QUARTERLY ECONOMY TRACKER

(JANUARY-MARCH 2017)

Socio-Economic Research Centre (SERC)

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Executive Summary

A. GLOBAL ENVIRONMENT

- **Off to a good start in 1Q 2017.** The global economy seems to show some growth traction going by the performance of global equity markets as investors' sentiment and market optimism was buoyed by expectations that the Trump administration's reflationary policies will lift the growth prospects of the global and US economy as well as better corporate earnings. Other bright spot is the firming of global crude oil prices to around US$56 per barrel before easing off in recent weeks, cementing positive effect from the OPEC's oil output cut deal. Despite the upshot to optimism, material risks could emanate from faster Fed's rate hikes, diminishing hopes of the US fiscal stimulus and the threat of trade protectionism amid a plethora of policy and political uncertainties.
- **Higher global growth expected.** Our tracking of high frequency global lead and forward indicators underpin a better year ahead, albeit still moderate. The International Monetary Fund's (IMF) estimated global growth of 3.4% in 2017 (3.1% in 2016) and 3.6% for 2018 is still a distance from an average growth of 4.2% in 1998-2007. The US growth is picking up steam and the improved outlook in Japan is expected to offset the still moderate pace of growth in Europe. China's growth and financial stability remained in focus as the government continues its economic rebalancing whilst ensuring financial stability and containing macro risks.
- **Higher inflation risk, tighter monetary policy ahead?** Has the tide turned? Better price prospects for oil and commodities, strong dollar's appreciation against most major foreign currencies as well as firmer wage growth could lift inflation risk and may threaten the central banks' price stability target in advanced economies and some emerging economies. Will the anticipated inflation risk prompt a radical gear shift in the advanced economies' monetary policy, which will bring to an end of negative interest rates by Bank of Japan (BoJ) and the European Central Bank (ECB)? The upshot could come from the US Federal Reserve, which may be forced to embrace faster pace of rate hikes this year from the expectations of 2-3 hikes currently.
- **A balancing act of headwinds and tailwinds.** Trade protectionism mindset, the Fed's interest rate upcycles, rising US dollar and hopes for the Trump administration's reflationary policies – tax cuts and increased fiscal spending – are setting the global agenda. While the year 2017 started off on a pretty well footing, certain threats and risks still warrant close monitoring. Among these include potential ramifications in relation to the Trump administration's trade and economic policies, the risk of stumbling blocks in the UK's Brexit negotiations, which was triggered on 29 March 2017, the economic and financial disruptions in China triggered by the blow up of debt and banking crisis. In terms of political risks, the wave of political changes will continue unrelentingly in some European countries in 2017.

B. MALAYSIA'S ECONOMIC PERFORMANCE AND OUTLOOK

- **The year 2016 ended on a moderate note.** The Malaysian economy moderated for two consecutive years since 2014 as GDP economic growth cooled from 6.0% in 2014 to 5.0% in 2015 and 4.2% in 2016 respectively. That said, we strongly believe that the economy has hit the bottom (the lowest point) seen in 2Q16 (4.0% yoy) and has slowly rebuild firmer base in the second half-year (4.3% in 3Q and 4.5% in 4Q respectively). As in previous years, domestic demand continues to remain the prime mover of economy amid a pick-up in exports in recent months.
- **Private spending still calling the shots.** In 4Q16, private sector demand sustained the growth (6.0% vs. 6.0% in 3Q), taking the full-year growth to 5.7% in 2016, albeit lower when compared to 6.0% in 2015. Consumer spending growth slipped a little to 6.2% in 4Q from 6.4% in 3Q and 6.3% in 2Q). For the year 2016, private consumption was resilient to grow by 6.1% (6.0% in 2015) backed by continued wage growth and cash handouts for the low and middle-income households. The disturbing signs are still weak and moderate pace of private investment (4.9% in 4Q vs. 4.7% in 3Q and 5.6% in 2Q respectively), taking the full-year growth to 4.4% in 2016 (6.4% in 2015), the slowest pace in six years.
- **Continued expansion in most economic sectors.** While most economic sectors continued to expand in 4Q16, both services and construction sectors surprisingly paced slower. Moderated growth in services were due to slower insurance and financial activities while that of construction output was pulled down by a subdued property market, especially residential subsector. The mining sector continued to expand higher while the agriculture sector contracted at a smaller magnitude.
- **SERC's 2017 GDP growth is maintained at 4.3%.** Our tracking of leading indicators suggest that economic activity is mixed in the first quarter of 2017. Exports continue to rise strongly in January, partly attributable to seasonality and weak ringgit effect, and industrial production paced at healthy pace. However, consumer sentiments remained soft on the back of high consumer inflation while business sentiments still weak as companies remained cautious amid continued uncertainty in the economic environment.
- **SERC's estimates of 4.3% economic growth this year falls within the range estimates of 4.3-4.8% by Bank Negara Malaysia** (BNM). This will be supported by continued expansion of domestic demand, albeit slower as well as better export growth. While consumer spending will continue calling the shots, it will grow by 5.7% this year (6.1% in 2016) on cautious sentiment, higher inflation, rising cost of living as well as lower purchasing power. Private investment growth is expected to remain stuck at "slow and moderate" growth path (4.5% vs. 4.4% in 2016) amid cautious investors' sentiment, the impact of weakening ringgit and lingering uncertainties ahead of the General Election (GE14). The ongoing implementation of public infrastructure projects and capital investment in manufacturing and services will underpin private investment.
- **Exports offer silver lining.** Exports had turned around to grow by 2.8% in 4Q16 from a decline of 2.3% in 3Q, thanks to higher manufactured exports and improvement in commodity earnings. In January, exports sustained the strong expansion trend to rise by 13.6% yoy (10.7% in December and 7.8% in November 2016 respectively). This was partly aided by the weak ringgit's valuation effect in addition to higher demand for electronics and better prices of crude oil and commodities. We now estimate Malaysia's exports to grow by 5.0% this year (revised from 1.5-2.0% previously; 1.1% in 2016). The downside risk to exports could come from the disruption of global trade flows arising from the trade protectionism threat in advanced economies. Crude oil price is estimated at US$55-60 per barrel vs. US$43.67 in 2016 and palm oil at RM2,700 per tonne vs. RM2,647 in 2016).

- **What risks lie ahead?** We would caution that 2017's economic growth estimate is premised on the strength of consumer spending, which may face hurdles from higher cost of living, cost-driven inflation pressures and weak sentiments. Exports too could falter if there is global trade flows disruption from the trade protectionist mindset as well as financial markets' volatility. Following the Trump's signing of executive orders aimed at identifying and targeting foreign trade abuses, Malaysia is among the 16 countries being identified incurring massive trade imbalances with the US.
- **Inflation tide has turned.** Inflationary pressures are developing in recent months, reflecting the combined impact of fuel prices adjustment, the spillovers of the ringgit's depreciation on imported goods and services and other cost-related pressures. Headline inflation, which has been moving higher from 1.7% yoy in 4Q16 to 3.2% in January 2017, accelerated further to an 8-year high of 4.5% in February, driven mainly by upward adjustments to domestic fuel prices as well as continued rise in food prices. Volatile crude oil prices remain a wild card. We revise our 2017's baseline estimate of inflation to average 3.0-4.0% from 2.5% previously (2.1% in 2016).
- **Private consumption and investment indicators remained mixed**. After contracting for six successive months since July 2016, car sales, which rose for the first time in January, expanded further by 14.2% yoy in February, partly aided by low base effect. Consumption credit remains moderate. Higher increases in imports of capital and intermediate while consumption goods declined in January. Seasonality effects due to the festive celebration normally occurs in January-February. Loan indicators such as loan applications, approvals and disbursements increased in February amid a moderate rise in overall loans growth.
- **The Ringgit still on weakening bias.** The ringgit starts the year with a modest appreciation against the US dollar relative to its regional peers. BNM's foreign exchange market stabilisation measures had seen some improvement in balancing the supply and demand of the ringgit. Net foreign exchange conversion from exports have increased to US$2.0 billion in the first two months of 2017 from net deficit of RM0.5 billion in Jan-Nov 2016. The ringgit will continue face hurdle from the US dollar strength, which is backed by the Fed's more rate hikes ahead. The ringgit is expected to be around RM4.30-4.40 per US dollar by end-2017 (RM4.4860 at end-2016).
- **BNM's overnight policy rate on hold at 3.00%.** We do not expect BNM to ease interest rates further going by the continued expansion of economic growth amid the developing of inflationary pressures, inflicted by higher fuel prices. The weakening ringgit is seen as tying the central bank's hands in pursuing more accommodative monetary policy to help bolster the economy should the economic growth momentum falters. The trigger for BNM to consider cutting interest rate is when the real GDP is assessed to be under threat, probably under 4%. We expect BNM to keep the overnight policy rate (OPR) at 3.00% in 2017 for now.

GLOBAL GROWTH STILL FEEABLE

Global indicators point to optimism. The global economy continues to stay on positive growth track, buoyed by expectations that the Trump administration's reflationary policies will boost the growth prospects of the US economy and corporate earnings. Global equity markets, which got a strong lift from the Trump's thumping victory in November last year continues its positive momentum in the first quarter of 2017. Emerging markets also followed in tandem though the strong US dollar rally, augmented by increasing prospects of higher US interest rates ahead have weighed on major foreign currencies, namely the euro and Japanese yen. Regional forex showed differentiated movements against the dollar.

While the International Monetary Fund (IMF) expects global growth to improve from 3.1% in 2016 to 3.4% in 2017 and 3.6% for 2018 respectively with caution risks, the growth rate remains below from an average growth of 4.2% in 1998-2007. This goes to show that the pace of global economy hinges on the sustained growth of advanced economies amid China's gradual growth after undergoing economic restructuring and stabilisation.

The release of 4Q16 GDP data indicated that the US economy is steadying while that of Japan is still growing, albeit moderately. Growth in the euro area remains uneven among the large economies.

What do the numbers tell us? Our tracking of global current and forward indicators have consistently point to a better year ahead. The OECD composite leading indicators continue to suggest growth gaining momentum in several advanced and emerging economies. Global Purchasing Managers Index (PMI) for manufacturing and services had a strong start in 1Q2017. Global semiconductor sales extended its expansion trail for six consecutive months since August 2016, a strong sign that the industry is firmly on the growth trajectory. Global crude oil and other commodities prices have firmed up, albeit uneven bode well for the commodity exporting economies.

But, downside risks to global growth still prevalent. Despite a reasonably better outlook, the balance of risks is still tilting to downside. These include the potential implications from the Trump administration's trade and economic stances, the impact of higher US interest rates and strong US dollar on exchange rates and international financial as well as liquidity conditions, putting emerging economies in vulnerable position, the rise in national populism and protectionism, potential complications associated with the UK's Brexit negotiations, the political uncertainty and potential upheaval associated with a slate of impending European elections leveraging on populists in the Netherlands, France and Germany as well as lingering concerns about China's high debt.

Trump's executive orders kick start the trade agenda. On 31 March 2017, President Donald Trump has signed a pair of orders aimed at identifying and targeting foreign trade abuses. One order commissions a 90-day study of US trade deficits totalling US$500 billion per annum with 16 trading partners to identify potential trade abuses and cheating. The second directive orders stricter and more effective enforcement of US anti-dumping laws to prevent foreign manufacturers from undercutting US companies by selling goods at an unfair price.

The US Commerce Secretary Wilbur Ross had identified 16 major countries with which the US has significant trade imbalances. Leading the pack is China with a massive trade imbalance of US$347 billion, followed by Japan (US$68.9 billion), Germany (US$64.9 billion), Mexico (US$63.2 billion), Ireland (US$35.9 billion and Vietnam (US$32.0 billion). Other countries in the list were Italy, South Korea, Malaysia, India, Thailand, France, Switzerland, Taiwan, Indonesia and Canada. Wilbur Ross has called China the "most protectionist" nation among the major economies.

Figure 1: Real GDP growth (% YoY)

	2015	2016	2016 1Q	2016 2Q	2016 3Q	2016 4Q	2017*f* (IMF)	2017*f* (WB)	2018*f* (IMF)	2018*f* (WB)
United States	2.6	1.6	1.6	1.3	1.7	2.0	2.3	2.2	2.5	2.1
Euro Area	1.9	1.7	1.7	1.6	1.8	1.7	1.6	1.5	1.6	1.4
China	6.9	6.7	6.7	6.7	6.7	6.8	6.5	6.5	6.0	6.3
Japan	1.2	1.0	0.4	0.9	1.1	1.6	0.8	0.9	0.5	0.9
India[1]	7.9	-	7.9	7.2	7.4	7.0	7.2	7.6	7.7	7.8
Malaysia	5.0	4.2	4.2	4.0	4.3	4.5	4.5	4.3	-	4.5
Singapore	1.9	2.0	1.9	1.9	1.2	2.9	2.2	-	-	-
Indonesia	4.9	5.0	4.9	5.2	5.0	4.9	5.1	5.3	-	5.5
Thailand	2.9	3.2	3.1	3.6	3.2	3.0	3.3	3.2	-	3.3
Philippines	5.9	6.8	6.8	7.0	7.0	6.6	6.7	6.9	-	7.0
Vietnam	6.7	6.2	5.5	5.8	6.6	6.7	6.2	6.3	-	6.3

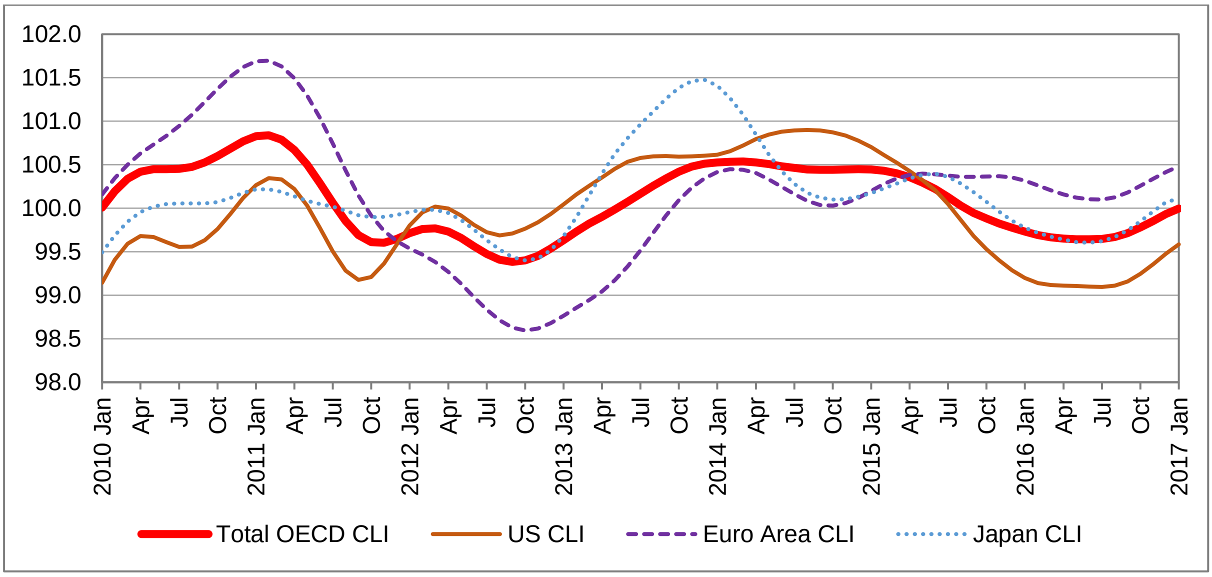
Source: Officials; IMF (World Economic Outlook, October 2016 & January 2017, Recent Article IV Mission Reports); World Bank (Global Economic Prospects, January 2017)

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

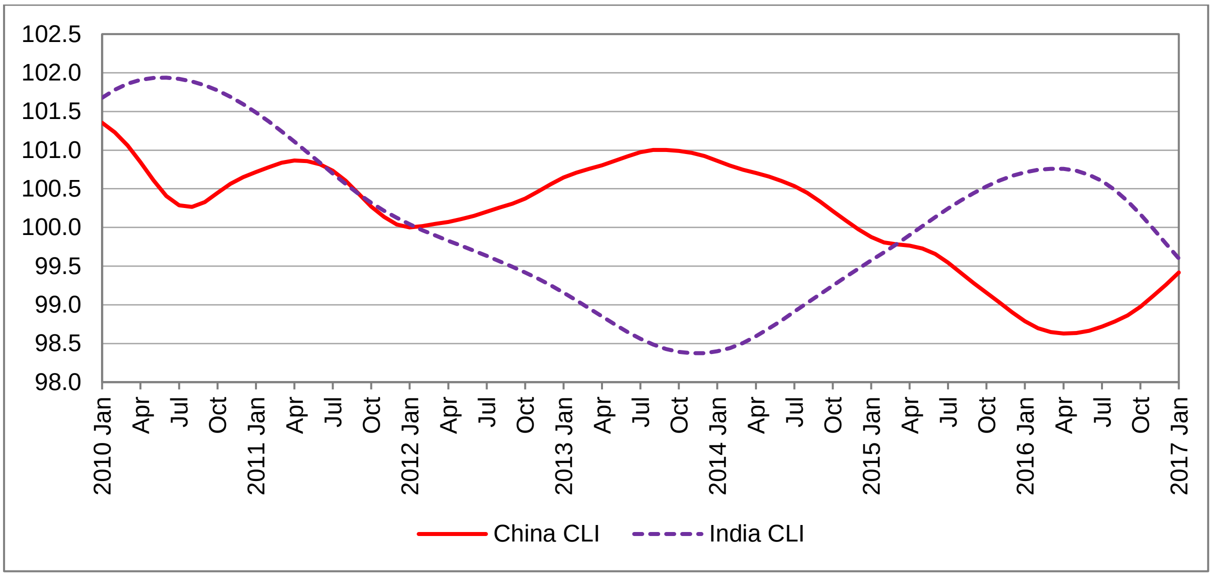
1) **The composite leading indicators (CLIs)**, which are designed to anticipate turning points in economic activity relative to trend continue to rise in January 2017 for three consecutive months, pointing to continued growth momentum in major advanced economies, namely the US, Japan, Germany and France. Growth momentum is expected to pick up in China while that of India likely to ease.

Figure 2: OECD CLI points to continued growth momentum



Source: OECD

Figure 3: China's growth is gaining traction while India's growth momentum eases

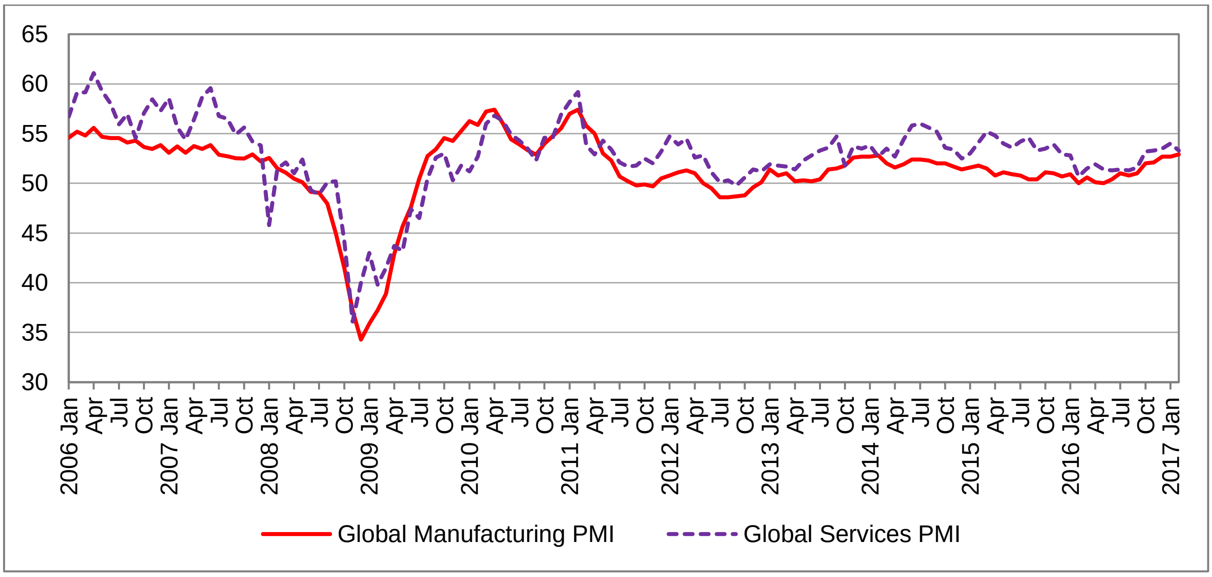


Source: OECD

2) **The global manufacturing sector** offs to a strong start in the first quarter of 2017, with the Purchasing Managers Index (PMI) accelerated to a three-year high of 52.9 in February (52.7 in January). This was supported by stronger growth in new orders and external trade. The PMI reading has been above the 50-pt expansion mark for 12 successive months.

3) **The global service sector** shows a contrasting picture as the PMI reading eased to 53.3 in February from 54.0 in January, its lowest reading in three months. Most components of the PMI for services slowed in February.

Figure 4: Global PMI for manufacturing and services continued their expansion trail



Source: Markit

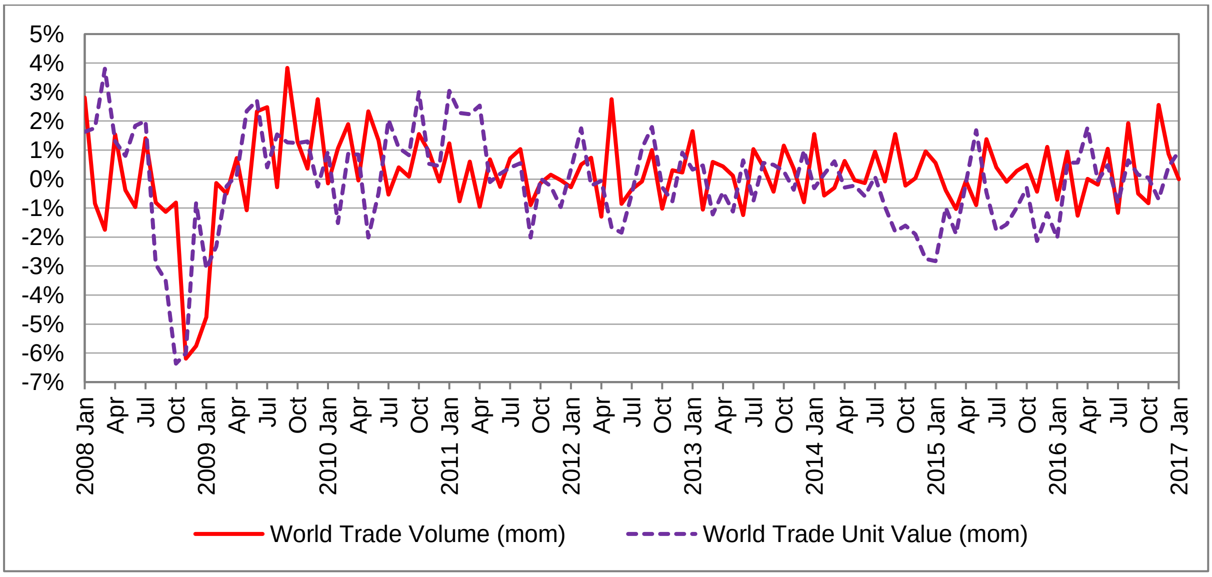
4) **World trade volume** growth was flat in January 2017 (+0.9% mom in December and +2.6% in November respectively in 2016; 1.4% qoq in 4Q and 0.6% in 3Q16). World imports grew by 0.7% mom (1.0% in 4Q) but offset by a decline of 0.7% in exports (+1.9% in 4Q).

Most advanced economies printed a decline in export volume (Japan: -1.1%, Euro Area: -1.1%; other: -1.9%) with the exception of the US (+0.1%). This led to an overall decline of 1.1% in the grouping of advanced economies (1.4% in December, 1.5% in November and 1.5% in 4Q). Emerging economies' export volume also contracted by 0.2% in January, compared to +4.7% and +0.6% in November and December respectively. This was mainly dragged by Africa and Middle East region (-3.5% and -0.1% in January and December respectively), whereas the Latin America region provided the support, growing by 7.8% in January.

While the prospects of improving global economic growth will support global trade activity, but if the Trump administration becomes overly protectionist, it could cause world trade to stagnate, turning into a long-term risk factor. Trump's decision to withdraw Trans-Pacific Partnerships (TPP) and renegotiate North American Free Trade Agreement (NAFTA), possibly even withdraw from the agreement as well as chooses to ignore the World Trade Organisation (WTO)'s trade rules may cause countries to take matters into their own hands and become more protectionist.

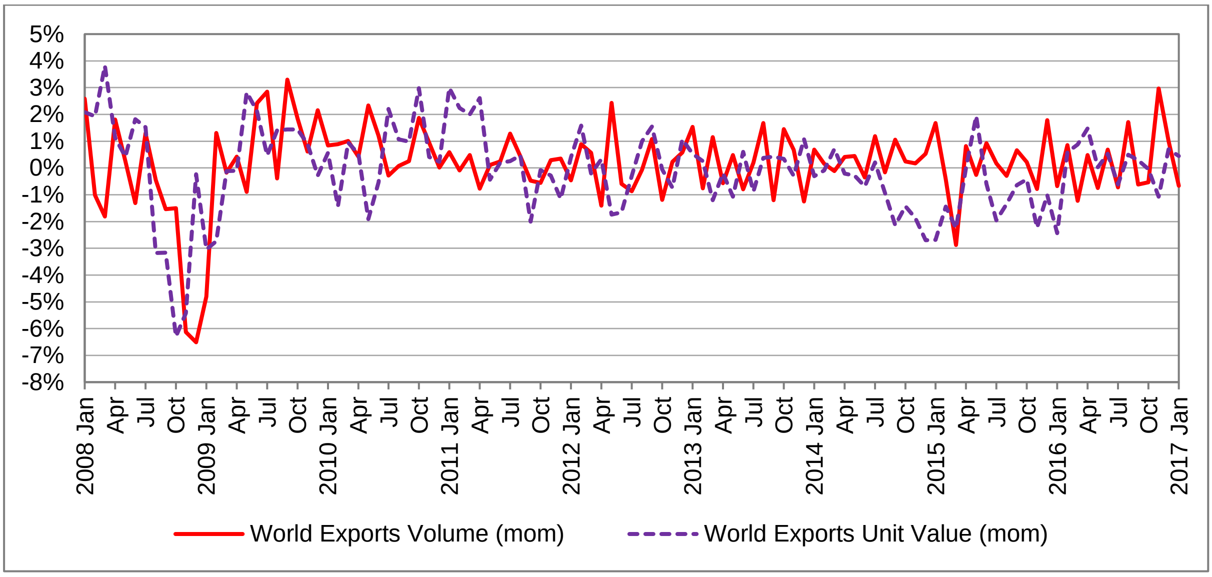
The World Trade Organization (WTO) slashed its estimates of global trade growth this year to 1.7% from 2.8% previously, reflecting a slowdown in China and falling imports into the US market.

Figure 5: World trade volume moves in fluctuating trend



Source: CPB Netherlands Bureau for Economic Policy Analysis

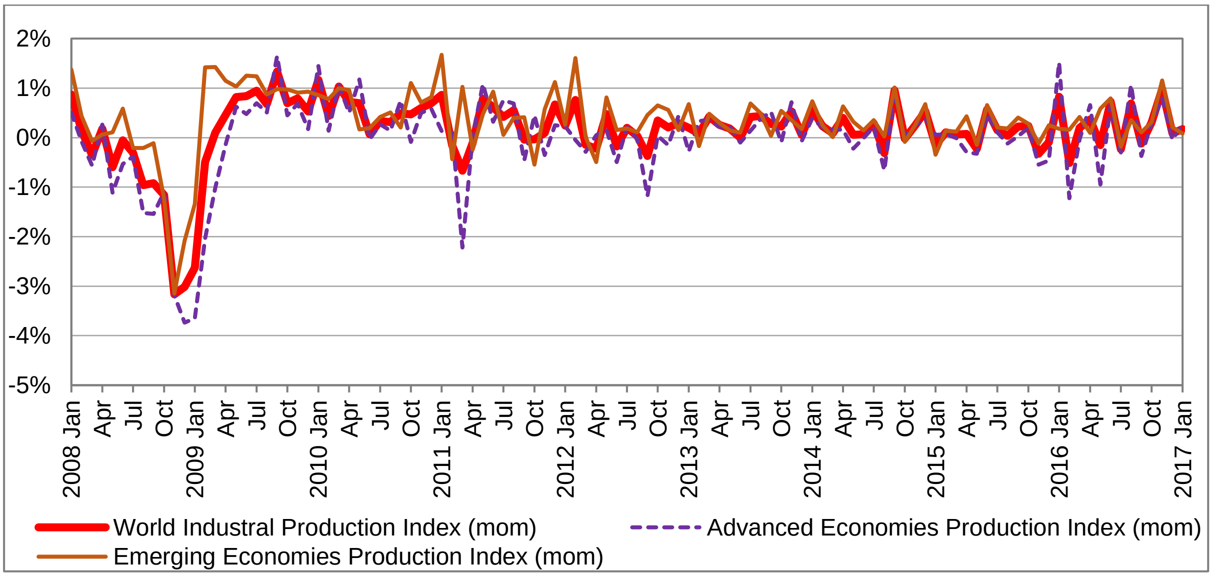
Figure 6: World exports volume remains volatile



Source: CPB Netherlands Bureau for Economic Policy Analysis

5) **World industrial production** increased slightly by 0.2% mom in January (0.1% in December and 1.0% in November, 1.1% qoq in 4Q16 and 0.6% in 3Q16). Both the advanced economies (0.3% vs. 0.0% in December) and emerging economies (0.1% vs. 0.2% in December) are facing similar trends. The leading growth in advanced economies is euro area (+1.0%) while the Central and Eastern Europe (+4.0%) is the major contributor in emerging economies whereas industrial production in Africa and Middle East contracted 2.7% in January 2017.

Figure 7: World industrial production remains uneven



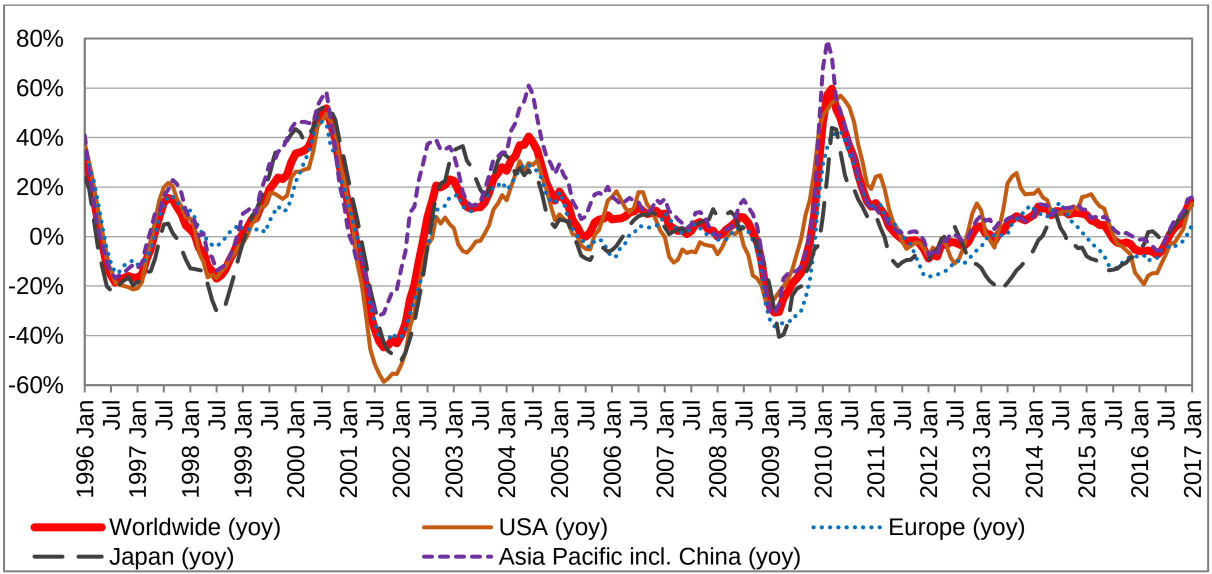
Source: CPB Netherlands Bureau for Economic Policy Analysis

6) **Global sales of semiconductors** declined 1.2% mom to US$30.6 billion in January after a flat growth in December, reflecting normal seasonal market trends. Month-to-month sales increased in Europe (1.2%), but fell slightly in China (-0.2%), Japan (-1.6%), Asia Pacific/All Other (-1.6%) and the Americas (-3.1%).

   However, on an annual basis, total chip sales jumped 13.9% in January (12.3% in December). This marks the largest year-to-year growth since November 2010, with sales increased substantially across all regions: China (+20.5%), the Americas (+13.3%), Japan (+12.3%), Asia Pacific/All Other (+11.0%) and Europe (+4.8%).

   January's semiconductor sales mark a strong and encouraging start to 2017, supported by firm demand for memory chips and analog devices. According to the World Semiconductor Trade Statistics (WSTS), worldwide semiconductor market is projected to grow higher by 6.5% in 2017 after a modest 1.1% rise in 2016. The product categories that will register strong expansion are memory (+12.8%), sensors (+9%) and analog (+7.8%).

Figure 8: Resilient global semiconductor sales



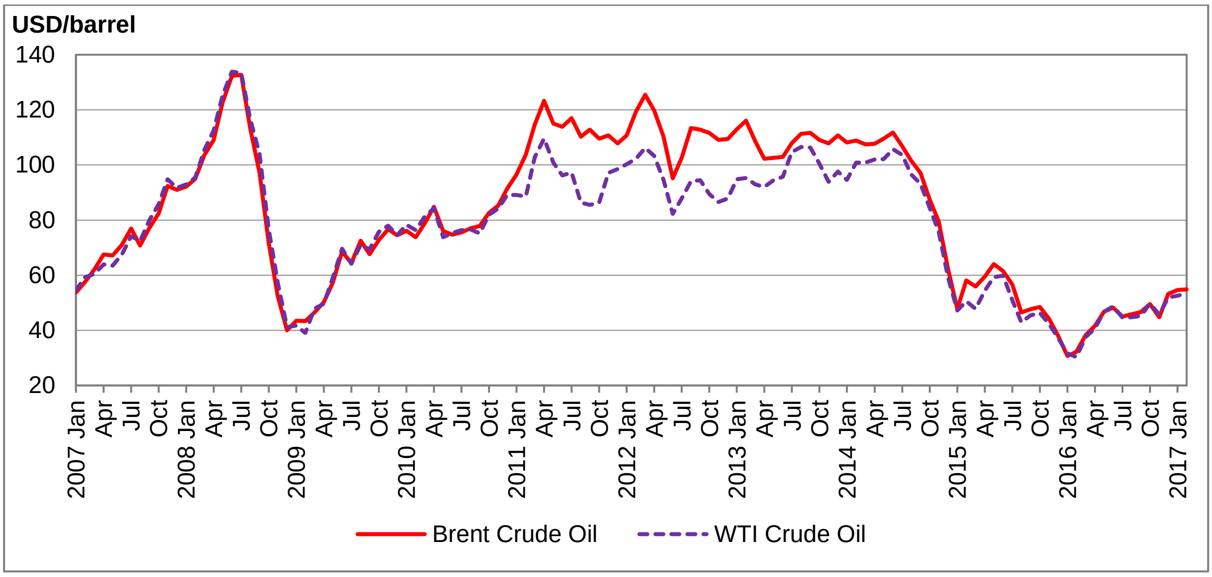
Source: Semiconductor Industry Association (SIA)

7) **Global oil prices**, as benchmarked by Brent crude oil rose to around US$56 a barrel in February, supported by commitment shown by Russia and OPEC producers to deliver on their promised supply cuts. OPEC has implemented most of its reduction. In January, OPEC members have delivered on about 82% of their deal to lower supply by 1.16 million bpd reductions. Russia's oil output cut of 100,000 bpd would be a third of Moscow's pledge to reduce its output by 300,000 bpd though its planned output reduction would be gradual.

   In the early weeks of March, Brent crude price dropped below US$53 per barrel, the lowest levels since early December when the OPEC deal was announced. The drop was due to a whopping 8.2 million barrel increase to crude oil inventories, pushing total stocks to another record high. The inventory increases were partly contributed by rising U.S. oil production and relentless stock building. In a surprise move, a joint committee of ministers from OPEC and non-OPEC producing countries decided to examine the possibility of extending production cuts in the second half of 2017.

Amid lingering concerns about oversupply as well as continued inventory adjustments relative to demand, what could drive the current oil price volatility is the strength of global demand, the US dollar and interest rate outlook. A stronger dollar rally, backed by higher-than-expected US interest rates hike would result in higher borrowing costs and hence, would temper investors to build large net speculative positions in the oil market. Brent crude oil prices are estimated to remain unchanged at US$55-60 per barrel in 2017-18.

Figure 9: Crude oil prices trend



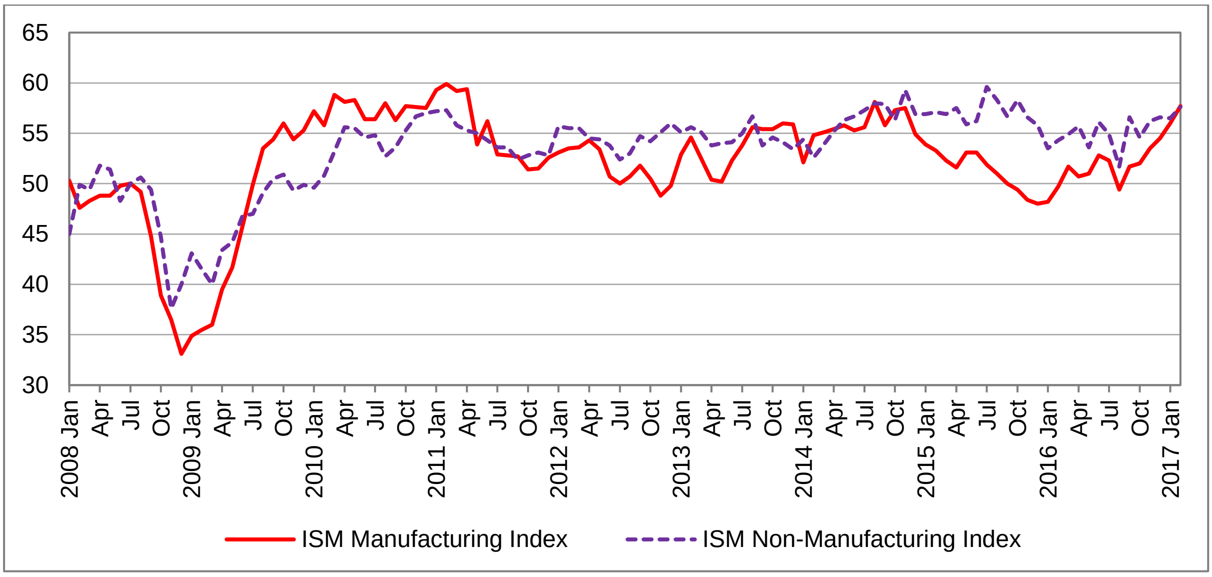
Source: US Energy Information Administration

US – MORE UPBEAT PICTURE

The **US economy** continues to firm up with the leading indicators showing upbeat tempo going into the first quarter of 2017. The 4Q16 GDP growth of 0.5% qoq and 2.0% yoy was supported by solid consumer spending amid weak capital spending, taking the full-year to 1.6% in 2016 (2.6% in 2015).

While the outlook is being affected by uncertainty regarding the Trump administration's economic policies, the growth drivers still in motion. Retail sales still growing; the ISM for manufacturing and services continued to stay comfortably above the 50-pts expansion mark as well as continuous job hiring with higher wage rate. The Federal Reserve expects the US economy to grow by 2.1% this year and 2.1% for 2018.

Figure 10: ISM manufacturing and services indices scale higher



Source: Institute for Supply Management

In his first joint address to Congress on 28 February, President Trump reiterated his administration's pledge of fulfilling "America First" agenda and will be working on a "historic tax reform", cutting taxes for both businesses and households while asking Congress to approve legislation that produces a US$1 trillion investment in the infrastructure. He also reaffirmed his protectionist mindset, embracing a free and fair trade.

Retail sales growth eased to a smaller gain in six months of 0.1% mom in February (0.6% in January), restrained by a temporary slowdown in individual tax refunds. Robust confidence, healthy job growth and steady incomes should provide some lift for consumer spending. On a year-on-year basis, growth in retail sales slowed to 2.1% in February (5.4% in January and 4.4% in December). The adjusted e-commerce sales rose 1.9% qoq and 14.3% yoy respectively in 4Q16 (3.4% qoq and 15.1% yoy respectively in 3Q), contributing an 8.3% share of total retail sales, which was higher than 7.6% in 4Q15.

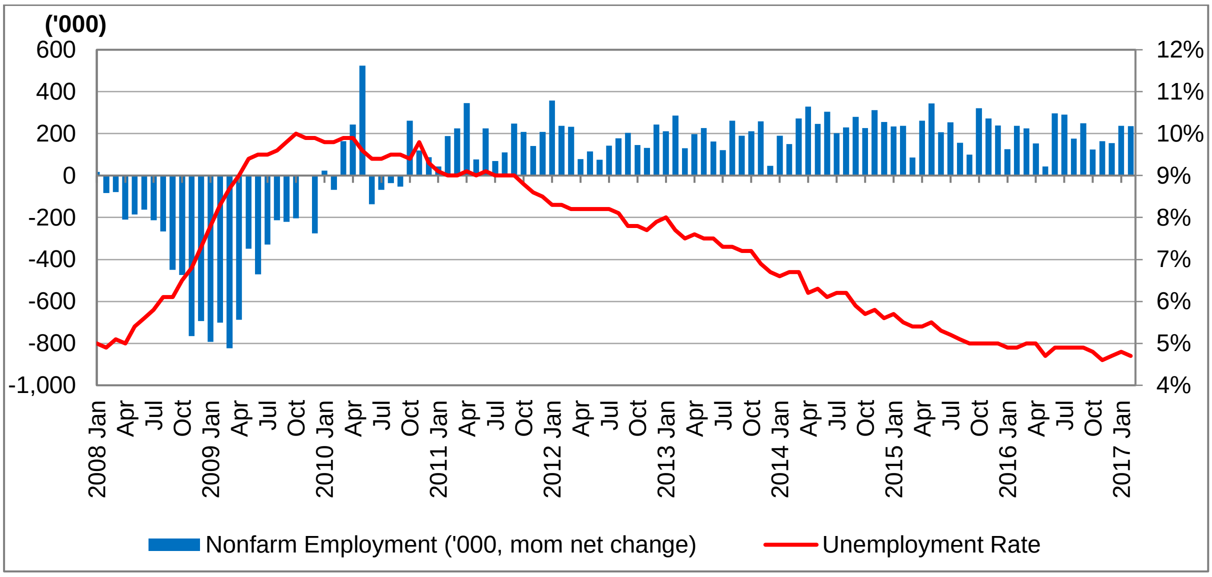
US manufacturing activity expanded in February for the sixth consecutive month (57.7 vs. 56.0 in January), the highest since August 2014 as businesses reported strong sales and demand. The **ISM for service industries** also expanded higher to 57.6 in February (56.5 in January), the highest reading since October 2015, indicating resilience in the biggest part of the economy.

Industrial production printed a flat growth in February (-0.1% in January). Manufacturing output grew 0.5% while mining output rose 2.7%, spurred partly by more oil and gas drilling. Utility production declined by 5.7% as unseasonably warm weather reduced the need for heating. Annually, industrial production rose 0.3% in February (0.2% in January).

U.S. **employers added jobs at a robust pace**. A total of 235,000 jobs were created in February (238,000 in January) with the construction sector posting the largest gain in nearly ten years due to unseasonably warm weather. Average hourly earnings rose 0.2% mom and 2.8% yoy respectively in February (0.2% mom and 2.6% yoy respectively in January). The unemployment rate fell to 4.7% in February from 4.8% in January.

Inflation pressures are climbing up. Consumer prices increased 0.1% mom in February, slowing from a 0.6% gain in January. It was the lowest monthly inflation since July 2016. However, on an annual basis, inflation climbed to 2.7% from 2.5% in January, lifted by higher gasoline prices. February's inflation was the biggest increase since March 2012. Stripping out the volatile food and energy categories, so-called core consumer prices eased to 0.2% mom and 2.2% yoy respectively in February (0.3% mom and 2.3% yoy respectively in January).

Figure 11: Jobs hiring is expanding



Source: US Bureau of Labor Statistics

EUROZONE – MODERATE RECOVERY CONTINUES

Growth in the **euro area** picked up steam in the second half-year of 2016 to end with a decent GDP growth of 1.7% in 2016 (1.9% in 2015). GDP rose by 0.4% in 4Q16 (0.4% in 3Q) and the expansion looks set to continue in the first quarter of 2017.

Encouragingly, some lead data released year-to-date pointing better recovery ahead. Private sector business activity quickened its pace in nearly six years in February, accelerating across all major economies with job creation reaching its fastest in almost a decade. The **composite Purchasing Managers' Index (PMI)** rose sharply to 56.0 in February from 54.4 in January. **Manufacturing PMI** came in higher at 55.4 in February (55.2 in January), the strongest expansion since April 2011 amid strong new business, production, and employment.

The **labour market remains stable**, which should bolster consumer spending. Unemployment rate held steady at 9.6% in January, the lowest level since May 2009. The youth unemployment rate was 20% in January.

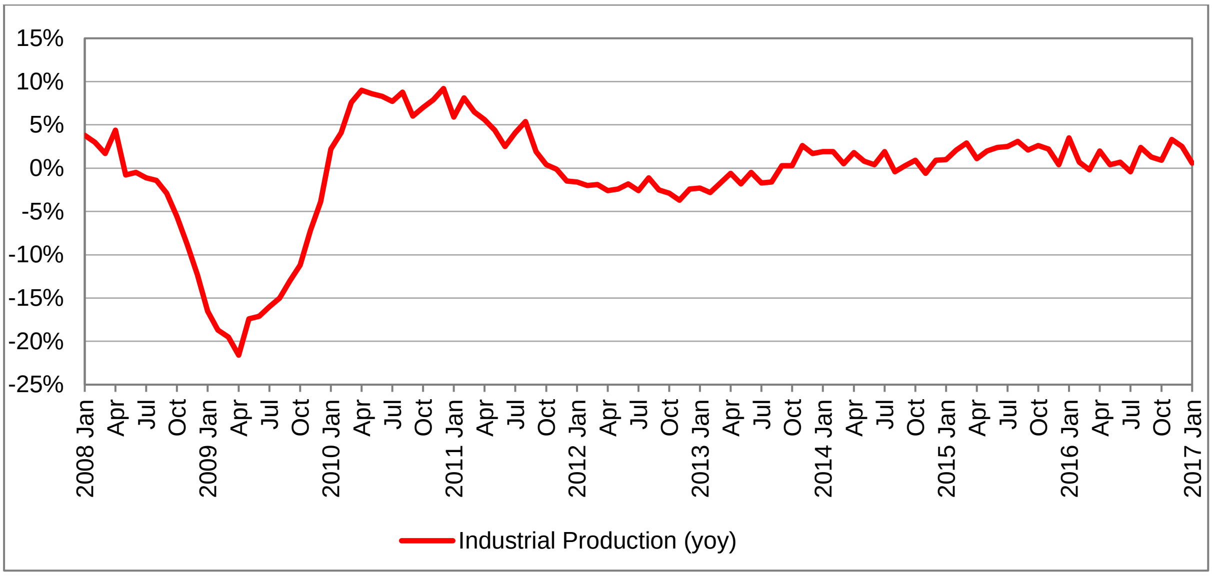
Industrial production rebounded to a 0.9% mom growth in January after a decline of 1.2% in December (+1.5% in November), mainly caused by a drop in intermediate, non-durable and durable goods. Production of capital goods and energy increased. On a yearly basis, industrial production growth eased to 0.6% in January from 2.5% in December.

Consumer price pressure accelerates as annual inflation increased to a four-year high of 2.0% in February (1.8% in January), mainly driven by higher energy prices, which jumped 9.3% (8.1% in January) as well as food, alcohol and tobacco (2.5% in February). Core inflation remained muted, steadying at January's 0.9% in February.

With the inflation rate above the European Central Bank (ECB)'s target, the central bank will be under pressure to scale back its bond-buying program. However, core inflation, which excludes volatile energy prices, remains too weak at 0.9% in February. Faced with an ardour task of reflating the economy, ECB is confronted with a delicate balancing act between removing the degree of monetary accommodation and managing the growth and price stability with falling unemployment and accelerating inflation.

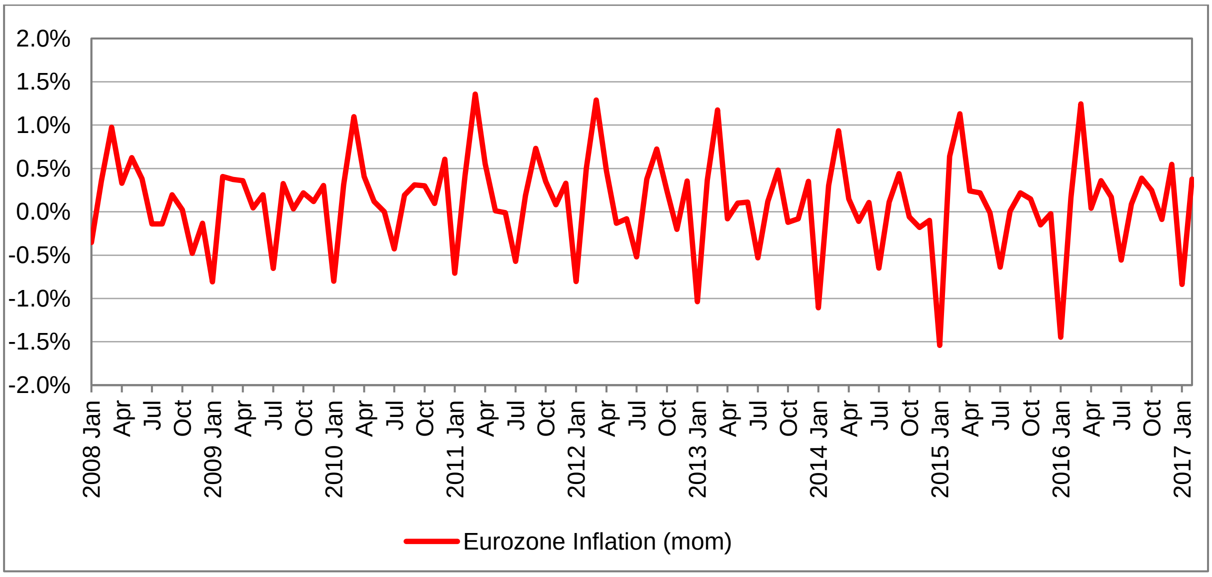
We would caution that there are clearly risks, which may dampen the euro area's growth outlook ahead. These include the potential political uncertainties and upheaval associated with elections in the Netherlands, France, Germany and possibly Italy as well as Brexit's negotiation process and Italy's banking problems. All these events have the potential to create additional economic uncertainties and punctuate growth in the euro area.

Figure 12: Industrial production remains volatile



Source: Eurostat

Figure 13: Inflation rate follows historical trend but stays higher



Source: Eurostat

JAPAN- PATCHY RECOVERY

The **Japanese economy** has yet to stand on a solid footing as the GDP growth, measured in seasonally-adjusted annualized terms (SAAR) remained unchanged at 1.2% in 4Q16, the same rate in 3Q, dragged by stagnating domestic demand. A weak yen helps to boost exports and business investment. For the full-year of 2016, real GDP growth eased to 1.0% from 1.2% in 2015.

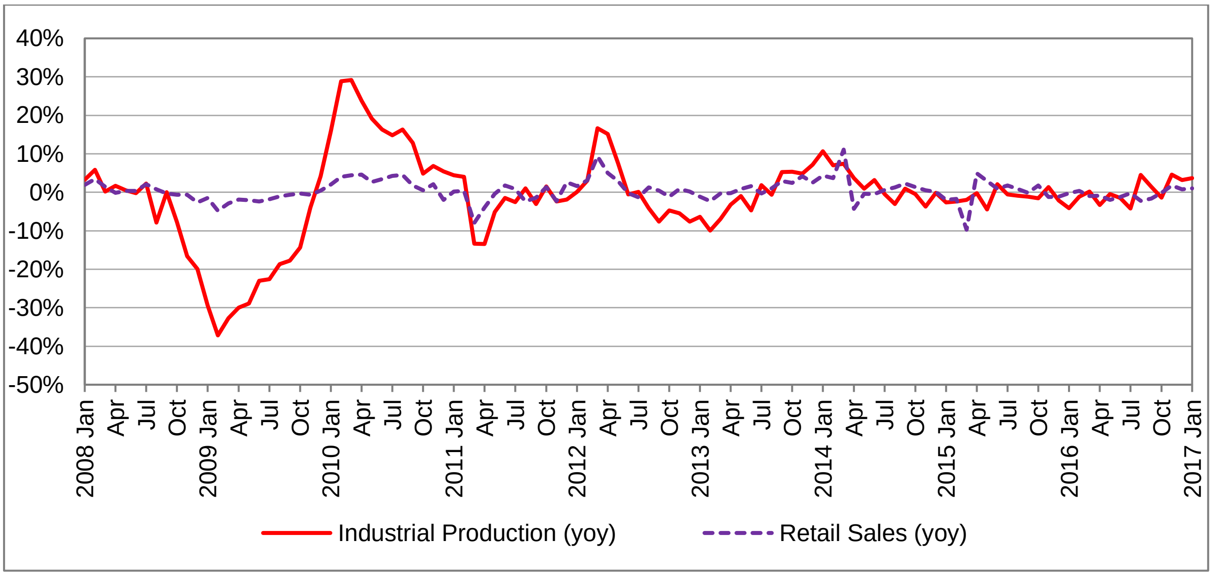
With increasing relying on the external sector to keep the economy afloat, any drastic change in Trump's trade protectionist policies will pose a risk to Japan's economic recovery. The U.S. is Japan's biggest export market after China. The Bank of Japan (BoJ) expects the economy to expand between 1.3% and 1.6% in the fiscal year 2017, which ends in March 2018.

The **Nikkei Japan Manufacturing Purchasing Managers' Index (PMI)**, continued to expand in February to 53.3 from January's 52.7, marking the highest reading since March 2014. New orders, output and employment expanded at faster rates than in January. The **PMI for services** fell to 51.3 in February from 51.9 in January, representing the fifth straight month of growth.

Industrial production fell 0.4% mom in January, contrasting December's 0.7% increase. The decline was driven by decreases in output of transport equipment, chemicals (excluding drugs) and general-purpose, production and business-oriented machinery while the electronic parts and devices, plastic products and pulp, paper and paper products subsectors added to growth. On an annual basis, industrial output rose 3.7% in January (3.2% in December).

Core machinery orders (leading indicator of capital spending over a three- to six-month period) reverted to decline by 3.2% mom in January following a strong rebound of 2.1% in December. This fuels worry about whether recent signs of recovery in capital spending will be sustainable. On an annual basis, core machinery order plunged 8.2% in January, the biggest fall in eight months (6.7% in December and 10.4% in November).

Figure 14: Both industrial output and retail sales improved



Source: Ministry of Economy, Trade and Industry, Japan

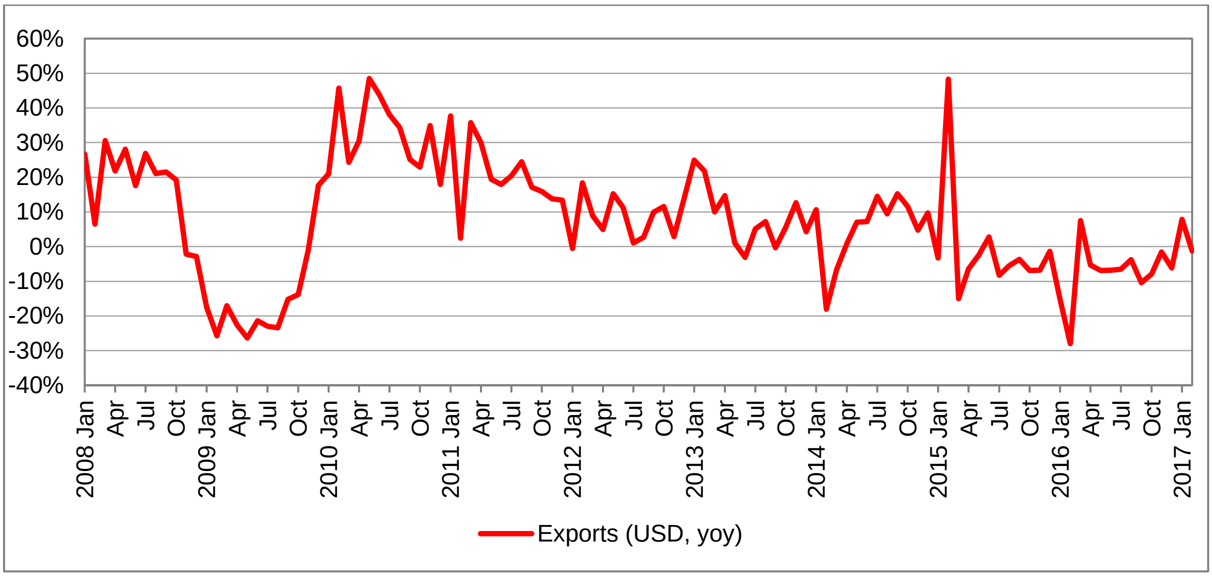
Consumer prices decreased 0.1% mom and but increased 0.3% yoy in February of 2017 (-0.2% mom and +0.4% yoy respectively in January), driven by two annual increases in transportation cost since March 2015 as well as faster pace of price increases for clothing and footwear and recreation and culture. Core consumer prices (excludes energy and food but includes alcoholic beverages) dropped 0.1% yoy, the first contraction after August 2013.

CHINA – GROWTH STABILISATION REMAINS ON TRACK

Defied investors' lingering concern about Beijing authorities to restructure the economy, **China's economy** finished the year 2016 on a firm note. Real GDP growth inched higher to 6.8% yoy in 4Q16 from 6.7% in 3Q as consumers stepped up spending and the property market rebounded. For the full year, China's economy grew by 6.7% in 2016 (6.7% in 2015).

The government sets **a lower economic growth target of 6.5% for 2017** compared to last year's range of 6.5% to 6.7%. There remain persistent concerns about the bloated debt and shadow banking as well as the overall health of China's property sector.

Figure 15: Moderate fixed assets investment growth



Source: National Bureau of Statistics of China

The **manufacturing PMI** rose from 51.3 in January to 51.6 in February, staying comfortably above the 50% threshold that separates expansion from contraction for seven consecutive months. Production and new orders expanded further into positive territory. New exports jumped to a nearly three-year high, signalling that global demand is picking up. The **PMI for services** stood at 54.2 in February, a slight drop from January's reading of 54.6.

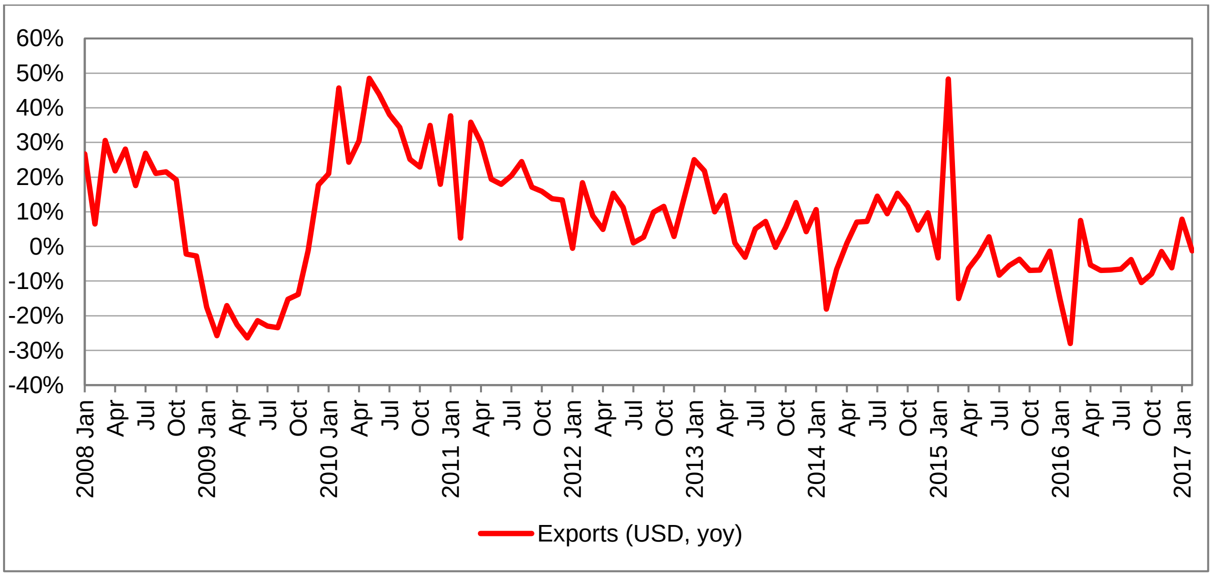
The **high frequency economic data for Jan-Feb** shows a mixed picture. 1) In the January-February period, **industrial production** accelerated to 6.3% yoy, higher than +6.0% growth in December. This was supported by higher manufacturing output and in electricity, gas and water supply activities while the mining output declined; 2) **Nominal retail sales** grew at a slower pace of 9.5% yoy in January-February (10.9% in December), marking the weakest growth in over a decade. Car sales plummeted due to the reduction of tax incentives to purchase low-emission cars; and 3) In the first two months of the year, **fixed-asset investment** (excluding rural households) expanded higher by 8.9% (8.1% in Jan-Dec 2016), the strongest growth in seven months. Investment growth among state-owned and state-holding units remained strong, albeit slower (14.4% in Jan-Feb 2017 and 18.7% in Jan-Dec 2016 respectively) while private companies' investment growth accelerated from 3.2% in January-December to 6.7% expansion in January-February.

New home prices across 70 major cities quickened pace to rise 0.3% mom in February (0.2% mom in January) after price gains had slowed in the previous four months in spite of a raft of new government curbs aimed at tempering speculative demand. On an annual basis, new home prices eased to 10.3% yoy in February (10.4% in January). New home prices, excluding subsidized housing, gained in February in 56 out of 70 cities (45 in January) while prices climbed in 67 out of 70 cities from a year earlier (66 in January). To contain the property heat and speculative buying, Beijing city raised the down-payment requirements for second homes by 10% to between 60% and 80%.

China recorded the first trade deficit in three years in February. **Exports** contracted 1.3% yoy in February from +7.9% in January as distorted by the week long Lunar New Year public holidays that shut down factories and ports. **Imports** expanded robustly by 38.1% in February (16.7% in January). Owing to the strong growth in imports relative to exports, the trade balance reverted from a surplus of US$51.4 billion in January to a deficit of US$9.1 billion in February, marking the first trade deficit in three years. It must be noted that the external trade trends in January and February can be distorted due to the Chinese New Year holiday.

While better global demand and firming commodity prices provide a fillip to China's exports, one should caution about the potential repercussions on China's trade relations with the US if Trump becomes protectionist against Chinese goods imported into the US market. The US has the largest trade deficit with China, with more than 40% of the U.S. trade deficit in goods was with China.

Figure 16: Exports contracted, resulting in the first trade deficit in February



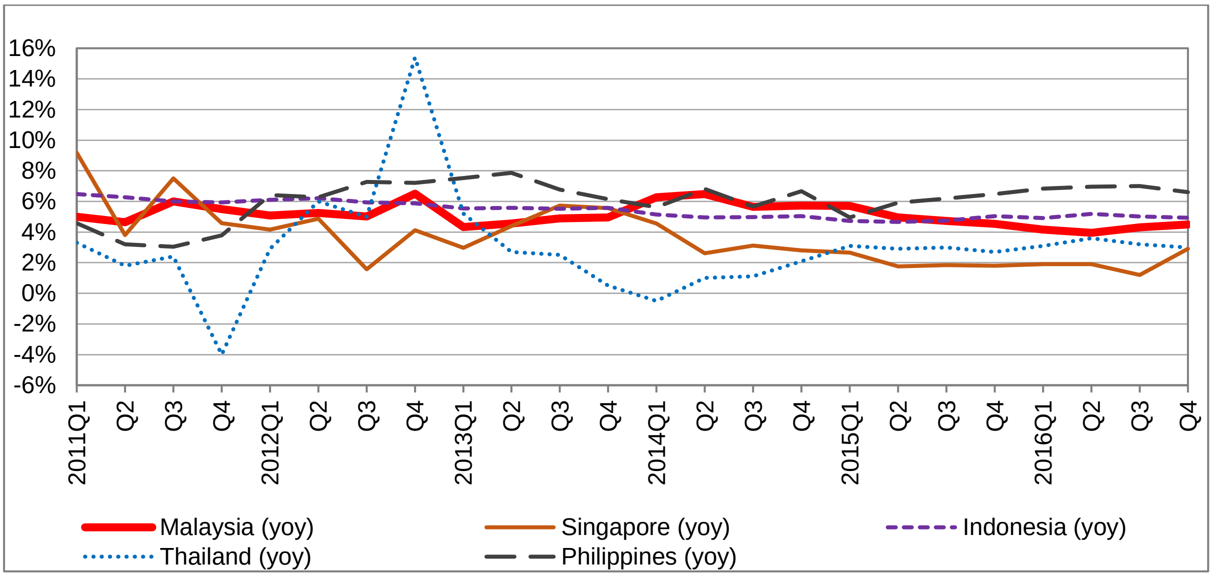
Source: National Bureau of Statistics of China

ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

Broadly, **ASEAN-5** economies' (Malaysia, Singapore, Indonesia, Thailand and Philippines) recorded mixed economic growth momentum in 4Q16. Real GDP growth in Malaysia and Singapore picked up in 4Q16 while that of Philippines, Indonesia and Thailand decelerated.

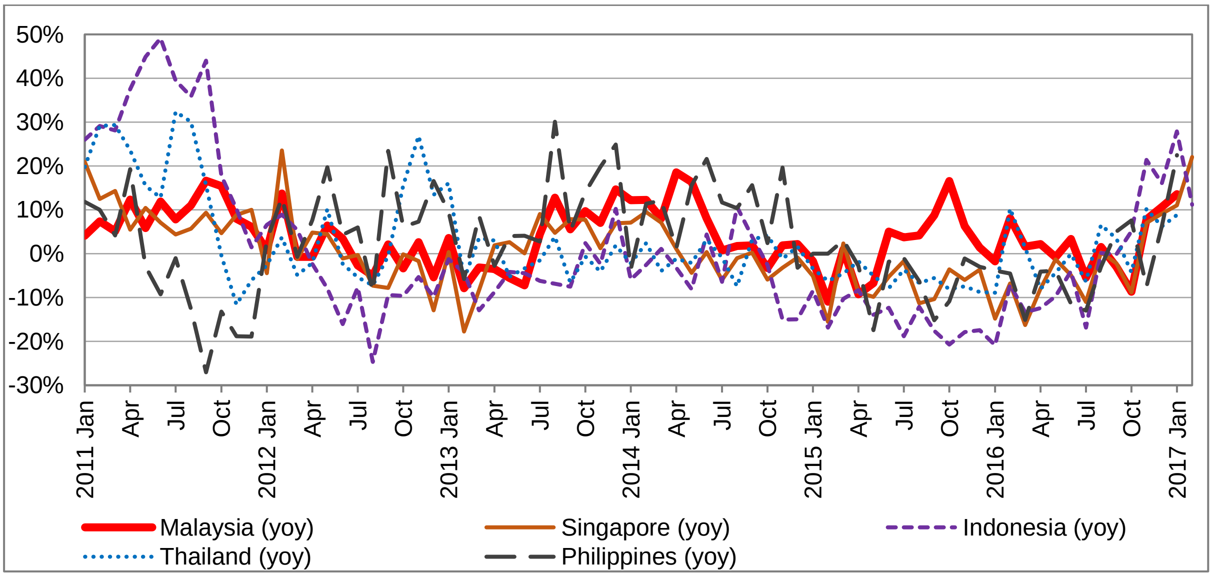
The latest batch of economic data indicates that ASEAN-5 should continue to stay in positive growth trajectory, albeit a mix set of outlook. Exports are gathering speed and industrial production still paced steadily. Inflation pressures firming, mainly cost-driven due to higher energy prices. The potential Fed's interest rate hikes in the months ahead will continue to provide a lift to stronger US dollar and hence, exerting pressure on regional currencies against the US dollar.

Figure 17: Real GDP growth trend



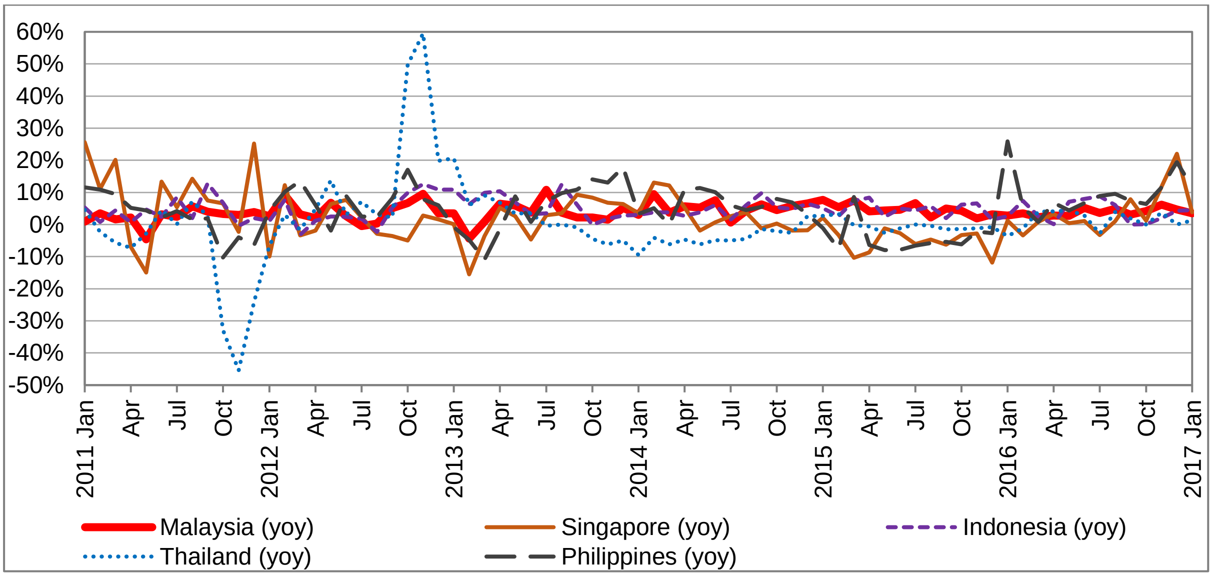
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 18: Export growth trend



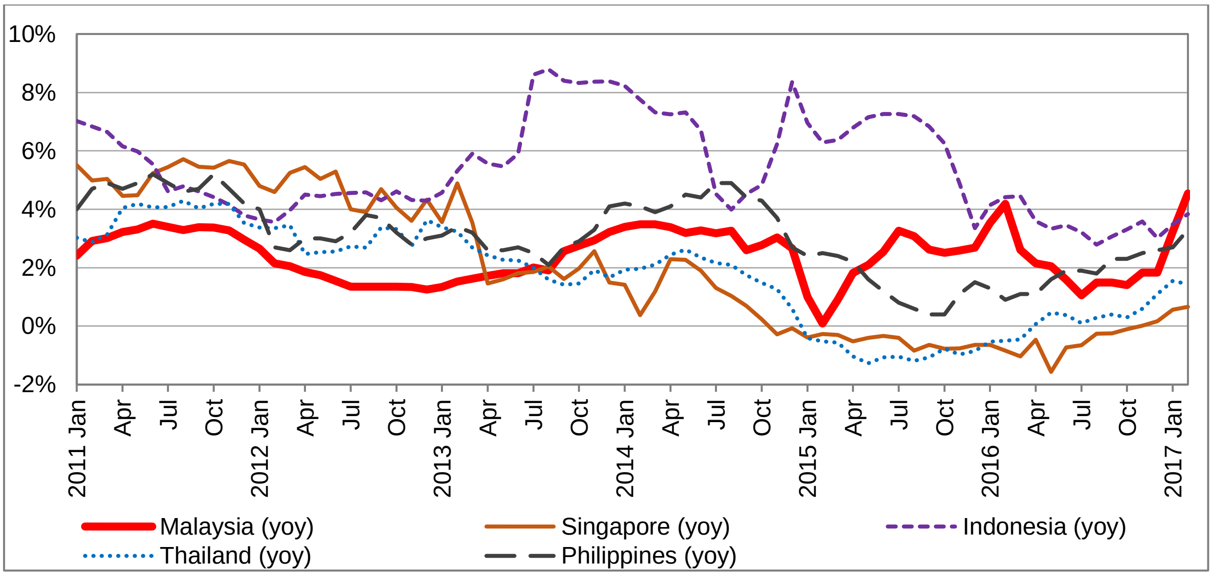
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

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

The Federal Reserve hiked its benchmark interest rate by 25bps to 0.75-1.00% after the policy meeting on 15-16 March. The Federal Open Market Committee (FOMC) maintained its positive outlook on the US economy and labour market while the Fed remains vigilant about higher prices ahead.

With the US economy on track for continued growth amid the rise in inflation risk, the Fed is expected to stay on course its projected three rate hikes this year. The Fed's chair, Yellen said that "The process of scaling back accommodation likely will not be as slow as it was in 2015 and 2016".

While the dual mandates of maintaining full employment and price stability at 2% inflation are currently guiding the Fed's rate hikes plan, the Fed policymakers also wary about further upside risks to inflation emanating from the Trump's reflationary policies.

If the inflationary expectations accelerate and economy continues to strengthen, the Fed may be compelled to tighten policy rate much more aggressively than markets are currently pricing in. For now, we expect the Fed to raise rates by a total of 75 bps to 1.25-1.50% by end-2017 (0.50-0.75% at end-2016).

With the Eurozone's inflation moving on the upside risk, the European Central Bank (ECB) is expected to be on a standby mode to provide forward guidance on the indicative timing for the removal of monetary accommodation and end its bond buying program. The ECB has targeted inflation levels of around 2% for many years but has undershot this aim for a sustained period. In December, the ECB extended the asset purchases programme until at least December 2017 albeit at a reduced level of 60 billion euros (US$62.9 billion) a month rather than the previous rate of 80 billion euros. Interest rates were also left unchanged at -0.4%.

Bank of Japan's (BoJ) monetary policy dynamic could shift from easing to the normalisation of monetary policy as a weaker yen and fiscal stimulus fuels inflation expectations. For now, BoJ is expected to maintain status quo until the economy shows signs of a sustained and self-reinforcing cycle of rising wages and consumer inflation.

Most regional central banks will continue to maintain cautious monetary policy stance faced with the prospects of higher US interest rates and strong US dollar as well as a compressed yields differential, which will result in capital reversals in favour of the US market.

Figure 21: Policy rate (%)

End-period of	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 Feb/Mar	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	0.50-0.75	0.75-1.00	1.25-1.50
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	-0.10
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	4.35	4.60
India, RBI Policy Repo Rate	6.50	4.75	6.25	8.50	8.00	7.75	8.00	6.75	6.25	6.25	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 O/N Policy Rate	3.25	2.00	2.75	3.00	3.00	3.00	3.25	3.25	3.00	3.00	3.00
Indonesia, BI 7-Day RR Rate	9.25	6.50	6.50	6.50	5.75	7.50	7.75	7.50	4.75	4.75	4.75
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	1.50
Philippines, BSP O/N 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 forecast
Note: Indonesia employed BI 7-Day Reverse Repo Rate (BI 7-Day RR Rate) as new policy rate from 19 Aug 2016

C. MALAYSIA ECONOMY ON TRACK FOR CONTINUED GROWTH

The economy has bottomed out. The Malaysian economy continued to firm up as real GDP growth gained traction to 4.5% yoy in 4Q16 from 4.3% in 3Q and 4.0% in 2Q respectively, bringing the full-year growth to 4.2% in 2016. This marks second year of moderation compared to 5.0% in 2015 and 6.0% in 2014 respectively on weak external demand. While resilient domestic demand continues to steer overall GDP growth, but its pace was slower (3.3% in 4Q16 vs. 4.6% in 3Q), reflecting lower public spending and moderated private investment growth.

Domestic demand continues to underpin growth. For the year 2016, private consumption was resilient to grow by 6.1% (6.0% in 2015) backed by continued wage growth and cash handouts for the low and middle-income households. The disturbing signs are still weak and moderate pace of private investment (4.9% in 4Q vs. 4.7% in 3Q and 5.6% in 2Q respectively), taking the full-year growth to 4.4% in 2016 (6.4% in 2015), the slowest pace in six years.

Continued expansion in most economic sectors. While most economic sectors continued to expand in 4Q16, both the services and construction sectors surprisingly paced slower. Moderated growth in services were due to slower insurance and wholesale activities while that of construction output was pulled down by a subdued property market, especially residential subsector. The mining sector continued to expand higher while the agriculture sector contracted at a smaller magnitude.

Bank Negara Malaysia maintains cautiously optimistic outlook for 2017. Bank Negara Malaysia (BNM) in its Annual Report 2016 maintained a positive economic outlook as it expects GDP growth to expand by 4.3-4.8% this year, which is a narrower range compared to the Ministry of Finance's estimate of 4.0-5.0% made during the 2017 Budget in October last year. Domestic demand continues to underpin overall economic growth, supported by higher exports.

All economic sectors are expected to register positive growth. The **services sector** is estimated to grow at a moderate pace (4.9% in 2017 vs. SERC's 4.9%; 5.6% in 2016), driven by the wholesale and retail trade, food and beverages and accommodation, information and communication as well as transportation.

Figure 22: Real GDP by economic sector (% YoY)

Economic Sector [% share to GDP in 2017*]	**2014**	**2015**	**2016**	**2016 Q1**	**2016 Q2**	**2016 Q3**	**2016 Q4**	**2017*f* (BNM)**	**2017*f* (SERC)**
Agriculture [8.0%]	2.1	1.2	-5.1	-3.8	-7.9	-6.1	-2.4	4.0	1.5
Mining & Quarrying [8.7%]	3.5	4.7	2.7	0.3	2.6	3.0	4.9	2.7	2.3
Manufacturing [22.9%]	6.2	4.9	4.4	4.5	4.1	4.2	4.8	4.3	4.2
Construction [4.7%]	11.7	8.2	7.4	7.9	8.8	7.9	5.1	8.0	8.5
Services [54.4%]	6.6	5.1	5.6	5.1	5.7	6.1	5.5	4.9	4.9
Overall GDP	**6.0**	**5.0**	**4.2**	**4.2**	**4.0**	**4.3**	**4.5**	**4.3-4.8**	**4.3**

Source: Department of Statistics, Malaysia; Bank Negara Malaysia (Annual Report 2016); SERC forecast
** % Share to GDP of 2017f from BNM*

The **manufacturing sector** will sustain at 4.3% growth in 2017 (vs. SERC's 4.2%; 4.4% in 2016), underpinned by the export-oriented industries on continued demand for electronics as well as chemical-related products. Growth in the domestic-oriented industries will be supported by production of food and construction-related products benefitting from the public infrastructure projects and property development.

Growth in the **construction sector** is projected to expand at a faster pace of 8.0% in 2017 vs. SERC's 8.5% (7.4% in 2016), driven mainly by new and existing civil engineering projects in the utilities, transportation and petrochemical segments. The **mining sector** growth is estimated to remain unchanged at 2.7% in 2017 (SERC's 2.3%; 2.7% in 2016), supported by acceleration of natural gas production from the LNG Train 9 and PETRONAS' FLNG Satu facilities as well as production from the new Malikai oil field. The **agriculture sector** is expected to rebound to 4.0% in 2017 (SERC's 1.5%) from a decline of 5.1% in 2016, mainly attributable to the recovery of crude palm oil yields from the adverse impact of El Niño.

The economy started 2017 on a mixed note. Our tracking of leading indicators suggest that economic activity is mixed in the first quarter of 2017. Exports continue to rise strongly in January, partly attributable to seasonality and weak ringgit effect, and industrial production paced at healthy pace. However, consumer sentiments remained soft on the back of high consumer inflation while business sentiments still weak as companies remained cautious amid continued uncertainty in the economic environment.

In the face of cautious external environment and domestic economic condition, **SERC maintained 2017's GDP growth estimate of 4.3% (4.2% in 2016) and 4.6% for 2018** vs. an average growth of 5.3% in 2011-15. The potential upside to our estimate of GDP growth could come from stronger exports amid moderate domestic demand.

Private consumption and investment holds the key. We have reasons to remain cautious about the strength of private consumption on weak consumer sentiment and the spillovers of the weakening ringgit, the rise in inflation mainly from higher fuel prices amid moderate income growth as well as worries about the job security. Bank Negara Malaysia estimates unemployment rate to hit 3.6-3.8% in 2017 (3.5% in 2016) and the expected salary increments for employees are estimated to average 5.4% in 2017 vs. 5.5% in 2016. We estimate private consumption growth to increase by 5.7% in 2017 vs. BNM's 6.0% (6.1% in 2016).

Private investment growing, though unevenly. Private investment is expected to expand by 4.5% in 2017 vs. BNM's 4.1% (4.4% in 2016), supported by the on-going implementation of public infrastructure projects and investment in manufacturing and services. However, investors remain wary about the still trying domestic business operating and economic conditions, lingering uncertainties ahead of the General Election (GE14) as well as about how the Trump's economic policies shaping up.

Figure 23: Real GDP by demand component (% YoY)

Demand Component [% share to GDP in 2017*]	2014	2015	2016	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017*f* (BNM)	2017*f* (SERC)
Private Consumption [54.0%]	7.0	6.0	6.1	5.3	6.3	6.4	6.2	6.0	5.7
Public Consumption [12.5%]	4.3	4.4	1.0	2.8	5.5	2.2	-4.2	-0.2	-0.5
Private Investment [16.8%]	11.1	6.4	4.4	2.2	5.6	4.7	4.9	4.1	4.5
Public Investment [8.3%]	-4.7	-1.0	-0.5	-4.5	7.5	-3.8	-0.3	1.5	2.0
Exports of Goods and Services [68.4%]	5.0	0.6	0.1	-0.5	1.0	-1.3	1.3	2.2	2.7
Imports of Goods and Services [60.3%]	4.0	1.2	0.4	1.3	2.0	-2.3	0.7	1.8	2.2
Overall GDP	**6.0**	**5.0**	**5.0**	**4.2**	**4.0**	**4.3**	**4.5**	**4.3-4.8**	**4.3**

Source: Department of Statistics, Malaysia; Bank Negara Malaysia (Annual Report 2016); SERC forecast
** % Share to GDP of 2017f from BNM*

Inflation comes roaring back. Inflation, as measured by the Consumer Price Index (CPI) surged to an 8-year high of 4.5% yoy in February from 3.2% in January 2017, mainly lifted by higher petrol prices (a cumulative of 55 sen increase from RM1.75 in February 2016), food prices and other services. Volatile crude oil prices will continue to exert a meaningful influence on the headline inflation in the months ahead.

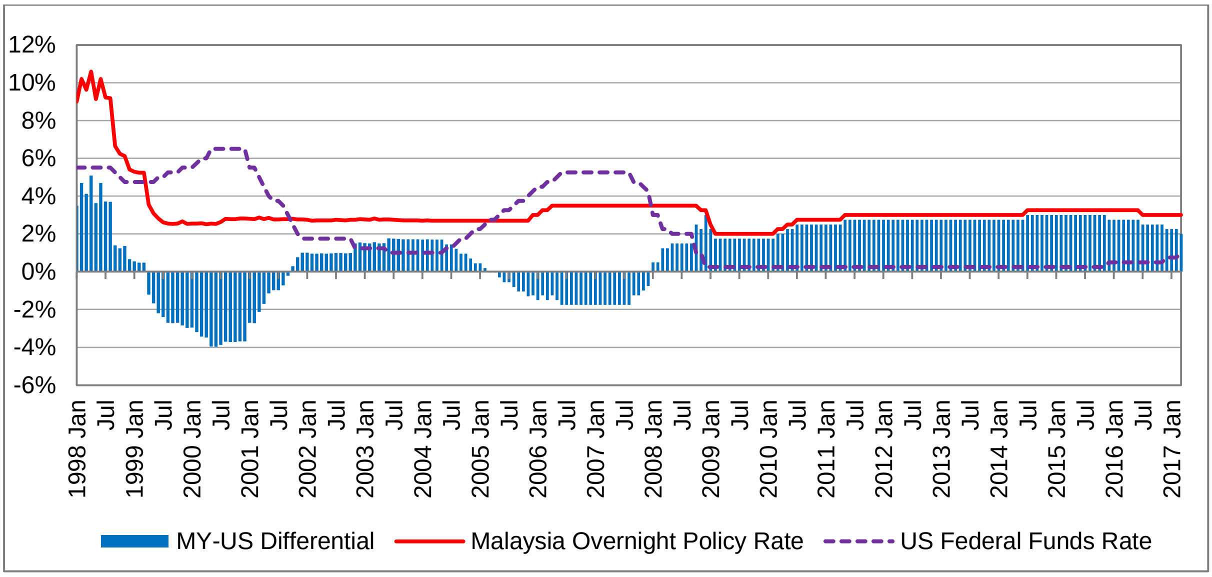
The cost-induced consumer pressures will continue this year as influenced by higher fuel prices, which is contingent on the direction of global oil prices. The transmission effect of weak ringgit on inflation via direct channel in the form of imported finished goods in the CPI basket (which makes up 7.2% of CPI basket) and indirect channel (via the usage of imported inputs in the production chain of local goods and services) will add pressure to consumer prices.

Overall, **we estimate inflation to increase by 3.0-4.0% in 2017** compared to 2.1% in 2016, with an average increase of 4.0-4.2% in 1H before moderating to 3.0-3.5% in 2H.

Bank Negara Malaysia's policy rate remains steady at 3.00% in 2017. Bank Negara Malaysia (BNM) is unlikely to change the course of monetary policy anytime soon in spite of the developing of cost-driven inflation pressures. Demand-induced price pressure is contained as core inflation increased 2.5% in February amid moderate economic growth. BNM expects higher inflation reading in the first half-year will recede in 2H as the transitory impact of petrol price adjustment subsides. It also expects core inflation to rise moderately. For 2017, BNM expects the headline inflation to be 3.0-4.0%.

We believe that the central bank will hold the policy rate steady at 3.0% this year as the risk to economic growth is somewhat contained.

Figure 24: Malaysia-US's interest rate differentials



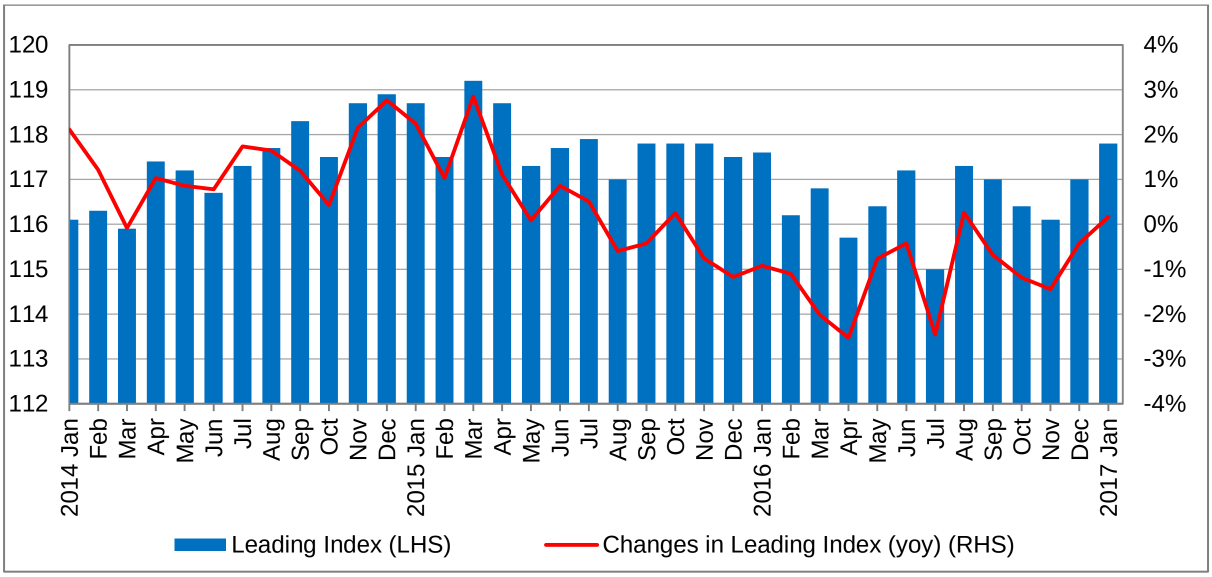
Source: Bank Negara Malaysia; Federal Reserve

REVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

High frequency data such **as exports, industrial production, manufacturing sales, services and loans** extended by the banking system suggests that activity continues in the first quarter of 2017. But, inflation pressures are developing, lifted primarily by the pass-through effect of the increase in global oil prices on domestic retail fuel prices. The spillovers of the weakening ringgit also partly responsible for the price increases.

1. The **leading index (LI)** turned around to increase by 0.2% yoy growth in January 2017 after four contractions in a row (-0.4% in December and -1.4% in November). This suggests that the Malaysian economy is expected to continue growing in the months ahead, albeit moderately. Among the components contributed to the rise in index were expected manufacturing sales (+0.9%), Bursa Malaysia Industrial Index (+0.4%), number of new registered companies (+0.4%) and real imports of semiconductors (+0.2%).

Figure 25: Leading index indicates positive economic growth ahead



Source: Department of Statistics, Malaysia

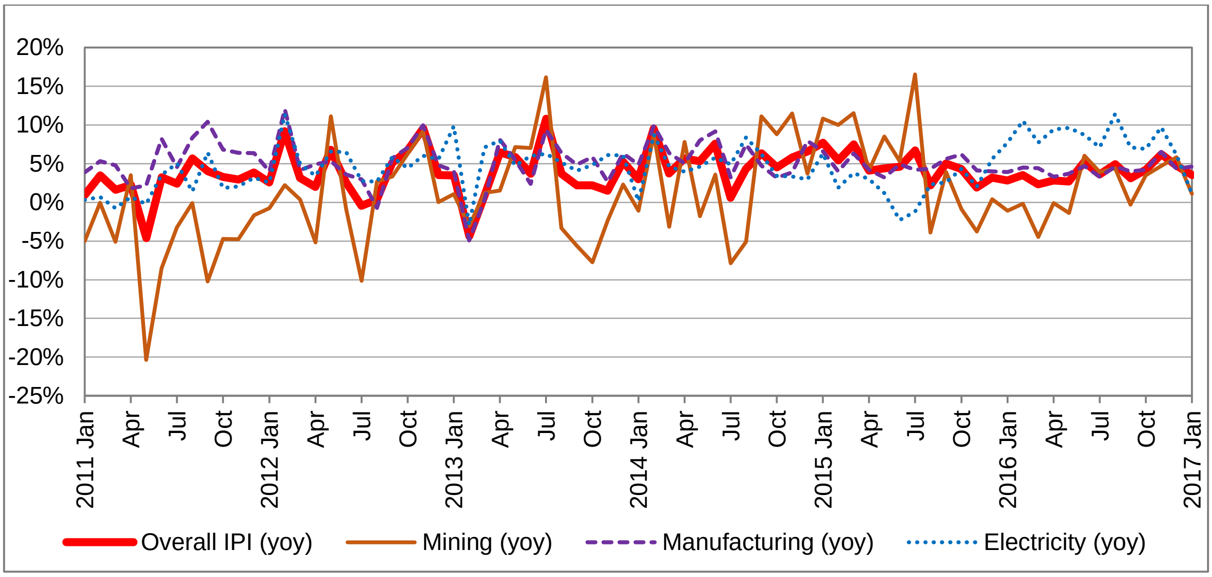
2. **Industrial production**, as measured by the Index of Industrial Production, rose at a slower rate of 3.5% yoy in January (4.7% in December) as higher gains in the manufacturing sector (4.6% vs. 4.3% in December) was offset by a sharp moderation in output growth of the mining (1.1% vs. 5.8% in December) and electricity sectors (1.1% vs. 6.1% in December).

   In the manufacturing sector, major sub-sectors which recorded increases were electrical and electronics products (6.9%); petroleum, chemical, rubber and plastic products (2.3%); and food, beverages and tobacco (6.8%). The drag in mining output came from a decline of 2.3% in crude oil production while natural gas output increased by 5.3%.

   The weak start of industrial output in January was partly due to the shutting down of factories during Chinese New Year celebrations. It must be noted that industrial output tends to exhibit uneven pattern in Jan-Feb due to seasonality, including shorter working days in the month of February.

   We expect the industrial output to grow by 4.0-4.5% in 2017 (3.8% in 2016), supported by higher expansion of manufacturing sector and electricity as well as moderate growth in mining output.

Figure 26: Overall industrial production slows down for two consecutive months



Source: Department of Statistics, Malaysia

3. The **external sector** continues to improve gradually, thanks partly to weaker exchange rate valuation effect, firming commodity prices as well as resilience demand for manufactured goods. **Exports** accelerated for three months in a row to a 15-month high of 13.6% yoy in January (10.7% in December). With exports rising at a slower pace mom relative to imports, the trade surplus shrank sharply to RM4.7 billion in January from RM8.7 billion in December.

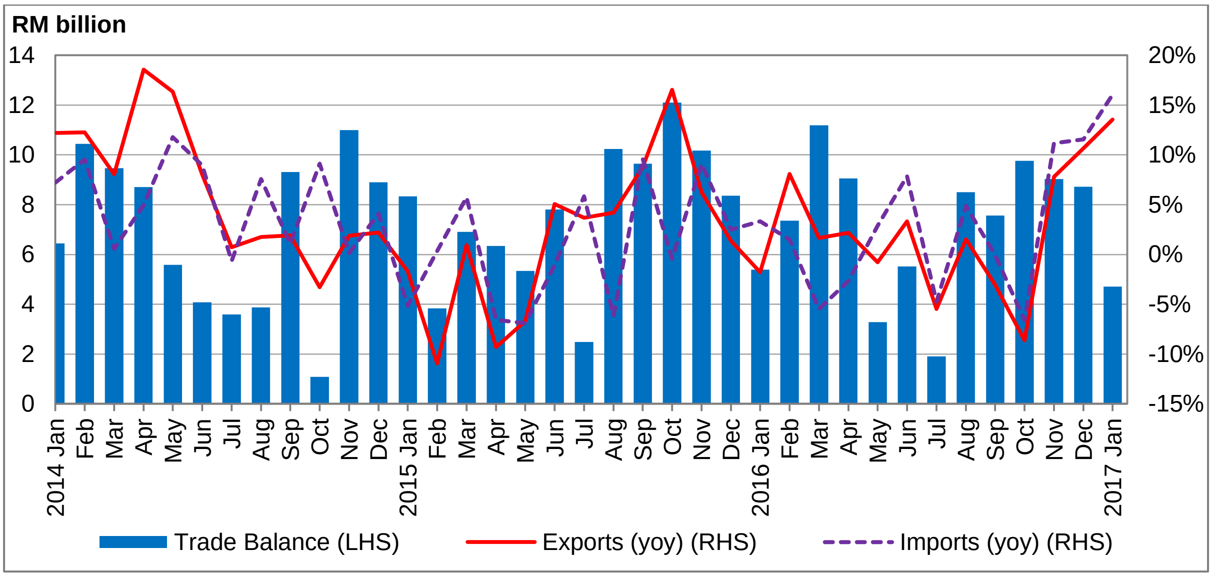
   Major contributors to export growth were electrical products and electronics (11.4%; share 35.4%), crude petroleum (48.1%; share 3.5%), chemicals (15.2%; share 7.1%), metal (10.8%; share 4.0%), palm oil (21.7%; share 6.0%), LNG (2.8%; share 4.7%), and refined petroleum products (81.7%; share 8.7%).

   Imports continued to accelerate to 16.1% yoy in January (11.5% in December), lifted by higher growth in intermediate goods (10.4%) and lumpy capital imports (35.2%). However, imports of consumption goods declined by 1.6%, reflecting the impact of falling ringgit and costlier imported goods and hence, curbing demand for imported consumer items.

   Exports are recovering to provide a fillip to the economy. The drivers to support our revised **higher export growth estimates to 5.0% this year** from 1.5-2.5% previously are i) an improved global economy, especially the US; ii) continued expansion of semiconductor sales; and iii) firming commodity and crude oil prices. Brent crude price jumped by 23.0% to an average US$53.73 per barrel in Jan-27 March this year from an average of US$43.67 in 2016 while palm oil price also delivered a strong performance to increase by 18.2% to average RM3,129/metric tonne in Jan-30 March 2017 from the 2016's average RM2,647/metric tonne.

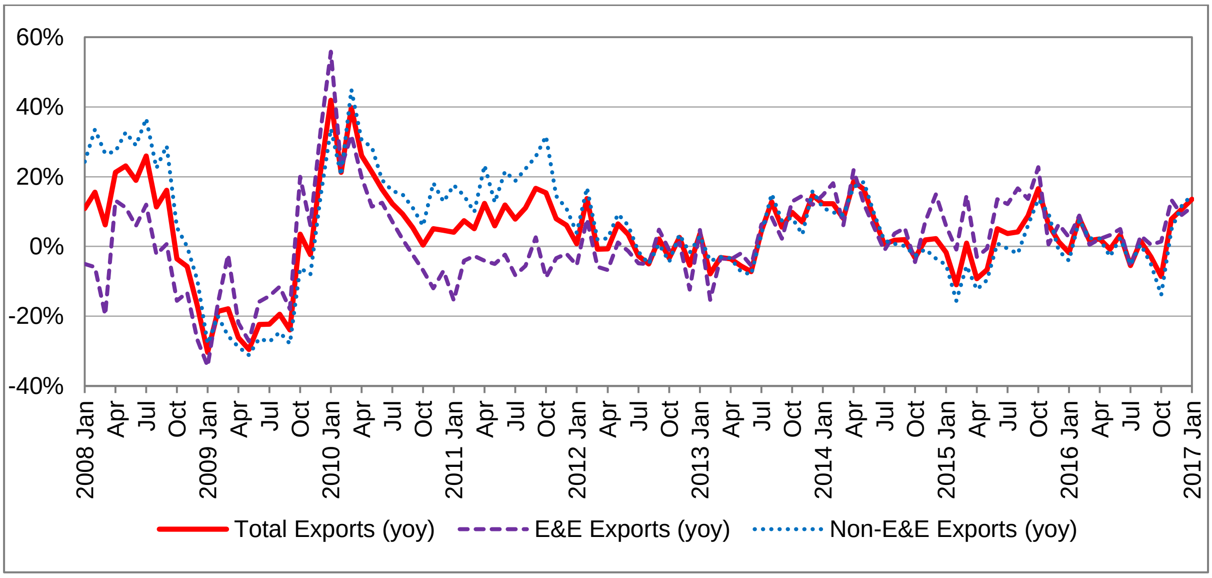
   There are risks to global trade environment threatened by policy uncertainties associated with the Trump's strong assertive of a free and fair trade policy, targeting at those countries running huge trade surpluses with the US, namely China and Japan as well as the trade deal in NAFTA. Following the Trump's signing of executive orders aimed at identifying ad targeting foreign trade abuses, Malaysia is among the 16 countries being identified incurring massive trade imbalances with the US.

Figure 27: Trade surplus narrows on stronger imports relative to exports



Source: Department of Statistics, Malaysia

Figure 28: Overall exports are picking up

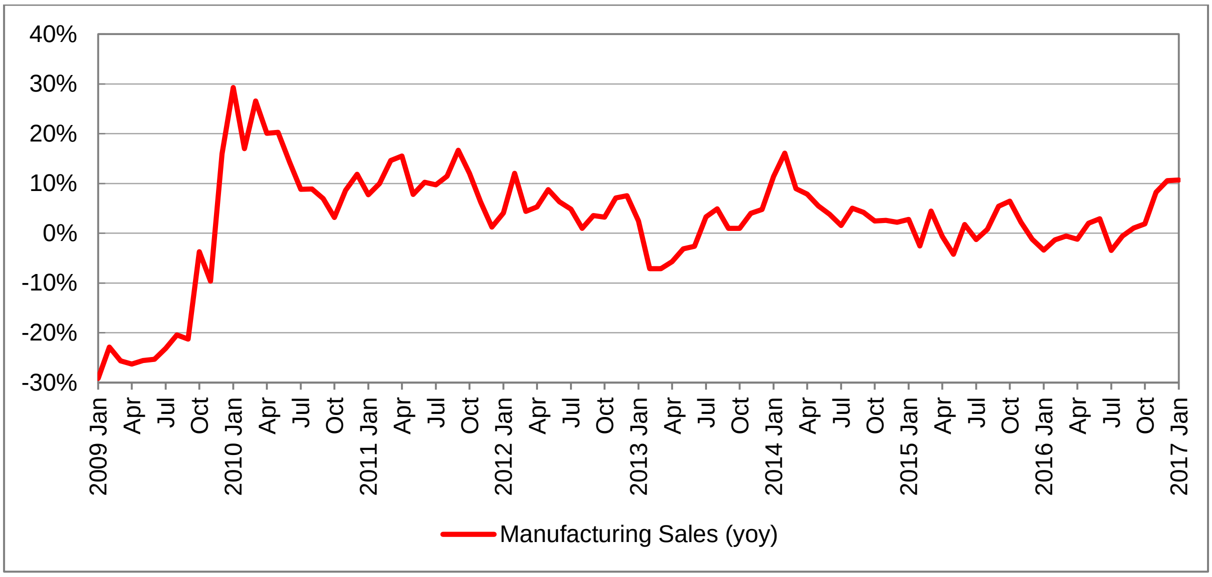


Source: Department of Statistics, Malaysia

4. Total **sales value of the manufacturing sector** rose by 10.7% yoy to RM61.2 billion in January (10.6% in December and 1.3% for 2016), underpinned by strong increases in manufacture of refined petroleum products (37.9%), manufacture of electrical capacitors and resistors, printed circuit boards and display components (65.4%), manufacture of passenger cars and commercial vehicles (33.1%), manufacture of basic organic chemicals and inorganic compounds (11.5%) and manufacture of diverse plastic products n.e.c. (34.6%).

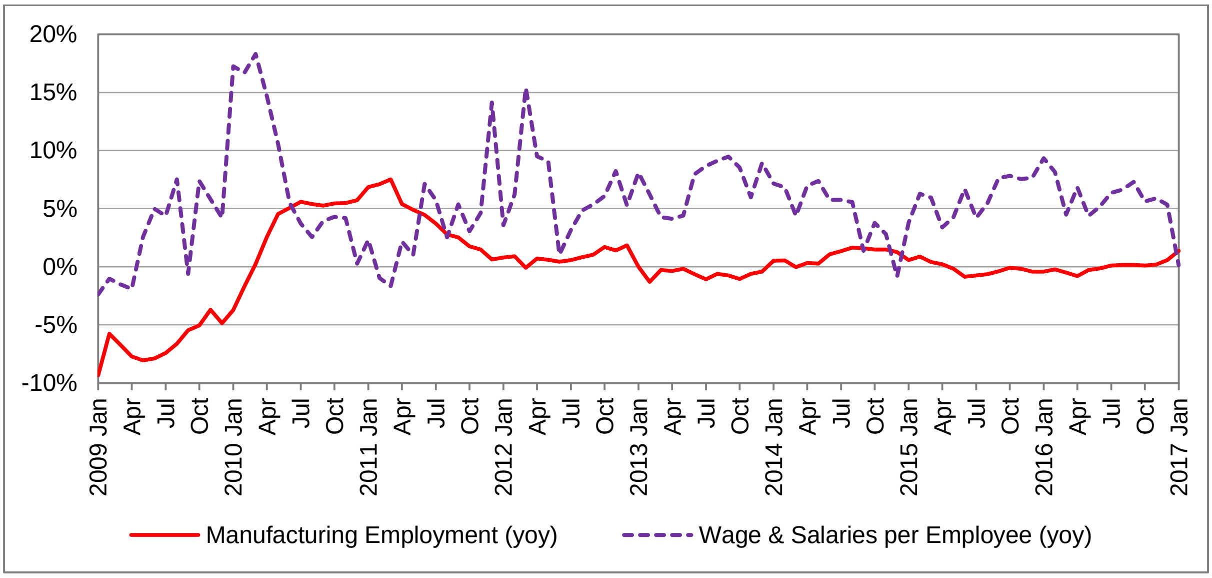
   Total employees engaged in the sector increased 1.4% yoy or 14,193 persons to 1,044,346 persons in January. Salaries and wages paid also rose by 1.5% to RM3.3 billion while productivity increased by 9.2% to RM58,580 sales per employee.

Figure 29: Manufacturing sales posted double-digit growth for two months



Source: Department of Statistics, Malaysia

Figure 30: Manufacturing employment rose but average salaries were flat



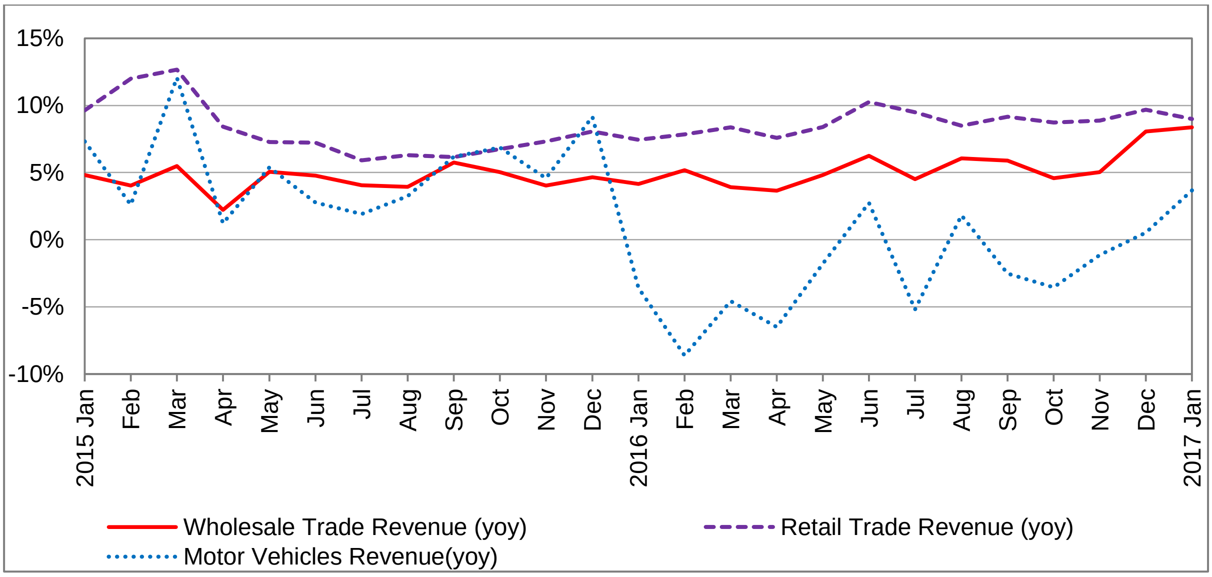
Source: Department of Statistics, Malaysia

5. **Distributive trade** begins the year 2017 with a 22-month high of 8.0% yoy increase to record RM93.6 billion sales value in January (7.6% in December and an average growth of 5.4% in 2016). As at end-2016, there are 1.7 million persons employed under this sector, accounted for 48.4% from the services sector.

   Both wholesale and retail sector collectively contributed 13.1% to overall GDP in 2016. These two sub-sectors of services posted increases of 8.4% and 9.0% in sales value respectively in January 2017 (+8.1% and +9.7% respectively in December). For motor vehicle, the sales value rose by 3.7% to RM11.4 million, in tandem with the car sales performance in January 2017. This marks an improvement from an average contraction of 2.7% in 2016.

The wholesale and retail sector is estimated to grow by 6.0% this year (6.2% in 2016), underpinned by continued expansion of domestic demand and tourists-related spending. The government has set a target of 31.8 million tourist arrivals and tourist receipts of RM118 billion for this year. In 2016, there were 26.8 million tourist arrivals in Malaysia, marked a 4.0% increase compared to 2015.

Figure 31: Wholesale and retail trade recorded steady revenue growth



Source: Department of Statistics, Malaysia

6. **Private consumption indicators** show mixed signals on consumer spending. Broadly, consumer sentiments remain cautious and weak, weighed down by rising inflation pressures and continued worries about job prospects. Anecdotal evidence points to cautious consumer spending during the Chinese New Year celebrations.

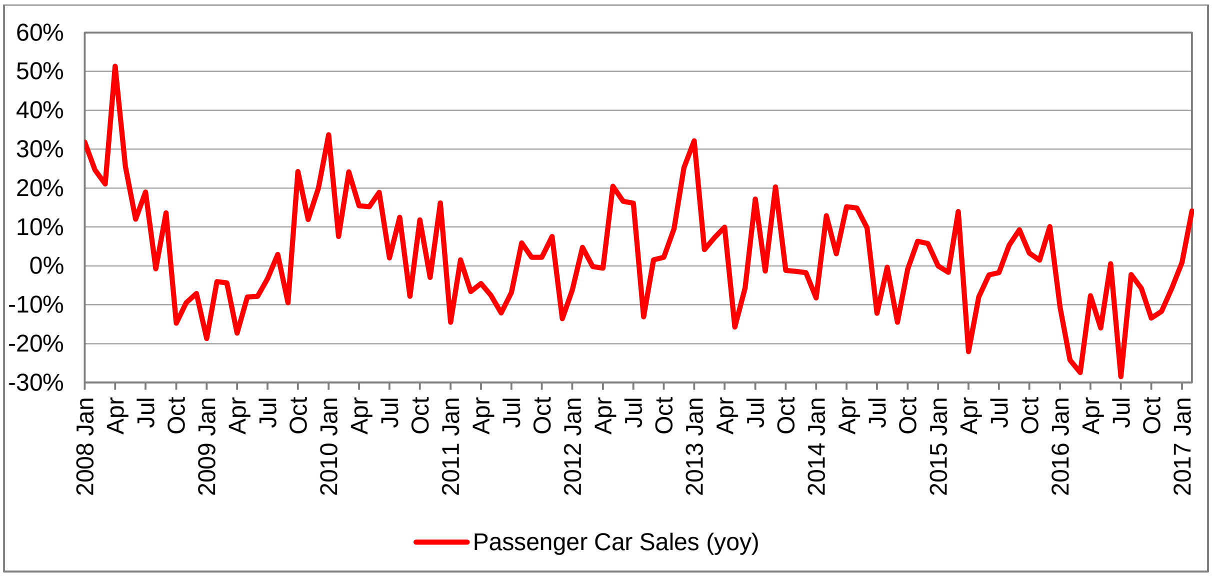
   MIER's consumer sentiment index slipped further to 69.8 in 4Q16 from 73.6 in 3Q, citing unfavourable current finances, subdued income and job outlook as well as expectations of rising prices intensify. Households remained cautious and selective on shopping plans.

   Unemployment rate remained unchanged at December's 3.5% in January (3.4% in November and 3.4% in 2016) and the number of unemployed persons increased 2.5% yoy to 514,100. During the period Jan-Sep 2016, about 40,000 workers were retrenched. In 2015, about 44,000 workers lost their jobs. The Malaysian Employers Federation (MEF) expects more people will be retrenched this year due to the current economic challenges. The other contributory factor is the introduction of "disruptive technology" in some industries.

   Consumers remained cautious committing purchase of big ticket items. After posting declining sales in 2H2016, sales of passenger car turned around to rise moderately by 0.9% yoy to 40,294 units in January (-5.8% in December). Due to a lower base effect, the passenger car sales increased further by 14.2% yoy in February while the unit of cars sold dropped by 1,413 units compared to January due to shorter working month.

The local automotive industry will remain challenging despite expecting a modest upturn of 1-2% increase in car sales this year following a sharp decline of 13% in 2016, the first decline in four years. Reasons that could cause the car buyers to stay cautious are soft economic conditions, weak consumer sentiments and stringent hire-purchase loan approvals. The embracing as well as increasing usage of e-hailing would also impact the passenger car sales. Nonetheless, the Malaysian Motor Association (MAA) expects total passenger cars sale to rise by 1.4% to 522,000 units in 2017 (514,545 units in 2016).

Figure 32: Passenger car sales on recovery mode



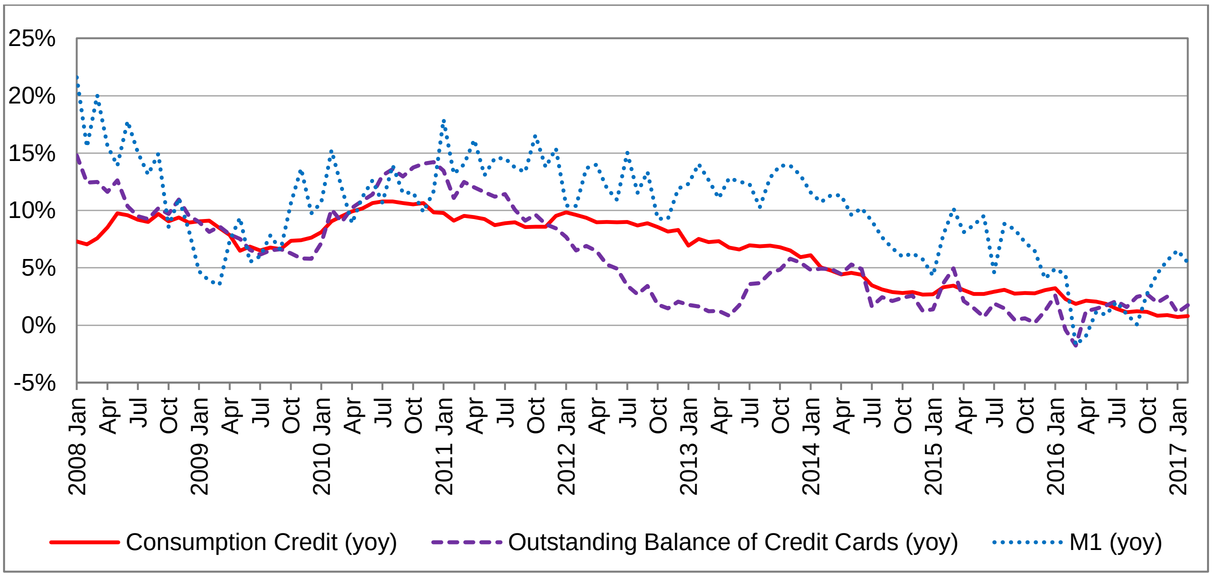
Source: Bank Negara Malaysia

Consumption credit growth continue to rise a modest pace of 0.8% yoy in February 2017 (0.7% in January), which is still below the average of 1.7% in 2016. Owing to the impact of falling ringgit, imports of consumption goods contracted 1.6% yoy in January, a reversal from +1.7% in December and +5.5% in November respectively.

Households still grappling with rising cost of living though the cash handouts provided some relief to the low-and middle-income households. Higher fuel prices and other cost-driven inflation pressures have taken a toll on consumer spending. The combined impact of cost-driven inflation and falling ringgit have forced some traders to pass on increased cost to consumers as they were unable to absorb rising operating costs.

The strength of consumer spending hinges critically on how consumers view the state of economy, job and income prospects as well as inflation expectations. Households will spend discretionary or defer spending on big-ticket items if they worry about the state of finances and economy. Private consumption growth is estimated to grow by 5.7% in 2017 and 6.0% in 2018 respectively (6.0% in 2016), slowing from an average growth of 7.1% in 2011-15.

Figure 33: Consumer sentiment remains cautious

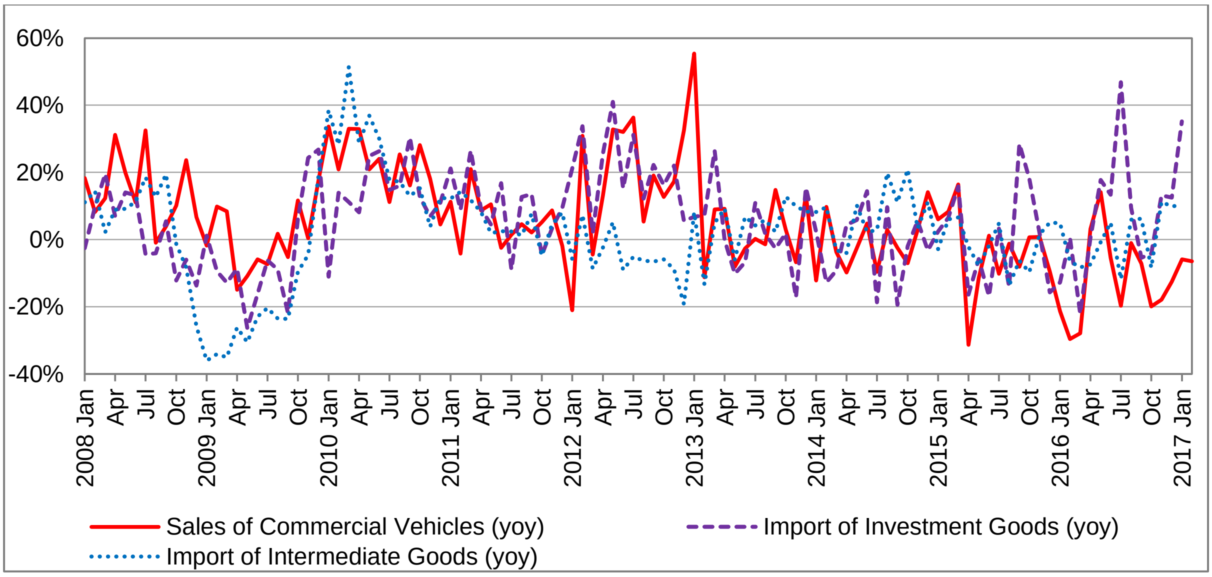


Source: Bank Negara Malaysia

7. **Private investment indicators** painted a mixed picture, suggesting continued uneven investment growth for this year. Business sentiments remained weak as reflected in MIER's Business Condition Index, which dropped for the second consecutive quarter to 81.2 points in 4Q16. Imports of capital goods expanded higher by 35.2% yoy in January (12.5% in December) while imports of intermediate goods also increased further (10.4% in January vs. 9.8% in December and 11.3% in November respectively) for three months in a row. Business loans growth slipped to 5.6% in February 2017 from 6.1% in January, particularly dragged by slower growth in the mining and quarrying sector.

   The on-going implementation of public transport projects and continued investment in manufacturing and services should keep private investment going. Lingering uncertainties associated with the General Election 14 (GE14) may temper investors' sentiment. We expect private investment to expand by 4.5% in 2017 and 6.1% in 2018 respectively (4.4% in 2016).

Figure 34: Private investment indicators show mixed outcomes



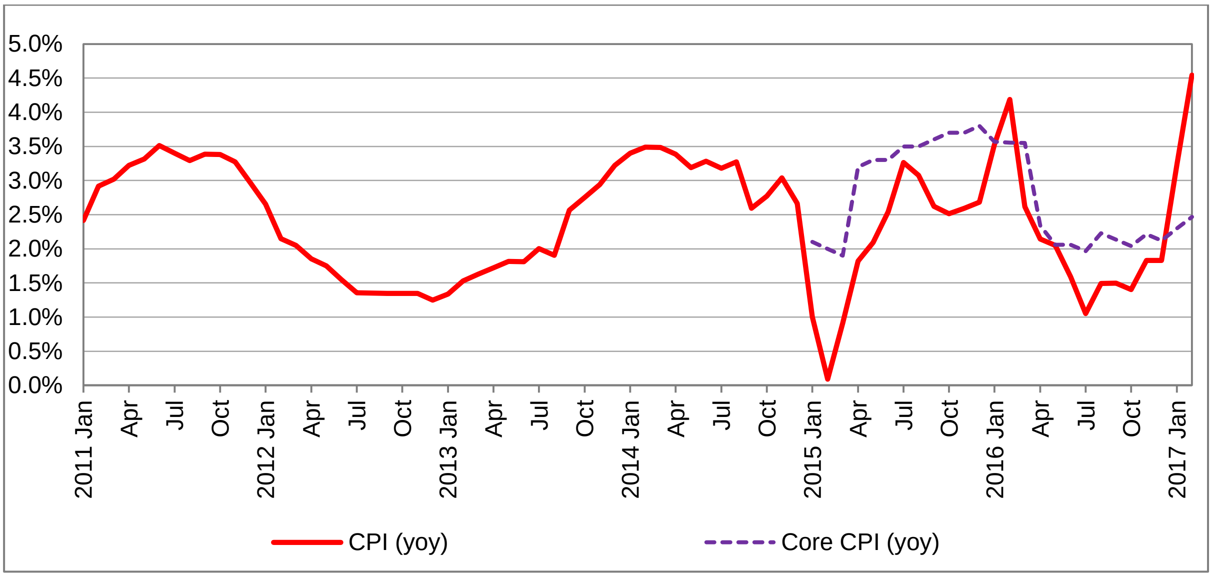
Source: Bank Negara Malaysia

8. **Headline inflation** shot up to 4.5% yoy in February (3.2% in January and 2.1% in 2016) and will likely to stay elevated in 1H17. Core inflation (excludes volatile items) which reflects the demand-induced inflation increased higher to 2.5% in February from 2.3% in January. It shows that demand price pressures are still within manageable level.

   February's 98-month high inflation was mainly lifted by the sharp hike in the transport component (+17.9%), particularly higher fuel prices, which caused the price index of "fuels and lubricants" component which carrying 7.8% of consumer basket rising 31.3% yoy. Price increases were also recorded in food and non-alcoholic beverages (4.3%), health (2.4%), education (1.7%), restaurants and hotels (2.3%), housing and utilities (2.2%) as well as household furnishings and maintenance (1.5%).

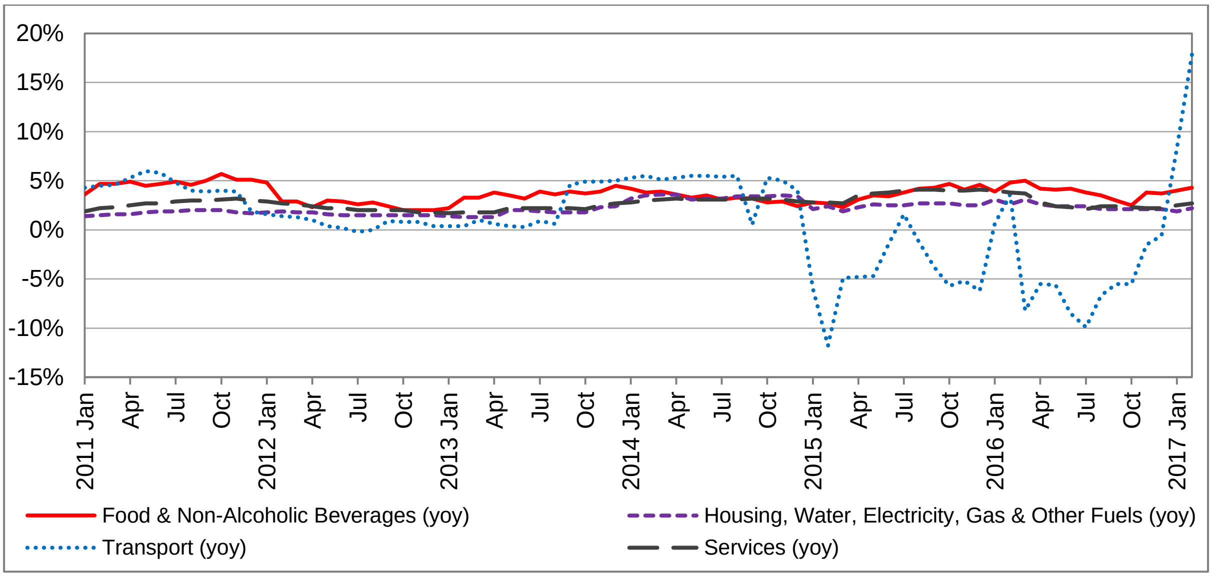
   We concur with Bank Negara Malaysia's assessment that headline inflation would remain relatively high in the first half-year, induced by the pass-through effect of the increase in global oil prices on domestic retail fuel prices. Global oil prices remain the wild card to exert greater influence on domestic inflation. Cost-induced price pressures along with other indirect costs such as the spillovers of the weakening ringgit would fuel higher consumer price inflation this year. As such, **we tweak our CPI estimate to 3.0-4.0% for this year** from 2.5% previously.

Figure 35: Inflation soared in January and February



Source: Department of Statistics, Malaysia

Figure 36: Fuel prices hike led to high inflation



Source: Department of Statistics, Malaysia

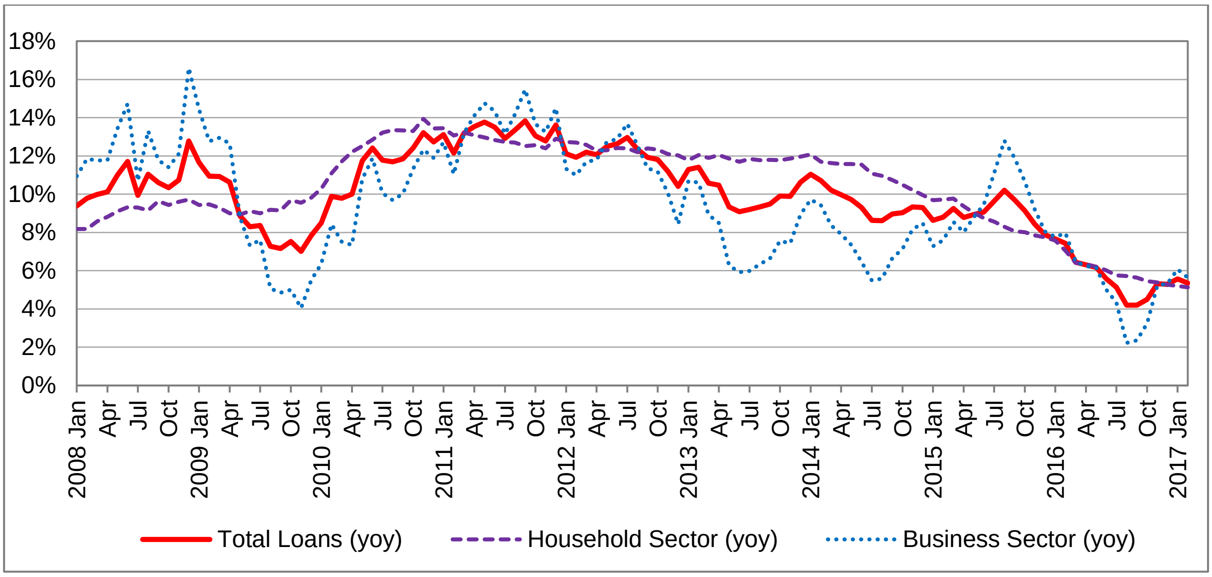
9. **Loan indicators improved in February, partly aided by low-base effect.** Total outstanding loans extended by banking system slipped to 5.3% in February (5.6% yoy in January and 5.3% in December 2016) on slower business loans (5.6% in February vs. 6.1% in January) and a marginal dip in household loans to 5.1% from 5.2% in January.

   February's **business loan growth** is still higher than 2016's average of 5.2%. Higher loans demand were recorded in construction, manufacturing, wholesale and retail trade, financing, insurance and business services, and transport, storage and communication. In the **household sector**, positive loan growth were reflected in the purchase of both residential and non-residential properties, credit cards, consumer durables and personal uses.

   Loan approvals and applications turned around to expand strongly by 17.4% yoy and 21.2% yoy respectively in February (-5.1% and -8.4% respectively in January) while **loan disbursements** eased slightly to 3.3% (3.4% in January). The strong loan applications growth was inflated by the low base effect (February 2016:RM50.5 billion), with higher applications coming from the purchase of securities, passenger cars, residential property and credit cards. Strong increases in loan approvals were recorded in utilities, hotel and restaurant, construction, and other sectors while the drag came from finance, insurance and business services, and transport, storage and communication.

   We estimate the banking system's loans growth to rise by 5.0% this year compared to 5.3% in 2016, supported by moderate loans demand from both households and businesses.

Figure 37: Household loans continue to soften



Source: Bank Negara Malaysia

10. **Bank Negara Malaysia's holdings of foreign exchange** fell slightly by US$0.1 billion to US$94.9 billion at 15 March compared to US$95.0 billion at end-February (US$95.0 billion at end-January). However, it rose by US$0.4 billion when compared to US$94.5 at end-December 2016. The level of reserves is sufficient to finance 8.3 months of retained imports and were 1.1 times the short-term external debt.

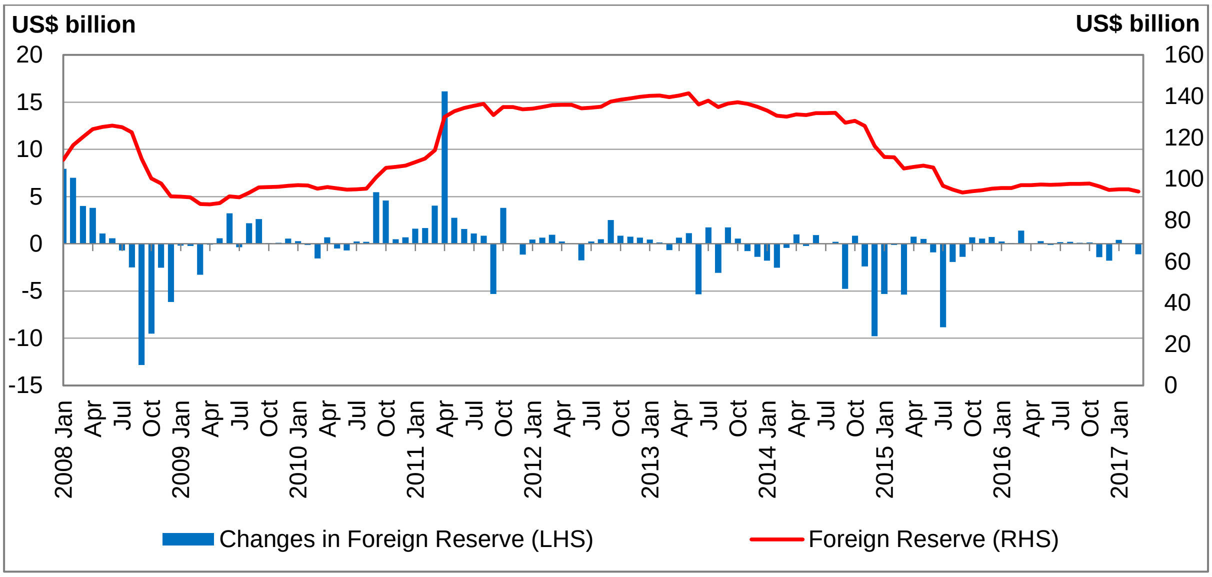
Foreign investors continued to pare down their holdings of Malaysia bonds, especially Malaysian Government Securities (MGS) as they remained wary about the measures related to non-deliverable forward markets (NDF). Foreign-owned of Malaysia bonds have been trending lower from RM246.9 billion at end-Aug 2016 to RM204.4 billion at end-Feb 2017 for six consecutive months. The holdings of MGS fell from RM186.9 billion at end-Aug to RM158.9 billion at end-Feb 2017. As a result, the share of foreign holdings of Malaysian Government Securities has eased to a two-year low of 44.7% in February (51.5% at end-Aug 2016) while the share of foreign holdings of government bonds also edged down to 29.7% in February (36.3% at end-Aug 2016).

Foreign interests in equities improved as they snapped up more local equities (+RM0.9 billion in February vs. +RM0.4 billion in January). The share of foreign-owned equities in February remained unchanged at 22.3% in January 2017 and December 2016.

Based on the Balance of Payments data, Malaysia recorded net inflows of portfolio investment totalling RM13.2 billion in the first half-year of 2016, which were more than offset by large net outflows of RM32.9 billion in 2H, bringing total net outflows of RM19.7 billion in the full year of 2016. This marks the fourth straight year of net outflows recorded since 2013 (-RM28.2 billion in 2015; -RM39.4 billion in 2014 and -RM3.0 billion in 2013).

Going forward, we expect foreign reserves to subject downward pressures coming from the potential hiking of the US interest rates, the narrowing of yield differentials with the US; maturing of outstanding Malaysian bonds (RM49 billion between July and November vs. RM18.3 billion between March and June 2017) as well as capital flows volatility associated with the Trump's economic policies.

Figure 38: Foreign reserves seen stabilising



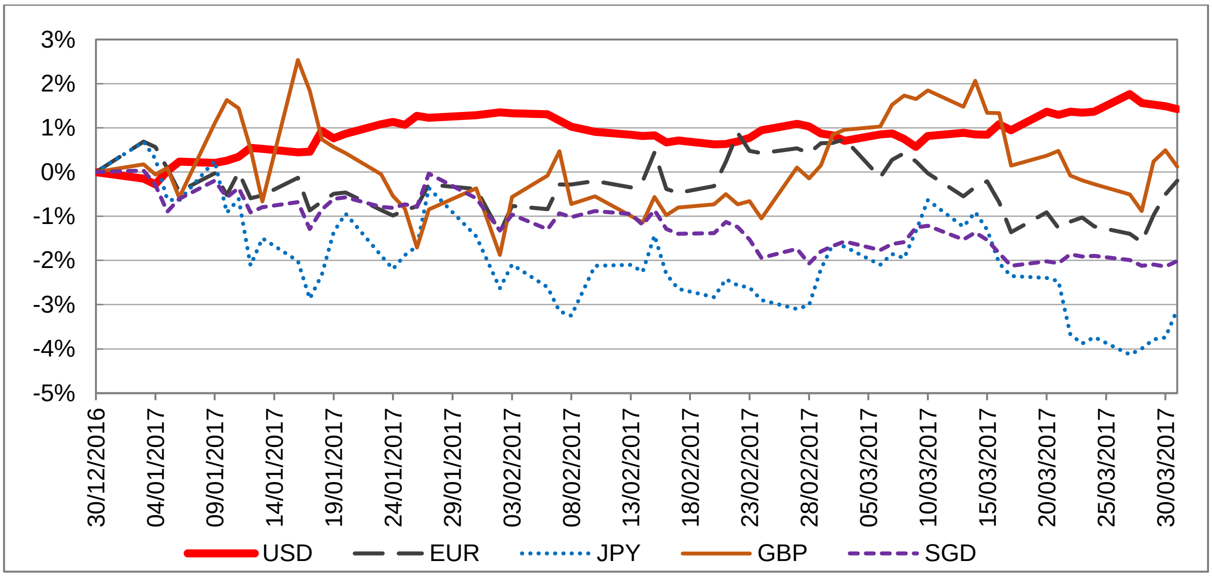
Source: Bank Negara Malaysia

In the period Jan-31 March, the ringgit showed a mixed picture against the currencies of most of Malaysia's major trade partners. As of 31 March, while the ringgit has gained 1.4% against the US dollar when compared to end-Dec 2016, the rate of depreciation was slower relative to regional currencies, whose strengthened more against the US dollar: South Korean won (7.6%), Australian dollar (5.9%), Indian rupee (+4.7%), Japanese yen (4.7%), Thai baht (4.1%) and Singapore dollar (+3.5%).

The strengthening of the US economy along with the prospective further tightening of the Fed's monetary policy and higher inflation risk on expectations of the Trump administration's reflation policies would underpin a sustained US dollar rally against regional currencies, including the ringgit.

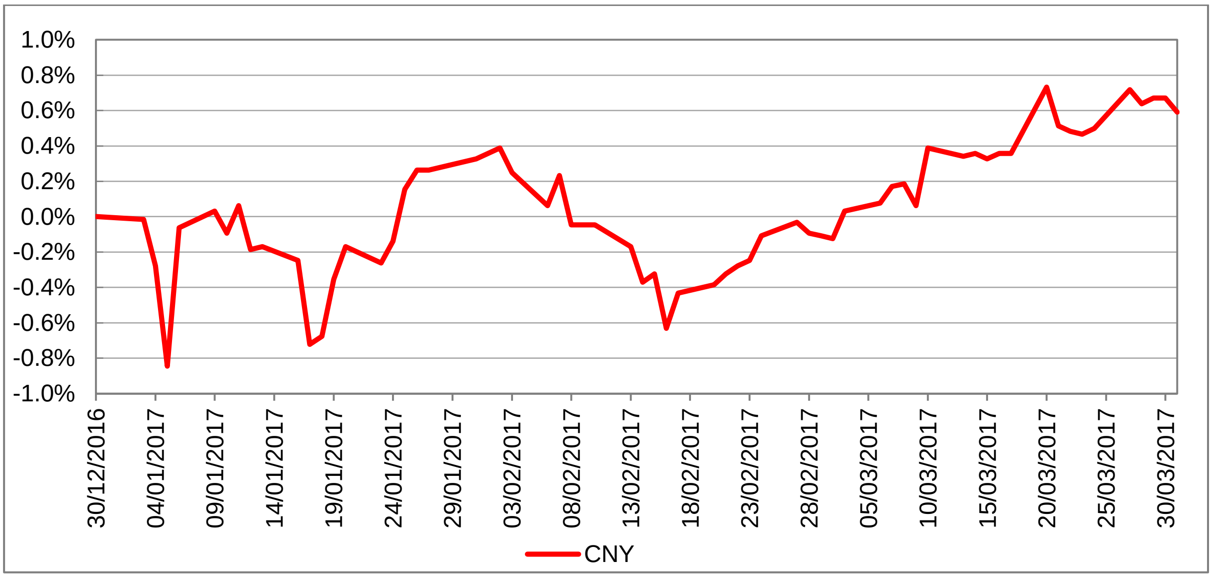
According to Bank Negara Malaysia (BNM)'s Financial Markets Committee, the ringgit continues to remain stable against the US dollar. The measures to develop the onshore financial market has seen some improvement in the volume of trading activities in the FX market as well as in the balance of foreign exchange flows between exports and imports. The ringgit is expected to end the year 2017 at RM4.30-4.40 per US dollar (End-2016: RM4.4860; End-2015: RM4.2935).

Figure 39: The ringgit show mixed performances in 1Q2017



Source: Bank Negara Malaysia

Figure 40: Ringgit appreciated against CNY



Source: Bank Negara Malaysia

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