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2H2026 ECONOMIC OUTLOOK: NAVIGATING GROWTH MODERATION AMID GEOPOLITICAL UNCERTAINTY

Executive Summary

- The global economy entered 2026 on a stronger-than-expected footing, supported by resilient consumer spending, robust investment in artificial intelligence (AI), and relatively accommodative financial conditions. However, this momentum has been increasingly challenged by escalating geopolitical tensions, most notably the ongoing U.S.–Iran conflict in West Asia. The disruption of the Strait of Hormuz and heightened uncertainty have reintroduced supply shocks, elevated energy prices, and renewed inflationary pressures. As such, the outlook for the second half of 2026 is characterized by moderate growth, higher inflation, and tighter financial conditions, with risks tilted to the downside.

Global Economic Developments

- In the first quarter of 2026, global economic activity remained resilient, largely reflecting conditions prior to the full impact of the Iran conflict. The U.S. economy expanded by 1.6% q-o-q on an annualized basis, supported by consumer spending, AI-related investments, and government outlays, although the pace moderated from earlier estimates. China's economy strengthened to 5.0% y-o-y, driven by a recovery in industrial activity and continued resilience in the services sector. Growth in the euro area remained subdued at 0.1% q-o-q, reflecting energy-related pressures and softer domestic demand, while the UK recorded a relatively stronger expansion of 0.6% q-o-q. Japan's economic performance was revised downward to 1.8% annualised, mainly due to weaker corporate investment.

Table 1: GDP Growth Selected Countries

	% Year-on-Year					% Quarter-on-Quarter				
	1Q26	4Q25	3Q25	2Q25	1Q25	1Q26	4Q25	3Q25	2Q25	1Q25
US	2.6	2.0	2.3	2.1	2.0	1.6	0.5	4.4	3.8	-0.6
Eurozone	0.8	1.2	1.4	1.6	1.6	0.1	0.2	0.3	0.1	0.6
UK	1.1	1.0	1.3	1.4	1.8	0.6	0.2	0.2	0.1	0.6
Japan	1.8	0.7	-2.3	1.1	2.0	0.5	0.2	-0.6	0.3	0.5
China	5.0	4.5	4.8	5.2	5.4	1.3	1.2	1.1	1.1	1.1
Malaysia	5.4	6.2	5.3	4.6	4.4	-4.4	3.3	5.4	1.2	-3.6
Singapore	6.0	5.7	4.5	5.4	4.5	3.9	5.2	7.8	7.3	2.5
Indonesia	5.6	5.4	5.0	5.1	4.9	-0.8	0.9	1.4	4.0	-0.9
Philippines	2.8	3.0	4.0	5.4	5.4	0.9	0.6	0.4	0.9	1.2
Thailand	2.8	2.5	1.2	2.8	3.1	0.7	1.9	-0.3	0.5	0.5
Vietnam	7.8	8.5	8.3	8.0	7.1	-	-	-	-	-

Sources: Bloomberg, Bank Islam

- Across Asia, economic performance was generally robust. Singapore recorded strong growth of 6.0% y-o-y, supported by broad-based sectoral expansion. Vietnam continued to outperform with growth of 7.8%, driven by manufacturing exports and public investment. Indonesia maintained steady growth at 5.6%, supported by domestic demand, while Thailand registered moderate expansion of 2.8%. In contrast, the Philippines experienced a slowdown, with growth easing to 2.8% amid higher energy costs and domestic challenges.

- Looking ahead, global growth is expected to moderate amid heightened uncertainty and rising inflationary pressures.

- The World Bank, in its semi-annual Global Economic Prospects report released on Jun 11, lowered its global growth forecast to 2.5% for 2026, down from 2.9% in 2025, marking the lowest rate since late 2019. The report cited higher energy prices, steeper inflation and increased borrowing costs amid the Middle East conflict for the growth cut. The World Bank said its baseline forecast assumed an average Brent crude oil price of USD94 per barrel for the year. Downside risks are significant, the report warned. Global growth could further slow to 2.1% if the energy disruptions lasted longer and oil prices averaged USD115 per barrel this year, driving inflation to 4.4%; or worsen to 1.3% if the energy shock affected financial markets. The report lowered growth forecast for two-thirds of countries compared to its January report this year. Global growth is expected to improve to 2.8% in 2027. The World Bank maintained its 2.2% growth forecast for the U.S. economy in 2026. Economy in the euro area is expected to grow 0.8% while Japan's GDP is forecast to grow 0.7% in 2026 and China's outlook was revised down to 4.2% from 4.4%.

- In its June 2026 Economic Outlook, the OECD sharply downgraded its global growth projections and warned that a prolonged energy crisis stemming from the conflict could leave "scarring effects on potential output" across the world economy. The OECD framed its projections around two scenarios, both shaped by how long disruptions to the Strait of Hormuz and Gulf energy infrastructure persist. In the more optimistic "time-limited disruption" scenario, which assumes energy prices gradually ease from mid-2026, global GDP growth slows to 2.8% this year, then recovers to 3.1% in 2027. G20 inflation rises to 4.0% in 2026, then fades to 3.1% in 2027. The second path is considerably darker. The OECD's "prolonged disruption" scenario assumes that current disturbances in Gulf energy production and exports will persist well into 2027, raising energy prices and increasing the likelihood of supply shortages and tighter global financial conditions. This would "carry broader and more long-lasting consequences" for the world economy. Under the scenario, global GDP growth will fall to 2.1% this year and 1.8% in 2027, leaving "a lasting mark" on many countries - especially those in Asia and Europe, as well as developing economies that are vulnerable to energy and food price shocks. Prolonged disruption could also push "some economies into or close to recession".

- The IMF, in its World Economic Outlook (April 2026), cut its 2026 global growth projection, warning that the world economy could be "thrown off course" by war in the Middle East - as the conflict roils commodity markets and sparks higher prices. The IMF said that the global economy is set to grow by 3.1% this year, down from 3.3% forecast in January. The IMF expects higher inflation this year at 4.4%, 0.6 percentage points above its January forecast. But these projections assume a relatively short-lived conflict with temporary energy market disruptions. In more adverse scenarios where energy prices remain steep, global growth could slow to 2.5% or even around 2.0%. Among the world's two biggest economies, U.S. growth is still set to accelerate to 2.3% this year, although the pace of growth was revised slightly lower. China's growth is anticipated to cool to 4.4%, a touch below the January forecast.

Table 2: GDP Growth Forecast

	IMF (April)		OECD (Jun)		World Bank (Jun)	
	2026	2027	2026	2027	2026	2027
Global	3.1	3.2	2.8	3.1	2.5	2.8
US	2.3	2.1	2.0	1.8	2.2	2.1
EuroArea	1.1	1.2	0.8	1.2	0.8	1.3
UK	0.8	1.3	0.9	1.1	0.8	n.a.
Japan	0.7	0.6	0.6	0.8	0.7	0.9
China	4.4	4.0	4.5	4.3	4.2	4.3
Malaysia	4.7	4.3	4.2	4.8	4.4	4.4
Singapore	3.5	2.7	-	-	-	-
Indonesia	5.0	5.1	4.7	5.0	5.0	5.2
Philippines	4.1	5.8	3.2	5.0	3.7	5.6
Thailand	1.5	2.1	1.7	2.1	1.7	2.1
Vietnam	7.1	6.7	6.5	6.2	6.8	7.1

Source: IMF, OECD, World Bank, Bank Islam

2H2026 Outlook

- The global economy enters the second half of 2026 at an important inflection point. The strong growth momentum observed in the first half of the year was driven primarily by two dominant forces: the continued expansion of the artificial intelligence (AI) investment cycle and heightened geopolitical tensions stemming from the U.S.-Iran conflict. While the AI-driven technology boom provided substantial support to investment, manufacturing activity and global trade, geopolitical developments generated significant volatility across energy and financial markets.

- Heading into 2H2026, global growth is expected to moderate amid tighter financial conditions and persistent inflationary pressures. While structural tailwinds, especially from AI, remain supportive, the macro landscape is increasingly characterized by policy uncertainty, elevated interest rates, and heightened geopolitical risks. We expect financial market volatility to remain elevated as investors recalibrate expectations around growth, inflation, and monetary policy trajectories.

- The U.S. economy is projected to maintain relative resilience, underpinned by continued AI-related investment and stable household consumption. However, inflation is expected to remain sticky, driven by elevated energy prices and second-round effects. This limits the Federal Reserve's ability to begin a meaningful easing cycle. Consequently, interest rates are likely to remain elevated for longer, creating a more challenging environment for risk assets and interest-sensitive sectors.

- In Europe, however, growth remains considerably weaker. Structural challenges, including elevated energy costs, declining industrial competitiveness and demographic constraints, continue to weigh on economic performance. Although the worst of the recent energy shock may have passed, growth is expected to remain subdued relative to other major economies.

- Japan is transitioning toward a more normalized monetary policy regime, supported by strengthening wage growth and more persistent inflation dynamics. The Bank of Japan's recent rate hikes signal a shift away from its ultra-loose stance, with further tightening contingent on sustained inflation.

- China's economic conditions are stabilizing, supported by the technology cycle and targeted policy measures, although domestic demand remains constrained by ongoing property sector adjustments and cautious consumer sentiment. Policy support is expected to remain measured and targeted, limiting the likelihood of a strong cyclical rebound.

- Across ASEAN, growth prospects remain closely tied to developments in global trade and technology demand. Economies with significant exposure to electronics and semiconductor supply chains, particularly Malaysia and Singapore, are expected to continue benefiting from the technology upcycle, although external demand conditions and energy price developments remain key risks. However, regional growth remains vulnerable to external demand conditions and energy price volatility.

- Overall, the second half of 2026 is expected to be characterized by a more complex policy environment where geopolitical developments, inflation dynamics and central bank decisions increasingly shape market outcomes. While the AI investment cycle continues to provide a powerful structural growth driver, higher-for-longer interest rates and elevated geopolitical risks are likely to contribute to greater market volatility.

Geopolitical Developments: From Escalation to Fragile Stabilization

- Geopolitical developments have emerged as the single most important source of uncertainty for the global economy in 2026. The prolonged conflict between the U.S. and Iran generated significant disruptions to global energy markets, increased supply chain costs and intensified concerns over inflation and global growth prospects.

- The U.S. and Iran reached a provisional peace agreement and signed a deal on June 17 meant to end the Middle East war. The document outlined several provisions set to take immediate effect, including;
  - Termination of all military operations on all fronts, including Lebanon, and commitment to not initiate military operations against each other
  - Removal of the U.S. naval blockade on Iran, with the full removal to be achieved within 30 days
  - Toll-free and safe passage for vessels from the Persian Gulf to the Sea of Oman, and vice versa, for 60 days
  - U.S. Department of Treasury will issue waivers for the Export of Iranian oil products and all associated services pending the termination of U.S. sanctions (which will be discussed as part of the final deal)
  - Release of Iran's frozen or restricted funds and assets

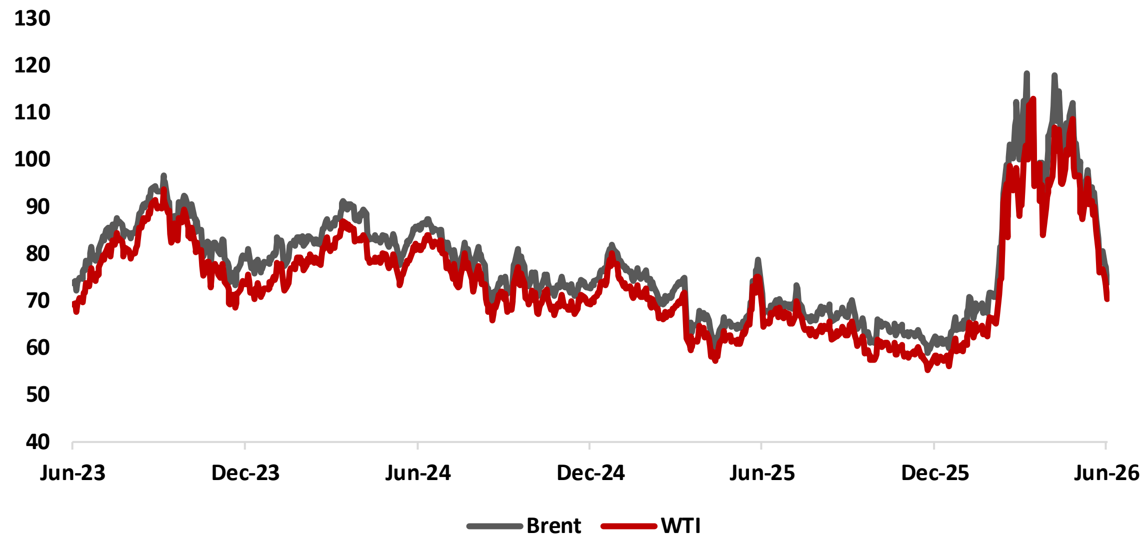
- Although a provisional peace framework has been established, the path towards a durable resolution remains uncertain. The current arrangement primarily focuses on maintaining the ceasefire and reopening key maritime routes, particularly the Strait of Hormuz, while more contentious issues, including Iran's nuclear program, sanctions relief and regional security arrangements, remain subject to ongoing negotiations.
- The reopening of the Strait of Hormuz represents a significant development for global markets given the waterway's critical role in facilitating energy exports from the Gulf region. The restoration of shipping activity has reduced immediate concerns regarding a prolonged energy supply shock and contributed to a decline in geopolitical risk premiums embedded in commodity prices.
- Nevertheless, risks remain elevated. Negotiations between the U.S. and Iran are likely to be lengthy and complex, while broader regional issues involving Lebanon, Israel and Gulf security continue to pose potential challenges. Any breakdown in negotiations could quickly reignite market volatility and reverse recent improvements in investor sentiment.
- The 60-day ceasefire extension intended to facilitate a nuclear agreement appears rather tight, while it will also take time for oil flows through Hormuz to normalize. Restoring the Gulf states' damaged infrastructure will take months. A rapid return of the Strait of Hormuz to full capacity seems unlikely. From a risk perspective, the balance has shifted from continued "hope for a deal" to "fear that the deal could derail".
- As a result, while geopolitical risks have shifted from acute crisis mode towards a more manageable phase, they remain a key downside risk to the global outlook.

Oil Market Outlook: From Supply Shock to Gradual Normalization

- The oil market experienced one of the most significant supply disruptions in recent history during the first half of 2026. However, unlike previous geopolitical crises, the disruption failed to trigger a sustained energy crisis, reflecting improved market flexibility, increased non-OPEC production and softer global demand conditions.
- The easing of tensions between the U.S. and Iran has accelerated the unwinding of geopolitical risk premiums that had previously pushed crude oil prices significantly higher. The gradual reopening of the Strait of Hormuz, combined with temporary sanctions waivers permitting Iranian oil exports, has contributed to improving market sentiment and easing concerns regarding supply shortages.
- Looking ahead, the normalization process is expected to be gradual rather than immediate. Although physical damage to energy infrastructure appears relatively limited, restoring full production capacity and rebuilding depleted inventories will require time. Commercial and strategic oil reserves across several major economies have been drawn down substantially during the conflict period, leaving markets vulnerable to renewed supply disruptions.
- Nevertheless, underlying market fundamentals remain broadly constructive. Non-OPEC production continues to expand; global demand growth has moderated and OPEC's ability to influence prices appears increasingly constrained by internal fragmentation and growing competition from non-member producers.

- Consequently, we expect crude oil prices to gradually stabilize over the medium term, with Brent crude likely to trade within the USD60-70 per barrel range once supply conditions normalize fully and inventory levels are rebuilt. However, geopolitical risk premiums are likely to persist, preventing a rapid return to pre-conflict pricing conditions.

Chart 1: Brent and WTI Crude Oil (USD per barrel)



Sources: Bloomberg, Bank Islam

Inflation Outlook: From Energy Shock to Persistent Price Pressures

- Inflation has re-emerged as a key concern for policymakers globally. The energy shock generated by the Middle East conflict has resulted in higher transportation costs, increased production expenses and renewed inflationary pressures across many economies.
- Although inflation remains relatively contained in several ASEAN economies, rising producer prices and elevated input costs suggest that pipeline pressures continue to build. The risk is that temporary energy-related inflation becomes embedded within broader price-setting behavior, resulting in more persistent inflation outcomes.
- The AI investment boom also introduces an additional source of inflationary pressure. Strong demand for labor, energy, specialized equipment and construction activity associated with technology infrastructure investment has contributed to capacity constraints in several sectors.
- As a result, inflation is proving more resilient than many central banks had anticipated at the beginning of the year. While a significant reacceleration in inflation remains unlikely, progress towards inflation targets is expected to be slower and more uneven.
- This suggests that policymakers may need to maintain restrictive monetary settings for longer than previously expected.

Table 3: Heat Map of Consumer Price Index (CPI), y-o-y %

	Jan-26	Feb-26	Mar-26	Apr-26	May-26
U.S.	2.4	2.4	3.3	3.8	4.2
Euro	2.0	2.1	2.8	3.2	3.3
UK	3.0	3.0	3.3	2.8	2.8
Japan	1.5	1.3	1.4	1.3	1.5
China	0.2	1.3	1.0	1.2	1.2
Singapore	1.4	1.2	1.8	1.8	1.8
Malaysia	1.6	1.4	1.7	1.9	2.0
Indonesia	3.5	4.8	3.5	2.4	3.1
Thailand	-0.7	-0.9	-0.1	2.9	2.8
Philippines	2.0	2.4	4.1	7.2	6.8
Vietnam	2.5	3.4	4.7	5.5	5.6

Sources: Bloomberg, CEIC Data, Bank Islam

Monetary Policy Outlook: The Return of a Hawkish Bias

- Monetary policy is likely to become the dominant macroeconomic driver during the second half of 2026 as geopolitical concerns gradually recede and inflation dynamics move back to the forefront of policymaking.

- Recent developments indicate a clear shift towards a more hawkish global policy environment. Several central banks have already resumed tightening or signaled a willingness to raise rates further should inflation pressures persist.

- The Bank of Japan has continued its policy normalization process, raising interest rates to their highest level in more than three decades. Elsewhere, Bank Indonesia, the Bangko Sentral ng Pilipinas, the European Central Bank and several other central banks have also adopted a more restrictive policy stance.

Table 4: Policy Rates of Selected Countries

Rate (Last Change)	Country	Central Bank Interest Rate	Date
5.75% (+0.25%)	Indonesia	BI Rate	Jun-26
4.75% (+0.25%)	Philippines	Target Reverse Repurchase	Jun-26
1.0% (+0.25%)	Japan	Overnight Call Rate	Jun-26
2.25% (+0.25%)	Euro Area	Key Deposit Facility Rate	Jun-26
5.50% (+0.25%)	Indonesia	BI Rate	Jun-26
4.35% (+0.25%)	Australia	Cash Rate	May-26
4.50% (+0.25%)	Philippines	Target Reverse Repurchase	Apr-26
1.00% (-0.25%)	Thailand	Repo Rate	Feb-26
0.75% (+0.25%)	Japan	Overnight Call Rate	Dec-25
3.75% (-0.25%)	UK	Base Rate	Dec-25
3.50% - 3.75% (-0.25%)	USA	Funds Rate Target	Dec-25

2.25% (-0.25%)	New Zealand	Official Cash Rate	Nov-25
2.25% (-0.25%)	Canada	Overnight Rate	Oct-25
2.75% (-0.25%)	Malaysia	Overnight Policy Rate	Jul-25
2.00% (-0.25%)	Euro Area	Key Deposit Facility Rate	Jun-25
2.50% (-0.25%)	South Korea	Base Rate	May-25
3.00% (-0.10%)	China	Loan Prime Rate (1Y)	May-25

Sources: Bloomberg, Bank Islam

- The Federal Reserve remains the most important central bank for global markets. While policymakers have maintained rates unchanged in recent meetings, the latest projections indicate growing concern regarding inflation persistence. Higher inflation forecasts, combined with relatively resilient economic activity, suggest that the Federal Reserve may delay policy easing significantly longer than markets had previously anticipated.
- Our base case remains for an extended period of policy stability through the remainder of 2026, with easing likely postponed until 2027. However, the probability of further tightening has increased materially and cannot be dismissed should inflation remain elevated.
- Consequently, the global interest rate environment is likely to remain restrictive, reinforcing the higher-for-longer narrative that has increasingly shaped financial market expectations.

Currency Markets: Policy Divergence Remains the Key Driver

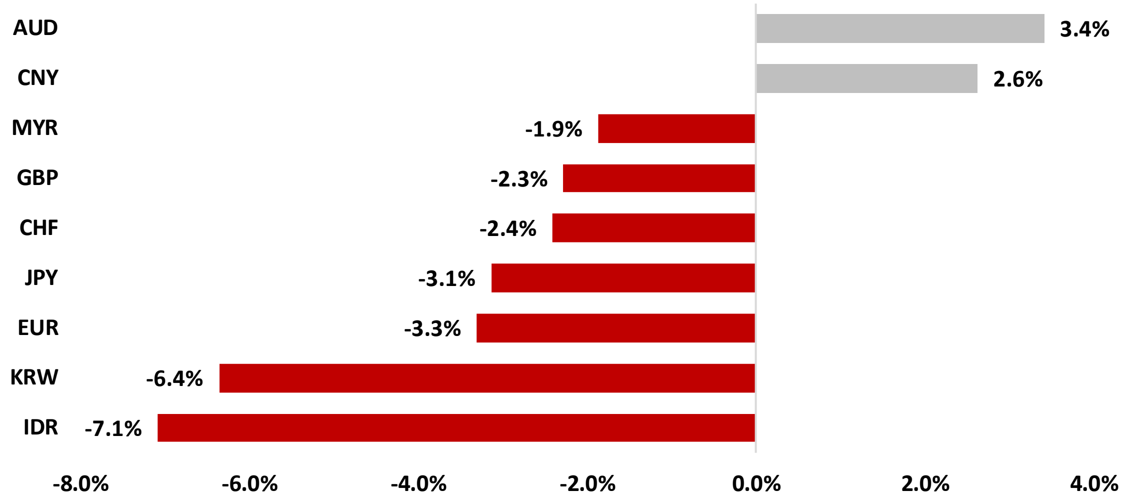
- Currency market performance during the second half of 2026 is expected to be driven primarily by monetary policy expectations and interest rate differentials rather than geopolitical developments alone.

- The US dollar (USD) has benefited from safe-haven demand, elevated energy prices and increasingly hawkish Federal Reserve expectations. Although the easing of geopolitical tensions has reduced some support for the currency, the prospect of higher US interest rates for longer continues to underpin the dollar's relative strength.

Chart 2: USD Index (DXY)

Sources: Bloomberg, Bank Islam

Chart 3: Year-to-Date Currency Performance against USD (as of 24 June 2026)



Sources: Bloomberg, Bank Islam

- At the same time, improving global risk sentiment and stabilizing energy markets may gradually reduce demand for traditional safe-haven assets. This could create conditions for a modest weakening of the USD over the medium term, particularly if inflation begins to moderate and policy divergence narrows.
- Nevertheless, the near-term outlook remains supportive of the dollar given the Federal Reserve's increasingly cautious approach towards easing and the relative resilience of the U.S. economy compared with other major regions.
- As a result, currency markets are likely to remain highly sensitive to incoming inflation data, central bank communications and developments surrounding global growth expectations.

Conclusion

- The global growth outlook for the second half of 2026 remains supported by the ongoing AI-led investment cycle, which continues to generate substantial demand for semiconductors, data centres, cloud infrastructure and advanced manufacturing capacity.
- Overall, while growth is expected to moderate from the exceptionally strong pace recorded earlier in the year, the broader global economy continues to benefit from these structural investment trends, which should help cushion against a more pronounced slowdown.
- That said, the outlook remains subject to several key uncertainties. The durability of the U.S.–Iran agreement will be critical in determining the trajectory of global energy supply and prices, particularly given the strategic importance of the Strait of Hormuz. At the same time, the sustainability of the AI investment cycle will be closely monitored, as any moderation could have meaningful implications for global capital expenditure and trade dynamics. Inflation trends remain another central risk, especially the extent to which elevated energy prices feed into core inflation and prolong the current higher-for-longer interest rate environment. In this context, the path of monetary policy, particularly the timing and scale of further tightening by major central banks, will

remain a key determinant of financial conditions. Meanwhile, China's ability to stabilize domestic demand through targeted policy measures will be essential in anchoring regional growth prospects. Finally, evolving financial market dynamics, including the breadth of equity market performance and prevailing valuation levels, will provide important signals regarding underlying economic resilience and potential vulnerabilities.

Malaysia Economic Outlook

Domestic Resilience Meets External Uncertainty

- Malaysia's economy remains on a firm footing heading into the second half of 2026, supported by resilient domestic demand, a favorable labor market and continued strength in technology-related exports. Nevertheless, the growth environment has become increasingly challenging as geopolitical tensions, elevated energy prices and trade policy uncertainty weigh on global economic prospects.
- Economic activity moderated in the first quarter of 2026, with GDP growth easing to 5.4% y-o-y from 6.3% in the preceding quarter. While the moderation was broad-based across major sectors, underlying economic fundamentals remain healthy. Household spending continues to be supported by steady income growth and near full-employment conditions, while investment activity remains underpinned by data center developments, semiconductor-related investments and ongoing infrastructure projects.
- Malaysia has also emerged as a beneficiary of the ongoing artificial intelligence (AI) technology cycle and supply-chain reconfiguration, which have supported exports and manufacturing activity. However, these tailwinds are increasingly being offset by higher production costs, weaker global demand prospects and uncertainty surrounding trade and geopolitical developments.
- Against this backdrop, we maintain our 2026 GDP growth forecast at 4.7%. Growth is expected to remain driven primarily by domestic demand, while external demand is likely to moderate as global economic conditions soften. Inflation is projected to rise to 2.5%, reflecting higher energy and food-related costs, although government intervention measures and price controls should help limit broader inflationary spillovers.
- While the baseline outlook remains constructive, risks have become increasingly skewed to the downside. Prolonged geopolitical tensions, renewed disruptions to global supply chains, further escalation in trade restrictions and a sharper-than-expected slowdown in external demand could weigh on Malaysia's growth trajectory in the second half of the year.

Growth Outlook: Moderating but Still Above Trend

- We maintain our forecast for Malaysia's economy to expand by 4.7% in 2026, representing a moderation from the strong growth recorded over the past two years but remaining broadly consistent with the country's medium-term growth potential.
- Domestic demand is expected to remain the principal driver of economic activity. Private consumption should continue to benefit from favourable labour market conditions, wage growth and policy support measures, although higher fuel costs and elevated living expenses may lead households to adopt a more cautious spending approach. Public consumption is expected to expand at a slower pace amid ongoing fiscal consolidation efforts and higher operating expenditure

pressures.

- Investment activity is projected to remain supportive, led by continued inflows into technology-intensive industries, including semiconductors, data centres, digital infrastructure and advanced manufacturing. Public investment growth is expected to moderate as fiscal authorities balance development priorities against rising expenditure commitments.
- On the external front, Malaysia continues to benefit from strong demand for technology products and supply-chain diversification. However, slowing global growth, elevated uncertainty and geopolitical developments are expected to moderate export momentum in the second half of the year.

Table 5: GDP Growth Forecast

Economy	2023	2024	2025	2026F
GDP (by expenditure)	3.6	5.1	5.2	4.7
-**Private Consumption**	4.7	5.1	5.3	4.8
-**Public Consumption**	3.3	4.7	5.3	3.6
-**Private Investment**	4.6	12.3	9.4	6.8
-**Public Investment**	8.6	11.1	10.3	5.0
-**Exports of Goods & Services**	-8.1	8.5	4.9	7.0
-**Imports of Goods & Services**	-7.4	8.9	6.3	6.7
GDP (by Industry)	3.6	5.1	5.2	4.7
-**Agriculture**	0.7	3.1	2.2	2.1
-**Mining & Quarrying**	0.5	0.9	0.6	-1.0
-**Manufacturing**	0.7	4.2	4.5	5.2
-**Construction**	6.1	17.5	12.2	6.8
-**Services**	5.1	5.4	5.4	5.2

Sources: BNM, DOSM, Bank Islam

Sectoral Outlook

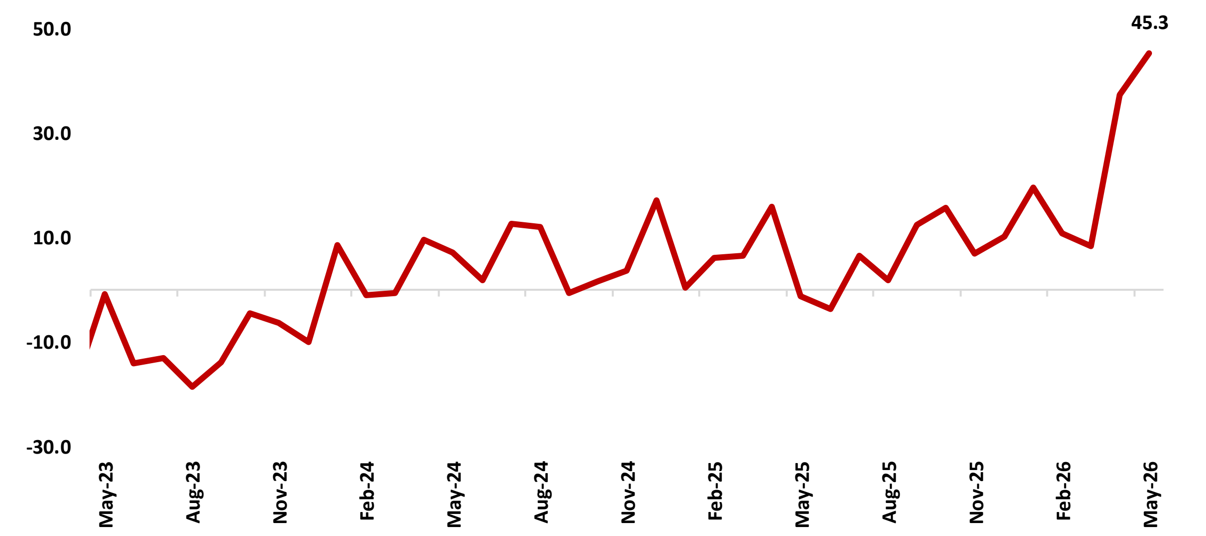
- The services sector is expected to remain the largest contributor to growth, supported by household spending, tourism-related activities and a resilient labour market. Nevertheless, growth may moderate slightly as higher fuel costs and softer consumer sentiment weigh on discretionary spending.
- Manufacturing is expected to remain a key growth engine, benefiting from the global semiconductor upcycle, AI-related demand and continued trade diversion flows. However, rising input costs, trade policy uncertainty and the eventual unwinding of front-loading activities are likely to temper growth later in the year.
- Construction activity should remain robust, supported by data centre developments, industrial projects and ongoing infrastructure investments. While higher fuel and logistics costs may compress margins, the sector continues to enjoy a healthy project pipeline.

- Agriculture is expected to register modest growth, supported by relatively favourable commodity prices. Nevertheless, higher fertiliser costs and policy-related adjustments to fuel subsidies may weigh on profitability and production.
- Meanwhile, the mining sector is likely to remain a drag on overall growth due to declining output from maturing oil fields and periodic maintenance activities at major oil and gas facilities.

Exports Continue to Benefit from Technology Demand and Trade Diversion

- Malaysia's external sector has significantly outperformed expectations in 2026. Export growth accelerated sharply in the first five months of the year, supported by strong demand for electrical and electronic products, AI-related technologies and continued supply-chain diversification.
- The combination of technology demand, trade diversion and precautionary inventory accumulation has created substantial support for export-oriented industries. As a result, we have revised our export growth forecast higher to 15.6% for 2026.
- Nevertheless, we remain cautious about the sustainability of the current pace of expansion. A significant portion of recent trade gains has been driven by front-loading activity and re-export flows, both of which could moderate as supply chain conditions normalise. In addition, uncertainty surrounding U.S. trade policy and potential semiconductor-related tariffs remains an important risk to the outlook.
- Despite these challenges, Malaysia remains well positioned to navigate a more uncertain global environment due to its diversified export base, strong integration into regional supply chains and continued efforts to broaden export markets.

Chart 4: Malaysia Exports (y-o-y %)



Sources: BNM, Bank Islam

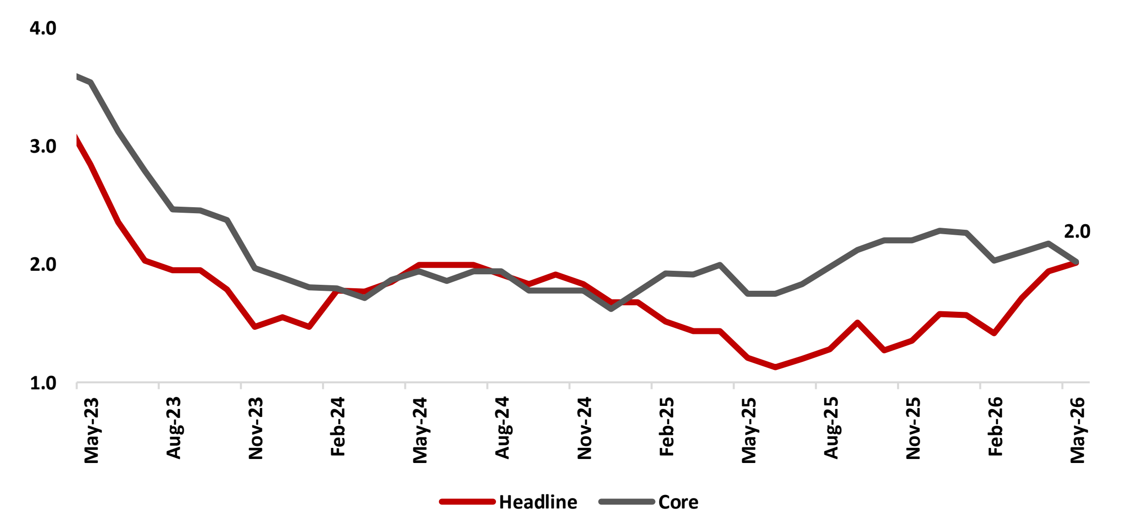
Manufacturing Outlook: Strong Demand Meets Rising Cost Pressures

- Manufacturing activity continues to benefit from resilient technology demand and inventory restocking. Industrial production remains supported by broad-based gains across manufacturing and electricity generation, reflecting healthy production activity.
- However, signs of moderation are beginning to emerge. Business surveys indicate weakening new orders and softer production momentum, while producer prices have accelerated sharply, pointing to increasing cost pressures throughout the supply chain. The divergence between rising input costs and softer business sentiment suggests that profit margins may come under increasing pressure in the months ahead.
- While near-term activity should continue to receive support from inventory rebuilding and technology demand, manufacturing growth is expected to moderate gradually as external demand normalises and cost pressures persist.

Inflation: Cost Pressures Are Building but Remain Manageable

- Malaysia's inflation environment remains broadly manageable, although upward pressures are becoming increasingly evident. Headline inflation has gradually accelerated, driven primarily by higher energy prices and rising global food costs.
- More importantly, upstream inflationary pressures have intensified. Producer prices recorded their strongest increase since 2022, suggesting that higher input costs are increasingly being transmitted through production chains.
- We have therefore revised our 2026 inflation forecast upward to 2.5%. While imported inflation and higher transportation costs are expected to contribute to further price increases, the overall inflation environment remains substantially more benign than in many regional economies.
- Government subsidies, targeted assistance programmes and existing price-control mechanisms should help cushion the pass-through of external cost shocks, preventing a more pronounced acceleration in consumer prices.

Chart 5: Malaysia CPI (y-o-y %)



Sources: BNM, Bank Islam

BNM Likely to Remain on Hold

- Bank Negara Malaysia is expected to maintain the Overnight Policy Rate at 2.75% throughout 2026.
- Although inflation is trending higher, underlying price pressures remain relatively contained, as reflected by stable core inflation. At the same time, policymakers must balance inflation concerns against the risks posed by a softer external environment and growing geopolitical uncertainty.
- The current policy setting remains supportive of economic growth while providing sufficient flexibility to respond should inflationary pressures become more persistent. As such, the threshold for additional monetary tightening remains relatively high.
- Nevertheless, a sustained rise in energy prices, renewed supply disruptions or a sharper acceleration in inflation could alter the policy outlook and prompt a reassessment of the current stance.

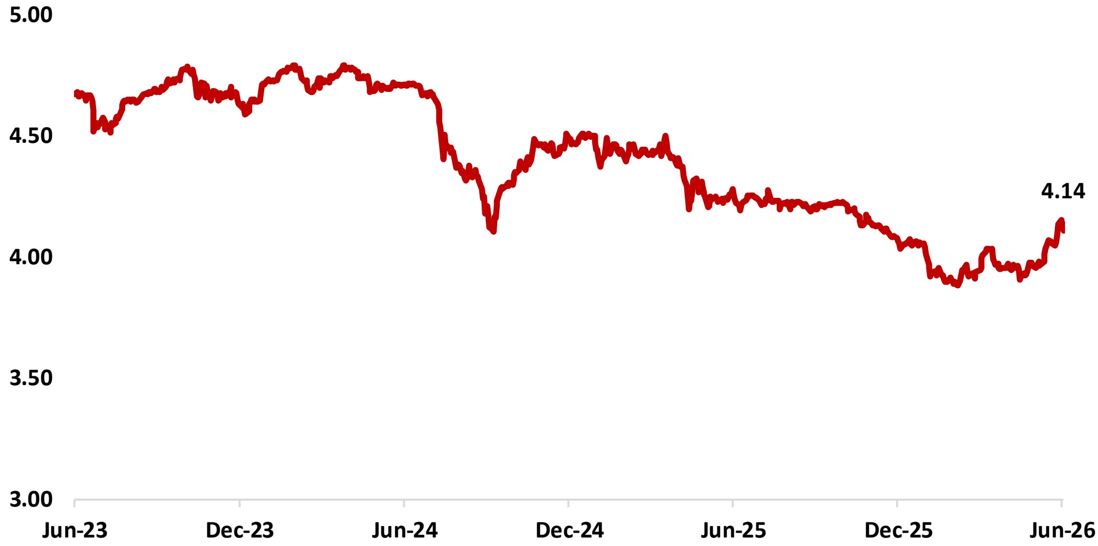
Labour Market Remains a Key Source of Stability

- Malaysia's labour market continues to provide an important foundation for domestic demand. Employment conditions remain close to full employment, supporting household income growth and consumer spending.
- The Visit Malaysia 2026 campaign, ongoing infrastructure projects and continued investment activity are expected to support hiring across tourism, construction and services-related sectors. While retrenchment indicators have shown some signs of normalisation, labour market conditions remain sufficiently healthy to absorb displaced workers.
- Although external uncertainties could weigh on hiring sentiment among export-oriented firms, overall labour market conditions are expected to remain supportive of economic activity throughout the year.

Ringgit Outlook: Resilient Fundamentals Amid External Volatility

- The ringgit is expected to remain relatively resilient despite periods of heightened volatility.
- Malaysia's position as a net energy exporter, healthy external balances and stable macroeconomic fundamentals provide important support for the currency. Furthermore, continued strength in exports and foreign direct investment inflows should help underpin medium-term ringgit performance.
- Nevertheless, the currency remains vulnerable to external developments, particularly changes in U.S. monetary policy expectations, geopolitical events and shifts in global risk sentiment. The widening divergence between Federal Reserve and Bank Negara Malaysia policy expectations has generated renewed support for the U.S. dollar, creating short-term headwinds for regional currencies, including the ringgit.
- While periods of volatility are likely, we expect Malaysia's economic fundamentals to remain supportive of the currency over the medium term, with USD/MYR projected to end 2026 near 3.95.

Chart 6: USD/MYR



Sources: BNM, Bank Islam

Conclusion: Growth to Continue, But Risks Have Shifted Lower

- Malaysia enters the second half of 2026 from a position of relative strength. Domestic demand remains resilient; investment activity continues to benefit from structural growth themes and exports are receiving support from the global technology cycle.
- However, the operating environment has become increasingly challenging. Elevated geopolitical tensions, trade policy uncertainty, rising production costs and slower global growth have increased downside risks to the outlook.
- Our baseline expectation remains that Malaysia will achieve GDP growth of 4.7% in 2026, supported by private consumption, investment and technology-related exports. Inflation is expected to rise moderately to 2.5%, while Bank Negara Malaysia is likely to maintain a steady monetary policy stance.
- Overall, Malaysia's diversified economic structure, improving investment ecosystem and continued participation in high-growth technology industries should help cushion external shocks and preserve growth momentum. Nevertheless, the economy is likely to face a more volatile and uncertain external environment in the second half of the year, requiring close monitoring of geopolitical developments, trade policies and global demand conditions.