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MALAYSIA: Macroeconomic Update

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In a nutshell

- Global growth prospects have continued to deteriorate in recent months, evidenced by the global manufacturing Purchasing Managers' Index (PMI) falling to below its boom-or-bust threshold in June. Adding to this, growth in global trade volume remained flat in the Jan-May 2019 period. This underscores the current deteriorating global demand and waning sentiment, mainly a result of the increasing trade tensions between the US and China.

- Downside risks of the Malaysian economy persist as global uncertainties continue to affect external trade performance and investment sentiment. The challenging trade environment will likely continue judging by the latest trade statistics. Because of the sharp decline in global semiconductor sales, Malaysia's electrical and electronic (E&E) exports have recently dropped more than they did compared to the 2015 downturn. Having said this, overall export numbers in ringgit terms are showing that the current downcycle is less severe than the ones experienced in 2008 and 2016.

- Given increasing external risks and weak investment growth, Malaysia will likely implement measures to support its overall economy in the near term. This is despite the stronger GDP growth recorded in 2Q2019. While Bank Negara Malaysia (BNM) will likely keep its options open before committing to further downward adjustments in the overnight policy rate (OPR), we feel that the rate cut could happen in 1H2020 if macroeconomic conditions deteriorate in the near term. Having said this, we do not expect the reduction to lead to a series of rate cuts akin to the one we saw during the Global Financial Crisis (GFC) in 2008-2009 where the OPR was reduced to 2%. On the fiscal side, the recent rhetoric from the government suggests that the fiscal policy could be relaxed slightly to avert a faster-than-expected deceleration in economic growth.

- We do not think a slight uptick in the budget deficit ratio, if it happens, would cause much concern among international credit rating agencies (CRAs) as the overall macro backdrop is not expected to deteriorate to the levels seen during the Asian Financial Crisis (AFC) in 1998 or during the GFC in 2008. Even during the 2008 GFC, Malaysia's sovereign rating was not revised by international CRAs.

- The possible economic support from both the monetary and fiscal sides will generally be positive for the financial market in the near term. This will alleviate the pressure arising from foreign capital outflows that the market has experienced since 2016. This is despite some outflows that could possibly take place due to investors' anxiety over FTSE Russell's decision of whether to exclude Malaysian government bonds in its global index in September. Downside risks would, however, emerge from a possible sustained depreciation in the Chinese renminbi and a faster-than-expected deceleration in the headline gross domestic product (GDP) growth.

Recent global developments have been downbeat

- Global growth prospects have continued to deteriorate in recent months, evidenced by the global manufacturing PMI which fell below its boom-or-bust threshold in June. It is now at the lowest level since October 2012. Its main components – Output, New Orders, New Exports and Employment – recorded readings of below the 50-point threshold.

- Weaker global trade is evidenced by a flat growth in global trade volume in the Jan-May 2019 period. This underscores the current weaker global demand and waning sentiment, mainly a result of the increasing trade tensions between the US and China. Exports in volume terms in emerging economies contracted by 0.3% y-o-y in the Jan-May 2019 period while imports fell by a larger magnitude of 0.7%. The announcement of an impending imposition of a 10% tariff on an additional USD300 billion worth of Chinese goods by the US and a retaliatory measure of suspending purchases of US agricultural products by China have further eroded global sentiment.

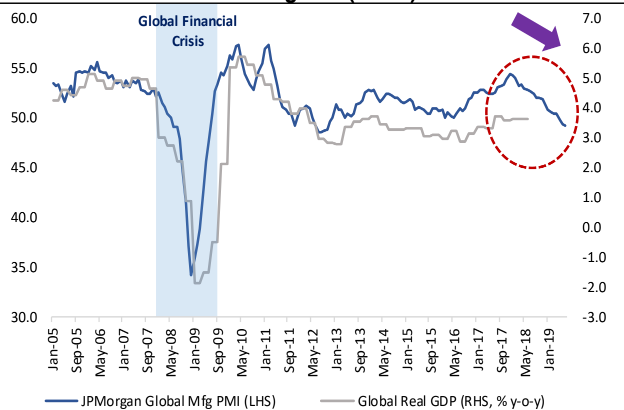
- Global semiconductor sales continued to contract significantly in June (-16.8% y-o-y) after a similar drop in the preceding month. This marked its fifth monthly double-digit contraction, the most severe since the GFC in 2008-2009. There is now a risk that the 12.1% contraction in global sales projected by the World Semiconductor Trade Statistics (WSTS) for 2019 will be exceeded.

- Against the backdrop of rising global economic uncertainties, the US Federal Reserve (the Fed) trimmed the federal funds rate (FFR) by 25 bps in late July. This is despite the relatively strong monthly payroll numbers of 151K in the first six months of 2019. Although the rhetoric from the Fed's chairman indicated that this is not the beginning of a continuing downward monetary easing, we still think another reduction is possible in 2019 judging by the deteriorating macro conditions and eroding sentiment worldwide.

- Macro releases in the US continued to be discomforting, with its leading index in June declining by the most since 2016. Despite a slightly higher-than-expected real GDP growth in 2Q2019, gross private domestic investment in the US fell by the fastest pace since 2015. Going forward, investment sentiment will likely continue to erode following increasing trade tensions with China.

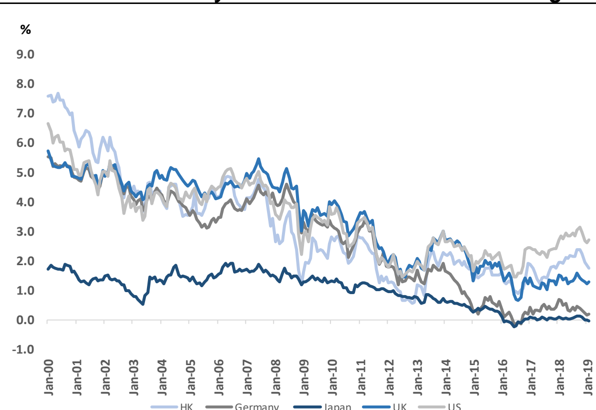
- The overall negative developments caused a pronounced reaction in the financial market, leading to a significant decline in bond yields in recent months. The yield on the 10-year UST fell by 84 bps from December 2018, dropping below the 2% support level on August 2, 2019 as investors scrambled for safe-haven financial assets. The 10y3m yield curve continued to contract by five bps by end-July.

Chart 1: Global manufacturing PMI (index)



Sources: Bloomberg, CEIC, MARC Economic Research

Chart 2: Global bond yields have retraced from their highs



Sources: Bloomberg, MARC Economic Research

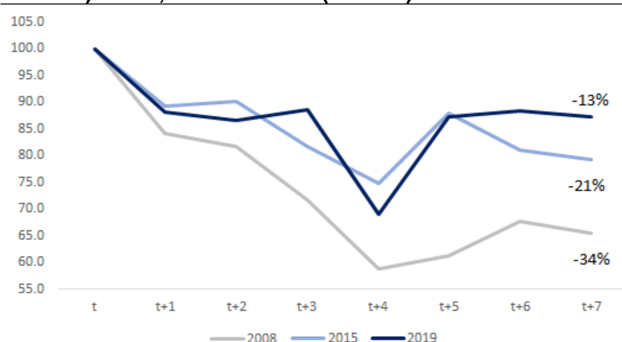
Malaysia: Growth to remain below potential

- Downside risks of the Malaysian economy persist as global uncertainties continue to affect external trade performance and investment sentiment. In 1H2019, Malaysia's exports fell by 0.2%, down from 6.9% in the corresponding period in 2018. A challenging trade environment will likely continue, judging by the latest trade statistics. The recent performance of neighbouring Singapore also reflects an increasing downward pressure on exports although its economy is more exposed to global trade vagaries compared to Malaysia. Singapore's exports fell by the most in six years in June following a plunge in electronics shipments.

- Having said this, export numbers in ringgit terms are showing that the current downcycle is less severe than the ones experienced in 2008 and 2016. From its peak in October 2018, gross exports have fallen by about 13% in the recent month. During the prior export downcycle in 2015, gross exports fell by 21% in the seven months following its peak in September that year. However, because of the sharp decline in global semiconductor sales, Malaysia's E&E exports have recently dropped more than they did compared to the 2015 downturn. From its peak in October 2018, it has fallen by 24% (2015: -17%, seven months after it peaked in October 2015).

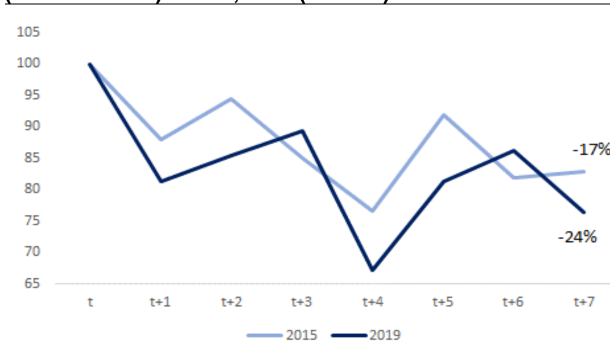
- Domestic demand continued to significantly support headline GDP growth as evidenced by a strong private consumption growth of 7.8% in 2Q2019 (1Q2019: 7.6%). It contributed about 90% of overall growth in 2Q2019. However, while private investment growth was stronger in 2Q2019 (+1.8%), it remained below trend. On balance, the economy remained relatively resilient with real GDP growth of 4.9% (1Q2019:4.5%). Going forward, however, we foresee the momentum in private consumption to weaken slightly amid a more cautious attitude among consumers following heightening uncertainties in the global economy. We maintain our GDP growth forecast at 4.6% for 2019.

Chart 3: Downturn in gross exports from cyclical peaks, (index rebased) - 2008, 2015 and 2019 (months)



Sources: BNM, MARC Economic Research

Chart 4: Downturns in exports of E&E from cyclical peaks, (index rebased) – 2015, 2019 (months)



Sources: BNM, CEIC, MARC Economic Research

More support through monetary and fiscal measures

- Given increasing external risks and weak investment growth, Malaysia will likely implement measures to support its overall economy in the near term. The continuing contraction in global semiconductor sales that would weigh on Malaysian headline GDP growth has raised a possibility of more pronounced support from both the monetary and fiscal sides. This is despite the stronger GDP growth of 4.9% recorded in 2Q2019 (1Q2019: 4.5%).

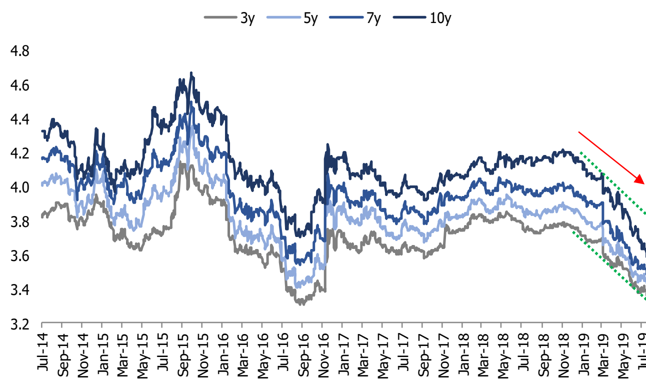
- While BNM will likely keep its options open before committing to further downward adjustments in the OPR, we feel that the rate cut could happen in 1H2020 if macroeconomic conditions deteriorate in the near term. Although Malaysia's high household debt of circa 83% of GDP calls for measures that prevent households' balance sheets from deteriorating, we think that another 25-bp reduction in the OPR, if

necessary, will not do much harm to the economy. This is because the household debt profile has improved in recent years. The share of borrowings by the so-called vulnerable group (monthly income level of RM5,000 and below) continued to fall to 39.8% in 2018 from 46.4% in 2014.

- Having said this, we do not expect the possible reduction in the OPR to lead to a series of rate cuts akin to the one we saw during the GFC (OPR was reduced to 2% during the peak of the crisis). The scale of current economic weakness has yet to match the episode that Malaysia went through in 2008-2009. Moreover, the US economy has not deteriorated significantly at this juncture while China's growth remains above 6%. More importantly, the experience during the GFC suggests that efforts by the global central banks to reflate their economies through low interest rates had resulted in economic imbalances (i.e. surging asset and property prices as well as higher household debt).

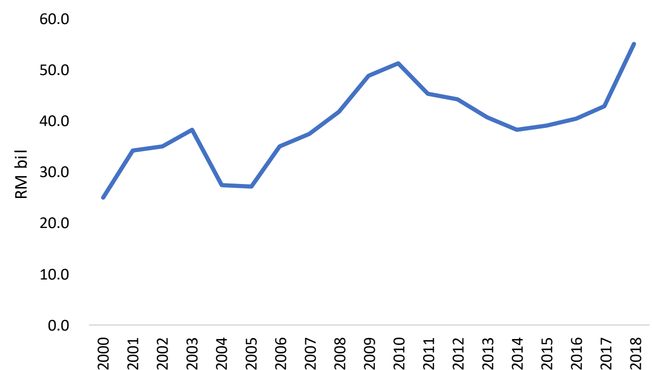
- On the fiscal side, the recent statement by the government that "it is challenging for Malaysia to achieve its budget deficit targets" in view of uncertainties due to the trade war, suggests that the fiscal policy could be relaxed slightly to avert a faster-than-expected deceleration of economic growth. Budget deficits had already declined by 39% in the first five months of 2019 to RM21.4 billion from RM35.0 billion in the corresponding period in 2018. This is despite a 13.4% increase in net development expenditure during the period. Going forward, we now expect development expenditure to be further increased and budget deficits for 2020 will remain circa 3.2% of GDP, a shade higher than the original target of 3.0% of GDP.

Exhibit 5: MYR IRS curves indicating a downside bias for interest rates (%)



Sources: Bloomberg, MARC Research

Exhibit 6: Net development expenditure



Sources: BNM, MARC Research

No revision in sovereign rating likely

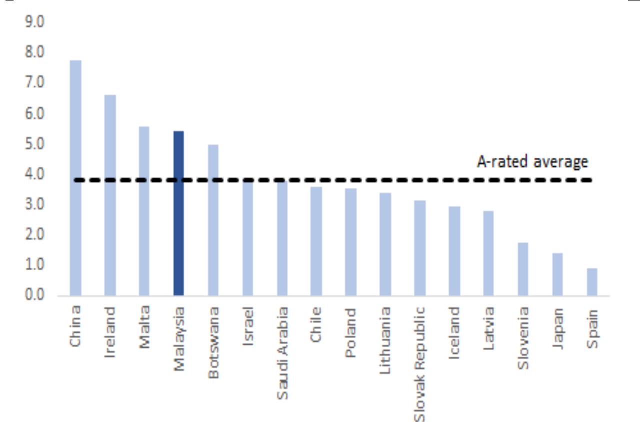
- We do not think a slight uptick in the budget deficit ratio would cause much concern among international CRAs as the overall macro backdrop is not expected to deteriorate to the levels seen during the AFC in 1998 or during the GFC in 2008. Even during the 2008 GFC, Malaysia's sovereign rating was not revised by international CRAs. Only its outlook was revised down by one CRA in 2013. Save for 2018, budget deficit ratios have been on the declining trend since the GFC (2009: 6.7% of GDP; 2014: 3.4% of GDP; 2017: 3.0% of GDP). In view of the present economic conditions, the new government has introduced more realistic budget deficit targets for 2018 and 2019.

- While there are concerns about declining government revenue due to the abolishment of GST in 2018, the government has managed to increase its tax collection through better compliance. For instance, although GDP growth moderated to 4.7% in 2018 (2017: 5.9%), Malaysia's direct tax revenue has increased by 12.1% (2017: 5.9%). With better management of operating expenditure (i.e. through reduction in leakages), we foresee the new fiscal consolidation target to be realistic.

- In addition, although the government debt ratio to GDP is above its rating peers (3-year median for rating peers: 50.2% of GDP), the government managed to keep its debt-service ratio below 15% of total revenue since 1994. This is encouraging considering that total debt has accumulated at a compound annual growth rate (CAGR) of 7.8% since 2010.While government guaranteed debt has risen sharply by 13.5% on a CAGR basis since 2010, recent rhetoric suggests that the government is now considering to limit the amount of contingent liabilities going forward.

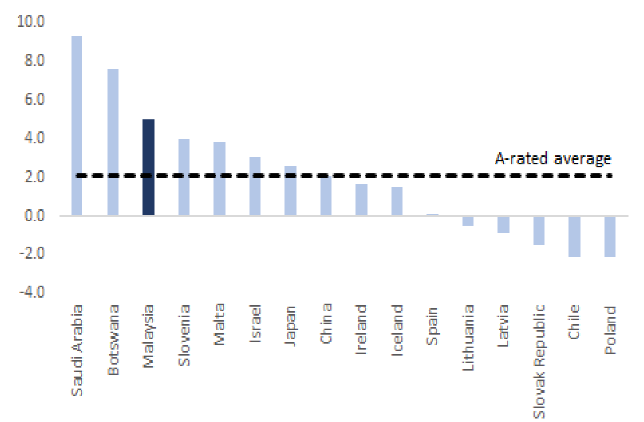
- Other than fiscal balance and debt, Malaysia's macro statistics remain generally more favourable compared to its rating peers. Its long-term GDP growth has averaged circa 5.4% between 2010 and 2018 (rating peers: 3.7%). The economy has never experienced a runaway inflation and it remains able to generate a positive current account balance, averaging 5.0% of GDP (rating peers 1.9%).

Chart 7: GDP growth – Malaysia & rating peers, % (average 2010-2018)



Sources: Trading Economics, IMF, MARC Economic Research

Chart 8: Current account balance, % GDP – Malaysia & rating peers (average 2010-2018)



Sources: Trading Economics, IMF, MARC Economic Research

Trend in capital flows will improve but volatility could persist

- The possible economic support from both the monetary and fiscal sides will be positive for the financial market in the near term. It will alleviate the pressure arising from foreign capital outflows that the financial market has experienced since 2016. This is despite some outflows that could possibly take place due to investors' anxiety over FTSE Russell's decision of whether to exclude Malaysian government bonds in its global index in September.

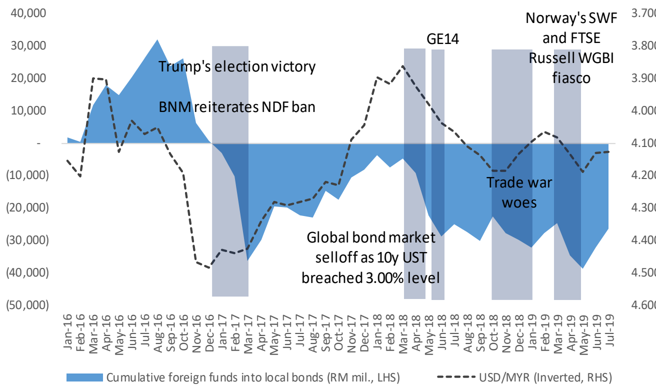
- In 1H2019, foreign flows into the local bond market improved. Total net foreign outflows shrank to RM2.2 billion (1H2018: net outflows of RM20.9 billion). The combined net foreign outflows with the equity market also improved to RM6.9 billion in 1H2019 (1H2018: RM33.6 billion).

- Lower net foreign outflows and a rally in the global bond market pushed MGS yields to their multi-year lows in 1H2019. Consequently, MGS yields were broadly lower by 33 bps to 60 bps as at end-June 2019 compared to their levels at end-December 2018. The 10y MGS fell to 3.63% from 4.07% in 2018, the lowest since October 2016, while the 3y MGS fell to 3.29% from 3.62% in 2018, the lowest since August 2017.

- The expected moderation in GDP growth in 2H2019 has also led the financial market to price in lower CPI inflation going forward. Inflation averaged 0.2% in 1H2019 and will likely register a growth of less than 2% in 2019. This will further suppress local bond yields to below their long-term averages in 2H2019. We now expect the 10y MGS yield to hover between 3.5%-4% for the rest of the year.

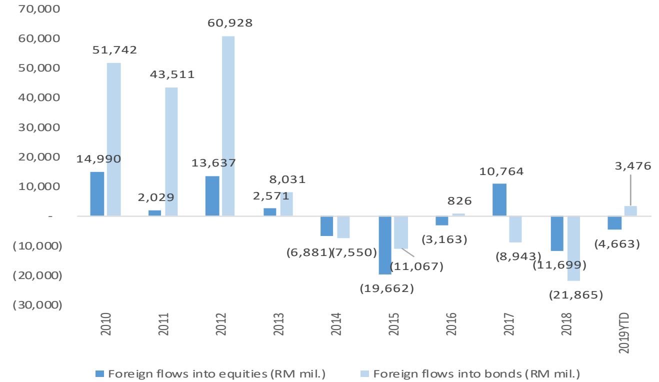
- Notwithstanding, downside risks would, however, emerge if the global economy continues to deteriorate. Heightening trade war between the US and China will add pressure on Malaysia's external sector. In addition, a continuing depreciation of Chinese renminbi would hit the ringgit as there is a strong correlation between the two currencies (correlation of 0.75 between 2016 and 2018). This could affect business and consumer sentiment and weigh on domestic demand.

Chart 9: Cumulative foreign flows into local bonds since January 2016



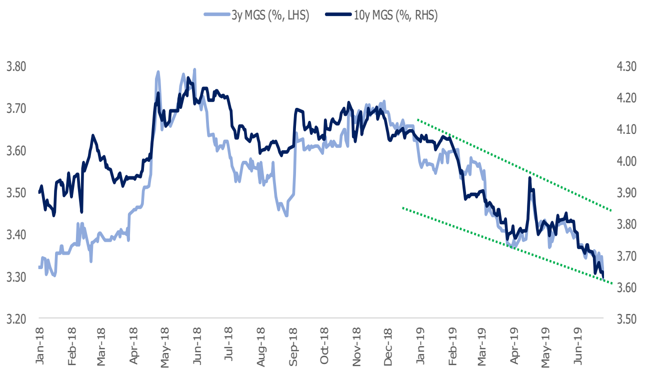
Sources: Bloomberg, BNM, MARC Research

Chart 10: Total yearly foreign flows for both Malaysian bond and equity markets



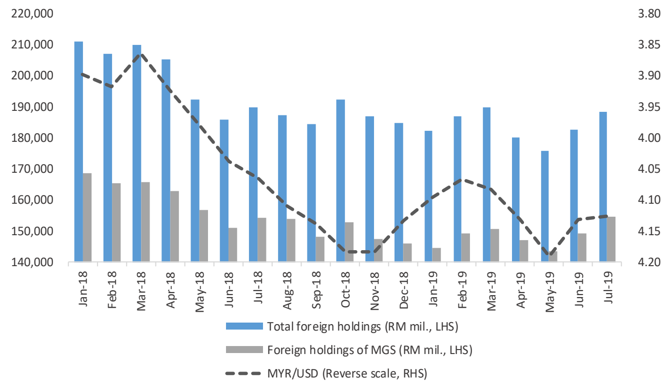
Sources:BNM, MARC Research

Chart 11: MGS yield curves are trending down



Sources: Bloomberg, MARC Research

Chart 12: Monthly performance of the ringgit versus total foreign holdings of local bonds and MGS



Sources: Bloomberg, BNM, MARC Research

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