Asia Bond Monitor Highlights

Emerging East Asia's Bond Yields Rose

Yields in emerging East Asia rose between 1 September and 31 October, tracking increases in yields in major advanced economies.[1] The rise in yields was largely due to strong global economic growth and tightening liquidity.

Growth in advanced economies continued to improve. The United States (US) economy is growing at a solid pace and the labor market remains strong, while both the eurozone and Japan have upgraded their forecasts for economic growth in 2017.

The US began its balance sheet normalization in October as expected and is likely to further raise the policy rate, possibly before the end of the year. The Bank of Canada and the Bank of England have also recently raised their respective policy rates. Furthermore, the European Central Bank announced it would taper its monthly asset purchases starting in January 2018. In summary, the tightening of monetary policy in advanced economies has led to a rise in yields.

While emerging East Asia's financial markets have been stable on the back of strong global economic growth, potential risks are looming. These include further tightening of global liquidity as more central banks move to normalize monetary policy, and the longevity risk faced by financial institutions, which will require more hedging instruments in financial markets.

This issue of the *Asia Bond Monitor* includes three special discussion boxes. Box 1 analyzes the surge in global equity prices. Box 2 discusses the sovereign rating ceiling in international bond markets. Box 3 highlights the rationale for developing financial markets and instruments to cope with longevity risk.

Local Currency Bond Markets in Emerging East Asia Continue to Post Strong Growth

Emerging East Asia's overall LCY bond market continued to expand in size to reach USD11.6 trillion at the end of September. Growth was higher at 4.2% quarter-on-quarter (q-o-q) and 11.6% year-on-year (y-o-y) in the third quarter (Q3) of 2017 compared with 3.3% q-o-q and 10.6% y-o-y in the second quarter (Q2) of 2017. The People's Republic of China (PRC) continued to drive the region's bond market growth, despite the government's deleveraging efforts.

The government segment still dominates the region's LCY bond market with USD7.7 trillion in bonds outstanding, accounting for a 66.5% share of the regional total at the end of September, up from 65.9% at the end of June. The region's outstanding stock of LCY corporate bonds reached USD3.9 trillion, with its share of the regional total slipping to 33.5% from 34.1% during the review period.

The size of emerging East Asia's LCY bond market as a share of regional gross domestic product rose to 70.5% in Q3 2017 from 69.0% in Q2 2017. The Republic of Korea and Malaysia continued to have the largest LCY bonds outstanding-to-gross domestic product ratios.

LCY bond issuance rose in Q3 2017 to USD1.3 trillion, driven largely by a recovery in the PRC's issuance. Issuance by the central government and other government institutions accounted for 52.0% of the region's aggregate issuance during the quarter.

Foreign Investor Sentiments Positive through September, Outflows Noted in October

Foreign investors' interest in emerging East Asia's LCY government bond market remained positive at the end of September amid the Federal Reserve's hawkish tone

[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.

in its September meeting. Nonresident holdings of LCY government bonds as a share of the total were up at the end of September compared with the end of June in the PRC, Indonesia, and Malaysia. The share of nonresident holdings was steady in Thailand during the review period.

Sell-offs in some bond markets were observed in October, resulting in a decline in the holdings of foreign investors. The foreign holdings share in Indonesia retreated to 38.4% at the end of October from 40.0% at the end of September. Capital outflows from the Thai bond market were also noted in October. Prior to this, both markets had posted capital inflows in every month of 2017 through September.

Local Currency Bond Yields Edge Higher

Government yield curves shifted upward in nearly all bond markets in emerging East Asia between 1 September and 31 October, tracking the rise in yields in advanced economies. The only exception was in Viet Nam, where the yield curve shifted downward following the central bank's policy rate cut in July.

AsianBondsOnline Annual Bond Market Liquidity Survey

AsianBondsOnline conducts a survey once a year to assess liquidity conditions in the region's LCY bond market and to identify potential issues and areas for development that can help in the further deepening of the region's bond markets. This year's survey was conducted between the last week of September through mid-October after the Federal Reserve announced it would begin its balance sheet reduction in October.

The overall assessment of market participants pointed to improved liquidity in five out of the nine markets in emerging East Asia: Hong Kong, China; Indonesia; Singapore; Thailand; and Viet Nam. On the other hand, roughly unchanged to tighter liquidity conditions were observed in the PRC, the Republic of Korea, Malaysia, and the Philippines.

The region's average bid–ask spread for government bonds narrowed in this year's survey to 3.2 basis points, while it was broadly unchanged for corporate bonds. Average transaction sizes were smaller in 2017 compared with 2016 for both the government and corporate bond segments.

Among qualitative indicators, the lack of well-functioning hedging mechanisms was identified as the most important common structural issue that requires attention from regional authorities in both segments. Other structural problems that were identified include the need for a more diversified investor base and better access to transaction funding sources.

Theme Chapter: Foreign and Domestic Investments in Global Bond Markets

The benefits of foreign participation in bond markets have long been known. These include improved liquidity, lower bond yields, and enhanced market efficiency. At the same time, foreign participation fosters international risk transmission by exposing emerging bond markets to global shocks. This dilemma has caught policy makers' attention, especially in those emerging markets with higher rates of foreign participation than others, on how to guide investor behavior to achieve a more desirable investor profile in bond markets.

The theme chapter empirically investigates the determinants of foreign and domestic investors' portfolio decisions in global bond markets. It analyzes and compares the differences in investment preferences between foreign and domestic investors in both developed and emerging bond markets.

Empirical evidence shows that foreign investors chase favorable risk–return profiles, particularly in emerging markets, while domestic participants as a whole are less sensitive to domestic market performance. Greater market openness and sound sovereign ratings attract foreign investors.

This study has policy implications with regard to the benefits of a broad investor base, especially the importance of a more diversified investor base. Emerging bond markets can also benefit from regional integration to broaden the investor base.