# Economic Research

KDN No.: PP14787/11/2012(030811)

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/008/2014

## *Economic Outlook 2015: Gyrations Amid Pockets of Silver Lining*

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## In a nutshell

- The increasing uncertainties in the global economy are now weighing on the overall outlook for 2015. The repercussions of the recent plunge in oil prices on oil exporting countries are now reverberating across the globe and raise the spectre of a scenario akin to the ruble crisis in 1998. Russia is now facing risks of a deeper recession than was initially anticipated in 2015 while Venezuela is grappling with a possible risk of sovereign default. Commodity-based countries are hit with currency depreciations with the Russian ruble weakening by 48.8% year-to-date (YTD); the Brazilian real by 12.4%; the Australian dollar (AUD) by 7.9%; and the Malaysian ringgit (MYR) by 6.3% as anticipation of a greater-than-expected drop in economic growth spread through financial markets. Euro economies are struggling with disinflation while Japan is expected to face more headwinds as a result of its recent sales tax hike. China, on the other hand, is feeling the pinch from government measures to stabilise its housing market.

- The only economic locomotive left is the United States (US), which at this juncture, remains resilient as growth is now supported by the further strengthening of its labour market, evidenced by the strongest payroll statistics since May 2010 in November 2014. The decline in the jobless rate to below 6% also sparked speculation that an interest rate hike is on its way. The manufacturing statistic (Purchasing Managers' Index or PMI) suggests that the country's overall growth profile will become more favourable in the next one year with the headline gross domestic product (GDP) growth anticipated to be in the range of 2.5%-3%.The services sector is also strengthening judging by the latest PMI non-manufacturing statistic. Except for the mediocre pace of inflation, the Federal Reserve (Fed) is now struggling to find excuses not to hike the federal funds rate (FFR) in the next one year.

- Going forward, we foresee an increasing volatility in the global economy and financial markets as a result of a higher gyration in commodity prices. Currencies and equities in commodity-based countries will likely remain under pressure while the spike in their bond yields will have material ramifications on growth outlook. Capital outflows will be a key feature and as such, the balancing act between the need to support growth and prevent massive outflows of capital will become increasingly challenging. Against such a backdrop, we anticipate stronger-than-expected growth deceleration in commodity-exporting countries and even in other countries which are relatively trade dependent.

- As for Malaysia, economic growth momentum was respectable in 2014. The headline GDP has surprised on the upside in the first three quarters of 2014, with growth averaging 6.1%, buoyed by the recovery of the external sector, although domestic demand continued to moderate amid rising consumer prices as well as stricter access to credit. Net trade added 2.2 percentage points to the overall headline GDP during the period, marking its first annual positive contribution since 2006. Domestic demand, on the other hand, slowed during the period as consumers and businesses grappled with higher inflationary pressures. The aggregate domestic demand added an average 5.6 percentage points to overall growth, the least since the Global Financial Crisis (GFC) (2013: 6.8 percentage points).

- Going forward, we foresee a downward bias in Malaysia's headline GDP growth in 2015 to 4.7% (our estimate for 2014: +5.8%), lower than the government's projection during Budget 2015 due to: (1) decelerating domestic demand in response to slower growths in private consumption and private investment; (2) moderating pace of export performance following weaker global trade as a result of uncertainties in major economies especially in Europe, China and Japan despite the continuing strength of the US economy; and (3) lower-than-expected average oil price, which despite having a positive impact on Malaysia's inflationary landscape, will on balance, drag down corporate earnings and performances.

- Although generally declining oil prices will boost consumer spending (as in the US), in the case of Malaysia, it may only prevent a significant erosion in consumer spending which would have taken place if pump prices were on the uptrend. This is because consumers are already overstretched by high household debt and are facing rising costs of living. On balance, we foresee private consumption growth to moderate from the 6.4% estimated in 2014 to 5.5% in 2015. On investments, we are of the view that although it will remain relatively resilient, the process of normalisation in the pace of its growth will likely continue as the government tightens its belt following a hazier outlook on the global economy as well as lower oil revenue. In addition, the leverage level of large corporations has evidently increased since 2012 with the average debt-to-EBIT (or earnings before interest and tax) levels of Bursa-listed companies (ex-financial) surging to 10.1% in 2013 from 5.6%. Such an increase would normally cause corporations to scale down their future investments as they would find it more difficult to service their debt.

- On inflation, we are the view that growth in the Consumer Price Index (CPI) will likely continue to ascend judging by several developments that will take place in 2015 – mainly the implementation of Goods and Services Tax (GST) and a possible further rationalisation of non-fuel subsidies. We think that the implementation of the GST and future non-fuel subsidies rationalisation measures will further impact consumers who will likely trim their discretionary spending in 2H2015. Experiences of other countries that implemented the GST (namely Australia, Singapore and China) suggest that consumers' reaction could be pronounced. Offsetting this, however, is the weaker domestic economy which will prevent demand-pull inflation from setting in. Overall, after taking into consideration the recent price developments in the oil market and the increase in the number of zero-rated items in the GST list, we anticipate an average inflation rate of 4% - 4.5% in 2015.

- On interest rates, while we foresee consumer prices will continue to surprise on the upside, we do not feel such a development would lead to a monetary response by Bank Negara Malaysia (BNM) as price increases will not likely be attributed to demand-pull pressures. In fact, the increase in the CPI in response to the GST implementation is likely to be a transient phenomenon and hence the CPI growth may start to subside in the following year. Notwithstanding this, two major developments are worth following; (1) the amount of capital outflows which may increase due to the narrowing interest rate gap with the US; and (2) the pace of real GDP growth which, if it remains resilient despite the headwinds faced by the economy, will risk an interest rate hike in 2015. On balance however, we are pencilling in our base case scenario of a stable rate of the Overnight Policy Rate (OPR) at 3.25% in 2015.

- Although interest rates are expected to remain unchanged and the spread between the Average Lending Rate (ALR) and Base Lending Rate (BLR) will remain relatively wide, we foresee overall lending growth to moderate in 2015 due to the lag effects of BNM's macro-prudential measures which will continue to be felt by consumers as well as because of slower economic growth which dampens demand for credit. The growth in household lending is expected to drop to below 10%, which we anticipate to be contributed by slowing personal and hire purchase loans despite a stable pace in loans growth for residential properties. Lending standards will likely be further tightened and households will continue to deleverage. Similarly, the pace in business loans growth will likely stabilise, resulting in an overall loan growth of 8.0% - 9.0% in 2015.

- On the fiscal side, the decision to remove the blanket fuel subsidy system in December 2014 was deemed as credit positive from a rating agency's perspective. The move came at a right time when global crude oil prices were hovering at a five-year low since late November 2014, thus minimising the impact on private consumption in the near term. Our rough estimate suggests that the government would be able to save about RM10-15 billion from the budgeted RM38 billion subsidy bill for 2015, hence cushioning the loss in revenue from lower oil prices.

- With regards to the impact of the recent drop in oil prices on the government revenue, we think that the overall repercussion would hinge on the sustainability of the current price (Tapis at USD65 per barrel at the time of writing). Based on global economic prospects and the long-term trend of oil prices, we view that the recent sell-offs are overdone and oil prices will rebound slightly and stabilise at around USD65-75 per barrel in 2015. Notwithstanding, we feel that oil prices of above USD90 per barrel are no longer a possible scenario, at least in the next one year. As we estimate that every USD1 drop in the price of Tapis will trim Malaysia's oil revenue by RM400-500 million, we see the task of meeting the budget deficit target of 3% of GDP becoming more challenging not only because the amount of government revenue is dropping, but also because of the shrinking value of nominal GDP in 2015. For this reason, we think that if the oil price is sustained below USD65 per barrel for a considerable period, the budget deficit target may be adjusted slightly by approximately 30 to 40 basis points (bps) above the initial target.

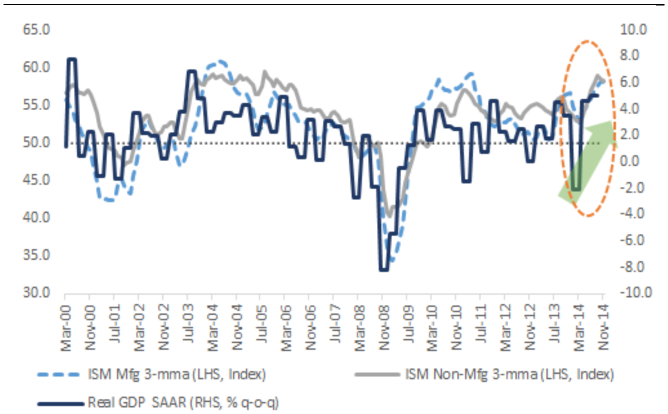
## Global economy: A wrap up for 2014

- The global economy continued to paint a mixed picture for 2014, with the US and UK economies heading for stronger growths, while the euro zone and Japan were struggling to get back on the right track. Meanwhile, China's growth slowed further, as the impact of the property market clampdown began to reverberate across the economy. In other parts of the world, the recent plunge in oil prices is taking a toll on oil exporting countries and raises the spectre of a scenario akin to the ruble crisis in 1998. Russia is now facing risks of a deeper recession than was initially anticipated in 2015 while Venezuela is grappling with a possible risk of sovereign default.

- The only economic locomotive left is the US which at this juncture remains resilient as growth is now supported by the further strengthening of its labour market, evidenced by the strongest payroll numbers since May 2010 in November 2014 and the latest GDP statistics. Its headline GDP growth for 3Q2014 was revised upward to 5%, the strongest since 3Q2003 from the earlier estimate of 3.9%, as the economy was turbocharged by stronger consumer and investment spending. In the labour market, non-farm payrolls have climbed by more than 200K per month since February 2014, marking the longest stretch of such increases since the 19 months through March 1995. The jobless rate, meanwhile, stood at a six-year low of 5.8% for a second consecutive month in November and is expected to remain so in the near term.

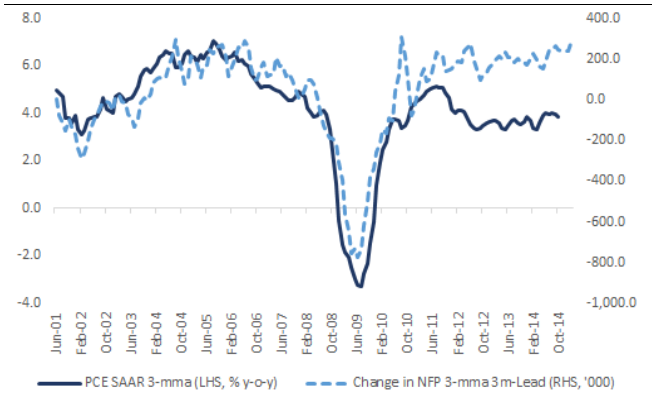
- The upbeat momentum of the ISM PMIs also bode well for the strength of the US economy, with the manufacturing index held near the strongest pace in three years, while the services measure stood close to a nine-year high in November. This has provided a reason for the Fed to effectively end their unprecedented asset purchase programme in October. As such, the focus now shifts towards the timing of an interest rate hike, although we do not foresee this to happen any time soon, especially prior to 2H2015. Moreover, the latest Fed quarterly forecast showed that officials are now projecting slower increases in borrowing costs at the end of 2015 than initially estimated in September. The statement that the Fed 'can be patient' in deciding to hike up the rates on top of the infamous 'considerable period' however suggests that policymakers are finally ready to lift up the rate from the zero level.

**Chart 1: US gdp growth and ISM PMIs**




*Source: CEIC, MARC Economic Research*

**Chart 2: US PCE and change in NFP 3-month lead**

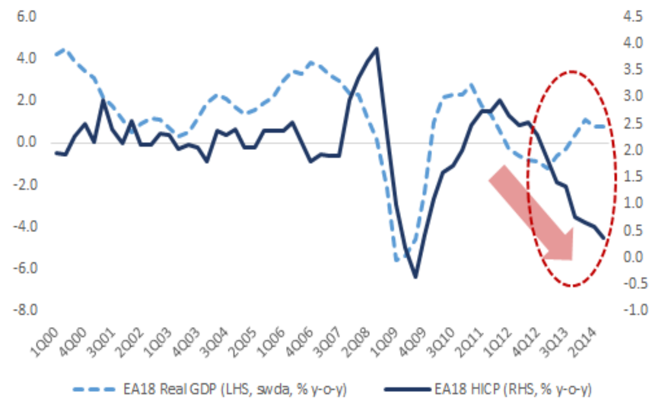



*Source: CEIC, MARC Economic Research*

- In Europe, while the UK economy has grown for seven consecutive quarters, and is set to post a stronger reading in 2015, its major export market – the 18-nation euro area – remains a key risk. The euro area as a whole is struggling due to rising disinflationary spells intensified by the recent plunge in global oil prices. Notwithstanding this, the improvement in investors' sentiment in Germany in the two months through December is expected to provide temporary support, although the overall picture remains biased towards the downside. To combat the disinflationary pressures, the European Central Bank (ECB) has introduced a so-called asset-buying programme in October, and pledged to keep its balance sheet near to the level at the beginning of 2012. As of December 12, the ECB has bought a total EUR24.8 billion of covered bonds and EUR788 million of asset-backed securities (ABS). The market is expecting the ECB to add more into its balance sheet, including government bonds in the near term. On top of that, the ECB continued with its stimulation programmes which were introduced earlier, namely the Long-Term Refinancing Operation (LTRO) and the Targeted Long-Term Refinancing Operation (TLTRO), although it has yet to yield the desired effect on bank loans.

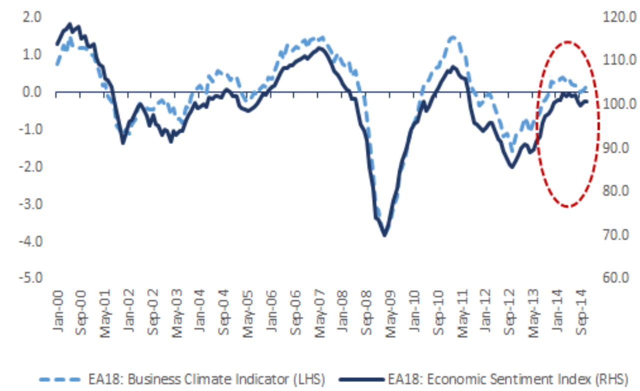
- As for Asian economies, April's sales tax hike in Japan has resulted in the country entering its fourth recession since 2008 in 3Q2014. Japan's GDP contracted at an annualised 1.9% rate in 3Q2014, threatening the success of Prime Minister Shinzo Abe's reflation programme. As a result, it prompted the government to postpone the initially planned increase in additional sales tax by 2% to April 2017 from October 2015. The inflation rate, meanwhile, has started to slow, easing for a fourth consecutive month in November, largely due to lower energy prices, hence complicating the task of achieving the official 2.0% inflation target over the near term. As for China, the economy is feeling the pinch from measures to stabilise the country's housing market. Additionally, industrial output is weakening coupled with a record-long factory-gate deflation. This resulted in a surprise move by the People's Bank of China (PBOC) to reduce the benchmark interest rate for the first time since 2012 in late November, in order to support the world's second-largest economy.

**Chart 3: Euro area GDP growth and inflation rate**



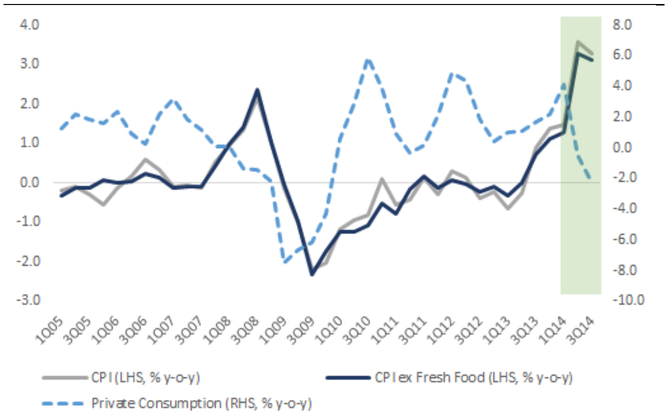

*Source: CEIC, MARC Economic Research*

**Chart 4: Euro area business climate index and economic sentiment index**



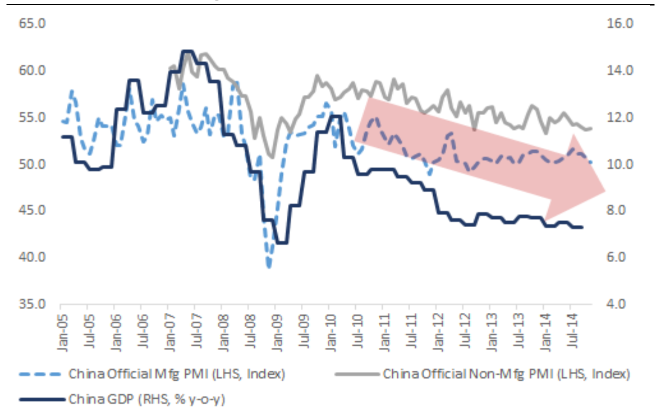

*Source: CEIC, MARC Economic Research*

**Chart 5: Japan private consumption growth and inflation rate**




*Source: CEIC, MARC Economic Research*

**Chart 6: China GDP growth and official's PMIs**



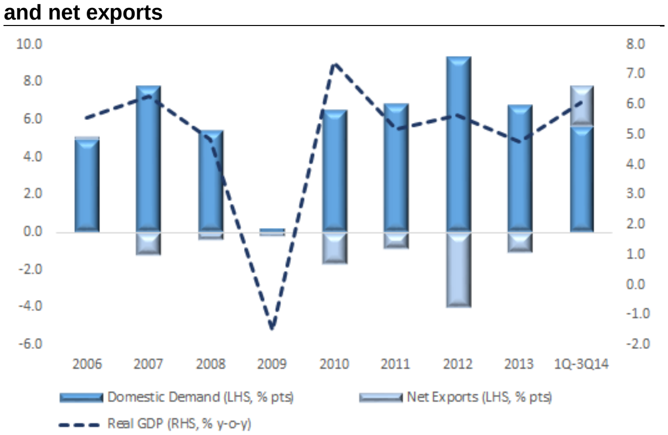

*Source: CEIC, Bloomberg, MARC Economic Research*

## Malaysian economy: A wrap up for 2014

- The 1H2014 headline GDP growth surprised the market on the upside, buoyed by the recovery of the external sector, although domestic demand continued to moderate amid rising consumer prices as well as stricter access to credit. Real GDP growth averaged 6.1% in the nine months ended September, the fastest pace since 2010, despite moderating slightly to 5.6% in 3Q2014. Growth was primarily bolstered by a rebound in net trade, which added 2.2 percentage points to the overall headline GDP during the first nine months of the year, marking its first annual positive contribution since 2006. The continued improvement in the Semiconductor Industry Association (SIA) global semiconductor sales as well as a sustained momentum in the US ISM New Orders Index also contributed to the positive performance of Malaysia's exports. Exports of manufactured goods, which accounted for more than two-thirds of total shipments, climbed at a faster pace of 9.6% in the nine months through September compared with an average 5.8% growth registered in 2013, thanks to the 10.0% increase in exports of electronics and electrical (E&E) products (2013: 3.0%). In addition, exports of major commodities also rebounded strongly with an average growth of 8.0% vis-à-vis a 3.6% decline recorded last year despite the generally lower global commodity prices after 1H2014.

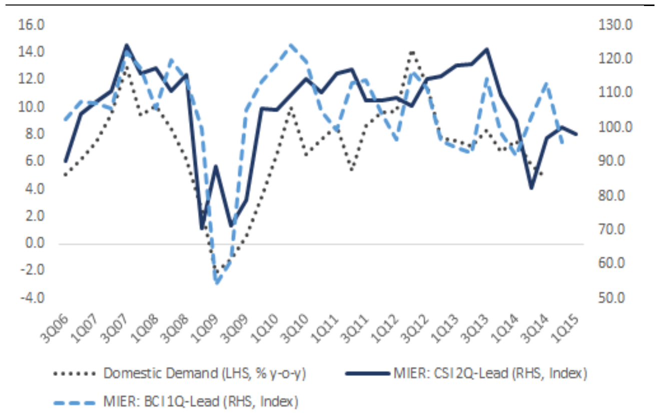
- Domestic demand, on the other hand, slowed during the three quarters through September 2014, as consumers and businesses grappled with higher inflationary pressures. In terms of contribution to the economy, domestic demand added an average 5.6 percentage points to overall growth, the least since the GFC, and lower than the 6.8 percentage points contribution in 2013. In fact, confidence among consumers has somewhat deteriorated, especially after a series of subsidy rationalisation measures imposed since late 2013. This is evidenced by the MIER Consumer Sentiment Index, which remained below the 100-point threshold in three of the four quarters through September 2014. Private consumption growth, while remaining resilient, slowed to an average of 6.8% in the three quarters ended September, from 2013's 7.2% increase. Also worth noting is the momentum in investment activities, as its growth unexpectedly eased to an average of 4.9% during the same period (2013: 8.5%), dragged down by the continued decline in public investment, as well as the moderation in private investment, especially in 3Q2014. From an average 13.1% increase in 1H2014, private investment growth almost halved to just 6.8% in 3Q2014, the weakest pace since 3Q2011, largely due to reduced outlays for the machinery and equipment category. Public investment, meanwhile, shrank at a faster pace, dropping 8.9% during the same period, marking the sixth consecutive quarterly decline (1H2014: -4.8%).

**Chart 7: Contribution to real GDP growth – domestic demand and net exports**




*Source: CEIC, MARC Economic Research*

**Chart 8: MIER CSI, MIER BCI and domestic demand growth**

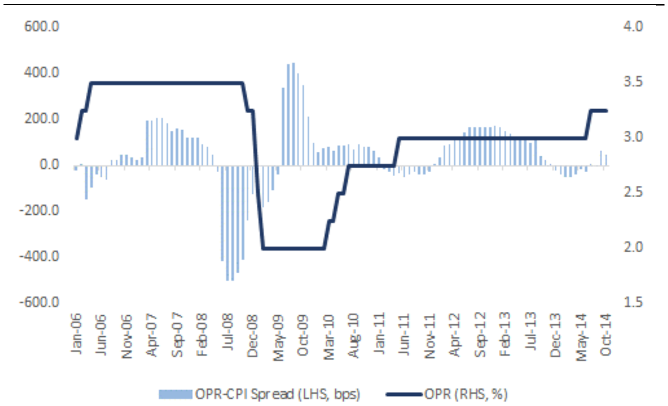



*Source: CEIC, MARC Economic Research*

- As widely expected, stronger price pressures were seen in 1H2014, with the CPI growth averaging 3.4% (2013: 2.1%), after reaching a peak of 3.5% in the two months through March. Up to November, however, the inflation rate eased slightly, averaging at 3.2% over the 11-month period as the impact of the subsidy rationalisation programme begins to fade. The inflation rate hit a cyclical low of 2.6% in September, before trending up slightly to 3.0% in November, after the government decided to increase fuel prices by 20 sen in early October. Much of the increase in the headline CPI was attributed to components with highly weighted categories, led by a 4.9% rise in transport cost, followed by a 3.4% gain in the prices of food and non-alcoholic beverages. Similarly, the cost of non-food items edged higher, doubling from the 1.4% pace in 2013 to an average 3.1% during the 11 months through November 2014.

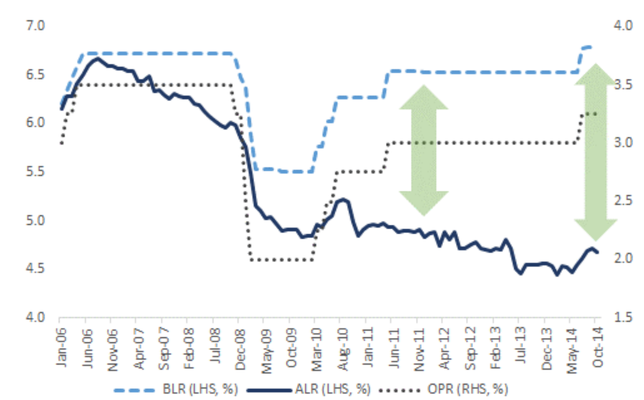
- After more than three years of an interest rate pause, the BNM finally nudged up the benchmark OPR by 25 bps to 3.25% in its July Monetary Policy Committee (MPC) meeting after considering the upside surprise in economic growth as well as stronger domestic inflationary pressures. Subsequently, the BLR went up by 25 bps to 6.78%, although the effective ALR increased by a marginal 7 bps to 4.61%. The widening spread between the ALR and BLR implies that there is stiff competition among banks such that they are still offering relatively cheap loans to the market.

**Chart 9: OPR and OPR-CPI spread**




*Source: CEIC, MARC Economic Research*

**Chart 10: OPR, BLR and ALR**




*Source: CEIC, MARC Economic Research*

- Even prior to the interest rate hike, the overall lending trend has started to moderate, suggesting that BNM's macroprudential measures have been effective. Total outstanding loan growth slowed for seven consecutive months to more than a four-year low of 8.6% in August 2014, compared to a peak of 11.0% in January 2014, before picking up slightly to 9.0% in the two months through October. The slowdown was mainly driven by the moderation in loans extended to businesses, while borrowings from the household sector continued to remain resilient. The expansion in business loans effectively slowed to a cyclical low of 5.5% in July, following the higher financing rate, as compared to a high of 9.7% at the start of 2014. Loans to the household sector, meanwhile, averaged at 11.3% in the first ten months of 2014, supported by steady lending growth for the purchase of residential properties (October 2014: 13.6%, January 2014: 13.3%). However, credit extended for the purchase of passenger cars slowed tremendously, reaching an all-time low of 2.2% in October 2014, as compared to a 6.6% increase in January 2014.

- Despite the moderation in total credit growth, the overall asset quality remained sturdy with the net impaired loans ratio at a historical low of 1.3% since the end of 2013. Additionally, the banking system as a whole remains highly capitalised as evidenced by the broad improvement in all capital ratio metrics which have been standing at a new high since August 2014. Notwithstanding this, the persistent increase in the net loans-to-deposit ratio is worth monitoring, as slower credit growth failed to offset the moderation in total deposits, extending its vulnerability to liquidity risks.

- On the fiscal side, the decision to remove the blanket fuel subsidy system in December 2014 was deemed as credit positive from a rating agency's perspective. The move came at the right time, whilst the global crude oil price was hovering at a five-year low since late November 2014, minimising the impact on consumers in the near term. In fact, the retail price for RON95 declined by four sen to RM2.26, although the price of diesel increased slightly by three sen to RM2.23. Our estimate suggests that the government would be able to save about RM10-15 billion from the budgeted RM38 billion subsidy bill for 2015, thus cushioning the loss in revenue from the lower oil price. However, if the oil price continues to be at the current low level for a prolonged period (i.e. more than six months), the impact on the overall fiscal position should not be underestimated and hence the 3.0% of GDP deficit target in 2015 may be revised accordingly.

# Outlook for 2015

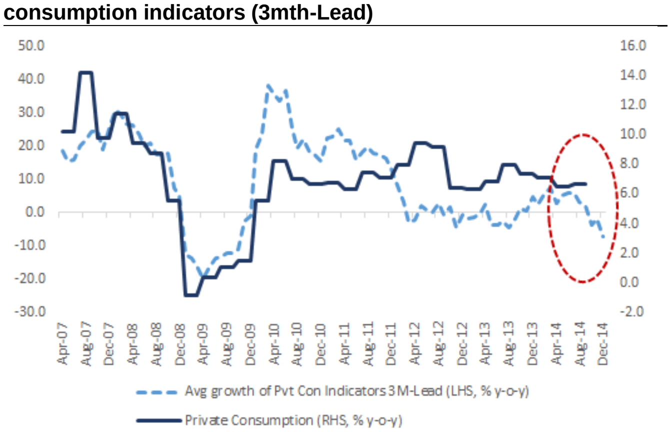
## Growth – a downward bias

- We foresee a downward trend in Malaysia's headline GDP growth in 2015 to 4.7% (our estimate for 2014: +5.8%), lower than the government's projection during Budget 2015 due to: (1) decelerating domestic demand, judging by the trend in major components of GDP, particularly for private consumption and private investment; (2) moderating pace of export performance due to the weaker global trade following uncertainties in major economies especially in Europe, China and Japan despite the continuing strength of the US economy; and (3) a lower-than-expected average oil price, which despite having a positive impact on Malaysia's inflationary landscape, will on balance, drag down corporate earnings and performances. Oil prices have had a strong correlation with Malaysia's nominal GDP (r-sq: 0.84) over the past 15 years and as such, a sustained low average price will likely shave nominal GDP and affect real GDP growth as well.

- We feel that inflation will be the key factor that will drag down consumer enthusiasm in 2015, eroding the strength of private consumption, the main pillar of domestic growth (which represents 52% of GDP). While the strength in consumer spending remained respectable in 2014, a confluence of factors which include subsidy rationalisation measures, implementation of the GST and stricter access to household credit may start to constrain its growth going forward.

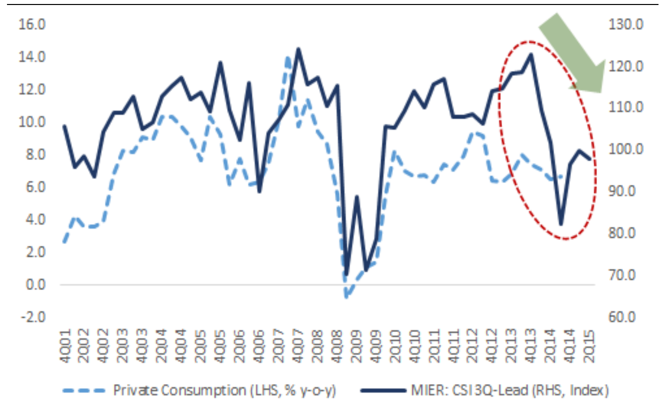
- On the flip side however, the relatively stable labour market will help prevent a sharp drop in spending. In addition, the sharp decline in oil prices may cushion the blow on consumers as businesses may choose to defer the price increases of certain goods and services. Although the generally declining oil price will boost consumer spending (as in the US), we do not see such a phenomenon emerging in Malaysia as consumers have been affected by rising costs of living in the past few years due to rising home and consumer prices. What it will likely do is prevent a significant erosion in consumer spending which would have taken place if pump prices did not decline as they did in the past one month. On balance, we foresee private consumption growth to moderate from 6.4% estimated in 2014 to 5.5% in 2015.

**Chart 11: Private consumption and ave. selected private consumption indicators (3mth-Lead)**




*Source: BNM, CEIC, MARC Economic Research*

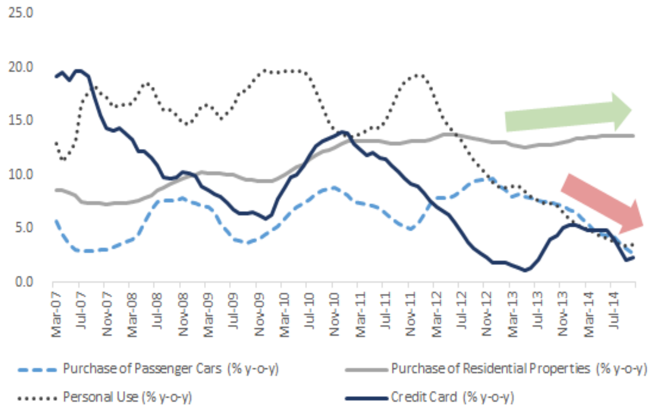
**Chart 12: Private consumption and MIER's CSI (3Q-Lead)**




*Source: CEIC, MARC Economic Research*

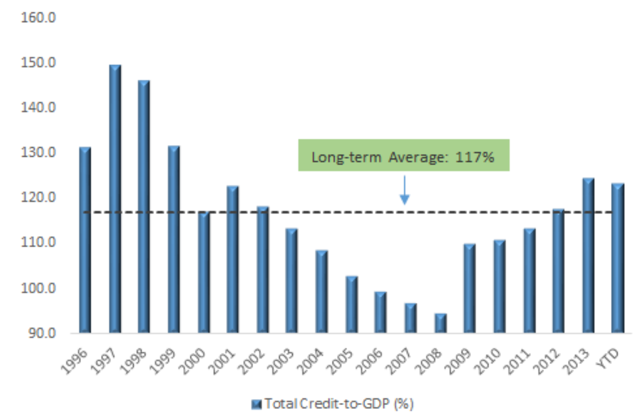
- Lending is also expected to continue to moderate in 2015 as a result of slower economic growth as well as due to the impact of BNM's macro-prudential measures which will continue to be felt by consumers. The growth in household lending is expected to decline to below 10%, which we anticipate will be contributed by slowing personal and hire purchase loans despite a stable pace in loans growth for residential properties. Lending standards will likely be tightened further and households will continue to deleverage. On the other hand, the pace in business loans will likely stablise, growing by 6.0% - 7.0%, while the overall loan growth is anticipated to be in the range of 8.0% - 9.0% in 2015.

**Chart 13: Lending growth by different purposes (3-month moving average)**




*Source: CEIC, MARC Economic Research*

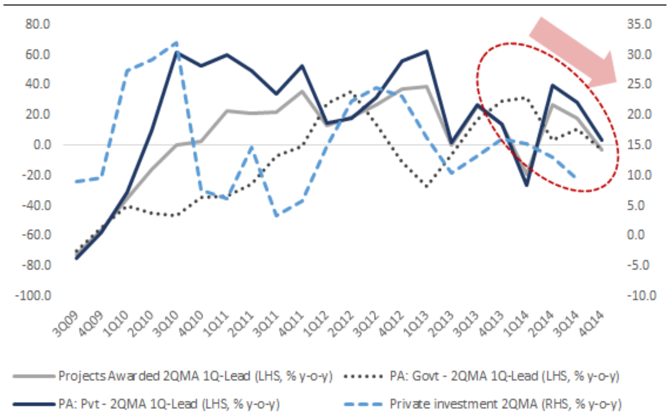
**Chart 14: Credit-to-GDP and LT average (excluding non-banks)**




*Source: CEIC, MARC Economic Research*

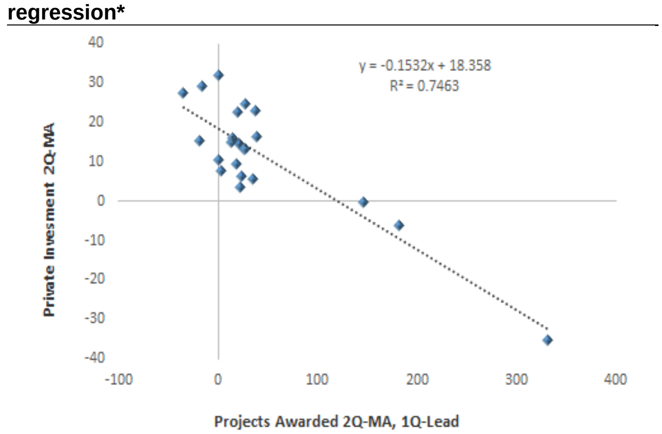
- As for investments, its contribution will be critical to the headline growth in 2015 given that private consumption growth is decelerating. Based on the recent trend however, the process of normalisation in the pace of private investment growth will likely persist as the government tightens its belt following a hazier outlook on the global economy as well as lower oil revenue due to slumping oil prices. The trend in projects awarded also indicates a softening pace in private investment growth (chart 15). As the number of projects awarded closely correlates with the pace of private investment, we foresee the growth of private investment to moderate in tandem (chart 16). Another critical factor is the leverage level of large corporations which has evidently increased significantly since 2012. Based on the average statistics, the debt-to-EBIT levels of Bursa-listed companies (ex-financial) have climbed to 10.1% in 2013 from 5.6%. Such an increase would normally cause corporations to scale down on their future investments as they are now finding it more difficult to service their debt.

**Chart 15: Private investments and projects awarded (1Q-Lead)**



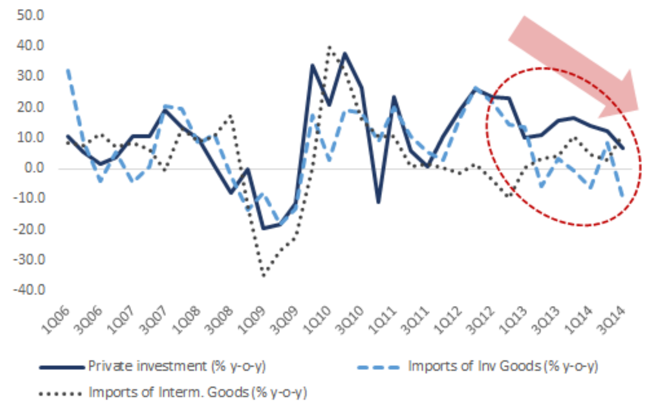

*Source: CEIC, MARC Economic Research*

**Chart 16: Private investments and projects awarded (1Q-Lead) – regression***




*Source: CEIC, MARC Economic Research*
**Ex-outliers (3Q-4Q2009)*

**Chart 17: Private investments and imports of invesment and intermediate goods**

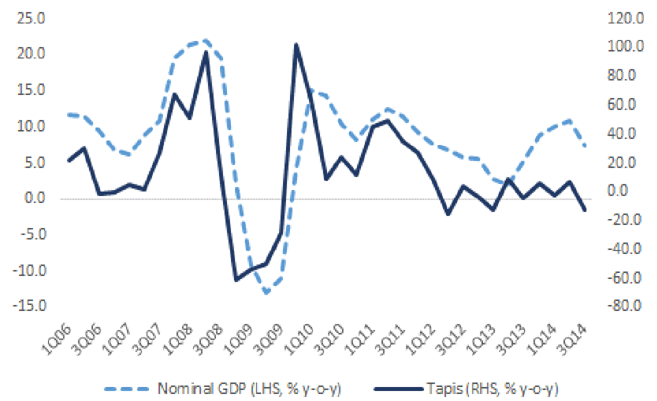



*Source: CEIC, MARC Economic Research*

**Chart 18: Debt-to-EBIT of Bursa listed companies (ex-financials)**

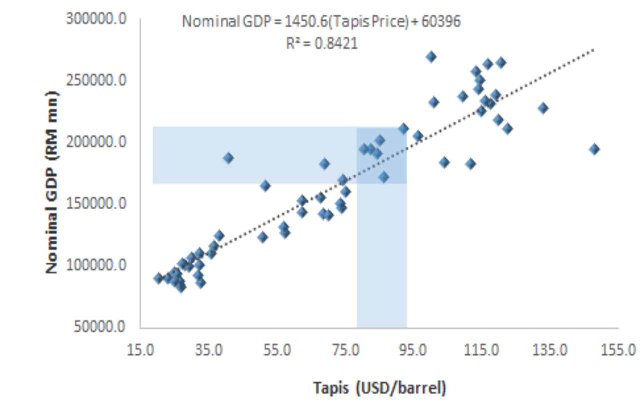

*Source: Bloomberg, MARC Economic Research*

**Chart 19: Annual change in nominal GDP and Tapis price**




*Source: Bloomberg, CEIC, MARC Economic Research*

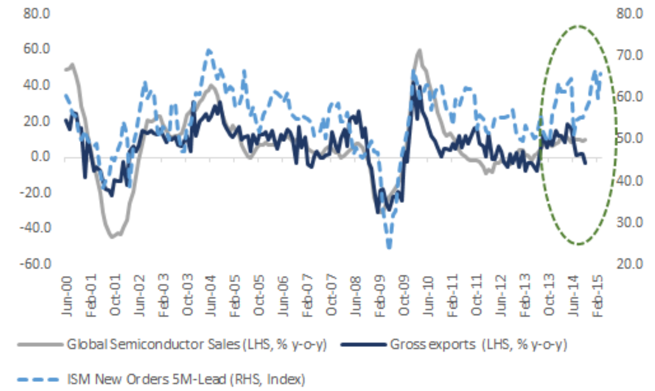
**Chart 20: Nominal GDP and price of Tapis (scatter)**




*Source: Bloomberg, CEIC, MARC Economic Research*

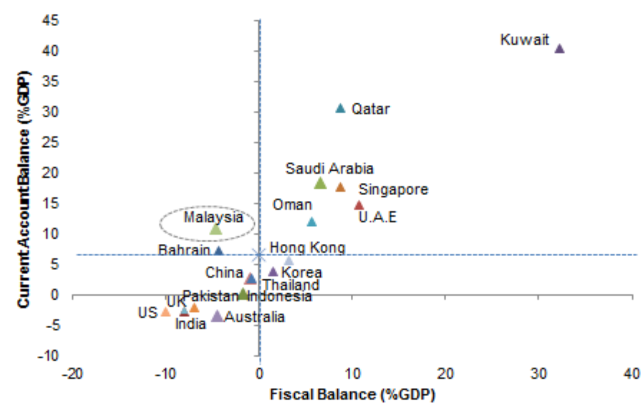
- Externally, exports will move in tandem with the global economic momentum which is supported by the increasing strength of the US economy despite the economic malaise in Europe as well as mediocre performances of China and India. The rising trend in the US ISM manufacturing index is a positive for Malaysian exports and demand for E&E products is expected to remain stable although the semiconductor book-to-bill ratio (BTB) has declined to below the unitary level since September 2014. Notwithstanding, the current weakness in commodity prices is a concern as commodity exports represent about 20% of total exports (palm oil and oil & gas). Oil prices, which are anticipated to be in the range of USD65-75 per barrel in 2015, will dent Malaysia's trade balance and hence trim the current account (CA) to approximately 3.5% to 4.5% of GDP, causing some concerns over the possibility of incurring twin deficits as experienced by India and Indonesia. On balance, we foresee real exports to register a less robust growth of 3.3% in 2015.

**Chart 21: US ISM New Orders 5-mth lead, SIA global semiconductor sales and Malaysia's exports growth (scatter)**




*Source: SIA, CEIC, MARC Economic Research*

**Chart 22: CA and budget deficit matrix of selected countries (5-year median)**




*Source: IMF, MARC Economic Research*

**Table 1: Real GDP growth on the demand side**

| Growth (%y-o-y) | 2010 | 2011 | 2012 | 2013 | MARC | | MoF | |
|---|---|---|---|---|---|---|---|---|
| | | | | | 2014E | 2015F | 2014E | 2015F |
| GDP | 7.4 | 5.2 | 5.6 | 4.7 | 5.8 | 4.7 | 5.5 - 6.0 | 5.0 - 6.0 |
| Domestic Demand | 7.7 | 8.1 | 10.7 | 7.4 | 6.5 | 5.3 | 6.4 | 6.2 |
| Private Consumption | 6.9 | 6.9 | 8.2 | 7.2 | 6.4 | 5.5 | 6.5 | 5.6 |
| Public Consumption | 3.4 | 16.2 | 5.0 | 6.3 | 5.4 | 3.3 | 2.1 | 3.8 |
| Private Investment | 18.4 | 9.4 | 22.8 | 13.1 | 12.8 | 8.4 | 12.0 | 10.7 |
| Public Investment | 4.9 | 2.6 | 14.6 | 2.2 | -1.1 | 1.4 | 2.6 | 4.7 |
| Real Exports | 11.1 | 4.5 | -1.8 | 0.6 | 6.0 | 3.3 | 3.5 | 2.1 |
| Real Imports | 15.6 | 6.2 | 2.5 | 2.0 | 5.9 | 4.9 | 3.5 | 4.0 |

*Source: CEIC, MoF, MARC Economic Research.*

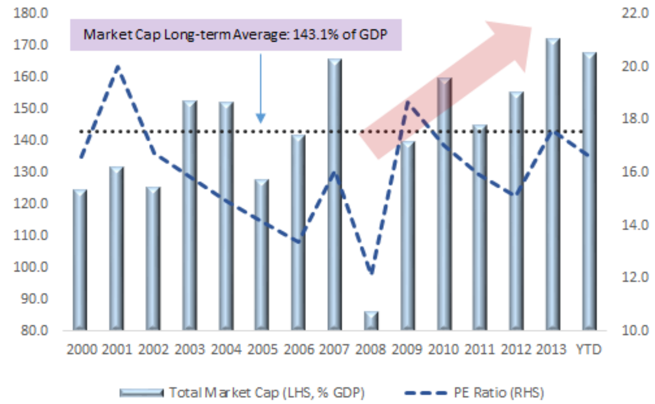
## Consumer and asset inflation

- Inflation will once again be a variable that will be closely monitored in 2015. After spiking by an estimated 1.1-percentage point in 2014, CPI will likely continue to ascend judging by several developments that will take place in 2015 – mainly the implementation of the GST and a possible further rationalisation of non-fuel subsidies. While declining pump prices are generally positive for consumer spending as seen in the US, declining prices of RON95 and diesel will not significantly boost consumer enthusiasm as consumers are already overstretched with high household debt and are at the same time facing rising costs of living. On the other hand, the implementation of the GST and future non-fuel subsidies rationalisation measures will further impact consumers who will likely trim their discretionary spending in 2H2015. The experience of other countries that implemented the GST (namely Australia, Singapore and China) suggests that consumers' reaction could be pronounced. Offsetting this however, is the weaker domestic economy which will prevent any demand-pull inflation from setting in.

- Based on the experience of some countries that implemented the GST, CPI climbed significantly in the first year of implementation. In Australia, inflation averaged 6% in the one year period post-GST compared with an average of 1.8% in the two-year period pre-GST. Similarly in China, inflation shot up to 24.2% post-GST from an average of 10.5% while in Singapore, CPI growth accelerated to 5.4% from an average of 0.8% when the GST rate was revised upwards to 7% in July 2007. Arguably for Malaysia, the increase should be cushioned by the fact that the number of zero-rated items has been increased. Our view, however, is that while zero-rated items can to some extent help prevent prices from escalating, it will not totally prevent businesses from raising prices especially if the Price Control and Anti-Profiteering Act 2011 is not strictly enforced. Overall, after taking into consideration the recent price developments in the oil market and the increase in the number of zero-rated items, we tweak our average inflation forecast for 2015 to 4.0% - 4.5%.

- Asset prices which have remained elevated in the past few years due to a massive buildup in liquidity will likely start to moderate especially for equities. The recent correction in the FBM-KLCI is not surprising if one were to assess the market based on fundamentals. On hindsight, the sharp increases in its price earnings ratio (P/E) and market capitalization-to-GDP since 2008 seem to have suggested that a correction was imminent. However, the latest steep correction came as a result of plunging oil prices which sparked the fear of a lower-than-expected government revenue, potentially derailing efforts to achieve a budget deficit target of 3% in 2015. In addition, concerns have also emerged on the possibility of the economy plunging into twin deficits as the CA surplus narrows on the back of declining exports. As for the property market, the slowdown in the pace of price increases in several states suggests that the moderation will continue. In addition, slower property sales growth in the recent quarters provide a similar scenario on the near term outlook of the sector.

**Chart 23: KLCI market capitalisation-to-GDP ratio and PE ratio**




*Source: Bloomberg, MARC Economic Research*

**Chart 24: Property sales growth**


*Source: CEIC, MARC Economic Research*

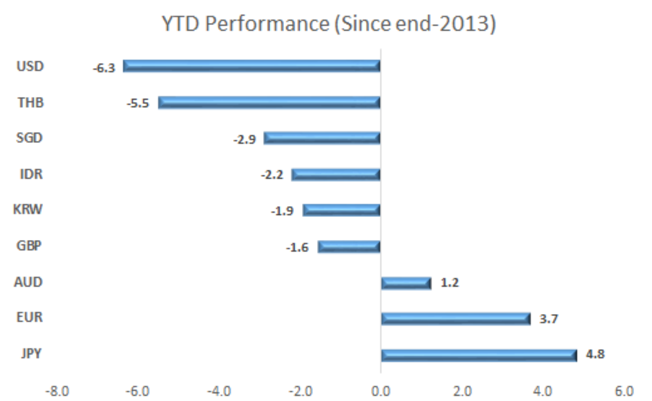
## Monetary-fiscal policies and ringgit

- Although we foresee consumer prices will continue to surprise on the upside, we do not feel that such a development would call for a monetary response as the increase will not likely be attributed to demand-pull pressures. In fact, the increase in the CPI in response to the GST implementation is likely to be a transient phenomenon and the inflation rate may start to subside in the following year. Experiences in Australia, China and Singapore suggest that inflationary pressures lasted only one to two years. Given that Malaysia plans to have more zero-rated items, we foresee the initial increase in the CPI will last only for a year. As such, the BNM is not expected to raise the OPR in order to diffuse any inflationary pressure in 2015.

- Notwithstanding the above scenario, two major developments are worth following. First is the amount of capital outflows which may induce speculations about a possible rate hike in 2015. Such an incident happened before in late 2005 where massive amounts of capital outflows (amounting to approximately RM19.5 billion) induced by the 'measured pace" increases in the FFR led to an OPR hike in early 2006. If such a scenario unfolds again following the expected narrowing in the interest rate gap between Malaysia and the US and the concern over Malaysia's growth profile in 2015, more capital outflows may take place, exerting pressures on the ringgit. This may induce speculations that the BNM will raise the OPR in 2015. Secondly, if for some reason (i.e. strong consumer spending and a significant rebound in investment momentum) real GDP growth remains resilient despite the headwinds faced by the economy, then there is a risk of an interest rate hike in 2015. On balance, we are pencilling in our base case scenario of a stable rate of OPR at 3.25% in 2015.

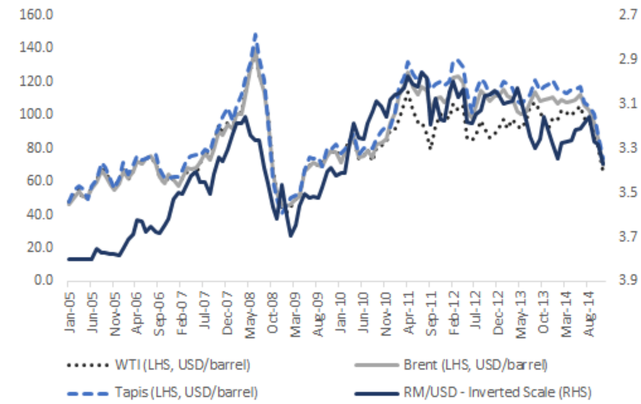
- With the Brent oil price plunging to below USD60 per barrel (at the time of writing, Brent is priced at USD59 per barrel and Tapis is priced at USD65 per barrel), there is deep concern that the government's revenue would be lower than what was projected during Budget 2015 as the amount of oil-related income, which accounts for roughly 30% of total revenue, will be adversely affected. We estimate that for every USD1 drop in the price of Tapis, Malaysia's oil revenue will decline by RM400-500 million. However, based on global economic growth and the long-term trend of oil prices, we view that the recent sell-offs are overdone and oil prices will rebound slightly and stabilize around USD65-75 per barrel in 2015. On balance, we foresee that the task of meeting the budget deficit target of 3% of GDP will become more challenging especially as not only is the amount of government revenue dropping, but also because the nominal GDP which will likely decline in 2015. For this reason, we are of the view that if the oil price is sustained below USD65 per barrel for a considerable period, the budget deficit will rise slightly by approximately 30 to 40 bps above the initial target. This is after taking into account the additional revenue to be collected from the GST and the savings that arise from the abolishment of fuel subsidies.

**Chart 25: Ringgit against selected currencies (year-to-date performance since end-2013)**




*Source: Bloomberg, MARC Economic Research*

**Chart 26: Ringgit and global oil prices**




*Source: Bloomberg, MARC Economic Research*

- Recent developments in the US are undoubtedly negative for the currencies of commodity exporters including Malaysia. The weakness of the ringgit against the USD is attributed to both external and internal factors. Externally, the moderating export sector's performance following uncertainties in major economies such as Europe, Japan and China is curbing global demand for Malaysian electronics and commodity exports. A general drop in the value of commodity exports as a result of declining prices is also weighing on Malaysia, trimming its trade balance and hence the CA surplus. A shrinking CA surplus on the back of possible increase budget deficits in 2015 will not augur well for the ringgit.

- Domestically, slower economic growth momentum on the back of a softer domestic demand and higher consumer prices will also induce investors to re-balance their portfolio by reducing their exposures to ringgit-denominated assets. In addition, the anticipation of an earlier-than-expected hike in the FFR, if it materialises, would be negative for the ringgit. As Malaysia has a high proportion of foreign holdings of Malaysian Government Securities (MGS), a portfolio rebalancing may lead further sell-offs hence preventing a quick recovery of the ringgit against the USD in the near term. Based on the past relationship between the ringgit and oil prices, and assuming a slight recovery of global crude oil prices, we foresee an average Tapis price of USD65-75 per barrel to be consistent with the ringgit-USD exchange rate of roughly RM3.30 – 3.40.

- As for ringgit cross-rates, we anticipate that the MYR-AUD would remain favourable as Australia would be impacted more significantly by the drop in commodity prices. Against the EUR, the spectre of further monetary easing by the ECB would likely cause the MYR-EUR to be more or less stable at the current level of RM4.20-4.50. On the other hand, the MYR-SGD is expected to be less favourable as Singapore's economy is not expected to be impacted too significantly by the commodity price rout.

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Published and Printed by:

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