



## **Part Five**

### **Capital market issues and outlook**

# CAPITAL MARKET ISSUES AND OUTLOOK

## THE WORLD ECONOMY

World output stayed strong in 2007 but global economic conditions turned less stable and became increasingly variable. According to latest estimates, world GDP grew at a real rate of 4.9% from 5% in 2006.<sup>1</sup> Global growth was supported by robust domestic demand in Asia. This helped to offset erratic growth in Japan and western Europe, and a continued slowdown in the US economy.

The US economy looked fragile towards the end of 2007 as problems in the housing and financial markets worsened. A sharp fall in house prices and rising mortgage defaults lessened the availability of credit to households.

**Table 1**  
**Summary of World Real GDP (Annual % Change)**

	2005	2006	2007	2008f
World	4.4	5.0	4.9	4.1
US	3.1	2.9	2.2	1.5
Euro area	1.5	2.8	2.6	1.6
Japan	1.9	2.4	1.9	1.5
Developing Asia	9.0	9.6	9.6	8.0
– China	10.4	11.1	11.4	10.0
– India	9.0	9.7	8.9	8.4
– Malaysia	5.2	5.9	5.8	5.6
– Indonesia	5.7	5.5	6.2	6.1
– Philippines	4.9	5.4	6.3	5.8
– Thailand	4.5	5.0	4.0	4.5

e = estimate, f = forecast

Source: International Monetary Fund

Meanwhile, firms faced higher costs of capital as a result of financial market turbulence.

As concerns over the US economy grew, the dollar weakened further across a spectrum of currencies. Renewed worries about US current account's large and persistent deficit intensified the decline during the fourth quarter. Mounting uncertainty over the dollar's roles as a global reserve currency and foreign-exchange peg for oil-exporting countries also contributed to the decline.

The dollar's depreciation added to inflationary pressures in many developing countries. These had grown as a result of high energy and food prices, and strong domestic demand. Oil prices continued to rise to new peaks, pushing up demand for biofuels. This in turn drove the international prices of related commodities sharply higher.

In countries where inflation had picked up, such as China and those in South Asia and parts of Latin America, central banks continued to raise policy interest rates. However, in the US, western Europe and Japan worries over financial system instability and the threat of recession prompted central banks to generally loosen monetary conditions in the second half of the year.

These developments have made the outlook for global growth less predictable. Current projections<sup>2</sup> suggest that global growth for 2008 will decelerate to 4.1% on the assumption that, among other things:

- US household and business spending does not weaken significantly;

<sup>1</sup> Based on purchasing power parities. Source: Update to *World Economic Outlook October 2007*, International Monetary Fund.

<sup>2</sup> Source: Update to *World Economic Outlook October 2007*, International Monetary Fund.

- Developing economies, continue to grow strongly without overheating; and
- Stability gradually returns to financial markets and credit markets operate normally.

However, there are several risks surrounding these assumptions as a result of developments in the second half of 2007.

A wider and more intense fall in house prices could lower US consumer spending sharply, especially if the stock market, another important component of household wealth, weakens at the same time. A more pronounced US housing downturn could also threaten a global decline in property prices.

Prospects for developing countries are generally favourable. But they have also become more integrated with the global economy through trade and financial flows. As a result, they remain vulnerable to global economic and financial contagion.

Financial markets are likely to remain volatile until the full extent of problems associated with the credit market turmoil becomes clear. Banks and other financial institutions have already announced close to US\$91 billion of subprime-related losses.<sup>3</sup> Estimates of potential losses<sup>4</sup> imply there could be another US\$57 billion waiting to be announced, although there is still much uncertainty as to where these exposures are held.

Therefore, news of unexpected losses by banks or financial difficulties affecting financial services providers could set off another round of volatility in financial markets, which in turn could lead to a severe tightening in global credit. This has the potential of depressing economic sentiment and activity, and would require appropriate easing of monetary and fiscal policy to support both growth and financial stability.

As a result of these uncertainties, there are risks that world output could fall short of current forecasts.<sup>5</sup>

## THE MALAYSIAN ECONOMY

The Malaysian economy proved robust to developments in the global economic environment. GDP grew by an estimated 6% in 2007; strong domestic activity, especially in the services sector, helped to offset slower exports.<sup>6</sup>

Higher household spending and a sharp rise in tourism contributed to faster growth of utilities, retail and wholesale trade, accommodation, and dining. A strong expansion in property and business services, as well as in financial services, reflected a renewed vibrancy in Malaysian asset markets and the increasing sophistication of the domestic financial sector.

An improvement in the property market and implementation of the Ninth Malaysia Plan projects led to a recovery in the construction sector. The mining sector also staged a recovery as higher global oil prices drove more production and exploration further afield.

However, a cyclical downturn in global electronics demand had an adverse impact on manufacturing and export growth. Agricultural output meanwhile was affected by extensive flooding during the year.

Higher food and energy prices added somewhat to inflationary pressures in the second half of the year. However, headline inflation for 2007 was at the lower end of official forecasts, averaging at 2%.<sup>7</sup> This allowed the central bank to maintain the official policy rate at 3.5%, which kept overall interest rates stable.

Improved foreign investor sentiment as well as looser monetary conditions in more advanced economies pushed

<sup>3</sup> Source: Standard & Poor's.

<sup>4</sup> As of November 2007 Goldman Sachs estimates that total write-downs from subprime-related credit obligations could be as much as US\$148 billion. Source: *The Economist*.

<sup>5</sup> In their October *World Economic Outlook*, the IMF estimated a one-in-six chance that 2008 world output growth could fall to 3.5% if global economic conditions were to worsen significantly.

<sup>6</sup> Source: *Economic Report 2007/2008*, Government of Malaysia.

<sup>7</sup> This and other monetary and financial data immediately below were taken from *Monetary and Financial Developments December 2007*, Bank Negara Malaysia.

the ringgit higher in 2007. The currency gained 6.8% against the US dollar, and nearly 5% against the British pound. International reserves remained strong at RM336 billion (US\$101 billion).

The outlook for the economy continues to be positive. Official estimates project GDP to grow by 6–6.5% in 2008, while the main multilateral agencies have forecast a slightly lower but still robust range of 5.6–5.9%.<sup>8</sup> The strength of domestic demand should help to offset a moderation in the external sector. A pick-up in spending on infrastructure projects and an increase in Ninth Malaysia Plan-related investment is expected to boost output growth.

Corporate profits are expected to be robust, with market earning estimates growth at around 12–13%.<sup>9</sup> Government-linked companies are entering the new year in a strong position as they continue to streamline their operations and improve efficiency. The plantation sector should continue to benefit from high commodity prices.

Headline inflation is forecast to be within a slightly wider range of 2–3% in 2008 because of pressure from fuels, commodities and various tariff increases.<sup>10</sup> Nevertheless, the market expects short rates to be more or less stable, reflecting views that inflationary pressures will be contained.

## GLOBAL CAPITAL MARKETS

Global financial market conditions turned volatile in the third quarter of 2007 following a reappraisal of US housing credit risk. This initially led to a sharp drop in valuations of securities backed by low-grade “subprime” mortgages, as well as related structured credit products, such as collateralised debt obligations.

However, fears quickly arose about the exposure of other credit markets to subprime mortgage risk. The rapid growth of securitisation through structured instruments in the last

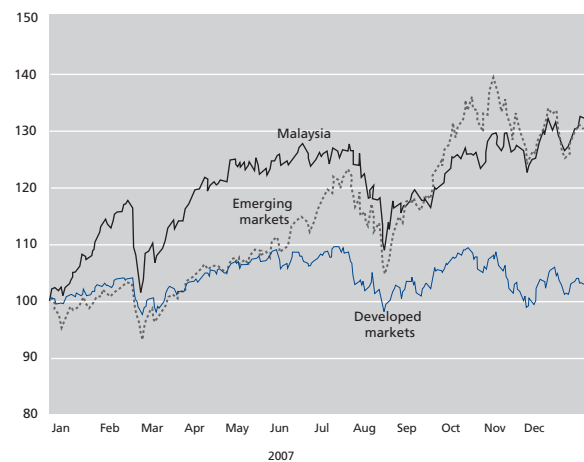
few years had increased linkages between these markets. It also allowed credit risk to be widely distributed among a diverse set of investors.

This quickly turned into a major correction across a wide spectrum of credit markets and a “flight to quality” to government bonds. In August, money market interest rates rose sharply in North America and western Europe. At the same time, new issues of asset-backed commercial paper and high-yield corporate bonds diminished.

Uncertainty over exposures to subprime mortgage risk fuelled the panic. Risk aversion in the financial system grew on news of large and mounting losses by major global banks and other financial institutions. The situation also highlighted the risk of a more extensive “credit crunch”.

**Chart 1**  
**Stock Market Performance**

MSCI World, Emerging Markets and Far East ex-Japan indices, and the Kuala Lumpur Composite index, rebased, Dec 31st 2006 = 100 (local currency)



Source: Thomson Financial Datastream, Securities Commission

The credit market turmoil also provoked a global sell-off in equity and bond markets, as hedge funds and other leveraged players sought to cover their portfolio losses.

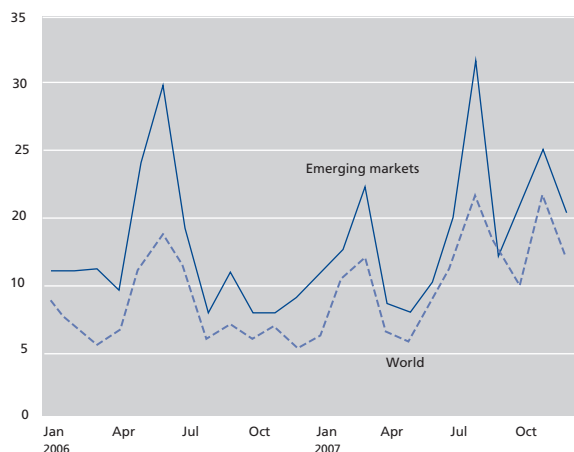
<sup>8</sup> Sources: *Economic Report 2007/2008*, IMF, World Bank and Asian Development Bank.

<sup>9</sup> 12-month forward earnings growth estimate. Source: I/B/E/S.

<sup>10</sup> Source: *Annual Report 2006*, Bank Negara Malaysia.

**Chart 2**  
**Stock Market Volatility**

Standard deviation of daily index movements per month, annualised percentages; MSCI World and Emerging Market indices (local currency)



Source: Securities Commission, Thomson Financial Datastream

Stock price volatility more than doubled in August–September. Meanwhile, emerging market bond yields spreads widened by 100 basis points amid a sharp decline in US Treasury yields.

Markets stabilised somewhat in October after the European Central Bank and US Federal Reserve took exceptional steps to alleviate liquidity pressures in the financial system. However, several more rounds of turmoil in the fourth quarter led the central banks in the US, western European and Japan to announce a set of monetary measures in December aimed at reducing stress in the financial system.

Although conditions have since improved, financial markets on the whole are likely to remain fragile until the full extent of unwinding from the subprime mortgage crisis has played out. Risks to financial stability have increased and international money markets and structured products are especially vulnerable if credit problems in more advanced economies spread beyond the housing markets.

Global equities, which have weathered the turmoil well so far, could also come under a lot more pressure. The market’s

**Chart 3**  
**Emerging Market Credit Risk Premium**

JPMorgan-Chase EMBI+ Composite index stripped yield spread over 10-year US Treasuries



Source: Thomson Financial Datastream

view on equity risk has steadily worsened, reflecting growing uncertainty about the world economy. Emerging markets should continue to attract capital flows on the basis of strong macroeconomic fundamentals.

The financial turmoil of 2007 has raised many important issues for markets and regulators, in particular, the unintended consequences of securitisation and structured finance, which has seen tremendous growth in only a few years.<sup>11</sup> Through such innovations, loans are packaged into debt securities, which are then pooled and repackaged into a new set of financial instruments that carry different levels of risk.<sup>12</sup> The instruments are then typically split up and sold in “tranches” according to the different risk appetites of investors. These range from securities designed to offer the credit risk of the highest-rated borrowers (and therefore lower yields), to those offering much higher potential returns but with a greater credit risk to match.

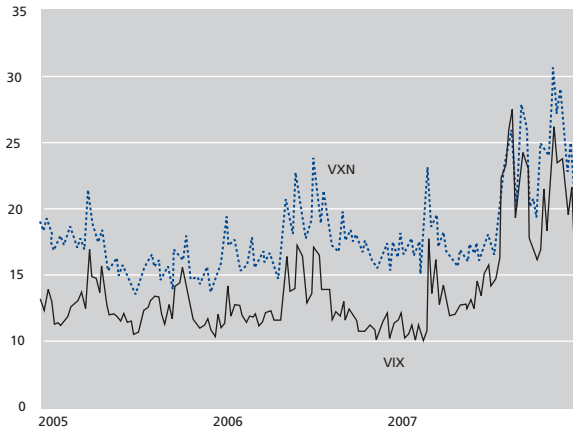
In doing so, structured products have allowed financial risks to be transferred from the balance-sheets of banks and other debtholders to the wider market, thus freeing capital so that it can be used more profitably elsewhere. However, this comes at a cost: that of not knowing who

<sup>11</sup> There are many excellent surveys and reports on the growth of this market, including those by the International Monetary Fund and Bank for International Settlements. For global data, see <http://www.bis.org/statistics/derstats.htm>.

<sup>12</sup> The fastest growth has been in credit default swaps (CDSs) and collateralised debt obligations (CDOs).

#### Chart 4 Equity Risk Aversion

30-day implied volatility for S&P 500 Composite (VIX) and Nasdaq Composite (VIXN) indices, annualised percentages



Source: Thomson Financial Datastream

ultimately holds the underlying credit risk on which such instruments are based, and how much exposure they have to potential losses. Under normal conditions, this poses few problems: by breaking up and dispersing such risks into the market, structured finance serves to diversify them within the financial system. But when risks all crystallise at the same time and in the same direction – triggered as they were in August by the rising default rate in subprime mortgages – then uncertainty over the distribution and scale of losses can affect confidence and impede the workings of markets.

The events affecting global credit markets this year illustrate how such unintended consequences – fundamentally, a case of poor transparency – can undermine not only capital market efficiency but, given the high degree of linkages between them, financial stability as well. That these consequences were not intended, let alone priced into valuations of structured products, make them a classic example of an economic “externality”.<sup>13</sup>

The events have also drawn attention to the role and accountability of credit rating agencies. By certifying the likely default rate associated with each tranche, the agencies gave structured products their marketability. However, they have been criticised for being too slow in downgrading these securities as valuations fell. As a result, investors were not given timely and accurate information, and were therefore unable to assess risks correctly.

## MALAYSIAN CAPITAL MARKETS

Malaysia’s capital market had a good year despite the global financial upheaval. Positive economic conditions provided a strong foundation to growth, which was balanced across all segments of the market.

Equities found greater momentum in 2007 and set new records for prices and activity. The KLCI closed off its all-time high but still ended the year 32% higher at 1,445.<sup>14</sup> Strong corporate earnings growth, especially among plantation, and oil and gas companies, helped to maintain reasonable valuations, despite rising share prices. The market also rewarded those, like a number of government-linked companies, that delivered strong corporate performance and improved governance.

Strong performance was not confined to blue-chips alone. Main Board stocks outside the 100 largest firms recorded a 64% increase for the year, dwarfing the performance of their larger cousins.<sup>15</sup> Moreover, efforts to promote smaller listed companies appear to be paying off. The smallest of the Main Board companies gained 31% as a group, while Second Board companies enjoyed a creditable 12% rise in their stock prices.<sup>16</sup>

The stockmarket acquired greater depth on more active trading by retail investors and foreign institutions. Turnover increased substantially and was sustained throughout the year

<sup>13</sup> Externalities are economic “side-effects”. They are defined as costs (or benefits) arising from an economic activity that affect somebody other than the people engaged in the economic activity, and are not reflected fully in prices. Examples include pollution. One solution is to regulate them, although it is generally more efficient to find a way for the market to take their costs into account when engaging in (or evaluating) economic activity. Source: Adapted from *The Economist*.

<sup>14</sup> The KLCI set a new intra-day high of 1,452.57 in 2007 on 31 December.

<sup>15</sup> This refers to the performance of the FTSE-Bursa Malaysia Small Cap index.

<sup>16</sup> Companies in the FTSE-Bursa Malaysia Fledgling index make up the smallest 2% of Main Board capitalisation. The Second Board performance was calculated by splicing the previous exchange-calculated index with the new FTSE-calculated index introduced in September this year.

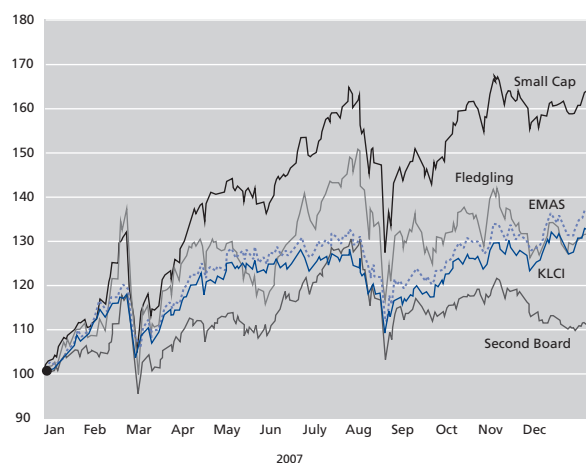
in spite of a marked increase in price volatility. Trading volume increased from 879 million per day in 2006 to 1,548 million in 2007. As a result, the market's turnover velocity, which measures the size of trading relative to the market, rose from 36% in 2006 to 58% in 2007.

Ringgit appreciation generated a strong demand for bonds. However, the deterioration in global credit markets put some pressure on the domestic market, although short-term papers continued to attract interest. A surge in domestic mergers and acquisition activity spurred growth of equities as well as bonds. The value of completed deals targeting Malaysian companies grew from RM38.3 billion in 2006 to RM132.5 billion in 2007; average deal size more than doubled from RM80.4 million to RM200.6 million.<sup>17</sup> By contrast, acquisitions by Malaysian companies during the year amounted to RM40.9 billion, reflecting significant foreign involvement in the market.<sup>18</sup>

**Chart 5**  
**Malaysian Stock Market Performance**

Kuala Lumpur Composite (KLCI), FTSE-Bursa Malaysia EMAS, Small Cap, Fledgling and Second Board indices, Jan 2nd 2007=100.

Note: Second Board index is spliced from the previous index and the new FTSE-Bursa Malaysia index introduced September 2007



Source: Thomson Financial Datastream

Buoyant conditions in their underlying markets drove stronger growth in derivatives. Notably, the stock index futures market appeared to reach critical mass, as activity surged alongside the cash market. Average daily volume jumped from 6,618 in 2006 to 12,733 contracts a day on greater foreign participation. CPO futures also drew strong foreign interest. The market tracked the worldwide boom in commodities and rediscovered its momentum following a lull at the beginning of the year.

Trading activity for structured warrants soared in December 2006 and stayed high throughout 2007, providing a significant boost to the market in tradable structured products. Average daily volume increased from around 23 million contracts to nearly 144 million contracts in 12 months, reflecting strong retail demand. Strong appetite for international markets led to a tripling in volume in October after warrants on foreign stocks, mainly blue-chip Chinese listings as well as a number US technology favourites, were introduced to the market.

Malaysia's capital market, like others in the region, faces prospects of being influenced by developments in global markets in the months ahead. The world's financial market environment is likely to remain volatile until credit markets stabilise and the global economic outlook becomes clearer. A situation where world growth moderated at a measured pace would probably have a minimal impact on the capital market. However, a "worst-case" scenario, where global growth falls sharply or even contracts, would bring renewed pressure on the whole region. Markets could be vulnerable to a quick reversal in global sentiment given their strong performance in the last 18 months. The Malaysian market can count on several strengths, which would lessen the longer-term impact of any downturn.

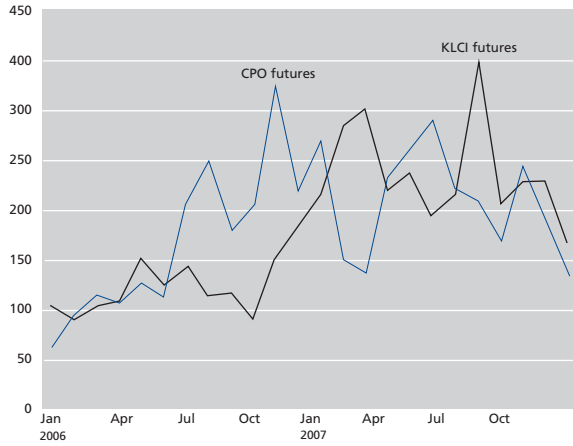
First, Malaysia has a stable economy anchored by domestic demand to provide support for further growth. Earnings are expected to benefit from buoyant commodity prices and a

<sup>17</sup> Source: Bloomberg data.

<sup>18</sup> Source: Bloomberg data.

**Chart 6**  
**Futures Activity**

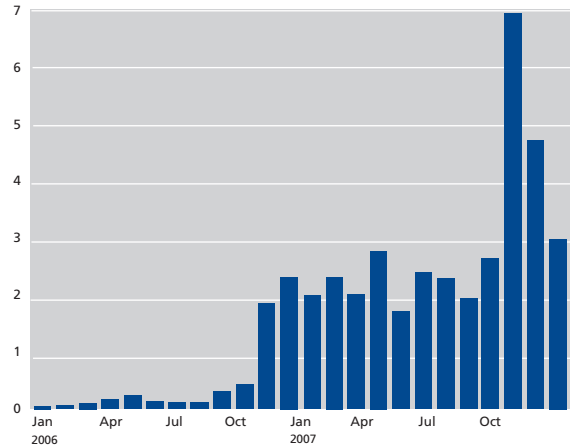
Monthly trading volume of Kuala Lumpur Composite and Crude Palm Oil futures contracts, thousands of contracts



Source: Bursa Malaysia

**Chart 7**  
**Structured Warrants Activity**

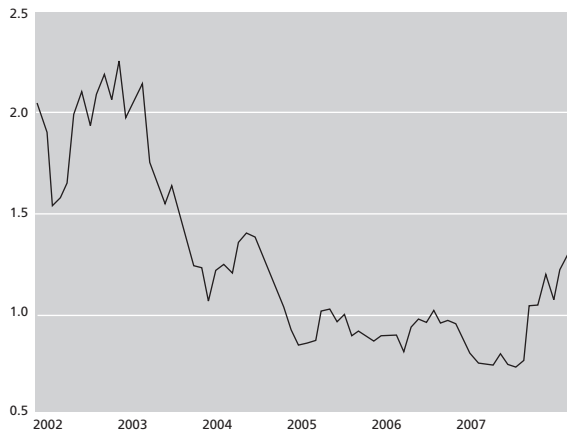
Monthly trading volume of structured call warrants, billions of units



Source: Bursa Malaysia

**Chart 8**  
**Malaysia International Equity Risk Premium**

Spread between sovereign-risk adjusted earnings yield and US 10-year Treasury yield, percent



Source: Securities Commission

relatively higher level of domestic productive capacity. Equities, for example, continue to trade at sound valuations; Malaysia’s equity risk premium has lessened since 2002 and remains well below that of other emerging markets.<sup>19</sup>

Second, Malaysia’s progress in corporate and economic restructuring has led to demonstrable improvements in fundamentals and opened more growth opportunities for the market. A strong follow-through on plans and on managing projects efficiently would reinforce confidence and lend weight to current market valuations. For instance, in 2008, the implementation of key infrastructure and other developmental projects under the Ninth Malaysia Plan will promote further growth of the domestic bond market. In addition, the market appears well placed to provide funding for regional infrastructure development, which is projected to be in the order of US\$150 billion over the next five years. The market is also likely to have to adopt more sophisticated bond structures and instruments such as hybrid capital, subordinated debt and securitisation to meet demanding financing needs.

Third, measures to strengthen the market’s foundations, such as investor protection, corporate governance and market structure, are improving efficiencies, helping to lower costs and uncovering investment value. The soundness of market intermediaries has improved in the past decade, with better risk management capabilities. While bolstering overall

<sup>19</sup> Malaysia’s international equity risk premium measures the extra return that investors require to hold Malaysian equities instead of a (credit) risk-free asset, like US government bonds. One indicator of this premium is the difference between the sovereign-risk adjusted earnings yield on the MSCI Malaysia stock index and the benchmark yield on 10-year US treasury bonds. In the chart above, we calculate earnings yields by using a 12-month forward earnings estimate on the stock index; sovereign risk is measured by the yield spread between the JPMorgan-Chase Global bond index for Malaysia and US 10-year Treasury bonds. All yields are in US dollars.

investor confidence in the market, these improvements will also continue to enhance the Malaysian market's "investibility" among global institutional funds.

Fourth, global structural trends bode well for the capital market's long-term development. Oil-exporting economies, Asian central banks, hedge funds and private equity have collectively amassed an estimated US\$8.4 trillion in assets.<sup>20</sup> Based on conservative assumptions on oil prices, foreign assets of oil exporters are estimated to grow by more than US\$1 billion per day, to reach US\$6 trillion by 2012.<sup>21</sup> In seeking new investments, they are expected to inject even more liquidity into the world's capital markets over the next few years. Concerted efforts at enhancing product innovation and supply would place the

market in stronger position to attract these funds.

Fifth, the market is in a good position to benefit from faster global expansion of Islamic finance, which has grown more established in the last two years. Islamic products and services are gaining widespread acceptance. On the supply side, there are now larger global offerings of Islamic securities by a wider array of issuers. A notable development was the British government's announcement that it plans to launch Shariah-compliant gilts. Islamic financial innovation has also grown rapidly. At the same time, the investor base for Islamic products is beginning to widen; around 50% of subscriptions for *sukuk* are said to come from non-Muslims, reflecting the competitive pricing of Islamic products.

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<sup>20</sup> Source: McKinsey & Co estimates.

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