HKEX 香港交易所

INSIDE FIXED INCOME AND CURRENCY MONTHLY NEWSLETTER

February 2016

Issue No 14

MONTHLY HIGHLIGHTS

- On 23 February 2016, the People's Bank of China (PBOC) announced that most types of overseas financial institutions will no longer require quotas to invest in the interbank bond market, which accounts for the bulk of debt in the nation.
- HKEX's USD/CNH futures contract had an average daily volume, or ADV, of 3,733 contracts (US$373 million notional) in February 2016, an all-time high and a 14 per cent increase from January 2016. The after-hours trading volume was 1,311 contracts (US$131 million notional) on 11 February 2016, an all-time high, surpassing the previous record in August 2015.
- The Chinese Bankers Survey of 2015, led by Dr.Ba Shusong, HKEX's Chief China Economist, gathered important information from the industry, including views on the Chinese financial market.
- In the Expert Corner, Frances Cheung of Societe Generale says that while liquidity management tools are used by the PBOC at the moment, reserve requirement cuts and lower rates are still needed due to the weakening economic growth outlook.

FROM THE CHIEF CHINA ECONOMIST'S VANTAGE POINT

CHINESE BANKS TO UNDERGO PROFOUND TRANSFORMATION

Dr. Ba Shusong, Chief China Economist, HKEX

Note: The Chinese Bankers Survey of 2015, led by Dr.Ba Shusong, has summarised some of the major updates from the sector including various views held on the Chinese financial market. Those views reflect how Chinese bankers think about their sector can adapt to the economic structural adjustment and undergo corresponding business transformation. More than 1,300 questionnaires were completed in the survey. Below are some of the key findings.

During 2015 the fragile global recovery combined with weak domestic demand to exerted downward pressure on the economy and intensified structural imbalances, resulting in ongoing uncertainty and instability. There was also a clear mismatch between under-developed new economic drivers and depleted older ones. The Chinese banking sector found itself in a more complex environment, with increasing risks and challenges due to the continuing economic downturn, further interest rate liberalisation and intense competition from internet finance. Narrowing interest rate spreads, a rebound in non-performing assets and slowing profit growth had become widespread across the whole sector. Net profit growth in the big four state-owned banks was lower than 1 per cent in Q3, while that in most joint-stock banks was only in single digits. But this might just be the beginning of the ordeal. How Chinese banks can adapt to their economy's structural adjustment and undergo corresponding business transformation deserves our sustained thinking and exploration.

1. Bankers' macroeconomic and market expectations

1.1 Growing concerns over structural imbalance as projected growth continued to fall

Economic growth in China has entered a new normal. The old economic model will give way to a new one as part of economic transformation under the 13th Five- Year Plan. As new industries replace old ones, bankers were concerned about China's economic growth prospects. Their projection for growth in the past few years' survey continued to fall. In the survey of 2015, 82.5 per cent of bankers estimated that GDP growth in the next three years would range from 6.5 per cent to 7.5 per cent, and of those, 52.4 per cent said the growth should range from 6.5 per cent to 7.0 per cent; while 14.9 per cent of bankers believed growth should be less than 6.5 per cent. Structural imbalances, overcapacity and regional debts were among these bankers' top concerns. (continued on page 6)

Fig 1: Bankers' Views on China's GDP Growth for the Next Three Years

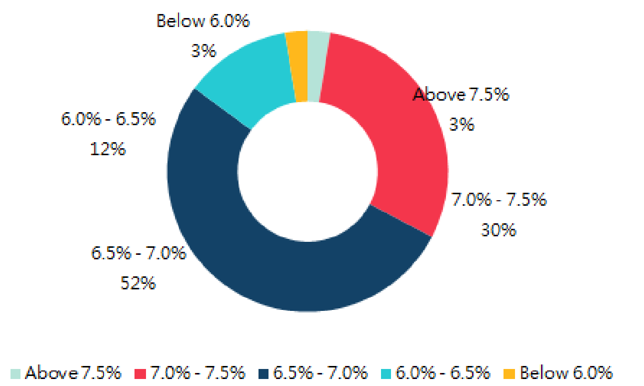


Fig 2: Bankers' Views on Major Issues Facing Chinese Economy

Sources: HKEX, Chinese Bankers' Survey 2015

CHINA MACRO UPDATE

Fig 3: China New Loan Breakdown

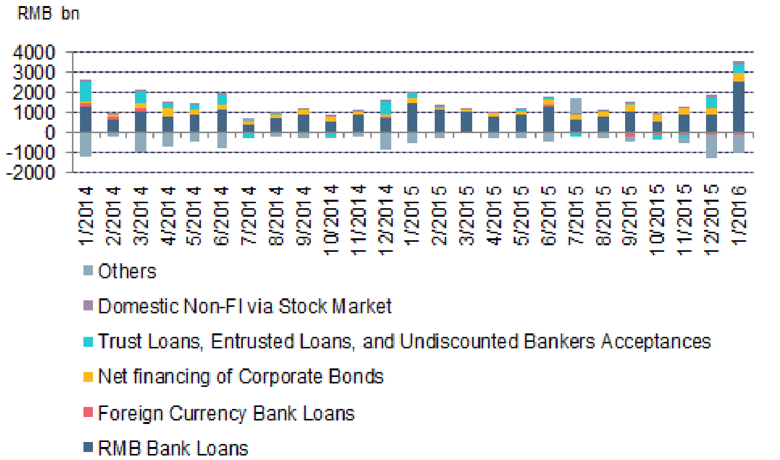


Fig 4: Macro-Economic Climate Index

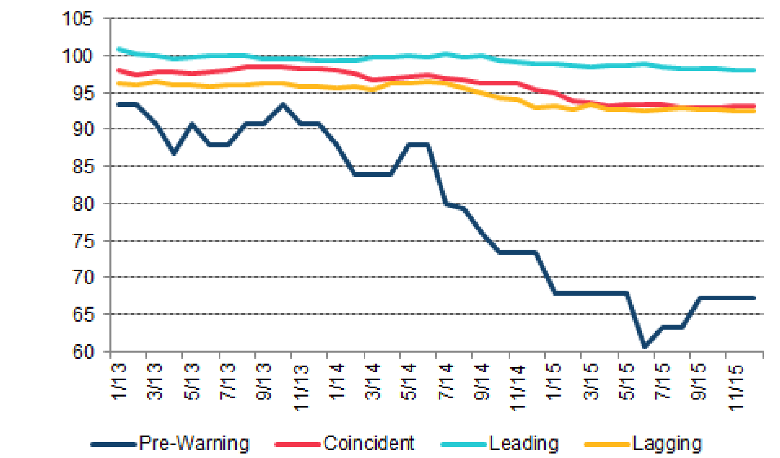


Table 1

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.8	6.9	⇩	04/15/2016 10:00
CPI (yoy %)	1.8	1.6	⇧	03/10/2016 09:30
PPI (yoy %)	-5.3	-5.9	⇧	03/10/2016 09:30
Industrial Production (yoy %)	5.9	6.2	⇩	04/15/2016 10:00
FAI (yoy %)	10	10.2	⇩	03/12/2016 13:30
Foreign Investment (yoy %)	3.2	-5.8	⇧	03/08/2016 03/12
CFLP Manufacturing PMI	49	49.4	⇩	04/01/2016 09:00
PBOC Bankers Confidence Index	37.9	40.6	⇩	TBC
PBOC Bankers Loan Demand Index	56.8	56.7	⇧	TBC
CEMAC Leading Economic Index	98.12	98.12	⇨	03/28/2016 03/31
Exports (yoy %)	-11.2	-1.4	⇩	03/08/2016
Imports (yoy %)	-18.8	-7.6	⇩	03/08/2016
M2 Money Supply (yoy %)	14	13.3	⇧	03/10/2016 03/15
Retail Sales (yoy %)	11.1	11.2	⇩	04/15/2016 10:00
Consumer Confidence Index	111.3	114.9	⇩	03/30/2016 09:45
Regulated Reserve Ratio (%)	17.5	18	⇩	Infrequent
Official Foreign Exchange Reserves (USD bn)	3230.89	3330.4	⇩	03/07/2016
Three-Month SHIBOR (%)	2.86	3.01	⇩	Continuous
10-Year Gov't Bond Yield (%)	2.89	2.83	⇧	Continuous
CNY/USD Exchange Rate	6.549	6.563	⇩	Continuous

REGULATORY/POLICY DEVELOPMENTS

- China's aggregate financing rose to RMB3.42 trillion (US$525 billion) in January 2016, according to a report from the PBOC on 16 February 2016. Chinese bank loans exploded to RMB2.51 trillion, up from RMB832.3 billion in December and a new high record. Corporate bond issuance increased, rising to RMB454.7 billion from RMB356 billion in December 2015. The increase in new loans was helped by banks front-loading their 2016 lending targets, strong corporate bond issuance, and companies switching foreign currency loans into Renminbi, or RMB, loans.
- The PBOC said on 23 February 2016 that most types of overseas financial institutions will no longer require quotas to invest in the interbank bond market, which accounts for the bulk of debt in the nation. This is a major step for China toward giving foreigners free access to the world's third-largest bond market.
- The PBOC on 18 February 2016 announced that it will carry out open market operations on a daily basis. The decision, which gave the central bank more flexibility in pumping money into the financial system, came just days after it temporarily increased the frequency of the operations to every working day from twice-a-week before the Lunar New Year holidays.

MACRO ECONOMIC UPDATE

- China is on the right economic path and will probably avoid a hard landing, said International Monetary Fund chief Christine Lagarde. "This is a big transition of a business model, moving from heavy manufacturing to lighter manufacturing and also a bit less predominantly export-driven," Lagarde said at forum in Dubai on 23 February 2016. She also praised China's parallel move from investment to consumption.

MARKET/PRODUCT DEVELOPMENTS

- Shanghai Pudong Development Bank issued China's first 'green bonds'. The RMB20 billion (US$3 billion) of 3-year bonds yields 2.95 per cent. The PBOC unveiled a framework for green bonds in December 2015.
- Export-Import Bank of India announced to raise US$300 million from Chinese financial markets through panda bonds to meet demand for credit.

KEY RESEARCH REPORTS/CONFERENCES

- China should open its bond market to more foreign investment and develop derivatives and inflation-linked products to improve the implementation of monetary policy, according to a PBOC working paper. The government needs to consider increasing the quota given to Qualified Foreign Institutional Investors and relaxing controls to allow more overseas institutions to enter the interbank debt market in order to boost trading, wrote researchers led by Ma Jun, the Chief Economist at the PBOC's Research Bureau.

  http://www.pbc.gov.cn/yanjiuju/124427/133100/3020256/3020260/index.html

RMB FX MARKET DYNAMICS

OFFSHORE RMB FX MARKET COMMENTS

- China's onshore CNY market reopened on 15 February 2016 with strong CNY fixing after the week-long Lunar New Year holiday. CNY surged by 1.2 per cent to a two-month high of 6.4893.
- Over the month, CNY fixings moved between 6.5118 to 6.5539, passing two-way FX volatility through to the offshore CNH market.
- The CNH-CNY spread remained tight, which made the PBOC comfortable enough to allow some manageable fluctuations. In our view, as long as the central bank believes the market has stabilized, it will allow more two-way volatility with reference to a basket of currencies.

Fig 5: Onshore/Offshore RMB Price Range

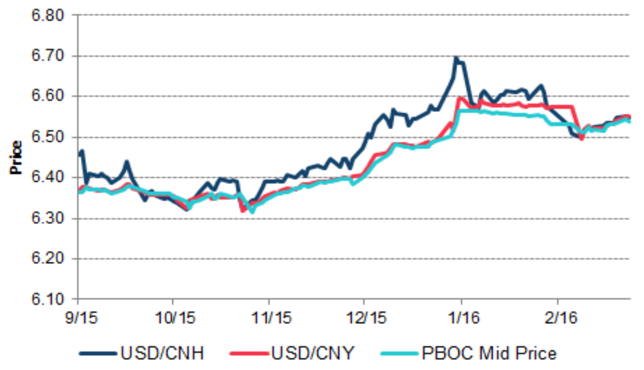


Fig 6: Implied Volatilities of OTC USD/CNH ATM Options

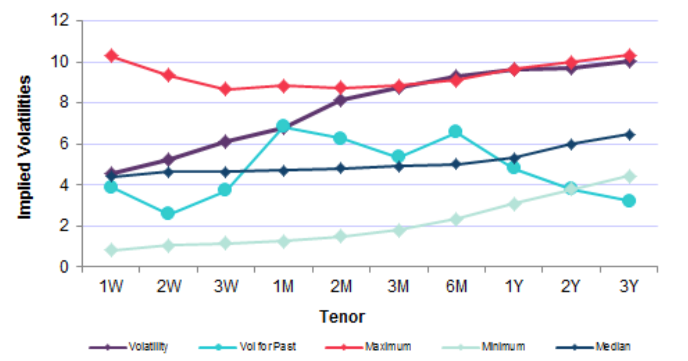
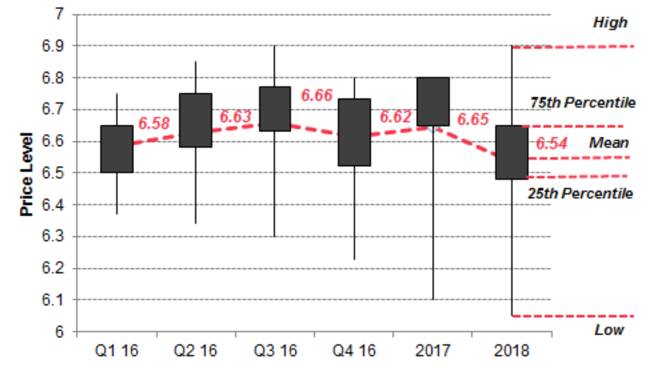


Fig 7: Market Forecasts for the Level of USD/CNH



HKEX'S USD/CNH FUTURES

PRODUCT HIGHLIGHTS

- HKEX's USD/CNH futures contract had a record high volume of 3,733 contracts (US$373 million notional) in February 2016. ADV was up 14 per cent from January 2016. The after-hours trading volume was 1,311 contracts (US$131 million notional) on 11 February 2016, an all-time high, surpassing the previous record in August 2015.
- Trading volume was high in the December 2016, March 2017 and September 2016 contracts, which accounted for 49 per cent of total volume in February 2016. Open interest was high in the December 2016, June 2016 and March 2017 contracts, which accounted for 70 per cent of total open interest at the end of February 2016.

Fig 8: USD/CNH Futures Turnover and Open Interest

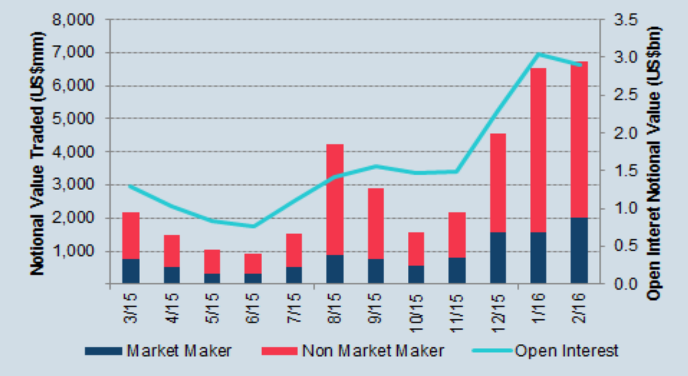


Fig 9: HKEX USD/CNH Futures Contract Provides Best Liquidity Amid Volatility

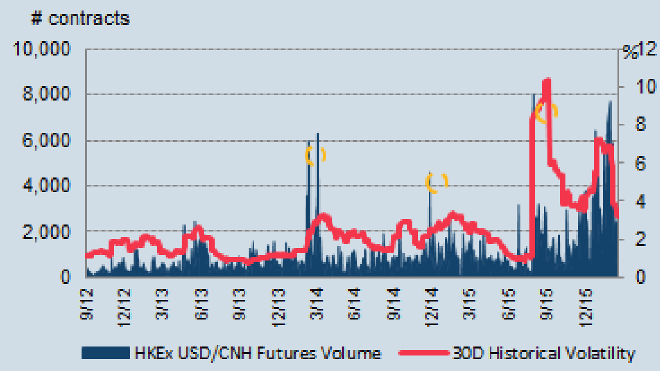


Fig 10: Breakdown of Volume by Contract Month (2/2016)

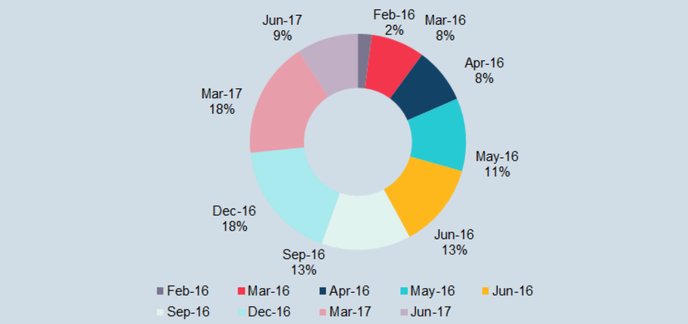
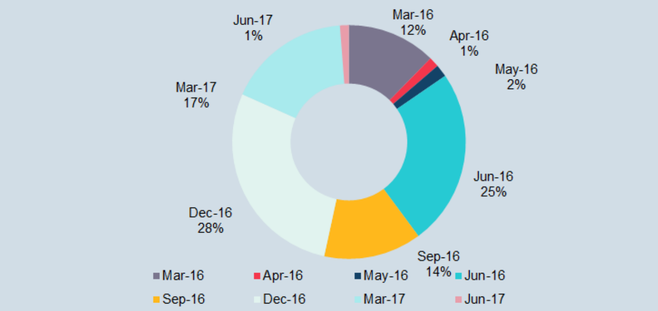


Fig 11: Breakdown of OI by Contract Month (29/2/2016)



OFFSHORE BOND MARKET DYNAMICS

OFFSHORE RMB BOND MARKET COMMENTS

- There were no primary issues in CNH in February 2016, as the market lost its appeal to Mainland developers, which are looking instead to the onshore market for their fundraising needs. Mainland real estate firms had been the backbone of the dim sum bond market, accounting for 10 per cent of the market last year.
- RMB deposits in Hong Kong increased by 0.12 per cent month-on-month to RMB852.1 billion at the end of January 2016. The total remittances of RMB for cross-border trade settlement amounted to RMB480.1 billion in January 2016, compared to RMB667.5 billion in December 2015.

Fig 12: Offshore RMB Deposits vs Outstanding Dim Sum Bonds

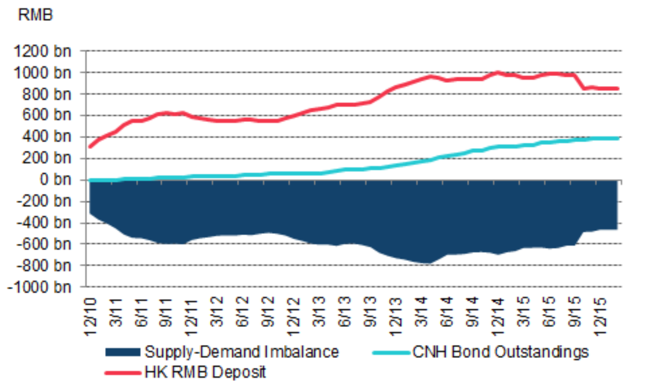


Fig 13: RMB Bond Issuances by Issuer Type

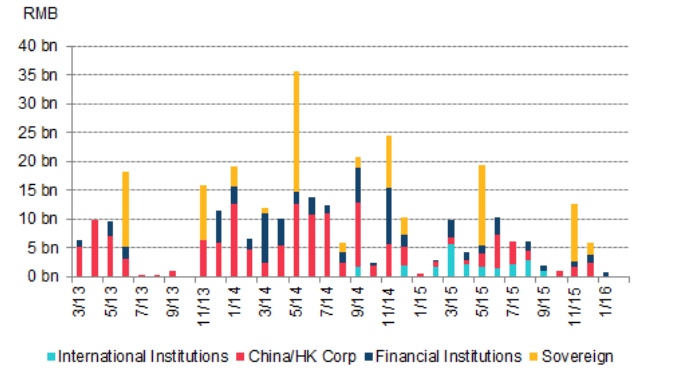
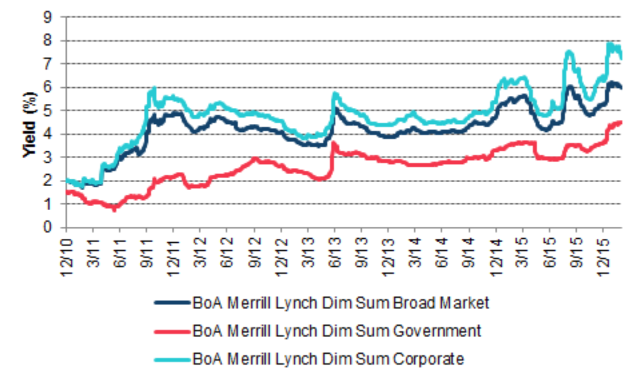


Fig 14: Dim Sum Bond Performance



ONSHORE BOND MARKET DYNAMICS

ONSHORE RMB BOND MARKET COMMENTS

- Onshore bond issuance decreased 14.7 per cent to RMB2.4 trillion in February 2016 from RMB2.8 trillion in January 2016.
- Mainland developers issued a total of RMB703 billion (US$107 billion) in bonds onshore last year, up from RMB262 billion in 2014, according to data from Wind. Beijing in June 2015 allowed real estate developers to issue bonds on the domestic Exchange Bond Market, ending a six-year hiatus.

Fig 15: MoF T-Bond Yield 5Y: Onshore vs Offshore (%)

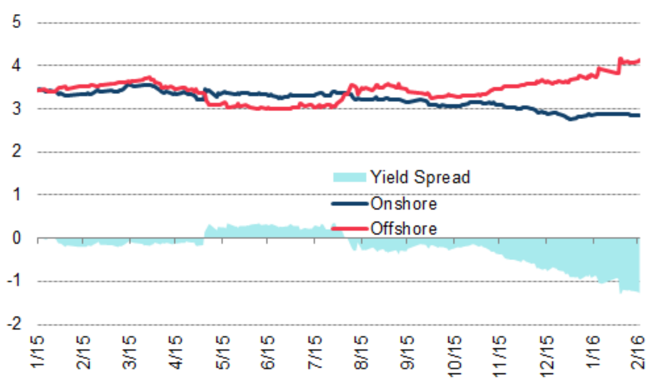


Table 2

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	23,113	26,658.76	2.9566
Treasury Bond	5,226	5,576.60	2.5919
Medium-term Note	8,244	6,083.65	4.6216
Corporate Bond	6,473	3,934.29	4.5883
CDs	2,764	6,831.30	3.0469
Commercial Paper	10,665	9,102.30	3.6618
Central Bank Paper	38	75.92	2.7468
Others	2,047	2,178.43	4.0572
Total	**58,570**	**60,441.25**	**3.4156**

Fig 16: MoF T-Bond Outstanding Split by Tenor

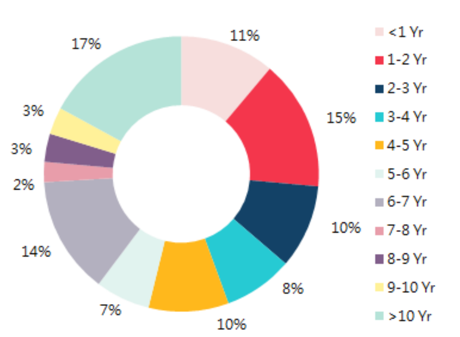


Table 3

NAFMII Guidance for Non FI Debt Issuing (as of 2016/2/29)																
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.09	↓	3.62	↓	3.86	↓	4.19	↓	4.44	↑	5.02	↑	5.19	↑	5.46	↑
AAA	3.28	↓	3.78	↓	4.04	↓	4.51	↑	4.74	↑	5.35	↑	5.61	↓	5.91	↑
AA+	3.49	↓	4.13	↓	4.53	↓	4.99	↓	5.39	↑	5.97	↑	6.33	↓	6.64	↑
AA	4.00	↓	4.66	↓	5.10	↓	5.64	↑	5.96	↑	6.65	↓	7.00	↓	7.46	↓
AA-	5.38	↓	5.97	↓	6.47	↓	7.37	↑	7.84	↑	8.34	↑	8.71	↓	9.00	↑

ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- The overnight TMA CNH HIBOR jumped 431 bps to 9.3 per cent on 19 February 2016, as offshore RMB liquidity tightened up significantly.
- The CNH HIBOR yield curve looked steeper at the end of February this year than it did at the end of February and August of last year (see Figure 19).
- The PBOC adopted daily open market operations, which will increase the central bank's flexibility in liquidity management and reduce its reliance on traditional easing tools such as reserves requirement cuts.

Fig 17: CNH Implied Yield vs. USD/CNH

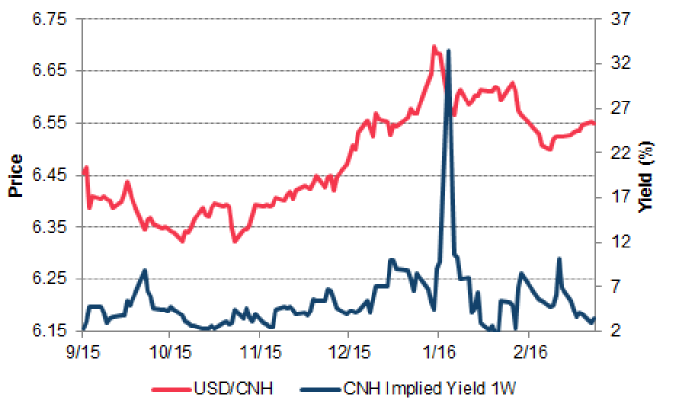


Fig 18: CNY SHIBOR Yield Curves

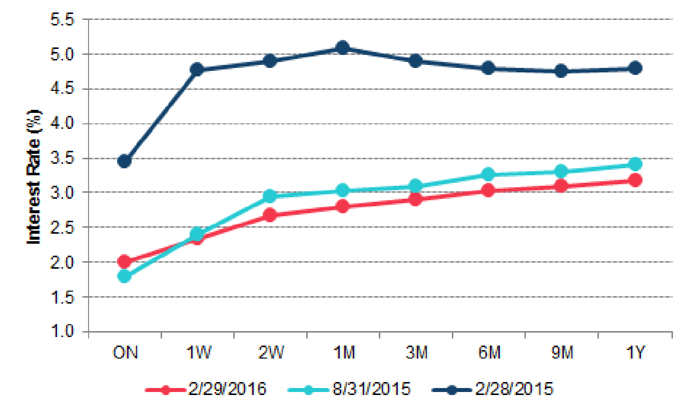


Fig 19: CNH HIBOR Yield Curves

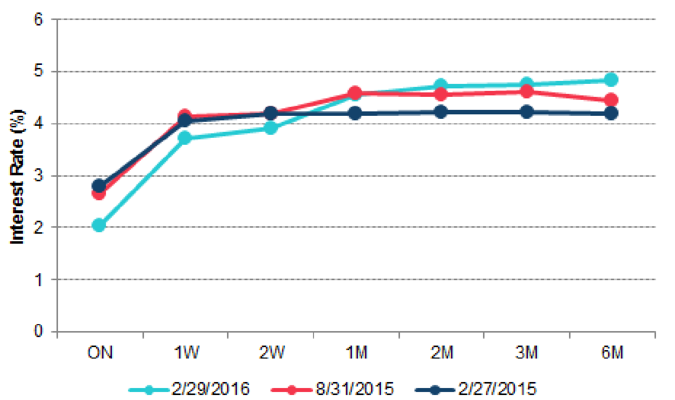


Fig 20: Onshore IRS (7D Repo) Yield Curves

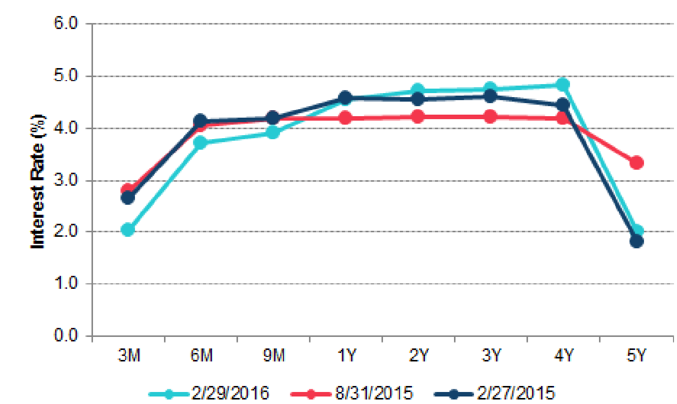


Fig 21: Onshore IRS Trading Notional Principal

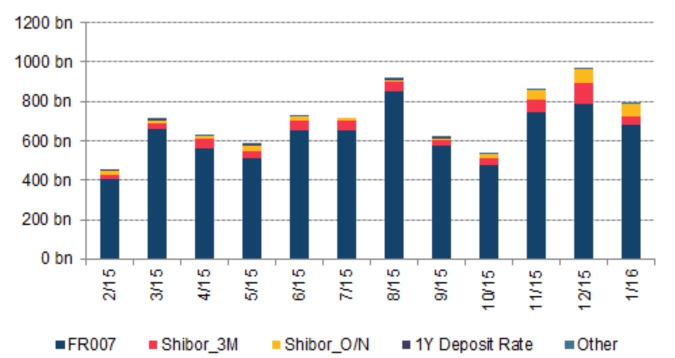


Fig 22: CNY SHIBOR vs CNH HIBOR

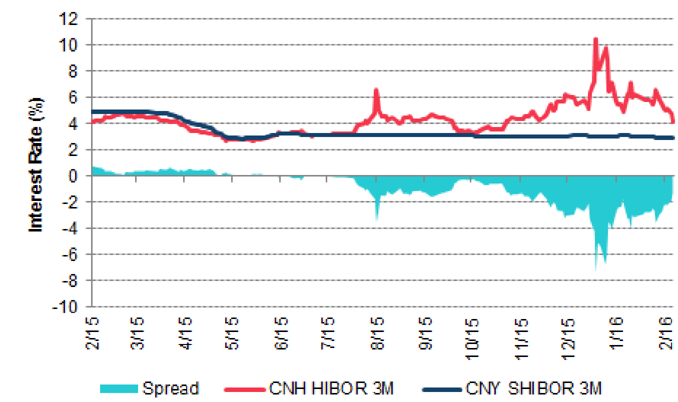
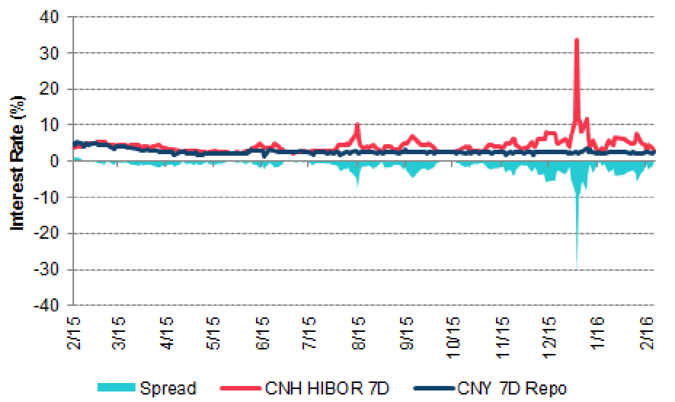


Fig 23: CNY 7D Repo vs CNH HIBOR



(Continued from page 1)

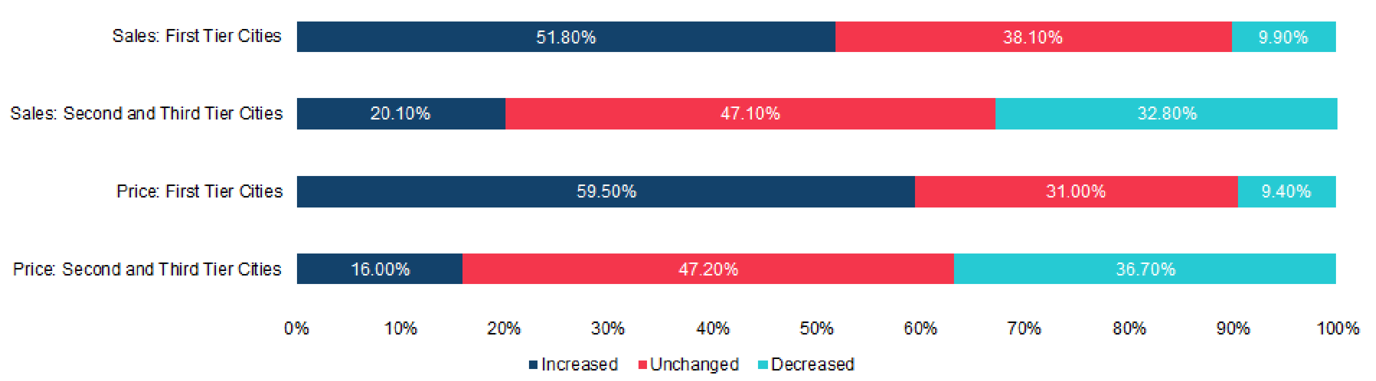
1.2 The inflection point of the property market has arrived with apparent divergence in market expectations

The golden age of China's property market is over. The turning point of bankers' expectation for the property market came in 2014 after which bankers began to adopt a cautious attitude towards the property market. Although the sales volume in the property market had improved after the implementation of the new policy for the property market in 2015, it did not change bankers' pessimism about the property market. Compared with their views in 2014, bankers now expected even greater divergence across different cities. More than half of bankers surveyed believed volumes and prices in first-tier cities would continue to rise in the coming year, but they were generally pessimistic about volumes and prices in second- and third-tier cities.

1.3 Bankers were very concerned about financial system reform, interest rate liberalization attracted the most attention from bankers, and the narrowing of interest rate spreads was cited as a challenge

Bankers were very concerned about the impact of financial system reform on the business operation of commercial banks. Interest rate liberalization (91 per cent) attracted the most attention from bankers. As the interest rate liberalization enters a new phase, it is important for Chinese banks to speed up their business transformation, further modify their profit structure and optimise their profit model to cope with the impacts. Bankers thought a variety of measures should be used to meet the challenges posed by the narrowing of interest rate spreads. While 90 per cent of bankers believed the balance sheet adjustments should gather pace, 76.8 per cent thought the pricing management should be enhanced, 75.2 per cent said the income structure should be modified and 67.2 per cent believed the customer structure should be adjusted.

Fig 24: Bankers' Views Towards Property Market in the Coming Year



1.4 Bankers' rising concern about industrial structural adjustment and technological innovation

Structural adjustment of industry was bankers' principal concern (73.5 per cent) among various socio-economic developments, a sharp increase from 2014 (56.9 per cent). Bankers' concerns about the technological innovation and advancement also shot up, increasing from 23.4 per cent in 2014 to 41.4 per cent in 2015.

Fig 25: Bankers' views on how banks should cope with narrowing of interest rate spreads

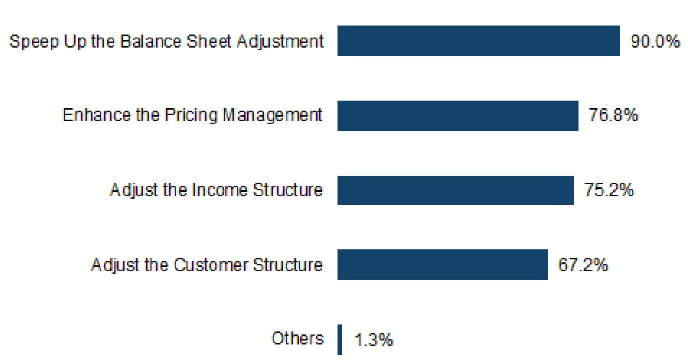
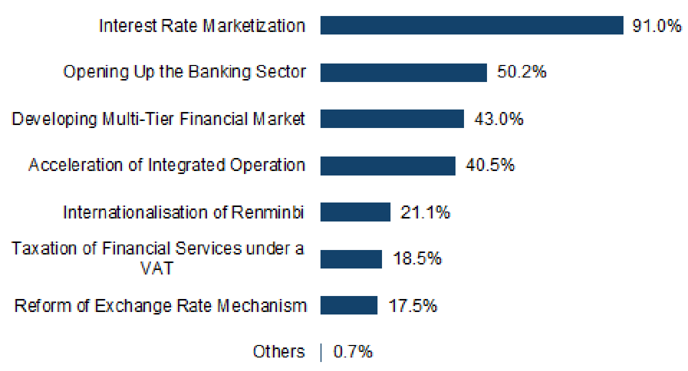


Fig 26: Impacts of Various Financial Reforms on Banking Business



2. New trends in strategic and structural adjustment at commercial banks

In 2015, China's banking industry encountered challenging conditions for asset quality. The balance of non-performing loan and non-performing loan ratios continued to increase in Q3 for most listed banks. Bankers were most concerned about credit risks from industries with overcapacity. The metallurgical industry was expected to have the highest non-performing loans, and was listed tops on credit restrictions.

Moreover, bankers continued to lower their expectations for operating income and after-tax profit in the next three years. About 80 per cent of bankers estimated their growth rate would be lower than 15 per cent and about 60 per cent of bankers expected it to be lower than 10 per cent, while only 30 per cent of bankers held the same expectation in 2014.

Rising non-performing loans, narrowing interest rate spreads and pressures on profits have prompted active strategic adjustment among commercial banks:

2.1 Support for large-scale entrepreneurship and innovation and focus on micro finance

Looking at corporate finance, loans to small and micro-sized enterprises (64.7 per cent) have been the top priority for bankers for four consecutive years. 86.2 per cent of bankers said large-scale entrepreneurship and innovation could encourage a further upgrade of the financial services they provide to small and micro businesses. 89.1 per cent believed that banks have more advantages in comprehensive financial services. When providing financial support to entrepreneurs, the most important qualities that bankers were looking for are experience of start-ups (91.3 per cent), technology content and development potential (89.6 per cent), and credit status (87.7 per cent).

2.2 Support for FTZ (Free Trade Zone) business and focus on cross-border activities

Bankers saw a double benefit from FTZs, as they enable banks to support and comply with state strategy (66.9 per cent) while also broadening their profit channels (45.6 per cent). Regarding the business for supporting FTZs, 60 per cent of bankers chose cross-border settlement, 50.2 per cent of bankers chose cross-border investment and financing, and 31.8 per cent of bankers chose cross-border financial management.

2.3 More attention to innovation in rural financial products

According to the survey, 77 per cent of bankers believed lack of diversification in the types of financial services offered was the biggest weakness of rural finance in China. When supporting agriculture, 80.3 per cent of bankers focused on innovative rural financial products, 60.6 per cent on increasing rural credit and 50.8 per cent sought to improve the branch network of rural financial institutions.

Fig 27: Highlights of Banking Business that Support the Development of FTZs in 2015

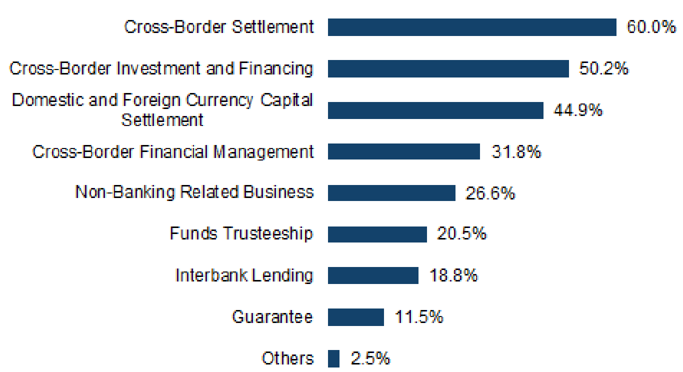
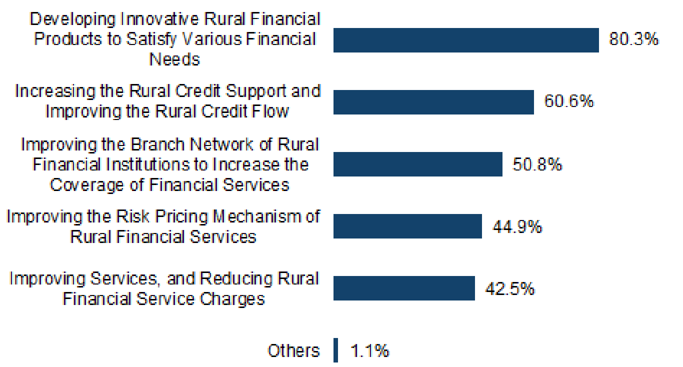


Fig 28: Work Highlights that Support the Development of "the Three Elements Concerning Agriculture, Rural Areas, and Farmers" by Banks in 2015



2.4 Increased internationalisation with focus on supporting the “One Belt One Road” national strategy

Chinese enterprises’ pursuit of overseas exposure by and the acceleration of the RMB’s internationalisation have provided ample opportunities for the Chinese banking sector to become more international. 70 percent of bankers surveyed thought overseas pursuits of Chinese banks are mainly aimed at serving national strategies such as “One Belt One Road”. Besides that, enhancing product and business models to serve Chinese enterprises’ overseas expansion and the development of professionals with an international profile were also seen as important. That shows Chinese banks’ overseas pursuits were not only related to national

Fig 29: Highlights of Oversea Business Developments of Chinese Banks

Sources: Chinese Bankers’ Survey 2015

economic strategies but are also aimed at improving customer services, and developing and enhancing products, services and talent.

2.5 Personal loans and wealth management have become major components of personal finance business

Personal loans were the primary component of China's personal financial business for the third consecutive year, according to the 2015 survey. Bankers who cited such loans rose from 61.6 per cent in 2014 to 68.7 per cent in 2015. Wealth management was the second most important component for the third consecutive year, while bankers mentioned their credit card business went from 48.8 per cent in 2014 to 55.1 per cent in 2015. On their attitude towards the credit card business, over 70 per cent of bankers said there should be greater development efforts or appropriate expansion, while less than 10 per cent saw a need for some contraction or stricter control.

2.6 Asset management as the main driver of transformation for banking business

In their attitude towards the development of asset management in China, more than 80 per cent of bankers thought there should be greater development efforts or appropriate expansion in China. Almost half of banks (48 per cent) saw asset management was the main driver of transformation for the banking business, 15 per cent thought it was a key channel to expand other business and 15.6 per cent said it was a new driver of profit growth.

2.7 Consolidation of operations is increasingly common, while consumer finance and financial leasing have become development priorities

As China's financial services continue to change, indirect financing is declining while direct financing is increasing, and the consolidation of operations has become significant in the strategic planning of many banks. On the focus of consolidation, consumer finance (70.8 per cent) and financial leasing (59.2 per cent) were high priorities for many bankers. Of the major difficulties faced by banks in consolidating their operations, the risk of complications and inadequate overall risk management capabilities (71.4 per cent), and a shortage of business consolidation experts to support development (70.3 per cent) were considered to be the two biggest obstacles.

EXPERT CORNER

RMB RATE STATES: PBOC LIQUIDITY MANAGEMENT

Contributed by Frances Cheung, Head of Rates Strategy, Asia ex-Japan at Societe Generale

The PBOC stepped up its liquidity operations – injections – in the two weeks into the Chinese New Year via open market operations (OMOs) and via other tools including standing lending facility (SLF) and medium-term lending facility (MLF). The central bank also decided to carry out daily OMOs if needed – initially between 29 January and 19 February, but later on this is decided to be a regular practice.

With monetary policy currently constrained by the inflexible currency and capital outflows pressure, the PBOC is actively adopting other liquidity management tools to offset the tightening inflicted by FX reserve selling. That said, higher frequency of OMOs does not necessarily point to more liquidity injections. Rather, the aim appears to be to increase the flexibility when OMOs react to the changing liquidity conditions in the market. After the Chinese New Year, the PBOC initially mopped up a significant portion of the liquidity it previously injected, before releasing more back as market liquidity became tight. Looking ahead, we believe the PBOC will continue to support liquidity when needed, which should help prevent spikes at short-end CNY rates. But these operations alone do not point to much downside to rates either. Money market rates are likely to trade in the range of 2.0-2.5% in the next few weeks.

The CNY IRS curve is likely to remain flat, as long as the worries over China's growth outlook linger, before steepening when the market pays more attention to supply risk in particular from local government bonds (LGBs), and when the market starts to price in more aggressively the prospect for looser monetary policy. While liquidity management tools are used at the moment, RRR cuts and lower rates are still needed with the weakening economic growth outlook. We expect a 50bp reduction in the OMO 7-day reverse repo rate and a total of 150bp cut (of which a 50bp cut was already announced) in headline RRR.

The potential supply of LGBs, in the order of CNY3-4trn or more per year, is significant compared with the usual CNY1.5-1.6trn gross annual issuance of CGBs (China Government Bonds - mainly by the central government prior to 2015). The repo transaction in the interbank market using LGBs as collaterals has become increasingly active since early 2015. While arguably the higher supply of LGBs upon the debt-swap program can lead to more of this instrument being used, the sign of potential leveraging for cash bond purchases cannot be ignored. Notably, CGB cash bond transactions rose alongside LGB repo transactions. We do not observe such a relation between other types of cash bond transactions and LGB repo transactions. A relation per se does not suggest causality but this leads us to be even more cautious against the huge LGB supply this year. Mid-to-long tenor CGB yields – where LGB issuance is likely to be the heaviest – should ultimately move up to reflect this supply risk.

In the offshore CNH market, CNH CCS (cross-currency swaps) can remain elevated amid policy uncertainty, especially uncertainty on regulations on cross-border flows and CNH business. For example, any further curb on lending will reduce the money multiplier and tighten CNH liquidity. Apart from the liquidity situation, FX expectation is another, and probably a more important, factor driving CNH CCS. We normally see spikes in CNH CCS as temporary. However, the CNH CCS curve is not functioning purely as an interest rate curve at the moment. If market continues to expect CNH depreciation, forward points and CNH CCS will stay high.

The CNH CCS curve shape depends pretty much on how front-end rates move while mid tenors should be relatively stable, with a likely lack of asset swap or issuer flows amid the quiet dim sum market. When risk-aversion is heightened, the CNH CCS curve is likely to bearish flatten – become more inverted with front-end CNH rates going higher more rapidly. CNH CCS and CNY IRS may not necessarily converge given the different nature of the two rates.

Frances Cheung has 15 years of experience in providing investment and economic research, as well as offering advice. Before joining Societe Generale Corporate & Investment Banking (CIB), Frances was Head of Asian Rates Strategy at Credit Agricole CIB. Prior to that she worked at Standard Chartered Bank, Primasia Securities (Asia) Limited and the Hong Kong SAR Government. Frances was named Best Interest Rate Research Analyst in the Asiamoney Fixed Income Poll 2012, 2013 and 2014, and Best Local Currency Analyst in FinanceAsia's Fixed Income Research Poll 2012 and 2013.

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