Economic Research

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Economic Outlook 2020

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Executive Summary

Global Economy

- We remain cautiously optimistic about the prospects of the global economy in 2020. This is despite a possible mild turnaround that may take place this year. We are also of the view that the expected mild recovery in 2020 may not broad-based. Much of the recovery will be due to more favourable performance from emerging market and developing economies (EMDE) rather than developed economies.

- The plus point, however, is that US growth remains resilient although headwinds from slowing global demand and looming trade policy uncertainties are starting to build up. A US recession is not the likely scenario for 2020 but there are growing signs that the weakness has slowly spilled over to other parts of the economy.

- China's economy remains relatively strong, but challenges prevail due to internal and external risks. Any re-escalation of trade tensions could exacerbate the slowdown of the economy. Given this, China's fiscal and monetary policy should remain growth-supportive. A continued devaluation of the renminbi (RMB) cannot be ruled out if trade tensions re-escalate.

- We view that a recession is not imminent in the euro zone as well as in the UK although their economies will likely remain subdued in 2020. Private consumption remains supportive, underpinned by a favourable labour market and loose monetary policy. There will likely be greater push for expansionary fiscal policies by countries with budget surpluses.

Malaysian Economy

- We are of the view that Malaysia's real gross domestic product (GDP) growth will decelerate to 4.3% in 2020, below the government forecast of 4.8% due to weaker external trade performance and softer domestic demand growth. Domestically, Malaysia remains largely dependent on its consumer support. However, there are signs of increasing cautiousness among consumers, judging from recent consumer surveys. The plus point is that the labour market remains stable and supportive of consumers' spending behaviour.

- Headline inflation numbers will likely rise modestly to an average between 1.2%-1.7% assuming that the abolishment of fuel price ceilings takes place in 2020. Weaker domestic demand, however, will keep inflation below the long-term trend. An alternative inflation indicator, the GDP deflator, also shows that a benign inflation environment is likely in 2020.

- The recent pick-up in *net capital inflows* in the first 11 months of 2019 was largely due to a surge in *net inflows* into the local bond market. However, equities remained under pressure with total *net outflows* of RM10 billion during the period. Rapid capital flows led to ringgit gyrations in 2019.

- Rhetoric from Bank Negara Malaysia (BNM) suggests a cautious monetary policy stance as global central banks acknowledge the limits of monetary tools in supporting growth. We foresee the trend in ringgit to be a crucial factor in determining BNM's future moves. On the fiscal front, there are already efforts by the government to become more flexible in its stance. Notwithstanding this, the balancing act between supporting growth and ensuring continuing fiscal consolidation efforts is becoming more challenging.

Global: Will uncertainties prevail in 2020?

Economic challenges to persist

Better global economic prospects hinge on improved growth of EMDE

- We remain cautiously optimistic on the prospects of the global economy in 2020. This is despite a possible mild turnaround that could take place. Similar to what was described by the International Monetary Fund (IMF) in its latest outlook, we are also of the opinion that the expected mild recovery in 2020 may not broad-based. Much of the recovery will be due to a more favourable performance of EMDE rather than developed economies. The IMF is projecting a pickup in growth to 4.6% for EMDE in 2020 (2019F: 3.9%). In advanced economies, however, GDP growth would likely remain sluggish (2019F and 2020F: 1.7%).

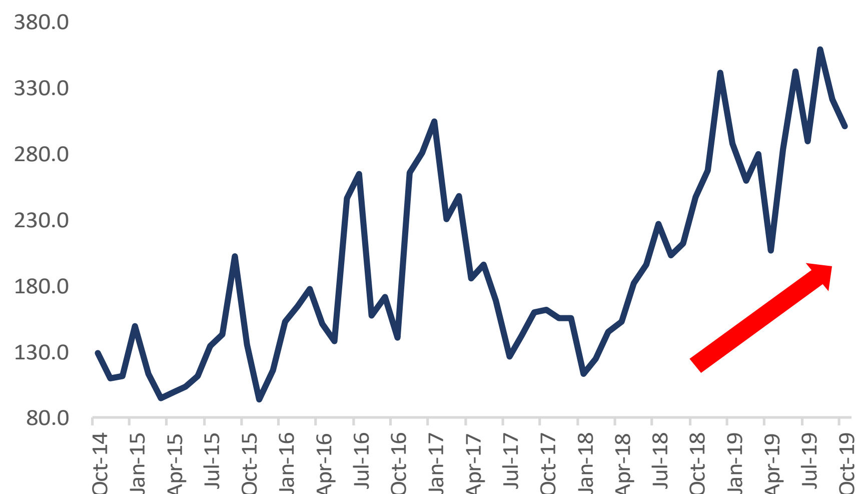
Fiscal policies to prop up economy but some countries could be restrained by debt levels

- There are also expectations that some countries (i.e. the G3 and China) will rely on fiscal policies to do the heavy lifting as central banks could potentially run out of monetary ammunition to prop up the economy. But this remains debatable especially if debt concerns begin to emerge. Euro countries are always skeptical over the need to use fiscal instruments in supporting growth (i.e. Germany). China, on the other hand, is troubled by rising debt which will eventually exert pressure on the government. Other EMDE that have limited fiscal space – India, Malaysia, to name a few – remain overly cautious when it comes to spending for fear of rising budget deficits.

A black swan event may reduce effectiveness of monetary policies

- Relying on low interest rates and unconventional monetary policy, on the other hand, could perpetuate a low inflationary environment and lead to a possible revival of deflation as well as an artificially inflated asset valuation. The effectiveness of monetary policy could also be blunted if a *black swan* event takes place. Other headwinds include a re-escalation of geopolitical and trade tensions as well as a disorderly Brexit. Uncertainties will likely prevail, evidenced by the rising of the global economic policy uncertainty index by an average of 71.5% year-on-year (y-o-y) since 3Q2018.

Chart 1: Global economic policy uncertainty index

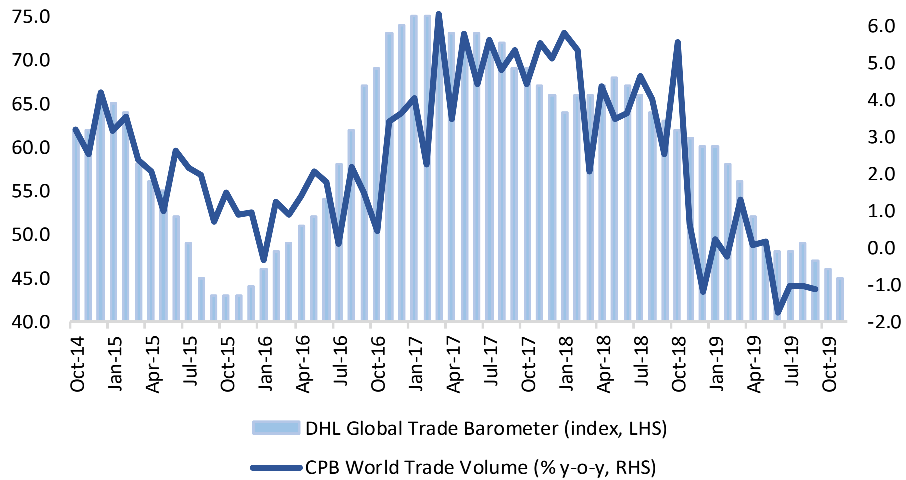


Source: Bloomberg

Trade momentum continues to ease

- Economic challenges in 2020 could also arise from a more pronounced trade-related downturn. In November 2019, a forward-looking indicator, DHL Global Trade Barometer, eased to a nearly four-year low, suggesting that global trade is losing momentum. The reading was corroborated by a sustained decline in world trade volume, which fell by an average of 1.2% y-o-y since June 2019.

Chart 2: DHL global trade barometer versus CPB world trade volume

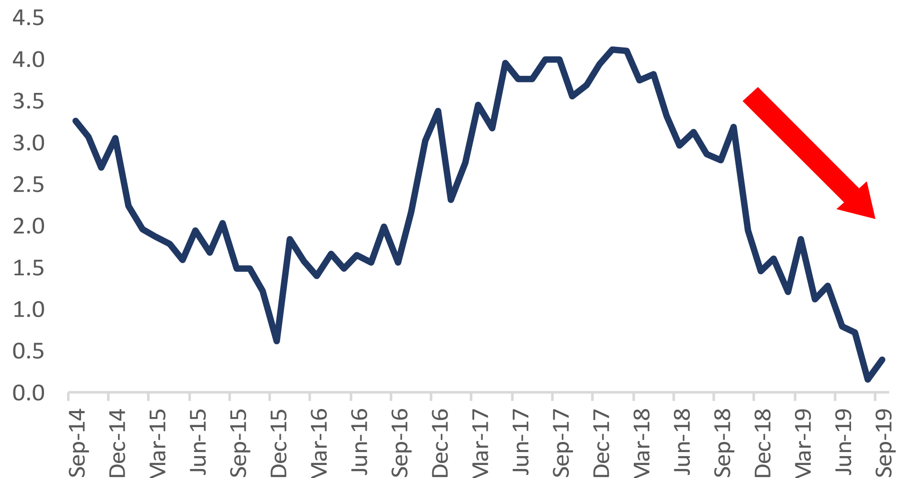


Sources: Bloomberg, MARC Economic Research

Slowing industrial output caused by weak automobile sales, business confidence and Chinese demand

- Weak global trade was driven by a notable slowdown in industrial output, which in terms of volume and excluding construction, grew below 1.0% for the fourth straight month in September 2019, its first time since the Global Financial Crisis (GFC). Sluggish industrial output was primarily attributed to slowing global vehicle sales, weak business confidence, and a slowdown in demand from China. We anticipate these weaknesses to spill over to at least 1H2020.

Chart 3: CPB industrial production excluding construction (% y-o-y)

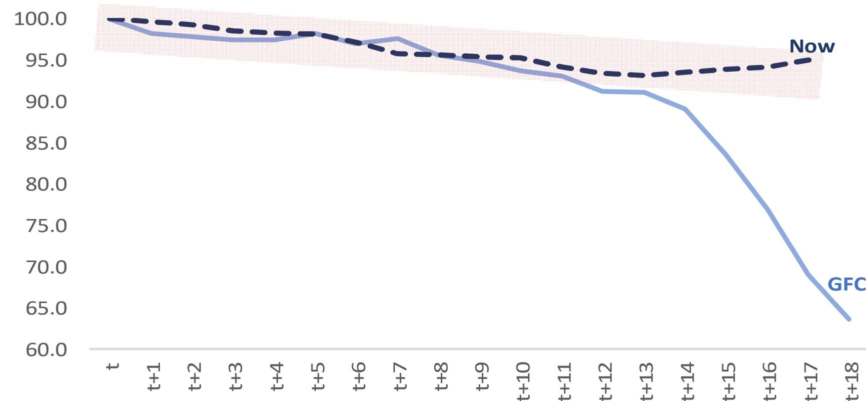


Sources: Bloomberg, MARC Economic Research

Green shoots of recovery seen in semiconductor sales and manufacturing PMI

- However, it is not all doom and gloom. The semiconductor sector has shown green shoots i.e. global sales fell at a softer pace in 3Q2019. The World Semiconductor Trade Statistics (WSTS) also expects a mild recovery in global sales to 5.9% in 2020 (2019: -12.8%) as 5G smartphones enter the market. Additionally, the current deceleration in the global manufacturing Purchasing Managers' Index (PMI) has been gradual compared to during the GFC period when the index fell sharply to as low as 34.3 from its peak of 53.9. Also, the global PMI had returned to an expansionary mode (November: 50.3), underpinned by marginal gains in output and new orders.

Chart 4: Peak-to-trough momentum of global manufacturing PMI (monthly following the peak, re-based)



Sources: Bloomberg, MARC Economic Research

Prospects of major economies

United States

The US economy remains resilient but weaknesses have started to build up

- The good news is that US economic growth remains resilient. We think a US recession is not likely the scenario for 2020. However, headwinds from slowing global demand and looming trade policy uncertainties are starting to build up. For instance, the US manufacturing PMI slipped into the contraction zone for the fourth consecutive month in November 2019, and the pace of its decline mirrors the slump during the dot-com bubble. New orders, a forward-looking indicator, suggest low probability of an upside rebound in the near term. Growth in business investment also slowed to 1.4% y-o-y in 3Q2019 (3Q2018: 6.8% y-o-y).

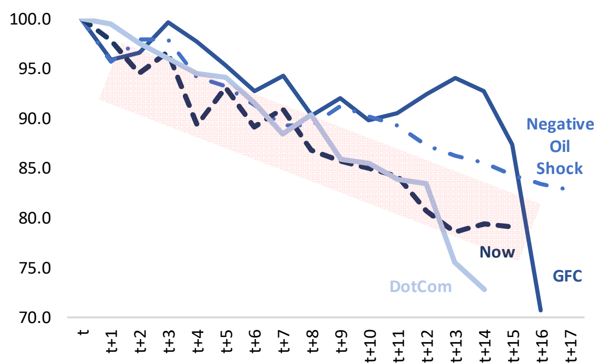
Consumers are also turning cautious

There are also growing signs that the weakness in the manufacturing sector and business investment has started to spill over to other parts of the US economy, i.e. the average hourly wage growth slowed to 3.1% in November 2019 (February 2019: 3.4%) despite the favourable job market. Consumers are turning cautious, evidenced by a decline in inflation-adjusted consumer spending to 2.4% in October 2019 from a peak of 3.7% in August 2018. Against this backdrop, US growth is expected to slow down to below 2% in 2020 (January-September average of 2.3%), which is still decent when compared with major developed countries.

Expect downward pressures on the USD going forward

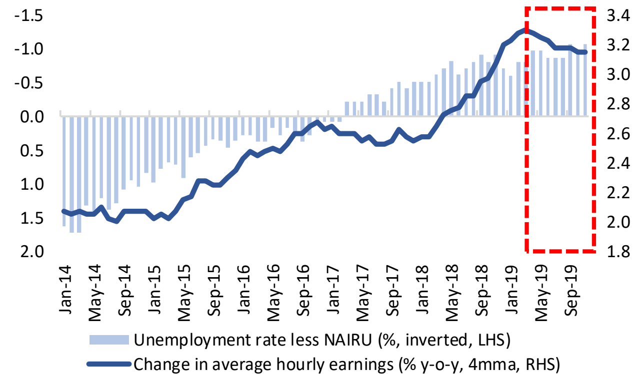
- A slower US growth momentum implies a weaker tailwind for the US dollar (USD). We foresee the rising current account deficit to continue weighing on the greenback. While the US Federal Reserve (the Fed) reiterated that it would pause the rate-cutting cycle, we believe there would be another federal funds rate (FFR) cut in the near-term. This will exert further downward pressure on the USD.

Chart 5: US manufacturing PMI in different business cycles (monthly following the peak, re-based)



Sources: Bloomberg, MARC Economic Research

Chart 6: US labour market indicators



Sources: Bloomberg, CEIC, MARC Economic Research

China

China's growth momentum continued to slip partly due to moderating investment growth

- China's economy remains relatively strong, but challenges abound due to prevailing internal and external risks. Growth momentum continued to slip, with real GDP growth falling to a 27-year low of 6% y-o-y in 3Q2019 (2Q2019: 6.2%). The moderation was partly attributed to the slowdown in fixed-asset investment growth, which fell to 5.2% in the first 11 months of 2019, the slowest reading on record. The decline reflects the continued efforts to cut excess capacity in heavy industry amid tepid corporate earnings and weaker business confidence.

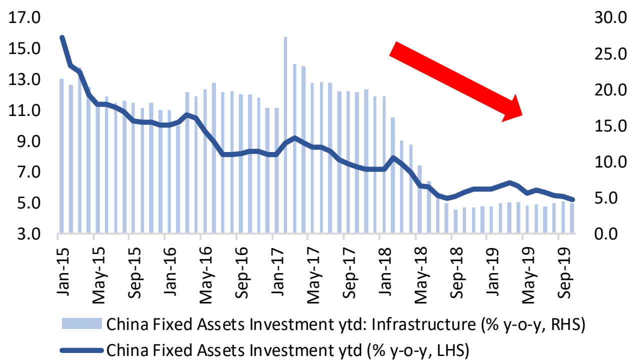
Any re-escalation of trade tensions could exacerbate the slowdown of the economy

- Despite the recent "phase one" US-China trade deal that was concluded in December 2019, any re-escalation of trade tensions could exacerbate the slowdown of the economy. Exports have contracted for four successive months, easing to -1.3% y-o-y in November 2019 (October 2019: -0.8%). The drop was mainly due to the slump in exports to the US (-23.0% y-o-y versus October's -16.2%). We foresee waning export momentum to remain as a drag on China's growth until a further conclusive trade deal is achieved.

Fiscal and monetary policy should remain growth-supportive

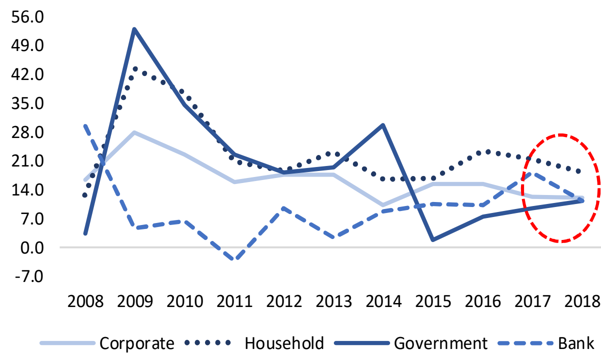
- Given the challenging economic backdrop, China's fiscal and monetary policy should remain growth-supportive. We expect more cuts on the lending rates and reserve requirement ratio (RRR) by the People's Bank of China (PBOC). We are of the view that a continued devaluation of the RMB will happen if the trade war re-escalates despite PBOC's pledge that it would not engage in "competitive devaluations". Fiscal measures, on the other hand, will be limited due to policymakers' concerns over high debt given that China's total debt had risen sharply to 276.2% of GDP in 2018 (2008: 162.4% of GDP).

Chart 7: China's investment growth



Source: Bloomberg

Chart 8: China's debt growth by sector (% y-o-y)



Source: Bloomberg, MARC Economic Research

Europe

European economies are expected to remain subdued

- European economies are expected to remain subdued (GDP growth in 3Q2019: 1.2% y-o-y in the euro zone; 1.0% y-o-y in the UK) as weakening global trade and uncertainties over Brexit took a toll on industrial activity and business investment. Germany, the key growth driver of the euro zone, has been particularly impacted by the industrial downturn and led the decline in the region's growth (3Q2019: 0.5% y-o-y). The strength of the services sector was also eroded by prolonged industrial weakness. In November 2019, for instance, the services PMI in the euro zone and the UK dropped to 51.9 and 49.3 (Oct: 52.2 and 50.0).

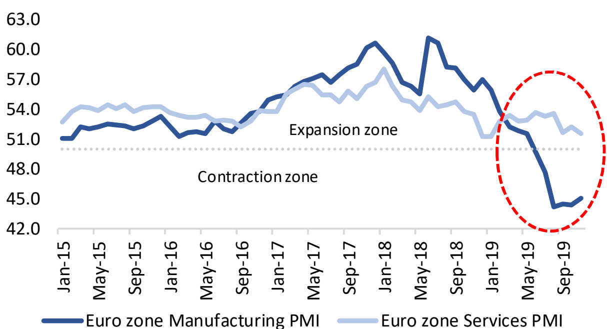
But private consumption will cushion economic slowdown

- Notwithstanding this, we view that a recession is not imminent in the euro zone or in the UK. Private consumption, a growth pillar for both economies, has remained relatively resilient. In 3Q2019, consumer spending growth bucked the trend and improved to 1.5% in the euro zone (2Q2019: 1.1%). In the UK, it grew by 1.1% (2Q2019: 1.3%). Going forward, private consumption will continue to be supported by robust hiring activity, loose monetary policy and subdued inflation.

Sluggish growth has underscored the need for fiscal stimulus given limited monetary policy space

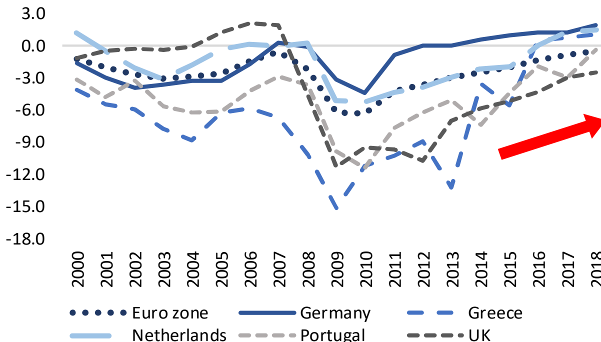
- Sluggish growth has underscored the need for fiscal stimulus given limited monetary policy space. Given that the European Central Bank (ECB) had pushed the interest rates further below zero and introduced a new round of asset purchases in 2019, newly appointed ECB President, Christine Lagarde has urged countries with budget surpluses to expand their fiscal spending. In the UK, the manifesto from the Conservative Party that won the recent election implies future increases in fiscal spending.

Chart 9: Euro zone's manufacturing and services PMI



Source: Bloomberg

Chart 10: Selected European governments' fiscal balance-to-GDP ratios



Sources: Eurostat, CEIC

Malaysia: Dancing to the tune of global gyrations

Base headline growth to remain below trend

Recent trend suggests decelerating growth in the near term

- The recent GDP statistics suggest a decent but further moderation of headline GDP growth in the near term (3Q2019: 4.4% versus 2Q2019: 4.9%). The slowdown was primarily attributed to decelerating domestic demand, resulting from weaker investment growth momentum. Growth in private consumption also waned, although it remained strong at 7%. In the first three quarters of 2019, headline GDP growth remained below growth trend at 4.6% (average 2010-2018: 5.2%).

Global headwinds will likely affect domestic business investments

- Going into 2020, investment growth will likely remain below the long-term average at 0.8% (2010-2018 average: 7.1%). Although the amount of approved investments climbed to RM149 billion in the first three quarters of 2019, global economic uncertainties will likely dent domestic business spending in the near term. Total domestic direct investment registered for the same period in 2019 accounted for only 67% of the total recorded in 2018.

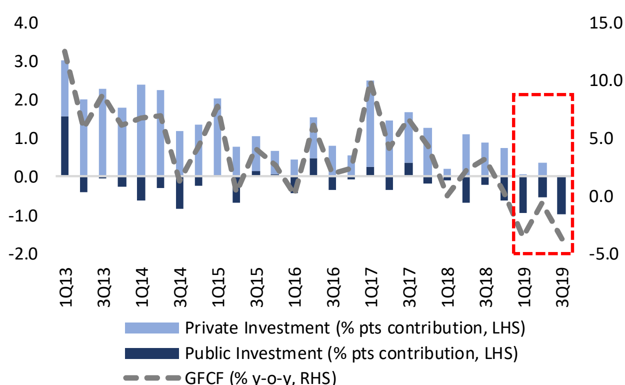
Budget 2020 highlights efforts to revive investments but results are only expected to kick in the year 2021

- Two years of contraction in public investment growth since 4Q2017 were partly a result of the government's efforts to rationalise expenditures and strengthen its fiscal position. This, however, raised some uncertainties among investors and partly resulted in slower private investment growth. This led to efforts to revive investments in Budget 2020 (i.e. investment incentives for global top 500 companies, unicorns and strong domestic exporters). We view such efforts positively but anticipate investment numbers to improve only in 2021.

Malaysia's long-term economic growth remained resilient due to strong domestic demand

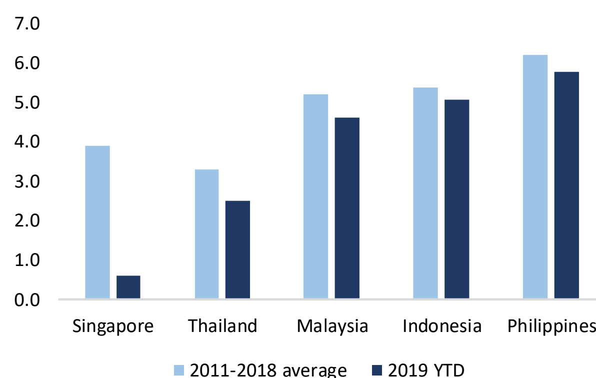
- On a yearly average between 2010 and 2018, Malaysia's real GDP growth ranked third among ASEAN-5 countries at 5.2%, after the Philippines (6.2%) and Indonesia (5.4%). Malaysia's relatively resilient growth is partly due to its strong domestic demand, particularly private consumption. In 2018, for instance, private consumption share of the economy was the second highest in the region (57.0% of GDP), compared with Indonesia (54.2% of GDP), Thailand (50.7% of GDP) and Singapore (36.8% of GDP).

Chart 11: Malaysia's private and public investments



Sources: DoSM, CEIC, MARC Economic Research

Chart 12: Real GDP growth of ASEAN-5 (% y-o-y)



Sources: DoSM, CEIC, MARC Economic Research

Consumers, consumers, consumers

Latest statistics point to increased cautiousness among consumers

- Malaysia remains largely dependent on its consumer support, which in the first three quarters of 2019, contributed circa 93% of headline growth. We do not think that this is sustainable and the latest statistics are already showing increasing cautiousness among consumers, i.e. the 3Q2019 Global Consumer Confidence Survey, conducted in collaboration with Nielsen showed the percentage of Malaysians planning to save had risen (60% versus 2Q2019's 54%). There was also a decline in the percentage of respondents who think now is the time to buy things they want (44% versus 2Q2019's 48%). A similar trend can be seen from MIER's Consumer Sentiment Index (CSI) which remained below the 100-point threshold since 1Q2019.

Labour market remains robust and growth of impaired loans is still modest

- The plus point, however, is that the labour market is still supportive of consumers' spending behaviour. A case in point: the y-o-y increase in the number of unemployed stood at only 1.2% on average during the January-October 2019 period, way below its peak of 18% during the economic slowdown in 2016. Impaired loans among households also rose at a moderate pace of 3% compared with 6.8% in 2016.

Further deceleration in domestic demand growth could soften headline GDP growth

- Going into 2020, we anticipate a lower headline GDP growth of 4.3% (MoF: 4.8%) due to a deceleration in the growth of domestic demand. We foresee private consumption growth to soften to 6.5%. We also view the cutbacks in capex to continue due to global trade uncertainties. The strength of the economy will also depend on developments in the financial market. Specifically, financial market volatility could spike if global equity and bond markets are surprised by unexpected geopolitical tensions and negative developments from the corporate sector (i.e. in the US, China, Malaysia).

.....but anxiety over the external sector's performance will prevail

Prospect of export sector is clouded by multiple factors

- Although net trade contributed positively to headline growth in 3Q2019, prospects of the export sector are clouded by multiple factors that include waning global demand and a downturn in the global semiconductor cycle. The larger contraction in import growth in recent months (October 2019: -8.7% y-o-y) suggests a continuing downward pressure on the export sector in the near term.

Falling demand from major trading partners

- In the first ten months of 2019, exports of mineral fuels, chemicals, manufactured goods as well as machinery and transport equipment declined between 0.7% to 7.9%. The decline was driven by falling demand from major trading partners namely Singapore, China, Hong Kong and Japan.

E&E exports also contracted

- Similarly, exports of electrical and electronics (E&E) also contracted (10M2019: -0.9%; 10M2018: 12.5%) amid a rapid decline in the export of thermionic valves and tubes, photocells etc., which accounted for 60% of total E&E. There was also a double-digit drop in the exports of parts and accessories for office machines etc.

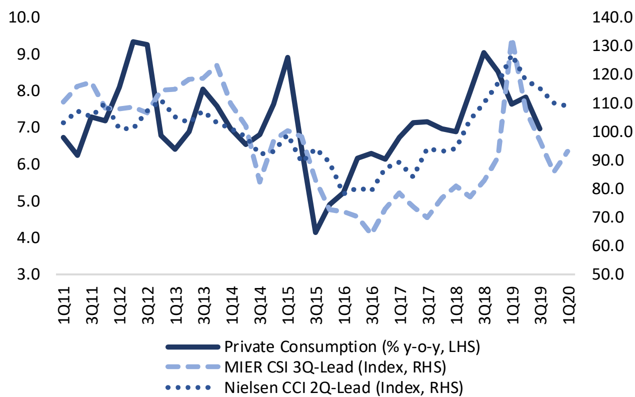
Mixed performance of commodity exports

In the commodity sector, exports of rubber rebounded in the first ten months of 2019 on the back of better prices. Meanwhile, exports of palm oil fell at a softer pace despite lower prices as export volumes improved. As for crude oil, exports fell due to both weak prices and volumes.

Trade diversion could marginally benefit Malaysia, but exports will be affected by the overall weakening global trade growth

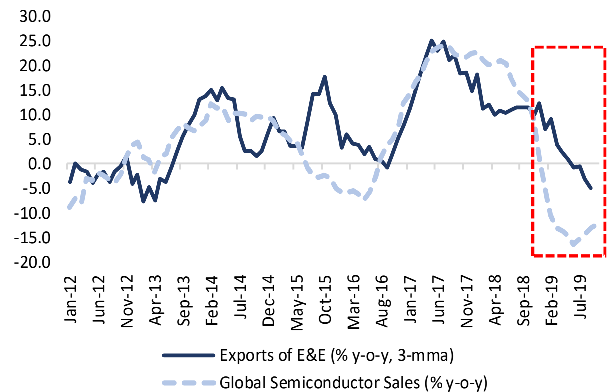
- Although trade diversion arising from trade tensions between the US and China could marginally benefit Malaysia in the short term, the overall weakening of global trade growth will continue to weigh on Malaysia's export sector. Forward indicators suggest a lacklustre outlook, i.e. a continuing downtrend of the export orders index of US manufacturing PMI and a continuing contraction in global semiconductor sales (January – October 2019: -13%).

Chart 13: Malaysia's private consumption and consumer confidence indices



Sources: DoSM, MIER, Nielsen, CEIC, MARC Economic Research

Chart 14: Malaysia's E&E exports and global semiconductor sales



Sources: DoSM, CEIC, Bloomberg, MARC Economic Research

Inflation rate: Nothing to shout about

Headline inflation slips further in 2019

- The headline consumer price index (CPI) slipped further in the first 11 months of 2019, averaging at 0.7% (11M2018: 1.0%; 11M2017: 3.8%). The moderation was mainly due to the fixing of retail pump prices for RON95 (RM2.08) and diesel (RM2.18). A temporary spike in headline inflation between June-August 2019 to around 1.5% waned due to high base effect when the sales and services tax (SST) kicked in in September 2018, causing headline CPI to ease to around 1.1%.

CPI expected to rise modestly in 2020

- Assuming that the abolishment of fuel price ceilings takes place in 2020, we expect headline inflation to rise modestly at an average of 1.2%-1.7%. An alternative inflation indicator, the GDP deflator, also shows that a benign inflation environment in 2020 is likely. In the first nine months of 2019, the deflator fell by an average of 0.2% y-o-y (9M2018: 0.8%).

Capital flows and ringgit: Will volatility continue?

Capital flows improved in 2019, underpinned by higher inflows into the bond market

- Net capital *inflows* in the bond and equity markets improved to RM1.8 billion in 11M2019 (2018: net *outflows* of RM33.6 billion) due to the recent pickup in *net capital inflows* into the local bond market (11M2019: RM11.8 billion). On the flip side, equities remained under pressure in 11M2019 with total *net outflows* of RM10 billion.

Initial outflows were due to several factors

- Prior to that, Malaysia recorded *net outflows* of RM3.6 billion in the bond and equity markets in 1Q-3Q2019. Among the factors that led to the initial outflows were: (a) interest rate hikes in the US; (b) growth differentials between the US and other major economies;

(c) Malaysia's slower GDP growth in the first three quarters of 2019; and (d) moderating crude oil prices.

Rapid capital flows led to ringgit gyrations

- Rapid capital flows led to ringgit gyrations in 2019. On a yearly basis, the ringgit appreciated by 1% against the USD, trailing behind the Thai baht (+8.8% against USD), Philippine peso (+3.8% against USD) and Indonesian rupiah (+3.8% against USD). Against regional currencies, the ringgit depreciated the most against the baht (-7.1%) followed by the peso (-2.6%) and the rupiah (-2.6%) in 2019.

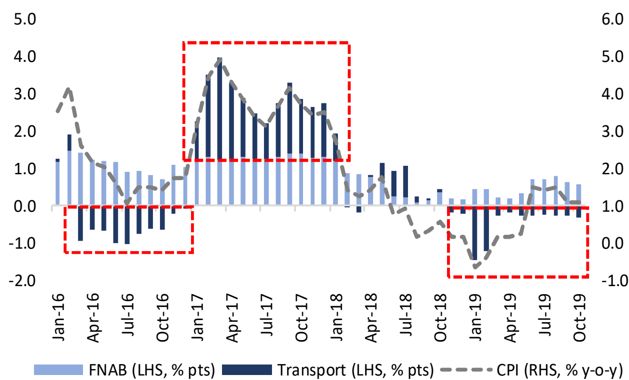
Ringgit is close to its long-term average based on REER

- On a real effective exchange rate (REER) basis, the ringgit depreciated by 0.6% for the period of January to November 2019, remaining close to its 10-year mean. This is compared with being almost 4% below its long-term mean in 2017.

Factors that will affect ringgit in 2020

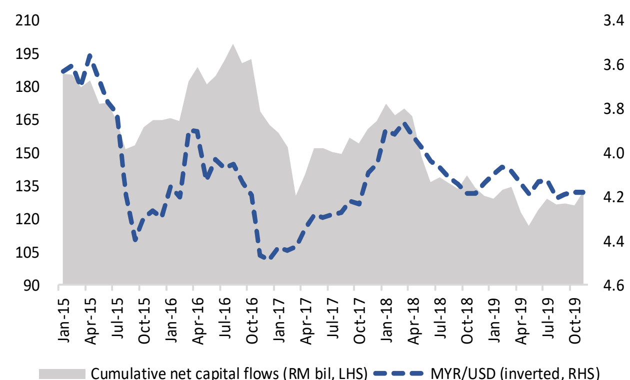
- Going forward, important factors that will affect the ringgit would include (a) risks of registering a slower GDP growth in 2020; (b) increasing expectations of lower overnight policy rate (OPR) due to the slowing economy; (c) ability to achieve fiscal targets against a backdrop of slower growth; and (d) concerns over the decisions by FTSE Russell on the possible exclusion of Malaysian government bonds from its global index. The upside risk of the ringgit, however, lies in the possibility of a softer USD due to the widening US current account and budget deficits, as well as its weaker economy in 2020.

Chart 15: Contribution of food, non-alcoholic beverages (FNAB) and transport to headline inflation



Sources: DoSM, CEIC, MARC Economic Research

Chart 16: Malaysia's cumulative net capital flows vs ringgit movement



Sources: BNM, CEIC, MARC Economic Research

Monetary and fiscal policy challenges

Rhetoric from BNM suggests a cautious monetary policy stance

- Rhetoric from BNM suggests a cautious monetary policy stance at a time when global central banks acknowledge the limits of monetary tools in supporting growth. This is to be expected as their effectiveness will wane when interest rates have remained low for quite some time. Although the findings are mixed, some studies have shown that even a negative interest rate policy could be ineffective as lending could remain lacklustre. This is due to banks' unwillingness to lend because of their compressed margins.

Another OPR cut is possible if macro weaknesses become pronounced

- The recent moves by regional central banks, however, have been viewed by investors as one of the factors that could exert pressure on BNM to lower the OPR. We respectfully disagree although we feel the possibility of another OPR reduction is increasing if macro weaknesses become more pronounced. We do not see the recent BNM move to reduce the statutory reserve requirement (SRR) as a precursor for an OPR cut; however, it

signals policymakers' concerns about falling liquidity which could affect the real economy going forward (i.e. lending growth of below 4% in September and October)

Aggressive cuts in OPR is unlikely amid concerns about capital outflows

- We foresee the trend in the ringgit to be a crucial factor in determining BNM's future moves. This is in view of continuing capital outflows especially from the domestic equity market. An aggressive reduction in the OPR (akin to the one during the GFC) is viewed not only to be less effective in supporting growth but will add pressure on the ringgit at a time when there is already rising concern about capital outflows.

A more flexible fiscal stance to support growth

- On the fiscal front, there are already efforts to indicate that the government is becoming more flexible in its stance, i.e. the target to boost development expenditures to above RM50 billion p.a. in 2019 and 2020. This is to ensure that headline growth will remain as close as possible to its potential of between 4.5% to 5%. We feel positive about the effort.

Balancing economic growth with fiscal consolidation will become more challenging

- Notwithstanding this, the balancing act between supporting growth and ensuring a continuing fiscal consolidation effort is becoming more challenging, especially at a time when global growth is weakening. From a policy perspective, reductions in expenditures must continue as revenue will come under pressure (the government anticipates revenue to decline by 7.1% in 2020, when the one-off dividend is included in the 2019 estimate). Such reductions, however, could have a knock-on effect on business sentiment if businesses start to believe it will prolong.

Sovereign rating and outlook

Sovereign rating likely to be maintained

- We believe the greater transparency about the government's total liabilities and efforts to address it are a positive factor for Malaysia's overall sovereign rating assessment. The government has taken respectable efforts to ensure Malaysia's A-/A3 rating is not threatened by some of the current macro challenges. Going forward, we believe the rating would be maintained at the current level.

- However, the trend of investments, a long-term growth driver for the economy, could be affected if uncertainties over political development are perceived to be increasing.

Table 1: GDP growth on the demand side

Growth (% y-o-y)	2016	2017	2018	9M2019	*MARC*		*MoF*	
					2019E	*2020F*	*2019E*	*2020F*
GDP	4.4	5.7	4.7	4.6	4.6	4.3	4.7	4.8
Domestic Demand	4.3	6.5	5.5	4.2	4.3	4.5	4.0	4.8
Private Consumption	5.9	6.9	8.0	7.5	7.1	6.5	6.8	6.9
Public Consumption	1.1	5.5	3.3	2.5	3.0	2.6	2.0	1.5
Private Investment	4.5	9.0	4.3	0.8	1.8	2.3	1.5	2.1
Public Investment	-1.0	0.3	-5.0	-12.1	-9.0	-3.0	-8.1	-0.6
Real Exports	1.3	8.7	2.2	-0.4	-0.4	0.2	-0.4	1.4
Real Imports	1.4	10.2	1.3	-2.3	-2.1	1.4	-2.1	1.9

Sources: BNM, MoF, CEIC, MARC Economic Research

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