

The Malaysian Government Bond Market Outlook 2H2010: Yield Curve to Bearish Steepen

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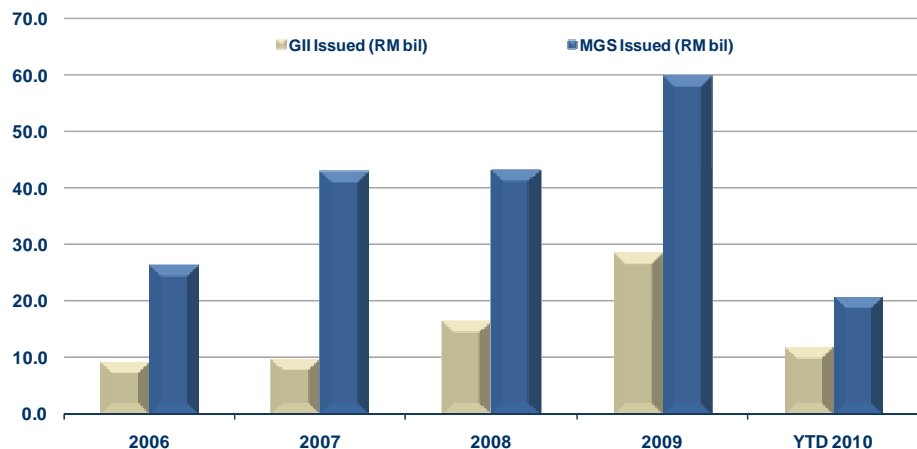
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Summary

- With the government tapping the non-ringgit market and the lower deficit forecast for 2010, we are revising our MGS/GII issuance target lower in the range of MYR50 billion to MYR55 billion from our previous estimate of between MYR60 billion and MYR65 billion.
- On the demand side, we do not see any significant factors that will push inflation higher as the growth in private consumption is still lower than the pre-crisis level, albeit posting positive year-on-year growth since 2Q2009.
- MARC's Economic Research expects the Overnight Policy Rate (OPR) to remain status quo, closing the year at 2.75%.
- We expect the benchmark curve to bearish steepen as the long end looks quite expensive, while interest rate normalisations by the central bank should also push short-end yields higher.
- With the OPR level at 2.75%, we opine that the 3-year MGS yield should trade within the 3.20%-3.40% range, while our target range for the 10-year yield is 4.20% to 4.40%.
- On the downside, MGS yields could rise higher, even exceeding our target range here, if there is a sharp outflow of foreign funds from the MGS market should there be spillover effect from the European debt crisis which may trigger flight-to-quality to the USD.

Government Bond Issuance Trend



Source: Bloomberg, MARC Fixed Income Research

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Government bond issuance: Lower domestic issuance size as the government taps the non-ringgit sukuk market

In the year-to-date, a total of MYR33 billion had been raised by the government via the MGS/GII market compared to MYR48.5 billion in the corresponding period in 2009, a decline of 32%. The outcome is not unexpected given the lower budget deficit target in 2010, and previous stimulus packages announced look adequate thus far in reviving the economy. During the tabling of the Tenth Malaysian Plan in June, Prime Minister Najib Abdul Razak said the budget deficit is projected to decline to 5.3% of gross domestic product (GDP) this year from 7.0% in 2009, and the government aims to reduce the shortfall to 2.8% by 2015.

Exhibit 1: MGS/GII auction schedule for 2010

No.	Issues	Tenure (Years)	Maturity Date	New / Reopening	Target Quarter	Target Month	Issue Date	Amount (RM million)	Avg. Yield (%)	Bid-to-cover Ratio (x)	Remarks
1	3.5-year New Issue of GII (Mat on 07/13)	3	15-Jul-13	New	1Q2010	January	15-Jan-10	3,000	3.29	2.12	
2	10-year Re-opening of MGS 11/19 4.378%	10	29-Nov-19	Reopening	1Q2010	January	29-Jan-10	3,500	4.32	2.10	
3	10-year Re-opening of MGS 11/19 4.378%*	10	29-Nov-19	Reopening	1Q2010	January	29-Jan-10	2,000			* via private placement
4	5.5-year New Issue of MGS (Mat on 08/15)	5	12-Aug-15	New	1Q2010	February	12-Feb-10	3,500	3.84	1.99	
5	7.5-year New Issue of MGS (Mat on 09/17)	7	15-Sep-17	New	1Q2010	March	15-Mar-10	3,500	4.01	2.24	
6	5.5-year New Issue of GII (Mat on 09/15)	5	30-Sep-15	New	1Q2010	March	30-Mar-10	3,500	3.86	1.94	
7	20-year New Issue of MGS (Mat on 04/30)	20	15-Apr-30	New	2Q2010	April	15-Apr-10	2,000	4.50	1.67	
8	5-year Re-opening of MGS 08/15	5	30-Sep-15	Reopening	2Q2010	April	30-Apr-10	3,500	3.61	1.56	
9	10-year New Issue of GII (Mat on 06/20)	10	15-Jun-20	New	2Q2010	June	15-Jun-10	2,500	4.28	2.27	
10	10-year New Issue of GII (Mat on 06/20)*	10	15-Jun-20	New	2Q2010	June	15-Jun-10	3,000			* via private placement
11	3-year Re-opening of MGS 05/13 3.210%	3	30-May-13	Reopening	2Q2010	June	30-Jun-10	3,000	3.22	3.40	
12	5-year New Issue of GII (Mat on 07/15)	5		New	3Q2010	July					
13	7-year Re-opening of MGS 09/17	7		Reopening	3Q2010	July					
14	10-year Re-opening of MGS 11/19 4.378%	10		Reopening	3Q2010	August					
15	5-year Re-opening of MGS 08/15	5		Reopening	3Q2010	August					
16	3-year New Issue of GII (Mat on 09/13)	3		New	3Q2010	September					
17	7-year Re-opening of MGS 09/17	7		Reopening	4Q2010	October					
18	3-year Re-opening of MGS 05/13 3.210%	3		Reopening	4Q2010	October					
19	10-year New Issue of GII (Mat on 11/20)	10		New	4Q2010	November					

Source: FAST, Bloomberg, MARC Fixed Income Research

The first six months of 2010 also saw Malaysia tapping the international bond market for the first time in eight years by selling USD1.25 billion of 5-year dollar sukuk. The Shariah-compliant notes received an overwhelming demand from investors with an oversubscription of nearly four times and a tighter-than-expected spread to US treasury. Due to the overwhelming response from the Middle East, Asia, Europe and US-based investors, the government would be selling an additional USD1.0 billion in conventional bonds by September this year.

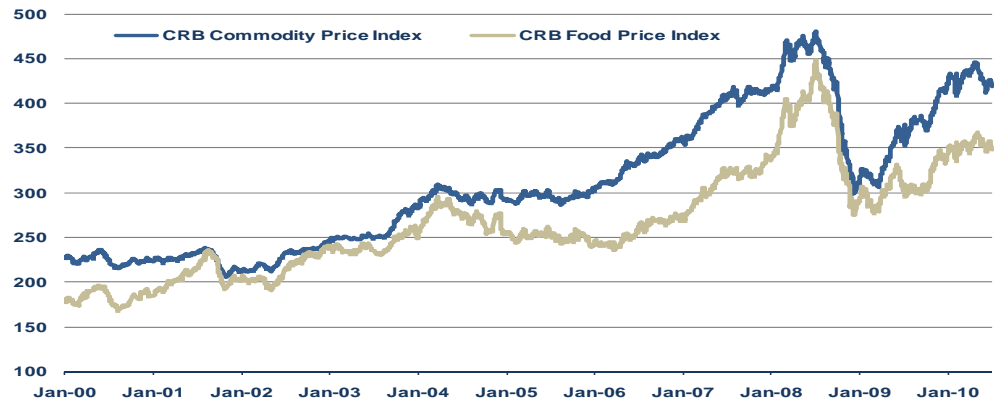
Additionally, the government also issued and allocated MYR2.4 billion of Sukuk 1Malaysia 2010 of 3-year maturity on June 21 to 74,781 local investors aged 21 years and above. This retail bond requires a minimum initial subscription of MYR1,000 (in multiples of MYR100) and is capped at MYR50,000 per subscription. Commencing June 22, the sukuk can be sold or purchased at a minimum amount of MYR100 and in multiples of MYR100 per investor. The daily prices are computed based on principal at par plus accrued profit. With these additional sources of financing for Malaysia and a lower deficit forecast for 2010, we are revising our total MGS/GII issuance for this year to be in the range of MYR50 billion to MYR55 billion from our previous estimate of between MYR60 billion and MYR65 billion.

In the remaining six months, there are eight public auctions to go, in which the issuance volume for the 3-year, 5-year, 7-year and 10-year tenures is spread across evenly. Since MYR33 billion had been issued, the average issue size per debt auction is approximately between MYR2.1 billion and MYR2.8 billion. Excluding MGS/GII notes that had matured and are due for redemption over the next six months amounting to MYR23.4 billion, the net issuance for the year is expected to be in the range of MYR26.6 billion to MYR31.6 billion, versus MYR51.8 billion in 2009.

No significant inflationary pressure to push up yields considerably

Our previous argument that the source of inflationary pressure would be food and commodity prices has not changed much (see MARC's 2010 Ringgit Bond Market Outlook published on December 31, 2009). On the local front, talk of subsidy removal has been taking place over the last few months and the government is now in the midst of studying a few sets of proposals. At this stage, the risk of higher petrol prices is still contained but the outcome will be completely different once global oil prices start to move upward if the economic recovery seen thus far can be sustained.

Exhibit 2: CRB Commodity and Food Price Indices

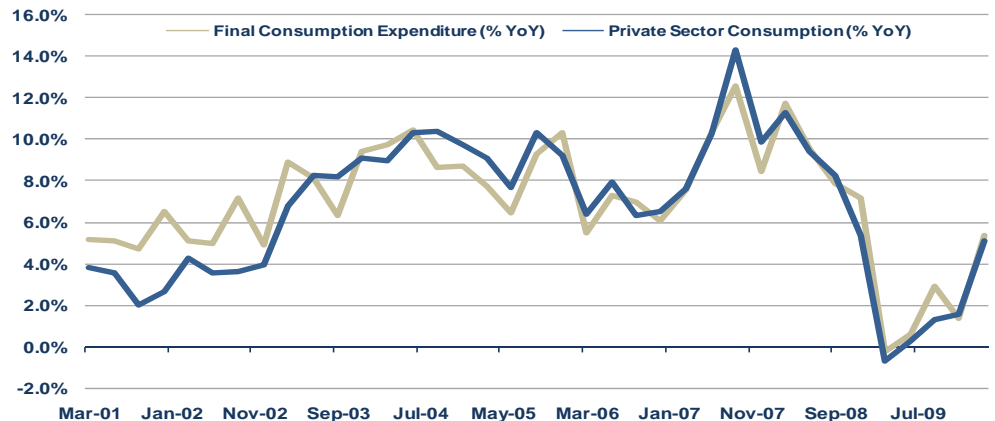


Source: Bloomberg, MARC Fixed Income Research

In the beginning of the year, we saw an increase in the retail prices of sugar by 20 sen per kg and the withdrawal of the subsidy for white bread. Further subsequent reduction in subsidies is expected to be seen in the coming months as the government works towards fiscal consolidation. Prices of vegetables have almost doubled since April due to shortage of manpower. Meanwhile, global crude oil prices tested above USD85/bbl in May, before falling back to the range of USD71/bbl to USD78/bbl in June. With recovery in sight, the market is now looking at oil prices of between USD82/bbl and USD85/bbl within the next two quarters. The higher fuel prices will have knock-on effects along the supply chain, increasing material, transportation and food prices, which will then be passed on to customers.

On the demand side, we do not see any significant factors that will push inflation higher as the growth in private consumption is still lower than the pre-crisis level, albeit posting positive year-on-year growth since 2Q2009. Hence, inflation expectations, if any, in the coming months would be driven by concerns at the headline level while core inflation will remain at a manageable level.

Exhibit 3: The growth in consumption expenditures is still below pre-crisis level



Source: Bloomberg, MARC Fixed Income Research

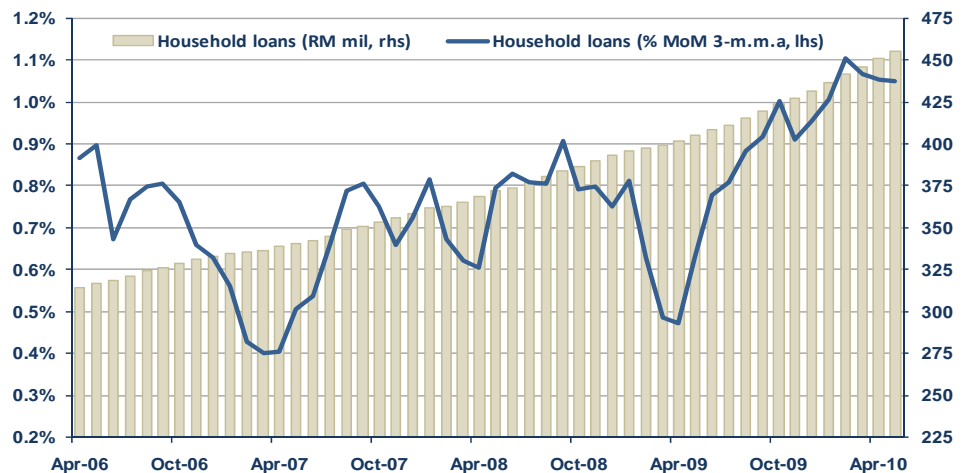
Interest Rate Outlook

Given the interest rate normalisations thus far, our economic research team is no longer expecting any further interest rate hikes with the OPR to remain status quo, closing the year at 2.75%. Using the Taylor's rule, the implied short-term rate given our estimates of output gap and headline inflation of 0.85% and 2.4% respectively stands at 3.25%.

Nonetheless, according to BNM Governor Zeti Aktar Aziz, the extent to which further normalisation will take place also hinges on the external conditions. She reiterated that the monetary policy will remain supportive of the economy and therefore there are no plans to move into the tightening phase. Therefore, we think that any level beyond 2.75% will be too aggressive and unwarranted at a time when there is downside risk to the economic outlook posed by external factors such as the European debt crisis. G7 (Group of Seven countries) finance ministers are in agreement that global recovery remains fragile and that it is too soon to withdraw stimulus measures such as government deficit spending and rock-bottom interest rates that have helped kick-start growth.

Meanwhile, Bank Negara Malaysia (BNM) had repeatedly highlighted in its previous monetary policy statements that if interest rates are kept too low for too long, it may give rise to financial imbalances such as excessive growth in loans. As shown in Exhibit 4 below, household loan growth has been on a rising trend since March 2009 after the central bank reduced its Overnight Policy Rate (OPR) to a record-low of 2.00% as part of its expansionary measures to boost private investment and consumption during the recession. Furthermore, during this period, household loans as a percentage of total loans increased to 55.4% in May 2010 from 54.3% in March 2009.

Exhibit 4: Household loan growth on a rising trend since 1Q2009

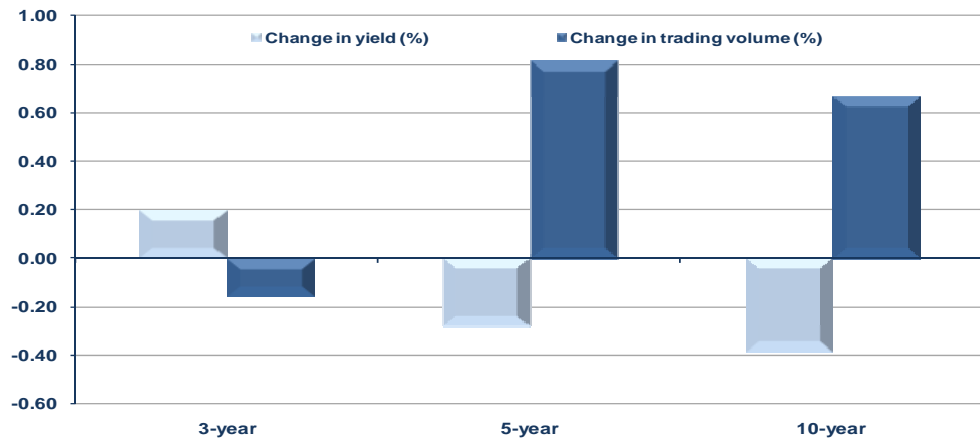


Source: BNM, MARC Fixed Income Research

Bearish steepening curve as the long end looks quite expensive, while interest rate normalisations by the central bank should also push short-end yields higher

The 3-year MGS yield rebounded from a 5-month low in April to end the second quarter of the year closer to 3.20% as players reacted to interest rate normalisations. We compared bond yields and trading activity along the MGS curve over the period of January – June 2009, when uncertainty was high, against January – June 2010, when the path of the economy and financial markets was much clearer. As depicted in Exhibit 5, the 3-year yield rose by 20 bps while trading volume fell by 15%, while contrary findings were derived at the body and long-end of the curve. While investors priced in interest rate normalisations at the short-end of the curve, the logic behind the rally at the long end of the curve could be that foreigners are buying along this sector on expectations of a strengthening local currency.

Exhibit 5: Yields at the body and long end of the curve fell as trading activities increased (change from Jan – June 2010 to Jan – June 2009)



Source: Bloomberg, MARC Fixed Income Research

The 3-year to OPR spread which was at the highest point prior to the first interest rate hike earlier in March 2010 is now reverting to its long-run mean of 40 – 50 bps. We do not expect to see the spread to narrow nor widen anytime soon as we do not see a clear-cut inflation threat in the coming months while the downside risk to the economy is somewhat mitigated at this juncture judging from recent economic data which supports the view that the economy has become more stable. As such, we think the 3/OPR spread should continue to hover around the 50 bps - 70 bps range. With the OPR level to remain at 2.75% in the remaining months of 2010, we opine that the 3-year MGS yield should trade within the 3.20%-3.40% range.

Exhibit 6: The 3/OPR spread reverting to its long run mean



Source: Bloomberg, MARC Fixed Income Research

Bearish steepening curve as the long end looks quite expensive, while interest rate normalisations by the central bank should also push short-end yields higher (continued...)

Under the assumption of sustainable global economic recovery, albeit at a moderate pace and realization of subsidy reforms by the government, we opine that the current level of the 10-year yield is quite expensive. Moreover, the level which dipped below the 4.00% mark in 2Q2010, the lowest level since May 2009, is not really reflective of a rebound in the level of economic activity and rising interest rate cycle. The current sub-4.00% 10-year yield implies that the economy is growing at less than 5.0% while MARC's Economic Research is projecting a 6.8% growth rate in 2010.

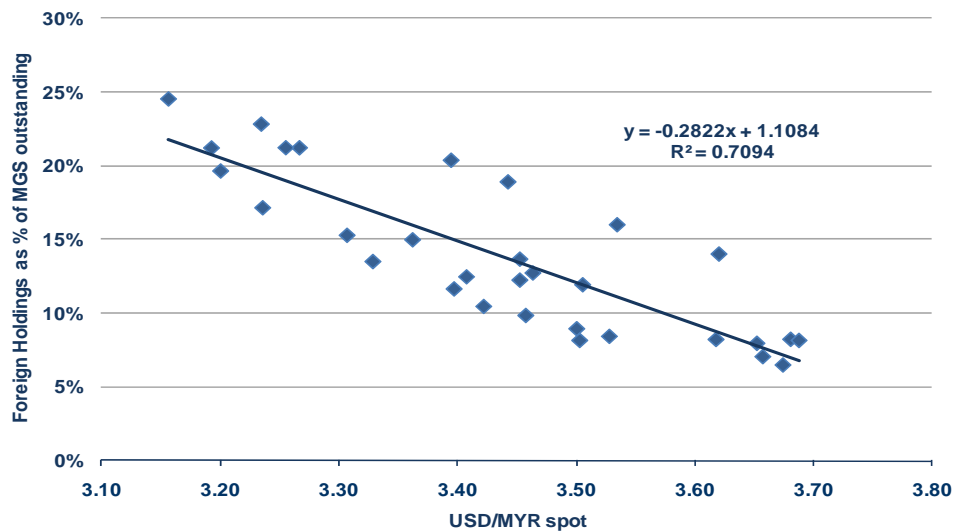
Furthermore, our estimate of real 10-year yields during the recovery from three previous economic slowdowns in 1997, 2001 and 2009 shows that the nominal yield is about 2.4% above inflation. With an inflation target of 2.4% for the full 2010 and using the average real rate of 2.3% derived from the analysis, the 10-year nominal yield should be around 4.7%. Nonetheless, other moderating factors such as foreign purchase of MGS in anticipation of strengthening local currency and lower bond supply are likely to limit the sell-off. At this juncture, we are looking at a 10-year MGS yield in the range of 4.20% - 4.40% in the remaining months of 2010. Investors can benefit by paying fixed in the swap market as we expect rates to increase across the board, and this will also help to lower the portfolio duration.

Risk of outflow if currency gains are halted somewhere but overall impact to yield level to be mitigated by abundant liquidity in the domestic financial market

It is worth noting that the MGS yields could rise higher, even exceeding our target range here, if there is a sharp outflow of foreign funds from the MGS market as a result of a reversal in US dollar weakness. The current low MGS yield levels are sustained by persistent foreign interest seen since March this year after the central bank normalized its monetary policy, and the fact that emerging economies weathered the financial crisis better than the developed counterparts also enticed investors to hunt for yields.

During this period, the ringgit surged 7.0% to 3.2365 per USD since financial market stability resurfaced in 3Q2009. Foreign holdings as a percentage of outstanding MGS also rose during this period, standing at 23.4% as at end of May, nearing its peak of 24.6% in April 2008, after sliding to 12.5% in March 2009. The negative correlation between foreign holdings and USD/MYR spot stood at 84% based on monthly historical data dated back to June 2006.

Exhibit 7: Negative correlation between foreign holdings and USD/MYR spot



Source: BNM, Bloomberg, MARC Fixed Income Research

Among the factors that are likely to cause a downward trend in the ringgit are:

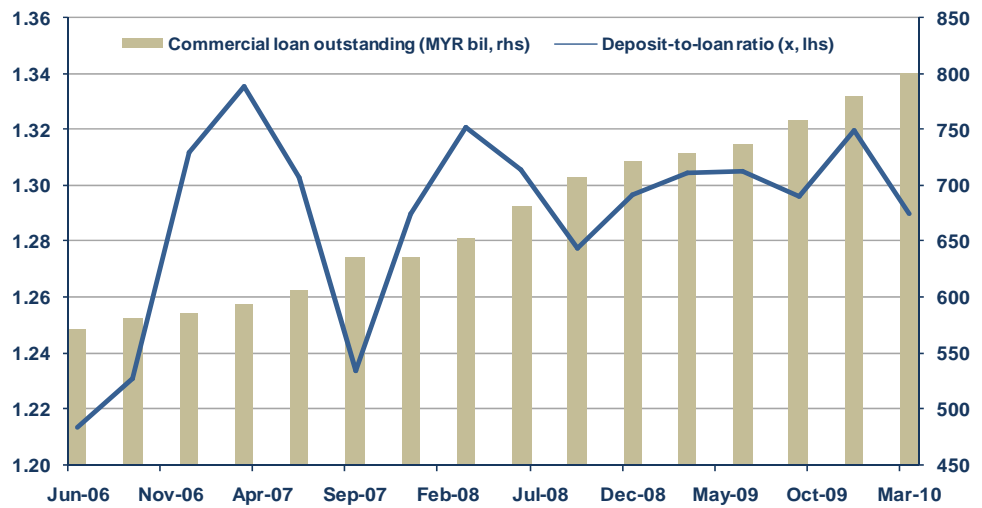
- Renewed risk aversion should the European debt crisis spill over to other parts of the world, causing another round of economic slowdown.
- Narrowing positive carry if the Federal Reserve unexpectedly raises its record-low interest rate.

Risk of outflow if currency gains are halted somewhere but overall impact to yield level to be mitigated by abundant liquidity domestic financial market (continued...)

Nonetheless, the sizeable demand from local players is likely to mitigate the significant upward pressure on yields should foreign funds pull out of the government bond market. As mentioned earlier, the issuance size of MGS/GII is expected to shrink this year. At the same time, corporate bond issuance looks lethargic this year with only MYR16.5 billion issued in 1H2010.

Moreover, with maturity proceeds will need to be reinvested, this could create new market segmentation in the MGS market in our view. The commercial banking sector deposit-to-loan ratio looks healthy at around 1.3 times (x), indicating a high level of liquidity in the domestic banking sector which means investable amount of funds is quite high.

Exhibit 8: The commercial banking sector deposit-to-loan ratio vs. commercial loan outstanding



Source: BNM, MARC Fixed Income Research

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