Malaysia 2H26 FX and Fixed Income Outlook

A detour through the storm, same road ahead

SUMMARY

- **USD View:** The energy shock has delayed the timing of policy easing, but it does not alter our structural, medium-term bearish USD view. Reserve diversification, portfolio reallocation and concerns surrounding US fiscal sustainability should continue to weigh on the USD once markets fully price an extended Fed pause.
- **US Politics and Fed Communication:** The approaching US midterm elections raise policy uncertainty and increase the odds of divided government from 2027. Meanwhile, Chair Kevin Warsh's lighter use of forward guidance has made markets more sensitive to incoming data, keeping volatility elevated across rates and FX.
- **G10 FX View:** Relative policy divergence remains the key driver of G10 performance. The euro should gain from continued ECB tightening and eventual Fed easing, while higher carry underpins sterling near term. We expect the yen to strengthen gradually as the BoJ continues normalisation and the US-Japan yield gap narrows.
- **Ringgit View:** The ringgit remains one of the more resilient currencies in emerging Asia, backed by strong sovereign fundamentals, persistent current account surpluses, and Malaysia's position as a net energy exporter. Geopolitical developments may trigger episodic volatility, but **we expect USDMYR to appreciate gradually towards 3.95 by end-2026 and 3.90 by end-2027.**
- **US Treasury (UST) View:** Long-end yields should stay contained despite persistent near-term upside risks. Slowing growth and a softer labour market should cap further tightening, with disinflation becoming clearer in 2H26 as oil prices ease. **We expect the 10-year UST to trade around 4.30% into end-2026, before edging down to 4.25% in 2027 as Fed easing takes hold.**
- **Malaysian Bonds View:** A stronger ringgit strength and calmer global markets should support a recovery in foreign inflows. Stable demand should **anchor the 10-year MGS around 3.40% into end-2026, drifting modestly higher to 3.50% in 2027**. Persistent global rate pressure and heavier issuance will keep yields elevated, with domestic political risk ahead of the next general election a key uncertainty.
- **Malaysia's Debt View:** Statutory debt is expected to remain manageable, supported by policy discipline and steady revenue gains that keep the medium-term adjustment on track. Elevated subsidy spending will slow fiscal consolidation temporarily, but the underlying trajectory remains intact, with the **2026 deficit revised only modestly higher to 3.8% of GDP.**
- **Malaysia's Sovereign Credit View:** Upgrade prospects look unlikely before 2029 at the earliest, as fiscal consolidation and debt reduction need more time to show through. Political developments ahead of the general election could test policy continuity, making sustained reforms essential to reopening rating upgrade prospects.

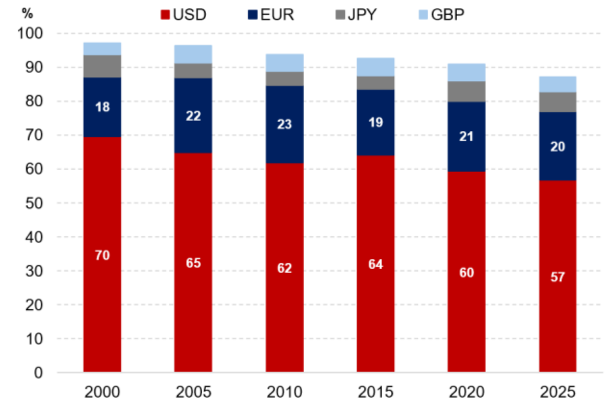
FX Outlook – 2H26

- **USD View: A Hawkish Detour, Not a New Destination**
  - The market's hawkish repricing, driven by the energy shock and the recent Fed leadership transition, does not change our structural medium-term USD view. Reserve diversification, portfolio reallocation and concerns over US fiscal sustainability continue to anchor our outlook.

– **The USD's share of global FX reserves has fallen to approximately 57.0%, its lowest level since the mid-1990s.** At the same time, the US fiscal deficit remains elevated at around 5.8% of GDP. Together, these factors point to gradual USD depreciation over the medium term, regardless of near-term policy timing.

– That said, gross long-term US securities purchases, based on Treasury International Capital (TIC) data, have stayed solidly positive all year. Most of the headline volatility traces back to banking-sector balance-sheet adjustments rather than a retreat from US assets. The slower-moving structural signal behind our medium-term USD view remains the separate, multi-year decline in the USD's reserves share, not any single month of TIC flows.

Graph 1: Currency Composition of Official Foreign Exchange Reserves



Source: IMF COFER Dataset, Kenanga Research

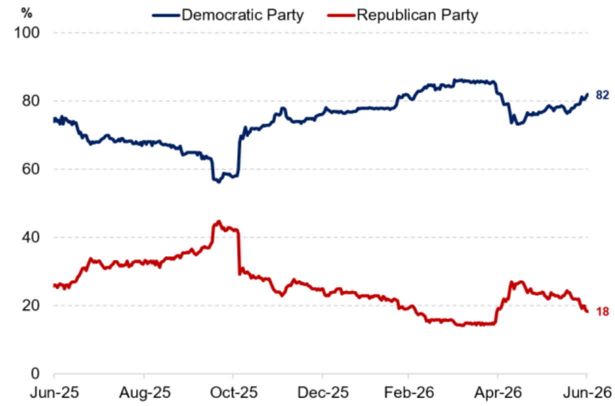
– As labour market conditions soften and geopolitical risks ease, **expectations of an extended Fed pause, rather than further tightening, should gradually unwind USD strength into 2027.**

- **US Midterm Elections: Policy Drift Rather Than Policy Shock**

– Current polling points to a meaningful probability of divided government after the 2026 midterms. The broader analytical consensus sees the House shifting away from unified Republican control, or at least seeing materially reduced margins, while the Senate map retains a modest structural lean toward the Republicans given the seats in play.

– While individual seat-level races remain highly uncertain, the market-relevant mechanism here is fiscal rather than partisan. **Divided government would likely reduce the probability of significant fiscal expansion**, which at the margin alleviates some of the medium-term concern around fiscal sustainability that anchors our structural USD view, though this is a modest offset rather than a reversal.

Graph 2: Which Party will Win the US House?



Source: Kalshi, Kenanga Research

– The election cycle nevertheless raises policy uncertainty through late 2026. Combined with elevated inflation expectations, this should reinforce a prolonged Fed pause and delay market conviction on eventual rate cuts.

- **The Fed at a New Crossroads**

– Federal Reserve Chair Kevin Warsh has shifted communication towards shorter statements and significantly reduced forward guidance. His first FOMC meeting on June 17 produced a unanimous 12-0 hold at 3.50–3.75%, but the statement was cut to 130 words, the easing bias was removed entirely, and Warsh abstained from the dot plot for the first time in Fed history, reinforcing his **preference for data-dependent policy over forward signalling.** The dot plot median moved to 3.8%, with nine of eighteen officials pencilling in a rate hike by year-end.

– The remaining half of the Committee continues to project a hold, leaving the outcome genuinely data dependent as US CPI printed 4.2% in May, its highest in over three years. With the Committee split on whether to act and the chair's own rate view deliberately absent from the grid, **incoming inflation and labour market prints now carry more weight in moving the curve.** We expect this to **keep volatility elevated across the front-end through 2H26.**

- **Geopolitics: Fragile Truce in the Strait of Hormuz**

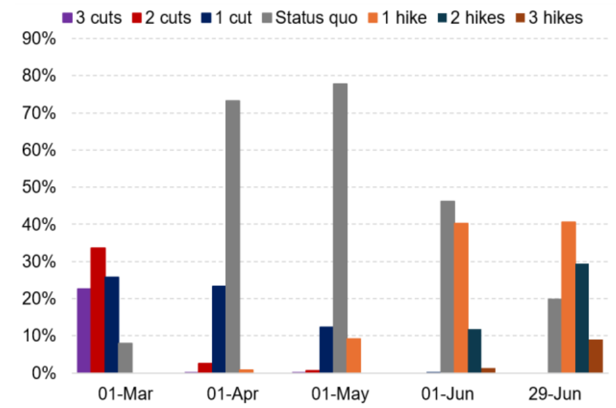
– Recent incidents show the ceasefire remains fragile. Even so, both sides retain strong incentives to preserve the agreement. Iran needs uninterrupted access to energy exports, while the US benefits from lower energy prices ahead of the midterms.

– We therefore **expect intermittent violations to persist without necessarily undermining the broader ceasefire framework;** isolated incidents are unlikely to derail it. However, a sustained pattern of escalation, rather than isolated incidents, would require us to reassess both our energy price path and the broader hawkish pivot unwind that underpins our 4Q26 views.

- **Selected G10 FX: Policy Divergence and Relative Value**

  – **EUR:** It is expected to remain supported in 2026 by relative ECB policy divergence, with the deposit rate staying elevated as the ECB prioritises inflation control amid lingering energy-related price pressures. We see EURUSD at **1.20 by end-2026**, reflecting still-restrictive financial conditions and subdued cyclical momentum across the Eurozone. Into 2027, as inflation converges more clearly towards target and the ECB begins easing, narrowing rate differentials versus the US and improved external balances should support further appreciation to around **1.25 by end-2027**.

Graph 3: Futures Market Expectations for Fed Funds Rate



Source: CME FedWatch, Kenanga Research

  – **GBP:** GBP is supported in 2026 by relatively high policy rates, which sustain carry attractiveness despite weakening growth momentum and persistent energy sensitivity for the UK's reliance on imported natural gas. We see GBPUSD at **1.35 by end-2026**, with gains capped by softening domestic activity and delayed policy easing. In 2027, as inflation pressures fade and the BoE turns more accommodative, gradual UK easing still leaves room for modest GBP appreciation. We see sterling at **1.38 by end-2027**, driven primarily by broad USD softness rather than strong domestic outperformance.

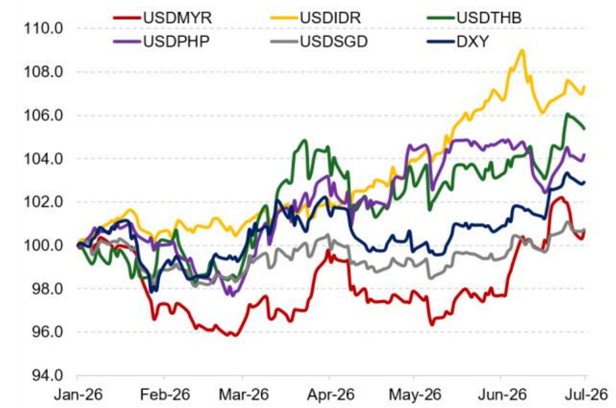
  – **JPY:** JPY remains structurally constrained in 2026, with USDJPY trading at elevated levels above 160.0 amid wide US–Japan yield differentials and persistent global carry demand for the USD. The BoJ continues gradual policy normalisation alongside firm wage growth, but the pace remains slow relative to global peers, limiting near-term yen appreciation. We see USDJPY at **150.0 by end-2026**, reflecting an eventual peak in USD strength as US growth slows and markets shift from "higher-for-longer" Fed narrative towards an extended pause. This move is less about an abrupt collapse in US yields and more about a gradual compression in real rate differentials, alongside reduced carry attractiveness at elevated USDJPY levels. Into 2027, continued but measured BoJ normalisation, combined with the start of Fed easing, should narrow US–Japan yield spreads further. At the same time, reduced incentives for leveraged carry positioning and a gradual improvement in Japan's income balance dynamics support modest yen appreciation. We see USDJPY at **145.0 by end-2027**, driven primarily by slow-moving portfolio reallocation.

- **MYR: A Steady Anchor, Tested but Intact**

  – **We expect USDMYR to trade within the 4.05-4.10 range in 3Q26** amid persistent geopolitical uncertainty before stabilising below 4.00 in 4Q26 as markets increasingly price an extended Fed pause rather than further tightening.

  – Our conviction doesn't depend on the exact timing or magnitude of Fed easing. Instead, it rests on a broader structural narrative: reserve diversification, portfolio reallocation and concerns over US fiscal sustainability, all pointing towards gradual USD depreciation over the medium term.

Graph 4: ASEAN-5 Currency Performance



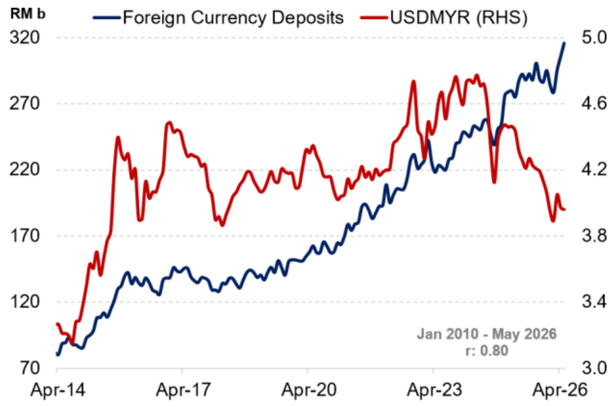
Source: Bloomberg, Kenanga Research

  – Malaysia's domestic fundamentals reinforce this view. It remains one of the few Single-A sovereigns in the region, benefiting from stronger credit metrics and favourable regulatory treatment. The World Bank and IMF's upward revision to Malaysia's growth outlook further reinforce the country's macroeconomic resilience.

  – **Foreign currency deposits reached a record RM316.0b in May,** representing substantial latent conversion potential should sentiment improve. Also, Malaysia's position as a net energy exporter provides an additional buffer during periods of elevated oil prices, supporting export receipts and terms of trade relative to regional energy importers.

- Malaysia continues to show relative defensive characteristics within emerging Asia, supported by persistent current account surpluses and stable macro fundamentals. We are not calling for a surge in inflows. Rather, we expect gradual ringgit appreciation supported by intermittent improvements in sentiment and portfolio positioning, consistent with our **end-2026 forecast of 3.95 and end-2027 forecast of 3.90.**
- The main downside risk remains domestic politics. Political developments could delay or cap the pace of ringgit appreciation near term. Even so, our medium-term appreciation view remains intact, provided domestic political developments do not materially undermine confidence in fiscal and policy continuity.

Graph 5: Foreign Currency Deposits and USDMYR



Source: Bloomberg, Kenanga Research

Table 1: Kenanga FX & Policy Rate Forecasts

Exchange Rate	End-2026	End-2027	Central Bank	End-2026	End-2027
DXY	97.0	94.0	**Fed**	3.75%	3.25%
EURUSD	1.20	1.25	**ECB**	2.50%	2.25%
GBPUSD	1.35	1.38	**BoE**	4.00%	3.25%
USDJPY	150.0	145.0	**BoJ**	1.25%	1.75%
USDCNY	6.70	6.50	**PBoC (1Y LPR)**	3.00%	3.00%
USDMYR	3.95	3.90	**BNM**	2.75%	2.75%
USDTHB	33.00	32.00	**BoT**	1.00%	1.00%
USDIDR	17,800	17,200	**BI**	6.25%	5.75%

Fixed Income Outlook – 2H26

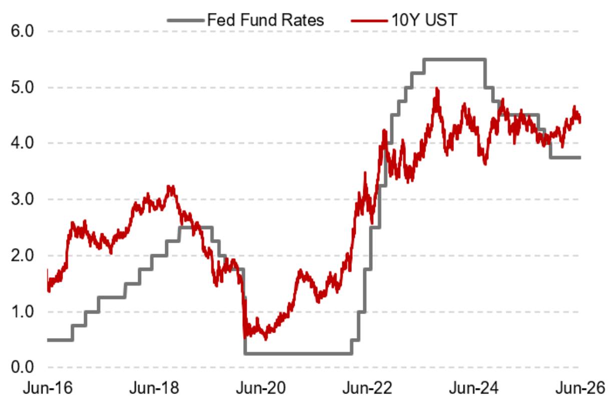
- **UST: Easing geopolitical tensions amid a hawkish Fed keep UST yields range-bound**
  - **Yield Curve Trend:** The UST curve continues to reprice unevenly as late-cycle forces dominate. Persistent inflation risks and a hawkish Fed have kept intermediate yields elevated, while softer labour market conditions and slowing growth continue to anchor the long-end. In turn, the compression in the spread highlights a divergence between elevated medium-term inflation risks and still-contained long-term expectations, consistent with a late-cycle environment shaped by geopolitical shocks, tightening financial conditions, and gradually weakening domestic demand.
  - **Yield Outlook:** Front-end yields should stay relatively elevated as markets continue to price a prolonged Fed pause and a higher-for-longer policy outlook. While US–Iran-related risks are likely to moderate gradually, the normalisation process is expected to be uneven, keeping energy-related price pressures

Graph 6: 10-2 Year and 30-10 Year Treasury Spreads

Source: Bloomberg, Kenanga Research

elevated near term. At the same time, structurally wide fiscal deficits and ongoing policy uncertainty should continue to support term premia, providing a floor to longer-dated yields. Even so, the long end is likely to remain relatively contained, with inflation expectations broadly anchored by credible policy. While near-term upside risks to yields persist, we see sustained tightening cycle as unlikely given the expected moderation in growth and gradual easing in labour market conditions. Disinflation should become more evident in 2H26, particularly as oil prices soften. Against this backdrop, we maintain **our 2026 year-end forecast for the 10-year UST yield at around 4.30%,** within a range-bound but still elevated environment. With continued disinflation momentum and the prospect of Fed easing into 2027, we expect the **10-year UST yield to edge slightly lower to around 4.25%.**

Graph 7: Fed Fund Rates vs 10-Y UST



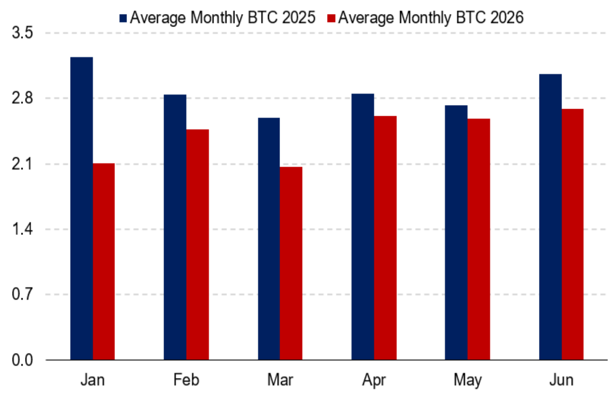
Source: Bloomberg, Kenanga Research

– We treat the current inflation overshoot as an energy-driven supply shock rather than a broad demand signal. With the Committee split roughly evenly on whether to act, and Warsh's own rate view deliberately unanchored from the grid, incoming CPI and PCE prints remain the swing factor. **A sustained re-acceleration in core inflation would be the primary trigger for us to revisit this call.**

- **MGS/GII: Sustained demand for local debt offsets higher issuances**

  – **Demand Conditions:** Year-to-date through May 2026, Malaysia's bond market recorded slower foreign inflows of RM4.1b, compared to RM26.9b over the same period in 2025, reflecting a more cautious and selective global investment environment. The moderation reflected a more cautious global investment environment amid geopolitical tensions, elevated oil prices and a more hawkish global rates backdrop. Even so, demand for Malaysian Government Securities (MGS) and Government Investment Issues (GII) stayed resilient, with the overall 1H26 average bid-to-cover (BTC) ratio holding at a still-healthy 2.42x, albeit lower than 2.88x in 1H25. Underlying support came from firm domestic macro fundamentals, consistent participation from long-term institutional investors, and a credible, well-anchored policy framework, all of which helped sustain market confidence despite heightened external headwinds.

Graph 8: Average Monthly BTC 1H25 vs 1H26



Source: Bloomberg, Kenanga Research

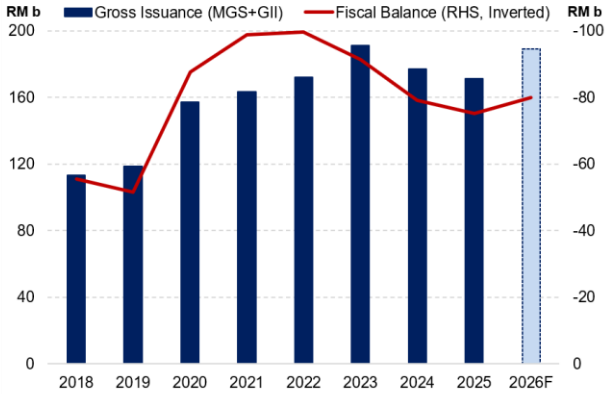
  – **Flows Outlook:** Geopolitical developments in the Middle East will remain the primary near-term driver of capital flows. While conditions are likely to stabilise gradually, the normalisation process is expected to be uneven. Foreign investors turned net sellers of Malaysian bonds in May, with net outflows of RM4.3b, but an early sign of reversal has since emerged in June, with **RM5.3b in net inflows recorded as of 25 June.** Malaysia remains relatively well-positioned, supported by resilient growth, contained inflation, stable sovereign ratings, and a predictable monetary policy framework, alongside deep domestic liquidity. An improving ringgit outlook should further support investor demand, with foreign inflows likely to recover as global volatility moderates.

  – **Yield Outlook:** Against this backdrop, we maintain our year-end forecast for the **10-year MGS yield at around 3.40%**, reflecting a stable but cautious rate environment. Looking further ahead to 2027, **we expect local yields to edge higher towards 3.50%** as increased domestic issuance requirements and still-elevated global term premia keep local yields structurally higher despite the onset of expected Fed easing. That said, the main risk remains domestic political developments, where heightened uncertainty could temporarily disrupt sentiment and delay the pace of yield normalisation near term.

  – **Broader investor participation:** Foreign participation remains concentrated in conventional government bonds, with **MGS holdings at 33.6% compared to just 6.6% for GII as of May.** This structural gap persists but remains manageable, given the depth of domestic liquidity and strong participation from local institutional investors, particularly within the Islamic investor base. From a strategic standpoint, **further development of the GII and broader sukuk segment remains a key policy priority.** This includes enhancing global recognition and standardisation of GII, deepening the availability of Shariah-compliant hedging and risk management tools, and improving secondary market liquidity to facilitate more efficient price discovery and investor access. Issuance structures could also evolve to better align with international investor preferences, including more flexible, investor-friendly frameworks.

– **Supply Conditions:** On the supply side, we project full-year gross MGS and GII issuance to edge higher to around RM189.0b in 2026 (2025: RM168.5b), up from RM186.0b previously. This largely reflects elevated refinancing needs from maturing securities of RM109.0b, alongside a modestly wider fiscal deficit. Although the deficit is projected to rise marginally to 3.8% of GDP from 3.7% in 2025 (MoF: 3.5%), issuance should remain primarily driven by rollover requirements rather than a material expansion in new borrowing. This points to a continued focus on funding stability while balancing fiscal consolidation objectives. Nonetheless, sustained progress on fiscal reforms and revenue raising measures will remain important to support investor sentiment and manage potential upward pressure on yields amid a still-heavy issuance calendar.

Graph 9: MGS/GII Issuances and Fiscal Balance



Source: Bloomberg, Kenanga Research

– **Debt Headroom:** Statutory debt is estimated at around RM1.34t as of May 2026, leaving an adequate fiscal buffer of about RM46.5b. **At 62.8% of GDP, debt levels remain comfortably below the 65.0% limit, providing ample headroom of roughly 2.2%.** Short-term instruments are well managed, with Treasury Bills at RM5.0b, well below the RM10.0b cap, while external borrowings of RM20.8b remain well within the RM35.0b threshold. Looking ahead, statutory debt is projected to stay within the projected RM1.39t limit in 2026, underpinned by disciplined fiscal management, steady economic expansion and continued progress on revenue strengthening measures, reinforcing confidence in Malaysia's fiscal position and policy credibility.

Table 2: Debt Headroom

		RM bil latest	limit	balance
Offshore borrowing	1Q26	20.8	35.0	14.2
Malaysian Treasury Bills (MTB)	May-26	5.0	10.0	5.0
Statutory (MGS, MGII, MITB)	May-26	1,340.7	1,387.2	46.5
Statutory (% of GDP)	May-26	62.8%	65.0%	2.2%
Total:		**1,366.5**	**1,432.2**	**65.7**

Source: BNM, Macrobond, Kenanga Research

– **Fiscal outlook:** Fiscal policy is expected to remain moderately expansionary, with the **2026 deficit projection revised slightly higher to 3.8% of GDP from 3.7% in 2025, compared to the earlier forecast of 3.6%.** This reflects the continued cost of subsidy measures such as recent diesel support under the Budi Madani framework. These measures provide necessary near-term relief but add to fiscal commitments. The upward revision is only marginal, however, partly cushioned by elevated oil prices, which have supported higher PETRONAS-related revenues. These dividends help bolster government revenues and could offset fiscal pressures arising from ballooning subsidies and external shocks. At the same time, the ongoing shift toward more targeted schemes like BUDI95, alongside gradual subsidy rationalisation, should help contain spending pressures over time. Complementary efforts to improve transparency and efficiency, including the rollout of the Government Procurement Act, further reinforce fiscal discipline, though their effectiveness will hinge on consistent implementation.

– **Federal Vs. Statutory debt:** It is worth distinguishing statutory debt from the broader concept of total Federal Government debt, which also includes offshore borrowings and Treasury Bills on top of the statutory instruments above. Each component carries its own legislative ceiling rather than being measured against a single combined limit, so Federal debt occasionally breaching the 65.0% statutory threshold is not uncommon. On this broader basis, Federal debt is expected to edge up to around RM1.43t, equivalent to 65.7% of GDP in 2026, from 65.3% in 2025. While the increase appears moderate, it points to a gradual upward trend that warrants continued monitoring. Maintaining debt sustainability will depend on sustained progress in revenue mobilisation and prudent expenditure management, and the government's ability to balance growth support with fiscal consolidation. Refinancing risks remain manageable for now, but preserving investor confidence will likely require consistent policy discipline and clear medium-term fiscal direction.

– **Malaysia Sovereign Rating:** Malaysia's sovereign credit profile is expected to remain stable through 2026, supported by ongoing structural reforms and a broadly stable policy environment, even as the government balances fiscal consolidation with socio-economic priorities. Current ratings of A3/Stable (Moody's), A-/Stable (S&P), and BBB+/Stable (Fitch) remain well anchored by these fundamentals, though external uncertainties and moderating global growth may limit near-term upside. **A potential upgrade is expected by 2029 at the earliest,** reflecting the need for sustained fiscal consolidation, a clearer reduction in the debt-to-GDP ratio, and continued growth resilience. The general election, which must be held by February 2028, introduces a degree of political uncertainty, particularly around policy continuity and reform momentum. While structural tailwinds such as the ongoing technology export cycle and AI-related demand continue to support growth, rating upside will ultimately depend on consistent reform execution, fiscal discipline, and political stability over the medium term. Positive outlook revisions from Fitch and S&P would likely require clearer post-election policy continuity and durable macro-fiscal improvement.

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