

Farah Zazreen Zainudin
Economist
fzazreen@bankislam.com.my

FED CAUTION AND U.S.-CHINA TRADE STANDOFF SET THE TONE FOR MARKETS

Powell Signals Fed Remains Open to Further Rate Cuts. The U.S. Federal Reserve delivered a mix of cautious optimism last week, as officials weighed persistent inflation against signs of a softening labour market, all while navigating the challenges of a federal government shutdown. According to the latest Beige Book survey, economic activity across most districts remained subdued, with businesses reporting stagnant hiring, limited layoffs, and growing hesitancy around future workforce expansion. Many firms noted rising input costs, exacerbated by ongoing trade tariffs, with some beginning to pass these costs on to consumers, adding to the inflation narrative. Federal Reserve Chair Powell echoed these concerns in his remarks, acknowledging that while the broader economy appears more stable than previously feared, the path forward remains uncertain. He emphasized the conflicting signals of slowing job gains and stubborn price pressures. Notably, Powell hinted that the Fed's balance sheet runoff may conclude sooner than expected, suggesting a gradual shift toward more accommodative financial conditions. The ongoing government shutdown also loomed large over the Fed's communication. With delayed data releases and reduced transparency into current economic trends, Powell underlined the importance of a meeting-by-meeting approach to monetary policy decisions, underscoring the central bank's reliance on real-time indicators in a data-constrained environment.

Trade Tensions Between U.S. and China Escalate. U.S.–China trade tensions intensified sharply last week, unsettling global markets and heightening fears over supply chain disruptions. The escalation began with China's decision to tighten export controls on rare earth materials, key inputs for semiconductors, electric vehicles, defense systems, and clean energy technologies. Although officially justified as a national security measure, the move was widely interpreted as a signal of Beijing's readiness to leverage its dominance in critical supply chains. In retaliation, the U.S. announced plans to impose a sweeping 100% tariff on all Chinese imports, set to take effect on November 1 should ongoing negotiations fail to yield progress. American officials justified the measure as a response to economic coercion, intellectual property risks, and rising dependence on China's control over vital materials. This represents one of the most severe tariff threats since the earlier stages of the U.S.–China trade war, underscoring a shift in focus from traditional trade imbalances to broader concerns over economic and technological security. With both sides adopting increasingly hardline positions, the risk of a full-scale tariff confrontation is growing, particularly if the upcoming ASEAN Summit in Malaysia does not deliver a diplomatic breakthrough. The renewed tensions have already rattled investors, driving a flight to safety toward bonds and gold. In the days ahead, markets will closely watch how negotiations unfold, as their outcome will be pivotal in setting the tone for global trade dynamics and risk sentiment heading into the year's final quarter.

Upcoming Events: Key Economic Data Release

Monday	China 3Q2025 GDP, Retail Sales, IPI, FAI, PBOC meeting
Tuesday	Canada CPI (Sep)
Wednesday	Malaysia CPI (Sep), UK CPI (Sep), BI meeting
Thursday	Singapore CPI (Sep), BOK meeting
Friday	Japan CPI (Sep), Singapore IPI (Sep), UK Retail Sales (Sep)

Weekly Changes, basis points (bps)

UST	Yields (%) 3-Oct-25	Yields (%) 10-Oct-25	Change (bps)	Yields (%) 17-Oct-25	Change (bps)
3-Y UST	3.59	3.52	-7	3.47	-5
5-Y UST	3.72	3.65	-7	3.59	-6
7-Y UST	3.90	3.83	-7	3.78	-5
10-Y UST	4.13	4.05	-8	4.02	-3
MGS	Yields (%) 3-Oct-25	Yields (%) 10-Oct-25	Change (bps)	Yields (%) 17-Oct-25	Change (bps)
3-Y MGS	3.09	3.10	2	3.07	-3
5-Y MGS	3.21	3.24	3	3.21	-3
7-Y MGS	3.40	3.46	6	3.40	-6
10-Y MGS	3.44	3.49	4	3.46	-2
GII	Yields (%) 3-Oct-25	Yields (%) 10-Oct-25	Change (bps)	Yields (%) 17-Oct-25	Change (bps)
3-Y GII	3.13	3.13	1	3.09	-5
5-Y GII	3.23	3.25	2	3.21	-4
7-Y GII	3.34	3.37	3	3.33	-5
10-Y GII	3.48	3.51	3	3.47	-4

Sources: Federal Reserve Board, BNM, Bank Islam

Commentaries

UST Yields

U.S. Treasury (UST) yields fell between 3bps and 6bps w-o-w for the week ending October 17 (Oct 10: -7bps to -8bps), as dovish Federal Reserve commentary and weaker economic data weighed on sentiment. Remarks from Chair Powell suggested that the Fed is nearing the end of its balance sheet tightening cycle and may consider rate cuts. The decline in yields was further reinforced by softening labour indicators, escalating U.S.–China trade tensions, and the prolonged U.S. government shutdown.

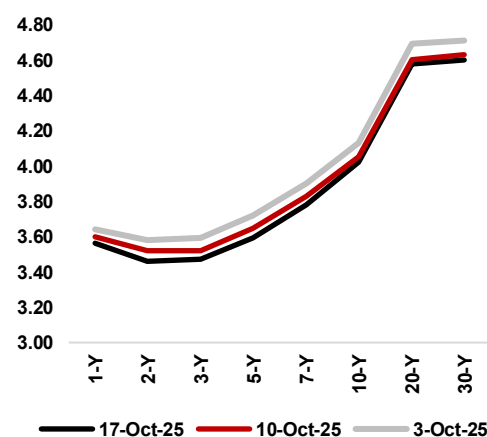
The Fed's latest Beige Book report underscored subdued hiring momentum, with many businesses citing tariff-related headwinds as a key constraint. Firms reported rising input costs and uncertainty linked to Trump's trade policies, prompting some to absorb higher expenses while others passed them on to consumers, adding to inflationary pressures. Overall, the report pointed to a more cautious economic outlook amid slowing employment growth and trade disruptions.

Meanwhile, tensions between the U.S. and China deepened after Beijing expanded export restrictions on rare earth metals, vital to high-tech industries such as semiconductors, electric vehicles, and defense technologies. The escalation prompted investors to seek refuge in safer assets, particularly government bonds, a move amplified by expectations of future Fed rate cuts and persistent political uncertainty in Washington. Together, these factors made the bond market increasingly attractive, driving yields lower across the curve.

Short-term outlook:

The U.S. 10-year Treasury yield once again slipped below the key 4% psychological threshold last week, extending its recent downtrend largely on expectations of forthcoming Fed easing. With the ongoing government shutdown limiting the release of fresh economic data, the bond market has entered a period of muted headline-driven volatility. Nonetheless, escalating U.S.–China trade tensions have emerged as a dominant market theme. A key focal point will be the anticipated meeting between U.S. and Chinese officials

UST Yield Curves, %



Sources: Federal Reserve Board, Bank Islam

at the upcoming ASEAN Summit in Malaysia, which could prove pivotal in determining whether the proposed 100% U.S. tariff on Chinese imports, scheduled to take effect on November 1, will proceed. A failure to achieve meaningful progress or a de-escalation in trade hostilities would likely trigger renewed risk aversion, driving investors toward safe-haven assets, spurring further Treasury demand, and exerting additional downward pressure on yields. If the 10-year yield stabilizes above 3.9%, it may signal a temporary reprieve as short-term market anxiety subsides. However, a decisive break below that level could evolve into a broader crisis of confidence, with potential spillover effects across other asset classes.

MGS/GII Yields

Yields on both Malaysian Government Securities (MGS) and Government Investment Issues (GII) closed lower on a w-o-w basis by between 2bps and 6bps for the week ending October 17 (Oct 10: +1bp to +6bps). The decline in bond yields was primarily due to the escalation in global trade tensions, which fuelled safe-haven demand and increased foreign inflows into Malaysian bonds, thereby keeping yields lower.

As both the U.S. and China are Malaysia's key trading partners, any developments involving reciprocal tariffs between the two economic superpowers could impact Malaysia's trade performance and broader economic outlook.

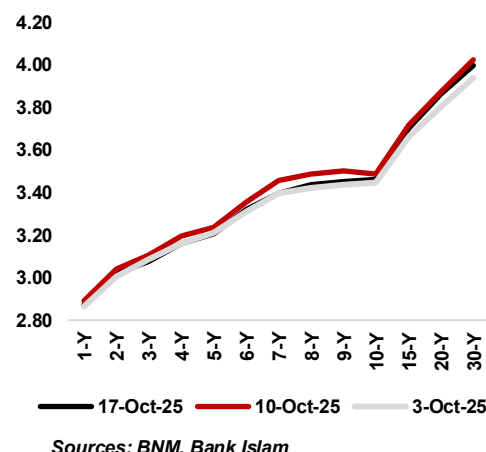
Although Malaysia stands to gain from the ongoing shift under the China+1 strategy, where multinational firms diversify supply chains away from China, it also remains exposed to external risks, particularly from a slowdown in U.S. and Chinese import demand. On a positive note, Malaysia's advance estimate for GDP growth in 3Q2025 came in at 5.2%, well above Bloomberg's consensus forecast of 4.2%.

Short-term Outlook: Malaysian government bond yields are expected to remain stable or drift slightly lower, supported by ongoing global uncertainty. Heightened trade tensions between the U.S. and China continue to fuel safe-haven demand, and Malaysia is likely to benefit from increased foreign inflows into its bond market. The upcoming U.S.–China meeting in Malaysia, set to address the potential imposition of a 100% tariff on Chinese imports by November 1, is a critical event to watch. A failure to reach a diplomatic breakthrough could intensify global risk aversion, potentially driving Malaysian yields even lower as investors seek safety. On the other hand, any signs of easing tensions may reverse some safe haven flows and cause yields to rise modestly. Domestically, a benign inflation reading would reinforce expectations for BNM to maintain a neutral policy stance, further supporting bond prices.

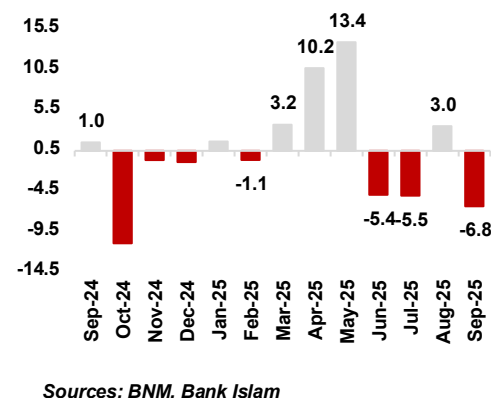
Foreign Flows into Local Bonds Market.

Malaysia recorded foreign portfolio outflows for the fourth consecutive month in September, as the local bond market saw net foreign outflows of RM6.8 billion (Aug: +RM3.0 billion), the largest in eleven months. The selloff was primarily driven by fading expectations of near-term interest rate cuts, alongside substantial bond maturities that weighed on reinvestment flows and reinforced cautious investor sentiment. Consequently, total foreign holdings of Malaysian debt securities fell further to RM287.3 billion in September from RM294.2 billion in August. MGS and GII recorded net outflows of RM3.7 billion (Aug: +RM2.8 billion) and RM2.7 billion (Aug: +RM461 million) in September, respectively. However, Malaysia Treasury Bills (MTB) and Malaysia Islamic Treasury Bills (MITB) were in the positive territory with net foreign inflows of RM21 million (Aug: -RM205 million) and RM34.4 million (Aug: +RM173 million) in September. Meanwhile, corporate bonds were in the negative region with net outflows of RM481 million (Aug: -RM199 million). Total foreign holdings' share to total outstanding in MGS remained at 34.6% in September. Corporate bonds lower at 1.9% of total outstanding in September. Meanwhile, GII dropped to 8.1% in September (Aug: 8.6%) and MITB lowered to 8.6% in September (Aug: 8.7%).

MGS Yield Curves, %



Foreign Fund Flows in Local Bond Market, RM Billion



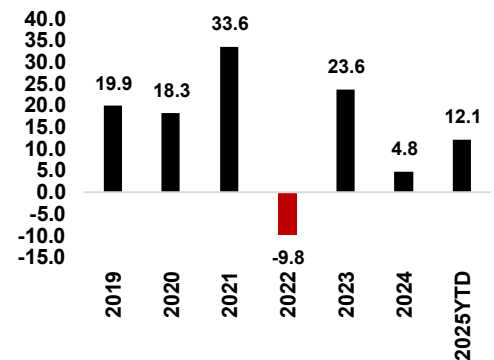
Of note, the percentage of foreign holdings to total outstanding in local govvnies bonds also declined at 21.6% in September. Overall, the foreign holdings' share of total outstanding dropped to 13.2% in September (Aug: 13.5%).

Total cumulative foreign holdings in the local bond market closed at RM12.1 billion as of September 2025 and lower relative to the cumulative net foreign inflows of RM18.7 billion from January to September 2024.

Short-term outlook:

Malaysia's bond market is expected to remain supported by steady demand, particularly as global investors adopt a more cautious stance amid persistent trade uncertainties. The outcome of the upcoming U.S.–China meeting in Malaysia will be a key driver of sentiment, with heightened geopolitical risks sustaining interest in safer assets such as Malaysian government bonds. Domestically, benign inflation and Bank Negara Malaysia's steady policy stance continue to anchor yields. Nonetheless, investors will be monitoring upcoming inflation data closely, as any indication of rising price pressures could alter monetary policy expectations and place upward pressure on yields.

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



Sources: BNM, Bank Islam