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Nor Lyana Zainal Abidin
Economist
nlyanaz@bankislam.com.my

TARIFF PRESSURES AND FED UNCERTAINTY STIR VOLATILITY ACROSS BOND MARKETS

Fed Rate Cut Certainty Erodes, All Eyes on CPI. For the majority of this year, bond investors were highly confident that the Federal Reserve (Fed) would implement another interest rate cut before September. However, this conviction has recently weakened. These emerging uncertainties have intensified focus on this week's Consumer Price Index (CPI) inflation data for June, which will be crucial in determining the Fed's next policy decision. The CPI figures will also indicate whether U.S. Treasury Bonds, which have seen their best first half in five years despite recent fluctuations, can sustain their strong performance. The release of these CPI figures is expected to set the tone for the Fed's policy direction and overall risk sentiment in the second half of the year. Markets generally expect a 0.3% m-o-m increase in core inflation, which would nudge the annual rate up slightly from 2.8% to 2.9%. A series of robust employment figures released in early July led traders to conclude that the Fed would not cut rates at its current month's meeting with the probability of 93.3%. Consequently, the estimated probability of a rate cut at the September meeting has fallen to approximately 58.8%, according to CME Fedwatch Tool, at the time of writing. This context makes the upcoming release of the U.S. CPI for June, due on Tuesday, exceptionally significant.

E.U. Seeks United Front Amid Rising Tariff Threats from U.S. The European Union (E.U.) is intensifying efforts to coordinate with allies such as Canada and Japan in response to escalating tariff threats from former U.S. President Donald Trump. With talks between the E.U. and U.S. stalled on key issues like car and agricultural tariffs, the bloc is preparing both for continued negotiations and possible retaliation. European Commission President Ursula von der Leyen announced that the E.U. will extend the suspension of its trade countermeasures against the U.S. until August 1 to allow more time for discussions. However, she emphasized that the E.U. is readying a new set of countermeasures covering up to EUR72 billion in U.S. goods, if talks fail. France and Germany have voiced strong concern, with President Macron calling for accelerated preparation of retaliatory tools and Chancellor Merz warning that a proposed 30% U.S. tariff would severely damage German exports. Trump has sent formal notices to several trading partners, threatening steep tariffs from August unless better trade terms are secured. The E.U. is pushing back, seeking lower agricultural tariffs and protection for industries such as aviation, spirits, and medical devices, while rejecting proposals that could lead to production shifts to the U.S. Negotiations are expected to continue this week, but uncertainty remains high as Trump signals new sectoral levies on cars, metals, pharmaceuticals, semiconductors, and copper.

Upcoming Events: Key Economic Data Release

Monday	**Malaysia Retail Sales (May), China Trade Balance (June)**
Tuesday	**U.S. CPI (June), China 2Q GDP, Retail Sales, IPI (June)**
Wednesday	**Bank of Indonesia (BI) meeting, U.K. CPI (June)**
Thursday	**U.S. Retail Sales (June). Initial Jobless Claims**
Friday	**Malaysia 2Q GDP Advance Estimate, External Trade (May)**

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Weekly Changes, basis points (bps)

UST	Yields (%) 27-Jun-25	Yields (%) 3-Jul-25	Change (bps)	Yields (%) 11-Jul-25	Change (bps)
3-Y UST	3.72	3.84	12	3.86	2
5-Y UST	3.83	3.94	11	3.99	5
7-Y UST	4.03	4.12	9	4.19	7
10-Y UST	4.29	4.35	6	4.43	8
MGS	**Yields (%) 26-Jun-25**	**Yields (%) 4-Jul-25**	**Change (bps)**	**Yields (%) 11-Jul-25**	**Change (bps)**
3-Y MGS	3.13	3.12	0	3.09	-4
5-Y MGS	3.20	3.18	-1	3.16	-2
7-Y MGS	3.39	3.38	-2	3.34	-3
10-Y MGS	3.51	3.45	-6	3.43	-2
GII	**Yields (%) 26-Jun-25**	**Yields (%) 4-Jul-25**	**Change (bps)**	**Yields (%) 11-Jul-25**	**Change (bps)**
3-Y GII	3.15	3.15	0	3.12	-4
5-Y GII	3.28	3.26	-2	3.22	-4
7-Y GII	3.39	3.37	-1	3.36	-1
10-Y GII	3.52	3.50	-2	3.48	-2

Sources: Federal Reserve Board, BNM, Bank Islam

Commentaries

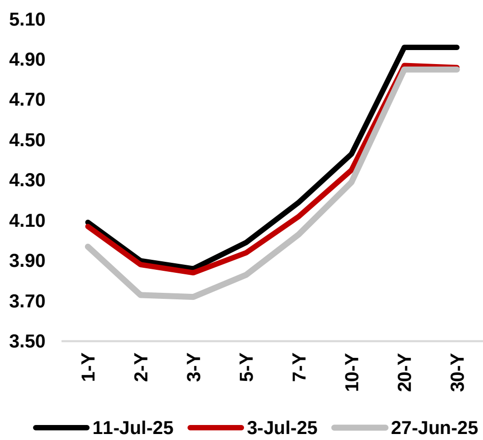
UST Yields

The U.S. Treasury (UST) yields inched higher in the range of 2bps to 8bps w-o-w for the week ending July 11 (Jul 3: +6bps to +12bps). Market tensions intensified due to new tariff threats from President Trump, who announced a 35% tariff on Canadian imports starting August 1 and plans for 15-20% broad-based tariffs on most other trading partners, up from the current 10%. These followed earlier weekly announcements of a 50% tariff on Brazilian imports and similar duties on copper, along with formal notices to other key trading partners, further escalating the administration's trade offensive.

Despite this, recent UST auctions for USD22 billion in 30-year bonds and USD39 billion in 10-year notes saw solid demand, while markets continued to anticipate the Fed holding interest rates steady later this month, with two quarter-point reductions by year-end.

Short-term outlook: Following the recent extension of the tariff deadline to August 1, market focus has shifted toward ongoing trade negotiations. Any meaningful progress with major trading partners is expected to provide a significant boost to investor sentiment. Going forward, markets are looking into the upcoming release of the U.S. CPI data in charting the trajectory of Fed's interest rate path. Still sticky inflation would strengthen expectations that the Fed will hold interest rate steady, driving UST yields upwards. In addition, investors will also closely monitor the upcoming release initial jobless claims data to examine whether there will be signs of sustained labor market resilience which may add further upward pressure on bond yields.

UST Yield Curves, %



Sources: Federal Reserve Board, Bank Islam

MGS/GII Yields

Yields on both Malaysian Government Securities (MGS) and Government Investment Issues (GII) closed lower on a w-o-w basis, dipping by between 1bp and 4bps for the week ending July 11 (July 4: 0bp to -6bps). To support domestic demand against increasing external headwinds and a modest inflation outlook, Bank Negara Malaysia's Monetary Policy Committee (MPC) reduced the overnight policy rate (OPR) by 25 bps to 2.75% in its July MPC meeting. We believe this rate cut is a singular, pre-emptive move intended to mitigate the economic impact of potential 25% U.S. tariffs on certain Malaysian imports, previously announced at 24% and set for August 1. Although the tariff deadline has been extended for negotiations, the outcome is uncertain, with Malaysia's Ministry of Investment, Trade and Industry (MITI) affirming its dedication to dialogue and the U.S. indicating a willingness to consider Malaysia's market access requests.

On the other hand, Malaysia's job market continued its positive trend in May 2025, with the unemployment rate holding steady at 3.0% which highlights the nation's economic resilience despite global shifts. This sustained recovery in employment and workforce confidence underscores Malaysia's robust and adaptable economic performance amidst evolving global economic and technological landscapes.

Short-term Outlook: Yields are anticipated to remain largely steady this week. On the domestic front, strong retail and trade momentum as well as the upcoming release of 2Q2025 advance GDP estimate are expected to buoy local bond yields. Nevertheless, the grappling global trade uncertainty and the impending August 1 deadline to pose significant near-term risks. At this juncture, we revised our 10-Y MGS yield to 3.45% for end-2025.

Foreign Flows into Local Bonds Market.

The domestic bond market logged net foreign outflows of RM5.4 billion in June (May: +RM13.4 billion) amid investor sentiment has weakened due to a combination of rising geopolitical risks and evolving expectations regarding U.S. monetary policy. Consequently, the accumulated total foreign holdings of Malaysia debt securities dipped to RM296.6 billion in June (May: RM302.1 billion).

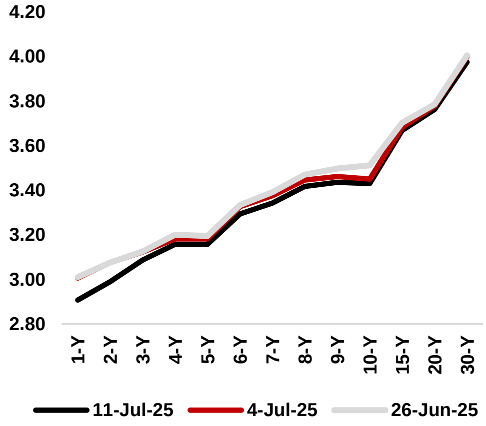
MGS and GII recorded net outflows of RM2.9 billion (May: +RM12.5 billion) and RM2.4 billion (May: +RM1.8 billion) in June, respectively. In addition, Malaysia Treasury Bills (MTB) and Malaysia Islamic Treasury Bills (MITB) were also in the negative region with net foreign outflows of RM611 million (May: -RM1.5 billion) and RM416 million (May: +RM3.5 million) in June. On the other hand, corporate bonds were in the positive territory with net inflows of RM903 million (May: -RM550 million).

Total foreign holdings' share to total outstanding in MGS slumped to 35.7% in June (May: 36.3%). Other segments of the local government bond market also dipped with the share of foreign holdings of GII, MTB and MITB edged lower to 8.9% (May: 9.3%), 9.0% (May: 21.2%) and 8.7% (May: 9.2%). Of note, the percentage of foreign holdings to total outstanding in local govvies bonds slid to 22.8% in June (May: 23.3%). Overall, the foreign holdings' share of total outstanding declined to 14.0% in June (May: 14.2%).

Total cumulative foreign holdings in the local bond market grew to RM21.4 billion in the first half of 2025 and significantly higher relative to the cumulative net foreign inflows of RM0.9 billion from January to June 2024.

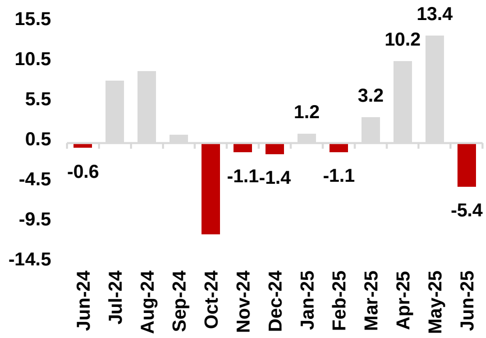
Short-term outlook: The short-term outlook for global capital flows remains volatile, largely due to significant headwinds like tariff uncertainty and geopolitical tensions. The Trump administration initiated sending letters on Monday, July 7, informing numerous countries, that new reciprocal tariff rates would take effect on August 1. Malaysia is among the nations facing a new 25.0% US tariff regime which may dampen investor sentiment in the near term. Nevertheless, persistent concerns regarding the US fiscal situation could prompt investors to shift their assets out of the US, benefitting markets, such as Malaysia, as investors seek alternative destinations for their capital.

MGS Yield Curves, %



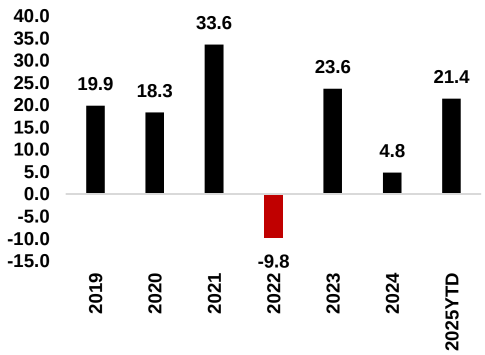
Sources: BNM, Bank Islam

Foreign Fund Flows in Local Bond Market, RM Billion



Sources: BNM, Bank Islam

Cumulative Net Foreign Flows in Local Bonds (Yearly Comparison, RM Billion)



Sources: BNM, Bank Islam