

Economic Research

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Economic Outlook 2013 – Sustaining domestic pillars amidst global uncertainties



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In a nutshell

- The economic malaise in the Euro region remains a drag on the global economy, in contrast with the macro picture of the United States (US) economy which is steadily improving. Recent developments in the Euro region suggest that the outlook for 2013 remains somber as the economy is likely to stall in the near term following the contraction of several economies such as Greece, Spain and Italy due to deep austerity measures implemented by their governments. The region's labour market continued to weigh on consumer spending as the unemployment rate shot up to a record high of 11.7% in October. What is more worrying is the level of youth unemployment which climbed to 23.9% in October, with the level in Spain more than double the rate at 55.9%. Notwithstanding this, the recent successful effort by the European authorities to provide the financially-strapped Greece temporary debt relief is positive for the financial market and has provided much needed confidence that future hurdles can be overcome.
- Offsetting the negative outlook in Europe is the US economy which we think will surprise on the upside, despite registering an average growth rate of below its long-term trend of 3-plus percent in the past three quarters. The bright spot of the US economy remains the consumer sector, underpinned by the rising confidence level as evidenced by the November Thomson Reuters/University of Michigan consumer sentiment index which rose to the highest level since July 2007. Adding to this is the steady rebound in the housing sector as reflected in the housing starts which hit a four-year high in October as well as a continued rise in home prices (measured by the S&P/Case-Shiller index in 20 cities) for five straight months in October 2012. Judging by employment statistics, the US labour market is indeed recovering, with the unemployment rate likely to continue trending downward, offsetting the mediocre performance of the business sector. The improvement in the labour market can also be seen in several states such as North Dakota, Iowa and Utah, where jobless rates have fallen below 6% (3.1%, 4.9% and 5.1% respectively) in November, indicating a clear turnaround in the employment conditions.
- In Asia, Japan's export sector has been adversely affected by the slowdown in demand from European economies and the strengthening of the yen against the euro currency between March and July 2012. On the domestic front, Japanese consumers are still grappling with deflation, evidenced by a continued decline in the core consumer price index (CPI) in November. Efforts by the government to shore up the economy through asset purchase programmes amounting to JPY11 trillion have yet to show results as firms hold back on capital expenditure in view of the global economic uncertainty. In contrast, China's economy is slowly healing and has begun to show promising signs of a meaningful recovery. High-frequency data such as imports, consumer spending and industrial production suggest that the economy may have bottomed out in 3Q2012. This has provided a glimpse of hope to Asian economies which are depending on China for their exports.
- Malaysia's economic growth prospects will largely hinge on the global economic momentum, which at this juncture is still clouded by the prospects of the recovery in the Euro region. However, the bottoming of Malaysia's exports will likely lead to a mild rebound in external trade performance as exports to Asian economies stabilise. In addition, the expected upturn in US new orders signals a recovery in Malaysia's future export performance. Notwithstanding this, the wobbly demand for semiconductors as evidenced by the declining book-to-bill (B-T-B) ratio and softening crude oil and crude palm oil prices (CPO) will cap Malaysia's external trade performance in 2013. Overall, we anticipate real exports to rebound mildly and expand by 4.0% in 2013.
- Malaysia's domestic demand will likely stay resilient amidst rising contributions from private investment and private consumption. Judging by the recent trend, the momentum in private investment is the key to the possible upside of Malaysia's gross domestic product (GDP) performance in 2013, although consumers play a leading role in supporting the economy. We foresee that Malaysia's private investment will continue to remain upbeat in view of the ongoing infrastructure as well as other mega projects to be undertaken by the government in the next few years. These include MY Rapid Transit (MRT), Second Penang Bridge, Tanjung Bin Power Plant, offshore pipelines for Gumusut-Kakap etc. Other mega projects such as Tun Razak Exchange (TRX), Menara Warisan, Refinery and Petrochemical Integrated Development Project (RAPID) will likely keep the investment momentum upbeat in 2013. On that score, we view that private investment will remain robust and register a growth rate of 14.0% in 2013.

- We think that the strength of private consumption will remain intact in 2013 as the labour market continues to be stable with an unemployment rate of circa 3.2%. Thus far, there has been no significant jump in the number of retrenched workers and the downward trend remains intact. The key factor to look at is the impact of a slowdown in export-oriented industries on the labour market. If a more serious downturn in the export-oriented industries leads to significantly higher retrenchments, then the strength of private consumption will be tempered. On balance, we anticipate private consumption to be able to chalk up another impressive growth of 6.2% in 2013. Overall, taking into consideration domestic forces that may offset weaknesses in the external sector, we foresee another resilient growth performance in 2013 with GDP growing at a 5.3% pace.
- Based on the above scenario, the inflation rate as measured by the CPI will not likely surpass the critical threshold that may cause a dramatic decline in private consumption. Against a slow recovery of the global economy, the moderate expansion of the Malaysian economy will not likely push the inflation rate above 2.5% in 2013. However, there are forces that will likely push the CPI higher than its level in 2011. These include amongst others: (1) the possibility of supply shocks such as higher global food and energy prices; (2) implementation of the minimum wage policy; (3) further rationalisation of subsidies; and (4) the reaction to the impending implementation of the goods and services tax (GST).
- Beyond consumer prices, we are of the view that the upward trend in asset prices will not wane – something we feel would slowly put a slight dampener on consumer spending. Of utmost concern is property prices which in some areas (Kuala Lumpur, Selangor, Penang and Negeri Sembilan) have increased at a double-digit pace, outpacing the growth of incomes of a majority of the population. Equity prices have also remained resilient, evidenced by the benchmark FBM KLCI which climbed by 9.5% this year to a high of 1,675.69 points despite rising equity risk premiums.
- As for interest rates, we feel that the monetary policy will remain unchanged in 2013 unless the growth momentum declines significantly. Based on its rhetoric, we sense that Bank Negara Malaysia (BNM) is not willing to endanger the financial system by inducing more over-leveraging practices through lower interest rates, especially among households. In addition, raising the policy rate (overnight policy rate or OPR) at a time when the US Federal Reserve (Fed) is planning to keep its key policy rate unchanged for a considerable period will lure more capital inflows which are dominated by portfolio flows. However, although in our base case scenario we do not anticipate changes in the level of OPR in 2013, we do not discount the possibility of a slight upward bias in interest rates (+25 basis points) if the US macro numbers improve materially and the financial markets begin to discount the possibility of the US Fed lifting interest rates earlier than planned in 2015.
- Recent developments are positive for the ringgit against the greenback in the near term. With the US embarking on Quantitative Easing 3 (QE3), which will bolster global liquidity in the US dollar (USD) and reduce long term US interest rates, capital flows to Asia will not likely subside in the near term as investors search for better yield. However, while we see a general strengthening of the ringgit against the USD, we think the short-term trend will be bumpy due to several reasons, namely (1) weaker prospects of the Malaysian equity market prior to the General Election (GE); (2) negative perception of the ringgit due to a shrinking current account surplus which when viewed with persistent budget deficits make the holding of the ringgit more risky. This, however, will be offset by a steady recovery of the US economy that tends to weaken the greenback against the regional currencies including the ringgit. On balance, we foresee the ringgit to move within the range of RM2.95 to RM3.15 against the USD in 2013.
- Based on the above scenario, we foresee the federal government fiscal position to improve in 2013 and the deficit target of 4% of GDP will not be difficult to achieve. This is also underscored by our expectation of a stronger revenue growth that the economy is likely to see. We are of the view that the 0.7% growth in revenue forecast by the government for 2013 is an underestimation as past experience indicates that revenue collection was on average RM8 billion more than projected per annum in normal years. We believe that the two-pronged strategy that the government is adopting to deal with budget deficits should be continued and that is (1) a steady reduction in deficits as a percentage of GDP without harsh austerity measures in order to avert a sharp deceleration in growth; and (2) a long-term target that should be strongly pursued to avoid major macro imbalances.

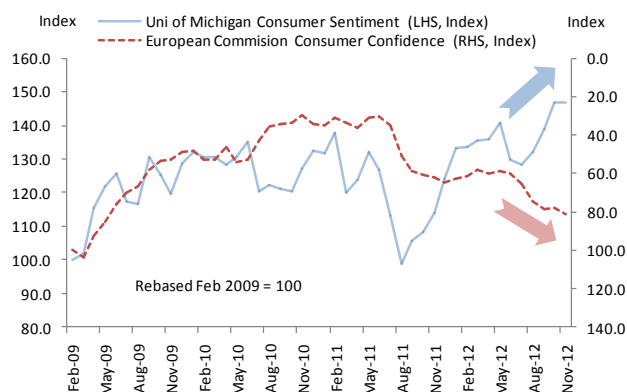
- There are, of course, areas of concerns. While the bird's eye view of the economy is rather comforting, there are areas which call for greater attention in our view. The major imbalances which we view with concern are (1) elevated levels of property prices which to some extent signify speculative activities; and (2) over-stretched household sector. Rising property prices have not abated despite measures imposed by the government and the central bank. Home affordability has also declined as incomes for most people have not increased in tandem with prices of residential properties. Even when compared with some major cities in the world (i.e. London and Los Angeles), the house price-to-income ratio in certain places such as Kuala Lumpur and Georgetown are indeed higher. Meanwhile, household debt level which has remained above 70% of GDP since 2009 may threaten the household sector if the economy experiences a sharp downturn. As for the financial market, jitters will likely surface if Malaysia's current account surplus continues to shrink which could lead to concerns that the country will experience a twin deficit in the future.

Wrap up for 2012

Global economy

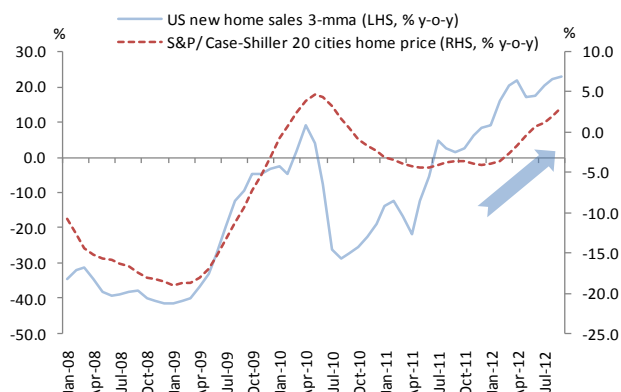
- Despite expectations of a mediocre performance, the US economy continued to cruise steadily and surprised the market as confidence among consumers climbed to a 5-year high. The overall economy clocked in a higher-than-estimated annualized growth of 3.1% in 3Q2012 (initial estimate: +2.7%). Gains were led by a narrower trade deficit which shrank to USD395.2 billion in 3Q2012, less than the USD403.0 billion previously estimated, while inventories added 0.73% points to growth instead of subtracting 0.46% points in the 2Q2012 growth.
- Household spending grew at a faster pace of 1.6% in 3Q2012 and as such, the bright spot of the US economy remains the consumer sector, evidenced by the Thompson Reuters/University of Michigan consumer sentiment index which rose to 82.7 in November, the highest level since July 2007. At the same time, the Conference Board index rose to a four-and-a-half-year high in November. Robust consumer spending is also evidenced by the amount of online shopping on 'Black Friday' which rose 26% to exceed USD1 billion for the first time according to one research firm. Another survey conducted to accompany the Bloomberg Consumer Comfort Index also showed an increase in the index to a decade high in November with 37% of respondents projecting that the economy will get better.
- The pickup in consumer confidence is mostly attributed to the improvement in the labour market as reflected in the unemployment rate which dropped to 7.7% in November (October: 7.9%), the third time it fell below 8% since the jobless rate jumped to as high as 10% during the Great Recession. Another plus point is that although the average unemployment rate is above 7%, several states in the US experienced jobless rates of less than 6% in November, including North Dakota (3.1%), Iowa (4.9%) and Utah (5.1%). In addition, the housing sector, which has finally stabilised, showed encouraging signs of a firmer recovery going forward. These include the National Association of Home Builders/Wells Fargo index which hit a six-year high, housing starts that reached a four-year high in October as well as continued rise in home prices (measured by the S&P/Case-Shiller index in 20 cities) for five straight months in October 2012.

Chart 1: Consumer sentiment indices (US and Euro-zone)



Source: Bloomberg, MARC Economic Research.

Chart 2: US new home sales and S&P/ Case-Schiller home prices in 20 cities

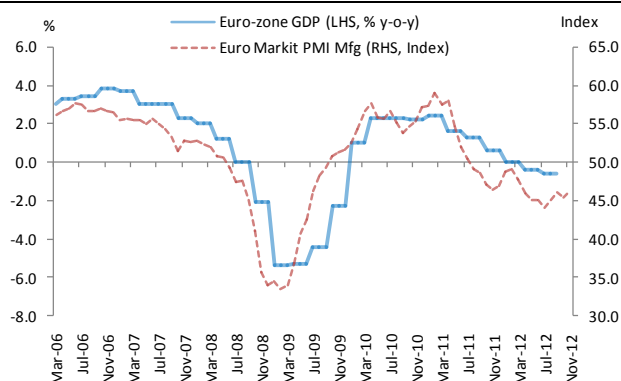


Source: Bloomberg, MARC Economic Research.

- Economic malaise in the Euro region remains a drag on the global economy as the region's GDP contracted again in 3Q2012 by 0.1% (2Q2012: -0.2%). Greece's economy registered a negative growth for 17 straight quarters while GDP for Spain and Italy declined by 0.3% and 0.2% respectively. Even Germany, the strongest member of the Euro 17, posted a slower expansion of 0.2% from 0.3% in the earlier quarter. Europe's economic malaise is largely attributed to the deep austerity measures that were implemented to reduce budget deficits and debts.

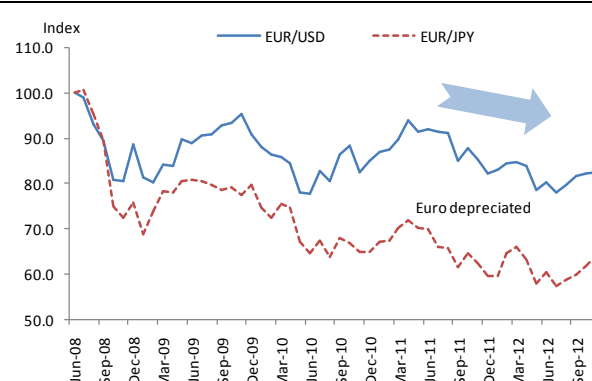
- The region's manufacturing sector continued to shrink as reflected by the Purchasing Managers' Index (PMI) reading of 47.3 in December, its 11th consecutive contraction. Even for the second largest economy, France – the manufacturing industry remained lackluster with PMI readings of 45.0 points in December. The region's labour market continued to weigh on consumer spending as the unemployment rate shot up to a record high of 11.7% in October. What is more worrying is the level of youth unemployment which climbed to 23.9% in October, with the level in Spain more than double the rate at 55.9%.
- With the overall prospects of the region clouded by the ongoing negotiations with various weak Euro members, especially on the timeframes for further reduction in deficit and debt levels, the outlook for 2013 remains uninspiring. Not surprisingly, the euro currency has continued to decline over the past year, the biggest loser among the 10 developed-nation currencies tracked by the Bloomberg Correlation-Weighted Indices. The somber prospects for the region also led to the downgrades of France's sovereign rating from its top level by Standard & Poor's in January and recently by Moody's, which underscores the concerns over the country's failure to recognise the urgency of its economic woes that may weigh on the Euro region. Notwithstanding this, recent successful effort by the European authorities to provide financially-strapped Greece a temporary debt relief is positive for the financial market and has provided the much need confidence that future hurdles can be overcome.

Chart 3: Euro's PMI and GDP growth



Source: Eurostat, Bloomberg, MARC Economic Research.

Chart 4: Euro currency against USD, Yen (indexed)

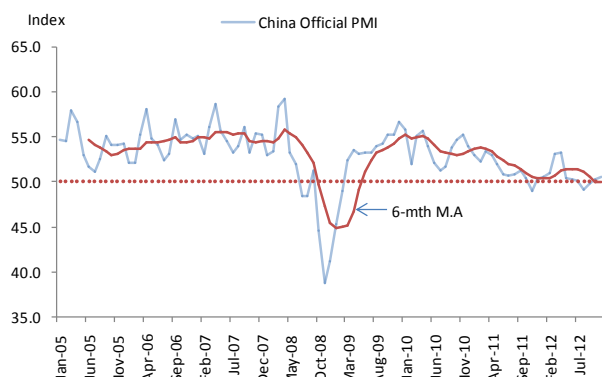


Source: Bloomberg, MARC Economic Research.

- Japan's economy, which rebounded commendably after the earthquake and tsunami disasters in March 2011, is slowing again amidst weak external and domestic conditions. Its GDP contracted 3.5% on an annualised basis in the July – September 2012 period after posting a 0.3% annualised expansion the prior quarter. Japan's export sector was adversely affected by the slowdown in demand from European economies and the strengthening of the yen against the euro currency between March and July 2012. On the domestic front, consumers are still grappling with deflation and have cut their expenditures by 0.5% quarter-on-quarter in the July – September period. The core CPI excluding food and energy is still in negative territory, dropping by 0.5% in November. Efforts by the government to shore up the economy through asset purchase programmes amounting to JPY11 trillion have yet to show results as firms hold back on capital expenditure in view of the global economic uncertainties.
- China's economy, which softened more-than-expected in the past year, has raised fears that it may not be able to provide a buffer for other Asian economies, prompting the latter to soften their monetary stance. India, Thailand and even South Korea trimmed their policy rates in anticipation of more downward pressures on their growth. China's GDP growth decelerated to 7.4% in 3Q2012 as a result of a weak export performance as reflected by its shipments which slowed to an average of 4.5% in the July to September period (2011 average: 20.6%). Compounding the anxiety is the unresponsive stance by the Chinese authorities which refused to interfere following the emergence of a property bubble after the huge RMB4 trillion fiscal injection following the Great Recession. Notwithstanding this, recent high frequency data such as PMIs and exports have somewhat relieved the fear of a hard landing. November's PMI climbed to the highest level in seven months while export growth rebounded to 11.6% year-on-year (y-o-y) in October. Overall, while jitters about

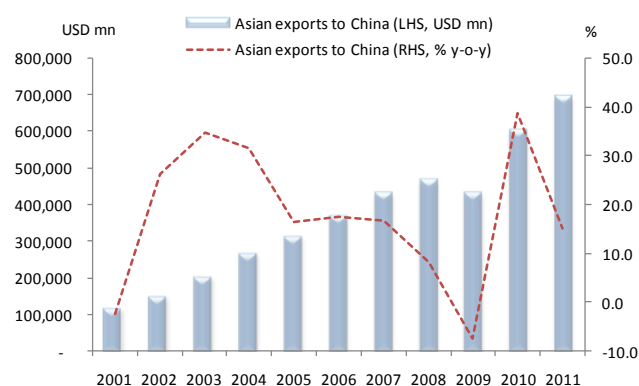
the prospects of China's economy have not fully subsided, the economy may have reached its bottom in 3Q2012.

Chart 5: China's PMI



Source: CEIC, MARC Economic Research.

Chart 6: Asian exports to China



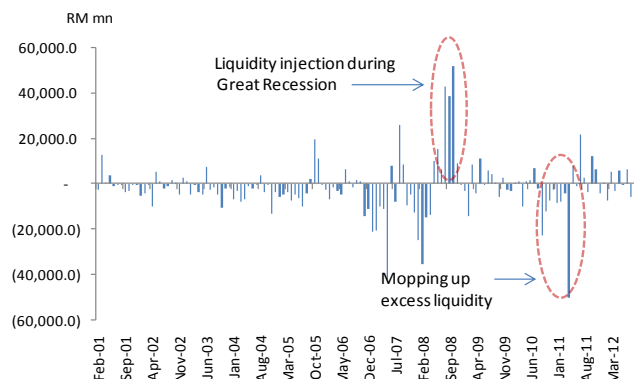
Source: WTO, MARC Economic Research.

Malaysian economy

- Malaysia's GDP growth surprised on the upside in the first three quarters of 2012, thanks to the unabated strength of the private sector. Although private consumption remained the biggest chunk of the economy and performed commendably, it was private investment that kept the growth momentum up, clocking an impressive 22.9% y-o-y expansion throughout 3Q2012. Similarly, private consumption remained resilient, registering a growth of 8.5% y-o-y over the same period, compared with an overall expansion of 7.1% y-o-y in 2011.
- Much of the growth in private investment came as a result of a continued expansion of mega projects which include, amongst others, the MRT, Second Penang Bridge, Tanjung Bin Power Plant and offshore pipelines for Gumusut-Kakap. Other mega projects such as the TRX, Menara Warisan and RAPID will likely keep the momentum intact in the next few years. Stronger foreign direct investment (FDI) following significant improvements in Malaysia's competitiveness position as well as the cost of doing business has also provided the much needed boost for investments. Private consumption, on the other hand, benefited from a stable labour market and the relatively easy access to credit as well as from the government cash handouts.
- Notwithstanding this, the external environment led to an abysmal trade performance as evidenced by the 3Q2012 statistics which showed the first contraction in real exports since 3Q2009. Due to waning demand for major products such as semiconductors as well as weaker commodity prices for crude oil and palm oil, Malaysia's gross exports shrank in two consecutive months in July and August before recovering slightly in September. Similarly, declining US B-T-B ratio and global chip sales have taken a toll on Malaysia, with exports of electronic and electrical products (E&E) declining by 4.6% y-o-y in August before rebounding by 4.6% in September. Falling demand from battered economies in Europe and China's weaker economy led to 19.2% and 11.6% contractions in exports to European Union (EU) countries and China respectively in 3Q2012.
- Inflationary pressure dissipated as global commodity prices softened. The growth in the headline CPI held at 1.3% in November, the slowest since March 2010. In the first 11 months of 2012, CPI grew by only 1.7%, with all components rising 2.5% or less except for food (+2.8%) and restaurants & hotels (+3.0%). Producer prices have also dropped from as high as 11.2% in September 2011, shrinking by 2.7% in October. Similarly, the GDP deflator, a broader price indicator, declined from as high as 7.7% in 2Q2011 to 0.6% in 3Q2012, suggesting a benign inflationary environment. Notwithstanding this, the rising cost of living has consistently been a main topic of discussion as incomes have failed to keep pace with overall prices, especially properties.

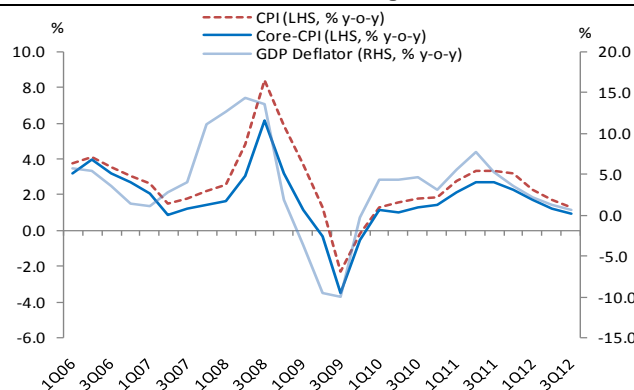
- The monetary policy remained accommodative, with the BNM refraining from trimming the OPR despite the softer global economy. With GDP growth averaging 5.3% in the first three quarters of 2012, BNM did not find any compelling reason to change its monetary stance. This is especially true when concerns over high household debt remain unabated. The banking system remains flushed with liquidity, and the BNM has continuously mopped up excess liquidity as evidenced by the amount added in the BNM balance sheet.

Chart 7: Liquidity injection and mopping in the banking system



Source: BNM, MARC Economic Research.

Chart 8: Headline and core CPI trending down



Source: CEIC, MARC Economic Research.

- Budget deficits remain a thorny issue despite the government's success in reducing it to an estimated 4% of GDP in 2012 from 6.7% of GDP in 2009. Rising operating expenditure (OPEX) is the main reason for the persistent increase in the government's overall expenditures which resulted in continuous deficits in the past several years. Besides emoluments, the major components that kept the OPEX at elevated levels are subsidies (20% of OPEX) and supplies and services (16%). The federal government debt level is another hot issue that is constantly discussed, especially when its ratio to GDP is approaching 55%. What is not often mentioned is the fact that the 55% limit refers to the debt financed by the issuance of Malaysian Government Securities (MGS) and Government Investment Issues (GII), which in 2011 stood at circa 45%. The external debt of the federal government remains insignificant at RM18 billion in 2011, and represents only 4% of total government debt. Total external debt (federal government and private sector) stood at RM258 billion in 3Q2012.
- Other imbalances such as rising property prices and high household debt are slowly being addressed by the government. Property prices in some states such as Selangor, Kuala Lumpur, Penang and Negeri Sembilan had risen by a double-digit pace before moderating recently. In response, the government has raised the Real Property Gains Tax (RPGT) by 5% to curb speculative activities which are the main force behind the escalating property prices. The BNM has also continued to curb loans to households to ensure that only those with strong financial standing are given access to financing. Notwithstanding this, property prices have hardly softened and persistent increases could lead to a property bubble, which in turn could undermine the economy if it bursts.

Outlook for 2013

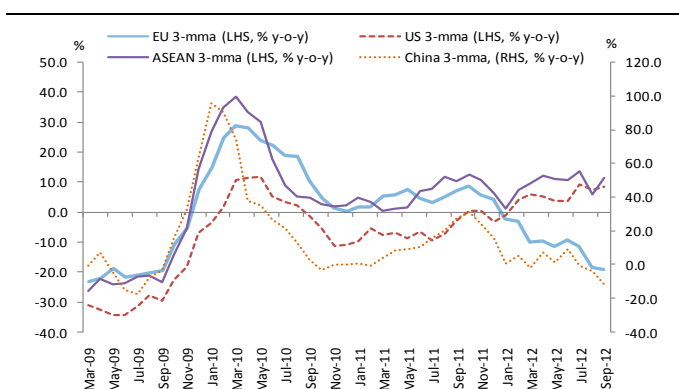
Growth – upward surprise may continue

- Malaysia's GDP growth performance will once again hinge on the global economic momentum, which at this juncture is clouded by the prospects of the recovery in the Euro region. Recent developments in the Euro region suggest that the outlook is less encouraging as the economy is likely to stall in the near term following the contractions of several economies such as Greece, Spain and Italy due to deep austerity measures

implemented by their governments. Offsetting this, however, is the US economy which we think will surprise on the upside, despite registering below its long-term growth trend of 3-plus percent. Judging by the latest statistics, its labour market is steadily healing and rising consumer confidence will likely offset the mediocre performance of the business sector. In Asia, the bottoming of China's economy will also help Asia's export performance and contribute to Malaysia's net trade in 2013.

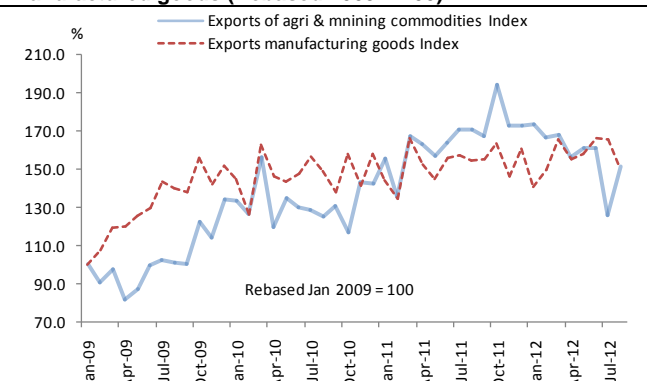
- The bottoming of Malaysia's exports will likely lead to a mild rebound in external trade performance as exports to Asian economies stabilise. In addition, an upturn in the US new orders signals a recovery in Malaysia's future export performance. Notwithstanding this, the wobbly demand for semiconductors as evidenced by the declining B-T-B ratio and softening crude oil and CPO prices will cap Malaysia's external trade performance in 2013. With semiconductor sales expected to rebound by only 4.5% (according to the estimates by World Semiconductor Trade Statistics) and palm oil prices expected to move within the range of RM2,200 and RM2,600 per tonne next year, we anticipate that Malaysian real exports will post a mediocre growth of 4.0% in 2013.

Chart 9: Export growth to major markets



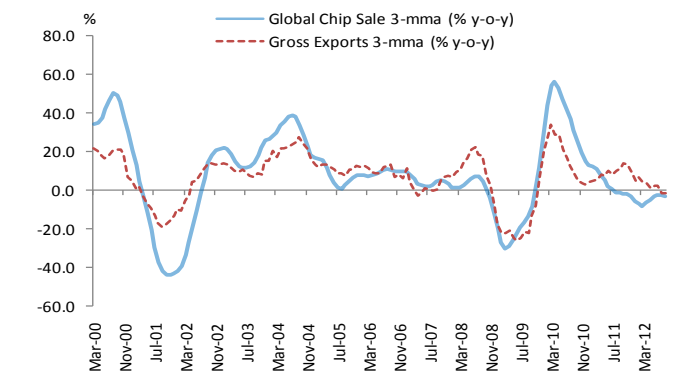
Source: BNM, CEIC, MARC Economic Research.

Chart 10: Exports of agriculture and mining commodities and manufactured goods (Rebased 2009 = 100)



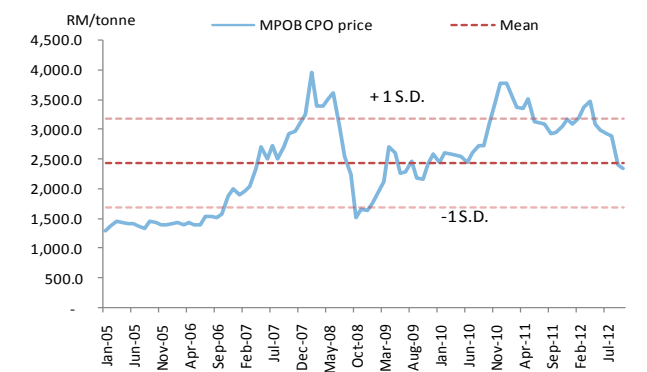
Source: BNM, CEIC, MARC Economic Research.

Chart 11: Global chip sales and Malaysian gross exports



Source: CEIC, SIA, MARC Economic Research.

Chart 12: CPO price, mean and standard deviations

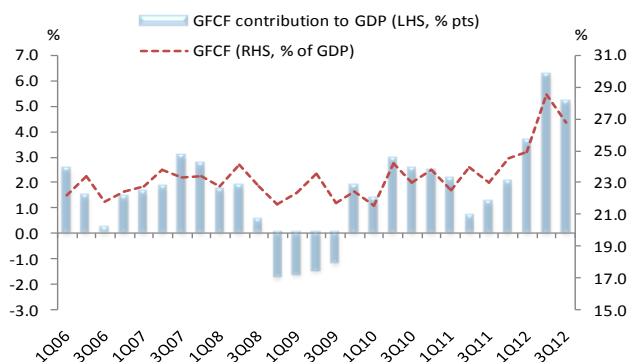


Source: Bloomberg, MARC Economic Research.

- Malaysia's domestic demand will likely stay resilient amidst rising contributions from private investment and private consumption. Judging by the recent trend, the momentum in private investment is the key to the possible upside of Malaysia's GDP performance in 2013, although consumers play a leading role in supporting the economy. We foresee that Malaysia's private investment will continue to remain robust in view of the mega projects that will be undertaken by the government in the next few years. These include, among others, the MRT project, Menara Warisan, the RAPID project and the Second Penang Bridge. It is worth

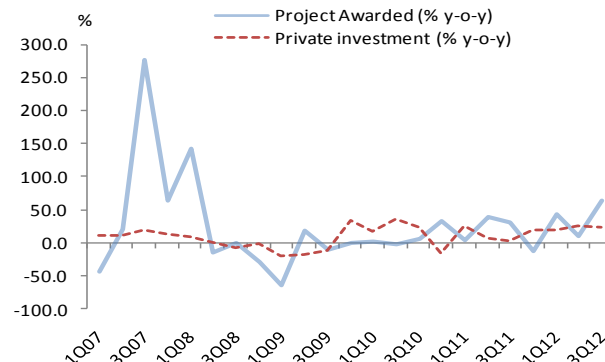
noting that the contribution by total investments to the headline growth has climbed to an average 5 percentage points in the first nine months of 2012, compared with the average contribution of 1.3 percentage points in the last six years. In addition, its share of Malaysia's GDP has risen from 22.3% in 2005 to an average of 26.7% in the January to September period. On that score, we view that private investment will remain robust and register a growth rate of 14.0% in 2013.

Chart 13: Contributions of investments to headline growth and its share in GDP



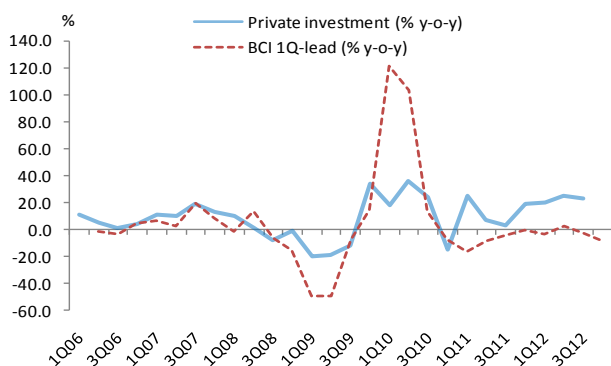
Source: BNM, CEIC, MARC Economic Research.

Chart 14: Projects awarded and growth in private investment



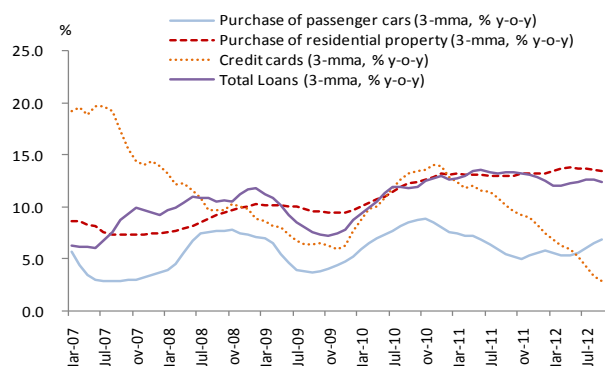
Source: BNM, CEIC, MARC Economic Research.

Chart 15: Private investment and BCI (1Qtr lead)



Source: BNM, CEIC, MARC Economic Research.

Chart 16: Lending by different purposes

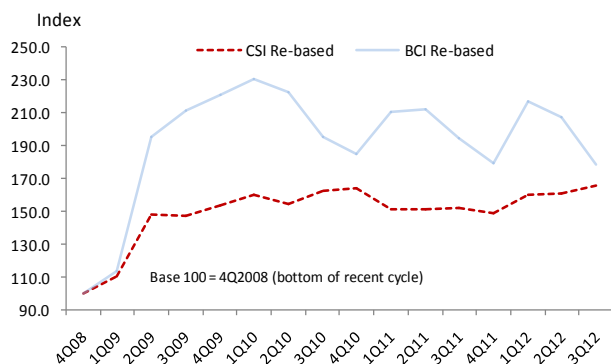


Source: BNM, MARC Economic Research.

- The strength of private consumption is undeniable as the labour market continues to remain stable. The unemployment rate remains relatively low at 3.2% in October, although it has climbed from as low as 2.7% in August 2012. Thus far, there has been no significant jump in the number of retrenched workers and the downward trend remains intact. The key factor to look at is the impact of the slowdown in export-oriented industries on the labour market. If a more serious downturn in the export-oriented industries leads to significantly higher retrenchments, then the strength of private consumption will be tempered.
- Another critical factor is the access to lending for consumers, which so far remains relatively easy despite the slowdown in household sector growth. Lending by banking institutions to the household sector slipped to 11.8% y-o-y in October but has remained well within the double-digit territory since January 2010. However, lending for credit cards and hire purchases declined more dramatically to 1.5% and 6.7% respectively in October 2012 following stricter lending rules by the BNM, with the latest measure imposed in January 2012. Notwithstanding this, the relatively resilient consumer sentiments suggest that GDP growth in 2013 will likely hover around Malaysia's long-term growth trend of 5.0% (chart 18). Assuming the upbeat sentiment is sustained and the labour market remains relatively stable, we anticipate private consumption to be able to chalk up another impressive growth of 6.2% in 2013, slightly slower than this year's estimated growth of

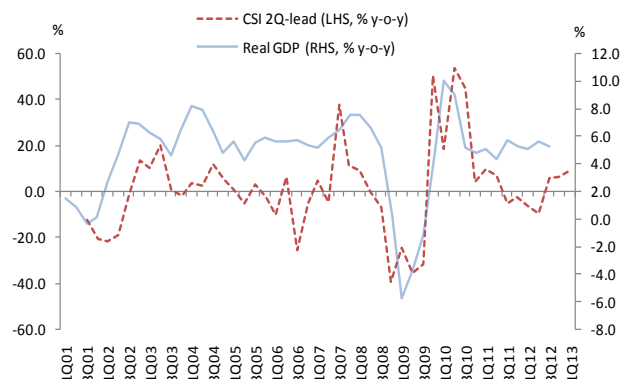
7.5%. Overall, taking into consideration domestic forces that may offset weaknesses in the external sector, we foresee another relatively resilient growth performance in 2013 with GDP growing at a 5.3% pace.

Chart 17: CSI and BCI growth since the recovery from Great Recession (Base 100 = 4Q2008)



Source: CEIC, MARC Economic Research.

Chart 18: GDP growth and CSI (2Q-Lead)



Source: CEIC, MARC Economic Research.

Table 1: GDP growth on the demand side

				MARC		MOF	
Growth % y-o-y	2009	2010	2011	2012F	2013F	2012F	2013F
GDP	-1.5	7.2	5.1	5.0	5.3	4.5 - 5.0	4.5 - 5.5
Domestic Demand	0.3	7.0	8.2	10.4	7.3	9.4	5.6
Private Consumption	0.6	6.6	7.1	7.5	6.2	7.0	5.7
Public Consumption	4.9	2.9	16.1	5.8	3.6	11.3	-1.2
Private Investment	-7.4	15.5	12.2	21.5	14.0	11.7	13.3
Public Investment	2.9	5.0	-0.3	16.1	6.3	15.9	4.2
Real Exports	-10.9	11.3	4.2	1.8	4.0	1.6	2.8
Real Imports	-12.7	15.6	6.2	6.2	6.4	5.1	3.6

Source: CEIC, MoF, MARC Economic Research.

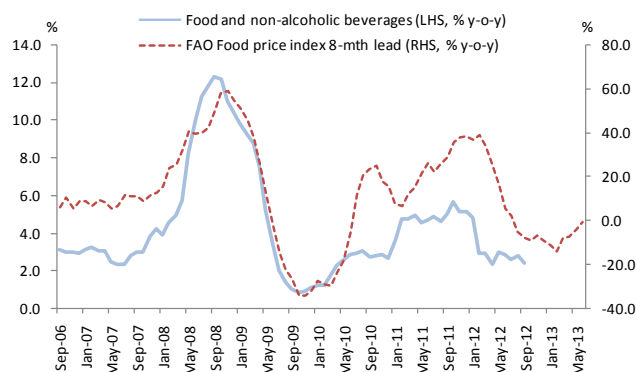
Inflation – benign despite an upside bias

- Based on the above scenario and barring unforeseen supply shocks, the inflation rate as measured by the CPI will not likely surpass the critical threshold that may cause a dramatic decline in private consumption. In view of the slow recovery of the global economy and the moderate expansion of the Malaysian economy, we do not see any compelling reason to forecast a CPI growth of more than 2.5% in 2013. However, there are forces that will likely push the CPI higher than its level in 2011.
- Possible supply shocks such as higher global food and energy prices are the wild card for 2013. Recent global developments point towards higher food prices following adverse weather conditions in the US and Eastern Europe that have pushed up prices of corn, soybean and wheat. The Food and Agriculture Organisation (FAO) food price index, which provides a good indication of the future trend in Malaysian food prices, suggests a likelihood of higher prices in the near future.
- In addition, we are factoring in some development that may take place in 2013 – implementation of the minimum wage policy, further rationalisation of subsidies and the reaction to the impending implementation of the GST – that will likely put a mild upside pressure on consumer prices. Implementation of the minimum wage will take off in early January 2013 and the rationalisation of subsidies will be undertaken in 2013 irrespective of the outcome of the GE in our view. Although we anticipate that subsidies will generally be rationalised rather than reduced dramatically, the adverse impact on CPI prices cannot be ignored. Secondly, although the government may only provide a timetable for the implementation of the GST (and not

implement it in 2013), some businesses will likely take advantage by charging higher prices on the pretext of getting ready for an eventual rise in prices after the implementation of GST.

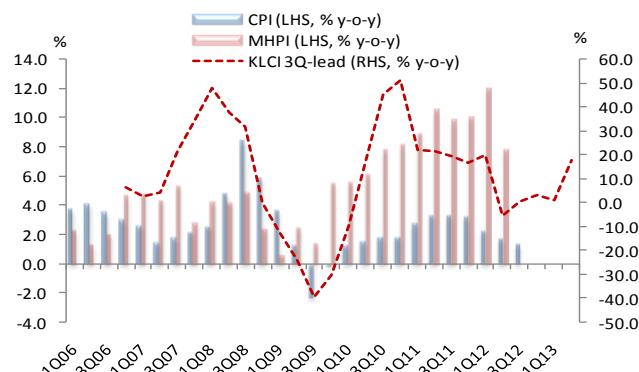
- Beyond consumer prices, we are of the view that the upward trend in asset prices will not wane - something we feel would slowly put a slight dampener on consumer spending. Of utmost concern are property prices which in some areas (Kuala Lumpur, Selangor, Penang and Negeri Sembilan) have increased at a double-digit pace, outpacing the growth of incomes of a majority of the population. Equity prices have also remained resilient, evidenced by the benchmark FBM KLCI which climbed by 9.5% this year to a high of 1675.69 points despite rising equity risk premiums.

Chart 19: Malaysia's index of food and non-alcoholic beverages and FAO food price index (8-month lead)



Source: BNM, CEIC, MARC Economic Research.

Chart 20: CPI, home prices and FBM KLCI



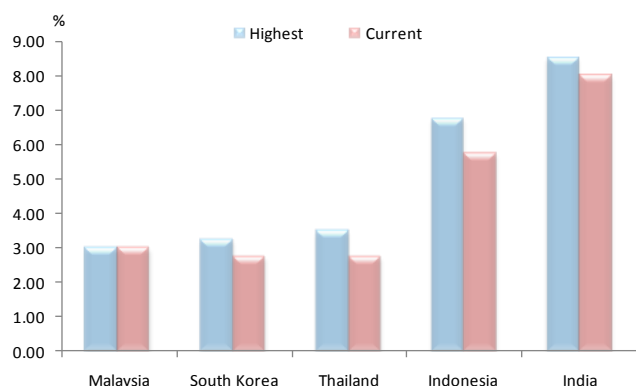
Source: Bloomberg, CEIC, MARC Economic Research.

Interest rates not likely to budge

- The BNM has maintained its policy rate – the OPR – unchanged at 3% despite the pressure to lower it amidst a weakening external sector. The rate has been normalised from as low as 2% during the height of the Great Recession in 2009. Among the primary reasons for keeping the rate status quo are: (1) upside surprise in GDP growth in the first three quarters of 2012; (2) strong consumer sentiment, evidenced by the Malaysian Institute of Economic Research's (MIER) rising consumer sentiment index (CSI); and (3) high household indebtedness.
- Strong headline GDP growth spurred by robust investments which has grown at a double-digit pace in since 1Q2012 has to some extent reduced the possibility of a significant downturn despite the weak external sector. Although net exports subtracted 4.9 percentage points from the headline growth in the first nine months of 2012, average GDP expanded by a robust 5.3%, outpacing neighbouring countries such as Thailand (2.6%) and Singapore (1.5%). Loan growth remained strong, expanding by an average 12.2% in the first 10 months of 2012. At the same time, capacity utilisation in the manufacturing sector has not softened since hitting its peak of 82% in 2Q2012.
- In 2013, we feel that the monetary policy will remain unchanged with a slight upside bias unless the growth momentum declines significantly. Based on its rhetoric, we sense that the BNM is not willing to endanger the financial system by inducing more over-leveraging practices through lower interest rates, especially among households. As household debt-to-GDP has topped 60% in the past one decade, premature reductions in the policy rate will not be in line with the central bank's intention to curb households' appetite for debt. In addition, raising the policy rate at a time when the US Fed is planning to keep the rate unchanged for a considerable period will lure more capital inflows which are dominated by portfolio flows. This may lead to a continuous surge in foreign holdings of Malaysian securities, especially MGS. As of September, foreign holdings of MGSs has reached an all-time high of 42.1% of total outstanding MGSs.
- In fact, we are of the view that if the US macro numbers improve materially and the financial market begins to discount the possibility of the US Fed lifting interest rates earlier than planned, then there is a possibility of an

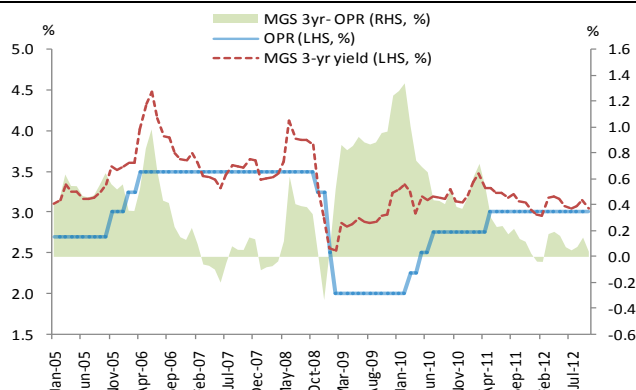
upward bias in the OPR. This is especially true if China begins to show a quick recovery from the current downward cycle and starts to increase their imports from other Asian countries.

Chart 21: Policy rates – peak of the cycle and current



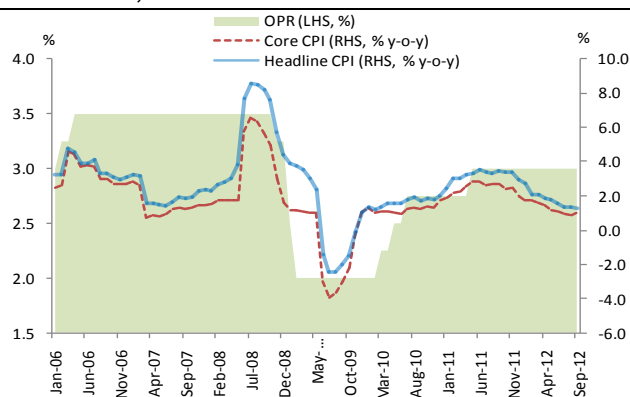
Source: CEIC, MARC Economic Research.

Chart 22: OPR, 3-Yr MGS yield and yield gap



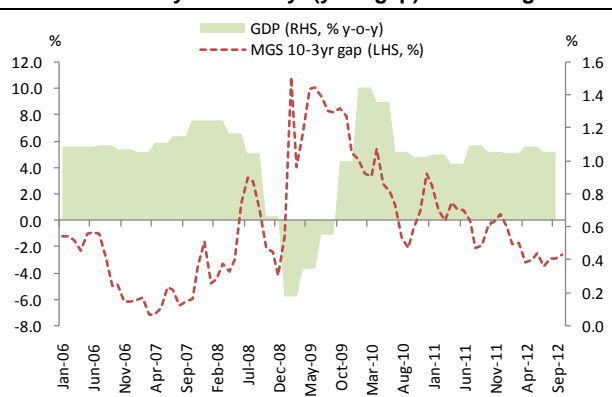
Source: BNM, CEIC, MARC Economic Research.

Chart 23: OPR, CPI and core CPI



Source: BNM, CEIC, MARC Economic Research.

Chart 24: MGS 10-yr minus 3-yr (yield gap) and GDP growth



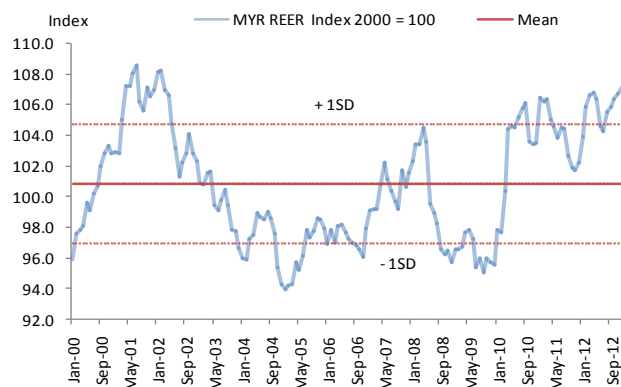
Source: BNM, CEIC, MARC Economic Research.

Ringgit – positive in long term

- Recent developments are positive for the ringgit against the greenback in the near term. With the US embarking on QE3, which will bolster global liquidity in the US dollar and reduce long term US interest rates, capital flows to Asia will not likely subside in the near term as investors search for better yield. Based on the level of current account (of the balance of payments) and the real effective exchange rate (relative to its long-term level), the outlook of the Malaysian ringgit is positive in the long term.
- While we see a general strengthening of the ringgit against the USD, we think the short-term trend will be bumpy for several reasons. Firstly, the weak prospects of the equity market do not augur well for the ringgit. The divergence in the relationship between KLCI and bond yields suggests that there is likelihood of a softer equity market ahead. This is mainly due to jitters among foreign investors with regard to the outcome of the GE. Secondly, the financial market's perception of the ringgit may be adversely affected by the shrinking current account surplus which coupled with persistent budget deficits will make holding of ringgit by asset managers more risky. Technically speaking, the ringgit's long-term moving averages against the USD (6- and 12-month M.A) are showing signs of a turnaround which may signal some weaknesses in ringgit/USD in the short term (Chart 26).

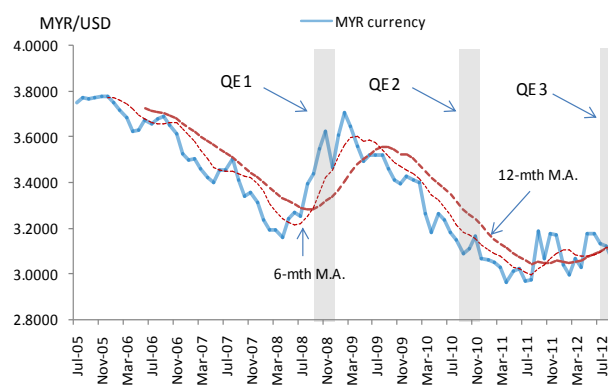
- Offsetting these factors, however, are the prospects of a steady recovery of the US economy that tends to weaken the greenback. This will be ringgit-positive. Secondly, with an expected recovery of China's economy, the Asian region will once again be inundated with capital as asset managers seek higher returns on their investment. A sustained inflow of capital into Malaysian shores as well as into the region will benefit the region's currencies and Malaysia is not an exception. On balance, we foresee the ringgit to move within the range of RM2.95 to RM3.15 against the USD in 2013.

Chart 25: Real effective exchange rate (REER) index



Source: Swiss RE

Chart 26: How ringgit reacted to QE1, QE2 and QE3



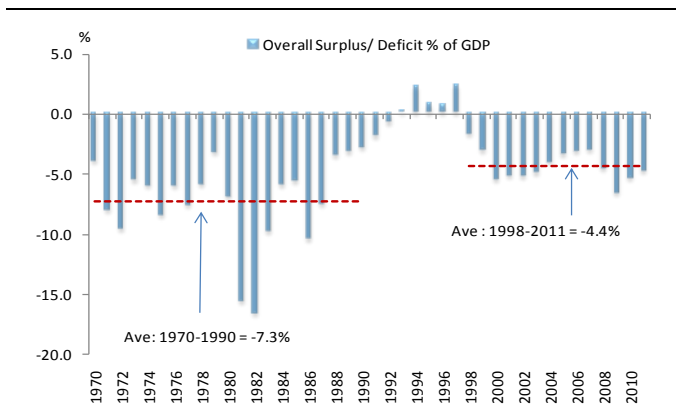
Source: Bloomberg, MARC Economic Research.

Government financial and debt positions

- Unless the growth momentum dissipates significantly in 2013, we foresee the federal government fiscal position to improve in 2013 and that the deficit target of 4% of GDP will not be difficult to achieve. This is based on the expectation of a stronger revenue growth that the economy is likely to see. At the heart of the argument, we think that the 0.7% growth forecast for revenue in 2013 is a gross underestimation. This is based on past experience which has shown that revenue collection was on average RM8 billion more than projected per annum in normal years. However, such an outcome is premised on the assumption that GDP growth will not be seriously dented by strong external headwinds.
- The only concern is on the expenditure side which again, based on past experience, suggests an underestimation. Again, except for the recessionary years of 2001 and 2009, operating expenditures were underestimated by an average RM8.8 billion per annum in the past 10 years. Adding to that is the possibility of higher government spending during an election year (should the GE be called towards the tail end of the allowable period in June 2013). Offsetting this, however, is the possibility that subsidy rationalisation measures will resume after the GE. We are of the view that this will take place irrespective of the outcome of the GE. Secondly, the government's determination to achieve the deficit target of 4% of GDP will mean that, barring unforeseen circumstances, it will be more cautious in its spending habits in 2013.
- On the whole, we believe that the two-pronged strategy that the government is adopting to deal with budget deficits should be continued and that is: (1) a steady reduction in deficits as a percentage of GDP without harsh austerity measures such as those imposed on some of the European economies in order to avert a sharp deceleration in growth; and (2) a long-term target that should be strongly pursued to avoid major macro imbalances. Bear in mind that Malaysia was on a steady path to balancing its budgetary position until the global economy fell into a deep recession in 2009. Up until 2007, Malaysia managed to slash its deficits from 5.5% of GDP to 3.1% of GDP. If the Great Recession had not occurred, the downtrend in the deficit would have continued, in our view.
- The federal government debt level will likely remain above 50% of GDP in 2013 as RM43 billion worth of issuance will take place to finance the deficits. Notwithstanding this, it is worth mentioning that the level of deficits that are financed through the issuance of MGSs and GLIs (and thus constrained by the self-imposed limit of 55%) remains circa 45% of GDP. The debt structure, which shows the overwhelming portion of the

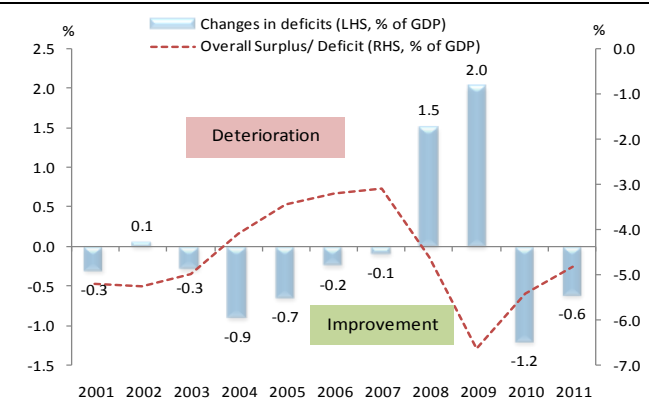
debt (circa 95%) being financed by domestic sources, suggests that the overall situation does not warrant alarm at this juncture. If there is an area worth paying attention to, it is the increasing proportion of short-term debt as a percentage of total debt.

Chart 27: Budget deficits as % of GDP 1970-2011



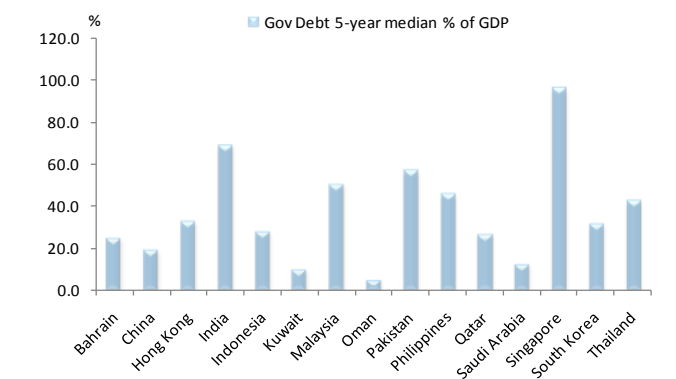
Source: BNM, CEIC, MARC Economic Research.

Chart 28: Overall surplus or deficit and changes in the amount of deficits as % of GDP



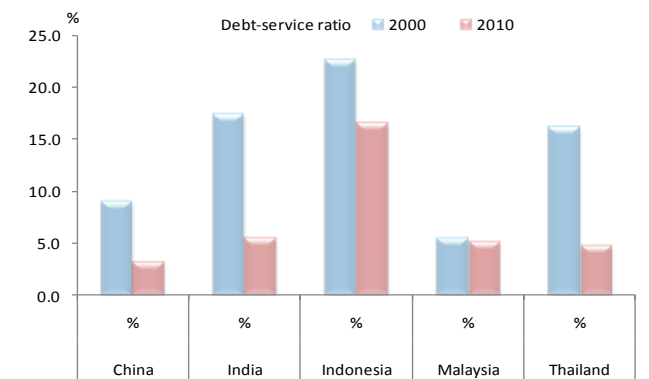
Source: BNM, CEIC, MARC Economic Research.

Chart 29: Government debt as % of GDP (5-year median)



Source: IMF, MARC Economic Research.

Chart 30: Debt service ratio of selected Asian countries



Source: World Bank, MARC Economic Research.

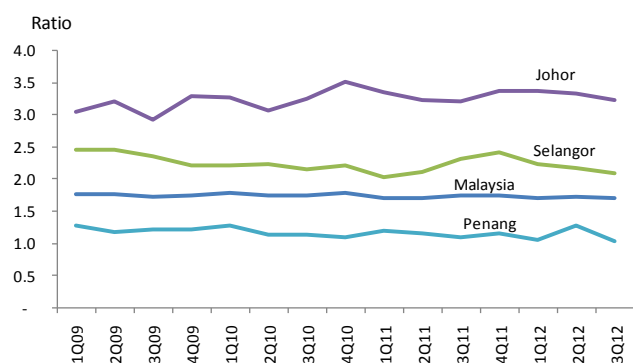
Areas of concerns

- While the bird's eye view of the economy is rather comforting, there are areas which call for greater attention in our view. The two major imbalances which we view with concern are (1) elevated levels of property prices which to some extent signify speculative activities; and (2) the overstretched household sector. Another minor factor which bears monitoring is the declining current account surplus which may cause uneasiness among financial market players.
- Rising property prices have not abated despite the implementation of some measures by the government and the central bank. While raising the RPGT and curbing loans through net income assessment are commendable measures, prices have not softened materially as these measures do not hit the groups which are buying properties on a large scale. Grouped buyers normally have great financial capacity and although this may lead to the conclusion that they do not present financial risk, we think otherwise as they tend to push up prices of properties beyond their reasonable ranges particularly in the high-end segment. While one may argue that this will not affect prices of the other property segments, we think otherwise as historical statistics seem to indicate that the ratio between prices in different segments of residential properties have tended to remain quite stable over the years. This phenomenon may be explained by the fact that unreasonably high

prices in one segment tend to cause investors or speculators to switch to different segments where prices have not risen substantially. Consequently, rising prices in the high-end segment will eventually trickle down to the midrange and lower segments.

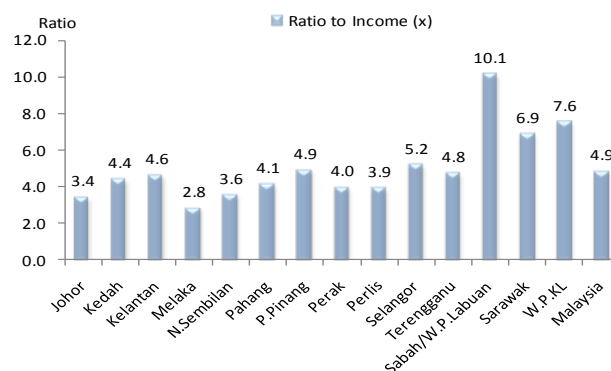
- Home affordability has also declined as incomes for most people have not increase in tandem with prices of residential properties. Even when compared with some major cities in the world, (i.e London and Los Angeles), the average price-to-income in certain places such as Kuala Lumpur and Georgetown are indeed higher. Overall, while we think that long-term fundamentals (i.e. population age profile) may be supportive of property prices, an exponential increase may lead to a significant decline which will no doubt affect overstretched borrowers.

Chart 31: Ratio of average prices between semi-D and linked houses



Source: NAPIC, MARC Economic Research.

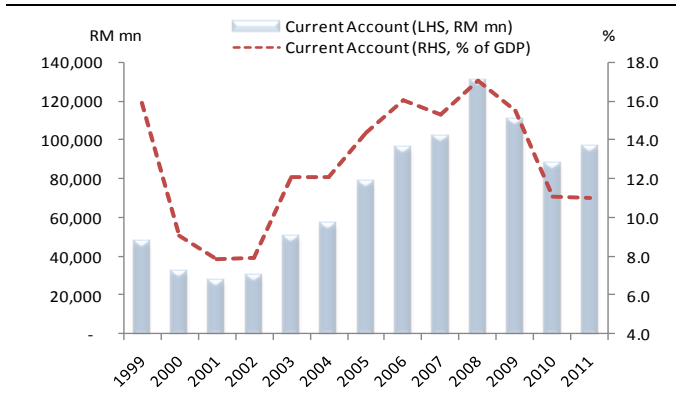
Chart 32: Ratio of average prices to income in different states



Source: DOS, NAPIC, MARC Economic Research.

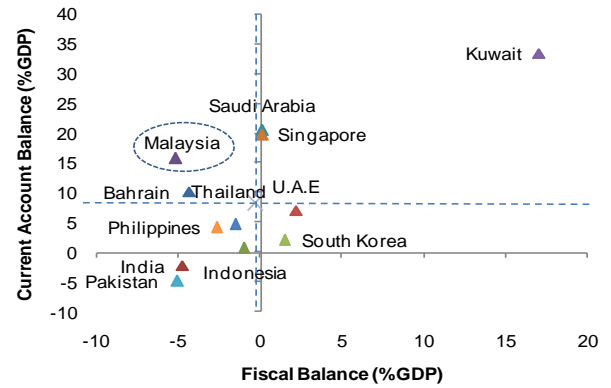
- The problem of high household debt has persisted since the new millennium, with its ratio to GDP remaining above the 60% level. By 2009, its ratio surpassed the 70% level. To be fair, this problem is to some extent being cautiously dealt with by the BNM through macro prudential measures. Credit should be given to BNM for delicately balancing the need to contain household debt while avoiding a hard landing of the household sector. By October 2012, the growth in loans to the household sector declined, albeit marginally, to 11.8% from as high as 13.9% in November 2010. Further scrutiny indicates that credit card loans have declined to 1.5% while lending for purchase of residential properties slowed to 13.2% in October.
- BNM's statistics indicate that a major chunk of borrowings are concentrated in the group with income level of RM3,000 per month and above (77% of banks' exposure to households or 87.3% of banking system loans in 2011). Although this is positive from one aspect (because of the small percentage of banks' exposures to households and banking system loans), we remain concerned that while borrowings from individuals in the lower income group (individuals earning below RM3,000 per month) remain low, they represent a major chunk of the population (about 53% of Malaysian households earn RM3,000 and below per month). As such, the proportion of the population that is prone to economic shocks should not be underestimated. This also means that an economic shock will likely produce a greater-than-expected impact on private consumption. We also view with concern that the leverage positions – measured by outstanding debt divided by the median annual income – of borrowers in the income group of less than RM3,000 per month are as high as 9.6 times, suggesting that the lower-income group will be hard-hit in an event of an economic downturn.
- We feel that the mediocre performance of Malaysia's export sector and rising imports due to the ongoing mega projects will put more pressure on the current account (CA) balance. The CA balance as a percentage of GDP has shrunk from 17.1% in 2008 to 11.0% in 2011 and will likely drop further in the next one year. Although the shrinking savings-investment gap in theory would not cause significant changes in the fundamentals of Malaysia's economy (as investment is mainly channeled towards productive sectors), investors' perception may not be too kind especially when the economy is already saddled with persistent budget deficits. This will be one of the reasons why the ringgit may come under pressure despite having strong fundamentals in the long term.

Chart 33: Current account



Source: BNM, CEIC, MARC Economic Research.

Chart 34: Current account and fiscal balance matrix (5-year median, % of GDP)



Source: IMF, MARC Economic Research.

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