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MALAYSIA: Macroeconomic Update

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In a nutshell

- Our view on the prospects of the global and Malaysian economies is generally in line with those presented by Bank Negara Malaysia (BNM) in its 2018 Annual Report. In the report, BNM acknowledges the uncertainties surrounding the world economy amidst slowing growth and increasing geopolitical risks. Being an open economy, Malaysia is bound to be affected by the deteriorating sentiment.

- BNM's forecast of a below trend real Gross Domestic Product (GDP) growth in 2019 (4.3%-4.8% versus MARC's 4.6%) is realistic. However, although policymakers are confident that domestic demand will continue to support the economy this year, we feel that its growth momentum could moderate as well. BNM also foresees exports to be less robust, with its growth moderating to circa 3.4% (2018: 6.8%) as the cyclical downturn in global trade continues. MARC concurs with this view.

- BNM expects private consumption to remain relatively vibrant, albeit expanding at a slower pace of 6.6% in 2019. This is, again, in line with MARC's prediction of 6.4% at the beginning of 2019. Our assumption of slower consumer spending growth is due to weaker sentiment arising from factors such as lower commodity prices and a cautious attitude among households and businesses. Domestic demand would also be dragged down by sluggish public investments and the deterioration in global sentiment.

- BNM also foresees inflation to be mild in 2019, at between 0.7% and 1.7%. It foresees the threat of deflation to be minimal at this juncture as the decline in prices in January reflects mainly the drop in transport prices. We have tweaked our inflation projection down to 1%-1.5%. We view that significant weaknesses in multiple price deflators (i.e. GDP and private consumption deflators) – if they occur in the near future – would signify softer overall aggregate demand.

- MARC believes that the recent tone by BNM in its March Monetary Policy Committee (MPC) statement provides the clearest signal that the central bank is preparing the market for a slight downward adjustment in the overnight policy rate (OPR). The timing for an OPR cut could not have been better, if it happens in the near term. This is because the ringgit has strengthened, and the US rate hike has paused. Given these occurrences, an OPR cut is unlikely to stoke significant domestic financial market volatility.

- The concerns over financial market volatility have not faded and hence, the ringgit's volatility may persist. Among factors that could affect the ringgit are: (1) prospects of a shrinking current account balance in the wake of a deteriorating external environment; (2) expectations of a stronger greenback; and (3) an increasing possibility of weaker crude oil prices. In addition, there is increasing uncertainty over China's policy with regards to the renminbi (RMB) following trade tensions with the US. Based on past experiences, the ringgit will be adversely affected if the RMB weakens significantly against the greenback.

- The continuing decline in the growth of household debt and its ratio to total household debt in 2018 are a credit positive for Malaysia. The share of vulnerable borrowers – those earning less than RM5,000 per month – has also declined slightly to 39.8% of total household debt from 40.6% in the preceding year. Despite this, we note the higher incidents of defaulters in the personal financing segment. About 50% of total outstanding personal financing is held by borrowers in this vulnerable group. MARC also notes that the share of personal financing among bankrupt borrowers has risen to 28% in 2018, from 15% in 2010.

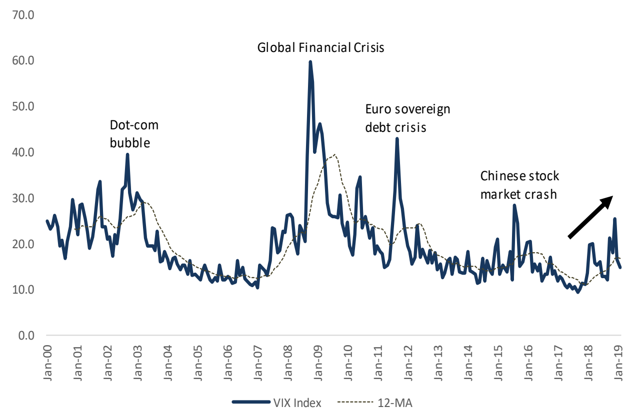
- While household debt remains a concern, MARC concurs with BNM's view that it does not necessarily pose a significant risk to financial stability. About two-thirds of the debt are secured and banks have continued to observe prudent lending practices. Notwithstanding this, the adverse impact on banks' credit growth, if the number of defaulters continue to rise, would have knock-on effects on private consumption and headline growth.

- The banking sector remained resilient although its capital ratios were generally lower due to the phasing-in of Basel III and adoption of the expected credit loss model under the MFRS 9. The gross impaired loan ratio was stable at 1.5% post-MFRS9. The sector continued to be predominantly funded by deposits. The loan-to-fund ratio improved marginally to 82.7% while the liquidity coverage ratio (LCR) expanded to 143.2% as banks recorded a drop in impaired loans due to better asset quality.

Prospects for the global economy in 2019

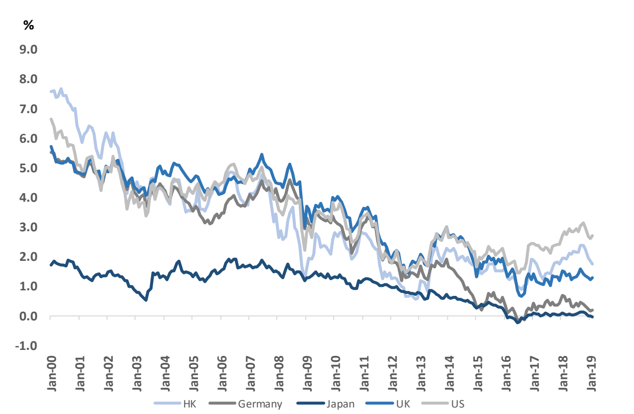
- MARC's view on the prospects of the global and Malaysian economies is generally in line with those presented by BNM in its 2018 Annual Report, released on March 27, 2019. In the report, BNM acknowledges the uncertainties surrounding the world economy amidst slowing growth, trade tensions and increasing risk aversion in the financial market. Notably, the prospects of the two largest world economies – the United States and China – are tilted on the downside for this year. The repercussion from trade tensions, although having somewhat subsided, has led to increasing risk aversion as reflected in the global financial market through the rising US VIX index and lower bond yields. Adding to this is political uncertainties across European countries due to Brexit-related issues. Jitters in emerging market economies are also building up following China's slower headline economic growth of 6.6% in 2018, its slowest in 28 years.

Chart 1: US VIX - uncertainties are rising



Sources: Bloomberg, CEIC, MARC Economic Research

Chart 2: Global bond yields have retraced from their highs



Sources: Bloomberg, MARC Economic Research

- That said, the US economy continues to be supported by a strong labour market as evidenced by its jobless rate of less than 4% in most of 2H2018. The average increase in non-farm payrolls by 151K per month and an average nominal wage growth of circa 4.5% in 4Q2018 suggests that the US economy remains resilient despite facing unfavourable global developments.

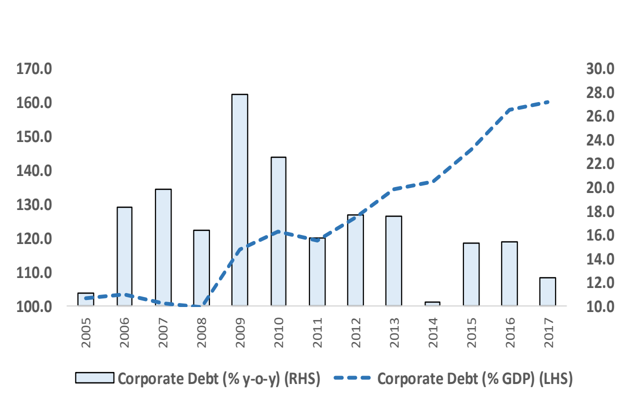
- Businesses remain resilient although growth is expected to moderate in 2H2019. The manufacturing sector continued to expand as reflected by the ISM Manufacturing Index which rebounded to above 55 in March 2019 after hitting a two-year low in the previous month, buoyed by new orders and production that jumped by 1.9 points and 1 point respectively. Capacity utilisation dropped slightly in February but remained above 78%.

- Notwithstanding this, anxiety over the lagged impact of interest rate hikes and spillovers from unfavourable global developments (i.e China's slowing economic growth, Brexit-related issues, trade wars) have led to a cautious stance by the US Federal Reserve (Fed). In fact, market implied probability of a rate cut in January 2020 has recently increased to 70%. While the impact of Trump's tax cut continues to wane, US growth is expected to soften in 2H2019.

- Uncertainties over the near-term outlook of China's economy are also weighing on the outlook of the global economy. Its real GDP growth slipped to 6.6% in 2018 – the slowest since 1992 – which has led the market to believe that the country's economic policies will take a sharper turn to support its growth as opposed to continuously reducing imbalances in the economy (i.e high corporate debt, strong credit expansion). MARC is of the view that policymakers' intentions to achieve multiple objectives will be China's greatest challenge in the near term. However, when external development becomes too challenging, China will likely choose to softly tap the brakes on its reforms in fear of a sharper-than-expected economic deceleration that could affect its social stability.

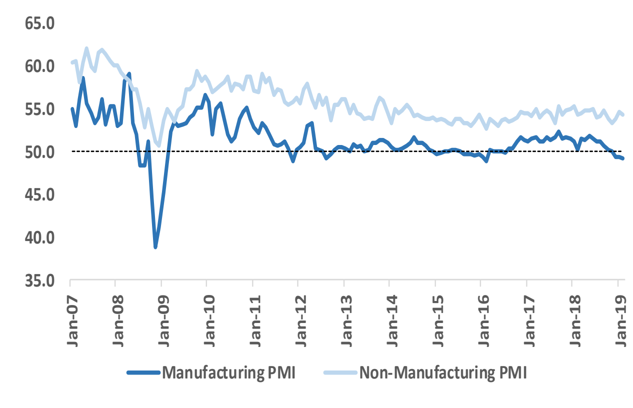
- Unfavourable corporate developments will likely receive particular attention in 2019. Surging corporate defaults – although they represent less than 0.2% of the total bond outstanding at this juncture – will likely have a negative impact on China's macro stability in the near term, if not properly contained. To avoid a sharper-than-expected growth deceleration, China will likely continue to be supportive from both monetary and fiscal sides. We see some room for further reductions in the reserve requirement ratio (RRR) and higher fiscal stimulus. At the same time, we also anticipate the RMB to remain relatively soft against the USD in 2019 as expectations of a more accommodative monetary policy and softer growth prospects are priced in by the market.

Chart 3: China's rising corporate debt



Sources: CEIC, MARC Economic Research

Chart 4: China's weakening mfg and non-mfg PMIs



Sources: Bloomberg, MARC Economic Research

Malaysia: A drag from adverse global developments

- BNM has forecast a respectable, although below trend, real GDP growth of 4.3%-4.8% for Malaysia in 2019. The projection is in line with our forecast of 4.6%. The main reasons for projecting a lower-than-average GDP growth in 2019 are the continuing drag from weakening world trade on Malaysian exports and the negative impact of slower investments.

- Although policymakers are confident that domestic demand – particularly private consumption – will continue to support the economy this year, MARC feels that its growth momentum could moderate especially at a time when the external sector is facing multiple global headwinds. BNM also foresees exports to be less robust, with growth moderating to circa 3.4% (2018: 6.8%) as the cyclical downturn in global trade continues. MARC concurs with this view. We foresee a downward pressure on exports due to the uncertainties in commodity prices as well as waning demand for electrical and electronic products. Crude oil prices have retreated from their cyclical high while palm oil prices will likely remain soft due to falling demand from the European Union.

- Indicators from World Trade Organisation (WTO) statistics suggest a likelihood of a continuing downtrend in the near future. In particular, global export growth has moderated to circa 2.7% from its peak in mid-2017. Similarly, the growth of container throughput index from 83 global ports measured by RWI/ISL has also slowed to -0.4% in February 2019. Malaysian exports have also slowed in tandem. In USD term, exports of palm oil and petroleum products fell by 19.9% and 32.7% in January.

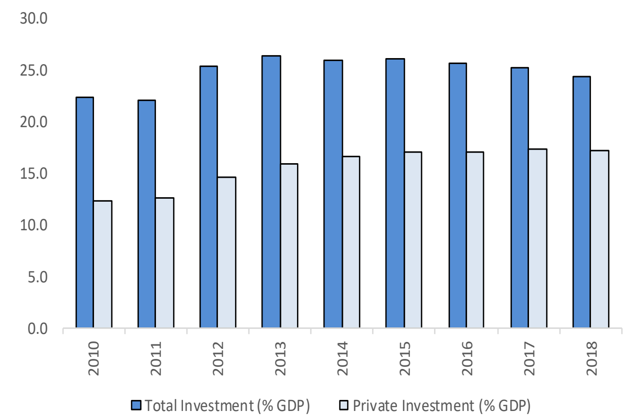
…. slower investments but supportive consumption growth

- BNM expects private consumption to remain relatively vibrant, albeit expanding at a slower pace of 6.6% in 2019 (2018: 8.1%). This is, again, in line with MARC's prediction of 6.4% at the beginning of 2019. Our assumption of slower consumer spending growth is due to weaker sentiment arising from factors such as lower commodity prices and a cautious attitude among households and businesses. The high base factor following the surge in consumption (due to the tax holiday and government assistance through *Bantuan Sara Hidup*) in 2018 also explains the likelihood of a softer growth in 2019.

- Domestic demand would also be dragged by sluggish public investments and the deterioration in global sentiment. Growth in private investment, which halved in 2018 (4.5% versus 2017's 9.3%) will likely remain subdued (BNM's forecast for 2019: 4.9%; MARC's forecast: 3.5%). Inflows of foreign direct investment (FDI) have also slowed in 2018, slipping to 10.1% of nominal GDP in 2018, from an average of 11.6% in 2016-2017. Net FDI inflows also shrank to 2.3% of nominal GDP from an average of 3.4% in 2016-2017. The moderation in private investment growth is also reflected in Malaysia's corporate bond issuance in 2018, which declined to RM103.9 billion from RM122.9 billion in the preceding year.

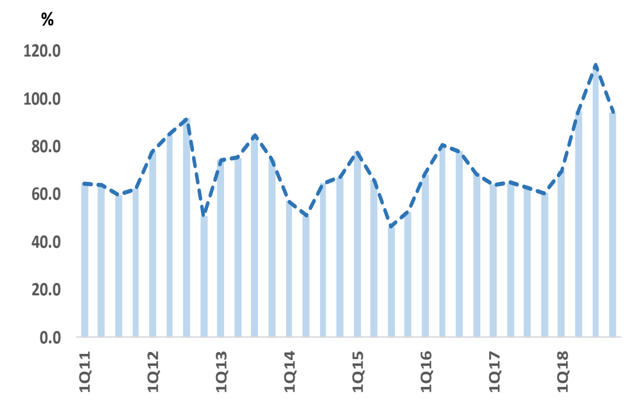
- Public investment will continue to feel the impact of a reduction in mega projects as the government continues to rationalise its expenditure to reduce debt. MARC is also of the view that FDI flows will be adversely affected in 2019. However, in the absence of significant turmoil in the financial market, we think that portfolio inflows would remain relatively favourable.

Chart 5: Private and total investments as a ratio to GDP



Sources: CEIC, MARC Economic Research

Chart 6: Rising private consumption contribution to headline GDP growth



Sources: BPAM, MARC Economic Research

- The major risks to Malaysia's growth trajectory in 2019 are primarily related to the external environment in view of the weakening global trade arising from protectionist sentiment. Although recent developments seem to suggest that the trade friction between the two largest world economies is subsiding, geo-political risks in Europe and in some parts of Asia could likely prevail and continue to put a drag on global trade performance.

- Secondly, a sharper-than expected deceleration in growth this year – if it happens – could exert pressure on Malaysia's sovereign rating outlook. This is due to the fact that most international credit rating agencies (CRAs) are banking on Malaysia's continuing growth to support its rating outlook. In addition, they are also looking for medium-term revenue generating measures by the government to assess the government's future fiscal trajectory.

Table 1: Malaysia – compared with A-rated peers, 3-year median (2016 – 2018)

	Malaysia	A-rated peers
GDP growth (%)	4.7	3.7
Inflation (%)	2.1	2.0
Fiscal balance (% of GDP)	-2.7	-0.9
CA balance (% of GDP)	2.9	2.2
General debt (% of GDP)	55.1	48.8

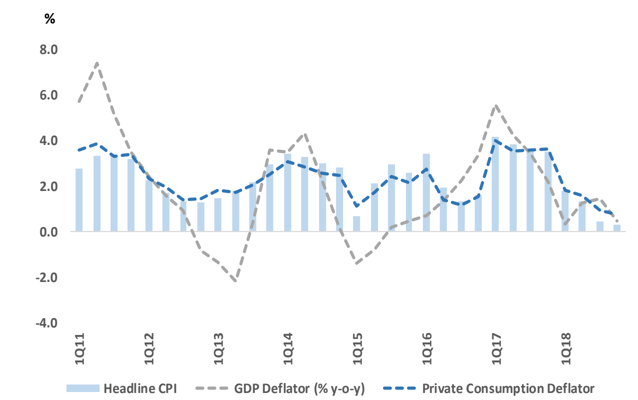
Source: International Monetary Fund (IMF), MARC Economic Research

Inflation to remain benign in 2019

- BNM also foresees inflation to be mild in 2019, at between 0.7% and 1.7%. This is despite the low base recorded in 2018 (at 1%). BNM foresees the threat of deflation to be minimal at this juncture as the decline in prices in January reflects mainly the drop in transport prices and not because of the weakness in aggregate demand. Growth in core prices remained positive, albeit growing at the slowest pace since August 2018. In addition, broad-based inflationary indicators such as GDP and private consumption deflators remained positive at 0.5% and 0.7% in the final quarter of 2018.

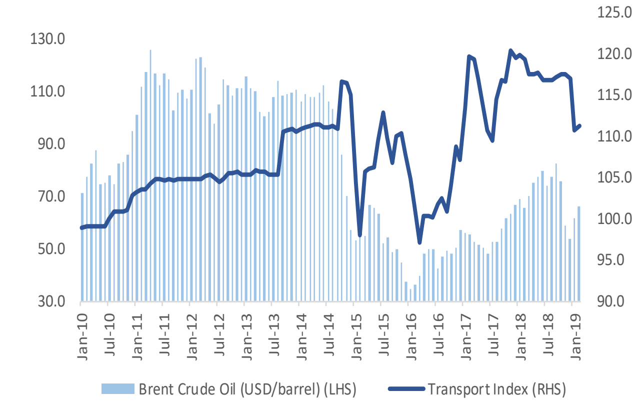
- We have tweaked our inflation projection down to 1%-1.5%. We are also cautious about the prospects of deflation and view that significant weaknesses in multiple price deflators (i.e. GDP and private consumption deflators) – if they occur in the near future – would signify weaker overall aggregate demand which will be accompanied by slower headline GDP growth. MARC also notes that based on BNM's statistics, GDP deflator growth is projected to be almost zero in 2019 (at 0.2%) while private consumption deflator is expected to post a merely 1% growth.

Chart 7: Inflation gauges - CPI and multiple prices deflators are moderating



Sources: CEIC, MARC Economic Research

Chart 8: Malaysia's transport index (re-based)



Sources: CEIC, MARC Economic Research

Household balance sheets and banking sector

- The continuing decline in the growth of household debt (4.7% versus 4.9% in 2017) and its ratio to total household debt (83% versus 83.6% in 2017) are a credit positive for Malaysia. The share of vulnerable borrowers – those earning less than RM5,000 per month – has also declined slightly to 39.8% of total household debt from 40.6% in the preceding year.

- There have been some improvements over the preceding year though, we note the higher incidence of defaults in the personal financing segment, especially by borrowers in the vulnerable group. BNM had also highlighted this. It is important to note that lower-income borrowers hold about 50% of total personal financing loans outstanding. Also, personal financing loans make up 26.6% of their total borrowings, compared with 14.5% in the case of the average borrower. MARC notes the rising and significant share of personal financing among bankrupt borrowers (2018: 28%; 2010: 15%).

- While household debt remains a concern, MARC concurs with BNM's view that it does not necessarily pose a significant risk to financial stability. A large portion of the debt (about two-thirds) is secured and banks have continued to observe prudent lending practices. Notwithstanding this, the adverse impact on banks' credit growth, if defaulters continue to rise, would have knock-on effects on private consumption and headline growth. This is because those in the vulnerable group generally have higher average propensity to consume than those with higher income.

- The banking sector remained resilient despite a slowdown in several key metrics. The Common Equity Tier-1 (CET1) ratio and total capital ratio were lower at 13.1% and 17.4% as at end-2018 (2017: 14.0% and 17.8%), partly driven by faster loan growth of 5.6% (2018: 4.1%). The capital levels were affected by the phasing-in of Basel III and the adoption of the expected credit loss model under the MFRS9. Nevertheless, the banking sector's capitalisation was stable due to new equity issuances in 2018.

- The gross impaired loan ratio was stable at 1.5% as at end-2018 post-MFRS9. The sector continued to be predominantly funded by deposits, led by individuals, business enterprises, and financial institutions with growth rates between 5.0% to 12.0%. The loan-to-fund ratio improved marginally to 82.7% (2017: 83.9%) while the LCR expanded to 143% (2017: 135%) as banks recorded a drop in impaired loans due to better asset quality.

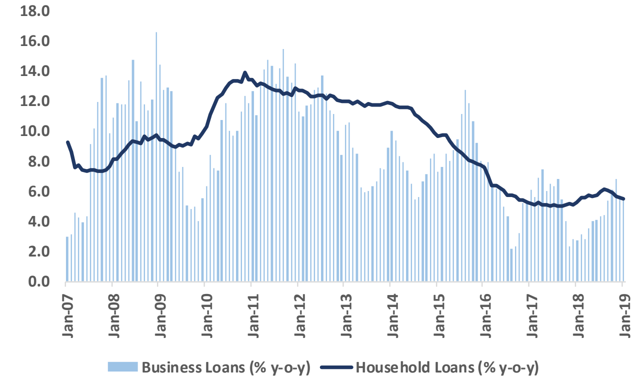
Corporate performance and development

- In 2018, non-financial corporates (NFCs) experienced marginal deterioration in their financial performance due to commodity supply disruptions, the weaker ringgit, US-China trade tensions, and the government's review on mega-infrastructure projects. Amid the challenging environment, corporates in most sectors experienced lower interest coverage ratios (ICR). Corporates in the oil and gas (O&G), property and construction sectors bore the brunt of the headwinds.

- Earnings and investments of O&G-related firms fell after global crude oil prices slumped by 61% from their peaks in October following oversupply woes. Similarly, property developers recorded sluggish sales performance in 2018 amid easing home prices following weaker demand for higher-end properties priced RM500,000 and above. This was mostly due to affordability constraints faced by most buyers. Oversupply in the office and retail segments remains a concern amid a large incoming supply of space. Meanwhile, the construction sector (especially the civil engineering segment) was negatively impacted by the government's cutback in expenditure on major infrastructure projects. As a result, impaired loans ratio for the sector rose to 2.7%. The oversupply of office space and shopping complexes had also impacted construction firms involved in non-residential property development.

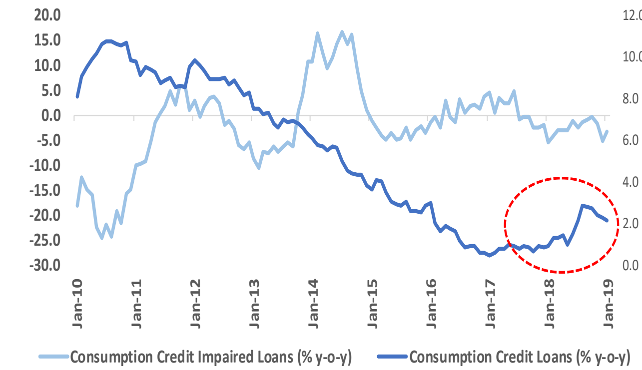
- Despite this, NFCs have generally healthy buffers to withstand the challenges. Hence, they will not likely pose a significant impact on domestic financial stability. Their overall debt servicing capacity and liquidity positions remained sound with an ICR ratio of 7.2X and a cash-to-short-term debt ratio (CASTD) of 1.6X. Furthermore, NFCs in Malaysia have a low risk profile of external borrowings as a large share of their borrowings are long-term in nature (76%).

Chart 9: Loan growth for household and non-household sectors



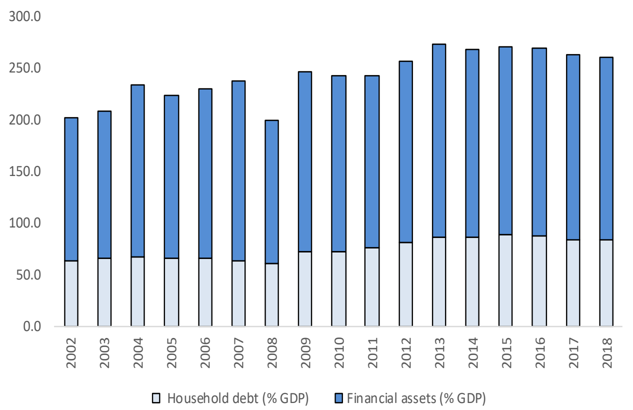
Sources: BNM, CEIC, MARC Economic Research

Chart 10: Turnaround in consumption credit growth and stable consumption credit impaired loans



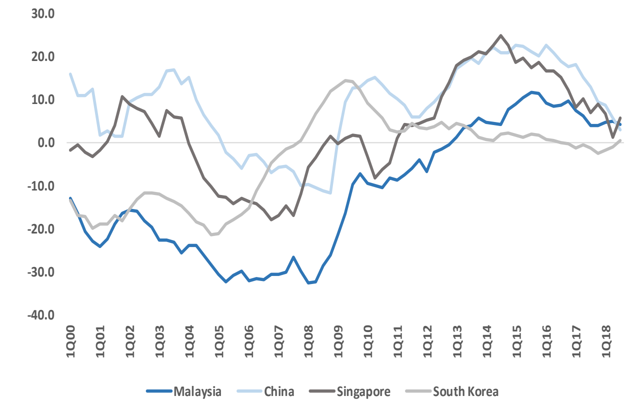
Sources: BNM, CEIC, MARC Economic Research

Chart 11: Household debt as % of GDP and financial assets-to-debt ratio



Sources: BNM, MARC Economic Research

Chart 12: BIS banking sector household credit-to-GDP of selected countries



Sources: BNM, BIS, MARC Economic Research

Monetary policy and interest rates

- MARC believes that the recent tone by BNM in its March MPC statement provides the clearest signal that the central bank is preparing the market for a slight downward adjustment in the OPR. In its statement, BNM pointed out that "on balance, the baseline forecast is for the Malaysian economy to remain on a steady growth path. However, ***materialisation of downside risks from unresolved trade tensions, heightened uncertainties in the global and domestic environment, and prolonged weakness in the commodity-related sectors could further weigh on growth***."

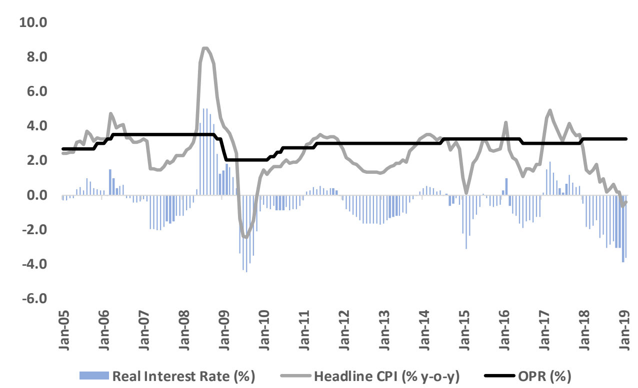
- More importantly, it says that "***recognising that there are downside risks in the economic and financial environment***, the MPC will continue to monitor and assess the balance of risks surrounding the outlook for domestic growth and inflation." MARC believes that the focus on the risks in the economic and financial environment will be given added weight in BNM's policymaking decisions going forward.

- With inflation falling into negative territory in January and the expectation that CPI numbers will be lower-than-initially expected, the spread between the OPR and CPI has widened to the most since August 2009. The benchmark bond yields for the 10-y MGS have also reacted in tandem, slipping to below 4% for the first time since April 2018. We see the rate cut – if happens in the near term – as an unwinding effort of the rate hike that took place in January 2018.

- We feel that the timing for an OPR cut could not have been better, if it happens in the near term. This is because the ringgit has strengthened (1.3% since beginning of the year) and the US rate hike has paused. Given these occurrences, an OPR cut is unlikely to stoke significant domestic financial market volatility.

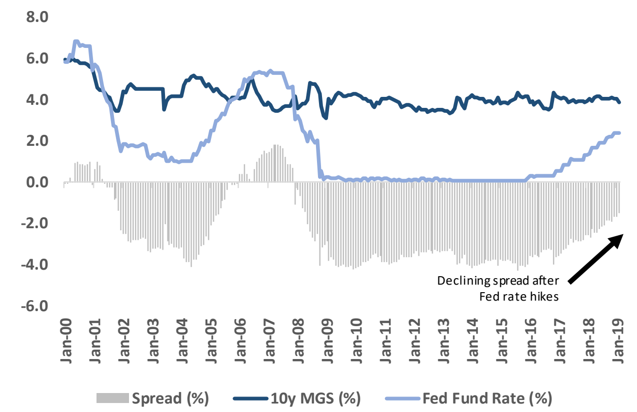
- The concerns over financial market volatility have not faded and hence, the ringgit's volatility may persist. Among factors that could affect the ringgit in the near term are: (1) prospects of a shrinking current account balance in the wake of a deteriorating external environment in 2019; (2) expectation of a stronger greenback due to its safe-haven status; (3) increasing possibility of softer crude oil prices due to the weaker global economy. Adding to this is the uncertainty over China's policy with regards to RMB following trade tensions with the US. Based on past experiences, the ringgit will be adversely affected if the RMB weakens significantly against the greenback.

Chart 13: Malaysia's OPR, CPI and spread



Sources: CEIC, MARC Economic Research

Chart 14: 10-y MGS, FFR and spread



Sources: BNM, CEIC, MARC Economic Research

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