

Monthly Highlights

- On Nov 30, the IMF agreed to add the Chinese yuan to its reserve currency basket with a 10.92% weighting.
- After months of capital outflow due to a slowing Chinese economy, the flow reversed in October as the central bank and others bought a net RMB12.9 billion in foreign exchange.
- HKEx's Chief China Economist, Dr Ba sees that it may be difficult for the boom in China's property market in 2015 to repeat in 2016, and aggregate turnover is expected to remain steady or fall.
- Interview with Randolph Tantzsch of Markit: A unified structure will provide the offshore market with a proper anchor to fully develop its potential as an international source of funding for Chinese and foreign corporations alike.

From the Chief Economist's Vantage Point

China's Property Market - 2015 in Review and Outlook for 2016: Regional Differences and Destocking

Contributed by Dr. Ba Shusong, Chief China Economist, HKEx

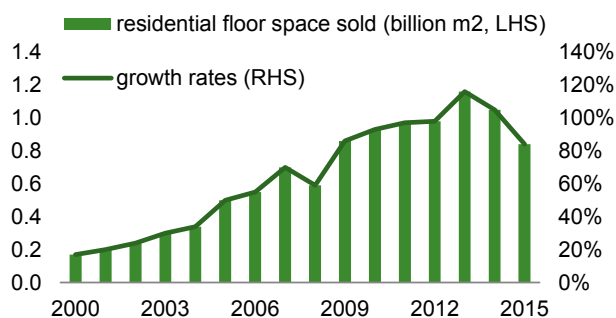
China's property market is now a key factor that impacts the country's investment and consumption and overall growth. New trends and characteristics have been seen in the Mainland property market in 2015.

I. 2015 in Review

There has been notable improvement in the market for new flats in 2015, but the degree of improvement varies among regions

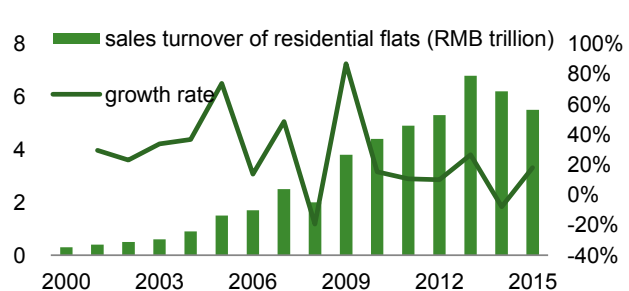
China's property market has notably improved on a nationwide scale in 2015. Both the number and prices of transactions are at their highest since 2010. Floor space sold in the first 10 months in 2015 increased 7.9 per cent year on year, and average traded price was up 9.4 per cent, with different markets faring differently. In the conventional high season of September and October, first- and second-tier cities fared better than in 2014, but third-tier cities basically returned to levels in 2014, and are expected to fall further.

Fig. 1 : Residential Floor Space Sold since 2000



Source: WIND

Fig. 2 : Sales Turnover of Residential Flats since 2000



Source: WIND

Investment in new flats is slow, and floor space of housing starts has slumped

The enthusiasm to invest in property projects has apparently decreased, with the floor space of housing starts down significantly. In the first 10 months of 2015, the floor space of housing starts slid 14.7 per cent year on year and floor space under construction was up a meek 0.8 per cent from the same period last year. Housing starts have been slow in 2015 mainly due to a large number of unsold flats in third- and fourth-tier cities, which dampened interest in housing starts in these cities and dragged down the performance of the whole industry.

Destocking remains a high priority of third- and fourth-tier cities

As at October 2015, floor space for sale in China totalled 680 million m², up almost 100 million m² year on year. The quantity of residential flats unsold is building up, especially in third- and fourth-tier cities. With limited capacity for flat consumption, many cities have taken longer than 15 months to dispose of their housing inventories. Destocking will remain a high priority of the majority of third- and fourth-tier cities. First-tier cities, on the other hand, have had much less pressure to destock. In fact, housing supply in cities like Shenzhen and Beijing has, in varying degrees, been unable to meet demand.

Fig. 3 : Floor Space of Housing Starts since 2000

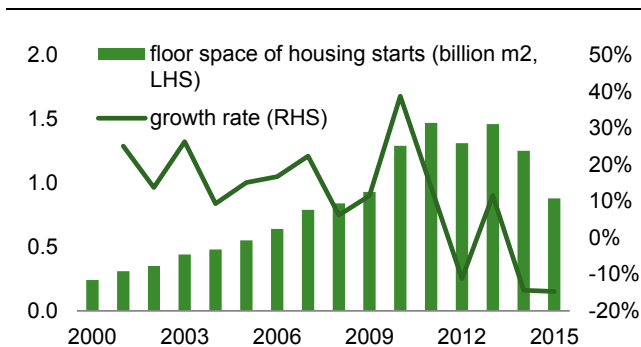


Fig. 4 : Unsold flats in Various Cities and Destocking Cycle (2015)



Source: WIND

Prices of new and used flats have generally recovered, with obvious improvement in first-tier cities

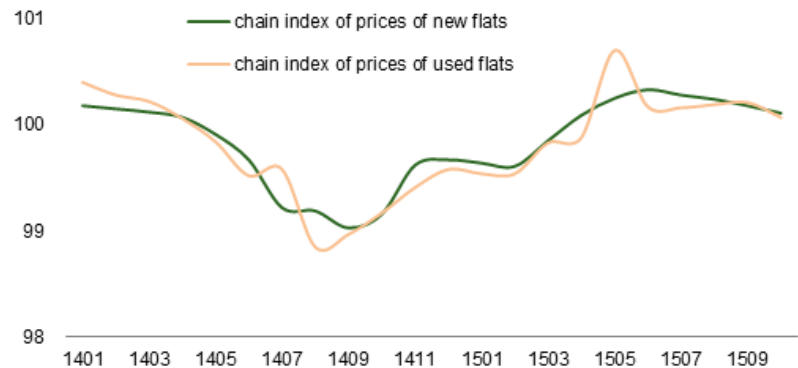
Judging by the housing price indices of 70 midsize and large cities, the prices of both new and used flats in China bottomed out in the second half of 2014. Later, as the atmosphere of the property market improved, declines gradually narrowed and prices started rising steadily in the second quarter of 2015. First-tier cities have seen their housing prices, both for new and used flats, rise by a larger degree and faster than other cities. There have been obvious differences in the movement of housing prices in different cities.

II. Prospects for 2016

Supply of new flats has fallen in 2015, prices are up and large inventories remain

According to data from the National Bureau of Statistics, supply indicators like land sales for new residential developments and housing starts have fallen significantly in 2015. In 2016, the total supply of newly completed residential flats is expected to decrease significantly, and both total floor space sold and sales turnover are expected to be lower than in 2015.

However, land prices are still going up. In first-tier cities and those second-tiers with greater land demand, the land market has been rather heated in 2015, with new houses priced more on the high end. A structural rise in the prices of newly constructed residential flats is expected in 2016. Prices of new residential flats across the nation may be higher than in 2015.



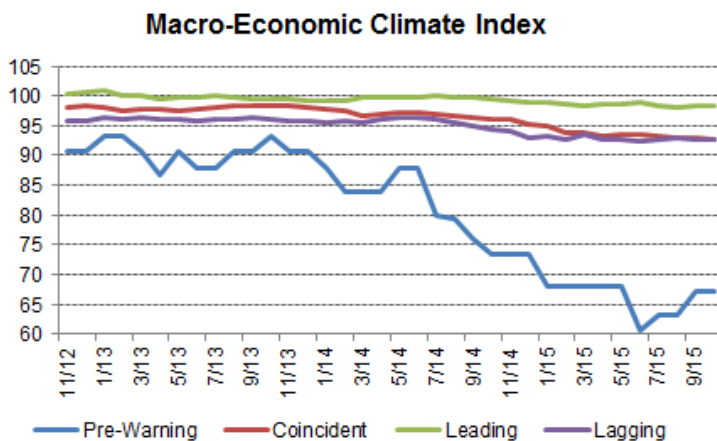
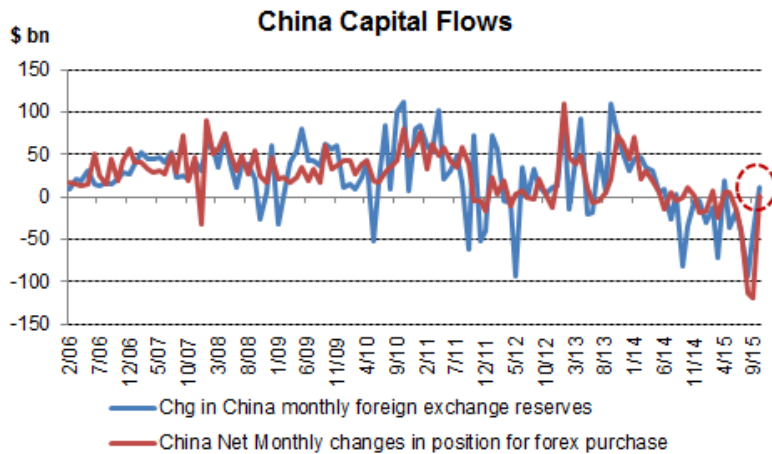
According to national data on residential flats under construction, works in progress are still rising but sales have shrunk. The resulting inventory pressure may increase, though it varies notably in different regions. With reduced land supply, first-tier cities do not have enough new flats, especially those with a high price performance ratio and inelastic demand. In some second-tier cities like Wuhan, Chongqing and Qingdao, and in most of the third-tier, the clearance of new residential flats takes longer and inventory pressure will persist for a longer period of time. All in all, destocking will remain a key word nationwide for the new flat market in 2016.

The used flats market has been generally stable, with differences between cities

Trading in used flats has hit a historical high in 2015, backed by policies that support the property sector and an expansionary credit environment. Sales have almost doubled in the first-tier cities of Beijing, Shanghai and Shenzhen. The second-tier also has seen rapid growth. The market share of used flats is up significantly.

In the fourth quarter of 2015, the government's supportive policies have been largely related to provident funds, which have not had a notable impact on the market. Given prevailing policies, it may be difficult for the boom in 2015 to repeat in 2016. Aggregate turnover is expected to remain steady or fall. Different regions will have different performances. For used flats in second-tier cities, there continues to be momentum for transactions to increase further.

China Macro Update



Regulatory/Policy Developments

- China's yuan on 11/30 took its place among the euro, US dollar, yen and pound sterling in the International Monetary Fund's basket of currencies with Special Drawing Rights. The yuan, which will have a share of 10.92%, thus achieves a milestone for itself and the IMF, with the approval marking the first time a currency has been added to the SDR basket.
- After months of capital outflow due to a slowing Chinese economy, the flow reversed in October as the central bank and others bought a net RMB12.9 billion in foreign exchange. Separate data earlier this month showed that China's official foreign exchange reserves, which only include holdings of the central bank, rose by US\$11.4bn in October, breaking five straight months of decline. The latest data suggest that market sentiment toward the RMB, which turned sharply bearish after its August move, has improved.
- China is considering merging its securities, banking and insurance regulators, sources say. Officials have concluded that poor coordination among the agencies, which operate independently, contributed to this summer's stock market turmoil. Any move to centralise regulatory supervision would shift power away from the three current agencies and create a more direct link between market oversight and China's leadership.

Macro Economy Update

- Chinese companies' borrowing to maintain cash flow in a softening economy are building up a possibly unsustainable debt load that could lead to a string of defaults, analysts say. Lending of this type is projected to grow 5% this year and raise the total burden to US\$1.2 trillion, a record.

Market/Product Developments

- Enthusiasm in China's revamped Panda bond market is threatening the prospects of Dim Sum debt. Foreign issuers have been studying and considering the possibility of issuing onshore RMB debt at today's historically low yields, according to a report by Reuters. Dim Sum issuance has fallen drastically in the past few months, as more Chinese companies have preferred to borrow onshore. Issuance in 2014 reached RMB337.8 billion (US\$53 billion), but the total year to date stands at just RMB150.8 billion.

Key Research Reports/Conferences

- Rapid development in corporate credit, massive issuance by municipal governments and the addition of new instruments stand to transform China's bond market in the near term, speakers at the annual Hong Kong Investment Fund Association forum said. Strong demand is expected for RMB-denominated assets when the currency gains SDR status with the IMF.

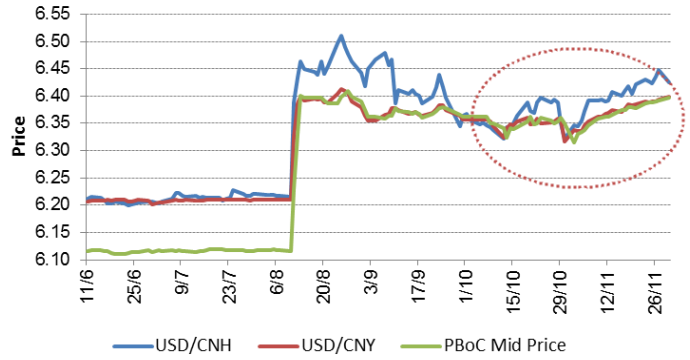
China Key Economic Indicators	Curren	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.9	7	↓	TBC
CPI (yoy %)	1.3	1.6	↓	12/09/2015 09:30
PPI (yoy %)	-5.9	-5.9	↔	12/09/2015 09:30
Industrial Production (yoy %)	5.6	5.7	↓	12/12/2015 13:30
FAI (yoy %)	10.2	10.3	↓	12/12/2015 13:30
Foreign Investment (yoy %)	4.2	7.1	↓	12/08/2015 12/12
CFLP Manufacturing PMI	49.6	49.8	↓	12/01/2015 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	98.36	98.29	↑	12/28/2015 12/31
Exports (yoy %)	-6.9	-3.7	↓	12/08/2015
Imports (yoy %)	-18.8	-20.4	↑	12/08/2015
M2 Money Supply (yoy %)	13.5	13.1	↑	12/10/2015 12/15
Retail Sales (yoy %)	11	10.9	↑	12/12/2015 13:30
Consumer Confidence Index	113.1	109.7	↑	01/06/2016 09:45
Regulated Reserve Ratio (%)	18	18.5	↓	Infrequent
Official Foreign Exchange Reserves (US\$)	3526	3514.1	↑	12/07/2015
Three-Month SHIBOR (%)	3.04	3.17	↓	Continuous
10-Year Gov't Bond Yield (%)	3.09	3.4	↓	Continuous
CNY/USD Exchange Rate	6.396	6.3473	↑	Continuous

RMB FX Market Dynamics

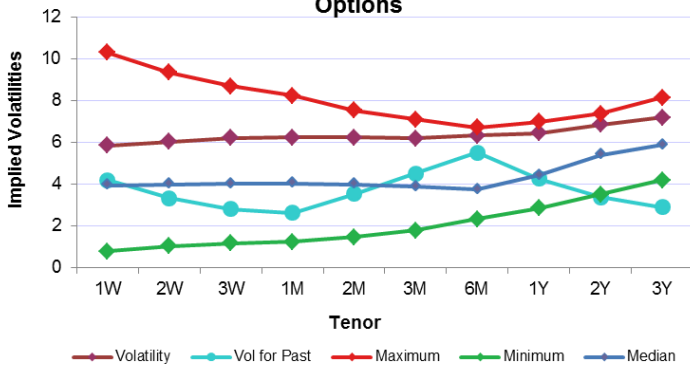
Offshore RMB FX Market Comments

- Following the SDR inclusion, the market expects the USD/CNH rate to remain relatively stable in the short to medium term with increased volatility.
- According to market forecast data from Bloomberg, the USD/CNH rate will most likely stay within the range of 6.4 to 6.5 before the first quarter of 2016.
- CNH-CNY spread widened substantially again as large as 500 pips towards the SDR vote in November. The reemergence of sizable CNY-CNH divergences going forward could make operations for SDR users more challenging. However, ongoing reforms that promote greater integration between the onshore and offshore markets should reduce the risk of spikes in the spread over time.

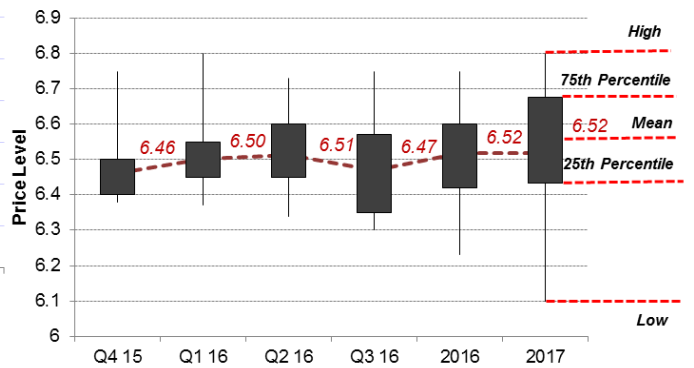
Onshore/Offshore RMB Price Range



Implied Volatilities of OTC USD/CNH ATM Options



Market Forecasts for the Price Level of USD/CNH

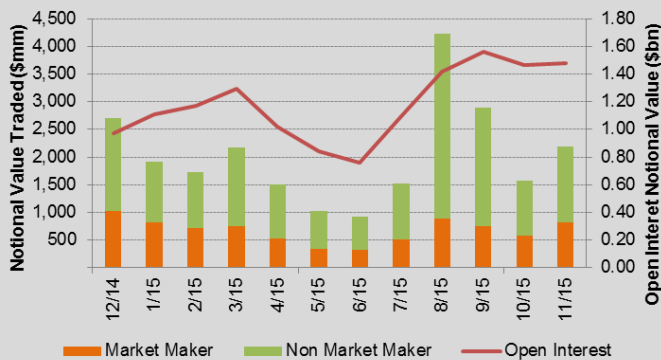


HKEx's USD/CNH Futures

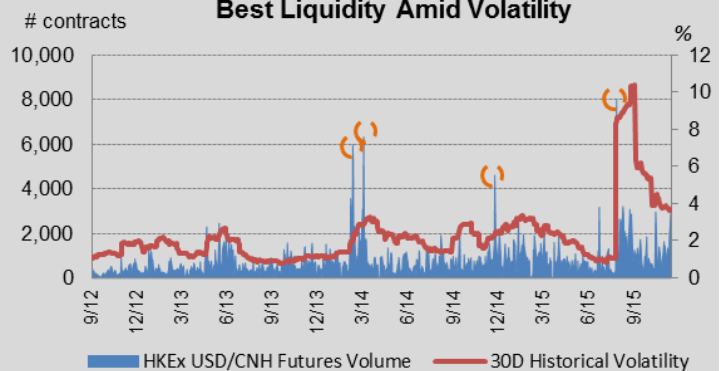
Product Highlights

- HKEx's USD/CNH futures contract recorded a turnover of 3,007 contracts (US\$301 million notional) on 30 November 2015, the highest since early September. OI reached 14,804 contracts (US\$ 1.48 billion notional) on the same day.
- There was a wide range of participants in HKEx's USD/CNH Futures market in November, with non-market makers contributing 63 per cent of the volume
- Trading volume was high in the December 2015, March 2016 and June 2016 contracts, which accounted for 64 per cent of total monthly volume in November. Open interest was high in the December 2015, March 2016 and June 2016 contracts, which accounted for 61 per cent of total open interest at the end of November.

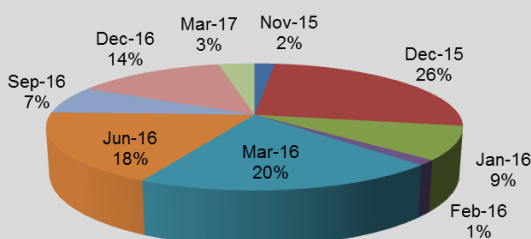
USD/CNH Futures Turnover and OI



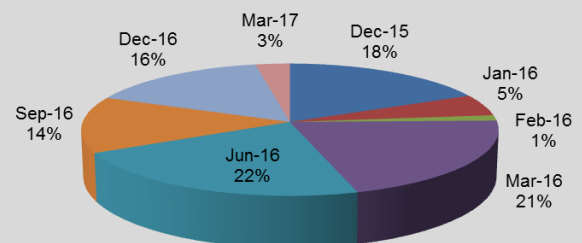
HKEx USD/CNH Futures Contract Provides Best Liquidity Amid Volatility



Breakdown of Volume by Contract Month (11/2015)



Breakdown of OI by Contract Month (30/11/2015)

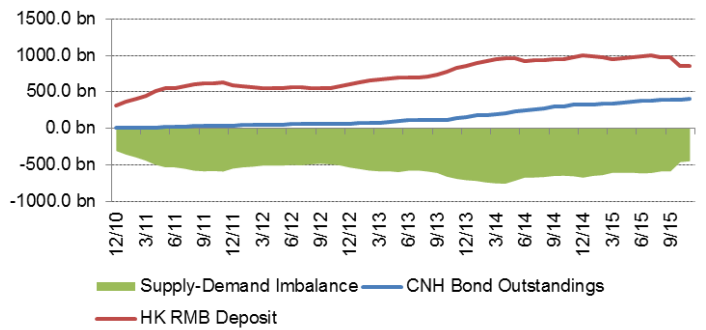


Offshore Bond Market Dynamics

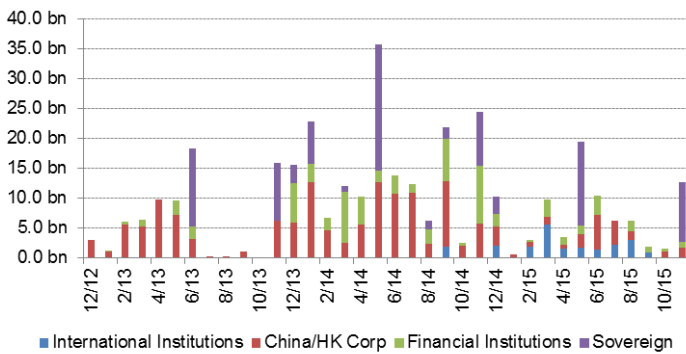
Offshore RMB Bond Market Comments

- Sovereign Dim Sum issuance has increased to 10Bn in November 2015, reversing the falling trend in the past few months, as more Chinese companies have preferred to borrow onshore. Issuance in 2014 reached RMB 338 billion (US\$ 53 billion), but the total year to date stands at just RMB 151 billion.
- China Construction Bank (Asia) has priced a two year dim sum amid a market sentiment that is less than favourable for dim sum issuance.

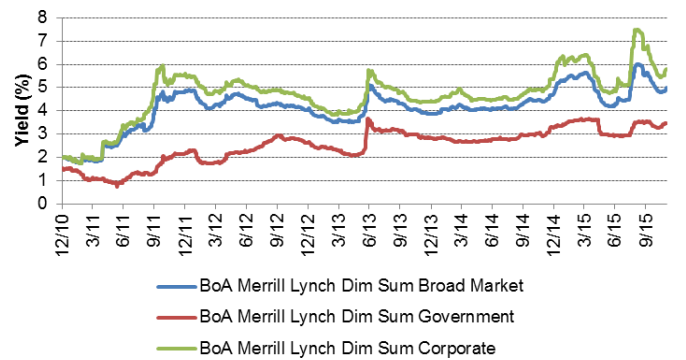
Offshore RMB Deposits vs. Outstanding Dim Sum Bonds



RMB Bond Issuances by Issuer Type



Dim Sum Bond Performance

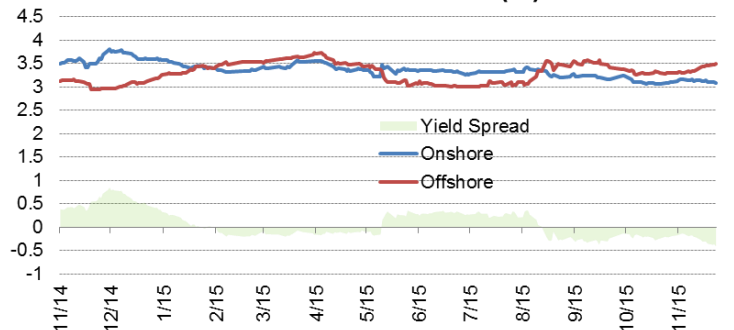


Onshore Bond Market Dynamics

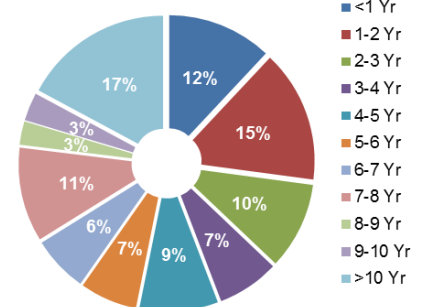
Onshore RMB Bond Market Comments

- Onshore bond issuance increased 18.5 per cent to RMB2.6 trillion in November from RMB2.2 trillion in October. Local government debt issuance is the largest contribution (68 percent) to the increase, due to the debt-swap program for helping China's debt-laden local governments.
- The default by China Shanshui Cement Group Ltd. is forcing more Chinese companies to scrap bond sales as yields surge. However, such default should not dent sentiment towards China's bond market, as China looks set to allow more bond defaults as part of its market reform agenda, which in the longer term should lead to more accurate pricing of default risk for onshore issuances.

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	36,265	46,913.05	3.2287
Treasury Bond	8,278	11,216.82	2.8575
Medium-term Note	12,999	10,975.66	4.6848
Corporate Bond	10,833	8,645.28	3.5961
CDs	3,418	8,745.62	3.1039
Commercial Paper	18,504	12,004.10	4.0376
Central Bank Paper	112	364.58	2.7404
Others	3,219	3,795.54	6.8701
Total	93,628	102,660.65	3.5714

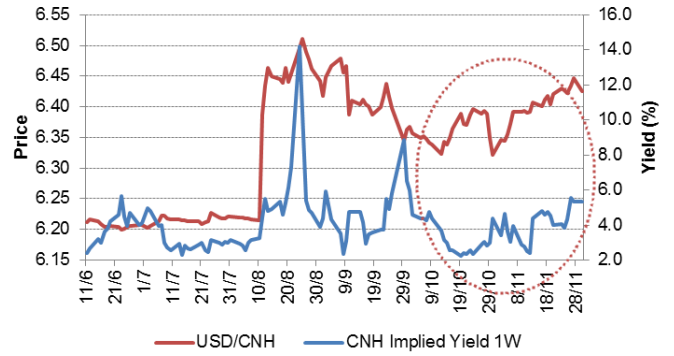
NAFMII Guidance for Non FI Debt Issuing (as of 2015/11/30)																
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.37	↑	3.89	↑	4.12	↑	4.38	↑	4.55	↑	5.09	↑	5.25	↑	5.52	↑
AAA	3.57	↑	4.05	↑	4.29	↑	4.67	↑	4.88	↑	5.42	↑	5.70	↑	5.97	↑
AA+	3.79	↑	4.42	↑	4.79	↑	5.15	↑	5.50	↑	6.07	↑	6.42	↑	6.69	↑
AA	4.25	↑	4.87	↑	5.29	↑	5.73	↑	6.05	↑	6.74	↓	7.07	↑	7.51	↑
AA-	5.52	↑	6.13	↑	6.63	↑	7.44	↑	7.90	↑	8.39	↓	8.76	↑	9.03	↑

Onshore/Offshore Short-Term Interest Rate Dynamics

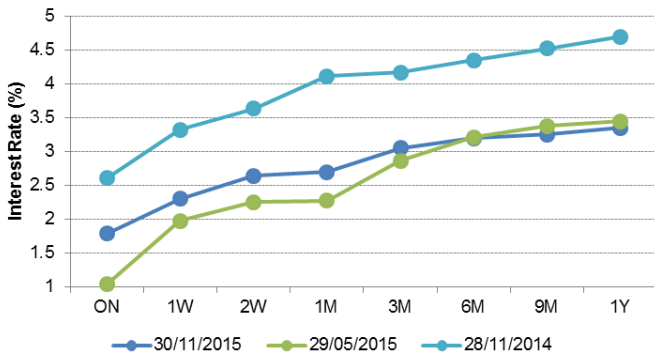
Onshore/Offshore RMB STIR Market Comments

- CNH implied yields rebounded from a low level of around 2% to close to 6% due to the continuous tightening of CNH liquidity as the result of speculation about potential FX intervention following RMB's SDR inclusion.
- The CNH HIBOR yield curve is generally flat in November as the yields on the short-end rebounded substantially from the lower level seen in October.

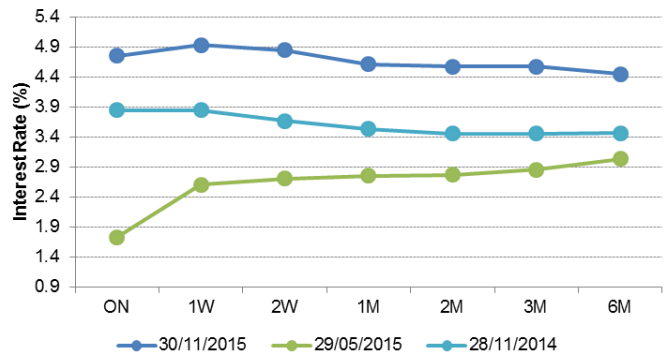
CNH Implied Yield Spike Driven by FX Movement



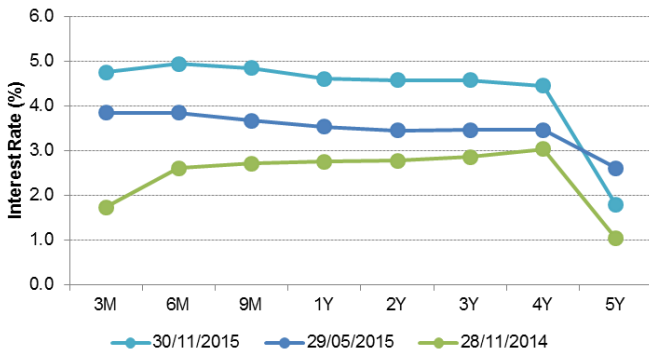
CNY SHIBOR Yield Curves



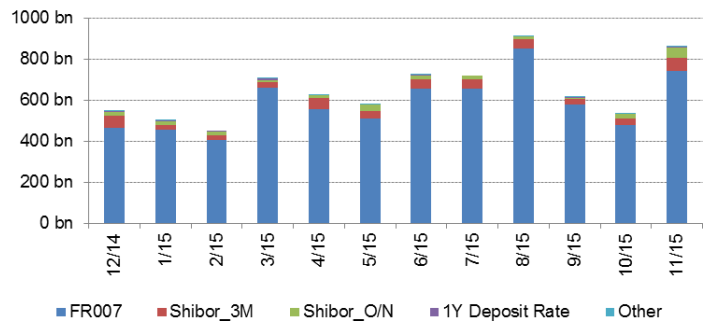
CNH HIBOR Yield Curves



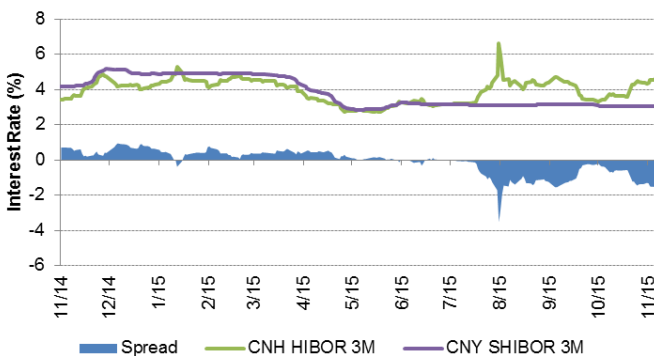
Onshore IRS (7D Repo) Yield Curves



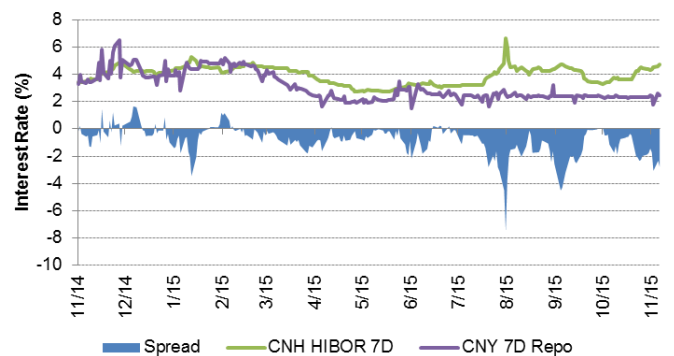
Onshore IRS Trading Notional Principal



CNY SHIBOR vs. CNH HIBOR



CNY 7D Repo vs. CNH HIBOR



Expert Corner

Contributed by *Randolf Tantzsch*, Director of Indices Asia-Pacific, Markit

Offshore and Onshore RMB Bond Market Integration – A Likely Prospect?

After a record 2014, the offshore RMB bond market has hit a rough patch in 2015. Concerns about Chinese real estate companies, equity market volatility and the RMB devaluation in August have contributed to a decline in the overall activity in the offshore market. A key question for investors is whether 2015 will be seen as a short pause along the way to new heights or whether underlying limitations will deter further development of the offshore market. Looking beneath the surface reveals a nuanced picture providing cause for optimism as well as concern.

The RMB bond market has been divided into the onshore and offshore markets, with different underlying dynamics. Foreign issuers do not have easy access to the onshore market, hence their RMB funding is principally limited to the offshore market. Chinese issuers can issue bonds in the onshore or offshore markets, typically basing their decision on funding costs.

Onshore corporate issuance has continued to grow this year on the back of the favourable funding environment caused by falling interest rates. However, this has not held true for the offshore RMB bond market.

Year-to-date, just RMB 55 billion of standard benchmark non-government offshore RMB bonds have been issued, compared to RMB 175 billion last year. When we take a closer look, it seems that much of the decline has been driven by Chinese issuers' withdrawal from the market.

However, foreign corporates have continued to be quite active in the market, amid RMB internationalisation and increased availability of RMB clearing centres and swap facilities. Out of the total non-government offshore RMB bonds issued, more than half (i.e. RMB 37 billion) came from non-Chinese issuers. In fact, the amount of offshore RMB bonds raised by non-Chinese issuers year-to-date is larger than it was during the same period in 2014 (RMB 31 billion).

A key factor contributing the drop in offshore RMB bond issuance by Chinese issuers is the interest rate differential between the onshore and offshore markets. Overall, this year's interest rate environment has been less favourable to the offshore RMB bond market, with the yield spread of onshore versus offshore government bonds turning negative for the first time. Following the RMB devaluation, the yield spread of onshore versus offshore government bonds was as low as -85 in late September.

There were very few Chinese offshore bonds issued in Q1 and Q3 2015, when onshore yields dropped below offshore levels. This contrasts with 2014, when yield spreads were positive (average of 125bps) throughout the year.

The volatility of offshore yields also impacted the volume of offshore RMB bond issuance. Offshore yields were significantly more reactive to external events than onshore yields, including the RMB devaluation this August.

The limited convertibility between onshore and offshore RMB bond markets contributes to the relative volatility of the offshore yields and the persistent yield differentials between the onshore and offshore RMB bond markets.

Market participants argue that better integration of the onshore and offshore markets will lead to a more stable relationship between the onshore and offshore interest rates, and will reduce the yield differential. In fact, there have already been a number of steps to better integrate the two markets.

China has been stepping up efforts to open its domestic capital markets. As the official Xinhua News Agency reported¹, central bank governor Zhou Xiaochuan pledged during the political "two sessions" in March to accelerate reform and open up of the capital market in 2015, with the aim of making the yuan convertible on the capital account.

Recently, the PBoC has approved two offshore lenders – Bank of China (Hong Kong) and HSBC – to issue "panda bonds", yuan-denominated debt sold on its domestic market, opening up the onshore renminbi market to overseas borrowers.

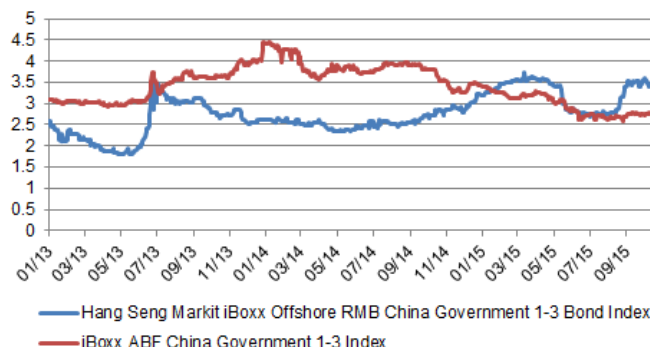
Of course, the convergence of the onshore and offshore RMB bond markets still faces a number of challenges, including the barrier created by the cost of issuing offshore for Chinese issuers. At the moment, issuers require special approval for the transfer of offshore RMB funds to the onshore market.

However, as China continues to open up its financial markets, the prospect of a gradual integration of the onshore and offshore markets looks promising. A unified structure will provide the offshore market with a proper anchor to fully develop its potential as an international source of funding for Chinese and foreign corporations alike.

Yield Spreads vs Issuance



Onshore and Offshore Government Bond Yields



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Randolf Tantzsch is director of indices at Markit. He is based in Hong Kong and joined the company in 2008 to drive the expansion of Markit's indices in Asia, and has subsequently launched the iBoxx SGD bond index and the Hang Seng Markit iBoxx Offshore RMB bond index family.

Prior to joining Markit, Randolf spent 7 years at Concerto Financial Solutions and FACT Unternehmensberatung GmbH where he was responsible for creating and launching the iBoxx ABF, iBoxx USD and a number of other indices across different asset classes. Randolf is a graduate in finance from Passau University in Germany.

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