Ringgit bonds facing bearish demand

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RAM Rating Services Bhd senior economist and head of economic research Woon Khai Jhek

PETALING JAYA: The demand for Malaysian bonds by foreign investors is likely to take a hit in the near term as the United States Federal Reserve (Fed) signals higher interest rates for a longer duration.

Fixed-income analysts said although foreign investor holding of ringgit bonds may be impacted due to higher interest rates in the United States and other developed economies, nonetheless the local bond market may to an extent hold up as it is well supported by local institutional investors.

RAM Rating Services Bhd senior economist and head of economic research Woon Khai Jhek

He said this is expected to dampen foreign investor demand for Malaysian bonds.

There are also market jitters surrounding the lofty interest rate levels and how it will place a huge debt-servicing burden on the government's fiscal position, he said.

Furthermore, he said the current negative yield differentials between US Treasuries (UST) and Malaysian Government Securities (MGS) also provide less of an incentive for investors to build up positions in the Malaysian market.

Contrary to market bets, the Fed "dot plot" for September not only maintained its expectation of one more 25-basis-point (bps) hike by end-2023, but also revised its interest rate forecast for 2024 and 2025 upwards.

The Fed now projects only two 25 bps rate cuts in 2024, as opposed to the four forecast in June this year.

The Fed "dot plot" shows the interest rate projections of individual Federal Open Market Committee members and is one of several ways investors try to anticipate future interest rate moves.

The recent selldown in the US bond market triggered a global bond rout. The impact was also evident in Malaysia as seen with the large net foreign outflow over the last two months (August: RM5bil; September: RM4.4bil), which narrowed cumulative net inflow to RM23bil.

Similar foreign selldown was also seen among regional emerging market (EM) peers such as Thailand and Indonesia.

Woon, however, said the country should see a return of foreign buying once some of the current market jitters subside and investors' current repricing run of the bond market ends.

"While the market may have underestimated the current interest rate path, the view that the Fed is nearing the end of its rate tightening cycle still holds.

"The limited upside for bond yields and recovery in market sentiment will help increase the attractiveness of bonds as an asset class and drive increased appetite for riskier EM assets, including Malaysian bonds.

"Though Malaysia may not attract 'yield-seeking' investors given the unattractive yield differentials against UST, the better overall market conditions should still support demand from investors looking to rebuild their EM exposure and diversification purposes," Woon said.

Foreign interest towards the Malaysian bond market has been surprisingly resilient for the first seven months of this year, with successive month-on-month (m-o-m) net inflow totalling RM32.4bil.

This is despite the still elevated UST yield and unattractive yield differential between MGS and UST, where the latter has consistently been narrowing since the start of the year.

From January till December 2022, total net outflow from the local bond market stood at RM9.8bil.

Bond Pricing Agency CEO Meor Amri Meor Ayob

Bond Pricing Agency Malaysia (BPAM) chief executive officer Meor Amri Meor Ayob said that on the contrary, the ringgit bond market has performed quite well year-to-date.

He said the benchmark RF BPAM All Bond index has risen by approximately 4% as of Oct 19 this year compared to equities, which reported a negative return during this period.

He acknowledged that higher interest rates in the United States and Europe did impact the local bond market, as foreign holdings in the MGS space have been trending lower since last year when the Fed started to hike interest rates.

He said it is inevitable for foreign investors to sell local bonds and buy US bonds as they offer higher interest rates.

That said, Meor Amri said the ringgit bond market is well supported by institutional investors with local mandate in flight-to-quality flows attributed to lacklustre performance in the stock market.

He said whether foreign funds would invest in the local bond market for the remainder of the year hinges on the Fed's monetary policy stance and the UST yields.

If the Fed is hawkish and the UST yields continue to rise, there is a possibility for foreign funds outflows for the remainder of the year.

"The growth driver for the local bond market this year will stem from the government's fiscal consolidation drive, which will widen the revenue base and gradually reduce subsidies as unveiled in the recent Budget 2024.

"The government had proposed to increase the sales and service tax rate and had introduced capital gains tax on sale of unlisted shares in addition to the luxury goods tax. The proposals are expected to bolster the government's fiscal position.

"However, the challenges faced by the local bond market include the higher external interest-rate environment, weakening external demand that could derail the growth projection and higher consumer prices resulting from the surge in global commodity prices," Meor Amri noted.

Maybank Investment Banking Group head of fixed Income research Winson Phoon

Maybank Investment Banking Group head of fixed-income research Winson Phoon expects foreign flows to stay choppy in the coming months due to the fast-evolving global risk landscape but still anticipates net inflow for the year, given the already large cumulative net gain in the first half-year.

"So far this year, the ringgit government bonds still managed to generate a total return that beats domestic equity and cash, although the recent correction in bond yields has trimmed the gain.

"In addition to external challenges from UST volatility and foreign flows, one domestic challenge in the fourth quarter of the year is the heavier government bond supply, as more MGS and Government Investment Issues (GII) issuances are needed to fund the planned reduction in Malaysia's treasury bills at an unexpectedly sharp pace."

Phoon, who is forecasting the benchmark 10-year MGS yield to hover at 3.80% by year-end, said he expected corporate bond returns to slightly outperform the MGS for the year.

Meanwhile, MARC Ratings Bhd said that in the upcoming months, ongoing volatility in foreign flows would likely be due to cautious market sentiment tied to the release of inflation and growth data as well as further comments from the Fed.

“Going into 2024, we expect the US dollar rally to lose momentum and the anticipated cut in the Fed fund rates to support foreign fund inflows into the local bond market. “Nonetheless, we anticipate volatility to persist as expectations shift during reassessments,” it said.

On the growth drivers and challenges in the local bond market, MARC said the expectations for easing inflation trends, unchanged Bank Negara policy rates and gradually improving fiscal metrics would likely help to offset the risk of the bond yield upsurge.

However, foreign investors reacting to the ongoing depreciation of the ringgit would add to the challenges in the local bond market, the rating agency noted.

On the MGS and GII issuances for this year, MARC expected it to be at RM185bil to RM190bil, while corporate bonds are expected to be at between RM60bil and RM70bil.

RAM Ratings is projecting MGS and GII issuance to rise to between RM170bil and RM180bil this year compared with RM171.5bil last year.

For 2023, RAM expected the volume of corporate bonds to normalise to between RM120bil and RM130bil, backed mainly by infrastructure financing and financial institutions’ capital augmentation plans.

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