Global and Regional Market Developments

Emerging East Asian bond markets started the year well despite uncertainties over the Greek debt crisis and the end of quantitative easing in the United States (US).[2] The fall in oil prices also helped reduce inflationary expectations in the region, which pushed down bond yields in most of the region's economies.

While the global economic outlook is generally weakening, the US has continued to sustain its growth momentum. The US economy created 257,000 jobs in January, marking 11 straight months of over 200,000 jobs gained. This has bolstered perceptions of an economy gaining strength and heightened expectations of an interest rate increase in the middle of the year. As a result, the US dollar strengthened against most of the region's currencies.

On the other hand, the eurozone's economic recovery is barely gathering pace as the region continues to flirt dangerously with deflation. To push up growth and stave off deflation, the European Central Bank (ECB) unveiled its version of quantitative easing in January, undertaking monthly purchases of EUR60 billion of government bonds for at least 19 months. Japan is also on an expansionary path, continuing with its plan to purchase JPY80 trillion worth of assets annually. Hence, there is a divergence in monetary policy stances among the major economies. The European and Japanese central banks' expansionary monetary policy actions could help offset some of the impacts of tighter US monetary policy.

Local currency (LCY) 10-year bond yields in emerging East Asia generally declined between end-December 2014 and mid-February 2015 **(Table A)**. Weaker inflationary pressures resulting from lower fuel prices in the region contributed to the lower yields. The biggest drop in yields was in Viet Nam, where the 10-year bond shed 64 basis points (bps). Other economies with large declines in 10-year bond yields were the Philippines and Hong Kong, China, where yields fell 45 bps and 44 bps, respectively. Most other emerging East Asian markets recorded drops in 10-year bond yields ranging from 19 bps to 30 bps, with the exception of Thailand where yields gained 3 bps during the period under review.

[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.

Most of the region's currencies weakened against the US dollar between end-December 2014 and mid-February 2015. The Indonesian rupiah and Malaysian ringgit had the largest depreciations at 3.3% and 2.4%, respectively. These two currencies were hardest hit likely because they have large oil and gas sectors, which are being adversely affected by lower global oil prices. The Singapore dollar depreciated 2.2% over the same period due to the government's announcement that it would slow the appreciation of its currency against the US dollar. On the other hand, currencies in the Philippines and Thailand appreciated against the US dollar by 1.0% and 0.9%, respectively. Being net oil importers, these countries' current account balances are likely to improve as a result of lower oil prices.

The region's credit default swaps (CDSs) remained stable, reflecting continued investor confidence in the region **(Figure A)**. In contrast, CDSs in the eurozone increased over concerns about the possibility of Greece leaving the monetary union following the election of a new government in January **(Figure B)**. Overall, global financial market conditions have been relatively calm in 2015, with emerging market spreads narrowing and the volatility index falling **(Figure C)**.

Bond yield trends in the advanced economies were mixed due to divergent monetary policies between the US on one hand and the eurozone and Japan on the other. US bond yields rose as a series of strong job reports suggests that the Federal Reserve may soon start raising rates. That said, yields are still below levels seen at the beginning of 2014 **(Figure D)**. Yields in Japan are also picking up as the economy improves. In contrast, eurozone rates were trending down as the ECB unveiled its asset purchase program. However, bond yields in Greece rose amid uncertainties over the new government's plan to restructure the nation's huge public debt. In emerging East Asia, risk premiums were declining in all of the region's economies except Malaysia **(Figure E)**. Investors are concerned about the large reliance of the Malaysian government on oil- and gas-based revenues amid falling oil prices.

Foreign holdings of Indonesian LCY government bonds rose in 4Q14 as investors continued to be attracted to their relatively higher yields. Furthermore, the Government of

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	(2)	(12)	–	1.9	–
United Kingdom	(6)	(8)	(1)	4.7	1.2
Japan	7	10	(16)	3.5	0.9
Germany	(12)	(20)	0.3	11.8	5.8
Emerging East Asia					
China, People's Rep. of	(26)	(27)	5	(1.0)	(0.6)
Hong Kong, China	(14)	(35)	–	4.6	(0.01)
Indonesia	(40)	(30)	(6)	2.8	(3.3)
Korea, Rep. of	(6)	(21)	7	2.2	(0.5)
Malaysia	(15)	(29)	21	2.3	(2.4)
Philippines	2	(45)	2	7.5	1.0
Singapore	26	(19)	–	1.8	(2.2)
Thailand	(2)	3	10	7.9	0.9
Viet Nam	(34)	(64)	(8)	7.6	0.3
Select European Markets					
Greece	47	(37)	265	8.2	5.8
Ireland	(8)	(25)	0.5	9.3	5.8
Italy	(16)	(26)	(4)	11.5	5.8
Portugal	(13)	(46)	(23)	11.2	5.8
Spain	(9)	(4)	11	4.5	5.8

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 31 December 2014 and 13 February 2015.
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, Institute of International Finance (IIF), and Thomson Reuters.

Indonesia's move to reform its fuel subsidies scheme is likely to strengthen fiscal sustainability. As of 20 February, the foreign-held share of the LCY government bond market in Indonesia had risen to 39.6% from 38.1% at end-December 2014. In contrast, foreign holdings of LCY government bonds in Malaysia declined to 30.9% at end-December 2014 from 31.8% at end-September 2014. The share of foreign holdings of LCY government bonds in Thailand picked up slightly from 17.6% at end-September 2014 to 18.3% at end-December 2014. Indonesia and Malaysia remain the economies with the largest share of foreign holdings of LCY government bonds **(Figure F)**. Meanwhile, in Japan and the Republic of Korea, foreign holdings stayed relatively unchanged.

Tighter US monetary policy could signal rising risks for the region's LCY bond markets:

Credit spreads could widen ahead of the Federal Reserve raising interest rates. Days of easy liquidity for the region's bond markets look set to end with the Federal Reserve expected to start raising interest rates. There is likely to be a reduction in the flow of funds searching for yields. Furthermore, foreign investors are likely to become more discerning in their choice of investment destinations in the region. The result could be wider spreads between high-quality and low-quality bonds. While economies with strong fundamentals are not likely to be affected, those with large fiscal and current account deficits could find themselves less attractive to foreign investors and at risk from a pullback.

The stronger US dollar is making it more costly to service foreign debts. In 2014, foreign currency issuance in emerging East Asia surged to a record of almost US$200 billion. The recent strength of the US dollar has highlighted the risk of borrowing in foreign currency. Issuers will find that the cost of servicing US$-denominated debt has increased, especially unhedged debt. Refinancing those debts will likely become more difficult. The default of a Chinese property company has also put the spotlight on risks in the real estate sector in the People's Republic of China (PRC), which was a large issuer of US dollar bonds in 2014.

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

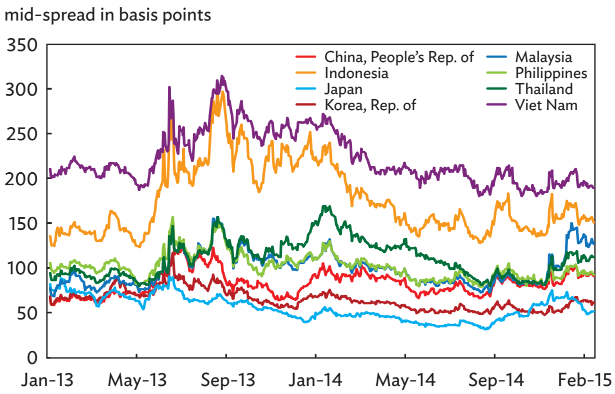


Figure B: Credit Default Swap Spreads for Select European Markets[a,b] (senior 5-year)

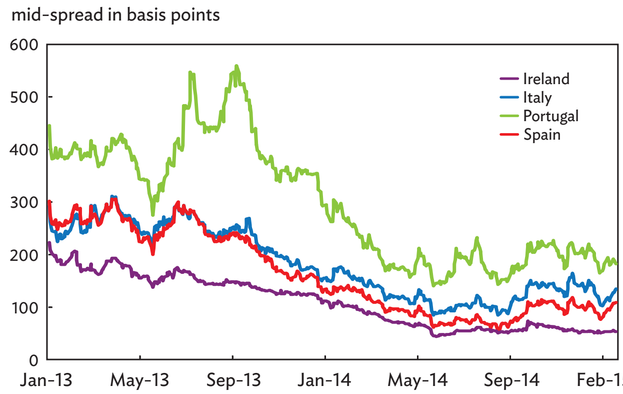


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

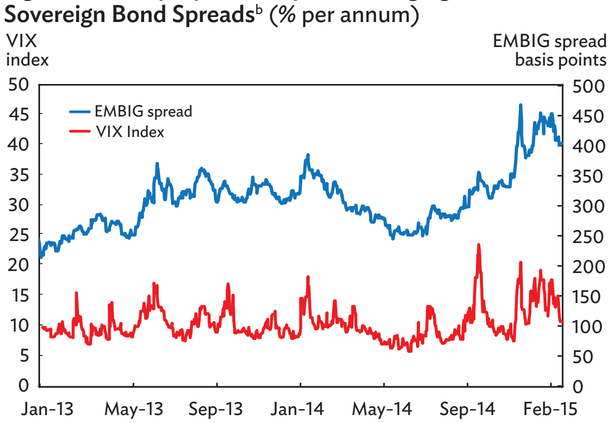


Figure D: 10-Year Government Bond Yields[b] (% per annum)

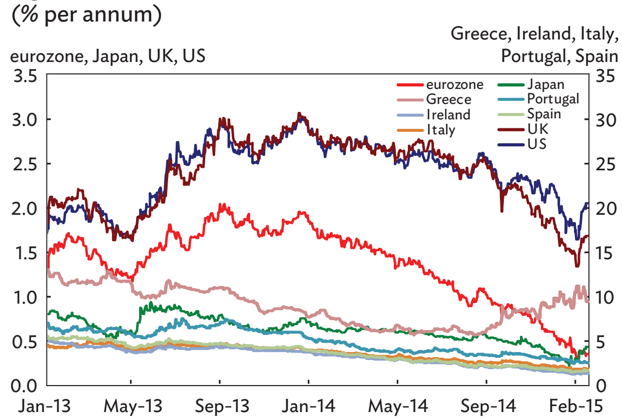


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a,b]

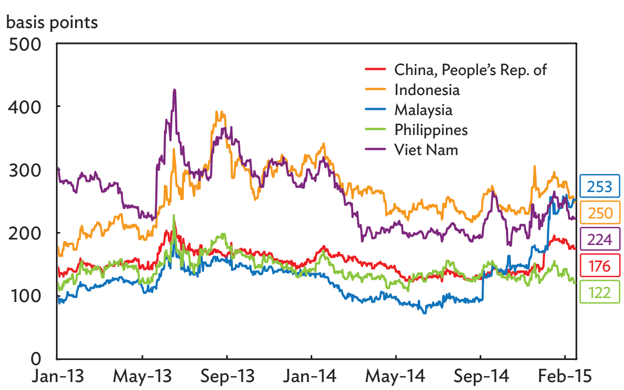
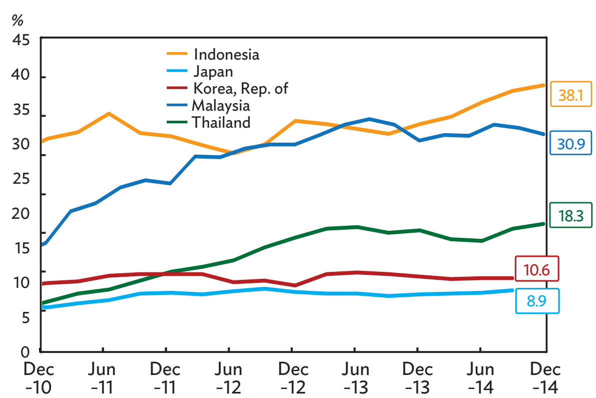


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c,d] (% of total)



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 15 February 2015.

[c] Data as of end-December 2014 except for Japan and the Republic of Korea as of end-September 2014.

[d] Data for Malaysia based on *AsianBondsOnline* estimates.

Sources: *AsianBondsOnline* and Bloomberg LP.

Plunging oil prices could hurt highly leveraged oil and gas companies. The sharp fall in oil prices has drawn attention to the debt obligations of oil and gas companies in the region. Oil exploration and production companies have been hit by cutbacks in capital spending. Refining and marketing companies are nursing losses on their inventories due to falling oil prices. The decline in revenues from lower oil prices could hamper oil and gas companies' ability to service their debts, particularly those companies with high leverage. Oil and gas companies that are increasingly turning to US dollar financing could also find the environment for refinancing more difficult. The Special Section on Oil and Gas Corporate Bonds in Asia in this edition of the Asia Bond Monitor will examine the issue in greater depth.