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Economic Outlook 2019 – "The Inconvenient Truth"

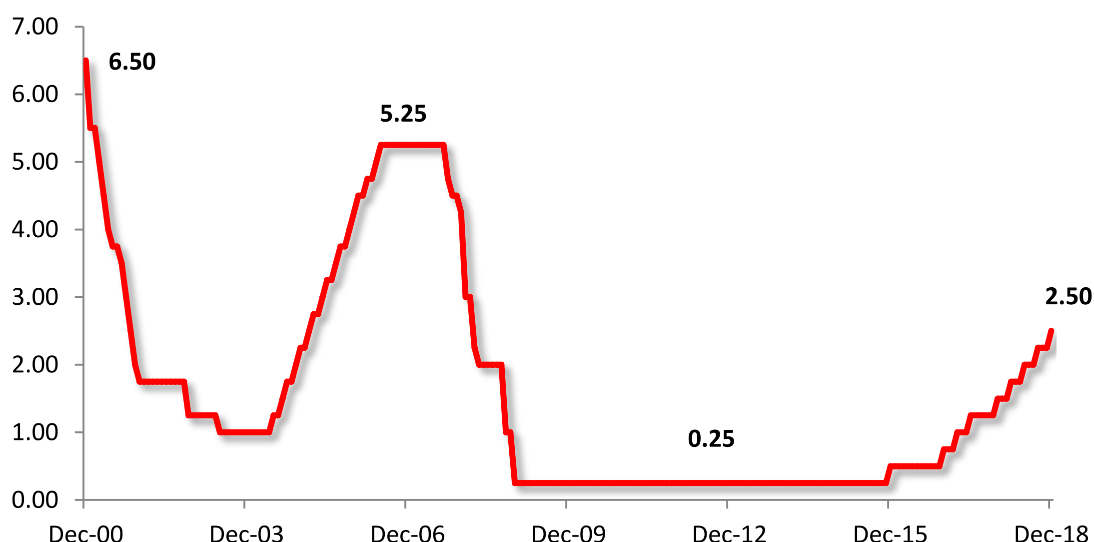
Reviewing the year 2018

1.0 Global landscape

Federal Fund Rate (FFR) – nearing its neutral state

In a scheme of things, the ongoing monetary tightening in the United States (US) has always been the main focal point. The Federal Open Market Committee (FOMC) has increased the Federal Fund Rate (FFR) by 25 basis points (bps) to a range between 2.25% and 2.50% in December 2018. This is the ninth time increases since the Federal Reserve (Fed) began to normalise the policy rate in December 2015. Looking forward, the Fed is expected to raise two more rate hikes in 2019 based on the recent FOMC survey. Other than the US Fed, the Bank of Canada (BOC) was the latest Central bank in the developed markets which has raised the policy rates by 25 basis points to 1.75% on 24 October this year. Consequently, the monetary tightening in the advanced economies will indirectly give an impact to the global growth. Although the rate rise indicates a vote of confidence in the state of the economy, it would, however tends to discourage domestic investment. At the most fundamental level, the lack of investment or capacity expenditure among the private firms in particular would result in growth moderation.

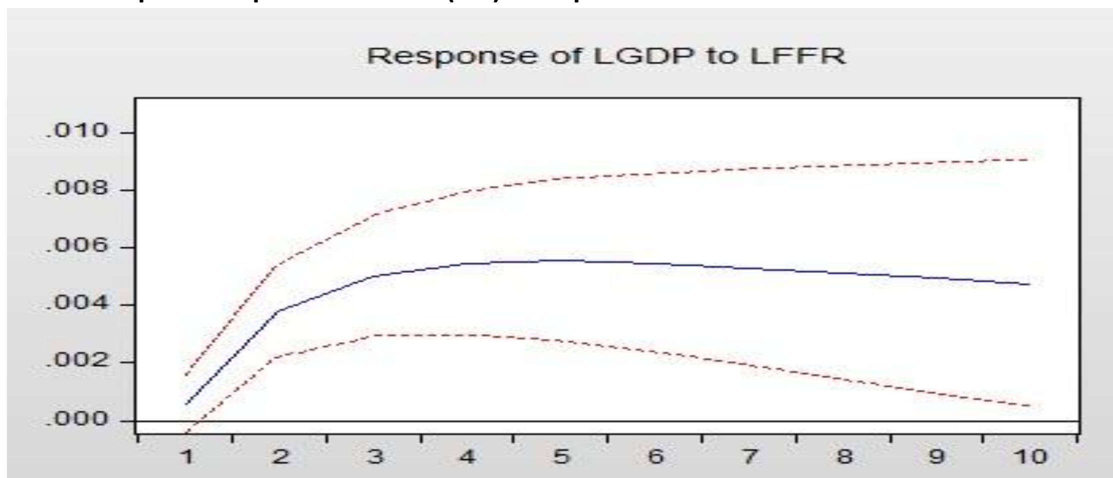
Chart 1: Federal Fund Rate (%)



Source: Bloomberg

Judging from the Vector Auto Regression (VAR) model, there is direct relationship between the US GDP and the FFR, whereby a unilateral causation was quite apparent from the FFR to GDP. What we can infer from the observed estimation is that, monetary tightening tends to have positive effect to economic growth, at least in the early stage. Nonetheless, the Impulse Response Function (IRF) has shown that the most optimum length criteria, in which the US GDP responded to FFR is within three quarters or for about 9 months. In that sense, the US economy should starts to moderate after the Fed has done with the tightening process. This would give rise to the argument of the neutral rate which has been actively discussed among the market participants. Neutral rate essentially a rate that is neither contractionary nor expansionary to the economy. Looking at the latest FOMC members' projection, **the neutral rate seems to lie within a range of 2.75% to 3.00%.** Therefore, we should see US economy starts to moderate once it reach the neutral rate which could be just 25 to 50 basis points away.

Chart 2: Impulse Response Function (IRF) – Response of US GDP to FFR



Source: Strategic Management, Bank Islam

UK Brexit deal – time is running out

On 29 March 2019 the United Kingdom (UK) is expected to leave the European Union (EU). It is a democratic decision when the Brits cast their vote in June 2016 referendum. Since then, UK's members of parliaments (MPs) have been scrambling to reach the best deal they could get from the separation exercise. A Political Declaration has been agreed which outlines parameters for the future trading and security relationship between the EU and the UK after the Brexit. There are 26 pages of Political Declaration which is not legally binding that sets out the drives for the trade talks to come. After 20 months of negotiations, the 27 EU leaders finally gave their blessing. The EU is very clear that there is no more negotiating after this, so it is either deal or no-deal situation.

Following that, UK Prime Minister, Theresa May need to get approval from the MPs in order to proceed with the plan. The vote by the MPs was scheduled to be held on 12 December 2018. However, Prime Minister May decided to delay the Brexit deal vote. The vote could take place soon or even be delayed until early January 2019. The ultimate deadline for the vote is on 21 January 2019.

Needless to say, the postponement will add another complication to the Brexit process and would allow less time for the Brexit legislation to be passed through the parliament before 29 March. We believe by deferring the parliamentary vote, it will raise the risk of a no-deal Brexit, leading to more uncertainties. Theresa May had to face leadership battle with Conservative MPs who were pursuing a vote of confidence to decide whether she should stay as a leader and UK prime minister. Nevertheless, she won the crucial confidence vote in the Conservative party after securing 63% of her MPs votes. At least for now, leadership will not be challenged for another year and should pave the way for concluding the Brexit deal.

Trade War – unsettling, uneasy and there is ceasefire

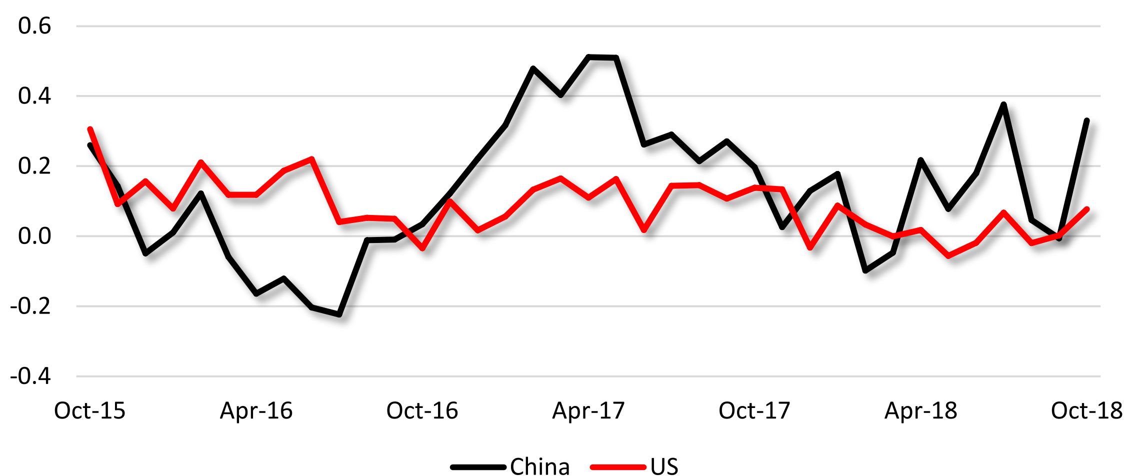
Escalation trade tensions between the US and China has posed the downside risk to overall economic performance. Disruptions in trade activities have adverse effect not only on the economic growth, but also in the production supply chain where everything is interconnected. Activities in the production of goods from sourcing the raw material to final assembly that happen across countries will be affected and Malaysia is no exception to this. In particular, production of parts and components for the international brands such as Apple, Samsung, Intel, BMW and Airbus are all can be related to Malaysian firms. The negative impacts on the trade disputes could increase the costs of running the businesses, reduce investors' confidence, and increase financial market volatility. On further scrutiny, the trade conflict between the US and China has significant impact to Malaysia's export-oriented industries.

Based on the Box Article in BNM Quarterly Bulletin, the repercussion from the prevailing trade friction is estimated to lead to a reduction in annual global growth of 0.3 percentage points (ppt). However, if the trade tension continues to intensifies, it could shave off 0.8 ppt to the baseline global GDP growth forecast. This would mean global GDP could grow as low as 3.2% in 2019. At this rate, the global economy is expanding below its trend level of around 3.8% growth. Following this, the Malaysian economy will be affected via trade, income and investment channels. In its current forms, the trade tensions are expected to weigh down **Malaysia's GDP in 2019 by 0.3 – 0.5 ppt**. However, **it could slash Malaysia's GDP growth by as much as 1.3 to 1.5 ppt** should US raise the tariff rates to 25% on the remaining trade with China[1] and blanket tariff on auto tariffs. **This would mean Malaysia's GDP could grow as low as 3.4% in 2019 from the official baseline growth forecast of 4.9%.**

[1] Jul – Sep 2018 – the US announced 10% on USD200 billion worth of China imports. The tariff rate will be raised to 25% on 1 January 2019 (Source: US Trade Representative - https://ustr.gov/about-us/policy-offices/press-office/press-releases/2018/september/ustr-finalizes-tariffs-200)

Be that as it may, the latest development has been forthcoming. China has purchased additional 0.3 million metric tons of U.S. soybeans (previously 1.13 million), reflecting a sign that both countries are now in the process of “mending the relationship”. We reckoned that the lunch meeting between President Donald Trump and Chinese President Xi Jinping in Buenos Aires, Argentina at the end of November has been fruitful. And yes, the “ceasefire” for 90 days has been conceived. As such, we are positive that the trade disputes could be resolved although it is still a tall order.

Chart 3: Malaysia’s export growth to China and US y-o-y (%)



Source: Strategic Management, Bank Islam

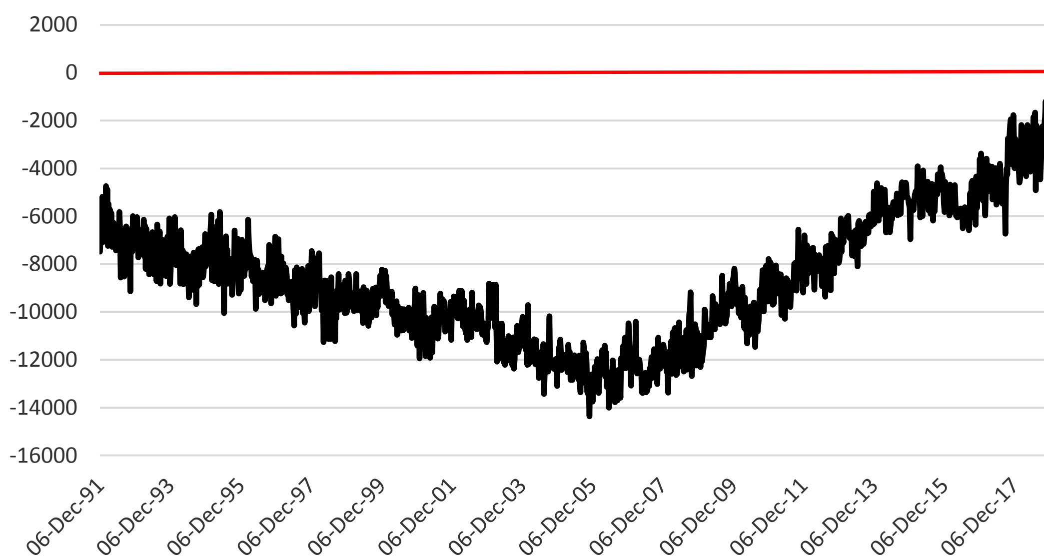
Crude Oil – fickle minded

There seems to be hope that crude oil prices will climb further, at least in the first nine months of this year. Brent crude oil price reached USD86.29 per barrel in early October on concerns that the market could tighten as economic sanctions against Iran will be implemented. Then, in less than a month, the Brent crude nosedived to USD50.47 per barrel on 24 December as excess oil supply narrative makes a forceful comeback. This happened despite the Organisation of the Petroleum Exporting Countries (OPEC) and Non OPEC decided on 7 December to reduce the overall production by 1.2 million barrels per day (mb/d) which will take effect in January 2019 for an initial period of six months. The contributions from OPEC and the voluntary contributions from non-OPEC participating countries of the ‘Declaration of Cooperation’ will correspond to 0.8 mb/d and 0.4 mb/d respectively.

According to International Energy Agency (IEA), the total crude oil supplies stands at 100.3 mb/d while total demand 99.8 mb/d, leaving an excess supply of 0.6 mb/d. This represents the third consecutive quarter whereby oil supplies exceeded demand in 2018. It remains to be seen whether such pact between the OPEC and some non OPEC countries would yield its intended effect. This is especially true when supplies from the US markets have been steadily rising. The latest data showed production from the US is currently at 11.6 mb/d as of 14 December. This is about 18.5% higher from the same period last year. Similarly, the US Shale oil production has increased by 22.5% year-on-year in November to 8.2 mb/d which was largely contributed from Permian Basin (+38.9%: 3.9 mb/d) followed by Bakken (+12.6%: 1.4 mb/d) and Eagle Ford (+4.0%: 1.3 mb/d).

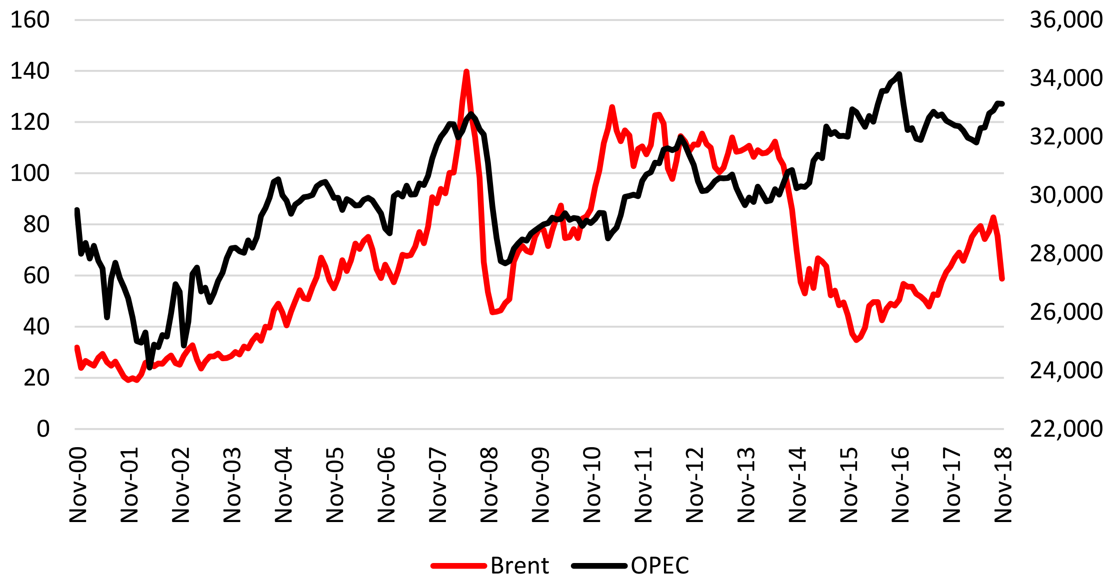
At the current juncture, the US has remained a net oil importer for the longest time with the latest date series showed -1.45 mb/d as of 14 December. However, the deficits have been significantly reduced compared to -14.4 mb/d on 4 November 2005. Therefore, the US appears to be gradually self-sufficient in crude oil markets. Therefore, it remain uncertain whether the pact between OPEC and some non OPEC countries could stabilise the crude oil prices effectively especially when the US was not involved in the discussion. Based on our internal estimates, the base case of Brent crude oil prices should stabilise at around **USD63 per barrel in 2019.**

Chart 4: US Crude Oil Trade Balance thousand barrels per day (kb/d)



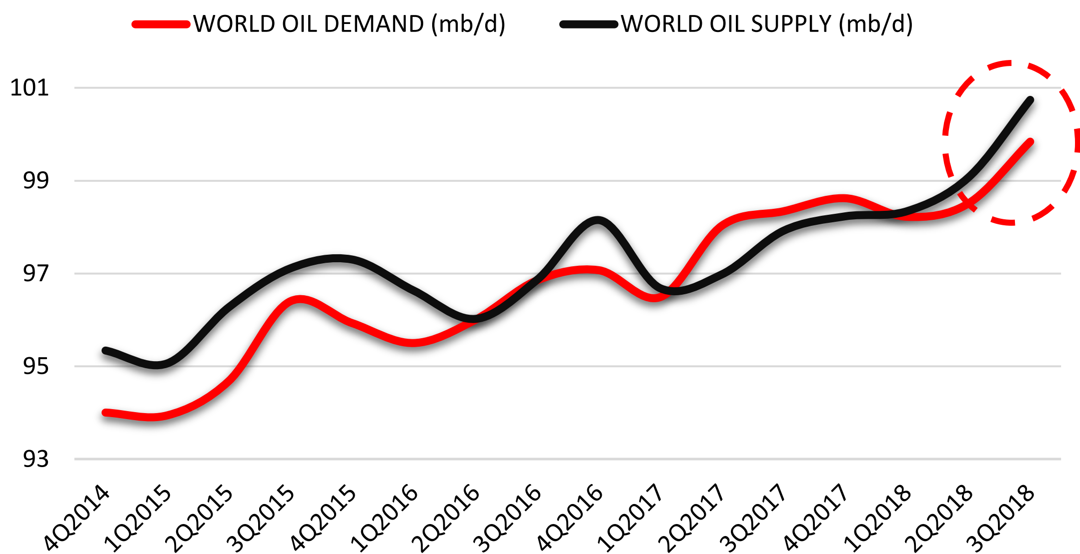
Source: US Energy Information Administration (EIA)

Chart 5: Brent price in USD per barrel vs. Oil Production, thousands per barrel



Source: Bloomberg

Chart 6: World oil demand and supply, million barrels per day (mb/d)

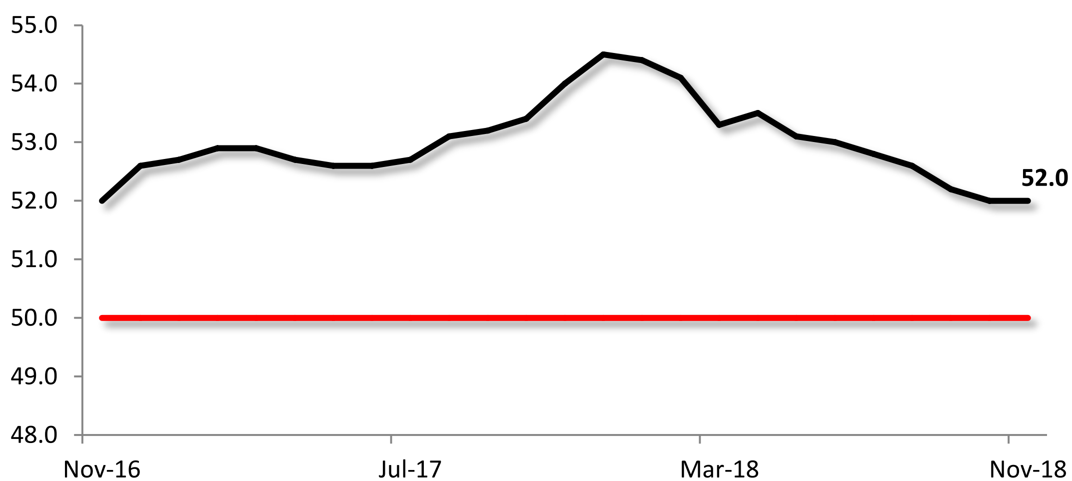


Source: International Energy Agency (IEA)

2.0 Malaysian Economy

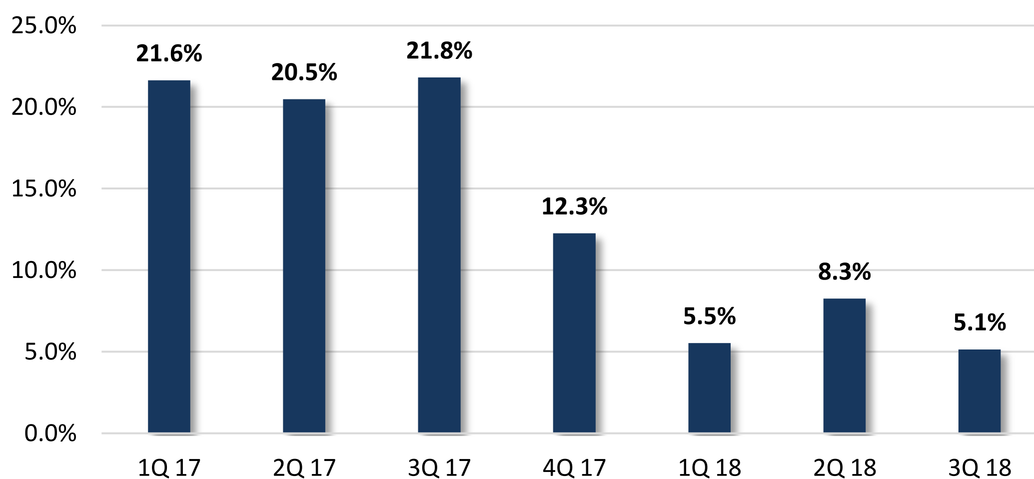
The country's GDP growth moderating to 4.7% in the first nine months of 2018 from 5.9% recorded in the same period of 2017. This was mainly on account of slower real export growth to 1.6% (9M2017: 10.3%) as global sentiments were badly affected by the trade war uncertainties. Such pessimism was reflected in the Global Purchasing Managers Index (PMI) for manufacturing sector which fell from 54.4 points in January to 52.0 points in November. Similarly, the Global Semiconductor Sales posted an average growth of 18.7% in the first ten months of 2018, slightly lower from 20.8% in the same period of 2018. At the same time, the global shipment for smartphones as reported by the International Data Corporation (IDC) also recorded 6.0% y-o-y contraction in the 3Q2018, making it the fourth consecutive quarterly decline. Such trend implies that the external demand is softening and will likely impact on key export products such as Electrical and Electronics.

Chart 7: Global Purchasing Managers Index (PMI) for manufacturing sector



Sources: IHS Markit & Bloomberg

Chart 8: Malaysia's nominal export growth y-o-y%



Source: CEIC

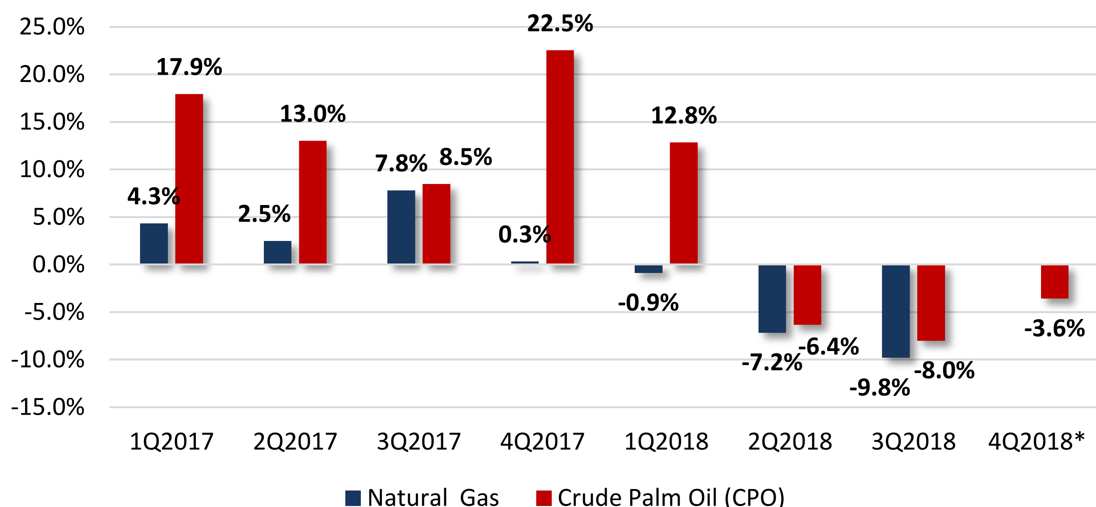
Table 1: Gross Domestic Product (GDP) y-o-y%

Y-o-Y%	1Q 17	2Q 17	3Q 17	4Q 17	1Q 18	2Q 18	3Q 18	9M2017	9M2018
GDP	**5.6%**	**5.8%**	**6.2%**	**5.9%**	**5.4%**	**4.5%**	**4.4%**	**5.9%**	**4.7%**
By expenditure									
Consumption	6.8%	6.4%	6.6%	6.9%	5.7%	7.0%	8.3%	6.6%	7.1%
-Private	6.7%	7.1%	7.2%	7.0%	6.9%	8.0%	9.0%	7.0%	8.0%
-Public	7.5%	3.3%	3.9%	6.8%	0.4%	3.1%	5.2%	4.8%	3.0%
Investment	10.0%	4.1%	6.7%	4.3%	0.1%	2.2%	3.2%	6.8%	1.8%
-Private	12.9%	7.4%	7.9%	9.2%	0.5%	6.1%	6.9%	9.3%	4.5%
-Public	3.2%	-5.0%	4.1%	-1.4%	-1.0%	-9.8%	-5.5%	0.8%	-5.3%
Net Exports	-15.3%	1.9%	2.0%	2.3%	62.4%	1.7%	-7.5%	-3.5%	14.8%
Exports	9.8%	9.4%	11.8%	6.7%	3.7%	2.0%	-0.8%	10.3%	1.6%
Imports	13.0%	10.4%	13.3%	7.3%	-2.0%	2.1%	0.1%	12.2%	0.1%
By Industry									
Agriculture	8.4%	5.9%	4.1%	10.7%	2.8%	-2.5%	-1.4%	6.0%	-0.4%
Mining	1.4%	0.1%	3.0%	-0.3%	0.1%	-2.2%	-4.6%	1.5%	-2.2%
Manufacturing	5.6%	6.0%	7.0%	5.4%	5.4%	4.9%	5.0%	6.2%	5.1%
Construction	6.6%	8.3%	6.1%	5.9%	4.9%	4.7%	4.6%	7.0%	4.8%
Services	5.8%	6.3%	6.5%	6.2%	6.5%	6.5%	7.2%	6.2%	6.8%

Source: CEIC

Additionally, public sector's spending is shifting into a lower gear with public investment fell 5.3% (9M2017: 0.8%) while public consumption expanded moderately from 4.8% in 9M2017 to 3.0% between January and September 2018. Near completion in some of the projects namely in Pengerang, Johor as well as a move to review the ongoing infrastructure projects have been the main reason for the sluggish performance in the public sector. Apart from that, the commodities supply shocks stemming from the decline in Natural Gas and Crude Palm Oil (CPO) have dragged the key sector in the economy such as mining and agriculture. Between January and October, Natural Gas output growth declined by 5.1% from 4.5% in the same period last year. Similarly, CPO production growth fell 1.1% between January and November 2018 from 14.7% growth in the same period in 2017.

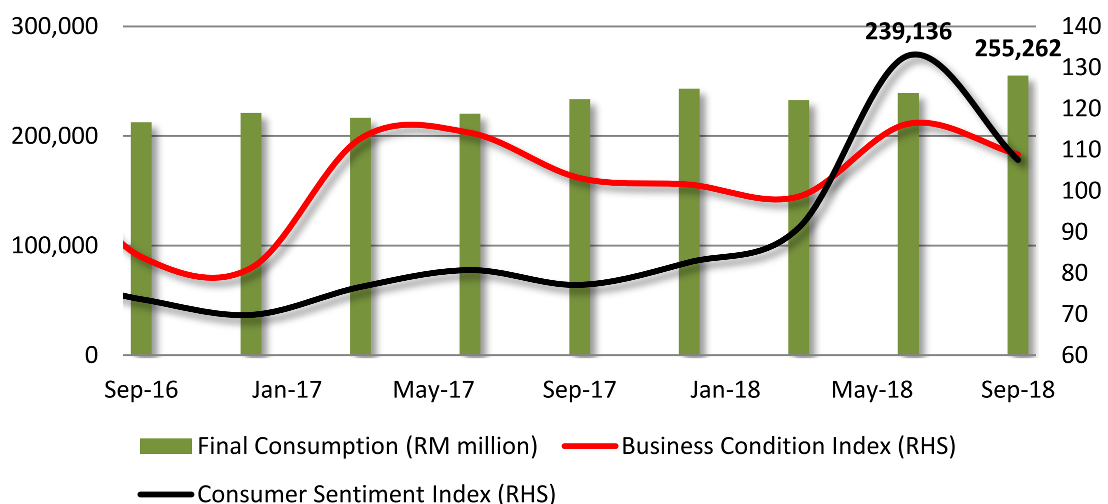
Chart 9: Natural Gas & Crude Palm Oil (CPO) output growth



Source: CEIC
*until November 2018

Despite that, the private sector has been quite resilient especially household spending. The private consumption growth expanded by 8.0% in 9M2018 from 7.0% growth in the corresponding period in 2017. The above-trend growth (6.9%) signals consumer spending has been extremely strong this year. The short-term catalyst would be none other than the three-month Goods and Services Tax (GST) holiday between June and August 2018 and its eventual abolishment in September has boosted optimism among the consumers. Based on the Malaysian Institute of Economic Research (MIER), the Consumer Sentiment Index (CSI) shot up to 132.9 points in the 2Q2018, a 21-year high, before reverting to 107.5 points in the 3Q2018. CSI of more than 100 points suggests that most Malaysians were feeling upbeat during the survey period. On the contrary, private investment growth was moderating from 9.3% in 9M2017 to 4.5% in 9M2018. Uncertainties on economic prospects may have prevented private firms to expand its production capacity excessively. This could be seen from the sharp deceleration in Machinery & Equipment spending growth from 12.3% in 9M2017 to 1.8% in 9M2018.

Chart 10: MIER Consumer Sentiment Index (CSI) and Business Sentiment Index (BSI) vs. Private Consumption



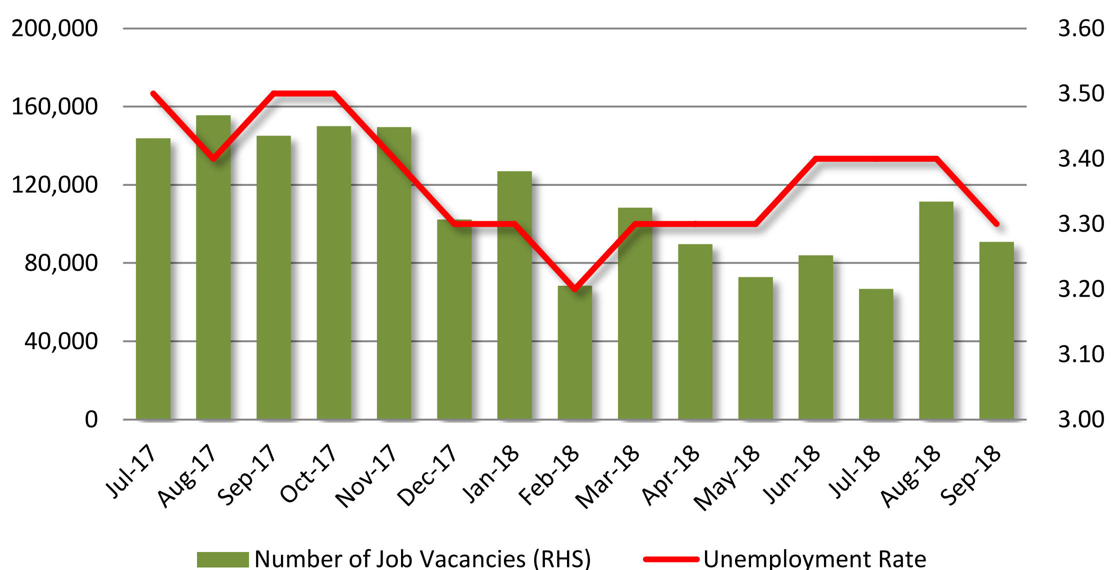
Source: CEIC

Meanwhile, labour market remained positive and supportive to economic activities. The average unemployment for the first 10 months of 2018 stands at 3.34% against 3.43% in the same period last year. In addition, the private sector wage growth sustained at 5.7% for two consecutive quarters in the 3Q2018. Services sector wages remain the main driver, growing 3.9% in the 3Q2018 (2Q2018: 3.7%) while manufacturing related industries wages moderated to 9.6% in the 3Q2018 (2Q2018: 10.1%). On further scrutiny, wages in the export-oriented industries posted 10.9% increases during the 3Q2018 from 10.6% previously in particular firms in the Electrical & Electronics (E&E) sector.

Notwithstanding that, the labour market condition varies according to industries. For instance, media companies such as Utusan Melayu (Malaysia) Berhad, Astro Malaysia Holdings Berhad and Media Prima Berhad will be reducing their men power and will be offering Voluntary Separation Scheme (VSS). The move is aimed at reducing their operating expenditure and enhancing operational efficiency. Additionally, a tiles producing company, Guocera Sdn. Bhd. has retrenched 182 workers as the business is slowing down[2].

While it's worrying, it is worth noting that the VSS exercise could also be motivated by the change in business landscape. In particular, the adoption of technology in the media industries has shifted the demand for media content to digital platforms. As a result, audience especially the younger generations have been leveraging on smartphones technology in order to access entertainment source. This has resulted in lower print advertisement among the mainstream media. Therefore, the labour market condition is still mixed although unemployment has been trending downwards.

Chart 11: Unemployment Rate vs. Job Vacancies in Malaysia

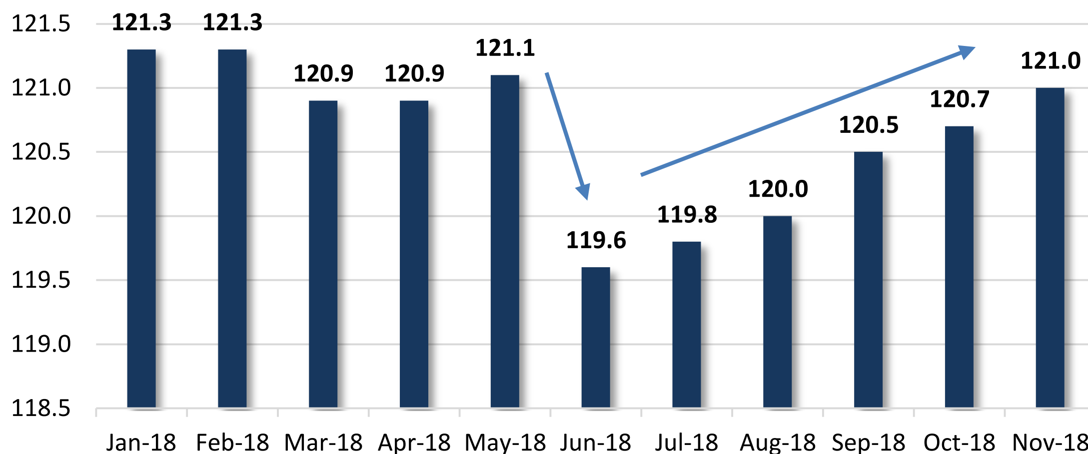


Source: CEIC

As for inflation rate, the Consumer Price Index (CPI) gained by only 1.0% in the first eleven months of 2018. This is lower compared to 3.8% in 11M2017. Most of the sub-indices were lower owing to the abolishment of Goods and Services Tax (GST) in September 2018. Notwithstanding that, the level of the CPI has been rising gradually from as low as 119.6 points in June to 121.0 points in November. There could be several factors contributing to such trend. This include weakening exchange rate, the reintroduction of Sales and Services Tax (SST) in September and strong consumer demand. At the moment, the inflation rate is very low and this is in tandem with the slowing economy, suggesting some degree of excess capacity in the economy.

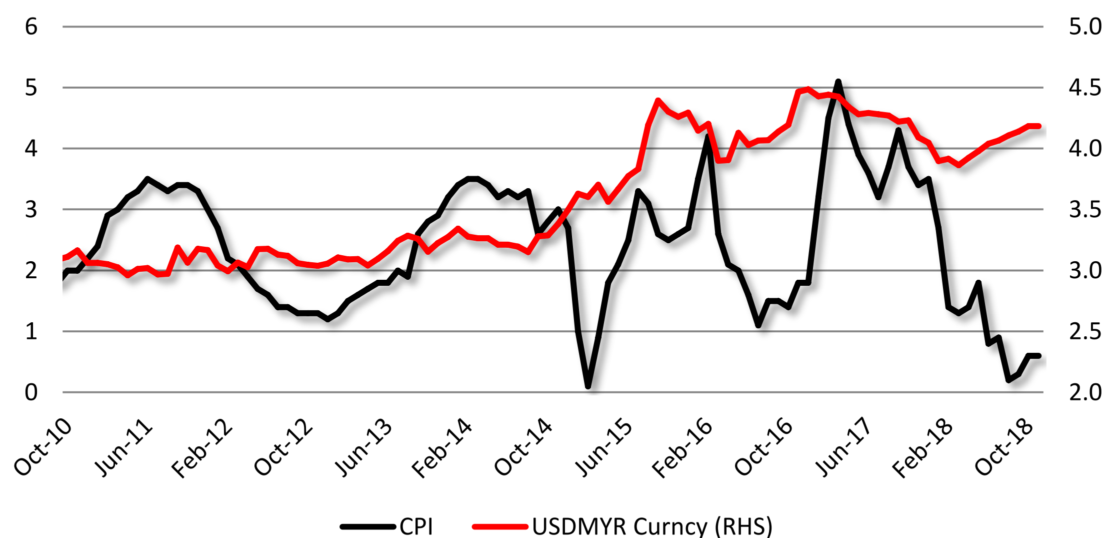
[2] https://www.freemalaysiatoday.com/category/nation/2018/10/17/kluang-factory-retrenches-over-180-workers-as-business-dwindles/

Chart 12: Consumer Price Index (CPI) - level



Source: CEIC

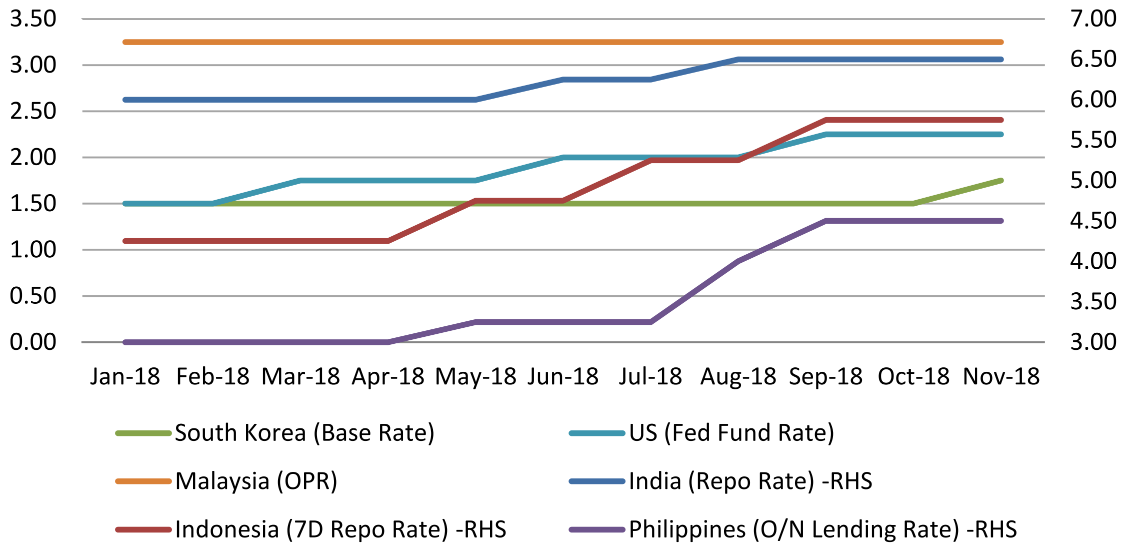
Chart 13: Inflation and Exchange Rate



Source: CEIC, Bloomberg

The BNM has raised the Overnight Policy Rate (OPR) by 25 basis points in January. Since then, the Monetary Policy Committee (MPC) has maintained the policy rate at 3.25% throughout the year. Other central banks in Asia have also decided to increase the policy rate especially countries that are experiencing twin deficits problems (fiscal and current account deficits). This includes Indonesia, India and Philippines. And recently, the Bank of Thailand (BOT) decided to raise the policy rate by 25 basis points from 1.50% to 1.75% on 19 December. However, the main motivation for such decision was to remove the degree of policy accommodation in view of improving economic condition. As such, reasons for the monetary tightening vary. But one thing for sure, higher interest rates would lead to slower growth at some point in the future.

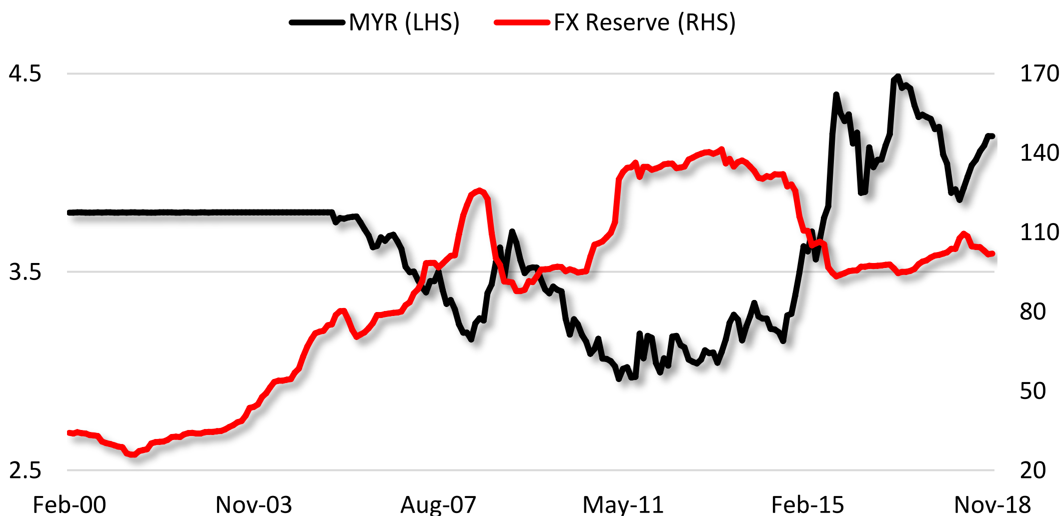
Chart 14: Regional policy rates



Source: Bloomberg

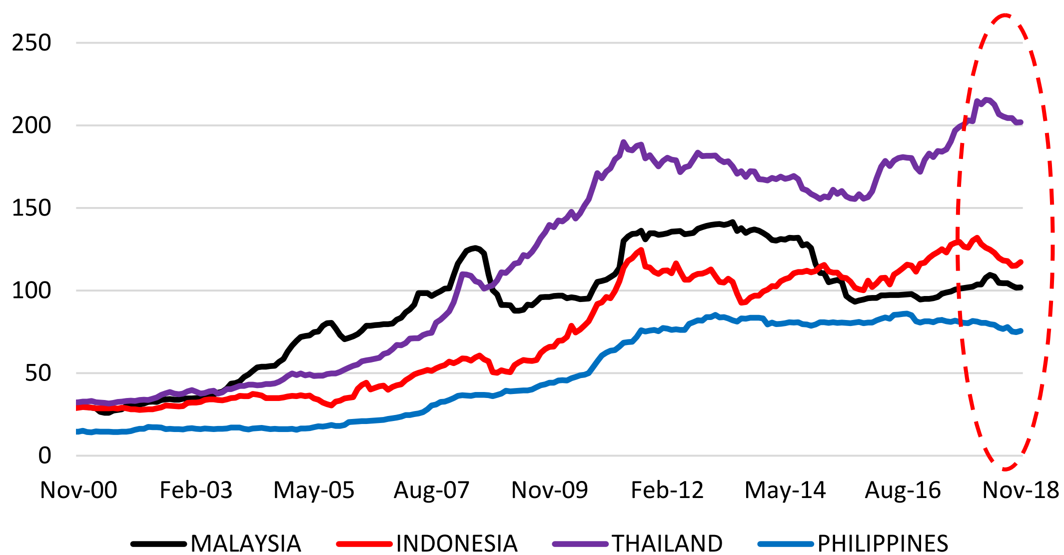
Malaysia's international reserves assets have declined from USD110 billion in mid-April to USD102.0 billion at the end of November. The declined in the reserve assets reflect BNM intervention in the foreign exchange markets in order to stabilise the ringgit. This is especially true when foreign investors have been net sellers in equity and fixed income markets in 2018. Between January and November this year, foreign investors have sold off RM10.5 billion and RM19.6 billion in equities and bonds. As a result, the USDMYR has depreciated from as high as RM3.862 on 2 April to RM4.1845 as of 24 December 2018.

Chart 15: MYR vs. FX Reserve (USD Billion)



Source: Bloomberg

Chart 16: FX Reserve (USD Billion) across emerging markets

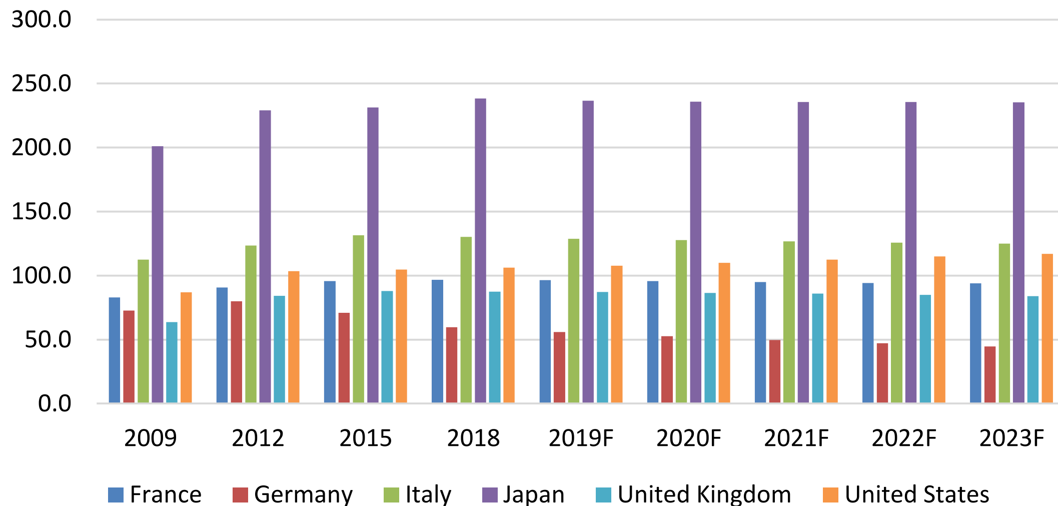


Source: Bloomberg

In a nutshell, it was an eventful year in 2018. The trade friction between the US and China has been the main market-moving news alongside with the expected increase in the FFR. Additionally, the turbulence saw in South Africa, Turkey and Argentina has brought the reminiscence of the past global economic contraction during 2008 and 2009. It give rise to policy uncertainty as to how policy makers should react at a time when public debt remains at elevated level. Judging from the latest IMF data, the US government debt as percentage of GDP stands at 86.9% in 2009 and it is expected to rise to 117.0% by 2023. Meanwhile, Japan's public debt would peak at 238.2% in 2018 and thereafter, it is expected to gradually decline to 235.4% in 2023.

On the contrary, Germany's public debt has been consistently on declining trend from 72.6% in 2009 to 59.8% in 2018 and by 2023, the level would further reduce to 44.6%. However, other major European countries such as France and Italy have exhibited different trajectory when government debt would ballooned from 83.0% and 112.5% in 2009 to 93.9% and 125.1% in 2023 respectively. Clearly, higher government indebtedness would affect the government ability to prescribe stabilisation policies. From political standpoint, it would be unpopular to institute major economic reforms in particular when the populations become older and it's affecting the tax revenue collection.

Chart 17: Government debt as percentage of GDP



Source: Fiscal Monitor, IMF

The unveiling of Mid Term Review of 11th Malaysian Plan (MTR11MP) and the tabling of Budget 2019 have set the tone for policy direction by the new government. The growth agenda will continue to focus on low income group, promoting private investment and inculcating entrepreneurial activities as well as spearheading institutional reforms to combat corruption and malpractices. The government is projecting Malaysia's GDP would grow 4.9% in 2019 from an estimated 4.8% in 2018 and between 2016 and 2020, the forecast GDP would range between 4.5% - 5.5% from the earlier 11MP projection of 5.0% to 6.0%. In some sense, the latest forecast trajectory entails slower potential growth for Malaysian economy. Therefore, reforms on various front (economy, institutional, industry etc.) are urgently needed in order to elevate the country's state of development (high income vs. developed nations).

3.0 Economic Outlook for 2019- "The Inconvenient Truth"

The global economy is set to grow at slower rate in 2019. Based on the latest IMF forecast, the world's GDP is projected to grow by 3.7% in 2018 and 2019. This represents a 0.2% reduction from the previous forecast made in July 2018. Such revision was premised on moderation in the US and China growth. Collectively, the advanced economy is projected to decelerate from 2.4% in 2018 to 2.1% of 2019. Monetary tightening in the advanced countries and the trade tension are the main key risks factors for the global growth. The World Trade Organization (WTO) has also downgraded their forecast for merchandise trade volumes from 4.4 % to 3.9% in 2018 and from 4.0% to 3.7% in 2019. The revision was mainly contributed by the US's decision to impose import tariff on USD250 billion of Chinese good.

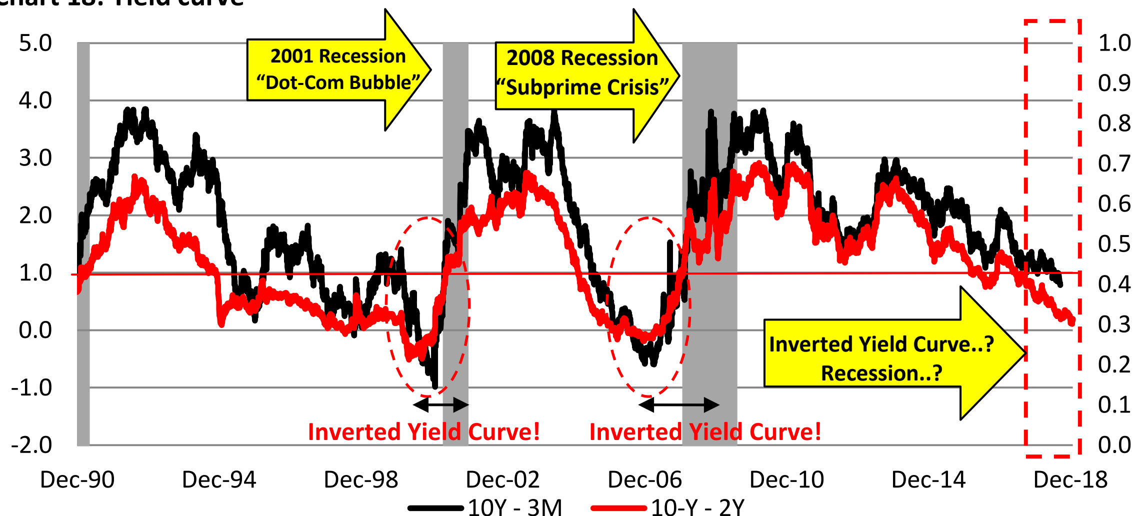
Table 2: IMF Forecast in October 2018

	Projections			Difference From July Update	
	2017	2018	2019	2018	2019
World Output	**3.7**	**3.7**	**3.7**	**-0.2**	**-0.2**
Advanced Economies	**2.3**	**2.4**	**2.1**	**0.0**	**-0.1**
United States	2.2	2.9	2.5	0.0	-0.2
Euro Area	2.4	2.0	1.9	-0.2	0.0
Germany	2.5	1.9	1.9	-0.3	-0.2
France	2.3	1.6	1.6	-0.2	-0.1
Italy	1.5	1.2	1.0	0.0	0.0
Spain	3.0	2.7	2.2	-0.1	0.0
Japan	1.7	1.1	0.9	0.1	0.0
United Kingdom	1.7	1.4	1.5	0.0	0.0
Emerging and Developing Asia	**4.7**	**4.7**	**4.7**	**-0.2**	**-0.4**
China	6.9	6.6	6.2	0.0	-0.2
India	6.7	7.3	7.4	0.0	-0.1
ASEAN - 5	5.3	5.3	5.2	0.0	-0.1
Malaysia	**5.9**	**4.7**	**4.6**		
Malaysia (World Bank)	**5.9**	**4.9**	**4.7**		

Source: IMF

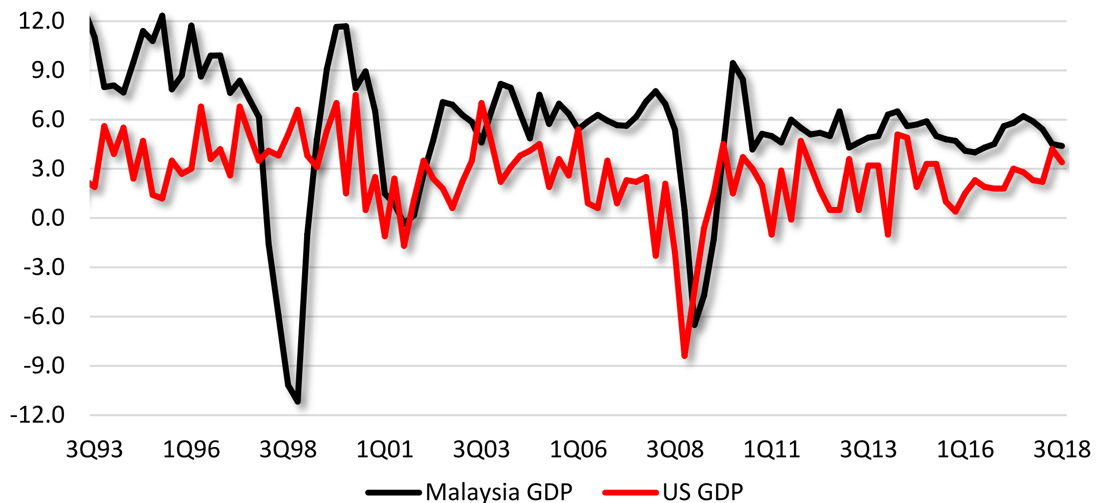
The flattening of the US Treasury yield curve is also quite disturbing sign. The difference between the 10-year and 2-year yield and the 10-year against the 3-month yield narrowed from 52 and 103 basis points at the end of 2017 to 18 and 35 basis points as of 26 December. It appears that the curve could invert at some point in the near future as the Fed is anticipated to raise the FFR by another two more rounds next year. In the past, the yield curve inversion whereby the long-term rate is lower than the short-dated yields, is the best predictor for US recession. **Typically, it takes about 12 to 27 months for the US economy to be in recession after the yield curve inverts**. So when the US sneezes, everyone would catch a cold. In view of the close association between the US and Malaysia's GDP growth, the output loss in the US is a cause for concern. The correlation between the US and Malaysian economy stands at 82.0% since 1999.

Chart 18: Yield curve



Source: Bloomberg, NBER

Chart 19: US & Malaysia GDP



Source: Bloomberg

Consequently, Malaysian economy is expected to grow at slower pace in 2019. This is premised on slower external demand as well as normalisation in private consumption amidst cautious spending by the private firms and the government. Uncertainties in the trade tension between the US and China, UK Brexit deal and challenging prospect for commodity prices are likely to have significant impact to the real exports. Apart from that, consumer sentiments would turn more edgy next year as the financial markets are anticipated to be more volatile while the implementation of Automatic Price Mechanism (APM) for fuel prices would result in fluctuation in RON95. Furthermore, companies would be more vigilant in their capital expenditure exercise as they would need to preserve more cash and to avoid excessive production capacity. The government would also be mindful in its spending plans as the fiscal room is very limited in light of the swing in the crude oil prices.

Against such backdrop, the economy would grow at 4.5% in 2019 from an estimated growth of 4.8% in 2018. This suggests availability of spare capacity in most industries as the economy is growing below its trend level of 4.8%. Notwithstanding that**, we expect the BNM would maintain the OPR at 3.25% throughout 2019** as gyrations in the foreign fund flows would be the main factor for policy consideration. Having said that, there is policy space for BNM given that **inflation rate is expected to rise to 2.2%** in 2019 from 1.1% in 2018. As for USDMYR, it will continue to **remain weak at RM4.21** in 2019 as further tightening in the US would result in further outflows of funds. All in all, it's a slowing economy in 2019 and perhaps in 2020 as well.

Table 3: GDP forecast for Malaysia

	2016	2017	2018E	2019F
GDP	**4.2%**	**5.9%**	**4.8%**	**4.5%**
By expenditure:				
Domestic Demand	4.3%	6.5%	5.7%	5.5%
Consumption	4.9%	6.7%	7.2%	6.4%
-Public	0.9%	5.4%	3.4%	3.3%
-Private	6.0%	7.0%	8.1%	7.1%
Investment	2.7%	6.2%	1.9%	2.9%
-Public	-0.5%	0.1%	-4.5%	1.5%
-Private	4.3%	9.3%	4.8%	3.5%
Exports	1.3%	9.4%	1.8%	1.5%
Imports	1.3%	10.9%	0.6%	4.5%
By industry:				
Agriculture, Forestry & Fishery	-5.2%	7.2%	-0.3%	2.3%
Mining and Quarrying	2.1%	1.0%	-1.9%	1.3%
Manufacturing	4.4%	6.0%	4.9%	4.7%
Construction	7.4%	6.7%	4.8%	4.5%
Services	5.7%	6.2%	6.5%	6.0%

Source: CEIC

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