Fixed Income Research

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MALAYSIAN RATING CORPORATION BERHAD
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FIXED INCOME UPDATE:
Yields to Ease on Dovish Outlook

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In a nutshell

- ***US government bond market***
  The Federal Reserve (Fed) brought down the target range of the federal funds rate (FFR) by 25 bps to 2.00%-2.25%, its first cut since the Global Financial Crisis (GFC) in 2008. We do not rule out another reduction in the FFR in the coming months if global economic uncertainties become more pronounced. In Jan-Jul 2019, yields on US Treasuries (UST) plunged due to rising global trade concerns and geopolitical tensions in the Middle East. The yield on the 10y UST fell by 67 bps to 2.01% by end-July from 2.68% in 2018. We expect UST yields to remain supported for the rest of the year amid persistent trade tensions.

- ***Malaysian government bond market – Primary market***
  Gross issuance of Malaysian Government Securities (MGS)/Government Investment Issues (GII) rose to RM77.5 billion in Jan-Jul 2019, up from RM72.5 billion in the corresponding period last year. GII issuances garnered strong demand at public auctions with an average bid-to-cover (BTC) ratio of 3.1x. With strong issuances in Jan-Jul 2019, we foresee total gross issuances of MGS/GII to be in the range of RM110.0 billion and RM120.0 billion for the whole of 2019. Demand for these notes, especially for long-dated tenures, would be supported by yield hunting activities as global central banks become increasingly dovish in their outlook.

- ***Malaysian government bond market – Secondary market***
  MGS yields fell sharply by end-July 2019 after surging in April and May. The 10y MGS yield fell by 50 bps to 3.57% from 4.07% in 2018, the lowest since October 2016, while the 3y MGS fell to 3.27%, the lowest since August 2017. We expect MGS yields to remain relatively low in Aug-Dec 2019 following the recent cut in FFR at end-July. In particular, we anticipate the yield for the 10y MGS to be in the range of 3.5% and 4% for the rest of the year.

- ***Malaysian corporate bond market – Primary market***
  Corporate bond issuance surged to RM85.9 billion in Jan-Jul 2019 amid large issuances from the unrated sukuk segment (Urusharta Jamaah Sdn Bhd or Urusharta). Other segments, however, registered a decline in their issuances due to the slowdown in both public and private investment growth, moderate 1Q2019 gross domestic product (GDP) growth and concerns over the ongoing global trade tensions. Corporate bond issuances for the whole of 2019 is projected to be between RM100.0 billion to RM110.0 billion following the higher-than-expected issuance in Jan-Jul 2019. Having said this, we expect issuance of quasi-government corporate bonds to decline amid the government's strong commitment to reduce its debt obligations.

- ***Malaysian corporate bond market – Rating activities by MARC***
  There were five downgrades recorded in Jan-Jul 2019, the most since 2013. The downgrades were mostly due to operational issues and industry-related challenges faced by corporate bond issuers. There were no upgrades or defaults during the period. The rating outlook for issuers in MARC's rating universe remained broadly stable with only two issuers recording downward revisions in its rating outlook.

- ***Foreign ownership trend of local bonds***
  Foreign holdings of local bonds declined by RM2.2 billion to RM182.6 billion in 1H2019 amid heavy outflows seen in April and May. The outflows slowed in June in tandem with the global bond rally during the period. We foresee the volatility in foreign capital flows to persist in 2H2019 as global economic uncertainties prevail. Nevertheless, annual cumulative foreign flows into local bonds for 2019 are expected to improve from their levels in 2016-2018.

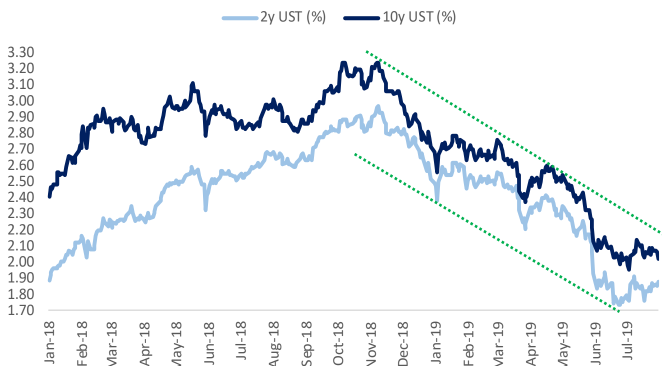
US Government Bond Market

- ***The Fed cuts rate.*** The anticipated rate cut by the Fed materialised in July, its first since the GFC in 2008. The Fed brought down the target range by 25 bps to 2.00%-2.25%. However, the move had disappointed the market as investors were expecting a 50-bp reduction instead. Investors were also disappointed with Chairman Powell's statement that the cut only serves to "insure against downside risks" but did not signal the start of an easing monetary policy cycle. However, although the US economy remained generally robust in the first half of the year, we do not rule out an additional reduction in the FFR in the coming months if global economic uncertainties become more pronounced.

- ***At end-July, geopolitical tensions in the Middle East and ongoing global trade concerns sent UST yields plunging.*** The UST market was supported by increasing expectations that global central banks would step in to boost sentiment given the increasing negative externalities. The worsening US-China trade disagreements had boosted the demand for safe-haven assets. With no trade deal in sight, the yield on the 10y UST plunged by 67 bps to 2.01% from 2.68% in 2018. Investors were also convinced that the Fed is now entering a rate-cutting cycle given that the yield curve has continued to invert. The 10y3m UST yield spread had turned negative (-5 bps) by end-July from 33 bps in 2018.

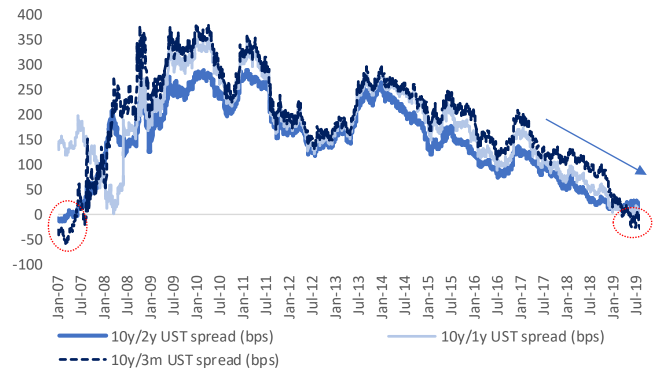
- ***UST yields to remain supported as downside risks to global growth persist.*** We are upbeat on USTs despite the less dovish than expected stance adopted by the Fed. We think that the cautious move adopted by the Fed signals that it is still open to more rate cuts in the future to avert a slowdown in the US economy down. The increasing trade tensions between the US and China would also dampen global growth, causing other global central banks to embark on easing measures, hence increasing the appeal of USTs. Furthermore, against the backdrop of tepid inflation in the US, UST yields will largely remain supported.

Exhibit 1: CNY AND MYR



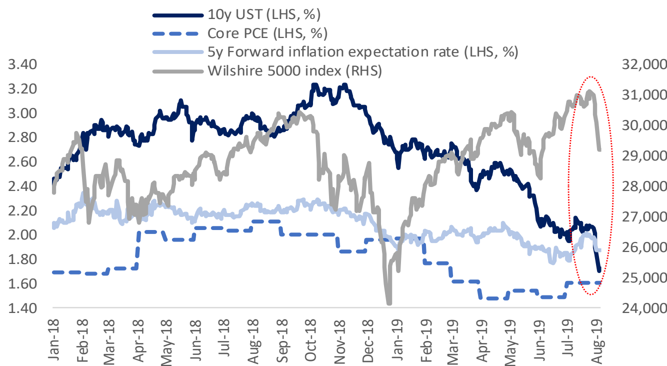
Sources: Bloomberg, MARC Fixed Income Research

Exhibit 2: UST yield spreads



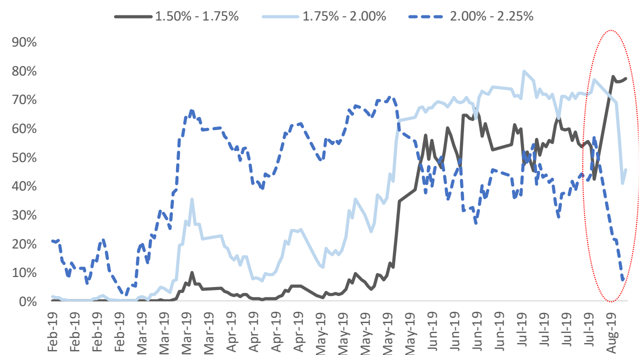
Sources: Bloomberg, MARC Fixed Income Research

Exhibit 3: 10y UST vs US Stock Market & inflation outlook



Sources: Bloomberg, MARC Fixed Income Research

Exhibit 4: Market implied probability of FFR target range



Sources: Bloomberg, MARC Fixed Income Research

Malaysian Government Bond Market

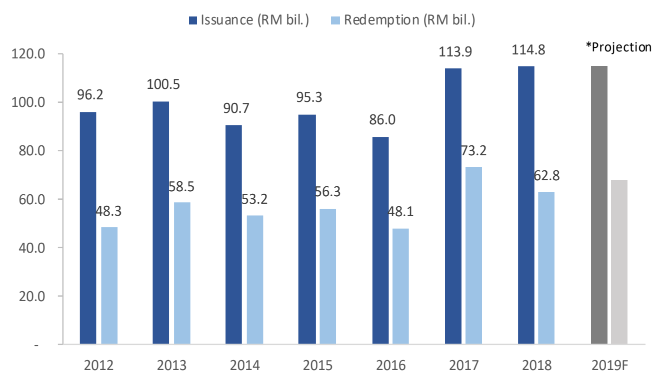
Primary market

- ***Gross issuance of MGS/GII papers rose to RM77.5 billion in Jan–Jul 2019 with GII dominating the issuance.*** The RM77.5 billion was raised through 20 offerings with RM38.0 billion via MGS and RM39.5 billion via GII, slightly higher than the amount in the corresponding period last year. The GII-to-MGS ratio stood at 51:5 (Jan-Jul 2018: 44:6), underscoring the government's preference for sukuk issuance. In Jan-Jul 2019, all tendered issues garnered an average BTC ratio of 2.8x (MGS: 2.4x, GII: 3.1x), better than the average BTC ratio of 2.3x recorded in the corresponding period last year. Demand was slanted towards GII with maturities of more than 10 years with support mainly coming from local institutional investors.

- ***We expect gross issuance of MGS/GII papers for 2019 to be in the range of RM110.0 billion and RM120.0 billion.*** Our forecast is premised on the government's projected budget deficit of RM52.1 billion and redemption value of RM67.9 billion. We also take into account the net proceeds from the JPY200.0 billion 10y Samurai bond issuance in March. In Jan-Jul 2019, net issuance of MGS/GII papers amounted to RM51.4 billion. Going forward, RM41.8 billion worth of MGS/GII is expected to mature Aug-Dec 2019.

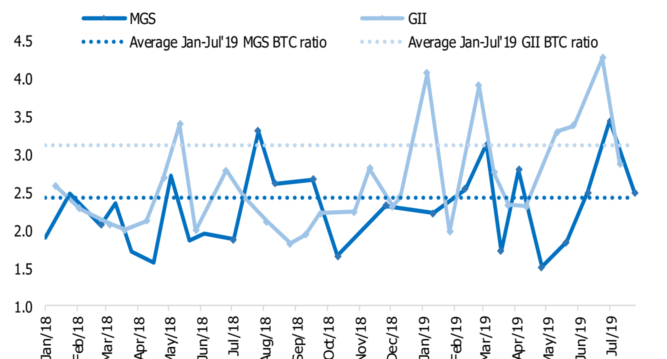
- ***Going into Aug-Dec 2019, we expect additional MGS/GII issuance of between RM32.5 billion to RM42.5 billion.*** The average issuance size is expected to be around RM3.0 billion and RM3.5 billion for the remaining 12 scheduled offerings. Total private placements would also trend lower for the remaining issues. However, we expect the positive sentiment for MGS/GII papers seen at public auctions in Jan-Jul 2019 to continue for the rest of the year given the ample supply of highly-in-demand longer-dated notes scheduled for upcoming auctions. Demand for these notes would be supported by yield hunting activities as global central banks become increasingly dovish.

Exhibit 5: Gross MGS/GII issuance



Sources: BNM Bond Info Hub, MARC Research

Exhibit 6: BTC ratios of government bond auctions



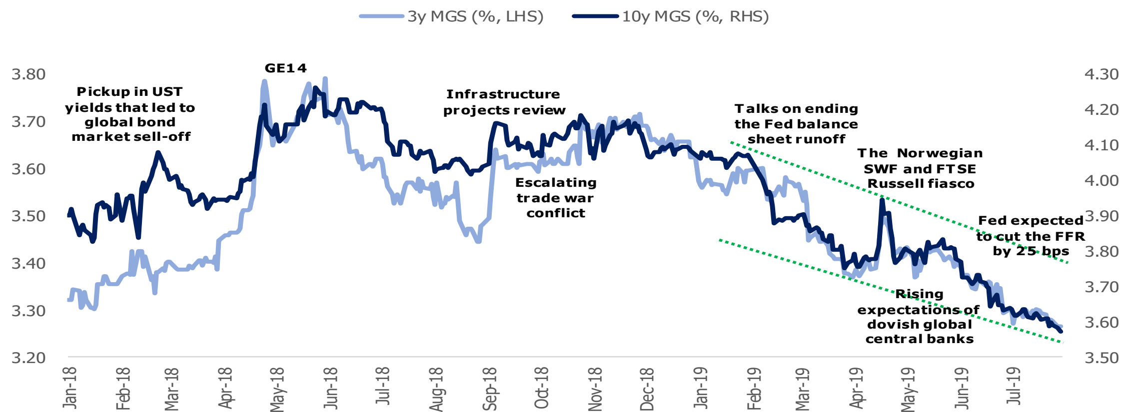
Sources: BNM FAST, MARC Research

Secondary market

- ***At end-Jul 2019, MGS yields had fallen significantly following increasing expectations of further monetary easing by global central banks.*** MGS yields initially surged in April and May due to heavy foreign outflows following downbeat comments from Norway's Sovereign Wealth Fund (SWF) and FTSE Russell on the possibility of Malaysian government bonds being excluded from the global index. In June, however, many major central banks eased their monetary stance from their already accommodative levels as concerns over a gloomier global economic outlook persisted. MGS yields continued their downwards trend in July as investors expect the Fed to cut the FFR in its July FOMC meeting. At end-Jul 2019, MGS yields fell to their multi-year lows with the yield curve continuing to be bull flattened, and the 20y/3y MGS spread narrowing to 70 bps from 104 bps in 2018. Overall, MGS yields were broadly lower by 33 bps to 69 bps. The 10y MGS fell by 50 bps to 3.57% from 4.07% in 2018, the lowest since October 2016, while the 3y MGS fell by 35 bps to 3.27% from 3.62% in 2018, the lowest since August 2017.

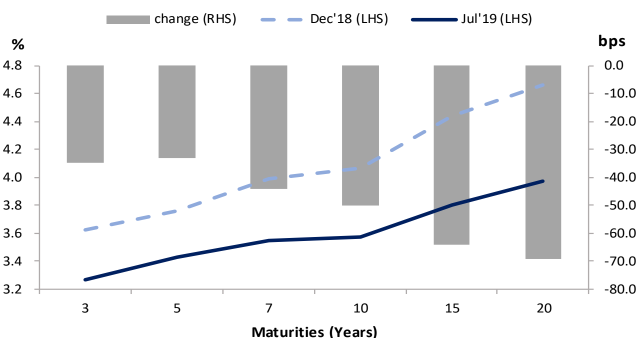
- ***MGS yields are likely to trend downwards for the rest of 2019 to below their pre-US President Trump era levels in 2016.*** This is due to the recent reduction in the FFR which will widen the MGS and UST yield spread further. The widening yield spread would trigger stronger demand for MGS because of its favourable yields when compared with those of A-rated government bonds in the region. In addition, the growing downside risk for the Malaysian economy could fuel expectations of a further cut in the overnight policy rate (OPR). All these will limit the upside for the yields of Malaysian government bonds. As such, although our base case forecast for Malaysia's benchmark OPR remains at 3% at this juncture, we now expect the yield for the 10-year MGS to be in the range of 3.5% and 4% for the rest of 2019.

Exhibit 7: Daily performance of three- and 10-year MGS yields



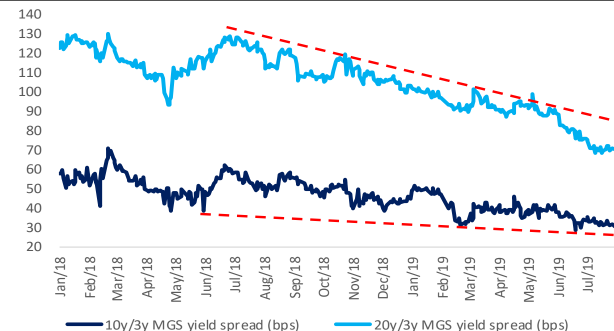
Sources: Bloomberg, MARC Research

Exhibit 8: MGS yield curve



Sources: Bloomberg, MARC Research

Exhibit 9: MGS yield spreads



Sources: Bloomberg, MARC Research

Malaysian Corporate Bond Market

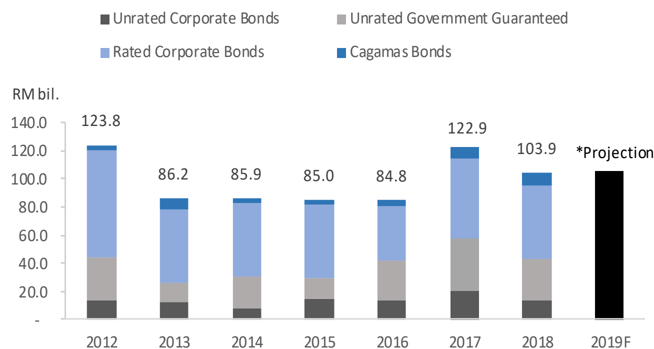
Primary market

- ***In Jan-Jul 2019, total issuance surged to RM85.9 billion (Jan-Jul 2018: RM60.9 billion), the highest Jan-Jul figure ever recorded.*** This was mainly due to the large issuances from the unrated segment (Urusharta). Other segments, however, registered a decline in their issuances due to the slowdown in both public and private investment growth, moderate 1Q2019 GDP growth and concerns over the ongoing global trade tensions. By sector, financial services contributed about 68.3% (Jan-Jul 2018: 45.7%) of total corporate bond issuances in Jan-Jul 2019.

- ***We forecast the total corporate bond issuance for 2019 to be between RM100.0 billion and RM110.0 billion.*** Corporate bond issuances in Aug-Dec 2019 are expected to be fairly robust as the OPR cut in May had lowered the cost of funds. We expect corporate bond issuers to take the opportunity to lock into lower rates. Furthermore, the government's recent proposal to acquire four toll concessionaires could boost issuances. The government has proposed to acquire KESAS Sdn Bhd, Sistem Penyuraian Trafik KL Barat Sdn Bhd (SPRINT), Lingkaran Trans Kota Sdn Bhd (LITRAK), and Syarikat Mengurus Air Banjir and Terowong Sdn Bhd (SMART) for RM6.2 billion.

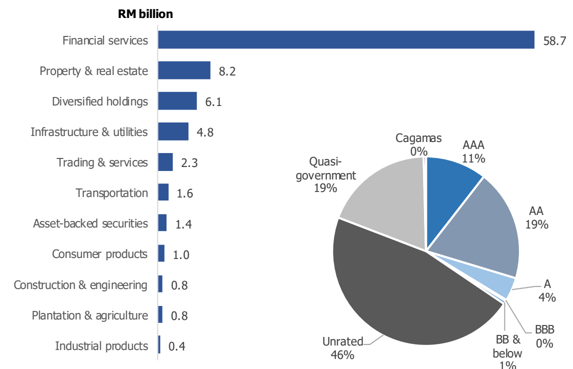
- ***Notwithstanding this, we expect the trend of issuances from quasi-government entities to decline.*** This is premised on recent news that the government may propose a limit on such issuances to reduce its debt obligations. This is further strengthened by the government's strict reviews on infrastructure projects with regard to costs and repayment ability, which may suppress issuances of quasi-government bonds for the rest of the year.

Exhibit 10: Corporate bond issuances



Sources: BPAM, MARC Fixed Income Research

Exhibit 11: Corporate bond issuance composition in 1H2019



Sources: BPAM, MARC Fixed Income Research

Rating activities by MARC

- ***MARC experienced an increase in rating downgrade activities within its universe in 1H2019.*** Marc's rating actions were skewed towards negative movements during the period compared to 2018. There were no upgrades or defaults in Jan-Jul 2019. In total, there were five downgrades recorded in Jan-Jul 2019, the highest since 2013. The downgrades were mostly due to operational issues and industry-related challenges faced by corporate bond issuers.

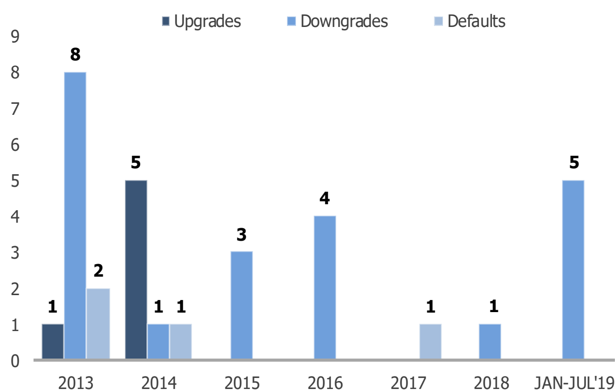
  I. In January, MARC downgraded Quantum Solar Park (Semenanjung) Sdn Bhd's (QSP Semenanjung) RM1.0 billion Green SRI Sukuk rating to A+$_{IS}$ from AA-$_{IS}$/Negative and concurrently placed the rating on MARCWatch Negative. The downgrade reflected the heightened risk of termination of solar power purchase agreements (SPPAs) related to QSP Semenanjung's Merchang and Jasin solar power plant projects. By end-1H2019, QSP Semenanjung's sukuk rating remained in MARCWatch Negative.

  II. MARC lowered its AA rating on Murud Capital Sdn Bhd's Senior Commercial Papers (CP)/Medium-Term Notes (MTN) programme of up to RM290.0 million by one notch to AA-. The downgrade reflects the reduced headroom in the loan-to-value band in line with the decline in Murud Capital's net operating income (NOI) on lower occupancy at Platinum Sentral, the collateral property.

  III. MARC downgraded three issues from two special purpose funding vehicles set up by TSH Resources Bhd (TSH) in June. The downgrades were due to TSH's continued high leverage position and its cash flow being hampered by low crude palm oil prices in recent years.

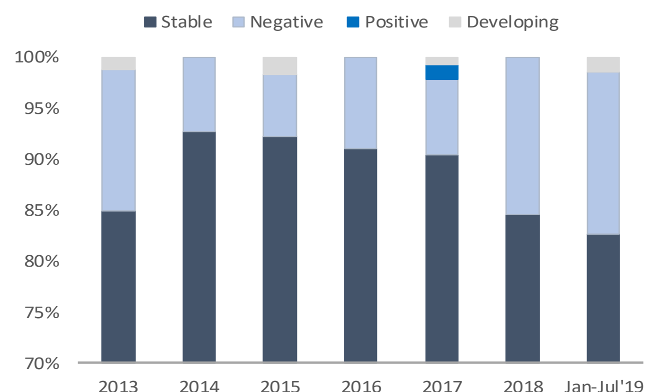
- ***Rating outlook for issuers in MARC's rating universe remained broadly stable in Jan-Jul 2019.*** Only two issuers had their rating outlook revised to negative. Specifically, the rating outlook for both Segi Astana Sdn Bhd and Inverfin Sdn Bhd were revised to negative from stable. The rating outlook revision on Segi Astana Sdn Bhd mirrors that of its parent WCT Holdings Bhd which has provided a cash deficiency support undertaking for the final repayment of its Medium-Term Notes (MTN) facility in 2028. Meanwhile, Inverfin Sdn Bhd's rating outlook revision reflects MARC's concerns on the continued pressure on the occupancy rate of the collateral property, Menara Citibank.

Exhibit 12: MARC's rating migration activities by issue count



Source: Bloomberg, MARC Fixed Income Research

Exhibit 13: MARC's rating outlook distribution



Source: Bloomberg, MARC Fixed Income Research

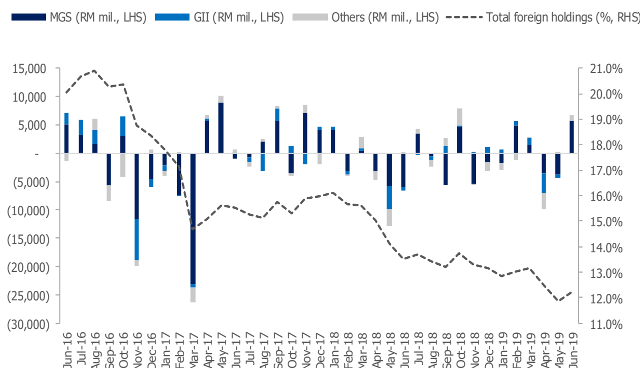
Foreign ownership trend of local bonds

- ***Foreign holdings of local bonds declined by RM2.2 billion to RM182.6 billion in 1H2019 with foreign share of total outstanding at 12.2% (2018: 13.1%).*** The local bond market experienced heavy foreign outflows in April and May amid: 1) the possibility that Norway's SWF and FTSE Russell will exclude Malaysian government bonds from their respective indices; 2) moderate 1Q2019 GDP growth; and 3) concerns of a prolonged US-China trade war. However, MGS registered net foreign inflows of RM3.0 billion in 1H2019 due to the surge in demand following the global bond rally in June. Other instruments, however, registered net foreign outflows.

- ***Moving forward, we foresee the volatility in foreign capital flows to persist in 2H2019 as global economic uncertainties prevail.*** In addition, concerns over the outcome of FTSE Russell's revision of the global bond index (World Government Bond Index or WGBI) in September would be among the factors that could affect foreign investor sentiment. Foreign investors could further trim their holdings in the months ahead leading up to FTSE Russell's announcement. Furthermore, if the US-China trade war worsens, foreign appetite for local bonds would also deteriorate.

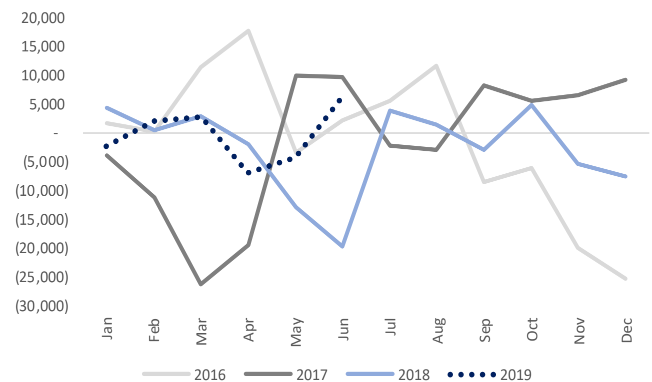
- ***Nevertheless, we expect annual cumulative foreign flows into local bonds to improve from their levels in 2016-2018.*** The expected further reduction in the FFR in 2H2019 will provide more room for Bank Negara Malaysia (BNM) to adjust the OPR downward again, if necessary, in the near future. This will increase the appeal for local bonds due to their attractive yields and benign inflation outlook. Hence, it will mitigate some of the outflows that are expected in 2H2019. Pockets of yield hunting activities would also provide some buffer to Malaysian bonds.

Exhibit 14: Monthly foreign flows and total foreign holdings of local bonds



Sources: BNM, MARC Research

Exhibit 15: Yearly cumulative foreign flows in local bonds performance comparison



Sources: BNM, MARC Research

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