ECONOMIC REPORT | Economic Development & Planning

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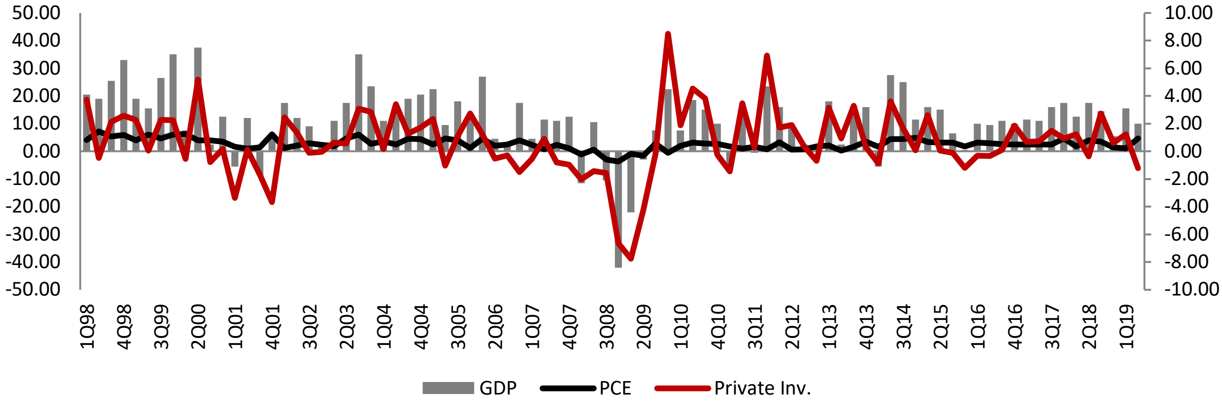
Mixed Signals on Recession?

- *Yield curve has inverted. Yield curve has been flattening since end of last year. Recently, yield curve has inverted with short rates exceeding longer yields, flashing warning of a recession. The gap between yields on two- and 10-year US government notes in Aug-19 recorded at -0.01, first negative figure since May-07. On average, since 1978, yield curve inversion occurred 15 months before the recession.*
- *Unemployment rate surpassed previous trough. US unemployment rate have started to bottom out since 2010, indicating that a trough is likely to occur soon. Unemployment rate witnessed the lowest trough prior to recession at 3.6% in Oct-00 and that level was touched again in May-18. The figure in Apr-19 went further below to 3.3%, the lowest rate ever recorded. On average, since 1978, unemployment rate trough occurred 10 months before the recession.*
- *Malaysia leading indicators signal expansionary path for the economy. According to the Business Tendency Survey, overall business performance is set to improve at 3.1% in 3Q19. Commodity based sectors such as agriculture and mining are predicted to recover in 3Q19. In addition, manufacturing sector is also expected to recover despite external headwinds. Besides that, leading index remains in negative sign but is rebounding gradually.*
- *Recession on the card? Overall picture has been a mixed bag with some leading indicators signalling recession for the US but most of the economic data just pointing towards a mild slowdown. Considering possibilities from the standpoint of two successful predictor of recessions: inverted yield curve and unemployment rate trough, recession is on the air. However, we do not foresee recession to take place in the nearest time. This time, it could be a different scenario especially with trade tensions around the world.*

Two consecutive quarters of negative growth. Recession often noticed when the GDP growth rate is negative for two consecutive quarters or more. However, recession is frequently underway when there are several quarters of slowing yet positive growth. The US GDP growth accelerated to 3.1%qoq in 1Q19 before it slowed to 2%qoq in 2Q19. Since GDP data generally released on quarterly basis, recession usually began before we even realize it. It is crucial to pay attention on signs of an impending recession through leading indicators which are released on more frequent basis. A leading indicator is an economic factor that changes first, in a particular direction and then followed by the rest of the economy. There are several leading indicators used as precursors to recession such as yield curve and unemployment.

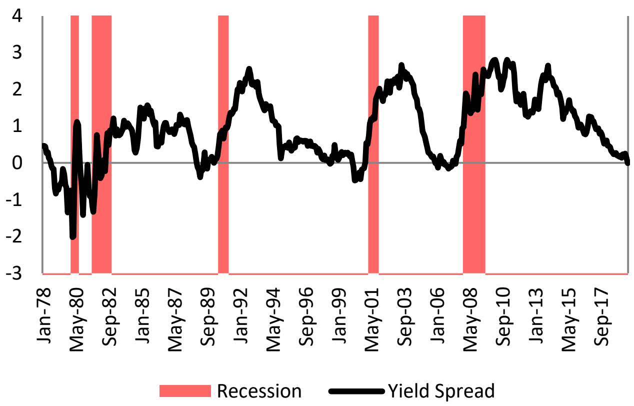
Chart 1: US Real GDP Growth (QoQ%)



Source: CEIC, MIDFR

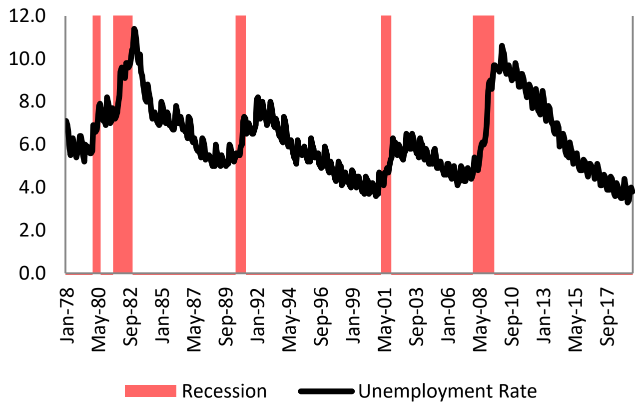
Yield curve vs unemployment rate troughs. Yield curve inversions tend to be a valuable predictor of business contractions and related market turbulence. An inversion occurs in an interest rate environment in which short-term Treasury securities have higher yield than long-term Treasury securities of the same credit quality. Historically, yield curve inversions have preceded many of the economic recessions since the 1970s. Similarly, unemployment rate trough is also considered a reliable indicator of a recession as it had regularly hit a low prior to periods of economic recessions. As soon as the recession begins, unemployment increases abruptly. Due to these historical correlations, concerns arise as the recent patterns of these two indicators have become noticeable.

Chart 2: Treasury Yield Curve



Source: BLOOMBERG, MIDFR

Chart 3: Unemployment Rate



Source: CEIC, MIDFR

Yield curve has inverted. Yield curve has been flattening since end of last year. Recently, yield curve has inverted with short rates exceeding longer yields, flashing warning of a recession. The gap between yields on two- and 10-year US government notes in Aug-19 recorded at -0.01, first negative figure since May-07. On average, since 1978, yield curve inversion occurred 15 months before the recession. The maximum lead times were 18 months while the minimum were 10 months. An inversion could be indicative when it inverts over several-weeks or even precise several-months time period. In addition, the magnitude of inversion also matters, as a brief inversion could just be a premature signal. Based on that, it is quite early to consider the recent inversion as a signal of forthcoming recession.

Unemployment rate surpassed previous trough. US unemployment rate have started to bottom out since 2010, indicating that a trough is likely to occur soon. Unemployment rate witnessed the lowest trough prior to recession at 3.6% in Oct-00 and that level was touched again in May-18. The figure in Apr-19 went further below to 3.3%, the lowest rate ever recorded. On average, since 1978, unemployment rate trough occurred 10 months before the recession. The maximum lead times were 14 months while the minimum were 5 months. In addition, the unemployment rate increases 0.9% on average between the trough and the peak.

Table 1: Unemployment Rate Troughs and Yield Curve Inversions Prior to Business Expansion Peaks

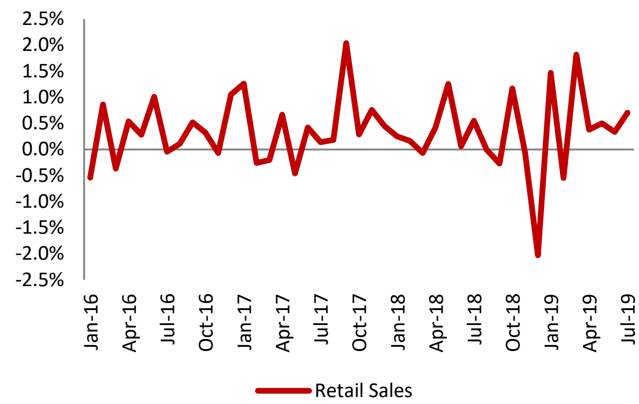
Unemployment rate trough statistics						Yield curve statistics	
Unemployment rate trough	Trough month	NBER peak	Unemployment rate at NBER peak	Difference between trough month and NBER peak month	Change in unemployment rate between trough month and NBER peak month	Inversion of yield curve	Difference between inversion month and NBER peak
5.2	May-79	Jan-80	6.9	-8	1.7	Aug-78	-17
6.9	Dec-80	Jul-81	7.3	-7	0.4	Sep-80	-10
5	May-89	Jul-90	5.6	-14	0.6	Dec-88	-19
3.6	Oct-00	Mar-01	4.5	-5	0.9	Feb-00	-13
4.1	Oct-06	Dec-07	4.8	-14	0.7	Feb-06	-18
Sample-period statistics: episodes since 1978							
Average				-10	0.9	Average	-15
Maximum				-14	1.7	Maximum	-19
Minimum				-5	0.4	Minimum	-10

Source: NBER, CEIC, BLOOMBERG, MIDFR

Retail sales reflect robust consumption. There are many other factors or leading indicators need to be observed rather than betting the farm on one or two. One rule of thumb for recession is three consecutive months of declining retail sales. Retail sales performance is important to look at as it indicates the level of consumption and how that will contribute to the economic growth. Retail sales growth in the US has been positive for the past five months with the latest figure at 0.7%mom in July-19, indicating a strong momentum still. On annual basis, retail sales for the first seven months of 2019 expanded by 3.1%yoy, softer compared to 5.4%yoy recorded for the same comparable period last year mainly due to higher base effect resulting from tax cut initiated by Trump. In fact, the latest GDP in 2Q19 showed annualized private consumption expenditure grew by 4.7%qoq, the strongest in four-and-a-half-year.

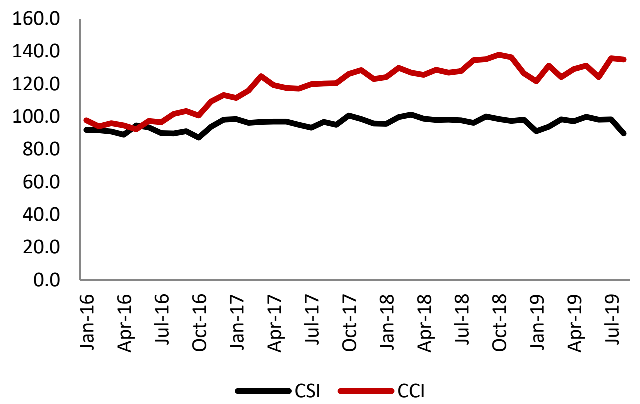
Consumer confidence remains strong. The Conference Board Consumer Confidence Index inched down to 135.1 in Aug-19 from 135.8 in the preceding month. In addition, University of Michigan's consumer sentiment fell to 89.8, the lowest level since Oct-16 due to weak consumer expectations and current condition sub-indexes. The recent escalation in trade dispute between the US and China could have dampened consumers' optimism concerning the short-term economic outlook as nearly all imports from China will subject to new taxes. We believe overall confidence is still strong and this is just a temporary glitch given that the inflationary pressure is low and labour market is stable. However, if the trade tension persists, it could dampen the sentiment further.

Chart 4: Retail Sales (MoM%)



Source: CEIC, MIDFR

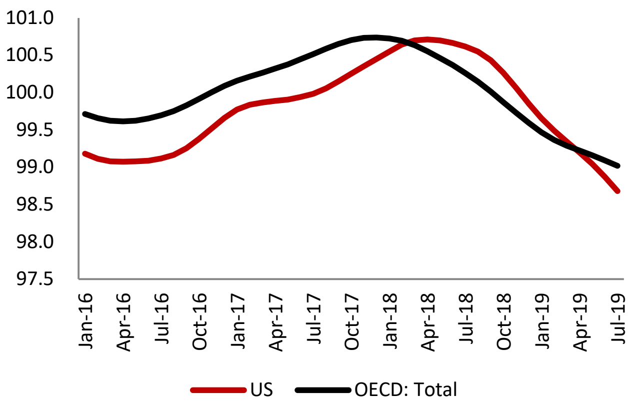
Chart 5: Consumer Confidence & Sentiment Index



Source: CEIC, MIDFR

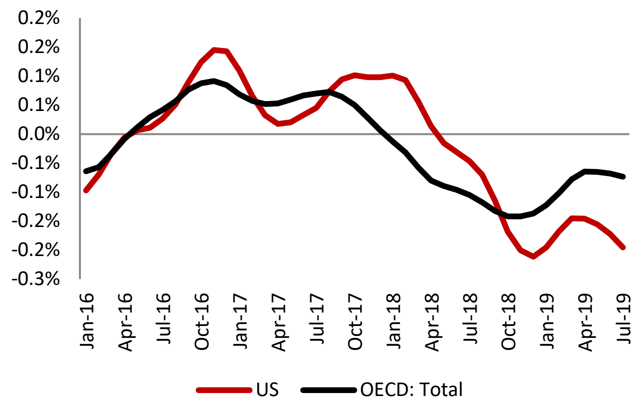
CLI for the US point towards a downtrend. OECD composite leading indicators (CLI) which provide early signals of turning points in business cycles continue to suggest a slowdown in the US. The CLI for the US fell further to 98.7 points in Jul-19, the eighth consecutive months of below 100 points. Similarly, the CLI for total OECD went down further to 99 points in Jul-19, the tenth consecutive months of below 100 points which points towards easing growth momentum. The fluctuation of the economic activity signalled by the indicators generally follows six to nine months after they are recorded.

Chart 6: OECD Composite Leading Index



Source: OECD, MIDFR

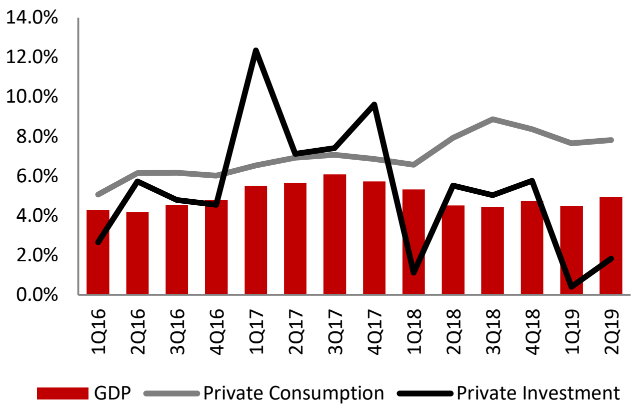
Chart 7: OECD Composite Leading Index (MoM%)



Source: FRED, MIDFR

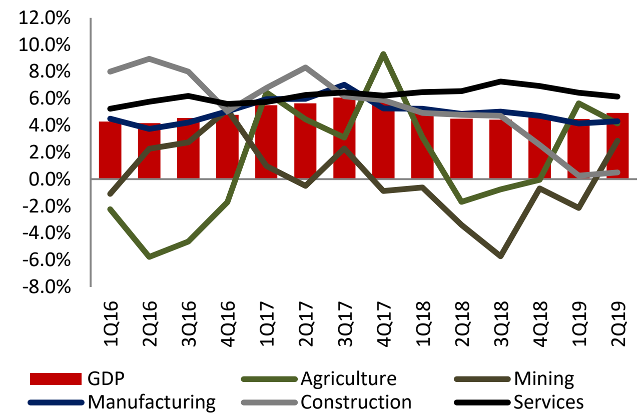
Solid economic growth for Malaysia. Malaysia's GDP growth expanded 4.9%yoy in 2Q19, the fastest rate in five quarters and marginally above market expectations. The strong pick-up in the economy is generally driven by continuous strong private consumption and recovery in commodity-based sectors. From expenditure side, private consumption and net exports contributed by 4.4% and 1.4% respectively. From supply side, services, mining and agriculture sectors contributed by 3.6%, 0.2% and 0.3% respectively during the quarter. External front remains weak due to global trade wars and decline in business optimism. On the other hand, domestic demand stays solid underpin by lower interest rate, stable labor market and low inflationary pressure.

Chart 4: GDP vs Private Sector (YoY%)



Source: CEIC, MIDFR

Chart 5: GDP by Supply-Side (YoY%)

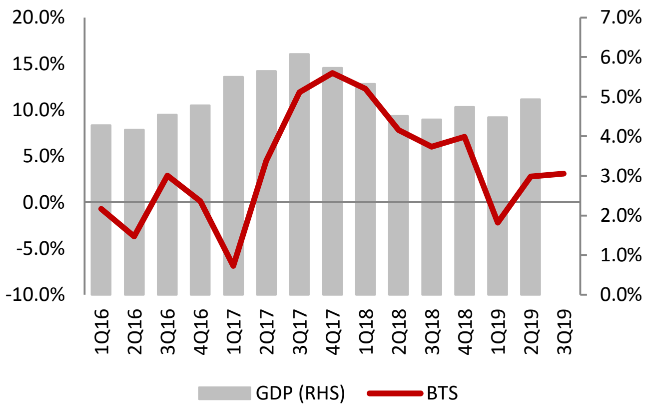


Source: CEIC, MIDFR

Malaysia leading indicators signal expansionary path for the economy. According to the Business Tendency Survey, overall business performance is set to improve at 3.1% in 3Q19. Commodity based sectors such as agriculture and mining are predicted to recover in 3Q19. In addition, manufacturing sector is also expected to recover despite external headwinds. Besides that, leading index remains in negative sign but is rebounding gradually. The index indirectly hints the economy to continue expanding at solid pace in 3Q19 and 4Q19. Effects of lower OPR are predicted to appear in 2H19 with inflationary pressure to stay low and job market at full-employment condition.

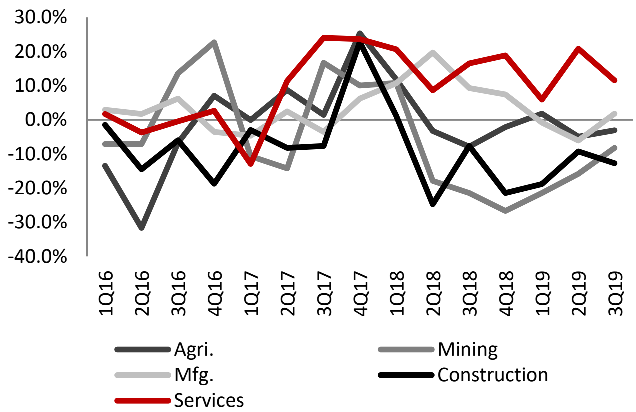
2H19 stays on expansionary path. Referring to business expectations for the next 6 months, overall business performance is expected to improve steadily. Overall business performance for the second half of 2019 is expected to enjoy steady pick-up especially for services, mining and manufacturing sectors. Strong domestic demand and low inflationary pressure are fundamental factors supporting the services sectors. On the external front, we view the trade war will result in slower global trade flows hence affecting export-led economies including Malaysia. Manufacturing sector which is export-oriented is predicted to be affected by the slowing global demand. However, demand from the domestic market could partially offset that impact. Malaysia IPI has been expanding steadily since Mar-19. For the 1H19, IPI growth averaged at 3.3%yoy, higher than 2018's average of 3%. As for commodity-based sectors, we expect better performance in 2H19 particularly for LNG and palm oil.

Chart 17: BTS (%) vs GDP (YoY%)



Source: CEIC; MIDFR

Chart 18: Confidence Indicators by Selected Sectors (%)

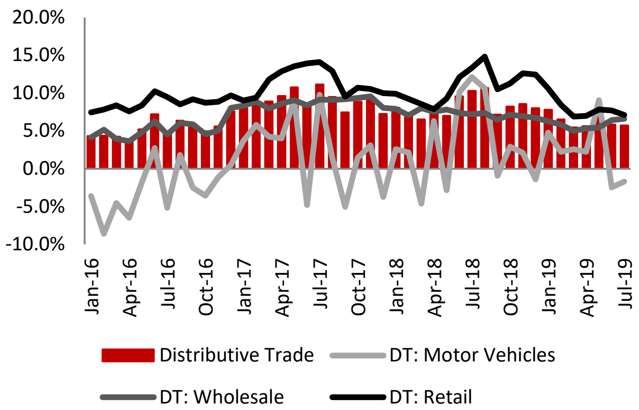


Source: CEIC; MIDFR

Distributive trade hit another new record high. Distributive trade continue to hit new record high at RM 112.5b in July-19. Motor vehicles sales declined by -1.7%yoy but improved from a larger negative growth of -2.5%yoy in June-19. Retail trade continued expanding but at a slightly lower pace of 7.1%yoy (June-19: 7.7%yoy). The moderation could be attributed to the higher base effect resulted from June-August tax holiday period last year which caused consumers to ramp up their spending. Motor vehicles and retail sales growth were the highest (double digit growth) during the tax holiday period compared to rest of the months of 2018. In contrast, wholesale trade which constitutes about 48% of total distributive trade advanced by 6.4%yoy in July-19, the fastest pace so far this year.

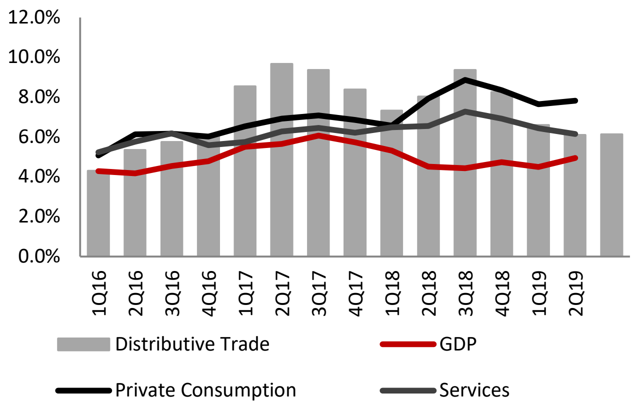
Continuous positive sales in 3Q19. For 2Q19, distributive sales expanded at a slightly moderating pace of 6.1%yoy compared to 6.6%yoy in 1Q19. Moving forward, for the 3Q19, we foresee a continuous positive performance in distributive sales underpinned by low inflation, stable job market and supportive monetary and fiscal policy changes such as the OPR cut and stabilized retail fuel prices. In addition, average passenger movement growth of 8.2%yoy in the first two months of 3Q19 (2Q19: 5.2%yoy) are likely to be translated into steady growth for retail sales in this quarter. Nevertheless, high base effect from tax holiday period last year could influence the estimate.

Chart 17: Distributive Trade Sales, DT (YoY%)



Source: CEIC; MIDFR

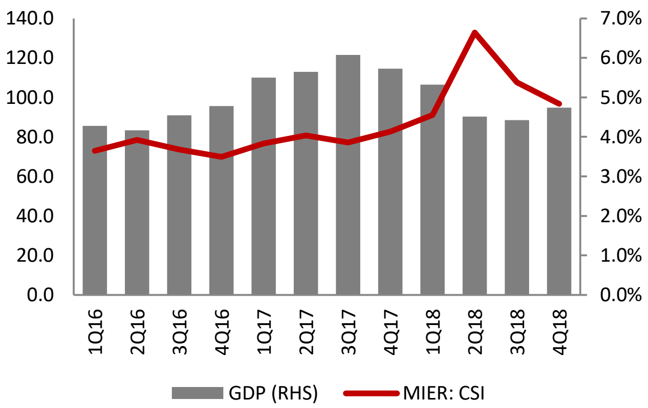
Chart 18: DT vs Private Consumption vs Services (YoY%)



Source: CEIC; MIDFR

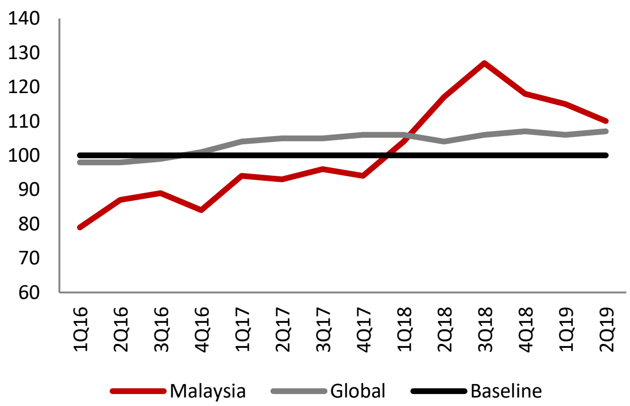
Consumer sentiment improves. Consumer sentiment had been deteriorating since 3Q18 after a record high performance of 132.9 in 2Q18. The latest reading for 2Q19 is still below baseline of 100 points but improved to 93 from 6-quarter low of 85.6 in the prior quarter. Besides that, Nielsen & Conference Board's global consumer confidence survey showed a slight dip in Malaysians' consumer confidence in 2Q19 but still above 100 which indicates optimism and also higher than global average. It is the sixth consecutive quarter of consumer optimism for the country, after undergoing 17 straight quarters of pessimism since 4Q13. Strong consumer confidence is expected to result in spending and will continue to drive Malaysian economy, which is dominated by private consumption.

Chart 17: MIER Consumer Sentiment (Points) vs GDP (YoY%)



Source: CEIC; MIDFR

Chart 18: Nielsen Consumer Confidence: Malaysia vs Global (Points)



Source: CEIC; MIDFR

Higher GDP growth in 2019 is still possible. Based on the current developments and indicators, we are maintaining our 2019 GDP growth forecast for Malaysia, the figure we had first published in Dec 2018, at 4.9%. Commodity-based sectors particularly of mining are expected to continue recovering as the Kebabangan gas field returned to full capacity in Aug-19. This continuous recovery would give substantial impact to the economy in 2H19 as it involves high value added activities. In addition, construction sector is likely to grow higher in 2H19 driven by projects such as LRT3. Besides that, the 25bp OPR cut on top of low inflationary pressure and stable labour market would continue to support both private consumption and investment in 2H19. GST refunds which are expected to be fully settled by 3Q19 would be an additional bolster.

Recession on the card? Overall picture has been a mixed bag with some leading indicators signalling recession for the US but most of the economic data just pointing towards a mild slowdown. Considering possibilities from the standpoint of two successful predictor of recessions: inverted yield curve and unemployment rate trough, recession is on the air. However, we do not foresee recession to take place in the nearest time. This time, it could be a different scenario especially with trade tensions around the world. The notion on how fast the recession could happen is somehow linked to the severity of trade wars. Recession could be triggered even faster if trade disputes keep escalating, badly affecting countries' external trade performances. In addition, upcoming US presidential election could also influence the estimate. On a different note, these indicators might say very little about the economy as a whole and it could be less meaningful in this current world where things have changed. Being the largest economy in the world, if US sneezes, the rest of the world catches a cold. If recession hit the US, it will be transmitted to the rest of the world including Malaysia due to the integrated and interconnected nature of the global economy. The severity of the impact will depends on how well regulated and insulated that individual economy from global shocks.

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