Coping with COVID-19: Key Developments in the Second Half of 2020

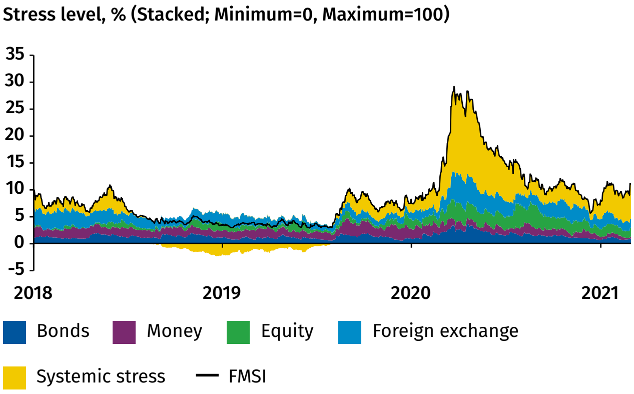
MARKET RISK

Domestic financial market conditions remained orderly despite continued bouts of volatility

Despite the resurgence in COVID-19 infections and the tightening of movement control restrictions globally towards the end of 2020, global financial market conditions in the second half of 2020 had improved compared to the early part of the pandemic. This improvement was supported by the massive monetary stimulus across many countries, progress in the development and deployment of vaccines, and prospects for a better-than-expected recovery, which collectively bolstered investor risk appetite. Domestically, periods of higher market stress[1] were observed in the first two months of 2021 as investors reacted to the re-introduction of the Movement Control Order (MCO), the Government's declaration of a state of emergency and rising global and domestic bond yields. Nonetheless, stress levels remained well below those observed in March to April 2020 (Chart 1.1). The downgrade of Malaysia's sovereign rating by Fitch Ratings in December had limited impact on financial markets, as conditions in the foreign exchange, bond, equity and money markets remained orderly.

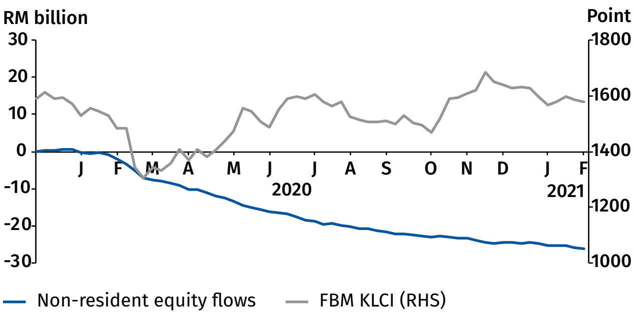
The domestic equity market sustained a broad-based recovery since March 2020 before paring some of these gains in the first two months of 2021 amid bouts of heightened volatility and non-resident outflows (Chart 1.2). Non-resident outflows persisted, amounting to RM10 billion (USD2.4 billion) from July 2020 to February 2021. Nevertheless, the impact of this has been muted given continued strong participation of domestic institutional and retail investors. In particular, the

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



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

[1] The Financial Market Stress Index (FMSI) is a tool the Bank uses to gauge the level of stress in domestic financial markets and drivers of market stress. It has been enhanced recently to improve its robustness and sensitivity as an early warning indicator. Of note, enhancements include (i) the inclusion of new price indicators which allows for more accurate differentiation between market rallies and slumps, (ii) the removal of the sub index for financial institutions, and (iii) the adoption of exponentially weighted moving average which places greater weightage on recent observations of volatility and liquidity indicators to improve the timeliness of the FMSI in capturing stress events.

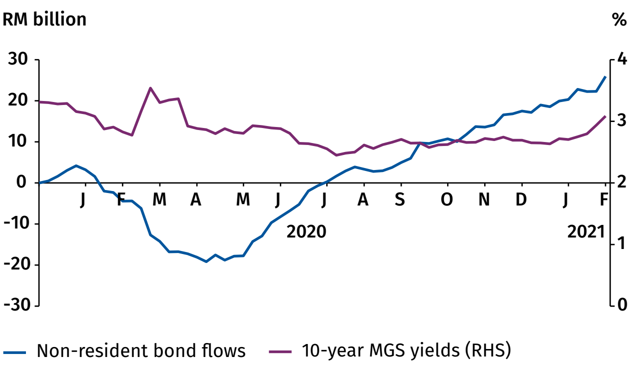
participation of retail investors in the domestic equity market has risen significantly to account for 37% of total value traded in February 2021 (2020: 34%; 3-year average: 19%), exceeding that of domestic institutional investors (February 2021: 27%; 2020: 30%; 3-year average: 41%). With interest rates at a historical low level, retail investor activity is expected to be sustained in the near term as investors seek higher returns. Risks to banks from this activity, however, is assessed to be limited given that it is not driven by borrowings. Further, household loans to purchase quoted shares remain small at 0.5% of total banking system loans (5-year average: 0.5%), with borrowers largely coming from the higher-income group who typically have larger financial buffers to withstand potential price shocks. Loans to stockbroking and fund management firms also remain negligible at 0.05% of total banking system loans. Domestic institutional investors continued to provide countercyclical support during periods of outflows in the second half of 2020 as some entities increased net equity purchases to take advantage of the market correction after the retail investor-driven rally subsided temporarily.

The bond market recorded increased net non-resident inflows amid improving risk sentiment

The domestic bond market recorded net non-resident inflows amounting to RM33.5 billion (USD8.1 billion) in the July 2020 to February 2021 period (Chart 1.3), amid improved risk sentiment on emerging markets and expectations of prolonged low interest rates in advanced economies. The share of non-resident holdings in the government bond market increased from 21% in April 2020 to 24.7% as at end-February 2021 (5-year average: 26%). Notwithstanding higher non-resident purchases, yields on 10-year Malaysian Government Securities (MGS) increased by 44 basis points (bps) to 3.09% as at end-February 2021 (end-December 2020: 2.65%), following higher expected government bond issuances in 2021 and rising US Treasury (UST) yields. The persistent increase in UST yields in the first two months of 2021 was mainly driven by expectations of higher growth and inflation amidst support from additional stimulus and the vaccine roll-out. This subsequently led to a steepening of government bond yield curves globally, including for the MGS where spreads between 3- and 10-year MGS yields increased to about 100 bps (5-year average: 55 bps). Despite this increase, the MGS-UST yield differential narrowed due to larger increases in UST yields (Chart 1.4). In the corporate bond market, credit spreads for 10-year AAA-rated papers normalised to around 57 bps (average between July 2020 and February 2021) after a temporary rise to 105 bps in April 2020. Coupled with actions by firms to shore up liquidity, the more favourable fund raising conditions have led to a recovery in gross corporate bond issuances, which amounted to RM65.5 billion in the second half of 2020 (1H 2020: RM38.6 billion).

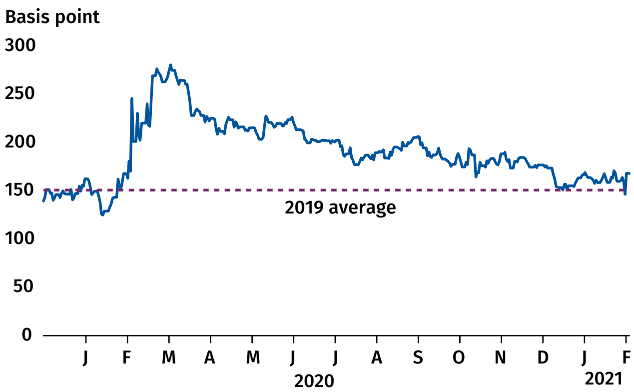
The higher government bond supply in 2021 and persistent increase in UST yields could place upward pressure on domestic bond yields, thus increasing risks of mark-to-market losses and raising costs of

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



Source: Bank Negara Malaysia and Bloomberg

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



Source: Bloomberg

funding for financial institutions, businesses and the Government. Given the active risk management and hedging strategies of financial institutions, any impact from heightened market volatility is expected to remain at manageable levels and will not pose a threat to the resilience of individual institutions. The higher yield environment is also not expected to have any significant impact on banks' cost of funds given their low reliance on market-based funding instruments (19.3% of total banking system funding). Further, Malaysia's deep and liquid market and diverse investor base are expected to alleviate some of the pressure on bond yields and preserve orderly market conditions, thus providing continued support to market confidence and financial intermediation. Amid improved risk sentiment, MGS remain relatively attractive and continue to offer positive real yields and total returns to investors. This is expected to sustain overall demand for government bonds and mitigate the impact on yields from the anticipated diversion of some liquidity held by domestic institutional investors to support government relief measures.

Going forward, domestic factors, such as the management of the pandemic and political developments, will continue to weigh significantly on investor sentiment and portfolio allocations as economic recovery progresses amid the global roll-out of vaccines.