12 April 2021

Malaysia 2Q21 Economic Outlook

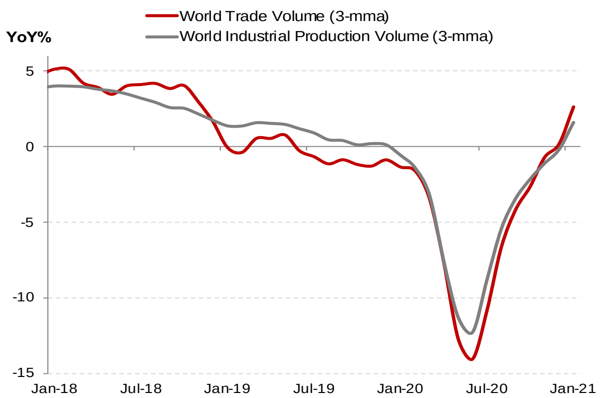
Recovery hopes grow on effective vaccination rollout; downside risks persist

SUMMARY

- 2Q21 marks a possible resumption of a stronger pace of global economic recovery, amid the ongoing COVID-19 vaccination drive, subsiding daily COVID-19 cases, deployment of additional fiscal stimulus by major economies and the release of pent-up demand.
- The rise in UST yields will likely continue in 2Q21 amid better US economic outlook, inflationary concerns and further vaccination progress. However, the pace of increase will likely slow amid a possible return of risk-off sentiment following Europe lockdowns.
- Key points to watch would be a steady rate of recovery in global trade and an almost broad conviction by central banks to keep rates low and the liquidity spigots to remain open for an extended time frame.
- Higher oil price expected amid the global economic recovery theme and as advanced economies improved on wider vaccine rollout. We revise up the oil price forecast to USD60.0/bbl (2020: USD43.0/bbl) from USD50.0/bbl.
- **2Q21 and 2021 GDP forecasts have been upgraded to 14.3% (previously: 10.3%; 1Q21F: -0.4%) and 6.5% (previously: 4.5%; BNM: 6.0-7.5%; 2020: -5.6%)** respectively, reflecting the better-than-expected performance of recent global and domestic economic indicators, injection of additional fiscal stimulus and the imminent release of pent-up demand.
- Given the additional stimulus spending, fiscal deficit is revised to 6.3% (MoF: 6.0%; 2020: 6.2%) from initial estimate of 5.8% on higher fiscal expenditure expectation. Consequently, government debt to GDP ratio to widen to 64.2% (2020: 62.2%) from initial forecast range of 57.0% to 59.0%.
- The expectation that UST yield will continue to steepen in the near term has prompted us to adopt a neutral-to-bearish stance for the ringgit. However, by the end of 2Q21, USDMYR is projected to strengthen at around 4.09 (2021F: 3.95).
- Foreign funds inflow into Malaysia's debt market is expected to continue, amid high yield differentials and FTSE Russell's latest positive review. Flows into the equity market may marginally improve on better recovery prospects, but outlook is still tilted to the downside.
- BNM is expected to stay pat at 1.75% on the Overnight Policy Rate for the rest of 2021 as the domestic economy is heading towards a vaccine-boosted recovery.
- External and domestic downside risks remain, arising from Europe's third wave of COVID-19 infections, renewed US-China tensions, domestic political situation and a potential resurgence of domestic COVID-19 cases.

- **The 2Q21 marks a possible resumption of a stronger pace of global economic recovery, as many countries gradually relaxed their restriction measures after emerging from the battle against a resurgence of COVID-19 cases in the early months of 2021.** Economic activities are poised to be lifted by the ongoing COVID-19 vaccination drive across 141 countries, subsiding daily COVID-19 cases (excluding major European and South American countries and India), deployment of additional fiscal stimulus by major economies and the release of pent-up demand.
  - Since June 2020, **global trade** volume has remained on an uptrend for eight successive months, registering its first expansion (0.9%) relative to pre-COVID level in November 2020. Industrial production activities have also charted a similar trend, with the latest January data coming in at 2.1% above the pre-COVID level.
    - This trend is expected to persist in the 2Q21, riding on the 5G-driven technology upcycle, an improved global growth, rising commodity prices and continued demand for vaccine-related goods.

Graph 1: Global Indicators

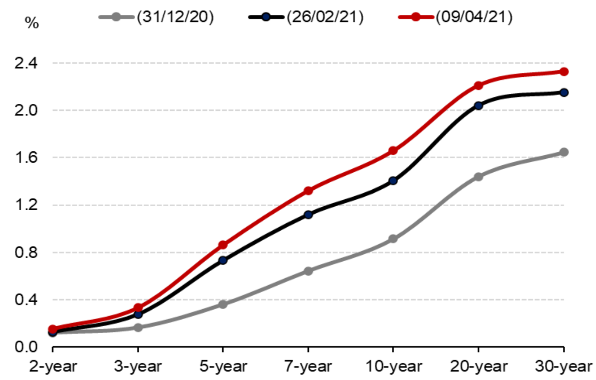


Source: CEIC, CPB Netherlands Bureau for Economic Policy Analysis

– The steepening of the **United States Treasury (UST) yield curve** is expected to continue on an improving U.S economic recovery, inflationary concerns and greater vaccine distribution

- UST yields have been on the ascent throughout 1Q21, especially among medium to long term bonds, with the 10Y UST rising 74.6 basis points (bps) to 1.659% and the 30Y UST increasing 68.4bps to 2.329% between Jan 1 and Apr 9. This bond sell-off comes amid an improving US growth outlook, enhanced by the USD1.9t American Rescue Plan, and rising inflation concerns with the inflation rate increasing to 1.7% in February, its highest level in a year. On the other hand, the 2Y UST yield has remained relatively flat, only rising 3.4bps to 0.155% between Jan 1 and Apr 9, as the market expects interest rates to remain very low going forward. This has caused the yield curve to steepen considerably, with the 10Y-2Y UST spread at 150bps as of Apr 9.

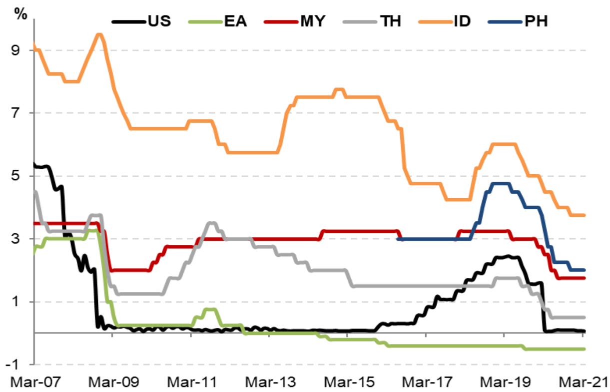
Graph 2: UST Yield Curve Comparison



Source: Bloomberg, Kenanga Research

- In 2Q21, we expect UST yields to continue rising and global bond yields increase in tandem. Yields will be driven by an improving US economic recovery, supported by a possible USD2.0t infrastructure plan. Greater vaccine distribution is also expected, with President Biden recently announcing that 90.0% of adults in the US may receive a vaccine by Apr 19. Furthermore, Chairman Powell's reiteration that the Fed's policy rate would remain near zero for the long term, will keep short tenure yields low and allow the yield curve to steepen further. However, the upward pressure on yields has recently softened following a possible return of risk-off sentiment, prompted by a resurgence in COVID-19 cases in Europe. This may moderately limit the rise in yields, but we still expect it to be overshadowed by the US's buoyant economic data, massive fiscal stimulus and continued vaccination progress.

Graph 3: Policy Rates

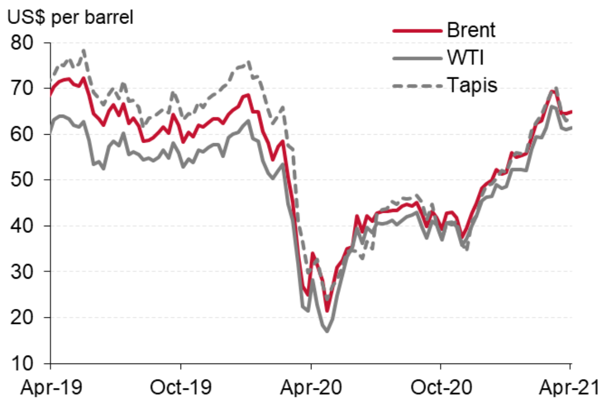


Source: CEIC

– **Crude oil prices** are expected to extend its recovery on the back of expected higher global oil demand, particularly from the advanced economies amid wider vaccine rollout resulting in gradual reopening of the economy

- Brent crude oil average price rose 20.7% YoY to USD61.3/bbl in 1Q21 and accelerated to 35.5% QoQ (4Q20: USD45.3/bbl) attributable to several backdrops. This includes output restraint following the OPEC+ decision in Dec 2020, which raise oil production by only 500k bpd starting Jan 2021 amid a pick-up in economic activities fuelled by wider vaccine rollout globally. In addition, the crude output was also affected by Texas cold weather in February as producers and refiners shut their facilities for several days. A drone attack on a key Saudi Arabian oil facility in March also boosted the price to USD70-level, the highest in more than a year.

Graph 4: Crude Oil Price Trend (USD/barrel)



Source: Bloomberg, CEIC, Kenanga Research

- On Apr 1, OPEC+ agreed to boost their collective oil production by more than 2.0m bpd in the coming months on the back of a positive outlook over the global economic recovery. The group alliance will increase output in May and June by 350k barrels a day and further increase production by another 450k barrels a day in July. Furthermore, Saudi Arabia has agreed to gradually ease its unilateral cuts of 1.0m barrels a day towards the end of July. Despite concern over the output boost and rising threat of new wave COVID-19 infections, the oil price is expected to remain elevated in the near term as recovery in advanced economies driven by various policy measures and aggressive inoculation campaign would likely support the price uptrend. As such, we expect Brent crude oil price to remain above USD60/bbl for the quarter, and we raise our whole year of 2021 estimate to average USD60/bbl (2020: USD43.2/bbl) from USD50/bbl, slightly lower than US Energy Information Administration's (EIA) revised projection of USD60.7/bbl.

Macro Outlook – 2Q21 and 2021

- **Despite fears over a third wave of COVID-19 infections globally, the domestic economy is expected to mark a strong rebound in 2Q21 on continued economic recovery**

  – **2Q21 and 2021 GDP forecasts have been upgraded to 14.3% (previously: 10.3%; 1Q21F: -0.4% from -1.3) and 6.5% (previously: 4.5%; BNM: 6.0-7.5%; 2020: -5.6%)** respectively, to reflect the better-than-expected performance of recent global and domestic economic indicators, injection of additional fiscal stimulus via the RM20.0b PEMERKASA package and the imminent release of pent-up demand.

  – The double-digit growth brought about by a lower base in the preceding year is broadly-based, steered by the private sector expenditure, particularly in the services sector. The kick-off of the 2nd phase of the COVID-19 vaccination drive on Apr 17 and a possible further easing of movement restrictions in the 2Q21 would allow further resumption of purchasing activities, especially those relying on mobility of consumers. With the improved revenue outlook, business sentiment would continue to rise leading to a greater investment activities, hence creating positive spillovers to the labour market. Externally, stronger economic growth of major trading partners, gradual reopening of international borders and the technology upcycle would catalyse a faster growth in Malaysian exports.

  – On the demand side, value-added private expenditure is projected to rebound strongly and register its first positive growth of 15.4% after four straight quarters of contraction, contributing 11.5 percentage points (ppt) to 2Q21 GDP growth. The bulk of the rise was attributable to the projected strong rebound of 16.1% of private consumption or 9.2 ppts of GDP growth, while private investment only contributed a projected 2.3 ppts on 13.3% growth. Meanwhile, public expenditure only contributed 1.6 ppts to GDP growth on 25.0% projected growth. All in, aggregate demand is projected to rebound sharply to 14.2% after four straight quarters of contraction or 13.1 ppts contribution to GDP growth. Net export is projected to continue to contribute positively to GDP growth (0.5 ppt) for the fourth straight quarter.

  – On the supply side, growth is expected to be broad-based and mainly attributable to the services (14.8% or 8.5 ppts) and manufacturing (15.3% or 3.4 ppts) sectors with a combine contribution to 2Q21 GDP growth of 11.3 ppts. Apart from the base

Table 1: Malaysia GDP Growth (constant 2015 prices)

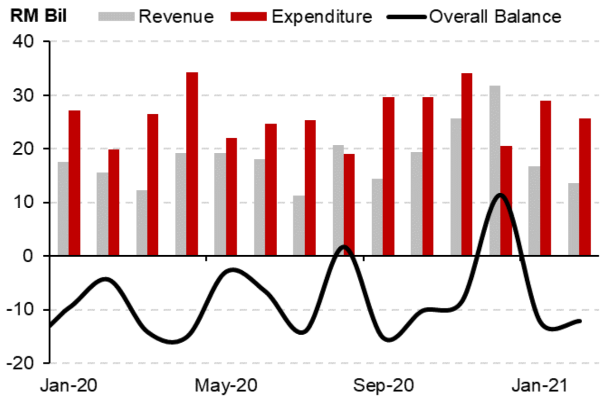
						Kenanga						BNM
YoY %	**2019**	**1Q20**	**2Q20**	**3Q20**	**4Q20**	**1Q21F**	**2Q21F**	**1H21F**	**2H21F**	**2020**	**2021F**	**2021F**
By Sector												
Agriculture	2.0	-8.8	1.0	-0.5	-0.7	3.2	5.6	4.4	3.1	-2.2	3.7	4.2
Mining	-2.0	-2.0	-20.0	-6.8	-10.6	-0.6	10.5	4.4	2.2	-10.0	3.3	3.1
Manufacturing	3.8	1.4	-18.3	3.3	3.0	2.8	15.3	8.5	6.6	-2.6	7.5	8.8
Construction	0.1	-7.9	-44.5	-12.4	-13.9	1.5	28.0	11.2	12.4	-19.4	11.9	13.4
Services	6.1	3.1	-16.2	-4.0	-4.9	-2.3	14.8	5.4	7.2	-5.5	6.4	6.6
Real GDP	**4.3**	**0.7**	**-17.1**	**-2.6**	**-3.4**	**-0.4**	**14.3**	**6.3**	**6.7**	**-5.6**	**6.5**	**6.0 - 7.5**
By Expenditure												
Consumption	6.6	6.5	-15.1	-0.6	-2.2	0.1	13.8	6.2	6.3	-2.9	6.3	7.3
Public	2.0	5.0	2.3	6.9	2.7	1.5	5.3	4.8	3.6	4.1	4.2	4.4
Private	7.6	6.7	-18.5	-2.1	-3.4	-0.9	16.1	6.6	6.9	-4.3	6.7	8.0
Investment	-2.1	-4.6	-28.9	-11.6	-11.9	-2.5	15.4	5.5	9.4	-14.5	7.5	7.8
Public	-10.9	-11.3	-38.7	-18.6	-19.8	11.1	25.0	16.4	13.5	-21.4	14.7	15.2
Private	1.6	-2.3	-26.4	-9.3	-7.0	-6.7	13.3	2.6	7.7	-11.9	5.1	5.4
Public Spending	-2.8	-0.6	-10.6	-1.6	-5.4	7.1	8.8	7.9	6.5	-4.6	7.1	7.4
Private Spending	6.2	4.7	-20.5	-3.6	-4.1	-2.1	15.4	5.7	7.1	-6.0	6.4	7.4
Aggregate Demand	4.3	3.7	-18.7	-3.3	-4.4	-0.5	14.2	6.1	7.0	-5.7	6.5	7.4
Exports	-1.3	-7.1	-21.7	-4.7	-1.8	6.5	16.7	11.2	10.7	-8.8	10.9	13.1
Imports	-2.5	-2.5	-19.7	-7.8	-3.3	7.1	17.3	11.8	11.8	-8.3	11.8	14.1
Net exports	9.7	-37.0	-38.6	21.9	12.4	0.4	10.2	4.7	2.8	-12.3	3.5	4.8
Real GDP	**4.3**	**0.7**	**-17.1**	**-2.6**	**-3.4**	**-0.4**	**14.3**	**6.3**	**6.7**	**-5.6**	**6.5**	**6.0 - 7.5**

Source: Dept. of Statistics, Kenanga Research, F: forecast effect, the sharp turnaround in services growth (+14.8%) is largely due to the projected strong comeback in wholesale, retail, finance, business as well as transport and storage sub-sectors. The continued strong global tech demand as well as commodity-based exports including rubber along with palm oil and crude oil downstream products helped spur the spike up in manufacturing value added growth (+15.3%). Thanks to the large stimulus allocation on infrastructure projects, the construction sector growth is forecast to surge by 28.0% in 2Q21, the highest in more than two decades, and the third highest contributor to GDP growth at 0.9 ppt. The mining and agricultural sector are not far behind with projected 0.8 ppt and 0.5 ppt contribution respectively to overall 2Q21 GDP growth.

– **Fiscal stance** set to remain expansionary in a bid to cement the economic recovery

- As of Feb 2021, the overall balance of federal government fiscal stands at a deficit of RM24.4b, 74.0% higher than in the same period of 2020 (-RM14.0b) as expenditure growth (+16.2%) far outpaced a decline in revenue (-8.4%). In addition, the government on Mar 17 launched PEMERKASA, its sixth economic stimulus package since the start of COVID-19 pandemic, worth RM20.0b with RM11.0b direct fiscal injection. Meanwhile, a new law gazetted on Mar 31, titled Emergency (Essential Powers) (Amendment) Ordinance 2021, allows the Finance Ministry and chief ministers of states to approve additional spending beyond the initial Budget 2021 without seeking the Parliament or state assembly's approval.
- Given the higher expenditure in the first two months of this year, additional economic stimulus and the introduction of new emergency law, we expect the deficit to remain elevated in the near term as the government is likely to step up its spending on the economy. Hence, we revised the fiscal deficit to 6.3% (MoF: 6.0%) from the initial projection of 5.8%, a tad higher than 6.2% in 2020. Consequently, this will expand the government debt to an estimated 64.2% of GDP in 2021 (2020: 62.2%) from the initial forecast of 57.0% to 59.0%. At this juncture, we reckon the government's target of reducing its debt-to-GDP level to 58.5% in 2021 would be rather daunting.

Graph 5: Federal Government Finances



Source: MoF, Kenanga Research

Table 2: Federal Government Fiscal Outlook

RM billion	Global Financial Crisis 2008	2009	2017	2018	2019	2020	MoF 2021F	KIBB 2021F
Revenue	**159.8**	**158.6**	**220.4**	**232.9**	**264.4**	**225.1**	**236.9**	**238.0**
Gross Expenditure	**196.3**	**206.6**	**262.6**	**287.1**	**317.5**	**314.0**	**322.5**	**335.3**
Net Expenditure	**195.4**	**206.1**	**260.7**	**286.3**	**315.9**	**315.2**	**321.7**	**334.4**
Operating Expenditure	153.5	157.1	217.7	231.0	263.3	224.6	236.5	237.8
Gross Development Expenditure	42.8	49.5	44.9	56.1	54.2	51.4	69.0	70.6
Loan Recoveries	-1.0	-0.5	-1.9	-0.8	-1.6	1.3	-0.8	-0.9
COVID-19 Fund						38.0	17.0	27.0
Overall Balance	**-35.6**	**-47.4**	**-40.3**	**-53.4**	**-51.5**	**-87.6**	**-84.8**	**-96.4**
% of GDP	-4.6	-6.7	-2.9	-3.7	-3.4	-6.2	-6.0	-6.3
Federal Government Debt (% of GDP)	39.8	50.8	50.1	51.2	52.5	62.2	58.5	64.2
Real GDP Growth (%)	**4.8**	**-1.5**	**5.7**	**4.7**	**4.3**	**-5.6**	**6.5 - 7.5**	**6.5**
Average Brent Price (USD/barrel)	97.7	64.1	55.7	71.6	64.6	43.2	42.0	60.0

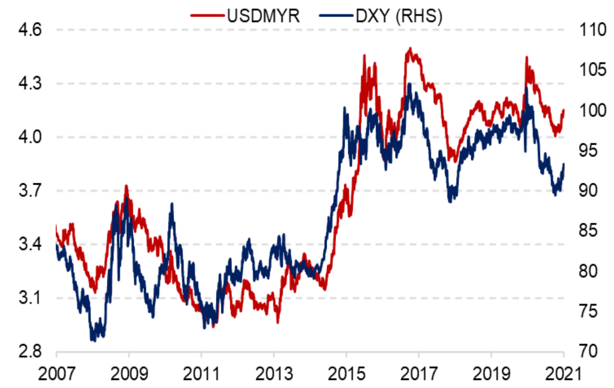
Source: MoF, Kenanga Research

– **Ringgit:** The USDMYR is expected to remain volatile and trade in between 4.10-4.20 in the immediate term. Heading into the end of 2Q21, the ringgit is seen to settle at around 4.09 amid better economic prospects.

- Despite markedly higher Brent crude oil price (end-Mar: USD63.5/barrel; end-Dec: USD51.8/barrel), Malaysia's removal from the FTSE Russell Watch List, decreasing COVID-19 positivity rate and the country's COVID-19 vaccination efforts, the ringgit fell by 3.1% against a strengthening USD on a quarterly basis. The weakness in the ringgit in 1Q21 was attributable to the global bond rout triggered by the sharp rise of the 10Y UST yield above the 1.7% level.

- In 2Q21, the ringgit is expected to remain under pressure as US's high vaccination rate, President Biden's USD2.0t infrastructure spending plan and improving US economic data could drive the 10Y UST yield higher, possibly breaching the 2.0% threshold. In addition, US-China tussle, oil market uncertainty and Europe's third wave of COVID-19 pandemic would add further downside to the ringgit. However, the ringgit may find a better footing if there is a significant change in the Fed's tone at the June FOMC meeting and if the domestic economy starts to open up as more people are being vaccinated. At this point, we still maintain our end-2021 USDMYR forecast at 3.95 (average: 4.00).

Graph 6: USDMYR and DXY trend



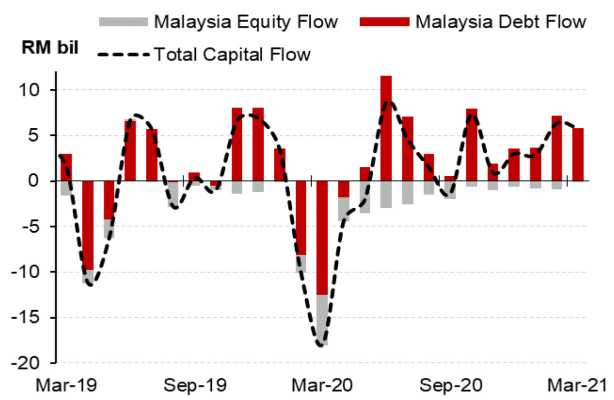
Source: Bloomberg, Kenanga Research

– **Capital Flows**: The capital market led the by the debt market is expected to continue attracting foreign funds in the 2Q21 despite the ongoing global bond sell-off, outweighing possible outflows from the equity market.

- Foreign investors have remained net buyers of Malaysia's debt securities for 11 consecutive months, with inflows elevated at RM5.8b in March (Feb: RM7.2b). This was largely due to Malaysian treasury bonds holding high yield differentials against developed market treasuries, with the 10Y MGS-UST yield spread averaging 163 bps YTD. Inflows into debt securities have kept the overall capital market registering a net foreign inflow for six consecutive months in March (RM5.8b; Feb: RM6.3b), as it outweighed 21 straight months of net foreign selling in Malaysian equities.

- In 2Q21, we expect foreign inflows into the debt market to persist as high yield differentials would keep local bonds attractive, whilst the wider distribution of vaccines locally and abroad may support risk-on sentiment in favour of emerging market bonds. The 10Y MGS-UST yield spread will likely remain near its current level, as the continuous rise in UST yields will probably be tracked by similarly high MGS yields. Furthermore, local debt may witness greater demand in the short-term following FTSE Russell's decision to keep Malaysian bonds in the World Government Bond Index. Nevertheless, downside risks remain following the reinstatement of lockdown measures in some EU countries, which may trigger global risk-off sentiment.

Graph 7: Net Foreign Capital Flows (RM Billion)



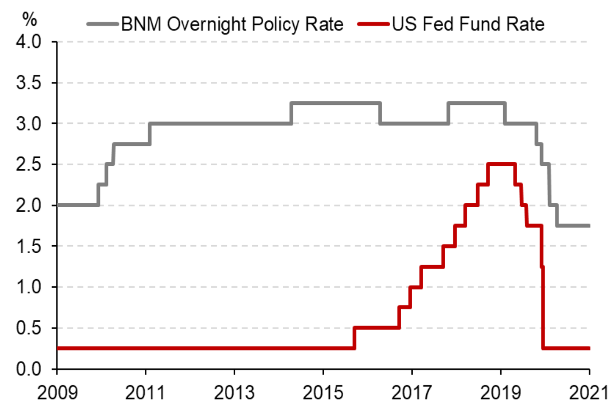
Source: BNM, Kenanga Research

- Foreign flows to the equity market should be boosted by Malaysia's improved growth outlook following the easing of lockdown measures in March, and on positive sentiment surrounding the recent RM20.0b PEMERKASA stimulus package. However, its 2Q21 outlook is still moderately tilted to the downside, as investors may remain cautious due to ongoing domestic political uncertainty and Malaysia's state of emergency running until August 2021.

– **Monetary Policy:** BNM is expected to leave the overnight policy rate unchanged at 1.75% for the rest of 2021 on the back of a better growth outlook and rising inflation.

- Amid a global bond market sell-off and Fed's ultra-low interest rate policy, BNM policy stance is expected to

Graph 8: BNM OPR Vs. US Fed Fund Rate



Source: Bloomberg, Kenanga Research

remain unchanged, and we reckon that the first rate rise will not happen until at least mid-2022.

- Even though we expect a double digit-growth of 14.3% in the 2Q21 GDP, downside risks remain, primarily if COVID-19 cases begin to rise again as the government started to ease some of the COVID-19 restrictions. Should this happen, it would raise the likelihood that the easing cycle would resume as BNM still has ample room to cut interest rates.

– Threading the risk needle with caution as **external and domestic headwinds** remain for Malaysia's economy, arising from Europe's third wave of COVID-19 infections, renewed US-China tensions, domestic political situation and a potential resurgence of domestic COVID-19 cases.

- While the US economy is making a strong progress in its COVID-19 recovery program, the eurozone economy is facing trouble to speed up its recovery progress as several European countries are struggling with the third wave of the COVID-19 pandemic, with France entering a third nationwide lockdown. This will further undermine Europe's vaccination effort which has already been quoted as "unacceptably slow" by the World Health Organization. Europe's slow vaccine rollouts could negatively impact the already-hammered global trade activities and consequently delay the global economic recovery, adding risk to Malaysia's economy which are dependent on trading activity.

- The US-China relations are in the gutter after their first high-level meeting in March as the two largest economies publicly criticized each other's policies. Despite the meeting ended with no breakthrough in the US-China future relations, they had pledged to work together in areas such as the climate change, North Korea, and Afghanistan. As climate change becomes one of the main economic themes in the long term, US-China cooperation on climate is necessary to effectively pursue a sustainable economic path. The current US-China tech and trade war has negatively affected the global economy growth and any potential conflict between the two countries, especially on the climate change issues, could put further downward pressure on the global economy.

- On Jan 12, Prime Minister Tan Sri Muhyiddin Yassin suspended the legislature after the king declared a national state of Emergency, in a move intended to halt the never-ending political tussle while the government are trying to curb the spread of COVID-19. Even though Malaysia will be in a state of temporary political stability until Aug 1, the measure is seen to undermine investor confidence as evidenced by the 20th consecutive months of net foreign selling of Malaysian equities as of February. This move coupled with Malaysia's relatively unstable COVID-19 situation will act as a stopper to any fresh elections at least until the 3Q21.

- Despite a steady decline in the number of new COVID-19 cases and Malaysia's phased vaccines rollout, we did not discount the possibility of a fourth wave of COVID-19 pandemic as the government slowly eases the anti-COVID-19 measures. The emergence of new COVID-19 variants could also pose a threat to the domestic and global vaccination effort, hampering nascent economic recovery. Of note, the Ministry of Health has already detected the South Africa COVID-19 variant in several cases in the country.

Table 3: Forecast and Assumptions

	2013	2014	2015	2016	2017	2018	2019	2020	2021F
Real GDP (%YoY)	4.7	6.0	5.0	4.2	5.9	4.7	4.3	**-5.6**	**6.5**
Consumer Price Index (avg.)	2.1	3.2	2.1	2.1	3.7	1.0	0.7	**-1.2**	**1.8**
Current Account Balance (% of GDP)	3.5	4.4	3.0	2.4	2.8	2.1	3.4	**4.4**	**3.5**
Fiscal Balance (% of GDP)	-3.8	-3.4	-3.2	-3.1	-3.0	-3.4	-3.4	**-6.2**	**-6.3**
Unemployment Rate (%)	3.1	2.9	3.2	3.3	3.4	3.4	3.3	**4.5**	**4.3**
Manufacturing Output (%YoY)	4.2	6.1	4.8	4.3	6.1	4.8	3.6	**-2.7**	**6.5**
Exports of Goods (%YoY)	2.5	6.4	1.6	1.2	18.8	7.3	-0.8	**-1.4**	**6.0**
Overnight Policy Rate (end-period)	3.00	3.25	3.25	3.00	3.00	3.25	3.00	**1.75**	**1.75**
USDMYR (end-period)	3.28	3.50	4.29	4.49	4.05	4.13	4.09	**4.02**	**3.95**
Palm oil (RM/tonne, avg.)	2,371	2,384	2,166	2,649	2,791	2,235	2,244	**2,767**	**3,000**
Crude oil (Brent) (USDD/barrel, avg.)	108.7	99.5	53.6	45.1	54.8	71.6	64.1	**43.2**	**60.0**

Source: MoF, BNM, Bloomberg, Kenanga Research, F = Forecast

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