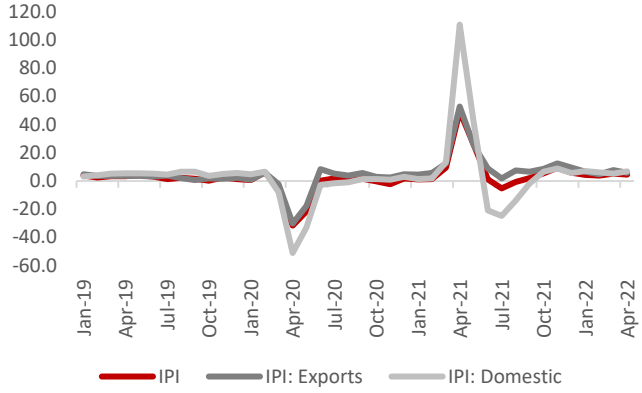
Strong economic fundamentals & elevated commodity prices. Fundamentally, Ringgit is on strong footing underpinned by firming domestic demand, robust external sector and elevated global commodity prices. Unemployment rate is on descending trajectory, 3.9% in May-22 (2021: 4.5%), slightly higher than the pre-pandemic level 3.4%. Inflationary pressure in Malaysia remains stable, among others thanks to the capped retail fuel prices and other subsidy assistances. In addition, we foresee moderation of food price inflation in 2HCY22 amid slight betterment in domestic food supply and correction in global commodity prices. We are optimistic that Ringgit to appreciate in 2HCY22 and reach RM4.25 per USD by year-end, driven by the strong economic fundamentals and elevated commodity prices.

Chart 1: Domestic Demand Improves (YoY%) as UE Rate Decline (%)



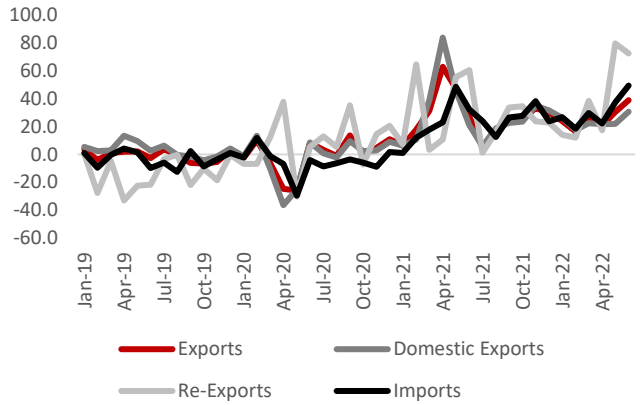
Source: CEIC, MIDFR

Chart 2: IPI Growth Stabilizing (YoY%)



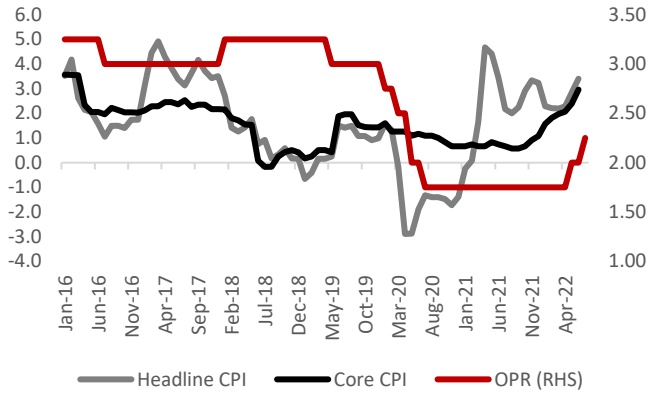
Source: CEIC, MIDFR

Chart 3: Robust External Trade Performances (YoY%)



Source: CEIC, MIDFR

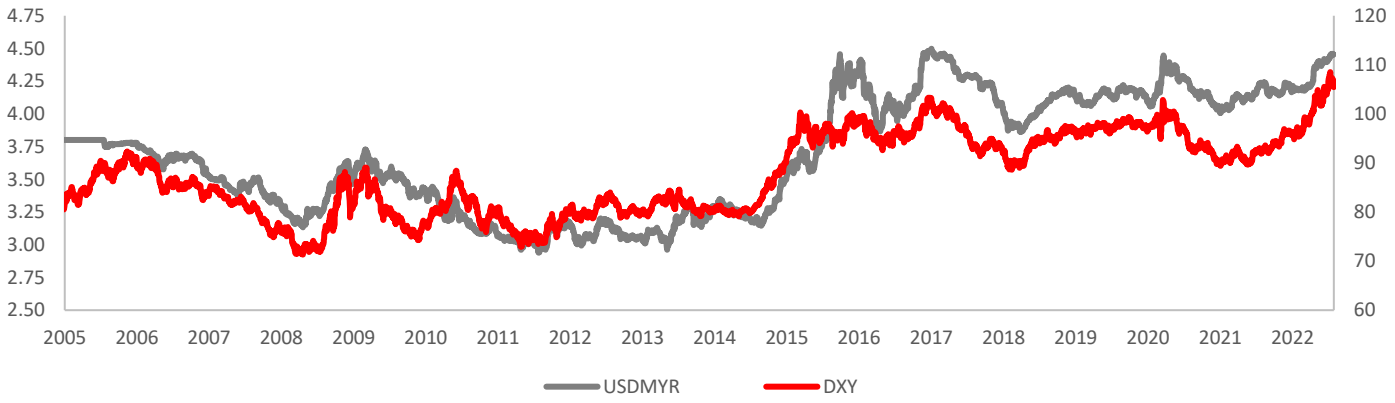
Chart 4: OPR (%) vs Inflation Data (YoY%)



Source: CEIC, MIDFR

Broad strength in USD as Fed tightened aggressively. Thus far, the recent weakness in Ringgit was primarily due to the effect of the broad strength in USD. A more aggressive policy tightening adopted by the Fed and the widening of interest differentials resulted in stronger demand for USD. As USD appreciated against other major currencies, the US dollar index (DXY) rose to 108.5 by mid-July 2022, the highest level in 20 years. Consequently, Ringgit was traded in the last 2 weeks around RM4.45, the weakest in 5 years. In the first 7 months of this year, Ringgit weakened by -6.4% against the dollar, from RM4.17 as of end-2021.

Chart 5: Ringgit vs. US Dollar (DXY) Index

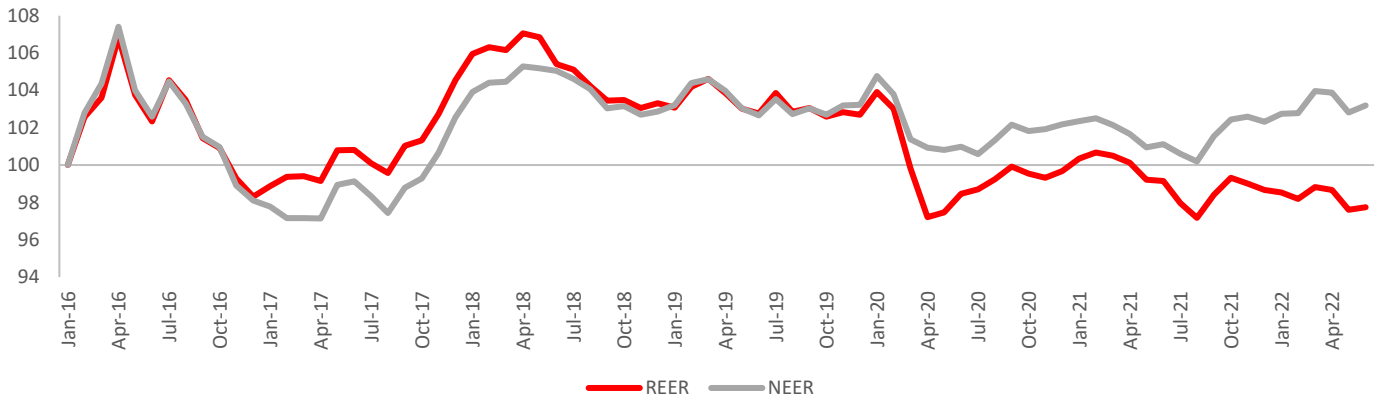


Source: Bloomberg, MIDFR

Will slower Fed tightening be positive for EM currencies? With the US Fed expected to slow down the pace of its policy tightening towards the end of year, we foresee less support for US dollars to strengthen further. In other words, movement in the financial market would pose less drag on EM currencies. In addition, possible reversal of financial flows towards EM markets and improved appetite for risk assets will be positive for regional currencies, including Ringgit. Moreover, EM currencies stand to gain from improved growth outlook in China in the latter part of the year, after being negatively impacted by the Covid-19 lockdowns re-imposed in 2QCY22. Considering the improved growth outlook and sustained current account surplus, we forecast Ringgit could appreciate and reach RM4.25 by end-2022.

REER shows Ringgit undervalued. Based on real effective exchange rate (REER), Ringgit remains undervalued. The value of Ringgit at REER even fell further in 1HCY22. Looking at improving growth momentum, elevated commodity prices, and increasing domestic economic activities on the back of economic reopening, we believe the economic fundamentals are more in favor of stronger Ringgit. This explains why Ringgit strengthened against other currencies according to nominal effective exchange rate (NEER). Ringgit has been strengthening on NEER basis from the recent trough in May-21 when the full nationwide lockdown was imposed last year. Unfortunately, movements in the financial market, which are more sensitive to the US FOMC's rate decisions, caused Ringgit to weaken specifically against the US dollars.

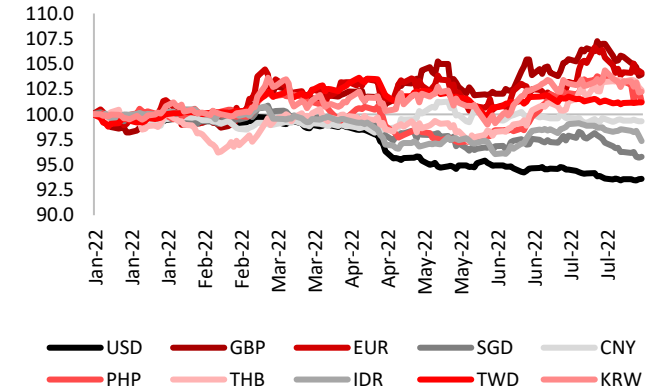
Chart 6: Ringgit's NEER and REER (Jan-16 = 100)



Source: Macrobond, MIDFR

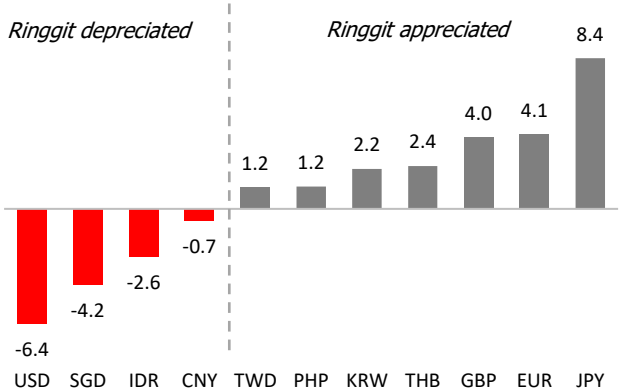
Ringgit shows resilience against other currencies. Relative to other currencies, Ringgit performed better mainly against other major currencies. From end-2022 until end-July 2022, MYR appreciated against EUR (+4.1%), GBP (+4.0%) and JPY (+8.4%). Ringgit performance against regional currencies is rather mixed; weakened against SGD (-4.2%), IDR (-2.6%), and CNY (-0.7%), but strengthened against THB (+2.4%), KRW (+2.2%), PHP (+1.2%), and TWD (+1.2%). We believe the overall resilience in Ringgit performance, in line with the trend in NEER, reflects the positive effect of elevated commodity prices on Ringgit, particularly from the high prices of crude oil and palm oil.

Chart 7: YTD Ringgit Performance vs. Other Currencies (end-2021 = 100)



Source: Bloomberg, MIDFR

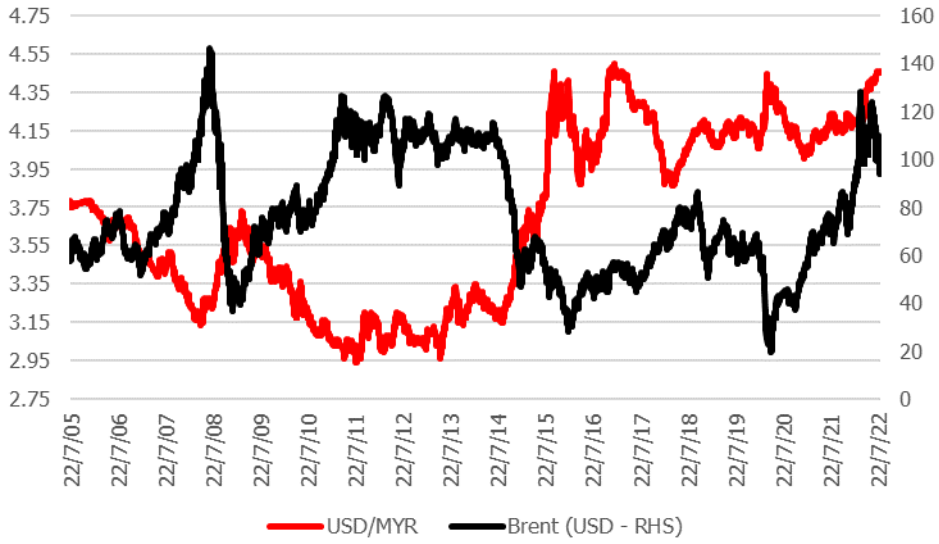
Chart 8: YTD Ringgit Performance vs. Other Currencies (% YoY)



Source: Bloomberg, MIDFR

Recent disconnect between oil prices and Ringgit. Ever since the Ringgit de-pegged against USD on 22 July 2005, it has moved relatively in tandem with Brent price. From that date until yesterday, the movement of USD/MYR and Brent have a correlation of -0.69, indicating a negative correlation i.e. when oil prices increases, Ringgit will appreciate and vice versa. A stronger negative correlation can be found from data that range between 22 July 2005 and 31 December 2021, where the correlation is -0.80. However, this relationship seems to have broken down this year where the correlation between USD/MYR and Brent is +0.45. This suggests that as oil prices increases, Ringgit depreciates; despite Malaysia being an oil producing nation. It seems that the effect of US Fed decision has a stronger weight at current juncture than the past relationship between Ringgit and oil. However, we expect that this disconnect will not last and the Ringgit will eventually reflect the elevated oil prices.

Chart 9: Daily USD/MYR vs. Brent price



Source: Bloomberg, MIDFR

Possible correction in commodity prices. While the jump in commodity prices earlier this year was mainly linked to supply constraints and the negative effect of war in Ukraine, the recent correction in commodity prices was due to two factors. First, demand outlook is weaker than previously anticipated due to concerns over recession risk in Europe and the US. In addition, consumers are adjusting their spending plans due to higher inflation and monetary policy tightening by central banks. Second, we believe there is limited upside pressure on commodity prices as the global supply chain activity is expected to improve.

...but don't expect sharp correction. While global supply condition would improve further as countries reopen their economies and international borders, we don't expect there will be a sharp correction in commodity prices. We believe prices will remain elevated, in view of the ongoing post-pandemic supply challenges and the war in Ukraine. Furthermore, the recent rise in geopolitical tension between the US and China also contributed to supply concerns. On another note, the reduced support for USD in the latter part of the year, as market priced in smaller rate hikes in the coming FOMC meetings, will also limit declines in commodity prices, especially crude oil prices.

TECHNICAL POINT OF VIEW

Ringgit impacted by aggressive Fed hikes. The USD/MYR was rather unperturbed by the 25bps hike in US Fed fund rate in March this year as it remined largely stable within a tight band of between 4.17 and 4.21 since early January. However, the USD/MYR broke decisively above the 4.24 resistance level in the third week of April attributable to the heightened possibility of the US Fed raising the pace of interest rate hike in its early May meeting. As it turned out, the US Fed announced

a 50bps hike in May and the pace heightened further to 75bps in each of the June and July meetings. Meanwhile, the USD/MYR risen rather persistently to 4.45 as of last Friday.

Chart 10: USD/MYR: Performance vis-à-vis Pace of US Fed Hikes (Actual & Expected)



Source: TradingView, MIDFR; Note: (e) – Expected

The pace of Fed hike may normalize in 4Q22. Going forward, the market is now (as implied by CME interest rate futures) expecting another 75bps hike in September. However, more importantly, the pace of interest rate hike is expected to normalize (i.e. back to 25bps) beginning in November meeting arguably due to lessening inflationary pressure from easing commodity prices as well as the anticipation of slowing US economic growth as early as later this year.

In above regard, we expect the USD/MYR to begin falling in the fourth quarter of this year to be assisted by returning funds eastward as the US economic growth may exhibit relative weakness vis-à-vis emerging economies, including Malaysia.

IMPACT OF A RINGGIT APPRECIATION

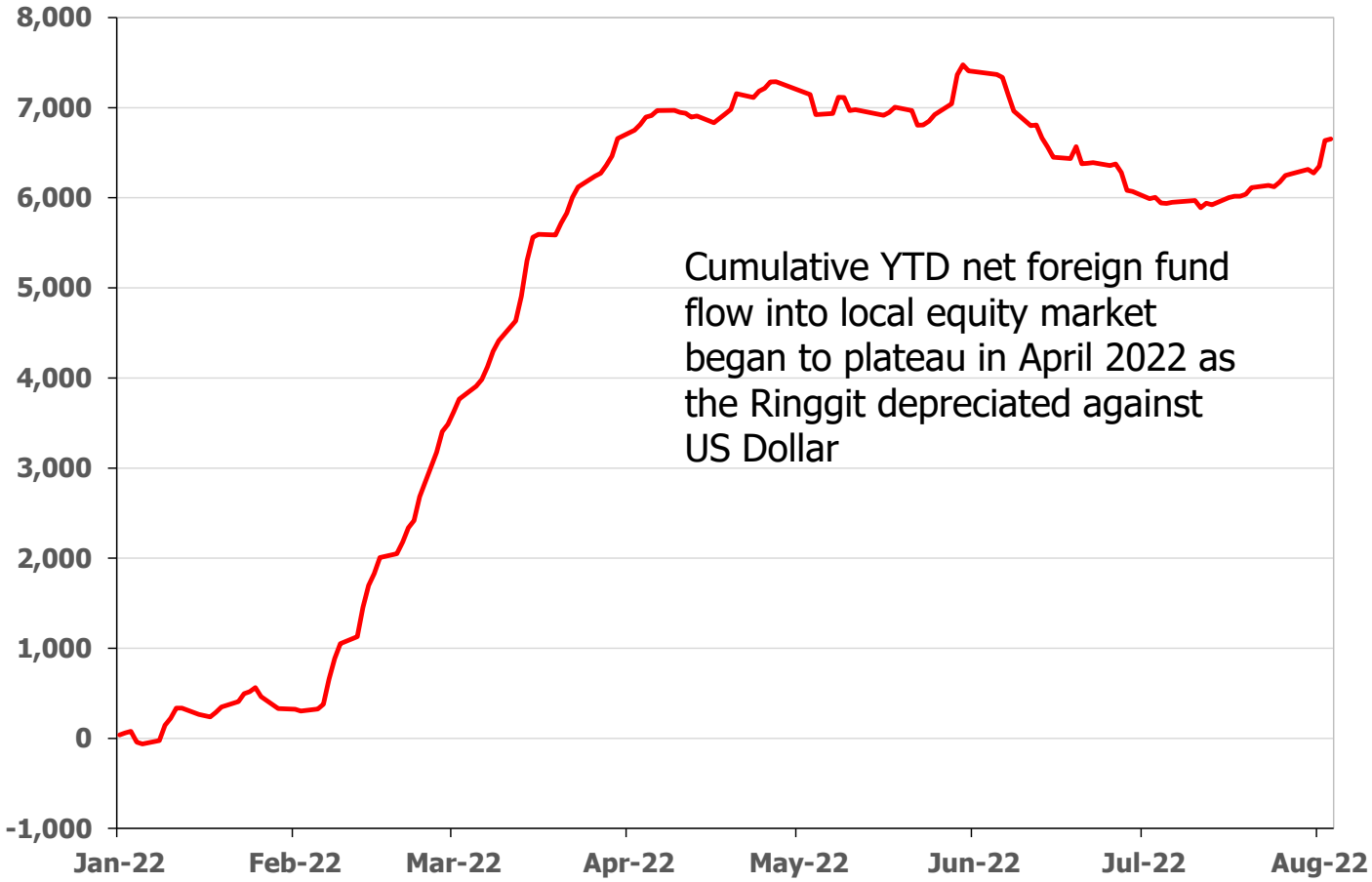
ECONOMY

Appreciation of Ringgit to ease food inflationary pressure. Malaysia's food inflation increased to +6.1%yoy, the highest ever recorded. Similarly, price growth of Food at Home and Away from Home touched new fresh high at +6.1%yoy and +6.6%yoy respectively. Among the food items, meat inflation at +11.9%yoy (record high) while fruits and vegetables inflation at more than 4-year high. As a net-food importer, depreciation of MYR vs. USD by -6.0%yoy in Jun-22 (close to 5-year low) had partially caused the food inflation spike. However, we expect Malaysia's domestic food inflation to rise at modest pace in 2HCY22 amid slight betterment in food supply, correction in commodity prices and appreciation of USD/MYR. In addition, global food inflation as reported by FAO of UN descended to 4-month low at +23.1%yoy in Jun-22. We believe the expected-resumption of grain exports via Ukraine's Black Sea ports may ease global food inflation pressure in the near term. We forecast food inflation to average at +4.5% for 2022 (2021: +1.5%).

STRATEGY

The depreciating Ringgit against US dollar proved a blow to the pace of foreign inflow into the local equity market. The cumulative YTD net foreign fund flow began to plateau since April and subsequently declined in June as the Ringgit continued to weaken. In tandem, the FBM KLCI saw its worst YTD monthly performance in June as it slumped -8.0% to 1,444 points level.

Chart 11: Bursa Malaysia: Cumulative YTD Net Foreign Flow



Source: Bursa Malaysia, MIDFR

Nonetheless, we are seeing improvement in the foreign fund flow since mid-July despite continued Ringgit weakness. Likewise, the FBM KLCI managed to recover from a low of 1,409 points and is now back above the 1,500 points level. We reckon some investors are looking ahead and foresee (i) the Ringgit to begin gaining support as the US Fed cranking down on the pace of rate hike beginning in the final quarter of this year, as well as (ii) the relative resiliency of Malaysian economy amid tightening global liquidity and anticipated slowdown in US economy.

Maintain FBM KLCI year-end 2022 baseline target of 1,600 points. Going forward, premised on above scenario, we can expect the foreign inflow to gradually gaining momentum with full recovery in the cumulative YTD net foreign fund flow by the final quarter. We reiterate our FBM KLCI year-end 2022 baseline target of 1,600 points (or PER22 of 15.5x).

EQUITIES

Different sector, different impact. As with any factors, different sectors will face different impact to an appreciation of the Ringgit. However, we should note that these impact to earnings are the impact coming from currencies only. There could be other factors that are stronger which may neutralize the impact of a MYR/USD appreciation. We divided the sectors based on whether a stronger Ringgit will have a positive, neutral or negative impact; as below:

POSITIVE IMPACT

Sector	Comments
Automotive	A stronger Ringgit is generally positive for the auto sector as it effectively lowers the cost of imported content. The non-nationals in particular are key beneficiaries given that they rely heavily on imported CKD kits and CBUs. The national cars in comparison are less affected by forex volatility given high localization rate of 80%-95% for their models. Of the companies under our coverage, **UMW Holdings (BUY, TP: RM4.78)** and **Tan Chong Motor (NEUTRAL, TP: RM1.20)** are key beneficiaries of a stronger Ringgit against the USD. Every 1% change in our USD:RM assumption impacts the respective companies' FY22F earnings by an estimated 3% and 62% (large percentage impact given that Tan Chong is close to break-even profit levels). **Bermaz Auto (BUY, TP: RM2.36)** is a beneficiary of a stronger Ringgit against the JPY as it is exposed to JPY denominated CBU imports. Every 1% change in our JPY:RM assumption impacts BAuto's FY23F (FYE April) earnings by 1.1%.
Aviation	For **MAHB (NEUTRAL, RM6.70)**, there is no material impact on its Malaysia operations as all loans and commitments are MYR-denominated. As for **Capital A (NEUTRAL, RM0.61)**, USD-denominated expenses take more part of their businesses than other currencies. In 1QFY22, the percentage of the operating expenses that were USD-denominated stood at about 50% for the aviation business, 11% for Super App and 19% for Teleport. Therefore, a stronger Ringgit against USD would benefit the company given that most of its transactions are primarily MYR-denominated.
Oil & Gas	Malaysia is a net exporter of hydrocarbon products of which the main currency is in USD. Malaysia's exports for petroleum products accounted for 9% of total exports, while LNG accounted for 4% and crude oil only constitutes about 2%. Oil and gas prices have a prominent impact on the currency rate in Malaysia via a relatively weak negative cross-correlation between Brent crude oil price and Henry Hub natural gas price with the USD/MYR exchange rate. In other words, a Ringgit appreciation would signal a stronger crude oil in the long run and higher natural gas prices in the short term. This supports that Malaysia would benefit from the energy sector, and as such the supply for crude oil is adjusted accordingly to the USD/MYR exchange rate. Meanwhile, Ringgit appreciation would only be more prominent when natural gas price slip in the long term. With the appreciation of the Ringgit currency, we believe energy companies with a strong ground on crude oil exploration, production and development would benefit the most, while companies that weigh heavily on natural gas could see advantages in a shorter duration to which a volatility in the exchange rate may occur if natural gas prices sharply and continuously increase. Other petroleum products and feedstocks, such as naphtha, methanol and ethylene also see an increase in production volume during a higher crude oil price, hence, we expect that a strong Ringgit could also add to a decrease in the import of feedstock prices and increase the demand for these feedstocks for petrochemical processing.
Power	**Tenaga (NEUTRAL, TP: RM8.45)** is exposed to USD-denominated coal imports. Generation cost currently makes up 62% of total cost, where coal accounts for 54% of total generation - a stronger Ringgit should therefore help to lower effective coal cost. Having said that, Tenaga's sizeable cost under-recovery in the past year has been largely driven by a sharp spike in underlying coal price which is still hovering around the USD330-430/MT price range *(Newcastle coal futures)* vs. RP3 coal price projection of USD79/MT. Given a lag in passing through the higher fuel price, which is also subject to Government approval, we expect the elevated cost under-recovery to continue impacting Tenaga's cash flows in the immediate term.
Telecommunication	The telecommunication companies like **TM (BUY, TP: RM6.91), Axiata (BUY, TP: RM4.90), Maxis (NEUTRAL, TP: RM3.78)** and **DIGI (NEUTRAL, TP: RM3.59)** are exposed to foreign exchange risk that predominantly arises from borrowings denominated in

Sector	Comments
	foreign currencies. Most of the players have cross-currency swaps that are primarily used to hedge selected foreign exchange borrowings to reduce the foreign currency exposure on these borrowings. In a situation where Ringgit appreciate against other currencies, it will bode well for the telco players as it will reduce the real cost of borrowing.

NEUTRAL IMPACT

Sector	Comments
Construction	Impact of a strengthening Ringgit is minimal, as cost and earnings are predominantly domestic-based. Some companies purchase steel bars quoted in USD, therefore a stronger ringgit will give them a slight edge in terms of cost, on top of the correction in commodity prices that was seen recently. We have previously highlighted that the average price of steel bars hit a high of about RM3,900 per tonne in June, but this has since moderated to between RM2,900 and RM3,500 per tonne. Other building materials such as cement and bricks are almost purely domestic based. We view the impact of a stronger ringgit to be negligible for the sector. Reiterate **POSITIVE** on the construction sector. Top **BUY** recommendations are **Gamuda (TP: RM4.02), IJM Corp (TP: RM2.18) and Sunway Construction (TP: RM1.87)** for their strong balance sheets.
Consumer	Most of the companies in the Consumer sector, except Aeon Co. (M), are exposed to the volatility of USD for imported materials and equipment for production, manufactured inventories as well as exports of goods. The depreciating USD is neutral for the companies under our coverage, as cheaper imported raw material cost in USD terms results in lower input cost, offsetting negative effects such as the impact on weaker export sales that were valued in USD. Note that most of the imported raw materials are priced in USD. The weaker USD gives the biggest advantage to companies, like **Nestle (NEUTRAL, RM141.50)**, that import most of its raw materials in USD term but sell domestically—80% of the total sales are domestic sales. Nestle's top line and bottom-line benefit from robust domestic demand and lower input costs. The group's PAT is estimated to increase +1.3% for every 5% decrease in USD. The group uses forward exchange contracts and cash flow hedges to hedge at least 70% of its exposure. Conversely, sales and earnings for companies that export their products in terms of USD would be affected by the depreciation of USD. Namely, **F&N (BUY, RM29.7), QL (BUY, RM5.54), Padini (NEUTRAL, RM3.00)**, and **Panasonic (SELL, RM22.75)**. For every 5% fall in USD, decrease the PAT by an estimated -1.1%/-2.9%/-2.6%/-5.7% for F&N/QL/Padini/Panasonic.
Glove	The companies in the glove industry are prone to shifts in the value of the USD for its borrowings, cash, and cash equivalents, export sales, and purchases of imported raw materials are all denominated in USD. The imported raw material (notably natural rubber latex and nitrile latex) that are priced in USD could result in a cheaper cost when converted back to MYR. The companies' earnings will likely be impacted by the weaker export sales which more than offset the slightly cheaper imported raw material. Particularly, **Hartalega (NEUTRAL, RM3.06), TopGlove (NEUTRAL, RM1.01), Kossan Rubber (NEUTRAL, RM1.28)**, and **Supermax (NEUTRAL, RM0.88)**. We computed that for every 5% decrease in USD, Hartalega/TopGlove/Kossan Rubber/Supermax's PAT targeted to drop -0.7%/-0.5%/-1.4%/-5.1%.

Sector	Comments
Plantation	Since most of the Upstream business use selling strategy c. average 70/30 Spot/Forward contract, an appreciation in local currency would not benefit planters top-line because of 30% only were used for forward contracts. However, we could see bulk of PO producers' borrowings and fertilizer costs mostly dominated in USD, hence, strengthening in ringgit could improve PO producers EBITDA margin in general as well as improve their net gearing. For example, appreciation of USD against RM by 1% resulting in impact of RM23mn for Sime Darby Plantation. Our top picks for plantation companies are **KLK (TP: RM31.50), Sime Darby Plant. (TP: RM6.30) and GenP (TP: RM8.00)**
Media	**Astro (BUY, TP: RM1.06), MPR (BUY, TP: RM0.82)** and **Star (BUY, TP: RM0.36)** will have a neutral stance on the appreciation of Ringgit against other currencies. The media companies largely operate on a national scale, although part of their revenue and costs are subject to foreign exchange risk due to different currency exposures, predominantly in USD. The primary expenses associated with such exposure are programme rights, newsprint, licenses, and software services.
Property	There is no impact on Ringgit appreciation on property companies as revenue and cost are mostly Ringgit-denominated.
REITS	No impact on REITs as REITs' asset exposure is in Malaysia and rental income is in Ringgit.

NEGATIVE IMPACT

Sector	Comments
Technology	The local semiconductor players such as **Inari (BUY, TP: RM3.65), Globetronics (BUY, TP: RM4.07)** and **Unisem (BUY, TP:1.94)** are mainly exposed to USD as most of the companies' revenue are derived in USD. When Ringgit appreciate against USD, we would see a reduction in profit after tax due to currency translation. For example, Inari, a 1% strengthening of the Ringgit against USD at end of reporting date for FY21 would decrease the Group's net profit for the financial year by RM3.82m, ceteris paribus. Hence, the appreciation of Ringgit will give a negative impact on the players' bottom line.

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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 +10% 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.
ESG RECOMMENDATIONS* - source Bursa Malaysia and FTSE Russell	
☆☆☆☆	Top 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆☆	Top 26-50% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆☆	Top 51%- 75% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell
☆	Bottom 25% by ESG Ratings amongst PLCs in FBM EMAS that have been assessed by FTSE Russell

* ESG Ratings of PLCs in FBM EMAS that have been assessed by FTSE Russell in accordance with FTSE Russell ESG Ratings Methodology