Inside Fixed Income and Currency (FIC) Monthly Newsletter

Issue No. 4

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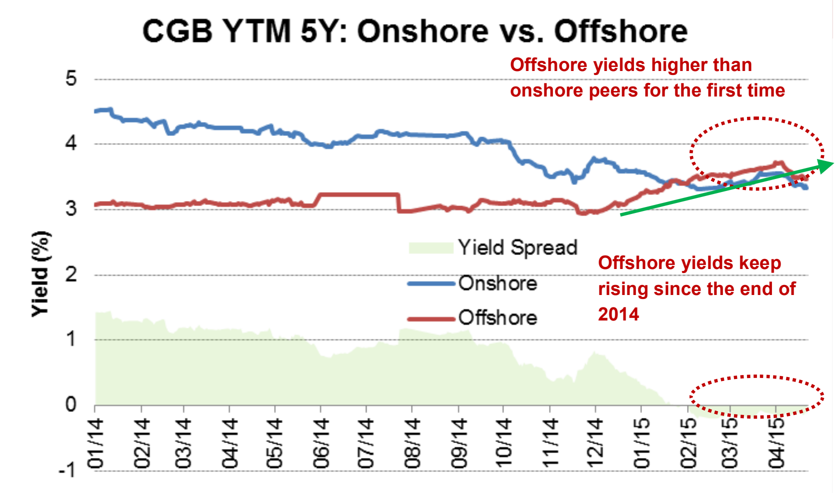
Monthly Highlights

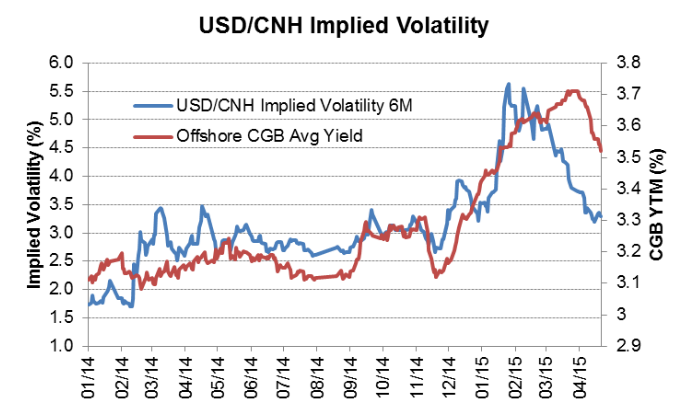
- **USD 1.5 billion in contract value of USD/CNH Futures was traded in April 2015, with an average daily notional value of USD 79 million.**
- **Non Market Makers contributed 68 per cent of contract volume, up from 66 per cent in March 2015.**
- **The average bid-ask spreads of Dec-15 and Mar-16 contracts of USD/CNH Futures tightened further to less than 20pips compared to March 2015.**
- **The trend of narrowing or even reversed yield spreads between offshore and onshore RMB bond markets is expected to continue.**

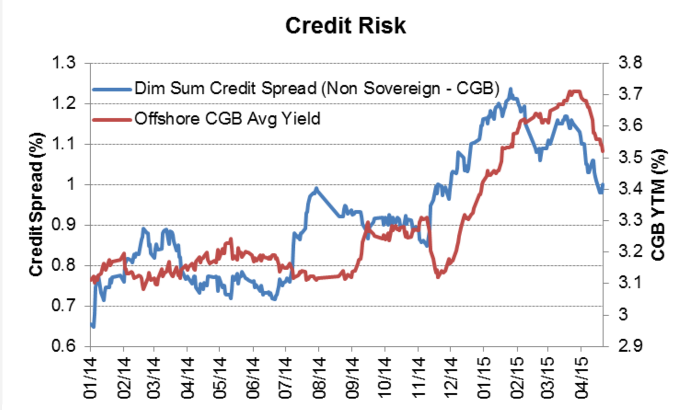
Yield spreads between the offshore and onshore RMB bond markets have decreased over time and even turned negative at the beginning of 2015. The average bond yield of 5y offshore CGBs increased almost 70 bps over the past three months to a record high of 3.72 per cent, while the average bond yield of 5y onshore CGBs fluctuated around 3.55 per cent during the same period. For the first time in history, offshore RMB bond yields have surpassed onshore levels.

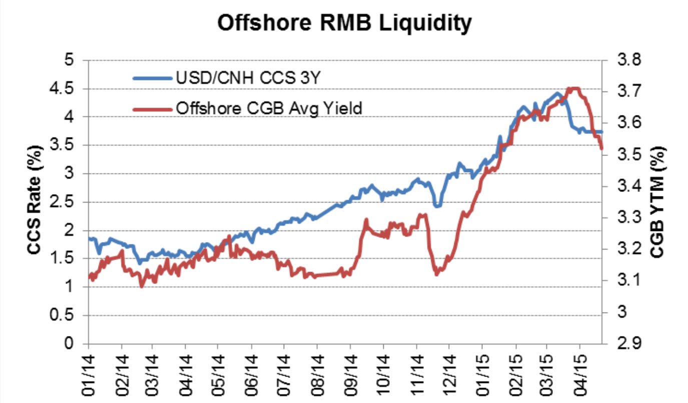


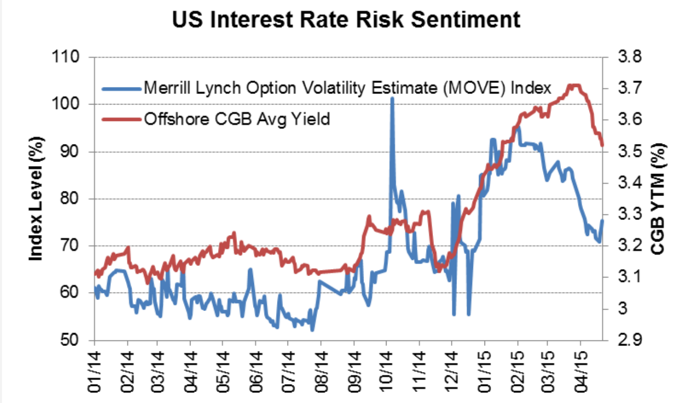
For offshore RMB bonds, the yield level had been relatively stable until last December. The rise in yields since then has been a response to a number of factors, including USD/CNH implied volatility, credit risk perception, offshore RMB liquidity, and US interest rate risk sentiment.

Firstly, in the early days of the offshore RMB bond market, people bought RMB bonds just to gain exposure to the currency; they were not particularly focused on yields. However, as the RMB market becomes more volatile, with two-way direction instead of one-way appreciation, investor appetite for RMB decreases, which in turn weakens bond prices and forces issuers to compensate with higher yields. As shown in the first chart below, along with the pick-up in offshore CGB yield, the USD/CNH implied volatility has spiked since the beginning of 2015. It hit an all time high of 5.5 per cent before dropping back recently to 4 per cent, which is still far beyond its historical range of 2 per cent to 3 per cent.









Secondly, though the dim sum market has yet to see a real default, negative news about the onshore bond market, such as the recent default by computing firm Cloud Live Technology, has kept foreign investors alert to the potential risks Chinese names carry. Issuers now have benchmarks that allow them to price credit risk with greater differentiation and that is helping to hold up yields of the offshore RMB market. As shown in the Credit Risk chart, the credit spread of the Dim Sum bond market has increased substantially, rising from less than 90 bps to more than 110 bps. The chart also shows the spread has moved in line with the offshore CGB yield.

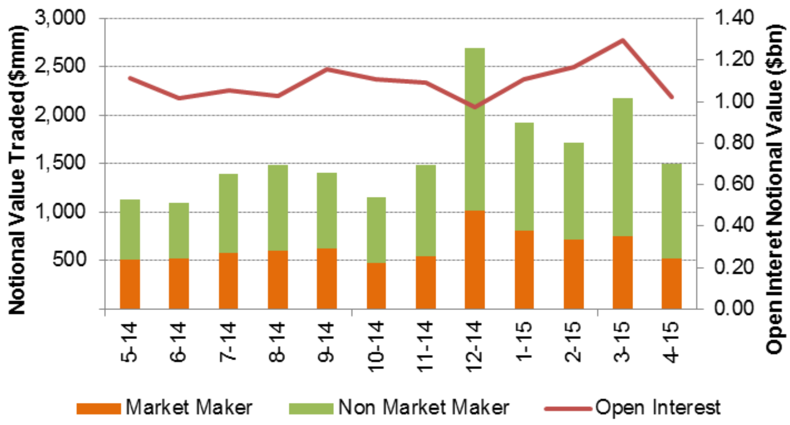
Thirdly, the USD/CNH cross currency swap (CCS) rate that reflects offshore yuan liquidity surged to an all time high in March, with a three-year contract touching 4.43 per cent on 20 March. By and large, as long as liquidity remains tight, the CNH CCS rate is likely remain at the current heightened level. The tightened liquidity condition has been driven by the broader repatriation channels facilitating easier backflow of RMB from offshore to onshore and the sustained market pessimism towards RMB. In order to raise offshore RMB in the current tight liquidity environment, issuers have to offer higher yields to attract investors.

Lastly, the uncertainty regarding the timing of the next Fed rate hike has driven market sentiment towards US interest rate risk volatility to a higher level. The Merrill Lynch Option Volatility Estimate Index has increased to 80 to 90 per cent this year, compared to last year's average level of 60 to 70 per cent. This has been priced into the offshore RMB bond yields and reflects the market's interest rate risk appetite.

In summary, the trend of narrowing or even reversed yield spreads between offshore and onshore RMB bond markets is expected to continue, due to rising offshore RMB bond yields driven by a more volatile RMB FX market, increased credit risk concerns due to events in the onshore market, tighter market liquidity and a heightened sense of interest rate risk.

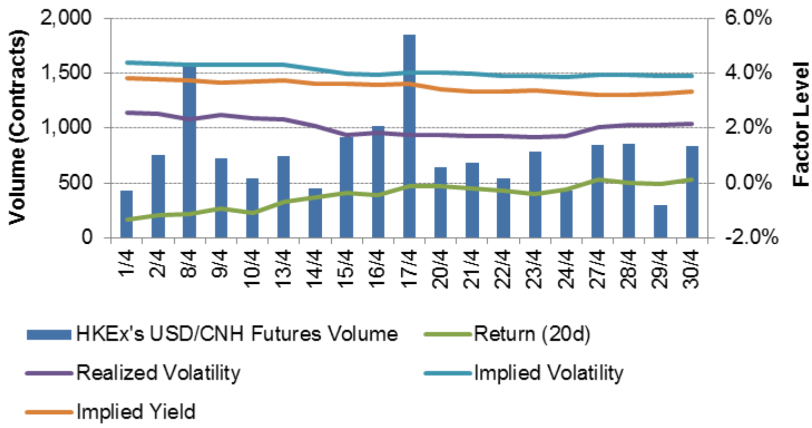
HKEx's USD/CNH Futures Market Statistics

USD/CNH Futures Turnover and OI



- In April 2015, a total of USD1.5 billion in contract value was traded, with an average daily notional value of USD79 million.
- Non Market Makers contributed 68 per cent of contract volume, up from 66 per cent in March 2015.

Key Driving Factors of USD/CNH Futures Volume



The following have been identified as the key driving factors behind the CNH futures volume:

- Cumulative return of USD/CNH,
- Realised volatility (20d),
- Implied volatility (USD/CNH 1Y ATM Implied Volatility from Bloomberg)
- 12 month forward implied yield

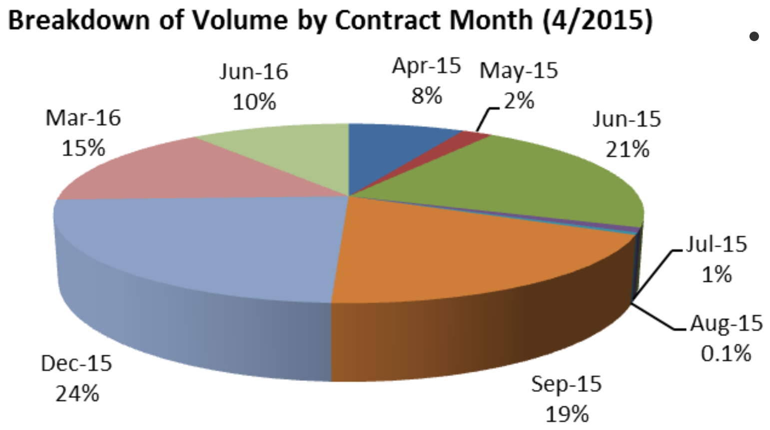
USD/CNH Futures Prices and Average Bid-Ask Spread

Contract Month	30 April Closing	Average Bid/Ask Spread*
Apr-15	-	0.0017
May-15	6.2147	0.0020
Jun-15	6.2301	0.0018
Jul-15	6.2453	0.0025
Aug-15	6.2623	0.0024
Sep-15	6.2757	0.0019
Dec-15	6.3187	0.0018
Mar-16	6.3619	0.0019
Jun-16	6.4017	0.0020

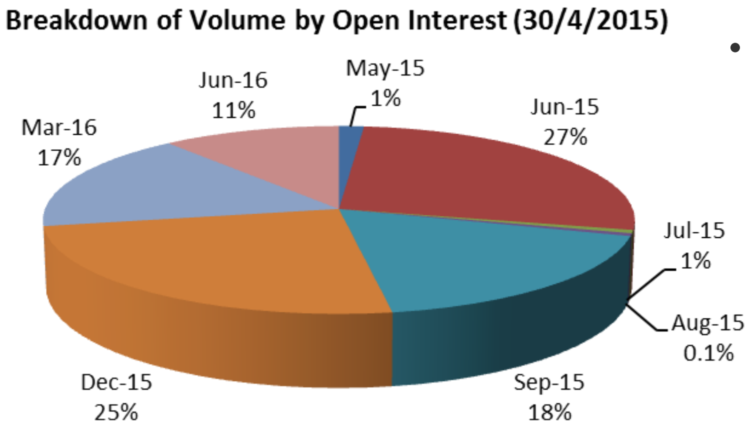
*Average Bid/Ask Spread between 9:30 am and 4:00 pm during the month

- During the day session, the average bid-ask spread of the April 2015 contract was 0.0017.

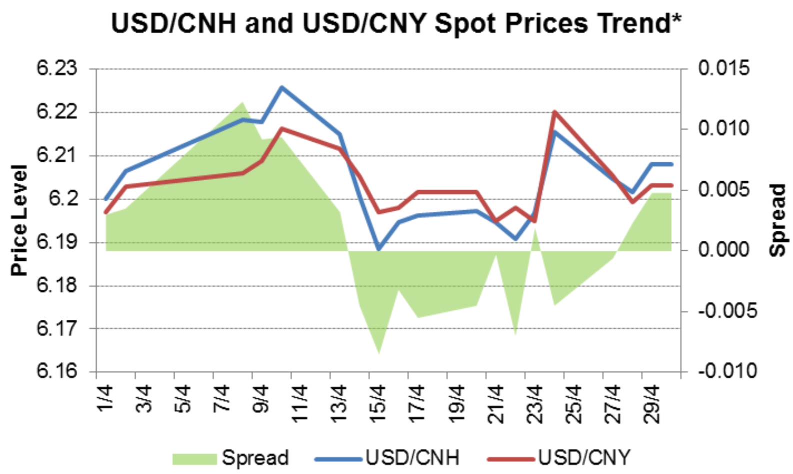
HKEx's USD/CNH Futures Market Statistics



- Trading volume was high in Sep-15, Dec-15 and Mar-16 contracts, which accounted for 58 per cent of total volume at the end of April.

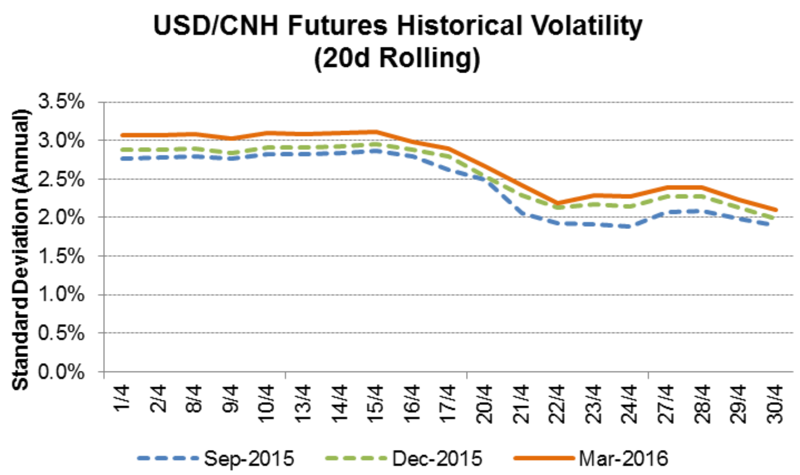


- Open interest was high in the Sep-15, Dec-15 and Mar-16 contracts, which accounted for 60 per cent of total open interest at the end of April.



*Bloomberg closing price

- The spread between the USD/CNH and the USD/CNY narrowed towards the end of April to less than 0.005. The majority of CNH was trading at a discount to the CNY against the USD.



- Volatility in USD/CNH Futures ranged between 1.5 to 3.5 per cent in April 2015.
- The volatility spreads across far month contracts and front month contracts were at par compared to March 2015.

Expert Corner

Contributed by Julien Martin, Head of the RMB Competence Centre at BNP Paribas

Latest RMB Developments for New Products Onshore

Executive Summary

Since 2009, the offshore RMB market has enjoyed a rapid growth with a variety of CNH products introduced, but in market size, offshore products still only represent 1 per cent of their onshore equivalent (CNY loans, bonds and deposits for instance). The Chinese authorities have embarked on a group of essential financial reforms of which the RMB's internationalisation is only the most visible to the offshore community. In a nutshell, the priorities are: repricing of onshore assets, extension of the duration of local government debt, development of onshore buy side to promote pension fund and health system reform, and of course the essential disintermediation of the financing risk following through interest rate mechanism marketization. This article outlines the development in the onshore fixed income market, with a quick focus on local government bonds and asset backed securities.

Latest RMB developments onshore and offshore

Since the start of RMB internationalisation in 2009, the offshore CNH market has developed very fast with different kinds of products available (dim sum bonds and Formosa bonds, etc.). At the end of 2014, RMB deposits in Hong Kong had broken through the RMB1 trillion mark, with dim sum bonds outstanding reaching RMB562 billion. RMB is the seventh most widely used currency for international payments and the second in terms of global trade finance. A variety of schemes have been introduced to further liberalise the access to onshore CNY equity and bond markets, including RQFII and Shanghai-Hong Kong Stock Connect. Overall, quotas available have expanded fivefold in the last five 5 years and now exceed RMB1.5 trillion. We expect more channels will be open to foreign investors like Bond Connect, a Shenzhen-Hong Kong stock link and mutual fund recognition. Moreover, almost 60 central banks and sovereign wealth funds are using RMB for their global investments. RMB-traded stocks (A shares) are going to be included in global indices from MSCI and FTSE, and the currency will probably be part of Special Drawing Rights, or SDRs, in the coming years, which will pave the way for RMB to become a world's reserve currency.

Despite the strong momentum that the CNH market has seen, offshore RMB products are still equal to only 1 per cent of onshore products. At the end of 2014, the RMB bonds outstanding in the onshore market stood at a CNY35 trillion, of which 92.6 per cent was traded in the China Interbank Bond Market (CIBM). The onshore bond market is the third largest bond market in the world, with average annual growth of 23 per cent over the last 10 years. This giant is nevertheless still a freshman when it comes to product complexity and innovation. As an example, local government bonds and asset backed securities are just being introduced and starting to catch the attention of both onshore and offshore investors!

New products that fit into a greater scheme of strategy

Before the introduction of local government bonds, most local infrastructure investments were financed through the Ministry of Finance, bank loans and shadow financing. The latter two are carrying major systemic risks: inadequate duration of the borrowing (less than 2 years) compared to the project duration (usually more than 15 years), heavy reliance on bank intermediation, high cost of funds, doubtful credit pricing and questionable state guarantees. In the grand scheme of its financial reforms, China needs to provide a better mechanism for onshore credit by allowing defaults while at the same time fostering bank disintermediation and the build-up of a more active buy-side industry. Moreover, through a transparent and regulated delivery system, issuance of local government debt will be better accounted for and will thus eventually replace complex local government financing vehicle, or LGFV, financing. These assets will also be investible by the newly (re)formed pension, social security and health protection systems. To further promote disintermediation and risk transfer, asset backed securities are being introduced, allowing banks to share financing risk with a larger community than before. Banks in China provide 80 per cent of all financing and hold two-thirds of onshore bond investments in the CIBM. This is not a long lasting solution.

Recent developments on local government bonds

In early March 2015, the Ministry of Finance announced that local governments could issue new municipal or provincial bonds to replace RMB1 trillion of maturing, high-interest local debt. The bonds will cover 53.8 per cent of direct local government liability, the total amount will be RMB1.86 trillion and the debt instruments will mature in 2015. In mid-March 2015, the Ministry of Finance released rules on the issuance of general local government bonds for public projects that won't generate revenue and will be repaid by the local fiscal revenue. Public projects that are expected to generate revenue will be funded by special local government bonds, with more rules to follow soon. The local government bond issuance will reach to RMB1.77 trillion in 2015, including RMB 500 billion of general local government bonds and RMB100 billion of specific local government bonds.

Recent development on asset backed securities

In November 2014, the CBRC and CSRC released simplified rules on asset backed securities (ABS) issuance. The ABS listed and traded on an exchange just have to file with the regulators after the issuance instead of going through the approval process required previously. In addition, according to the PBoC's new regulation released in early April 2015, ABS issuance in the CIBM only requires registration with the PBoC. The central bank's approval is not required. Due to the simplified process, we expect the ABS market will boom in 2015, with total issuance approaching approximately RMB600 billion.

Expert Corner

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Latest RMB Development for New Products Onshore

This is just a beginning, as the municipal and ABS markets still only represent less than 1 per cent of China's GDP, compared with 34 per cent in the US! Watch this space.

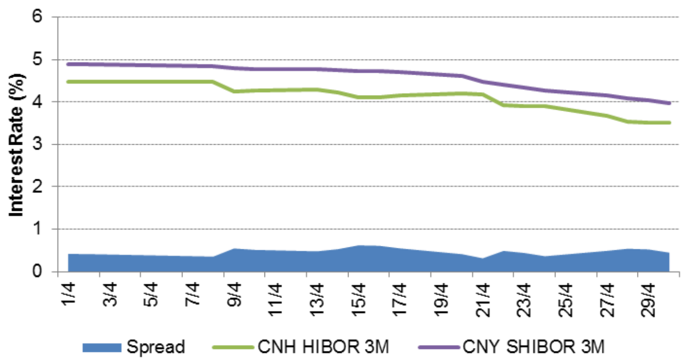
Disclaimer: This content is for general information purposes only and should not be used as a substitute for consultation with professional advisors.

Julien Martin is Head of the RMB Competence Centre at BNP Paribas. Based in Hong Kong, he plays a key role in the Group's worldwide platform to follow customers' needs in China and in the rest of the world for the fast-growing RMB transactions. Julien has more than 15 years' experience with BNP Paribas and is an Asian financial market and fixed income expert.

After graduating from ESSEC MBA in Paris, Julien joined BNP Paribas in London in 1999, running strategic development and working in emerging market business. He was relocated to Hong Kong in 2006 as regional front office Chief Operating Officer, Fixed Income Asia Pacific. Since 2009, Julien has taken up another role to overlook the development of the China trading, marketing and research teams in Shanghai, Beijing and Guangzhou with a focus on local currency capacity build up. He has also been tasked with building up BNP Paribas's client and product capacity around the RMB space from corporate banking to markets and investment solutions.

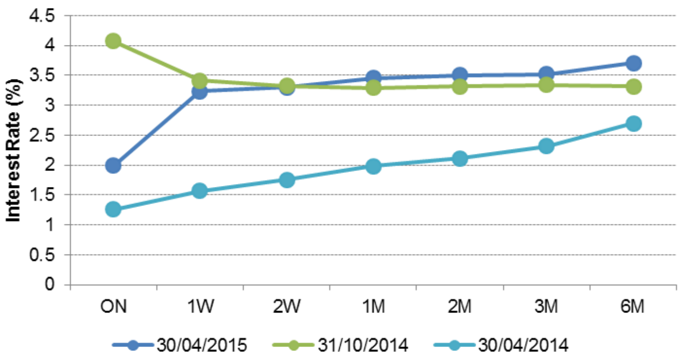
RMB FIC Market Review - Short-Term Interest Rates and Fixed Income

CNY SHIBOR vs. CNH HIBOR



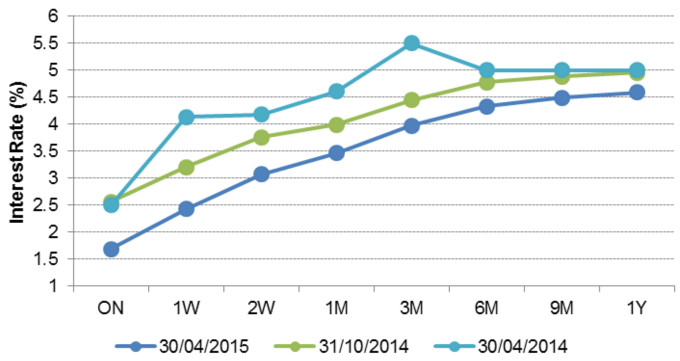
Onshore rates (CNY SHIBOR) remain higher than offshore rates (CNH HIBOR). However, the spread between them was at par towards the end of April 2015.

CNH HIBOR Yield Curves



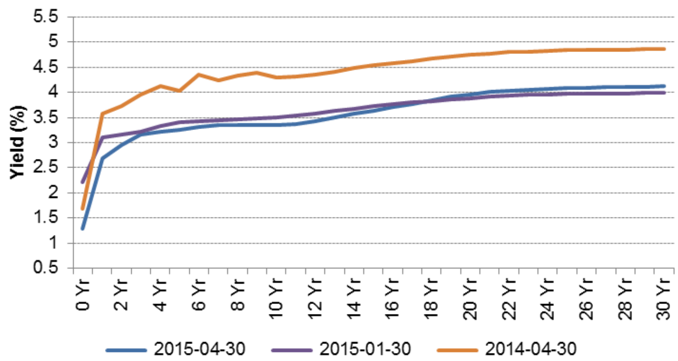
The CNH HIBOR yield curve was flatter in April 2015 than in April 2014.

CNY SHIBOR Yield Curves



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

MoF T-Bond Yield Curve



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

RMB FIC Conference 2015

11 June 2015 (Thursday), 9:00am – 4:30pm

JW Marriott Hotel Ballroom, Hong Kong

HKEx's 2nd Annual RMB FIC Conference will be held in Hong Kong on 11 June 2015. This forum provides a unique platform for senior executives from banks, product providers and institutional investors to explore regulatory and business issues relating to RMB FIC market with international and Mainland market participants. Visit www.hkexgroup.com/eng/events/ficconference for more details.

Kindly note that capacity is limited and registration is subject to final confirmation. HKEx reserves the right to limit attendance on a first-come-first-served basis.

For more information, please email us at FICDevents@hkex.com.hk.

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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