# Global and Regional Market Developments

Emerging East Asian bond markets have regained their bounce as they shrugged off the impact of ongoing tapering by the United States (US) Federal Reserve.[2] In the first 4 months of 2014, the Federal Reserve reduced its monthly purchase of securities by US$30 billion to US$45 billion per month. While the US economy barely grew in 1Q14, this did not affect the Federal Reserve's planned tapering as the meager growth was mainly attributed to temporary winter weather conditions. The US economy is expected to pick up in the coming months as consumers catch up on their spending. Hence, the tapering is expected to proceed as planned until phasing out in October, which will likely contribute to tighter liquidity for the region's bond markets in the coming months. However, markets have mostly taken into account the planned tapering and the region's bond yields have barely reacted to the recent cutback in purchases of securities by the Federal Reserve.

In fact, bond yields have fallen in some of the region's economies. The fall reflects reduced risk premiums as global investors regain their risk appetite. Asia was not the only beneficiary of this trend, yields have fallen in the eurozone's peripheral economies as well. The decline in yields was due to a reassessment of risk following the strong reaction by investors last year to the Federal Reserve's initial tapering announcement. Economic fundamentals in the region remain sound despite some moderation in the expected growth rates. Investors are also comforted by generally low levels of foreign debt and increased reliance on domestic currency debt financing. Further, the improving economic outlook in both the US and eurozone should provide a boost to the region's exports.

Bond yields in the US declined in the first 4 months of 2014. While the tapering of quantitative easing operations was expected to push up bond yields, the weak economic growth in 1Q14 due to harsh winter weather may have held back any increases. Heightened geopolitical tensions also could have contributed to investors purchasing more US Treasuries as a safe-haven asset. Nevertheless, expectations are that bond yields will start rising as the US economy gathers pace.

Asian bond markets staged a recovery in the first 4 months of the year as yields for most of the region's economies fell between 1 January and 30 April **(Table A)**. Among the region's economies, Indonesian bond yields had the largest decline, falling 43 basis points (bps). This was closely followed by declines of 35 bps and 33 bps for 10-year bond yields in Thailand and Viet Nam, respectively. Bucking the trend, Philippine bond yields rose 55 bps during the period as investors expect that the monetary authority, Bangko Sentral ng Pilipinas (BSP), will soon raise policy rates to counter rising prices.

Over the same period, most of the region's currencies gained against the US dollar. The Indonesian rupiah appreciated 5.0%, the most among all emerging East Asian economies, as policy actions helped stabilize the Indonesian economy and investors returned. On the other hand, the renminbi declined 3.4% between 1 January and 30 April after a long period of growing strength against the US dollar. One explanation is that the People's Bank of China (PBOC) is pursuing a weaker renminbi to deter excessive capital inflows into the country. The renminbi had been an attractive currency for the long-end of the carry trade, with interest rates in the People's Republic of China (PRC) much higher than those in the US. As long as the renminbi is appreciating, this is a profitable trade. The recent depreciation could help reduce speculative inflows by demonstrating that the renminbi is no longer a one-way appreciation bet.

As mentioned above, investors' risk appetite has returned as global financial markets recover from the turmoil of the introduction of US tapering last year. The region's financial markets have also benefitted from improved investor sentiments. Credit default swaps (CDSs) have declined in the region in general and in particular in Indonesia, the Philippines, Malaysia, Thailand, and the Republic of Korea **(Figure A)**. Improved market sentiment has also been beneficial for European economies as CDSs for most European economies have fallen **(Figure B)**. The improvements have been such that the Greek government was able to issue EUR3 billion worth of 5-year bonds in an offering that was oversubscribed. Financial conditions in developing economies have improved and emerging market spreads have narrowed considerably since January. Similarly, the so-called Volatility Index (VIX)

[2] 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.

**Table A: Changes in Global Financial Conditions**

| | 2-Year Government Bond (bps) | 10-Year Government Bond (bps) | 5-Year Credit Default Swap Spread (bps) | Equity Index (%) | FX Rate (%) |
|---|---|---|---|---|---|
| **Major Advanced Economies** | | | | | |
| United States | 3 | (38) | – | 1.9 | – |
| United Kingdom | 12 | (36) | (5) | 0.5 | (1.9) |
| Japan | (0.2) | (11) | 6 | (11.2) | 2.9 |
| Germany | (7) | (46) | (4) | 0.5 | (0.8) |
| **Emerging East Asia** | | | | | |
| China, People's Rep. of | (57) | (24) | 9 | (4.2) | (3.4) |
| Hong Kong, China | 3 | (13) | 0 | (5.0) | 0.02 |
| Indonesia | (10) | (43) | (63) | 13.2 | 5.0 |
| Korea, Rep. of | (0.3) | (6) | (5) | (2.5) | 2.1 |
| Malaysia | 0.6 | (5) | (9) | 0.2 | 0.4 |
| Philippines | 57 | 55 | (13) | 13.9 | (0.4) |
| Singapore | 7 | (14) | – | 3.1 | 0.7 |
| Thailand | (49) | (35) | (7) | 8.9 | 1.1 |
| Viet Nam | (145) | (33) | – | 14.5 | 0.1 |
| **Select European Markets** | | | | | |
| Greece | (257) | (217) | – | 6.0 | (0.8) |
| Ireland | (35) | (90) | (53) | 7.9 | (0.8) |
| Italy | (48) | (96) | (55) | 14.8 | (0.8) |
| Portugal | (228) | (215) | (182) | 13.7 | (0.8) |
| Spain | (82) | (115) | (67) | 5.5 | (0.8) |

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 January 2014 and 30 April 2014.
2. For emerging East Asian markets, a positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the US dollar.
3. For European markets, a positive (negative) value for the FX rate indicates the depreciation (appreciation) of the local currency against the US dollar.
Sources: Bloomberg LP and Institute of International Finance (IIF).

has also moved downward, which is indicative of reduced volatility in equity markets **(Figure C)**.

Bond yields in the advanced economies have been declining despite Federal Reserve tapering **(Figure D)**. The threat of deflation is looming over the eurozone with inflation in April at just 0.7%, well below the European Central Bank (ECB) target of 2.0%. First quarter GDP growth for the eurozone of only 0.2% (seasonally adjusted, quarter-on-quarter) also disappoints. This suggests that the ECB is likely to maintain its expansionary monetary stance and may even further ease its policy rates. Japanese bond yields have been quite stable as the Bank of Japan continues with its quantitative easing operations. Meanwhile, interest rates in emerging East Asia have been stable or falling, reflecting reduced risk perceptions in emerging markets in general **(Figure E)**.

Foreign holdings of the region's local currency (LCY) government bonds have started rising again after a dip following the Federal Reserve's announcement of tapering last year. The share of foreign holdings of government bonds remained the highest in Indonesia at 33.6% as of end-March, followed by Malaysia at 29.4% as of end-December 2013 **(Figure F)**. The shares of foreign holdings in Japan, the Republic of Korea, and Thailand have remained relatively stable.

The risks to the region's LCY bond markets have eased as investors' risk sentiments improve:

**The region's bond markets could be vulnerable to the effects of a slowdown in the Chinese economy.** Recent economic indicators point to a moderation in the PRC's economic growth; growth in fixed asset investment and retail sales slowed in April, and industrial production growth remained steady. While part of the reason for the moderation is the PRC's attempt to rebalance its economy, there is a risk that rebalancing will result in large declines in certain sectors, particularly the property and heavy industry sectors. After rapid growth over the past few years, the property sector is cooling. Transaction volumes have been on a downward trend and prices are easing. While large property developers should be able to

**Figure A: Credit Default Swap Spreads[a, b] (senior 5-year)**

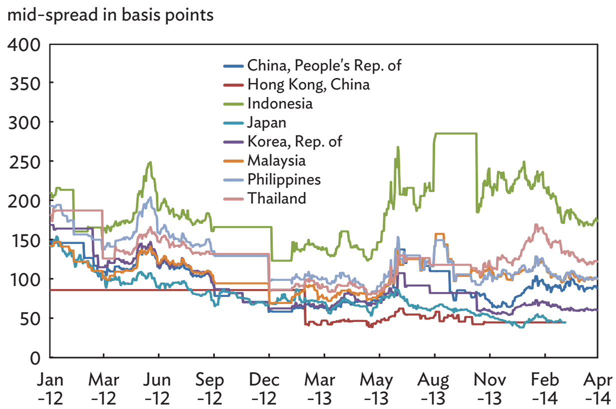



**Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)**

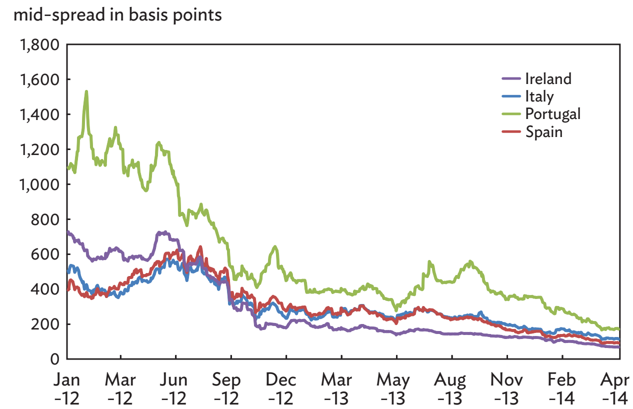



**Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)**

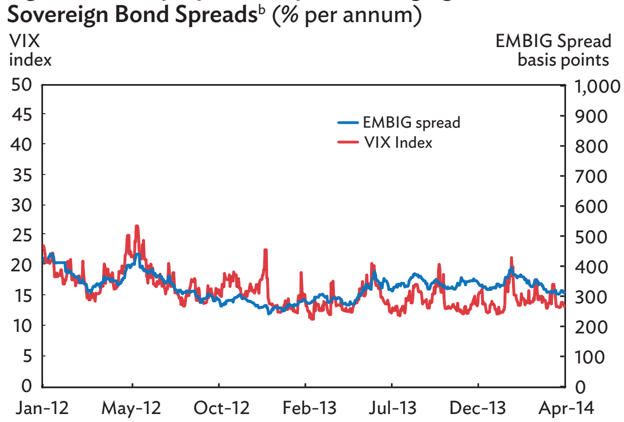



**Figure D: 10-Year Government Bond Yields[b] (% per annum)**

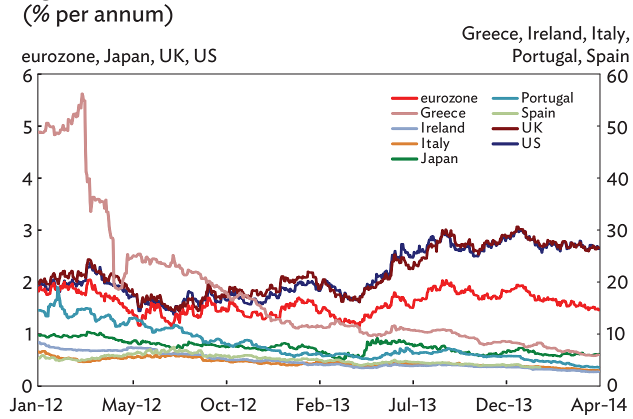



**Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]**

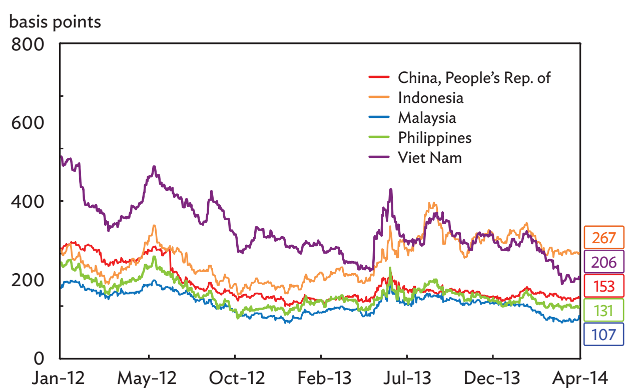
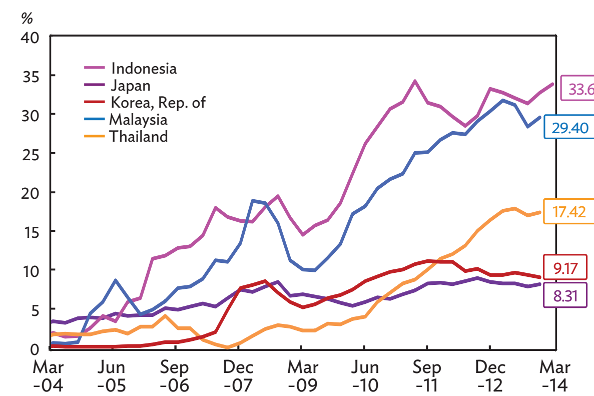



**Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)**




EMBI = Emerging Markets Bond Index, EMBIG = Emerging Markets Bond Index Global, LCY = local currency, UK = United Kingdom, US = United States, VIX = Chicago Board Options Exchange Volatility Index.

Notes:

[a] In US$ and based on sovereign bonds.

[b] Data as of end-April 2014.

[c] Data as of end-December 2013, except for Indonesia as of end-March 2014.

Sources: *AsianBondsOnline* and Bloomberg LP.

ride out the slowdown, smaller players in the market may have difficulty meeting their debt obligations.

**Market turmoil may return as the Federal Reserve winds down tapering amid speculation over when it will raise policy rates.** The Federal Reserve continues to assert that it will keep its overnight target rate between zero and 0.25% for a considerable period of time after the completion of tapering. This could be a potential source of uncertainty in the future. Market sentiments expect that the Federal Reserve will start raising rates in the middle of 2015. But if US economic growth picks up, the Federal Reserve could raise interest rates earlier. This could potentially cause another withdrawal of funds from the region's bond markets. Thus, financial markets are expected to be more volatile as the Federal Reserve exits the market and removes a source of demand for bonds.

**Capital flows could become volatile if the ECB moves to counter the potential threat of deflation in the eurozone.** With inflation in the eurozone running at 0.7% in April, only about one-third of the target inflation rate of 2.0%, there are fears that the eurozone is on the verge of deflation. While there have been some signs of economic recovery, unemployment remains stubbornly high. Hence, there have been calls for the ECB to take a more expansionary monetary stance. As interest rates are already close to zero, further actions might take the form of asset purchases by the ECB (i.e., quantitative easing). While this would provide a boost to the eurozone's growth, it also has the potential to make capital flows more volatile. In addition, quantitative easing by the ECB could make eurozone bonds more attractive relative to Asian bonds, thereby dampening investor interest in Asian bonds.