Key Developments in the Second Half of 2023

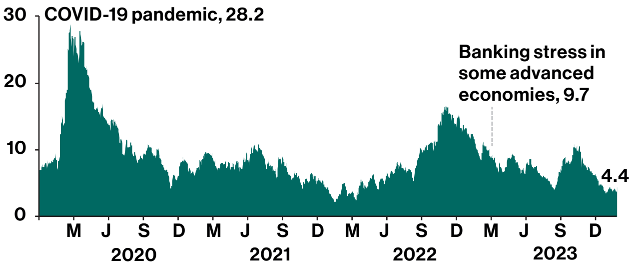
MARKET RISK

Domestic financial markets remained orderly despite volatile global markets

In the second half of 2023, central banks of major economies paused or slowed the pace of policy rate increases, signalling that a turning point in their monetary policy path could be approaching. While this development provided some support to global financial markets, volatility continued to remain high due to shifting expectations on the timing and magnitude of policy rate cuts. Increased concerns over the escalation of geopolitical tensions since October 2023 led to a higher demand for safe haven currencies, such as the US dollar. In addition, data releases related to China's slower-than-expected economic growth have dampened investor sentiment towards the region.

Domestic financial markets remained orderly despite the global volatility. Domestic market stress, as measured by the Financial Market Stress Index (FMSI) (Chart 1.1), increased in October and November. This was driven mainly by the higher volatility observed in the equity and foreign exchange (FX) markets. Market stress subsequently decreased in December amid growing expectations of a reduction in the Federal Funds Rate (FFR) following the release of the Federal Open Market Committee's (FOMC) projected policy rate path and the anticipation for the US economy to achieve a 'soft landing'.

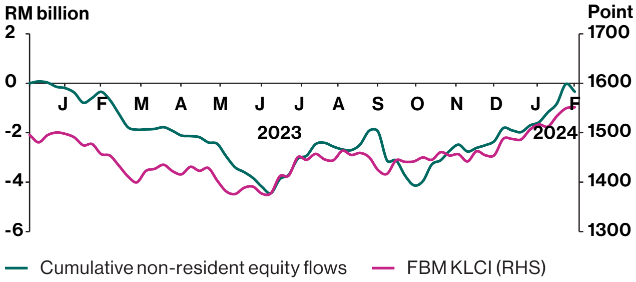
Chart 1.1: Financial Market – Financial Market Stress Index (FMSI)



Source: Bloomberg, Reuters and Bank Negara Malaysia estimates

For 2023 as a whole, non-residents were net sellers in the domestic equity market (net outflow of RM2.3 billion) (Chart 1.2), in line with regional trends (Malaysia: -USD0.5 billion; regional[1] average: -USD2.2 billion). However, non-resident flows into the equity market turned positive since November 2023 and continued into 2024 year-to-date (YTD),[2] mainly supported by the positive sentiments surrounding the announcements of national master plans and special economic zones.[3] Higher demand for industrial land and data centre sites, as well as the rollout of large public infrastructure projects, such as the Pan Borneo Sabah Phase 1B, Bayan Lepas Light Rail Transit (LRT) and Sabah-Sarawak Link Road further lifted the performance of stocks in the construction sector. Meanwhile, expectations of the increased power demand from data centre sites and

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



Source: Bloomberg

[1] Regional countries comprise Thailand, Philippines, and Indonesia.
[2] All data in the Market Risk section are as at 29 February 2024, unless stated otherwise.
[3] These included the New Industrial Masterplan (NIMP) 2030 and the NETR, Johor-Singapore Special Economic Zone as well as key infrastructure projects such as Bayan Lepas Light Rail Transit (LRT).

the expected rollout of the National Energy Transition Roadmap (NETR) helped boost the utilities sector. Gains were also recorded in the transport sector, particularly the aviation sector, driven partially by expectations of improved tourism following the announcement of visa-free travel between Malaysia and China, India and the Middle East.

Domestic institutional investors[4] remained net buyers of domestic equities (October 2023–February 2024: +RM0.2 billion; October 2022–February 2023: +RM3 billion). While value traded by retail investors as a share of total value traded on Bursa Malaysia has declined further from the peak seen during the pandemic (August 2020 (peak): 40.3%), retail participation (October 2023–February 2024 average: 24.9%) remained above the pre-pandemic average level (2015–19 average: 18.5%). The increase in net cumulative purchases by retail investors since 2018 (2018–24 (YTD): +RM33.3 billion) has been driven mainly by the search for higher returns amid the low interest rate environment. More recent trends after the dissipation of pandemic-related factors suggest that retail participation in the domestic equity market may settle at levels higher than that observed before the pandemic. This is not expected to have a material impact on overall household resilience arising from exposures to equity price movements given that the bulk of the increase in the purchases of quoted shares has not been funded by debt. Household loans to purchase quoted shares remained low and stable at 0.5% of banking system loans.

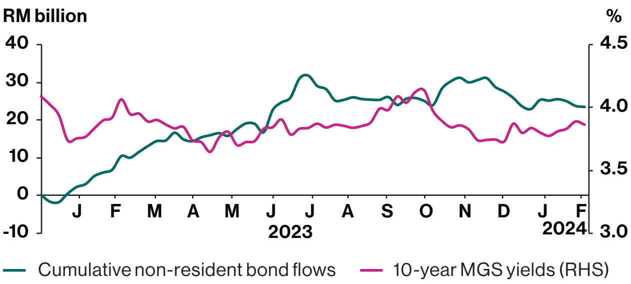
Non-resident flows in the government bond market continued to be largely influenced by external factors

The 10-year Malaysian Government Securities (MGS) yields declined by 12 basis points (bps) (Chart 1.3) since end-September 2023, in line with regional trends (regional[5] average: -40 bps). The yield differential between 10-year MGS and 10-year US Treasuries (UST) narrowed to -39 bps (end-September 2023: -59 bps; 2022 average: +113 bps) due to a steeper decline in the UST yield (change since end-September 2023: -32 bps) on expectations of a decrease in the FFR. Market liquidity remained healthy with continued demand for government bonds in the primary market, as evidenced by the sustained average bid-to-cover ratio of 2.5 times between October 2023 and February 2024 (2022 average: 2.2 times). Meanwhile, in the secondary market, the daily trading volume for government bonds averaged RM3 billion between October 2023 and February 2024 (2022 average: RM2.6 billion).

Overall in 2023, the domestic government bond market recorded non-resident inflows (+RM27.4 billion; 2022: -RM7.8 billion), with sizeable (+RM31.9 billion) inflows in the first seven months. This followed positive investor sentiment on the back of fiscal reforms and favourable domestic macroeconomic prospects as well as attractive currency-hedged yields.[6] Non-resident flows turned negative from August 2023 onwards and persisted into 2024, partially driven by the lower currency-hedged returns of domestic government bonds. These outflows were also consistent with other regional economies. Consequently, the share of non-resident holdings in the government bond market declined marginally to 21.8% (end-September 2023: 23%; 2022 average: 23.8%). Domestic institutional investors remained active in the government bond market (2023: +RM90.4 billion; 2022: +RM56.7 billion), driven by sustained appetite for government bonds on the back of market expectations that yields have peaked. This sustained appetite by domestic institutional investors has continued to support liquid and orderly market conditions.

Corporate bond market funding conditions for businesses continued to improve. Credit spreads between 10-year AAA-rated papers and 10-year MGS narrowed further (October 2023–February 2024

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



Source: Bank Negara Malaysia and Bloomberg

[4] Domestic institutional investors include banks, non-bank financial institutions (NBFIs) and insurers and takaful operators (ITOs).
[5] Regional countries comprise Singapore, Thailand, and Indonesia.

[6] From a non-resident investor's perspective, this refers to the returns from holding a foreign currency-denominated bond (e.g. MGS) in which the currency risk is hedged back to the home currency of the investor (e.g. USD). For illustration, in 2023, the approximate currency-hedged yields from holding a 3-year MGS hedged using 3-month USDMYR foreign exchange (FX) forward contracts could range up to 6.5% on an annualised basis.

average: 31.3 bps; October 2022–February 2023 average: 58.8 bps), reflecting sustained interest by yield-seeking investors. Gross corporate bond issuances amounted to RM46 billion between September 2023 and January 2024 (September 2022–January 2023: RM82.7 billion).[7] Issuances remained concentrated in high quality papers. As at end-2023, almost 80% of outstanding corporate bonds were rated AA and above, with government-guaranteed (GG)[8] and AAA-rated papers accounting for more than half of outstanding corporate bonds.

Total banking system liquidity remained sufficient to support financial intermediation, ranging between RM115 billion and RM144 billion between October 2023 and February 2024 (average: RM129 billion). Consistent with past seasonal trends, interbank rates rose in the fourth quarter of 2023 (3-month interbank rate: +12 bps). The extent of the rate increases, however, was relatively muted compared to the same period in the previous year amid expectations that Overnight Policy Rate (OPR) increases have peaked. The less intense deposit competition in 2023 also contributed to the lower extent of rate increases, as rate-hunting behaviour by corporates moderated. The upward trend in the longer-term interbank rates subsequently eased and has remained broadly stable since January 2024.

Between October 2023 and February 2024, the ringgit weakened by 1% against the US dollar to 4.7428. Towards end-2023, the ringgit strengthened following improvement in investor sentiment towards emerging market currencies amid signs that interest rates in advanced economies were nearing their peak. Since the beginning of 2024 however, the ringgit depreciated by 1.8% against the US dollar,[9] in line with most regional currencies. This was mainly driven by the broad US dollar strength as markets pared down expectations on FFR cuts as well as uncertainties surrounding the outlook for global growth.

Daily onshore trading volume averaged at USD15.4 billion in 2024 (2023: USD15.6 billion). Ringgit volatility has risen slightly since the start of the year (2024 YTD average: 5.2%) alongside those of regional currencies, and remains elevated compared to levels observed in recent years (2022 average: 4.5%; 2021–23 average: 4.7%).

The ringgit remains undervalued and does not reflect Malaysia's positive economic fundamentals and prospects. Financial markets continue to expect the ringgit to trade stronger as pressure from external factors abates. Coordinated actions by the Government, BNM, government-linked companies (GLCs) and government-linked investment companies (GLICs) to increase flows into the FX market on a more sustained manner have helped preserve orderly conditions and support for the ringgit, while encouraging more consistent repatriation and conversion of foreign investment income by corporates and other investors. Over the medium-term, the ongoing structural reforms by the Government, which will raise Malaysia's productivity and competitiveness, will provide more enduring support to the ringgit.

7 The higher levels in 2022 were driven mainly by a large issuance by a major toll road operator in December 2022 (RM25.2 billion).
8 As at end-2023, government-guaranteed (GG) securities accounted for almost 30% of outstanding corporate bonds.
9 Data as of 12 March 2024.

Currency Fluctuations – Transmission Channels to Financial Stability

Currency fluctuations can be transmitted into the financial system through multiple channels. Firstly, adverse movements in the ringgit exchange rate could increase corporates' external debt obligations in ringgit terms. This increases the level of overall indebtedness and debt repayments for these corporates which could expose banks to higher credit risks. The higher cost of foreign currency (FCY) debt-servicing may also make it harder for corporates to obtain additional fresh financing, affecting loan growth. However, despite movements in the ringgit, the share of FCY non-financial corporate debt has risen only marginally above recent historical levels to 27.9% of total business debt (June 2023: 27.8%; 2015–19 average: 26.6%). Most of these external debt exposures (71%) have maturities of above one year, mitigating rollover risk, i.e. the risk that the counterparty is unwilling to rollover these loans when these loans fall due. Furthermore, the bulk of corporates' external debt is hedged, either financially or naturally. This limits foreign exchange (FX) risk arising from currency mismatches. About 22% of large resident-controlled corporates' external borrowings are unhedged (equivalent to only 1.8% of total business debt) and may be susceptible to exchange rate volatility. However, these borrowers have minimal domestic borrowings (less than 0.5% of total domestic banking loans), substantially reducing credit risks to banks. Another channel affecting businesses is via higher import prices which may lead to increased input costs. This could affect profitability, and subsequently the overall debt-servicing capacity of businesses, especially if businesses are unable or unwilling to pass on cost increases to customers. This is more likely to affect businesses in the manufacturing, construction and agriculture sectors due to their higher reliance on imported materials. As at end-2023, these sectors accounted for 11.8% of total domestic banking loans.

Household FCY loan exposures are small at 0.4% of total household loans in the banking system. The bulk (72%) of these FCY loan accounts are attributable to high-income borrowers with a monthly income of RM10,000 and above, who would have larger financial buffers to sustain loan repayments. Thus, the overall household indebtedness and debt-servicing capacity are not directly affected by a weaker ringgit. However, as changes in the exchange rate will have an impact on the domestic cost of goods and services, a weaker ringgit can lead to higher prices and costs of living, particularly from expenditures on selected consumer items such as food[10] that are more sensitive to exchange rate fluctuations. This may in turn reduce household buffers and affect household debt-servicing capacity if households are unable to adjust their expenditure and/or offset the impact of higher prices against current or future incomes.

The aggregate impact from higher costs affecting households and businesses on banks' asset quality is expected to be manageable given the current low level of impairments (gross impaired loan ratio, December 2023: 1.6%; June 2023: 1.7%). This is supported by favourable labour market developments and an improving economic outlook. Correspondingly, the overall share of firms-at-risk, including those more exposed to higher import prices has continued to trend lower, although it remains above the pre-pandemic average level. The share of household loans classified as Stage 2 (identified as having higher credit risk) also remains low (refer to the section on 'Key Developments in the Second Half of 2023 – Credit Risk' for further details).

Banks themselves could also experience higher debt-servicing obligations on their FCY debt following adverse movements in the ringgit exchange rate. At present, onshore banks' external debt remains manageable at 8.3% of banking system total funding, indicating a low level of dependence on external debt to fund their ringgit operations. Interest payments on such exposures have not been significant, with banks' interest expense on FCY external debt making up only about 4.6% of their overall interest expense. Banks also continue to maintain sizeable FCY liquid assets to help cushion the impact from bilateral currency exchange rate movements.

Banks are also exposed to FX risks through their provision of FCY-related products to their clients, such as providing FCY loans and accepting FCY deposits. Most of these FX risks are typically passed through or hedged, while some may be warehoused, depending on the individual bank's view on FX movements. For FX risks that are warehoused, banks may experience FX valuation gains or losses, depending on whether they are in a net long or net short FCY open position. Banks with a net short FCY open position would experience a valuation loss as the ringgit depreciates, which could

[10] Refer to box article on 'Revisiting Exchange Rate Pass-Through to Inflation in Malaysia' in the BNM Economic & Monetary Review 2022 for further details.

weigh on earnings. Nevertheless, such risks remain limited as banks' FX positions are largely hedged. This is evidenced by banks' foreign exchange net open position (FX NOP) from domestic operations which remains manageable at 3.9% of banks' total capital. This reflects the low risk appetite of banks for uncovered exposures which limits further FCY liquidity risk from movements in the ringgit.

Another channel is via non-bank financial institutions (NBFIs) such as pension funds and other domestic institutional investors that have asset exposures abroad vis-à-vis mainly ringgit-denominated liabilities. Some of these domestic NBFIs venture abroad as part of their investment strategy to diversify and enhance returns. In such cases, a higher valuation of foreign assets following a weakening ringgit would support investment returns. Nevertheless, these NBFIs would typically hedge some of their FCY exposures, which limits volatility in both the gains and losses from extreme currency movements (see also box article titled 'Contagion Risk from Non-Bank Financial Institutions' (NBFI) Activity' for an assessment of the NBFI sector in Malaysia and possible contagion channels with the banking system).

Finally, excessive weakening of the exchange rate could weigh on investor confidence and sentiments in the domestic financial markets. Despite the recent depreciation in the ringgit, domestic market conditions have remained resilient, supported by the smooth intermediation of two-way flows in the market (refer to the section on 'Key Developments in the Second Half of 2023 – Market Risk' for further details). Malaysia's sovereign credit rating and outlook have remained stable. Government bonds are mostly denominated in ringgit, with FCY government bonds accounting for less than 3% of outstanding government bonds, thus limiting FX risk. Malaysia's external position is also strong, supported by adequate FCY reserves and continued current account surplus. Additionally, Malaysia's international investment position (IIP) remained favourable. As at end-2023, Malaysia's net IIP recorded a higher net external asset position of RM119.4 billion (equivalent to 6.6% of GDP; end-2022: RM54.2 billion or 3% of GDP). Meanwhile, the net FCY external asset position[11] stood at RM 1.3 trillion (equivalent to 70.8% of GDP; 2022: RM1.2 trillion, or 64.5% of GDP). These net positive positions act as a buffer against external shocks, as a depreciation in the ringgit would result in greater FX translation gains for the country (refer to white box on 'Malaysia's International Investment Position' in the BNM Economic & Monetary Review 2023 for further details).

[11] As measured by external assets in FCY less external liabilities in FCY.