Fixed Income Research

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MALAYSIAN RATING CORPORATION BERHAD
(364803-V)

Vol.: FI/010/2018

FIXED INCOME UPDATE: Jitters on the External Front

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In a nutshell

- ***US Treasury (UST) yields are expected to continue its uptrend, with the curve-flattening bias to persist.*** Against the backdrop of a continuing growth in the US and rising inflation towards the US Federal Reserve's (Fed) targeted 2% pace, we retain our mildly bearish call for the USTs. The prospects of higher UST supply amid the Fed's ongoing balance sheet reduction and larger fiscal spending will exert an upward pressure on yields. The flattening trend of the UST curve will likely persist as further Fed rate hikes will lead to a faster rise in short-term yields. The rise in yields, however, would be capped by geopolitical risks and rising rate differentials between the US and other major economies.

- ***The European yields will remain mostly rangebound.*** Steady inflation and signals from the European Central Bank (ECB) that its monetary tightening still has a long way to go should support the demand for European government bonds (EGB). Given lingering geopolitical risks, the safe-haven status of core EGBs such as the German bund will appeal to risk-averse investors, thereby restricting the upward momentum in yields that was initiated by rising UST yields. Investors will continue to shy away from countries perceived as high risk, notably Italy, Spain and some peripheral countries.

- ***MARC maintains its 2018 gross Malaysian Government Securities/Government Investment Issues (MGS/GII) issuances forecast.*** We continue to expect the gross issuance of local govvies to be in the range of RM100.0 billion to RM105.0 billion. Going into 2H2018, we estimate the average issue size for each offering to be between RM2.5 billion and RM3.3 billion. Given our projection of RM62.8 billion worth of MGS/GII notes maturing in 2018, net issuance is expected to range between RM37.2 billion and RM42.2 billion.

- ***MARC does not rule out the possibility of a continuing foreign outflow from local govvies in 2H2018.*** We expect the pressure from foreign selling of local govvies to persist in the near term, to be driven mainly by external factors. This would, however, be a short-term phenomenon. We also expect the size of the outflows to be reduced due to: (1) resilient global crude oil prices; (b) greater clarity from the current government on its medium-term fiscal plan; and (3) expectation of improved medium-term economic fundamentals for Malaysia.

- ***In the primary market for corporate bonds, we maintain our 2018 forecast of corporate bond issuances of between RM90 billion and RM100 billion.*** This is despite a more aggressive than previously expected issuance of rated corporate bonds in 1H2018. Issuance from the government-guaranteed (GG) segment has been declining in recent times and we expect the trend to continue in 2H2018 due to the review of some mega projects by the new government. Notwithstanding this, we do not expect a significant impact on the overall health of corporate bond issuance activities as there are still several large corporate bond issuances in the pipeline for the rest of 2018.

- ***MARC expects the upward yield momentum from 1H2018 for both MGS and corporate bonds to extend into 2H2018.*** Faltering demand of emerging market (EM) financial assets would likely persist in 2H2018 amid concerns over rising interest rates, trade war jitters, possibility of currency devaluations worldwide, and political developments in some European countries. However, we do not expect sharp increases in yields due to some mitigating factors: (1) Malaysia's commendable economic growth; and (2) new positive effort to address high government debt by the new administration.

- ***In 1H2018, MARC's rating activities were stable as all corporate bond issuers within our rating universe experienced no rating changes.*** For 2H2018, MARC foresees more challenges ahead for corporate and financial institutions in its rated universe. MARC's opinion reflects the ongoing uncertainty following the proposal to abolish tolls, cancellation of some mega infrastructure projects and the escalating trade tensions between the US and China that may erode future earnings of corporate bond issuers within MARC's rated universe.

The US Treasury Market

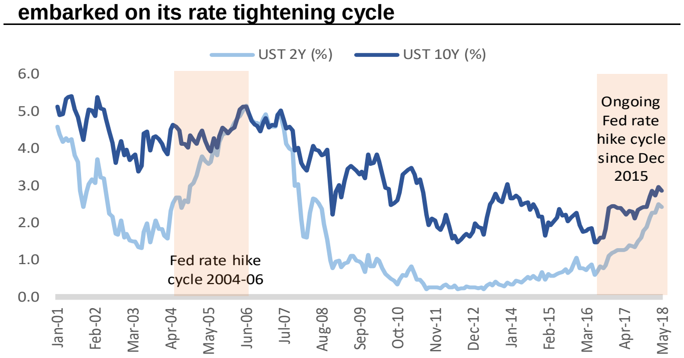
- ***US growth to remain strong.*** The tightening US labour market, as evidenced by the fall in unemployment rate to multiyear lows, has fuelled consumer spending growth. A sizeable fiscal stimulus comprised of tax cuts and increased public spending will also provide an additional boost to US growth in the near future. However, downside risks to the US outlook are emerging. There are signs that the recent trade tensions between the US and its major trading partners could already be hurting US business sentiment.

- ***The return of inflation***. In March 2018, the growth of the Personal Consumption Expenditures (PCE) index finally hit the 2% inflation target for the first time in twelve months. We maintain our view that the tightening labour market will continue to manifest itself in higher wages, exerting upward inflationary pressure. This will remove a major concern over the strength of the economy among policymakers. A surge in US producer prices, driven by firmer crude oil prices and the US imposing tariffs on some imports, should support the current uptrend in consumer prices.

- ***Fed to stay on course.*** Given the solid US macro outlook, we expect the Fed to continue with its policy normalisation in a gradual manner. We see an increasing likelihood for the Fed to raise interest rates for a total of four times in 2018 as Fed policymakers stay relatively hawkish despite rising global uncertainty. At the time of writing, the Fed funds futures market indicates a more than 55% chance for more than four US rate hikes in 2018.

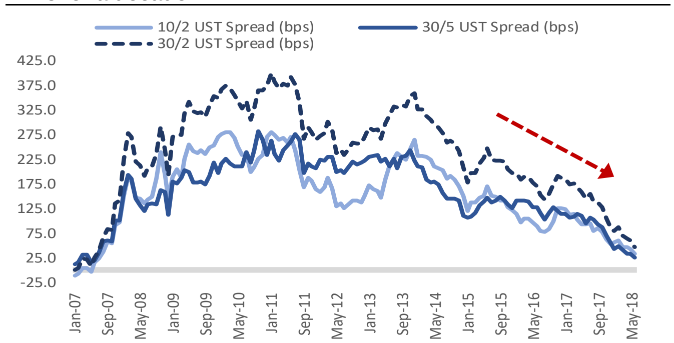
- ***Yields to continue its uptrend; curve-flattening bias to persist.*** Against this backdrop, we retain our mildly bearish call for the USTs. The prospects of higher UST supply amid the Fed's balance sheet reduction and larger fiscal spending will exert an upward pressure on yields. The flattening trend of the UST curve will persist as further Fed rate hikes will lead to a faster rise in short-term yields. The rise in yields, however, would be capped by geopolitical risks and rising rate differentials between the US and other major economies.

Exhibit 1: UST yields have been on the uptrend since the Fed embarked on its rate tightening cycle



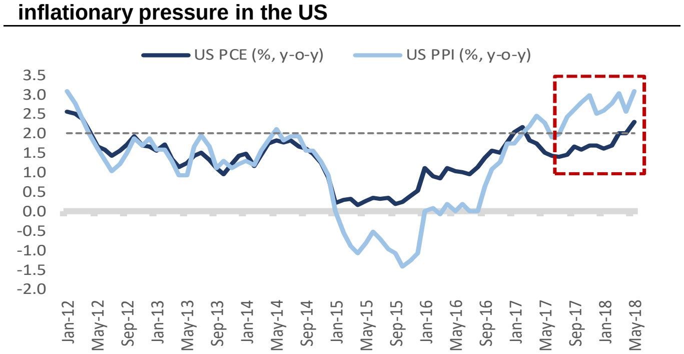
Source: Bloomberg, MARC Fixed Income Research

Exhibit 2: The UST yield curve compressed to its flattest level in over a decade



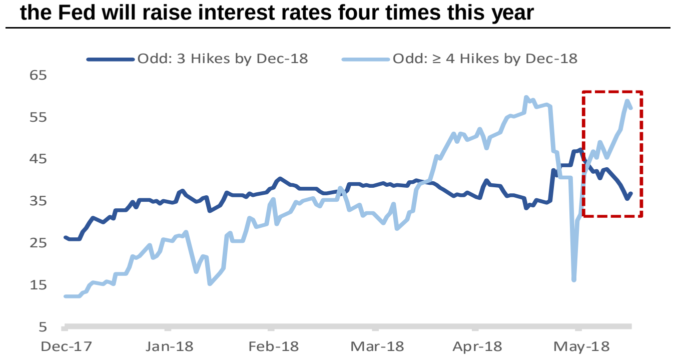
Source: Bloomberg, MARC Fixed Income Research

Exhibit 3: A surge in producer prices signals an increase in inflationary pressure in the US



Source: CEIC, MARC Fixed Income Research

Exhibit 4: The bond market appeared to be more convinced that the Fed will raise interest rates four times this year



Source: Bloomberg, MARC Fixed Income Research

Euro Zone and UK Sovereign Bond Market

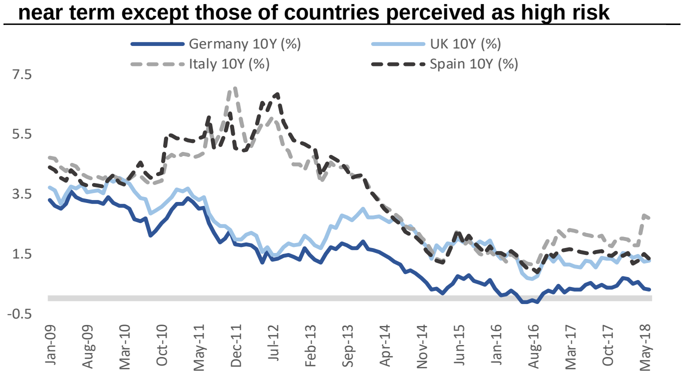
- ***Growth momentum wanes but remains respectable.*** Despite moderating in 1Q2018, economic growth in the euro zone and the UK remains commendable, underpinned by improving labour market conditions and robust activity in the services sector. That said, we are mindful of the escalating global trade tensions and domestic political disputes arising from issues such as migration and the Brexit deal which could weigh on near-term confidence in both economies.

- ***Steady inflation***. The acceleration in the euro zone headline inflation towards the targeted 2% rate in June 2018 could prove short-lived amid tepid underlying price pressure. Core inflation remains stubbornly low, averaging 1% in 1H2018, and is expected to inch up slowly given stable wage growth. Meanwhile, in the UK, the downward trend in prices has halted and inflation will likely hover around the current level of 2%-3% in the near term.

- ***"Gradual and limited" monetary normalisation.*** While the ECB foresees that the euro zone economic backdrop is sufficiently strong to end its massive bond-buying programme by year end, it nevertheless signalled that monetary tightening is still a long way off. Key ECB interest rates are expected to stay at their current levels at least through summer of 2019. In any case, with ECB's concern over rising global uncertainty, we opine that interest rate hikes would take place later rather than earlier. In the meantime, we expect one interest-rate hike by the Bank of England in 2018 in view of the recent hawkish remarks from its policymakers.

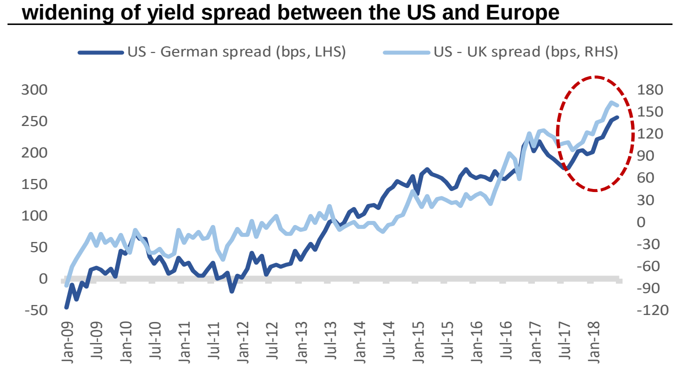
- ***Yields to remain mostly rangebound.*** Given lingering geopolitical risks, the safe-haven status of core European government bonds such as the German bund and UK gilt will appeal to risk-averse investors, thereby restricting the upward momentum in yields. Investors will continue to shy away from countries perceived as high risk, notably Italy, Spain and some peripheral countries.

Exhibit 5: Yields are expected to remain rangebound in the near term except those of countries perceived as high risk



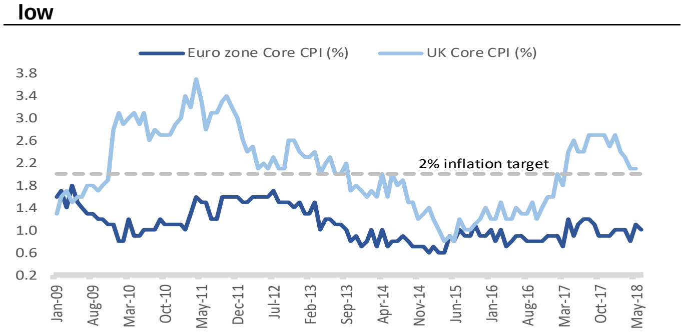
Source: Bloomberg, MARC Fixed Income Research

Exhibit 6: Monetary policy divergence has led to a further widening of yield spread between the US and Europe



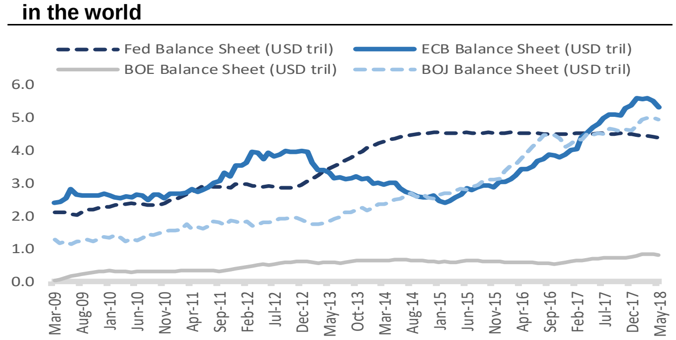
Source: Bloomberg, MARC Fixed Income Research

Exhibit 7: Core inflation in Europe has remained stubbornly low



Source: Bloomberg, MARC Fixed Income Research

Exhibit 8: The size of ECB's balance sheet is by far the largest in the world



Source: Respective central banks, Bloomberg, MARC Fixed Income Research

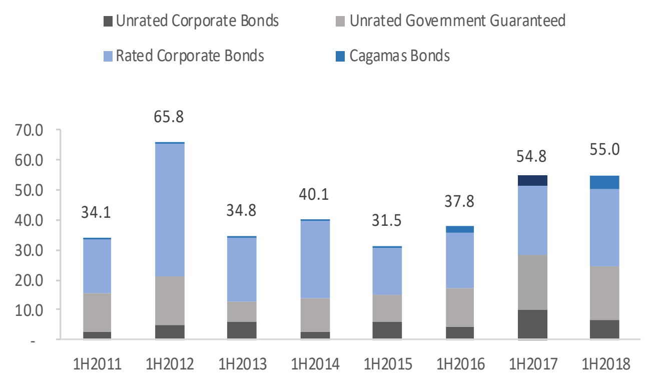
Malaysian Government Bond Market

Primary market

- ***The government raised a total of RM62.7 billion in 1H2018, higher than the amount raised in the previous corresponding period.*** Of the total, RM55.0 billion was raised through 18 public offerings (RM27.0 billion via MGS, RM28.0 billion via GII). Despite the increased supply, demand for government bonds was relatively stronger. The average bid-to-cover (BTC) ratio for all government bond auctions during 1H2018 came in higher at 2.3x compared with 2.0x in 2H2017. Bidding interest remained skewed towards the higher-yielding GII papers, reflecting an increased popularity of *sukuk* among investors.

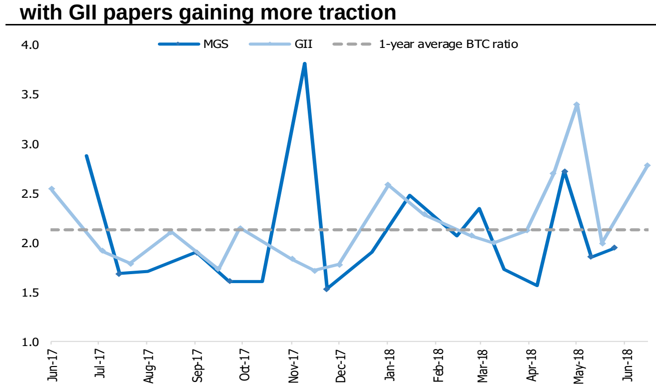
- ***Despite the marginal increase, the issued amount of MGS/GII in 1H2018 is within our projected range of RM100.0 billion to RM105.0 billion for the whole of 2018.*** Going into 2H2018, there are 15 remaining scheduled public offerings based on the auction calendar - six for MGS and nine for GII. We estimate the average issue size for each offering to be between RM2.5 billion and RM3.3 billion. Given our projection of RM62.8 billion worth of MGS/GII notes maturing in 2018, net issuance is expected to range between RM37.2 billion and RM42.2 billion. While the new government's measures (i.e. zero-rating of the Goods and Services Tax (GST) and stable prices of RON95) could exert some upward pressure on Malaysia's budget deficit, the increase in the government bond issuance will be capped given the new government's focus to reduce overall fiscal liability.

Exhibit 9: Gross MGS/GII issuance in 1H2018 grew at the same pace as 1H2017



Source: BNM Bond Info Hub, MARC Fixed Income Research

Exhibit 10: Demand for MGS/GII papers in 1H2018 was stable with GII papers gaining more traction



Source: BNM FAST, MARC Fixed Income Research

Exhibit 11: Auction results/calendar for government bonds 2018

Issues	Tenure (Years)	Target Quarter	Target Month	Issue Date	Amount (RM Mil)	Bid-To-Cover ratio (x)	Average Yield (%)
20-year Reopening of MGS 04/37 4.762%	20	1Q2018	January	05-Jan-18	2,000	1.91	4.61
5-year Reopening of MGII 04/22 3.948%	5	1Q2018	January	15-Jan-18	4,000	2.58	3.82
15-year Reopening of MGS 04/33 3.844%	15	1Q2018	January	29-Jan-18	2,500	2.47	4.45
7.5-year New Issue of MGII (Mat on 08/25)	7.5	1Q2018	January	07-Feb-18	3,000	2.28	4.13
10-year Reopening of MGS 11/27 3.899%	10	1Q2018	January	28-Feb-18	3,500	2.07	4.06
30-year Reopening of MGII 05/47 4.895%	30	1Q2018	January	09-Mar-18	1,500	2.07	4.93
7-year New Issue of MGS (Mat on 03/25)	7	1Q2018	January	14-Mar-18	3,000	2.35	3.88
15-year Reopening of MGII 06/33 4.724%	15	1Q2018	March	23-Mar-18	2,500	2.00	4.55
3-year Reopening of MGS 11/21 3.620%	3	1Q2018	March	30-Mar-18	3,000	1.72	3.45
20-year Reopening of MGII 08/37 4.755%	20	2Q2018	April	13-Apr-18	2,500	2.12	4.80
5-year New Issue of MGS (Mat on 04/23)	5	2Q2018	April	20-Apr-18	4,000	1.56	3.76
10.5-year New Issue of MGII (Mat on 10/28)	10.5	2Q2018	April	30-Apr-18	4,000	2.70	4.37
15.5-year New Issue of MGS (Mat on 11/33)	15.5	2Q2018	May	07-May-18	3,000	2.72	4.64
7-year Re-opening of MGII (Mat on 08/25)	7	2Q2018	May	15-May-18	3,000	3.40	4.20
10-year Reopening of MGS 06/28 3.733%	10	2Q2018	May	24-May-18	3,500	1.85	4.20
5-5-year New Issue of MGII (Mat on 11/23)	5.5	2Q2018	May	31-May-18	4,000	1.99	4.09
20-year New Issue of MGS (Mat on 06/38)	20	2Q2018	June	08-Jun-18	2,500	1.94	4.89
15-year Reopening of MGII 06/33 4.724%	15	2Q2018	June	29-Jun-18	3,500	2.78	4.78
30-year New Issue of MGS (Mat on 07/48)	30	3Q2018	July				
10-year Reopening of MGII (Mat on 10/28)	10	3Q2018	July				
7-year Reopening of MGS (Mat on 03/25)	7	3Q2018	July				
20-year Reopening of MGII 08/37 4.755%	20	3Q2018	August				
15-year Reopening of MGS (Mat on 11/33)	15	3Q2018	August				
5-year Reopening of MGII (Mat on 11/23)	5	3Q2018	August				
30-year Reopening of MGII 05/47 4.895%	30	3Q2018	September				
10-year Reopening of MGS 06/28 3.733%	10	3Q2018	September				
3.5-year New Issue of MGII (Mat on 03/22)	3.5	3Q2018	September				
20-year Reopening of MGS (Mat on 06/38)	20	4Q2018	October				
10-year Reopening of MGII (Mat on 10/28)	10	4Q2018	October				
7-year Reopening of MGII (Mat on 08/25)	7	4Q2018	November				
5-year Reopening of MGS (Mat on 04/23)	5	4Q2018	November				
20-year Reopening of MGII 08/37 4.755%	20	4Q2018	December				
3-year Reopening of MGII (Mat on 03/22)	3	4Q2018	December				

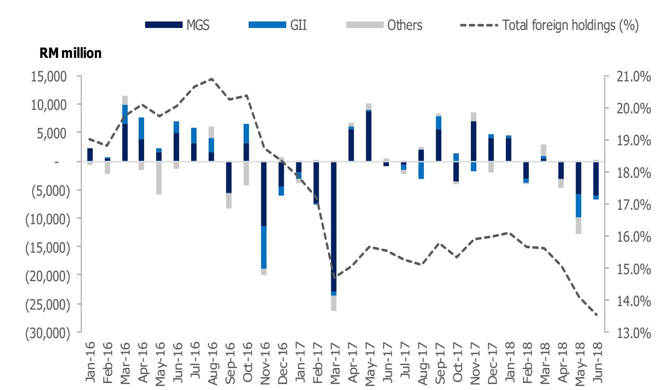
Source: BNM FAST, MARC Fixed Income Research

Foreign ownership trend of local govvies

- ***Foreign investors were net sellers of local govvies in 1H2018 with total net foreign outflow of RM18.7 billion.*** The local govvies market experienced heavy foreign outflows since the start of 2Q2018 primarily driven by external factors: (1) a rebound in the USD, evidenced by a 6% rise in the USD index; (b) a continuing FFR hike by the Fed; (3) a planned termination of ECB's asset purchase programme by end-2018; and (4) the ongoing US-China trade tensions. As at end-1H2018, total foreign holdings of local govvies amounted to RM167.6 billion (2017: RM186.3 billion), equivalent to 23.8% (2017: 28.0%) of the total outstanding (MGS: 40.1%, GII: 4.8%).

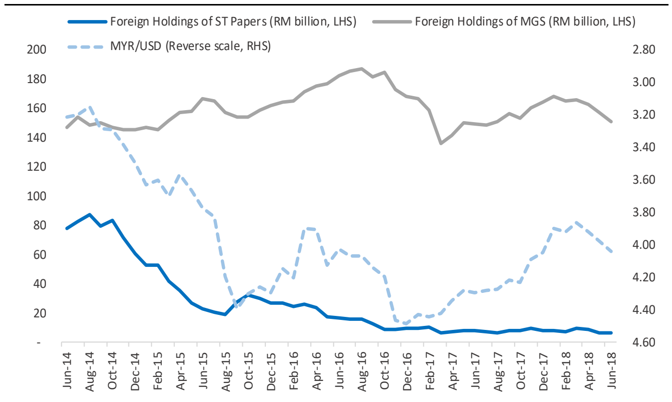
- ***MARC does not rule out the possibility of continuing foreign outflows from local govvies in 2H2018 but the magnitude is expected to be reduced.*** We expect the pressure from foreign selling of local govvies to persist in the near term, again to be driven mainly by external factors. This would, however, be a short-term phenomenon. Malaysia could face the risk of a contagion effect if recent financial market turbulence in some EM economies (such as Argentina, Brazil and Turkey) intensifies. Foreign demand for local govvies could also be hit by global central banks' expected plans to end their post-global financial crisis (GFC) stimuli by year-end. The unresolved trade spat between the US and China would continue to strengthen the demand for the US dollar and safe-haven assets from developed markets, deterring foreign demand for assets from EMs. Notwithstanding these, we expect the size of the outflows to be reduced due to: (1) resilient global crude oil prices; (b) greater clarity from the current government on its medium-term fiscal plan; and (3) expectation of improved medium-term economic fundamentals for Malaysia.

Exhibit 12: Foreign ownership of local govvies had fallen significantly in 1H2018



Source: BNM, MARC Fixed Income Research

Exhibit 13: Foreign outflows moved in tandem with the ringgit



Source: BNM, Bloomberg, MARC Fixed Income Research

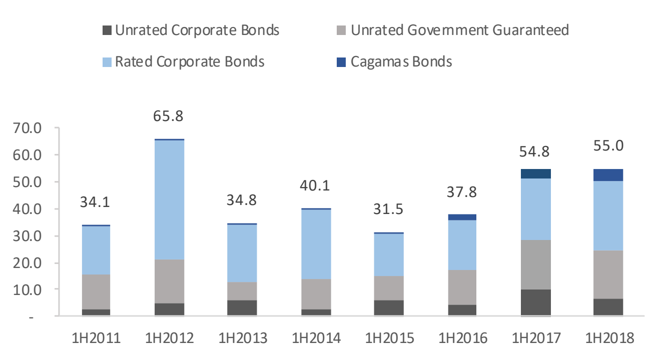
The Ringgit Corporate Bond Market

Primary market

- ***The ringgit corporate bond issuance totalled RM55.0 billion in 1H2018, almost the same amount as in 1H2017, which was the highest since 1H2012.*** This is in spite of a slowdown after issuance activities hit a peak of RM13.1 billion in March 2018 prior to GE14 in May. The corporate bond primary market was largely supported by issuers from the rated corporate bonds segment (including Cagamas), which grew by RM4.2 billion y-o-y to RM30.6 billion in 1H2018. Funds raised via unrated segments (including quasi-sovereign or GG), however, declined by RM4.0 billion y-o-y to RM24.4 billion. A bulk of the issuance came from issuers from the financial services sector which made up 47.2% of total gross issuance in 1H2018. The top five corporate bond issuers in 1H2018 were DanaInfra Nasional Bhd (RM6.5 billion), Edra Energy Sdn Bhd (RM5.1 billion), Cagamas Bhd (RM4.9 billion), Danga Capital Bhd (RM3.5 billion), and Prasarana Malaysia Bhd (RM3.0 billion).

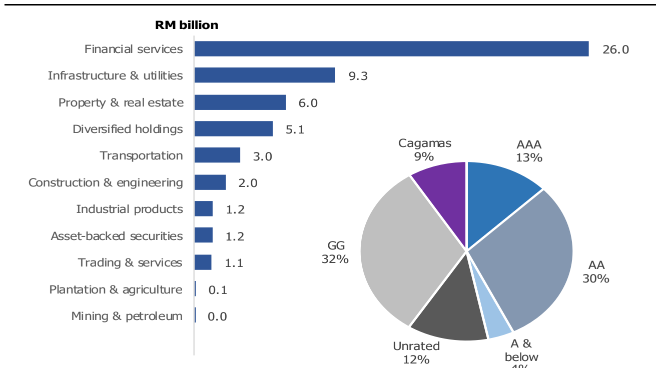
- ***We maintain our 2018 forecast of corporate bond issuances of between RM90 billion and RM100 billion.*** This is despite a more aggressive than previously expected issuance of rated corporate bonds in 1H2018. The issuance from the GG segment has been declining in recent times and we expect the trend to continue in 2H2018 due to the review of some mega projects by the new government. The government had recently ordered the suspension of the East Coast Rail Link (ECRL) project. At this time, it remains unclear which other large-scale infrastructure projects would be affected. Notwithstanding this, we do not expect a significant impact on the overall health of corporate bond issuance activities for the rest of 2018. There are still several large corporate bond issuances (more than RM1.0 billion) expected in the pipeline for the rest of 2018 from issuers such as GENM Capital Bhd, FGV Resources Sdn Bhd, Yong Tai Bhd, United Overseas Bank (Malaysia) Bhd, Country Heights Holdings Bhd, Hong Leong Financial Group Bhd, OSK I CM Sdn Bhd, and Medini Iskandar Malaysia Sdn Bhd,

Exhibit 14: Corporate bond issuances in 1H2018 grew at the same pace as 1H2017



Source: BPAM, MARC Fixed Income Research

Exhibit 15: The financial services sector contributed nearly 50% of total issuance in 1H2018

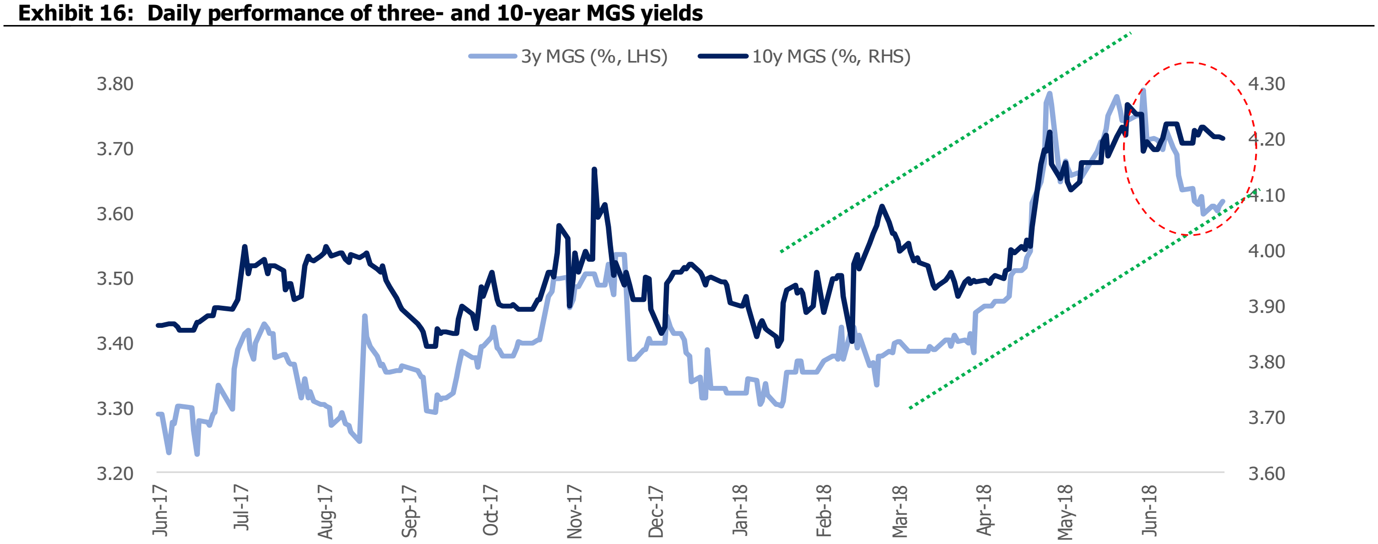


Source: BPAM, MARC Fixed Income Research

Upward ringgit bond yields to be sustained in 2H2018

- ***MARC expects the upward yield momentum from 1H2018 to extend into 2H2018.*** Faltering demand of EM financial assets would likely persist in 2H2018 amid concerns over rising interest rates, trade war jitters, possibility of currency devaluations worldwide, and political developments in some European countries. We also expect the 10y MGS yield to gradually rise alongside the 10y UST, ranging between 4.0% and 4.5% for 2H2018. We are of the view that the magnitude of the yield increase will depend on the pace of the US Fed's FFR hike and the ringgit's trend against the greenback. Notwithstanding this, we do not expect sharp increases in yields due to some mitigating factors that include: (1) Malaysia's commendable economic growth; and (2) new positive effort to address high government debt by the new administration.

Exhibit 16: Daily performance of three- and 10-year MGS yields

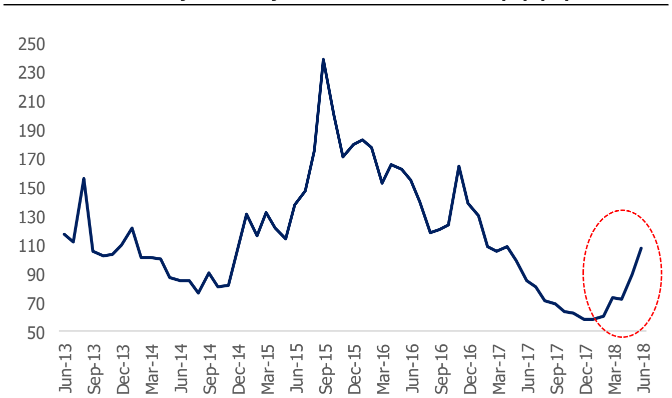


Source: Bloomberg, BPAM, MARC Fixed Income Research

Exhibit 17: 10/3 MGS spread (bps)

Source: Bloomberg, MARC Fixed Income Research

Exhibit 18: Malaysia five-year credit default swap (bps)



Source: Bloomberg, MARC Fixed Income Research

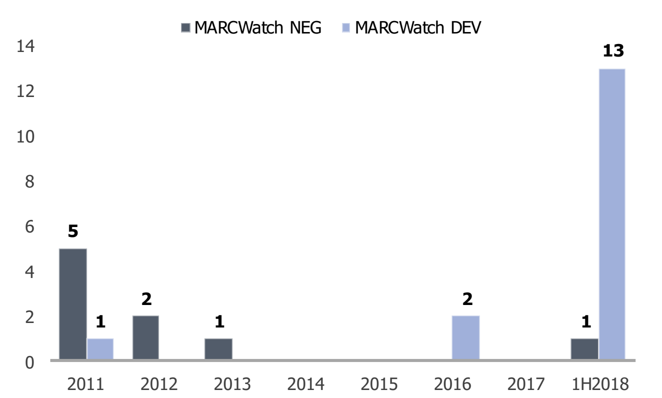
Rating Migration

- ***No issuers within MARC's universe experienced rating changes in 2H2018.*** MARC's rating activities remained stable during the period with affirmations continuing to dominate. There were no downgrades, upgrades or defaults in 1H2018. However, 14 issues were placed under MARCWatch in May 2018. MARC placed Murud Capital Sdn Bhd's debt ratings on MARCWatch Negative amid heightened risk of weakening in its net operating income (NOI) following the new government's plan to abolish the Land Public Transport Commission (SPAD). The remaining 13 issue ratings which were from MARC's toll road universe were placed on MARCWatch Developing. These placements were driven by the increased near-term uncertainty pending full clarity on the current government's exact plans to deliver pre-election commitments on the scrapping of toll road charges.

- ***Rating outlook for issuers in MARC's rating universe remained broadly stable in 1H2018***. Only two issuers had their rating outlook revised. Specifically, the rating outlook for both Malaysia Marine and Heavy Engineering Holdings Berhad (MHB) and Sistem Penyuraian Trafik KL Barat Sdn Bhd (SPRINT) were revised to stable from negative. The rating outlook revision on MHB is driven by its increasing order book and the improving outlook for the oil and gas (O&G) industry that would mitigate any significant asset impairment. Meanwhile, SPRINT's rating outlook revision reflects the firm's manageable upcoming financing obligations, supported by sufficient cash flow generation despite its traffic performance trailing projections.

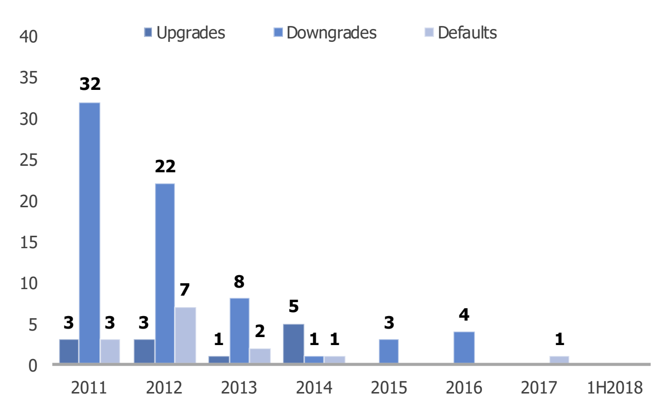
- ***For 2H2018, MARC foresees more challenges ahead for corporate and financial institutions in its rated universe.*** MARC's opinion reflects the ongoing uncertainty following the proposals to abolish tolls, cancellation of several mega infrastructure projects and the escalating trade tensions between the US and China that may erode future earnings of corporate bond issuers within MARC's rated universe. As such, further revisions on rating outlook and possible rating migrations would be unavoidable.

Exhibit 19: MARCWatch placements by issue count



Source: Bloomberg, MARC Fixed Income Research

Exhibit 20: MARC's rating migration activities by issue count



Source: Bloomberg, MARC Fixed Income Research

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