BLOOMBERG

The timely introduction of GST provided the government with a new revenue foundation

Market volatility and oil price will continue to hog headlines

Guest writer

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YEAR 2015 is drawing to a close. Perhaps it is about the right moment we look at the past and hopefully from there, we will be able to catch a glimpse of what's to come in 2016.

Over the past seven years (2007 to last year), the ringgit bond market as measured by the TR BPAM All Bond index registered a compounded annual return of 4.2%. The effects of the Great Recession in the US as well as sovereign debt crisis in the euro area were not significant enough to have caused negative annual returns for the ringgit bond market. As of Nov 30, 2015, the TR BPAM All Bond index stood at 142.46 points, which is approximately 3.85% higher from last year's closing of 137.18. It is anyone's guess whether it will breach the long-run average of 4.2% by Dec 31.

One major global event that is the precursor to volatility in almost every market is the performance of crude oil prices. The ripple that emanated from the Organisation of Petroleum Exporting Countries' (Opec) decision in November last year not to cut crude oil production continued to depress global crude oil prices throughout this year. By mid-January 2015, the Brent crude oil price had plunged 42% to about US$45 per barrel.

Owing to this external development, the 10-year Malaysian Government Securities (MGS) yield surged to as high as 4.3% (price decreases when yield increases, and vice-versa) in January from below 4% pre-Opec announcement. Market players offloaded MGS as concerns mounted over the ability of the government to meet its fiscal target.

To alleviate the concerns and tackle the potential budget shortfall, Prime Minister Datuk Seri Najib Razak announced a budget revision on Jan 20, 2015 to reduce operating expenditure by RM5.5 bil and revised the budget deficit target from 3% to 3.2% of the gross domestic product (GDP) for 2015. As a result, the selldown stopped and the 10-year MGS yield recovered, touching 3.78% in early February.

From February to May, the movement of the 10-year MGS yield was contained and oscillated narrowly between 3.8% and 4%, while global crude oil prices rebounded as oversupply concerns started to ease on the back of rising demand. On the domestic front, the announcement of a better-than-expected GDP growth of 6% for 2014 also lent support to the MGS yields during this time.

Thereafter, the financial market became increasingly anxious over the timing of the US Federal Reserve (Fed) interest rate lift-off as officials continued to give mixed signals amidst improving economic data. The uncertainty made markets jittery and foreigners started to pull money out of Malaysia to seek the safe haven of the US dollar. In July alone, Bank Negara Malaysia's (BNM) international reserves declined by approximately 8.4% or US$8.8 bil from the previous month to US$96.7 bil. In that time, the ringgit depreciated to RM3.8245 against the greenback.

This was the first time the ringgit had breached the RM3.80 per US dollar level since the US dollar peg was scrapped in 2005. Despite the breach of this psychological "barrier", BNM did not intervene as the country's economic fundamentals were strong enough to bring the ringgit to its true value.

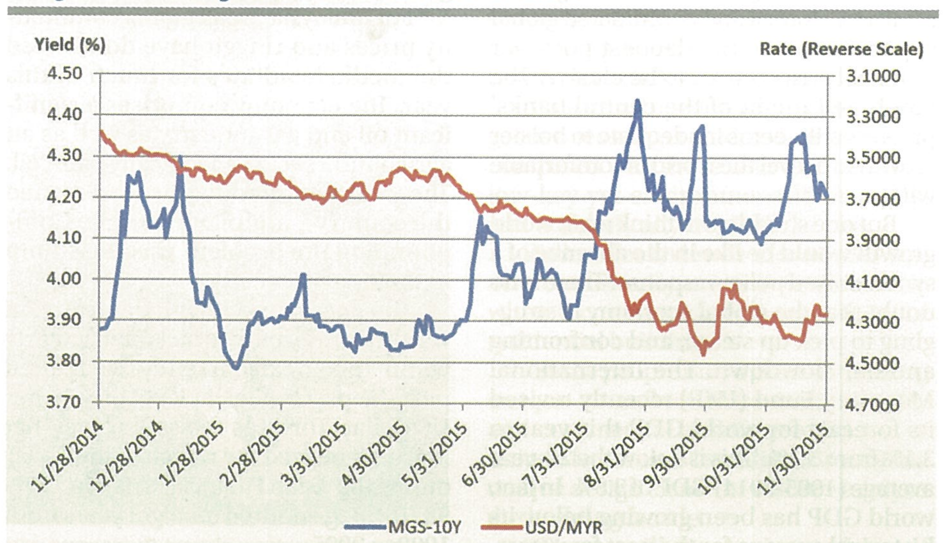
Subsequent politicking and alleged economic mismanagement at state investment fund, 1Malaysia Development Bhd (1MDB), continued to dominate headlines. The heightened perception of political uncertainties unnerved investors. By the end of September, BNM's international reserves were reported at US$93.3 bil, while the ringgit lost further ground and closed at RM4.3955 against the USD. During this period, the 10-year MGS yield surged above 4.4% before recovering to around 4.15%.

Ringgit bond market

Date	TR BPAM All Bond index
Dec 31, 2007	102.73
Dec 31, 2008	109.61
Dec 31, 2009	112.62
Dec 31, 2010	118.61
Dec 31, 2011	124.53
Dec 31, 2012	130.11
Dec 31, 2013	131.57
Dec 31, 2014	137.18
Dec 31, 2015	?

Source: BPAM

10-year MGS yield vs USD/MYR rate



Source: BPAM and BNM

Looking to reduce budget deficit

On Oct 23, Prime Minister Datuk Seri Najib Razak delivered the Budget 2016 speech to Parliament. Some of the macroeconomic highlights include the reduction of the budget deficit to 3.1% of GDP from 3.2% this year, an economic growth projection of 4-5%, an inflation forecast of around 2-3%, and most importantly, the expectation of oil and gas-related revenues at 14.1% of the total revenue in 2016, which is much lower than the 19.7% expected in 2015 as a direct consequence of persistent depressed global crude oil prices.

Despite lower contributions from oil and gas-related revenues to Malaysian government coffers, comfort can be drawn from the fact that the reliance on the commodity has been diminishing over the years. To help support the shortfall, the timely introduction of the goods and services tax provided a new revenue foundation. This is expected to allow the government to meet its fiscal target. The structural reforms introduced earlier are starting to show positive results. This fact was acknowledged by major international institutions such as the World Bank as well as international rating agencies.

On Nov 23, 1MDB announced that it sold the power assets under Edra Global Energy Bhd to China General Nuclear Power Corp (CGN), a Chinese state-owned firm for a cash consideration of RM9.83 bil or US$2.3 bil. Those power assets include 13 power plants across five countries from Malaysia to Egypt. It was announced that CGN will assume all the debts as well. This transaction is a major milestone for 1MDB under its debt rationalisation plan and has helped allay a number of misconceptions surrounding 1MDB in the eyes of investors.

Towards the end of 2015, it has become increasingly clear that the US Fed is going to hike its benchmark interest rate sooner rather than later from its current level of 0% to 0.25%. Once this uncertainty is lifted, coupled with the good news aforementioned as well as the diversity of Malaysia's economy, the ringgit exchange rate will recover eventually to reflect its fundamental value.

Gradual rate hike seen

The weak ringgit presented a good opportunity for foreign investors to accumulate quality assets, be it in portfolio investment like the MGS or in direct investment such as the acquisition of Edra's power assets by CGN, at a much lower cost. The narrowing interest rate differential between Malaysia and the US will definitely feature in the foreign investor's perspective. Having said that, it is also widely known that the US Fed will most likely hike its interest rate gradually and then observe economic data, rather than raising its interest rate too steep too soon. As such, Malaysia's positive interest rate differential over the US remains.

Going into 2016, more volatility is expected from the external environment. There is no doubt as to China's economic slowdown; the correct question to ask is whether it will be a hard or soft landing. Bearing in mind also the colossal shadow banking system in China, it is a ticking time-bomb in the eyes of investors.

'Clear and present danger'

Another potential risk that is harder to predict and to quantify is geopolitical risks. As demonstrated from the recent downing of a Russian bomber jet by Turkey near the Syrian border, any future escalation of tension between the countries will lead to military expansion in the Middle East. This will not bode well for global economies as the Middle East is a major oil-producing hub. Besides, the threat posed by extremist groups operating in Iraq, Syria and certain countries in Africa is real. Their tentacles have spread internationally and this presents a "clear and present danger" to those they oppose.

The ability of such groups to operate with such impunity against the might of nations is puzzling. Some level of complicity must be at work to enable these groups to be continuously supplied with men, money and materials. Such situation does not bode well for the world.

If the geopolitical elite do come to their senses, the ringgit bond market only needs to be worried about fundamental economic issues which appear to be abating. However, heightened volatility due to the effect of fear on currencies and commodities is already here and may not go away anytime soon. FocusM

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