Global and Regional Market Developments

Bond yields rose amid signs of economic recovery and vaccination.

Long-term government bond yields rose in major advanced economies and most emerging East Asian markets from 31 December to 15 February on optimism over the global economic recovery and vaccine rollouts in 2021 (**Table A**).[1] Positive economic sentiment was also reflected in the widening of the spread between 2-year and 10-year government bond yields.

During the review period, 10-year government bond yields among major advanced economies rose, supported by improved economic forecasts. In the United States (US), the 10-year government bond yield gained a significant 30 basis points (bps), while the 2-year yield marginally fell by 1 bp (**Figure A**). In addition to the positive economic outlook, rising yields were supported by expectations of additional fiscal stimulus and ongoing vaccination efforts.

Recent economic data reflect the continued recovery of the US economy. The Federal Reserve noted that gross domestic product (GDP) in the US grew at an annualized rate of 4.1% in the fourth quarter (Q4) of 2020, following a 33.4% gain in the previous quarter. Nonfarm payrolls rebounded in January, with an addition of 166,000 jobs versus a decline of 306,000 in December 2020. In February, nonfarm payrolls further improved, with an additional 379,000 jobs. The unemployment rate fell to 6.2% in February from 6.3% and 6.7% in January and December, respectively. Retail sales also gained 7.6% month-on-month in January after declines of 1.0% and 1.3% in December and November 2020, respectively. The Federal Reserve indicated that investor optimism was high, driven by vaccination efforts and expectations of strong fiscal stimulus.

The Federal Reserve upgraded its GDP forecast in December, raising the forecasts for growth in 2021 and

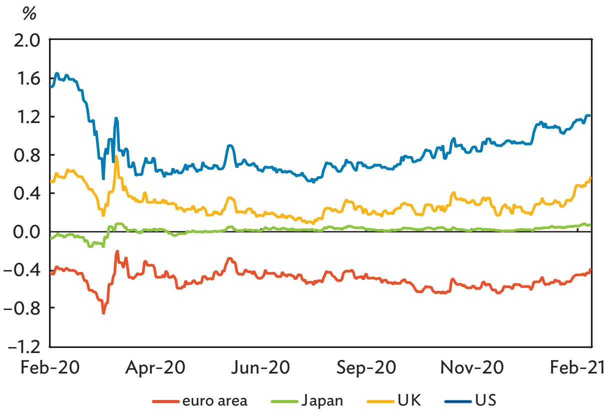
Table A: Changes in Global Financial Conditions

	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	(1)	30	–	4.8	–
United Kingdom	13	37	(2)	4.6	1.7
Japan	(0.3)	6	(0.03)	8.3	(2.0)
Germany	0.5	19	0.1	2.8	(0.7)
Emerging East Asia					
China, People's Rep. of	10	10	1	5.2	1.1
Hong Kong, China	2	26	–	10.8	0.01
Indonesia	70	36	0.1	4.9	1.0
Korea, Rep. of	(4)	14	0.6	9.5	(1.4)
Malaysia	(0.1)	20	1	(1.2)	(0.3)
Philippines	4	13	2	(2.5)	0.2
Singapore	4	24	–	3.1	(0.1)
Thailand	12	11	2	5.1	0.2
Viet Nam	14	(27)	(1)	1.0	0.4

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 31 December 2020 and 15 February 2021.
2. A positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the United States dollar.
Sources: Bloomberg LP and Institute of International Finance.

[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.

Figure A: 10-Year Government Bond Yields in Major Advanced Economies (% per annum)



UK = United Kingdom, US = United States.
Note: Data as of 15 February 2021.
Source: Bloomberg LP.

2022 to 4.2% and 3.2%, respectively, from 4.0% and 3.0% in September. As widely expected, the Federal Reserve left monetary policy unchanged during its 26–27 January meeting, leaving the federal funds target rate range at 0.0%–0.25%.

The euro area's economy continued to contract in Q4 2020, as GDP declined 4.9% year-on-year (y-o-y) following a decline of 4.2% in the third quarter. Industrial production also declined 0.1% month-on-month in December before rising 0.8% month-on-month in January. Concerns about rising cases of the coronavirus disease (COVID-19) and the emergence of new strains led the European Central Bank (ECB), at its 10 December 2020 meeting, to increase its pandemic emergency monthly purchase program by EUR500 billion to EUR1,850 billion, and to extend the program's end date to March 2022 from June 2021. The ECB subsequently left monetary policy unchanged at its monetary policy meeting on 21 January.

The ECB noted that the pandemic caused a near-term decline in output, while the central bank remained cautiously optimistic over the medium-term amid improving signs for the global economy as well as expanded vaccination programs around the world. In December, the ECB downgraded its 2021 and 2022 GDP forecasts to 3.9% and 4.2%, respectively, from 5.0% and 3.2% in September.

Similar to the US, Japan also posted positive GDP growth in Q4 2020 at 11.7% y-o-y, albeit this was weaker than the 22.8% y-o-y gain in the third quarter. At its 18 December meeting, the Bank of Japan left the monetary policy rate unchanged and extended the duration of its asset purchase program (commercial paper and corporate bonds) by 6 months until the end of September 2021. The Bank of Japan also upgraded its GDP growth forecast for 2021 and 2022 to 3.9% and 1.8%, respectively, from 3.6% and 1.6% in September.

Similar to advanced economies, 2-year and 10-year government bond yields rose in most emerging East Asian markets during the review period. The largest rise in yields came from Indonesia, with its 2-year and 10-year yields rising 70 bps and 36 bps, respectively. Indonesia was one of the earliest regional economies to start a vaccination program. In Q4 2020, Indonesia posted a GDP contraction of 2.2% y-o-y, smaller than the 3.5% y-o-y contraction in the previous quarter. On 18 February, Bank Indonesia lowered its policy rate by 25 bps to support economic growth and downgraded its forecast for 2021 GDP growth to a range of 4.3%–5.3% from 4.8%–5.8%.

Malaysia's 10-year yield gained 20 bps during the review period. At its 20 January monetary policy meeting, Bank Negara Malaysia said that it expected economic growth to recover in the second half of 2021 despite near-term weaknesses. Malaysia's yields were also affected by a ratings downgrade by Fitch to BBB+ from A– on 4 December 2020. Hong Kong, China; Singapore; the Republic of Korea; the Philippines; Thailand; and the People's Republic of China (PRC) all witnessed an increase in their respective 10-year government bond yield. The only exception to the regional trend was Viet Nam, which experienced a 27-bps decline in the 10-year government bond yield that was driven by strong investor demand. However, inflationary concerns are rising due to the unprecedented fiscal stimulus in response to the pandemic, potentially placing further upward pressure on yields. The recent passage of the USD1.9 trillion (8.8% of GDP) fiscal stimulus plan in the US has raised concerns about inflation in the US. Those concerns are evident in rising US bond yields and may prompt the Federal Reserve to tighten policy. Such tightening can potentially trigger capital outflows and financial instability in the region.

In terms of economic performance, all emerging East Asian markets posted contractions in Q4 2020 except the PRC and Viet Nam. The PRC's GDP growth rate rose to 6.5% y-o-y in Q4 2020 from 4.9% y-o-y in Q3 2020, while Viet Nam's GDP growth rose to

Table B: Policy Rate Changes

Economy	Policy Rate 1-Mar-2020 (%)	Rate Change (%) Mar-2020	Apr-2020	May-2020	Jun-2020	Jul-2020	Aug-2020	Sep-2020	Oct-2020	Nov-2020	Dec-2020	Jan-2021	Feb-2021	Policy Rate 28-Feb-2021 (%)	Change in Policy Rates (basis points)
United States	1.75	↓1.50												0.25	↓ 150
Euro Area	(0.50)													(0.50)	
Japan	(0.10)													(0.10)	
China, People's Rep. of	3.15		↓0.20											2.95	↓ 20
Indonesia	4.75	↓0.25			↓0.25	↓0.25				↓0.25			↓0.25	3.50	↓ 125
Korea, Rep. of	1.25	↓0.50		↓0.25										0.50	↓ 75
Malaysia	2.75	↓0.25		↓0.50		↓0.25								1.75	↓100
Philippines	3.75	↓0.50	↓0.50		↓0.50					↓0.25				2.00	↓ 175
Thailand	1.00	↓0.25		↓0.25										0.50	↓ 50
Viet Nam	6.00	↓1.00		↓0.50					↓0.50					4.00	↓200

( ) = negative.
Notes:
1. Data as of 28 February 2021.
2. For the People's Republic of China, the 1-year medium-term lending facility rate is used. While the 1-year benchmark lending rate is the official policy rate of the People's Bank of China, market players use the 1-year medium-term lending facility rate as a guide for the monetary policy direction of the People's Bank of China.

Sources: Various central bank websites.

4.5% y-o-y in Q4 2020 from 2.6% y-o-y in the previous quarter. To further support economic recovery in 2021, most central banks in the region maintained their accommodative monetary stances, leaving policy rates unchanged during the review period (**Table B**).

However, central banks may begin to tighten monetary policy in response to inflationary pressures. More recently, there are growing concerns about a possible spike in inflation fueled by the massive fiscal stimulus and monetary easing seen in 2020.

Economic Outlook

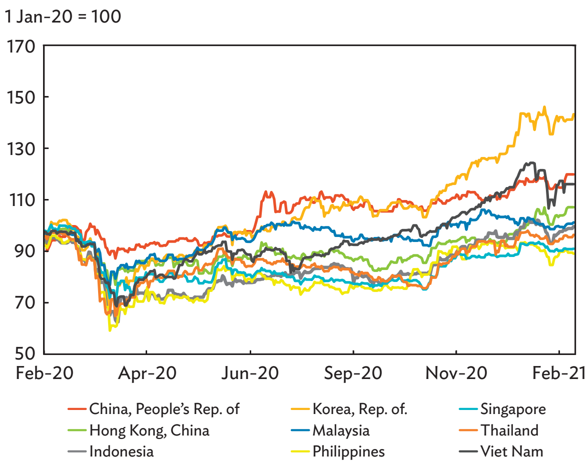
One big positive shock to the global economy was the advent of safe and effective COVID-19 vaccines in November. The pandemic is far from over, but the good news on vaccine developments and rollouts has lifted business and consumer confidence. Reflecting the positive vaccine developments, the International Monetary Fund (IMF), in its latest *World Economic Outlook Update* released in January 2021, upgraded its global growth forecast for 2021 to 5.5% from an October 2020 forecast of 5.2%. The IMF also estimated that the world economy contracted by 3.5% in 2020. For 2022, the IMF kept its global growth forecast at 4.2%. For advanced economies, the IMF is projecting growth of 4.3% in 2021 and 3.1% in 2022, following an estimated contraction of 4.9% in 2020. The 2021 growth forecast for the US was upgraded sharply in January to 5.1% from 3.1% in October. For emerging markets and developing economies, growth is projected to be 6.3% in 2021 and 5.0% in 2022, following an estimated contraction of 2.4% in 2020.

According to the *Asian Development Outlook Supplement* released in December 2020, developing Asia is projected to grow 6.8% in 2021 after contracting an estimated 0.4% in 2020.[2] The Asian Development Bank's projected 2021 growth figures for the PRC; the Association of Southeast Asian Nations (ASEAN); the Republic of Korea; and Hong Kong, China are 7.7%, 5.2%, 3.3%, and 5.1%, respectively. Relative to the *Asian Development Outlook* released in September 2020, ASEAN's growth forecast was downgraded by 0.3 percentage points from 5.5%, while the other three forecasts remained the same. In 2020, the PRC grew by an estimated 2.1%; ASEAN; the Republic of Korea; and Hong Kong, China contracted by 4.4%, 0.9%, and 5.5%, respectively.

To sum up, both regional and global economic growth is expected to rebound strongly in 2021 after the severe pandemic-induced downturn in 2020. The development of safe and effective vaccines was a positive shock to the regional and global economies. Despite the advent of vaccines, however, the economic outlook for developing Asia and the world remains subject to a great deal of uncertainty since COVID-19 is likely to persist for some time.

[2] Developing Asia comprises the 46 developing member economies of the Asian Development Bank.

Figure B.1: Equity Indexes in Emerging East Asia



Note: Data as of 15 February 2021.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

Figure B.2: Changes in Equity Indexes in Emerging East Asia

( ) = negative.
Notes:
1. Changes between 31 December 2020 to 31 January 2021 and from 31 January 2021 to 15 February 2021.
2. Numbers on the chart refer to the net change between the two periods.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

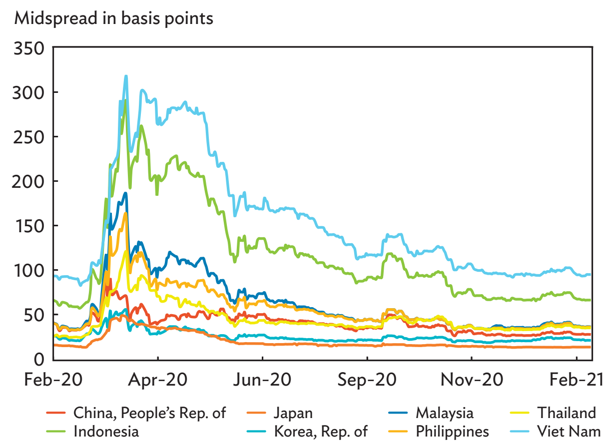
Improvement in investment sentiment supported regional equity markets. Most emerging East Asian economies posted equity gains during the review period (**Figure B.1**). Equity markets moved upward in the middle of February on progress on the proposed USD1.9 trillion stimulus package in the US (**Figure B.2**). The region's most rapidly rising equity market indexes were in Hong Kong, China and the Republic of Korea, which posted gains of 10.8% and 9.5%, respectively. The only exceptions to the regional trend were Malaysia (−1.2%) and the Philippines (−2.5%), with the latter posting the largest GDP decline among all markets in emerging East Asia in Q4 2020 at −8.3% y-o-y.

Positive investment sentiment was also seen in declines in risk premia, as credit default swap spreads largely trended downward (**Figure C**). Sovereign stripped spreads showed similar movements to the J. P. Morgan Emerging Market Bond Index Global (**Figure D**).

During the review period, regional currencies were broadly stable versus a weakened US dollar, with marginal movements (**Figure E.1**). The Chinese yuan strengthened the most, rising 1.1% from 31 December 2020 to 15 February 2021 on continued economic growth. The largest decline was in the Republic of Korea, where the won depreciated 1.4% versus the US dollar during the review period (**Figure E.2**).

The shares of foreign holdings in the region's bond markets posted mixed patterns in Q4 2020 (**Figure F**).

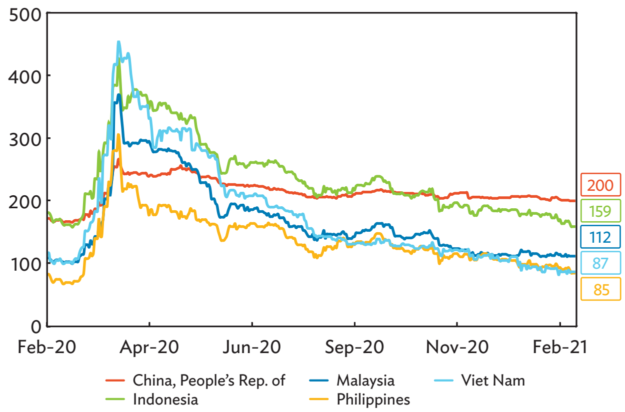
Figure C: Credit Default Swap Spreads in Select Asian Markets (senior 5-year)



USD = United States dollar.
Notes:
1. Based on USD-denominated sovereign bonds.
2. Data as of 15 February 2021.
Source: Bloomberg LP.

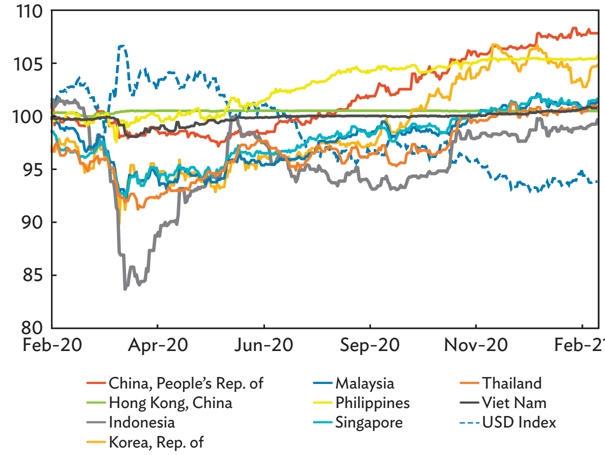
The share of foreign holdings in the PRC bond market gained 0.3 percentage points during the quarter. After declining throughout much of the year, the share of foreign holdings in the Philippines recovered to 2.7% at the end of December as investment sentiment improved. The foreign holdings share in Malaysia rose by 1.6 percentage points in Q4 2020 to reach 25.2% at the end of December. The foreign holdings shares in Thailand and Indonesia

Figure D: JP Morgan Emerging Markets Bond Index Sovereign Stripped Spreads



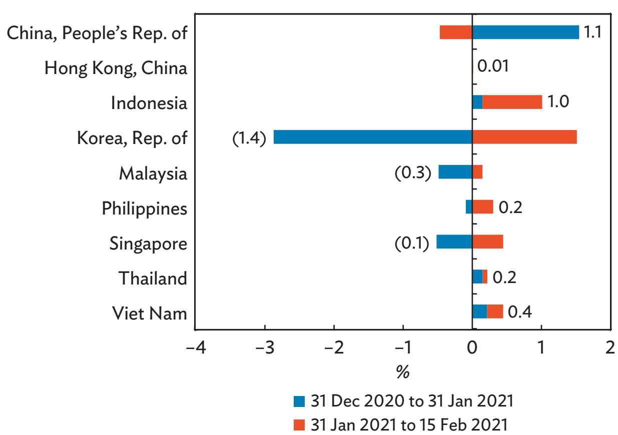
USD = United States dollar.
Notes:
1. Based on USD-denominated sovereign bonds.
2. Data as of 15 February 2021.
Source: Bloomberg LP.

Figure E.1: Currency Indexes in Emerging East Asia and the United States



USD = United States dollar.
Note: Data as of 15 February 2021.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

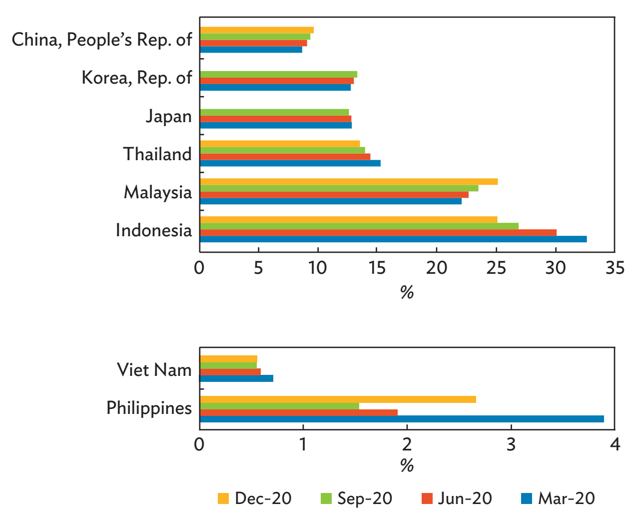
Figure E.2: Changes in Spot Exchange Rates vs. the United States Dollar



Notes:
1. Changes between 31 December 2020 to 31 January 2021 and from 31 January 2021 to 15 February 2021.
2. Numbers on the chart refer to the net change between the two periods.
3. A positive (negative) value for the foreign exchange rate indicates the appreciation (depreciation) of the local currency against the United States dollar.

Source: Bloomberg LP.

Figure F: Foreign Holdings of Local Currency Government Bonds in Select Asian Markets (% of total)



Note: Data for Japan and the Republic of Korea as of 30 September 2020.
Source: *AsianBondsOnline* calculations based on data from local market sources.

registered declines of 0.4 percentage points and 1.8 percentage points, respectively, in Q4 2020.

Risks to Economic Outlook and Financial Stability

Broadly speaking, the risk that COVID-19 poses to the world economy and financial markets has receded tangibly. The development of multiple safe and effective vaccines is a massive game-changer that can show a clear path toward the normalization of the economy and society. The unexpectedly rapid development of vaccines is nothing short of a miracle and a testament to the ingenuity and hard work of the medical and scientific communities. The experience of Israel, which leads the world in terms of vaccination rate, gives plenty of cause for optimism that vaccines will restore the world to pre-COVID-19 normalcy or something close to that. Infection rates are coming down sharply, social distancing restrictions are being relaxed, and the economy is being reopened.

Notwithstanding the arrival of safe and effective vaccines, the overarching risk to the global economic outlook and financial stability remains the trajectory of the COVID-19 pandemic. There are a number of reasons why vaccine development mitigates the risk from the pandemic but does not eliminate it altogether. In fact, while this risk has receded, it remains substantial for both emerging East Asia and the world.

Above all, vaccine rollouts have been uneven across countries. Specifically, most of the global supply of safe and effective vaccines has been secured by advanced economies. Some advanced economies such as Canada have secured quantities that are several times larger than their respective population. In stark contrast, many developing countries face a severe shortage of vaccines. Since COVID-19 is an infectious global disease that can easily cross borders, it will not be brought fully under control until much of the world, including developing countries, has been vaccinated. And as long as the virus is not contained across the world, there is a nonnegligible risk of a virulent resurgence like the one that ravaged Europe last fall. The slow progress of vaccine rollouts in developing countries thus harms the entire world.

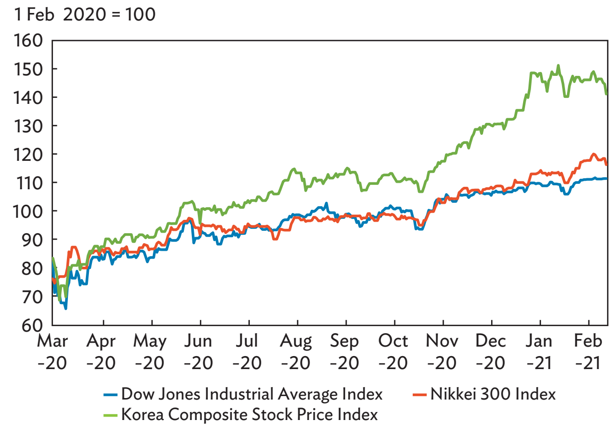
There are negative factors that amplify the risk from the uneven vaccine rollouts and positive factors that mitigate the risk. On the negative side, the last few months have seen the emergence of new strains of COVID-19 in Brazil, South Africa, the United Kingdom, and elsewhere. There is some evidence indicating that particular variants may be more infectious and even more deadly. More importantly, there are concerns that existing vaccines may be less effective against some variants. These considerations make it all the more imperative for vaccines to be distributed and administered across the world before we see a proliferation of intractable variants.

On the positive side, the rapid rollout in advanced economies implies there will be more vaccines available for developing countries in the coming months. The COVID-19 Vaccines Global Access facility, which is commonly known as COVAX, has been set up by the World Health Organization and other bodies to promote equitable access to vaccines. The facility has already secured sizable supplies of vaccines for distribution to developing countries. Furthermore, some of the vaccines do not have to be stored at extremely cold temperatures, which reduces the storage and distribution logistics challenges for developing countries.

To sum up, the advent of safe and effective vaccines is a massive positive shock for the global economy and financial markets, but the world is not out of the COVID-19 woods yet. Far from it. The Israeli experience suggests that extensive vaccination can normalize the economy and society fairly quickly, even though the post-COVID-19 normal will differ in some ways from the pre-COVID-19 normal—e.g., voluntary social distancing and more work-from-home opportunities. Nevertheless, the slow progress of vaccine rollouts in many countries, especially developing countries, means that the threat of a virulent resurgence remains.

Beside risks that are directly related to COVID-19 and uneven vaccine rollouts, financial supervisory authorities would do well to monitor asset prices. Some of the abundant liquidity unleashed by global and regional central banks is finding its way into asset markets. In this connection, many stock markets around the world have risen sharply since the market volatility of early March 2020 (**Figure G**). While there are definitely major positive factors at play—such as vaccine development and the reopening of economies—it is not clear whether the magnitude of the escalation can be mostly, or even largely, explained by those factors. Potentially unsustainable asset price inflation fueled by monetary expansion entails the risk of a subsequent sharp and abrupt correction that could destabilize the financial system. Furthermore, the mix of monetary and fiscal stimulus may generate inflationary pressures for goods and services, not just assets. Central banks may respond by tightening monetary policy, which could destabilize financial markets. An additional source of potential risk is the passage of the USD1.9 trillion US fiscal stimulus program, which has triggered concerns about inflation, as evidenced by rising US bond yields. If the Federal Reserve responds by raising interest rates, the consequent tightening of global liquidity may cause a pullback of capital, which can potentially destabilize the region's financial markets.

Figure G: Stock Market Indices in Japan, the Republic of Korea, and the United States



Note: Data as of 24 February 2021.
Source: Bloomberg LP.