

Higher-for-Longer Global Rates, But No Automatic Malaysian Tightening Cycle

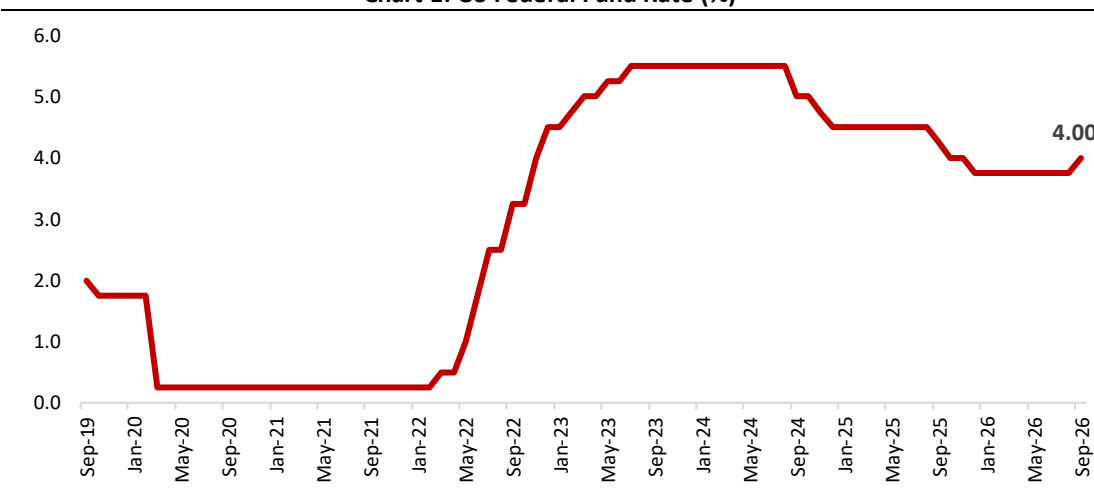
Key Takeaways

- The global interest-rate landscape has shifted towards a **higher-for-longer environment**, following the Federal Reserve's 25bps rate hike to 3.75%–4.00% and renewed concerns over inflation, energy prices and the U.S. fiscal outlook. The 10Y UST has approached the 5.0% threshold, reflecting not only tighter monetary policy but also a higher term premium and concerns over the sustainability of U.S. fiscal borrowing. Recent market developments suggest that the global rate floor is likely to remain higher than previously anticipated.
- Our house view is for the Fed to remain restrictive through 2026, with the Fed Funds Rate expected to end the year at **4.00%–4.25%**. While another 25bps increase remains possible, we do not expect an aggressive tightening cycle. For 2027, we expect the Fed Funds Rate to remain around **4.00%–4.25%**, reflecting a higher-for-longer policy stance rather than a rapid return to monetary easing.
- Accordingly, we revise our **10Y UST forecast to 5.00% by end-2026 and 4.60% by end-2027**. We expect the 10Y UST to remain elevated in the near term before gradually moderating as inflation pressures ease, although structural factors such as fiscal borrowing and term premium should prevent a return to the lower-yield environment of previous years.
- For Malaysia, the transmission should be more moderate. **We do not expect BNM to automatically follow the Fed higher.** Our house view remains for the OPR to stay at **2.75% throughout 2026 and 2027**, with an upward bias should inflationary pressures intensify materially and become broad-based. BNM has maintained the OPR at 2.75% throughout 2026 and continues to assess the current policy stance as consistent with price stability and sustainable growth.
- Consequently, we expect the adjustment in Malaysian rates to occur primarily through the **market-determined yield curve rather than the policy rate**. Shorter-tenor MGS yields should remain relatively anchored, while the 10Y segment will continue to carry a higher global term premium.
- Our revised **10Y MGS forecast is 3.90% by end-2026 and 4.00% by end-2027**, compared with the current 4.15% level. We expect the yield to remain around 4.0% in the near term before moderating towards year-end as expectations of an OPR hike are gradually unwound.

Global Rates: The Interest-Rate Floor Has Shifted Higher

- The recent bond-market repricing marks a significant change from the relatively benign global rates environment assumed earlier in the year.
- The Federal Reserve raised the federal funds target range by 25bps to 3.75%–4.00% on 16 September 2026, its first rate increase in more than three years. The move reflected the Fed's concerns over elevated inflation and the need to support a more timely return of inflation towards its 2% objective.

Chart 1: US Federal Fund Rate (%)



Source: Bloomberg, Bank Islam

- The latest Summary of Economic Projections also shows a relatively resilient US economy, with median real GDP growth projected at 2.3% in 2026 and 2.4% in 2027. The median federal funds rate projection is around 4.1% at end-2026 and end-2027.
- This suggests that the Fed is not positioning for a rapid return towards a low-rate environment. More importantly, the increase in long-term yields is not solely a function of the Fed Funds Rate.
- The 10Y UST has been pressured by:
 - persistent inflation concerns
 - higher energy prices
 - elevated term premium
 - increased US Treasury issuance
 - fiscal deficit concerns
 - greater uncertainty over the long-run neutral interest rate
- The 10Y UST briefly reached around 5.0% in September before retreating modestly, illustrating that the 5% threshold is no longer viewed as an extreme tail event.
- We therefore believe the global rate environment has undergone a structural upward adjustment in the rate floor, although the recent speed of repricing is likely to moderate.

Fed Outlook: Higher-for-Longer, But Not an Aggressive Tightening Cycle

- We expect the Fed to maintain a restrictive stance over the coming quarters.

Table 1: Fed Funds Rate Forecast (%)

	3Q26	4Q26	1Q27	2Q27	3Q27	4Q27
FFR	3.75-4.00	4.00-4.25	4.00-4.25	4.00-4.25	4.00-4.25	4.00-4.25

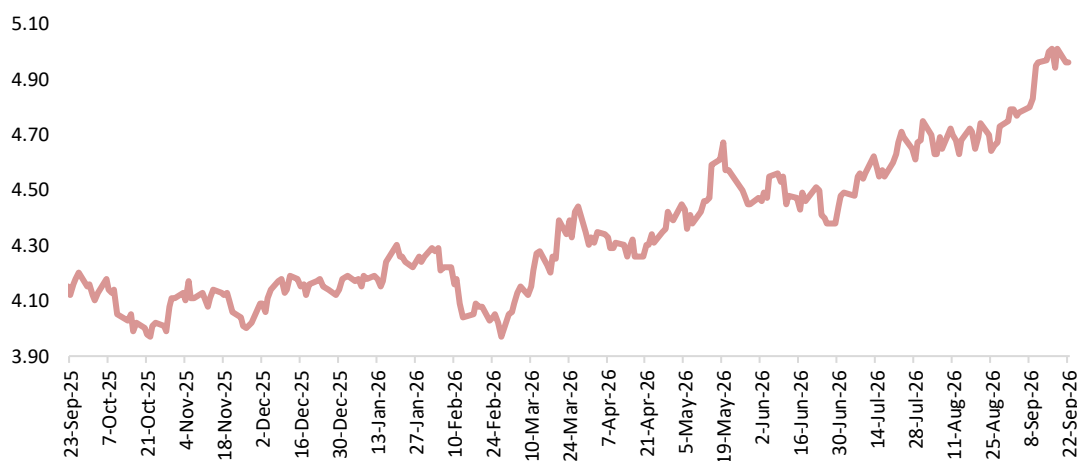
Source: Federal Reserves, Bank Islam

- Our base case incorporates **one additional 25bps hike in 4Q26**, although the timing remains dependent on inflation and energy prices.
- We do not incorporate a further increase in 2027 under the base case. Instead, we expect the Fed to remain on hold at a relatively high level while assessing whether inflation is returning sustainably towards target.
- The risk, however, remains skewed towards a more prolonged restrictive stance if:
 - energy prices remain elevated
 - inflation expectations become less anchored
 - wage pressures intensify
 - domestic demand remains stronger than expected
- Conversely, a material deterioration in the US labor market would provide scope for eventual easing.

10Y UST: 5.0% Becomes the New Reference Point

- The 10Y UST has become the key transmission channel for global financial conditions.
- The recent move towards 5.0% reflects a combination of Fed tightening expectations, inflation risk and fiscal concerns. Importantly, the rise has been relatively orderly rather than reflecting a disorderly market liquidation. Reuters reported that the 10Y UST reached 5.0% in September, while options-market indicators suggested investors were becoming more comfortable with elevated yields.

Chart 2: 10Y US Treasury Yield (%)



Source: Bloomberg, Bank Islam

- Our view is that the 10Y UST will remain elevated through the remainder of 2026.

Table 2: 10Y UST Forecast (%)

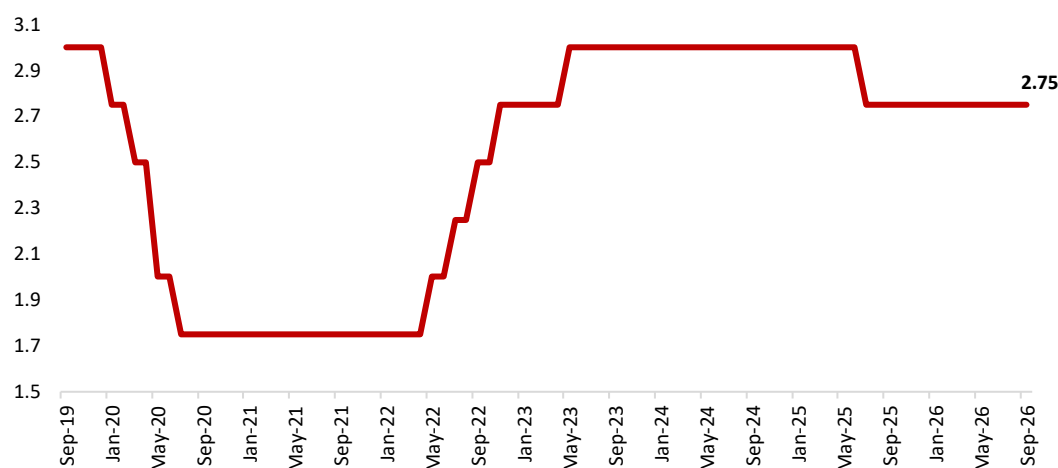
	3Q26	4Q26	1Q27	2Q27	3Q27	4Q27
10Y UST	4.90	5.00	4.85	4.75	4.65	4.60

Source: Federal Reserves, Bank Islam

- We expect the yield to peak around the 5.0% area in late 2026 before gradually moderating in 2027. However, the decline should be relatively gradual because the structural drivers of higher long-term yields, particularly fiscal borrowing and term premium, are unlikely to disappear quickly.

Malaysia: Domestic Fundamentals Provide a Buffer

- Malaysia is entering this global rate environment from a relatively strong domestic position. BNM has maintained the OPR at 2.75% at all five MPC meetings in 2026 to date. The latest September statement noted that the current policy setting remains consistent with price stability and sustainable economic growth.
- Malaysia's economy also remains resilient, with GDP growth of 6.0% in 2Q26 according to BNM's latest monetary stability indicators, while headline inflation was 1.8% in July. This provides some buffer against the global bond sell-off.
- The key distinction for Malaysia is therefore: **Higher US yields increase the required market risk premium, but do not automatically require a higher BNM policy rate.**

Chart 3: Malaysia Overnight Policy Rate


Source: Bloomberg, Bank Islam

BNM OPR: Hold at 2.75%, With an Upward Bias

- Our house view remains:

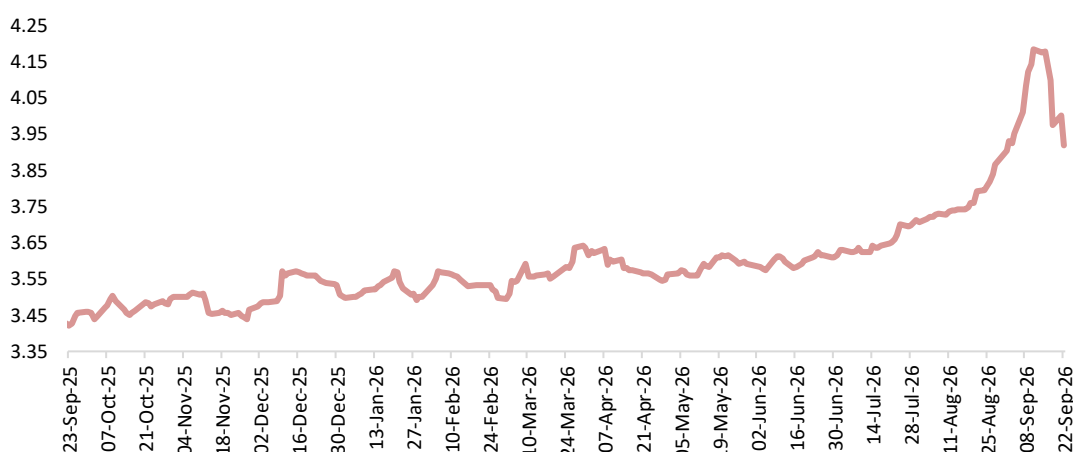
	2026	2027
OPR	2.75%	2.75%
Bias	upward	upward

- We expect BNM to remain on hold through 2026 and 2027.
- The rationale is straightforward:
 - Inflation remains contained** – While headline inflation increased marginally to 1.9% y-o-y in August (July: 1.8%), inflationary pressures remain broadly contained. In its latest statement, BNM highlighted that potential energy cost pass-through remains a key upside risk to the inflation outlook.
 - Growth remains resilient** - The economy continues to expand at a healthy pace, reducing the need for additional monetary support but also not creating an immediate need for monetary tightening.
 - The current OPR remains broadly appropriate** - BNM continues to view 2.75% as consistent with price stability and sustainable growth.
 - Cost-push inflation does not automatically warrant monetary tightening** - A temporary energy-price shock would be treated differently from persistent, broad-based domestic inflation.
- A 25bps OPR hike could therefore be considered if inflation becomes materially more broad-based, particularly if energy costs begin to generate second-round effects through wages, services and domestic demand.

MGS Outlook: Near-Term Elevated, Gradually Moderating

- The 10Y MGS yield reached **4.15% on 21 September 2026**, according to BNM's Financial Markets Information Platform. This represents a significant increase from our earlier forecast and reflects the global repricing in duration.

Chart 4: 10Y MGS Yield (%)



Source: Bloomberg, Bank Islam

- However, we do not expect the 4.15% level to become the permanent equilibrium. Our view is that the market has priced in a relatively aggressive path for domestic rates, while our house view remains that the OPR will stay at 2.75%.
- As these expectations are gradually unwound, we expect the 10Y MGS yield to moderate.

Table 3: 10Y MGS Forecast

	3Q26	4Q26	1Q27	2Q27	3Q27	4Q27
10Y MGS	4.05	3.90	3.95	4.00	4.00	4.00

- This path reflects three considerations.
 - Near-term global pressure remains** - The elevated UST yield means the MGS cannot rally aggressively even if BNM remains on hold.
 - Domestic policy expectations should provide support** - As markets become more comfortable with our expectation of a 2.75% OPR through 2027, the shorter and intermediate sections of the curve should stabilise.
 - The long end should remain structurally higher** - Even if the Fed eventually moves towards easing, the higher US term premium and fiscal concerns should keep the 10Y MGS yield from returning to the lower levels seen previously.

Shorter and Medium Tenors: More Stable Than the 10Y

- We expect the adjustment in Malaysian yields to be **non-parallel**, with greater pressure concentrated at the longer end.
- **3Y MGS** - The 3Y segment should remain relatively stable because it is closely linked to the expected path of the OPR.
- **5Y MGS** - The 5Y segment should carry somewhat more term premium than the 3Y but remain below the pressure experienced at the long end.

Table 4: Year-end House View (%)

Indicator	2026	2027
Fed Fund Rate	4.00-4.25	4.00-4.25
10Y UST	5.00	4.60
OPR	2.75	2.75
3Y MGS	3.50	3.45
5Y MGS	3.80	3.70
10Y MGS	3.90	4.00

Implications for Malaysian Fixed Income

- The main implication is that **the Malaysian yield curve should not be expected to move in parallel with the UST curve.**
- The front end should remain relatively anchored by the OPR at 2.75%, while the 10Y MGS will continue to incorporate a higher global term premium.
- This creates three distinct dynamics:
 - **Short end - relatively stable:** The absence of an OPR hiking cycle limits upside pressure on 3Y yields.
 - **Medium end - modestly elevated:** The 5Y segment will reflect both domestic monetary policy and global duration repricing.
 - **Long end - higher structural premium:** The 10Y MGS remains most exposed to UST yields, fiscal risk and global term premium.
- Therefore, even as we expect the 10Y MGS to moderate from 4.15% currently towards 3.90% by end-2026, we do not expect a return to the previous low-yield regime.

Risks to Our Forecast

- **Upside risk to yields** - The main risks to our yield forecasts are:
 - oil prices remaining elevated for longer
 - another Fed rate hike beyond our base case
 - US inflation proving more persistent
 - further deterioration in the US fiscal position
 - a sustained UST yield above 5%
 - Ringgit weakness and portfolio outflows
 - Malaysian inflation becoming more broad-based
- **Downside risk to yields - Conversely, yields could moderate faster if:**
 - geopolitical tensions ease materially
 - oil prices retreat
 - US inflation falls more rapidly
 - US growth weakens
 - the Fed signals eventual easing
 - foreign demand for Malaysian government securities strengthens

Conclusion

- The global rates environment has shifted towards **higher-for-longer**, but we do not see this automatically translating into a Malaysian tightening cycle.
- The Fed's latest 25bps hike to 3.75%–4.00%, combined with persistent inflation and fiscal concerns, supports our view that the **10Y UST will remain around 5% through end-2026 before moderating gradually to 4.60% by end-2027**.
- For Malaysia, however, the policy transmission should be different. **Our house view remains for BNM to keep the OPR at 2.75% through 2026 and 2027, with an upward bias rather than a base-case rate hike.** BNM's current assessment of contained inflation and sustainable growth provides room to remain on hold.
- Consequently, we expect the Malaysian yield curve to adjust unevenly. **3Y and 5Y MGS yields should remain relatively stable**, anchored by the unchanged OPR, while the **10Y MGS will continue to carry a higher premium because of global duration risk**.
- The key message is not that Malaysian rates are immune to global repricing, but rather that **higher global yields should be absorbed predominantly through the market yield curve, particularly the long end, rather than through an automatic increase in the BNM policy rate.**