Economics

DBS Flash

Malaysia: Rate cut ahead

Group Research

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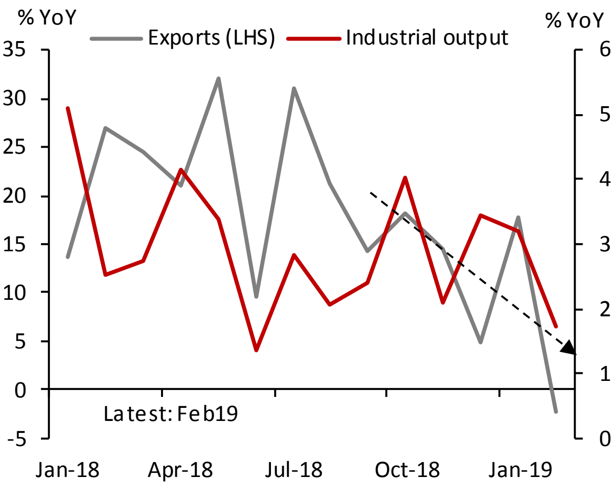
- *External economic conditions have been challenging, and 1Q19 GDP growth is likely to disappoint*
- *Inflation is expected to remain manageable*
- *Downside risks to growth juxtaposed with moderate inflation could warrant a slightly more accommodative policy*
- *We expect Bank Negara to cut the OPR by 25bps to 3.00% this year, and it could happen as early as the next meeting in May*
- *Onshore swap markets are in agreement with our call.*
- *Implication for our forecast – expect Bank Negara to cut the OPR by 25bps to 3.00% as early as May*
- *Implications for investors – Usually the strategy call would be to receive rates, but the prospect of removal from WGBI index could continue to put upward pressure on Malaysia rates.*

Downside risk to growth

GDP growth for the first quarter will be out next month and based on the data flows in some of the regional peers, the headline number is likely to disappoint. Expectation is that **the economy could register a paltry growth of 4.2% YoY in the first quarter**. This will be the slowest since 2Q16 and below the central bank's official full year GDP growth forecast of 4.3-4.8%.

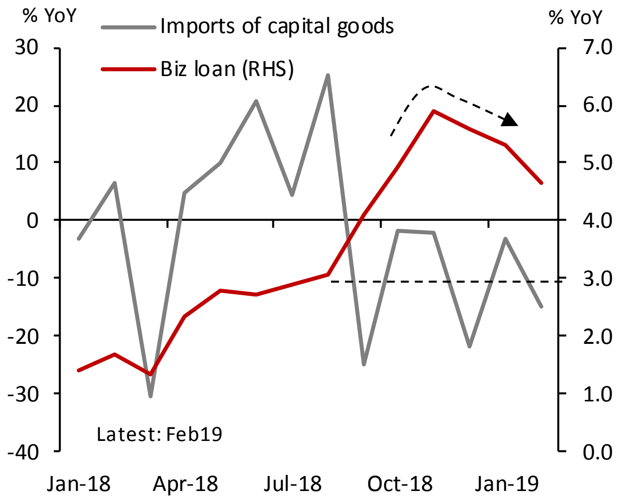
The main drag will likely come from the external front. Like in many emerging Asian economies, export and industrial output growth have dipped in recent months. This can be attributed to the trade tension between the US and China, and a broad-based slowdown in global demand. Malaysia will be no exception, with potential downside being reflected in the headline GDP figures as well. Although there are emerging signs of a bottom-out in the cycle, based on most recent PMIs figures in some regional markets, growth will very likely remain subdued in 1H19 as some external catalysts, such as the policy stimulus in China, will need time to take effect.

Exports and industrial output are down



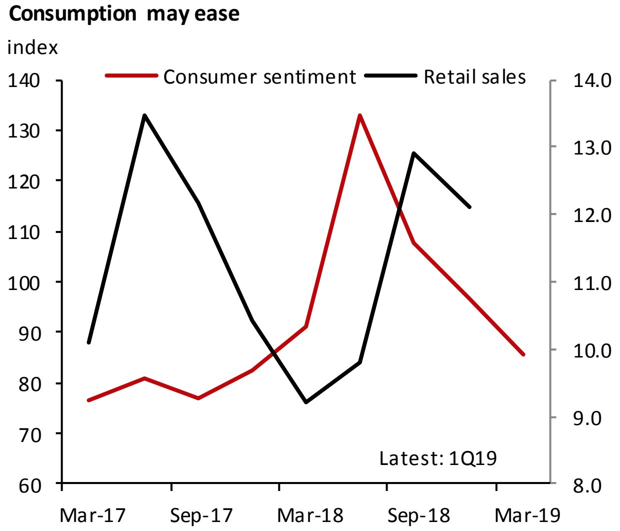
Meanwhile, the economy would have to rely on the domestic engines - consumption and investment – to keep growth intact. Yet, business loan growth has peaked and is seen declining. Imports of capital goods, a proxy for investment demand, has continued to contract since Sep19, averaging -11.5% in the past six months. These points to a subdued outlook for domestic investment growth going forward.

Investment growth to remain weak



Consumption growth could be holding up, but the outlook is less than being sanguine. Although retail sale growth has remained in double digit pace, much thanks to the zero-rating of the GST in mid last year, consumer sentiments appeared to have peaked and trending lower. This could possibly suggest some weakening in private consumption growth in the coming quarters. We expect GDP growth to moderate to 4.5% in 2019, down from 4.7% previously, with risk on the downside.

Consumption may ease



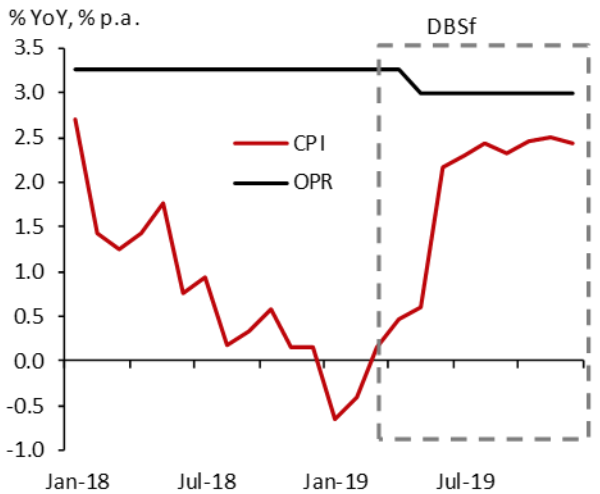
In the most recent policy March meeting, Bank Negara (Malaysia) continues to keep the OPR at 3.25%. **However, rhetoric has turned marginally dovish with more focus on the downside risks on growth** resulting from the unresolved trade tensions, heightened uncertainties in the global and domestic environment, 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 (see DBS article, "Malaysia: Bank Negara turned marginally dovish", dated 14 Mar19).

Inflation risk remains low

Separately, **inflation dynamics also favour a slightly softer monetary policy stance**. Inflation has been benign thus far. While latest inflation figure (Mar19) has picked up to 0.2% YoY, from -0.7% in January, it remains subdued by historical standards.

The low 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. We expect inflation to bottom in 1H19 and to start rising from 2Q19 onwards. Even with the increase, overall full year inflation is expected to register only 1.7%, still way lower than the average inflation of 2.1% over the past decade.

Inflation and the monetary policy



Lastly, the US Fed is expected to keep interest rate steady this year. Regional central banks are also either keeping their monetary policies steady or having an accommodative bias in their policies. This provides a window for Bank Negara to adjust the Overnight Policy Rate (OPR) lower without excessive pressure on the ringgit. In this regard and considering all the above, **we now expect the central bank to cut the OPR by 25bps to 3.00% this year, and it could happen as early as the next meeting in May**.

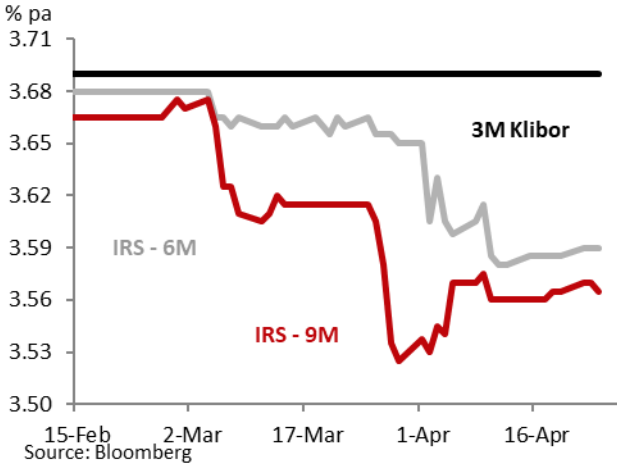
Onshore swap markets in agreement

Onshore swap markets seem to be in agreement with our view. Current pricing is for BNM to cut once at either May or July meetings and then stay on hold through end-2020.

The MYR has been weakening on increased rate cut expectations and fears of potential foreign bond outflows from two technical events. Norway's sovereign wealth fund will be cutting Malaysian bonds, together with other emerging market peers, from its benchmark index (implementation is expected to be after June). As of end-2018, the fund held USD2bn of Malaysian government bonds (no corporate bonds). Separately, FTSE Russell has placed Malaysia on its Watch List for a potential downgrade of market accessibility level, putting Malaysian government bonds at risk of being removed from the FTSE World Government Bond Index (WGBI). If FTSE Russell's September review yields a decision to remove, based on AUM tracking the WGBI, potential outflows could be as high as USD9bn. Ultimately, we think that the impact of these events on the MYR is likely to be transitory and limited and therefore, would not hold back BNM (from cutting).

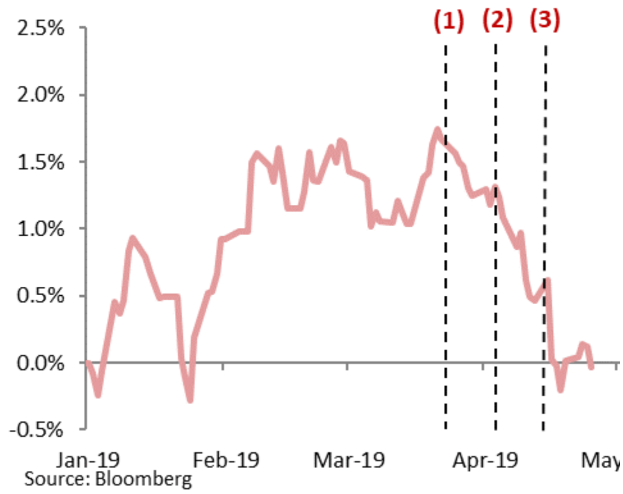
In the immediate term, with a rate cut largely priced in, markets' attention will likely center on FTSE Russell's September review. The associated risks and uncertainties should continue to put upward pressure on government bond yields.

Onshore swap markets are pricing for higher chances of a BNM cut occuring as soon as May meeting.



Source: Bloomberg

Year-to-date spot MYR returns



Source: Bloomberg

(1) Surge in BNM rate cut expectations
(2) Norway sovereign wealth fund cut Malaysia bonds from benchmark index
(3) FTSE Russell place Malaysia government bonds on Watch List

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