QUARTERLY ECONOMY TRACKER

(OCTOBER-DECEMBER 2016)

Socio-Economic Research Centre (SERC)

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Executive Summary

A. GLOBAL ENVIRONMENT

- **The year 2016 ends on a moderate pace.** Global lead and forward indicators continued to indicate the global economy would end the year 2016 on a moderate note. The IMF's estimated global growth of 3.1% in 2016 marks the sixth consecutive year of slow growth since 2011 when compared to an average growth of 4.2% in 1998-2007. During the year, we have witnessed periods of volatility in global financial markets and emerging markets' currencies as inflicted by the ongoing political, policy and economic uncertainties in major advanced economies. In just the last six months, the world has had two "black swan" events (Brexit and Trump's victory) triggered sharp market reverberations, albeit short-lived.
- **Global growth improves but downside risks remain.** Growth in G-3 showed some traction, with the United States leading the pack, followed by a moderate growth in eurozone, which defies the gravity of post Brexit's impact and Japan's moderate recovery despite the strong yen. China's economy is in cruising speed, underpinned by continued expansion of private consumption and services.
- **Better growth performance in 2017.** A slew of high frequency indicators lends credence to the continued expansion of global economy though not that exciting. In a quarterly update to its World Economic Outlook, the International Monetary Fund (IMF) maintained its forecast for global growth of 3.4% in 2017 (3.1% in 2016) and 3.6% for 2018, unchanged from the Fund's previous forecast in October. The World Bank forecasts global GDP growth to increase by 2.7% in 2017 compared to 2.3% in 2016.
- **The Fed sees three interest rate hikes in 2017.** The Federal Reserve (Fed) hiked its key interest rate for the second time since Dec 2015 to 0.50-0.75% at end-Dec 2016. Key indicators lend credence to the US recovery is firmly in place to warrant for small rate increases ahead. In 2017, the Fed will have to balance its interest rate hikes between supporting stronger economic growth coming from Trump's reflationary fiscal stimulus and to tame inflationary expectations. Our base case expects the Fed's interest rates to reach 1.25-1.50% at end-2017.
- **Headwinds outweigh tailwinds in 2017.** 2017 will be yet another challenging year for the world economy. The shaping of Trump's economic plans and the intended impact on the US economy as well as the calibration of the Fed's monetary policy, including its forward guidance on interest rates would remain in high focus. Other key events and developments to watch are the political outcomes of some major European countries (France, Germany and Netherland) that will be having their national or Presidential elections as well as the lingering unresolved issues associated with post Brexit. Investors will still be paying close attention to China not only about its growth trajectory but also growing concerns about its high debt exposure as well as the direction of Chinese renminbi as Trump has labelled China as a currency manipulator.

B. MALAYSIA'S ECONOMIC PERFORMANCE AND OUTLOOK

- **On track to meet 2016's GDP growth target of 4.0-4.5%.** Malaysia's GDP growth improved to 4.3% yoy in 3Q16 (4.0% in 2Q), underpinned by sustained private consumption amid moderate private investment. Overall domestic demand paced at a slower rate of 4.7% in 3Q (+6.3% in 2Q). With the economy already locked in 4.2% in the first nine months, the government should be able to meet the growth target of 4.0-4.5% for 2016. We are keeping our estimate of 4.2%.

- **Resilient consumer spending; moderate private investment.** Faced with uneven export growth, sustaining domestic demand is vital to deliver the growth target. Consumer spending was sustained at 6.4% yoy in 3Q (6.3% in 2Q), partly lifted by the salary increment for public sector, cash handouts and higher minimum wage. What worries us is private investment momentum (4.7% in 3Q vs. 5.6% in 2Q) though had regained traction from the lows, it remained stuck at "slow and moderate" growth path amid cautious investors' sentiment and the ringgit's volatility.

- **Major economic sectors still growing.** Key contributors to overall economy expansion, namely services, manufacturing and construction sectors continued to expand at commendable pace. The mining sector continued to sustain its turnaround trend while the sharp decline in agriculture output has narrowed in 3Q due to the diminishing effect of El Niño. The industrial production indices for the months of October and November showed continued higher output growth in the manufacturing and mining sectors.

- **GDP outlook remains positive but not too exciting.** We expect the Malaysian economy to continue growing at 4.3% in 2017 and 4.6% in 2018 respectively (estimated 4.2% in 2016). With still uneven pace of exports, the government will continue to lean on enhancing domestic demand to keep the economy going. Consumer spending will be supported by moderate income growth and higher cash handouts amid cautious sentiment. The ongoing implementation of public infrastructure projects and capital investment in manufacturing and services will underpin private investment.

- **Inflation will move higher.** Headline inflation edged higher to 1.8% in November (1.4% in October; 1.5% in September; 1.3% in 3Q16; 1.9% in 2Q and 3.4% in 1Q), mainly due to increases in food prices, partly inflicted by higher prices of cooking oil and fresh meat as well as a smaller decline in transport prices. The continued subsidy rationalisation, both the direct and indirect impact of weak ringgit on imported goods and services could add some pressure on inflation going forward. We project inflation to average 2.5% in 2017 (estimated 2.1% in 2016).

- **Exports still volatile.** Exports continue to grow unevenly, reflecting the impact of variations in demand of electronics and electrical products, weak commodity prices as well as base effects. Exports reversed to increase by 7.8% yoy in November (-8.6% in October; -2.2% in 3Q and +1.4% in 2Q). Amid a pick-up in global growth in 2017 and moderate improvements in commodity prices (oil price: estimated US$55-60 per barrel vs. US$43.67 in 2016 and palm oil: RM2,700 per tonne vs. RM2,572 in 2016), we expect exports to grow by 1.5-2.0% in 2017, a moderate improvement from estimated rise of 0.6% in 2016.

- **Mixed performance of private consumption and investment indicators**. Car sales contracted in November for five months in a row since July. Consumption credit remains moderate. Broad-based increases in imports of capital, intermediate and consumption goods in November, partly caused by the low base effect a year ago. Loan indicators showed mixed performance in November, with contractions in loan applications and approvals while loans disbursed increased.

- **The Ringgit outlook remains challenging.** In 2017, the ringgit will continue to remain under pressure as influenced by capital flows volatility, expectations of higher US interest rates, Bank Negara Malaysia's (BNM) interest rate policy and inflation trajectory. BNM's assertive measures to contain the influence of non-deliverable forward market on the ringgit, deepen the onshore ringgit market as well as capping the retention of export proceeds in foreign currency account will help to stabilise the ringgit as well as enhance demand for ringgit. The ringgit is expected to be around RM4.20-4.40 by end-2017 (RM4.4860 at end-2016).

- **Bank Negara Malaysia is trapped in horns of a dilemma**. By far, the most important message from BNM's November policy statement was that it will ensure sufficient domestic liquidity, supply of loanable funds as well as supportive interest rate to anchor growth and inflation expectations amid the heightened volatility in ringgit. We expect BNM to keep the overnight policy rate (OPR) at 3.00% in 2017 for now. The decisive factors for further easing of interest rates will be GDP momentum and the ringgit's stability.

GLOBAL GROWTH STILL LOOKING POSITIVE ALBEIT MODERATE

Global economic expansion remains on track. The global economy is still moving at a moderate pace amid growing market anxieties and uncertainties surrounding President-elect Donald Trump's economic policies and how it would impact the US and world economy. In a quarterly update to its World Economic Outlook, the International Monetary Fund (IMF) maintained its forecast for global growth of 3.4% in 2017 (3.1% in 2016) and 3.6% for 2018, unchanged from the Fund's previous forecast in October. The World Bank forecasts global GDP growth to increase by 2.7% in 2017 compared to 2.3% in 2016.

A slew of high frequency indicators lends credence to the continued expansion of global economy though not that exciting. The Composite OECD leading indicators point to stable growth momentum in the OECD area. Global Purchasing Managers Index (PMI) for manufacturing and services accelerated. Global semiconductor sales, which had gained traction in recent months, continued its expansion trail in October.

Both advanced and emerging economies showed divergent growth performance. The US economy rebounded in 3Q16 after a disappointing performance in 1H. Amid the uncertainty related to Brexit, the eurozone grew moderately. Japan displayed a moderate recovery, defying the dampening impact of a strong yen. China's economic restructuring stays on course amid growing worries about the bloated debt.

After Brexit, comes the Trump's shock victory. After experiencing a short-lived market turmoil inflicted by the Brexit's aftershocks on 24 June, global financial markets saw another knee-jerk selling reaction on 8 November when Donald Trump won a decisive victory at being elected as the 45th US President.

As we move into 2017, global equity investors will closely track the impact of Trump Administration's economic policies direction on the US economy. Can Trump make America great again? Will there be a new world order given Trump's "American First and inward" policies and an unabashedly non-interventionist approach to world affairs?

Global investors were spooked by Trump's rhetoric on issues related to trade deals, immigration, race relations, Muslim refugees, global climate change and banking regulations.

While these rhetoric comments may be "watered down" when President-elect Trump takes office on 20 Jan, historical research suggests that presidents tend to carry out their major campaign promises.

What does Trump's sweeping campaign pledges mean to the US economy and its potential spillover effects on global economy? The financial markets will keenly watch on two potential impactful outcomes in 2017.

I. **Will the Fed raise interest rates higher and faster-than-expected?** The US Treasury yields spiked and the US dollar soared on expectations that Trump's reflationary plans to cut taxes and boost fiscal spending have the potential to drive up inflation. This situation could prompt the Fed to accelerate its interest rates normalisation and tighten global financial conditions. Higher US interest rates, surging US bond yields and a stronger dollar have added to the pressure on emerging markets' currencies; and

II. **Any leadership changes in the Fed, a big mover and shaker in global financial markets**. The terms of Fed chairman Janet Yellen will expire in February 2018. Trump and his advisors, who held hawkish views on monetary policy have been critical of Yellen's performance. They have expressed concern about an extended period of excessively loose monetary policy has created a stock market bubble and penalised savers. It is unlikely that Yellen will leave office before her term ends. Being an apolitical central banker, we believe that the Fed would weigh on all aspects before hiking interest rates aggressively.

Massive fiscal stimulus amid high debt ceiling. The proposed tax plans and domestic infrastructure spending worth of US$1 trillion are expected to provide fiscal boost to the US economy. But, some were sceptical whether the fiscal stimulus package will compromise on the fiscal stability given the US' stretched budget deficit and high debt ceiling. The national debt stood at US$19.88 trillion at end- 2016 and still rising.

Anti-trade mindset hurts global trade and economy. What worries investors most is Trump's rhetoric anti-trade policies, which he calls for a renegotiating of the trade deals, namely the 1994 North American Free Trade Agreement (NAFTA) with Canada and Mexico and the 2001 entry of China into the World Trade Organization for causing massive U.S. factory job losses. Weeks after the US elections, President-elect Trump has promised to extract the United States from the Trans-Pacific Partnership Agreement (TPPA) on his very first day in office.

His trade protectionism mindset will hurt global trade and negatively impact the global economy. Trump has proposed a 45% tariff on Chinese imports and a 35% on Mexican goods. He also claimed that China has manipulated its currency to gain cost competitiveness in the US market.

If Trump is adamant to push through the trade protectionist measures, this may invite retaliation from China and Mexico and create trade tensions and stifle the flows of trade and investment. A trade war between the world's two largest economies would certainly disrupt global trade and affect some of the export-driven economies in the region.

China is one of the largest trading partners of the US, accounting for 12.4% total US trade. Hence, both China and the US will be impacted. Higher import tariffs on Chinese goods entering the US market will have an indirect impact on China's trading partners in Asia, including Malaysia which supply intermediate products to China for processing into finished goods for export to the US.

Another challenging year in 2017. With continued growth divergence in major advanced and emerging economies, the global economy is in for another challenging year in 2017. The policy makers will face on-going headwinds to keep global economy on the expansion track. Emerging markets will remain highly sensitive to the different policy outcomes and uncertainties associated with the advanced economies.

The main challenges facing the world economy in the upcoming Year of the Rooster are as follows:

I. The impact of Trump's economic plans on the US economy and how they will influence the Fed's rate hikes path. While the Fed has reassured that it will be raising rates gradually; however, a much more aggressive run of rate increases can cause more uncertainty in markets. Many emerging market currencies are already under pressure due to decreasing prospects for growth, low commodity prices, declining productivity and a stronger dollar.

II. Brexit and European instability. There remain lingering issues and uncertainties associated with Post Brexit. When will Britain trigger Article 50 of the Libson Treaty and commence its slow exit from the European Union? There are potential economically and politically damaging risks in the eurozone with national elections set for France, Germany and the Netherlands in 2017.

III. Concerns about the limitations and effectiveness of monetary policy to boost growth while some governments face budget constraints to increase fiscal spending to drive growth.

IV. China's ongoing economic adjustment and its disruptive spillovers on the world economy remained in focus. There remain concerns about still-rising credit-to-GDP ratio and the lack of decisive progress in addressing corporate debt in state-owned enterprises.

Figure 1: Real GDP Growth (% YoY)

	2014	2015	2016 1Q	2016 2Q	2016 3Q	2016*e* (IMF)	2016*e* (WB)	2017*f* (IMF)	2017*f* (WB)
United States	2.4	2.6	1.6	1.3	1.7	1.6	1.6	2.3	2.2
Euro Area	1.2	2.0	1.7	2.3	1.5	1.7	1.6	1.6	1.5
China	7.3	6.9	6.7	6.7	6.7	6.7	6.7	6.5	6.5
Japan	0.3	1.2	0.4	0.9	1.1	0.9	1.0	0.8	0.9
India[1]	7.2	7.6	7.9	7.1	7.3	6.6	7.0	7.2	7.6
Malaysia	6.0	5.0	4.2	4.0	4.3	4.3	4.2	4.5	4.3
Singapore	3.3	2.0	2.1	2.1	1.2	1.7	-	2.2	-
Indonesia	5.0	4.8	4.9	5.2	5.0	4.9	5.1	5.1	5.3
Thailand	0.8	2.8	3.2	3.5	3.2	3.2	3.1	3.3	3.2
Philippines	6.2	5.9	6.8	7.0	7.1	6.4	6.8	6.7	6.9
Vietnam	6.0	6.7	5.5	5.8	6.6	6.1	6.0	6.2	6.3

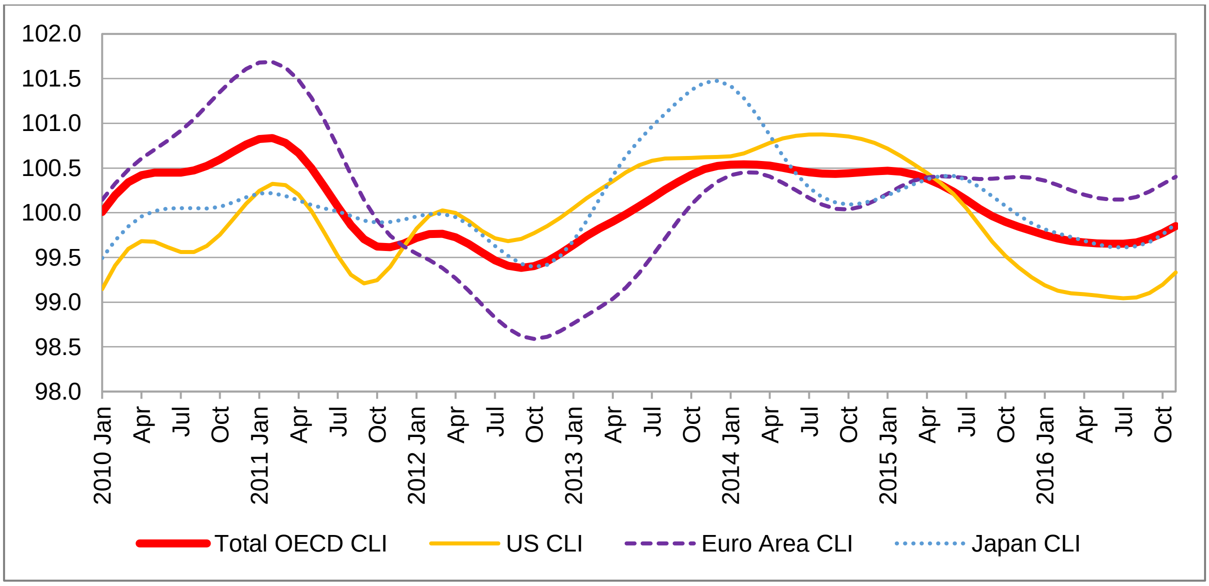
Source: Officials; IMF (World Economic Outlook, October 2016 & January 2017, Recent Article IV Mission Reports); World Bank (Global Economic Prospects, January 2017)

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

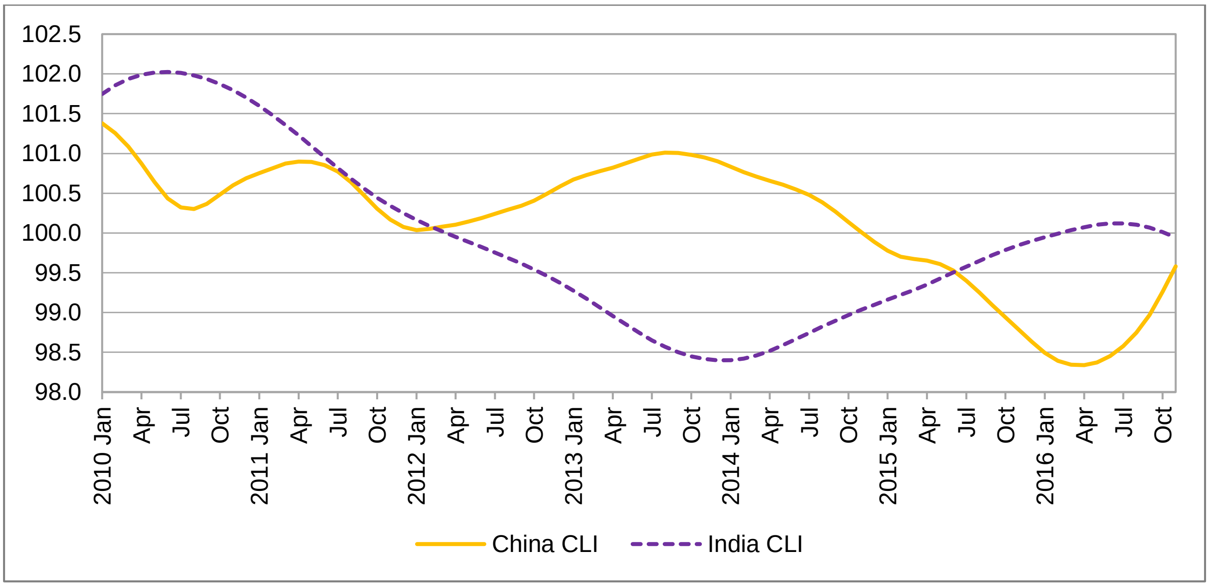
1) **The composite leading indicators (CLIs)**, which are designed to anticipate turning points in economic activity relative to trend reversed to rise marginally in November though staying below the 100-pt threshold for fifteen consecutive months since September 2014. This points to growth momentum picking up in several advanced economies, including the US as well as firmer growth in major emerging economies such as China. The CLI signals easing growth momentum in India. In the OECD area as a whole, the CLIs point to stable growth momentum.

Figure 2: OECD CLI points to stable growth momentum



Source: OECD

Figure 3: Mixed growth momentum for China and India

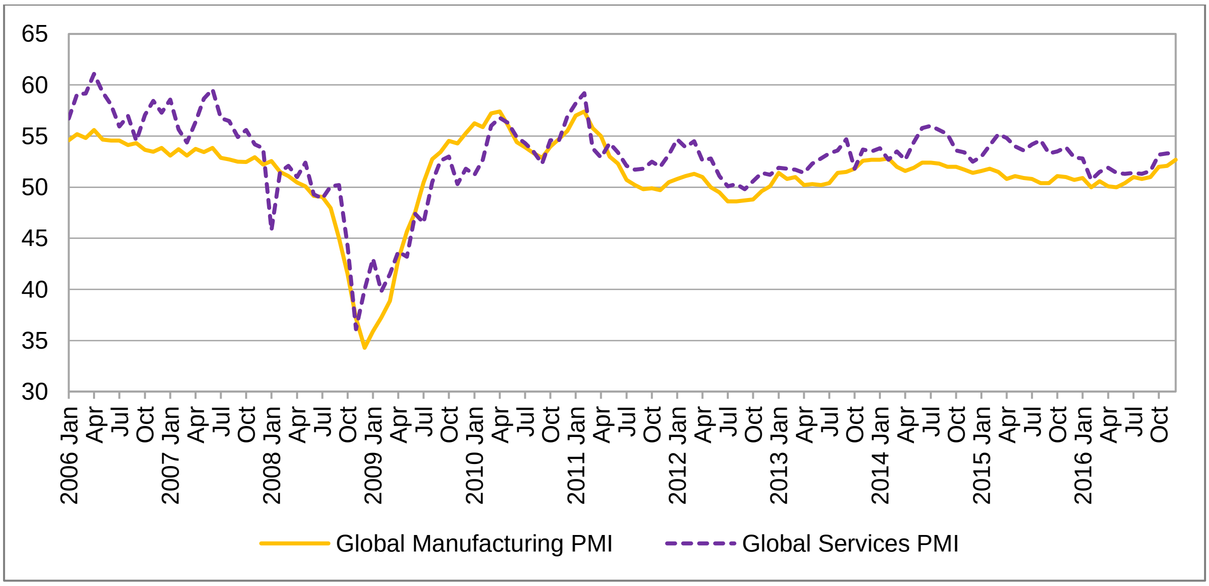


Source: OECD

2) **The global manufacturing sector** offs to a strong start in the last quarter of 2016, with the Purchasing Managers Index (PMI) rising further to 52.7 in December (52.1 in November and 52.0 in October respectively), the highest level since February 2014. The 34th month high was supported by increases in output, new orders and input prices.

3) **The global service sector** also expanded at a solid pace, with the index sustaining at 53.3 in December (53.3 in November and 53.2 in October respectively). This signalled expansion for 51 successive months. Activity increased across the business, consumer and financial services sectors.

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



Source: Markit

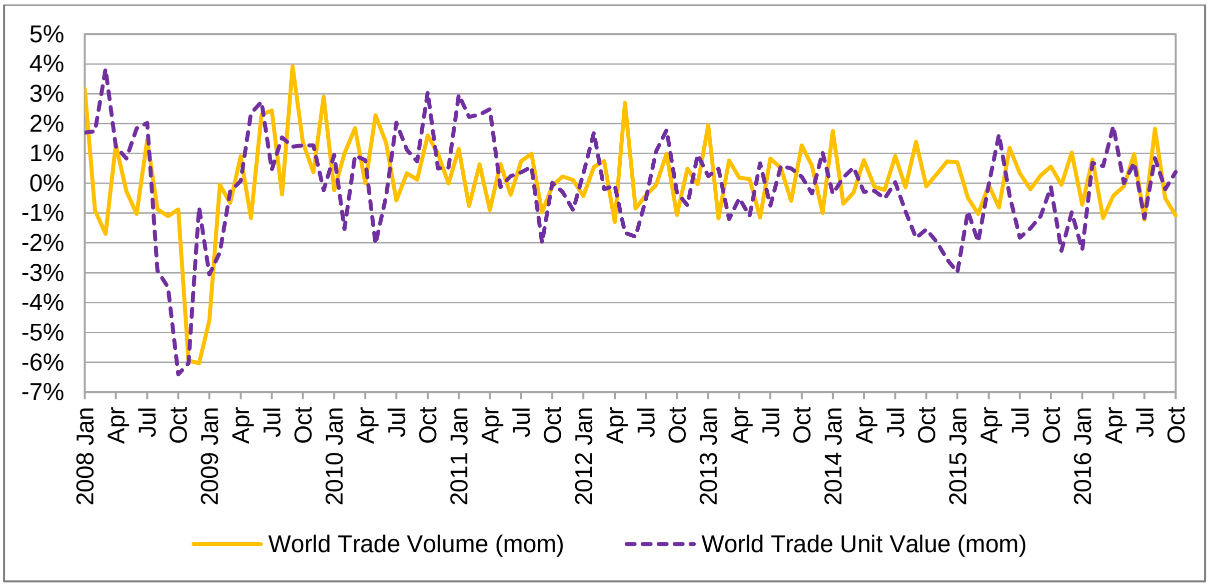
4) **World trade volume** remains volatile, with the growth oscillating between expansions and contractions. It declined further by 1.1% mom in October (-0.5% in September and +1.8% in August respectively). Both exports and imports contracted by 0.8% and 1.3% respectively in October (-0.2% and -0.8% in September respectively). World trade up 0.4% in 3Q16, following a 0.7% decline in 2Q.

   Emerging economies recorded a sharp drop in export volume (-1.2% in October vs.+1.1% in September) due to declines in Central and Eastern Europe and Asia. Export volume in advanced economies dipped marginally by 0.3% for two consecutive months, owing to contractions in the US and euro area.

   Looking ahead, the projected global trade recovery hinges on the upturn in China economy, the potential demand in the US and euro area as well as continued push for market openness and trade liberalisation. The key risk could come from increasing protectionism and unhealthy trade practices. Since the 2008-09 Global Financial Crisis, many more protectionist measures have been introduced and added more in countries in response to slowing growth, creating a “global trade disorder”.

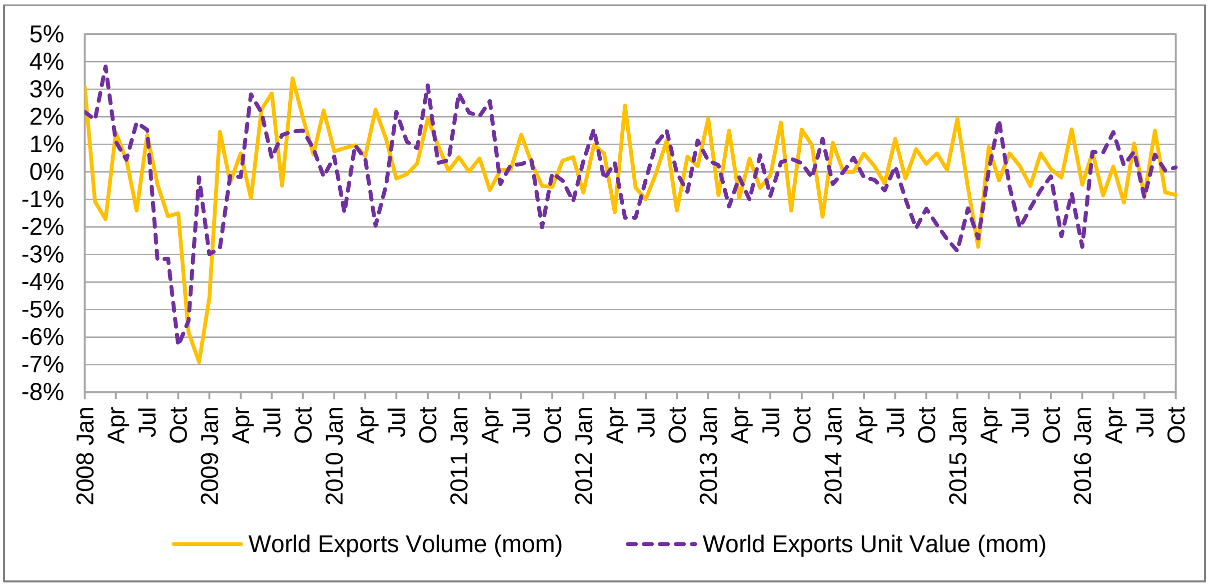
   The World Trade Organization (WTO) slashed its estimates of global trade growth this year to 1.7% from 2.8% previously, reflecting a slowdown in China and falling imports into the US market. The trade organisation also marked down 2017’s trade growth forecast to between +1.8 and +3.1% from 3.6% estimated in April 2016.

Figure 5: World trade volume declined further in October



Source: CPB Netherlands Bureau for Economic Policy Analysis

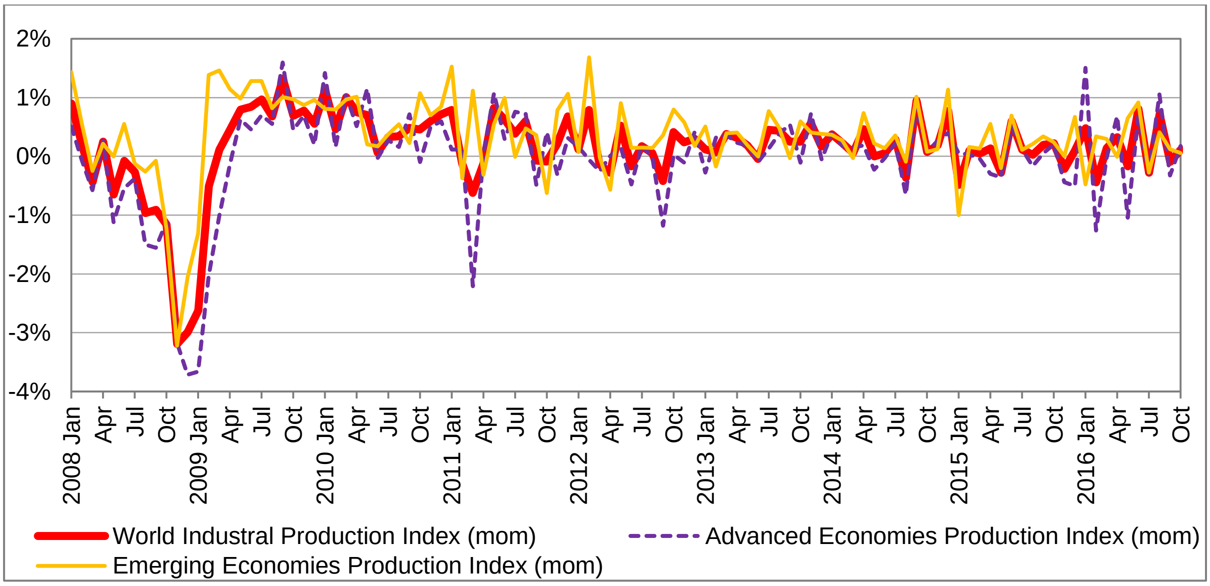
Figure 6: World exports volume remains volatile



Source: CPB Netherlands Bureau for Economic Policy Analysis

5) **World industrial production** also exhibited uneven pace in tandem with volatile trends in world trade volume. It increased by 0.1% mom in October (-0.1% in September and +0.7% in August respectively). The increase in industrial production was due to a 0.2% rise in advanced economies (-0.3% in September and +1.3% in August respectively). Emerging economies grew marginally by 0.1%, the same rate as in September (+0.4% in August), mainly thanks to Africa and Middle East region (+1.0%) while industrial output of Latin America contracted (-0.7%). On a quarterly comparison, world industrial production up 0.5% in 3Q16, a marginal improvement from 0.3% in 2Q.

Figure 7: World industrial production remains uneven



Source: CPB Netherlands Bureau for Economic Policy Analysis

6) **Global semiconductor sales** extended its expansion trail for the seventh consecutive month, underscoring its stability track. Sales rose 2.0% mom to US$31.0 billion in November (3.4% in October and 4.3% in September respectively). Regionally, sales were up across all regional markets: the US (3.3%), China (2.7%), Europe (2.5%), and Asia Pacific/All Other (0.7%), and Japan (0.4%).

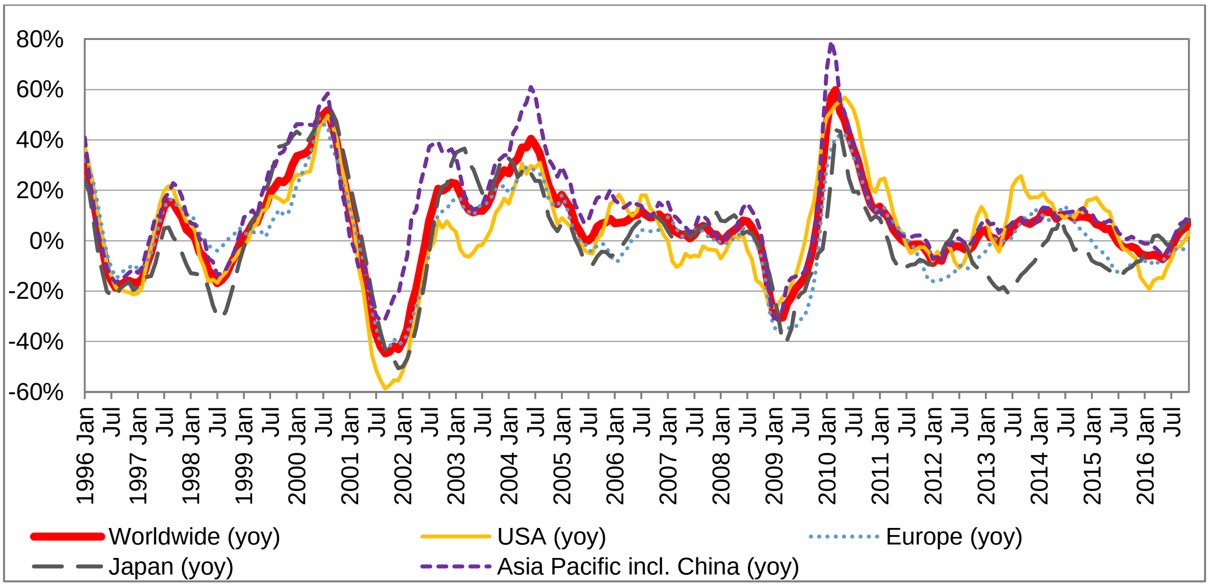
   On an annual basis, total sales rose higher by 7.4% yoy in November (5.0% in October and 3.6% in September respectively), with sales rising in China (15.8%), Japan (8.2%), Asia Pacific/All Other (4.8%), and the US (3.2%) while Europe sales declined by 1.6%.

   Global sales of semiconductors of US$84.8 billion in the third quarter of 2016 mark the industry's highest quarterly sales compared to two preceding quarters, an increase of 8.2% qoq, bringing a total of US$242.2 billion for three quarters. However, sales still lag 2015's same period total of US$251.8 billion.

   Despite the strong sales registered in recent months supported by NAND flash and microprocessors, the overall industry outlook remains moderate due to uneven pace of global demand especially from some advanced economies.

   The World Semiconductor Trade Statistics (WSTS) revised lower the rate of decline in worldwide semiconductor sales (-0.1% to US$335.0 billion in 2016 from -3.2% previously). For 2017, it forecasts a 3.3% growth globally to US$346.1 billion and 2.3% growth to US$354.0 billion for 2018.

Figure 8: Annual sales of semiconductor rose four months in a row



Source: Semiconductor Industry Association (SIA)

7) **Global oil prices**, as benchmarked by Brent crude continued to move in a volatile mode, subjecting to news flow about the supply and demand conditions in the oil market as well as sporadic incidents of supply disruptions.

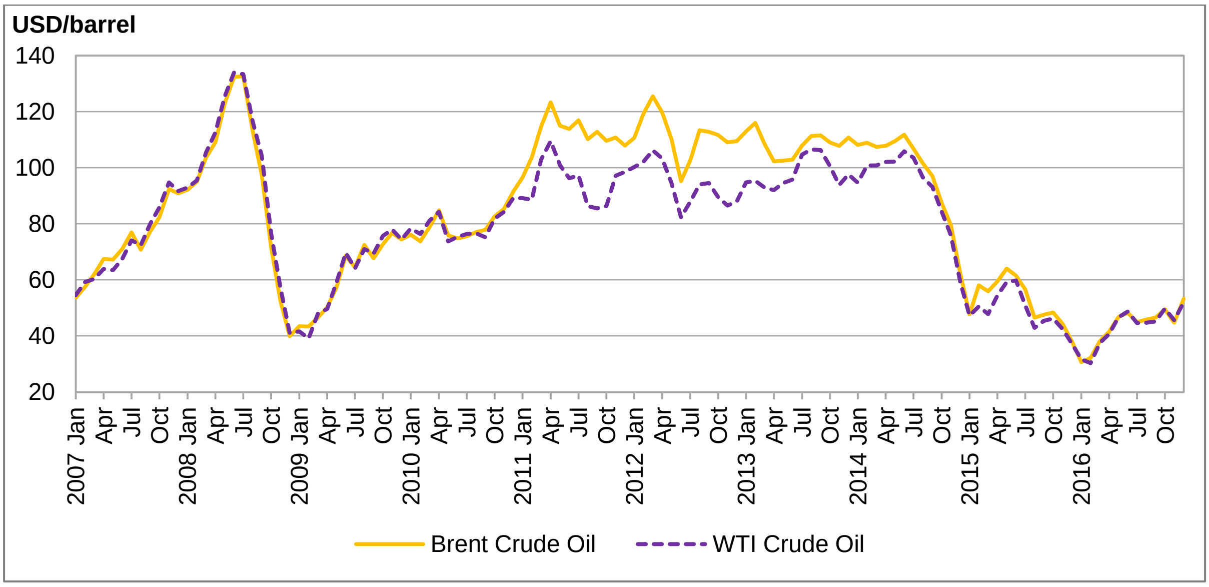
   After months of fruitless attempts to prop up the oil market, all 14 members of the Organization of the Petroleum Exporting Countries (OPEC) have finally reached a consensus on production cuts next year by about 4.5% or 1.2 million barrels from 33.8 million barrels a day (b/d) to 32.5 million b/d in an effort to prop up prices. It will be the first cut in eight years. OPEC has won the backing of non-OPEC countries to join supply cuts for the first time since 2001, with Russia (the biggest oil exporter) together with 10 other countries such as Mexico, Oman and Azerbaijan agreeing to reduce their production by 558,000 barrels a day.

The oil production cuts deal sent Brent crude prices rallied by around 19% since 30 November to US$53.29 a barrel on 30 December amid volatile oil futures. Brent crude futures for January delivery settled at US$50.47 per barrel while February delivery settled at US$56.82 per barrel.

Oil prices will continue to strengthen on the oil output cuts deal, but sharp gains will be limited as market scepticism lingers about how closely the production caps will be adhered to. Kuwait, Venezuela and Algeria have agreed to monitor compliance with the OPEC agreement.

As long as both Opec and non-Opec players adhere to the production cuts, coupled with a moderate rise in the US oil supplies not to exploit higher prices, the rebalancing of global oil market should continue into 2017. In its latest oil market report, the International Energy Agency (IEA) expects global oil demand growth to slow to just 1.3 mb/d in 2017, down from 1.4 mb/d this year and 1.9 mb/d in 2015. Brent crude oil prices are estimated to be around US$55-60 per barrel in 2017-18.

Figure 9: Brent crude oil price likely to move higher on OPEC's output cuts



Source: US Energy Information Administration

US – GATHERING MOMENTUM

After a lacklustre in 1H16, the US economy picked up momentum to an annual rate of 3.5% qoq in 3Q from 1.4% in 2Q, backed by a further expansion of consumer spending though it grew at a slower pace of 3.0% compared to 4.3% in 2Q. A build-up of business inventories and a one-time jump in exports due to better soybean shipments that helped to shrink the trade deficit also aided the third quarter GDP growth higher.

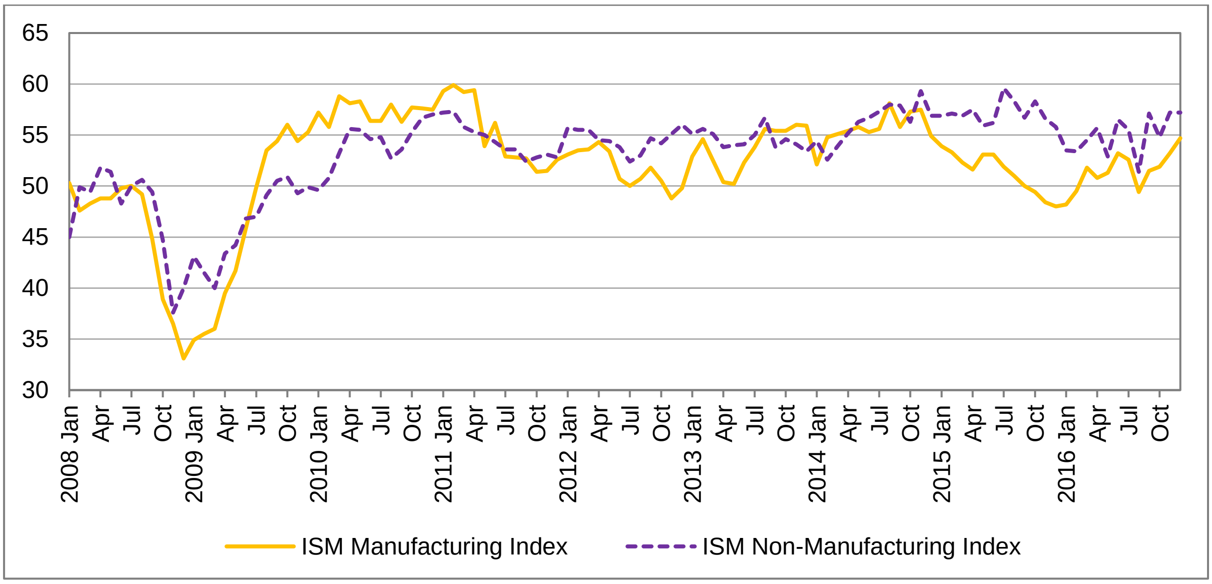
Business investment still sluggish, only managed to grow by 0.1% in 3Q (-1.1% in 2Q), dragged down by a 4.1% drop in residential investment and business spending on equipment also fell 4.5%, the fourth straight quarterly decline.

The 2017 growth outlook should stay on the expansion track, growing by 2.0%, underpinned by consumer spending, a moderate recovery in investment and the trickle-effects from the fiscal stimulus. That said, this remains subject to the as of yet uncertain evolution of economic policy under the Trump Administration.

Industrial production dipped 0.4% mom in November (+0.1% in October and -0.2% in September respectively), dragged by a marginal drop of 0.1% in manufacturing output (+0.3% in October) amid continued increase in mining (+1.1% vs. +1.9% in October). The utilities sector contracted by a larger magnitude of 4.4% in November (-2.8% in October) as warmer-than-normal temperatures reduced the demand for heating.

A gauge of U.S. factory activity surged higher in November, a sign the manufacturing sector could be stabilizing after staying above the 50-point expansion mark for four months in a row after slipping below 50 in August. The Institute for Supply Management (ISM) of manufacturing rose to 54.7 in December (53.2 in November and 51.9 in October respectively), indicating that manufacturing activity is growing fast, thanks to increases in employment, production and new orders. The ISM for services sector index maintained at 57.2, the fastest pace of the year in December (57.2 in November and 54.8 in October respectively).

Figure 10: December ISM manufacturing index rose to 2-year high

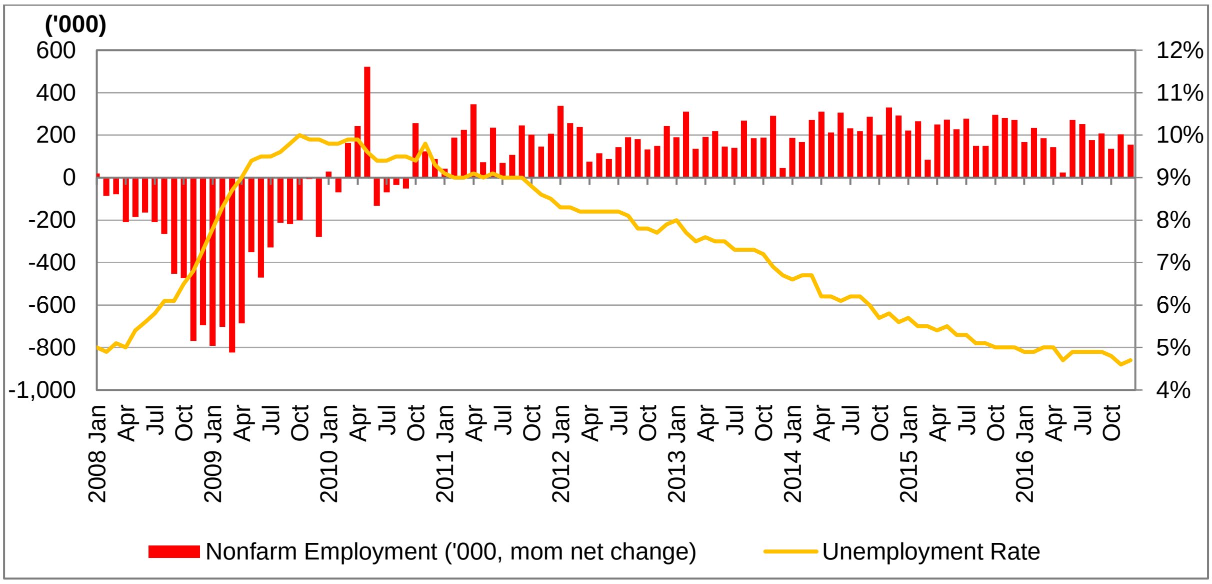


Source: Institute for Supply Management

Retail sales barely rose in November (+0.1% mom vs. +0.6% in October) as households cut back on purchases of motor vehicles, suggesting some loss of momentum in economic growth in the fourth quarter. On an annual basis, sales were up 5.3% yoy in November (2.0% in October and 4.1% in September respectively). Sales at non-store retailers, a category that includes internet merchants were up 15.3% yoy in November (9.7% in October and 11.8% in September respectively), suggesting online sellers are grabbing a bigger share of holiday sales.

Job growth continues. In December, total nonfarm payroll employment increased by 156,000 (204,000 in November and 135,000 in October respectively). Employment gains occurred in healthcare and social assistance. For the full-year of 2016, employment growth has averaged 180,000 per month, compared with an average monthly increase of 229,000 in 2015. The unemployment rate ticked up to 4.7% in December (4.6% in November and 4.8% in October respectively). Average hourly earnings for private non-farm sector workers rose 2.9% in 2016.

Figure 11: Job creation continues



Source: US Bureau of Labor Statistics

EUROZONE – MODERATE RECOVERY CONTINUES

Defying the Brexit's aftershocks, the eurozone's modest growth trajectory continued in the third quarter (0.3% qoq vs. 0.3% in 2Q), underpinned by solid domestic demand amid still subdued external demand. The stable unemployment rate of 9.8% in November and negative interest rates helped to support consumer spending. GDP growth slowed in most countries, including Germany and Spain but picked up in France and Italy.

High frequency data for the fourth quarter suggests that growth in the eurozone should continue to grow at moderate pace amid lingering unresolved issues associated with Brexit amid heightened market volatility following the US Presidential elections. Going into 2017, with national elections set for France, Germany and the Netherlands, there are potential economically and politically instability given the strong influences of left-wing parties.

Business activity in the euro area has picked up momentum as the Eurozone Composite Purchasing Managers' Index (PMI) rose from 53.9 in November to 54.4 in December. The upbeat reading was supported by stronger activity in both manufacturing and services sectors. Growth of incoming new orders was the fastest since December 2015 while work-in-hand rose in the nineteenth month running in December.

The industrial sector grew strongly. Industrial production rose 1.5% mom in November (0.1% in October and -0.8% in September respectively). The increase was attributed to the production of non-durable consumer goods (+2.9%) and intermediate goods (+1.6%). On an annual basis, industrial production also grew sharply by 3.2% yoy in November from 0.8% in October and 1.4% in September.

The PMI for manufacturing increased to 54.9 in December from 53.7 in November (53.5 in October), the highest reading since April of 2011 amid intensified price pressures.

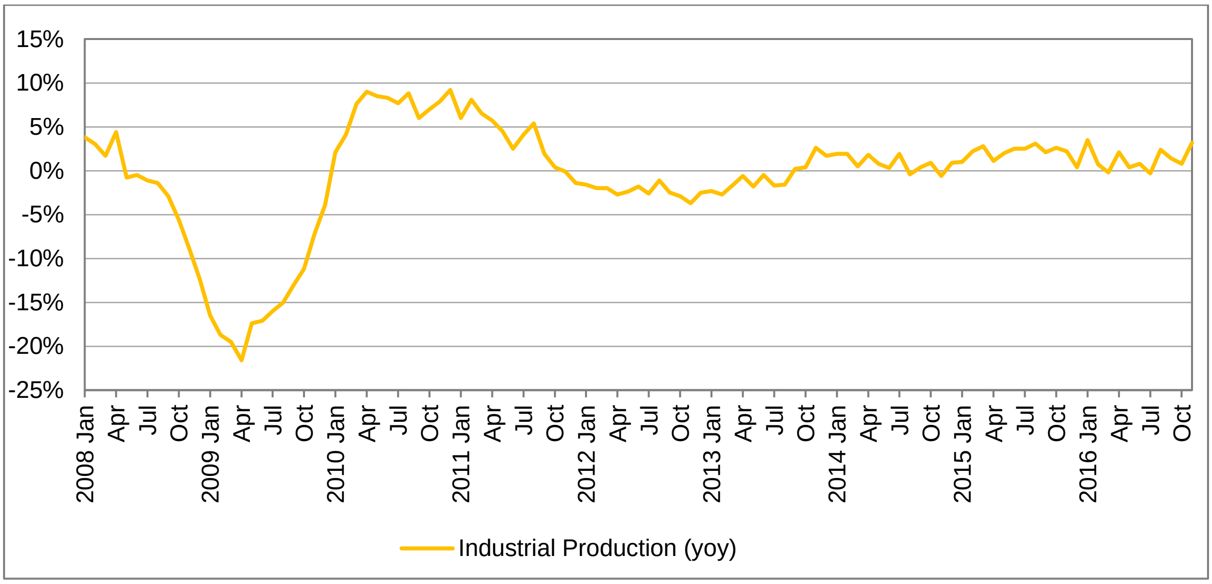
The PMI for services moderated to 53.7 in December of 2016 from 53.8 in November (52.8 in October), supported by the solid inflows of new orders and rising backlogs of work.

Though inflation has picked up in recent months, this would not be enough to convince the ECB to slow the pace of its asset purchases yet. Consumer prices are estimated to edge higher to 1.1% yoy in December 2016 (0.6% in November and 0.5% in October respectively), the highest inflation rate since October 2013. The rise was attributed to higher cost of energy.

However, excluding the most volatile prices for unprocessed food and energy, core inflation was 1.0% yoy, a five-month high rate.

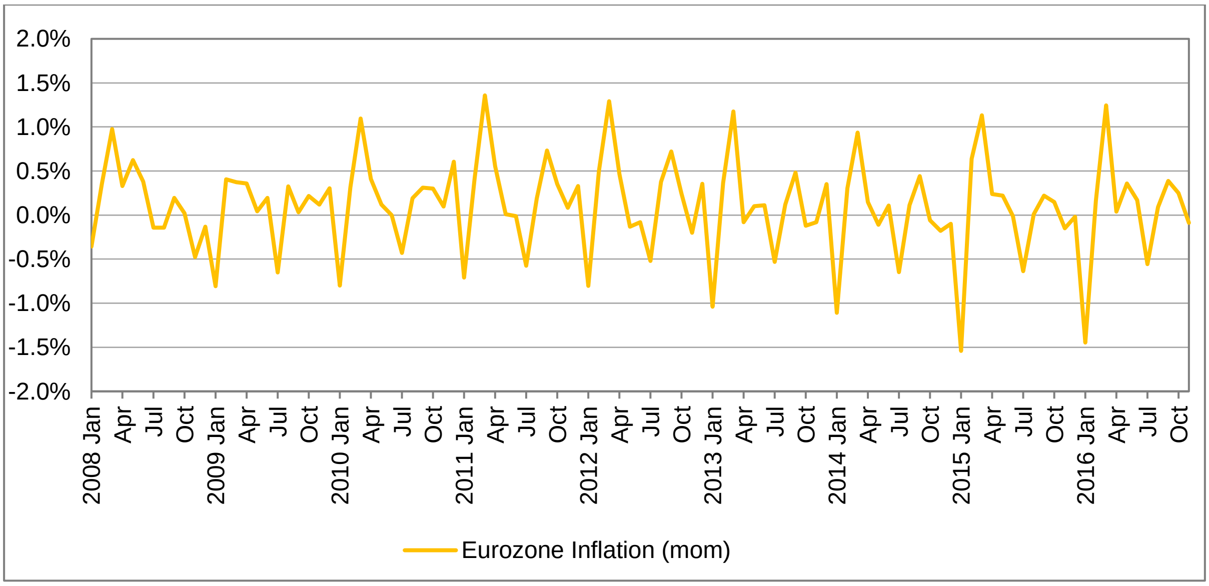
The ECB anchors core inflation when formulating its monetary policy. The central bank wants a higher rate of overall inflation close to 2% over the medium term. It has been buying euro zone government bonds to inject cash into the banking system and make banks lend to the real economy to boost spending and fight deflation. After the monetary policy meeting on 9 December, the bank announced that it will shrink its bond buying program from the current €80 billion worth of bonds monthly to €60 billion every month starting in April 2017. The recalibration of bonds buying programme reflects the moderate but firming recovery of the euro area economy and still subdued underlying inflationary pressures.

Figure 12: Sluggish industrial production



Source: Eurostat

Figure 13: Inflation picked up in recent months



Source: Eurostat

JAPAN- PATCHY RECOVERY

Despite a sustained appreciation of the yen, the Japanese economy moderated slightly in 3Q16 (+1.3% qoq vs. +1.8% in 2Q), led by the external sector while domestic demand remained weak. This raises concerns about the sustainability of the economic recovery ahead. On an annual basis, real GDP increased 1.1% yoy in 3Q, a moderate improvement from 0.9% in 2Q.

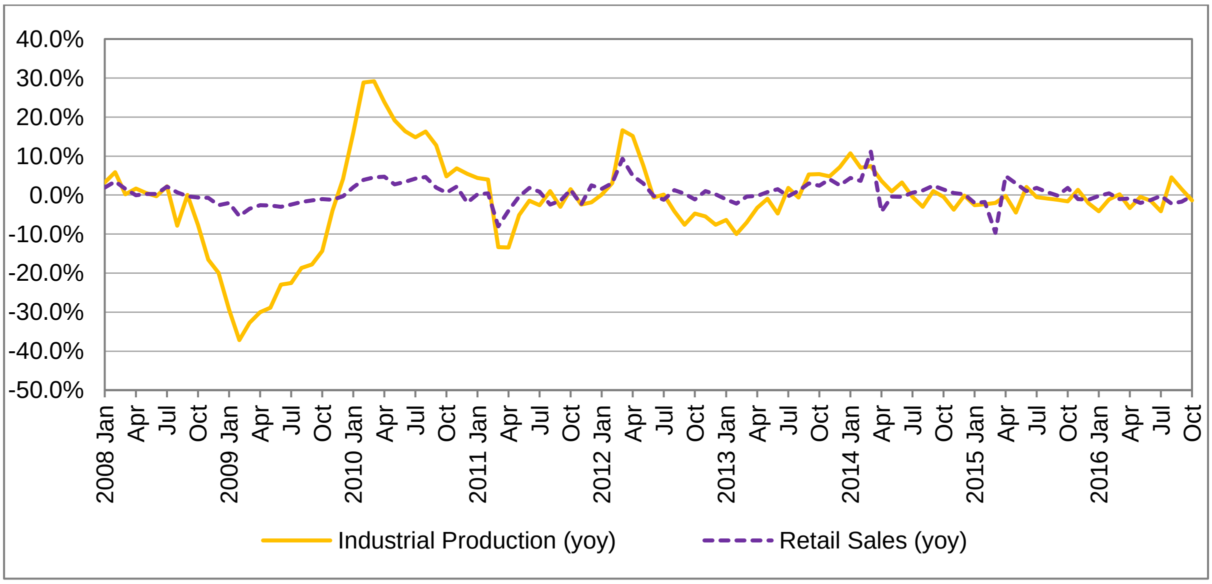
Private consumption growth grew marginally by 0.3% qoq in 3Q (+0.2% in 2Q), constrained by weak wage growth and bad weather. The government's fiscal stimulus led to higher public spending (+1.7% in 3Q), a turnaround from a contraction of 1.3% in 2Q. Business investment was weighed down by concerns about the global outlook and a prolonged strong yen, which saw gross fixed capital formation slowed from a 4.4% increase in 2Q to a 0.8% expansion in 3Q.

The growth traction in 3Q provides some respite to the policy makers that the ultra-expansionary monetary measures and fiscal stimulus have worked slowly to stem the risk of falling into stagnation. However, uncertainties and downside risks to growth remain as domestic demand still growing unevenly and Donald Trump's victory is raising fears of trade protectionism.

The Nikkei Flash Manufacturing Purchasing Managers' Index (PMI) fell from October's 51.4 to 51.1 in November though the index remains above the 50-threshold that separates expansion from contraction in the manufacturing sector. While growth in output, new orders and employment were weaker, growth in new export orders was robust in November. The PMI for services jumped to 51.8 in November from 50.5 in October (48.2 in September), marking the highest reading since January this year.

Japan's October core machinery orders rose for the first time in three months to beat expectations, a tentative sign of a pickup in capital expenditure. It rose 4.1% mom in October after contracting 3.3% in September and 2.2% in August respectively. The rise was underpinned by a 6.4% rise in orders for non-manufacturing rose while those for manufacturing dropped 1.4%. Annually, core orders fell 5.6% yoy in October after growing 4.3% in September.

Figure 14: Industrial output increases while retail sales decline in October



Source: Ministry of Economy, Trade and Industry, Japan

Industrial output rose for a third consecutive month in October by 1.0% mom (+0.6% in September and +1.3% in August respectively). Industries that had increased production were electronic parts and devices, fabricated metals and transport equipment. Industries that had decreased production were general-purpose, production, business-oriented machinery, electrical machinery and chemicals. On an annual basis, production fell 1.3% yoy in October (+0.9% yoy in September and +4.5% in August respectively). The outlook for production remains positive as the manufacturers expect to expand output by 1.1% in October and 2.1% in November though the actual outturn may be slower than expectations. Retail sales fell marginally by 0.1% yoy in October (-1.7% in September) for the eighth straight month of contraction. However, it rose 2.5% mom in October.

The Bank of Japan (BoJ) expects the economy to expand between 0.8% and 1.0% in fiscal year 2016, which ends in March 2017. In the subsequent fiscal year, the BoJ sees GDP growth of between 1.0% and 1.5%.

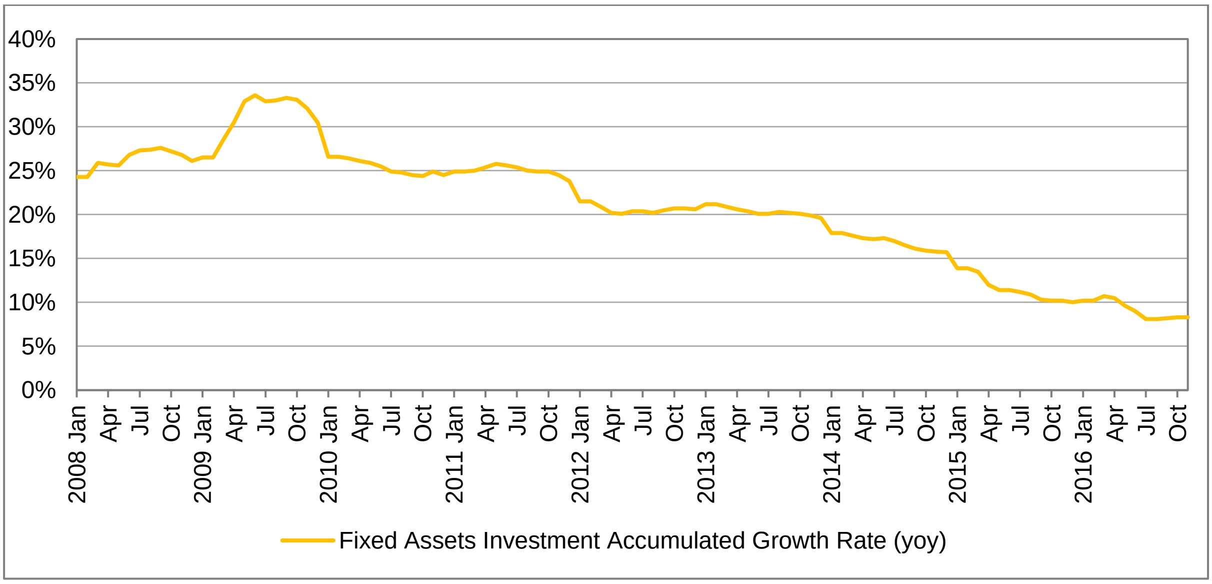
Core inflation rate declined 0.4% yoy in October (-0.5% in September) for the eighth straight month since March this year, illustrating the sheer scale of the Bank of Japan (BOJ)'s struggle to beat deflation and stagnant growth with diminishing policy options.

With a moderate economic recovery and tentative firming of consumer spending, pressures are piling on the policy makers to do more to stimulate the economy. With three years of aggressive monetary easing failed to accelerate inflation to BOJ's 2% target, a strong dose of fiscal stimulus package is needed though its effectiveness is limited by high debt.

CHINA – GROWTH STABILISATION REMAINS ON TRACK

The Chinese economy continues to stabilise within the government's target of 6.5-7.0%. The third quarter GDP growth expanded 6.7% yoy, the same rate in 1Q and 2Q16. The driving factors underpinning the growth were resilient consumer spending amid some recovery in investment.

Figure 15: Fixed investment growth remains moderate



Source: National Bureau of Statistics of China

The data flows show continued steady growth in the fourth quarter. 1) Industrial production edged higher to 6.2% yoy in November after remaining unchanged at 6.1% in September and October respectively. The gain was supported by higher output in manufacturing (6.7%) and electricity, gas and water production (9.9%). Meanwhile, mining production fell 2.9%; 2) retail sales gained growth traction (10.8% yoy in November vs. 10.0% in October) on higher sales across-the-board such as communication equipment, home appliances, automobiles and personal care; and 3) Fixed-asset investment grew by 8.3% in the period January to November, the same pace as in the first ten month. Investment by private firms, which accounted for about 60% of total investment increased at a faster rate of 3.1% yoy (2.9% in January-October) while that of public sector firms grew by 20.2% over the same period.

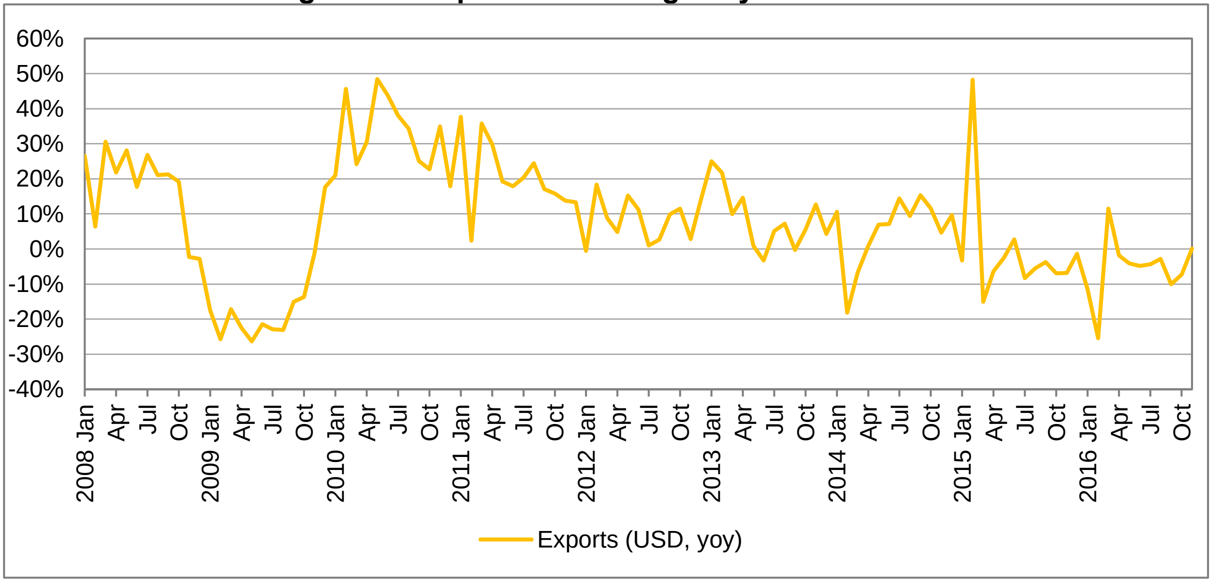
December's official manufacturing PMI reading of 51.4 marked the second highest reading in the year (51.7 in November and 51.2 in October respectively), backed by higher new orders and production. As for services, the PMI reading moderated slightly to 54.5 in December from 54.7 in November (54.0 in October).

November's new home prices rose 0.6% mom in the nation's 70 major cities, slowing from October's 1.0%. But yoy price growth was at a record 10.5%, higher than 10.1% in October, highlighting why regulators are keen to implement further curbs to clamp down on asset price bubbles even at the expense of slowing the property sector.

Chinese exports defied expectations to rise 0.1% yoy in November, reversing a decline of 7.3% in October. This marks the first positive growth after seven months of contraction. Imports grew at the fastest pace since September 2014, rising 6.7% yoy (-1.4% in October), reflecting a recent pick-up in the price of industrial commodities that likely pushed up import values. Despite the rebound in November, exports still declined 7.9% yoy in the first eleven months of the year while imports also contracted 6.5%.

Going forward, China's exports are expected to remain uneven due to a small improvement in global growth. There are also lingering concerns about the trade relations between China and US as the Trump Administration has vowed to get tough on trade with China.

Figure 16: Exports rose marginally in November



Source: National Bureau of Statistics of China

Looking ahead, we expect China's economic rebalancing to continue at a similar gradual pace in 2017-18, with GDP growth estimated at 6.5-6.6%. China's embracement of monetary and fiscal stimulus measures had caused the country's outstanding debt to balloon to almost 250% of GDP, with corporate debt forming the largest share of China's total debt, which is about 165% of GDP.

China's monetary policy setting will maintain a "prudent and neutral" stance in 2017 considering risks from exchange rate volatility, rising inflation, the stock market and the property market while vowing to keep the economy on a path of stable and healthy growth.

The policy makers, including People's Bank of China would face challenges to contain asset bubbles, restructure and reduce corporate debt levels as well as continue to stabilise growth in a more sustainable pace. The State Council has announced a multi-pronged guideline to reduce company debt, including encouraging mergers and acquisitions, bankruptcies, debt-to-equity swaps and debt securitization.

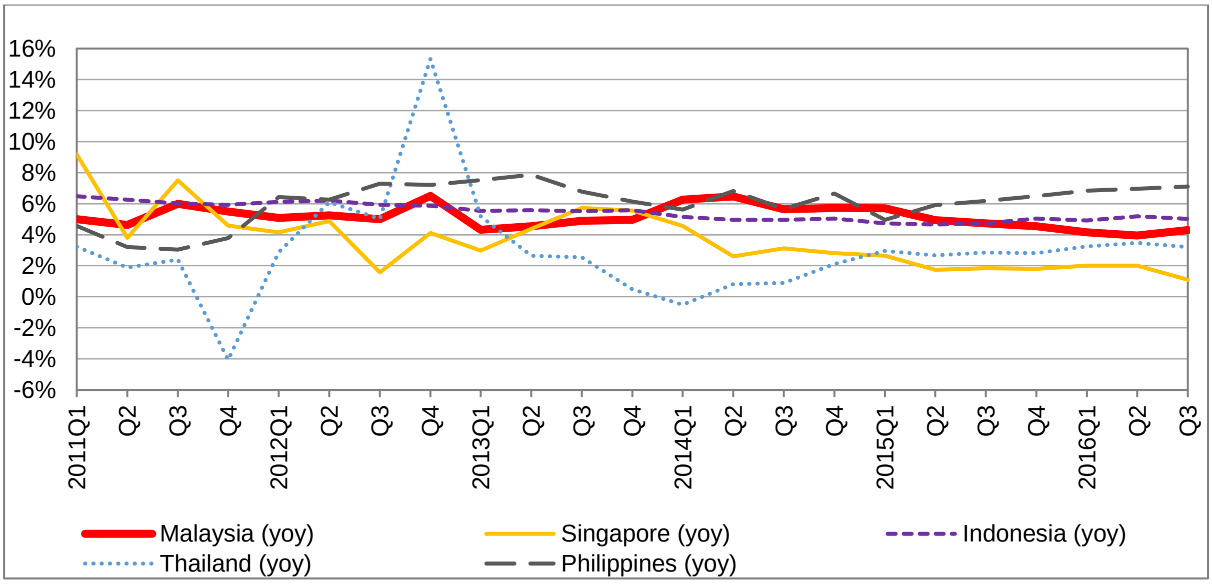
There remain uncertainties as to what extent President Donald Trump will implement his anti-trade measures against China (such as to enact 45% tariff on all Chinses products) and his labelling of China as a currency manipulator would hamper trade between the two world largest economies. Though political and economic realities will undoubtedly keep Trump from fully fulfilling his election campaign pledge, even targeted tariffs on specific goods could do real damage to China's economy.

ASEAN-5 ECONOMIES' KEY ECONOMIC DATA TRACKER

Broadly, ASEAN-5 economies' (Malaysia, Singapore, Indonesia, Thailand and Philippines) high frequency indicators still pointing to moderate growth for exports and industrial production. With the exception of Singapore and Malaysia, real GDP growth eased in Philippines, Indonesia and Thailand.

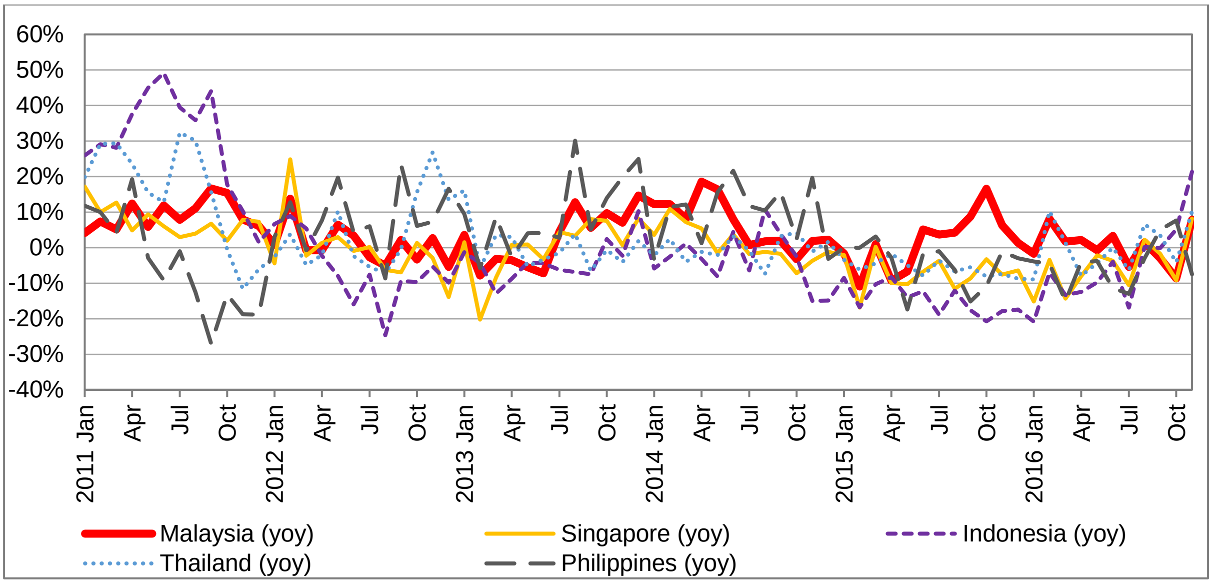
The spiked in the US Treasury yields coupled with expectations that Trump's expansionary fiscal will lift inflation and hence, may lead to higher US interest rates ahead have pressurised regional currencies against the US dollar.

Figure 17: Real GDP growth trend



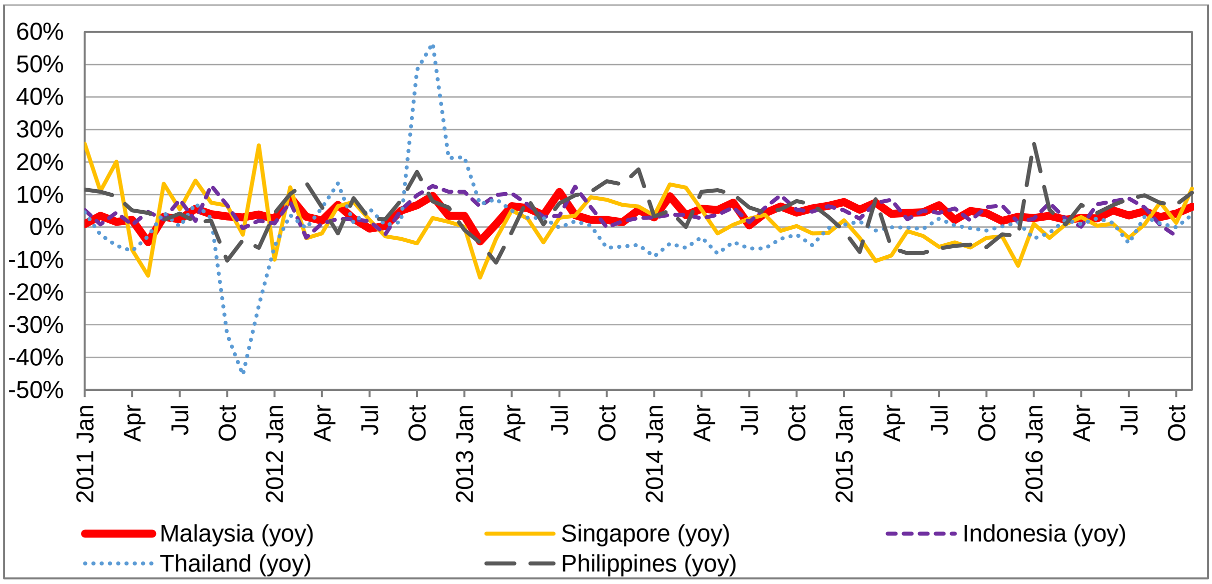
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; National Economic and Social Development Board, Thailand; Philippine Statistics Authority

Figure 18: Export growth trend



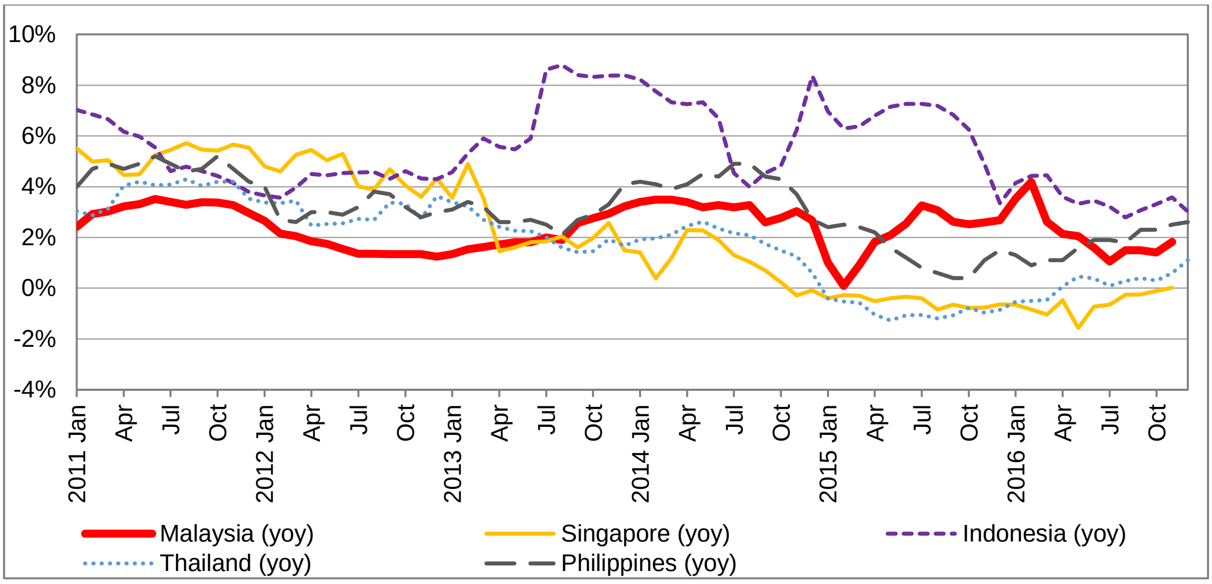
Source: Department of Statistics, Malaysia; Singapore Department of Statistics; Statistics Indonesia; Bank of Thailand; Philippine Statistics Authority

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

Monetary policy divergence should continue into 2017, with investors eyeing on the Fed's forward guidance, which has committed itself to raising rates gradually to achieve the dual mandates of employment and prices. What could derail the Fed's commitment is the risk of inflation associated with President Trump's expansionary fiscal stimulus to cut tax rates and infrastructure spending. If the inflationary expectations accelerate and economy strengthens, 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 75 bps to 1.25-1.50% by end-2017 (0.50-0.75% at end-2016).

Both the European Central Bank (ECB) and Bank of Japan (BoJ) should continue to keep their accommodative monetary policies for a longer while as current economic conditions and inflation trajectory are not convinced enough for these two central banks to abandon the highly accommodative monetary conditions to secure firmer economic recovery. While the ECB will reduce its monthly bond purchases to 60 billion euros from 80 billion euros starting in April, the program will run until at least December 2017, longer than market expectations. It also lifted the restriction of buying bonds yielding less than the deposit rate and reduced the lower-maturity bound to one year from two years, making a raft of new securities eligible for the central bank's asset-purchase program.

In Asia, Reserve Bank of India and Bank Indonesia cut their respective policy rate by 25 bps to 6.25% and 4.75% respectively during the last quarter of 2016.

For the year 2016, monetary divergence continues with the US Fed ending the year with a 25 bps hike while most central banks in Asia eased their interest rates with the exception of Thailand and China.

Central banks in regional economies are expected to maintain cautious monetary stance with growth outweighing inflation risk amid facing downward pressure on their currencies. International investors sold more than US$12 billion of equities and bonds in Asia's emerging markets after Trump's thumping victory in the U.S. presidential elections, which spurred higher Treasury yields and a dollar rally on expectations of his reflationary fiscal plan could spur inflation and hence, will drive US interest rates higher.

With Asian currencies dropping to the weakest this decade, this will probably deter regional central banks from easing monetary policies as the prospects of higher U.S. rates spurred capital outflows due to a compressed yields differential.

As such, most regional central banks will probably have to stay on hold for quite some time while waiting to assess the impact of the negative spillovers from a strong dollar and prospects of higher US interest rates.

Figure 21: Policy rate estimates (%)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	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	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
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
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	4.60
India, RBI Policy Repo Rate	6.50	4.75	6.25	8.50	8.00	7.75	8.00	6.75	6.25	6.00
Korea, BOK Base Rate	3.00	2.00	2.50	3.25	2.75	2.50	2.00	1.50	1.25	1.25
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
Indonesia, BI 7-Day Reverse Repo Rate	9.25	6.50	6.50	6.50	5.75	7.50	7.75	7.50	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
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

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 STILL TRACKING MODERATE GROWTH

On track to meet 2016's GDP growth target of 4.0-4.5%. The Malaysian economy improved to expand by 4.3% yoy in 3Q16 from 4.0% in 2Q (4.1% in 1Q), marking the end of moderation for five consecutive quarters since 2Q15. Economic growth averaged 4.2% in Jan-Sep 2016 and remains on track to meet our full year estimates of 4.2% as well as the official target of 4.0-4.5%.

Domestic demand remains the key driver. While domestic demand continues to steer overall GDP growth, but its pace was slower (4.7% in 3Q vs. 6.3% in 2Q), reflecting lower public spending and moderated private investment.

No let-up in consumer spending. Consumer spending held its resilience to rise by 6.4% in 3Q (6.3% in 2Q), underpinned by higher minimum wages; civil servants' pay hike and the final payment of BR1M cash handouts. Private investment growth still exhibiting uneven trend as it eased to 4.7% in 3Q from 5.6% in 2Q, dragged by a sharp pullback in capital spending on machinery and equipment (0.9% in 3Q vs. 8.1% in 2Q) and other assets (-12.5% in 3Q vs. +0.8% in 2Q) while spending on structures was sustained at 5.0% in 3Q (5.9% in 2Q), backed by infrastructure development projects.

Most economic sectors registered higher growth. Both the services and manufacturing sectors continued to deliver better performance. The services sector expanded higher to 6.1% in 3Q (5.7% in 2Q), backed by resilient consumer spending. Higher growth was recorded in wholesale trade (8.9%), retail trade (7.5%), restaurants (8.2%), accommodation (4.9%), real estate and business services (7.0%), other services (5.1%), and government services (5.5%). Growth in the manufacturing sector edged to 4.2% (4.1% in 2Q), thanks to the export-oriented industries. The construction sector sustained a robust pace of 7.9% in 3Q (8.8% in 2Q), attributable to the on-going implementation of public infrastructure projects. Higher crude oil production helped to lift the mining output growth to 3.6% in 3Q from 2.6% in 2Q. The agriculture sector contracted at a smaller magnitude of 5.9% in 3Q compared to -7.9% in 2Q on improved CPO output.

Sustained positive GDP outlook amid external risks. In the face of heightening external uncertainty and near-term pressure, we maintain our full year GDP growth estimates of 4.3% in 2017 (estimated 4.2% in 2016) and 4.6% for 2018 vs. an average growth of 5.3% in 2011-15.

Domestic demand still calling the shots. We remain cautious about the strength of private consumption on weak consumer sentiment and the spillover effects of weak ringgit, on-going subsidy rationalisation amid moderate income growth as well as worries about the job security. Private consumption growth is estimated at 5.3% in 2017 (estimated 5.9% in 2016).

Private investment growth continues. The strong dollar spillover-induced financial volatility, uncertainty associated with Trump's reflationary policies coupled with the sharp volatility of ringgit and rising cost pressures would pose challenges to private investment in varying degrees. Some may take a cautious investment approach by considering global and domestic economic environment as well as financial condition. The on-going implementation of public infrastructure projects and investment in manufacturing and services should help private investment to grow by 4.9% in 2017 compared to estimated 4.2% in 2016.

Bracing exchange rate adjustments. The weak ringgit will continue to induce adjustments by both consumers and businesses. Some form of trade-offs and substitutions occur arising from the ringgit's depreciation. Consumers will have to pay costlier imported goods, spend more on travelling abroad and parents have to fork out more on education expenses for sending children studying overseas. High export-orientation industries with low import content (or high local content) will gain more not only from the exchange rate revaluation effect but also cost competitiveness, albeit limited. These include plantation, wood products and rubber products. However, industries with high import content and high domestic sales such as automobiles and metal products will be impacted negatively.

Inflationary expectations set in. Inflation, as measured by the Consumer Price Index (CPI) has generally behaved well, which saw consumer inflation eased from 4.2% in February to 1.8% in November. This was attributed to manageable food prices and lower fuel prices.

Looking ahead, the on-going subsidy rationalisation and the weakening ringgit effect may spur the risk of inflationary pressures and adds to higher cost of living. The transmission from the exchange rate depreciation to inflation occurs through i) direct channel via imported finished goods in the CPI basket, which makes up 7.2% share of the CPI basket; and ii) indirect channel via the usage of imported inputs in the production chain of local goods and services.

Overall, the inflation trajectory will be affected by market-based pricing via subsidy rationalisation, exchange rate's pass-through, commodity prices variation and the firms' pricing-setting behaviour. We estimate inflation to rise by 2.5% in 2017 compared to estimated 2.1% in 2016.

Bank Negara Malaysia faces a dilemma in policy rate-setting. Bank Negara Malaysia's (BNM) monetary policy stance will remain supportive of domestic demand in the face of heightening ringgit volatility. The broad-based nature of the dollar rally is expected to continue into 2017 given the widening short-term rate spreads will support the US dollar versus its major currency peers.

The prospect of higher US interest rates supporting a strong dollar means weaker ringgit ahead. This will place a constrain on further monetary easing as the risk of capital outflows could accelerate and exert more downward pressure on the ringgit.

But, if the GDP growth is seriously under threat slipping below 4%, Bank Negara Malaysia may compel to cut interest rates even at the expense of much weaker ringgit. For now, we expect BNM to keep the overnight policy rate (OPR) status quo at 3.0% for 2017.

Facing challenges in 2017. Amid a moderate global growth outlook and global risk sentiment, Malaysia will face significant challenges in the medium-term, with capital flows fluctuating with the uncertainty about the Fed's interest rate direction is expected to weigh on the ringgit. A prolonged period of financial and exchange rate volatility would dampen consumer sentiment and investor confidence.

How will the Trump's victory impact Malaysia? For Malaysia, the main concern is the fallout of TPPA and its ramifications on our trade growth, especially for gaining a wider market share in the US and Mexico and other TPPA members. Currently, the United States is Malaysia's third largest trading partner, contributing to 9.2% of Malaysia's total trade in the first eleven months for 2016. Of this total, our exports share to the US is 10.3% of total exports and that of imports share is 8.0%.

It is expected that the proposed Regional Comprehensive Economic Partnership (RCEP) between the 10 member states of ASEAN (Malaysia, Brunei, Myanmar, Cambodia, Indonesia, Laos, the Philippines, Singapore, Thailand, Vietnam) and the six states with which ASEAN has existing FTAs (Australia, China, India, Japan, South Korea and New Zealand) would offset any negative impact of the Trans-Pacific Partnership (TPP) not taking off, should the US choose to cancel the deal. The government can consider to explore and initiate FTA with members of TPPA, namely the US, Mexico and Canada to deepen our trade and investment growth.

The US investors still favouring Malaysia though the pace of investment has dwindled. Gross FDI inflows from the US into Malaysia, which averaged RM11.3 billion per year during 2008-2015, have slipped to RM10.8 billion in 9M16 with a share of 10.9% of total gross inflows compared to a high of 17.1% in 2010.

The US portfolio investors generally were net sellers as they recorded net cumulative portfolio outflows totalling RM30.8 billion during the period 2008-2015 and net outflows of RM17.5 billion in 9M16. The prolonged market uncertainty related to the US Presidential election results will risk more capital reversals. It must be noted that as at end-December 2016, foreign investors owned 47.1% or RM168.5 billion of Malaysian Government Securities (Nov: 48.4% or RM173.0 billion; Oct: 51.6% or RM184.6 billion) and RM191.8 billion worth of government bonds or 32.2% of total (Nov: RM198.5 billion or 33.4% of total; Oct: RM218.4 billion or 36.2% of total).

Trump's proposed reduction of corporate tax rate to 15% from 35% currently as well as a one-time tax rate of 10% for repatriated corporate profits would encourage the retention of US investors at home as well as entice the repatriation of US corporations' profits back to the US. This could result in lower reinvestment in Malaysia as well as less investment in domestic equities and bonds.

Figure 22: GDP by Demand Component (% YoY)

Demand Component [% share to GDP in 2017*]	**2014**	**2015**	**2016 Q1**	**2016 Q2**	**2016 Q3**	**2016*e* (MOF)**	**2016*e* (SERC)**	**2017*b* (MOF)**	**2017*f* (SERC)**
Private Consumption [54.2%]	7.0	6.0	5.3	6.3	6.4	6.1	5.9	6.3	5.3
Public Consumption [12.4%]	4.3	4.4	3.8	6.5	3.1	0.2	4.3	0.4	0.9
Private Investment [17.2%]	11.1	6.4	2.2	5.6	4.7	5.3	4.2	5.8	5.2
Public Investment [8.4%]	-4.7	-1.0	-4.5	7.5	-3.8	1.7	-0.3	1.1	2.2
Exports of Goods and Services [69.0%]	5.0	0.6	-0.5	1.0	-1.3	0.7	-0.3	2.5	1.3
Imports of Goods and Services [61.3%]	4.0	1.2	1.3	2.0	-2.3	1.4	0.4	2.6	2.2
Overall GDP	**6.0**	**5.0**	**4.2**	**4.0**	**4.3**	**4.0-4.5**	**4.2**	**4.0-5.0**	**4.3**

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

** % Share to GDP of 2017b from MOF*

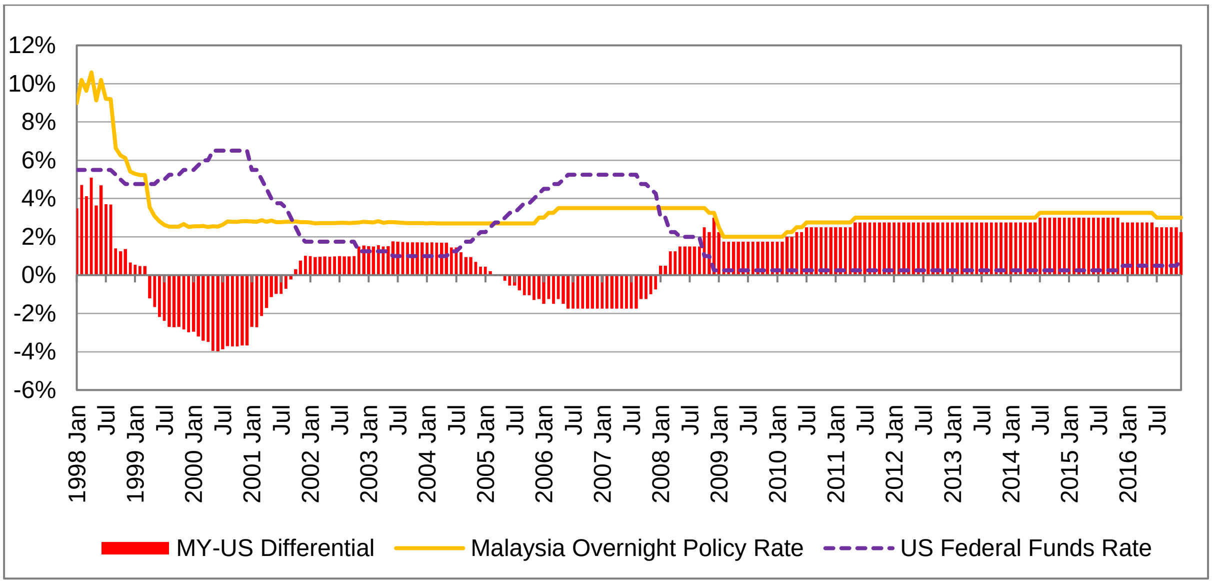
Figure 23: GDP by Economic Sector (% YoY)

Economic Sector [% share to GDP in 2017*]	**2014**	**2015**	**2016 Q1**	**2016 Q2**	**2016 Q3**	**2016*e* (MOF)**	**2016*e* (SERC)**	**2017*b* (MOF)**	**2017*f* (SERC)**
Agriculture [8.0%]	2.1	1.2	-3.8	-7.9	-5.9	-3.3	-5.0	1.5	1.0
Mining & Quarrying [8.4%]	3.5	4.7	0.3	2.6	3.6	1.1	1.8	1.4	2.0
Manufacturing [22.8%]	6.2	4.9	4.5	4.1	4.2	4.0	4.2	4.1	4.2
Construction [4.7%]	11.7	8.2	7.9	8.8	7.9	8.7	8.5	8.3	8.8
Services [54.8%]	6.6	5.1	5.1	5.7	6.1	5.6	5.6	5.7	5.0
Overall GDP	**6.0**	**5.0**	**4.2**	**4.0**	**4.3**	**4.0-4.5**	**4.2**	**4.0-5.0**	**4.3**

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

** % Share to GDP of 2017b from MOF*

Figure 24: Malaysia-US's interest rate differential



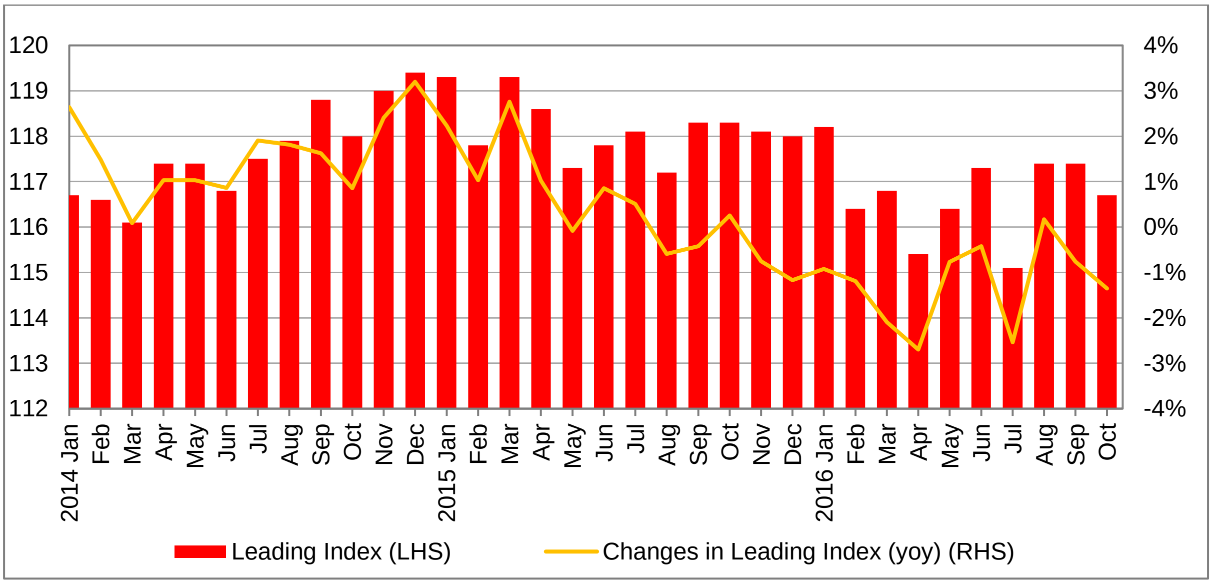
Source: Bank Negara Malaysia and Federal Reserve

REVIEW OF KEY ECONOMIC AND FINANCIAL INDICATORS

The current and lead economic and financial indictors lend credence to our assessment that domestic economic growth will continue to expand at a moderate pace of 4.2-4.3% in 4Q16 (4.3% in 3Q16), bringing the 2016's full-year GDP growth estimate to 4.2%. Nevertheless, the renewed downward pressure on the ringgit, if prolongs is expected to weigh on consumer and investor sentiment. We maintain our estimate of 2017-18's real growth at 4.3-4.6%.

1. The **leading index (LI)**, a gauge of forward growth expectations reversed to decline by 1.4% yoy in October (-0.8% yoy in September) for two months in row after a small rise of 0.2% in August. This goes to show that the Malaysian economy has yet to fully move out from the slower growth trajectory due to external headwinds, which pressurised exports as well as challenging domestic conditions.

Figure 25: Leading index indicates moderate economic growth ahead



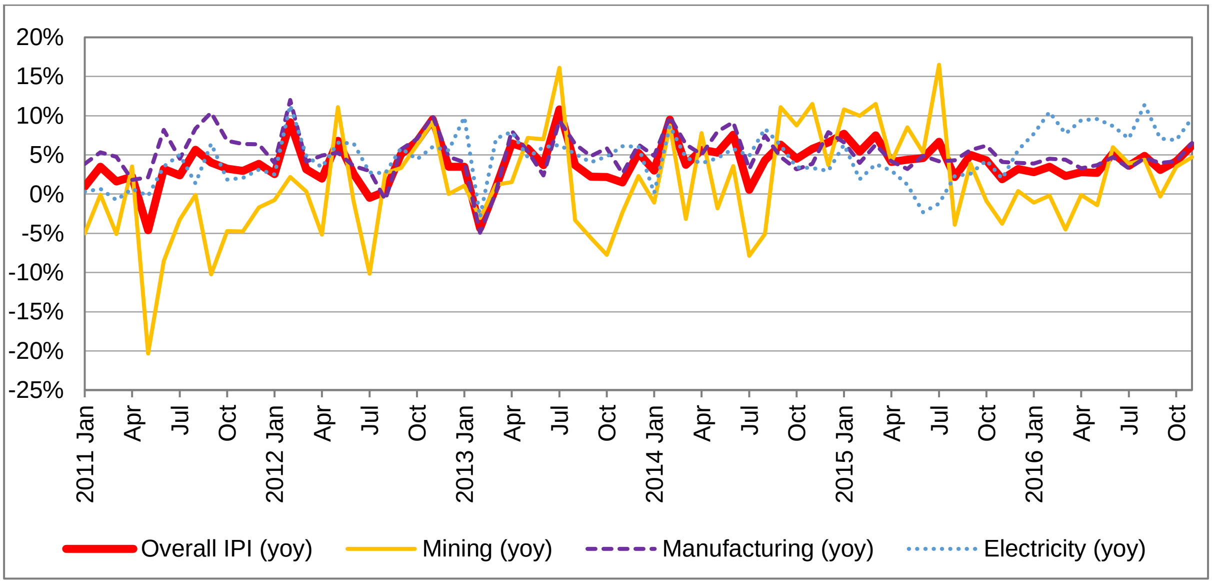
Source: Department of Statistics, Malaysia

2. **Industrial Production Index** (IPI) growth, which captures the output of three major sectors (manufacturing, mining and electricity) rose higher to 6.2% yoy in November (4.2% in October and 3.1% in September respectively). This 16-month high index growth marks a good start to the fourth quarter of 2016. The expansion was driven by improved growth in manufacturing (6.5% vs. 4.2% in October and 4.0% in September), mining output (+4.7% vs. 3.5% in October) and electricity output (9.7% vs. 6.9% in October).

   Within the manufacturing sector, the major subsectors which recorded growth were ppetroleum, chemical, rubber and plastic products (6.1%); electrical and electronic products (8.9%) and food, beverages and tobacco (10.4%). Higher growth in in mining output was solely supported by a 13.2% jump in natural gas production.

   The industrial output is expected to grow by 4.0-4.5% in 2017, underpinned largely by continued expansion in the manufacturing and electricity sectors amid a moderate expansion in mining output.

Figure 26: Industrial production gains traction in November



Source: Department of Statistics, Malaysia

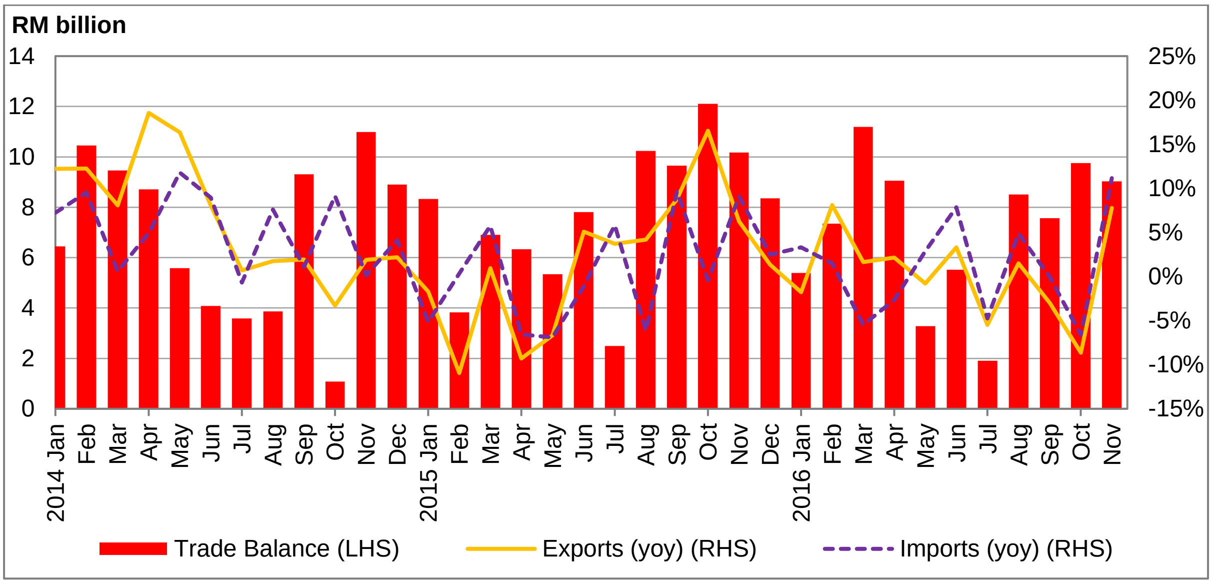
3. The **external sector** remains uneven with exports oscillating between contractions and expansions due to weak global demand, low commodity prices as well as base effects. Exports rebounded by 7.8% yoy from -8.6% in October and -3.0% in September. In Jan-Nov 2016, exports increased by 0.2% over the same period a year ago.

   Sectors that significantly contributed to the export expansion in November were electrical and electronic products (+13.2% to RM26.2 billion; share 35.9%) and palm oil (24.5% to RM6.6 billion; share 6.7%). The drags on overall exports came from liquefied natural gas (LNG), which declined by 21.3% or RM849.6 million) and crude petroleum (-6.1% or RM162.9 million).

   Imports also increased strongly by 11.2% yoy in November after contracting for two months (-6.6% in October and -0.1% in September respectively) due to increases in capital goods (+13.1%), intermediate goods (+11.3%) and consumption goods (+5.4%). In Jan-Nov, total trade balance amounted to RM78.6 billion.

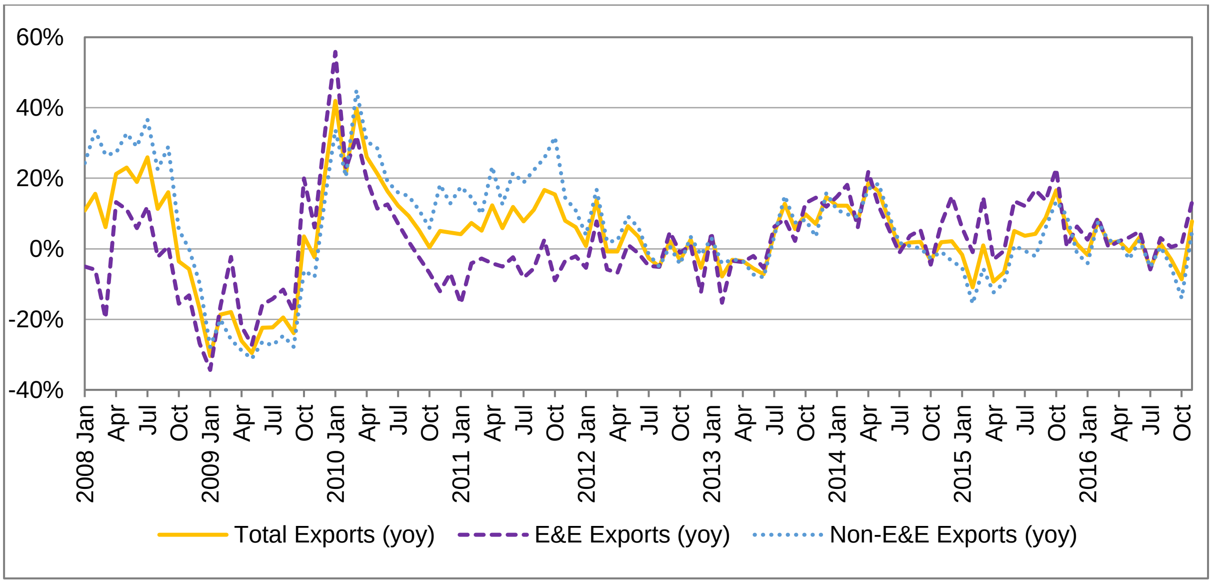
Looking ahead, we remain cautious about the export outlook amid gaining some competitive advantage from a weak ringgit. Exports are estimated to increase by 0.6% in 2016 before rebounding moderately by 1.5-2.0% in 2017. The exports drivers are still not strong enough to lift our export growth higher. i) Growth in advanced economies and large emerging economies remain moderate; ii) a gradual pick-up in global semiconductor sales; and iii) moderate commodity prices amid a pick-up in crude oil prices.

Figure 27: Uneven exports



Source: Department of Statistics, Malaysia

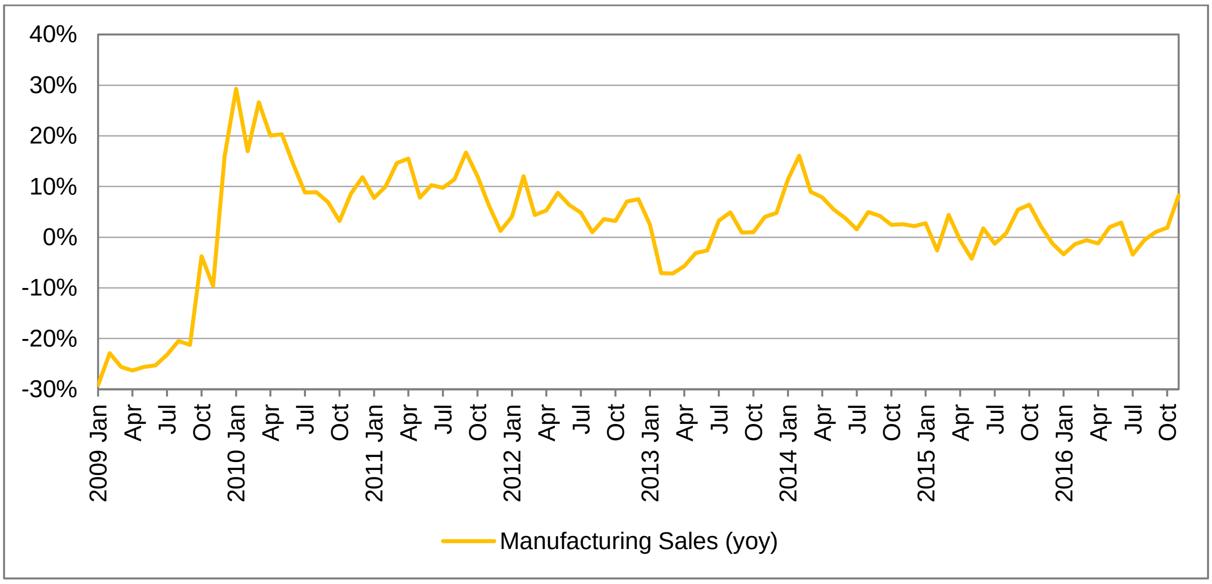
Figure 28: Improved exports of electrical and electronic products



Source: Department of Statistics, Malaysia

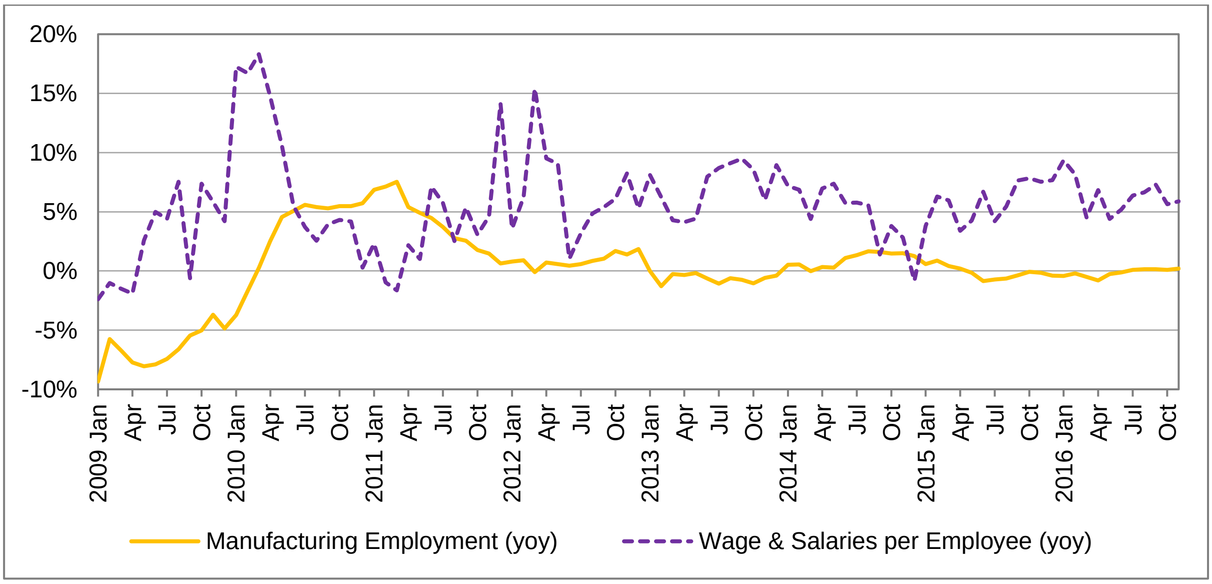
4. **Manufacturing sales** rose significantly by 8.2% yoy to RM60.1 billion in November (+1.9% in October and +1.1% in September respectively) for three consecutive months, supported by higher demand for electrical and electronic products, refined petroleum products, passenger cars and commercial vehicles and chemical products. As at end-November, manufacturing employment growth rose for the fifth consecutive month by 0.2% yoy to 1.03 million persons (0.1% in October and 0.2% in September respectively) after registering 14 successive months of decline since May 2015. Total salaries and wages paid per employee grew at 5.9% yoy in November compared to 5.6% in October and 7.3% in September respectively.

Figure 29: Manufacturing sales rose for three straight months in November



Source: Department of Statistics, Malaysia

Figure 30: Growing manufacturing employment growth



Source: Department of Statistics, Malaysia

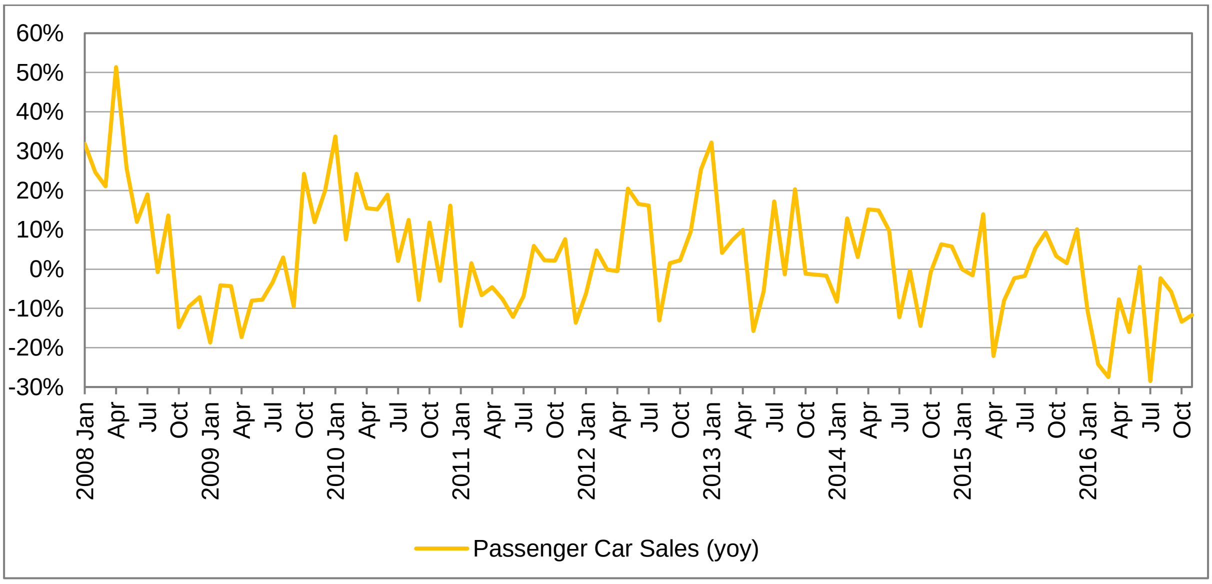
5. **Private consumption indicators** suggest cautious discretionary spending on weak sentiment and growing worries about prices and high cost of living. The weakening ringgit not only hurts consumer's purchasing power but also dampens sentiment if the rate of depreciation prolongs. MIER's consumer sentiment index dipped to 73.6 in 3Q16 from 78.5 in 2Q (72.9 in 1Q) and remained below the 100-pt threshold level of optimism since second half of 2014. While current incomes have improved somewhat, the respondents cited the factors that will cause weak consumer sentiments are uninspiring employment and financial outlook and worries over jobs.

   The unemployment rate stood at 3.5% in October, the same rate as in Jul-Sep. According to the Malaysian Employers Federation (MEF), a total of 31,476 Malaysians was retrenched from January to September this year and more will be retrenched by end-2016. In 2017, MEF expects the retrenchment to hit 50,000.

   Consumers continue to adopt a wait and see approach on big purchases. Passenger car sales contracted 11.7% yoy to 43,550 units in November (-13.4% in October; -5.7% in September), bringing total passenger car sales to 456,943 units in January-November 2016, representing a decline of 13.8% a year ago. In December, 58,057 units have to be sold to meet the Malaysian Automotive Association (MAA)'s downward revised target of 515,000 units in 2016.

   The year-end promotional campaigns such as attractive discounts and the launch of new models should help to boost some sales of affordably priced range cars. The passenger car sales outlook is expected to remain challenging in 2017, dampened by the on-going weak consumer sentiments, worries about job security as well as the impact of weakening ringgit.

Figure 31: Declines in passenger car sales persisted

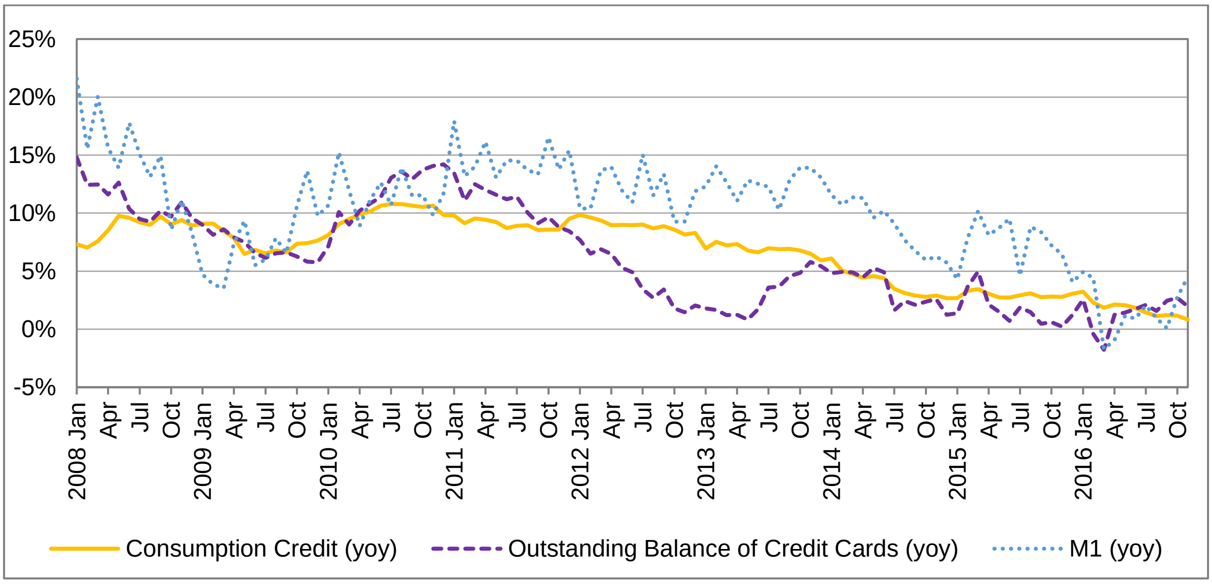


Source: Bank Negara Malaysia

Loans extended by the banking system for consumption purposes such as for the purchase of durables and personal use still growing at measured pace. Imports of consumption goods grew by 5.4% yoy in November (- 8.0% in October;-4.8% in September and +10.4% in August respectively). Consumption credit growth eased to 0.8% yoy in November (1.2% in October vs. 1.2% in 3Q; +1.8% in 2Q and +1.9% in 1Q16 respectively).

Private consumption continued to sustain its resiliency, growing from 4.9% yoy in 4Q15 to 6.4% in 3Q16 (6.3% in 2Q and 5.3% in 1Q respectively) for four successive quarters. Though this marks the normalisation of GST impact on consumer spending, there are still real and sentiment risks that could put a damper on the strength of consumer spending. These include the state of economy, employment and income prospects and inflation expectations. A prolonged weakness of the ringgit and the associated financial volatility could cause the households to defer their spending. Private consumption growth is estimated to grow by 5.3% in 2017 and 5.6% in 2018 respectively (estimated 5.9% in 2016), slowing from an average growth of 7.1% in 2011-15.

Figure 32: Discretionary consumer spending amid cautious sentiment



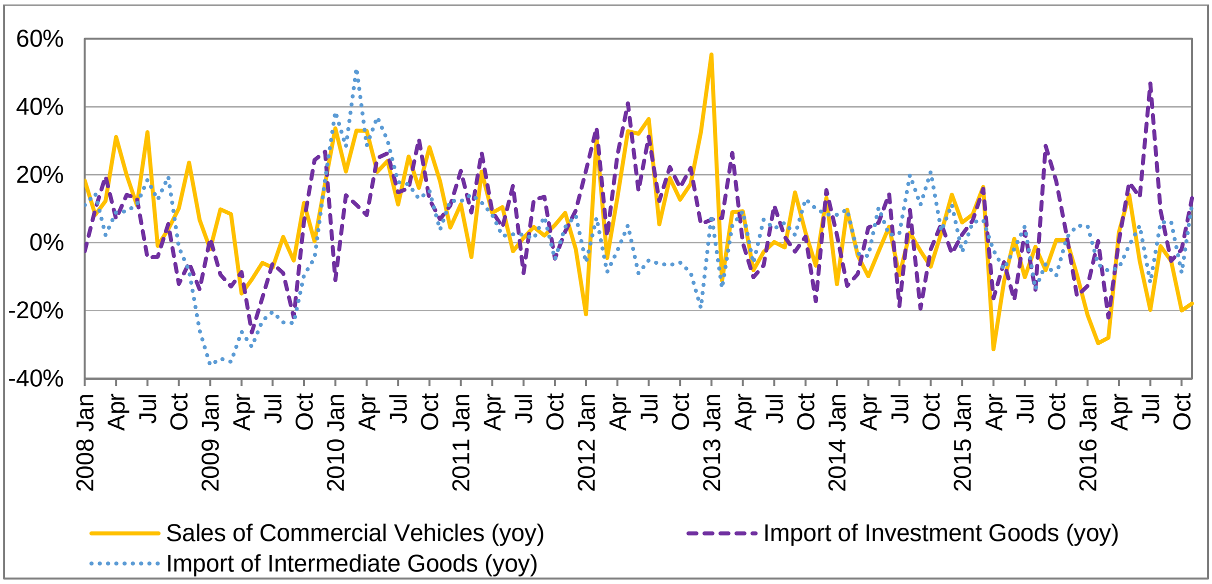
Source: Bank Negara Malaysia

6. **Private investment indicators** point to moderate private capital spending. Investor sentiment turned cautious and weaker as MIER's business confidence index (BCI) dived below threshold to settle at 83.9 points in 3Q16 from 106.4 in 2Q. Amongst the reasons cited for undermining business confidence were slowdown in overall sales and production; decline in domestic market and export orders and the bleak near-term outlook.

   After declining for two months in a row, imports of capital goods turned around to increase strongly by 13.1% yoy in November (-2.0% in October and -5.4% in September respectively on higher spending on industrial machinery and equipment. Sales of commercial vehicles also extended the contraction trend (-17.9% in November vs. -19.9% in October and -5.4% in September respectively). Imports of intermediate goods reversed to increase by 11.3% yoy in November (- 8.9% yoy in November and +6.2% in September respectively), a sign of expansion ahead in the production of exports.

   Private investment growth continued to rise by 4.7% yoy in 3Q16, albeit slower compared to 5.6% in 2Q, underpinned by continued investment in manufacturing and services. We expect private investment to expand by 5.2% in 2017 and 6.1% in 2018 respectively (estimated 4.2% in 2016).

Figure 33: Private investment indicators show mixed outcomes

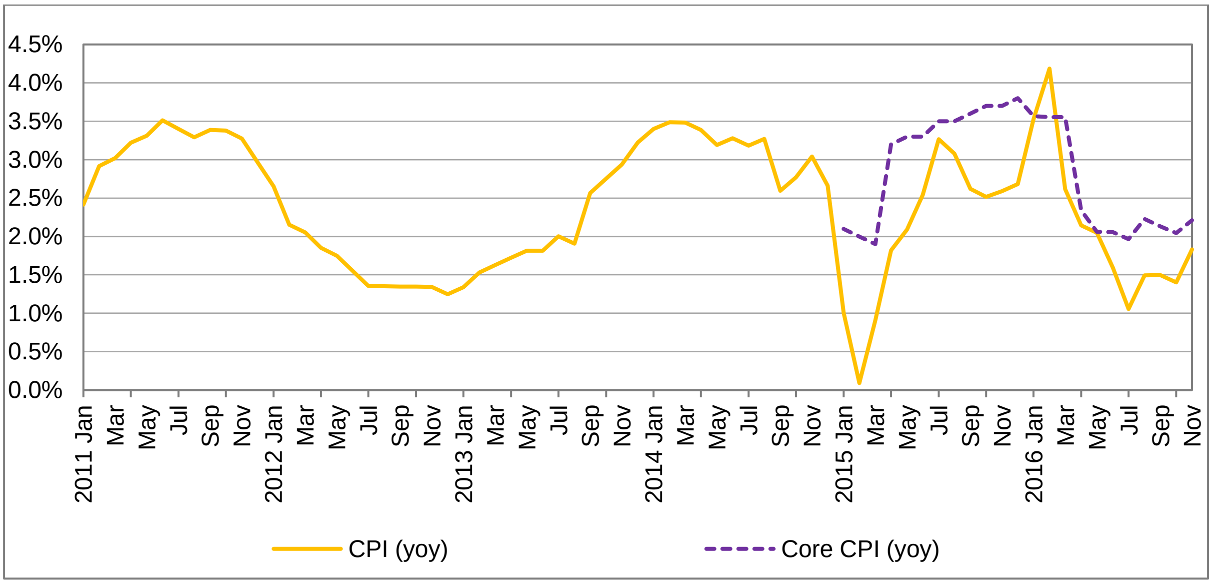


Source: Bank Negara Malaysia

7. **Headline inflation,** as measured by the Consumer Price Index (CPI) increased by a higher rate of 1.8% yoy in November (1.4% in October and 1.5% in September respectively), partly aided by the diminishing favourable base effect. The increase was largely lifted by higher prices for food & non-alcoholic beverages (+3.8% vs. 2.5% in October), reflecting the direct impact of increases in cooking oil prices (+45.6% yoy) following the subsidy rationalisation as well as a smaller decline in transport prices (-1.5% vs.-5.5% in October). Housing, water, electricity, gas & other fuels rose 2.1% while communication prices declined by 2.7% (-2.6% in October).

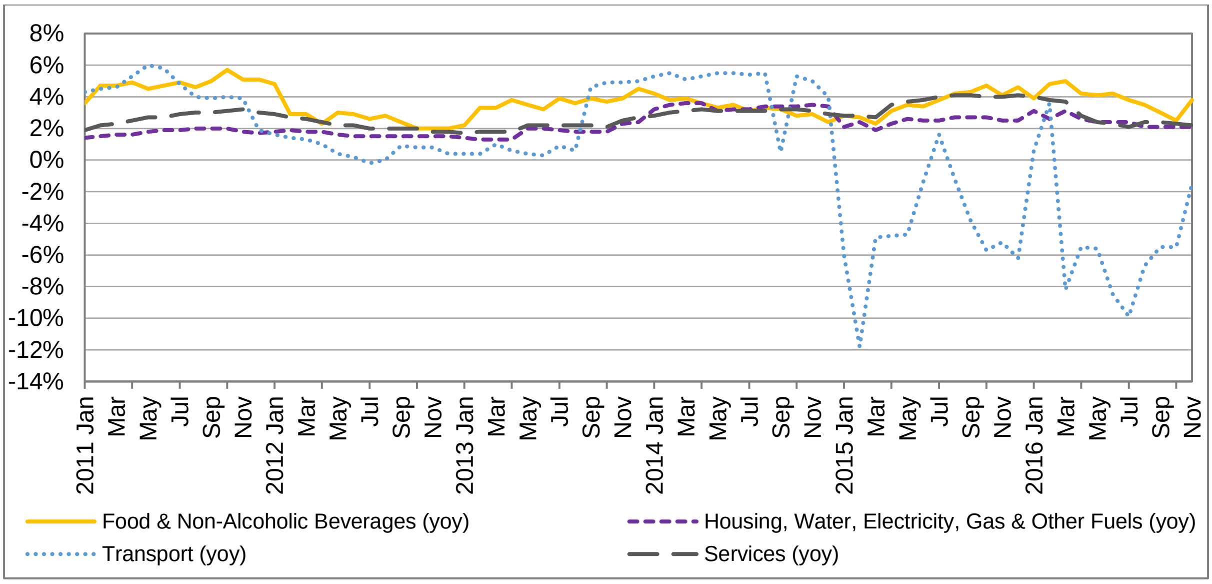
   Based on the average CPI growth of 2.1% in 11M16, we project headline inflation to end the year 2016 at 2.1% and will rise to 2.5% in 2017, mainly to reflect the diminishing of favourable base effect amid the risk of inflationary pressures from continued subsidy rationalisation and the impact of weak ringgit as well as the firming up of oil prices.

Figure 34: Inflation picks up in November



Source: Department of Statistics, Malaysia

Figure 35: Food prices increase and a smaller decline in transport prices



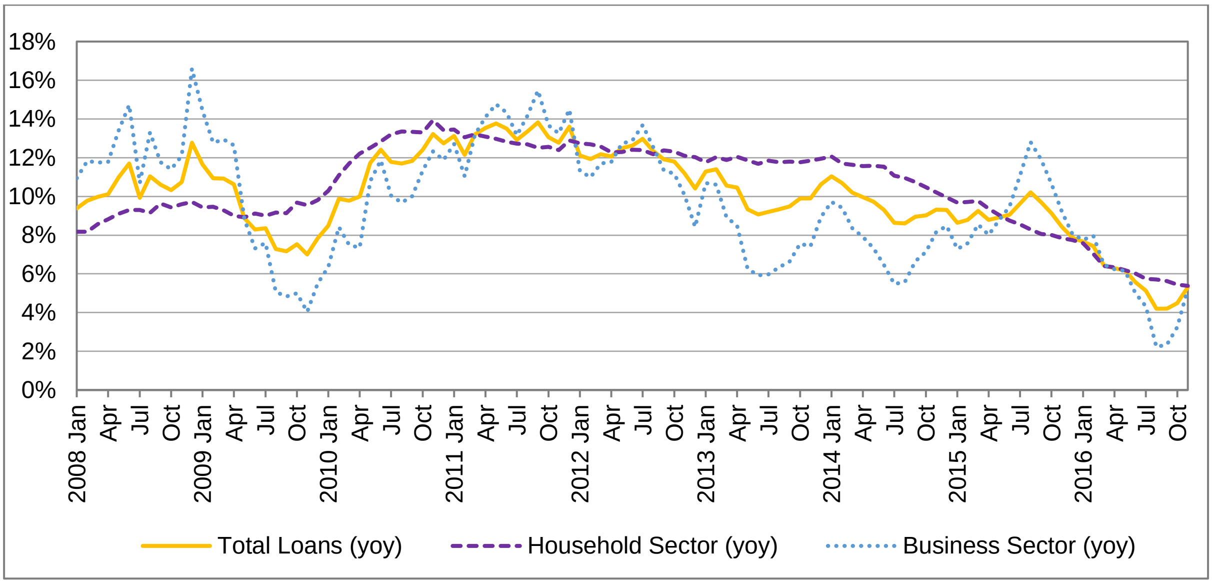
Source: Department of Statistics, Malaysia

8. **Loan indicators showed mixed performance in November.** Loan applications contracted by a smaller magnitude of 0.3% yoy in November (-14.5% in October; -8.7% in September). The smaller decline was due to increased applications for vehicle purchases, credit cards and working capital. Loan approvals declined by 4.6% yoy (-3.9% in October; -8.2% in September), mainly dragged down by lower approvals for the purchases of vehicles amid higher increases for the purchase of shares, residential and non-residential property as well as credit cards. Loan disbursement reversed to increase by 9.6% yoy in November (-2.0% in October; -6.5% in September). In November, the level of loan applications increased for both businesses and households to RM71.2 billion (Oct: RM69.2 billion; Sep: RM68.3 billion), but the level of loan approvals moderated to RM29.9 billion (Oct: RM33.8 billion; Sep: RM29.6 billion), the lowest loan approval level in the past five months.

Banking system loan growth improved to 5.3% yoy at end-November from +4.5% in October and +4.2% in September respectively. Business loans edged higher for three months in a row to 5.2% in November (3.2% in October and 2.3% in September respectively). The improved business loans growth was driven mainly by loans expansion in the transport, storage and communication; construction; finance, insurance and business services; and wholesale and retail trade, restaurants and hotels sectors. Some small firms have made a number of large one-off repayments.

In the household sector, outstanding loan growth remained stable at 5.4% yoy in November (5.4% in October and 5.6% in September respectively), reflecting the moderation in the overall loans for the purchases of residential property; passenger cars and non-residential property.

Figure 36: Business loans growth edged higher while household loans stable



Source: Bank Negara Malaysia

9. **Bank Negara Malaysia's holdings of foreign exchange** stood at US$94.6 billion as at end- December 2016, a decline of US$0.7 billion from US$95.3 billion as at end-Dec 2015, after taken into account the adjustment of foreign exchange revaluation. The level of reserves is sufficient to finance 8.8 months of retained imports and were 1.3 times the short-term external debt.

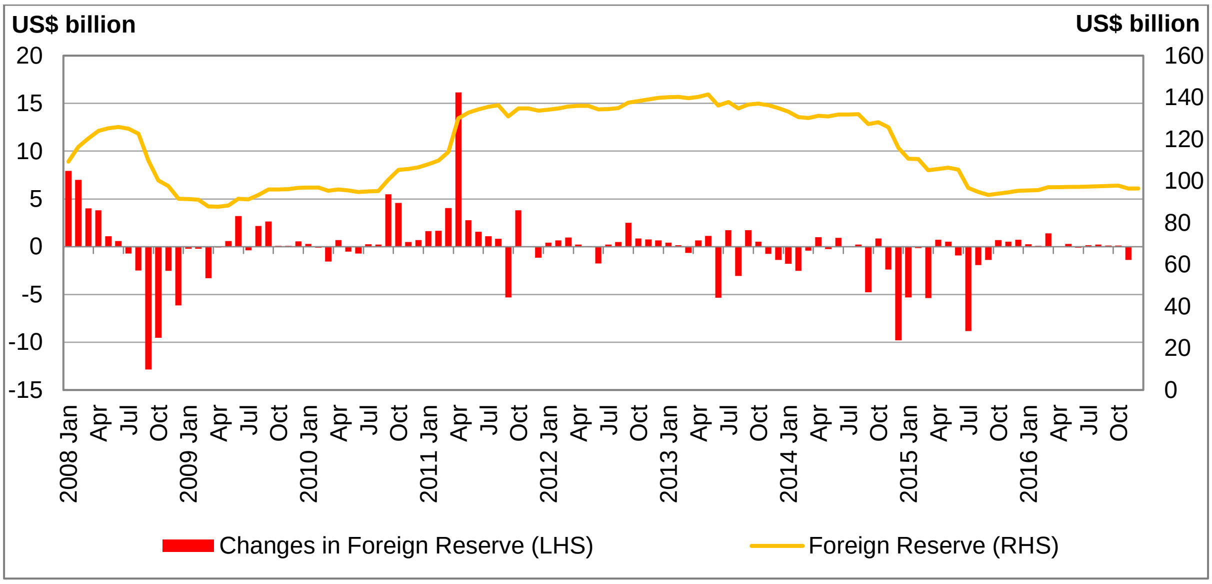
   Net inflows of portfolio investment reversed to large outflows of RM10.6 billion in 3Q16 (+RM77 million in 2Q and +RM13.1 billion in 1Q respectively), reflecting outflows by both foreign investors and local residents. Portfolio investment by non-residents recorded a net outflow of RM3.5 billion, a reversal from net inflows of RM4.8 billion in 2Q due mainly the maturity of foreign currency denominated Wakala Global Sukuk by the Federal Government and Bank Negara Monetary Notes (BNMN), which more than offset the net purchase of equity securities during the quarter. Portfolio investment by residents also registered a higher net outflows of RM 7.1 billion (-RM4.7 billion in 2Q), following higher net acquisition of foreign debt and equity securities, particularly by domestic institutional investors. Bursa data showed that foreign institutional investors were net seller of domestic equities for four consecutive months since September (-RM314.0 million in September; -RM450.2 million in October; -RM3.9 billion in November and -RM1.0 billion in December).

   Foreign investors also trimmed their holdings of Malaysian government bonds. As at end-December 2016, foreign investors owned 47.1% or RM168.5 billion of Malaysian Government Securities (Nov: 48.4% or RM173.0 billion; Oct: 51.6% or RM184.6 billion) and RM191.8 worth of government bonds or 32.2% of total (Nov: RM198.5 billion or 33.4% of total; Oct: RM218.4 billion or 36.2% of total).

   Post Trump's victory in the US Presidential elections on 8 November, the spiked in the US Treasury yields, strong US dollar and the growing expectations of higher US interest rates ahead in anticipation of Trump's reflationary policies will lift inflation risk has prompted foreign investors to liquidate their holdings of Malaysia bonds. Besides that, foreign investors also were net seller of domestic equity securities.

   Faced with greater uncertainty associated with the Fed's rate hike path as well as the implications of Trump's economic policies on the US economy and his anti-trade mindset on emerging economies, capital flows and financial volatility are expected to persist in 2017.

Figure 37: Foreign reserves rise marginally



Source: Bank Negara Malaysia

In November-December, the ringgit depreciated against the currencies of most of Malaysia's major trade partners, except Japanese yen. The speed and magnitude of the ringgit's depreciation against the US dollar accelerated post the US Presidential elections, which saw the ringgit lost by nearly 6.5% for the period of 8 November to 31 December. During this period, the ringgit's decline against the US dollar was sharper when compared to the Chinese renminbi (-2.3%), euro (-4.6%), Thai baht (-2.5%), Indonesian rupiah (-2.9%), Singapore dollar (-4.2%), South Korean won (-5.9%), Philippine peso (-1.9%), Taiwan dollar (-2.7%) and Indian rupee (-1.9%).

For the full-year of 2016, the ringgit depreciated by 4.3% against USD to RM4.4860 as of 31 December from RM4.2935 at end-Dec 2015, marking the fourth consecutive year of depreciation since 2013. Over the period, the ringgit lost 31.8% against the dollar from RM3.0580 at end-Dec 2012.

For the week ended 13 January 2017, the ringgit appreciated by 0.5% against the US dollar, followed by the pound sterling (+1.3%); while depreciated against euro (-0.5%), renminbi (-0.2%), yen (-1.5%) and Singapore dollar (-0.8%), compared with end-December 2016.

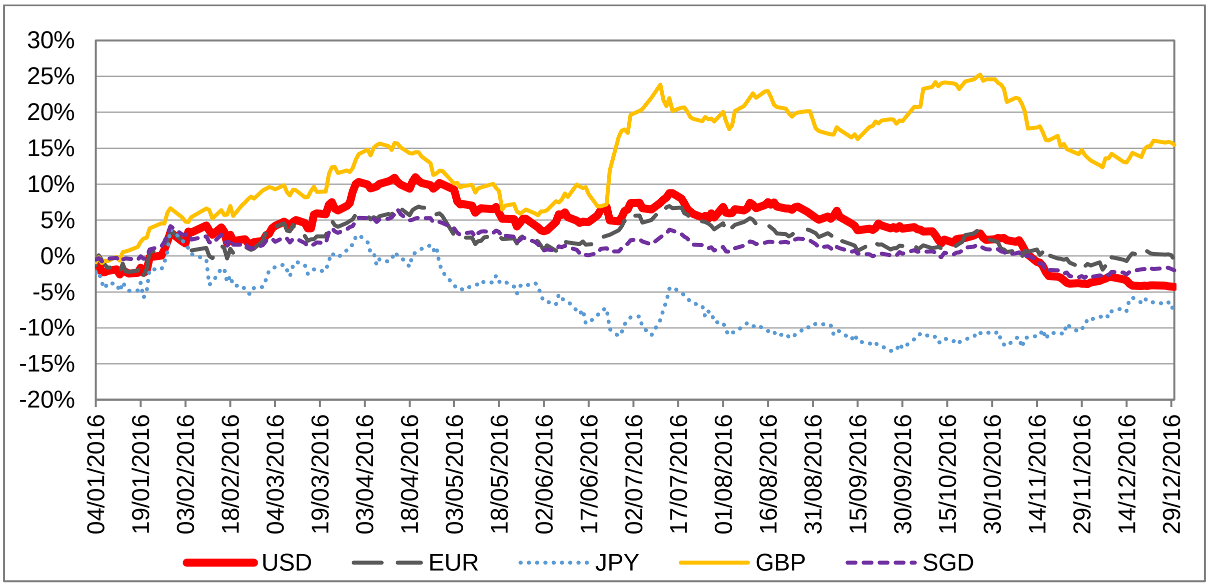
The ringgit, together with regional currencies depreciated against the US dollar due to expectations that the Trump Administration will boost fiscal spending, growth and inflation pushed up the US Treasury yields as investors bet the Federal Reserve will need to raise borrowing costs at a faster pace than previously anticipated.

The pressure on the ringgit was also inflicted by investors' uneasiness as well as negative perceptions and sentiments toward Bank Negara Malaysia's forex restriction measures in the non-deliverable forward markets (NDF), which is seen as a bold policy move to curtail the influence of NDF market on the ringgit given that the ringgit is non-internationalised offshore. BNM expressed concern about ringgit prices and its volatility had been affected by activities and prices in the offshore NDF market. This is not necessarily reflective of economic fundamentals and underlying trade and investment activities.

The ringgit will continue to remain under pressure as a pick-up in the US economy, stronger US dollar and rising US yield environment on the expectations of rising US interest rates, which imply a compressed yields differential tends to cause volatility in capital flows and pose a headwind to the ringgit.

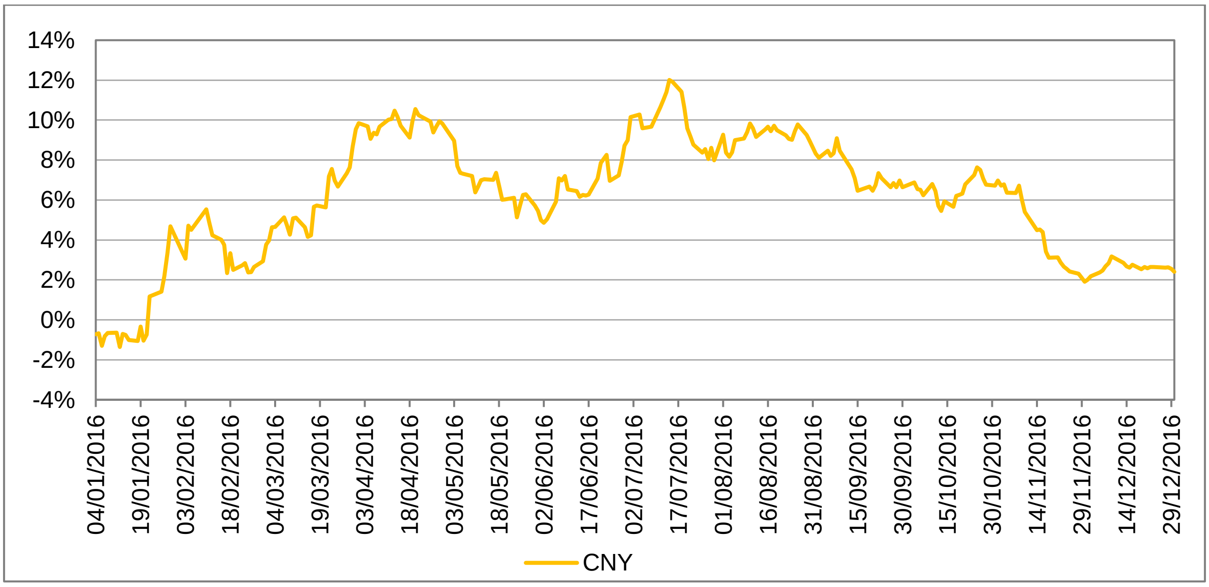
Investors' negative sentiment on the ringgit will stay for a while as they remained wary about the effectiveness of BNM's rule, which requires onshore banks not to facilitate the offshore ringgit NDF market. However, the export proceeds retention measure, which caps the export proceeds to be retained in the foreign currency account at 25% and the balance of 75% converted to ringgit, is expected to provide a support to the ringgit via enhanced demand as well as a steady accumulation of foreign reserves. Other influencing factors are BNM's policy rate, economic growth prospects and inflation trajectory. The ringgit is expected to end the year 2017 at RM4.20-4.40 (End-2016: RM4.4860; End-2015: RM4.2935).

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



Source: Bank Negara Malaysia

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



Source: Bank Negara Malaysia

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