PART 4
CAPITAL MARKET REVIEW AND OUTLOOK

OVERVIEW

Global growth softened in 2018, with uneven performances across major economies. The year, which started on a positive footing, subsequently saw materialisation of key downside risks to growth, particularly the increase in trade tensions and tightening of global financial conditions. The global capital market ended the year with markedly higher levels of global financial market stress and volatility. Notwithstanding the challenging global environment, the Malaysian capital market remained resilient compared to global and regional market performance and continued to play a vital role in financing the domestic economy.

The global economy is expected to grow at a more moderate pace in 2019, with synchronised deceleration across all major economies including the US and China. The global capital market will continue to be shaped by uncertainties surrounding key developments, including the pace of developed economies' monetary policy normalisation, the prospects of further increase in trade tensions and the risk of slower global growth. Against a backdrop of a more challenging and uncertain global environment, the Malaysian economy is expected to remain on a steady growth path, underscored by the continued resilience of domestic private sector activities. Domestic capital market performance will continue to be influenced by developments on the external front and the general increase in volatility of global financial markets. Nevertheless, the domestic market is expected to remain stable on the back of Malaysia's strong macroeconomic fundamentals, deep domestic liquidity and well-developed capital market infrastructure.

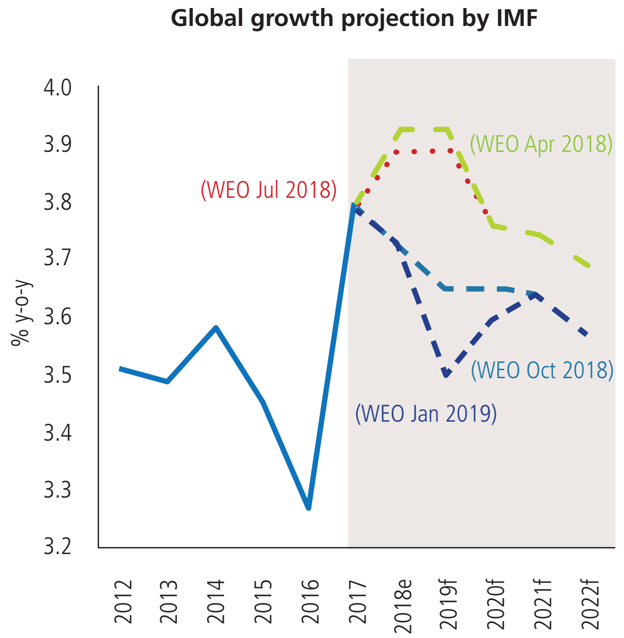
GLOBAL DEVELOPMENTS IN 2018

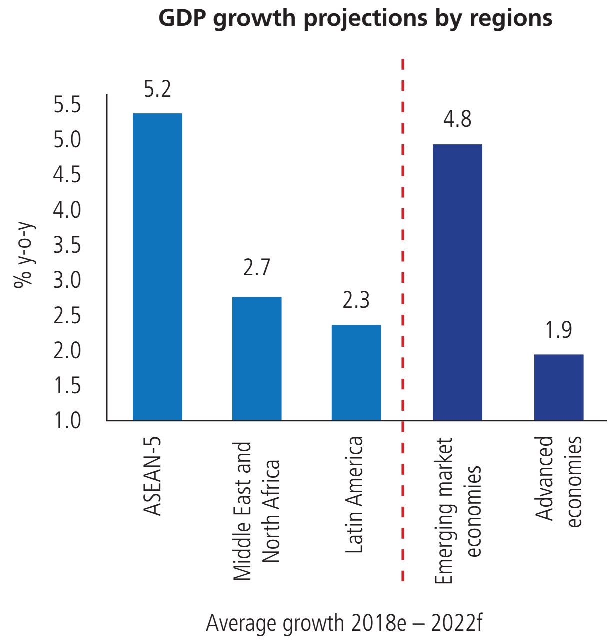
Global growth moderated in 2018, with most major markets witnessing uneven performances throughout the year. It started on a positive footing with the continuation of low level of financial markets volatility from the year before, underpinned by higher global growth expectations after a synchronised acceleration in 2017. As the year progressed, economic growth gradually became weaker than initially expected amid materialisation of key downside risks to growth, particularly the continued increase in trade tensions and tightening of global financial conditions. The International Monetary Fund (IMF) downgraded the global growth forecast during the year (Chart 1).

The US economy in 2018 was driven by robust consumer spending, underpinned by strong labour market conditions, coupled with the continued rise in private capital expenditure due to sizeable

Chart 1

Global economic outlook revised downward in 2018 amid materialisation of downside risks but ASEAN economies continued to stand out as a global growth centre





Source: IMF World Economic Outlook (WEO)

fiscal stimulus introduced in late 2017. In addition to weaker exports and unfavourable weather conditions, growth in Europe was hindered by rising political risks. China's real gross domestic product (GDP) growth, meanwhile, slowed as expected, reflecting weaker investment momentum as the government continued to tighten regulations on the property and non-bank sectors. Nevertheless, China's economy remained resilient, given the government's proactive policy response to offset difficulties arising from challenging external demand.

In the region, the Association of Southeast Asian Nations (ASEAN) economies continued to experience sturdy growth but at a more moderate pace, supported by strong domestic demand that helped offset challenging external environment. Real GDP growth remained close to or above potential for the region as rising infrastructure needs helped sustain investment momentum, and favourable demographic profile supported private consumption activities.

Global monetary policy tightened in 2018 led by continued rate hikes by the US Federal Reserve (Fed), while other major central banks such as the European Central Bank (ECB) and Bank of Japan (BOJ) cautiously adjusted their policies, given the subdued inflationary pressures and continued weakness in economic growth. The Fed raised the benchmark federal funds rate by a cumulative 100 basis points (bps) to a range of 2.25% to 2.50% in four separate moves on the back of strong labour market conditions and stable inflation. The ECB maintained its key refinancing rate at 0%, pledging to keep rates at the current level at least until summer 2019 and retired its asset purchases programme in December 2018. The BOJ, meanwhile, adjusted its yield curve control policy in July 2018 by allowing for wider deviation band for the benchmark 10-year yield around an unchanged target of about 0%.

Several emerging markets economies' (EMEs) central banks have also raised policy rates in order to limit the currency and financial market pressures. The People's Bank of China (PBOC), on the other hand, maintained its benchmark one-year lending rate but reduced its reserve requirement ratio four times to prevent a sharp deceleration in growth.

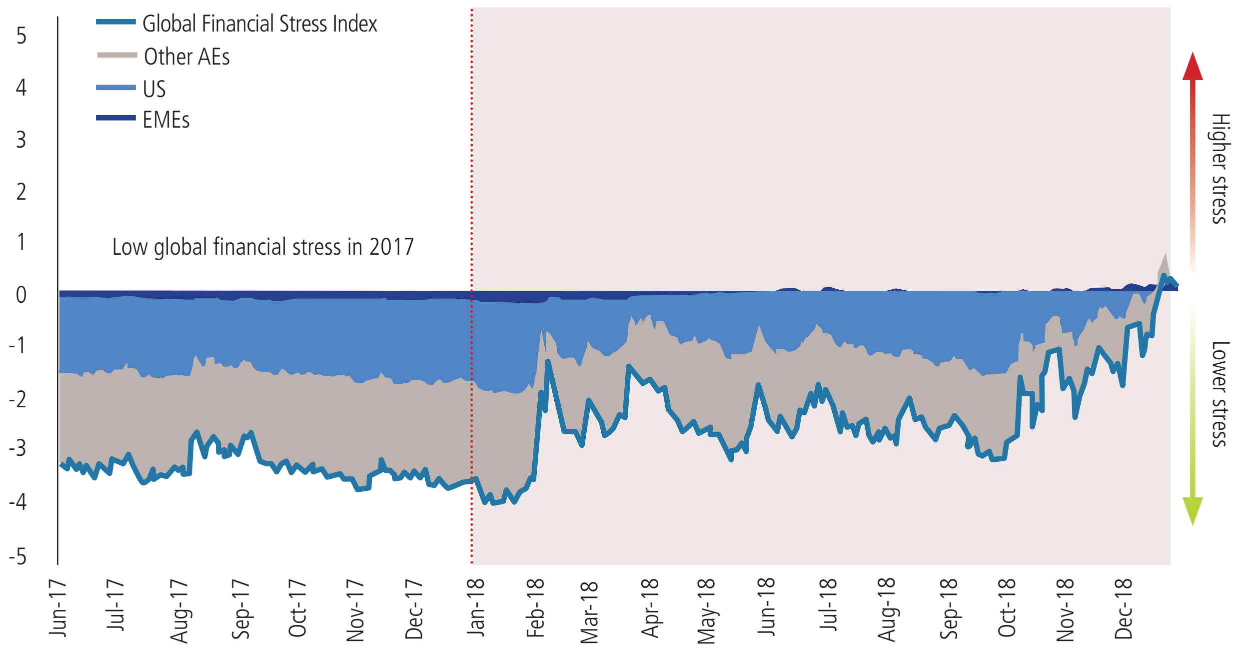
Conditions in global financial markets deteriorated throughout most of 2018 compared to 2017 (Chart 2). Stress in the global financial markets was rising steadily since February 2018 with financial conditions tightening considerably towards the latter part of 2018 for the advanced economies (AEs). EMEs, on the other hand, faced significant financial market pressures since June 2018, driven by the shift in global liquidity, particularly from economies with weaker macroeconomic fundamentals and large financing needs. Overall, global financial market conditions in 2018 were shaped by three key inter-related developments, namely escalation of the US-China trade war, pressures on EMEs arising from a stronger US dollar and the general increase in global financial market volatility especially towards the end of the year.

The intensification of global trade tensions had led to a repricing of risks that resulted in volatility in the global financial markets. The escalation began after

Chart 2

Conditions in global financial markets deteriorated in 2018 as compared to 2017

Global Financial Stress Index by the US Office of Financial Research (OFR FSI)



Note:
The OFR FSI is a daily market-based snapshot of stress in global financial markets. It is constructed from 33 financial market variables such as yield spreads, valuation measures and interest rates. The OFR FSI is positive when stress levels are above average, and negative when stress levels are below average.

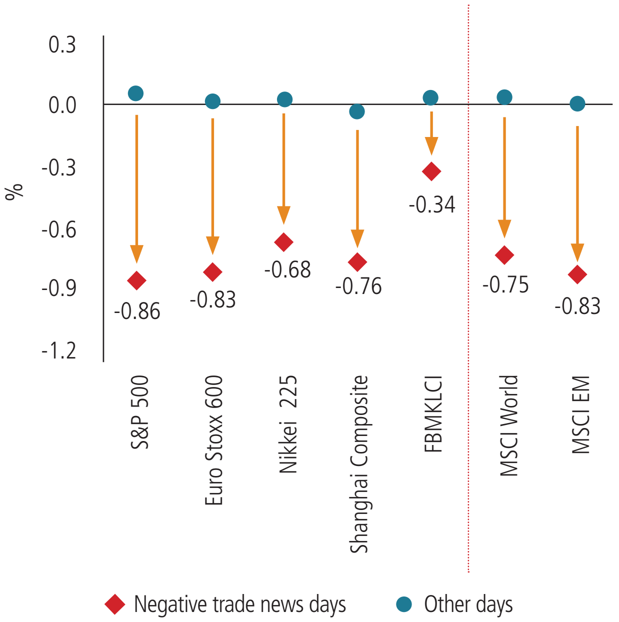
Source: Office of Financial Research, US Department of the Treasury the US imposed tariffs on imported steel and aluminium in March, following earlier tariffs on washing machines and solar panels imposed in January. Subsequently, tensions heightened as the US shifted its focus to China from the second quarter onwards, which resulted in a series of tariffs and counter-tariffs imposed by the two countries. This adversely affected investors' sentiments (Chart 3), particularly for EMEs which are more dependent on trade.

In addition, financial conditions also tightened in EMEs vis-à-vis that of AEs in 2018 due to the shift in global liquidity arising from the US monetary policy normalisation and the consequent appreciation of the US dollar. Wider growth and interest rates differentials between the US and other major economies also contributed to the strength in the US dollar, especially in the middle of the year, leading to pressures on EMEs' assets. EMEs' sovereign bond

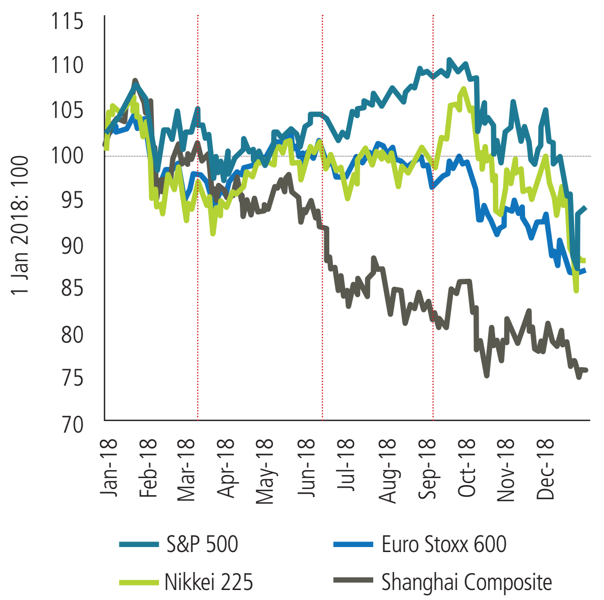
Chart 3

Trade war negatively affected investors' sentiments, leading to a marked increase in price volatility

Average daily return on selected equity markets during negative news days[1] versus normal days



Selected major equity markets performances[2]



Notes:

[1] Negative trade news days: 1 March 2018 (US announced plans to impose steel and aluminium tariffs); 22-23 March 2018 (US announced US$60 billion tariffs on imports from China pursuant to USTR Section 301 investigation, and triggered subsequent retaliation from China); 19 June 2018 (US announced additional tariffs of US$200 billion on imports from China); 25 June 2018 (Harley-Davidson announced to shift production overseas to offset EU tariffs); 6 July 2018 (US and China imposed tariffs on US$34 billion of each other's imports); 10 July 2018 (US announced additional US$200 billion tariffs on China); 20 July 2018 (US threatened to impose tariffs on all imports from China); 23 August 2018 (US and China imposed tariffs on another US$16 billion of each other's imports); 17 September 2018 (US finalised US$200 billion tariff list that is subject to 10% rate to be increased to 24% on 1 January 2019); 24 September 2018 (US imposed tariffs on US$200 billion imports from China, and China retaliated with tariffs on US$60 billion of US imports); 6-7 December 2018 (Huawei CFO arrested for alleged violation of US sanctions on Iran).

[2] Key events affecting equity market performances, as depicted by the red vertical lines: 22-23 March 2018 (US announced US$60 billion tariffs on imports from China pursuant to USTR Section 301 investigation, and triggered subsequent retaliation from China); 19 June 2018 (US announced additional tariffs of US$200 billion on imports from China); and 17 September 2018 (US finalised US$200 billion tariff list that is subject to 10% rate, to be increased to 24% on 1 January 2019).

Source: Bloomberg, SC's calculations

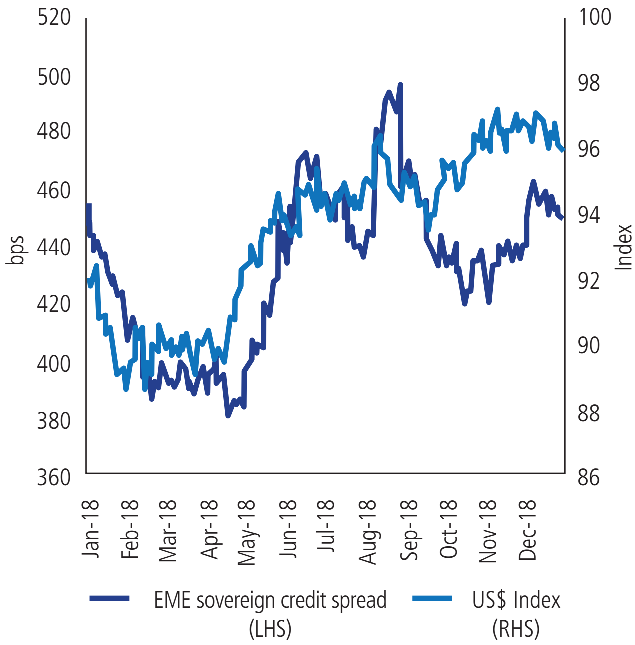
spreads also widened in line with the exchange rate dynamics. Nevertheless, the pressures were uneven across EMEs, reflecting differentiated stress conditions related mostly to economic fundamentals and policy frameworks. Emerging Asia, in particular, continued to exhibit resilient financial market performance, given the region's solid macroeconomic fundamentals and lesser dependence on external financing (Chart 4).

After a prolonged period of low volatility in the preceding year, 2018 marked the return of global financial market volatility (Chart 5), with broad-based increase in volatility across all asset classes especially in the latter part of the year. The strong equity prices at the start of the year was short-lived as the release of stronger-than-expected US labour market data led to the upward shift in US interest rates expectations. The rise in US Treasury (UST) yields accelerated in late January, preceding the US equity market correction. This subsequently spread to other major markets. Market correction re-occurred in October, triggered by unsustainably high US equity valuations on the back of challenging global macroeconomic outlook. The trend exacerbated through the final part of the year, wiping off 2018 gains as the abrupt decline in oil prices in November, alongside the inversion of the UST 5/3 yield curve in early December, collectively contributed to the widespread risk-off sentiments across all markets.

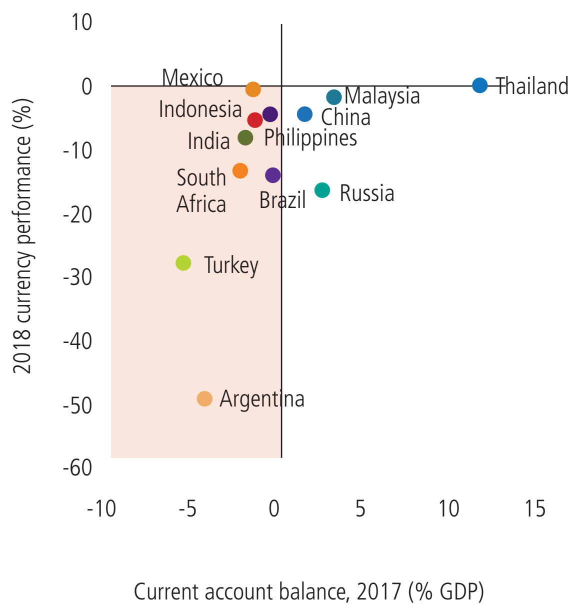
Chart 4

EMEs faced increased pressure with the strengthening of the US dollar, but the effect was not generalised and was differentiated based on macroeconomic fundamentals

US$ Index and EMEs credit spread[1]



Selected EMEs currencies' performances versus current account balances



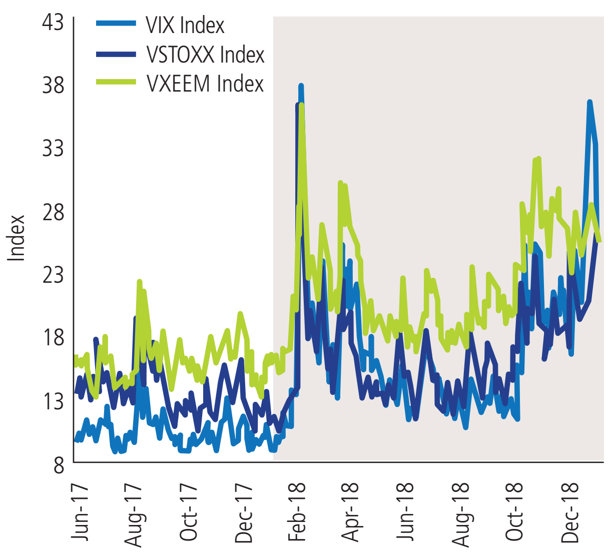
Note:
[1] JP Morgan Government Bond Index-Emerging Market (GBI-EM) spread over 10-year US Treasury

Source: Thomson Reuters Datastream, Bloomberg, IMF, SC's calculations

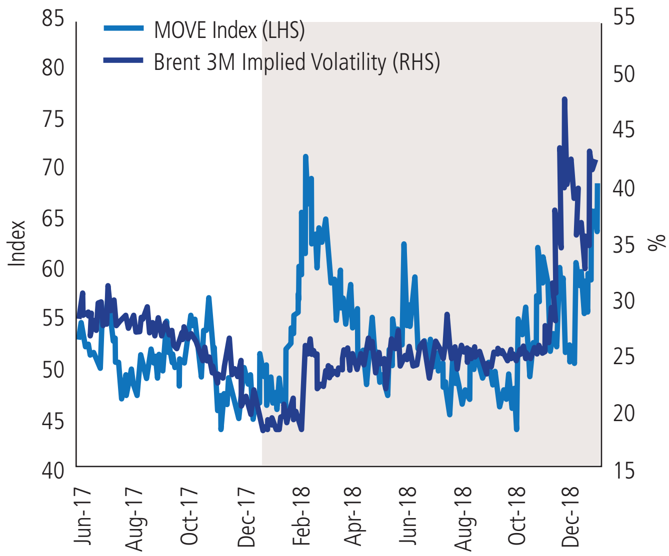
Chart 5

2018 marked the return of global financial market volatility especially in the latter part of the year

Volatility measures of major equity markets (VIX, VSTOXX, VXEEM)



Volatility measures of the US bond market and Brent crude oil prices (MOVE Index and Brent 3-month Implied Volatility)



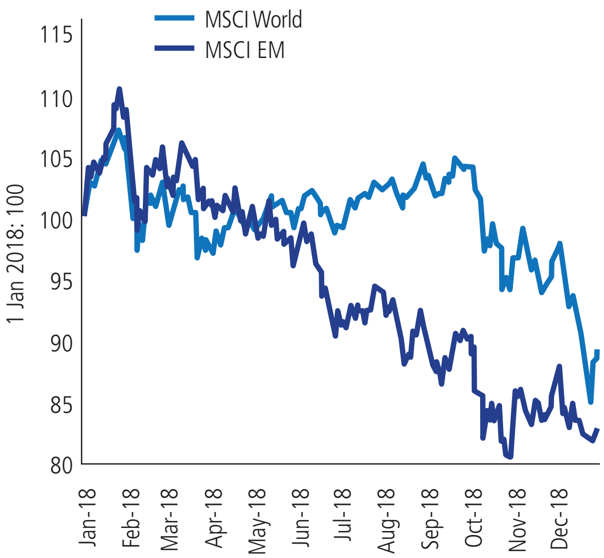
Source: Bloomberg

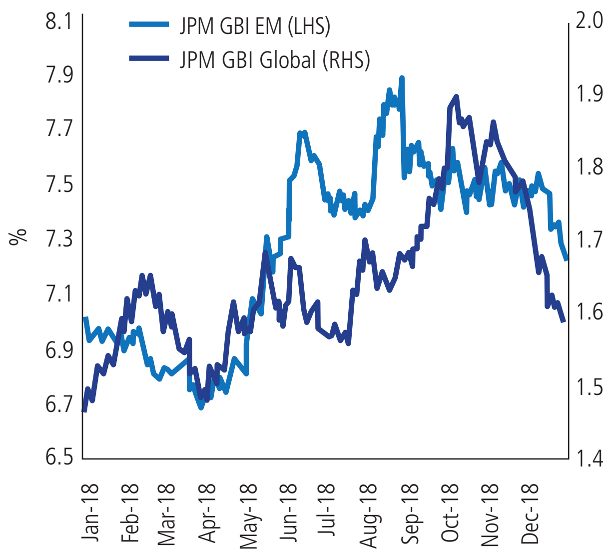
Overall, the global capital markets ended significantly weaker in 2018 (Chart 6), with higher levels of global financial market stress and volatility. In the equity market, the MSCI World ended the year -10.4% lower to 1,883.93 points (2017: 20.1% to 2,103.45 points), marking its worst annual performance since the Global Financial Crisis (GFC) in 2008. Similarly, the MSCI Emerging Markets declined by a double-digit rate of -16.6% to 965.67 points (2017: 34.3% to 1,158.45 points), and down by -24.1% from its peak of 1,273.07 points on 26 January 2018.

Meanwhile, the global bond market also ended relatively weaker as higher global interest rates drove bond yields higher with notable upward pressure among EMEs local currency sovereign bonds. However, stronger risk aversion particularly in the latter part of the year had kept long-term yields anchored, leading to a further flattening and even an inversion of the yield curve as experienced in the UST mid-range tenures in early December 2018.

Chart 6

Global capital markets ended weaker in 2018, especially for equities





Source: Bloomberg, Thomson Reuters Datastream

MALAYSIAN CAPITAL MARKET DEVELOPMENTS IN 2018

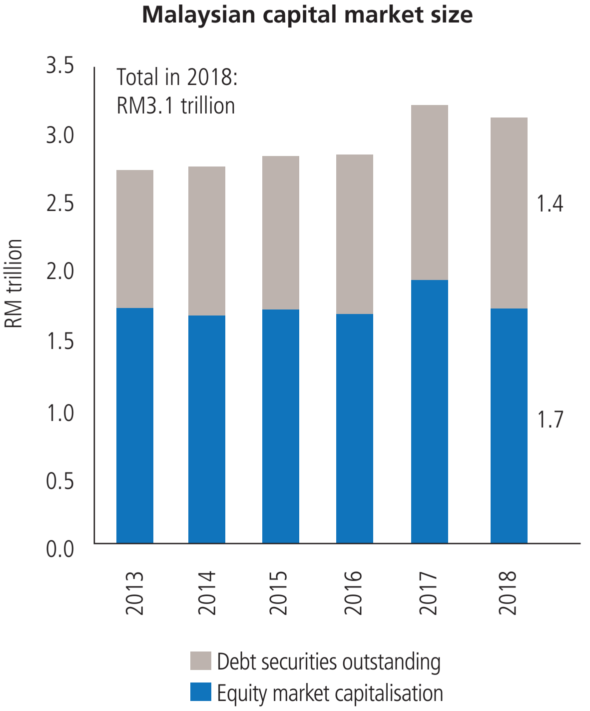
The Malaysian economy grew steadily in 2018, driven by sustained resilience in private sector activities amid a challenging global environment. Against this backdrop, the Malaysian capital market continued to play a vital role in financing the domestic economy. The total size of the capital market amounted to RM3.1 trillion in 2018, retaining above the RM3 trillion mark (Chart 7), with debt securities outstanding rising to RM1.4 trillion, while equity market capitalisation contracted to RM1.7 trillion. Overall, the non-resident portfolio outflows amounted to -RM33.6 billion in 2018 (2017: inflow of +RM2.8 billion) in tandem with regional trend, albeit at a lesser degree. A sum of 65% of the net outflow was from the bond market at -RM21.9 billion, while the remainder of -RM11.7 billion was from the equity market.

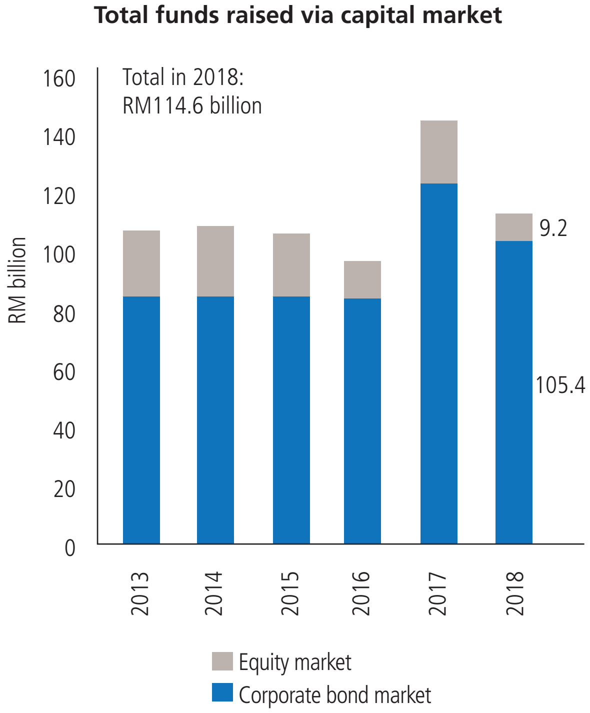
Given the challenging global environment and ongoing domestic policy reforms, the Malaysian capital market witnessed a more moderate level of fundraising activities during the year with total funds raised amounting to RM114.6 billion in 2018 (Chart 7). A total of RM105.4 billion was raised in the corporate bond and sukuk market, while RM9.2 billion was raised via the equity market. Total bond and sukuk issuance exceeded the five-year average of RM97.7 billion with new issuances mainly in utilities and financial services. Sukuk made up 68.9% of total issuances in 2018. Meanwhile, out of the total funds raised in the equity market, RM0.7 billion was raised via Initial Public Offerings (IPOs)[1] with 21 new equity listings in the primary market, and RM8.5 billion via secondary fundraising. In 2018, two companies were listed on the Main Market, nine companies on the ACE market and the remainder on the LEAP Market.

[1] Total number of IPO listing for 2018 was 22, with one IPO in a form of 'proposed listing by way of introduction of the entire issued share capital' in the LEAP market, without raising funds.

Chart 7

The Malaysian capital market continued to play a vital role in financing the domestic economy





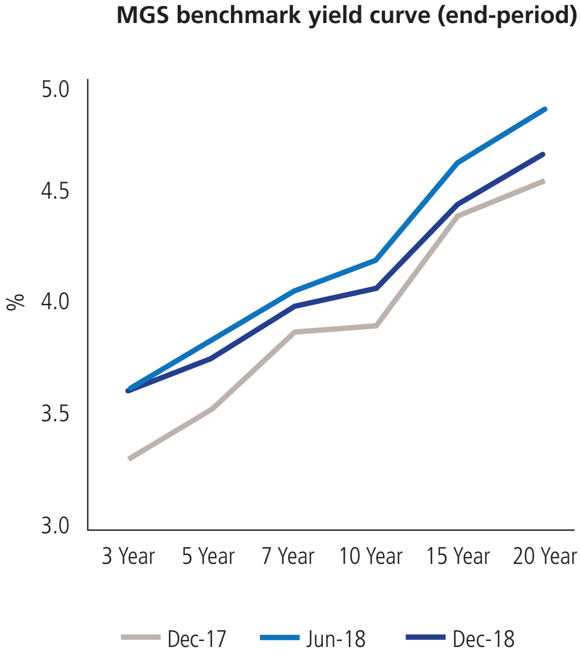
Source: SC, BNM, Bursa Malaysia

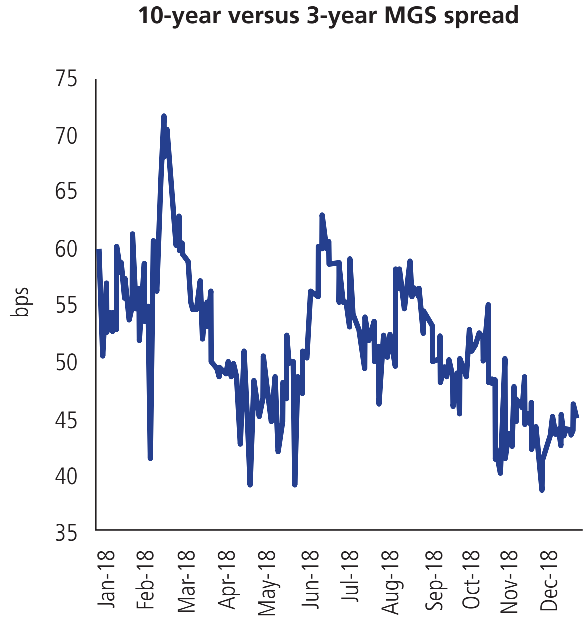
The Malaysian bond market grew 8.8% from RM1.3 trillion in 2017 to RM1.4 trillion as at end of December 2018, with Malaysia remaining as the third largest local currency bond market as a percentage of GDP in Asia in 2018, after Japan and South Korea. Ongoing trade tensions, tighter financial conditions globally due to monetary policy normalisation by major central banks and general risk-off sentiments towards emerging markets stemming from contagion fears, however, drove volatility in the bond market throughout 2018.

Malaysian Government Securities (MGS) yields experienced upward pressure across tenures during the year (Chart 8). In June, however, yields eased amid weaker inflation outlook, and as the government's focus on consolidating its fiscal position bolstered market confidence. The yield reduction extended to all tenures in July as lower inflation expectations and market's interpretation of a dovish hint by Bank Negara Malaysia (BNM) in its July Monetary Policy Committee meeting supported demand. Yields remained broadly stable thereafter

Chart 8

MGS spreads tightened in 2018





Source: Bloomberg

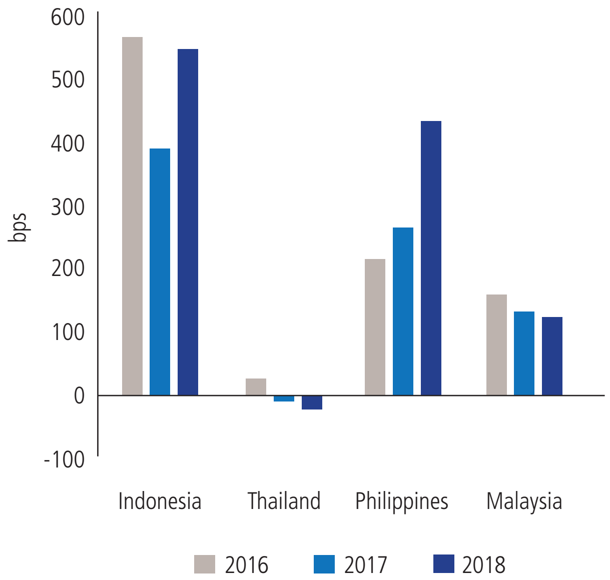
but with varying performances for longer- and shorter-term tenures. Yields on shorter tenures trended upwards over trade tension concerns and EMEs pressure while longer-term tenures trended downwards on the back of solid macroeconomic fundamentals.

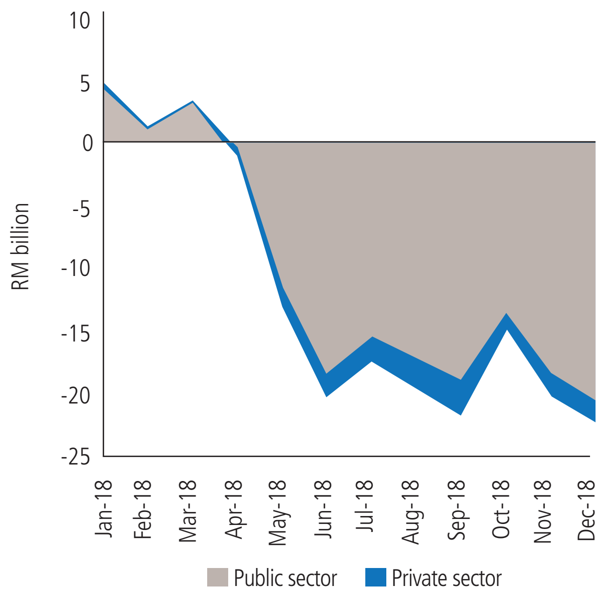
The upward pressure on sovereign bond yields was not limited to Malaysia as yields ended the year higher across other ASEAN bond markets after having fluctuated significantly throughout the year. The spread between the 10-year UST and 10-year MGS however continued to narrow on the back of strong fundamentals in the Malaysian economy and solid demand from local institutional investors. The 10-year UST/MGS spread narrowed to 139 bps as at end-2018 (Chart 9). Overall, notwithstanding the increase in Overnight Policy Rate (OPR) in January 2018, Malaysian sovereign bond yields recorded relatively small increases compared to others in the region.

Foreign holdings in domestic bonds started to decline in the first half of the year (Chart 9), in line with the shift in global liquidity away from the EMEs. Nonetheless, foreign outflows were largely absorbed by local institutions on the back of ample domestic liquidity. Total foreign ownership of domestic bonds stood at RM184.8 billion, representing 13.1% of total bonds outstanding in 2018. Foreign holdings in MGS accounted for 38.4% of total MGS outstanding, reflecting investors' long-term positive outlook on Malaysia. Meanwhile, foreign ownership in corporate bonds was little changed despite the outflows. Corporate bonds owned by foreigners remained concentrated on highly rated papers ranging from mid- to long-term tenures.

Chart 9

Sentiment towards MGS remained positive, supported by strong economic fundamentals





Source: Bloomberg, BNM

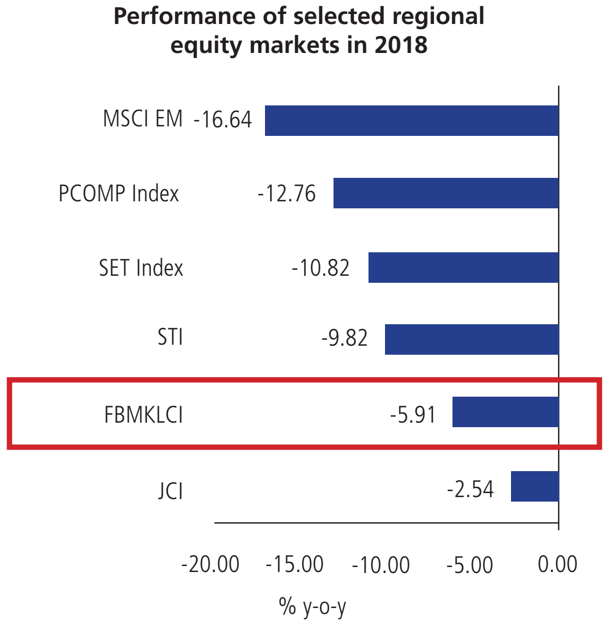
The Malaysian equity market capitalisation contracted by 10.8% to RM1.7 trillion in 2018 from RM1.9 trillion in 2017, amid challenging external developments. The domestic stock market commenced the year on a stronger footing, mirroring global equity markets performances but settled lower towards the end of the year amid heightened external headwinds from the escalating trade tensions between the US and China, the uncertainties surrounding US monetary policy tightening, fear of contagion from the EMEs and volatile oil prices.

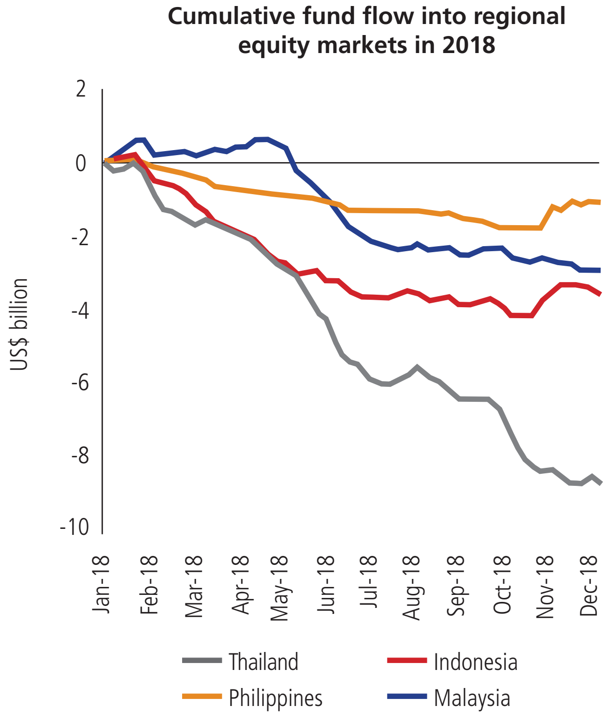
Following a year of event-driven fluctuations in sentiment, the FBMKLCI however, remained resilient compared to global and regional markets performance, declining by 5.9% to close at 1,690.58 as at end December 2018. The FBMKLCI was weighed by construction, technology and property sectors in 2018. Weak corporate earnings was also a pressure point for the FBMKLCI for the year. The Small Cap and ACE Market indices ended 2018 lower by 33.7% and 34.6% respectively, declining more towards year end on profit-taking activities (Chart 10).

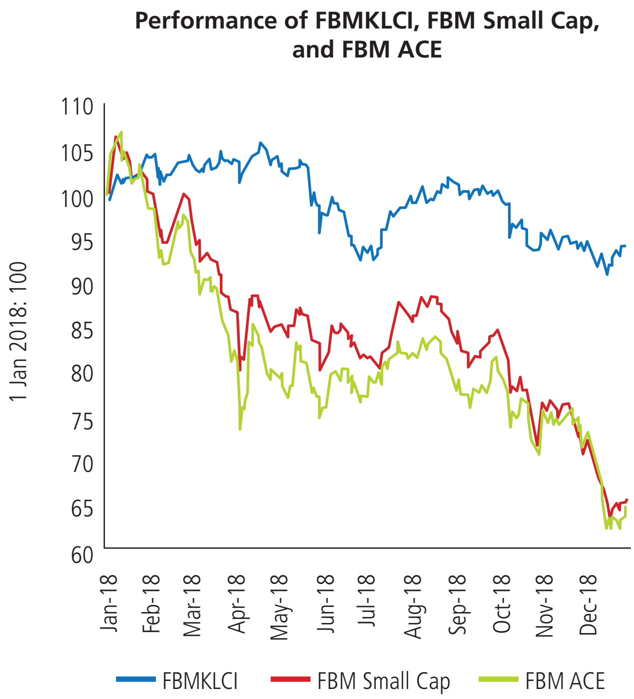
The challenging global environment also resulted in shifts in foreign investor positions throughout the year. Foreign investors registered a net outflow at the end of the year amounting to -RM11.7 billion (Chart 10). Local institutional investors turned net buyers for the year to the tune of RM7.7 billion, with the remainder taken up by retail investors, thus cushioning foreign equity outflows. The high level of domestic liquidity in the capital market allowed for sustained orderly market adjustments of funds between non-resident and local investors.

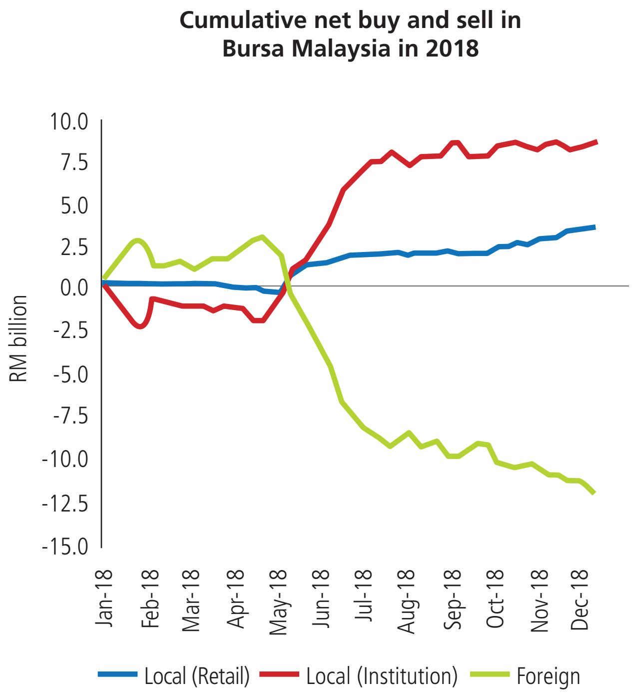
Chart 10

FBMKLCI performed relatively well in comparision to regional peers









Source: SC, Bloomberg, Bursa Malaysia

Regionally, the FBMKLCI performed relatively well. The local bourse performed better than Singapore's STI, Thailand's SET and the Philippines' PCOMP, which declined by 9.8%, 10.8% and 12.8% respectively, but behind Indonesia's JCI which fell by 2.5% for the year (Chart 10). In addition, Malaysia had a more contained outflow of funds compared to its ASEAN-4 counterparts. The outflow of funds for Malaysia was less severe than Indonesia and Thailand which both recorded net cumulative outflows to a tune of -US$3.7 billion and -US$8.9 billion respectively (Chart 10).

Meanwhile, in the fund management industry, total assets under management (AUM) for 2018 stood at RM743.6 billion (2017: RM776.2 billion). The unit trust industry remained the largest source of funds under management, with net asset value (NAV) amounting to RM426.2 billion in 2018 (2017: RM427 billion). Overall, 79.4% of the fund management industry's AUM was invested locally, of which 44.2% was in domestic equities, followed by 28.5% in money market placements and 22.7% in fixed income. Compared to 2017, investment in local equities declined in value by RM36.2 billion whereas domestic money market placements and fixed income increased by RM5 billion and RM7 billion respectively.

GROWTH OF THE MALAYSIAN CAPITAL MARKET IN THE LAST 25 YEARS: MOBILISING FINANCIAL RESOURCES FOR ECONOMIC DEVELOPMENT

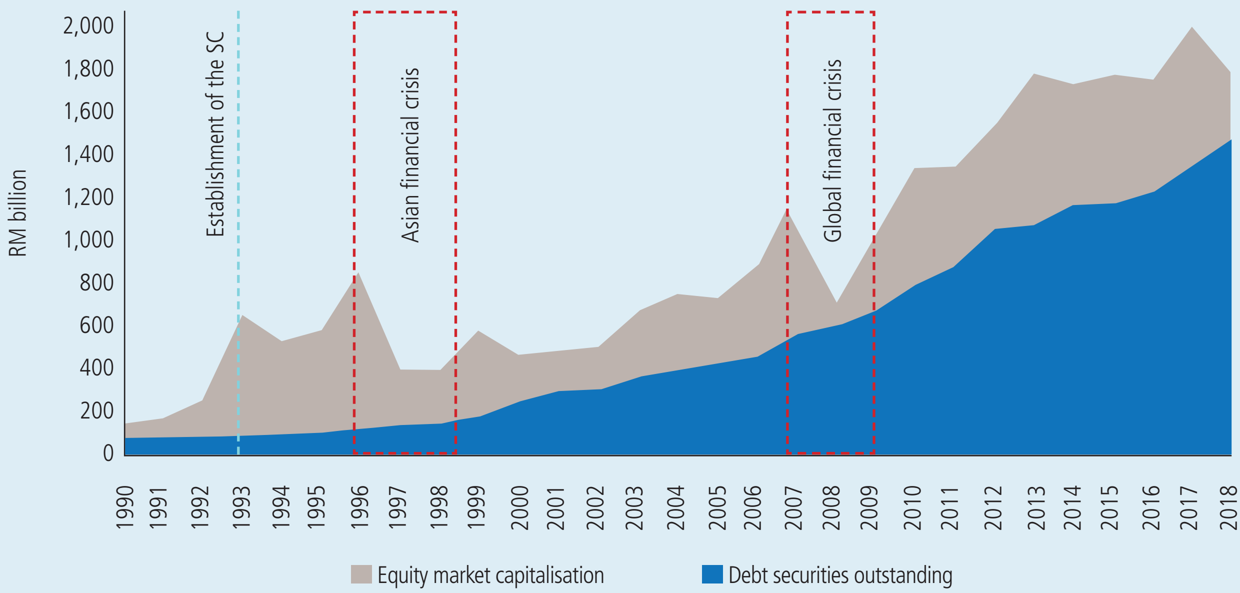
In the economic development of a country, the financial system plays an essential role in mobilising financial resources for business activities and long-term investment for future growth. This includes the capital market, which typically grows in importance as an economy becomes more developed.

The size of the Malaysian capital market was at RM699.5 billion when the Securities Commission Malaysia (SC) was established in 1993. Since then, it has increased by 4.4 times over the past 25 years – notwithstanding the adverse impacts of the 1997-98 and 2007-08 financial crises – to RM3.1 trillion as at end-2018 (Chart 11). Importantly, the capital market has also expanded its funding capacity from mainly equity financing to include debt financing. The bond market grew at a compound annual growth rate (CAGR) of 12.1% per annum (p.a.) since 1993 to account for 45.3% of the Malaysian capital market in 2018 (1993: 11.6%). The ringgit bond market is the third largest as a percentage of GDP in Asia after Japan and South Korea, and the second largest in terms of absolute size in ASEAN after Thailand.

The growth in market-based financing was in line with the structural change in the Malaysian economy, particularly following the 1997-98 Asian financial crisis. Malaysia has also been able to diversify its market-based funding avenues by developing the Islamic capital market (ICM), particularly the sukuk segment. Malaysia's ICM expanded at a CAGR of 10.9% p.a. from RM294 billion in 2000 to RM1.9 trillion as at end 2018. Sukuk continued to comprise the majority of domestic bonds outstanding in 2018, making Malaysia the largest sukuk market in the world.

Chart 11

The Malaysian capital market grew 4.4 times over the past 25 years, at a CAGR of 6.1% p.a.



Source: SC, BNM

GROWTH OF THE MALAYSIAN CAPITAL MARKET IN THE LAST 25 YEARS: MOBILISING FINANCIAL RESOURCES FOR ECONOMIC DEVELOPMENT *(Continued)*

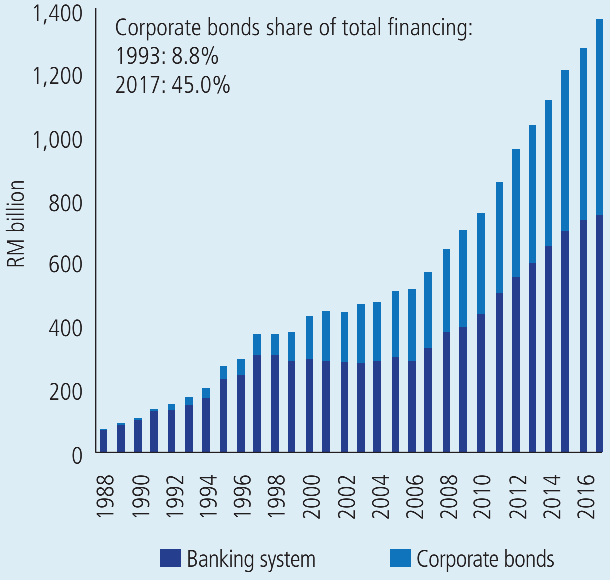
The continued growth and more diversified structure of the economy has increased the funding requirement for domestic businesses, with the debt capital market developing to become an important alternative for business financing, complementing bank credit. Corporate bonds accounted for 45% of total business financing in Malaysia as at end 2017, compared to only 8.8% in 1993.

Pension funds, insurance companies and other institutional investors have also played an important role in mobilising savings by investing in the domestic capital market. This has allowed the capital market to continue to provide long-term financing – with the thrust more pronounced in corporate bond issuances – for businesses to fund their activities and for the country's long-term economic development, including managing infrastructure development needs. The bond market has contributed to more than half of the private-sector infrastructure investments since the early 1990s. The increase in investment is characterised by the secular increase in gross fixed capital formation (GFCF) over the years (Chart 12).

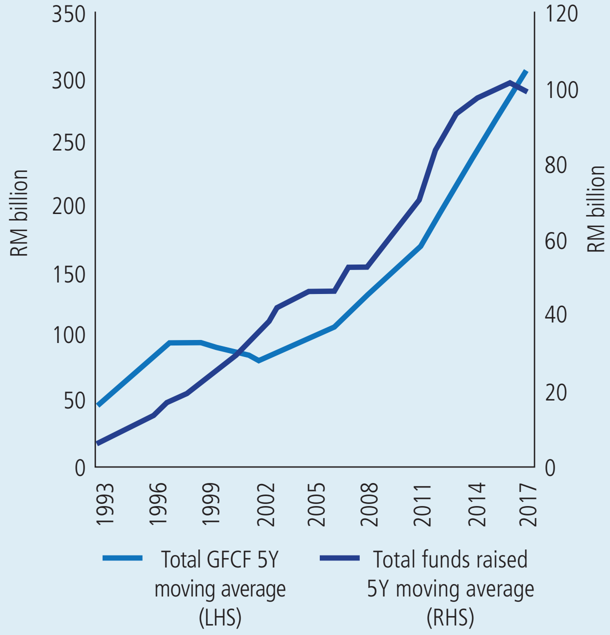
Chart 12

The Malaysian capital market continued to grow in importance, providing finance and mobilising capital to support economic development

Business financing extended via the banking system and corporate bonds



Trends of nominal GFCF(1,2) and total funds raised moving in tandem



Notes:

1 The 5-year moving average illustrates the direction of the trend for each category.

2 Total GFCF refers to private and public investment in fixed assets in the services, manufacturing, mining & quarrying, agriculture, and construction sectors. It includes land improvements; plant, machinery and equipment purchases; and the construction of roads, railways and buildings.

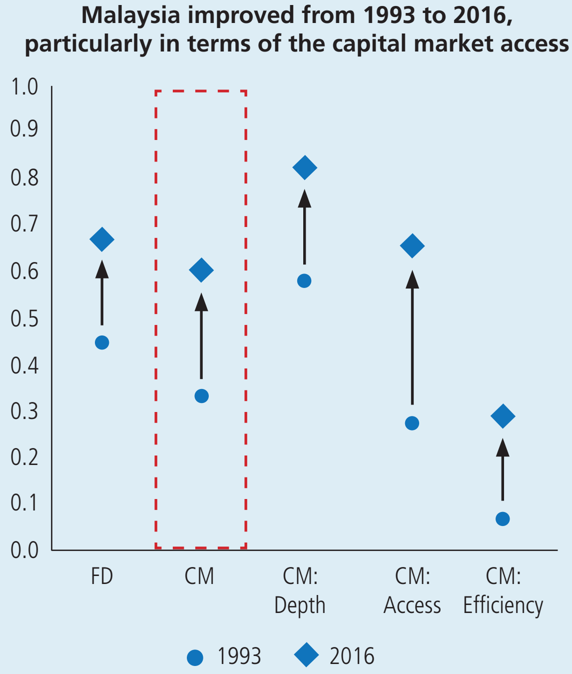
Source: SC, BNM, Department of Statistics Malaysia (DOSM)

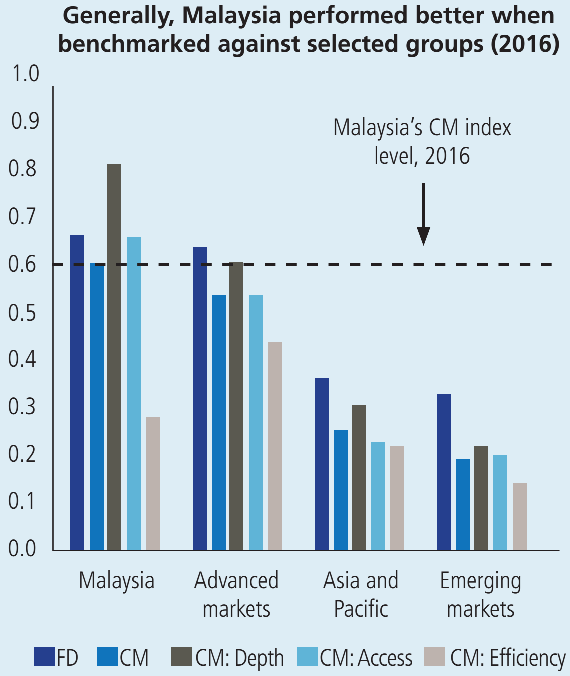
The growth of the Malaysian capital market has not been just in terms of size, as witnessed by the robust and comprehensive development in terms of infrastructure, institutions, regulations and products over the years. This progress is clearly reflected in IMF's index of financial development for Malaysia, which allows for consistent comparisons across time and between countries. Based on IMF's index, the development of the capital market can be assessed through three key dimensions – depth, access and efficiency[2].

The IMF's measurement shows that Malaysia's overall financial sector development has improved significantly between 1993 and 2016 on the back of advancement in all three dimensions (Chart 13). Notably, in terms of international comparison, Malaysia has achieved commendable performance overall and is ahead of emerging market peers and in some aspects, advanced markets (Chart 13).

Chart 13

The development of the Malaysian capital market[1] had contributed to improvement in the country's overall financial development (FD) index[2]





Notes:

[1] IMF uses 'Financial Market', which comprises bond and equity markets, to designate the capital market (CM). For consistency purposes, Financial Market is referred to as CM in this article.

[2] The indices summarise how developed a CM is in terms of (a) depth (size and liquidity of markets), (b) access (ability of individuals to access financial services), and (c) efficiency (provision of financial services at low cost and with sustainable revenues, and the level of activity of capital markets), all of which contribute towards the overall level of a country's FD.

Source: IMF Financial Development Index database, 2017

[2] *Rethinking Financial Deepening: Stability and Growth in Emerging Markets, IMF Discussion Note*, May 2015.

GROWTH OF THE MALAYSIAN CAPITAL MARKET IN THE LAST 25 YEARS: MOBILISING FINANCIAL RESOURCES FOR ECONOMIC DEVELOPMENT *(Continued)*

Over the past 25 years, the SC has invested and put in place efforts to create a facilitative ecosystem for the capital market to develop and provide productive and efficient financing of the economy. Among others, a holistic Digital Markets Strategy was rolled out in 2016 to facilitate innovative market-based solutions and develop a conducive digital finance ecosystem. In particular, to ensure that the capital market continues to provide financing for the needs of not only larger businesses but also smaller firms, alternative market-based financing avenues such as equity crowdfunding and peer-to-peer financing were introduced. This is an area in which the benefits of utilising newer technology can clearly be seen by lowering the costs of obtaining capital and enhancing transparency for smaller firms, making them more accessible and attractive to potential investors.

Going forward, as Malaysia continues to undergo structural reforms in its transition to a high-income economy, it will continue to challenge the SC in driving new initiatives that will help to facilitate the evolution of the capital market and enhance access to financing of new growth areas necessary for a more modern economy while ensuring that it remains sustainable and inclusive.

OUTLOOK FOR 2019

Global economic expansion is expected to continue in 2019, although at a more moderate pace. Major economies are on track for a synchronised deceleration in growth. Although the US economy is anticipated to grow further on the back of robust consumer spending, the momentum is expected to gradually moderate amid diminishing impact from the fiscal stimulus. In Europe, economic growth is projected to moderate as economic activities will continue to be weighed down by political uncertainties. Growth in China is poised to slow further as policymakers continue to aim for a more balanced and sustainable growth path for the economy. Against the backdrop of moderating global demand, major commodity prices are expected to remain subdued and continue to be volatile, driven by supply-related developments alongside policy and geopolitical-related risks.

Given its significant interconnectedness to the global economy, the ASEAN region is not immune to a weaker global environment and greater downside risks to global growth. Nevertheless, the region is anticipated to remain a global growth centre, anchored by firm macroeconomic fundamentals as well as favourable demographic profile and large infrastructure needs which will continue to support domestic demand. Deeper economic integration within the region will also allow the ASEAN economies to secure the benefits of higher productivity and efficiency to sustain growth over the longer term.

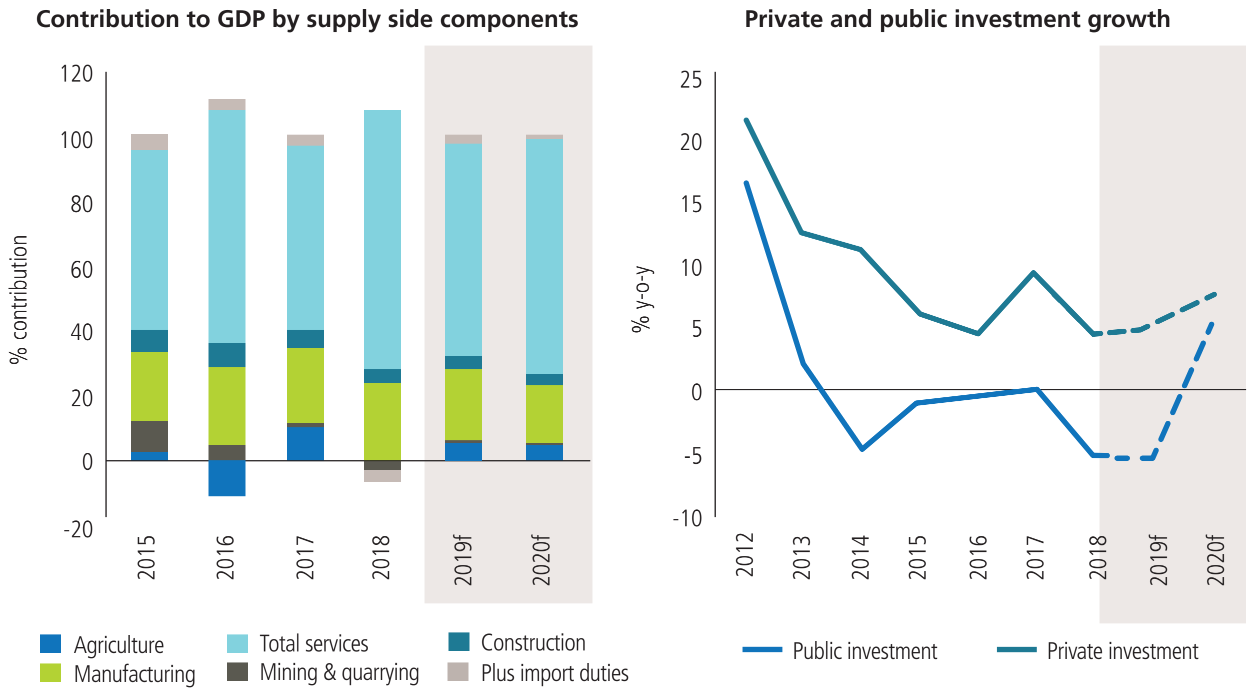
Meanwhile, the prospect of rising trade protectionism will remain a key downside risk to not only the global economy, but also global capital markets in 2019 and beyond, especially in EMEs. Although the impact thus far remained largely contained, a protracted period of US-China trade dispute can significantly derail the growth of the global economy. Over the short to medium term, continued negative trade developments could affect investor sentiments, heighten market volatility and disrupt global trade networks, thus affecting overall economic performance. Over the longer term, persistent trade uncertainties could hit real investment activities that may lead to an even lower economic growth potential because of limited productive capacity. While some Asian economies, including Malaysia, may benefit from the reconfiguration of the global trade production chain, all economies stand to lose due to overall weaker global trade and investment activities.

The global capital markets will also be characterised by the ongoing shift in global financial liquidity, mainly driven by developed markets' monetary policy normalisation. However, heightened downside risks to global growth have induced most major central banks, including the Fed, to communicate that the future pace of monetary tightening will likely be gradual and data-dependent. The flattening trend of the global bond yield curves will likely persist, catalysed by higher global risk aversion.

On the other hand, the prospects of global equities are expected to remain subdued, given persistently stretched valuations in selected key markets and diminishing earnings growth outlook. Meanwhile, credit spreads between EMEs and AEs are projected to remain relatively contained, amid the possible turnaround in global portfolio flows favouring EMEs' assets as a result of a potentially less aggressive Fed. However, investors' appetite towards EMEs' assets are likely to remain selective and in favour of economies with strong fundamentals.

Chart 14

Malaysian economy will be driven by continued expansions in manufacturing and services sector, and supported by recovery in private investment spending



Source: DOSM, Ministry of Economic Affairs, SC's calculations

Domestically, against the backdrop of a more challenging and uncertain global environment, the Malaysian economy is anticipated to remain on a steady growth path, backed by firm domestic private sector activities (Chart 14). Growth will be underpinned by sustained manufacturing activities and further supported by resilient services sector expansion, especially in wholesale and retail trade sub-sectors. On the demand side, steady wage and employment growth will continue to drive private consumption expansion while new and ongoing projects in the services and manufacturing sectors will remain supportive of private investment growth. The government's effort to promote the adoption of digital technology and automation will also be an important catalyst for future investment activities.

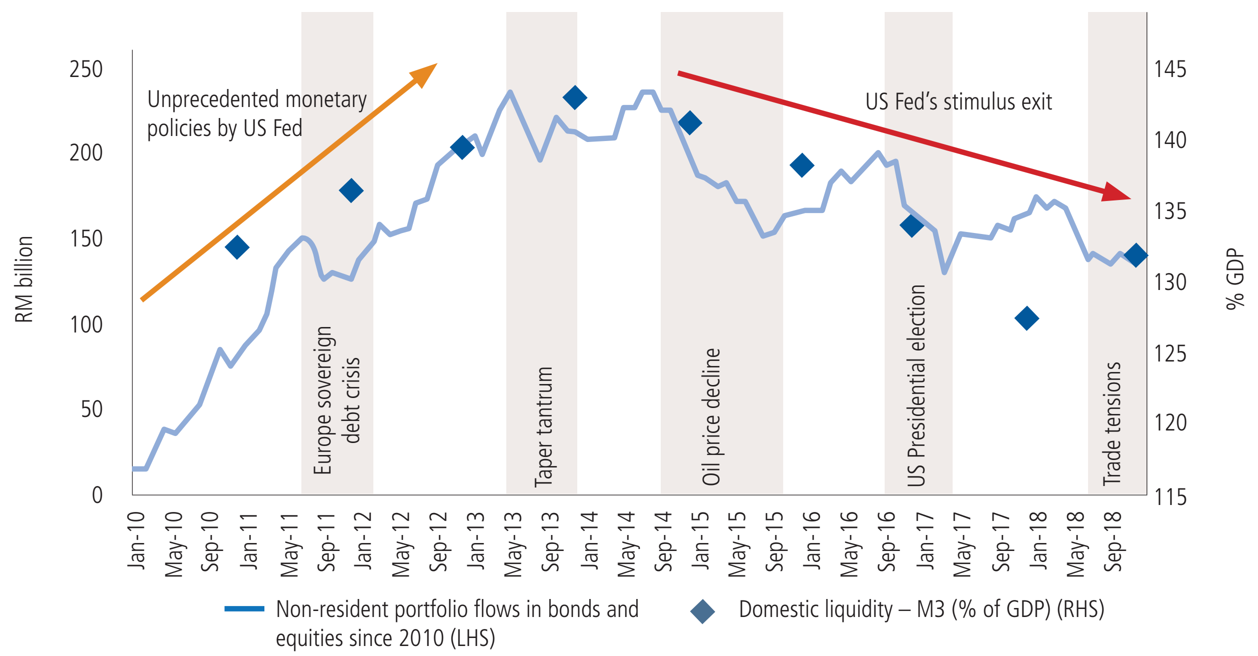
The domestic capital market will continue to play an important role in supporting economic growth through financing of business expansion and infrastructure. Total capital raising through primary and secondary issuances is expected to remain robust especially in the bond market.

Meanwhile, trading activities in the secondary market will continue to be driven by external developments, mainly movements in portfolio flows arising from the shift in global liquidity and the general increase in global financial market volatility.

Notably, the developments observed in the aftermath of the GFC indicate that the underlying trend movement in non-resident portfolio flows was, to a large extent, determined by major central banks' monetary policy directions, especially the Fed (Chart 15). Beyond the trend movement, episodes of financial market volatility post-GFC could be attributed to specific negative events ranging from the European debt crisis, taper tantrum, China's surprise yuan devaluation, the collapse in oil prices, US presidential election and more recently, the trade tension. The outlook for the domestic capital market in 2019 will continue to be influenced by key global developments, mainly the direction and pace of global monetary policy with volatility driven by continued uncertainty surrounding major risks,

Chart 15

The US monetary policy is a key factor in the underlying trend of non-resident portfolio flows in Malaysia's capital markets



Source: Bursa Malaysia, BNM, SC's calculations especially in relation to ongoing trade tension and concerns over global growth.

Nevertheless, the domestic capital market is expected to remain resilient and orderly, underpinned by Malaysia's strong macroeconomic fundamentals, deep domestic liquidity and well-developed capital market infrastructure. Importantly, the progressive development of the domestic capital market will enable it to continue to play an instrumental role in supporting longer-term economic growth through financing of business expansion and infrastructure investment as Malaysia transitions towards becoming a high-income country in the coming decade.