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The Malaysian Economy Sectoral Overview: The Perspective From 20,000 Feet

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In a nutshell

- With uncertain prospects clouding the global economy, Malaysia's growth momentum is expected to moderate in 2012 in the wake of languishing external demand, despite resilient domestic demand. Exports are expected to continue its downtrend as a result of the European economic crisis which has sapped demand for goods from major Asian economies, including China and India. We expect real exports to grow by an average of 1.2% in 2012. However, prospects for the electronics and electricals (E&E) sector have improved of late, indicating better demand for global semiconductors going forward. These positive developments will prevent further deterioration in Malaysia's E&E exports in the next six months.

- Demand for palm oil from Malaysia is significantly driven by emerging Asian economies. China is the main importer of Malaysian palm oil, followed by the European Union, Pakistan and India. Due to the strong demand, palm oil prices climbed to an average RM3,245 per tonne in 2011, up from RM2,287 per tonne in 2009 and RM2,787 per tonne in 2010. Anecdotal evidence of an economic slowdown in China and India has raised some doubt on whether prices of palm oil can be sustained above RM3,000 per tonne this year. However, even though a moderate decline in demand is likely to happen, the expected limited global supply will likely continue until 1Q2013.

- The oil & gas (O&G) sector has seen a decline in overall production due to maturing offshore fields and sand contamination at Malaysia's first deepwater field. As consumption continues to rise, there are fears that Malaysia will become a net oil importer in the next several years. However, recent oil discoveries by Petronas in offshore Sarawak have somewhat revived excitement among O&G players. According to industry observers, the new finds could somewhat arrest the steady decline in the country's O&G production and consequently boost reserves by approximately 2% for oil and 3% for gas.

- On the domestic front, demand has remained resilient and is expected to be a major source of support for the Malaysian economy. In addition, the relatively easy credit conditions will ensure that consumer spending will remain strong despite a slight weakness in loan growth following stricter lending guidelines. Notwithstanding this, we view the guidelines as a major step in containing ballooning household debt which may endanger the overall macro economy if not properly addressed. The momentum in private investments looks encouraging, and judging by the current sentiment, private investment is expected to register another respectable growth year in 2012, underpinned by efforts implemented through the Economic Transformation Programme (ETP).

- As a proxy for the economy's health, the banking sector's loan growth is expected to moderate slightly in view of slower economic growth in 2012. Notwithstanding this, the outlook of the banking sector remains encouraging. Corporate loan growth has remained stable while loan impairment remained low in April. The encouraging prospects in the second half of the year are also supported by the rollout of ETP projects which will likely bolster demand for corporate loans. In addition, household balance sheets, while having been overstretched for several years, is not likely to deteriorate further if Bank Negara Malaysia (BNM) continues to focus on containing household debt in the next few years. In addition, if BNM ensures lending by non-bank institutions (Development Financial Institutions or DFIs and cooperatives) are somewhat in line with the new prudent guidelines, unnecessary lending to the household segment can be contained.

- Malaysia's insurance industry is one of the key drivers of the services sector. The life insurance industry has been growing at a rapid pace in the past decade following strong economic growth that led to rising incomes and living standards among the population. Several developments in the Malaysian capital markets will affect the landscape of the insurance industry. For instance, a framework similar to the risk-based capital (RBC) framework is being considered for takaful operators while takaful business has been identified as a near-term insurance priority with micro-takaful, medical and retirement products seen as the next steps for the industry. In the motor segment, gradual increases in premiums will continue in the next four years after they were revised for the first time in 30 years with effect from January 2012.

- As for the construction industry, the sector showed a stellar performance in 1Q2012, surging by 15.5% on a year-on-year (y-o-y) basis, the fastest pace since 2001. The sector has been supported mainly by various domestic activities implemented by the government under the ETP and National Key Economic Areas (NKEAs) as well stronger residential and non-residential construction. Of late, leading indicators for the construction sector also look encouraging.

- The property sector will also be boosted by the government's establishment of 1Malaysia People's Housing (PR1MA) which will serve as the sole agency to develop and maintain affordable and quality houses specifically for the middle-income group. Anecdotal evidence also indicates that the prospects of the property sector are quite encouraging. For instance, the value of property sales has remained robust in the past five years, rising from RM61 billion in 2006 to RM138 billion in 2011. The strong performance was mainly attributed to the overall strength of the economy which led to rising incomes and living standards, greater urbanisation, as well as the favourable demographics of the population.

- Sustainable levels of employment, rising wages and disposable incomes have, to some extent, supported Malaysia's consumer sentiment, which in turn has had a positive effect on Malaysia's auto industry. Favourable demographics, persistently low interest rates and the relative lack of integrated public transportation have also supported the demand for motor vehicles. In the short term however, the outlook has been tempered by the moderation in consumer sentiment. Global economic uncertainties as well as tighter lending requirements under the latest BNM guidelines may have contributed to the trend.

External sector to be dented by weaker global demand

With uncertain prospects clouding the global economy, Malaysia's growth momentum is expected to moderate in 2012 in the wake of languishing external demand, despite resilient domestic demand. Exports contracted for the second month in April, declining by 0.1% y-o-y, after posting its first negative growth in March 2012. In the first four months of 2012, Malaysia's gross exports grew 3.3% (Jan-April 2011: 6.5%), largely attributed to a continuous drop in E&E exports by 1.6%.

Based on quarterly statistics, exports to China fell by 3.2% in 1Q2012 (1Q2011: 3.9%) while shipments to the European Union (EU) contracted by 10.4% (1Q2011: 5.3%). As Malaysia's total trade accounts for more than 200% of the country's gross domestic product (GDP), the bleak prospects for global trade for the rest of the year does not augur well for the country's external sector. In fact, exports are expected to continue its downtrend as a result of the European economic crisis which has sapped demand for goods from major Asian economies, including China and India. We expect real exports to grow by an average of 1.2% in 2012.

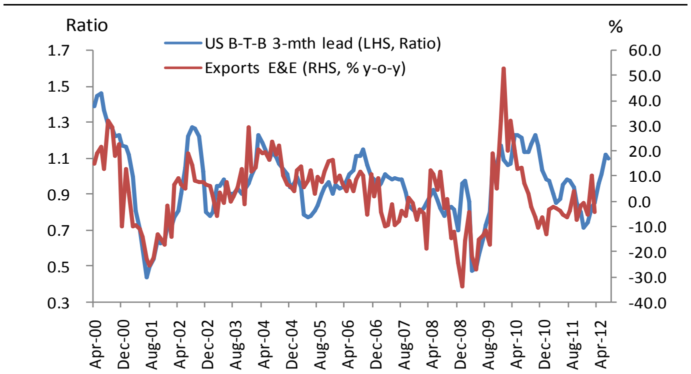
E&E exports will remain moderate

Malaysia's external sector will continue to be pressured by weakening global demand as a result of the economic crisis in Europe. Softer economic growth in major Asian economies, namely China and India, continue to dent Malaysia's export performance, particularly in the E&E sector. In addition, the earthquake which hit Japan in early 2011 caused supply chain disruptions for semiconductors and electronic items, which resulted in electronic companies operating below capacity. As a result, the global ripple effect exerted downward pressure on production.

Malaysia's E&E exports continued to post a negative growth of 0.3% in 1Q2012 after a 4.1% contraction in 2011. This is in tandem with global chip sales which has recorded negative growth since July 2011. The United States (US) book-to-bill (B-T-B) ratio also fell from as high as 1.23 in July 2010 and hit the cycle low of 0.71 in September 2011.

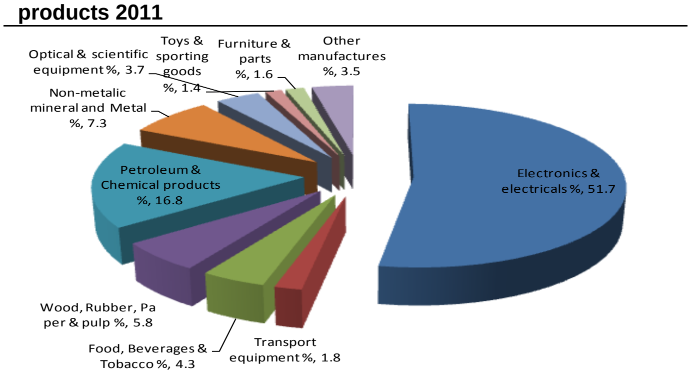
However, the prospects for the industry have improved of late as evidenced by some upward revisions by industry experts. For instance, Taiwan Semiconductor Manufacturing Company (TSMC) and United Microelectronics Corporation (UMC) are expecting strong growth in their businesses in 2Q2012 following a pickup in demand since 1Q2012. The US B-T-B ratio has also climbed from its cyclical low of 0.71 to 1.10 in April 2012, indicating better demand for global semiconductors going forward. These positive developments will prevent further deterioration in Malaysia's E&E exports in the next six months. Notwithstanding this, we are of the view that it is too early to foresee a sharp recovery as the outlook for the global economy is still uncertain amidst the Euro crisis and the deceleration in Asian economic growth.

Chart 1: E&E exports growth and US B-T-B (3-mth lead)



Source: CEIC, SIA, MARC Economic Research

Chart 2: Breakdown of Malaysian exports of manufactured products 2011



Source: CEIC, BNM, MARC Economic Research

Palm oil exports to partly cushion the drop in exports

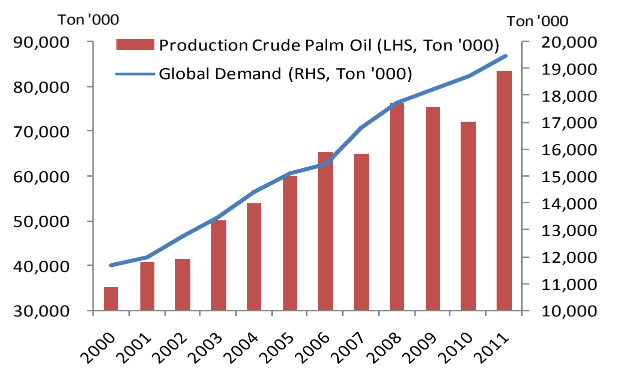
The palm oil sector is also highly dependent on global demand. The total production of palm oil in Malaysia has increased by an average of 5.8% in the past two decades from merely 6.1 million tonnes in 1990 to 18.9 million tonnes in 2011, reflecting the growing importance of this sector. In 2011 alone, total production grew at a robust rate of 11.3%.

Demand for palm oil from Malaysia is significantly driven by emerging Asian economies. China is the main importer of Malaysian palm oil, accounting for 22.1% of total palm oil exports in 2011, followed by the European Union at 11.2%, Pakistan 10.1% and India 9.3 %. Due to the strong demand, palm oil prices climbed to an average RM3,245 per tonne in 2011, up from RM 2,287 per tonne in 2009 and RM 2,787 per tonne in 2010.

Anecdotal evidence of an economic slowdown in China and India has raised some doubt on whether prices of palm oil can be sustained above RM 3,000 per tonne this year considering that prices of other commodities such as oil and iron ores have declined significantly from their recent highs. However, even though a moderate decline in demand is likely to happen, the expected limited global supply will likely continue until 1Q2013, according to the Oil World.

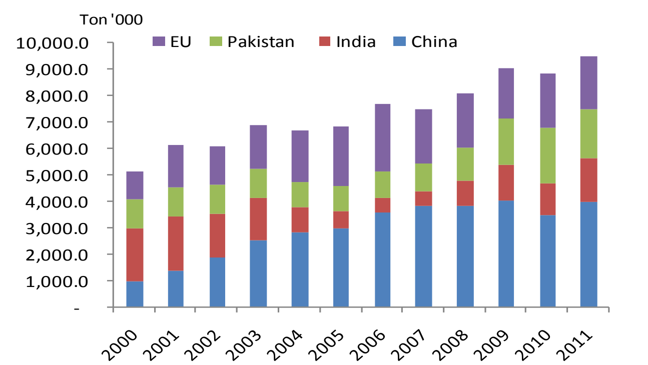
In addition, the focus on the palm oil sector as a NKEAs under the ETP will provide some buffer for the sector going forward. According to a report by the Performance Management & Delivery Unit (PEMANDU), the palm oil industry is forecast to grow by 7.1% per annum to 2020, driven by the eight Entry Point Projects (EPPs) under the ETP initiated by the Malaysian government to promote the industry as one of the main economic drivers. In addition, the government aims to raise the industry's contribution to Gross National Income (GNI) up to RM178 billion in 2020 from RM52.7 billion in 2009.

Chart 3: Local production CPO and global demand



Source: CEIC, BNM

Chart 4: Malaysian palm oil major importers



Source: CEIC, BNM, MARC Economic Research

Oil and gas

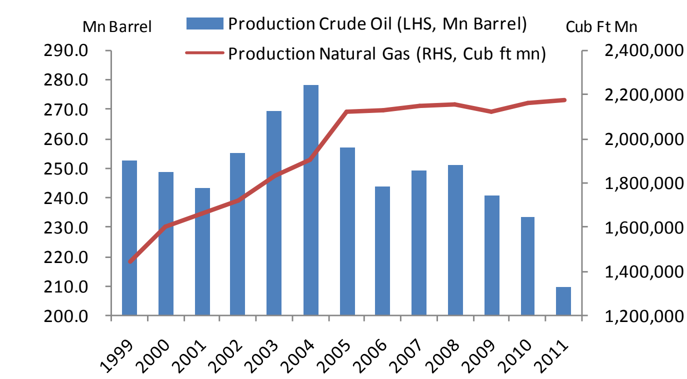
The O&G industry is a major sub-component of Malaysia's mining and quarrying sector, which accounted for 6.3% of GDP in 2011. The importance of the industry to the Malaysian economy can be seen from the share of oil revenue to total federal government income which had climbed to an average of 38% between 2006 and 2011 from an average of 23% between 2000 and 2005. In fact, during the peak of the cycle when oil prices surged to nearly USD150 per barrel in 2008, oil revenue accounted for 46% of government income through the year of 2009. In terms of its contribution to external trade, exports of crude oil and condensates and liquefied natural gas (LNG) represented about 11.8% of total gross exports for Malaysia in 2011.

The O&G sector has seen a decline in overall production due to maturing offshore fields and sand contamination at Malaysia's first deepwater field. Crude oil production declined for three consecutive years from 240 million barrels in 2009 to 209 million barrels in 2011. In terms of percentage, production fell by 4.2%, 3.1% and 10.2% in 2009, 2010 and 2011 respectively (average 2000-2011: -1.4%). Similarly, the growth of natural gas production slowed to 0.6% in 2011 from 1.9% in 2010 (average 2000-2011: 3.5%). As consumption continues to rise, there is fear that Malaysia will become a net oil importer in the next several years.

Recent oil discoveries by Petronas in offshore Sarawak have somewhat revived excitement among O&G players. The discovery of 2.6 trillion standard cu feet (tscf) of natural gas at the NC3 well and 100 million barrels of oil plus 0.2 tscf of gas at the SK306 block of Sarawak shores were the first major discoveries in four years (after Sabah's Rotan field discovery by Petronas and Murphy Oil). According to industry observers, the new finds could somewhat arrest the steady decline in the country's O&G production and consequently boost reserves by approximately 2% for oil and 3% for gas. It is estimated that Malaysia's O&G reserves could be depleted in 15 years if no actions are taken.

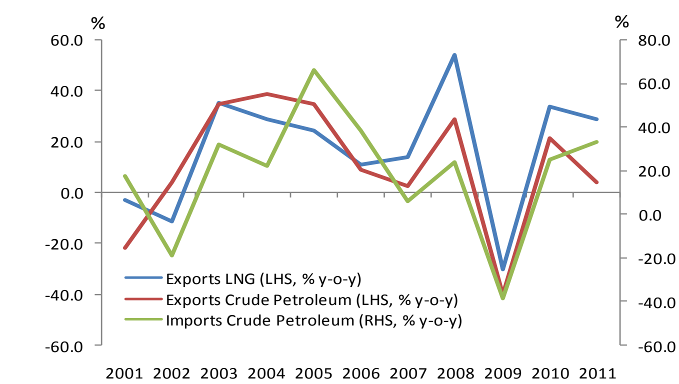
Through the efforts by PEMANDU, the government has identified the O&G sector as one of the 12 NKEAs under the ETP. The EPPs for the sector include, among others: (1) enhanced oil recovery (EOR) projects where Petronas and ExxonMobil signed a production-sharing contract (PSC) under a joint venture to invest about USD2 billion at the Tapis field and six others; (2) more deepwater exploration projects, beginning in Gumusut and Kakap, to boost domestic production and expedite development of more domestic fields; (3) development of Malaysia as an oil storage hub, especially in Johor where sheltered ports are available at Pengerang, Tanjung Pelepas, Tanjung Bin and Tanjung Langsat; and (4) developing marginal fields which have been somewhat neglected as their returns do not entice big players.

Chart 5: Production crude oil and natural gas



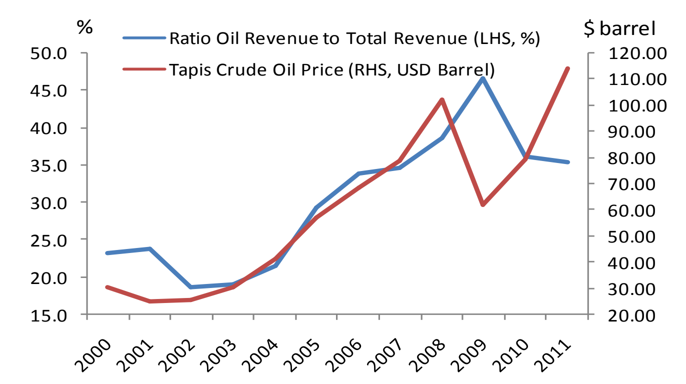
Source: CEIC, Malaysia Energy Commission

Chart 6: O&G external sector growth



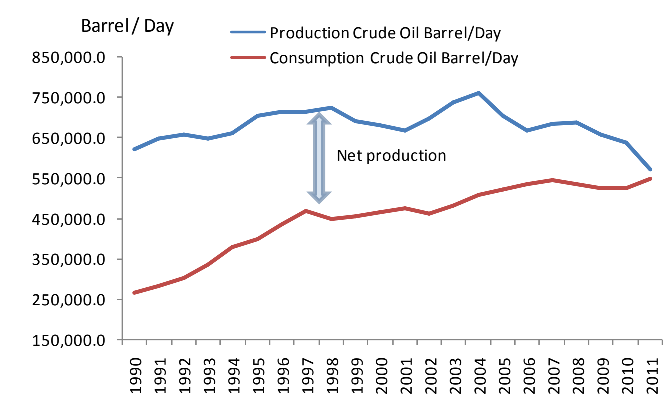
Source: CEIC, BNM, MARC Economic Research

Chart 7: Ratio of oil revenue to total government revenue and Tapis crude oil prices



Source: CEIC, BNM, PETRONAS, MARC Economic Research

Chart 8: Production and consumption of crude oil.



Source: CEIC, PETRONAS

Domestic demand will cushion the blow

Domestic demand has remained resilient and is expected to be a major source of support for the Malaysian economy. Real private consumption expanded at a robust 7.4% in 1Q2012 (4Q2011: 7.3%) and will remain relatively strong with an estimated growth of 6.2% in 2012, supported by a stable labour market with unemployment rate circa 3%. In addition, the relatively easy credit conditions will ensure that consumer spending will remain strong despite some weaknesses in loan growth following stricter lending guidelines imposed by BNM starting January 2012. Notwithstanding this, we view the guidelines as a major step in containing ballooning household debt which may endanger the overall macro economy if not properly addressed.

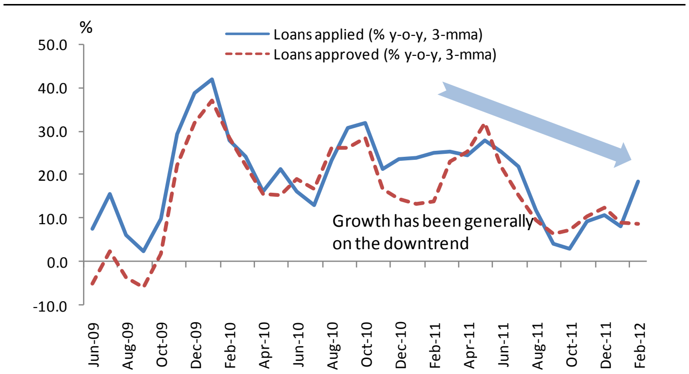
The momentum in private investments looks encouraging. And judging by the current sentiment, private investment is expected to register another respectable growth year in 2012, underpinned by efforts implemented through the ETP. The upswing in private investment can be seen from the latest statistics in 1Q2012 where total investments grew at a robust 16.2% pace (4Q2011: 8.4%), largely driven by strong private investments. In 2011 alone, RM94 billion in private investment was recorded, exceeding PEMANDU's target of RM83 billion. In real terms, the share of private investment grew to 13.4% of GDP in 2011, the highest in four years (2010: 12.5% of GDP). Thus far, the ETP has attracted 110 projects with RM179.2 billion worth of investment committed. Accordingly, about 83% of these investments are either in operation or have commenced work. These projects are expected to create over 313,741 new jobs by 2020 and to contribute about RM129.5 billion worth of GNI.

Services sectors will continue to be economic drivers

As a proxy for the economy's health, the ***banking sector's*** loan growth is expected to moderate slightly in view of slower economic growth in 2012. The new lending guidelines implemented by the BNM to keep household debt in check will also have an adverse impact on lending to the household sector to some extent. This is already evident from the recent downtrend in loan growth to this sector in April where loans to households grew at a more moderate pace despite being relatively strong at 11.7% y-o-y (March: 11.9%), as borrowers underwent longer approval processes. Total loan applications have also slowed, expanding by 5.8% in April, down from a double-digit pace of 14.1% in the previous month.

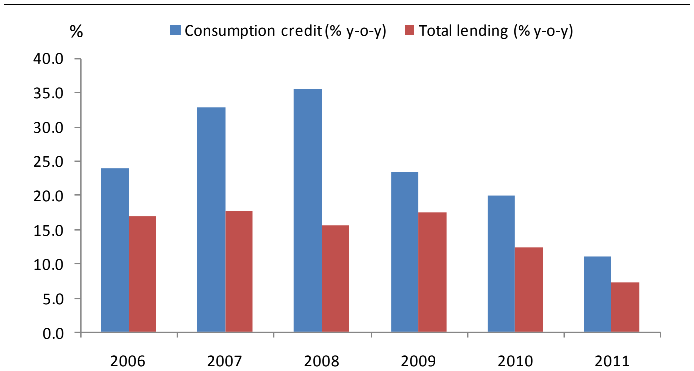
Notwithstanding this, the outlook of the banking sector remains encouraging. Corporate loan growth have remained stable at 12.9% in April (March: 12.3%). Loan impairment has remained low at 1.8% in April. The encouraging prospects in the second half of the year are also supported by the rollout of ETP projects which will likely bolster demand for corporate loans. In addition, household balance sheets, while having been overstretched for several years, is not likely to deteriorate further if BNM continues to focus on containing household debt in the next few years. In addition, if BNM ensures lending by non-bank institutions (Development Financial Institutions or DFIs and cooperatives) are somewhat in line with the new prudent guidelines, unnecessary lending to the household segment can be contained.

Chart 9: Growth in loan applications and approvals



Source: CEIC, BNM, MARC Economic Research

Chart 10: Growth in lending to DFIs – total and for consumption credit



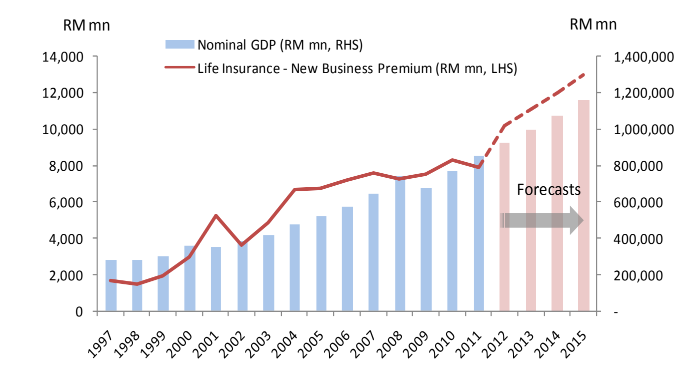
Source: BNM, MARC Economic Research

Malaysia's ***insurance industry*** is one of the key drivers of the services sector. A general breakdown indicates that the country's finance and insurance industry accounted for 20.1% of the services sector's output in 2011 (2000: 18.6%) as well as 11.8% of the country's GDP (2000: 9.2%).

The life insurance industry has been growing at a rapid pace in the past decade following strong economic growth that led to rising incomes and living standards among the population. Life new business premiums have expanded at a compounded average growth rate (CAGR) of 9.4% between 2000 and 2011, growing from merely RM2.9 billion to RM7.9 billion, faster than Malaysia's nominal GDP which expanded by a CAGR of 8.3% per annum within that period. Gross direct premiums of general insurance, on the other hand, grew at a more moderate pace between 2000 and 2011, expanding by a CAGR of 7.8% and rising from RM5.9 billion to RM13.6 billion, partly due to a decline in the growth of premiums for Marine, Aviation and Transit (MAT) which was partially offset by the growth in Medical and Personal Accident premiums, which expanded at a faster pace of 12.1% in the last five years compared with 9.5% between 2000 and 2005.

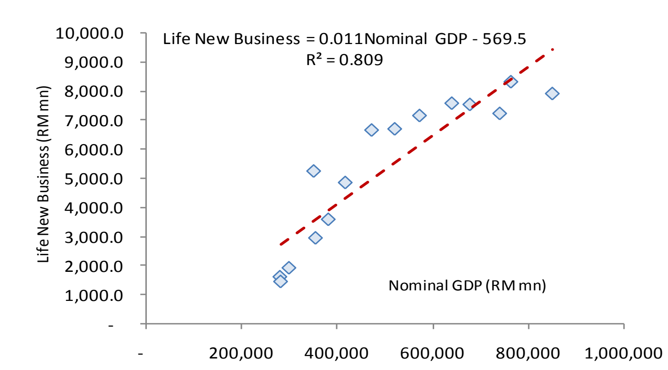
Several developments in the Malaysian capital markets will affect the landscape of the insurance industry. For instance, a framework similar to the RBC framework is being considered for takaful operators. In line with Malaysia's bid to become an Islamic Financial hub, the BNM has also identified the family takaful business as a near-term insurance priority with micro-takaful, medical and retirement products seen as the next steps for the industry. In the motor segment, gradual increases in premiums will continue in the next four years after they were revised for the first time in 30 years with effect from January 2012.

Chart 11: Life new business premiums and nominal GDP



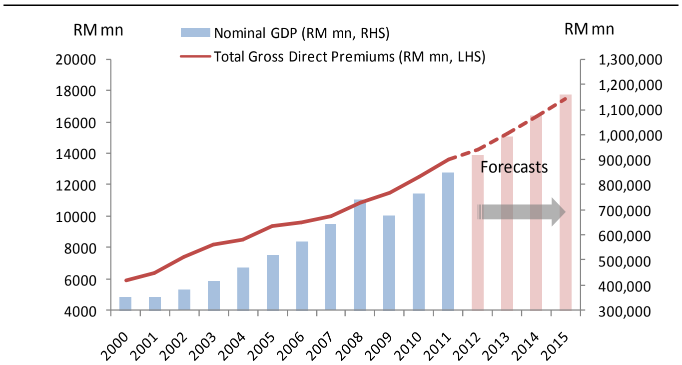
*Source: CEIC, BNM, MARC Economic Research, *2011 figures are from LIAM statistics*

Chart 12: Scatter diagram of life new business premiums and nominal GDP



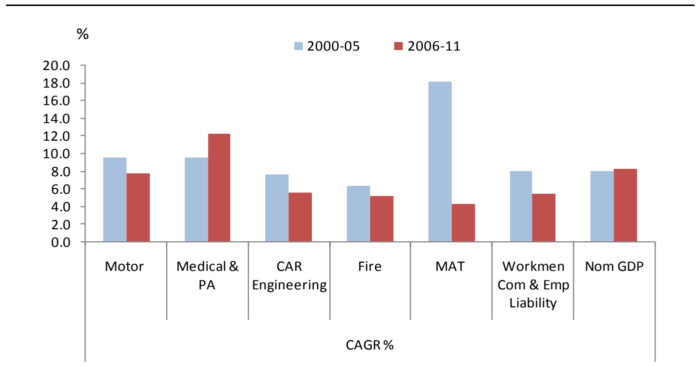
Source: CEIC, BNM, MARC Economic Research

Chart 13: Gross direct premiums of general insurance and nominal GDP



Source: CEIC, BNM, MARC Economic Research

Chart 14: Growth of general insurance segments 2000-05 and 2006-11



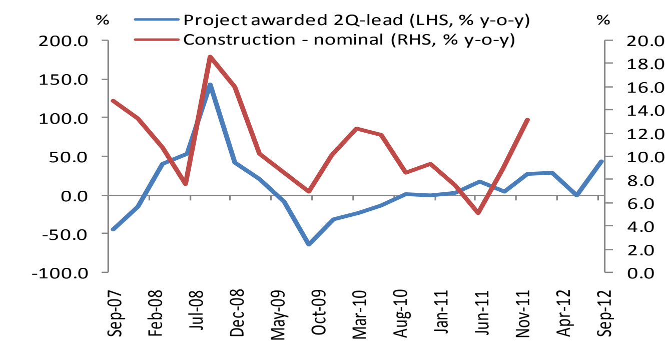
Source: CEIC, BNM, MARC Economic Research

Construction and property sectors will remain resilient

The ***construction sector*** showed a stellar performance in 1Q2012, surging by 15.5% on a y-o-y basis, the fastest pace since 2001. The sector has been supported mainly by various domestic activities implemented by the government under the ETP and NKEAs as well stronger residential and non-residential construction. Although its share of contribution to GDP remained relatively small at 3.0% in 2011, the spill-over effects will have important ramifications for domestic spending. In the past five years, the construction sector has moved in tandem with Malaysia's economic output, growing at a CAGR of 5%, slightly outpacing GDP growth of 4% per annum.

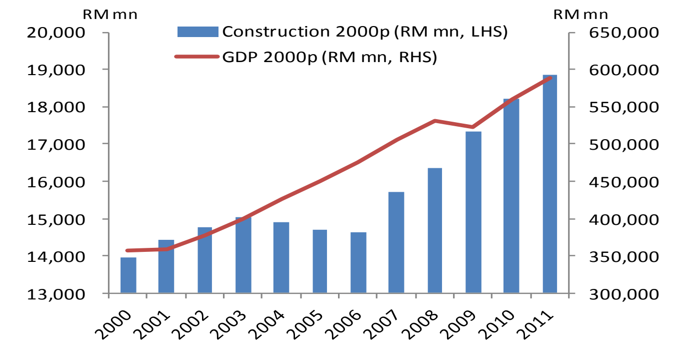
Of late, leading indicators for the construction sector also look encouraging. For instance, the number of projects awarded in 1Q2012 surged by 11.2% y-o-y compared to -10.2% in the same period last year and -7.5% in 4Q2011. The value of projects awarded also jumped by 43.9% in 1Q2012 (1Q2011: 4%), underpinned by progressive roll-out of contracts from the Klang Valley My Rapid Transit (KVMRT) project as one of the EPPs under the ETP. The construction of the first phase of KVMRT line (Sungai Buloh – Kajang) has been approved by the government with an expected completion by 2017.

Chart 15: Growth in project awarded 2Q-lead and construction nominal



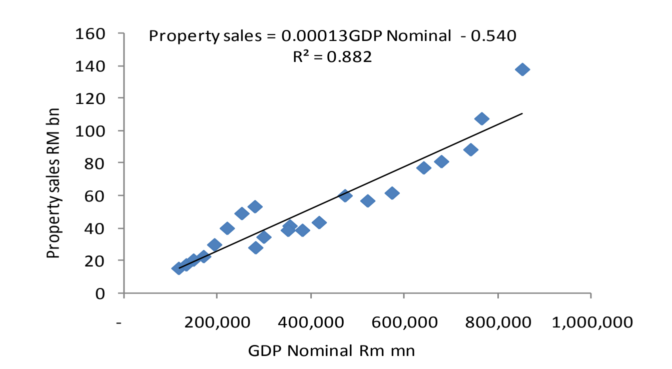
Source: CEIC, CIDB, MARC Economic Research

Chart 16: Construction and GDP in real terms



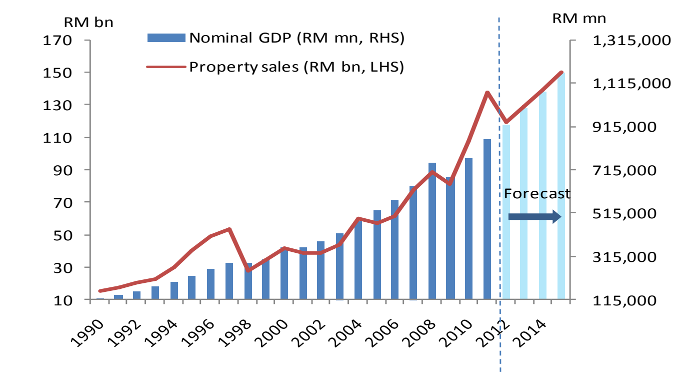
Source: CEIC, CIDB

Chart 17: Scatter diagram of property sales and nominal GDP



Source: CEIC, BNM, MARC Economic Research

Chart 18: Nominal GDP and property sales



Source: CEIC, BNM, MARC Economic Research

Looking at the bigger picture, the allocation of RM29.8 billion under Budget 2012 for investment in infrastructure, industry, agriculture and rural development will provide further impetus for the construction sector in the medium term. The Second Rolling Plan (RP2) of the 10th Malaysia Plan (10MP) will commence in 2012, involving a total amount of RM98.4 billion in expenditure over two years. The focus of the RP2 will be on improving public highways, a railing system for the Gemas-Johor Bahru line as well as the redevelopment of the Sungai Besi Kuala Lumpur Air Base.

The ***property sector*** will also be boosted by the government's establishment of PR1MA which will serve as the sole agency to develop and maintain affordable and quality houses specifically for the middle-income group. A total of 7,700 houses will be built in the Klang Valley by PR1MA together with other private construction companies. Anecdotal evidence also indicates that the prospects of the property sector are quite encouraging. For instance, the value of property sales has remained robust in the past five years, rising from RM61 billion in 2006 to RM138 billion in 2011. On a CAGR basis, the number of property sales recorded a double-digit pace of 17.5% per annum in the past five years compared to a 7.7% expansion per annum between 2000 and 2006. The strong performance was mainly attributed to the overall strength of the economy which led to rising incomes and living standards, greater urbanisation, as well as the favourable demographics of the population.

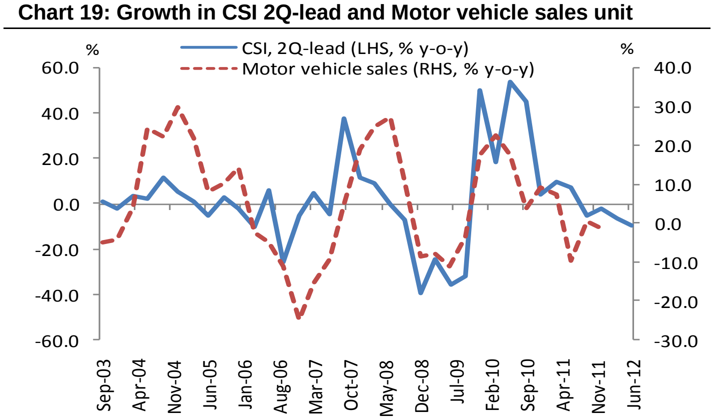
Auto sales are taking cues from consumer sentiment

Sustainable levels of employment, rising wages and disposable incomes have, to some extent, supported Malaysia's consumer sentiment, which in turn has had a positive effect on Malaysia's ***auto industry***. Favourable demographics, persistently low interest rates and the relative lack of integrated public transportation have also supported the demand for motor vehicles.

Looking at the big picture, the value of motor vehicle sales has been rising at an exponential rate from a mere RM22.6 billion in 2000 to RM115.9 billion in 2011, in line with the increase in nominal GDP which grew from RM356.4 billion to RM852.7 billion within the same period. If the strong correlation continues over the long term and assuming that nominal GDP expands at an average of 8% per annum in the next few years, sales of motor vehicles are envisaged to climb to circa RM181.7 billion by 2015.

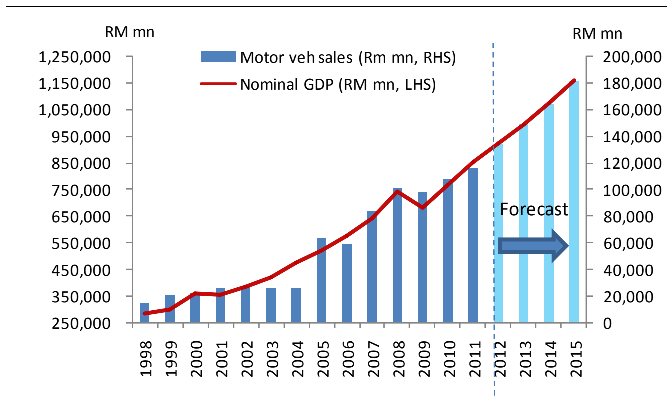
In the short term however, the outlook has been tempered by the moderation in consumer sentiment. From an analytical point of view, the Malaysian Institute of Economic Research (MIER) consumer sentiment index (CSI) tends to lead motor vehicle sales by two quarters. And judging by the latest trend in the CSI which showed a contraction of 2.3% y-o-y in 2Q2011, it was not surprising to see a decline in motor sales by 1.3% in 4Q2011. Recent developments in the global and domestic economy have certainly clouded the short-term outlook of the industry. For instance, the Malaysian Automotive Association (MAA) in its latest review in January 2012 projected that the auto industry will post a minuscule growth of 2.5% in 2012 and will expand at a mediocre pace of 2.2% per annum in the next five years. Global economic uncertainties as well as tighter lending requirements under the latest BNM guidelines may have contributed to the trend.

Chart 19: Growth in CSI 2Q-lead and Motor vehicle sales unit



Source: CEIC, BNM, MARC Economic Research

Chart 20: Motor vehicle sales and nominal GDP



Source: CEIC, BNM, MARC Economic Research

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