Inside Fixed Income and Currency (FIC) Monthly Newsletter

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Monthly Highlights

- In January 2015, a total of USD 1,923 million in contract value of USD/CNH Futures was traded, with an average daily notional value of USD 92 million. Non Market Makers contributed 58 per cent of contract volume, down from 62 per cent in December 2014.
- USD/CNH Futures Open Interest was to 11,078 contracts (i.e. USD 1,107.8 million notional) as of 30 January 2015. Open interest was high in the March 2015 and June 2015 contracts, which accounted for 52 per cent of total open interest.
- Tight bid-ask spreads of USD/CNH Futures were observed in the January 2015 contract, with an average spread of 0.0013.
- When there was a wide price differential between CNH and CNY, the trading volume of HKEX's USD/CNH futures contracts picked up significantly.
- Expert Corner: Renminbi rates and FX outlook for 2015, by Becky Liu, Senior Rates Strategist, Standard Chartered

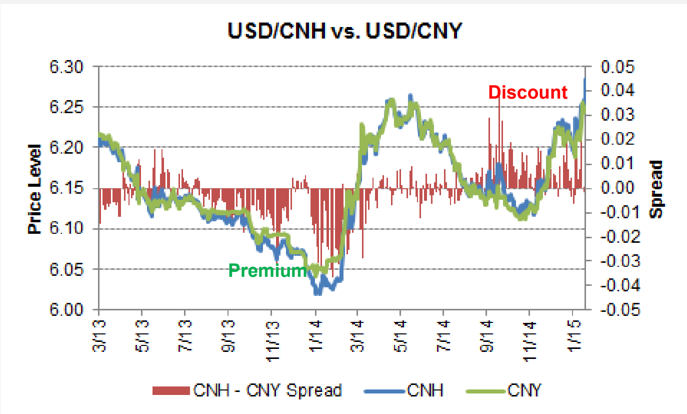
The trade of Renminbi (RMB) in two separate foreign exchange markets - onshore (CNY) and offshore (CNH) - creates significant price differentials that can potentially lead to arbitrage opportunities. These price differentials between CNH and CNY exist because of the capital controls in China and are transient in nature. Large price differentials suggest exploitable arbitrage opportunities as we observed that CNH tends to converge back to the CNY when differentials arise due to the greater volatility of CNH. In this article, we further analyse the price differential dynamics of CNH and CNY to explore the relationship between the CNH-CNY spread and the trading of HKEx's USD/CNH futures.

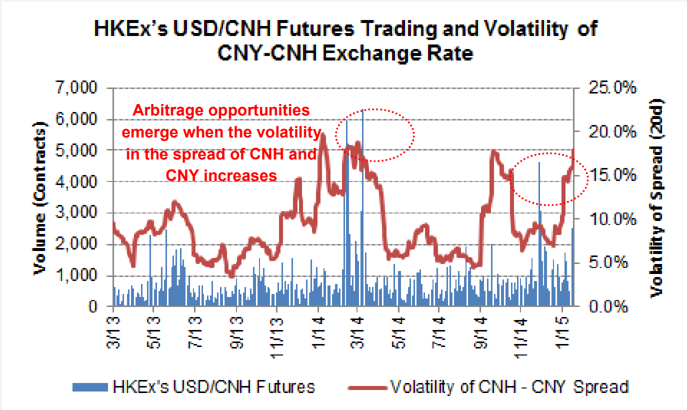
The official value of the CNY (CNY Fixing) is fixed every morning by the PBOC. The value of the onshore RMB (CNY) is then allowed, by regulation, to trade up or down 2 per cent from this daily CNY Fixing according to market forces. The offshore RMB (CNH) is a freely traded currency that is allowed to trade at any level the market can bear. Therefore, it is not bound by the 2 per cent band. Hong Kong's TMA spot USD/CNH fixing serves as a benchmark for the offshore RMB market.

Depending on foreign investor and large Chinese bank bearishness and bullishness on the RMB, the CNH may at times be trading at premium or discount to the CNY. When the price differential between CNH and CNY increases substantially (either positive or negative), the volatility in the CNH-CNY spread tends to increase as well. Investors can exploit this arbitrage opportunity by taking long-short positions in the underlying CNH and CNY, expecting the CNH would converge back to the CNY later.

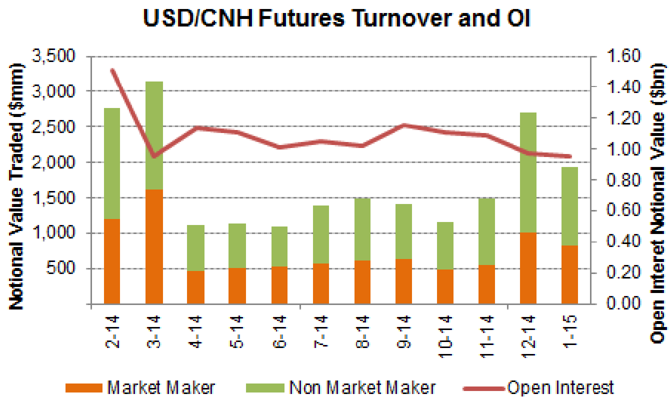
As HKEx's USD/CNH Futures contract continues to be the most liquid and transparent listed RMB futures contract in the global marketplace, the contract has proved to be an especially efficient way to exploit the arbitrage opportunities when the price differential between CNH and CNY is large, as witnessed towards the end of 2014 and March 2014. Both times, when the volatility of the CNH-CNY spread increased, the USD/CNH Futures' trading volume also picked up. A closer look at the market environment shows that the 20-day historical volatility of the CNH-CNY spread jumped above 15 per cent in March 2014. During the same period, the trading volume of USD/CNH Futures rose and touched an all-time high of 6,318 contracts on 19 March. Similarly, towards the end of 2014, when the volatility of the CNH-CNY spread increased substantially, the volume of USD/CNH Futures hit an 8-month high of 4,608 contracts on 9 December.

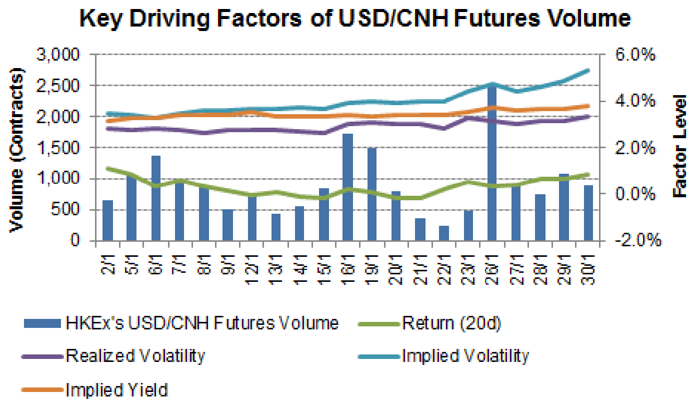
We observed that when there was a wide price differential between CNH and CNY, the trading volume of HKEX's USD/CNH futures contracts picked up significantly. When the volatility of the price differential between CNH and CNY increases, investors can capitalise on trading opportunities via HKEx's USD/CNH futures.





HKEx's USD/CNH Futures Market Statistics





In January 2015, a total of USD 1,923 million in contract value was traded, with an average daily notional value of USD 91.6 million. Non Market Makers contributed 58 per cent of contract volume, down from 62 per cent in December 2014.

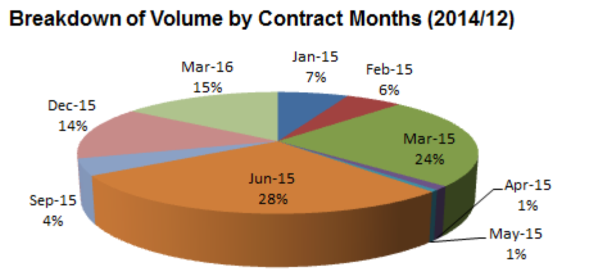
The following have been identified as the key driving factors behind the CNH futures volume: cumulative return of CNH/USD, realised volatility (20d), Implied volatility (USD/CNH 1 Year ATM implied Volatility from Bloomberg), 12 month forward implied yield.

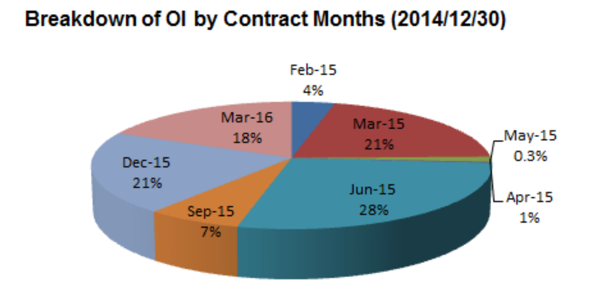
USD/CNH Futures Prices and Average Bid-Ask Spread

Contract Month	30 January Closing	Average Bid/Ask Spread*
Jan-15	-	0.0013
Feb-15	6.2743	0.0015
Mar-15	6.2956	0.0021
Apr-15	6.3145	0.0019
May-15	6.3361	0.0026
Jun-15	6.3521	0.0019
Sep-15	6.4013	0.0022
Dec-15	6.4457	0.0020
Mar-16	6.4911	0.0021

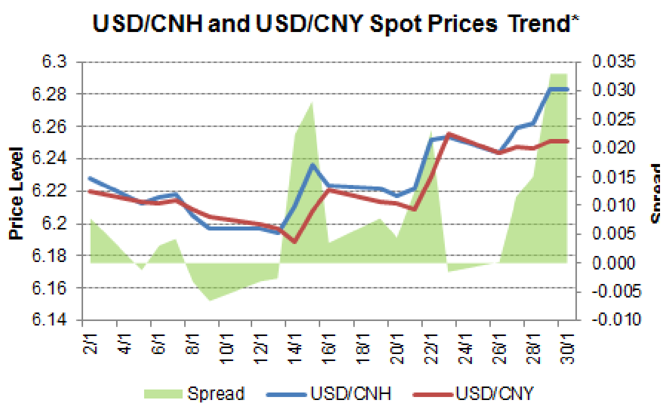
*Average Bid/Ask Spread between 9:30 am and 4:15 pm during the month

During the day session, the average bid-ask spread of the February 2015 contract was 0.0015.



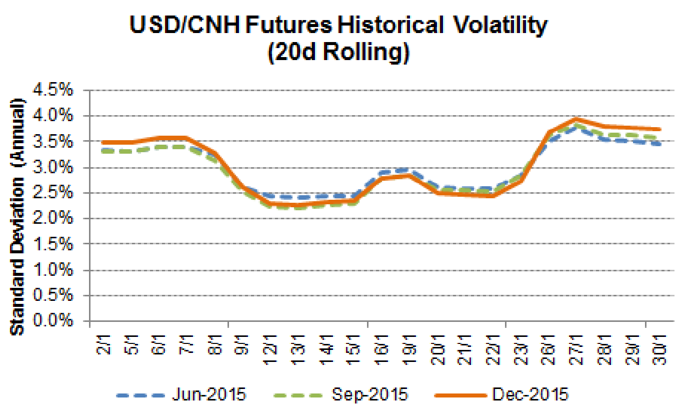


Open interest was high in the March 2015 and June 2015 contracts, which accounted for 49 per cent of total open interest at the end of January.



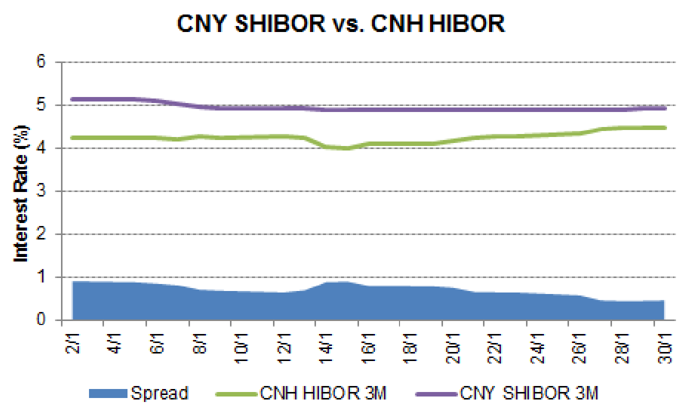
*Bloomberg closing price

The spread between the USD/CNY and the USD/CNH widened towards the end of January to more than 0.030. The CNH was trading at a discount to the CNY against the USD.

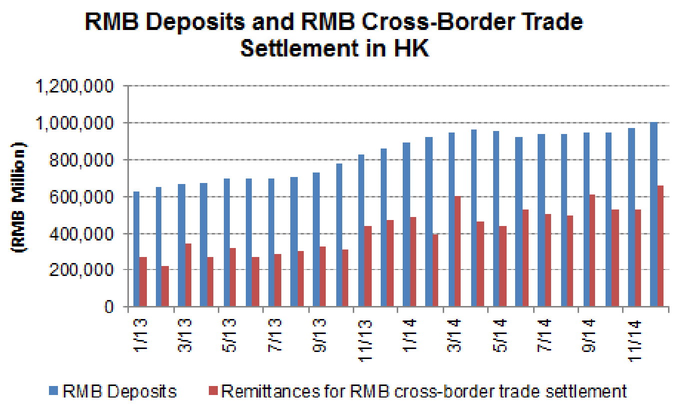


Volatility in USD/CNH Futures ranged between 2 per cent to 4 per cent in January 2015. The volatility spreads across far month contracts and front month contracts were narrower through January 2015 compared to December 2014.

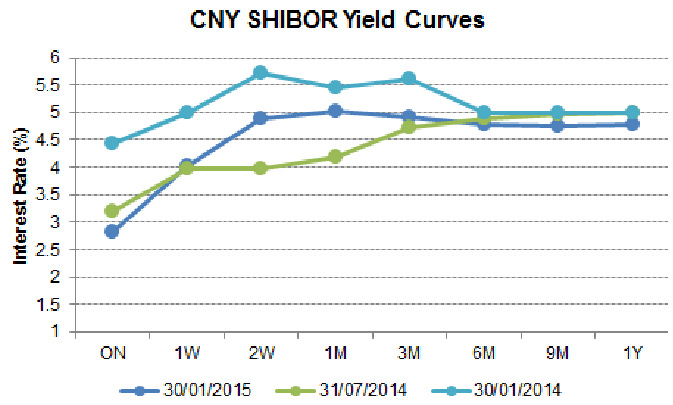
RMB FIC Market Review - STIR and Fixed Income



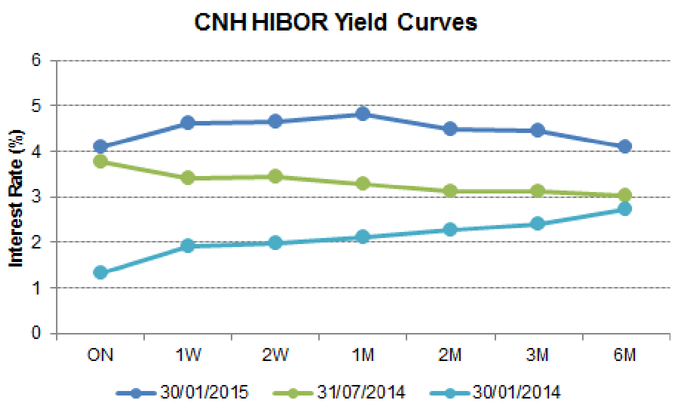
Onshore rates (CNY SHIBOR) remain higher than offshore rates (CNH HIBOR). However, the spread between them was tighter towards the end January 2015.



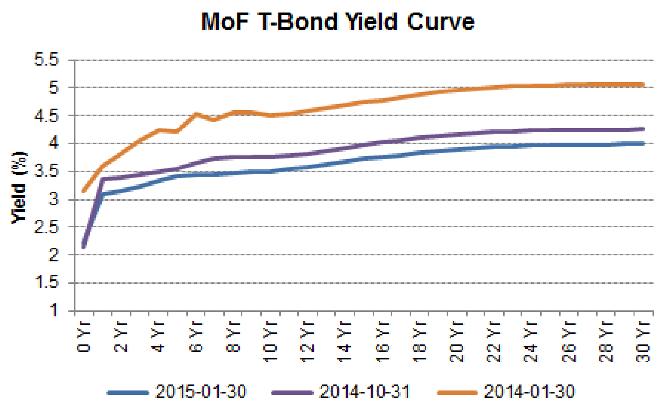
The growth of RMB deposits in Hong Kong has flattened out since early 2014 and a similar trend has been observed in the cross-border trade settlement in Hong Kong.



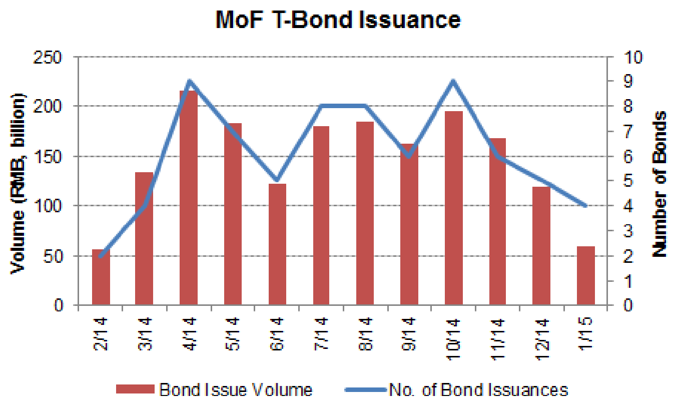
The short end of the CNY SHIBOR yield curve steepened in January 2015 while the long end remained relatively stable.



The CNH HIBOR yield curve was flatter in January 2015 than in January 2014.



The MoF T-Bond yield curve was gradually moving down through 2014. Compared to the long end of the yield curve, the short end dropped more during that period.



The issuance of onshore MoF T-Bonds decreased since October 2014.

Expert Corner

Contributed by Becky Liu, Senior Rates Strategist, Global Research, Standard Chartered Bank (HK) Ltd

Renminbi rates and FX outlook for 2015

2014 was a year of on/offshore interest-rate convergence, marked by accelerating capital account liberalisation in China and a sharp rise in short-dated offshore RMB rates (CNH). The 3Y offshore China Government Bond (CNH CGB) yield rose 80bps and the RMB depreciated 2.5 per cent against the USD, and the market posted its worst annual return since its start, 0.26 per cent. We expect total return to improve materially in 2015 to 4 per cent on higher interest accruals and more robust price performance owing to further policy easing in the domestic market. This is despite the likely continuation of weak FX performance in H1 before a potential recovery in H2.

RMB internationalisation progressed significantly in 2014, and we expect it to accelerate this year. Of a total of 15 offshore RMB clearing banks, 10 were assigned in 2014, and one more was committed at the start of 2015. We expect an additional 10 to be appointed this year, the R-QFII programme to be extended to 5-10 new centres, and more cross-border investment programmes to be launched. CNH assets – including deposits, certificates of deposit (CDs), bonds and loans – are likely to exceed CNY 3tn by year-end.

We also expect a few 'first times' in the offshore RMB market this year. First, we think CNH deposit rates are likely to remain above onshore rates as China's capital account opens up further. The 1Y CNH deposit rate has risen from 2.85 per cent a year ago to 4.0 per cent at present, far surpassing the 1Y RMB term deposit rate in China's domestic market, which the PBOC caps at 3.3 per cent. We expect it to remain higher than onshore comparables in the coming quarters as more cross-border investment programmes are launched and existing ones are expanded. The investment programmes will likely include the launch of a Shenzhen-Hong Kong Stock Connect programme, the expansion of the Shanghai-Hong Kong Stock Connect programme, the start of a mutual-fund recognition programme, the expansion of the cross-border two-way swapping programmes, and the ongoing extension of the R-QFII programme.

Second, we expect primary issuance to see its first year-on-year decline, owing to high CNH funding costs, low G3 currency yields and the improvement in China's onshore bond market. We expect gross issuance at CNY 480-500 billion (vs CNY 564 billion in 2014), including CNY 230-240 billion in Dim Sum bonds, about CNY 200 billion in CDs and CNY 50-60 billion in Formosa bonds. Total market size is likely to reach approximately CNY 900 billion by end-2015 vs CNY 758 billion as of end-2014.

Third, we expect foreigners to own more China onshore bonds than offshore bonds for the first time. Foreign investors owned CNY 672 billion worth of bonds in China's onshore market by end-2014 vs outstanding offshore RMB bonds and CDs of CNY 758 billion. We expect foreigners to boost onshore bond positions by CNY 250-300 billion upon further liberalisation of China's capital account this year and expect net offshore issuance to decline to CNY 140-160 billon. Foreign ownership of China onshore bonds is therefore likely to reach CNY 922-972 billon and exceed the size of the offshore RMB market by end-2015.

In terms of the rates and FX outlook for 2015, we expect the RMB to trade under further pressure in H1 amid a strong USD and heightened geopolitical risk in the euro area. We expect USD-CNH to weaken to 6.29 by H1 before it recovers in H2. We expect CNH rates to rise further in Q1 before they decline in Q2 and end the year lower. Heavy refinancing pressure, the ongoing capital account liquidity drain, and a weaker FX outlook are likely to keep USD-CNH CCS and CNH CD rates elevated in Q1. CNH rates will likely trend lower from Q2 as redemptions become substantially lighter from May onwards and onshore policy easing is likely to filter through.

Becky joined Standard Chartered bank in November 2012 as a senior rates strategist, focusing on China (both on- and offshore) and Hong Kong rates markets.

For more information about the USD/CNH Futures Contract Specifications, please visit: http://www.hkex.com.hk/eng/prod/drprod/rmb/cnhspecs.htm

If you have any question , please contact us at:

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