3 October 2014

MALAYSIA

No hike in the OPR until 1Q15

We maintain our expectation that BNM will keep the Overnight Policy Rate (OPR) at 3.25% at its meeting on November 6. As we have highlighted earlier, if the tightening is meant to contain financial instability risks, the central bank can afford to wait. We believe that another rate hike before year-end when rates in the rest of EM are likely to stay put, will only invite speculative flows. BNM may defer any OPR move until next year when the US Fed starts tightening. That is also when the central bank can gauge better the likely path of inflation expectation in anticipation of the GST.

Growth is set to trend lower. The economy is unlikely to sustain the high growth at least in the next 12 months. Higher interest rates – both domestically and in the US, the structural changes that we have to undertake to raise our potential growth as well as the deleveraging process – would all lead to growth staying close to potential instead (4.5 – 5.0%). The leading indicators showed that economic activity may rebound in the coming months after exports and . and Industrial Production Index (IPI) unexpectedly slumped in July, nonetheless the pace may not be able to match that seen in the 1H 14. Domestic demand is already softening - a sign that it is responding further to the micro and macro prudential measures. The downward trend in the growth of broad money supply, M3 points to private consumption expenditure growth moderating further. We expect real GDP growth to be slower at 4.5 – 5.05 in the 2H 2014, much slower than the 6.3% pace recorded in the 1H 14, bringing the overall growth to 5.5% and to slow down further to 5.0% in 2015.

Chart 1: Production activities may rebound modestly

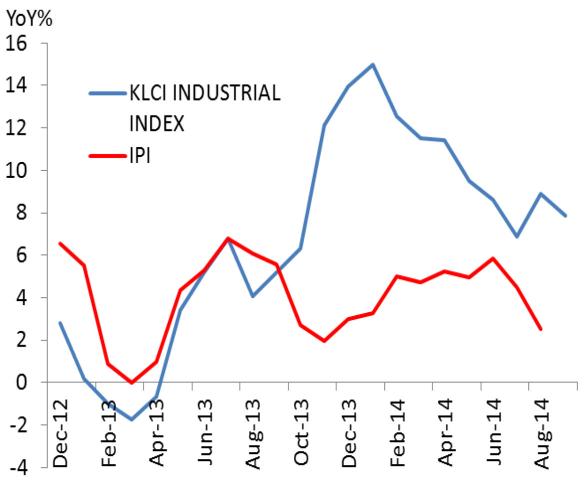
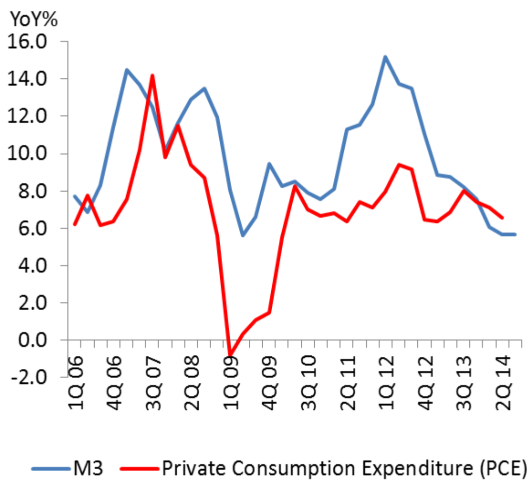


Chart 2: Consumer spending to slow down further



Source: BNM

Risks to financial stability may have ebbed, slowdown in housing market likely to be orderly in line with economic conditions. House prices increase slowed down in 1Q 14 to 8.0% YoY in 1Q 14- the slowest since the 4Q 2010. We expect house prices to continue to trend lower to 4 – 5% on the back of overall slowdown in economic activity, higher interest rates and stricter bank lending. According to the first half 2014 Property Industry Survey by the Real Estate and Housing Developers' Association Malaysia (Rehda), close to 90% of the respondents experienced a slowdown in property sales due to cooling measures announced in Budget 2014 and over 80% of the respondents of the survey held a "neutral" to "pessimistic" outlook for the first half of 2015.

Chart 1: Property prices cooling off across all segments

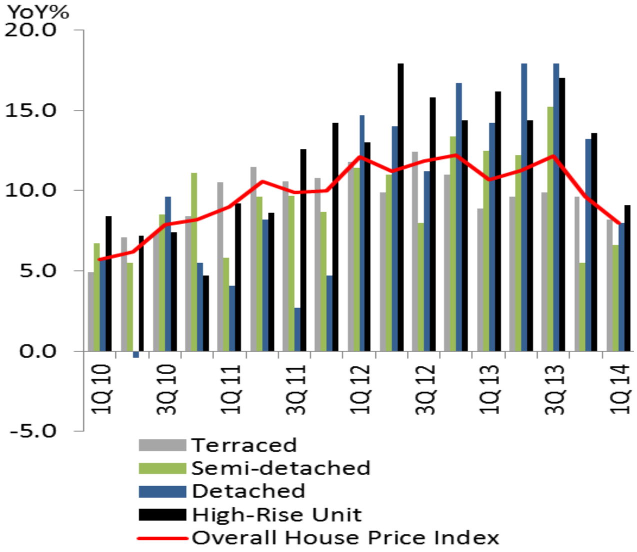
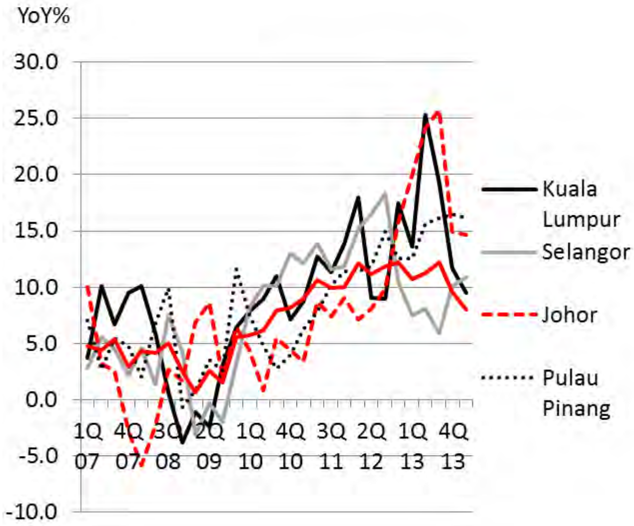


Chart 2: Prices in KL and Johor decelerated the most in KL and Johor



Source: NAPIC, BNM

Credit expansion slows.. Total loans growth had eased to 8.6% YoY in August, the same as the pace recorded in July, marking the seventh consecutive month of slowdown. The slowdown was more notable in lending to businesses, which rose by 6.7% during the month compared to 8.5% at the end of 2013 and its peak at 14.6% in July 2012. Total loans to household grew by 11% in August, marginally slower than 12% growth recorded at the end of 2013 and its recent peak of 13.9% posted in November 2010.

..but household debt burden still high With growth has yet to come down significantly, total household debt has hardly come down much. As long as nominal GDP growth is slower than the rise in total household debt, the ratio would continue to edge up. Data on lending by development financial institutions (DFIs) is not regularly available unlike that of the banking system. Nonetheless, we expect lending by DFIs to household sector to slow down significantly following the tighter lending conditions and that would see the household debt-to-GDP ratio to at least stay flat around last year's level of 86.8%.

Chart 3: Loans approved by the banking system

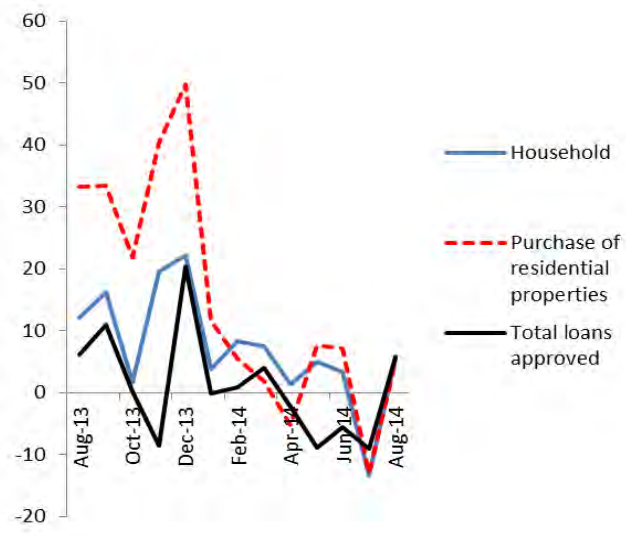
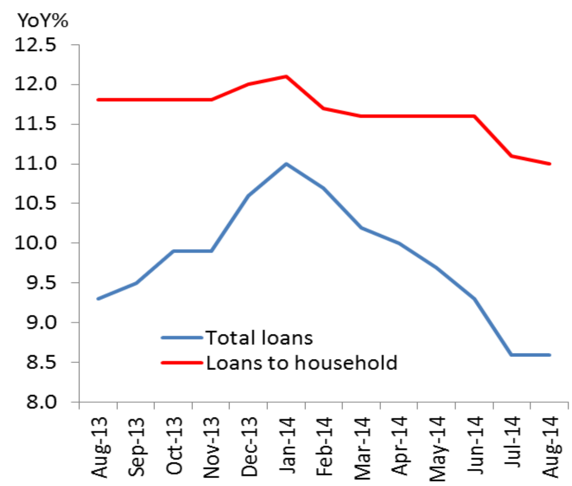


Chart 4: Household outstanding debt has yet to slow down significantly



Source: BNM

Marginal impact from fuel price hike on 2014 inflation The 20sen hike represents about 9.5% jump from the previous price of RM2.10 per litre for RON95 and 10% for diesel, which is smaller than the 10.5% and 11.1% margin of increase seen last year. As such, the impact on the CPI index for October onwards would see perhaps only 0.5 – 0.6% MoM jump from September index level. The hike last year caused the index jumped 0.8% MoM in September index (the hike took effect 3 September 2013). Assuming that the index continues to edge up by 0.1 – 0.3% up to December, that would bring the overall index to rise by 3.0 – 3.1% for the whole of 2014, well within our expectation of 3.0 – 3.5% for this year.

Fundamentals suggest BNM can wait; the impact on overall CPI next year has yet to be seen. With GST coming into effect April 1, CPI is set to edge up higher but we believe that as long as inflation expectation is well-anchored, the pick-up in inflation be still within our expectation of 3.5 – 4.0% in 2015. Having said that there is still a risk of inflation expectation may remain elevated and that still pose a policy concern. But for now, with the economy on course for further slowdown resulting from the macro-prudential measures as well as higher interest rates, we expect BNM can wait before tightening again in 1Q 14 before the roll out of the GST.

Risks of bigger outflows and much weaker Ringgit when US Fed starts to tighten. We believe another rate hike before year-end when rates in the rest of EM are likely to stay put, will only invite speculative flows. BNM may want to save the bullets for next year when the US Fed starts tightening. Fund outflows in the 3Q14 is likely to be much bigger than that seen in the post-selloff in May 2013 and in January this year when the US started the taper programme. This was based on the foreign equity fund outflows in the month of September which was the worst since March this year. This was also reflected in the performance of the Ringgit which hit a 5-month low at the end of the month following the BNM's decision to keep the OPR unchanged at 3.25% at its recent meeting held on September 18. Given the high foreign holdings of Malaysian Government Securities (MGS), Malaysia is indeed vulnerable to further outflows once the Fed starts to tighten. The timing of the first move by the Fed in the current cycle remains a big uncertainty but market expectation as well as statements by the Fed officials suggest that the rate tightening cycle could start in the late 2Q or 3Q15.

Chart 5: Bigger outflow expected to put pressure on Ringgit

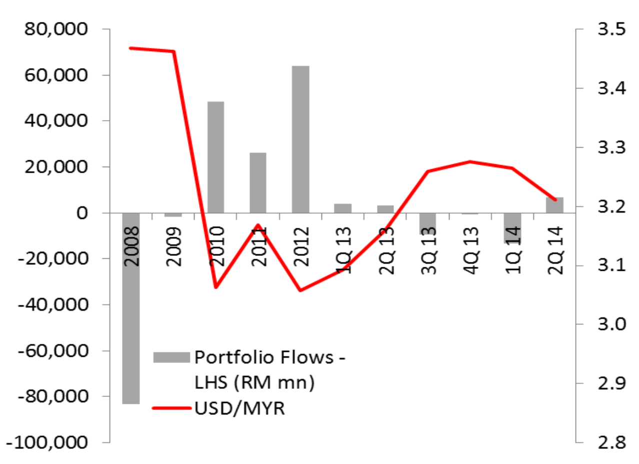
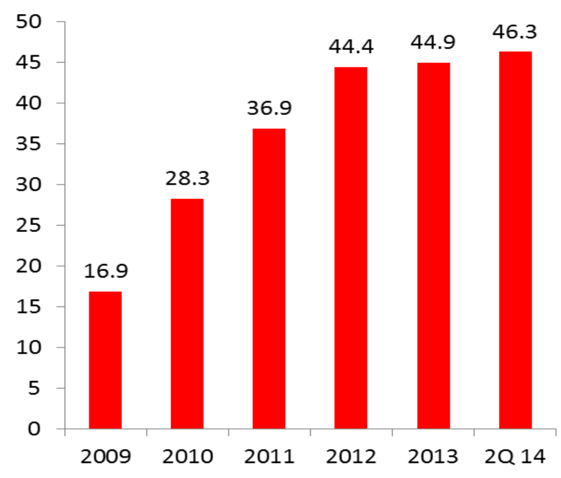


Chart 6: Foreign shareholding of MGS (%)



Source: BNM

BNM may want to save bullets for next year. It may not be the best policy option to tighten in a bid to stem the outflow. We doubt that BNM will opt for such a move if the Ringgit is not in misalignment with the other regional currencies. However, it is imperative that inflationary expectations remain checked next year, as the Ringgit faces downward pressure while the economy slows down. These point to another one or two tightening moves but delivered at the right timing. Policy challenge may be as tough as that seen when BNM was handling the 2008 Financial Crisis. We expect BNM to resume hiking up the OPR again early 2015 before the GST kicks in April 1.

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