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THEMATIC REPORT

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Poking the Dragon - Quantifying Taiwan Potential Dispute Effects

KEY HIGHLIGHTS

- **Having to contend with the Covid-19 pandemic, the world now faced with the impacts of geopolitics The latest area of potential conflict is in the Taiwan Strait between China and Taiwan**
- **While we believe that conflict in the Taiwan strait is not imminent, we believe that it is a simmering situation**
- **We envision three possible scenarios which could unfold with regards to the tension between China and Taiwan**
    - **First scenario: No military actions taken on Taiwan, but sanctions imposed on China**
    - **Second scenario: China launches military actions on Taiwan without interventions from other countries**
    - **Third scenario: China launches military actions, but other countries intervene to support Taiwan**
- **We believe First scenario is the most likely scenario because we do not expect the escalation of tension will lead to an outright war and military actions on Taiwan**
- **In the event of actual military conflict between Taiwan and China, we simulate our global-linked model by assuming -1.0% contraction in the Chinese and Taiwanese economies. We project global output to decline by -0.166%. Malaysia is among the top five countries to be hit the most, with contraction rate of -0.091%**
- **Based on the First scenario, we reckon the fallout of China-Taiwan spat to Malaysia's macro growth and on the local equity market to be not significant. At this juncture, we do not foresee the prevailing tension between China and Taiwan would jeopardize our FBM KLCI end-2022 target of 1,600 points**

BACKGROUND

Current state of affairs - a geopolitical minefield. Having to contend with the Covid-19 pandemic in the past two years, the world now faced with the impacts of geopolitics thrown into the mix. This year saw the Russia-Ukraine/NATO dispute escalated to open conflict with the announcement of Russia's Special Military Operation in Ukraine in February. The consequence of this conflict, whether intended or not, has led to rethinking by nations of the previous established global order. As such, it has been suggested by some geopolitical experts that the world may be heading towards a multipolar world. In our opinion, this may give rise to more geopolitical conflicts in the future, whether continuation of current ones such as in Ukraine and Syria, or newer ones such as in the Taiwan Strait.

History of China and Taiwan. The latest area of potential conflict is in the Taiwan Strait between China and Taiwan. Officially known as the Republic of China (ROC), Taiwan is an island separated from China by the Taiwan Strait and has been governed independently of China since 1949, when the nationalist of ROC lost control of mainland China to the Communist Party of China (CCP) in a civil war. China, officially the People's Republic of China (PRC) views Taiwan as a renegade province and vows to eventually "unify" Taiwan with the mainland. This stems from what it calls the One-China principle which it claims that Taiwan is bound by an understanding known as the 1992 Consensus reached between representatives of the CCP and the Kuomintang (KMT) party that then ruled Taiwan. However, the content of this so-called consensus has not been agreed upon.

US-China relations in regard to Taiwan. In 1979, the US established formal diplomatic relations with the PRC and severed diplomatic ties and abrogated its mutual defense treaty with the ROC. However, the US maintains a robust unofficial relationship with Taiwan. The US approach is governed by its One-China policy, based on several documents, such as the three US-China communiqués in 1972, 1978, and 1982; the 1979 Taiwan Relations Act and the "Six Assurances" in 1982. The US has attempted for decades to tried to maintain a delicate balance between supporting Taiwan and preventing a war with China. However, President Biden seems to reject this policy by stating that the US would assist Taiwan in its defense should China attack. Nevertheless, we should note that White House officials have commented that the One-China policy has not changed.

Poking the dragon. This change of approach is not new. The previous White House administration in its "United States Strategic Approach to the People's Republic of China" paper stated, "*…the Administration has adopted a competitive approach to the PRC, based on a clear-eyed assessment of the CCP's intentions and actions, a reappraisal of the United States' many*

strategic advantages and shortfalls, and a tolerance of greater bilateral friction." Therefore, from here, we could understand the antagonistic approach the US has adopted towards China such as the trade war unleashed by President Trump and the passing of the CHIPS act for example. We can view the visit by US Speaker Nancy Pelosi's visit to Taiwan could be viewed in this vein. Meanwhile, it has been reported that the US is considering options for a sanctions package against China to deter it from invading Taiwan, and the EU has come under diplomatic pressure from Taiwan to follow suit. However, we believe that the potential sanctions on China will be a more complex exercise than sanctions on Russia, given the interlinkage of these countries with China's economy.

A repeat of Ukraine and Russia? Geopolitical conflicts rarely happen out of this air. There has been an ominous escalation of conflict between the US and China since 2017. The question is that will this be a tipping point for a new geopolitical conflict in the Taiwan straits very much like the Ukraine-Russia conflict? We opine that this may not yet be the case. Recall, the conflict between Ukraine and Russia did not start to escalate in February this year or in December 2021 when Russia requested for a written guarantee that Ukraine will not join NATO. We believe that it started in January of last year when President Biden's administration begun shifting its policy regarding Ukraine.

A conflict that is potentially simmering. While we believe that conflict in the Taiwan strait is not imminent, we believe that it is a simmering situation. It will all boils down to the action and reaction of the participants in this geopolitical arena and will take some time to ignite much like the Ukraine-Russia conflict. However, unlike the Ukraine-Russia conflict, Malaysia and ASEAN will be impacted much more should the China-Taiwan conflict escalates to military action. Here, we attempt to envisage several scenarios and the impact it will have to Malaysia's economy and equity market.

ECONOMICS & POLICY

Escalating risk of military action as tension intensified. The visit by Nancy Pelosi to Taiwan in early August triggered China to react and launch series of military drills around Taiwan. Although Beijing announced the end to the military drills on 10 August 2022, preparations and training for war will continue as China remains committed to possible military action if diplomatic approach "by peaceful means" did not yield any results. Towards end of August, tensions remained high as Taiwan fired warning shots to at China's drone following orders by Taiwan's President Tsai Ing-wen for "strong countermeasures" against provocations from China. With these new developments, we opine the risk for a potential military attack on Taiwan is higher than before, though we think it is in everyone's interest to maintain the stability and peace in this region. We view the military drills as a form of diplomatic protest by China due to its claims that the visit by US officials to Taiwan is a violation of its sovereignty.

Possible scenarios to consider. Using the war in Ukraine as a point of reference, it will take at least months if not years before Russia decided to act against the expansion of NATO membership to include Ukraine. Similarly, the escalation of geopolitical tension between Taiwan and China will likely continue for now even without actual military aggression. However, the utmost risk will be the start of war in the North East Asian region, which will be negative to the global economy and international trade. We envision three possible scenarios which could unfold with regards to the China-Taiwan tension:

- **First scenario: No military actions taken on Taiwan, but sanctions imposed on China**. This is the most likely scenario because we do not expect the escalation of tension will lead to an outright war and military actions on Taiwan. Apart from the military drills, China also imposed visa bans and sanctions on Taiwanese officials to pressure Taiwan and the US following Pelosi's and other congressional visits. On top of this, China imposed some restrictions on trade with Taiwan, which are claimed to be politically motivated, such as bans on sand exports to Taiwan, and suspension of imports of some fish and fruits from Taiwan. Meanwhile, the US recently tightened its trade rules on trade with China, requiring special rules for American-made advanced and cutting-edge technology to be exported to China. In this first scenario, we do not expect any significant impact to Malaysia's trade thus far, but the growing US-China trade war increases the risk of destabilizing the global trade activity once again.
- **Second scenario: China launches military actions on Taiwan without interventions from other countries**. If China proceeds to launch an attack on Taiwan, we expect the trade activity will be impacted because all trade routes to the Northeastern Asian economies will be halted. If the military action is taken without interventions from other countries, we anticipate the impact to trade activity will be temporary as China may want

to quickly end the war with Taiwan and make sure trade to resume. However, this can last longer depending on the ability of Taiwan to defend and counter against China's attacks. Nevertheless, we foresee tighter sanctions will be imposed by the Western markets on trade with China. We opine Malaysia will be hit by direct effects from the collapse of regional trade and production chain and the sanctions imposed by the world on trade with China. We predict a lower probability for this scenario to occur as we do not think the US and its allies will sit still without providing any military supports to Taiwan.

- **Third scenario: China launches military actions, but other countries intervene to support Taiwan**. Following the continued tension between China and Taiwan, we are increasingly concerned that the possible military action on Taiwan will invite other countries like the US to be more involved in Taiwan's war with China. A larger scale and prolonged war in the region will have wider adverse effects to the stability of trade and industrial production in East Asia. However, we anticipate a short-term pain but with possible longer-term gains as multi-national companies relocate to other countries. Malaysia stands to benefit if the investment outflows from China and Taiwan which may be redirected to ASEAN countries. However, the short-term consequences will result in declines in Malaysia's trade due to the collapse in the global trade and production activities. Like the war in Ukraine, the supply disruption increases input costs and overall trade costs and extending the delivery time.

Challenges for Taiwan to join larger scale FTAs. Despite the high integration with the regional production network, Taiwan has limited participation in FTAs with Malaysia and other regional countries. Getting "blocked" by China from joining the Regional Cooperation and Economic Partnership (RCEP), Taiwan applied on 22 September 2021 to be a member in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). A study by Taiwan's National Development Council estimated a potential boost of 2% to Taiwan's economic growth by participating in the CPTPP. Until today, Taiwan has limited number of Free Trade Agreements (FTAs) and Economic Cooperation Agreements (ECAs) with regional countries. The list of Taiwan's trade agreements with other countries are as follows:

Table 1: List of Taiwan FTAs and ECAs

Date Signed	Name of Agreements
August 2003	FTA with Panama
July 2005	FTA with Guatemala
June 2006	FTA with Nicaragua
May 2007	FTA with El Salvador and Honduras
June 2010	Cross-Strait Economic Cooperation Framework Agreement (ECFA) with China
July 2013	ECA with New Zealand
November 2013	ECA with Singapore
February 2019	ECA with Paraguay
May 2019	ECA with Eswatini
October 2019	ECA with Marshall Islands
September 2020	ECA with Belize

Source: Taiwan's Bureau of Foreign Trade, MIDFR

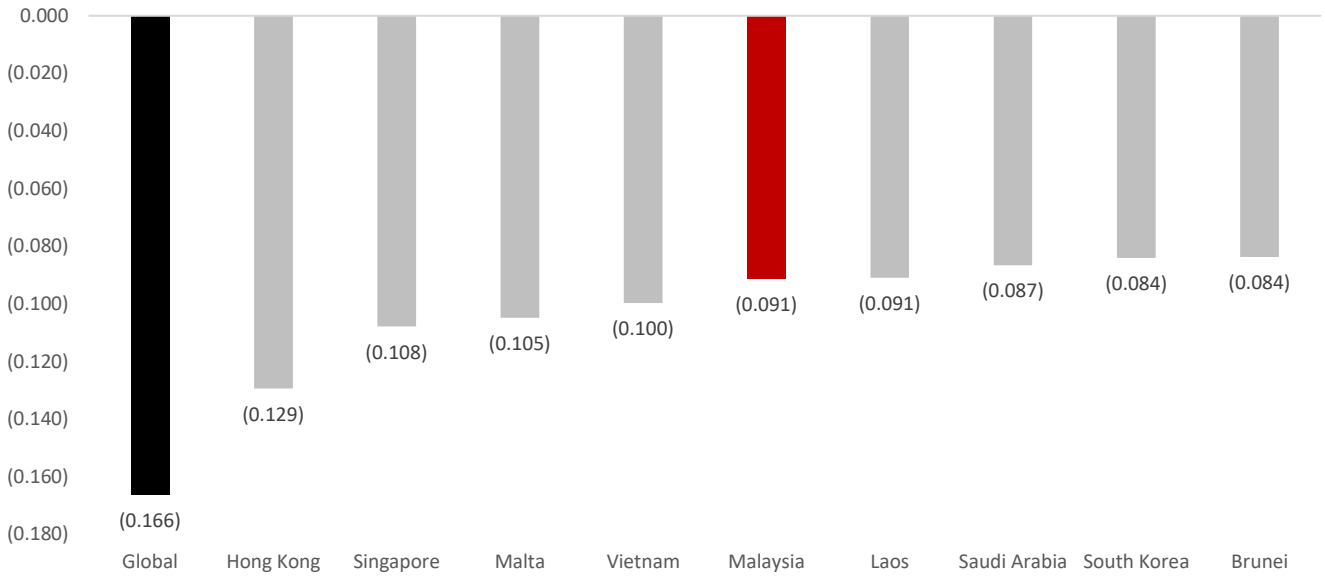
Taiwan contributes about 1.0% to world economy. Based on our global-linked model, Taiwan contributes about 0.7-1.0% to global output.[1] Among its regional peers, Taiwan's involvement is much lower as compared to China (16.0%), Japan (5.8%) and South Korea (1.97%). By sector, Taiwan's biggest support is 6.7% of world's Computer, Electronic & Optical Equipment. Taiwan also plays critical role in sectors such as Chemicals, Rubber & Plastic, Basic Metal and Fabricated Metal products. If the economy of Taiwan were to slow down due to the military conflict with China, we believe this will lead negative consequences on global trade activities especially affecting shipping routes among others to Japan, South Korea and China.

World economy to decrease by -0.166% if China and Taiwan down by -1.0% each. In the event of actual military conflict between Taiwan and China, we simulate our global-linked model by assuming -1.0% contraction in the Chinese and Taiwanese economies. Limited domestic spending and output, investment outflows will bleed the economy significantly. We

[1] Consistent with our global-linked model, Taiwan's economy accounts for about 1.0% of the world economy at the purchasing-power parity (PPP) basis in 2021, based on the IMF World Economic Outlook calculations.

project global output to decline by -0.166%. Malaysia is among the top five countries to be hit the most, with contraction rate of -0.091%. Among the top ten, four are ASEAN countries namely Singapore, Malaysia, Vietnam and Brunei.

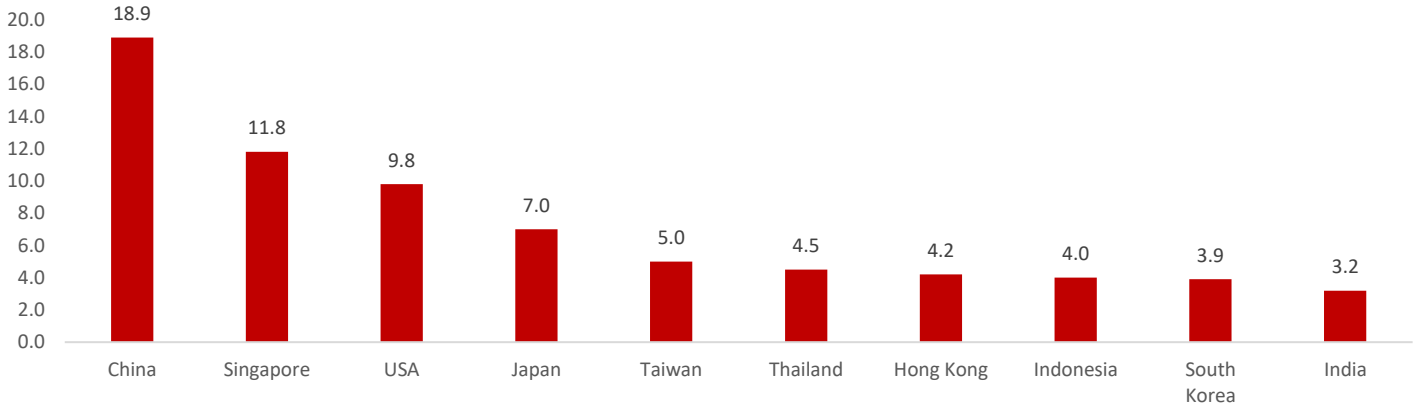
Chart 1: World Output Impact (Change %)



Source: OECD, MIDFR

Taiwan is Malaysia's 5th largest trading partner. Based on total trade data in 1H22, the size of total trade with Taiwan reached RM73.8b, an increase of +38.4%yoy from the first 6 months last year. Trade with Taiwan, therefore, accounted for 5.5% of Malaysia's RM1.36t total trade during the period. This positions Taiwan as Malaysia's 5th largest trading partner, after China, Singapore, USA and Japan. As the 9th largest export market and 3rd largest source of imports for Malaysia in 1H22, the direct effect of a complete halt in trade with Taiwan will potentially wipe out up to 3.5% of Malaysia's total exports and 7.3% of total imports.

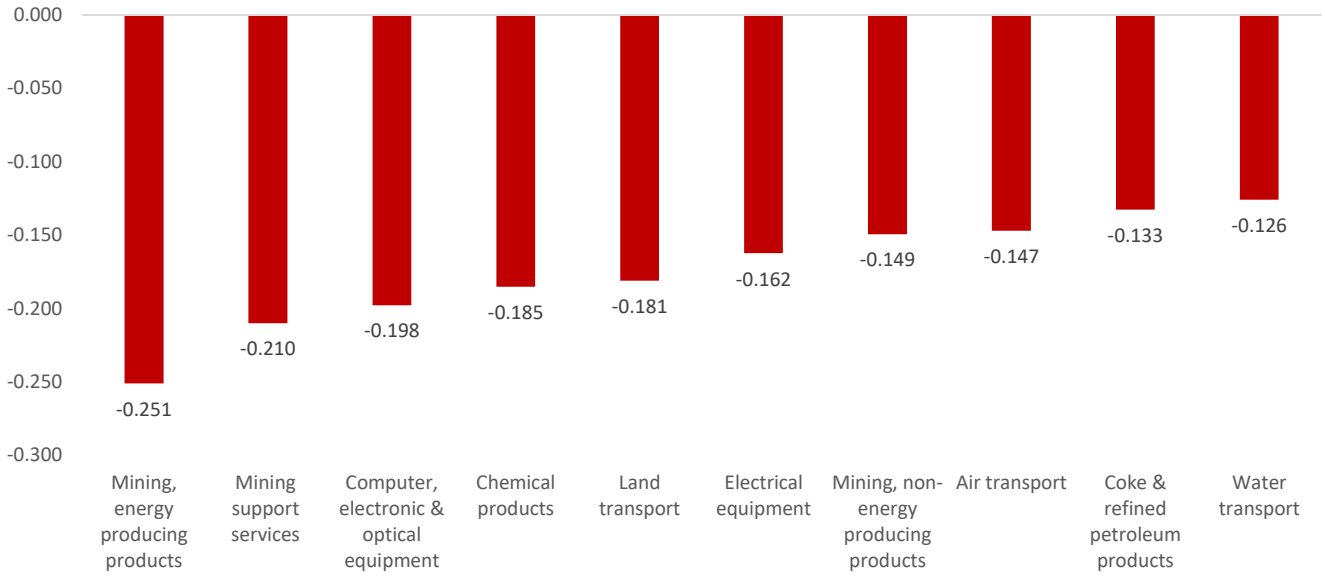
Chart 2: Malaysia's Top 10 Trading Partners in 1H 2022 (% of total trade)



Source: DOSM, MIDFR

Mining and E&E products to decline the most. In the event of slowdown in China and Taiwan's economies, we predict Malaysia's output to be dragged among others by Mining-Energy, Wood Products, Basic Metals and Coke & Refined Petroleum Products. We believe the direct and indirect factors cause the various sectors to be impacted especially with Malaysia, China and Taiwan involve heavily in the global and regional supply chain of E&E, particularly Computer, Electronic & Optical products. As one of mining producing countries, Malaysia's production, and outbound shipment of mining and refined petroleum products to be affected as China, Taiwan and other major Asian countries are the major energy importers for the Malaysian products.

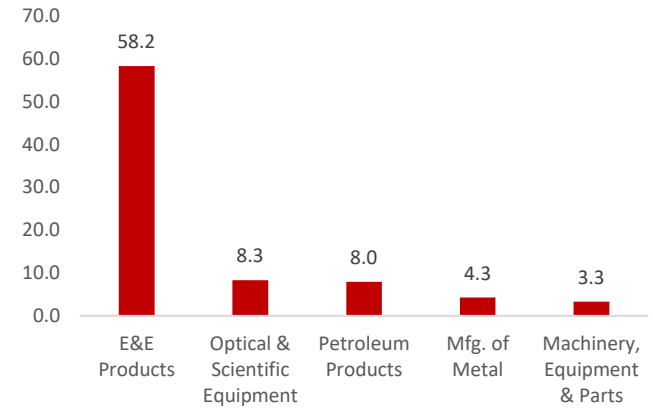
Chart 3: Malaysia's Sectoral Impact (Change %)



Source: OECD, MIDFR

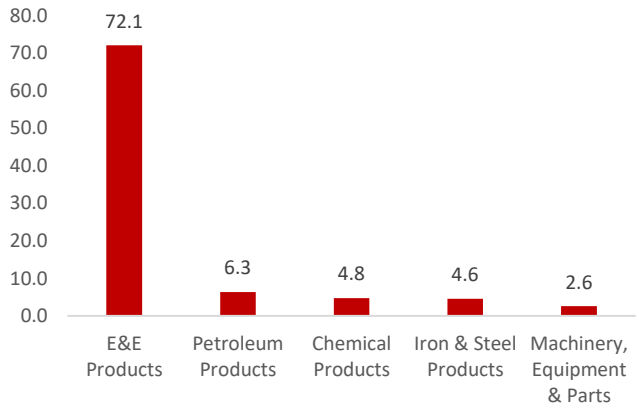
Almost 20% of E&E imports from Taiwan. More than half of Malaysia's exports to Taiwan is E&E products in 1H22. This represents 5.4% of Malaysia's total E&E exports. Other than E&E, shipments to Taiwan booked 9.0% of Seafood products, 8.3% of Optical & Scientific Equipment, and 5.7% of Saw Logs. As for inbound shipment, E&E took the largest share and followed by Petroleum, Chemical and Iron & Steel products. By product, 18.2% of total E&E imports and 11.8% of Iron & Steel were sourced from Taiwan. In the event of slowdown in Taiwanese economy, we are concerned on the E&E supply chain activities given that E&E is the largest exporting product for Malaysia and close to one fifth of E&E imports coming from Taiwan.

Chart 4: Top 5 Exports Product Share to Taiwan (%)



Source: CEIC, MIDFR

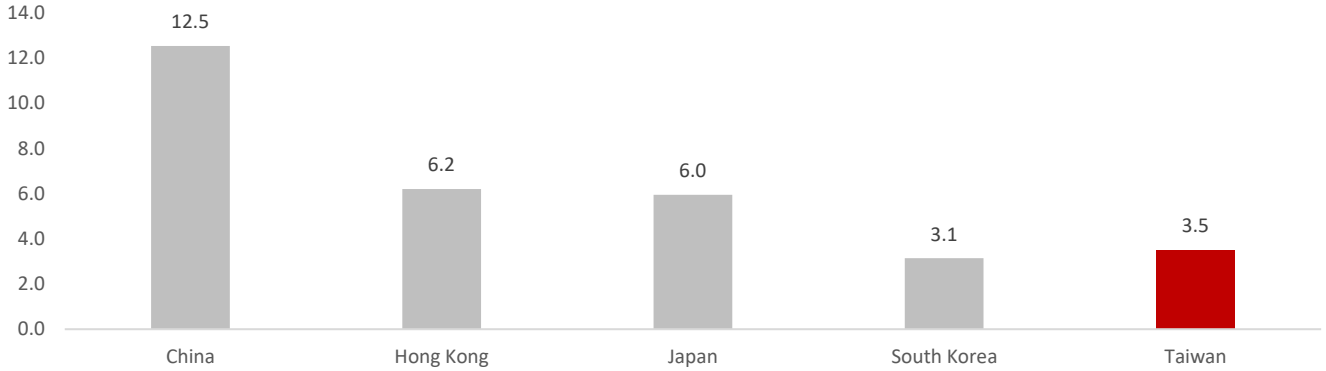
Chart 5: Top 5 Imports Product Share to Taiwan (%)



Source: CEIC, MIDFR

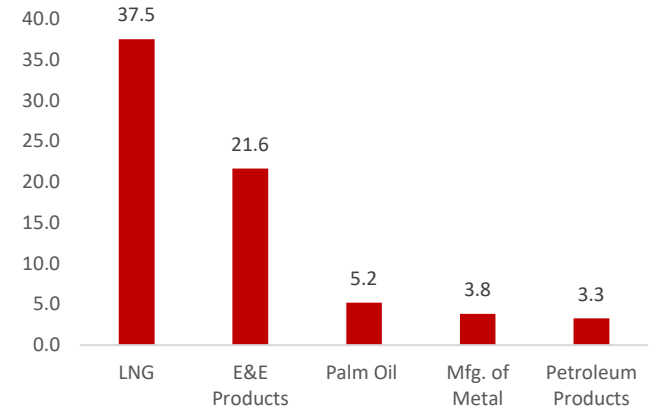
If direct military confrontation takes place in Taiwan, shipping route for Malaysia to be at risk. As of Jun-22, 31.4% of Malaysia's total exports went to China, Hong Kong, Japan, South Korea and Taiwan. If China-Taiwan conflict leads to military action, we predict Malaysia's shipping route to be badly affected as more than one-third of exports travel to the region. By sector, we predict the exports of E&E, LNG, Palm Oil, Petroleum Products and Manufacturing of Metal to be impacted the most. LNG accounts close to 40.0% of Malaysia's exports to Japan, and Japan booked 52.1% of Malaysia's total LNG exports in Jun-22. China took another 21.0% of the LNG exports share and 21.8% of chemical products outbound shipment.

Chart 6: Malaysia's Exports Share (%)



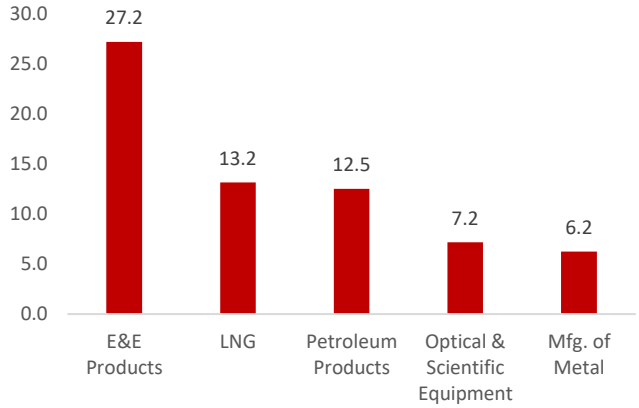
Source: CEIC, MIDFR

Chart 7: Top 5 Exports Product Share to Japan (%)



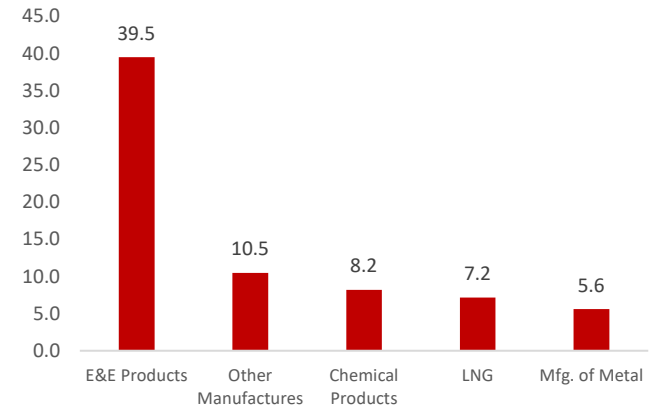
Source: CEIC, MIDFR

Chart 8: Top 5 Exports Product Share to South Korea (%)



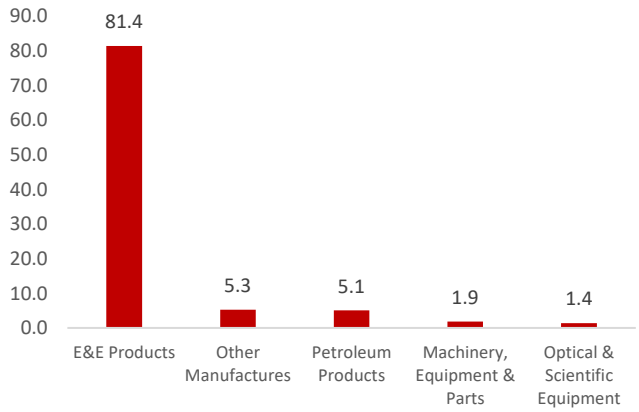
Source: CEIC, MIDFR

Chart 9: Top 5 Exports Product Share to China (%)



Source: CEIC, MIDFR

Chart 10: Top 5 Exports Product Share to Hong Kong (%)



Source: CEIC, MIDFR

A more significant impact from disruption to global trade activity. The above analysis only highlights the potential direct impact to Malaysia's trade with the Northeast Asian economies. We are also concerned that the impact will be more significant if the military confrontation disrupts all trade route (both by sea and air) near Taiwan. Based on the Ukraine-Russia war experience which caused a jump in global commodity prices, the disruption in the regional trade (primarily manufactured goods i.e., E&E) would increase the cost of sourcing parts and components. While companies will explore sourcing their parts from other countries, we expect delivery time will be even longer because of new disruption to the supply chain, in addition to the existing challenges emerged from the post-pandemic recovery. Ultimately, Malaysia's trade and production activities could experience a sharper contraction if we consider the impact of a broader fall and disruption to Malaysia's trade with other trading partners such as ASEAN, USA, and European countries. Shipments to all these 3 markets accounted for combined share of 47.9% of Malaysia's total exports in 1H22. Based on our global-linked model, -1.0%

contraction by China will drag world economy by –0.16% and Malaysia's output by -0.085%. Much worse if the US economy declines by -1.0% will bite world output by -0.255% and Malaysia by -0.057%.

Foreign banks' claims on Taiwan and China. According to the consolidated banking statistics as of Mar-22 published by the Bank of International Settlement (BIS), American, UK and Japanese banks have the highest exposures to China and Taiwan. The combined total claims (based on intermediate counterparty basis) by American banks on these two markets stood at USD201.3b, while the UK banks had higher claim of USD286.2b because of larger claims on China. Meanwhile, Japanese banks had combined claims on China and Taiwan at USD135.4b as of Mar-22.

Volatility in the global financial system to affect stability in Malaysia's and regional markets. Due to the larger foreign claims on China and Taiwan, we predict the destabilizing effect of a war in Taiwan will be more detrimental to Asian markets, more significant when the Russia-Ukraine war began earlier this year. While there have been outflows from Taiwan's equity market following the latest tension with China, a military action on Taiwan increases the risk of capital flight from Taiwan and other East Asian markets. Sentiment in the market will also weaken following the rise in trade war and possible slowdown in international trade due to tighter trade rules imposed on China.

EQUITY

Simmering, not erupting anytime soon. The geopolitical tension between Taiwan and China is a longstanding issue. In our opinion, it will continue simmering without erupting into an actual military engagement anytime soon. Having said that, the situation may escalate going forward due to the recent (and potentially future) provocative actions, in China's view, by the US and its allies.

Sanctions, and drills. Nonetheless, apart from saber-rattling by China, we do not expect the escalation of tension will lead to an outright war and military actions on Taiwan, at least not in the near future. It is also in China's interest to preserve the peace (hence denying casus belli for external powers) in this region. As earlier stated, the First scenario, i.e. more economic sanctions and bigger (likely more intimidating) military drills by China in lieu of outright military engagements, was and will most probably be the outcomes.

Impact to Malaysia's trade. In the above scenario, we do not expect China-Taiwan spat to bear significant impact to Malaysia's trade. Instead, the rekindling of trade war between US (together with its allies) and China bears more significant risk of destabilizing global trade activity, and Malaysia (due to its high trade dependency particularly to China, US, Europe and Japan) may be caught in the middle. However, we anticipate a short-term (trade) pain due to potential disruptions in Malaysia's external commerce but with possible longer-term (investment) gains as some multi-national companies may relocate out of China into South Asian and Southeast Asian countries, including Malaysia.

Fallout on local equity market. Based on the First scenario, we reckon the fallout of China-Taiwan spat to Malaysia's macro growth and on the local equity market to be not significant. At this juncture, we do not foresee the prevailing tension between China and Taiwan would jeopardize our **FBM KLCI end-2022 target of 1,600 points**.

SECTOR

BANKING

Most banks under our coverage have minimal exposure to the China market. The exceptions are Hong Leong Bank (HLB), and by default, Hong Leong Financial Group. This is through HLB's 18% stake of the Bank of Chengdu (BOCD). In FY22, HLB's associate contributions amounted to RM1.03b, largely due to BOCD. This translates to 24% of HLB's FY22 profit before tax, which is by all accounts a sizeable portion.

BOCD, being in its growth phase, still boasts very impressive financial metrics. Its loan and profit after tax is in the >+30%yoy growth region, while its ROE is a robust >18.0%. All of it is contingent on the city of Chengdu maintaining its rate of rapid growth. The recent Covid-19 lockdowns in Chengdu will have some impact on BOCD's performance, and we are still monitoring the situation closely.

For context, Chengdu is one of the most important economic, financial and commercial, transportation and communication centres in China. It hosts many international companies, with more than 270 fortune 500 companies establishing branches in the city. Any sanction imposed by other countries could throw a spanner into works, and derail BOCD's impressive growth trajectory -- and by extension, HLB and HLFG's earnings.

CONSUMER

We opine that the impact of Scenario 1 is limited to consumer companies. The majority of the F&B companies within our portfolio derive a considerable portion of their income from domestic sales. **F&N (BUY, TP: RM29.70)** and **Hup Seng Industries (BUY, TP: RM0.79)** both export their goods to 83 and 40 different nations, although their total export sales made up 22% and 23.4% of the group's revenue in FY21. Hence, we do not foresee a significant impact in this scenario. We could expect negative effects on the consumer sector if the China-Taiwan issue results in military action. Given that consumer companies under our coverage sourced most of their raw material from China.

GLOVE

In view of no military actions taken on Taiwan, but sanctions imposed on China. In this scenario, glove companies within our coverage will prosper, we opine that European clients would seek alternative sources from glove producers in Malaysia or Thailand. The increasing demand improved the sales volume and ultimately boost topline growth for the companies. Recall that the US tariff on China-manufactured gloves has resulted in US buyers seeking alternative sources from countries like Malaysia and Thailand. Due to this, the US now serves as the primary market for Malaysian glove manufacturers, while Chinese manufacturers diverted its exports of gloves from the US to Europe. Frost and Sullivan reported that developed countries such as the United States, Germany, and the United Kingdom has the highest glove per capita consumption in 2020 at 300/208/180 pieces as compared to the Philippines, China, and India at 14/9/7 pieces. In the worst-case scenario, if the conflict between China and Taiwan leads to military action, we could anticipate negative effects on the glove industry as rising input costs could more than outweigh the higher sales from European countries. The military action could have a spillover impact over the global supply chain disruption that causes further increases in the pricing of raw materials and commodities.

HEALTHCARE

Despite only representing 1% of the current total global chip supply, the medical technology industry is expecting the demand for semiconductors to double by CY28. Healthcare subsectors that rely highly on high-tech equipment for its operations – including ultrasound machineries, defibrillators and vital signs monitors – as well as real-time data for intensive and palliative care patients, would be disrupted, subsequently facing a shortage of these devices and services in the medium-long-term, if not addressed. Taiwan makes up 92% of the world's semiconductors, and an intensified conflict between China and Taiwan would risk the manufacturing and shipment of these chips, thus slowing down the fulfillment for crucial medical devices.

Shortages of chips is not new. To accommodate the shortage, nearly three quarter of the world's global medical devices manufacturers are pursuing alternative semiconductor sources, while also increasing their inventories and mitigating other challenges such as visibility and agility. Additionally, we believe that, should the China-Taiwan conflict escalate towards an economic embargo in the near term, hospitals that rely on advanced medical equipment would see a tightness in supply as the end of the pandemic would increase demand for delayed medical care. Additionally, the world's aging population is set to increase demand for more hospital treatment and surgeries; causing more tightness in medical equipment supplies.

We believe that the chip shortages will persist, with or without China and Taiwan's trade embargo. Medical devices manufacturers will be needing better policies and alternative sources to maintain production, in order to meet the sector's demands. Nevertheless, with our local hospitals and healthcare companies continue to upskill in equipment maintenance for sustainability, we opine the risks to a short-term shortage would be mitigated.

OIL & GAS

Taiwan's energy system is shown to be weak with pretty low amount of oil and natural gas inventories over the years. It is reported that, as of CY21 Taiwan only has 10+ days-worth of natural gas and +140 days-worth of refined oil stocked up – slightly above the minimum. Meanwhile, as of CY21, nearly 98% of Taiwan's fossil fuels are imported, with natural gas filling up 37% of its total power generation. Should any interruptions happen i.e., should China implement a full or partial embargo, Taiwan's energy system will cease to be resilient. Natural gas will be in the most vulnerable position, whereas oil and other renewables are neglectable.

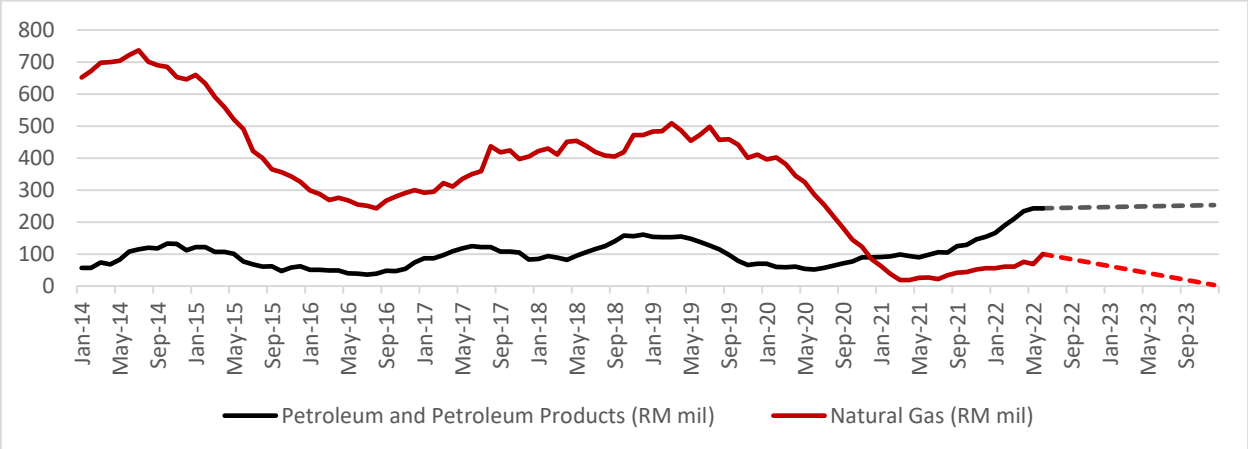
Taiwan is seeking to reinforce its LNG storage capacity, whilst expanding its renewable energy sources to lower import dependence. While LNG shipments have not been interrupted during the numerous military exercises in the waters near Taiwan, concerns on the stockpile remained. According to its Economic Ministry, about 10 more LNG storage tanks are needed to increase reserves by an extra 20 days, with a renewed challenge of finding land to build these storage tanks while stalling environmental impacts on its marine ecosystem. The country is expecting 9 new storage tanks by CY26, although these terminals are still under evaluation, and some had yet to finalize its plans.

We believe that in the event of a Taiwan embargo, the impact on shipping will be imminent albeit at a moderate scale. Shipments of LNG and petrochemical products will remain in operation; however, if the ports were to close, all shipping traffic will be forced to divert around the country which would subsequently affect global freight rates. But it wouldn't immediately put the LNG shipment on hold. Reportedly LNG carriers had already found ways to reroute or slowed movement to accommodate to the dangers of China's military exercises. Additionally, China had been vigilantly warning foreign ships to divert during the drills, indicating that some commercial sea lanes to Taiwan are still open.

Taiwan's import of Malaysia's petroleum products is expected to remain consistent, with or without China's embargo on the country. However, any escalation of tensions between the two nations would be a threat to the international trading of petroleum products. Natural gas exports to Taiwan are expected to decrease over time due to a potential risk to LNG shipping routes with military drills taking place near drop-offs and China threatening to sanction trade items coming in and out of Taiwan; subsequently causing Taiwan to take immediate measures to minimize dependency on energy imports.

Nevertheless, we maintain a **POSITIVE** stance on our local oil and gas players in terms of trading petroleum and petroleum products with Taiwan. Petronas and MISC had been large contributors to LNG shipment to the island since CY14, with the latest LNG cargo delivery from PETRONAS Floating LNG SATU in Sabah in CY21. We believe that being one of the pioneers in the LNG business, Malaysia has the capacity to produce and deliver the required products, while also tapping into opportunities for storage farms, FPSOs and renewable energy businesses to assist Taiwan in minimizing the impact of a trade sanction.

CHART 11: Taiwan's Petroleum And Natural Gas Imports



Source: Macrobond, MIDFR

PLANTATION

To summarise, a series of Zero-Covid related policies and lockdowns affecting cities across China dampened food service industry consumption for vegetable oils, which, when combined with high global vegetable oil prices, halved China's vegetable oil imports, including PO (-56.4%ytd) and SBO (-78.5%ytd) (Chart 12), in the first seven months of 2022. To note, we do expect China reopening would take in place sooner rather than later and demand is projected to rise as restocking efforts begin in earnest ahead of the holiday season (Chinese New Year). However, if any intensified actions such bans on China commodities due to China-Taiwan conflicts arise, this would augur well with our planter's top-line, as sanctions on Chinese would put pressure on its import of Soybean Meal (SBM) and Soybean Oil (SBO), hence better demand for palm oil due to price competitiveness.

Historically, China's intake of PO and SBO is on uptrend since 2016 to 2019 up by +68.7% and +47.4% to 7.55m tonnes and 0.83 tonnes respectively (Chart 12). But demand seems calmed throughout 2020 – 2021 on the back of Covid environment; with PO constituting approximately 87-85% of total edible oils import by China while 13-14.9%% for SBO (Jan-Dec19: 90.1% for PO and 9.9% for SBO). With price of PO tuning sideways circa RM3,500-4,500/mt cheaper in remaining month, coupled with higher price disparity against SBO, ultimately PO commodity turns up as a winner if the bans occur. On the other side, low SBM imports will decrease locally SBO processes and increased the spread between SBO price and PO price, which makes PO more competitive, in our view. As to-date, Malaysia holds 42.1% of China PO import slightly lower its counterpart due to low levy duty imposed by Indonesia government (Chart 13).

Chart 12: China's Soybean & Palm Oil import (2015 – 2022 Ytd)

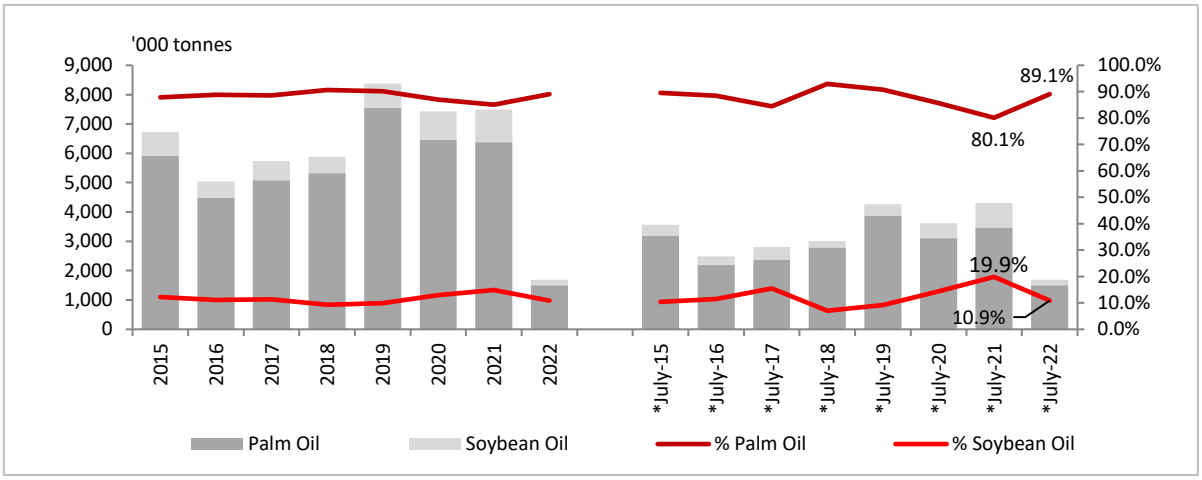
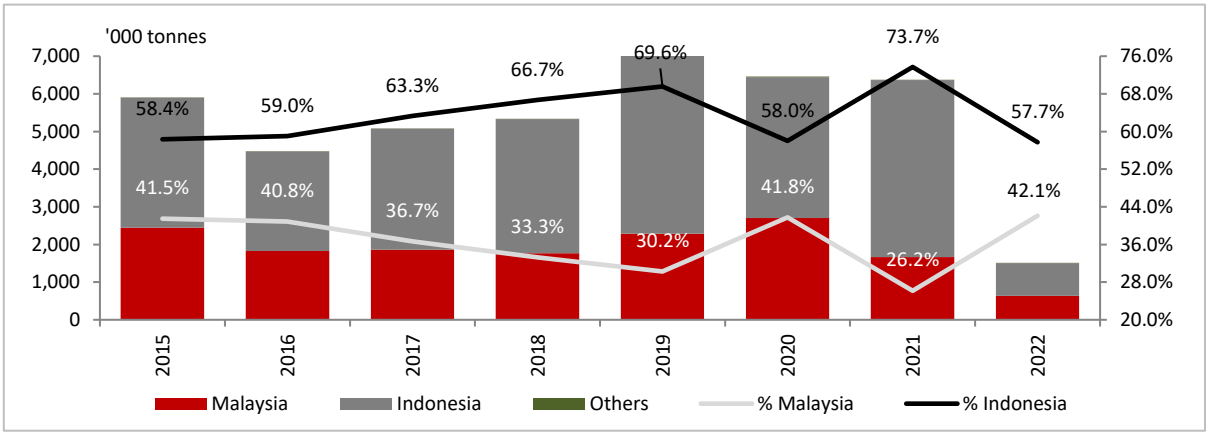


Chart 13: Malaysia & Indonesia PO market share for China export (2015 – 2022 Ytd)



Source: Bloomberg, MIDFR

TRANSPORTATION (Port)

As mentioned in the earlier section, Western economic sanctions on China might not pose a significant threat to Malaysia's trade flow as the impact would be mainly directed towards the respective trading countries. However, any geopolitical incident in the Taiwan Strait could disrupt the global container shipping traffic given that it is a major route that connects

Asia with the rest of the world. The South China Sea is connected by the Taiwan Strait with the East China Sea, which meets South Korea and Japan, and by the Luzon Strait with the Philippine Sea. Based on the data compiled by Bloomberg, close to 50% of the world's container ships were reported to have transited at Taiwan Strait in the first 7 months of this year, with majority of those vessels servicing transcontinental routes to Europe. Only less than 6% of trading partners are directly connected, hence the closure of this critical waterway, albeit temporary, would have have ripple effects across the supply chains.

In the event of a crisis, vessels might be forced to reroute to avoid having to pay war-risk premiums. The Luxon Strait between the Philppines and Taiwan offers an alternative north-south path, but at the expense of adding a few more days to the journey and having to navigate typhoon formations during typhoon season. Northbound ships that go through this alternative route might not have to incur extraordinary costs. However, those that have to double back through the South China Sea by rerouting through the Phillipines and/or Indonesia would have to navigate additional typhoon formations and this would likely drive up the shipping rates in this region. Port players that would likely be impacted by this would those that are primarily involved in the transhipment business like **Westports Berhad (BUY, RM4.00)** which handles c.65% of transshipment cargo. Although the congestion at Westports earlier this year has eased, the potential Taiwan Strait crisis might prompt vessels to arrive out of their designated berthing windows and this could be a concern for Westports. Nevertheless, we view this scenario to be unlikely as we believe that China would not want to disrupt its own commercial links to the world.

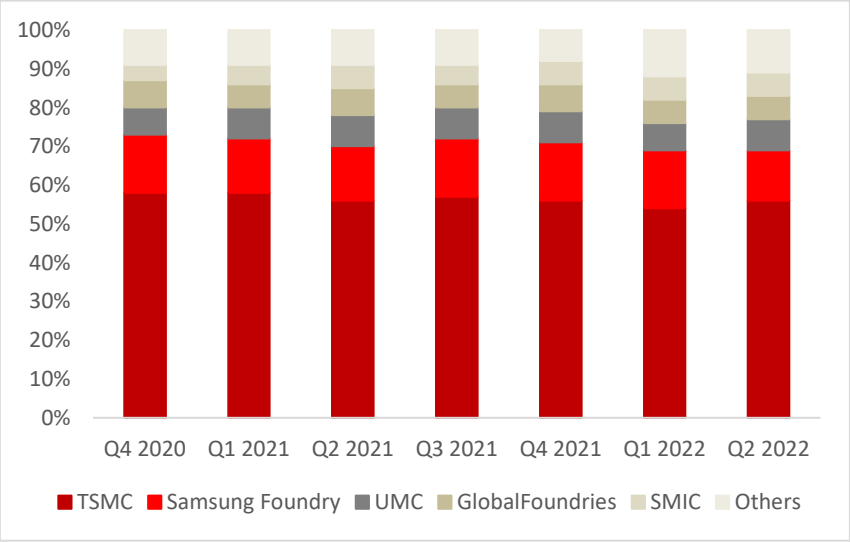
PROPERTY

We think there is no impact on property sector in Malaysia as most of the developers have little or no exposure to China property market except for IOI Properties Group. Note that IOI Properties Group has project development in Xiamen China. Nevertheless, we think that impact is minimal on IOI Properties Group due to its diverse property exposure in Malaysia, Singapore and China. Overall, we maintain NEUTRAL on property sector.

TECHNOLOGY (Semiconductor)

Taiwan Semiconductor Manufacturing Company (TSMC) is the world's top foundry, accounting for more than half of the worldwide chip manufacturing market share. TSMC is the heart of semiconductor manufacturing, which keeps the world's technology running. The two largest economies, the United States and China, rely heavily on Taiwan for semiconductors, since Taiwan manufactures more than 90% of the world's mid-range to sophisticated computer chips, which are used in smartphones, computers, automobiles and military equipment. If an invasion occurs, Taiwan's prominent position in this sector would jeopardise the global supply chain of semiconductors; thus, we opine that the possibilities of second and third scenarios are minimal due to the benefit of the 'silicon shield' that Taiwan holds.

Chart 14: Global Semiconductor Foundry Market Share (%)



Source: Counterpoint, MIDFR

In scenario one, the local semiconductor industry players could get a positive spillover effect if Multinational Corporations (MNCs) relocate certain operations out of China. During the US-China trade war which occurred in 2017-2018, we can observe that MNCs had tried to relocate its operations outside of China to mitigate the risk of higher tariffs imposed by the US on China products. Thailand, India, Vietnam, Malaysia and etc are some of the countries that have seen the raise in Foreign Direct Investment (FDI) during the trade war. We may experience the same inflow of FDI, especially in the semiconductor sector as Malaysia has a preferable ecosystem and ready areas such as Penang, Batu Kawan, Bukit Minyak and Kulim for the northern site.

China would have a double whammy impact if sanctions were imposed on them because China's semiconductor sector was already hurt by the introduction of CHIPS Act. The funding recipients from this bill prohibit them from expanding semiconductor manufacturing in China and countries defined by US law as posing a national security threat to the US. We would see a separation technology hub and its ecosystems, particularly between China and US. Companies under our coverage which are Inari Amerton, Unisem and Globetronics may take this opportunity to get the market share that has been left by China's companies if the US stop doing business with the mainland. Even though, Inari Amerton and Unisem have factories in China, we opine that the potential reduction in volume sales for the factory in China would be offset by the higher volume from factories outside the mainland.

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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