An Update on the
Malaysian Bond Market

Summary

The Malaysian bond market is underpinned by the pause in U.S. interest rate hikes, sustained demand for domestic bonds and resilient economic growth.

The Malaysian bond market has performed well in the first half of 2019, with prices of both government and corporate bonds rising as yields declined. As bond yields and bond prices are inversely related, bond prices rise when bond yields fall, and vice-versa.

Looking ahead, three factors should help to underpin the domestic bond market:

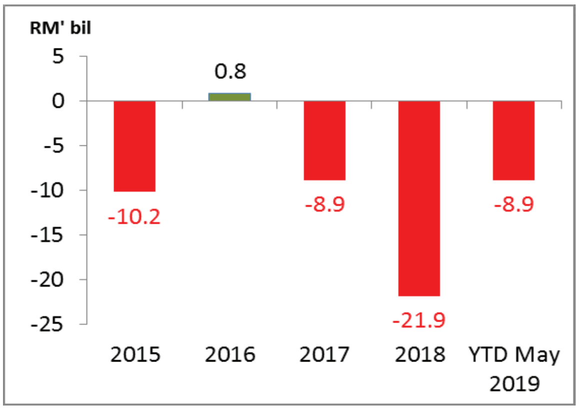
1. Peaking in the U.S. Interest Rate Cycle

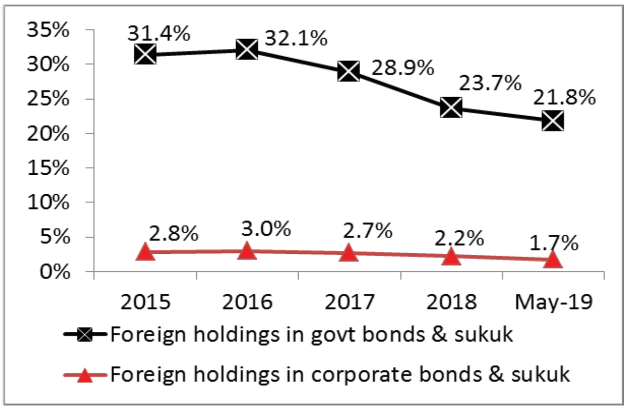
The U.S. Federal Reserve (Fed)'s signal for a pause in its interest rate hikes amid softer U.S. economic growth and low inflation has contributed positively to the bond market for 2019 to-date.

Since 2015, the Fed has raised its funds rate nine times to normalise its interest rate policy. As global funds exited the emerging markets in favour of U.S. bonds, the Malaysian bond market has registered foreign fund outflows amounting to RM49.1 billion since then.

Consequently, foreign holdings in Malaysian government bonds and sukuk fell to a multi-year low of 21.8% as at end-May 2019 from 31.4% in 2015. Likewise, foreign holdings in corporate bonds and sukuk dropped to 1.7% from 2.8% over the same period.

Fig. 1: Foreign Flows and Foreign Holdings in Government & Corporate Bonds





Source: Bank Negara Malaysia's Monthly Statistical Bulletin, May 2019

With rising expectations that the Fed may cut interest rates later this year after signalling a pause in rate hikes, Malaysian debt securities may potentially see renewed foreign interest. This may, in turn, lead to higher bond and sukuk prices as foreign flows return.

Both government and corporate bond prices have been increasing in response to this positive development. The yield of 10-year Malaysian Government Securities (MGS) declined by 47 basis points (bps) from 4.10% as at end-2018 to 3.63% as at end-June 2019, while the yield of 10-year AA1-rated corporate bonds fell by 50 bps from 4.74% to 4.24% over the same period.

2. Favourable Demand Dynamics

There has also been strong demand for domestic bonds amid the growing size of funds managed by domestic institutional investors, that invest in bonds to generate recurring income. Bonds provide regular income to investors via coupon payments.

As the fund size of domestic institutional investors (which comprises pension funds, mutual funds and insurance companies) is expected to continue expanding, demand for domestic bonds is likely to increase. The presence of domestic institutions which generally have a long-term investment horizon and a need for recurring income helps provide stability to the bond market.

3. Resilient Economic Growth Outlook

Bank Negara Malaysia's (BNM) forecast for real GDP growth of between 4.3% and 4.8% in 2019 is supportive of the domestic bond market. Due to the resilient economic growth outlook, Malaysia's investment-grade sovereign credit rating of A-/ A3 with a stable outlook was reaffirmed by international rating agencies such as Fitch and Moody's in the first half of 2019.

To mitigate the impact of external uncertainties amid the U.S.-China trade war, BNM reduced its Overnight Policy Rate (OPR) from 3.25% to 3.00% on 7 May 2019. The reduction in the OPR has resulted in lower bond yields and higher domestic bond prices. Moving forward, domestic monetary policy is expected to remain accommodative to sustain economic growth.

Conclusion

As the outlook for Malaysia's bond market is envisaged to be underpinned by the peaking in the U.S. interest rate cycle, favourable demand dynamics and resilient economic growth, investors can consider investing in bond funds to provide stability to their investment portfolios and generate recurring income. A well-structured unit trust investment portfolio should be diversified across equities, bonds and money market instruments in line with investors' risk profiles and financial goals. The allocation to bond funds in the portfolio should be higher if the investors' requirement for distribution of income or lower volatility of returns is more important.