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2013 Bond Market Outlook

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Liquidity Wave: Will Bond Yields Continue To Be Pulled Down?

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Global & Domestic Risk Scenario

The risk of automatic spending cuts and failure to secure a new deal for the debt ceiling in the United States

Automatic spending cuts have not been resolved in the United States

Two hours after the Bush-era tax cuts expired, (on January 1, 2013) the United States (US) Senate reached a deal to avert a fiscal cliff. Under the deal, tax rates of individuals and households with income above USD400,000 and USD450,000 will increase to 39.6% from 35.0% respectively, while automatic spending cuts have been pushed to March 2013.

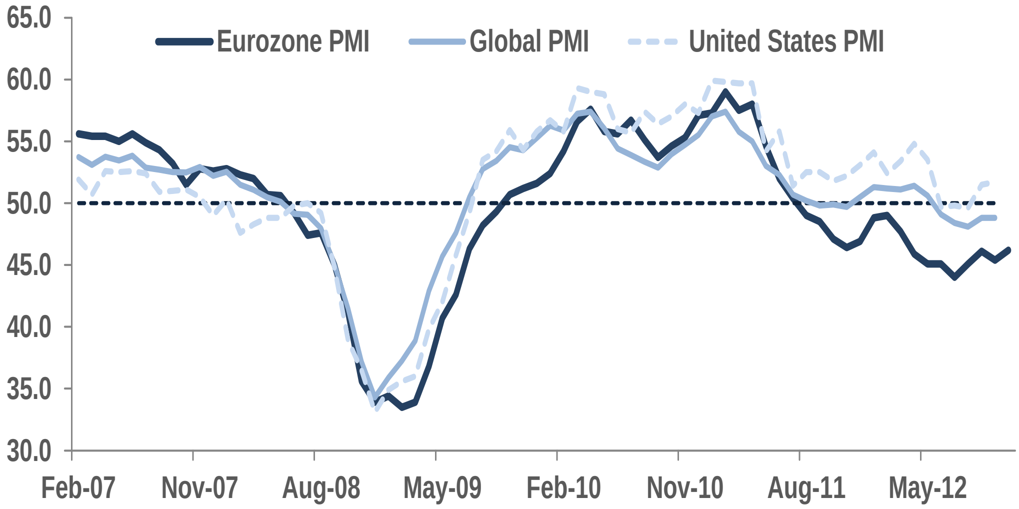
Apart from the automatic spending cuts which will take effect in March, the world's largest economy continues to face the debt ceiling issue where the US government has reached its debt limit of USD16.4 trillion. We view this as a potential threat to the US economy and the global economy due to the fragile sentiment in financial markets (as there has been no decoupling of trade and financial flows). Such an event, if it happens, could spark another round of risk aversion in markets across the globe, reversing the gains in emerging market stocks, bonds and currencies while sending the US dollar up again. A failure to reach a new debt ceiling agreement could also increase the risk of another round of sovereign rating downgrade of the US.

Recession to continue in Europe

Excessive fiscal austerity does not bode well for economic recovery

At this juncture, sustained economic recovery is difficult to see in Europe. Of concern to us are the significant spending cuts under fiscal austerity measures implemented to address the Euro debt crisis. Consumer and business sentiments have nosedived, a manifestation of the fiscal tightening. While a reduction in debt levels is warranted, spending cuts that are too deep could hamper economic recovery, translating to higher unemployment, lower consumer spending and tapering investments. Over-aggressive fiscal austerity may cause the economy to contract and under this scenario, the yields on 10-year Germany Bund and UK Gilt could decline further.

Exhibit 1: Purchasing Managers Index



Source: CEIC, Bloomberg

Domestic political concern

Foreigners are the biggest holders of MGS

Should jitters surrounding the General Election emerge among foreign investors, the likelihood of a sell-off in the local currency should not be dismissed. Considering that foreign investors are now the biggest holders of Malaysian government bonds, such a scenario does not augur well for this asset class. As there is a significant correlation between the level of MYR/USD and foreign holdings of government bonds, a sell-off in the local currency would no doubt affect the ringgit sovereign bond market negatively.

US Treasury Market Review

Treasury yields remained low in 2012

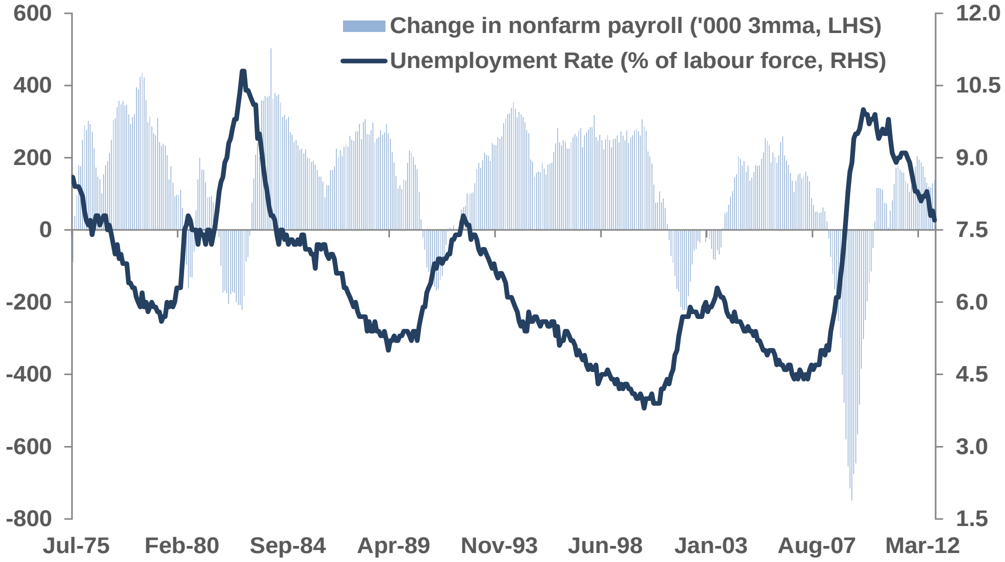
US Treasury yields remained low in 2012 as faltering global economic growth boosted demand for safe haven currencies. In October 2012, the International Monetary Fund (IMF) revised its global growth projection for 2012 and 2013 lower to 3.3% (July: 3.5%) and 3.6% (July: 3.9%) respectively. The year 2012 saw the recovery in the US job market continue to be below expectations despite the unemployment rate falling below 8.0%. The yield curve flattened with the 10/2s spread narrowing to 151 bps after the 2- and 10-year yields closed the year at 0.25% and 1.76% respectively. Meanwhile, the US Federal Reserve (Fed) kept the benchmark rate unchanged at 0.25% as expected, citing downside risk to the economy.

Exhibit 2: Fed funds and Treasury yields – 2012 vs. 2011

Rates	Dec-12	Dec-11	Change (bps)
Fed Funds Rate	0.25	0.25	0
2-year UST	0.25	0.24	1
5-year UST	0.72	0.83	-11
10-year UST	1.76	1.88	-12
30-year UST	2.95	2.89	6

Source: Bloomberg

Exhibit 3: US non-farm payroll and unemployment rate



Source: Bloomberg, US Bureau of Labor Statistic

Monetary policy will depend on the unemployment rate

In a move to lower long-term interest rates to spur economic activity, on June 20, 2012, the Fed extended its "operation twist" programme by purchasing USD267.0 billion of longer-dated Treasuries and disposing shorter-dated Treasuries of the same amount simultaneously. The Fed also unveiled a third round of quantitative easing (QE3) by committing to purchase USD40.0 billion of Mortgage-Backed Securities (MBS) per month on top of the USD2.3 trillion purchased in QE1 and QE2. During the final Federal Open Market Committee (FOMC) meeting in 2012 on December 12, the Fed made the unprecedented move of pegging the Fed Funds Rate (FFR) against the unemployment rate and inflation, stating that the rate would remain at a record low of 0%-0.25% until the unemployment rate falls below the 6.5% mark and inflation does not exceed 2.5%. In the same meeting, the central bank also announced the additional purchase of government debt securities amounting to USD45.0 billion per month to replace "operation twist" which expired at the end of 2012.

Euro and UK Sovereign Bond Market Review

Significant rally in German Bunds

Rising demand for safe haven assets in the US was not an isolated phenomenon as German Bunds also witnessed hefty buying in 2012 amidst the Euro debt crisis. The 10-year yield closed the year at 1.32%, falling 51 bps y-o-y while the 2-year note saw its yield sliding into negative territory to settle at -0.2% (-16 bps). Meanwhile, the European Central Bank's (ECB) refinancing rate closed the year at 0.75% after it was cut by 25 bps in July 2012. Investor sentiment in the Euro zone improved following ECB President Mario Draghi's pledge to save the Euro at whatever cost, helping to compress government yields in troubled nations as evidenced by Spain's 10-year yields dipping 235 bps to 5.27% from a 2012 high of 7.62% in mid-July 2012, while Italian government bonds of the same maturity fell circa 210 bps over the same period to close the year at 4.50%. Confidence climbed further after Greece successfully passed a bill to implement stricter austerity measures and executed its bond buy-back programme, leading to the release of a long-delayed aid disbursement totaling EUR49.1 billion.

Similar rally in the UK sovereign bond market

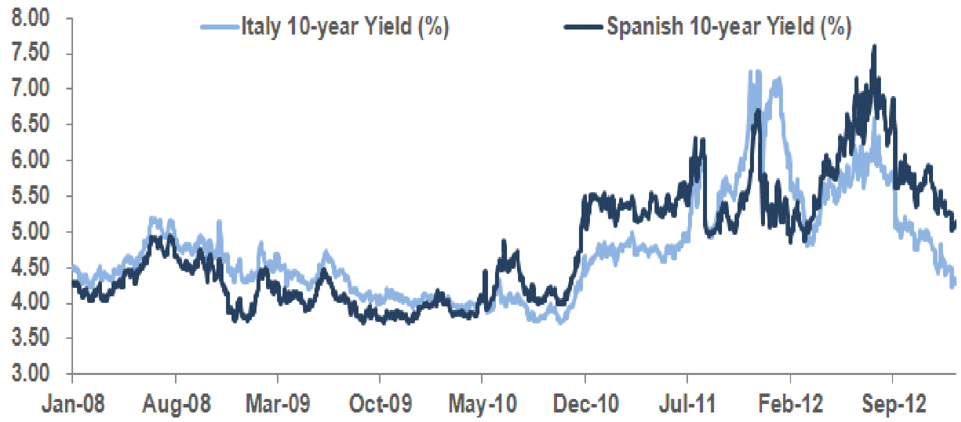
In the United Kingdom (UK), UK Gilts traded higher in 2012 with the 2- and 10-year yield declining 1 bp and 15 bps to 0.32% and 1.83% respectively. The UK economy slipped into a double-dip recession in 1Q2012 after recording Gross Domestic Product (GDP) growth of -0.2% q-o-q (4Q2011: -0.4%). In order to combat a slowdown in economic activity, the Bank of England (BoE) increased its asset-purchase target by GBP100.0 billion to GBP375.0 billion in 2012 (GBP50 billion in February 2012 and GBP50 billion in July 2012) while the benchmark rate remained unchanged at 0.50%. However, the central bank halted its QE programme in November 2012 as inflationary pressure built up, with the latest consumer price index (CPI) holding at 2.7% in three straight months to December 2012, far exceeding the bank's target of 2.0% for the whole of 2012. Apart from that, in July 2012 the BoE also introduced the Funding for Lending Scheme (FLS) which was designed to make more mortgages available and revive the housing market. Nonetheless, the country's housing market remains lethargic as anemic economic growth prospects curbed property demand.

Exhibit 4: ECB Refi, BOE rates, Bund and UK Gilt yields – 2012 vs. 2011

Euro Rates	Dec-12	Dec-11	Change (bps)
ECB Refinancing Rate	0.75	1.00	-25
2-year Bund	-0.15	0.14	-29
5-year Bund	0.30	0.76	-46
10-year Bund	1.32	1.83	-51
30-year Bund	2.18	2.37	-19
UK Rates	**Dec-12**	**Dec-11**	**Change (bps)**
Bank of England Official Rate	0.50	0.50	0
2-year UK Gilt	0.32	0.33	0
5-year UK Gilt	0.86	1.05	-20
10-year UK Gilt	1.83	1.98	-15
30-year UK Gilt	3.10	3.05	5

Source: Bloomberg

Exhibit 5: 10-year Spain and Italy bond yields



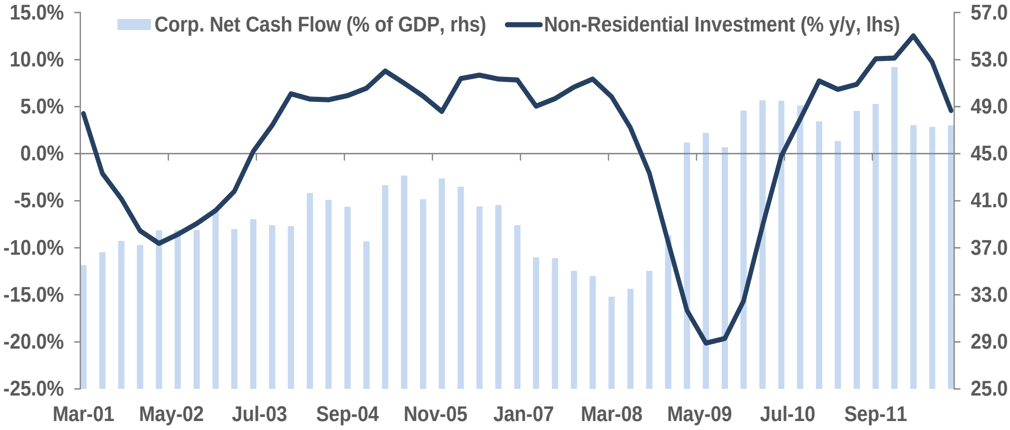
Source: Bloomberg

US Treasury Outlook

US economic recovery to gain more momentum

Even as political uncertainty and the on-going debt saga in Europe affected sentiment, the US recorded decent economic growth this year, witnessing GDP growth of 2.2% in 2012 compared to the 1.8% expansion registered in 2011. The economy managed to avoid a double-dip recession that was once a potential scenario discussed among the investing community earlier in 2012. President Barack Obama's recent re-election has somewhat removed the element of political uncertainty and should be positive for overall investment sentiment in the economy. Going into 2013, MARC expects the US economy to grow in the range of 2.3%-2.8% (WSJ survey consensus estimate: 2.4%) with asset purchases by the Fed to continue.

Exhibit 6: Capital spending which fell ahead of the Presidential Election in 2012 is likely to rebound on improving sentiment



Source: Bloomberg, Federal Reserve of St. Louis

Expect higher Treasury yields

Fed Chairman Ben Bernanke has made it clear that interest rates would remain low at least until 2015, and until the unemployment rate falls below 6.5%. While the unemployment rate remains stubbornly high - close to 8% - recent improvements in economic data coupled with the agreement passed by the US Senate to avoid the fiscal-cliff raises the likelihood for Treasury yields to increase. Assuming that the flow of positive economic data persists and stronger economic activity takes place in China, we are looking at the 10-year yield to be in the range of 2.0% and 2.5%.

But debt ceiling and automatic spending cuts are potential risks

The upside for the Treasury market, while potentially limited, has not completely abated at this point as there are two major risks in the US namely the budget sequestration and debt ceiling where the current ceiling of USD16.4 trillion has already been breached. If these issues are resolved by Congress before March 2013, there is a possibility for Treasury yields to move higher in 2013. Failure to reach a new debt ceiling agreement would on the other hand increases the odds for another round of sovereign rating downgrades for the US.

Exhibit 7: Conference Board Consumer Confidence Index is improving

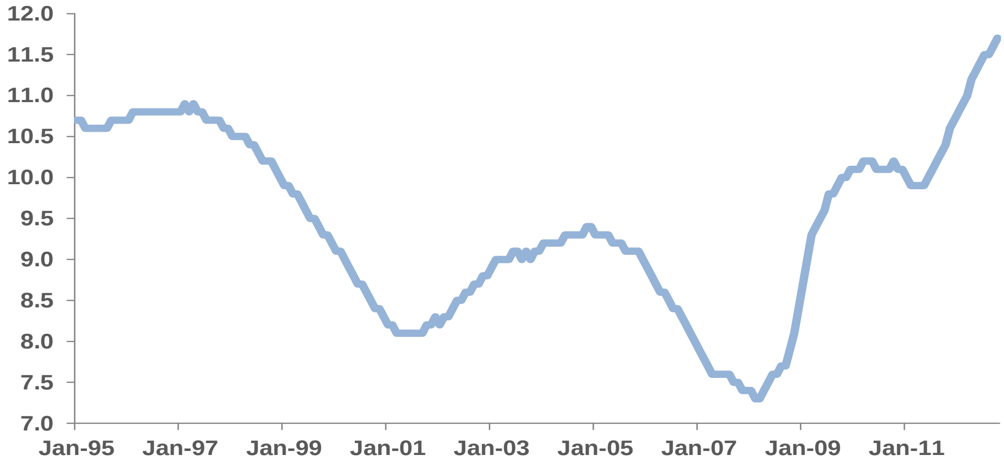
Source: Bloomberg, Federal Reserve of St. Louis

Euro and UK Sovereign Bond Market Outlook

Restarting growth in the Eurozone will be challenging

A little more than a year ago, the European debt crisis was primarily centred along the peripheral countries but today even the core countries are feeling the pain. The European Union (EU) economy, which is expected to contract by 0.3% in 2012, continues to face troubled times ahead. The unemployment rate, which rose to a euro-era record high of 11.7% in December 2012, will remain elevated and is expected to climb above the 12.0% mark. Personal consumption will continue to be weak while private investments are not expected to pick up. On this basis, we expect the unemployment rate to continue to increase.

Exhibit 8: Eurozone unemployment rate is at Euro-era all time high



Source: Bloomberg, CEIC

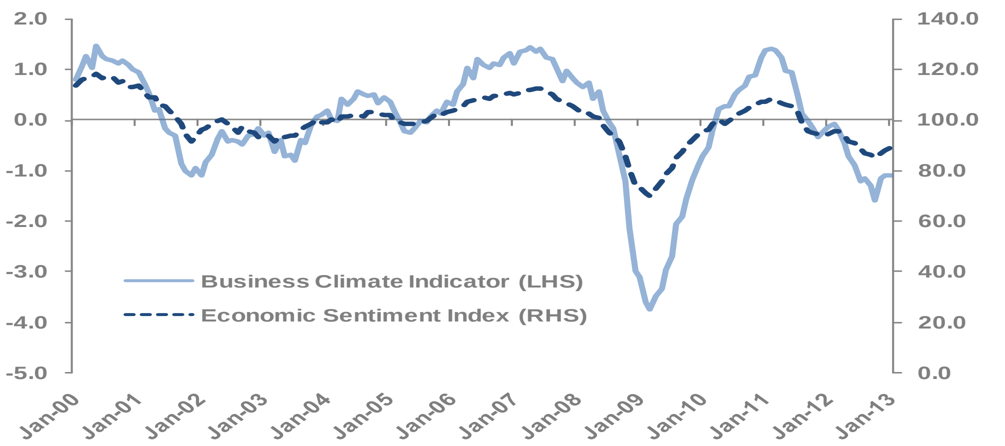
UK AAA credit rating may come under pressure

The UK, which is currently rated AAA/Aaa with a negative outlook by Standard & Poor's, Moody's and Fitch, faces the risk of a downgrade in 2013 if its fiscal situation continues to weaken. In order to secure Britain's AAA sovereign credit rating, Chancellor George Osborne expressed a strong commitment to his contractionary fiscal policy. In view of further austerity measures and a still weak global growth, the UK economy is expected to grow at a slower rate of 1.2% in 2013 vis-à-vis an earlier estimate of 2.0% growth, and thus demand for the UK Gilts is expected to be supported.

Unlike the US, we expect yields to remain low in major European govvies

Germany, the main pillar of the European economy, is suffering from the spill-over effects from the region's debt crisis while other pillars like Italy and Spain are already in recession, with a painfully high unemployment rate seen in Spain (26.1% in December 2012). On monetary policy, the ECB is not expected to alter the benchmark refinancing rate but is likely to adopt other non-traditional policy tools such as direct liquidity injections if the economy deteriorates more than forecast. On that note, yields of the European safe haven assets are likely to remain depressed this year.

Exhibit 9: Survey data also points to hazy days ahead



Source: Bloomberg, CEIC

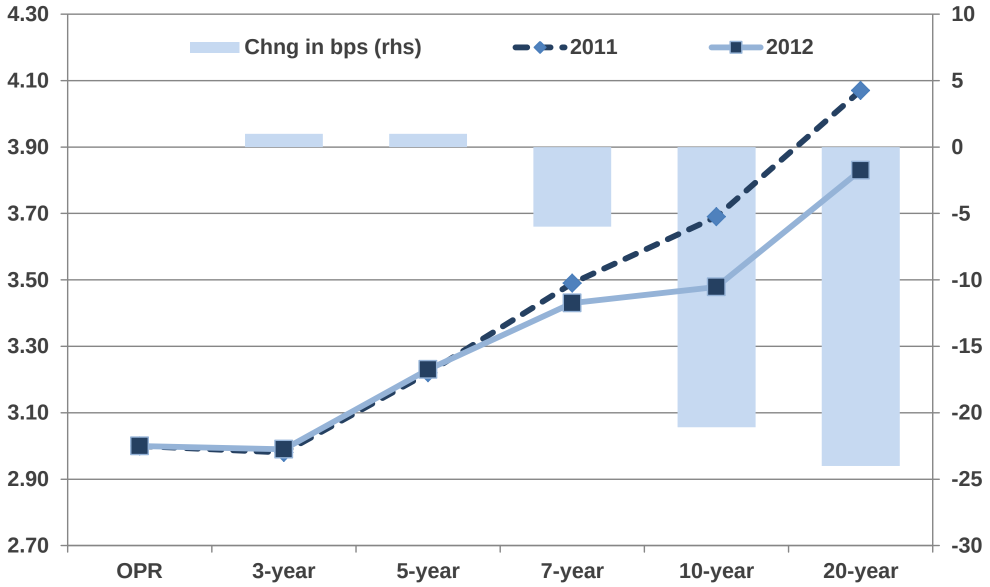
Ringgit Sovereign Bond Market: Steepening yield curve is likely in 2H2013

Sovereign bond market review – still bullish, but yield curve flattened in 2012

10/3s spread closing the year at 49 bps from 71 bps seen at the end of 2011

The ringgit sovereign bond market rallied at the longer end of the curve with the 10-year and 20-year Malaysian Government Securities (MGS) yields declining 21 bps and 24 bps respectively to close the year at 3.48% and 3.83% amidst receding inflationary pressure. Headline inflation has slowed to 1.2% in December 2012, the lowest inflation level recorded since February 2010, from 3.0% in December 2011. Additionally, global crude oil prices, which peaked at USD114/bbl in April 2011, have since declined and settled at USD91.8/bbl in December 2012, a decrease of approximately 19.5% from their peak. The benchmark yield curve flattened in 2012 with the 10/3s spread closing the year at 49 bps from 71 bps at the end of 2011.

Exhibit 10: MGS benchmark yield curve – 2012 Vs. 2011



Source: Bloomberg, MARC Fixed Income Research

BNM kept the 2012 OPR unchanged at 3.00%

Bank Negara Malaysia's (BNM) Monetary Policy Committee, which met in its six scheduled (MPC) meetings during the year, had on all occasions kept the benchmark Overnight Policy Rate (OPR) unchanged at 3.00% as expected. Despite the interest rate cuts announced by most regional central banks in boosting their respective economies, BNM's decision to maintain the benchmark rate is understandable in our view as domestic demand remained firm over the same period. In fact, domestic demand has had a crucial role in keeping the country's GDP above 5.0% in the first three quarters of 2012. Moreover, Malaysia also needs to address the growing imbalances in household balance sheets where the country's household debt-to-GDP ratio climbed to 76.6% as at December 2011, which is among the highest in the region.

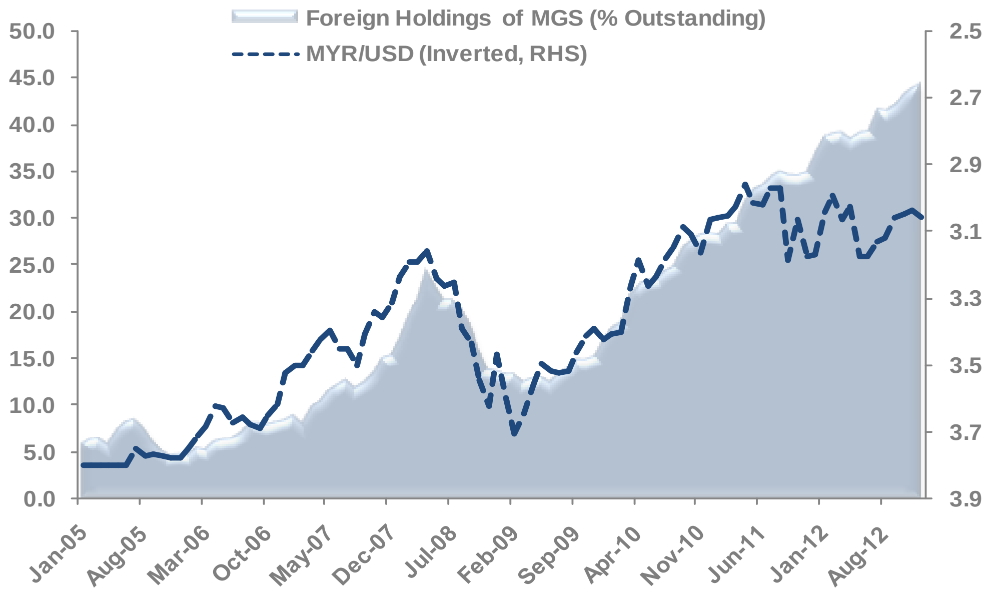
Slow growth expected in the global economy

Even as the Malaysian economy recorded an average growth of 5.3% in the first three quarters of the year, the bond market has hardly experienced any sell-offs, indicating lingering concern of the possible downside risk associated with a weak external sector among bond investors. Export growth from January to November 2012 averaged 1.6% compared to an average of 9.3% over the corresponding period in 2011. Meanwhile, in its final MPC meeting of the year, BNM highlighted that "*The global economy is expected to continue to experience slow growth. There continues to be uncertainties surrounding the growth prospects of the advanced economies. However, despite the weaker external demand, growth in the regional economies remains supported by domestic demand".*

Influx of foreign funds helped push MGS yields lower

Apart from the increasing size of investible funds among local investors, an influx of foreign funds has also helped to push MGS yields lower. Foreign holdings of MGS climbed to MYR129.7 billion as at December 2012, equivalent to about 44% of the outstanding amount, which is the highest level thus far. Liquidity injections by major central banks in developed countries have triggered capital flows into this region, which is also reflected by the appreciation of the local currency. The ringgit gained 3.5% against the USD to close the year at 3.0580 per USD.

Exhibit 11: Foreign holdings of MGS vs. MYR/USD



Source: Bloomberg, Bank Negara Malaysia

Meanwhile, the primary issuance of MGS/GII totaled MYR94.0 billion in 2012 compared to MYR90.2 billion recorded in the previous year. A detailed summary of MGS/GII issuance in 2012 is given in the Exhibit 12.

Exhibit 12: MGS/GII Issuance Calendar for 2012

No.	Issues	Tenure (Years)	Maturity Date	New / Reopening	Issue Date	Amount (RM million)	Avg. Yield (%)	Bid-to-cover Ratio (x)
1	7-year Re-opening of MGS 09/18 3.580%	7.0	13-Sep-18	Reopening	13-Jan-12	3,500	3.415	3.60
2	3.5-year New Issue of GII (Mat on 07/15)	3.5	3-Feb-15	New	3-Feb-12	4,000	3.186	2.93
3	10.5-year New Issue of MGS (Mat on 08/22)	10.0	14-Aug-22	New	14-Feb-12	4,000	3.418	2.35
4	5.5-year New Issue of GII (Mat on 08/17)	5.5	28-Feb-17	New	29-Feb-12	3,500	3.309	2.31
5	15-year New Issue of MGS (Mat on 03/27)	15.0	15-Mar-27	New	15-Mar-12	3,000	3.892	1.65
6	7.5-year New Issue of GII (Mat on 09/19)	7.5	30-Mar-19	New	30-Mar-12	4,500	3.704	2.04
7	3.5-year New Issue of MGS (Mat on 10/15)	3.5	15-Oct-15	New	6-Apr-12	3,000	3.197	1.95
8	20-year New Issue of MGS (Mat on 04/32)	20.0	15-Apr-32	New	13-Apr-12	3,000	4.127	1.93
9	5.5-year New Issue of MGS (Mat on 10/17)	5.5	31-Oct-17	New	30-Apr-12	4,000	3.314	1.92
10	10.5-year New Issue of GII (Mat on 11/22)	10.5	15-Nov-22	New	15-May-12	4,500	3.669	1.94
11	7-year Re-opening of MGS 09/18 3.580%	7.0	28-Sep-18	Reopening	31-May-12	3,000	3.419	1.46
12	15-year New Issue of GII (Mat on 06/27)	15.0	15-Jun-27	New	8-Jun-12	3,000	3.899	2.37
13	3-year Re-opening of MGS (Mat on 10/15)	3.0	15-Oct-15	Reopening	15-Jun-12	3,000	3.094	2.19
14	7-year Re-opening of GII (Mat on 09/19)	7.0	30-Sep-19	Reopening	29-Jun-12	3,500	3.498	2.68
15	10-year Re-opening of MGS (Mat on 08/22)	10.0	15-Aug-22	Reopening	13-Jul-12	3,500	3.443	2.35
16	5-year Re-opening of GII (Mat on 08/17)	5.0	30-Aug-17	Reopening	23-Jul-12	3,500	3.245	1.91
17	15-year Re-opening of MGS (Mat on 03/27)	15.0	15-Mar-27	Reopening	31-Jul-12	2,500	3.591	1.71
18	3.5-year New Issue of GII (Mat on 02/16)	3.5	8-Feb-16	New	8-Aug-12	3,500	3.235	1.92
19	5-year Re-opening of MGS (Mat on 10/17)	5.0	31-Oct-17	Reopening	15-Aug-12	4,000	3.270	1.24
20	10-year Re-opening of GII (Mat 11/22)	10.0	15-Nov-22	Reopening	14-Sep-12	4,000	3.689	1.68
21	7.5-year New Issue of MGS (Mat 03/20)	7.5	31-Mar-20	New	28-Sep-12	4,000	3.492	1.46
22	20-year Re-opening of MGS (Mat on 04/32)	20.0	15-Apr-32	Reopening	5-Oct-12	2,500	3.992	2.12
23	5-year Re-opening of GII (Mat on 08/17)	5.0	30-Aug-17	Reopening	15-Oct-12	2,500	3.353	2.01
24	10-year Re-opening of MGS (Mat on 08/22)	10.0	15-Aug-22	Reopening	31-Oct-12	3,000	3.476	1.64
25	7.5-year New Issuance of GII (Mat on 05/20)	7.5	15-May-20	New	12-Nov-12	3,500	3.576	2.59
26	5-year Re-opening of MGS (Mat on 10/17)	5.0	31-Oct-17	Reopening	30-Nov-12	2,500	3.268	2.38
27	15-year Re-opening of GII (Mat on 06/27)	15.0	15-Jun-27	Reopening	4-Dec-12	2,000	3.866	2.15
28	7-year Re-opening of MGS (Mat on 03/20)	7.0	31-Mar-20	Reopening	14-Dec-12	3,500	3.476	2.08

Source: Bloomberg, Bank Negara Malaysia

Budget 2013 – domestic demand will continue to support the economy

Budget 2013 to boost domestic spending

In Budget 2013, the government will extend cash handouts totalling MYR3.0 billion under the Bantuan Rakyat 1 Malaysia 2.0 (BR1M 2.0) scheme to benefit 4.3 million households and 2.7 million single unmarried individuals. During the tabling of Budget 2013, the government also committed to reducing the country's budget deficit-to-GDP ratio to 4.0% in 2013.

Crucial for the government to transform its revenue base

What is critical for Malaysia is to widen the revenue base through the implementation for instance of the Goods and Services Tax (GST) and utilising extra revenue collection for lowering the budget deficit. In the first nine months of 2012, federal government revenue actually surged by 10.1%, way above the projected growth of 1.9%. We are of the view that these extra revenues can come in handy in the government's efforts to trim the budget gap.

Fiscal consolidation to continue – stable outlook on sovereign credit rating

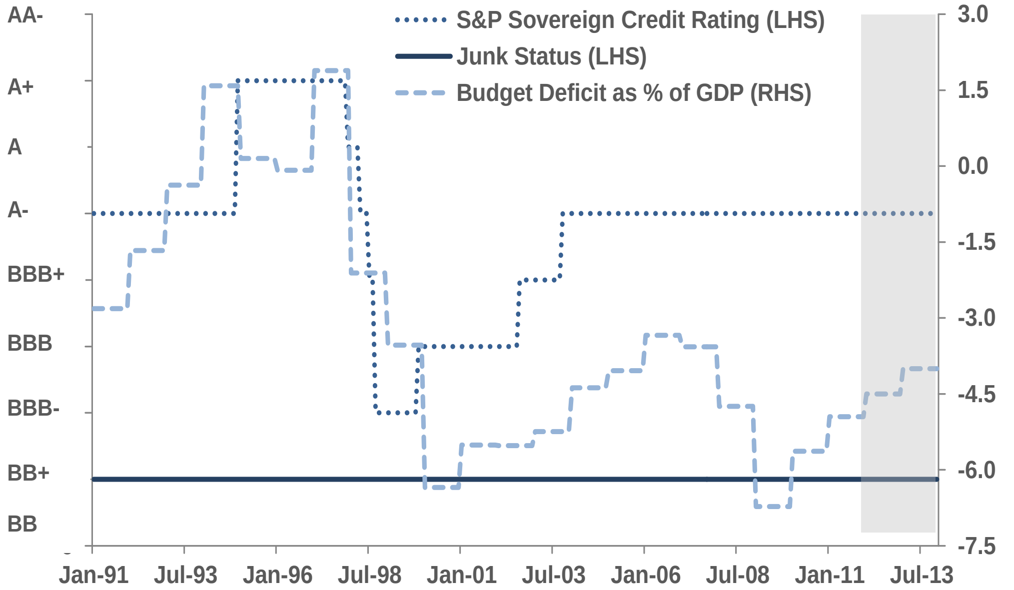
Budget deficit to narrow further in 2013 while government debt will not exceed the ceiling

The government has committed to fiscal consolidation, targeting a fiscal deficit of 4.0% of GDP in 2013, lower than the 4.5% estimated for 2012. The government also pledged to keep the debt-to-GDP ratio below a "self-imposed" ceiling of 55% and we think the target is achievable as it can opt for off balance-sheet funding via the Government-Guaranteed (GG) bond market. While we are seeing a rise in debt guaranteed by the government, the risk of such practice is partly off-set by extremely deep liquidity in the domestic bond market seen at present. Overall, we do not expect any negatives as far as Malaysia's sovereign credit rating is concerned.

International credit rating agencies will closely monitor the development of subsidy reform and GST implementation

The challenge going forward is for the government to resume its subsidy rationalisation programme and introduce a new model to enhance its revenue base in the form of GST. This in our view is crucial as international rating agencies have clearly indicated that any credit rating movement going forward hinges on these reforms.

Exhibit 13: The government is committed to narrowing the budget deficit with a target of 4.0% of GDP which should be supportive of the sovereign credit rating



Source: Bloomberg, Bank Negara Malaysia

Supply of government bonds to be in the range of MYR90-95 billion in 2013

MGS/GII issuance of MYR90-95 billion in 2013 and expect more GG issuance

The government expects the budget deficit to shrink further to MYR40 billion in 2013 from MYR45 billion in 2012. Given the deficit target and with an expected MYR50.5 billion maturing in 2013, we foresee the issuance of government bonds to be in the range of MYR90-95 billion. Demand for govvies should not be a major problem as the domestic market is flush with liquidity. Pension funds, insurance funds and excess deposits are growing rapidly and this should help sustain demand for government bonds. In addition, the GG segment will see another year of robust issuance considering that the current public debt-to-GDP ratio of 53% is close to the self-imposed debt ceiling of 55%. As such, we think the GG primary market activity will continue to be active in 2013.

Foreign funds to continue flowing into the domestic sovereign debt market

MGS will continue to be favoured by foreign investors

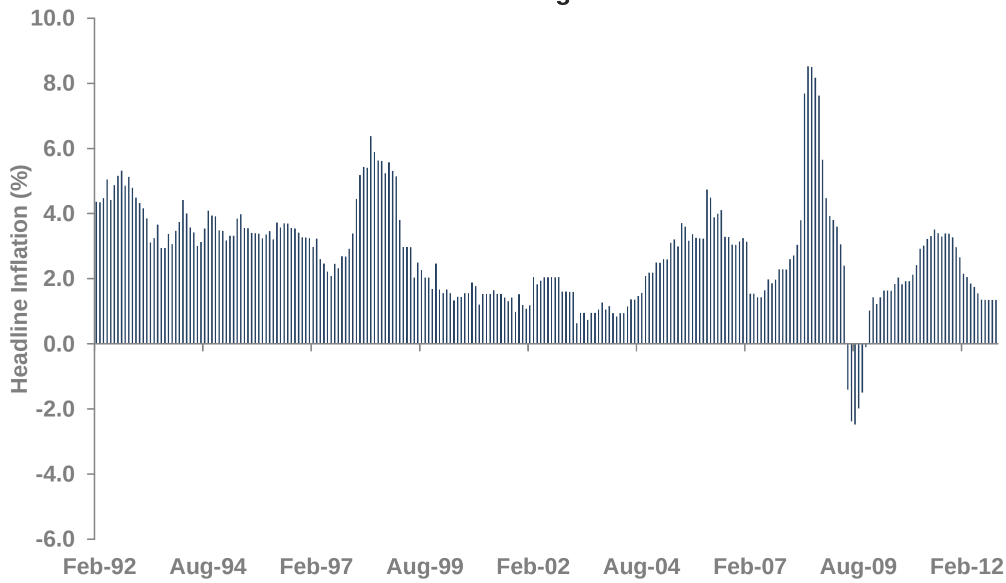
Foreign holdings of MGS rose to a record high of MYR129.7 billion in December 2012, or about 44% of the outstanding amount. At this juncture, foreign funds appear to be the biggest holders of MGS, holding amounts even higher than the Employees Provident Fund (EPF). Against the backdrop of QE3 and other central bank asset purchase programmes, the MGS market will continue to be favoured by foreign investors. In addition, positive interest rate differentials between Malaysia and developed countries as well as a stable sovereign credit rating will likely keep luring foreign funds into the MGS market.

Inflation to inch higher in 2013 but will still be below the cash rate

Strong domestic demand and minimum wage policy will be among the sources of inflationary pressure

Headline inflation slowed to 1.3% for three consecutive months since September 2012 and to a 3-year low of 1.2% in December, indicating relatively low price pressures due to slower increases in food prices and a decline in commodity prices. Going into 2013, we expect inflation to be higher given the implementation of the minimum wage policy, which will affect about 3.2 million workers in the private sector. In addition, the tight labour market coupled with resilient domestic demand might induce traders to raise prices of goods and services. Lastly, assuming subsidy rationalisation efforts are resumed once the General Election is over, a build-up in inflationary pressure will be unavoidable. We expect inflation to climb from last year’s average of 1.7% to between 2% - 2.5% in 2013.

Exhibit 14: Inflation to increase in 2013 due to minimum wage policy and tight labor market hence narrowing the real interest rate.



Source: Bloomberg, Bank Negara Malaysia

Monetary Policy - policy rate to stay put

But inflation would not be high enough to prompt a rate hike

Despite our view that inflation would trend higher and while domestic demand is expected be resilient in 2013, we do not foresee BNM altering the OPR in 2013 because external headwinds still pose some downside risk to the economy. In addition, the US Fed's decision to extend the low interest rate environment in the US would also mean that there is no immediate pressure for BNM to raise the benchmark rate.

Expect the status quo in the OPR

On the other hand, there is also no compelling reason for BNM to lower the OPR at this juncture as domestic demand remains resilient thus far. In addition, the central bank has made it clear that its main concern right now is the high level of household debt, and lowering the OPR at this juncture would jeopardise its efforts to contain financial imbalances among households. Should there be any move by the central bank in 2013, the greater likelihood is for a rate hike rather than a rate cut assuming gradual improvement is seen in US and China.

Exhibit 15: BNM Monetary Policy Committee meeting schedule for 2013

MPC Meeting No.	1st	2nd	3rd	4th	5th	6th
Day	30 & 31	6 & 7	8 & 9	10 & 11	4 & 5	6 & 7
Month	January	March	May	July	September	November

Source: Bank Negara Malaysia

Bond yields will likely creep up in 2H2013

Yield compression to persist in the early part of 2013

Our central case for the ringgit bond yields at this juncture is for *status quo ante* as we do not expect the central bank to ease monetary policy further. This is based on the assumption that there will be a gradual improvement in the US and China economies. As such, we expect 10-year MGS yields to trade in the range of 3.40% - 3.60% and 3-year yields to trade in the range of 3.00%-3.30%. The 3-year yield is not expected to fall below 3.00% as there are no compelling reasons for investors to look for any rate cut from BNM at this juncture.

But yields are likely to move higher in 2H2013 once inflationary pressure creeps in

Going into the 2H2013, there will be an upside bias in bond yields as we expect inflationary pressure to creep in due to the factors already mentioned. The case for higher bond yields will become stronger should the federal government continue to proceed with its subsidy rationalisation effort right after the General Election. Although we think that inflation will be capped at circa 2.5%, we are also of the view that bond investors will be more sensitive to inflation premiums. Given this hypothesis statement, we expect the 10-year yield to trade above 3.60% in 2H2013 although unlikely to exceed 4.00% on a sustainable basis unless the central bank decides to tighten monetary policy. Overall, we expect a steepening bias in the yield curve with the 10/3s spread around 70-80 bps (current level is 40 bps).

Ringgit Credit Market: Risk-reward pricing anomaly

High liquidity compressed corporate bond yields

Yield compression globally due to high liquidity and flight to safety

The credit market has benefited from global loose monetary policies in 2012 as investors sought yields. Enhancing investment yields in the bond market has always been traditionally implementable via lengthening the duration and going down the credit curve, but which also means adding more interest rate and credit risks to the portfolio. Such strategies are not a feature unique to the ringgit credit market alone.

…given loose monetary policy in advanced economies

In the US, the Fed has pledged to keep the FFR close to zero, and the 10-year bond yields have averaged 1.78% in 2012, while in the struggling European continent, the 10-year Germany Bund and the 10-year UK Gilt averaged 1.57% and 1.87% respectively over the same period. The blended speculative grade corporate bond yield dipped to a historical low of 7.10% in 2012.

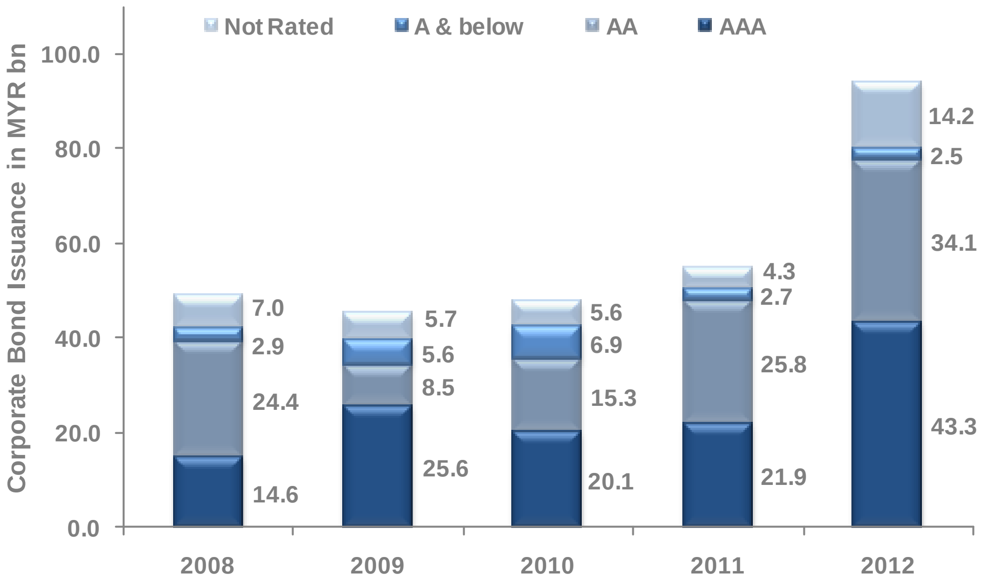
The same conditions on the local front

The conditions on the domestic front are almost identical, where demand for primary issuance has been overwhelming. Growing investable funds in the country and government bond yields hovering at the low of this cycle are the catalysts, and these factors are likely to persist in 1H2013. We opine that government bond yields will continue to be depressed as the likelihood of a hike in the OPR is quite remote at this juncture. In conclusion, we do not expect any significant yield pick-up from the corporate bond primary market segment, particularly in 1H2013.

MYR124.6 billion issued but more than 40% came from unrated issuances and PLUS refinancing

2012 was a bumper year for corporate bond issuances, with total rated primary market issuance of MYR94 billion compared to MYR55 billion issued in 2011, while total gross corporate issuance standing at MYR124.6 billion. The issuance in 2012 was also well above the average annual issuance size of MYR49 billion from 2008 to 2011. However, it is worth noting here that PLUS Berhad (AAA) alone issued MYR19.6 billion from its Sukuk programme amounting to MYR23.4 billion. Other significant bond issuances were in the GG non-rated segment by Johor Corp of MYR1.8 billion and Perbadanan Tabung Pendidikan Tinggi Nasional of MYR2.5 billion. Meanwhile, the proportion of GG non-rated bonds issuance increased significantly from MYR15.0 billion in 2011 to MYR30.4 billion in 2012 with Syarikat Prasarana, DanaInfra, Turus Pesawat and SME Bank as the major issuers.

Exhibit 16 : New corporate bond issuance by rating band (including Cagamas, ex-NR Government-Guaranteed)



Source: Bond Pricing Agency Malaysia

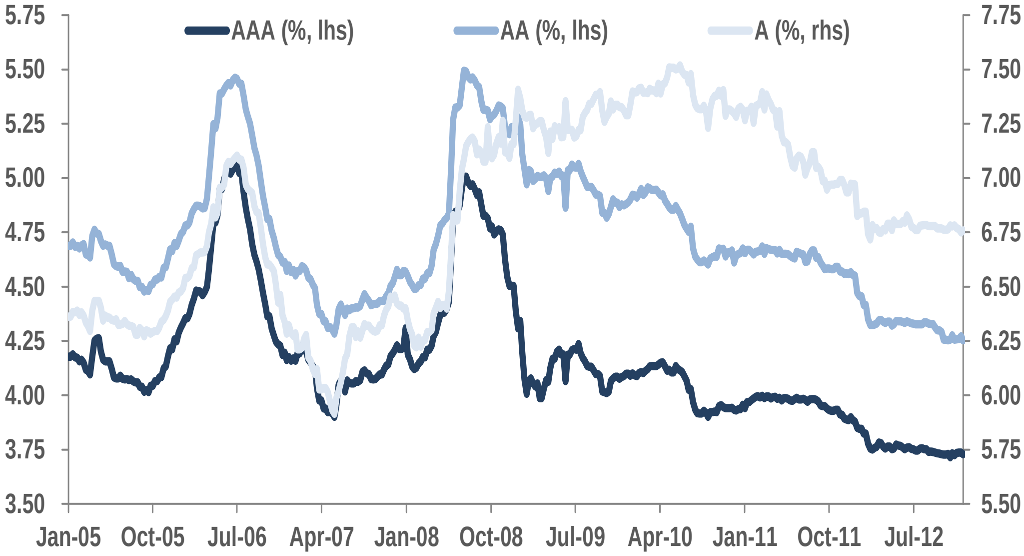
Corporate bond yields are hovering at historical lows in developed and emerging markets

Exhibit 17 : International Market : BofA Merrill Lynch corporate bond yields

Source: Bloomberg

The same situation is evident in Malaysia along the AAA and AA credit segments

Exhibit 18 : BNM PDS Indices : 3-, 5- and 7-year blended yield



Source: Bloomberg, Bank Negara Malaysia

High quality issuances dominated the primary market in 2012

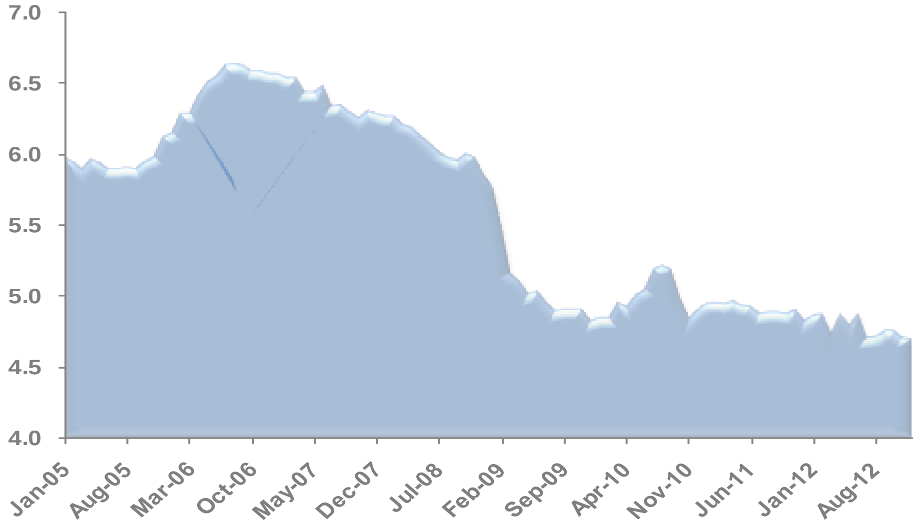
Exhibit 19 : 2012 Corporate bond Issuance by rating band – Quarterly breakdown

Rating Band	1Q2012		2Q2012		3Q2012		4Q2012	
	MYR bn	%	MYR bn	%	MYR bn	%	MYR bn	%
AAA	22.8	67.4	6.0	36.4	9.1	35.3	5.5	30.0
AA/AA2	7.9	23.4	7.5	46.0	8.9	34.5	9.8	53.6
A/A2	0.2	0.7	0.1	0.4	1.0	3.9	1.2	6.6
BBB/BBB2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
BB/BB2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
B/B2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NR	2.9	8.5	2.8	17.1	6.8	26.3	1.8	9.8
Total	33.8	**100.0**	16.4	**100.0**	25.8	**100.0**	18.3	**100.0**

Source: Bond Pricing Agency Malaysia

Average lending rate at historical low, meaning cheap credit in loan markets as well

Exhibit 20 : Malaysia average lending rate (%) – commercial banks



Source: CEIC, Bank Negara Malaysia

Corporate bond demand and supply outlook in 2013

MARC expects gross supply of corporate bonds to be in the region of MYR75-90 billion in 2013

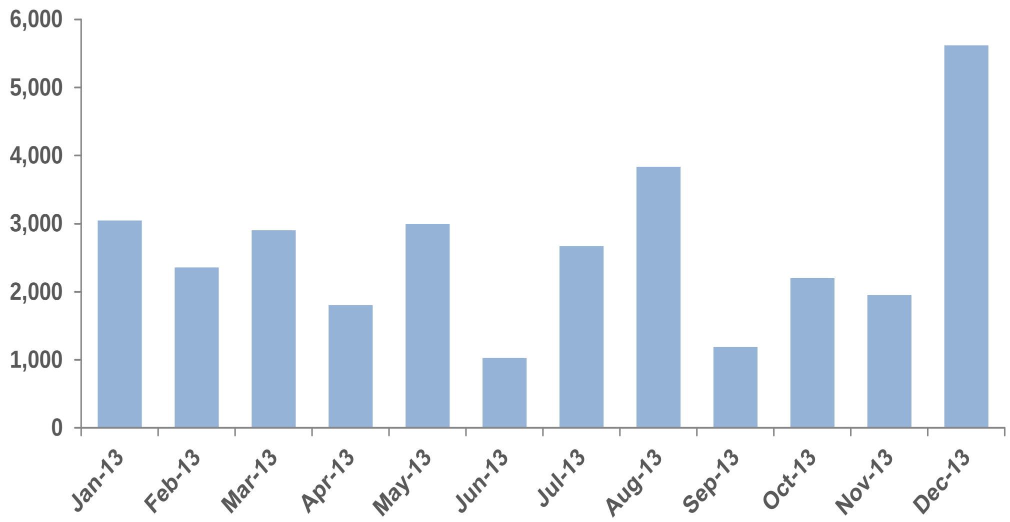
We expect gross corporate bond issuance to come in at MYR75-90 billion for the full year of 2013 with the implementation of projects under the Economic Transformation Programme (ETP) as the major catalyst. That said, a large amount of the financing for the ETP is likely to come in via unrated GG notes. That means bond yields coming in at circa 3.80% - 4.30%, assuming the benchmark 10-year MGS yields max out at 3.80% in 2013. The rest of the issuances are likely to be driven by AAA-rated bonds which currently have a spread of just 40-50 bps above govvies.

… net supply to come in the range of MYR43-58 billion

Corporate bond maturity in 2013 is estimated to be approximately MYR32.5 billion and given our gross issuance level of MYR75-90 billion, net issuance will be in the range of MYR43-58 billion. That kind of issuance size can be comfortably absorbed by domestic funds alone. The Employees Provident Fund (EPF) and Kumpulan Wang Persaraan (Diperbadankan) or KWAP combined recorded a Compound Annual Growth Rate (CAGR) in total investible fund size of 7.4% from 2007 to 2011. Meanwhile, takaful and insurance funds recorded a CAGR of 20.3% and 9.4% respectively over the same period. The conclusion from this analysis is that corporate bond yield compression will likely persist into 2013.

The schedule suggests heavy maturity of approximately MYR32 billion in 2013

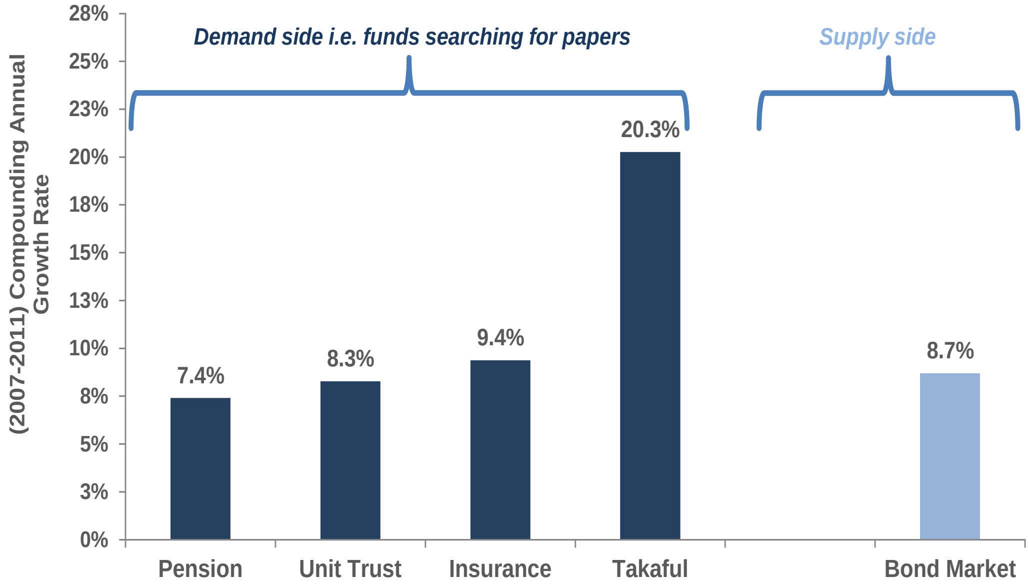
Exhibit 21 : Corporate bond maturity profile by month in 2013 (MYR m)



Source: Bloomberg, Bond Pricing Agency Malaysia

Investible funds are growing rapidly and bond demand will continue to be supported

Exhibit 22 : Selected fund size – 5-year CAGR vs. bonds outstanding



Source: Bloomberg, Bank Negara Malaysia

Investors are sidelining credit risk

Liquidity is reducing investor credit risk premiums

The impact of the massive amount of liquidity injected globally has somewhat changed investors' perception towards credit risk. In particular, judging by credit risk premiums and economic data, it seems that investors are willing to forgo what would be the "ideal compensation" with yields falling again and again, resulting in a steep narrowing of credit spreads.

Low yields will spur more issuances

While the liquidity injections by central banks in troubled developed nations to avert further economic contraction have been well received by financial markets, the price credit investors are paying are shrinking credit risk premiums. To make things even more complicated for bond investors, direct competition from bank loans are depressing bond yields further. The average lending rate for bank loans dipped to a historical low of 4.70% (Exhibit 20). Given these facts, corporate bond issuance is expected to remain strong in 2013.

Corporate bond yields are falling along the AAA and AA rating bands

The bond bull-run we are seeing thus far is a function of fund flows

Given the fact that bond yields have dropped significantly in the past few years, it is hard to imagine yields falling even further this year especially when economic fundamentals do not suggest any significant downside risk in the next one year. In our view, the bond bull-run we are seeing thus far is a function of fund flows and hence it may be time to more closely monitor credit fundamentals. This is especially true when bond yields are declining (shrinking risk premiums) at a time when negative rating actions outpace positive rating actions significantly, something which is rather unusual.

Almost no bargains in AAA and AA credits at this point

There is an increasing concentration towards the AAA rating band and to some extent along the AA1/AA+ rating cohort which is understandable as far as avoiding credit risk is concerned. Exhibit 23 shows that AAA and AA yields have fallen by 130 bps and are hovering at the lowest level since 2004. As such, we think that the massive liquidity that has been injected globally has to some extent heightened investors' credit risk tolerance.

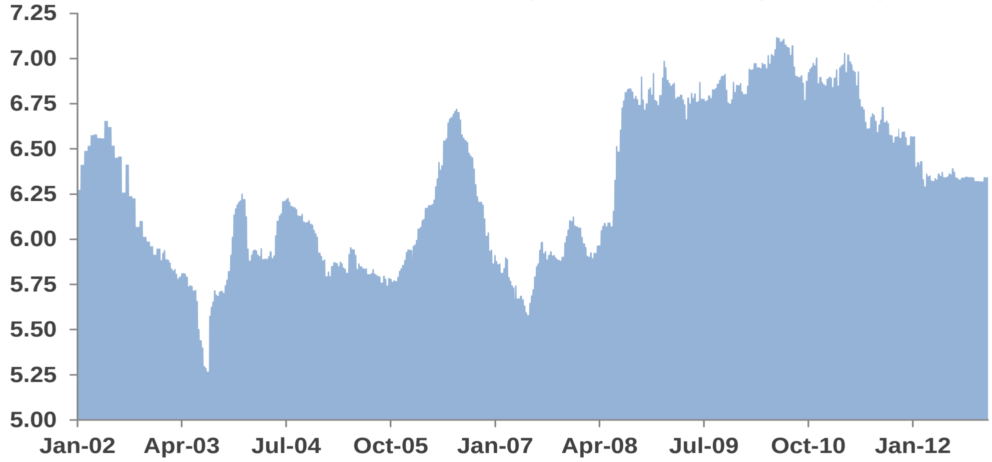
Post global financial crisis, despite the recovery in economic activity, demand for highly rated credits continues to escalate

Exhibit 23 : "AAA" & "AA" bond yields – 130 bps lower from the previous peak

Source: Bloomberg

The "A" market is sidelined due to excessive risk aversion on investors' part

Exhibit 24 : "A" bond yields – 70 bps lower from the previous peak



Source: Bloomberg

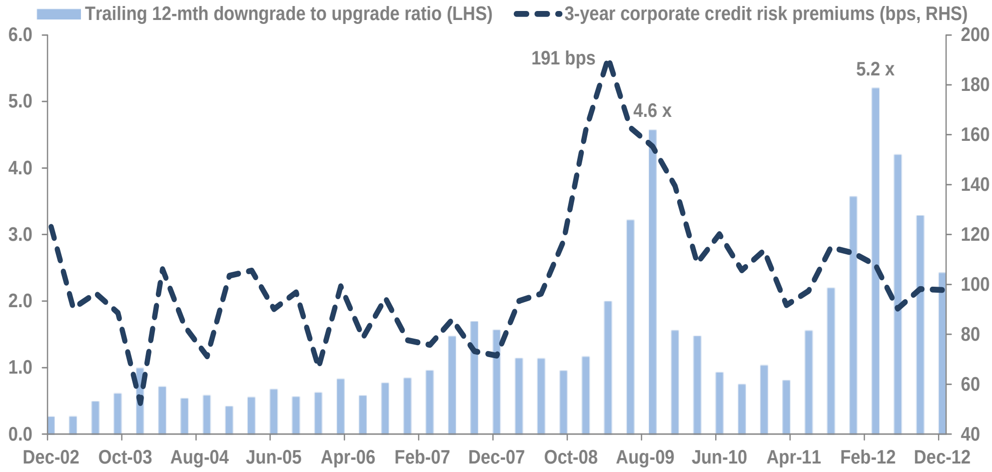
Current valuation vis-à-vis credit metrics and rating actions trends

Narrowing credit spreads, yet downgrades are outpacing upgrades by more than 2.0 x at the moment

Exhibit 25 shows that the credit-spread to risk-free rate peaked at 191 bps in early 2009 when the operating environment was difficult due to the global financial crisis. Such a challenging operating environment was manifested by the corporate bond downgrade-to-upgrade ratio rising to 4.6x. In the current market environment, the downgrade-to-upgrade ratio has actually exceeded that peak at 5.2x in 2Q2012 even as credit risk premiums continued to narrow, a rather unusual phenomenon.

Risk premiums are low although negative ratings are significantly outpacing positive ratings which is unusual in our view

Exhibit 25 : Downgrade-to-upgrade ratio Vs. credit risk premium



Source: Bloomberg

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