Economic Research

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2H2017 Economic Outlook: Sustaining the Positive Momentum

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In a nutshell

- The global economy is on the mend. Based on high frequency data year-to-date, global economic growth seems to be more evenly balanced. The Global Purchasing Managers' Index (PMI) continues to be on the uptrend, aided by a more robust global trade performance. Industrial production is picking up although inflation has not yet reached the targets in most of the advanced economies. The United States' (US) economy is gaining strength, with a strong labour market and rising capacity utilisation (CAPU) despite a mild pullback by consumers in 1Q2017. Industrial production rose at the fastest annual pace since January 2015 and robust job gains (+162K jobs per month on average year-to-date until May) would be supportive of consumer spending going forward. Given such a backdrop, MARC is of the view that the Federal Reserve (Fed) would continue to normalise its monetary policy despite not achieving its inflation target. The downside risk to the economy, however, remains the potential setback in delivering President Trump's promised fiscal stimulus, given increased political noises.

- Other major economies are also supporting the global expansion. China's growth, for instance, is rebounding after last year's deceleration. The economy expanded 6.9% in 1Q2017 (4Q2016: 6.8%), faster than expected and well above the government's full-year 6.5% target. Higher government infrastructure spending, as well as the boom in the property sector, both of which helped lift industrial output by the most in over the last two years, provided the boost. Notwithstanding China's improved short-term economic outlook, we would remain cautious on how its economic rebalancing efforts to put the economy on a more sustainable footing will pan out in the medium term. Financial sector risks due to the build-up of debt remain a veritable concern. On the whole, however, 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.

- In Europe, the 19-nation euro-area's economic growth continues to accelerate, clocking its best run since the Global Financial Crisis (GFC) nearly a decade ago. Thus far, concerns over rising Eurosceptism have somewhat receded, following the defeat of populist candidates in French and Dutch elections in the early part of this year. In addition, sentiment among businesses and consumers has returned to pre-crisis level, suggesting that the current economic recovery is becoming more sustainable. The region's manufacturing and services gauges continued to show strong upward momentum in recent months, with the composite PMI holding at a six-year high in each of the three months ended June. On the whole, MARC is of the view that the euro-area recovery is set to continue, underpinned by fiscal support, accommodative monetary conditions and a weaker currency.

- As for Japan, the economy remains on a moderate recovery trend. Helped by an uptick in exports, it expanded at an annualised 1.0% pace in 1Q2017, driven by both domestic and external demand. It was the fifth consecutive quarter of growth, and marked the longest period of expansion in a decade. Notwithstanding the improvement, MARC views that growth over the longer term could be curbed by Japan's failure to spur inflation, which remains stubbornly below the central bank's 2.0% target. Another concern is its huge government debt burden, which stands at more than twice the size of gross domestic product (GDP). Longer-term growth is also being threatened by a shrinking labour force as the population continues to age rapidly. While recent positive GDP growth data may have brought some relief to policy makers, the longer-term outlook remains uncertain.

- On the local front, Malaysia's real GDP which rebounded strongly in 1Q2017 to 5.6% year-on-year (y-o-y), is expected to continue chalking up decent numbers in 2H2017, supported by both external and internal factors. On the external front, global trade value which turned positive for the first time in the final quarter of 2016, is benefitting Malaysia's exports sector. In US dollar (USD) terms, Malaysian exports had posted positive growth in 4Q2016 and 1Q2017 for the first time since 3Q2014. In ringgit terms, real exports growth accelerated to 9.8% in 1Q2017, the strongest since mid-2010. Exports of manufactured products also benefitted from rising global semiconductor sales while major commodity exports surged by nearly 30% after contracting in the past two years.

- MARC is of the view that resilient private consumption growth and stronger investment momentum will continue to drive domestic demand going forward. Malaysia's relatively favourable demographic profile has, to a certain extent, contributed to the stable pace of consumer spending over the past few years. While the headline unemployment rate held steady at 3.5% in 1Q2017, some indicators have already pointed to a slight improvement in the labour market. Collectively, we think that these positive factors will support private consumption growth at around 6%-7% for the rest of 2017.

- Total investment, meanwhile, will continue to get a boost from a steady inflow of mega infrastructure projects, such as the High Speed Rail (HSR), Mass Rapid Transit 3 (MRT3) and East Coast Railway Link (ECRL), all of which will keep growth buoyant in 2H2017. In addition, the spillover effect from improving demand from abroad will keep capital spending upbeat, as reflected by the recent surge in machinery and equipment investment growth in 1Q2017. This is further evidenced by a rebound in the Malaysian Institute of Economic Research (MIER) Business Conditions Index (BCI) in 1Q2017 which surpassed the 100-point threshold level for the first time in three quarters, the strongest level since at least mid-2014. As such, we are now tweaking upward our private investment growth projection to 6.0% for 2017. All in all, MARC foresees real GDP growth to accelerate to 5.0% in 2017, up from our earlier estimate of 4.3%.

- MARC views the recent spike in inflation to 4.2% y-o-y in the first five months of 2017 as transitory and that the near-term outlook for inflation is broadly unchanged. Current inflation momentum is expected to decelerate in the coming months as cost pressure moderates on the back of the stronger ringgit and softening commodity prices. However, the inflation rate will likely remain higher than last year due to the lower base, especially in 2H2016 when the consumer price index (CPI) grew at an average pace of only 1.5%. As a result, we now foresee an average inflation rate of 3.3% - 3.8% for the whole of 2017, up from our previous forecast of 2.8%-3.3%.

- On interest rates, MARC retains its view that the Overnight Policy Rate (OPR) will be maintained at the current level of 3.0% throughout the rest of 2017. With the global economic outlook expected to turn more positive on the back of stronger performances from the US and China, as well as a rebound in the domestic economy, we do not expect a further reduction in the OPR for the rest of 2017. The possibility of an upside movement of OPR is also rather limited. Although inflation figures will be closely watched in the next six months following the spike in the first five months of 2017, we think that cost-push factors will not induce Bank Negara Malaysia (BNM) to react as it could lead to a deterioration in consumers' financial position.

- As for the government's financial position, MARC opines that the fiscal deficit target of 3.0% of GDP in 2017 is achievable. This is premised on the slightly higher average crude oil prices expected for this year, combined with a continued acceleration in economic growth. Over the medium term, however, we foresee the government's target of achieving an almost balanced budget of -0.6% of GDP by 2020 as challenging, unless crude oil prices rebound back their pre-2014 level and economic growth picks up meaningfully.

- On capital flows, the situation has improved recently with Malaysia recording bond inflows over two consecutive months in April and May 2017. Total foreign bond holdings as of end-May 2017 stood at RM195 billion, RM51.8 billion (21%) lower than its August 2016 peak. While the fall may seem large, it is still relatively small compared to the drop in the aftermath of the GFC in 2008-2009. Total foreign holdings had then fallen 67% by March 2009 from its peak at April 2008. Going forward, there are positive factors supporting the Malaysian bond market. These include: (1) brighter growth prospects of the Malaysian economy in 2017; (2) better-than-expected fiscal and external balances; and (3) a stable ringgit against the greenback. We expect these factors to induce stronger capital inflows in 2H2017.

- As for the ringgit, positive macro developments have helped its performance in the past few months. In fact, the ringgit's performance has topped regional currencies, appreciating by 4.5% since end-2016. This is not surprising as the ringgit had depreciated immensely based on its real effective exchange rate (REER). Going forward, the prospects of the ringgit remain positive although it may go through episodes of bumpy rides following the expected mild downtrend in crude oil prices. We maintain our average forecast for the ringgit of RM4.20-RM4.30 per USD for the next six months.

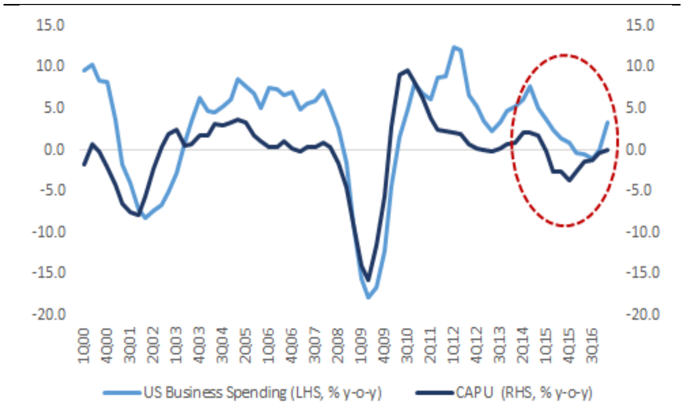
Global Economy – more positive vibes

- The global economy is on the mend. Based on high frequency data year-to-date, global economic growth seems be more evenly balanced. Global PMI is sustained on the uptrend, aided by a more robust global trade performance. Industrial production is picking up although inflation has not yet reached the targets in most of the advanced economies. The US economy is gaining strength, with a strong labour market and rising capacity utilisation. Other major economies are also supporting the global expansion. China's growth is rebounding after last year's deceleration and European economies are on the mend despite concerns over the impact of the United Kingdom's (UK) Brexit. Japan, meanwhile, posted its fifth consecutive quarter of growth in 1Q2017.

- Despite a mild pullback by consumers in the US in 1Q2017, the economy continued to cruise smoothly on the back of an improvement in investment activities. Industrial production surged by more than 2% y-o-y in both April and May, its biggest annual rise since January 2015. An increasingly tighter labour market, as evidenced by robust job gains (+162K jobs per month on average year-to-date until May) and a multi-year low jobless rate (4.3% in May) would be supportive of consumer spending going forward.

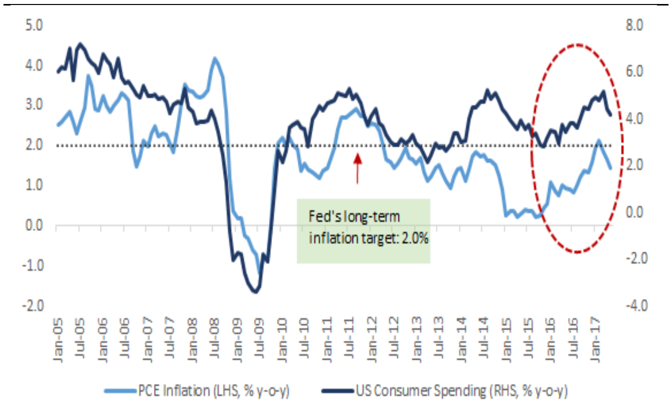
- Given such a backdrop, MARC is of the view that the Fed would continue to normalise its monetary policy despite the setback in achieving its inflation target. Fed's preferred inflation gauge, the personal consumption expenditure (PCE) deflator which has peaked at 2.1% in February, retreated to 1.4% in May amid an absence of sustained acceleration in wages. Going forward, inflationary pressure could also be weakened slightly by a more stable USD and softer crude oil prices. The downside risk to the economy, however, remains the potential setback in delivering President Trump's promised fiscal stimulus, given increased political noises and his over-focus on border control as well as on healthcare.

Chart 1: US business spending and CAPU



Source: CEIC, MARC Economic Research

Chart 2: PCE inflation and US consumer spending growth



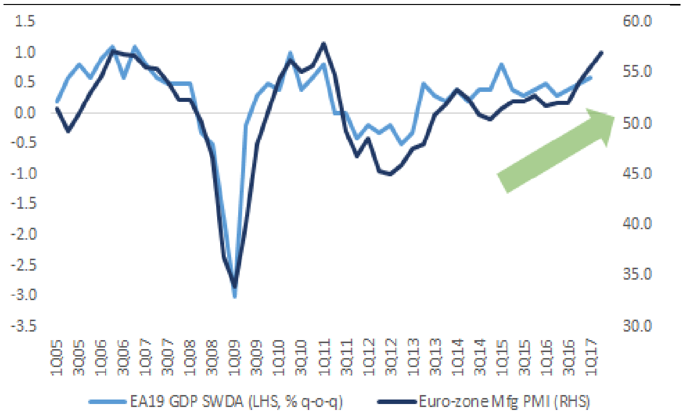
Source: CEIC, MARC Economic Research

- In Europe, the 19-nation euro-area's economic growth continues to accelerate, clocking its best run since the GFC nearly a decade ago. Real GDP growth accelerated to 0.6% quarter-on-quarter (q-o-q) in 1Q2017 (4Q2016: 0.5%), and was up by 2.5% from a year earlier (4Q2016: 1.5%). Thus far, concerns over rising Euroscepticism have somewhat receded, following the defeat of populist candidates in French and Dutch elections in the early part of this year. In addition, sentiment among businesses and consumers has returned to pre-crisis level, suggesting that the current economic recovery is becoming more sustainable. Evidently, the region's manufacturing and services gauges continued to show strong upward momentum in recent months, with the composite PMI holding at a six-year high in each of the three months ended June.

- Inflationary pressure appears to have resurfaced, thanks to the uptick in commodity prices and weaker euro currency, although the rebound in headline figures could be short-lived amid tepid underlying price pressure. The headline inflation rate hit an average of 1.7% in the first five months of 2017, the strongest since 2012, in line with the European Central Bank's (ECB) target range of "below, but close to, 2%". The core-index, however, remained subdued at 0.9% during the same period (2016: 0.9%).

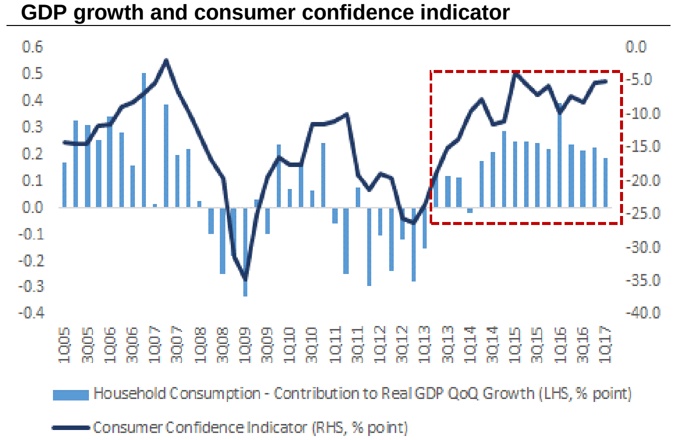
- Given the backdrop, we are not surprised by the ECB's slightly hawkish tone in its latest monetary policy meeting in early June. It, however, remained vigilant on its inflation assessment. With the underlying domestic price pressure expected to remain subdued over the near term, the ECB is expected to continue its asset purchases programme at full pace at least until 2018. But one notable point is that the central bank has now dropped the possibility of a rate cut, citing that the risks on the economy are broadly balanced. On the whole, MARC is of the view that euro-area recovery is set to continue, underpinned by fiscal support, accommodative monetary conditions and a weaker currency. Notwithstanding this, the region will not be spared from the downside risks of a renewed political uncertainty owing to a number of elections in some parts of the region in the latter part of the year. The future relationship of the European Union (EU) and the UK also poses some degree of risk to the region.

Chart 3: Euro-area GDP growth and manufacturing PMI



Source: CEIC, Bloomberg, MARC Economic Research

Chart 4: Euro-area household consumption contribution to real GDP growth and consumer confidence indicator



Source: CEIC, MARC Economic Research

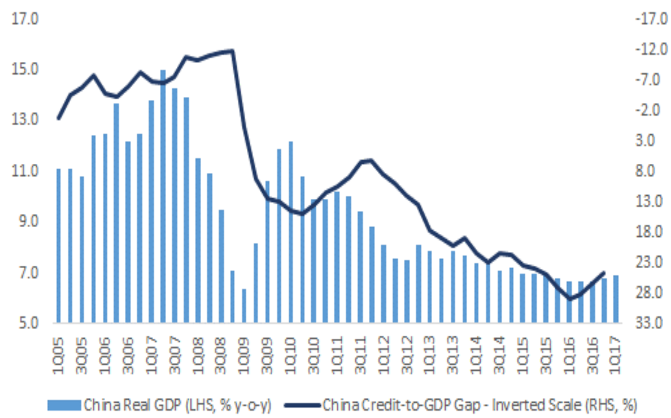
- The short-term outlook of the Chinese economy has improved. In 1Q2017, the Chinese economy expanded 6.9% (4Q2016: 6.8%), faster than expected and well above the government's full-year 6.5% target. Higher government infrastructure spending, as well as the boom in the property sector, both of which helped lift industrial output by the most in over the last two years provided the boost. Meanwhile, the International Monetary Fund (IMF) upgraded its 2017 growth forecast for China by 0.1 percentage point to 6.7% in June, its third increase this year. It cited, among other things, policy support and public investment. It expects the Chinese GDP growth to average 6.4% annually over the 2018-2020 period, in line with our expectations.

- Notwithstanding China's improved short-term economic outlook, we would remain cautious on how its economic rebalancing efforts to put the economy on a more sustainable footing will pan out in the medium term. Financial sector risks due to the build-up of debt remain a veritable concern. China's total debt – government plus households plus businesses – stood at 277% of GDP at end-2016 (end-2015: 254%), high for a developing country. While the People's Bank of China (PBOC), the central bank, is expected to continue guiding short-term interest rates higher to dampen credit growth, it could still loosen credit conditions if economic growth falters. Another important concern is debt build-up outside the regulated banking system. If it continues, China could become increasingly financially vulnerable.

- As for Japan, the economy remains on a moderate recovery trend. Helped by an uptick in exports, it expanded 1.0% in 2016. In 1Q2017, it expanded at an annualised 1.0% pace, driven by both domestic and external demand. It was the fifth consecutive quarter of growth, and marked the longest period of expansion in a decade. The Bank of Japan (BoJ) expects the economy to expand by 1.6% in the 2017-18 fiscal year. MARC expects the Japanese economy to expand between 1.0%-1.5% in 2017.

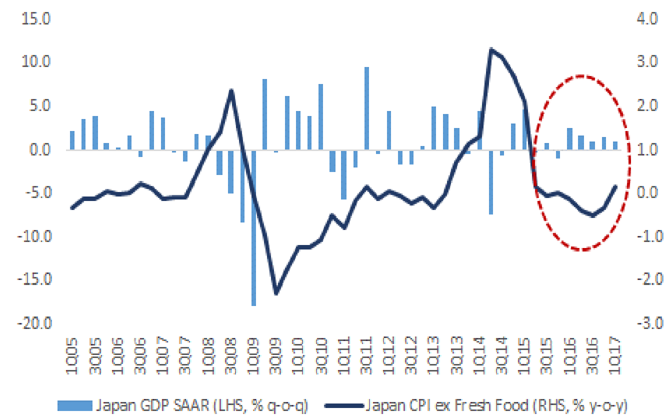
- Notwithstanding the improvement, MARC views that growth over the longer term could be curbed by Japan's failure to spur inflation, which remains stubbornly below the central bank's 2.0% target. This despite the core CPI – stripped of the volatile cost of the fresh food component – rising 0.4% in May, its fifth consecutive month of rises on the back of higher energy costs. Notwithstanding BoJ's core CPI forecast of 1.4% in the 2017-18 fiscal year, many are hopeful that higher oil prices and wages going forward could spur inflation in the near term. This would help efforts to manage the huge government debt burden, which stands at more than twice the size of the GDP. Longer-term growth is also being threatened by a shrinking labour force as the population continues to age rapidly. While recent positive GDP growth data may have brought some relief to policy makers, the longer-term outlook remains uncertain.

Chart 5: China real GDP growth and BIS credit-to-GDP gap



Source: BIS, CEIC, MARC Economic Research

Chart 6: Japan real GDP growth and core inflation



Source: CEIC, MARC Economic Research

Malaysian Economy

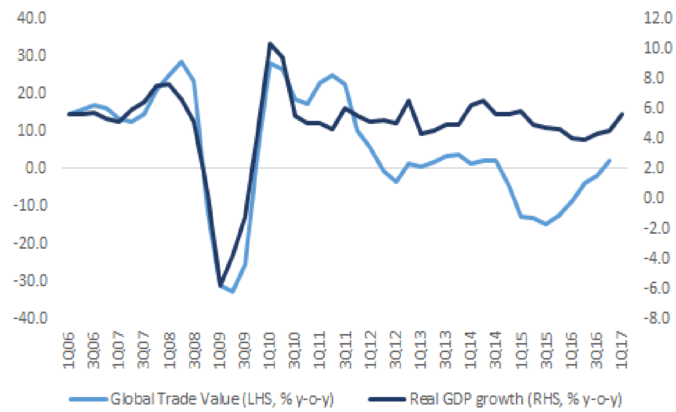
Growth – recovery in external demand and commodity prices

- The Malaysian economy appears to have bottomed out in 2016, with real GDP growth having surprised on the upside, registering a 5.6% pace in 1Q2017, the strongest since the first three months of 2015. On a q-o-q seasonal adjusted basis, it was up by 1.8%. The expansion was bolstered by a rebound in domestic demand growth, in tandem with the recovery in external demand. Notably, private consumption growth remained resilient, expanding by 6.6% y-o-y, underpinned by steady wage gains and a slight improvement in the labour market. Although it was the strongest since early 2015, private consumption growth remained below the post-GFC trend of 6.9%.

- On external trade, while net exports subtracted 1.2 percentage points from headline growth in 1Q2017 (4Q2016: +0.5 percentage points), the pickup in real exports growth to 9.8% - the strongest since mid-2010 – came in as a breather after a long stretch of lacklustre performance. The rebound in exports helped restore business sentiment and reinvigorated the investment climate, evidenced from the 21.8% surge in capital spending on machinery and equipment. This, in turn, resulted in a 12.9% jump in private investment growth, compared to its trough of 2.1% expansion in the same corresponding period last year (4Q2016: 4.9%).

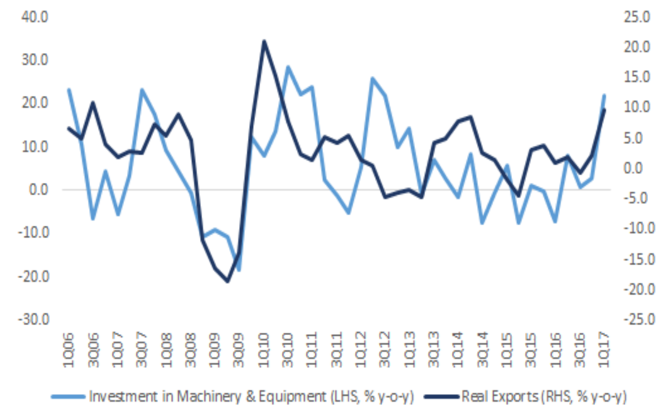
- The recovery in global trade momentum looks relatively solid at this juncture, with a broad base improvement in global demand, ranging from electronics to commodities. This was in spite of heightening external uncertainties which include, among other things, the possibility of inward trade policy by the new US administration, concerns over the UK and European parliamentary elections and the crisis among GCC countries. Notably, growth in global trade value has turned positive for the first time in the final quarter of 2016, ending eight consecutive quarters of contraction. Similarly, Malaysia's exports in USD terms posted a positive growth for the first time since 3Q2014 in the final three months of 2016 (2.2%), and strengthened further to 14.6% in 1Q2017.

Chart 7: Real GDP and global trade growth



Source: CEIC, WTO, MARC Economic Research

Chart 8: Investment in machinery and equipment growth versus real export growth

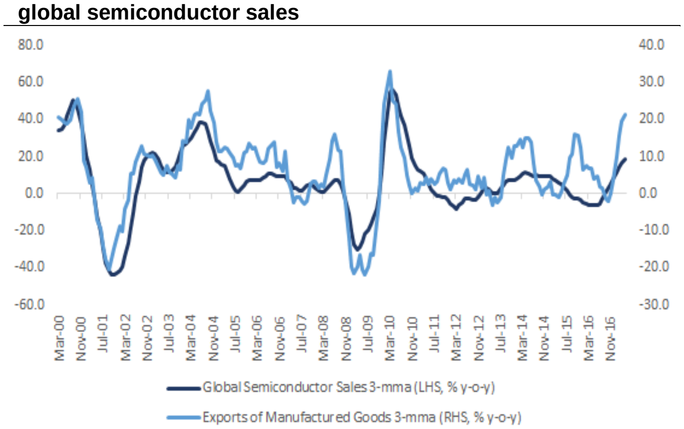


Source: CEIC, MARC Economic Research

- The improvement in global semiconductors demand is also evidenced by double-digit increases in global semiconductor sales between December 2016 and April 2017, reinforcing the case for stronger trade performance for the rest of this year. Not surprisingly, the World Semiconductor Trade Statistics (WSTS) is projecting a double-digit increase of 11.5% in global semiconductor sales for this year, up from a mere 1.1% growth in 2016. Likewise, Malaysia's exports of manufactured products climbed by an average 19.5% in 1Q2017, up from an average 3.5% pace in 2016. In addition, a modest recovery in commodity prices since early this year is a boon for commodity exporters such as Malaysia. This can be seen from an average 29.8% increase in Malaysia's major commodity exports in 1Q2017, after contracting the past two years (2016: -8.5%, 2015: -16.5%). On the whole, MARC expects Malaysia's real exports growth to accelerate to 4.0% for 2017, higher than our initial expectation of a 2.4% growth seen early this year.

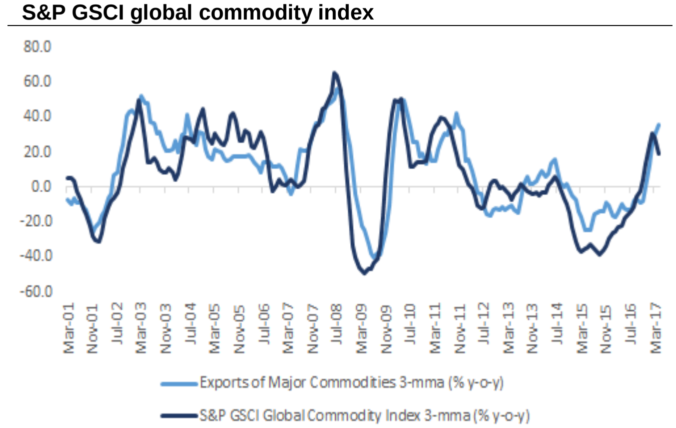
- On crude oil, MARC is of the view that the output cut extension by the Organisation of the Petroleum Exporting Countries (OPEC) and its affiliates will continue to lend some support to prices in the near term despite their recent decline in recent months. With rising production among non-OPEC members, increasing crude oil inventories and flattish demand growth, we foresee a rather limited upside in crude oil prices in 2018. Our base case assumption for the average price of Brent crude oil for 2017 is USD45-55 per barrel.

Chart 9: Annual change in exports of manufactured goods and global semiconductor sales



Source: SIA, CEIC, MARC Economic Research

Chart 10: Annual change in exports of major commodities and S&P GSCI global commodity index



Source: Bloomberg, CEIC, MARC Economic Research

Domestic demand to remain resilient

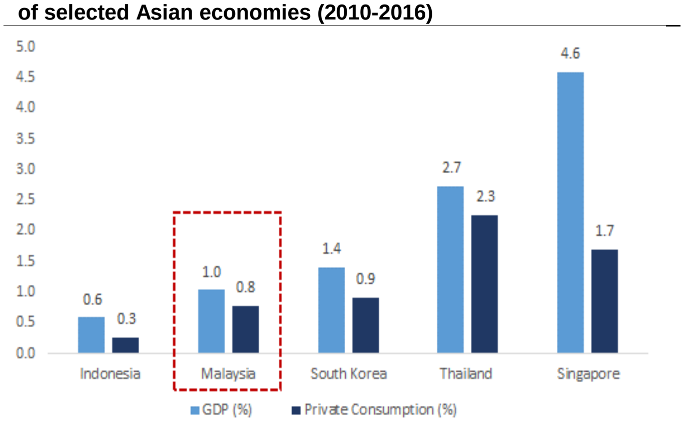
- MARC is of the view that resilient private consumption growth and stronger investment momentum will continue to drive domestic demand going forward. Malaysia's relatively favourable demographic profile has, to a certain extent, contributed to the stable growth in consumer spending over the past few years. In fact, Malaysia's private consumption growth volatility is among the lowest in the region between 2010-2015 (0.8%; Thailand: 2.3%; Singapore 1.7%; South Korea 0.9%; Indonesia: 0.3%). In addition, Malaysia's average consumer spending growth outpaced its regional peers in the past few years.

- A mild pickup in the MIER Consumer Sentiment Index (CSI) to 76.6 points in 1Q2017 (4Q2016: 69.8 points) suggests that the mood among consumers was more upbeat than in the preceding two quarters. While the headline unemployment rate held steady at 3.5% in 1Q2017, some indicators have already pointed to a slight improvement in the labour market. The number of people unemployed, for instance, increased at a slower pace of 2.6% in 1Q2017, sharply below its average of 10.0% seen in 2016. Meanwhile, the number of job vacancies available in the market appears to have normalised, with the number of people unemployed vying for every job vacancy having shrank to an average 5.1 times in 1Q2017, down from its peak of 24.3 times in mid-2016. Collectively, we are of the view that these positive factors will support private consumption growth at around a 6%-7% pace for the rest of 2017.

- Total investment, meanwhile, will continue to get a boost from a steady inflow of mega infrastructure projects, such as the HSR, MRT3 and ECRL, all of which will keep growth buoyant in 2H2017. In addition, the spillover effect from improving demand from abroad will keep capital spending upbeat, as reflected by the recent surge in machinery and equipment investment growth in 1Q2017. This is further evidenced by a rebound in MIER BCI which surpassed the 100-point threshold level for the first time in three quarters, climbing to 112.7 points in 1Q2017, the strongest level since at least mid-2014. All in all, we are now tweaking upward our private investment growth projection to 6.0% in 2017, an increase by 40 basis points from our previous estimate.

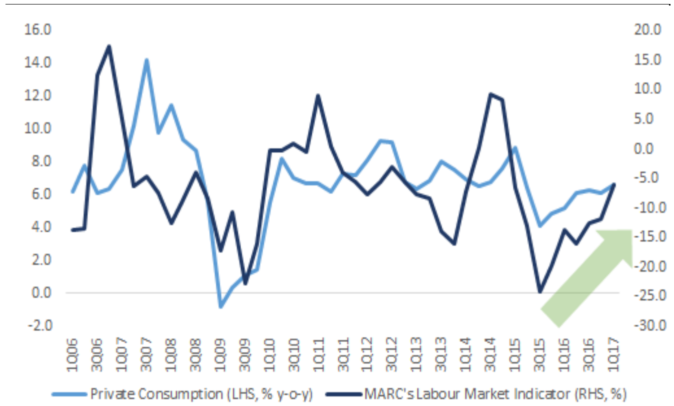
- Notwithstanding the positive outlook, there are risks in the near term. The most prominent are the renewed geopolitical tensions in North Korea, as well as between GCC countries that could dampen investment sentiment and temper global economic growth. In addition, in the UK, Prime Minister Theresa May's loss of majority power in the recent parliamentary election could lead to another round of financial market volatility as there are now uncertainties over the pace of the UK's departure from the EU. On top of that, a continuing monetary policy normalisation in the US will continue to widen interest rate gaps between the US and emerging economies, hence exerting additional pressures on emerging market (EM) currencies. This could result in another round of capital outflows from the region. On balance, however, MARC is of the view that Malaysia's real GDP growth will be in the range of 5.0% in 2017, up from our initial estimate of 4.3%.

Chart 11: Real GDP and private consumption growth volatility of selected Asian economies (2010-2016)



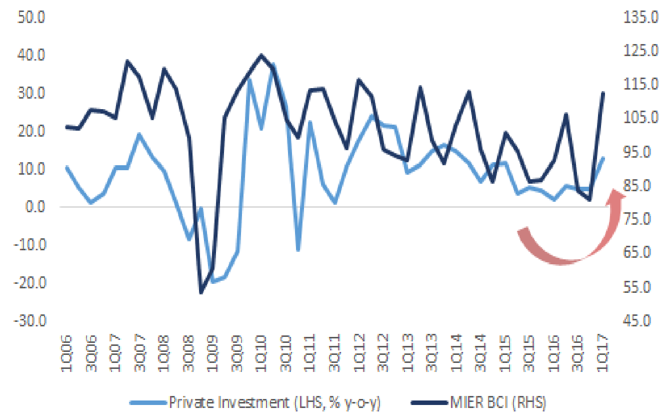
Source: CEIC, MARC Economic Research

Chart 12: Private consumption growth and MARC's Labour Market Indicator



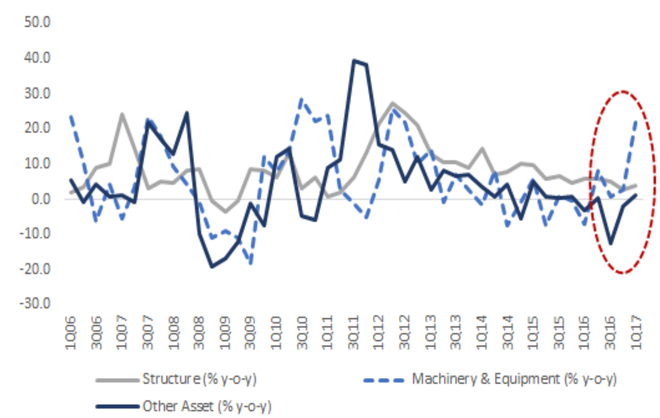
Source: CEIC, MARC Economic Research

Chart 13: Private investment growth and MIER BCI



Source: CEIC, MARC Economic Research

Chart 14: Investment growth by asset classes



Source: CEIC, MARC Economic Research

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

Growth (%y-o-y)	2012	2013	2014	2015	2016	MARC 2017F	BNM 2017F	MoF 2017F
GDP	5.5	4.7	6.0	5.0	4.2	5.0	4.3 - 4.8	4.0 - 5.0
Domestic Demand	10.7	7.3	6.0	5.1	4.3	5.4	4.4	4.9
Private Consumption	8.3	7.2	7.0	6.0	6.0	6.8	6.0	6.3
Public Consumption	5.4	5.8	4.4	4.4	0.9	1.6	-0.2	0.4
Private Investment	21.4	12.8	11.1	6.3	4.3	6.0	4.1	5.8
Public Investment	15.9	1.8	-4.7	-1.1	-0.5	1.0	1.5	1.1
Real Exports	-1.7	0.3	5.0	0.3	1.1	4.0	2.2	2.5
Real Imports	2.9	1.7	4.0	0.8	1.1	4.8	1.8	2.6

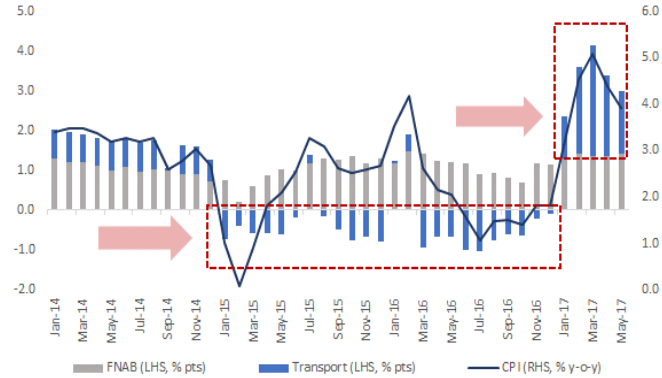
Source: CEIC, MoF, BNM, MARC Economic Research

Stronger inflationary pressure amid higher fuel cost

- Malaysia's headline CPI has surprised on the upside, registering an average growth of 4.2% in the first five months of 2017, compared to 2.9% in the corresponding period in 2016. The rapid pace of inflation was mainly attributed to the base effect as the drag from lower crude oil prices in early 2016 dissipated. This is evidenced by a sharp upturn in the transport component of the CPI which increased by 15.8% over the same period, contributing 1.9 percentage points to headline CPI growth. Elsewhere, the lagged inflationary impact of the cooking oil subsidy removal in November 2016 and weaker ringgit helped keep the growth of food and non-alcoholic beverage cost at an elevated pace of 4.2%. Notwithstanding this, the core measure, which excludes prices of administered goods and services, grew at a steady pace of 2.5% in the first five months of 2017.

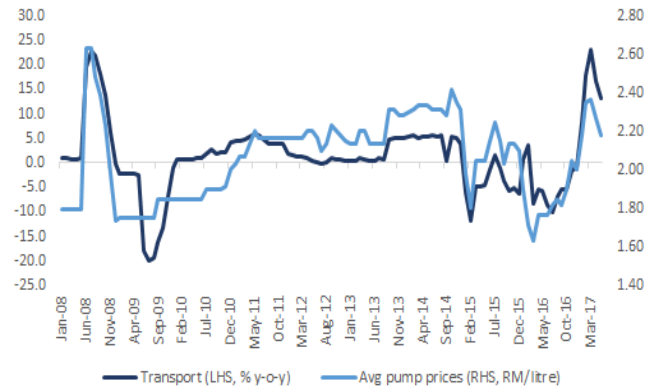
- Overall, MARC views the recent spike in inflation as transitory and that the near-term outlook for inflation is broadly unchanged. Current inflation momentum is expected to decelerate in the coming months as cost pressure moderates on the back of the stronger ringgit and softening commodity prices. However, the inflation rate will likely remain higher than last year due to the lower base, especially in 2H2016 when CPI grew at an average pace of only 1.5%. As a result, we now foresee an average inflation rate of 3.3% - 3.8% in the whole of 2017, up from our previous forecast of 2.8%-3.3%.

Chart 15: 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 16: Transport CPI and average pump prices



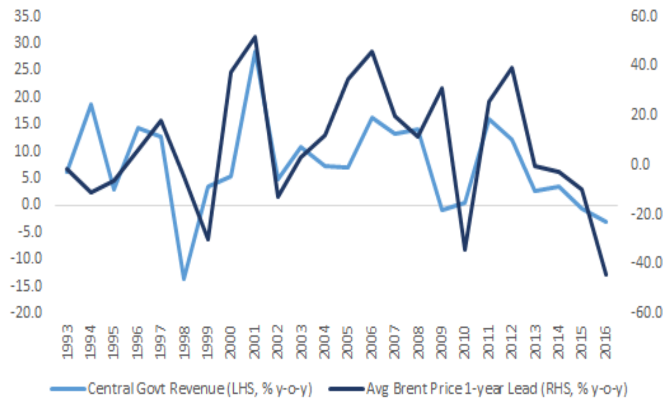
Source: CEIC, MARC Economic Research

Fiscal policy – delicate balancing act will continue

- While our initial view was that achieving the fiscal deficit target of 3.1% of GDP in 2016 would be challenging, the surprise pickup in nominal GDP growth, alongside tight control on expenditure at the end of 2016 have, to some extent, helped push the overall fiscal shortfall down to within the targeted level. To recap, total government revenue shrank 3.0% in 2016, the most since the depth of the Asian Financial Crisis (AFC) in 1998, while total expenditure dropped by 2.1%, more than the 1.9% decline estimated during the Budget 2017. Of note, oil-related revenue fell to an estimated 14.6% of total government revenue in 2016, down from an average of 35% during the heydays prior to 2015. However, the foregone oil-related revenue has been partially offset by the timely implementation of the Goods and Service Tax (GST) which added RM41.2 billion to government coffers in 2016 (2015: RM27.0 billion). Meanwhile, the turnaround in nominal GDP growth in 2016 (+6.3% versus 4.6% in 2015) helped the government to achieve a budget deficit ratio of 3.1% of GDP.

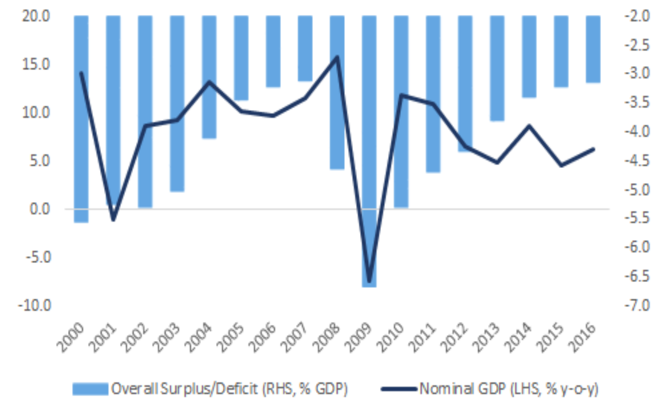
- Looking ahead, MARC opines that the government's fiscal deficit target of 3.0% of GDP in 2017 is achievable. This is premised on the slightly higher average crude oil prices expected for this year, combined with a continued acceleration in economic growth. In fact, nominal GDP growth accelerated to 11.6% in 1Q2017, the strongest since 2Q2011, a pace that will improve some of the headline ratios – i.e. fiscal deficit, government debt, household debt and etc. – in 2017. Over the medium term, however, we still foresee the government's target of achieving an almost balanced budget of -0.6% of GDP by 2020 as challenging, unless crude oil prices rebound back to their pre-2014 level and economic growth picks up meaningfully. Back-of-the-envelope calculation suggests that in order to achieve a fiscal deficit of 0.6% of GDP in 2020, the government would have to reduce its fiscal deficit ratio by an average of 0.8 percentage point per annum in the next three years. Historically, the reduction in the fiscal deficit ratio had averaged around 0.5 percentage point per annum over the past seven years. Nevertheless, it is important to note that while the government may not achieve a balanced budget by 2020, the fiscal consolidation effort will remain on track. In fact, the delay in achieving a balanced budget was mainly due to a downward economic cycle arising from unfavourable external factors.

Chart 17: Annual change in federal government revenue and average Brent price with one-year lead



Source: CEIC, Bloomberg, MARC Economic Research

Chart 18: Fiscal balance-to-GDP ratio and nominal GDP growth



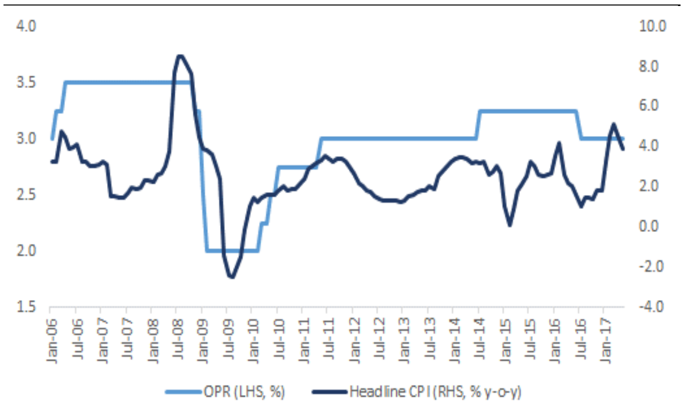
Source: CEIC, MARC Economic Research

OPR – to maintain status quo in 2017

- We are retaining our call that the OPR will maintain its status quo in 2017. With the global economic outlook expected to turn more positive on the back of stronger performance of the US and China, as well as a rebound of the domestic economy following better business and consumer sentiment, we foresee a stability in the OPR level for the rest of 2017. With real GDP growth in 1Q2017 having already surpassed 5% and ringgit recovered after depreciating against the USD late last year, there are now more reasons to believe that the rate cut in July 2016 was the last in the current cycle.

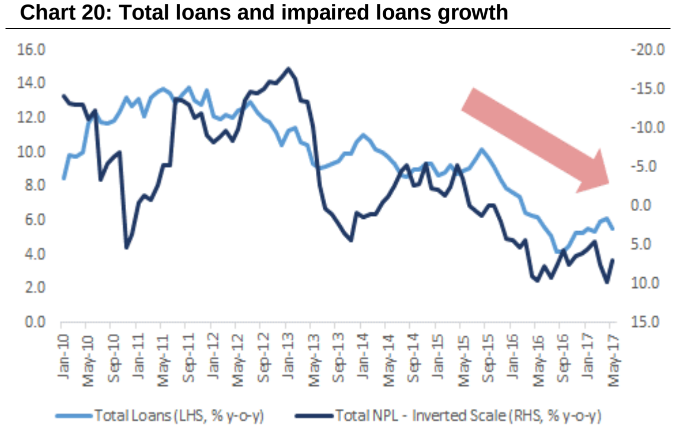
- The possibility of a higher OPR is also rather limited, in our view. Although inflation figures will be closely watched in the next six months following the spike in the first five months of 2017, we think that cost-push factors will not induce BNM to react. In fact, core inflation has remained relatively subdued, averaging at 2.5% in the first five months of 2017, well below its recent peak of 3.6% in each of the three months through March 2016. And although domestic demand growth had accelerated to nearly 8% in 1Q2017, the fact remains that private consumption – an important growth driver for the economy – has not surpassed its trend growth post-GFC (average 2010-2016: 6.9%). In addition, a hike in the OPR will affect consumers' balance sheet which has already deteriorated slightly since mid-2015. It is worth noting that as of May 2017, the absolute amount of gross impaired loans has picked up by 20.5% from its trough in April 2015. A rate hike would likely cause further deterioration in consumers' financial position.

Chart 19: OPR and headline inflation rate



Source: CEIC, MARC Economic Research

Chart 20: Total loans and impaired loans growth



Source: BNM, CEIC, MARC Economic Research

Capital flows and ringgit

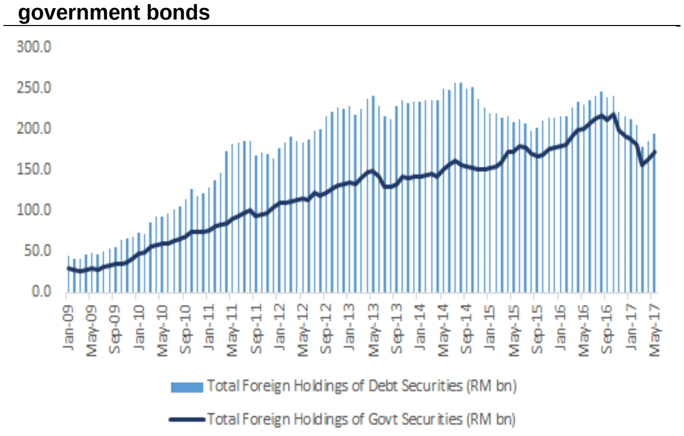
- While global economic recovery has slowly strengthened, we do not rule out the possibility of renewed global financial market volatility. This is premised on continuing US interest rates normalisation that would widen interest rate gaps vis-à-vis the rest of the world. A persistent strength in USD against other major and EM currencies will have a material impact on global capital flows.

- On capital flows, the situation has improved recently with Malaysia recording bond inflows over two consecutive months in April and May 2017. Total foreign bond holdings as of end-May 2017 stood at RM195 billion, about RM51.8 billion (21%) lower than its August 2016 peak. While the fall may seem large, it is still relatively small compared to the drop in the aftermath of the GFC in 2008-2009. Total foreign holdings had then fallen 67% by March 2009 from its peak in April 2008.

- Going forward, there are some offsetting factors that could prevent another round of capital outflows from Malaysian shores. One of such factors would be the brighter growth prospects of the economy in 2017. Judging by the current momentum, real GDP growth for 2017 will likely be at the top end of the government's forecast. Adding to this is the better-than-expected fiscal performance and external balances this year. With average crude oil prices likely to be higher than the government forecast of USD45 in 2017, government budget deficits could end up lower than initially expected. In addition, a stronger ringgit vis-à-vis the USD will also be a positive factor for Malaysia. All these will induce stronger capital inflows in 2H2017.

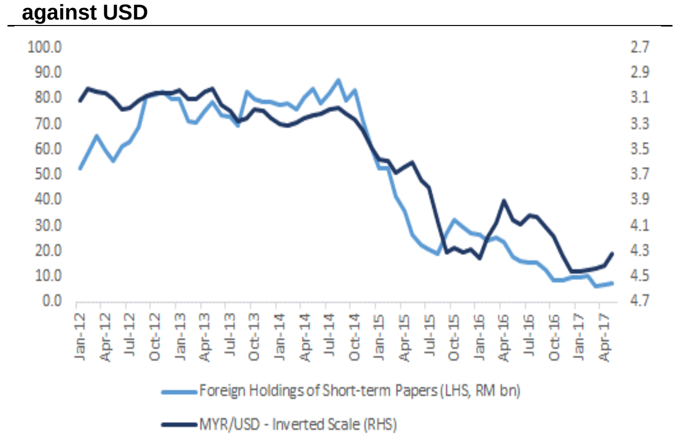
- As for the ringgit, positive macro development has helped its performance in the past few months. In fact, the ringgit's performance has topped regional currencies, appreciating by 4.5% since end-2016. This is not surprising as the ringgit had depreciated immensely based on its REER. Going forward, the prospects of the ringgit remain positive although it may go through episodes of bumpy rides following the expected mild downtrend in crude oil prices. We maintain our average forecast for the ringgit of RM4.20-RM4.30 per USD for the next six months.

Chart 21: Total foreign holdings of debt securities and government bonds



Source: CEIC, MARC Economic Research

Chart 22: Foreign holdings of short term-papers and MYR against USD



Source: CEIC, MARC Economic Research

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