Global and Regional Market Developments

Bond yields in most emerging East Asian markets fell between 1 March and 15 May against the backdrop of a weak world economy.[4] The main exceptions were the People's Republic of China (PRC) and the Philippines, where yields picked up during the review period. Bond yields in most major economies also declined, reflecting very low inflation bordering on deflation.

The overall trend of declining yields reflects a number of factors. The United States (US) Federal Reserve continued to exercise caution and decided to keep interest rates steady during Federal Open Market Committee meetings on 15–16 March and 26–27 April. The US Federal Reserve moderated its concerns over the world economy and presented a mixed overall picture of the US economy that included slowing economic activity, below-target inflation, and strengthening job market conditions. The central bank finds itself in a delicate situation in which the cases for and against higher interest rates are finely balanced, yet it decided to err on the side of caution.

Within emerging East Asia, the People's Bank of China reduced its reserve requirement ratio by 50 basis points (bps) on 1 March. Bank Indonesia has lowered its benchmark interest rate three times by a cumulative 75 bps since the beginning of the year.

The International Monetary Fund (IMF) cut its 2016 global growth forecast to 3.2% in its World Economic Outlook published in April, down from 3.4% in January, although it projected an uptick to 3.5% growth in 2017. The downward revision was driven by a number of trends. The advanced economies are still struggling to fully overcome the after effects of the global financial crisis. As a result, growth in advanced economies as a whole is projected to stall at 1.9% in 2016 before picking up only marginally to 2.0% in 2017. US growth is expected to remain flat at 2.4%, with only a slight acceleration to 2.5% in 2017. Strengthened public finances and an improved housing market notwithstanding, the strong dollar is impeding export growth and net exports thus remain a major drag on growth. High unemployment and weak investment are weighing on the eurozone's growth, which is projected by the IMF to reach only 1.5% in 2016 and 1.6% in 2017. In Japan, growth of 0.5% and −0.1% is projected for 2016 and 2017, respectively, amid tepid private consumption.

Emerging markets are also contributing to the IMF's downward revision to its global growth forecast. Subdued global commodity prices are slowing growth in emerging markets in Latin America, the Middle East, and elsewhere. Emerging East Asia is not only adversely affected by the gloomy global outlook, but is also contributing to it. For example, the PRC's ongoing growth slowdown is impacting both the regional and global outlook. In March 2016, the Asian Development Bank (ADB) projected developing Asia's growth to decelerate from 5.9% in 2015 to 5.7% in both 2016 and 2017.[5] The corresponding growth figures for the PRC are 6.9%, 6.5%, and 6.3%. East and Southeast Asian markets, which have close trade and other economic linkages with the PRC, will feel the impact of its slowdown. ADB's forecasts made in September 2015 for growth in developing Asia and the PRC in 2016 were 6.0% and 6.7%, respectively, both of which were higher than subsequent ADB forecasts made in March 2016.

Continued sluggishness in the world and regional economies, evident in the recent downward revisions of IMF and ADB growth forecasts, has helped push down bond yields in the region. Yields for 10-year local currency (LCY) government bonds declined in most emerging East Asian markets between 1 March and 15 May **(Table A)**. Due to the region's relatively strong fundamentals, the growing risk aversion in emerging markets has had only a limited effect in emerging East Asia so far. In fact, some emerging East Asian markets such as Indonesia, Malaysia, and Thailand have seen substantial foreign capital flows into their bond markets since the beginning of the year. Indonesia's 10-year bond yield fell by 56 bps during the review period, the 10-year yields of Singapore and Thailand fell by almost 30 bps each, and Viet Nam's 10-year yield saw a drop of 15 bps. Within the region, 10-year bond yields rose only in the Philippines (75 bps) and the PRC (2 bps).

[4] 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.

[5] Developing Asia comprises the 45 member economies of the Asian Development Bank.

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	(9)	(12)	–	3.5	–
United Kingdom	(5)	(2)	(3)	(0.2)	(3.0)
Japan	(3)	(5)	(10)	1.1	4.7
Germany	5	(2)	(5)	2.4	(4.1)
Emerging East Asia					
China, People's Rep. of	7	2	(2)	3.4	0.3
Hong Kong, China	0	(5)	–	1.6	0.1
Indonesia	(77)	(56)	(39)	(0.4)	0.2
Korea, Rep. of	(1)	(2)	(1)	2.6	5.0
Malaysia	(22)	(4)	(10)	(2.5)	3.3
Philippines	45	75	(3)	10.5	1.6
Singapore	(2)	(28)	–	2.0	2.0
Thailand	(3)	(27)	(25)	3.5	0.4
Viet Nam	(11)	(15)	(46)	8.8	(0.3)
Select European Markets					
Greece	(247)	(259)	(370)	19.7	(4.1)
Ireland	(4)	(5)	(3)	(3.8)	(4.1)
Italy	(0.2)	10	(6)	(1.6)	(4.1)
Portugal	6	14	(6)	1.2	(4.1)
Spain	(6)	5	(10)	1.3	(4.1)

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 March and 15 May 2016.
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.

Equity markets were up in all of the region's economies between 1 March and 15 May except for a marginal decline of 0.4% in Indonesia and a 2.5% drop in Malaysia. The Philippines' equity market climbed the most in the region during the review period, with a 10.5% gain, as the market cheered the relatively peaceful elections on 9 May. Viet Nam's equity market rose 8.8% on higher growth expectations.

The region's currencies generally rose between 1 March and 15 May. The Korean won appreciated the most vis-à-vis the US dollar, gaining 5.0% during the review period. The Malaysian ringgit gained 3.3%. Foreign fund inflows have buttressed financial markets in emerging East Asia. Positive investor sentiments and increased inflows contributed to the appreciation of exchange rates and gains in equity markets.

Credit default swap (CDS) spreads mostly fell between 1 March and 15 May, an indication of perceptions of reduced default risk **(Figure A)**. CDS spreads declined in mid-March after the US Federal Reserve held off raising interest rates. However, there has been a slight uptick in CDS spreads in some markets since March, particularly in the PRC due to increased corporate bond defaults, in Malaysia due to the 1MDB scandal, and in the Philippines due to preelection jitters. After peaking in February over concerns about Portugal's budget woes, CDS spreads in European markets declined following the announcement of stimulus measures by the European Central Bank on 10 March, including expanded bond purchase under its quantitative easing program **(Figure B)**. Reflecting a degree of optimism about the US economy, the US equity market gained and volatility measures declined during the review period **(Figure C)**.

Bond yields in major advanced economies declined between 1 March and 15 May, albeit by relatively small margins. Despite further stimulus from the European Central Bank, some peripheral eurozone economies saw their yields increase marginally. Most significantly, the yields of Greek bonds dropped 259 bps on expectations of a favorable debt agreement with international lenders **(Figure D)**. Emerging East Asia's risks premiums generally declined during the review period, with declines most evident in Indonesia and Viet Nam **(Figure E)**.

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

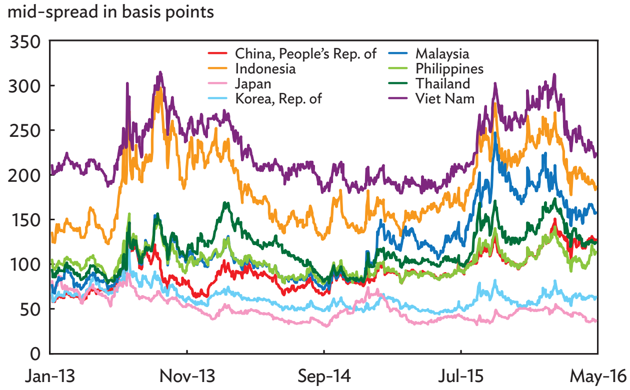


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

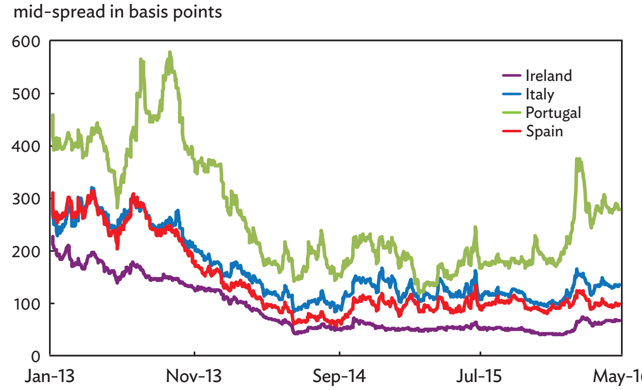


Figure C: United States Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

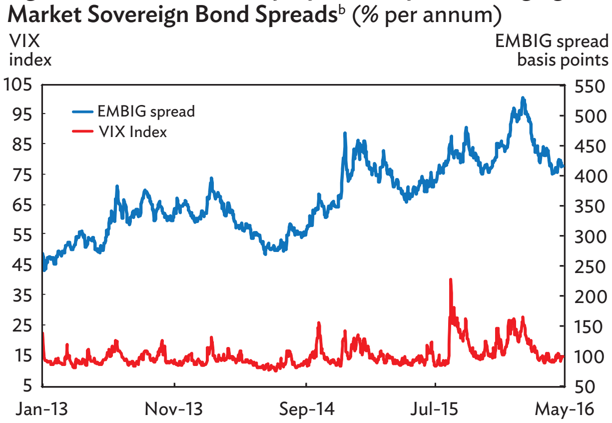


Figure D: 10-Year Government Bond Yields[b] (% per annum)

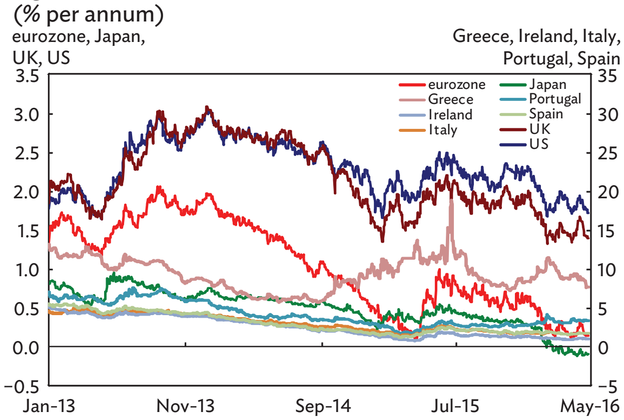


Figure E: JPMorgan Emerging Markets Bond Index Sovereign Stripped Spreads[a, b]

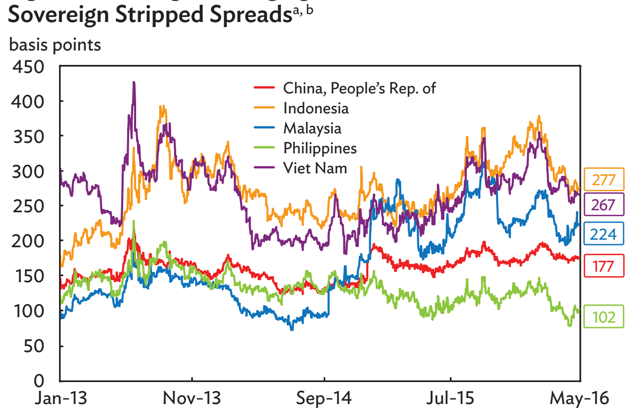
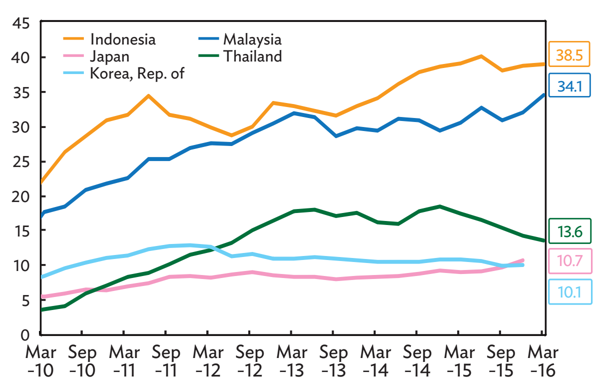


Figure F: Foreign Holdings of Local Currency Government Bonds in Select Asian Economies[c] (% of total)



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

Notes:

[a] In United States dollar and based on sovereign bonds.

[b] Data as of 15 May 2016.

[c] Data as of end-March 2016 except for Japan and the Republic of Korea (end-December 2015).

Sources: *AsianBondsOnline* and Bloomberg LP.

Recoveries in the Indonesian rupiah and Malaysian ringgit helped attract foreign funds into the Indonesian and Malaysian LCY government bond markets. Indonesia's foreign holdings as a share of the total market rose to 38.5% at the end of March as foreign investors continued to seek the region's highest yields. The share of foreign holdings in the Malaysian government bond market rose to 34.1% at the end of March from 31.7% at the end of December **(Figure F)**.

The generally benign picture for emerging East Asia's LCY bond markets is subject to a number of risks, even if these risks have abated somewhat since 1 April.

The US Federal Reserve may raise interest rates within the year, which could cause investors to pull back from the region's bond markets. While the US Federal Reserve kept interest rates unchanged in March and again in April, the minutes of the Federal Open Market Committee's April meeting, which were released on 18 May, raised the possibility that a June rate hike was much more likely than was being reflected in market expectations. However, US payroll data for May released on 3 June was weaker than expected, leading to renewed uncertainty over the timing of the next US Federal Reserve rate hike.

A broad-based global economic slowdown could amplify global financial instability, which would further dent global growth. The failure to gain sustainable growth traction since the global financial crisis has spread from advanced economies to emerging economies and now afflicts the entire world economy. The global financial system has also suffered two episodes of turbulence during the last 14 months. While a major global crisis does not seem imminent, the convergence of economic weakness and financial fragility make for a risky combination. Financial turmoil in Brazil, the Russian Federation, or other brittle emerging economies could spark worldwide financial volatility.

Deflation is emerging as a new risk to financial stability in emerging East Asian markets. While falling prices were confined to advanced economies until recently, the PRC, the Republic of Korea, Malaysia, Thailand, and other emerging economies experienced deflation in 2015. Deflation is so far largely limited to producer prices, with consumer price inflation remaining largely in positive territory. Nevertheless, falling prices expand the real value of debt and thus increase the repayment burden of borrowers, which can put lenders at risk. Furthermore, borrowing firms and households might be forced to cut back on investment and consumption, hurting aggregate demand and economic growth.