

Coping with COVID-19: Risk Developments in the First Half of 2020

MARKET RISK

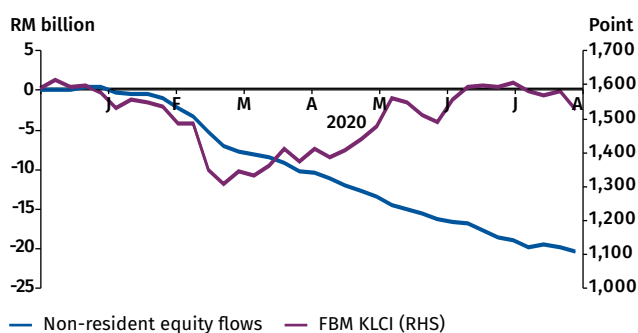
Domestic financial market conditions remained orderly despite significant market volatility

Developments surrounding the pandemic, combined with uncertainty on the impact of COVID-19 policy measures, ongoing geopolitical tensions and volatile oil prices, led to a tightening in global financial conditions in March and April 2020. On the domestic front, the implementation of the Movement Control Order (MCO)¹ to curb the spread of COVID-19 and weak external demand conditions have led to a contraction in economic activity which also resulted in higher levels of domestic market stress in 1H 2020. Policy interventions by the Bank served to maintain orderly conditions within the foreign exchange, bond, and money markets during this period, with conditions largely normalising by the end of 1H 2020. The Bank's open market operations, which included the purchase of government securities, helped to contain potential market dislocation and smoothen excessive volatility in the bond market, further aiding the market's recovery from the period of heightened volatility and significant capital outflows at the onset of the COVID-19 shock. The reduction in Statutory Reserve Requirement (SRR) also continued to ensure ample liquidity to support effective intermediation and orderly market conditions.

In the domestic equity market, non-resident (NR) outflows have persisted, amounting to RM20.3 billion (USD4.7 billion) up to end-August 2020 on heightened investor concerns over the economic impact of the pandemic (Chart 1.1). The impact on equity prices was however offset by a higher participation of domestic retail investors in the equity market, and a strong rally in healthcare and technology stocks. Of note,

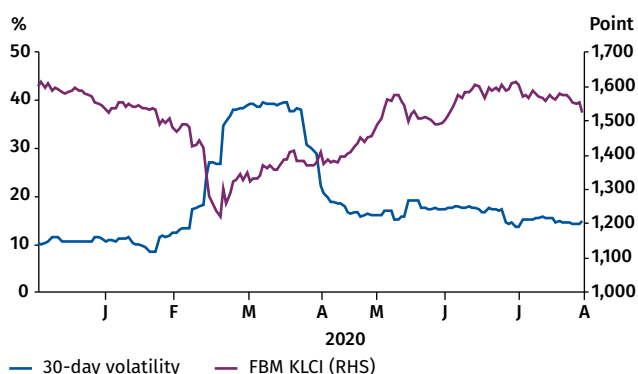
retail investors drove trading value and volume on the local bourse, overtaking domestic institutional investors, although more recent profit-taking activity since August has led to some price correction. While market volatility has subsided from the peak observed in March, it remained above levels observed prior to the crisis as markets remain sensitive to newsflows around COVID-19, the escalation of trade tensions, and domestic political developments (Charts 1.2 and 1.3).

Chart 1.1: Financial Market – Cumulative Non-resident Equity Flows and Performance of the Domestic Equity Market



Source: Bloomberg

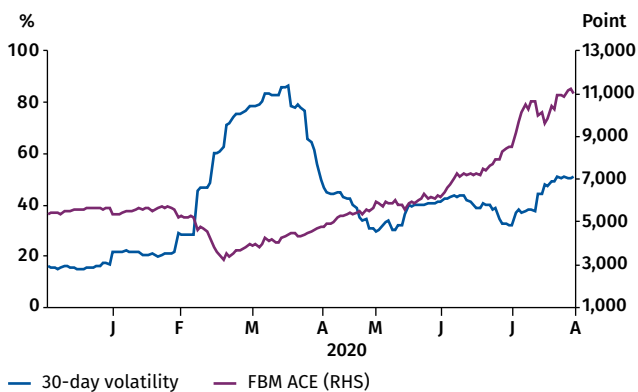
Chart 1.2: Financial Market – Performance and Volatility of FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI)



Source: Bloomberg

¹ The MCO was implemented on 18 March 2020 by the Government as a preventive measure in response to the COVID-19 pandemic.

Chart 1.3: Financial Market – Performance and Volatility of FTSE Bursa Malaysia ACE Index (FBM ACE)



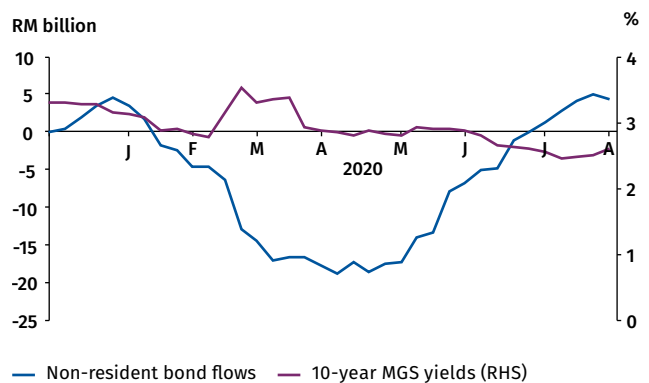
Source: Bloomberg

The domestic bond market experienced a temporary spike in bond yields with 10-year Malaysian Government Securities (MGS) and 10-year AAA corporate bond yields rising by 84 bps and 59 bps respectively, amid significant NR outflows (RM22.4 billion or USD5.2 billion) between February and April. Cumulative NR outflows which peaked in April 2020 have since reversed to record a RM4.3 billion (USD1.1 billion) net inflow until end-August 2020 (Chart 1.4) amid the gradual improvement in global investor sentiment and a continued stable base of NR investors, such as governments and central banks, in the domestic bond market. Sustained demand by domestic investors for Malaysian government bonds was supported by the Bank’s measures to ease liquidity conditions, reflected in the bid-to-cover (BTC) ratio which averaged at 2.4 times in the first seven months of 2020. However, auctions for long-term bonds since August saw a slight tapering in demand amid excess supply concerns post-tabling of the COVID-19 stimulus bill. Among NR investors, demand for Malaysian government bonds began recovering since May, supported by improved market sentiment and the positive yield pickup over US Treasuries (Chart 1.5). Along with the more accommodative monetary policy, this has seen MGS yields gradually retreat from the sharp increase observed in March. The corporate bond market continued to function smoothly with credit spreads for 10-year AAA papers normalising to around 54 bps after reaching a peak of 105 bps in April. Net corporate bond issuances have also recovered as firms sought to shore up liquidity while taking advantage of lower borrowing costs, although issuances remain below levels in 2019 (January-August 2020: RM17.8 billion, January-August 2019: RM28.8 billion). As in previous episodes of market stress, the sustained demand from domestic institutional investors, such as banks,

non-bank financial institutions (NBFIs) and insurers and takaful operators (ITOs), continues to play an important role in preserving orderly conditions and providing continued access to credit markets throughout 1H 2020 (for more information, refer to the Information Box on ‘Impact of COVID-19 on Systemic Non-bank Financial Institutions’). Malaysia’s deep and liquid bond market with the support from this diverse investor base will also lend continued support to orderly market conditions.

In the near term, financial market volatility is expected to remain elevated. A resumption in the rise of COVID-19 infections in several countries will continue to weigh on financial markets and heighten market volatility. Investor sentiment could also turn more cautious on weaker-than-expected corporate earnings and an escalation of trade tensions.

Chart 1.4: Financial Market – Cumulative Non-resident Bond Flows and Performance of the Domestic Bond Market



Source: Bank Negara Malaysia and Bloomberg

Chart 1.5: Financial Market – 10-year MGS-UST Yield Differential



Source: Bloomberg

Impact of COVID-19 on Systemic Non-bank Financial Institutions

Amid the COVID-19 outbreak, several systemic non-bank financial institutions (NBFIs) experienced increased demands for liquidity arising from the implementation of Government support measures.² Despite their significant investment holdings in the capital market, rebalancing activities by some NBFIs in response to liquidity needs have not had a material impact on asset prices. Increased liquidity needs of NBFIs were largely met from available cash and other liquid assets, with rebalancing activities generally conducted in an orderly manner. Although NBFIs' deposit placements in banks fell briefly in the first quarter, this had limited impact on banks' liquidity as the share of banking system deposits held by these systemic NBFIs remained low (June 2020: 5.3%).

NBFIs remain key participants in the domestic financial markets with sizeable investment holdings of 30.5% and 42.4% of equity market capitalisation and outstanding debt issuances, respectively. During periods of heavy sell-offs, NBFIs have continued to provide countercyclical support to markets, as observed when the FTSE Bursa Malaysia KLCI (FBM KLCI) fell by 15% in the first quarter of 2020. NBFIs' investments in equities correspondingly increased amid attractive market valuations. Systemic NBFIs similarly provided support to the government bond market amid bouts of sizeable non-resident outflows. NBFIs' holdings of shares in banks increased during this period from 37% to 40% of the market capitalisation of listed banks. Financial stability risks associated with such holdings remain low given the continued financial strength of NBFIs, the strategic and longer-term nature of these investments and the strong governance requirements imposed on licensed financial institutions.

Continued uncertainty surrounding the pandemic is likely to weigh on NBFIs' investment performance for the year. Some NBFIs may experience higher withdrawals or redemptions by investors who are more sensitive to investment returns if returns underwhelm. Redemption risks by such investors, however, are expected to be mitigated by more cautious risk appetite and low returns from alternative investments in the current environment. Systemic NBFIs generally also continue to hold sufficient liquid financial buffers in the form of cash deposits and government debt securities to meet potential stressed withdrawals over a period of more than 90 days.

² The relief measures include lowering the contribution rate and allowing the withdrawal of contributions from retirement funds, introducing wage subsidy programmes to encourage continued employment, and education loan deferments.