Global and Regional Market Developments

Long-term bond yields declined and yield curves flattened in emerging East Asia on a dimming economic outlook.

Between 15 June and 24 August, a moderating growth outlook and mounting downside risks in emerging East Asia contributed to declining yields for 10-year local currency (LCY) government bonds, flattened yield curves, and currency depreciations against the United States (US) dollar across the region.[1] Short-term bond yield rose in a few markets as central banks accelerated monetary tightening to tame inflation and safeguard financial stability. Meanwhile, financial conditions eased modestly, as evidenced by narrowed risk premiums, and equities rallied in most emerging East Asian markets, largely supported by optimistic market sentiment since the second half of July on better-than-expected corporate earnings and expectations of a possible peak in inflation and thus a milder-than-expected tightening path by the US Federal Reserve (**Table A**).

From 15 June to 24 August, 10-year government bond yields trended downward and yield curves flattened, as proxied by narrowed spreads between 10-year and 2-year bond yields in most major advanced economies, driven by a weakening economic outlook.

In the US, growth prospects have dimmed, inflation remains elevated, and the Federal Reserve continues with aggressive tightening. During the review period, however, market sentiments in global financial markets were hugely shaped by expectations based on US economic data releases and forward guidance from the Federal Reserve. Tightening financial conditions were exacerbated on 13 July when US consumer price inflation for the month of June posted a 41-year high of

Table A: Changes in Global Financial Condition in Emerging East Asia and Major Advanced Economies

	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	20	(18)	–	9.3	–
United Kingdom	97	23	6	2.7	(3.1)
Japan	(6)	(3)	(2)	6.0	(2.4)
Germany	(16)	(27)	4	(2.0)	(4.6)
Emerging East Asia					
China, People's Rep. of	(18)	(19)	(11)	(2.7)	(2.1)
Hong Kong, China	8	(43)	–	(9.6)	0.04
Indonesia	44	(39)	(13)	2.7	(0.7)
Korea, Rep. of	(21)	(33)	(16)	0.003	(3.9)
Malaysia	(13)	(37)	(13)	0.6	(1.6)
Philippines	20	(101)	(12)	5.1	(4.7)
Singapore	0	(37)	–	4.1	(0.6)
Thailand	(30)	(53)	2	2.4	(2.8)
Viet Nam	93	22	(2)	5.2	(1.0)

( ) = negative, – = not available, bps = basis points, FX = foreign exchange.
Notes:
1. Data reflect changes between 15 June 2022 and 24 August 2022.
2. A positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the United States dollar.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

[1] Emerging East Asia is defined to include Cambodia; the People's Republic of China; Hong Kong, China; Indonesia; the Republic of Korea; the Lao People's Democratic Republic; Malaysia; the Philippines; Singapore; Thailand; and Viet Nam.

9.1% year-on-year (y-o-y), as the market showed concern that the Federal Reserve would become even more aggressive in its monetary tightening—an 80% probability emerged of a 100 basis points (bps) hike at the 27–28 July Federal Open Market Committee (FOMC) meeting. Such fears quickly waned as both Federal Reserve Governor Christopher Waller, on 14 July, and St. Louis Federal Reserve President James Bullard, on 15 July, indicated their support for a 75 bps rate hike at the July meeting as previously anticipated.

Beginning in mid-July, investors expressed optimism over an expected "Fed pivot," or milder-than-expected tightening by the Federal Reserve, supported by a smaller contraction in US gross domestic product (GDP) in the second quarter (Q2) of 2022 compared with the previous quarter, better-than-expected corporate earnings, slightly lower inflation in July, as well as a continued strong domestic job market. Per data released on 28 July, US GDP contracted an annualized 0.9% in Q2 2022 (later revised to -0.6% on 25 August), which was less than the 1.6% contraction in the first quarter (Q1) of 2022. On 5 August, US nonfarm payrolls showed a gain of 528,000 in July, up from 398,000 in June, while the July unemployment rate fell further to 3.5% after holding steady at 3.6% from March to June. Furthermore, the release of July consumer price inflation of 8.5% y-o-y on 10 August ignited expectations of a possible peak in inflation. US producer price inflation also retreated from 11.1% y-o-y in May and 11.3% y-o-y in June to 9.8% y-o-y in July. These data contributed to optimistic sentiment in the market and some speculation on the possibility of less significant monetary tightening by the Federal Reserve.

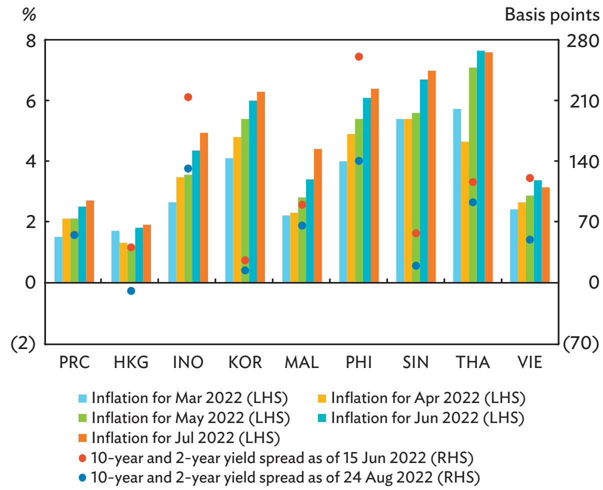
In contrast to expectations of a pivot, the Federal Reserve repeatedly affirmed it would continue with its tightening trajectory to tame inflation. During the July FOMC meeting, Federal Reserve Chairman Jerome Powell noted that market expectations of the path of the future federal funds rate were lower than what the Federal Reserve had indicated in its June dot-plot. Moreover, during the Aspen Ideas Conference on 10 August, Minneapolis Federal Reserve Bank President Neel Kashkari said that he did not see the need for any deviation from the current trajectory. The San Francisco Federal Reserve Bank's Mary Daly, in an interview with the *Financial Times* on 11 August, said that it was still too early to assume that inflation is on its way to being contained. St. Louis Federal Reserve President James Bullard, in a *Wall Street Journal* interview on 18 August, indicated support for a 75 bps rate hike in September as he was also not ready to say that inflation had peaked. Meanwhile, the Federal Reserve also confirmed its commitment to continue reducing its bond holdings. Amid such developments, on 24 August the federal funds futures market priced in a slightly lower chance for a 50 bps (45.5%), compared to a 75 bps (54.5%), rate hike at the September FOMC meeting. Expectations for a 75 bps rate hike at the September meeting were further strengthened by Federal Reserve Chairman Jerome Powell's speech at the Jackson Hole conference on 26 August, which highlighted that "reducing inflation is likely to require a sustained period of below-trend growth." Powell also said that the Federal Reserve's policy stance would be sufficiently restrictive to return inflation to its 2.0% target, which increased the chance for a 75 bps hike in September, as implied in the federal funds futures market, to 61.0% on the same day.

The euro area continued to grapple with both high inflation and growth moderation. In July, inflation in the euro area rose to 8.9% y-o-y from 8.6% y-o-y in June and 8.1% y-o-y in May. Inflation rose further to 9.1% y-o-y in August. Meanwhile, GDP growth softened to 3.9% y-o-y in Q2 2022 from 5.4% y-o-y in Q1 2022. The European Central Bank (ECB) noted that uncertainties related to the Russian invasion of Ukraine have led to a weakening of economic growth as well as a rise in food and energy prices. As inflationary pressure remained elevated, the ECB raised its key policy rates—the refinancing rate, marginal lending facility, and deposit facility—by 50 bps each to 0.50%, 0.75%, and 0.0%, respectively, during its 21 July policy meeting. The rate hikes were larger than the 25 bps rate hikes previously signaled by the ECB. To ensure the smooth and effective transmission of its monetary stance, the ECB unveiled the Transmission Protection Instrument, which allows the central bank to purchase securities issued by the governments and government agencies of individual member countries based on their current financial conditions.

In Japan, inflation rose modestly compared to the US and euro area, while its economic outlook weakened too. In July, the Bank of Japan (BOJ) revised downward its GDP forecast for 2022 from 2.9% made in April to 2.4%, while raising its inflation forecast for 2022 to 2.3% from the forecast of 1.9% made in April. While inflation in Japan stayed above the BOJ's 2.0% target, recording 2.5% y-o-y in both April and May, as well as 2.4% y-o-y in June and 2.6% y-o-y in July, it is much milder compared to that in the US and euro area. Meanwhile, Japan's GDP posted annualized growth of 3.5% in Q2 2022 versus 0.2% in Q1 2022. With this development, the BOJ maintained its monetary policy during its 21 July meeting, keeping the short-term policy rate target at −0.1% and the 10-year Japan Government Bond yield target at 0.0%, and leaving unchanged the amount of monthly asset purchases of exchange-traded funds and Japanese real investment trusts.

Nearly all 10-year local currency government bond yields fell in emerging East Asian economies and yield curves flattened between 15 July and 24 August, largely driven by the softened growth outlook in the region. In emerging East Asia, higher global oil and food prices, lingering supply chain disruptions, and economic re-openings contributed to rising inflation (**Figure A**). Regional central banks have accelerated monetary tightening, via more and larger rate hikes, to ease inflationary pressure and safeguard financial stability amid aggressive Federal Reserve tightening (**Table B**). From 1 April to 15 June, emerging East Asia witnessed four 25 bps rate hikes, while from 15 June to 25 August, emerging East Asian economies conducted eight rate hikes with an average hike of 38 bps. Accelerated monetary tightening in the region pushed up 2-year bond yields in some markets, while a moderation in the regional growth outlook led to lower 10-year bond yields and flattened yield curves, as proxied by narrowed spreads between 10-year bond yields over 2-year bond yields.

Figure A: Inflation and Changes in Term Spreads in Emerging East Asia



( ) = negative; PRC = China, People's Rep. of; HKG = Hong Kong, China; INO = Indonesia; KOR = Korea, Rep. of; LHS = left-hand side; MAL = Malaysia; PHI = Philippines; RHS = right-hand side; SIN = Singapore; THA = Thailand; VIE = Viet Nam.
Sources: Various local sources.

Table B: Changes in Monetary Stances in Major Advanced Economies and Emerging East Asia

Economy	Policy Rate 15-Aug-2021 (%)	Rate Change (%) Aug-2021	Sep-2021	Oct-2021	Nov-2021	Dec-2021	Jan-2022	Feb-2022	Mar-2022	Apr-2022	May-2022	Jun-2022	Jul-2022	Aug-2022	Policy Rate 25-Aug-2022 (%)	Change in Policy Rate (basis points)
United States	0.25								↑0.25		↑0.50	↑0.75	↑0.75		2.50	↑ 225
Euro Area	(0.50)												↑0.50		0.00	↑ 50
United Kingdom	0.10					↑0.15		↑0.25	↑0.25		↑0.25	↑0.25		↑0.50	1.75	↑ 165
Japan	(0.10)														(0.10)	
China, People's Rep. of	2.95						↓0.10							↓0.10	2.75	↓ 20
Indonesia	3.50													↑0.25	3.75	↑ 25
Korea, Rep. of	0.50	↑0.25			↑0.25		↑0.25			↑0.25	↑0.25		↑0.50	↑0.25	2.50	↑200
Malaysia	1.75										↑0.25		↑0.25		2.25	↑ 50
Philippines	2.00										↑0.25	↑0.25	↑0.75	↑0.50	3.75	↑ 175
Singapore	–			↑			↑			↑			↑		–	–
Thailand	0.50													↑0.25	0.75	↑ 25
Viet Nam	4.00														4.00	

( ) = negative.
Notes:
1. Data coverage is from 15 August 2021 to 25 August 2022.
2. For the People's Republic of China, data used in the chart are for the 1-year medium-term lending facility rate. While the 1-year benchmark lending rate is the official policy rate of the People's Bank of China, market players use the 1-year medium-term lending facility rate as a guide for the monetary policy direction of the People's Bank of China.
3. The up (down) arrow for Singapore signifies monetary policy tightening (loosening) by its central bank. Monetary Authority of Singapore utilizes the exchange rate to guide its monetary policy.

Sources: Various central bank websites.

Viet Nam is the only market in emerging East Asia that witnessed a rise in both the 2-year and 10-year yields. The overall uptick in bond yields was partly driven by the State Bank of Vietnam's money market operations to tighten liquidity and stabilize the Vietnamese dong, although the central bank did not directly adjust the policy rate. Meanwhile, the central bank increased the issuance of central bank bills in Q2 2022, draining liquidity and indirectly pushing up bond yields.

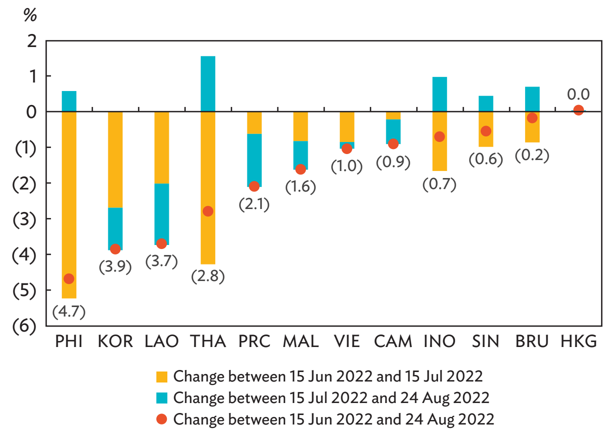
Indonesia witnessed a 44 bps increase in its 2-year yield, largely driven by an unexpected policy rate hike by Bank Indonesia of 25 bps on 23 August. Prior to the rate hike, Bank Indonesia used open market operations to tighten liquidity conditions and lift yields, particularly for the 2-week and 1-year maturities. It also started to offload bonds with maturities of up to 5 years from its balance sheet under its burden-sharing agreement with the government during the pandemic.

The Philippines saw an increase in its 2-year bond yield during the review period as the Bangko Sentral ng Pilipinas has been one of the most aggressive in the region, hiking the policy rate by a total of 175 bps with four consecutive monthly rate hikes from May through August to contain inflation.

Bucking the monetary tightening trend in the region, the People's Bank of China eased its monetary stance by lowering the 7-day repo rate and 1-year medium-term lending facility rate by 10 bps each on 15 August. On 22 August, it cut the 5-year loan prime rate and 1-year loan prime rate by 15 bps and 5 bps, respectively, to support recovery and stabilize the real estate sector as growth was negatively affected by measures to contain the pandemic. Meanwhile, inflation in the People's Republic of China (PRC) remained modest compared to other regional economies, offering some policy scope. With a subdued economic outlook and easing monetary stances, both the 2-year and 10-year yields declined in the PRC.

Rising inflation and a moderation in the regional growth outlook contributed to currency depreciations across the region between 15 June and 24 August. From 15 June to 15 July, regional foreign exchange rates posted a simple average loss of 1.7% (or 1.0% in GDP-weighted average terms) against a strong US dollar that was buttressed by aggressive Federal Reserve tightening. The currency depreciations continued from 15 July to 24 August by a simple average of 0.2% (or 1.1% in GDP-weighted average terms), although improved market sentiment supported currencies in a few markets (**Figure B**). The Philippines witnessed the region's largest depreciation versus the US dollar during the review period on a widened trade deficit and consecutive monthly outflows from the equity market since March.

Figure B: Changes in Emerging East Asian Currencies

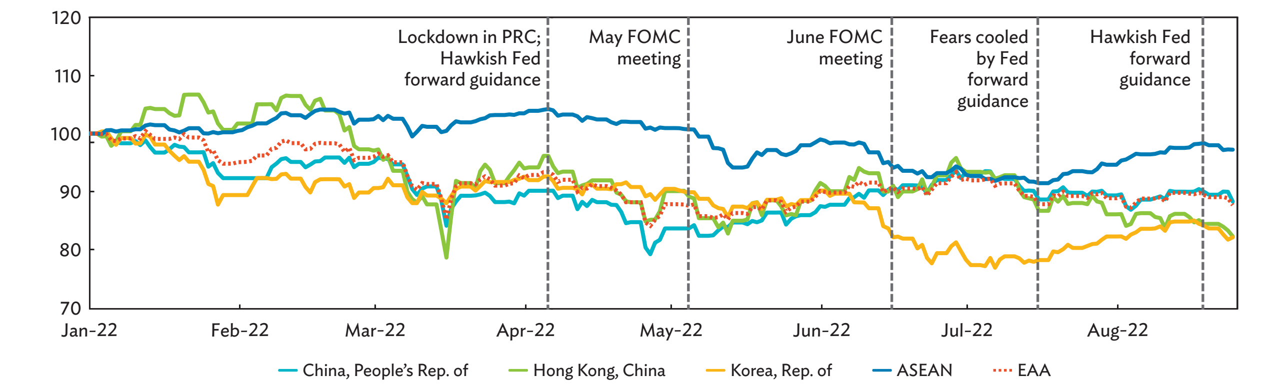


( ) = negative; BRU = Brunei Darussalam; CAM = Cambodia; PRC = China, People's Rep. of; HKG = Hong Kong, China; INO = Indonesia; KOR = Korea, Rep. of; LAO = Lao People's Democratic Republic; MAL = Malaysia; PHI = Philippines; SIN = Singapore; THA = Thailand; VIE = Viet Nam.
Note: A positive (negative) value for the FX rate indicates the appreciation (depreciation) of the local currency against the United States dollar.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

Despite a weakening economic outlook, optimistic market sentiment fueled by expectations of a potential Fed pivot led to a rally in equity markets, narrowed risk premiums, and capital inflows into the region beginning in mid-July.

During the review period, equity markets in the region, excluding the PRC and Hong Kong, China, collectively gained after fears of a 100 bps rate hike by the Federal Reserve in July were cooled by forward guidance from two Federal Reserve officials on 14–15 July (**Figure C**). From 15 June to 15 July, nearly all emerging East Asian equity markets posted losses amid a weak global economic outlook and aggressive Federal Reserve tightening, generating a market-weighted average loss of 3.1% across the region. As market sentiment improved after 15 July, most regional markets rallied. From 15 July to 24 August, regional equity markets, excluding the PRC and Hong Kong, China, all gained, posting a value-weighted return of 5.6%. From 15 June to 24 August, equity markets in the PRC and

Figure C: Movements in Equity Indexes in Emerging East Asia

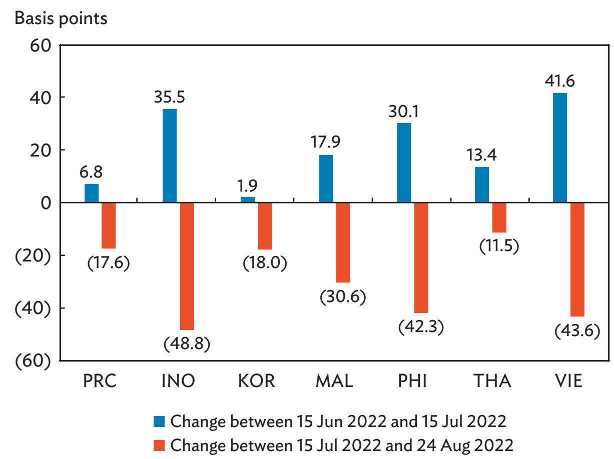


ASEAN = Association of Southeast Asian Nations, bps = basis points, EEA = European Economic Area, Fed = Federal Reserve, FOMC = Federal Open Market Committee, PRC = People's Republic of China.
Notes:
1. 1 January 2022 = 100.
2. ASEAN comprises the markets of Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet Nam.
3. Data as of 24 August 2022.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

Hong Kong, China recorded losses of 2.7% and 9.6%, respectively, over concerns about a slowdown in the PRC's economic growth. The PRC's GDP grew only 0.4% y-o-y in Q2 2022, after gaining 4.8% y-o-y in the previous quarter, as economic activities were negatively affected by measures to contain the coronavirus disease (COVID-19) pandemic. Hong Kong, China was the sole market in the region to post two consecutive quarterly GDP contractions of 3.9% y-o-y and 1.3% y-o-y in Q1 2022 and Q2 2022, respectively.

Similarly, improved sentiment since mid-July drove down risk premiums, proxied by credit default swap spreads, across the region. From 15 June to 15 July, risk premiums in major regional economies collectively widened by an average of 21 bps (simple average) and 9 bps (GDP-weighted) on tightening global monetary stances and a gloomy recovery outlook, but the trend reversed between 15 July and 24 August when risk premiums collectively narrowed by an average of 30 bps (simple average) and 20 bps (GDP-weighted). From 15 June to 24 August, risk premiums in the region narrowed by 9 bps in simple average terms and 11 bps in GDP-weighted average terms (**Figure D**).

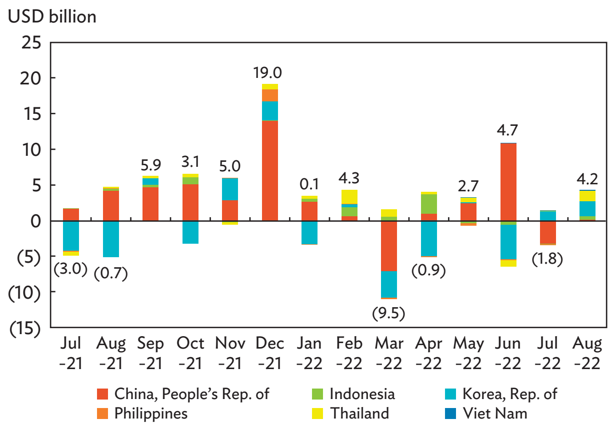
Figure D: Changes in Credit Default Swap Spreads in Emerging East Asia (senior 5-year)



( ) = negative; PRC = China, People's Rep. of; INO = Indonesia; KOR = Korea, Rep. of; MAL = Malaysia; PHI = Philippines; THA = Thailand; VIE = Viet Nam.
Source: *AsianBondsOnline* computations based on Bloomberg LP data.

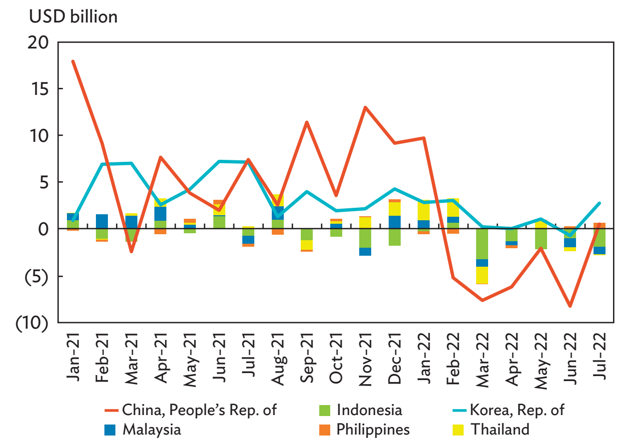
Improved market sentiment brought portfolio inflows back into regional equity markets in August. The region experienced net inflows of USD7.0 billion in equity markets from 1 June to 24 August (**Figure E**). The gains stemmed largely from the PRC, especially in June, when USD10.9 billion of inflows were recorded following the introduction of economic stimulus measures and the lifting of a COVID-19 lockdown in Shanghai. However, the gloomy economic outlook led to outflows from the PRC's equity market in July. Excluding the PRC, the region witnessed net outflows of USD1.0 billion from 1 June to 24 August; in June, outflows of USD6.3 billion

Figure E: Foreign Capital Flows into Equity Markets in Emerging East Asia



( ) = outflows, USD = United States dollar.
Notes:
1. Data coverage is from 1 July 2021 to 24 August 2022.
2. Figures refer to net inflows (net outflows) for each month.
Source: Institute of International Finance.

Figure F: Foreign Capital Flows in Local Currency Bond Markets in Emerging East Asia



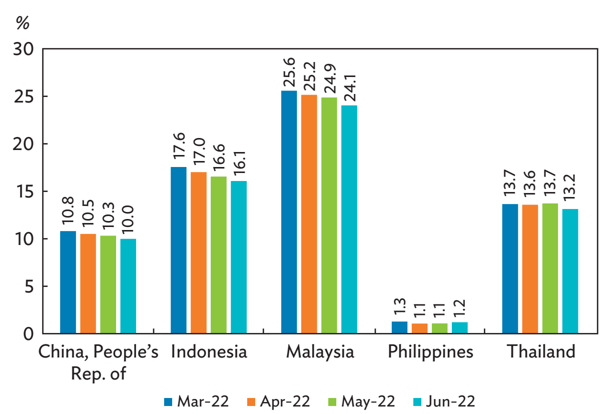
( ) = negative, USD = United States dollar.
Notes:
1. The Republic of Korea and Thailand provided data on bond flows. For the People's Republic of China, Indonesia, Malaysia, and the Philippines, month-on-month changes in foreign holdings of local currency government bonds were used as a proxy for bond flows.
2. Data are as of 31 July 2022.
3. Figures were computed based on 31 July 2022 exchange rates and do not include currency effects.
Sources: People's Republic of China (Bloomberg LP); Indonesia (Directorate General of Budget Financing and Risk Management, Ministry of Finance); Republic of Korea (Financial Supervisory Service); Malaysia (Bank Negara Malaysia); Philippines (Bureau of the Treasury); and Thailand (Thai Bond Market Association).

were recorded. After market sentiment improved in the second half of July, portfolio inflows were recorded in all regional markets except the Philippines (USD0.1 billion of outflows) between 1 August and 24 August, posting aggregate regional inflows of USD4.2 billion.

Tightened financial conditions led to capital outflows of USD21.5 billion from the region's bond markets during Q2 2022 (**Figure F**). As a result, foreign holdings declined in nearly all of the region's LCY bond markets during the quarter (**Figure G**). In Q2 2022, the Republic of Korea and Thailand were the only two bond markets that posted positive net inflows, particularly in May. In the Republic of Korea, sentiment was buoyed by news in the last week of April that it would seek inclusion in the FTSE's World Government Bond Index. In July, the Republic of Korea recorded capital inflows of USD2.7 billion on expectations of the removal of taxes on foreign bond purchases. In Thailand, market sentiment was boosted when the government announced that it would ease travel restrictions for foreigners on 1 June.

The risk outlook to the region remains titled to the downside. In the short term, the region faces a moderation in the global and regional economic recoveries, and there are uncertainties regarding the containment of inflationary pressure, the pace of Federal Reserve tightening, the lingering impacts of the

Figure G: Foreign Holdings of Local Currency Government Bonds in Select Emerging East Asian Markets (% of total)



Sources: People's Republic of China (Bloomberg LP and CEIC Data Company); Indonesia (Directorate General of Budget Financing and Risk Management, Ministry of Finance); Malaysia (Bank Negara Malaysia); Philippines (Bureau of the Treasury); and Thailand (Bank of Thailand).

COVID-19 pandemic, possibly greater-than-expected negative spillover from the Russian invasion of Ukraine, and a bigger-than-expected slowdown in the PRC. As many major regional economies have committed to move to net-zero emissions, over the midterm the regional financial sector faces asset vulnerability issues, especially in high-emitting sectors, as well as large financing gaps for investments in both low-emission projects and the transitioning of high-emitting sectors. Providing enough financing for a resilient and timely transition, in a sustainable way, calls for policy support and will require continued market development and innovation in the financial sector.