AMRO
ASEAN+3 MACROECONOMIC RESEARCH OFFICE

Market Insights

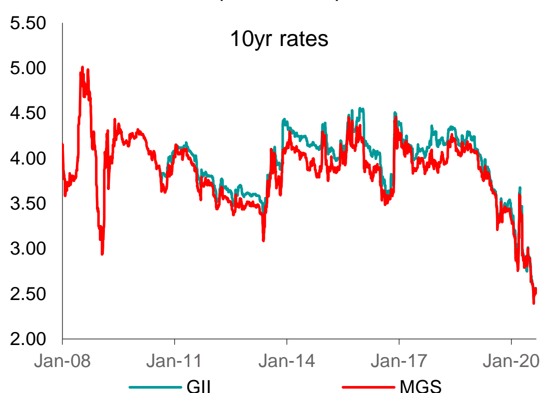
Malaysia's Bonds: Factors Behind the Rally and Outlook[1]

August 27, 2020

1. **Setting:** Malaysian government bonds—comprising both conventional bonds, i.e., Malaysian government securities (MGS), and Islamic bonds, i.e. government investment issues (GII)—have rallied significantly over the past few months. Bond markets staged a sharp recovery after the sell-off in March, and yields have moved to record lows since then, with 10-year yields falling from a year-to-date peak of 3.60 percent on March 23 to below 2.40 percent on August 5 (Figure 1). There are multiple factors that have facilitated the rally, although some of them are becoming less supportive (see below).

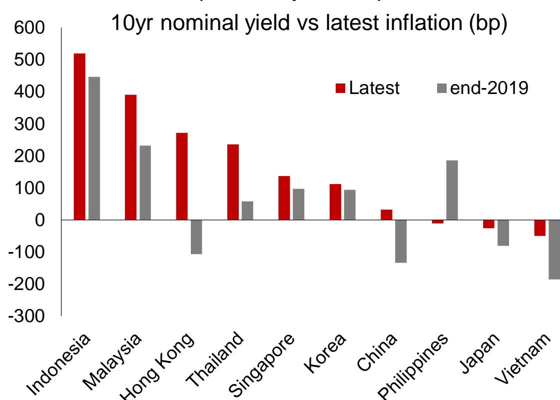
2. **Slowing inflation:** The disinflationary environment is likely the primary reason for the decline in yields. Although government bond yields are lower by almost 90 basis points year-to-date, headline inflation has softened by almost 230 basis points during this period. The lower inflation rate has increased the attractiveness of bonds despite the sizeable fall in yields. Malaysia's 10-year real yield (bond yield adjusted for headline inflation)[2] is second only to Indonesia's in the region, and is significantly higher than its end-2019 rate (Figure 2).

Figure 1. Malaysia: 10-Year Government Bond Yields
(Percent)



Sources: Haver Analytics; and AMRO staff calculations.

Figure 2. Selected ASEAN+3: Real Bond Yields
(Basis points)



Sources: Haver Analytics; and AMRO staff calculations.

[1] Prepared by Prashant Pande (Financial Surveillance), with input from Diana Del Rosario (Regional Surveillance and Malaysia desk economist); reviewed by Li Lian Ong; authorized by Hoe Ee Khor (Chief Economist). The views expressed in this note are the author's and do not necessarily represent those of the AMRO or AMRO management.

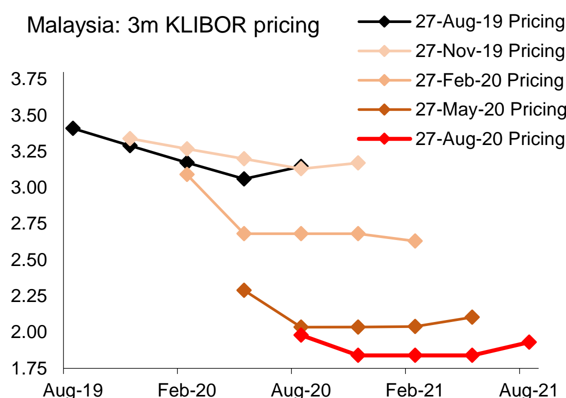
[2] Generally, bond yields should be compared with average inflation over a longer period of time (e.g., one year) when inflation movements exhibit two-way or gradual movements. However, the current backdrop is exceptional given the disinflationary pressures. Inflation expectations in such scenarios are more dependent on the latest readings rather than the trend, and hence we use the former in our analysis.

3. **Monetary easing (and expectations):** Bank Negara Malaysia (BNM) has eased policy rates by 125 basis points this year, of which 75 basis points have been delivered since March (when bond yields hit a year-to-date high). It has also led to a comparable 100–140 basis point year-to-date fall in Interest Rates Swaps (IRS), which are a reflection of the market's expectations of the future path of monetary policy. The current pricing indicates that the market is assigning a 60 percent probability of a further 25 basis point rate cut in the next three months (Figure 3). Given the low levels of inflation and growth, any expectation of rate hikes should remain at bay, thus preventing any material rise in IRS rates.

4. **Falling sovereign risk premia:** Credit default swap (CDS) spreads—a measure of sovereign risk premia—have narrowed by 135 basis points since March, creating a favorable environment for yields to fall. Spreads are still around 15 basis points wider than their pre-pandemic minimum (Figure 4). Although not a predictor of yields in Malaysia's case, a simple fair value model (rate implied by adding CDS spreads and inflation to US real rates) shows that the fall in yields is not only justified but may still have some room to continue (Figure 5).

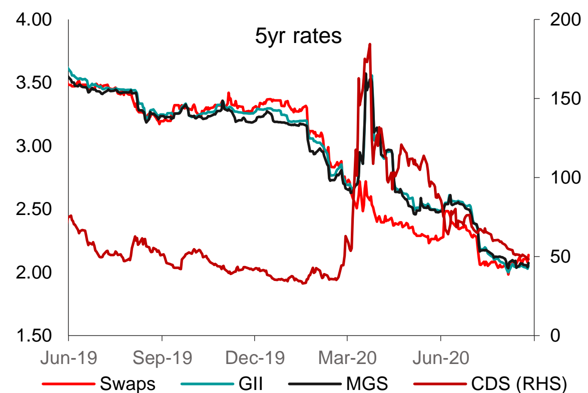
5. **Recovering foreign demand:** One key factor leading to the divergence between bond yields and IRS rates is the demand-supply environment for bonds. In March, foreign outflows pushed yields much higher than IRS (Figure 4); foreign investor interest has gradually returned since then, helping to close the gap between the two (Figure 6). An encouraging trend is the increase in holdings by foreign governments and central banks in Q1 and Q2 (Figure 7), which typically take a longer-term view and are less susceptible to fluctuations in risk sentiment. Although foreign holdings of government bonds have declined from 36 percent (of the outstanding nominal amount) in October 2016, to 23.5 percent currently, foreign investors remain a key source of demand for Malaysian government bonds, especially MGS, holding 38 percent of the outstanding nominal amount (Figure 8).

Figure 3. Malaysia: Swap Implied Pricing of 3-Month KLIBOR
(Percent)



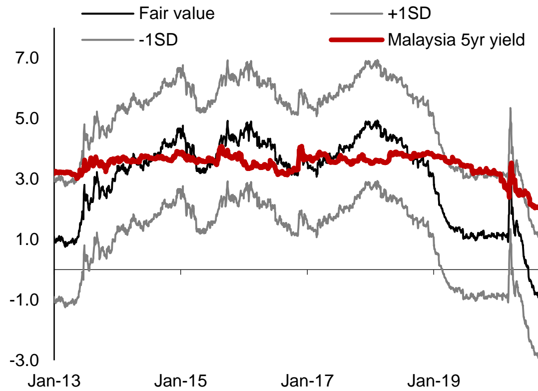
Sources: Haver Analytics; and AMRO staff calculations.
Note: The curve for a particular date shows 3m KLIBOR and 3m swap rates in 3m, 6m, 9m and 12m forward swap.

Figure 4. Malaysia: 5-Year Credit Default Swap Spreads, Bond Yields, and Swap Rates
(Percent; basis points)



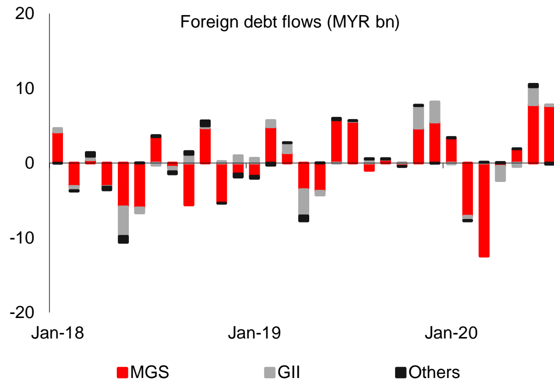
Sources: Haver Analytics; and AMRO staff calculations.

Figure 5. Malaysia: 5-year Bond Yield—Fair Value
(Percent)



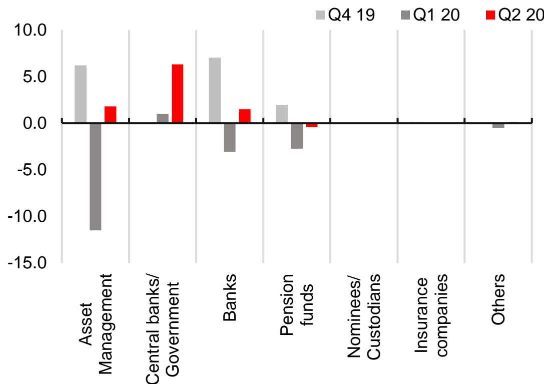
Sources: Haver Analytics; and AMRO staff calculations.
Note: Fair value is implied by adding the 5-year CDS spread and headline inflation to the US 5-year real yield. The standard deviation of fair value is based on January 2007 to latest available reading.

Figure 6. Malaysia: Foreign Flows into the Bond Market
(Billions of ringgit)



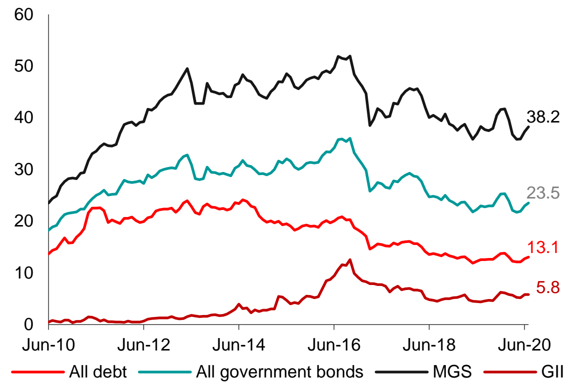
Sources: Haver Analytics; and AMRO staff calculations.

Figure 7. Malaysia: Foreign Inflows by Type of Investors
(Billions of ringgit)



Sources: Bank Negara Malaysia; and AMRO staff calculations.
Note: Quarterly flows estimated by AMRO based on proportional holdings of investors published by Bank Negara Malaysia.

Figure 8. Malaysia: Foreign Holdings in Debt Markets
(Percent of Outstanding)

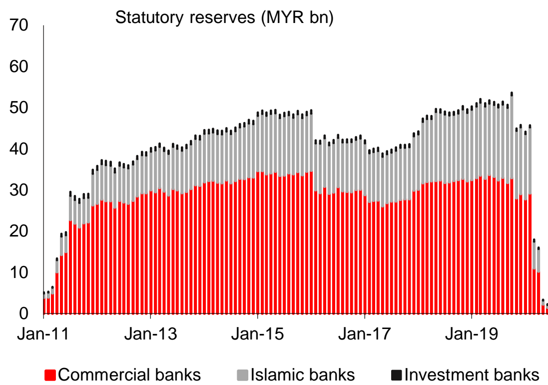


Sources: Haver Analytics; and AMRO staff calculations.

6. **Supportive domestic demand:** BNM's actions to ease liquidity conditions have also been favorable for bonds. Liquidity easing through the 100 basis point cut in the Statutory Reserve Requirement (SRR) in March, and allowing the inclusion of both MGS and GII in banks' SRR in March and May, released almost MYR 44 billion of liquidity, which would have (at least partially) found its way into government bonds (Figure 9). BNM also supported bond markets during the exodus of foreign investors in March and April by increasing its holdings of government debt (Figure 10). Liquidity received another boost from the rise in bank deposits relative to loans (Figure 11), which would have fed into bank demand for government bonds—commercial banks significantly increased their investment in both government bonds and treasury bills in 2020, holding almost a third of the outstanding nominal amount.

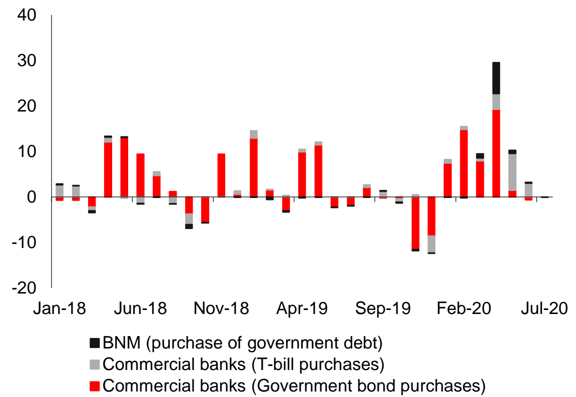
7. **Subdued supply:** The increase in bond supply has been limited. The net issuance planned for 2020 was MYR 53 billion and the fiscal stimulus in response to the pandemic is expected to add another MYR 35–45 billion in net supply—a significant rise in funding needs. However, the absence of a sharp pick-up in gross supply thus far may have helped reduce market concerns over a surge in issuances (Figure 12).

Figure 9. Malaysia: Statutory Reserves of Banks
(Billions if of ringgit)



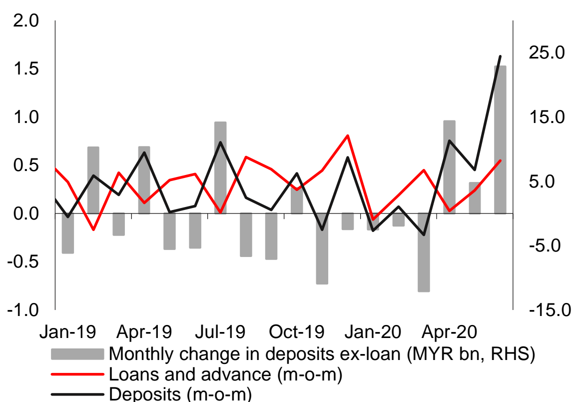
Sources: Haver Analytics; and AMRO staff calculations.

Figure 10. Malaysia: Net Purchase of Government Securities by BNM and Commercial Banks
(Billions of ringgit)



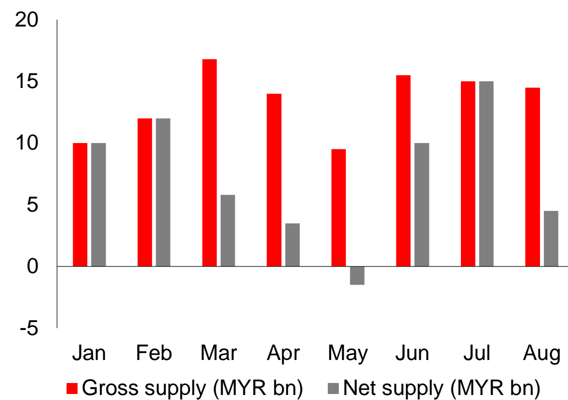
Sources: Bank Negara Malaysia; and AMRO staff calculations.

Figure 11. Malaysia: Deposit versus Loan growth
(Percent month-over-month; billions of ringgit)



Sources: Haver Analytics; and AMRO staff calculations.

Figure 12. Malaysia: Supply of Government Bonds
(Billions of ringgit)



Sources: Bank Negara Malaysia; and AMRO staff calculations.

8. **Comparison with peers:** Among quantifiable factors, easing inflation seems to be the most important factor for Malaysia (Figure 13). Philippine bonds have been the regional outperformers but proactive and large monetary easing—which was partly enabled as a result of the significant slowing in headline inflation in 2019—has been the largest contributor to their rally. Inflation weakened significantly in Thailand but limited room for further monetary policy easing constrained any upside for bonds. Meanwhile, the lack of any sizeable pick-up in Indonesian bond markets may be partly attributable to the rise in its sovereign CDS spreads. Yields in both Hong Kong and Singapore have been driven by the move lower in US rates, as well as by the easing in inflation and flows related to carry trade and flight-to-quality, respectively.

Figure 13. Selected ASEAN+3: Bond Yields, Inflation, Policy Rates, and CDS Spreads
(basis points)

(year-to-date)	Δ10yr yield	Δheadline inflation	Δpolicy rate	Δ5yr CDS
China	-13	-179		4
Hong Kong	-134	-512		7
Japan	6	-49		-3
Korea	-27	-45	-75	0
Indonesia	-32	-105	-100	35
Malaysia	**-72**	**-231**	**-125**	**13**
Philippines	-175	22	-175	13
Singapore	-78	-117		2
Thailand	-9	-186	-75	14

Sources: Haver Analytics; and AMRO staff calculations.

9. **Looking ahead:** On balance, we still see room for further upside in Malaysian bonds but much of the rally is likely behind us:

- There is probably room for another 25 basis point policy rate cut; CDS spreads could narrow further to pre-pandemic levels as economic activity resumes; and foreign investor demand could pick up if the global risk backdrop remains favorable.

- Developments around bond index inclusions will also play a crucial role in determining the trajectory of yields. Malaysian bonds constitute 0.4 percent of the FTSE Russell's World Government Bond Index and are currently on the watch list for a potential downgrade (and removal) in September. Market estimates suggest that removal from the index could trigger around USD 4–6 billion in outflows from Malaysia's bond market. On the other hand, bond prices could strengthen if Malaysia were to remain in the index, given that markets may have already priced in some probability of the event.

- A few factors have also turned less supportive of bonds. Inflation appears to have bottomed out from April/May, and the cheapness of bonds versus IRS has dissipated. The SRR has also dropped to MYR 2.3 billion (as of June), which limits the amount of liquidity that can be released through conventional measures such as SRR cuts. Hence, further liquidity support may have to come through market operations and bond buying. That said, subdued credit growth may support banking system liquidity amid rising deposits.

- The risk of a pick-up in supply remains. In order to meet the issuance target, the average issuance for the rest of the year is estimated to be MYR 14 billion (gross) and MYR 9.1 billion (net) as compared to the actual issuance of MYR 13.3 billion and MYR 7.8 billion respectively, from January to July. There is a proposal to temporarily raise the public debt–to-GDP ceiling from 55 percent to 60 percent until end-2022. It would open up the possibility of markets pricing in increased supply in the coming years.