Economic Research

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2H2016 Economic Outlook: Another Bumpy Stretch Ahead

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In a nutshell

- The global economy continued to go through a rough patch in 1Q2016, despite enjoying some support from the first meaningful recovery in crude oil prices since they hit the bottom in January 2016. The downgrades in growth forecasts by international institutions like the World Bank, International Monetary Fund (IMF) and Organisation for Economic Co-operation and Development (OECD) reflect growing concerns about both the near-term prospects of global trade and commodity prices, as well as the economic momentum of the United States (US) and China, the two largest economies in the world. Uncertainties with regard to the United Kingdom's (UK) shocking decision to exit from the European Union (EU) – commonly termed "Brexit" – following the vote held on 23 June also led to wild swings in global financial markets and will, in the near term, hold back business and investment decisions. Adding to this, the possibility of higher US interest rates at year end is putting global financial market players on their toes. Indeed, the possibility of drastic policy changes in the US after the election in November compounds the anxiety of the global business community.

- While the US Federal Reserve's (Fed) monetary policy is increasingly taking global economic developments into account, the Fed is not losing sight of domestic growth concerns like the setback in the recent non-farm payroll (NFP) numbers in May (+38K versus an average of +210K per month in the past six months). While we think this data point represents an anomaly and the US will continue to normalise its policy rate by the end of the year, the pace will be much slower than expected. We also acknowledge that the confluence of positive factors in the US economy of late, such as low unemployment, wage gains, strong monthly non-farm payrolls, and a core inflation rate of above 2% in the six months to May 2016, is sufficient to warrant a slight increase in the federal funds rate (FFR). However, it is assuring that the Fed's attention is also on pertinent international developments like the Brexit, China's weaker growth prospects, and struggling emerging market economies (EME), all of which have significant repercussions for global growth.

- The implications of such developments for the global financial market cannot be underestimated. The consolation is that China, which is struggling with chronic overcapacity in the manufacturing sector, high private debt and a rapid demographic transition, will likely be more aggressive in its fiscal and monetary measures by raising its budget deficit target and lowering interest rates further. Its pledge to maintain the stability of its renminbi (RMB) will also help. While we acknowledge the problems faced by the authorities and that the economy will not be able to turbocharge itself as it did in the past, China will not likely see a hard landing in the near term. Its medium-term prospects, however, will depend on its ability to address high corporate debt without denting its financial market and growth trajectory.

- Uncertainty over commodity prices, despite the significant rebound in crude oil prices, will weigh on commodity-based economies like the Gulf Cooperation Council (GCC) countries, Russia, and Australia. Notwithstanding this, recent developments in the crude oil market suggest that another sharp fall in prices is unlikely as production is now less than anticipated. Demand will remain decent at about 97 million barrels per day (mbpd) by end-2016, according to the International Energy Agency's (IEA) estimate, surpassing 1Q2016's production of about 96 mbpd. Although the uptrend in prices has sparked fears that shale production will make a comeback, breakeven costs in major regions such as Eagle Ford West, East and Bakken are reported to be above prevailing prices, suggesting that major players may not be able to quickly raise production again as they are still in the red. We foresee the average crude oil price for 2016 to be in the range of USD40 to USD50 per barrel.

- While the euro zone economies are now banking on the effectiveness of the Negative Interest Rate Policy (NIRP), the repercussions of the Brexit cannot be underestimated. The short-term impact of the Brexit will depend, to some extent, on damage control responses by the leaders of the UK and the EU. On the other hand, the long-term impact hinges on the new relationship between the two parties. Another risk, which is more worrisome, is that the UK's decision might prompt other countries in the region to renegotiate their relationship with Brussels, or even worse, consider leaving the EU altogether. Such a scenario will have a material impact on the global economy going forward. With the euro zone already adopting the NIRP, the Brexit will likely intensify capital outflows from Europe as investors rush for safe-haven assets, namely assets denominated in the US dollar (USD) and Japanese yen (JPY).

- On the local front, Malaysia's gross domestic product (GDP) growth continued to decelerate in 1Q2016, clocking in at 4.2% year-on-year (y-o-y) and 1.0% quarter-on-quarter (q-o-q) on a seasonally adjusted basis. This was largely the result of lacklustre external demand, although it was somewhat offset by a slight pickup in consumer spending. Trade continued to drag headline growth, as exports in USD terms remained relatively weak on account of low overall commodity prices. Slower investment growth also exerted downward pressure on GDP as global economic uncertainties clouded business sentiment and decisions. Domestic demand growth weakened to 3.6% as consumer spending growth remained below the historical average at 5.3%. The brighter side, however, is that nominal GDP growth (4.9%) has outpaced real GDP growth, in contrast to the overall situation in 2015 where nominal GDP growth (4.6%) trailed real GDP growth (5.0%), reflecting a deflating economy.

- The global trade momentum remained anaemic in 1H2016, although the rebound in commodity prices, particularly crude oil prices, has sparked hopes of some light at the end of the tunnel in 2H2016. Global trade value had contracted since 4Q2014, while in volume terms, growth had moderated to a mere 1.0% in 4Q2015 from 4.2% in 4Q2014. The momentum in the electrical and electronic (E&E) sector is also not too encouraging, a reflection of weak global semiconductor sales which contracted at an average pace of 3.8% in the nine months up to March 2016. Going forward, while we are less pessimistic about the crude oil market amid slower global production that will lead to more favourable demand-supply dynamics by the end of the year, uncertainties about the repercussions of the Brexit will likely continue to cause global trade to remain sluggish.

- We are also of the view that domestic demand will not likely pick up significantly in 2H2016, although the recent uptick in consumer spending growth provides some comfort. Private consumption growth has rebounded since hitting its trough in 3Q2015, expanding by 5.3% in 1Q2016. Going forward, however, consumer sentiment will likely continue to be downbeat, and consumers will remain cautious about their discretionary spending habits amid rising prices and more stringent lending practices by financial institutions. Investment growth, which was flat in 1Q2016, will not likely gain much momentum in 2H2016 as anxiety over the ramifications of the Brexit, expectations of a hike in the FFR, and lack of clarity on China's economy will continue to take a toll on business sentiment. Offsetting these downside risks are the ongoing implementation of the government's mega projects and the relatively low interest rate environment, which will prevent a sharp drop in total investments in 2016. On balance, MARC is of the view that Malaysia's GDP growth will remain below its potential in 2016. We are now adjusting our 2016 GDP growth forecast lower by 30 basis points (bps) to 4.1%.

- The inflation rate, which accelerated to 3.4% in 1Q2016 due to the low base effect from the decline in domestic fuel prices in 1Q2015 and the reduction in electricity tariff rebates in January 2016, started to normalise to 2.1% y-o-y and 2.0% y-o-y in April and May, respectively. At this juncture, we think that Malaysia's inflationary landscape in 2016 will be contingent on two opposing forces: (1) rising price pressures due to the lag effect of government subsidy rationalisation efforts, the weaker ringgit, and the possible increase in future pump prices amid rising global crude oil prices; and (2) slower domestic demand due to the moderation in economic activity. On balance, we have adjusted our average inflation target to 2.8% for 2016, from 3.2% previously.

- Malaysia's sovereign rating will continue to hog the limelight. Given that the impact of low crude oil prices on Malaysia's financial position will be fully realised in 2H2016, the country's fiscal balance will be under the microscope. Of particular interest is the effectiveness of the measures projected to reduce expenditures by approximately RM9 billion, as planned under the recalibration of Budget 2016. The reduction in expenditures is crucial to achieve the government's 2016 deficit target of 3.1% of GDP. Besides the pressure from low revenue this year, Malaysia's fiscal position also faces another challenge, which is the lower-than-anticipated nominal GDP growth that will affect various performance indicators, namely the budget deficit, government debt, current account, and household debt ratios as a percentage of GDP.

- Malaysia's total debt level is another area of concern relating to the country's sovereign rating. Total federal government debt has been stubbornly above 50% of GDP in recent years (2015: RM630.5 billion, or 54.5% of GDP). Although under The Loan (Local) Act 1959 and Government Funding Act 1983, the federal government domestic debt cap is measured by the sum of outstanding Malaysian Government Securities (MGS), Government Investment Issues (GII), Malaysian Islamic Treasury Bills (MITB) and syndicated loans raised within the country – which in total we estimate to be circa 49% of GDP – we think the government will try to ensure the amount of total debt to GDP is below 55% in order to maintain investor confidence. The bright spot is that only 3% of the total federal government debt is foreign currency-denominated, implying a very low exposure to foreign exchange risks. While we commend the government's effort to shift a portion of its debt to a newly formed entity called the Public Sector Home Financing Board to reduce the debt level by approximately two percentage points, we caution that additional amounts of contingent liabilities will continue to attract the attention of international rating agencies.

- Our stance on the Overnight Policy Rate (OPR) has changed somewhat since we published our views in our Annual Economic Outlook in late 2015. We foresee increasing pressure on Bank Negara Malaysia (BNM) to trim the OPR in the months ahead as the domestic economic momentum is expected to moderate further, while the global economic outlook is anticipated to turn more negative after the UK's Brexit vote. We now believe that there is greater justification for BNM to loosen its stance before the year is out, especially after the ringgit starts to stabilise following the Brexit. It should be noted that the ringgit's volatility has been high in the lead-up to the UK's EU Referendum. That said, however, we are of the view that BNM will try to resist doing so, unless headline GDP growth tumbles more than expected.

Global Economy

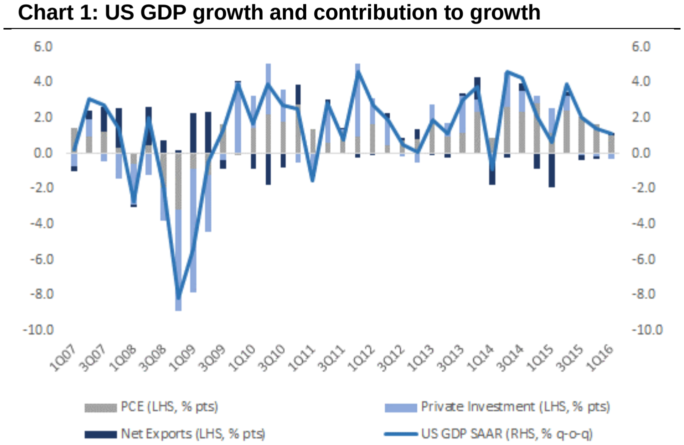
Renewed global headwinds

- The global economy continued to go through a rough patch in 1Q2016, despite enjoying some support from the first meaningful recovery in crude oil prices since they hit the bottom in January 2016. The two largest economies in the world, the US and China, moderated in 1Q2016, registering 1.1% and 6.7% growth respectively, prompting policymakers to be extra cautious in their policy maneuvering. The downgrades in growth forecasts by international institutions like the World Bank, IMF and OECD reflect growing concerns about both the near-term prospects of global trade and commodity prices, as well as the economic momentum of the US and China. Uncertainties with regard to UK's shocking decision to exit from the EU – commonly referred to as Brexit – following the voting that was held on June 23 also led to wild swings in the financial markets and will in the near term hold back business and investment decisions. Adding to this, the possibility of higher US interest rates at the year-end is putting global financial market players on their toes. Indeed, the possibility of drastic policy changes in the US after the election in November compounds the anxiety of the global business community.

- While the US Fed's monetary policy is increasingly taking global economic developments into account, the Fed is not losing sight of domestic growth concerns such as the setback in the recent NFP numbers in May (+38K versus an average of +210K per month in the past six months). While we think this data point represents an anomaly and the US will continue to normalise its policy rate by the end of the year, especially if the authorities think that the impact of the Brexit will be milder than anticipated, the pace will be much slower than expected. We also acknowledge that the confluence of positive factors in the US economy of late, such as low unemployment, wage gains, strong monthly NFPs, and a core inflation rate of above 2% in the six months to May 2016, is sufficient to warrant a slight increase in the FFR. However, it is assuring that the Fed's attention is also on pertinent international developments such as the impact of the Brexit, China's weaker growth prospects and struggling EMEs, all of which have significant repercussions for global growth.

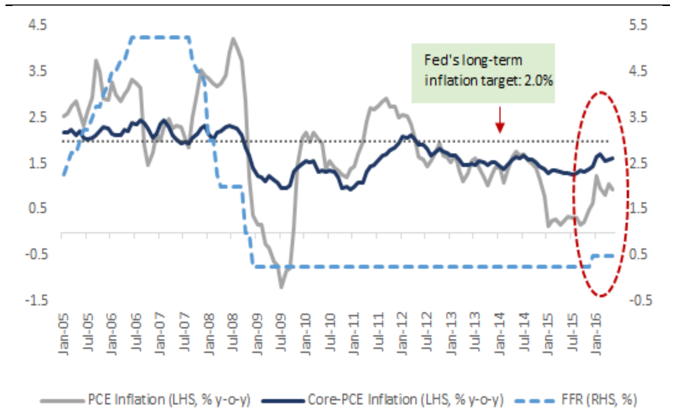
- With the global economy facing uncertainties as a result of the Brexit, China's weaker growth prospects, mediocre outlook for the euro and Japanese economies, and struggling EMEs, the repercussions for the global financial market cannot be underestimated. As of the time of writing, the MSCI Global has corrected by 7.5% while the MSCI EM index fell by 6.9% from their recent highs. Bond yields continued to drift downward with the 10-year German Bund yield falling into negative territory for the first time in history.

Chart 1: US GDP growth and contribution to growth



Source: CEIC, MARC Economic Research

Chart 2: FFR and PCE inflation



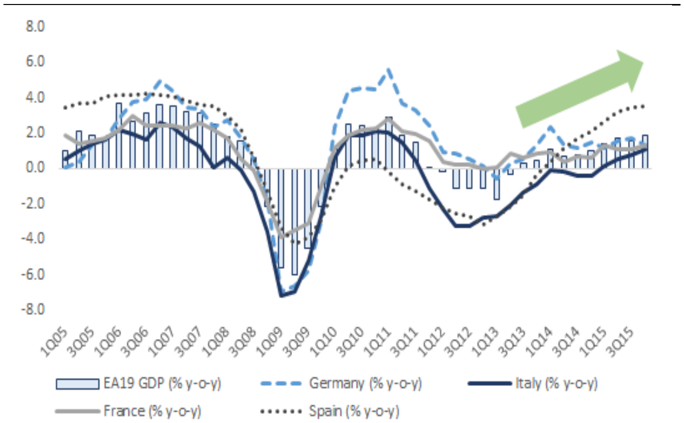
Source: CEIC, MARC Economic Research

- The euro economies are now banking on the effectiveness of the NIRP measures after the European Central Bank (ECB) pledged further efforts to revive inflation and support growth. In addition, in early June, corporate bonds were included in the ECB's EUR80 billion asset purchases programme. While inflation remains a far cry from the officials' target of just below 2%, the economy appears to have recovered somewhat. Real GDP growth accelerated to 0.6% q-o-q in 1Q2016 (4Q2015: 0.4%), although from a year earlier, the economy grew at a slower pace of 1.6% from 1.9% in the preceding quarter. The inflation rate, on the other hand, has been under 2.0% for more than three years, and barely shows any signs of a pick-up (average YTD: 0%). Looking ahead, domestic demand is expected to remain the key support to growth, underpinned by higher real disposable incomes amid the previous declines in key commodity prices and a gradual improvement in the labour market.

- On the external front, a gloomier global outlook and subdued confidence, especially following the Brexit, will act as a persistent drag on business investment, complicating the task of achieving stronger economic growth in the near term. In the financial market, the widening yield gap between euro bonds and the US Treasuries is increasingly exerting downward pressure on the euro currency vis-à-vis the greenback. With the 10-year German Bund registering a negative yield in mid-June amid concerns over the Brexit, the flight to safety assets will likely cause the USD to appreciate further. The ECB's NIRP is also expected to affect global capital flows, heightening the risk of a significant correction in the global bond market.

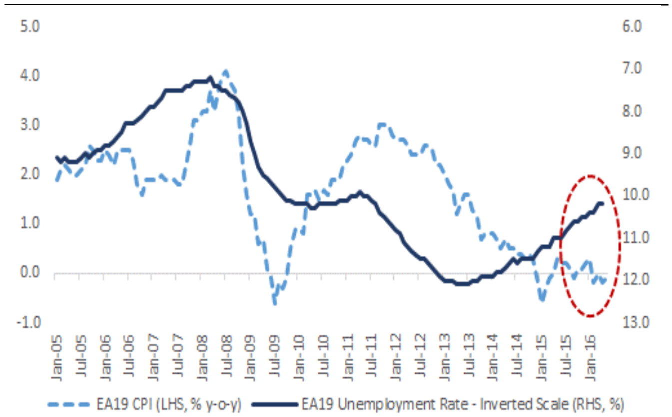
- The repercussions of the Brexit cannot be underestimated. The short-term impact of the Brexit will depend, to some extent, on damage control responses by the leaders of the UK and the EU. On the other hand, the long-term impact hinges on the new relationship between the two parties. Another risk, which is more worrisome, is that the UK's decision may prompt other countries in the region to renegotiate their relationship with Brussels, or even worse, consider leaving the EU all together. Such a scenario will have a material effect on the global economy going forward. With the euro zone already adopting the NIRP, the Brexit will likely intensify capital outflows from Europe as investors rush for safe haven assets, namely the USD and JPY denominated assets.

Chart 3: Euro area GDP growth by major economies



Source: CEIC, MARC Economic Research

Chart 4: Euro area CPI growth and unemployment rate



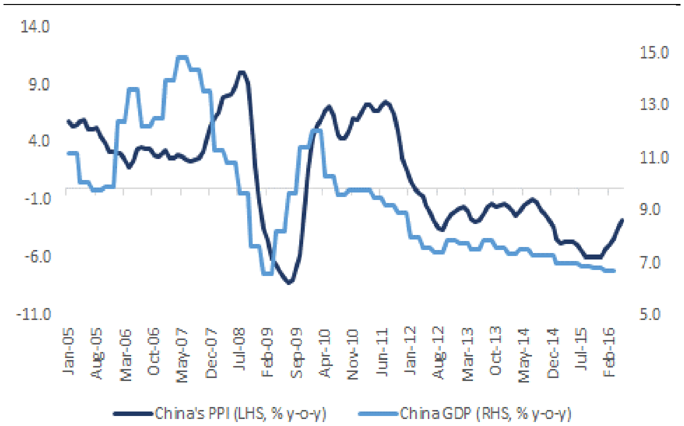
Source: CEIC, MARC Economic Research

- China's economic slowdown continues, albeit at a slower pace. In 1Q2015, the economy grew 6.7%, a tad slower than in the earlier quarter (4Q2015: 6.8%). Meanwhile, the latest data show inflation remaining soft. In May, the Consumer Price Index (CPI) rose 2.0% y-o-y (April: 2.3%). The producer price index (PPI), on the other hand, fell 2.8% (April: -3.4%). China's slowdown is increasing jitters in global markets as it faces challenges that include weak exports, slowing investment and high debt levels. Its near-term outlook, based on the latest readings of the official Purchasing Managers' Index (PMI), is not encouraging. In May, the non-manufacturing PMI fell slightly to 53.1, compared with 53.5 previously while the official manufacturing PMI remained unchanged at 50.1. The balance sheets of debt-ridden firms continue to be weighed down by high (and still rising) debt levels, as well as industrial overcapacity. The level of corporate debt outstanding, equivalent to about 145% of GDP, is high when compared to those of other developing countries. On a more positive side, however, China will likely be more aggressive in its fiscal and monetary measures by continuing to pump prime its economy, raising its budget deficit target and lowering interest rates further. Its pledge to maintain the stability of the RMB will also help. While we acknowledge the problems faced by the authorities and that the economy will not able to turbocharge itself as it did in the past, China will not likely see a hard landing in the near term. We anticipate the economy to sustain its headline GDP growth between 6.5%-7.0% in 2016.

- As for Japan, the economy continues to struggle, expanding by just 0.1% y-o-y in 1Q2016 (4Q2015: 0.7%). External demand shocks are a concern, and supply chain disruptions from the Kumamoto earthquake have not helped. In May, overall exports slumped 11.3% y-o-y, while China-bound shipments fell 14.9%. At the same time, Japan remains especially vulnerable to weak domestic demand on account of disappointing wage growth. While the government's move to delay the planned increase of its national sales tax to 2019 is understandable given the current economic backdrop, from a sovereign rating perspective, this is a negative development. It highlights the enormous fiscal difficulties faced by Japanese policymakers. Not surprisingly, Japanese policymakers are increasingly pinning their hopes on monetary policy to keep the economy growing. With the Bank of Japan's (BOJ) quantitative easing programme seemingly having lost its punch, the central bank on January 29, 2016 resorted to the NIRP, charging banks 0.1% for parking additional reserves with it from February 16 onwards.

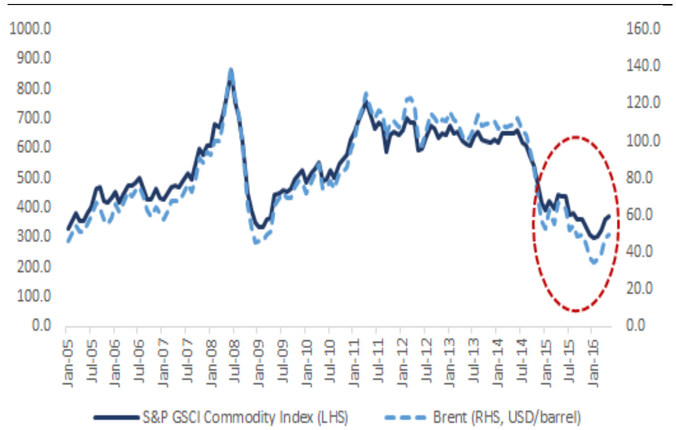
- Uncertainty about the prospects of commodity prices, despite the significant rebound in crude oil prices, will weigh on commodity-based economies like the GCC countries, Russia, and Australia. Notwithstanding this, recent developments in the crude oil market suggest that another sharp fall in prices is unlikely as production is now less than anticipated. Demand will remain decent at about 97 mbpd by end-2016, according to the IEA's estimate, surpassing 1Q2016's production of about 96 mbpd. Although there will be a recovery in production in Canada, the situation in Nigeria is less certain. Nigeria lost about 1 mbpd because of sabotage by a militant group, the Niger Delta Avengers. US production is now down by 840,000 bpd from last year's peak of about 9.6 million bpd. Although the uptrend in prices has sparked fears that shale production will make a comeback, breakeven costs in major regions such as Eagle Ford West, East and Bakken are reported to be above prevailing prices, suggesting that major players may not be able to quickly raise production again as they are still in the red. We foresee the average crude oil price for 2016 to be in the range of USD40 to USD50 per barrel.

Chart 5: China real GDP and PPI growth



Source: CEIC, MARC Economic Research

Chart 6: S&P GSCI Commodity Index and Brent oil price



Source: Bloomberg, MARC Economic Research

Malaysian Economy

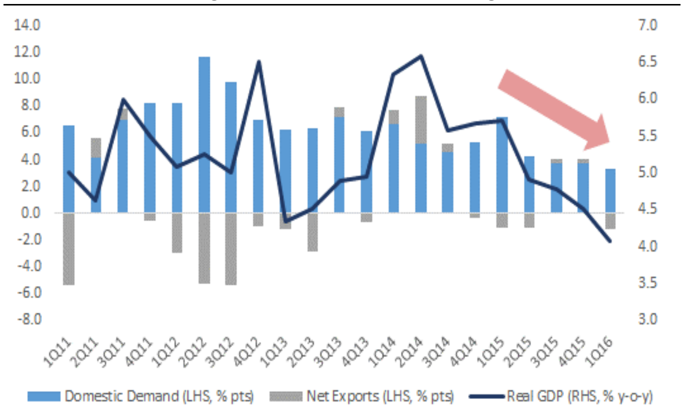
Growth – unabated external headwinds

- As anticipated, Malaysia's GDP growth continued to decelerate in 1Q2016, clocking in at 4.2% y-o-y and 1.0% q-o-q on a seasonally adjusted basis. This was largely the result of lacklustre external demand, although it was somewhat offset by a slight pickup in consumer spending. Trade continued to drag headline growth in 1Q2016 (-1.2 percentage points), as exports in USD terms remained relatively weak on account of low overall commodity prices. Slower investment growth also exerted downward pressure on GDP as global economic uncertainties clouded business sentiment and decisions. Domestic demand growth weakened to 3.6% as consumer spending growth remained below the historical average at 5.3%. The brighter side, however, is that nominal GDP growth (+4.9%) has outpaced real GDP growth, in contrast to the overall situation in 2015 where nominal GDP growth (+4.6%) trailed real GDP growth (+5.0%), reflecting a deflating economy.

- The global trade momentum remained anaemic in 1H2016, although the rebound in commodity prices, particularly crude oil prices, has sparked hopes of some light at the end of the tunnel in 2H2016. Global trade value had contracted since 4Q2014, registering an average negative growth of 11% during the period. Meanwhile, in volume terms, growth had moderated to a mere 1.0% in 4Q2015 from 4.2% in 4Q2014. Overall, Malaysia's exports of major commodities continued its downtrend, although they have stabilised somewhat. Its three-month moving average (3-mma) growth rate has not rebounded meaningfully from its recent trough in mid-2015.

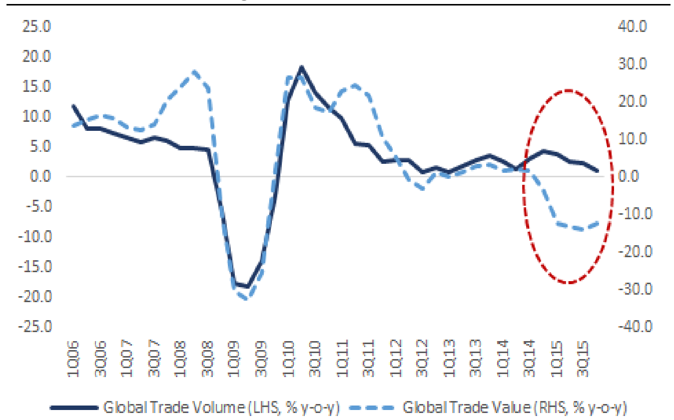
- The momentum in the E&E sector is also not too encouraging, a reflection of weak global semiconductor sales which contracted at an average pace of 3.8% in the nine months up to March 2016. Malaysia's E&E export growth has softened to a single-digit pace since November 2015 compared with an average growth of 15.7% between June and October 2015. Having said that, however, in ringgit terms, exports have slowly recovered in recent months due to the ringgit's depreciation. Even in USD terms, exports have also made a slight upturn although we do not expect a strong rebound in 2H2016. Going forward, while we are less pessimistic about the crude oil market amid lower global production that will lead to more favourable demand-supply dynamics by the end of the year, uncertainties over the repercussions of the Brexit will likely continue to cause global trade to remain sluggish.

Chart 7: Real GDP growth and contribution to growth



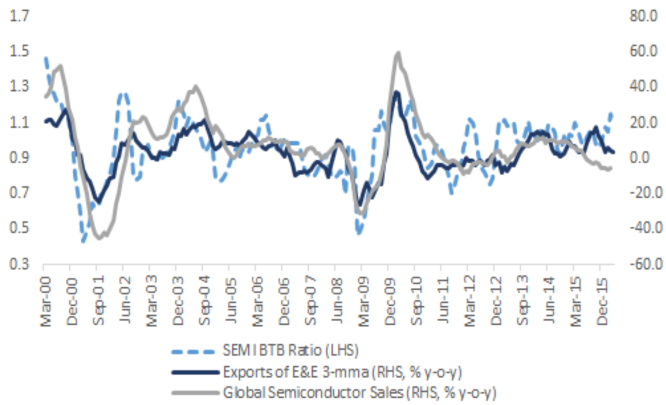
Source: CEIC, MARC Economic Research

Chart 8: Global trade growth in value and volume terms



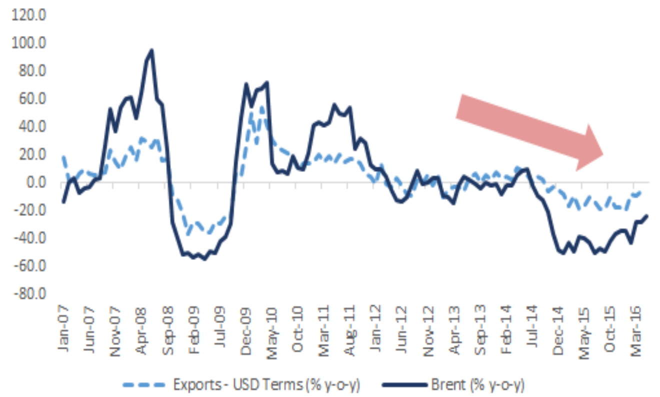
Source: WTO, MARC Economic Research

Chart 9: Exports of E&E, SIA Global Semiconductor Sales and SEMI Book-to-Bill Ratio



Source: SEMI, SIA, CEIC, MARC Economic Research

Chart 10: Exports growth in USD terms and annual change in Brent crude oil price



Source: WTO, Bloomberg, MARC Economic Research

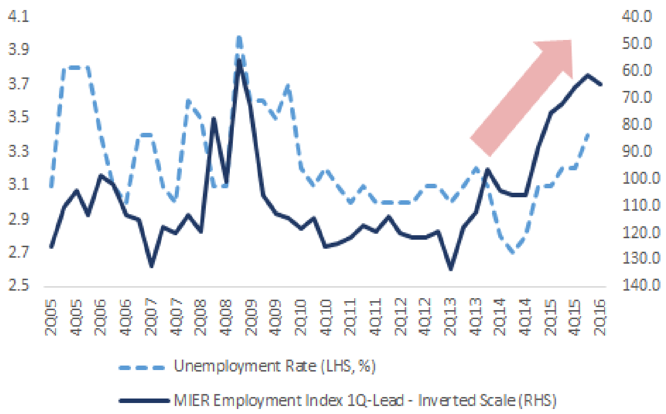
Weakening domestic demand poses further challenges

- We are also of the view that domestic demand will not likely pick up significantly in 2H2016, although the recent uptick in consumer spending growth provides some comfort. Private consumption growth has rebounded since hitting its trough in 3Q2015, expanding by 5.3% in 1Q2016. We are of the view that other than easy credit from financial institutions, much of the support has come from wage and employment growth, although the unemployment rate has picked up recently. Labour market conditions are becoming slightly fragile at this juncture following retrenchments not only in the oil & gas industry, but also in the services sector, particularly the banking sector. Save for February 2016, the total number of unemployed has risen by a double-digit pace since June 2015. In addition, the Malaysian Institute of Economic Research's (MIER) employment index which has registered readings below the 100-point threshold for six consecutive quarters, the longest stretch since the record began in 1988.

- Consumer sentiment has also remained weak, although it has shown some signs of bottoming in 4Q2015. The MIER's Consumer Sentiment Index (CSI) has remained below the 100-point threshold for seven straight quarters, again, the longest stretch in history. Not surprisingly, Retail Group Malaysia reported that retail sales across the country contracted by 4.4% in 1Q2016 (2015: 1.4%), although it partly reflected the high base in 1Q2015. This is mainly due to consumers' extra cautious attitude towards discretionary spending amid rising prices and more stringent lending practices by financial institutions on the back of bleaker economic prospects in the near term.

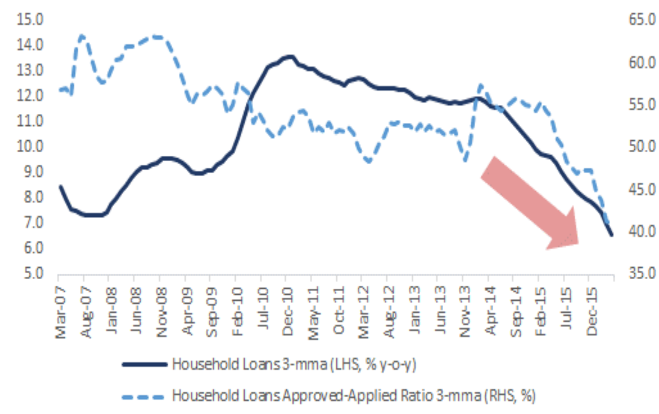
- The weaker prospects of household balance sheets have prompted banks to be extra cautious in their lending practices. Total loan growth continued to slip to 6.3% in April 2016, down from the cyclical peak of 10.2% in August 2015. On a 3-mma basis, loans to households grew at a slower pace of 6.6% in April 2016 compared with a 10.2% pace recorded in December 2014. On a y-o-y basis, total loans approved for the household sector dropped significantly by an average 24.2% in the first four months of the year, compared with an average contraction of 17.8% for total loans. The average approved-applied ratio for the household segment also fell to 40.9% between January-April 2016 from an average of 53.9% in the corresponding period in 2015.

Chart 11: MIER Employment Index and unemployment rate



Source: CEIC, MARC Economic Research

Chart 12: Household loans growth and household loans approved-applied ratio

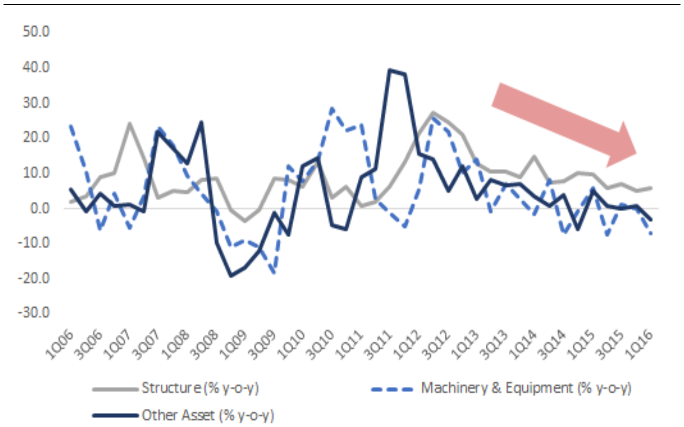


Source: BNM, CEIC, MARC Economic Research

- Total investments have slowed significantly in 1Q2016, registering a growth of merely 0.1%, the weakest pace since 3Q2009. The moderation came on the back of a slowdown in private investment to 2.2%, the weakest since 3Q2011, while public investments contracted by 4.5% during the same period. The slowdown in private investments was largely attributed to the cutbacks in mining-related investments due to the slump in crude oil prices. Investments in total machinery and equipment already contracted by 7.1% y-o-y in 1Q2016, its second consecutive contraction, in contrast to the heydays in 2012 when they grew by an average of 15.8%. Similarly, growth in structural investments remained below 6% in 1Q2016 compared with an average of 10% in 2014. The statistics on foreign direct investments (FDI), however, remain commendable. Total net FDI in 1Q2016 rose to RM15 billion, driven by an increase to RM11.8 billion in the services sector.

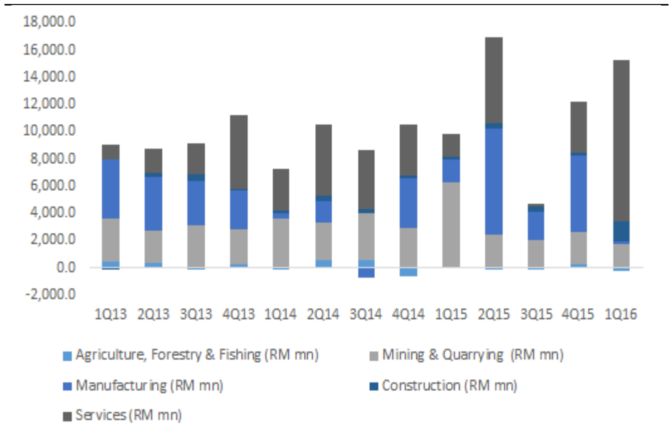
- Going forward, the anxiety over the ramifications of the Brexit, expectations of a hike in the FFR and uncertainties about China's economy will continue to take a toll on business sentiment. Offsetting these downside risks are the ongoing implementation of the government's mega projects and the relatively low interest rate environment, which will prevent a sharp drop in total investments in 2016. On balance, MARC is of the view that Malaysia's GDP growth will remain below its potential in 2016. We are now tweaking our GDP growth forecast for 2016 lower by 30 bps to 4.1%.

Chart 13: Investment growth by asset class



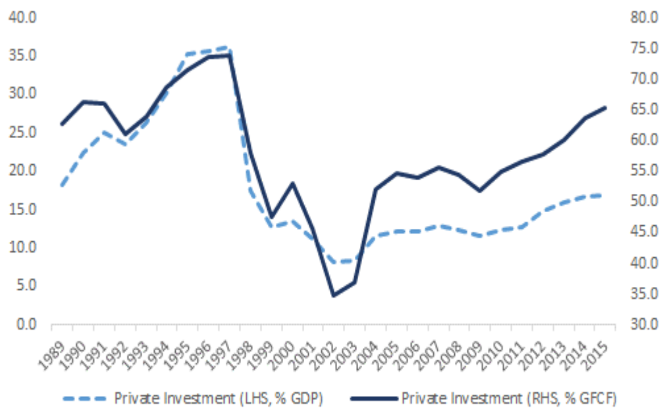
Source: CEIC, MARC Economic Research

Chart 14: Net FDI by sector



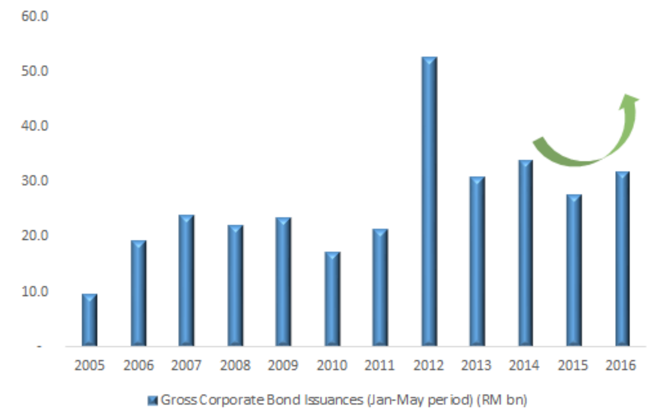
Source: BNM, CEIC, MARC Economic Research

Chart 15: Private investment as % GDP and as % total investment



Source: CEIC, MARC Economic Research

Chart 16: Gross corporate bond issuances (Jan-May period)



Source: BPAM, MARC Economic Research

- The risks to our outlook, however, are: (1) on the external front, the sustainability of commodity prices – particularly crude oil and palm oil – is critical for Malaysian economy as it affects business conditions and the labour market. A sharp retreat in crude oil prices will put a lid on a possible recovery of the external sector and will hamper business sentiment; (2) global uncertainties arising from the impact of the Brexit, the risk of China's decelerating economy and its policy response as well as the impact of NIRP on an emerging economy like Malaysia; and (3) on the local front, the strength of consumer spending, which may erode further if the labour market continues to deteriorate. Weaker private consumption growth will add to the risk of lower-than-expected headline GDP growth in 2016.

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

Growth (%y-o-y)	2011	2012	2013	2014	2015	MARC 2016F	BNM 2016F	MoF 2016F
GDP	5.3	5.5	4.7	6.0	5.0	4.1	4.0 - 4.5	4.0 - 4.5
Domestic Demand	7.8	10.7	7.3	5.9	5.1	4.2	4.3	5.5
Private Consumption	6.9	8.3	7.2	7.0	6.0	4.5	5.1	6.4
Public Consumption	14.2	5.4	5.8	4.3	4.4	2.4	2.0	3.0
Private Investment	9.5	21.4	12.8	11.1	6.4	5.5	5.5	6.7
Public Investment	2.6	15.9	1.8	-4.7	-1.0	3.1	1.1	2.3
Real Exports	4.2	-1.7	0.3	5.0	0.6	1.9	3.2	0.9
Real Imports	6.3	2.9	1.7	4.0	1.2	2.1	3.4	1.5

Source: CEIC, MoF, BNM, MARC Economic Research

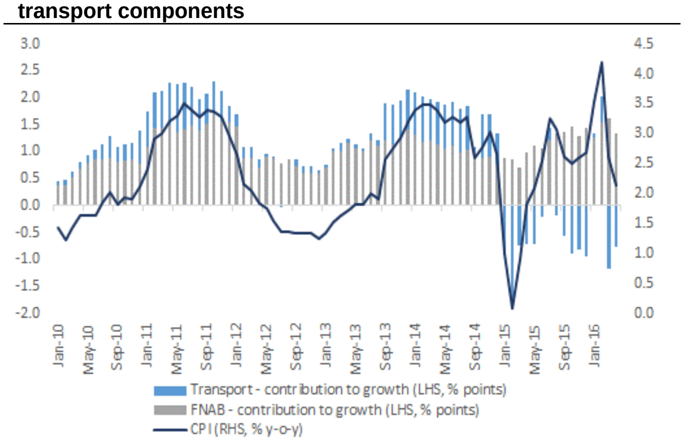
Stabilising inflationary pressure but no relief on cost of living

- The inflation rate, which accelerated to 3.4% in 1Q2016 due to the low base effect from the decline in domestic fuel prices in 1Q2015 and the reduction in electricity tariff rebates in January 2016, started to normalise to 2.1% y-o-y and 2.0% y-o-y in April and May, respectively. The moderation in the CPI growth in recent months partly reflects the high base in April 2015 during and after the implementation of the Goods and Services Tax (GST). The stronger increase in the inflation rate in the first five months was driven primarily by food and non-alcoholic beverage items which saw average increases of 4.4%, up from 2.9% in the corresponding period in 2015. Meanwhile, the core measure, which excludes prices of administered goods and services, grew 3.0% in the first five months of 2016.

- Notwithstanding the rise in inflation, we expect the pace to moderate in the months to come due to the higher base in 2H2015 after the implementation of GST. We think that Malaysia's inflationary landscape in 2016 will be contingent on two opposing forces: (1) rising price pressures due to the lag effect of government subsidy rationalisation efforts, the weaker ringgit, and the possible increase in future pump prices amid rising global crude oil prices; and (2) slower domestic demand due to the moderation in economic activity. On balance, we have adjusted our average inflation target to 2.8% for 2016, from 3.2% previously.

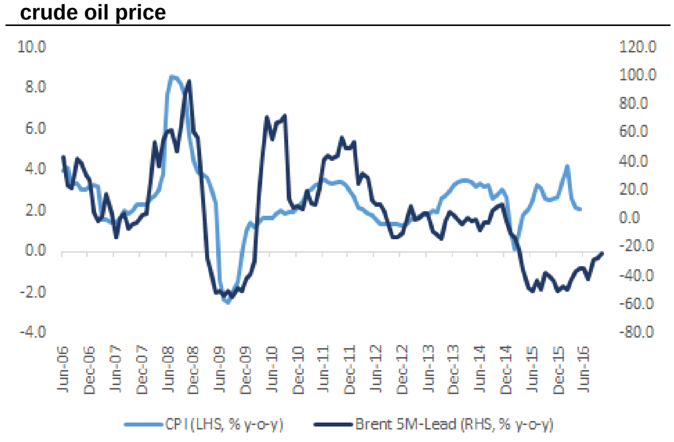
- While CPI inflation will likely be kept below 3.5% this year, the rising cost of living will continue to exert some pressure on private consumption, especially on the lower income group and those who are in urban centers. The cost of living – which includes both expenditures on goods and services as well as financial obligations to maintain a certain standard of living – has been rising due to different spending patterns by urban and rural households and increasing financial obligations, partly due to the high cost of homes in Malaysia. A recent study by the BNM revealed that home prices in key states are beyond the reach of many Malaysians and that prices have grown at a faster pace than income levels. With decelerating economic growth and rising unemployment in 2016, the issue of the high cost of living will continue to hog the limelight in the near term.

Chart 17: CPI growth and contribution to growth by FNAB and transport components



Source: CEIC, MARC Economic Research
Note: FNAB refers to Food & Non-Alcoholic Beverages

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



Source: CEIC, Bloomberg, MARC Economic Research

Fiscal position, debt level and sovereign rating will be the focus

- Malaysia's sovereign rating will continue to hog the limelight. Given that the impact of low crude oil prices on Malaysia's financial position will be fully realised in 2H2016, the country's fiscal balance will be under the microscope. Of particular interest is the effectiveness of the measures projected to reduce expenditures by approximately RM9 billion, as planned under the recalibration of Budget 2016. The reduction in expenditures is crucial to achieve the government's 2016 deficit target of 3.1% of GDP. This is to ensure that Malaysia's sovereign rating will not be downgraded in the near term amid a sharp drop in oil-related revenue.

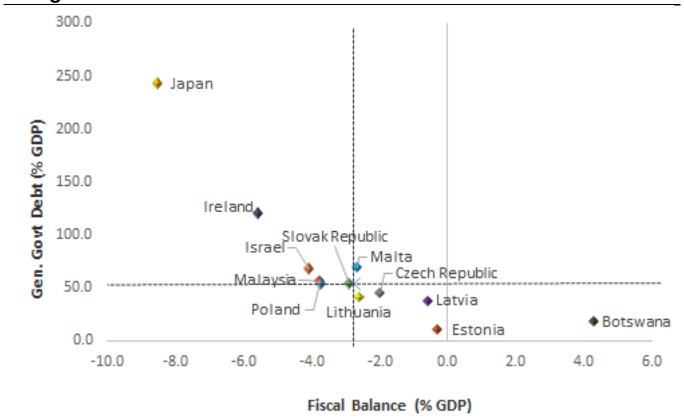
- It is worth noting that Malaysia's deficit level is at the lower range of the regression band among its A-rated peers. While Malaysia's single-A rating is supported by other factors, which among others include a positive current account (CA) balance and stable growth, the amount of CA surplus has been declining in the past few years and will be in the range of 1% to 2% of GDP in 2016, in our view. Lacklustre trade performance arising from anemic global demand and low commodity prices are major contributing factors of a smaller CA surplus this year. Such a situation will spark concerns about the possibility of a twin deficit which, if it happens, will exert more pressure on the ringgit.

- Besides the pressure from low revenue this year, Malaysia's fiscal position also faces another challenge, which is the lower-than-anticipated nominal GDP growth that will affect various performance indicators, namely the budget deficit, government debt, current account, and household debt ratios as a percentage of GDP. In the recalibration of Budget 2016, most of the indicators were anticipated to be relatively unchanged from their levels projected late 2015 during the tabling of the annual budget. At the time, nominal GDP was projected to grow by 6.8% in 2016. However, with moderating economic growth in 1H2016 we think that achieving such a target is a tall order. Even for the whole of 2015, nominal GDP registered a growth of only 4.6%, lower than real GDP growth of 5%, reflecting the 'deflationary environment' faced in 2015 due to weak demand.

- Going forward, as we have pointed out in our BNM Annual Report, we foresee a possibility of nominal GDP expanding by approximately 4.5%-5.5% in 2016, making it likely for budget deficits to be in the region of 3.1%-3.3% of GDP. Even if the deficits turn out to be slightly higher than projected, we do not see this as a threat for the economy and the sovereign rating as the fiscal consolidation remains on track. We are of the view that a slight increase, if it happens, will not derail the fiscal consolidation efforts as the government is serious about balancing the budget by 2020. It is merely a result of a downward economic cycle arising from unfavourable external factors.

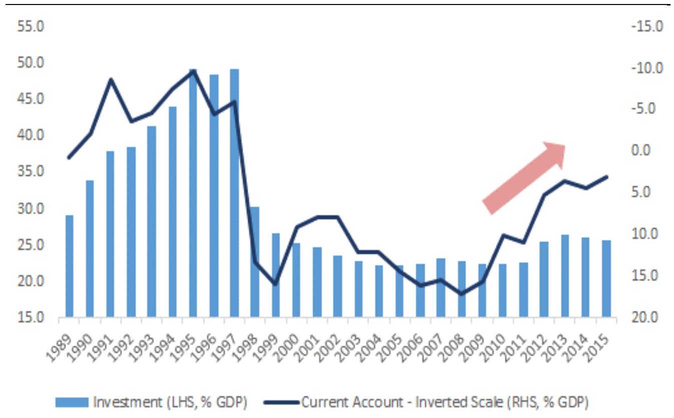
- Malaysia's total debt level is another area of concern relating to the country's sovereign rating. Total federal government debt has been stubbornly above 50% of GDP in recent years (2015: RM630.5 billion, or 54.5% of GDP). Although under The Loan (Local) Act 1959 and Government Funding Act 1983, the federal government domestic debt cap is measured by the sum of outstanding MGS, GII, MITB and syndicated loans raised within the country – which in total we estimate to be circa 49% of GDP – we think the government will try to ensure the amount of total debt to GDP is below 55% in order to maintain investor confidence. The bright spot is that only 3% of the total federal government debt is foreign currency-denominated, implying a very low exposure to foreign exchange risks. While we commend the government's effort to shift a portion of its debt to the newly formed Public Sector Home Financing Board to reduce the debt level by approximately two percentage points, we caution that additional amounts of contingent liabilities will continue to attract the attention of international rating agencies.

Chart 19: General government debt versus fiscal balance of single-A band countries



Source: IMF, MARC Economic Research

Chart 20: Current account and total investment as % GDP



Source: CEIC, MARC Economic Research

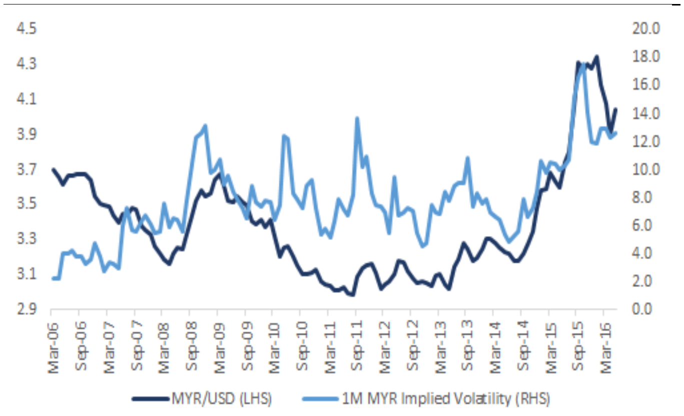
OPR – Brexit may change the game plan despite BNM's resistance

- Our stance regarding the OPR has changed somewhat since we published our views in our *Annual Economic Outlook* in late 2015. With the global economic outlook expected to turn more negative after the UK's Brexit vote, as well as the domestic economy expected to moderate further going forward, we foresee increasing pressure on BNM to trim the OPR in the months ahead. We now believe that there is greater justification for the BNM to loosen its stance before the year is out, especially after the ringgit starts to stabilise following the Brexit. It should be noted that ringgit volatility has been high in the lead-up to UK's EU Referendum.

- That said, however, we are of the view that the BNM will try to resist doing so unless headline GDP growth tumbles further than expected. While the authorities are concerned about decelerating growth this year, signs of a pickup in consumer spending have slowly emerged with private consumption growth accelerating to 5.3% in 1Q2016, up from a low of 4.1% in 3Q2015. Additionally, given the current situation, the new governor of the BNM will continue to maneuver its policy in line with the tone set by his predecessor. Under the previous governor, the BNM hinted that reducing the policy rate may not necessarily provide a meaningful boost to the economy as experiences in other countries have shown that monetary policy alone has its limitations in supporting growth. We sense that, as far as the BNM is concerned, additional efforts from the fiscal side are necessary to complement its policies in supporting the economy.

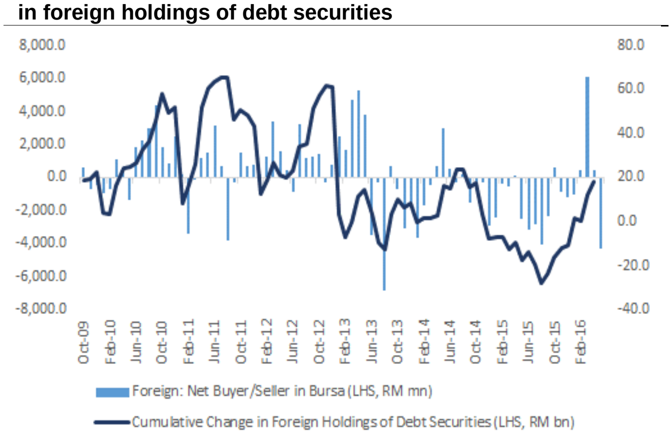
- Notwithstanding this, we believe that the Brexit will somewhat change the BNM's game plan. A higher probability of downside risks to the economy will likely persuade the BNM to change its monetary course along with other major central banks. We think that this may happen when the ringgit starts to stabilise. Against this backdrop, we foresee a high possibility of BNM cutting the OPR by 25 bps in 2016.

Chart 21: MYR/USD and 1M MYR implied volatility



Source: Bloomberg, MARC Economic Research

Chart 22: Foreign transactions in Bursa and cumulative change in foreign holdings of debt securities



Source: CEIC, MARC Economic Research

- As for the ringgit's performance against the greenback, we think that it hinges on several factors: (1) the possibility of an interest rate reduction if GDP growth tumbles more than expected; (2) the trend in global crude oil prices will, to large extent, determine oil-related revenue in 2016. This will in turn determine the government's ability to achieve the targeted deficit of 3.1% in 2016; (3) the near-term trend of CA surpluses, given the lackluster trade performance so far this year. A sharp reduction in CA surpluses could lead to a speculation that a twin deficit is on the cards, although essentially, a reduction in CA surpluses is not necessarily a bad thing for Malaysia if seen from the perspective of a savings-investment gap. A narrower gap signals rising investments relative to savings which could enhance Malaysia's future productive capacity; and (4) how aggressive the US rate hike will be as this will influence the direction of capital flows in this region, Malaysia included.

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