HKEx
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Inside Fixed Income and Currency (FIC) Monthly Newsletter

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Monthly Highlights

- **HKEx's Chief China Economist, Dr Ba sees no huge hindrances to the RMB's inclusion in the International Monetary Fund's Special Drawing Rights, or SDRs**
- **Chinese GDP growth slows further in Q3 and National Bureau of Statistics cuts its 2015 growth forecast to 7.3 per cent from 7.4 per cent**
- **China plans to open its currency market to foreign central banks, making it easier for other nations to hold RMB**
- **President Xi Jinping says China will continue to adhere to its reform in letting the market's supply and demand forces determine the RMB's exchange rate**
- **HKEx has been recognised by Asian Banker as the "Best Exchange for Offshore RMB FX Future" for 2015**
- **USD/CNH futures' open interest at HKEx rose to 15,645 contracts (US$1.56 billion notional) at the end of September 2015, the highest in 19 months**
- **Interview with Liu Fan of China Central Depository & Clearing: Chinabond's yield curves are becoming increasingly important for commercial banks**

From the Chief Economist's Vantage Point

Going forward, HKEx's Chief China Economist, Dr Ba Shusong, will share his thoughts and insights on the recent macroeconomic developments related to RMB FIC markets.

HKEx's Chief China Economist, Dr Ba Shusong, doesn't expect any huge hindrances to the RMB's eventual inclusion in the International Monetary Fund's (IMF) Special Drawing Rights, or SDRs. The following are some of his other views on the subject.

After the RMB's inclusion in the IMF's SDRs, 188 of the world's economies will automatically increase their RMB reserves, and each central bank with RMB-denominated holdings will strengthen its research of the RMB's characteristics and the products associated with the currency. The initial increase in the size of RMB-denominated assets is expected to be limited, but it will grow significantly in the future. Hong Kong should enhance the level of its professional services and seize the related business opportunities. They will include providing in-depth research on the RMB, providing investable RMB-denominated financial products for central banks, and providing investment and clearing infrastructure facilities for central banks. With the opening of the global clearing system for RMB, Hong Kong should expect a significant reduction in the market's reliance on RMB clearing services because it will no longer have the unique clearing bank status it currently enjoys. Its other advantages in attracting offshore RMB may be reduced as well. Hence there will come a real test of Hong Kong's capacity in providing professional financial services to maintain its role as the largest offshore RMB centre.

Dr Ba's views on outflows from China's foreign reserves and China's recent revaluation of the RMB

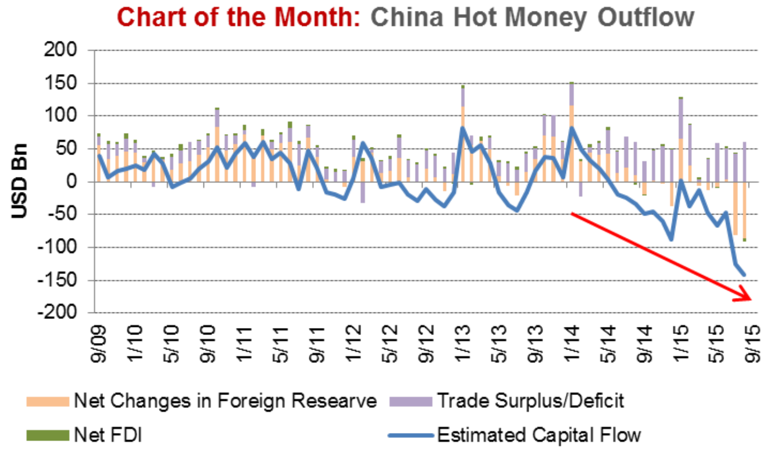
Dr Ba sees the outflows as the evolution of China's foreign reserves as ownership is transferred from the state to businesses and residents, and the market's need to adapt to the new exchange rate regime after the Aug 11 exchange rate reform. At present, there are no significant capital flows.

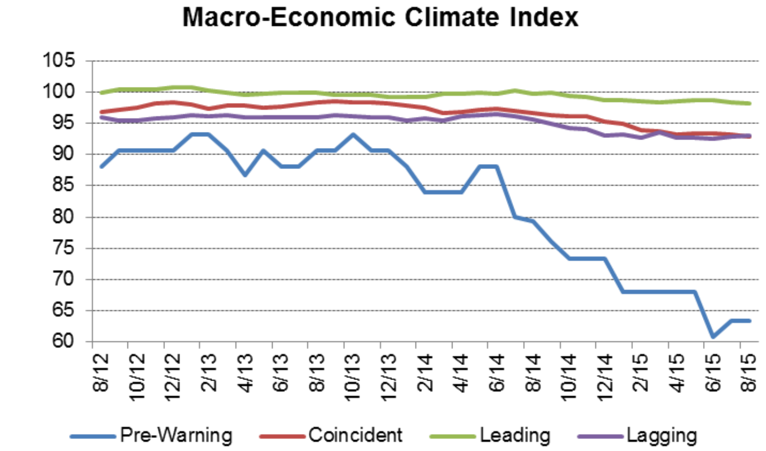
Dr Ba believes last month's RMB devaluation was to meet the need for changes to support the RMB's inclusion in the IMF's SDRs, with emphasis on eliminating the gap between the PBoC's RMB mid-price and the market closing price, and narrowing the gap between onshore and offshore RMB FX rates. He sees that when the short-term market fluctuations gradually stabilises, the fluctuations of RMB FX rate are expected to increase in the future. The implementation of RMB internationalisation can only be sustainable if RMB FX rates are on the basis of two-way fluctuations, in Dr Ba's view.

Dr Ba Shusong is the Chief China Economist of Hong Kong Exchanges and Clearing Limited (HKEx). He is also the chief economist of the China Banking Association, a member of the HKSAR Government's Economic Development Commission, a deputy secretary general of China Society of Macroeconomics, a member of MOFCOM's Advisory Committee on Economic and Trade Policy, a member of CBRC's expert guidance committee for the banking industry to implement the new Basel capital accord, a member of CSRC's M&A Specialists Committee, and a member of China's "13th Five-Year Plan" National Development and Planning Specialists Committee. Dr Ba is a fellow of experts who receive the State Council Special Allowance. He was previously a deputy general manager of the Bank of China in Hangzhou, an assistant general manager of Bank of China (Hong Kong), director-general of the strategy and development committee of the Securities Association of China, and a deputy director general of the Financial Research Institute of the State Council's Development Research Centre. He has done post-doctoral research in the China Centre for Economic Research at Peking University and been a senior visiting scholar at Columbia Business School in the US.

Dr. Ba has published several academic articles and books on the new Basel capital accord and China's economic and financial development. He received the Global Youth Leader award from the World Economic Forum in 2009.

China Macro Update





China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	7	7	⇨	10/19/2015 10:00
CPI (yoy %)	2	1.6	⇧	10/14/2015 09:30
PPI (yoy %)	-5.9	-5.4	⇩	10/14/2015 09:30
Industrial Production (yoy %)	6.1	6	⇧	10/19/2015 10:00
FAI (yoy %)	10.9	11.2	⇩	10/19/2015 10:00
Foreign Investment (yoy %)	22	5.2	⇧	10/08/2015 10/12
CFLP Manufacturing PMI	49.8	49.7	⇧	11/01/2015 09:00
PBOC Bankers Confidence Index	40.6	43.4	⇩	TBC
PBOC Bankers Loan Demand Index	56.7	60.4	⇩	TBC
CEMAC Leading Economic Index	98.23	98.4	⇩	10/28/2015 10/31
Exports (yoy %)	-5.5	-8.3	⇧	10/13/2015
Imports (yoy %)	-13.8	-8.1	⇩	10/13/2015
M2 Money Supply (yoy %)	13.3	13.3	⇨	10/10/2015 10/15
Retail Sales (yoy %)	10.8	10.5	⇧	10/19/2015 10:00
Consumer Confidence Index	118.2	116.5	⇧	10/28/2015 09:45
Regulated Reserve Ratio (%)	18	18.5	⇩	Infrequent
Official Foreign Exchange Reserves (USD bn)	3557.4	3651.31	⇩	10/07/2015
Three-Month SHIBOR (%)	3.15	3.09	⇧	Continuous
10-Year Gov't Bond Yield (%)	3.27	3.59	⇩	Continuous
CNY/USD Exchange Rate	6.3613	6.3969	⇩	Continuous

Regulatory/Policy Developments

- China Q2 balance of payments data may signal accelerated capital flight with net hot money outflows. In a sign of growing concern over capital outflows, the People's Bank of China (PBoC) introduced new measures aimed at keeping more money in the country, including injecting liquidity into the financial system to keep borrowing costs low, clamping down on illegal movement of cash outside of China, dipping into its foreign exchange reserves and using dollars to buy RMB in order to keep the exchange rate from weakening further.
- China plans to allow foreign central banks to participate in its foreign exchange market, Premier Li Keqiang said on Sept 10 in his keynote speech at the World Economic Forum in Dalian.
- President Xi Jinping stressed in Seattle on Sept 23 that China opposes competitive currency devaluation, is against currency wars, will not devaluate the RMB in a bid to stimulate exports and will continue to adhere to its reform in letting the market's supply and demand forces determine the RMB's exchange rate, and allowing two-way fluctuations in the RMB.

Macro Economy Update

- The National Bureau of Statistics announced on Sept 6 that it had revised its economic growth forecast. It now expects China's GDP to rise by 7.3 per cent this year instead of 7.4 per cent.
- China's imports fell 13.8 per cent in August from a year earlier, reflecting both lower world commodity prices and persistently sluggish demand at home. The decline was more than the 8.2 per cent economists had expected and well about the 8.1 per cent drop in July.

Market/Product Developments

- To help meet the requirements for the RMB's inclusion in the IMF's SDRs, the PBoC has focused on eliminating the gap between the currency's mid-price and close price, and narrowing the gap between the offshore and onshore RMB FX rates. To achieve that, the central bank has made some policy changes. They include relaxing curbs on the two-way cross-border RMB pool business, which led to the most significant jump of the CNH in four weeks on Sept 11 and contributed to the narrowing of the differences between the offshore and onshore RMB FX rates.

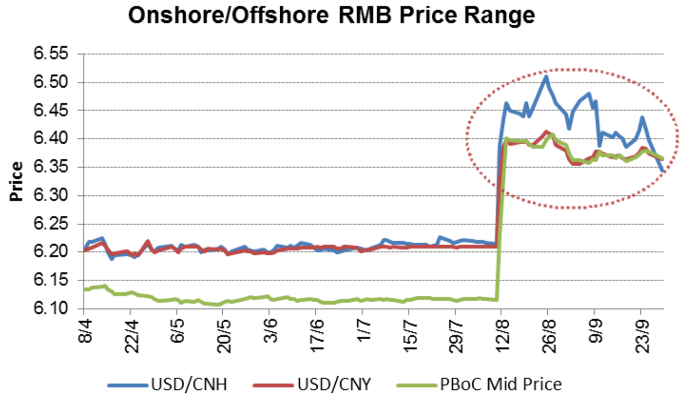
Key Research Reports/Conferences

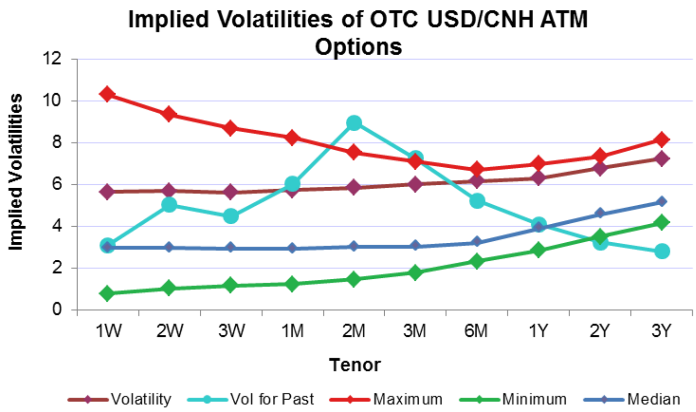
- Dagong Global Credit Rating (HK) sees the lack of confidence in the RMB will hurt demand for offshore RMB bonds and decrease CNH liquidity. On the other hand, the ability to issue CNH bonds at a lower yield will be credit positive for some Chinese issuers and, when RMB stabilizes next year, CNH bond yield is expected to gradually converge with CNY bond yields.

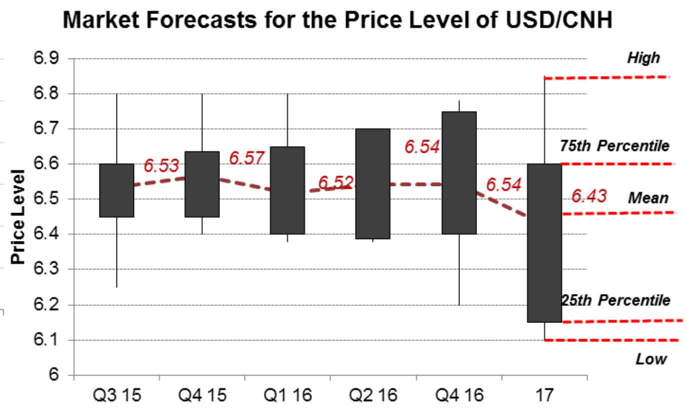
RMB FX Market Dynamics

Offshore RMB FX Market Comments

- The recent PBOC adjustment drove divergence between CNH and CNY rates to as much as 1,000 pips in August. However, in September the CNY/CNH differential narrowed to less than 500 pips.
- The wide dispersion of forecasts suggests the market has yet to reach consensus regarding the future movement of the offshore RMB.
- The current level of implied volatilities of ATM USD/CNH options in the OTC market are higher than their historical average level.



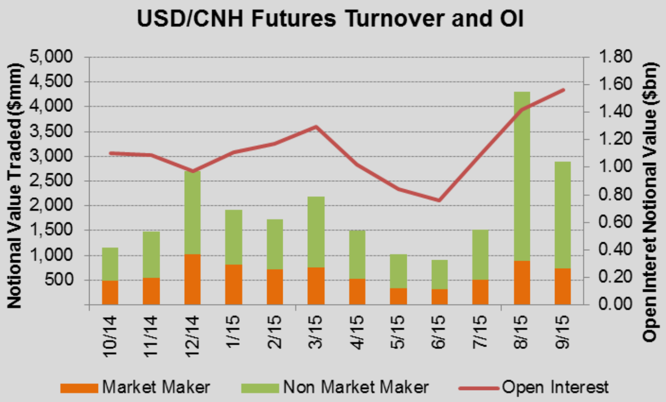


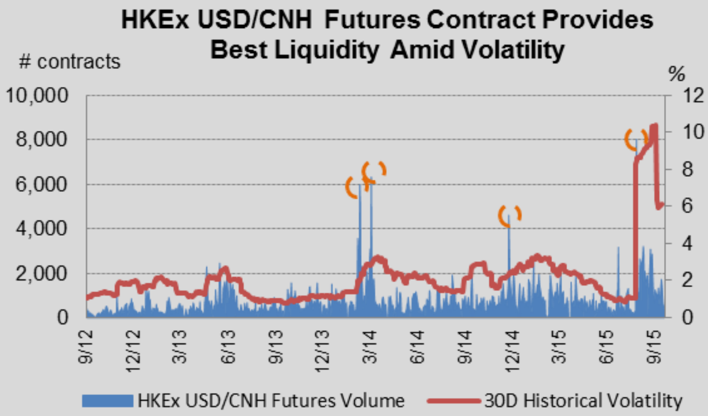


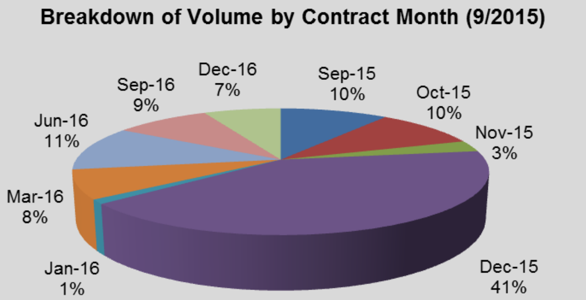
HKEx's USD/CNH Futures

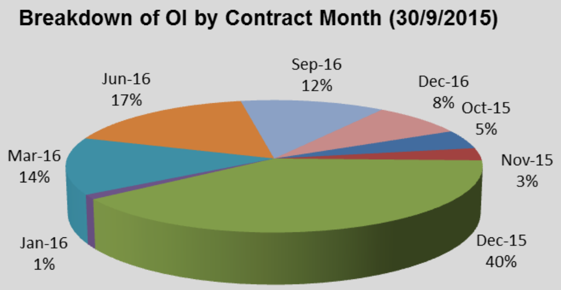
Product Highlights

- HKEx has been recognised by Asian Banker as the "Best Exchange for Offshore RMB FX Future" for 2015. The ranking is based on a detailed and transparent scorecard that assesses commercial banks, asset managers, exchanges, brokerages and corporates across various dimensions which include size and growth of their Renminbi business
- There was a wide range of participants in HKEx's USD/CNH Futures market in September, with non-market makers contributing 74 per cent of the volume
- Trading volume was highest in the December 2015 contract. Open interest was high in the December 2015, March 2016 and June 2016 contracts, which accounted for 71 cent of total open interest at the end of September







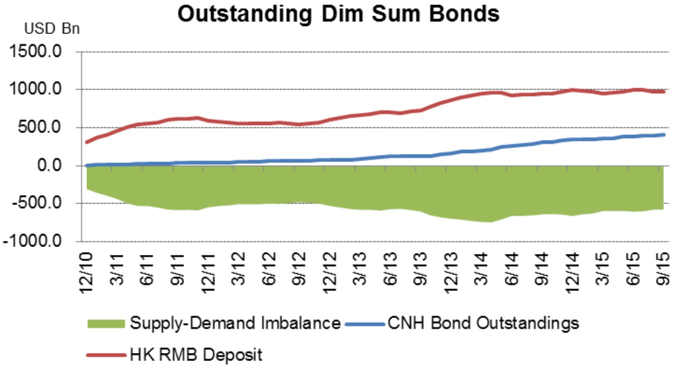


Offshore Bond Market Dynamics

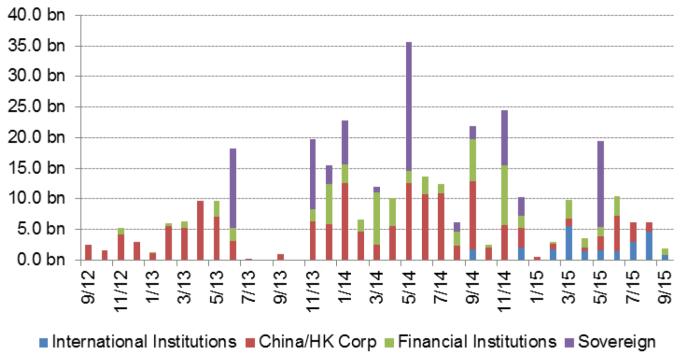
Offshore RMB Bond Market Comments

- The MoF T-Bond yield curve has been moving down gradually. Compared to the short end of the yield curve, the long end dropped more during that period.
- Dim sum bond yields jumped following the RMB's recent devaluation.
- Dim sum new issuance activities are subdued, due to the recent depreciation of offshore RMB and the National Development and Reform Commission (NDRC) has held off issuing new approvals for Chinese companies to sell dim sum bonds.

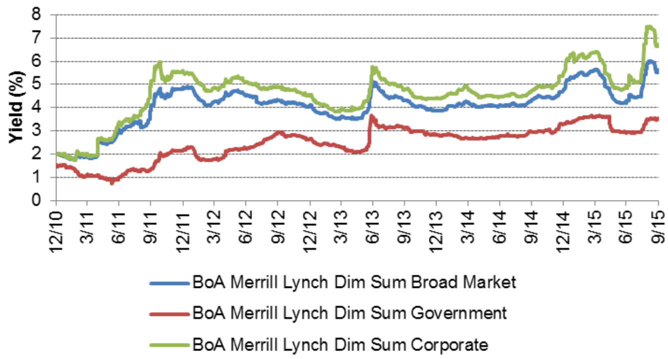
Offshore RMB Deposits vs. Outstanding Dim Sum Bonds



RMB Bond Issuances by Issuer Type



Dim Sum Bond Performance

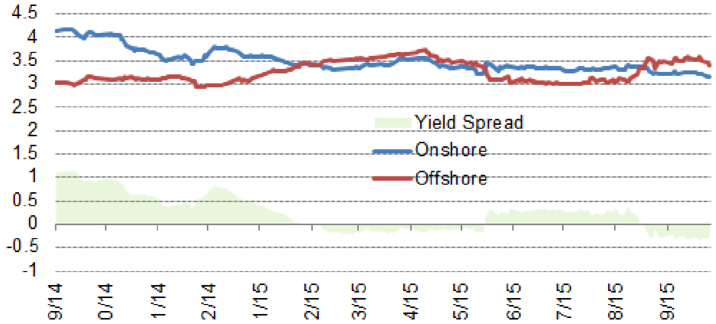


Onshore Bond Market Dynamics

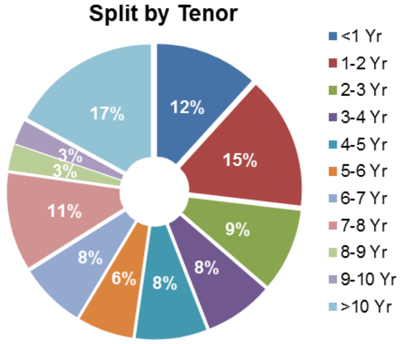
Onshore RMB Bond Market Comments

- PBoC is drafting new rules for yuan-denominated bonds sold by foreigners on the mainland, known as panda bonds, and plans to let more companies issue them and ease controls on how proceeds can be used within and outside of China.
- HSBC Holdings plc and Bank of China (Hong Kong) Ltd. have been approved by PBoC to issue 1 billion yuan ($156.9 million) and 10 billion yuan of panda bonds, respectively. They are the first overseas commercial banks to get permission to sell bonds in China's $6 trillion interbank bond market.

MoF T-Bond Yield 5Y: Onshore vs. Offshore (%)



MoF T-Bond Outstanding Split by Tenor



Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types)

Bond Type	Number of Deals	Trading Value(100M)	Yield to Maturity(%)
Policy Financial Bond	25,010	34,836.63	3.3748
Treasury Bond	8,235	10,142.17	2.9080
Medium-term Note	9,359	8,096.61	4.7042
Corporate Bond	9,167	5,643.19	5.4145
CDs	2,042	4,332.25	3.3557
Commercial Paper	13,832	10,020.51	3.5065
Central Bank Paper	217	797.46	2.5672
Others	2,673	2,714.14	5.4498
Total	**70,535**	**76,582.96**	**3.6903**

NAFMII Guidance for Non FI Debt Issuing (as of 2015/9/7)

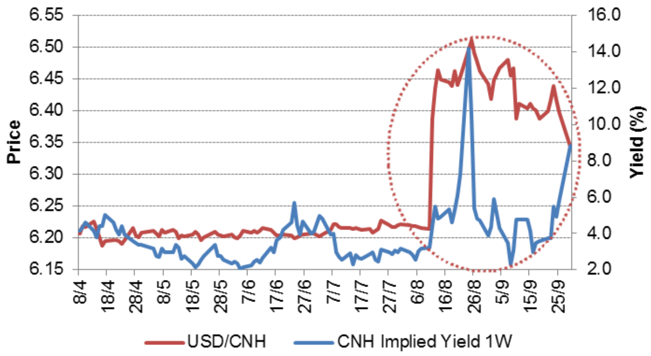
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.42	↓	3.98	↓	4.22	↓	4.48	↓	4.67	↓	5.17	↑	5.31	↓	5.57	↑
AAA	3.63	↓	4.12	↓	4.39	↓	4.76	↓	4.99	↓	5.50	↓	5.76	↓	6.03	↑
AA+	3.86	↓	4.49	↓	4.89	↓	5.24	↓	5.62	↓	6.15	↓	6.49	↓	6.75	↑
AA	4.32	↓	4.96	↓	5.38	↓	5.79	↓	6.17	↓	6.83	↓	7.13	↓	7.54	↓
AA-	5.52	↓	6.24	↓	6.75	↓	7.53	↓	7.98	↓	8.47	↑	8.82	↑	9.08	↓

Onshore/Offshore Short-Term Interest Rate Dynamics

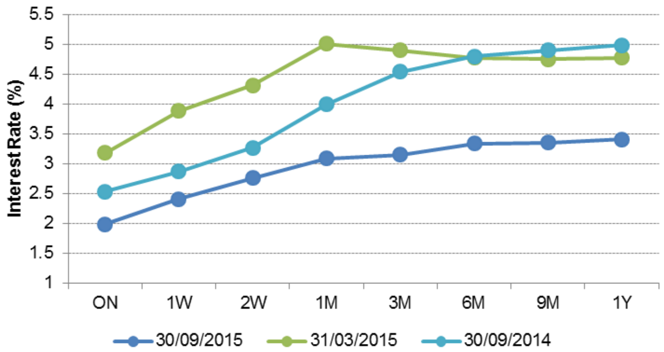
Onshore/Offshore RMB STIR Market Comments

- CNH implied yields has come back from its recent peak of 14 per cent in August to a level close to its historical average of 4 per cent in September.
- The spread between onshore rates (CNY SHIBOR) and offshore rates (CNH HIBOR) has widened recently.
- The CNH HIBOR yield curve became steeper at the short end in September and remained relatively stable at the long end.

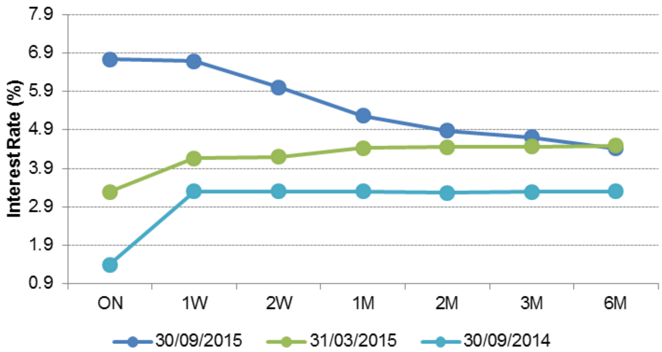
CNH Implied Yield Spike Driven by FX Movement



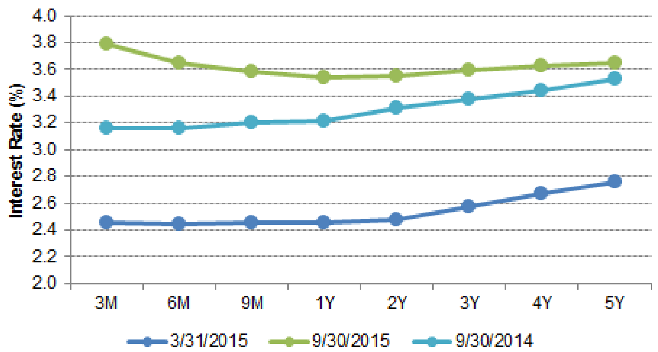
CNY SHIBOR Yield Curves



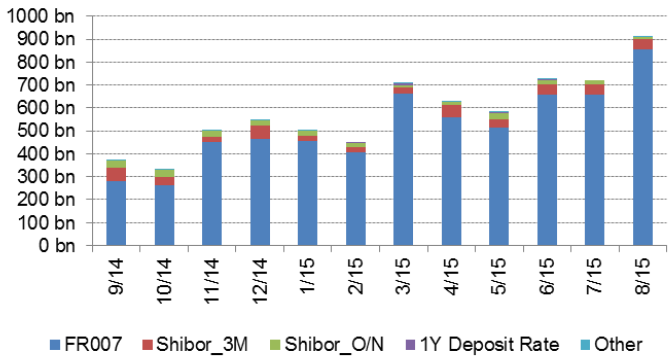
CNH HIBOR Yield Curves



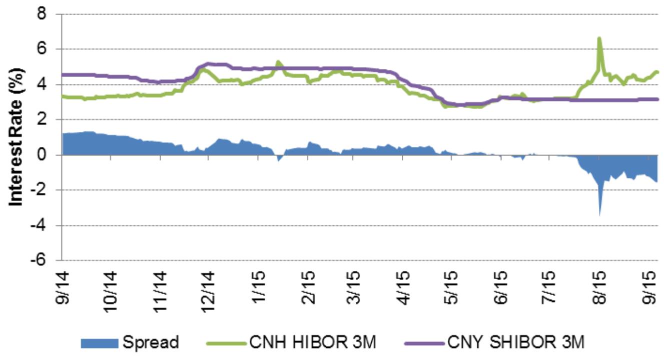
Onshore IRS (7D Repo) Yield Curves



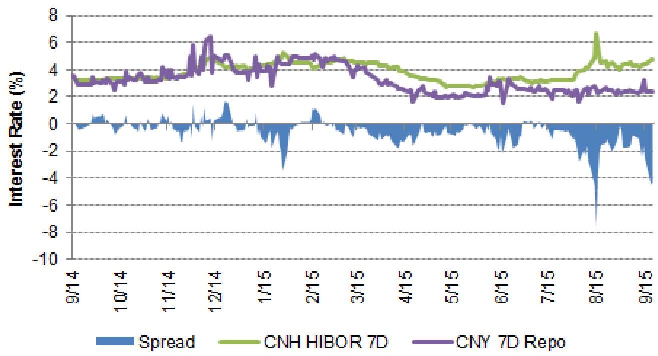
Onshore IRS Trading Notional Principal



CNY SHIBOR vs. CNH HIBOR



CNY 7D Repo vs. CNH HIBOR



Expert Corner

Contributed by Liu Fan, Business Director, China Central Depository & Clearing Co, Ltd

Market-Oriented Interest Rates and Bond Yield Curve

On June 25, 2015, the PBoC announced the cancellation of the interest rate cap for deposits of more than one year. The announcement brought China's market oriented interest rate reform to its formal end. Going forward, the benchmark deposit and lending rates announced by the PBoC should be the central bank's targets for commercial banks' lowest deposit and lending rates but nothing more. Basically, they are only guidance for commercial banks. From the legal perspective, commercial banks can freely implement the benchmark interest rates announced by the central bank according to their own situations. That raises a question for commercial banks with different qualifications and sizes. Pricing their deposits and loans with reference to a single pair of relatively stable guiding benchmark interest rates is far too ineffective, so what else should they refer to?

I believe the bond yield curve is an increasingly important reference for the pricing of deposit and lending rates by commercial banks. Currently, China's bond market has reached RMB40 trillion, equivalent to two-thirds of GDP, and ranked third highest in the world. Domestic and foreign investors, third-party intermediaries and information vendors are all preparing RMB bond yield curves. Among these, the Chinabond yield curves have a history of 16 years. Following their successful application in the front, mid, and back office management of bond investments by commercial banks, insurance companies, fund companies and securities companies, they have grown to become the specified pricing benchmarks for government bonds, local government bonds, corporate perpetual bonds and commercial banks' preferred shares. Some banks have tried to use them as their loan pricing benchmark. The Chinabond yield curves adopt the PBoC's credit rating standards, covering all fixed and floating rate curves for debts with credit ratings from AAA to CC, which correspond with commercial banks' internal corporate ratings. Since last year, Chinabond yield curves have been effectively used in the valuation of centrally registered non-standard assets under banks' wealth management teams. Fairly speaking, commercial banks only need to add a liquidity premium to the Chinabond yield for a corresponding credit rating to get a fair market lending rate for the loans they offer. It complements commercial banks' internal cost pricing (FTP). If commercial banks' FTP is lower than the fair lending rate, there will be a profit, otherwise there will be a loss.

Some people say that the immaturity of China's bond market means its yields are also immature and cannot be used as the benchmark deposit and lending rates. It is true to a certain extent, but not absolutely true. First of all, although the bond market has much room for improvement, it cannot be denied that bonds are far ahead of the deposit and loan market when it comes to the process of market-oriented interest rates. Secondly, the inherent privacy of nationwide commercial banks' lending rate information means aggregate information for different credit ratings is not observable on a daily basis. After the fading of the central bank's official interest rates, there will be no alternative benchmark that moves and tracks changes on a daily basis. Other officially recommended market benchmarks are either too simple or lack real transaction data. Their movements are too stable to be credible to the market. Therefore, yield curves of corporate bonds of a whole range of credit ratings are the first choice from among potential new benchmarks for corporate lending rates.

Some have said commercial banks do not refer to corporate bond yield curves when pricing their deposits and loans. I think that reveals a very profound issue. Most commercial banks, it is understood, lack a market-oriented loan pricing model. They are still obsessed with the pricing model based on the official benchmark interest rate. In other words, they only move up 30-40 per cent of the central bank's guiding benchmark rate according to an enterprise's credit rating. Any further move upwards risks being labelled as an "expensive loan". Such pricing has little impact on large enterprises, because in the face of unreasonable loan pricing, large enterprises can choose to issue bonds in the highly market oriented bond market. SMEs, however, have no such alternative. Because of their lower qualifications, non-standardised information disclosure and struggles with the high market thresholds, they have difficulties entering the bond market in large quantities. Meanwhile, commercial banks, unwilling to refer to the corporate bond yield curves, cannot increase interest rates high enough to cover the loan risk, thus offering little or no lending to SMEs.

There is also another serious problem in the loan management system of commercial banks, especially state-owned commercial banks. Whoever hands out a loan has to make sure it is repaid in full. For any loan that cannot be repaid, the loan officer will have to face punishment ranging from pay cuts to being dismissed. As the bad debt probability is higher for SMEs than for large enterprises, loan officers and commercial banks' basic level branches, out of the instinct to protect themselves, are reluctant to lend to SMEs, which further exacerbates the difficulties of SMEs obtaining loans. China's Internet banking and other private finance prospers because of "lending difficulties" caused by unreasonable loan pricing and collection at commercial banks. However, lack of brand awareness, management inexperience, and license restrictions mean it is difficult for private finance to completely replace traditional commercial banks. The correct solution should be to train commercial banks to refer to corporate bond yield curves for SME loan pricing, implement big data management, and for each bank to standardise its loan accounting system. Lending should be considered successful so long as total loans repayments exceed the lent-out amounts with reasonable profits. Loan officers and commercial banks' basic level branches are only marketing staffs and marketing outlets. As long as there are no irregularities, they should not be made to bear the responsibility if a load is not repaid in full.

Retail deposit pricing by commercial banks is relatively transparent, and the information is available at bank counters. Interbank large-denomination negotiable certificates of deposit (CD) are issued in large quantities, and so also provide a new reference for deposit pricing. The Chinabond yield curve family provides a compendium of loan pricing by commercial banks for various credit ratings and maturities, based on the daily consolidated issuance and transaction information of bonds and CDs issued by commercial banks of all credit ratings, and with reference to PBoC's credit rating standards. It provides convenience for commercial bank loan pricing and the cost analysis of commercial bank debt.

With more than 30 years of experience in banking, equity and bond regulation and services, Mr Liu Fan currently serves as business director of China Central Depository & Clearing Co, Ltd, as well as director of its bond information department and Chinese bond management system department. The bond bookkeeping system and the valuation system which Mr Liu serves won the People's Bank of China's first and second prize for technology. As head of the bond data product team since 2003, Mr Liu has improved and launched a range of Chinese bond data products including the Chinese bond yield curve, valuation, indices, VAR, bond market statistics and clearing membership statistics. These products have been widely accepted and recognized as importance references for the pricing of Chinese bonds.

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