Economic Research

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Economic Outlook for 2H2010 - Mission 2010: Keep Growth Momentum Alive

MALAYSIAN RATING CORPORATION BERHAD
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Economics Team

Nor Zahidi Alias
Chief Economist
+ 603 2092 5398
zahidi@marc.com.my

Mohd Afzanizam Abd. Rashid
Economist
+ 603 2092 5398
afzanizam@marc.com.my

James Foo Kok Chye
Economic Analyst
+ 603 2092 5398
jamesfoo@marc.com.my

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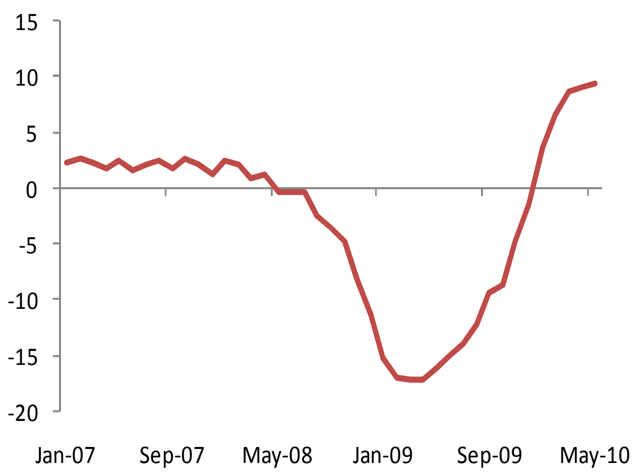
Review

Global Economy – Jitters Re-emerge

Overview

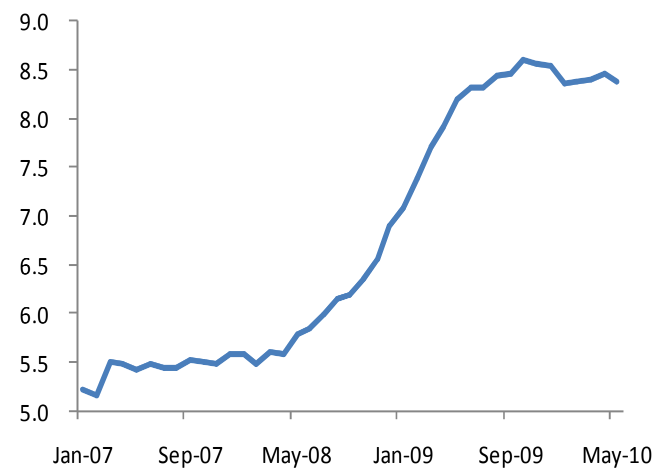
The world economy is finally on firmer footing in 1H2010, a view supported by the latest April 2010 forecast by the International Monetary Fund (IMF), in which global output is projected to grow by 4.2% in 2010 after falling by 0.6% in 2009. This was higher than January's forecast of a 3.9% expansion. Policy responses from both the fiscal and monetary authorities have been commendable in putting a brake on the recession. The Purchasing Managers Indices (PMIs) across the globe have surpassed the critical 50-point mark since June 2009, signaling that businesses have started to feel more confident about the prospects of the economy, which has a significant bearing on worker hiring and investment decisions. Unemployment rates have fallen from their peak levels but remain at elevated levels in most countries, leading to guarded optimism, as evidenced by moderate increases in consumer spending. To some extent, we believe that household wealth has slowly recovered following the rebounds in equity markets in the past 15 months.

Chart 1: G7 industrial production index (IPI) year-on-year (y-o-y) (weighted average %)



Source: MARC Economic Research

Chart 2: G7 unemployment rate (weighted average %)



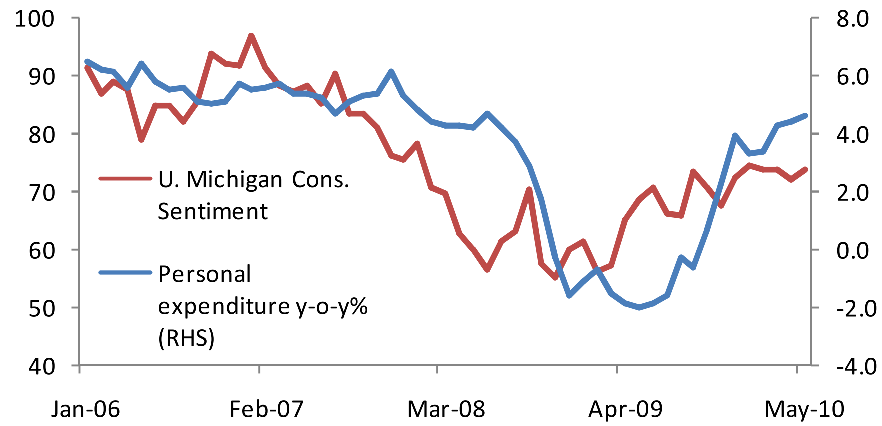
Source: MARC Economic Research

Given the emerging signs of recovery, the removal of stimulus measures has recently become a central topic of debate. The extent of austerity measures proposed and implemented in debt-laden European countries has led to criticism that such moves will severely hamper these nations' growth prospects in the near term. Additionally, risks of a property asset bubble in China have clouded the prospects of a self-sustaining economic recovery, which will have adverse implications on the global economy. The possibility of military action in the North Korea/South Korea stand-off – although a seemingly remote possibility - will easily add to the risk-premium equation. We opine that this may lead to a return of volatility, which may cause global economic conditions to remain uncertain.

US economy is on the mend

The US economy is still holding up relatively well in 1H2010. Consumer and business confidence levels are reasonably resilient at this time, resulting in higher private spending and investments which fueled the economy in 1H2010. GDP growth, while moderating from the 4Q2009 level, managed to clock in a decent 2.7% annual pace, driven by personal consumption expenditure (PCE), which contributed 2.13 percentage points (ppt) to total growth, while gross private domestic investments held up 1.82 ppt of the overall growth. In the same vein, labour markets have somewhat improved, despite the relatively high unemployment rate registered in recent months. Approximately 200,000 jobs per month have been created between January and May, compared with the 635,000 jobs wiped out during the same period last year. Despite the substantial rise in temporary hirings, we believe that the increase in the labour-market participation rate to 65.0% in May from a cyclical low of 64.6% in December last year indicates that more Americans are now joining the labour force to look for suitable jobs. Additionally, alternative measures of the unemployment rate which takes into account those who are marginally attached to the labour market appear to have peaked at 17.1% in April, before falling to 16.6% in May. Therefore, we believe the personal consumption expenditure, which forms more than two-thirds of the economy, will provide an important buffer against any sharp drop in economic activity.

Chart 3: US consumer sentiment and personal expenditure

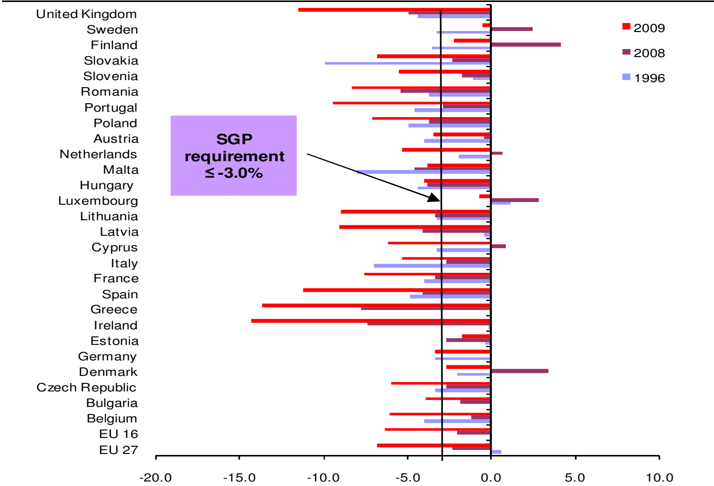


Source: Bloomberg

Eurozone - painful austerity measures

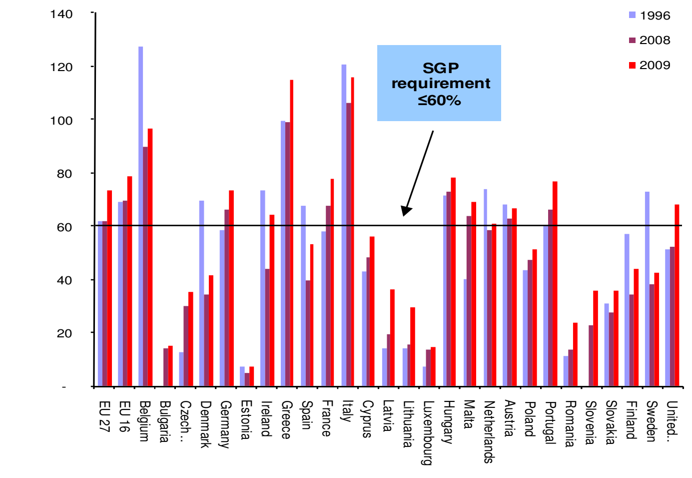
Within the eurozone, the Greek economy received a great deal of attention as the government struggles to address the problems of rising fiscal deficits and mounting government debts. A slew of austerity measures were introduced in the early part of the year to slash fiscal deficits from 13.6% of GDP in 2010 to below 3.0% in 2014. Among the measures introduced were an increase in value-added tax (VAT), and reductions in public-sector salaries and allowances. In addition, the sovereign-rating downgrades by international rating agencies have led to further skepticism of whether the European countries can actually pull their act together to honour their deficit-reduction plans. Notwithstanding this, the real economy thus far has been steadily improving, with the PMIs hovering in expansionary territory, resulting in countries such as Germany, the main driver of the eurozone economy, to experience a decline in its unemployment rate. The depreciation in the Euro by 20.5% against the greenback since December 2009 has also boosted external demand, causing exports to climb by 6.0% in 1Q2010 after several quarters of contraction.

Chart 4: Eurozone fiscal balance as a % of GDP



Source: Eurostat

Chart 5: Eurozone government debt as a % of GDP



Source: Eurostat

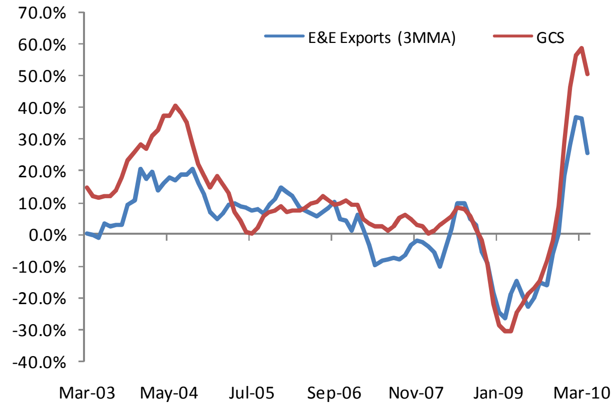
Malaysia – taking the cue from rising external demand

Malaysia emerged from the global economic malaise in relatively good shape in the final quarter of 2009, after a brief three-quarter period of contractions in GDP (1Q2009 to 3Q2009). As the economy remains predominantly dependent on the external sector, the strong GDP growth in 1Q2010 of 10.1% y-o-y (4Q2009: 4.4%) can largely be attributed to the dramatic growth in exports in the quarter. Indeed, April's exports rose a whopping 26.6% y-o-y (March: 36.4%), a fifth straight month of growth, on account of the global boom in demand for electrical and electronic (E&E) products. Accordingly, it is no surprise that employment has risen, particularly in the manufacturing sector, by 2.7% y-o-y while salaries and wages increased by 18.3% y-o-y in April, giving private consumption a much-needed boost. Notwithstanding the strong growth registered in 1H2010, inflationary pressures remain under control, with the latest reading of the consumer price index (CPI) showing a marginal increase of 1.6% y-o-y in May.

Following stronger economic fundamentals, Bank Negara Malaysia (BNM) hiked up the overnight policy rate (OPR) by 25 basis points (bps) twice, i.e. in March and May respectively, to normalise monetary conditions and prevent the risks of financial imbalances that could undermine the economic recovery process. These acts garnered the central bank significant attention in the international banking and financial arenas, especially in light of the rest of the world still largely maintaining ultra-low interest-rate environments to prop up their ailing economies. The BNM has through these preventive measures earned the distinction of being the first central bank in the region to raise its OPR in March, and is ahead of the curve in terms of the interest-rate normalisation process. Nonetheless, it has also cautiously maintained that the OPR, standing at 2.50% at present with floor and ceiling rates of 2.25% and 2.75% respectively, will remain accommodative and supportive of the prevailing economic growth. The rate hikes are justified, as increases in household debt levels have raised their proportion to GDP to 76.6% in 2009, risking a downturn in the consumer sector.

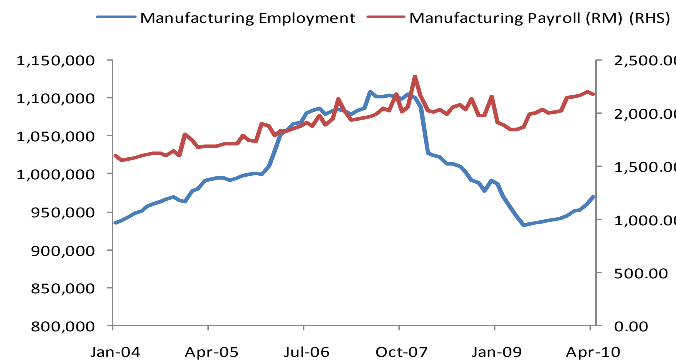
The New Economic Model (NEM) was launched by the Prime Minister on March 30 as one of four pillars proposed by the government in its national transformation program to achieve Vision 2020 in 10 years (the other three being 1Malaysia, the Government Transformation Program, and the Tenth Malaysia Plan (10MP)). The NEM outlines broad strategies to turn Malaysia into a nation with per capita income of at least US$15,000 by 2020, with inclusiveness and sustainability factored into the equation. This model comprises eight strategic reform initiatives, each with corresponding policy purposes that should spur private investments, produce a superior workforce, improve economic efficiency, reduce income disparity, foster entrepreneurship, preserve natural resources and promote equal and fair access to opportunities, amongst others. The government also unveiled the hotly anticipated 10MP, which offers an insight into the government's plans to spearhead the Malaysian economy over five years beginning 2011 to achieve developed-nation status by 2020. This plan will see the country's economy growing at 6.0% per annum on average in the next five years via the allocation of RM230 billion in development expenditure, and envisages the private sector taking over the reins in driving the nation's growth, while the public sector serves as a catalyst or enabler of the growth process.

Chart 6: E&E Exports (3-month moving average) vs. Global Chip Sales



Sources: Department of Statistics (Malaysia) & Semiconductor Industry Association

Chart 7: No. of manufacturing workers vs. Salaries and wages (RM' million)



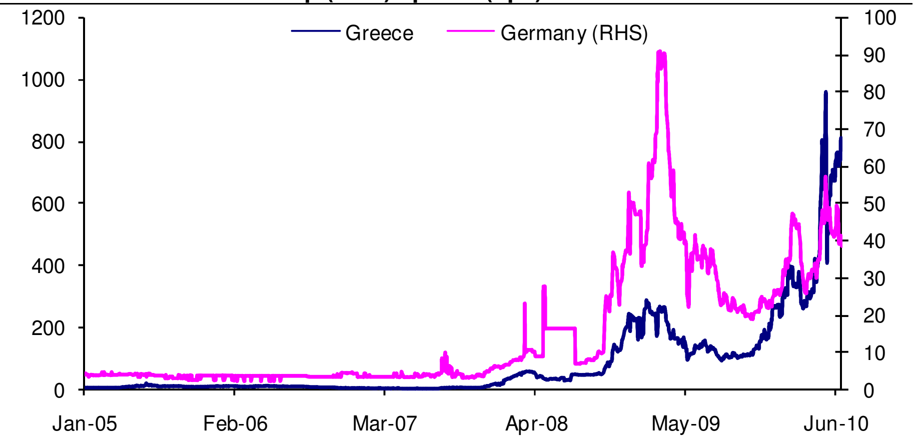
Source: Department of Statistics (Malaysia)

Prospects for 2H2010

Global economy – austerity measures will cloud the prospects of 2H2010

The global economy in 2H2010 looks increasingly challenging in our view, given the negative vibes from the eurozone economy and rising property prices in China that could result in more aggressive monetary tightening by the People's Bank of China. In addition, arithmetic will play an important role in the next six months' statistics as the high base effect of 2H2009 starts to kick in, resulting in smaller growth numbers. The current downturn in global equity markets will also start to affect financial stability in some countries, causing further moderations in business and consumer sentiments. Notwithstanding this, monetary policies will likely remain accommodative in countries such as the US, Japan and the eurozone in light of the weak domestic demand levels. This will lend some support to Asia's external demand.

Chart 8: Credit default swap (CDS) spread (bps)



Source: Bloomberg

Malaysian economy - keeping growth momentum alive

A V-shaped recovery, but global clouds are emerging

First-quarter statistics and the latest high-frequency data confirm that Malaysia's economic growth momentum will continue in 2H2010, albeit at a slower pace. Commendable growth numbers are expected on the back of an acceleration in external trade and sustainable domestic demand owing to a decent expansion in private consumption. Private consumption, the main force behind domestic demand, is supported by a stable labour market and continuous flow of credit, particularly from the banking sector, as a result of a relatively loose monetary stance by the BNM. We maintain our growth forecast for private consumption at 3.8% in 2010, as spending is anticipated to recover from last year's level but remain below its long-term average following increases in prices of selected consumer goods. On the other hand, private investment is anticipated to remain muted and to contract for the second year due to persistent risk aversion in the global economy. This is not surprising, as past experience indicates that private investments remained in negative territory in the year following the recession and a slowdown in 1998 and 2001 respectively. However, there are more encouraging signs on the external front. While exports are anticipated to moderate in 2H2010, judging by the recent softness in demand for E&E products, they are likely to register a commendable 19.2% growth after slumping by 10.4% in 2009. Against such a backdrop, we now anticipate the overall economy to expand by 6.8% in 2010 and 5% in 2011 after contracting by 1.7% last year.

From 2011 onwards, private investments will play a crucial role in charting the growth profile of Malaysia. While private consumption will still be imperative in supporting the economy in the medium term, organic growth will eventually have to come from private investments. We believe that the government's target of registering a 12.8% annual expansion in private investments in the next five years is critical to achieving the envisaged 6% GDP annual growth under the 10MP. Without such increases in private investments, Malaysia's economic growth may chug along its long-term potential growth of 4.25%, as estimated by the IMF (our estimate: 4.2% to 4.5%).

Table 1: GDP forecasts

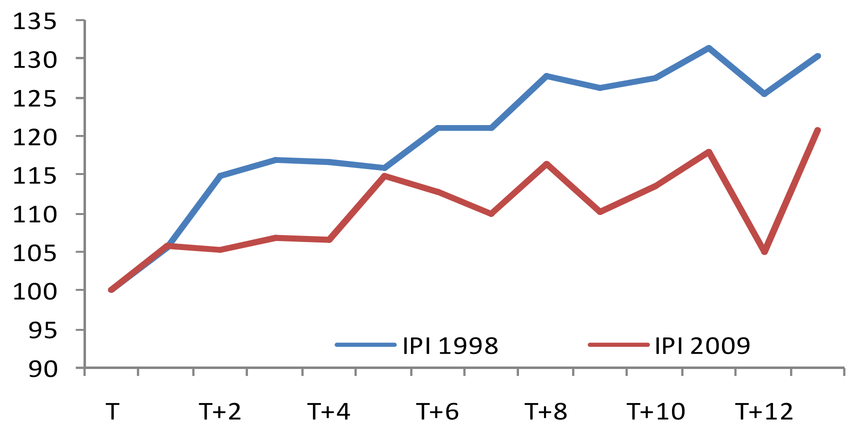
Demand side Growth (Real)	**2007**	**2008**	**2009**	**MARC 2010F**	**BNM 2010F**	**10MP 2010F**
GDP	6.5%	4.7%	-1.7%	6.8%	4.5% to 5.5%	6.0%
Domestic Demand	9.6%	6.8%	-0.5%	3.1%	3.2%	5.7%
Consumption Expenditure	9.7%	9.0%	1.2%	3.4%	2.4%	4.5%
Private Consumption	10.5%	8.5%	0.7%	3.8%	3.8%	6.0%
Public Consumption	6.6%	10.7%	3.1%	1.8%	-2.7%	-1.2%
Investment	9.4%	0.7%	-5.6%	2.3%	5.5%	9.5%
Private Investment	13.1%	1.0%	-17.2%	-5.2%	0.7%	7.0%
Public Investment	5.3%	0.5%	8.0%	9.1%	9.3%	11.6%
Exports	4.1%	1.6%	-10.4%	19.2%	7.7%	8.4%
Imports	5.9%	2.2%	-12.3%	20.8%	11.7%	12.0%

Source: MARC Economic Research

The recovery story - impressive but lagging the previous cycle

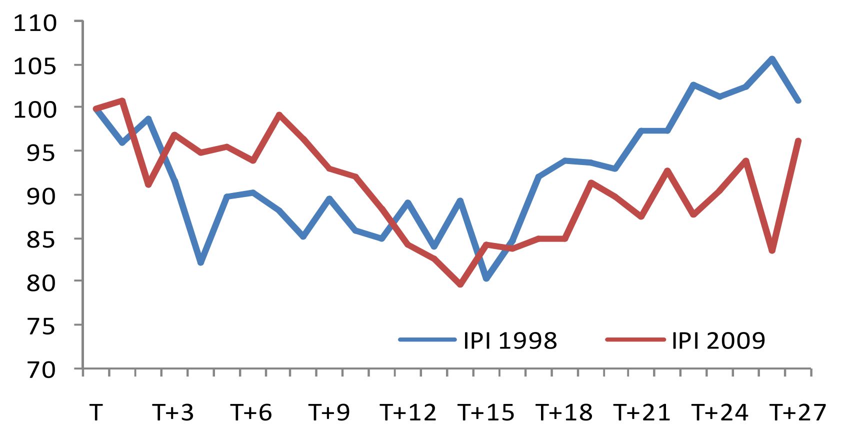
We are encouraged by 1Q2010's GDP expansion of 10.1% y-o-y, the strongest since 1Q2000. Notwithstanding this, the rebound in industrial production in the past several months still lagged the speed of the recovery in 1999 (Chart 9). After more than two years since its downturn, the industrial production index (IPI) has not recovered to its peak recorded in January 2008. In contrast, during the 1999 recovery phase, the IPI surpassed its previous peak approximately 23 months after the downtrend started. This phenomenon could be partly explained by the fact that the contraction in the IPI in 1997/1998 was sharper than the one we experienced in 2009 (Chart 10). From this observation, we think that a milder rebound in the IPI during the current phase of recovery suggests that manufacturers are still cautious about their production levels by trying not to overproduce when global demand may turn wobbly against a backdrop of shaky European economies. This slower expansion in global trade may imply a weaker-than-expected expansion in 2H2010.

Chart 9: IPI post-1998 & 2009 recessions (T=months)



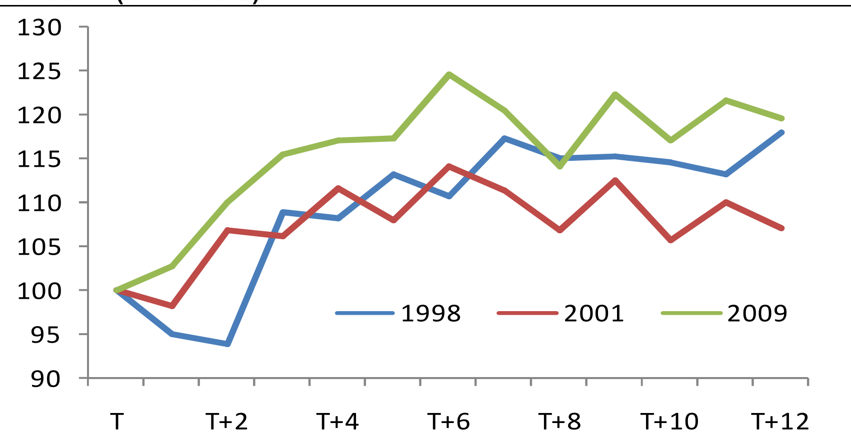
Source: MARC Economic Research
Base=100 in January 1999 for recovery from 1998 recession
Base=100 in February 2009 for recovery from 2009 recession

Chart 10: IPI prior to 1998 & 2009 recessions (T=months)



Source: MARC Economic Research
Base=100 in October 1997, peak of IPI prior to 1998 recession
Base=100 in December 2007, peak of IPI prior to 2009 recession

Chart 11: Electricity consumption post-1998, 2009 recessions & 2001 slowdown (T = months)



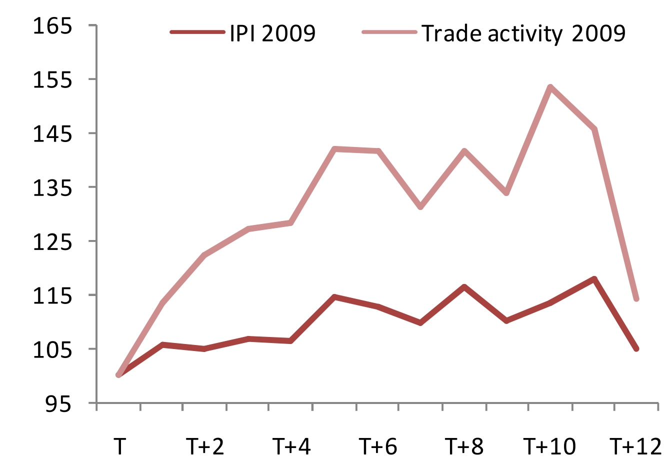
Source: MARC Economic Research
Base=100 in January 1999 for recovery from 1998 recession
Base=100 in February 2002 for recovery from 2001 technical recession
Base=100 in February 2009 for recovery from 2009 recession

Back to the global economic equation

Although it is generally believed that domestic demand will offset weaknesses in external demand, it can only cushion the latter to a certain extent. We opine that external demand will remain the primary catalyst for the Malaysian economy in the next few years, given its degree of openness to world trade. This is not to say that Malaysia's domestic demand is not a force to be reckoned with. In fact, a sharp rebound in electricity consumption proves that domestic activities played an important role in supporting the economy (Chart 11). The recovery in domestic demand post-2009 recession is stronger than their recoveries in the subsequent recession in 1998 and the technical recession in 2001. But an important point to remember is that the domestic and external economies are linked - robust external demand will spur domestic activities such as ports, logistics, transport and even banking activities. Without strong external demand, domestic activities will remain muted, unless aggressively driven by the public sector.

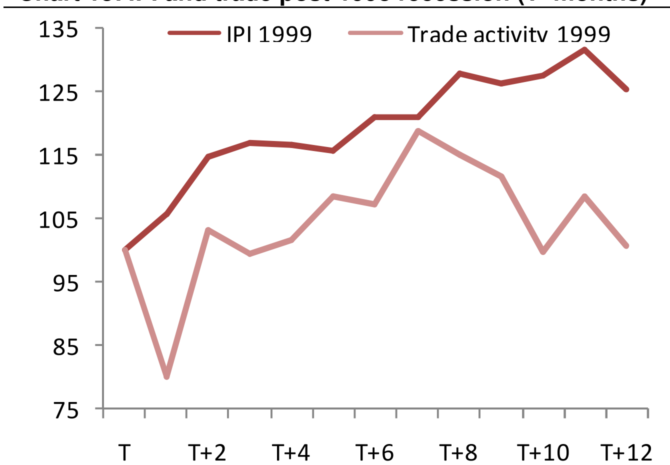
Another interesting feature about the ongoing recovery in Malaysia is that trade activity – defined as the amount of cargo loaded and discharged at ports - has rebounded at a stronger pace than industrial production, contrary to what happened during the recovery phase in 1999 (Charts 12 and 13). Such a phenomenon may suggest that exporters, while responding to higher external demand, remain cautious about their production levels. The precipitous contraction in trade activity in recent months (as depicted in Chart 12) was also accompanied by a decline in industrial production, suggesting a moderation in industrial activity is in order in 2H2010.

Chart 12: IPI and trade post-2009 recession (T=months)



Source: MARC Economic Research
(The amount of cargo loaded & discharged at ports is used as a proxy of trade activity)

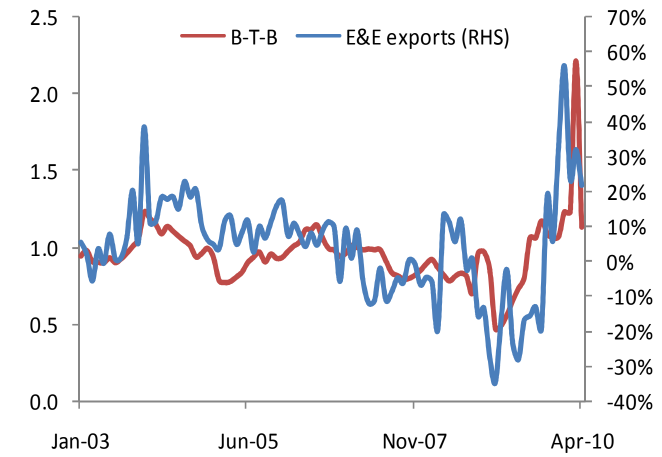
Chart 13: IPI and trade post-1998 recession (T=months)



Source: MARC Economic Research
(The amount of cargo loaded & discharged at ports is used as a proxy of trade activity)

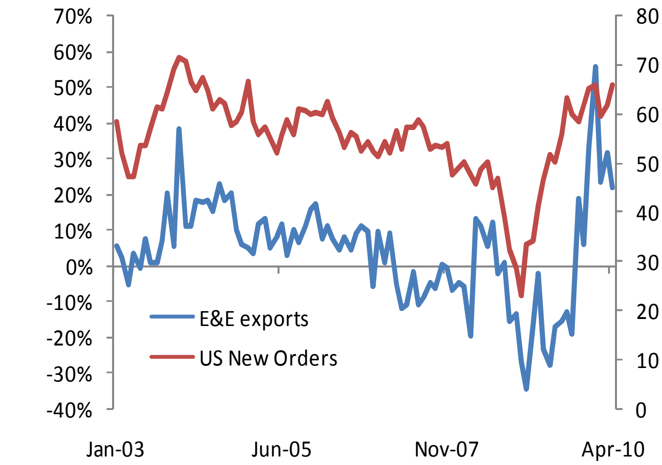
The prospects for Malaysia's external trade remain favourable in 2H2010, but less sanguine when compared with 1H2010. Export growth will likely remain in double-digit territory despite moderating from 1Q2010's level, which was largely attributable to the low base factor in 1Q2009 and a strong demand for E&E products. For the whole of 2010, we envisage nominal exports to expand by 18.2%, down from 30.7% in 2Q2010 as the low base effect diminishes and demand for semiconductors weakens, as evidenced by lower readings of the US semiconductor book-to-bill (B-T-B) ratio and the ISM new orders index (Charts 14 and 15), which typically precede slower growth in exports of Malaysia's E&E manufactures by three to six months.

Chart 14: US B-T-B and E&E exports



Sources: SEMI & CEIC

Chart 15: US ISM New Orders & E&E exports



Sources: Bloomberg & CEIC

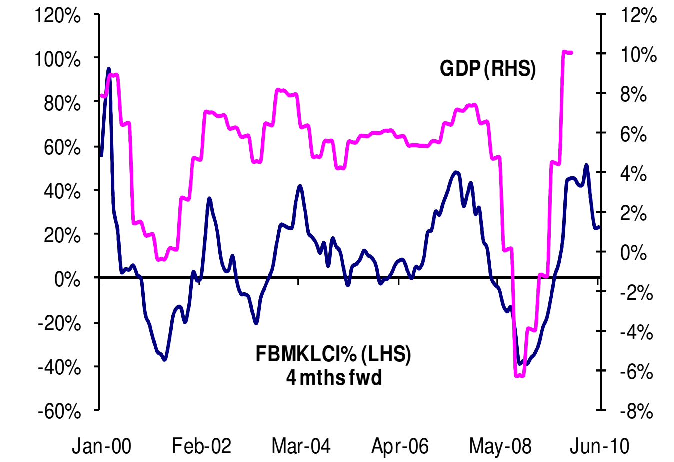
More rollercoaster rides in the financial market

The relationship between Malaysia's equity-market performance and the real economy is significant enough that the former leads the latter by approximately four months (Chart 16). Thus, the impact of the equity market on the real economy should not be underestimated. A significant decline in the equity market will affect businesses, and more crucially, the banking sector, which in turn will influence their lending activities. This will eventually trickle down to companies through reductions in credit lines and to individuals, which will subsequently affect business activities and consumer spending.

While we do not anticipate a hard landing for the global equity market, we are less sanguine about the prospects of the Malaysian equity market in the immediate term, as the FBM KLCI is still trading at a one-standard deviation above its long-term regression line (Chart 17). Even fundamental valuations based on the price-earnings ratio do not look too appealing when compared with the historical average since 2001 (Chart 18). The US equity market, which is positively correlated with the FBM KLCI, is also not doing too well. The Dow, S&P and Nasdaq are all trading below their 200-day moving averages since May 2010, a level which is considered undesirable by many technical traders.

Notwithstanding this, there appears to be no indication that the recent run-up in the FBM KLCI until April has led to any anomalies that preceded major stock-market corrections in the past. Such anomalies can be seen through exceptional gains recorded in both equity and bond markets, as depicted in shaded areas in Chart 19. The implications of such a backdrop are that growth in private consumption, while positive, will not be exceptional this year (hence we stick to our previous estimate of a 3.8% expansion in 2010); and second, businesses will continue to be cautious, as banks remain vigilant about lending to the corporate sector.

Chart 16: GDP FBM KLCI (4 mths forward)

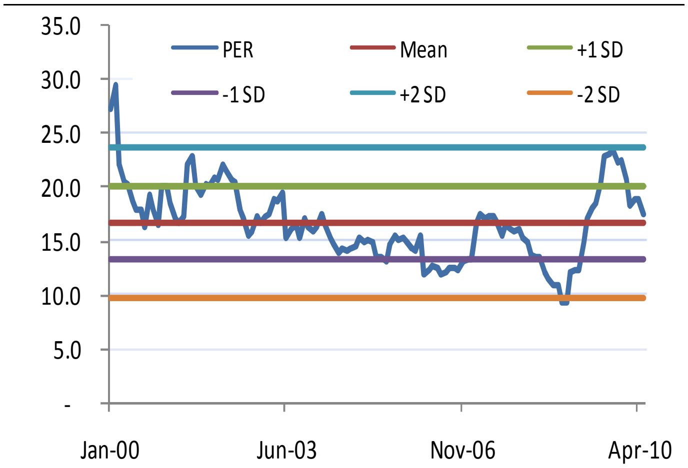


Sources: CEIC & MARC Economic Research

Chart 17: FBM KLCI long-term regression trend

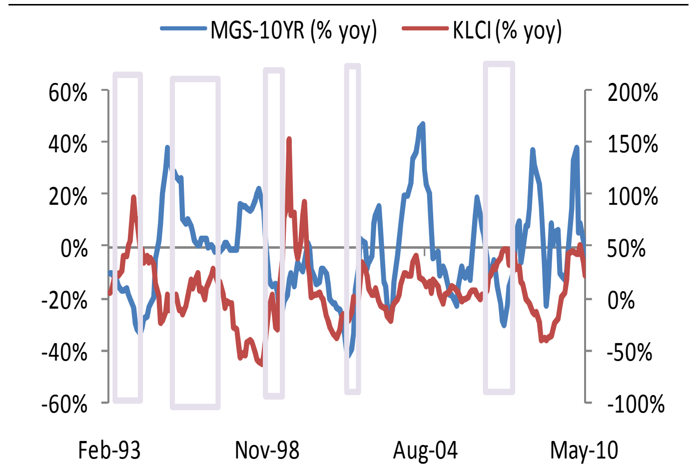
Sources: Bloomberg & CEIC

Chart 18: FBM KLCI PER & average since 2001



Source: Bloomberg

Chart 19: FBM KLCI & 10-year MGS yields

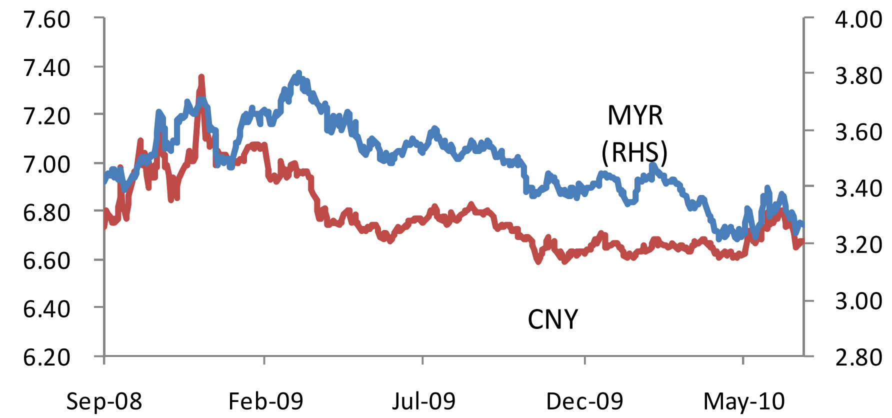


Sources: Bloomberg & CEIC

The Ringgit - not a one-way bet

Although general belief holds that the ringgit will strengthen and test the strongest resistance level of RM3.00 against the USD in the long term, we see a bumpy road ahead. For one thing, the rollercoaster ride of risk appetite among international investors will likely lead to rising volatility of the ringgit, while the widening deficits in Malaysia's financial and capital account (FCA) of the balance of payments (BoP) suggest that capital outflows have risen in recent months. In 1Q2010, although the current account (CA) of the BoP has increased to RM30.4 billion (4Q2009: RM27.4 billion), the BoP registered a deficit of RM19.6 billion due to a RM19.5 billion deficit in the FCA. Should for some reason this trend persist, the ringgit will likely weaken against the USD in the near term. Third, although China once again abandoned its peg against the USD on June 19, such a move will not necessarily lead to a strong appreciation of the yuan against the USD, as the Chinese authorities will likely keep controlling the yuan's movements within a tight band so as not to destabilise the real sector. With this in mind, we think that the ringgit, whose sentiment has lately been affected by the outlook of the yuan, will not necessarily have a smooth upward trend against the USD. We therefore maintain our forecast that the ringgit will average between RM3.20 and RM3.30 against the USD in 2010.

Chart 20: Ringgit (MYR) & yuan (CNY) 12-month non-deliverable forward (NDF)

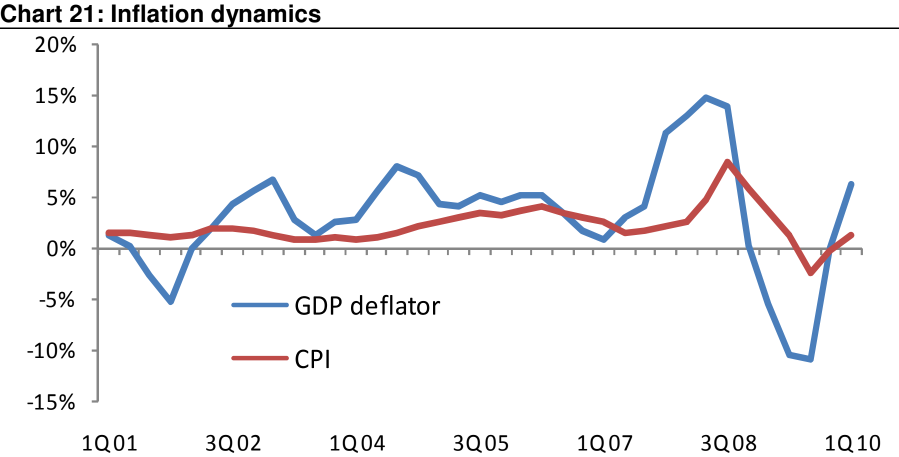


Source: Bloomberg

Moderate growth in CPI, but rising cost of living

Much has been said about the rising living costs in recent months. According to the news flow, farmers claimed that prices of vegetables have doubled since April due to difficulties in getting workers, while prices of chicken, steel round bars and cement are expected to rise following the abolishment of retail licenses on July 15 to allow market forces to determine their prices. Additionally, the government's push for lower subsidies will likely cause a general rise in consumer prices. With approximately 60% of households reportedly earning RM3,000 per month or less, price increases may dent private consumption to some extent, as consumers tighten their purse strings in the near term. This is to be expected despite the government's assertion that the dismantling of the subsidies will be done gradually. On that score, we retain our call that the CPI will rise moderately at 2.4% after growing 0.6% in 2009.

Chart 21: Inflation dynamics

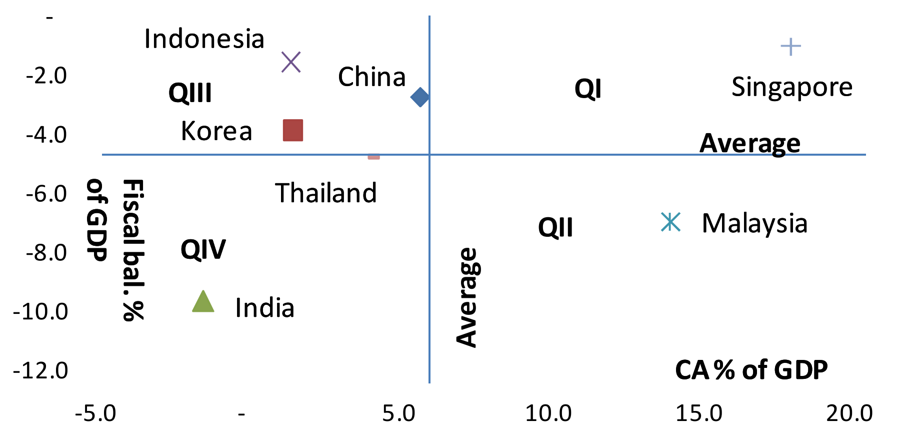


Sources: CEIC & MARC Economic Research

Budget deficit – no big deal

Although Malaysia's fiscal balance has come under scrutiny in the past year following a surge in its ratio to GDP to 7% in 2009, the future trend does not suggest any critical threat to the country's macro condition. While the budget deficit has lingered since the Asian Financial Crisis (AFC), one must remember that Malaysia has experienced a series of fiscal deficits in most of the years since its independence in 1957. The important fact remains that the deficits are easily financed by domestic resources which do not lead to hyperinflation or a big jump in government debt, such as that experienced by some Latin American countries where hyperinflation led to a series of capital flights, crushing their economies. We opine that in 2010, the higher-than-expected revenue, resulting from stronger nominal growth in GDP, will mean smaller deficits than initially expected. Additionally, although the federal government debt level is anticipated to remain above 50% of GDP this year, its external debt portion remains at a minuscule 4% of total debt. Using the fiscal-current account matrix, it becomes evident that Malaysia's position is not the most untenable when compared with other Asian countries, as its current account ratio to GDP has remained favourable since the AFC. In fact, history shows that Malaysia's fiscal and current account matrix has actually improved over the decades (Chart 22).

Chart 22: Current account (Y10) –fiscal balance (Y09) matrix



Sources: ADB & MARC Economic Research

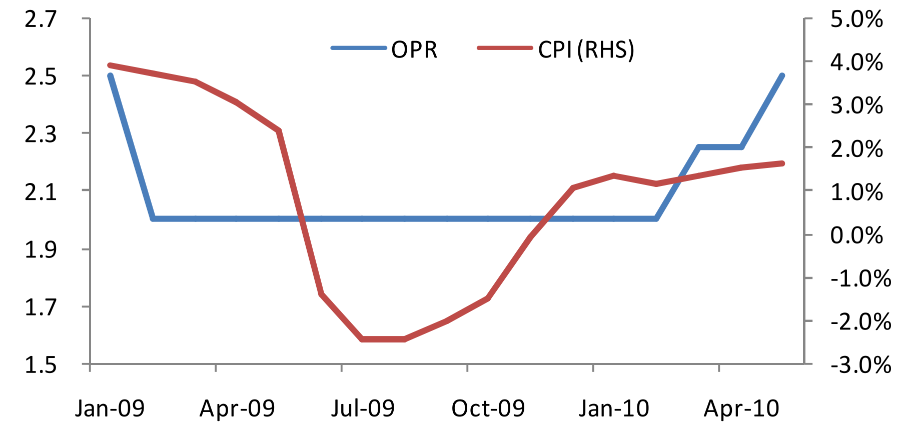
With the government continuing to promote private-sector participation in the implementation of their projects through public-private partnership (PPP) as well as through open tenders, we are optimistic that its target of shrinking the fiscal deficit level to 5.3% of GDP is attainable in 2010. Similarly, for the debt level, we are optimistic that the government's target of bringing down its ratio to GDP to 49.9% by the end of the 10MP can be surpassed, based on past policy trends.

Interest rates – measured pace in normalisation

We believe that there is a high probability that the BNM will raise the OPR by another 25 bps, bringing the policy rate to 2.75% in 2H2010 as officials have consistently said that low interest rates could lead to financial imbalances that could threaten the overall economy. By this, we think that the problem of rising household debts is the BNM's main concern. The ratio of household debt to GDP has surged to a precarious 76.6% in 2009, and has been above 60% since the beginning of the new millennium. Additionally, higher rates will ensure depositors a positive real rate of return to offset rising living costs (Chart 23). Thus, an interest-rate normalisation process is warranted.

We are of the view that another 25 basis-point hike should not compromise the BNM's objective of ensuring price stability while supporting the growth of the economy. In addition, it will not place undue pressure on households which are already burdened with debts, but it would instead prevent them from further leveraging their financial capacity. Our estimate shows that the neutral rate – the rate which is neither restrictive nor accommodative – is currently higher than the present level of OPR (between 3.25% and 3.5%), suggesting that another 25 basis-point hike will not likely be too restrictive for economic activities in the near future.

Chart 23: BNM's policy rate & CPI y-o-y%



Source: CEIC

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MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803 V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: [603] 2092 5398 Fax: [603] 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my