QUARTERLY ECONOMY TRACKER

(JAN-MAR 2018)

Socio-Economic Research Centre (SERC)

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Executive Summary

World Economic Situation and Prospects for 2018

- **Global economy in the ninth year of expansion**. Continuing a synchronized economic upswing in 2017, the global economy should maintain strong growth momentum, albeit somewhat balanced of risks in 2018, marking the ninth year of economic expansion since 2008-09 Global Financial Crisis.
- **Activity indicators point to continued global growth**. Tracking of current and forward indictors lend credence to our assessment that the global economy remains in a healthy clip: steadying trade expansion, higher manufacturing and services activities, steadying commodity prices, low unemployment, high levels of corporate profits, moderate inflation (at least for now) and still accommodative interest rates, though the Fed's guidance of future path of interest rate hikes is somewhat hawkish.
- **Broadening growth in advanced economies**. The US economic expansion, which had picked up pace to average 2.4% in 2H17, will continue to grow above-trend pace of growth in 1H18 as lower income tax and corporate tax cuts promote increased consumer and investment spending. The European economy's momentum will be sustained in 2018, supported by rising employment, high levels of sentiment and a loose monetary policy. Amid a slow start to the year, Japan is likely to show decent growth, thanks to very low unemployment that supporting consumption. Backed by political stability, China will continue to focus on sustaining the quality of economic restructuring growth, safeguarding financial stability and controlling its bloated debt. There seems little reason to fear an abrupt slowdown.
- **Rising interest rate trend to continue in 2018**. The year 2017 witnessed a number of major central banks raised interest rates, a trend that we expect to continue in 2018 and raises the spectre of convergence global monetary policy. The economic effects of interest rate increases should be manageable unless inflation rises faster than expected, compelling more aggressive rate hikes. We believe that the US Fed Reserve will continue to be relatively aggressive, raising interest rates between three and four times in 2018. The European Central Bank (ECB) is unlikely to change its interest rate course any time soon at least until the expiry of the bond purchases by September this year. Bank of Japan (BOJ) could be the last of the big central banks to change the course of monetary policy though some board members voiced the consideration of raising interest rates or slow purchases of risky assets if the economic recovery continues.
- **Keep an eye on event risks**. As in 2017, 2018 does have the potential for some pockets of event risks and market turbulences, some of which could stem from the unpredictable behaviour of President Trump and his loyalists. Trade barriers is one of the most closely watched trade policy risk. The Fed's aggressive interest rate hikes remain a possibility if interest rates were to rise faster. The recent spike in the 10-year Treasury yields to near 2.90% underlies investors' nervousness about inflation stemming from rising wages and tight labour market. Other risks arise from the continued geopolitical tensions in the Middle East and North Korea or some political/election hotspots in Europe, and in a multitude of Latin American countries.

Malaysia's Economic and Financial Conditions

- **The economy bounced back strongly in 2017**. The Malaysian economy maintained solid momentum in 4Q17, with GDP expanding by 5.9% yoy (6.2% in 3Q), taking the full-year growth to 5.9% in 2017. It was the best in three years since 2014 (6.0%) and after slowing two years in a row in 2015 (4.2%) and 2014 (5.0%). Domestic demand momentum and contribution from the external sector held firm.
- **2018's growth prospects still looking good**. The underlying strength of domestic economy remains intact amid some external headwinds. With improving global growth (estimated 3.9% in 2018 vs. 3.7% in 2017), supportive fiscal measures and overall sustaining global demand's positive spillover on our exports (estimated 7.5% in 2018 vs 18.9% in 2017) as well as still-positive current and forward (industrial production, exports, sales, and bank lending), we remain positive on Malaysia's economic growth prospects.
- **SERC expects 2018's GDP growth of 5.5%**. We, therefore expect GDP growth of 5.5% in 2018, tweaking higher from 5.1% estimated previously, mainly to account for firmer domestic demand. That said, technical high base effects in 2017 will take off some heat from year-on-year growth comparison. Real GDP growth in 1H18 is estimated to average 5.6% before easing to 5.4% in 2H as the high base effect kicks in (2017's GDP growth: 5.7% in 1H vs. 6.1% in 2H).
- **BNM maintains favourable economic outlook**. In the 2017 Annual Report released on 28 March, Bank Negara Malaysia maintained its upbeat assessment of economic outlook for 2018, with GDP expecting to grow higher by 5.5-6.0% (5.9% in 2017). This is more optimistic when compared to 5.0-5.5% projected during the Budget Day in October last year.
- **Domestic demand continuing to be the key driver of growth**, with sustained private consumption (6.9% in 2018 vs. 7.0% in 2017) and continued expansion in private fixed investment (8.3% in 2018 vs. 9.3% in 2017).
- **Consumer spending has continued to surprise on the upside**, defied expectations in an environment of rising cost of living and inflation as well as cautious consumer sentiment. Though MIER's consumer sentiment has increased by 5.5 points to 82.6 in 4Q17, it remains below 100-pt optimism threshold for fourteen consecutive quarters since 2Q14. The survey's respondents indicated that reasons contributed to the improvement of consumer sentiment were their current incomes in better shape; employment and financial outlook continues to improve; inflationary jitters easing amid cautious and pragmatic shopping plans ahead. The first instalment payout (out of three instalments) of BR1M cash handouts totalling RM6.8 billion for 7.2 million recipients was in February and had helped to provide some income relief to low and middle-income households for discretionary consumption.
- **Business sentiment still relatively soft in recent quarters**. MIER's Business Conditions Index (BCI) fell for the second consecutive quarter to 101.5 points in 4Q17. The ongoing projects including the MRT2, LRT3, Pan Borneo Highway, PNB 118, and TRX as well as continued investment in both manufacturing and services sectors will continue to support private investment momentum. We expect private investment to grow by 8.3% this year (9.3% in 2017) vs. BNM's estimate of 9.1% in 2018.
- With an imminent 14th General Election (GE14), some cautiousness in investors' sentiment would prevail on lingering uncertainties pertaining to the outcome of GE14. The General Elections tend to bring surprises that keep consumers and investors on their toes. Their perspectives can have an impact on what happens as we navigate through an often-heated campaign trail. And policies uncertainty can tip the scales in either direction.

- The **external sector** is expected to contribute moderately to overall GDP growth as exports are now estimating to grow at a moderate pace, partly challenged by high base effects and the diminishing exchange rate revaluation gains. The Trump's trade policy wild card could put global trade growth at risk.
- **Drivers of domestic economic growth is broadening**. On the supply side, the services sector is expected to benefit from continued trade activities, domestic consumption, especially tourism related and growth in the financial services. The manufacturing sector will see expansion in both export- and domestic-oriented sub-sectors. The agriculture sector's growth will be driven by further improvements in CPO yields amid the maturing of oil palm trees. Higher output from new oil and gas facilities will underpin the mining sector. The construction sector's growth will continue be supported by new and existing civil engineering projects amid the consolidation in commercial projects and high-end residential properties.
- **Inflation will rise at a moderate pace**. After hitting a nine-year high of 3.7% in 2017 since 2008 (5.4%), overall price level is expected to increase at a slower pace in this year, partly due to technical high base effects, reflecting a markedly slowdown in fuel prices that led to lower prices of transportation as well as moderate increase in food prices. For the full-year of 2018, the inflation rate is estimated at 2.0-3.0% (revised lower from 3.0-3.5% previously). Potential upside risks are fuel price, utility cost, wage growth and firm demand fuelling demand inflation.
- **Early set of indicators point to continued economic growth**. High frequency economic data and indicators such as Malaysia's composite leading index, exports, imports, industrial production, sentiment gauges, loan data pointed towards continued expansion of the economy. Our preliminary estimates indicate real GDP to expand by 5.6% in 1Q18, 5.7% in 2Q; 5.5% in 3Q and 5.4% in 4Q.
- **Interest rates unlikely to move for a while**. Bank Negara Malaysia's (BNM) decision to hike interest rate by 25 bps to 3.25% in January is a significant sign that the central bank is confident that economic growth and domestic spending will continue, supported by improved wages and income as well as a mildly expansionary fiscal policy.
- **The current OPR of 3.25% will remain for a while**. Some prerequisite conditions have to be met before continuing with the pace of gradual rate hikes in the months ahead. These include the strength of domestic economic expansion and global growth; to anchor inflation expectations given still-resilient consumer spending despite coping with high cost of living; and global financial conditions, especially tracking the Fed's continuing down the path of steady rate hikes and balance sheet reduction. Our expectation of end-2018 BNM's Overnight Policy Rate (OPR) target is 3.25-3.50%.
- **Ringgit gets a boost from a weak dollar**. The Ringgit receives a boost from the softening US dollar. The US dollar-weighted index on a tactical downturn despite the anticipation of further hikes in interest rate by the Fed, probably worries about rising twin deficits (current account deficit and budget deficit) and higher debt ceiling in the US economy.
- **Drivers and hurdles for the Ringgit**: Better economic prospects; financial stability; still enjoying current account surplus estimated 2.7% of GDP in 2018; foreign reserves accumulation at a healthy clip and the inflows of long-term capital. The imminent 14th General Election may temper investors' sentiment on the Ringgit as investors likely to stay sideline pending on the election's outcome. The key risks counteract the strength of the Ringgit is a full-blown trade war among the large trading nations impacting export-oriented economies like Malaysia via global supply chains and the Fed's more aggressive hikes in the US interest rate, in response to faster than expected rise in inflation.

GLOBAL MOMENTUM CONTINUES UNABATED

Global economic activity continues to strengthen. The pickup in global growth has been broad based, with notable upside surprises in Europe and Asia. The global economic prospects for 2018 should remain good, with a broadening base of growth coming from trade, sustained higher manufacturing and services activity as well as still firmed business and consumer confidence. Global PMI hit a seven-year high in January.

Both the advanced and emerging economies ended the year 2017 on fairly respectable growth, which allows the growth momentum to carry forward in 2018 as the recovery in investment, manufacturing and trade as well as commodity-exporting developing economies benefitting from firming commodity prices. The labour market continues to strengthen with the unemployment rate ticking down and wages are improving.

Incoming data for 1Q18 suggests economic growth continued to be solid in early 2018, with the January PMI for manufacturing and services sustaining at record pace of expansion. Business and consumer confidence held up well.

The US economic expansion, which had picked up pace to average 2.4% in 2H17, will continue to grow above-trend pace of growth in 1H18 as lower income tax and corporate tax cuts promote increased consumer and investment spending. The European economy's momentum will be sustained in 2018, supported by rising employment, high levels of sentiment and a loose monetary policy.

In Asia, Japan also likely to show a good economic performance amid a slow start in the year, thanks to very low unemployment that helping to keep up consumption. China will continue to sustain the quality of growth, maintain financial stability and control its bloated debt (210.5% of GDP as at September 2017). There seems little reason to fear an abrupt slowdown.

Global equity markets, which were well supported by the Trump's tax reform and reflation policies and improved global earnings growth in 2017, are expected to continue performing in 2018, albeit intermittent market rout and slower pace of earnings growth.

We anticipate scope of surprises that could uneasiness in the market calmness and disrupt its upward momentum, causing investors to reprice risk of investing in stocks. With share prices have risen higher than earnings growth coupled with low market volatility, this gives rise to some sense of market complacency.

One of the market surprises that caused wide swings in the US Dow Jones Industrial Average (DJIA) in early February was investors' fear about the prospect of aggressive interest rate hikes by the Fed to contain the rise of inflation expectations as the US economy gets stronger to spur consumer spending and wage demand-induced price inflation. Then in early and late March, the proposed slapping of import tariffs on steel and aluminium products (though some watering down for some countries) to protect the US producers as well as US$50 billion import tariffs related intellectual property on China, prompting China to counter slap with tariffs on US$3 billion worth of products from the US. Both the US's and China's trade retaliation actions have stoked fear of a full-blown trade war if both sides do not exercise restraint and escalate the magnitude of trade confrontation or both countries widen the list of products under tariffs protection, impacting more countries.

Risks to global outlook remain tilted to the downside. Policymakers should take advantage of their strengthening economies to secure a durable and structural recovery via accelerated reforms. Investors should not become too complacent after a long bull run in the stock market as unanticipated market surprises or policy shocks would cause a risk repricing.

Global monetary convergence in the central banks of advanced economies could set the stage for a removal of accommodation liquidity conditions that have been supporting the economy and financial markets. In this regard, an abrupt monetary tightening especially from the Fed could derail the expansion. Escalating confrontation of trade barriers, the disruption of Brexit's negotiation process and transitional arrangement as well as rising geopolitical tensions could dampen investors' confidence and economic activity.

Figure 1: Real GDP growth (% YoY)

	2016	2017	2017 1Q	2017 2Q	2017 3Q	2017 4Q	2018*f* (IMF)	2018*f* (WB)
United States	1.5	2.3	2.0	2.2	2.3	2.6	2.7	2.5
Euro Area	1.8	2.3	2.7	1.8	2.5	2.4	2.2	2.1
China	6.7	6.9	6.9	6.9	6.8	6.8	6.6	6.4
Japan	0.9	1.7	1.4	1.5	1.9	2.0	1.2	1.3
India[1]	7.1	6.6	6.1	5.7	6.5	7.2	7.4	7.3
Malaysia	4.2	5.9	5.6	5.8	6.2	5.9	5.3	5.2
Singapore	2.0	3.6	2.5	2.8	5.5	3.6	2.6	-
Indonesia	5.0	5.1	5.0	5.0	5.1	5.2	5.3	5.3
Thailand	3.3	3.9	3.4	3.9	4.3	4.0	3.5	3.6
Philippines	6.9	6.7	6.4	6.7	7.0	6.6	6.7	6.7
Vietnam	6.2	6.8	5.2	6.3	7.5	7.7	6.3	6.5

Source: Officials; IMF (World Economic Outlook, October 2017; WEO Update, January 2018; Recent Article IV Consultations); World Bank (Global Economic Prospects, January 2018)

Note 1: Annual GDP for India is on fiscal year basis, as per reporting practice of the country.

A. SNAPSHOT REVIEW OF KEY GLOBAL ECONOMIC INDICATORS

Current and Forward indicators

Incoming economic and leading indicators suggest the continuity of global economic expansion. The OECD Composite leading index still growing above the 100-pt threshold of expansion, albeit somewhat softened in Dec 2017 and Jan 2018. Global trade continued to grow, as reflected in the WTO's World Trade Outlook Indicator (WTOI), which printed a marginal higher reading of 102.3 in 1Q18 (4Q17: 102.2). PMI readings of both manufacturing and services were sustained at high levels. Increasing fears of a wider trade war triggered by President Trump's administration could put global trade at risk.

Figure 2: OECD CLI slipped for two months, albeit remained above long-term average

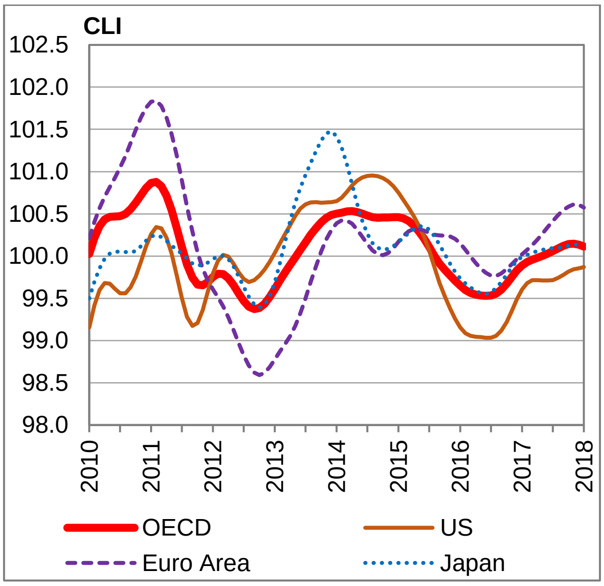


Figure 3: India CLI growth is gaining traction

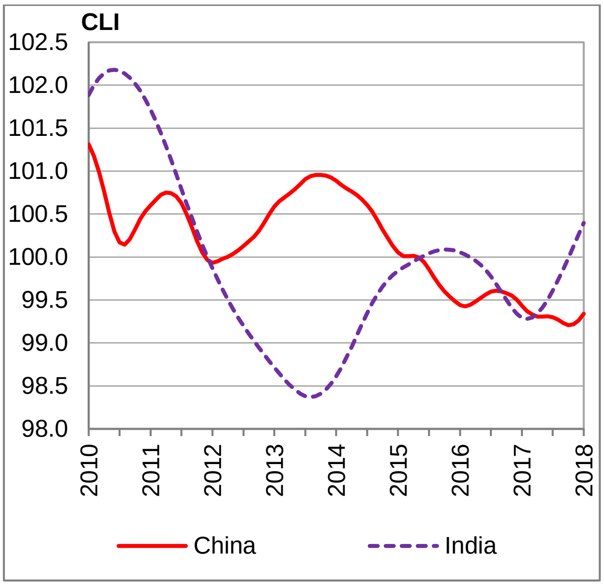


Figure 4: OECD business and consumer confidence are improving

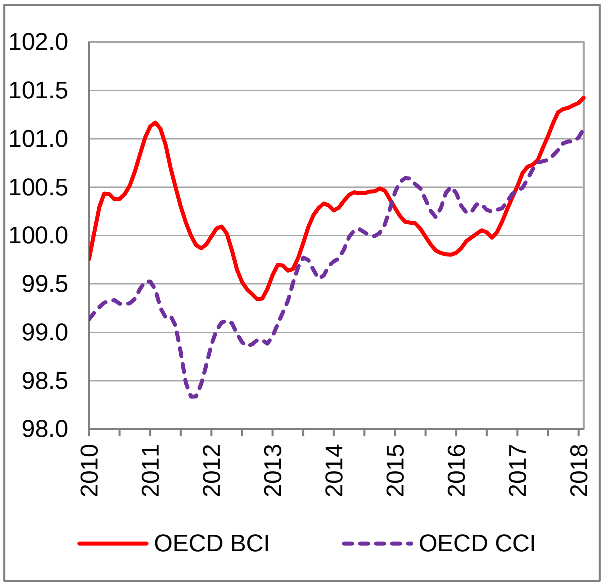


Figure 5: Global PMI for manufacturing and services sectors remained positive

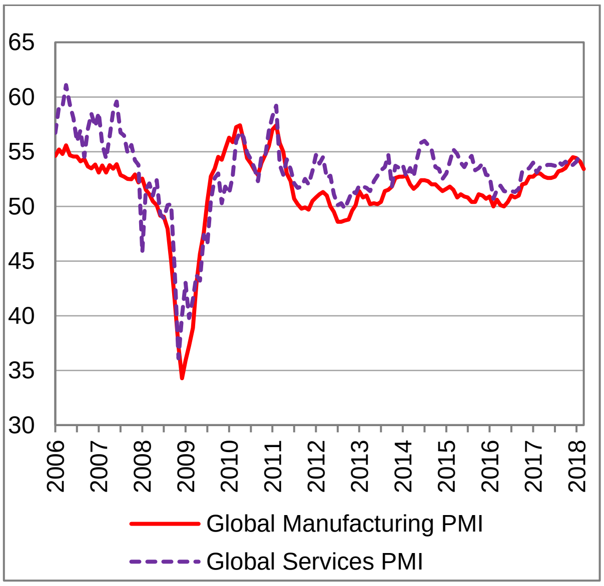


Figure 6: World trade volume rising steadily

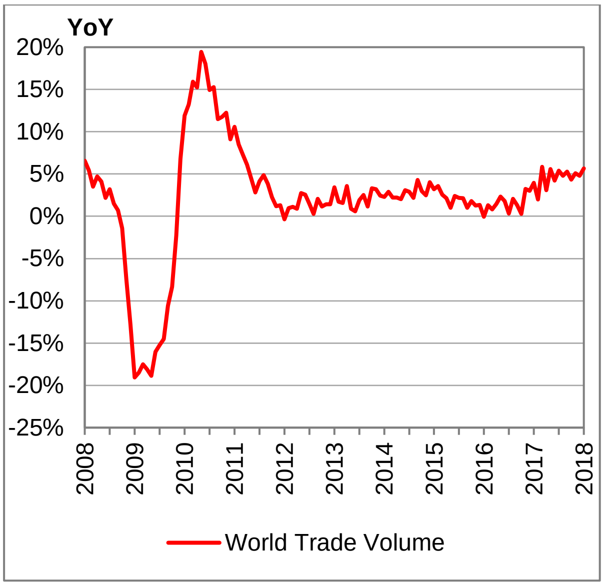


Figure 7: World exports volume growth also trending higher

Source: OECD; Markit; CPB Netherlands Bureau for Economic Policy Analysis

Industrial production and Semiconductor sales

In tandem with the expansion of manufacturing and exports, world industrial production grew strongly by 3.6% in 2017 (1.9% in 2016), reflecting a broad-based growth in advanced and emerging Asia.

Global sales of semiconductors, which ended the year 2017 with an outstanding growth of 21.6% to US$412.2 billion, continued to increase by 21.0% yoy in February 2018 (22.7% in January), with strong sales recorded in the Americas region (35.0% growth in Jan-Dec 2017), followed by China (22.2%), Europe (17.1%), Asia Pacific/All Other (16.4%) and Japan (13.3%). The World Semiconductor Trade Statistics (WSTS) expects chip sales to grow by 9.5% to US$451.2 billion in 2018 while other semiconductor forecasters (IC Insights, Semiconductor Intelligence and Gartner) projected sales growth rates of between 7.5% and 15.0%.

Figure 8: World industrial production growth mostly in positive territory …

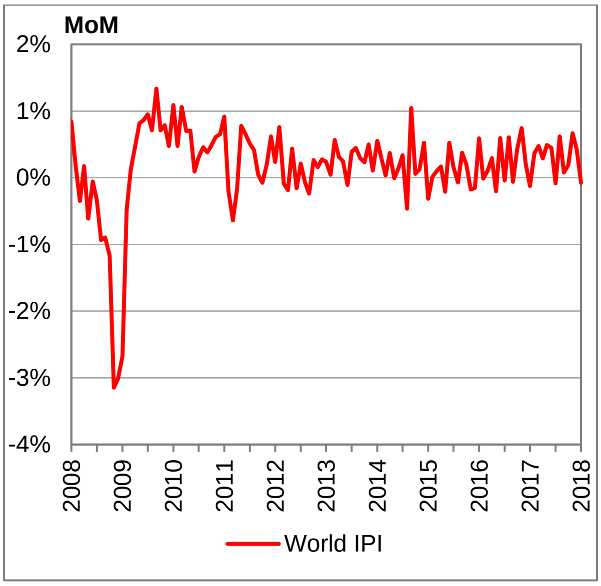


Figure 9: … on stable growth in emerging economies relative to advanced economies

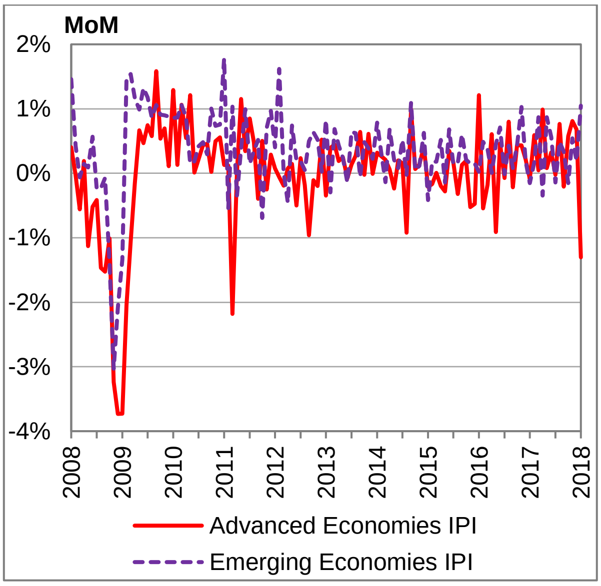


Figure 10: Chip sales remained strong but may negatively impacted by trade war

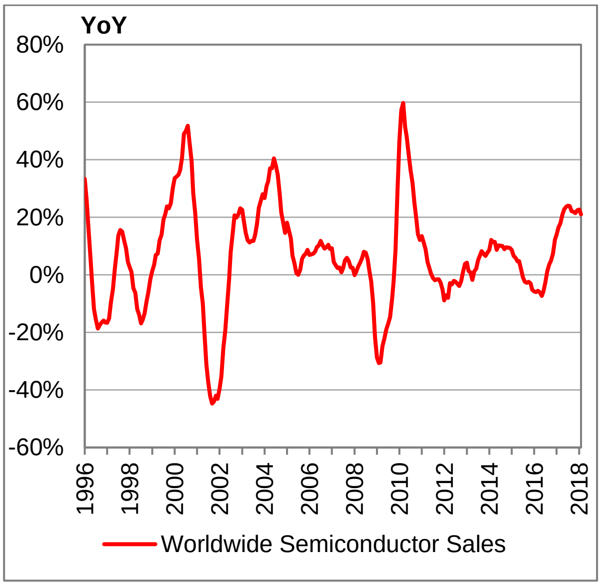
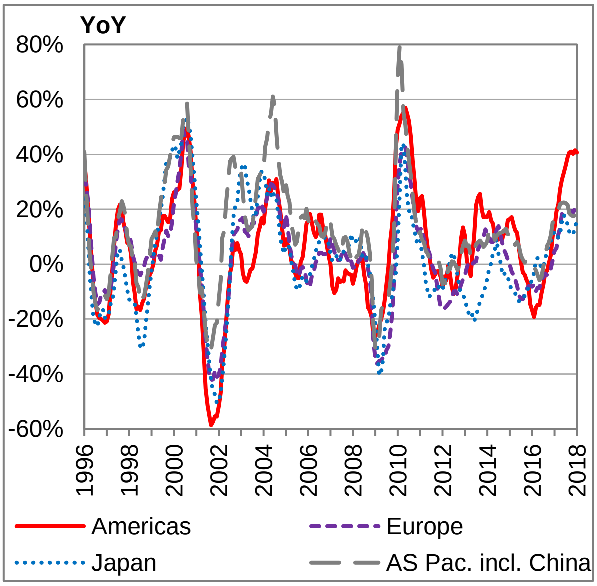


Figure 11: America-led strong global semiconductor sales growth



Source: CPB Netherlands Bureau for Economic Policy Analysis; Semiconductor Industry Association

Commodity prices

Commodity prices started the year 2018 on a high note in 1Q18. Energy prices increased significantly by 21.3% yoy, non-energy prices up 3.4% and precious metal prices grew higher by 6.5%. Despite being pressured by shale oil production, Brent crude oil price rose higher to an average of US$66.86 per barrel in 1Q18 (US$61.40 in 4Q17 and US$52.10 in 3Q17), thanks to increasing compliance of crude oil supply cut within OPEC nations (achieved 147% compliance in February 2018) amid talks of a price stabilisation framework. Brent crude oil prices are estimated around US$60-65 per barrel this year (US$54.12 in 2017).

Crude palm oil (CPO) prices averaged at RM2,461.50/metric tonne in 1Q18 (RM2,783 in 2017), lifted by the suspension of export taxes for three months starting 8 Jan 2018 to ease the pressure of stocks piling up. There are headwinds to CPO prices: Higher import tariffs imposed by India and the proposed ban of using palm oil as biodiesel in Europe starting 2021. Overall, the CPO prices are estimated to average at RM2,650 in 2018.

Figure 12: Commodity prices off 2018 on higher level

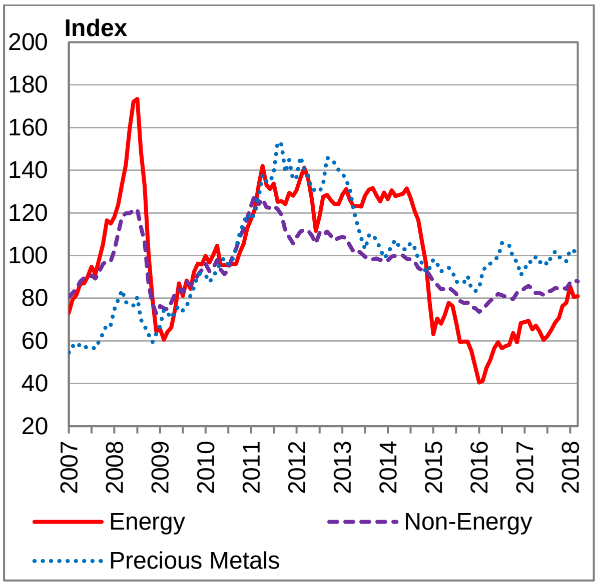


Figure 13: Production cut agreement proven effective in lifting oil prices

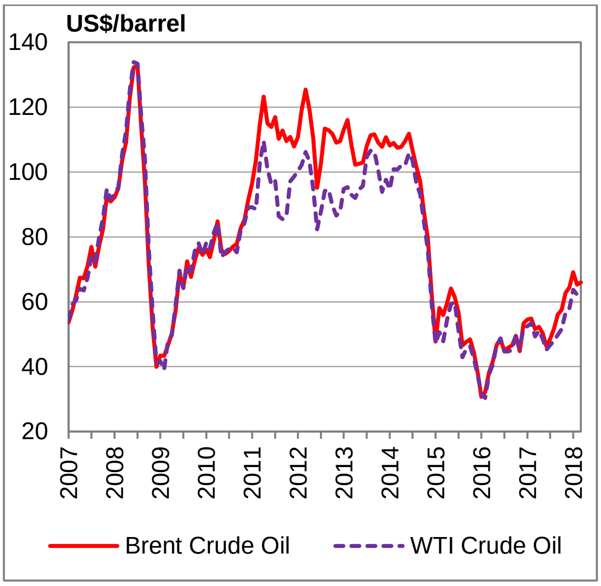


Figure 14: Crude palm oil prices continue to soften since early-2017

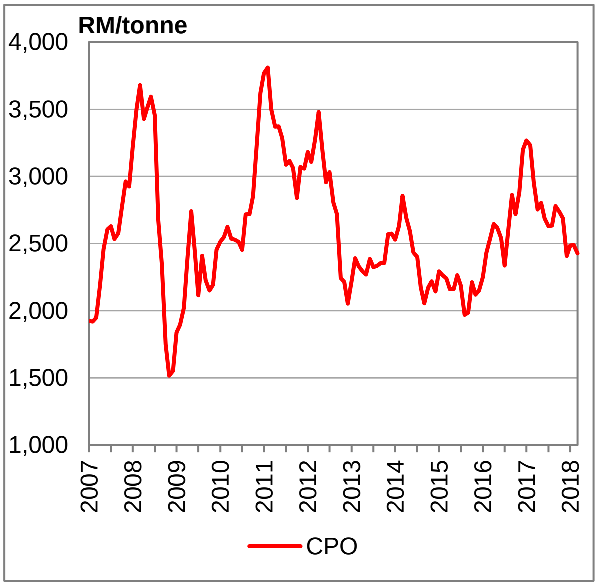
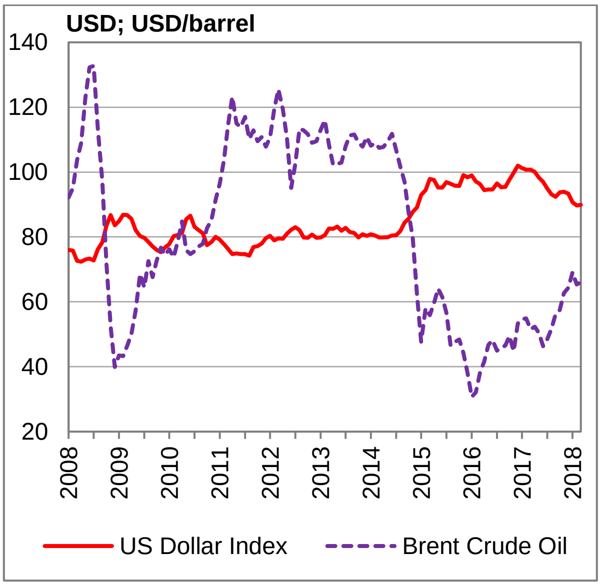


Figure 15: US dollar index vs. Brent oil price



Source: World Bank; US Energy Information Administration; Malaysian Palm Oil Board; The Wall Street Journal

US – GROWTH IS COMING BACK STRONG

The US economy hit a strong chord (an annualised qoq rate of 2.9% in 4Q17 and a full-year growth of 2.3% in 2017 (1.5% in 2016), marking the eighth year of expansion since 2008-09 Global Financial Crisis. The labour market is strengthening, wages are improving; and both manufacturing and services sectors continued to stay firmly on the expansion trajectory. Retail sales also printed firm growth (4.7% yoy in Jan-Feb 2018). Price pressures are developing, driving higher bond yields to between 2.44% and 2.94% in recent months on expectations of more aggressive interest rate hikes.

The economy is expected to grow on a faster pace estimated 2.7% this year, backed by tax reforms and fiscal stimulus amid the dampening impact from the trade barriers. President Trump's trade barriers' aggression against its major trading partners, including China is bad for global trade and economy if it escalates into a scalable and destructive tit for tat trade war.

Figure 16: The US economy posted fifteen consecutive quarters of economic expansion

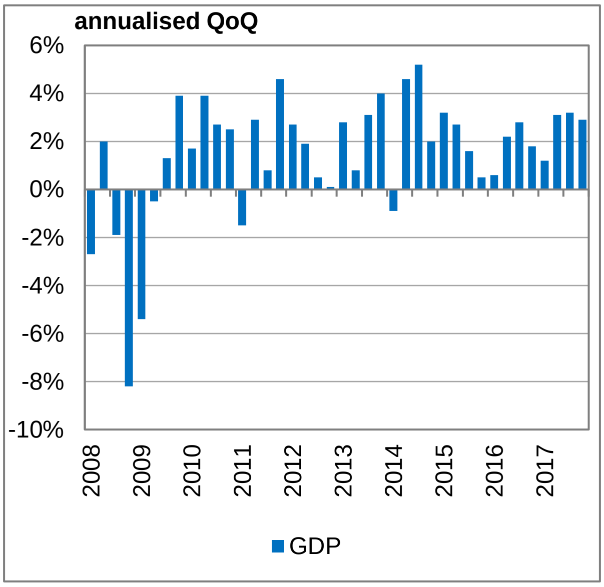


Figure 17: Stable growth in consumption and investment activities in 2017

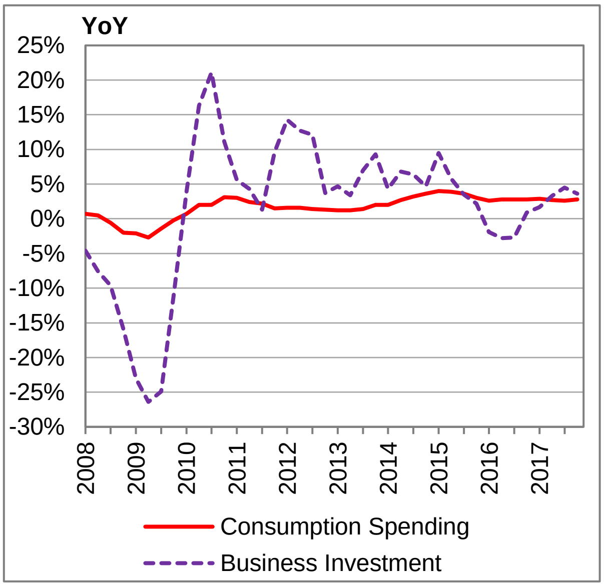


Figure 18: PMI suggests strong economic growth ahead

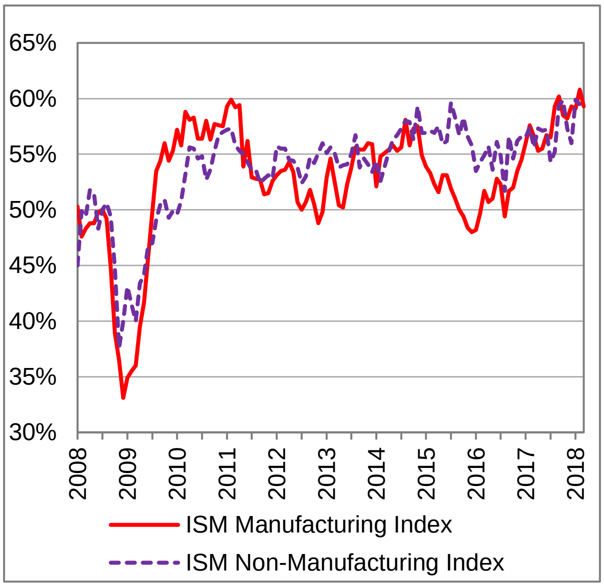


Figure 19: Strongest growth in industrial production since March 2011

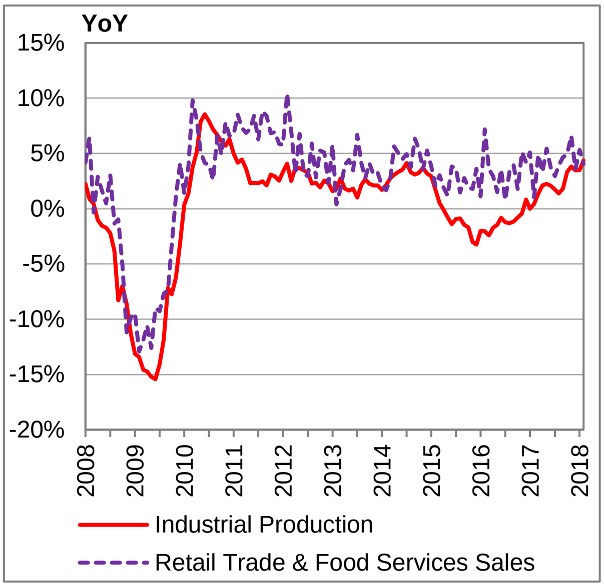


Figure 20: Best unemployment rate since Dec 2000

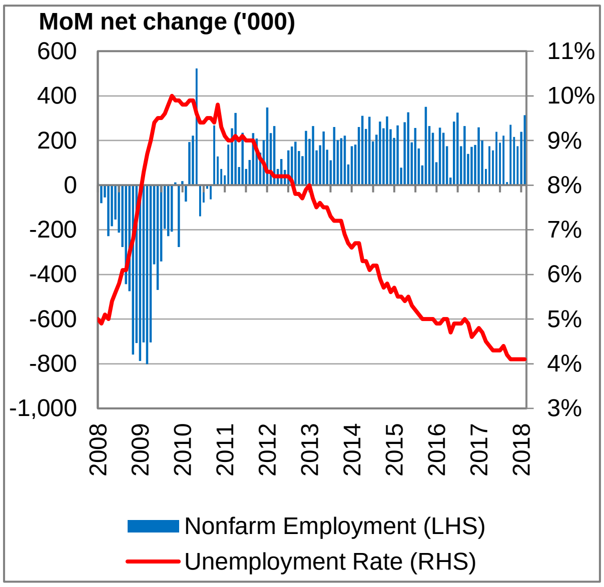
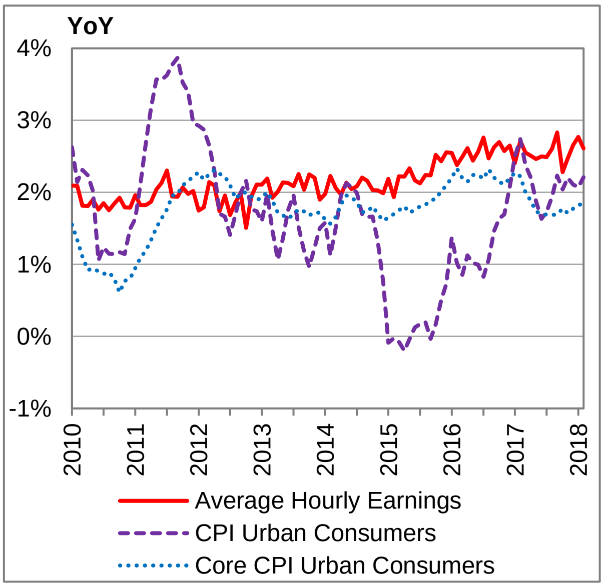


Figure 21: Higher wage growth lifts consumption amid fuelling inflation



Source: US Bureau of Economic Analysis; Institute for Supply Management; Federal Reserve System; US Census Bureau; US Bureau of Labor Statistics

EUROZONE – ECONOMY BUOYANCY LOSSES STEAM

The eurozone bounced back strongly to grow by 2.3% in 2017 (1.8% in 2016), driven by buoyant external demand and solid domestic demand. Economic sentiment indicators (ESI) decreased to 112.6 in March 2018 after achieving its 17-year high in December 2017. Business and consumer confidence sustained above long-term average. Though both PMI for manufacturing and services had eased in February but still staying above the 50-pt threshold expansion. Industrial production had a slow start in January while retail trade volume grew unevenly. Inflation remained moderate (1.1% in Feb; 1.3% in Jan 2018 vs. 1.5% in 2017). Higher employment gains led to improving jobless rate of 8.6% in January 2018.

The ongoing issues of focus include Brexit's negotiation and transitional arrangement, high debt level in Italy, migration flows, youth unemployment as well as the growing inequalities.

Figure 22: Eurozone expanded for nineteenth consecutive quarter …

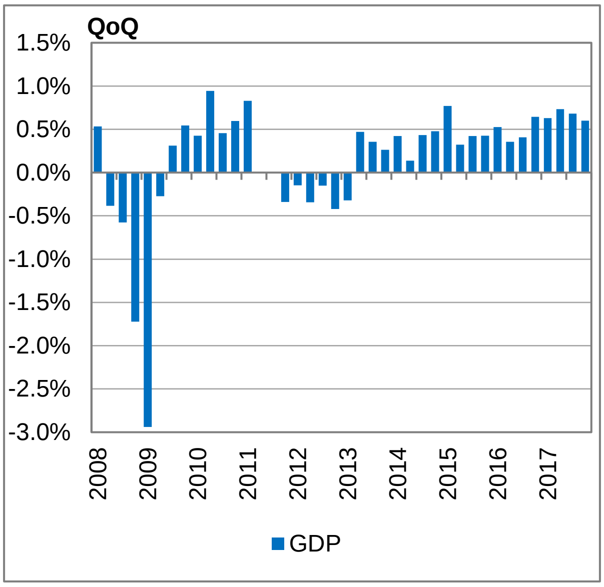


Figure 23: … underpinned by domestic and external demand

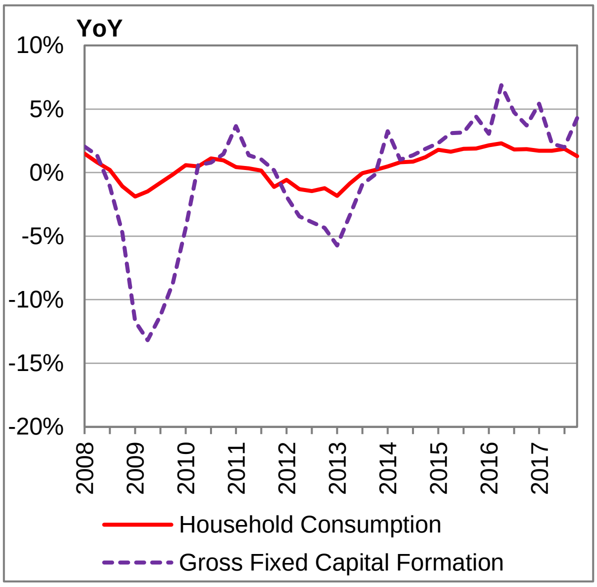


Figure 24: PMI readings though eased but still at high levels

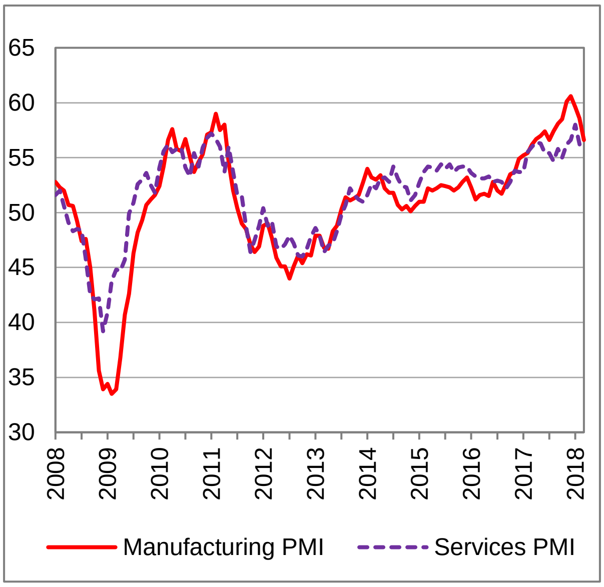


Figure 25: Softening industrial production; uneven retail volume

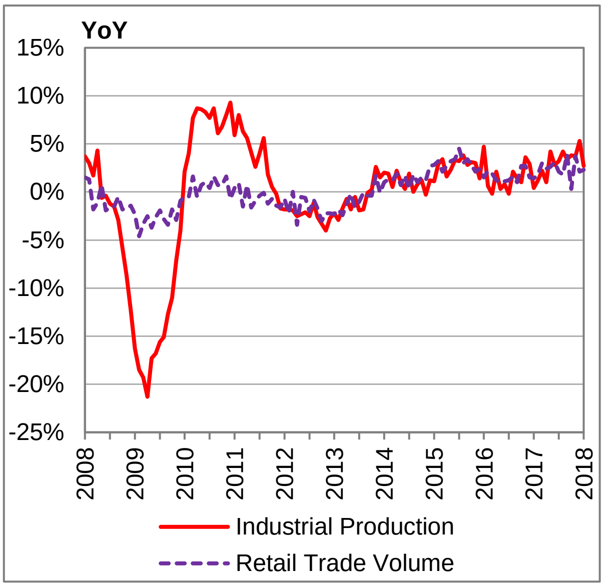


Figure 26: Job market continues to improve

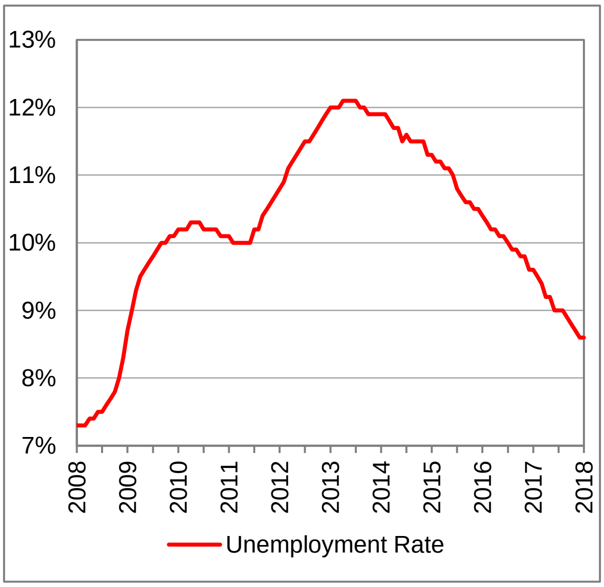
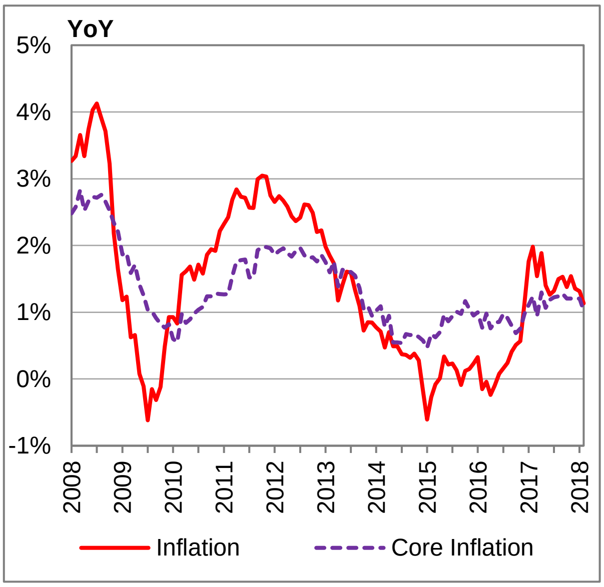


Figure 27: Inflation moved against the targeted 2%



Source: Eurostat; Markit

JAPAN – ON TRACK FOR A RECORD SETTING STREAK

The Japanese economy continued its unbroken eight consecutive quarter of continuing growth in 4Q17, albeit slower at 0.4% qoq (0.6% in both 2Q and 3Q), backed by a tight labour market that keeps consumer spending going. A mix set of incoming data for 2018 suggests a slow start to the year: Core machinery orders, a leading indicator of future capital expenditure, turned around in January after falling sharply in December 2017; industrial production growth paced slower; softer retail sales; the manufacturing PMI eased further to 53.1 in March; and exports growth turned slow in February reflecting the impact of strengthening yen. The latest inflation reading shows some pick-up but still a gap from the targeted 2%.

Nevertheless, the tax reforms unveiled in December last year, weaker yen-led exports and investment activities as well as infrastructure spending ahead of 2020 Olympic Games in Tokyo are expected to provide some strength to the economy.

Figure 28: Japan's economy continued its unbroken eight consecutive quarters of expansion

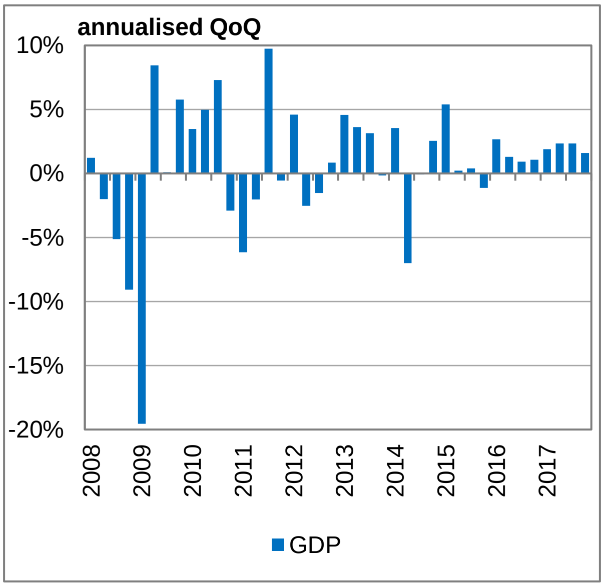


Figure 29: Stable growth in private consumption and investment

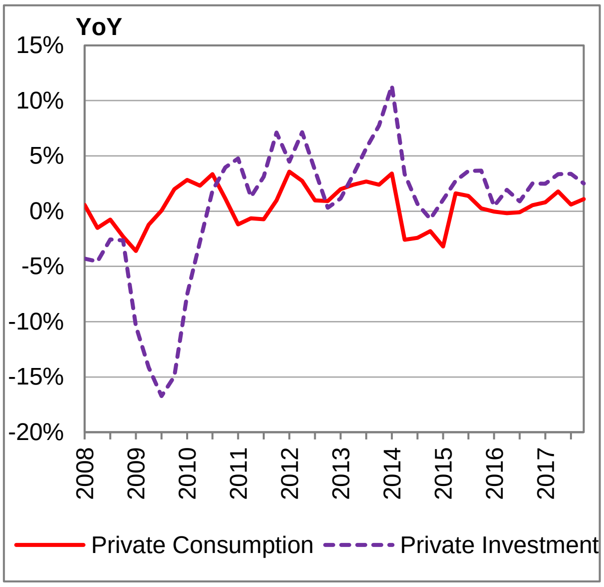


Figure 30: Industrial output and retail sales growth softened in early-2018

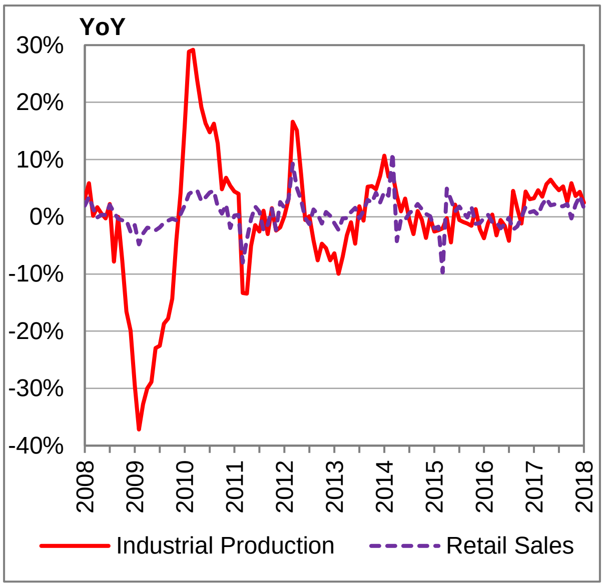


Figure 31: Exports growth challenged by high base effect

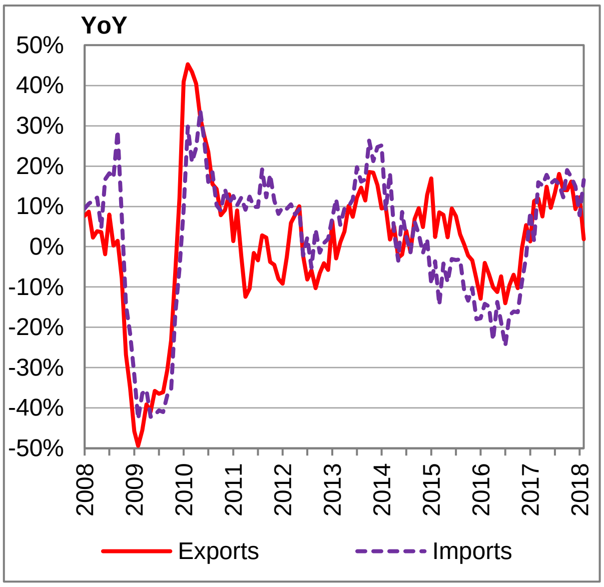
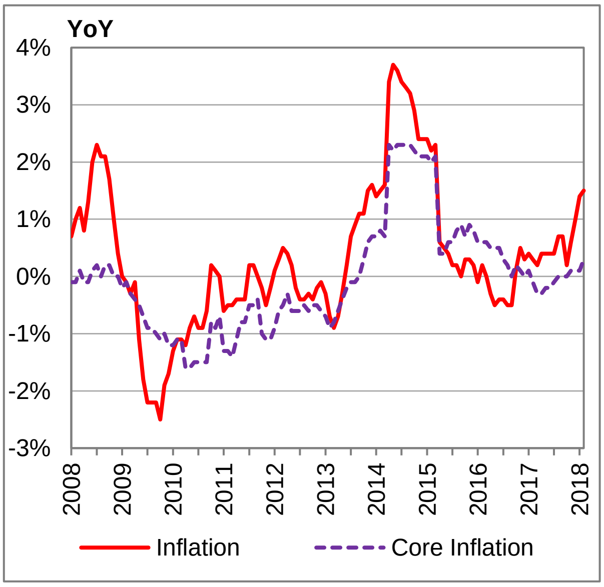


Figure 32: Lowest unemployment rate in January 2018 since April 1993 supports consumption …

Figure 33: … amid slow rise in inflation rate



Source: Economic and Social Research Institute; Ministry of Economy, Trade and Industry, Japan; Japan Customs; Statistics Bureau, Japan

CHINA – ACCUMULATING QUALITY GROWTH

China's economic restructuring moving at steady pace. Real GDP growth had exceeded the authorities' target to grow by 6.9% in 2017 and looks set to deliver another year of good growth estimated 6.5% in 2018. A slew of economic data points to continued growth in the first two months of 2018: Retail sales firmed up indicating healthy consumption; industrial production and manufacturing activity held up their momentum, defying the impact of ongoing policy to control pollution; and infrastructural spending supports urban fixed assets investment.

China's retaliation measures of US$3 billion against the US's trade barriers worth US$50 billion heightens the fear of a wide scale trade war if both countries continue to counteract and add more products in the hit list. China's ballooned debt (210.5% of GDP as at September 2017) warrants close monitoring, apart from the continued deleveraging and debt restructuring and curtailment of credit expansion.

Figure 34: China set a 6.5% growth target for 2018

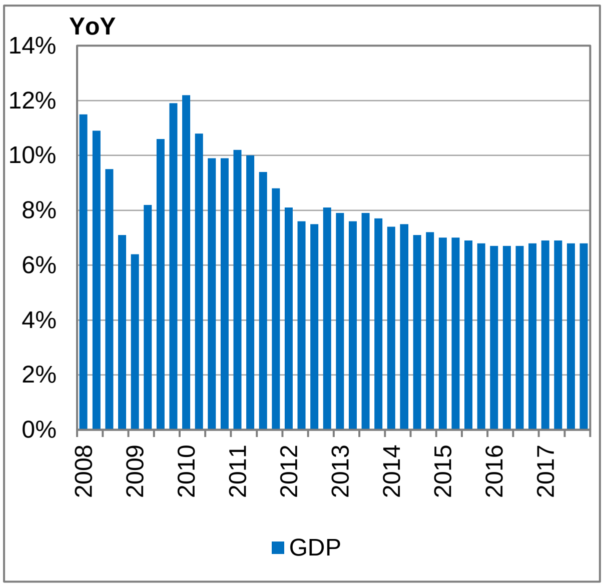


Figure 35: PMI points to continue growth momentum

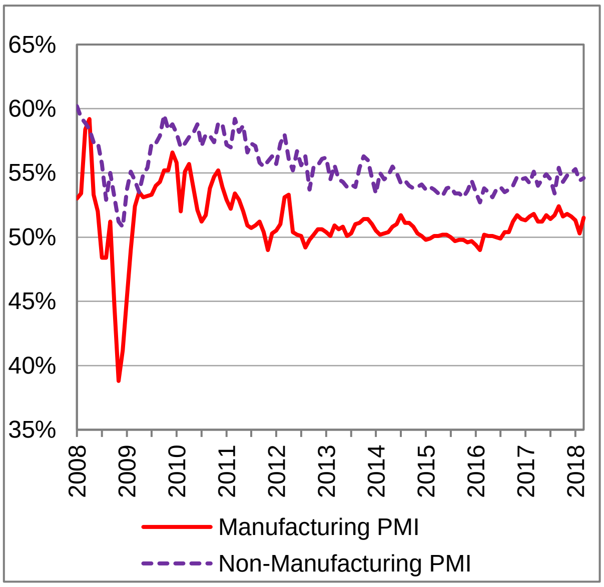


Figure 36: Industrial production growth seems picking up

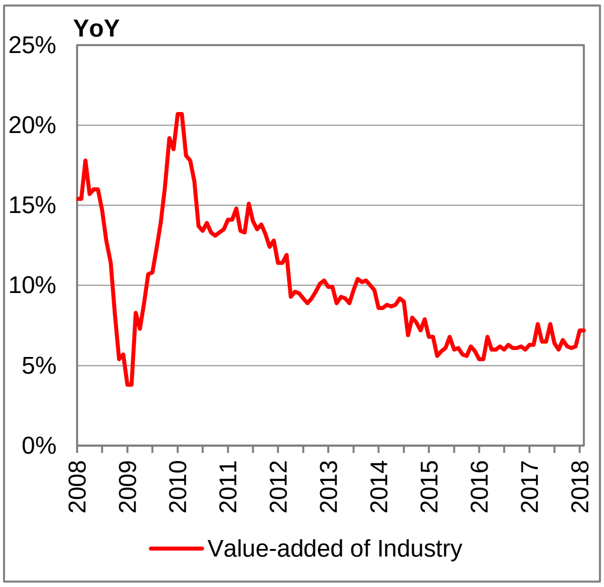


Figure 37: Retail sales growth remained at single-digit, last seen in 2003

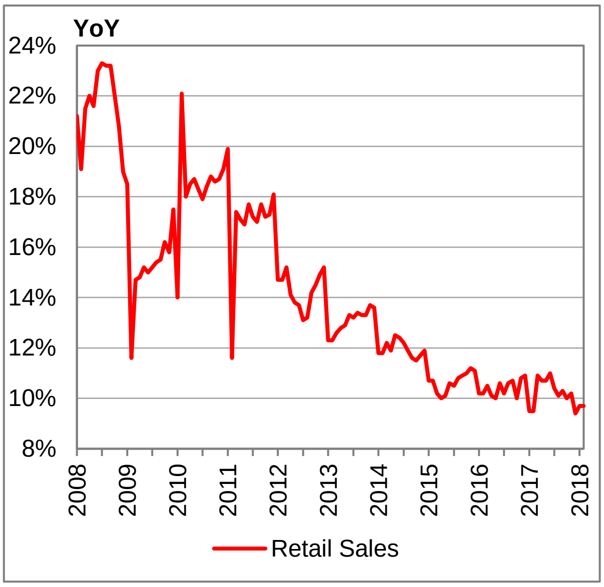


Figure 38: Fixed assets investment growth could be bottoming up

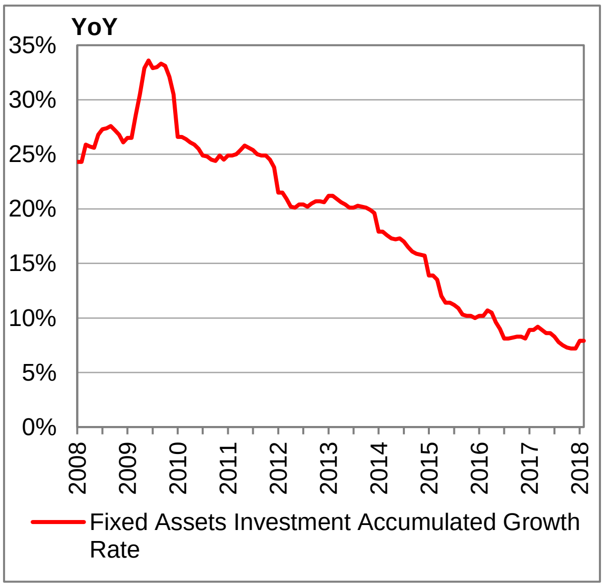
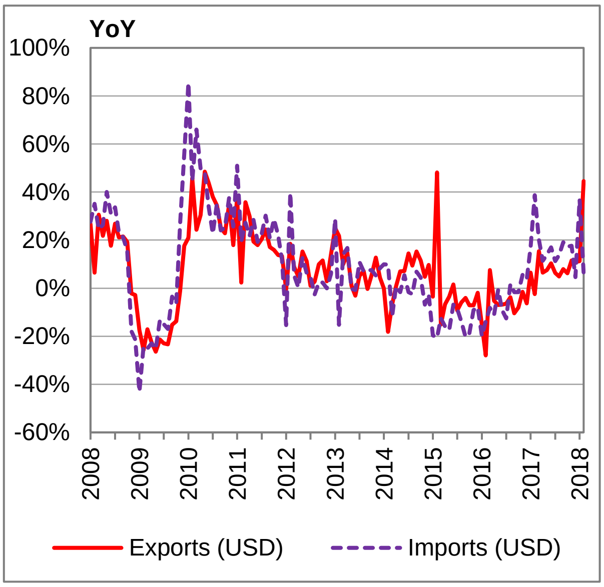


Figure 39: Both export and import growth soared in recent months



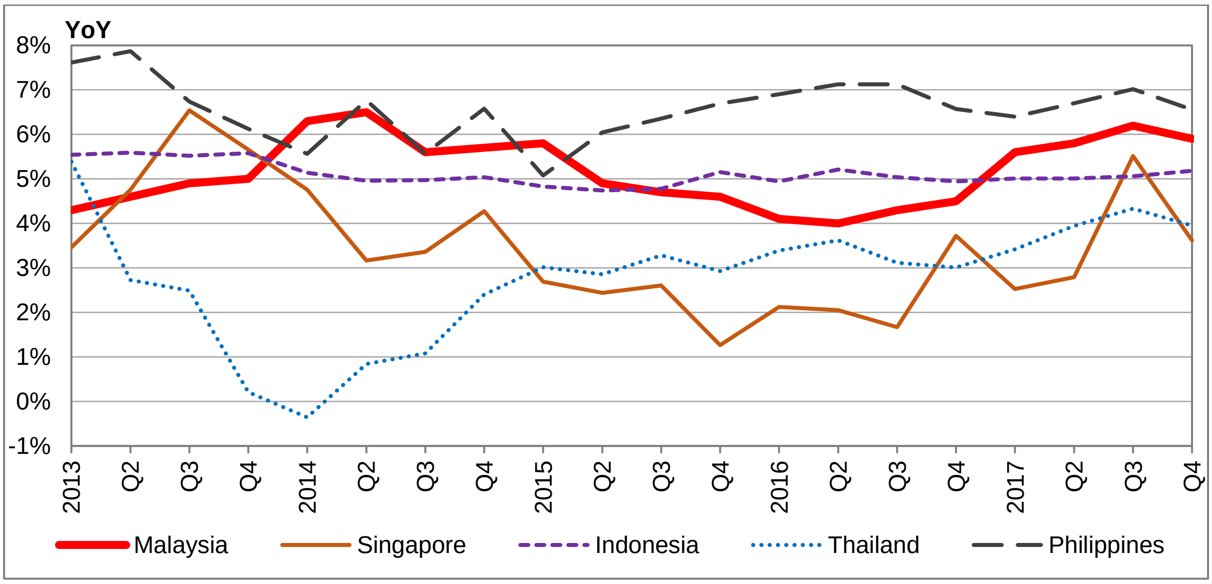
Source: National Bureau of Statistics of China

ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

In 4Q17, ASEAN-5 countries (Malaysia, Singapore, Indonesia, Thailand and Philippines) experienced some moderation in economic growth after registering strong expansion in 3Q, except Indonesia which expanded slightly faster. Overall, Malaysia, Singapore, Indonesia and Thailand enjoyed better annual GDP growth from a year ago.

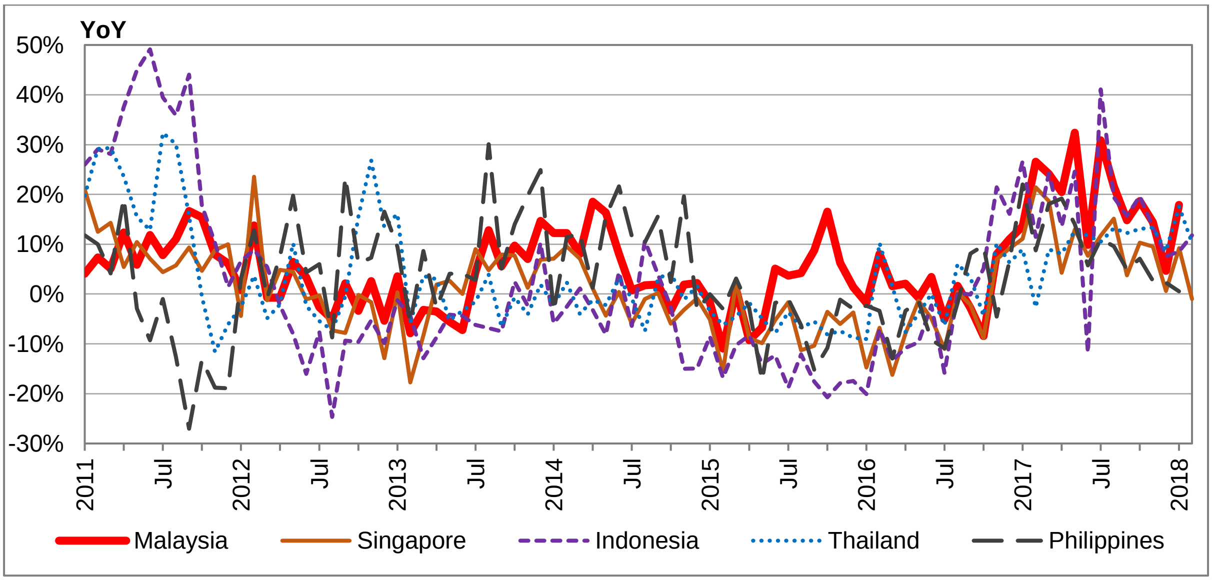
In terms of export and industrial production growth, ASEAN-5 countries showed mixed picture. While headline inflation is somewhat stable or even trended lower to zero in the case of Singapore in January 2018, oil prices wild card could add upside risk to the general price level.

Figure 40: Real GDP growth trend



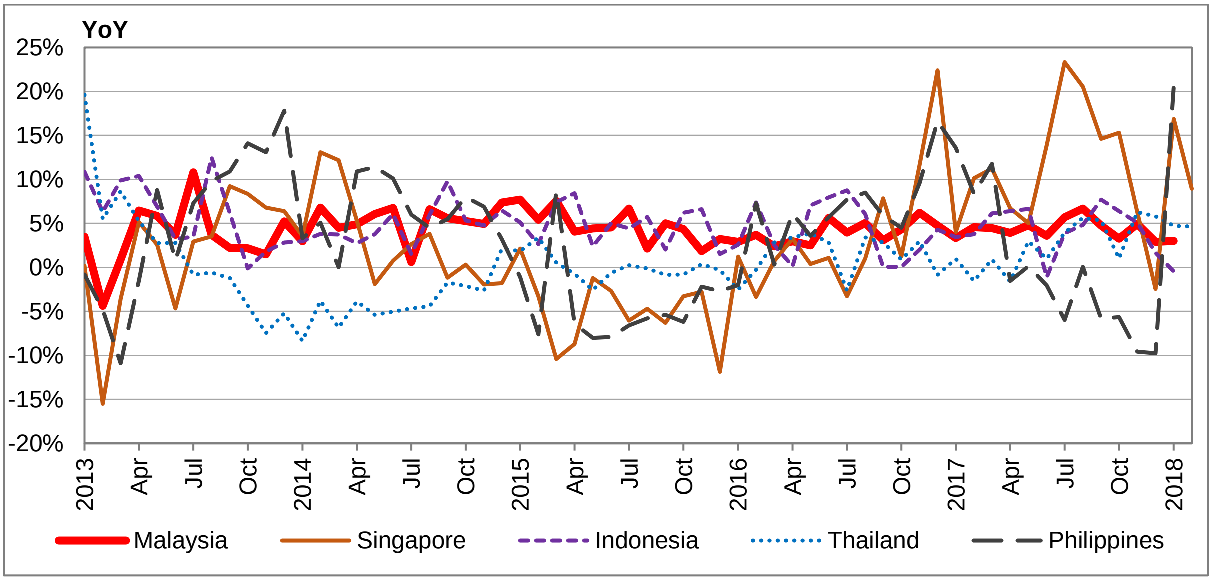
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 41: Export growth trend



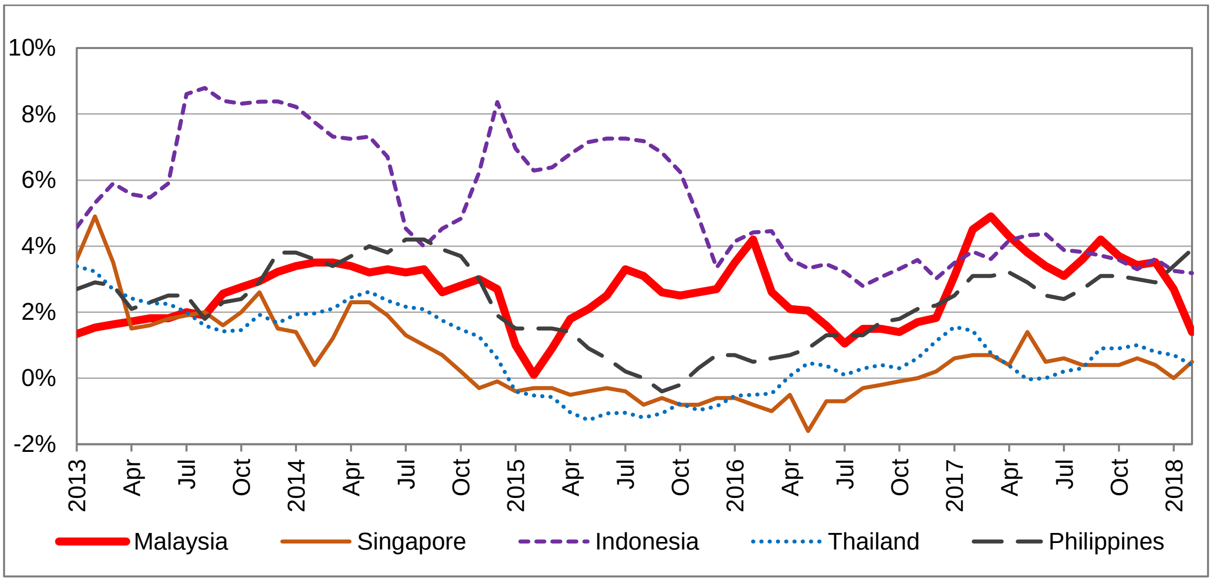
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

Figure 42: Industrial production growth trend



Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Office of Industrial Economics, Thailand; Philippine Statistics Authority

Figure 43: Inflation trend



Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Bank Indonesia; Ministry of Commerce, Thailand; Philippine Statistics Authority

B. GLOBAL MONETARY POLICY TRACKER

The US Federal Reserve, which has been the first mover in both interest rate hikes and balance sheet reduction will likely ramp up over the course of 2018 and beyond.

The strengthening of US economy, which is now in the eight year of expansion, supported by somewhat relative tight labour market and steady increases in price pressures strengthen the case for continued hikes in interest rate in 2018. The Fed chairman, Powell and his Fed colleagues will try to balance stronger growth with the potential for "an overheated economy" now that "fiscal policy is becoming more simulative" with tax cuts and increased federal spending.

The Fed hiked the Fed fund rate by 25 bps for the sixth time to 1.50-1.75% on 21 March since December 2015 and is expected to hike by another 50-75 bps to 2.00-2.50% by end-2018. As scheduled, the Fed's balance sheet will be reducing by US$30 billion per month in 2Q18 and likely to contract by about US$420 billion by the end of 2018 from last October. China lifted its 7-day reverse repurchase agreements by 5 basis points on 22 March, similar reaction with the last Fed fund rate increase in last December.

The ECB will run the monthly asset purchases under its quantitative easing (QE) program until September, after which we expect a very gradual tapering of purchases.

In Japan, BOJ Governor Haruhiko Kuroda remarked that the Japanese economy was not in a situation for the central bank to consider exiting its ultra-easy policy. But, some board members voiced the central bank should consider raising interest rates or slow purchases of risky assets if the economic recovery continued.

In the wake of the 2008-09 Global Financial Crisis, Asia's central banks acted in synchronizing with their counterparts in advanced economies to pursue loose monetary policy as a leading role in supporting domestic growth. But, as the global economic recovery gains momentum, the time has come to begin tightening monetary policy.

Some central banks such as Bank of Korea (BOK) and Bank Negara Malaysia (BNM) have raised their benchmark policy rates in late 2017 and early 2018 as they assessed that their economic conditions are in good shape to absorb a gradual rise in interest rate amid moderate inflation pressures.

Going forward, while not bowing to external pressure or taking cue from the US Fed, Asian central banks are expected to pursue monetary policy normalization at a rate appropriate to safeguard macroeconomic and financial stability without hurting domestic economic activity.

Figure 44: Policy rate (%)

End-period of	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018 (Mar)	2018*F*
US, Federal Funds Rate	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.25-0.50	0.50-0.75	1.25-1.50	1.50-1.75	2.00-2.50
Euro Area, ECB (Deposit Facility)	2.00	0.25	0.25	0.25	0.00	0.00	-0.20	-0.30	-0.40	-0.40	-0.40	0.00
Japan, BOJ Policy Rate	0.10	0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	-0.10	-0.10	-0.10	0.00-0.10
China, PBOC 1-yr Benchmark Loan I/R	5.31	5.31	5.81	6.56	6.00	6.00	5.60	4.35	4.35	4.35	4.35	4.85
India, RBI Policy Repo Rate	6.50	4.75	6.25	8.50	8.00	7.75	8.00	6.75	6.25	6.00	6.00	6.00
Korea, BOK Base Rate	3.00	2.00	2.50	3.25	2.75	2.50	2.00	1.50	1.25	1.50	1.50	1.75
Malaysia, BNM O/N Policy Rate	3.25	2.00	2.75	3.00	3.00	3.00	3.25	3.25	3.00	3.00	3.25	3.25-3.50
Indonesia, BI 7-Day RR Rate	9.25	6.50	6.50	6.50	5.75	7.50	7.75	7.50	4.75	4.25	4.25	4.25
Thailand, BOT 1-Day Repurchase Rate	2.75	1.25	2.00	3.25	2.75	2.25	2.00	1.50	1.50	1.50	1.50	1.75
Philippines, BSP O/N RR Rate	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.00	3.00	3.00	3.00	3.25

Source: Officials; SERC

C. MALAYSIA: SEEKING SUSTAINABLE GROWTH

A strong economic rebound in 2017. The Malaysian economy staged a strong rebound of 5.9% in 2017 after slowing to 4.2% in 2016 and 5.0% in 2015 respectively. The strong economic growth was fired on all cylinders as gross exports grew robustly by 18.9%, the best in 13 years and domestic demand sustained strong growth (6.5% vs. 4.3% in 2016), especially accelerated consumer spending (7.0% vs. 6.0% in 2016) and private investment (9.3% vs. 4.3% in 2016). This was despite still weak consumer sentiment and business confidence.

Positive prospects for continued economic growth. We concur with Bank Negara Malaysia's upbeat assessment of domestic growth, upping 2018's GDP growth estimate to 5.5-6.0% from 5.0-5.5% forecast during the 2018 Budget in October 2017. With global economic growth sustaining at higher rate of 3.9% in 2018 (3.7% in 2017), we estimate Malaysia's real GDP to deliver a set of commendable growth rate of 5.5% in 2018 (5.9% in 2017), underpinned by resilient domestic demand. We have upgraded our GDP growth estimate from 5.1% previously, mainly to account for higher domestic demand.

Broadening economic growth. On the supply side, the services sector is expected to benefit from continued trade activities, domestic consumption, especially tourism related and improved demand of financial services. The manufacturing sector will see expansion in both export- and domestic-oriented sub-sectors. The agriculture sector's growth will be driven by further improvements in CPO yields amid the maturing of oil palm trees. Higher output from new oil and gas facilities will underpin the mining sector. The construction sector's growth will be supported by new and existing civil engineering projects amid continued consolidation in commercial projects.

Will exports surprise on the upside? After growing robustly by 18.9% in 2017, exports started the year 2018 on a high double-digit growth of 17.9% yoy in January after two months of slower growth in Nov-Dec 2017, partly aided by low export levels in Jan-Feb17. This was backed by higher demand for manufactured goods, especially electronics and electrical goods, higher prices of liquefied natural gas and better shipments of palm oil and palm oil related products.

We expect overall exports to rise at a more moderate pace throughout 2018 as the exceptionally high average export levels of about RM80.0 billion per month in 2017 would challenge the year-on-year growth. The drivers of exports are 1) still growing global economy; 2) a moderate pace of global semiconductor sales estimated 7-8% this year (23.1% in 2017); 3) slower CPO prices; and 4) diminishing favourable ringgit exchange rate valuation gains.

Brewing trade barriers erected by President Trump administration on key building materials (steel and aluminium), followed by the imposition of import tariffs worth US$50 billion from China and a retaliation by China worth US$3.0 billion of products importing from the US is seen as counterproductive trade policy that is harmful to global trade and economy.

Impact on Malaysia is manageable if the trade war is mild. While the import tariffs may not have significant direct impact on Malaysia's external trade and producers given its small export share of these products to the US, but the impact would be more hurtful if the US trade protectionism escalates into a full-blown trade war involving more goods and in many countries, causing the US's trading partners to retaliate. The impact on Malaysia will be via global supply chains as Malaysia's inputs are used as intermediate in the production of finished goods exporting to the US and China.

Inflation will rise at a moderate pace. After hitting 3.7% in 2017, the highest in nine years since 2008 (5.4%), headline inflation pulled back to 2.7% in January and 1.4% in February 2018, thanks to a markedly slowdown in fuel prices that led to lower prices of transportation. Food prices also moderated.

We have lowered this year's CPI growth estimate to 2.0-3.0% from 3.0-3.5% previously (3.7% in 2017), mainly to reflect moderating food prices amid the variation in fuel prices, which remain a wild card. Other potential drivers of inflation are utility cost, wage growth and firm demand fuelling demand inflation. Higher technical base effects in 1H17 (4.2% in 1Q17; 3.8% in 2Q vs. 3.6% in 3Q and 3.5% in 4Q) also plays a part.

Of growth, inflation and monetary policy. After keeping domestic interest rate, as benchmarked by the Overnight Policy Rate (OPR) at 3.00% for 18 months since the surprise cut in July 2016 in the aftermath of Post Brexit, Bank Negara Malaysia (BNM) has resumed its interest rate normalization, tweaking it higher by 25 basis points to 3.25% on 25 January 2018.

The decision marks a significant sign that the central bank is confident that economic growth and domestic spending will continue, supported by improved wages and income as well as a mildly expansionary fiscal policy.

BNM needs to reload when the economy is doing better amid some disillusionment about the distributional effects of strong economic growth in 2017. Hence, the economy does not require too "accommodative" interest rate to get it growing at reasonable pace in 2018.

When interest rates were kept low for extended periods, it becomes complacent to take things for granted that rates will never go up even as the domestic economy has rebounded. It's a matter of fact that interest rates will generally begin to rise as an economy rebounds, and is the time to begin preparing for this shift in the interest rate environment.

BNM's MPC policymakers will weigh on all aspects when reviewing the process of gradually, systematically normalizing rates back up to more appropriate yet accommodative levels without hurting economic growth, discourage consumption and investment.

The current OPR of 3.25% will remain for a while. Some prerequisite conditions have to be met before continuing with the pace of gradual rate hikes in the months ahead. These include the strength of domestic economic expansion and global growth; to anchor inflation expectations given the still resilient consumer spending despite coping with high cost of living; and global financial conditions, especially tracking the Fed's continuation of interest rate hikes. The Fed may be compelled to hike interest rate more aggressively if the US economy and inflation accelerate beyond expectations. Higher US interest rates and stronger US dollar not only result in tighter financial conditions but also ignite volatility in the foreign exchange market and capital flows.

Figure 45: Real GDP by economic sector (% YoY)

Economic Sector [% share to GDP in 2017]	2015	2016	2017	2017 1Q	2017 2Q	2017 3Q	2017 4Q	2018*F* (BNM)	2018*F* (SERC)
Agriculture [8.2%]	1.3	-5.1	7.2	8.3	5.9	4.1	10.7	3.6	3.8
Mining & Quarrying [8.4%]	5.3	2.2	1.1	1.6	0.2	3.1	-0.5	1.8	1.5
Manufacturing [23.0%]	4.9	4.4	6.0	5.6	6.0	7.0	5.4	5.9	5.7
Construction [4.6%]	8.2	7.4	6.7	6.5	8.3	6.1	5.8	7.3	8.0
Services [54.4%]	5.1	5.6	6.2	5.8	6.3	6.5	6.2	6.1	6.0
Overall GDP	**5.0**	**4.2**	**5.9**	**5.6**	**5.8**	**6.2**	**6.2**	**5.5-6.0**	**5.5**

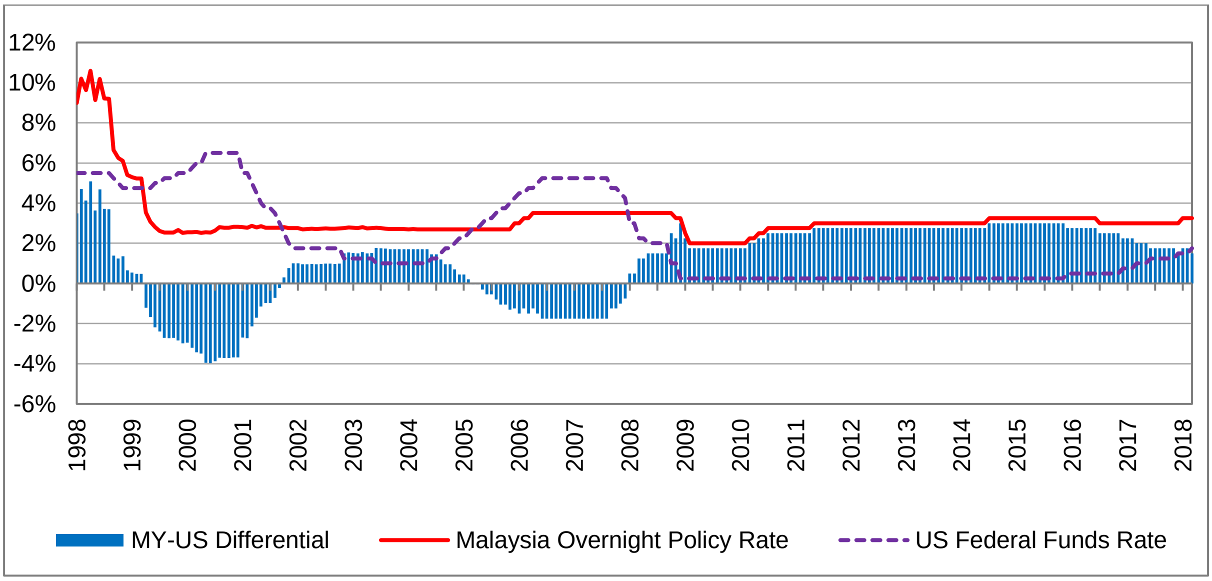
Source: Department of Statistics, Malaysia; Bank Negara Malaysia; SERC

Figure 46: Real GDP by demand component (% YoY)

Demand Component [% share to GDP in 2017]	2015	2016	2017	2017 1Q	2017 2Q	2017 3Q	2017 4Q	2018*F* (BNM)	2018*F* (SERC)
Private Consumption [53.7%]	6.0	6.0	7.0	6.6	7.1	7.2	7.0	7.2	6.9
Public Consumption [13.0%]	4.4	0.9	5.4	7.5	3.3	3.9	6.9	0.6	1.0
Private Investment [17.4%]	6.3	4.3	9.3	12.9	7.4	7.9	9.2	9.1	8.3
Public Investment [8.0%]	-1.1	-0.5	0.1	3.2	-5.0	4.1	-1.4	-3.2	-1.5
Exports of Goods and Services [72.9%]	0.3	1.1	9.6	9.8	9.6	11.8	7.1	8.8	7.9
Imports of Goods and Services [65.1%]	0.8	1.1	11.0	12.9	10.7	13.4	7.4	9.1	8.8
Overall GDP	**5.0**	**4.2**	**5.9**	**5.6**	**5.8**	**6.2**	**6.2**	**5.5-6.0**	**5.5**

Source: Department of Statistics, Malaysia; Bank Negara Malaysia; SERC

Figure 47: Malaysia-US's interest rate differentials



Source: Bank Negara Malaysia; Federal Reserve

REVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

Leading indicators and Industrial production

Leading index (LI), a forward gauge of growth expectations continued to expand, albeit slower in January 2018 after hitting the peak at 121.2 points in November 2017. This suggests continued economic growth in 1H17. **Industrial production** growth eased sharply to 3.0% yoy in January 2018 (4.4% in 2017), mainly dragged by slower growth in manufacturing sector, particularly the electrical and electronic products, refined petroleum products, chemicals and chemical products as well as rubber products. Mining output was supported by higher extractions of crude petroleum. Overall industrial production is estimated to grow by 4.0-4.5% this year, underpinned by a still solid growth in manufacturing output and recovery in mining sector.

Figure 48: Leading index eased from the peak

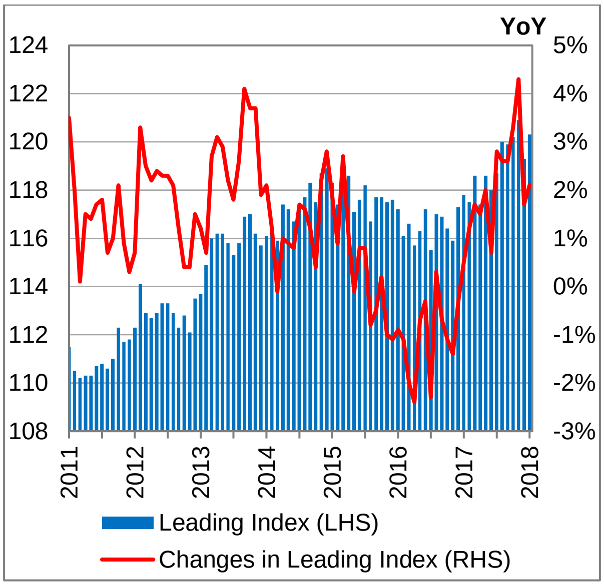
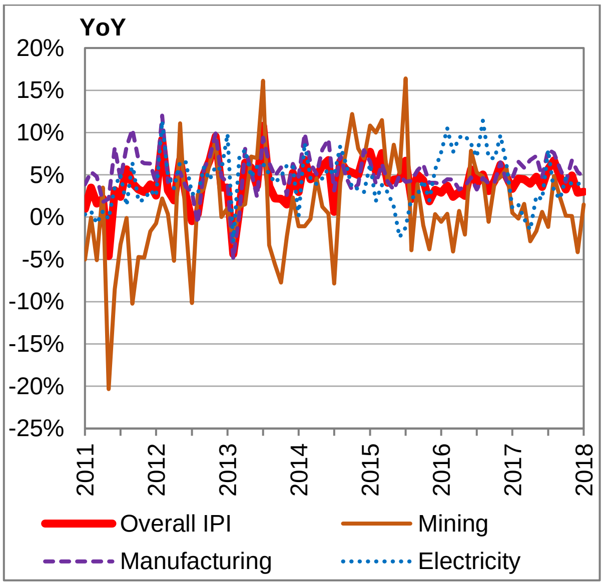


Figure 49: Industrial production continues to grow but smaller magnitude



Source: Department of Statistics, Malaysia

Exports, Manufacturing sales and Services

Export growth had a good start in the year (17.9% in January), continued to be driven by demand of electrical and electronic products, chemical and chemical products, liquefied natural gas and palm oil. With resilient global demand amid heightened fears of escalating trade war between the US and China, exports are estimated to increase by 7.5% in 2018.

Manufacturing sales have moderated in January and likely to pace somewhat slower in coming months due to the extraordinary high growth base effects last year. Retail sales, which had expanded strongly by 11.5% in 2017, are projected to register a low single-digit rate of 4.7% this year, according to Retail Group Malaysia (RGM). In view of the cannibalization impact from an increasing number of retail malls and flourishing e-commerce, individual retailers, especially non-food based brick and mortar business will have to retool their business models in such challenging environment.

Figure 50: Export growth off to a strong start in 2018 …

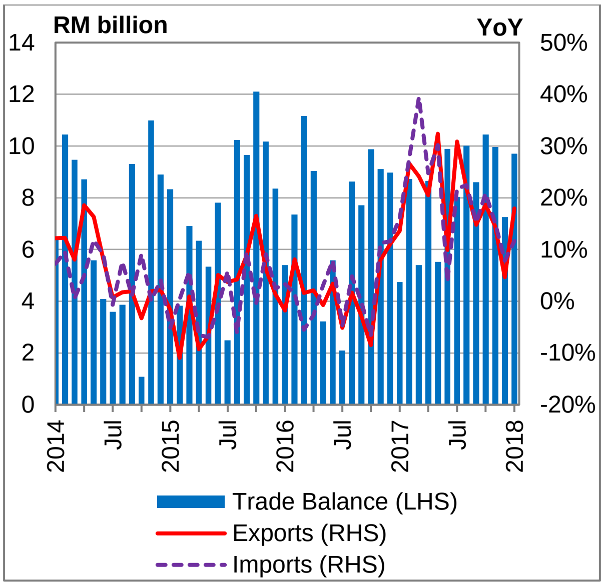


Figure 51: … driven by electronics and electrical products

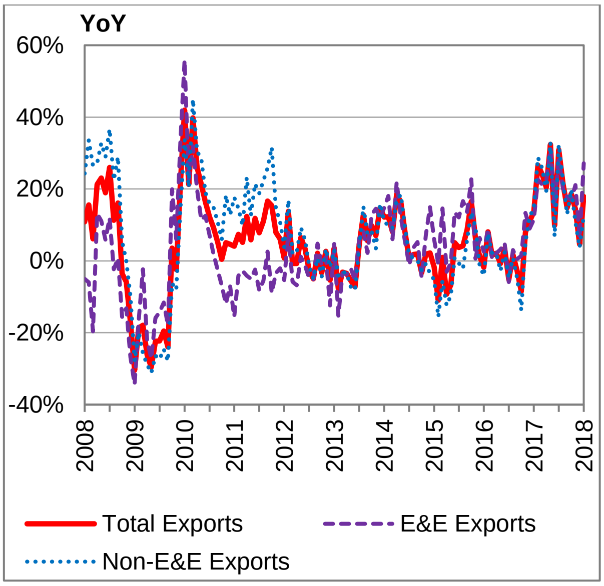


Figure 52: Manufacturing sales growth remained strong

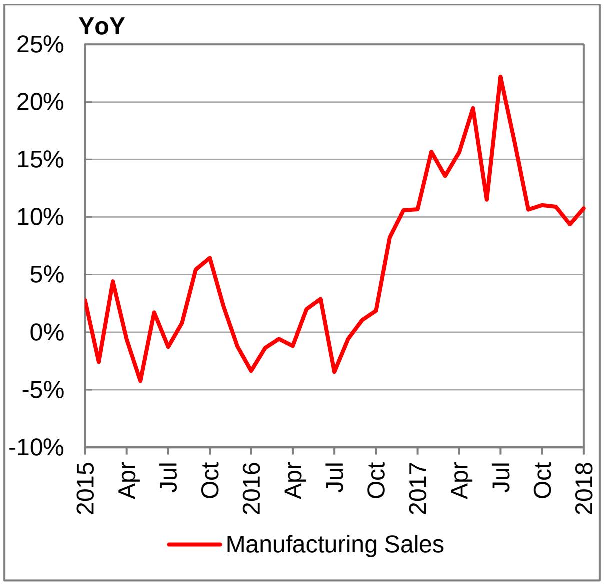
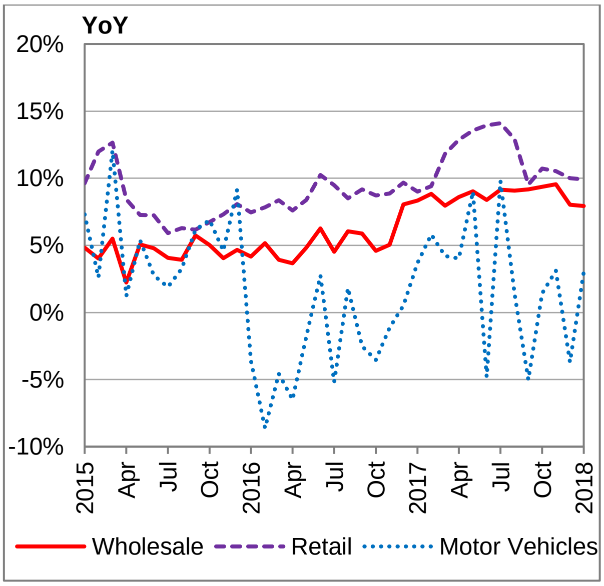


Figure 53: Stable sales growth in wholesale and retail sectors



Source: Department of Statistics, Malaysia

Private consumption indicators

Consumers remained cautious and pragmatic on their shopping plans ahead as reported by MIER's consumer sentiment index (CSI), which regained some lost ground in 4Q17, but still remained below the confidence threshold since 2Q14. Unemployment rate ticked a little higher to 3.4% in January. While manufacturing employees enjoyed a decent wage growth in 2017, due to overtime pay on buoyant export orders, wage growth of employees working in the services sector was moderate.

Passenger vehicle sales missed the 2017 target by registering total sales of 514,679 units, a marginal increase from 514,594 units in 2016. In the first two months of 2018, passenger vehicle sales contracted by 3.2% yoy to 76,605 units. With stricter lending guidelines on hire purchase loan and more popular ride hailing and rail services, Malaysian Automotive Association (MAA) forecasted passenger vehicle sales to increase by 2.3% to 526,500 units this year.

Figure 54: Continued weak sales of passenger cars

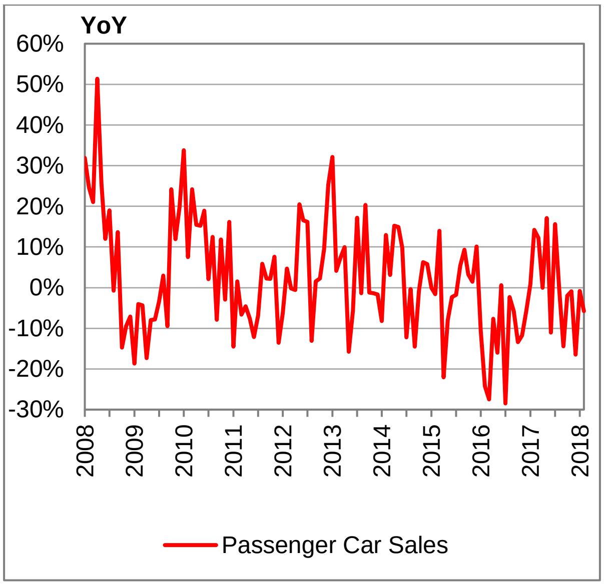


Figure 55: Selected private consumption indicators

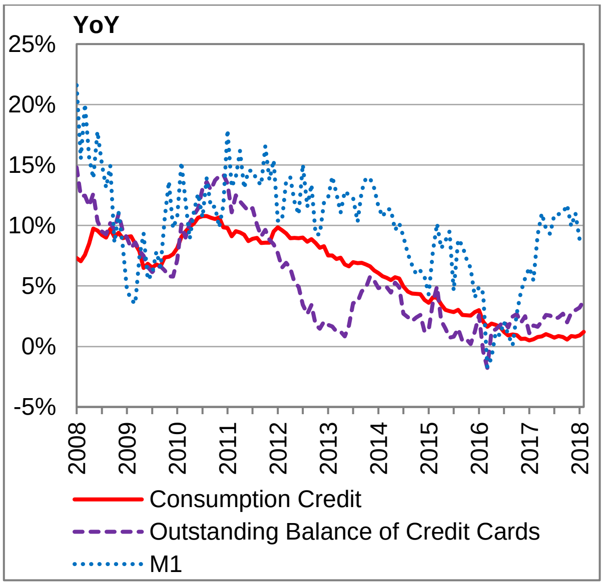


Figure 56: Moderate wage growth of services employees in 2017

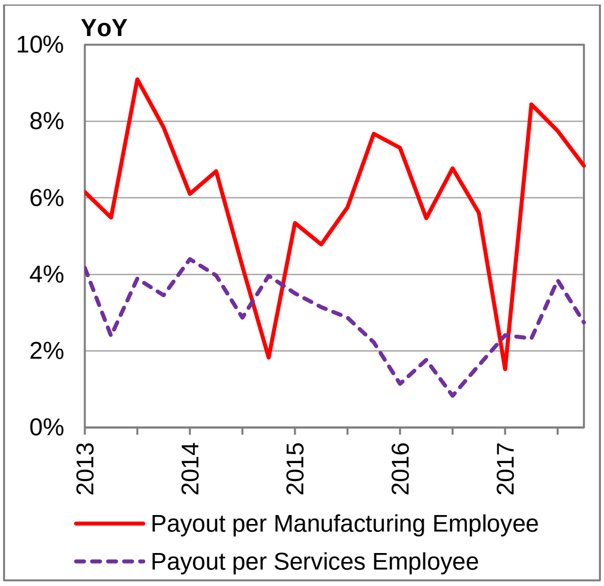
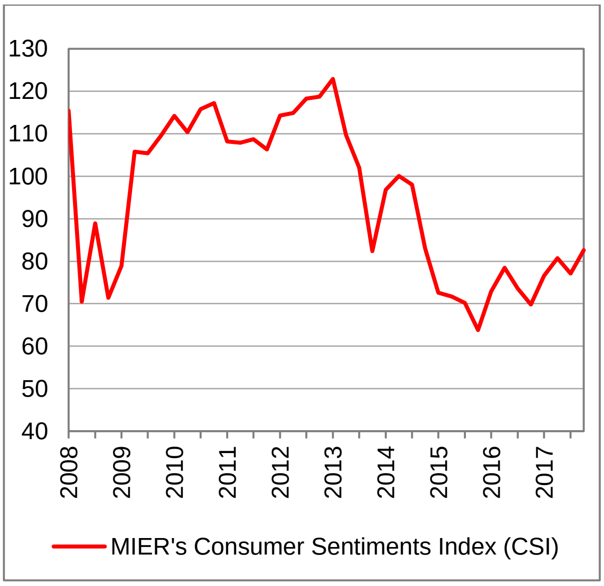


Figure 57: Consumer sentiment still weak, albeit small improvement



Source: Department of Statistics, Malaysia; Malaysian Institute of Economic Research

Private investment indicators

Business sentiment turned more cautions, probably due to increases in the cost of doing business such as the implementation of Employment Insurance System (EIS), higher gas price and expected increase in minimum wage. Lingering uncertainties ahead of 14th General Election may weigh on investors' sentiment. MIER business condition index (BCI) slipped to 101.5 points in 4Q17 (103.1 in 3Q17 and 114.1 in 2Q17). Local orders are expected to rebound while export orders are expected to be somewhat flat. The last time BCI fell below threshold was back to 4Q16.

Capital investment prospects look favourable as imports of capital and intermediate goods grew strongly in 2017, albeit some contractions in January 2018. In the first two months of 2018, commercial vehicle sales increased by 7.5% yoy to 8,548 units (-5.4% in 2017). MAA forecasted sales of commercial vehicles to bounce back by 2.5% this year to 63,500 units.

Figure 58: Private investment indicators showed mixed results

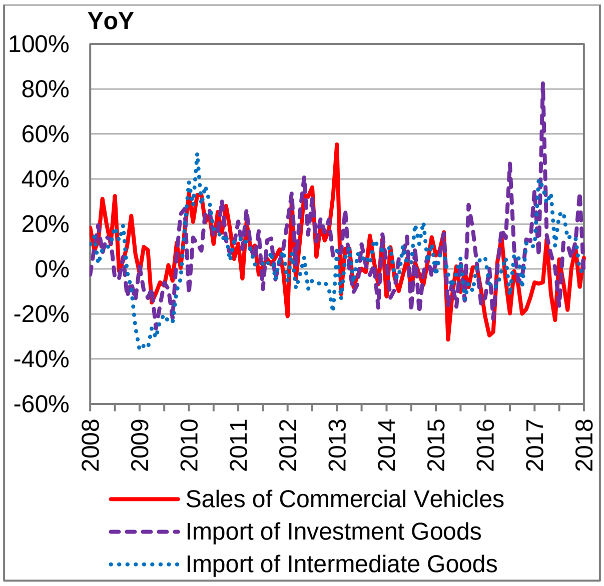


Figure 59: Real private investment growth on upward trend

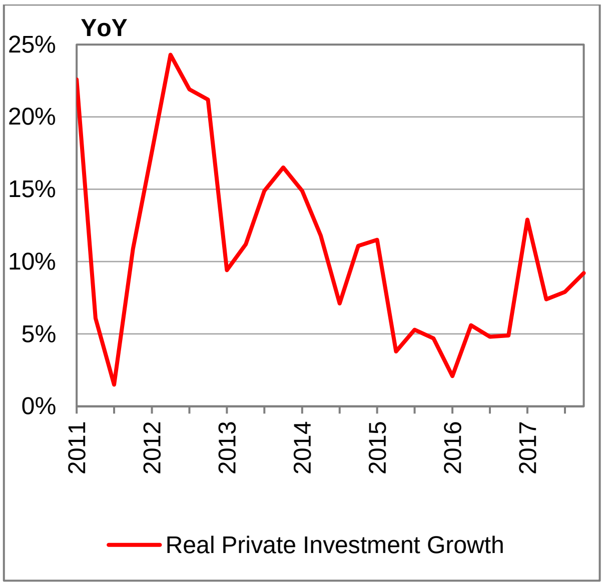


Figure 60: Business condition may fall below the optimism threshold in coming quarters

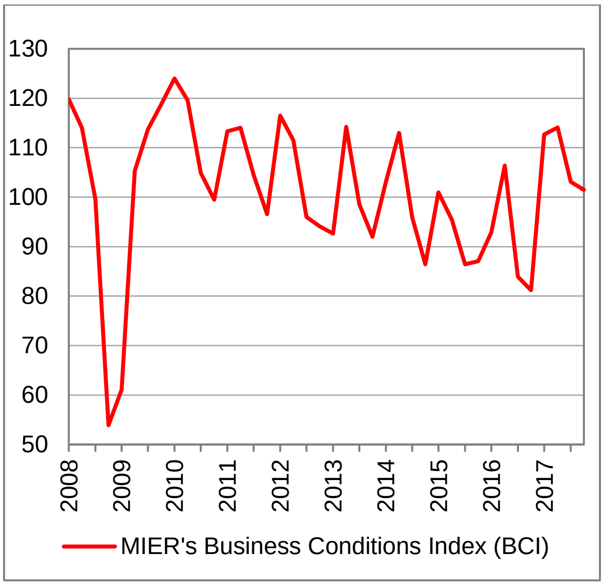
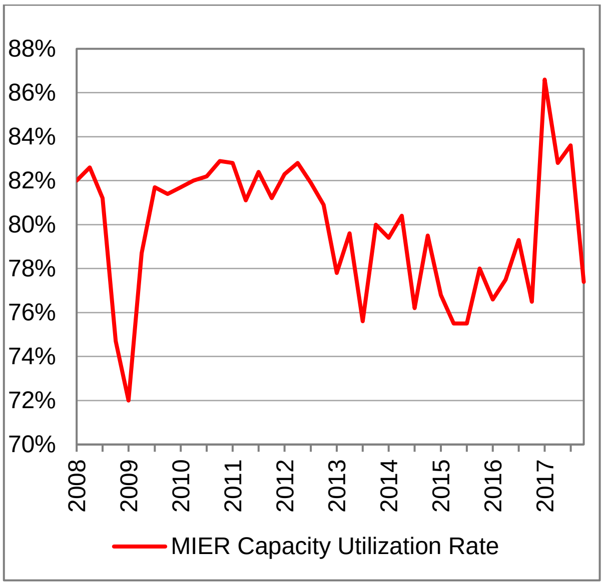


Figure 61: Capacity utilization dropped



Source: Department of Statistics, Malaysia; Bank Negara Malaysia; Malaysian Institute of Economic Research

Price indicators

Consumer price inflation seen trending lower for five consecutive months since September 2017. Headlined inflation eased to 1.4% yoy in February 2018, reflecting a broad-based softening price of a majority of the CPI categories, notably transportation and food. Excluding the volatile items like fuel and fresh food, core inflation also trended lower. However, the issue of rising cost of living continues to linger as households were not convinced with the receding headline inflation. Inflation rate is expected to increase by 2.0-3.0% this year (revised lower from 3.0-3.5%), with fuel prices remained a wild card.

Figure 62: Both headline and core inflation eased in recent months

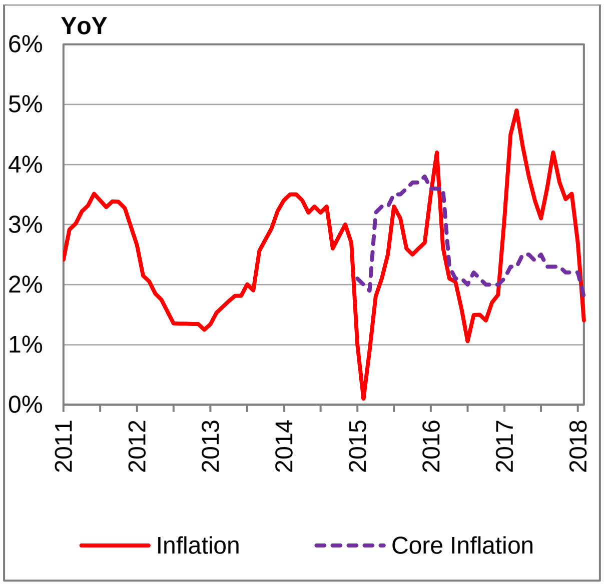
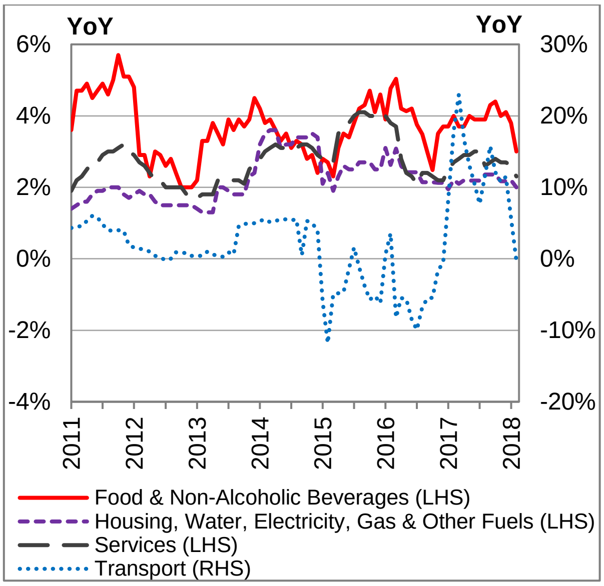


Figure 63: Prices of major components are rising at a slower pace



Source: Department of Statistics, Malaysia

Banking loan indicators

While loan approvals remain healthy in 2017 with approval rate of 77% for SMEs and 73% for residential properties, banks are more cautious in screening loan applications for construction and purchase of commercial lots due to the oversupply conditions. Coupled with lower loan disbursements and higher loan repayments, total loan outstanding growth slowed down significantly in 4Q17 but it has gradually picked up in the first two months of 2018. In February, both loan applications and approvals growth contracted due to festival season and relatively higher base effect as loan picked up after the Lunar Chinese New Year in January 2017. It is noteworthy that the non-performing and impaired loan, which had been increasing from RM21.3 billion in April 2015 to a peak of RM26.1 billion in July 2017, has moderated to RM24.8 billion in February 2018, helped by the improvement in working capital and purchase of securities.

Figure 64: Loan growth seen picking up in early 2018

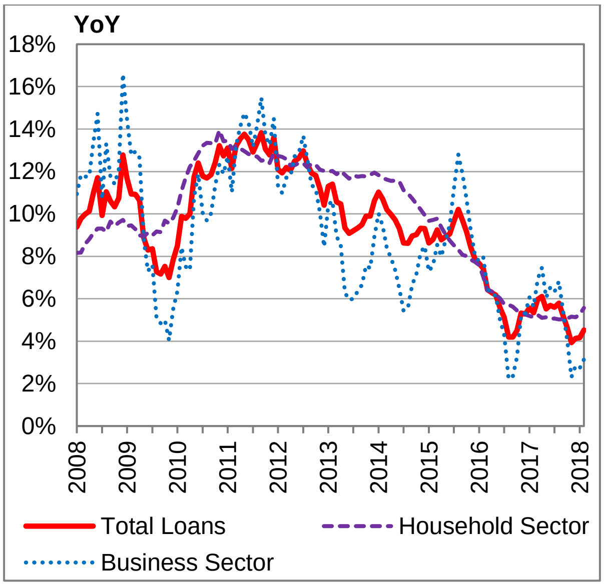


Figure 65: Loan applications growth

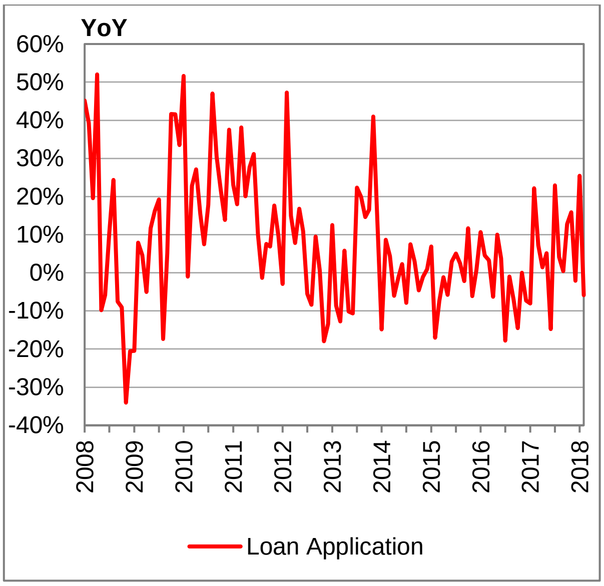


Figure 66: Loan approvals growth

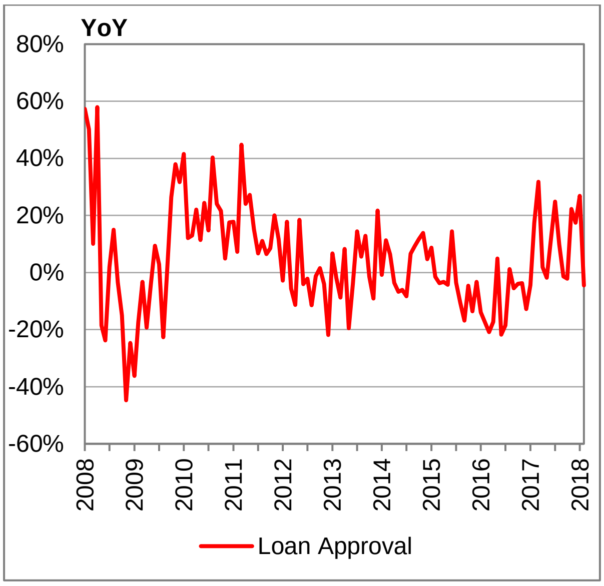
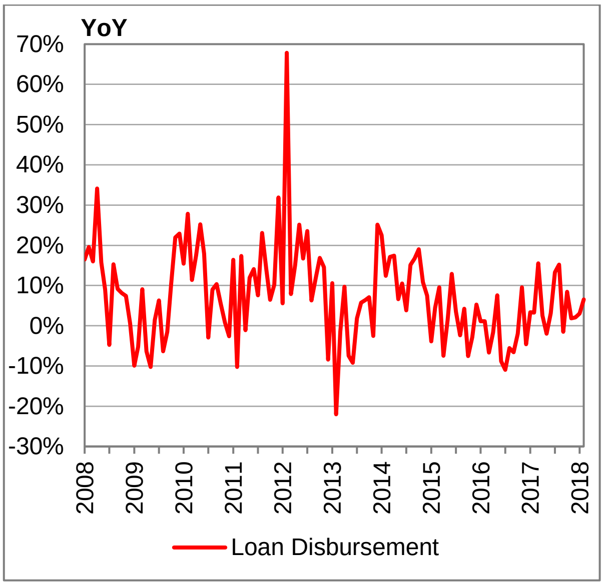


Figure 67: Loan disbursements growth



Source: Bank Negara Malaysia

Financial indicators

With the support of sustaining high trade surpluses and continued capital inflows, foreign reserves rose steadily to RM103.9 billion as at 15 March 2018. The huge capital inflows in January 2018 retreated in February in both bonds and equity market, mainly due to external volatility in global equity markets arising from the heightened fears of a trade war and lingering uncertainty ahead of the 14th General Election. Foreign-owned of Malaysian Government Securities (MGS) climbed gradually to 45.7% in January since the recent low of 38.5% in March 2017 and now stood at 45.4% as at end-February.

The Ringgit continued to appreciate further against the greenback, albeit moving in a tight range. As at end-March, the ringgit appreciated by 4.8% to RM3.8630 per US dollar since end-2017. Against a composite basket of trade-weighted currencies, the Ringgit has returned to its best level since July 2015, with real effective exchange rate (REER) has been appreciating steadily since August 2017.

Figure 68: Foreign reserves expand steadily

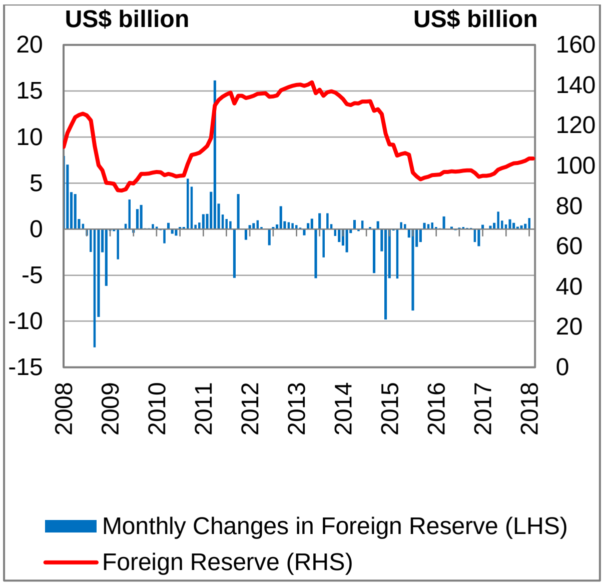


Figure 69: Ringgit continues to appreciate against the greenback

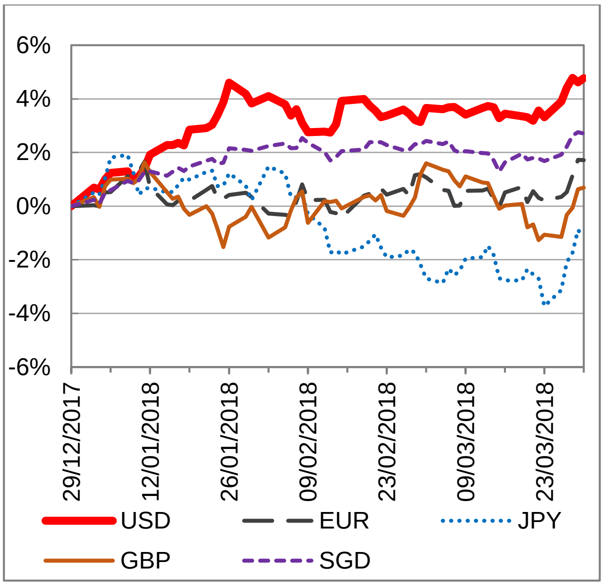


Figure 70: Ringgit gained 1.0% against CNY since end-2017

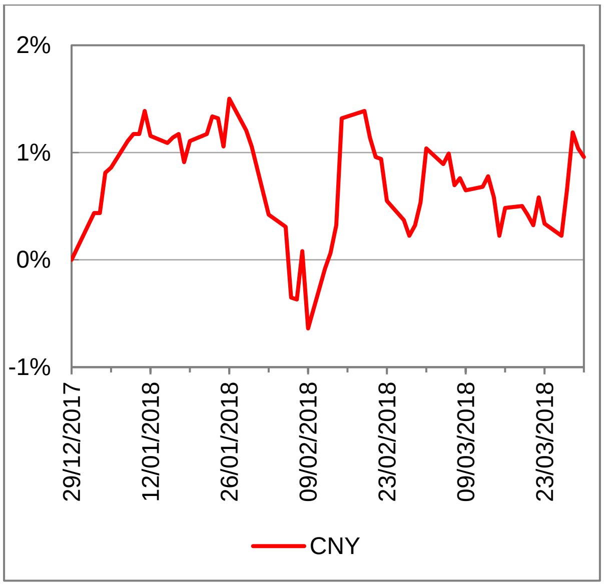
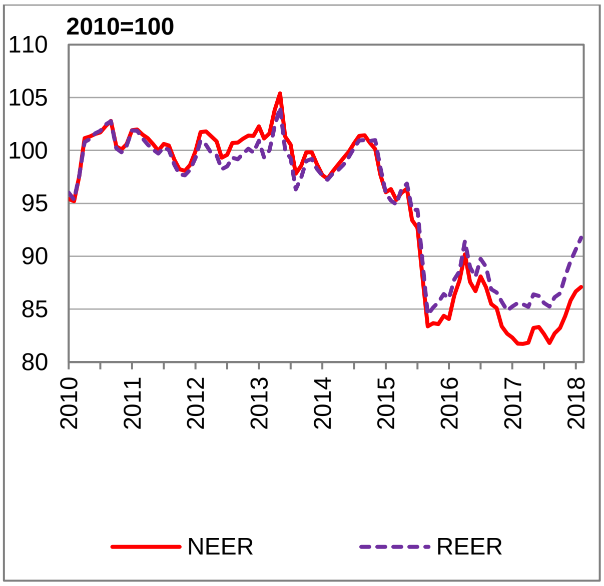


Figure 71: Real effective exchange rate of ringgit strengthened since 2H17



Source: Bank Negara Malaysia; Bank for International Settlements

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