DBS Flash

Malaysia: Bank Negara turned marginally dovish

Group Research

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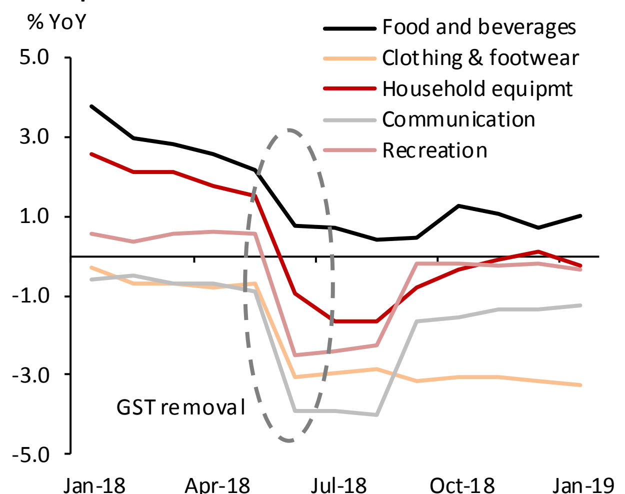
- *We have lowered our full year inflation forecast to 1.7% as inflation has continued to surprise on the downside*
- *However, inflation will bottom in 1Q19 and should rise rapidly in 2H19*
- *Yet, rhetoric from the central bank has turned marginally dovish amid concerns regarding growth outlook*
- *Weaker growth outlook and rising inflation complicates monetary policy stance*
- *We reckon that the central bank could be taking a "wait-and-see" approach in the interim as policy direction will be data driven in the coming months*
- *While we maintain the view of a stable monetary policy, a pre-emptive move, e.g. a 25bps cut, by the central bank should not be discounted if economic data disappoints*

Inflation has eased faster than expected. Latest Jan19 CPI inflation surprised on the downside with a decline of 0.7% YoY in the month. This is down from +0.2% in Dec18 and is also the first negative reading since Dec09. The rapid decline in inflation has significant implications on our full year inflation forecast, as well as Malaysia's monetary policy direction.

The steep fall in inflation was largely driven by two factors – a slew of fiscal policies aimed at lowering the cost of living, including the zero rating of the Goods and Services Tax (GST), and a correction in oil prices in late 2018.

Fiscal policies drove inflation lower



The government announced a slew of people centric policy measures after the election. These include the zero rating of the GST, cash handouts, removal of toll charges for motorcycles, subsidies for petrol, public transport, healthcare and housing, and exemption from the subsequent Sales and Services Tax (SST) for basic necessities. As a result, **inflation for many of the CPI components saw a pronounced downward shift.** Though the subsequent introduction of the SST has lifted some of these indexes, inflation trajectory for these household related components was generally still lower compared to the period prior to the GST removal.

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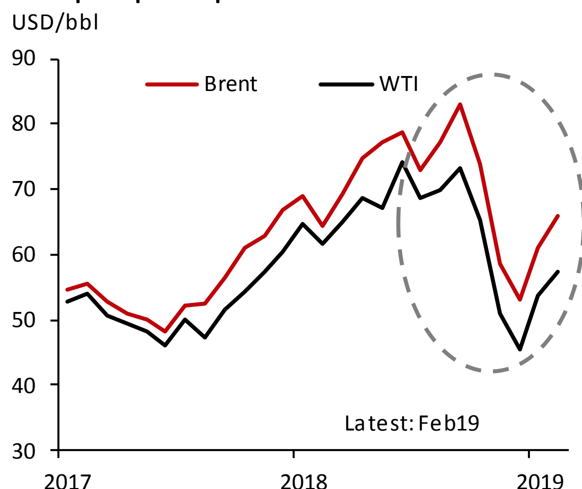
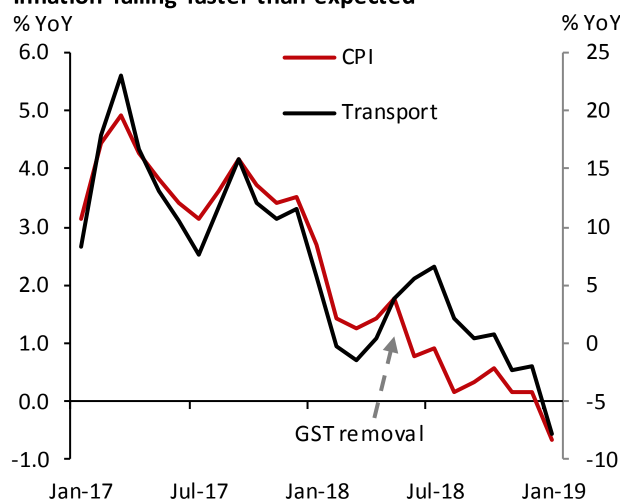
Sharp drop in oil prices



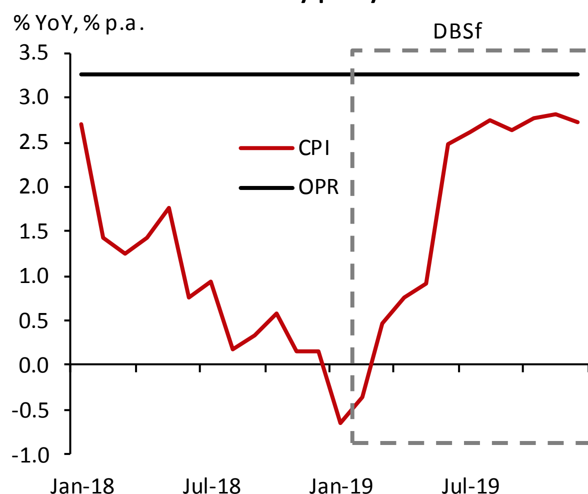
Oil prices is another key driver. The trade disputes between the US and China, juxtaposed with a slowdown in global demand have driven global energy prices down sharply over the past few months. Between Sep-Dec18, oil prices fell on average by about 37%. This was reflected in Malaysia's transport CPI inflation. While transport inflation registered just -0.8% YoY on average during this period, it plunged further by 7.8% in Jan19, partly on account of the high base last year. Note transport inflation was already on a downward trend in 2H18 because of the base distortion in 2H17.

Inflation falling faster than expected



We expect inflation to bottom in 1H19 and to start rising from 2Q19 onwards. The increase will be even more pronouncedly in 2H19. Oil prices are likely to average about USD 70-75/bbl and the base effect from the fiscal policy changes will also dissipate by 2H19. **Taking all into account, we now expect full year inflation to register 1.7% in 2019**. More importantly, inflation is likely to stay range-bound between 2.5-3.0% in the second half. This means that if the Overnight Policy Rate (OPR) remains at 3.25%, real policy rate will still be less than 1% and overall monetary policy is still deemed to be accommodative.

Inflation and the monetary policy

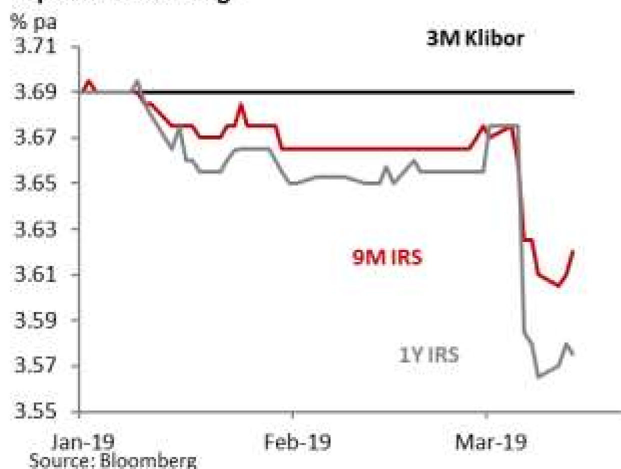


In the most recent policy March meeting, Bank Negara (Malaysia) continues to keep the OPR at 3.25%. **However, rhetoric has turned marginally dovish with more focus on the downside risks on growth** resulting from the unresolved trade tensions, heightened uncertainties in the global and domestic environment, and prolonged weakness in the commodity-related sectors. Additionally, the inclusion of sentence "Recognising that there are downside risks in the economic and financial environment…", on top of the usual concluding line that "the MPC will continue to monitor and assess the balance of risks surrounding the outlook for domestic growth and inflation", does suggest policymakers' rising worry on the growth outlook.

Indeed, **overall GDP growth for 2019 is expected to register 4.5% in our opinion, well short of the government's forecast of 4.9%.** This could perhaps prompt policymakers to consider a slightly more accommodative monetary policy stance.

Market has responded to the slight change in language in the policy statement and the emerging concern on growth outlook. **Onshore swap markets have re-priced from no change to one cut this year (to occur at July or September meetings, small chance of May meeting).** There are currently no hike/cut priced for 2020 and 2021.

Onshore IRS markets are expecting 1 cut at July or September meetings.



Source: Bloomberg

Bank Negara last cut policy rate by 25bps in Jul16. This is after two consecutive quarters of growth that averaged just 4%, and with inflation falling from 3.5% to 1.0% in that same period. The situation is slightly different this time. Growth in the first half of the year could disappoint but inflation will likely pick up sharply in 2H19. Monetary policy could be in the fix if that pans out.

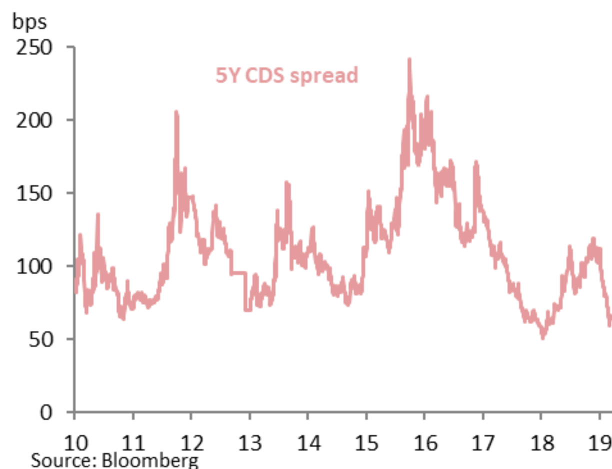
We reckon that the central bank could be taking a "wait-and-see" approach. Notwithstanding the marginally dovish rhetoric, policy direction will be very much data driven in the coming months. **While we are maintaining the view of a stable monetary policy with the OPR at 3.25% for the rest of the year, a pre-emptive move, e.g., a 25bps cut, by the central bank should not be discounted if economic data disappoints.**

MGS/MGII: Possible bottoming of foreign ownership

Year-to-date, led largely by easing fiscal concerns and compressing of credit risk premium, Malaysian Government Securities (MGS) have rallied strongly (c1.7% in price for the 10Y tenor).

We note that 5Y credit default swap spreads on Malaysian bonds have fallen to historically low levels. Therefore, any further rally in MGS would likely have to be driven by lower global yields, pricing of more BNM cuts or the sustained return of foreign inflows.

Credit risk premium within Malaysian bonds are likely at low levels.



Source: Bloomberg

Net foreign buying of MGS and MGII (Islamic bonds) in February 2019 was particularly large at MYR5.7bn. We think this could mark a bottoming of foreign ownership considering that Malaysian bonds are attractive assets to hold in the current carry environment and foreign asset managers are likely still quite underweight (from 2018's outflows).

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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