Introduction: **Global and Regional Market Developments**

The external environment facing emerging East Asian economies is bleak.[2] Unresolved sovereign debt issues in the United States (US) and an ongoing eurozone debt crisis has jolted global asset markets.

Global stock market turbulence and rising volatility has fed investor fears and prompted safe haven flows into gold, the bonds of higher rated corporates with strong balance sheets, long-dated US treasuries, Japanese yen, and Swiss francs. The sovereign debt crises in mature markets and the potential impact on the wider economy have led investors to re-think their definitions of risk-free and risky assets. Furthermore, investors are now factoring in an extended period of weakness in the US and other mature economies. This worrying macro backdrop is likely to continue dampening investor sentiment in the medium-term.

US treasury yields are hovering near historic lows,[3] reflecting concerns over slowing global growth and debt sustainability in developed economies **(Figure A)**. Mixed economic data and the unprecedented announcement of the US Federal Reserve that it will keep rates low over the next 2 years have fuelled expectations that growth may remain weak and further stimulus measures are in the offing.

Corporate bond spreads in the US, Japan, and Europe have declined since the beginning of the year, although European corporate spreads have turned upward in recent weeks **(Figure B)**. Rising risk aversion has sharply dragged down global equity markets, particularly in the aftermath of Standard & Poor's (S&P) downgrade of US sovereign debt **(Figure C)**.

Emerging market economies are increasingly viewed as a relatively safe shelter. Investor preferences for emerging market assets are reflected in JP Morgan's Emerging Markets Bond Index (EMBI) for sovereign stripped spreads **(Figure D)** as well as an outperformance in credit default swap (CDS) spreads for emerging East Asian government bonds **(Figure E)** at the same time that CDS spreads for European countries have presented a more mixed picture **(Figure F)**.

Capital flows into emerging East Asian bond markets remain strong as investors chase yields that are being buoyed by sound fundamentals, interest rate differentials—resulting from continued accommodative monetary policies in mature markets, and the potential appreciation of the region's currencies.

As the correlation between the index returns of US treasuries and Asian government bonds has weakened, capital flows into Asia have risen as investors seek returns and diversify away from mature markets **(Figure G)**.

Demand for local currency (LCY) government bonds picked up in the middle of 2010 and remained strong throughout the first half of 2011. Overall, there has been a bullish flattening of yield curves in most markets; in many cases there has been a downward shift of the entire yield curve. Yields were pushed down even further in most markets after the S&P downgrade of US sovereign debt.

Total LCY bonds outstanding in emerging East Asia grew 2.4% on a quarterly basis in 2Q11 to reach US$5.5 trillion, with growth driven more by the region's corporate markets rather than its larger government markets. The most rapidly growing corporate bond markets in 2Q11 were Indonesia (8.9%), the People's Republic of China (PRC) (6.3%), Malaysia (4.9%), and Singapore (4.7%).

Growth in emerging East Asian economies is expected to moderate, yet remain relatively strong, in the second half of 2011. Inflation continued to

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

[3] Yields on 10-year German bonds have also been driven down to record lows.

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

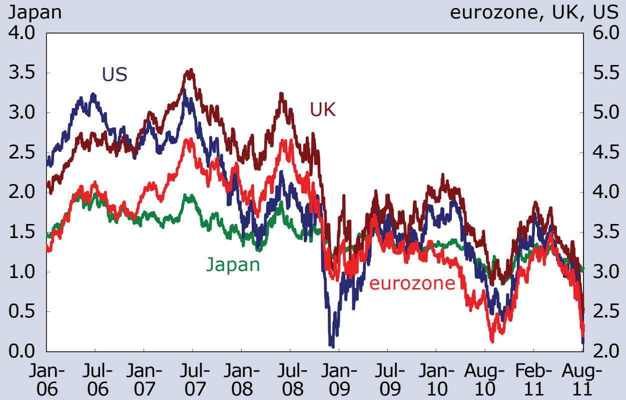


Figure D: JPMorgan EMBI Sovereign Stripped Spreads[c]

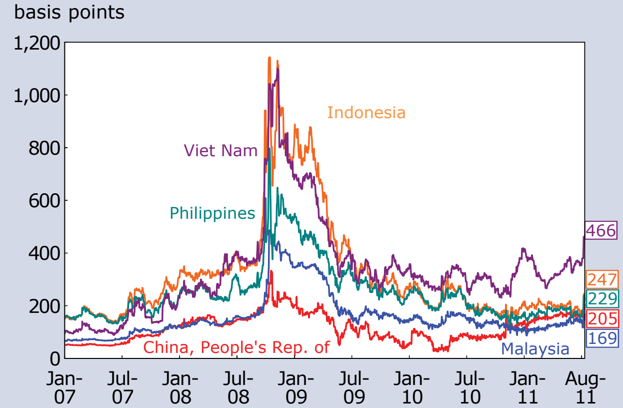


Figure B: Corporate Bond Spreads[a]

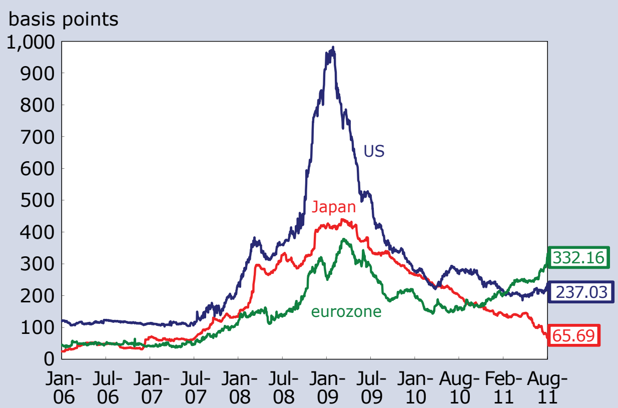


Figure E: Credit Default Swap Spreads
(senior 5-year)[c]

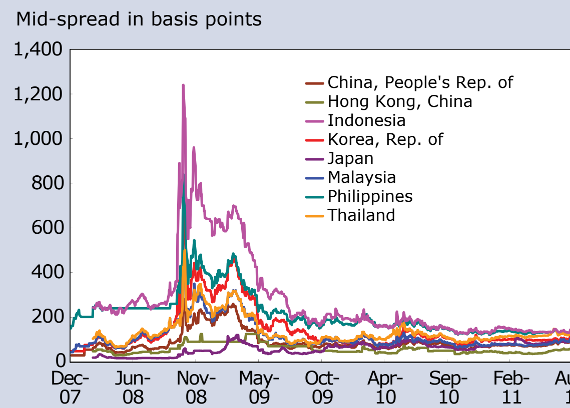


Figure C: MSCI Indexes
(January 2007 = 100)

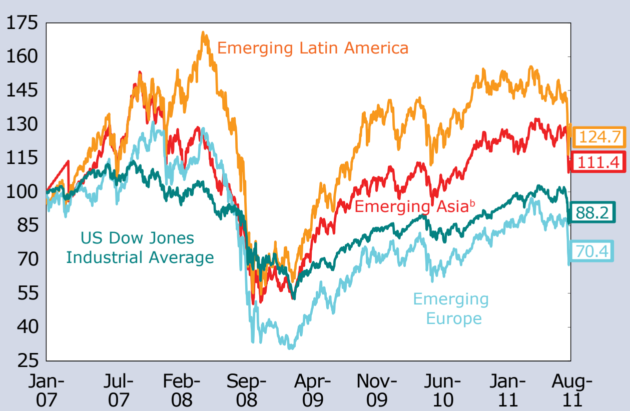
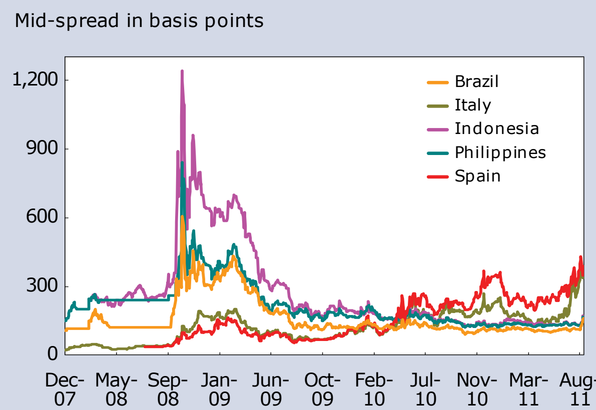
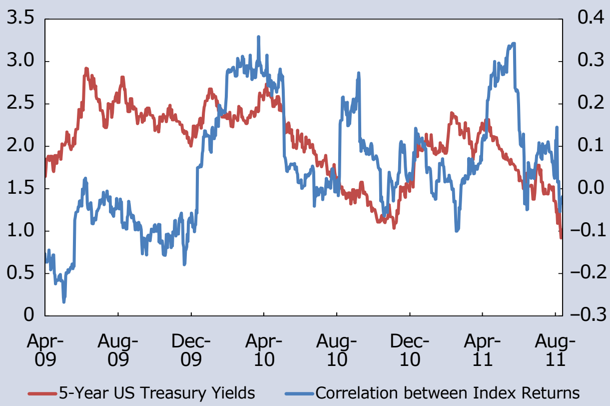


Figure F: Credit Default Swap Spreads for Select European and Emerging Markets (senior 5-year)[c]



EMBI = Emerging Market Bond Index, UK = United Kingdom, US = United States.
a. 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.
b. Emerging Asia includes People's Republic of China; India; Indonesia; Republic of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand.
c. US$ spread based on sovereign bonds.
Note: Data as of 12 August 2011.
Source: Thomson Reuters, Morgan Stanley Capital International (MSCI) Barra, and Bloomberg LP.

Figure G: 5-Year US Treasury Yields and Correlation between Index Returns of US Treasuries and Asian Government Bonds



Note: Data as of 12 August 2011.
Source: Bloomberg LP.

rise in the first half of 2011 across much of the region, driven by higher commodity prices and the strong economic recovery. This led to increased issuance of inflation-linked sovereign bonds in some countries.

At end–December 2010, emerging East Asia's share of the global bond market stood at 8.0%, compared with only 2.1% before the onset of the 1997/98 Asian financial crisis **(Table A)**. The two largest markets in the region were the PRC (4.7% of the global bond market) and the Republic of Korea (1.8%).

The risks to the region's outlook are tilted toward the downside. These include (i) a severe slowdown or contraction in mature economies with a corresponding impact on emerging East Asian exports, (ii) destabilizing capital flows, (iii) a lack of timely and appropriate policy interventions in mature markets, and (iv) potential commodity price fluctuation.

Table A: Bonds Outstanding in Major Markets (US$ billion)

Economy	2010		1996	
	LCY Bonds Outstanding	% of World Total	LCY Bonds Outstanding	% of World Total
United States	25,349	38.8	10,926	42.9
Japan	11,723	17.9	4,456	17.5
France	3,170	4.8	1,261	4.9
Germany	2,616	4.0	1,888	7.4
United Kingdom	1,647	2.5	678	2.7
Emerging East Asia	5,210	8.0	531	2.1
of which: PRC	3,052	4.7	62	0.2
Emerging East Asia excl. PRC	2,158	3.3	469	1.8
of which: Rep. of Korea	1,149	1.8	283	1.1
of which: ASEAN-6	845	1.3	149	0.6
Indonesia	107	0.2	7	0.0
Malaysia	247	0.4	71	0.3
Philippines	73	0.1	28	0.1
Singapore	179	0.3	25	0.1
Thailand	225	0.3	19	0.1
Viet Nam	16	0.0	–	–
Memo Items:				
Brazil	1,338	2.0	299	1.2
PRC (excl. policy bank bonds)	2,272	3.5	–	–
India	709	1.1	81	0.3
Russian Federation	67	0.1	43	0.2

– = not available, ASEAN = Association of Southeast Asian Nations, LCY = local currency, PRC = People's Republic of China.
Source: Bank for International Settlements and *AsianBondsOnline*.