

Duncan Tan
Strategist

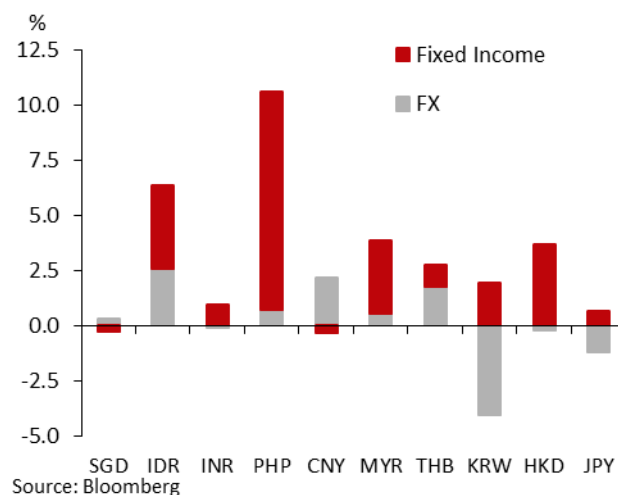


Please direct distribution queries to
Violet Lee +65 68785281 violetleeyh@db.com

- *MGS valuations are no longer cheap and risks around performance have risen. Technicals could be less supportive ahead.*
- *We have changed our view from bullish to neutral.*
- *Risks and uncertainties around FTSE Russell's September review is clouding the outlook; MGS and MYR could trade more volatile.*

Since the start of the year, we have written on several occasions of our bullish view on Malaysian Government Securities (MGS). The basis had been that MGS valuations were cheap, technicals appeared supportive and fundamentals were improving. Tactically, MGS also possess attractive carry attributes that are well suited to the current low-volatility and goldilocks market environment. Year-to-date, it is fair to say that our call has gone well. 10Y MGS's performance has been the 3rd-best within EM Asia, just behind Philippine and Indonesia government bonds. However, recent events have led us to re-evaluate our view. We now think that valuations are no longer as cheap and the risks around performance have risen considerably. Hence, we have changed our view from bullish to neutral.

10Y Local Government Bond - YTD Total Return



At the centre of our shift are concerns that technicals could be less supportive ahead. Norway's sovereign wealth fund is expected to cut Malaysian bonds, together with nine other emerging market peers, from its benchmark index (implementation expected to be after June). The decision was largely made to "increase the equity share" of the fund portfolio, based on the "assessment that capacity to take on risk in of the Fund has increased over time" (Ministry of Finance, 5 April 2019). As of end-2018, the fund held USD2bn of Malaysian government bonds. Separately, FTSE Russell has placed Malaysia on its "Watch List of fixed income

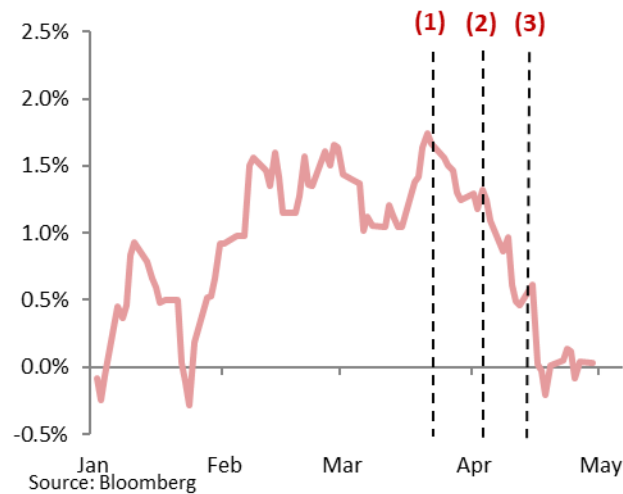
markets that will be reviewed for potential changes to their Market Accessibility Levels". Malaysia is "being considered for a potential downgrade to "1" which would render Malaysia ineligible for inclusion in WGBI" (FTSE Russell, 15 April 2019). Based on AUM tracking the WGBI, passive investors could be holding as much as USD9bn of Malaysian government bonds. In aggregate, USD11bn of potential outflows (expected USD2bn and possible USD9bn) which represents approx. 7% of outstanding and 27% of current foreign holdings.

Amongst foreign bond holders, there is understandably some amount of anxiety over the market impact of potential outflows. Of late, we are seeing the weakening in spot MYR coincide with falling forward points. USDMYR bases have also widened modestly. This could be some foreign holders unwinding FX hedges alongside their bond sales. Therefore, we expect the strong bond inflows of February and March to reverse in April.

uncertainties and risks around future developments and outcomes would likely see MGS and MYR trade more volatile ahead. It would be prudent not to discount the possibility of an extended selloff should MGS holders decide that event risks are too much to bear.

In terms of MGS valuation, there appears to be limited scope for further capital gains. Bank Negara Malaysia's easing cycle (expected) is likely to be shallow and a cut at the May or July meeting has already been priced in. Earlier in the year, we had expected compression of credit risk premium (as fiscal concerns ease) to drive much of the price appreciation. That has since been largely realized with 5Y CDS spreads falling from 110 to 55bps. From this point on, much lower MGS yields are unlikely unless global core yields fall (we expect core yields to be rangebound with slight upward bias). Ultimately, the reward-risk proposition of MGS is much less attractive when compared to the start of the year.

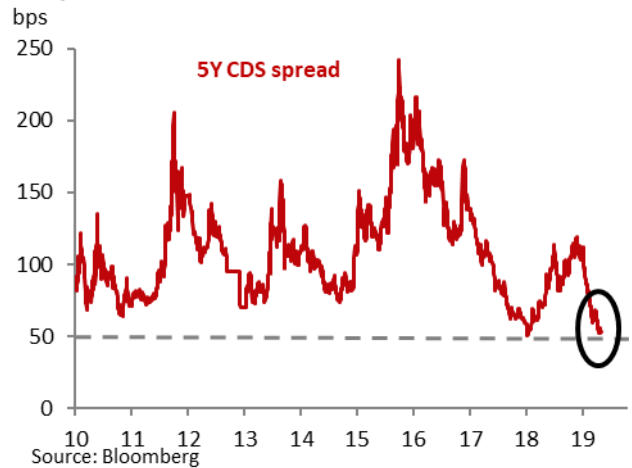
Year-to-date spot MYR returns



- (1) Surge in BNM rate cut expectations
- (2) Norway sovereign wealth fund cut Malaysia bonds from benchmark index
- (3) FTSE Russell place Malaysia government bonds on Watch List

Our base case is that Norway's sovereign wealth fund would sell its holdings in a very gradual manner, to limit market impact and get the best possible price. We also expect Malaysia's regulators to be in constant engagement with FTSE Russell to address issues and avert an exclusion decision at the September review (we think a retain decision is most likely). However, the elevated

Credit risk premium is low. Limited room for further compression.



Group Research

Economics & Strategy

Taimur Baig, Ph.D.

Chief Economist - G3 & Asia

+65 6878-9548 taimurbaig@dbs.com

Nathan Chow

Strategist - China & Hong Kong

+852 3668-5693 nathanchow@dbs.com

Masyita Crystallin, Ph.D.

Economist – Indonesia & Philippines

+62 21 2988-4003 masyita@dbs.com

Joanne Goh

Regional equity strategist

+65 6878-5233 joannegohsc@dbs.com

Neel Gopalakrishnan

Credit Strategist

+65 6878-2072 neelg@dbs.com

Eugene Leow

Rates Strategist - G3 & Asia

+65 6878-2842 eugeneleow@dbs.com

Chris Leung

Economist - China & Hong Kong

+852 3668-5694 chrisleung@dbs.com

Ma Tieying

Economist - Japan, South Korea, & Taiwan

+65 6878-2408 matieying@dbs.com

Radhika Rao

Economist – Eurozone, India & Thailand

+65 6878-5282 radhikarao@dbs.com

Irvin Seah

Economist - Singapore, Malaysia, & Vietnam

+65 6878-6727 irvinseah@dbs.com

Duncan Tan

FX & Rates Strategist - ASEAN

+65 6878-2140 duncantan@dbs.com

Samuel Tse

Economist - China & Hong Kong

+852 3668-5694 samueltse@dbs.com

Philip Wee

FX Strategist - G3 & Asia

+65 6878-4033 philipwee@dbs.com

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

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