Economics

# DBS Flash

# MYR Rates: Navigating monetary, fiscal and politics

**Strategy/Rates**

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- *Amid considerable risk factors in the near term, we are removing our bullish duration bias on MYR rates.*
- *Foreign index and non-index demand for MGS/MGII is expected to wane ahead as global investor re-evaluate.*
- *Pressure will build for BNM to ease further. We think BNM has the capacity and the willingness.*
- ***Implications for investors** – Position in front-end IRS (1y1y, 2y1y). Expect bond-swap spreads to widen.*

**Recent developments across Malaysia's economic and political landscape have prompted us to remove our bullish duration bias on Malaysian government securities (MGS).** To recap, on 22 January, Bank Negara Malaysia (BNM) pre-emptively cut rates in anticipation of economic weakness. This proved prescient as 4Q GDP eventually printed 3.6% YoY (the slowest since GFC), underscoring slowing growth momentum even before the COVID-19 outbreak struck. To further support the economy, a MYR20bn (USD4.8bn) fiscal package to cushion the impact from COVID-19 was announced on 27 February. At the same time, the government downgraded **2020 growth to 3.2%-4.2% range**, down from earlier forecast of 4.8%. **The fiscal deficit target is also estimated to widen to 3.4%**, up from previous target of 3.2% of GDP. Lastly, **former Prime Minister Mahathir Mohamad unexpectedly resigned** on 24 February. Former interior minister Muhyiddin Yassin was subsequently sworn in as the new Prime Minister on 2 March.

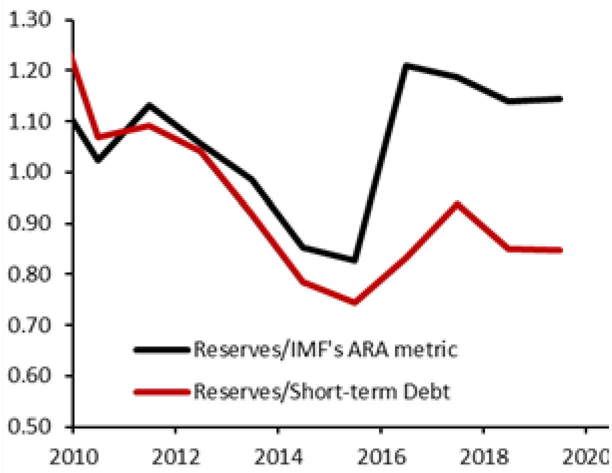
## Removing bullish duration bias amid near-term headwinds

**Amid considerable risk factors in the near term, we are removing our bullish duration bias** on Malaysian government bonds. Political uncertainties could stay elevated for a while. With falling oil prices expected to reduce petroleum-related revenues (current ~$45-50 vs Budget assumption of $62/bbl) and weak economic activity likely to lower tax receipts, the **risks of further fiscal slippages and greater bond issuances need to be monitored**. Looking ahead, we think longer-tenor MYR rates are likely to price in (more fully) this higher political and credit risk premiums. **Foreign non-index demand for Malaysian government securities (MGS) are also expected to wane ahead** as global investors re-evaluate.

**Technical headwinds in the form of index-based bond outflows will continue to weigh on MGS**. Malaysia's weight in the GBI-EM index (benchmark for local currency EM sovereign bonds) is set to be cut, to make way for China's inclusion. FTSE Russell's next review of Malaysia's Market Accessibility Level, which could have implications on the eligibility for inclusion in the WGBI index, is also coming up in March. Summing it up, there would be ~USD2.0-2.5bn of outflows from GBI-EM weight reduction (confirmed) and ~USD4.0-8.0bn from WGBI exclusion (potential). To put into context, net foreign buying of Malaysian bonds totalled only USD5.1bn in 2019.

**Assessing the likely impact of these index and non-index outflows (potential) is far from straightforward.** There are two key considerations and a lot will depend on the pace and size of actual outflows. First, we expect onshore banks and local social security funds (EPF/KWAP) to step up their buying to smooth volatility, as they usually do. However, onshore support may not be adequate to fully offset an adverse decision from FTSE Russell. Second, the sufficiency of Malaysia's FX reserves to accommodate large foreign outflows and by extension, possible implications for the currency is also worth considering.

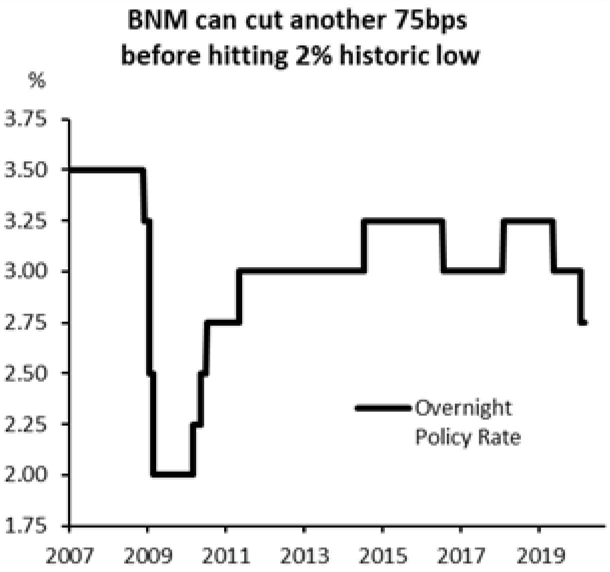
**IMF indicators for assessing Reserve Adequacy**




Source: IMF

## There is room for BNM to ease

With the 2020 fiscal deficit target revised upwards for the second time, there may be limited appetite for further fiscal stimulus. **Pressure will build for BNM to do more.** We think BNM has the capacity and the willingness to ease further if needed. Notably, the policy rate can be cut by another 75bps before BNM hits the historic low level of 2%. Inflation is expected to continue to be broadly stable. Depreciation in the MYR has been mild (~3% ytd), orderly and in line with the broad Asian FX complex. Therefore, compared to some Asian peers, BNM is certainly much less constrained in terms of ability to ease further.

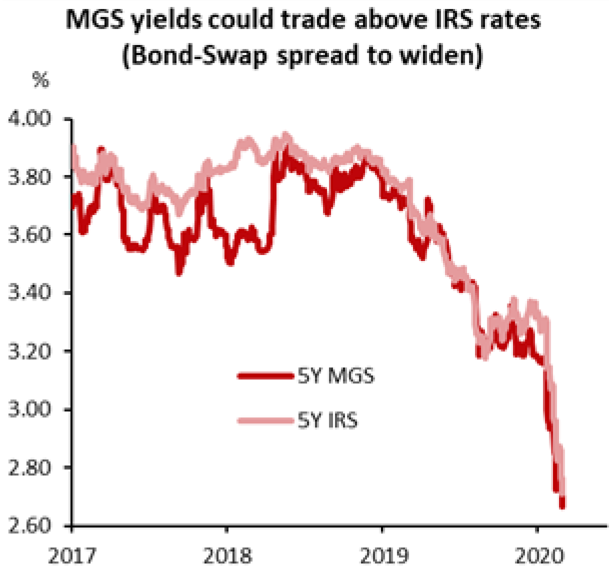


Source: Bloomberg

## Maximize exposure to monetary, minimize exposures to fiscal and politics

As written in an earlier report ([link]), we think **investors need to be positioned at the front-end of the swap curve**, in 1y1y or 2y1y IRS. At present, swap markets are pricing for another 1-2 cuts in 1H and none thereafter. Until we get signs of a trough in economic activity, we think **cut expectations and pricing could have further room to run**. More importantly, **positioning at the front-end maximizes exposure to monetary easing and minimizes exposures to fiscal and political uncertainties**. In the event that swap markets fully price for 3 more cuts in 2020, we think 3Y IRS rates could fall to ~2.4% levels.

While we have removed our bullish duration bias, we are **wary of turning outright bearish on longer-tenor (>5Y) MYR rates**. There is the possible scenario that the pull from falling US rates could overwhelm rising fiscal or political risks, and hence, longer-tenor MYR rates move lower. Therefore, for investors who are worried about fiscal deterioration or political uncertainties, positioning for wider bond-swap spreads (at ~5Y tenor) would offer more targeted protection.



Source: Bloomberg

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**Sources**: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations)