06 January 2016

MONTHLY ECONOMIC REVIEW | December 2015

Leading Indicator Rebounding as Expected

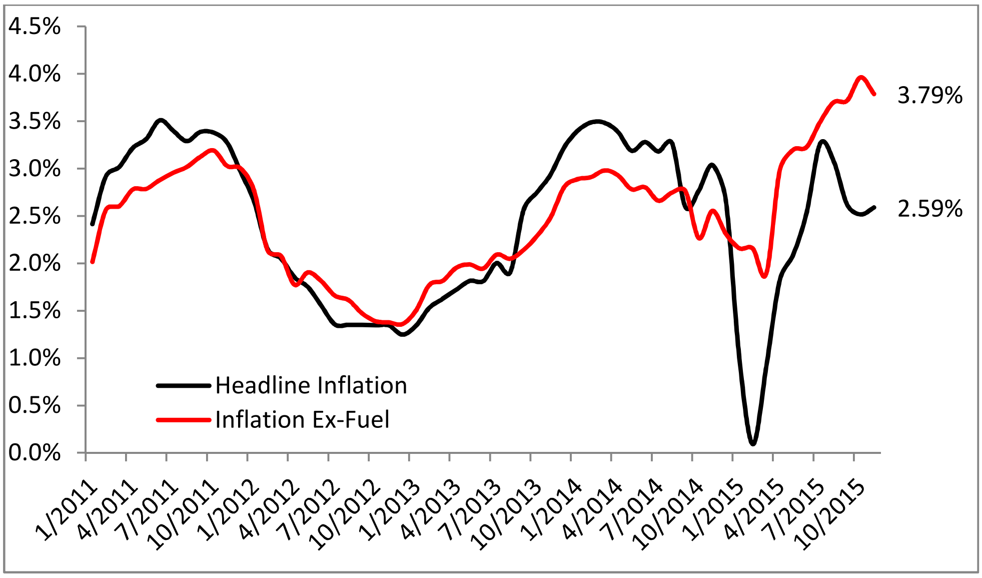
- *Leading indicator is rebounding as per our earlier expectation, where it enters into positive territory on year-on-year basis after contracting for the previous three months. As such, we could expect the economy to continue weakening until 1Q16, and will only begin rebounding in 2Q16. We maintain our GDP expectation of 5.0% for year 2016 on the expectation that the global trade activity will rebound in the 1H16.*
- *Inflationary pressure continues to be capped by low oil price, and the OPEC December meeting has further pushed the oil price downward. We are maintaining our inflation forecast for year 2016 at 2.90%, on the expectation that the oil price will only begin to rebound significantly in 2H16.*
- *Despite the decision to increase the Fed fund rate in the FOMC December meeting, we are not expecting Bank Negara Malaysia to follow suit. The risk of slowdown in private consumption in 2016 remains as a potential downward pressure for the OPR. However, for now we are expecting that BNM will keep its interest rate unchanged at 3.25% for the whole 2016.*

Malaysia's leading indicator remains in negative territory on year-on-year basis. Malaysia's leading indicator rebounded into positive territory in October after contracting for three consecutive months on year-on-year basis since July 2015. However, on a 3-month moving average basis, Malaysia leading indicator was still contracting by 0.28%, albeit slightly better than 0.39% contraction for the 3-month moving average in September. Moving forward, we are expecting that the leading indicator will continue its positive momentum, and this will be reflected in the GDP figure with a 2 quarter lag, reflecting a significant rebound in Malaysia's GDP in the second half of 2016.

Strong performance in exports supported October's IPI growth. IPI came in at 4.2%yoy in October, with the manufacturing index led the growth with a stellar growth at 6.2%yoy followed by electricity index at 4.3% while mining contracted by 1.4%yoy. However, the relatively lower IPI in October on year-on-year basis was due to the all-time high of the natural gas mining index in October 2014, hence dragging down the overall IPI in October. On a seasonally adjusted basis, IPI contracted on a month-on-month basis marginally by 0.4% in October 2015, after a high growth of 2.4%mom in the previous month.

Record trade balance in October at RM12.2 Billion. October's trade balance figure tops previous high in August with strong performance in October at RM12.2 billion. Malaysia's exports continued to surge past the RM70 billion mark with RM75.8 billion (16.7%yoy), registering its first double digit increase during the year while imports marginally declined to RM63.7 billion (-0.4%yoy). On a seasonally adjusted basis, both exports and imports increase on month-on-month basis by 4.9%mom and 1.2%mom respectively. The stronger exports performance compared to imports has led to the highest trade balance in 48 months.

Chart 1: YoY Inflation



Source: DoS, CEIC, MIDF Research

Higher than expected inflation in November due to the increase in tobacco excise tax. On year-on-year basis, consumer price index rose by 2.59%yoy, higher than our expectation of 2.30%yoy. The higher than expected inflation was mostly due to the unprecedented increase in the cigarette excise tax by more than 40% in 4 November 2015. However, the overall inflationary pressure is slowing down, with the FNAB price index shrank marginally by 0.25%mom in November 2015, the first month-on-month decline in 8 month since GST implementation. The effect of the toll hike was apparent with the transport sub-index, 'other service in respect of personal transport equipment' saw its largest year-on year and month-on-month increase by 8.78% and 7.67% respectively. The large difference for the pump price on year-on-year basis i.e. RM2.26/litre in November 2014 against RM1.95/litre in November 2015 continued to put a cap on the inflationary pressure, causing a gap between our inflation ex-fuel figure and the headline inflation. We are expecting the gap to close up in January 2016 due to the smaller difference in the pump price, which would cause the headline inflation to surge to 3.60%yoy in January 2016.

Unanimous decision for rate hike in December by the Federal Reserve. In line with the market's unanimous expectation, the Fed decided on 16 December 2015 to increase its interest rate by 25 basis points to 0.50%. 15 out of 17 FOMC members were voting for the hike, reflecting that there are still some members in the FOMC who think that the economy is yet to ready to experience a rate hike this month. Despite that, the overall expectation in the December meeting compared to the one in September was significantly better, reflecting that all of the FOMC members are of the opinion that the economy is doing better recently. At this juncture, we do not think that Bank Negara Malaysia will follow the step by increasing the OPR as the current interest rate differential between Malaysia and the US is abnormal, hence the process of normalisation which will see the gap between the two interest rates shrinking is necessary for the long term financial market stability. Furthermore, the uncertain economic condition in 2016 particularly for the private consumption would put a downward pressure on the interest rate, rather than an upward pressure. However, currently we are not expecting any revision on the OPR as we are expecting that the economy could be doing better than expected due to the recovery of global trade activity.

Oil drops after OPEC maintains output despite glut. As expected, there was no agreement to cut the oil price in the December OPEC meeting. Indeed, thinking from the Saudi's point of view, there is little reason to cut its production if the same action is not being taken by non-OPEC producers, as the price hike could possibly lead to higher production by the non-OPEC producers, pushing the oil price downward again. Besides, in the long term, the low oil price would benefit state-controlled producers like the Saudi, as the low oil price would further push down capex in the industry, leading to a much higher oil price in the longer period. For Malaysia's fiscal position, currently we are not expecting a revision in Budget 2016 as long as the oil price remains above $30 per barrel. From our calculation, an oil price of $30 per barrel would lead to a shortfall in Government revenue only by approximately RM5.9 billion vs that projected in the Budget. The impact of lower oil price to Malaysia's fiscal position is capped by the fact that Petronas has already allocated its dividend for the Government which is expected to be at the minimum RM16 billion this year.

China is having a new Yuan index. Due to its pegging to USD, China's export has lost its competitiveness due to the Yuan appreciation relative to its other trading partners. When China made a move to devalue its Yuan, a massive capital outflow occurred, leading to instability in its financial market and taking up their reserves. With the inclusion of Yuan in the SDR basket, China possesses some room to depreciate its currency against the USD, where it announced its basket of currency for its new exchange rate policy in December. As a lot of Asian countries exports are dependent on China's exports, how well China does in maintaining its exports performance are essential to the Asian economies. How China and international investors act in 2016 could very well affect the performance of the Asian economies next year. For now we are maintaining our expectation that China GDP growth will be at 6.6% in 2016.

Table 1: Yuan Index

Currency	CFETS weight	BIS weight
USD	26.40%	17.76%
EUR	21.39%	18.67%
JPY	14.68%	14.13%
HKD	6.55%	0.81%
AUD	6.27%	1.47%
MYR	4.67%	2.15%
RUB	4.36%	1.76%
GBP	3.86%	2.91%
SGD	3.82%	2.74%
THB	3.33%	2.15%
CAD	2.53%	2.12%
CHF	1.51%	1.37%
NZD	0.65%	0.21%
Others	0.00%	31.75%

Source: CFETS, BIS, MIDF Research

December Key Economic Events

1 Dec 2015: Yuan included in SDR basket. The IMF accepted Yuan as part of its currency basket, with a weight of 10.92%, higher than Japanese Yen and Pound Sterling at 8.33% and 8.09% respectively. Although the inclusion is unlikely to cause sudden increase in demand for Yuan, it could act as a cushion for the Yuan particularly if it were to deviate from USD.

4 Dec 2015: OPEC Meeting. OPEC decided in its December meeting to maintain its current policy of 30 million barrel productions per day, although it has been producing higher than the self-imposed quota recently. The decision has caused the oil price to slump further, as the market sees little possibility for the oil glut to reduce in the near future. However, as long as the oil price remains above $30 per barrel, we are not expecting a revision in Budget 2016.

16 Dec 2015: Fed rate hike. The Fed decided to increase the interest rate by 25 basis points in December, leading to a 0.50% level for its fed fund rate. In line with most of economist expectation, Fed is expecting to end year 2016 with a rate of 1.50%, reflecting a 25 basis points increase at the end of every quarter.

1 Dec 2015: Fare hike for most railway services. Most of the railway services i.e. KTM (Klang valley area), LRT, Monorail and ERL are increasing their fare in December after getting permission from the authority. The impact of the fare hike should be marginal towards overall inflation rate, although it could affect consumer sentiment in the short term.

12 Dec 2015: New Yuan Index. China is adopting a new exchange rate policy where it will be based on a new-trade weighted Yuan exchange rate index. Due to the inclusion of Yuan in the SDR currency basket, China is currently able to deviate its currency further from USD without risking massive capital outflow from the country, hence improving its export competitiveness. Higher exports activity by China should be a positive indicator for Asian economies.

17 Dec 2015: Fitch keeps Malaysia's rating at A-. Fitch Ratings is keeping Malaysia's rating at A- with Stable outlook as external liquidity position deteriorated due to large capital outflows, loss of forex reserves. Despite the expected volatility, the rating agency opined that flexible exchange rate and large gross external assets would continue to cushion Malaysia's vulnerability

Yearly Forecast

(YoY%) unless stated otherwise	2014	2015f	2016f	2017f
Real GDP	6.0	5.0	5.0	5.2
Private consumption expenditure	7.1	6.5	6.8	7.0
Government expenditure	4.4	5.2	4.2	4.0
Gross fixed capital formation	4.8	3.0	3.2	3.8
Exports of goods and services	5.1	1.5	3.4	3.1
Imports of goods and services	4.2	1.0	3.8	3.5
Net exports	12.8	5.1	0.6	-4.3
Consumer price index	3.2	2.1	2.9	3.1
Fiscal balance - % of GDP	-3.5	-3.5	-3.3	-3.0
Federal government debt - % of GDP	53.2	54.0	53.8	53.0
USD/MYR – Year End	3.497	4.500	4.200	3.800
Overnight policy rate (%)	3.250	3.250	3.250	3.200