Introduction: **Global and Regional Market Developments**

Concerns have been mounting that the global economic recovery and stabilization of world financial markets, which has been underway since the last half of 2009, may stutter as vulnerabilities persist in mature economies. Financial markets have been gripped by fear that growth in advanced economies may stay low for longer periods.

While global and regional growth forecasts for 2010 still remain robust, largely driven by a strong performance in the first half of the year, the downside risks to the outlook for the second half of 2010 and 2011 have increased. Large fiscal deficits and burgeoning public debt in developed economies, particularly the euro area, may impact the banking system and sovereign debt. Markets are pricing in these risks amid moves by credit rating agencies to downgrade European sovereigns and financial institutions. These developments, as well as signals from policymakers that interest rates in developed economies may remain low and expectations that the United States (US) Federal Reserve may resume quantitative easing, have pushed Treasury bond yields lower as investors seek refuge in safe-haven government bonds.

While key global financial markets have recovered dramatically from the worst days of 2008, the outlook remains uncertain and subject to further volatility. These trends can be seen in (i) the continued decline of 10-year government bond yields since the beginning of this year as investors have sought the safe haven of government paper **(Figure A)**; (ii) a renewed widening of corporate bond spreads in the US and Japan, following a recovery between end-2009 and end-April 2010 **(Figure B)**; (iii) a recovery of major MSCI indices in the first half of 2010, followed by a new round of weakness in early August **(Figure C)**; (iv) a renewed decline in JP Morgan's EMBI sovereign stripped spreads **(Figure D)**; and (v) a decline in credit default swap spreads for emerging East Asia **(Figure E)**, with a more mixed picture for European countries **(Figure F)** since the beginning of July.

Emerging East Asian[2] economies have thus far not been significantly impacted by the sovereign debt crisis in Europe. The region's financial systems have remained stable, with banks holding ample capital cushions and showing strong profitability. The economies of emerging East Asia are reporting impressive growth performances, as can be seen in the year-on-year (y-o-y) gross domestic product (GDP) growth rates for 2Q10. Not only did the People's Republic of China (PRC) grow 10.3% y-o-y in 2Q10, Malaysia also grew 8.9%, Thailand 9.1%, and the Philippines 7.9%, while the Republic of Korea (Korea) reported GDP growth of 8.1% in 1Q01 and 7.2% in 2Q10.

Some economies in the region began to unwind policy stimulus in the first half of the year. However, many Asian central banks, while generally tightening monetary policy, are exercising caution with respect to the growth outlook for the second half of 2010 and 2011. As a result, policy normalization appears to have been put on hold for now.

Flush liquidity in global markets, investors' hunt for yields, the appreciation of regional currencies, and the region's strong growth performance have spurred foreign portfolio capital inflows into Asian markets. Foreign holdings of local currency (LCY) government bonds **(Figure 4 on page 17)** have surged; investors have also pumped funds into local stock markets **(Figure G)**. LCY bonds in most markets have rallied in line with US Treasuries as the correlation between them has increased in recent months **(Figure H)**. Foreign fund inflows and the rally in US Treasuries continue to underpin support for LCY bonds despite the strong regional growth outlook. This has led to a flattening of

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

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

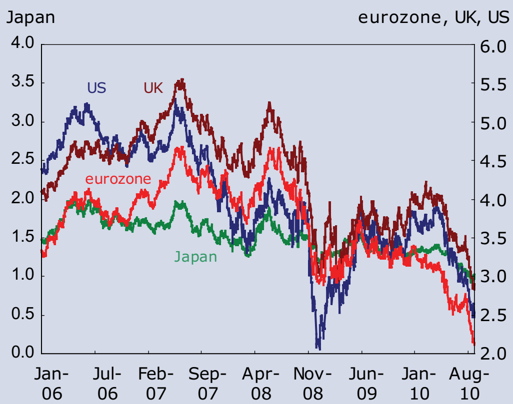


Figure D: JPMorgan EMBI Sovereign Stripped Spreads[3]

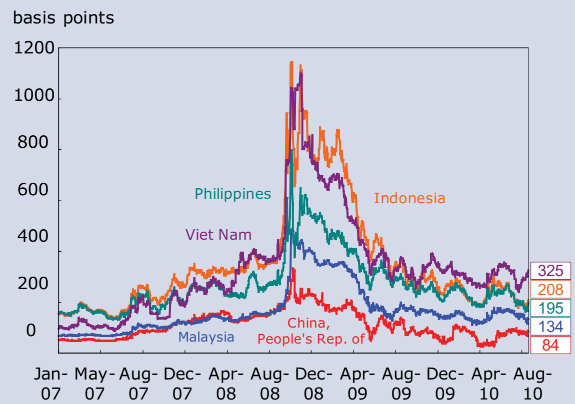


Figure B: Corporate Bond Spreads[1]

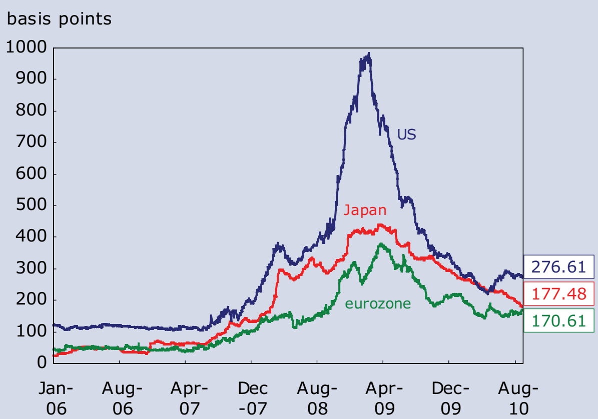


Figure E: Credit Default Swap Spreads
(senior 5-year)[3]

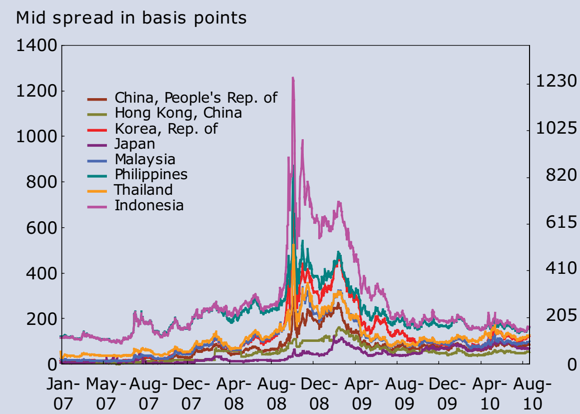


Figure C: MSCI Indexes[2]
(January 2007 = 100)

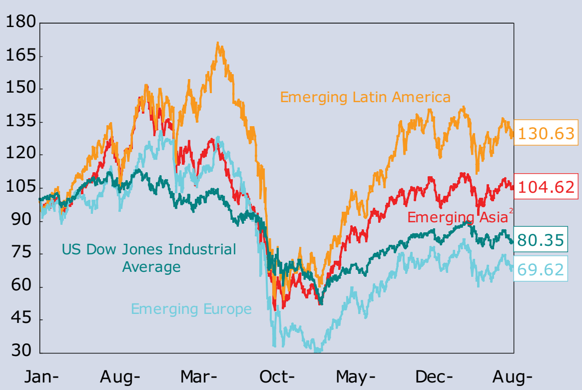
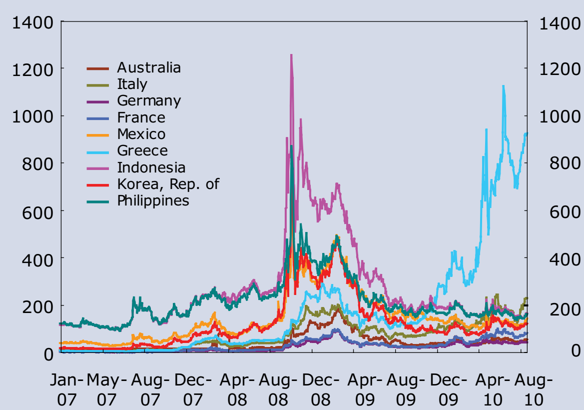
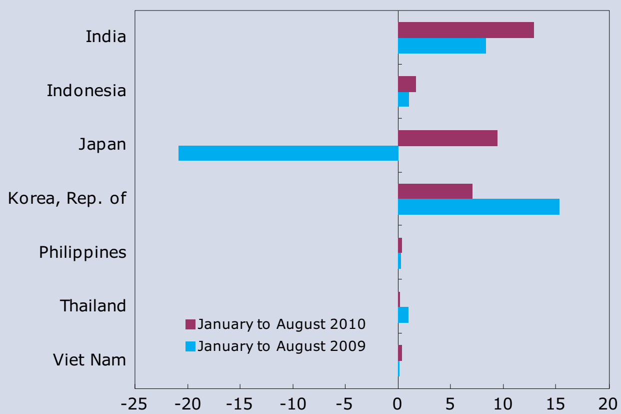


Figure F: Credit Default Swap Spreads for Select OECD and Asian Economies



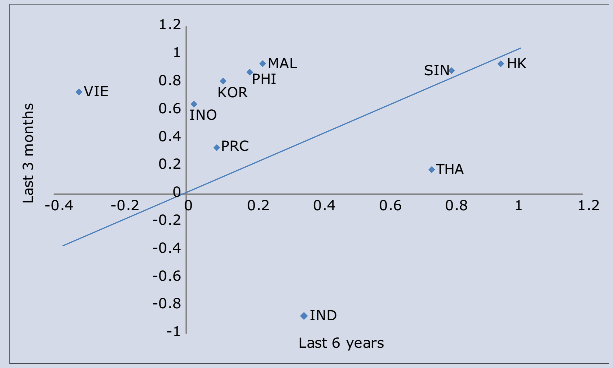
US = United States, UK = United Kingdom, EMBI = Emerging Markets Bond Index, OECD = Organisation for Economic Co-operation and Development.
Notes:
1 Bond spread refers to the difference between yields of 5-year bonds issued by BBB-rated finance companies and yields of sovereign benchmark bonds of the same tenor.
2 Includes People's Rep. of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand.
3 USD based on sovereign bonds.
Source: Thomson DataStream, Morgan Stanley Capital International (MSCI) Barra and Bloomberg LP.

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



Source: Bloomberg LP.

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



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

government bond yield curves in most emerging East Asian markets, especially at the long-end.

Risks to the market outlook in the region, which are now tilted to the downside, include (i) a sharp slowdown in mature economies, (ii) destabilizing capital flows, and (iii) a rise in inflationary pressures.

Emerging East Asian LCY bonds showed strong growth in the first half of 2010. The y-o-y growth rate in 2Q10 rose slightly to 18.8% from 17.1% in 1Q10, and was driven primarily by 24.4% y-o-y growth in the corporate sector. Meanwhile, the government bond market grew by 16.7% y-o-y in 2Q10. Given that the region's corporate bond markets are emerging as an important source of funding for private sector investment, the growth of these fledgling markets in emerging East Asia will be an important point to watch in coming years.

At the end of March, 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. The two largest markets in the region at the end of 1Q10 were the PRC (4.2% of the global bond market) and Korea (1.7%) **(Table A)**.

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*.