2011 Ringgit Bond Market Outlook

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2011 Investor Briefing
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MARC

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  - *Strong Demand for Risky Assets Globally*
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  - *…But Asian Market Remained Immune*
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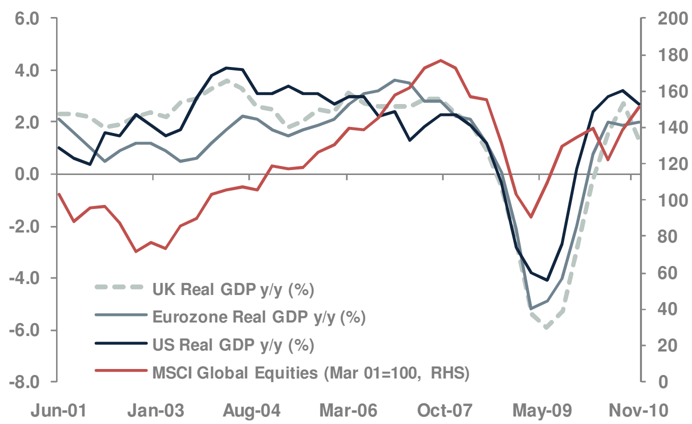
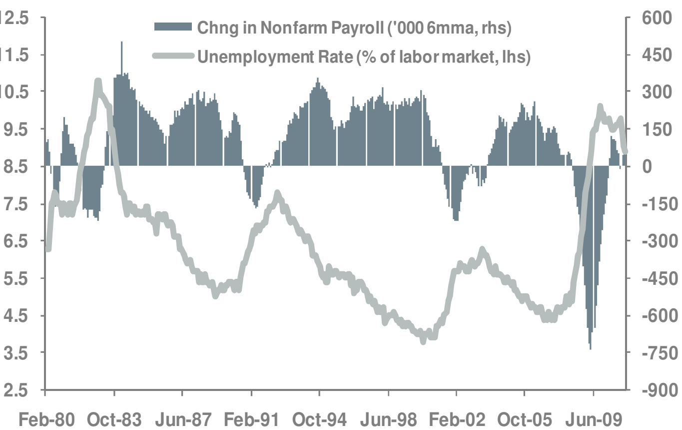
- Corporate Operating Environment
- Credit Spreads Assessments
- Risk Scenario to The Outlook

The global economy continued to ride the recovery path thanks to the various stimulus packages, but the US unemployment rate remained relatively high in 2010.

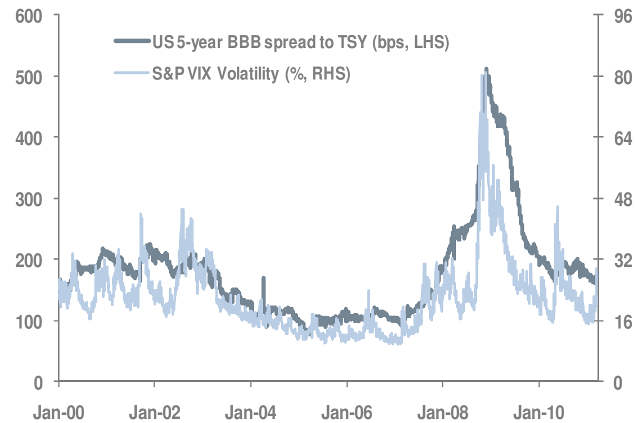


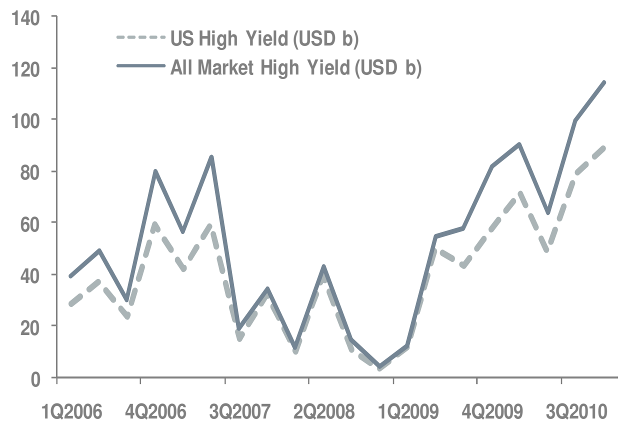


Source: Bloomberg, MARC Fixed Income Research

Demand for risky asset classes remained strong

Lower risk-free rates, improving economic data and stable financial markets sent **investors hunting for yields** elsewhere **in risky asset classes. Risk premiums narrowed** and global **high yield issuance rose** significantly.

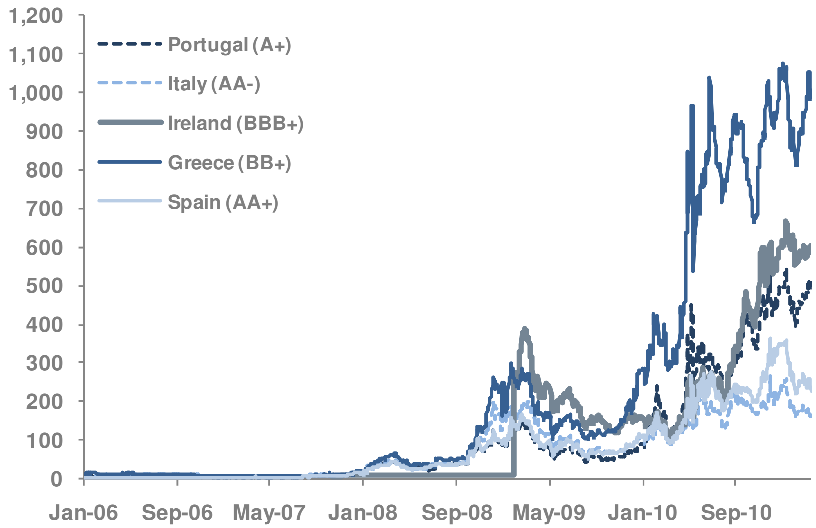




Source: Bloomberg, MARC Fixed Income Research

European Sovereign Debt Crisis Crashed The Party

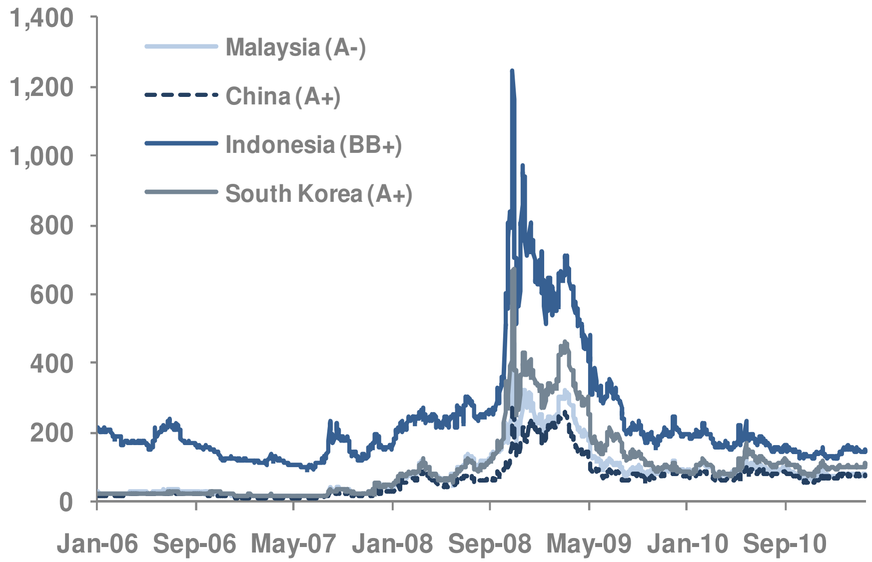
The sovereign **debt crisis** in **Europe** witnessed some **countries losing** their **top-notch credit ratings,** posing **challenges** to **global economic recovery** and making it **costly** for countries with **ballooning CDS spreads to raise funds.**



Source: Bloomberg, MARC Fixed Income Research

But the Asian Market Remained Immune

However, the **Asian market** in general was **unaffected** by the **adversities** facing the **European continent**. The **CDS spreads** remained below the crisis level in this region.



Source: Bloomberg, MARC Fixed Income Research

Ringgit sovereign bonds: Strong demand by foreign funds in 2Q2010 and 3Q2010

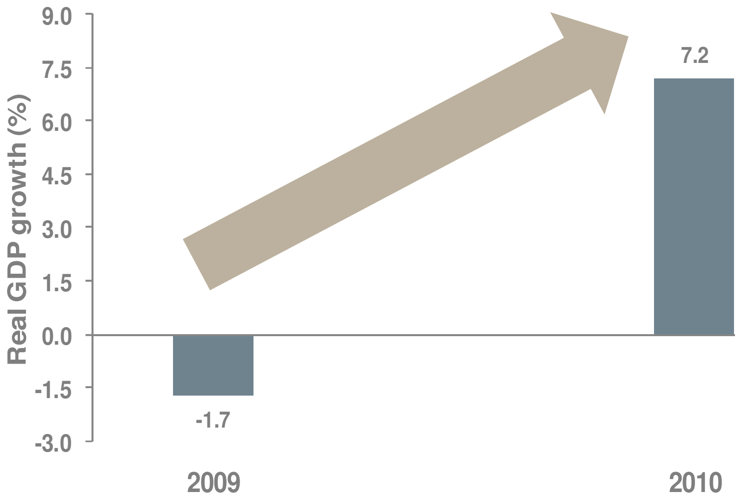
Despite a rebound in the economy which led to a **75 bps hike** in the **OPR**, bond **yields** remained **low** in **2Q2010** and **3Q2010. Foreign funds** dominated this market **on a strengthening ringgit**.

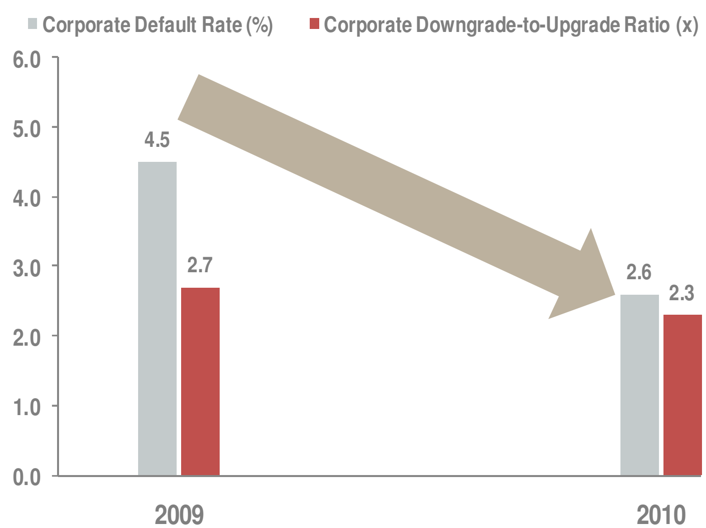
The **10-year yield** and **USD/MYR** were **almost perfectly** positively **correlated** in 3Q 2010.

Source: Bloomberg, MARC Fixed Income Research

Ringgit corporate bonds: Credit quality improved as the economy rebounded

Lower corporate default rates and declining corporate downgrade-to-upgrade ratio seen in 2010 on an improved operating environment brought by a pickup in economic activity.

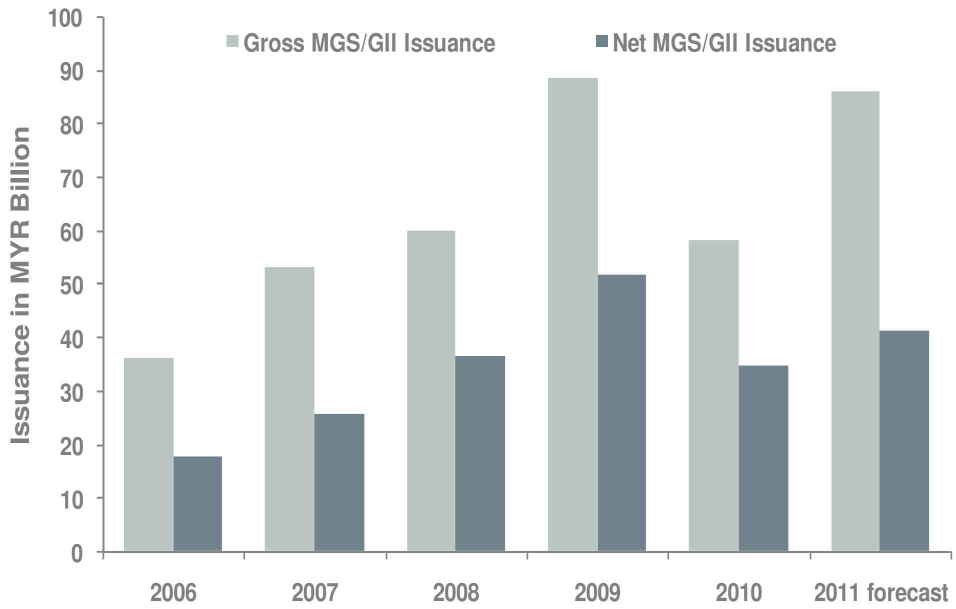




Source: Bloomberg, CEIC, MARC Fixed Income Research

Government bond supply in 2011

The government is expected to raise around **MYR86 billion to MYR88 billion** in **2011** via **MGS/GII** issuance to finance its budget deficit and maturing bonds compared to **MYR58.1 billion** seen in **2010.**



Source: Bank Negara Malaysia, MARC Fixed Income Research

Government bond supply in 2011

The possibility of a **retail bond** offering from the government is **not discounted** given its past **success** and the government's **efforts to boost retail participation in the bond market** under the Economic Transformation Programme **(ETP).**

Government bond supply in 2011

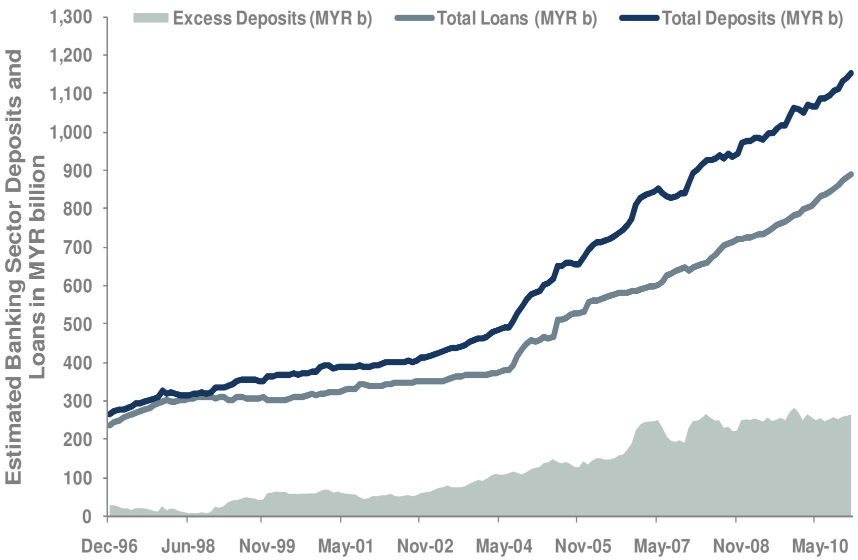
With **USD1.75 billion** of **international bonds maturing** in 2011, there is **motivation** for the **government** to **tap** this **market, but** for **benchmark** continuation rather than financing needs. **The current environment** looks **supportive** for new issuance :

- **Narrowing** credit **spreads**.
- **Overwhelming demand** in the **previous issuance**, i.e. oversubscription of almost 5.0 times.

Source: Bloomberg, MARC Fixed Income Research

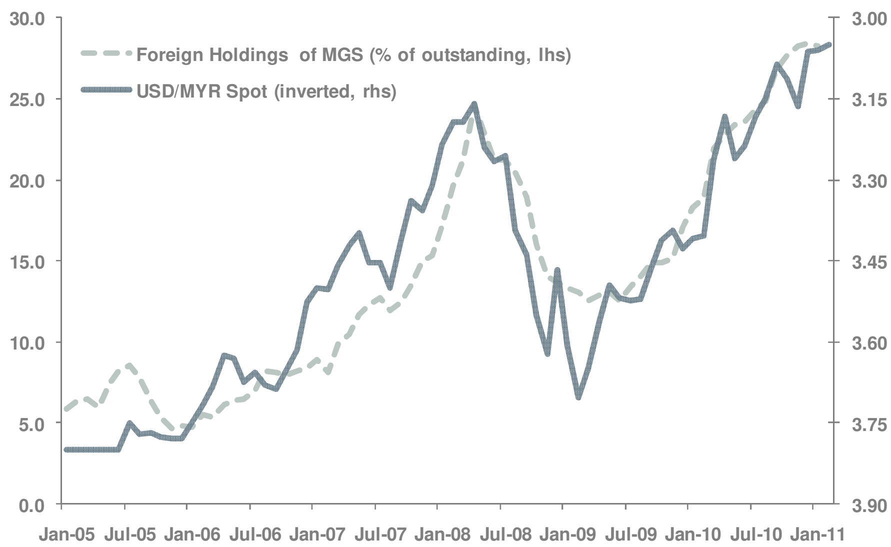
MGS/GII: Demand-side considerations

Demand is **not** going to be **a major issue** as the domestic **market** is still **flushed with liquidity**; using **banking** sector **excess deposits as a proxy**, the estimated **investable** amount is **MYR258 billion**, and this **has yet to include funds** from **insurance** and **asset management** industries.



Source: Bank Negara Malaysia, CEIC, MARC Fixed Income Research

Moreover, a **rise** in **global liquidity** thanks to the **quantitative easing** in the US will find its way **into emerging currencies**, raising bets on further **strengthening** of the **ringgit** and resulting in **foreign funds** flowing **into** the **MGS market**.

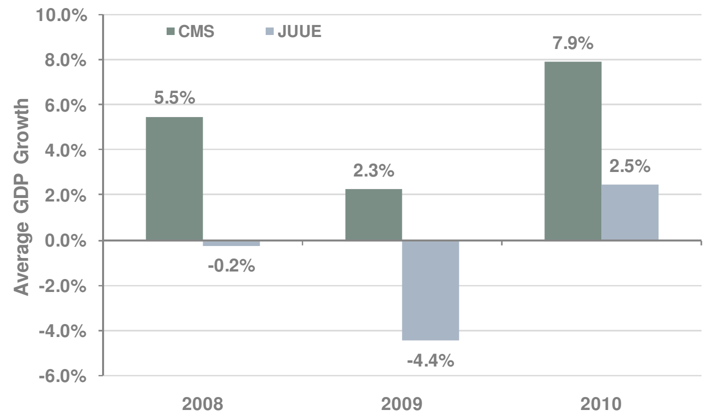


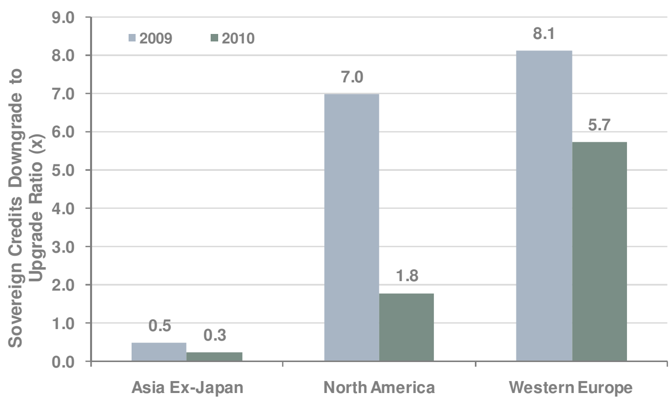
Source: Bank Negara Malaysia, CEIC, MARC Fixed Income Research

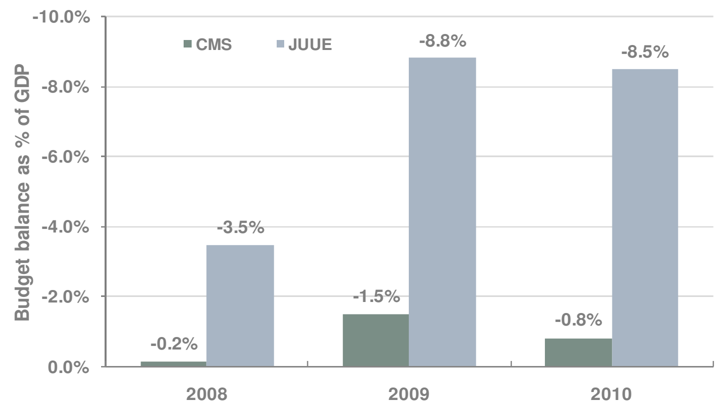
MGS/GII: Demand-side considerations

Foreign funds will continue to favour emerging currencies due to:

- Stronger **economic fundamentals**.
- Healthier **fiscal conditions**.
- Relatively stable **sovereign credits**.
- Huge positive **rate differentials**.







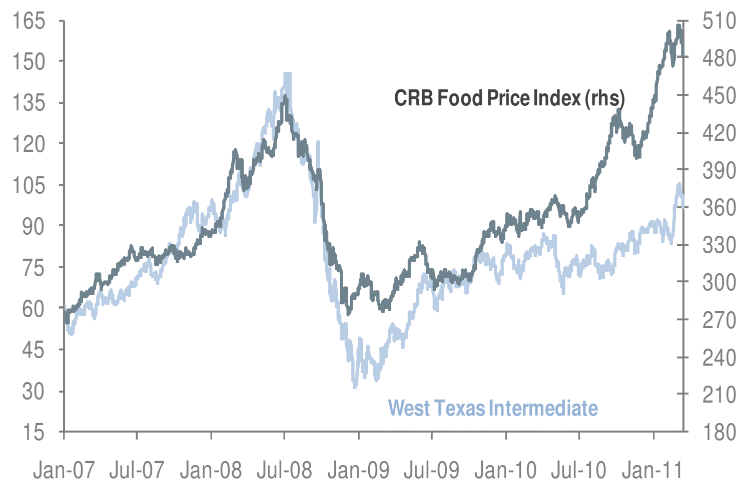
Source: Bloomberg, MARC Fixed Income Research

CMS = China, Malaysia, South Korea

JUUE = Japan, US, UK, Eurozone

Interest rate expectations

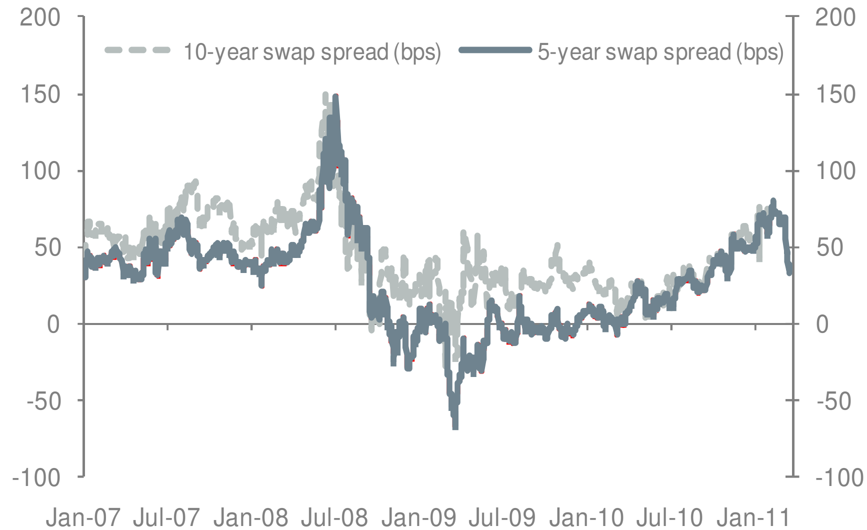
The build-up in **inflationary expectations** brought by a persistent **rise** in **commodity prices** is expected to put **upward pressure** on **interest rates.** Crude **oil prices** and the CRB **food price** index **gained more** than **50% since** the peak of the global financial crisis in **early 2009**.



Source: Bloomberg, MARC Fixed Income Research

Interest rate expectations

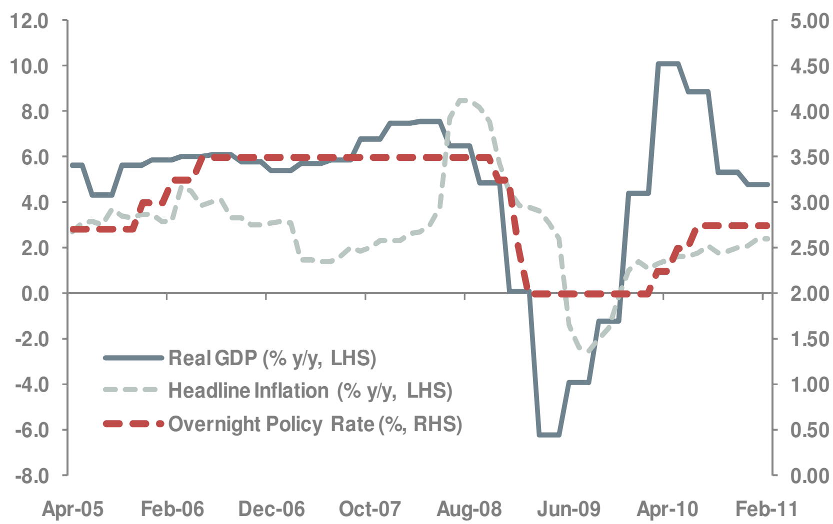
We expect a **steepening bias** in **the yield curve** as **supply** is **anticipated** to **center** at the **longer end of the curve** with rising inflationary expectation is another catalyst. The **swap rates** are also **pointing towards a rising** interest **rate** environment.



Source: Bloomberg, MARC Fixed Income Research

Interest rate expectations

Having rebounded in 2010, economic **growth** is expected to remain in **positive territory in 2011**. Hence, bias on the **OPR** is on the **upside** and we are looking at a **25-50 bps hike in 2H2011 if** any **adjustments** are **to take place.**



Source: Bloomberg, MARC Fixed Income Research

Interest rate expectations

In summary, **MGS yields** are expected **to head north with a steepening bias** in the yield curve in 2011 due to:

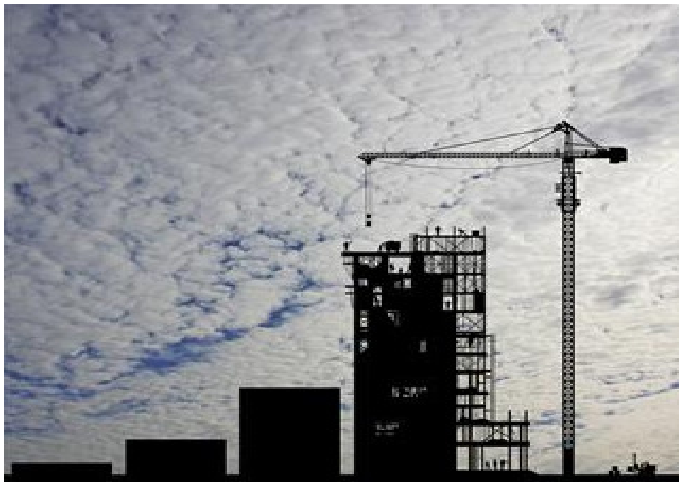
- Higher Supply
- Positive Economic Outlook
- Rising Inflation Expectations

but

Continuous **foreign interest** in this asset class will come in **to limit the sell-offs.**

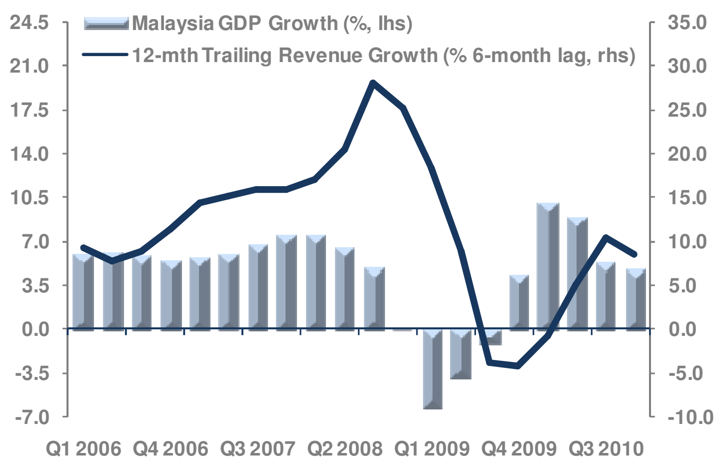
Corporate Bond Issuance

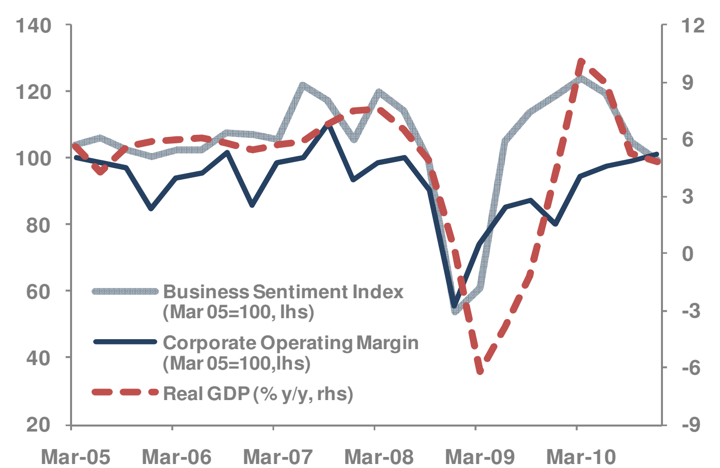
We expect corporate bond issuance **to hit** the **MYR50 billion** mark in 2011 (2010: MYR48 billion) **on continued economic recovery** and **the announcement of the Public-Private Partnerships (PPP)** programme during the tabling of Budget 2011, involving **MYR14.5 billion worth of projects** to be implemented this year.



Operating environment to remain healthy

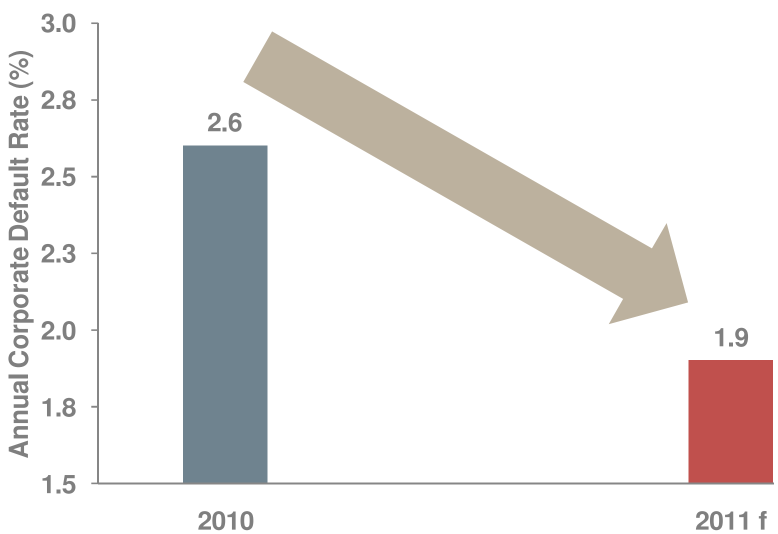
Should the economy remain on its growth trajectory, consumer and business confidence are likely to stay put, which would translate to higher revenue and profitability.

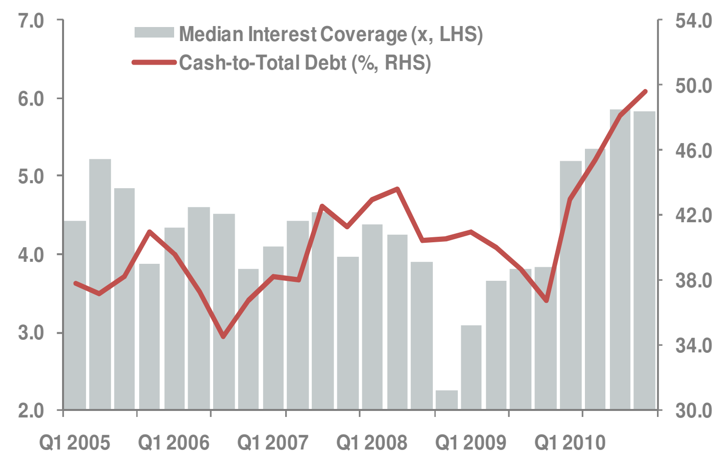




Source: Bloomberg, MARC Fixed Income Research

And that should **help** to further **improve** corporate **credit quality** and debt **repayment capacity** in general, resulting in a **lower expected default rate**

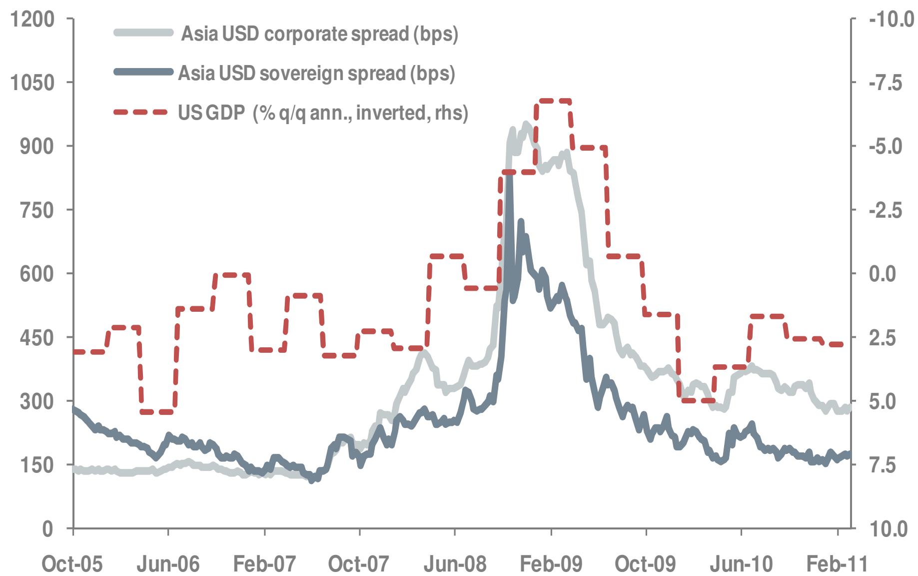




Source: MARC Fixed Income Research

Credit spread assessments

The **rally in risky asset** classes, including global equities, **sent** the global **corporate** credit **spreads** narrowing as **super-low government** bond **yields** and the **economic recovery** sent investors elsewhere for **yield enhancement**.



Source: Bloomberg, MARC Fixed Income Research

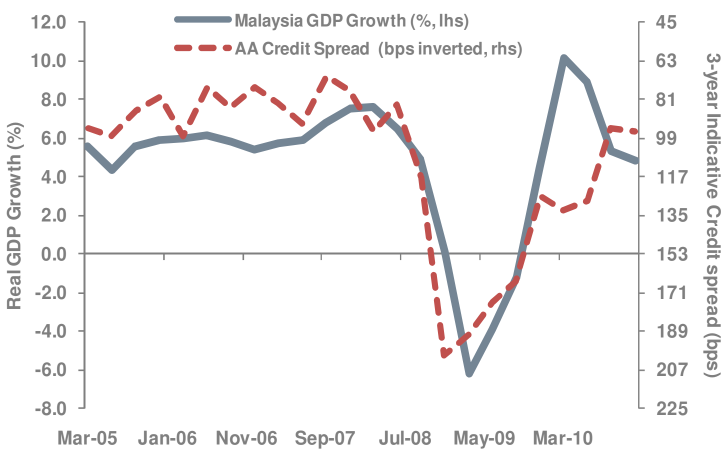
Credit spread assessments

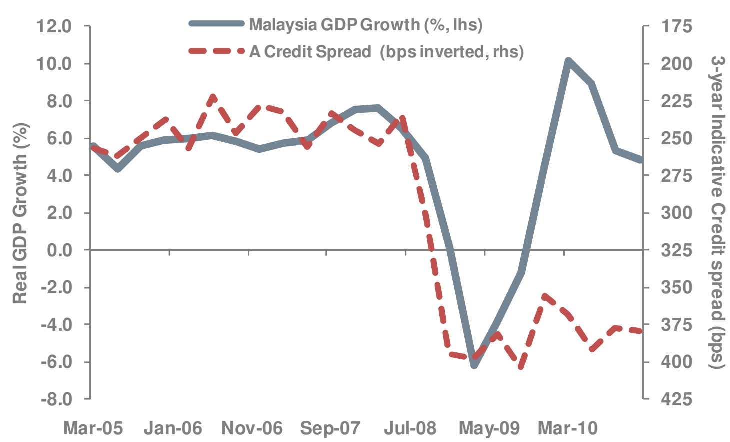
The **same pattern** is also observed **in the domestic** corporate bond **market but only in** the **AA** and **AAA** rating **bands** with the 3-year indicative **spreads** for these credits **hovering below** their respective **long-run means,** but the **A spread** remained **wide despite the economic recovery**.

Source: Bloomberg, MARC Fixed Income Research

Credit spread assessments

Persistent risk aversion in the A rating band is **an anomaly** in this cycle **considering the rebound in the economy**, **widening** operating **margins** and **falling** corporate **default** rates.





Source: Bloomberg, MARC Fixed Income Research

Credit spread assessments

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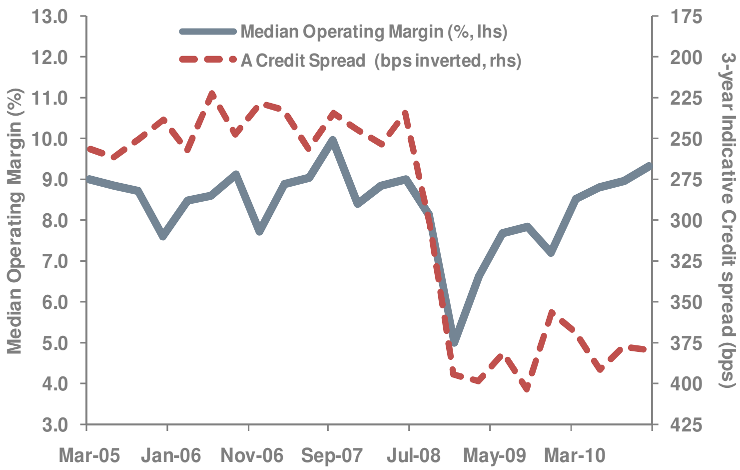
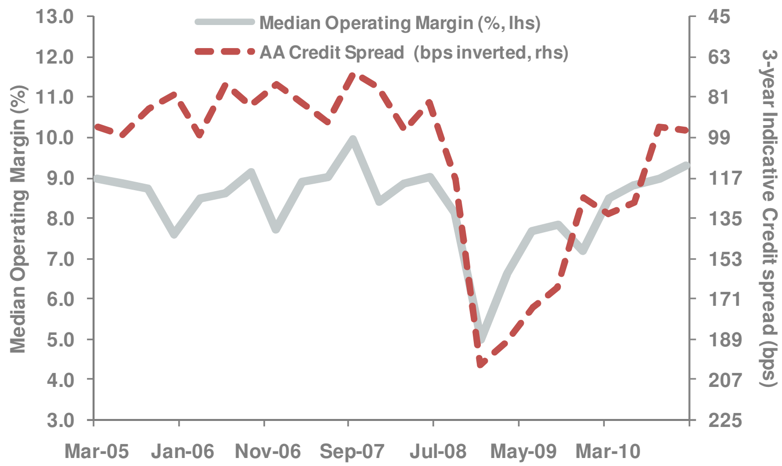
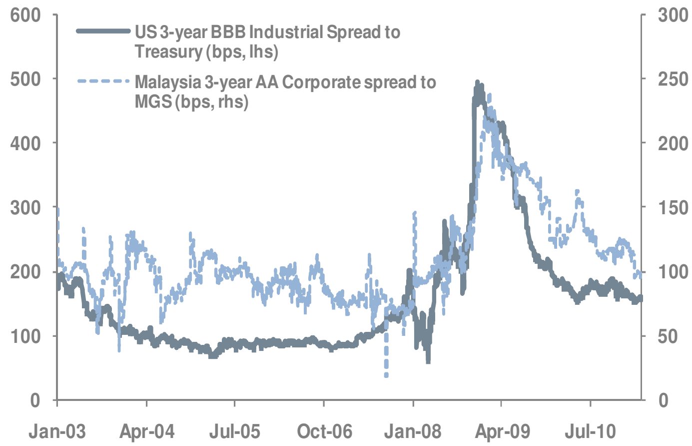




Source: Bloomberg, MARC Fixed Income Research

Credit spread assessments

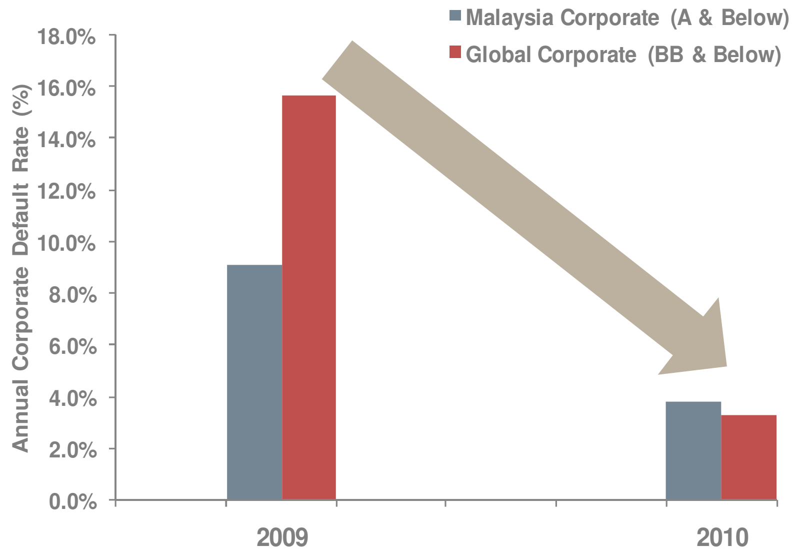
A similar **narrowing** of **high yield** credit **spreads** across the board as experienced **in the international market** was **not seen in domestic bonds rated below AA.**



Source: Bloomberg, MARC Fixed Income Research

Credit spread assessments

Interestingly, despite the diverging trend in domestic versus international risk premiums trend, **corporate default rates** in both the **domestic** and **international credit markets declined** in 2010. We **compared** the default rates for **BB credits in the international market** against **the A credits in the ringgit market.**



Source: MARC Fixed Income Research

Risks to this outlook

1. Greater-than-expected fallout from the European debt crisis and an extreme slowdown in the US economy which could cause a significant slowdown in the global economy.

2. Further announcements of fiscal expansion due to a slowdown in the economy will result in the market pricing in huge supply pressure.

3. Greater-than-expected fallout from the Japan earthquake and Middle East North Africa (MENA) geopolitical risk.

Thank You