QUARTERLY ECONOMY TRACKER

(JUL-SEP 2016)

Socio-Economic Research Centre (SERC)

This research paper was commissioned and funded by ACCCIM SERC Trust and managed by Socio-Economic Research Centre (operating under SERC Sdn. Bhd.).

Socio-Economic Research Centre (SERC)

Executive Director

Mr. Lee Heng Guie - *hglee@acccimserc.com*

Head of Research

Ms. Sum Kum Mooi - *kmsum@acccimserc.com*

Researcher

Mr. Goh Kong Jun - *kjgoh@acccimserc.com*

Mr. Lee Soon Thye - *stlee@acccimserc.com*

Administrative and IT Executive

Ms. Vicki Lai Mun Yee - *vickilai@acccimserc.com*

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Executive Summary

A. GLOBAL ENVIRONMENT

- **Moderate global growth continues amid challenges**. The global economy is still muddling through in a slow and weak mode. While most stock markets and currencies have recouped the losses suffered from post-Brexit turmoil, high-frequency indicators suggest that global growth continues, but at a moderate and uneven pace going into the second half-year of 2016 and in 2017. In its World Economic Outlook (WEO) October report, the International Monetary Fund (IMF) maintained global output growth estimates at 3.1% in 2016 and at 3.4% in 2017, the same as in early July shortly after taking into account the short-and medium-term impact of Brexit on the world economy.
- **Continued growth divergence**. Growth in the United States picked up, albeit still weak in 2Q while the eurozone's economic recovery has lost some steam. Japan's growth nears stalling, prompting more fiscal and monetary stimulus. China's stable growth in 1H16 seems to show some incipient signs of weakness, reinforcing the persistent worries of an "L-shaped" recovery.
- **Ultra-monetary accommodation remains, albeit limited effects**. The persistent slow global growth means that low interest rates and yields will remain depressed for a longer while. Negative interest rates could go deeper for some central banks to avoid growth stagnation and deflation risk. Regional central banks mostly stay on the sidelines with the monetary policy leaning towards easing.
- **Risks to outlook**. Multiple events and uncertainties are still casting a shadow on the global economy and financial markets. 1) The Fed's forward guidance on the US interest rates direction; 2) lingering risks and unresolved issues post the United Kingdom's referendum decision to leave the European Union (Brexit); 3) a disruptive China's economic rebalancing process and the risks of Chinese renminbi devaluation; and 4) the US Presidential election on 8 November.

B. MALAYSIA'S ECONOMIC PERFORMANCE AND OUTLOOK

- **GDP growth may be bottoming out.** After slowing for five consecutive quarters since 2Q15, the Malaysian economy may hit its trough and is bottoming out. Private consumption and investment growth has picked up strength. If the strength of domestic demand continues to sustain at this pace or even stronger, the economy will likely perform slightly better in the second half-year.
- **GDP growth will improve in 2H16.** Real GDP growth is expected to improve in the second half-year, supported by continued strength in private consumption and investment. The improvement of public service schemes, including salary increment costing RM1.0 billion for 1.6 million civil servants and higher minimum wage in July as well as the final instalment payout of BR1M in September should help consumer spending somewhat. Public investment should accelerate further, backed by continued implementation of public transportation-related infrastructure projects.

- **Exports likely to drag but agriculture and mining sectors should improve.** Shrinking trade surplus would remain a drag on GDP. The big drags from agriculture sector, which had slumped in 1H16 is expected to rebound due to the diminishing effect of El Niño. The turnaround in mining output should remain supported by higher oil and gas production, particularly in Sabah. Mining output, as measured by the Industrial Production Index has gained stronger traction in Jun-Jul.
- **GDP growth will gradually resume to higher trajectory.** Two years of economic adjustments starting from 2015 attributable to on-going economic reforms (subsidy rationalisation and the implementation of Goods and Services Tax (GST)) as well as lower oil prices should be gradually normalised in 2H16**.** Real GDP growth is estimated to average 4.2-4.3% in 2H16 compared to 4.1% in 1H, taking the full-year growth to 4.2%.
- **Growth prospects for 2017-18 remain challenging**, with real GDP growth estimating at 4.3-4.6%. With global trade likely to remain soft, the potential for Malaysia to enjoy higher GDP growth rates could come from an economy-wide productivity growth. Domestic demand will remain the principal driver of growth.
- **Inflation trending lower in 2H16.** Headline inflation, which averaged 3.4% in 1Q16 eased to 1.9% in 2Q before reversing gear to edge higher to 1.5% in August from 1.1% in July. This was partly due to smaller declines in transport prices (-6.7% in Aug vs. -9.9% in Jul). Inflation is expected to average 1.7-1.9% in 2H (vs. 2.7% in 1H16), taking the full-year average of 2016 to 2.3-2.4%. Stable inflation outlook (2.4-2.5%) is expected for 2017.
- **Private consumption and investment indicators**. Car sales declined at a much smaller rate of 2.3% yoy in August (-28.5% in July) and jumped 22.8% mom, thanks to longer working month as well as new model launches. Consumption credit remains moderate. Imports of capital goods grew further in August while that of intermediate and consumption goods rebounded after recording sharp declines in July. Loan indicators improved in August, with smaller rate contractions in loan applications and disbursement while loan approvals increased marginally.
- **A prudent growth-oriented 2017 Budget.** The 2017 Federal Budget, to be tabled in Parliament on 21 October should focus on strengthening our economic and financial fundamentals. Amidst global challenges, the government should present a prudent growth-oriented Budget without straying from the fiscal deficit reduction road map. The Ministry of Finance is expected to craft a fiscal deficit target of 3.0-3.1% of GDP for 2017, backed by a projected GDP growth of 4.0-5.0% (2016E: fiscal deficit of -3.1% of GDP; real GDP growth of 4.0-4.5%). Development expenditure allocation for 2017 Budget is estimated at RM45.0-48.0 billion.
- **The Ringgit outlook.** We forecast RM/US$ at 4.15 at end-2016 and RM4.00-4.10 for end-2017**.** YTD, the ringgit gained 3.8% against the US dollar to RM4.1355 as of end-Sep 2016 from RM4.2935 at end-Dec 2015. Uneven global growth, capital flows volatility, diverging monetary policy risks, softer global crude oil prices and the unresolved issues post-Brexit are likely to influence the movement of ringgit over the course of next 12 months.
- **Bank Negara Malaysia (BNM) to safeguard both growth and financial stability.** We expect BNM to adopt a cautious monetary policy, weighing against the impact of external uncertainties on Malaysia's growth prospects while maintaining financial stability. With the expectation of improving economic growth in 2H16, BNM is expected to keep the policy rate steady but keeps door open to easing. The monetary path will be data dependent. BNM must reserve its firepower to counteract against future external shocks. The policy rate is estimated at 3.00% at end-2016 and 2.75-3.00% in 2017.

GLOBAL GROWTH STILL HANGING ON

After a brief post-Brexit shocks, the global economy seems to be hanging in balance, with growth divergence continuing in major advanced and emerging economies. Most stock markets and currencies have crawled back to levels prior to the Brexit. High frequency indicators show global growth continues, albeit at a moderate and uneven pace. Global Purchasing Managers Index (PMI) for manufacturing and services remained in the expansion zone though marginally above the threshold 50-pt expansion level. Global semiconductor sales registered positive annual growth in August for the first time since June 2015.

The US economy is still muddling through as GDP growth edged higher in 2Q. Economic growth in the eurozone seems losing some steam and Japan's growth nears stalling. After stabilizing in 1H16, China's growth indicates some incipient signs of weakness.

The general consensus is that a global recession risk has not risen significantly even after the Brexit's shock. The International Monetary Fund (IMF)'s chief Christine Lagarde commented that while the Britain's shock vote to quit the European Union has injected significant uncertainty into the global economy but is unlikely to cause a world recession. British Prime Minister, Theresa May announced that the triggering of the Article 50 of the Libson Treaty will be done by end-March 2017, marking the start of a two-year exit negotiation process.

In its World Economic Outlook (WEO) October report, the IMF maintained global output growth estimates at 3.1% in 2016 and at 3.4% in 2017, the same as in early July shortly after the United Kingdom's Brexit vote to leave the EU. However, 2016 growth prospects for advanced economies were slightly marked down. Prospects for 2017 are unchanged for both advanced and emerging economies relative to July's update.

Figure 1: Real GDP Growth (% yoy)

	2014	2015	2016 1Q	2016 2Q	2016*e* (IMF)	2016*e* (WB)	2017*f* (IMF)	2017*f* (WB)
United States	2.4	2.6	1.6	1.3	1.6	1.9	2.2	2.2
Euro Area	1.1	2.0	1.7	1.6	1.7	1.6	1.5	1.6
China	7.3	6.9	6.7	6.7	6.6	6.7	6.2	6.5
Japan	0.0	0.5	0.2	0.8	0.5	0.5	0.6	0.5
India	7.2	7.6	7.9	7.1	7.6	7.6	7.6	7.7
Malaysia	6.0	5.0	4.2	4.0	4.3	4.2	4.6	4.3
Singapore	3.3	2.0	2.1	2.1	1.7	-	2.2	-
Indonesia	5.0	4.8	4.9	5.2	4.9	5.1	5.3	5.3
Thailand	0.8	2.8	3.2	3.5	3.2	3.1	3.3	3.1
Philippines	6.2	5.9	6.8	7.0	6.4	6.4	6.7	6.2
Vietnam	6.0	6.7	5.5	5.6	6.1	6.0	6.2	6.3

Source: Various officials; IMF World Economic Outlook (October 2016); World Bank Global Economic Prospects (June 2016); World Bank East Asia and Pacific Economic Update (October 2016)

Note: For India, data based on financial year instead of calendar year for 2014 and 2015.

We concur with the IMF's assessment that the uncertainties associated with Brexit will not cause a global recession. As a weak global growth renders it vulnerable to shocks, policymakers in major advanced and emerging economies must prescribe the right policies to prevent the global growth from falling off the cliff. A worrying trend is the looming threat of deepening deflation in some developed economies given the monetary policy is hitting its limit.

We assign the probability of a global economic recession of 10-20% in a worst case scenario. A global recession is loosely defined as growth below the roughly 2.5% needed for the world economy to keep up with an expanding population.

Global recessions are rare events and often inflicted by a severe demand-side shock due to financial crisis, a steep rise in interest rates or sharp contraction in asset prices, causing massive income/asset deflation.

Over the past half century, only four episodes of global recessions were identified, with each occurring during or around a U.S recession. With the US economy (the world's largest economy contributing 25.1% of world GDP) being the epicentre of global recessions, a close tracking of US economic indicators is highly importance.

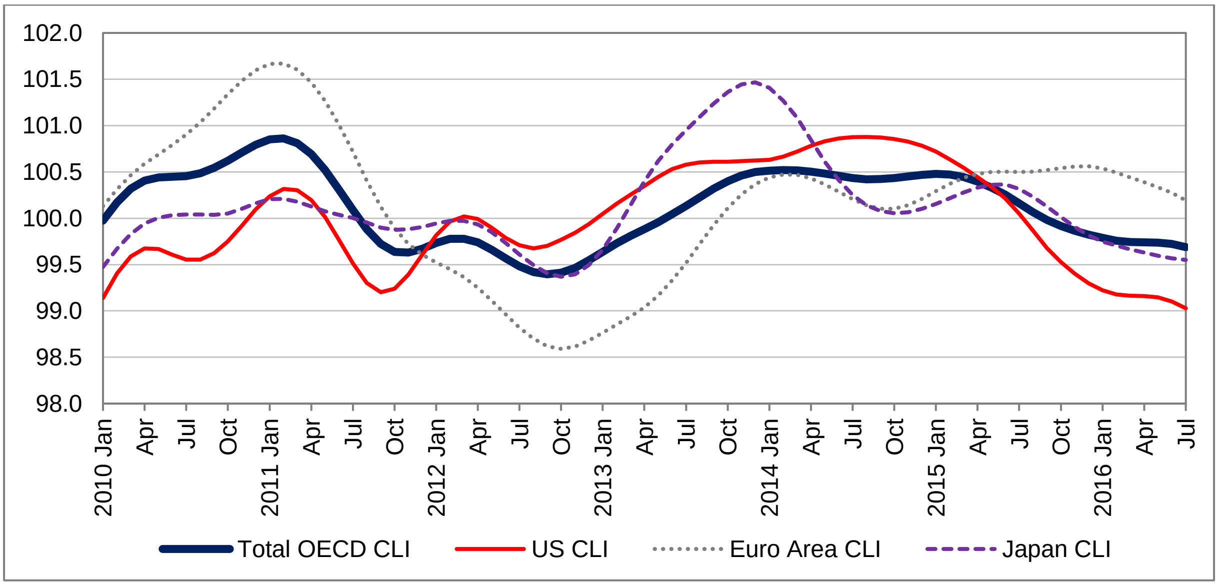
Notwithstanding a mixed bag of economic data, the probability that the US is currently in or about to enter a recession is at most 15% according to available estimates. The Citigroup Economic Surprise Index (CESI), which tracks how economic data are faring relative to expectations indicate that no pressure point is developing. The index rises when economic data exceed economists' consensus estimates and falls when data come in below estimates.

In the current environment of weak growth, the global economy faces risks that could cause a setback in growth. Topping the list is the US Presidential election on 8 November, lingering uncertainties associated with Post-Brexit's negotiation process, stagnation in some advanced economies, sharp changes in financial market sentiment triggered by continued divergence in monetary policy, a disruptive China's economic rebalancing process, geopolitical risks and concerns about the effectiveness of monetary policy in spurring stronger growth.

A. SNAPSHOT REVIEW OF KEY GLOBAL ECONOMIC INDICATORS

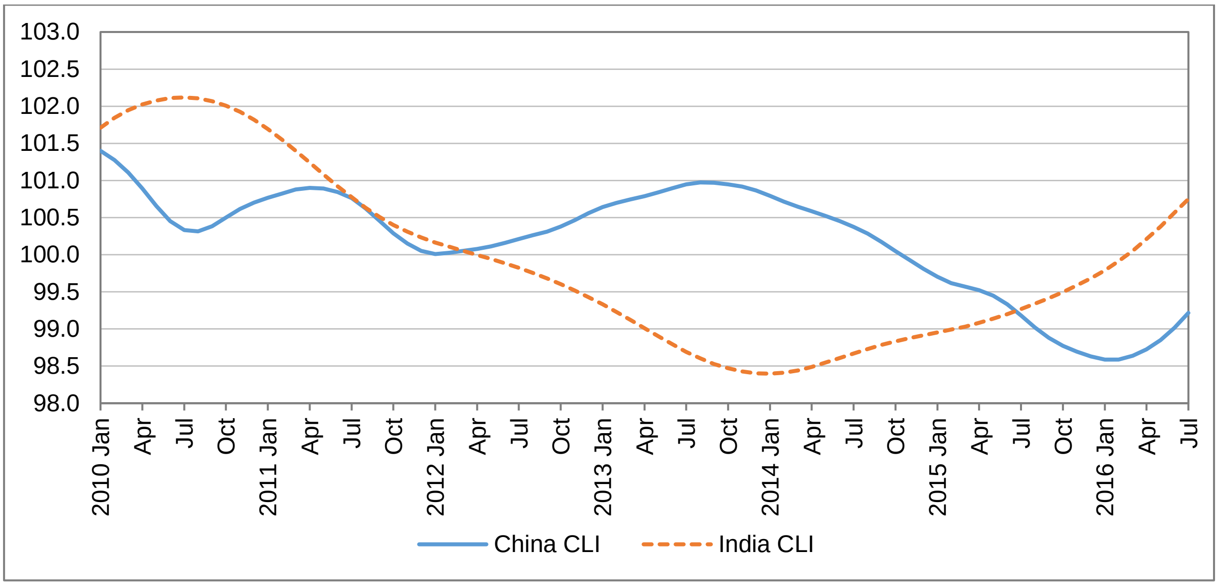
1) The July **OECD composite leading indicators** (CLIs), which anticipate turning points in economic activity relative to trend, point to stable growth momentum in the OECD area as a whole, including the United States, Japan as well as the euro area. Amongst major emerging economies, the CLIs continue to indicate that growth is picking up in China, Russia and Brazil while the CLI for India continues to point to firming growth.

Figure 2: OECD CLI points to stable growth momentum



Source: OECD

Figure 3: China's and India's CLI on upward trajectory

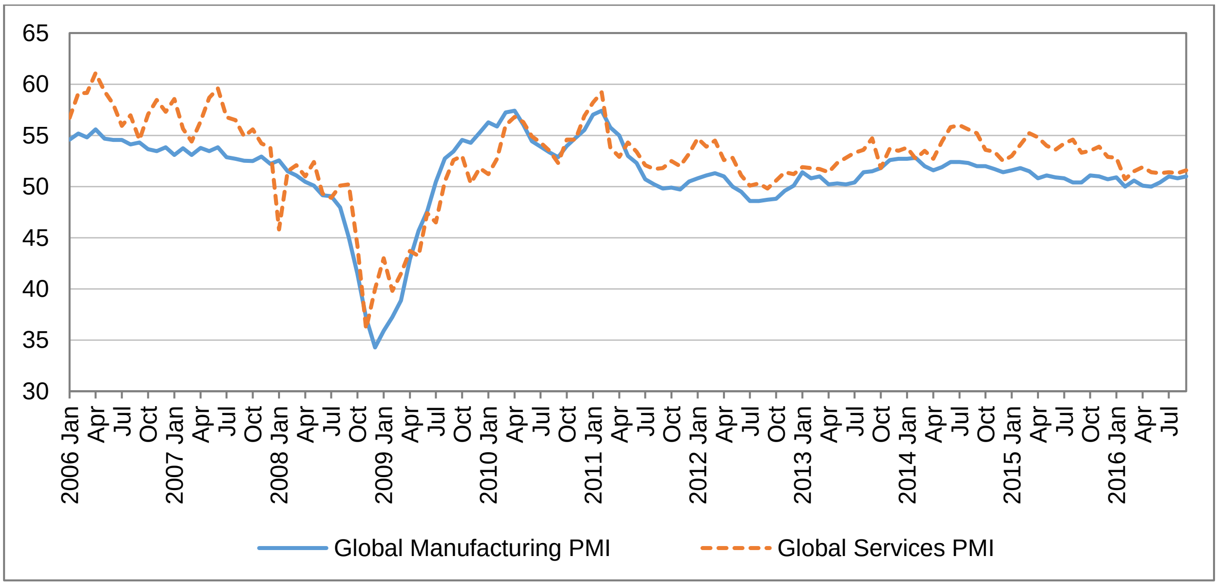


Source: OECD

2) **Growth of manufacturing sector output, as measured by the Purchasing Managers Index (PMI)** edged slightly to 51.0 in September (50.8 in August and 51.0 in July), marking a relatively moderate growth in third quarter though some improvement were seen in output, new orders and exports. Encouragingly, global manufacturing production increased for the fourth successive month in September, a positive sign that the manufacturing sector is breaking out of the sluggish trend seen in 1H16. The average PMI of 50.9 in 3Q16 was the highest since 4Q15. Nevertheless, growth of global manufacturing sector output is still below its three-year average.

   PMI for services edged higher to 51.6 in September from 51.3 in August (51.4 in July), supported by continued expansion of new orders, albeit slower. The modest growth still staying well below long-run average of 53.0 in the period 2006-15, suggesting that a sustained expansion is still a long way to go.

Figure 4: Global PMI for manufacturing and services showed continued expansion



Source: Markit

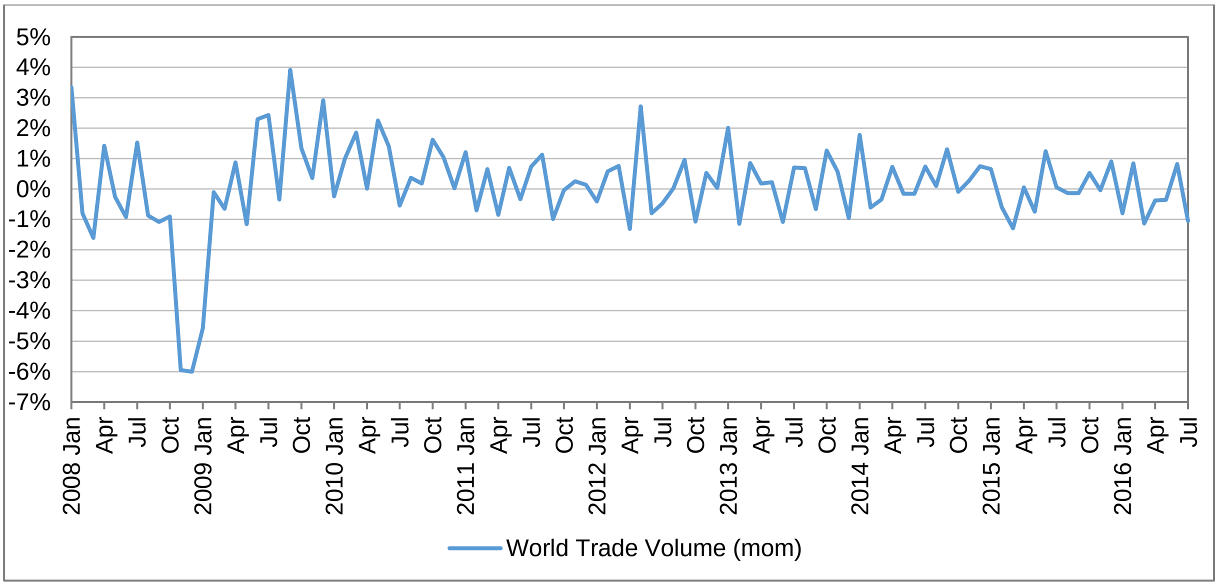
3) **World trade volume** continues to exhibit uneven trend. It reversed to decline by 1.1% mom in July from +0.8% in June due to contractions in both exports (-0.9% vs. +0.9% in June) and imports (-1.2% vs. +0.8% in June).

The drop in export volume was sharper in emerging economies (-1.4% vs. +0.8% in June) relative to advanced economies (-0.5% vs. +0.9% in June). In advanced economies, a strong rise of 2.8% in the US was not sufficient to offset declines in Japan, eurozone and others. Export volume contracted in all emerging economies, with Asia leading a decline of 1.9% in July vs. +0.6% in June. Import volume dropped the most in emerging economies (-2.1% vs. 0.0% in June) compared to advanced economies (-0.6% vs. +1.3% in June).

There remains for some time for global trade activity to return on a sustained growth track. We expect world trade volume to remain weak due to moderate economic growth, increased protectionism, re-shoring and greenfield investment for domestic demand and a slowdown of global value chains' expansion.

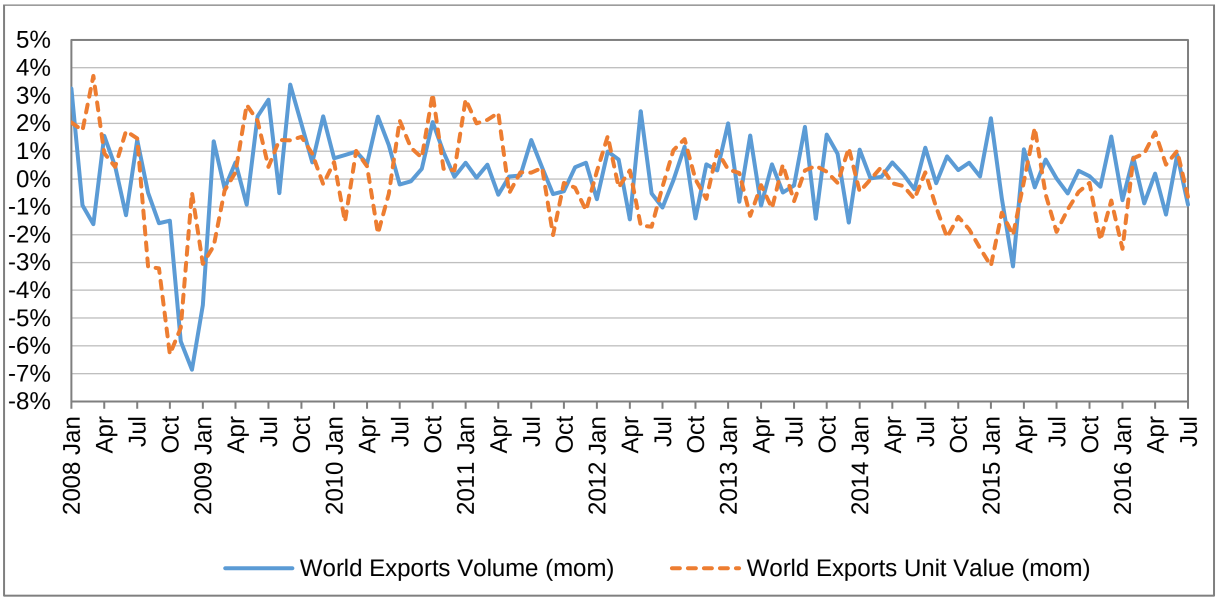
The World trade Organization (WTO) slashed its estimate of global trade growth this year to 1.7% from 2.8% previously, reflecting a slowdown in China and falling imports into the US. The trade organisation also marked down 2017's trade growth forecast to between +1.8 and +3.1% from 3.6% estimated in April.

Figure 5: World trade volume reversed to decline in July



Source: CPB Netherlands Bureau for Economic Policy Analysis

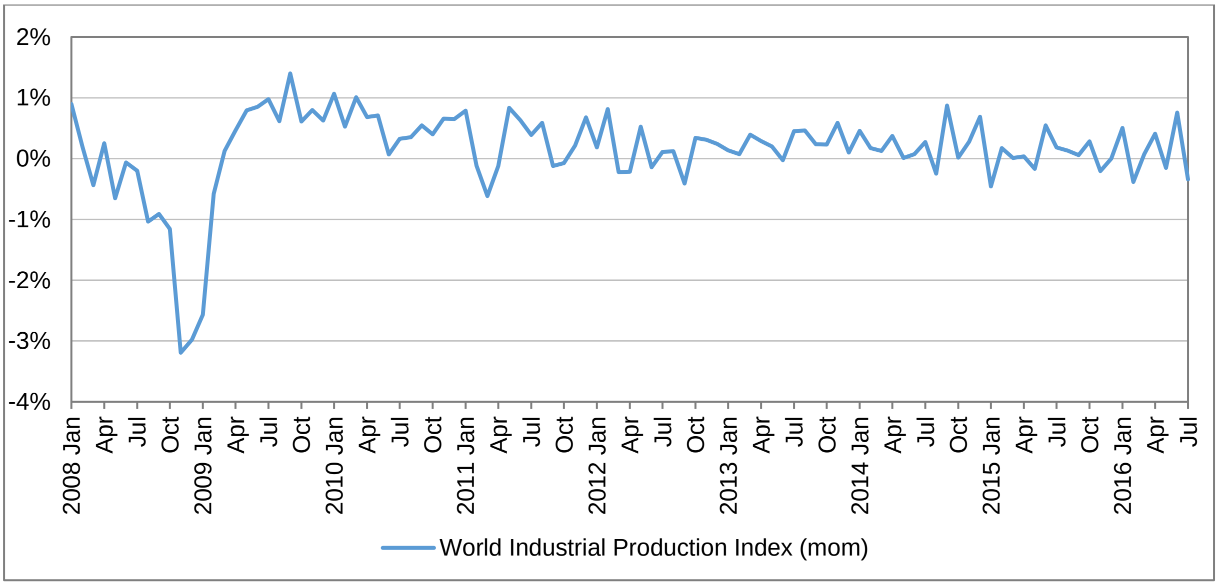
Figure 6: World exports volume remains volatile



Source: CPB Netherlands Bureau for Economic Policy Analysis

4) **World industrial production** declined by 0.3% mom in July 2016, following a 0.8% increase in June. The rate of decline was fairly equal in advanced and emerging economies. With the exception of the US registering positive output growth, industrial production contracted in all country blocks. On a quarterly basis, world industrial production up 0.4% in 2Q16, a tad higher than a 0.2% rise in 1Q.

Figure 7: World industrial production remained stuck in low gear



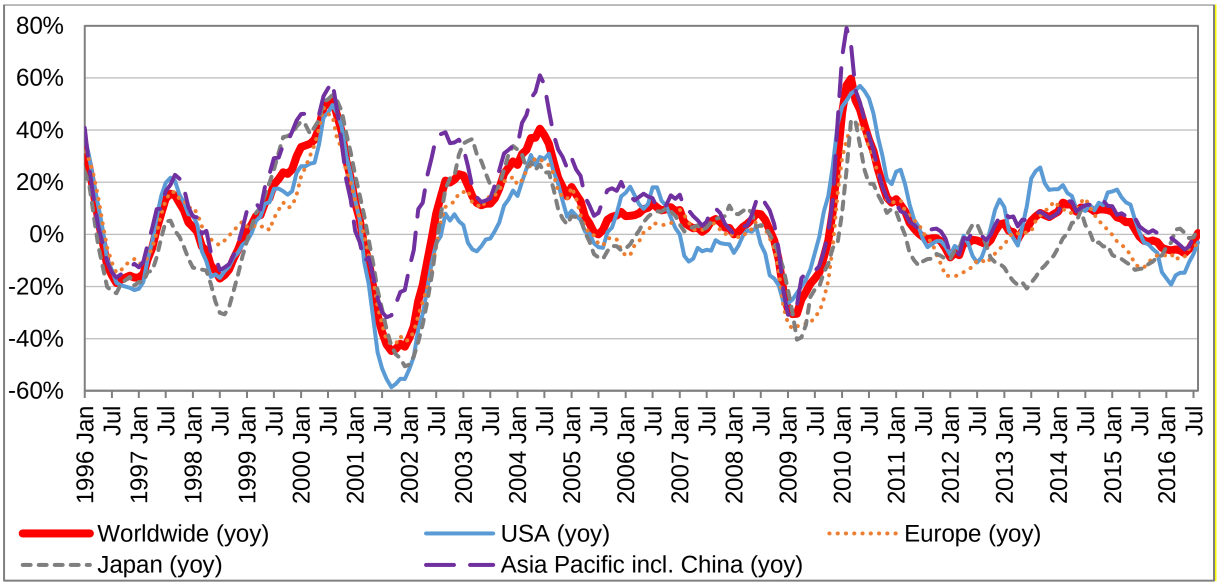
Source: CPB Netherlands Bureau for Economic Policy Analysis

5) **Global semiconductor sales** rose further by 3.5% mom to US$28 billion in August for the fourth consecutive month (+2.6% in July and +1.3% in June). It is the largest monthly growth since May 2013. Sales increased across all regions: the Americas (6.3%), Japan (4.8%), China (3.1%), Asia Pacific Ex-China (2.7%), and Europe (0.7%).

   On an annual basis, total sales rose 0.5% in August, the first positive growth after thirteen months of contraction since June 2015. This incipient signs of turnaround is encouraging as it shows potential resilient. Total annual sales increased in China (7.1%) and Japan (2.2%), but fell in Asia Pacific Ex-China) (-2.7%), the Americas (-3.1%), and Europe (-3.3%).

   The overall landscape for semiconductor industry remains modest due to soft demand and unfavourable macroeconomic conditions. After taking into account the 2Q data, the World Semiconductor Trade Statistics (WSTS) expects worldwide semiconductor sales to decline by a larger magnitude of 3.2% (-2.4% previously) to US$325 billion in 2016 before picking up in next two years (+2.0% to US$331 billion in 2017 and + 2.2% to US$338 billion in 2018 respectively).

Figure 8: Semiconductor sales turned around in Aug for the first time since June 2015



Source: Semiconductor Industry Association (SIA)

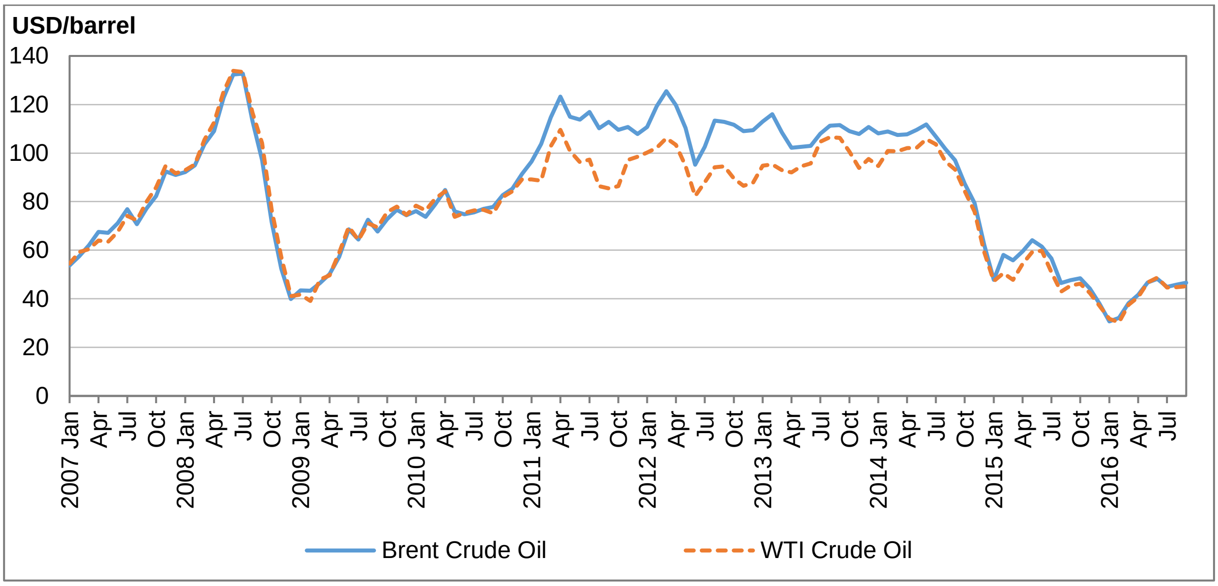
6) **Global oil prices**, as benchmarked by Brent crude continued to struggle and stay firmly above US$50 per barrel for the greater part of this year against the backdrop of continuing concerns about oil glut, a stronger dollar and sporadic incidents of supply disruptions.

   The oil market cheers on the Organization of the Petroleum Exporting Countries (OPEC)'s much-awaited deal to cut oil production after a meeting in Algeria on 26-28 September, marking the first deal since 2008. While the level of oil output in which each country will reduce its pumping will be sorted out on 30 November, OPEC would reduce output to a range of 32.5-33.0 million barrels per day (bpd), representing a reduction of around 700,000 bpd from its estimated current output at 33.24 million bpd.

   The oil output curbs deal may provide some short-term price support though there remain risks to cap the upside. Strict compliance of the production quotas as well as cooperation from non-OPEC members to curtail drilling is crucial to support prices.

Ultimately, a return to a sustainable oil price recovery would require the market to balance out between excess supply and sustaining demand. The International Energy Agency (IEA) in its monthly Oil Market Report expects global oil demand growth to slow down from 1.4 million barrels a day (mb/d) in 2016 to 1.2 million barrels a day in 2017, due to a "dimmer macroeconomic outlook." Brent crude oil prices are estimated to be around US$45-55 per barrel by end-2016 and in 2017.

Figure 9: Brent crude oil price struggles for momentum amid OPEC's output cut



Source: US Energy Information Administration

US – A WEAK START IN 1H BUT NO WORRIES

The US economy paced gradually in 1H16 as real GDP growth increased 1.4% in 2Q, moderately higher than 0.8% in 1Q. A snapshot of growth components showed a mixed performance of consumption and investment. On an annual basis, US GDP growth eased to 1.3% in 2Q from 1.6% in 1Q.

Private consumption remained resilient in 2Q, increasing at a robust pace of 4.3% (+1.6% in 1Q) as households remained upbeat on economic growth, albeit still moderate will continue to add jobs at a solid pace. However, gross fixed investment contracted further in 2Q (-1.1% vs. -0.9% in 1Q), dragged down by a 7.7% decline in residential investment. Non-residential investment turned around to increase by 1.0% in 2Q after two consecutive quarters of decline, reflecting some dissipating signs of sluggishness in oil investment.

Despite a disappointing performance in the first half-year of 2016, we believe that the US economy will pick up momentum in 2H16, supported by decent consumer spending, an improvement in investment and a rebuilding of inventories.

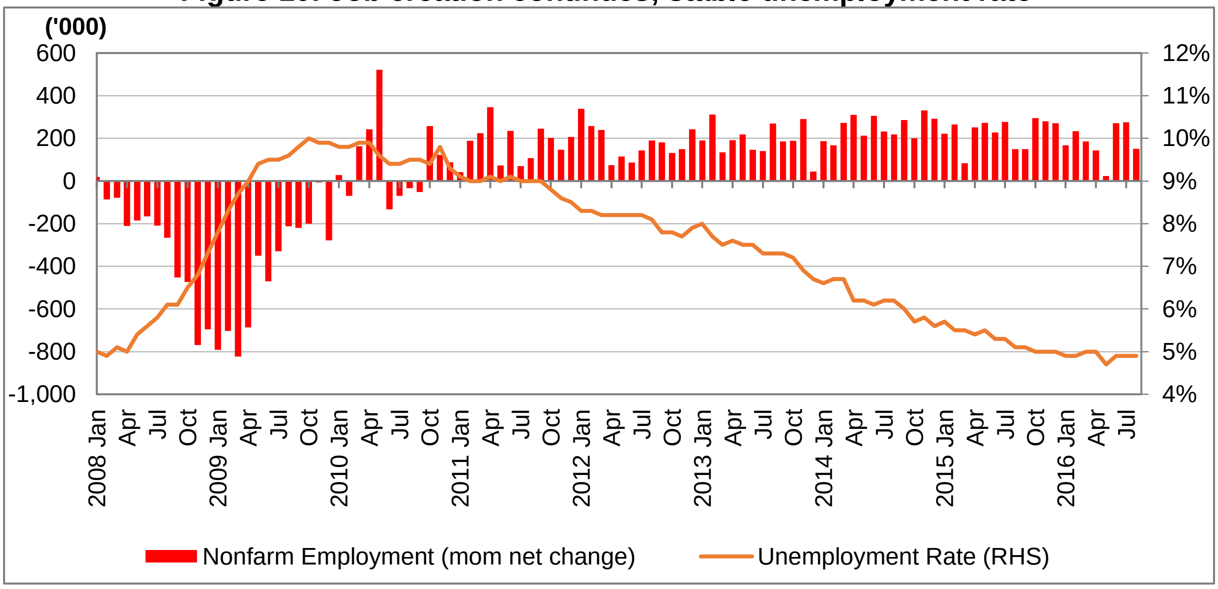
A slew of key leading and forward indicators going into third quarter showed mixed outcomes. Industrial production fell 0.4% mom in August (+0.6% in July), hurt in part by a sharp decline in utilities output (-1.4%). Manufacturing output also dipped 0.4%, reversing the 0.5% gain in July. However, there were some positive signs for the hard-hit energy sector, with mining output rising 1.0% (+0.7% in July), marking the fourth consecutive monthly increase.

The Institute Supply Management (ISM) manufacturing index rebounded to 51.5 in September after dipping into negative territory in August (49.4). New orders jumped to 55.1 from 49.1 in August while production also increased from 49.6 in July to 52.8 in August. The services sector grew at the most in 11-mth high of 57.1 in September (51.4 in August). Services firms have now expanded for 80 straight months.

Retail sales unexpectedly declined 0.3% mom in August after a marginal 0.1% rise in July amid weak purchases of automobiles, furniture and building material as well as gasoline. On an annual basis, retail sales decelerated from +2.4% yoy in July to +1.9% in August. Sales at so-called non-store retailers, a proxy for e-commerce sales continued to show strong growth (+10.9% yoy), suggesting that American consumers are increasingly opting to make purchases online. US consumer confidence jumped to the highest level since recession, hitting 104.1 in September (101.1 in August), citing more upbeat about the short-term employment outlook.

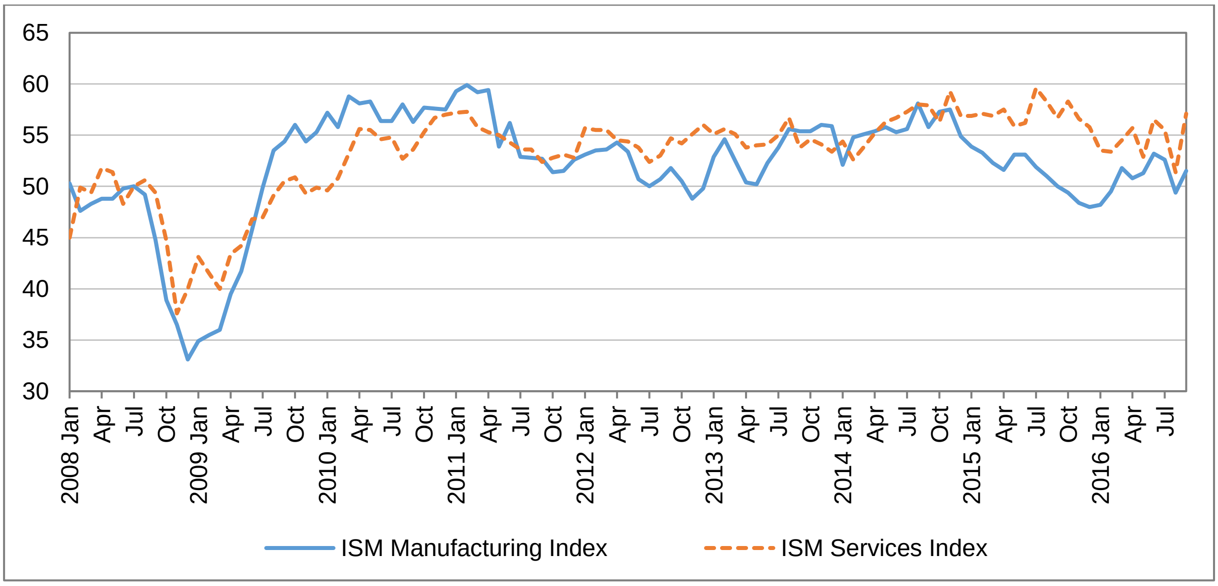
Job creation continues, albeit slower compared to previous months. The labor market should remain strong as long as consumers maintain their robust spending pace. Total non-farm payroll employment increased 151,000 in August (275,000 in July and 271,000 in June) while the headline unemployment rate held steady at 4.9%. The job data represented a record period of 71 consecutive months of job creation. Employment continued to trend up in several service-providing industries, namely food services, professional and technical services, financial activities as well as health care. Average hourly earnings for private-sector workers rose 2.4% yoy in August, a slowdown from July's 2.7%, which was the best in seven years.

Figure 10: Job creation continues; stable unemployment rate



Source: US Bureau of Labor Statistics

Figure 11: ISM manufacturing rebounded in September



Source: Institute for Supply Management

EUROZONE – MODERATE RECOVERY AMID BREXIT'S HEADWINDS

The third estimated GDP data indicated eurozone growth halved to a seasonally-adjusted 0.3% in 2Q from 1Q's 0.5%, due to the fading of transitory tailwinds and stalled France's economic growth. France, the eurozone's second-largest economy, saw no growth in 2Q after expanding by 0.7% in 1Q. On an annual basis, eurozone's GDP expanded 1.6% in 2Q, a tad lower than 1Q's 1.7%.

Going forward, an expansionary monetary policy and improving labour market would continue to support economic activity in the bloc. Eurozone's unemployment rate stood at 10.1% in July, its lowest level in five years. High frequency data indicates the pace of economic activity edged moderately higher at the start of the third quarter.

The uncertainty as well as threat from Brexit lingers when the negotiation process begins next year. Brexit could have significant negative spillovers to the euro area via trade and financial markets. The IMF has slashed eurozone's GDP growth estimates from 1.7% previously to 1.6% this year and next year, to just 1.4% from 1.7% previously.

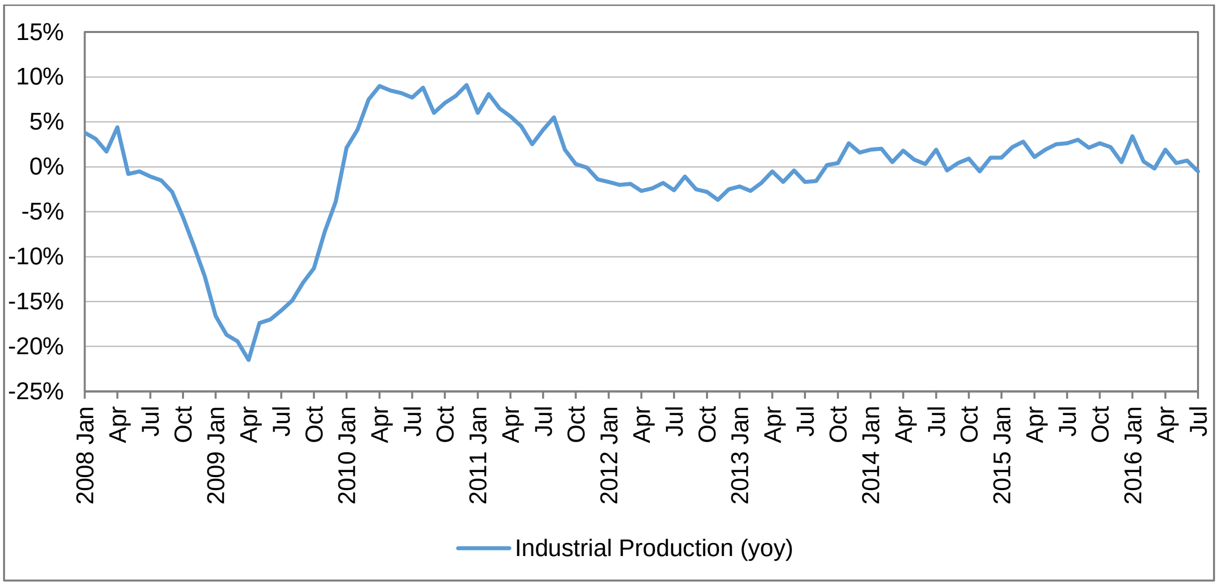
Amid lingering concerns over Brexit-induced headwinds, the eurozone's manufacturing sector ticked up to hit a three-month high in September, as the PMI rose to 52.6 from 51.7 in August. Six countries experienced growth, with Germany leading the pack, followed by Austria and the Netherlands. The PMI tracking the services sector fell to 52.2 in September from 52.8 in August (52.9 in July), marking the lowest since December 2014.

In July, industrial production fell by 1.1% mom (+0.8% in June), due to declines in production of capital goods, energy, durable consumer goods and intermediate goods. On an annual basis, industrial production declined 0.5% yoy in July (+0.7% in June).

With concerns that the eurozone's economic recovery was losing momentum, the headline inflation remained unchanged at 0.2% yoy in August (0.2% in July). Prices eased for food, services and industrial goods while energy prices fell at a slower pace. Prices increased marginally by 0.1% mom in August (-0.6% in July).

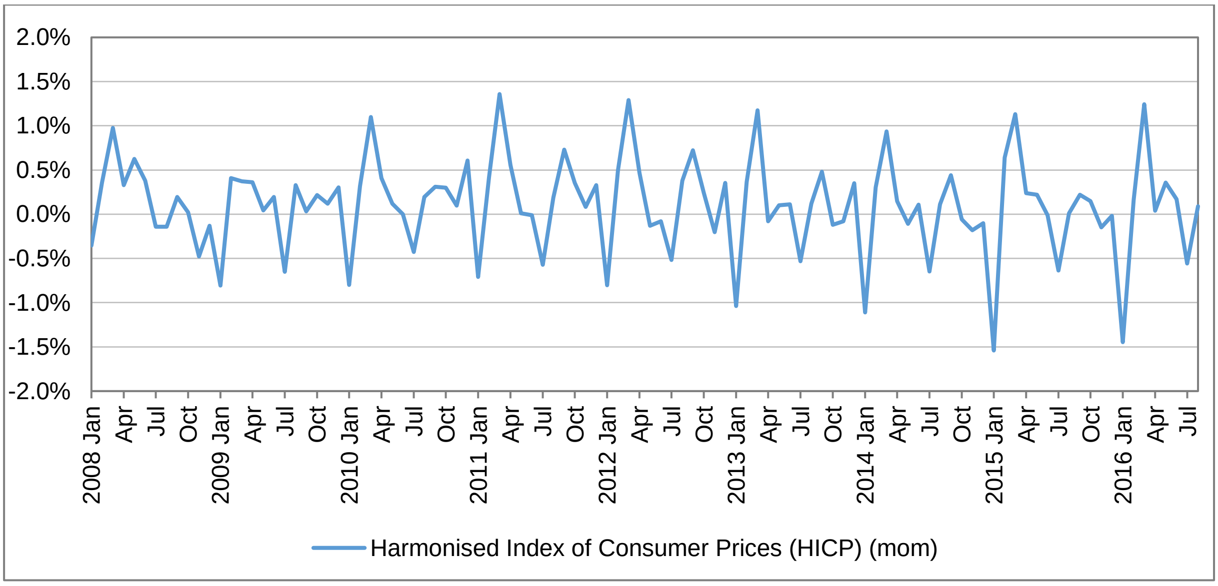
Despite efforts by the European Central Bank (ECB) to implement negative interest rates to stoke prices, persistent economic slack and low oil prices continue to confine inflation in the "danger zone" of below 1.0%. This raises the prospect that even more stimulus is needed amid worries what if monetary policy has reached its limits for bolstering growth?

Figure 12: Sluggish industrial production



Source: Eurostat

Figure 13: Consumer prices followed its past trend



Source: Eurostat

JAPAN- ABENOMICS HITS ITS LIMITS

The Japanese economy nears stalling in 2Q16 as it managed to grow at a disappointing seasonally adjusted annualized rate of 0.7% after a strong 2.1% growth in 1Q. On an annual basis, GDP growth increased 0.8% yoy in 2Q, moderately higher than 0.2% in 1Q.

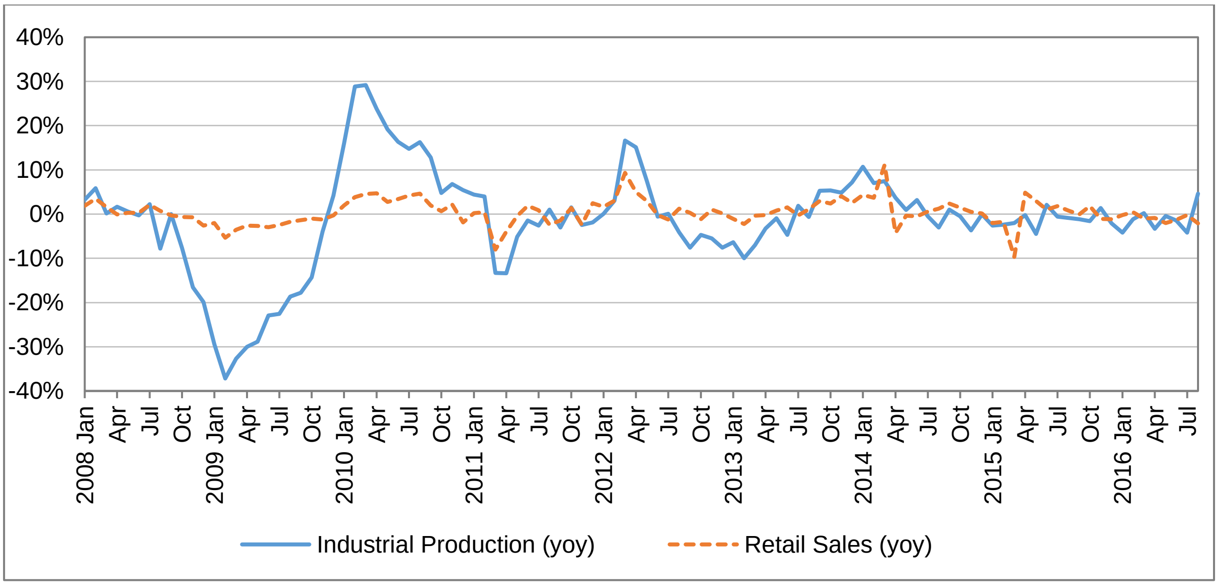
The weak economic dynamics were dampened by falling consumer spending and sluggish exports due to a rising yen. The previous fiscal stimulus also faded as reflected in a sharp pullback in government spending growth to 0.9% in 2Q from 3.7% in 1Q.

Broad set of indicators continued to show a mixed start into the third quarter. A strong yen and subdued global demand continued to take a heavy toll on exports as it declined by 9.6% yoy in August following July's nearly seven-year low of 14.0%.

The manufacturing PMI rose from August's 49.5 to 50.4 in September, marking the highest reading in eight months. Output increased for the second consecutive month, while new orders decreased at a slower rate. New export orders jumped above the 50-threshold expansion mark, suggesting that global demand is gradually improving. However, the services PMI declined further to 48.2 in September from 49.6 in August.

Preliminary report for industrial production showed a growth of 1.5% mom in August, a rebound from 0.4% contraction in July. This was supported by increases in electronic parts and devices, information and communication electronics equipment as well as chemicals, excluding drugs. August's gain of 4.6% yoy also marked a turnaround from a 4.2% contraction in July.

Figure 14: Industrial output up but retail sales dipped in August



Source: Ministry of Economy, Trade and Industry, Japan

Machinery orders (a leading indicator of capital spending over a three- to six-month period) unexpectedly rose 4.9% mom in July (+8.3% in June) for second consecutive month, easing some pessimism over capital spending. Manufacturers' orders rose 0.3% while the services sector's orders increased by 8.6%. On an annual basis, machinery orders rebounded to 5.2% growth from a 0.9% drop in June.

The Bank of Japan's (BOJ) closely watched Tankan business sentiment survey revealed the mood among big manufacturers was flat in the third quarter. However, sentiment in the service sector worsened to plus-18 to 3Q16 from plus-19 in 2Q. It was the third straight quarterly deterioration and the lowest reading since December 2014. For the quarter ahead, BOJ expects a reading of plus-16.

Consumer spending seems struggling to maintain traction as it fell 1.1% mom in August for the first time in three months (+1.5% in July). Bad weather and fewer weekends in August were largely to blame for the downbeat sales. Retail sales fell 2.1% yoy in August (-0.7% in July), with sales of department stores and supermarkets contracted 3.6%.

Faced with the fading fiscal stimulus, Prime Minister Shinzo Abe's cabinet approved ¥28.0 trillion (US$265bn) stimulus measures on 2 August to jumpstart the near-stalling economy, which is at risk of stagnation. Only ¥7.5 trillion will be new spending on public infrastructure, including high-speed railways and facilities at ports visited by cruise liners.

BOJ's Governor Haruhiko Kuroda has vowed repeatedly to do "whatever it takes" to reach 2% inflation. But inflation is nowhere near that level and in recent months has been moving in the opposite direction.

Amid the decline in core prices deepened to over five-year low in July, BOJ took the new and unusual monetary step of implementing so-called "yield curve control", a policy that is designed to keep the 10-year Japanese government bond yield near current levels, around 0% and introducing an inflation-overshooting commitment. This is again a sign that BOJ may be running up against the limits of monetary policy.

CHINA – GROWTH STABILISATION IS SEEN FADING

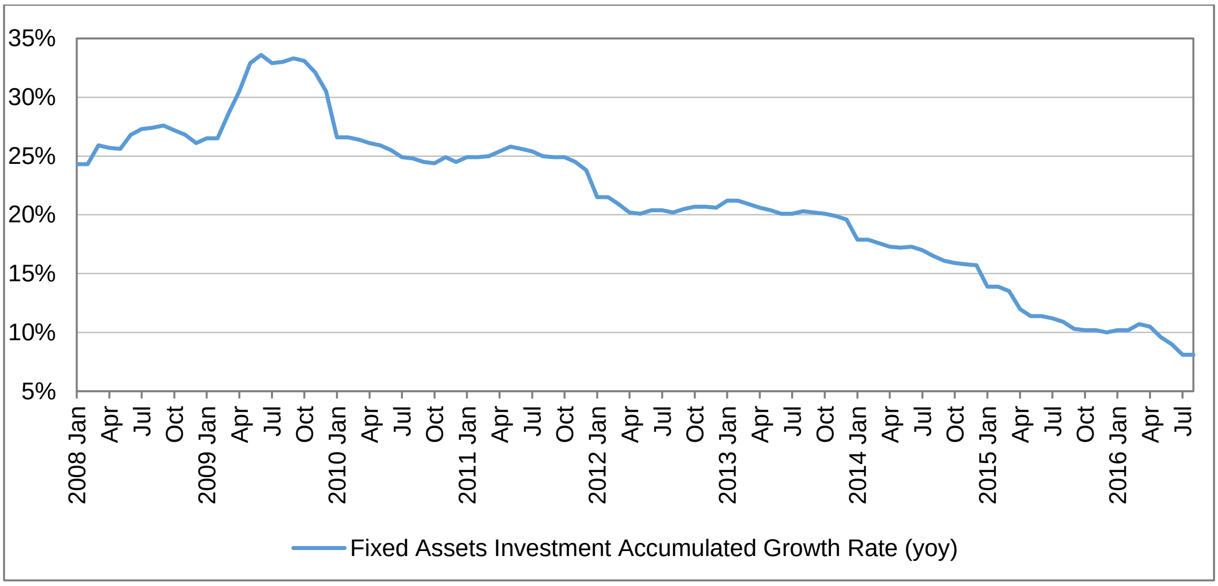
After achieving growth stability of 6.7% in 1H16, the on-going rebalancing of China's economy is seemingly showing some incipient signs of weakness. This underscores the continuation of pro-active fiscal and monetary support to achieve the GDP growth target of 6.5-7.0%. There were concerns that the economic stabilisation effects have gradually fading away.

Key economic indicators for July-Aug suggest continued expansion in the third quarter. August's data benefitted from a recovery following July's flood-related disruptions and higher real estate investment. i) Industrial production growth edged higher to 6.3% in August (6.0% in July), mainly supported by electricity, gas and water production while mining output contracted; ii) retail sales sustained at 10.6% yoy in August (10.6% in July; 10.2% in June) on higher sales of building materials, office supplies, automobiles, furniture, telecoms and personal care as well as household appliances; and iii) In January-August, urban fixed-asset investment (FAI), excluding rural households, held steady at 8.1% though still remained the slowest since December 1999. The data showed a growing imbalance between public and private spending that raised questions about China's longer-term growth prospects. Capital investment by state firms surged 21.4% in January-August, though the pace did ease slightly from 21.8% in January-July.

The closely-watched real estate development indicator, namely property prices continued to rise on a month-on-month and annual basis. House prices in 70 large- and medium-sized cities rose 1.5% mom and 9.2% yoy in August (7.9% in July). On a mom comparison, sales prices of newly-constructed residential buildings declined in 4 cities, increased in 64 cities and remained flat in 2 cities. The annual rise of 9.2% in house prices marked the fastest expansion since February 2014.

The official manufacturing PMI, which mainly tracks large state-owned companies, remained unchanged at 50.4 in September, the same level as August (49.9 in July and 50.0 in June), representing the highest reading since November 2014. The latest manufacturing PMI reading is encouraging, with caveats. While new export orders and output increased, total new orders slipped. The PMI for services sector expanded at a slightly faster pace (53.7 in September vs. 53.5 in August).

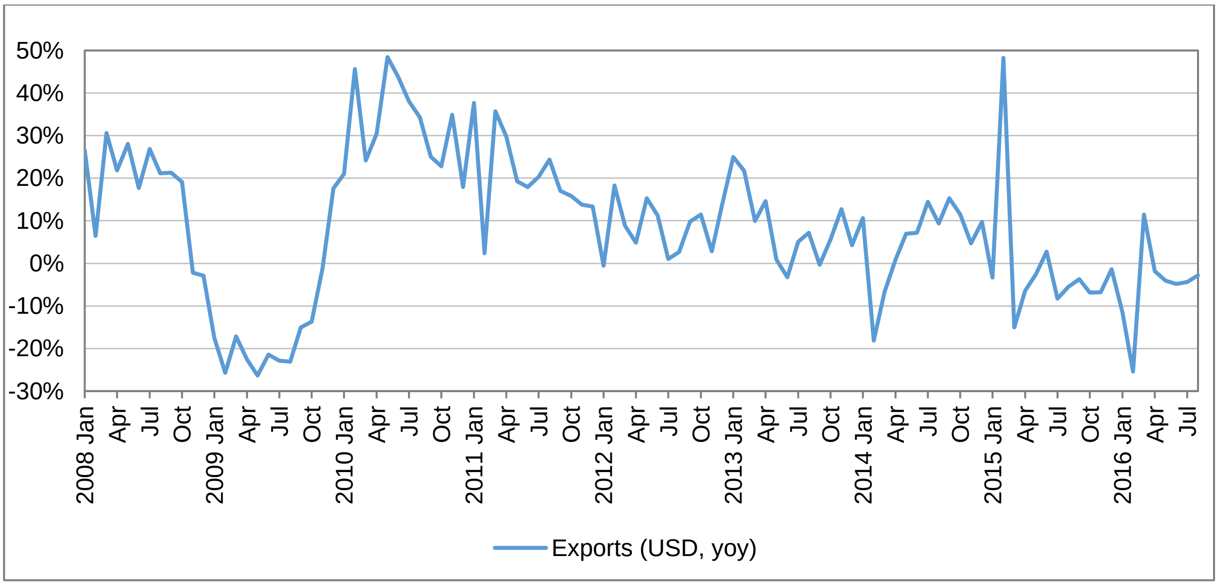
Figure 15: Fixed investment growth still trending down



Source: National Bureau of Statistics of China

China's exports fell by a smaller pace of 2.8% yoy in August (-4.4% in July) while imports unexpectedly grew by 1.5% (-12.5% in July), the first monthly gain since 2014. The small rise in imports suggest lacklustre Chinese domestic demand might be recovering. Looking ahead, export growth may improve moderately, underpinned by a gradual recovery in global demand.

Figure 16: Exports declined five months in a row since April 2016, albeit smaller



Source: National Bureau of Statistics of China

The economy is increasingly driven by services and consumption, which marks a rebalancing of growth away from investment. Nevertheless, the pace of economic transition will continue to remain challenging given the lagging aspects of accelerated reforms to tackle the resource allocation in the state-owned enterprises (SOE) and bloated debt (225% of GDP) and corporate debt, which is approximately 145% of GDP; reduce the reliance on credit-financed, state-led investment; and improve financial governance.

The International Monetary Fund's Executive Board of Directors have highlighted the urgency of addressing the corporate debt problem through a comprehensive approach. Amongst the approaches include to harden budget constraints on SOEs; triage and restructure or liquidate over-indebted firms; and recognize losses as well as share them among relevant parties, including the government if necessary.

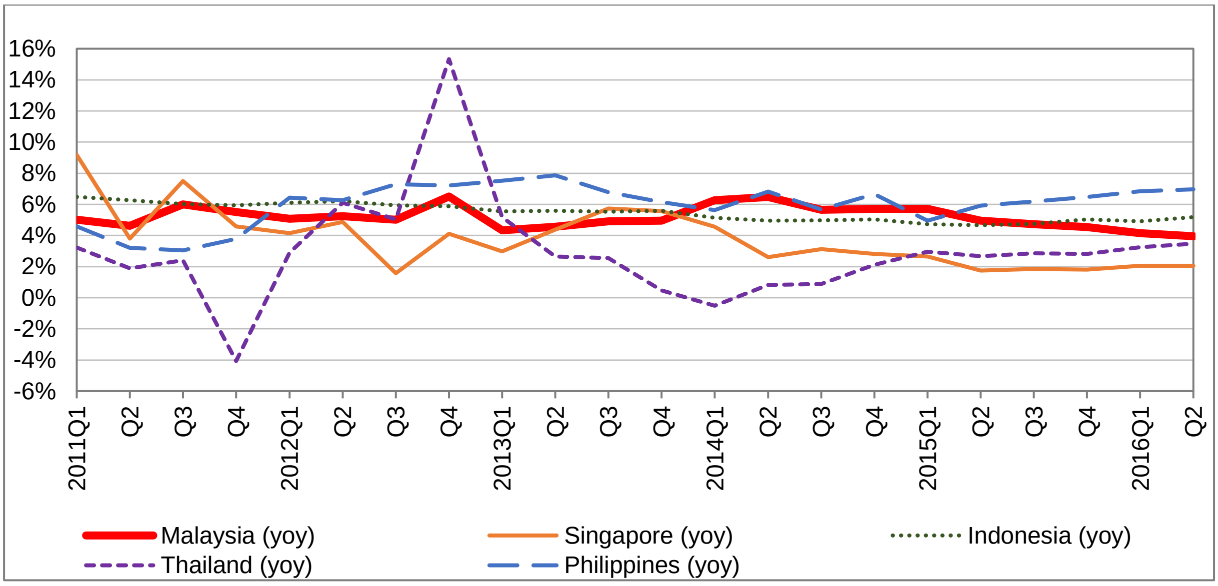
China's renminbi (RMB) has officially joined the IMF's elite currency club, known as Special Drawing Rights (SDR) on 1 October. SDR is an international reserve asset created by the IMF to supplement countries' official reserves.

As SDR is not a currency and tradable in the foreign exchange market, the RMB's inclusion in the basket will have a small market impact. Over time, it is the proven stability of RMB in the SDR basket, accompanied by a measured pace of market reforms toward full capital account convertibility that would determine the status of RMB as a reliable reserve currency over the long-term. The risks for large devaluation of the RMB remain low as China strives to establish itself as a credible reserve currency.

ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

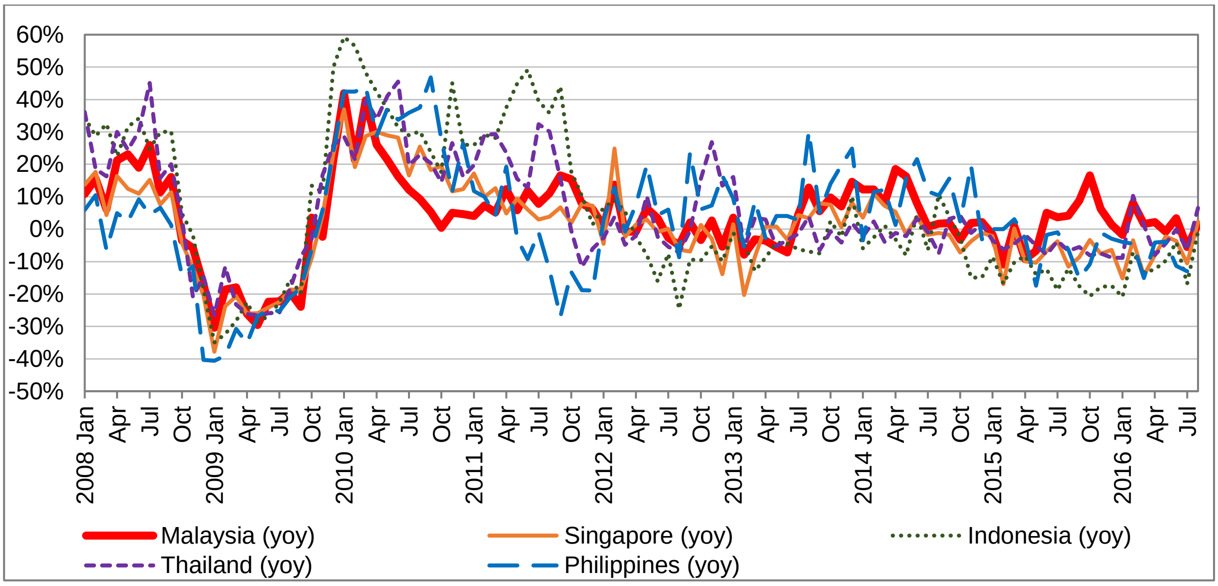
Broadly, ASEAN-5 economies (Malaysia, Singapore, Indonesia, Thailand, and Philippines) printed a mixed bag of economic readings, which point to still uneven pace of economic growth momentum. With the exception of Malaysia, real GDP growth accelerated in the second quarter in Singapore, Indonesia, Thailand and Philippines.

Figure 17: Real GDP growth trend



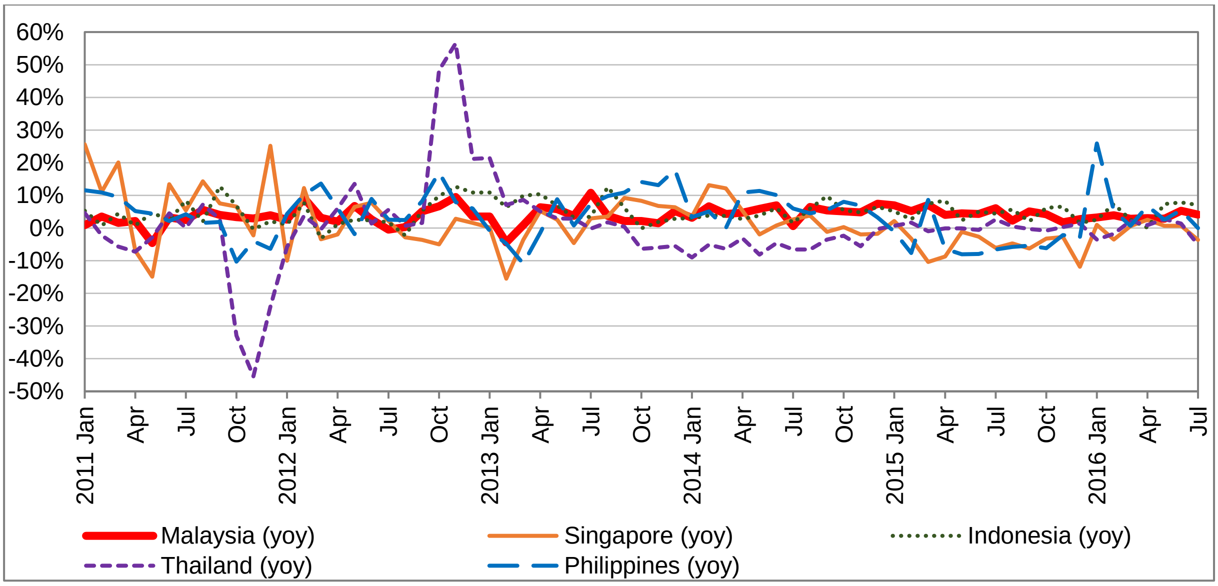
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 18: Export growth trend



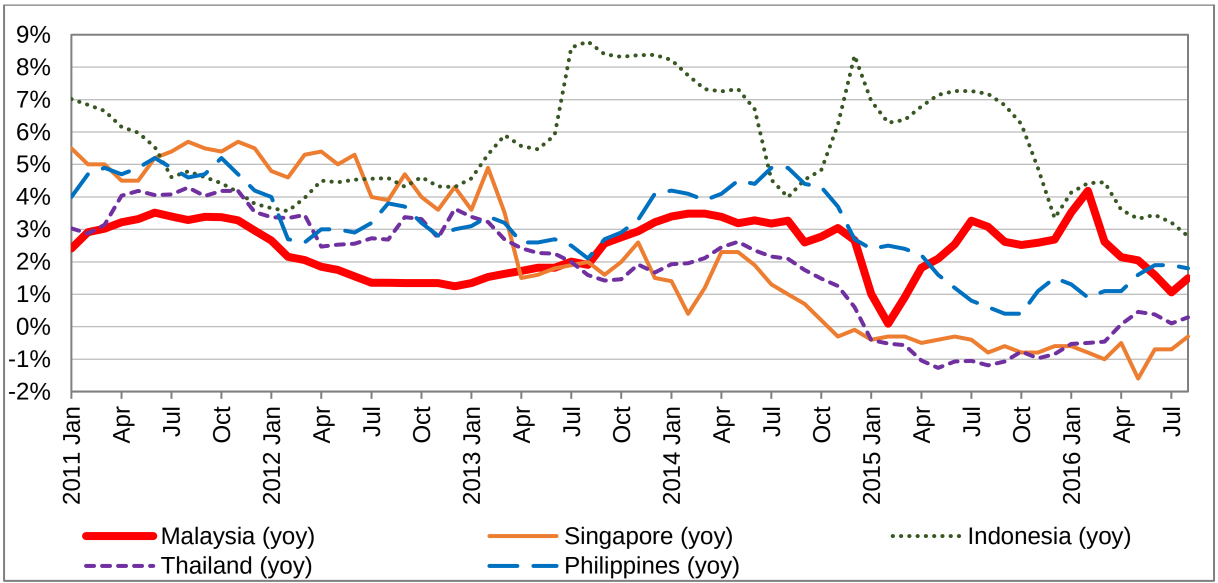
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

Figure 19: Industrial production growth trend



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

Figure 20: Inflation trend



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

B. GLOBAL MONETARY POLICY TRACKER

A tug of war has developed between support from more monetary stimulus, including additional central bank liquidity and the challenges posed by uncertain global economic outlook. But, the reality is some central banks facing limited monetary space have resorted to unconventional policy tools to fight the slackening global growth and subdued inflation or deflation.

With the global economy still muddling through, continued growth divergence as well as lingering uncertainties surrounding the ramifications of Post-Brexit, global central bankers continue to contrast their monetary approaches.

The US Fed policymakers remained split between those who worry that reducing this economic stimulus would undermine growth and those who fear that waiting for too long could allow inflation to take hold. In the Federal Open Market Committee's (FOMC) meeting on 21-22 September, three voting members dissented for a rate hike. The Fed Chairman Yellen asserted that that the case for rate increases has strengthened, adding that risks to the outlook were "roughly balanced".

The Fed still finding interventions by fellow central bankers bore out that impression. BOJ announced two new monetary initiatives to bolster growth and inflation, that is "yield curve control" and an inflation-overshooting commitment.

The "yield curve control" is designed to keep the 10-year Japanese government bond yield near current levels, around 0%. Such a move is expected to bring down real interest rates by steepening the difference between short- and long-term yields and fanning inflationary pressures. BOJ also pledged the readiness to ease monetary policy further by cutting the short- and long-term key benchmark rates, expanding asset purchases and accelerating the expansion of the monetary base.

The ECB warned that negative interest rates could become the norm in economic downturns while ultra-low interest rates will become the norm even in boom times. Nevertheless, a prolonged period of negative interest rates and ultra-low interest rates could come with unwanted side-effects as the initial simulative effect on the economy wears off. The side effects include encourage greater risk-taking investment in riskier assets or engage in speculative activities to compensate for loss of income or lower rates of return. Negative interest rates may act to increase risk aversion and uncertainties across the financial system through portfolio decisions.

How should emerging Asian central bankers react? Asian central banks are expected to continue keeping monetary easing bias to mitigate the impact of external uncertainties on their economies. So far, none of these countries has been forced to resort to unconventional monetary policies of quantitative easing, negative policy interest rates, or "forward guidance" of making specific promises on future actions.

Figure 21: Policy rate estimates (%)

	2008	2009	2010	2011	2012	2013	2014	2015	2016 Sep/Oct	2016*e*	2017*f*
US, Federal Funds Rate	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.00-0.25	0.25-0.50	0.25-0.50	0.50-0.75	0.75-1.00
Euro Area, ECB (Deposit Facility)	2.00	0.25	0.25	0.25	0.00	0.00	-0.20	-0.30	-0.40	-0.40	-0.40
Japan, BOJ Policy Rate	0.10	0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	0.00-0.10	-0.10	-0.10 to -0.20	-0.10 to -0.20
China, PBOC 1-year Benchmark Loan I/R	5.31	5.31	5.81	6.56	6.00	6.00	5.60	4.35	4.35	4.10	4.10
India, RBI Policy Repo Rate	6.50	4.75	6.25	8.50	8.00	7.75	8.00	6.75	6.25	6.00	6.00
Korea, BOK Base Rate	3.00	2.00	2.50	3.25	2.75	2.50	2.00	1.50	1.25	1.25	1.25
Malaysia, BNM Overnight Policy Rate	3.25	2.00	2.75	3.00	3.00	3.00	3.25	3.25	3.00	3.00	2.75-3.00
Indonesia, BI 7-Day Reverse Repo Rate	9.25	6.50	6.50	6.50	5.75	7.50	7.75	7.50	5.00	5.00	4.75-5.00
Thailand, BOT 1-Day Repurchase Rate	2.75	1.25	2.00	3.25	2.75	2.25	2.00	1.50	1.50	1.25	1.25
Philippines, BSP Overnight RR Rate	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.00	3.00	3.00	3.00

Source: Various officials; SERC estimates and forecast

Note: Indonesia employed BI 7-Day Reverse Repo Rate (BI 7-Day RR Rate) as new policy rate from 19 Aug 2016

C. THE MALAYSIAN ECONOMY HITTING THE TROUGH

The Malaysian economy is bottoming out and may hit its trough. The second quarter GDP report showed some positive news on domestic demand. If the strength of domestic demand continues to sustain at this pace or even stronger, the economy will likely perform slightly better in the second half-year (2H16).

The second quarter GDP growth (+4.0% yoy vs. 4.2% in 1Q16) was in line with market consensus though it marked the fifth consecutive quarter of moderation since 2Q15. Average real GDP growth of 4.1% in 1H16 remains within the government's range estimate of 4.0-4.5% for the full year of 2016.

The 2Q GDP growth was helped by a meaningful growth traction of private sector demand, which expanded higher by 6.1% in 2Q (4.5% in 1Q). Public sector spending rose even stronger (6.9% in 2Q vs. 0.4% in 1Q), thanks to a sharp turnaround in public investment growth of 7.5% from a decline of 4.5% in 1Q. This was underpinned by higher disbursement of federal government spending on public infrastructure and socio-economic projects as well as fixed assets acquisition by some public corporations.

The good news is **consumer spending** accelerated further for three consecutive quarters to 6.3% in 2Q from 5.3% in 1Q, supported by improved sentiment, special Hari Raya cash assistance and the instalment cash transfers under BR1M. Although that rate of growth is probably unsustainable, continued income growth, including salary increment and the improvement of public service schemes for 1.6 million civil servants and upward revision to minimum wages should continue to underpin spending for the rest of 2016 amid still stubbornly high cost of living.

Private investment growth, which slowed sharply to a low 2.2% in 1Q also strengthened to 5.6% in 2Q, driven by continued capital spending in services and manufacturing sectors. While the oil and gas related investment will remain a drag, investment in machinery and equipment as well as structures should continue to come from manufacturing and services sectors.

Higher growth in services and construction sectors as well as a turnaround in the mining sector helped to offset a sharp decline in agriculture sector amid slower manufacturing output.

Overall, the GDP report was mildly positive or at least 2Q GDP growth was not slipping below 4%. The five straight quarters of slowing growth rates put the economy at the risk of a prolonged slowdown, but the drags to growth during past quarters, namely private consumption and investment are fading though they are still far away from having the latent pace to push overall GDP growth to above 5%.

While the GDP growth is expected to improve in 2H16 against the backdrop of continuing higher private consumption and investment. Public investment should accelerate further, backed by continued implementation of public infrastructure projects.

The big drags from agriculture sector, which had contracted for two consecutive quarters, are expected to rebound due to the diminishing effect of El Niño. The turnaround in mining output should remain supported by higher oil and gas production, particularly in Sabah.

Real GDP growth is estimated to average 4.2-4.3% in 2H16 compared to 4.1% in 1H, taking the full-year growth to 4.2%. The growth prospects for 2017-18 should continue to remain challenging, with real GDP growth estimating at 4.3-4.6%. The potential to enjoy higher GDP growth rates could come from an economy-wide productivity growth. Domestic demand remains the key driver of growth.

But wild cards remain on Malaysia's growth prospects as the "weak and fragile" global growth remains vulnerable to any shift in expectations about events and policy risks. Shrinking trade surplus would remain a drag on domestic growth.

The 2017 Federal Budget, to be tabled in Parliament on 21 October should focus on strengthening our economic and financial fundamentals. Amidst global challenges, the government should present a prudent growth-oriented Budget without straying from the fiscal deficit reduction road map.

As the economy is not in recession and hence, an argument for relaxing the deficit target on "fiscal stimulus" grounds is unconvincing. The overall stance of the Budget has to be fiscally prudent if Malaysia is to demonstrate its firm commitment towards fiscal consolidation. Any fiscal slippage may put Malaysia's sovereign ratings under watch.

The fiscal deficit target for 2017 is expected to be around 3.0-3.1% of GDP compared to estimated -3.1% of GDP in 2016. The Ministry of Finance is likely to set real GDP growth estimate at 4.0-4.5% for 2017.

The Budget spending programs should be carefully planned, prioritized and implemented. The growth, investment and consumption-enhanced tax measures or incentives must be well targeted.

Development expenditure allocation estimated at RM45.0-48.0 billion in 2017 will be slated for socio-economic, national security and public safety, education and healthcare as well as the construction of on-going and new public transportation infrastructure projects such as the Mass Rapid Transit, Light Rail Transit, double-tracking, ports facilities and highways.

The bottom 40% households (B40) with a monthly income of up to RM3,855 and middle 40% households (M40) earning between RM3,860 and RM8,319 will continue to benefit from the tax incentives and financial assistance to mitigate against the high cost of living.

With the balance of payments' current account surplus shrinking rapidly to a mere RM1.9 billion or 0.6% of GDP in 2Q16, investors would remain wary about the risk of twin deficits should the current account surplus revert to a sustained deficits in the years ahead. As such, measures to expand the export capacity of goods and services, including value add them should be further enhanced.

Figure 22: GDP by Demand Component (% yoy)

Demand Component [% share to GDP in 2015]	**2014**	**2015**	**2016 Q1**	**2016 Q2**	**2016*e* (BNM)**	**2016*e****	**2017*f****	**2018*f****
Private Consumption [52.4%]	7.0	6.0	5.3	6.3	5.1	5.6	5.3	5.6
Public Consumption [13.5%]	4.3	4.4	3.8	6.5	2.0	5.0	0.9	0.7
Private Investment [16.9%]	11.1	6.4	2.2	5.6	5.5	4.5	5.4	6.1
Public Investment [8.9%]	-4.7	-1.0	-4.5	7.5	1.1	1.5	2.2	2.4
Exports of Goods and Services [72.9%]	5.0	0.6	-0.5	1.0	3.2	0.8	1.3	3.3
Imports of Goods and Services [64.3%]	4.0	1.2	1.3	2.0	3.4	1.8	2.2	3.5
Overall GDP	**6.0**	**5.0**	**4.2**	**4.0**	**4.0-4.5**	**4.2**	**4.3**	**4.6**

Source: Department of Statistics, Malaysia; Bank Negara Malaysia (Annual Report 2015)
** denotes SERC estimates and forecast*

Figure 23: GDP by Economic Sector (% yoy)

Economic Sector [% share to GDP in 2015]	2014	2015	2016 Q1	2016 Q2	2016e (BNM)	2016e*	2017f*	2018f*
Agriculture [8.9%]	2.1	1.2	-3.8	-7.9	-0.3	-2.0	1.0	1.5
Mining & Quarrying [9.0%]	3.5	4.7	0.3	2.6	3.5	1.8	2.0	2.3
Manufacturing [23.0%]	6.2	4.9	4.5	4.1	4.1	4.2	4.2	4.6
Construction [4.4%]	11.7	8.2	7.9	8.8	7.9	8.5	8.8	9.0
Services [53.5%]	6.6	5.1	5.1	5.7	4.4	5.2	5.0	5.1
Overall GDP	**6.0**	**5.0**	**4.2**	**4.0**	**4.0-4.5**	**4.2**	**4.3**	**4.6**

Source: Department of Statistics, Malaysia; Bank Negara Malaysia (Annual Report 2015)
** denotes SERC estimates and forecast*

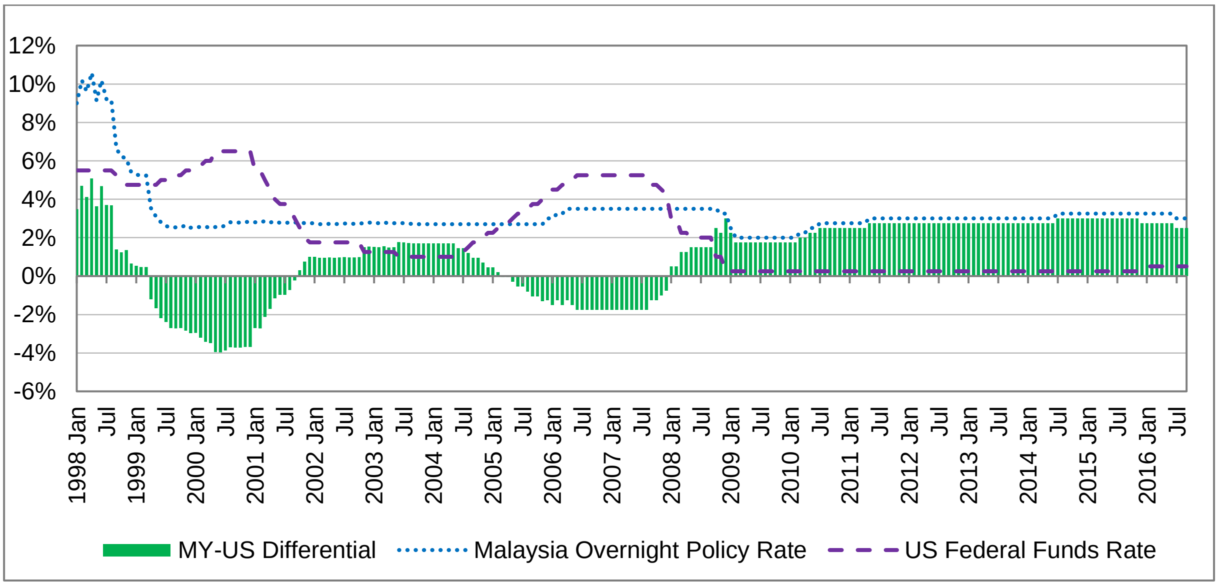
After a surprise pre-emptive rate cut in July, Bank Negara Malaysia (BNM) kept the overnight policy rate (OPR) unchanged at 3.00% after the September's Monetary Policy Committee (MPC), citing that the current interest rate policy is accommodative to support the domestic economy on a steady growth trajectory amid stable inflation.

Notwithstanding subdued external demand, BNM is confident that domestic demand to remain the key driver of growth, with private consumption and private investment growing at a faster pace in 2H16.

Going forward, the monetary stance will be data dependent. We think BNM will assess the implications of 2017 Budget's measures and initiatives on domestic economy, especially whether there will be additional impetus to sustain consumer spending and private investment. This is to ensure that the degree of monetary accommodation is consistent with the fiscal policy stance.

With the growth risk remains a concern, BNM is expected to keep the option opens to monetary easing if the growth under threat. We expect the overnight policy rate to stay steady at 3.00% until year-end and 2.75-3.00% in 2017.

Figure 24: Malaysia-US's interest rate differential



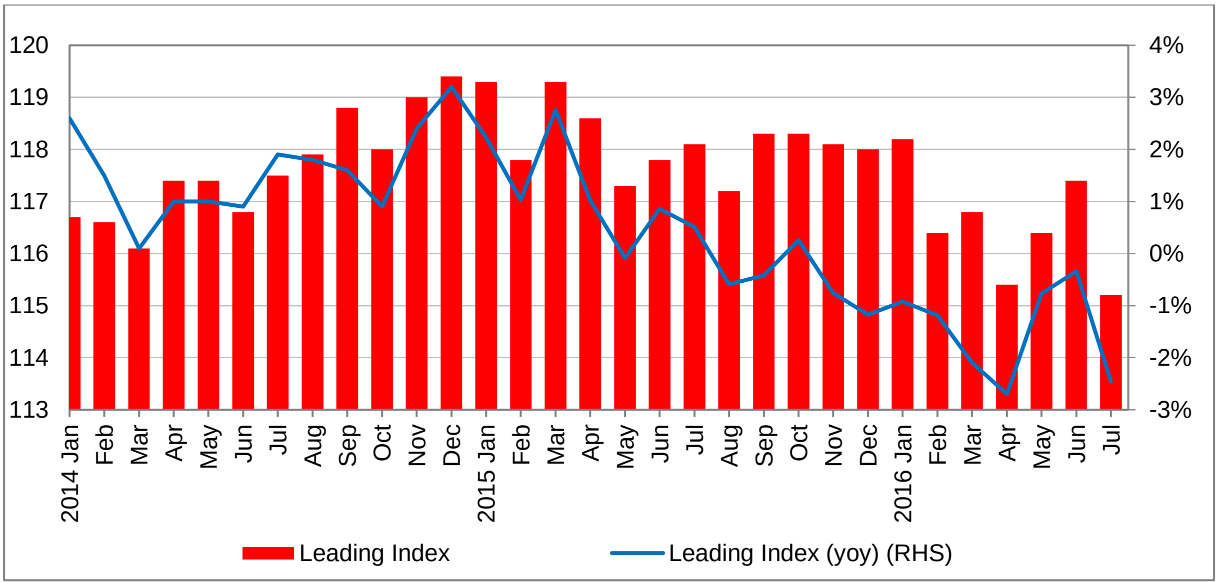
Source: Bank Negara Malaysia and Federal Reserve

REVIEW OF KEY ECONOMIC INDICATORS

High frequency data for the months of July-Aug showed mixed outcomes but not pointing towards significant deceleration in GDP growth rate. Real GDP growth is estimated to average 4.2-4.3% in 2H16 compared to 4.1% in 1H, taking the full-year growth to 4.2%. The growth prospects for 2017-18 should continue to remain challenging, with real GDP growth estimating at 4.3-4.6%.

1. The **leading index (LI)**, a gauge of forward growth expectations continued to indicate the economy will grow at a slower pace in the months ahead. The annual rate of LI contracted by a larger magnitude of 2.5% in July after registering small declines of -0.8% in May and -0.3% in June. It must be noted that the annual growth of index has been down for nine successive months since November 2015. This indicates that the economic growth will remain positive but at a slower rate in the coming months.

Figure 25: Leading index indicates moderate economic growth ahead



Source: Department of Statistics, Malaysia

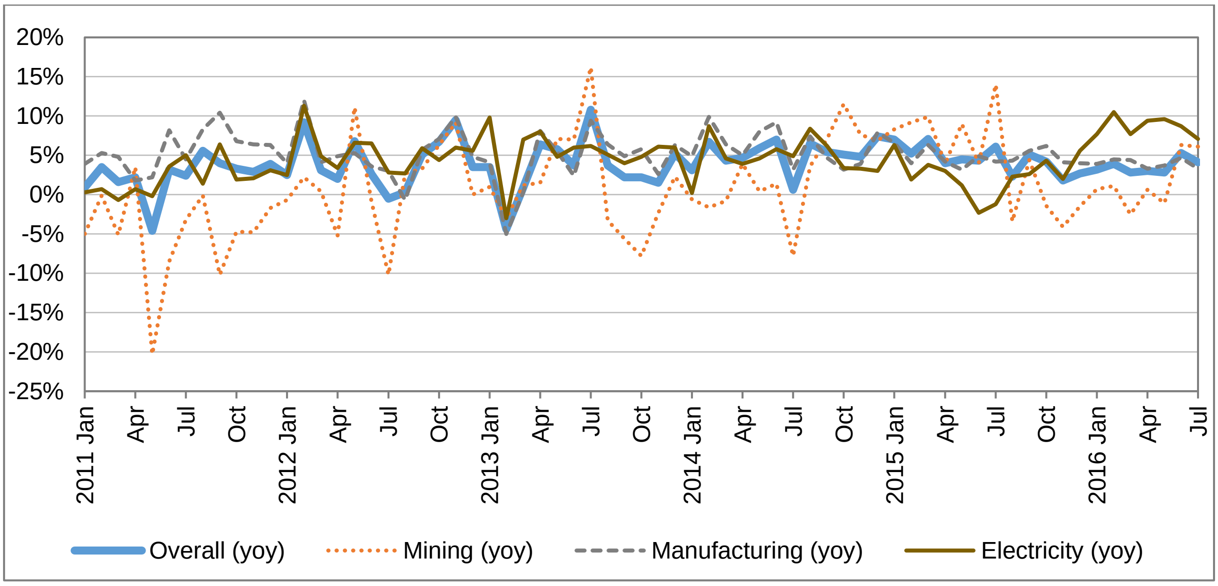
2. **Industrial Production Index** (IPI) growth, a proxy of overall economy eased to 4.1% yoy in July (+5.3% in June), partly distorted by shorter working days during Hari Raya celebrations. It marks moderately good start to the third quarter (+3.7% yoy in 2Q and +3.3% in 1Q).

   All three sectors recorded positive growth, albeit slower: manufacturing (3.3% vs. 4.7% in June), mining (6.1% vs. 6.3% in June) and electricity (7.1% vs. 8.7% in June). On a positive note, mining output had expanded for two months in a row and the growth rate was significantly higher compared to 2Q (+1.9%).

   The major sub-sectors which recorded expansions in July were petroleum, chemical, rubber and plastic products (3.5% vs. 5.0% in June), electrical products and electronics (4.1% vs.9.1% in June), non-metallic mineral products, basic metal and fabricated metal products (4.1% vs. 5.1% in June).

   Going by a moderate pace of overall industrial production and manufacturing output in July, the start of the third quarter, real GDP growth is estimated at 4.1-4.2% in 3Q16 (4.0% in 2Q). The improvement of public service schemes and salary increment for 1.6 million civil servants, higher minimum wage in July, the final instalment payout of BR1M in September as well as year-end festive spending are expected to lift consumer spending.

Figure 26: Industrial production grew steadily



Source: Department of Statistics, Malaysia

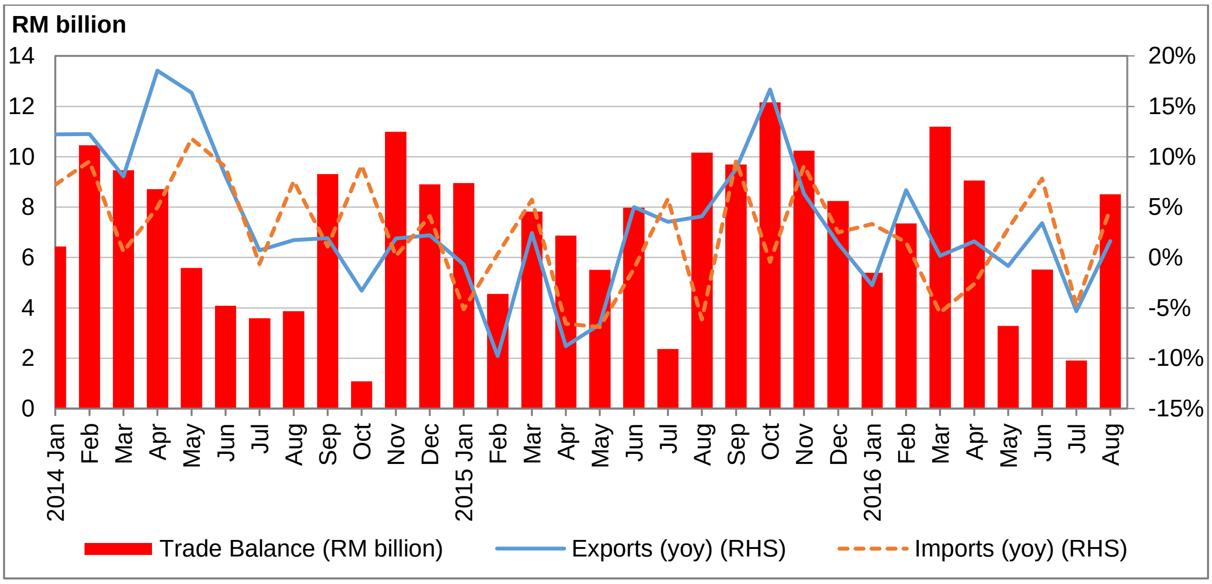
3. The **external sector** strengthened in August as exports grew by 1.5% yoy (-5.3% in July) relative to higher import growth (4.9% vs. -4.8% in July). The trade surplus widened substantially to RM8.5 billion in August from a surplus of RM1.9 billion in July. On a cumulative basis, Malaysia's trade surplus totalled RM52.2 billion in Jan-Aug as both exports and imports rose moderately by 0.9% each.

   Major products that recorded increases were electrical products and electronics (3.0%; share 38.2%), chemicals and chemical products (11.8%; share 7.6%), palm oil and palm oil-based products (21.3%; share 7.3%) and crude petroleum (13.9%; share 2.9%). The products that recorded sharp declines were liquefied natural gas (LNG) (-38.9%; share 2.8%), followed by petroleum products (-15.7%; share 5.8%) and manufactures of metal (-11.1%; share 4.0%).

   The rise in imports were across-the-board. Intermediate goods turned around to increase by 6.1% in August (-11.8% in July), followed by capital goods (+9.0% vs. 46.6% in July) and consumption goods (+10.4% vs. -6.8% in July). The rise in consumption goods were contributed by non-durables, food and beverages mainly or household consumption and durables.

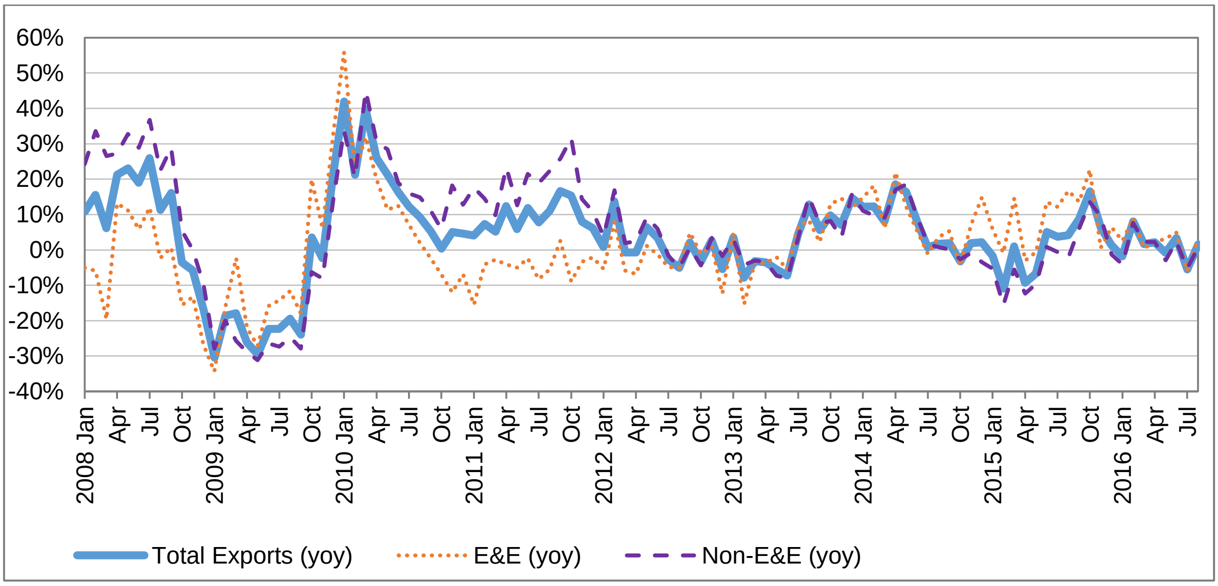
   Moderate global growth and weak commodity prices will continue to weigh on exports, which are expected to grow unevenly in 2H16. High export levels in September and October 2015 would cause a sharp pullback in export growth on a yoy comparison. In Jan-Aug, exports remained subdued at 0.9%. Exports are estimated to rise by 0.1% in 2016 and 1.0-1.5% in 2017.

Figure 27: Subdued export growth



Source: Department of Statistics, Malaysia

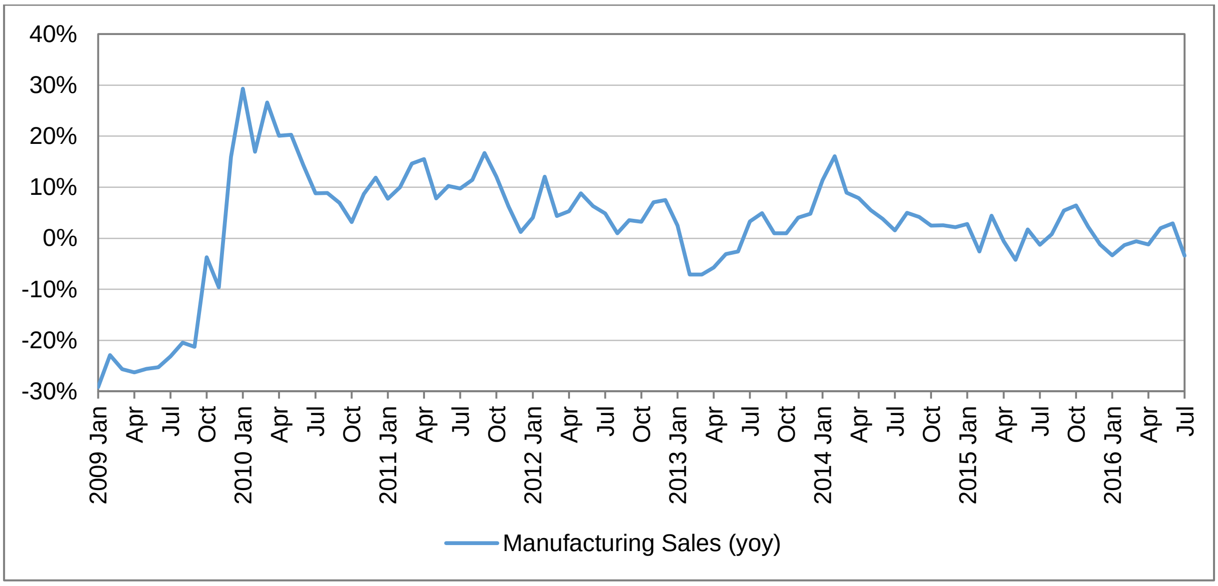
Figure 28: Weak exports of electronics and commodities



Source: Department of Statistics, Malaysia

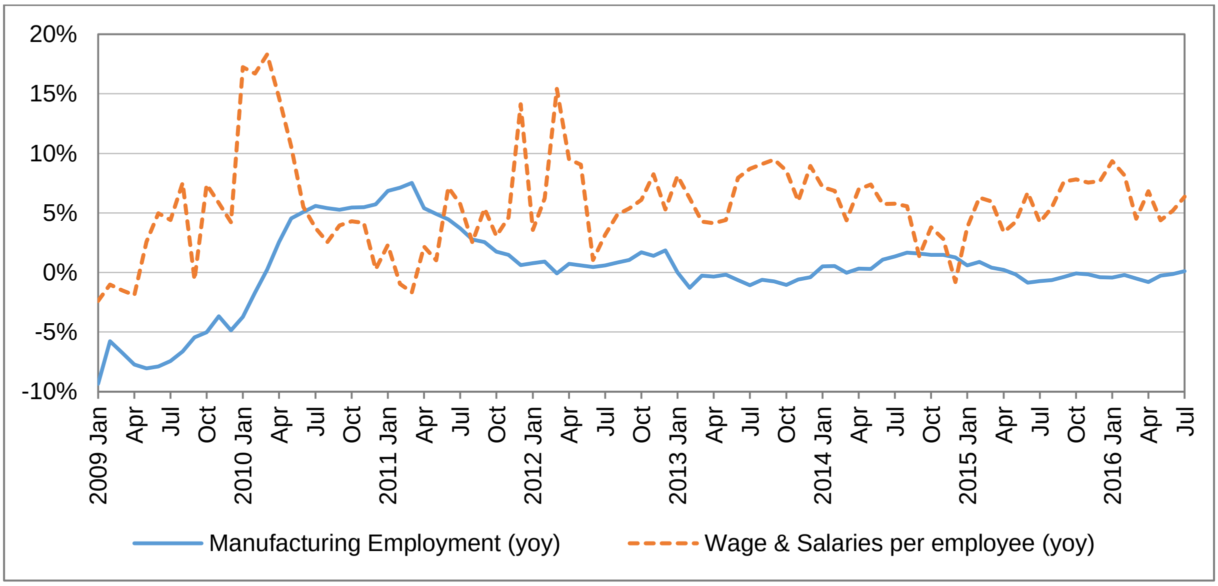
4. **Manufacturing sales** reversed to decline by 3.4% yoy to RM52.3 billion in July after two months of increases. Higher sales growth were recorded in refined petroleum products, consumer electronics, passenger cars, building of ships and floating structures. As at end-July, manufacturing employment growth rose 0.1% yoy for the first time to 1,024,823 after registering 14 successive months of decline since May 2015. Total salaries and wages paid grew further by 6.5% yoy in July (+5.0% in Jun) while productivity declined by 3.5%.

Figure 29: Manufacturing sales reversed to decline in July



Source: Department of Statistics, Malaysia

Figure 30: Sluggish manufacturing employment growth



Source: Department of Statistics, Malaysia

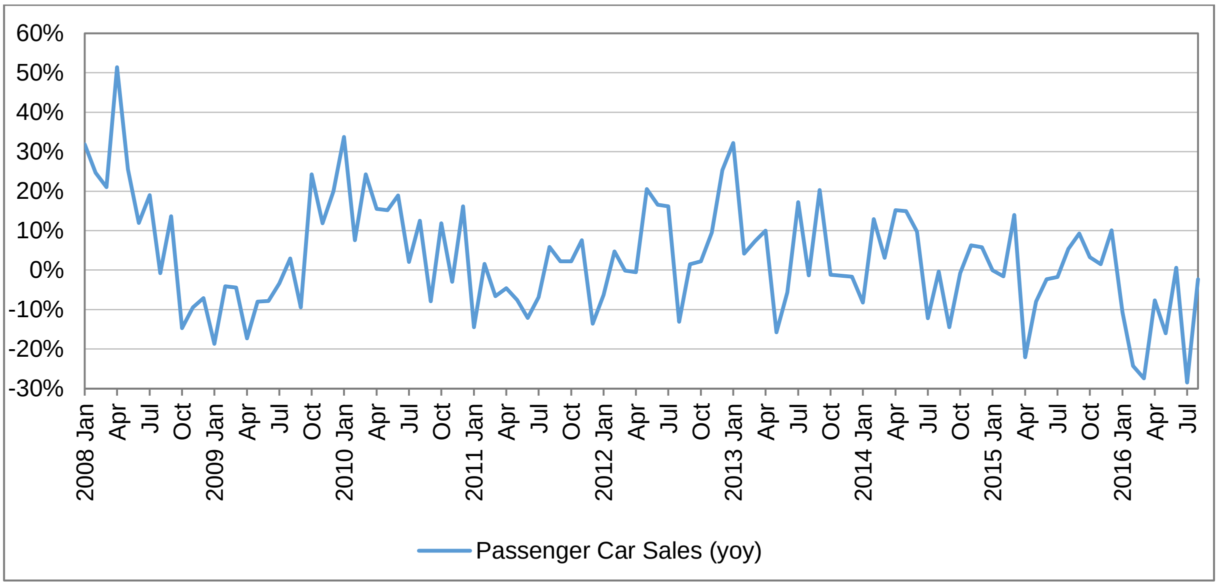
5. **Private consumption indicators** present a mixed bag of reading. MIER's consumer sentiment index rose further by 5.6 points to 78.5 in 1Q (72.9 in 1Q), backed by a fairly stable household income amid cautious expectations about job and financial as well as growing worries about prices. Nevertheless, the consumer sentiment index remains below the 100-pt threshold level of optimism.

   Amid selective retrenchments in some manufacturing industries either due to the redundancy of productivity or restructuring, the unemployment rate rose to 3.5% in July after unchanged at 3.4% for two consecutive months in May and June.

Passenger car sales dipped by a smaller magnitude of 2.3% yoy to 46,223 units in August (-28.5% in July). However, it jumped 22.8% mom in August, partly due to a longer working month and new models launches. In the first eight months, total car sales contracted by 15.1% to 328,227 units while production also declined by 17.9% to 315,940 units.

In the months ahead, a strong pipeline of new models, attractive discounts and promotions are expected to help modest sales. Nevertheless, cautious mood amongst customers still prevail, especially for big-ticket items amid slow macroeconomic environment on the back of rising living costs, worries about job prospects and moderate wage growth.

Figure 31: Passenger car sales dipped smaller in August

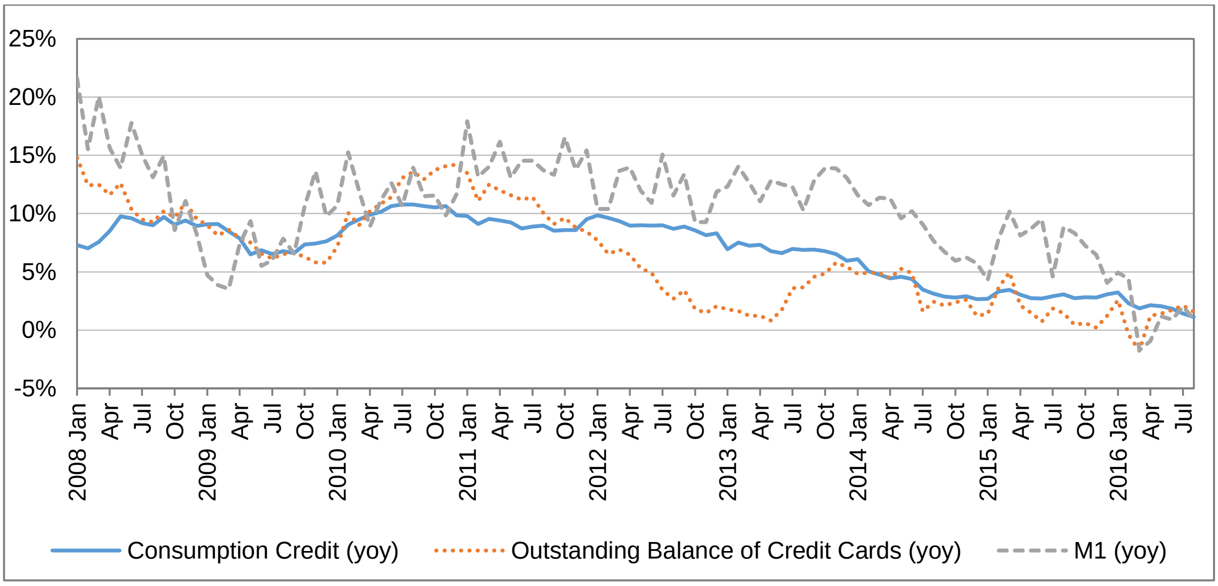


Source: Bank Negara Malaysia

Loans extended by the banking system for **consumption purposes** such as for the purchase of durables and personal use still growing at measured pace. Imports of consumption goods returned to positive growth of 10.4% yoy in August (-6.8% in July; +1.8% in June). Consumption credit growth of 1.1% yoy in Aug (1.4% in July) was moderately below from 1.8% growth in 2Q and 1.9% in 1Q16.

Private consumption has been gaining stronger growth traction since 4Q15, upping from 4.9% yoy in 4Q15 to 5.3% in 1Q and 6.3% in 2Q16, a positive sign that consumer spending remains resilient. The 2017 Budget is expected to deliver some personal tax relief measures, including higher cash handouts (via BR1M) to sustain consumer spending. Private consumption growth is estimated to grow by 5.8% in 2016-17, albeit slower compared to +7.1% growth in 2011-15.

Figure 32: Discretionary consumer spending amid cautious sentiment



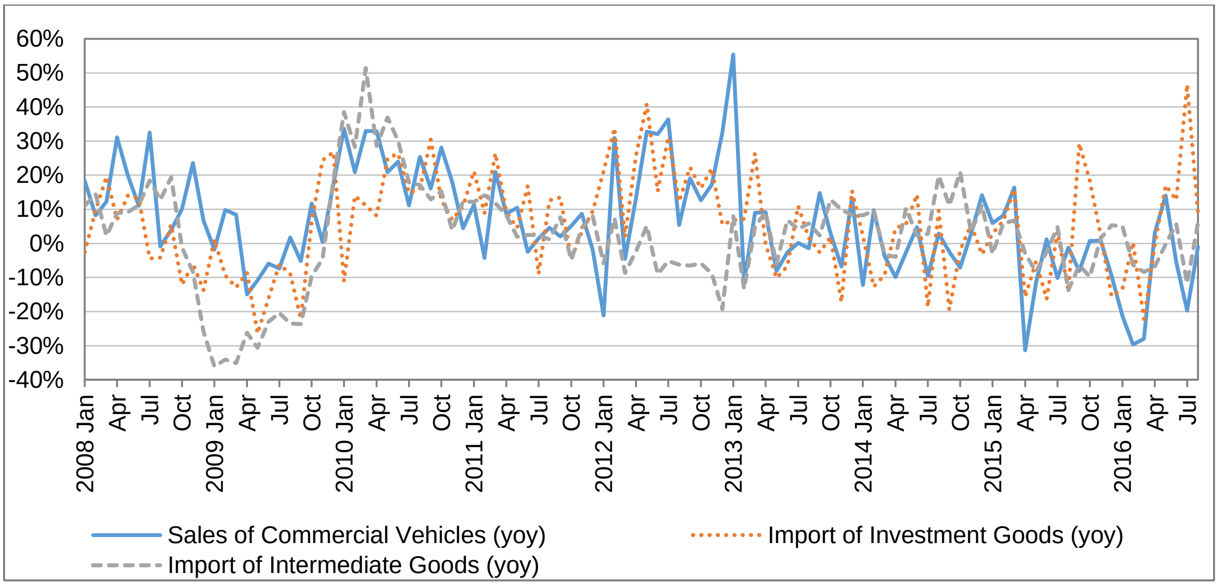
Source: Bank Negara Malaysia

6. **Private investment indicators**, including sales of commercial vehicles, imports of capital and intermediate goods showed mixed growth. Imports of capital goods continued to expand by 9% yoy in August, albeit slower when compared to 46.6% in July (12.7% in Jun), backed by higher spending on industrial machinery and equipment. Imports of intermediate goods, a forward indicator of future production and exports rebounded to +6.1% yoy in August from a sharp contraction of 11.8% in July (5.7% in Jun).

   After slowing for four consecutive quarters since 2Q15, private investment growth rebounded to 5.6% yoy in 2Q16 from 2.2% in 1Q, raising hopes that private investment is not totally lost in translation, underpinned by continued investment in manufacturing and services, which counteracted the sluggish mining investment.

   MIER's business confidence index (BCI) gained 13.6 points to 106.4 in 2Q16, as businesses surveyed expecting sales to trend higher; pick-up in output activities; and higher local and overseas orders.

Figure 33: Private investment indicators show mixed outcomes

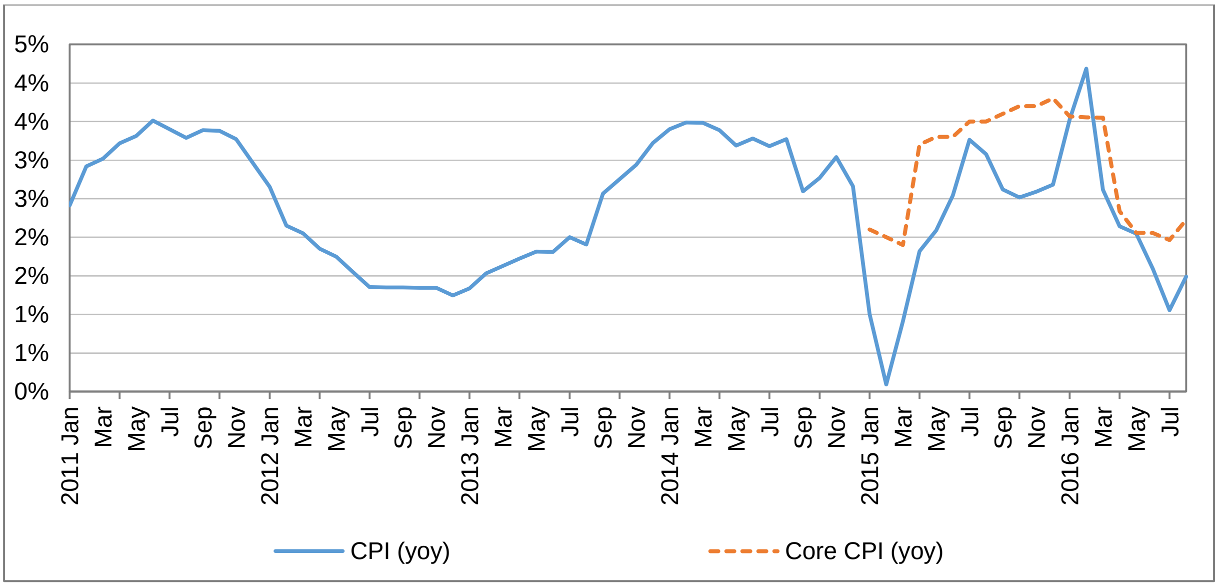


Source: Bank Negara Malaysia

7. **Headline inflation** edged higher to 1.5% yoy in August (1.1% in July), thanks to a smaller drop in transportation prices (-6.7% vs. -9.9% in July) mainly aided by base effects from the reduction in domestic fuel prices in August 2015. Higher price increases were reflected in health services (2.2% vs. 2.0% in July) as well as recreation and services (3.6% vs. 1.7% in July). Amongst the CPI index, which recorded slower price increases were food (3.5% vs. 3.8% in July), alcoholic beverages and tobacco (19.7% vs. 19.9% in July), housing, water and electricity (2.1% vs. 2.4% in July) as well as education (2.0% vs. 2.2% in July) while communication declined (-2.4% vs. -2.3% in July). Overall price index for services edged higher to 2.4% in August from +2.1% in July.

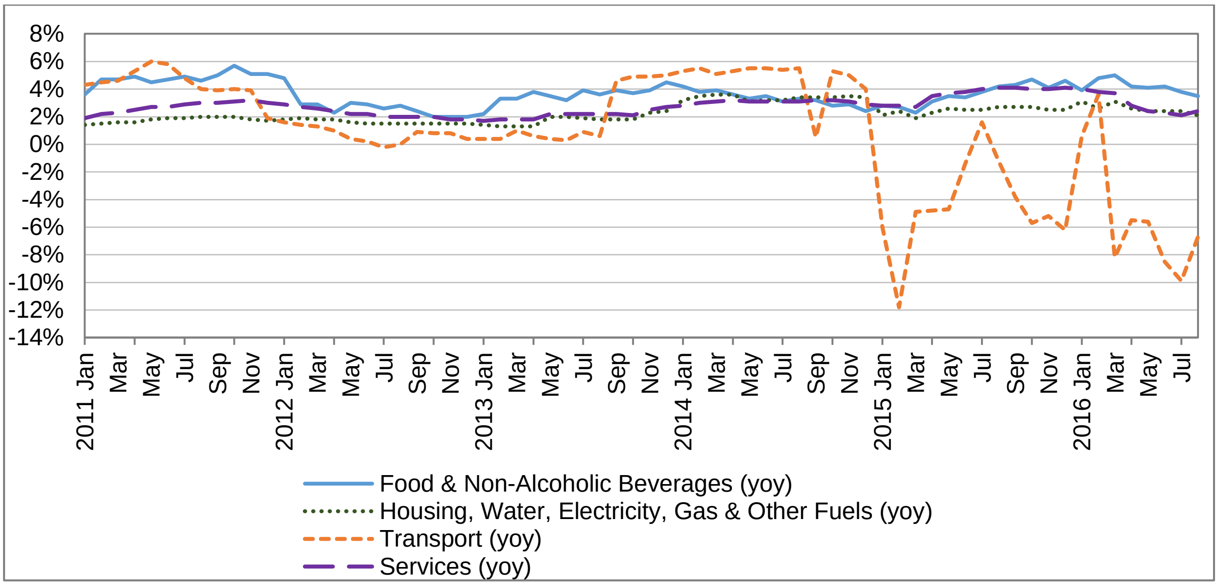
   In the first eight months of 2016, inflation increased 2.3%. We expect inflation to edge higher as the favourable base effect diminishes, aided by soft global oil prices. Headline inflation is estimated to average 2.3-2.4% this year and remain relatively stable around 2.4-2.5% in 2017.

Figure 34: Inflation edged higher to 1.5% in August



Source: Department of Statistics, Malaysia

Figure 35: Food prices eased amid smaller declines in transport prices

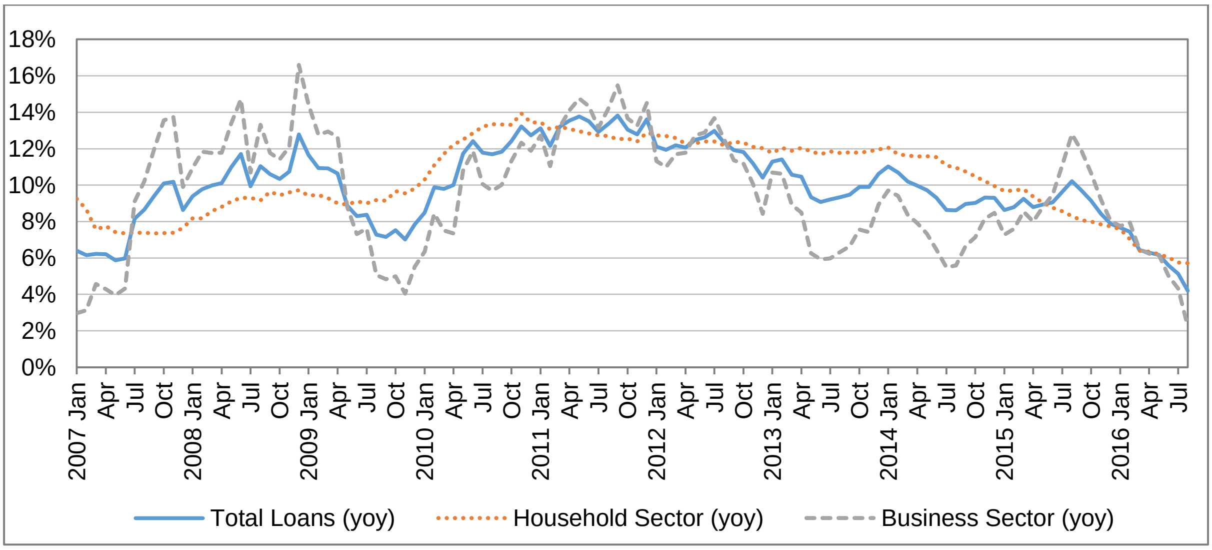


Source: Department of Statistics, Malaysia

8. **Loan indicators** showed improvement in August. Loan applications contracted by a much smaller rate of 1.6% in August (-18.0% in July), supported by positive growth in loan applications for the purchase of residential and non-residential properties, passenger cars, securities as well as credit cards. Loan approvals increased marginally by 0.2% (-19.4% in July) due to increases for the purchase of shares and passenger cars, credit cards utilisation as well as a smaller decline in residential property lending. Loan disbursement declined by 6.0% in August, an improvement from a double-digit decline of 11.0% in July.

   Banking system loan growth eased further to 4.2% yoy as at end-August (5.1% in July), due to a sharp pullback in business loans (2.2% vs 4.3% in July) while household loans were sustained at 5.7% (5.7% in July). In the business sector, lower loan growth mainly reflecting the high base effect in August 2015 and large one-off loan repayments by a few domestic businesses.

Figure 36: Business loans growth slowed while household loans sustained



Source: Bank Negara Malaysia

9. **Bank Negara Malaysia's holdings of foreign exchange** stood at US$97.7 billion as mid-September, an increase of US$2.4 billion from US$95.3 billion as at end-Dec 2015. The level of reserves is sufficient to finance 8.1 months of retained imports and were 1.2 times the short-term external debt.

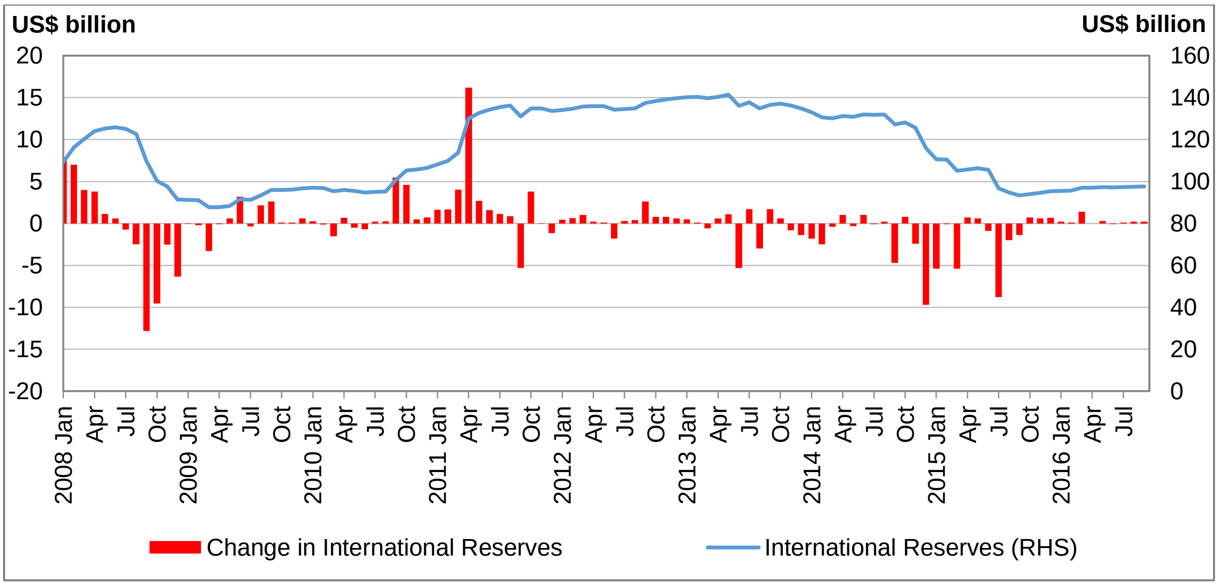
Net inflows of portfolio investment narrowed sharply to only RM77 million in 2Q16 from RM13.1 billion in 1Q, taking the cumulative net inflows to RM13.3 billion in 1H16. This marks the third consecutive quarter of net inflows since 4Q15. It must be noted that Malaysia had suffered net outflows for three successive years (-RM28.2 billion in 2015; -RM39.4 billion in 2014 and -RM3.0 billion in 2013).

The sharp pullback in net portfolio investment inflows in 2Q was due to foreigners' mid-year portfolio rebalancing, post-Brexit induced selling, albeit short-lived as well as sporadic fears over the Fed's rate lift-off. Data compiled from Bursa Malaysia showed that net foreign institutional selling amounted to RM4.3 billion in May and RM1.8 billion in June on disappointing corporate earnings for second quarter, lower oil prices as well as the guessing game over the Fed's interest rates action. The selling trend reversed its course to net foreign buying of RM1.0 billion in July and RM1.6 billion in August. However, foreigners turned net sellers amounting to RM300 million in September.

Post-Brexit fears, non-resident holdings of Malaysia bonds, including Malaysian Government Securities (MGS) and Malaysian Government Investment Issues (GII) rose to an all-time high of RM217.6 billion as at end-August or 36.3% of total Malaysia bonds. Foreign holdings of MGS accounted for 51.5% of total MGS outstanding, which is equivalent to RM186.9 billion.

Concerns about global growth outlook, the Fed's rate hike path as well as lingering uncertainty related to post-Brexit will continue to induce capital flows volatility in emerging markets, including Malaysia.

Figure 37: Foreign reserves rise marginally

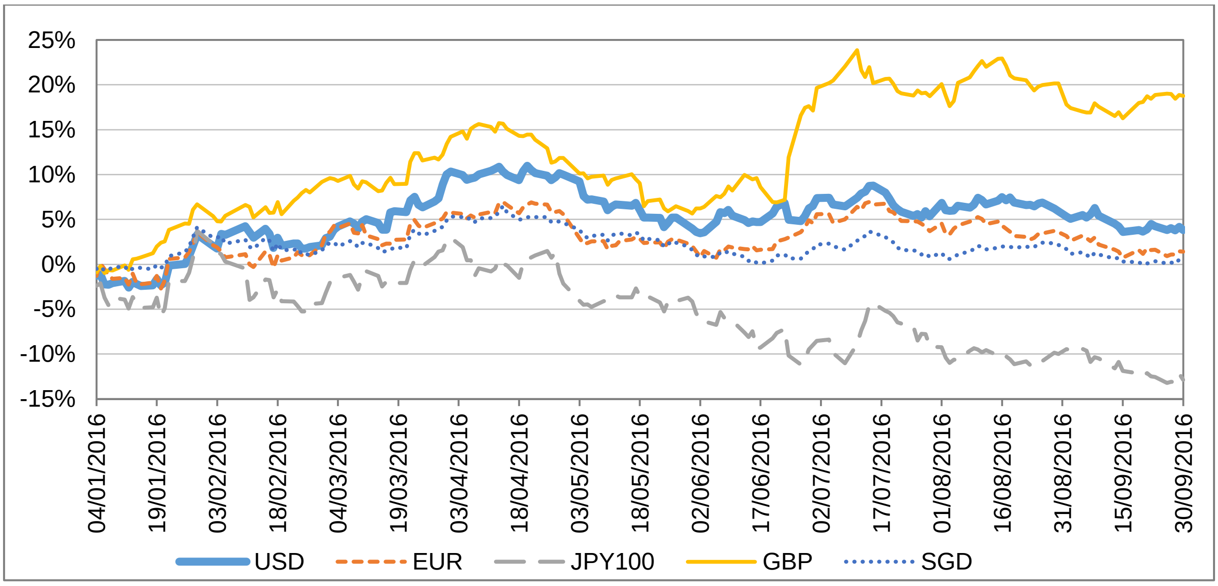


Source: Bank Negara Malaysia

During the third quarter, the ringgit depreciated against the currencies of Malaysia's major trade partners due to portfolio outflows, renewed volatility in global crude oil prices, the expectations of a possibility of the Fed lifting US interest rates. As at end-Sep 2016, the ringgit depreciated by 2.5% against the US dollar to RM4.1355 compared to RM4.0315 as at end-June. YTD, the ringgit still gained 3.8% from RM4.2935 at end-Dec 2015.

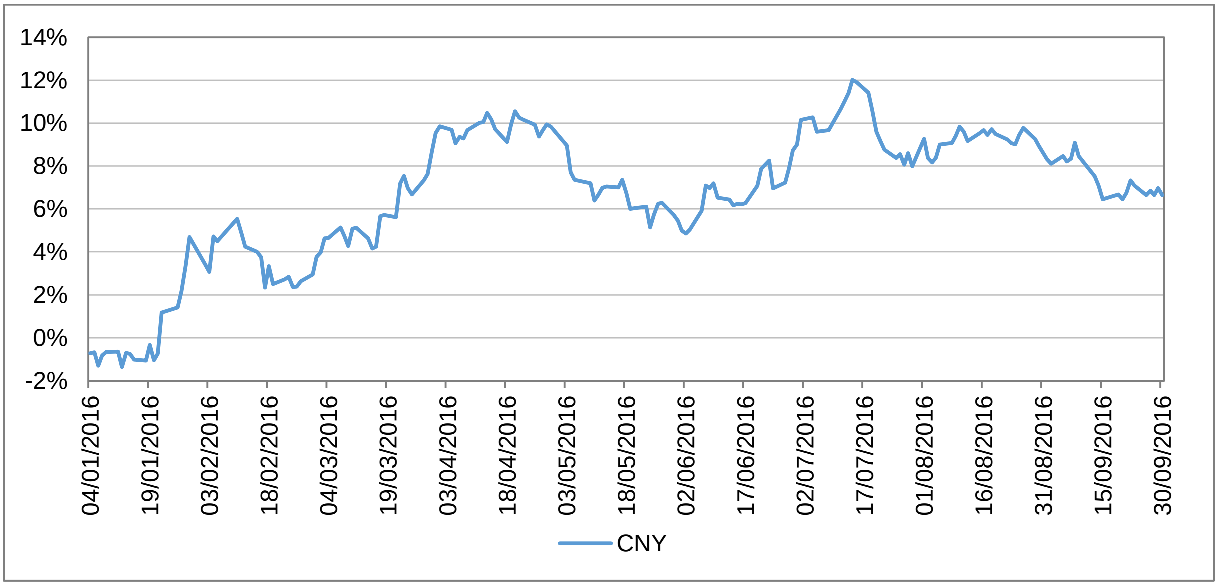
The ringgit will continue to remain under pressure, influenced by investors' sentiment towards emerging markets on intermittent concerns about the impact of global growth slowdown, lower crude oil prices, negative spillovers from the Fed's rate liftoff as well as the cloud of uncertainty surrounding post-Brexit. Bank Negara Malaysia's future monetary stance and domestic macro conditions also come into play. The ringgit is expected to end the year at RM4.15 per US dollar (End-2015: RM4.2935).

Figure 38: Ringgit appreciated against USD, EUR, GBP & SGD but depreciated against JPY since end-2015



Source: Bank Negara Malaysia

Figure 39: Ringgit appreciated against CNY, albeit at smaller magnitude



Source: Bank Negara Malaysia

SOCIO-ECONOMIC RESEARCH CENTRE (SERC)
SERC SDN BHD (918837-W)

6th Floor, Wisma Chinese Chamber,
258, Jalan Ampang, 50450 Kuala Lumpur, Malaysia.
Tel: (603) 4260 3116 / 3119   Fax: (603) 4260 3118
Email: serc@acccimserc.com
Website: http://www.acccimserc.com