Bond market in wait-and-see mode

MY Say

BY NOR ZAHIDI ALIAS

News about the US Federal Reserve's plan to trim some of the US$4.5 trillion worth of assets it accumulated after the 2008/09 recession and possibly continue pushing up the fed funds rate late this year took market participants by surprise. With inflation running well below historical norms and geopolitical events shaking the market's confidence, many had expected the Fed to stay on hold towards the end of the year.

The emerging market economies are paying close attention to the Fed's next steps in normalising its monetary stance. Bond market players, in particular, are busy assessing the possible impact of such moves on the global financial markets. It is noteworthy that many central banks in the region have taken advantage of sliding inflation rates to trim policy rates in order to support growth.

The central bank of Indonesia, for instance, has trimmed its policy rate since late 2015 to ensure its growth trajectory remains within the 5.0% range. The key focus here is to support consumer spending, which is expected to moderate in line with slower headline growth. Similarly, Thailand has maintained its policy rate at the lowest level since mid-2010, while Vietnam's policy rate had been reduced to a 12-year low in July 2017. Generally, the accommodative stance adopted by Asean's central banks has been premised on the uneven recovery of the global economy.

This, according to some observers, puts a country like Malaysia at a crossroads. Malaysia's economic growth has accelerated beyond expectations this year, averaging more than 5.5% in the first half of the year. Exports have rebounded, not just in ringgit terms but also in US dollar value. The ringgit, battered after the US' November 2016 election, recovered by 7% in the third week of September from a low of around 4.50 to the US dollar late last year.

With inflation pushing past 5% in the early part of the year — a relatively rare phenomenon for Malaysia — some are starting to guess that Bank Negara Malaysia's overnight policy rate (OPR) is going to be on an upward trend again soon, pushing bond yields higher. Of course, the recent Fed policy rate statement only served to compound speculations of an eventual rate hike in the country.

In my opinion, this is unlikely to happen soon, although the possibility of a higher rate will increase next year, and a sudden pickup in bond yields should not be ruled out. Why? First of all, despite the rising momentum of consumer spending, the general economic expansion was externally driven. No doubt, statistics show a minute contribution of net exports to headline gross domestic product.

However, the export sector often yields positive spillover effects on domestic industries and consumers. In addition, despite the recent upgrade in the World Trade Organisation's outlook on global trade volume this year, the limited upside in the price of crude oil and other commodities (for example crude palm oil) in the next one year may cap the strength of Malaysia's export growth going forward.

In addition, according to our estimates at Malaysian Rating Corp Bhd, Malaysia's output gap — the difference between actual and potential output — had remained negative despite the surge in real GDP growth rates in the first half of the year. To top it off, consumer spending — a key determinant in rate hike decisions — has not surpassed its trend growth despite having recovered from its low in the third quarter of 2015.

If one were to speak to the man in the street, the general feedback would indicate that consumers are still cautious about spending because of the weaker ringgit (averaging 4.370 to the US dollar in the first six months of this year, namely down by about 7% from its average in the corresponding period last year). It will take some time before consumers start to feel the impact of the recent strengthening of the currency.

Of course, many people realise that Malaysia's inflation this year is primarily driven by cost factors rather than demand-pull factors. This can be gleaned from the core rate, which has stabilised at around 2.5% in recent months despite a headline number of 3% to 4%. The surge in pump prices by almost 45% (based on average prices of RON95, RON97 and diesel in March this year) since hitting their low in March last year, largely explains the surge in headline numbers to more than 5% in March 2017. Thus, it is hard to make a compelling argument for the rate hike based on current inflationary trends.

Regional capital flow trends form another important consideration. During the period immediately after the November 2016 US election, huge capital outflows from Malaysian shores ignited speculations that the OPR may be raised to stem the outflows. But the amount leaving the country has reduced since then. In fact, recent statistics show that the Malaysian bond market posted average foreign inflows of RM5.5 billion in the three months ended June 2017, as opposed to an average outflow of RM12.5 billion in 1Q2017. With more funds flowing into both the bond and equity markets in recent months, the need to prevent funds from leaving our shores through higher interest rates is no longer crucial.

Malaysia's household debt level also plays an important role in deciding the trend of the policy rate in the near term. At nearly 90% of GDP, household debt has become a contentious issue among economists. This is despite the fact that improvements have slowly taken place in recent years. With households, whose incomes are less than RM5,000 per month, comprising about 43% of total household debt, there is naturally a concern that higher interest rates may cause them to reduce their expenditure. If such a scenario unfolds, the momentum of consumer spending — a key pillar that supports Malaysia's headline growth — may falter.

Many also believe that with the general election scheduled to take place in less than a year, policymakers will try to ensure as stable an economic growth momentum as possible. As nobody has any meaningful control over the external environment, domestic pillars will have to be strengthened to avoid a significant economic deceleration.

All these, however, should not make bond market players complacent. It remains debatable whether the Fed's gradual measures to unwind its balance sheet will cause a shock to the bond market. However, a knee-jerk reaction cannot be ruled out.

As for Malaysia, while the OPR may seem to be sticky at this juncture, the upward trend in US Treasury yields — if it happens in the near term — may induce the yields of Malaysian Government Securities (MGS) to move in tandem. It is worth noting that the long-term trend of MGS yields has slowly changed since the mid-2000s. Yield curves are indeed steepening, based on the difference between 10-year and 3-year MGS yields.

The consolation is, Malaysia's overall improved growth trajectory in the short term may tempt foreign investors to remain upbeat. Should growth moderate again and the Fed keep nudging up interest rates, bond market players will have to be extra cautious.

Let us hope for the best. E

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