Global and Regional Market Developments

Emerging East Asia's bond markets were volatile in early June amid a sell-off due to rising global concerns over the possibility of a Greek debt default and an interest rate hike in the United States (US).[2] Global interest rates, which were falling up until April, started picking up in early May. The sell-off was most pronounced in Europe where investors felt that bond yields had declined too much. The protracted negotiations over the Greek debt crisis have also likely unnerved the market. At the same time, falling oil prices, which had been driving deflationary pressures, have reversed course. As a result, the region's bond yields have been moving upward since the beginning of May.

The US turned in a surprisingly weak economic performance in 1Q15, contracting at an annual rate of 0.7%. Cold winter weather, a strong US dollar, and labor disputes at West Coast ports contributed to the weak performance. Leading indicators suggested that the economic climate improved in subsequent months as housing starts hit 1.135 million in April and 280,000 jobs were added in May. However, this will probably not be enough for the Federal Reserve to start raising interest rates in June as had earlier been predicted. Markets expect an interest rate rise no earlier than 3Q15. Regarding oil prices, while they have risen recently, further upward pressure is limited.

Across the Atlantic, the eurozone's economy is perking up, growing 1.0% year-on-year in 1Q15. While still low, growth in 1Q15 signals that the eurozone is slowly recovering. Stimulus from the European Central Bank (ECB), a weaker euro, and lower oil prices likely contributed to the recovery. Despite the improvement, growth remains sluggish and the ECB is expected to continue with its quantitative easing program. Worries about Greece's debt sustainability and its membership in the eurozone continue to weigh upon growth.

The Japanese economy has also been improving, expanding at an annual rate of 3.9% in 1Q15 as a weaker yen spurred exports. The better economic news provides some evidence that the Bank of Japan's (BOJ) massive stimulus program is working. The BOJ remains committed to continuing its annual asset purchase program of JPY80 trillion.

Local currency (LCY) 10-year government bond yields in emerging East Asia generally rose between 2 March and 5 June **(Table A)**. Most increases came at the beginning of May, with yields further picking up through early June in response to rising US and eurozone bond yields. The rally in oil prices also may have raised inflationary expectations, leading to higher yields. The biggest increase was in Indonesia, where the yield on the 10-year bond rose 145 basis points (bps). Other economies with large increases in 10-year bond yields were Singapore, Thailand, and the Philippines, which saw gains of 42 bps, 37 bps, and 34 bps, respectively. 10-year bond yields in other emerging East Asian markets rose between 13 bps and 26 bps.

Exchange rates in emerging East Asia weakened during the same period, with the US dollar gaining strength over most of the region's currencies. 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. The exceptions were the currency of the PRC, which gained 1.1%, and the currencies of Hong Kong, China and Singapore, which were broadly unchanged.

The region's credit default swap (CDS) spreads began rising toward the end of May, reflecting investor perceptions of increasing risk in the region's bond market **(Figure A)**. The CDS spread in Indonesia gained the most, rising 43 bps between 2 March and 5 June. The only exceptions to this rising trend were in the Republic of Korea and Malaysia, where CDS spreads shed 2 bps and 4 bps, respectively. In early June, CDS spreads in Italy, Spain, Ireland, and Portugal were also rising on concerns over the possibility of Greece leaving the eurozone and the central government's capacity to service its huge debt burden **(Figure B)**. Overall, global financial market conditions were quite volatile in the second half of May, through early June, with emerging market spreads and the volatility index rising **(Figure C)**.

[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	5	33	–	(1.2)	–
United Kingdom	(0.4)	29	(0.5)	(2.0)	0.6
Japan	(3)	14	(0.6)	9.0	(4.6)
Germany	4	49	(2)	(1.9)	0.6
Emerging East Asia					
China, People's Rep. of	(72)	22	11	50.6	1.1
Hong Kong, China	(3)	26	–	9.5	0.03
Indonesia	135	145	43	(6.9)	(2.5)
Korea, Rep. of	(31)	13	(2)	3.6	(0.9)
Malaysia	(13)	17	(4)	(4.0)	(2.4)
Philippines	(47)	34	9	(3.2)	(1.8)
Singapore	5	42	–	(2.1)	0.6
Thailand	(49)	37	10	(4.7)	(4.8)
Viet Nam	69	26	15	(2.1)	(2.2)
Select European Markets					
Greece	116	165	1652	(8.5)	0.6
Ireland	6	68	3	2.4	0.6
Italy	5	94	1	2.5	0.6
Portugal	17	109	35	2.8	0.6
Spain	(0.5)	98	(12)	(1.0)	0.6

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 2 March and 5 June 2015.
2. For emerging East Asia, 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).

Bond yields in the eurozone fell in 1Q15, following the ECB announcement of a new stimulus program and given the deflationary effects of lower oil prices. However, with oil prices recovering and the eurozone's economic performance improving, yields have since started rising. **(Figure D)**. Yields in the US and Japan began rising in late April as economic news became more promising. Bond yields in Japan and the eurozone remained lower than in the US, reflecting the expansionary monetary policies that are being pursued in these economies. In Greece, as uncertainty over the debt situation continues, bond yields have risen sharply. In emerging East Asia, risk premiums have mostly remained stable. Malaysia's risk premium dropped sharply after a spike at the beginning of the year when investors were concerned about the government's reliance on oil and gas revenues. With oil prices recovering, some of the concerns have eased **(Figure E)**.

Foreign holdings of Indonesian LCY government bonds continued to rise in 1Q15 as investors remained attracted to the high yields. The foreign share of LCY government bond holdings in Indonesia rose to 38.6% at end-March from 38.1% at end-December. The share of foreign holdings of LCY government bonds in Malaysia rose to 31.3% at end-March after dipping slightly to 31.0% at end-December. Foreign holdings of LCY government bonds in Thailand were down slightly to a 17.3% share at end-March from 18.3% at end-December **(Figure F)**. In Japan and the Republic of Korea, the shares of foreign holdings stayed relatively unchanged.

Risks to the region's bond markets are rising:

Expectations of higher US interest rates could result in greater volatility in the region's bond markets. While the Federal Reserve is not expected to raise interest rates until later in the year, recent upward movements in bond yields mean that markets may already be anticipating the hike. If bond yields gradually adjust, it will likely have minimal negative effects on the region's bond markets. However, there is a risk that bond yields could rise sharply, as occurred during the "taper tantrum" of 2013, leading to sudden and disruptive selloffs and capital outflows.

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

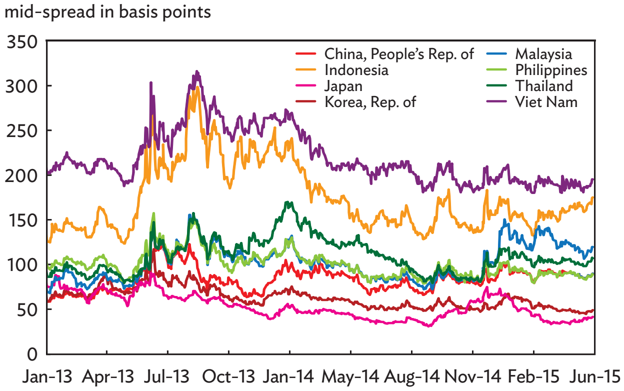


Figure B: Credit Default Swap Spreads for Select European Markets[a,b] (senior 5-year)

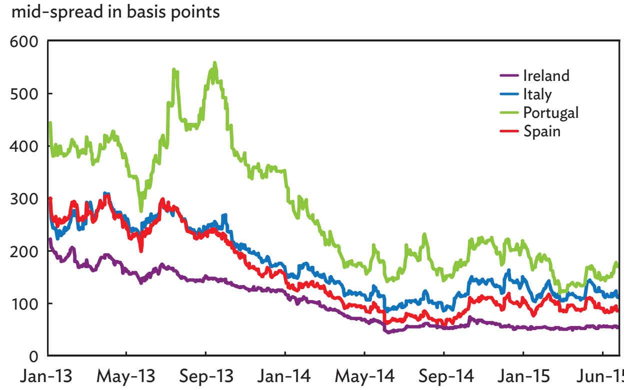


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

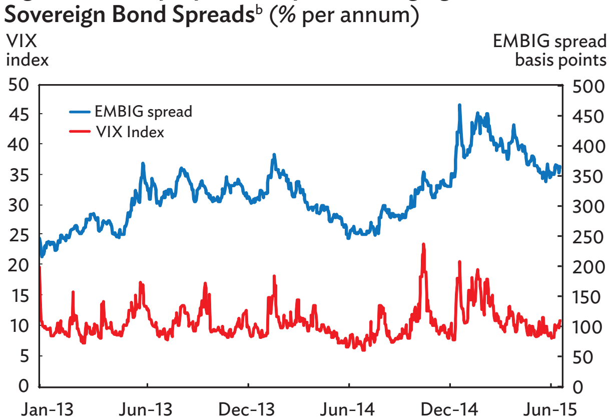


Figure D: 10-Year Government Bond Yields[b] (% per annum)

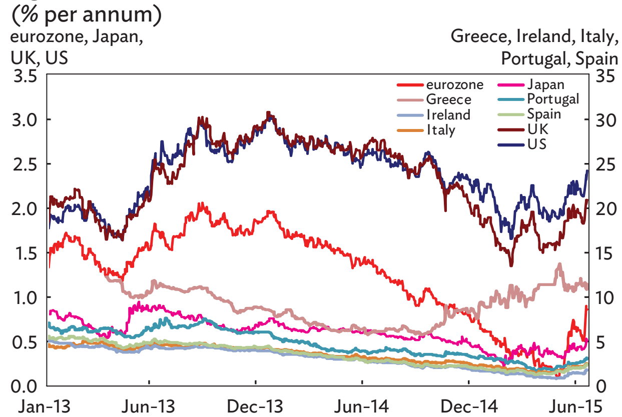


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a,b]

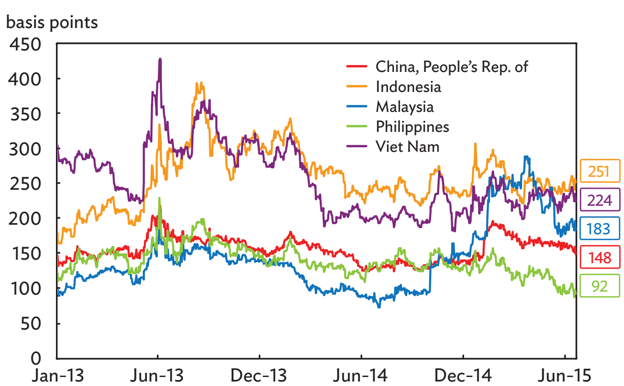
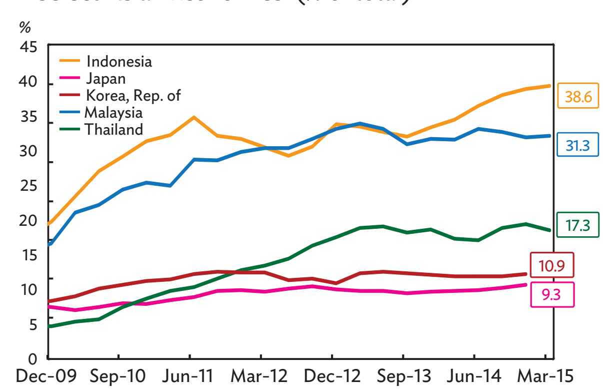


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 5 June 2015.

[c] Data as of end-March 2015 except for Japan and the Republic of Korea (end-December 2014).

Sources: *AsianBondsOnline* and Bloomberg LP.

The lack of liquidity in the region's bond markets could magnify the volatility effect. A rise in US interest rates could prompt a large outflow of funds from the region as US assets will look more attractive relative to those in the region. However, a large number of investors suddenly fleeing could be disruptive if there is not enough liquidity in the bond market. Tighter regulations in the aftermath of the 2008/09 global financial crisis led to banks reducing the size of their trading books, making them less active participants in the market. At the same time, Exchange-Traded Funds (ETFs) have become very popular. Bond ETFs offer a liquid investment vehicle for investors. However, the underlying assets of a bond ETF are much less liquid than the ETF itself. If a large number of investors were to sell ETFs, there could be huge price swings in the underlying bonds.

The continued strengthening of the US dollar could hurt issuers of foreign currency bonds in the region. Higher interest rates could help push up the value of the US dollar. In 2014, foreign currency issuance in emerging East Asia totaled more than US$230 billion, with 82% of the issuance comprising US$-denominated bonds. While the pace of foreign currency issuance through end-April 2015 was slightly lower than in the same period last year, the region has accumulated a large stock of outstanding foreign currency debt amounting to US$858 billion.[3] Of this total, corporates account for US$712 billion. Companies that have issued US dollar debt will find their debt servicing costs increasing with the stronger dollar. The impact will be stronger on companies that have not hedged or do not have foreign earnings that can offset some of the impact of the appreciating dollar. Refinancing debt may also become more difficult.

[3] Foreign currency bond issuance and bond outstanding refer to bonds denominated in currencies other than the home country's currency. The data excludes certificates of deposit and offshore renminbi-denominated bonds.