PP7004/02/2013(031762)
31 March 2014

Economic Outlook 2Q14

A cold start but springing to a better 2H14

Economics
wansuhaimi@kenanga.com.my
farah@kenanga.com.my
Tel: 603-2079 1376

Short term hitch in global growth – due to weather conditions in the US and uncertainties in Europe pretaining to the situation in Crimea and sanctions against Russia. China's structural changes and tax hike in Japan adds to worries. However, production and exports remain on a steady upward trajectory, which goes to show that fundamentals are on the mend.

Exports on the mend – Improving external demand and sustainable domestic growth should be able to keep 2Q14 GDP around 5.0%, just a slight lower than our 1Q14 estimate of 5.1%. Overall 2H14 GDP growth is projected to average by 5.1%.

Better 2H14 – growth will be driven by gradually improving global economy, led by the US and Europe as well as other developed economies. Sustainable domestic demand growth would also lend support to 2H14 uptrend projected at 5.6%. Given the global growth uncertainty our whole year GDP forecast is 5.0-5.5% (2013: 4.7%).

Further fiscal consolidation – both public and private sectors are keeping their belt tight and patiently wading through inflationary pressures as a result of fiscal consolidation. Baring any external shocks, this should be able to reign in debt and deficit. Fiscal deficit is projected to narrow to 3.7% of GDP (-3.9% of GDP).

Inflation above long term average – Inflation remains cost-push and will take a while to normalize the impact of subsidy rationalisation and regulated price increases. Average CPI rate would remain elevated for much of the 1H14 but should taper off by the 2H14. Our full year CPI forecast is 3.3%, up from 2.1% in 2013.

Interest rate to stay pat – Current rates are supportive of the economy and with inflationary pressures being non pervasive, it gives little reason for BNM to raise the OPR for the rest of year.

Ringgit to remain volatile – QE tapering, emerging market uncertainties and US dollar strength will add volatily in the forex market. The recent widening of the Yuan trading band would add downward pressure on regional currencies in the short to medium term. Though fundamentals would support the ringgit, it would remain volatile in the ST. Our year-end USDMYR forecast is 3.21 (2013: 3.17).

Macro balance manageable – Despite the capital outflows, the situation remains manageable and the current account balance continues to remain in a surplus. Though federal debt is starting to scrape the 55%, macro prudential measures and fiscal consolidation steps has already been put in place to reduce public debt and narrow the fiscal deficit.

Some risk remains – Fiscal consolidation may end up hampering domestic growth beyond unwarrented levels whilst risks from Europe, China and Japan may be prolonged, jeopordizing overall growth.

Beyond 2014 – The higher possibility that the Fed would hike interest rates and the impact of the implementation of GST next year would generate an interesting macro environment with a possible downside bias to the economy and the financial market in the 1H15. On the expectation of further improvement in the global economy and a steadier domestic growth traction in the 2H15 we expect economic growth may stay above 5.0% next year.

Kenanga Research Malaysia Macroeconomic Forecast Summary

	2012	2013E	2014F	Remarks
GDP (%YoY)	5.6	4.7	5.0-5.5	Though geopolitical risks and China's transitional period of reform could jeopardise global economic growth, further global growth recovery led by the US and Europe is expected revive exports and manufacturing throughout the year.
CPI (Average %YoY)	1.6	2.1	3.3	Inflationary pressures to remain cost-push due to fiscal consolidation and higher imported inflation as ringgit weakens.
OPR (%) End-period	3.00	3.00	3.00	Current rates are more likely to stay pat to promote growth in light of fiscal consolidation measures. Earliest hint of hike in the later part of 2015.
USD/MYR End-period	3.06	3.17	3.21	Ringgit pressured by capital volatility and the strength of the US dollar. It will probably trade around the 3.25 and 3.30 levels in the ST but by 2H14 we foresee that sturdy fundamentals will prop up the ringgit, partially mitigating the effects of its weakness in the 1H14.

Sources: Kenanga Research, E=Estimate, F=Estimate

Summary

A bumpy start. The global economy started off on a mixed and bumpy start, with severe weather distorting economic growth in the US and China's structural issues dampering its overall domestic growth. In addition to that, the 1Q14 was a very short working quarter on account of the Lunar New Year holidays in Asia. However, we are confident of recovery in the rest of the year, with improvements in the developed economies cascading to other economies, propping up exports, consumption and investment througout the year.

A durable growth trend. In Malaysia, inflationary pressures on account of fiscal consolidation means a round of patience and belt tightening for both the public and private sectors. There is also some financial volatility to wade through as the US Fed continues on their path of QE tapering, increasing fears of credit tightening. However, these are short term fears and strong fundamentals, high reserves and savings remains a steady buffer for the country. The rest of the year should be welcoming a recovery in domestic demand as prices begin to normalize and global uncertainties start to wane. Due to a myriad of uncertainties currently though, we stay on the cautious side and project the GDP to expand between 5.0% to 5.5% in 2014.

Global outlook

A challenging transition towards stability and growth

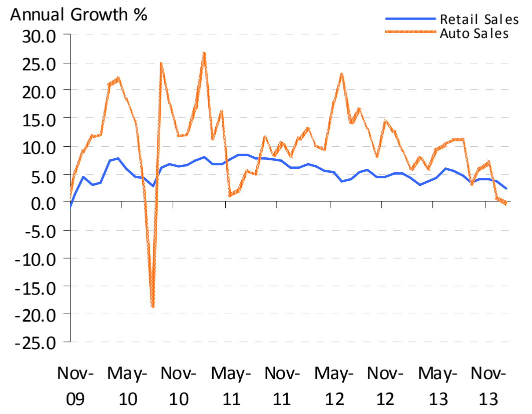
A cold start. Due to the worse than expected climate at the end of 2013 and into much of the 1Q14, growth in the USA could end up starting off the year below what many expect to be the year of recovery. Though the 1Q14 is traditionally the weakest quarter of the year, the harsh weather has been seen dragging back the economy to an unprecedented level as a result of loss of productivity due to closures, lack of consumer spending (nobody wants to go shopping whilst battling the elements) and higher heating bills pinching consumer and producer pockets alike.

Sentiment remains high. It is estimated that the frigid chills could cost the US economy about US$5.0b in the near term. But winters eventually thaw and based on consumer sentiment, spring is well on the way. The glut in spending is expected to recover exponentially in the coming quarters. Conference Board sentiment index was last seen at a six year high level whilst the PMI manufacturing remains comfortably above the expansion level of 50 (last seen at 57.1 in February).

Jobs conundrum. But the bane of the US' economic recovery is the uncertainty of their jobs market. Unemployment rate ticked up to 6.7% in February (from 6.6%), with barely any changes in their labour participation rate of 63%, a low unseen since the 1970s. There is a growing opinion that US labour participation is closer to capacity than previously thought. The argument goes that the current unemployment issue is in fact more structural than cyclical beause long term unemployment is largely due to aging workforce and effect of technology on jobs, rather than inadequate stimulus.

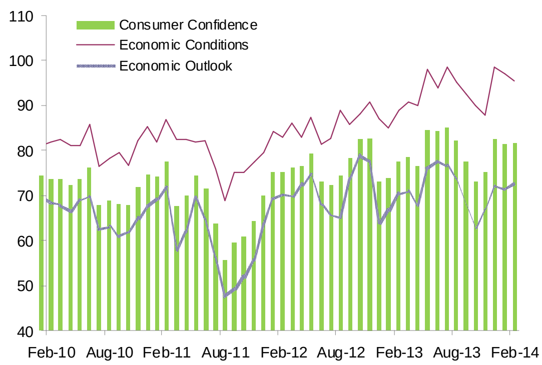
QE tapering continues. Seeing as to how the Federal Reserves has opted to continue with their tapering (now reduced to US$55b a month), they seem confident that the economy as a whole is well on the path to recovery. This add to the growing speculation in the market that the Fed may raise interest rates sooner or some time in 2015. Sans unemployement and inflationary trend, investors are expecting more positive US economic data going forward. Our view is that the Fed's bias remains dovish, and its chairman Jenet Yelen will be cautious, especially given that even the optimistic forecast for US GDP hitting 3.0% are hardly suggestive of robust growth.

Graph 1: US sales effected by the weather



Source: Bloomberg, Kenanga Research

Graph 2: US consumer and economic sentiment still upbeat



Source: Markit, Bloomberg, Kenanga Research

Crimea crisis rattles EU's recovery. On the other side of the Atlantic, markets have been roiling on uncertainties pertaining the situation in Ukraine and Crimea. Energy supply concerns is currently at the forefront as the Western allies imposes sanctions against Russia (of which Russia retaliates in kind). Russia is Europe's biggest supplier of energy and one of the world's top three producers of oil. These sanction could have wider economic consequences, threatening the already precarious economic recovery in Europe. Incidentally though, these sanctions against Russia may give new impetus for negotiations between the EU and the US (also known as the T-TIP – Transatlantic Trade and Investment Partneship) so as to allow Europe to import US gas, amongst other possible agreements. If the T-TIP does go through, it is estimated to generate US$100b in additional economic output a year on both sides of the Atlantic.

On the mend. But putting aside these geopolitical uncertainties, we hadn't need to look far to point out that Europe is finally beginning to climb out of their economic slump. Malaysia's exports to the EU for the last six months up till January this year has been (with the exception of December) on the uptrend after over a year of contraction. Though industrial output in the Eurozone fell by 0.2% in January, the full 28-country EU production was up by 0.1%, a soft start to the year but a modest recovery nonetheless. Up ahead, there's an expectation of further improvement in the EU, if the manufacturing and services PMI is of any indication. It was latest seen at 53.2 (50 and above being expansion level), staying close to a three-year high.

Banking readiness doubtful. In spite of improving fundamentals, the financial risk remains. So far EU has yet to create a credible bank backstop or strong central bank authority, both critical for surviving the next banking crisis. The euro-zone needs a real banking union to prevent doubts about the solvency of national governments from undermining confidence in their banks. That, however, can't happen unless the resolution fund has the backstop of further European funding.

Deflationary threats. Another major growth risk factor is that the steady EU recovery is being accompanied by very low inflation along with falling prices in some southern European nations. That means nominal GDP growth will remain lackluster and will pose a threat for countries that face high debt burdens (will raise debt to GDP ratio and reduces repayment ability).

Japan's vulnerable recovery. Meanwhile, Japan is gearing up for a rise in sales tax come April, pushing up retail sales, industrial production, and household spending, rising by 4.4%, 4.0% and 1.1% respectively in the month of January. In addition to that, businesses are finally taking heed of Shinzo Abe's pleas and for the first time in 11 months. Wages rose as base pay excluding bonuses and overtime increased by 0.1% in January. However, it is not enough to counter the rise in prices, with the core inflation rate rising by 1.3%, fastest pace seen since 2008.

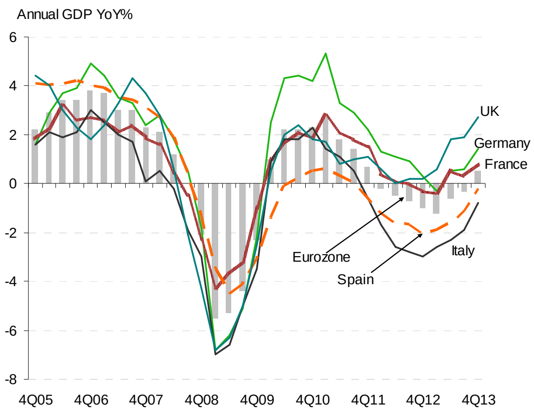
Rising tax threat. In addition to that, there is growing uncertainty about the direction of the economy once the sales tax hike (from 5% to 8%) is implemented. Unless wages are able to rise fast enough, or further compensation or stimulus is dished out to partially mitigate the consumption tax, there are worries that Japan's growth will take a step backwards. According to IMF estimates confirmed by unpublished projections from the Ministry of Finance, the tax hike will result in a fiscal tightening worth about 2.5% and 1.0% of GDP for this year and 2015 respectively. Consequently, this would shave Japan's GDP growth to 1.4% in 2014 from 2.5% in 2013.

Additional stimulus likely. The weaker yen, though advantageous to exports, has pushed up the costs of imports for both households and businesses, leading to trade deficits for twenty consecutive months in February. This is also due to the fact that they have fallen into dependency of importing energy following the Fukushima disaster shutting down the nation's energy reactors. It is possible that the Bank of Japan to add further stimulus following the tax hike, a further top up to the ¥96 trillion budget for the year that starts in April 1.

Threat to China's growth. Across the sea, China has been in the limelight as its growth prospects has been rather shaky while efforts to implement reforms faces mounting obstacles. Manufacturing, one of the major backbones of the economy has been contracting, with the PMI index below the 50 point expansion mark for three straight months, despite demand from developed nations improving. The property market – unit prices and sale has also been on the downtrend, which meant that local governments could no longer rely on land sales to finance infrastructure projects, which tends to reduce the multiplier effects for the economy. This also puts strains on locals banks paying their dues.

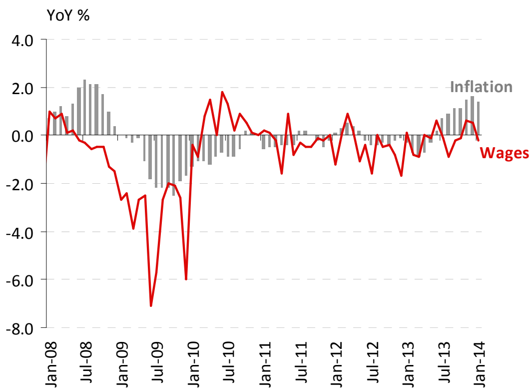
Solution: weaker yuan. The drop in the yuan is in line with China's slowdown story apart from the deliberate widening of its trading band to 2.0% from 1.0% in mid-March. The Peoples' Bank of China appear to be willing to suffer some currency volatility in order to punish speculators, and also provide some help to struggling exporters. It may also help support China's economic growth that comes from competitive exports. Added to the move to tighten credit, it would still be rather challenging for China to outpace last year's GDP growth of 7.7%.

Graph 3: Eurozone Quarterly Growth Trend (%YoY)



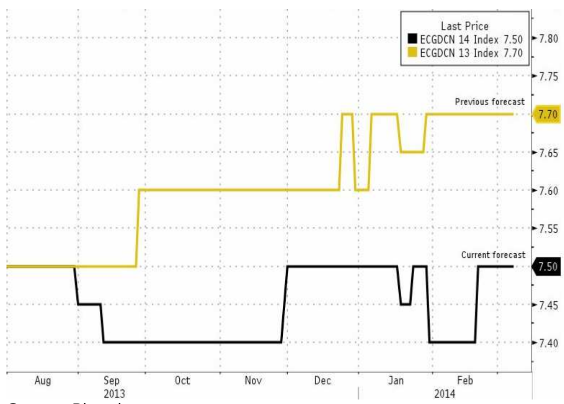
Source: Bloomberg, Kenanga Research

Graph 4: Japan's inflation vs wage growth



Source: Bank of Japan, Bloomberg, Kenanga Research

Graph 5: Doubts on China – GDP forecast survey



Source: Bloomberg,

New realities. In the last two decades exports and a booming property sector has brought some positive spillovers throughout the economy. But now the two sectors were no longer sufficient in carrying the weight of the whole economy. Trade surplus once accounted for about 8% of the whole economy a decade ago now accounts for just 1.8%. Therefore, the country now needs to go through a round of restructuring, and with further emphasis on supporting domestic growth. It will take some time before the country acclimatizes itself with the change in policies but until then, growth will be tapered. With the advancing growth recovery of US and the eurozone, we expect to see improvement coming in the later part of 2014 and 2015 with GDP growth possibly above the 7.5%-level next year.

Growth Prospects

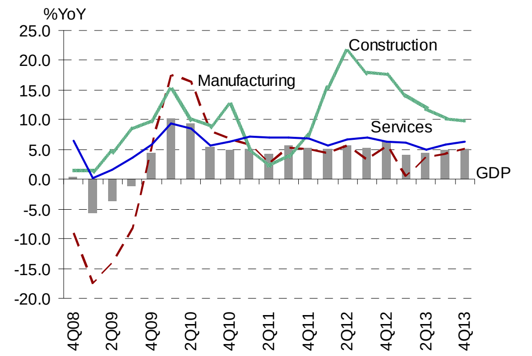
1Q14 Overview

Sustained growth trend. We reckon that the 1Q14 may post a better than expected growth despite the lesser working days on account of multiple cultural and religious holidays in the month of January. Plus apart from being the shortest month of the year, production and exports still remained elevated in February. Moreover, it could also be partially attributed by the fact that growth in the 1Q13 was weaker, giving a lower base comparison.

Export driven. Regardless, production in January recorded a positive annual growth of 3.7%, with manufacturing expanding by 4.7%. Though below expectations, this is more likely than not explained by the reason already mentioned – lesser working days. Regardless of the holidays, it was of no hinder to exports, which expanded at a double-digit pace of 12.2% in January.

Momentum support. Alongside that, there is also momentum to be had coming in from the 4Q13, of which the GDP expanded by 5.1% mainly backed by exports recovery. We continue to expect that exports will also be one of the primary drivers of growth in the 1Q14 and throughout the rest of the year. We estimate that the 1Q14 export component of the GDP to expand by 2.3% comparatively a large turnaround compared to -0.6% in 1Q14 though slightly lower than 2.9% registered in the 4Q13.

Graph 6: GDP, Supply side growth trend



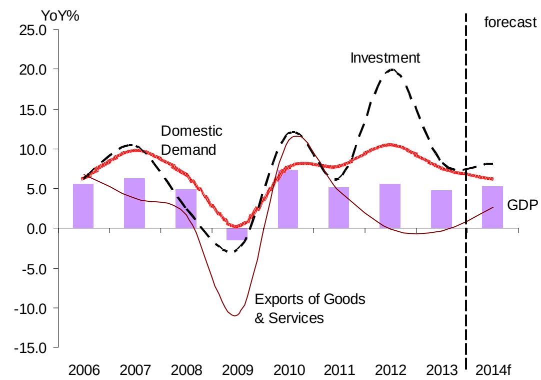
Source: Department of Statistics, Kenanga Research

Seasonally influenced. We also feel it justified to estimate that the manufacturing component of the GDP will also grow at a more moderate pace, of 2.3% from 5.1% in 4Q13. This is on account of the lesser working days and a more subdued aggregate demand as consumption takes a breather after seasonal festivities and some belt tightening following a general rise in prices due to fiscal consolidation. Overall consumption is estimated to moderate to 5.3% (4Q13: 6.7%) though investment is expected to remain relatively steady at 5.6% (4Q13: 5.8%). As a whole, we estimate that the GDP growth in 1Q14 GDP to be relatively unchanged from the preceding quarter at 5.1%.

Outlook 2014

Uncertainty and paralysis in 1H14. On account of uncertainties of global economic recovery in the start of the year, we feel that the 2Q14 may expand somewhat around the same level as the 1Q14. Growth upside would largely be held back by China reforms' setback, Japan's impact on consumption tax hike, and the European situation with Crimea and Russia. Weaker ringgit would also have a downside impact on consumption. Though Malaysia's export is projected to grow by 2.4% in 2Q14, just a tick more than the 2.3% we're estimating in the 1Q14, higher imports (2.6%) would reduce its contribution to overall growth. With a negative net exports growth, even with a higher projected domestic demand growth of 5.6%, slightly higher than the estimated 5.3% in the 1Q14, GDP growth is projected to grow by 5.0% in 2Q14 just a tad lower that 5.1% in 1Q14.

Graph 7: Annual growth trend



Source: Department of Statistics, Kenanga Research

Exports-driven growth. Nonetheless, compared to the previous year, indicators have been more positive than not (just not as high as it could be) and still remains on a good note for Malaysia's exports for the rest of the year. Growth in the overall global economy, especially on revival of consumer spending and investment in developed economies allows us to foresee value-added exports in the 1H14 to expand by 2.3%, adding up to 2.1 percentage points (ppts) to growth and improve further to 2.9% (2.6ppts) in the 2H14, bringing about to an overall exports growth of 2.6% for the whole year, a positive 2.4ppts contribution to exports, compared to the 0.3ppts negative impact in 2013.

Better output in 2H14. Alongside exports, the manufacturing sector is projected to grow by 4.3% (1.1ppts) in the 1H14, partly to cater for exports demand and the continual of major projects under the ETP. However, we estimate that it won't be until the 2H14 that we begin to see a stronger recovery in domestic demand spurring on manufacturing as consumers and businesses alike no longer feel the pinch of higher inflation. Thus, we're looking at manufacturing to improve further by 5.3% (1.3ppts) in the 2H14, bringing about an average growth of 4.8% in 2014 (2013: 3.4%).

Infrastructure boom fizzles. Construction growth ought to keep steady throughout the year, though at a more moderate pace as many civil engineering works begin completion. However, there will still be ample infrastructure projects still on going, as well as those expected to begin commencing this year spurring on expansion in this sector. We are looking at the 1H14 to expand by 9.4% and the 2H14 to moderate slightly to 9.0%.

Better GDP growth in 2H14. In regard to the domestic situation, we are on the more cautious side due to the effects of fiscal consolidation mitigating overall growth. It would take anywhere between 6 to 9 months before the price hike begins to normalize, which is why we are looking at a generally more moderate aggregate demand this year, particularly in the 1H14 where we estimate it to grow by just 5.5%. This is on account of moderate consumption from both the public and private sectors and lower public investment. Barring any unforeseen circumstance and external shocks, the 2H14 should be looking at a revival in aggregate demand of about 7.0%. Coupled with a stronger external demand, this brings about a faster GDP growth of 5.6% in 2H14 compared to 5.1% in 1H14.

Table 1: GDP Growth Trend and Forecast – (% YoY)

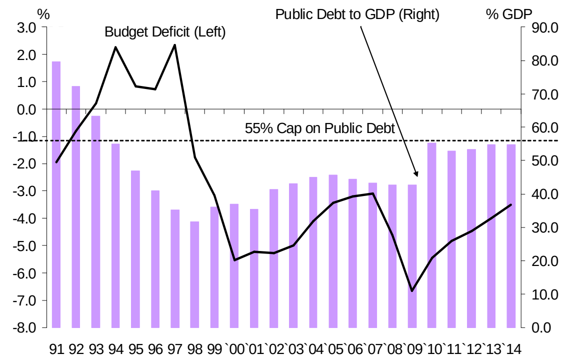
								Kenanga Forecast				
	2011	2012	2013	1Q13	2Q13	3Q13	4Q13	**1Q14E**	**2Q14**	**1H14**	**2H14**	**2014**
By Sector												
Agriculture	5.8	1.0	2.1	6.0	0.4	2.1	0.2	2.1	3.1	2.6	4.7	3.7
Mining	-5.5	1.4	0.5	-1.9	4.1	1.7	-1.5	2.5	3.0	2.7	2.5	2.6
Manufacturing	4.7	4.8	3.4	0.3	3.5	4.2	5.1	2.3	4.2	4.3	5.3	4.8
Construction	4.7	18.1	10.9	14.2	9.9	10.1	9.7	8.7	10.1	9.4	9.0	9.2
Services	7.0	6.4	5.9	6.1	5.0	5.9	6.4	5.7	5.5	5.6	5.9	5.8
Real GDP	**5.1**	**5.6**	**4.7**	**4.1**	**4.4**	**5.0**	**5.1**	**5.1**	**5.0**	**5.1**	**5.6**	**5.0-5.5**
By Aggregate Demand												
Consumption	8.6	7.1	7.3	6.2	8.1	8.1	6.7	5.2	5.2	5.2	5.8	5.5
Public	15.8	5.1	6.3	0.6	11.8	7.8	5.1	3.7	3.1	3.4	3.3	3.3
Private	6.8	7.7	7.6	7.5	7.2	8.2	7.3	5.5	5.7	5.6	6.5	6.1
Investment	6.2	19.9	8.2	13.1	6.0	8.6	5.8	5.6	6.7	6.2	10.0	8.1
Aggregate Demand	7.9	10.6	7.6	8.2	7.4	8.3	6.4	5.3	5.6	5.5	7.0	6.3
Exports	4.6	-0.1	-0.3	-0.6	-5.2	1.7	2.9	2.3	2.4	2.3	2.9	2.6
Imports	6.1	4.7	1.9	3.6	-2.0	1.8	4.4	2.2	2.6	2.4	3.3	2.9
Real GDP	**5.1**	**5.6**	**4.7**	**4.1**	**4.4**	**5.0**	**5.1**	**5.1**	**5.0**	**5.1**	**5.6**	**5.0-5.5**

Source: Dept. of Statistics, Kenanga Research, E= denotes estimates

Fiscal Policy – Continued Consolidation

Fiscal commitment. It's just as well that the global economy in general is on the path to recovery this year. Not only will it help boost exports, there will be spillovers to other industries such as services and tourism (further boosted by Visit Malaysia Year). With private sector investment and consumption on the mend, the government has to now take a step back and keep their promise to narrow the fiscal deficit. It would definitely contribute less to GDP growth as we project that public expenditure to moderate further this year to 2.6% from 3.7% and 10.3% in 2013 and 2012, respectively to reflect prudent spending on supplies, services and emoluments. This is largely reflected in the operating expenditure of the fiscal account which is projected to grow by only 1.8% from 5.2% last year.

Graph 8: Fiscal Deficit vs Public Debt



Source: Department of Statistics, Kenanga Research

Huge burden. That is why the government has resumed its rationalization plan, after a long lull, by cutting the petrol subsidy at the tail-end of 2013 and by increasing the electricity tariff at the start of the year. We believe there is a possibility of another round of petrol subsidy rationalization later in the year but could very well be dependant on the global fuel prices. Currently, oil prices have been put under pressure on worries in supply due to the situation with Crimea and the sanctions against Russia. However, in the longer term, we feel that oil prices will remain moderate this year and we are looking at crude oil (WTI) to average around US$102.1/barrel. At the current pump petrol price of RM2.10/liter for RON95 the government is subsidizing around 70 to 80 sen per liter which estimated could ramp the subsidy bill to an estimated RM23b-RM25b bill per annum. This is based on the assumption that the average crude oil prices are at US$100-US$110 per barrel annually.

Small hike big impact. Based on the above estimate if global prices remain moderate, even a small subsidy rationalization would have a bigger impact on narrowing the fiscal situation. However, if for any reason global oil prices rise, whether on geopolitical uncertainties or natural disasters disrupting supplies, we may very well face a higher subsidy cut. There are some dangerous repercussions if the government does the latter, jeopardizing already moderating domestic demand but also inciting public wrath which could have some very dire political repercussions. Hence, we believe the threshold level whereby the government would be pressured to hike fuel prices is when average crude rises and remain above US$110/barrel. Realistically speaking though, we doubt that the rise in petrol prices will be any more than 10 to 20 sen a liter for this year and only at a point where overall inflation has normalized and real interest rates turns positive again.

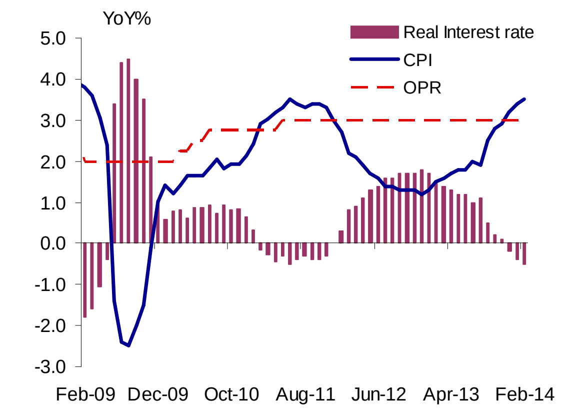
Social and fiscal commitment. If the government stays true to their word (and barring external shocks), it's possible for them to achieve their deficit target of 3.5% of GDP in 2014 or even lower. However, we're giving them a wider berth of 3.7% of GDP on account of the possibility of overshooting their expenditure target on financial assistance to cushion the impact of higher costs of living. Though we figure that the amount of cash handout via 1Malaysia People's Aid or BR1M has already been allocated the cost may overshoot as the government could sanction additional amount as and when it deems necessary to alleviate the burden of the lower income group. The Government estimated that a total of 6.48m people will receive BR1M this year involving an allocation of RM3.4b.

Monetary Policy – no changes this year

Cost-push pressure. As a result of price adjustment from fiscal consolidation, which BNM believes the government will stay true to their word, cost-push inflation is of a concern this year and BNM is projecting that the inflation rate would be on the higher side of historical average, ranging from 3.0% to 4.0%. Though this higher than average inflation rate has put pressure on real interest rates in recent months, dipping it to a negative level, BNM believe it is not pervasive.

No rate hike. Barring any external shocks such as unwarranted weather conditions or geopolitical risks, BNM sees negative real rates will eventually taper off and normalize. The closest hint of when a hike in interest rate would even be considered is when inflationary pressures are demand pull, and this is not expected to be the forefront of inflation until past the implementation of GST, of which we reckon won't be until the later part of 2015. Therefore on that basis, we maintain our stance that BNM will keep the Overnight Policy Rate (OPR) at 3.00% for the rest of the year.

Graph 9: Inflation Vs. Interest Rate



Source: Department of Statistics, Kenanga Research

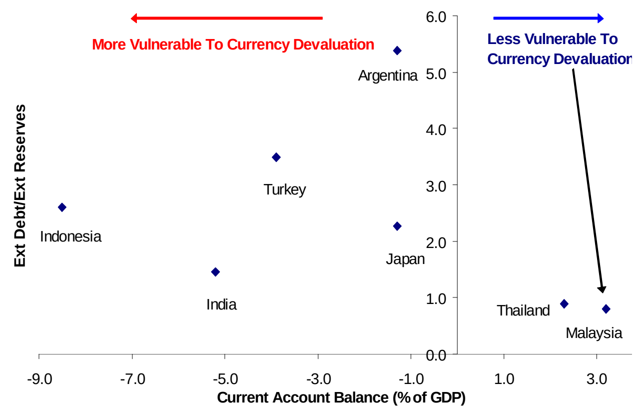
Ringgit outlook – To remain weak but fundamentally less vulnerable

No repeat of 1998. Further weakness still seems probable for many EM currencies, including the ringgit, in the event of sluggish growth in global trade, continued weakness in commodity prices, and, in select cases, political instability. Countries that run large debt and sizeable current account deficit are especially vulnerable. As in the previous bout of ringgit depreciation post Asian Financial Crisis, the tendency for the ringgit to slide beyond 3.50-level to the dollar is relatively low chiefly because it's fundamentally well supported.

Better prospects in 2H14.Taking into account the view of further improvement in the global economy in the 2H14, and the expectation of a more stable global financial market, we reckon that the value of the ringgit vis-à-vis G10 currencies would gradually improve. However, the downward pressure of the ringgit would remain as economic improvement in the US would continue to strengthen the dollar. But not for long, as US buying power improves and consumer demand strengthens it would be passed on towards improvement of Malaysia's exporters' earnings and eventually the economy as a whole.

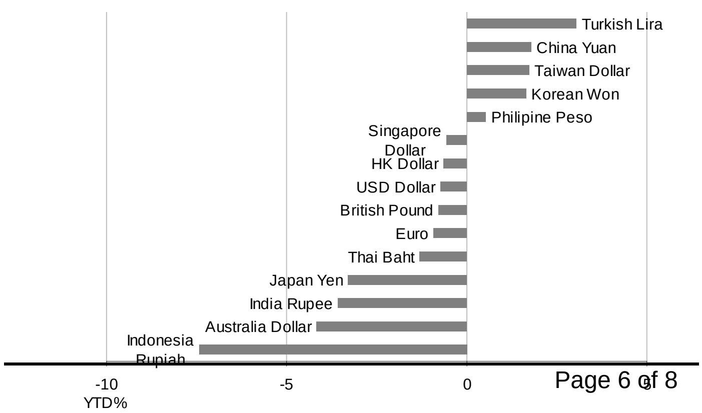
Short term Volatility. Given a lag of 3 to 6 months, the ringgit's underlying value should start to gradually appreciate and partially offset its weakness against the US dollar by 2H14. Backed by a better economic prospect in 2H14, positive current

Fig. 11: Vulnerability of Involuntary Forex Devaluation



Source: Bloomberg, BNM, Kenanga Research

Graph 12: Ringgit Performance Year-to-Date (26 March 2014)



Source: Bloomberg, Kenanga Research

Table 2: Level of Currency Vulnerability of Selected EM Countries (plus Japan - as point of reference)

	Stock Market Performance %Δ YtD*	Vs US$ %Δ YtD*	Current Account Balance (US$b)	%Debt-to-GDP	GDP growth YoY%	External Reserves US$b	Gross External Debt US$b	External Debt/External Reserves US$b[1]
Argentina	13.8	-22.7	-1.3	44.8	5.5	21.7	135.0	**6.22**
Turkey	-0.1	-3.8	-4.9	37.6	4.4	107.1	372.7	**3.48**
Japan	-11.1	+2.5	-15.5	219.1	2.4	1,221.1	2,730.3	**2.24**
Indonesia	10.6	+6.3	-8.5	23.0	5.7	102.7	257.9	**2.51**
India	4.7	+2.6	-5.2	51.7	4.8	169.8	388.5	**1.44**
Thailand	4.8	+0.6	0.2	45.7	2.7	159.3	141.0	**0.89**
Malaysia	-1.5	-0.7	3.2	53.3	5.0	126.3	105.7	**0.84**

[1]A lower ratio indicates less vulnerability to currency devaluation in relative terms.
**Data as at 26th March 2014*
Note: Current account balance is calculated quarterly, except for Japan, Thailand and Turkey, which is monthly (Latest available data)
Source: CIA, World Bank, IMF, Respective Central Banks, Bloomberg, Kenanga Research

account balance, low external debt, along with implementation of policies to tackle fiscal debt and deficit, Economic Transformation Programme (ETP) projects running more or less on schedule, a well structured financial system and favourable outlook from the IMF and rating agencies, we do believe that the currency has every capability to regain its strength. However, on the expectation that the Fed may hasten the QE tapering and end its monetary stimulus sooner than expected, we are revising our year-end target for the USD/MYR to 3.21 (2014 average: 3.25) from our earlier forecast of 3.09 (average: 3.17). This also takes into account the recent move by the PBOC to widen the yuan trading balance which was a deliberate move to weaken the currency and punish speculators. Following this, we expect that the regional currency, including the ringgit, to move in tandem and remain volatile with a downside bias over the short to medium term.

Risk to growth

Geopolitical concerns. Though we are more positive than not on the global economy as a whole, there are on-going issues that could pose a real threat to its recovery. The situation in Crimea and the sanctions of the West towards Russia could end up escalating even further. Though there have now been agreements to allow the EU to import energy from the US, it would still take some time for the switch in supplies. Russia still supplies a significant amount of energy to the EU and supply disruptions could be very detrimental for the already precarious economic recovery in Europe.

Tough reforms. Here in the East, there are some significant worries about the restructuring going on in China, many feeling that it could take even longer before it begins to pick up pace once again. The impact of the changes could also end up deeper than initially estimated and when the 2nd largest economy is at stake, much of the world is at stake too, particularly those with strong relations to China, such as much of the Asian world. A growth of below 7.0% would be a major concern but it looks like it might pull through with a decent growth of growth exceeding 7.0% this year and the next. Meanwhile, Japan's tax hike come 1st April (first hike in 17 years), though needed to address their burgeoning debt, may end up being too much, too soon, jeopardising growth in Japan. Let's not forget the impact of QE tapering (admittedly a good sign about the US economy) towards emerging economies, whose currencies and capital markets have taken a beating.

Domestic struggles. Here in Malaysia, inflationary pressures could end up taking longer than expected to normalize. Though an increase in prices as a result of the petrol subsidy rationalization at the end of 2013 has been seen to taper off, there are still the pressures from the electricity tariff hikes and the implementation of the minimum wage to consider. Though these are not expected to impact households directly, businesses would end up pricing in the rise in costs towards the consumers. Dwindling real incomes might permeate and bleed throughout the whole of 2014, threatening growth of the overall economy.

Beyond 2014

US rate hike – finally? Looking at the trajectory and Fed outlook on the US economy, there's a possibility that the US will finally raise the interest rates from their historical low some time at the tail-end of 2015. This is, of course dependant on not just the unemployment rate, but also labour market conditions (which remains one of the main problems in the US) and the health of the financial market, amongst other indicators. If and when the US economy increases their interest rates, this will set precedence on the global economic stage.

Tough call. Even here in Malaysia, we reckon that the soonest that Bank Negara will increase the OPR is in the later part of 2015, when inflationary pressures turn demand pull, and not cost-push as it currently is. However, this is also depends on how deep the impact will be towards the domestic demand after the implementation of the GST come April 2015. We expect a run up of consumption and investment one to two quarters before the GST and a moderation in growth a few months later as the economy adjusts to the new tax regime. Maintaining our cautiously optimistic view on the long-term economic outlook, Malaysia's GDP growth may remain above 5.0% in 2015.

Kenanga Research Macroeconomic Forecast and Assumption 2013 - 2014

	2007	2008	2009	2010	2011	2012	2013	2014F
Real GDP (%YoY)	**6.5**	**4.8**	**-1.5**	**7.2**	**5.1**	**5.6**	**4.7**	**5.0-5.5**
Consumer Price Index (avg.)	2.0	5.4	0.6	1.7	3.2	1.7	2.1	3.3
Current Account Balance (% of GNP)	**15.7**	**17.6**	**15.8**	**11.5**	**11.3**	**5.3**	**3.8**	**3.5**
Fiscal Balance (% of GDP)	-3.2	-4.8	-7.0	-5.6	-5.4	-4.7	-4.0	-3.7
Unemployment rate (% of working population)	**3.2**	**3.3**	**3.7**	**3.4**	**3.3**	**3.2**	**3.3**	**3.4**
Manufacturing output (%YoY)	2.3	0.6	-9.9	11.1	4.6	5.2	4.2	5.3
Exports of goods (%YoY)	**2.7**	**9.6**	**-16.5**	**15.5**	**8.7**	**0.7**	**2.4**	**3.3**
Overnight Policy Rate (end period)	3.50	3.25	2.00	2.75	3.00	3.00	3.00	3.25
Exchange rate: Ringgit/US$ (avg.)	**3.4378**	**3.3325**	**3.5189**	**3.2182**	**3.0595**	**3.0898**	**3.1678**	**3.2498**
Exchange rate: Ringgit/US$ (end period)	3.3065	3.4640	3.4245	3.0835	3.1770	3.0583	3.1743	3.2124
Crude Oil (WTI)- US$/barrel (avg.)	**72.29**	**99.59**	**61.69**	**79.43**	**95.05**	**88.99**	**97.54**	**102.11**
Crude Oil (WTI)- US$/barrel (end-period)	96.00	44.60	79.36	91.38	98.83	91.82	99.81	104.07

Source: BNM, Ministry of Finance, Dept of Statistics, Bloomberg, CEIC, Kenanga Research

Published and printed by:
KENANGA INVESTMENT BANK BERHAD (15678-H)
8th Floor, Kenanga International, Jalan Sultan Ismail, 50250 Kuala Lumpur, Malaysia
Telephone: (603) 2166 6822 Facsimile: (603) 2166 6823 Website: www.kenanga.com.my

Chan Ken Yew
Head of Research