Introduction: **Global and Regional Market Developments**

Emerging East Asia faces a global economic environment that is stabilizing but still weak.[2] The United States (US) turned in a weaker-than-expected growth performance in 4Q12 and the eurozone economies remain mired in recession and struggling to cope with high and rising unemployment. The recent downgrade of the United Kingdom's (UK) sovereign credit rating by Moody's from Aaa to Aa1 is another negative factor for the broader European outlook. In contrast, emerging East Asia's outlook is brightening with growth in the People's Republic of China (PRC) accelerating toward the end of last year. Meanwhile, the Southeast Asian economies continue to sustain robust growth supported by strong domestic demand. The unresolved budget deadlock in the US and the banking and debt crisis in Europe remain major risks for investors.

Confidence in eurozone financial markets has been rising and the euro has rallied against the US dollar in recent months. Nevertheless, financial conditions in the eurozone remain fragile with political uncertainty in Italy after the inconclusive election results. In addition, Cyprus is on the verge of a bailout of its banking system. While the size of the Cyprus bailout would be relatively small, there is reluctance within the European Union (EU) to proceed with a rescue package due to concerns over the huge size of Cyprus' banking system and fears that a bailout could saddle the Mediterranean island with an unsustainable level of debt. However, failure by the EU to rescue Cyprus could renew concerns about its commitment to the euro.

Emerging East Asia is showing signs of recovery. Growth in the region had been affected by the slowdown in the advanced economies that hit hard the export-oriented economies of Singapore; the Republic of Korea; and Hong Kong, China. However, in the PRC, the easing of monetary policy and a recovery in exports is helping to improve the growth outlook for the region's largest economy. Furthermore, growth in other emerging East Asian economies is expected to remain robust, supported by domestic consumption and investment growth.

Investors' risk perceptions of regional capital markets remain positive amid the improved regional growth outlook, even though this outlook is coupled with a continued weak global economic environment. The positive perceptions are reflected in widely falling bond yields, rising stock markets, and appreciating currencies across emerging East Asia **(Table A)**. Credit default swap (CDS) spreads in the region have remained relatively stable **(Figure A)**. Global investor sentiment has also improved with the narrowing of CDS spreads in several European economies as fears of a eurozone break-up have receded **(Figure B)**. Emerging market bond spreads similarly have benefited from rising investor confidence as spreads narrow **(Figure C)**.

Bond yields in the advanced economies have remained stable with a slight downward bias for the peripheral economies of the eurozone **(Figure D)**. The European Central Bank's commitment to keep government bond yields low has helped to reduce the bond yields of the peripheral economies. Low inflationary expectations in Europe have also contributed to lower yields. Meanwhile, the Bank of Japan has set an inflation target of 2.0%, putting downward pressure on the yen. As a result, Japan's currency has seen a sharp depreciation against the dollar. Yields in Japan, however, have remained stable.

Emerging East Asia's local currency (LCY) bond yields have been mixed, but have generally shown a downward bias since end-September. Amid some signs of recovery, the region's policymakers have been cautious about further reductions in policy rates. One exception is the State Bank of

[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	36	0	3.7	–
United Kingdom	18	18	(23)	7.8	1.7
Japan	(3)	(3)	(9)	28.3	(15.0)
Germany	22	22	(26)	6.1	(5.1)
Emerging East Asia					
China, People's Rep. of	19	16	(16)	14.3	1.1
Hong Kong, China	(5)	45	(5)	13.9	(0.01)
Indonesia	(90)	(60)	(17)	5.1	(1.7)
Korea, Rep. of	(7)	8	(15)	(1.7)	2.4
Malaysia	(1)	(4)	(13)	(1.0)	(1.4)
Philippines	19	(78)	(18)	17.6	2.8
Singapore	(2)	(2)	0	7.4	(0.7)
Thailand	(20)	22	(14)	13.4	3.0
Viet Nam	(125)	(77)	–	24.1	0.2
Select European Markets					
Greece	(289)	(756)	0	32.6	(5.1)
Ireland	(152)	(86)	(129)	8.1	(5.1)
Italy	(64)	(74)	(75)	12.3	(5.1)
Portugal	(160)	(303)	(19)	18.5	(5.1)
Spain	(106)	(83)	(79)	7.4	(5.1)

– = not available, ( ) = negative, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 October 2012 and 31 January 2013.
2. For emerging East Asia, a positive (negative) value for the FX rate means the appreciation (depreciation) of the local currrency against the US dollar.
3. For European markets, a postive (negative) value for the FX rate means the depreciation (appeciation) of the local currrency against the US dollar.
Source: Bloomberg LP, Institute of International Finance (IIF), and Thomson Reuters.

Viet Nam (SBV), which reduced its discount rate and refinancing rate by 100 basis points (bps) each in December.

Meanwhile, interest rates remained low in most advanced economies and Japan's expanded asset purchase program should help keep interest rates low there for some time. Sovereign spreads in Viet Nam have tightened, while the spreads for other emerging market bonds have remained broadly stable **(Figure E)**.

The shares of foreign holdings in the region's LCY government bond markets have continued their upward trajectory **(Figure F)**. For example, more than 30% of Indonesian bonds are now held by foreigners, while Thailand's foreign share of bond holdings has reached 16.4%.

Risks to the region's LCY bond markets are biased toward the downside:

- **Government spending cuts threaten the US recovery.** While the threat of the "fiscal cliff" has been averted for now, the US still faces the threat of looming across-the-board budget cuts, which are known as the sequestration. The budget agreement at the beginning of the year postponed the sequestration until 1 March. The US Congress, which remains bitterly divided, will have to act before then to stop the sequestration from taking effect. If Congress fails to act, US government spending will be reduced by $1,200 billion over the next 10 years; $85 billion of the cuts would take effect in 2013. Spending cuts of such magnitude could derail the US' tentative

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

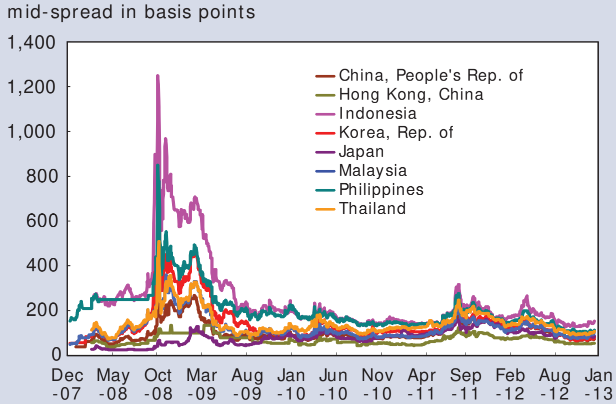


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

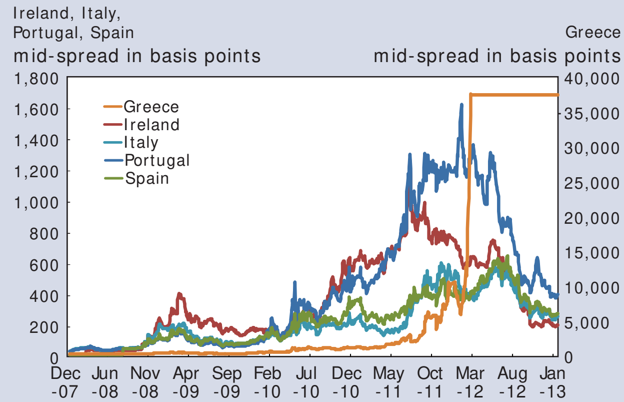


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

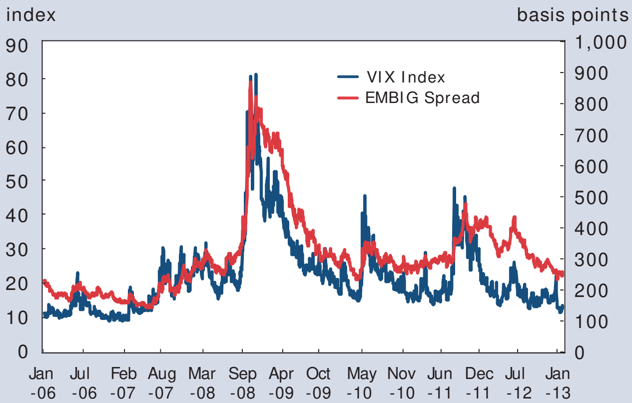


Figure D: 10-Year Government Bond Yields[b] (% per annum)

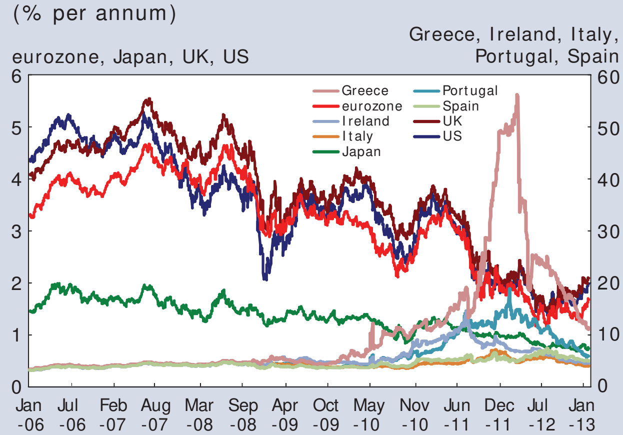


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a,b]

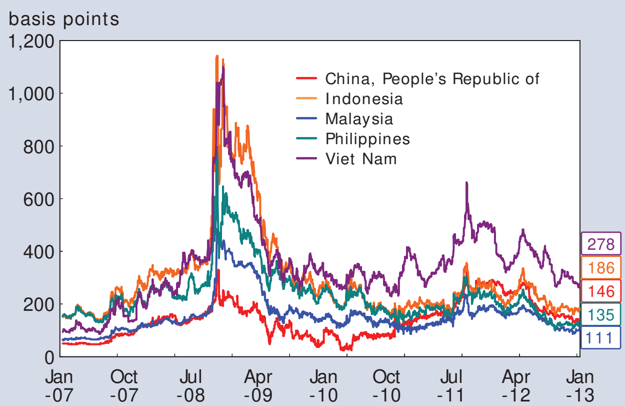
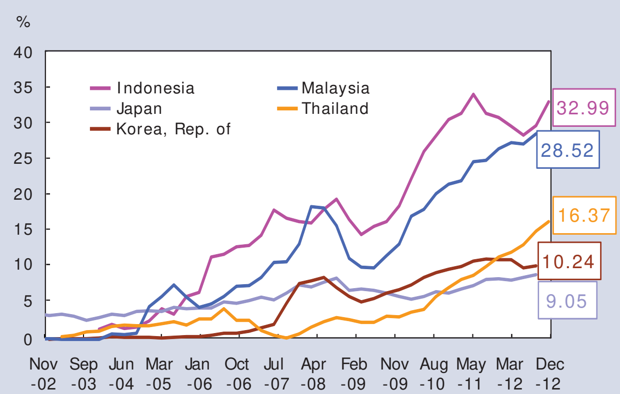


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 31 January 2013.

[c] Data as of end-September 2012 except for Indonesia and Thailand as of end-December 2012.

Source: *AsianBondsOnline*, Bloomberg LP, and Thomson Reuters.

economic recovery. Without an agreement on a long-term plan to manage the budget, the US economy will continue to be subject to periodic bouts of uncertainty.

- **Stronger growth could lead to higher interest rates and inflation.** Inflationary pressures have remained relatively benign, allowing policymakers in the region to keep policy rates low to support growth. However, there are signs that economic conditions in the region are improving. There is also the potential threat of upward pressure on inflation from higher food prices. This could lead policymakers to reverse course and start raising policy rates to cool their economies, leading to falling bond prices.

- **Surge of capital inflows might contribute to appreciating local currencies and asset price bubbles.** The continued low interest rates prevailing in the advanced economies have raised concerns that emerging East Asia could be flooded with capital searching for higher yields. The relatively stronger economic conditions in the region have also attracted new foreign investors. These developments might put upward pressure on exchange rates, making exports less competitive. There are also concerns that higher levels of liquidity could lead to excessive credit growth, thus fueling asset price bubbles in the region.