

04/09/2000

Lacklustre trading seen to continue this week

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WITH a relatively short week due to the National Day holiday, secondary trading volume on the Malaysian fixed income market was thin. In the absence of any major fundamental economic data, price movement was range-bound with most investors and traders sidelined.

The most active issue for the week were the Band-1 Treasury Bills, which have a maturity of up to 21 days at a discount yield of 2.84 to 2.86 per cent. The two-year 27/00 Cagamas Bond 4.518 per cent maturing on August 16 2002 was actively traded among principal dealers within a narrow price range of 100.12 to 100.19, yielding between 4.41 per cent and 4.45 per cent. The actively-traded recapitalisation bond, Danamodal 0.00 per cent 10/03, lost its shine with only RM290 million transacted, with prices trapped within a range of 84.90-84.95, yielding approximately 5.29 per cent. With traders still holding onto sour long positions at higher levels and the absence of any positive boost, we expect the current lacklustre condition to continue for the most of this week.

A pick-up in activity was seen in the corporate bond market. Spreads of corporate bonds have widened after the recent rise of 25 bps in deposit rates. The AAA-rated bonds were particularly hard-hit, given their close link to sovereign bonds. Good demand was seen in short-term 1-2 year maturity, BBB and BB-rated corporate bonds by "high-yield traders" taking a bet on credit spread convergence on general improvement in credit quality.

The market has been in a bearish mood since the wobbling of inter-bank rates and subsequent 25 bps increase in deposit rates about one month ago. Where are we headed from here?

The economic fundamentals are still favourable for long in bonds. Even though the second quarter GDP made an impressive headline of 8.80 per cent, it was below market expectations. Prime Minister Datuk Seri Dr Mahathir Mohamad last week criticised banks for failing to grow loans sufficiently, calling them "a drag on the economy". This underlines the Government's concern about the sustainability of the current recovery process.

Growth was mainly export-led, with domestic consumption remaining flat. With the US economy finally showing signs of cooling off, export-driven growth will be hit. The July M3 (the broadest measure of money supply) growth slowed to 3.70 per cent year-on-year compared to 4.10 per cent in June, underscoring the slow loan growth that continues to irk the Government.

The current growth outlook is definitely not supportive of a higher interest rate regime. So why the bearish mood? Inflation?

Malaysia is currently enjoying historically low inflation, with July CPI at 1.40 per cent year-on-year after bottoming at 1.30 per cent in May and June 2000. This is not surprising given the cautious spending pattern of consumers. The market is currently troubled by the potential price pressure from increases in fuel and transport costs.

Economists and statisticians are divided on the final impact of such price increases, ranging between an additional 0.5 per cent and 1.50 per cent on CPI, depending on the impact of fuel prices on other goods. Even if this is the case, so what? An increase in interest rates to dampen consumer demand is definitely not the solution to cost-push inflation.

The problem at hand is the deficiency of spending, not a heavy spending

spree driving prices up. Pushing interest rates higher when facing cost-induced inflation will be a recipe for disastrous stagflation (stagnant economy with inflation), as evidenced in the 1970s.

The market should decipher all the fundamentals of economics better. Inflation does not automatically lead to interest rate increases and a drop in bond prices.

Malaysia is unlike the US where inflation pressure stems from overly buoyant consumer spending. After the recent 25 bps increase in the deposit rate for protection of savers' interest, we do not expect any further upward movement in rates, at least for the next six to nine months, until consumer spending heats up. So, what is the conclusion? Go long in bonds and ride on the steepness of the yield curve.