Asia Bond Monitor Highlights

ADB

Bond Market Outlook

Emerging East Asia's bond markets have seen rising yields as investors shift away from emerging markets.[1] Weaker growth and depreciating currencies have combined to make emerging market bonds less attractive to investors. Bond yields in advanced economies have remained broadly stable, with inflationary pressures muted amid hesitant economic recoveries. Falling oil prices have further dampened inflationary pressures.

The brighter economic outlook in the United States (US) suggests that the Federal Reserve could be poised to raise interest rates as early as September. However, recent weakness in developing economies and declining oil prices may make the Federal Reserve more cautious in raising interest rates.

Movements in 10-year local currency (LCY) government bond yields in emerging East Asia were mixed between 1 June and 14 August. While stock markets have experienced large losses, bond prices in several economies have held up. In the People's Republic of China (PRC) and the Philippines, bond yields have even fallen. On the other hand, Indonesian, Malaysian, and Vietnamese bond markets experienced large increases in yields. Both Indonesia and Malaysia have a large foreign investor share in their bond markets and therefore are exposed to the shift in investor preferences away from emerging markets.

Currencies across the region depreciated against the US dollar between 1 June and 14 August. The only exception was Hong Kong, China, whose currency is pegged to the US dollar. The People's Bank of China (PBOC) moved to make the Chinese renminbi more market-oriented, resulting in a fall of 3.1% in the currency's value against the US dollar during the period under review. Among the region's currencies, the Malaysian ringgit experienced the largest depreciation at 10.7%, followed by the Korean won at 6.3% and the Thai baht at 4.5%.

The possibility of the Federal Reserve raising interest rates and a shift in preferences away from emerging market assets have combined to increase the risks for the region's bond markets, given that (i) outflows of funds from the region could be destabilizing to the region's bond markets, (ii) further depreciations of the region's currencies could weaken corporates with large amounts of foreign currency bonds outstanding, and (iii) lower commodity prices could adversely affect highly leveraged companies in the commodity sector.

[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.

LCY Bond Market Growth in Emerging East Asia

The size of emerging East Asia's LCY bond market rose to US$8,625 billion at end-June, with growth accelerating on both a quarter-on-quarter and year-on-year basis in 2Q15 compared with the previous quarter. Five out of the nine emerging East Asian markets recorded faster quarter-on-quarter growth in 2Q15—the PRC, the Republic of Korea, Malaysia, Singapore, and Thailand—while all markets in the region exhibited positive year-on-year growth.

The PRC was the largest LCY bond market in emerging East Asia at the end of June with outstanding bonds worth US$5,590 billion, followed by the Republic of Korea at US$1,756 billion. The third largest bond market in the region was Malaysia at US$285 billion, more than half of which comprised *sukuk* (Islamic bonds), making it the largest *sukuk* market in the region.

The value of emerging East Asia's LCY bonds outstanding as a share of gross domestic product (GDP) climbed to 59.5% at end-June from 57.7% at end-March, buoyed by an increase in the size of government bonds relative to GDP. The Republic of Korea posted the highest bonds-to-GDP share at 129.8%, followed by Malaysia (95.3%), Singapore (82.5%), and Thailand (72.3%).

LCY bond issuance in emerging East Asia climbed to US$1,423 billion in 2Q15 from US$958 billion in 1Q15, led by greater bond issuance activity in the PRC; Hong Kong, China; and the Republic of Korea.

Structural Developments in Emerging East Asia's LCY Bond Markets

Foreign investors' share of the Indonesian LCY government bond market rose to 39.6% at end-June from 38.6% at end-March, induced by higher yields. Similarly, foreign holdings of LCY government bonds in Malaysia increased to 32.4% at end-June from 30.1% at end-March, while foreign holdings of LCY government bonds in Thailand slid to 16.5% from 17.3% in the same period. Meanwhile, the foreign investor shares of the LCY government bond markets in Japan and the Republic of Korea have remained relatively constant.

In LCY corporate bond markets, foreign investors' share in the Indonesian market fell to 9.5% at end-June from 10.5% at end-March, while in the Republic of Korea, foreign investors account for a negligible 0.2% of the total.

In July, LCY bond markets in Indonesia, the Republic of Korea, and Malaysia experienced net foreign capital outflows, influenced partly by expectations of an interest rate hike in the US. In contrast, Thailand's LCY bond market posted net foreign capital inflows in the same month.

LCY Bond Yields

The majority of emerging East Asian LCY bond yields rose between 1 June and 14 August on the back of heightened expectations that the Federal Reserve would raise interest rates.

Yields in Hong Kong, China and Singapore rose for most tenors, as both markets typically track US market movements owing to the nature of their monetary policies. In Indonesia, rising inflation, due to currency depreciation and the removal of fuel subsidies, resulted in a rise in all yields except for the 1-year tenor. In Malaysia, lower global oil prices, ringgit depreciation, and higher inflation drove yields upward.

In other emerging East Asian markets, yields fell on lowered growth outlooks as the region's governments sought to boost growth by easing monetary policy. The entire yield curve of the Republic of Korea and Thailand shifted downward. The Republic of Korea reduced its policy rates by 25 basis points (bps) in June to 1.50%. In Thailand, policy rates were kept unchanged in 2Q15, but the central bank emphasized the need to keep monetary policy accommodative to spur demand and move away from deflation. In the PRC, yields fell at the longer-end of the curve as the PBOC implemented a number of monetary easing measures to stimulate growth. In the Philippines, yields fell for most tenors on the back of easing inflation. In August, the central bank kept policy rates unchanged, citing a benign inflation outlook in the short-term.

Special Section: *Sukuk* Developments in Emerging East Asia

Emerging East Asia's *sukuk* (Islamic bond) market held firm despite headwinds from challenging developments in the global economy. The region's *sukuk* market managed to post modest growth in the first half of the year amid uncertainties surrounding an anticipated interest rate hike by the Federal Reserve and, more importantly, falling oil prices that affected oil-rich producing markets who are active participants in Islamic financial markets. Growth was largely driven by *sukuk*'s rising acceptance as an important source of financing as demand for infrastructure funding continues to grow and interest from nonmainstream *sukuk* markets begins to advance.

The outstanding amount of *sukuk* in emerging East Asia reached US$186.3 billion at end-June, compared with only US$59.9 billion at the end of 2008, representing a compounded annual growth rate of 19.1%. The region's *sukuk* market was up 6.0% from US$175.9 billion at end-December 2014. At the end of June, emerging East Asia's outstanding government *sukuk* reached US$89.2 billion and corporate *sukuk* stood at US$97.2 billion.

Malaysia is home to the largest *sukuk* market in emerging East Asia and the entire world, accounting for an 86.5% share of the region's total *sukuk* stock at end-June. It was followed by Indonesia with a share of 11.1%, while all other emerging East Asian markets (Brunei Darussalam; Hong Kong, China; Singapore) had a combined 2.3% share. The region's outstanding *sukuk* were largely denominated in Malaysian ringgit, with an equivalent value of US$154.9 billion, representing an 83.1% share of the total stock.

Sukuk issuance in emerging East Asia declined to US$78.5 billion in 2014 from highs of US$89.7 billion in 2012 and US$79.5 billion in 2013. While still robust, issuance volume has been on a downtrend since the 2013 "taper tantrum" when emerging markets experienced large capital outflows in response to statements from the Federal Reserve that it planned to wind down its monthly asset purchases. In the first half of 2015, total *sukuk* issuance volume in emerging East Asia reached US$26.9 billion.