HKEx
香港交易所

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Monthly Highlights

- **On Oct 24, the PBOC reduced its one-year lending rate, one-year deposit rate, and the reserve requirements for all banks. It also scrapped a deposit rate ceiling that limited what banks could pay savers**
- **On Oct 8, the PBOC launched the Cross-border Interbank Payment System (CIPs), a worldwide payments superhighway for the RMB to facilitate trade settlement and investment in RMB**
- **Premier Li Keqiang hint at less than 7% growth for China's economy this year**
- **Interview with Alexis Garatti of Taikang Asset Management (HK) : the Chinese monetary policy is now at the heart of the international currency system, being a part of the SDR currency basket being finally a secondary issue**

From the Chief Economist's Vantage Point

With Stimulus Measures Being Strengthened, Improving the Economic Efficiency Shall Be the Real Challenge Contributed by Dr. Ba Shusong, Chief China Economist, HKEx

Macro-economic statistics for September show that China economy continued to be weak amid overall stability. Even with positive news such as stable consumption growth, a rebound in the real estate market in major cities and increased infrastructure investment, the downturn in economic growth continued. Corporate results and investments have added to market concerns on China economy.

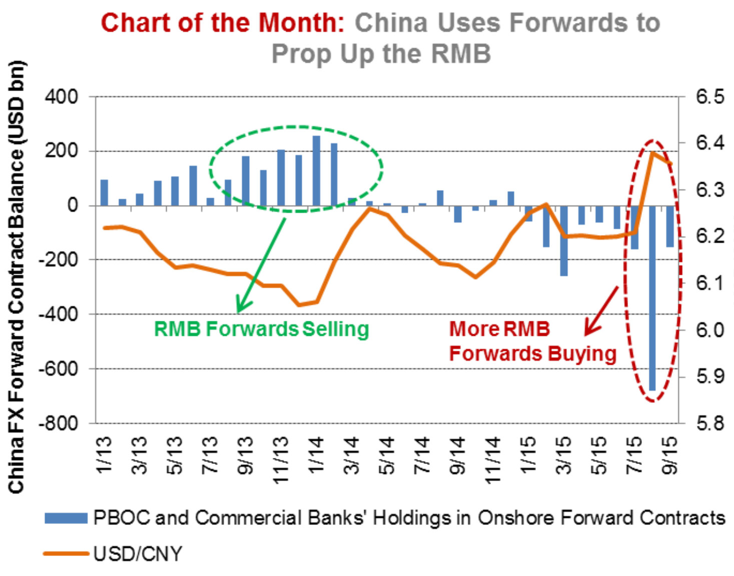
The recent spate of policies adopted by the Chinese government to further stimulate its economy, including the interest rate cuts and lowering of the RRR for banks on 24 October, gave us some reason to be optimistic about economic growth in the short term. As these stimulus measures being upgraded as expected, it can be hoped that economic growth from the last quarter of 2015 to early 2016 will regain some momentum. The real challenge as for now should be dealing with the huge overcapacity and accumulating leverage in the economy, and thus to raise economic efficiency after the latest stimulus measures have become in effect.

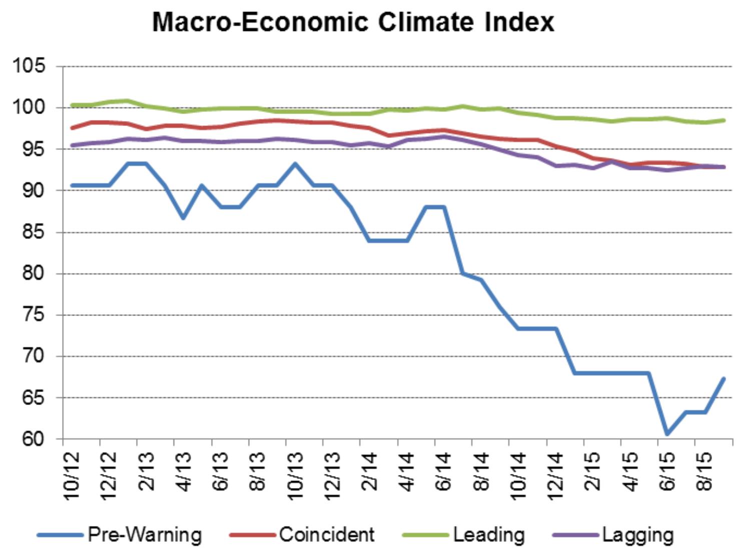
As China economic growth slowed down, we saw two opposing viewpoints dominate in the market. One focuses on structural transformation, which declares that a slowdown in economic growth is an inevitable result of structural transformation and should be acceptable. Another viewpoint stresses that cyclical declines should not be allowed to go too far otherwise they will hamper structural transformation, which is a medium-term process with gradual improvements. After the release of a series of economic data that pointed to weaker than expected growth due to internal and external pressure, we noticed that there is a growing consensus that stimulus measures should be strengthened to avoid huge downturn in the economy.

China reported a year-on-year GDP growth of 6.9% for the third quarter, which was the first time in nearly six years that growth failed to reach 7%. This number makes sense in many ways if we take into account the current relatively large base of the Chinese economy, the economy's ongoing structural transformation and the impending end of a period of high-growth reliant on demographic dividends, investment and exports. China's growth rate is still quite decent comparing to other economies across the globe.

While the market is concerned about the recent slowing down in China economy, we see opportunities for a rebound in the fourth quarter as the stimulus measures further boost the economy. People should pay more attention to the real challenges that China shall face in 2016 – de-capacity, deleveraging and improving its economic efficiency. We saw clear differences across different industries in the progress of China's economic transformation. Services and consumer sectors have been doing well, while the real estate sector has regained some momentum in terms of sales in first-tier cities, but has remained weak in terms of investment growth. Some innovative industries are performing relatively well as well. In contrast, growth of the secondary industries has been very weak with PPI declining for four consecutive years. We also see abundant stocks in the real estate market of second-and third-tier cities. Furthermore, some upstream industries with over-capacities and some highly-leveraged industries shall inevitably face bankruptcy, restructuring and/or clearing of excess capacity in 2016. For China's economic recovery to be sustainable, deleveraging should be the way which must be passed as we cannot rely solely on continuing accumulation of debt in some highly-leveraged industries. Deleveraging might potentially lead to some increase in the non-performing assets of banks, however, it is a real issue that cannot be avoided if the China economy wants to resume its upward trend and step up its transformation.

China Macro Update





China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.9	7	↓	11/10/2015 09:30
CPI (yoy %)	1.6	2	↓	11/10/2015 09:30
PPI (yoy %)	-5.9	-5.9	→	11/10/2015 09:30
Industrial Production (yoy %)	5.7	6.1	↓	11/11/2015 13:30
FAI (yoy %)	10.3	10.9	↓	11/11/2015 13:30
Foreign Investment (yoy %)	7.1	22	↓	11/08/2015 11/12
CFLP Manufacturing PMI	49.8	49.8	→	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	98.51	98.53	↓	11/28/2015 11/30
Exports (yoy %)	-3.7	-5.5	↑	11/08/2015
Imports (yoy %)	-20.4	-13.8	↓	11/08/2015
M2 Money Supply (yoy %)	13.1	13.3	↓	11/10/2015 11/15
Retail Sales (yoy %)	10.9	10.8	↑	11/11/2015 13:30
Consumer Confidence Index	109.7	118.2	↓	11/25/2015 09:45
Regulated Reserve Ratio (%)	18	18.5	↓	Infrequent
Official Foreign Exchange Reserves (USD bn)	3514.12	3557.4	↓	11/07/2015
Three-Month SHIBOR (%)	3.04	3.12	↓	Continuous
10-Year Gov't Bond Yield (%)	3.08	3.49	↓	Continuous
CNY/USD Exchange Rate	6.331	6.3665	↓	Continuous

Regulatory/Policy Developments

- China injected more stimulus into its slowing economy on Oct 23, when the central bank cut interest rates and reduced bank reserve requirements. The moves were defended with a nod to the overall economic situation and an inflation rate that remains subdued.
- The PBOC and local lenders increased their holdings in onshore forward positions to US$67.9 billion in August. These positions are intended to support the RMB against the US dollar. The August amount is five times more than the average in the first seven months of this year, according to PBOC data. These positions are part of a three-step method to support the currency without immediately draining reserves, according to information from China Merchants Bank and Goldman Sachs.
- The PBOC reduced its one-year lending rate to 4.35 % from 4.6 % effective Oct 26, while the one-year deposit rate was cut to 1.5 % from 1.75 %. Reserve requirements for all banks were lowered by 50 basis points, with an extra 50 basis point reduction for some. The PBOC also scrapped a deposit rate ceiling that limited what banks could pay savers, saying the move was made possible by a decline in market interest rates
- China's central bank, the PBOC, on Oct 8 launched the Cross-border Interbank Payment System (CIPs), a worldwide payments superhighway for the RMB to facilitate trade settlement and investment in RMB. It is a milestone in bolstering the RMB's global usage and cross-border clearing of the currency from the Chinese mainland.

Macro Economy Update

- New statements by Premier Li Keqiang and a top Chinese central bank official hint at less than 7% growth for China's economy this year. The remarks set the stage for the meeting on the country's 13th Five-Year Plan .

Market/Product Developments

- The National Development and Reform Commission and the State-owned Assets Supervision and Administration Commission used a rare intervention in the bond market to pre-empt a potential default by Sinosteel. The company's debt holders were told to redeem their notes a month after they were scheduled to be redeemed.

Key Research Reports/Conferences

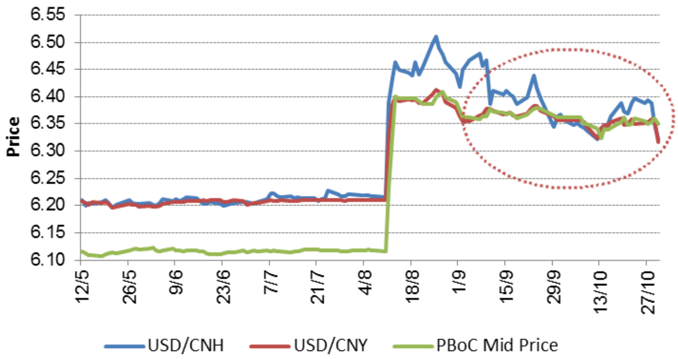
- Chinese corporate bonds appear to be the new favorite of the mass of investors who began pulling out of China's stock market this summer. The strength of the switch into corporate credit is underscored in a HSBC report, arguing that the links between China's credit market and other parts of its financial system have been strengthening.

RMB FX Market Dynamics

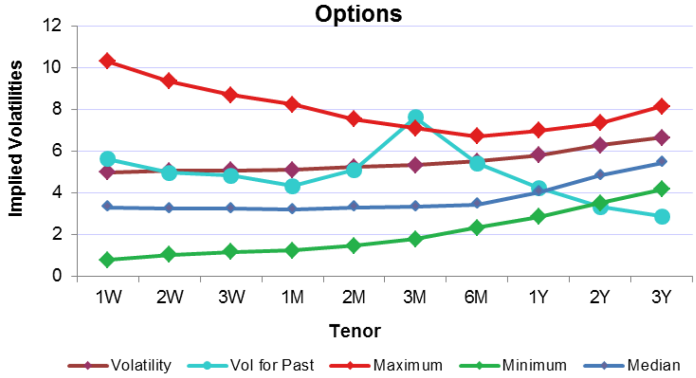
Offshore RMB FX Market Comments

- Based on media reports, market players believe the spread between CNH and CNY FX rates will be curbed at below 500 pips, in anticipation that the People's Bank of China could combat any expectation of continuous Renminbi depreciation.
- The current level of implied volatilities of ATM USD/CNH options in the OTC market are higher than their 1-year historical average level in most maturity period.

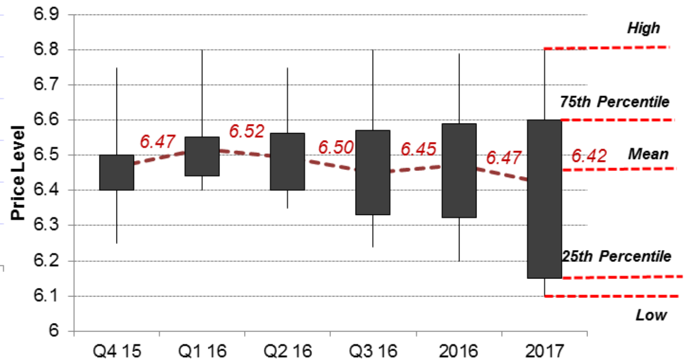
Onshore/Offshore RMB Price Range



Implied Volatilities of OTC USD/CNH ATM Options



Market Forecasts for the Price Level of USD/CNH

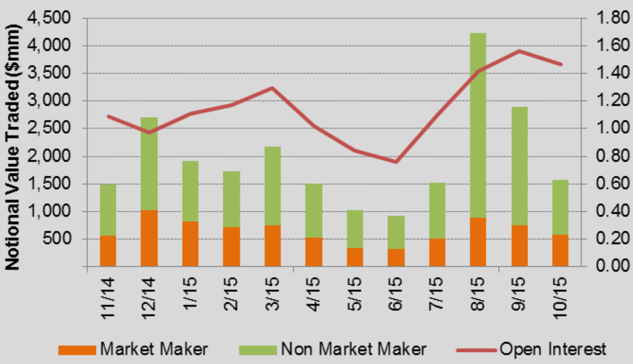


HKEx's USD/CNH Futures

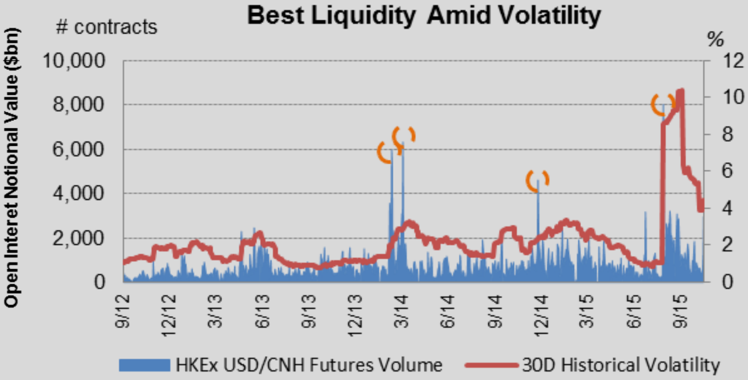
Product Highlights

- The turnover of HKEx's USD/CNH futures was 2,956 contracts as of 30 October 2015, a 7-week high
- There was a wide range of participants in HKEx's USD/CNH Futures market in October, with non-market makers contributing 63 per cent of the volume
- Trading volume was high in the December 2015 and June 2016 contracts, which accounted for 50 per cent of total monthly volume in October. Open interest was high in the December 2015 and June 2016 contracts, which accounted for 53 per cent of total open interest at the end of October.

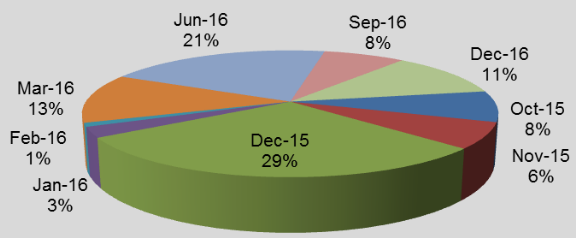
USD/CNH Futures Turnover and OI



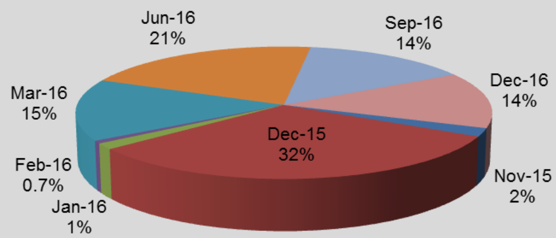
HKEx USD/CNH Futures Contract Provides Best Liquidity Amid Volatility



Breakdown of Volume by Contract Month (10/2015)



Breakdown of OI by Contract Month (30/10/2015)

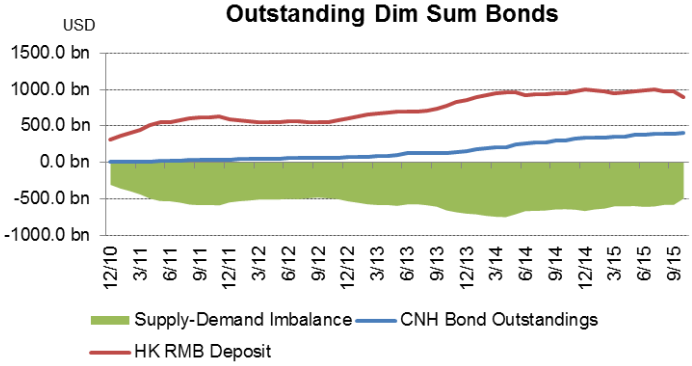


Offshore Bond Market Dynamics

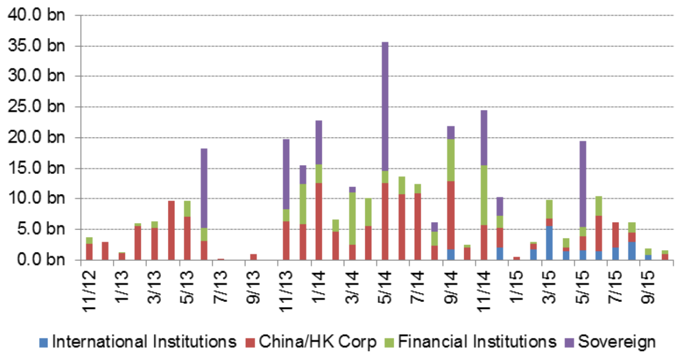
Offshore RMB Bond Market Comments

- The MoF T-Bond yield curve has been moving down gradually.
- Dim sum bond issuance has dropped significantly this year with volumes in the first nine months amounting to RMB 139 billion, only half that during the same period in 2014.

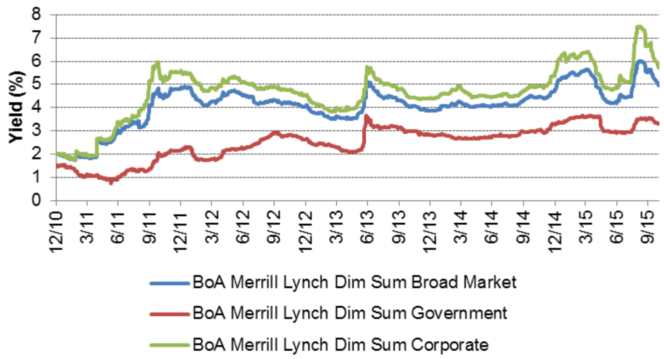
Offshore RMB Deposits vs. Outstanding Dim Sum Bonds



RMB Bond Issuances by Issuer Type



Dim Sum Bond Performance

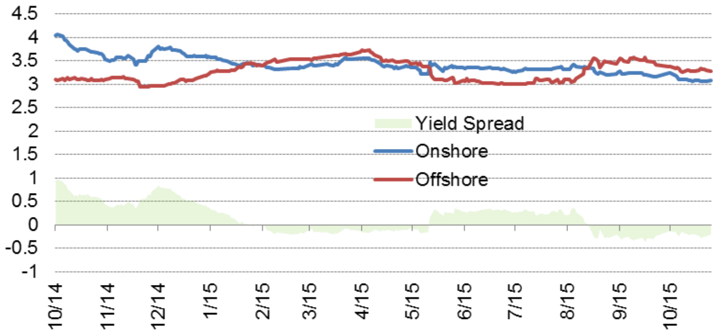


Onshore Bond Market Dynamics

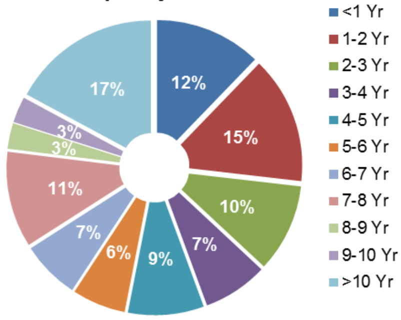
Onshore RMB Bond Market Comments

- Bonds issued in China last month totaled 2.5 trillion yuan, more than double the year-earlier total, bringing bond issuance over the first three quarters to 15.1 trillion yuan for a 70.8% year-over-year gain. The surge is attributed in part to falling financing costs since 2014.
- HSBC announced it was launching a joint venture with Shenzhen Qianhai Financial Holdings, to give it an onshore securities license and build an onshore renminbi debt capital markets business.

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	28,812	34,947.52	3.2621
Treasury Bond	7,980	9,568.15	2.8268
Medium-term Note	10,068	8,709.14	4.6732
Corporate Bond	7,780	6,363.06	3.5154
CDs	2,257	4,869.28	3.2301
Commercial Paper	14,868	9,587.40	4.0622
Central Bank Paper	105	244.88	2.7652
Others	2,332	2,833.91	5.3615
Total	**74,202**	**77,123.35**	**3.6171**

NAFMII Guidance for Non FI Debt Issuing (as of 2015/10/28)

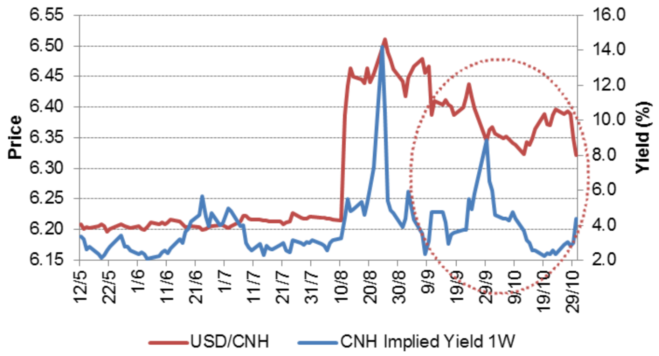
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.33	↓	3.84	↓	4.10	↓	4.36	↓	4.54	↓	5.09	↓	5.25	↓	5.52	↓
AAA	3.52	↓	4.00	↓	4.26	↓	4.64	↓	4.87	↓	5.42	↓	5.70	↓	5.97	↓
AA+	3.74	↓	4.35	↓	4.76	↓	5.11	↓	5.48	↓	6.07	↓	6.42	↓	6.69	↓
AA	4.18	↓	4.81	↓	5.24	↓	5.68	↓	6.04	↓	6.75	↓	7.07	↓	7.50	↓
AA-	5.41	↓	6.07	↓	6.58	↓	7.42	↓	7.88	↓	8.40	↓	8.75	↓	9.02	↓

Onshore/Offshore Short-Term Interest Rate Dynamics

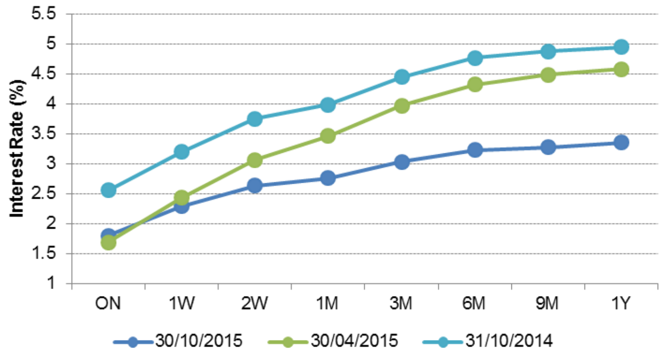
Onshore/Offshore RMB STIR Market Comments

- 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 October.
- The spread between onshore rates (CNY SHIBOR) and offshore rates (CNH HIBOR) has been narrowed recently.
- The CNH HIBOR yield curve is generally flat in October as the yields on the short-end dropped substantially from the higher level seen in September.

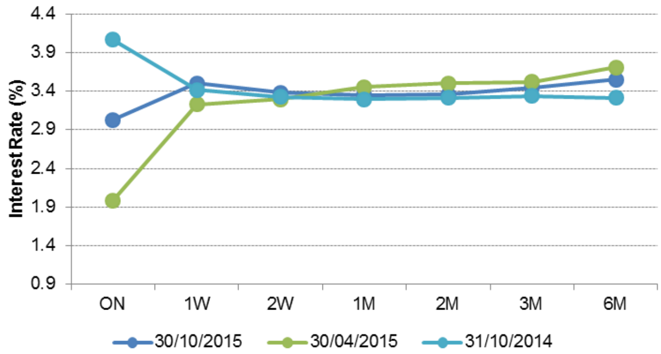
CNH Implied Yield Spike Driven by FX Movement



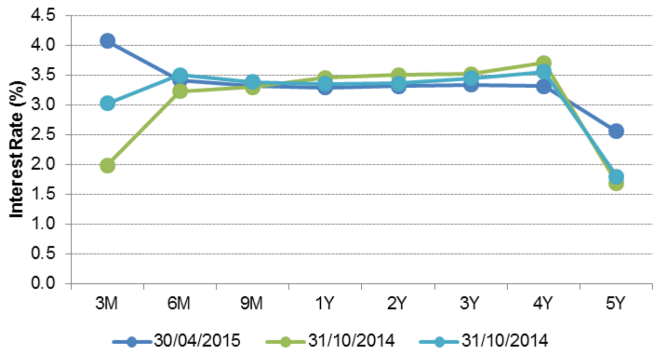
CNY SHIBOR Yield Curves



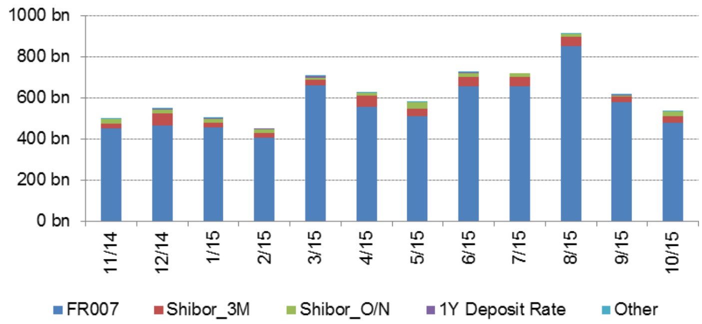
CNH HIBOR Yield Curves



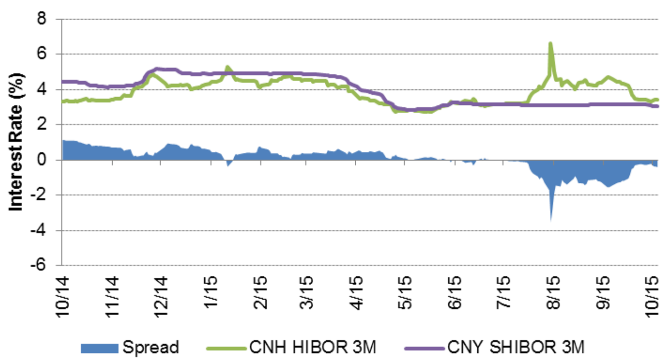
Onshore IRS (7D Repo) Yield Curves



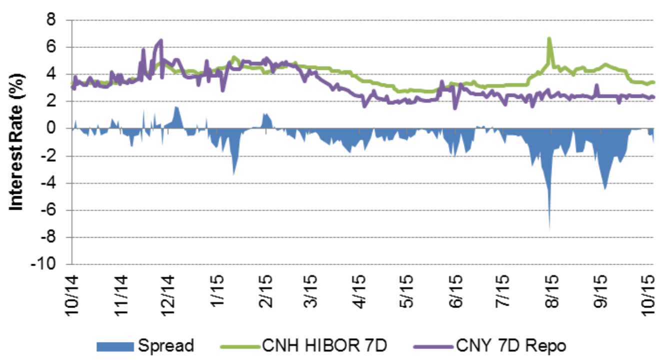
Onshore IRS Trading Notional Principal



CNY SHIBOR vs. CNH HIBOR



CNY 7D Repo vs. CNH HIBOR



Expert Corner

Contributed by Alexis Garatti, Head of Global Economic Research, Taikang Asset Management (HK)

Global Impact of RMB Devaluation, An Inconvenient "Untruth"

Far from representing a short-sighted move from Chinese authorities to support growth, PBOC's decision to devalue the RMB by more than 2% on August 10th and 11th marked a turning point in the organization of the international financial system and a new step in the implementation of structural reforms. This move has been criticized, amid mounting doubts on the stewardship of Beijing's economic team, who was accused of backpedalling on structural reforms, nurturing instability and triggering a global sell-off of equity markets. We believe that these arguments rest on a series of untruths, which blur the signals of Chinese economic policy.

Untruth 1: RMB depreciation was not fundamentally justified

Error correction models such as those developed by the Bank of Canada allow combining long-term and short-term equations to describe exchange rate movements. We use this framework to estimate RMB's real exchange rate versus the USD in function of oil prices, Chinese GDP and China's productivity (all expressed in logarithm), on the basis of a sample ranging from 1Q05 to 4Q14.

Growth and productivity represent the major drivers of RMB fluctuations over the long-term, with oil prices having a low explanatory power. Inflation differentials between China and the US were not significant. In the short-term, the RMB depends on interest rate spreads and growth differential compared to the US.

We use this model to build our forecast on the RMB versus USD by factoring in values of our exogenous variables on the basis of Oxford Economics' expectations. The expected profile of the RMB, produced by our model, is broadly flat in 2015, with a 5.6% margin of error for the nominal exchange rate of the RMB against USD. To this regard, the 2.4% depreciation of the RMB observed YTD can therefore be fundamentally justified and weaken the argument of those accusing China of currency manipulation.

Untruth 2: RMB depreciation will create a new wave of deflationary pressures

The deflationary impact of RMB devaluation is now a consensus. It deals with the reaction of Chinese consumers, tit for tat devaluation of competing economies, prices of imported goods in developed economies and commodity prices. These factors only focus on the short-term impact of currency devaluation and neglect long-term aspects, which are decisive in explaining global inflation. At a global level, in the absence of rebound in salaries, a commodity – induced acceleration of prices is destined to be temporary and not see any second round effects. Only healthy gains of productivity can support in a permanent manner salaries and a higher level of prices. Therefore, the analysis of RMB devaluation should not only be interpreted under the angle of global demand or commodity prices, but under the perspective of structural reforms leading to higher levels of productivity in China and therefore higher productivity at a global level.

Untruth 3: RMB depreciation shows China entering currency war and worsens the global coordination of monetary policies

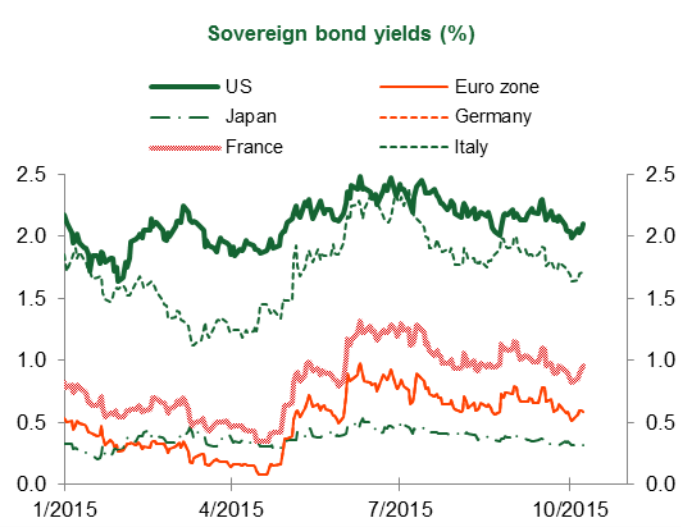
Many commenters now see the PBOC entering a currency war. In our view, this interpretation is not valid. RMB devaluation should not be interpreted as a way to unfairly boost growth, but as a necessary step to accompany structural reforms. Monetary policies beneficially interact with structural reforms. Accommodative fiscal and monetary policies smooth short-term painful impacts unavoidably associated with the transformation of an economy. This process is clearly at work in China. RMB devaluation aims at giving some breathing space to economic actors in a time of de-leveraging, environment-related restrictions in old industry, growing competition from outside and tight monetary conditions. By experiencing a too sharp deterioration of macroeconomic conditions, the Chinese government could face mounting obstacles to the continuation and completion of structural reforms. Moreover, China's new exchange rate mechanism "appears a welcome step as it should allow market forces to have a greater role in determining the exchange rate", according to the IMF. At last, recent Chinese FX interventions show, beside the necessity to control capital outflows, that the authority has no intention to revisit a model of growth based on low value of the RMB boosting the price competitiveness of traditional industry.

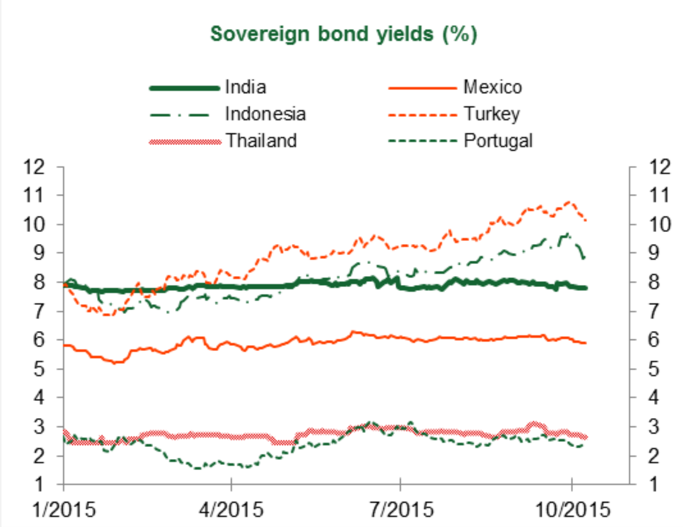
Untruth 4: PBOC has weakened the case for a role of the RMB in the international currency system

These FX interventions take mainly the form of sales in US Treasuries, which undoubtedly represent the bulk of Chinese foreign exchange reserves. The current bout of volatility observed in the global equity market, has been paradoxically accompanied by an increase of OECD countries' long-term interest rates. In usual circumstances of high uncertainty and volatility, long-term bonds of developed economies, see their yield move on the downside thanks to their status of safe heaven. This time, this is not the case. The selling by the PBOC of US Treasuries has probably a much more important impact on the global fixed income market than generally thought. Sell-off in equity prices, widening of credit spreads, increase of risk premiums and sovereign yields represent a major impact of RMB devaluation, i.e. a tightening of global monetary and financial conditions.

This tightening takes place after many years of ZIRP policies and QE programs in the three major developed economies, which created bubbles and limited incentives to reduce public debts. To this regard, the recent devaluation of the RMB marks a turning point in global monetary and financial conditions as it is accompanied with a decline of Chinese foreign exchange reserves.

This shift in the Chinese foreign exchange policy is a crucial change in the organization of the international financial system. It will contribute to elevate interest rates and reduce global liquidities. The implicit coordination of central banks policies has therefore improved as global liquidity, currently nurtured by the over-expansionary stance of the Fed, BOJ and ECB, will be contained and





even reduced thanks to the diminution of international reserves. As the main initiator of this trend of decline in foreign exchange reserves of emerging economies, PBOC's monetary policy contributes to tighten global monetary conditions and avoid further inflation of three different global bubbles, i.e. in the equity, fixed income and real estate markets. The Chinese monetary policy has therefore been the initiator of a normalization in global monetary conditions, which has been constantly and dangerously postponed by central banks of developed economies.

In this context, the Chinese monetary policy is now at the heart of the international currency system, being a part of the SDR currency basket being finally a secondary issue. As the market scrutinizes now all the decisions of the PBOC, the RMB has de facto acquired a status of international currency

Alexis Garatti holds a PHD on "macroeconomic shocks inside a monetary union". He started as an economist in the Research Department of Natixis, working three years in Paris and two years in London. He first covered the UK and European Nordic economies and then focused on the US and Euro zone. He published "Why England lost", a book analyzing the UK's economic decline. In 2009, he joined Citic securities in Hong Kong as a Senior Global Macroeconomist and worked for Haitong Securities International, with a growing focus on China and Asia Pacific. He joined TKAMCHK in January 2015 as the Head of Global Economic Research, providing multi - asset analysis for Taikang Asset Management.

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