Economic Research

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2H2013 Economic Outlook – Normalisation Setting In

MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

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Economics Team

Nor Zahidi Alias
Chief Economist
+603 2082 2277
zahidi@marc.com.my

Nurhisham Hussein
Economist
+603 2082 2231
nurhisham@marc.com.my

Afiq Akmal Mohamad
Economic Analyst
+603 2082 2274
afiq@marc.com.my

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In a nutshell

- The lackluster demand from advanced economies continues to impact global trade performance. Economic malaise in Europe is hurting Asian exports, putting pressure on their economies. The cloudy outlook of the Eurozone economy following its sixth quarterly consecutive contraction in 1Q2013 does not bode well for export-oriented economies such as Malaysia, which is dependent on exports of palm oil, semiconductor and oil-related products to support its headline growth. The Eurozone labour market remains a key concern with the unemployment rate hitting a record high of 12.2% in April as a result of the austerity measures widely implemented in the region.

- Adding to that, jitters over global economic weaknesses are being amplified by softer macro numbers in China in recent months, the most significant being the failure to sustain growth momentum in 1Q2013 which slipped to 7.7% from 7.9% in the preceding quarter. The prospect of a further moderation in exportshas also tempered business enthusiasm at large, and the fear of a slowdown was underscored by a contraction in HSBC's China Purchasing Managers' Index (PMI) which slipped further to 48.3 points in June from May's reading of 49.2 points. The primary concern is that in an effort to wean the nation off a credit binge that may destabilise China's economy, policy makers will not intervene as much as they have in the past, threatening China's growth as well as the global economy at large.

- Similarly, the Indian economy looks wobbly at this juncture. Graft scandals which undermined Prime Minister Manmohan Singh's efforts to revive investments and the twin deficit problem have affected confidence, pushing the rupee down by 10.4% year-to-date (YTD). A continued improvement in United States (US) job data has also taken a toll on the rupee's performance against the greenback, causing it to slip against the USD to an all-time low of 60.73 in the final week of June. India's gross domestic product (GDP) growth also continued to be under pressure, slipping to 5% in 2012, and is expected to expand at almost a similar pace this year, a far cry from its long-term average of 8.5%.

- It is not all gloom. The US economy is recovering well despite occasional worries on its budget issues. The labour market is on the mend, although long-term unemployment remains a thorny problem. Upbeat statistics in non-farm payrolls in recent months have kept the unemployment rate below 8%. Rising confidence in the housing market is becoming more evident following a continuous pick-up in prices reflected by the S&P/Case-Shiller index which has rebounded by 10.9% since the bottom of the cycle. Household wealth also surged to USD70.3 trillion in 1Q2013, surpassing the pre-recession high, giving a boost to private consumption. The only concern is the financial market's reaction and the impact of the Federal Reserve's (Fed) plan to scale back bond purchases as announced by Chairman Ben Bernanke in the third week of June.

- Japan's economy is also picking up pace with GDP growth accelerating to an annualised 4.1% quarter-on-quarter (q-o-q) in 1Q2013 (4Q2012: 1.2%). Confidence on the success of "Abenomics" has improved the financial market's perception of Japan, pushing its equity market up drastically before recent corrections took place. The World Bank's upward revision on the growth outlook for 2013 from 0.8% to 1.4% reflects the rising confidence in new macroeconomic policies which are thought to have turned prospects around at least in the short term.

- Corrections in several Asian equity markets in June reflect the financial market's anxiety over the Asian economy's prospects vis-a-vis the US, especially after the US Fed announced that asset purchases may be scaled down in response to better macro numbers in recent months. The concerns over a possible outflow of capital from emerging markets stems from the rising holdings of Asian government securities by foreign investors as well as sharp increases in the MSCI index since the Quantitative Easing (QE) policy was implemented.

- The Malaysian economy softened in 1Q2013 with GDP growth decelerating to 4.1% year-on-year (y-o-y) (4Q2012: +6.5%) as the impact of weaker trade performance continued to put downward pressure on net trade. Net trade subtracted 3.8 percentage points from the headline growth in 1Q2013. Gross exports to the European Union (EU) shrank by 19.7% in 1Q2013 from its peak in 4Q2011 due to economic malaise in the

Euro region. Malaysia's trade performance with the People's Republic of China (PRC) was also affected by China's weaker economic engine evidenced by the trade deficits incurred by Malaysia since 2Q2012, compared with a RM15.8 billion surplus recorded in the whole of 2011. Weak commodity prices, especially for palm oil (-38.2% since its peak in January 2011), will likely keep weighing on Malaysia's export performance.

- Going forward, we do not anticipate a significant rebound in commodity prices as external headwinds have yet to fully dissipate. That said, further deep corrections in prices may also not be likely for the rest of 2013. Oil prices may soften slightly compared to last year but will likely benefit from a steady improvement of the US economy. Palm oil prices have consolidated with the price of the most active futures dwindling between RM2,300 and RM2,550 per tonne in recent months.

- While external demand is still hitting speed bumps, domestic forces remained relatively unperturbed with investments and private consumption continuing to hold the fort for the economy. Spurred by mega projects, investment momentum remains respectable and will likely grow at a double-digit rate again in 2013, albeit slower than its performance last year. Investments have contributed an average of 2.9 percentage points per annum to the headline growth between 2010 and 2012.

- Recent statistics, however, have indicated that the normalisation process is setting in. For instance, the growth in imports of capital goods has softened to 1.4% in April (1Q2013: 12.8%) while passenger car sales have grown at a more moderate pace of 10.0% (1Q2013: 14.5%). But as major projects will not likely slow down the momentum of private investments, we are still holding on the view that the outlook remains promising and that these mega projects will keep on spurring related economic activities in the next half year. Overall, we foresee another year of a respectable growth of circa 10% in private investments in 2013.

- Private consumption remains a strong pillar of the domestic economy, contributing about 3.8 percentage points to the headline growth and expanding by 7.5% in 1Q2013, up from the 6.2% expansion in the preceding quarter. The major factors that drove up private consumption are well-known: a stable labour market and easy access to credit. Banks have continued to fuel consumer activities through strong lending practices, evidenced from the statistics in the first four months of 2013 which showed that loans extended by the banking sector to households grew at an average pace of 12.1% (4Q2012: 11.7%).

- Inflation numbers have not stirred any excitement in 1H2013. Inflation (growth in CPI) has averaged 1.6% y-o-y in the first five months, attributed to rising food prices which climbed by an average 3.2% between January and May 2013 (4Q2012: 2%). Weak commodity prices have also become a positive factor for Malaysia's inflationary trend. Stable oil prices and declining palm oil prices augur well for Malaysia's consumer prices. The benign inflation landscape is also reflected in the GDP deflator which has registered negative growth in the last two quarters (4Q2012 and 1Q2013). As such, going forward, we do not anticipate any surprises in Malaysia's inflation landscape in the next six months and hence we maintain our inflation target of 2% for 2013.

- With other countries in the region starting to lower their policy rates in response to weaker global economic prospects, speculation is rife that Bank Negara Malaysia (BNM) may follow suit. MARC respectfully disagrees with the above view. While we acknowledge that GDP growth may taper off in 1H2013, we are of the opinion that it is not sufficient to induce policy makers to consider lowering the policy rate. The main reason is the lingering problem of elevated household debt level which Malaysia is struggling to contain. Lowering the policy rate may give rise to a perception that the central bank is not serious in managing the growing household debt in the economy.

- We are also mindful of the manufacturing sector's present level of capacity utilisation (CAPU), which has remained relatively elevated since the economy recovered from the recession in 2009. CAPU in the manufacturing sector has remained high, surpassing the pre-recession peak of 80% in 2Q2012 before softening in 1Q2013. The level of the real interest rate also matters as it will come under pressure if BNM decides to soften its policy rate. Such a scenario will adversely affect savers, a situation which the government has always tried to avoid in the past mainly because of political reasons. With all these considerations, we maintain our base line scenario of the Overnight Policy Rate (OPR) at 3% for 2013.

- The ringgit has gone through a relatively volatile period, strengthening to RM2.96 against the USD post General Election 13 (GE13) and then lost its momentum and weakened to around RM3.20/USD in June. On a YTD basis, the ringgit fell by 4.6%. Going forward, the outlook for the ringgit and other Asian currencies generally hinges on several factors, namely: (1) investors' perception of the US economy (2) expectations of the US equity market performance which is improving relative to the emerging market equities; (3) growth moderation in Asian economies. With Malaysia's economic growth expected to moderate in 2013 and the fact that foreign shareholding of government bonds remains high, there is an increasing possibility of higher capital outflows in the near term. This will likely cap any upside of the ringgit in the next six months. As such, we now view the ringgit to trade against the greenback between RM3.05 – RM3.25 for the rest of the year.

Global Economy

Global growth momentum slides but US strength is intact

- The lackluster demand from advanced economies continues to impact global trade performance. Economic malaise in Europe is hurting Asian exports, putting pressure on their economies. The cloudy outlook of the Eurozone economy following its sixth quarterly consecutive contraction in 1Q2013 does not bode well for export-oriented economies such as Malaysia, which is dependent on exports of palm oil, semiconductor and oil-related products to support its headline growth.

- Eurozone's labour market remains a key concern with the unemployment rate hitting a record high of 12.2% in April as a result of the austerity measures widely implemented in the region. France saw its unemployment rate climbed to a record rate in April while Italy experienced the highest jobless rate in almost 40 years. Weak consumer prices of barely 1.4% y-o-y in May are also another sign of the bleak prospects in the immediate term.

- Adding to that, jitters over global economic weaknesses are amplified by softer macro numbers in China in recent months, the most significant being its failure to sustain the growth momentum in 1Q2013. China's GDP growth which moderated to 7.7% in 1Q2013 has once again raised concern from investors who were predicting an expansion of over 8%. Moreover, property prices have picked up again in recent months, making it more likely that the authority will keep imposing new measures to avert another property bubble.

- The expected adverse effect from various measures by the Chinese government to cool off the property sector and the prospects of further moderation in exports which barely grew by 1% in May (Apr: +14.7%) have tempered business enthusiasm at large, evidenced by the slide in the growth of industrial production to a single digit of 9.2% in May. Other negative vibes on the economy include contractions in imports and producer price index (PPI) in May which signaled weaker domestic demand. The fear of a slowdown was also underscored by a contraction in HSBC's China PMI which slipped further to 48.3 points in June from May's reading of 49.2 points. The primary concern is that in an effort to wean the nation off a credit binge that may destabilise China’s economy, policy makers will not intervene as much as they have in the past, threatening China’s growth as well as the global economy at large.As such we foresee economic growth to moderate to around 7.0%-7.5%.

- Similarly, weaker Indian economy - relative to its past performance - has triggered expectations that Asian economies may "catch the flu" again, putting pressure on its growth. Graft scandals which undermined Prime Minister Manmohan Singh's efforts to revive investments and the twin deficit problem have affected confidence, pushing the rupee down by 10.4% YTD. A continued improvement in US job data has also taken a toll on the rupee's performance against the greenback, causing it to slip against the USD to an all-time low of 60.73 in the final days of June. India's GDP growth also continued to be under pressure, slipping to 5% in 2012, and is expected to expand at almost a similar pace this year, a far cry from its long-term average of 8.5%.

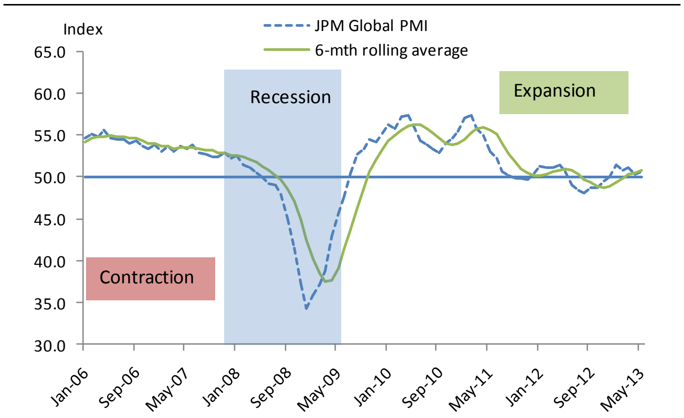
- Corrections in several Asian equity markets in June reflect the financial market’s anxiety over the Asian economy’s prospects vis-a-vis the US, especially after the US Fed announced that asset purchases may be scaled down in response to better macro numbers in recent months. The concerns over a possible outflow of capital from emerging markets stems from the rising holdings of Asian government securities by foreign investors as well as sharp increases in the MSCI index since the QE policy was implemented.

Table 1: MSCI retracement since recent peaks

	Period of Uptrend (Months)	Recent Peak (Index)	Retracement from peak (%)	Technical Indicators
MSCI Asia Pacific	11	144.9	-11.9	<100 dma
MSCI Asia Pacific ex-Japan	11	491.2	-13.8	<200 dma
MSCI Emerging Market	8	1083.4	-16.1	<200 dma

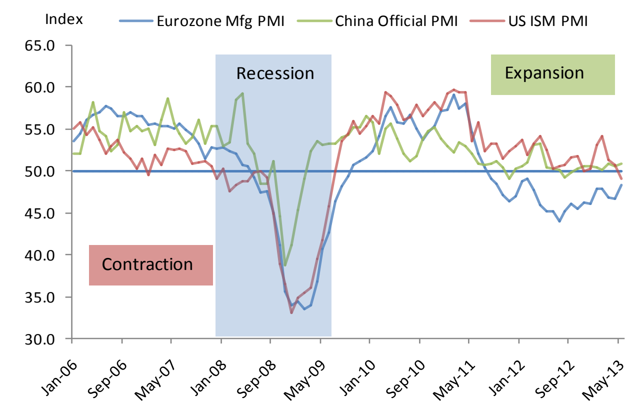
Source: Bloomberg

Chart 1: Global PMI and MA



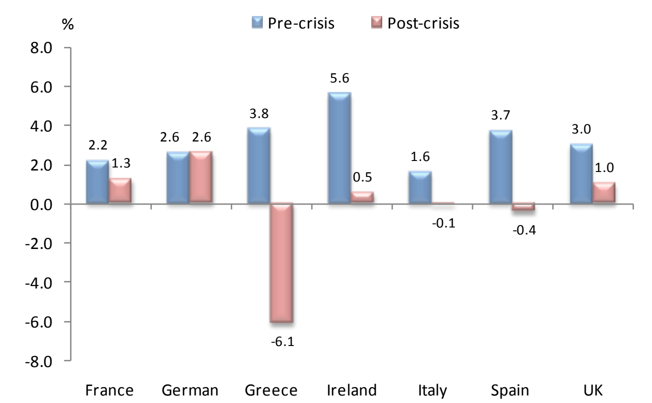
Source: Bloomberg, MARC Economic Research.

Chart 2: PMI of selected countries



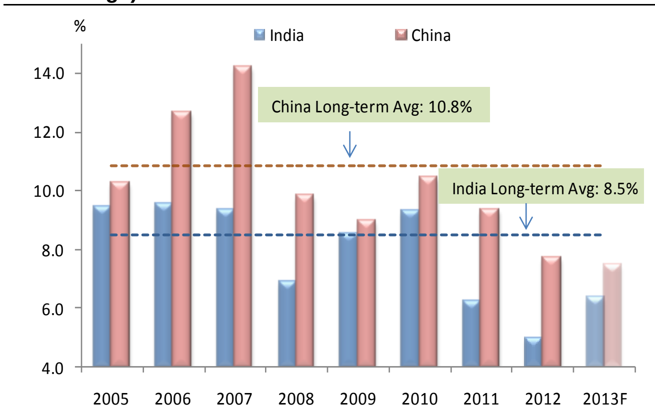
Source: Bloomberg, MARC Economic Research.

Chart 3: Selected European countries' GDP growth – pre and post crisis (% y-o-y)



Source: CEIC, MARC Economic Research.

Chart 4: China and India's growth (bar charts – compared with LT average)



Source: CEIC, MARC Economic Research.

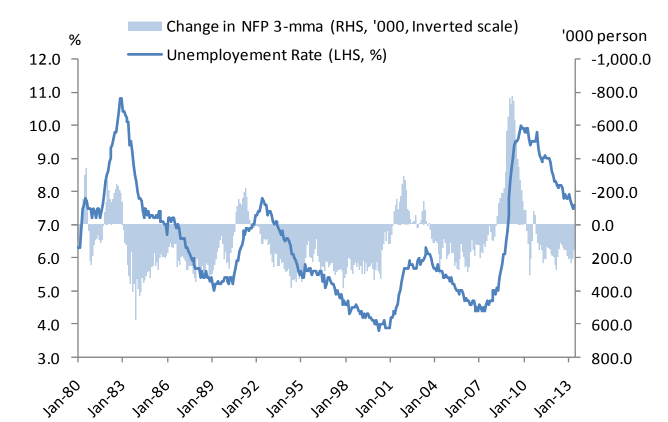
- It is not all gloom. The US economy is recovering well despite occasional worries on its budget issue. The labour market is on the mend, although long-term unemployment remains a thorny problem. Upbeat statistics in non-farm payrolls in recent months (average increases by 189.2K per month YTD) have kept the unemployment rate below 8%. Rising confidence in the housing market is becoming more evident following a continuous pick-up in prices reflected by the S&P/Case-Shiller index which has rebounded by 10.9% since the bottom of the cycle. The rising 30-year mortgage rate also signifies stronger confidence about future prospects of the housing market as well as the favourable outlook of the labour market.

- Household wealth surged to USD70.3 trillion in 1Q2013, surpassing the pre-recession high of USD68.1 trillion in 2007, giving a boost to private consumption. The strong equity market which saw the S&P 500 and Dow Jones Industrial Average surge by 14.3% and 15.3% respectively YTD, despite minor corrections recently, will likely sustain consumer spending growth and we believe that growth in real consumer spending will continue to exceed 2% in the next several quarters.

- Notwithstanding this, cutbacks in government spending are pinching some parts of the economy. Federal government spending was largely affected by the "sequester" budget cuts, continued to weigh on the economy, dropping 8.7% somewhat offsetting a rebound in private-sector activity. However, improvements in the labour market and housing sector will likely diminish the negative effects of budget cuts, leading to a respectable headline GDP growth of circa 2.5% in 2013.

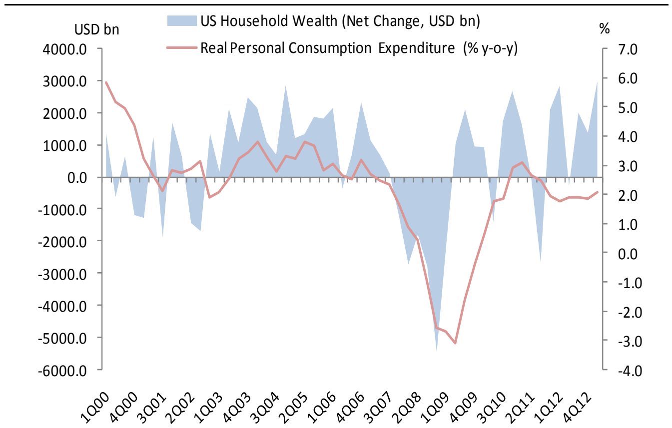
- Japan's economy is also picking up pace with GDP growth accelerating to an annualised 4.1% q-o-q in 1Q2013 (4Q2012: 1.2%). Confidence on the success of “Abenomics” has improved the financial market’s perception of Japan, pushing its equity market up drastically before recent corrections took place. A weaker Japanese yen will likely continue to assist major exporters, helping the country’s export performance. The World Bank’s upward revision on the growth outlook for 2013 from 0.8% to 1.4% reflects the rising confidence in new macroeconomic policies which are thought to have turned around prospects at least in the shortterm. Notwithstanding this, the long-term targets of accelerating inflation and the side effects of huge liquidity injections to the economy will be closely monitored by the financial market.

Chart 5: US Labor market and NFP



Source: CEIC, MARC Economic Research.

Chart 6: US household wealth and pvt consumption



Source: CEIC, MARC Economic Research.

Malaysian Economy

External sector is searching for the dawn

- The Malaysian economy softened in 1Q2013 with GDP growth decelerating to 4.1% y-o-y (4Q2012: +6.5%) as the impact of weaker trade performance continued to put downward pressure on net trade. Net trade subtracted 3.8 percentage points from the headline growth in 1Q2013. Weak commodity prices, especially for palm oil (-38.2% since the peak of RM3,764.5 per tonne in January 2011), will likely keep weighing on Malaysia's export performance.

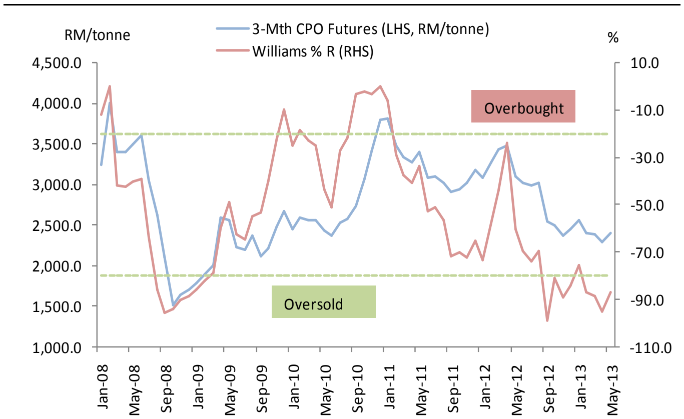
- As for exports of electronics and electrical products, lackluster demand is evidenced by its value which continued to shrink by 5.1% q-o-q in 1Q2013 (4Q2012: -5.4%). Semiconductor exports, on the other hand, have stabilized, slipping by 2.5% in 1Q2013 from the preceding quarter, slower than the 7.5% q-o-q contraction recorded in 4Q2012.

- Gross exports to the EU shrank by 19.7% in 1Q2013 from its peak in 4Q2011 due to economic malaise in the Euro region. For the whole of 2012, exports to EU slipped by 13.7%, the first decline since the Great Recession in 2009. Malaysia's trade performance with the PRC was also affected by China's weaker economic engine evidenced by the trade deficits incurred by Malaysia since 2Q2012, compared with a RM15.8 billion surplus recorded in the whole of 2011.

- Notwithstanding the fact that the outlook on trade performance remains uncertain, pronounced downside risks may not be on the cards as commodity prices may have bottomed out at least for this year. For instance, palm oil prices (MPOB local delivery) hit its cyclical low in December 2012 and have picked up by an average of 12% in the first four months of 2013. Similarly, rubber prices (export unit value) have rebounded by 7% in March 2013 from its cyclical low in October 2012. As for crude oil, the average export unit value per barrel actually edged up slightly by 2.6% in the first three months of 2013, compared with the average value in 4Q2012 despite the weaknesses in global demand.

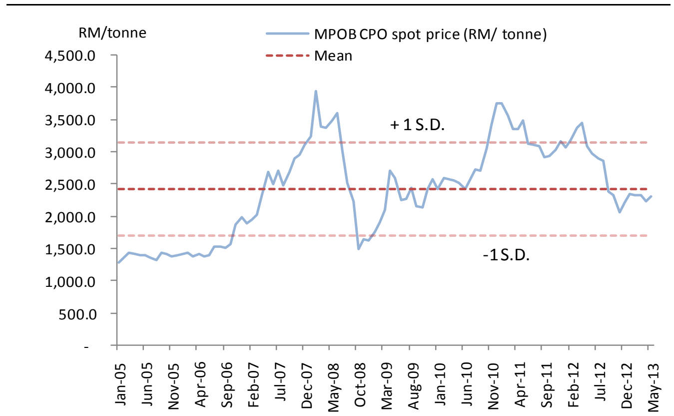
- Going forward, we do not anticipate a significant rebound in commodity prices as external headwinds have yet to fully dissipate. Prices may flip back downward in 2014 if major economies such as the Eurozone, China and India continue to succumb to further weaknesses. That said, further deep corrections in prices may also not be likely for the rest of 2013. Oil prices may soften slightly compared to last year but will likely benefit from a steady improvement of the US economy if the rebound in the housing sector and consumer spending remains intact on the back of a steady recovery of the labour market. Palm oil prices have consolidated with the price of the most active futures dwindling between RM2,300 and RM2,550 per tonne in the recent month. Technical reading for the most the third month futures contract (the most active) provides a less bearish scenario evidenced by 'upward hook-ups' of stochastics and Williams % R indictors, suggesting a lower likelihood of major corrections in the next several months.

Chart 7: Technical indicators on 3-mth CPO futures



Source: Bloomberg, MARC Economic Research.

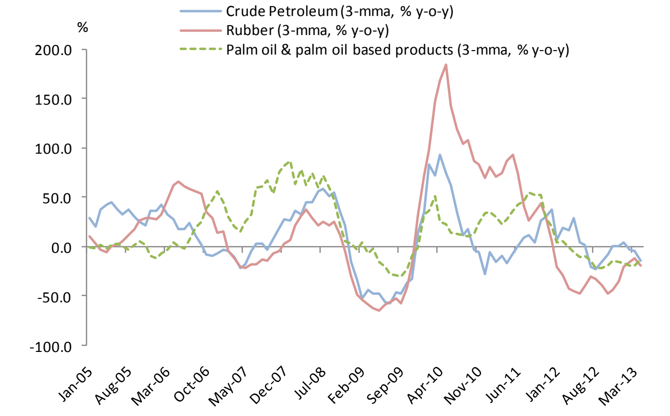
Chart 8: MPOB crude palm oil spot price



Source: Bloomberg, MARC Economic Research.

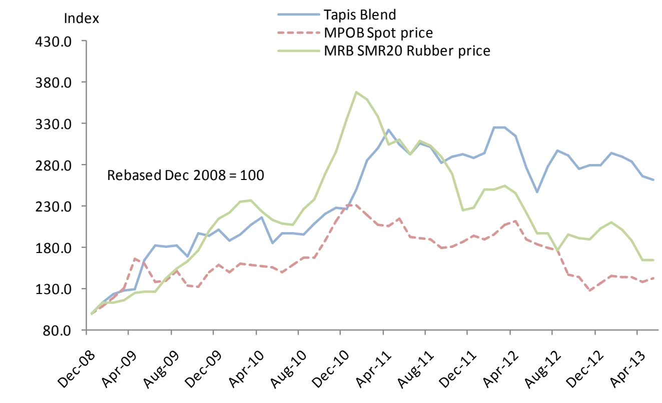
- At the same time, the new growth momentum in Japan will also lend some support to Malaysia's external sector. Notwithstanding this, after taking account stronger-than-expected external headwinds in 1H2013, we are trimming our real export growth forecast to 2.0% for the whole of 2013.

Chart 9: Exports of oil, palm oil rubber



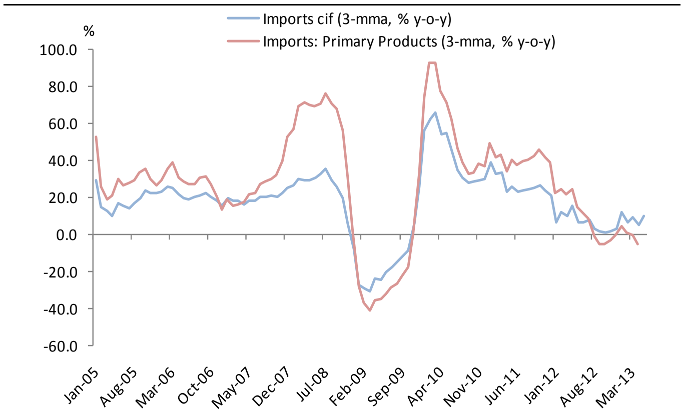
Source: CEIC, MARC Economic Research.

Chart 10: Prices of tapis, palm oil, rubber (index from GR)



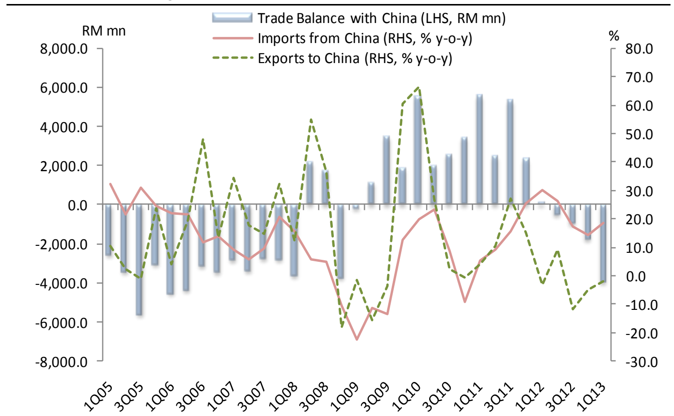
Source: Bloomberg, MARC Economic Research.

Chart 11: Imports of commodities by China



Source: CEIC, MARC Economic Research.

Chart 12: Malaysia's trade with China



Source: CEIC, MARC Economic Research.

Domestic demand to rely on private investments and consumers

- While external demand is still hitting speed bumps, domestic forces remained relatively unperturbed with investments and private consumption continuing to hold the fort for the economy. Spurred by mega projects, investment momentum remains respectable and will likely grow at a double-digit rate again in 2013, albeit slower than its performance last year. On a nominal basis, private investments have surged by 20% (19.3% on a CAGR basis) since 2010 when Performance Management and Delivery Unit (PEMANDU) first launched its initiative to drive up investments to the amount of RM1.4 trillion by 2020. Investments have contributed an average of 2.9 percentage points per annum to the headline growth between 2010 and 2012.

- Recent statistics, however, have indicated that the normalisation process is setting in. For instance, the growth in imports of capital goods have softened to 1.4% in April (1Q2013: 12.8) while passenger car sales have grown at a more moderate pace of 10.0% (1Q2013: 14.5%). But as major projects will not likely slow down the momentum of private investments, we are still holding on the view that the outlook remains promising and that these mega projects will keep on spurring related economic activities in the next half year. Overall, we foresee another year of a respectable growth of circa 10% in private investments in 2013.

Table 2: List of mega projects

No.	List of Mega Projects	Estimated cost	Estimated completion date
1	Refinery and Petrochemical Intergrated Development project (RAPID)	RM60.0 bn	2017
2	Klang Valley MyRapid Transit (MRT) - Sg. Buloh-Kajang Line	RM36.0 bn	2017
3	KL Singapore High-Speed Rail (HSR)	RM30.0 bn	2020
4	PJ Sentral Project	RM11.0 bn	2023
5	West Coast Expressway	RM6.0 bn	2018
6	Menara Warisan	RM5.0 bn	2015
7	Pengerang Petroleum Terminal	RM4.2 bn	2014
8	Tun Razak Exchange (TRX)	RM2.0 bn	2017
9	Tanjung Bin Petrochemical and Maritime Industrial Centre	RM1.0 bn	2016
	Total Committed Investment To-date	**RM211.3 bn**	

Source: PEMANDU

- Private consumption remains a strong pillar of the domestic economy, expanding by 7.5% in 1Q2013, up from the 6.2% expansion in the preceding quarter. It represented a hefty 52% of the economy and contributed 3.8 percentage points to the headline growth in 1Q2013. The major factors that drove up private consumption are well-known: a stable labour market and easy access to credit. Banks continued to fuel consumer activities through strong lending practices. This can be seen from the statistics in the first four months of 2013 which showed that loans extended by the banking sector to households grew at an average pace of 12.1% (4Q2012: 11.7%). The role of non-bank financial institutions in supporting consumer binging habits should also be acknowledged. For instance in 2012, non-bank financial institutions extended 57% of personal financing credit to households, and personal financing activity grew at a robust pace of 30% during the period, the fastest so far, according to the BNM.

- Passenger car sales, another indicator, continued to grow at positive rates, averaging 13.4% in the first four months of 2013, up from an average 12.3% in the final three months of 2012. It is also a far cry from the 11.1% average contraction recorded in the first four months of 2012 after the BNM started to impose prudent lending guidelines in January that year. Going forward, we foresee private consumption to grow circa 6.8%, up from our current target of 6.2%.

- As a whole, we are of the view that Malaysia's economic growth will remain decent in 2013 although weaknesses in the export sector may constrain the economy from achieving a headline growth forecast by the BNM (mid-point: 5.5%). However, the performance in 2H2013 will likely improve as external headwinds slowly dissipate, exerting less downward pressure on commodity prices. At the same time, strong lending to consumers, particularly for consumer credit and residential properties, will persist while the impact of robust investments in mega projects continue to trickle through the economy, benefiting ancillary activities in 2H2013. Overall, however, we are of the view that the average headline growth will likely taper off to 5.0% in 2013 from 5.6% in 2012.

Table 3: Real GDP growth – demand side (%)

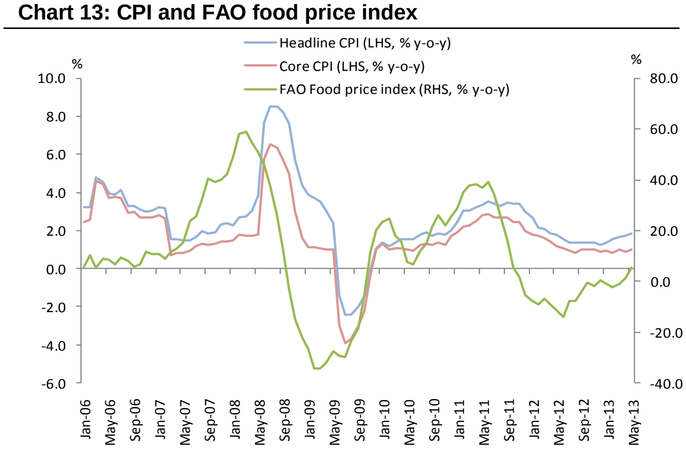
Growth % y-o-y	2009	2010	2011	2012	MARC 2013F	BNM 2013F	MoF 2013F
GDP	-1.5	7.4	5.1	5.6	5.0	5.0 - 6.0	4.5 - 5.5
Domestic Demand	0.3	7.7	7.9	10.6	7.8	8.1	5.6
Private Consumption	0.6	6.9	6.8	7.7	6.8	7.1	5.7
Public Consumption	4.9	3.4	15.8	5.1	6.2	3.6	-1.2
Private Investment	-7.4	18.4	10.5	21.9	10.0	15.6	13.3
Public Investment	2.9	4.9	1.0	17.1	11.0	7.5	4.2
Real Exports	-10.9	11.1	4.6	-0.1	2.0	1.8	2.8
Real Imports	-12.7	15.6	6.1	4.7	5.4	3.9	3.6

Source: CEIC, MoF, BNM, MARC Economic Research

Inflation remains benign and rates will likely stay put

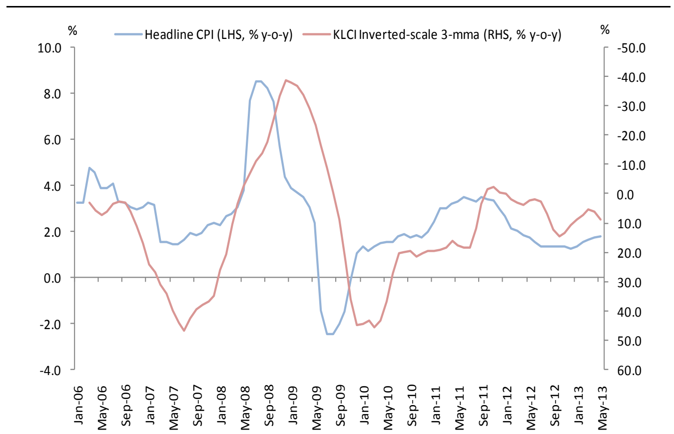
- Inflation numbers have not stirred any excitement in 1H2013. On average, inflation (growth in CPI) has averaged 1.6% y-o-y in the first five months, a slight pick-up from the 1.3% registered in 4Q2012. Rising food prices attributed to the recent rise in general prices with the food sub-index climbing at an average of 3.2% between January and May 2013 (4Q2012: 2%). The low base in 2H2012 will likely lead to higher CPI readings in 2H2013. However, offsetting this is the moderation in economic activity which will take the pressure off consumer prices.

Chart 13: CPI and FAO food price index



Source: CEIC, FAO, MARC Economic Research.

Chart 14: Headline CPI vs KLCI



Source: CEIC, MARC Economic Research.

- Weak commodity prices have also become a positive factor for Malaysia's inflationary trend. Stable oil prices and declining palm oil prices augur well for Malaysia's consumer prices. The benign inflation landscape is also reflected in the GDP deflator which has registered negative growth in the last two quarters (4Q212 and 1Q2013). As such, going forward, we do not anticipate any surprises in Malaysia's inflation landscape in the next six months or so as we assume no major changes in the structure of subsidies despite the anticipation of the preparation of Goods and Services Tax (GST) time-frame and further rationalisation of fuel subsidies. We maintain our inflation target of 2% for 2013.

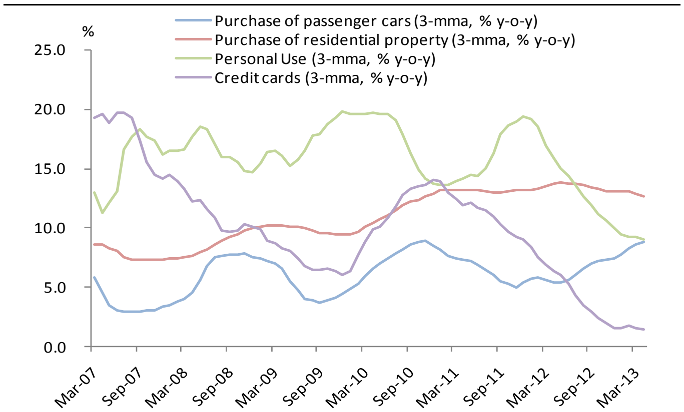
Status quo on interest rates

- With other countries in the region starting to lower their policy rates in response to weaker global economic prospects, speculation is rife that BNM may follow suit. After all, the OPR has remained unchanged at 3.00% in the past 25 months. The softer-than-expected GDP growth in 1Q2013 has further supported the belief that there will be some form of monetary response in the near term if the growth momentum continues to change its trajectory towards the downside. The weakness in Malaysia's trade performance owing mainly to sharp declines in commodity prices (palm oil by -38.2% , rubber by -55.5% from the peak in January 2011) gives another reason to argue that Malaysia's OPR may reverse its course to accommodate and ensure that its headline growth will be at least 5% this year.

- MARC respectfully disagrees with the above view. While we acknowledge that GDP growth may taper off in 1H2013, we are of the opinion that it is not sufficient to induce policy makers to consider lowering the policy rate. There are indeed compelling reasons to think that the BNM will try to resist any measures that can be seen as too accommodative.

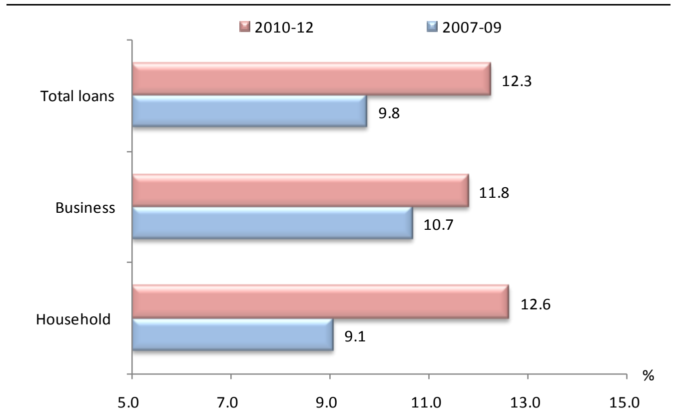
- The main reason is the lingering problem of high household debt level. As previously mentioned, Malaysia is struggling to contain its household debt which surpassed the 80% level against GDP in 2012. Measures imposed by the BNM, the most prominent being the prudent lending guidelines introduced in January 2012, have to some extent tempered household enthusiasm in some loan segments. Credit card loan growth slowed to 1.2% in April, while loans for personal use eased to 8.7% in April, the lowest in five years. Notwithstanding this, loan growth for residential property purchases and purchases of passenger cars remain stubbornly elevated at 12.7% and 9.0% respectively in April. What is more pressing is the surge in growth rates of lending by non-bank institutions.

Chart 15: Loan growth to different segments



Source: CEIC, MARC Economic Research.

Chart 16: Average loan growth to different sectors



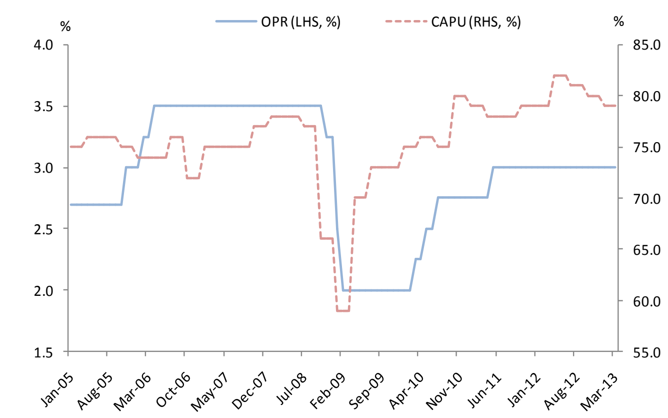
Source: CEIC, MARC Economic Research.

- Given the above scenario, lowering the policy rate may give rise to a perception that the central bank is not serious in managing the growing household debt in the economy. In fact, such a move could exacerbate the problem as banks will likely become more aggressive in dishing out loans to the household sector. This will not augur well for the long-term fundamentals of the economy.

- We are also of the view that the performance in 2H2013 will likely improve and push the average headline growth number to our forecast of 5.0% in 2013. While we think that soft commodity prices will prevail in 1H2013, they may have bottomed out and will start to stabilise in 2H2013. Under such circumstances, we do not foresee further sharp declines in palm oil prices in 2H2013. This will to some extent mitigate the downside risk of a significant negative contribution from net trade to the headline growth. And as mentioned previously, we feel that at this juncture private investment and consumption-led domestic demand will able to shoulder the responsibility of sustaining the headline growth at circa 5% in 2013, making it unnecessary for the BNM to accommodate its policy stance further.

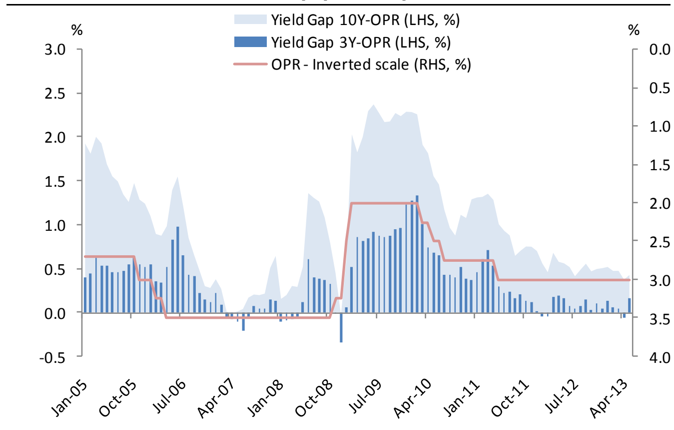
- We are also mindful of the manufacturing sector's present level of capacity utilisation, which has remained relatively elevated since the economy recovered from the recession in 2009. While GDP growth has softened to an average of 5.4% in 2011-2012 compared to a blistering 7.4% recorded in 2010, CAPU in the manufacturing sector has remained elevated, surpassing the pre-recession high of 80% in 2Q2012 before softening in 1Q2013. Historically, CAPU has been a good gauge for the direction of the policy rate as it signals overheating and slowdown in the real economy.

Chart 17: OPR and CAPU



Source: CEIC, MARC Economic Research.

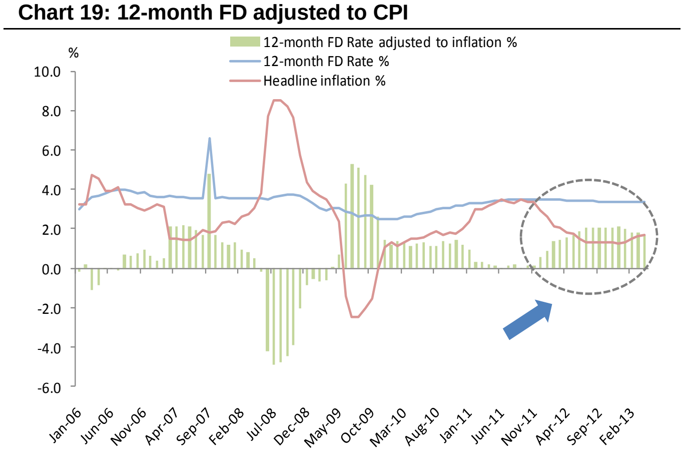
Chart 18: OPR and Yield Gap (10Y, 3Y)



Source: CEIC, MARC Economic Research.

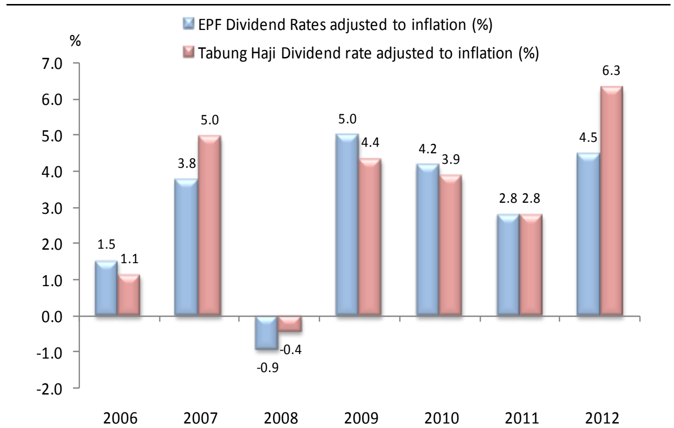
- The real interest rate will also come under pressure if the BNM decides to soften its policy rate. With inflation expected to pick up slightly from last year due to the low base effect and rising expectation of further rationalisation of subsidies (although it may not likely happen this year), the real interest rate will continue to decline. Such a scenario will adversely affect savers, a situation which the government has always tried to avoid in the past mainly because of political reasons. With all these considerations, we maintain our base line scenario of the OPR at 3.00% for 2013.

Chart 19: 12-month FD adjusted to CPI



Source: CEIC, MARC Economic Research.

Chart 20: EPF dividend/Tabung Haji rate, adjusted to CPI



Source: EPF, Tabung Haji, MARC Economic Research.

Ringgit strength will be limited against the USD

- The ringgit has gone through a relatively volatile period, strengthening to RM2.96 against the USD as foreign investors flocked into both the equity and bond markets following the removal of political uncertainties after the GE 13. By late May, however, the ringgit lost its momentum and weakened to around RM3.20/USD in June as the financial market reacted to the possibility of the US Fed scaling down bond purchases as hinted by the Fed's Chairman Ben Bernanke.

- Compared with regional currencies, the ringgit has depreciated by over 8% against the greenback since its high of RM2.96 in early May, the worst performer between early May and mid-June (the Thai baht was the second worst performer, depreciating by -6% against the USD). On a YTD basis, the rupee was the worst performing currency, depreciating by 10.4% while the ringgit fell by 4.6%. Major factors that dragged Asian currencies down in 1H2013 were slower growth, twin deficits (in the case of India) and narrower interest gap.

- Going forward, the outlook for the ringgit and other Asian currencies generally hinges on several factors, namely: (1) investors' perception of the USD which is becoming more bullish in view of the continued improvement of the economy judging by the recovery of the housing and labour market; (2) expectations of the US equity market performance which is improving relative to the emerging market equities; (3) growth moderation of Asian economies that led to interest rate cuts in countries such as India and Australia. With Malaysia's economic growth expected to moderate in 2013 and the fact that foreign shareholding of government bonds remained high, there is an increasing possibility of higher capital outflows in the near term. This will likely cap any upsides of the ringgit in the next six months. As such, we now view the ringgit to move within the range of RM3.05 – RM3.25 against the greenback for the rest of the year.

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MALAYSIAN RATING CORPORATION BERHAD (Company No.: 364803-V)
5th Floor, Bangunan Malaysian Re, No. 17, Lorong Dungun, Damansara Heights, 50490 KUALA LUMPUR
Tel.: +603 20822200 Fax: +603 2094 9397 E-mail: marc@marc.com.my
Homepage: www.marc.com.my