Global and Regional Market Developments

Bond yields in most emerging East Asian markets declined amid mounting gloom over global growth prospects.[2] The main exceptions to the downward trend were the People's Republic of China (PRC) and Hong Kong, China.

After raising interest rates on 16 December for the first time since the onset of the global financial crisis, the United States (US) Federal Reserve held rates steady on 27 January. Meanwhile, the People's Bank of China has refrained from further monetary easing and bond yields in the major advanced economies have declined against the backdrop of subdued inflation. Indeed, there are concerns about deflation in some advanced economies.

US economic growth disappointed in the fourth quarter (Q4) of 2015, with gross domestic product expanding at an annual rate of only 1.0%, based on second estimates, down sharply from 2.0% annualized growth in the third quarter of 2015. The combination of a strong dollar and weak global growth dragged down trade and investment. Private consumption remains healthy but, overall, the US economy is slowing, which may put pause to the Federal Reserve's gradual escalation of interest rates until it sees data indicating a stronger recovery.

Growth in the eurozone remains lackluster, with the economy expanding 1.6% both in Q4 2015 and in full-year 2015. Declining consumer confidence pulled down consumption toward the end of 2015. In response to the deflationary pressures being exerted by weak aggregate demand and low oil prices, the European Central Bank decided to continue its quantitative easing policies. In Japan, the economy grew by only 0.5% in 2015. Following a sharp drop in industrial production and tepid inflation, the Bank of Japan introduced negative interest rates in January.

Yields for 10-year local currency (LCY) government bonds in emerging East Asia mostly fell between 1 January and 15 February **(Table A)**. Investor confidence in the region remained relatively high despite the Federal Reserve's interest rate hike in December and global stock market jitters in early January. Indonesia saw its 10-year bond yield decline by 79 basis points (bps) during the review period. Singapore and Thailand experienced drops of 40 bps or more, while yields fell by more than 20 bps in the Republic of Korea and Malaysia. Within the region, only the 10-year yield in the PRC saw an increase, gaining a marginal 2 bps.

Over the same period, most emerging East Asian stock markets fell. The only exceptions to the region-wide decline were in Indonesia, where the market rose by 3.2%, and in Thailand, where the market held steady. The catalyst for the declines was uncertainty in the PRC, where the stock market has fallen by more than 20% since the start of the year.

The region's foreign exchange markets were also mixed over the same period. The Korean won depreciated by 3.0% and the Philippine peso by 1.2% against the US dollar, while the Indonesian rupiah and Malaysian ringgit appreciated by 3.3% and 3.8%, respectively. The region's other currencies were more or less stable, with only the Thai baht appreciating by more than 1%.

Credit default swap (CDS) spreads across emerging East Asia have remained volatile during the review period **(Figure A)**, mirroring the lingering uncertainty about the region's growth prospects. In particular, spreads have trended upward in the PRC amid concerns over economic growth. Spreads have also risen in the Philippines and Thailand. In Europe, CDS spreads have escalated discernibly in Ireland, Italy, Portugal, and Spain. Rising spreads in Europe were partly the result of concerns about nonperforming loans and other structural issues in the Italian banking sector **(Figure B)**. Reflecting growth slowdowns across emerging markets in general and commodity-exporting economies in particular, emerging market CDS spreads have climbed discernibly in early 2016. As an indication of increasingly uncertain US financial market conditions, the volatility index also edged up between 1 January and 15 February **(Figure C)**.

In the eurozone, bond yields have been falling amid deflationary pressures and sluggish growth **(Figure D)**. In December, the European Central Bank considered further expansionary measures by cutting its deposit rate by 10 bps. Japanese and US bond yields have also

[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	(33)	(52)	...	(8.8)	...
United Kingdom	(28)	(53)	15	(6.7)	2.1
Japan	(13)	(18)	5	(15.7)	4.9
Germany	(18)	(39)	10	(14.3)	(2.8)
Emerging East Asia					
China, People's Rep. of	5	2	30	(22.4)	(0.04)
Hong Kong, China	30	(14)	...	(13.7)	(0.4)
Indonesia	(94)	(79)	9	3.2	3.3
Korea, Rep. of	(17)	(26)	16	(5.1)	(3.0)
Malaysia	26	(28)	2	(2.5)	3.8
Philippines	(7)	(14)	20	(3.7)	(1.2)
Singapore	(2)	(40)	...	(9.5)	0.8
Thailand	(11)	(42)	22	0.03	1.1
Viet Nam	1	(4)	(4)	(6.1)	0.6
Select European Markets					
Greece	688	292	428	(22.7)	(2.8)
Ireland	(0.4)	(26)	24	(12.3)	(2.8)
Italy	5	3	53	(20.4)	(2.8)
Portugal	79	92	168	(12.7)	(2.8)
Spain	5	(2)	30	(14.3)	(2.8)

... = data not available, ( ) = negative, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 January and 15 February 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 (IIF).

followed a downward trend. Emerging East Asia's risk premiums have been on the rise amid widespread uncertainty over the region's growth prospects **(Figure E)**.

Currency appreciation has made Indonesian and Malaysian bonds more attractive to foreign investors. For example, foreign holdings of Malaysian LCY government bonds as a share of total LCY government bonds outstanding rose to 31.7% at the end of December from 30.5% at the end of September. The share of foreign holdings in the Indonesian LCY government bond market also increased in Q4 2015, while the share of foreign holdings in the Thai LCY government bond market fell **(Figure F)**.

A number of risks loom on the horizon for the region's LCY bond markets. These risks have intensified since the beginning of the year.

The Federal Reserve may raise interest rates within the first half of the year, which could generate outflows from the region's bond markets. While the Federal Reserve held interest rates steady on 27 January, there is a possibility that it could resume raising rates within the first half of the year. However, a gradual and cautious increase in interest rates, combined with emerging East Asian bond markets having already factored in US monetary policy normalization, suggest that the adverse impacts would be limited.

A strengthening dollar could adversely affect corporate balance sheets and exacerbate funding challenges. Further strengthening of the US dollar will reduce the LCY profits of some Asian companies and increase the LCY debts of those that have borrowed in US dollars. Heightened risk premiums could make it more difficult for Asian companies to issue bonds, particularly in light of tighter global financing conditions as the Federal Reserve normalizes US monetary policy.

A broader loss of investor confidence in emerging markets looms as the single biggest risk. Market-specific economic and political risk factors—such as a growth slowdown in the PRC or political instability and sharply lower growth in commodity-exporting emerging economies—could combine with global risk aversion, lower liquidity, and slower growth in emerging markets as a whole to spark a general selloff of emerging market assets. A crisis in one or more vulnerable emerging markets could have spillover effects and heighten risk aversion toward emerging markets in general. East Asian bond markets would not be immune in this scenario.

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

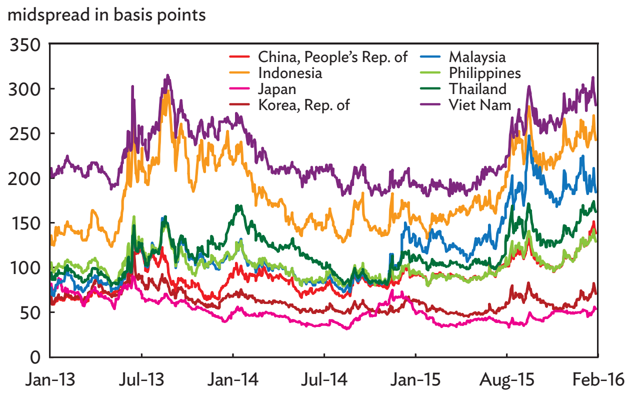


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

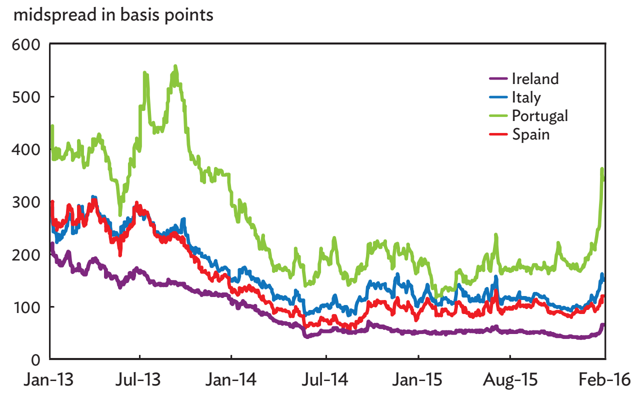


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

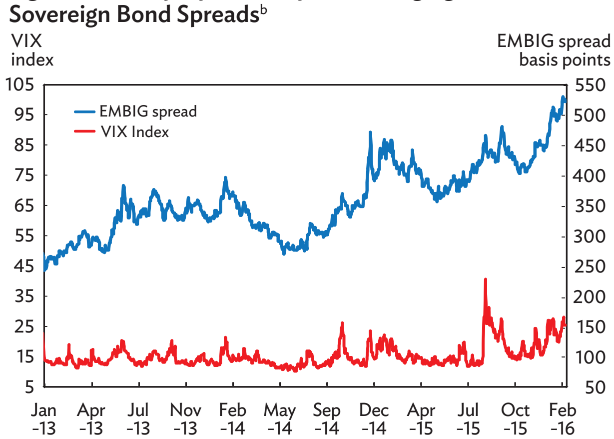


Figure D: 10-Year Government Bond Yields[b] (% per annum)

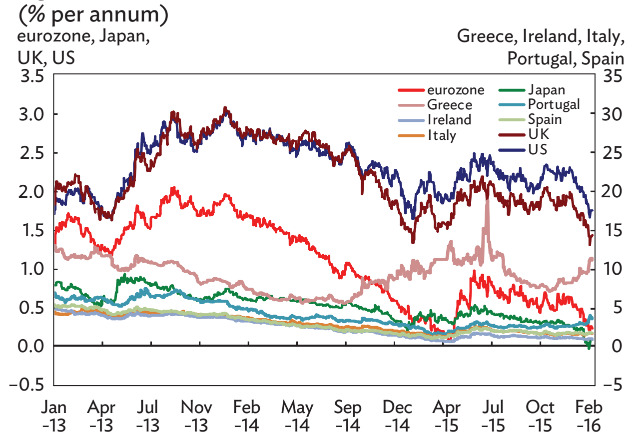


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

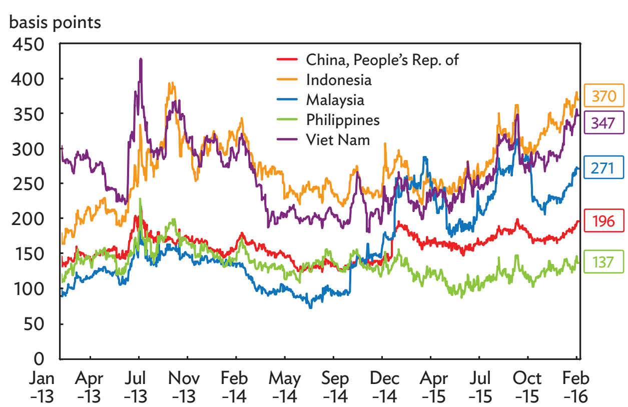
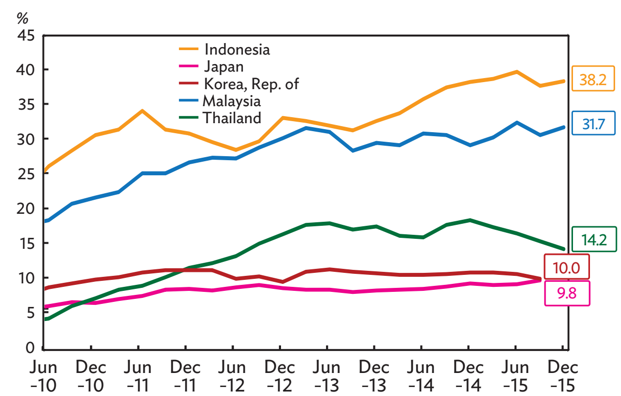


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 USD and based on sovereign bonds.

[b] Data as of 15 February 2016.

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

Sources: *AsianBondsOnline* and Bloomberg LP.