Economic Research

KDN No: PP14787/11/2008(006772)

Malaysian Rating Corporation Berhad
(Company No. : 364803 V)

Vol.: ER/009/2009

Economic Outlook for 2H 2009: Light at the end of tunnel…?

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Global economy in the 1H 2009

Advanced economies: The crash and the green shoots

Dismal economic performance in advanced countries continued in the 1Q2009. The United States, which accounts for about one fifth of the world's total output, contracted at a 5.5% annualized pace, its third consecutive quarter of negative growth. The lingering malaise was largely attributed to a massive 48.9% drop in investment activities, exacerbated by a minuscule 1.4% growth in personal consumption expenditure (PCE) following a US$280 billion tax reduction that forms a significant part of the US$787 billion fiscal stimulus program announced in February this year.

Across the Pacific Ocean, Japan's gross domestic product (GDP) plunged by a 14.2% annualized pace in the 1Q2009, its biggest contraction on record, marking a fourth back-to-back decline since the 2Q2008. The sharp contraction was primarily due to a collapse in the country's export and import by an alarming 70.0% and 47.8% respectively. Adding to its woes was the 8.8% slide in domestic demand, led by significant declines in private non-residential investment (-31.0% versus -23.4% in 4Q2008) and private consumption (-4.2% versus -3.1% in 4Q2008). In the Eurozone, the economy collectively contracted by 4.8% in the quarter under review after declining by 1.7% in the preceding quarter. As expected, the external sector was the culprit, with real exports registering a sharp 15.5% decline (4Q2008: -6.5%), followed by investment (-10.4%) and private consumption (-1.1%).

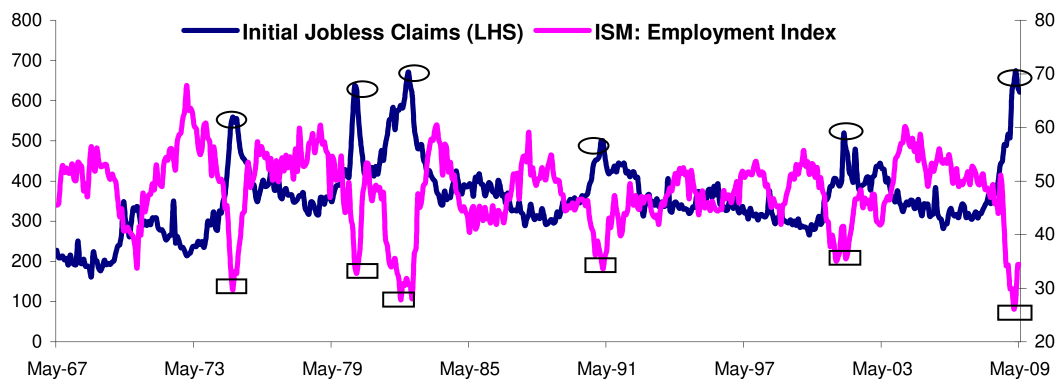
Table 1: GDP performance in 1Q 2009 for advanced economies

	2Q 08	3Q 08	4Q 08	1Q 09
US				
GDP*	**2.8**	**(0.5)**	**(6.3)**	**(5.5)**
Personal Consumption Expenditure	1.2	(3.8)	(4.3)	1.4
Gross private domestic investment	(11.5)	0.4	(23.0)	(48.9)
Government consumption expenditures and gross investment	3.9	5.8	1.3	(3.1)
Exports	12.3	3.0	(23.6)	(30.6)
Imports	(7.3)	(3.5)	(17.5)	(36.4)
Japan				
GDP*	**(2.2)**	**(2.9)**	**(13.5)**	**(14.2)**
Domestic Demand	(4.4)	(2.7)	(1.3)	(8.8)
Private Consumption	(3.8)	0.5	(3.1)	(4.2)
Gross fixed capital formation	(9.3)	(9.2)	(14.0)	(24.3)
Exports	(3.2)	4.0	(47.1)	(70.0)
Imports	(15.7)	6.3	13.1	(47.8)
Eurozone				
GDP**	**1.5**	**0.5**	**(1.7)**	**(4.8)**
Private Consumption	0.5	0.1	(0.6)	(1.1)
Gross fixed capital formation	1.6	(0.3)	(5.5)	(10.4)
Exports	3.8	1.4	(6.5)	(15.5)
Imports	2.4	1.4	(3.7)	(11.7)

Source: US Bureau Economic Analysis (BEA), Japan Cabinet Office & Eurostat
* Annualised Rate %
** Y-o-Y%

As a result of unprecedented monetary and fiscal responses by global economies, the so-called "green shoots" emerged in the 2Q2009. This is evident in the monthly data which indicates the contraction pace has shifted into lower gear in most parts of the world. For instance, the latest release on US non-farm payroll (NFP) in May revealed total job losses slowing markedly to 345,000 after averaging 644,500 since the start of the year. This implies that the labour market has probably hit the bottom based on our view of a strong relationship between initial jobless claims (IJC) and the ISM manufacturing employment index (Chart 1). Historical evidence suggests that IJC tend to peak when ISM manufacturing employment index reaches the bottom. This is simply due to the fact that when manufacturers start to increase hiring, claims for unemployment benefit begin to decline.

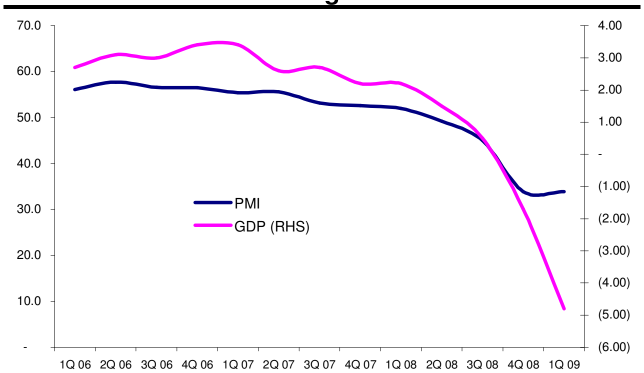
1. Labour market indicators - Initial jobless claims & ISM employment Index



Source: Bloomberg

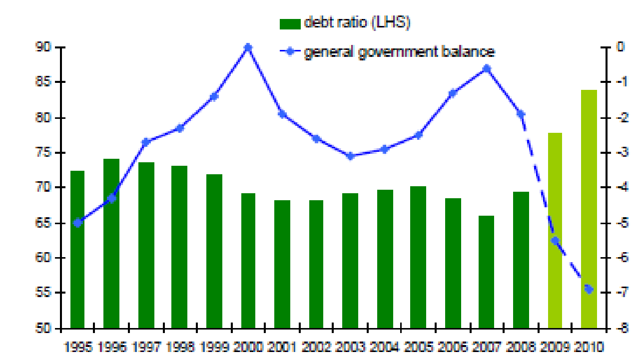
In the Eurozone, the manufacturing sector's Purchasing Managers' Index (PMI), a good leading indicator for economic activities, has trended up with the latest reading of 42.6 points in June, 1.9 points higher than in the preceding month. However, aggressive fiscal expansionary measures have badly affected the region's public debt-to-GDP ratio which according to the European Commission (EC), will rise substantially to 83.8% by 2010 from 66.0% in 2007.

2. Eurozone PMI and GDP growth



Source: Bloomberg

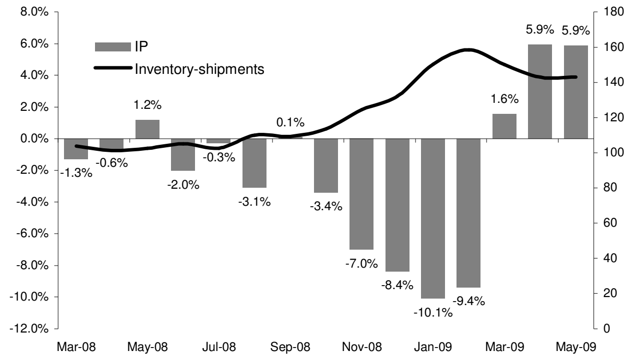
3. Eurozone budget balance and debt



Source: BNP Paribas, Eurostat & EC forecasts

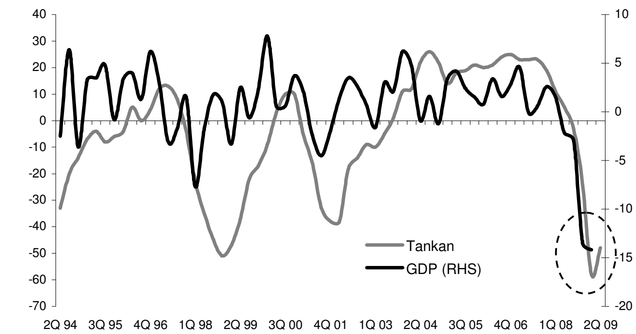
To a lesser extent, Japan's economy has also started flashing some good news. The latest industrial production index (IP) showed that production jumped by 5.9% m-o-m in May, the same pace for April's expansion and the largest gain in more than 50 years after rising by 1.6% in March this year. The improvement suggests that manufacturers have started restocking in anticipation of higher demand in the near term. This is evidenced by the decline in inventory-to-shipment ratio to 1.43x in April after reaching a high of 1.59x in February. In addition, sentiment among manufacturers has also improved as reflected by the Tankan index which declined at a slower pace to 48 points in 2Q2009 versus -58 previously. However, we foresee that it will take a while before a meaningful recovery takes place in the manufacturing sector as excess capacity remains large by historical standard.

4. Japan's IP and inventory-to-shipment ratio



Source: Bloomberg

5. Tankan survey and economic growth

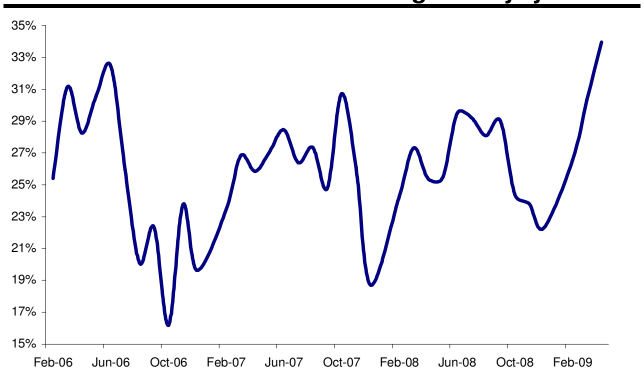


Source: Bloomberg

Asia Pacific: Banking on China

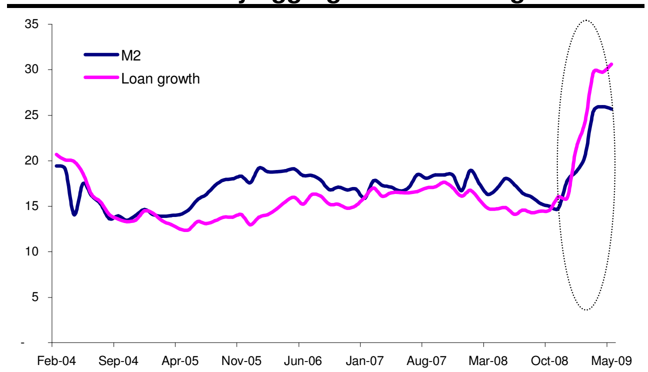
Signs of economic recovery also emerged in China and other countries in the Asia Pacific region. China's sizeable fiscal stimulus (4 trillion yuan or 13% of GDP) and successive rate cuts since August last year have started to bear fruit in the late 2008. The country's PMI has risen from its low and remained above 50 point threshold level for the third straight month in May, signaling a pick up in manufacturing activities. In addition, a strong 30.6% surge in lending activities in May has fueled fixed asset investment, resulting in a sharp 32.9% expansion in the first 5 months of the year (Chart 6).

6. China's fixed asset investment growth yoy%



Source: Bloomberg

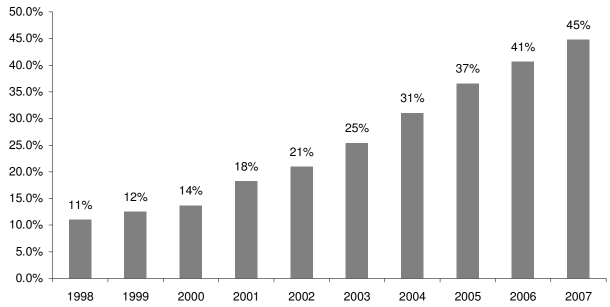
7. China's monetary aggregate and loans growth



Source: Bloomberg

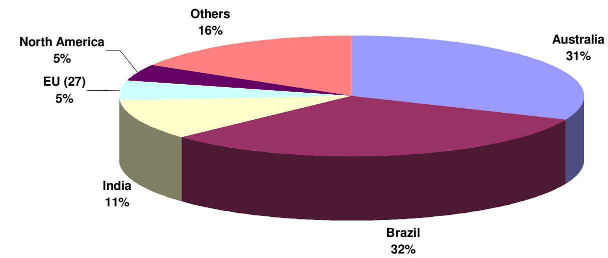
China's fiscal stimulus package, which is primarily aimed at infrastructure construction (1.8 trillion yuan) and post-disaster reconstruction (1 trillion yuan), has resulted in enormous demand for building materials. This has benefited economies such as Australia, Brazil and India which are primary exporters of iron ore, the main raw material for steel products. Apart from that, oil demand will likely increase given that China is also among major countries that consume a sizeable amount of global oil which stood around 9.6% of total world consumption in 2008, up from 6.3% and 3.5% in 2000 and 1990 respectively.

8. China's import of iron ore as % of world imports



Source: World Steel Association

9. Iron ore's exporters profile in 2007



Source: World Steel Association

Global prospect for 2H 2009

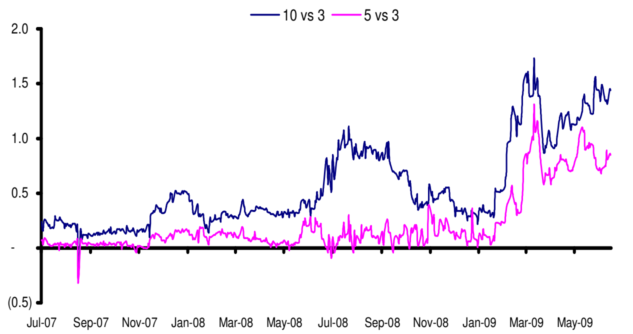
Despite criticism by some quarters about the possible impact of future inflation and rising debt levels, the unprecedented moves by global central banks to reduce borrowing costs and flood the global economy with liquidity is bearing fruit. The risk of a collapse in global economy has diminished and the world can look forward for a possible mild turnaround in economic activity. It is true that fiscal conditions in many countries have changed dramatically in the past one year but unorthodox measures were clearly needed to prevent a major economic catastrophe. As a result, risk aversion has slowly receded and investors are increasingly placing their bets on more risky assets. The steepening of yield curves and marked improvement in global stock prices suggest that worldwide recession may soon come to an end. This is based on past experiences that showed financial market is typically a vital leading indicator for the real economy.

According to the US National Bureau of Economic Research (NBER), the longest period from peak-to-trough in the US was 21 months during the mid 70's. The current economic downturn has been on-going for 18 months since December 2007. If history is any guide and the pace of economic deceleration continues to moderate, the current recession could end by the 3Q2009.

However, the nagging question is how strong and sustainable the expected economic recovery will be? Will the global economy be saddled with subpar growth? Because of the high degree of deleveraging taking place in this downturn, many remain skeptical about the extent of a turnaround in consumer spending particularly in the US. On the other hand, the emergence of 'green shoots' is raising concerns that inflation could be re-ignited and derail the recovery process. We, however, are of the opinion that inflation will not be an issue at this juncture as the recovery process this time around will be bumpier compared to other recent downturns. Instead, the massive destruction in personal wealth that has ensued will act as a major drag on consumer spending, leading to a subpar growth in the US and other global economies.

Notwithstanding that, policy makers in many countries have opted to keep their policy rates unchanged, waiting to assess the impact of their recent monetary accommodation and fiscal expansion measures. We anticipate most of central banks will keep their rates unchanged in the next few months in view of a mild turnaround in global economic condition at the end of this year.

10. MGS yield curves steepened in recent months



Source: Bloomberg

11. The 2/10 UST spread has widened

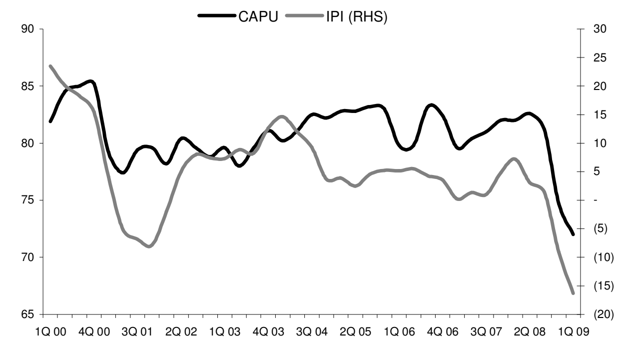
Source: Bloomberg

Malaysian economy in retrospect

An outright recession in 2009

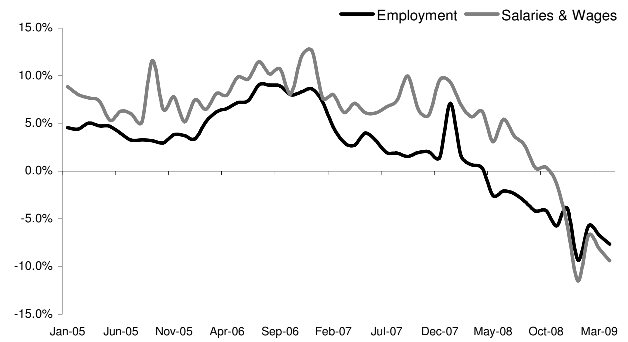
The economy turned out to be worse than expected in the 1Q2009 as GDP contracted by stunning 6.2% the sharpest drop since 4Q1998 during the Asian Financial Crisis. On a quarter-on-quarter basis, the economy also plummeted by 7.7%, again the sharpest decline since 1Q1998. As a result, the government changed its stance by projecting an outright recession for 2009 in the region of -5%. The reasons are very straight forward: the significant fall in external demand has reverberated into the domestic economy. The latest print showed that contractions in exports have not abated with total shipments plunging by 26.3% in April. The extent of the decline will no doubt have a serious implication on production as manufacturers continue destocking in light of weakened demand. Not surprisingly, industrial production index (IPI) fell by 13.7% in the first four months of the year, resulting in a widening of spare capacity in the industry. Against this backdrop, employment in the manufacturing sector continues to deteriorate, shrinking by 7.7% in April (March: -6.7%) while salaries and wages among manufacturing workers decreased by 9.4% (March: -8.1%).

12. Capacity utilization rate (CAPU) and IPI Y-o-Y%



Source: CEIC

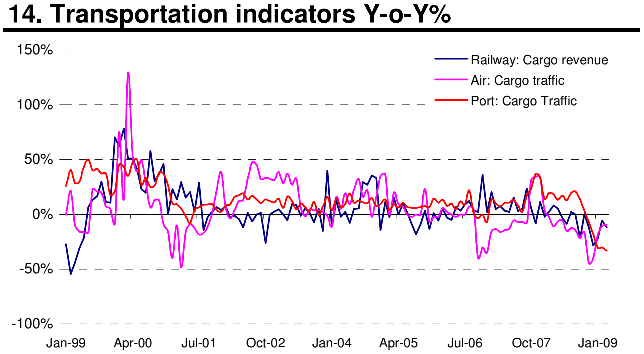
13. Manufacturing employment & payroll Y-o-Y%



Source: CEIC

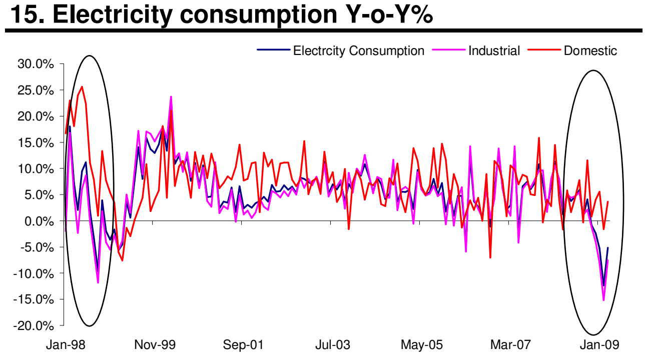
What started as an external shock has now cascaded into the domestic economy. This can be seen particularly from indicators in the services sector that are associated with export-oriented industries. Chart 14 shows that transportation sector has been hard hit hard by a reduction in activities related to export oriented industries following the global headwind. Similarly, electricity consumption particularly among industrial users declined sharply in line with a slowdown in industrial activity. This explains the 2.9% contraction in domestic demand in the 1Q2009, its first decline since 3Q2001.

14. Transportation indicators Y-o-Y%



Source: CEIC

15. Electricity consumption Y-o-Y%



Source: CEIC

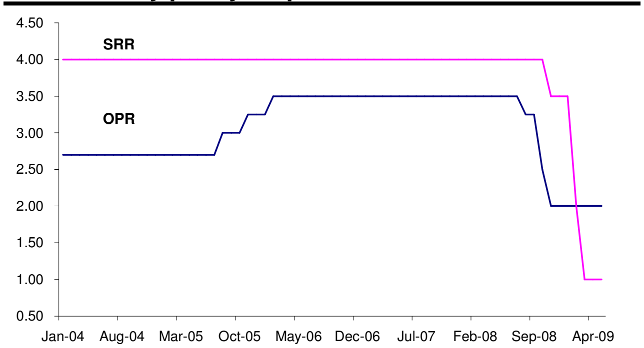
Swift policy response

Given the severity of the recession, policy responses crafted by monetary and fiscal authorities have been forthcoming. For the first time since September 1998, the Statutory Reserve Requirement (SRR) was lowered by 300 basis points in a bid to ensure intermediary process is cost effective. The overnight policy rate (OPR) was also reduced by a total 150 basis points since August last year and has remained at 2.00% since November 2008. Fortunately, Malaysia's banking system has not suffered from credit crunch as reflected in loans growth which continued to hover around 10%. In addition, loan-to-deposit (LD) ratio has remained below historical average of 80%.

The central bank governor highlighted that lowering interest rate is not constructive as there are limitations to its impact in promoting growth. We take this as a signal that the central bank is not inclined to reduce policy rates aggressively and shifted its focus on addressing the problem of accessibility to financing. In this regard, the setting up Financing Guarantee Institution (FGI) in mid-May is a step in the right direction as it allows companies to have better access to corporate bond market. As such, we think the risk of BNM to resort to Quantitative Easing (QE) is quite remote at this point in time.

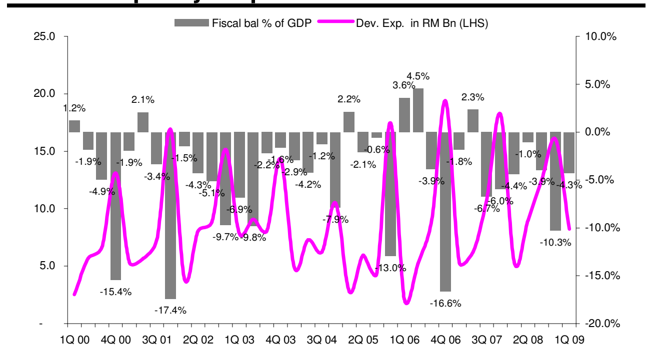
On the fiscal side, the government has stepped up its efforts to spur spending to avert sharper contraction in economic activity. This can be seen from the total development expenditure incurred in the 1Q2009 which climbed to RM8.2 billion, 55.4% higher than the level registered in the corresponding period last year. As a result of expansionary fiscal policy, budget deficit climbed to RM6.7 billion or 4.3% of GDP in the 1Q2009. But as the deficit target of 7.6% of GDP in 2009 is likely to be breached following an expected sharp reduction in government revenue, Malaysia's local currency rating was downgraded by Fitch on June 10 from A+ to A with a stable outlook. As expected, the international credit rating agency highlighted its concern on fiscal deficit which will likely to rise to 8.7% in 2010 in its estimation.

16. Monetary policy response %



Source: BNM & Bloomberg

17. Fiscal policy response



Source: CEIC

Short and medium-term prospects

What started as an external shock for Malaysia has now cascaded into the domestic economy. As has been the case with most Asian economies, plunging exports led to massive cutbacks in production, resulting in weakened labour markets on increased layoffs particularly in the manufacturing sector. Following a contraction in domestic demand due to the weakening of private consumption, the economy contracted sharply in the 1Q2009 and is expected to experience an outright recession this year, its first since the Asian Financial Crisis.

Notwithstanding, the prospects for the second half of 2009 and 2010 looks more encouraging as improving global economic conditions will provide the impetus for an open economy like Malaysia. On the domestic front, private consumption, while struggling to revive, will gain strength following better prospects in the labour market. The Malaysian ringgit will get some reprieve from a weakening US dollar (USD) as risk aversion diminishes. Monetary and fiscal policies are likely to remain status quo as policy makers try to gauge the impact of past measures. Concerns that budget deficits could affect Malaysia's macroeconomic landscape have been exaggerated given its favourable fundamentals.

Growth: Firmer recovery in 2010

We foresee the economy to shrink by 3.8% in 2009 as opposed to our previous forecast of a 1.5% contraction. The latest revision is primarily based on the following factors:

- More severe contraction in exports
- Weaker-than-expected domestic demand

The vulnerability of Malaysia's external sector arises from its heavy dependence on electrical and electronic products (E&E) segment which accounts for as much as 38.3% of its total exports. As such, a meaningful recovery in global demand for semiconductor products is critical for Malaysia's export sector. In addition, two other important export components – oil-related products and palm oil – are not likely to grow significantly as in early 2008 when prices hit all-time highs. In addition to the external sector, domestic demand has played an important role in magnifying economic weakness in the 1Q2009.

Notwithstanding that, a mild recovery in global economic activity, as envisaged by the World Bank and the International Monetary Fund (IMF) will lead to rebound in the country's exports. Moreover, the impact of the government's RM67 billion fiscal stimulus will take effect in late 2009 and the first half 2010. As such, we foresee a milder contraction of 1.6% in the 2H2009 before rebounding by 3.0% in 2010.

Table 2: GDP forecast

Growth	2007	2008	2009F	2010F
GDP	**6.3%**	**4.6%**	**-3.8%**	**3.0%**
Domestic Demand	9.7%	6.9%	1.6%	3.7%
Consumption Expenditure	9.7%	9.1%	2.9%	4.0%
Private Consumption	10.8%	8.4%	2.4%	3.9%
Public Consumption	6.6%	11.6%	4.7%	4.4%
GFCF	9.6%	1.1%	-2.2%	2.6%
Private Investment	9.8%	1.5%	-20.2%	-8.0%
Public Investment	9.3%	0.7%	16.7%	10.3%
Exports	4.2%	1.5%	-11.2%	3.5%
Imports	5.4%	2.2%	-8.2%	6.0%

Source: MARC Economic Research

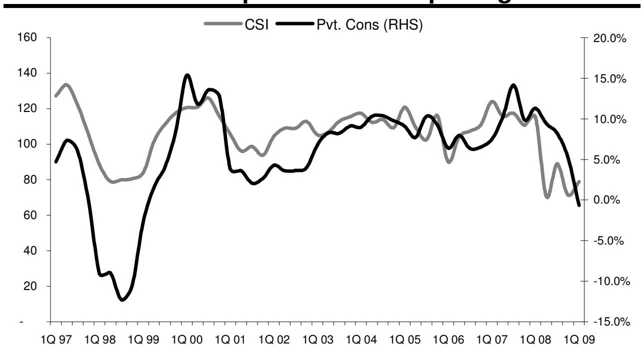
Private consumption will slowly gain strength

The contraction in private consumption in the 1Q2009 convinced us that consumers will no longer be able to withstand economic shocks associated with the crash in external sector. Private consumption, an important pillar against a sharp downturn in economic activity, is now feeling the brunt of a deteriorating a labour market particularly in the manufacturing sector which registered a 7.7% decline in the 1Q2009.

The significant drop in the level of consumer spending from +5.3% in the 4Q2008 to -0.7% in the 1Q2009 signified the sudden shift in consumers' attitude towards spending. In addition, forward looking indicator such as the MIER consumer sentiment index (CSI) has remained at near historical low since 3Q1998 while the MasterCard Worldwide Index of consumer sentiment recently dropped to the lowest level since 1H2001.

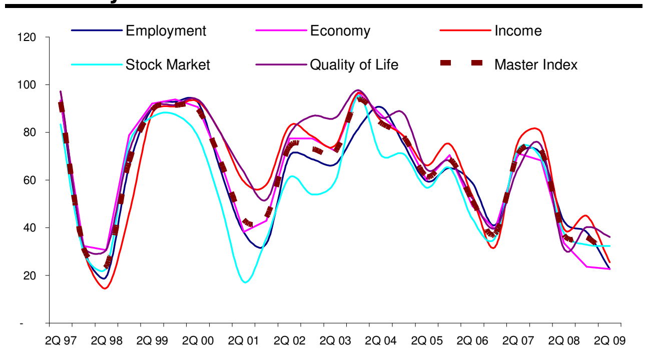
Going forward however, we expect the deterioration in private consumption to moderate as labour market condition stabilizes. Slowing inflation will also boost consumers' appetite for spending. Against such a backdrop, although we anticipate private consumption to grow at a much slower pace of 2.4% in 2009, we foresee it to rebound and register a positive growth of 3.9% in 2010.

18. MIER's CSI and private consumption growth



Source: CEIC

19. Malaysia's consumer confidence



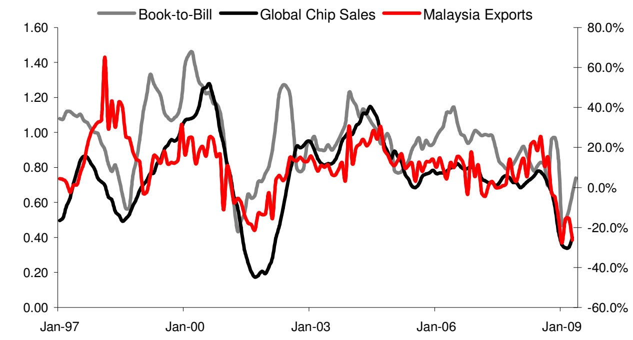
Source: Mastercard Worldwide Index of Consumer Confidence

External sector will benefit from improvement in global trade

The outlook for E&E products, Malaysia's major export component, remains murky as global appetite for semiconductor has yet to improve. This is despite the recent improvement in two important forward looking indicators for the sector: the US book-to-bill (BTB) ratio which rebounded from its low of 0.47 in January this year to 0.74 in May; and Institute of Supply Management's (ISM) new orders index which recovered from its low of 33.1 in February to 51.1 in the recent month. Nevertheless, we are of the opinion that it is too soon to conclude a meaningful recovery in export sector in the 2H2009 is underway, considering the unusual nature of the current economic cycle.

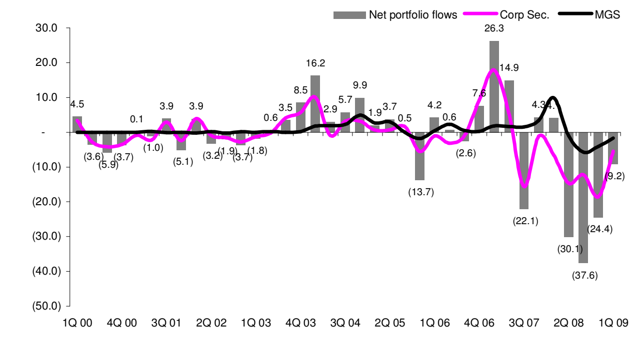
Improving global economic conditions envisaged in 2010, will help Malaysian exports to register a positive growth following an expected 11.2% contraction in 2009. With the collapse in imports, higher surplus in merchandise balance will likely result in another year of huge current account surplus. Further improvement in the financial account will come on the back of a smaller net outflow of portfolio investment. This is evidenced by the first quarter statistics which showed a RM9.2 billion net outflow, as opposed to RM37.6 billion in the 3Q2008.

20. Global chip sales, B-T-B & Malaysia exports



Source: SEMI & SIA

21. Net portfolio flows (RM Billion)



Source: BNM & CEIC

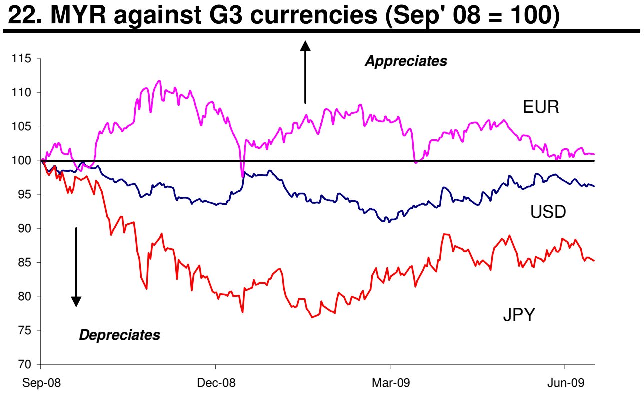
Ringgit to gain from weaker greenback

Weaknesses in Malaysia's macro performance following the global economic crisis has led to a sharp depreciation in ringgit against the USD between December 2008 and March this year. The ringgit fell from as high RM3.13 in April 2008 to as low as RM3.73 in March this year, almost to the level it was pegged against the greenback in 1998. However, since other major currencies also weakened excessively due to global economic malaise, the ringgit has not moved significantly against currencies like Singapore Dollar (SGD), Chinese Yuan (CNY) and Thai Baht (THB).

The outlook of ringgit is closely linked to the prospects of the greenback. We do not foresee a collapse in USD as some are predicting due to the fact that an excessive weakness in the greenback is not in the interest of not only the US but also other countries like Japan and China which are heavily invested in US Treasuries. In addition, there are no other currencies or asset classes large enough to absorb the amount of global liquidity without creating another bubble.

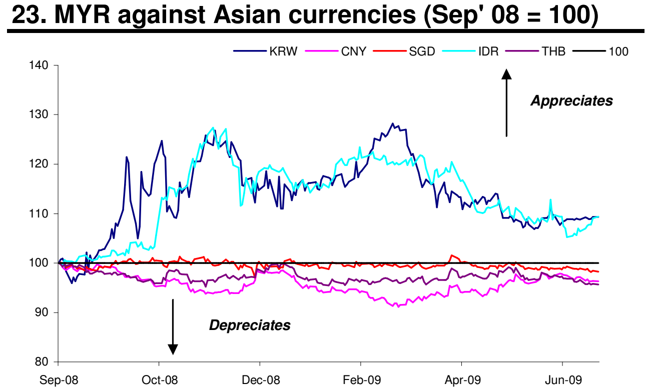
Against such a backdrop, we foresee a slight appreciation of the ringgit against the greenback as risk aversion among investors continues to abate. Based on Nominal Effective Exchange Rate (NEER), the ringgit is about 3% undervalued against its major trading partners. Looking from a technical side, although the ringgit is about to break its short-term downtrend channel against the greenback, a downward breakout of the head-and-shoulder formation may bring the ringgit to RM3.37 in the medium term especially if net inflows into the financial market improve by the end of the year. We foresee a range of RM3.35 and RM3.55 for the ringgit against the USD in the next six months.

22. MYR against G3 currencies (Sep' 08 = 100)



Source: Bloomberg & MARC Economic Research

23. MYR against Asian currencies (Sep' 08 = 100)



Source: Bloomberg & MARC Economic Research

Future policy response

We see a limited possibility of monetary intervention following an anticipated recovery in the global economy. As economic contraction becomes milder in the 2H2009, Bank Negara Malaysia (BNM) will leave its policy rate at the current level of 2% well until next year. In addition, the authority has made it clear that it does not favour an extremely low interest rate environment. As mentioned, BNM is focused on ensuring credit availability rather than on the absolute financing cost.

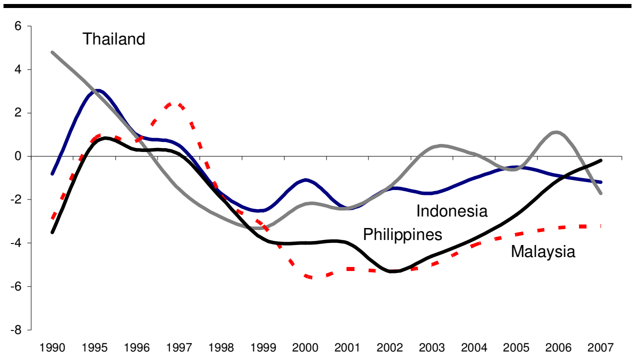
Judging by recent government rhetoric to be more fiscally prudent in the medium term, there is also less likelihood of using fiscal policy to support the economy. This is not surprising as government budgetary position has been in the red since the Asian Financial Crisis in 1998. We opine that the government's projected budget deficit will exceed 7.6% of GDP as economic contraction will be more severe than had been originally expected. On that score, we think the government will take greater effort to trim budget deficit starting 2010 when economic recovery becomes firmer.

Budget deficit and sovereign rating

We beg to differ in respect of concerns on the budget deficit that certain quarters have taken into consideration in evaluating the country's sovereign ratings. First and foremost, the speed of reduction in budget deficit since the Asian Financial Crisis has been almost the same with other regional countries. The likely reason that Malaysia is still incurring a deficit is because the country had a bigger budget gap to start with in 2000. Secondly, one of the plausible explanations for Malaysia to experience budget surplus in the mid-1990s was related to its high economic growth which averaged around 9% during that period – meaning that the growth has to be robust enough to put the budget back on track. Since Malaysia's average growth has declined to an average 5.5% between 2000 and 2008, naturally the deficit could not be eliminated. The question now is whether the deficit should be reduced through efforts to stimulate growth or measures to cut spending. Our fear is that measures that are meant to cut spending will dampen overall growth of the economy.

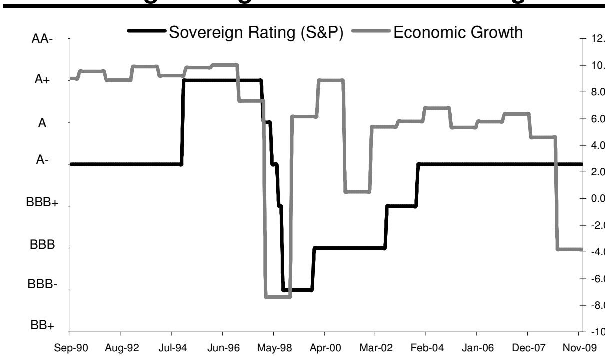
Thirdly, Malaysia's macro condition remains generally healthy. For instance, international reserve position remains huge and sufficient to cover retained imports by more than 8 months, way above the required level of 3 months, while external debt level stood at 31.8% of GDP in 2008 (1997: 57.6% of GDP), relatively low by historical standards. In addition, the fact that Malaysia is highly integrated with the global economy also reduces moratorium risk, the risk associated with the country's decision to stop servicing its foreign debt. This is a stark contrast with a country like Argentina, which defaulted on its US$132 billion debt in 2001 and imposed moratoria on its foreign debt services.

24. Fiscal balance as % of GDP



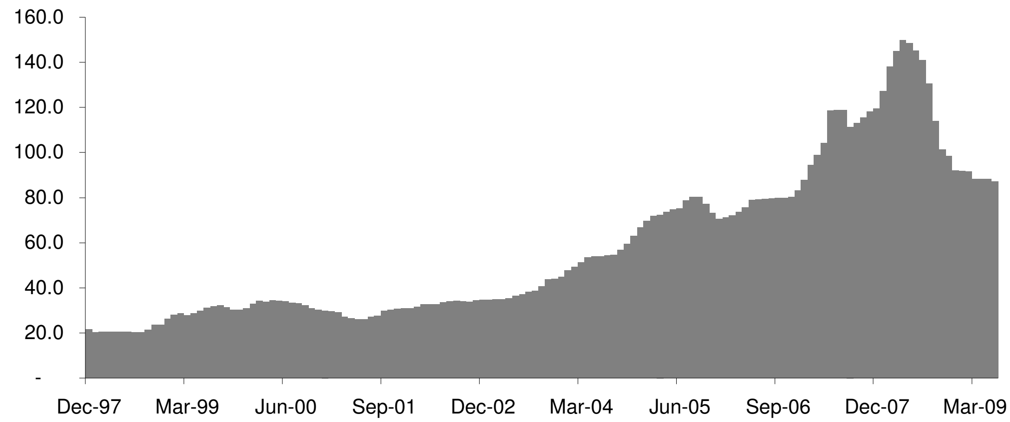
Source: ADB

25. Sovereign rating movement and GDP growth



Source: Bloomberg & MARC Economic Research

26. International reserve assets in USD billion



Source: Bloomberg

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