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Macro Note

Malaysia: FTSE Russell Retains Malaysia But Still On Watch List

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- FTSE Russell announced that Malaysia will remain in its World Government Bond Index (WGBI) with 0.4% weight of the index. However, Malaysia will remain on the watch list until its next interim review in March 2020.
- The statement highlights that FTSE Russell and index users are encouraged by the efforts and engagement of Malaysian authorities to address concerns on market liquidity and accessibility. They will continue to monitor conditions in the bond and FX markets in order to assess efficacy of the reforms.
- Earlier Bank Negara Malaysia (BNM) said they had positive engagements with FTSE following further liberalization of the foreign exchange administration (FEA) rules to improve market liquidity and accessibility. While these measures have helped to sustain Malaysia's position in the WGBI for now, FTSE retains Malaysia on the watch list to ensure sufficient progress of reforms.
- MYR bonds were sold–off since last week ahead of the FTSE announcement as well as cautious mood surrounding US-China trade talks. Going forward, we expect USD/MYR should continue to move alongside USD/CNY as we keep our view of a modestly higher level of 4.19 by end-2019 and 4.26 by mid-2020.

FTSE Russell Retains Malaysia In WGBI But Still On Watch List

FTSE Russell kept Malaysia's Market Accessibility Level of "2" which is the required minimum for inclusion in the WGBI. China was also kept on the watch list for a potential upgrade during the latest review while Israel was included in the index. The overall effect on Malaysia's weight from Israel's inclusion effective from April 2020 is not apparent from the statement but we deem the impact to be negligible. Malaysia will remain on the watch list until the next interim review in March 2020. The interim review in March 2020 may include an update to the Watch List countries, whereby reclassification of Market Accessibility Levels and resulting index inclusion changes can be taken after the annual September review only. Malaysia was first placed on FTSE Russell's watch list back in March 2019 for a potential exclusion from the WGBI.

BNM said they had positive engagements with FTSE Russell following further liberalization of the foreign exchange administration (FEA) rules to improve market liquidity and accessibility. While the risk of exclusion has been averted for now, FTSE Russell retains Malaysia on the watch list until the next interim review in March 2020. They will continue to monitor conditions in the bond and FX markets in order to assess efficacy of the reforms.

FTSE Russell's announcement follows earlier reports that JP Morgan will include China in its benchmark bond indices from February 2020, resulting in a lower weight for Malaysia in their GBI-EM index (from 6.12% to 5.17%).

Ultimately, we think FTSE Russell will retain Malaysia in the WGBI but lower the index weight for Malaysia to pave the way for China's inclusion. We estimated that the potential exposure from these actions of a lower weight by 0.1% in the FTSE Russell's WGBI and 0.95% in JP Morgan GBI-EMI is around MYR10bn-12bn, or equivalent of 6%-9% of foreign holdings of government bonds or 1% of total bonds outstanding.

Domestic Liquidity Remains Orderly Despite Foreign Outflows

Domestic financial markets and liquidity remain supportive of economic growth despite cumulative foreign outflows of MYR4.8bn between 2016 and Aug 2019 that pushed foreign holdings of government bonds down to 22% from a peak of 34% in Oct 2016.

1. On bond market liquidity, total outstanding Malaysian Government Securities (MGS) expanded 14% from MYR357bn in 2016 to MYR408bn as at Aug 2019. There are more than thirty issuances in both new and re-openings in a year. By market size, Malaysia has the largest local currency government bond market within ASEAN.
2. On FX hedging, BNM introduced a dynamic hedging program in Dec 2016 to provide market access for investors to actively manage FX exposures via onshore banks and the Appointed Overseas Offices (AOOs) network. The AOO network includes more than 150 AOOs from 21 banking groups operating in 36 countries to-date. In May, the program was

further expanded to include trust banks and global custodians that undertake dynamic hedging on behalf of clients. This allows institutional investors to manage their FX exposures of invested assets with no documentation requirement of the underlying and unwinding of the hedge is allowed. As at 2Q 2019, total assets under this program have grown to MYR128bn under the management of 72 non-residents and 17 resident investors.

3. The onshore daily FX volume has also increased by 50% from an average of USD8bn in 2016 to over USD12bn, of which half are FX forwards and swaps.

Economy And MYR

Malaysia's economic growth stayed robust with real GDP expanding 4.7% y/y in 1H 2019. This bucks the regional trend of decelerating growth. The economy was lifted by resilient domestic demand amid robust private consumption. Private investments remain muted which was apparent from the decline in imports of capital goods and inventory drawdowns for six straight quarters. Both services and manufacturing sectors remain the mainstays of the economy. Growth was also supported by the recovery in agriculture and mining amid improved production of palm oil and natural gas.

Going forward, we remain cautious given escalating external risks. We expect overall growth to ease from 4.6% in 2019 to 4.4% in 2020. This will be supported by an expansionary budget for 2020, continued recovery of commodity production, supportive labour market conditions, and potential benefits from trade diversion amid ongoing US-China trade disputes. Key downside risks to watch include a breakdown of US-China negotiations followed by further retaliatory actions, possibility of a no-deal Brexit, excessive financial market volatility and lingering geopolitical tensions.

MYR bonds were sold-off since last week ahead of the FTSE Russell announcement as well as cautious mood surrounding US-China trade talks. MGS yield curve steepened following the sell-offs although we think foreign investors may deem benchmark 3-, 5-, and 7-year MGS yields at 3.143%, 3.281%, and 3.378% respectively on 26 Sep as attractive under current low interest rate environment. We believe Malaysia's stable macro fundamentals and "A-" rated sovereign ratings provides underlying support for domestic bonds.

Going forward, we expect USD/MYR should continue to move alongside USD/CNY as we keep our view of a modestly higher level of 4.19 by end-2019 and 4.26 by mid-2020.

Table 1: FTSE Russell's Fixed Income Watch List As Of September 2019 Review

Source: FTSE Russell, UOB Global Economics & Markets Research

Region	Country	Currency	EM vs DM Designation	Preliminary Market Accessibility Level	FTSE WGBI Inclusion	FTSE EMGBI Inclusion	Index Credit Rating	Market Size (USD bn)*	Watch List Consideration
APAC	Malaysia	MYR	Emerging	2	•	•	A	82.5	Potential Downgrade to 1
	China	CNY	Emerging	1		•	A+	1,387.3	Potential Upgrade to 2

Note: Market Size refers to the par amount of index eligible bonds only. Data are as of August 31, 2019.

Figure 1: Size Of LCY Bond Market In ASEAN-6

Source: AsianBondsOnline, UOB Global Economics & Markets Research

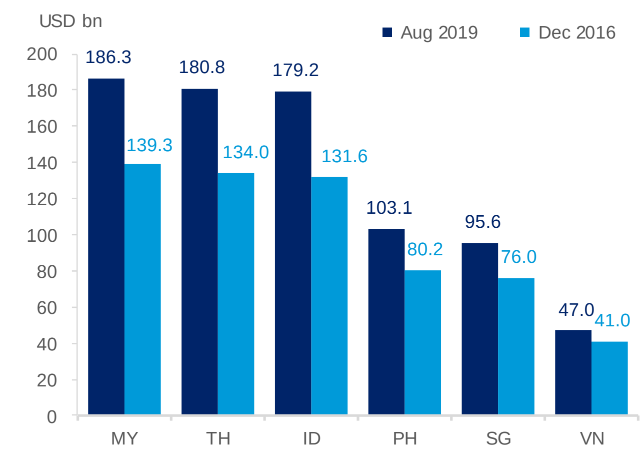


Figure 2: Foreign Holdings Of MGS

Source: Macrobond, UOB Global Economics & Markets Research

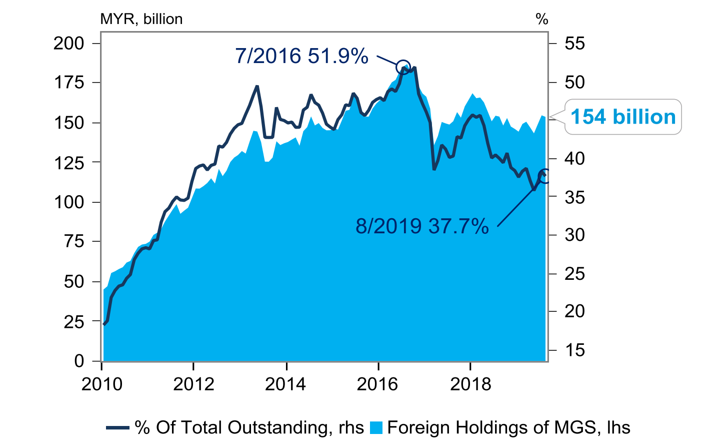


Table 2: Pro Forma Impact Of Inclusion Of Israeli Government Bonds To The FTSE WGBI

Source: FTSE Russell, UOB Global Economics & Markets Research

	WGBI			Projected WGBI + ILS			Difference		
	Count	Market Value*	MV%	Count	Market Value*	MV%	Count	Market Value*	MV%
United States	243	9,135.1	38.6	243	9,135.1	38.5	-	-	-0.11
Japan	263	4,548.2	19.2	263	4,548.2	19.2	-	-	-0.06
France	45	1,915.7	8.1	45	1,915.7	8.1	-	-	-0.02
Italy	70	1,722.8	7.3	70	1,722.8	7.3	-	-	-0.02
Germany	50	1,235.2	5.2	50	1,235.2	5.2	-	-	-0.01
United Kingdom	43	1,191.2	5.0	43	1,191.2	5.0	-	-	-0.01
Spain	40	1,082.3	4.6	40	1,082.3	4.6	-	-	-0.01
Belgium	28	482.5	2.0	28	482.5	2.0	-	-	-0.01
Australia	23	377.6	1.6	23	377.6	1.6	-	-	-0.00
Canada	33	367.6	1.6	33	367.6	1.5	-	-	-0.00
Netherlands	19	357.7	1.5	19	357.7	1.5	-	-	-0.00
Austria	22	269.5	1.1	22	269.5	1.1	-	-	-0.00
Mexico	15	146.4	0.6	15	146.4	0.6	-	-	-0.00
Ireland	15	138.5	0.6	15	138.5	0.6	-	-	-0.00
Poland	17	110.6	0.5	17	110.6	0.5	-	-	-0.00
Finland	18	110.3	0.5	18	110.3	0.5	-	-	-0.00
South Africa	13	103.0	0.4	13	103.0	0.4	-	-	-0.00
Denmark	7	102.5	0.4	7	102.5	0.4	-	-	-0.00
Malaysia	35	88.2	0.4	35	88.2	0.4	-	-	-0.00
Singapore	20	77.6	0.3	20	77.6	0.3	-	-	-0.00
Israel	**-**	**-**	**-**	**13**	**68.2**	**0.3**	**13**	**68.2**	**0.29**
Sweden	8	64.1	0.3	8	64.1	0.3	-	-	-0.00
Norway	8	44.1	0.2	8	44.1	0.2	-	-	-0.00
Total	1,035	23,670.7	100.0	1,048	23,738.9	100.0	**13**	**68.2**	**100.0**

*in USD billions. Source: FTSE Russell. Data are as of August 31, 2019.

Figure 3: Malaysia's Onshore Average Daily FX Volume

Source: BNM, UOB Global Economics & Markets Research

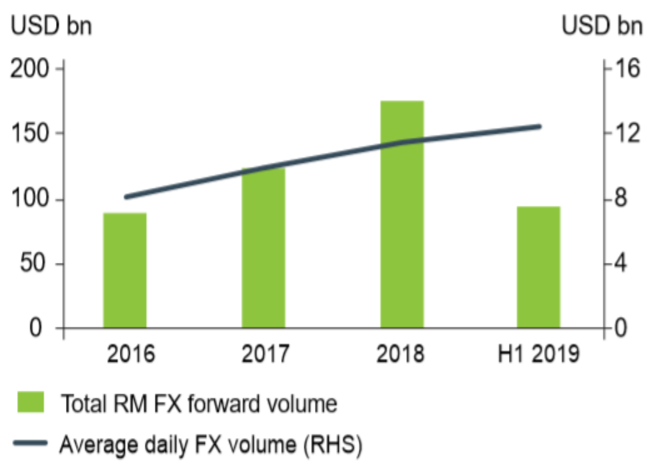
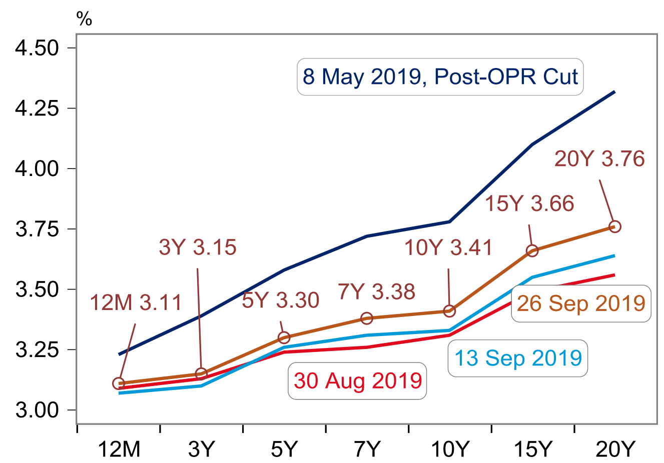


Figure 4: MGS Yield Curve Bear Steepened

Source: Macrobond, UOB Global Economics & Markets Research



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