Bond Market Outlook

Local currency (LCY) government bond yields in advanced economies and emerging East Asia diverged between 31 December and 15 February.\(^1\) \(^2\) Yields in advanced economies rose while yields fell in most emerging East Asian bond markets due to heterogeneous economic fundamentals and changes in risk appetite.

In the United States (US), the Federal Reserve hinted that it would accelerate the pace of policy rate increases in 2017 on the back of a strengthening US economy as evidenced by steadily rising inflation and an unemployment rate that remains low. In the eurozone, gross domestic product (GDP) growth is stable and labor market conditions have improved. However, the European Central Bank indicated that monetary policy may need to remain accommodative. While the Bank of Japan raised its domestic growth outlook in January, it is also likely to maintain an easy monetary policy stance.

Emerging East Asia has shown signs of improving economic growth and rising inflation and a decline in LCY government bond yields was seen in most markets given improving investor confidence. The improved outlook could also strengthen emerging East Asia’s financial markets against the possible reversal of capital flows in response to the Federal Reserve’s expected monetary policy normalization.

The notable exception to the regional trend of declining yields was the People’s Republic of China, where 2-year and 10-year yields rose between 31 December and 15 February as the People’s Bank of China engaged in tightening measures to protect against asset and credit risks. Indonesia saw the biggest decline in yields in emerging East Asia during the review period, due to improving investor sentiment buoyed by a narrowing current account deficit in the fourth quarter (Q4) of 2016, an upgrade in sovereign rating outlooks from Fitch Ratings and Moody’s Investors Service, rising international reserves, and various policy reforms initiated by the government.

Improving investor confidence also resulted in a decline in credit default swap spreads in all emerging East Asian economies except the Republic of Korea. Furthermore, all currencies in the region appreciated versus the US dollar except for the Hong Kong dollar and Philippine peso.

As the global economy starts to pick up, uncertainties remain that could pose threats to the region’s bond markets. These include (i) the acceleration of rate hikes by the Federal Reserve; (ii) uncertainty over policies in major developed economies, particularly the US and the eurozone; and (iii) the depreciation of the Chinese yuan, which challenges growth prospects in Asia.

This issue of the Asia Bond Monitor includes three special discussion boxes. Box 1 discusses the risk of Federal Reserve rate hikes to emerging Asia’s financial stability.\(^3\) Box 2 analyzes the risks to emerging Asia’s financial markets stemming from policy and political uncertainties in the US and the eurozone. Box 3 tackles the impacts of the depreciation of the Chinese yuan.

Local Currency Bond Market Growth in Emerging East Asia

Emerging East Asia’s LCY bond market reached a size of USD10,177 billion at the end of December, with growth moderating on both a quarter-on-quarter (q-o-q) and year-on-year (y-o-y) basis.

Leading the region in terms of LCY bond market size at the end of December was the People’s Republic of China, whose outstanding bonds of USD7,129 billion accounted for 70.0% of the region’s total. The next largest LCY bond market in the region in Q4 2016 was the Republic of Korea’s, with outstanding bonds of USD1,714 billion and a regional share of 16.8% at the end of December.

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\(^1\) 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.

\(^2\) Bond yields in many emerging East Asian markets have rebounded slightly since the end of the review period (mid-February), largely due to the United States Federal Reserve’s policy rate hike on 15 March. Nevertheless, regional bond yields were still mostly down year-to-date as of 15 March.

\(^3\) Emerging Asia comprises the People’s Republic of China; Hong Kong, China; India; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Taipei (China); Thailand; and Viet Nam.
Emerging East Asia’s LCY bond market continued to be dominated by government bonds, which totaled USD6,572 billion and accounted for 64.6% of the regional total at the end of December. LCY corporate bonds outstanding stood at USD3,605 billion.

As a share of emerging East Asia’s GDP, LCY bonds outstanding were the equivalent of 68.5% of the region’s GDP at the end of December, declining from 69.2% in the previous quarter due to weaker growth in the corporate bond market. The Republic of Korea maintained its position in Q4 2016 as the market with the largest LCY bonds-to-GDP share of 117.3%.

LCY bond issuance declined in Q4 2016 compared with the third quarter as most central banks and governments pared their issuance. On the other hand, corporates were more active issuers during the fourth quarter as they locked in lower borrowing costs ahead of anticipated interest rate increases in the US.

**Structural Developments in Local Currency Bond Markets**

At the end of December, the foreign holdings share in most emerging East Asian markets declined due to a stronger US dollar and expectations of accelerated US interest rate hikes in 2017. The share of foreign holdings in emerging bond markets fell in Indonesia, Malaysia, and Thailand at the end of December.

However, neither Indonesia nor Malaysia experienced yield upticks as a result of a foreign sell-off. These markets have become more resilient to capital outflows due to solid economic fundamentals, increased demand from domestic market participants, improved investor profiles, and better-developed local currency bond markets following the implementation of the Asian Bond Markets Initiative.

Due to risk aversion among foreign investors, foreign capital outflows were registered in Q4 2016 in all four bond markets for which data are available, with the largest net bond outflows observed in the Republic of Korea. For full-year 2016, the Republic of Korea was the only market that posted net foreign bond outflows, while Thailand recorded the largest foreign capital inflows.

Recent data from January suggest improving sentiments toward emerging market assets, with most markets experiencing a net inflow of foreign capital into their bond markets during the month. Malaysia, however, continued to experience bond outflows in January, albeit at a much slower pace than in Q4 2016.

**Local Currency Bond Yields**

Emerging East Asian bond yields fell for most tenors in nearly all markets between 31 December and 15 February due to improving investor sentiments resulting from strengthened economic conditions across the region.

Given emerging East Asia’s improved economic prospects, the 2-year versus 10-year yield spread rose in all of the region’s markets except Singapore between 31 December and 15 February.