

# Introduction: Global and Regional Market Developments

The external environment facing emerging East Asian<sup>1</sup> economies has weakened as the United States (US) economy continues to struggle and a shadow lingers over the eurozone. While global financial markets have largely stabilized, the debt crisis facing several peripheral economies in Europe is a reminder of the risk overhang.

Emerging East Asia's robust growth is expected to moderate due to a weaker global outlook and the normalization of stimulus packages. The region's still relatively strong growth outlook, along with rising interest rate differentials and ongoing accommodative policies in mature markets, will continue to drive foreign capital inflows into the region's asset markets (**Figure A**). Some economies are now introducing capital controls and other administrative measures to dampen volatility and ease pressure on exchange rates.

Compared with end-2009, the government yield curves in mature markets, as well as in local currency (LCY) bond markets in the region, have witnessed a flattening trend. However, this trend has been partially reversed by the introduction of the second round of quantitative easing by the US Federal Reserve. Yields on 10-year government bonds in mature markets have risen (**Figure B**). Market attention has also turned to high levels of public debt in the US and parts of Europe.

Financial market conditions have largely stabilized, with emerging markets posting steady gains, amid flush global liquidity. Corporate bond spreads have tightened even in mature markets experiencing a strong recovery in credit conditions this year (**Figure C**). Since the middle of 2010, there has been a rapid recovery in global stock markets, with Latin America and emerging Asian markets leading the way (**Figure D**).

Investor preference for emerging market assets is also reflected in a renewed decline in JP Morgan's Emerging Markets Bond Index (EMBI) sovereign stripped spreads (**Figure E**) and a continued decline in credit default swap (CDS) spreads for emerging East Asian government bonds (**Figure F**). However, CDS spreads for some European paper have widened over investor worries about fiscal conditions (**Figure G**).

The correlation between LCY bond markets and US treasuries has decreased for some markets in recent months (**Figure H**). LCY bond yield curves have also steepened recently on inflationary concerns and interest rate hikes in some markets. However, strong foreign demand for LCY bonds is counteracting this rise.

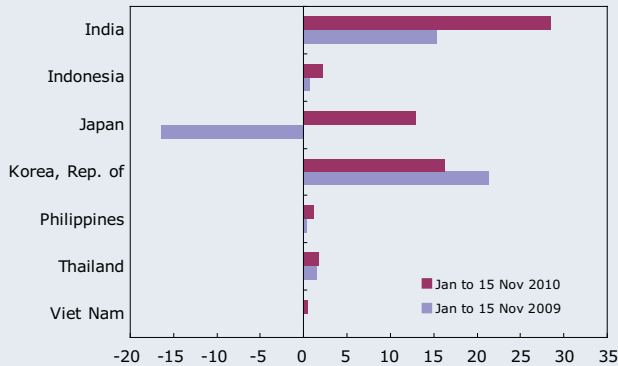
The growth performance of emerging East Asian economies generally tempered in 3Q10 compared with the previous quarter. The People's Republic of China (PRC) reported that its economy expanded 9.6% year-on-year (y-o-y) in 3Q10 versus 10.3% in 2Q10. The Republic of Korea's gross domestic product (GDP) grew 4.5% y-o-y in 3Q10 against 7.2% in 2Q10. However, the Republic of Korea's domestic consumption remained strong even as exports weakened. Also in 3Q10, GDP grew 6.5% y-o-y in the Philippines, 5.3% in Malaysia, 6.7% in Thailand, and 10.6% in Singapore (based on preliminary estimates).

The risks to the market outlook in the region are now tilted to the downside. These include (i) a reversal of growth in advanced economies, (ii) destabilizing capital inflows, and (iii) possible overheating of some economies if governments are too slow to withdraw their economic stimulus programs.

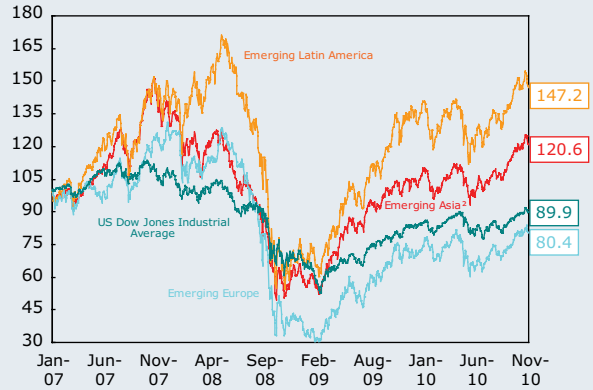
Emerging East Asian LCY bonds continued their strong performance in 2010, with corporate bond growth as the major driver this year compared with the generally more dominant government

<sup>1</sup> Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia; Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.

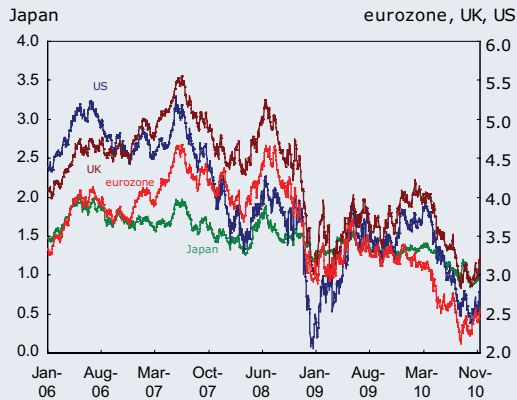
**Figure A: Net Foreign Portfolio Investment in Equities (USD billion)**



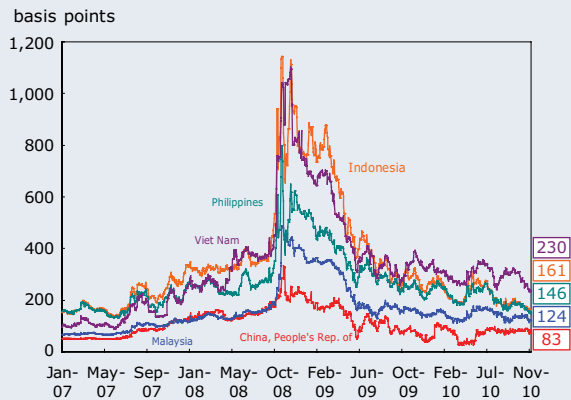
**Figure D: MSCI Indexes<sup>2</sup> (January 2007 = 100)**



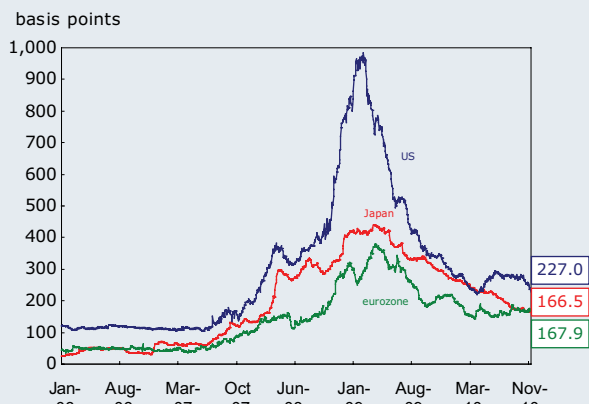
**Figure B: 10-Year Government Bond Yields (% per annum)**



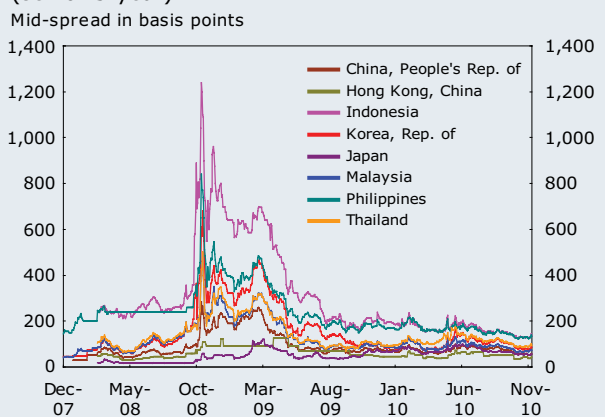
**Figure E: JPMorgan EMBI Sovereign Stripped Spreads<sup>3</sup>**



**Figure C: Corporate Bond Spreads<sup>1</sup>**



**Figure F: Credit Default Swap Spreads (senior 5-year)<sup>3</sup>**



EMBI = Emerging Markets Bond Index, UK = United Kingdom, US = United States.

Notes:

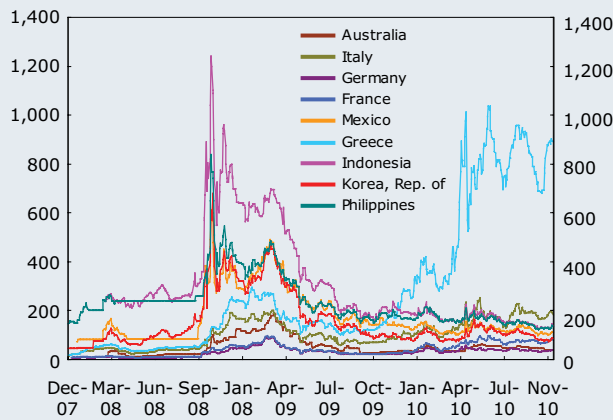
<sup>1</sup> Bond spread refers to the difference between yields of 5-year bonds issued by BBB-rated finance companies and yields of sovereign benchmark bonds of the same tenor.

<sup>2</sup> Includes People's Republic of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Taipei, China; and Thailand.

<sup>3</sup> USD spread based on sovereign bonds.

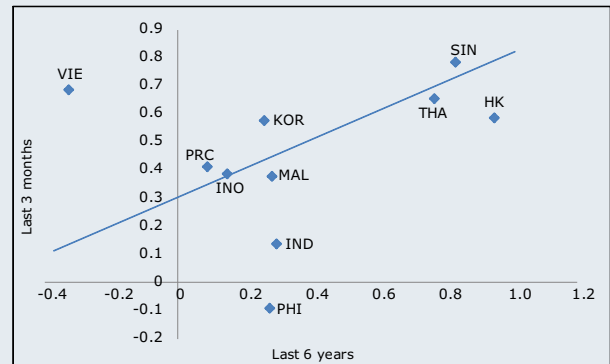
Source: Thomson DataStream, Morgan Stanley Capital International (MSCI) Barra, and Bloomberg LP.

**Figure G: Credit Default Swap Spreads for Select OECD and Asian Economies**



OECD = Organisation for Economic Co-operation and Development  
Source: Thomson DataStream.

**Figure H: Correlation between Yields on 10-Year US Treasury Bonds and 10-Year LCY Government Bonds**



HK = Hong Kong, China; IND = India; INO = Indonesia; KOR = Rep. of Korea; LCY = local currency; MAL = Malaysia; PHI = Philippines; PRC = People's Rep. of China; SIN = Singapore; THA = Thailand; US = United States; and VIE = Viet Nam.  
Source: Bloomberg LP and Standard Chartered.

sector. The y-o-y growth rate for the region's LCY bond market in 3Q10 was 17.2% against 18.7% in 2Q10, driven by 23.8% growth in corporate bonds. The slowdown in government bonds outstanding, from 16.6% in 2Q10 to 14.6% in 3Q10, was due to a paring down of fiscal stimulus and a drop in central bank issuance.

At the end of 1Q10, emerging East Asia's share of the global bond market stood at 7.4%, compared with 2.1% before the onset of the 1997/98 Asian financial crisis (**Table A**). The two largest markets in the region at the end of 1Q10 were the PRC (4.2% of the global bond market) and the Republic of Korea (1.7%).

**Table A: Bonds Outstanding in Major Markets (USD billion)**

	Mar-10		Dec-96	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	24,978	39.8	10,926	42.9
Japan	9,754	15.5	4,456	17.5
France	3,094	4.9	1,261	4.9
Germany	2,632	4.2	1,888	7.4
United Kingdom	1,525	2.4	678	2.7
Emerging East Asia	4,633	7.4	527	2.1
of which: PRC	2,648	4.2	62	0.2
Emerging East Asia excl. PRC	1,985	3.2	465	1.8
of which: Korea, Rep. of	1,095	1.7	283	1.1
of which: ASEAN-6	735	1.2	148	0.6
Indonesia	108	0.2	7	0.0
Malaysia	199	0.3	71	0.3
Philippines	66	0.1	28	0.1
Singapore	159	0.3	25	0.1
Thailand	191	0.3	18	0.1
Viet Nam	12	0.0	—	—
Memo Items:				
Brazil	1,218	1.9	299	1.2
PRC (excl. policy bank bonds)	1,971	3.1	—	—
India	652	1.0	81	0.3
Russia	51	0.1	43	0.2

— = not applicable, ASEAN = Association of Southeast Asian Nations, LCY = local currency, PRC = People's Republic of China.

Note: Emerging East Asia comprises the People's Republic of China; Hong Kong, China; Indonesia: Republic of Korea; Malaysia; Philippines; Singapore; Thailand; and Viet Nam.

Source: Bank for International Settlements and *AsianBondsOnline*.