

Malaysia

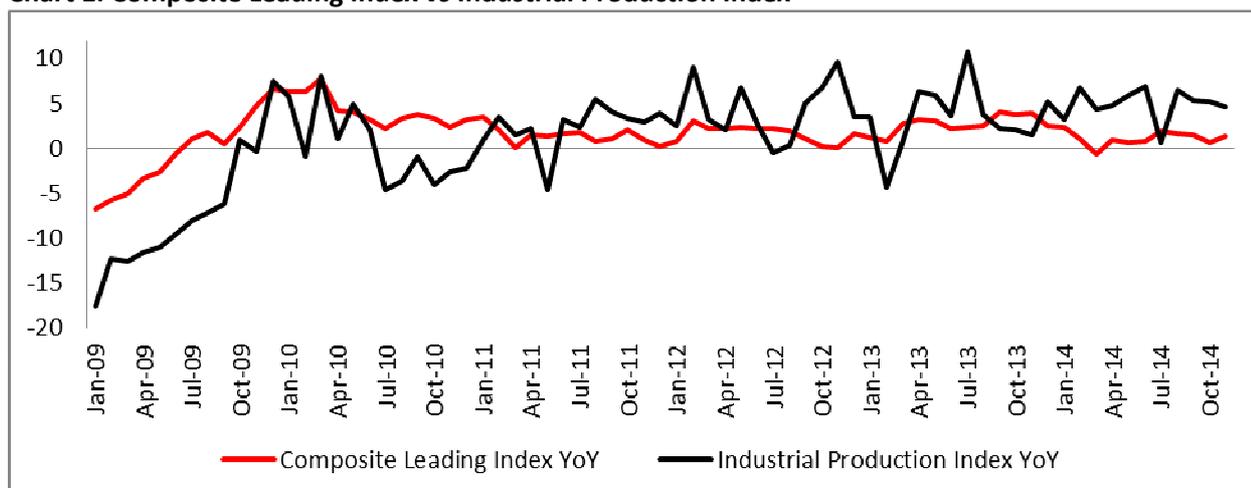
## Leading indicators pointed towards moderating 1Q 15

- Our tracking of forward looking indicators shows production activities are likely to trend downward in the 1Q 15, led by moderating external performance but this to be partially offset by likely sustained strength in domestic demand.
- Nonetheless, production activities are likely to pick up in the 2Q period but domestic demand is likely to lose momentum as the GST starts to kick in April,

The Composite Leading Indicator (CLI), published by the Department of Statistics (DoS), is the only official Leading Indicator (LI) but we need to track the economic cycles as early as possible. DoS's CLI is widely utilized to anticipate turning points in economic activities. We do not intend to undermine the CLI's predictive capability as it comes with a broad range of indices and is a very comprehensive composite leading indicator. However, it is released with a 2-month lag and only available at the end of the month, i.e. the December CLI will only be released on February 25. Thus, this has prompted us to do our own tracking of leading indicators in order to enable us to detect the next movements in the economic cycle as early as possible. The selected LI will be used to predict the next cycle in industrial production which is widely used as a proxy for GDP. Although GDP give a better indication on the state of the overall economic activities, it is only available on a quarterly basis and is published after a 2 month lag, i.e. 4Q 14 GDP numbers were only released on February 12.

But not all the sub-indices are available publicly that we can track on our own. Although it is ideal to assess all the components in the CLI, not all of the indices are widely available to the public i.e. number of housing units approved. We have chosen two variables in DoS's CLI that are publicly and easily available to be tracked as our set of leading indicators, namely Bursa Industrial index and the money supply, to predict the near-term outlook for the IPI and hence the GDP.

Chart 1. Composite Leading Index vs Industrial Production Index



Source:

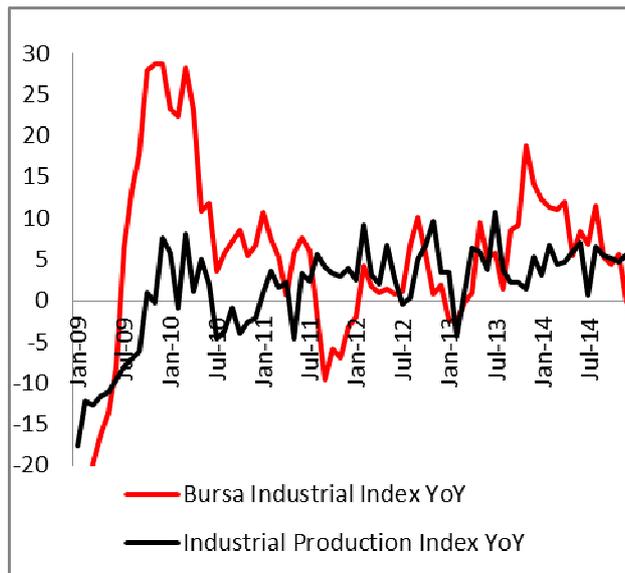
CEIC; Bloomberg; MIDFR

The Bursa Industrial Index (BII) has strong predictive power against the IPI. Latest reading showed a modest turnaround. Based on trend, movements in the BII usually lead to a tandem movement in IPI, sometimes with a 3 -6 month lag. More recently, the BII had risen sharply in August by 11.45% yoy from an annual increase of 6.8% in the previous month. This indicates that industrial activities were likely to pick up in the following months. Evidently, growth in IPI surged in December by 7.4% and IPI accelerated at an average pace of 5.14% in 4Q14 compared to 3.13% in the previous quarter. The latest reading showed the index rebounded by 5.5% yoy in

January following a contraction of 0.3% in December. The index had been on downward trend in the last few months of 2014. With the slight upturn, we can expect that if the expansion is sustained, industrial activities are likely to moderate in the 1Q 15 before picking up in the 2Q 15.

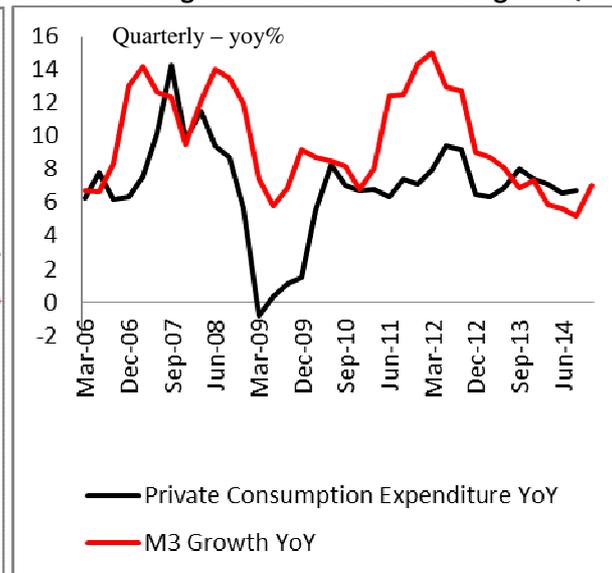
**On the domestic demand front, the broad money supply, M3 signaled sustained robust domestic demand.** Although, DoS uses M1, our internal analysis shows that M3 has a closer feed to private consumption expenditure (PCE) and in turn GDP. Most importantly the publishing of M3 is timely and consistent, released frequently with long operating history. To add to that, M3 growth has been reliable in signaling the health of domestic demand. Case in point, when M3 grew modestly in the last 3 quarters of 2011 averaging at a pace of 13%, PCE growth trended upwards during the same period. Similarly, when M3 growth cooled off in 4Q12 by expanding at a slower pace of 9% (3Q12: 12.7%, 2Q12: 12.9), PCE growth moderated in the same quarter to 6.47% (3Q12: 9.18%, 2Q12: 9.41%). On quarterly basis, the M3 picked up to 7.2% yoy in 4Q 14 from 5.2% in the previous quarter. However, the latest reading on M3 showed that in December it has lost momentum slightly to 6.9% yoy from 7.0 % yoy in November. That indicates domestic demand is likely to stay robust in the 1Q 15 but to lose steam in the 2Q period, which is understandable given that GST kicks in effective April.

**Chart 2. Industrial activities to moderate**



Source: Bloomberg; MIDFR

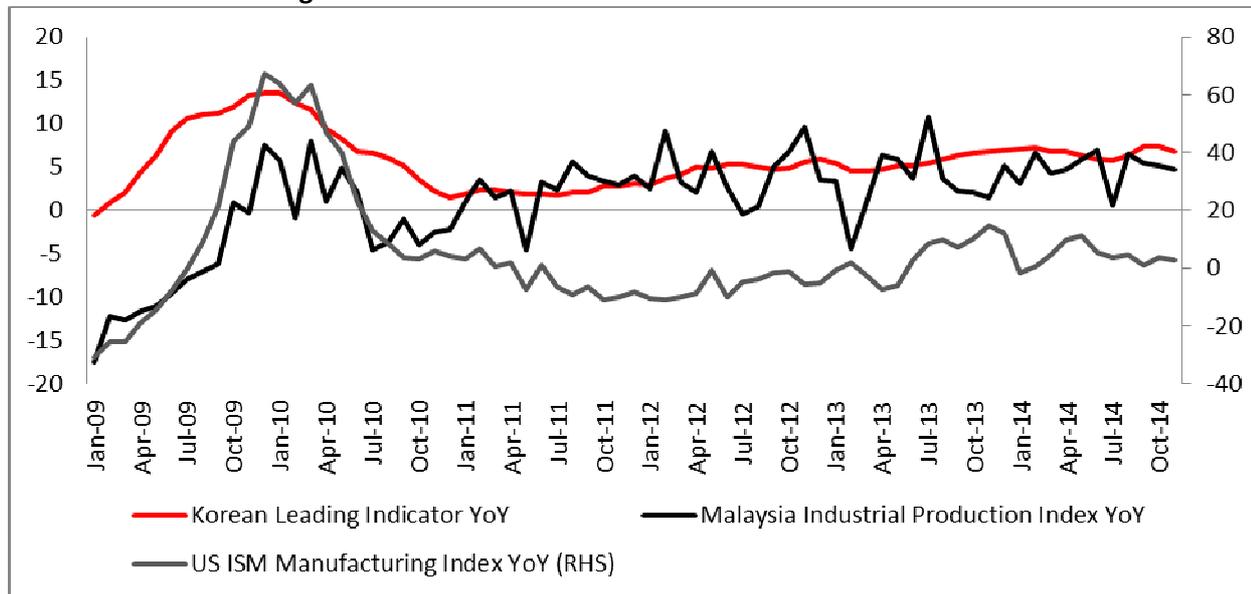
**Chart 3. M3 signals PCE to remain strong in 1Q15**



Source: Bloomberg; MIDFR

**In addition, we will track an 'external' indicator, a normal exercise done in developing composite leading indicators by many research institutions.** This is useful given that Malaysia's manufacturing sector is part of the global value-chain especially in the electronics and electrical. For this purpose, we have chosen the Korean Leading Index (KLI). This index is usually published before the first trading session on the month in Asia, which makes it the first of the world's major economic indicators to be released. In addition, as Korea's industrial activities are largely exported to China, Japan and US, and it reflects closely the value-chain in Asia. Hence it reinforces the predictive power of the KLI. We have also tried US ISM index as well as US book-to-bill ratio but the cross correlations with the IPI are not as strong and their movements do not show strong and steady leading properties. The latest reading on KLI available was for December which showed that the index had eased slightly, suggesting that the regional manufacturing activities can be expected to cool off a bit in the 1Q 15, especially with the Chinese New Year festivities.

**Chart 4. External Leading Indicators**



Source: Bloomberg; MIDFR

**Overall, we think that economic activities are likely to moderate slightly in the 1Q 15 as the pullback from the production side to be buffered by strong domestic demand.** Moving forward, we will continue to monitor other variables which we think possesses the economic and statistical criteria, and that has strong predictive capabilities, apart from what we have identified and highlighted earlier. However, it is worth to note that unlike developed economies which have larger collections of highly frequent published data and readily available publicly in a timely manner, we are faced with limited set of information and of which, many not qualify as leading indicators. 

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