Asia Bond Monitor Highlights

Bond Market Outlook

Local currency (LCY) government bond yields in advanced economies and emerging East Asia climbed between 31 October and 18 November due to increased concerns over the direction of the United States (US) economy.[1] With the recently concluded US election, markets outside of the US experienced rising uncertainty and increased risk aversion as investors struggled to discern the future direction of the incoming US administration's economic policy. The US economy has also strengthened, increasing the likelihood that the Federal Reserve will raise the policy rate in December.

Nearly all markets in emerging East Asia saw an uptick in 2-year and 10-year LCY government bond yields between 31 October and 18 November. The only exception was the People's Republic of China's (PRC) 2-year tenor which was unchanged.

Given rising uncertainty, most central banks in emerging East Asia maintained their existing monetary policies in order to wait for greater clarity regarding US economic policy and its potential impacts on global financial markets.

Currencies in all emerging East Asian markets fell against the US dollar between 31 October and 18 November. Regional currencies depreciated mainly on rising US yields and declining equity markets across the region. Almost all emerging East Asian equity markets declined except for those in the PRC and Singapore. Credit default swap spreads rose in all regional markets except in Thailand during the review period.

Risks to emerging East Asia's LCY bond market include (i) the prospective interest rate hike by the Federal Reserve; (ii) uncertainty over the direction of US economic policy; (iii) a "hard Brexit," which would have serious repercussions for financial markets in emerging East Asia; (iv) the possibility of generalized global risk aversion toward emerging markets; and (v) the rise of protectionism and economic nationalism.

This issue of the *Asia Bond Monitor* includes a special discussion box on the possible effects on the region of a Federal Reserve rate hike. (Please see The Potential Impact of a United States Interest Rate Hike on Emerging Asia.)

Local Currency Bond Market Growth in Emerging East Asia

Emerging East Asia's LCY bond market reached a size of USD10,435 billion at the end of September. Growth in the third quarter (Q3) of 2016 moderated to 3.3% quarter-on-quarter (q-o-q) and 19.2% year-on-year (y-o-y) from 5.9% q-o-q and 21.7% y-o-y in the second quarter (Q2) of 2016.

Indonesia was home to the fastest-growing bond market on both a q-o-q and y-o-y basis. In terms of absolute size, the largest markets were in the PRC and the Republic of Korea. These two markets together accounted for 86.9% of the region's total bond stock at the end of September.

Growth in Q3 2016 was largely driven by government bonds, which rose 4.8% q-o-q and 26.9% y-o-y. Corporate bonds grew at a slower pace of 0.9% q-o-q and 7.8% y-o-y.

As a share of regional gross domestic product (GDP), the size of emerging East Asia's LCY bond market rose to 69.9% in Q3 2016 from 68.2% in the previous quarter. The expansion was largely driven by government bonds, whose share of GDP rose by more than 1 percentage point to 44.6% in Q3 2016. On the other hand, the share of corporate bonds to GDP was broadly unchanged. Leading the region in terms of bond market size as a share of GDP were the Republic of Korea and Malaysia at 136.3% and 96.9%, respectively.

Issuance of LCY bonds in emerging East Asia reached USD1,167 billion in Q3 2016, down 12.0% q-o-q but up 7.0% y-o-y. The q-o-q contraction stemmed from lower LCY bond sales in the PRC and the Republic of Korea.

Structural Developments in Local Currency Bond Markets

Foreign investor holdings of emerging East Asia's LCY government bonds continued to rise amid a global low interest rate environment and after the US held off raising interest rates. Nonresidents increased their holdings of

[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.

Indonesian, Malaysian, and Thai government bonds at the end of September. However, foreign outflows from these markets were observed in November amid global volatility in the aftermath of the US presidential election.

Consistent with the foreign holdings data, foreign capital flows into emerging East Asia's LCY bond market were positive in Q3 2016, albeit lower than in the previous quarter. The only market in the region that posted net capital outflows during the quarter was the Republic of Korea. However, some degree of reversal is expected given current market conditions that include investors shifting to safe-haven assets.

Local Currency Bond Yields

Emerging East Asian bond yields rose for nearly all markets and for most tenors between 31 October and 18 November amid uncertainty over future US economic policy and the likelihood of a Federal Reserve rate hike in December.

Most emerging East Asian bond markets experienced a widening spread between the 2-year and 10-year yields between 31 October and 18 November, leading to steepening yield curves across the region. The only exceptions to this trend were in the bond markets of Indonesia, Malaysia, and Viet Nam.

AsianBondsOnline Annual Bond Market Liquidity Survey

Overall liquidity conditions for emerging East Asia's LCY bond market have improved in 2016, according to the results of the most recent *AsianBondsOnline* bond market liquidity survey, which was conducted from late September through early October. The region's average bid–ask spread for on-the-run government bonds narrowed to 3.8 bps in 2016 from 5.4 bps in 2015. Bid-ask spreads narrowed in all of the region's government bond markets except for the Philippines, Singapore, and Thailand.

The average transaction size for on-the-run government bonds climbed to USD5.2 million in 2016 from USD3.5 million in 2015, indicating an ability to transact larger volume trades.

A widening of bid–ask spreads was observed in 2016 for corporate bond markets in the PRC, the Philippines, Singapore, and Thailand. Bid–ask spreads for corporate bonds fell in Hong Kong, China; and were broadly unchanged in Indonesia, the Republic of Korea, and Malaysia.

Theme Chapter: Infrastructure Bond Market Developments in Asia—Challenges and Solutions

We attempt to identify the determinants of infrastructure bond market development in Asia and to evaluate the impact of the Project Bond Initiative (PBI) on the development of infrastructure bond markets in Europe, with the objective of deriving policy implications for Asia.[2]

The empirical results show that an economy's size is positively associated with infrastructure bond market development. In addition, bond market standardization and harmonization through the Association of Southeast Asian Nations Plus Three (ASEAN+3) Bond Market Forum can facilitate the integration of individual Asian bond markets to help them obtain the minimum efficient scale needed to enhance liquidity and depth through an integrated regional bond market.[3]

The empirical results also show that the PBI has contributed significantly to infrastructure bond market development in Europe. Considering the positive impacts of the PBI in Europe and the relatively lower credit ratings of infrastructure bonds in Asia, ASEAN+3 economies should take policy measures to facilitate the issuance of infrastructure bonds and strengthen the role of the Credit Guarantee and Investment Facility in providing guarantees for infrastructure bonds.

Asia's infrastructure bond markets are still at a nascent stage of development, especially when the amount of issuance is compared with needed investment levels. At the same time, meaningful progress has been achieved in facilitating an environment conducive for the issuance of infrastructure bonds. ASEAN+3 has demonstrated its commitment to developing infrastructure bond markets and the regional Credit Guarantee Investment Facility is now providing guarantees for infrastructure bonds. The time is opportune for ASEAN+3 to strengthen regional initiatives to promote infrastructure bond market development across Asia.

[2] Asia refers to Brunei Darussalam; the People's Republic of China; Hong Kong, China; Indonesia; Japan; the Republic of Korea; the Lao People's Democratic Republic; Malaysia; the Philippines; Singapore; and Thailand.
[3] ASEAN+3 refers to the 10 members of the Association of Southeast Asian Nations plus the People's Republic of China, Japan, and the Republic of Korea.