Global and Regional Market Developments

Emerging East Asian local currency (LCY) bond markets continued to perform well as global financial conditions have remained relatively benign thus far in 2014.[2] The United States (US) economy bounced back strongly in 2Q14 after contracting in 1Q14. The robustness of the US economy should give confidence to the US Federal Reserve to continue on its current path of gradually normalizing monetary policy. Therefore, the region should prepare for tighter liquidity as quantitative easing is expected to end in October. The US Federal Reserve has also indicated it may wait a "considerable time" after the end of quantitative easing to hike interest rates. This should allow the region to adjust gradually to higher interest rates. So far, the region's LCY bond markets have remained calm in the lead-up to the end of tapering, suggesting that investors have likely incorporated it into their expectations.

While economic conditions in the US continue to improve, growth in the eurozone and Japan has been more disappointing. With the eurozone flirting with deflation, there have been increasing calls for the European Central Bank to take more aggressive monetary actions. In Japan, following the increase in the sales tax, growth dropped sharply in 2Q14. Slowing growth could put pressure on the Bank of Japan to introduce further measures. More expansionary monetary actions from the eurozone and Japan could offset some of the impact on liquidity conditions caused by the end of US quantitative easing.

Despite the tapering of US Federal Reserve quantitative easing operations, 10-year bond yields in the US were on a downward trend in April–August. One reason could be increased demand for US Treasuries as safe-haven assets in the face of growing geopolitical tensions. There also may have been larger purchases of US bonds by emerging market governments in order to build up foreign exchange reserves after the market volatility of last year. Nevertheless, if the US economy continues to perform strongly, bond yields there are likely to start rising again.

Supported by ample global liquidity, emerging East Asian 10-year bond yields continued to fall in April–August **(Table A)**. Among the region's economies, Viet Nam's 10-year bond yield experienced the largest decline, dropping 92 basis points (bps). The fall was mostly due to lower inflation and the economy's upgrade by Moody's in July. This next largest dips in yields were 50 bps and 46 bps declines in the Republic of Korea and Hong Kong, China, respectively. Only in Indonesia did 10-year bond yields rise in April–August. This was likely due to concerns about the widening current account deficit in 2Q14, which was driven primarily by increased imports ahead of Eid celebrations.

Most of the region's currencies appreciated against the US dollar between April and August. The strongest gains were recorded in the Republic of Korea and Malaysia, where domestic currencies appreciated 4.2% and 3.4%, respectively. Both economies likely benefited from increased inflows of funds, while Malaysia's improved growth performance likely supported its exchange rate as well. In the People's Republic of China (PRC), the renminbi halted its decline against the dollar and appreciated 1.0% in April–August. In contrast, the Indonesian rupiah lost 3.3% of its value over the same period after giving up gains made during the first 3 months of the year

Funds flowed back into emerging East Asia as global financial conditions stabilized in 2Q14. The region's stable macroeconomic conditions and improved investor sentiment also helped in attracting foreign investors. Credit default swaps (CDSs) in the region were mostly stable in 2Q14, reflecting the generally higher level of geopolitical tensions rather than economy-specific factors **(Figure A)**. The eurozone has also benefitted from improved market sentiments, with CDSs falling in a number of European economies that had previously experienced soaring rates **(Figure B)**. The exception was Portugal, which saw its CDS rise after it had to rescue one of its largest banks, Banco Espirito Santo. Emerging market spreads have broadly been stable, but the so-called volatility index spiked recently, likely due to heightened geopolitical tensions **(Figure C)**

Bond yields in advanced economies continued their downward trend between January and July. US bond yields were down slightly despite the US Federal Reserve's tapering actions **(Figure D)**. Inflation in the eurozone fell

[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	6	(41)	–	6.3	–
United Kingdom	15	(36)	(4)	2.5	0.2
Japan	(1)	(12)	(14)	5.6	(0.4)
Germany	(20)	(68)	(2)	(1.4)	4.8
Emerging East Asia					
China, People's Rep. of	31	(25)	(18)	8.3	1.0
Hong Kong, China	(7)	(46)	–	10.2	0.1
Indonesia	27	29	(37)	5.4	(3.3)
Korea, Rep. of	(35)	(50)	(9)	3.8	4.2
Malaysia	8	(20)	(22)	1.0	3.4
Philippines	(13)	(1)	(20)	8.2	2.6
Singapore	(8)	(22)	–	4.0	0.8
Thailand	30	(1)	(37)	12.6	1.3
Viet Nam	(64)	(92)	–	9.0	(0.5)
Select European Markets					
Greece	(226)	(56)	–	(13.5)	4.8
Ireland	(45)	(111)	(24)	(5.8)	4.8
Italy	(32)	(87)	(32)	(6.7)	4.8
Portugal	(49)	(59)	(22)	(23.2)	4.8
Spain	(38)	(112)	(37)	2.5	4.8

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 April 2014 and 31 August 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.

to just 0.3% year-on-year (y-o-y) in August, bringing the region close to deflation. Expectations are rising that the European Central Bank will initiate more aggressive measures to bring inflation to its target level of 2.0%. Unemployment in the eurozone has also remained stubbornly high. Japanese bond yields have been relatively stable despite signs of rising inflationary expectations. Interest rates in emerging East Asia have been broadly stable or falling, reflecting ample liquidity in the region **(Figure E)**.

Foreign holdings of Indonesian LCY government bonds continued to rise in 2Q14 as relatively high interest rates attracted investors chasing yields **(Figure F)**. At end-June, foreign investors' share of the total market was 35.7%, up from 33.6% at end-March. 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 in Indonesia remained the highest in the region, followed by Malaysia at 30.8% at end-March, the latest date for which data are available. Foreign holdings in Japan and the Republic of Korea remained relatively stable in 1Q14.

While financial conditions in the region have been calm in 2014, the risks to the region's LCY bond markets are rising:

The US Federal Reserve could hike interest rates earlier than expected, prompting fund outflows from the region. With US economic growth back on track, the US Federal Reserve looks set to end quantitative easing by October as planned. The US Federal Reserve also appears committed to keeping interest rates low for a considerable time after the end of tapering. However, if economic indicators were to show a stronger-than-expected recovery, the US Federal Reserve might accelerate its timetable for interest rate hikes. Financial markets in the region would experience volatility if this resulted in capital outflows. That said, the region's economies look to be better prepared to handle the end of tapering now compared with 2013; current account deficits have narrowed and fiscal deficits have been trimmed. In addition, greater Japanese investment in the region may help offset some of the outflows.

Geopolitical tensions could disrupt fuel supplies, resulting in higher inflation. As conflicts in the

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

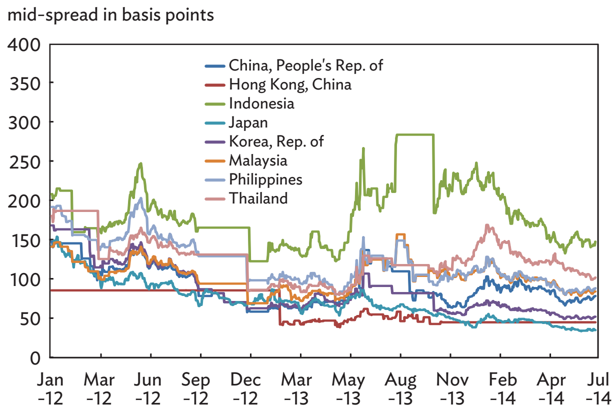


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

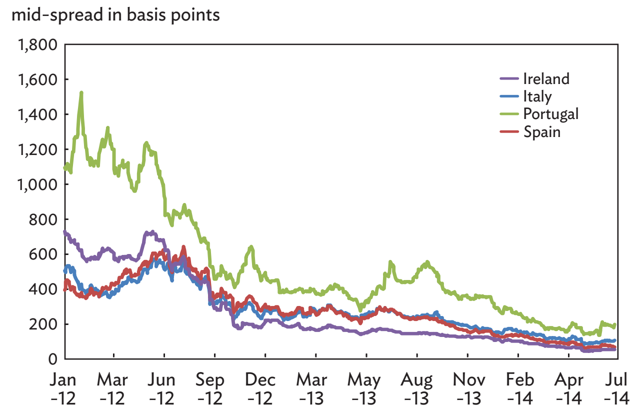


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b] (% per annum)

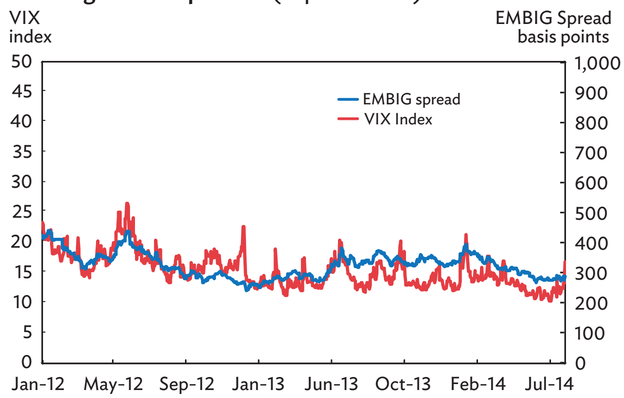


Figure D: 10-Year Government Bond Yields[b] (% per annum)

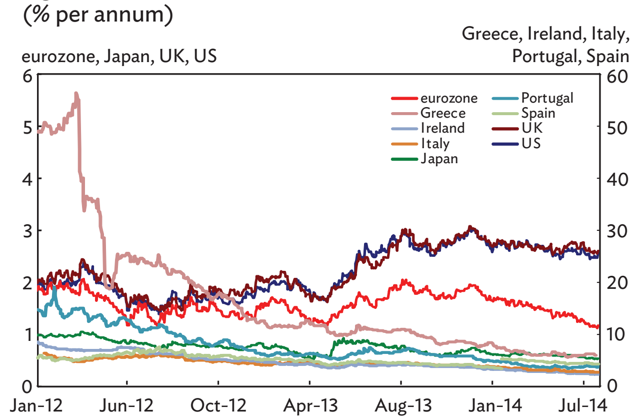


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

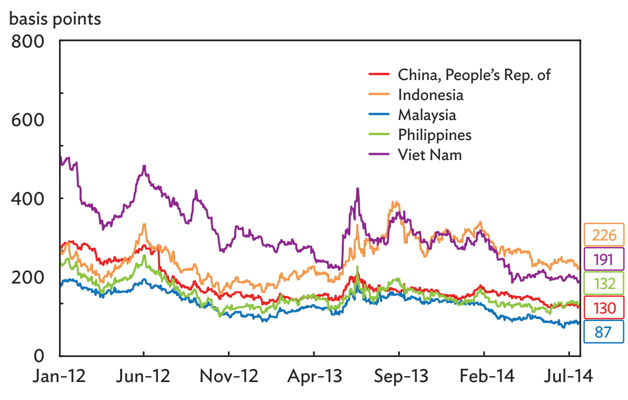
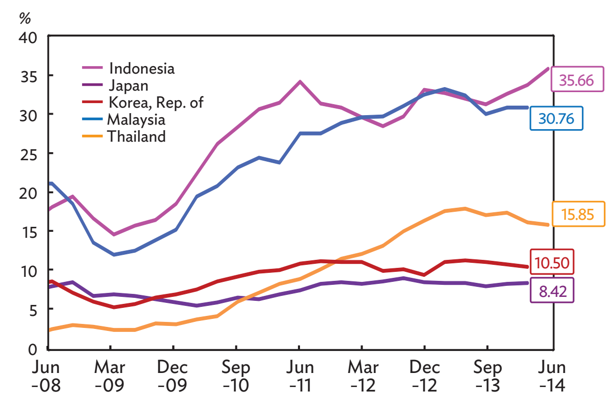


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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-July 2014.

[c] Data as of end-March 2014, except for Indonesia and Thailand as of end-June 2014.

Sources: *AsianBondsOnline* and Bloomberg LP.

Middle East continue, there is a risk that oil supplies could be threatened by the violence. A worsening of the conflict in Ukraine could put further upward pressure on oil prices. While oil prices have remained low despite rising violence in major oil-producing countries such as Iraq and Libya, prices could start rising if demand picks up in the months ahead. This could cause inflation to rise in the region and prompt monetary authorities to raise policy rates. In countries where fuel subsidies are a major portion of the budget, higher oil prices could result in widening fiscal deficits. Above all, heightened geopolitical tensions may cause a broad pullback from all emerging markets if investors' risk aversion were to rise.

Bond markets could be affected by a slowdown in the PRC's property market. While macroeconomic conditions remain favorable in the PRC, there are increasing signs of weakness in the property market. Data released in August show that residential property prices declined on a monthly basis in 64 out of 70 medium- and large-sized cities in July. Declining prices are problematic as most collateralized borrowings are secured against property. Furthermore, many local governments are dependent on property-related transactions for a large part of their revenue. Hence, a slowdown in the property market will affect their ability to service the large amount of bonds that have been issued by local government financing vehicles. While regional investors are generally restricted from participating in the PRC's onshore bond market, investors' exposure to PRC bonds has increased due to the rising number of issuances made by property companies in the offshore market.