

Bond Market Outlook

Emerging East Asia's bond markets were volatile due to rising global concerns over the unresolved Greek debt crisis and possibility of an interest rate hike in the United States (US).¹ Global interest rates, which had been falling up until April, started picking up in early May. Contributing factors to the recent increases include protracted negotiations over the Greek debt crisis, firmer oil prices, improving economic indicators in the US in April–May, and faster 1Q15 GDP growth in the eurozone. As a result, the region's bond yields have also moved upward since the beginning of May.

Exchange rates in emerging East Asia have weakened, with the US dollar gaining strength over most of the region's currencies between 2 March and 5 June. The currencies of Thailand and Indonesia depreciated the most, falling 4.8% and 2.5%, respectively. Most of the region's other currencies also weakened against the US dollar over the same period. The exceptions were the currency of the People's Republic of China (PRC), which gained 1.1%, and the currencies of Hong Kong, China; and Singapore, which were broadly unchanged.

Risks to the region's bond markets are rising and include (i) a sudden US rate hike triggering volatility in the region's bond markets; (ii) the lack of liquidity in the region's bond markets and the increasing popularity of Exchange-Traded Funds could also worsen volatility; and (iii) higher US interest rates could strengthen the dollar, hurting issuers of foreign currency bonds and increasing payments on existing US dollar bonds.

LCY Bond Market Growth in Emerging East Asia

The local currency (LCY) bond market in emerging East Asia continued to expand in 1Q15 to reach US\$8.3 trillion at end-March. Growth, however, moderated on both a quarter-on-quarter and year-on-year (y-o-y) basis. The region's government bond market reached a size of US\$4,952 billion in 1Q15,

accounting for 59.9% of emerging East Asia's total bond stock. The corporate bond market, with an outstanding size of US\$3,320 billion at end-March, accounted for 40.1%.

The three largest bond markets in the region were those of the PRC, the Republic of Korea, and Malaysia. The PRC led the region in terms of size for both government and corporate bonds. Malaysia is home to the largest *sukuk* (Islamic bond) market in the region, with more than half of its LCY bond stock comprising *sukuk* at end-March.

As a share of gross domestic product (GDP), the size of emerging East Asia's bond market was broadly unchanged, accounting for a 57.7% share in 1Q15 and a 57.6% share in 4Q14. The Republic of Korea had the highest ratio of bonds to GDP in 1Q15 at over 100%, followed by Malaysia with a share of 96.0%.

LCY bond issuance in emerging East Asia totaled US\$924 billion in 1Q15, down from US\$1,032 billion in 4Q14 but up from its level in 1Q14.

Structural Developments in Emerging East Asia's LCY Bond Markets

Foreign investor interest in LCY government bonds remained upbeat for select emerging East Asian markets despite the US dollar gaining strength against most of the region's local currencies. The share of foreign holdings in Indonesia and Malaysia continued to climb, with over 30% of government bonds in both markets held by foreign investors at end-March.

The corporate debt holdings of foreign investors in 1Q15 remained miniscule compared with their holdings of government bonds. Foreign holdings of corporate debt in Indonesia only accounted for 10.5% of the total corporate bond stock at end-March, while the share was a negligible 0.3% in the Republic of Korea.

Foreign capital flows into emerging East Asia's LCY bond market have climbed since the beginning of the year, with foreign investors shoring up their bond holdings despite uncertainty over the timing of a US interest rate hike. Among the four markets providing data on capital

¹ Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.

flows, Malaysia recorded the largest inflow year-to-date, as appetite for MYR-denominated securities significantly improved in March and April.

LCY Bond Yields

Bond yields in the US and the eurozone began rising in early May. The US Federal Reserve indicated that economic weakness in 1Q15 was partially due to transitory factors such as unusually cold weather and a labor dispute at West Coast ports. Recent economic data support this assessment, including an improvement in nonfarm payroll growth in April. In the eurozone, GDP growth rose to 1.0% y-o-y in 1Q15 from 0.9% y-o-y in 4Q14. Oil prices have also firmed in recent months, leading to rising inflation expectations.

Between 2 March and 5 June, emerging East Asia's LCY government bond yields rose at the long-end of the curve for all markets except the Philippines, while yields at the short-end were driven mostly by differences in inflation and policy rate movements. In Indonesia, the rise in yields was driven by increasing inflation expectations as firmer oil prices and the removal of oil subsidies were expected to drive inflation higher. In Malaysia, rising inflation had the opposite effect, with most yields falling, particularly at the short-end of the curve.

In Viet Nam, yields rose as the central bank devalued the Vietnamese dong on 7 May rather than adjust policy rates to stimulate the economy. In the Philippines, the yield curve rose for the majority of tenors as the market does not expect the Bangko Sentral ng Pilipinas to reduce policy rates this year.

In the PRC, the Republic of Korea, and Thailand, yields at the short-end of the curve fell and yields at the long-end rose. In the PRC, yields on bonds with shorter tenors declined following the People's Bank of China's policy rate reductions in March and May. In the Republic of Korea, yields fell at the short-end of the curve following the central bank's policy rate reduction in March. In Thailand, yield declines at the short-end of the curve were the result of accelerated deflation, while higher yields at the long-end were due to a better GDP outlook and long-term inflation expectations.

Yields rose for most tenors in Hong Kong, China and for all tenors in Singapore as both markets closely track

US interest rate movements due to the nature of their exchange rates, which do not float freely in response to market movements.

Special Section: Bond Financing for Renewable Energy

Increased diversification of energy sources away from fossil fuels and toward renewable energy is required to sustainably meet the growing energy needs of Asia. However, a lack of financing is constraining the wider adoption of renewable energy.

Multilateral development banks, governments, and the private sector are potential financiers for renewable energy projects. However, the public sector can only meet a small portion of the financing needs. While Asia has long been reliant on the banking sector to fund investment projects, the adoption of Basel III regulations will make long-term and risky lending less attractive.

Given the large pool of investable funds in Asia, the growing appeal of developing economies as an investment destination, and heightened interest in renewable energy investments, bond financing is becoming increasingly popular.

Total bonds issued by renewable energy corporations have increased from US\$5.2 billion in 2010 to US\$18.3 billion in 2014. Asia has been leading the way in the use of such bonds, with the PRC accounting for a huge chunk of the region's renewable energy sector bond issuance.

Green bonds have also taken off in recent years, supported by growing investor interest in adhering to environmental, social, and governance criteria. In 2014, total issuance of global green bonds reached US\$30.5 billion, more than double the amount in 2013.

Several policy challenges need to be overcome to meet the financing needs for renewable energy. Governments play a key role in formulating and implementing policies that promote the development and adoption of renewable energy. As renewable energy projects tend to have cost disadvantages compared to conventional energy projects, guarantees and dedicated funds can be used to help reduce these disadvantages. Narrowing the information gap for lenders interested in investing in renewable energy would also be beneficial.