Asia Bond Monitor Highlights

Bond Market Outlook

Local currency (LCY) bond yields declined in most emerging East Asian economies between 1 June and 15 August.[1] The 2-year and 10-year yields fell in all emerging East Asian economies except in Thailand (2-year) and Viet Nam (10-year). The declines were driven by global investors seeking higher yields as well as the monetary easing measures being conducted by some central banks, which served to increase investor appetite for emerging market assets.

While the United Kingdom's (UK) decision to leave the European Union (EU) via a referendum held on 23 June temporarily led to rising volatility in global financial markets and affected emerging East Asia by causing currencies to depreciate and some yields to rise, markets have since recovered and the economic impact on emerging East Asia of what has come to be known as "Brexit" is likely to be muted. A special discussion box is included in this issue of the *Asia Bond Monitor* detailing the likely impacts of Brexit on the region (see Brexit—What Does It Mean for Asia?).

Stronger growth in emerging East Asia than in developed economies during the review period resulted in the appreciation of the region's currencies and rising equity markets. While the International Monetary Fund downgraded its 2016 global growth forecast in July to 3.1% from 3.2% in April, the Asian Development Bank is projecting developing Asia to grow 5.6% in 2016.[2]

During the review period, the Republic of Korea was the biggest gainer in terms of currency appreciation due to the won's safe-haven status and a one-notch ratings upgrade to AA by S&P Global Ratings in August, while Hong Kong, China's equity market was the biggest gainer on account of the planned linking of its stock exchange with the Shenzhen Stock Exchange.

Credit default swap markets around the world have also shrugged off the impact of the UK referendum, with spreads since falling in all markets except the UK and Greece.

While financial markets are calm, there are rising risks to emerging East Asia's bond markets. As the sole major developed economy to show growth, the likelihood of a policy rate hike in the United States could prompt capital outflows from the region. Furthermore, the full impact of Brexit has yet to be seen and if the UK's transition is marred by problems, volatility could return. Lastly, if negative interest rates in the EU and Japan continue, it will reduce monetary authorities' flexibility in the event of another major financial shock. Negative rates also reduce banking profitability and can exacerbate capital inflows to emerging markets. This issue of the *Asia Bond Monitor* includes a special discussion box on the impacts of negative interest rates (see Negative Interest Rates—What Are the Implications for Emerging Asia?).

Local Currency Bond Market Growth in Emerging East Asia

Emerging East Asia's LCY bond market reached a size of USD10,034 billion at the end of June, up 6.0% quarter-on-quarter (q-o-q) and 21.8% year-on-year (y-o-y). The PRC is still the region's largest LCY bond market in terms of absolute size at USD6,904 billion.

The region's LCY bond market is dominated by government bonds, which represented 63.3% of the total bond stock. Corporate bonds account for the remaining 36.7% share.

Emerging East Asia's total LCY bonds outstanding as a percentage of regional gross domestic product (GDP) climbed to 68.1% in the second quarter (Q2) of 2016 from 65.3% in the previous quarter, mainly driven by government bonds outstanding, which increased to the equivalent of 43.1% of GDP from 39.9%, offsetting the marginal decline in corporate bonds as a percentage of GDP. The Republic of Korea again led the region with bonds outstanding equal to 129.5% of GDP, followed

[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.

[2] Developing Asia comprises the 45 regional developing member economies of the Asian Development Bank.

by Malaysia at 98.1%. The two smallest markets in GDP terms were Indonesia and Viet Nam at 16.7% and 22.6%, respectively.

In Q2 2016, issuance of LCY bonds in emerging East Asia totaled USD1,323 billion, recording double-digit growth on both a q-o-q and y-o-y basis that was driven by robust bond issuance in the PRC. LCY bond sales in the PRC, which accounted for 67.6% of the regional total in Q2 2016, were buttressed by local government bond issues.

Structural Developments in Local Currency Bond Markets

Foreign investors continued to chase emerging East Asian LCY government bonds in Q2 2016 in a search for yield amid a low interest rate environment globally. Foreign holdings' share of the LCY government bond market was up at the end of June compared with the end of March in Indonesia, Malaysia, and Thailand. In contrast, the share of foreign holdings in the Republic of Korea's LCY government bond market slipped at the end of March compared with the end of December.

For corporate bonds, foreign holdings' shares generally remained weak in the two markets for which data are available. In Indonesia, the share of foreign holdings in the LCY corporate bond market continued its year-long decline at the end of June, while the share of foreign holdings remained insignificant in the Republic of Korea at the end of March.

Foreign capital flows into emerging East Asia's LCY bond market were generally strong in Q2 2016. Positive inflows were recorded in Indonesia, Malaysia, and Thailand, while the Republic of Korea experienced net bond outflows.

Local Currency Bond Yields

Yields of LCY government bonds fell in most emerging East Asian markets between 1 June and 15 August, with the yield curve shifting downward in most markets. This trend was a reflection of the weak global economic environment, particularly among the major advanced economies, and benign inflation that has led to a continuation of monetary easing policies in the EU and Japan. The persistence of low global yields has increased the attractiveness of emerging East Asian bonds, resulting in decreasing bond yields in the region.

With economic growth remaining subdued and inflation on the decline, the 2-year versus 10-year yield spread fell for all markets in emerging East Asia between 1 June and 15 August with the exception of Viet Nam.

Credit spreads between AAA-rated corporate bonds and government bonds fell for all tenors in the PRC and the Republic of Korea, and rose for all tenors in Malaysia. Meanwhile, lower-rated credit spreads narrowed in the PRC but widened in the Republic of Korea and in Malaysia.