Economic Research

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Economic Outlook 2014 – Focusing on Domestic Challenges

MALAYSIAN RATING CORPORATION BERHAD
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In a nutshell

- The Malaysian economy has performed slightly below our expectations in 2013 as abysmal trade performance continued to drag headline growth (our June forecast for 2013: 5.0%, latest: 4.7%). Net exports subtracted 2.3 percentage points from headline growth in the first nine months of the year. Notwithstanding, the domestic economy continued to be resilient, with private consumption and private investments contributing 6.1 percentage points to headline growth during the period. Going into 2014, however, we are of the view that Malaysia's real gross domestic product (GDP) growth will be respectable at 5.0%, although it will likely be at the lower range of the government's forecast due to numerous challenges ranging from softer consumer spending in the wake of rising prices partly attributed to the rationalisation of subsidies as well as stricter lending standards by financial institutions induced by Bank Negara Malaysia's (BNM) measures to cap household debt as well as the increasing level of gross impaired loans. We also think that a meaningful recovery of global trade is the key to Malaysia's ability to maintain a decent 5.0% growth in 2014.

- We are of the view that commodity prices will stabilise and palm oil prices, which have been trading at deep discounts to soybean prices, will rebound in 2014, although a sharp increase is not foreseen at this juncture. The outlook of the electronics and electrical industry (E&E) is also more promising. The United States (US) book-to-bill ratio continued to gain strength, surpassing the unitary level again in October while global chip sales are anticipated to be firmer than in 2013 following a recovery in the US, Japan and the euro economies. Another positive indicator is the uptrend in the US Institute for Supply Management (ISM) new orders which is supportive of Asian and Malaysian export performances. As such, we are of the view that real exports will expand by 4.0% in 2014, stronger than the Ministry of Finance's (MoF) projection of a 1.6% growth.

- The role of domestic demand is also crucial to achieving the 5.0% headline GDP growth in 2014. In particular, the positive contribution from private investments may prove to be the saviour for the economy in 2014 as the pace of private consumption may moderate due to rising consumer prices. With a slew of projects in the pipeline under the Economic Transformation Programme (ETP), the strong momentum in investments will likely be sustained. Based on this scenario and the anticipation of a strengthening of the global economy, we foresee that private investment will continue to register a decent growth of circa 11.0%. We are also of the view that Malaysia will not face a major hurdle in attracting net foreign direct investment (FDI) inflows of between RM30 billion – RM35 billion in 2014.

- Lending by banking and non-bank institutions to certain segments of the economy (i.e. purchase of residential property and passenger cars) remains resilient despite the softening of overall loan growth to below 10.0% in 2013. Such a scenario augurs well for consumer spending. However, on the flip side, recent developments are exerting downward pressure on consumer sentiment. In particular, we anticipate the combined knock-on effect from higher consumer prices resulting from higher electricity tariff, fuel, transport costs and possibly toll charges as well as stricter lending guidelines by financial institutions will start to dent consumer sentiment despite stable labour market conditions. As such, we are projecting a softer growth of 6.2% for private consumption in 2014 (estimate for 2013: 7.1%).

- As for the banking system, although it has remained sturdy with asset quality continuing to improve as observed in the gradual easing of the gross impaired loans ratio, the concerns over the high level of household debt will continue to influence monetary policy measures by the BNM. Although the ratio of gross impaired loans declined to an all-time low in October 2013, the absolute amount of these loans has increased in the past few months as evidenced by the positive growth in the past four consecutive months to October, the longest stretch since 2010 when the economy was impacted by the Global Recession. Two critical developmentsare worth monitoring: (1) the possibility of an interest hike which makes it more likely for impaired loans to continue rising; (2) the relatively skewed income distribution where approximately 40.0% of households earned less than RM3,000 per month, which means the financial burden is still overwhelmingly high on the low-income group.

- Inflation is a key concern in 2014. All eyes are now glued on monthly consumer prices which are expected to ascend in the next one year. We believe that the consumer price index (CPI) will spike up by more than one-percentage point from its average level in 2013 due to several developments which have taken place or are likely to happen in the near term. These include, amongst others: (1) tariff hike for electricity starting January 2014; (2) further reduction in fuel subsidy expected in 2H2014; (3) pre-Goods and Services Tax (GST) price hikes due to rising demand and increasing speculation; and (4) possible hike in toll charges. We foresee a high probability that the latter three events will happen based on recent developments, the tone set in Budget 2014 and the rhetoric among the officials. We have penciled in a 3.5% rate of inflation for 2014.

- Although price developments possibly call for a monetary response, making an interest rate call may still prove to be tricky in 2014. On one hand, a slower momentum of domestic demand indicates that the policy rate may stay put at the current level of 3.0%. On the other hand, an uptrend in consumer prices, especially if core prices start to accelerate, an elevated level of capacity utilisation (CAPU) in the manufacturing sector and a possibility of substantial capital outflows due to the US Federal Reserve's (Fed) trimming of bond purchases may justify a rate hike in the next one year. The key will be the trend in the core CPI which we think is a critical factor in determining the official rate (overnight policy rate or the OPR). Based on a slew of increases in food, petrol, electricity and other goods and services, we are of the view that there is a high possibility of a rate hike in the OPR by 25 basis points (bps) in 2014 as the BNM positions itself to be ahead of the curve to avert an excessive price increase following some of the measures to be undertaken by the government to reduce the burden on its coffers.

- Recent developments in the US are undoubtedly negative for Asian currencies, including the ringgit, although we do not expect a major setback for the local currency as in 2009 this time around. On the whole, we concur with the view that the recent cutback in bond purchases by the Fed does not imply a tightening of monetary policy in the near term. Notwithstanding this, we think that the focus will now shift to the speed of the cut backs in bond purchases as this would indicate the timeframe that the Fed is looking at in terms of changing the course of its policy rate. We believe that bond investors will continue to sideline this asset class and push yields higher in the near term while currency traders will trim their exposures to Asian currencies in favour of the greenback.

- Going forward, we do not discount further weakening of the ringgit as asset managers continue to re-focus on diverting their investments into dollar-denominated assets following expectations of a stronger greenback on the back of a sustained recovery of the US economy. We are of the view that the ringgit may not have a strong upside in the next one year – at least not until a clearer picture of the US Fed policy action emerges. Other factors that may exert downward pressure on the ringgit include (1) weakening domestic growth momentum; (2) concerns over high household debt; and (3) concerns over the shrinking of current account surplus. On the flip side, however, we feel that the changing profile of foreign investors of Malaysian financial assets (which include central banks' holdings of Malaysian Government Securities or MGSs) and measures undertaken by the BNM through currency swap arrangements with several Asian countries will somewhat mitigate the volatility of the ringgit going forward. On the whole, we now see the ringgit to average circa RM3.20 to RM3.30 in 2014, compared with an estimated average of RM3.17 per USD in 2013.

- On the issue of the government budgetary position in 2014, we are less pessimistic unless economic growth momentum weakens excessively (which may not be the case). We are of the view that the government can achieve the targeted deficit of 4.0% of GDP in 2013, premised on the favourable performance in the first three quarters of the year where the deficits amounted to only RM24.8 billion, compared with the overall projection of RM40 billion deficit for 2013. Going forward, the government is likely able to achieve the targeted deficit level of 3.5% of GDP in 2014 on account of (1) higher-than-expected revenue growth of circa 7.0% as real economic growth sustains at the 5.0% level amidst a favourable external environment; (2) further cutbacks in development expenditure to offset the increase in operating expenditure; and (3) a slower expansion of operating expenditure in the wake of further subsidy rationalisation efforts by the government.

- Notwithstanding this, we are of the view that the reduction in the headline deficit figures will have to be seen from a broader perspective. In particular, much of the reduction in recent times was due to the drop in development expenditure. At the same time, reducing operating expenditure is still a challenging task for the government as can be seen from the 2012 statistics which showed a 12.6% increase, compared with the six-year median growth rate of 12.2% per annum. Such significant declines in certain components of development expenditure are not likely sustainable in the long term. It may, in fact, dampen economic activity in general. The more sustainable approach would be a consistent effort to cap the increase in operating expenditure.

- The pressure on government debt will likely continue as the amount of borrowings approaches the 55.0% self-imposed debt limit. Although budget deficits are shrinking, the pressure on the debt level will persist, especially if nominal GDP fails to expand above its growth trend of 10.0% in the near term. The consolation is that a big chunk of it – more than 95.0% of total government debt – is domestic debt. Contingent liabilities as estimated by the amount of debt guaranteed by the federal government are another area of concern as they have risen significantly from RM55.7 billion at end-December 2005 to RM152.2 billion at end-September 2013. As a percentage of GDP, it stood at 15.8% at end-September 2013, compared with 10.2% at the end of 2005. However, it is worth mentioning that the sharp increase in contingent liabilities was mainly attributed to a surge in investment which involves several mega projects such as transportation network, property and infrastructure projects, most of which will contribute to higher productive capacity in the future.

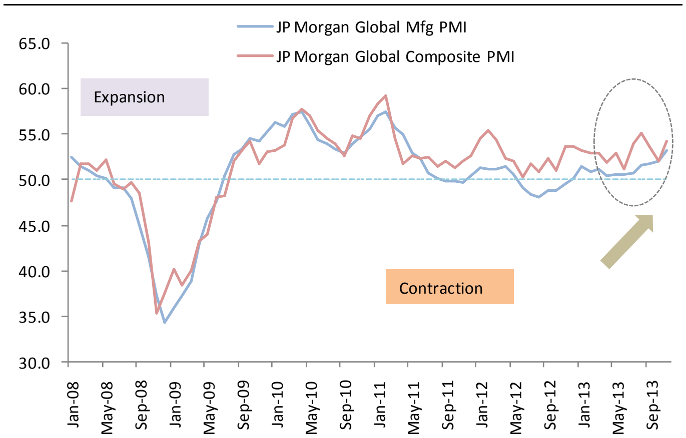
Global economy: A wrap up for 2013

- We reiterate the view published in our 2H2013 Outlook that the global economy will continue to surprise on the upside in the near term despite some hiccups associated with the moderation of the emerging economies and the negative reactions from the financial market on the US Fed tapering its bond purchases. Improvements in economic conditions in advanced economies as evidenced by a steady recovery in the labour market in the US and rising economic sentiment in Europe as well as Japan will likely continue to provide important support to global growth. This is evidenced by the recent pickup in the global Purchasing Managers' Index (PMI) which suggests an overall improvement worldwide.

- The global financial and commodity markets are also flashing positive signals, supporting the view that better prospects are on the horizon. Worldwide equity markets are still on the uptrend, despite recent moderations following some uncertainties that resurfaced in the emerging economies. The S&P 500 gained 26.6% as at end November 2013, while the Euro Stoxx 600 and United Kingdom (UK) FTSE advanced 16.3% and 12.8% respectively. In Asia, the benchmark Nikkei 225 surged 50.7% in the same period, reflecting investors' confidence in Prime Minister Abe's policies. At the same time, global bond markets continued to soften as bond yields climbed in response to better economic prospects. Based on Bloomberg calculations, the US Treasury Bond Index posted a -3.5% return in the 52 weeks ended 27 December 2013, while the UK and Germany Sovereign Bond Indices registered -4.9% and -2.2% returns respectively.

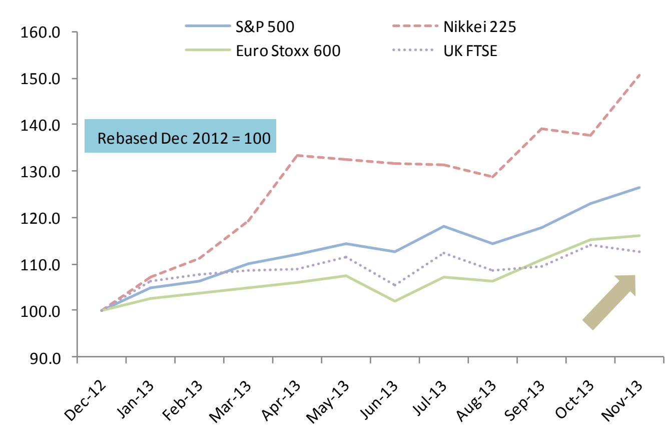
- Commodity prices are also signaling better days ahead despite some concerns over China's economy. Iron ore prices have flipped up, climbing to USD136 per dry metric tonne from a cyclical low of USD89 per dry metric tonne, suggesting a greater likelihood of a recovery in steel prices as economic activities pick up pace. China imported iron ore at a record amount in September, according to customs data. The World Bank is now forecasting an average price of USD134 per dry metric tonne this year and USD135 per dry metric tonne in 2014. At the same time, gold prices continued to languish as investors become more upbeat about the prospects of the global economy. The plan to reduce bond purchases by the US Fed announced in May exerted upward pressure on interest rates, prompting investors to sideline gold investments which resulted in gold prices falling to as low as USD1,200 per troy ounce in June 2013 from a high of nearly USD1,900 per troy ounce in September 2011.

Chart 1: JP Morgan Global Manufacturing PMI and Composite PMI



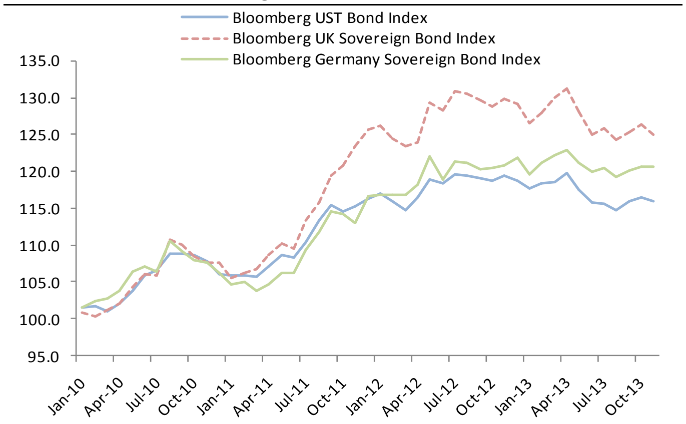
Source: Bloomberg, MARC Economic Research

Chart 2: Selected equity indices – (S&P 500, Euro Stoxx 600, UK FTSE, Nikkei 225)



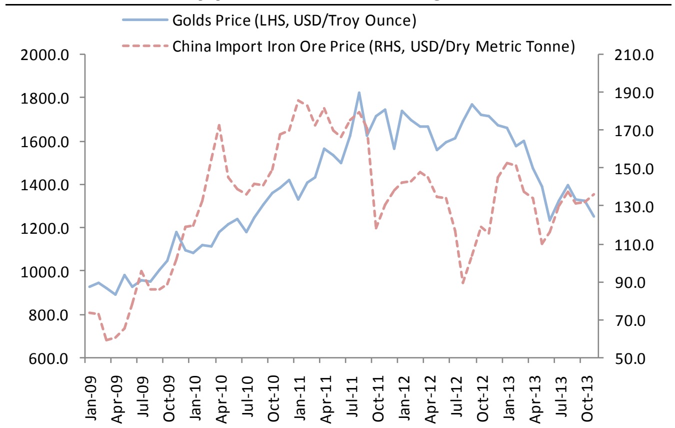
Source: Bloomberg, MARC Economic Research

Chart 3: Selected sovereign bond indices



Source: Bloomberg, MARC Economic Research

Chart 4: Commodity prices – iron ore and gold

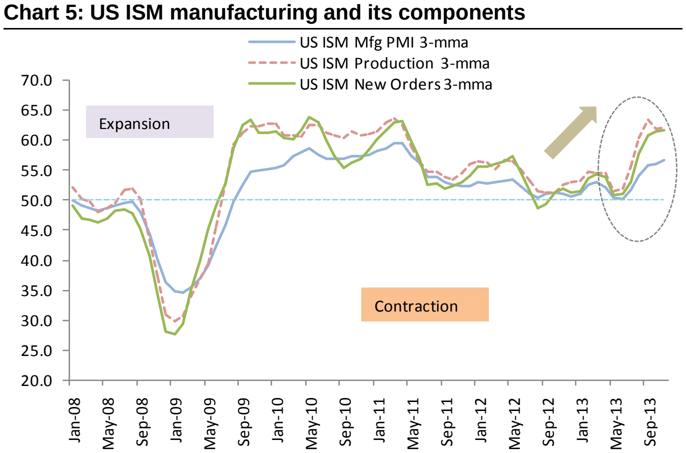


Source: Bloomberg, MARC Economic Research

- In the US, the manufacturing sector continued to surprise on the upside with the ISM manufacturing index averaging 56.2 in the five months to November, the strongest pace since 1H2011 before the global economy was tempered by the Euro crisis. The new orders index, which is a useful gauge of the future direction of manufacturing activity, has also remained above the crucial 60-point level in the past four months (since August), implying a high probability of a sustained expansion in the manufacturing sector. The last time such a reading was observed was during the first four months of 2011 when the US economy recovered strongly from the Global Recession. The positive outlook is also supported by a pickup in China's economic activity which is expected to improve further in the near term. Going forward, we are anticipating a sustained reading above the 60-point level for the new orders index which is consistent with a stable expansion of the economy around its long-term trend of 3.0%. Such a scenario will be positive for Asian export-oriented economies such as Malaysia.

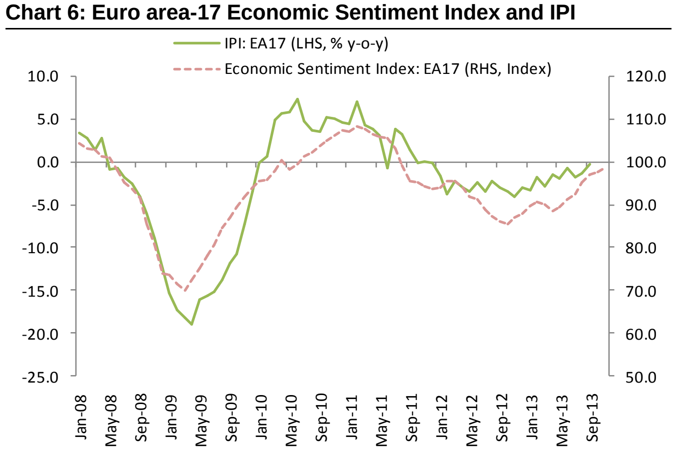
- Labour market conditions – a critical sign of a sustained expansion – have also improved significantly as evidenced by the latest jobless claims and the expansion in non-farm payrolls which benefited from the broader strengthening of the economy resulting from the rising confidence in both manufacturing and non-manufacturing sectors. The latest jobless rate of 7.0% was a surprise as it came on the back of an expansion in the size of the labour force. Although we do not expect the jobless rate to break the 6.5% threshold before 2H2014, we view the labour market to be stable enough to keep consumer spending humming above a 2.0% annualised rate in the next few quarters. The revised 3Q2013 GDP growth number was propelled by stronger consumer spending and business investment, reflecting the rising confidence among consumers and businesses which will eventually result in firmer labour market conditions and stronger hiring. This will in turn provide a potent stimulus to consumers to support the economy going forward.

Chart 5: US ISM manufacturing and its components



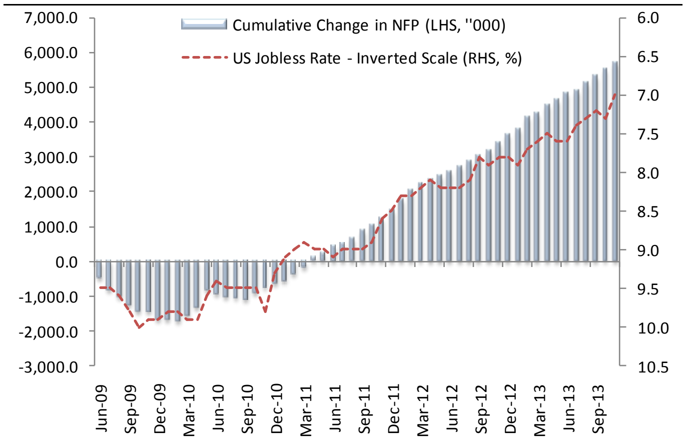
Source: ISM, MARC Economic Research

Chart 6: Euro area-17 Economic Sentiment Index and IPI



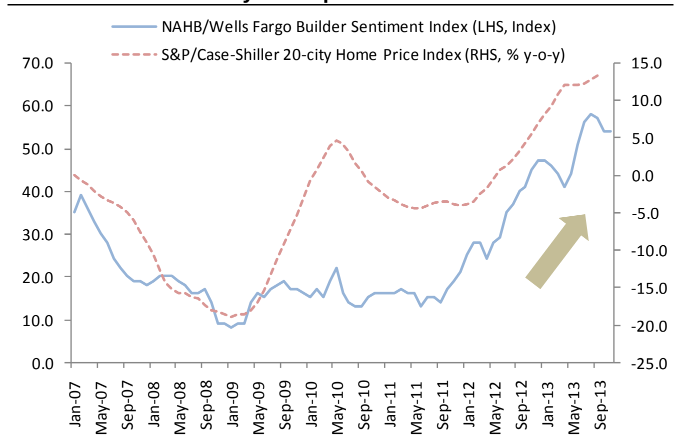
Source: CEIC, MARC Economic Research

Chart 7: US cumulative non-farm payrolls and jobless rate



Source: CEIC, MARC Economic Research

Chart 8: NAHB/Wells Fargo Builder Sentiment Index and S&P/Case-Shiller 20-city home prices

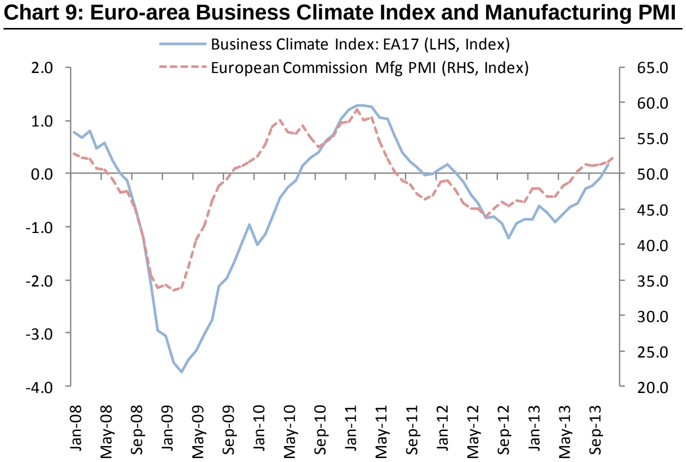


Source: Bloomberg, MARC Economic Research

- In the Eurozone, improvements can be seen from the continued uptrend in the Economic Sentiment Index, an important gauge of the region's economic activity, which climbed to 98.5 points in November, the strongest level since the region was hit by the Euro Crisis in 2011. The recent upward cycle which has persisted since May was mainly supported by improvements in major economies such as Germany, Italy, Spain and Netherlands. Industrial confidence continued to rise in November following managers' positive assessment of the current level of production as well as their future expectations, although the latter climbed by a lesser degree. Notwithstanding this, the high unemployment rate of 12.1% continued to weigh on the region's economy as evidenced by the consumer confidence indicator which remained below its long-term average.

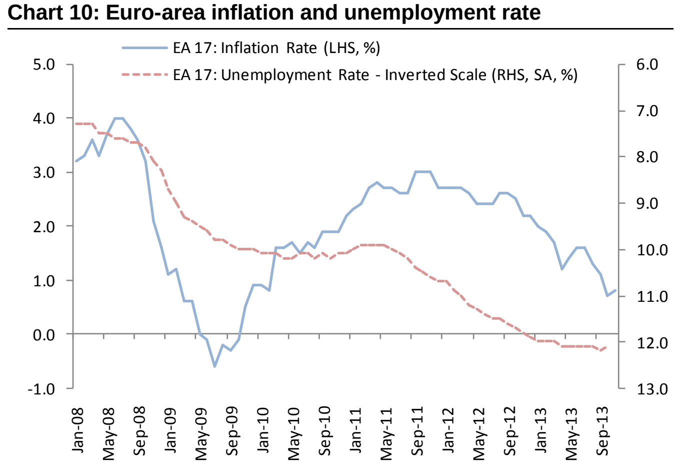
- The European Central Bank's (ECB) latest move to maintain its ultra-accommodative monetary policy at 0.25% is an indication of policymakers' concern over the sustainability of the recent pick-up in economic activity as inflation statistics suggested the possibility of a deflationary spell in the region. The annual inflation rate remained below 1.0% in November (0.8%), far from the ECB's targeted rate of circa 2.0%, although it has picked up from October's 0.7% pace. The situation in some countries like Greece remains worrying as consumer prices continued to contract by nearly 3.0%, the deepest deflation on record. Notwithstanding this, the overall picture of the Euro economy is no doubt more encouraging with a small positive GDP growth expected in 2014.

Chart 9: Euro-area Business Climate Index and Manufacturing PMI



Source: Bloomberg, CEIC, MARC Economic Research

Chart 10: Euro-area inflation and unemployment rate

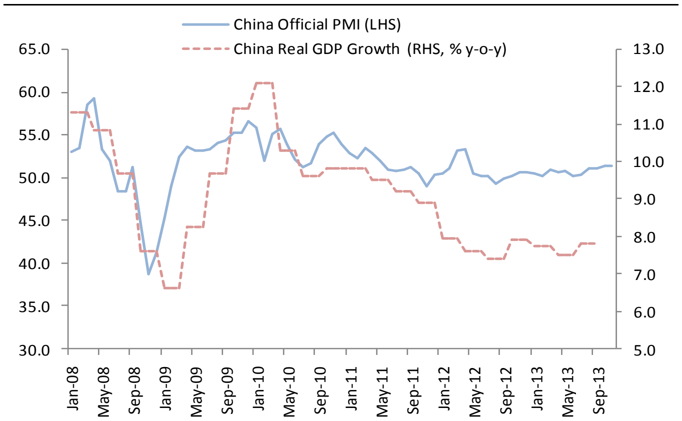


Source: CEIC, MARC Economic Research

- As for China, although we do not anticipate the economy to be able to garner its post-Great Recession trend growth rate of 9.0% in 2014, we have ruled out a hard landing scenario despite the downward pressures from the measures put in place by the government to reduce economic imbalances. The latest reading of its official PMI clearly suggests that factory activity has managed to sustain its momentum at an 18-month high as it was supported by more conducive global demand. Its new orders index has also remained at its 50-point boom-or-bust threshold in November. Notwithstanding this, we are cautious about the brisk credit growth and strong record house prices which climbed by the most since January 2011 in November, making it likely for policymakers to continue planning for tighter monetary policy in the near future. Such measures, however, will not likely derail the growth from its target. As such, we anticipate the stronger global trade momentum to result in GDP growth in the range of 7.0% to 7.5%.

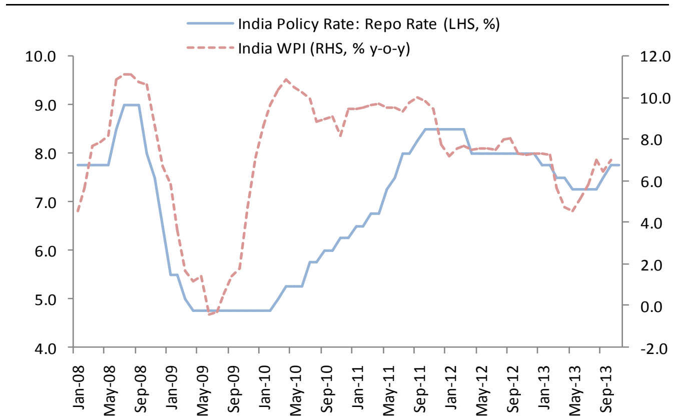
- Unfortunately we do not feel as bullish about India in the immediate term as the economy is faced with a difficult juggling act to manage the twin deficit and at the same time support the headline growth. Higher costs of imports following elevated oil prices and the cutback in subsidies exerted upward pressure on the current account deficit and inflation, and as the Reserve Bank of India (RBI) continues its efforts to raise credibility in fighting inflation, interest rates will likely be on the uptrend in 2014. The latest statistics on inflation suggest that future readings will remain in the range of 6.0% to 7.0%, which the RBI still finds rather uncomfortable. With interest rates likely to be increased by another 25 bps to 50 bps in 2014 in order to fight inflation and to stop the rupee exchange rate from deteriorating, India's headline GDP growth will be stuck around 5.0% within the time frame.

Chart 11: China's Official Manufacturing PMI and GDP growth



Source: Bloomberg, CEIC, MARC Economic Research

Chart 12: India's repo and inflation rate



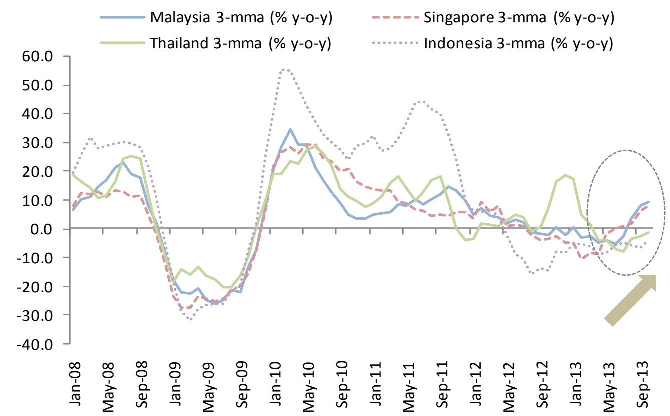
Source: CEIC, MARC Economic Research

- As for the East Asian economies, the strengthening of global trade in 2014 will be a major plus point which will help them buy some time to continue addressing critical macro imbalances in their countries. Singapore, for instance, will continue to fight asset price inflation which has led to a property bubble in recent times as reflected by property prices which gained 45.9% since 2009. Recent strong measures undertaken by the government include a cap on debt at 60.0% of income of borrowers, higher stamp duties on home purchases and an increase in real-estate taxes have somewhat done the trick, causing prices to cool off dramatically by 3Q2013 when they grew at the slowest pace in the last six quarters. Inflation has also moderated to 2.4% in the past few months, compared with nearly 5.0% one year ago.

- For Indonesia, the recent moderation in GDP growth to an average of 5.8% from over 6.0% traditionally will likely continue in the near term. This, however, does not mean that the growth trajectory will continue on its downward trend. We believe that the efforts by the government to take the country out from the twin deficit scenario will only moderate its headline GDP growth temporarily. Fighting inflation is never easy but once the central bank's credibility improves, inflation expectations will be properly anchored. And once the economy starts to move away from the twin deficit condition, confidence will return, pulling in investments and bolstering consumer confidence and private consumption.

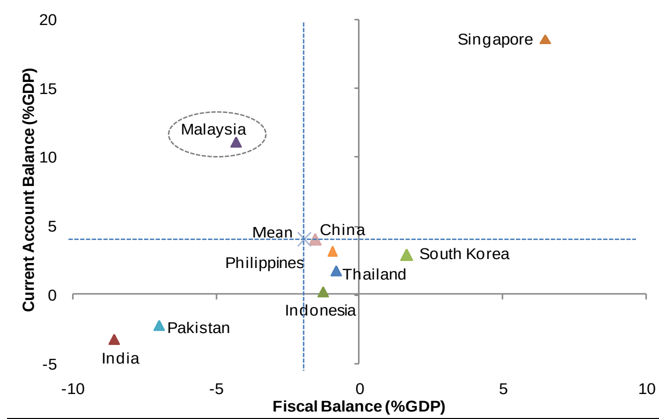
- As for Malaysia, stronger trade performance stemming from firmer global demand for electronic and commodity products and a pick-up in major commodity prices will augur well for the economy despite moderating domestic demand in 2014. We acknowledge the pressures from rising consumer prices and measures to reduce the government and household debt which will somewhat temper the growth momentum in the domestic economy. However, we believe that a recovery in the external sector, especially in palm oil prices, resilient investment momentum and a stable labour market will support headline growth in 2014. Macro imbalances such as budget deficits and the narrowing of current account surplus will slowly improve as the government continues its efforts to strengthen the economic foundation.

Chart 13: Exports growth of selected Asian countries



Source: CEIC, MARC Economic Research

Chart 14: Fiscal balance and current account matrix of selected Asian countries (5-yr median)



Source: IMF WEO, MARC Economic Research

Malaysian economy: A wrap up for 2013

- The Malaysian economy performed slightly below our expectations in 2013 as abysmal trade performance continued to drag headline growth (our June forecast for 2013: 5.0%). In the first three quarters of 2013, GDP growth averaged 4.5%, making it unlikely to register an overall expansion of more than 5.0% (our latest forecast for 2013: 4.7%). Net exports subtracted 2.3 percentage points from headline growth in the first nine months of the year. Commodity exports, particularly palm oil, were hit by lower prices due to rising inventories and weak global demand. Palm oil prices averaged RM2,315 per tonne in the first three quarters of 2013, down from RM2,834 per tonne in the whole of 2012, and its exports (crude and processed) fell by 15.6% compared to the corresponding period last year. Exports of E&E were also hit, although not as severely, slipping by 1.0% within the same period with exports of telecommunication equipment, parts and accessories contracting by 7.6% in the first nine months.

- Notwithstanding this, the domestic economy continued to be resilient, with private consumption and private investment supporting headline growth. Surprisingly, private consumption remained sturdy, expanding by a robust 8.2% in 3Q2013 despite stricter lending standards following measures implemented by BNM to cap the rising household debt which reached circa 83.0% during the period. It remained a major driver for the economy, contributing 4.3 percentage points to the overall growth. Similarly, private investment momentum was also sustained at a respectable level, evidenced by the 12.9% expansion in the first three quarters of 2013. Although domestic investment approvals in the manufacturing sector slipped to RM14.2 billion in the first nine months in 2013 from RM15.8 billion in the corresponding period last year, foreign approvals actually increased to RM20.9 billion from RM16.1 billion during the period. Net inflows of FDI were surprisingly strong, amounting to RM27.6 billion, considering the relatively weak global economic environment.

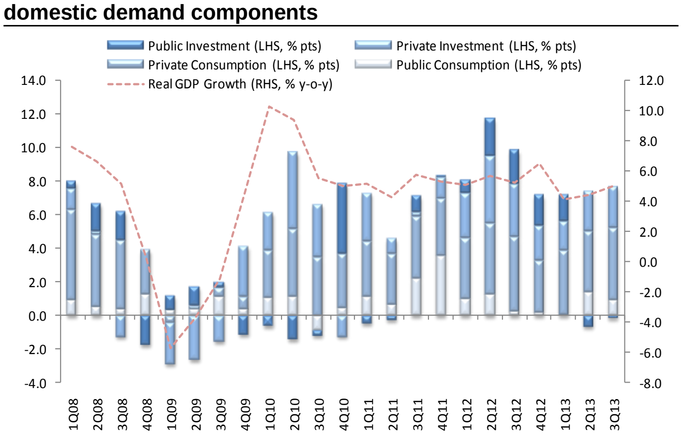
- Inflationary pressure, which remained muted in 2012, started to pick up to an average of 1.6% in 1H2013 and climbed further to 2.9% by November. CPI growth was higher since the beginning of 2H2013, averaging 2.4% in the five months ended November 2013, driven by higher transport costs resulting from a hike in fuel prices in September and stronger increases in prices of food and beverages. Excluding food, CPI climbed by 1.9% in September, higher than the average of 0.9% in 1H2013. The GDP deflator also started to contract at a slower pace in 3Q2013, registering a smaller negative growth of -0.3% compared to -2.5% in 2Q2013. Portraying a similar trend, the private consumption deflator rose by a stronger pace of 2.0% in 3Q2013 from an average of 1.7% in 1H2013.

- Interest rates were stable throughout 3Q2013 with the BNM policy rate remaining unchanged at 3.0%. With inflation remaining muted and the economy under downward pressure from languishing external demand, the monetary policy was mainly tuned to sustain the growth momentum. Even capital outflows, which accelerated in 3Q2013 and caused the net balance of portfolio investments to turn into negative RM9.7 billion, failed to induce the BNM to nudge up its policy rate, although some regional economies such as India and Indonesia responded by pushing up their policy rates to curb the outflows of capital. Following the outflows, the ringgit weakened, depreciating as much as 8.3% against the greenback to RM3.33 per USD in August before strengthening again as fears of the tapering of bond purchases subsided.

- Concerns over an interest hike are also compounded by the fact that Malaysia's household debt was sustained above 80.0% of GDP in 3Q2013, a level which normally sparks investor jitters. While some measures by the BNM managed to cool off certain loan segments, loan segments such as mortgages and hire purchases remained unperturbed. In the banking system, although the ratio of gross impaired loans continued to decline to an all-time low of 2.0% in October 2013, worries over the increase in the absolute amount of sour loans is becoming more widespread. In fact, on a year-on-year basis, the amount of gross impaired loans registered positive growth for four consecutive months since July 2013, the longest stretch since the end of 2010 when the economy recovered from the recession.

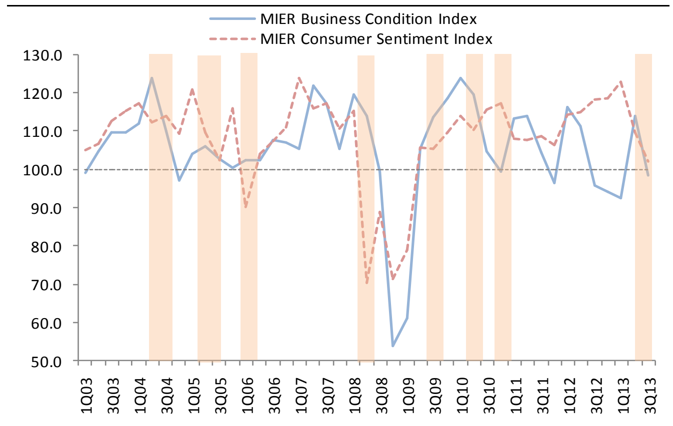
- Lingering budget deficits and concerns about the government's commitment to strengthening its fiscal health led to a downgrade in Malaysia's sovereign rating outlook to 'negative' from 'stable' in July by Fitch Ratings. The budget deficit which stood at RM24.8 billion in the first three quarters was not overly alarming. The concern was more on the subsidy rationalisation plan which hit a speed bump following the election in May 2013. Subsequently, after the downgrade in the rating outlook by Fitch Ratings, subsidy rationalisation efforts resumed with prices of RON95 and diesel raised by 20 sen per litre in September, followed by a complete removal of the sugar subsidy in October. Despite declining deficits, government debt continued to climb, approaching the self-imposed limit of 55.0% of GDP.

Chart 15: Real GDP growth and contribution to growth by domestic demand components



Source: CEIC, MARC Economic Research

Chart 16: MIER CSI and BCI during fuel hike periods



Source: CEIC, MARC Economic Research
Note: Shaded areas are fuel hike periods

Outlook for 2014

Growth – stable but pressure on consumers

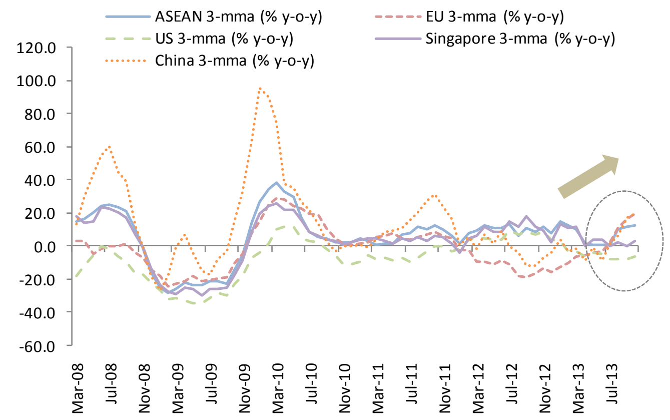
- We are of the view that Malaysia's headline GDP growth will be respectable at 5.0%, although it will likely be at the lower range of the government's forecast in 2014 due to numerous challenges ranging from softer consumer spending in the wake of rising prices partly attributed to the rationalisation of subsidies as well as stricter lending measures by financial institutions due to the increasing level of impaired loans and the measures imposed by the BNM to cap the household debt from rising further. We also think that a meaningful recovery of global trade is the key to Malaysia's ability to maintain a decent 5.0% growth in 2014. Of importance is the stabilisation of palm oil prices, a sector that provides an important boost to rural incomes, an important pillar for private consumption. Palm oil prices have been trading at deep discounts to soybean prices and will likely stabilise with an upside bias in 2014, although a sharp increase is not foreseen at this juncture. Based on fundamentals, it is conceivable that palm oil prices will re-test the RM2,600 per tonne level and will likely register a positive growth, especially if the global economy picks up.

- The outlook is more promising for the E&E sector, another important export product for Malaysia. The US book-to-bill ratio continued to gain strength, surpassing the unitary level again in October after dropping to 0.97 in September. Global chip sales are anticipated to perform better than in 2013 following a recovery in the US, Japan and euro economies. In Malaysia, exports of E&E registered positive growth rates in the four months to October, the first time such a performance was recorded since mid-2010. Given this, Malaysian exports of E&E products are anticipated to post a stronger growth in 2014 after posting an estimated 1.0% expansion in 2013. Another positive indicator is the uptrend in the US ISM new orders which we foresee to be in the range of 55.0% to 60.0% in the next one year, suggesting that Malaysian export performance will be stronger than initially anticipated. As such, we are of the view that real exports will expand by 4.0% in 2014, stronger than the MoF's projection of a 1.6% growth.

- Domestic demand is also crucial to achieving the 5.0% headline GDP growth in 2014. In particular, the positive contribution from private investments may prove to be the saviour for the economy in 2014 as the pace of private consumption may moderate due to the knock-on effects from rising consumer prices. With a more meaningful recovery expected to take place in 2014, the momentum in investments will likely be sustained at a relatively strong level. In fact, what really surprises us is the fact that FDI inflows have remained respectable in 2013 despite the shaky global economic environment. This has offset the weakness in the domestic investment, particularly in the manufacturing sector in the first nine months of 2013. The resilient momentum in investment can also be seen from the ETP statistics which showed private investment led total investments by 65.0% during the same period. Based on this development and the anticipation of a strengthening of the global economy, we foresee private investment to continue registering a decent growth of circa 11.0%. We are also of the view that Malaysia will not face a major hurdle in attracting net FDI inflows of between RM30 billion – RM35 billionin 2014.

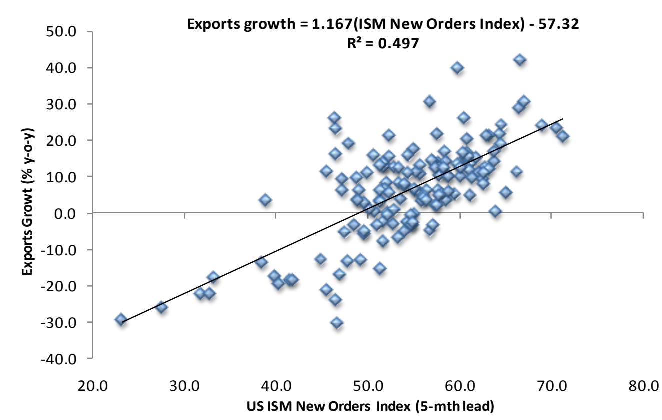
- Lending by banking and non-bank institutions to certain segments (purchase of residential property and passenger cars) remains resilient despite the softening of overall loan growth to circa 9.0% in 2013. Such a scenario augurs well for consumer spending. However, on the flip side, recent developments in the domestic economy are exerting downward pressure on consumer sentiment. In particular, we anticipate the combined knock-on effects from higher consumer prices resulting from higher electricity tariff, fuel, transport costs and possibly toll charges as well as stricter lending guidelines by financial institutions will start to crimp consumer spending despite stable labour market conditions. Past experiences suggest that the pace of consumer spending tends to moderate during the years when the CPI climbs significantly.

Chart 17: Malaysia's exports to major markets growth



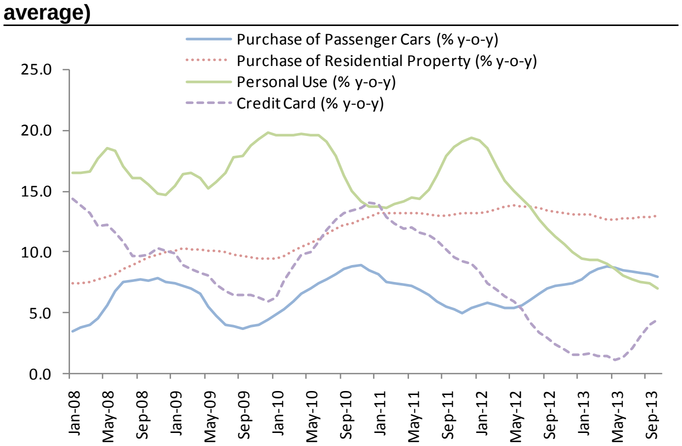
Source: CEIC, MARC Economic Research

Chart 18: US ISM New Orders 5-mth lead and Malaysia's exports growth (scatter)



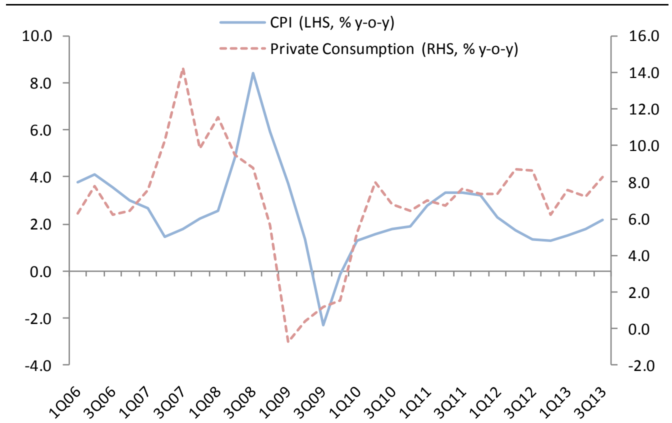
Source: ISM, CEIC, MARC Economic Research

Chart 19: Lending growth by different purposes (3-month moving average)



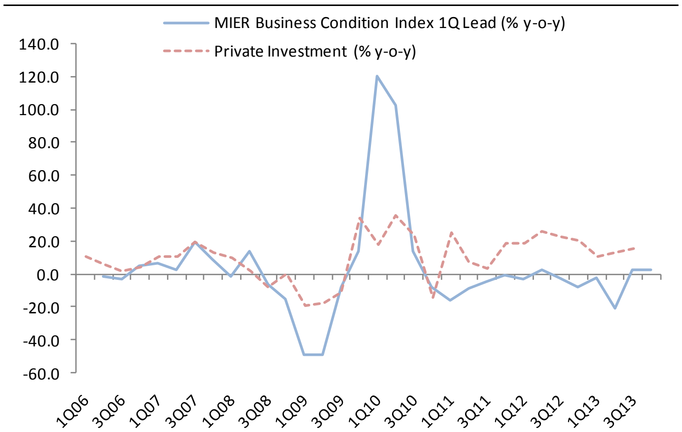
Source: CEIC, MARC Economic Research

Chart 20: Private consumption and headline CPI



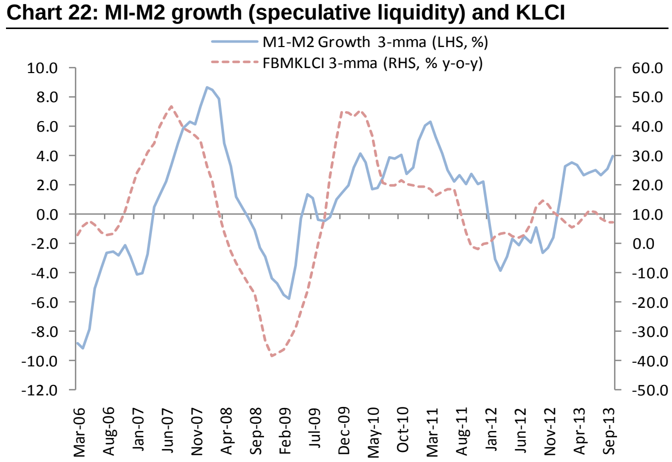
Source: CEIC, MARC Economic Research

Chart 21: Private investment and MIER BCI



Source: CEIC, MARC Economic Research

Chart 22: MI-M2 growth (speculative liquidity) and KLCI



Source: CEIC, MARC Economic Research

Table 1: Real GDP growth on the demand side

Growth (% y-o-y)	2010	2011	2012	MARC		MoF	
				2013F	2014F	2013F	2014F
GDP	7.4	5.1	5.6	4.7	5.0	4.5 - 5.0	5.0 - 5.5
Domestic Demand	7.7	7.9	10.6	7.7	6.4	8.7	5.9
Private Consumption	6.9	6.8	7.7	7.1	6.2	7.4	6.2
Public Consumption	3.4	15.8	5.1	5.6	4.1	7.3	3.3
Private Investment	18.4	10.5	21.9	11.5	11.0	16.2	12.7
Public Investment	4.9	1.0	17.1	7.5	3.7	5.5	-2.7
Real Exports	11.1	4.6	-0.1	-0.2	4.0	1.2	1.6
Real Imports	15.6	6.1	4.7	1.6	5.6	4.4	2.2

Source: CEIC, MoF, MARC Economic Research.

Watch for the two I's: Inflation and interest rates

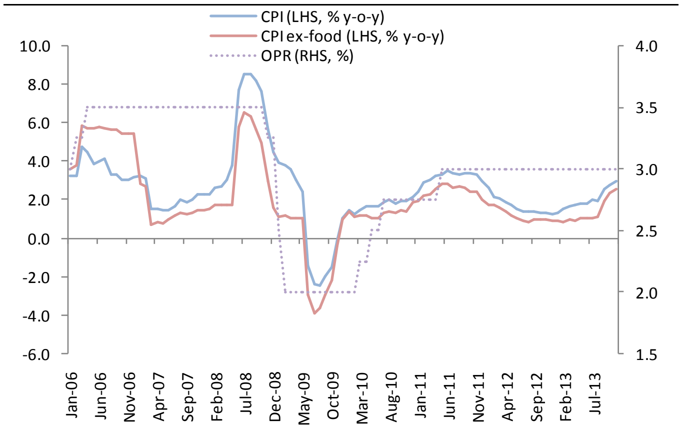
- Inflation has not been an exciting variable to track in the past couple of years in Malaysia. This may not be the case in 2014. All eyes are now glued on monthly consumer prices which are expected to ascend in the next one year. We believe that the CPI will spike up by more than one-percentage point from its level in 2013 due to several developments which have taken place or are likely to happen in the near term. These include, amongst others: (1) tariff hike for electricity starting January 2014; (2) further reduction in fuel subsidy expected in 2H2014; (3) pre-GST price hikes due to rising demand and increasing speculations; and (4) possible hike in toll charges. While only the electricity tariff hike and the removal of sugar subsidy have been announced so far, we see a high probability that the latter three events will happen based on recent developments and the tone set in Budget 2014 as well as the rhetoric among officials.

- We do not believe that subsidies on consumer products will be further rationalised next year after the abolishment of the sugar subsidy announced during Budget 2014. This is due to the sensitive nature of such measures as many have already voiced their concerns over the high cost of homes and consumer goods in rural and urban centers. Because of this, the only way the government can continue implementing measures to relieve its burden on operating expenditures is by adjusting prices of fuel more frequently. Such a measure augurs well for the man on the street as the fuel subsidy benefits higher income groups more than the rest of the population. As such, we are of the view that the price for RON 95 will continue to rise in 2H2014. The knock-on effects from the impending electricity tariff hike should not be underestimated. While the direct impact on consumers will be lower as only 30% of them will be affected by the new rates, the indirect impact through higher business costs (which in turn will be passed on to consumers) will exert an upward pressure on the headline CPI. Higher toll charges, if it becomes a reality, are also likely to be passed on to consumers through higher transport costs. Based on this scenario, we are raising our inflation forecast to 3.5% for 2014.

- Although price developments possibly call for a monetary response, making an interest rate call may still prove to be tricky in 2014. On one hand, a slower momentum of domestic demand indicates that the policy rate may stay put at the current level of 3.0%. On the other hand, an uptrend in consumer prices, especially if core prices start to accelerate, an elevated level of CAPU in the manufacturing sector and a possibility of substantial capital outflows due to the Fed's trimming of bond purchases may justify a rate hike in the next one year.

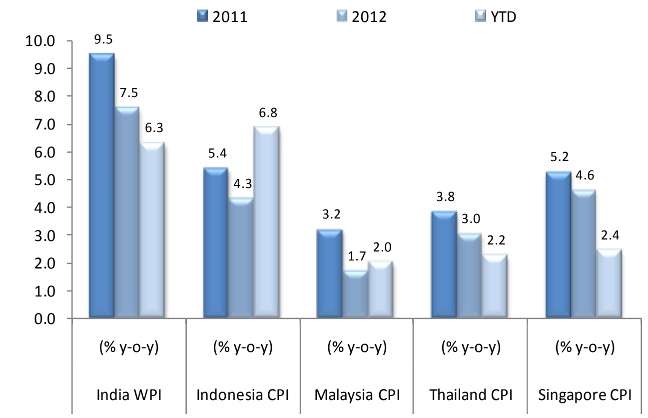
- The key is the trend in core CPI (excluding food) which we think is a critical factor in determining the official rate. Based on a slew of increases in food, petrol, electricity and other goods and services, we think that there is a high possibility of a rate hike by 25 bps in 2014 as the BNM positions itself to be ahead of the curve to avert an excessive price increase following some of measures to be undertaken by the government to reduce the burden on its coffers.

Chart 23: OPR, headline CPI and CPI ex-food



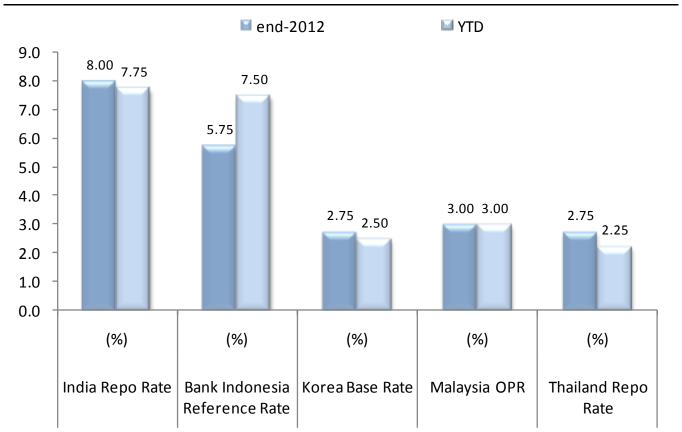
Source: CEIC, MARC Economic Research

Chart 24: Inflation rates – selected Asian countries



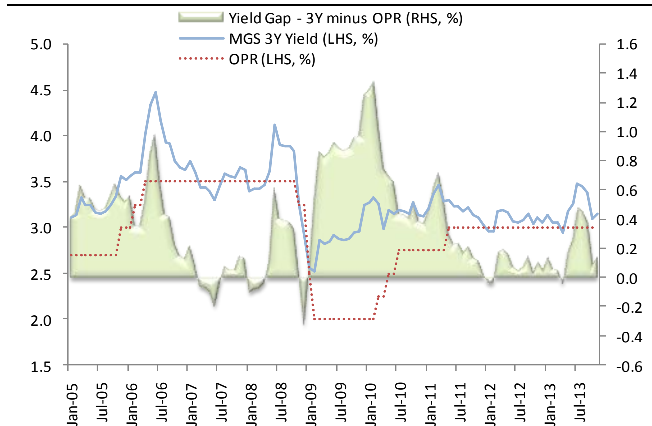
Source: CEIC, MARC Economic Research

Chart 25: Policy rates in selected Asian countries – End 2012 and Year-to-date



Source: CEIC, MARC Economic Research

Chart 26: OPR, 3Y MGS yield and yield gap



Source: CEIC, MARC Economic Research

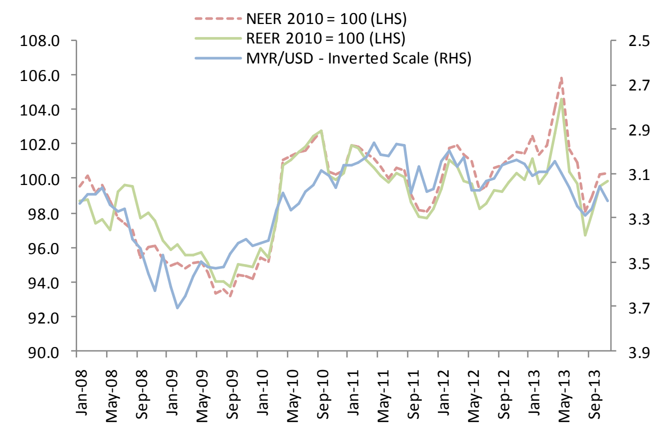
Capital flows and ringgit

- Recent developments in the US are undoubtedly negative for Asian currencies, including the ringgit, although this time around, we do not expect a major setback for the local currency as in 2009. With the US Fed about to initiate its first step to trim its monthly bond purchases to USD75 billion from USD85 billion, the financial market is set to react further in the near term. On the whole, we concur with the view that such an action by the Fed does not imply a tightening of monetary policy in the near term. Notwithstanding this, we foresee that the focus will now shift to the speed of the cutbacks in bond purchases by the Fed as this would indicate the timeframe that the central bank is looking at in terms of changing the course of the policy rate.

- While a tighter monetary policy is not on the horizon in the US at this juncture, the beginning of the tapering is seen as an important turning point about the way the Fed assesses the strength of the US economy. The strengthening of non-farm payroll numbers which have averaged 188.5K per month up to November 2013 suggests that the headline growth will be strong enough for bond investors to continue pushing bond yields higher in the near term. This is evidenced from the yields of many sovereign bonds worldwide which have generally risen since mid-2013. The currency market also reacted. In particular, Asian currencies took a hit, although in some cases (i.e. India and Indonesia), the depreciation was largely attributed to their twin deficit phenomenon. In the case of the ringgit, the depreciation was primarily attributed to capital outflows which resulted from a drop in foreign holdings of MGS to as low as 42.7% of total outstanding in the market and the continued flow of direct investment overseas (reverse investment).

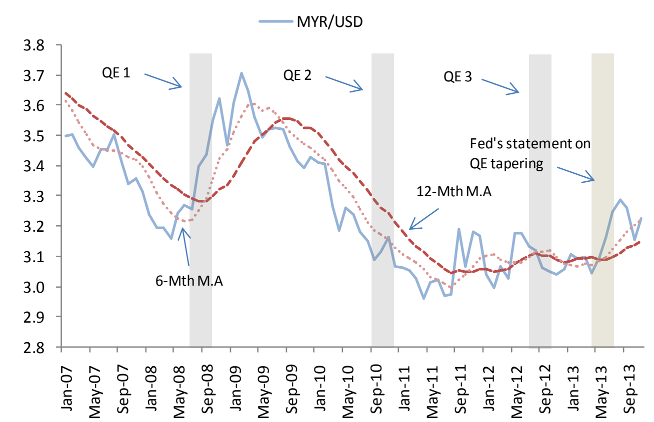
- Going forward, we do not discount a further weakening of the ringgit as asset managers continue to re-focus on diverting their investments into dollar-denominated assets following expectations of a stronger greenback on the back of a sustained recovery of the US economy. We are of the view that the ringgit may not have a strong upside in the next one year – at least not until a clearer picture of the US Fed policy action emerges. Other factors that may exert a downward pressure on the ringgit include: (1) weakening domestic growth momentum; (2) concerns over high household debt; and (3) concerns over the shrinking current account surplus. On the flip side, however, we feel that the changing profile of foreign investors of Malaysian financial assets (which include central banks' holding of MGS) and measures undertaken by the BNM through currency swap arrangements with several Asian countries will somewhat mitigate the volatility of the ringgit going forward. On the whole, we see the ringgit will average circa RM3.20 to RM3.30 in 2014, compared with an estimated average of RM3.17 per USD in 2013.

Chart 27: REER, NEER and MYR/USD



Source: Bloomberg, CEIC, MARC Economic Research

Chart 28: MYR/USD 6-mma and 12-mma



Source: Bloomberg, MARC Economic Research

Government financial and debt positions

- On the issue of the government's budgetary position in 2014, we are less pessimistic unless economic growth momentum weakens excessively (which may not be the case). We note that the government will likely achieve the targeted deficit of 4.0% of GDP in 2013. This is premised on the favourable performance in the first three quarters of the year where the deficits amounted to only RM24.8 billion (1Q-3Q2012: -RM20.9 billion), compared with the overall projection of RM40 billion deficit for 2013. Although revenue in the first three quarters has moderated immensely, growing by only 1.0% from the corresponding period in 2012, development expenditure was also scaled back by 11.1%, making the overall deficit target achievable. Operating expenditure also grew at a slower pace of 6.0% compared with an average growth of 16.5% in 2011-2012.

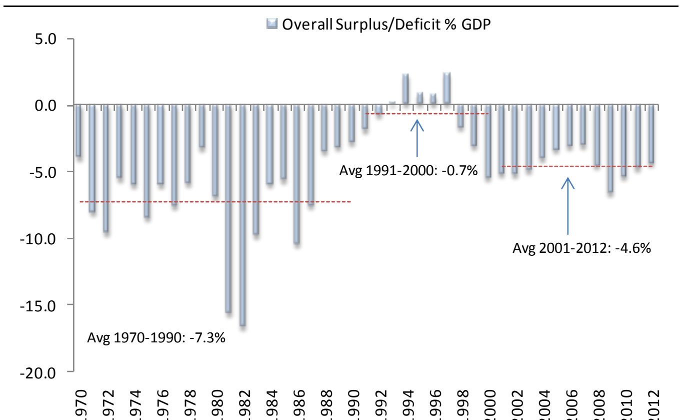
- Looking at the bigger picture, we note that the concern over the deficit is largely associated with rising operating expenditure which climbed at a compound annual growth rate (CAGR) of 11.8% per annum between 2003 and 2012, outpacing revenue which grew at a CAGR of 9.4% per annum. The bulk of operating expenditure consists of emoluments, which is unlikely to decline, while subsidies accounted for 21.4% of operating expenditure in 2012, a large increase from merely RM2.7 billion in 2003. In terms of growth, subsidies grew at a robust pace of 36.5% per annum on a CAGR basis. Development expenditure, on the other hand, expanded by only 1.6% per annum on a CAGR basis within the same period and had declined for two consecutive years since hitting its peak of RM51.3 billion in 2010. Total expenditure increased at a CAGR of 9.2% per annum between 2003 and 2012, and stood at 26.5% of GDP in 2012.

- Going forward, the government is likely able to achieve the targeted deficit level of 3.5% of GDP in 2014 on account of (1) higher-than-expected revenue growth of circa 7.0% as real economic growth is sustained at the 5.0% level amidst a favourable external environment; (2) further cutbacks in development expenditure to offset the increase in operating expenditure; and (3) a slower expansion of operating expenditure in the wake of further subsidy rationalisation efforts by the government. Notwithstanding this, we are of the view that the reduction in the headline deficit figures will have to be seen from a broader perspective. In particular, much of the reduction in recent times was due to the drop in development expenditure. Breaking it down, it can be seen that development expenditure on economic services grew by merely 2.8% in 2012 while expenditure for social services contracted by 1.6%, a far cry from their six-year median growth rates of 11.7% and 23.1% per annum respectively. At the same time, reducing operating expenditure is still a challenging task for the government as can be seen from the 2012 statistics which showed a 12.6% increase, compared with the six-year median growth rate of 12.2% per annum. The significant declines in certain components of development expenditure are not likely sustainable in the long term. It may, in fact, dampen economic activity in general. The more sustainable approach would be a consistent effort to cap the increase in operating expenditure.

- The pressure on government debt will continue as the amount of borrowing approaches the 55.0% self-imposed debt limit. Although budget deficits are shrinking, the pressure on the debt level will persist, especially if nominal GDP fails to expand above its trend growth of 10.0% in the near term. The consolation is that a big chunk of it – more than 95.0% of total government debt – is domestic debt. However, Malaysia's domestic debt climbed at a robust CAGR of 13.8% per annum between 2003 and 2012. It has grown at a double-digit pace every year since 2007, although the pace has moderated from 21.8% per annum in 2009 to 10.7% per annum in 2012.

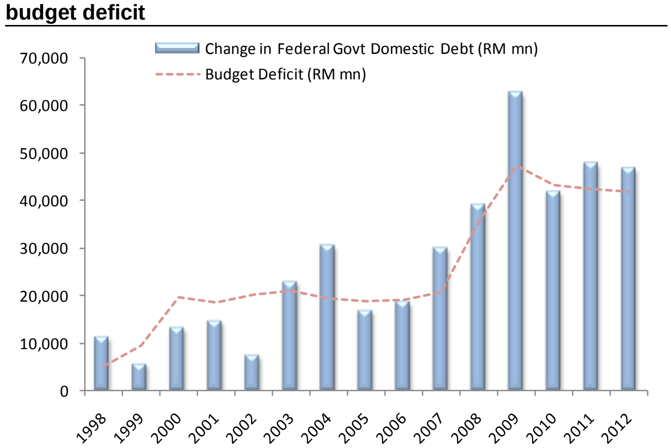
- Contingent liabilities as estimated by the amount of debt guaranteed by the federal governmentare another area of concern. They have risen significantly from RM55.7 billion at end-December 2005 to RM152.2 billion at end-September 2013 (3.3% per quarter on a CAGR basis). Prior to that, contingent liabilities only grew at a CAGR of 0.5% per quarter from 2000 and 2005. As a percentage of GDP, it stood at 15.8% at end-September 2013, compared with 10.2% at the end of 2005. The sharp increase in contingent liabilities was mainly attributed to a surge in investment which involves several mega projects such as transportation network (through Prasarana Negara Bhd and Dana Infra Nasional Bhd), property and infrastructure projects.

Chart 29: Budget deficit as % of GDP 1970-2012



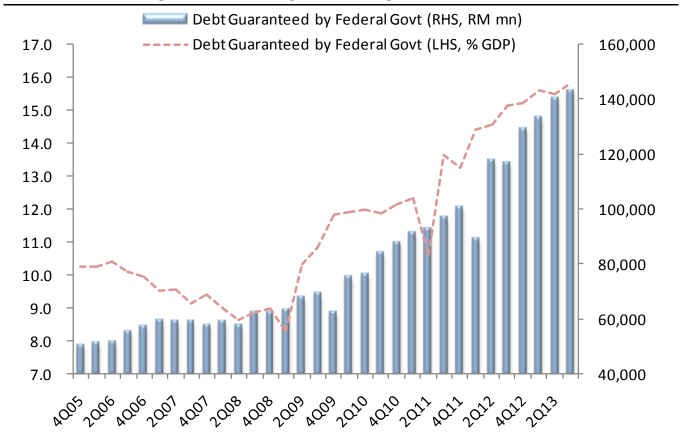
Source: CEIC, MARC Economic Research

Chart 30: Change in federal government domestic debt and budget deficit



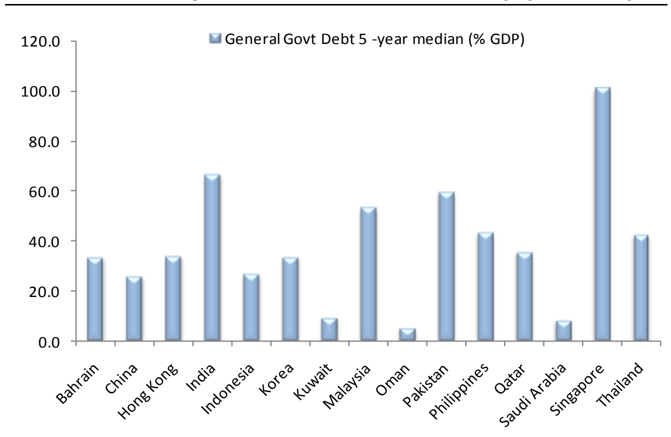
Source: CEIC, MARC Economic Research

Chart 31: Debt guaranteed by federal government



Source: CEIC, MARC Economic Research

Chart 32: General government debt as % of GDP (5-yr median)



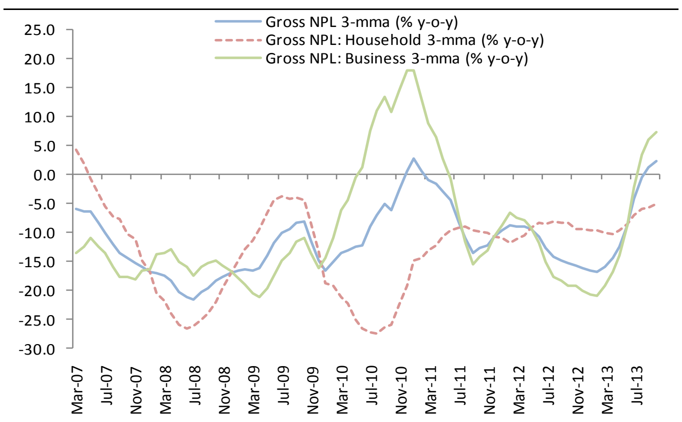
Source: IMF WEO, MARC Economic Research

Household debt

- Overall, while Malaysia's banking system remains sturdy with asset quality continuing to improve as observed in the gradual easing of the gross impaired loans ratio, the concerns over the high level of household debt will continue to influence monetary policy measures by the BNM. Although the ratio of gross impaired loans has declined to an all-time low of 2.0% as at end-October 2013 (end-December 2012: 2.0%; end-December 2011: 2.7%), the absolute amount of these loans has increased in the past few months as evidenced in the positive growth in four consecutive months to October, the longest stretch since 2010 when the economy was impacted by the Global Recession. On the positive side, however, we concur with the view that the elevated level of Malaysia's household debt is somewhat mitigated by even larger holdings of financial assets. In other words, in the event of an economic downturn, such assets can be utilised to cover the debt of an individual.

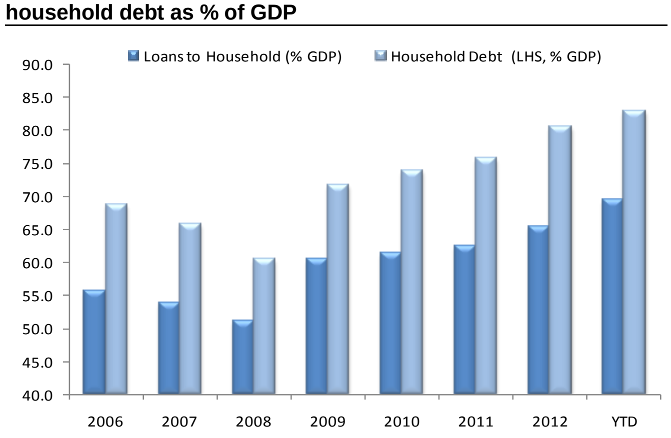
- Notwithstanding this, there are two factors worth mentioning: (1) the possibility of an interest hike which makes it more likely for impaired loans to continue rising; (2) the relatively skewed income distribution where approximately 40.0% of households earned less than RM3,000 per month, which means the financial burden is still overwhelmingly high on the low-income group. Both are negative factors which could further lead to a spike in the amount of impaired loans and result in a higher burden on lower-income households. On the whole, we view that a notable increase in the amount of bad debt and write-offs for this group will lead to stricter credit standards that will further moderate growth in lending for low-income groups. In addition, we see this as a likely negative effect on private consumption as this group of households normally has a higher propensity to consume than higher-income groups.

Chart 33: Gross NPL growth 3-mma



Source: CEIC, MARC Economic Research

Chart 34: Loans to household sector (banking system) and total household debt as % of GDP



Source: CEIC, MARC Economic Research

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