2H2011 Government Bond Market Outlook

July 6, 2011

An inflow-driven market rather than fundamentals…

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- Overall, our assessment is that the bond market has hardly reacted to inflation and growth fundamentals as well as a rising bond supply thus far, and the movement seen has largely been driven by an inflow of foreign funds. This is also the case in the equities market.

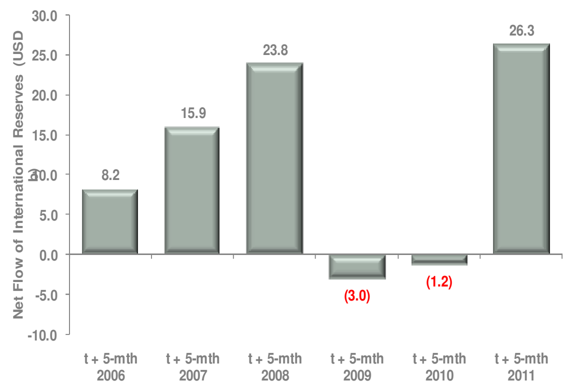
- We agree with our economist that the current period of softening economic data is just a soft patch rather than a prelude to a further marked economic slowdown. Bank Negara Malaysia (BNM) is likely to pull the trigger in 2H and the quantum that we are looking at right now is another 25 bps of rate hike.

- We still expect bond yields to close the year at a much higher level as we think that the current level is too low, and in this game between investors' expectations and economists' assessments, economists will eventually turn out to be the winner this time around.

- Although foreign funds will continue to be supportive of the valuation, the evolution of inflation data and inflation-fighting policy by the central bank would certainly narrow the real bond yields and bond yields-cash spread. Therefore, we opine that it will come to a point where investors realise that fact and start recouping the forgotten premiums latest by 4Q2011, in our view.

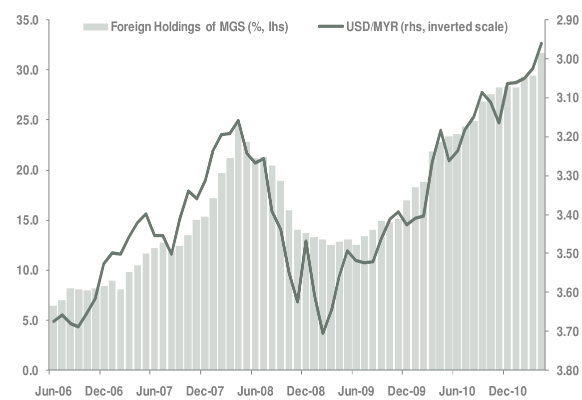
- On the global front, the recent weaker-than-expected economic data and the peripheral crisis in the eurozone have also pushed the yields in the major government bond markets lower with a sub-3.00% yield seen on the 10-year US Treasury bonds at one point.

More than USD25 billion of inflow was recorded within the first five months of 2011, the highest inflow based on data gathered since the year 2000.



Source: Bloomberg, MARC Fixed Income Research

Foreign holdings of MGS recorded new high month after month in the first half of the year as the ringgit continued to strengthen



Source: Bloomberg, BNM

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An inflow-driven market rather than fundamentals…

Overall, our assessment is that the bond market has hardly reacted to inflation and growth fundamentals as well as a rising bond supply thus far, and the movement seen has largely been driven by an inflow of foreign funds. This is also the case in the equities market. There is no compelling reason to be overly concerned at this juncture as this is not idiosyncratic (i.e. other regional bond and equity markets are experiencing almost the same thing).

That said, the risk of a massive outflow must not be totally ignored. Going into the third quarter of the year, we do not expect to see a significant deviation from the trend observed in 2Q, and further influx of foreign funds could take the domestic government bond market to more expensive levels, albeit at a very limited quantum. Hence range-trade is likely to take place over the next three months.

We agree with our economic team that the current period of softening economic data is just a soft patch rather than a prelude to a further marked economic slowdown. Bank Negara Malaysia (BNM) is likely to pull the trigger in 2H and the quantum that we are looking at right now is another 25 bps of rate hike. We still expect bond yields to close the year at a much higher level as we think that the current level is too low, and in this game between investors' expectations and economists' assessments, economists will eventually turn out to be the winner this time around.

Although foreign funds will continue to be supportive of the valuation, the evolution of inflation data and inflation-fighting policy by the central bank would certainly narrow the real bond yields and bond yields-cash spread. Therefore, we opine that it will come to a point where investors realise that fact and start recouping the forgotten premiums latest by 4Q2011, in our view.

On the global front, the recent weaker-than-expected economic data and the peripheral crisis in the eurozone have also pushed the yields in the major government bond markets lower with a sub-3.00% yield seen on the 10-year US Treasury bonds at one point.

The downgrade of Greece to CCC by the international credit rating agencies sent the CDS spread to a level indicating that sovereign default is the most likely scenario. As we do not believe there will be another serious economic downturn, we do not see this as the beginning of a decline in yields along the major government bond markets.

We are revising our year-end target for the 10-year MGS yield lower to 4.10%-4.20% range from the previous target range of 4.20%-4.30%.

Exhibit 1: MGS yields scenario (%) - Year-end target

Interest Rates	Inflation Model	USD/MYR Model	Bloomberg Consensus	Our Forecast	Current Level
OPR (%)	*n.a*	*n.a*	*3.25*	*3.25*	*3.00*
10-year (%)	*4.27*	*3.89*	*4.27*	*4.10 - 4.20*	*3.93*
5-year (%)	*3.73*	*3.35*	*n.a*	*3.60 - 3.70*	*3.51*
3-year (%)	*3.53*	*3.15*	*n.a*	*3.30 - 3.40*	*3.24*

Source: Bloomberg, MARC Fixed Income Research

**Used two separate univariate regressions for inflation and USD/MYR model. Assume inflation rate of 3.5% for 2011 and USD/MYR to average 3.00 in 2H2011.*
***Bloomberg consensus as at June 30, 2011.*
****Current level as at June 30, 2011.*

The end of the guessing game. The guessing game on when the central bank would resume its monetary normalisation ended with an unexpected 25 bps hike in the Overnight Policy Rate (OPR) in May 2011, bringing the benchmark rate to 3.00%. This unexpected move (53% of economists surveyed by Bloomberg expected it to remain status quo) caused the price of liquidity to be more expensive.

A quick look at its policy statement revealed that BNM was highlighting the positive prospects of the Malaysian economy going forward and a potential domestic demand-driven inflation in the second half of the year. In other words, the central bank appeared to be more hawkish in its language compared to the two meetings that took place earlier in the year.

Soft landing scenario in the global economy. Fast forward to today, the months of better-than-expected economic data, particularly in the US, which was a major catalyst in sending the global government bond yields higher in the middle of 1H2011 is no longer the case. Fed governors and regional bank presidents are now saying the US economy will grow by 2.7% to 2.9% this year compared to a range of 3.1% to 3.3% estimated earlier in April, sending the US Treasury 10-year yield dipping below the 3.00% mark.

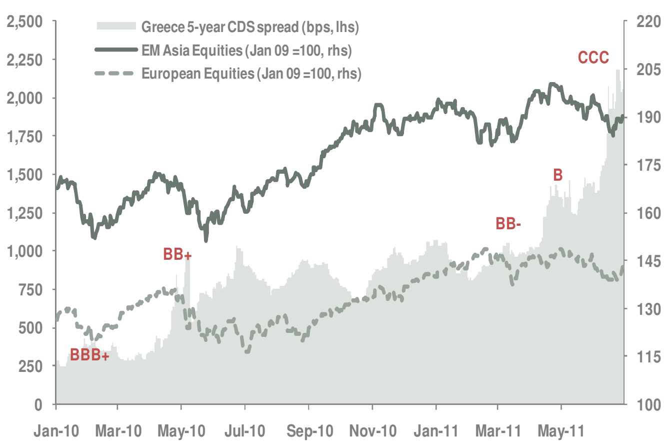
The economic soft patch as we approach the end of the first half of 2011 witnessed the global oil prices correcting by 20% from its high of USD114/barrel in April this year. Meanwhile, lingering concerns on the sovereign debt crisis in the eurozone with Greece now just a notch away from defaulting also played a role in pushing govvies higher.

Exhibit 2: UST 10-year yield dipped below the 3.00% mark on weaker economic data

Source: Bloomberg, MARC Fixed Income Research

As depicted in Exhibit 3, the massive downgrade of Greece by international rating agencies affected risky assets valuations but it was a short-term sell-offs (knee-jerk reactions) rather than a structural shift in risk appetite, which supports the case that the Greece story is idiosyncratic. The decline in global shares and widening of corporate spreads did not point to aggressive re-pricing of risks although the Greece CDS spreads swelled above 2,000 bps, a level that was unimaginable along the sovereign credits universe before this.

Exhibit 3: The eurozone debt crisis remains an isolated case thus far



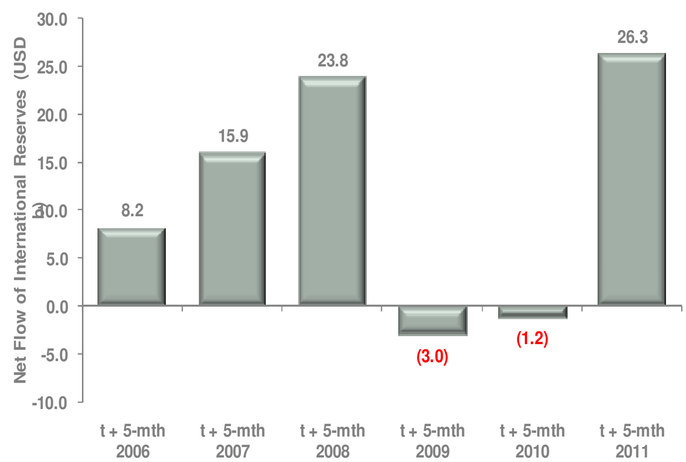
Source: Bloomberg, MARC Fixed Income Research

MGS yields: No, it isn't about reassessment of growth. While economic fundamentals are pointing towards a soft patch in the US and rising inflation in Asia, there were hardly any effects on the domestic government bond market. Considering that the central bank has already resume its rate hiking cycle and is becoming more hawkish in its rhetoric, we view the current bond yields as somewhat low by the usual standards.

The 10-year benchmark MGS note yields stood at 3.92% at the time of writing, 8 bps lower than its opening level during the year, while the 3-year benchmark yield at 3.22% is just 11 bps higher over the same period. At one point in 1H2011, the 3-year MGS note traded at 3.47%, its highest level over the last six months. However, at the current speed, the front end of the curve seems to have positioned itself for a dovish scenario, or at least the central bank is not going to alter the policy rate anymore.

Whether investors have reassessed the growth scenario given the soft patch seen in the US and ongoing concern with regard to the eurozone situation remains questionable in our view. Nevertheless, it does not mean that there is no explanation for this anomaly. We would like to reiterate our view in the previous outlook that this market is dominated by foreign inflow alone in this cycle. The level of the international reserves indicates that the country recorded an inflow of USD26.3 billion in the first five months of 2011, surpassing the previous record inflow of USD23.8 billion registered over the same period in 2008 when the ringgit was also rallying against the greenback.

Exhibit 4: More than USD 25 billion of inflow was recorded within the first five months of 2011, the highest inflow based on data gathered since the year 2000



Source: Bloomberg, MARC Fixed Income Research

Putting things into perspective, we estimated two univariate regressions using the 10-year benchmark MGS yield as the dependent variable while the headline inflation and USD/MYR exchange rate act as the explanatory variables. We analysed two periods; 2006 to August 2008 and 2010 to May 2011. The reason we excluded the period in between is the steep external shocks in the financial market brought by the global economic crisis could have distorted the estimated parameters.

2006 to August 2008 Univariate regression:

10-year MGS = 3.35 + 0.22 Headline Inflation $_t + \varepsilon_t$ *;*

$R^2 = 59\%$ $\varepsilon = 0.3$

10-year MGS = 1.36 + 0.77 USD/MYR $_t + \varepsilon_t$ *;*

$R^2 = 9\%$ $\varepsilon = 0.44$

2010 to May 2011 Univariate regression:

10-year MGS = 4.09 - 0.05 Headline Inflation $_t + \varepsilon_t$ *;*

$R^2 = 4\%$ $\varepsilon = 0.17$

10-year MGS = 1.94 + 0.65 USD/MYR $_t + \varepsilon_t$ *;*

$R^2 = 22\%$ $\varepsilon = 0.15$

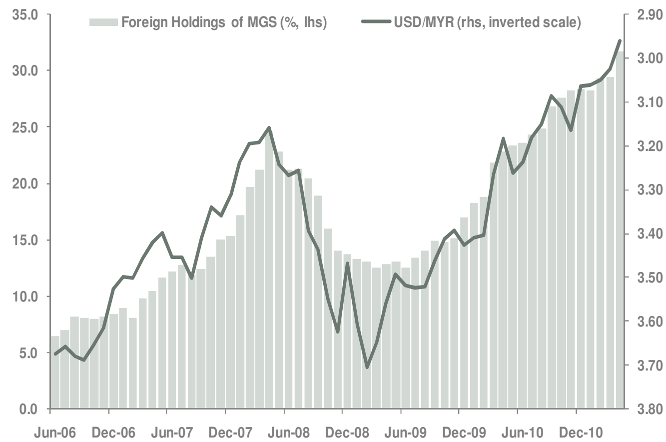
The finding is that headline inflation, which used to have greater influence in the domestic rates market before the crisis, now has minimal influence with a significant decline in the explanatory power. In fact, the estimated coefficient contradicts the hypothesis of a positive correlation between bond yields and inflation. On the other hand, the exchange rate has obviously gained traction in determining bond yields with the explanatory ratio rising from just 9.0% before the crisis to 22% presently.

Exhibit 5: 10-year yield as a function of inflation (regression residuals – 2010 to May 2011)

Source: Bloomberg, MARC Fixed Income Research

Foreign inflow sent bonds and equities higher. Foreign holdings of MGS continue to hit new highs month after month, and as at end of May 2011, approximately 33.1% of the outstanding MGS were held by foreigners. This is the first time the ratio surpassed the 30% mark. Given the nature of this data, we opine that the current yield compression is not reflective of reassessments of growth or inflation expectations by investors but rather a manifestation of foreign funds betting on stronger local currency.

Exhibit 6: Foreign holdings of MGS recording new highs month after month in the first half of the year as the ringgit continued to strengthen



Source: Bloomberg, BNM

This hypothesis is further supported by a continuous rally in Malaysian shares with the FBM KLCI index recording a new high over the same period. Right now, it appears that a bet on a stronger ringgit has sent the valuation for both asset classes, government bonds and equities into expansive territory. Looking at the Price-to-Earnings (P/E) ratio of selected indices, we find that the current P/E in this region is either above or at least on par with their respective averages. On the other hand, the P/E in the developed equity markets depicted a completely reversed scenario.

Exhibit 7: Price-to-Earnings ratios in the Emerging East Asia are either above or at par with their averages but that is not the case in the developed market

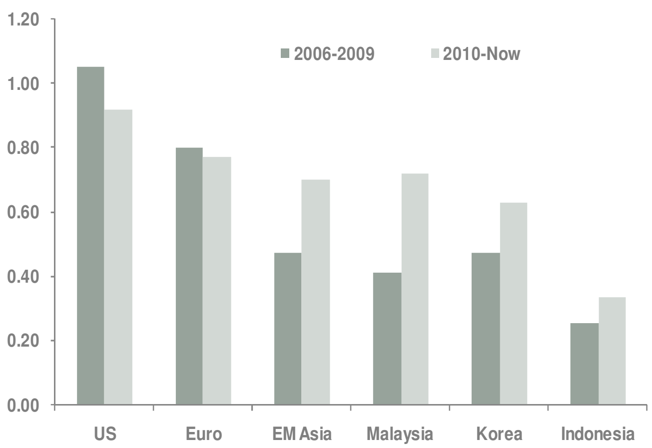
Equity Indices	May 2011 P/E	2004-May 2011 Avg. P/E	Difference Against Average
London FTSE	14.6	20.0	-5.3
Germany DAX	12.6	17.9	-5.3
S&P 500	15.3	16.8	-1.5
Kuala Lumpur Composite	16.5	15.5	1.0
Korea KOSPI	14.3	14.1	0.1
Thailand SET	13.6	13.5	0.1
Jakarta Composite	17.7	17.7	0.0

Source: Bloomberg, MARC Fixed Income Research

This means foreign inflows are seen not only in Malaysia but also across across Emerging Asia Ex Japan countries. We also estimated the beta of the rate of change in indices in some selected countries in this region against the global index from January 2010 until May 2011 and found that they are now less defensive compared 2006-2009 period, which also means they are now relatively riskier.

Heavy inflow of foreign funds witnessed the 10-year MGS yield declining 22 bps from its peak in 1H2011 to 3.92%. Over the same period, the headline inflation in Malaysia continued to climb higher, touching 3.3% in the month of May, and that remains supportive of an upward bias in the OPR as we enter the second half of the year. Common wisdom has it that the back-end of the curve would have normally reacted to such expectations but the outcome thus far has been different.

Exhibit 8: Selected equity indices beta: Emerging market equities are more sensitive in the current cycle

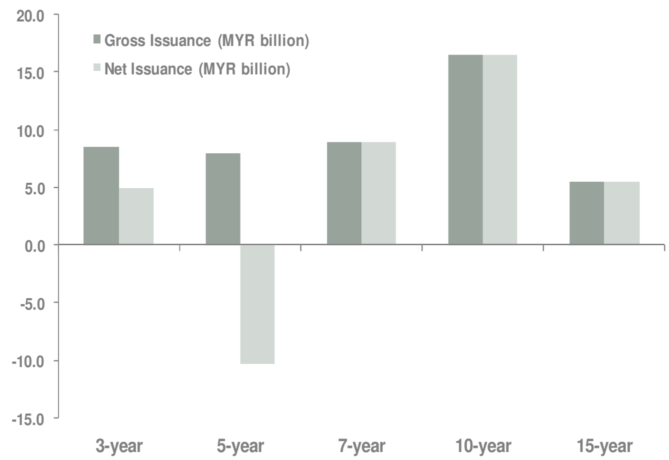


Source: Bloomberg, MARC Fixed Income Research

Even supply premiums temporarily vanished. In the previous outlook report published late last year, we mentioned that government's financing needs for this year stand at MYR90.5 billion and that MGS/GII issuance to be in the range of MYR86 billion to MYR88 billion. The government had already raised funding of MYR51.0 billion via MGS/GII issuances during the first half of the year (59% of the expected total issuance for the whole 2011) and the redemption amount over the same period was MYR22 billion, translating to net issuance of MYR29.2 billion.

Going by maturity bucket, the10-year sector recorded the highest spread of net issuance at MYR16.5 billion. Nonetheless, bond yields did not move higher. A direct conclusion is that investors have been willing to forgo some of the premiums for inflation and higher supply as foreign funds were coming in heavy into this asset class (i.e. larger investors' base now). Going forward, we still expect total MGS/GII issuance for the full year to be in the range of MYR86 billion to MYR88 billion.

Exhibit 9: MGS/GII gross and net issuance in 1H2011 by maturity bucket



Source: Bloomberg, MARC Fixed Income Research

Just a soft patch, not a marked slowdown, hence we are still in for inflation-fighting policy. The conundrum right now is whether the current soft patch is temporary or a prelude to another round of global economic slowdown. Although this appears to be more correlated to external development rather than domestic issues, we still think that it is a very (highly) crucial assumption for the bond market outlook in the second half of the year.

If the current soft patch in the US is just another soft patch and regional inflation continues to move higher, then the real bond yields are likely to remain narrow as foreign funds are unlikely to budge from this region, not at least until there is a clear sign on when policy tightening should start to take place in the US. On the other hand, if what we are seeing now is the build up to a more serious global economic slowdown, then a flight-to-quality trade will pull back these funds, resulting in a sell-off across emerging market sovereigns.

Although the US is running on a huge budget deficit, which led to a serious warning from the rating agencies, and interest rates are relatively low, we must not forget that Treasuries remain the most liquid asset class in the investment universe.

Our economic research team believes that the setback seen now is temporary and that we are not heading for another round of serious economic slowdown. Once clearer signs emerge that we are going to see light at the end of the tunnel, possibly in the final quarter of the year, which will increase the probability of monetary tightening in the developed nations, foreign funds are likely to rebalance their exposure. That, in our view, is going to push rates in the domestic bond market higher.

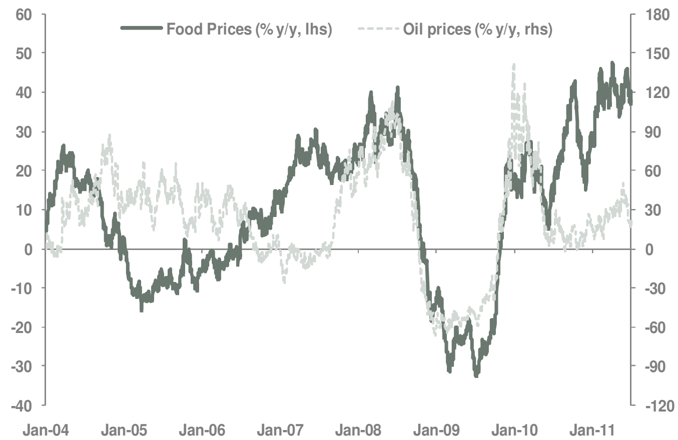
However, the current scenario is likely to persist until 3Q2011 and the back-end will continue to remain in expensive territory where we do not see it closing the third quarter in excess of 4.10%. We do not think the 10-year can rally to below 3.80% because at that level, the real rate would just stand at 50 bps (using our in house inflation forecast of 3.3%) and that is very well below the 5-year average of 130 bps. Given the scenario observed in the first half of the year where foreign funds was a dominant factor in the domestic government bond market, we are revising our year-end target for the 10-year MGS yield lower to 4.10%-4.20% range from the previous target range of 4.20%-4.30%.

On the OPR front, our economic team is of the view that there will be another 25 bps rate hike this year which means the highest potential level of OPR for this year would be 3.25%. Despite signs of economic slowdown in the US recently, we still think that focus of monetary policy will still be about anchoring inflation expectations given that the growth momentum remains intact in the emerging economies albeit at relatively slower pace than in 2H2010.

Meanwhile, the front end of the curve is now yielding lower than the inflation rate and we highlighted earlier that it seems to have positioned itself for a dovish scenario or at least the central bank is done with alteration for now. We think that the current level is too low as in this game between investors' expectations and economists' assessments; economists will eventually turn out to be the winner in our view.

While we view that currency bet was the sole determining factor in the government bond market over the last few months, if the central bank hikes the benchmark rate just by another 25 bps, the 3-year yield at the current level will be below the cash rate, a scenario that is unlikely to be sustainable. On that note we are not revising our previous call for the 3-year benchmark yield to be in the range of 3.30%-3.40% come year end.

Exhibit 10: Major source of inflation is still going to be from the supply side, and rising trend in food and oil prices right now is no longer driven by the low base effect



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Published and Printed by:

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