

ECONOMIC OUTLOOK 2017

RAM
RATINGS

A delicate
recovery

November 2016



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Summary of Forecasts and Expectations

Economic growth

Annual change (%)	2015	2016e	2017f
Overall GDP	5.0	4.2	4.5
Private consumption	6.0	5.8	6.0
Public consumption	4.4	4.3	4.0
Private investment	6.4	4.5	5.5
Public investment	(1.0)	(0.1)	(0.2)
Exports	0.6	(0.2)	1.7
Imports	1.2	0.4	1.8
Agriculture	1.2	(3.8)	1.8
Mining	4.7	2.3	1.6
Manufacturing	4.9	4.0	4.1
Construction	8.2	7.9	7.1
Services	5.1	5.4	5.3

Monetary and financial conditions

	2015	2016e	2017f
Global			
Average oil price (USD/bbl)	52	45	50
Domestic			
OPR (% , year-end)	3.25	3.00	3.00
CPI (% , annual change)	2.1	2.5	3.0
USD/MYR (average)	3.90	4.00-4.25	4.00-4.50
Gross Government Securities Issuance (RM billion)	106.5	90-100	100-110
Gross Corporate Bonds Issuance (RM billion)	85.9	75-85	75-85

Executive Summary

Economic growth momentum is expected to stabilise in 2017, on the back of resilient domestic demand and improving prospects for external demand as indicated by the strengthening of the US economy and China's steadfast structural rebalancing. That said, the prevailing uncertainties vis-à-vis the commencement of BREXIT negotiations and the impact that this may have on European businesses, the US's trade strategy under a new administration and the lingering uncertainties over global oil prices will still pose crucial downside risks to our forecasts for next year. RAM Ratings projects GDP growth to come in at 4.5% in 2017, slightly better than our expectation of 4.2% for 2016.

The marginal improvement in Malaysia's expected growth trajectory remains supported by resilient domestic demand. That said, broad-based recovery in business and consumer sentiment is not widely envisaged next year, with sales of durable goods yet to show any sustained momentum and the lack of any impetus for businesses to expand their production capacity. Nonetheless, private consumption should still be buoyed by demand for basic necessities and a normalisation of labour market conditions; growth in this area is projected to reach 6.0% in 2017. On the other hand, private investment growth will remain supported by big-ticket infrastructure projects and is anticipated to clock in at 5.5% next year, despite lacklustre capacity-building activities.

We expect export growth to also improve next year, based on stabilising growth momentum for major export markets, which augurs well for intermediate goods (mainly to China) and investment-type products (mainly headed to the US). As such, we expect a more promising growth of 1.7% for exports in 2017. Ongoing investment activity will keep imports robust and is expected to post a 1.8% increase.

Meanwhile, we envision inflationary pressures to intensify in 2017, with headline inflation coming in at 3.0% on the back of recovering oil prices and stabilising core inflation. The USD/RM exchange rate will remain volatile next year amid persistent global uncertainties. We expect the average exchange rate to trade within a slightly wider band of USD/RM 4.00-4.50 on account of this.

Given the expectation of stabilising growth momentum, elevated inflationary pressures and the continued volatility of the USD/RM exchange rate, we opine that Bank Negara Malaysia (BNM) will hold the overnight policy rate (OPR) steady at 3.00%, barring any significant downside risks arising from deteriorating external conditions. If indeed such downside risks materialise, we believe that BNM would still have room for a further OPR cut 25 bp in 1H 2017. However, this decision will also depend on the perceived extent of the destabilising impact on capital flows at that point.

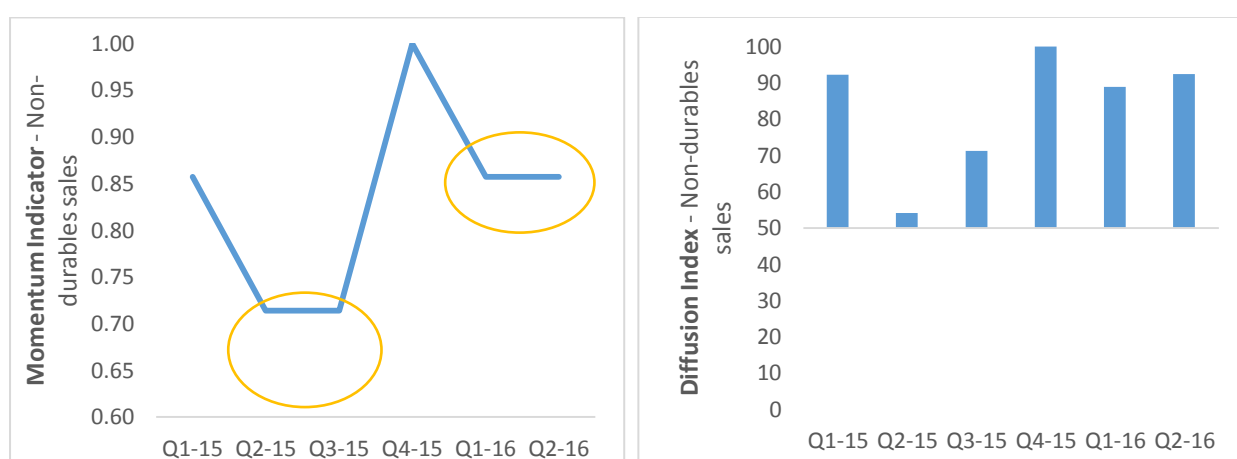
We expect growth momentum to stabilise in 2017, on the back of resilient domestic demand and improving prospects for external demand as indicated by the strengthening of the US economy and China's steadfast structural rebalancing. That said, the prevailing uncertainties vis-à-vis the commencement of BREXIT negotiations and the impact that this may have on European businesses, the US's trade strategy under a new administration and the lingering uncertainties over global oil prices will still pose crucial downside risks to our forecasts for next year. **We expect GDP growth to stand at 4.5% in 2017**, i.e. slightly better than our projection of 4.2% for this year.

Fundamental demand still underscores private consumption

Based on our analysis of consumption trends over the last 2 years, the favourable demographic dividend remains a significant contributor to the resilience of overall private consumption growth. Despite the slew of headwinds that have battered the domestic economy through the past year or so, e.g. less tight labour conditions and more costly food and utilities, **private consumption growth** has kept up a positive pace, on track towards meeting our **forecast of 5.8% for 2016**.

Following the implementation of the GST in 2Q 2015, the Momentum Indicator¹ (MI) for consumer non-durables has decelerated and bottomed out over the course of 2 quarters – as expected (Figure 1, left panel). After the spike at the end of last year, momentum has stabilised at a more robust level of activity. This trend supports our proposition that fundamental demand, which is necessities-driven (partly represented by the non-durables sector), remains vital to the resilience of private consumption. The corresponding Diffusion Index (DI), which measures the breadth of movement in this trend, also shows that increased sales of non-durables were broad-based across the various sub-components of this grouping (Figure 1, right panel). Even so, the upward momentum of durables sales is still weak, signalling consumers' continued risk aversion and a lack of confidence about economic prospects. We therefore expect private consumption growth to remain on a positive trend, but still fall short of the average trend growth attributable to a more robust economic climate. Fiscal measures that support purchasing power (such as BR1M) - just announced under Budget 2017 – are also expected to contribute an additional 0.2% to GDP. As such, **private consumption growth is anticipated to pick up to 6.0% in 2017, from the projected 5.8% for this year**.

Figure 1: Non-durables still main driver of overall retail sales



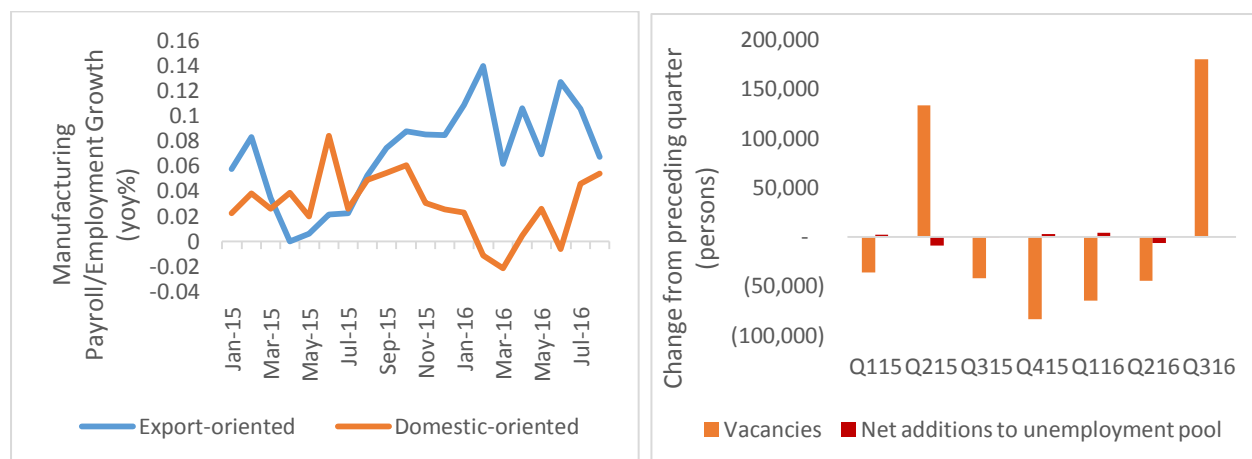
Source: Department of Statistics, Malaysia (DoSM) and RAM

Besides actual sales, we also observe trends that indicate normalising labour conditions next year, which should also help shore up private consumption. Based on our proxy for manufacturing wages, we note

¹ Please refer to the appendix for our calculation of the Momentum Indicator and the Diffusion Index.

that the downtrend in domestic-oriented wages is starting to turn around (Figure 2, left panel). Moreover, net additions to the unemployment pool have been markedly lower in 2Q 2016 while vacancies are opening up (Figure 2, right panel). As such, **we expect the unemployment rate to normalise to 3.2% in 2017**, compared to the forecast of 3.5% for this year.

Figure 2: Signs of normalising labour conditions



Source: BNM and RAM

Given the anticipated resilience of private consumption, we envisage a similar trend for the services sector next year. Although some lingering headwinds will curb any broad-based resurgence in consumer sentiment, normalising labour conditions and stabilising domestic demand will contribute to the positive pace of the services sector's growth. We expect **services to expand 5.3% in 2017**, i.e. almost unchanged from this year's projected 5.4%.

Weak business sentiment and ongoing risk aversion to constrain productive capacity expansion

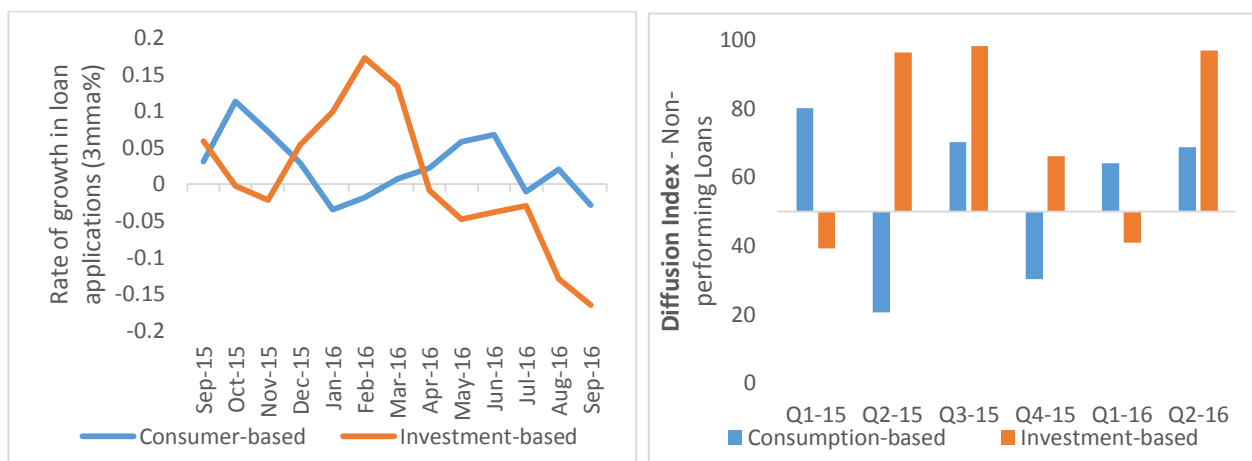
Unlike private consumption, which has weathered downside risks, private investment has not exhibited a similar level of resilience. Although infrastructure development projects still provide a floor for private investment growth, productive capacity expansion remains lacklustre.

The 25-bp OPR cut in July this year somewhat stimulated consumer-based loan² applications but failed to spur investment-based loan³ applications (Figure 3, left panel). Our analysis of non-performing loans also shows that the bulk of these originated from investment-based lending (Figure 3, right panel). As such, there is very little impetus for businesses to scale up and invest, unless sentiment picks up significantly in the next few months.

² Consumer-based loans comprise the purchase of securities, passenger cars, residential property and consumer durables, as well as for personal use and credit cards.

³ Investment-based loans entail the purchase of non-residential property, transport vehicles for industrial use and fixed assets, as well as for working capital and construction.

Figure 3: Weak business sentiment biggest culprit of hindrance to capacity expansion



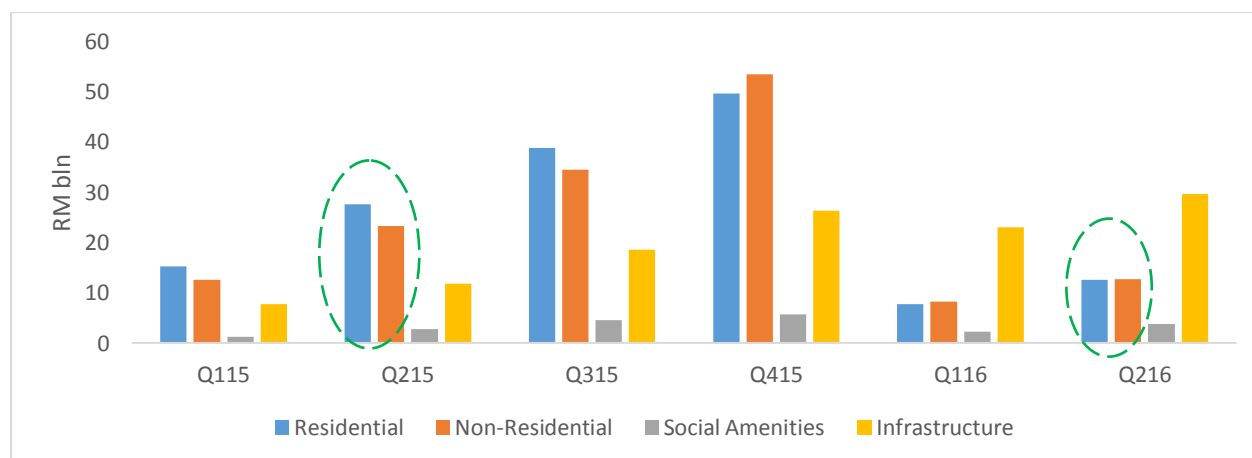
Source: BNM and RAM

In light of the myriad and persistent uncertainties, we do not expect this improvement to take place anytime soon. Existing big-ticket infrastructure projects will remain the fundamental drivers of **private investment, which is anticipated to expand 5.5% in 2017**, as opposed to the 4.5% projected for this year. The recently announced East Coast Rail Link (ECRL) has the potential to be a significant contributor to this momentum, depending on the level of involvement by private concessionaires, which is yet to be announced.

Construction sector to benefit most from ongoing developmental activities

The construction sector, particularly civil engineering, is expected to remain the key beneficiary of the continued positive momentum of infrastructure projects and the healthy pipeline of construction work going into 2017. The property sub-segment’s contribution to growth is, however, expected to remain relatively muted on the back of a decline in the number of projects awarded in 1H 2016 amid oversupply concerns (Figure 4). On the whole, **the construction sector is anticipated to maintain its robust performance, with a projected expansion of 7.1% in 2017**, compared to the 7.9% forecast for this year.

Figure 4: Construction sector still buoyed by developmental activities



Source: Construction Industry Development Board (CIDB) and RAM

The 2 sectors that are expected to exhibit a marked improvement from this year’s showing are agriculture and mining. After a challenging first half for the palm-oil industry - a significant contributor to agricultural

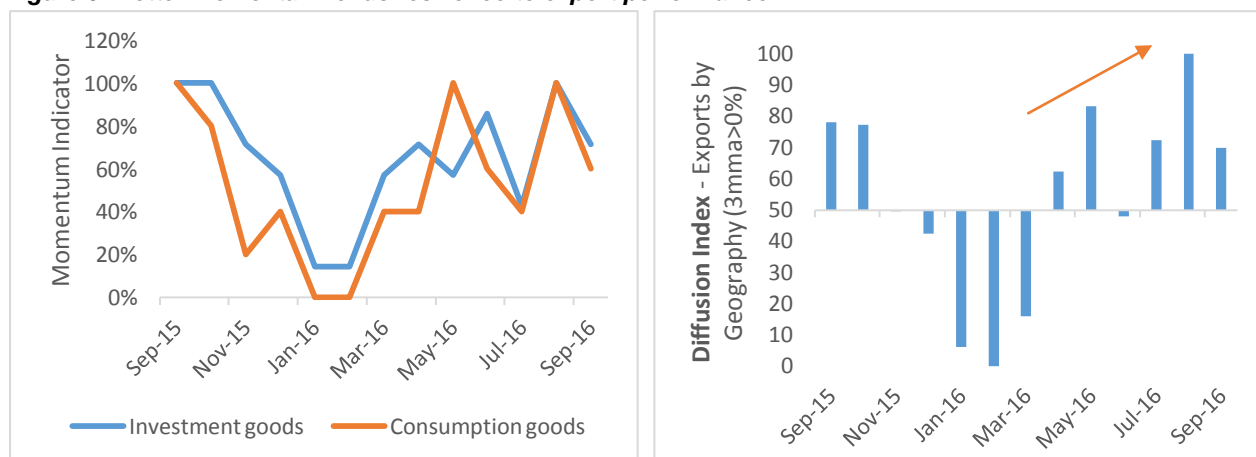
output - amid the lagged effects on yields from the previous year's severe haze and the El Niño phenomena, output is expected to normalize in 2017 on the back of more conducive weather conditions and the low-base effects from this year. We anticipate an **improvement in agricultural output in 2017, with a 1.8% growth** as opposed to the 3.8% contraction projected this year.

In 2017, the **mining sector is envisaged to continue growing at a rate of 1.6%**. The continued positive momentum is mainly attributable to improved production from the existing capacity given the anticipated recovery of oil prices (RAM's projection: average USD 50/barrel in 2017). This contrasts against the broad-based ramp-up from new supply sources given the cessation of exploration activities due to more costly upfront funding and longer gestation periods for these investments.

Signs of some upside for exports despite still-challenging external environment

Sluggish exports on the back of uneven growth momentum have been a feature through a good part of the last few years. Despite the ringgit's depreciation, export growth was dismal at the start of this year; signs of a pick-up have only been apparent in the last quarter. Notably, consumption and investment-type exports have been gaining traction since the beginning of 2016 (Figure 5, left panel). Moreover, there has also been a broad-based improvement in export demand from various markets in the last 2 quarters (Figure 5, right panel).

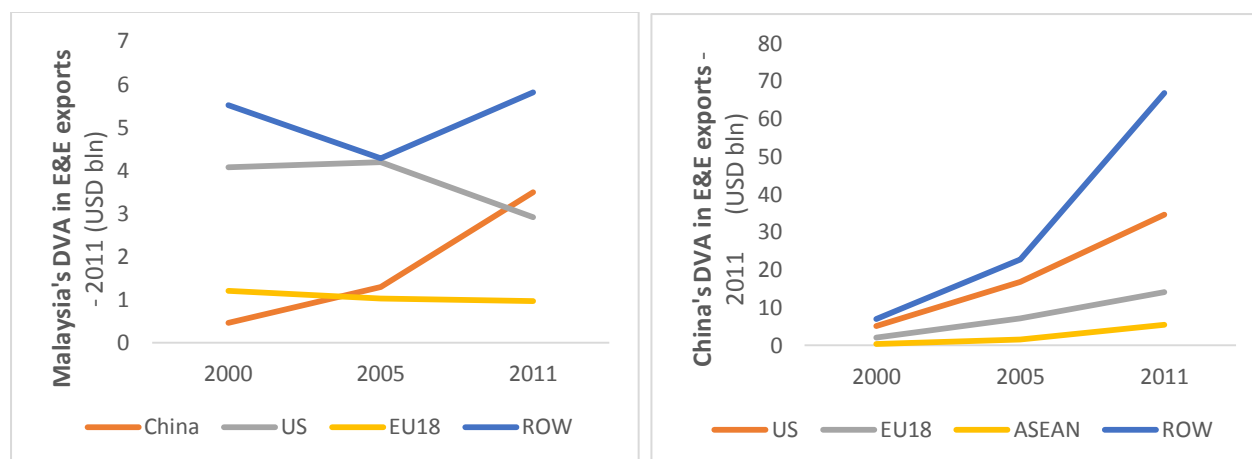
Figure 5: Better momentum lends resilience to export performance



Source: DoSM and RAM

Electrical and electronic (E&E) goods remain significant export items for Malaysia, with a share of over 30% of total exports. In the last decade, domestic value-added (DVA) in E&E exports has stayed relatively constant in terms of value. However, we note an acceleration in supply to the Chinese market following China's accession into the World Trade Organisation (WTO) and more diversified export destinations, as underlined by the increase in value-added to the rest of the world (ROW). Nonetheless, the rising importance of the Chinese market has displaced some of Malaysia's value-added exports, especially to the US and the EU18 group of countries (Figure 6, left and right panels). In the meantime, China's exports to these markets and the ROW have surged. We believe that this indicates the structural shift in the supply chain through the last decade, during which China has been established as a conduit of trade. Therefore, the managed rebalancing of the Chinese economy and the further weakening of the renminbi is not perceived as significant threats to the overall health of Malaysia's exports, so long as the global economy continues picking up the slack through a stronger pace of recovery.

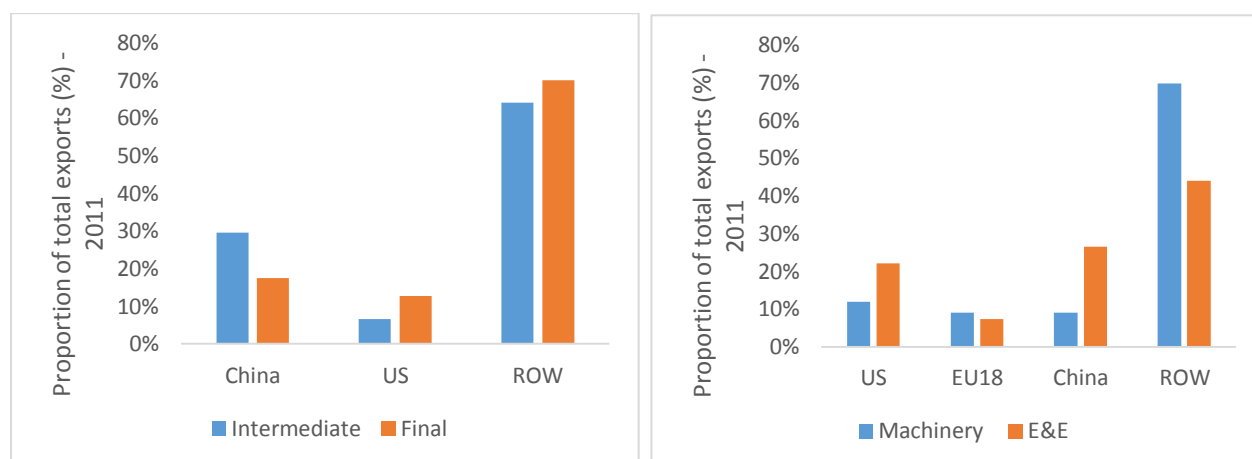
Figure 6: Malaysia's resilience in E&E contribution to trade growth depends on China's characteristics as a conduit in the global marketplace



Source: Trade in Value-Added (TiVA) database and RAM

China remains a key export market for Malaysia's intermediate goods (Figure 7, left panel) with a large proportion stemming from the E&E sector (Figure 7, right panel). However, the US market is more important than China for investment-type goods (proxied by machinery).

Figure 7: China's demand for Malaysian exports lies mainly in intermediate goods



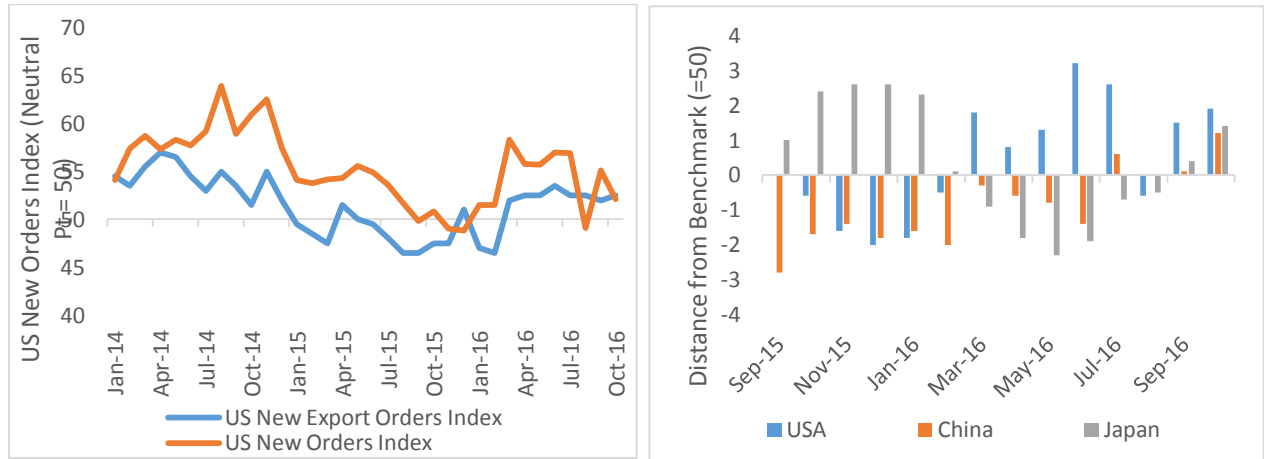
Source: TiVA and RAM

While data from industrialised economies have improved compared to the beginning of this year, it may still be too early to confidently declare a sustainable recovery. Nonetheless, the EU18's unemployment rates, industrial production indicators and inflation rates are seemingly more positive while American labour market trends are stabilising and falling inventories signal a more broad-based economic recovery (Figure 8, left and right panels). This augurs well for the external demand trajectory of Malaysia's investment-based and intermediate exports.

That said, some uncertainties still linger, primarily concerning President-elect Trump's eventual official stance on US trade policy. Given that he is not known as a proponent of trade deals such as the Trans-Pacific Partnership Agreement (TPPA), President Obama's attempt at a "shift to Asia" seems to have petered out. Asian economies are now pinning their hopes on a successful conclusion for the Regional Comprehensive Economic Partnership (RCEP). This agreement would contribute towards the strengthening of Asian trade ties, which could act as a trade-off for a potentially more protectionist US as a trade partner. Although it may still be too early to tell the extent of the protectionist stance the US will

adopt, the nature of global trade flows and connectivity means that it would be painful for it to suddenly turn its back on the trade relationships that have been so painstakingly established through the decades. We therefore do not expect to see an immediate and hard landing for global trade on account of this.

Figure 8: US export orders index shows stronger momentum while PMI readings are improving across major markets

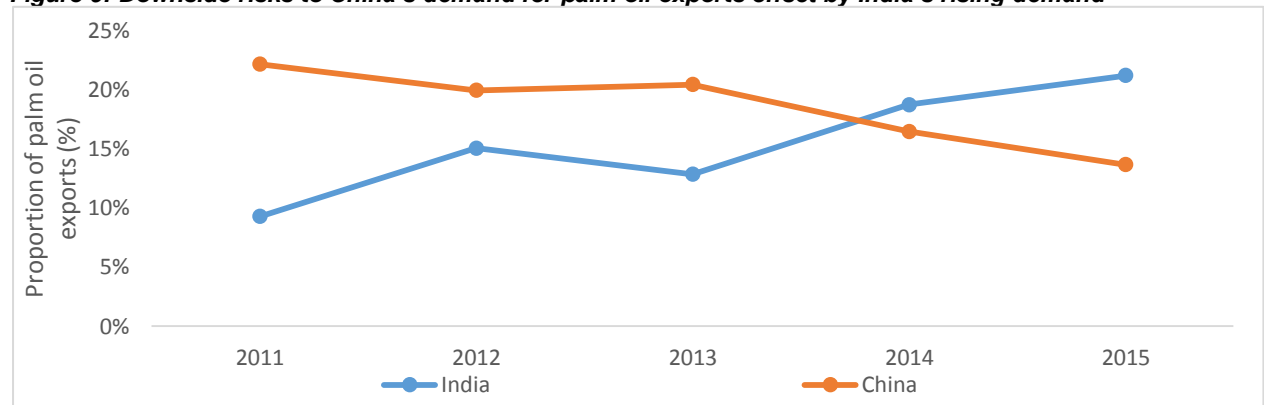


Source: Institute for Supply Management, Markit-Caixin and RAM

As mentioned earlier, we do not expect a broad-based recovery in business and consumer sentiment next year. However, the latest data points and forward-looking indicators on momentum as well as the breadth of these trends point towards some stabilisation in economic momentum. Even so, uncertainties over the resilience of the recovery in external demand will still pose downside risks to industrial activity. Based on the current pace of production, we expect **manufacturing activities to pick up slightly next year, with a 4.1% growth against this year's 4.0%.**

Commodity exports are also expected to deliver a better showing next year, with more favourable weather conditions supporting greater output capacity. China's softer demand for palm oil remains a key downside risk for the industry due to its increasing preference for its own supply of soymeal, as well as keener competition from other markets. That said, some of this weakness is offset by India's growing demand for Malaysian palm oil (Figure 9). We expect some upside potential from this market given the recent reduction in India's import duty by 5.0% in September from the original 12.5%. Oil exports are also envisaged to rebound from this year's performance, primarily due to better production trends.

Figure 9: Downside risks to China's demand for palm oil exports offset by India's rising demand



Source: Malaysian Palm Oil Board and RAM

We expect export growth to improve moderately in 2017, underpinned by the continued stabilisation of its momentum. Exports **are projected to increase 1.7% next year**, in contrast to the 0.2% contraction in 2016. Ongoing investment activities will keep driving **imports in 2017, with a projected growth of 1.8% compared to** just 0.4% this year.

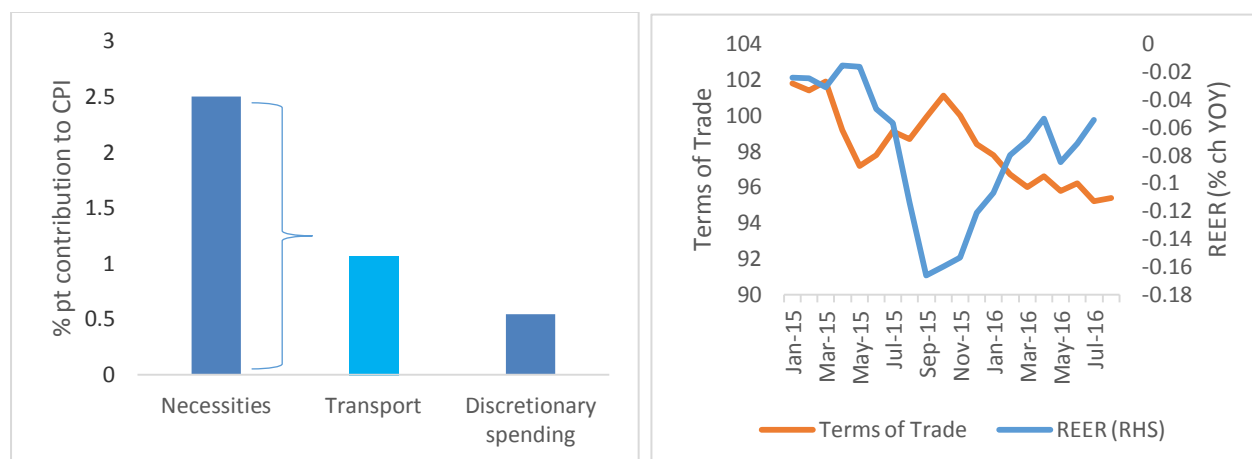
The relative competitiveness of the RM exchange rate is envisaged to normalise through the course of the year. Judging from export performance in 1H 2016, however, this would not have as significant an effect as the overall strength of external demand from the export markets. Even with this normalisation, we believe that any trade-off in terms of demand will be marginal. We therefore place more significance on the improvement in demand momentum from the main export markets. Meanwhile, weakening terms of trade have also had little effect on the rebalancing of the country's current account position; imports remain sticky amid weak demand for exports. That said, an improvement in the relative terms of trade on the back of improving commodity prices next year will help **maintain a current account surplus of around 1.0% of GDP**.

Mounting inflationary pressures and stabilising growth leave more leeway for OPR pause

Inflationary pressures are expected to intensify next year against the anticipated recovery of oil prices and stabilising core inflation. Necessities are expected to continue accounting for the bulk of the contribution to headline CPI at 2.5% (Figure 10, left panel) while the role of discretionary items in the CPI basket will remain marginal amid subdued consumer sentiment. As such, price trends for several of these discretionary items (e.g. clothing, footwear and communications) have been subject to deflationary pressures after the initial impact of the GST had dissipated. This indicates a lack of rebound momentum for broad-based consumer spending beyond necessities. **We expect headline inflation to average 3.0% in 2017**, in comparison to 2.5% this year.

Global uncertainties pose downside risks to Malaysia's economic prospects next year. Similarly, they are also expected to still drive the volatility of the USD/RM exchange rate. Fluctuations in the USD/RM exchange rate have been largely influenced by risk aversion and expectations on the direction of global monetary policies. Uncertainties engendered by the unexpected outcomes of BREXIT and the recent US presidential election have largely pushed global funds towards "safe haven" currencies and gold, thereby further depressing the ringgit. On the other hand, the continuation of unconventional monetary policies has driven funds towards higher-yielding markets such as emerging Asia. Given that such uncertainties concerning the outlook on oil prices as well as the imminent BREXIT negotiations and US foreign and monetary policies are expected to persist, we opine that **the average USD/RM exchange rate will move within a wider band of 4.00-4.50 in 2017**. This is premised on our base-case scenario of domestic economic growth stabilising at 4.5%, the maintenance of a current account surplus and the OPR staying put at 3.00%.

Figure 10: OPR expected to be unchanged amid mounting inflationary pressures and improving growth prospects



Source: BNM, Bank for International Settlements and RAM

Given our premise of stabilising growth momentum, elevated inflation and the continued volatility of the USD/RM exchange rate, **we expect BNM to hold the OPR steady at its current level of 3.00%**, barring significant downside risks from deteriorating external conditions. Should these downside risks materialise, we believe that BNM should still have room for a further OPR cut of 25 bp in 1H 2017. However, this decision will also depend on the perceived extent of the destabilising impact on capital flows at that point.

Appendix

The **Momentum Indicator** aims to uncover the underlying pervasiveness of a data trend. It is a composite index of growth rates of respective subcomponents registering values higher than the minimum growth threshold.

The **Diffusion Index** aims to measure the breadth of a particular data trend. Index values of 0, 0.5 and 1 are assigned to readings of negative, neutral and positive growth of weighted sub-components respectively. The benchmark reading stands at 50.

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