Malaysia 2H18 + 2018 Economic Updates & Outlook

Sailing through headwinds and charting new direction

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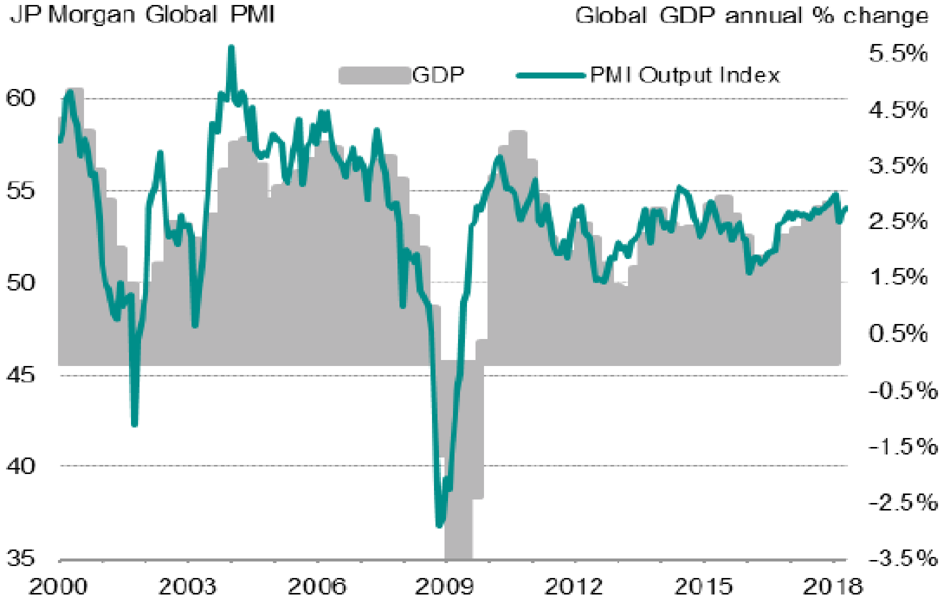
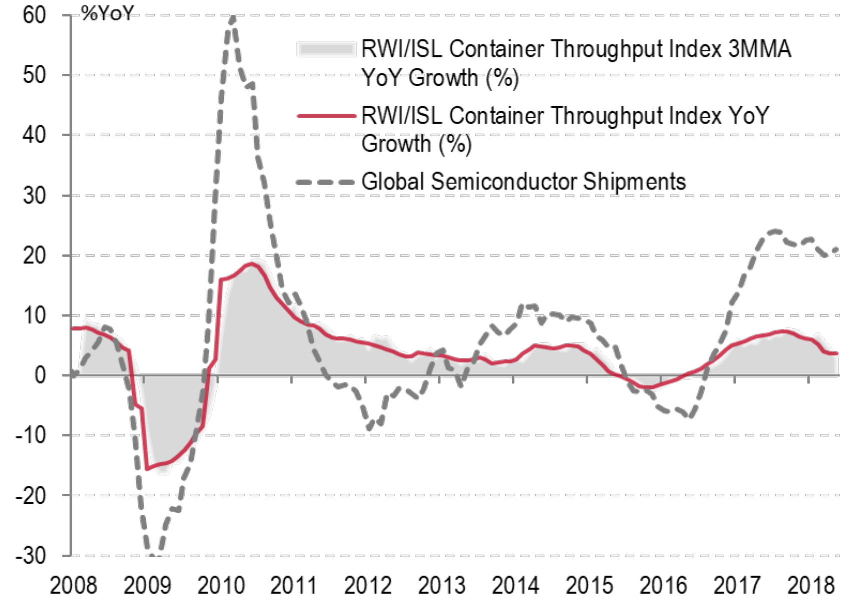
Global Growth: A Gradual & Sustained Slowdown on Risk Build Up

Last hurrah for PMI as Global GDP Peaks



Source: IHS Markit

Global Trade Trend On A Slowing Pace



Source: Semiconductor Industry Association, Institute of Shipping Economics & Logistics

- The broad-based nature of the weakening of the global economy suggests growth has peaked but the concern is that it will now taper off sooner than expected.
- The favourable global backdrop should ensure that upcoming downturn is bearable.
- Though advance economies likely to remain above trend, it is expected to slow sharply going into 2H18.
- Recent events suggest the slowdown might prove problematic for the most vulnerable emerging markets.
- Slowing global tech demand and rising trade tensions to underpin impending growth slowdown in 2018

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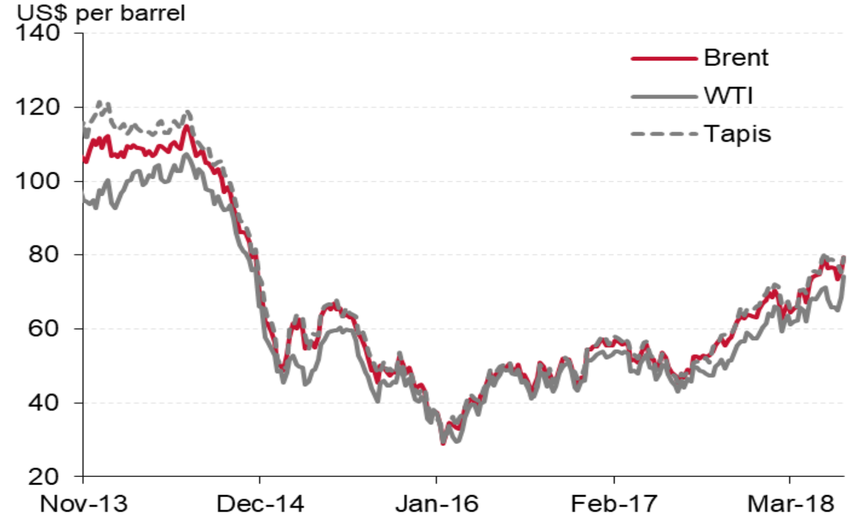
Risk to Global Growth Continue to Rise – Trade Tensions Lead

Synchronous Global Growth Trend Reverses

Source: IHS Markit

Oil Prices on the Rise



Source: Bloomberg

Risk To Global Growth

- Peak global growth – cyclical slowdown is imminent (US is the "last man" standing)
- Trade protectionism – hurting open economies and a negative repercussions to the global value chain
- Tighter financial conditions – Rising US rates and global QE unwinding pose challenging capital flow backdrop
- Global tech cycle slows – taking a breather after solid, structural uptrend since 2016 (4^{th} Industrial Revolution)
- China's rebalancing act – tighter policy weighing on growth
- Rising oil prices – unfavourable to oil importers and raises risk to terms of trade shock
- Geopolitical tensions – in the Middle East (Saudi/Iran/Syria/Yemen), North Asia (North Korea), Russia, etc.

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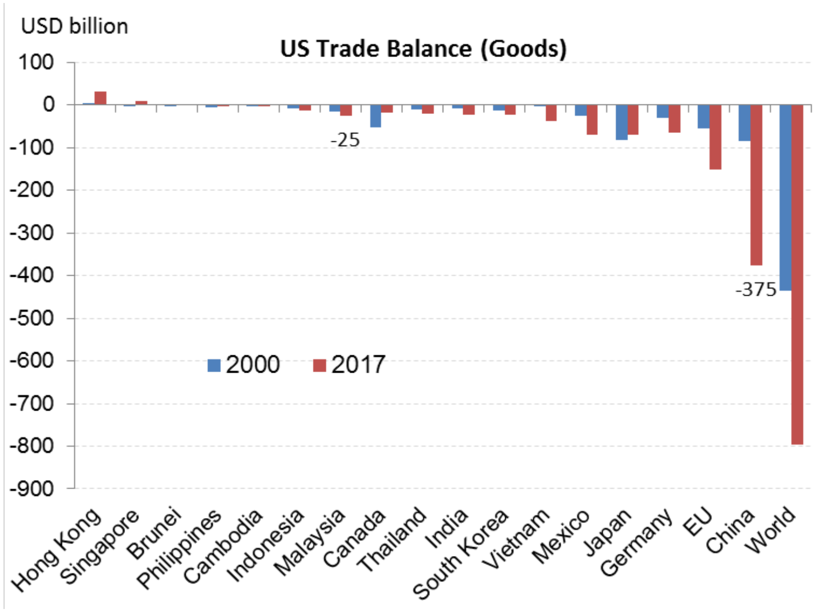
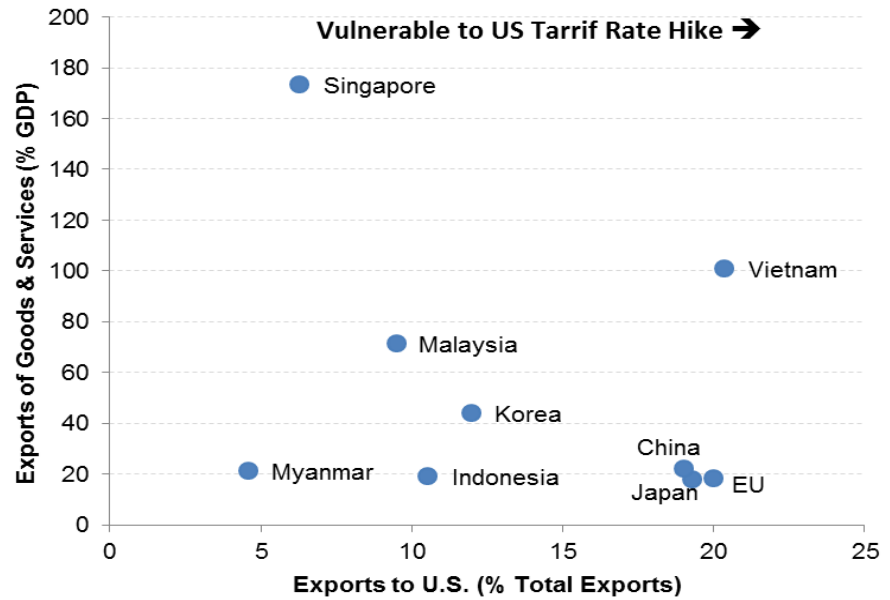
Looming Trade War – Impact on Malaysia

Taking Aim At China (Largest Trade Surplus)



Source: CEIC, Kenanga Research

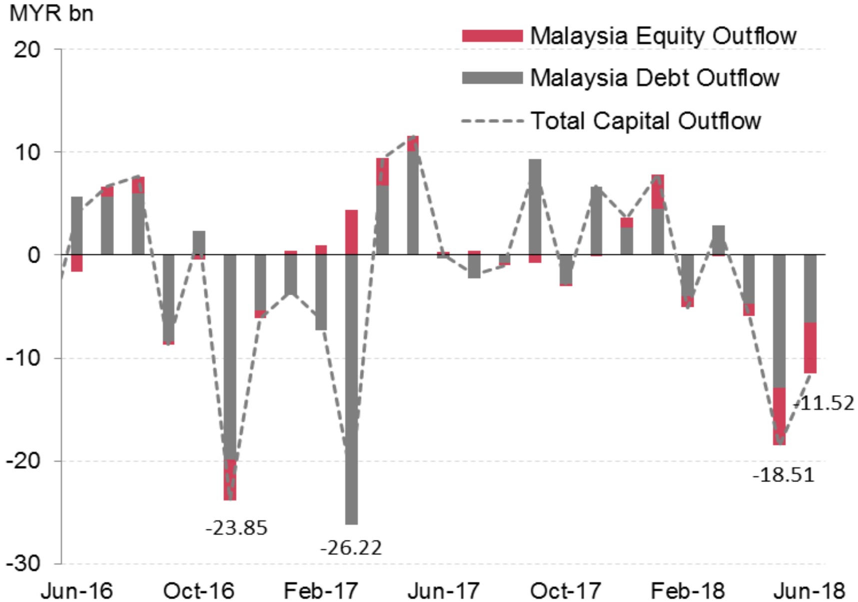
Vulnerability to Changes in US Trade Policy



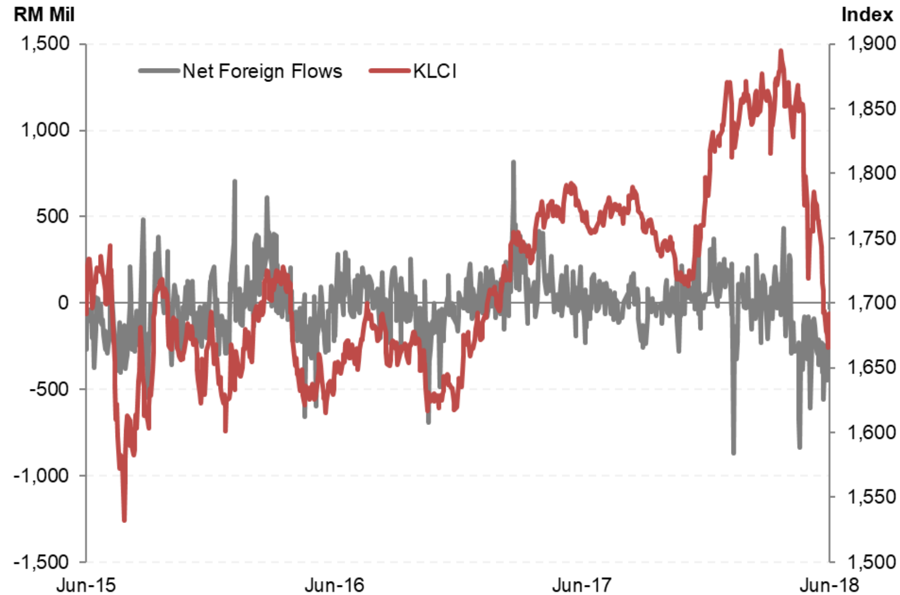
- The probability of the current rhetoric would turn into a full blown trade war is relatively small for now given China's measured plan retaliation of Trump's plan to reduce deficit with China (>USD150b)
- Comparatively Malaysia is less vulnerable to US Tariff hikes compared to Vietnam, China and the EU due to lower share of exports to US (about 10%) and relatively small total exports share to GDP (71%)
- A full blown trade war would have a negative impact on Malaysia as combined export destination to both countries is almost a quarter of total exports (US: 9.5% Vs China: 13.5% of total exports in 2017)

Global QE Unwinding/Rate Rise – A Bane To Capital Market

Running For Safety From EM Market



Market Rout – Foreign Selling Continues

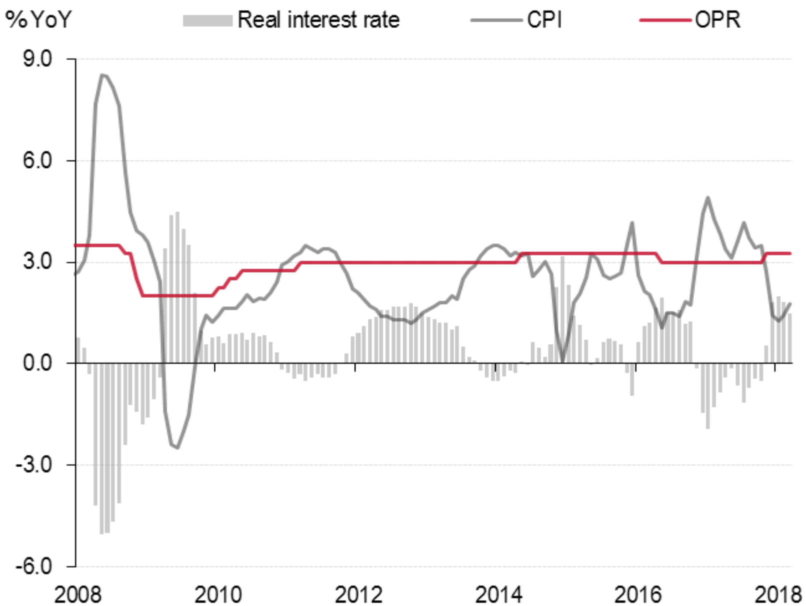


Source: BNM, Bursa, CEIC, Kenanga Research

- Total equity (-RM5.6b) and bond market (-RM12.9b) net outflows hit RM18.5b as at end-May worsen by the surprise outcome of GE14. In June it fell by another RM11.5b.
- Total portfolio outflow would continue in the 2H18 due to escalating trade tension and US Fed increasingly hawkish stance coupled with the period of transition of the new government (revelations, prosecutions and painful fiscal reform measures)

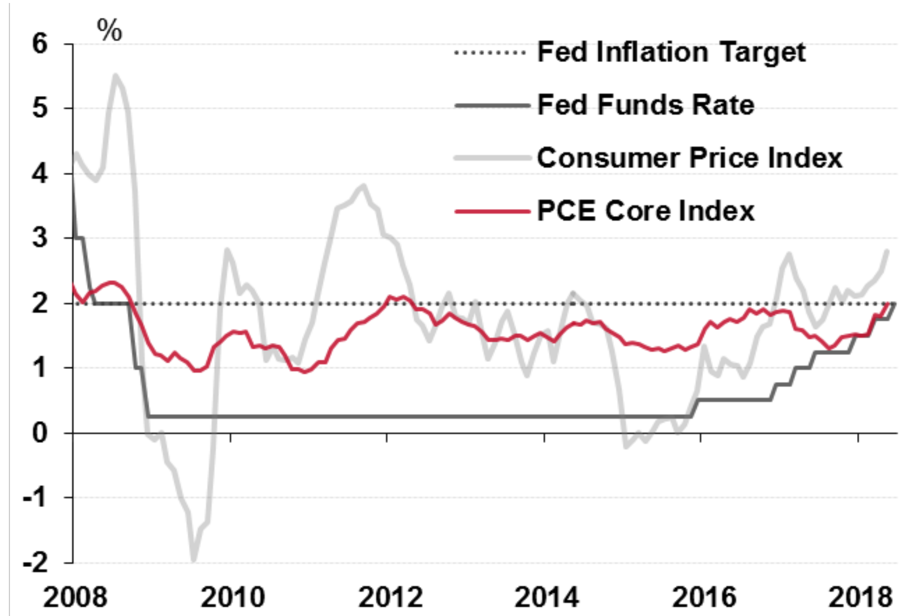
OPR to Stay Pat in Spite of Tighter Financial Conditions

OPR to stay put on growth concern



Source: Bloomberg, BNM, Kenanga Research

Fed signals hawkish tendencies

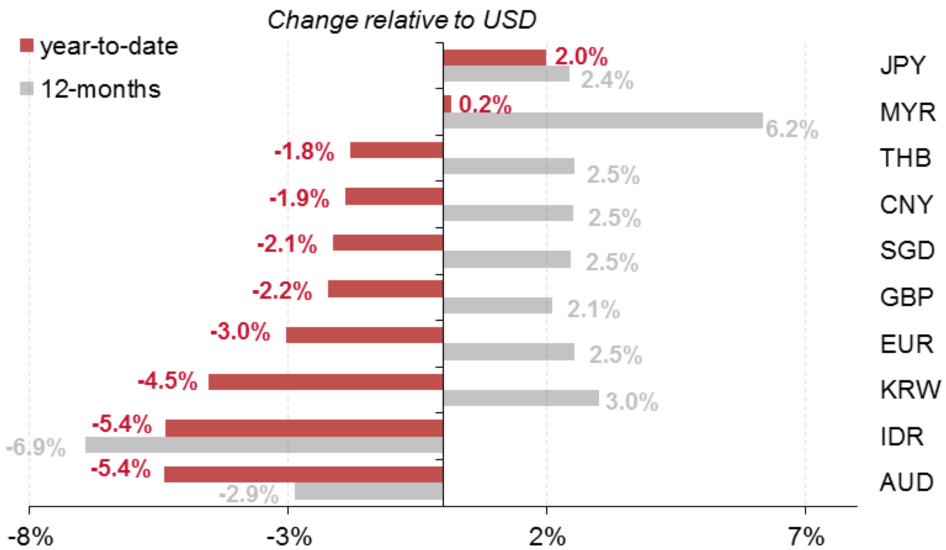


Source: Dept. of Statistics, BNM, Kenanga Research

- In spite of tighter monetary conditions globally led by the US Fed and unwinding of QE, we expect BNM to continue adopting an accommodative stance and hold the OPR at 3.25% for the year
- This is to ensure capital market stability, ample liquidity and more importantly to support growth
- With inflation trending lower (2018F: 1.8% vs 3.7% in 2017), raising real interest rates, lack of demand pull factor and slower GDP growth in 2H18 (1H18F: 5.3% vs. 2H18F: 5.0%), narrowing the output gap, are ample reasons for monetary policy to remain accommodative

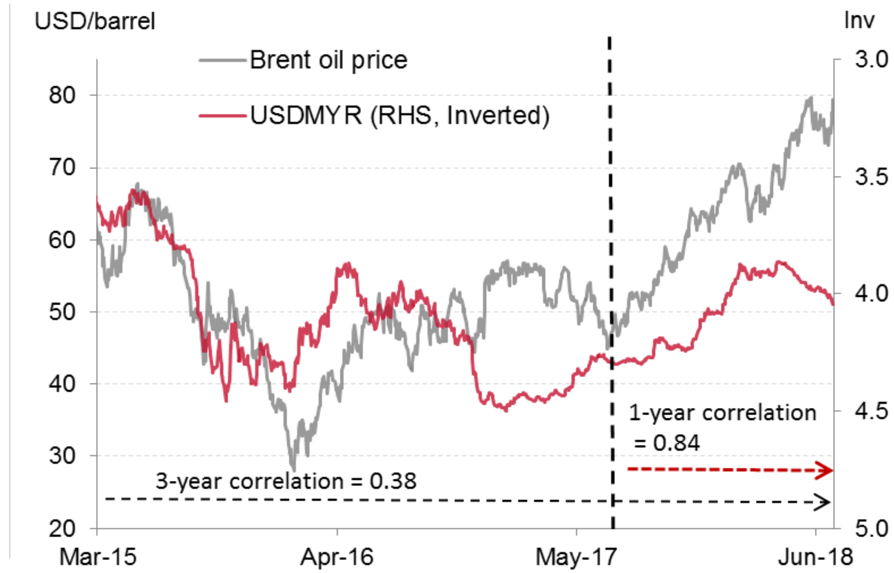
Post GE14 Exacerbate Ringgit Weakening Bias and Volatility

Ringgit's performance against major FX



Source: Bloomberg, Kenanga Research Data last updated: 4 July 2018

Increasingly correlated to rising crude oil price

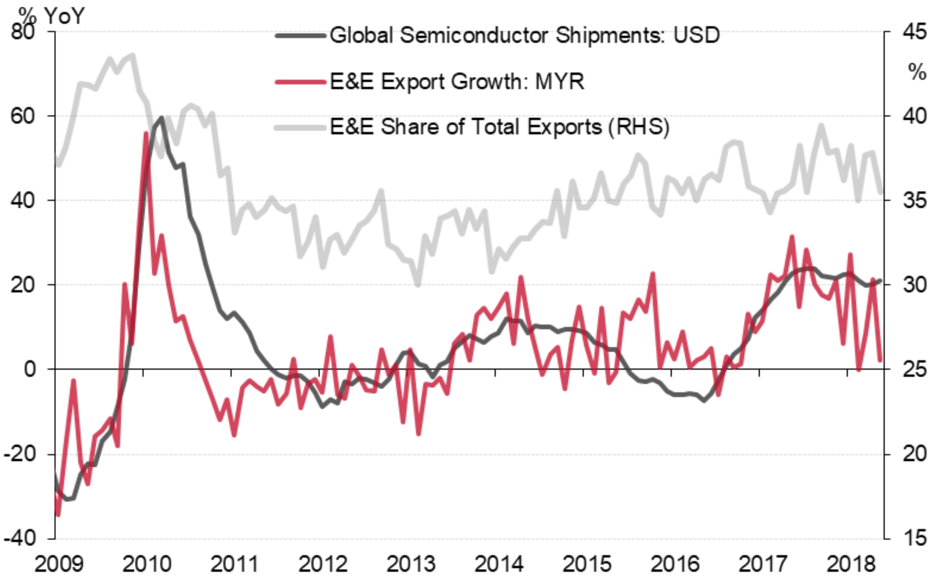


Source: Bloomberg, Kenanga Research

- Negative sentiments and eroding investor confidence post GE14 have overtaken economic fundamentals supporting the ringgit. Plus the ringgit's potential upside is still facing some resistance amid lingering external risks.
- Along with the lingering external risk, we see a weaker bias and a volatile ringgit. Hence, we expect 2H18 USDMYR to be range bound between 4.00-4.15.
- Over the past year the ringgit has a high propensity to appreciate with the rise in crude oil. This would provide support to the ringgit but we still expect some downside bias. Our USDMYR year-end 2018 target is 4.05.

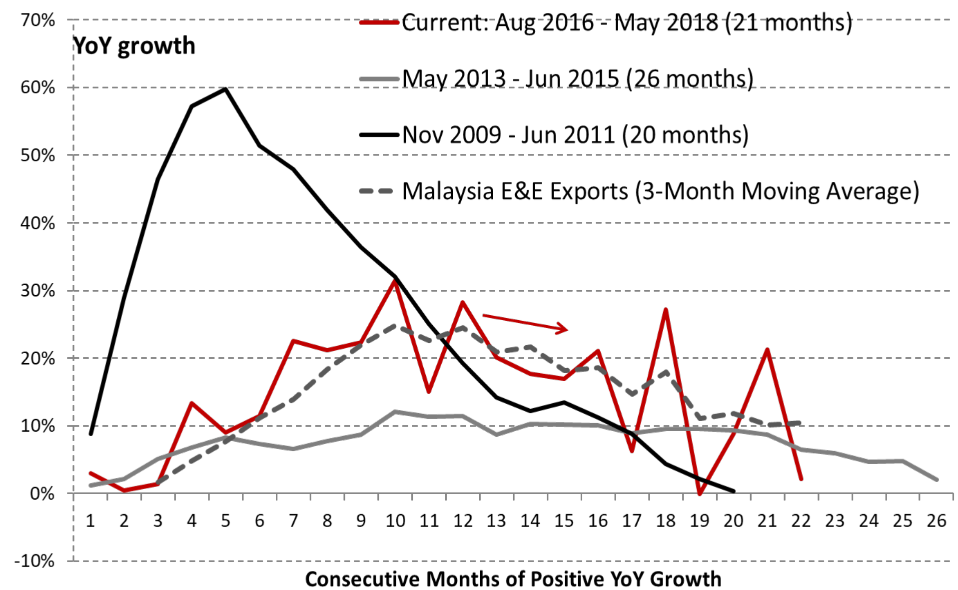
Global Tech Cycle Peaks – Malaysia E&E Exports Slows

Global Chip Growth Peaks



Source: Semiconductor Industry Association (SIA), Dept of Statistics, Kenanga Research

Msia E&E Exports Sequential Growth Trend



Source: SIA, Dept. of Statistics, Kenanga Research

- Malaysia's electrical and electronics (E&E) export YoY (3-MMA basis) stayed positive since Oct 2016 (21 Months) though Feb non-seasonally adjusted saw its first contraction (-0.1% YoY) since July 2016
- At the current trajectory it may still remain on a positive growth trend for at least another 6 months barring external shocks
- This would support our export forecast of 7%-10% for 2018 (2017: 18.9%) presumably enough to support GDP growth to nudge above 5.0%. The rest has to come from domestic demand.

Rising Oil Prices - A Potential Gain And Saviour

Sensivity Analysis of Changes in Crude Oil Price on 2018 Fiscal Deficit, GDP Growth and Inflation

Average Oil Price Assumption (US$/barrel)	Forecast Oil related Revenue (RM Bil)	Revenue For Every $5/barrel Oil Increase (RM bil)	Revenue Surplus/Total Expenditure (%)	Overall Surplus/Deficit (RM bil)	**Fiscal Deficit/ Nom GDP (%)**	Percentage Point Change to GDP	**Real GDP Growth (%)**	**CPI Growth (%)**
50.0	48.6			-60.4	**-4.2**		**3.9**	**1.3**
55.0	53.5	4.9	1.7	-54.1	**-3.7**	0.4	**4.2**	**1.6**
60.0	58.3	9.7	3.5	-51.0	**-3.5**	0.8	**4.6**	**1.8**
65.0	63.2	14.6	5.2	-47.8	**-3.3**	1.2	**5.0**	**2.1**
70.0	68.0	19.4	7.0	-44.7	**-3.0**	1.6	**5.4**	**2.3**
75.0	72.9	24.3	8.7	-41.5	**-2.8**	2.0	**5.8**	**2.4**
80.0	77.8	29.2	10.4	-38.4	**-2.6**	2.4	**6.2**	**2.4**

Source: Bloomberg, and Ministry of Finance, Kenanga Research
Assumptions: 1) Government provides subsidy if oil prices >USD70/barrel; 2) Minimum achievable official 2018 GDP growth target of 5.5%; 3) Removal of GST manageable

- Apart from Brunei as the only net oil and gas exporter in the region, Malaysia also stands to benefit from rising oil prices
- With OPEC sticking to its measured oil production cuts and Trump's persistence in ditching Iran nuclear deal, crude oil could reach an average price of above USD75/barrel this year (YTD: USD72/b).
- Barring the unforeseen, this may help to raise the prospect of achieving the official deficit target of 2.8% of GDP this year.

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Post GE14 Impact: Trade Off Btw Growth & Fiscal Consolidation

Revenue Impact	Base	Worst	Best	Expenditure Impact	Base	Worst	Best	Net Impact	Base	Worst	Best
Total	**-6.50**	**-9.50**	**-3.50**		**6.30**	**3.30**	**8.30**		**-0.20**	**-6.20**	**4.80**
Additional tax revenue from higher oil price	5.50	4.50	6.50								
Dividends from GLCs	5.00	4.50	5.50								
Estimated Proceeds from SST	4.00	3.50	4.50	Expenditure Rationalisation	10.00	8.00	11.00				
Zero-rate GST	-21.00	-22.00	-20.00	Hari Raya Assistance	-0.70	-0.70	-0.70				
				Petrol Price Subsidy	-3.00	-4.00	-2.00				
Fiscal Deficit (% of GDP)									**-2.8%**	**-3.2%**	**-2.4%**
2018 GDP Growth Scenario									**5.0-5.5%**	**<5.0%**	**>5.5%**

Source: Ministry of Finance, Kenanga Research

Note: The scenario is based on the baseline official GDP growth target of 5.5% and average crude oil of USD70-75/barrel

- The surprise win by PH has left them in a challenging situation whereby it needs to fulfil its promises (10 within 100 days). More than 70% has been fulfilled.
- Discovering that the national debt is about RM1 trillion or 80.3% of GDP makes things more challenging for PH as it also needs to find ways to reduce the shortfall (RM20-22b) after it zero-rated the GST and re-introducing non-targeted fuel subsidies (RM3.0b)
- Higher debt, slowing economy, and a weaker ringgit would pose a big challenge on PH to rationalise expenditure. Higher oil price is the only saviour for now but not enough and its volatile.
- Reviewing and suspending megaproject (ECRL, HSR, etc) linked to China (Approx RM300-400b next 10 years) may be good in the long term but would affect investor confidence in the short term
- A 2.8% deficit target is achievable provided oil price is >USD70/barrel and GDP growth >5.0%

Malaysia: Growth to slow 2018

GDP Growth Forecast by Sector and Demand Aggregate

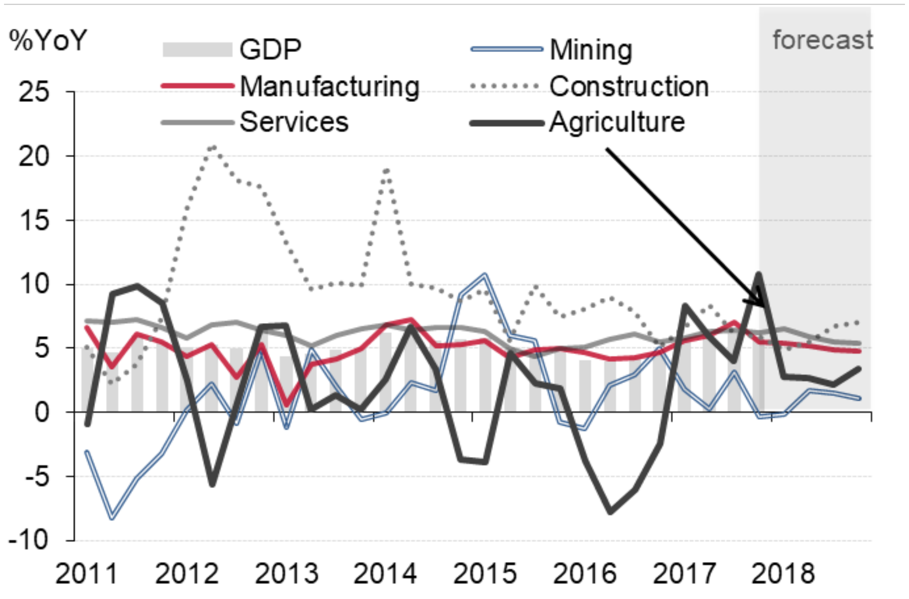
	2016	2017	4Q17	1Q18	2Q18F	3Q18F	4Q18F	1H18F	2H18F	Kenanga 2018F	BNM 2018F
By Sector											
Agriculture	-5.2	7.2	10.7	2.8	2.6	2.2	3.4	2.7	2.8	2.8	3.5
Mining	2.1	1.2	-0.3	-0.2	1.7	1.5	1.1	0.7	1.3	1.0	1.8
Manufacturing	4.4	6.0	5.5	5.3	5.1	4.9	4.8	5.2	4.8	5.0	6.0
Construction	7.4	6.7	5.9	4.9	5.5	6.5	6.7	5.2	6.6	5.9	7.0
Services	5.7	6.2	6.2	6.5	5.9	5.6	5.4	6.2	5.5	5.8	6.0
Real GDP	**4.2**	**5.9**	**5.9**	**5.4**	**5.3**	**5.1**	**4.9**	**5.3**	**5.0**	**5.1**	**5.5-6.0**
By Aggregate Demand											
Consumption	4.9	6.7	6.9	5.7	5.2	5.7	5.0	5.5	5.3	5.4	5.8
Public	0.9	5.4	6.8	0.4	-0.2	-0.3	-0.1	0.1	-0.2	-0.1	0.4
Private	6.0	7.0	7.0	6.9	6.5	7.0	6.5	6.7	6.8	6.7	7.1
Investment	2.7	6.2	4.3	0.1	1.8	1.9	2.3	0.9	2.1	1.5	5.2
Public	-0.5	0.1	-1.4	-1.0	0.7	-1.0	-0.5	-0.2	-0.7	-0.5	-3.2
Private	4.3	9.3	9.2	0.5	2.1	3.1	4.5	1.3	3.7	2.4	9.1
Public Spending	0.3	3.3	3.4	-0.1	0.1	-0.6	-0.3	0.0	-0.4	-0.2	-1.0
Private Spending	5.6	7.5	7.4	5.2	5.3	6.1	6.1	5.3	6.1	5.7	7.6
Aggregate Demand	4.3	6.5	6.2	4.1	4.2	4.7	4.3	4.2	4.5	4.3	5.6
Exports	1.3	9.4	6.7	3.7	3.5	3.1	2.9	3.6	3.0	3.3	8.8
Imports	1.3	10.9	7.3	-2.0	-1.6	0.7	1.3	-1.8	1.0	-0.4	9.1
Real GDP	**4.2**	**5.9**	**5.9**	**5.4**	**5.3**	**5.1**	**4.9**	**5.3**	**5.0**	**5.1**	**5.5-6.0**

Source: Ministry of Finance, BNM, Kenanga Research,   F: denotes forecast

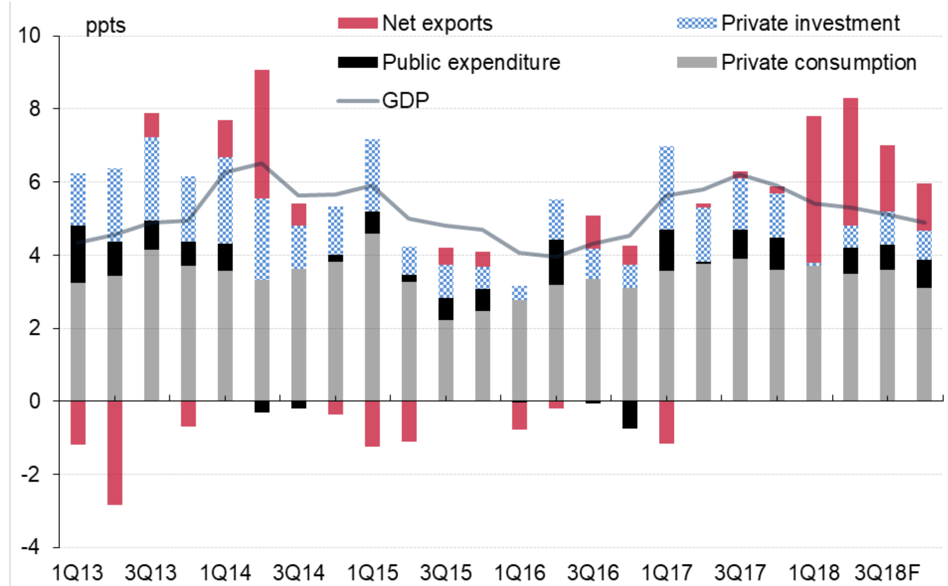
Source: Dept of Statistics, Kenanga Research

- Malaysia's economy is expected to moderate in 2018 to 5.1% compared to the official target of 5.5% lower than the average rate of expansion witnessed in 2011-17 (5.2%) after a stronger-than-expected performance in 2017 of 5.9%.

Domestic Demand to Support Growth in 2018



Source: Dept. of Statistics, CEIC, Kenanga Research

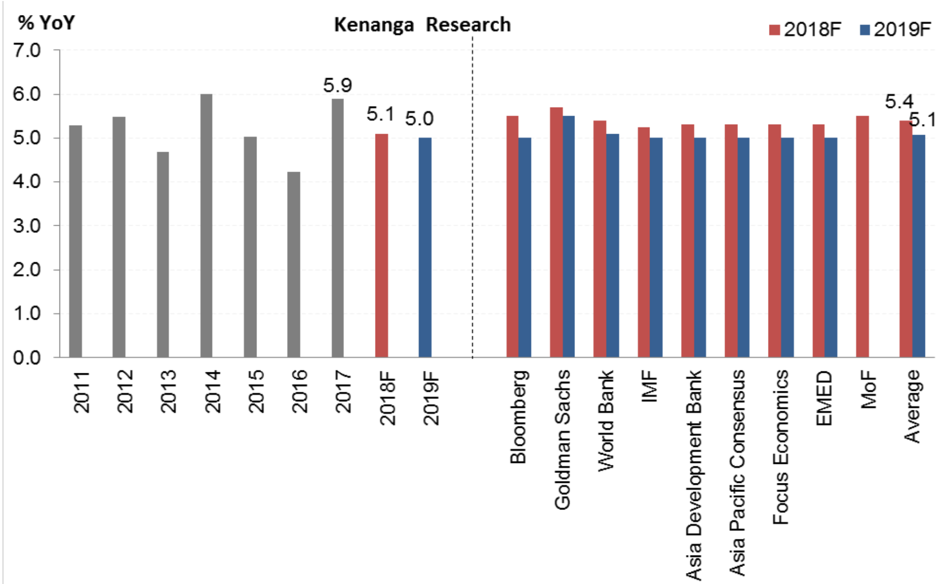


Source: Dept. of Statistics , CEIC, Kenanga Research

- A 3-month tax holiday beginning in June following PH promise of abolishing GST rate and re-introducing SST is expected to boost private consumption and help to support GDP growth in 2Q18 and 3Q18.
- Private investment may be affected by the government's decision to review all Chinese-linked megaprojects
- Public spending is expected to decline as the government steps up expenditure rationalisation
- Sector-wise, our bets remain on the services sector and some recovery from the agriculture sector on the expected re-emergence of El Nino in 2H18. Mining is expected to be better on higher crude price

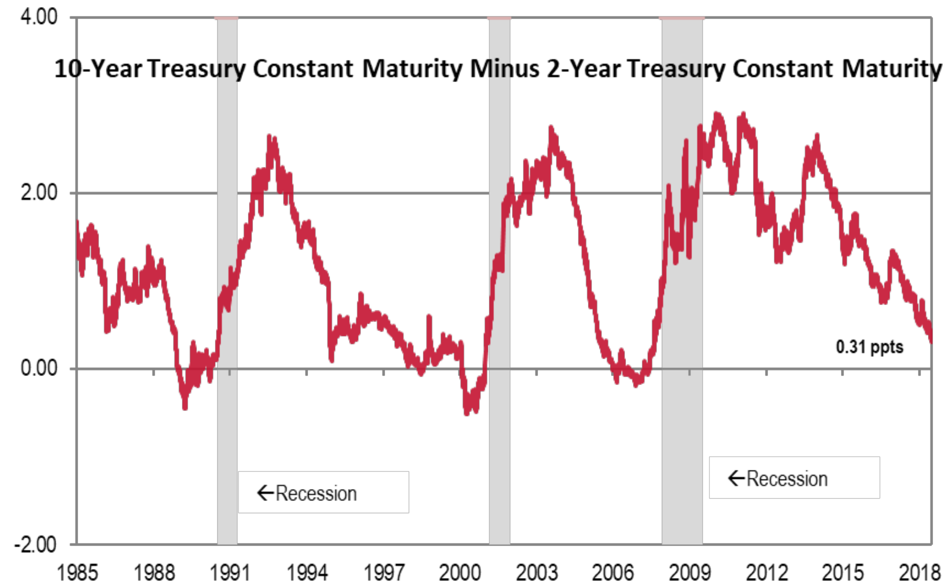
What to Expect in 2019 – Bias Towards A Slowdown

Kenanga Vs Others' GDP Forecast



Source: Bloomberg, Kenanga Research, Respective Multilateral Agencies, Media and Independent Data Surveyors

Treasury Flattening – A Recession Warning



Source: Fed St Louis, Kenanga

- For 2019, against our preliminary projection of 5.0%, the average consensus and multilateral agencies' forecast is 5.1% (2018F: 5.4%)
- Another global slowdown/recession is looming and probably led by the US. Signs are abound starting with the threat of an escalating trade war, the end of an extended US cyclical upturn and signals from the capital market mainly the flattening of the Treasury yield curve.
- China's economy is also showing signs of weakening especially in its overbearing capital market. Externally, there are rising risks from a potentially disruptive trade war.

What to Expect in the 2019 Federal Budget

- To be tabled in November, with a fresh mandate the Government would continue to consolidate, restructure its working machinery, improve its efficiency and to deal with debt restructuring
- With the challenge of trying to close the revenue gap due to the abolishment of GST, we expect there would be measures to fine tune the proposed SST.
- We expect the government would still assign a deficit target of below 3.0% of GDP although it would be visibly challenging in an environment of slower growth and lower revenue in 2019.
- Priority would be on dealing with the high cost of living especially for the B40 and to a certain extent M40 who are living in the urban area.
- BR1M is likely to continue until an alternative is introduced in the form of providing a basic social security net for those in the lower income bracket
- The affordable home scheme and cheap housing for the rural poor would likely be reviewed to ensure that cost and land allocation are being managed accordingly.
- Education reforms would be top priority and a big chunk of the operating and development expenditure (4-5% of GDP) should be channelled towards improving quality of teaching and training
- The Technical and Vocational Education and Training (TVET) is likely to be the main focus on upskilling and preparing future workforce for the Fourth Industrial Revolution

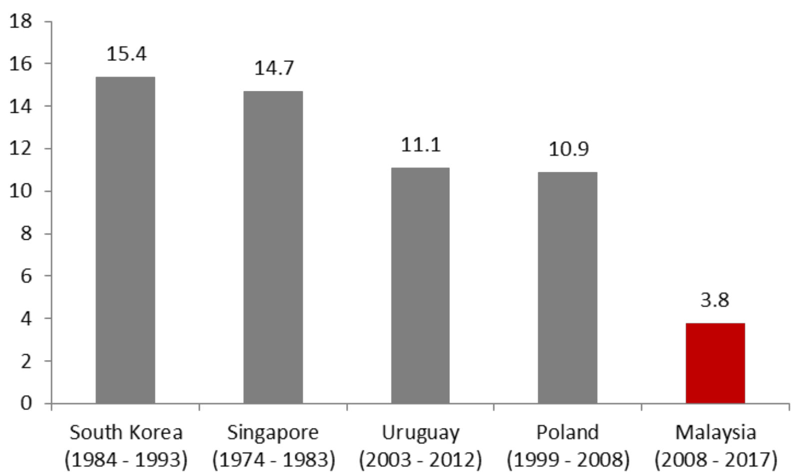
The Way Forward - Recession Proof Workforce

- **Job creation priority**. Measures to create more skilled job opportunities to support growth should be given higher priority other than enhancing skills and knowledge.
- **Reforming Education**. The education system should prepare a flexible workforce who are capable of learning and adaptive to changing environment while the teaching approach should be changed (Critical thinking, adaptive learning, etc).
- **Social Protection System**. Create a social protection system that caters to the increasingly high number of the self-employed (gig economy, consultants, free agents, etc).
  - Flexible benefits that do not fixed to an employer and options for continuous learning for adult would be the best social protection;
  - Universal healthcare and social assurance;
  - Universal flexi-pension system – contribution made as and when income is made.
- **Universal Basic Income (UBI)**. Something to ponder on, once Malaysia reached the developed status, not as a giveaway but as a temporary crutch and also to alleviate abject poverty. Practiced in a few Nordic countries and even considered in Singapore. It has been suggested that a UBI be given to deal with the growing wealth gap and ensure that everyone have a decent life when they are jobless.

The Way Forward – Plugging The Leakages

- Will Malaysia achieve Vision 2020 to be a developed high income nation? The simple answer is no. Based on World Bank recent Economic Monitor, Malaysia is expected to pass the high-income nation threshold within the next 2-6 years…

… at a slower pace of convergence



Source: Malaysia Economic Monitor June 2018 - Navigating Change
Note: Average Growth Rate of GNI Per Capita, 10-Year Period Prior to Achieving High Income Country Status, World Bank Atlas Methodology (US$)

… this is the reason why

The latest Global Financial Integrity (GFI) report shows that illicit financial outflows (IFFs) from developing countries … China, Russia, Mexico, India and Malaysia lead all countries in illicit capital flight. Since 2012, emerging and developing countries have lost over a trillion dollars yearly that could invested productively in industry, agriculture, healthcare, education, or infrastructure.

Source: IPS News Agency, "Mounting Illicit Financial Outflows from South", Oct 31 2017, Authors: Jomo Kwame Sundaram and Zera Zuryana Idris

The Way Forward – Adopting the Digital Economy

- "For Malaysia to successfully achieve high-income and developed country status, It will be important to unlock the potential created by the digital economy." – The World Bank
- The faster Malaysia adopt it the sooner it would close the wealth gap. The wealth gap will only worsen over time, as mechanisation occurs and more jobs are replaced by robots.
- It promotes growth via 1) promoting inclusion and expands markets by reducing transaction cost; 2) boosting efficiency; 3) significantly reducing the economic and social transactions for household, businesses and government. – the World Bank
- Malaysia is a fast adopter of digital access from 51% in 2006 to more than 80% at present but lags behind international peers in terms of digital adoption in business. This is due to 1) high cost 2) lack of competition in the fixed broadband market.
- The Government should have a clear national policy on Digital Economy and lead the way for its speedier adoption.
- To moot, this could potentially be a better substitute or complement to the affirmative action policy to bridge the wealth gap without inadvertently discriminating between race, religion or social status.

Forecast and Assumption

	2012	2013	2014	2015	2016	2017	2018F	2019F
Real GDP (%YoY)	**5.5**	**4.7**	**6.0**	**5.0**	**4.2**	**5.9**	**5.1**	**5.0**
Consumer Price Index (avg.)	1.7	2.1	3.2	2.1	2.1	3.7	1.8	2.1
Current Account Balance (% of GDP)	**5.2**	**3.5**	**4.4**	**3.0**	**2.4**	**3.0**	**2.0-2.5**	**2.1**
Fiscal Balance (% of GDP)	-4.3	-3.8	-3.4	-3.2	-3.1	-3.0	-3.0	-2.9
Unemployment rate (%)	**3.0**	**3.1**	**2.9**	**3.2**	**3.3**	**3.4**	**3.4**	**3.5**
Manufacturing output (%YoY)	5.2	4.2	6.1	4.8	4.3	6.1	4.5	4.1
Exports of goods (%YoY)	**0.7**	**2.5**	**6.4**	**1.6**	**1.2**	**18.9**	**7.0-10.0**	**6.0**
Overnight Policy Rate (end period)	3.00	3.00	3.25	3.25	3.00	3.00	3.25	3.25
Exchange rate: Ringgit/US$ (avg.)	**3.0886**	**3.1501**	**3.2729**	**3.9074**	**4.1424**	**4.2996**	**4.0000**	**3.8500**
Exchange rate: Ringgit/US$ (end period)	3.058	3.2757	3.4973	4.2943	4.4862	4.0465	4.0500	3.8500
Palm oil: RM/tonne (avg.)	**2,764**	**2,371**	**2,384**	**2,166**	**2,649**	**2,791**	**2,400**	**NA**
Palm oil: RM/tonne (end-period)	2,231	2,573	2,283	2,198	3,203	2,390	2,400	NA
Crude Oil (Brent)- US$/barrel (avg.)	**111.68**	**108.7**	**99.45**	**53.56**	**45.1**	**54.75**	**75.00**	**67.00**
Crude Oil (Brent)- US$/barrel (end-period)	111.11	110.8	57.33	37.28	56.82	66.87	75.00	65.00

Source: BNM, Ministry of Finance, Dept of Statistics, Bloomberg, CEIC, PORIM, Kenanga Research, F=Forecast, E=Estimate

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