

## Bond Market Outlook

Emerging East Asia's bond markets remained relatively unaffected as global financial market turmoil impacted other emerging markets in 3Q14.<sup>1</sup> A weaker global economic outlook combined with the end of quantitative easing in the United States (US) has generated increased volatility in financial markets, particularly currency markets. Amid elevated market uncertainty, the US dollar has appreciated on the back of a relatively stronger economic performance in the US and an expected rise in interest rates as quantitative easing ends.

Emerging East Asian 10-year bond yields generally exhibited a downward trend between July and October. Viet Nam's 10-year bond yields dipped the most, dropping 235 basis points (bps) on lower inflation. Other economies with large declines in 10-year bond yields were the Republic of Korea, Thailand, and the People's Republic of China (PRC), where yields fell 51 bps, 48 bps, and 26 bps, respectively. On the other hand, 10-year bond yields in the Philippines rose 10 bps amid elevated inflation.

Most of the region's currencies weakened against the US dollar between July and October. The Korean won experienced the largest decline, depreciating 5.7% against the US dollar. Currencies in Singapore and the Philippines depreciated 3.2% and 2.9%, respectively. In contrast, the PRC and Viet Nam saw the value of their currencies strengthen 1.4% and 0.2%, respectively.

The risks to the region's local currency (LCY) bond markets are rising, including (i) tightening liquidity in the region's corporate bond market; (ii) a weaker property market in the PRC that might limit the ability of some property companies to service debt obligations; and (iii) an earlier-than-expected rate hike in the US that could raise borrowing costs and lead to the further appreciation of the US dollar.

## LCY Bond Market Growth in Emerging East Asia

The LCY bond market in emerging East Asia continued to expand in 3Q14, reaching US\$8.2 trillion at end-September. Government bond markets accounted for about 60% of the total at US\$4.9 trillion, representing an increase of 3.2% quarter-on-quarter (q-o-q) and 11.3% year-on-year (y-o-y). LCY corporate bonds outstanding reached US\$3.3 trillion at end-September on growth of 2.9% q-o-q and 11.3% y-o-y.

The PRC's bond market remained the largest in the region in 3Q14, accounting for 63% of the total market at end-September, followed by the Republic of Korea and Malaysia.

As a share of gross domestic product (GDP), the size of emerging East Asia's LCY bond market was broadly unchanged at 59.4% in 3Q14, compared with 59.2% in 2Q14. In 3Q14, the Republic of Korea and Malaysia had the highest ratios of bonds to GDP at 119.9% and 102.1%, respectively. In contrast, Indonesia (15.3%), Viet Nam (20.9%), and the Philippines (37.0%) had the smallest shares of bonds to GDP in emerging East Asia.

## Structural Developments in LCY Bond Markets

The shares of foreign holdings in LCY government bond markets have been generally stable across emerging East Asia, except in Indonesia and Malaysia. In Indonesia, the share of foreign holdings in the LCY government bond market climbed to 37.3% at end-September from 35.7% at end-June. In Malaysia, foreign holdings as a share of the total LCY government bond market rose to 32.0% at end-June from 30.8% at end-March.

The shares of foreign holdings in LCY corporate bond markets pale in comparison with those in government bond markets in Indonesia and the Republic of Korea. The share of foreign holdings in the LCY corporate bond market in Indonesia rose 1 percentage point in 3Q14 to 8.8%, while the share remained negligible in the Republic of Korea at less than 1% in 2Q14.

<sup>1</sup> 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.

In September, net foreign capital flows in bond markets in select emerging East Asian economies remained positive, but at smaller amounts compared with previous months.<sup>2</sup> Indonesia is the only market where foreign capital flows have been consistently positive in 2014, reflecting the rising share of foreign holdings in the LCY government bond market.

## LCY Bond Yields

LCY government bond yields fell in most markets in the region between end-June and end-October. In some of the region's more developed markets (Singapore and Hong Kong, China), the fall in yields tracked US interest rate movements, while in other markets such as the PRC, the Republic of Korea, and Thailand, yields fell mostly due to slowing inflation. In the case of the Philippines, the yield curve's performance was mixed, falling at the longer-end as inflation expectations moderated. In Indonesia, the fall in yields was driven by expectations of a reduced supply of bonds in 4Q14.

The 2-year versus 10-year spread narrowed in most markets due to (i) much larger declines in longer-dated yields that tracked falling US yields, and (ii) the influence of easing inflation.

## Special Section: *AsianBondsOnline* Bond Market Liquidity Survey

*AsianBondsOnline* conducts an annual bond market liquidity survey to provide market participants and policy makers with a comprehensive view of liquidity conditions in individual markets in emerging East Asia. The 2014 survey was undertaken through interviews and email questionnaires conducted in July–September.

LCY bond markets in emerging East Asia remained resilient, with most market participants noting improving liquidity conditions in 2014 compared with 2013. This finding was validated by our quantitative survey results as average bid–ask spreads for both government and corporate bond markets were lower this year compared with the previous year's survey. At the same time, liquidity in corporate bond markets continued to lag government markets.

Market participants identified greater investor diversity as the most important structural issue as it relates to deepening liquidity in both government and corporate bond markets. The relative importance of greater diversity of the investor profile vis-à-vis other structural issues appears driven by the presence of a few investor groups that continue to dominate emerging East Asia's LCY government bond markets.

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<sup>2</sup> Foreign capital inflows were assessed in Indonesia, the Republic of Korea, Malaysia, and Thailand.