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Yields of longer term MGS remain volatile

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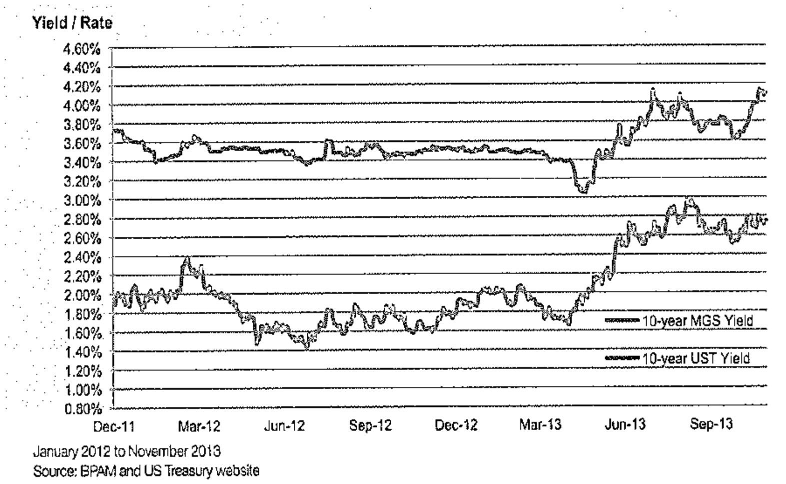
THE YEAR 2013 started off with the US Federal Reserve's (US Fed) large-scale asset purchases (LSAPs) or more commonly known as the quantitative easing (QE) programme continuing to inject much-needed liquidity into the US banking system for which the effects were felt globally. Emerging-market assets such as Malaysian government securities (MGS) were highly sought after by international investors as Malaysia's economy had withstood the financial turbulence emanating from advanced economies pretty well. Despite external headwinds, Malaysia's gross domestic product (GDP) had recorded a robust growth of 5.6% in 2012 amid a benign inflationary environment as the consumer price index (CPI) printed an average 1.6% increase in the same year. In addition, foreign inflows continued to surge throughout 2012 judging from the foreign holdings of MGS, which had increased from 36.92% at the end of 2011 to 44.39% of total outstanding as at December 2012.

As a result, the remarkable economic achievement in 2012 coupled with increased foreign holdings have underpinned the MGS yields for the first four months of 2013 with the benchmark 10-year MGS yield ranged narrowly between 3.37% and 3.54%. Subsequently, with the conclusion of the 13th general election (GE13) on May 5, the 10-year MGS yield started to trend downwards as investors viewed the GE13 result favourably. It reached a low of 3.05% on May 20 from its 3.39% yield level just before GE13.

However, towards the end of May, the 10-year MGS yield started to climb upwards as the then US Fed chairman Ben Bernanke first hinted, in his response to the US Congress Joint Economic Committee on May 22, that the LSAPs will be scaled back if supported by incoming economic data. His remarks were viewed as hawkish in nature and global financial markets started to experience heightened volatility amid the Fed's QE tapering concern. Since then, the 10-year US Treasury (UST) spiked from below 2.00% to 2.86% on Sept 17, a day before Bernanke reassured investors that the quantum of its QE will be maintained as the Fed had decided to wait for more evidence that the economic progress could be sustained before adjusting the pace of its asset purchases. Bernanke's statement had managed to calm the market and eased investors' concerns as the 10-year UST yield began to halt its ascent and averaged about 2.67% since then until the end of November 2013.

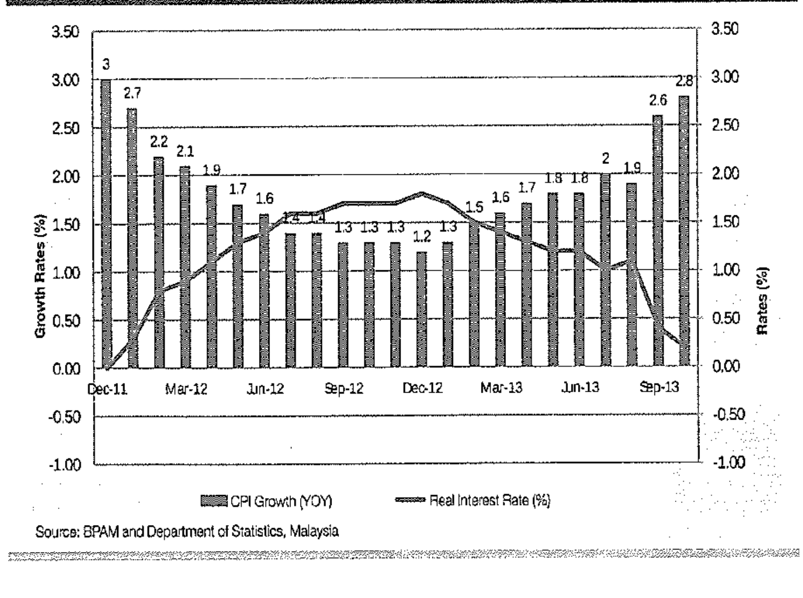
On the domestic front, from May 23 to Sept 18, the 10-year MGS yield had increased from 3.15% to 3.74%, which were mainly a direct result of foreign outflows as the climb in UST yields has provided foreign investors a valid reason to reduce their exposure to emerging-market assets, including the MGS. The foreign outflows were evident as the foreign holdings of MGS declined substantially from RM144.5 bil to RM128.1 bil during the same period and further substantiated by the weakening of the ringgit against the US dollar (USD) from 3.0330 to 3.2340.

10-year MGS yield vs 10-year UST yield



January 2012 to November 2013
Source: BPAM and US Treasury website

CPI growth rates vs real interest rates



Source: BPAM and Department of Statistics, Malaysia

Since the beginning of September, the Malaysian government's fuel subsidy cut and subsequently the removal of the sugar subsidy during the 2014 budget announcement had resulted in the leap in the CPI reading from 1.9% in August to 2.6% in September, which had inched up further to 2.8% in October. With rising fears of a cost push inflationary environment, the 10-year MGS yield once again crept up from 3.63% to 4.09% from end-October to end-November 2013. Despite Moody's Investors Service's recent upgrade of the Malaysian sovereign rating outlook from stable to positive on the back of improved prospects for fiscal consolidation adopted by the Malaysian government and continued macroeconomic stability, the yields of longer term MGS papers remain volatile, suggesting growing concerns over inflationary pressures going forward.

With the latest market consensus showing that the Fed is expected to scale back its LSAPs by the middle of next year and with the announcement on Dec 2 of a hike in electricity tariff by an average of 14.89% for Peninsular Malaysia, and 17% for Sabah and Labuan effective Jan 1, 2014, the ringgit bond market is expected to remain subdued as tapering concerns in the US and domestic inflationary concerns weigh on the MGS market and the general market as a whole.

Ultimately, with the recent fall in current account surplus over the past few quarters, the savings-investment gap has also narrowed in tandem. With the real interest rate falling to a mere 0.2% in the month of October, it is not impossible for Bank Negara Malaysia to raise the benchmark interest rate in order to encourage savings next year, a decision which would also be dependent on upcoming economic data such as GDP growth, CPI, current account balance and not forgetting the dynamics of foreign outflows with regards to Malaysia's external position and its foreign reserves once the Fed begins scaling back its LSAPs.

Therefore, bond investors should brace for market uncertainty and embrace the heightened volatility that comes with it.