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2H2023 MACRO OUTLOOK: SAME RISKS, DIFFERENT OUTCOMES

- On 18 January 2023, Bank Islam published an Economic Outlook report entitled "When Prices Are Entrenched", highlighting key macroeconomic indicators that may shape the macroeconomic outlook of the global, regional and domestic economies in the new year. Many of our earlier projections were on point; some missed the mark, while others, much to our surprise, were oblivious from the get-go. This report is an update to our earlier projections, intending to provide a more accurate account of how we see the 2023 macroeconomic environment as it progresses.

- The world started the new year with gloomy growth prospects, with some major economies on the cusp of a recession amid persistent inflation. In mid-1H2023, the global economy was rocked by bank failures in advanced economies amid aggressive rate hikes, although it did not turn out as contagious as initially feared. The global economy is entering 2H2023 at where it all started; high interest rates, sticky inflation, volatile commodity prices, and a tight labour market. Considering the conundrum policymakers face in bringing the economy back to some degree of normalcy, more policy intervention is needed rather than less.

- The situation is no different in Malaysia, although inflation is well under control compared to its regional neighbours. The new government, formed through an untested coalitional formula, is still searching for a palatable economic narrative since its formation in late November 2022. A revised Budget 2023 was tabled in February, intended to offer a glimpse of the economic priorities of the new government, but did not spark much interest from investors and analysts alike.

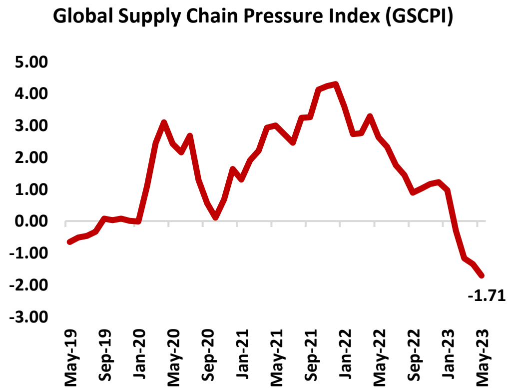
- We believe such a muted response was because the public expects Malaysia to eventually experience similar economic threats facing advanced economies. Instead, it is business as usual as far as the government is concerned, all in the name of political stability, at least not before the state elections. In reality, post-pandemic macroeconomic variables behave differently in different parts of the world; ergo, Malaysia cannot possibly replicate the policy response of advanced economies even if they want to. The later part of this report will highlight Malaysia's macroeconomic challenges, which we believe require new thinking about crafting the country's growth path in the post-pandemic era.

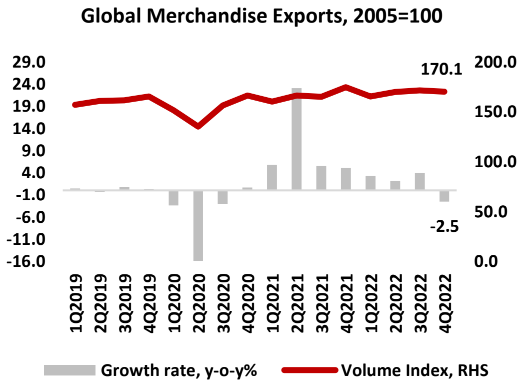
PART ONE: THE GLOBAL ECONOMY: GROWTH UPGRADED

	IMF (Apr'23)		World Bank (June'23)		OECD (June'23)		ADB (Apr'23)	
	2023	2024	2023	2024	2023	2024	2023	2024
World	2.8	3.0	2.1	2.4	2.7	2.9	-	-
Advanced Economies/OECD	1.3	1.4	0.7	1.2	1.4	1.4	-	-
US	1.6	1.1	1.1	0.8	1.6	1.0	-	-
Euro Area	0.8	1.4	0.4	1.3	0.9	1.5	-	-
EMDEs	3.9	4.2	4.0	3.9	-	-	-	-
China	5.2	4.5	5.6	4.6	5.4	5.1	5.0	4.5
India	5.9	6.3	6.3	6.4	6.0	7.0	6.4	6.7
Note: These forecasts reflect different reporting times								

Sources: IMF, World Bank, OECD, ADB, Bank Islam

- The global economy has proven to be resilient to the deleterious macroeconomic environment by major central banks in 1H2023 and will likely remain so in the remaining months of the year. The global gross domestic product (GDP) is expected to grow between 2.1-2.8% in 2023 and even higher between 2.4-3.0% in 2024. All multilateral development banks (MDBs) have upgraded their 2023 global growth forecasts, driven by higher updated projections of advanced and emerging market and developing (EMDEs) economies. The 2023 growth outlook of the U.S., Euro Area and China is seemingly better than expected. Despite the upgrades, the International Monetary Fund (IMF), World Bank and Asian Development Bank (ADB) were less optimistic about the prospects of the Indian economy when the Organisation for Economic Co-operation and Development (OECD) upgraded its forecast for India from 5.7% to 6.0% in 2023.



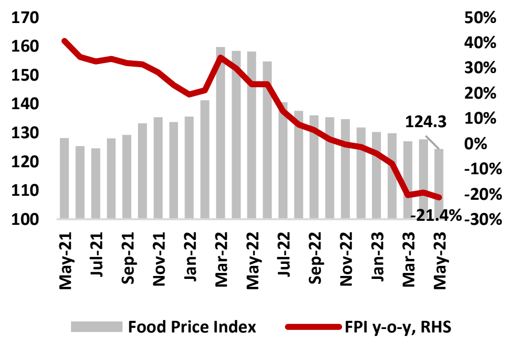


Sources: N.Y. Federal Reserve, UNCTAD, Bank Islam

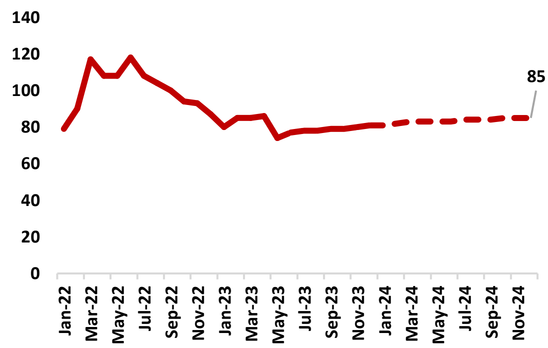
- World trade prospects are no longer as ominous as six months ago. The Global Supply Chain Pressure Index (GSCPI) has been trending in the negative territory since February 2023 and will likely remain so in the coming months before returning to the historical average. China's economic reopening, moderating demand conditions, and supply-side improvements are among the key factors in lower GSCPI. Meanwhile, global trade reached a historic high in 2022 with USD22.34 trillion in total merchandise trade and USD7.17 trillion in total services trade. Notwithstanding a healthy trade growth, we noticed that the global merchandise exports index was relatively flat throughout 2022, dragging its y-o-y growth to the negative territory in 4Q2022 amid easing demand conditions.

- Global food inflation is no longer hot as last year, and the downtrend will continue until 3Q2023. According to the United Nations Food and Agriculture Organisation (FAO), the Food Price Index in May 2023 was lower at 124.3 points, the lowest since August 2021, bringing the y-o-y food inflation to -21.4%. Meanwhile, global energy prices are expected to trend flattish. The latest projections by The United States (U.S.)'s Energy Information Administration expects the Brent Spot to average USD77-81 per barrel in the remaining months of 2023.

FAO Monthly Real Food Price Indices



EIA Forecast: Brent Spot Average (USDpb)



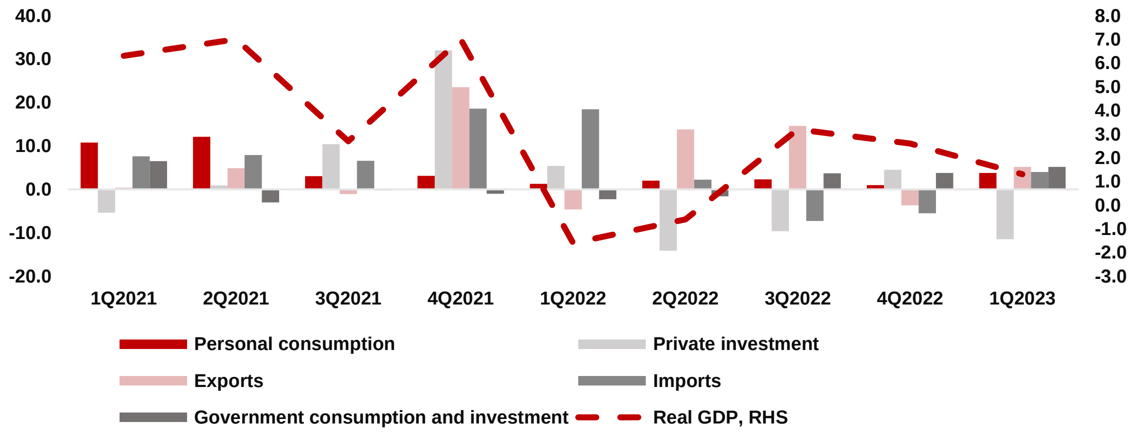
Sources: The Food and Agriculture Organisation of the United Nations (FAO), EIA, Bank Islam

PART TWO: MAJOR ECONOMIES: THE PAINS AND GAINS OF RATE HIKES

The United States: Resilience without consequence?

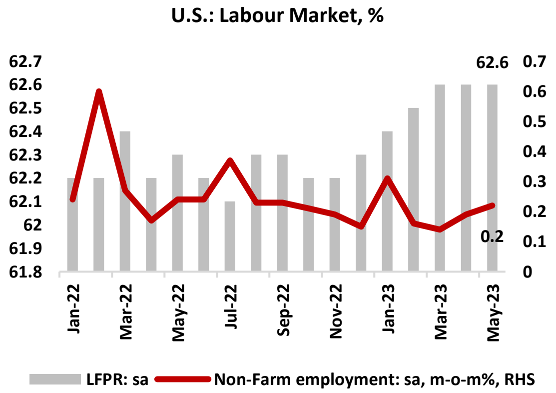
- The Federal Reserve (Fed) has delivered a 500bps hike since March 2022, yet the U.S. labour market remains hot. Furthermore, World Bank upgraded its U.S. GDP growth projections for 2023 from 0.5% to 1.1%, whereas the OECD expects the economy's growth to be higher at 1.6%. For 2024, however, the U.S. GDP growth will moderate to between 0.8% to 1.1% in 2024. These projections exemplify the economy's resilience to aggressive tightening and support our earlier take that the U.S. would likely circumvent a recession in 2023.

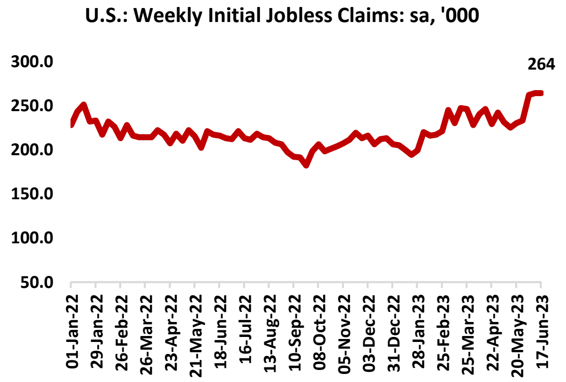
U.S.: Real GDP, q-o-q%



Sources: U.S. Bureau of Economic Analysis, Bank Islam

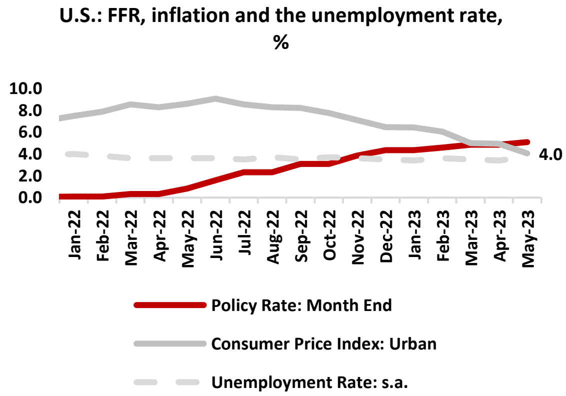
- Interestingly, all expenditure items increased in 1Q2023 on a q-o-q basis but private investment. Real GDP growth, however, appears to be moderating steadily since 3Q2022, the proceeding quarter after the "technical recession". Its Labour Force Participation Rate (LFPR) has continued its uptrend since the pandemic, while non-farm unemployment remains positive on a m-o-m basis. We notice an uptick in the weekly jobless claims, leading to a higher unemployment rate, but it is still within the universal definition of full employment.

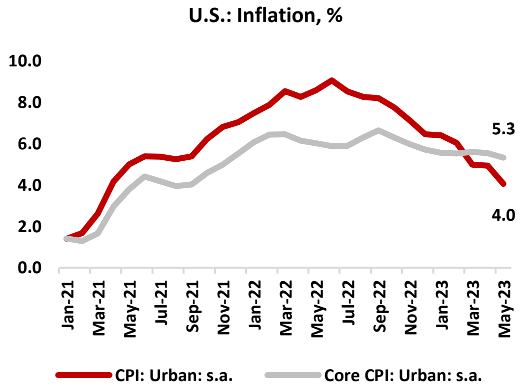




Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Bank Islam

- Additionally, inflation appears to be responding to the sharp increase in the federal funds rate (FFR), which came in lower at 4.05% in May 2023 versus 4.9% a month earlier. In contrast, the Personal Consumption Expenditures (PCE) – the Fed's preferred inflation indicator – came in higher at 4.4% in April 2023 and still far from the 2% target, suggesting that the central bank's inflation fight is still far from over. As of June, the Federal Open Market Committee paused its tightening cycle at a 500bps hike, but Fed Chair Jerome Powell indicated that there would be another two more hikes this year out of the remaining four meetings in 2023.

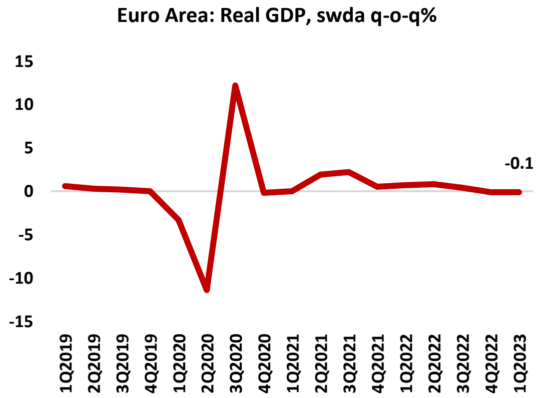


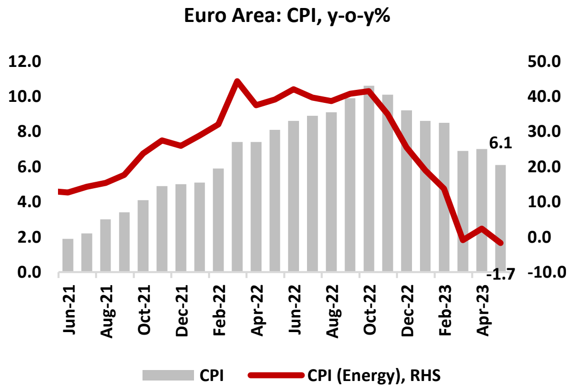


Sources: U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Bank Islam

Euro Area: Short and shallow recession, perhaps?

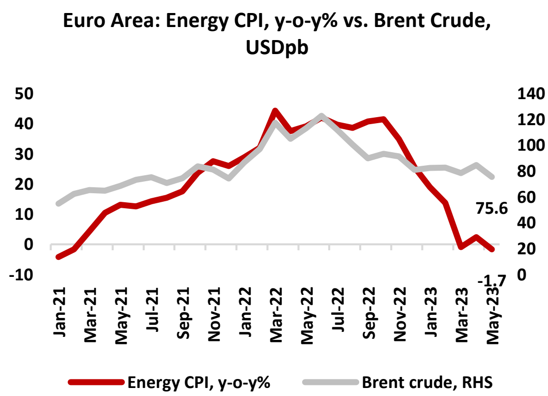
- All MDBs upgraded their earlier GDP growth forecast of the Euro Area but remained the lowest among major economies in 2023. However, the economy entered a technical recession in 1Q2023 following a contraction of 0.1% in 4Q2022, its second recession since the pandemic. Despite a shallow recession, the Euro Area's labour market remains solid, where its unemployment rate continues to trend lower from 6.9% in January 2023 to 6.6% in April 2023. Improvements in the economy's labour market cause inflation to remain sticky at 6.1% in May 2023, thus making the cumulative 375bps hike in policy rate seem inadequate in reining in inflation. Energy Consumer Price Index (CPI) is downward-trending, but global oil prices remain elevated.

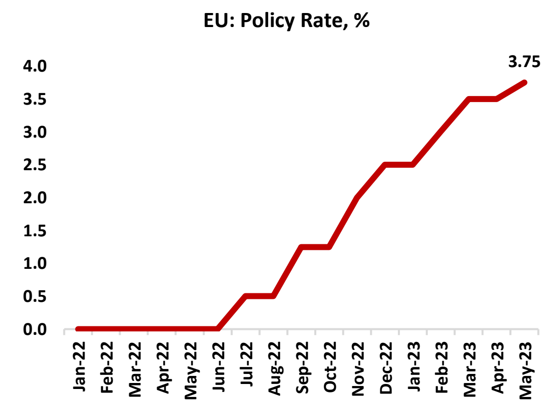




Sources: Eurostat, CEIC, Bank Islam

- At the recent European Central Bank (ECB) news conference in Frankfurt, ECB President Christine Lagarde highlighted that the economy's growth outlook could be slower "if the effects of monetary policy are more forceful than projected". On the contrary, she added that growth could also tilt to the upside amid the strong labour market. As such, we believe that the economy's technical recession is similar to the U.S. in early 2022, and it will likely be a short and shallow recession amid continuous improvements in the labour market.





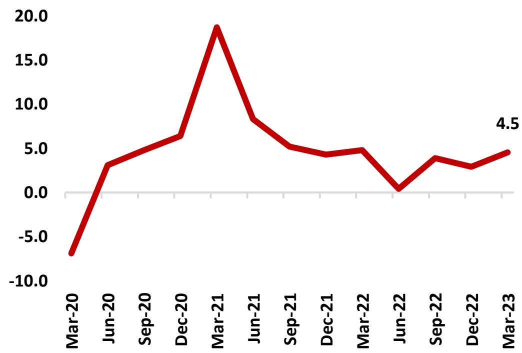
Sources: Eurostat, Bank Islam

China: Fragile economic rebound rests on thin ice

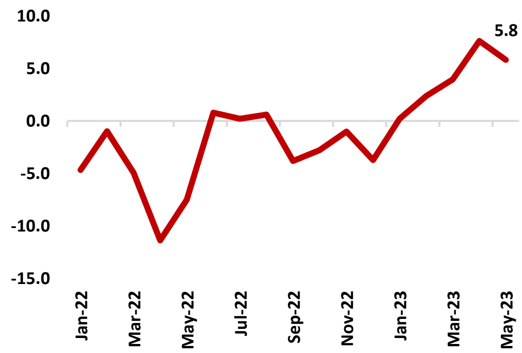
- All MDBs expect the People's Republic of China (China)'s growth to expand by 5.0-5.6% in 2023, revising their previous outlook upwards following China's stronger-than-expected 1Q2023 GDP growth of 4.5%. Interestingly, manufacturing activities remained robust despite China's total trade decelerating to the point of a contraction in exports (May: -7.5% vs. April: 8.5%).

- Nonetheless, alarm bells are ringing as signs of domestic demand losing steam emerge, jeopardising the hopes of a solid 2Q2023 expansion. Unlike other major economies actively combating inflation, China is fighting its own battle against deflation. Our earlier anticipation of an increase in China's inflation in 2023 falls flat as China's CPI y-o-y has been trending downwards throughout the first five months of the year. Owing to the cooling demand and falling global commodity prices, China's CPI rose by 0.2% in May (April: 0.1%) while PPI slumped by 4.6% (April: -3.6%). However, there is a possibility of an uptick in inflation should the labour market conditions improve, with the unemployment rate moderating to 5.2% in April (March: 5.3%).

China: Quarterly Real GDP Growth, y-o-y%



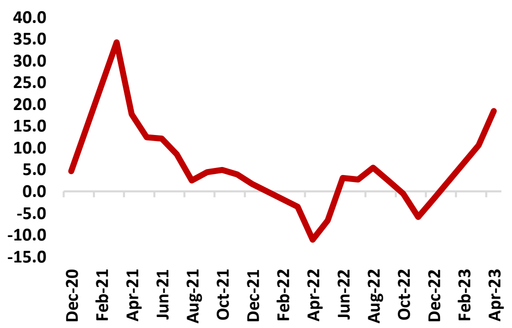
China: Manufacturing PMI s.a., y-o-y%



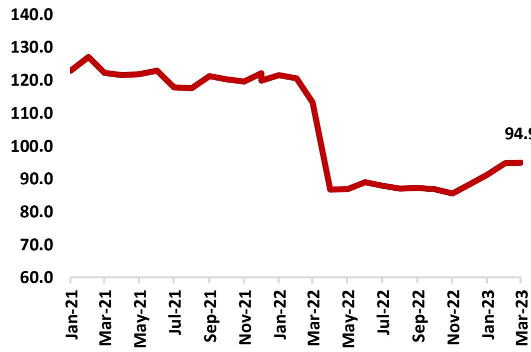
Sources: National Bureau of Statistics, S&P Global, Bank Islam

- With domestic demand settling as the crux of China's growth, there is time for the government to dole out measures to revive consumer spending to achieve its growth target of 5% in 2023. Following the economy's softening momentum, the People's Bank of China (PBOC) cuts its seven-day reverse repurchase rate by 10bps from 2.0% to 1.9%, easing monetary approaches. We posit that China's monetary policy path will support private consumption in attaining its growth target.

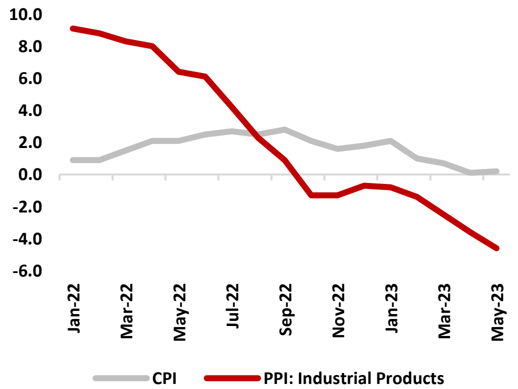
China: Retail Sales of Consumer Goods y-o-y%



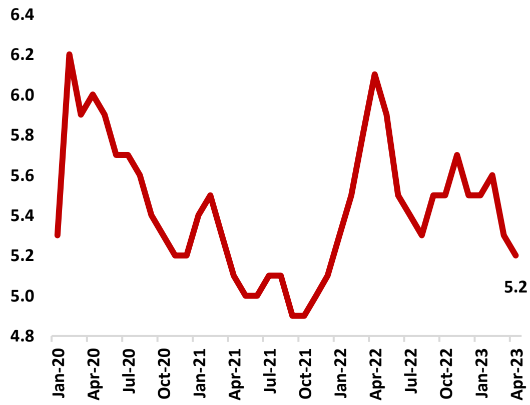
Consumer Confidence Index



China: Inflation, %



China: Unemployment Rate: Urban, y-o-y%



Sources: National Bureau of Statistics, Bank Islam

PART THREE: SOUTHEAST ASIA

- The updated GDP growth projections for Southeast Asia remain flat but with a downward bias considering the IMF's latest estimate of 4.5% (October 2022 projection: 4.9%). The downside risk to growth is weighed on the performance of Singapore, Thailand and Vietnam, which accounts for around 38% of Southeast Asia's nominal GDP. On the contrary, in 2023, the World Bank upgraded Thailand's growth forecast from 3.6% to 3.9%, whereas the ADB revised Vietnam's output higher from 6.3% to 6.5%. In 2024, the IMF and the World Bank's projections appear to be mixed, but the ADB believes that all Southeast Asian economies' growth to come in even higher, bringing the bloc's growth forecast (including Timor Leste) to 5.0%.

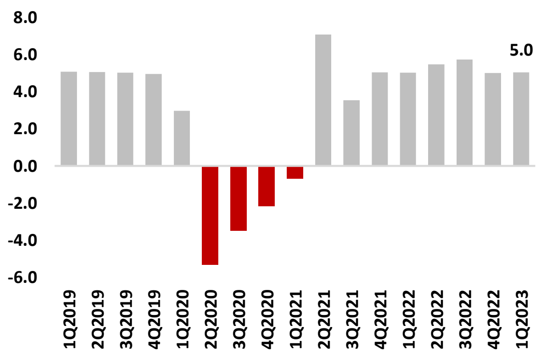
	IMF (Apr'23)*		World Bank (June 23)		ADB (Apr'23)**	
	2023	2024	2023	2024	2023	2024
ASEAN	4.5	4.6	-	-	4.7	5.0
Malaysia	4.5	4.5	4.3	4.2	4.7	4.9
Indonesia	5.0	5.1	4.9	4.9	4.8	5.0
Philippines	6.0	5.8	6.0	5.9	6.0	6.2
Singapore	1.5	2.1	-	-	2.0	3.0
Thailand	3.4	3.6	3.9	3.6	3.3	3.7
Viet Nam	5.8	6.9	6.0	6.2	6.5	6.8

**ASEAN-5*
***Including Timor-Leste*
Sources: IMF, World Bank, ADB, Bank Islam

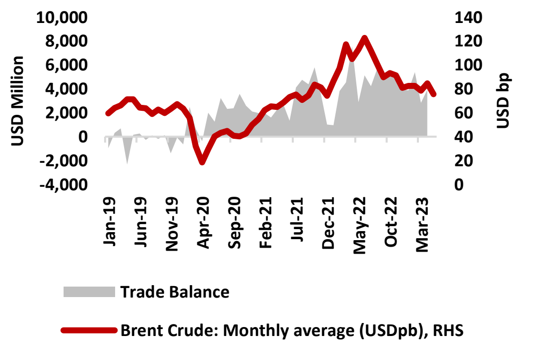
Indonesia: Winning streak

- Unlike most Southeast Asian economies, Indonesia was able to sustain its quarterly growth momentum in 1Q2023 at 5.03% (4Q2022: 5.01%). The uptick in y-o-y consumption in 1Q2023 of 4.52% (4Q2022: 2.97%) provided the necessary cushion to growth in the said quarter amid moderating investments and exports. Nevertheless, Indonesia's trade balance continues to trend positive for 36 consecutive months, the longest streak since the Global Financial Crisis. Inflation is trending higher than Bank Indonesia's target of 3%, although consumer and producer inflation has been moderating steadily since 3Q2022 amid lower energy prices. Its policy rate has been flat throughout 1H2023, following a 225bps hike within the last four months of 2022. The economy's unemployment rate is already trending below its long-term average of 5.8% and will likely trend lower amid higher tourist arrivals. We are optimistic about the prospect of the Indonesian economy in 2023 and beyond following the historic-high foreign direct investment (FDI) inflow of USD43.0 billion last year.

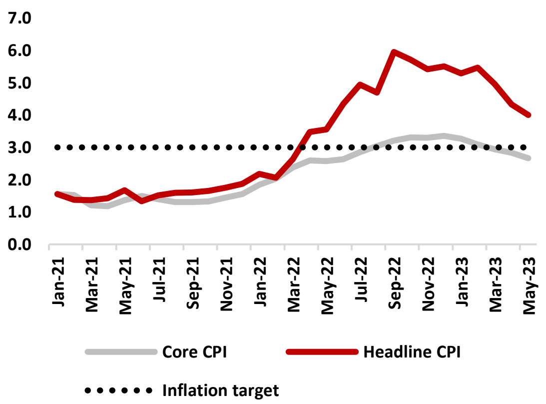
Indonesia: Real GDP, y-o-y%



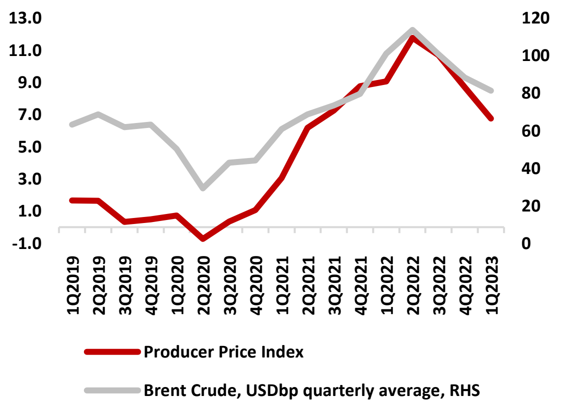
Indonesia: Trade Balance



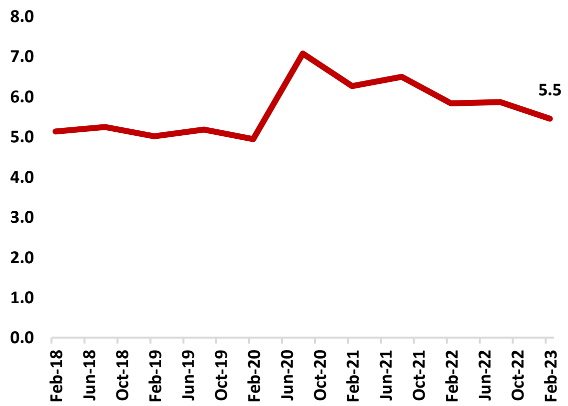
Indonesia: Consumer Inflation, y-o-y%



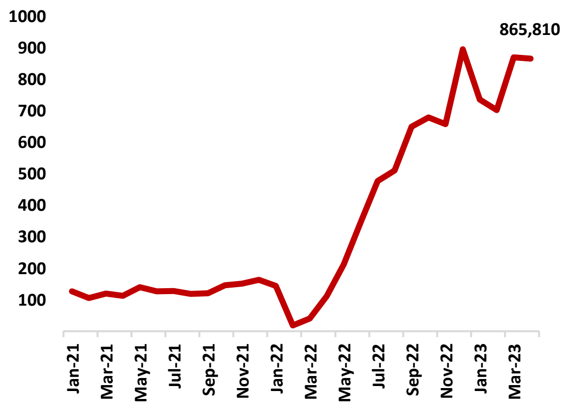
Indonesia: Producer Inflation, y-o-y%



Indonesia: Unemployment Rate, half-yearly %



Indonesia: Tourist Arrivals

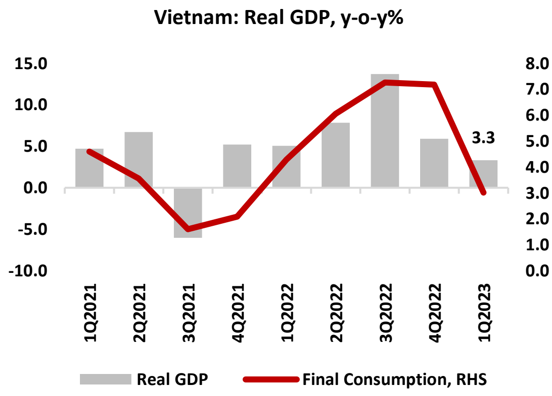


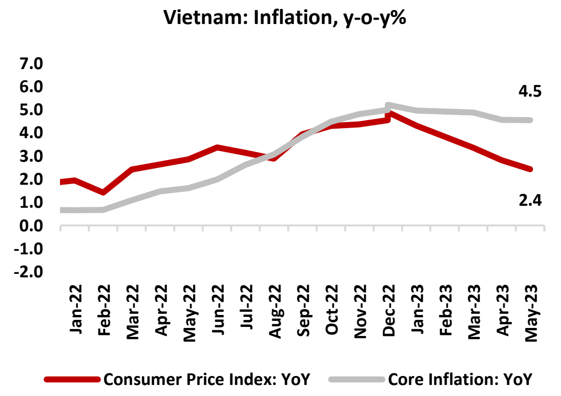
Sources: Central Bureau of Statistics (BPS), Bank Indonesia, OPEC, Bank Islam

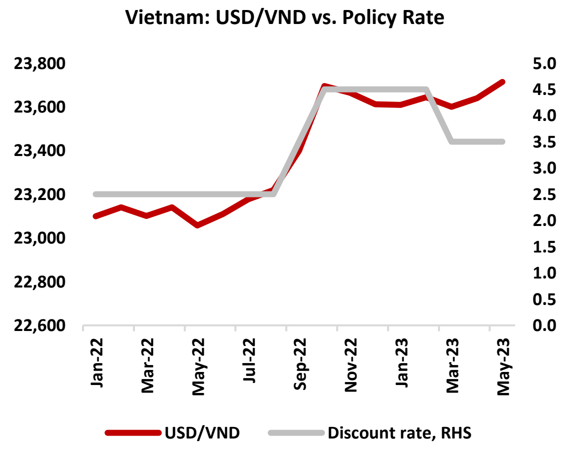
Vietnam: Sluggish consumption with solid growth rates

- The ADB expects Vietnam to be the fastest-growing Southeast Asian economy at 6.5% in 2023 and 6.8% in 2024. Despite the positive outlook, its growth momentum appears to be on a downtrend since 3Q2022 amid slower consumption, although its labour market has returned to its pre-pandemic levels in 1Q2022. One reason for the sluggish consumption growth is the persistently high core inflation since

October 2022. The State Bank of Vietnam (SBV) raised its discount rate by 200bps over two months starting August 2022 but ended up cutting it by 100bps in 1Q2023 and subsequently by another 50bps in June 2023 to address demand-side woes. We did not see a spike in USD/VND following the rate cut and believed that SBV's move was justified within the ambit of maintaining the stability of the national currency value.







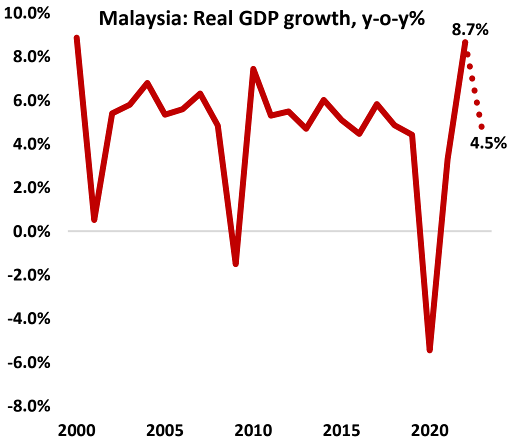
Sources: General Statistics Office of Vietnam (GSO), State Bank of Vietnam (SBV), Bank Islam

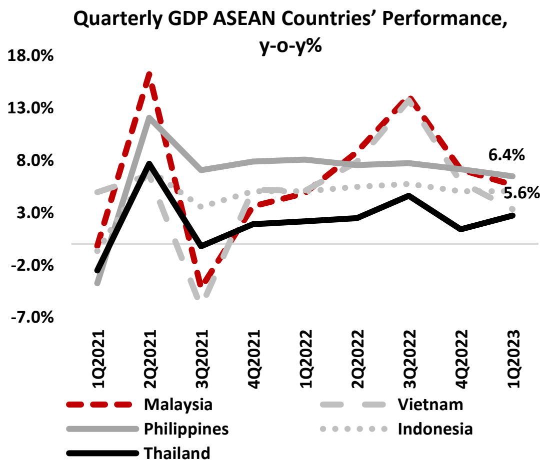
PART FOUR:
MALAYSIA IN 2H2023: GROWTH IS ANTICIPATED TO LIE IN THE RANGE ESTIMATED BY BNM DESPITE POLICYMAKING WHITENOISE

- The IMF projects Malaysia's growth at 4.5% in 2023 and 2024. Once again, ADB seems more optimistic about the country's growth than other MDBs, with 4.7% in 2023 and 4.9% in 2024. Meanwhile, World Bank's latest forecast in June demonstrates that the country's growth will come in at 4.3% in 2023 before dipping slightly to 4.2% in the following year, given moderating outlook on the global economy.

- Malaysia recorded the best first-quarter performance since 2015 when the economy expanded by 5.6% y-o-y. Private consumption remains the primary driver of economic growth, buoyed by a steady recovery in the labour market. Additionally, the growth print during the said quarter was the second highest in the ASEAN countries, just behind the Philippines at 6.4% while surpassing Indonesia (5.0%), Vietnam (3.3%) and Thailand (2.7%).

- A slower growth print is inevitable this year, given the base effects, the challenging global environment amid higher interest rates and a tighter credit environment. For now, we maintain Malaysia's FY2023 to fall in the midpoint of Bank Negara Malaysia (BNM)'s projection, specifically at 4.5%, aligning with the MDBs' projections between the 4.3% and 4.7% range.



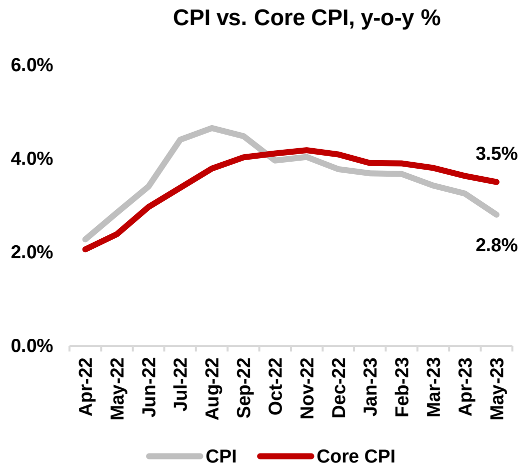


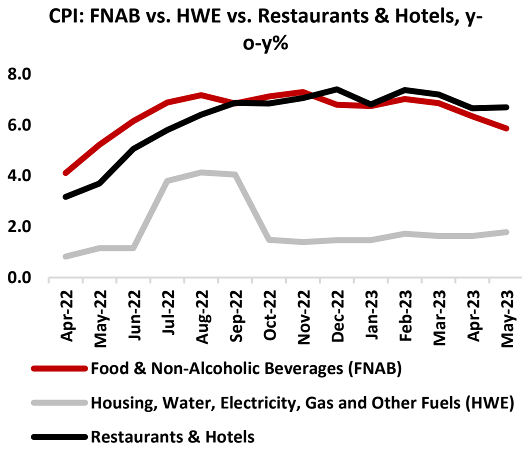
Sources: DOSM, Bank Islam

Inflation is expected to ease to 3.0% in 2023.

- Malaysia's CPI readings have been easing following the surge in commodity prices last year following the Russia-Ukraine military conflict. Headline inflation clocked in at 2.8% y-o-y in May (April: 3.3%), signaling we are on the right track on disinflation. The encouraging trend was driven by base effects and the moderating food and transport inflation as commodity prices eased. However, the upside risks to price for 2H2023 remain amid evolving global circumstances that pushed the greenback to remain elevated.

- In 2H2023, we believe the CPI would decelerate amid base effects. As such, we maintain our projection of inflation averaging at 3.0% in 2023 (2022: 3.4%), supported by the government's decision to maintain chicken and egg subsidies after 1 July. However, considering the government's fluid stance on price controls and subsidies, risks are biased to the upside, with inflation likely to edge up should subsidy rationalisation be implemented or any changes in the indirect tax system in 2H2023.





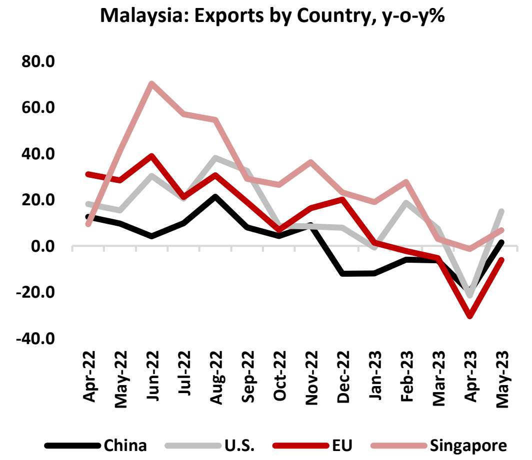
Sources: DOSM, BNM, Bank Islam

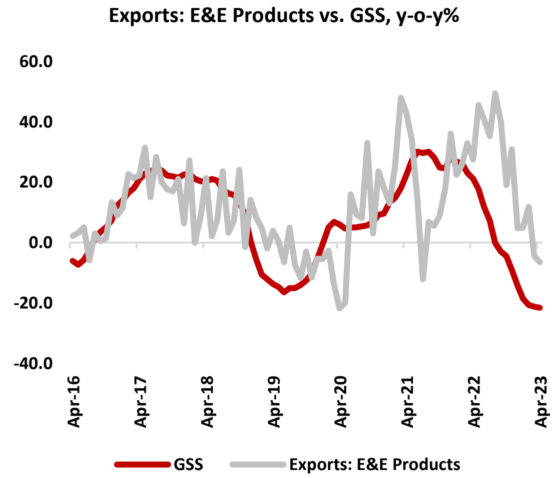
International trade posts risk to growth.

- As we anticipated, the slump in external demand has weighed on export growth, leading to a minor expansion of 2.8% y-o-y in 1Q2023 (4Q2022: 11.8%). Commodity prices have been decreasing on the back of softening global demand, dragging down Malaysia's export growth. Furthermore, soft momentum of outbound shipments to our major trade partners were recorded, with exports to EU (May: -6.1% vs. April: -30.5%), China (May: 1.5% vs. April: -20.4%), Japan (May: 2.1% vs. April: -22.1%) and Singapore (May: 6.8% vs. April: -1.4%) recovering at slow paces. The anticipated cushioning from China's full economic reopening, Malaysia's Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) ratification and the Regional Comprehensive Economic Partnership (RCEP) has yet to materialise meaningfully.

- As external headwinds intensify, we posit foreign trade for 1H2023 would continue to deteriorate as Malaysia's Purchasing Manager's Index (PMI) and Global Semiconductor Sales (GSS) persist in their downcycles while the Industrial Production Index (IPI) contracted for the first time since August 2021. The latest PMI showed that manufacturing activities edged down (May: 47.8 points vs. April: 48.8 points) as businesses scaled back their activities amid dwindling demand. Conversely, the IPI slumped by 3.3% y-o-y in April (March: 3.2%) as broad-base production across all categories slowed. Malaysia's E&E exports have been slipping and could fare worse amid widespread weakness, especially in the technology industry this year, taking cues from the continuous downcycle of the GSS.

- We believe the declining external demand remains the primary risk of a slowdown of Malaysia's export growth and economic outlook for 2H2023. The pessimism surrounding the global economy will lead to cautious steps across the globe. However, there is time for our trade to recover if the global economy picks up and lifts sentiments, following the stabilising conditions of global financial markets and an early recovery of the Eurozone recession.



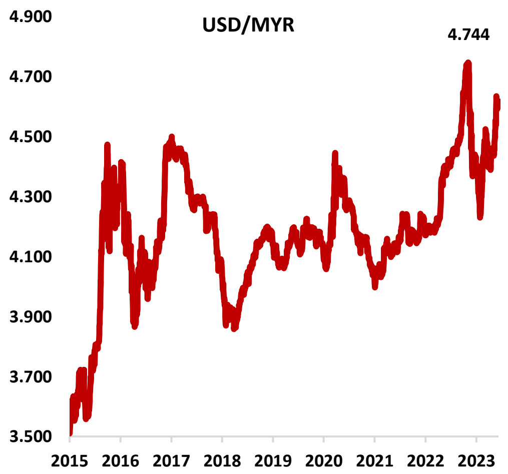


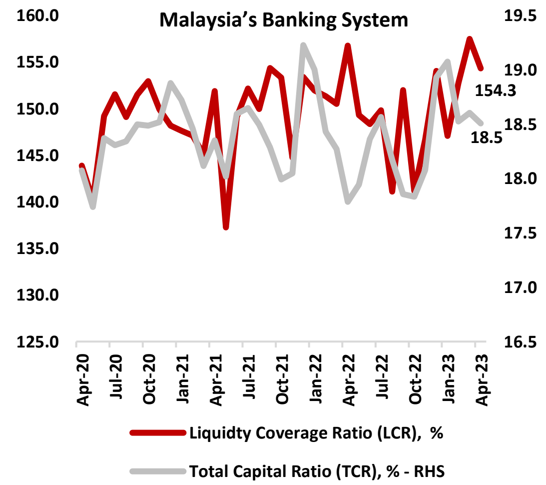
Sources: DOSM, BNM, Bank Islam

Ringgit is anticipated to strengthen in 2023.

- Ringgit was attractive at the start of the year, rebounding about 10.6% from a historic high of RM4.7465 on 4 November 2022 to RM4.241 on 2 February 2023 amid anticipation of U.S. slower rate hikes from November last year. Additionally, the Ringgit was stronger than its trading partners' currencies, as reflected by the local note's nominal effective exchange rate (NEER), which increased by 1.5% over the same period on a m-o-m basis.

- However, the Ringgit's weakness made headlines again in light of the recent global banking meltdown during mid-March. In response, BNM assured that our banking system remains resilient and can withstand "severe economic and financial shocks", given that our liquidity ratio coverage (LCR) stood at 147.0% as of January.





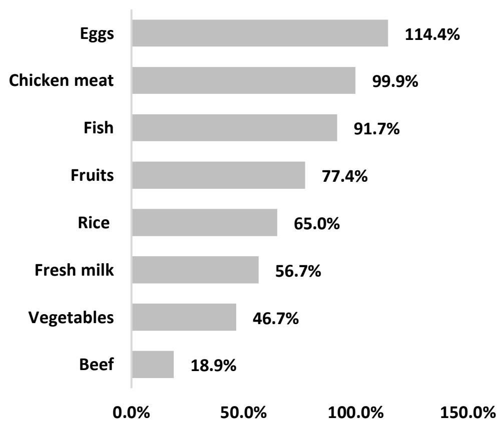
Sources: BNM, Bank Islam

- Despite that, the depreciation of the Ringgit against the USD is not unique to the country, as other currencies experienced a similar trajectory. Thus, fluctuations in the local note should be expected to occur occasionally, given Malaysia's flexible exchange rate regime. We should note that small movements in the exchange rate are common, especially in a financially integrated world that is often influenced by global developments and not necessarily reflective of the country's economic fundamentals. Considering that many of the variables are not within the government's control, at the very least, Malaysia should keep its eye on the ball in sustaining its growth rates in the coming quarters.

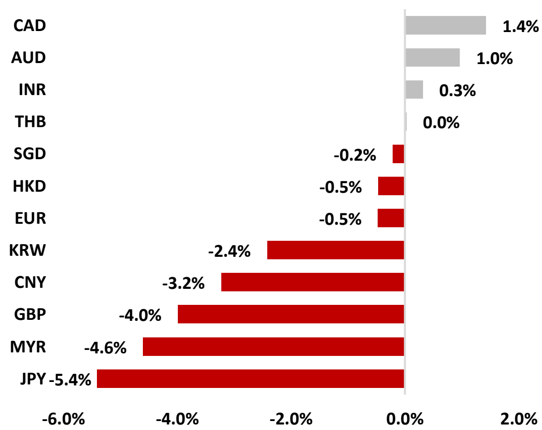
- This was certainly the case when the U.S. debt ceiling talk dominated the global sentiment as the U.S. Treasury Secretary Janet Yellen warned the country might run out of cash by 1 June should it fails to raise or suspend the debt ceiling. The Ringgit was under pressure, breaching the threshold of RM4.60 level in a matter of days as the greenback continued to strengthen on the back of the U.S. debt impasse, before rebounding to RM4.5910 on 2 June amid improved sentiment as the negotiation ended on a positive note.

- Be it the appreciation or depreciation of the Ringgit against the USD, it will eventually create both winners and losers in the domestic economy. The main focus of the country's exchange rate regime should not be picking either one. Instead, a sound policy is to ensure long-term benefits for the overall economy. As the global economy remains challenging, U.S.-led developments will likely be the focal point affecting the Ringgit. However, it is notable that if such a situation persists, the economy may be adversely impacted as around 60.0% of our food supply is imported. As a result, containing inflation may be complicated. While we note that global headwinds could limit the upward potential of the Ringgit's trajectory recovery, <u>we believe the local note could end the year at RM4.28 following our resilient domestic outlook</u>. Our projection is further supported by optimism about China's reopening based on the positive outlook from the MDB's latest stance and the unveiling of a new economic narrative in 3Q2023. That said, our current project may change should the evolving conditions of the global economy becomes more rapid in 2H2023.

Malaysia: Self Sufficiency Ratio (SSR), %



Other Currencies Against USD, YTD% Gain



Sources: BNM, Bank Islam
Note: Currencies data as of 9 June 2023

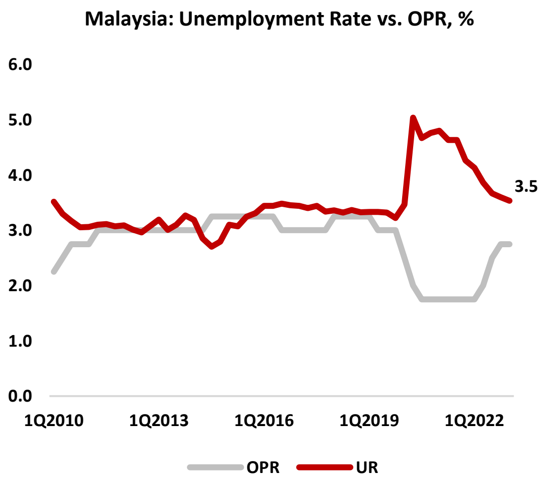
OPR hike – It's now or never.

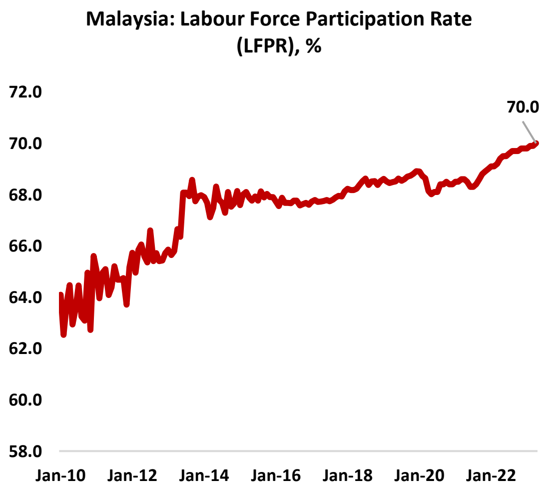
- The rate cuts following the pandemic were necessary to aid anti-cyclical policy during a crisis. However, keeping it too low for too long can be harmful, leading to overspending and over-borrowing. Hence, avoiding such a situation is imperative to sidestep a build-up of future risk to prevent upward price pressures that could badly impact the lower household income category. As the country's recovery was on track, we foresaw that the Overnight Policy Rate (OPR) would be gradually adjusted at the start of the year. Yet, it did not happen during the January meeting.

- Likewise, BNM held the rate steady at 2.75% in its March meeting, with a hawkish tone from the MPC statement about the resumption of policy normalisation. However, it was a different story when BNM decided to resume its monetary tightening during its May meeting as the Malaysian economy was showing strength. We believe the move was justified amid an expectation of a strong GDP 1Q2023 print, which came in as expected.

- While BNM may have unexpectedly normalised the OPR in May, it was not entirely unexpected as we already anticipated that the central bank would normalise as early as 1Q2023 due to a lower unemployment rate and positive spillover effects from China's economic reopening. Instead of 1Q2023, the 25bps hike in May was more of a "now or never" situation considering that 2H2023 could be challenging from the growth's perspective.

- Malaysia's inflation rate continued to trend down (April: 3.3% vs. March: 3.4%), marking the lowest print since March last year, though the core inflation is still trending higher than the headline at 3.6% in April. Unlike in many parts of the world, Malaysia's inflation reading gives limited clues on the trajectory of the monetary policy. In our view, labour market recovery means the OPR should progressively return to its new terminal level as it correlates more strongly with the unemployment rate rather than inflation (-86.0%). At the current rate, we do not rule out the possibility of another OPR hike during the 2H2023 should the unemployment rate steadily improve, reaching 3.3% in August when the official data released in October, a month before the scheduled final Monetary Policy Committee (MPC) meeting in 1-2 November 2023. Failing which, the OPR may rest at 3% until the year-end.





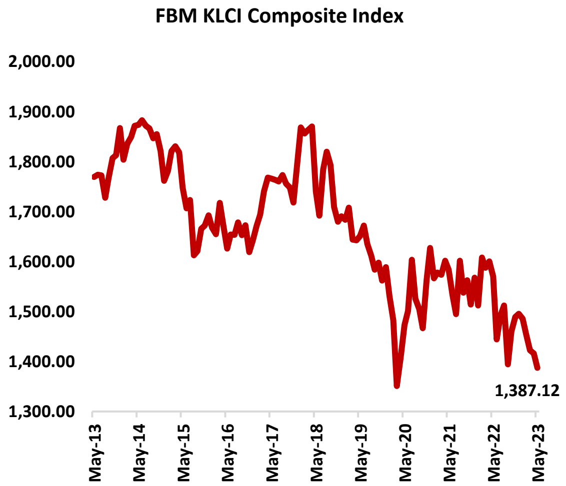
Sources: BNM, Bank Islam

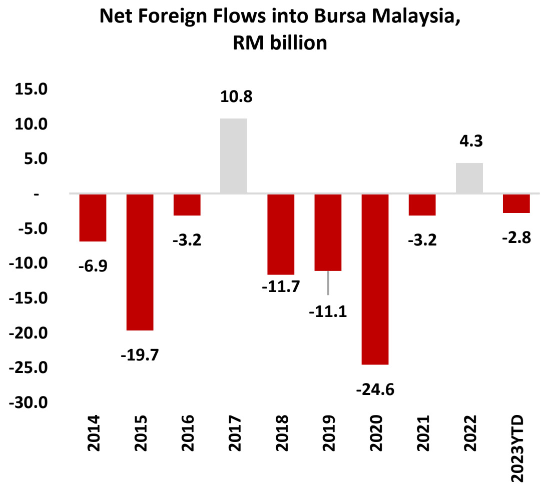
Capital Markets

Global headwinds to exert volatilities in equity markets.

- Sentiments are likely to influence the movement of FBM KLCI as the market adjusts to the global economic slowdown and tighter monetary policy. Banking stocks weighed down year-to-date, the local equity market performance amid fears of contagion from advanced economies and delayed policy normalisation, which accounts for around 42.0% of the total FBM KLCI basket.

- Global sentiment remains subdued amid slower economic growth. Local equity market foreign fund flows continued to be in the red sea each month this year, amounting to RM2.8 billion in outflows as of May 2023. Should the macro environment become more favourable in 2H2023, investor sentiment improvement will likely follow. The impending announcements of Malaysia's key economic policies will help to rally positive investor sentiment for the local market. Overall, the current outlook for the FBM KLCI is mixed. The index is likely to remain volatile in the near term, but it could recover in the long term if the prospect of the global economy improves.





Sources: Bursa Malaysia, Bank Islam

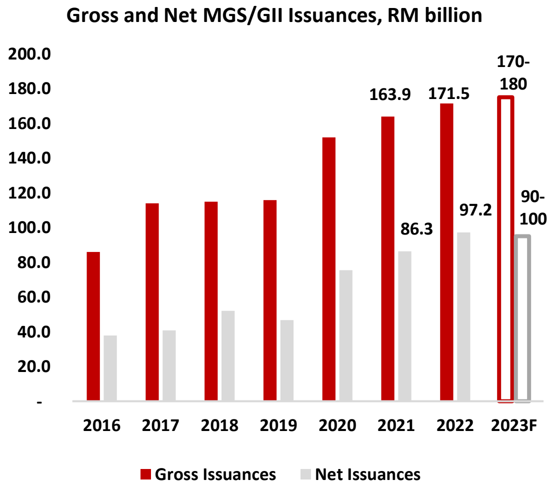
Fixed Income

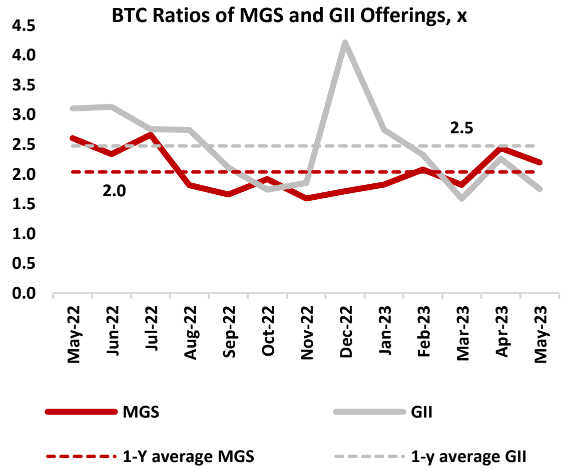
Robust demand of local govvies.

- As of the first five months of 2023, RM83.0 billion of Malaysian Government Securities (MGS) and Government Investment Issues (GII) have been issued, which is relatively higher compared to RM72.5 billion in the same period in the prior year. However, the redemption of MGS/GII up to May 2023 of RM47.9 billion exceeded the previous year's RM28.5 billion. Consequently, net issuances of MGS/GII in 2023 hovered at RM35.1 billion, a tad lower than RM44.0 billion in the same period last year.

- Despite the higher issuances, public offerings for local government bonds attained robust demand during the first five months of the year. The average bid-to-cover (BTC) ratio stood at 2.2x as of May 2023, the same magnitude as from January to May 2022. The BTC values above 2.0x reflect strong demand from local institutional investors.

- <u>We foresee that the gross MGS/GII issuance will amount in the range of RM170.0 to RM180.0 billion as at end-2023</u> (2022: RM171.5 billion) based on the government's projected 2023 fiscal deficit of RM93.9 billion in the revised Budget 2023, the matured MGS/GII amounting to RM47.9 billion and the upcoming MGS/GII maturities of RM29.6 billion.





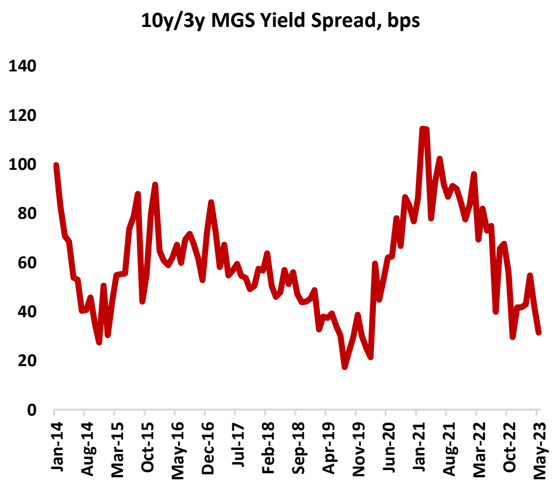
Sources: BNM, Bank Islam

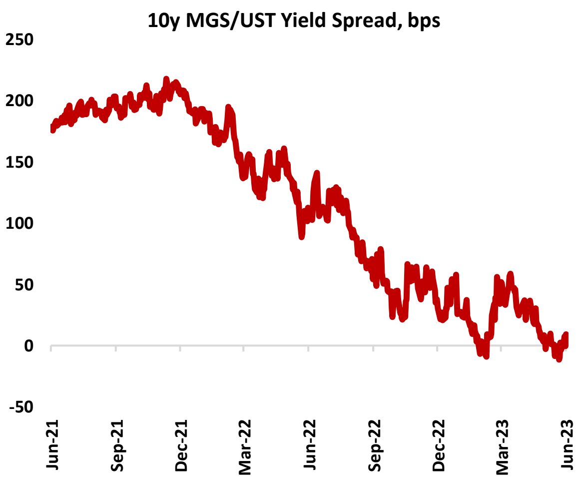
Flattening bias on yields to persist in the near term.

- MGS yields have been trending down in the range of 3bps and 46bps for all maturities. Buying interest skewed towards the longer-term notes resulted in a flatter MGS yield curve portrayed by the narrowing of the 10y/3y MGS yield spread, which reduced to 31bps at the end of May from 42bps at the end of December.

- The 10y MGS/UST yield spread has narrowed significantly since the Fed started its jumbo 75bps rate hikes in June 2022. In 1H2023, the U.S. banking crisis and debt ceiling negotiations, which sent additional jitters to investors and the Fed's hawkish pause in its June meeting, slumped the 10y MGS/UST yield spread to the negative region. The last time such a yield spread was negative was in May 2007.

- Inflation in Malaysia has been relatively low in recent months, which has led to lower inflation expectations. Headline inflation has been moderating, with the latest CPI inflation print at 2.8% in May 2023 (April: 3.3%). Additionally, foreign investors have been buying Malaysian government bonds for five consecutive months this year which has helped to push down bond yields. We expect the flattening bias to continue following a bigger yield fall on longer-tenure bonds than the shorter-tenure ones.



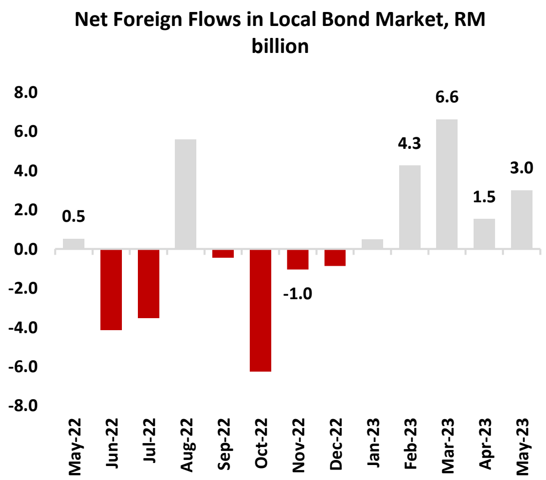


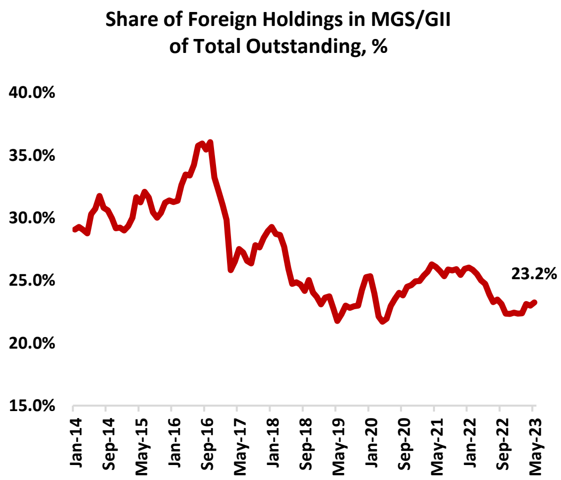
Sources: BNM, Bank Islam

Foreigners remain the net buyers of local bonds.

- In the first five months of 2023, the domestic bond market logged net foreign inflows of RM15.9 billion, significantly higher than RM0.9 billion recorded in the same period last year. The five consecutive months of net foreign inflows elevated the share of foreign holdings in Malaysian Government Securities (MGS) and Government Investment Issues (GII) to 23.2% in May 2023 (End-2022: 22.4%).

- Looking forward to 2H2023, we expect the outlook for foreign inflows into Malaysia's bond market to be positive, albeit volatile, supported by the country's strong economic fundamentals and attractive yields. However, there are risks considering the global economy faces headwinds from rising inflation and interest rates, which could weigh on demand for Malaysian bonds.





Sources: BNM, Bank Islam

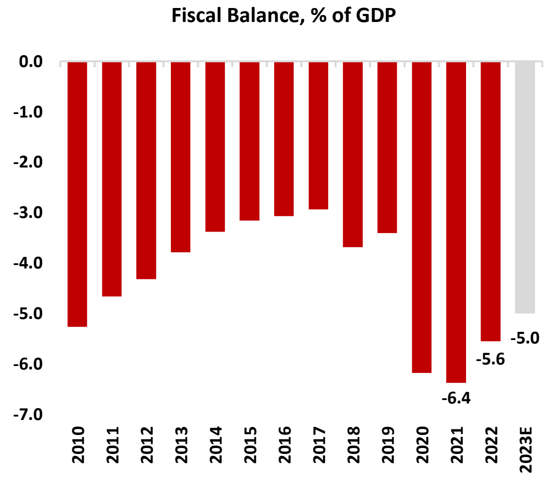
Public Finance

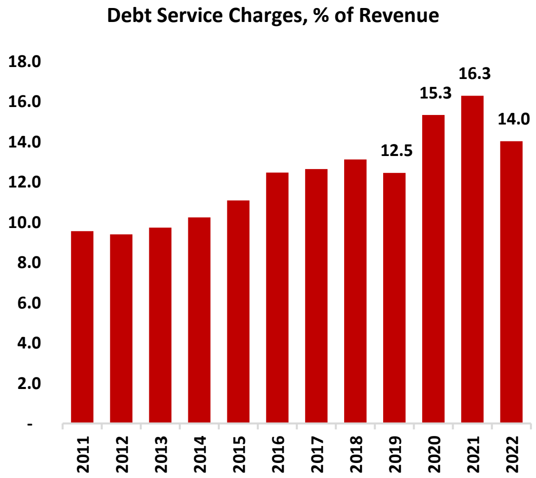
Fiscal reform is needed to achieve the medium-term fiscal target.

- In the revised Budget 2023, the government projected that the fiscal balance to moderate further to -5.0% in 2023 (2022: -5.6%) derived from the estimated 5.4% nominal GDP growth, lower operating expenditures, and the expiry of the Covid-19 Fund.

- The government has announced plans to reduce the deficit and debt over the medium term via Medium Term Fiscal Framework, but it remains to be seen whether these plans will be successful. In the medium term, the government puts a fiscal deficit target of 3.2% by 2025.

- Debt service charges to revenue hovered below the 15.0% administrative limit at 14.0% as of end-2022 given the high revenue growth in 2022 due to the elevated oil prices in 2022. The tax revenue-to-GDP of 11.6% in 2023 (2022: 11.7%) projected in the revised Budget 2023 remained a concern as it is still lower than the pre-pandemic level of 11.9%. In addition, the country's economic growth has slowed in recent years, and there are concerns that the government may be unable to raise enough revenue to meet its targets.





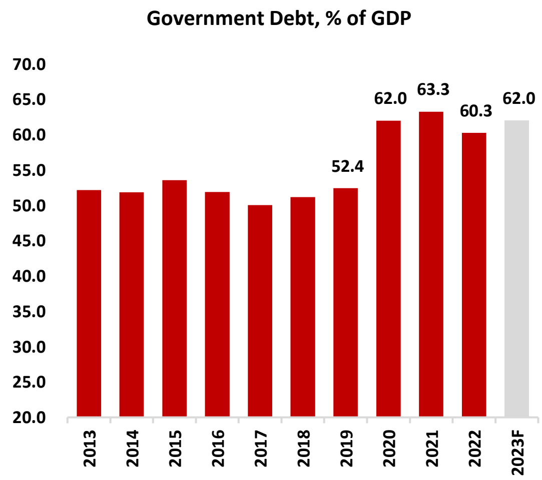
Sources: MOF, BNM, Bank Islam

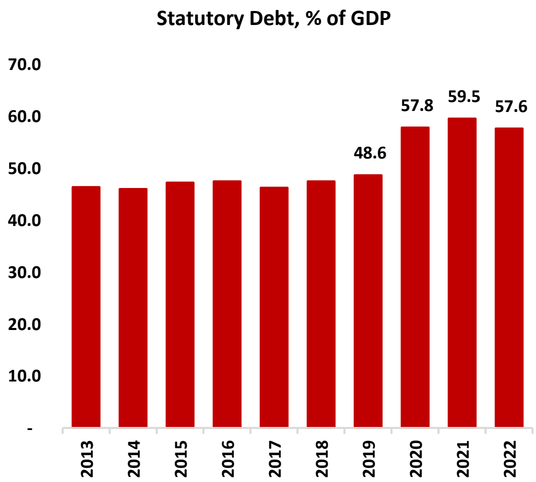
Debt Management – It's all relative.

- Debt-to-GDP ratio contracted to 60.3% in 2022 (2021: 63.3%), contributed by the higher nominal GDP growth rate in 2022. The debt level was RM1.1 trillion in 2022 (2021: RM979.8 million) and will increase this year. The government projected that the government debt to hover at 62.0% of GDP in 2023.

- Statutory debt-to-GDP (MGS, GII and MITB) stood at 57.6% in 2022 (2021: 59.5%). Thus, we envisage <u>sufficient headroom to issue government debt this year without breaching the statutory debt ceiling of 65.0%</u>.

- Foreign exchange risks remain very low as the percentage of government debt denominated in foreign currency stood at only 2.6% of the total debt outstanding as of 1Q2023. Hence, reducing foreign exchange vulnerabilities will elevate the cost of debts given the high-interest rate environment.





Sources: MOF, BNM, Bank Islam

KEY POLICY ISSUES IN 2H2023

1. The higher EPF contribution proposal.

- According to the EPF December 2022 data, 51.0% of the 6.7 million EPF contributors under 55 have less than RM10,000 in savings, up from the 4.7 million contributors recorded during April 2020. This phenomenon is problematic as an uptick in withdrawal would have long-term implications for contributors' retirement. As such, should employer contributions to the EPF increase from 13.0% to 20.0%, as proposed by the government, the increase would be a significant enabler in addressing the low retirement saving issue among Malaysians.

- However, the spike in employer contribution increment is punitive, especially for small and medium enterprises (SMEs), as it will impact their profitability amid higher labour costs and, subsequently, their business model. In turn, this will ultimately reduce the demand for workers as it discourages employers from hiring, leading to a slowdown in job creation and wage growth. Additionally, higher EPF contribution relative to our ASEAN neighbours would make Malaysia less competitive.

- All in all, various factors are in play as the proposal is a complex issue requiring a thorough data-driven assessment and multiple considerations before finally reaching a consensus. We take it that such a move is too bold on the economy's state and business competitiveness. Undoubtedly, the EPF talks might also affect the current minimum wage negotiations, creating challenges between employers and employees. Therefore, the decision should be guided toward creating sustainable economic growth and social welfare in the country.

2. The ongoing fiscal consolidation efforts through subsidy rationalisation.

- Despite having no clear-cut policy in place, the government's repetitive indications on subsidy rationalisation are disruptive to predictability in economic policymaking. Our country's policy concerning social welfare has always been tied up on household income categories involving B40, M40 and T20 with the so-called popular reference of the poor, the middle class and the rich. Following the agenda, the government has withdrawn electricity subsidies to domestic users who consume more than 1,500 per kilowatt hour (kWh) of electricity a month.

- Generally, we expect T20 households to be in a better financial position than those in M40 and B40 categories. However, a T20 household is by no means "rich", and a B40 household is not necessarily poor. Yet, our policy assumes that the B40 income category deserves more assistance than T20, considering that such a policy is anchored on household income alone. In our view, the problem with this approach is not only because of the lack of clear representation of household incomes at various levels but also because of the outdated database based on estimates of household incomes in 2021.

- Furthermore, the idea of distributing social assistance through net disposable income will be too complex to implement, administer and sustain in the long run. For this idea to work, the government has to run the programme like banks do, which will be tricky considering that no single entity runs social assistance programmes in Malaysia. Besides, potential applicants may be deterred from applying if full accounting disclosures are required for a small amount, which can be problematic for low-income earners. In time, the government may subsequently be enticed to create a super-agency, which will be difficult to rationalise in the future should the programme need to change with demographic changes.

- As such, the existing pro-poor framework calls for a paradigm shift. Instead of pursuing different mechanisms after each regime change, we opine that it is better to redirect the focus on improving tax revenues while ensuring near-term growth remains robust. The minimum wage implementation necessitates a closer look as well. As a result, the fiscal incidence will “shrink” naturally as wages increase. Removing subsidies can be punitive to near-term growth and complicates improvements in wages at a time when price levels remain elevated in the post-pandemic era.

3. Growth-enhancing strategies via Madani Growth Narrative (NEM), Mid-Term Review of the 12th Malaysia Plan and Budget 2024.

- In the revised Budget 2023, the allocation for development expenditures (D.E.) increased by 35.5% to RM97 billion from RM71.6 billion in 2022, equivalent to 5.1% of GDP. Nevertheless, the lack of granular breakdown on the D.E. makes it hard to estimate the multiplier effects that it will have on growth. The absence of new infrastructure projects other than the ongoing projects dampens Malaysia's short- to mid-term growth outlook.

- Given the declining tax-to-GDP ratio and to ensure sustainable income for the country, the government should eventually consider reintroducing the goods and services tax (GST) to widen the revenue base. Much has been said about the tax system in our 2023 Economic Outlook report. Although it will unlikely be implemented in 2023, we opine that the government may reignite the idea of reintroducing GST after the state elections.

- The 12th Malaysia Plan (12MP) MTR, designed to monitor progress and identify relevant modifications considering the evolving global circumstances, will be announced in 4Q2023. Racing within the time frame of the 12MP, uncertainties remain high on whether the policies are up to the task of attaining the targets. With the fragile political landscape and lack of a common policy framework, we feel that the MTR needs an overhaul to reflect the economic priorities of the new government. With that in mind, the deliverables of Budget 2024 should be the subset of the MTR.

4. The impact of the upcoming state elections on policymaking

- Despite the worries and question marks surrounding the upcoming state elections, we believe that the outcome will inevitably shape policymaking at the federal level, but it will not lead to the reconfiguration of government seats in the Parliament. Although the official dates of the six state polls (namely Kedah, Penang, Selangor, Negeri Sembilan, Kelantan and Terengganu) have not been announced at the point of writing, we expect them to be held in early 3Q2023 following the dissolution of each state assembly. The timing of announcements of key economic plans is a sign of things to come. With a sound economic plan in the current political mandate, Malaysia’s political landscape should improve if the ruling coalition pursues a formal registration as a political bloc.