BONDS

Regulated short selling positive for bond market

BY **KUEK SER KWANG ZHE**

The recently implemented framework for regulated short selling of Malaysian government and corporate bonds, which allows investors to hedge currency risks, is positive for the local bond market, say industry experts.

Tutiana Jusat, chief investment officer for Malaysia fixed income and global sukuk at Amundi Malaysia, says the framework "provides options to all resident entities to hedge interest rates and foreign currency positions. It can also curb short-term speculation."

Meor Amri Meor Ayob, CEO of Bond Pricing Agency Malaysia Sdn Bhd, says the introduction of the framework is timely, especially since the US Federal Reserve is embarking on a rising interest rate cycle, which could cause volatility in the global bond market and currency fluctuation.

"Essentially, it equips investors with an effective avenue to manage interest rate risk while adding liquidity to the market. The additional hedging flexibility allows foreign investors to better manage their currency exposures. It is not surprising to see the ringgit as well as government bond yields strengthening following the announcement of the new measures, as liquidity is one factor that attracts and retains investors," he says.

Kevin Chan, head of fixed income investment at Apex Investment Services Bhd, says the local bond market reacted positively to the announcement of the new framework by Bank Negara Malaysia and the Securities Commission Malaysia (SC). The positive sentiment is reflected in the yields of Malaysian government bonds, he adds.

"Government bond yields have come down in tandem with the announcement on April 13. The ringgit has also strengthened. It is positive for the bond market in the medium to long term," says Chan.

The 10-year Malaysian government bond yield fell 3.87% to 3.944% on May 8 from 4.103% on the day of the announcement. The ringgit strengthened by 174 basis points during the corresponding period.

On April 13, Bank Negara announced the new framework for regulated short selling of government bonds, allowing all resident entities, including non-bank entities, to short sell selected government bonds. Previously, only licensed banks and investment banks were allowed to do so.

The framework also allows non-banks entities to hedge their foreign currency exposure up to 100% of their underlying assets. According to the central bank's announcement, only government bonds with an outstanding nominal amount of at least RM2 billion can be short sold.

The new framework is part of Bank Negara's second series of development initiatives to expand and deepen the onshore financial markets. The first set of measures were introduced in December last year.

On the same day, the SC announced new guidelines that would expand the range of bonds that could be short sold. The initiative was part of its continuous efforts to boost the liquidity of the secondary bond market while ensuring a comprehensive and facilitative infrastructure and regulatory framework.

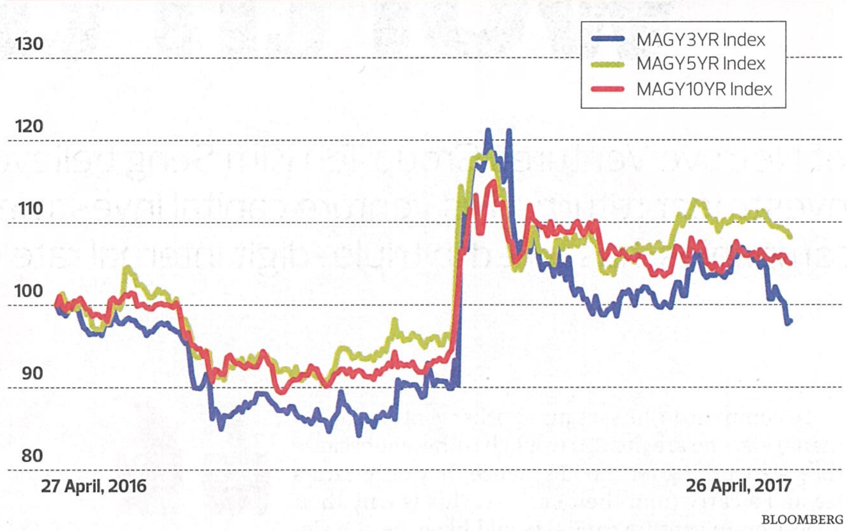
For corporate bonds, some of the new criteria include having an issue size of at least RM500 million and guaranteed by the Malaysian government or having a minimum credit rating of "AA" by rating agencies regulated by the SC.

Liquidity in the local bond market, especially government bonds, is expected to improve on the back of these new measures, says Meor Amri. That is because Malaysian bonds are now more attractive to local and foreign investors as they are able to hedge their positions when the market is volatile.

"As it is regulated, whether or not the short selling measures will spark speculation and cause volatility in the market is not much of a concern," says Chan.

Gan Kong Yik, chief investment officer at KAF Investment Funds Bhd, agrees. He says local institutional investors that were qualified to short sell Malaysian government bonds under the previous framework had been short selling for hedging purposes instead of speculation. "It is unlikely to spur speculation and cause a huge impact on the bond market."

Comparison of Malaysian government bonds' yields



BROADENING THE SCOPE FOR FUND MANAGERS

Chan suggests that regulators look at changing the mandate of retail unit trust funds to enable fund managers to capitalise on these new measures. "The existing mandates for retail funds only allow fund managers to have minimal exposure to trade derivatives for hedging purposes. To change this, it will need the consent of the majority of stakeholders, which is a huge task," he says.

According to the SC's website, the total net asset value of unit trust funds stood at RM381.34 billion as at February, or 21.92% of Bursa Malaysia's market capitalisation.

Wholesale funds are not affected as they have flexible mandates that are able to capitalise on these new measures, says Chan. However, the total net asset value of wholesale funds stands at RM84.78 billion — about 4.5 times smaller than retail funds.

Edward Iskandar Toh, chief investment officer for fixed income at Areca Capital Sdn Bhd, is more concerned about whether fund managers at non-bank-backed asset management firms can hedge their currency positions under the new measures. "Fund managers like us will not be able to hedge any forex positions as we cannot sign the International Swaps and Derivatives Association Master Agreement, which is a counter-party agreement for swaps that would allow us to hedge our currency risks.

"That is because we do not own the fund, but only have the management rights to it. The trustees are the rightful owners. But the trustees will not sign the agreement. Why would they want to be responsible for fund managers' decisions?

"Also, while we can trade forward contracts, it is not easy for non-bank-backed asset management firms like us to get credit lines as we tend to have lower paid-up capital. This means that even though the measures allow us to hedge our positions in bonds and currencies, we are actually not able to execute it. It is a structural issue." E

> "Essentially, it equips investors with an effective avenue to manage interest rate risk while adding liquidity to the market. The additional hedging flexibility allows foreign investors to better manage their currency exposures." > **Meor Amri**

> "The framework "provides options to all resident entities to hedge interest rates and foreign currency positions. It can also curb short-term speculation." > **Tutiana**

> "There will be intermittent buying and selling. But there will be less hot money coming in and out. Eventually, you will see more stability and robust demand mainly from local investors." > **Chan**

Demand for local bonds to remain strong

The bond market is expected to remain stable going forward, with demand still strong, say industry experts.

Kevin Chan, head of fixed income investment at Apex Investment Services Bhd, is positive on the outlook for the bond market. On top of the recently implemented measures by Bank Negara Malaysia and Securities Commission Malaysia, the demand for local bonds remains strong, he says.

This could be seen at last month's five-year Government Investment Issuance (GII) auction, which saw bid-to-cover ratio of 2.773 times, says Chan. "It was the highest ratio since February last year. The demand mainly comes from local investors."

GII is a non-interest-bearing government securities issued based on Islamic principles. The bid-to-cover ratio is an indicator of the demand for government securities during an auction. The higher the ratio, the stronger the demand.

Chan says the local bond market will remain stable because a lot of short-term capital has flowed out of the country. "Foreign holdings of Malaysian government bonds have come down from nearly 50% to about 40% today and are held by long-term investors such as pension funds."

While the US Federal Reserve is on a rate hike cycle, the Malaysian bond market will see some volatility like before as most of the hot money has left the country. "There will be intermittent buying and selling. But there will be less hot money coming in and out. Eventually, you will see more stability and robust demand mainly from local investors," says Chan.

Going forward, the possibility of Bank Negara raising rates in tandem with the Fed is one of the main risks to the local bond market. However, Chan's view is that the central bank will hold the overnight policy rate (OPR) steady.

He cites the high inflation in February and relatively low growth of the economy. "The high inflation is due to the weak ringgit instead of an increase in the market's demand. The situation will improve if the ringgit strengthens via the implementation of the new measures and improving sentiment in the market. We think that the ringgit remains undervalued."

The inflation rate hit 4.5% in February. It was the highest in the past eight years. The country's gross domestic product came down to 4.2% last year from 6% in 2014. It is expected to increase slightly to 4.35% by the end of this year, according to Bloomberg's estimates.

Gan Kong Yik, chief investment officer at KAF Investment Funds Bhd, also expects Bank Negara to keep the OPR steady. "I see no reason for the central bank to tighten its monetary policy. Inflation is high and global growth does not look as rosy as before," he says.