Malaysia 3Q22 & 2H22 Economic Outlook

Growth to sustain at a moderate pace with persistent downside risks

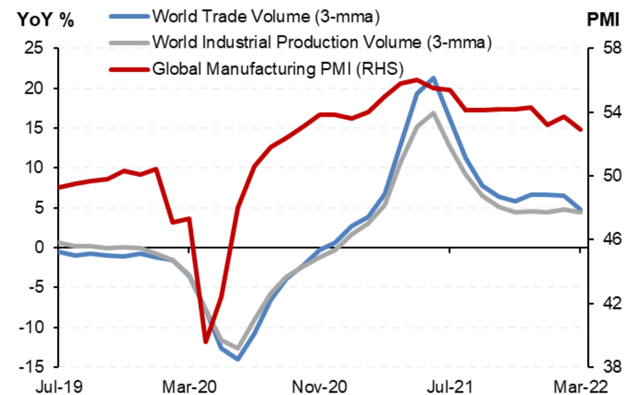
SUMMARY

- The global economy is poised for a bumpy ride in 2H22, driven mainly by soaring inflation, acceleration in global monetary policy tightening, prolonged Russia-Ukraine crisis, and ongoing China's zero-COVID policy which are likely to extend global supply chain disruptions and elevated energy prices.
- Red-hot inflation may continue to dominate the financial markets, forcing major central banks to become more aggressive. The aggressive move may cause a sharp rise in the unemployment rate and amplify the risk of a sharp economic slowdown.
- US Treasury (UST) yields will likely be driven considerably higher in 2H22 as the Fed continues to tighten monetary policy aggressively. As such, we raise our 3Q22 forecast for the 10Y UST to 3.50% and our end-2022 target to 3.70%.
- Given the elevated commodity prices amid ongoing supply disruptions caused by the Russia-Ukraine crisis and supply restraint from the OPEC+ alliance, we have revised 2022 Brent crude oil prices to USD110.0/bbl (2021: USD70.9/bbl) from USD90.0/bbl. Price would also remain relatively high compared to the 2021 level, supported by rising global demand.
- Even though COVID-19 cases may trend higher in the next few months, it is highly unlikely that the world may experience another round of lockdown. However, China may still stick to its zero-COVID policy until end-2022.
- As Malaysia's COVID-19 situation may continue to be under control due to the country's high vaccination rate, the government is expected to intensify efforts to rebuild tourism-related sectors. This may help to boost economic growth in 2H22, but downside risks remain.
- GDP growth is expected to be supported by a robust recovery in the services sector and sustained expansion in the manufacturing sector amid growing demand from the domestic and international markets. In addition, private consumption will continue to drive growth underpinned by financial measures (special EPF withdrawal) and improvement in labour market conditions. Overall, we retained our GDP growth forecast at 5.0% - 5.5% (2021: 3.1%).
- The labour market is expected to improve, with the unemployment rate projected to settle at 3.9% for 2022 (2021: 4.6%), which indicates a full-employment level but remains below the pre-pandemic level (3.3%).
- Fiscal policy is expected to remain expansionary but at a reduced deficit of 5.8% in 2022 (MoF: 6.0%; 2021: 6.4%) with the government to step up its spending in 2H22. With that said, we project the federal government debt to GDP ratio to ease to 62.6% (2021: 63.5%), with statutory debt well below the 65.0% limit.
- Malaysia recorded a solid RM27.8b worth of FDI approvals in 1Q22 and MIDA has recently outlined several initiatives that should bolster Malaysia's foreign and domestic investments going forward.
- Rising food prices due to the global supply chain disruptions and removal of price ceilings, coupled with dissipating high-base effect may push the inflation rate higher in 2H22, bringing the headline CPI to average at 3.3% in 2022.
- BNM may raise the OPR by 25 bps at each of the three remaining Monetary Policy Committee (MPC) meetings this year, as it pre-emptively addresses growing inflationary pressures and aggressive rate hikes by other major central banks.
- With the strong bullish USD momentum in place, driven mainly by a more hawkish Fed, foreign inflows are expected to remain tepid across most emerging markets, including Malaysia. Coupled with elevated level of volatility, the ringgit may continue to face depreciatory pressure. Hence, USDMYR is projected to settle at 4.35 at the end of 2022.
- The Malaysian bond market is expected to record a substantial foreign portfolio outflow in 3Q22 as it is expected to experience broad weakness over 2H22 amid the Fed's aggressive monetary policy tightening, a further global bond sell-off, and potentially slower domestic economic growth.
- MGS yields are expected to be steered higher over 2H22 due to a strong UST yield uptrend and likelihood of further BNM rate hikes. As such, we raise our 3Q22 target for the 10Y MGS to 4.45% and our end-2022 forecast to 4.60%.
- Several external downside risks to Malaysia's outlook remain, from China's sustained zero-COVID policy, the prolonged Russia-Ukraine war, and the increased probability of a US recession following the Fed's larger rate hikes.

- **Heightened risk to global economic recovery amid persistent global supply chain disruptions, rising inflation threat with acceleration in global monetary policy tightening, prolonged Russia-Ukraine crisis, and elevated commodity prices**

  – The post-pandemic recovery is expected to moderate for the remainder of the year, although the risk associated with the COVID-19 pandemic is dissipating, mainly due to heightened geopolitical tension brought by the Russia-Ukraine crisis and the acceleration in global monetary policy tightening to combat rising inflation. Meanwhile, the unabated surge in COVID-19 cases in China with a series of lockdown measures under its zero-COVID policy continue to disrupt the global supply chain. Consequently, the World Bank recently slashed global GDP growth to 2.9% in 2022 (2021: 5.7%) from its January forecast of 4.1%. Similarly, the IMF slashed the global growth forecast for 2022 to 3.6% from 4.4% it projected earlier in January and is expected to cut further in July.

Graph 1: Global Indicators



Source: CEIC, CPB Netherlands Bureau for Economic Policy Analysis

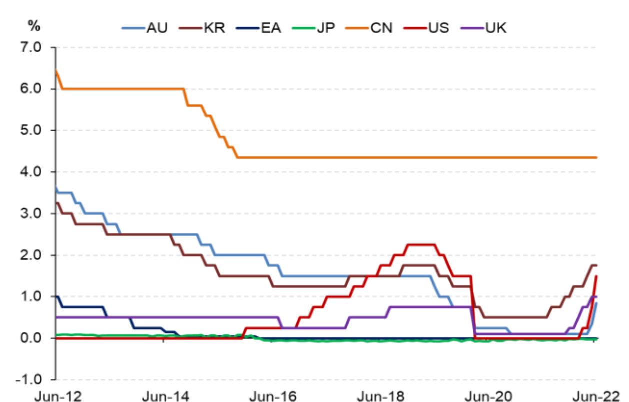
  – Despite the reopening of the economy and the resumption of international tourism, **global trade** activity has been weighed by the global supply chain disruptions brought by China's zero-COVID policy and the Russia-Ukraine crisis.

    ▪ This is reflected in the latest world trade volume growth, which moderated sharply to 2.5% YoY in March (Feb: 6.2%), its lowest growth recorded in 15 months. Similarly, the performance in trade volume was also associated with a weaker world industrial production index (3.7%; Feb: 5.5%). In addition, the latest high-frequency indicator of Global Manufacturing PMI registered at 52.4% in May (Apr: 52.3), indicating a weak expansion in manufacturing activities. Therefore, we expect global trade activity to remain moderate in the coming months amid extended global supply chain disruptions and as the lower base effect dissipates.

  – In an attempt to curb inflation, major central banks may be compelled to tighten **monetary policy** more aggressively, increasing risk to the global economy.

    ▪ A soft landing is increasingly implausible after the Fed raised its benchmark interest rate by 75 basis points (bps) in June. The unexpected pivot was mainly due to a hotter-than-expected inflation rate figure of 8.6% in May (consensus: 8.3%; Apr: 8.3%). Following suit, Bank of England and Bank of Korea have delivered back-to-back interest rate hikes, despite at a much slower pace of 25 bps, mainly to ease upward pressure on prices. To add, the Reserve Bank of Australia and Swiss Central Bank announced a bigger-than-expected rate hike of 50 bps in June to restrain runaway inflation. Meanwhile, the dovish European Central Bank (ECB) has also turned hawkish due to the eurozone's record high inflation of 8.1% (Apr: 7.4%). Bucking the hiking trend, the Bank of Japan (BOJ) maintains its ultra-dovish stance as wage growth remains weak and inflation remains relatively muted.

Graph 2: Selected Central Banks Policy Rates



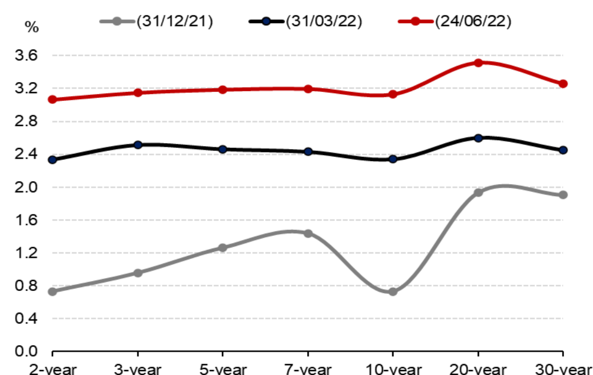
Source: Bloomberg, Kenanga Research

    ▪ In the next few months, most major central banks may continue to tighten more aggressively to keep a lid on inflation. This aggressive move may cause a steep rise in the unemployment rate and amplify the risk of a sharp economic slowdown. The expected slowdown in major economies (i.e. US, EU) may have significant negative ripple effects throughout the global economy, increasing the risk of a recession. Of note, a potential deployment of a new tool by the ECB in the near term to address eurozone fragmentation risk may speed up the central bank tightening cycle. The rising likelihood of faster tightening has also been pressuring Asian central banks to accelerate, and in the case of People's Bank of China and BOJ, to start their tightening cycle. The BOJ may surprise the market by turning hawkish if the yen continues to slide and consumer prices continue to rise.

– **UST yields** will likely be driven considerably higher in 2H22 than initially expected, with an increased probability of a higher terminal Fed's Funds Rate (FFR) and at a hastened pace amid concerns regarding strong inflationary pressures. As such, we raise our 3Q22 forecast for the 10Y UST to 3.50% from 3.15%, and our end-2022 target to 3.70% from 3.20%.

  - Over 2Q22, UST yields trended substantially higher-than-expected as the US Fed raised the policy rate by 50 bps in May and 75 bps in June, as it endeavours to bring down heightened inflationary pressures and regain credibility after initially stating that inflation was transitory. With that said, yields experienced phases of decline as investors dipped into the safety of bonds and intermittently shifted out of equities during a period of heightened volatility. The 10Y UST averaged 2.91% (1Q22 average: 1.95%) so far during this period, reaching 3.47% on June 14 (its highest level since 2011), and currently appears on track to close the quarter above our initial 3.1% forecast.

Graph 3: UST Yield Curve Comparison



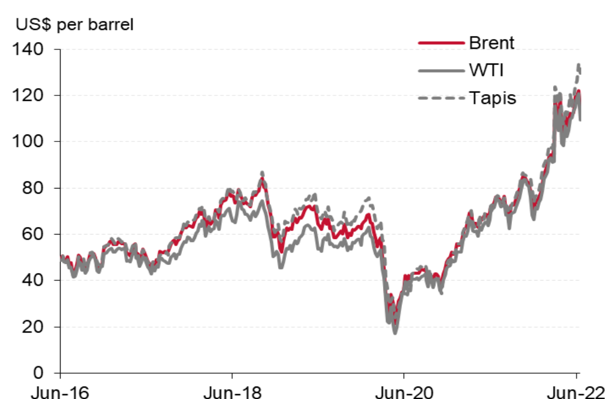
Source: Bloomberg, Kenanga Research

  - In the second half of 2022, we expect UST yields to remain on a strong and steady uptrend as the Fed raises rates faster and higher than initially indicated. This is signposted by the Fed's latest dot plot, with the median year-end FFR projection at 3.4% (previous projection: 1.9%), whilst our in-house forecast is between 3.50% and 3.75%. Despite the recent surge in yields, we believe that forthcoming rate hikes have not yet been fully priced in, especially as market expectations have only recently shifted from a year-end FFR of just 3.25%. In the longer-term we expect yields to peak in 1Q23 once the Fed potentially completes its tightening cycle. However, this is subject to expectations of a US recession, whereby 10Y UST yields could be capped and experience an early downturn if a recession is deemed to be imminent. Nonetheless, UST may still experience periods of support as demand occasionally shifts away from equities amid heightened market volatility.

– **Crude oil prices** are expected to remain elevated in the 2H22 and 2022 amid rising demand and ongoing supply restrain

  - Brent crude oil price has remained elevated in the 1H22 because of the prolonged Russia-Ukraine crisis and ongoing OPEC+ supply restrain. This was further amplified by rising global demand amid the reopening of economic and social activities underpinned by the effectiveness of the COVID-19 vaccine. As of June 24, the Brent crude oil was traded at USD111.6/barrel (bbl) with a year-to-date average price of USD104.6/bbl. This is 47.5% higher than the 2021 average price.

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



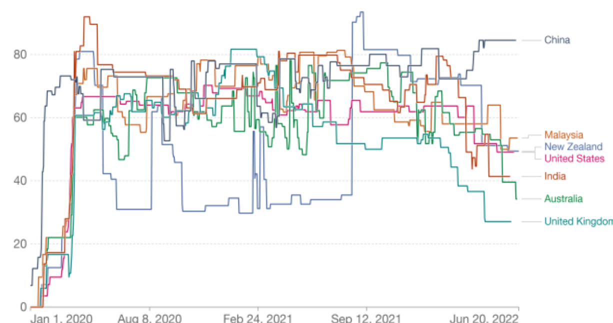
Source: Bloomberg, Kenanga Research

  - With the further resumption of international tourism and a gradual pick-up in economic activities, as more nations lift their COVID-19 pandemic restrictions, energy demand is expected to rise further in tandem with higher mobility. Therefore, we revised the average Brent crude oil price forecast to USD110.0/bbl for 2022 (2021: USD70.9/bbl), from the previous estimate of USD90.0/bbl, as the crude oil price is expected to remain elevated in 2H22. This is mainly due to growing demand and supply restraint amid the prolonged Russia-Ukraine crisis and sanctions hitting Russia, as the EU decided to ban 90.0% of Russian crude oil by the end of the year. Nevertheless, we expect the price to moderate slightly towards the year-end due to the increase in US crude oil production and the release of 45.0m/bbl of oil from the US Strategic Petroleum Reserve over the coming months.

– **Despite the improving COVID-19 situation in most parts of the world, the great reopening may cause an increase in the number of new infections due to waning immunity and increased mobility. However, the probability of a renewed lockdown measures is relatively low, except for China**

- It has been almost 30 months since the world was caught off guard by the COVID-19 pandemic. Since then, we have seen an unprecedented spike in global COVID-19 cases, mainly due to the emergence of Delta and Omicron variants. To note, there are now more than 500.0m cumulative COVID-19 cases and more than 6.3m deaths globally. The pandemic has taken a significant toll on the economy and people all around the world due to the various lockdown measures and vaccine inequality.
- Looking ahead, the world may continue to face rising COVID-19 uncertainty due to a potential emergence of new COVID-19 variants and Omicron subvariants reinfection. However, most economies are highly unlikely to implement a new round of restrictive measures, mainly due to improving pandemic preparedness and widespread COVID-19 vaccine availability. This is of course excluding China, as the country of more than 1.4b population may likely stick to its dynamic zero-COVID strategy. Despite some optimism surrounding China's gradual reopening, we reckon that the process would be painfully slow due to fears of a resurgence in COVID-19 cases.

Graph 5: COVID-19 Containment and Health Index



Source: Oxford COVID-19 Government Response Tracker, Blavatnik School of Government, University of Oxford, Our World in Data. Updated: 2022-6-22.

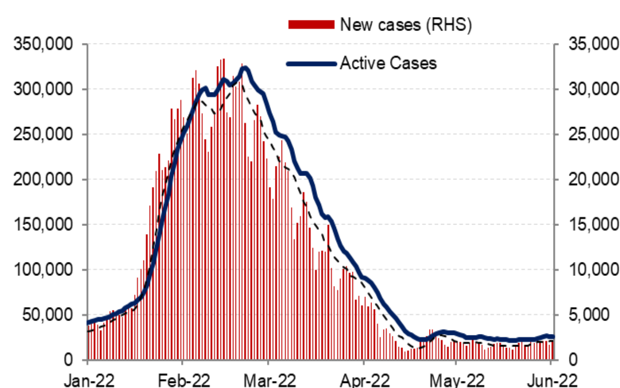
Macro Outlook – 3Q22 and 2H22

- **Malaysia's transition to endemic phase, coupled with the loosening of the standard operating procedures, to drive tourism and growth**

  – As of June 25, the Ministry of Health reported that there are now more that 4.5m cumulative COVID-19 cases and 35,745 deaths (0.8% mortality rate). On the vaccination front, 83.5% of the population have received their second dose and almost 60.0% of them have been boosted. Due to the country's high vaccination rate, there is a significant drop in the number of active cases (latest: 28,010) from its peak in March (323,503), with more than 96.0% undergoing home quarantine.

  – As there is no apparent spike in cases since Malaysia reopened its borders to international tourists on April 1, the government is expected to further boost efforts to rebuild the tourism-related sectors moving forward. According to the Malaysian Association of Tour and Travel Agents (MATTA), there are roughly 1.0m international tourist arrivals since April 1, with the majority (60.0%) coming from Singapore. By the end of 2022, MATTA projected that the number of foreign tourist arrivals to Malaysia may reach 5.0m. Despite much lower than the pre-pandemic level of 26.0m arrivals, the improvement in the tourism industry is expected to reduce the rate of unemployment and support the overall economic growth. It is to note that Malaysia only recorded a total of 134,728 tourist arrivals in 2021 (2020: 4.33m). However, downside risks remain, stemming from a potential spread of new COVID-19 variants and rising risk of the monkeypox virus.

Graph 6: Malaysia COVID-19 Pandemic Trend



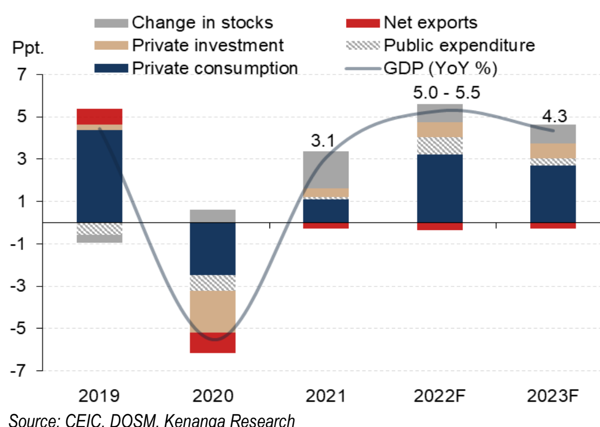
Source: MoH, Kenanga Research

- **Economic growth to sustain a recovery driven by strong private spending and expansion in the services sector amid tighter labour market conditions. Nevertheless, the momentum is expected to slow towards the end of the year amid rising inflation, the withdrawal of policy support, and the prospect of further tightening in monetary policy**

  – **GDP:** The Malaysian economy is expected to sustain its growth recovery (3Q22F: 5.0%; 2Q22F: 7.7%) on the back of a full reopening of economic and social activities and almost entirely relaxing pandemic restrictions.

- In 2H22, the economy is expected to benefit from the spillover effect of the special EPF withdrawal, given the sizeable amount of applications that reached RM40.1b (as of April 14). The financial measures will likely boost private consumption, which we forecasted to expand by 5.5% in 2022 (2021: 1.9%). Furthermore, growth will be supported by a robust recovery in the services sector (6.2%; 2021: 1.9%), especially with the resumption of tourism activity and the reopening of international borders. Likewise, the manufacturing sector is expected to expand (5.7%; 2021: 9.5%) albeit at a moderate pace, supported by sustained domestic and external demand. Against this backdrop, we retained the 2022 GDP growth forecast at 5.0%-5.5% (2021: 3.1%).

Graph 7: GDP Growth Trend



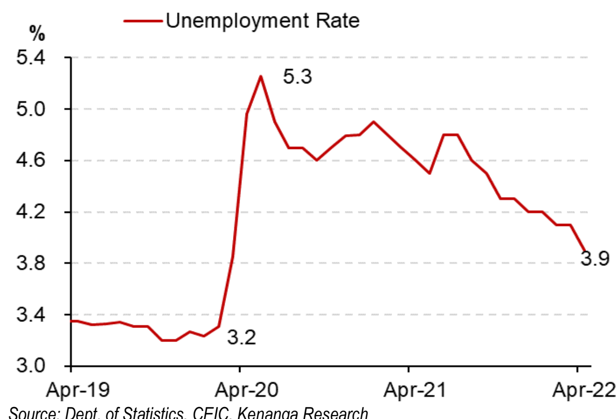
Source: CEIC, DOSM, Kenanga Research

- Nonetheless, we remain cautious due to several downside risks to growth. This includes the prolonged Russia-Ukraine crisis and the unabated surge in COVID-19 cases in China, which may trigger another lockdown under its zero-COVID policy and intensify global supply chain disruptions. On the domestic front, political risk may drag growth, particularly in the investment component, as the 15th General Election is on the horizon. The emergence of new COVID-19 variants and sub-variants may weigh on GDP growth should there be any retightening in pandemic restrictions to contain the outbreak. However, the probability of a renewed lockdown is unlikely given the higher vaccinated population.

– **Labour market:** The labour market has continued to improve in the recent month, supported by ongoing policy support such as the JaminKerjaya that will guarantee 600,000 jobs and the reopening of the economy as the nation transition to the endemic phase.

- The latest unemployment rate dipped to 3.9% in April (Mar: 4.1%), the lowest level since the pandemic hit in 2020, indicating a continued improvement in the labour market and a relatively robust economy. On a MoM basis, the unemployed persons fell for the ninth straight month in April (-3.0%; Mar: -0.4%) and the sharpest drop since October 2021. This is also reflected in the number of unemployed persons, which fell to 649.3k (Mar: 669.2k), the lowest level since March 2020, and almost reaching pre-pandemic level, while new job creation surged to a six-month high of 84.1k (Mar: 38.5k). As the economy and social activities are expected to return to normalcy, the labour market will continue to tighten, with the unemployment rate projected to settle at 3.9% in 2022 (2021: 4.6%), well supporting the private consumption.

Graph 8: Unemployment Rate

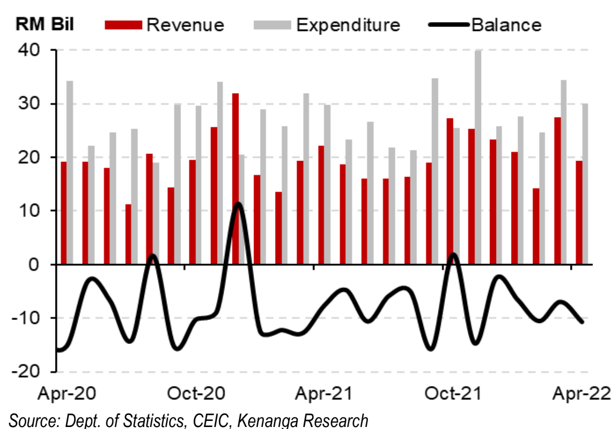


Source: Dept. of Statistics, CEIC, Kenanga Research

– **Fiscal Balance:** Fiscal expansionary will remain to support post-pandemic recovery and to protect the consumer from an inflation shock

- As of April 2022, total government revenue grew sharply by 14.5% YoY to RM82.0b. Meanwhile, expenditure increased slightly by 0.2% YoY to RM116.5b. Consequently, the overall balance of the federal government fiscal stands at a deficit of RM34.4b, a 22.8% lower than in the same period of 2021 (-RM44.6b). This signalled that the

Graph 9: Federal Government Finance



Source: Dept. of Statistics, CEIC, Kenanga Research

government's fiscal balance sheet remains manageable despite rising subsidy bills as the elevated commodity prices contributed to higher revenue to the government.

- Given the elevated commodity prices and the need to support post-pandemic recovery while keeping a moderate inflation rate, we expect fiscal expansionary to remain in the 2H22. The government will likely step up its fiscal spending for the remainder of the year on the back of ample debt headroom and higher revenue collection. While the government is looking at the possibility of removing blanket fuel subsidies, we reckon the decision would not be taken aggressively as it may impede consumer sentiment, accelerate domestic inflation, and subsequently weigh on growth recovery. Nevertheless, targeted measures for the B40 group are likely to be introduced to cushion the impact of blanket subsidy removal.

Table 1: Federal Government Fiscal Outlook

	Global Financial									MoF	KIBB
RM billion	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2019**	**2020**	**2021**	**2022F**	**2022F**
Revenue	**159.8**	**158.6**	**159.7**	**185.4**	**207.9**	**213.4**	**264.4**	**225.1**	**157.9**	**234.0**	**249.0**
Gross Expenditure	**196.3**	**206.6**	**204.4**	**229.0**	**252.5**	**253.5**	**317.5**	**314.0**	**242.1**	**332.1**	**346.0**
Net Expenditure	**195.4**	**206.1**	**202.9**	**227.9**	**249.9**	**252.0**	**315.9**	**315.2**	**241.5**	**331.5**	**350.0**
Operating Expenditure	153.5	157.1	151.6	182.6	205.5	211.3	263.3	224.6	168.0	233.5	248.0
Gross Development Expenditur	42.8	49.5	52.8	46.4	46.9	42.2	54.2	51.4	50.6	75.6	76.0
Loan Recoveries	-1.0	-0.5	-1.5	-1.1	-2.6	-1.5	-1.6	1.3	-0.6	-0.6	-2.0
COVID-19 Fund								38.0	23.5	23.0	28.0
Overall Balance	**-35.6**	**-47.4**	**-43.3**	**-42.5**	**-42.0**	**-38.6**	**-51.5**	**-87.6**	**-83.6**	**-97.5**	**-101.0**
% of GDP	-4.6	-6.7	-5.3	-4.7	-4.3	-3.8	-3.4	-6.2	-6.4	-6.0	-5.8
Federal Government Debt (% of GDP)	39.8	50.8	49.6	50.0	51.6	53.0	52.4	62.1	63.5	N/A	62.6
Real GDP Growth (%)	**4.8**	**-1.5**	**7.4**	**5.3**	**5.5**	**4.7**	**4.3**	**-5.6**	**3.1**	**5.3 - 6.3**	**5.0 - 5.5**
Average Brent Price (USD/barrel)	97.7	64.1	80.7	112.3	111.5	108.4	64.6	43.2	70.9	N/A	110.0

Source: CEIC, MOF, Kenanga Research

- **Debt:** We forecast federal government debt to reach 62.6% of GDP in 2022 (2021: 63.5%), despite a slightly higher fiscal deficit projection of RM101.0b (previous forecast: RM98.8b), mainly due to a larger expected nominal GDP figure amid stronger inflationary pressures. To note, as of May 2022, the government has issued RM48.5b worth of new statutory debt, and considering the debt ceiling of 65.0%, there remains an ample RM152.7b worth of fiscal space before reaching the statutory limit.

- **FDI:** In 1Q22, Malaysia approved RM42.8b of investments in the manufacturing, services, and primary sectors. FDI applicants accounted for RM27.8b or 65.0% share of total approvals but this was down from a newly revised RM70.3b or 71.2% share in 1Q21. Of this total, the bulk of the investment or 96.3% of total share, goes towards the manufacturing sector. The Malaysian Investment Development Authority (MIDA) stated that the decline in approved investments compared to last year was primarily due to the approval of a megaproject in 1Q21. In terms of the origin of the approved FDIs, Germany led the pack with RM8.9b (32.0% share), followed by Brunei (RM5.1b or 18.3%), and the US (RM3.9b or 14.0%).

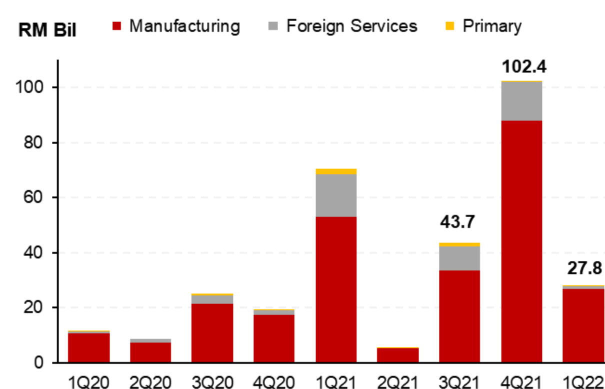
  - In terms of outlook, MIDA recently outlined several initiatives to bolster Malaysia's foreign and domestic investments. For instance, the

Table 2: Federal Government Debt Headroom

		latest	RM bil limit	balance
Offshore borrowing	1Q22	29.2	35.0	5.8
Malaysian Treasury Bills (MTB)	May-22	9.5	10.0	0.5
Statutory (MGS, MGII, MITB)	May-22	970.3	1123.0	152.7
Statutory (% of GDP)	May-22	56.2%	65.0%	8.8%
Total:		**1,009.0**	**1,168.0**	**159.0**

Source: BNM, CEIC, Kenanga Research

Graph 10: Foreign Investment Approved



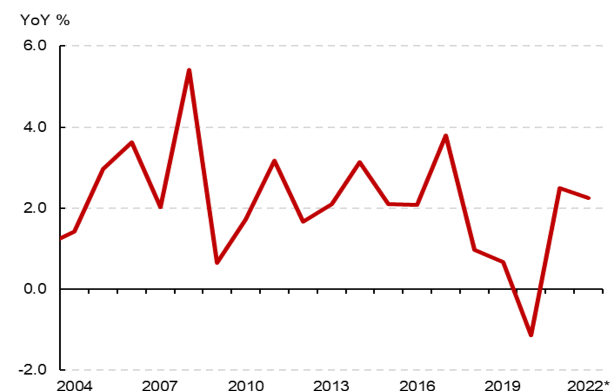
Source: MIDA, CEIC, Kenanga Research

government's trade and investment mission (TIM) to the US in May 2022 successfully secured RM16.5b in committed investments for the year. Furthermore, there are currently 268 projects with proposed investments of RM14.4b within MIDA's pipeline, and the organisation has also identified 446 further investment prospects with a total investment value of RM150.4b.

– **Inflation may start to heat up in 2H22** due to the removal of staple food price ceilings, dissipating high-base effect, China's strict COVID-19 policy and the continuation of the Russia-Ukraine war. As food prices expected to rise further, we have revised up the headline Consumer Price Index (CPI) forecast to 3.3% from 2.9%.

- In spite of concerns over rising inflation globally due to soaring food and energy prices, Malaysia still recorded a tolerable inflation level of 2.4% YTD. This was mainly due to the various government price control scheme and subsidy measures. However, it is to note that domestic food inflation surged to a 127-month high in May (5.2%; Apr: 4.1%) amid growing input costs and increased consumer demand.
- In 2H22, the inflation rate is expected to heat up and average around the 4.1% level, bringing the 2022 CPI to settle at 3.3%. The rise in inflation is expected to be mainly driven by higher food prices due to the removal of selected food price ceilings and the ongoing global supply chain disruptions amid China's uncertain COVID-19 situation and the continuation of the Russia-Ukraine war. On top of that, inflation may also peak due to dissipating high-base effect. However, in the short term, the abolishment of the approved permit for some food items and the partial ban on chicken export may help to alleviate some of the inflationary pressure. In an unlikely scenario, if the government replaced the current fuel subsidies with a targeted fuel subsidy mechanism plus provide cash transfers to the bottom 60.0% income group, we expect the inflation rate may spike up to above the average 6.0% level this year, as the price of RON95 petrol could jump to more than RM4.00/litre. Which is why we believe that a tiered or volume fuel pricing may be a better alternative and would have a less adverse impact on inflation and the overall economy.

Graph 11: Malaysia Inflation Rate

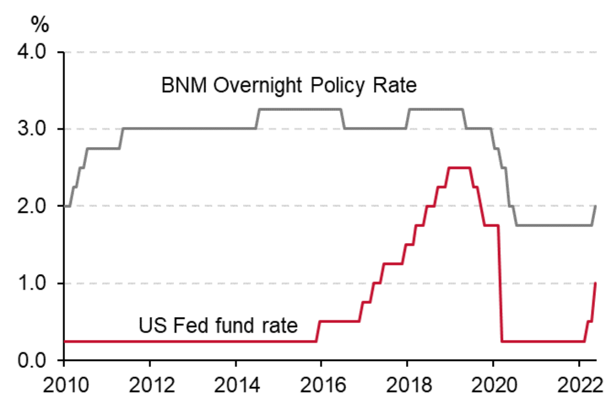


Source: CEIC, Kenanga Research
**As of April*

– **Monetary Policy:** Bank Negara Malaysia (BNM) may raise the OPR by 25 bps at each of the three remaining MPC meetings in 2022, bringing the rate to 2.75% by the end of this year

- The earlier-than-expected rate hike in May signals BNM's hawkish pivot mainly due to indications that domestic demand has improved after the easing of COVID-19 restrictions. Furthermore, BNM's stance may also be pre-emptively addressing inflationary pressures, as Malaysia's CPI is expected to accelerate in 2H22, amid the removal of various price ceilings and subsidies, as well as the ongoing global supply chain disruptions.
- Furthermore, BNM may be motivated to raise the OPR in order to provide some modest support to the struggling ringgit and partially minimise the impact of capital outflows. This comes amid expectations that the US Fed will continue with larger-than-usual rate hikes and that narrowing MGS-UST yield differentials would exacerbate foreign fund outflows from the Malaysia bond market. Likewise, further OPR hikes would help keep BNM in line with other major central banks and its regional peers. Nonetheless, aggressive sequential rate hikes, resulting in reaching the terminal rate faster than anticipated, could weigh on economic growth. This, however, is unlikely to materialise until 2023.

Graph 12: BNM OPR vs. US Fed Fund Rate

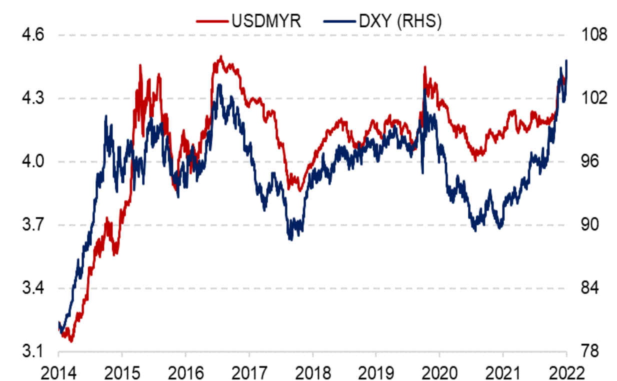


Source: Bloomberg, CEIC, Kenanga Research

– **Ringgit:** The expectation that both the USD index (DXY) and 10-year UST yield may continue to trend higher, due to a potential back-to-back rate hikes by the Fed and growing fears over a global recession, is likely to dampen investors' risk appetite in the next three to six months, pressuring the ringgit to trade around the 4.35-4.45 range.

- The ringgit depreciated sharply above the 4.40 threshold against the USD in June as the DXY breached the 105.0 mark on June 13 for the first time since December 2002. The USD bullish momentum was mainly driven by US hotter-than-expected inflation reading, a more hawkish move by the Fed, growing recession fears, China's economic uncertainty and the ongoing Russia-Ukraine war. However, the ringgit managed to pare some of its losses due to improving macroeconomic indicators and the optimism surrounding the domestic economic outlook.
- As we project that the Fed may increase the FFR to 3.50%-3.75% (dot plot: 3.50%-3.75%) by December, the local note may continue to be under immense pressure, mainly due to the narrowing of 10Y MGS-UST yield spread (potentially around 90 bps). On top of that, the DXY may accelerate to as high as 106.0 as the USD continues to attract safe-haven flows, especially if there is any upside surprise to inflation. Nevertheless, the DXY upside may be limited if the ECB decides to speed up its tightening cycle. The direction of the ringgit may also be heavily influenced by the trajectory of the Brent crude oil price, the development of the war in Ukraine, China's reopening timeline and the prospect of an early general election in Malaysia. Hence, due to the elevated level of volatility, our USDMYR year-end forecast has been revised upwards to 4.35 from 4.28.

Graph 13: USDMYR and DXY trend

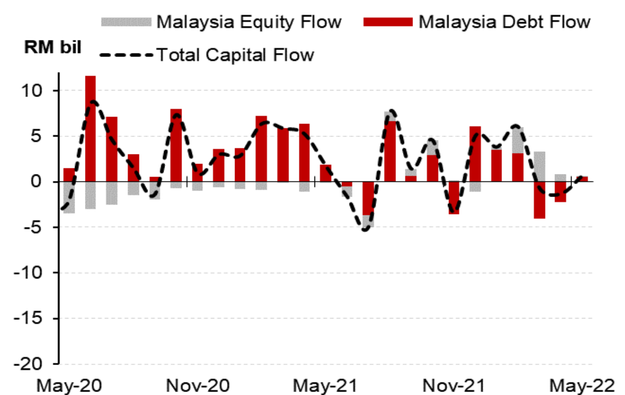


Source: Bloomberg, Kenanga Research

– **Bond Market:** Foreign demand for Malaysian bonds is expected to be heavily pressured in 3Q22 amid the Fed's accelerated monetary policy tightening, an associated global bond sell-off, and expectations of a slower domestic economic recovery in 2H22. These factors, as well as considerably greater UST yields and the increasing likelihood of further BNM rate hikes, will likely steer MGS yields higher over 2H22. As such, we raise our 3Q22 target for the 10Y MGS to 4.45% from 4.30%, and our end-2022 forecast to 4.60% from 4.35% previously.

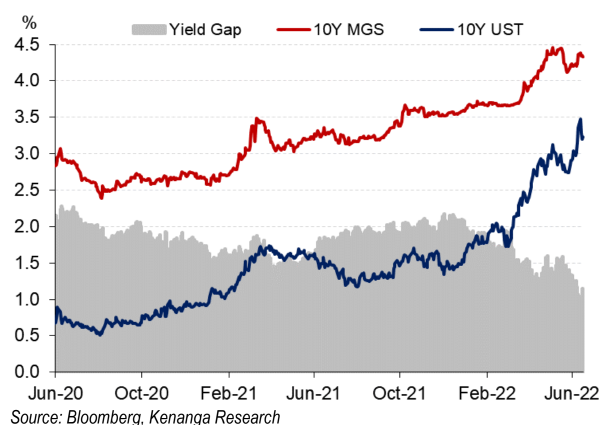
- Following a solid return of foreign fund inflows in 2021 (RM33.6b), the bond market has since been weighed by strong periods of global risk-aversion. For 2Q22, it looks likely to record its first quarterly net outflow in two years, after a smaller net inflow in 1Q22 (RM2.6b; 4Q21: RM5.5b). This comes despite a sustained domestic economic recovery in 1H22, as Malaysia began to transition into the endemic phase. The main factor for this pressure comes from the faster and stronger monetary policy tightening by the US Fed and other major central banks, as global inflation remained elevated. The shift in Fed stance has particularly impacted yield differentials and made Malaysian bonds less attractive to foreigners; the 10Y MGS-UST yield spread registered a significantly lower average of around 135 bps in 2Q22 (1Q22: 175 bps; 4Q21: 201 bps).
- In 3Q22, we expect the bond market to record a significant net outflow of foreign funds. This may be front-loaded in July, as the Fed could potentially raise rates by another 50 – 75 bps and with RM19.0b worth of domestic government bonds scheduled to mature. Foreign flows will also be pressured by a steady decline in MGS-UST yield differentials, especially with the strong likelihood of the FFR overtaking BNM's overnight policy rate (OPR) in 2H22, for the first time since 2008. This pressure may be marginally alleviated by further rate hikes by BNM, but the Malaysian central bank is unlikely to keep pace with the Fed due to the

Graph 14: Net Foreign Capital Flows



Source: BNM, Kenanga Research

Graph 15: 10Y MGS-UST Yields and Yield Gap



Source: Bloomberg, Kenanga Research

differing inflationary environments and downside risks to domestic growth. Likewise, our projections of slower economic growth and the increasing probability of a snap general election in 2H22 may also weigh on foreign demand for bonds.

- MGS yields trended higher-than-expected in 2Q22 on an early BNM lift-off in May and unexpectedly large back-to-back Fed rate hikes. The 10Y MGS yield has averaged 4.23% in 2Q22 so far (1Q22: 3.69%), reached a 14-year high of 4.445% in May, and will likely close the quarter above our initial 4.20% forecast. For 2H22, we expect the 10Y MGS to continue tracking the rise in UST yields and remain at a level higher than the expected OPR would typically entail. For the longer-term, we reckon the 10Y MGS yield may peak in 1Q23, after both BNM and the Fed have finished tightening, then steadily trend lower over 2023 towards more normal levels.

– Malaysia's **recovery momentum remains subject to several external downside risks**, from China's sustained zero-COVID policy that threatens regional growth, the ongoing Russia-Ukraine war that could prolong and worsen inflationary pressures, as well as the increased probability of a US recession following the Fed's larger rate hikes

  - China's zero-COVID policy has seen large segments of the country return to lockdown, weighing on its own economic recovery and prolonging pandemic-era supply chain disruptions. Despite COVID-19 infections falling under 1,000 daily cases since May, China continues to impose targeted restriction measures wherever an outbreak occurs. Chinese officials have repeatedly proclaimed the zero-COVID approach a success, highlighted the country's relatively low COVID-19 deaths, and stressed that vaccination rates of the elderly remain comparatively low. As such, we believe that China will continue to implement targeted lockdowns over 2H22, which may impact Malaysia's external trade given its sizeable contribution, prolong supply chain issues that exacerbate global inflationary pressures, and could weigh on global economic growth.

  - The Russia-Ukraine conflict has entered its fifth month and appears to have shifted into a long war of attrition, with intense combat centring around the Donbas region. The conflict continues to disrupt major shipping routes to the south of Ukraine, which exacerbate global food supply shortages. Together with European sanctions on Russian oil, the war has led to strong global inflationary pressures, which will likely drag on into the next year.

  - The risk of a US recession has increased markedly following the larger-than-expected 75 bps hike by the Fed in June. Although a recession is not conclusive at this point, with the Fed's new economic projections indicating a growth slowdown instead (2022 GDP forecast: 1.7%), any signs of inflation accelerating could leave the Fed with no choice but to embark on similarly large rate hikes in July and September. This could induce a US recession towards the end of 2022 or in 2023, which may avoid entrenched inflation, but would also significantly raise the risk of a global recession.

Table 3: Forecast and Assumptions

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022F
Real GDP (%YoY)	4.7	6.0	5.0	4.2	5.9	4.7	4.4	**-5.6**	**3.1**	**5.0 – 5.5 (5.3)**
Consumer Price Index (avg.)	2.1	3.2	2.1	2.1	3.7	1.0	0.7	**-1.2**	**2.5**	**3.3**
Current Account Balance (% of GDP)	3.5	4.4	3.0	2.4	2.8	2.1	3.4	**4.4**	**3.8**	**3.9**
Fiscal Balance (% of GDP)	-3.8	-3.4	-3.2	-3.1	-3.0	-3.4	-3.4	**-6.2**	**-6.6**	**-5.8**
Unemployment Rate (%)	3.1	2.9	3.2	3.3	3.4	3.4	3.3	**4.5**	**4.6**	**3.9**
Manufacturing Output (%YoY)	4.2	6.1	4.8	4.3	6.0	5.0	3.8	**-2.6**	**9.5**	**7.0**
Exports of Goods (%YoY)	2.5	6.4	1.6	1.2	18.8	7.3	-0.8	**-1.1**	**26.0**	**6.9**
Overnight Policy Rate (end-period)	3.00	3.25	3.25	3.00	3.00	3.25	3.00	**1.75**	**1.75**	**2.75**
USDMYR (end-period)	3.28	3.50	4.29	4.49	4.05	4.13	4.09	**4.02**	**4.17**	**4.35**
Palm oil (RM/tonne, avg.)	2,371	2,384	2,166	2,649	2,791	2,235	2,244	**2,767**	**4,407**	**4,000**
Crude oil (Brent) (USDD/bbl, avg.)	108.7	99.5	53.6	45.1	54.8	71.6	64.1	**43.2**	**70.9**	**110.0**

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

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