Fixed Income Research

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MARC
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1H2021 Bond Market Update

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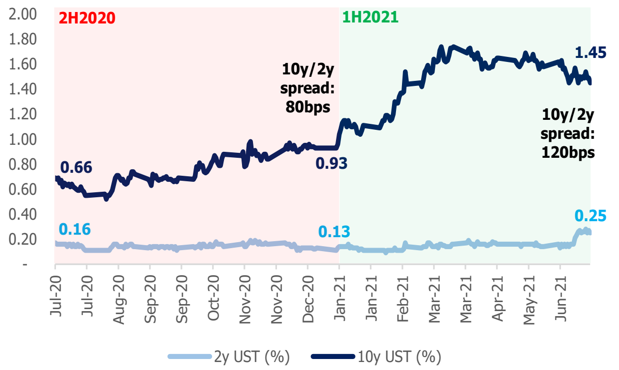
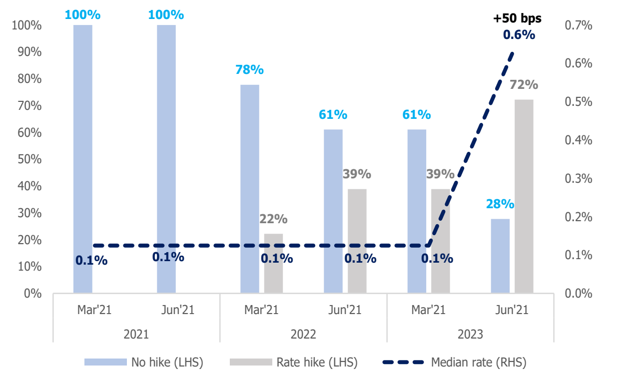
Chart 1: 2y and 10y UST yield trend



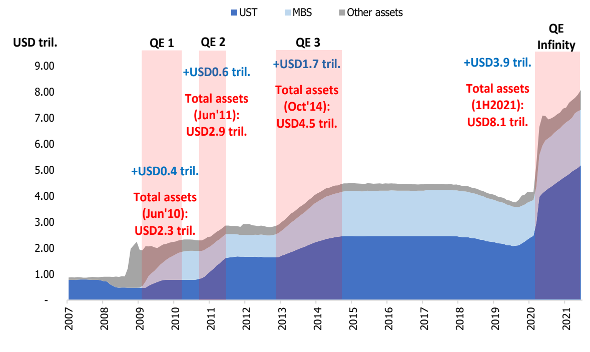
Sources: US Treasury, MARC Research

Chart 2: US Fed FFR expectations - Mar'21 vs Jun'21



Sources: US Fed, MARC Research

Chart 3: US Fed's balance sheet (Assets)



Sources: CEIC, MARC Research

US Government Bond Market Brief

- **Debt market trend in 1H2021**
  Yields on US Treasuries (UST) along the 5y30y curve have retracted by 5bps to 35bps after surging in 1Q2021 as inflation fears eased. The US Federal Reserve (Fed) insists that the high inflationary periods in the US are transitory. Despite the announcement of massive fiscal programmes for 2021, UST yields fell on strong safe-haven demand amid rise in the global spread of the Delta variant coronavirus. Meanwhile, UST yields at the shorter-end rose 1bp to 11bps following the more hawkish tone of the Fed at the conclusion of its June Federal Open Market Committee meeting. The Fed is expected to raise the Federal Funds Rate (FFR) twice in 2023.

- **Outlook for 2H2021**
  UST yields are expected to trend upwards as the US recovery narrative is robust. Our economists believe that the US economy will continue to perform well in the coming months, supported by high vaccination rates and historic levels of government spending. As the Fed has moved up its timeline for rate hikes, taper talks could take place sooner than expected. Markets believe that the Fed will hold off taper talks until its Jackson Hole economic symposium in August. If the Fed proceeds with tapering, we foresee the 10y UST touching the 2.00% level in 2H2021 and massive bond sell-offs in emerging markets

Table 1: Economic projections by the US Fed

US Fed projections (Median)	2021		2022		2023	
	Mar'21	Jun'21	Mar'21	Jun'21	Mar'21	Jun'21
Real GDP growth (%)	6.5	7.0	3.3	3.3	2.2	2.4
Unemployment rate (%)	4.5	4.5	3.9	3.8	3.5	3.5
PCE inflation (%)	2.4	3.4	2.0	2.1	2.1	2.2
Core PCE inflation (%)	2.2	3.0	2.0	2.1	2.1	2.1

Sources: US Fed, MARC Research

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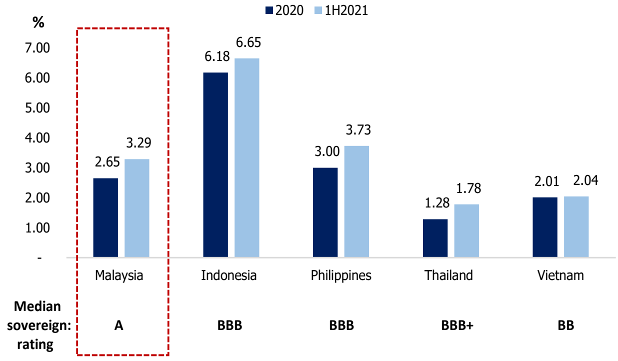
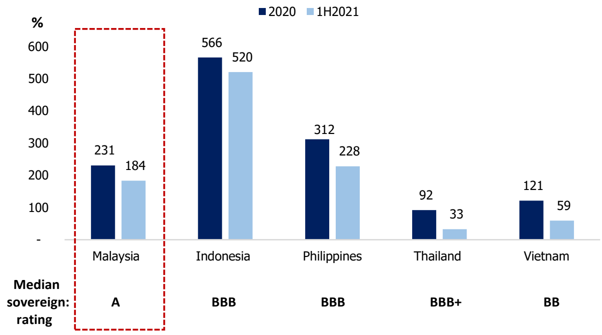
Chart 4: Nominal yield



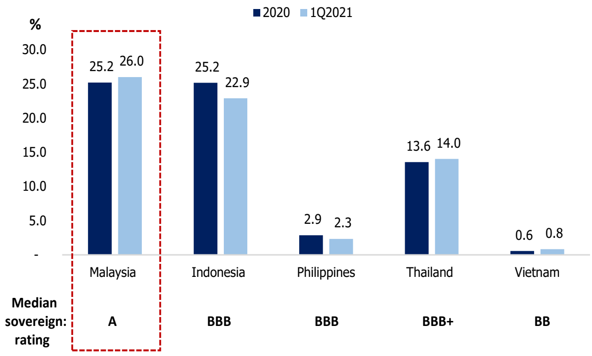
Sources: BNM, Bangko Sentral ng Pilipinas (BSP), Hanoi Stock Exchange (HNX), Ministry of Finance (MoF) Indonesia, Thai Bond Market Association (ThaiBMA), MARC Research

Chart 5: UST yield spread (bps)



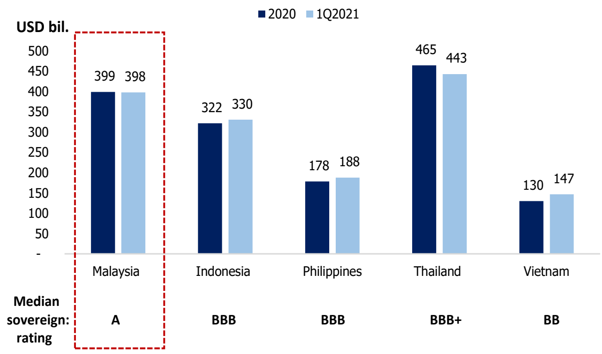
Sources: BNM, BSP, HNX, MoF Indonesia, ThaiBMA, MARC Research

Chart 6: Foreign ownership of LCY govvies



Sources: AsianBondsOnline, MARC Research

Chart 7: Size of LCY bond market



Sources: AsianBondsOnline, MARC Research

ASEAN Bond Markets Brief

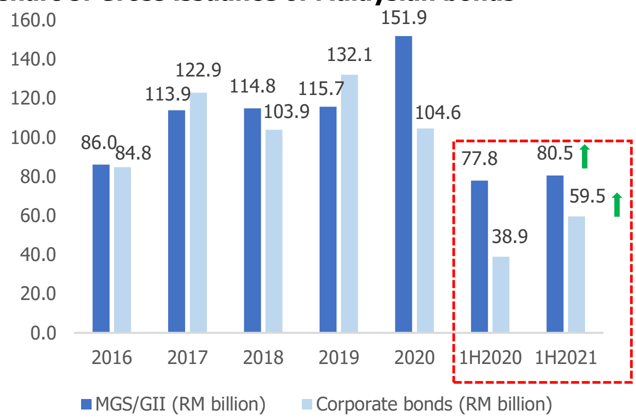
- **INDONESIA**
  Yields on Indonesian government bonds fell across most tenures after surging in March. Indonesian government bonds were supported by the recovery in foreign flows amid weak inflation growth and a less-than-expected contraction in 1Q2021 Gross Domestic Product (GDP). Foreign flows into the Indonesian bond market amounted to IDR3.5 trillion (2020: - IDR87.9 trillion). In February, Bank Indonesia had slashed the 7d repo rate by 25bps to 3.50%, the only central bank in the region that cut its policy rate in 2021YTD.

- **PHILIPPINES**
  A worsened economic outlook combined with stricter lockdown measures and rising COVID-19 infections continued to drive local demand for government bonds. Philippines registered negative GDP growth for the fifth consecutive quarter in 1Q2021 at 4.2% y-o-y, the country's longest recession since the 1980s. Foreign ownership of Philippines local currency (LCY) government bonds remains minimal at 2.3% of total outstanding in 1Q2021.

- **THAILAND**
  Yields on Thai government bonds fell between 5bps to 26bps along the 3y20y curve after spiking in 1Q2021 similar to most emerging markets due to the US reflation trade. Buying support mostly came from local investors amid growing uncertainties on the prolonged impact of COVID-19 on Thailand's trade and tourism-reliant economy. This was exacerbated by the low vaccination rate and disappointing 1Q2021 GDP growth (-2.6%). Despite this, Thai government bonds experienced a boost in foreign ownership amid low inflation.

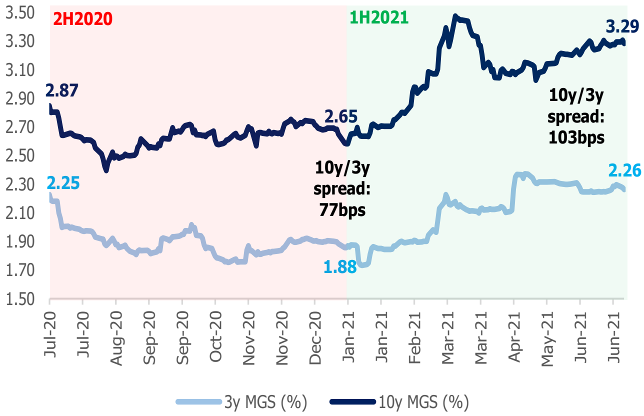
- **VIETNAM**
  Yield movements on Vietnamese government bonds are mostly dictated by local investors. Foreign participation in Vietnamese government bonds is among the lowest in the region at 0.6% in 1Q2021. In 1H2021, yields across the curve were broadly higher amid improved local risk sentiment due to an acceleration in economic growth. Vietnam's 2Q2021 GDP grew 6.6% y-o-y (1Q2021: 4.5%). Yields were also pressured by the government's plan to borrow more than USD74 billion between 2021 to 2023 for socio-economic development.

Chart 8: Gross issuance of Malaysian bonds



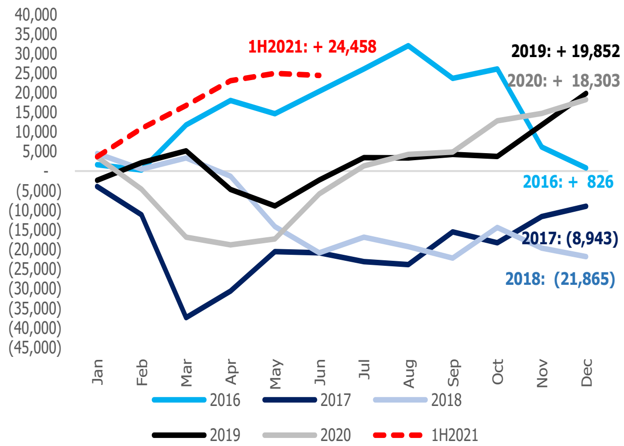
Sources: BNM Bond Info Hub, Bond Pricing Agency Malaysia (BPAM), MARC Research

Chart 9: 3y and 10y MGS yield trend



Sources: CEIC, MARC Research

Chart 10: Cumulative net foreign inflows into local



Sources: CEIC, MARC Research

Malaysia's Bond Market Trend in 1H2021

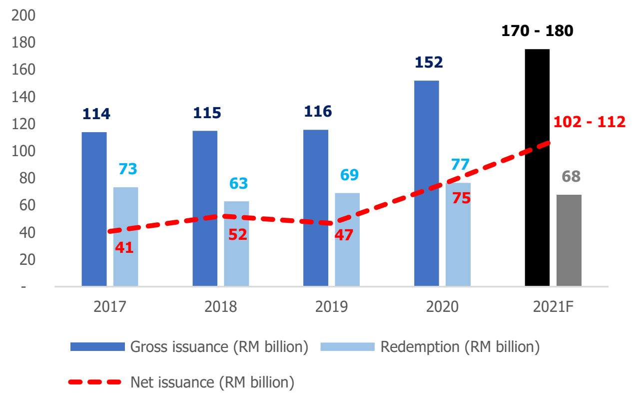
- **Gross issuance of local bonds surged**
  The uncontained number of positive COVID-19 cases in Malaysia had led to stricter lockdown measures. This resulted in greater calls for further fiscal support to complement the lockdown and caused the supply of Malaysian Government Securities (MGS)/Government Investment Issues (GII) to trend upwards. In 1H2021, gross issuance of MGS/GII amounted to **RM80.5 billion (1H2020: RM77.8 billion)**. Meanwhile, the supply of new corporate bonds has also been trending upwards as the OPR remains unchanged at 1.75% and the economy is still slated for a rebound in 2021. Gross issuance of corporate bonds amounted to **RM59.5 billion (1H2020: RM38.9 billion)**.

- **Yields trended upwards, off their all-time lows seen in 2020**
  Amid greater supply pressure, MGS yields across the curve surged between **6bps to 79bps** on a steepening bias compared to end-2020. In June, the 10y MGS was quoted at **3.29% (2020: 2.65%).** Amendments to the National Trust Fund (KWAN) Act and expectations of declined buying support from Employees Provident Fund (EPF) were also partly to blame for the rise in MGS yields. Meanwhile, short-term MGS yields were anchored by Bank Negara Malaysia's (BNM) firm hold on the overnight policy rate (OPR). Corporate bond yields also exhibited a similar trend. However, credit spreads were much tighter as yield movements in the corporate bond market tended to lag behind MGS.

- **Negative rating actions on the rise**
  In MARC's rating universe, a total of **eight** bond issuances had their ratings downgraded compared to two in the previous year. The downgrades were mostly due to cash flow shortfalls as lockdown measures remained in place. Meanwhile, three issuers remained on the MARCWatch Negative list.

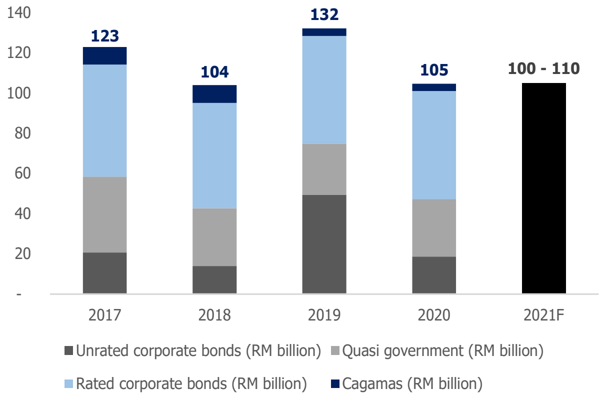
- **Foreign investors remain as net buyers**
  Nevertheless, the local bond market continued to attract foreign inflows. Foreign inflows for the first six months of 2021 amounted to **RM25.0 billion**, supported by FTSE Russell's decision to maintain Malaysia in the World Government Bond Index (WGBI), firmer crude oil prices and affirmation of Malaysia's sovereign credit rating by international rating agencies. However, foreign inflows have turned negative in June amid heightened inflationary pressure, taper tantrum fears, and a worsened fiscal outlook.

Chart 11: Gross issuance of MGS/GII



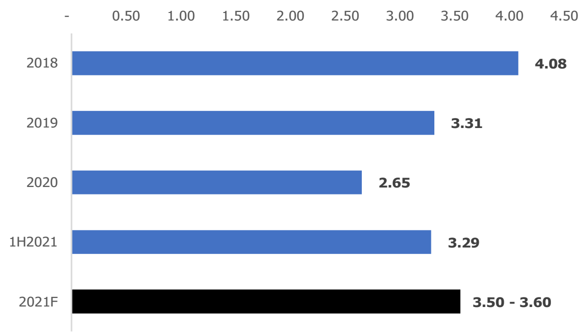
Sources: BNM Bond Info Hub, BPAM, MARC Research

Chart 12: Gross issuance of corporate bonds



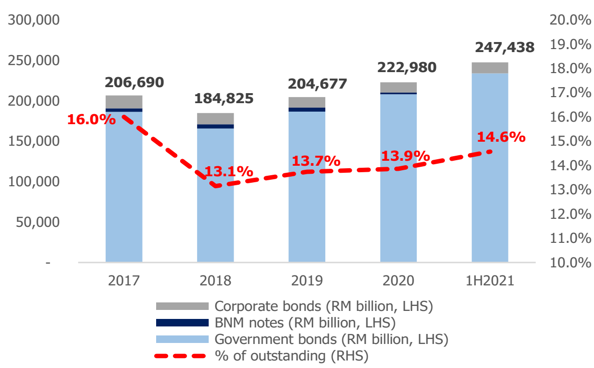
Sources: BPAM, MARC Research

Chart 13: MGS yields



Sources: BNM, MARC Research

Chart 14: Foreign holdings of local bonds



Sources: CEIC, MARC Research

2021 Projections for Malaysia's Bond Market

- **Gross issuance of MGS/GII is expected to be around RM170.0 billion to RM180.0 billion**
  This would be the highest annual gross issuance amount in recorded history. Our projection takes into account of the upside risk to the budget deficit, PEMERKASA, PEMERKASA+ & PEMULIH stimulus packages, proceeds from the USD sustainability sukuk and the withdrawal from KWAN.

- **Demand for MGS/GII in the primary market to remain robust**
  Demand for MGS/GII at public auctions is expected to be sustained for the rest of the year with an average bid-to-cover ratio of at least 2.0x. Majority of the bidding interest is expected to come from local institutional investors as risk sentiment remains dampened.

- **Meanwhile, corporate bond issuances are slated to be around RM100.0 billion to RM110.0 billion**
  This assumes that Malaysia's economic recovery prospects remain intact, leading to an improvement in private investments as business confidence increases. The current conducive financing landscape would also persuade issuers to increase their issuances to secure financing costs. We also expect a steady growth of quasi-government corporate bonds in 2021 amid the resumption of large infrastructure projects to stimulate the economy.

- **Benchmark yields on the 10y MGS to be around 3.50% to 3.60%**
  In recent weeks, MGS yields were seen increasing across all tenures on a steepening bias. We expect the trend to continue for the rest of the year. MGS yields would be pressured by ongoing debates on tapering programmes from global central banks, heightened inflationary pressure, growing new supply of MGS, and waning buying support from EPF.

- **Corporate bond yields to trend higher in line with MGS**
  However, we may see wider credit spreads as negative rating actions have been on the rise due to the extension of lockdown measures. Economic growth forecasts have been revised downwards amid the extension, reducing the appetite for corporate bonds. A possibility of defaults among bond issuers must not be discounted as cash flow reserves are slowly drying up.

- **Foreign investors to remain as net buyers**
  The local bond market is likely to record net foreign inflow in 2021, albeit at a smaller magnitude compared to last year. We do not expect the local bond market to record net foreign outflow for 2021 despite expectations of slower-than-expected economic growth for 2021 due to the implementation of a total lockdown as Malaysia is still poised for a strong rebound. Positive progress in Malaysia's vaccination drive and FTSE Russell's decision to retain Malaysia in the WGBI will continue to attract foreign interest in local bonds.

Final Thoughts on Malaysia's Bond Market

- **Vitally important to contain the pandemic**
  The series of lockdowns have put a significant strain on the economy. Going forward, any failure to contain the pandemic will invite further increases in new supply of MGS/GII to finance, among other things, the government's fiscal packages. Under this scenario, gross issuance of MGS/GII could reach between RM200.0 billion to RM210.0 billion in 2021 if total fiscal direct injections come in around 2020's RM55.0 billion. As for corporate bonds, gross issuance could slow down on further deterioration of business confidence.

- **Fiscal consolidation plans after economic recovery will hurt its long-term development plans**
  We assume that the present debt ceiling will not return to pre-pandemic levels in the near to medium term. During recovery, the Malaysian government may need to reduce its debt issuances in an effort to consolidate its fiscal deficit. Prolonged, excessive debt levels may exert additional rating pressure and increase financing cost.

- **Intra-ASEAN sovereign debt competition will intensify**
  A downgrade would result in Malaysia's rating moving close to those of its lower-rated regional peers and away from Singapore's. This could intensify the competition for sovereign debt among lower-rated sovereigns in the region. However, we believe that the probability for upgrades of other regional powerhouses such as Indonesia and Vietnam is much higher in the long-run. This is premised on the larger and ever expanding middle class in those economies to push for faster economic recovery.

- **Fiscal support vital over the long term**
  Additional government spending is required to restore Malaysia's economy back to its pre-COVID levels. As Malaysia has been recording fiscal deficits for several decades, the government has limited resources to fund its spending without triggering sovereign rating pressure. The government has to step up its debt undertakings to boost its spending to allow for faster economic recovery. Malaysia's debt-to-GDP level remains conservative when compared to its rating peers. In any case, we do not expect the debt ceiling to return to the 55% of GDP level in the near to medium term.

- **Threat of a sovereign rating downgrade**
  During times of crisis, the risk of a sovereign rating downgrade increases. A downgrade would make it harder for fiscally challenged countries to raise debt to nurse their economies back to recovery. In this current crisis, we believe that it makes economic sense for Malaysia government continue spending and risk a sovereign rating downgrade than undergo fiscal austerity. This is because fiscal austerity would hurt future growth rates and reduce Malaysia's drive for reforms and capabilities to combat the current pandemic.

- **Reliance on EPF withdrawals sets a very dangerous precedent as the nation ages**
  EPF withdrawals by contributors under the i-Citra programme are estimated to be around RM30.0 billion. Although EPF's capital and contributions from members remain sufficient to cater for the withdrawals, this limits EPF's ability to invest in new funds. With waning buying support from EPF, we expect bond yields to trend higher.

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