Economic/Thematic Research:

OPR vs FFR

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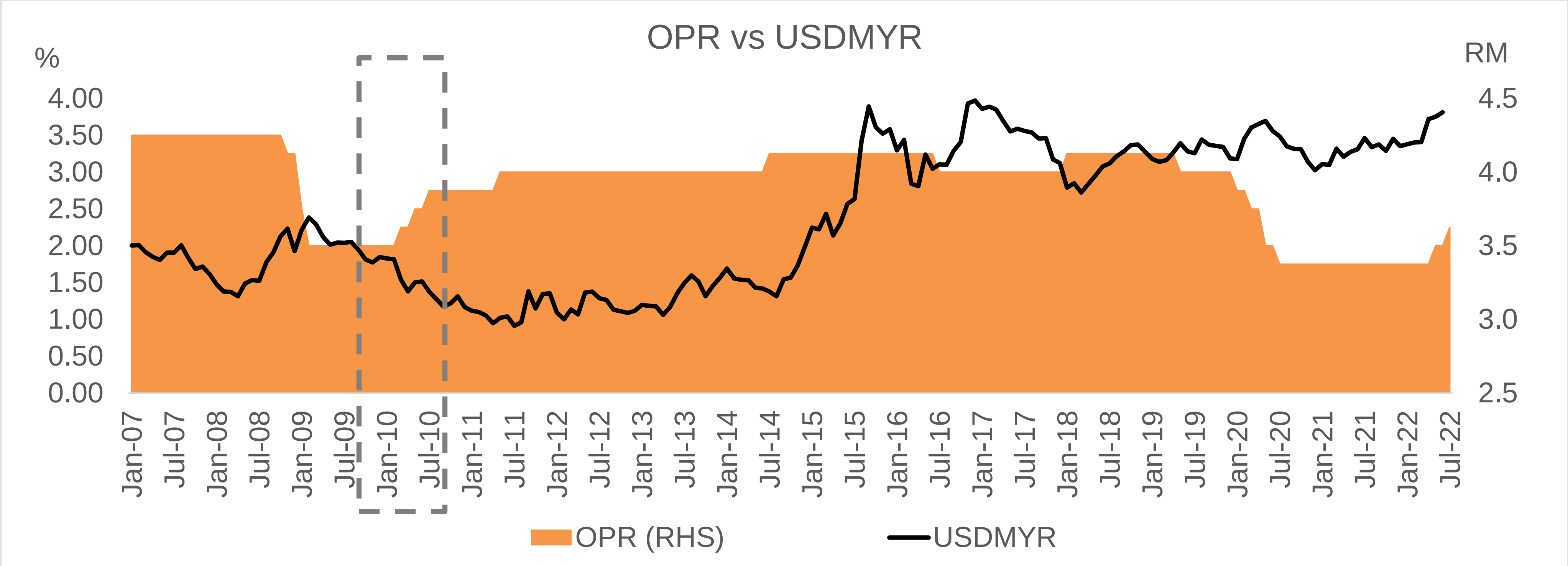
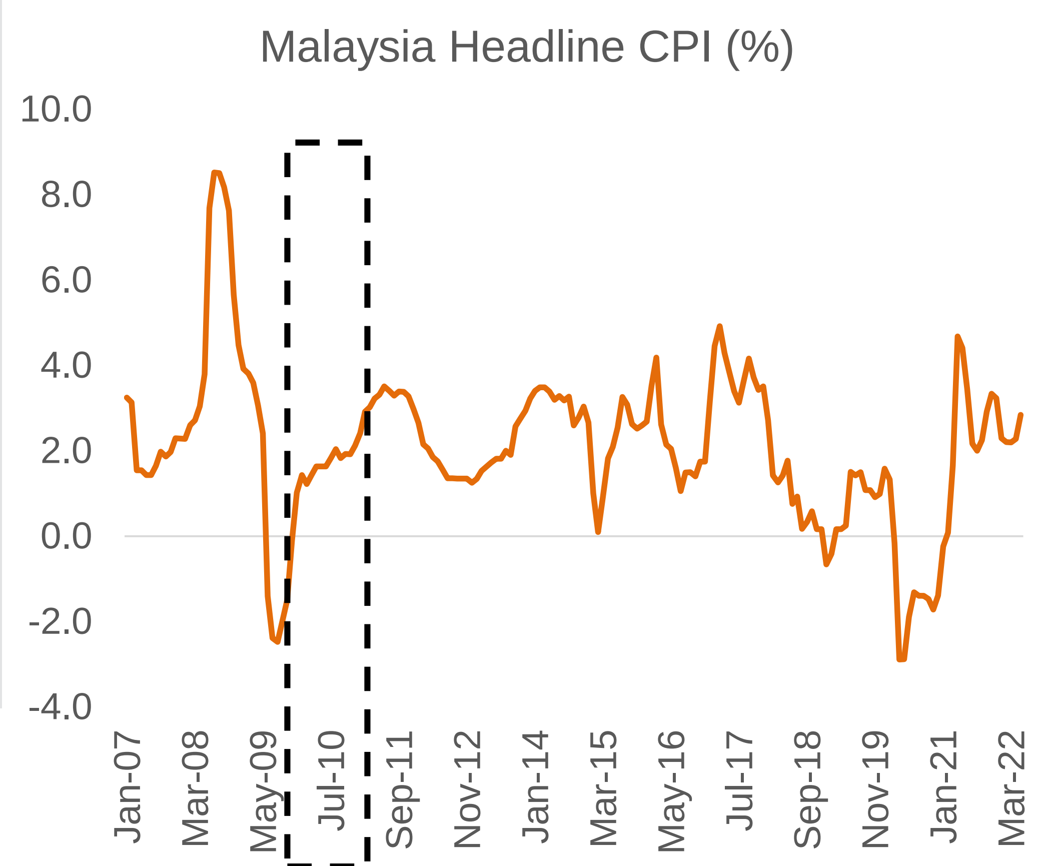
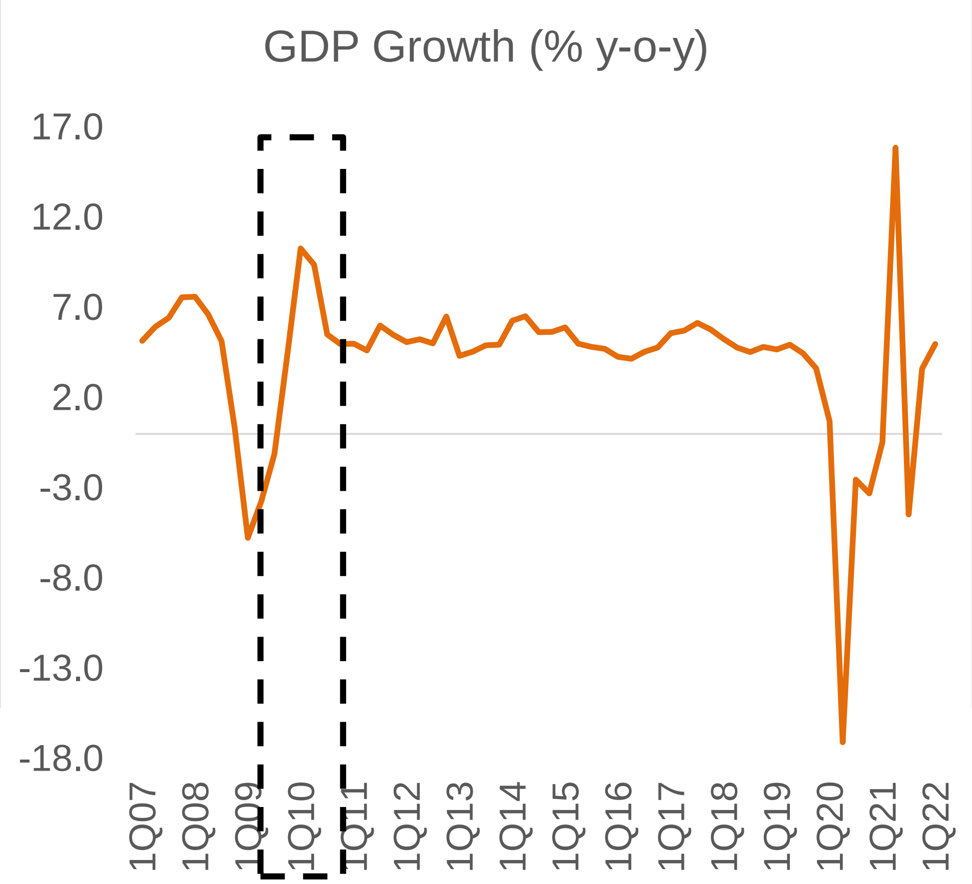
BNM normalises Overnight Policy Rate (OPR)







- In line with our expectations, **BNM raised OPR** in its July MPC meeting by **25bps to 2.25%,** the first consecutive rate hike since 2010.
- We anticipate another **25 bps hike in September** before a pause to allow for the effects to filter through the economy. However, should inflation remain elevated with continuously large capital outflows, BNM could further raise OPR by another 25bps in November to end the year at 2.75%.
- Ringgit weakened close to 6% against the greenback thus far this year. Although Malaysia's inflation is still relatively low compared with many other economies due to active fiscal policy interventions via subsidies, BNM continued to raise its OPR to contain rising inflationary pressures and capital outflows as the U.S. Fed hikes aggressively.
- BNM **last raised rates 3x in a row from March – July 2010** after a series of rate cuts due to the 2008/09 Global Financial Crisis. While inflation continued to inch up despite the monetary policy tightening, the rate hikes managed to shore up Ringgit against USD without much damage to our economic performance. Following the series of hikes, GDP growth maintained around 5% level, normalising from base effect post-crisis era.

Sources: CEIC, BNM and SME Bank SCEA

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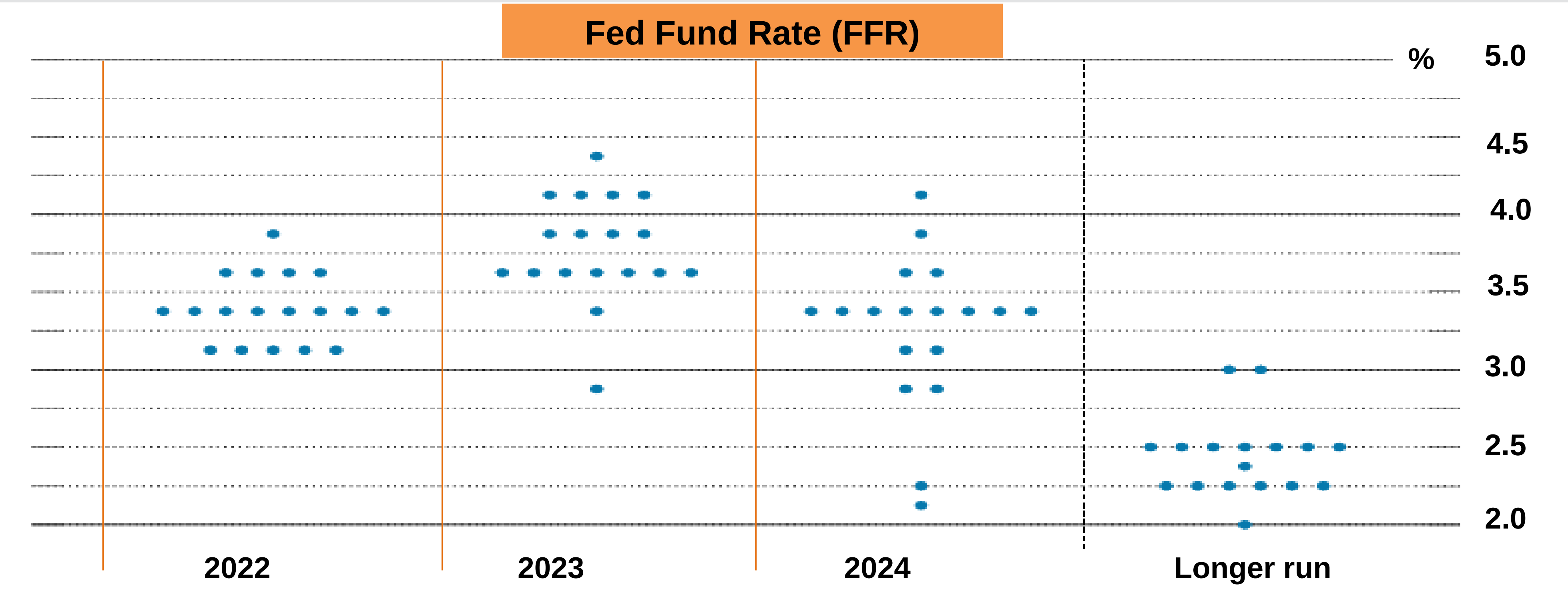
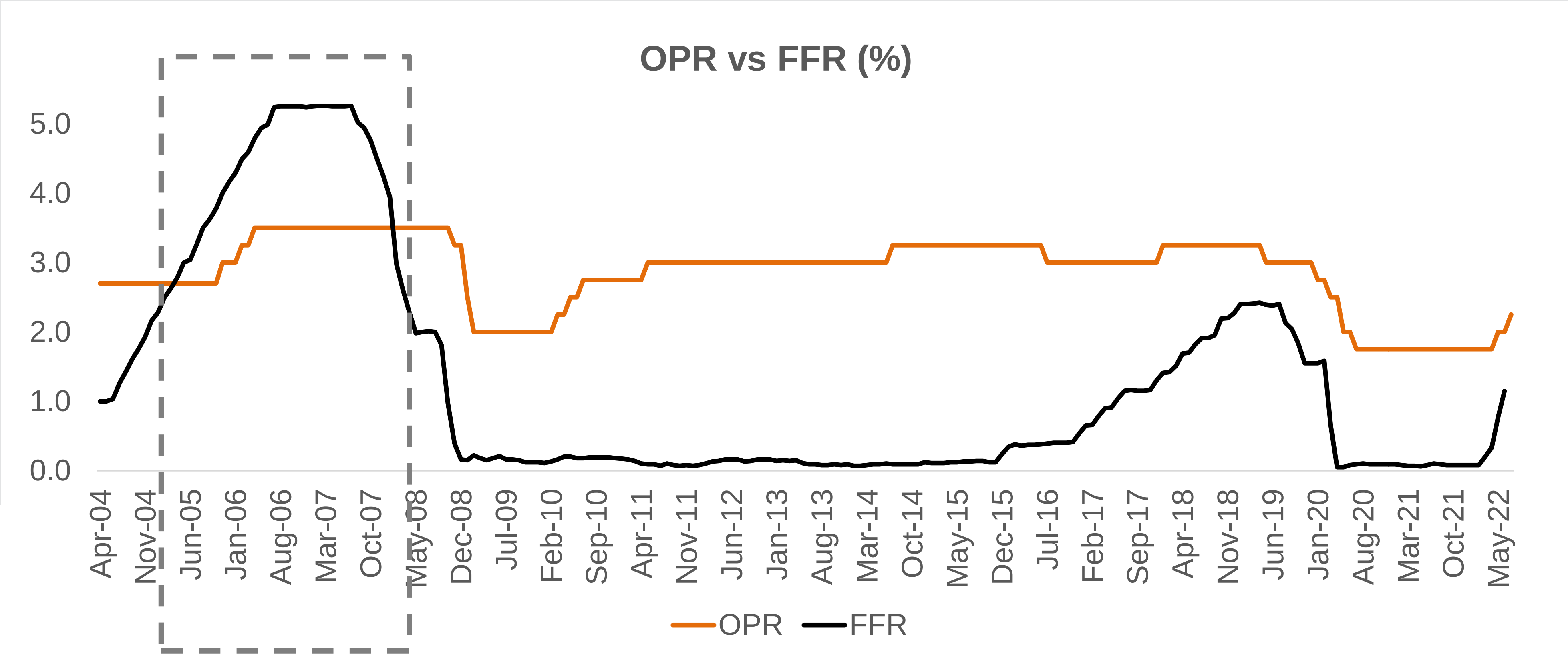
BNM normalises OPR



Each dot represents one Fed official's projection for the US Central Bank's key interest rate at the end of the year



- **Fed is set to continue lifting rates** in upcoming meetings as displayed by its latest dot plot in Jun-22. The dot plot indicates the consensus for FFR to clock in between **3.00% – 3.50% this year** (currently at 1.50% - 1.75%).

- Hence, we opine that BNM will also raise the OPR in order to shore up our currency to maintain the interest rate differential, besides cooling current inflationary pressures and preventing inflation expectations from becoming entrenched. We expect BNM to raise rates in a measured and gradual manner to avoid hampering the nascent economic recovery.

- Having said that, even if BNM were to raise 25bps in each meeting for the remaining 2 meetings for this year, the **OPR** (2.75%) will still be **< FFR** (3.00% - 3.50%).

- The last time **OPR < FFR** was during the period between **Apr-05 – Jan-08**. Between 2004 and 2006, Fed raised interest rates 17 times from 1.0% to 5.25% to curb rising inflation and to cool off an overheated economy.

Sources: CEIC, Federalreserve.gov and SME Bank SCEA

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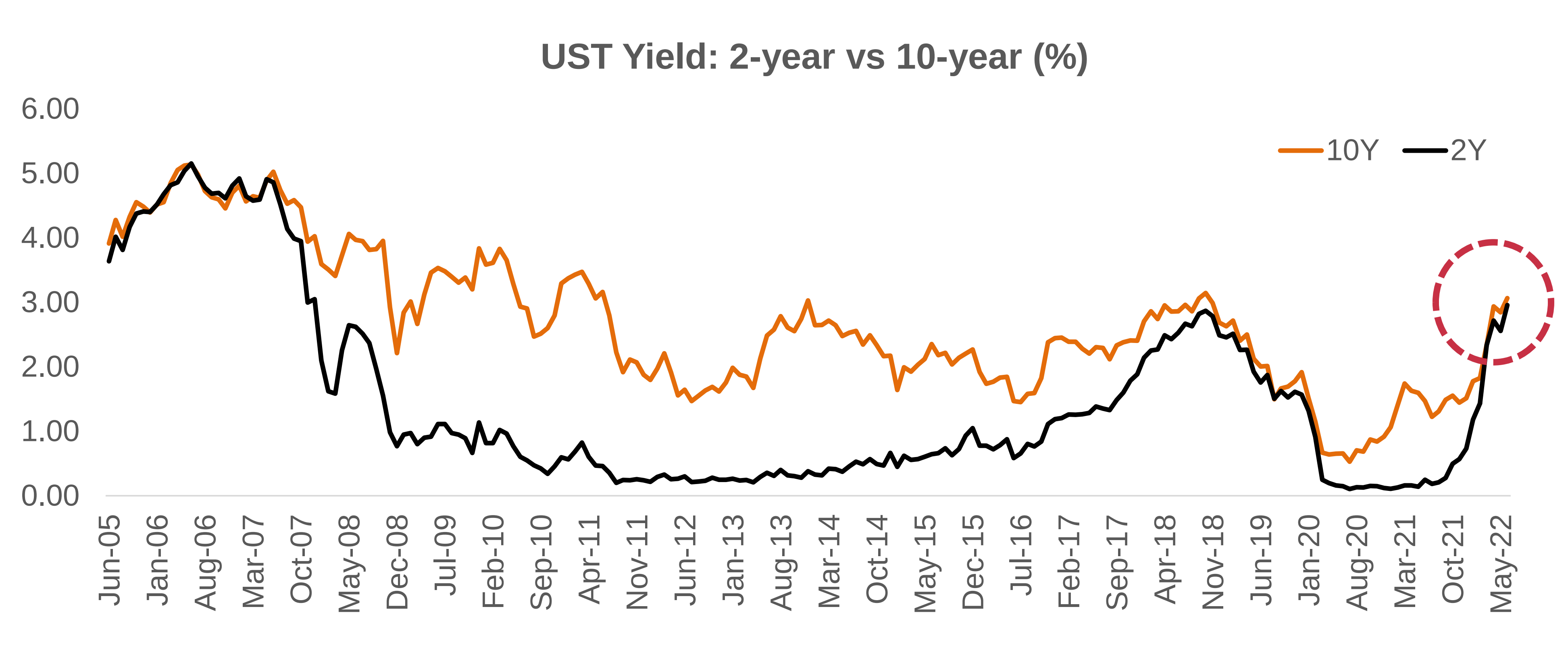
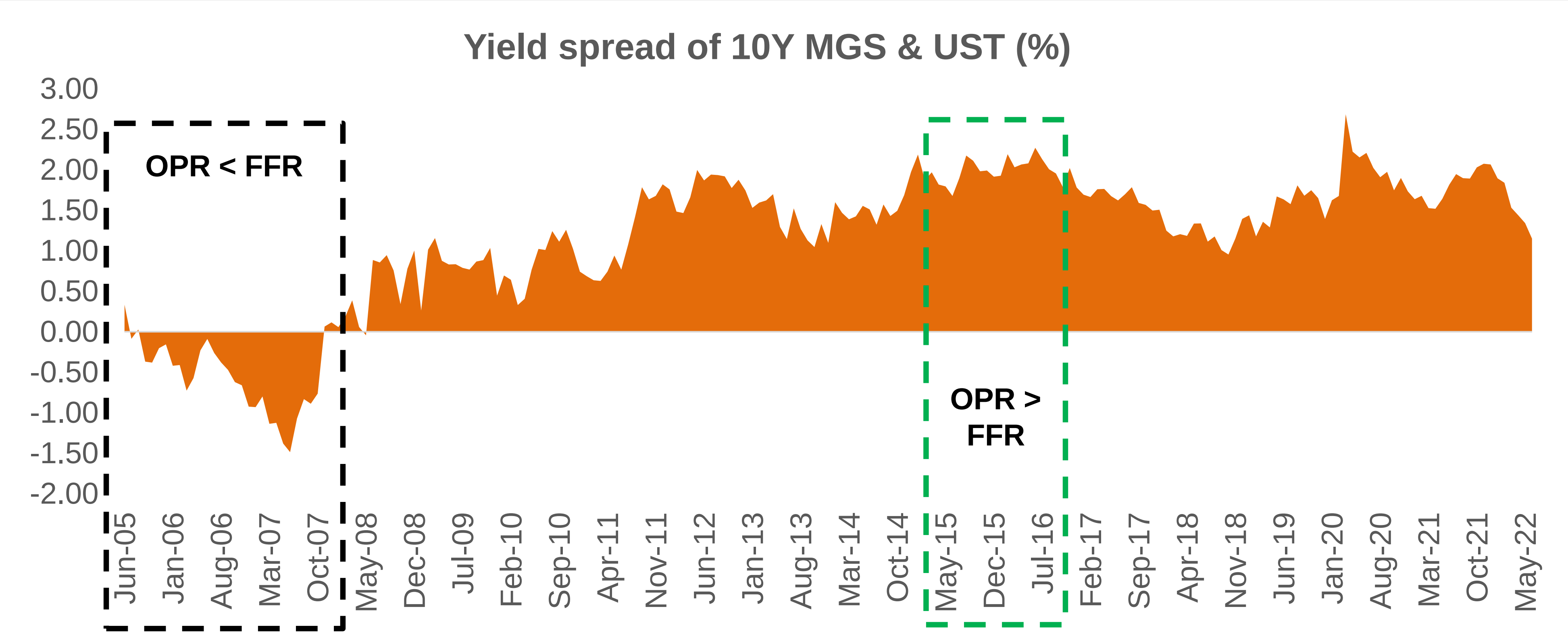
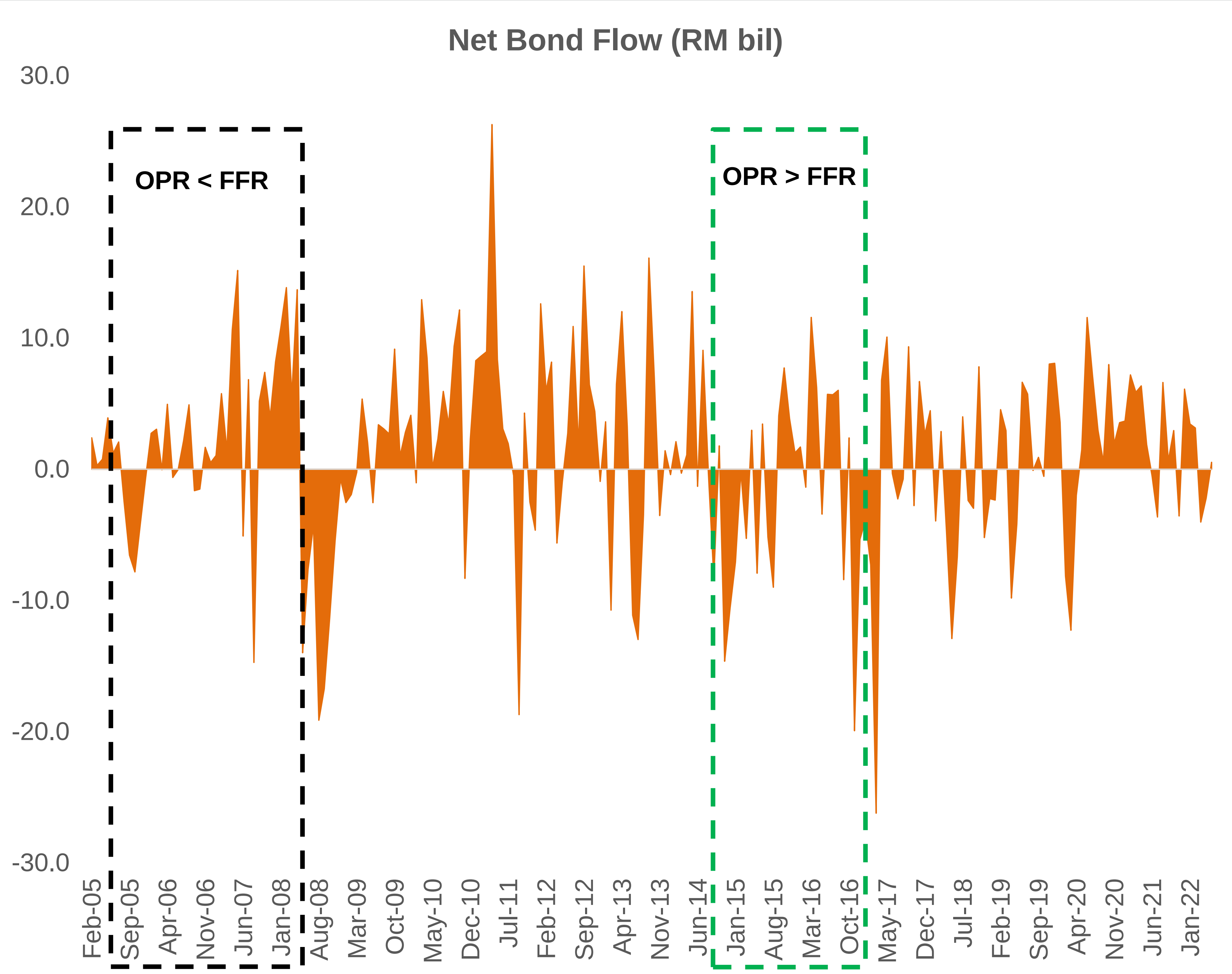




- Despite Fed's aggressive hikes, yield curve flattened as short-term rates increased while longer yield declined. The **yield curve had inverted in recent months.**
- An inverted yield curve is a lead indicator of a **recession**. Long-term yields fall as investors expect monetary policy tightening to slow growth by too much, hence forcing the central bank to reverse course and ease.
- Due to Fed's aggressive rate hikes, the yield spread between Malaysia and the US Treasuries (UST) have been narrowing, making Malaysia's bond market less attractive compared with the US, which could induce capital flight.
- According to historical data during Apr-05 and Jan-08 when the **OPR < FFR, the spread** between Malaysia's Government Securities (MGS) and the UST 10Y yield **were negative.**
- Taking cue from the past, there is a likelihood for the spread to become negative again should the OPR < FFR.

Sources: CEIC, Bloomberg and SME Bank SCEA

BNM normalises OPR



- During the negative spread period (OPR < FFR), some fund (bond) outflows were observed. However, it was not immediate nor persistent throughout the negative spread period.
- There seem to be an inconclusiveness between the spread and fund flows. In general, **capital will flow in** when the **spread is positive and high**, and vice-versa.
- However it wasn't always the case as reflected by the green dotted line where there were a mixed trend of bond flows when the spread was positive (OPR > FFR) and high.
- This suggest that there are also other factors influencing capital inflows/outflows besides interest rates which includes political stability, policies & regulations and the attractiveness of markets in other countries.

**Data refers to monthly movements of foreign holdings of Malaysian Ringgit denominated bonds*

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Sources: CEIC, Bloomberg and SME Bank SCEA

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