Economic Research

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

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: ER/006/2015

2H2015 Economic Outlook: Veritable Challenges Ahead

Economics Research Led By:

Nor Zahidi Alias
Chief Economist
+603 2082 2277
zahidi@marc.com.my

In a nutshell

- The global economy sailed through some rough seas in 1Q2015, shaken by the crisis in Greece as well as persistent weaknesses in China and other emerging economies. Admittedly, however, there were pockets of positivity in the euro zone, as seen in the region's latest gross domestic product (GDP) growth performance. Growth has slowly improved and fears of deflation have dissipated following the European Central Bank (ECB)'s bond-buying programme. Notwithstanding this, anxieties over the repercussions of a possible 'Grexit' have put the financial market on a veritable rollercoaster ride. As for China, the pressure on headline growth persists, compounded by recent weakening of inflation numbers and increasing risk of corporate defaults. China's economic woes are now affecting Asian exporters, Malaysia included. As for Japan, 1Q2015 economic growth provided some respite that helped offset China's weakening growth momentum. Evidently, the relatively weak yen continued to support businesses and the economy in general.

- Global support, however, came from the United States (US), whose solid labour market conditions continued to offset the impact of adverse weather conditions and the strong US dollar (USD) in 1Q2015. While the economy unexpectedly contracted in the first three months of the year, the overall momentum in the labour market remained upbeat, with the jobless rate in May standing at almost a seven-year low. The fact that consumer spending growth remained above 2% annualised pace in 1Q2015, despite a contraction in headline GDP, suggests that private consumption will likely continue to play a vital role in the overall expansion in 2015. The wildcard, however, is the impact of an eventual rate hike by the US Federal Reserve (Fed) on the economy, especially when inflation remains distant from its 2% goal and the USD is exerting downward pressure on its net trade.

- On the local front, while Malaysia's GDP growth was commendable in 1Q2015, it was largely the result of a sustained momentum of domestic demand, which we envision will slow down in 2H2015. Apart from the pre-Goods and Services Tax (GST) spending, private consumption was also underpinned by a low inflation rate, following reductions in fuel prices between December 2014 and February 2015 as a result of a slump in global crude oil prices. On an overall basis, private consumption's contribution in 1Q2015 accelerated to 4.6 percentage points, compared with an overall contribution of 3.6 percentage points in 2014. Another positive development in 1Q2015 was the pace of investment, which picked up compared with 4Q2014. The momentum of private investment continued to be sustained by different mega projects and flows of foreign direct investment (FDI) which, to some extent, benefited from the weak ringgit.

- Trade performance continued to remain lacklustre, judging by statistics in the first four months of 2015. The culprit is none other than a slump in oil and oil-related exports on the back of weak crude oil prices (despite a recent rebound), and sluggish palm oil prices. The overall lacklustre export performance also reflects the challenging international trade environment, which might persist until the end of the year as the global economy (save for the US) struggles to find its footing. Of significant concern is the declining economic growth rate of China, Malaysia's major market, as a result of stringent measures imposed by the government to alleviate macroeconomic imbalances.

- Going forward, we anticipate private consumption growth to moderate due to stronger inflationary pressures and a higher base effect. There is also a possibility of higher unemployment in view of staffing cutbacks in the oil and gas, airline and banking industries. Although retrenchment statistics have not demonstrated a marked increase, we believe the labour market will be somewhat softer in 2H2015. While the overall impact on spending power might not be very significant, weaker sentiment will cause consumers to become more cautious in their spending. Access to credit is another factor that will likely moderate consumer spending. More stringent lending standards have resulted in a single digit-loan growth for the household sector (9.9% in December 2014), the first time since the economy got out of the recession in 2009. As such, on balance, we maintain our consumer spending growth forecast of 5.5% for 2015 against 7.0% in 2014.

- The trade performance outlook for the rest of the year is less inspiring. While last year's growth was aided by a positive contribution from the external sector, this year's prospects are clouded by the near-term trend of Malaysia's major commodity exports, i.e. crude oil, liquefied natural gas (LNG) and palm oil. While

Malaysia is not a major net exporter of crude oil, exports of LNG are relatively huge; and global gas prices are currently on a downward trend. We draw comfort from the more promising outlook of palm oil prices, based on expectations of an El Niño occurrence which could support palm oil prices in 2H2015. The prospects for the electrical and electronics (E&E) sector remain fluid as reflected in the growth of its exports, averaging 4.2% in the four months ending April 2015 (1H2014: 13.1%). A stronger pick-up in global demand, particularly from major economies (US, Europe and China), are needed to ensure further recovery in 2H2015.

- All in all, we maintain our overall GDP growth forecast at 4.7% for 2015 (from 6% in 2014) on an expected moderation in both domestic and external demand. Despite this, we expect investments in mega projects related to the Economic Transformation Programme (ETP) will continue to flow into the economy to shore up economic growth in the near term. In the financial market, we also foresee lending growth to soften further, averaging at 8-9% in 2015 as demand for consumption-related credit continues to weaken. The risks to our growth outlook, however, will be the repercussions of GST on consumer spending, sharp reversals in oil prices, and stronger external shocks that may affect Malaysia's export sector.

- Inflation remained muted in the first five months of 2015, largely attributed to benign crude oil prices which translated into lower domestic pump prices. Transport was the primary component that dragged down the Consumer Price Index (CPI) in the Jan-May period, pushing headline inflation to 1.2%. Overall, slower growth of the CPI in the first five months was also attributed to weak consumer sentiment, as evidenced by a third consecutive decline and the lowest reading in six years in the Malaysian Institute of Economic Research (MIER) Consumer Sentiment Index (CSI) in 1Q2015. Going forward, the pace of inflation would hinge on several main factors: (1) fuel prices, which will depend on global crude oil prices; (2) the impact of GST on consumer spending; and (3) overall labour market conditions. Given the muted inflation readings in the early part of the year, we are revising our full-year CPI forecast to 2.5-3.0%, although we also foresee slightly higher inflationary pressures in 2H2015.

- The Overnight Policy Rate (OPR) has been maintained at 3.25% for 12 months and will likely remain unchanged for the whole year. Although there is currently downward pressure on growth, we think that Bank Negara Malaysia (BNM) will resist taking more accommodative measures at this juncture for several reasons: (1) monetary policy has its limits because financial institutions are reluctant to take risks if they foresee overall economic sentiment deteriorating; (2) fiscal expenditure might still be used to support growth. Based on past trends, development expenditure was not fully utilised; (3) financial imbalances do not induce BNM to take accommodative monetary measures. Lowering interest rates at this juncture would only contradict BNM's efforts to address the problem of high household debt in Malaysia; and (4) lowering the interest rate will further dent the sentiment on the ringgit and might cause sharp capital flow reversals.

- As for the ringgit's performance against the greenback, we think that it hinges on several factors: (1) the outlook of global crude oil prices which influences Malaysia's ability to achieve its targeted budget deficit reduction in the medium term; (2) the near-term trend of current account (CA) surpluses, given that Malaysia is already incurring budget deficits; a sharp reduction in CA surpluses could lead to speculation that a twin deficit is on the cards; (3) the possible rate hike in the US which will influence the direction of capital flows in this region, Malaysia included. As foreign holdings of Malaysian government bonds are relatively high, a reversal in capital flows will naturally affect the ringgit's performance against the USD. All these factors have capped the ringgit's upside at this juncture. We think that RM3.80 per USD is a critical psychological support level, which, if broken, could lead to temporary weakness in the near term.

Global Economy

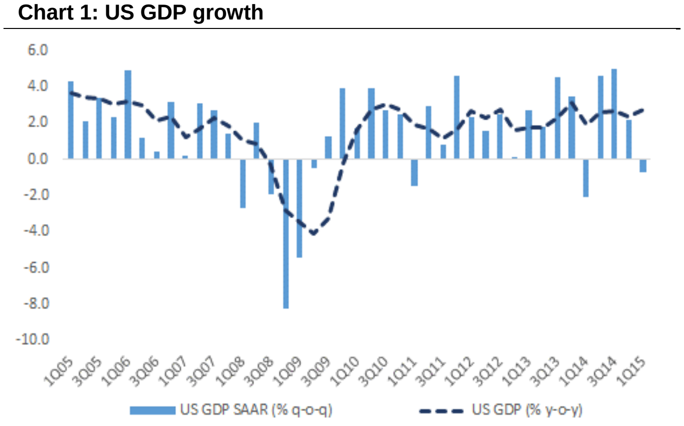
Renewed global headwinds

- The global economy sailed through some rough seas in 1Q2015, shaken by the crisis in Greece as well as persistent weakness in China and other emerging economies. Although the euro economy is flashing some positive signs amid a recovery in business and consumer sentiment, the anxiety over the repercussions of a possible 'Grexit' have put the financial market on veritable rollercoaster ride. Notwithstanding this, the weak euro currency resulting from ECB's bond-buying programme has somewhat supported the region's economy, sustaining its GDP growth at 0.4% in 1Q2015, the same as in the earlier quarter. In Asia, China's increasing economic woes continued to unfold judging by the anemic pace of inflation and weak fixed asset investments. With GDP growth potentially slipping below 7%, China's monetary stance will likely continue to be accommodative in the near term. In Japan, 1Q2015's growth provided a respite and helped to offset the impact of weakening growth momentum in China.

- The good news, however, is the US economy which remains a global growth locomotive, supported by a solid labour market despite the apparent effects from the adverse weather conditions and strong dollar on its economy in 1Q2015. The overall strength of the US economy continued to be underpinned by the improvement in the non-farm payroll (NFP) which raised the odds on the timing of the first interest rate hike in nine years. While the economy unexpectedly contracted at an annualised 0.2% quarter-on-quarter (q-o-q) pace in the first three months of the year, the overall momentum in the labour market continued to remain upbeat, with a jobless rate of 5.5% in May, a shade higher than the seven-year low of 5.4% registered in the preceding month. Consumer spending has been largely supported by relatively cheap pump prices which have boosted consumers' real disposable income. The fact that consumer spending growth has remained above 2% in 1Q2015 despite a contraction in the headline GDP suggests that private consumption will likely continue to play a vital role in the overall expansion in 2015.

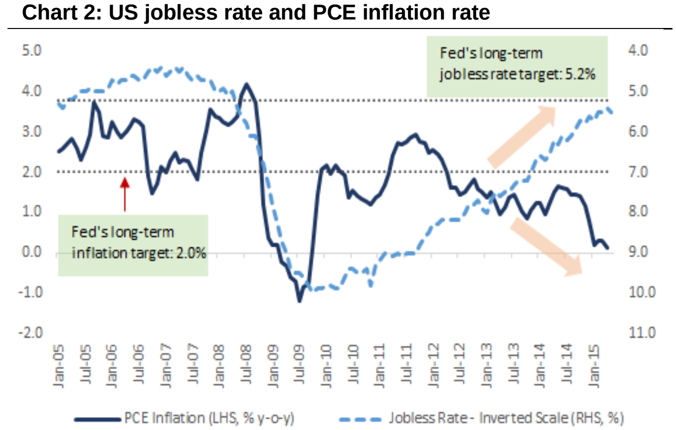
- Notwithstanding this, the negative aspect of the economy is reflected in the Fed's preferred inflation gauge, which remains a distance from its 2% goal. Both the headline and core measure continued to drift lower, rising by only 0.2% and 1.2% respectively in May, thanks to a decline in energy prices. Adding to this is the appreciation of the USD which acts as a major drag on economic growth as it reduced export competitiveness. This is reflected by the recent ISM new orders index, a proxy for future exports, which averaged at 53.3 points in the first five months of the year, about 6 points lower than the 2014 average, suggesting weak prospects for exports in the months ahead.

Chart 1: US GDP growth



Source: CEIC, MARC Economic Research

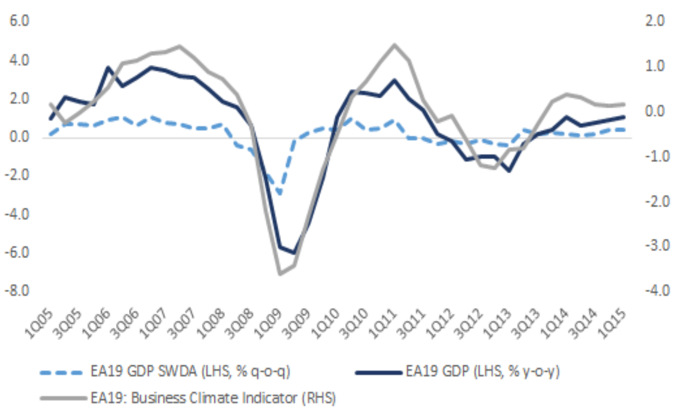
Chart 2: US jobless rate and PCE inflation rate



Source: CEIC, MARC Economic Research.

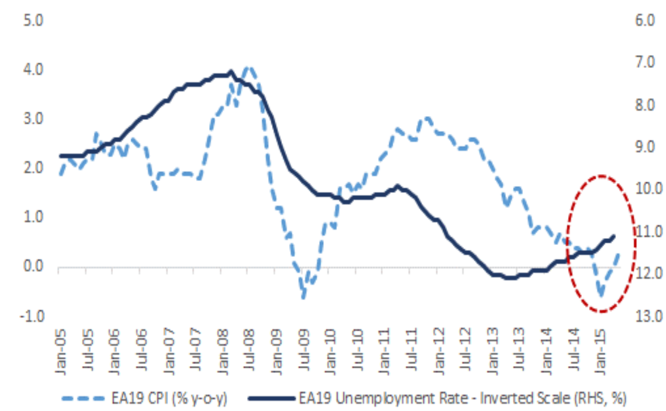
- In Europe, while Greece is still making numerous efforts to reach a deal with its creditors, the euro zone economy continued to gather steam as evidenced by the recent quarterly economic growth performance. The economy remained on a steady growth path, expanding 0.4% q-o-q in 1Q2015, the same as in the preceding quarter, and up 1.1% from a year earlier, slightly faster than 4Q2014's 0.9% increase. The massive quantitative easing undertaken by the ECB seems to have paid off for the time being, with inflation now in positive territory, rising 0.3% year-on-year (y-o-y) in May compared to a 0.3% drop in the three months through March. Similarly, confidence among businesses and consumers is on the rise, supported by low commodity prices and a weaker euro. Notwithstanding this, pockets of vulnerability remain, particularly over the issue of a possible exit by Greece from the currency bloc, should it fail to seal an agreement with its creditors. Meanwhile, the unemployment rate, especially youth unemployment, remains stubbornly high, although improving slightly, raising the probability of hysteresis which could pose a serious threat to the region's long-term economic prospects.

Chart 3: Euro area GDP growth and business climate indicator



Source: CEIC, MARC Economic Research.

Chart 4: Euro area CPI growth and unemployment rate



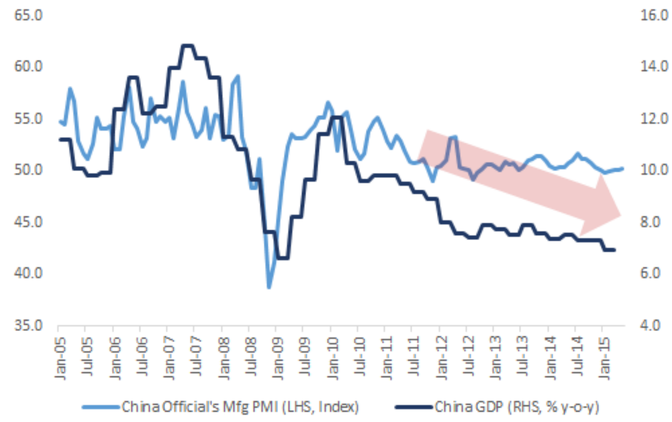
Source: CEIC, MARC Economic Research.

- As for China, the news has not been good; in 1Q2015, the Chinese economy expanded 7% y-o-y, the slowest quarterly growth since 2009. As this affords China little cushion to hit its 2015 government-set growth target of 7%, the lowest level in about a quarter-century, the pressure is on policymakers to ease fiscal and monetary policies to stimulate economic growth but without boosting leverage and fueling more overcapacity, especially in sectors like real estate and heavy industry. In May 2015, the official Purchasing Managers' Index (PMI) climbed marginally higher to 50.2 points, a six-month high; however, it remains far below last year's high of 51.7 points. The non-manufacturing PMI, on the other hand, slipped to 53.2 points, the lowest since December 2008, indicating a slower pace of expansion. Infrastructure investment, the heart of the economy, is declining. After disappointing trade and inflation data, the People's Bank of China (PBOC) shaved a quarter of a percentage point off benchmark lending and deposit rates at end June, the fourth time it cut interest rates in six months.

- The latest inflation data shows that inflation in 2015 could fall well below Beijing's target of around 3%, on account of subdued demand and low oil prices. In May, the CPI rose 1.2%; for the January to May period, overall consumer prices were up by 1.3% on average over the same period last year. The bigger problem is with the producer price index, often regarded as a leading indicator for consumer prices. In May, producer prices deflated for a 39th consecutive month after it fell 4.6%, the same as in the preceding two months. It is obvious that the fear of disinflation, even deflation, was what prompted the central bank to cut interest rates four times in six months.

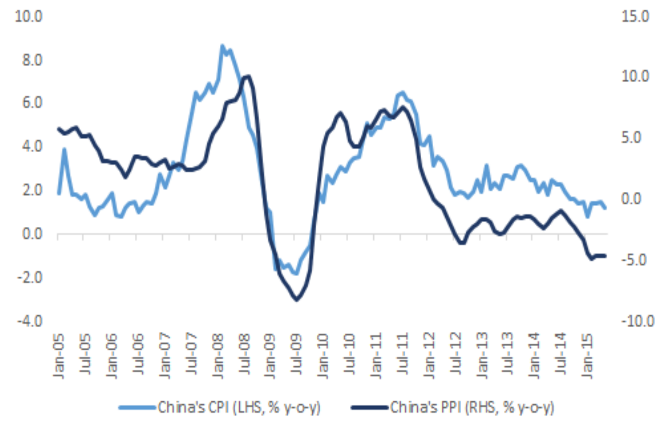
- We see growth slowing down further for the rest of the year. The Chinese economy is likely to fall short of reaching its 2015 growth target of 7%. Growth is being constrained by rising debt which, while limiting fiscal space to boost the economy, is forcing China to use a lot of resources to repay and roll over debt. Slowing demand overseas for China's exports continues to be a stumbling block, and China's efforts to keep the yuan from depreciating in value have also not helped.

Chart 5: China official's manufacturing and real GDP growth



Source: CEIC, Bloomberg, MARC Economic Research.

Chart 6: China's CPI and PPI growth



Source: CEIC, MARC Economic Research.

Malaysian Economy

Growth – internal and external challenges ahead

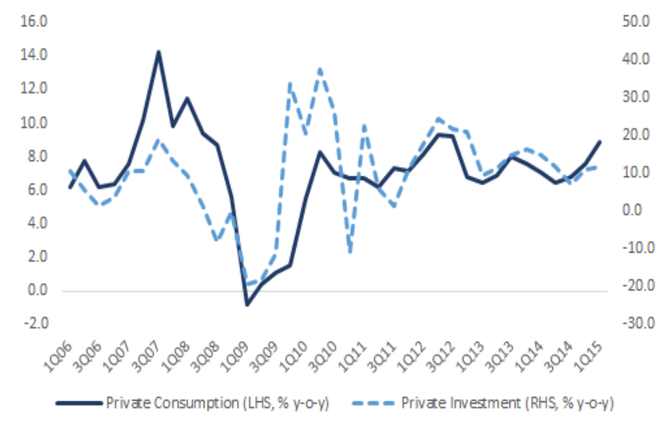
- GDP growth was decent in 1Q2015, but was largely the result of a sustained momentum in domestic demand, especially consumer spending which benefitted from expenditures related to pre-GST and flood relief by the government. This has, to some extent, offset the lackluster pace of trade performance resulting from weaker global demand on softer US economic growth as well as lingering uncertainties in the euro economy. Investment also picked up pace, expanding by 7.9% after a lackluster 4.3% expansion in 4Q2014. Private investment continued to be sustained by implementations of different mega projects and flows of foreign direct investment (FDI) which to some extent benefitted from the weaker ringgit.

- Apart from pre-GST spending, private consumption was also underpinned by the low inflation rate, following reductions in fuel prices since December 2014 as a result of a slump in global crude oil prices. Prices of Brent hit a low of USD46.6 per barrel in January, triggering a total reduction of 60 sen and 50 sen in petrol and diesel prices respectively until February 2015. Prices have since been revised upward (most recently in June by 10 sen per litre to RM2.05 for both RON95 and diesel) following a rebound in crude oil prices by approximately 41% by end of May from its low. Overall, private consumption contribution in 1Q2015 accelerated to 4.6 percentage points compared with an overall contribution of 3.6 percentage points in 2014.

- Total investments continued to register a commendable growth, supported by private investments which accounted for 68.5% of the total amount in 1Q2015. In general, private investments were supported by investments in the manufacturing and services sectors. In addition, the continuing implementation of mega projects, mainly related to the transport sector, is sustaining the momentum of private investment. Adding to this is the positive flow of FDIs which benefitted from the lower ringgit-USD exchange rate. FDIs rose to RM9.9 billion in the first three months of 2015, a decent performance considering the uncertainties that lingered in the global economy. The ringgit has depreciated 4.3% in the year-to-date (YTD) against the greenback, and by 1.6% on a trade-weighted basis.

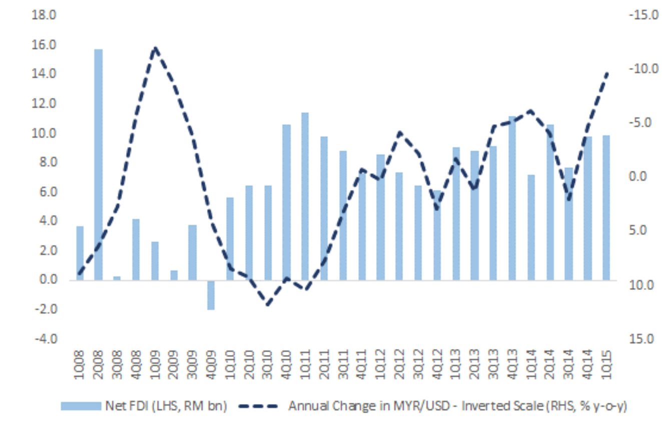
- Trade performance continued to remain lackluster as evidenced by April's statistics which showed that overall exports contracted by 8.8% y-o-y after a brief rebound in March. In the first four months, exports contracted by 4.2%, largely on account of weak crude oil prices, despite the recent rebound, and sluggish palm oil prices. The overall weak performance also reflects the challenging international trade environment which may persist until the year-end as the global economy, save for the US, struggles to find its footing. Of concern is the lacklustre trade performance of China, Malaysia's major market, as a result of stringent measures imposed by the government to alleviate macroeconomic imbalances. Exports to China have declined by 8.9% in the first four months of 2015, despite the sustained demand from the US.

Chart 7: Private investment and private consumption growth



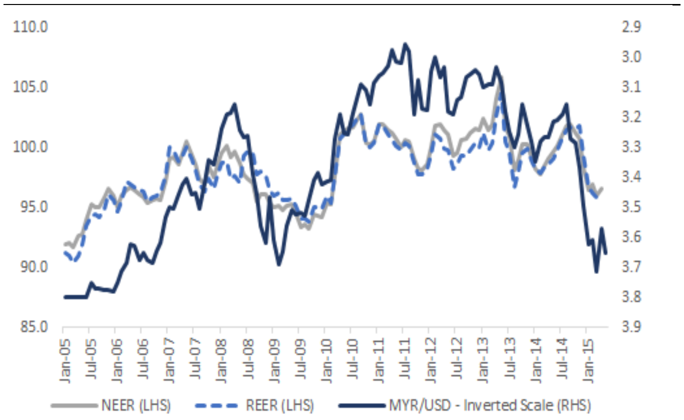
Source: CEIC, MARC Economic Research.

Chart 8: Net FDI and annual change in ringgit



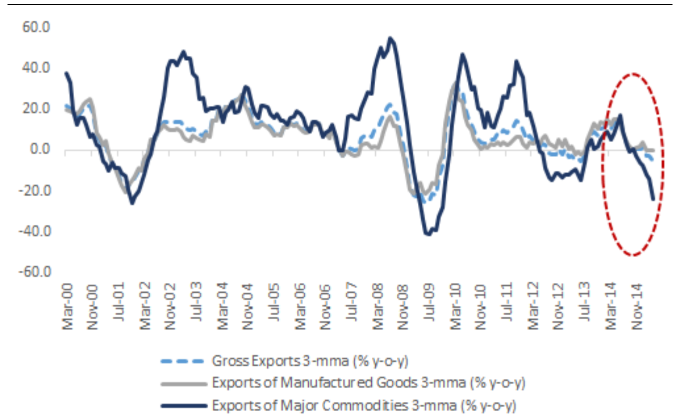
Source: CEIC, MARC Economic Research.

Chart 9: MYR/USD, REER and NEER



Source: CEIC, MARC Economic Research.
Note: NEER refers to Nominal Effective Exchange Rate
REER refers to Real Effective Exchange Rate

Chart 10: Exports growth



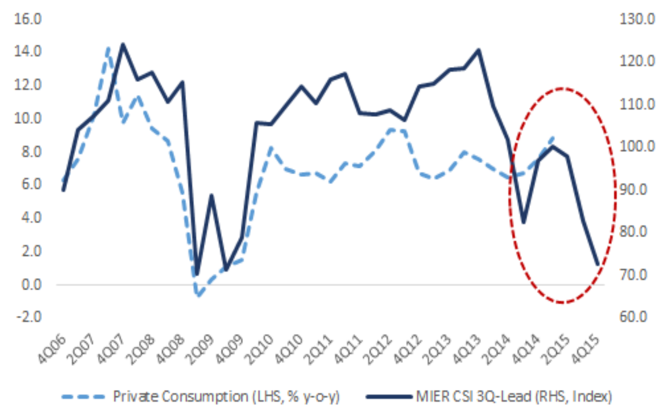
Source: CEIC, MARC Economic Research.

But no hard landing seen…

Going forward, the growth path for 2015 will hinge on several factors, which among others include:

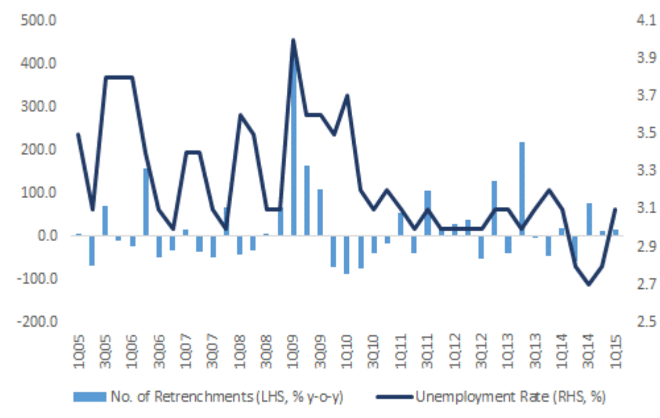
- ***Private consumption***: We are of the view that the 8.8% expansion in 1Q2015 is not sustainable due to: (1) eroding consumer sentiment as reflected in the MIER CSI in the past three quarters; (2) rising consumer prices post-GST; (3) continuing volatility in commodity prices; and (4) weakening consumer purchasing power due to the ringgit's depreciation, particularly against the greenback. Sentiment has also been recently affected by the possibility of higher unemployment in view of staffing cutbacks in the oil and gas, airline and banking industries. Although statistics on retrenchment have not shown a significant increase, we believe the labour market will be somewhat softer in 2H2015. While the overall impact on spending power may not be very significant, weaker sentiment will cause consumers to become more cautious in their spending patterns. Access to credit is another factor that will likely moderate consumer spending. More stringent lending standards have resulted in a single digit-loan growth for the household sector (9.9% in December 2014), the first time since the economy got out of the recession in 2009. As such, on balance, we maintain our consumer spending growth forecast of 5.5% for 2015 against 7.0% in 2014.

Chart 11: Private consumption and MIER CSI (3Q-lead)



Source: CEIC, MARC Economic Research.

Chart 12: Unemployment rate and retrenchments



Source: BNM, CEIC, MARC Economic Research.

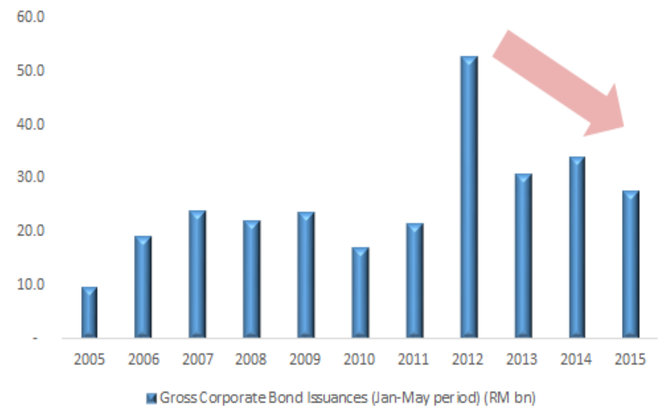
- ***Investments:*** The pace of growth may be weakened by various uncertainties in the global economy, namely the prospect of an interest rate hike in the US and the weakening of Asian economies such as China, South Korea and Singapore. Although the rate hike in the US is more or less expected in 3Q-4Q2015, we believe the impact has not been fully discounted in the level of interest rates. Once interest rates start to pick up, investors will likely react negatively, at least for a short period. Although investments have been boosted by domestic activities in 1Q2015 which led to a sharp increase in investment approvals to RM33.7 billion, a big chunk of it (RM25.4 billion) is attributed to the Pengerang project. Excluding this, total manufacturing approvals would have contracted on a year-to-year basis. At the same time, the uncertainties over the future prospects of the global economy have to some extent reduced investment appetite and were reflected in Malaysia's weak corporate bond issuance in the first five months of the year which dropped to RM27.8 billion, as opposed to RM34.1 billion in Jan-May 2014. In the medium term, however, the continuation of mega projects – MRT2, the extension of selected highways, and the high-speed railway – will likely remain supportive of private investments.

- As for portfolio investments, the sentiment will be influenced by factors such as growth prospects, oil prices, CA surpluses and debt profile. These are the factors that influence the sentiment of the ringgit which in turn determines the direction of capital flows. Another key consideration is Malaysia's high exposure to foreign holdings of sovereign bonds. About 47% of Malaysian Government Securities (MGS) is in the hands of foreign investors and as such, any substantial withdrawal by them will affect the ringgit in the short term. In addition, rising volatility in the currency markets following the persistent turmoil, particularly in Europe (i.e. Greece) will also affect investors' sentiment.

- ***Trade performance:*** While last year's growth was aided by a positive contribution from the external sector - the first since 2006 - this year's prospects are clouded by the prospects of Malaysia's major commodity exports – crude oil, LNG and palm oil – which accounted for roughly 20% of total exports in 2014, up from 15.3% a decade earlier. While Malaysia is not a major net exporter of crude oil, exports of LNG are relatively huge, and global gas prices are currently on a downward trend. Notwithstanding, we draw comfort from the more promising outlook of palm oil prices, based on expectations of an El Niño occurrence which could support palm oil prices in 2H2015.

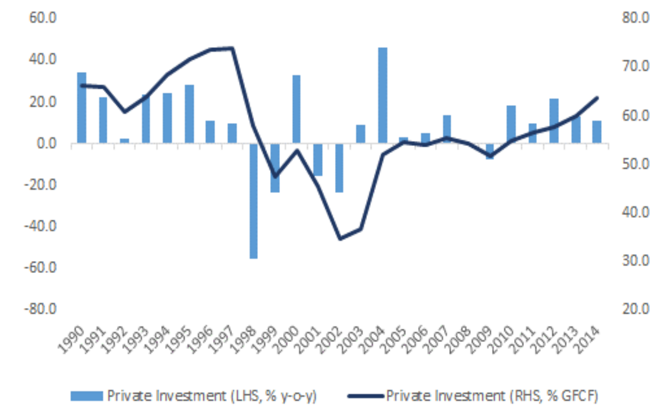
- The prospects for the E&E sector remain fluid as reflected in the growth of its exports, averaging 4.2% in the four months ending April 2015 (1H2014: 13.1%). A stronger pick-up in global demand, particularly from major economies (US, Europe and China), is needed to ensure further recovery in 2H2015. However, improvements have been seen in the SEMI Book-to-Bill (BTB) ratio which averaged 1.05 in the Jan-Apr period, compared with a 1.0 average in the last six months of 2014. This forward-looking indicator suggests that the prospects are not that bleak in the near term. On balance, we envision exports to climb by a real growth of 1.4% in 2015.

Chart 13: Gross corporate bond issuances (Jan-May period)



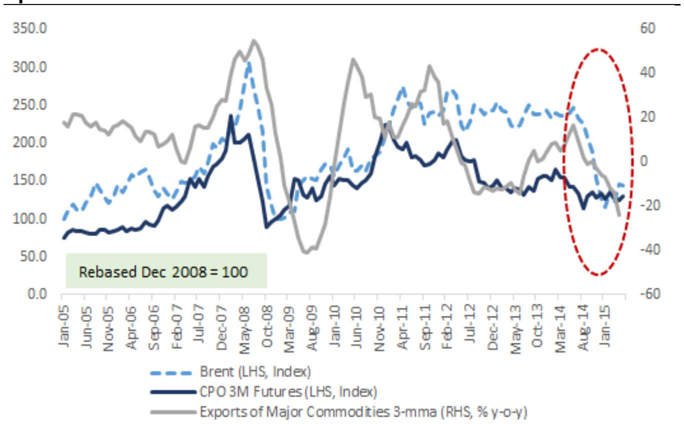
Source: BPAM, MARC Economic Research.

Chart 14: Private investment ratio of total and growth



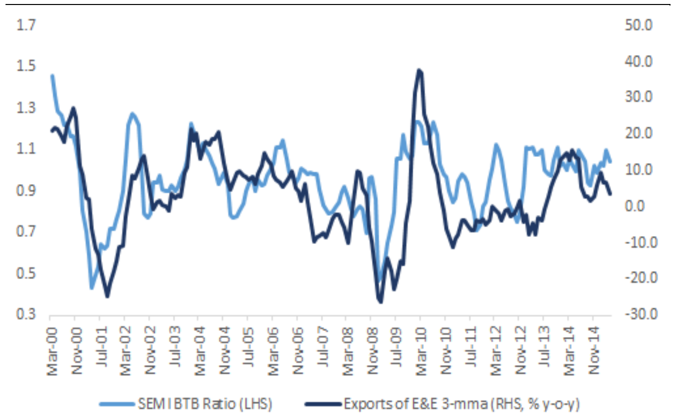
Source: CEIC, MARC Economic Research.

Chart 15: Exports of major commodities versus crude oil and palm oil indexes



Source: CEIC, Bloomberg, MARC Economic Research.

Chart 16: SEMI BTB Ratio and exports of E&E



Source: SEMI, CEIC, MARC Economic Research.

- On balance, MARC is of the view that Malaysia's GDP growth will decelerate to 4.7% in 2015 from 6% in 2014 following a moderation in both domestic and external demand. Despite this, we expect investments in mega projects related to the ETP will continue to flow into the economy to shore up economic growth in the near term. In the financial market, we also foresee lending growth to soften further, averaging 8-9% in 2015 as demand for consumption-related credit continues to soften.

- The risks to our outlook are: (1) on the local front, the strength of consumer spending, which may erode more than expected due to the impact of GST. In addition, further recovery in crude oil prices will likely raise future pump prices, which in turn, will dent consumers' splurging habits; (2) on the external front, further weaknesses in exports will likely filter through the economy, denting business conditions and the labour market.

Table 1: Real GDP growth – demand side (%)

Growth (%y-o-y)	2010	2011	2012	2013	2014	MARC 2015F	BNM 2015F	MoF 2015F
GDP	7.4	5.3	5.5	4.7	6.0	4.7	4.5 - 5.5	4.5 - 5.5
Domestic Demand	7.7	7.8	10.7	7.3	5.9	5.3	6.0	5.9
Private Consumption	6.9	6.9	8.3	7.2	7.0	5.5	6.0	6.2
Public Consumption	3.4	14.2	5.4	5.9	4.4	3.3	2.7	3.3
Private Investment	18.4	9.5	21.4	12.8	11.0	8.4	9.0	12.7
Public Investment	4.9	2.6	15.9	1.9	-4.7	1.4	5.1	-2.7
Real Exports	11.1	4.2	-1.7	0.3	5.1	1.4	3.0	1.6
Real Imports	15.6	6.3	2.9	1.7	4.2	3.0	4.0	2.2

Source: CEIC, MoF, BNM, MARC Economic Research

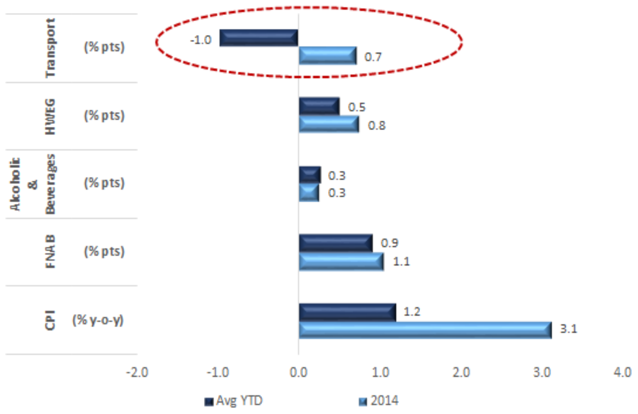
Rising inflationary pressure seen in 2H2015

- The inflation rate remained muted in the first five months of 2015 but will likely pick up pace in 2H2015. Besides the high base effect in 1H2015, the low inflation rate environment in the Jan-May period this year was largely attributed to benign crude oil prices which translated to lower domestic pump prices. As a result, the 'transport' component in the CPI registered a sharp decline averaging -6.4% in the Jan-May period, compared with an average growth of 5.3% in the corresponding period in 2014. In contrast, the 'alcoholic beverages and tobacco' component chalked up the highest growth, averaging 11.2% during the period. Overall, the slower growth of the CPI in the 1H2015 was also attributed to weak consumer sentiment as evidenced by a third consecutive decline and the lowest reading in six years in the MIER CSI in 1Q2015. In the latest survey in 1Q2015, the main concerns cited by respondents were their financial and employment expectations going forward which have deteriorated, especially among the low-income group (with only 7% reporting being better off as opposed to 24% in 1Q2014).

- Going forward, the pace of inflation hinges on several factors: (1) fuel prices, which depend on global crude oil prices; (2) the impact of GST on consumer spending; (3) overall labour market conditions. On the first factor, we foresee a more stable Brent crude oil price ranging from USD65-USD75 per barrel. As we mentioned in our 2015 Economic Outlook, the possibility of prices reverting to -1 standard deviation (SD) below its long-term mean (USD65-75 per barrel) cannot be ruled out due to several factors, namely: (1) the extreme pessimism on the prospects for the oil market in late 2014 and early 2015 which suggests some element of negative irrational exuberance. Historically, such phenomena lead to readjustments of supply and demand, which in turn cause prices to recover by a certain degree; (2) a sharp drop in the number of oil rigs in operation in the US will likely trigger fears of a rapid decline in oil production. Although the actual fundamentals may not be fully supportive of higher prices, the fear itself will tend to push up prices to a level which is more sustainable; (3) sustained growth momentum in the US and a soft landing of China's economy may cause further readjustment of the demand and supply dynamics.

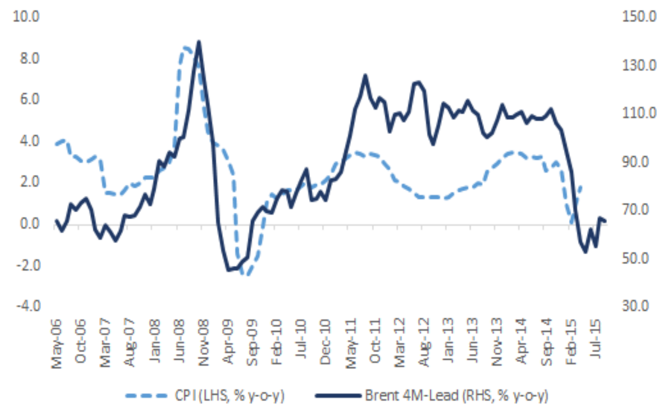
- Visibility on the impact of GST has yet to emerge as sufficient statistics have not been released. A few months of data on the CPI and its sub-components are needed to fully assess the magnitude of price increase this year. However, judging from the first jump in April's inflation rate as well as the low base factor in 2H2014, there is a possibility that the upward trend in prices will continue in 2H2015. Notwithstanding this, a softer labour market will act to avert a sharp increase in inflation as consumers become cautious in their spending habits. Given the muted inflation readings in the early part of the year, we are revising our full-year CPI forecast to 2.5%-3.0%, although we also foresee slightly higher inflationary pressures in 2H2015.

Chart 17: Contribution to headline CPI growth by major components



Source: CEIC, MARC Economic Research.
Note: FNAB refers to Food & Non-Alcoholic Beverages
HWEG refers to Housing, Water, Electricity, Gas & Other Fuels

Chart 18: Headline inflation rate and annual change in Brent crude oil price



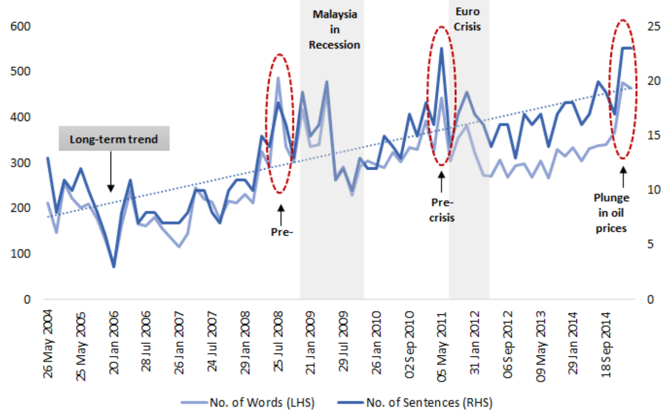
Source: CEIC, Bloomberg, MARC Economic Research.

OPR will likely remain status quo

- The OPR has been maintained at 3.25% for 12 months and will likely remain unchanged for the whole year. Admittedly, there are arguments for lowering the rate. Specifically, weaker growth prospects and tight fiscal conditions would call for a more accommodative stance. Based on our analysis of Monetary Policy Committee (MPC) statements, the recent trend of a rising number of words in the statements suggests that BNM is making more effort to explain the uncertainties in both the domestic and international economy. In the past, such practices normally coincide with softer growth prospects for Malaysia. The fact that the government is strongly focusing on achieving the targeted fiscal deficit target suggests that the fiscal space is rather limited to provide any support to the economy should the weakness become apparent. This leaves the monetary policy to provide a helping through lower rates.

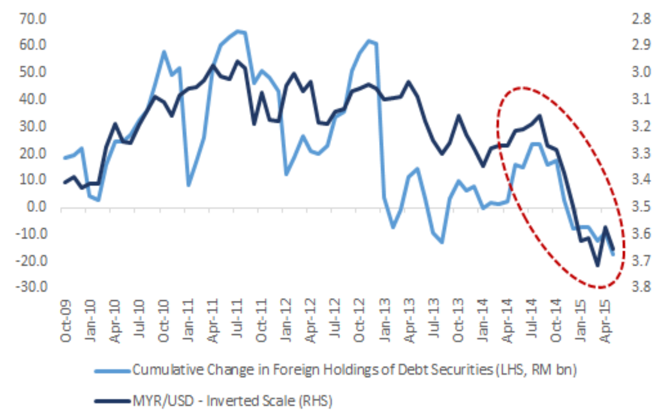
- We respectfully disagree with such a view. We think that the BNM will resist taking accommodative measures at this juncture for several reasons: (1) the monetary policy itself has its limits as shown by experiences in other countries where lending growth did not improve even with low interest rates. This is simply because financial institutions are reluctant to take risks if they foresee overall economic sentiment deteriorating; (2) fiscal conditions may not be as tight as some may perceive. Based on past trends, development expenditures were not fully utilised; on average, only 93% of the budget was spent. If the need arises, the government will spend the entire amount allocated in the budget. This will to some extent help keep economic activity more vibrant; (3) financial imbalances do not induce BNM to take accommodative monetary measures. Since reducing household debt is becoming a major focus by policymakers to avert further financial imbalances in the economy, a policy of lowering interest rates would only contradict BNM’s efforts to address the problem of high household debt in Malaysia. It may also be seen as contradicting the macro measures that have been implemented to clamp down on the rapid increase in household indebtedness; (4) lowering the interest rate will further dent sentiment on the ringgit and may lead to sharp reversals in capital flows if investors start to perceive that monetary policy will continue to be used to support growth. The ringgit has already depreciated by 16% against the greenback since its high in August 2014.

Chart 19: Number of words and sentences in MPC statements



Source: BNM, MARC Fixed Income Research.

Chart 20: Cumulative change in foreign holdings of debt securities and ringgit



Source: CEIC, MARC Economic Research.

- As for the ringgit's performance against the greenback, we think that it hinges on several factors: (1) the outlook of global crude oil prices which will, at the end of the day, determine the government's total revenue. This is critical in assessing its ability to achieve the targeted deficit reduction in the medium term. While the projected revenue for 2015 does not look unfavourable at this juncture, the prospects of 2016 are on investors' minds; (2) the near-term trend of CA surpluses, given the lackluster trade performance so far this year. This is important as Malaysia is already incurring budget deficits; a sharp reduction in CA surpluses could lead to speculation that a twin deficit is on the cards. Bear in mind, however, that a reduction in CA surpluses is not necessarily a bad thing, especially if it is associated with rising investments which in the long term will increase a country's productive capacity; (3) the possible rate hike in the US which will influence the direction of capital flows in this region, Malaysia included. As foreign holdings of Malaysian government bonds are relatively high, a reversal in capital flows will naturally affect the ringgit's performance against the USD. All these factors have capped the ringgit's upside at this juncture. We think that RM3.80 per USD is a critical psychological support level, which, if broken, could lead to temporary weakness in the near term.

THIS PAGE IS INTENTIONALLY LEFT BLANK

THIS PAGE IS INTENTIONALLY LEFT BLANK

THIS PAGE IS INTENTIONALLY LEFT BLANK

--- Disclaimer ---

Published and Printed by:

MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 2082 2200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my