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DOMESTIC ANCHORS AMID GLOBAL DRAGS IN MALAYSIA'S 2026 FIXED INCOME LANDSCAPE

Executive Summary

The Federal Reserve (Fed) delivered a 25bp rate cut at its final Federal Open Market Committee (FOMC) meeting for 2025 on December 10, lowering the Fed Funds Rate (FFR) to the range of 3.50–3.75%. While this marks the third cut of the year, the Fed maintained a cautious tone and signalled a shallow easing path ahead, projecting only one additional cut in 2026. In response, U.S. Treasury (UST) yields declined modestly, risk sentiment improved, and the USD briefly slipped.

For Malaysia, the combination of easing global benchmark yields and resilient domestic fundamentals sets a constructive tone for Malaysian Government Securities (MGS) heading into 2026. Stable macroeconomic conditions, a firmly anchored Overnight Policy Rate (OPR), and steady demand from institutional investors continue to provide a strong anchor for MGS yields. At the same time, key risks—including foreign exchange volatility, bouts of global risk aversion, and potential surprises on the fiscal or inflation fronts—remain relevant as investors reassess the fixed-income landscape in the year ahead.

Malaysia remains relatively well insulated among emerging markets due to its credible monetary policy, improving fiscal dynamics, and deep domestic investor base. These factors suggest that while external volatility may trigger short-term yield fluctuations, the medium-term trajectory for MGS remains fundamentally constructive.

As a small and open economy with deepening financial integration, Malaysia will feel the spill over from U.S. policy, but domestic fundamentals are likely to anchor MGS yields, limiting upside pressures from global rates.

The FOMC Decision and Its Global Significance

The December FOMC meeting reaffirmed the Fed's commitment to a measured and gradual easing cycle. While the 25bp rate cut was widely anticipated, the more meaningful development came from the Fed's forward guidance. The latest projections maintained the September outlook, signaling only one 25bp rate cut in 2026. This policy path is predicated on a balanced macroeconomic backdrop: inflation easing toward 2.4% by end-2026, economic growth accelerating to an above-trend 2.3%, and unemployment remaining steady at around 4.4%. Financial markets responded positively but cautiously. U.S. Treasury yields dipped by 4–6 bps across the curve, while risk assets posted modest gains. The tone of the meeting underscored a key message—while the easing cycle has resumed, the Fed remains in no rush to accelerate rate cuts. Instead, policymakers appear comfortable maintaining a slow and steady approach to recalibrating policy in 2026.

UST	Yields (%)		Change (bps)
	9-Dec-25	10-Dec-25	
3-Y UST	3.62	3.56	-6
5-Y UST	3.78	3.72	-6
7-Y UST	3.96	3.92	-4
10-Y UST	4.18	4.13	-5

Source: Federal Reserve Board

Spillover Effects to Global Fixed Income Markets

The Fed's decision has several implications for global fixed income, particularly emerging-market (EM) bond markets. Lower UST yields reduce the global risk-free benchmark and ease external funding conditions for EM sovereigns. Nevertheless, Malaysian Government Securities (MGS) and Government Investment Issues (GII) yields edged slightly higher, by between 0 and 4 bps, as markets positioned ahead of the December FOMC's forward guidance and the Malaysian government's final bond issuance for the year, a RM3 billion reopening of the benchmark 10-year MGS. From Malaysia's perspective, the softening in UST yields continues to enhance the relative appeal of domestic bonds by narrowing the MGS–UST yield spread. This narrowing differential strengthens the competitiveness of MGS in the eyes of global investors. Although the easing cycle is modest, it nevertheless contributes to a more supportive environment for capital flows into EM fixed income.

MGS	Yields (%)		Change (bps)
	9-Dec-25	10-Dec-25	
3-Y MGS	3.02	3.05	3
5-Y MGS	3.28	3.31	3
7-Y MGS	3.48	3.50	2
10-Y MGS	3.53	3.57	4
GII	Yields (%)		Change (bps)
	9-Dec-25	10-Dec-25	
3-Y GII	3.13	3.15	2
5-Y GII	3.29	3.30	1
7-Y GII	3.36	3.37	1
10-Y GII	3.56	3.56	0

Source: BNM

Impact on Malaysian Rates and MGS Yield Trajectory

1. Upward Pressures on Yields (Short-Term)

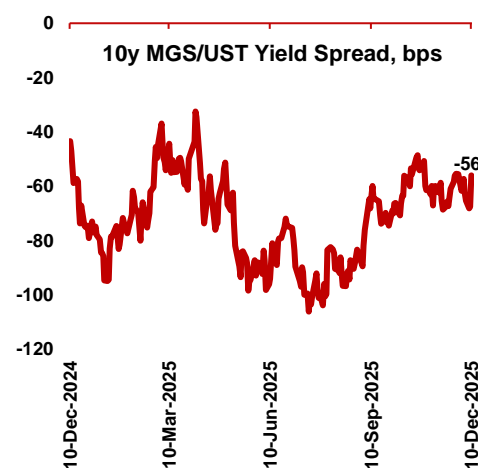
The Federal Reserve's slower easing path could:

- Narrow expectations for the MGS–UST spread recovery**
 MGS–UST yield differentials have remained in negative territory since September 2024. With the OPR expected to hold at 2.75% in the near term, a pause in Federal Funds Rate (FFR) adjustments would keep the OPR–FFR gap firmly negative. As a result, the MGS–UST yield spread is also likely to stay in the negative zone.

A meaningful recovery in the spread toward neutral or positive territory hinges primarily on a decline in UST yields once the Fed initiates its rate-cut cycle. However, if the Fed eases more slowly than anticipated, the expected decline in UST yields becomes less pronounced. This means the interest-rate differential between Malaysia and the U.S. remains unfavourable for longer, delaying or weakening any recovery in the MGS–UST spread.

- Introduce mild upward pressure on short- and medium-tenor MGS**

A slower Fed easing path could introduce mild upward pressure on short- and medium-tenor MGS because the front end of the global rates curve would reprice higher as U.S. short- and belly-tenor yields stay elevated for longer. This limits the potential for Malaysian yields to ease in the near term, especially since the narrower expected policy-rate differential reduces the likelihood of BNM cutting rates or signalling any early accommodation. At the same time, a slower Fed



Sources: Federal Reserve Board, Bank Islam

rate cut cycle typically results in a stronger USD and a weaker Ringgit, prompting investors to demand a higher yield premium on short- and medium-tenor MGS to compensate for foreign exchange volatility. With the long end of the curve anchored by domestic institutional demand, these dynamics create flattening pressure, pushing the short and belly segments slightly higher relative to the rest of the curve.

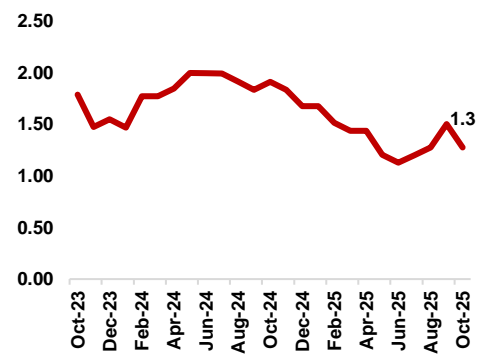
2. Downward (Anchoring) Forces (Medium-Term)

Domestic fundamentals offer an important counterbalance:

- Inflation remains within BNM's comfort range**

Malaysia demonstrates a stable and benign inflation environment, supported by a sustained moderation in price pressures. Headline inflation eased to 1.3% in October 2025 from 1.5% in September, undershooting the market's median expectation and extending a remarkable 27-month streak of sub-2% inflation. This prolonged period of price stability has provided policymakers with valuable room to focus on supporting economic growth. For the first ten months of 2025, inflation averaged a modest 1.4%. Looking ahead, price pressures are expected to remain contained. Bank Negara Malaysia (BNM) projects headline inflation at 1.5%–2.3% for 2025 and 1.3%–2.0% for 2026. Malaysia's inflation rate also remains comparatively favourable within the region: October's 1.3% reading was below that of Vietnam (3.25%), Indonesia (2.86%), and South Korea (2.4%). The stability is supported in part by targeted policy measures, including the rollout of the BUDI95 targeted subsidy for RON95 petrol. The scheme is expected to have only a limited pass-through to consumer prices, helping keep overall inflation dynamics well-anchored as Malaysia moves into 2026.

Malaysia - Consumer Price Index, y-o-y%

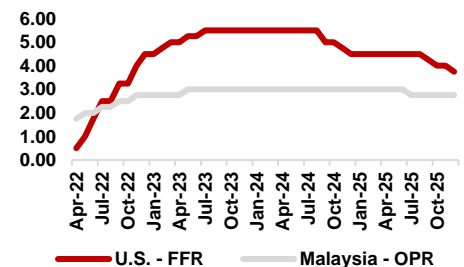


Sources: Department of Statistics Malaysia (DOSM)

- BNM maintains the OPR at 2.75%, with no urgency to tighten**

The latest Monetary Policy Statement (MPS) from BNM in November 2025, announced that the Monetary Policy Committee (MPC) maintained the Overnight Policy Rate (OPR) at 2.75%. The MPS indicates that the global economy faces challenges, including the impact of higher tariffs and geopolitical tensions, which could affect local and international financial markets. Domestically, Malaysia expects sustained economic growth, supported by household spending, strong investment, and robust labor markets. The Monetary Policy Committee (MPC) maintains that the current OPR is suitable, providing necessary support for the economy while preserving price stability. The MPC will keep monitoring economic developments and assessing the balance of risks to growth and inflation.

U.S. Federal Funds Target Range, (Upper Limit) vs. Malaysia's OPR, %

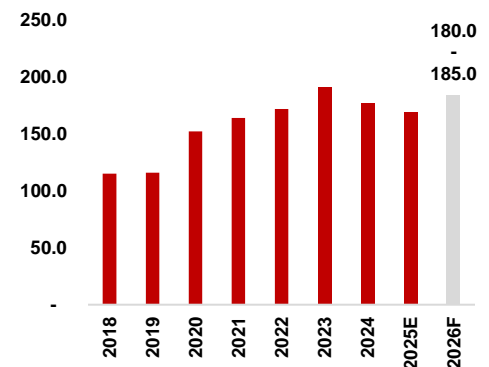


Sources: Federal Reserve Board, BNM

- Fiscal consolidation continues, reducing supply-side pressure on MGS issuance**

The government is committed to improving its fiscal position and continues its consolidation efforts. The fiscal deficit is projected to narrow to 3.5% of GDP in 2026, an improvement from the estimated 3.8% in 2025. Based on the anticipated maturity schedule and the government's commitment to fiscal consolidation, we posit that gross MGS/GII issuance will be between RM180.0 billion and RM185.0 billion in 2026. This issuance will be necessary to roll over the RM108.7 billion in maturing debt (MGS: RM46.5 billion, GII: RM59.2 billion) and to fund the projected fiscal deficit of RM74.6 billion, which reflects an improvement over the 2025 deficit of RM76.7 billion. The Public Finance and Fiscal Responsibility Act 2023 (Act 850) mandates that overall debt should not exceed 60% of GDP in the medium term, while setting the ceiling for Government Guarantees (GG) at 25% of GDP. Given that current overall debt is higher (64.7% in 2Q2025), the government is expected to leverage the unused GG limit to drive down the official debt ratio towards 60% by 2028. This move involves shifting financing from direct debt to guaranteed obligations. As current GG debt stands at 21.1% of GDP, the government has significant

Gross Issuances



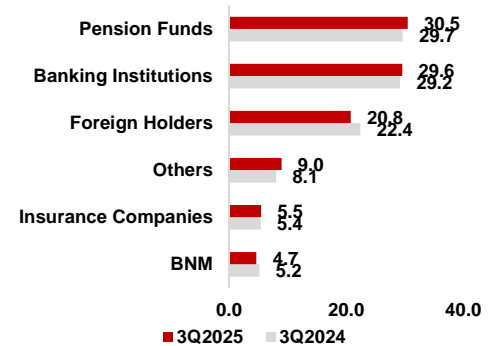
Sources: Ministry of Finance, Bank Islam

capacity—potentially issuing at least RM80 billion more in 2026, plus refinancing RM15.6 billion of maturing bonds—before reaching the Act’s 25% cap.

- **Stable domestic demand from institutional investors for MGS acts as a natural shock absorber**

In the third quarter of 2025, pension funds secured their position as the largest holders of local government bonds, holding a 30.5% share of the total outstanding (3Q2024: 29.7%). They were immediately followed by banking institutions, which accounted for 29.6% of the outstanding bonds (3Q2024: 29.2%). Overall demand in the local government bond market was also significantly bolstered by other domestic institutional investors, such as Development Financial Institutions (DFIs), the Central Bank (BNM), and insurance companies.

Ownership Distribution of MGS, GII, MTB and MITB (%)



Sources: BNM, Bank Islam

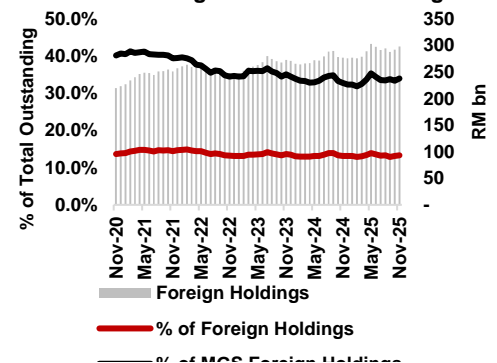
Yield Curve Outlook (2026)

The near-term outlook for MGS is constructive. The downward drift in UST yields in the short-term is likely to translate into modest yield declines for Malaysian bonds. Foreign investors are expected to regain interest as relative value improves and global duration becomes more attractive. Over the medium term, however, the Fed’s slower easing path limits the potential for a deep rally. This suggests that while MGS yields may continue to decline gradually, the magnitude of the move could be contained. The yield curve is expected to flatten modestly as long-end yields remain anchored by structural demand while the 5Y–10-Y segment absorbs most of the foreign inflow-driven rally.

Foreign Participation and Flow Dynamics

Foreign flows into Malaysia’s local bond market are likely to remain sensitive to the Fed’s slower easing path, as global investors reassess duration risks amid a narrower expected FFR-OPR rate differential. While Malaysia has enjoyed relatively stable inflows in recent months—supported by its credible fiscal stance, resilient domestic demand, and steady BNM policy—the outlook may turn more cautious in the near term. As a result, investors may take a more measured approach toward adding exposure to MGS and GII until there is greater clarity on the U.S. disinflation trajectory and the timing of the Fed’s actual rate cuts. Still, Malaysia’s structural strengths—deep market liquidity, a sizeable and stable institutional investor base, and a maturing fiscal consolidation path—should limit the risk of any pronounced outflows. Instead, portfolio flows are more likely to fluctuate in a choppy but contained manner rather than turn decisively negative.

Foreign Holdings of Ringgit Bonds as a Percentage of Total Outstanding



Sources: BNM, Bank Islam

Key Risks to Monitor

1. **Sharper-than-expected Fed tightening bias**

One of the most significant external risks for MGS is the possibility of a more persistent U.S. inflation path. If U.S. core inflation, especially in shelter, services, and wage-driven components eases more slowly than expected, the Fed could be compelled to scale back its projected rate cuts or delay the start of its easing cycle. Such an outcome would keep U.S. real rates elevated for an extended period, lifting UST yields and pushing the MGS–UST spread deeper into negative territory. In this environment, foreign demand for MGS may soften, especially in the front and belly of the curve where sensitivity to U.S. rate expectations is highest.

There is also a risk of a broader hawkish repricing in U.S. rates. If U.S. data were to surprise on the upside, such as a reacceleration in labour-market conditions or a rebound in inflation, UST yields could face renewed upward pressure. Such shifts typically spill over into emerging-market bond markets, including MGS, by pushing global risk-free benchmarks higher, prompting foreign outflows, and exerting steepening domestic yield curves.

2. Renewed USD strength weighing on Ringgit

Malaysia is also exposed to risks stemming from foreign exchange dynamics. A prolonged period of USD strength, perhaps due to elevated UST yields or broader risk aversion, could weaken the ringgit and reduce the attractiveness of Malaysian bonds to foreign investors. A weaker Ringgit is often associated with higher foreign selling in the MGS market, and a preference among foreign investors for safer USD assets. If the ringgit approaches sensitive thresholds, it may trigger additional outflow pressures and lift MGS yields.

Additionally, Malaysia faces terms-of-trade risks, as fluctuations in commodity prices—such as crude oil, LNG, and palm oil—could affect export revenues and currency performance. A sharp decline in commodity prices might weaken the ringgit, reduce investor confidence, and indirectly increase volatility in the local bond market.

3. Upside surprises in Malaysia's inflation trajectory

Domestically, Malaysia faces inflation risks arising from targeted subsidy reforms. The rationalisation of fuel or food subsidies could temporarily lift headline inflation and heighten concerns that Bank Negara Malaysia (BNM) may need to tighten policy or delay any future easing. Even without an actual rate hike, higher inflation expectations alone could increase short- and medium-tenor MGS yields.

Fiscal risks also warrant attention. While Malaysia has reaffirmed its commitment to fiscal consolidation, slippages in revenue collection, higher social or development expenditures, or delays in subsidy reforms could undermine fiscal credibility. Any deviation from the deficit reduction path may lead to expectations of higher MGS and GII issuance, putting upward pressure on long-end yields.

In addition, while the domestic political environment has been relatively stable, unexpected political developments—such as changes in policy direction or governance challenges—could erode investor confidence. Even if such risks do not directly affect sovereign issuance, they may lead to wider MGS spreads and weaker foreign demand.

4. Global geopolitical shocks affecting risk sentiment

The global geopolitical environment presents another layer of uncertainty. Escalating tensions involving major economies—such as the U.S. and China—or conflicts in the Middle East could drive investors into safe-haven assets, strengthen the USD, and weaken EM currencies and bonds. Malaysia, given its close trade ties with China, would be particularly vulnerable to China-related geopolitical shocks, which could result in weaker MYR sentiment and reduced foreign participation in MGS.

Furthermore, a global growth scare—such as the risk of a U.S. or eurozone recession—could introduce volatility in Malaysia's fixed-income markets. While such fears may depress global yields, emerging markets often experience FX-driven tightening, where a weaker local currency forces domestic bond yields higher even as UST yields fall. In a global risk-off scenario, capital typically flows out

of emerging markets and into safe-haven assets, strengthening the U.S. dollar and weakening EM currencies, including the Ringgit. The resulting currency depreciation then exerts upward pressure on local bond yields to compensate foreign investors for the higher foreign exchange risk and wider hedging costs.

Conclusion

The December 2025 Fed meeting underscores a backdrop of moderate global rate volatility, yet Malaysia's fixed-income market remains supported by domestic stability. While MGS yields may experience temporary upward pressures, particularly along the short and belly segments, the medium-term outlook remains constructive and well-anchored. This resilience reflects Malaysia's credible monetary and fiscal framework, a deep domestic investor base, low inflation volatility, and moderating issuance supply. As a result, MGS continues to offer attractive defensive characteristics heading into 2026, with potential opportunities to accumulate duration during periods of market weakness.