QUARTERLY ECONOMY TRACKER

(OCT-DEC 2018 & 2019 OUTLOOK)

Socio-Economic Research Centre (SERC)

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Socio-Economic Research Centre (SERC)

Executive Director

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

Researcher

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

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

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Executive Summary

World Economic Situation and Prospects for 2019

Heightened concerns over slowing global growth. The global economy continued to grow at a moderate pace in the fourth quarter of 2018, extending its moderating trajectory after peaking in the first half-year of 2018. A synchronised global slowdown will persist in 2019 amid lingering concerns about the outcome of the US-China's 90-day deadline trade truce talks to thrash out their trade differences before a 2 March 2019 deadline; the UK's Brexit deal by end-March 2019 as well as unpredictable geopolitical events and political risks. Intensified concerns about slowing global economy has caused extreme volatility in global financial markets and fast tumbling crude oil prices. Oil prices have plunged more than US$30 a barrel since the start of October 2018, when Brent crude rose to nearly US$87 a barrel and US WTI crude traded just shy of US$77.

A critical year ahead, focusing on the drivers of global economy stress. While we expect the global economy to expand at still-moderate pace (estimated 3.6% in 2019 vs. estimated 3.9% in 2018), significant risks are materializing and darker clouds are looming. The biggest storm is the possibility of a messy global trade war, no-deal (hard) Brexit could further dent investors' confidence as well as the deteriorating and over-tightening global financial conditions. If the US and China's trade negotiations come to a "compromise" deal without ramping up more tariffs, it bodes well for the global economy at a time when the US economy is facing headwinds and China faces softening growth.

Continued slow growth in advanced and emerging economies. While current and forward economic indicators for advanced economies have slowed albeit mixed, they are not collapsing. The US economy grew a brisk 3.4% annualised qoq rate in 3Q18 and a growth of 2.5-2.8% is expected in 4Q18, putting the economy on track to record 3.0% growth in 2018. The strength of the US economy will likely to fade towards end-2019 as the fiscal stimulus effects run out of steam. In the euro area, real economic and sentiment indicators suggest further deceleration of activity. In Japan, 2019's GDP growth should be supported by Bank of Japan (BOJ)'s ultra-loose monetary policy, a tight labour market and construction works related to the 2020 Tokyo Olympics amid the impact of persistent trade tensions on exports and the planned hike in consumption tax will weigh on consumption. Growth in Asia though has slowed but still credible. China's economy will continue to slow in 2019 (estimated 6.3% vs. 6.7% in 2018) on continued deleveraging from a slump in the property market amid the dampening impact of uncertainties surrounding the trade spats with the US as well as a slowdown in global economy.

Will global interest rates on easing mode? The Federal Reserve (Fed) ended the year 2018 with four rate hikes, taking the Fed funds rate to 2.25-2.50% (three rate hikes in 2017 to 1.25-1.50%), citing still strong economy and near-balanced inflation risk. The Fed lowered its interest rate hikes projection to two for 2019 from three previously, citing continued monitoring of economic conditions (data dependent). While market consensus expect the nearing of rate-hiking cycle, the baseline Fed funds rate is expected to reach 2.75-3.00% by end-2019. While the European Central Bank (ECB) has halted its quantitative easing in December 2018, it would continue to reinvest the principal payments from maturing securities "for an extended period of time" while keeping interest rates at their present record-low levels until at least the end of summer. BOJ is expected to continue maintaining easing monetary policy given sluggish inflation. Most Asian central banks are expected to keep policy rate steady as the Fed looks toward topping its interest-rate hiking cycle.

Malaysia's Economic and Financial Conditions

Growth bottoming out in 3Q18? Stronger exports, higher industrial production and services output for the months of Oct-Nov suggesting an improvement in GDP growth in the fourth quarter, which is estimated to grow by 4.5-4.6% (4.4% in 3Q18). This would bring the full-year GDP growth to 4.7% in 2018 (5.9% in 2017).

A tumultuous year for 2019. With the global economy looking to moderate further and weaker exports, the Malaysian economy is expected to grow at a gentle pace of 4.7% in 2019. Still, domestic demand (2018: 92.3% of total GDP) will remain the dominant driver of economic growth with private sector spending (72.3% of GDP) holding the fort as public sector spending (20.0% of GDP) continues to rationalise, focusing on essential sectors and programs.

Slower consumer spending but still respectable. Solid consumer spending has been sustaining at a buoyant rate of averaging 7.4% yoy during 2017-3Q18 to support overall economic growth. The central question is whether its strength can be sustained in 2019? While the one-off spending boost from a 3-month tax holiday will normalize in 4Q18 and in 2019, private consumption growth is expected to grow by 6.8% in 2019 (estimated 7.3% in 2018) as supported by stable employment and income growth. According to the Malaysian Employers Federation's (MEF) Salary Surveys for Executives and Non-Executives, overall average forecast salary increases for executives in 2019 is 4.86% (4.88% in 2018) while it is 4.89% in 2019 (4.88% in 2018) for non-executives. Higher minimum wage increases (between 10.0-19.6% or RM100-180 per month) as well as continued cost of living aid also help to ease the burden of low and middle income households. Moderate inflation along with lower petrol prices bode well for consumption.

Caution prevails for private investment. Slower global economy amid persistent trade tensions and global financial markets' volatility as well as investors still getting in tune with domestic policy landscape, private investment growth is likely to stay in cautious mode. Private investment, which grew by an average growth of 4.5% yoy in the first nine months of 2018 will expand moderately higher from estimated 4.1% in 2018 to 4.3% in 2019. Capital spending in the manufacturing and services sectors continued, offsetting slower growth in construction and mining sectors.

A more difficult outlook for exports. Exports hit a record high of RM96.4 billion or an increase of 17.7% in October before easing off to RM84.8 billion or +1.6% in November, partly reflecting the normalisation of the front-loaded shipments ahead of the planned higher tariffs of 25% of the US-China's trade war starting 1 January 2019, which has been postponed for three months until 2 March to set the stage for a 90-day trade truce talks (December 2018 to February 2019). Looking ahead, exports will be challenged by slowing global demand for electrical and electronic products, weaker commodity and crude oil prices as well as technical base effect of high exports value averaging RM83.3 billion per month in 2018. We estimate exports to grow at a slower rate of 3.3% in 2019 (estimated 6.9% in 2018; 18.8% in 2017).

Inflation will pick up gradually. Despite the introduction of Sales and Service Tax (SST), inflation continues to stay on the backburner with annual inflation rate hovering between 0.2% and 0.6% between September and November 2018, thanks to a high year-ago base effect. Softer prices of food and housing as well as a sharp decline in transport prices also helped keeping overall general prices at subdued levels.

With fuel prices reverting to a weekly managed float system starting January 2019 while working on the targeted fuel subsidy by the second quarter, headline inflation is likely to be influenced by variation in global crude oil prices. Post-SST two months transition period allowing for inventory adjustment, hypermarkets and retail chains had to adjust their prices by 15 November. Headline inflation is estimated to increase gradually to 1.5-2.0% in 2019 from estimated 0.9% in 2018.

Interest rate is seen on hold with "easing" bias. With the balance of risks tilting toward the downside, Bank Negara Malaysia (BNM)'s monetary policy stance ahead will be data dependent, focusing on ensuring domestic demand can endure the dampening impact of external headwinds. SERC expects BNM's Overnight Policy Rate (OPR) to hold steady at 3.25% in 2019. What would prompt a cut in interest rate is when real GDP growth slipping to around 4.0% even at the expense of exerting downward pressure on the ringgit.

The Ringgit will strengthen gradually in 2H19. The fundamental drivers to support ringgit are positive economic prospects, continued surplus in current account, healthy foreign reserves, stable fiscal and debt path as well as the affirmation of Malaysia's sovereign ratings.

The restraining factors weighing on the ringgit are concerns about slowing global economy, capital flows volatility and the prospects of higher US interest rates, which the Fed has scaled down the number of hikes in 2019 to two from three previously.

On balance, SERC expects the ringgit to remain weak in most of 1H19 before gathering strength towards 4Q19, taking into account the likely pausing of the Fed's interest rate or could be peaking in 3Q19. This would take some pressure off the ringgit. Our end-2019 ringgit per US$ target is RM3.95-4.00 (End-2018: RM4.1385/US$1).

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GLOBAL OUTLOOK 2019: NAVIGATING THE HEADWINDS AND TAILWINDS

Heightened concerns over slowing global growth. The world economy, which has reached its strongest point of expansion since 2011 is growing less evenly and synchronized in advanced and emerging Asia. The US economy looks set to slow in 2019-2020 as the fiscal stimulus fades and higher interest rates started to bite on interest rate sensitive sectors. China's growth continues to face hurdles from lingering uncertainty surrounding the trade disputes with the US. In our view, the odds of global recession in 2019-2020 is around 30-40% while that for the US economy may be toward end-2019 or in 2020.

High frequency leading and forward indicators such as the OECD leading indicators, Purchasing Managers' Indices (PMI) for services and manufacturing, trade and investment indicated that the global economic expansion has passed its recent peak and the growth momentum has eased and more generally, there are escalating risks to the outlook.

The International Monetary Fund (IMF) has marked down global GDP growth estimates to 3.7% for 2019 (3.7% in 2018) from 3.9% previously, citing the balance of risks are tilted on the downside. The Organisation for Economic Co-operation and Development (OECD) also slashed its estimate of global GDP growth to 3.5% for 2019 from 3.7% previously.

Gone are the days when accelerating and a synchronized global economic expansion and financial markets' vibrancy were given, thanks to a prolonged period of still accommodative interest rates though the Federal Reserve had started to normalize interest rates at small steps since 2015, accompanied by an unwinding of the quantitative easing.

We are now in an era of considerable economic uncertainties, geopolitical risks and political fluidity. The outlook for growth and global liquidity conditions as well as foreign exchange market will likely become even more uncertain and divergent in advanced and emerging economies.

Bear in mind that global growth and equity markets, especially that of the US is running on a two-year stretched cycle, powered by President Trump's unprecedented tax cuts and spending stimulus as well as tariffs war, which only yields short-term benefits but long-term pain.

The combination of trade, fiscal and monetary policies will be taking the foot off the accelerator and turning somewhat less friendly for growth this year. On a positive note, the current softening of commodity prices, especially crude oil if persists, would provide a relief to consumer spending though lower oil prices could presage slowing global demand.

Trade war troubles remain a big wild card. The escalation of the US-China's drawn-out trade war will surely pose significant risks to the global economy and trade via both trade and financial channels. First, the spillover effects, which the impact felt not only in the US and China but also across the value chains that span several countries; Second, the escalation effect, which had impaired trade flows and undermined global growth; and finally, the uncertainty effect as it dampens business confidence, affects corporate earnings and unsettles financial markets.

While both the US and China have agreed to a 90-day trade truce talks starting December 2018, it prolongs investors' uncertainty and cautious sentiment.

The devil is in the details. Lingering doubts remain on how comprehensive a new trade deal can be compromised. If there is no progress achieved within 90 days, the US administration will proceed to raise the tariffs rate to 25% from 10% on the US$200 billion worth of Chinese goods. This may extend to cover the remaining US$257 billion worth of Chinese goods that are not currently subject to duties.

It is estimated that the intensified trade protectionism measures are expected to slash world growth by 0.8% pts and world trade by 1.1% pts. Asia's economic growth could be lowered by 0.8% pts in coming years.

Economic prospects of major economies. On the **US economy**, the fiscal stimulus boost will start to fade in the second half-year of 2019. There are early signs that the US corporates' capital spending have somewhat moderated. Likewise, consumer spending will slow following the lapsing of income tax cuts, tighter financial conditions and increasing borrowing costs. US GDP growth is estimated to slow to 2.5-2.7% in 2019 compared to estimated 3.0% in 2018.

Although growth in eurozone and Japan have decelerated in the course of 2018, it remains above trend. In the **eurozone**, a solid domestic economy should drive decent growth in 2019. But, the threat of rising global protectionism, financial markets turbulence and political risks in some countries as well as lingering uncertainty about the Brexit will weigh on the pace of expansion. Growth in the eurozone is estimated at 1.8% in 2019 (estimated 2.0% in 2018).

The **Japanese economy**, which was disrupted by strong typhoons and a powerful earthquake, is expected to return to growth in 4Q18 following the recovery of supply chains post the natural disaster. 2019's estimated economic growth of 1.0% (estimated 0.9% in 2018) should remain supported by domestic demand, thanks to continued ultra-loose monetary policy, a tight labour market and construction works related to the 2020 Tokyo Olympics. The restraining factors on growth are the planned hike in consumption tax (to 10% from 8% in October 2019) would dampen consumption and rising trade protectionism will weigh on exports.

The **China economy**, which has slowed to an estimated 6.7% in 2018 from 6.9% in 2017 will remain strained in 2019 (estimated GDP growth of 6.3%) as deleveraging continues, persistent trade tensions as well as slowing global demand. The authorities have implemented a raft of measures, including reductions in reserve requirements for banks, tax cuts and more infrastructure spending to ward off a sharp deceleration in economic activities. Further proactive fiscal policy steps and prudent monetary police are expected to hold the economy above the 6% threshold.

Emerging markets, despite strengths, still get no respite. Countries with weak economic fundamentals would remain vulnerable to the higher US interest rates, capital outflows and suffered exchange rate pressure.

Countries, notably in the Southeast Asia still growing at decent economic growth rate, albeit slower. Domestic demand continued to support growth amidst slowing exports on the back of trade disputes' disruption. Some have fewer domestic imbalances. Smaller budget deficits amid larger current account deficits for some (Indonesia, India and Philippines). External debt levels generally aren't alarming and, in some countries, debt burdens are lower than previously. Foreign reserves adequacy is maintained at healthy level to cushion against external outflows. Exchange rates flexibility allows domestic currencies to absorb the two-way of capital flows.

Another class of risks are geopolitical and political events or flashpoints, which are also becoming more of a worry and made forecasting difficult. These include the US's and China's economic and political power play; Middle East instability or sanctions; North Korea provocations; Russia's political play; Brexit – can it be concluded by end-March 2019 or a hard Brexit? These risks often intertwined and can exacerbate financial and economic risks, increase uncertainty and may sap global growth.

Figure 1: Real GDP growth (% YoY)

	2016	2017	2018 1Q	2018 2Q	2018 3Q	2018*e* (IMF)	2018*e* (WB)	2019*f* (IMF)	2019*f* (WB)
United States	1.6	2.2	2.6	2.9	3.0	2.9	2.9	2.5	2.5
Euro Area	2.0	2.4	2.1	2.3	1.6	2.0	1.9	1.9	1.6
China	6.7	6.9	6.8	6.7	6.5	6.6	6.5	6.2	6.2
Japan	0.6	1.9	1.2	1.4	0.0	1.1	0.8	0.9	0.9
India[1]	7.1	6.7	7.7	8.2	7.1	7.3	7.3	7.4	7.5
Malaysia	4.2	5.9	5.4	4.5	4.4	4.7	4.7	4.6	4.7
Singapore	2.4	3.6	4.6	4.1	2.3	2.9	-	2.5	-
Indonesia	5.0	5.1	5.1	5.3	5.2	5.1	5.2	5.1	5.2
Thailand	3.3	3.9	4.9	4.6	3.3	4.6	4.1	3.9	3.8
Philippines	6.9	6.7	6.6	6.2	6.1	6.5	6.4	6.6	6.5
Vietnam	6.2	6.8	7.5	6.7	6.8	6.6	6.8	6.5	6.6

Source: Officials (unadjusted data); IMF (World Economic Outlook, October 2018; WEO Update, July 2018; Recent Article IV Consultations); World Bank (Global Economic Prospects, January 2019)

Note 1: Annual GDP for India is on fiscal year basis, as per reporting practice of the country.

A. SNAPSHOT REVIEW OF KEY GLOBAL ECONOMIC INDICATORS

Current and Forward indicators

The advanced economies have displayed growth moderation in 3Q18 or even contraction in the case of Japanese economy. A slew of current and forward indicators showed a synchronised slowdown ahead as the confluences of headwinds and uncertainties continue to dampen real activity and cause wide swings in global financial markets.

The **OECD Composite Leading Index** (CLI) continued pointing to easing growth momentum, mainly dragged by the eurozone, Canada and United Kingdom. The US's CLI indicated a tentative sign of easing growth in six to nine months ahead. **Global manufacturing Purchasing Managers' Index** (PMI) remained unchanged at 52.0 in November for two successive months before slipping further to 51.5 in December, marking year-end closing of a moderation from end-2017. **Global services PMI** though ticked higher to 53.1 in December, it was the second lowest reading for the year as new order rose at the slowest pace in the past two years. Overall, there is still no sign for a solid growth ahead.

The **World Trade Outlook Indicator** (WTOI)'s latest reading has fallen below 100 points in November 2018 to 98.6 with declines seen in all component indices. This suggests further lost traction of trade momentum in the last quarter of 2018. The World Trade Organisation (WTO) has revised downward its trade growth estimation for 2018 from 4.4% previously to 3.9% and projected a more moderate growth of 3.7% in 2019. While the rising trade tensions remained as the largest threat, the uncertainty of monetary policy in major advanced economies and induced financial markets' volatility would add to further downside risks to global growth.

Figure 2: OECD CLIs continued pointing to easing growth momentum

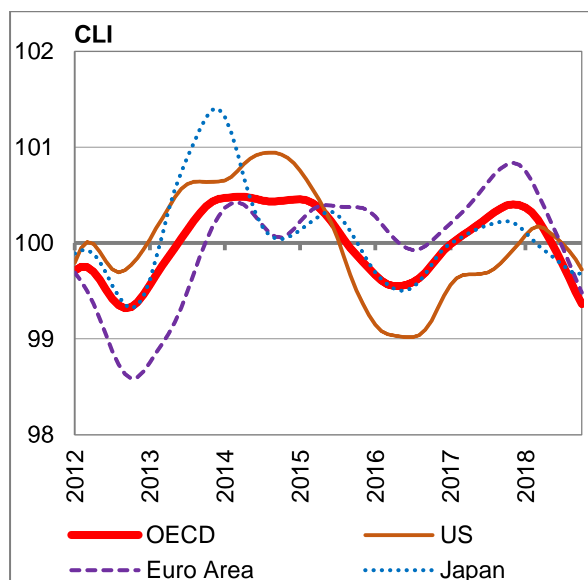


Figure 3: Stable growth momentum seen in both China and India

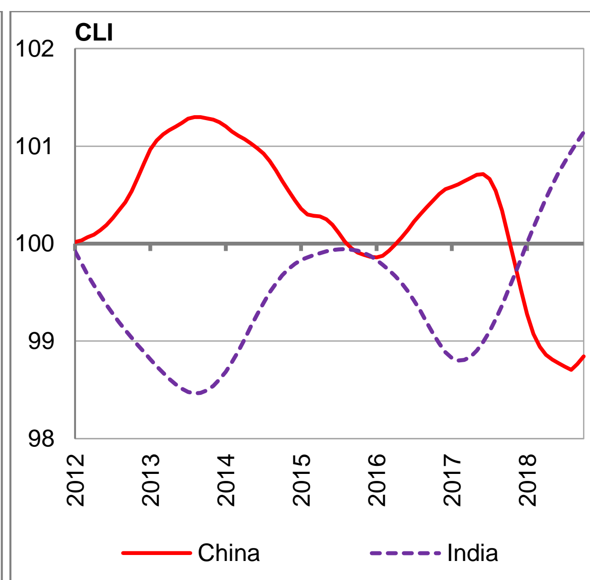


Figure 4: Both businesses and consumers became less optimistic

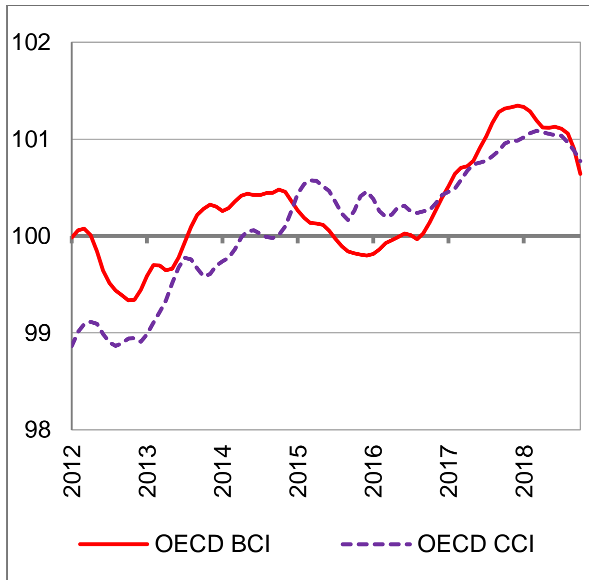


Figure 5: Global manufacturing PMI reading ended the year at 27-month low

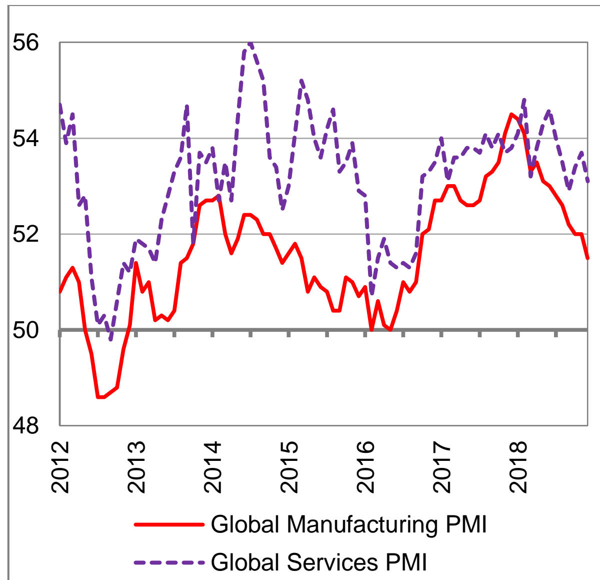


Figure 6: Higher trade volume was partly boosted by front-loaded shipments ahead of the potential higher tariffs

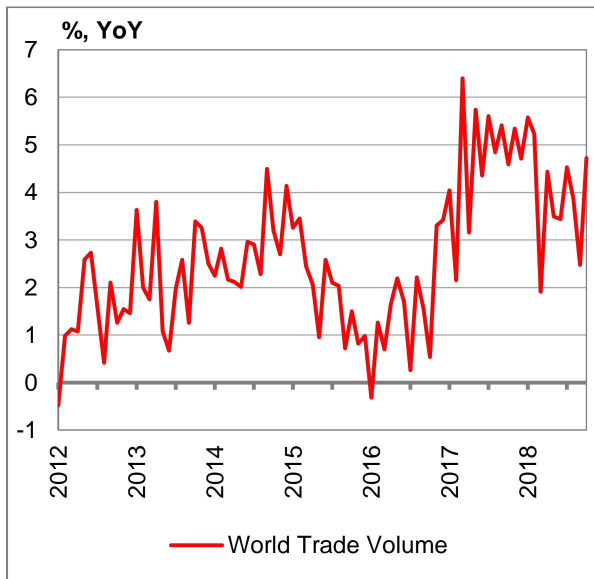
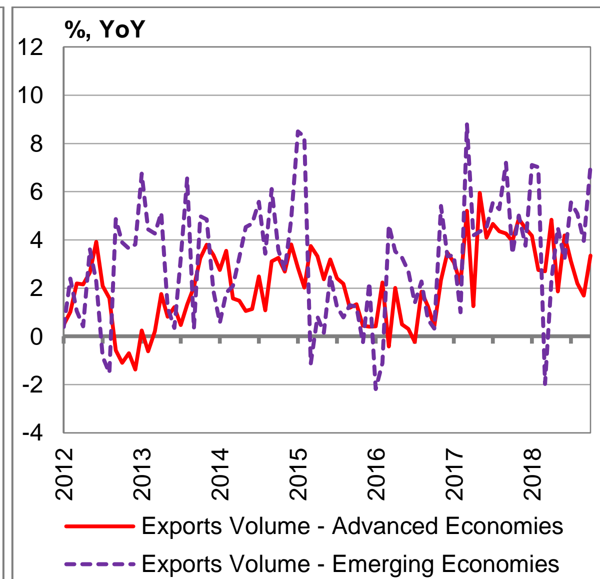


Figure 7: Export growth were contributed mainly by emerging economies



Source: OECD; Markit; CPB Netherlands Bureau for Economic Policy Analysis

Industrial production and Semiconductor sales

Global **industrial production** growth on annual basis is decelerating for another cycle, mainly dragged by continued contraction in Japan's production as well as a prolonged slowdown in the euro area. For emerging economies, industrial production has been growing positively in all regions since the beginning of 2018, albeit at an uneven pace except Latin America region. With the lingering uncertainty about the trade tensions as well as the softening crude oil prices amid lower manufacturing PMI, the outlook of industrial production is expected to remain cautiously positive in 2019.

Semiconductor sales recorded a shining growth of 17.6% yoy in the first eleven months of 2018 and has surpassed the full-year sales in 2017. However, the sales rally was mainly emanated from the first half-year of 2018 and thereafter the growth momentum has been decelerating fast. While most of the regions' sales growth have reversed from strong double-digit to single-digit, China's market still registering an outstanding growth of 17.4% yoy in November, albeit at decelerating pace. While global semiconductor sales are expected to grow strongly by 15.9% in 2018 (2017: 21.6%), the World Semiconductor Trade Statistics (WSTS) has revised downward 2019's sales growth projection from 5.2% previously to 2.9%, mainly attributable to negative growth in memory products. Meanwhile, other semiconductor forecasters have projected slightly higher rate of sales growth (4.4% by IHS Markit and 4.0% by Semiconductor Intelligence).

Figure 8: Global industrial production growth is trending down …

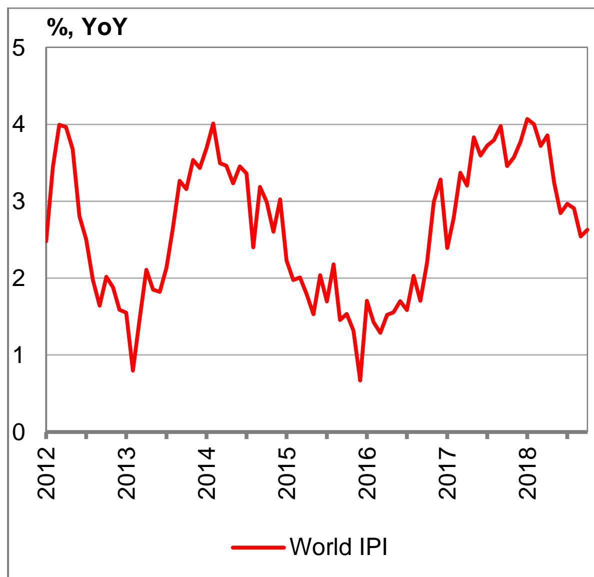


Figure 9: … dragged by advanced economies

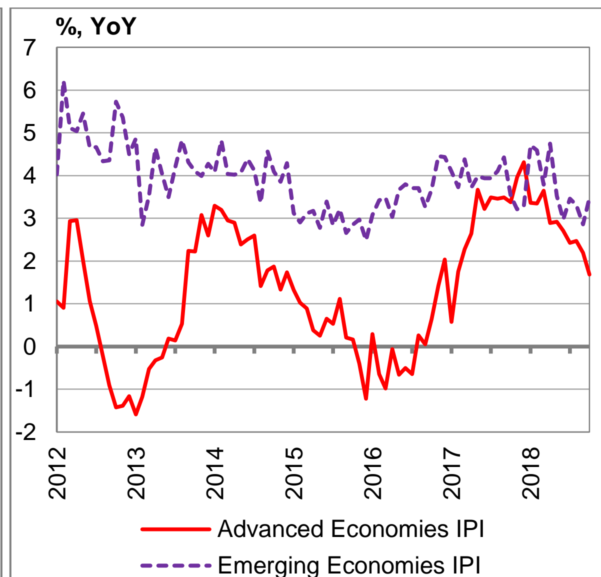


Figure 10: Global chip sales growth slowed down from recent peak …

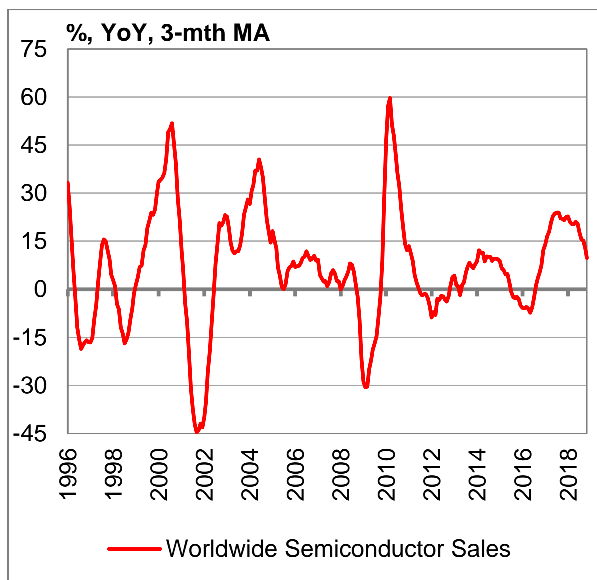
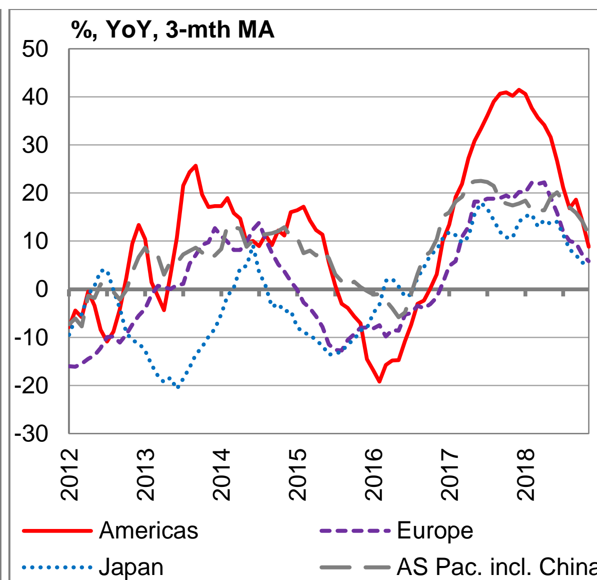


Figure 11: … in most regions, except China



Source: CPB Netherlands Bureau for Economic Policy Analysis; Semiconductor Industry Association

Commodity prices

Energy prices slumped since end-October 2018 due to increasing crude oil supply and stockpiles, particularly from the United States. Despite the Organisation of the Petroleum Exporting Countries (OPEC) and its allies have agreed to continue slashing 1.2 million barrel per day (mb/d) in the first half-year of 2019, Brent crude oil price levels still trending down and recorded the lowest reading for the year at US$50.57 per barrel as at 28 December 2018 (average US$71.34/bbl in 2018 and US$54.12/bbl in 2017). While the US Energy Information Administration (EIA) expects the US's production to climb higher to an average of 12.1 mb/d in 2019 from average 10.9 mb/d in 2018 (9.4 mb/d in 2017) in its December's Short-Term Energy Outlook, the EIA also projects that average Brent oil prices to be US$61/bbl for the year 2019. This has casted a doubt whether the OPEC's further output cut will be effective to stem the slide in oil prices?

Prices for **non-energy commodities** continue to soften whereas precious metals prices ticked up a little. Palm oil planters had suffered setback in 2018 as crude palm oil (CPO) prices remained depressed, dropping below the confidence level of RM2,000/metric tonne (mt) in November before picking up slightly towards end-December. This took the full-year average CPO prices to RM2,232.50/mt in 2018 (RM2,783/mt in 2017).

Recent actions undertaken by some countries in the EU do not augur well for palm oil prices. The French National Assembly has decided to end tax incentive for adding palm oil as biodiesel starting 2020, a year earlier than the EU's banning plan starting 2021. The Norwegian Parliament also adopted similar decision to halt the use of palm oil as their biofuel starting 2020. While both France and Norway are not major importers of palm oil, their decisions have dented the use of palm oil due to deforestation.

On a comforting note, India, the biggest palm oil importer has cut 4% pts of base import duties on crude oil to 40% and refined palm oil to 50% respectively importing from ASEAN starting 2019. Malaysia's refined palm oil enjoys an additional 5% pts lower compared to the rest. CPO prices have moved higher to RM2,019.50/mt on the first trading day of 2019. With a potential El Nino phenomenon in 2019 may dampen CPO production and hence, helping to lift CPO prices though the price enhancement effect could be offset by negative news dampening demand. Moving forward, World Bank expects generally stable prices for three commodity groups (energy, metals and agriculture) in 2019.

Figure 12: Energy prices fell sharply; others soften gradually

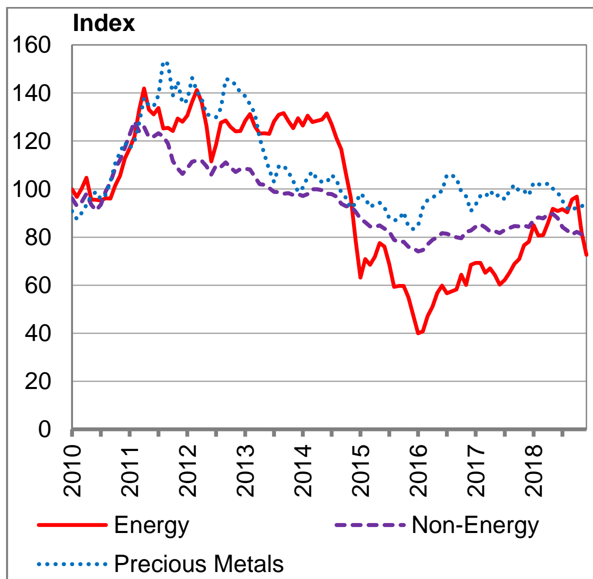


Figure 13: Crude oil prices slumped again since November

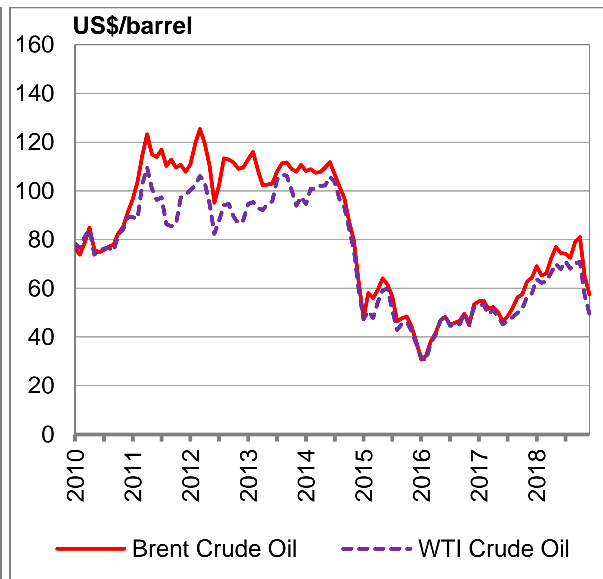


Figure 14: CPO prices hit lows amid increasing stock level

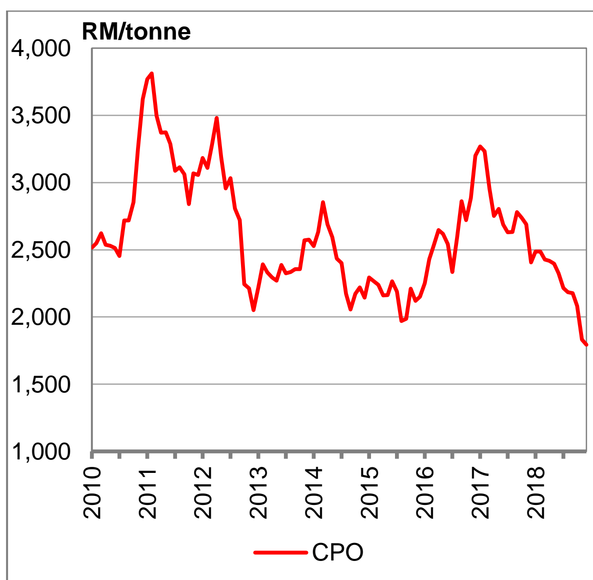
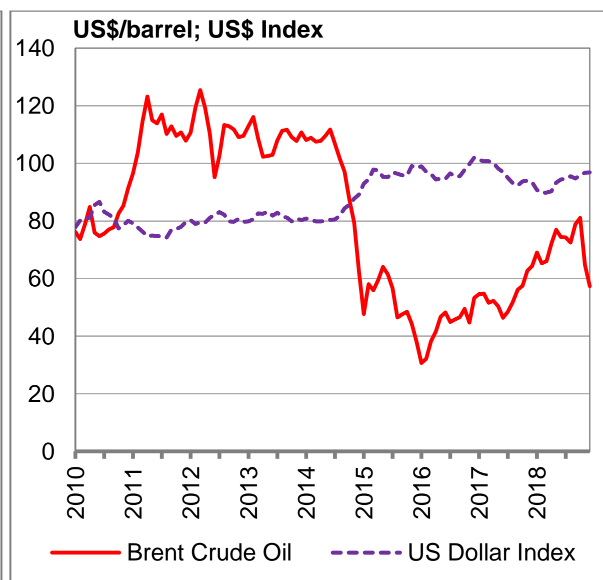


Figure 15: Brent crude oil price vs. the US dollar index



Source: World Bank; US Energy Information Administration; Malaysian Palm Oil Board; The Wall Street Journal

US – GROWTH REMAINS STRONG, BUT MAY NOT LAST LONG IN 2019

The US economy continues to charge ahead as it expanded further by 3.4% annualised qoq growth in 3Q18 (4.2% in 2Q18), supported by strong and firm consumption spending and non-residential investment activities, thanks to the income tax reforms that lifted the purchasing power and profit reserves for reinvestments. However, external demand has deteriorated significantly due to the tit-for-tat tariff measures, particularly from its major trading partner, China. Imports also growing fast to avoid any escalating tariffs from both sides.

In the final quarter of 2018, the labour market remains healthy as job hiring continues strongly with hourly pay growth rising above 3% yoy, last seen in April 2009. Unemployment rate hit a record-low of 3.7% in September and November before ticking up to 3.9% in December. Inflation rate has softened back towards the medium-term target of 2%, thanks to moderated energy prices. Industrial production growth normalises after surging by an average 5.0% yoy in 3Q18 while retail activities still growing. ISM manufacturing index fell to the lowest level in two years at 54.1% in December though still way above the 50-pt expansion threshold. Looking ahead, the spectacular GDP growth in 2018 may not be sustainable in 2019-2020 as the stimulus fiscal and tax effects faded and higher borrowing costs started to bite.

Figure 16: The US economy still solid but signs of weakening ahead

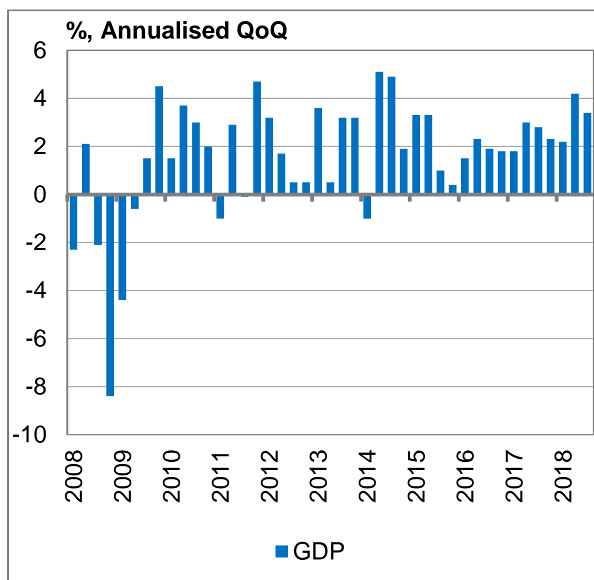


Figure 17: Spending and investments reflect the favour of income tax cut

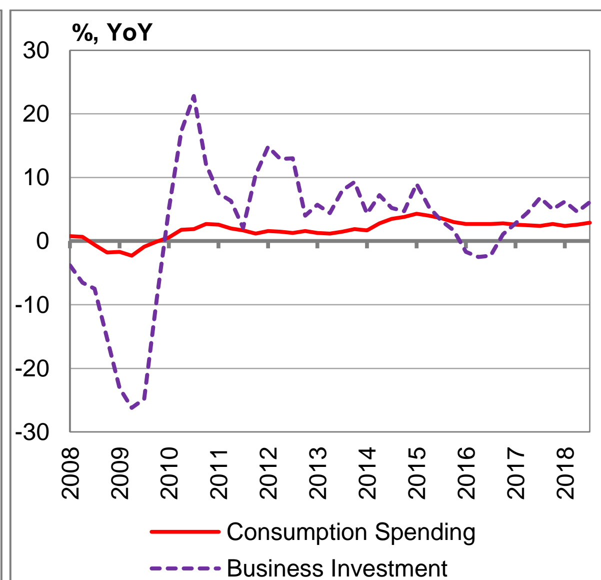


Figure 18: Manufacturing PMI dropped significantly in December but still way above the expansion threshold

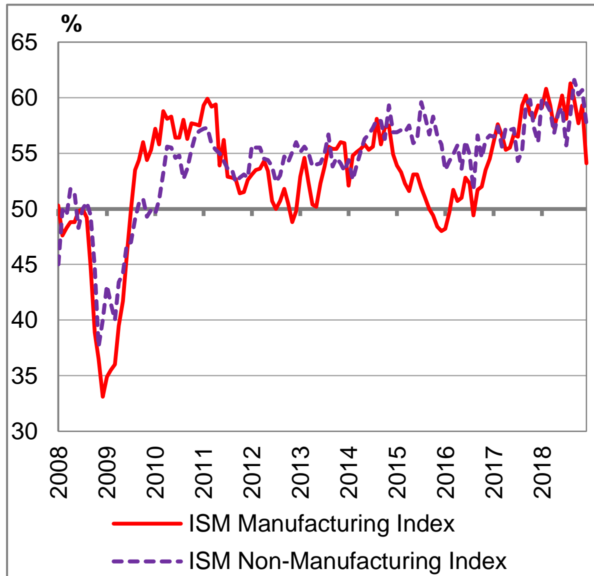


Figure 19: Industrial production growth normalises after a strong surge in 3Q18

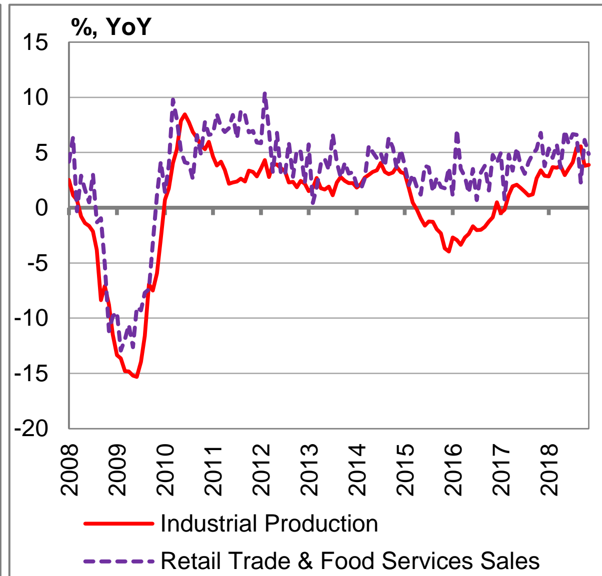


Figure 20: Job gains of 762,000 in 4Q18, the best since 3Q16

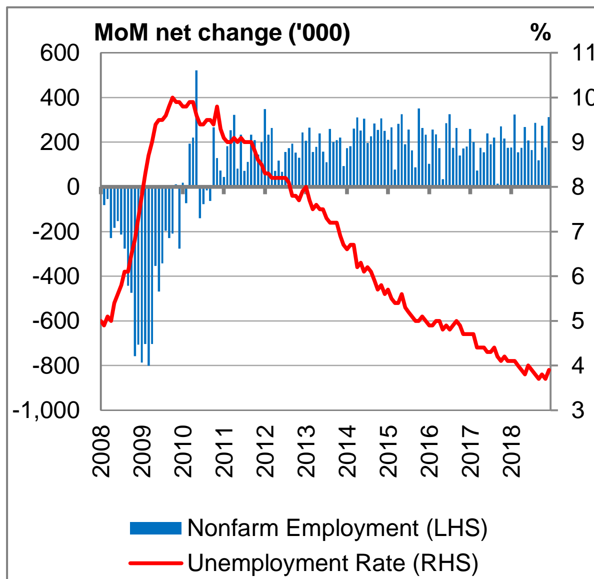
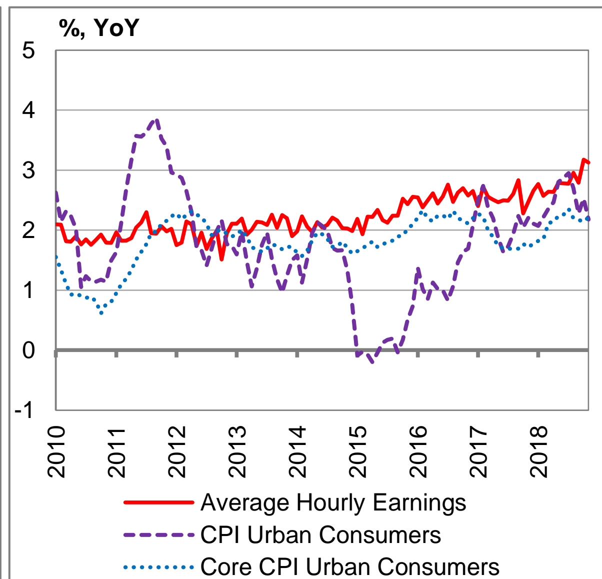


Figure 21: Inflation moved back towards medium-term target of 2%



Source: US Bureau of Economic Analysis; Institute for Supply Management; Federal Reserve System; US Census Bureau; US Bureau of Labor Statistics

EUROZONE – NEAR FLATTISH GROWTH, WHAT'S NEXT?

The eurozone economy weakened to 0.2% qoq in 3Q18 (0.4% in 2Q18 and 1Q18), mainly dragged by contractions in Germany and Italy. Household consumption and capital investment growth slowed down while external balance pulled down overall GDP growth. The manufacturing industry and primary sector contracted by 0.4% and 0.3% respectively. Economic Sentiment Indicators (ESI) witnessed an unbreakable contraction since the beginning of the year till November, led by the drop in consumer confidence for six consecutive months since June. Manufacturing PMI has been moving south unstoppable while both industrial and retail activities remained soft. Jobless rate has improved to its best level since November 2008.

Although the ECB has ended its asset purchase programme by December 2018, monetary stimulus will be continued at least in the first half of 2019 to ensure the sustained convergence of inflation rate around 2% in the medium-term. Currently, the headline inflation has been hovering around the medium-term target. Event and policy risks to be closely monitored include Brexit, which the UK is scheduled to leave the EU on 29 March as well as the potential re-imposition of automotive import tariff by the US.

Figure 22: Slower quarterly economic growth, dragged by low exports and …

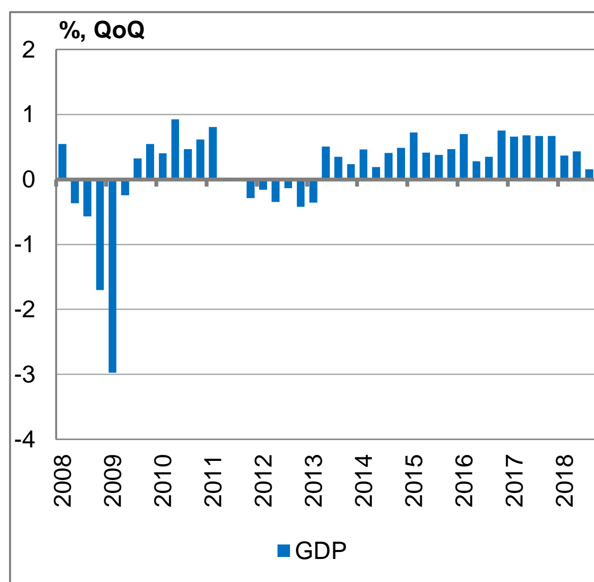


Figure 23: … lack of supports from household consumption

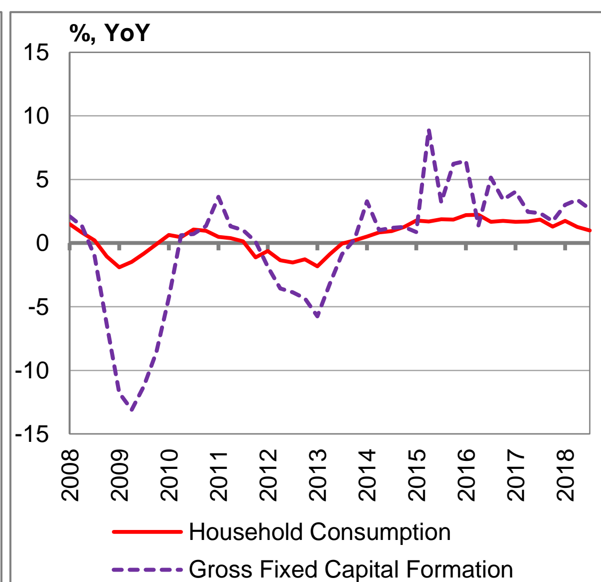


Figure 24: Manufacturing PMI is heading into negative territory

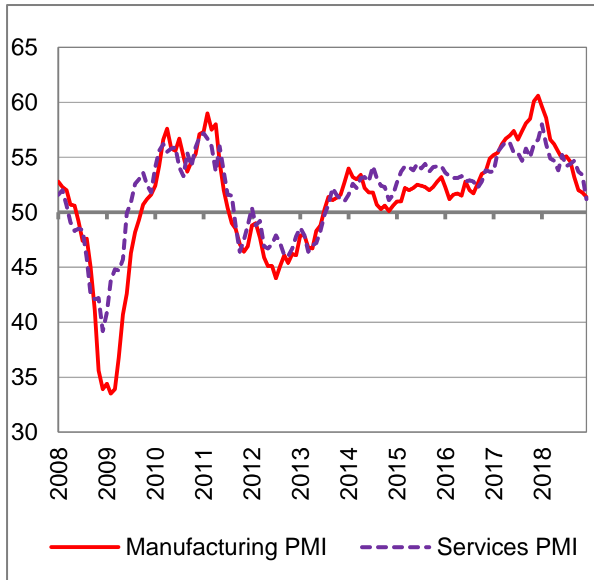


Figure 25: Sluggish in both industrial and retail activities

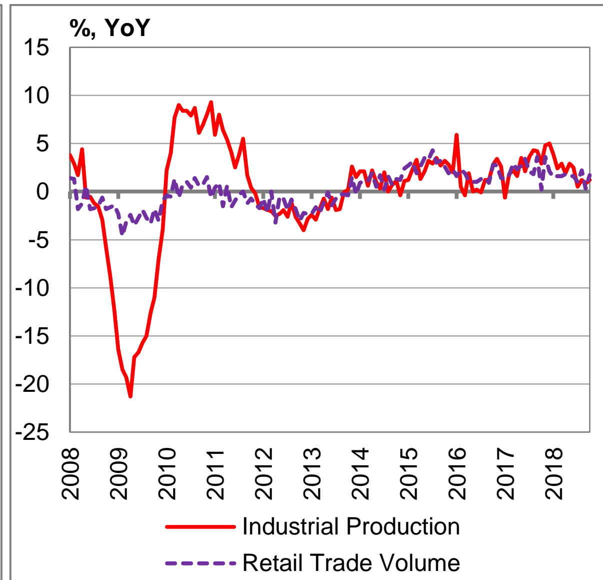


Figure 26: Unemployment rate stood firm at 8.1% for four months

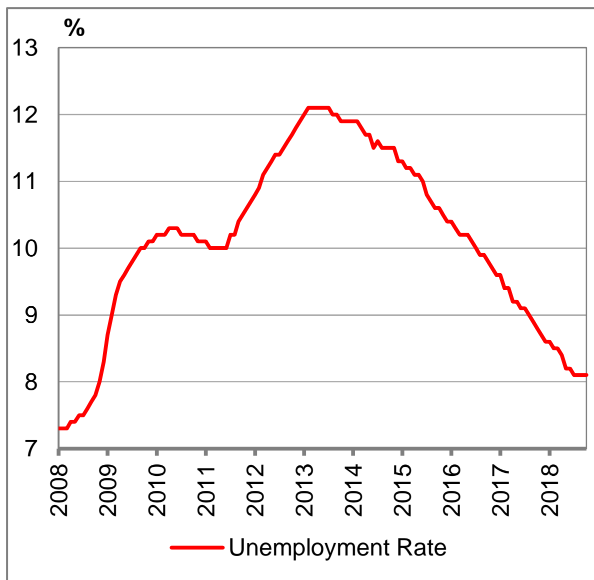
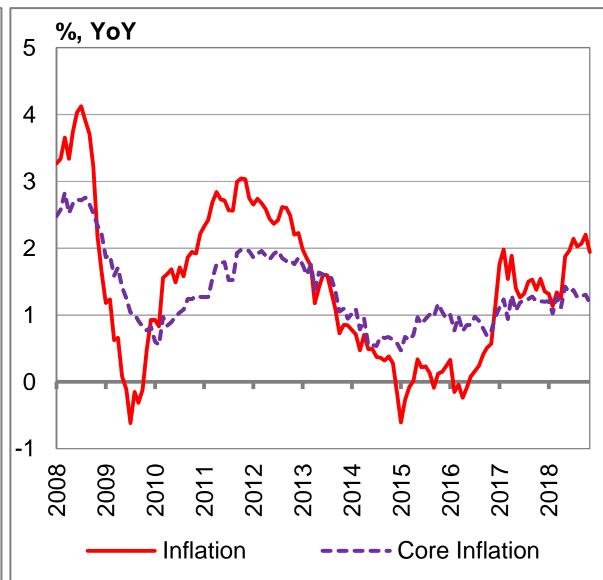


Figure 27: Headline inflation hovering around 2%



Source: Eurostat; Markit

JAPAN – FACING INTERNAL AND EXTERNAL HEADWINDS

After a rebounding growth of 0.7% qoq in 2Q18 (-0.3% in 1Q18), Japan's GDP growth reverted to a contraction of 0.6% in 3Q18, the worst performing quarter since 2Q14, hit by natural disasters and widen trade deficit. Industrial production growth remained uneven while retail sales growth accelerated since posting the recent lowest reading in May. The consumption tax hike announcement will keep the retail sales good until the new rate of 10% (up from 8% currently) comes into effect in October 2019. The planned 2% pts increase in consumption tax is to cover some of the rising medical and nursing costs. It must be noted that the last hike of 3% pts consumption tax in 2014 had responsible for a notable recession as household consumption was significantly undermined. Hence, a similar trend may be observed in the final quarter of 2019.

In the near term, the potential escalation of trade war could further dampen the already badly affected external sector. The tight labour market also constraining supply capacity. Headline inflation rate was hovering between 0.8% and 1.4% in July-November 2018, still a long way to reach the 2% target despite the prolonged ultra-loose monetary policy or Quantitative and Qualitative Monetary Easing (QQE). With the implementation of higher consumption tax in October 2019, a one-off effect on higher inflation rate can be seen as in 2014.

Figure 28: Japan's 3Q18 GDP was the worst quarterly contraction since 2Q14

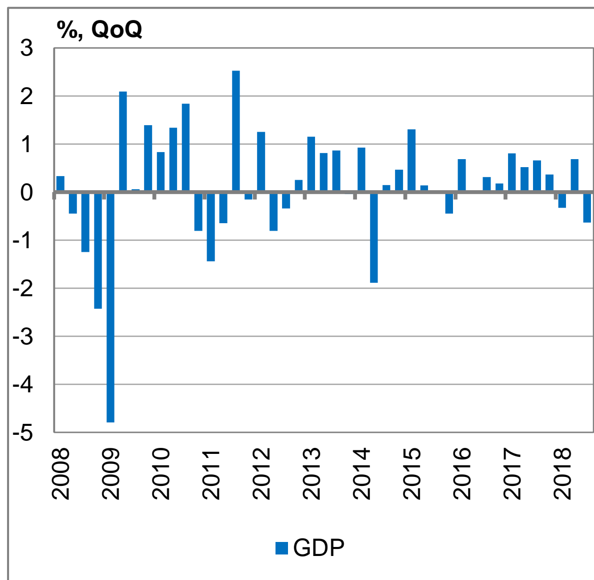


Figure 29: Business investment activities contracted marginally

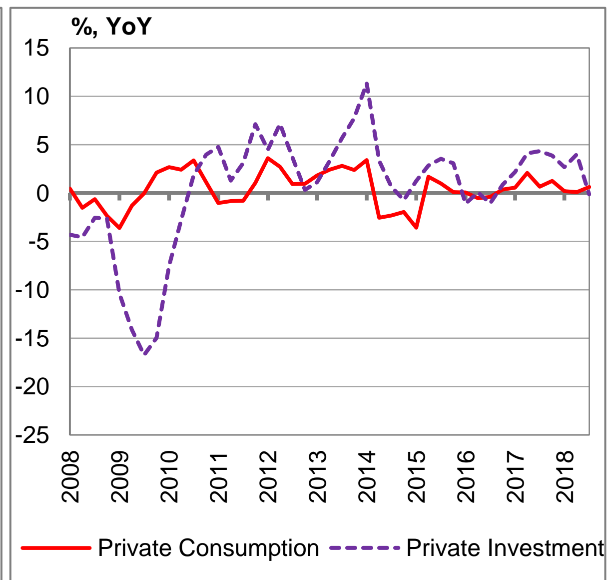


Figure 30: Retail sales growth climbing fast

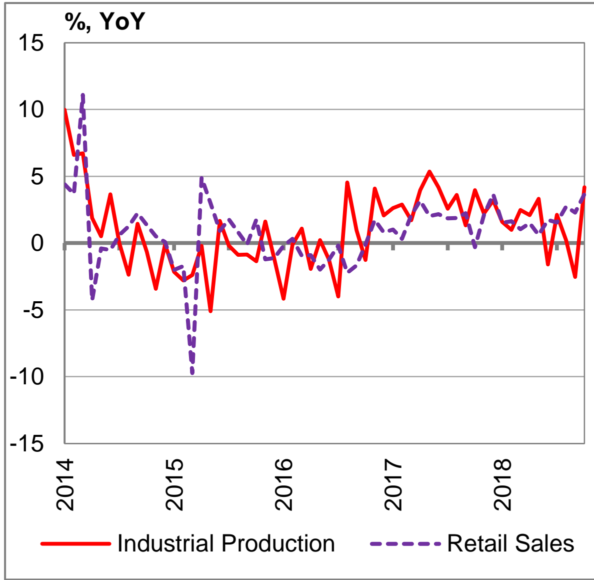


Figure 31: Trade deficit continues to widen

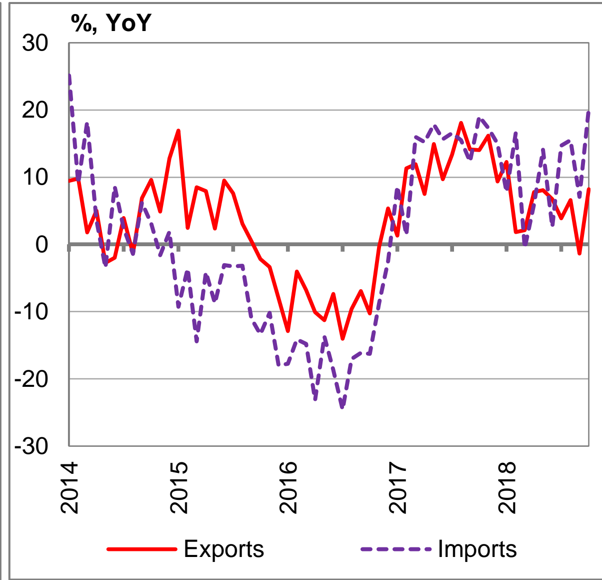
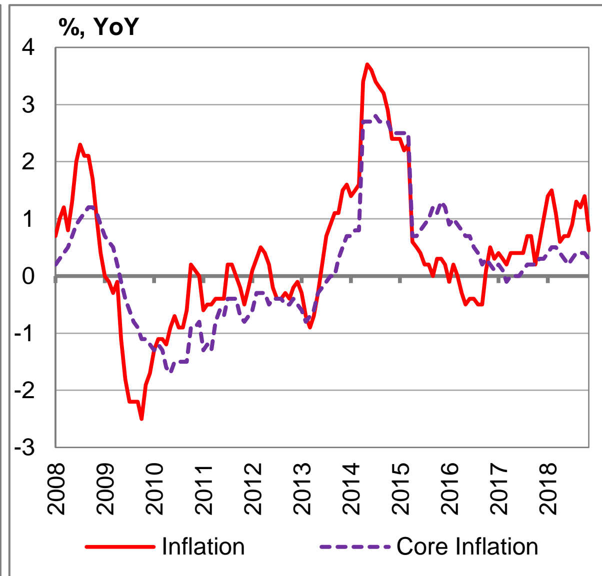


Figure 32: Unemployment rate is ticking up

Figure 33: Inflation rate still a long way to reach the BOJ's 2.0% target



Source: Economic and Social Research Institute; Ministry of Economy, Trade and Industry, Japan; Japan Customs; Statistics Bureau, Japan

CHINA – FOCUSING ON SIX "STABILITIES"

China's economy still growing strong albeit at a slower pace at 6.5% yoy in 3Q18 (6.7% in 2Q18 and 6.8% in 1Q18) and it is expected to meet the Government's full-year target of 6.5% set in early-2018. Industrial production printed the lowest growth rate since early-2009 at 5.4% in November 2018, together with the 15-year low of retails sales growth of 8.1% has stirred concerns about increasing downside risks engulfing the economy. The worries were compounded by the industrial profit growth, which fell for the first time in the past three years, by 1.8% yoy in November and the slippage of December's manufacturing PMI below the 50-pt expansion threshold.

Nevertheless, some indicators have shown positive signs that helped to allay concerns about a sharp economic slowdown. These include the advanced manufacturing production, which grew faster than the headline figure at 11.8% yoy in Jan-Nov 2018 and online retails sales growth continues to outpace the conventional channel. Fixed assets investment growth also picked up in the final quarter of 2018. The deleveraging efforts are progressing as the industry's asset-liability ratio reduced to 56.7% as at end-October 2018 vis-à-vis 57.2% a year ago. The Chinese authorities are expected to focus on six "stabilities" introduced in July 2018, targeting to stabilise the employment, finance, foreign trade, foreign investment, domestic investment and economy expectation.

Faced with the threats of a slowing global economy and lingering uncertainty on the trade tensions with the US, China's authorities, including the People's Bank of China (PBC) have already and will implement a slew of pro-active fiscal and monetary measures to spur growth and support lending to productive sectors. This includes a steep cut in the level of cash that banks must hold as reserves (RRR) to lower financing costs. Potential tax cuts and fee reductions are in the pipeline to shore up the world's second largest economy.

Figure 34: China's GDP growth continues to ease slowly

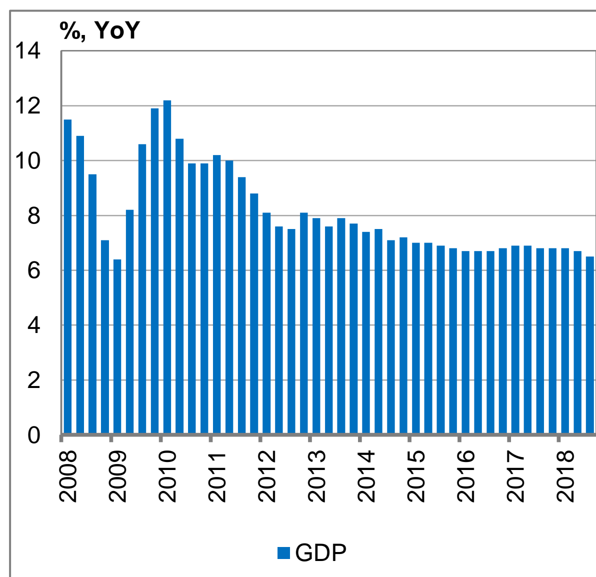


Figure 35: Manufacturing PMI fell below the 50-pt expansion threshold in December

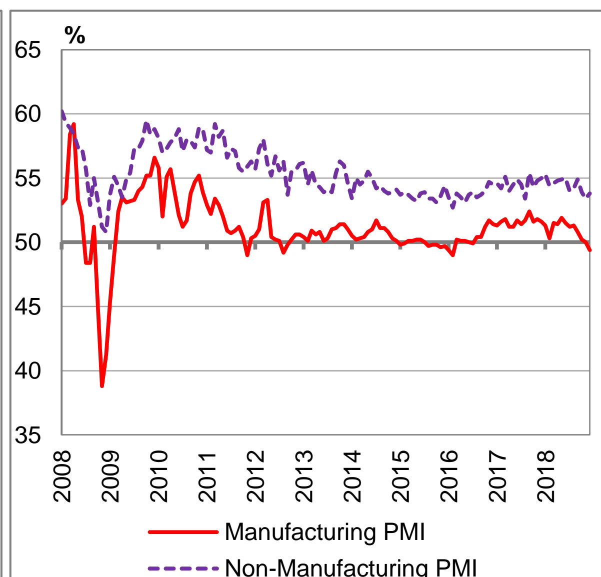


Figure 36: Lower industrial output growth in November

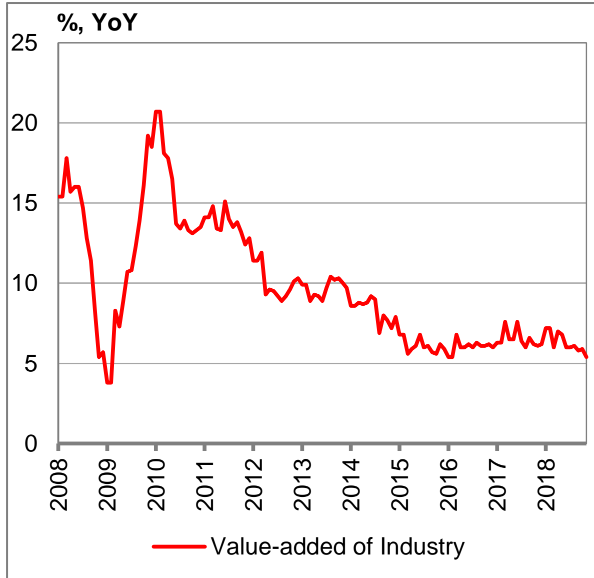


Figure 37: Retail sales growth at fifteen-year low

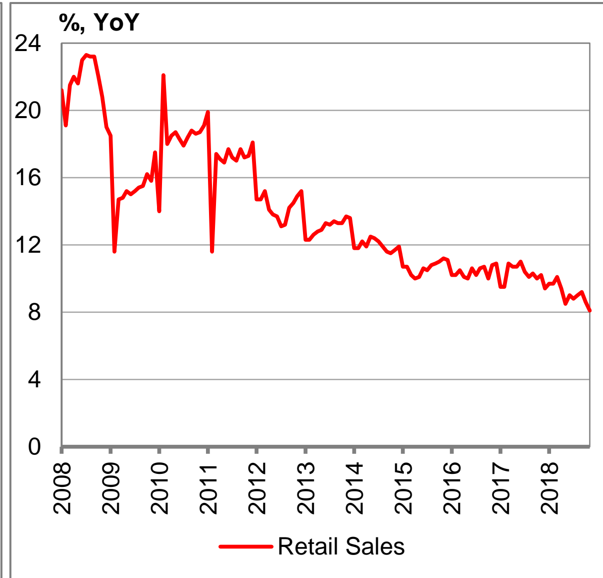


Figure 38: Fixed assets investment growth picked up in 4Q18

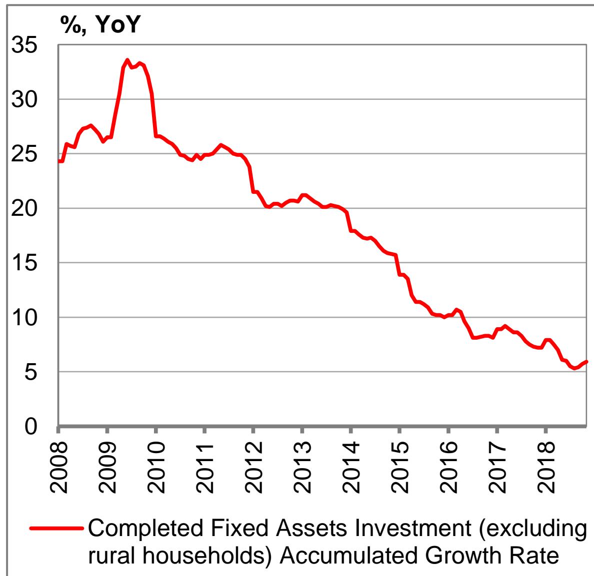
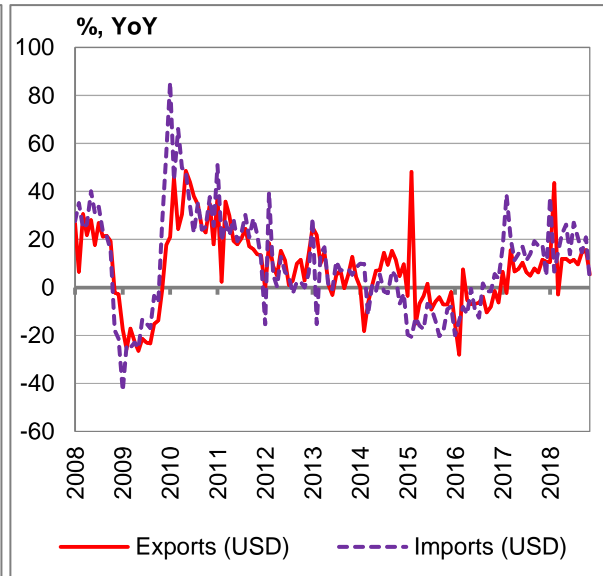


Figure 39: Is export growth losing momentum?



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

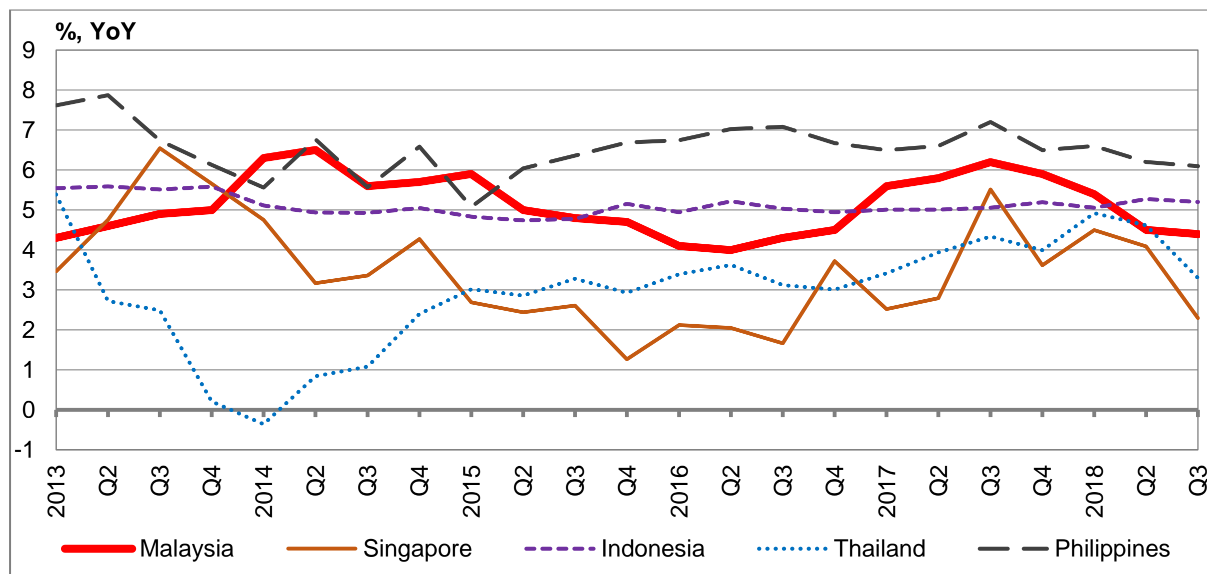
ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

ASEAN-5 economies still growing decently in 3Q18, albeit at a slower pace. Domestic demand has remained the prime contributor to overall GDP growth while exports were uneven for some countries. Based on the incoming indicators, some mild rebound in economic growth may be seen in the final quarter of 2018.

Exports had expanded strongly in October, mainly reflecting the front-loaded shipments ahead of the planned higher US tariffs on Chinese goods comes January 2019, which was subsequently deferred pending on a 90-day trade truce talks before a 2 March deadline. In November, exports momentum eased sharply with contractions observed in Indonesia and Thailand.

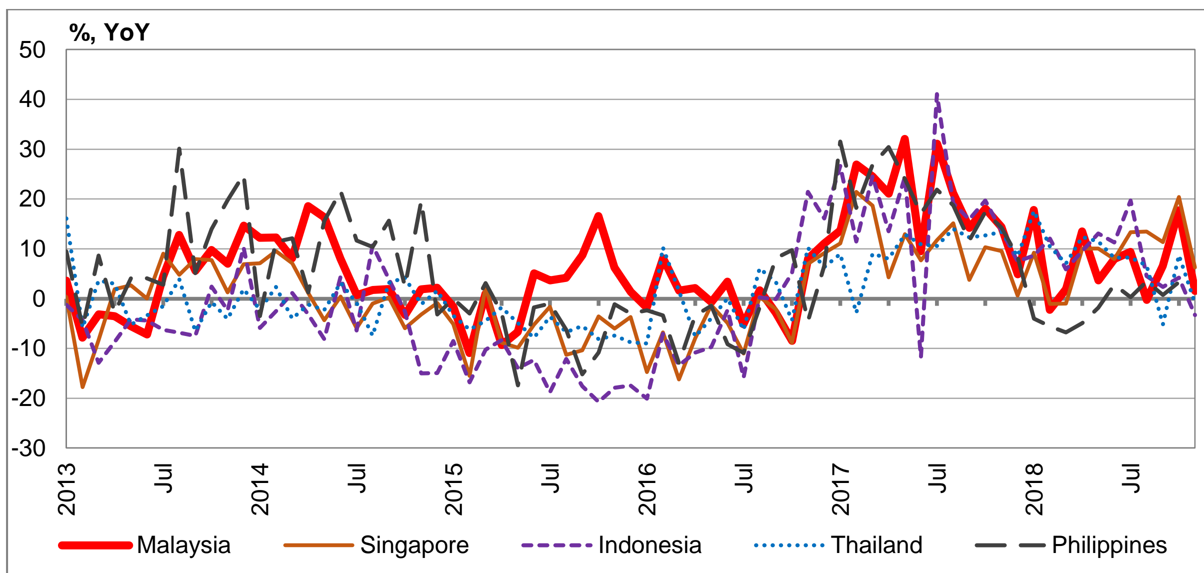
Moving forward, we remain cautious about ASEAN economies' exports outlook given the slowing global economy, trade tensions uncertainty, moderate prices of commodities, including crude oil as well as demand for semiconductors. Industrial production growth is likely to grow unevenly. Headline inflation has broadly remained stable in the third quarter and October but moderated in November and December, helped by declining crude oil prices.

Figure 40: Real GDP growth trend



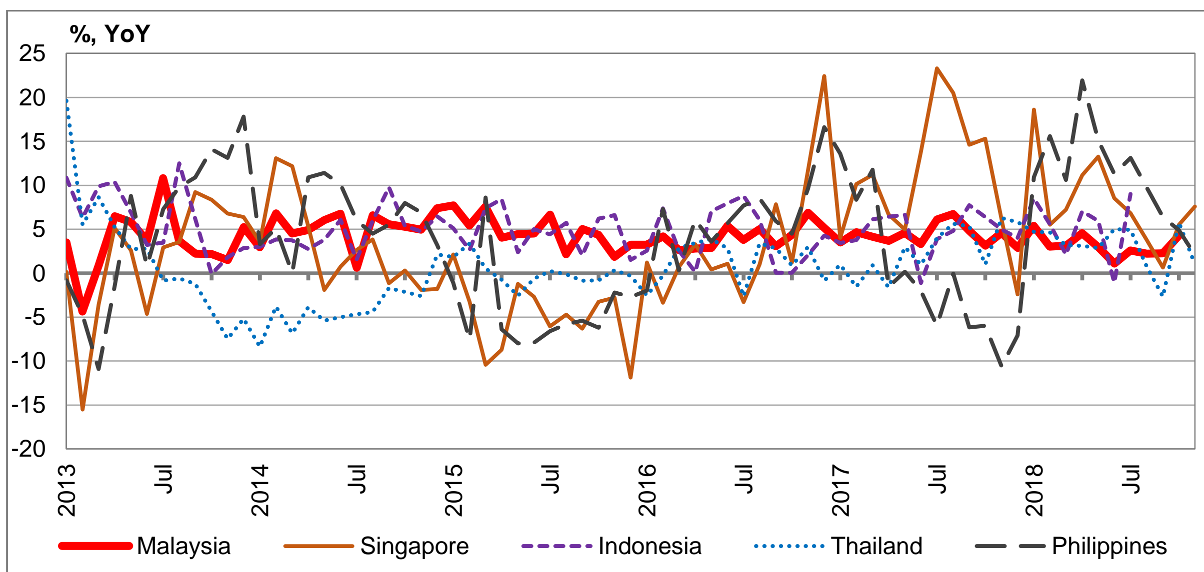
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 41: Export growth trend



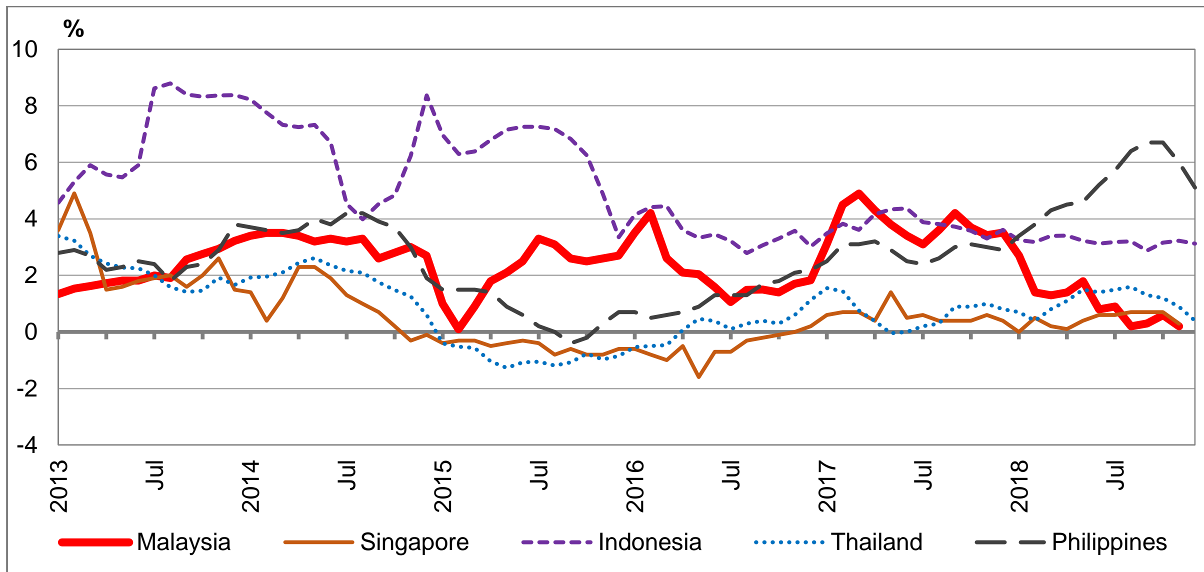
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

Figure 42: Industrial production growth trend



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

Figure 43: 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

Amid the seemingly dovish about future interest rate hikes, the **Federal Reserve** (Fed) is facing a tough and delicate balancing act to navigate the course of rate hikes in 2019, which is either not too high to put the brakes on economic growth or too low to cause excessive asset price imbalances.

The Fed's future rate moves are expected to be data dependent and will likely to hit 3.00% by end-2019 in our baseline forecast (End-2018: 2.25-2.50%), with the first-rate hike probably in 2Q19. If the worsening trade troubles threaten to undermine the US economy, the Fed may have to go slow on the interest rate increases or even pausing.

While the **European Central Bank** (ECB) has halted its four year's quantitative easing in December 2018, it would continue to reinvest the principal payments from maturing securities "for an extended period of time" while keeping interest rates at their present record-low levels until at least the end of summer. **Bank of Japan** (BOJ) is expected to continue maintaining easing monetary policy given sluggish inflation outlook.

To free up more funds in the market as well as supporting financial assistance to the small and private enterprises, **People's Bank of China** (PBC) had lowered the reserve requirement ratio (RRR) four times in 2018. In January 2019, RRR will be slashed by a total of 100 basis points (bps) – 50bps each on 15 January and 25 January respectively across all the banking corporations to free up 1.5 trillion yuan to support economic growth, optimise liquidity structure and lower financing costs.

In contrary, some central banks in Asia have tightened their monetary policy to contain capital outflows as well as ease downward pressure on their currencies, particularly the Bangko Sentral ng Pilipinas (+50bps in September and +25bps in November following a total increase of 100bps from May to August) and Bank Indonesia (+25bps each in September and November, resulting in a total increase of 175bps in 2018).

Meanwhile, South Korea central bank and Bank of Thailand (BOT) also raised their policy rate by 25bps in November and December respectively. BOT's decision marked the first rate hike since 2011. Market seen these central banks' action a one-off rate hike to build policy space and hence, it is perceived as a dovish stance.

So far, there is no risk of contagion from Asia to any other emerging markets. In 2019, most of Asian central banks are expected to keep policy rate steady as the Fed looks toward topping its interest-rate hiking cycle.

Figure 44: Policy rate (%)

End-period of	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019*E*
US, Fed **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	0.50-0.75	1.25-1.50	2.25-2.50	2.75-3.00
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	-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	-0.10	-0.10
China, PBC **1-Year Benchmark Loan I/R**	5.31	5.31	5.81	6.56	6.00	6.00	5.60	4.35	4.35	4.35	4.35	4.35
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	6.50	6.50
Korea, BOK **Base Rate**	3.00	2.00	2.50	3.25	2.75	2.50	2.00	1.50	1.25	1.50	1.75	1.75
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	3.25	3.25
Indonesia, BI **7-Day RR Rate**	9.25	6.50	6.50	6.50	5.75	7.50	7.75	7.50	4.75	4.25	6.00	6.25
Thailand, BOT **1-Day Repurchase Rate**	2.75	1.25	2.00	3.25	2.75	2.25	2.00	1.50	1.50	1.50	1.75	2.00
Philippines, BSP **Overnight RR Facility**	5.50	4.00	4.00	4.50	3.50	3.50	4.00	4.00	3.00	3.00	4.75	4.75

Source: Officials; SERC

C. THE MALAYSIAN ECONOMY: GLASS HALF FULL OR HALF EMPTY?

Growth bottoming out in 3Q18? Malaysia's economic growth momentum, as measured by Real Gross Domestic Products (GDP) has slowed to an annual rate of 4.4% in the third quarter of 2018, the slowest pace in almost two years. The drag on growth came from multi-facetted reasons (weakening exports, declines in mining and agriculture output, a sharp contraction in public investment and not so strong private investment growth).

Stronger exports, higher industrial production and services output for the months of Oct-Nov suggesting an improvement in GDP growth in the fourth quarter, which is estimated to grow by 4.5-4.6% (4.4% in 3Q18). This would bring the full-year GDP growth to 4.7% in 2018 (5.9% in 2017).

A tumultuous year for 2019. The Malaysian economy is expected to face another tumultuous year in 2019 as it is being challenged by on-going domestic adjustments and also rising external headwinds, particularly lingering uncertainties about the state of the US-China trade disputes and further tightening of the US interest rates.

The US-China's 90 days trade truce talks would prolong the period of uncertainty and cautious investors' sentiments. There are serious doubts over whether a "compromise" trade deal can be reached before a 2 March 2019 deadline. According to Bank Negara Malaysia, (BNM), the trade protectionism measures will cause Malaysia's GDP growth to lose 0.3-0.5% point or 1.3-1.5% points if there is any escalated measure. Other global pressure points developing are the UK's Brexit deal; the movements of global oil prices, geopolitical and political risks.

What lies ahead? Challenges remain as the Government continues to undertake structural reforms and recalibrate policies covering fiscal, subsidy, products and labour markets as well as sectoral (telecommunications, construction, property, the government-linked companies, media and energy).

The Mid-term Review of the 11th Malaysia Plan and 2019 Budget have set the near- and medium-term directions where our country is heading. New targets of macro-economic numbers were set: (i) Real GDP growth is expected to grow by 4.9% in 2019 and 4.5-5.5% in 2018-2020; (ii) Fiscal deficit was reset with the deficit will narrow from -3.7% of GDP in 2018 to -3.4% in 2019 and -3.0% in 2020; (iii) Private sector spending would remain as the dominant driver of economic growth; and (iv) Continued rationalisation of public investment to make it more effective in disbursement and impactful in terms of broadening economic spillovers.

The key driver of 2019's economic growth. SERC now estimates real GDP to grow by 4.7% in 2019 (estimated 4.7% in 2018), largely driven by domestic demand with private sector spending holding the baton. Public sector expenditure will continue to consolidate and rationalise, focusing on essential sectors such as socio-economic projects, education and the on-going public infrastructure projects (LRT, MRT and highways).

Private consumption will hold, albeit slower. As private consumption makes up 55.0% of GDP in 2018, its strength must be held firmly by at least 6.5% growth in 2019 (an average of 6.8% pa in 2016-18). Besides underpinned by the fundamental drivers of steady income growth and employment, the following measures would help to support household consumption:

a) The 2019 Budget measures (cost of living aid of RM5.1 billion benefitting 4.1 million households, RM100 unlimited LRT and bus rides and RM1 billion cash assistance to civil servants) are expected to support discretionary consumption on necessities (food, healthcare, telecommunication and transportation).

b) A rise in minimum wage of RM100 per month (10% from RM1,000 to RM1,100) for workers in Peninsular Malaysia and RM180 per month (19.6% from RM920 to RM1,100) for employees in Sabah and Sarawak. Low-wage earners with income below RM1,000 have higher marginal propensity to consume as they spend 81 sen out of every RM1 of income.

With households already front-loaded purchases of durable goods (electrical appliances and household equipment) and big-ticket items (motor vehicles) during the 3-month tax holidays (zero-rated GST), they may decrease these purchases or postponing them until periods when their income improves.

In addition, the planned rationalisation of fuel subsidy targeted at Bottom 40 households (B40) earning below RM4,360 per month by second quarter of 2019 are expected to take some steam off spending. In the rural household sector, lower palm oil and rubber prices have dampened rural household income and spending power.

How about the prospects for private investment? Private investment growth grew by an average rate of 4.5% in the first nine months of 2018 (an average of 6.8% pa in 2016-17), supported by continued investment in the manufacturing and services sectors. FDI approvals in manufacturing investment projects rose substantially by 250% yoy from RM14 billion to RM49 billion in the first nine months of 2018.

In the near-term, there were some cautiousness about private investment growth as investors' sentiment would be dampened by still-considerable external uncertainties (on-going negotiation of the US-China trade disputes; higher US interest rate as well as how will Brexit really pan out by end-March 2019). Domestic investors are still adjusting to new political landscape and getting around with the policy transition and adjustment. Overall, we estimate private investment to grow by 4.3% in 2019 (estimated 4.1% in 2018).

Malaysia's exports engine will likely to face hurdles from slowing global growth; persistent trade tensions; a sharply slower demand growth in global semiconductor sales (estimated 2.9% in 2019 vs 15.9% in 2018) as well as softer crude oil prices (estimated US$60-65 per barrel in 2019 vs. US$71 per barrel in 2018) and crude palm oil prices (estimated RM2,300/mt in 2019 vs RM2,232.50/mt in 2018). The exceptionally high export base averaging RM83.3 billion per month in 2018 will challenge the growth in 2019. Overall, exports are estimated to grow at a moderate pace of 3.3% in 2019 from estimated 6.9% in 2018.

Supportive investment policies and initiatives. The Government remains highly committed towards making right the policies and business investment environment to sustain and push more domestic direct investment (DDI) and foreign direct investment (FDI). Policy clarity and consistency as well as pragmatic are key to ensuring sustainable investment. Sustained high quality and value-added investment growth is much needed to create high income paying and skilled jobs for Malaysians.

Strategic policies and initiatives as well as incentives were drawn up to encourage investment in high technology and value-added manufacturing industries, e-commerce, Industry Revolution 4.0 or Industry4WRD (via the Industry Transformation Fund), logistics and agro-based industries.

Both the Ministry of International Trade and Industry (MITI) and Ministry of Finance (MOF) will be driving governance reform agenda, particularly to improve the trade process and tax administration, which will contribute to improve the ease of doing business and attract investors to Malaysia. There will be a thorough review of over 130 types of fiscal schemes administered by 32 approving authorities to support investments, with the intention to expire incentives which are no longer relevant or are duplicated.

We believe the streamlining of regulatory and compliance costs, the removal of impediments and redefining the role of government in business to avoid "crowding out" along with institutional and economic reforms, would increase domestic investment and FDIs over the medium-term.

Inflation will pick up gradually. Despite the introduction of Sales and Service Tax (SST), inflation continues to stay on the backburner with annual inflation rate hovering between 0.2% and 0.6% between September and November 2018, thanks to a high year-ago base effect. Softer prices of food and housing as well as a sharp decline in transport prices also helped keeping overall general prices stayed at subdued level.

With fuel prices reverting to a weekly managed float system starting 5 January 2019 while working on the targeted fuel subsidy by the second quarter, headline inflation is likely to be influenced by variations in global crude oil prices. Post-SST two months transition period for inventory adjustment, hypermarkets and retail chains had to adjust their prices by 15 November. Headline inflation is estimated to increase gradually to 1.5-2.0% in 2019 from estimated 0.9% in 2018.

Monetary policy still has room. Bank Negara Malaysia (BNM) still has monetary policy room to provide the breathing space in ensuring accommodative interest rates to support domestic demand. BNM is expected to hold the interest rate steady at 3.25% in 2019. In the event of a sharp pull pack in GDP growth closer to 4.0%, the central bank will be compelled to lower interest rate even though it will weigh on the ringgit.

What could derail 2019's domestic GDP growth? The downside risks would come from external sources: (i) Unrelenting trade troubles, which significantly dampen the US and China economies and severely disrupt global trade flows; (ii) The Fed's over tightening of interest rates throwing the US economy into recession; and (iii) Sharp correction in global financial markets pulling down emerging markets, including downward pressures on currencies.

Domestic risks to the growth outlook are cautious consumer spending and a sharp deceleration in private investment as investors remained highly wary about external headwinds. The existence of a big gap between planning and implementation of the 2019 Budget measures would clip the growth. The 2019 Budget may compel a recalibration if crude oil prices fell below US$50/bbl for a sustained period, says 3-6 months (vs. the Budget's assumption of US$72/bbl) as oil-related revenue contributes RM80.9 billion or 30.9% of Federal revenue. In addition, persistent volatility in domestic and external financial markets would undermine domestic investors' confidence and sentiment.

Figure 45: Real GDP by economic sector (% YoY)

Economic Sector [% share to GDP in 2017]	**2017**	**2018 1Q**	**2018 2Q**	**2018 3Q**	**2018*E* (MOF)**	**2018*E* (SERC)**	**2019*F* (MOF)**	**2019*F* (SERC)**
Agriculture [8.2%]	7.2	2.8	-2.5	-1.4	-0.2	-0.4	3.1	1.8
Mining & Quarrying [8.4%]	1.0	0.1	-2.2	-4.6	-0.6	-1.8	0.7	0.5
Manufacturing [23.0%]	6.0	5.3	4.9	5.0	4.9	4.8	4.7	4.5
Construction [4.6%]	6.7	4.9	4.7	4.6	4.5	4.5	4.7	4.4
Services [54.5%]	6.2	6.5	6.5	7.2	6.3	6.5	5.9	5.8
Overall GDP	**5.9**	**5.4**	**4.5**	**4.4**	**4.8**	**4.7**	**4.9**	**4.7**

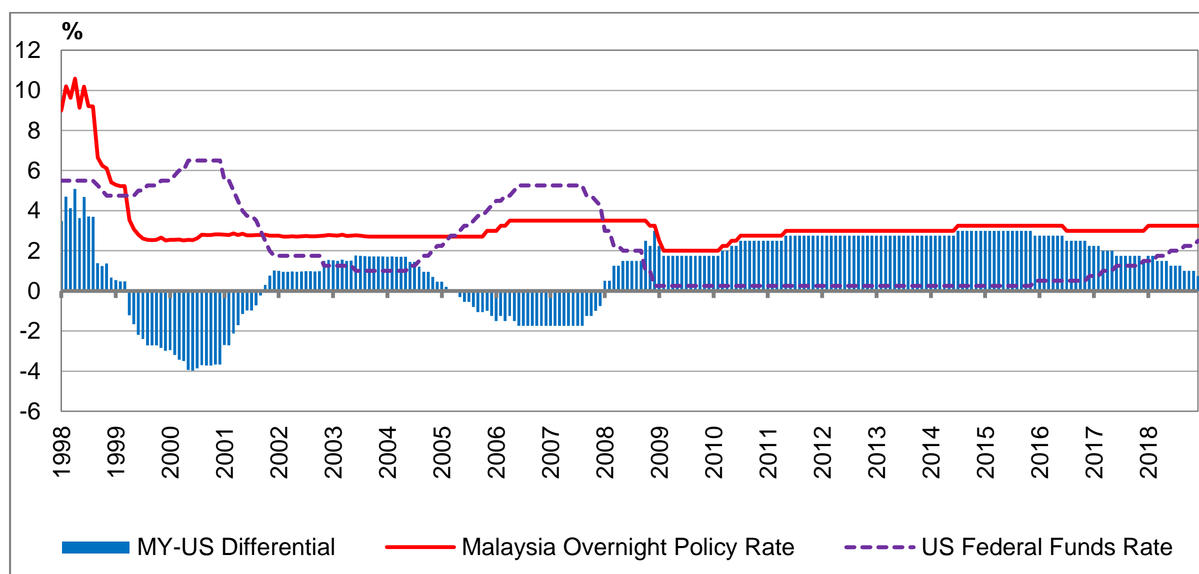
Source: Department of Statistics, Malaysia; Ministry of Finance (Economic Outlook 2019); SERC

Figure 46: Real GDP by demand component (% YoY)

Demand Component [% share to GDP in 2017]	2017	2018 1Q	2018 2Q	2018 3Q	2018*E* (MOF)	2018*E* (SERC)	2019*F* (MOF)	2019*F* (SERC)
Private Consumption [53.7%]	7.0	6.9	8.0	9.0	7.2	7.3	6.8	6.8
Public Consumption [13.0%]	5.4	0.4	3.1	5.2	1.0	2.0	1.8	1.8
Private Investment [17.4%]	9.3	0.5	6.1	6.9	4.5	4.1	5.0	4.3
Public Investment [8.0%]	0.1	-1.0	-9.8	-5.5	-1.5	-1.8	-5.4	-4.8
Exports of Goods and Services [72.8%]	9.4	3.7	2.0	-0.8	2.0	1.8	1.6	1.5
Imports of Goods and Services [65.1%]	10.9	-2.0	2.1	0.1	1.4	0.5	1.8	1.3
Overall GDP	**5.9**	**5.4**	**4.5**	**4.4**	**4.8**	**4.7**	**4.9**	**4.7**

Source: Department of Statistics, Malaysia; Ministry of Finance (Economic Outlook 2019); SERC

Figure 47: Malaysia-US's interest rate differentials



Source: Bank Negara Malaysia; Federal Reserve

REVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

Leading indicators and Industrial production

Leading index (LI), which is designed to indicate the direction of economy over the next four to six months ahead anticipates the economic growth will ease in 1Q18 and likely to gain traction thereafter.

Industrial production perked up to 4.2% yoy in October (average 2.4% in 3Q18), contributed by manufacturing output (4.8% in October and 3Q18) and a long-waited positive growth from the mining sector (1.4% vs -5.6% in 3Q18) while electricity output eased to 2.1% from 4.2% in 3Q18.

With the manufacturing sector will be affected by slowing global demand for electrical and electronic products amid the US-China's trade spats uncertainty, its performance will dictate overall industrial production. The mining output, which has been a big drag on industrial production in 2018, is expected to resume recovery growth in 2019. In support of the OPEC's output cut to help stabilising global crude oi prices starting 2019, Malaysia will continue to cut crude oil production by 15,000 barrels per day, which is lower compared to 20,000 barrels in 2018. The Kebabangan gas field is expected to return to its full capacity in the second half of 2019, which will give a helping hand to the mining sector.

Figure 48: Leading index signals easing growth in 1Q19

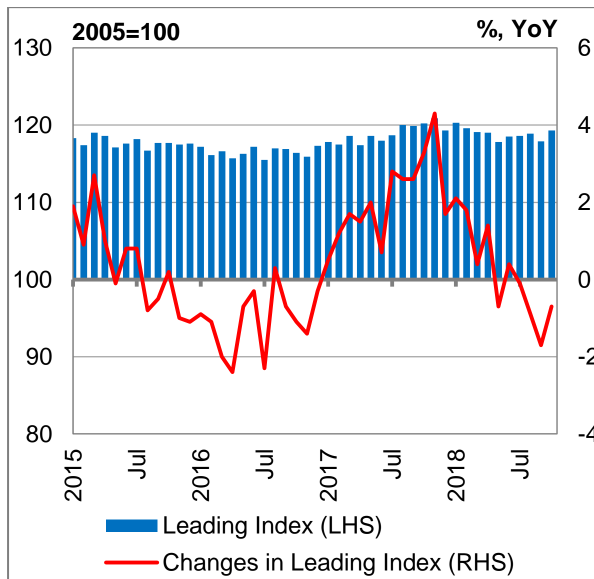
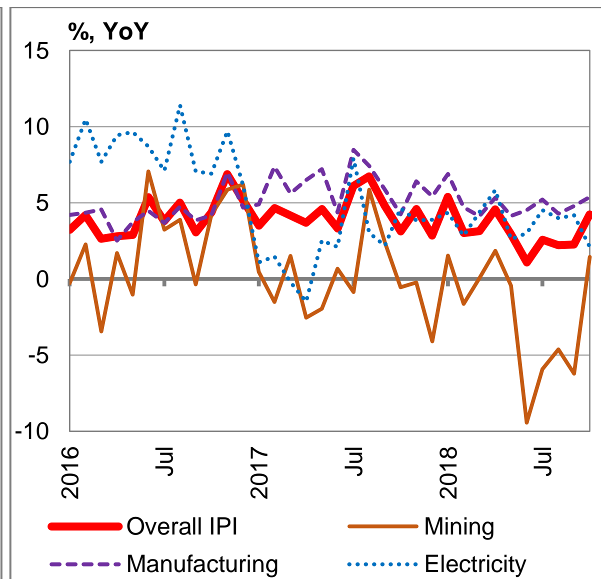


Figure 49: Mining sector may resume growth to help lifting overall production



Source: Department of Statistics, Malaysia

Exports, Manufacturing sales and Services

Exports growth have exhibited erratic patterns in recent months, caused by the on-going trade dispute between the US and China. The front-loaded shipments ahead of the planned tariffs hike in January 2019, which was postponed later helped boosting October's exports growth to 17.7% yoy or RM96.4 billion, the highest level on record before pulling back sharply to 1.6% in November. The pullback was in tandem with other regional peers.

In the first eleven months of 2018, exports growth of 6.9% was mainly lifted by manufacturing products and crude petroleum, which partially offset by contraction in agricultural products and natural gas. It must be noted that Malaysian manufacturing industries recorded little value-added as re-exports have been growing rapidly at 41.9% in Jan-Nov 2018 while domestic exports, which come with higher value-add merely grew by 0.6% for the same period. This goes to indicate the prevalence of structural weakness in manufacturing industries, which compel the rapid utilisation and upgrading of technology to deepen high value-added creation. Faced with the uncertain outcome of the US-China trade negotiations, slowing global demand, weaker commodity prices and high exports base, exports are expected to grow at a much slower pace of 3.3% in 2019 from estimated 6.9% in 2018.

After registering nine months of single-digit growth, **manufacturing sales** growth climbed back to double-digit growth of 10.2% in October 2018, contributed by transport equipment & other manufactures products (13.3%), electrical and electronic products (11.5%), and petroleum, chemical, rubber and plastic products (11.5%). For distributive trade, the bumper purchases of big-ticket items during the 3-month consumption tax holiday will likely subside post the reintroduction of Sales and Service Tax (SST).

Figure 50: Exports outlook remained cautious

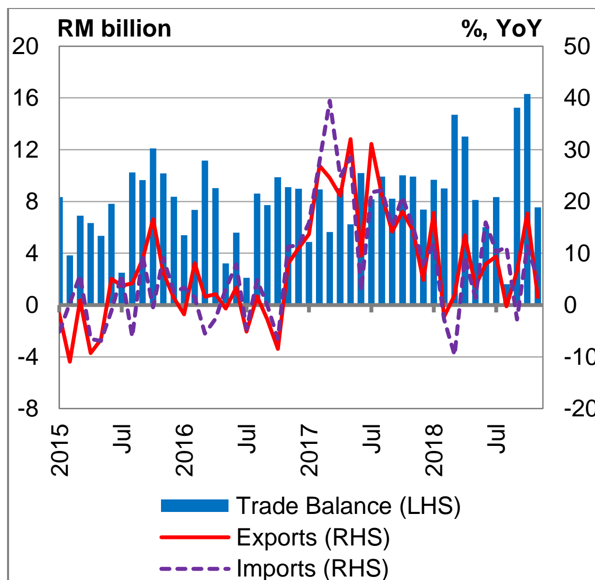


Figure 51: Slower chip sales will drag overall exports

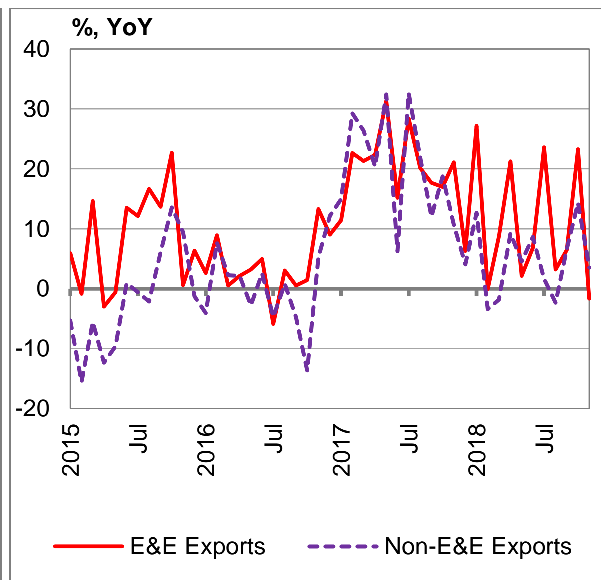
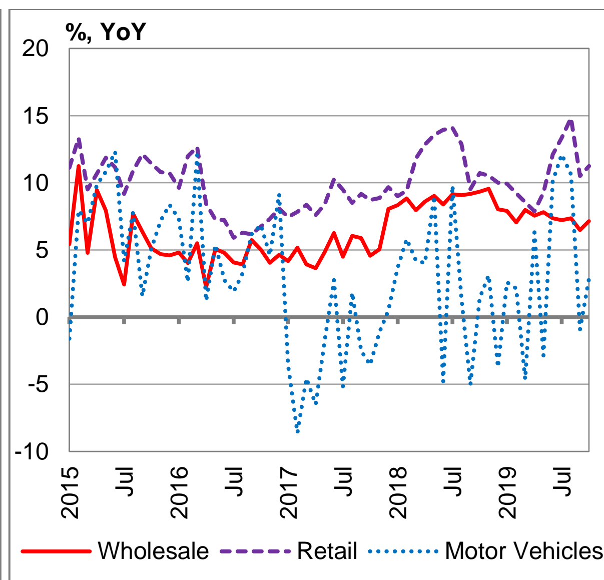


Figure 52: Manufacturing sales continue to climb higher

Figure 53: No big shopping plans expected in near-term



Source: Department of Statistics, Malaysia

Private consumption indicators

Following the euphoria sentiment post the 14th General Election, MIER's Consumer Sentiment Index (CSI) moderated sharply to 107.5 points in 3Q18 from 21-year high's 132.9 points in 2Q18, but still way above the 100-pt threshold. Financial expectations head up on better employment prospect.

Unemployment rate remained healthy at 3.3% in Sep-Oct 2018 and it has been hovering between 3.3% and 3.5% since December 2015. For the period Jan-7 Dec 2018, 21,532 employees lost their jobs, of which 7,755 were from top three high paying occupations, i.e. managers, professionals and technicians. However, with the implementation of Employment Insurance Scheme (EIS), these employees should be well-sheltered to tie them over the period of unemployment. As the general price levels did not move up higher than expected post SST implementation on 1 September, overall private consumption growth still be in a good shape, albeit slower as the big one-off spending during the 3-month tax holiday normalises.

In the first quarter of 2019, households' spending power will be enhanced by the following measures: (i) Higher increases in minimum wage to RM1,100 (RM100 for Peninsular Malaysia and RM180 for East Malaysia); (ii) Lower weekly petrol prices of RM1.93 per litre for RON95 starting in the first week of January 2019; and (iii) First tranche payment of cost of living aid (also known as Bantuan Saraan Hidup (BSH)) amounting to RM300 each for eligible households totalling RM1.2 billion starting on 28 January.

Other measures to help easing cost of living burden include a RM100 monthly pass for unlimited usage of Rapid KL's transport network, lower telecommunication charges, more balanced prices of necessity goods and the freezing of all toll rate hikes in 2019 costing a total compensation of nearly RM1.0 billion would help to improve consumer discretionary spending. It must be noted that the household electricity subsidy, petrol price subsidy and cost of living aid will be made more targeted for B40 households as approved in the 2019 Budget. With headline inflation staying low in 2019, private consumption is estimated to grow by 6.8% in 2019 (estimated 7.3% in 2018).

Figure 54: Passenger car sales moderated but would get support from the introduction of few new car models

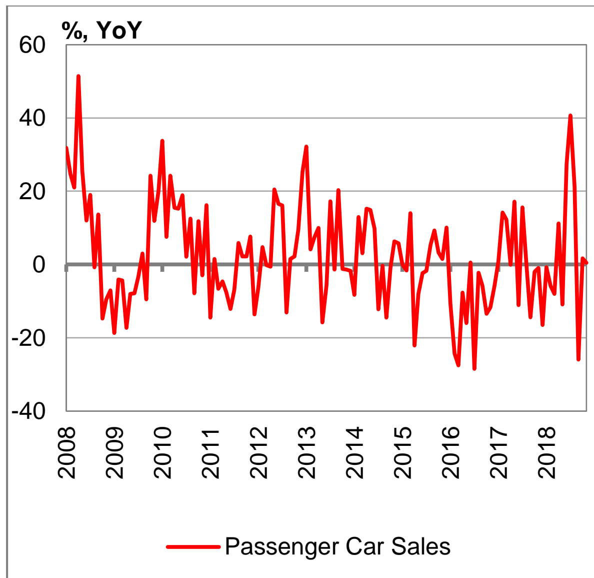


Figure 55: Selected private consumption indicators

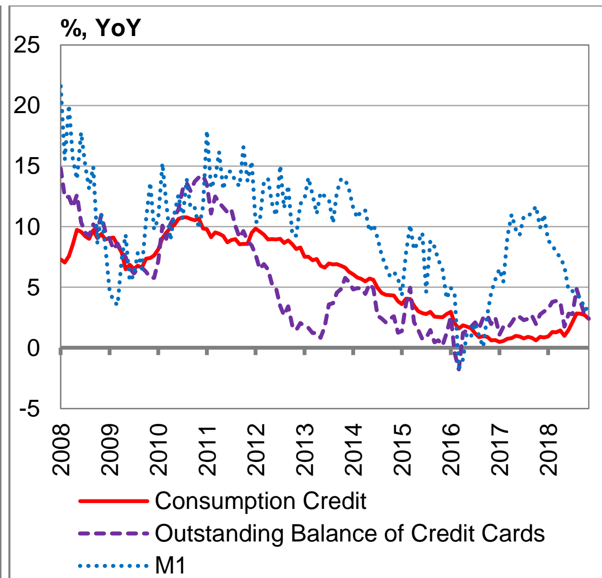


Figure 56: Moderated payout in services sector

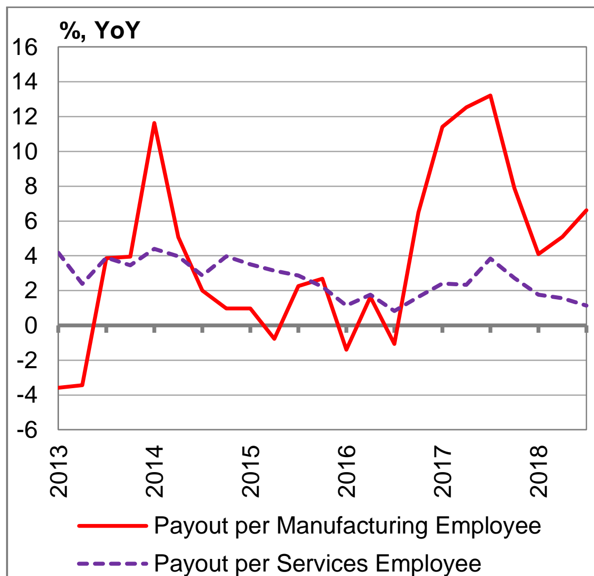
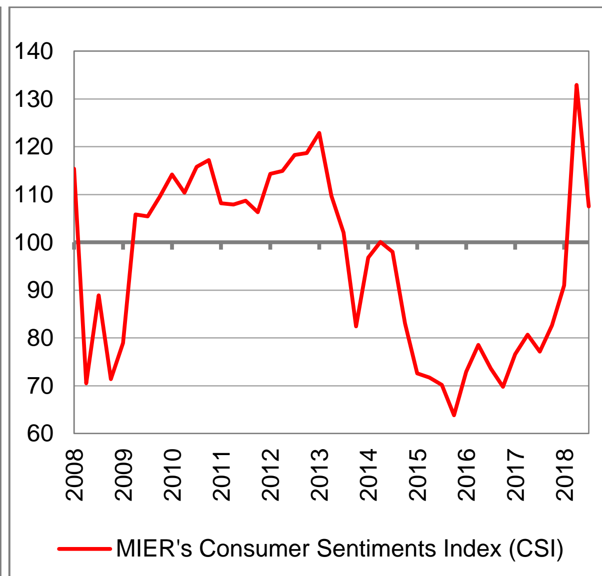


Figure 57: Consumers still feeling good



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

Private investment indicators

The latest Business Tendency Survey indicated that businesses, particularly from the wholesale and retail trade and other services sectors expect a more favourable performance in 4Q18 while the construction players remained pessimistic. It is envisaged that the RM37 billion of GST and income tax refund would leave businesses with more cash for investment spending and capacity expansion.

However, weighing on uncertainties about the negotiation of trade disputes and moderating global demand, businesses may adopt a cautious stance to commit large expansion plans. More so when businesses, especially SMEs are still struggling with higher operating (higher minimum wage and utility costs) and compliance costs amid several unresolved outstanding issues such as shortage of foreign workers and potential higher revision of foreign worker levy. Overall, SERC expects private investment to grow moderately by 4.3% in 2019 (estimated 4.1% in 2018).

Figure 58: Selected private investment indicators

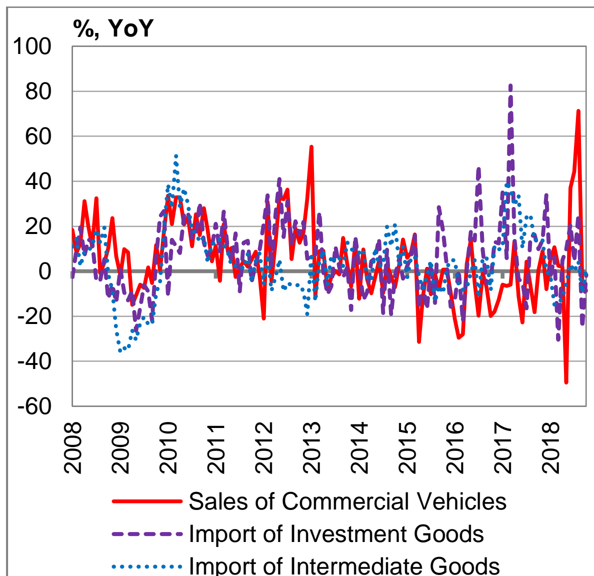


Figure 59: Real private investment growth gained more ground in 3Q18

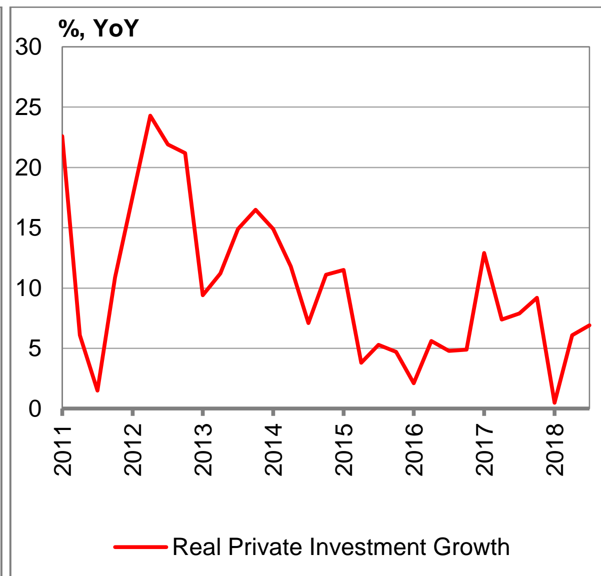


Figure 60: Business expectation index fell but overall still well above the threshold

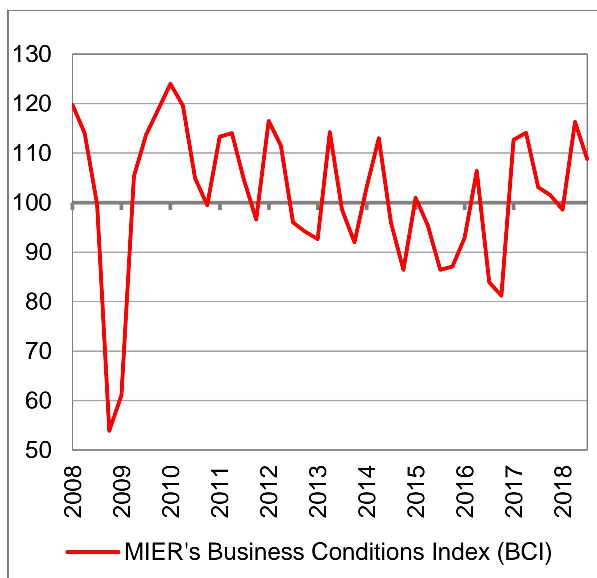
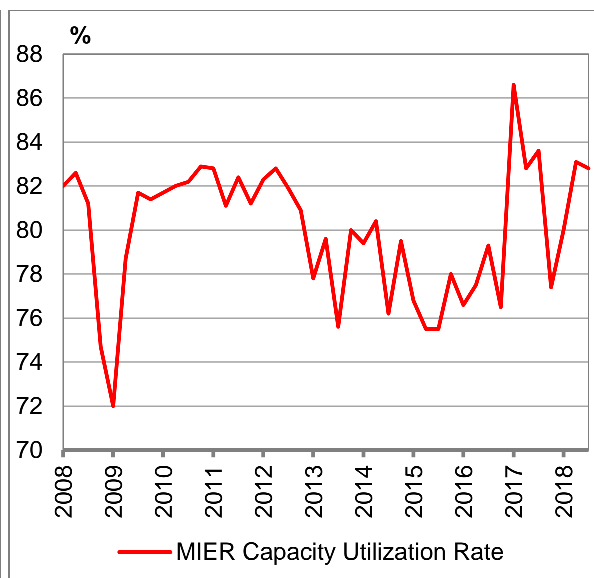


Figure 61: Capacity utilisation rate stood at 82.8% in 3Q18



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

Price indicators

Inflation rate remained subdued at 0.3% and 0.6% yoy in September and October 2018 respectively post-SST reimplementation, mainly due to the price locked-in during inventory adjustment and flattish petrol prices compared to a year ago. In November 2018, inflation increased marginally by 0.2%, reflecting the decline in RON95 petrol price (RM2.20/litre in November 2018 compared to average RM2.28/litre in November 2017) amid price differentials impact between SST and GST as the SST only accounted for 38% of the Consumer Price Index (CPI) basket of goods compared with 60% under the GST. **Core inflation** also stayed at the lower-end of 0.5% yoy in November (0.4% in October and 0.3% in September). Excluding the impact of changes in consumption tax, core inflation remained broadly stable at 1.6% (October: 1.5%).

Moving forward, the weekly managed floating of RON95 petrol price will be capped at RM2.20/litre even if the crude oil prices move beyond the cost price. This weekly floating fuel price system will remain in place until the targeted subsidy plan is scheduled to roll out in the second quarter of 2019. Nonetheless, crude oil prices are widely expected to stay below US$70/bbl and hence, the chance of consumers paying high petrol price is quite minimal. On the effect of consumption tax changes, it is expected that low inflation rate will be normalised starting June 2019. For the full year of 2019, inflation is estimated to increase by an average of 1.5-2.0% (estimated 0.9% in 2018).

Figure 62: Inflation rates will remain low until at least May 2019

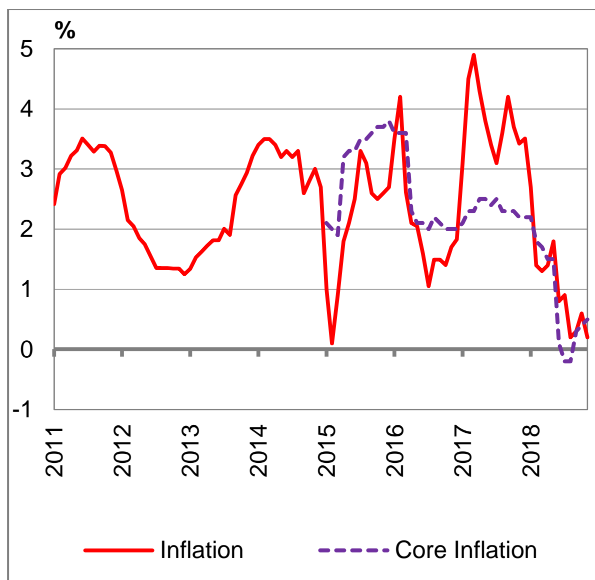
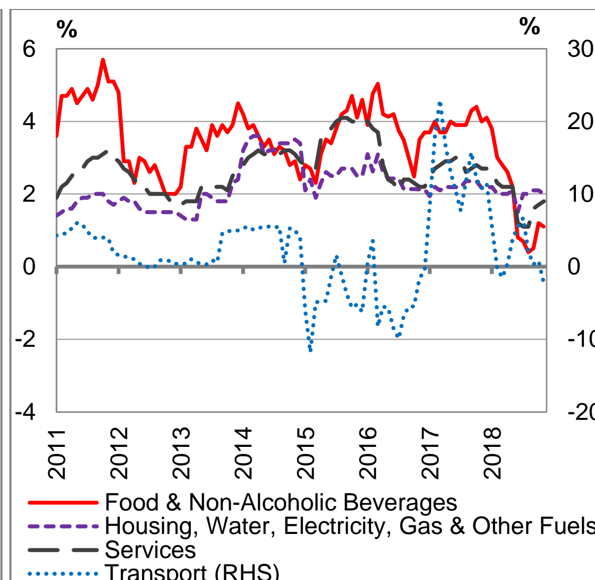


Figure 63: Transport price index will contract on lower fuel prices



Source: Department of Statistics, Malaysia

Banking loan indicators

Total loans outstanding extended by the banking system remained on its expansion track in November (6.2% yoy vs. 6.0% in October and 5.5% in 3Q18), led by business sector, in particular the wholesale and retail trade, restaurants and hotels; construction; and manufacturing sectors. Household sector's loans outstanding have been slipping since September 2018 to 5.7% in November, mainly due to lower disbursement for the purchase of residential property as the property market continues to soften. In terms of loan applications, there was a significant drop in November 2018 on lower applications for the purchase of passenger cars. This is not surprising as such big-ticket items have been largely bought and the hire-purchase loans have been approved during the 3-month tax holiday (June to August).

The banking system's asset quality remains sound. Banks have maintained sufficient buffers against potential credit losses with total provisions to total loans ratio sustained at 1.5%.

Figure 64: Outstanding loans growth continues to expand

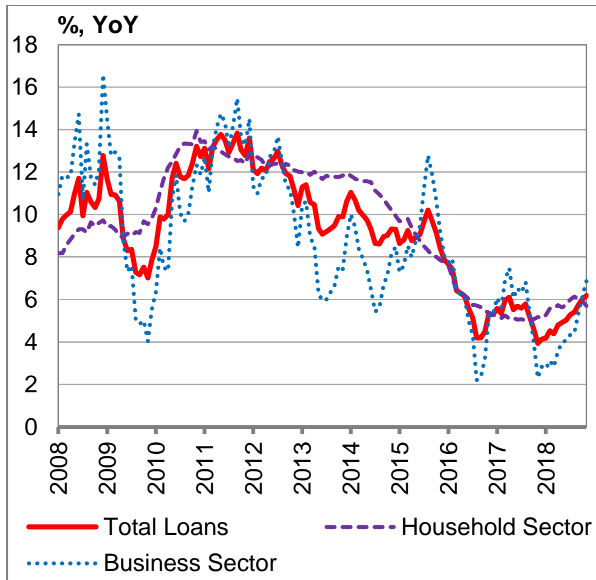


Figure 65: Loan applications growth

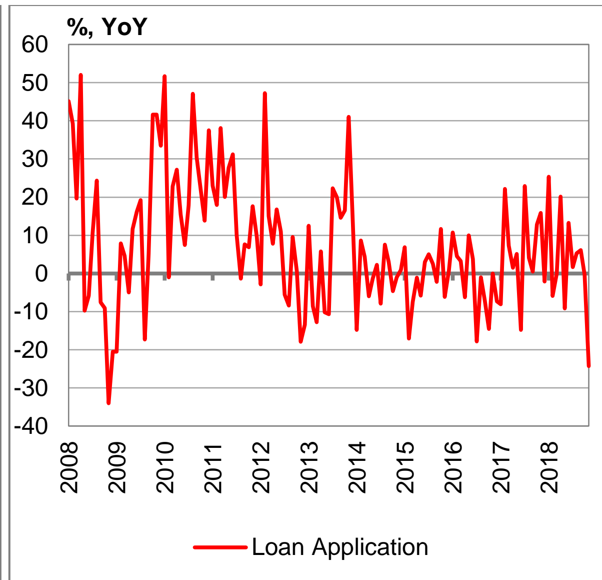


Figure 66: Loan approvals growth

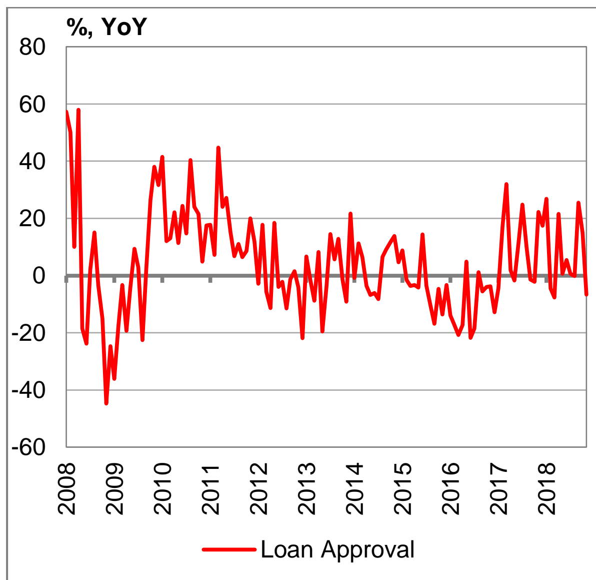
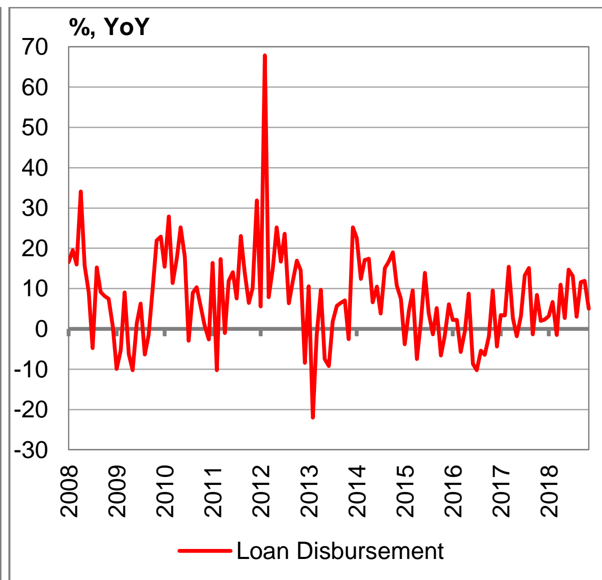


Figure 67: Loan disbursements growth



Source: Bank Negara Malaysia

Financial indicators

Bank Negara Malaysia's **holdings of foreign reserves** rose a mere US$0.3 billion in November to reach US$102.0 billion at end-November, this follows six consecutive months of decline (totalling US$7.8 billion) since May. In December, reserves fell again by US$0.6 billion to US$101.4 billion, bringing a total net decline of US$1.0 billion for the full-year of 2018. As at end-December 2018, foreign reserves position to short-term external debt ratio stood at 1.0, lower than 1.1 times compared to a year ago. There are valid concerns that any slippage in the ratio to below 1.0 would jeopardise Malaysia's sovereign assessment score.

As at end-December 2018, foreign investors held RM184.8 billion or 13.1% of total ringgit-denominated debt securities (RM206.7 billion of 16.0% as at end-2017), of which the largest portion was Malaysian Government Securities (MGS) at RM146.2 billion. In 2018, foreign investors net sold a sizeable RM18.3 billion of MGS, resulted in foreign holdings of MGS dropping to 38.4% (45.1% as at end-2017), the lowest level since December 2011. Net foreign selling also seen in the Malaysian Government Investment Issues (GII) and private conventional bonds, which declined by RM2.6 billion and RM2.5 billion respectively.

Foreign net selling of domestic equities reached RM11.9 billion in 2018 with only three out of 12 months recorded net buying position. Dampened by both new domestic political landscape and policy transition as well as global uncertainties, the FBM KLCI has dropped by 106.23 points or 5.9% to close at 1690.58 in the last trading day of 2018. In terms of market capitalisation, a total of RM134.3 billion or nearly 10% of total GDP was wiped out. Nonetheless, Malaysia was not the sole victim as other regional bourses also saw declines in their indices though our FBM KLCI has fallen lesser: Shanghai Composite Index (-24.6%), Hang Seng Index (-13.6%), PSEi (-12.8%), Nikkei 225 Index (-12.1%), SET Index (-10.8%), Straits Times Index (-9.8%) and Jakarta Composite Index (-2.5%).

In 2018, the ringgit has depreciated against the greenback by 1.8% to RM4.1385 per US dollar at end-December (RM4.0620 per US dollar as at end-2017). The ringgit generally has performed well against other major currencies in 2018 as it has appreciated against the Australian dollar (8.3%), Indian rupee (7.1%), Indonesian rupiah (4.9%), pound sterling (4.1%), Chinese renminbi (3.5%), Philippine peso (3.2%), euro (2.5%) and the Singapore dollar (0.2%), while only weakened against Thai baht (-2.1%) and Japanese yen (-3.9%).

Supported by strong fundamental drivers such as positive economic prospects, continued surplus in current account, healthy foreign reserves, stable fiscal and debt path as well as the affirmation of Malaysia's sovereign ratings, the ringgit is expected to strengthen gradually in 2H19, taking into consideration the likely pausing of the Fed's interest rate hike, which probably peaking in 3Q19. The ringgit is expected to trade at RM3.95-4.00 per US dollar as at end-2019.

Figure 68: Foreign reserves declined by US$1.0 billion in 2018

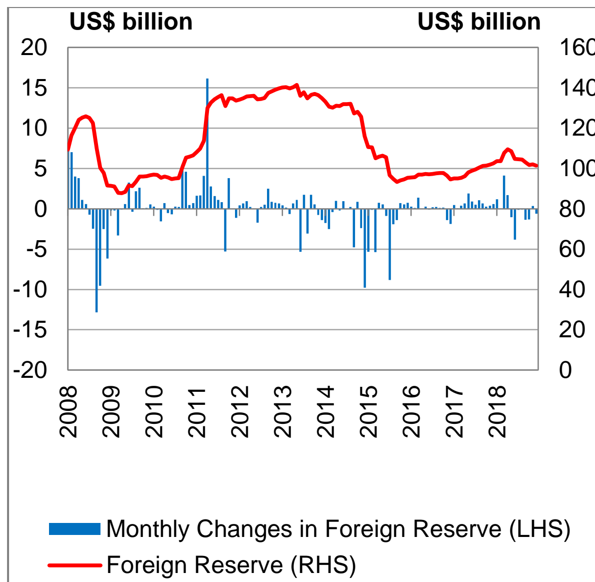


Figure 69: Ringgit started to strengthen against greenback in recent weeks

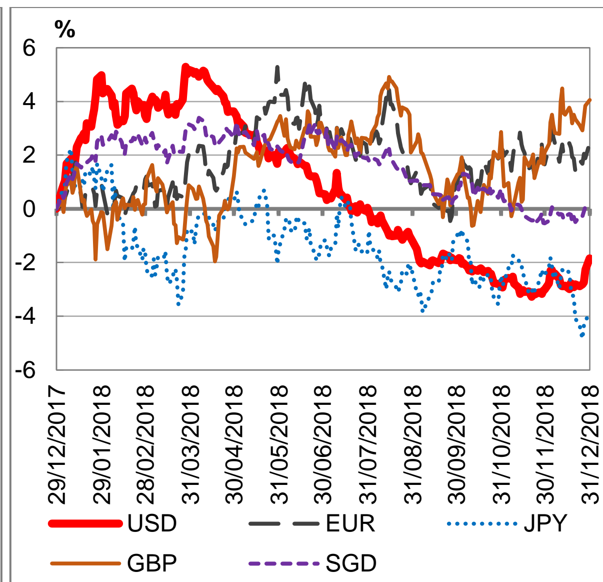


Figure 70: Ringgit appreciated by 3.5% against the Chinese yuan in 2018

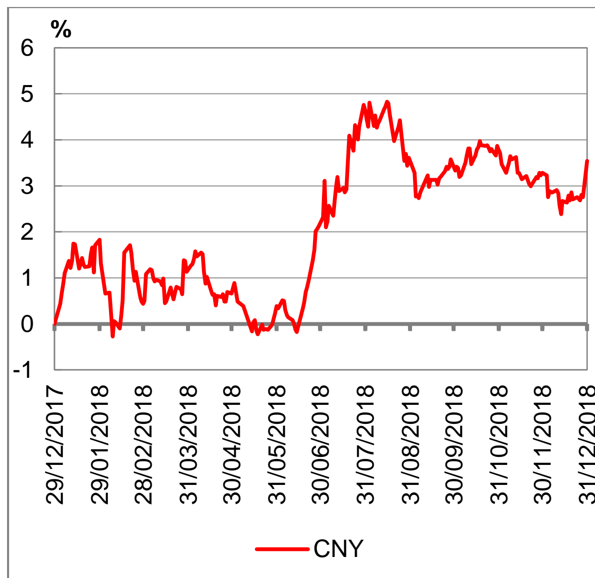
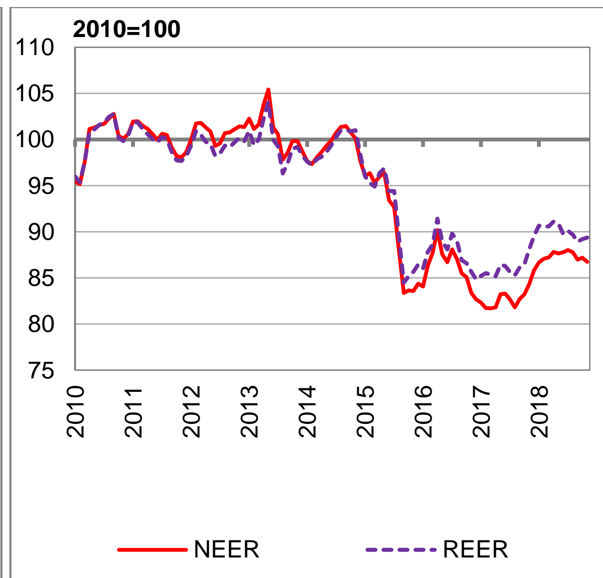


Figure 71: REER ticked up in November, yet still lower than 3Q18



Source: Bank Negara Malaysia; Bank for International Settlements

SOCIO-ECONOMIC RESEARCH CENTRE (SERC)
SERC SDN BHD (Company No.: 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