Global and Regional Market Developments

Emerging East Asia's bond markets remained relatively unaffected as global financial market turmoil impacted other emerging markets in 3Q14.[3] A weaker global economic outlook combined with the end of quantitative easing in the United States (US) has generated increased volatility in financial markets, particularly currency markets. Amid elevated market uncertainty, the US dollar has appreciated on the back of a relatively stronger economic performance in the US and an expected rise in interest rates as quantitative easing ends.

In contrast, the latest economic indicators from the eurozone indicate slower growth and dangerously low inflation. With the eurozone flirting with deflation, there is increasing pressure on the European Central Bank to take more aggressive monetary actions. Momentum is also slowing in the Japanese economy following an increase in the sales tax in April. In response, the Bank of Japan announced at the end of October that it would increase its annual asset purchases to JPY80 trillion yen. More expansionary monetary actions from the eurozone and Japan could help offset the tighter liquidity conditions caused by the end of the US Federal Reserve's quantitative easing. Meanwhile, Japanese investment trusts have maintained their level of bond investment in emerging East Asia. Indonesia and Malaysia have been the favored destinations of Japanese investment funds who are looking for higher yields.

Asian 10-year bond yields generally exhibited a downward trend between July and October **(Table A)**. Viet Nam's 10-year bond yields dipped the most, dropping 235 basis points (bps), due to moderating inflation which led the central bank to lower a key policy rate; in October, the State Bank of Viet Nam reduced the deposit rate cap to 5.5% from 6.0%. Other economies with large declines in 10-year bond yields were the Republic of Korea, Thailand, and the People's Republic of China (PRC), where yields fell 51 bps, 48 bps, and 26 bps, respectively. On the other hand, 10-year bond yields in the Philippines rose 10 bps amid elevated inflation.

Most of the region's currencies weakened against the US dollar between July and October. The Korean won had the largest decline, depreciating 5.7% against the US dollar. Currencies in Singapore and the Philippines also depreciated 3.2% and 2.9%, respectively. In contrast, the People's Republic of China (PRC) and Viet Nam saw the value of their currencies strengthen 1.4% and 0.2%, respectively.

The region's credit default swaps (CDSs) declined in October, after rising in September, as investor risk perceptions normalized **(Figure A)**. In contrast, CDSs in the eurozone increased on concerns over the region's economic growth **(Figure B)**. Emerging market spreads and the volatility index fell as uncertainty in US markets abated amid a strong growth outlook **(Figure C)**.

Bond yields in the advanced economies also continued to trend downward between July and October. US bond yields dropped despite the Federal Reserve's tapering actions in the first half of October, likely reflecting increased flows into the government bond market with investors seeking safe haven assets amid global market uncertainty **(Figure D)**. However, by the end of the month, the Federal Reserve's announcement that its quantitative easing program would end sent yields rising again in the US and the United Kingdom. Yields fell in Japan due to additional stimulus measures taken in October, while inflation in the eurozone remained dangerously low at 0.3% year-on-year (y-o-y) in September. The European Central Bank has taken steps to buy asset-backed securities and covered securities, but more action may be needed. With the German economy close to a recession and unemployment in the eurozone stubbornly high, there are rising expectations that the European Central Bank will launch a larger-scale quantitative easing program. Reflecting increased global risk perceptions, Greek bond yields saw a big jump at end-October. Meanwhile, interest rates in emerging East Asia have also fallen, following US yields **(Figure E)**.

Foreign holdings of Indonesia local currency (LCY) government bonds continued to rise in 3Q14 as relatively high interest rates attracted yield-hungry investors. At end-September, the share of foreign ownership in the Indonesian LCY government bond market was 37.3%, up

[3] 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	3	(23)	–	2.3	–
United Kingdom	(25)	(46)	1	(3.8)	6.7
Japan	(4)	(10)	11	4.4	(10.6)
Germany	(8)	(41)	(0.2)	(5.8)	8.4
Emerging East Asia					
China, People's Rep. of	(16)	(26)	4	18.0	1.4
Hong Kong, China	(9)	(19)	–	3.5	(0.1)
Indonesia	2	(11)	(14)	4.2	(1.9)
Korea, Rep. of	(53)	(51)	(1)	(1.7)	(5.7)
Malaysia	6	(20)	(3)	(1.3)	(2.6)
Philippines	(1)	10	2	5.7	(2.9)
Singapore	9	1	–	1.0	(3.2)
Thailand	(16)	(48)	(27)	6.6	(0.6)
Viet Nam	(140)	(235)	–	3.9	0.2
Select European Markets					
Greece	206	232	–	(25.5)	8.4
Ireland	(3)	(52)	18	0.2	8.4
Italy	5	(37)	35	(8.3)	8.4
Portugal	(10)	(38)	47	(24.3)	8.4
Spain	0.4	(55)	30	(4.8)	8.4

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 July 2014 and 31 October 2014.
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 and Institute of International Finance.

from 35.7% in June. In Thailand, foreign holdings of LCY government bonds dipped slightly to 15.8% at end-June from 16.1% at end-March. The share of foreign holdings of government bonds was highest in Indonesia at the end of 3Q14, followed by Malaysia at 32.0% at end-June (the latest period for which data are available) **(Figure F)**. Meanwhile, foreign holdings in Japan and the Republic of Korea remained relatively stable in the first half of 2014.

Increased global financial market volatility points to rising risks in the region's LCY bond markets:

There is a risk that liquidity might dry up in the region's LCY corporate bond market. Having ample liquidity is important for the smooth functioning of a bond market as it enables participants to enter and exit the market easily with minimal cost. There are concerns that liquidity conditions are tightening because the higher capital requirements under Basel III regulations have pushed banks to reduce their holdings of bonds. The rules are meant to reduce risk-taking by banks. To do this, the capital that banks are required to hold against risky assets, such as low-rated LCY corporate bonds, has risen significantly. This has had the effect of making the region's LCY corporate bond market much less liquid.

A weaker property market in the PRC may make it difficult for some property companies to service their debt obligations. The latest indicators show that the property market is continuing to slow in the PRC. September data indicates that housing prices fell for the fifth consecutive month. The weakness in the property market is occurring across the country as housing price in all but one of the 70 largest cities in the PRC showed a decline in September. While Chinese households have relatively little leverage, the greater risk lies with property developers who tend to have high degrees of leverage. As concerns grow over the property market, small and less creditworthy companies might find access to funds limited and/or more expensive. They might also find it difficult to service their existing borrowings. Only a relatively small portion of the property sector's borrowings (both bonds and loans) are sourced from abroad, but the amount is still large in nominal terms as offshore property sector bonds

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

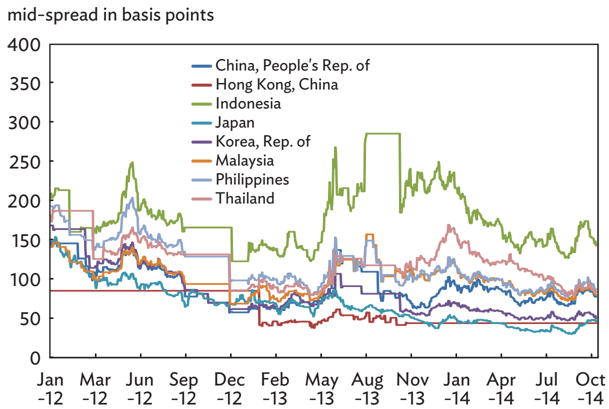


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

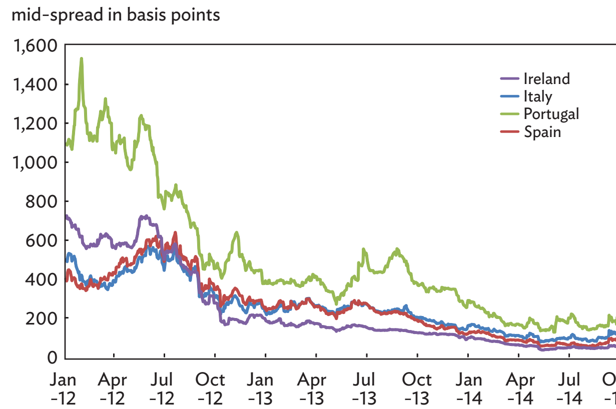


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

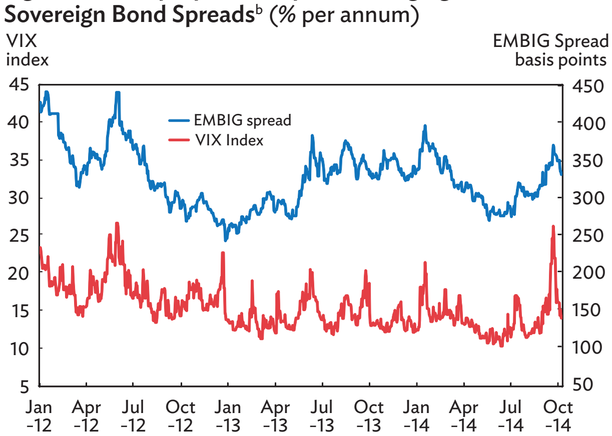


Figure D: 10-Year Government Bond Yields[b] (% per annum)

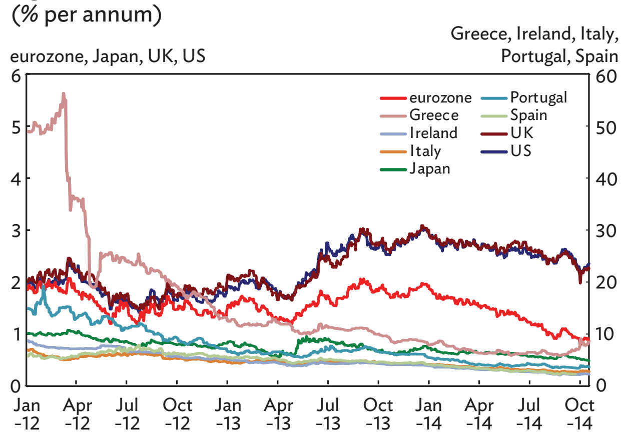


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

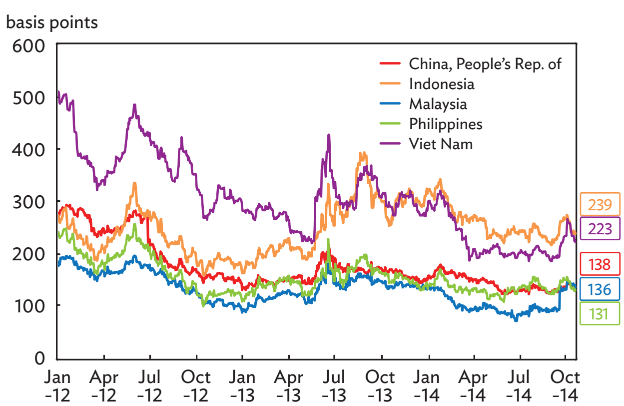
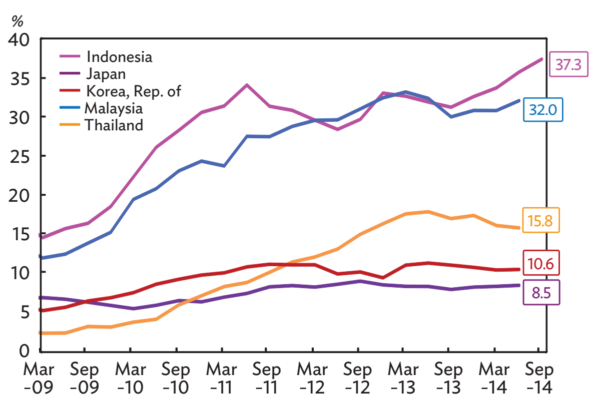


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 end-October 2014.

[c] Data as of end-June 2014, except for Indonesia as of end-September 2014.

Sources: *AsianBondsOnline* and Bloomberg LP.

issued by PRC-based companies totaled US$67 billion in November. Hence, regional investors who have purchased these bonds could be affected.

Improved economic conditions in the US may cause the Federal Reserve to raise interest rates sooner than expected. The US announced the end of its quantitative easing program in October, citing an improving labor market. While an interest rate increase is expected next year, a favorable shock to the US economy could result if the Federal Reserve raises interest rates sooner than expected. An earlier-than-anticipated monetary tightening could roil emerging East Asia's financial markets. Low interest rates in the US over the past few years have spurred inflows of funds into the region's bond markets as investors chased yield. Since foreign holdings of financial assets in the region have increased, the region may be more susceptible to changes in US interest rates. The appreciating US dollar could also pose a problem for companies that have been issuing foreign currency bonds at a record pace. Between January and September, a total of US$143.0 billion in foreign-currency-denominated bonds were issued in emerging East Asia, exceeding the US$141.5 billion issued for the whole of last year.