Global and Regional Market Developments

Yields for emerging East Asian bonds have declined as investor sentiments have improved.[2] Financial markets have been calmer in recent months with the United States (US) Federal Reserve holding back from raising interest rates and the People's Republic of China (PRC) undertaking monetary stimulus. With inflation in the US remaining low and economic growth tepid, the much-anticipated US interest rate hike has been pushed back to December at the earliest. With inflationary pressures remaining muted, bond yields in advanced economies have eased. Subdued growth and weaker oil prices have put further downward pressure on inflation.

The US economy moderated in 3Q15, growing by an annual rate of 1.5%, based on advance estimates, down from 3.9% in 2Q15. A drawdown of inventories combined with a drop in private investment contributed to the slower growth. The slowing US economy might give reason for the Federal Reserve to postpone its rate hike until next year. However, some of the drag on the economy, such as the inventory rundown, is temporary and consumer spending has remained strong, easing only slightly, which could give the Federal Reserve an opening to raise interest rates in December.

Similarly, the eurozone's economic recovery remains tepid with quarterly gross domestic product growth of just 0.3% in 3Q15 down from 0.4% in the previous quarter. Faced with a weakening growth outlook, the European Central Bank has signaled that it is ready to pursue more aggressive monetary expansion to counter deflationary pressures. Slowing growth in Asia also contributed to Japan's economy entering into a technical recession in 3Q15 contracting by an annualized rate of 0.8%, after falling by 0.7% in 2Q15.

Yields for 10-year local currency (LCY) government bonds in emerging East Asia were mostly down between 1 September and 31 October **(Table A)**. Investor confidence was buoyed as financial markets in the region stabilized and stock markets staged a recovery. The Philippines had the largest drop in 10-year bond yields in the region with a decline of 64 basis points (bps). The PRC; Hong Kong, China; and Singapore all saw 10-year bond yields decline by more than 30 bps. Only Indonesia experienced an increase of a marginal 7 bps.

Over the same period, most emerging East Asian currencies gained against the US dollar, reflecting improved investor sentiments. The Indonesian rupiah and Korean won appreciated the most against the US dollar, rising by 2.9% and 2.7%, respectively. Meanwhile, the Malaysian ringgit retreated against the US dollar, depreciating by 3.3%.

Credit default swap (CDS) spreads across emerging East Asia have been declining after peaking in September. **(Figure A)**. The initial rise in CDS spreads reflected concerns about slowing growth in the region.However, CDS spreads started falling as PRC growth concerns diminished due to stimulus measures taken by the central bank. CDS spreads in Indonesia, Malaysia, Thailand, and Viet Nam all declined substantially. In Europe, CDS spreads in Ireland, Italy, Portugal, and Spain have remained relatively stable **(Figure B)**. Financial market conditions have also improved in the US and the volatility index has dropped sharply after spiking in August. In line with calmer market conditions, emerging market spreads, which had been on a rising trend, pulled back toward the end of October. **(Figure C)**.

In the eurozone, bond yields have been easing with growth sluggish and the economy in deflationary territory. In September, consumer prices fell 0.1% year-on-year (y-o-y), prompting the European Central Bank to signal that it will consider further expansionary measures in December **(Figure D)**. Japanese and US bond yields have also been on a downward trend. In emerging East Asia, risk premiums have been falling. The delay in the Federal Reserve's interest rate hike and prospects of further monetary easing in Europe have helped buoy the market **(Figure E)**.

Foreign holdings of Indonesian LCY government bonds as a share of total bonds outstanding declined in 3Q15, dipping to 37.6% at the end of September from 39.6% in the previous quarter. Foreign holdings of LCY government bonds in Malaysia declined to 30.5% at the end of

[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	2	(1)	...	8.6	0.0
United Kingdom	(6)	(1)	(2)	5.0	(0.8)
Japan	(0.2)	(5)	5	5.2	(1.0)
Germany	(10)	(28)	(0.5)	8.3	2.7
Emerging East Asia					
China, People's Rep. of	5	(32)	(17)	6.8	0.7
Hong Kong, China	(14)	(32)	...	6.9	(0.006)
Indonesia	26	7	(26)	1.0	2.9
Korea, Rep. of	(3)	(19)	(11)	6.0	2.7
Malaysia	(31)	(12)	12	3.5	(3.3)
Philippines	(25)	(64)	(19)	0.7	(0.3)
Singapore	17	(37)	...	4.0	0.8
Thailand	(4)	(15)	(20)	2.4	0.3
Viet Nam	(5)	0	6	8.0	0.7
Select European Markets					
Greece	89	(134)	(426)	12.8	2.7
Ireland	(11)	(30)	(5)	2.7	2.7
Italy	(19)	(49)	(14)	4.6	2.7
Portugal	5	(14)	(2)	6.7	2.7
Spain	(14)	(44)	(13)	3.7	2.7

... = data not available, ( ) = negative, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 September and 31 October 2015.
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).

September from 32.4% at the end of June **(Figure F)**. Slower economic growth and weakening currencies have made these bonds less attractive.

The risks to the region's bond markets are easing.

The Federal Reserve looks likely to raise interest rates in December, which could result in outflows from the region's bond markets. The Federal Reserve is expected to hike interest rates in December, which could reduce the attractiveness of the region's bonds and prompt an outflow of funds. That said, the region is better prepared to deal with the effects of a rate rise this time around. The region's bond markets have had plenty of time to prepare for the impending rise and investors may already have gradually reallocated their portfolio. When the rate hike occurs, it could be welcomed as an end to the uncertainty. A gradual withdrawal of funds is not likely to have a major adverse impact on the region's bond markets.

Low levels of liquidity in the region's bond markets could exacerbate the impact of an outflow of funds. The smooth functioning of a bond market requires sufficient liquidity to enable investors to buy and sell bonds at minimal cost. However, there are concerns that liquidity is tightening in the region's markets because banks are cutting back on their bond inventories. While investors' sentiments have improved in recent months, there remains the risk of large destabilizing outflows of funds from the region's bond markets. Limited liquidity could mean there are few buyers at a time when investors are looking to sell their bonds, resulting in large price swings that could make bond markets look riskier and induce greater outflows.

Slowing economic growth in emerging East Asia could lead to bond rating downgrades. After a strong expansion over the past few years, growth in the region's economies has been trending downward lately. The more difficult economic environment could lead to weaker fiscal conditions for governments, while corporates will likely see their profits reduced. These factors could lead to a ratings downgrade for some of the region's bonds. The increased risk perception could also push up yields and make it harder for corporates to raise funds through the bond market.

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

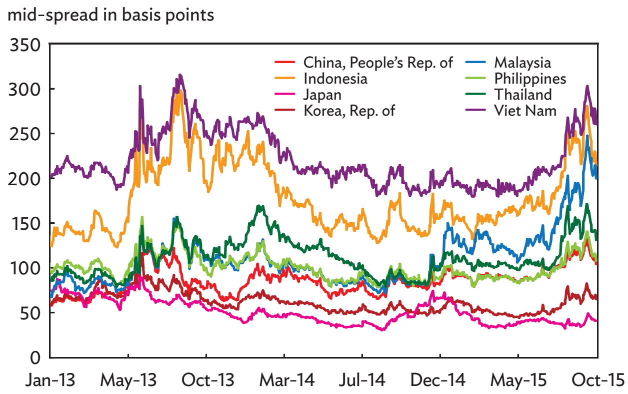


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

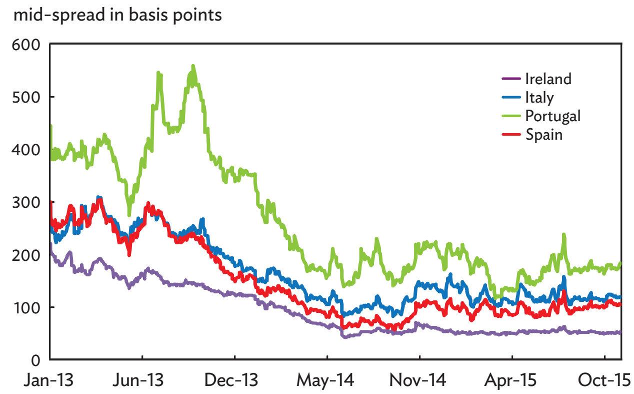


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

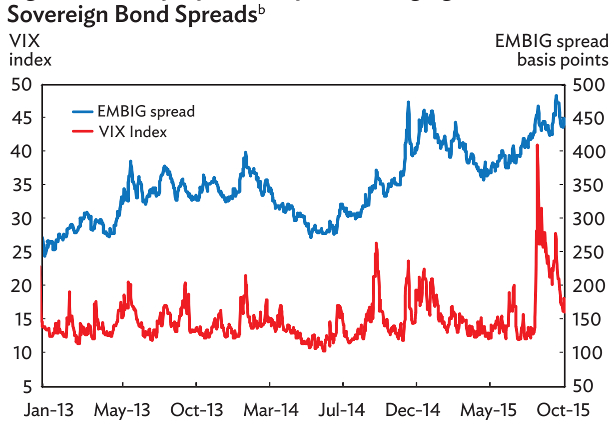


Figure D: 10-Year Government Bond Yields[b] (% per annum)

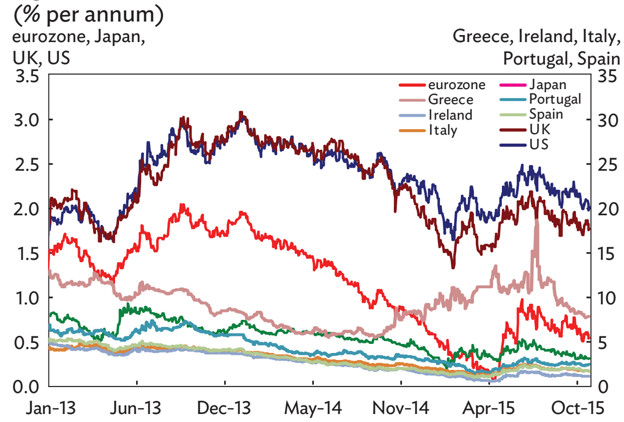


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

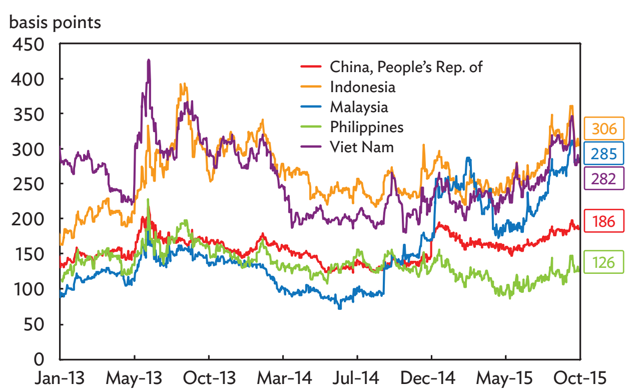
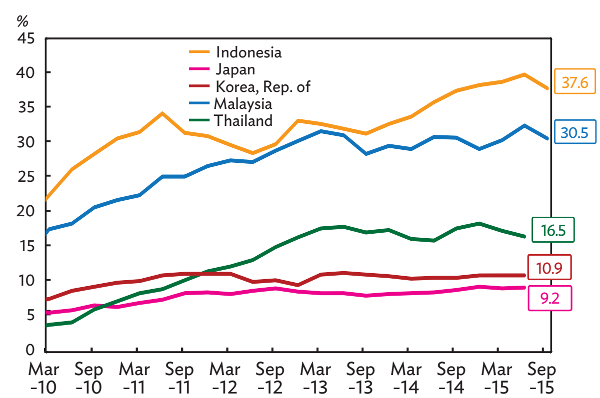


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 US$ and based on sovereign bonds.

[b] Data as of 15 October 2015.

[c] Data as of end-June 2015 except for Indonesia and Malaysia (end-September 2015).

Sources: *AsianBondsOnline* and Bloomberg LP.