

# Coping with an Uneven Recovery: Key Developments in the First Half of 2021

## MARKET RISK

### Domestic financial market conditions remained orderly

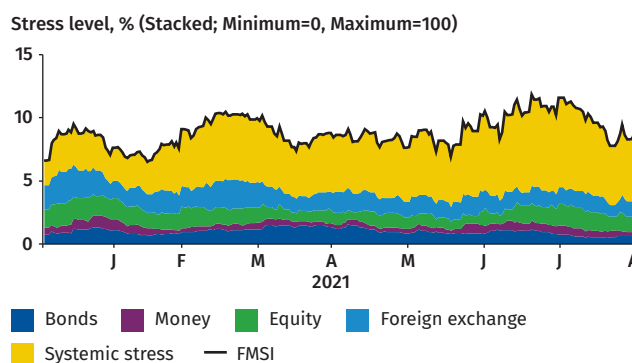
In the first half of 2021, global financial markets were lifted by the stronger-than-expected economic recovery, particularly in advanced economies where an acceleration in vaccine deployment has led to the easing of pandemic restrictions. Nevertheless, the global economic rebound remained uneven as a resurgence of COVID-19 infections and lagging vaccine rollouts weighed on the recovery in many emerging markets. On the domestic front, market stress increased in mid-June and July (Chart 1.1) amid rising global bond yields, more restrictive containment measures in response to an escalation in COVID-19 cases as well as domestic political developments, before easing slightly in August. Stress levels, nevertheless, remained well below those observed at the onset of the COVID-19 pandemic between March and April 2020.

The domestic equity market saw non-resident outflows amounting to RM4.5 billion for the eight months up to end-August 2021 amid subdued investor sentiment (Chart 1.2). While lingering uncertainties surrounding the re-opening of the economy could trigger further outflows by non-residents in the period ahead, the continued presence of large domestic institutional and retail investors is expected to provide some support to equity prices. Notably, retail investors continued to purchase the bulk of the sell-offs in the equity market, accounting for 34% of the total value traded in August 2021 (2020: 34%; 3-year average: 19%).

Importantly, such investments have not been associated with higher leverage which could increase risks to households under more volatile market

conditions. Household loans to purchase quoted shares remained small at 0.5% of total banking system loans, consistent with the 5-year historical average, while loans to stockbroking and fund management firms also remained stable at less than 1% of total banking system loans. Retail investor activity<sup>1</sup> is expected to be sustained in the near term, as households, particularly those with higher

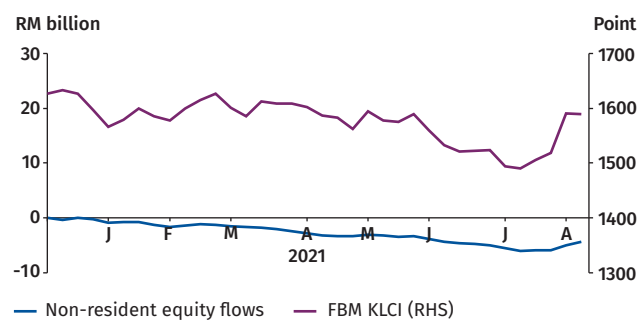
**Chart 1.1: Financial Market – Financial Market Stress Index (FMSI)**



Note: The FMSI reached a peak of 28.2% at the onset of the COVID-19 pandemic in March 2020

Source: Bloomberg, Reuters and Bank Negara Malaysia estimates

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



Source: Bloomberg

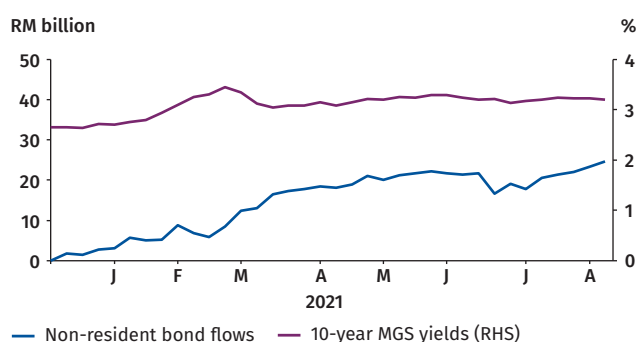
<sup>1</sup> Based on the CGS-CIMB 2021 Retail Investors' Sentiment Survey, the majority of retail investors in Malaysia were observed to be those earning monthly incomes of above RM5,000 with investments that are primarily funded by savings and income.

incomes, continue to seek higher returns amid the low interest rate environment. Although there has been evidence of some households using monies from deferred loan repayments to invest in the equity market, this is not prevalent and more likely to occur among higher-income households with greater financial flexibilities given the potential costs associated with deferring loan repayments. Market insights also suggest that these retail investors tend to be those with some experience in equity investments, seeking to increase longer-term returns on their savings. Collectively, these factors continue to limit any risks to financial stability from higher levels of retail investor activity seen in the more recent period. A prolonged period of low interest rates, however, could increase risks going forward by intensifying the search for yield among households that may be less capable of managing investment risks.

### The domestic bond market remains attractive to non-resident investors

The domestic government bond market recorded larger net non-resident inflows in the first eight months of 2021 (RM23.9 billion) compared to the whole of 2020 (RM17.2 billion) (Chart 1.3). This followed the affirmation of Malaysia's sovereign rating of "A-" and "A3" by S&P Global Ratings and Moody's Investors Service, respectively, and Malaysia's retention in FTSE Russell's World Government Bond Index (WGBI). The share of non-resident holdings in the government bond market consequently increased to 25.2% as at August 2021 (December 2020: 24.2%; 5-year average: 25.9%). Demand for Malaysian Government Securities (MGS) is

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

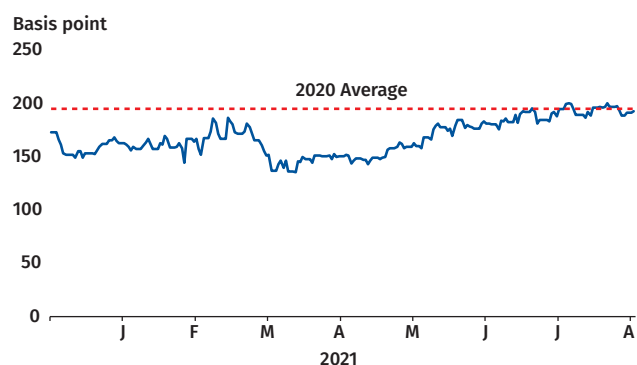


Source: Bank Negara Malaysia and Bloomberg

expected to remain supported by the attractive yield pick-up over US Treasuries (UST). On average, the 10-year MGS-UST yield differential stood at 169 basis points (bps) during the first eight months of 2021 (2020 average: 195 bps; 2019 average: 151 bps) (Chart 1.4). Longer-term bonds (10 years and longer) continued to command a healthy average bid-to-cover ratio of 2.6 times in the first eight months of 2021 (2020 average: 2.1 times). Meanwhile, domestic institutional investors continued to play an important role in supporting orderly conditions in the domestic bond market, with banks' holdings of government bonds increasing markedly during the period amid subdued loan growth. Domestic funding conditions also remained favourable for corporates. Gross corporate bond<sup>2</sup> issuances increased during the first seven months of 2021 (RM63.8 billion; January to July 2020: RM45.6 billion), with the credit spread for 10-year AAA-rated papers hovering around 63 bps on average between January and August 2021 (2020 average: 59 bps). More than half of these issuances were from the finance, insurance, real estate and business services sectors.

Looking ahead, domestic bond yields could see continued upward pressure from the higher incoming government bond supply and a further rise in UST yields from improvements in US economic prospects. This increases risks from mark-to-market losses and higher borrowing costs for financial institutions, businesses and the Government. Active risk management and hedging strategies of financial institutions are expected to contain any significant impact from heightened market volatility on the resilience of individual institutions. For banks, while the elevated domestic bond yields during the first half of 2021 led to revaluation losses from bond

**Chart 1.4: Financial Market – 10-year MGS-UST Yield Differential**



Source: Bloomberg

<sup>2</sup> Include banks and non-financial corporates, but exclude short-term papers in conventional and Islamic principles and issuances by Cagamas.

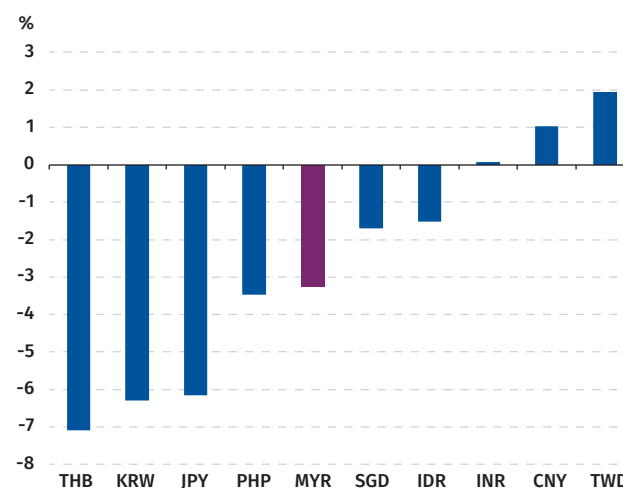
holdings in the banking book, the impact has been manageable at less than 1% of total risk-weighted assets. In addition, banks' costs of funds are not expected to be significantly affected by higher yields, given their low reliance on the bond market as a funding source.<sup>3</sup> Based on a sensitivity analysis of banks' balance sheets to bond yield movements, an increase in bond yields of up to 89 bps<sup>4</sup> and higher resultant funding costs<sup>5</sup> could reduce banks' aggregate profits before tax and total capital ratio by up to 11% and 1 percentage point (ppt), respectively.

For insurers and takaful operators (ITOs), a similar shock could have a more significant impact with the profitability<sup>6</sup> of life and family funds, and general funds declining by up to 85% and 29%, respectively. From a solvency standpoint, an increase in bond yields is expected to be positive for the life and family sector given correspondingly lower valuations of liabilities relative to assets,<sup>7</sup> while the aggregate capital adequacy ratio of the general sector could decline by up to 11 ppts. Overall, the impact of rising bond yields on banks and ITOs' solvency positions is expected to remain limited with aggregate capital levels remaining comfortably above the regulatory minima.

Conditions in the Malaysian foreign exchange market were influenced by both external and domestic factors in the first eight months of 2021. In the first quarter of the year, the rise in long-term UST yields saw the rebalancing of portfolio investments towards US financial assets, which in turn led to a broad-based strengthening of the US dollar against most emerging market currencies. Investors were also more cautious in the second quarter as COVID-19 cases surged across several Asian economies, including Malaysia. Domestic risk factors also weighed on the ringgit. From January to end-August 2021, the ringgit exchange rate depreciated by 3.3% to close at RM4.1552 against the US dollar in line

with movements of regional currencies (Chart 1.5). Exchange rate adjustments continued to be orderly, with the 1-month RM/USD implied volatility averaging at 4.4% (3-year average: 4.5%).

**Chart 1.5: Financial Market – Movement of Ringgit and Regional Currencies against the US Dollar**



Note: 1. THB - Thai baht, KRW - Korean won, JPY - Japanese yen, PHP - Philippine peso, SGD - Singapore dollar, IDR - Indonesian rupiah, INR - Indian rupee, CNY - Chinese renminbi, TWD - New Taiwan dollar  
2. Refers to year-to-date movement as at end-August 2021

Source: Bloomberg

The degree of financial market volatility will remain highly dependent on global and domestic economic recovery prospects, uncertainty surrounding potential shifts in the monetary policy stance in advanced economies and concerns over the effects of COVID-19 variants. The flexible domestic exchange rate regime will continue to serve its critical role as a shock absorber by facilitating appropriate adjustments in the external sector and cushioning the domestic economy from adverse global shocks. Malaysia's deep and liquid bond market and diverse investor base will also support the intermediation of portfolio flows, thus preserving orderly market conditions.

<sup>3</sup> Funding via equity and interbank financing, and bond issuances account for 17% and 2.6% of total banking system funding, respectively.

<sup>4</sup> Based on the steepest increase in bond yields observed in the first quarter of 2021.

<sup>5</sup> Higher funding costs due to potential tightening in domestic funding conditions accompanying the steepening yield curve.

<sup>6</sup> Refers to excess income over outgo for life and family funds, and operating profit for general funds.

<sup>7</sup> Due to the longer duration of liabilities compared to assets as highlighted in the BNM Financial Stability Review for Second Half 2019.