Key Developments in the Second Half of 2022

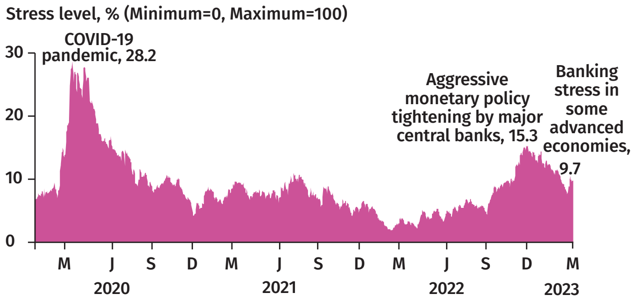
MARKET RISK

Domestic financial market conditions remained orderly amid heightened volatility in the global financial markets

The global financial markets continued to be driven by changes in the anticipated monetary policy stance of major central banks and the global growth outlook. Inflation remained elevated amid the slower growth in major economies in the second half of 2022. Major central banks have responded by aggressively increasing policy rates. This has led to a tightening in global financial conditions. These global developments also affected Malaysian financial markets. Despite the stronger domestic economic performance, market stress, as measured by the Financial Market Stress Index (FMSI) increased significantly during the period. This was driven by the higher volatility observed in the foreign exchange (FX), bond and money markets. Stress levels rose to levels last seen in mid-2020, but remained well below the peak observed at the onset of the pandemic in March 2020 (Chart 1.1). The recent global market volatility due to concerns in the banking sector of some advanced economies had minimal impact on Malaysian financial markets beyond some weakness observed in the domestic equity market. The Bank remains vigilant of potential spillover risks from the global banking sector to the domestic financial markets.

The domestic equity market declined in tandem with regional markets (Chart 1.2). Performance was weighed down by profit-taking activities in the technology and healthcare counters amid an environment of rising interest rates and waning concerns over the pandemic. Notwithstanding this, an easing in global financial conditions towards the end of 2022, stronger domestic economic activity and positive investor sentiment amid an orderly political transition following the 15th General Election lent some support to equities in the fourth quarter of the year. The overall new capital raised in the domestic equity market rose to RM4.1 billion[1] during the period (January 2021-January 2022: RM3.2 billion; January 2020-January 2021: RM2.0 billion), reflecting improvements in business confidence and investor demand. However, renewed uncertainty over the pace of US monetary policy tightening amid a persistent increase in inflation and the failure of some US banks in the first quarter of 2023 has dampened the performance of equity markets globally, including Malaysia's. While the risk-off sentiment among investors due to concerns in the global banking sector has placed some pressure on the domestic equity market, especially the banking counters, the impact was nevertheless moderate and short-lived.

Chart 1.1: Financial Market – Financial Market Stress Index (FMSI)



Source: Bloomberg, Reuters and Bank Negara Malaysia estimates

Non-resident flows into equities turned negative since September 2022, partly reflecting subdued investor sentiment following continued inflationary pressures and expectations of faster monetary policy tightening by major central banks. However, for 2022 as a whole, non-residents were net buyers in the

[1] For a 13-month period between January 2022 and January 2023.

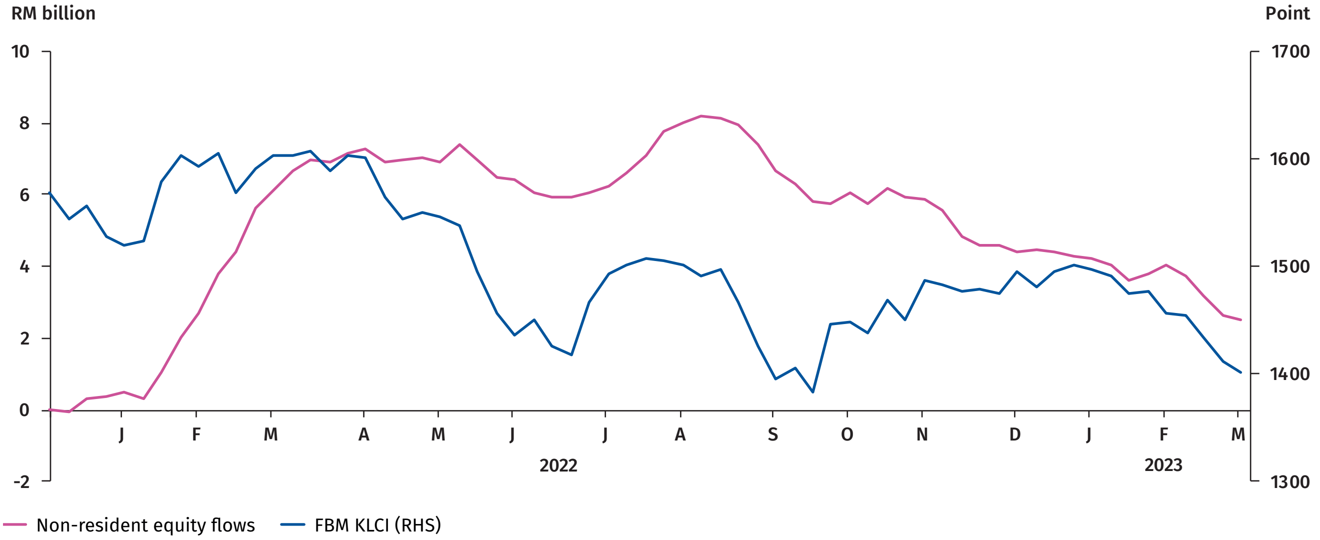
domestic equity market (net inflow of RM4.4 billion), after recording four consecutive years of net outflows since 2018. Retail investors remained a key player in the market, although the level of participation has declined from the highs seen during the pandemic (year-to-date (YTD)[2] average: 27.3%; 2020-2021 average: 34.3%) amid the higher returns on deposits and sharp price corrections in the technology and healthcare sectors. These investments have not, so far, been associated with an increase in leverage, shielding households from debt-related stress due to volatile equity prices. Household loans to purchase quoted shares remained small and stable at 0.5% of total banking system loans, unchanged from the 5-year average share of banking system loans.

Non-resident portfolio flows in the government bond market were largely influenced by external factors

The domestic bond market remained resilient despite heightened market volatility in an environment of rising interest rates. The 10-year Malaysian Government Securities (MGS) yields rose by 51 basis points (bps) in 2022 (Chart 1.3) following increases in the Overnight Policy Rate (OPR) (2022: +100 bps). At its peak, yields rose to 4.55% in late October consistent with global yield trends amid uncertainties around the outlook for global interest rates. Market liquidity has remained healthy with sustained demand for government bonds in the primary market, as evidenced by the average bid-to-cover ratio of 2.1 times between September 2022 and March 2023[3] (2015-2019 average: 2.3 times). Meanwhile, in the secondary market, the daily trading volume for government bonds averaged RM3.3 billion between September 2022 and March 2023 (2015-2019 average: RM3.1 billion). Liquidity conditions were also largely unaffected by the expiry of the Statutory Reserve Requirement (SRR) flexibility[4] at the end of 2022 given the healthy liquidity buffers of banks. More recently, liquidity conditions remain stable following the recent failures of some US banks. Banks continue to have access to various types of instruments to manage liquidity, including repurchase arrangements (repo), reverse repo, FX swaps and standing facilities with the Bank.

For 2022 as a whole, non-residents were net sellers in the domestic government bond market (net outflow

Chart 1.2: Financial Market – Cumulative Non-resident Equity Flows and Performance of the Domestic Equity Market



Source: Bloomberg

[2] Data as of 20 March 2023.

[3] Data as of 20 March 2023.

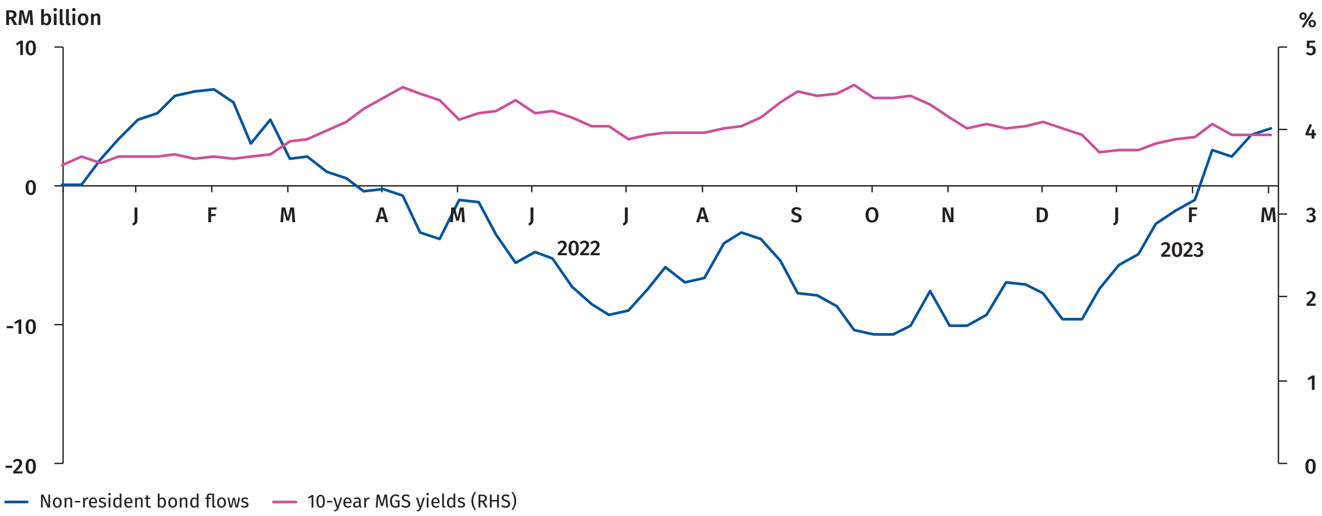
[4] The flexibility to allow banks to use MGS and Malaysian Government Investment Issues (MGII) to meet the SRR compliance was introduced at the onset of the pandemic to provide greater flexibility for banks in their liquidity management and support the continued smooth functioning of the bond market.

of RM7.8 billion) – a trend also observed in many other emerging economies amid expectations of tighter global monetary conditions. Non-resident flows turned positive since November 2022, in line with regional trends, amid the relatively attractive total return of domestic government bonds. Consequently, the share of non-resident holdings in the government bond market increased marginally to 22.8% YTD (December 2022: 22.2%; 2015-2019 average: 27.0%). Domestic institutional investors, such as banks, non-bank financial institutions (NBFIs), and insurers and takaful operators (ITOs), remained active in the government bond market (2022: net purchase of RM56.7 billion; 2021: net purchase of RM51.0 billion), supporting market liquidity amid volatile non-resident flows.

The corporate bond market continued to function in an orderly manner in support of corporate fundraising activities. Gross corporate bond issuances rose sharply (August 2022-January 2023: RM94.7 billion; August 2019-January 2020: RM48.8 billion), driven mainly by a large issuance by a major toll road operator in December (RM25.2 billion). Corporate bonds remained an attractive investment instrument for investors. Credit spreads between 10-year AAA papers and 10-year MGS have remained broadly stable, reflecting sustained investor demand for corporate bonds (September 2022-March 2023[5] average: 56.1 bps; 2015-2019 average: 55.4 bps). This will continue to support orderly conditions.

Between September 2022 and March 2023,[6] the ringgit weakened by 0.2% against the US dollar to close at 4.4860. The ringgit recorded its all-time closing low of 4.7480 in early November as the US dollar rose to a 20-year high following the aggressive monetary tightening by the US Federal Reserve (Fed). The ringgit subsequently strengthened towards the end of 2022 mainly on signs that the Fed might slow the pace of its policy tightening. This improvement continued into January 2023 as the anticipated reopening of China's economy added to the positive sentiment on the ringgit. However, the rebound in the US dollar since February 2023 led to a weaker ringgit as global investors revised their expectations for a higher terminal Federal Funds Rate (FFR). Recent market volatility amid concerns over the US banking sector saw markets readjust their expectations for a lower FFR increase, leading to a marginal appreciation in the ringgit against the US dollar in March. The ringgit continued to adjust in an orderly manner, underpinned by the healthy average daily onshore FX trading volume (YTD: USD15.5 billion; 2022: USD13.7 billion; 2021: USD11.3 billion). While the 1-month USD/MYR implied volatility increased slightly to 5.3% between September 2022 and March 2023 (2020-2022 average: 4.6%), it remained largely in line with regional trends, and was well below the highest volatility level observed in the past 10 years (2015 peak: 15%). Significant movements in the ringgit exchange rate could increase risks for businesses with high external debt although such

Chart 1.3: Financial Market – Cumulative Non-resident Bond Flows and Performance of the Domestic Bond Market



Source: Bank Negara Malaysia and Bloomberg

5 Data as of 20 March 2023.

6 Data as of 20 March 2023.

risks are presently contained (refer to the section on 'Key Developments in the Second Half of 2022 – Credit Risk' for further details). Looking ahead, movements in the ringgit will continue to be largely driven by external developments amid an evolving global growth and inflation outlook. Downside risks include continued aggressive increases in US interest rates, heightened global market volatility and contagion fears arising from banking system stresses in some advanced economies. These risks may lead to a further deterioration in investor sentiment, which may result in near-term pressure arising from non-resident portfolio outflows. Nevertheless, continued domestic economic growth and positive spillover effects from the reopening of China's economy (refer to Chapter 2 of the BNM Economic and Monetary Review 2022 for further details) would provide some support to the ringgit.