2018 Fixed Income Outlook

To recap; 2017 was indeed an eventful and unforgettable year; taking cue from a torrent of prominent global events. These include three interest rate hikes and balance sheet run-offs (reduction) in the US by the Fed, appointment of Jerome Powell as Federal Reserve Chair succeeding Janet Yellen, Atlantic hurricanes namely the infamous trio of Irma, Harvey and Maria hitting the US coasts, geo-political spats with North Korea and subsequent extensions of the US government debt ceiling to avert a government shutdown.

2018 is likely to see higher interest rate regime with ongoing "quantitative normalization" as the US economy continues to be on a firm footing. The flood of UST supplies by the Treasury to fund the Federal deficit arising out of the new tax incentives may dampen the demand on UST's; hence our mildly bearish call on UST's. On the local front we expect relatively decent support for primary tenders with supply and also secondary market trades on liquid tenors with offshore interest anchored mainly in currency-play as Malaysia continues to churn decent set of economic numbers. Expect the govvies market to see more net foreign inflows in 2018. As for Corporate bond issuances, we expect RM90-100b of gross issuances with investors eagerly hunting for yield. This is expected to spill over to secondary market trades with investors potentially moving down the yield-curve into the AA-space.

Global growth to pick up further in 2018, extending its recovery in 2017

Global growth projection by IMF is expected to rise from 3.6% in 2017 to 3.9% in 2018 based on its revised growth outlook published recently. This was marginally higher by 0.2% versus the previous projection back in October 2017 and is the strongest expansion since 2011. On a related note, ADB in its latest growth outlook released in December 2017; revised higher its 2017 growth projection for developing Asia by 0.1% to an impressive 6.0% and maintaining a 5.8% outlook for 2018. Promising macro growth backdrop is expected to result in higher bond yields going forward.

Policy normalization and balance sheet reduction are key themes in 2018 followed by recovering oil prices

We expect the potential end of ultra-loose monetary policy regime in the US, and Europe as well. From policy perspectives, investors will be eagerly watching developments and policies arising from both US and Europe as the ECB and BOE have portrayed a more hawkish tilt. The ECB signaled a plan to exit from the QE program by cutting its monthly bond purchases by half to EUR30 billion effective January 2018 whilst BOE raised the Official Bank rate from 0.25% to 0.50% in November 2017. The front-end rates in US are buoyed by expectations for further Fed tightening whilst the absence of meaningful inflationary pressures has weighed on longer-maturity yields; hence the **ongoing flattening of the yield curve in** the graph above.

With the conclusion of the 3rd rate hike at the December FOMC meeting and the approval and implementation of Trump's Tax-overhaul bill, the US Treasury is expected to fund the deficit via further issuances amid the easing of geopolitical tensions with North Korea.

Recovering oil prices may also be a prominent theme in 2018 as levels reverse form its previous 13-year lows of USD26/barrel in Jan-Feb 2016 period for WTI. The US Energy Information Administration in its recent Energy Outlook Catalysts projects that crude oil prices to average $60/barrel for 2018. The renewed optimism at the time of writing include OPEC's ongoing output cut by about 1.2million b/d. Hence this coupled with returning demand has reinforced our view on the impact on USD and its subsequent effect on both US and Malaysia Fixed Income space.

Source: Bloomberg

Growth in the Malaysian economy is expected to moderate from 5.7% in 2017 to 5.0% in 2018; putting less pressure on Govt Bonds

While the Malaysian economy is expected to continue expanding at a pace of at least 5.0% this year, this marked a moderation from the high-5% growth estimated for 2017. While growth outlook remains decent, there is less room for monetary policy tightening barring further upside growth risks to. Expectations by some on another OPR hike going forward were debatable after the 25bps hike to 3.25% on 25th January 2018. Our base case is for OPR to remain at the current level of 3.25% for the year, unless growth significantly surprises on the upside. The table below shows the subsequent five BNM MPC meeting dates in 2018.

SCHEDULE OF MONETARY POLICY MEETINGS IN 2018	
MPC Meet No	Date
1	25-Jan (Thurs)
2	7-Mar (Wed)
3	10-May (Thurs)
4	11-Jul (Wed)
5	5-Sep (Wed)
6	8-Nov (Thurs)

Source: BNM

3.7% Inflation within range for 2017; prospects of lower inflation in 2018 again relieving pressure on Govt bond yields

Inflation was pegged at 3.7% YOY for the entire 2017 (2016: +2.1% YOY). However due to the high base effect going forward, we anticipate sub-3.0% inflation for 2018 despite prospects of higher crude oil prices.

Fiscal consolidation remains on track in 2018, narrowing towards deficit target of 2.8%; capping gross supply of Govt Bonds

Fiscal consolidation is expected to remain on track in the coming 2018, towards a targeted fiscal deficit level of 2.8% of GDP. Going forward, the Federal Government's (GOM) revenue is expected to improve to RM239.9b in 2018 due to higher tax revenue, largely from GST and income tax collection. Bearing in mind that the 2018 Budget was calibrated based on an oil price assumption of $52/ barrel, higher oil prices would offer rooms for upside surprises in government revenue. Brent crude oil prices is trading at US$69-70/ barrel currently. On the expenditure side, RM46bn will continue to be allocated for development expenditure in 2018 for upgrading of infrastructure, improvement of roads and public transport systems and also to promote greater connectivity.

RM 'Bil	2015	2016	2017	2018
Revenue	219.1	212.4	225.3	239.9
Operating Expenditure	217.0	210.2	219.9	234.3
Current Surplus/(Deficit)	2.1	2.2	5.4	5.6
Gross Development Expenditure	40.8	42.0	46.0	46.0
Net Development Expenditure	39.3	40.6	45.3	45.4
Overall surplus/(deficit)	37.2	38.4	39.9	39.8
Fiscal Deficit as a % of GDP	3.2%	3.1%	3.0%	2.8%

Source: Economic Report 2017/2018

OPR raised from 3.00% to 3.25% in Jan 2018 while policy tone shifted to a more neutral bias

To recap, BNM expectedly held the OPR unchanged at 3.00% at its November MPC meeting but shifted to a slightly hawkish tone, paving the way for an early OPR hike in January 2018 to 3.25%. After the January hike and a more neutral tone struck in the latest policy statement, we project no further OPR hikes by BNM in 2018 as MPC's intention was to normalize the degree of monetary accommodation and as a preemption to prevent the build-up of risks that could arise from a prolonged period of low interest rates.

Lower gross MGS/GII supply in 2018, circa RM103b; net supply unchanged at RM40b

RM (Billion)	2017	2018
MGS/GII Maturities	67.2	62.8
Net Govt Bond Supply (MGS/GII)	39.9	39.8
Gross Supply (MGS/GII)	107.1	102.6

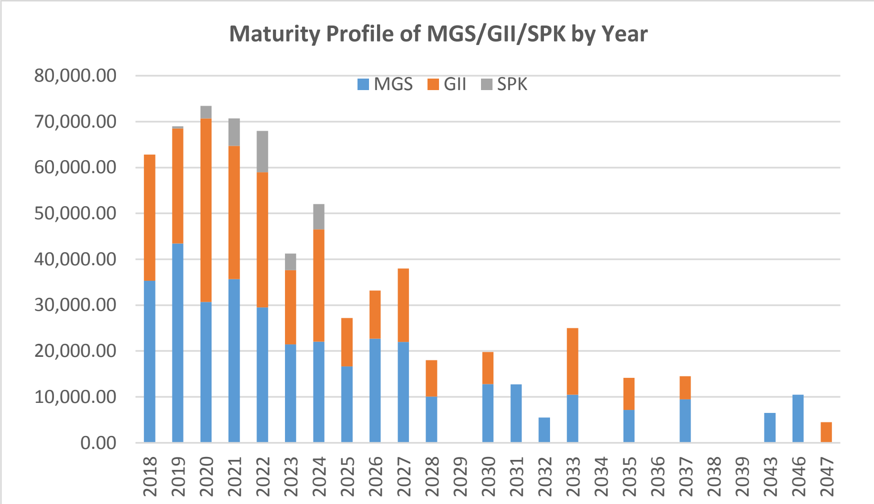
Source: Economic Report 2017/2018,, BPAM, HLB Global Markets Research

As we progress into 2018, gross MGS/GII supply is lower at circa RM103b despite lower maturities due to December 2017 bilateral switch auction of about RM4.0b of MGS 2/18 and MGS 3/18 to MGS 4/37. However on a net issuance basis, supply is seen constant with anticipated buffer against potential outflows from upcoming maturities in 2018. The Federal Government's funding needs are expected to be funded primarily onshore via issuances of MGS/GII given that there are no scheduled USD GOM (Government of Malaysia) sovereign bond/sukuk maturities in 2018.

2018	Stock	Maturity by month (RMm)	Quarter	Maturity by quarter (RMm)
JAN	MGS 1/18	2,000		
FEB	MGS 2/18	8,380 (revised from 14,100)	Q1	18,471
MAR	MGS 3/18	8,091		(revised from 24,886)
APR	-	-		
MAY	GII 5/18	7,500	Q2	7,500
JUN	-	-		
JUL	-	-		
AUG	GII 8/18	8,500	Q3	22,355
SEP	MGS 9/18	13,855 (revised from 11,440)		(revised from 19,940)
OCT	MGS 10/18, GII 10/18	10,500		
NOV	GII 11/18	4,000	Q4	14,500
DEC	-	-		
Total		40,591		62,826

Source: BPAM, HLB Global Markets Research

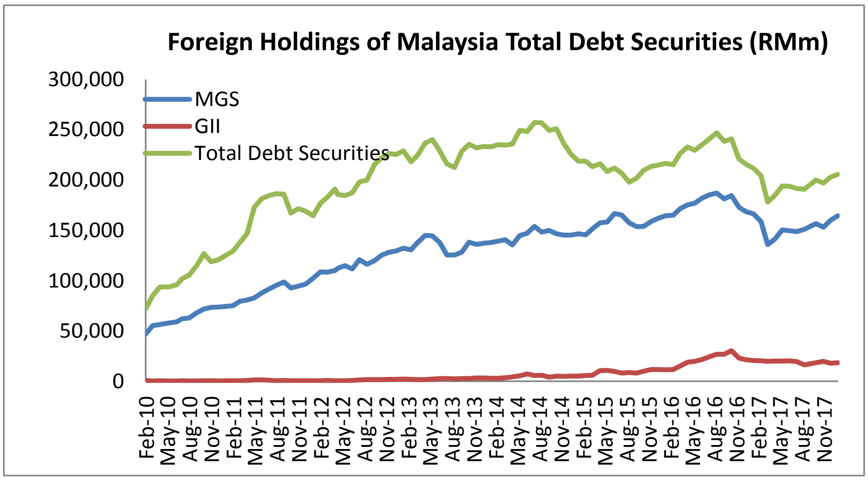
Going into 2018, investors should look out for sizeable maturity windows in Q1, Q3 and Q4 respectively from scheduled MGS/GII maturities. Funds from maturing MGS/GII is expected to return as reinvestments into the MYR bond space. Total combined MGS/GII maturities for 2018 amounted to circa RM63b. We expect reinvestment flows to remain supportive of MYR bond dynamics.



Source: BPAM, HLB Global Markets Research

Foreign holdings of MYR bonds moderated in 2017 after having spiked the previous year

The average monthly foreign holdings of MYR government bonds in 2017 was lower at RM172b overall compared to RM197b in 2016 following the curbing of offshore ringgit trading. This along with major political landscape changes including Brexit uncertainties and appointment of Trump as President of the US caused some outflows. However the last quarter of 2017 ending December saw foreign holdings rebound to increase QOQ to RM182.9b (Sep: RM175.2b) amid liberalization initiatives on currency and interest rate hedging. However, the foreign holdings as at Dec 2017 still ended lower by about RM7.0b at RM183b (Dec 2016: RM190.0b)



Source: Bloomberg, BNM, HLB Global Markets Research

MGS/GII tenders remained healthy despite key global events, with BTC cover averaging 2.20x in 2017

Government bond tenders in 2017 ended the year with a strong average BTC of 2.20x taking cue from sustained foreign holdings and the active stance of local onshore investors. Despite a series of key global events having influenced trading/investment sentiments in 2017, i.e. US Fed chair succession, Fed's balance sheet run-off Republican's Tax proposal and three (3) Fed rate hikes; the BTC for government bond tenders (MGS/GII) concluded in 2017 stayed healthy.

MGS/GII issuance pipeline in 2017

No	Stock	Tenure-yrs	Tender Month	Quarter	Tender Date	Expected size (RM mil)	Issuance (RM mil)	Private Placement	Amt Issued YTD	BTC (times)	Low	Average	High	Cut-off
1	3-yr Reopening of MGII (Mat on 04/20)	3	Jan	Q1	5/1/2017	3,000	3,500		3,500	1.789	3.657	3.690	3.700	75.0%
2	15-yr Reopening of MGS (Mat on 06/31)	15	Jan	Q1	12/1/2017	3,500	4,000		7,500	2.503	4.773	4.786	4.796	25.0%
3	10.5-yr New Issue of MGII (Mat on 07/27)	10	Jan	Q1	25/1/2017	4,000	4,000		11,500	3.413	4.245	4.258	4.265	10.6%
4	7.5-yr New Issue of MGII (Mat on 08/24)	7	Feb	Q1	14/2/2017	4,000	4,000		15,500	3.123	4.030	4.045	4.050	100.0%
5	30-yr Reopening of MGS (Mat on 03/46)	30	Feb	Q1	27/2/2017	3,000	2,000	1,000	17,500	2.562	4.660	4.676	4.686	5.0%
6	5-yr New Issue of MGS (Mat on 03/22)	5	Mar	Q1	9/3/2017	4,000	4,000		21,500	1.538	3.859	3.882	3.903	3.0%
7	15-yr Reopening of MGII (Mat on 08/33)	15	Mar	Q1	23/3/2017	3,000	3,000	1,000	24,500	1.897	4.660	4.696		27.0%
8	7.5-yr New Issue of MGS (Mat on 09/24)	7	Mar	Q1	30/3/2017	3,500	3,000	1,000	27,500	2.064	4.030	4.059	4.072	64.0%
9	20-yr New Issue of MGS (Mat on 04/37)	20	Apr	Q2	6/4/2017	3,000	2,000	1,000	29,500	1.585	4.725	4.762	4.799	90.0%
10	5-yr New Issue of MGII (Mat on 04/22)	5	Apr	Q2	13/4/2017	4,000	4,000		33,500	2.773	3.925	3.948	3.957	29.0%
11	15-yr Reopening of MGS (Mat on 04/33)	15	Apr	Q2	27/4/2017	3,000	2,500	500	36,000	2.057	4.469	4.503	4.515	64.0%
12	30-yr New Issue of MGII (Mat on 05/47)	30	May	Q2	5/5/2017	3,000	2,000	500	38,000	2.393	4.850	4.895	4.913	19.0%
13	10.5-yr New Issue of MGS (Mat on 11/27)	10	May	Q2	15/5/2017	3,500	3,000	1,000	41,000	3.340	3.880	3.899	3.910	95.0%
14	7-yr Reopening of MGII (Mat on 08/24)	7	May	Q2	30/5/2017	4,000	3,000	1,000	44,000	2.480	3.909	3.926	3.933	82.0%
15	20-yr Reopening of MGS (Mat on 04/37)	20	Jun	Q2	6/6/2017	2,500	2,500		46,500	1.704	4.540	4.558	4.576	3.0%
16	10-yr Reopening of MGII (Mat on 07/27)	10	Jun	Q2	14/6/2017	3,500	3,000	1,000	49,500	2.541	3.991	4.013	4.021	6.9%
17	7-yr Reopening of MGS (Mat on 09/24)	7	Jul	Q3	6/7/2017	3,500	3,000	1,000	52,500	2.877	3.913	3.919	3.924	63.0%
18	30-yr Reopening of MGII (Mat on 05/47)	30	Jul	Q3	13/7/2017	2,500	2,000		54,500	1.915	4.900	4.926	4.946	66.7%
19	10-yr Reopening of MGS (Mat on 11/27)	10	Jul	Q3	27/7/2017	4,000	3,000	1,000	57,500	1.683	3.957	3.978	3.989	5.6%
20	20-yr New Issue of MGII (Mat on 08/37)	20	Aug	Q3	3/8/2017	3,000	2,500		60,000	1.784	4.723	4.755	4.783	50.0%
21	3.5-yr New Issue of MGS (Mat on 02/21)	3	Aug	Q3	14/8/2017	4,000	3,500		63,500	1.706	3.422	3.441	3.455	72.0%
22	7-yr Reopening of MGII (Mat on 08/24)	7	Aug	Q3	29/8/2017	3,500	3,500	500	67,000	2.104	3.963	3.975	3.980	62.5%
23	5-yr Reopening of MGS (Mat on 03/22)	5	Sep	Q3	14/9/2017	3,500	4,000		71,000	1.899	3.481	3.501	3.520	72.9%
24	15-yr Reopening of MGII (Mat on 08/33)	15	Sep	Q3	28/9/2017	3,000	3,000	1,000	74,000	1.727	4.520	4.579	4.640	53.3%
25	7-yr Reopening of MGS (Mat on 09/24)	7	Oct	Q4	5/10/2017	3,500	3,000		77,000	1.604	3.850	3.879	3.898	20.0%
26	20-yr Reopening of MGII (Mat on 08/37)	20	Oct	Q4	12/10/2017	2,500	1,500	1,000	78,500	2.147	4.755	4.785	4.803	36.4%
27	30-yr Reopening of MGS (Mat on 03/46)	30	Oct	Q4	26/10/2017	2,000	2,000	500	80,500	1.603	4.850	4.957	5.000	2.5%
28	10-yr Reopening of MGII (Mat on 07/27)	10	Nov	Q4	14/11/2017	3,000	3,000		83,500	1.832	4.300	4.347	4.370	95.0%
29	15-yr Reopening of MGS (Mat 04/33)	15	Nov	Q4	22/11/2017	2,500	2,000	1,000	85,500	3.811	4.532	4.550	4.563	93.8%
30	5-yr Reopening of MGII (Mat on 04/22)	5	Nov	Q4	28/11/2017	3,000	3,000		88,500	1.715	3.84	3.872	3.900	5.6%
31	10-yr Reopening of MGS (Mat on 11/27)	10	Dec	Q4	6/12/2017	3,000	2,000	500	90,500	1.53	3.89	3.946	3.988	100.0%
32	15.5-yr New Issue of MGII (Mat on 06/33)	15	Dec	Q4	14/12/2017	2,500	2,000	500	92,500	1.775	4.668	4.724	4.79	25.0%
	Actual gross MGS/GII supply in 2017						92,500	15,000						

Source: Bloomberg, BNM, HLB Global Markets Research

Of the two government bond tenders for the month of January 2018 as stated below the BTC ratios were commendable; especially the reopening of the 5Y GII 4/22 which averaged 3.823% on BTC of 2.581x. This was in spite of anticipation for an OPR hike, which materialized in the January MPC meeting.

MGS/GII issuance pipeline in 2018

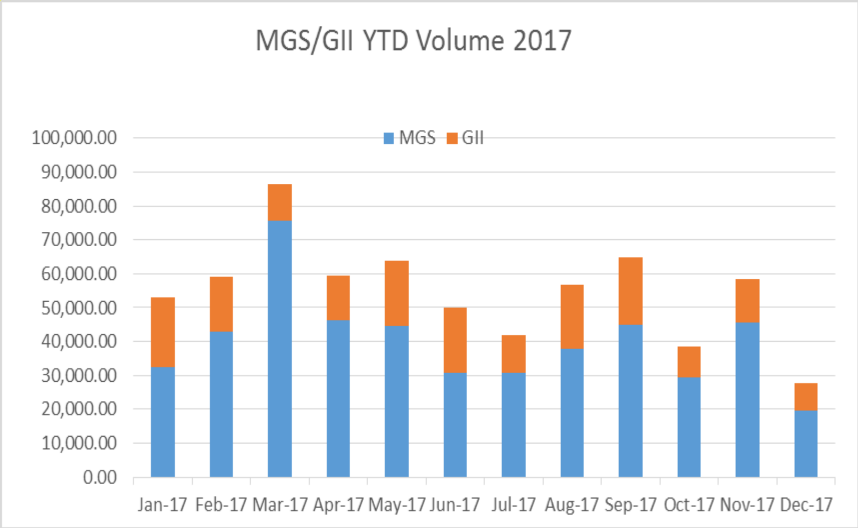
No	Stock	Tenure (yrs)	Tender Month	Quarter	Tender Date	Total Expected Size (RM mil)	Auction Issuance (RM mil)	Private Placement	Amt Issued YTD	BTC (times)	Low	Average	High	Cut-off
1	20-yr Reopening of MGS (Mat on 04/37)	20	Jan	Q1	4/1/2017	3,000	2,000	1,000	3,000	1.905	4.573	4.607	4.640	14.3%
2	5-yr Reopening of MGII (Mat on 04/22)	5	Jan	Q1	12/1/2018	3,000	4,000		7,000	2.581	3.81	3.823	3.829	78.6%

Source: Bloomberg, BNM, HLB Global Markets Research

Trading volume for MGS/GII dropped in 2017; amid strength in Ringgit and positive economic data

Trading volume for MYR govvies shed from about RM58b in November to RM29b for the month of December mainly due to low holiday-month staffing levels i.e. year-end festivities. There was a surge in the shorter off-the-runs and amid concerns of "rate-inflammatory" remarks on OPR as the market seemed to react more on the strength and rally of the Ringgit instead of relying heavily towards foreign-related indicators with both onshore and offshore investors showing interest.

For the last quarter of 2017 there was renewed interest for MYR government bonds literally following the 2nd consecutive net foreign inflows of RM4.7b (RM9.9b in total for both November and December 2017). Corporate Bonds saw consistent foreign holdings of about RM16.1b despite a significant drop in monthly turnover to RM5.8b from RM8.8b the previous month. The mild fear emanating out of stronger economic data from US followed by the December rate hike did not dampen demand. MGS generally rallied with yields lower between 3-12bps across most tenures save for the much-watched 10Y benchmark MGS 11/27, which closed 2bps higher at 3.91% (3.89% at the point of writing following 25bps rate hike). Interest was mainly skewed to the short-end off-the-runs 18-20's with the strengthening of the Ringgit.



Source : BPAM, Bloomberg

Corporate bonds issuances trend for 2018 projected at gross supply of circa RM90.0-100.0b

In terms of corporate bonds/sukuk supply for 2018, we are projecting gross supply of RM90.0-RM100.0bn. However net supply remains manageable i.e. circa RM35-45bn due to higher RM55b worth of maturing corporate bonds in 2018. (Corporate bonds/sukuk issuances in 2017 circa RM123 billion was seen tracing higher than our earlier RM100-110 billion gross supply projections). This was exceptionally high when compared to the primary issuance for corporate bonds/sukuk that trended within the range of RM80b-RM86bn in the previous three years (from 2014-2016).

Primary issuance print in 2017 boosted by the following names:

Recall, last year was a bumper year for primary corporate bond issuances; boosted by notable prints from the finance sector which contributed close to 50% of total issuance size followed by the infrastructure sector. Overall top five(5) corporate bond issuances were

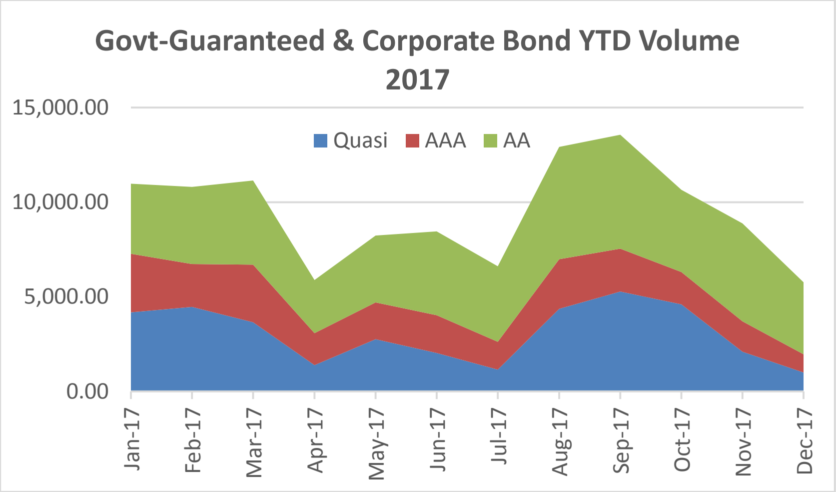
- Danainfra (circa RM10b)
- Cagamas (circa RM9b)
- LPPSA (circa RM7b)
- Prasarana (circa RM6b)
- CIMB Bank (circaRM4b)

Also worth noting were the substantial issuances of non-GG bonds i.e. CIMB Bank Bhd, Southern Power Generation Sdn Bhd, Maybank Islamic Bank Bhd, GENM Capital Bhd (part of the Genting Group) and YTL Power International Bhd.

However despite 2018 potentially being a year for a breather; we continue to expect a sturdy pipeline of issuances within the GG sector related to the infrastructure projects; namely MRT2, LRT3, PNB118 Tower, ECRL, HSR among others. The potential savings associated with issuance costs may see interest in the issuance of unrated bonds.

In the secondary market, corporate bonds/ sukuk gathered interest; albeit on lower volume mirroring govvies momentum…as there was no let-up on primary issuances…

However the average monthly trading volume for corporate bonds/sukuk saw a drop in overall interest. The total transacted amount for 2017 was markedly lower at about RM114b versus the previous year's RM158b. However we note steady interest in the AA-rated space as investors continued to hunt for yields. By segment, transacted amount for AA papers was higher at 66% of total trades.



Source : BPAM, Bloomberg

The actives i.e. top volume generating Corporate Bonds for 2017 which are noted for both volume and frequency of secondary market trades composed both Govt-Guaranteed and and also the AAA/AA space as follows:

- Prasarana 9/24, 9/27, 9/37, 7/41 and 9/47
- PTPTN 8/32
- Jambatan Kedua 7/41
- Maybank 24NC19
- Tenaga 8/37
- Genting Malaysia Capital 8/25
- Danga Capital 4/20, 9/27
- UMW Holdings 6/20, 6/22
- Benih Restu 6/25
- BGSM 12/18
- YTL Power 5/27
- Lebuhraya DUKE3 8/34

Credit rating upgrades for 4 issuers (same as 2016) whereas downgrades were reduced to 5 issuers (2016: 12)

CREDIT RATING UPGRADE/DOWNGRADE					
Issuer	Agency	Date of rating	Current	Previous	Action
Hong Leong Banking entities	RAM	2-Nov-17	AAA	AA1	⇧
Unitapah Sdn Bhd	RAM	25-Sep-17	AA2	AA1	⇧
Al-Dhazab Assets Bhd (Class B sukuk)	RAM	12-Sep-17	AA2	AA3	⇧
Encorp Systembilt Sdn Bhd	RAM	5-May-17	AA1	AA2	⇧
Cendana Sejati	RAM	7-Dec-17	BB2	AA1	⇩
Alam Maritim Resources Bhd	MARC	6-Jul-17	DD-(IS)	BB+(IS)	⇩
Media Chinese International Ltd	RAM	10-Nov-17	AA2	AA1	⇩
Media Prima Bhd	RAM	10-Nov-17	AA3	AA1	⇩
Star Media Group Bhd	RAM	10-Nov-17	AA2	AA1	⇩

Source: RAM; MARC

Majority of credit rating upgrades in 2017 were from banking and govt-concession related projects. The Hong Leong banking entities consisting of Hong Leong Bank, Hong Leong Islamic bank and Hong Leong Investment Bank were upgraded (refer to table above). Meanwhile about five (5) issuers were downgraded in the same period; especially the print media industry. Overall, the credit quality/metrics of the rated portfolios improved YOY but downward rating pressure by RAM/ MARC may continue to persist for technology-driven areas affecting media or even cyclical sectors i.e. plantation, automotive, oil and gas.

Conclusion

The Fed's monetary policy normalization via interest rate hikes and balance sheet reduction, coupled with potential further issuances by the US Treasury to fund the deficit arising from the imposition of the Tax proposal will be seen as major influence on UST's ahead. We continue to expect investors to react with caution in the US Treasuries market in the months to come as predictions on the number of potential rate hikes are bandied about with both the 2Y and 10Y UST at multi-year highs. Hence we are mildly bearish on UST's.

Other risk factors on the global front are potential heightening geopolitical tension involving North Korea and the US, potential global trade war, upside surprise to inflation if oil prices sustains above the US$70 per barrel level and also a surge or faster than expected rate hikes by the Fed. Hence, expect cyclical pressures associated with a tightening labor market to filter down to higher inflation over the medium-term. Much of the softness in core inflation for 2017 may come to an end and inflation is expected to rise albeit moderately.

Our risks to the upside are the abilities of pension funds, sovereign wealth funds, central banks and governments as a whole to absorb future primary issuances and shore up the secondary market availability of US Treasuries as higher yields attract inflows.

On the local front, we expect govvies to weaken slightly initially with the recently concluded 25bps OPR hike at the 1st MPC meeting scheduled on 25th January; thereby confirming the earlier hawkish tone of the central bank. However gross supply is estimated at about RM102-103bn as compared to the RM107.5bn in 2017. There is a lower amount of maturing MGS/GII papers in 2018 at RM62.8b. All these coupled with the strength of Ringgit and economic numbers are expected to provide support to local govvies. Improvement in global oil prices will also benefit the Malaysian economy. Opportunities are expected to emerge along the way with investors vigilantly looking for bargain levels from a relative higher yield perspective. We also expect portfolio managers to balance between yield and liquidity as market re-prices the existing secondary market especially for Corporate Bonds which are expected to be resilient. The hunt for yields may proliferate lower down the yield curve especially in the AA-space.

Hong Leong Bank Berhad
Fixed Income & Economic Research, Global Markets
Level 8, Menara Hong Leong
6, Jalan Damanlela
Bukit Damansara
50490 Kuala Lumpur
Tel: 603-2081 1221
Fax: 603-2081 8936
Email: HLMarkets@hlbb.hongleong.com.my