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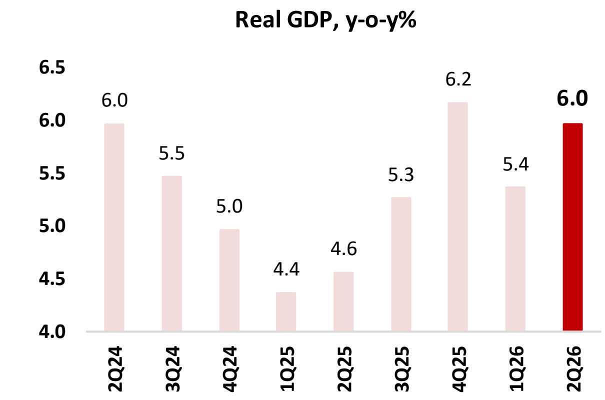
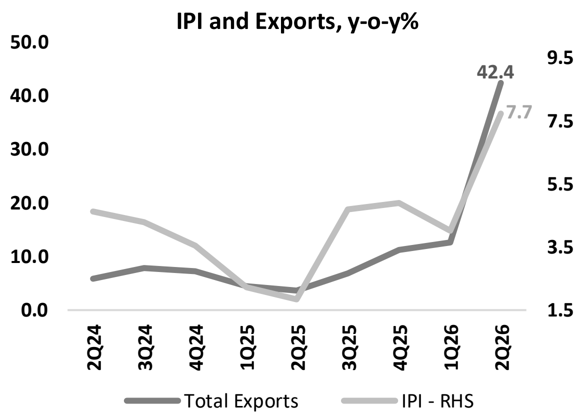
2Q26 GDP PREVIEW: MALAYSIA'S 2Q26 GDP GROWTH LIKELY TO SURPASS ADVANCE ESTIMATE





Sources: Department of Statistics Malaysia (DOSM), Bank Islam

- **Malaysia's economy is estimated to have expanded at a stronger pace of 6.0% y-o-y in 2Q26, surpassing the Department of Statistics Malaysia's (DOSM) advance estimate of 5.8%.** The stronger-than-expected growth underscores the economy's resilience, supported by sustained domestic demand and continued strength in the external sector. This performance contrasts with earlier expectations of a moderation in growth amid heightened geopolitical tensions in the Middle East and concerns that higher global oil prices could erode household purchasing power and increase production costs. The adverse effects of these external developments on the domestic economy were partly mitigated by Malaysia's fuel subsidy mechanism, which helped maintain relatively stable domestic fuel prices and contained inflationary pressures. At the same time, favorable labor market conditions, marked by near-full employment and steady wage growth, continued to support household consumption and overall economic activity. Consumer spending, however, showed signs of moderating, with retail sales growth easing to 6.7% in 2Q26 (1Q26: 7.1%), following the strong festive-related spending recorded in the preceding quarter. Despite the softer retail performance, overall distributive trade activity remained robust, supported by a significant acceleration in wholesale trade growth to 18.3% (1Q26: 9.1%). The stronger wholesale segment reflects sustained business demand, inventory replenishment, and improving activity in the manufacturing and export-oriented sectors, which helped offset slower retail momentum and contributed to the economy's solid overall performance during the quarter.

- **Robust manufacturing demand and mining rebound underpin production and export growth.** The acceleration in manufacturing production, particularly in the electrical and electronics (E&E) segment together with the recovery in mining output, provided additional support to overall economic growth during the quarter. This was reflected in the Industrial Production Index (IPI), which expanded by 7.7% in 2Q26, compared with 4.0% in 1Q26. The stronger performance was driven by higher growth in both manufacturing and mining activities, which increased by 7.4% (1Q26: 5.7%) and 9.9% (1Q26: -2.8%) respectively, alongside a further improvement in electricity output to 7.4% (1Q26: 5.2%). Export-oriented industries continued to outperform, recording growth of 8.3% (1Q26: 6.5%), while domestic-oriented industries also strengthened to 5.5% (1Q26: 4.0%). This suggests that Malaysia's industrial expansion was increasingly supported by external demand, although domestic demand remains resilient. The stronger industrial performance was consistent with a sharp acceleration in Malaysia's total exports, which surged by 42.4% y-o-y in 2Q26 (1Q26: 12.6%). Export growth was primarily driven by manufactured goods, which expanded by 46.4% (1Q26: 14.6%), supported largely by robust E&E exports (57.4%; 1Q26: 26.7%). In addition, exports of petroleum products rebounded strongly by 67.3% following a contraction of 7.7% in 1Q26. Meanwhile, mining exports rose sharply by 49.1% (1Q26: 4.7%), underpinned by broad-based improvements across the sector, particularly Liquefied Natural Gas (LNG) exports, which rebounded to 55.2% growth from a decline of 16.4% in the previous quarter.

- **Investment momentum is expected to moderate further as heightened geopolitical uncertainties in the Middle East continues to weigh on construction activity.** Gross fixed capital formation eased to a nine-quarter low of 7.3% y-o-y in 1Q2026 (4Q25: 9.3%), partly reflecting increasingly cautious capital deployment and a slower pace of realized investments. The moderation was broad-based, underscoring slower growths across both private (1Q26: 7.8% vs. 4Q25: 9.2%) and public segments (1Q26: 5.3% vs. 4Q25: 9.5%). Given the persistence of episodic geopolitical tensions, investment activity is expected to remain cautious in the second quarter of the year. Ongoing conflicts in the Gulf region have heightened uncertainty across key global shipping routes, leading to rising freight charges, higher insurance premiums, and longer delivery times. These supply-side disruptions have gradually filtered through global supply chains, contributing to higher construction-related input costs. The impact is increasingly evident in the prices of key building materials. In July, cement and steel prices remained elevated, recording increases of up to 7.5% and 8.4% y-o-y, respectively, while aggregates and sand prices rose more sharply by as much as 26.6% and 33.3%. At the same time, volatility in global energy markets has added further cost pressures, particularly given the fuel-intensive nature of construction activities. Against this backdrop, rising input cost inflation is expected to weigh on investment sentiment by increasing project costs, compressing profit margins, and potentially delaying project implementation timelines. As a result, businesses may adopt a more cautious approach to capital expenditure decisions, resulting in a moderation of investment momentum over the near term. As such, rising input cost inflation is expected to delay project execution timelines and compress margins, weighing on investment appetite.

- **Nevertheless, several structural growth pillars are expected to continue encouraging investment activity.** Notably, data center demand, ongoing progress across multi-year infrastructure projects, the expansion of high-growth, high-value industries and affordable housing initiatives will bolster construction activity. Major infrastructure projects, such as the East Coast Rail Link (ECRL), Penang Light Rapid Transit (LRT) and Pan Borneo Highway, are expected to support public-sector outlays while creating opportunities for transit-oriented development and last-mile connectivity projects. Capital flows are expected to be concentrated towards data centre projects amid the ongoing global AI upcycle, alongside industrial and logistics industries, driven by robust demand for Malaysia's semiconductors and specialized manufacturing equipment. Additionally, initiatives linked to the national sustainability and affordable housing commitment, as highlighted in key national strategies, will also provide modest support to investment momentum. As such, while investment momentum will likely moderate amid a highly uncertain external backdrop and elevated cost pressures, Malaysia's strategic investment ecosystem, infrastructure development and competitive advantages are expected to preserve the sector's resilience.

- **Stronger-than-expected growth in 1H26 suggests upside potential to Malaysia's 2026 GDP outlook.** The robust economic performance recorded in 2Q26 highlights the economy's resilience in the face of external headwinds, particularly ongoing geopolitical tensions and continued uncertainty surrounding global trade. Export growth strengthened significantly during the quarter, driven by increased shipments of E&E products and stronger global demand associated with semiconductor and artificial intelligence (AI)-related investment cycles. Meanwhile, the recovery in mining activity and firmer manufacturing output point to improving business conditions and stronger external demand. Although global energy price volatility continues to pose inflationary risks, domestic price pressures have remained well contained, with inflation averaging 1.8% in 1H26. This has helped preserve household purchasing power and provided continued support for private consumption, which remains a key pillar of economic growth. Looking ahead, downside risks remain. These include a potential deterioration in global trade conditions, a sharper-than-expected slowdown among major trading partners, and any escalation in geopolitical conflicts that could disrupt commodity markets and global supply chains. In addition, growth in the mining sector is likely to moderate in the coming quarters as favourable base effects fade and production levels normalise. Nonetheless, several factors are expected to continue underpinning growth in 2H26. Sustained investment inflows into high-value-added manufacturing industries, particularly the E&E sector, supported by strong AI-driven demand and an ongoing semiconductor upcycle, should provide a meaningful boost to economic activity. Together with resilient domestic demand and favourable labour market conditions, these factors are expected to support continued economic expansion. Given the stronger-than-expected performance in 1H26, with GDP growth projected to average 5.7%, Malaysia's full-year growth is likely to exceed our earlier forecast of 4.7%. Should current growth momentum be sustained, full-year GDP growth could remain above 5.0% for the year. We will reassess our full-year projection following the release of the official 2Q26 GDP data on 14 August 2026, with the balance of risks now tilted towards an upward revision.

- **Banks are expected to benefit from stronger economic activity, although external risks warrant continued vigilance**. The stronger growth environment should support business financing demand, particularly from manufacturing, construction and trade-related sectors. The sharp recovery in export-oriented industries, especially E&E, is expected to strengthen corporate earnings and support asset quality. Stable labour market conditions and resilient household spending should also continue to support retail banking activities, including mortgages and consumer financing. Nevertheless, banks remain exposed to downside risks stemming from potential external demand weakness, commodity price volatility and geopolitical developments that may affect business confidence and investment decisions.