QUARTERLY ECONOMY TRACKER

(APR-JUN 2019)

Socio-Economic Research Centre (SERC)

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World Economic Situation and Prospects for 2019

Escalating trade war raises the spectre of global recession. Global growth defies pessimism to expand further in the first quarter of 2019, with most advanced and regional economies have recorded either a sustained or slower pace of economic expansion. High frequency indicators such as manufacturing and trade started the second quarter on somewhat weak note. Global financial market volatility continues as investors' anxiety remains over escalating trade tensions between the US and China as well as the potential spreading of the trade spat risk involving more countries. A prolonged and full-blown trade war would further dent business and financial market sentiments, slowing investment and trade. This may tip the scale towards a sharper economic slowdown in the US and China, pushing the slowing global economy into recession.

Mixed performances in advanced economies. While the US economy roared back strongly by an annualised 3.1% qoq in 1Q19 (2.2% in 4Q18), the heightened uncertainty on the trade war escalation would weigh on business sentiment in the quarters ahead. Moreover, private consumption and investment have already weakened in 1Q19. In euro area, high frequency data and survey information still pointing to soft economic and industrial activities and it remains to be seen if the momentum will continue to keep pace in 2Q-3Q. Japanese economy's unexpected growth spurt (0.9% yoy in 1Q19 vs. 0.3% in 4Q18) comes with caution about the strength of domestic demand. There have been growing calls to delay the planned consumption tax hike to 10% from 8% in October in the face of worsening domestic and external conditions. Although China expanded robustly by 6.4% in 1Q19, a slew of weak data and the intensifying trade tensions with the US in recent weeks likely to further dent confidence, prompting the roll out of more fiscal measures to cushion overall activity from decelerating.

Dovish monetary stance remains. Global central banks have tilted towards the path of monetary easing amid heightened concerns about global economic weakness. The recent escalation in trade wars open the prospect of rate cut if the economic outlook deteriorates further. The Fed funds futures indicate that the most likely outcome is that the Fed will cut once or twice in 2H 2019, with the first move potentially coming in July or September. Looking ahead, the European Central Bank (ECB) is expected to its dovish tone for a while longer. It has reiterated that interest rates are expected to remain at their present levels at least through the first half-year of 2020 and it would continue to fully reinvest the principal payments from maturing securities "for an extended period of time". Bank of Japan (BOJ) has decided to provide forward guidance on monetary policy for the first time ever and stated that it will keep the short- and long-term interest rates at the current low levels till at least spring 2020.

Risks to global growth. There are many downside risks to global growth as follows: (a) If the trade tensions continue unabated and get worse; (b) Even if a trade agreement is reached, tensions in trade policy could flare up again and cause disruptions to global supply chains; (c) Growth in the US (fading stimulus and rich equity market valuations), euro area (sovereign debt) and China (financial and debt risks) may surprise on the downside. The risks surrounding Brexit remain heightened; and (d) A deterioration in market sentiment could tighten financing conditions in an environment of large private and public sector debt in many countries, including sovereign-bank doom loop risks. As at end-Dec 2018, global debt amounted to US$180.3 trillion or 233.7% of GDP, of which non-financial corporations made up 39.2% of total (91.6% of GDP); followed by general government 35.3% of total (82.5% of GDP) and households and non-profit institutions serving households (NPISHs) (25.5% of total or 59.7% of GDP).

Malaysia's Economic and Financial Conditions

The Malaysian economy slowed in 1Q19; downside risk remains. Malaysia's economic growth grew at a slower pace of 4.5% yoy in 1Q19 (4.7% in 4Q18) due to slowing domestic demand and exports. Looking ahead, real GDP growth is expected to grow by between 4.5% and 4.7% in the remaining quarters as external environment still impaired by the escalation of trade war. On the domestic front, cautious business and consumer sentiments would continue to weigh on private spending. SERC maintained this year's real GDP growth estimates of 4.5%-4.7% (4.7% in 2018).

Still moderate economic indicators. Weak data for April suggests that economic growth would continue to grow moderately estimated between 4.5-4.6% in 2Q. Retail sales, industrial production, exports and banking system loans all continued to grow, albeit moderately for some.

Consumer spending continues; private investment indicators seen mixed. Sales of consumer durables such as car sales grew by 8.0% in April (8.3% in 1Q19); consumption credit eased slightly while imports of consumption goods grew robustly by 18.9% in April (1.1% in 1Q19). Private investment indicators were mixed: Sales of commercial vehicles contracted by 9.3% in April though narrowed from -14.9% in 1Q19. Imports of investment goods turned around to grow by 5.7% in April from a sharp decline of 9.8% in 1Q.

Exports turned positive in April. Following two straight months of declines, exports grew by 1.1% in April (-0.7% in 1Q), reflecting some improvement in demand of electrical and electronic products, crude petroleum, chemical and chemical products while agriculture exports declined, mainly due to a much lower exports of palm oil.

We continue to stay cautious about the outlook of Malaysia's exports, particularly in the second half-year, with a lot hinging on the US-China trade deal that is proving elusive so far. With trade tensions escalating to the next level of more and higher tariffs, it could further dent business and financial market sentiment, slowing investment and trade.

Headline inflation remains subdued. Malaysia has crawled out from the trap of technical deflation as the distortionary effect from the transport prices normalizes. Headline inflation reading, as measured by the Consumer Price Index (CPI) has remained in positive trajectory for two months in a row (0.2% each in April and March respectively). YTD (Jan-Apr), inflation declined by 0.2% while core inflation up 0.4%, indicating continued domestic demand. SERC expects headline inflation to average 1.0%-1.5% in 2019 (1.0% in 2018) due to some cost pass-through from domestic cost factors. These include the lapse in consumption tax policy; increase in prices of soft drinks due to soda tax; increase in minimum wage; higher electricity surcharges for businesses; and potential higher increase in food prices.

BNM to keep rates steady at 3.00%. Bank Negara Malaysia (BNM) cut the overnight policy rate (OPR) by 25 basis points (bps) to 3.00% on 7 May in a bid to mitigate the economy against the risk of sharper economic slowdown. Looking ahead, the central bank will remain focus to ensure financial stability and the provision of credit facilities at reasonable rate to support business and consumer spending. SERC expects BNM to keep monetary arsenal for now while continue to assess the impact of interest rate cut on domestic demand amid keeping close monitoring the on-going trade war's spillover effects on investment and trade. We maintain our OPR estimates at 3.00% by end-2019 (3.25% at end-2018).

Headwinds seen continuing weighing on the ringgit. The ringgit has succumbed to downward pressure against the US dollar in late May and early June due to a confluence of negative sentiments: Concerns over heightened uncertainty of the US-China trade tensions and the potential widespread to involve more countries; investors' uneasiness about FTSE Russell putting Malaysia on a watch list of fixed income markets for a review of potential downgrade to "1" from "2" currently, which would render Malaysia ineligible for inclusion in

FTSE World Government Bond Index (WGBI) on 1 September; and the US Treasury places Malaysia in the US Treasury's Monitoring List.

While the Ringgit will continue to be subjected to external pressures in times of increasing uncertainty, we believe that Malaysia's economic and financial fundamentals should remain supportive of the ringgit over the medium-term. The fundamental factors like the projected continued economic growth, current account surplus and still ample foreign reserves would continue to support the ringgit. The ringgit is estimated at RM4.00-RM4.15 per US dollar by end-Dec 2019 (End-Dec 2018: RM4.1385/US$).

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GLOBAL ECONOMY SLOWING ON ESCALATING TRADE TENSIONS

Table 1: Real GDP growth (% YoY)

	2017	2018	2018 Q3	2018 Q4	2019 Q1	2019*e* (IMF)	2019*e* (WB)	2020*f* (IMF)	2020*f* (WB)
United States	2.2	2.9	3.0	3.0	3.2	2.3	2.5	1.9	1.7
Euro Area	2.4	1.9	1.7	1.2	1.2	1.3	1.2	1.5	1.4
China	6.8	6.6	6.5	6.4	6.4	6.3	6.2	6.1	6.1
Japan	1.9	0.8	0.1	0.3	0.9	1.0	0.8	0.5	0.7
India	7.2	6.8	7.0	6.6	5.8	7.3	7.5	7.5	7.5
Malaysia	5.7	4.7	4.4	4.7	4.5	4.7	4.6	4.8	4.6
Singapore	3.9	3.2	2.6	1.3	1.2	2.3	-	2.4	-
Indonesia	5.1	5.2	5.2	5.2	5.1	5.2	5.2	5.2	5.3
Thailand	4.0	4.1	3.2	3.6	2.8	3.5	3.5	3.5	3.6
Philippines	6.7	6.2	6.0	6.3	5.6	6.5	6.4	6.6	6.5
Vietnam	6.8	7.1	6.8	7.3	6.8	6.5	6.6	6.5	6.5

Source: Officials (unadjusted data except quarterly GDP for Euro Area); IMF (World Economic Outlook, Apr 2019); World Bank (Global Economic Prospects, Jun 2019)
Note: Annual GDP for India is on fiscal year basis.

Faced with rising concerns about a prolonged trade tensions' inflicted risks on global growth, major central bankers have either paused their interest rate normalisation plans or provided forward guidance shifting towards monetary easing ahead. In Asia, some central bankers have reduced interest rates in the first half-year of 2019: India (three rounds of rate cut totalling 75 bps), Malaysia and the Philippines (25 bps cut each in May respectively).

Table 2: Policy rate (%)

End-period of	2011	2012	2013	2014	2015	2016	2017	2018	2019 (May/Jun)	2019*E*
US, Fed Federal Funds Rate	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.25-0.50	0.50-0.75	1.25-1.50	2.25-2.50	2.25-2.50	1.75-2.00
Euro Area, ECB Deposit Facility	0.25	0.00	0.00	-0.20	-0.30	-0.40	-0.40	-0.40	-0.40	-0.40
Japan, BOJ Short-term Policy I/R	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
China, PBC 1-year Benchmark Loan I/R	6.56	6.00	6.00	5.60	4.35	4.35	4.35	4.35	4.35	4.35
India, RBI Policy Repo Rate (LAF)	8.50	8.00	7.75	8.00	6.75	6.25	6.00	6.50	5.75	5.50
Korea, BOK Base Rate	3.25	2.75	2.50	2.00	1.50	1.25	1.50	1.75	1.75	1.50
Malaysia, BNM Overnight Policy Rate	3.00	3.00	3.00	3.25	3.25	3.00	3.00	3.25	3.00	3.00
Indonesia, BI 7-Day RR Rate	6.50	5.75	7.50	7.75	7.50	4.75	4.25	6.00	6.00	5.50-5.75
Thailand, BOT 1-Day Repurchase Rate	3.25	2.75	2.25	2.00	1.50	1.50	1.50	1.75	1.75	1.75
Philippines, BSP Overnight RR Facility	4.50	3.50	3.50	4.00	4.00	3.00	3.00	4.75	4.50	4.50

Source: Officials; SERC

CURRENT AND FORWARD INDICATORS

The incoming data continues to suggest that growth momentum in most major economies continued to moderate. The PMI reading indicates global manufacturing activity eased to near three-year lows in May. The World Trade Organisation (WTO) lowered this year's trade growth estimates to 2.6% from 3.7% previously (3.0% in 2018) while global semiconductor sales are expected to contract by 12.1% in 2019 (+13.7% in 2018), dampened by a prolonged slowdown in demand as investors and consumers hold on their investment and purchase plans pending the maturation of 5G technology.

Figure 1: CLIs continue signalling easing growth momentum in most major economies

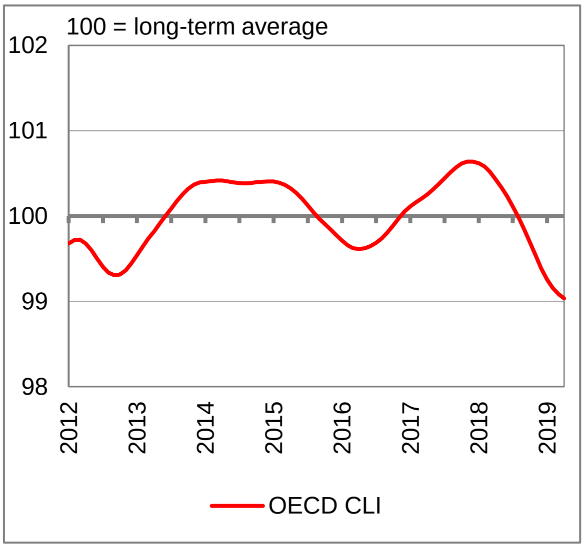


Figure 2: Global manufacturing PMI fell below 50-pt threshold in May, last seen in Nov 2012

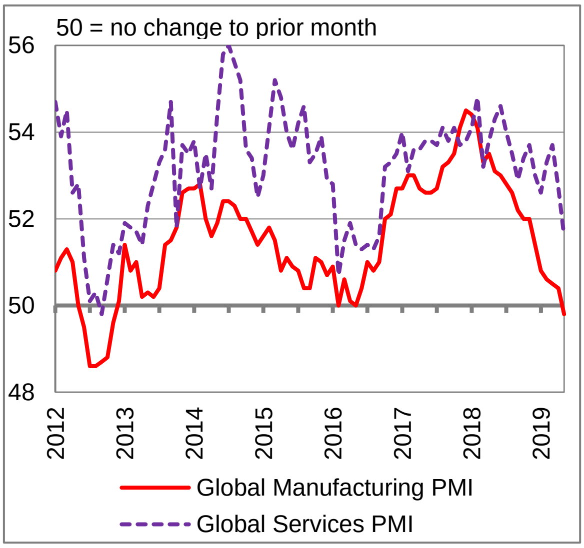


Figure 3: WTO indicator suggests trade weakness extending into second quarter

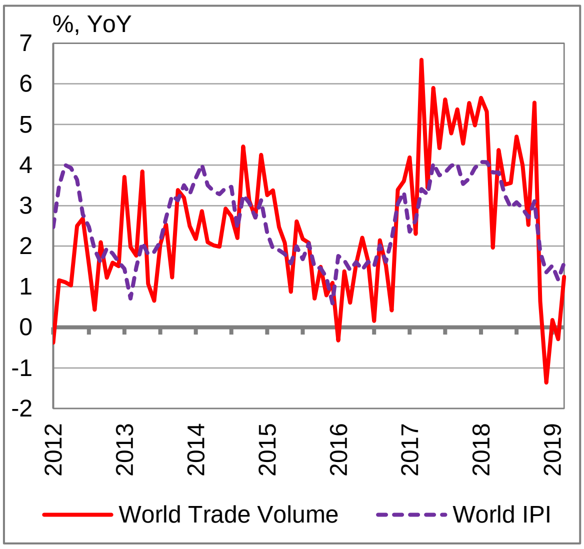
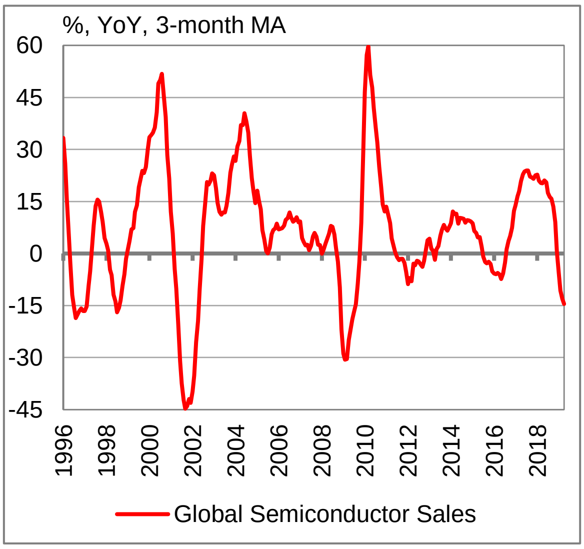


Figure 4: WSTS projected a sharp contraction of 12.1% in chips sales this year



Source: OECD; Markit; CPB Netherlands Bureau for Economic Policy Analysis; Semiconductor Industry Association (SIA)

Notes: WSTS refers to World Semiconductor Trade Statistics

Global business confidence continued to weaken on worries about the impact of trade tensions and geopolitical risks surrounding global economy while consumer confidence has somewhat recovered.

Figure 5: OECD Business Confidence Index

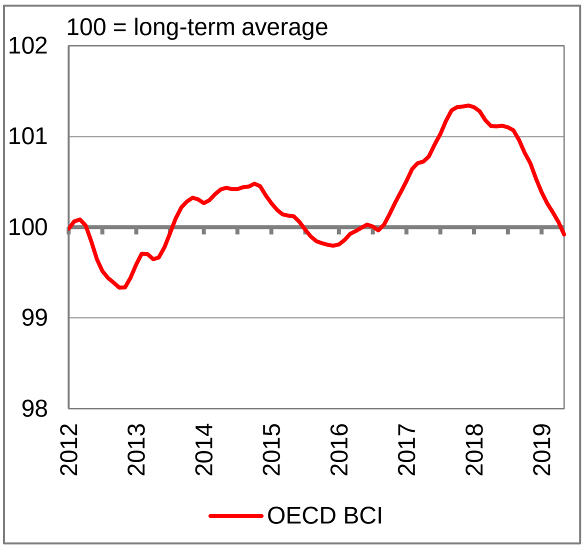
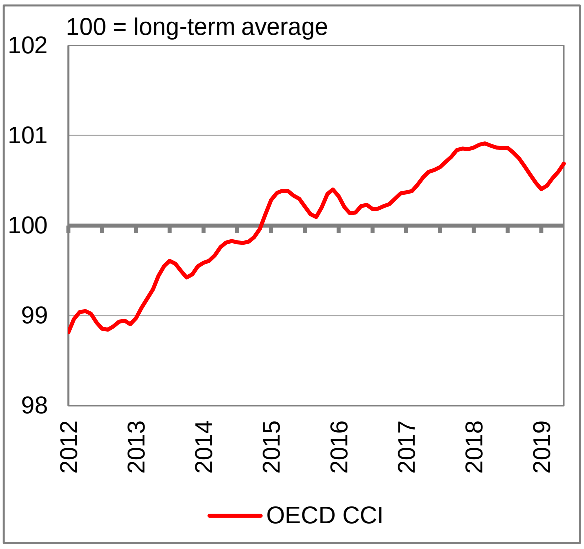


Figure 6: OECD Consumer Confidence Index



Source: OECD

Crude oil prices are expected to stay firm in the second half-year of 2019 on the likely continuation of supply cut in the upcoming OPEC+ meeting on 26 June while the US's production is increasing gradually. We would caution that geopolitical risks and tensions could cause volatility in crude oil prices on concerns about the potential supply disruptions. In Jan-17 June, Brent crude oil prices average US$66.10 per barrel. The US Energy Information Administration (EIA) expects Brent crude oil prices to average US$66.69 per barrel in 2019 and US$67.00 per barrel in 2020.

Figure 7: Brent crude oil prices remained broadly stable at US$71/bbl in Apr-May

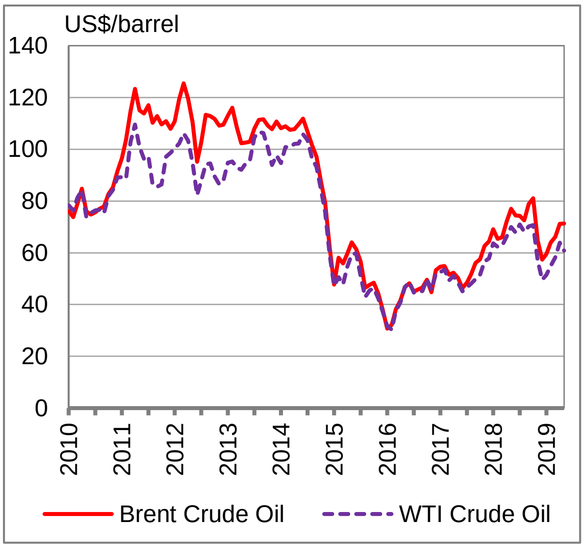
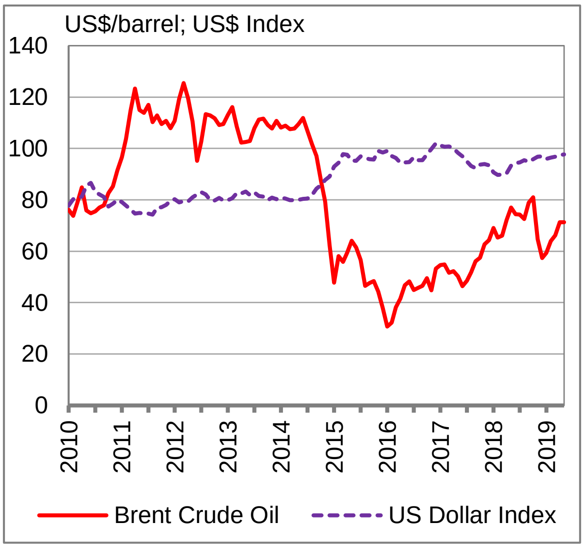


Figure 8: Brent crude oil price vs. the US dollar index



Source: US Energy Information Administration (EIA); The Wall Street Journal

CPO prices average RM2,003.50/mt in Jan-May and RM1,982.00/mt in 1-15 June. Overall prices continued to remain lacklustre despite declining palm oil inventories and the imposition of zero-rated export duty till December 2019 while the European Union has yet to lift the ban on palm biodiesel. Both Malaysia and China have signed a Memorandum of Understanding (MoU) whereby China will buy an additional 1.9 million tonnes of palm oil from Malaysia for five years (2019-2023). In 2018, Malaysia shipped 1.9 million tonnes of palm oil or 11.3% of total palm oil exports to China. In Jan-May 2019, Malaysia's palm oil exports expanded by double-digit growth of 12.5% to 7.9 million tonnes, of which China bought 899,375 tonnes (11.3% of total palm oil exports).

Figure 9: Prices of most agriculture commodities and base metals soften

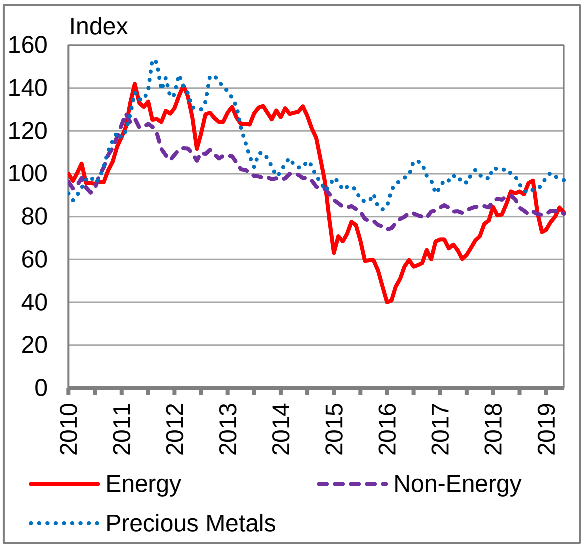
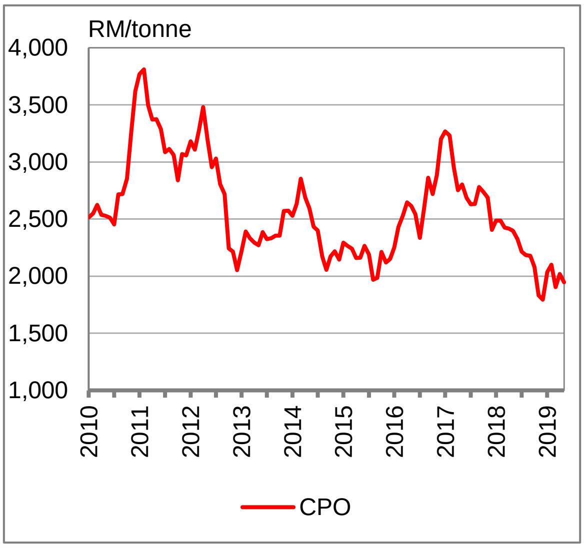


Figure 10: Palm oil prices fell below RM2,000/mt again in May



Source: World Bank; Malaysian Palm Oil Board (MPOB)

ECONOMIC DEVELOPMENTS IN ADVANCED ECONOMIES AND CHINA

The United States: The economy started the year on a strong note as its economic growth regained traction to 3.1% annualised qoq in 1Q19 (2.2% in 4Q18 and 3.4% in 3Q) on stronger net exports and a recovery in government spending post the shut-down. The frontloading of imports and the build-up of inventories ahead of the tariffs deadline also boosted the growth. Private consumption and investment were weak. Data in the quarters ahead are expected to remain uneven given the dampening effects from the elevated trade tensions with major trading partners and fading tax stimulus. With the trade disputes uncertainty threatening to take a toll on the current economic expansion, the Fed faces pressure to cut interest rate to prop up the economy.

Figure 11: ISM manufacturing index in May marks the lowest reading since Oct 2016 …

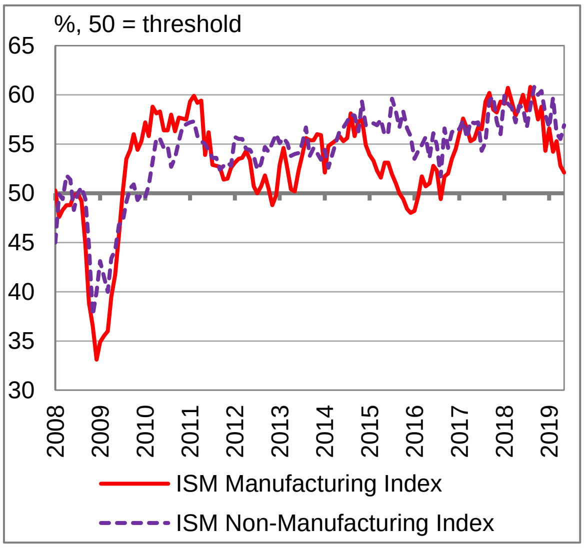


Figure 12: … leading to softer industrial output outlook ahead

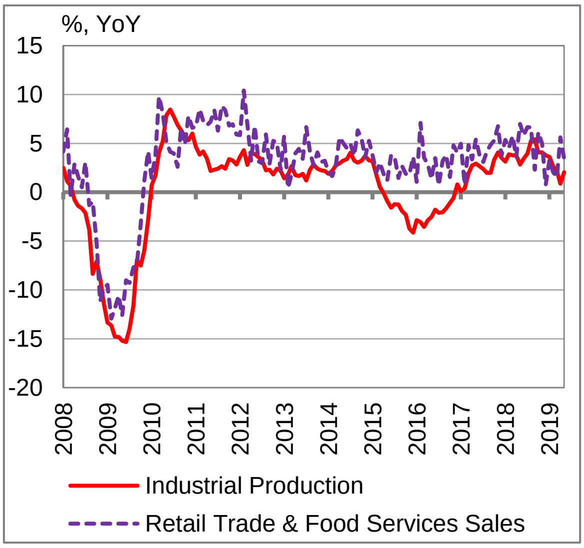


Figure 13: Tighter labour market with the lowest unemployment rate (3.6% in May) in half-century

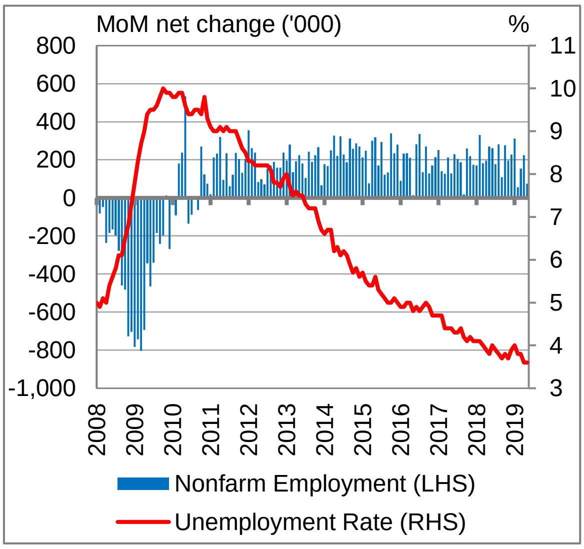
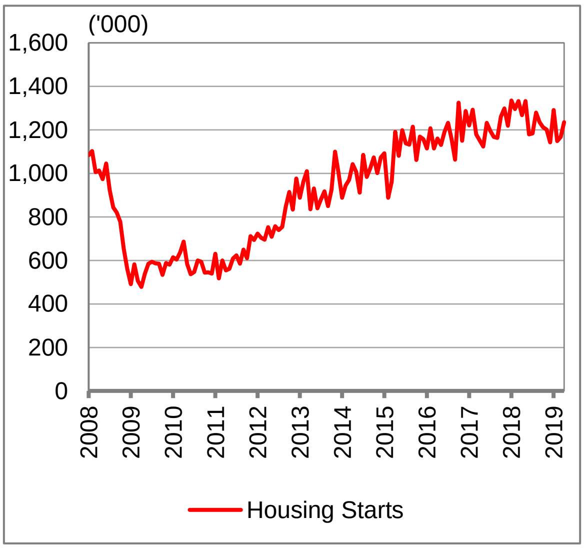


Figure 14: Housing starts regained momentum in April amid declining mortgage rates



Source: Institute for Supply Management (ISM); Federal Reserve System; US Census Bureau; US Bureau of Labor Statistics

Euro area: Growth in the euro area expanded at a slightly higher pace in 1Q19 (0.4% qoq vs. 0.2% in 4Q18), driven by stronger household consumption and improved external demand. But, it remains to be seen whether the momentum can be sustained. The incoming data and market sentiments remained weak, suggesting a challenging economic environment ahead. Following the resignation of UK Prime Minister Theresa May and the impending election of new Prime Minister, Brexit uncertainty continues to linger and may getting more complex as the EU is likely to give an ultimate deadline for Brexit. A hard Brexit would be damaging not only for the UK economy but creates disruption on the EU amid the potential trade conflicts with the US.

Figure 15: Manufacturing PMI dropped below threshold for four consecutive months since Feb

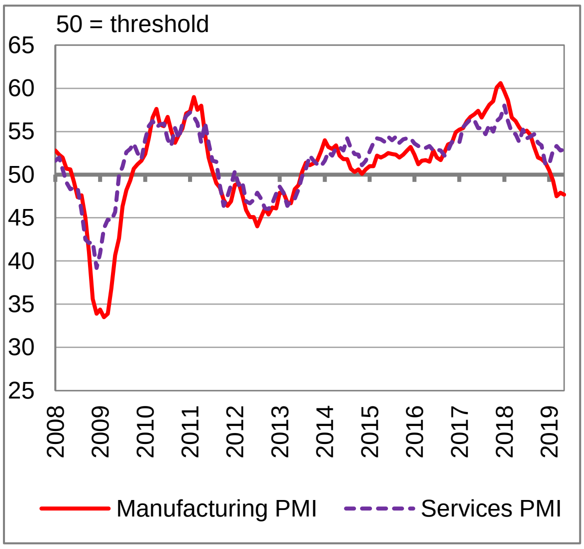


Figure 16: Industrial production contracted in Mar-Apr

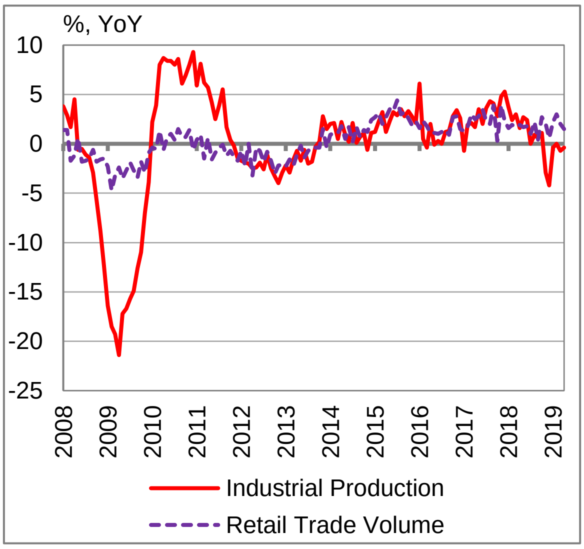


Figure 17: Inflation rate remains subdued

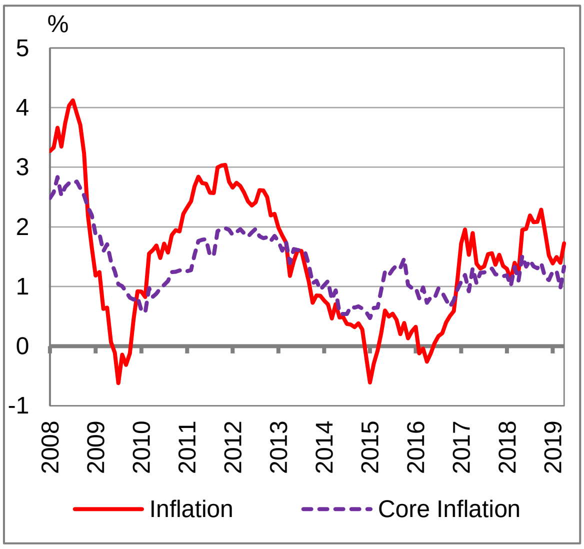
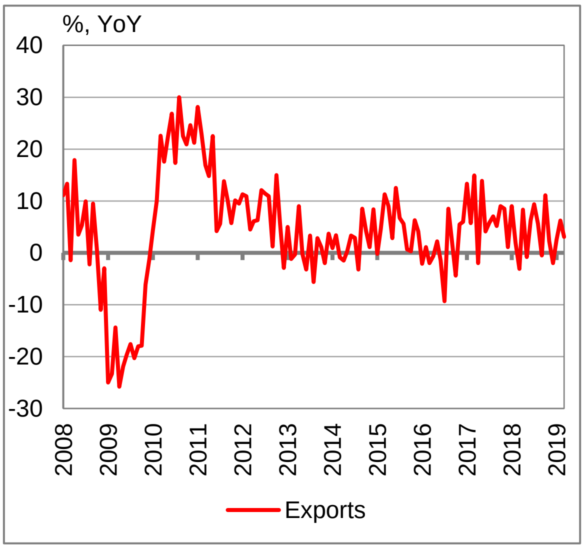


Figure 18: Exports clouded by potential trade conflicts with the US



Source: Markit; Eurostat

Japan: Despite registering two consecutive quarters of GDP expansion (0.6% qoq in 1Q19 and 0.5% in 4Q18), the coming quarterly results may not continue the trend as growth in first quarter was driven by falling imports and industrial production remained weak. The incoming data have not shown favourable growth in the second quarter.

Figure 19: The leading gauge of economic growth suggests moderation ahead

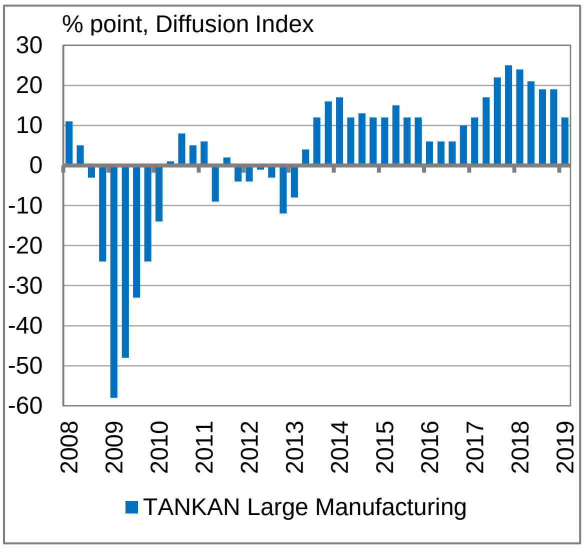


Figure 20: April's industrial production growth contracted for third consecutive month; retail sales growth eased to 18-month low in April

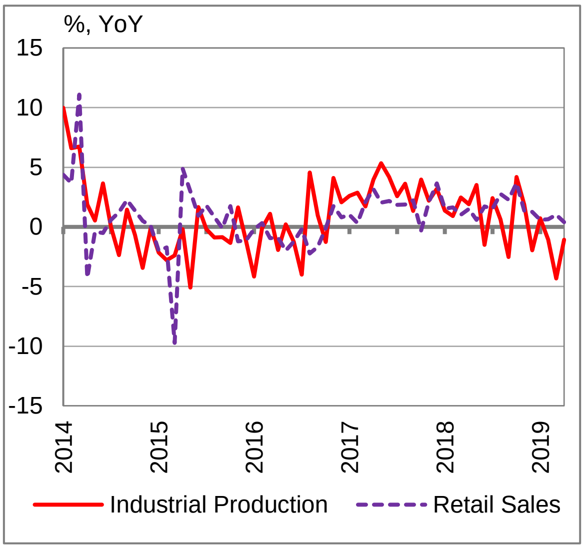


Figure 21: Inflation rate continues to stay below 1%

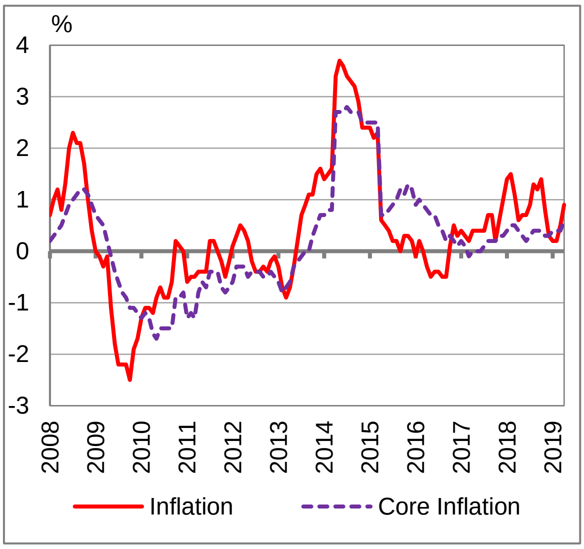
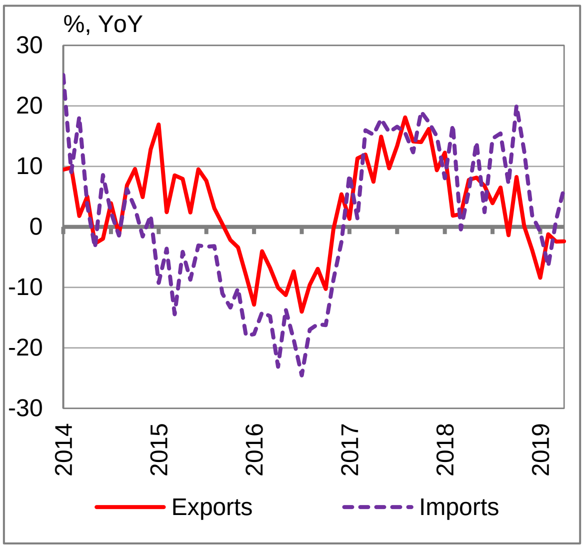


Figure 22: Exports still mired in contraction mode, albeit smaller



Source: Bank of Japan (BOJ); Ministry of Economy, Trade and Industry (METI), Japan; Japan Customs; Statistics Bureau, Japan

China: The economy expanded steadily by 6.4% yoy in 1Q19, thanks to the monetary easing and fiscal stimulus effect. Nevertheless, with the new round of higher trade tariffs to 25% from 10% on US$200 billion of Chinese goods on 10 May and potentially another US$300 billion of China products add to the list of new tariffs imposition, this poses larger downside risks to the economy amid still not strong domestic demand.

Figure 23: Manufacturing PMI reverses into contraction in May

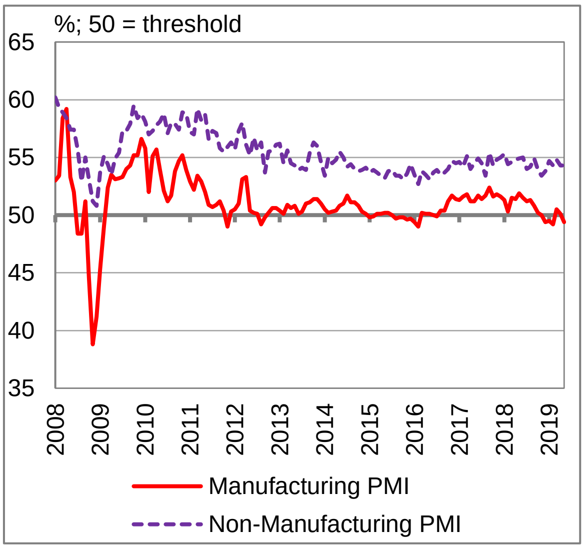


Figure 24: Growth of industrial production and retail sales continued on downward trend

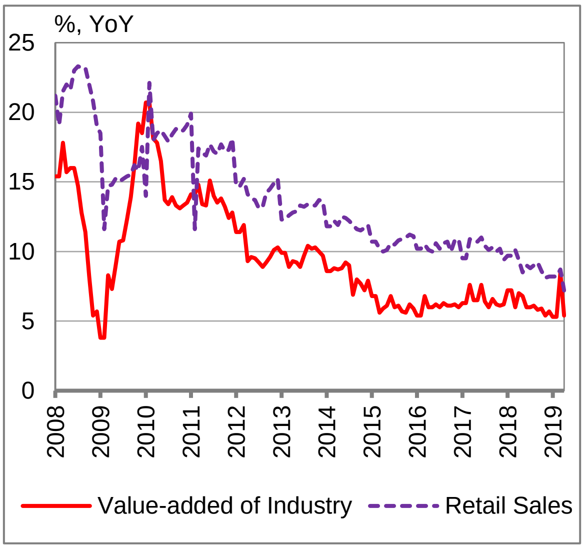


Figure 25: Fixed assets investment growth remained broadly stable

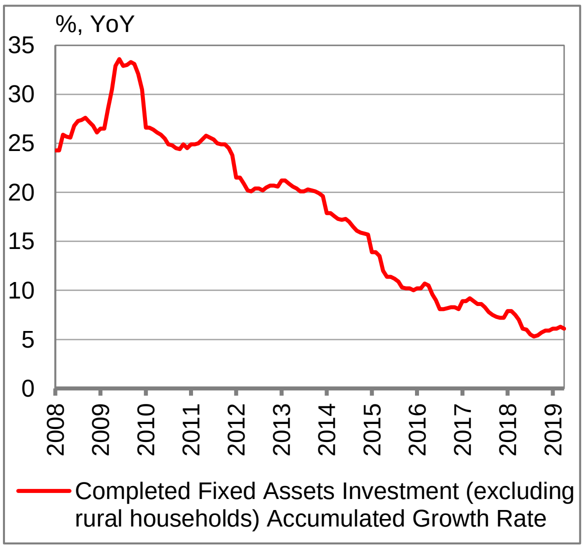
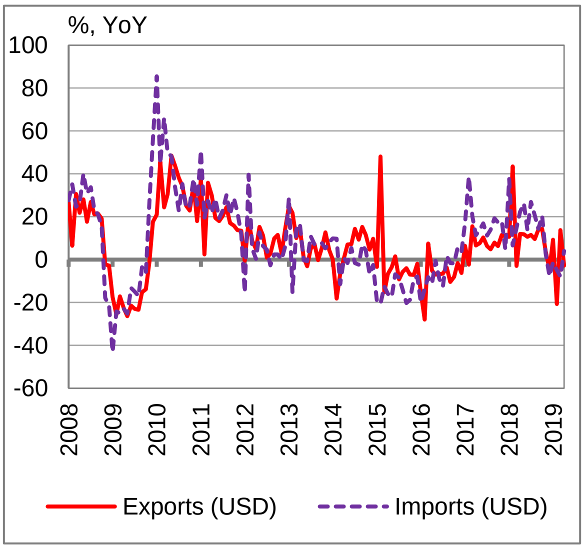


Figure 26: Uneven export growth, undermined by a prolonged trade spat

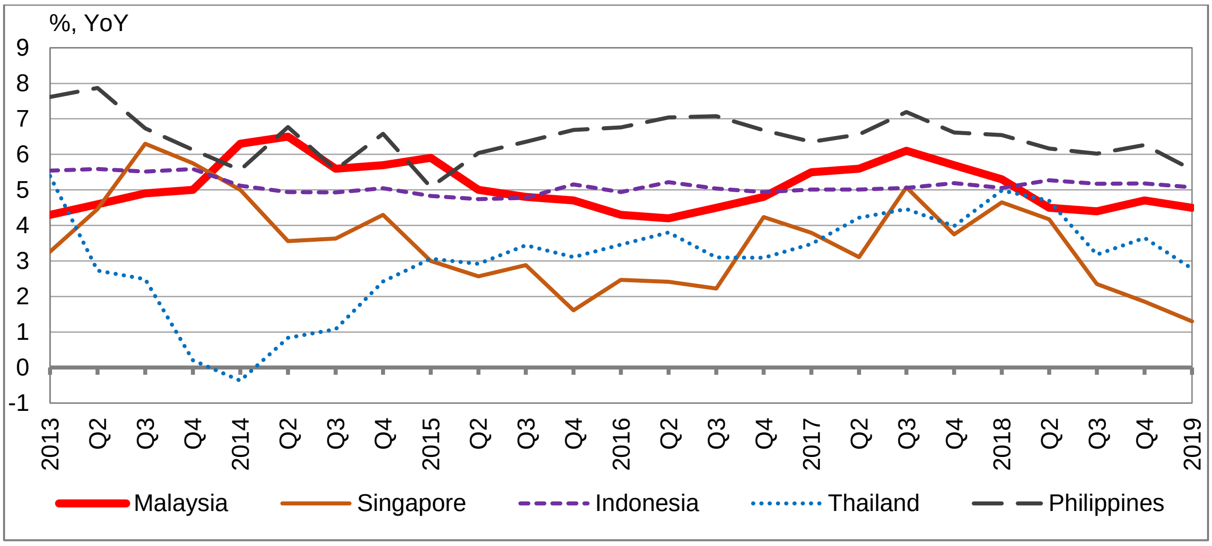


Source: National Bureau of Statistics of China; General Administration of Customs, China

ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

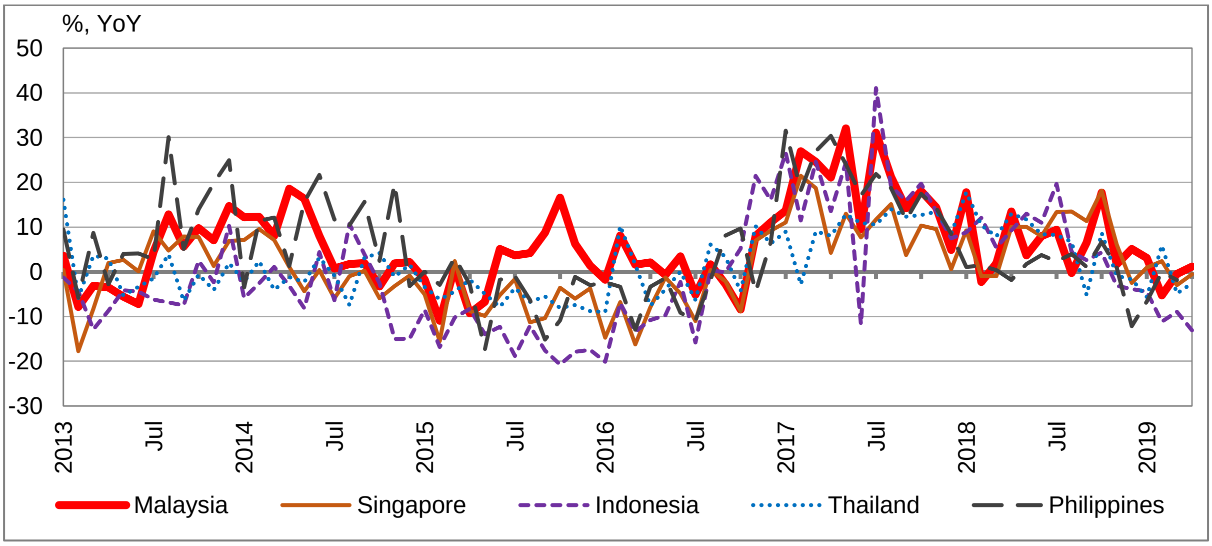
ASEAN-5 economies (Malaysia, Singapore, Indonesia, Thailand and the Philippines) have slowed down in syncrohnisation in 1Q19, albeit at a different speed. Export growth also affected unevenly by the on-going trade conflicts given the region's integration of supply chains though some have benefitted from the trade diversion in the short-term. Industrial production growth also grew unevenly. On the monetary policy perspective, Malaysia and Philippines have lowered their interest rate in May on wary about the risk of a global economic slowdown and the spillover effects of trade tensions on domestic economy.

Figure 27: Real GDP growth trend



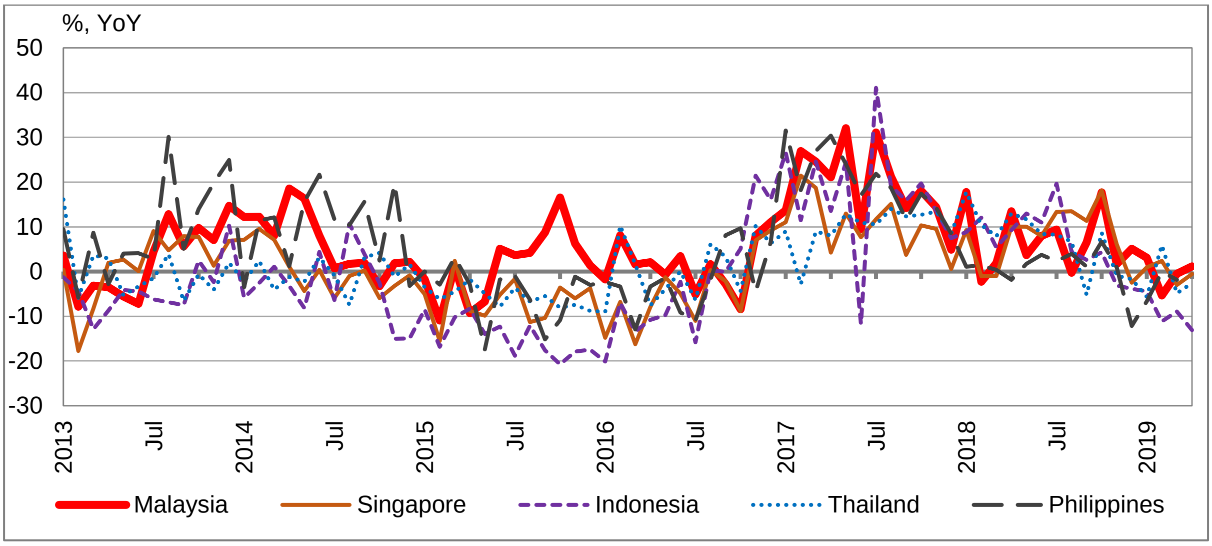
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 28: Export growth trend



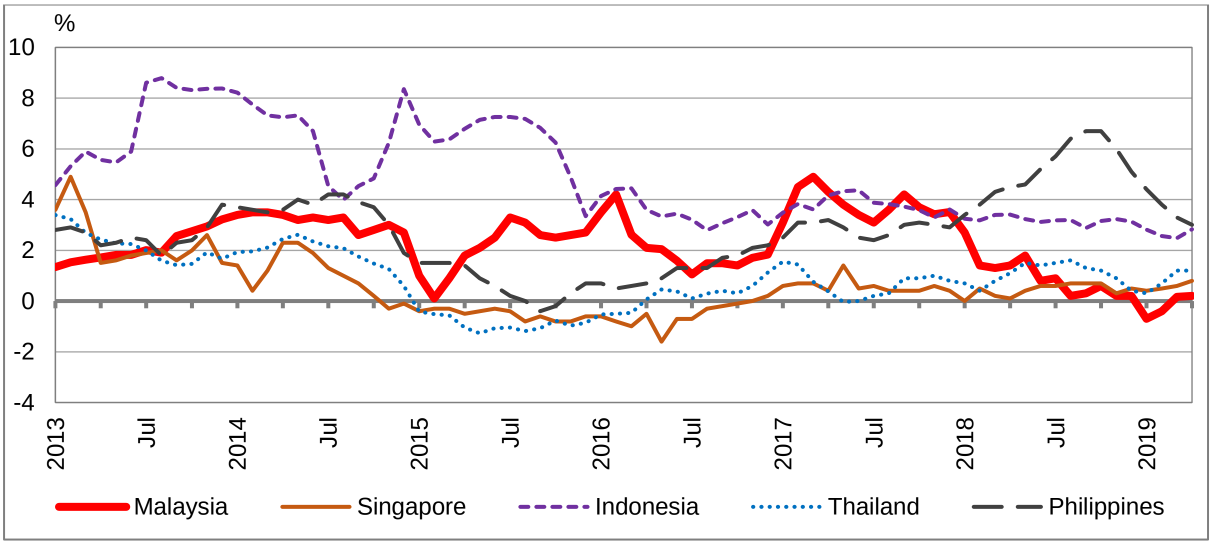
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

Figure 29: Industrial production growth trend



Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Office of Industrial Economics, Thailand; Philippine Statistics Authority

Figure 30: Inflation trend



Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Bank Indonesia; Ministry of Commerce, Thailand; Philippine Statistics Authority

MALAYSIA'S ECONOMIC AND FINANCIAL CONDITIONS

Real GDP growth slowed to 4.5% yoy in 1Q19. Moderate global economic expansion, weaker exports as well as slower pace of domestic demand weighed on Malaysia's economic growth in 1Q. Real GDP growth grew at a slower rate of 4.5% in 1Q (4.7% in 4Q18).

1Q19 GDP marks a weak domestic demand undertone (4.4% in 1Q19 vs. 5.7% in 4Q18), especially **private investment growth**, which has slowed to 0.4% in 1Q19 from 5.8% in 4Q18, the slowest pace in 2010s. The sharp pullback in private fixed capital spending is worrisome as private investment is critical for sustaining our economic growth on a sustained basis, raise productivity, create high income jobs and increase exports. **Private consumption also paced slower** to 7.6% in 1Q from 8.4% in 4Q18 as consumer spending continues to normalize post the 3-month tax holiday.

Bank Negara Malaysia (BNM) expects the Malaysian economy to remain broadly sustained this year amid a continued challenging global environment. Continued expansion in domestic demand and moderate exports growth would continue to support overall economy. BNM keeps this year's GDP growth estimate at 4.3%-4.8% amid cautioned that risks to growth remain tilted to the downside.

SERC maintains GDP growth estimate at 4.5%-4.7% in 2019. Looking ahead, real GDP growth is expected to grow by between 4.5% and 4.7% in the remaining quarters as external environment still impaired by the escalation of trade war. On the domestic front, cautious business and consumer sentiments would continue to weigh on private spending. SERC maintained this year real GDP growth estimate of 4.5%-4.7% (4.7% in 2018).

Weak data for April suggests that economic growth will continue to expand, albeit moderately in 2Q. Retail sales, industrial production, exports and banking system loans all registered positive growth.

Sustained consumer spending holds the key. The factors supporting continued households' consumption are: Stable labour market condition (unemployment rate at 3.3-3.4%) and continued wage growth as well as Cost of Living Aid (Bantuan Sara Hidup (BSH)). The second payment of BSH totalling RM1.42 billion was disbursed on 28 May, benefiting 3.6 million household (together with 3.23 million children of BSH recipients). Amid volatile global crude oil prices, RON95 petrol price is being kept unchanged at RM2.08 per litre, involving an estimated total subsidy amount of RM758.8 million between 24 April and 14 June. Indications are that the Government has deferred the roll out of targeted fuel subsidy, which is scheduled to be implemented in June.

Private investment on watch. Malaysia's private investment growth has displayed weakening trend in recent years. Private investment's momentum had moderated from 12.1% pa in 2011-15 to 5.9% pa in 2016-18. It pulled back sharply to 0.4% in 1Q19 from 5.8% in 4Q18 (4.3% in 2018 vs 9.0% in 2017). Private investment indicators were mixed: sales of commercial vehicles contracted by 9.3% in April though narrowed from -14.9% in 1Q19. Imports of capital goods turned around to grow by 5.7% in April compared to a sharp decline of 9.8% in 1Q.

Investors' cautiousness about capital spending was due to unsettling uncertainties surrounding external environment, especially the US-China trade tensions and wary about domestic policy landscape.

While the intensifying trade spat between the US and China provides an opportunity for Malaysia to attract the relocation of production bases from China and the US, our regional peers such as Vietnam, Thailand and Indonesia are stepping up the plate to woo FDI.

In 1Q19, a total of RM53.9 billion of investment was approved, largely lifted by a robust growth of 126.8% yoy in manufacturing sector (47.1% of total approvals), of which notable foreign participation investments were from the US (Micron Technology and Jabil Circuit) as well as XSD International Paper from China. While approved foreign participation investment jumped 73.4% to RM29.3 billion (54.4% of total approvals), approved domestic direct investment declined significantly by 30.5% to RM24.6 billion (45.6% of total), reflecting a weak domestic business confidence.

In the first four months of 2019, a total of RM17.1 billion GST and income tax refund has been made (RM9.5 billion for GST refund, RM5.2 billion on corporate tax refund and RM2.4 billion for non-corporate – mainly individual income tax refund). It is expected to inject some dynamism to the market in terms of capital investment and household consumption.

Exports to grow unevenly. While exports have turned positive to grow by 1.1% yoy in April after two consecutive months of contraction, we continue to stay cautious about the outlook of Malaysia's exports, particularly in the second half-year, with a long hinging on the US-China trade deal that is proving elusive so far. With trade tensions escalating to the next level of more and higher tariffs, it could further dent business and financial market sentiment, slowing investment and trade.

In May-June, exports could see better annual growth, partly aided by relatively low exports level a year ago. Broadly, the performance of major export products, namely the electronics and electrical products, chemicals and chemical products, metal products and palm oil continued to remain moderate. We see downside risk to our current export growth estimate of 3.3% for this year (6.8% in 2018). YTD (Jan-Apr), total gross exports declined marginally by 0.2%.

Headline inflation remains subdued. Malaysia has crawled out from a brief technical deflation as the distortionary effect from the transport prices normalizes. Headline inflation, as measured by the Consumer Price Index (CPI) has remained in positive trajectory for two months in a row (0.2% each in April and March respectively). YTD (Jan-Apr), inflation declined by 0.2% while core inflation up 0.4%, indicating continued domestic demand.

The fall in energy prices as reflected in a sustained decline in the price of transport between -7.8% in January and -2.6% in April has pushed inflation down. Food prices also subdued at an average of 1.0% in the first four months.

Bank Negara Malaysia (BNM) expects average headline inflation to be broadly stable for this year compared to 2018. The trajectory of headline inflation will continue to be dependent on global oil prices. Nevertheless, the underlying price pressure is expected to remain moderate, supported by continued expansion in economic activity in the absence of strong demand pressures.

SERC expects headline inflation to average 1.0%-1.5% in 2019 (1.0% in 2018) due to some cost pass-through from domestic cost factors. These include the lapse in consumption tax policy; increase in prices of soft drinks due to soda tax; increase in minimum wage; higher electricity surcharges for businesses; and potential higher increase in food prices.

BNM to keep policy rate steady at 3.00%. Bank Negara Malaysia (BNM) cut the overnight policy rate (OPR) by 25 basis points (bps) to 3.00% on 7 May in a bid to mitigate the economy against the risk of sharper economic slowdown. Looking ahead, the central bank will remain focus to ensure financial stability and the provision of credit facilities at reasonable rate to support business and consumer spending.

SERC expects BNM to keep the monetary arsenal for now while continue to assess the impact of interest rate cut on domestic demand amid keeping close monitoring the on-going trade war's spillover effects on investment and trade. We maintain our OPR estimate at 3.00% by end-2019 (3.25% at end-2018).

Headwinds seen continuing weighing on the ringgit. For the period 1 Jan-14 Jun 2019, the ringgit had depreciated against major and regional currencies: Thai baht (4.9%), Japanese yen (2.6%), Philippine peso (2.0%), Indonesian rupiah (1.7%), Indian rupee (1.1%), Hong Kong dollar (0.8%), US dollar (0.7%), pound sterling (0.6%), Vietnamese dong (0.6%), Singapore dollar (0.5%) and Chinese renminbi (0.1%). However, the ringgit appreciated against South Korean won (5.7%), New Taiwan dollar (2.4%), Australian dollar (1.6%) and euro (0.8%).

The ringgit has succumbed to downward pressure against the US dollar in late May and early June due to a confluence of negative sentiments: Concerns over heightened uncertainty of the US-China trade tensions and potential widespread to involve more countries; investors' uneasiness about FTSE Russell putting Malaysia on a watch list of fixed income markets for a review of potential downgrade to "1" from "2" currently, which would render Malaysia ineligible for inclusion in FTSE World Government Bond Index (WGBI) on 1 September; and the US Treasury places Malaysia in the US Treasury's Monitoring List.

Malaysia put on the US Treasury's Monitoring List. In the latest semi-annual currency report, the US Treasury Department has added Malaysia in the Monitoring List of the US's major trading partners that accounts for a large and disproportionate share of the overall US trade deficit.

Malaysia meets two of the three specific criteria to identify where potentially unfair currency practices or excessive external imbalances may be emerging that could weigh on the US trade balance. The two criteria set are (1) exceeding the threshold of US$20 billion of trade surplus with the US; and (2) 2% of current account surplus over GDP.

The US Treasury report indicated that Malaysia recorded a bilateral trade surplus with the US of US$27 billion and having a current account surplus of 2.1% of Malaysia's GDP in 2018. However, the Treasury's assessment clearly indicates that there is no compelling evidence to show that Malaysia uses the exchange rate as a weapon to gain trade competitiveness advantage. The ringgit exchange rate is market-driven and Bank Negara Malaysia only resorts to foreign exchange intervention to avoid excessive volatility of the ringgit, especially during the occasions of wide swings in capital flows.

The exchange rate variability is influenced by both the flows of trade and services in the current account and a two-way capital flows in the financial account. Hence, it's the large swings in capital flows that caused the ringgit to experience volatility.

In reality, Bank Negara Malaysia had compelled to intervene sporadically to smoothen the ringgit's movement either on the depreciation or appreciation side, ensuring an orderly foreign exchange market. A rapid depreciation of the ringgit exchange rate would amplify capital outflow pressures and destabilise domestic economic and financial stability.

Bank Negara Malaysia's press statement stresses that Malaysia adopts a floating exchange rate regime. The fact that the ringgit has over the years faced multiple episodes of significant appreciation and depreciation points to the flexibility of the exchange rate.

The central bank goes further to reiterate that Malaysia supports free and fair trade, and does not practice unfair currency practices. The ringgit exchange rate is not relied upon for exports competitiveness. Any intervention is limited to ensuring an orderly market and avoiding excessive volatility of the exchange rate that may affect macroeconomic stability.

The US Treasury argument for putting Malaysia on the Monitoring List seemed to be based on economic generalisation and interpretation of Malaysia's bilateral trade surplus with the US. Malaysia's current account surplus is the outcome of better economic management, exports and products diversification as well as maintaining a good balance between national investment and savings.

Overall, we think that the US Treasury has no strong compelling arguments and basis to warrant further action in labelling Malaysia as a currency manipulator in its next report in 4Q19.

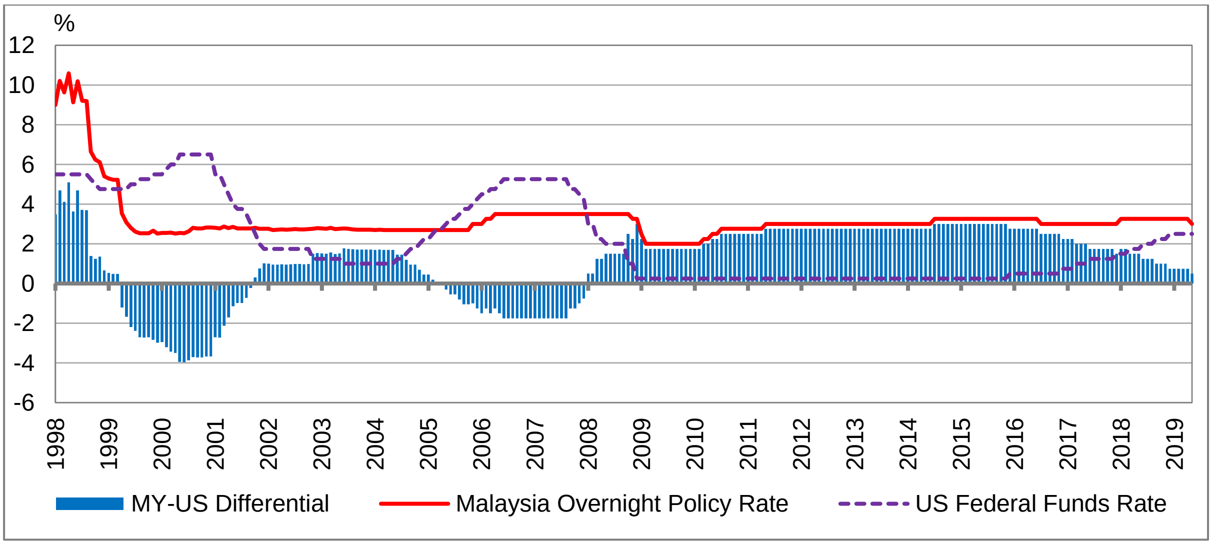
Table 3: Real GDP growth (% YoY)

Economic Sector [% share to GDP in 2018]	**2017**	**2018**	**2018 Q3**	**2018 Q4**	**2019 Q1**	**2019*E* (BNM)**	**2019*E* (SERC)**
By economic sector							
Agriculture [7.3%]	5.7	0.1	-0.8	-0.1	5.6	2.8	1.8
Mining & Quarrying [7.6%]	0.4	-2.6	-5.7	-0.7	-2.1	0.8	0.5
Manufacturing [22.4%]	6.0	5.0	5.0	4.7	4.2	4.8	4.5
Construction [4.9%]	6.7	4.2	4.7	2.6	0.3	3.0	4.4
Services [56.7%]	6.2	6.8	7.3	6.9	6.4	5.7	5.8
By expenditure approach							
Private Consumption [57.0%]	6.9	8.0	8.9	8.4	7.6	6.6	6.8
Public Consumption [12.5%]	5.5	3.3	5.2	4.0	6.3	1.2	1.8
Private Investment [17.3%]	9.0	4.3	5.0	5.8	0.4	4.9	4.3
Public Investment [7.4%]	0.3	-5.0	-2.7	-5.9	-13.2	-7.1	-4.8
Exports of Goods and Services [67.6%]	8.7	2.2	0.7	3.1	0.1	0.1	1.5
Imports of Goods and Services [60.6%]	10.2	1.3	2.0	1.8	-1.4	0.0	1.3
Overall GDP	**5.7**	**4.7**	**4.4**	**4.7**	**4.5**	**4.3-4.8**	**4.5-4.7**

Source: Department of Statistics, Malaysia; Bank Negara Malaysia (Annual Report 2018); SERC

Bank Negara Malaysia (BNM) cut the overnight policy rate (OPR) by 25 basis points (bps) to 3.00% in May in a bid to mitigate the economy against the risk of sharper economic slowdown. The gap between the Fed Funds Rate and OPR has been narrowing to a mere 50 bps currently from 75 bps in 2018.

Figure 31: Malaysia-US's interest rate differentials



Source: Bank Negara Malaysia; Federal Reserve

REVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

Leading indicators and Industrial production

Malaysia's economic growth is anticipated to ease in 3Q19 as indicated by the leading index (LI), albeit the negative annual change of LI has improved in March. In April, industrial production growth, a proxy of overall economy suggests continued economic growth. Mining output turned around to increase by 2.3% yoy in April (-1.9% in 1Q19) while growth in the manufacturing sector sustained at 4.3% (4.0% in 1Q19).

Figure 32: Leading index suggests easing of growth in 3Q

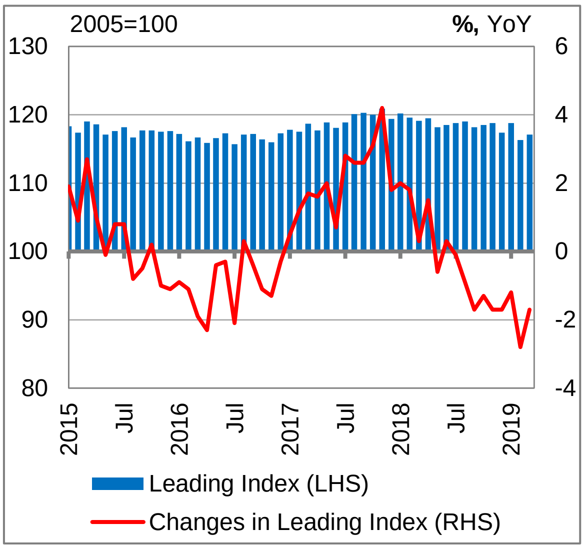
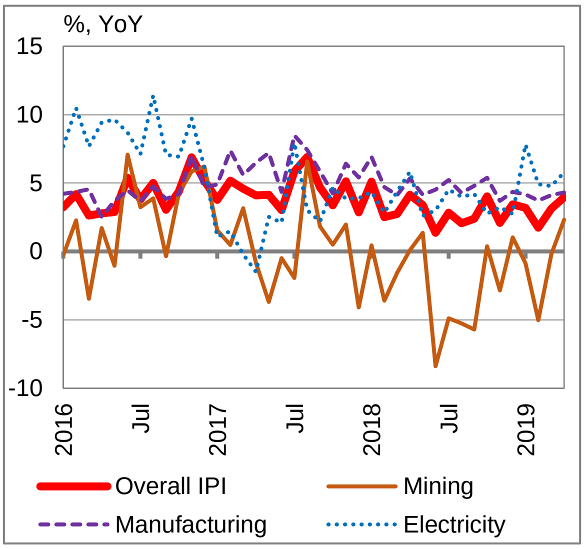


Figure 33: Industrial production growth sustained in April (4.0% vs. 2.7% in 1Q19), thanks to a rebound in mining output



Source: Department of Statistics, Malaysia

Exports; Manufacturing sales and Distributive trade

Exports reverted to positive trajectory in April (+1.1% yoy) after two consecutive months of contraction. Prospects are likely to remain challenging in the remaining months due to slowing global trade growth, continued adjustment in the semiconductor industry and escalating trade tensions between the US and its major trading partners. Manufacturing sales continue to grow higher in April (6.8% yoy vs. 6.1% in 1Q19). Retail sales recorded the lowest growth of 6.3% in April since Sep 2015. As wholesale trade growth rebounded slightly to 5.3%, this may help retail sales in the months ahead.

Figure 34: Cautious export growth

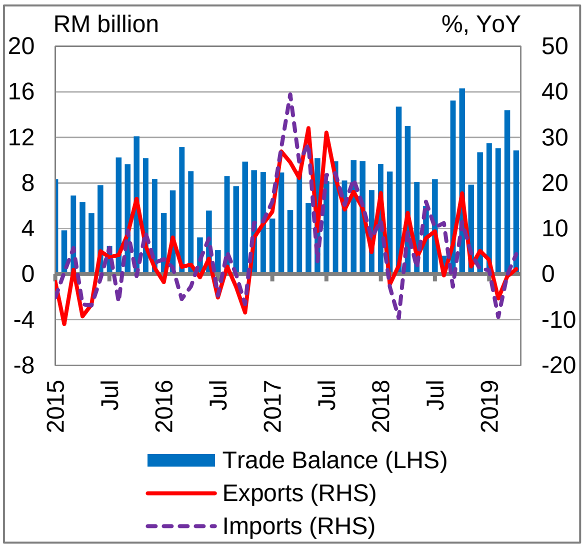


Figure 35: Electrical and electronic products as well as commodities paced unevenly and moderately

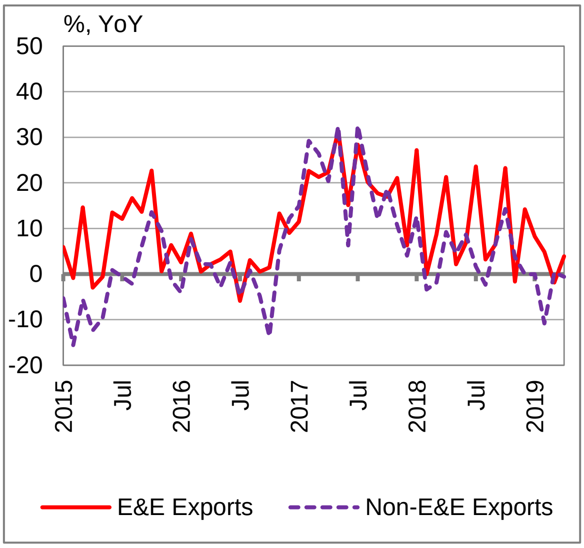
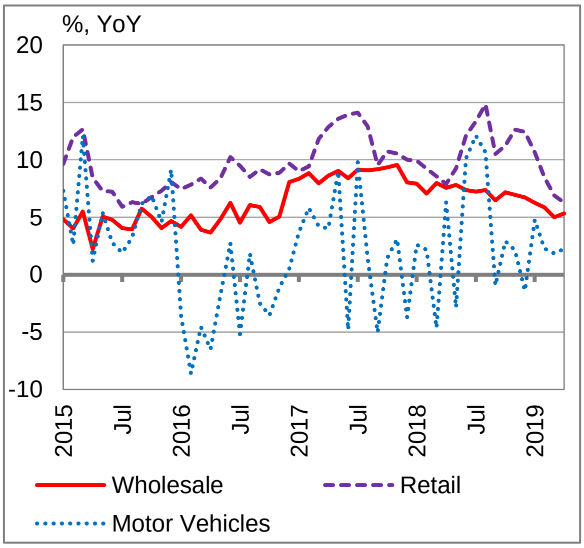


Figure 36: Manufacturing sales value improved in April

Figure 37: Retail sales growth continues to moderate



Source: Department of Statistics, Malaysia

Private consumption indicators

Consumer spending remains on track, aided by continued payment of Cost of Living Aid (BSH), higher minimum wage and festive celebration in June. Buying interest in passenger cars continues, backed by the launching of new car models. Money supply and consumption credit continued to ease but imports of consumption growth soared in April. Overall, private consumption is expected to grow by 6.8% this year (8.0% in 2018).

Figure 38: Passenger car sales recorded growth for four straight months since Jan 2019

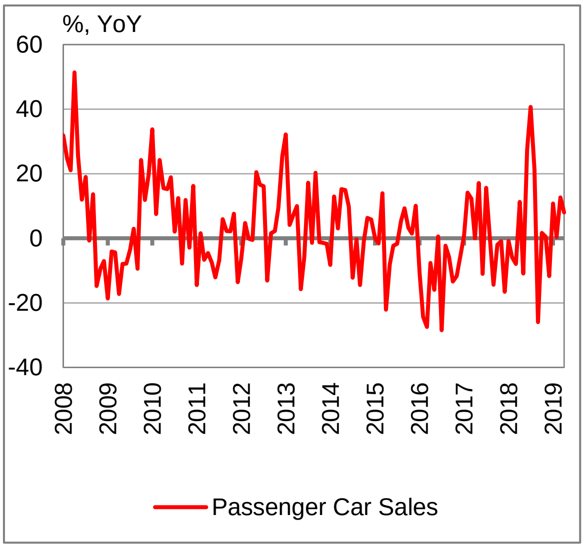


Figure 39: Selected private consumption indicators

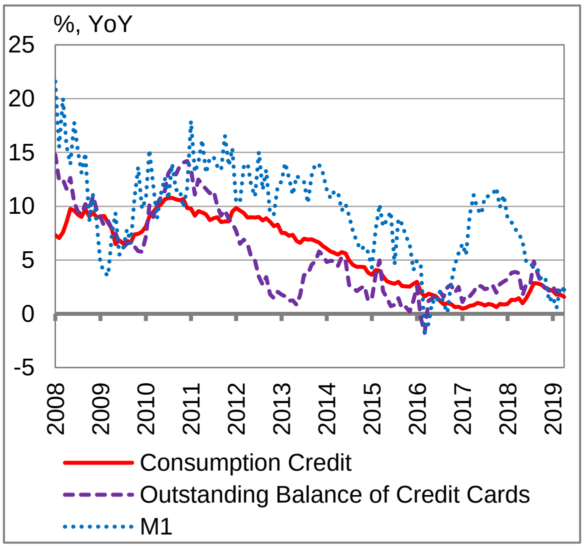


Figure 40: Higher minimum wage did not translate into significant pay-out growth

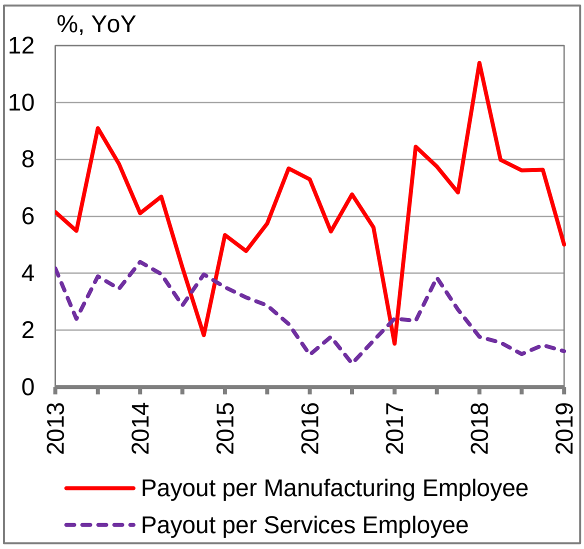
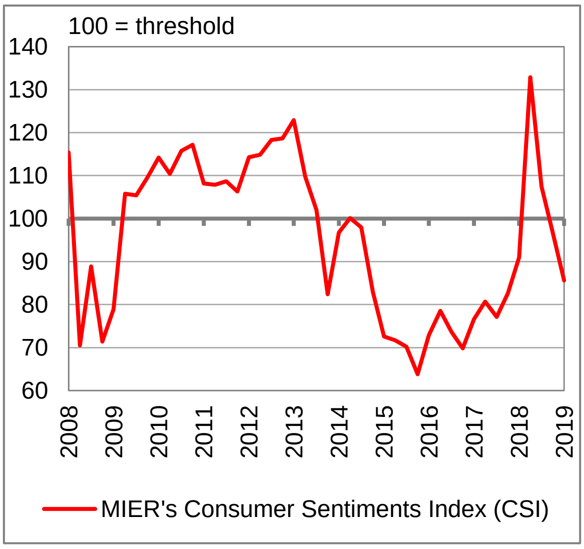


Figure 41: Consumer sentiments turned pessimistic again



Source: Department of Statistics, Malaysia; Malaysian Institute of Economic Research

Private investment indicators

Private investment seems improving with imports of investment goods turned around to grow by 5.7% yoy in April from a sharp decline of 9.8% in 1Q19. Imports of intermediate goods grew robustly by 20.3% in April vis-à-vis a flat growth in 1Q. Commercial vehicles sales declined by 9.3% in April, albeit narrower compared to -14.9% in 1Q19.

In 1Q19, a total of RM53.9 billion of investment was approved, lifted by a robust growth of 126.8% yoy in manufacturing sector, of which notable foreign participation investments were from the US (Micron Technology and Jabil Circuit) as well as XSD International Paper from China. While approved investment with foreign participation jumped 73.4% to RM29.3 billion (54.4% of total approvals), approved domestic direct investment dropped significantly by 30.5% to RM24.6 billion (45.6% of total), reflecting a weak domestic business confidence. With heightened uncertainty in external environment and cautious business sentiment, private investment is expected to grow moderately by 4.3% in 2019 (4.3% in 2018).

Figure 42: Selected private investment indicators

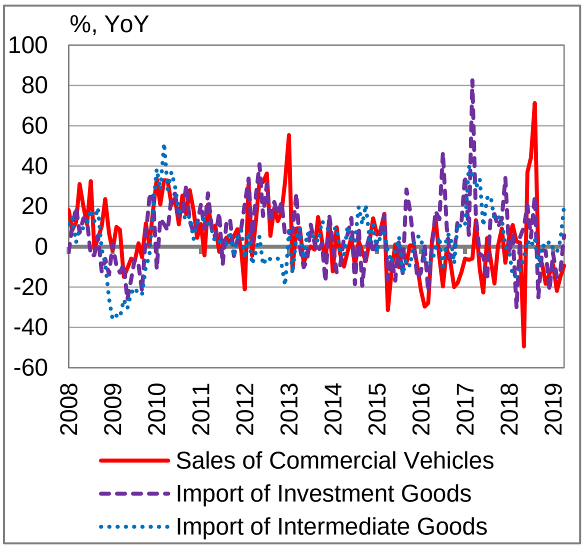


Figure 43: Real private investment trend

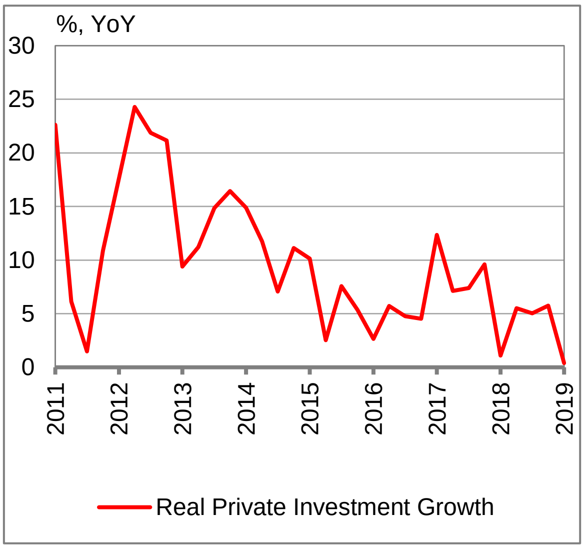


Figure 44: 38% of manufacturing companies reported production close to full capacity in 1Q19 (32% in 4Q18)

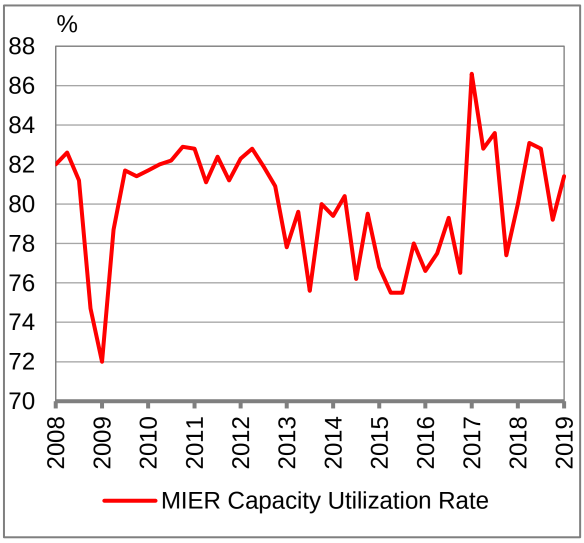
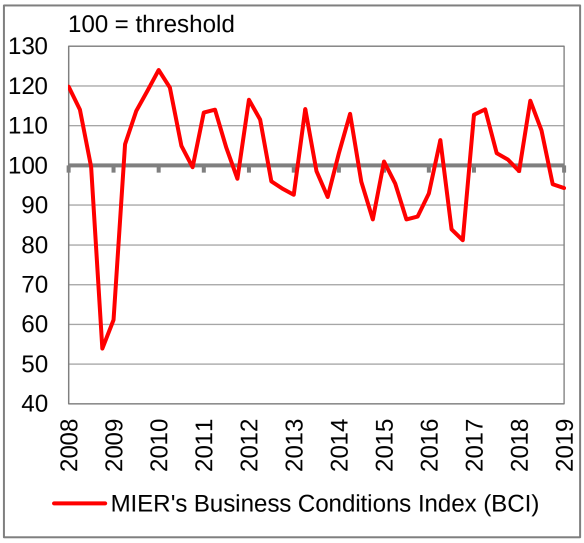


Figure 45: Overall business conditions deteriorated



Source: Department of Statistics, Malaysia; Malaysian Institute of Economic Research

Price indicators

After two successive months of negative inflation in January and February, overall price level has returned to positive trajectory with small increases of 0.2% each in March and April respectively, mainly due to a smaller decline in transportation prices. Excluding the effect of consumption tax policy, core inflation has remained at 1.6% for three straight months since February.

SERC expects headline inflation to average 1.0%-1.5% in 2019 (1.0% in 2018) due to some cost pass-through from domestic cost factors and normalisation of the effect of consumption tax change. These include the lapse in consumption tax policy; increase in minimum wage, higher electricity surcharges for businesses; increase in soda tax on soft drinks and potential higher increase in food prices.

Figure 46: Inflation returned to positive trajectory in March and April

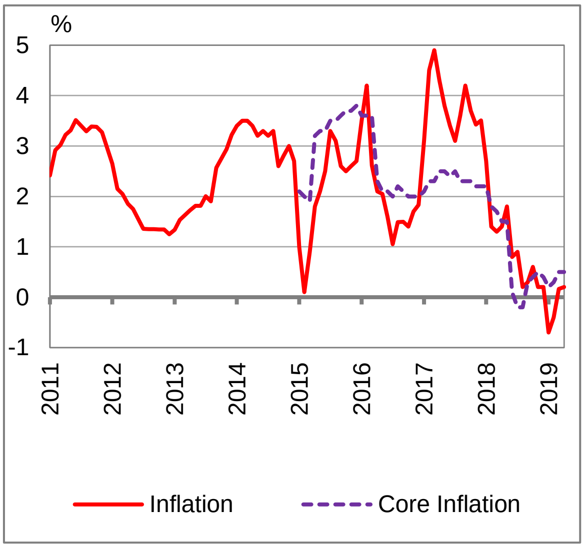
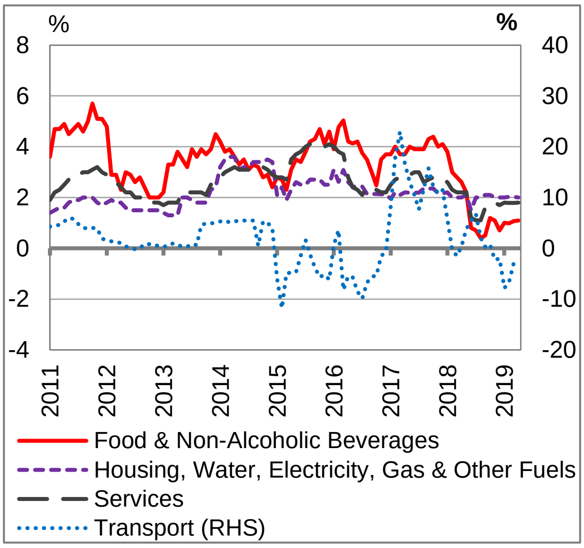


Figure 47: Price level for most goods will be normalised comes June



Source: Department of Statistics, Malaysia

Banking loan indicators

Growth in total outstanding loans extended by banking system moderated to 4.5% in April (4.9% in 1Q19). Business loans paced slower (3.2% vs. 4.1% in 1Q) while households loan increased by 5.2% (5.3% in 1Q). Loan repayment growth outpaced that of loan disbursements though loan disbursements of RM101.6 billion in April was significantly higher than monthly average of RM93.0 billion in 2014-18.

Figure 48: Business loan growth slowed to 3.2% in April, reflecting lower loan demand across many sectors

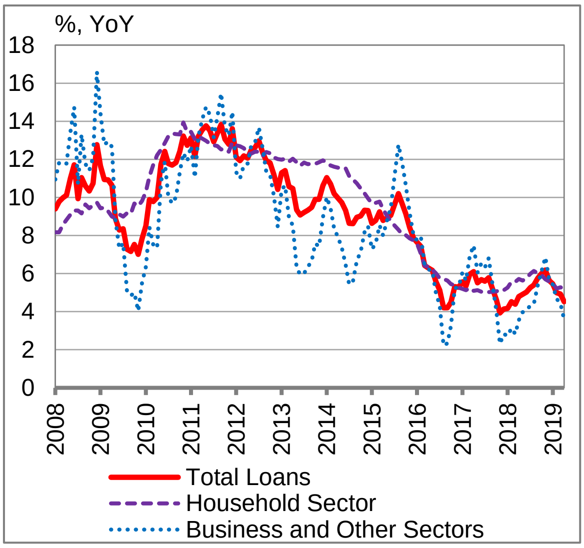


Figure 49: Loan applications growth

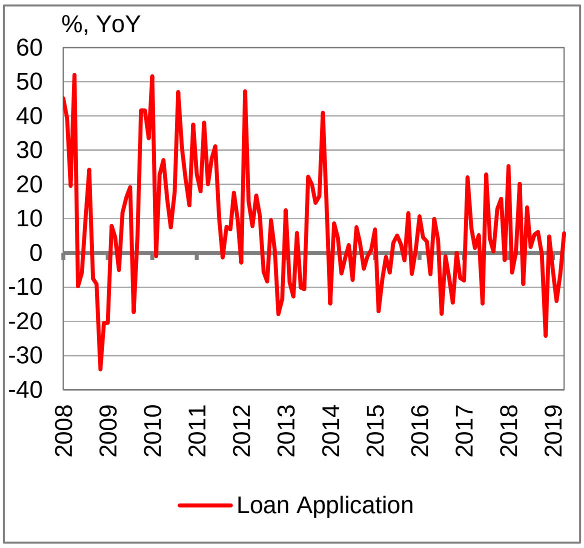


Figure 50: Loan approvals growth

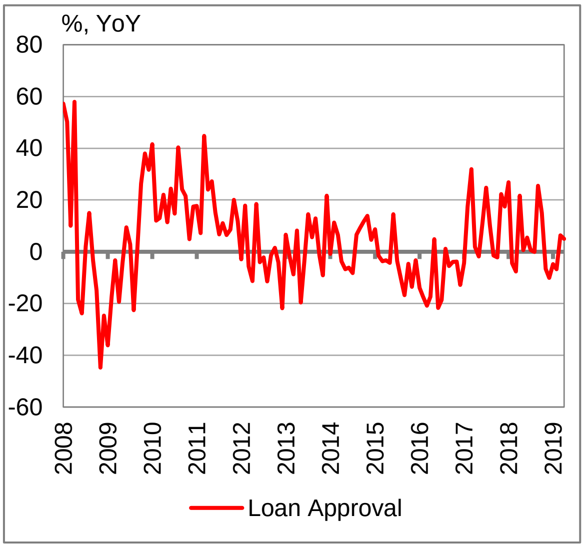
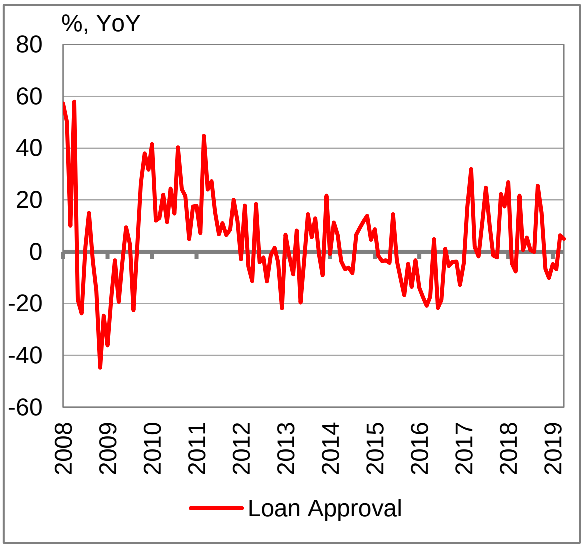


Figure 51: Loan disbursements growth



Source: Bank Negara Malaysia

Financial indicators

Foreign reserves slid by 1.1% or US$1.1 billion to US$102.3 billion as at end-May 2019 from US$103.4 billion as at end-April, but still sufficient to finance 7.3 months of retained imports and is 1.1 times of total short-term external debt.

In Apr-May, foreigners had made a net selling of RM12.6 billion of government debt securities (MGS, GII, T-bills and Islamic T-bills), resulting in the ownership of MGS dropping to 35.8% as at end-May 2019 (38.7% at end-March, lowest since Nov 2011) as the potential risk of exclusion from the World Government Bond Index (WGBI) has weighed down sentiments in the domestic bond market. In addition, foreign investors have sold a net total of RM5.9 billion of equities in Feb-May on uncertainties over the global economic environment. The sustained net outflows of foreign portfolio capital in both equity and bonds markets have taken a toll on the ringgit, which has depreciated by 1.4% against the greenback in the first five months.

As of 14 June, the weaken ringgit regained some ground to down by just 0.7% to RM4.1685/US$ compared to RM4.1385/US$ as at end-Dec 2018 (RM4.1970/US$ at end-May and RM4.0810/US$ at end-Mar 2019). The fundamental factors like the projected continued economic growth, current account surplus and still-ample foreign reserves would continue to support the ringgit. The ringgit is estimated at RM4.00-RM4.15 per US dollar by end-Dec 2019.

Figure 52: International reserves slid by US$1.1 billion in May

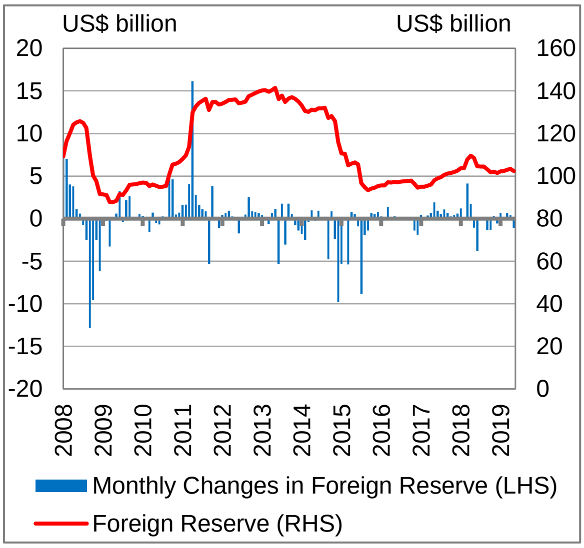


Figure 53: Ringgit's effective exchange rate

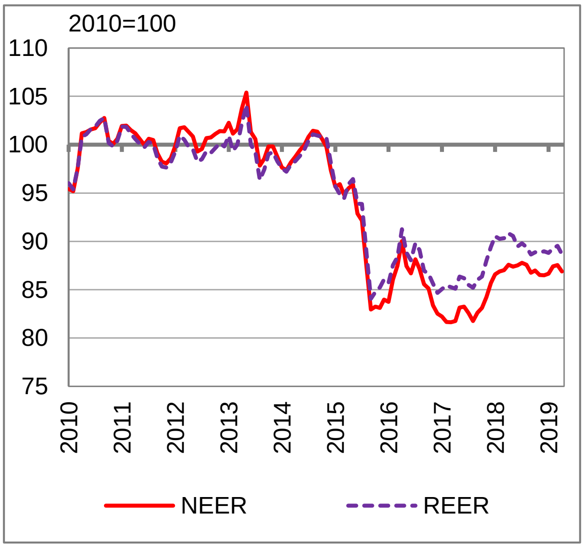


Figure 54: Ringgit against major foreign currencies

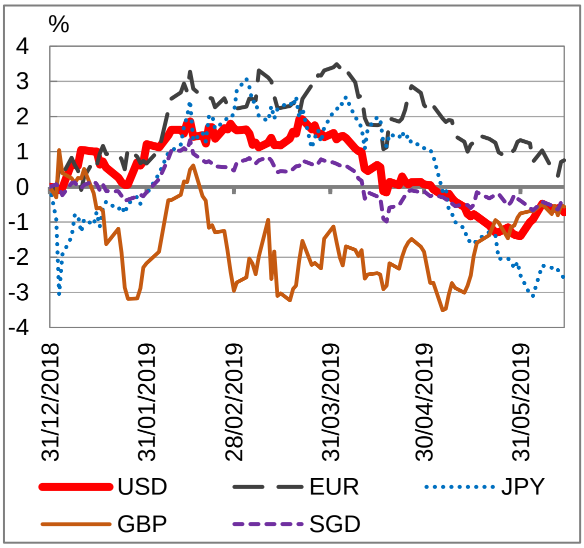
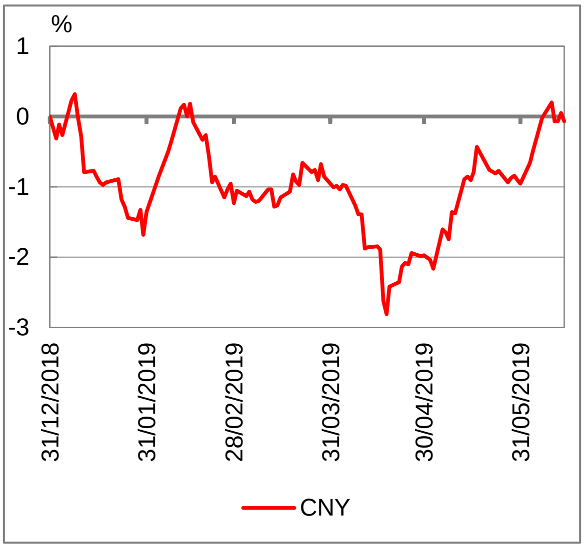


Figure 55: Ringgit against Chinese renminbi



Source: Bank Negara Malaysia; Bank for International Settlements

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