Global and Regional Market Developments

Emerging East Asia's bond markets have seen rising yields as investors shift away from emerging markets.[2] Weaker growth and depreciating currencies have combined to make emerging market bonds less attractive to investors. Bond yields in advanced economies have remained broadly stable, with inflationary pressures muted amid hesitant economic recoveries. Falling oil prices have further dampened inflationary pressures.

The United States (US) economy gathered pace in 2Q15, growing by an annual rate of 3.7%, up from 0.6% in 1Q15. Personal consumption and exports contributed to the improved growth performance. The brighter economic outlook in the US suggests that the Federal Reserve could be poised to raise interest rates as early as September. However, recent weakness in developing economies and declining oil prices may make the Federal Reserve more cautious in raising interest rates.

The eurozone's economy has also picked up, growing 1.5% year-on-year (y-o-y) in 2Q15, a slight improvement from 1.2% y-o-y growth in 1Q15. A weaker euro has helped provide a boost for exports, thereby supporting growth and offsetting the poor performance in the industrial sector. With the agreement on a third bailout for Greece, the threat of a spread of the debt crisis to the rest of Europe has been avoided for now. Nevertheless, concerns remain about the sustainability of the Greek debt burden without substantial debt relief.

The Japanese economy contracted at an annual rate of 1.4% in 2Q15 after posting strong growth of 4.5% in 1Q15. Declines in personal consumption, business investment, and exports contributed to the negative growth. With the economy still weak, the Bank of Japan will likely continue its expansionary monetary stance.

Movements in 10-year local currency (LCY) government bond yields in emerging East Asia were mixed between 1 June and 14 August **(Table A)**. While stock markets have experienced large losses, bond prices in several economies have held up. In the People's Republic of China and the Philippines, bond yields have even fallen—by 16 basis points (bps) and 10 bps, respectively. On the other hand, Indonesian, Malaysian, and Vietnamese bond yields have increased by 54 bps, 34 bps, and 31 bps, respectively. Both Indonesia and Malaysia have a large foreign investor share in their bond markets and therefore are exposed to the shift in investor preferences away from emerging markets. Currencies across the region depreciated against the US dollar between 1 June and 14 August. The only exception was Hong Kong, China, whose currency is pegged to the US dollar. The People's Bank of China moved to make the Chinese renminbi more market-oriented, resulting in a fall of 3.1% in the currency's value against the US dollar during the period under review. Among the region's currencies, the Malaysian ringgit experienced the largest depreciation at 10.7%, followed by the Korean won at 6.3% and the Thai baht at 4.5%.

Credit default swap (CDS) spreads across emerging East Asia have been rising **(Figure A)**, reflecting increased risk perception among investors amid slowing growth and falling stock markets. Malaysia, Indonesia, Viet Nam, and Thailand all saw their CDS spreads rise sharply. In contrast, CDS spreads in Italy, Spain, Portugal, and Ireland have all stabilized with the agreement on the third bailout for Greece **(Figure B)**. They had spiked earlier over concerns that Greece might not be able to service its large debt burden and would be forced to leave the eurozone. Financial market conditions have been relatively calm in the US and the volatility index has remained stable. However, emerging markets have been perceived as riskier and emerging market spreads are rising as a result **(Figure C)**.

In the eurozone, bond yields have been easing as the agreement on the third bailout for Greece has removed the risk of a debt crisis for now. The continued expansionary stance of the European Central Bank and declining oil prices have also contributed to lower yields in the eurozone **(Figure D)**. The resolution of the Greek debt crisis has helped to bring Greek bond yields down sharply. Both US and Japanese bond yields have eased slightly. In emerging East Asia, risk premiums increased. Rising Malaysian and Indonesian risks premiums likely reflect investor concerns about these economies' reliance on oil and gas revenues amid declining global prices **(Figure E)**.

[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	8	2	–	(1.0)	–
United Kingdom	7	3	0.4	(5.8)	(2.9)
Japan	0.2	(3)	(4)	(0.9)	0.4
Germany	(6)	12	(1)	(3.9)	(1.7)
Emerging East Asia					
China, People's Rep. of	5	(16)	14	(17.9)	(3.1)
Hong Kong, China	2	17	–	(13.1)	0.0
Indonesia	22	54	38	(12.1)	(4.3)
Korea, Rep. of	(6)	(6)	12	(5.7)	(6.3)
Malaysia	27	34	57	(8.4)	(10.7)
Philippines	(36)	(10)	16	(3.4)	(3.7)
Singapore	3	17	–	(8.2)	(3.7)
Thailand	(3)	(1)	29	(5.5)	(4.5)
Viet Nam	12	31	38	2.4	(1.3)
Select European Markets					
Greece	603	(186)	(1,631)	(18.3)	(1.7)
Ireland	(6)	7	(2)	3.9	(1.7)
Italy	(5)	(10)	(6)	(0.8)	(1.7)
Portugal	(25)	(24)	(3)	(4.7)	(1.7)
Spain	0.7	5	6	(3.2)	(1.7)

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 1 June and 14 August 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).

Foreign holdings of Indonesian LCY government bonds continued to increase in 2Q15. Higher yields have attracted foreign investors to Indonesian bonds, with the foreign share of LCY government bonds rising to 39.6% from 38.6% at the end of 1Q15. Similarly, foreign holdings of LCY government bonds in Malaysia increased to 32.4% at end-June from 30.1% at end-March. In contrast, foreign holdings of LCY government bonds in Thailand slid from 17.3% to 16.5% between end-March and end-June **(Figure F)**. In Japan and the Republic of Korea, foreign holdings of LCY governments have remained relatively constant.

The possibility of the Federal Reserve raising interest rates and a shift in preferences away from emerging market assets have combined to increase the risks for the region's bond markets:

Outflows of funds could destabilize the region's bond markets. Increased risk perception has led to a sell-off across emerging markets as a whole. The impending rise in US interest rates has also made emerging market bonds less attractive. Hence, bond yields have generally risen across the region as foreign investors withdraw funds from the market. If the withdrawal is gradual, the impact on the region's bond markets should be minimal. However, if there is a sudden rush for the exit, it could result in large swings in bond prices similar to what happened during the "taper tantrum" of 2013. Low levels of liquidity in the region's bond markets could exacerbate the volatility. Large bond price movements could make the bond markets look more risky and potentially lead to even greater outflows of funds.

Further depreciation of the region's currencies could weaken corporates with a large amount of foreign currency bonds outstanding. Most emerging East Asian currencies have weakened relative to the US dollar in 2015. If more funds were to flow out of the region, it would put further downward pressure on the region's currencies. Governments have borrowed mostly in local currency so the risk to them from depreciation is less. However, the corporate sector has relied more on foreign currency borrowing. In 2014, foreign currency

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

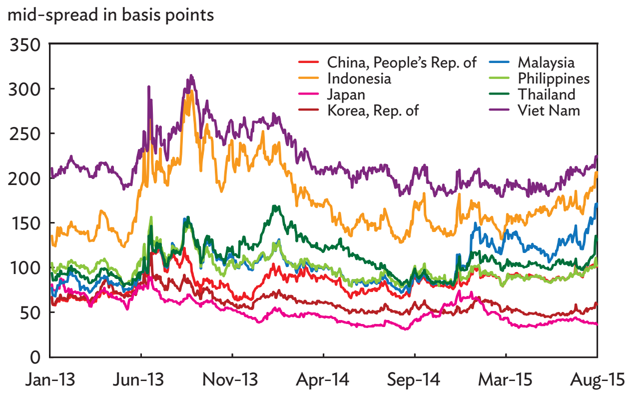


Figure B: Credit Default Swap Spreads for Select European Markets[a, b] (senior 5-year)

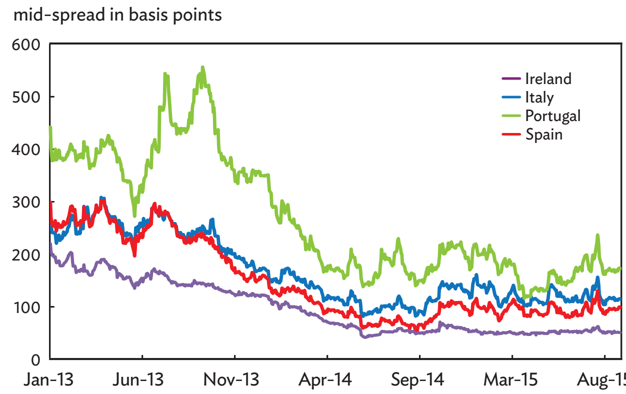


Figure C: US Equity Volatility and Emerging Market Sovereign Bond Spreads[b]

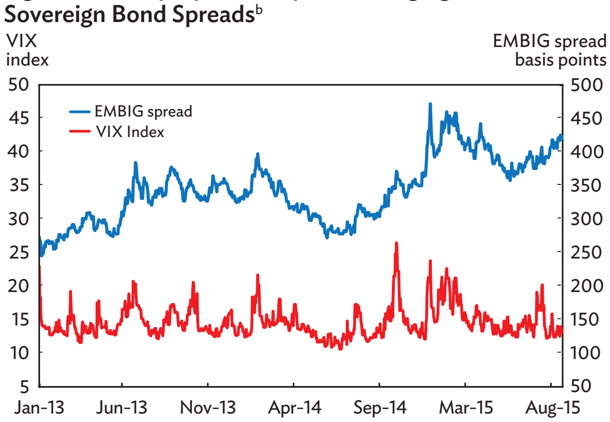


Figure D: 10-Year Government Bond Yields[b] (% per annum)

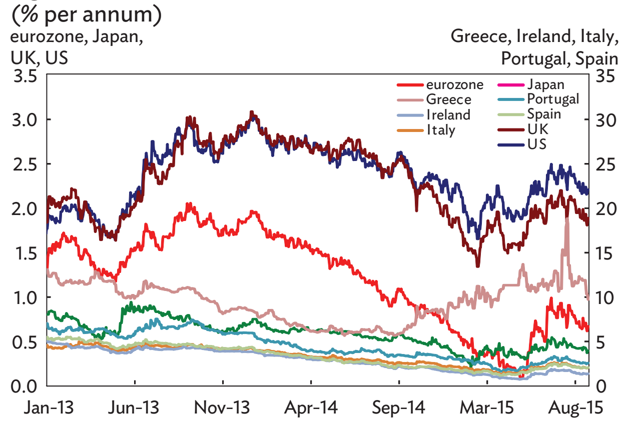


Figure E: JPMorgan EMBI Sovereign Stripped Spreads[a, b]

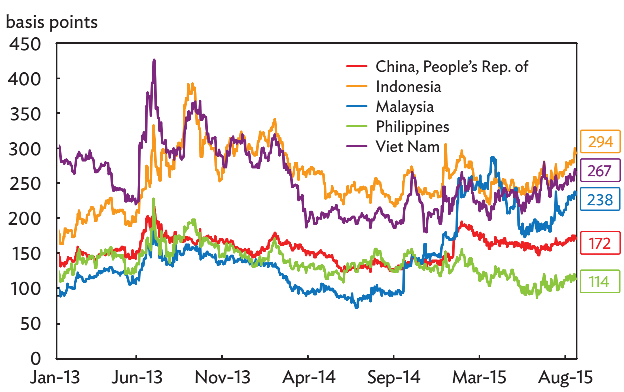
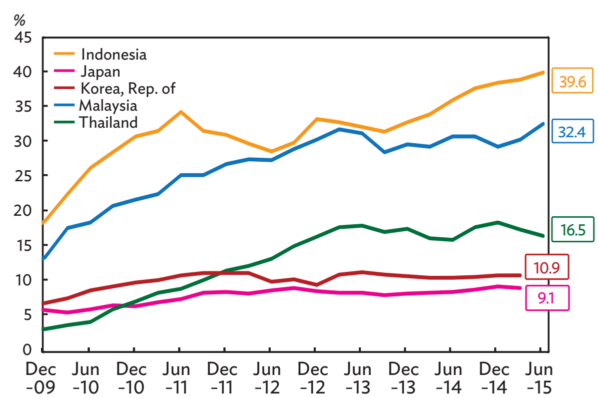


Figure F: Foreign Holdings of LCY Government Bonds in Select Asian Economies[c] (% of total)



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 14 August 2015.

[c] Data as of end-June 2015 except for Japan and the Republic of Korea (end-March 2015).

Sources: *AsianBondsOnline* and Bloomberg LP.

issuance by the corporate sector in emerging East Asia reached US$207 billion.[3] This exposes them to higher debt servicing costs in the face of depreciation, especially if they do not have foreign currency earnings. Another concern is that the environment for refinancing foreign currency borrowings will become more difficult.

Lower commodity prices could adversely affect highly leveraged companies in the commodity sector. The slide in commodity prices, especially oil, has sharply reduced revenues for companies in the commodity sector. Companies that borrowed heavily during the preceding commodity boom will face a harder time servicing their loans with their earnings under pressure. Those companies that have resorted to US dollar loans face the additional risk of higher interest rates and tighter refinancing requirements.

[3] Foreign currency bond issuance refers to bonds denominated in currencies other than the home economy's currency. The data exclude certificates of deposit and offshore renminbi-denominated bonds.