QUARTERLY ECONOMY TRACKER

(APR-JUN 2018)

Socio-Economic Research Centre (SERC)

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Socio-Economic Research Centre (SERC)

Executive Director

Mr. Lee Heng Guie - *hglee@acccimserc.com*

Senior Researcher

Mr. Liew San Yee - *syliew@acccimserc.com*

Researcher

Mr. Goh Kong Jun - *kjgoh@acccimserc.com*

Mr. Lee Soon Thye - *stlee@acccimserc.com*

Administrative and IT Executive

Ms. Vicki Lai Mun Yee - *vickilai@acccimserc.com*

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Executive Summary

World Economic Situation and Prospects for 2018

- **Global expansion remains on track, albeit moderately.** The global economy ended the first quarter of 2018 on mixed growth performance in advanced and emerging economies. While we reckon that the global engine will continue to cruise along in the second half-year, albeit moderately, there are real risks that could undermine the global expansion and investors' confidence. Midway through the year, we saw the starting of the US-China trade war on 6 July, return of market volatility; emerging markets under pressure and the reality of central banks' monetary tightening.
- **Activity indicators point to stable growth**. The start of the second quarter indicators saw continued stable growth momentum in OECD areas. The rate of expansion of the global manufacturing and services sectors continued to pick up. Global trade though will continue growing above trend this quarter but will be slower on trade protectionism risk. Higher crude oil prices are positive for net oil exporting economies. There is a divergent trend of inflation rate between advanced and emerging economies, with the Fed turning more hawkish on its future interest rate hikes path.
- **Strengthening US economy; slow cruising speed in euro area and Japan.** Recent data suggest that the US economic activity continued to rise at solid rate, supported by strengthening labour market, a pick-up in household spending and expanded fixed investment. However, both overall inflation and core inflation have moved closer to 2% comfort zone. In eurozone, disappointing and uneven data have heightened fears that the recovery is petering out or just a temporary blip. The Japanese economy is seemingly pulling out of a rough patch after shrinking in the first quarter. China's growth continues to consolidate, albeit somewhat weaker under the weight of a multi-year crackdown on riskier lending amid escalating trade tensions with the US, which pushes the renminbi to its lowest level since December. Nevertheless, we dismiss fears an abrupt economic slowdown.
- **The Fed signals two more rate increases.** Global liquidity and financial conditions, which are already somewhat tightened following the paced unwinding of the Fed's quantitative easing (QE) program and continued interest rate hikes, will get tighter if the European Central Bank (ECB)'s QE program ends in September. The US economy is strong enough to absorb further rise in borrowing costs without choking off economic growth. The ECB has signalled that it plans to wind up its historic €2.4tn bond-buying programme at year-end while Japan's monetary policy is diverging further from the U.S and Europe, with Bank of Japan (BOJ) pledging to continue with stimulus until Japan reaches its 2% inflation target.
- **Uncertainties cloud economy.** Risks to global economy and global financial markets stability have increased over past six months, which could put global markets and growth at risk. With trade tensions stalking the global economy, rising US bond yields on economic acceleration, rising inflation, a strong dollar and the Fed's guidance of more interest rate hikes ahead caused capital flows reversal from emerging markets and exerted pressure foreign exchange. Stretched valuations of risky assets, with some late-stage credit cycle dynamics emerging pose the risk of sharp market correction.

Malaysia's Economic and Financial Conditions

- **The economy will continue to grow at healthy clip.** After registering a growth of 5.4% yoy in 1Q18, the start of second quarter indicators show continued economic expansion, with domestic demand (especially private consumption) and exports supporting the growth. Going into 2H18, weighing on the impact of external headwinds as well as the implications of domestic political and policies transition, we have trimmed our GDP growth estimates to 5.2% for this year from 5.5% previously (5.9% in 2017) while introducing a forecast of 4.9% for 2019. We will review our estimates after the tabling of 2019 Budget on 2 November.
- **Consumer spending still calling the shot.** Private consumption resilience held intact (6.9% in 1Q18 vs. an average of 6.5% in 2016-17) on improved income growth and stable labour market condition (unemployment rate of 3.3% in Feb-Apr). The three months "tax holiday" from the zerorised of GST rate between June and August, the payment of cost of living aid and the stabilisation of fuel prices (RON 95) are expected to keep consumer spending growth steady estimated 6.9% in 2018. The rolling out of new revamped Sales and Services Tax (SST) on 1 September and its net impact on the price of goods and services may take off some spending strength.
- **Private investment growth pulls pack sharply.** The sharp pullback in private investment growth to 0.5% yoy in 1Q18 (9.3% in 2017) is expected to remain weak between 3-4% this year (revised lower from 8.3% previously), reflecting the "wait and see" approaches by both domestic and foreign investors until clarity emerges on the new Government's policy directions, including the on-going review of mega projects, and also what 'catalysts' are in store in the tabling of new Government's 2019 Budget for the first time.
- **Exports at risk on trade tensions.** Exports, which had accelerated to 14.0% in April (5.8% in 1Q18) slowed substantially to 3.4% in May, dragged by slower manufactured goods and a sharp decline in agricultural products amid higher exports of crude petroleum and liquefied natural gas (LNG). Exports are expected to move on a bumpy ride ahead given the trade tensions risk between the US and China as well as the US' allies impacting the technology sector, automobile, steel and aluminium industries. The tit-for-tat trade war amongst these economies would inflict damage to the global economy and trade. Malaysia will be affected via the global supply and value chains though at this current state, the impact is manageable. We lowered our exports growth estimate to 6.5% this year from 7.5% previously (18.9% in 2017).
- **Inflation numbers to stay low for quite some time.** Inflation rate, as measured by Consumer Price Index (CPI) has been staying on subdued trajectory (1.4% in April and 1.8% in May vs. 1.8% in 1Q18), reflecting largely the technical impact of high base effect, aided by stabilised fuel prices. The CPI growth will print low rate of below 1%, thanks to the removal of GST rate starting 1 June and continued stabilisation of fuel price (RON95). We now expect inflation to rise by 1.0-2.0%, a marked down from 2.0-3.0% previously. The 2019 Budget is expected to roll out more initiatives to keep stable prices of staple food amid high oil prices and weak ringgit.
- **Austerity drives can unleash confidence.** It is clear that the new Government will deliver its fiscal plan and put deficit and public debt firmly on a downward path. If plans for fiscal and debt consolidation are credible and involve structural reforms, there is every chance growth can resume even as cuts or rationalization of public spending take hold. The fiscal condition that we are in now is not about acute austerity in spending but more of rationalizing or reprioritizing the capital expenditure and operating spending. Cost savings and expenditure efficiency derived from the value for money projects mean wider economic and multiplier impact on the economy, rakyat and businesses.

- **Domestic interest rates would remain stable for now.** Weighing on the trade tensions and market volatility risks to global growth as well as domestic political and policies transition, Bank Negara Malaysia's (BNM) is expected to keep its Overnight Policy Rate (OPR) steady at 3.25% for the rest of the year. Nevertheless, should domestic economic conditions getting stronger, the market and investors must prepare for a further removal of the monetary accommodation.
- **Ringgit is likely to trade between 4.00-4.10 against the US dollar.** After gaining by 4.8% in 1Q18, the ringgit has weakened by 4.3% against the US dollar since end-March to RM4.0385 on 6 July, resulting in a marginal cumulative appreciation of 0.2% year-to-date. Post the 14th General Election (GE)'s political and policies transition; net selling of domestic equities and bonds; surging U.S. Treasury yields; the expectation of further US interest rate hikes; fears of contagion risk in emerging markets and a revived strength of the dollar have weighed on the ringgit. What could provide a counteract strength to support the ringgit are strong economic and financial fundamentals, the clarity of policies, the fiscal and debt path and the affirmation of Malaysia's sovereign ratings.

GLOBAL EXPANSION REMAINS ON TRACK, ALBEIT MODERATELY

Global economy is on cruising speed. In the first quarter of 2018, the growth performance was mixed among advanced economies and emerging economies. The underlying momentum of the global economy remains intact though likely to be challenged by a rise in protectionism risks, the return of market volatility, and the reality of central banks' monetary tightening, especially the Fed's more hawkish stance, expressing confidence that the US economy is strong enough to absorb the impact of higher borrowing costs.

The start of the second quarter indicators suggest stable global growth momentum, diffusing fears the ninth year of global expansion is petering out though the PMI has signalled that the global growth has peaked or is peaking. The rate of expansion of the global manufacturing and services sectors continued to pick up. Global trade though will continue growing above trend this quarter but will be slower on trade protectionism risk. While higher crude oil prices are positive for net oil exporting emerging economies, it is a bane for net oil-importing economies in the form of oil-induced inflation pressures and fuel subsidies. There is a divergent trend of inflation rate between advanced and emerging economies, with the US's 12-mth headline and core inflation have risen to the Fed's target of 2%.

The US economy continues to grow at solid rate, supported by an ever-tighter labour market that bolsters wage growth; the recent tax reform boosting household incomes and spending. Nevertheless, the trade and manufacturing sectors may be dampened by the heightened uncertainties caused by the Trump administration's ongoing trade disputes with China and allies.

Growth in the eurozone registered the slowest growth in 18 months, heightening fears the recovery is fizzling out or a just a temporary blip. Trade tensions stalking the global economy, a stronger euro and capacity constraints are dampening factors on the region's growth.

For Japan, though data suggest some improvement in economic activity on better exports but the patchy path remains. Historically-low unemployment rate is failing to translate into substantive wage gains. The manufacturing PMI fell to a nine-month low in May due to soft demand pressures.

Early data for the second quarter suggests that China's economic activity is losing some steam, following a strong GDP growth in 1Q18. The tightening of risky lending and the on-going deleveraging has weakened property sector and investment in fixed assets. Solid demand still supporting manufacturing output. The unresolved trade conflicts between the US and China are expected to act as a dampener on China's external sector. China's renminbi slid to a fresh six-month low against the dollar at 6.6145 since 19 December 2017, sparking speculation China could use a weakened yuan as a weapon if tensions with the US turn into an out-and-out trade war.

Market volatility is here to stay. Recent sell-off pressures in equities and foreign exchange of emerging market economies (EMEs), associating with the weakest link in Argentina and Turkey have stirred the fear of contagion risks in asset class of other emerging market economies in Asia such as India, Indonesia, and Philippines.

The capital outflows are a natural reaction to rising US bond yields, a revived strength of the dollar, the expected further rise in the Fed's interest rate, and further amplified by recent trade and geopolitical tensions. Higher crude oil prices also have exerted upward pressures on inflation in oil-importing countries and hence, compelled some central banks to tighten their interest rates to defend their currencies at the expense of slowing economic growth and domestic demand.

There are also lingering concerns that the current synchronized global economic expansion, especially the US economy running into the ninth year of economic cycle since 2008-09 Global Financial Crisis, could hit the speed bump by year-end or in 2019, as the US tightening cycle accelerates to tame inflation pressures. Policy makers could have miscalculated the risk from proliferating trade tensions and investment restrictions as well as the damage to confidence.

Uncertainties cloud economy. While we do not expect a sharp pullback in global growth, one should remain wary about the risks to global economy and financial stability, which have increased over past six months and could put markets and growth at risk. With trade tensions stalking the global economy, rising US bond yields on economic acceleration, rising inflation, a strong dollar and the Fed's guidance of more rate hikes ahead caused capital flows reversal from emerging markets and exerted pressure foreign exchange. Stretched valuations of risky assets, with some late-stage credit cycle dynamics emerging pose the risk of sharp market correction. Risks to global outlook remain tilted to the downside.

Figure 1: Real GDP growth (% YoY)

	2016	2017	2018 1Q	2018*f* (IMF)	2018*f* (WB)	2019*f* (IMF)	2019*f* (WB)
United States	1.5	2.3	2.8	2.9	2.7	2.7	2.5
Euro Area	1.8	2.4	2.2	2.4	2.1	2.0	1.7
China	6.7	6.9	6.8	6.6	6.5	6.4	6.3
Japan	1.0	1.7	1.1	1.2	1.0	0.9	0.8
India[1]	7.1	6.7	7.7	7.4	7.3	7.8	7.5
Malaysia	4.2	5.9	5.4	5.3	5.4	5.0	5.1
Singapore	2.4	3.6	4.4	2.9	-	2.7	-
Indonesia	5.0	5.1	5.1	5.3	5.2	5.5	5.3
Thailand	3.3	3.9	4.8	3.9	4.1	3.8	3.8
Philippines	6.9	6.7	6.8	6.7	6.7	6.8	6.7
Vietnam	6.2	6.8	7.4	6.6	6.8	6.5	6.6

Source: Officials; IMF (World Economic Outlook, April 2018; Recent Article IV Consultations); World Bank (Global Economic Prospects, June 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 continued stable growth amid slippage in business confidence, which was mainly due to the US-inflicted trade tensions with its key trading partners. The OECD Composite Leading Index (CLI) dipped marginally below the 100-pt threshold of expansion in April 2018, with easing sign in the euro area. PMI readings of both manufacturing and services continued to stay firmly above the 50-pt threshold, which separates between expansion and contraction though they signalled that the global growth has peaked or is peaking.

The latest WTO's World Trade Outlook Indicator (WTOI) printed lower reading of 101.8 in 2Q18 (1Q18: 102.3), suggesting slower pace of growth. Nevertheless, the tit-for-tat tariffs battle between the US and China as well as the US's allies are threatening to undermine global trade activity via the global supply and value chains impacting not only among these countries but also their major trading partners.

Figure 2: OECD CLI continues to anticipate stable growth momentum

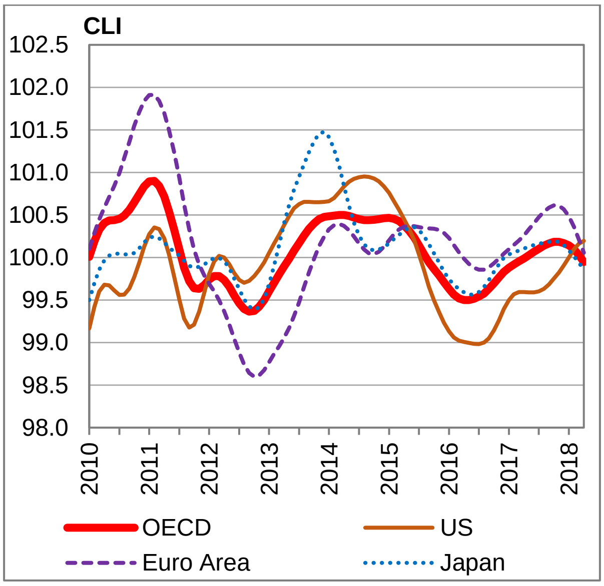


Figure 3: China CLI shows tentative sign of growth gaining momentum

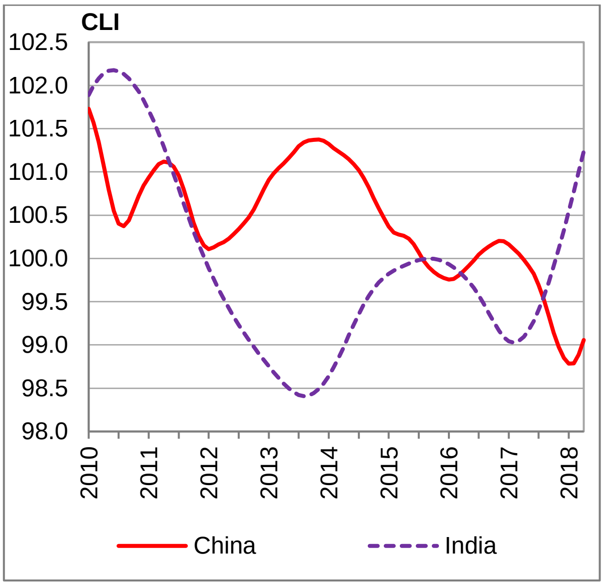


Figure 4: Business confidence slips in OECD area

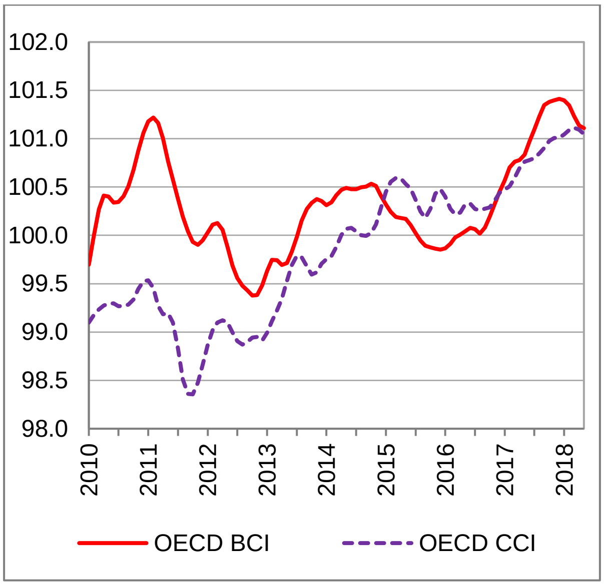


Figure 5: Global PMI for manufacturing and services sectors still well-above threshold of expansion

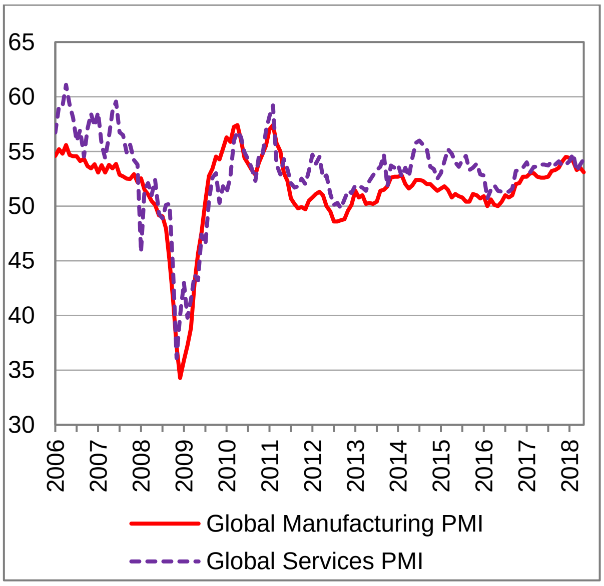


Figure 6: World trade volume growth rebounded in April

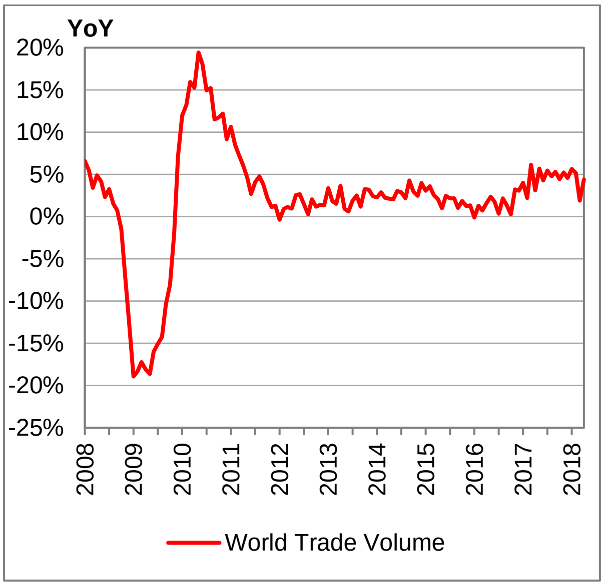
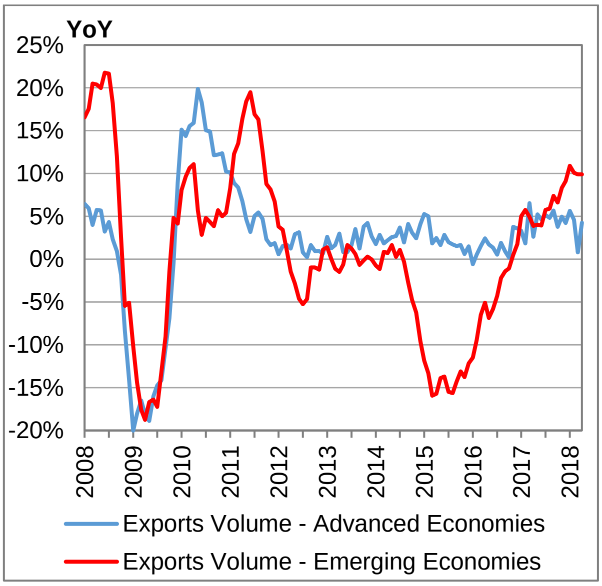


Figure 7: Exports volume growth in emerging economies outpaced that of advanced economies



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

Industrial production and Semiconductor sales

World industrial production improved steadily, reflecting increasing global demand and better economic prospects. However, the trade war if deepens and prolongs may hurt industrial production.

Global sales of semiconductors sustained at a strong growth of 21.0% yoy in the first five months of 2018 (2017: 21.6%), with the Americas region contributing the strongest sales growth of 35.9% yoy in Jan-May 2018 while other regions also grew markedly between 14.6% and 20.9%. Following the continuous solid growth of semiconductor sales, the World Semiconductor Trade Statistics (WSTS) revised upward the chip sales growth again to 12.4% in 2018 from 9.5% previously. Semiconductor Intelligence also revised the sales growth higher to 16.0%. For 2019, WSTS projects sales growth of 4.4% with sensors contributing the highest growth rate among the major product categories.

Figure 8: World industrial production continues to grow and fluctuate lesser

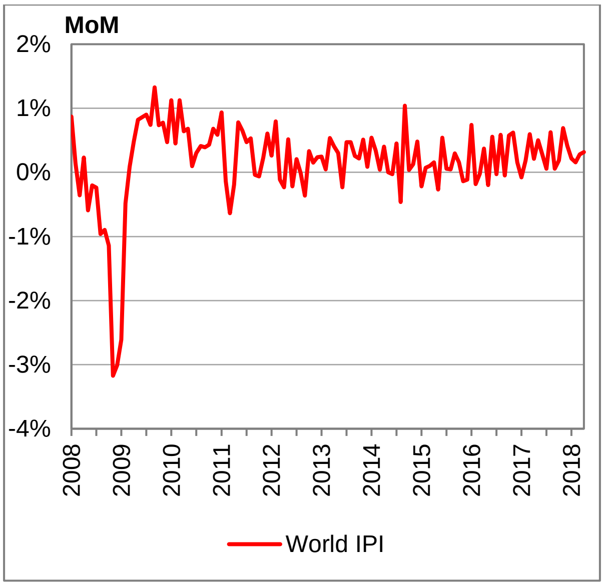


Figure 9: Both regions often move in opposite direction in 2018

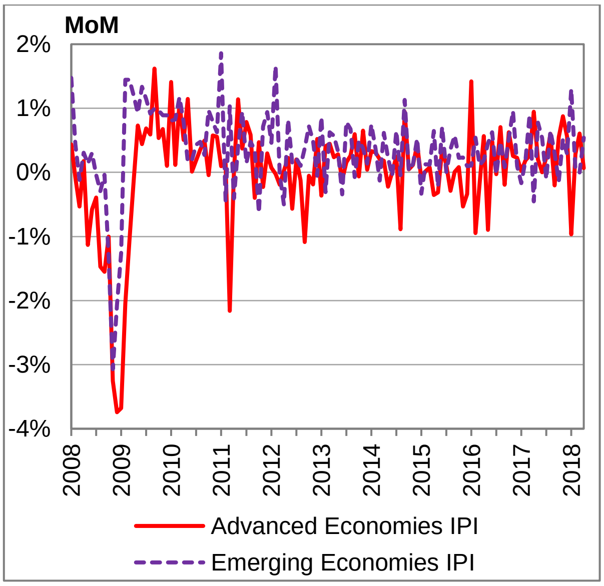


Figure 10: Global semiconductor sales have been growing for 22 months …

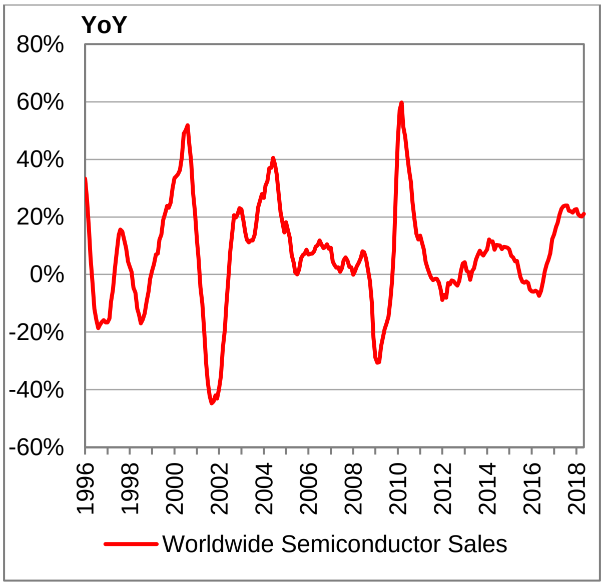
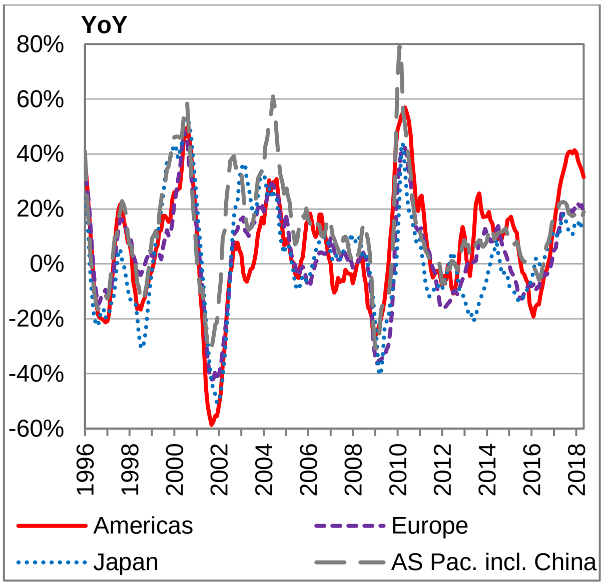


Figure 11: … with strong positive contributions from all the regions



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

Commodity prices

Both energy and non-energy prices continued to trend higher in the second quarter of 2018, increased by 7.4% mom and 0.1% respectively in May (energy: 8.2% mom in April and 9.8% qoq in 1Q18; non-energy: 2.0% mom in April and 3.8% qoq in 1Q18) while precious metal prices dropped by 2.1% mom in May after a 0.7% increase in April (+3.6% qoq in 1Q18). Supported by the compliance of crude oil supply cut within the OPEC nations (cutback target reached an average of 120% from Jan 2017 to May 2018), Brent crude oil prices rose higher to an average of US$74.53 per barrel in 2Q18 (US$66.86 in 1Q18 and US$54.12 in 2017), bringing prices to an average of US$70.67 per barrel in 1H18 (US$51.57 per barrel in 1H17). Crude oil prices are expected to soften in the second half-year as the 4th OPEC and non-OPEC Ministerial Meeting in June concluded to scale back the compliance to 100% from July as part of the agreement to boost supply. Hence, the Brent crude oil prices are estimated around US$65-70 per barrel this year.

In the absence of supporting factors amid facing headwinds, crude palm oil (CPO) prices trended lower to average RM2,324/metric tonne in 2Q18 (RM2,461.50 in 1Q18 and RM2,783 in 2017). In 1H18, CPO prices averaged RM2,421/metric tonne, a decline of 18.0% from RM2,954/metric tonne in 1H17. Overall, the CPO prices are estimated to average RM2,450 in 2018 (RM2,783/metric tonne in 2017).

Figure 12: Commodity prices trend higher, led by crude oil and food categories

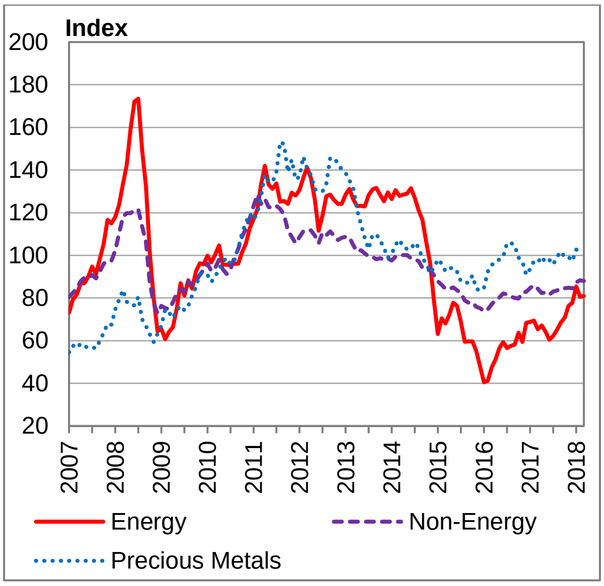


Figure 13: Crude oil prices likely to soften in the second half

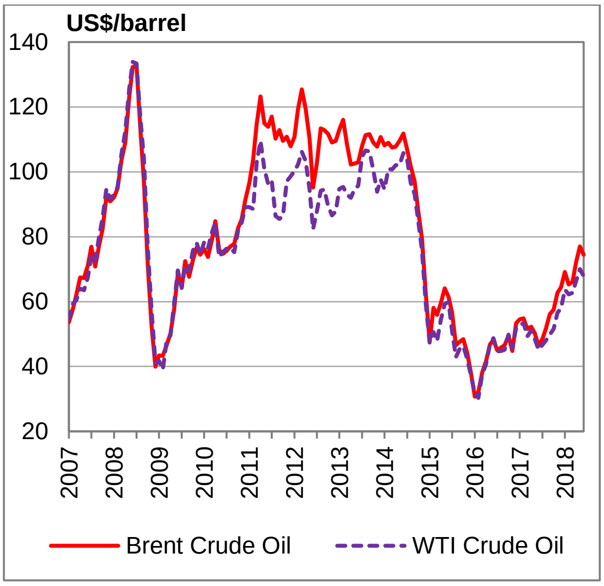


Figure 14: Crude palm oil prices remained sluggish

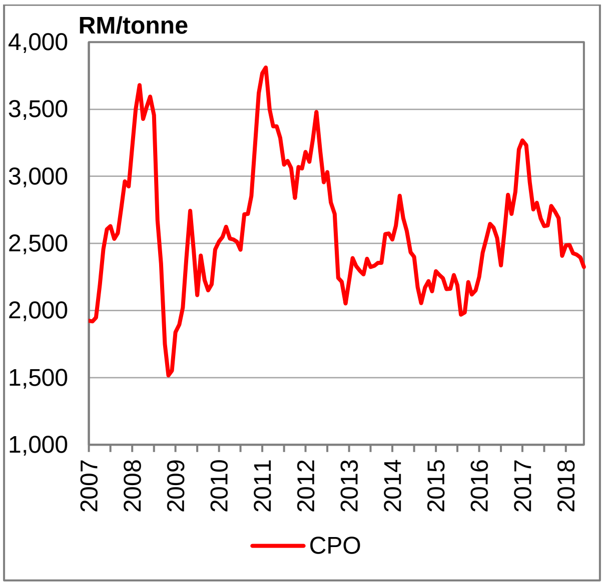
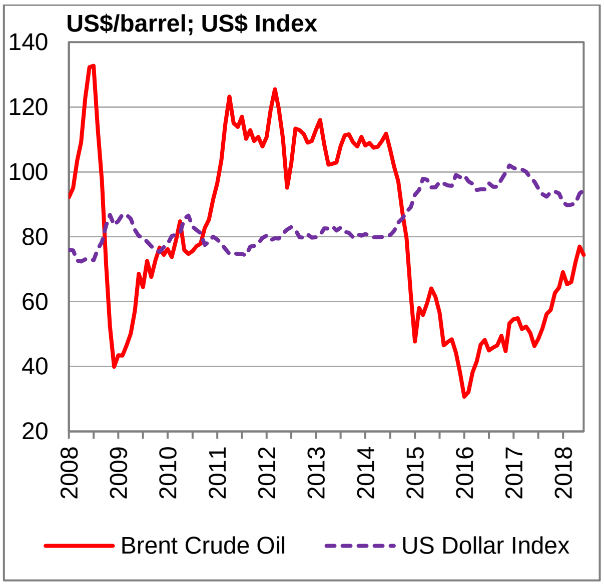


Figure 15: Brent crude oil price vs. US dollar index



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

US – BRIGHTENING ECONOMIC PROSPECTS

The US economy posted a strongest year-on-year growth of 2.8% in 1Q18 (2.0% annualised qoq) since the second quarter of 2015. Job creation continues to expand with a stable and healthy wage growth. Manufacturing and services activities remained buoyant. Industrial production grew strongly by an average 3.4% yoy during Jan-May 2018 compared to an average of 1.6% in 2017 (2016: -1.9%). For the same period, retail sales increased by 5.2% yoy, improving from 4.3% in Jan-Dec 2017. Both headline and core inflation rates have surpassed the Fed's desired rate of 2%, triggering expectations of a faster pace of interest rate increases ahead.

In the near-term, there are lingering concerns over the aggressiveness and tit-for-tat trade retaliations from the US's trading partners may eventually dampen the US domestic economic activities amid fuelling rising inflation pressure.

Figure 16: US economy still growing strongly

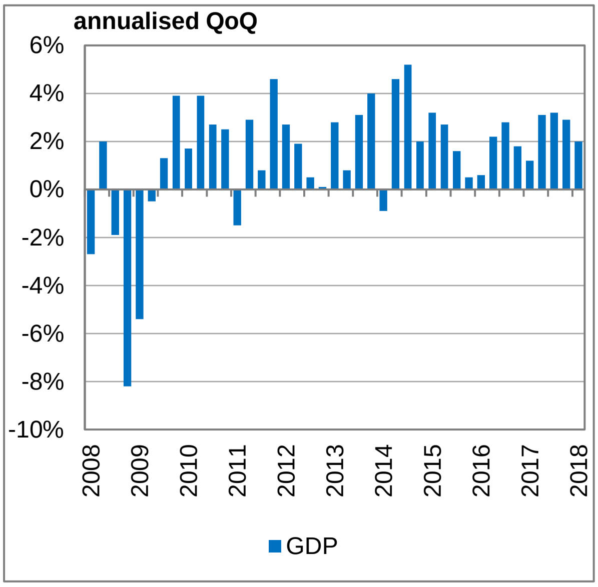


Figure 17: Buoyant business investment and stable consumption activities

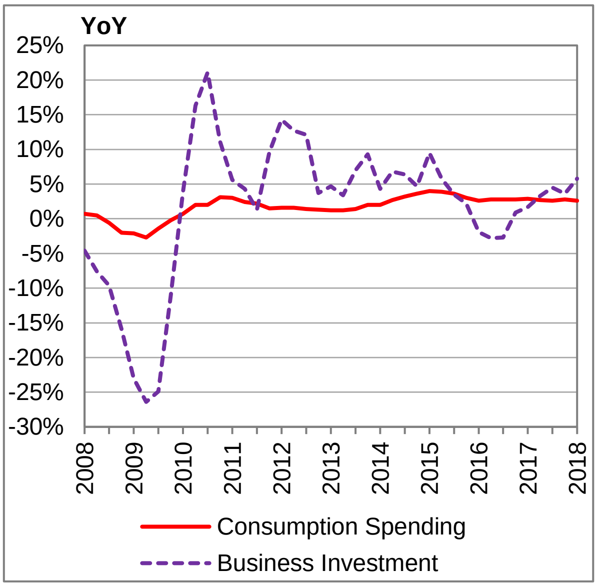


Figure 18: PMI indicates fast growing manufacturing ahead

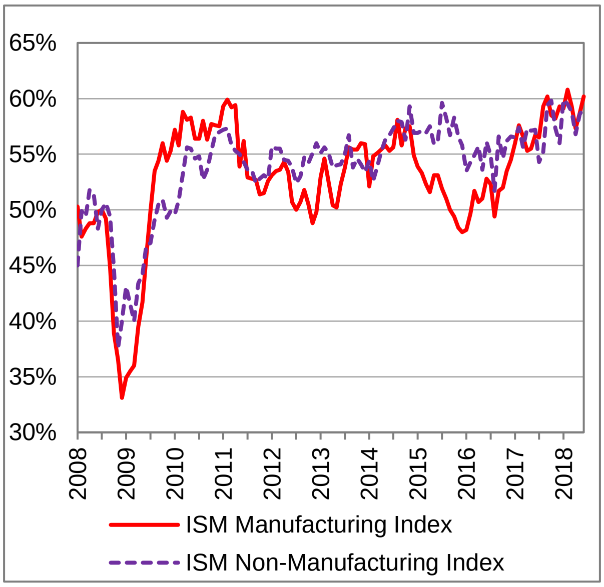


Figure 19: Encouraging growth in industrial production and retail sales

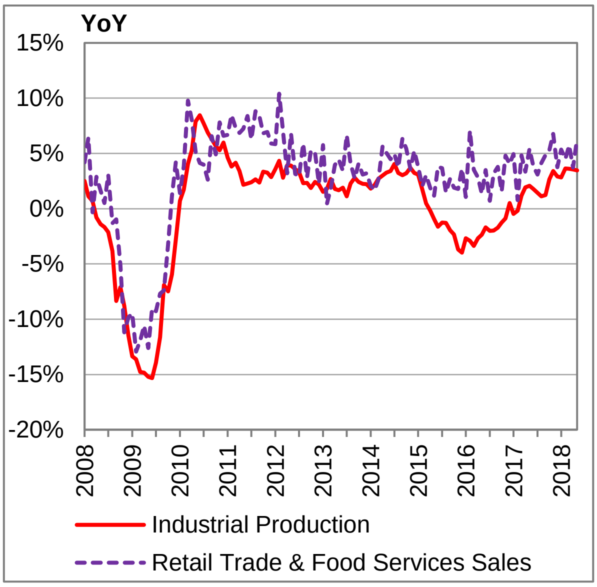


Figure 20: Unemployment rate ticked down to 3.8% in May, the lowest since April 2000

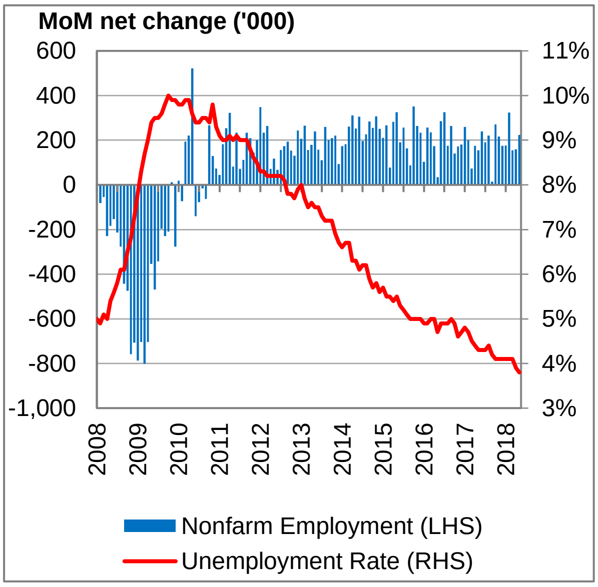
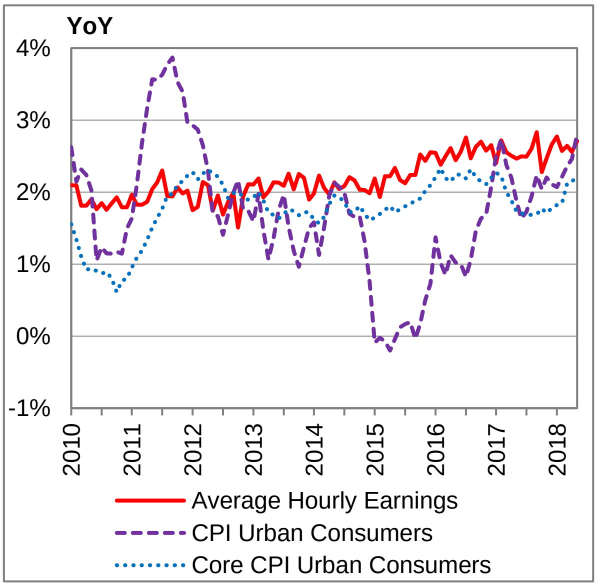


Figure 21: Highest headline inflation rate in May since February 2012



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

EUROZONE – UNCERTAINTIES CLOUDING AHEAD

The eurozone started the year 2018 on a softer note as real GDP growth expanded by 0.4% qoq (0.7% in 1Q18), the slowest in the past six quarters, mainly dragged by weak external demand. Economic Sentiment Indicators (ESI) also have been declining for six consecutive months since beginning of the year. Retail trade volume growth remained stable. Industrial production growth moderated significantly to 1.7% yoy in April from an average of 3.1% in 1Q18, due to the falling in energy production.

Job market continues its improvement track with unemployment rate marking its best level (8.4% in April and May) since December 2008. While headline inflation rate accelerated to 1.9% in May 2018 (1.3% in both April and 1Q18), core inflation rate excluding energy prices did not increase as much (1.4% in May, 1.1% in April and 1.2% in 1Q18). With Greece's debt crisis coming to an end, this provides a relief to the European region amid lingering concerns about the political risk in Italy and Brexit.

Figure 22: Eurozone economic growth softens

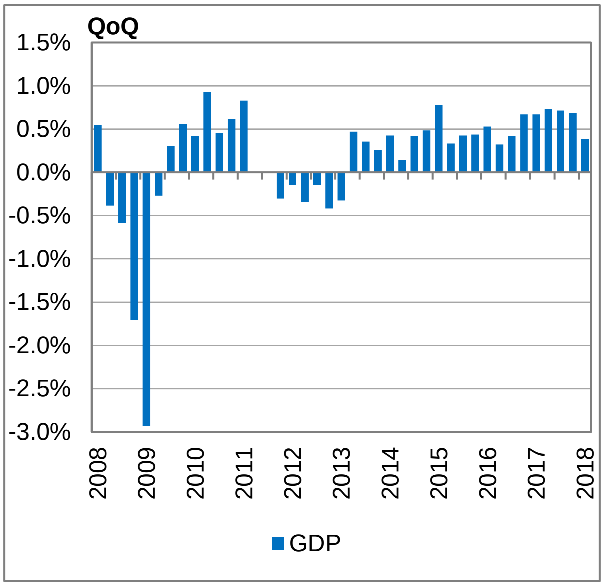


Figure 23: Domestic demand still on growth trajectory

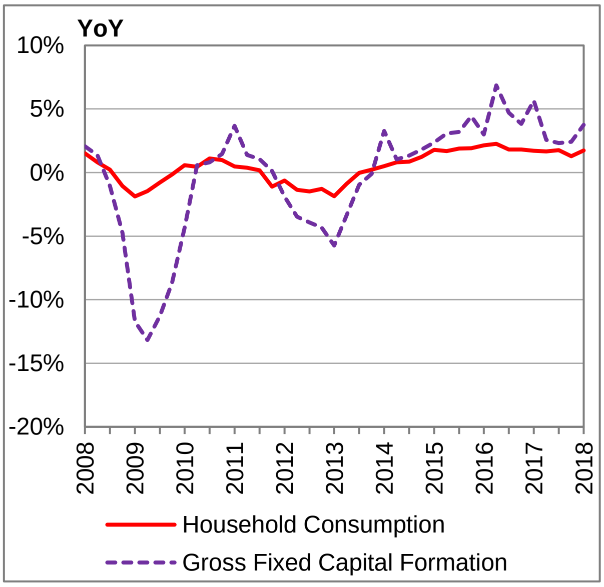


Figure 24: Manufacturing PMI readings eased sharply, albeit positive expansion ahead

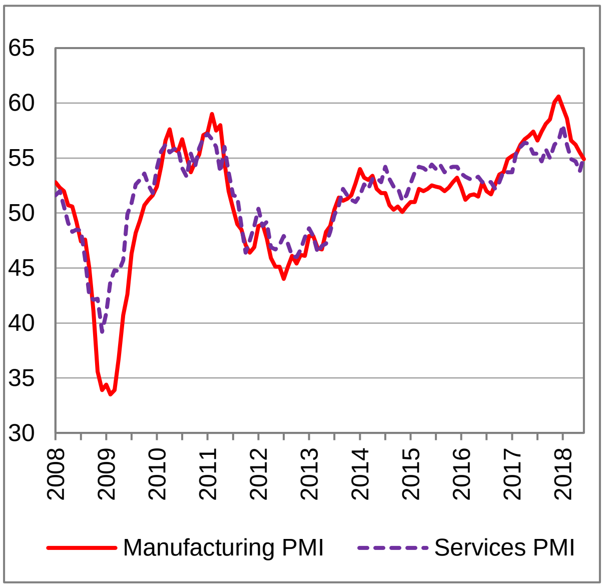


Figure 25: Easing momentum for industrial production

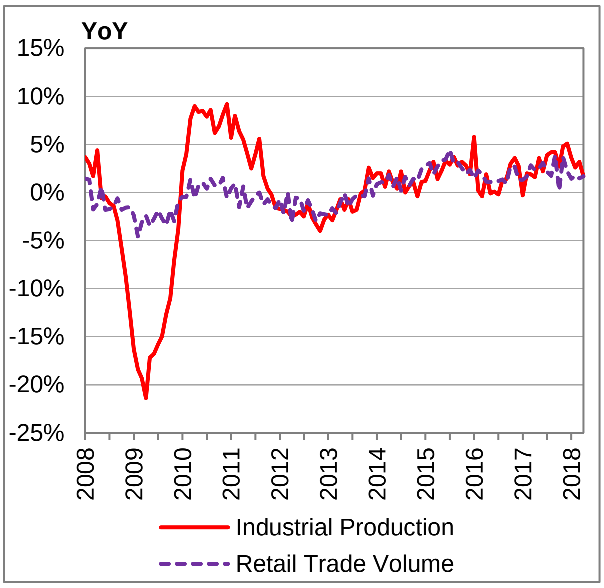


Figure 26: Unemployment rate continues to improve

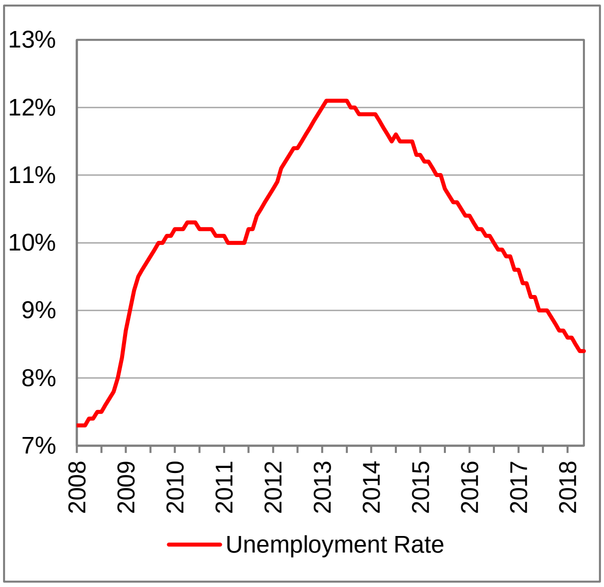
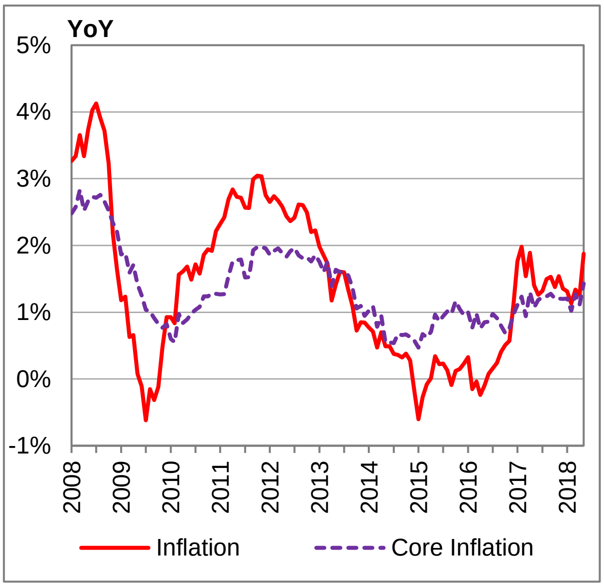


Figure 27: Headline inflation increased by 1.9% in May due to surging energy prices



Source: Eurostat; Markit

JAPAN – FINALLY, A PAUSE

The Japanese economy reached an end on its continuously growing record, registering a contraction of 0.2% qoq in the first quarter of 2018 (4Q17: +0.3%), mainly driven by sluggishness in private consumption. It is more worrying as the preliminary retails sales growth was unexciting in May. Nevertheless, core machinery orders projected an improvement of 7.1% qoq in 2Q18 from 3.3% in 1Q18. Industrial production growth seen an improvement at the start of second quarter but, further momentum is needed for a solid and sustainable growth ahead.

Low inflation readings in April and May were mainly due to lower increase in food prices. Persistently lower unemployment rate (2.2% in May), which reflects Japan's ageing population issue and shrinking workforce further dampening its long-term growth.

Figure 28: Japan's quarterly economic growth contracted after a record of eight consecutive quarters of growth

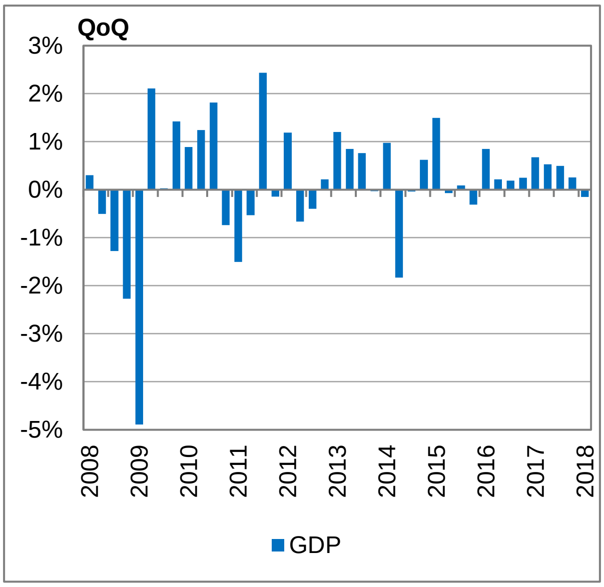


Figure 29: Both private consumption and investment growth moderated

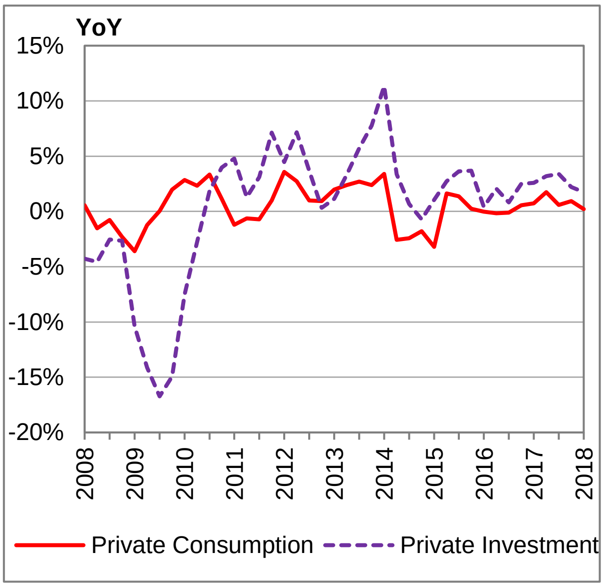


Figure 30: Industrial output picking up in the second quarter

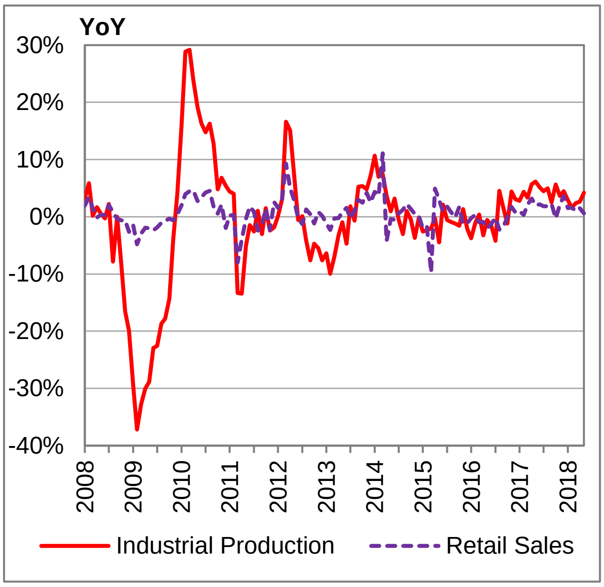


Figure 31: Uneven external trade activities

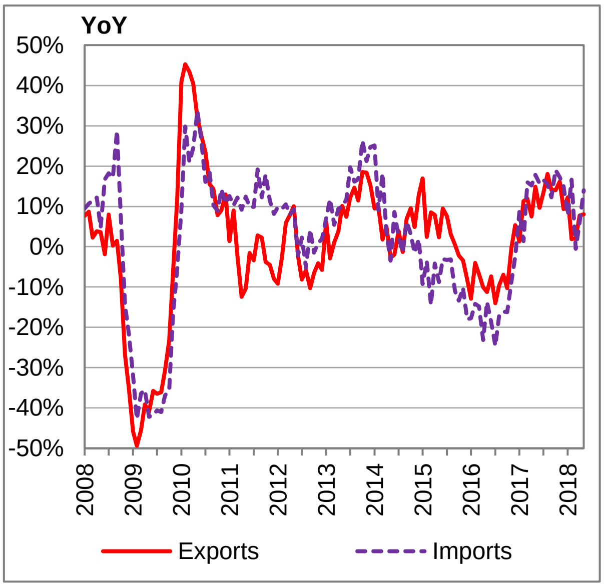


Figure 32: May's unemployment rate dropped to 25-year low

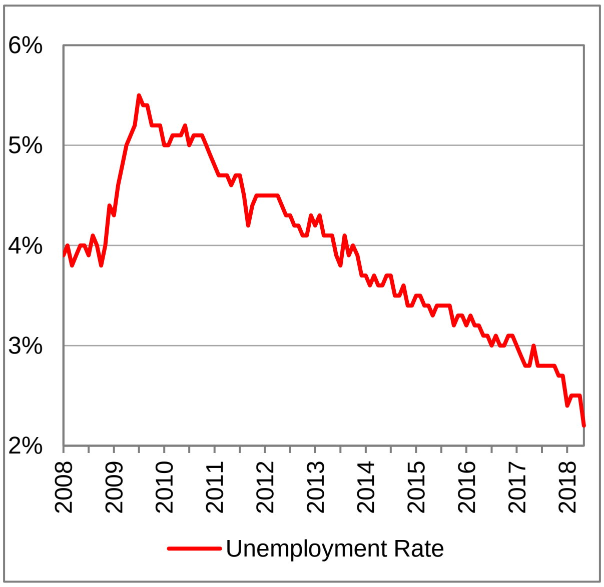
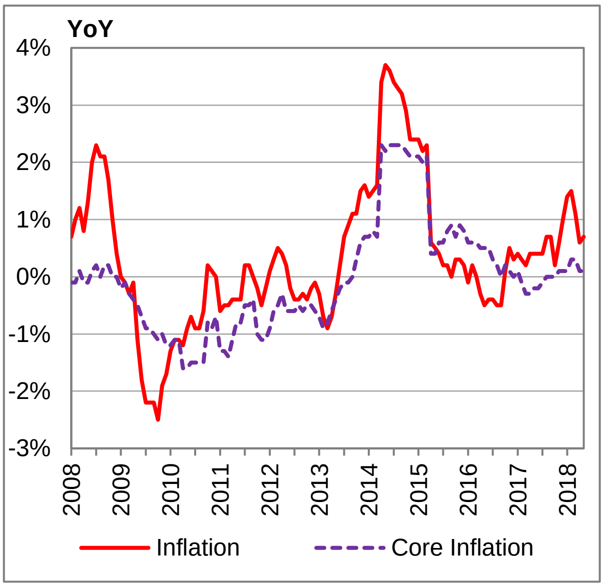


Figure 33: Inflation rate falls below 1% again



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

CHINA – BRACES FOR BUMPS

China's economy appears to have hit a significant speed hump, with a number of key indicators across the industrial, construction and retail sectors slowing to either multi-year, multi-decade or record lows. Completed fixed asset investment (excluding rural households), a proxy for infrastructure spending fell to 6.1% yoy in the first five months of the year, down from 7.0% in Jan-Apr. Retail sales also disappointed, tumbling from 9.4% growth in April (10.1% in March) to 8.5% in May, its slowest pace in around 15 years. Tougher lending standards could slow growth more heading into the second half of 2018.

The trade war with the US and a batch of weak economic data have revived fears whether the world's second-largest economy can meet the official's target growth of 6.5% this year (6.8% in 1Q18).

Figure 34: China's economy expanded by 6.8% in 1Q amid weak date in 2Q

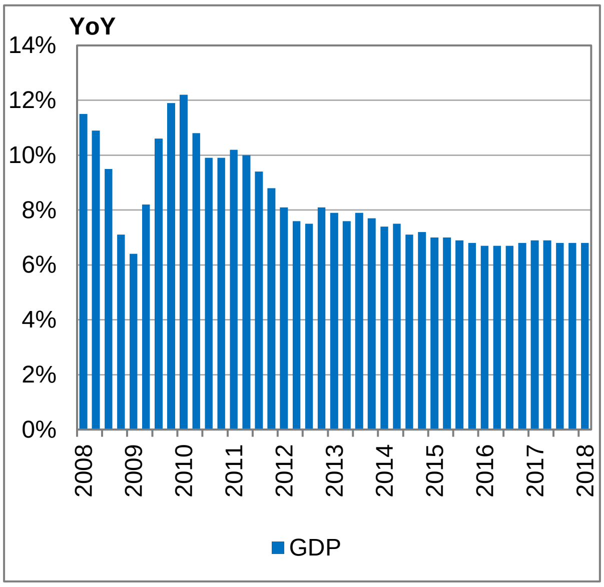


Figure 35: PMI points to stronger growth momentum

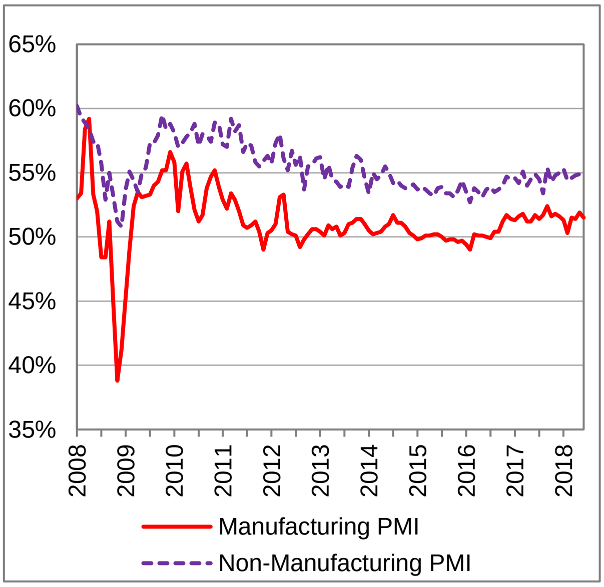


Figure 36: Industrial production grew by 6.0-7.6%

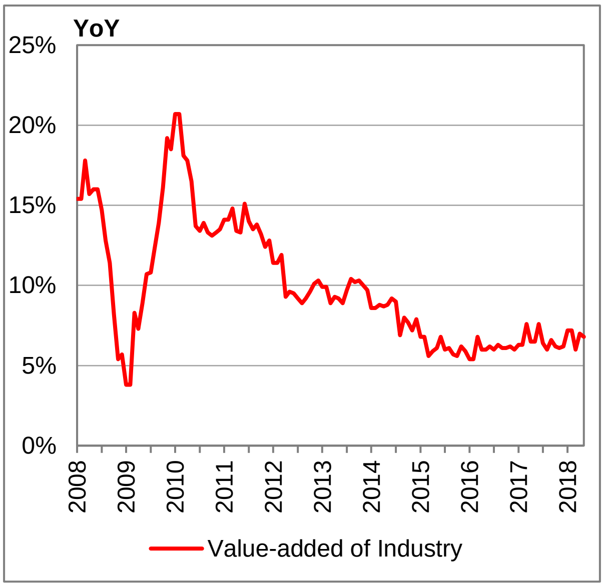


Figure 37: Retail sales growth moderated sharply

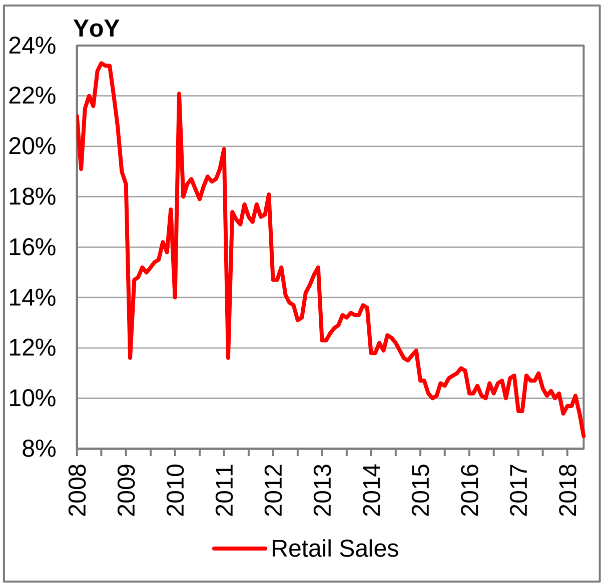


Figure 38: Fixed assets investment growth slipped further

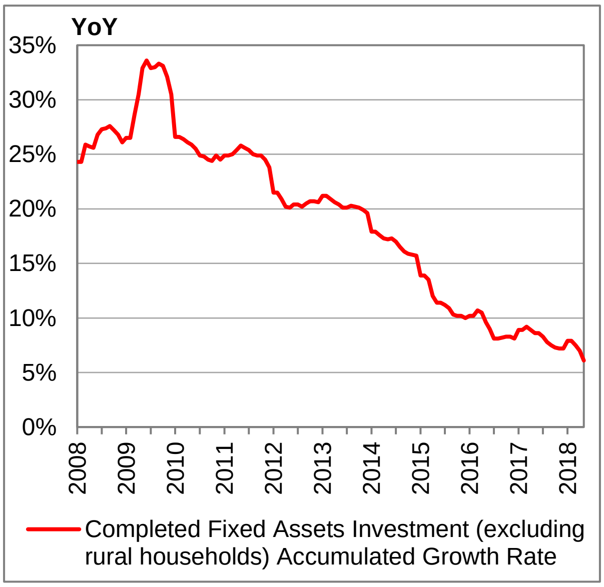
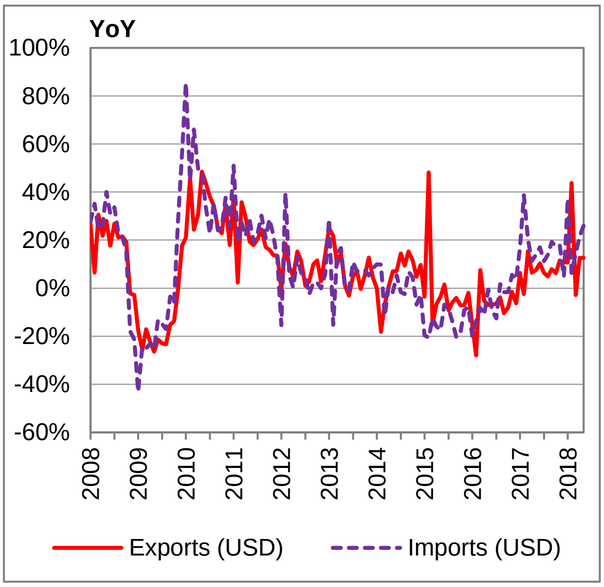


Figure 39: Both exports and imports registered double-digit growth

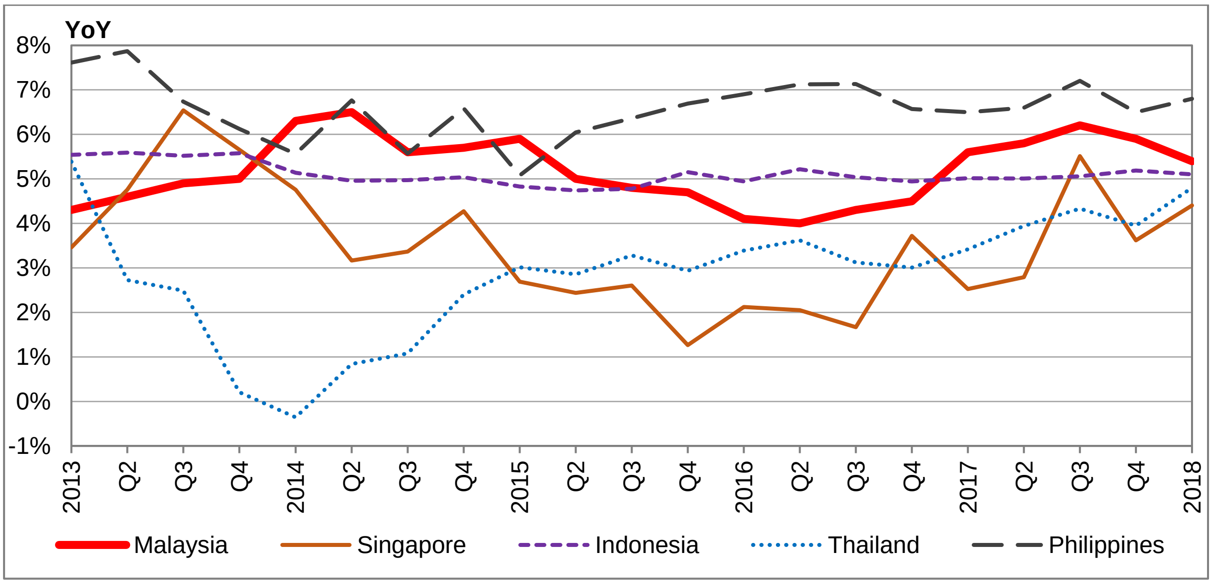


Source: National Bureau of Statistics of China; General Administration of Customs, China

ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

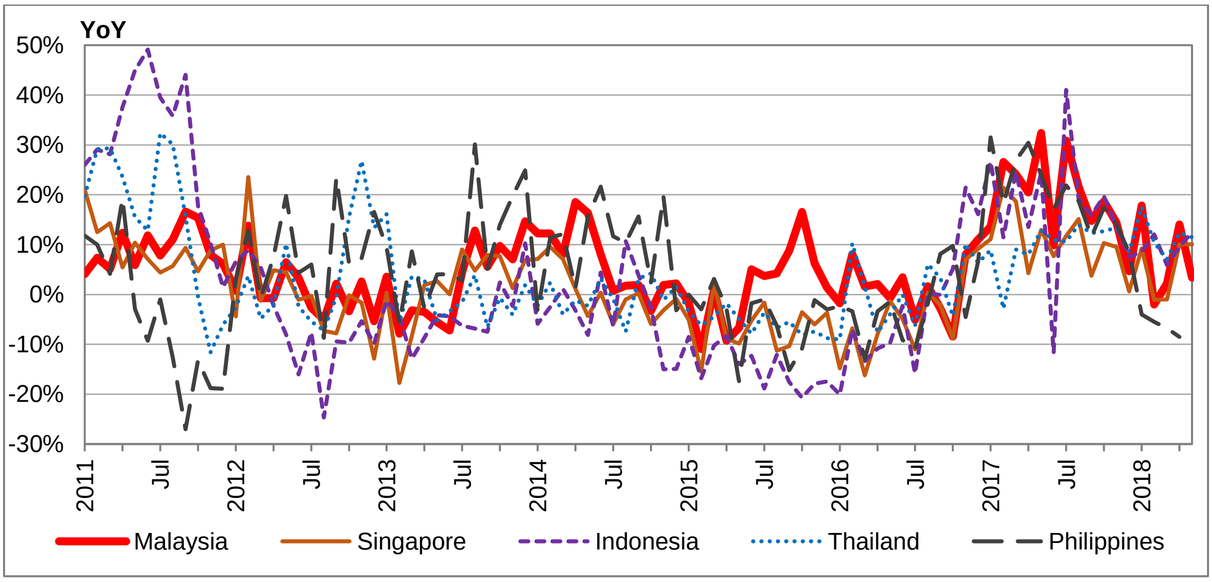
ASEAN-5 countries (Malaysia, Singapore, Indonesia, Thailand and Philippines) were still growing, albeit at an uneven pace in the first quarter of 2018. Overall industrial production and exports in most countries grew faster at the start of second quarter, with the exception of Philippines' exports, which still mired in negative territory since January 2018, partly due to its high base effect on the revision of data collection. Inflation is trending up in some countries on increasing energy prices. Despite the energy prices may be capped by increasing crude oil supply from both OPEC and non-OPEC countries at the recent concluded meeting, any trade tariff increases among major advanced economies could potentially ratchet up overall price levels for the rest of the world.

Figure 40: Real GDP growth trend



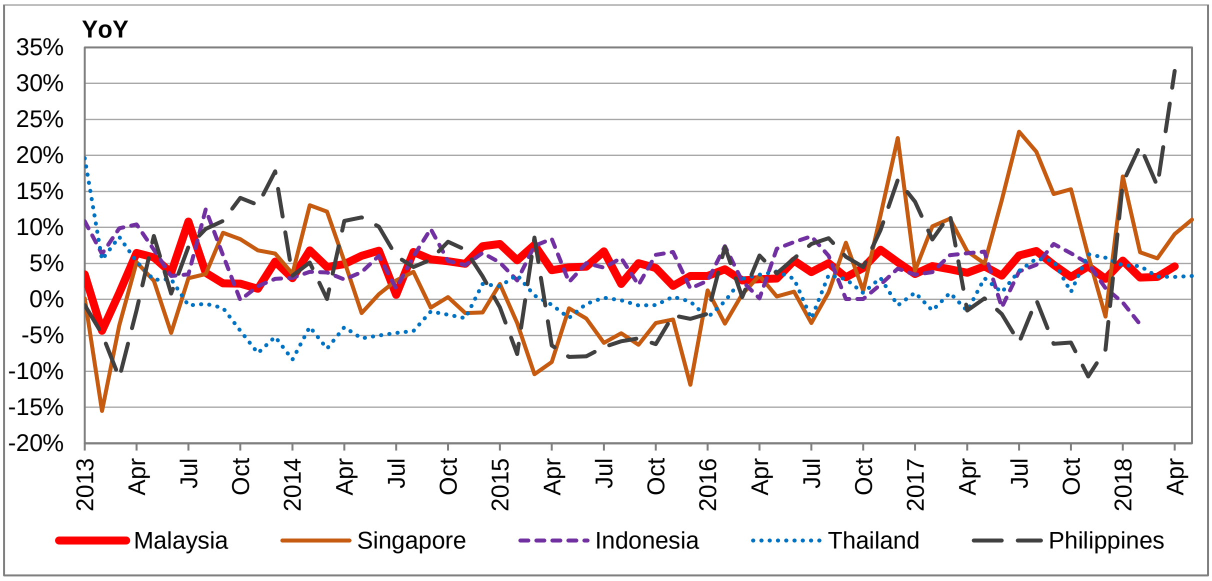
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 41: Export growth trend



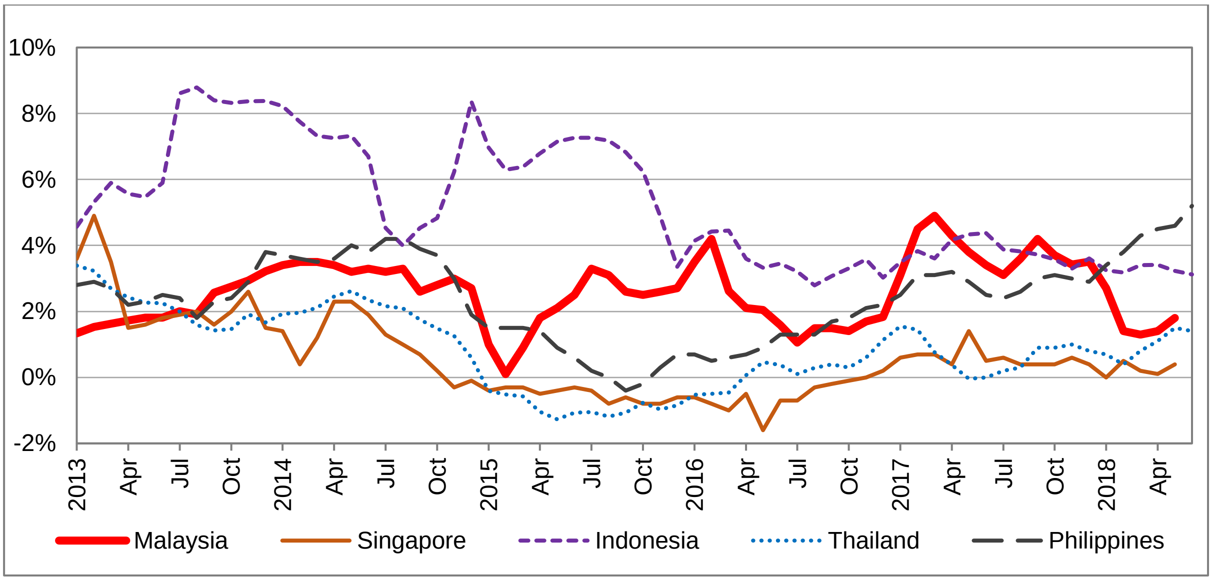
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

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 Fed Reserve (Fed) continued its rate hike as guided, taking its target rate to 1.75-2.00% after its 12-13 June monetary policy meeting, signalling two more increases in 2H18. The Federal Reserve's Open Market Committee (FOMC) expressed confidence that the US economy is strong enough to absorb the rate hike without impacting economic growth. The underlying inflationary pressures have been picking up on solid gains in employment and improved wage growth.

Barring the impact of trade tensions on economic growth, the Fed is likely to stay on the course of further rate hikes as it is assessed that the US economy has returned to the normal level without the support of high level of monetary accommodation. The Fed's median interest rate projection for 2018 is now 2.4%, indicating four interest rate increases this year. For 2019, the Fed projects the median federal funds rate will end at 3.1%, before moving towards its longer-run goal of 2.9%.

The European Central Bank (ECB) signals that it will end the bonds buying program by year-end but interest rates will remain at record lows at least through the summer of 2019. The QE programme had succeeded in its aim of putting inflation on course to meet its target of being below but close to 2% over the medium term.

The Bank of Japan (BOJ)'s monetary policy stance continues to lag behind the Fed and ECB as Japanese economy still exhibiting uneven pace of economic growth and inflation expectations were moving sideways.

In China, the People's Bank of China (PBOC) announced a 1 percentage-point (ppt) reduction in the reserve requirement (RR) in April for most banks to liquidize RMB900 billion from repaying the medium-term facility (MLF) and free up RMB400 billion for lending purposes, which mainly to support the financial accessibility of the small and medium enterprises (SMEs). Subsequently, the PBOC further reduced 0.5 ppt of RR for five state-owned banks and twelve joint-equity commercial banks to unlock RMB500 billion to promote debt-to-equity swap program, at the same time, reduced 0.5 ppt of RR with RMB200 billion released for some lenders in supporting SMEs' financial needs, both effective from 5 July.

Some Asian central banks such as Bank Indonesia (BI), Reserve Bank of India (RBI) and the Bangko Sentral ng Pilipinas (BSP) hiked their benchmark policy rates in May and June, driven by different policy considerations. BI tightened interest rates three times (total of 100 bps) within six weeks to support its exchange rate, which was under pressured as investors' sentiment turned cautious on emerging market economies, leading to capital outflows. Both RBI and BSP also hiked their interest rates in bolstering their credentials on the inflation-fighting front.

Going forward, while some are bowing to external pressures 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 (Jun)**	**2018*F***
US, Fed 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	1.75-2.00	2.25-2.50
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	-0.40
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	-0.10
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	4.35
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	6.25	6.50
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	1.50
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
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	5.25	5.75
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	3.50	3.75

Source: Officials; SERC

C. MALAYSIA: JUGGLING BETWEEN POPULISM AND SUSTAINABILITY

The economy will continue to grow at healthy clip. After registering a growth of 5.4% yoy in 1Q18, the start of the second quarter indicators show continued economic expansion, with domestic demand (especially private consumption) and exports supporting the growth. Going into 2H18, weighing on the impact of external headwinds as well as the implications of domestic political and policies transition, we have trimmed our GDP growth estimates to 5.2% for this year from 5.5% previously (5.9% in 2017) while introducing a forecast of 4.9% for 2019. We will review our estimates after the tabling of 2019 Budget on 2 November.

Consumer spending still calling the shot. Private consumption resilience held intact (6.9% in 1Q18 vs. an average of 6.5% in 2016-17) on improved income growth and stable labour market condition (unemployment rate of 3.3% in Feb-Apr). The three months “tax holiday” from the zerorised of GST rate between June and August, the payment of cost of living aid and the stabilisation of fuel prices (RON 95) are expected to keep consumer spending steady estimated 6.9% in 2018. The rolling out of new revamped Sales and Services Tax (SST) on 1 September and its net impact on the price of goods and services may take off some spending strength.

Private investment growth pulls pack sharply. The sharp pullback in private investment growth to 0.5% yoy in 1Q18 (9.3% in 2017) is expected to remain weak between 3-4% this year (revised lower from 8.3% previously), reflecting the “wait and see” approaches by both domestic and foreign investors until clarity emerges on the new Government’s policy directions, including the on-going review of mega projects, and also what ‘catalysts’ are in store in the tabling of the new Government’s 2019 Budget for the first time.

Exports at trade tensions risk. Exports, which had accelerated to 14.0% in April (5.8% in 1Q18) slowed substantially to 3.4% in May, dragged by slower manufactured goods and a sharp decline in agricultural products amid higher exports of crude petroleum and liquefied natural gas (LNG). Exports are expected to move on a bumpy ride ahead given the trade tensions risk between the US and China as well as the US’ allies impacting the technology sector, automobile, steel and aluminium industries. The tit-for-tat trade war amongst these economies would inflict damage to the global economy and trade. Malaysia will be affected via the global supply and value chains though at this current state, the impact is manageable. We lowered our export growth estimate to 6.5% this year from 7.5% previously (18.9% in 2017).

Inflation numbers to stay low for quite some time. Inflation rate, as measured by Consumer Price Index (CPI) has been staying on subdued trajectory (1.4% in April and 1.8% in May vs. 1.8% in 1Q18), reflecting largely the technical impact of high base effect, aided by stabilised fuel prices. The CPI growth will print low rate of below 1%, thanks to the removal of GST starting 1 June and continued stabilisation of fuel price (RON95). We now expect inflation to rise by 1.0-2.0%, a mark down from 2.0-3.0% previously. The 2019 Budget is expected to roll out more initiatives to keep stable prices of staple food.

Austerity drives unleash confidence. It is clear that new Government will deliver its fiscal plan and put deficit and public debt firmly on a downward path. With the anticipated revamping of Sales and Services Tax (SST) not yielding higher revenue than the Goods and Services Tax (GST), both operating and development expenditures will have been rationalized, realigned or reduced to keep overall deficit in check and debt at sustainable levels.

The rationalisation of expenditure and containment of government debt is to achieve macroeconomic stability and fiscal sustainability; to create fiscal space for future shocks; to increase expenditure allocative efficiency by scaling cutting back; rescheduling or reforming government activities.

Public spending containment and spending reforms is a must to build strong fiscal buffer for future shocks. The rationalization and scaling back of expenditure can be carried out on many fronts: a) reform of public procurement, which is one of the government activities most vulnerable to corruption via competitive open tender in a transparent manner to reduce corruption and save cost; b) public investment spending should focus more on maintenance rather than expansion given the country's high quality and quantity of infrastructure. If financial condition permits, the planned infrastructure projects can revive but relooking at the cost; c) rationalizing local and state-owned enterprises investment to avoid duplication; d) a critical review and assessment of the effectiveness of various social safety net and welfare assistance programs under various ministries and agencies with a view of consolidating these various funds and programs. An endowment fund can be considered to generate recurrent return to finance these financial assistance programs; e) right-sizing public delivery services; and f) out-sourcing or privatization.

Fiscal policy should be countercyclical, not pro-cyclical. As the Government has the capacity to honour all its debt obligations, one should not misconstrue that austerity is a surrogate for attempts to reduce the size of the government. The priorities of government spending remain on the provision of public goods and services, investing in public infrastructure, education and etc.

In this regard, when economic activity is already pacing up, the government should avoid or refrain from pro-cyclical policy actions that provide unnecessary stimulus amid facing the fiscal budget and debt constraints. Instead, the government should remain committed to deliver on their fiscal plans and put deficits and public debt firmly on a downward path.

If plans for fiscal and debt consolidation are credible and involve structural reforms, there is every chance growth can resume even as cuts or rationalization of public spending take hold. The fiscal condition that we are in now is not about acute austerity in spending but more of rationalizing or reprioritizing the capital expenditure and operating spending. Cost savings and expenditure efficiency derived from the value for money projects mean wider economic and multiplier impact on the economy, rakyat and businesses.

Spending splurges reduce growth and austerity drives raise growth. This is because a disciplined and financially prudence government not only impacts positively on private sector's expectations but also unleashes confidence. A lean and good governing government with sound fiscal conditions strengthen confidence as the private sector expects lower future taxes and lower interest rates. This works to raise disposable income and boost asset values, which become the engine for a sustainable expansion.

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

Economic Sector [% share to GDP in 2017]	2015	2016	2017	2018 1Q	2018*F* (BNM)	2018*E* (SERC)
Agriculture [8.2%]	1.4	-5.2	7.2	2.8	3.6	2.4
Mining & Quarrying [8.4%]	5.3	2.2	1.0	0.1	1.8	0.8
Manufacturing [23.0%]	4.8	4.4	6.0	5.3	5.9	5.1
Construction [4.6%]	8.4	7.4	6.7	4.9	7.3	6.0
Services [54.5%]	5.3	5.7	6.2	6.5	6.1	6.3
Overall GDP	**5.1**	**4.2**	**5.9**	**5.4**	**5.5-6.0**	**5.2**

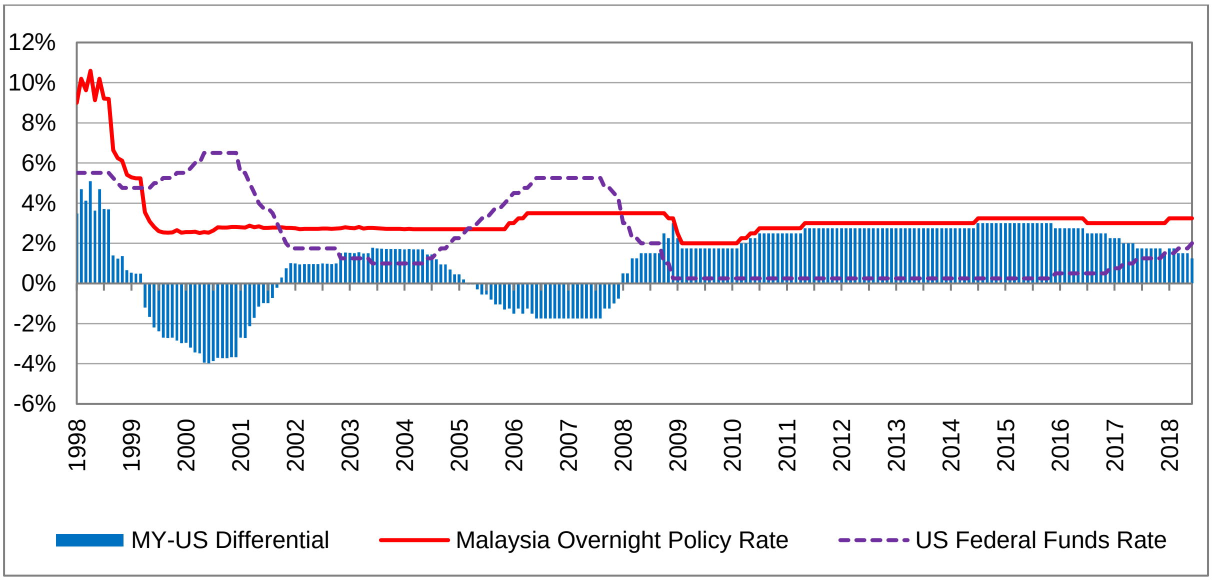
Source: Department of Statistics, Malaysia; Bank Negara Malaysia; SERC

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

Demand Component [% share to GDP in 2017]	2015	2016	2017	2018 1Q	2018*F* (BNM)	2018*E* (SERC)
Private Consumption [53.7%]	6.0	6.0	7.0	6.9	7.2	6.9
Public Consumption [13.0%]	4.5	0.9	5.4	0.4	0.6	1.0
Private Investment [17.4%]	6.3	4.3	9.3	0.5	9.1	3.0
Public Investment [8.0%]	-1.1	-0.5	0.1	-1.0	-3.2	-1.5
Exports of Goods and Services [72.8%]	0.3	1.3	9.4	3.7	8.8	5.9
Imports of Goods and Services [65.1%]	0.8	1.3	10.9	-2.0	9.1	3.9
Overall GDP	**5.1**	**4.2**	**5.9**	**5.4**	**5.5-6.0**	**5.2**

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

April's **leading index** (LI), a forward gauge of growth expectations suggest that the Malaysian economy remains favourable between August and October. However, the coincident index, which examines current economic activities showed some decreases, due to lower capacity utilisation in the manufacturing sector and lower retail volume.

Industrial production growth has picked up in April (4.6% yoy vs. an average of 3.8% in 1Q18 and 4.3% in 2017), backed by output expansion in petroleum products, electrical and electronic products, chemical and chemical-related products as well as metal products. Mining output increased unevenly, due to the reduction in natural gas output.

Figure 48: Leading index suggests economy remains favourable

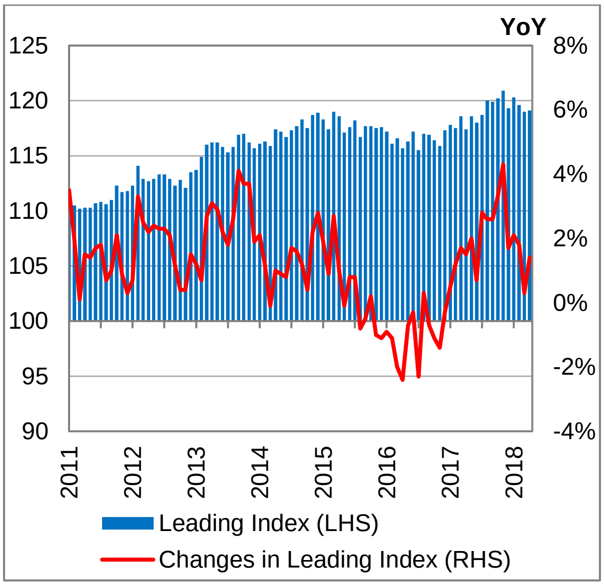
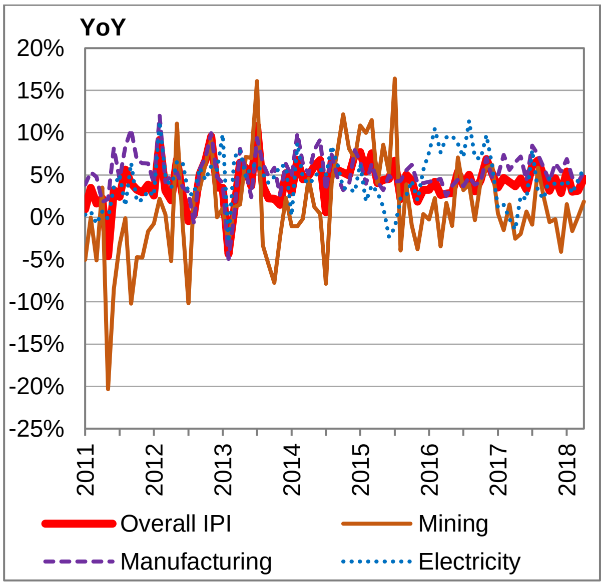


Figure 49: Industrial production starts to pick up



Source: Department of Statistics, Malaysia

Exports, Manufacturing sales and Services

Despite being challenged by a high base in 2017, **exports** continue to expand by 6.9%, albeit unevenly in the first five months of 2018 (5.8% in 1Q, 14.0% in April and 3.4% in May), with support coming from manufactured goods, particularly electrical and electronic products. Nevertheless, agricultural exports growth did not perform well and deteriorated by 11.5% in Jan-May. Exports of crude oil and liquefied natural gas (LNG) remained strong.

Imports moderated sharply to 1.3% in the first five months of 2018, mainly dragged by intermediate goods, which had declined for six consecutive months, presaging weak production and exports ahead. With resilient global demand amid heightened fears of escalating trade war between the US and China as well as its allies (Canada, Mexico and EU), exports are estimated to increase by 6.5% in 2018 (19.8% in 2017).

After registering a slower pace of 6.5% yoy in 1Q18, **manufacturing sales** expanded higher by 8.4% in April despite having the extraordinary high base effect last year. Retail sales growth moderated. With the zerorised GST starting from 1 June, retail sales are expected to expand decently, at least till August, before the implementation of Sales and Services Tax (SST) in September.

Figure 50: Trade surplus surged in March and April, backed by stronger exports

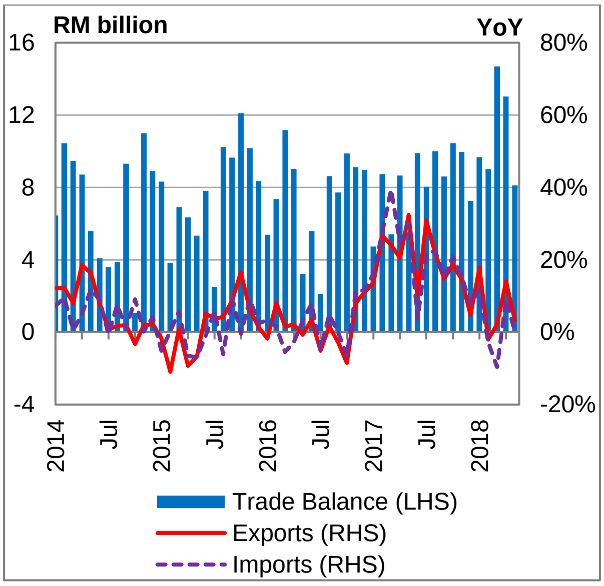


Figure 51: E&E continued to outperform, except in May

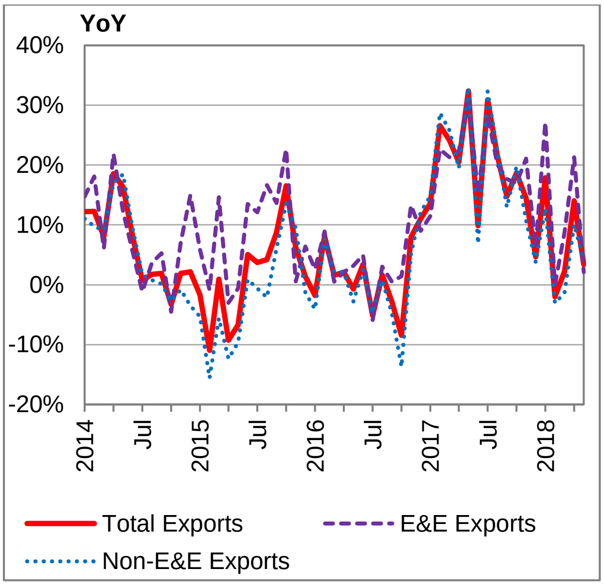


Figure 52: Manufacturing sales still growing

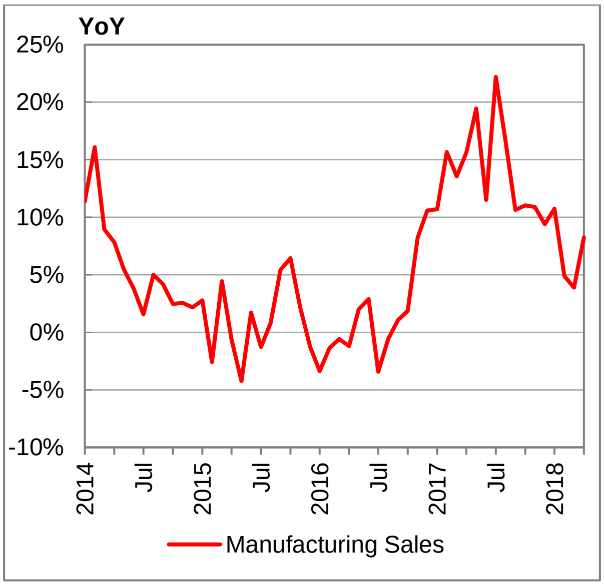
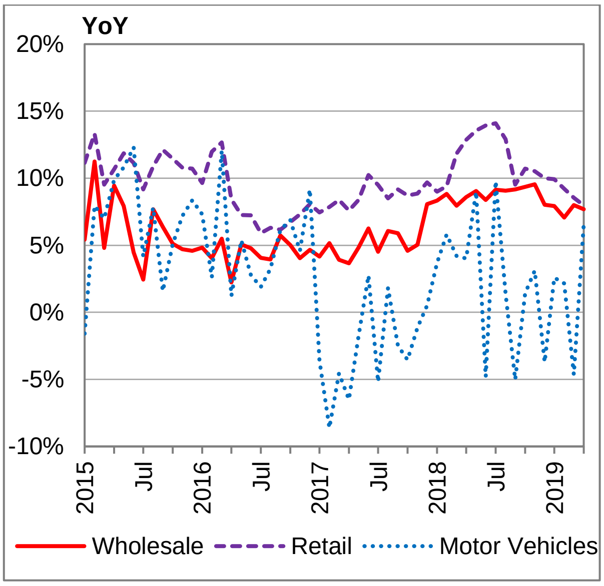


Figure 53: Moderating retail sales



Source: Department of Statistics, Malaysia

Private consumption indicators

Consumer sentiments have improved, supported by a steady household income and better job and financial expectations. MIER's Consumer Sentiment Index (CSI) increased by 8.4 points to 91.0 in 1Q18, gaining ground to return to the 100-pt optimism threshold. Unemployment rate remained at 3.3% for three months in a row since February. Consumer spending is expected to get a boost from the removal of GST for three months starting June before the implementation of SST in September.

Passenger vehicle sales dropped significantly by 10.9% yoy in May as buyers held back their purchases following the announcement of zero-rated GST w.e.f. 1 June. As such, car sales are expected to get a boost starting from June until August before the implementation of SST on 1 September. With the SST, car prices are likely to cost more as the expected SST of 10% is higher than GST rate of 6%.

Figure 54: Passenger car sales are expected to improve in June, thanks to the zerorised GST rate

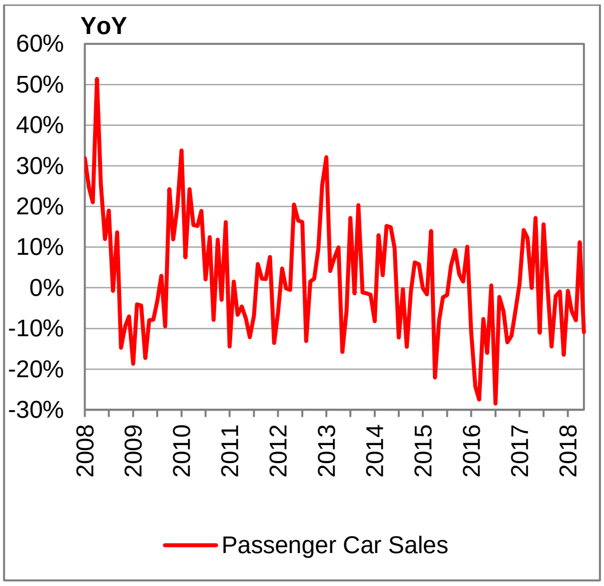


Figure 55: Selected private consumption indicators

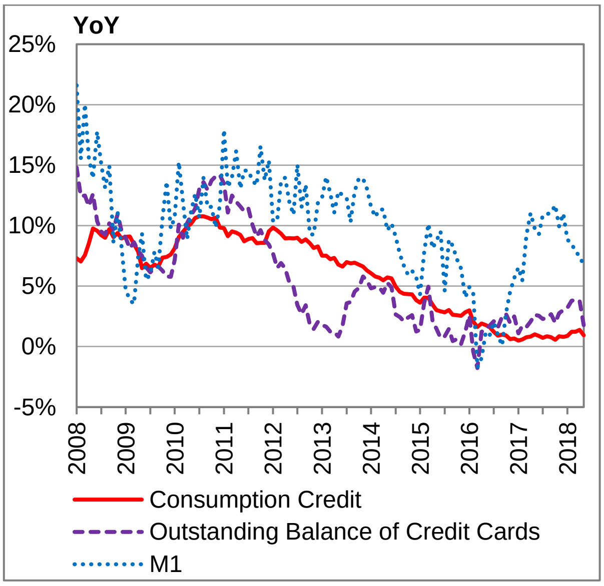


Figure 56: Higher pay-out in manufacturing sector

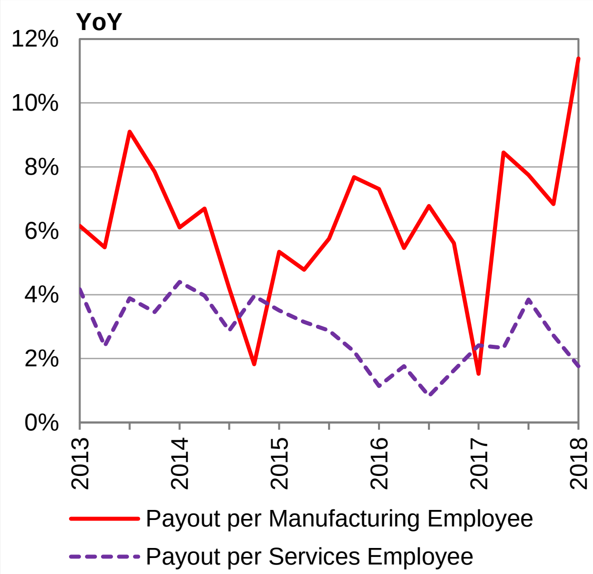
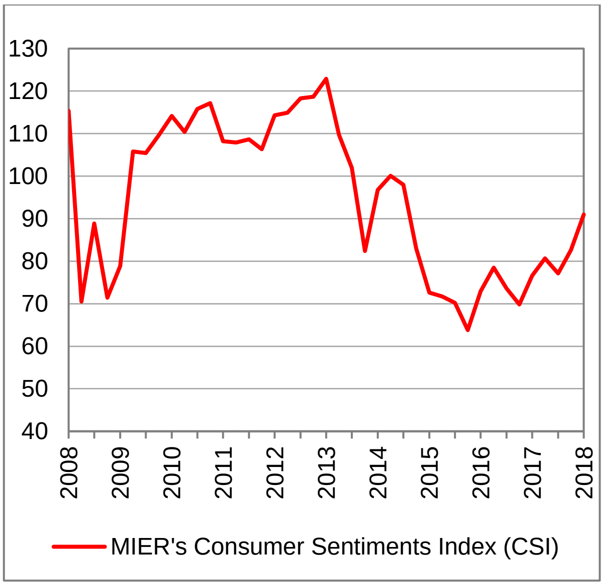


Figure 57: Improving consumer sentiments



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

Private investment indicators

Business sentiments have weakened as reflected in MIER Business Condition Index (BCI), which dipped below the 100-pt threshold in 1Q18, which last seen in 4Q16, citing falling sales and undemanding orders. Prior to the 14th General Election (GE), private investment growth had slowed sharply to 0.5% yoy in 1Q18, the slowest quarter since fourth quarter of 2010. During this period of political and domestic policies, private sector is expected to adopt a wait-and-see approach until they are clear about new Government's policies direction.

Sales of commercial vehicles, which had increased by 4.6% yoy in the first four months of 2018, contracted sharply by 49.4% in May as buyers held back their purchases to save on the car price differentials when the GST was zerorised on 1 June. Hence, sales of commercial vehicles are expected to resume to positive growth in the months ahead. Imports of intermediate goods have been down for six consecutive months, implying weak production and exports ahead.

Figure 58: Selected private investment indicators

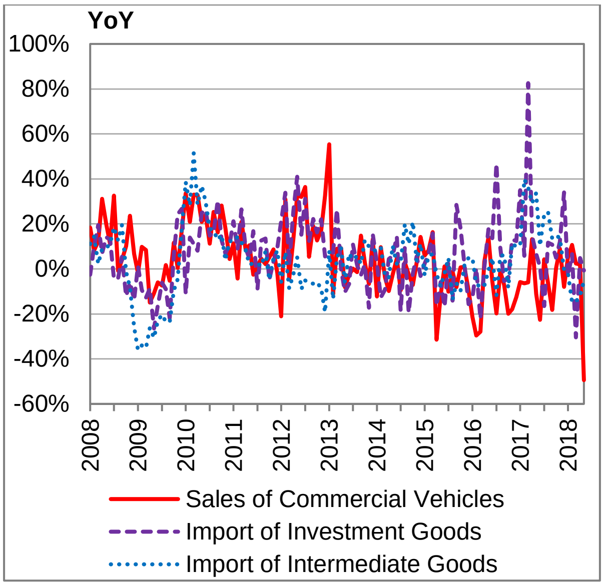


Figure 59: Real private investment growth nearly flat in 1Q18

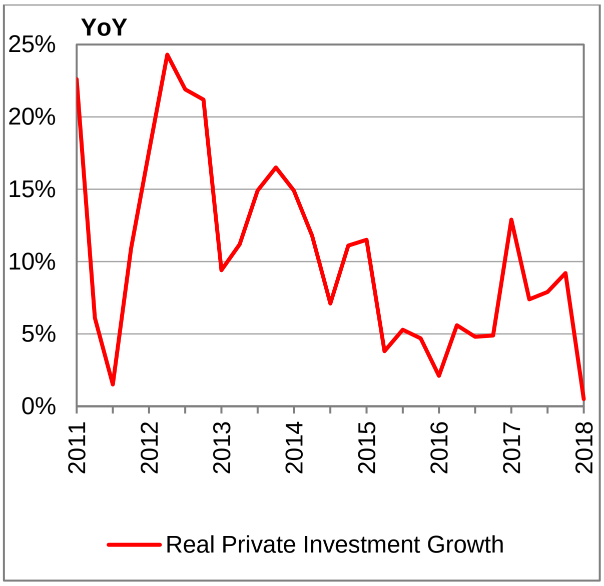


Figure 60: Businesses did not feel good at the start of 2018

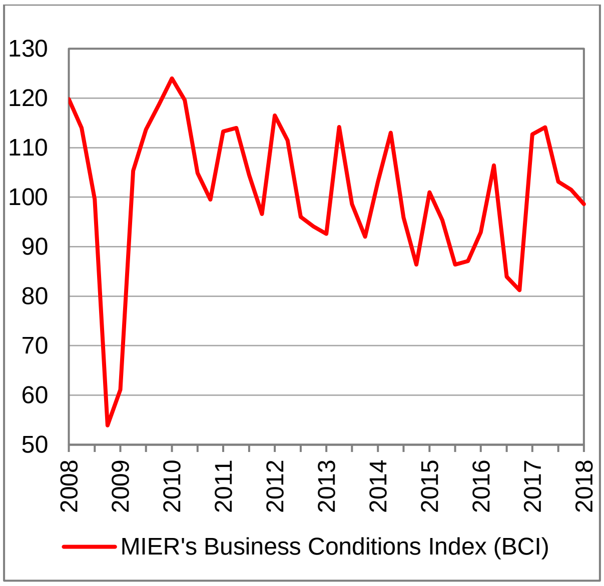
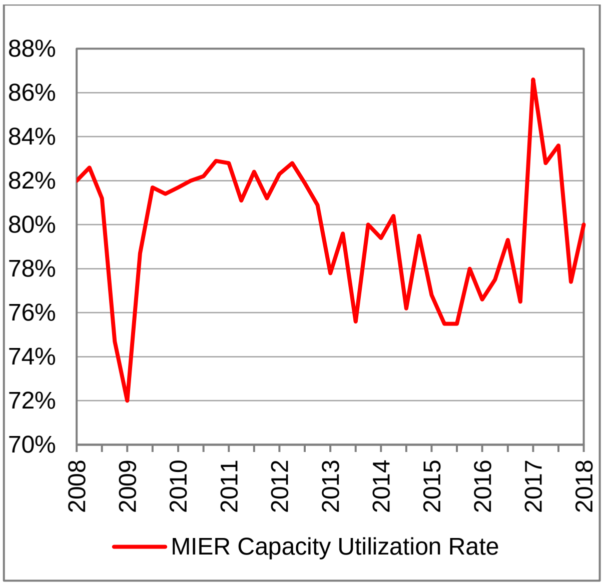


Figure 61: Plastic industry reported close to full capacity



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

Price indicators

Inflation, as measured by the Consumer Price Index (CPI) is expected to pace much slower going into the second half of 2018, thanks to the zero-rated GST. Another wild card helping to keep inflation low is the fixing of RON95 petrol price at RM2.20 for the remainder months even if international crude oil prices go higher. The forthcoming of at least 25% price reduction in broadband services are expected to ease the price of telecommunication services. The 2019 Budget is expected to introduce measures to keep prices of goods and services reasonable, especially for essential items. Headline inflation is expected to average at 1.0-2.0% in 2018, revised from 2.0-3.0% previously.

Figure 62: Inflation rates held below 2% in recent months

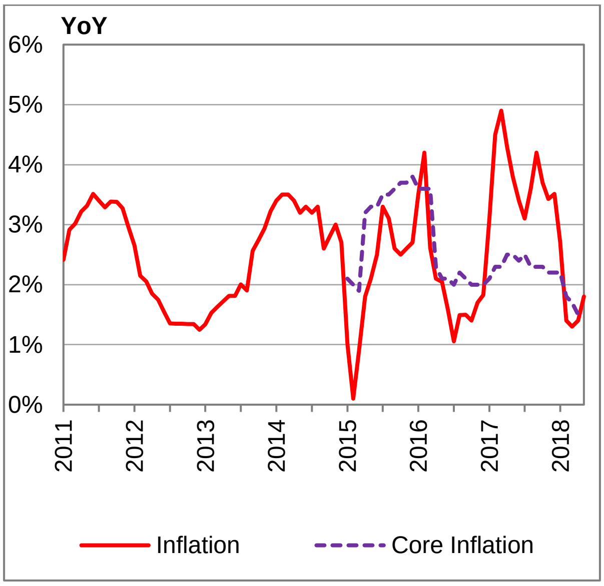
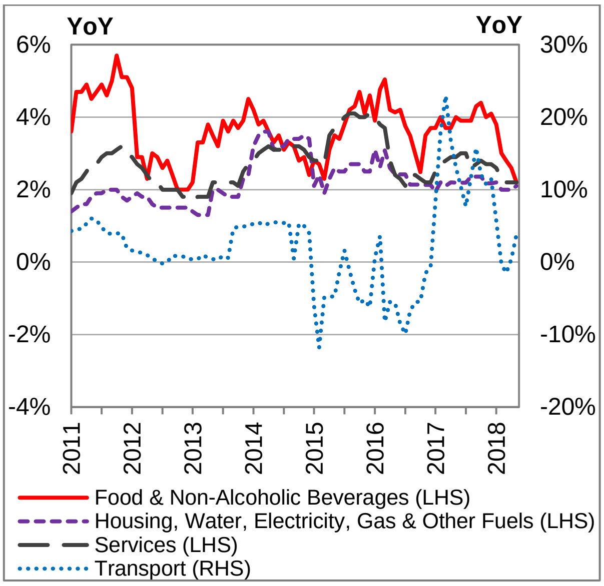


Figure 63: Food and petrol prices increased at slower pace



Source: Department of Statistics, Malaysia

Banking loan indicators

Total loans extended by banking system has been picking up steadily in the second quarter of 2018 (4.9% yoy in May and 4.8% in April vs. average 4.4% in 1Q18), mainly driven by higher business loans demand (4.0% in May and 3.6% in April vs. 2.9% in 1Q). Both loan applications and approvals growth fell in May, particularly for the purchases of transport vehicles and property sector as the borrowers deferred purchases due to the announcement of zero-rated GST starting 1 June. Banks expect higher loan applications from June. BNM reported that the banks' liquidity and funding positions post-GE remained conducive to support financial intermediation.

Figure 64: Higher outstanding loan growth

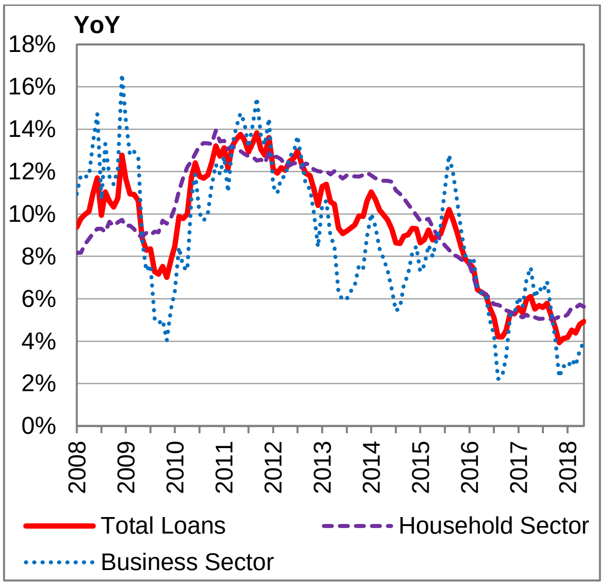


Figure 65: Loan applications growth

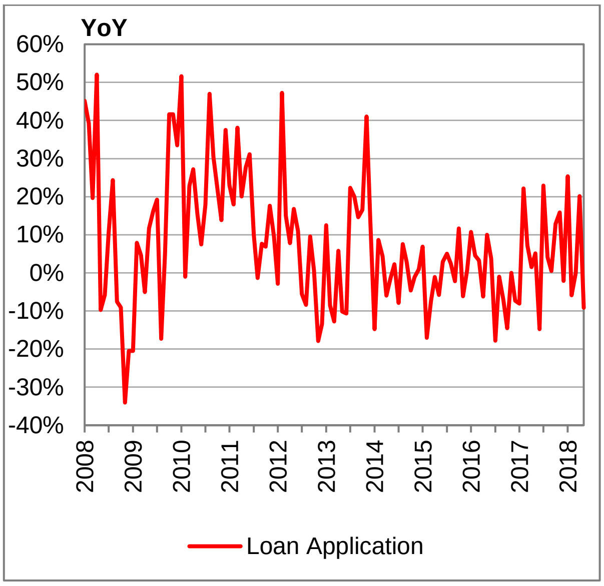


Figure 66: Loan approvals growth

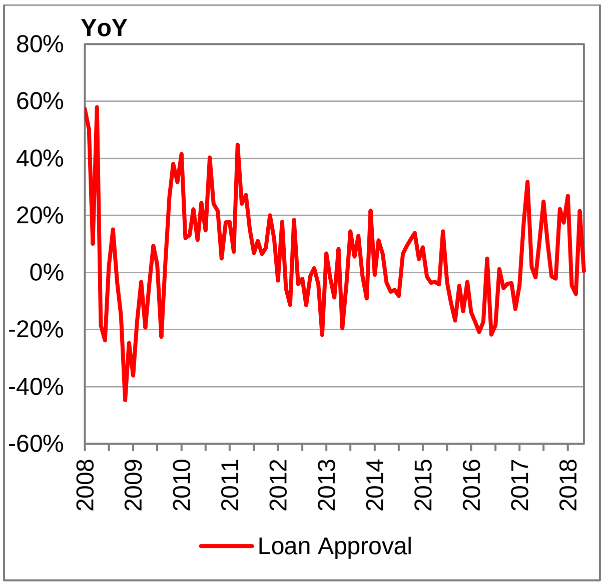
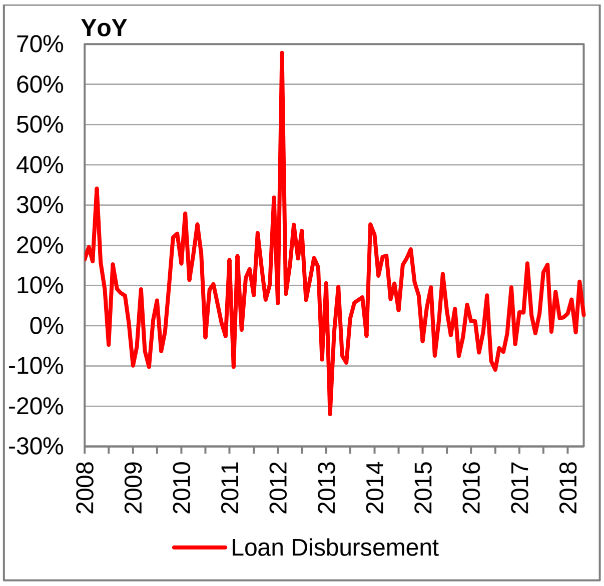


Figure 67: Loan disbursements growth



Source: Bank Negara Malaysia

Financial indicators

Malaysia suffered persistent net capital outflows as investors rebalanced their portfolio holdings following the unexpected results of the 14th General Election and adjusting to new political and domestic policies transition. This was aggravated by rising US bond yields; prospects of more US interest rate hikes; concerns about a full-blown trade war as well as the risk of contagion in emerging markets, triggered by macroeconomic stresses in Argentina and Turkey.

Foreign investors continue to liquidate their holdings of domestic equities and bonds since mid-April. As at end-June, the share of foreign-owned Malaysian Government Securities (MGS) has dropped to 40.1% (41.9% as at end-May, 44.3% as at end-April and 45.6% as at end-March), with a total net outflow of RM15.0 billion in April-June. Total ringgit-denominated debt securities recorded net outflows of RM24.3 billion in April-June, pushing foreign-owned share of total ringgit-denominated debt securities to 13.5%, the lowest since May 2010. In equity market, foreigners were net sellers for many consecutive weeks since the GE14 (sold RM5.6 billion in May and RM4.9 billion in June), bringing total cumulative net selling of RM10.5 billion. As a result, the FBMKLCI lost 178.87 points or 9.6% to 1691.50 at end-June compared to 1870.37 at end-April. As of 6 July (1663.86 points), the index lost by 7.4% when compared to 1796.81 points at end-December 2017.

In tandem with capital outflows, Bank Negara Malaysia's foreign exchange holdings declined by US$6.3 billion to US$104.7 billion as of end-June from the recent peak of US$110.0 billion as of 13 April.

After appreciating steadily against a composite basket of trade-weighted currencies over the past few months, the Ringgit, measured in terms of Real Effective Exchange Rate (REER) softened in May. The nominal exchange rate of ringgit slid to surpass RM4.00 per US dollar level in mid-June and moved closer to the level of RM4.0475 per US dollar at end-2017. As at end-June, the ringgit stood at RM4.0375 per US dollar.

Going forward, the ringgit is expected to remain on weakening bias, pressurised by the on-going trade tariffs battle amongst the advanced economies and global monetary policy adjustments. The ringgit is likely to trade around RM4.00-4.10 per US dollar at end-2018, revised from RM3.80-3.90 previously.

Figure 68: Foreign reserves have fallen

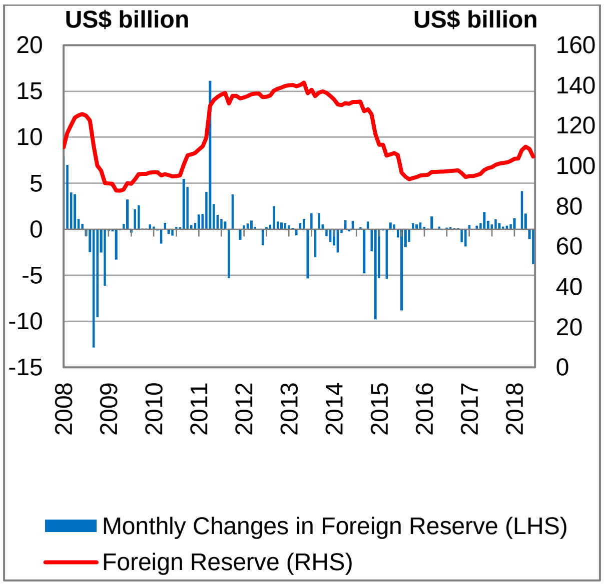


Figure 69: Ringgit weakened against the US dollar in recent months

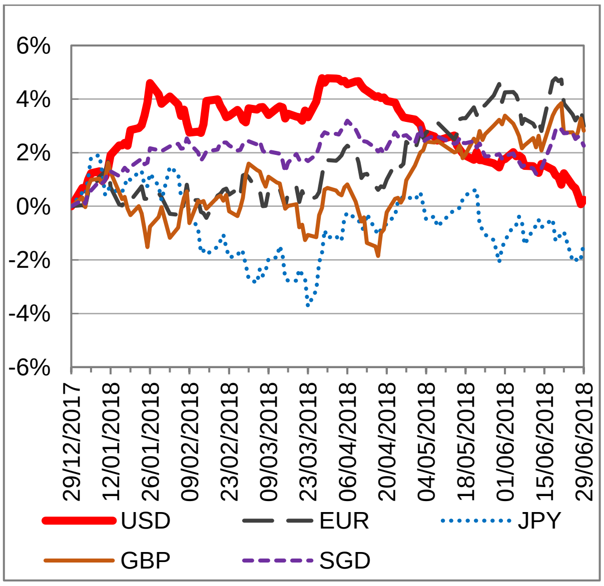


Figure 70: Ringgit up against renminbi in the second half of June

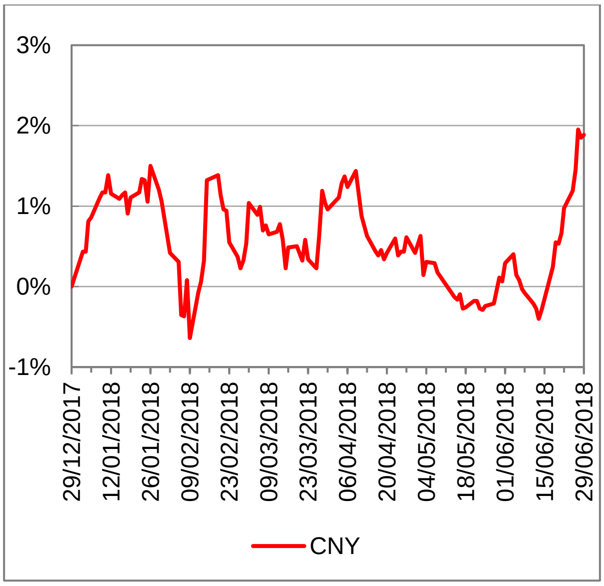
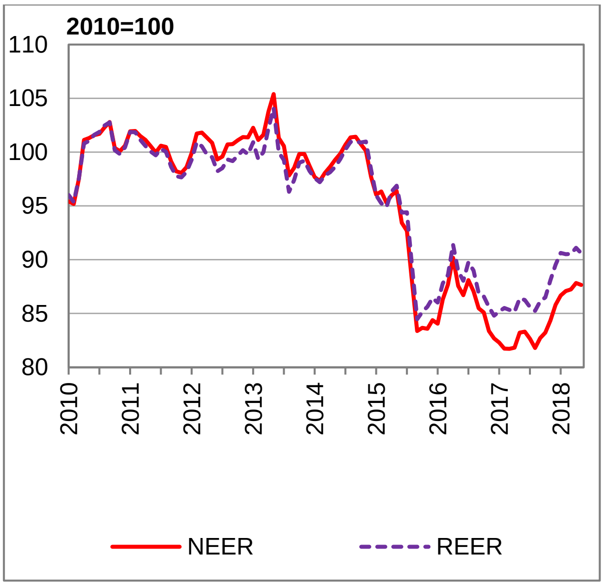


Figure 71: Real effective exchange rate of ringgit lost momentum in May



Source: Bank Negara Malaysia; Bank for International Settlements

SOCIO-ECONOMIC RESEARCH CENTRE (SERC)
SERC SDN BHD (918837-W)

6th Floor, Wisma Chinese Chamber,
258, Jalan Ampang, 50450 Kuala Lumpur, Malaysia.
Tel: (603) 4260 3116 / 3119 Fax: (603) 4260 3118
Email: serc@acccimserc.com
Website: http://www.acccimserc.comr