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ECONOMIC REVIEW | Fitch Bond Rating

Fitch Downgrade Ringgit Denominated Sovereign Bond

- *Fitch downgrade Malaysia's government long-term local bond rating to 'A-' from 'A' last week. The international credit rating agency cited the absence of strong public finance fundamentals against external finance fundamental and the preferential treatment of local-currency creditors against the foreign-currency ones. We believe the latter should not much of a consideration given the fact most of the government bond issuance were Ringgit denominated.*
- *Initial market reaction suggests that Ringgit and bond yield could be less affected. The downgrade should weigh on Ringgit and 10Y bond yield but market was seemingly not reflecting such concern. Ringgit appreciated early in the intraday trade against the dollar to 4.0515 or 0.36% but giving back the gain later on while 10Y bond yield was flattish.*
- *We maintained our year-end forecast for Ringgit at 3.95 despite the downgrade as other factors plays bigger roles in determining the currency future movement.*

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Fitch assessment was based on projected oil prices at USD33pb average oil prices for 2016. Fitch assumption on the deteriorating public finance is partly based on Brent prices at USD33pb in 2016 which differs from our assumption of higher average oil prices at USD45pb for the year. Fitch's assumption of Petronas dividend at RM16 billion is equal to our projection. However, we note that Fitch had just revised its projection for oil prices yesterday from USD32pb to USD42p. This has made revision inconsistent with its input for the downgrade of Malaysia's local currency IDR rating. We believe the revision should be reflected in its next rating exercise.

Initial market reaction suggests that Ringgit and bond yield could be less affected. The downgrade should weigh on Ringgit and 10Y bond yield but market was seemingly not reflecting such concern. Ringgit appreciated early in the intraday trade against the dollar to 4.0515 or 0.36% but giving back the gain later on while 10Y bond yield was flattish. Despite being perceived as heavily reliant on commodities, Malaysia's fiscal is less dependent on oil related revenues**.** According to our estimate, oil related revenues will contribute about 11.9% – 12.6% to the total federal revenue with oil prices projected at average of USD30/35 respectively.

Petronas's Standalone Credit Profile maintained at 'AA-'despite downgrades on Long Term Foreign and Local Foreign Issuer Default Ratings. Along with the downgrade of Ringgit denominated bonds, Fitch downgraded Petronas's Long Term Foreign credit rating and Local Currency Issuer Default Ratings (IDR) to 'A-' from 'A', with a stable outlook while maintaining its short-term Foreign Currency IDR at 'F1'. Similar downgrade was made to Petronas's foreign currency senior unsecured and debt rating issued by Petronas Capital Ltd and guaranteed by Petronas, from 'A' to 'A-'. The rating cited the downgrade was in line with the downward revision to the Long Term Local Currency IDR.

We maintained our year-end forecast for Ringgit at 3.95 despite the downgrade. Logically, a revision in credit rating usually has an eventual material impact to the exchange rate via change in fund flows to the respective country. A lower credit rating would imply higher yield and could affect fund flow as investors and institutions rebalance their portfolio accordingly. However, this appears not to be the general situation. Case in point, Philippines and Thailand holds lower credit rating than Malaysia but have lower 10-year sovereign bond yield.

Table 1: Regional Comparison on Fitch Rating and 10Y Bond Yield

Country	Fitch Rating	10 Year Bond Yield (%) (June 2016)	Debt to GDP (%)	Fiscal Balance over GDP (%)	International Foreign Reserve (USD billion) June 2016
Singapore	AAA (stable)	1.76	105.0	-1.2	247.2
Malaysia	A- (stable)	3.85	54.5	-3.2	97.2
Indonesia	BBB- (stable)	7.12	27.0	-2.5	110.0
Thailand	BBB+ (stable)	2.06	44.4	-2.5	178.7
Vietnam	BB- (stable)	6.92	50.5	-5.4	34.1
Philippines	BBB-	3.23	45.0	-0.9	84.0

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