Inside Fixed Income and Currency (FIC) Monthly Newsletter

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Monthly Highlights

- **The rally of Dim Sum bonds is likely to continue, due to the easing of tight liquidity, reduced CNH volatility, strong demands for dim sum bonds, and the continuous fund inflows under the stock connect scheme.**
- **Hong Kong Exchanges and Clearing Limited (HKEx) has hosted the second annual renminbi (RMB) fixed income and currency (FIC) conference on 11 June 2015 in Hong Kong.**
- **USD 914 million in contract value of USD/CNH Futures was traded in June 2015, with an average daily notional value of USD 42 million.**

The Dim Sum bond market rallied strongly in Q2, thanks to further monetary loosening in China and easing of tight liquidity that has lasted for months.

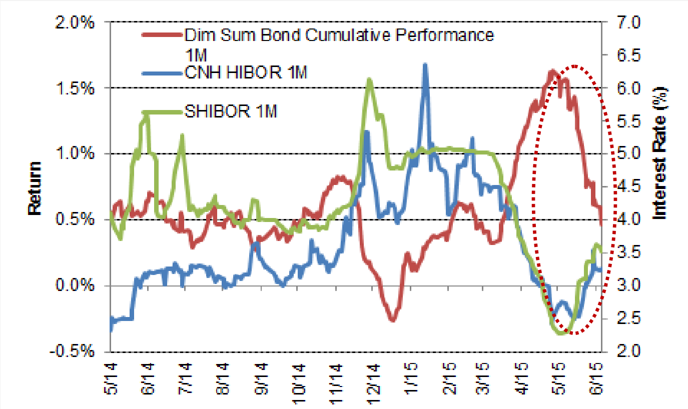
The historical performance and relative value of the Dim Sum market is highly compelling at the moment. To put this in perspective, Dim Sum bonds outperformed US corporates and Euro corporates in the last 12 months with significantly lower volatility. US corporate bonds come at a yield of 3.1 per cent and a duration of 6.9 years, while Euro corporates have a 1.2 per cent yield and a duration of 5.1 years. Dim Sum bonds now yield 4.3 per cent for a duration of just 2.1 years.

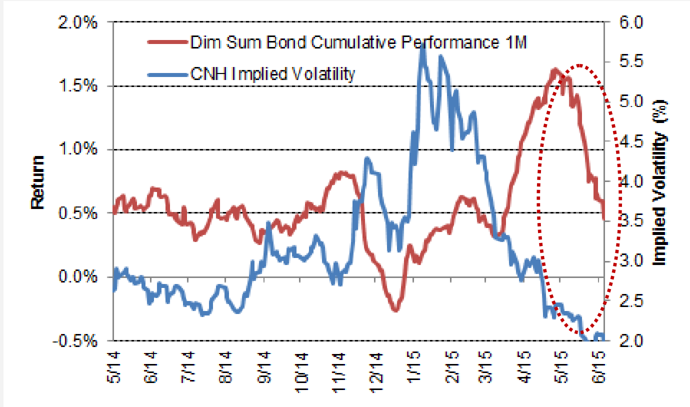
The high yields and low duration of the Dim Sum bond market also make it very resilient. A sharp rise in US and Euro yields is unlikely to seriously damage returns from this market.

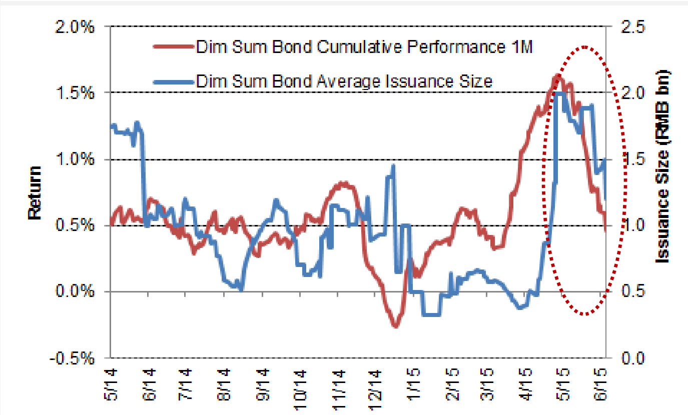
Statistics **As of 30 Jun 2015**	**Dim Sum Bonds**	**US Corporate Bonds**	**Euro Corporate Bonds**
Return (12m)	7.0%	1.0%	1.8%
Standard Deviation (12m)	0.7%	4.2%	1.9%
Yield to Maturity	4.3%	3.4%	1.5%
Duration	2.3	6.9	5.2
Correlation (12m)		-0.01	-0.09

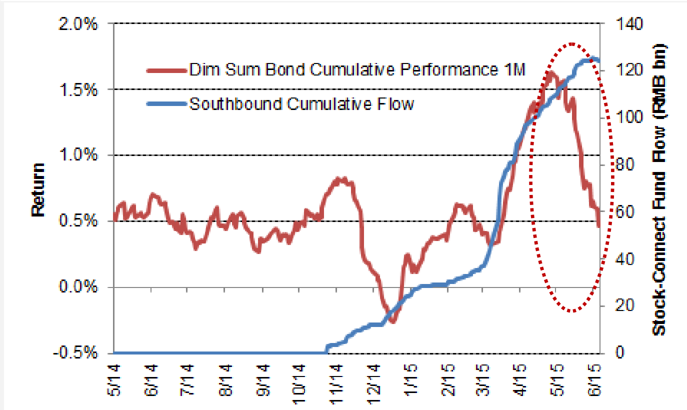
The Dim Sum bonds' outperformance has been a response to a number of driving factors, including offshore RMB liquidity, USD/CNH implied volatility, average issuance size and southbound flows in the Stock Connect scheme.

Firstly, the People's Bank of China (PBoC) has cut interest rates three times since November 2014, and the central bank trimmed its reserve requirement ratio (RRR) in February and April. These actions have helped inject more money into the economy and relieved tight liquidity both in China's domestic market and the offshore RMB market. The interbank lending rate in Hong Kong's









RMB market and the onshore Shanghai Interbank Offered Rate slipped to their lowest levels in seven months in June.

Secondly, since mid-March, the currency has strengthened and remains relatively robust on reduced speculation of further depreciation, supporting overall bond market sentiment. The implied volatility of USD/CNH options has dropped to its lowest level (less than 2.5 per cent) in a year. As the RMB became less volatile in Q2, Investor appetite for the currency rebounded, which in turn, strengthened bond prices and made investors more willing to accept lower yields due to lower level of currency risk.

Thirdly, confidence in Dim Sum bonds has rebounded and the primary market for the bonds has recovered from Q1, as shown in the record high average issuance size in recent months. The average issuance size for Dim Sum bonds has risen to RMB2 billion.

Lastly, the Dim Sum bond market is seeing strong support from continuing fund inflows under the Stock Connect scheme. Increased Southbound flows have pushed the average funding cost down and that bodes well for the issuance pipeline in the coming months. Stock Connect brought in a net of more than RMB60 billion into Hong Kong in the last two months, thanks to increased demand for Hong Kong stocks from Mainland investors.

In summary, the rally of Dim Sum bonds is likely to continue, due to the easing of tight liquidity in the offshore RMB market, reduced implied volatility and elevated market sentiment, continued strong demand, the recovery of the primary market, and continuing fund inflows under the Stock Connect scheme.

HKEx's RMB FIC Conference

HKEx hosted its second annual renminbi (RMB) fixed income and currency (FIC) conference on 11 June 2015 in Hong Kong.

This year's event coincided with HKEx's ongoing efforts to build on the momentum of Shanghai-Hong Kong Stock Connect, its ground-breaking mutual market access programme with Mainland China.

The 2015 conference hosted more than 500 delegates, with senior representation from the industry, and included more than 40 notable speakers who explored issues related to the exciting fixed income and trading developments in connection with the RMB.

The event featured opening remarks by HKEx Chief Executive Charles Li on RMB internationalisation leveraging on mutual market access. There were also speeches from senior representatives of four major organisations and a series of panel discussions with industry experts.

There were two morning panels. One discussed new developments in RMB fixed income and interest rates. The other panel looked at whether the world is ready for the RMB as a capital market currency. The afternoon panels had two streams. The China-focused stream examined topics related to the Mainland FIC market, and there was an international stream on how lessons from international markets can be applied to RMB FIC development.

The topics covered during the conference included:

- The Future Development of China's FIC Markets;
- The Rise of New FIC Trading Platforms and their Implications for the Market;
- How International Investors should look at RMB FIC Benchmarks; and
- Recent Developments in China Credit Market – Distress, Defaults and Development

RMB FIC represents a tremendous opportunity for HKEx and its market participants in the era of mutual market access and RMB internationalisation. HKEx has already developed a variety of RMB products, and it plans to do a lot more as China continues to internationalise its capital market.

HKEx looks forward to hearing and exchanging views with market practitioners in the second half of the year. It is also looking forward to next year's RMB FIC conference.

Source: HKEx, Bloomberg, WIND, BOCOM

For more information, please email FICD@hkex.com.hk

Expert Corner

Contributed by Patrick Ho, Economist and Strategist (Global Markets) at Bank of Communications Hong Kong Branch

Local Government Debt Swap Deals

With the first batch of local government debt swap deals announced in March still in process, the Ministry of Finance (MoF) of China announced the amount of second batch of debt swap deals. Each round accounts for RMB1 trillion, which means a total of RMB2 trillion has been channelled into the deals.

The debt swap deals are an important vehicle for the implementation of a proactive fiscal policy. In recent years, the dysfunction of local financing platforms and the resulting financing pressure on local governments made them an Achilles heel in the transmission mechanism of the nationwide stabilisation policy. With the debt swap deals, local governments will be able to replace their existing high-yield short-term (under 5 years) debt with low-yield long-term (7-10 years) debt, cut their interest payments and extend the maturity of their debt. As a result, the deals strengthen the fiscal support to local infrastructure development and economic growth. They may also be viewed as a balance between debt and growth stability.

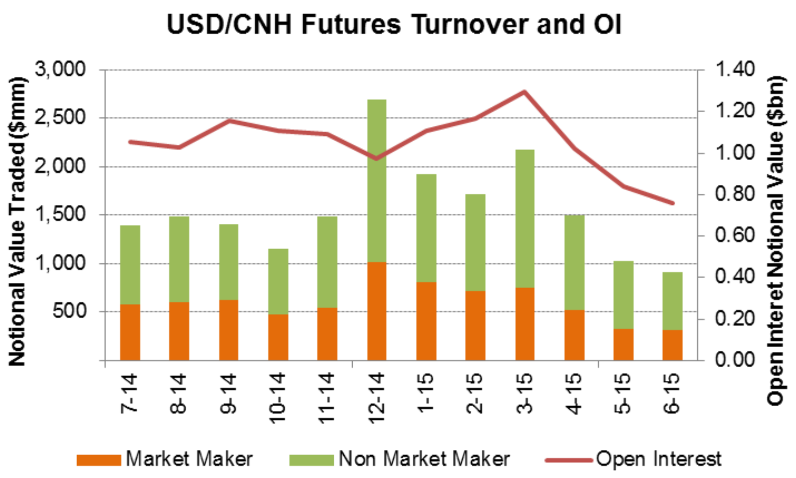
Replacing the high-yield short-term debt with low-yield long-term debt may be viewed as a sort of Operation Twist (OT) implemented by the US Federal Reserve in 2011 and 2012. It was aimed at extending the average maturity of debt and putting downward pressure on longer-term interest rates, in turn providing additional support for the economic recovery.

The second round of debt swap deals requires the proceeds received to be used to repay the audited debt as of 30 June 2013 and due in 2015. The year ended June 30, 2013 witnessed an uptrend of yield towards the peak in recent decades, while the debt issued in this period bore a higher cost overall. MOF also stated that the high-yield debt is first to be swapped, and the proceeds cannot be used to repay the interest. All these measures are designed to lessen the interest burden arising from the high-yield short-term debt on one hand, and bring down the long-end of the curve on the other hand, which has similar effects to OT.

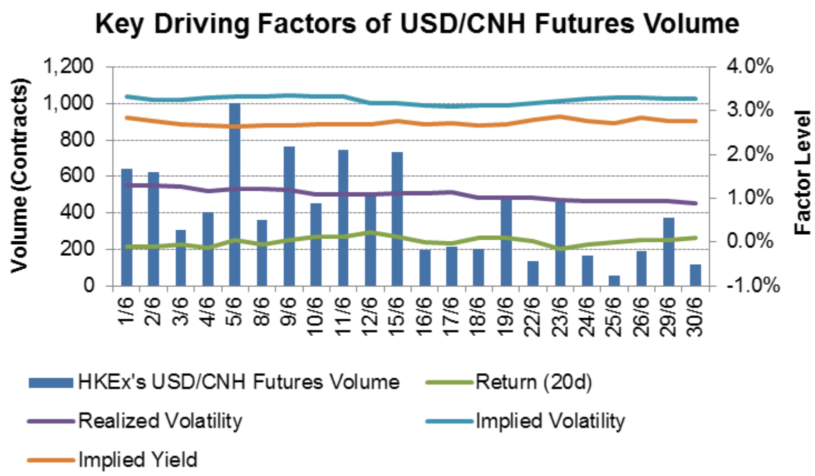
With the debt swap deals and other liquidity operations carried out by the PBoC such as extending the Pledged Supplementary Lending (PSL), at lower rates, it is reasonable to expect the long-end will be traded at a lower range in the coming quarters.

Patrick Ho joined Bank of Communications Hong Kong Branch in 2011 as Economist and Strategist (Global Markets), focusing on global macro, China policy and cross assets research

HKEx's USD/CNH Futures Market Statistics



- In June 2015, a total of USD 914 million in contract value was traded, with an average daily notional value of USD42 million.
- Non Market Makers contributed 65 per cent of contract volume, decreased from 68 per cent in May 2015



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 1Y ATM Implied Volatility from Bloomberg)
- 12 month forward implied yield

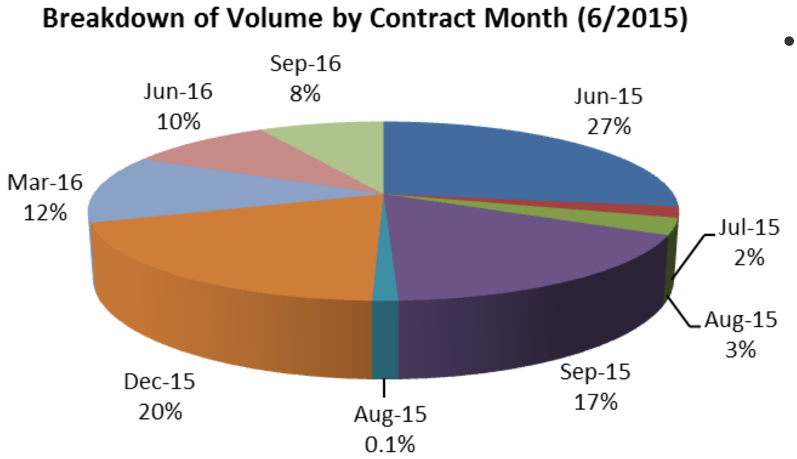
USD/CNH Futures Prices and Average Bid-Ask Spread

Contract Month	30 June Closing	Average Bid/Ask Spread*
Jun-15	-	0.0013
Jul-15	6.2125	0.0021
Aug-15	6.2272	0.0023
Sep-15	6.2389	0.0016
Oct-15	6.2534	0.0019
Dec-15	6.2754	0.0019
Mar-16	6.3093	0.0019
Jun-16	6.3403	0.0019
Sep-16	6.3720	0.0023

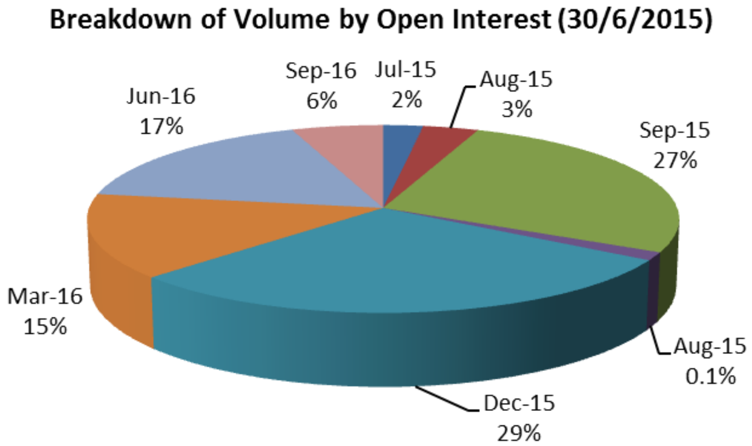
*Average Bid/Ask Spread between 9:30 am and 4:00 pm during the month

- During the day session, the average bid-ask spread of the June 2015 contract was 0.0013.

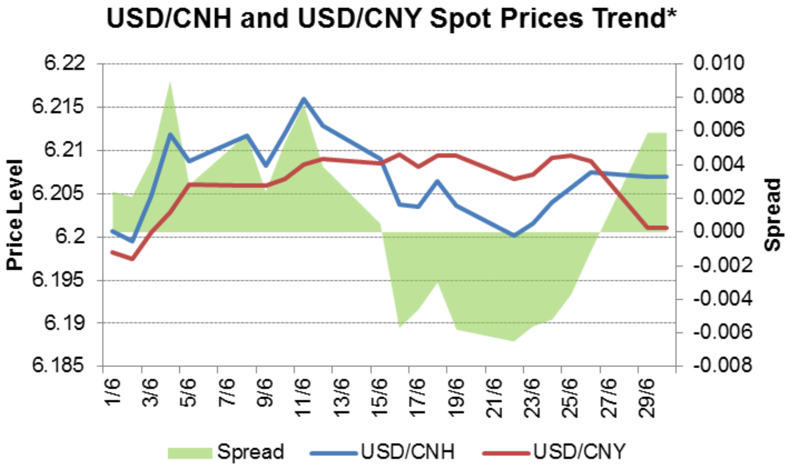
HKEx's USD/CNH Futures Market Statistics



- Trading volume was highest in the June 2015 contract and subsequent quarter-month contracts.

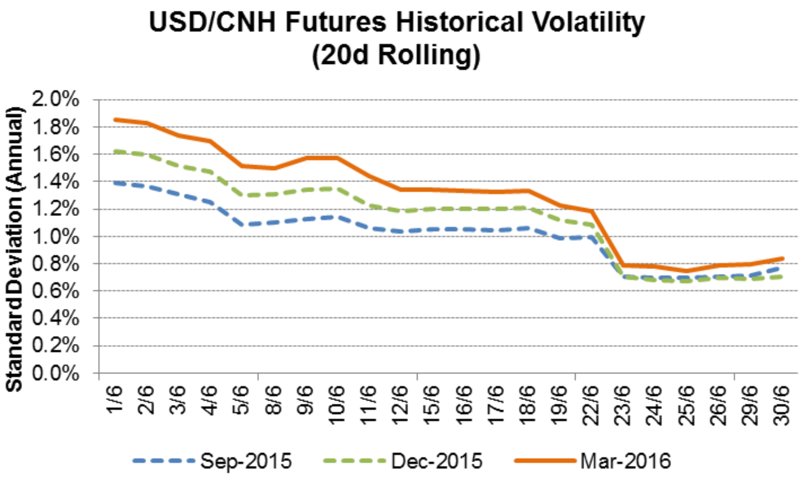


- Open interest was high in the September 2015 and December 2015 contracts, which accounted for 56 cent of total open interest at the end of June.



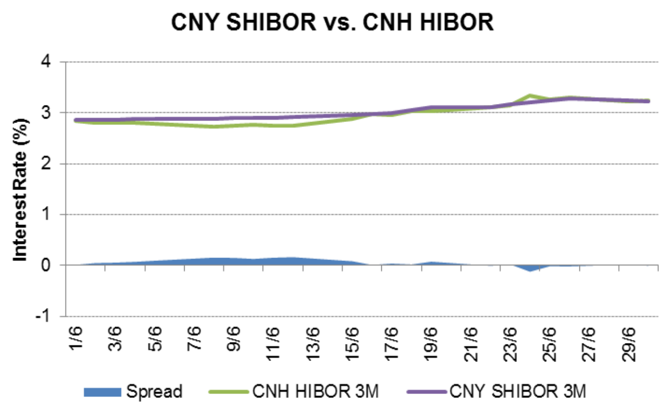
*Bloomberg closing price

- The spread between the USD/CNH and the USD/CNY widened towards the end of June to around 0.006. The CNH was trading at a discount to the CNY against the USD.

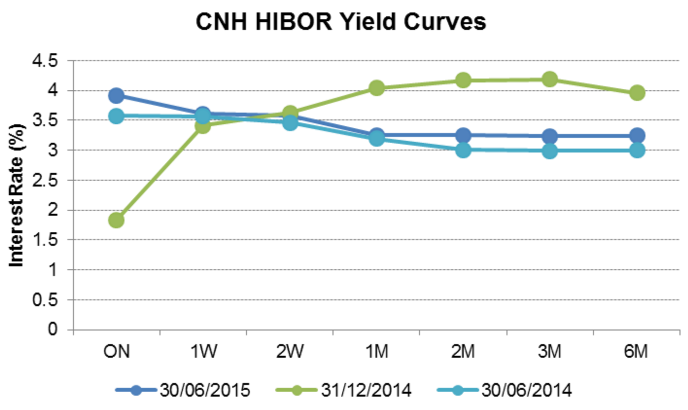


- Volatility in USD/CNH Futures ranged between 0.8 to 1.8 per cent in June 2015.
- The volatility spreads across far month contracts and front month contracts narrowed towards the end of June 2015.

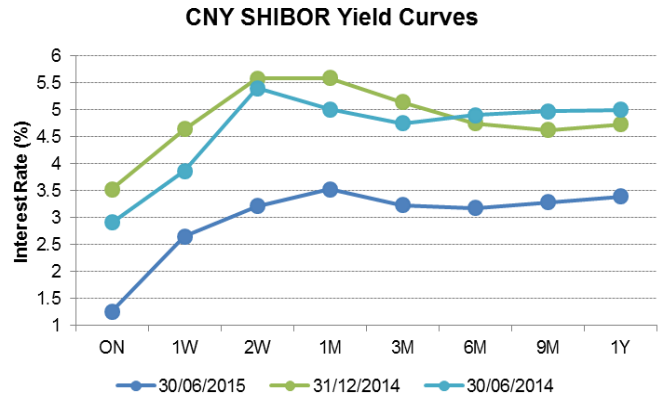
RMB FIC Market Review - Short-Term Interest Rates and Fixed Income



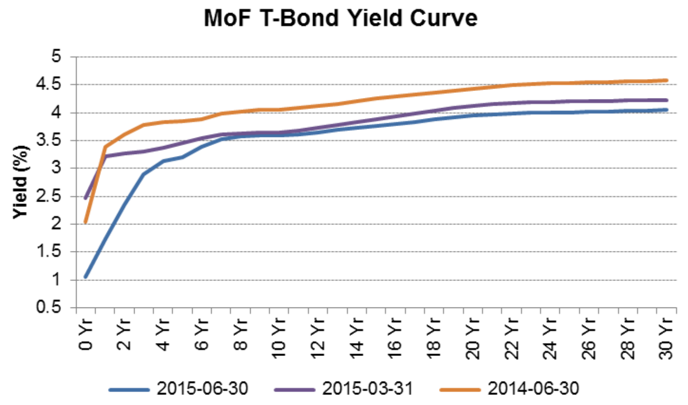
Onshore rates (CNY SHIBOR) is similar to offshore rates (CNH HIBOR) and the spread between them was narrowed throughout the month.



The CNH HIBOR yield curve in June 2015 steepened in the short end and relatively remained stable in the long end, a comparable shape as the yield curve in June 2014.



The CNY SHIBOR yield curve in June 2015 steepened in the short end and sloped gradually upwards towards the long end.



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.

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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