HKEX 香港交易所

INSIDE RMB FIXED INCOME AND CURRENCY MONTHLY NEWSLETTER

August 2016 Issue No 20

MONTHLY HIGHLIGHTS

- TR/HKEX RXY Global CNH Index fell 0.74 per cent to 95.14 while the People's Bank of China (PBOC) USD/CNY Fixing increased 0.60 per cent to 6.6908 in August 2016.
- HKEX's Chief China Economist, Dr Ba Shusong, sees that China's economy is still testing its bottom at the current stage, and greater flexibilities in RMB exchange rate policy has provided leeway for China's economic policies to accommodate external fluctuations.
- In the Expert Corner, CITIC Securities' Chief Analyst of Fixed Income Research, Mr Ming Ming, looks at the bond market and its outlook from the perspectives of macroeconomics, overseas development, policies, bond strategies and asset allocation.

FROM THE CHIEF CHINA ECONOMIST'S VANTAGE POINT

A New Stage for China's Economy: New Cyclical and Structural Features Transfer

Dr Ba Shusong, Chief China Economist, HKEX

1. China's economy testing its bottom again post a short first quarter recovery

Current Mainland economic trends can be analysed based on comparisons with historical Mainland economic performance. China's economy dipped to a cyclical bottom during the Asian financial crisis after which China adopted a series of reform and opening up measures, such as joining the World Trade Organisation (WTO), reforming state-owned enterprises (SOEs), listing state-owned banks after stripping off their non-performing assets and reforming their shareholder structure, and developing the property market. These measures fuelled the longest growth cycle ever experienced by the Mainland since China's reform and opening up. The cycle peaked in 2007 before falling steeply against the US subprime mortgage crisis in 2008 and dipped down to a cyclical trough in 2009. After 2009, driven by a bundle of economic stimulus measures led by the RMB 4tn fiscal stimulus plan, the Mainland economy witnessed a V-shape rebound and reached a cyclical peak in 2010 Q1. Economic growth slowed gradually as the stimulus momentum weakened afterwards. And I see China's economy is still testing its bottom at the current stage. The recovery in the first quarter of 2016 was mainly backed by the short-term recovery of the property market, and an increase in fiscal expenditure due to growing land income. As the property sector enters a periodic adjustment stage, China's economy is expected to see another downtrend cycle.

The most prominent feature of the "new normal" is the beginning of structural transformation in China's economy where new growth engines are being formed while old drivers are gradually phasing out. In a period of economic transformation, it is most important to seize the trend of industrial structure changes . In the 13th Five-Year Plan, this stage of economic movement is summarised as growth pace change, structure optimization and growth driver transformation, where economic growth slows down and economic structure upgrades to be better-balanced. Various changes in current internal and external environments also pushes China to seek new drivers for its economic growth. In short, factors boosting the rapid growth of China's economy in the past 30 years are fading. These include the demographic dividend, investment dividend, trade dividend, resources dividend and savings dividend. The so-called "transformation" is about finding new drivers for economic growth.

2. The focus of economic policies needs to return to supply-side reform

To put it in another way, supply-side reform can be described as a multiple-stages transformation from primary expansion as the first stage, to "after benchmarking" which targets to narrow the gaps as the second stage, to breakthroughs and innovative growth as the third stage. In other words, economic transformation is the movement of growth from primary expansion to after benchmarking and then to frontier exploration.

In the face of changing internal and external environments, China's policymakers experienced such a process in which they gradually came up with corresponding countermeasures against the series of changes. The first phase began in May 2014, policymakers first advanced the idea that "China's economy is entering a 'new normal' phase" and defined the "new normal". The second phase began in October 2015, at the 5th Plenary Session of the 18th Communist Party of China (CPC) Central Committee, five development concepts were put forth: innovation, coordination, green, opening and sharing. These could be interpreted as new beliefs held by decision makers when they are coping with the evolving internal and external environments. In November 2015, the Central Leading Group for Financial and Economic Affairs formally called for supply-side structural reforms at its 11th meeting. It helped further clarify China's recent policy focus.

In the short run, cutting excessive industrial capacity, de-leveraging and destocking will remain the focus of China's macroeconomic policies.

(to be continued on page 9)

CHINA MACRO UPDATE

Fig 1: Chart of the Month: TR/HKEX RXY Reference CNY vs China Export Growth

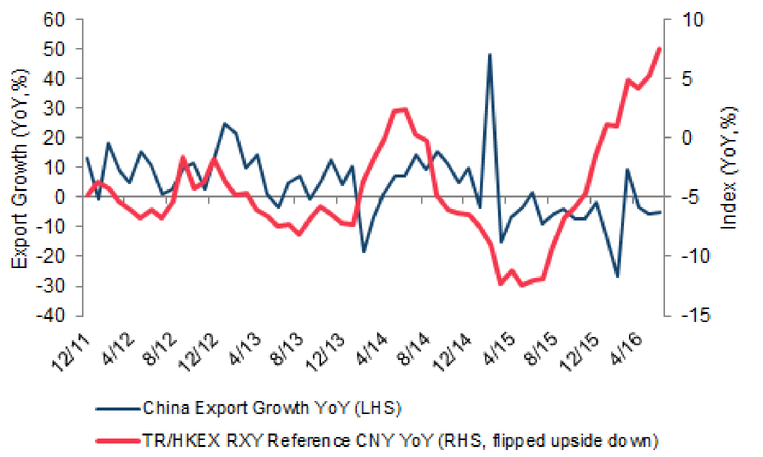
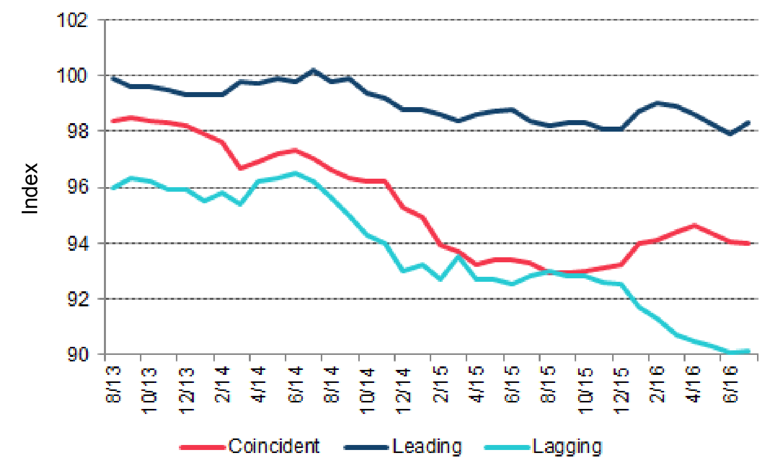


Fig 2: China's Macro-Economic Climate Index



- The coincident index is the index reflecting the current basic trend of the economy, and it is calculated using the following data: (1) industrial production; (2) employment; (3) social demands (including investment, consumption and foreign trade); and (4) social incomes (including the government taxes, profits of enterprises and income of residents).
- The leading index is calculated using a group of leading indicators, which take a lead before the coincident index, and is used for forecasting the future economic trend.
- The lagging index is calculated using the lagging indicators, which lag behind the coincident index, and is mainly used for confirming the peak and trough of the economic cycle.

TABLE 1

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.7	6.7	⇨	19/10/2016
CPI (yoy %)	1.8	1.9	⇩	09/09/2016
PPI (yoy %)	-1.7	-2.6	⇧	09/09/2016
Industrial Production (yoy %)	6.0	6.2	⇩	13/09/2016
FAI (yoy %)	8.1	9	⇩	13/09/2016
Foreign Investment (yoy %)	-1.6	9.7	⇩	08/09/2016
CFLP Manufacturing PMI	50.4	49.9	⇧	01/09/2016
PBOC Bankers Confidence Index	43.7	38.1	⇧	TBC
PBOC Bankers Loan Demand Index	56.7	62.7	⇩	TBC
Share of Payments via SWIFT in CNY (%)	1.9	1.72	⇧	29/09/2016
Exports (yoy %)	-4.4	-4.8	⇧	08/09/2016
Imports (yoy %)	-12.5	-8.4	⇩	08/09/2016
M2 Money Supply (yoy %)	10.2	11.8	⇩	10/09/2016
Retail Sales (yoy %)	10.2	10.6	⇩	13/09/2016
Consumer Confidence Index	111.5	114	⇩	28/09/2016
Regulated Reserve Ratio (%)	17.5	18.0	⇩	Infrequent
Official Foreign Exchange Reserves (USD bn)	3201.1	3205.2	⇩	07/09/2016
Three-Month SHIBOR (%)	2.79	2.86	⇩	Continuous
10-Year Gov't Bond Yield (%)	2.80	2.82	⇩	Continuous
USD/CNY Exchange Rate	6.68	6.69	⇩	Continuous
TR/HKEX RXY Global CNH Index	**95.14**	**95.85**	⇩	**Continuous**

Sources: Bloomberg, WIND, HKEX, Thomson Reuters, SWIFT
(31 August 2016)

CHART OF THE MONTH

- The TR/HKEX RXY Reference CNY index has been inversely correlated with China's exports in the past. The index, which measures the strength of the RMB against a basket of 13 currencies, descended to 94.44 on 26 August 2016, the lowest since inception, following a steady declining trend since late last year. In the meantime, China's year-on-year (YoY) export growth figure has rebounded from its trough in March 2016.

REGULATORY/POLICY DEVELOPMENTS

- The China Banking Regulatory Commission (CBRC) responded to a proposal from Chinese people's Political Consultative Conference (CPPCC) on 23 August 2016, stating that commercial banks, a major player of Treasury bond (T-bond) spot market, will remain outside of the trading of T-bond futures. Given the increasing bond defaults recently and the relatively higher market volatility in the futures market, relevant regulators are now making research to tighten regulations, said the CBRC.
- The PBOC said it planned to push the RMB's global use by seeking more cooperation with other countries and improving the infrastructure needed to support wider use of the currency, according to a statement posted on its website on 10 August 2016.
- OTC Clearing Hong Kong Limited (OTC Clear), a subsidiary of Hong Kong Exchanges and Clearing Limited (HKEX) that provides clearing and settlement services for OTC derivative transactions, announced the smooth launch on 15 August 2016 of its clearing service for cross currency swaps (CCS). OTC Clear is initially providing clearing for swaps in the USD/CNH currency pair. OTC Clear is the first international clearing house to provide clearing for USD/CNH CCS.
- Shanghai Clearing House (SHCH) started central counterparty clearing services for over-the-counter USD/RMB options on 15 August 2016. There are 19 market participants among the first batch of institutions offering such services and 10 institutions submitted 27 trades for clearing on the first day, with nominal principal amount of RMB630 million (single-sided). SHCH said it is the first central counterparty to clear OTC forex options in the world.

MACRO ECONOMIC UPDATE

- China's non-financial outbound direct investment (ODI) soared in the first seven months by 61.8 percent year on year, data from the Ministry of Commerce (MOC) on 17 August 2016 showed China's ODI from January to July hit RMB673.24 billion (USD102.75 billion), the MOC said in a statement. The ODI in July alone reached USD13.89 billion, down 9.5 percent month on month, according to the MOC.

MARKET/PRODUCT DEVELOPMENTS

- Chinese currency is increasingly being accepted in cross-border transactions, as the currency gains increased global recognition, according to the PBOC 2016 Annual Report on RMB Globalisation report published on 10 August 2016. In 2015, the volume of cross-border RMB receipts and payment reached RMB12.1 trillion (USD1.83 trillion), an increase of 21.7 percent year on year. It accounts for nearly one third of the total volume of cross-border receipts and payments .

RMB FX MARKET DYNAMICS

OFFSHORE USD/RMB

- In August 2016, USD/CNY fixings moved between 6.6056 and 6.6856, and CNH was trading 0.89 per cent higher versus the US dollar from a month ago. The PBOC set the CNY fixing to 6.6056 on 18 August 2016, the highest level since the UK announced the results of the Brexit referendum.
- According to the minutes of a forum held on 2-3 August 2016 among governors of PBOC branches, the two-way movements of the RMB's exchange rate against the USD will become more flexible while the RMB's exchange rates against a basket of currencies will remain "basically stable".

Fig 3: Onshore/Offshore RMB Price Range

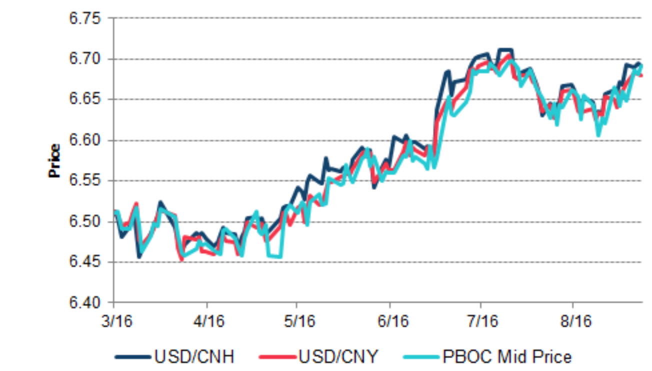


Fig 4: Implied Volatilities of OTC USD/CNH ATM Options

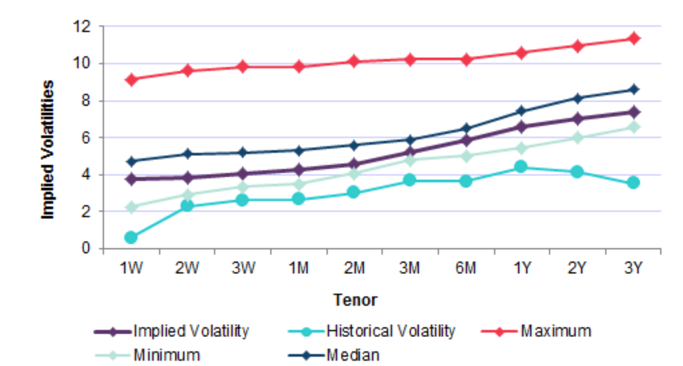
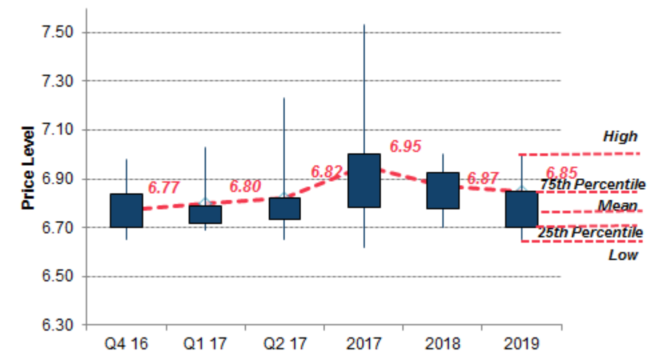


Fig 5: Market Forecasts for the Level of USD/CNH



HKEX'S USD/CNH FUTURES

PRODUCT HIGHLIGHTS

- Open interest (OI) was 28,174 contracts (US$2.8 billion notional) as of the end of August 2016.
- Trading volume was highest in the Dec-16, Sep-16, and Mar-17 contracts, which accounted for 66.7 per cent of total volume in August 2016. Open interest concentrated in the Dec-16, Mar-17, and Jun-17 contracts, accounting for 74.8 per cent of total open interest at the end of August 2016.

Fig 6: USD/CNH Futures Turnover and Open Interest

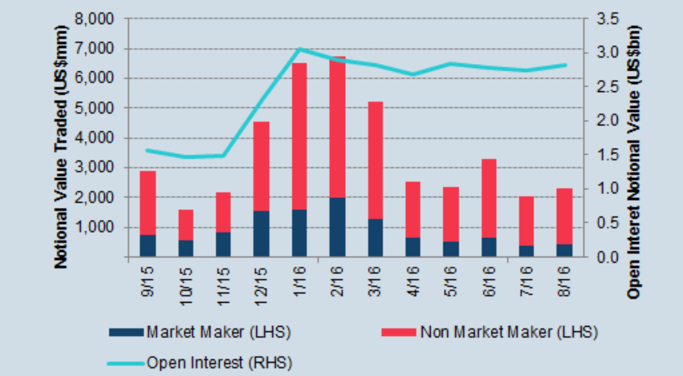


Fig 7: HKEX USD/CNH Futures Contract Provides Best Liquidity in Volatile Market

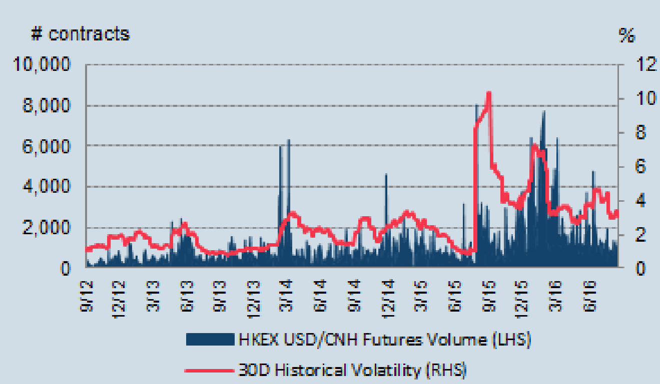


Fig 8: Breakdown of Volume by Contract Month (8/2016)

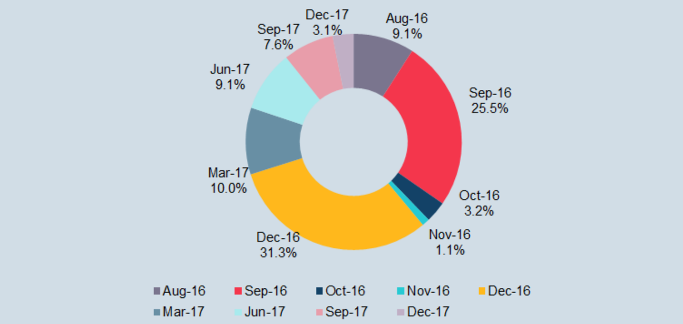
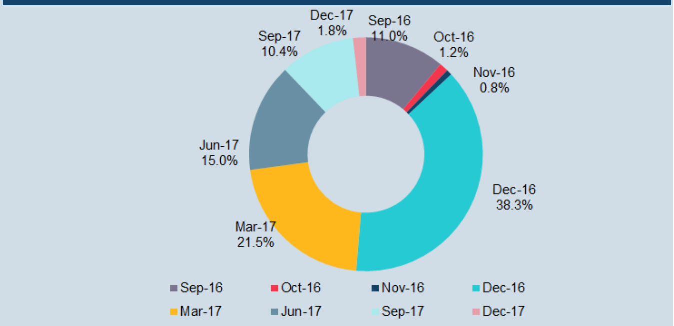


Fig 9: Breakdown of OI by Contract Month (31/8/2016)



TR/HKEX RMB CURRENCY INDICES (RXY)

- TR/HKEX RXY Global CNH index fell 0.74 per cent to 95.14 while the PBOC USD/CNY Fixing increased 0.60 per cent to 6.6908 in August 2016.
- The largest contributor to the performance of the TR/HKEX RXY Global CNH Index in August 2016 was the EUR, which appreciated 0.40 per cent against the USD during the same period of time.

TABLE 2: Summary Table for TR/HKEX RMB CURRENCY INDICES

Indices	Return					Risk				
	2016/8/1 - 2016/8/31 (Month)	2016/7/1 - 2016/7/29 (Month)	Chg	MTD	YTD	30-Day Realized Volatility (as of 2016/8/31)	30-Day Realized Volatility (as of 2016/7/29)	Chg	Correlation with China Foreign Exchange Trade System (CFETS) RMB Index	Beta vs CFETS RMB Index
TR/HKEX RXY Global CNH	-0.74%	0.09%	↓	-0.74%	-5.39%	3.38%	3.44%	↓	0.97	0.69
TR/HKEX RXY Global CNY	-0.68%	-0.05%	↓	-0.68%	-6.37%	2.97%	3.40%	↓	0.98	0.67
TR/HKEX RXY Reference CNH	-0.72%	0.48%	↓	-0.72%	-5.22%	3.22%	3.31%	↓	0.97	0.64
TR/HKEX RXY Reference CNY	-0.65%	0.34%	↓	-0.65%	-6.21%	3.09%	3.55%	↓	0.97	0.71

Fig 10: Performance: TR/HKEX RXY Global CNH, CFETS RMB Index and USD/CNH

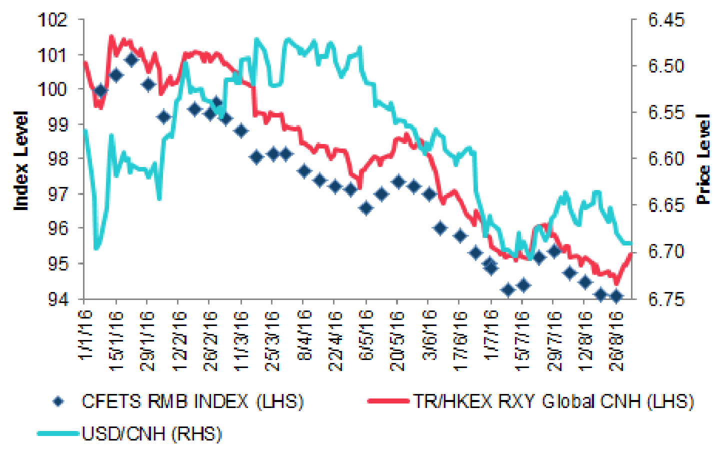
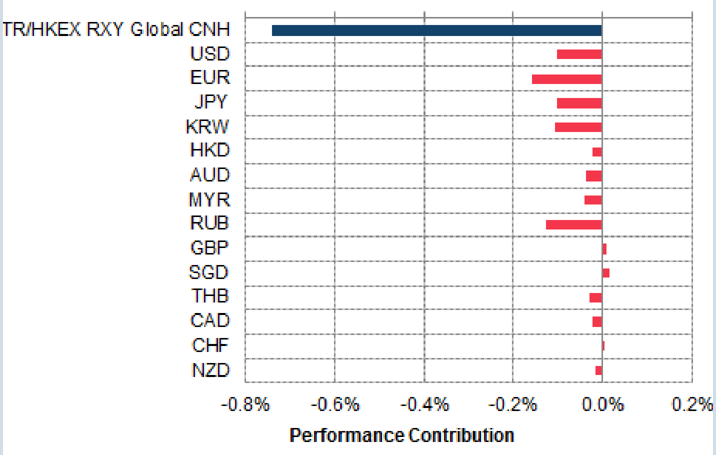


Fig 11: Monthly Performance Contribution Breakdown: TR/HKEX RXY Global CNH



PRODUCT HIGHLIGHTS

- The RXY indices offer independent, transparent and timely benchmarks for RMB against Mainland China's most important trade partners' currencies.
- The indices are calculated based on WM/Reuters foreign exchange rates (WM/Reuters FX Rates) and managed in accordance with the IOSCO (International Organisation of Securities Commissions) principles for financial benchmarks.
- The RXY indices are designed to be the basis for investment and trading products such as futures, options and exchange traded funds.

METHODOLOGY

Calculation Method: Geometric Average

Weighting Method: Bilateral trade weighted with adjustment for Hong Kong re-exports

Trade Data Source: UN Comtrade, Hong Kong Census and Statistics Department

Weighting Rebalance: Annual review. Announcement in June, Implementation on the first business day of Q4

Calculation Frequency: Hourly

FX Rate Data Source: WM/Reuters FX Rates

Base Date: 100 as of 31 December 2014

For more details, a complete methodology document is available at: financial.thomsonreuters.com/fxindices

Fig 12: TR/HKEX RXY Global CNH Currency Index

Index Weights: Valid Until 30 September 2016

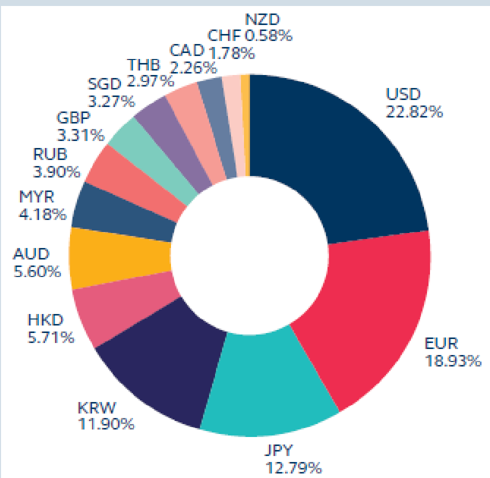


TABLE 3: Index Weights

Currency	RXY Global Currency Indices	RXY Reference Currency Indices	CFETS RMB Index
USD	22.82%	25.89%	26.40%
EUR	18.93%	21.49%	21.39%
JPY	12.79%	14.52%	14.68%
KRW	11.90%	0.00%	0.00%
HKD	5.71%	6.48%	6.55%
AUD	5.60%	6.36%	6.27%
MYR	4.18%	4.74%	4.67%
RUB	3.90%	4.43%	4.36%
GBP	3.31%	3.75%	3.86%
SGD	3.27%	3.71%	3.82%
THB	2.97%	3.38%	3.33%
CAD	2.26%	2.57%	2.53%
CHF	1.78%	2.02%	1.51%
NZD	0.58%	0.66%	0.65%

OFFSHORE RMB AGAINST OTHER CURRENCIES

EUR/CNH

- The CNH was trading 0.80 per cent lower against the EUR in August 2016 from a month ago and remained in a relatively tight range of 7.39 to 7.54.
- The implied volatility of 3M OTC options decreased to near 8 per cent in August 2016, as inflation in the Eurozone rose by only 0.2 per cent MoM and 0.8 per cent YoY in August.
- On the FX radar, the fundamental and valuation factors were well above their historical average, while the carry, sentiment, and risk factors were below their historical average.

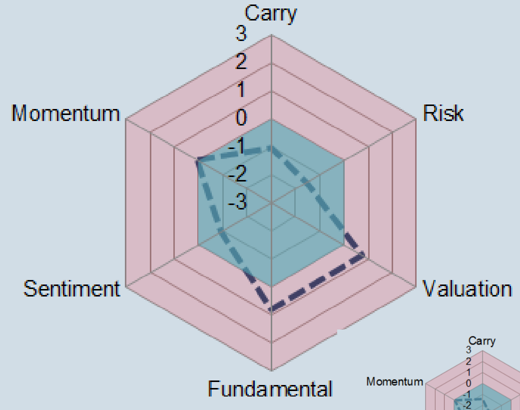
Monthly CNH Performance vs EUR

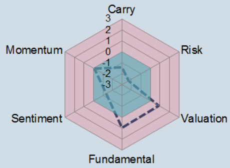
-0.80%

Implied Volatility

7.9%

Fig 13: FX Radar*





A similar pattern in history: 2016/6/21
The CNH appreciated against EUR by 0.2 per cent in the subsequent month

Fig 14: FX Volatility (3M Implied)

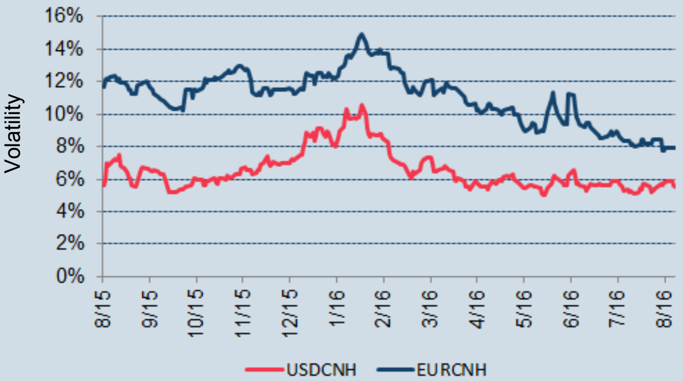
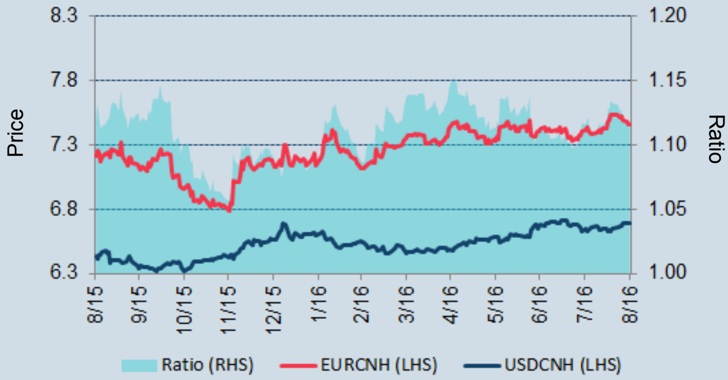


Fig 15: Price Ratio: EURCNH / USDCNH



AUD/CNH

- The CNH was trading only 0.05 per cent higher against the Australian dollar (AUD) in August 2016 from a month ago.
- The implied volatility rebounded to near 11 per cent in August 2016.
- On the FX radar, the risk and carry factors were below their historical average, while the valuation and momentum factors were above their historical average.

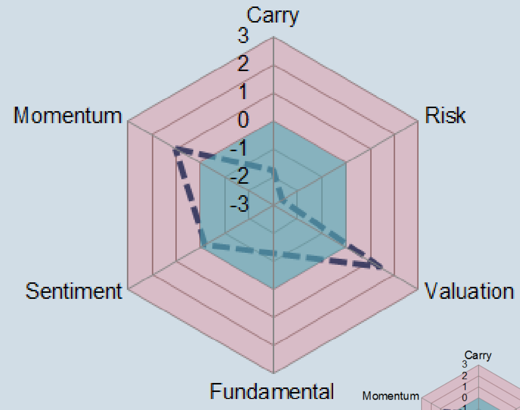
Monthly CNH Performance vs AUD

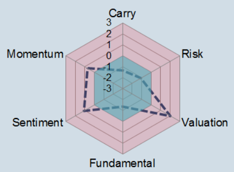
0.05%

Implied Volatility

11.0%

Fig 16: FX Radar*





A similar pattern in history: 2016/7/29
The CNH appreciated against AUD by 0.2 per cent in the subsequent month

Fig 17: FX Volatility (3M Implied)

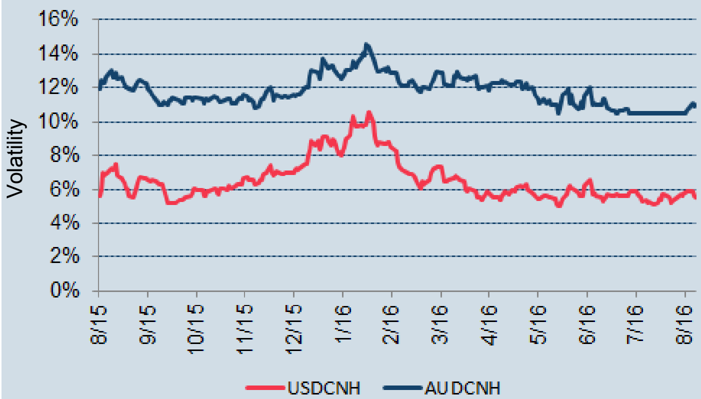
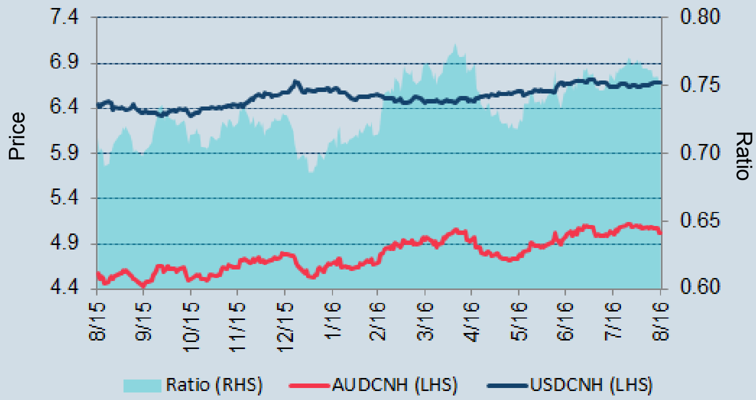


Fig 18: Price Ratio: AUDCNH / USDCNH



Sources: Bloomberg, WIND (31 August 2016)
* For detailed information, please see appendix

JPY/CNH

- The CNH was trading 0.39 per cent higher against the JPY in August 2016 from a month ago, as Japan's economy was barely growing and inflation was sliding further away from the Bank of Japan's 2 per cent target.
- The 3-month implied volatility OTC options centered around 13 per cent in August 2016.
- On the FX radar, the momentum, risk, sentiment, and fundamental factors were above their historical average, while the valuation and carry factors were below their historical average.

Monthly CNH Performance vs JPY

⬆ 0.39%

Implied Volatility

12.7%

Fig 19: FX Radar*

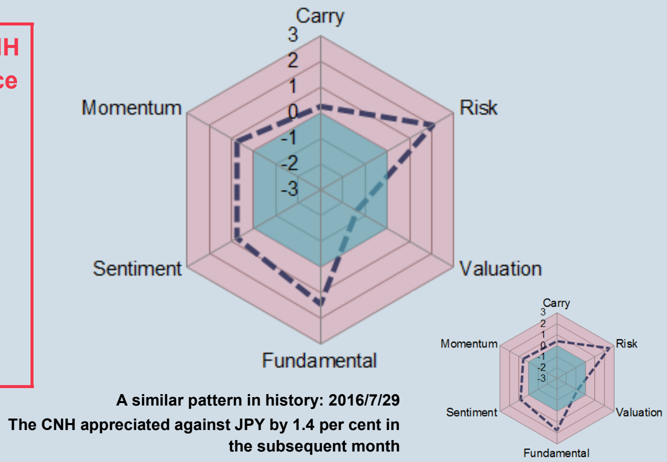


Fig 20: FX Volatility (3M Implied)

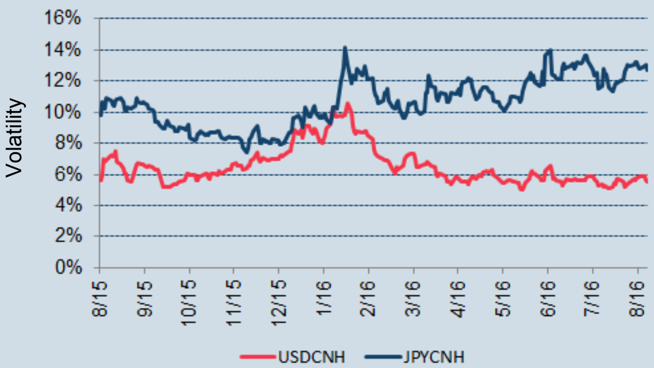


Fig 21: Price Ratio: JPYCNH / USDCNH

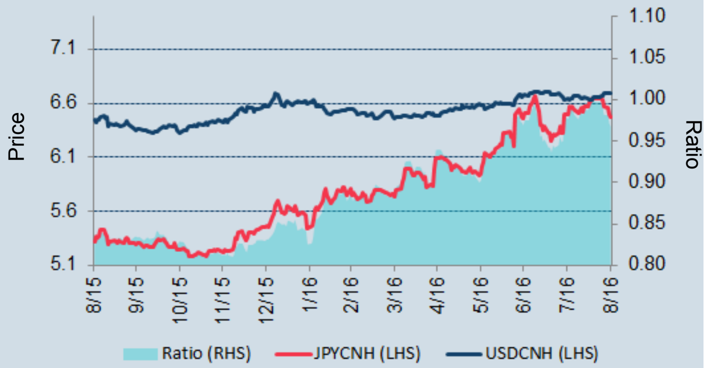


TABLE 4: Summary Table for RMB Currency Pairs

	Performance					Volatility					
	August	July	Chg	Prior 3 Month	YTD	Implied	Prior	Chg	Historical	Prior	Chg
USDCNH	-0.92%	0.61%	⬇	-1.59%	-1.88%	5.6%	5.3%	⬆	3.5%	3.6%	⬇
EURCNH	-0.80%	0.02%	⬇	-1.83%	-3.98%	7.9%	8.3%	⬇	6.2%	6.2%	⬇
AUDCNH	0.05%	-1.25%	⬆	-5.58%	-5.10%	11.0%	10.5%	⬆	9.8%	10.6%	⬇
JPYCNH	0.39%	-0.48%	⬆	-8.78%	-18.74%	12.7%	11.7%	⬆	14.5%	14.5%	⬆

OFFSHORE BOND MARKET DYNAMICS

OFFSHORE RMB BOND MARKET COMMENTS

- The Shanghai city government was exploring the idea of issuing up to RMB5 billion (USD750 million) of municipal debt in its free trade zone (FTZ), according to a notice published on the zone's website on 16 August 2016. This will mark the opening of an offshore RMB bond market in the FTZ.
- RMB deposits in Hong Kong decreased by 6.2 per cent month-on-month to RMB667.1 billion in July 2016. The total remittances of RMB for cross-border trade settlement amounted to RMB407.5 billion in July 2016, compared to RMB459.2 billion in June 2016.

Fig 22: Offshore RMB Deposits vs Dim Sum Bonds

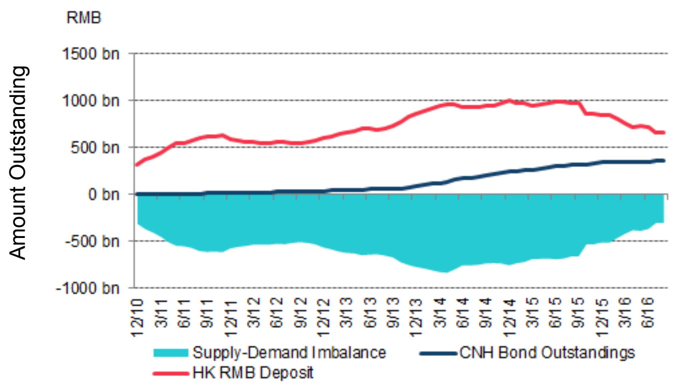


Fig 23: Offshore RMB Bond Issuances by Issuer Type

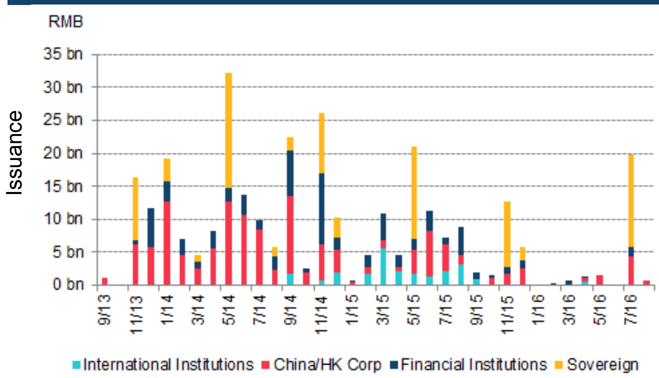
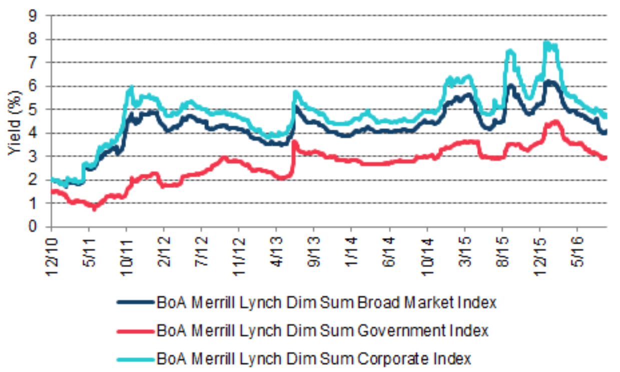


Fig 24: Dim Sum Bond Performance



Sources: Bloomberg, WIND (31 August 2016)

* For detailed information, please see appendix

ONSHORE RMB BOND MARKET COMMENTS

ONSHORE BOND MARKET DYNAMICS

- Onshore corporate bond issuance dropped sharply in August, down 40 per cent from the prior month amid tightened regulations. Since early August, local branches of China's securities regulator have introduced numerous measures to curb the increasing risk in corporate bonds.
- Dealogic data showed that sales of panda bonds in the first seven months this year totaled RMB49.7 billion, more than six times of last year's total, and close to the RMB54 billion dim sum bond issuance this year (excluding the RMB14 billion T-bonds issued by Ministry of Finance (MoF). Comparatively, panda bond issuance in 2015 was less than 10 percent of dim sum bond sales on the same basis

Fig 25: MoF T-Bonds Yield 5Y: Onshore vs Offshore (%)

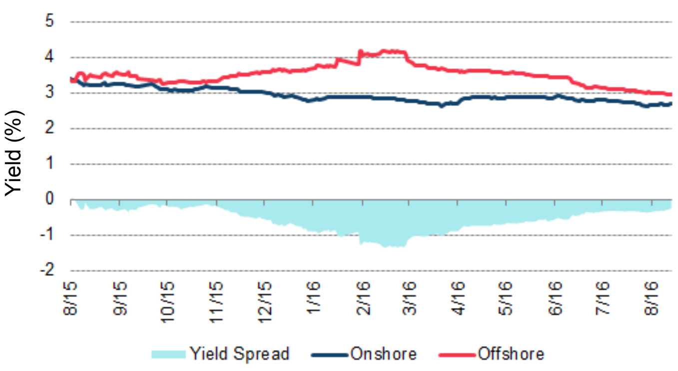


TABLE 5

Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types, for August 2016)			
Bond Type	Number of Deals	Trading Value(RMB 100M)	Yield to Maturity(%)
Policy Financial Bond	72,997	65,732.96	2.8336
Treasury Bond	17,112	15,915.86	2.5997
Medium-term Note	13,586	9,330.42	4.7832
Corporate Bond	11,356	6,540.06	4.6151
CDs	8,361	19,263.05	2.8886
Commercial Paper	17,307	14,229.56	3.3880
Central Bank Paper	33	111.10	2.2338
Others	5,021	6,253.53	4.6026
Total	**145,773**	**137,376.54**	**3.1306**

Fig 26: MoF T-Bond Outstanding Split by Tenor

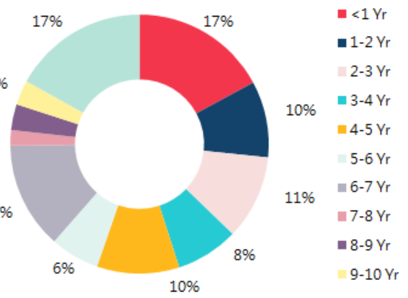


TABLE 6

NAFMII Guidance for Non Fixed Income Debt Issuing (as of 2016/8/31)																
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	2.89	↓	3.41	↓	3.60	↓	4.00	↓	4.26	↓	4.89	↓	5.05	↓	5.31	↓
AAA	3.08	↓	3.50	↓	3.80	↓	4.32	↓	4.56	↓	5.19	↓	5.51	↓	5.82	↓
AA+	3.31	↓	3.89	↓	4.24	↓	4.80	↓	5.19	↓	5.81	↓	6.21	↓	6.54	↓
AA	3.78	↓	4.38	↓	4.75	↓	5.47	↓	5.70	↓	6.56	↓	6.91	↓	7.39	↓
AA-	5.17	↓	5.75	↓	6.21	↓	7.21	↓	7.58	↓	8.23	↓	8.62	↓	8.93	↓

NAFMII – National Association of Financial Market Institutional Investors

Fig 27: Foreign Participation in the CIBM Market

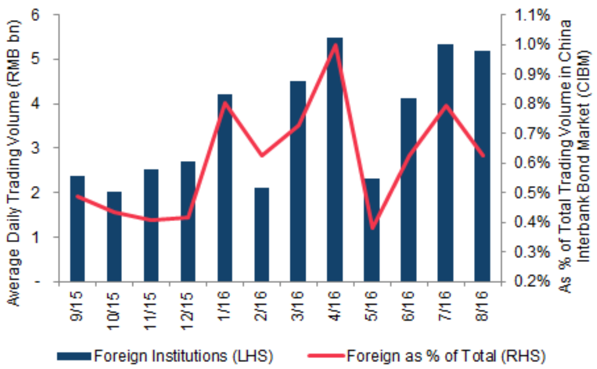


Fig 28: Onshore Bond Holdings by Foreign Institutions

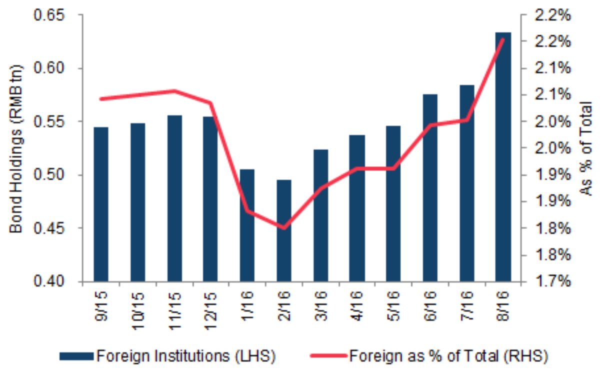


Fig 29: Bond Holdings Composition by Foreign Institutions

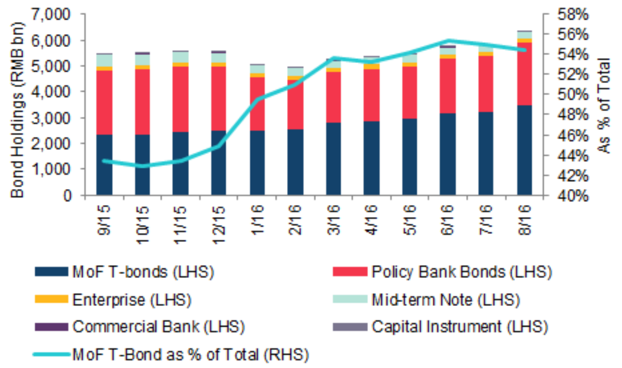
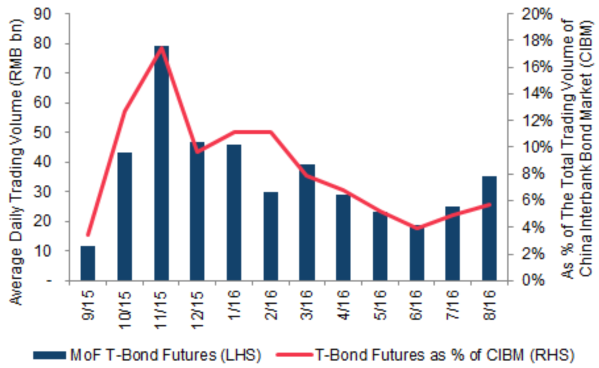


Fig 30: MoF T-Bond Futures Trading Volumes



ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- China has a lot of room to guide interest rates lower and keep liquidity reasonably loose, according to Cao Yujin, a researcher at the National Development and Reform Commission (NDRC) in a commentary published at the Commission's website on 26 August 2016.
- The PBOC issued 14-day repurchase agreements (repo) for the first time in six months on 24 August 2016. Deputy Governor of the PBOC, Yi Gang, said on 26 August 2016 that the 14-day reverse repo is only a new type of tools to meet demand for liquidity. He assured that the central bank will continue to provide sufficient and stable liquidity in China's financial markets.

Fig 31: CNH Implied Yield vs. USD/CNH

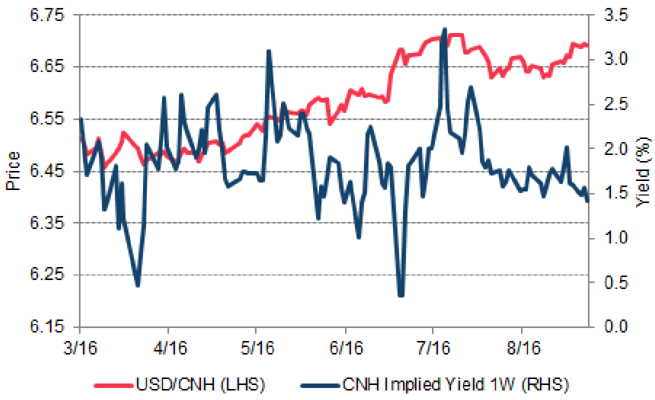


Fig 32: CNY SHIBOR Yield Curves

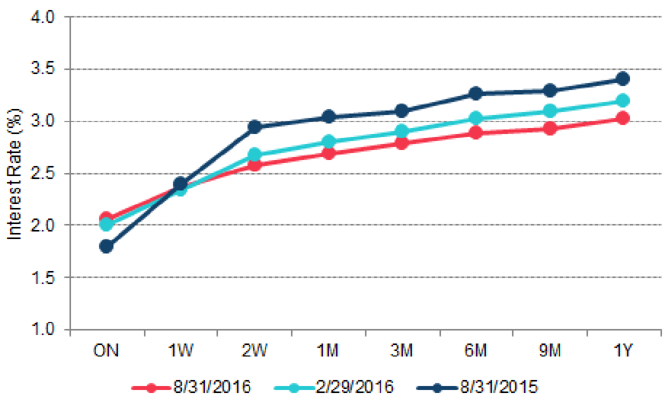


Fig 33: CNH HIBOR Yield Curves

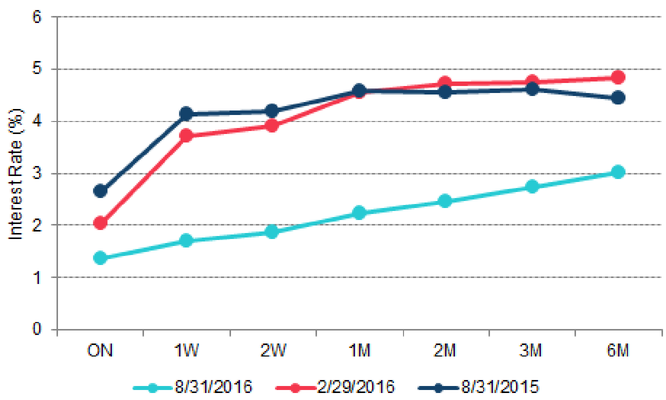


Fig 34: Onshore IRS (7D Repo) Yield Curves

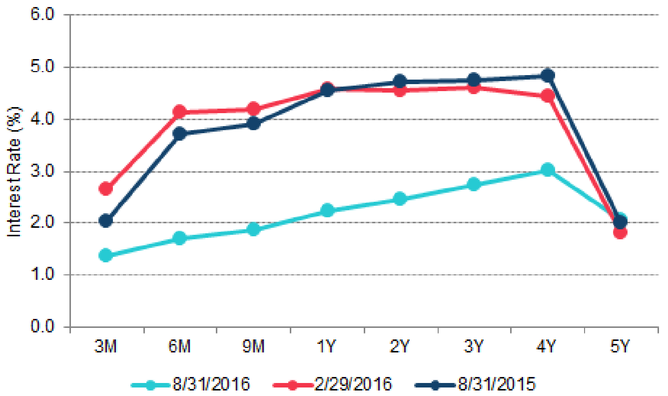


Fig 35: Onshore IRS Trading Notional Principal

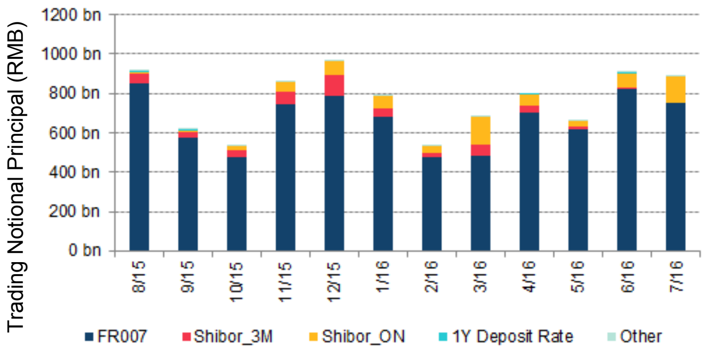


Fig 36: CNY SHIBOR vs CNH HIBOR

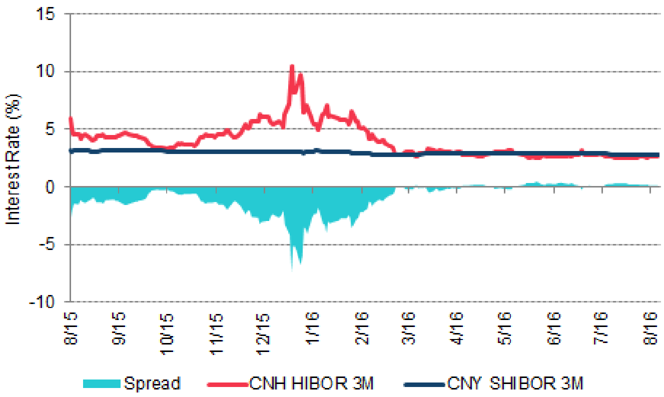
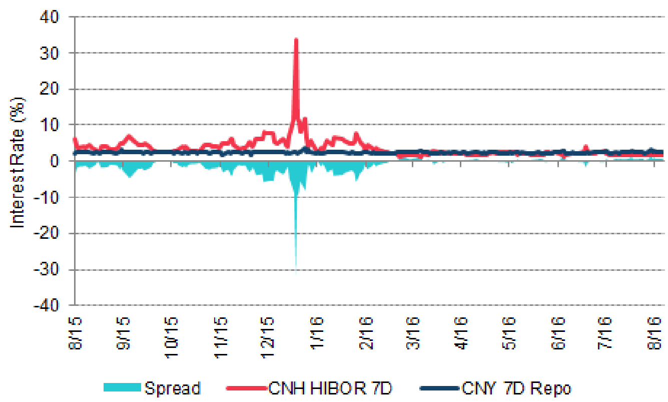


Fig 37: CNY 7D Repo vs CNH HIBOR



Sources: Bloomberg, CFETS (31 August 2016)

(Continued from page 1)

(1) Capacity reduction. Capacity reduction is normally plagued by changes and progress may not be easy, but now the process can be said to have entered a mid-late stage. The progress of capacity reduction determines the recovery of corporate profitability. Without significant progress, all enterprises within the industry will lose regardless of their quality and performance. Therefore, current economic policy assessment while paying attention to the bottoming of economic growth is also more concerned with the bottoming of corporate profitability.

(2) Deleveraging. Deleveraging at present is the combination of lowering the leverage ratio and leverage transfer. The government sectors are continuously increasing leverage. The leverage level of the Chinese government still lags behind that of developed countries. The residential sector is also increasing leverage and its leverage level is also below that of developed countries, which has directly to do with China's high saving ratios and is also a result of the short term recovery of the property sector. The sectors really undergoing deleveraging are non-financial business sectors. In this process, the property sector with encouraging sales, certain competitive service sectors, and emerging sectors are increasing leverage, whilst some highly leveraged industries with excessive capacity and inventories are in general in a process of deleveraging. Expectantly, deleverage will continue in the business sector in the next few years. It is a gradual process and it is difficult to increase leverage vigorously within a short period of time.

(3) Destocking. Full-scale destocking has been taking place since 2012. According to the statistics of listed companies and PMI readings from Wind as of July 31, 2016, the whole manufacturing industry and the inventory indicators for finished products of the PMI have trended downward since 2012.

(4) Overseas investment. China's overseas investment has seen a change in direction since the beginning of 2016 when its overseas investments started to surpass foreign investments in China. Chinese enterprises' overseas investment has shifted its focus from paying attention to resources only in the past to paying more and more attention now to industry innovation, consolidation and the integration of overseas investments with industries in China to facilitate upgrades.

Among factors affecting investment and the overall economic trend, the property sector has been a very important one. The economic recovery in the first quarter of this year is to a large extent attributable to the property sector. The cyclical recovery of the property sector has not only boosted the property market itself but has also driven the recovery of the land market and in turn supported the government's investment in infrastructure. Slowing economic growth since the second quarter may also be attributable to the property sector. Driven by adjustment in the property sector, the macro economy will in the short run enter another downward trend. The property sector will also be trending downward. As the monetary policy maintains relatively loose conditions with gradual marginal tightening, the leverage ratio it is starting to decrease gradually. The tightening of housing policies in some cities is also a direct reason for the adjustment and the destocking.

3. Greater flexibilities in RMB exchange rate policy has provided leeway for China's economic policies to accommodate external fluctuations.

The global economy remains volatile and diverged in the short term. Many developed economies are entering an era of negative interest rates. Due to the global economic downturn and declining investment returns, the interest rates of some developed countries cannot continue sustained elevation and are at historic lows. According to the data as of 30 June 2016 from Fitch Ratings and Bloomberg, the world's total value of bonds with negative interest rates is USD10 trillion, and an increasingly number of developed countries are entering the era of negative interest rates. Such sentiment, despite its bearishness, implies new opportunities. From a longer-term prospective, the global economy is actually at a new starting point in the Kondratieff Cycle.

Amid such global economic turmoil, we note that in order to cope with external economic shocks, there has been evidently greater flexibility in the RMB's exchange rate movements. The RMB has now been accepted by the FX market as a currency that moves within a flexible range which provides a good buffer against external shocks. Since August 2015, the PBOC has been adjusting RMB exchange rates with flexibility in response to market supply and demand. After a short period of fluctuation, the RMB's exchange rate against the US dollar remained largely stable in the first quarter of 2016. In the second quarter, uncertainty caused by Brexit brought short-term pressure on the RMB, and the spread between onshore and offshore RMB exchange rates widened. From a fundamental point of view, Brexit would help ease short-term pressure on the RMB's depreciation. It is worthy to note that PBOC has started to adjust the spread between onshore and offshore RMB exchange rates to maintain stability, reduce room for arbitrage and stabilise market expectations.

TABLE 7: Economies Implementing Negative Interest Rates

	Denmark	Eurozone	Switzerland	Sweden	Japan
Implementation Time	2012.07	2014.06	2015.01	2015.02	2016.02
First negative interest rate	-0.20%	-0.10%	-0.25%	-0.10%	-0.10%
Current interest rate	-0.65%	-0.40%	-0.75%	-0.50%	-0.10%
Underlying of negative interest rate	7-day fixed deposit rate	Overnight deposit rate	Overnight interest rate on sight deposit which exceeds certain threshold	Repo rate	Additional excess reserve

Source: Danmarks Nationalbank, European Central Bank, Swiss National Bank, Sveriges Riksbank, Bank of Japan

Fig 38: China's Total Leverage Growth Has Accelerated Since Global Financial Crisis

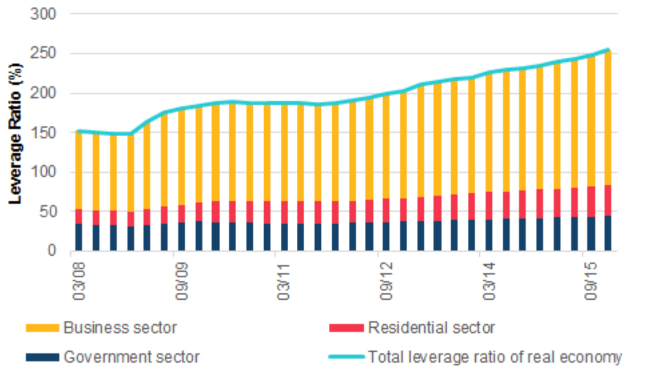


Fig 39: PMI：Finished Product Inventory Indicator

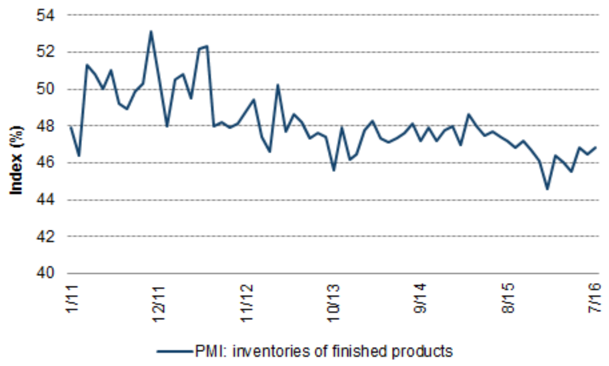
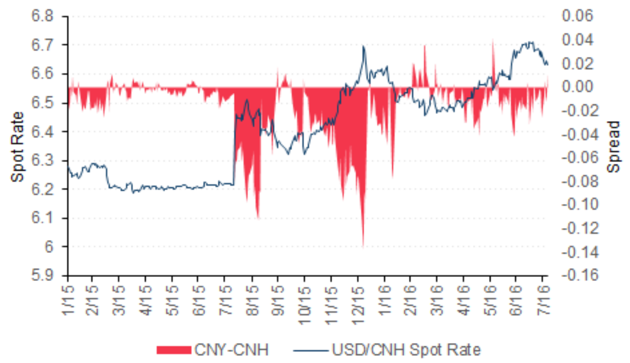


Fig 40: USD/CNH Spot Price and Spread of USD/CNY and USD/CNH



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EXPERT CORNER

OUTLOOK FOR CHINA BOND MARKET

Contributed by Ming Ming, Chief Analyst of Fixed Income Research of CITIC Securities International

We have been emphasising since the beginning of the year that 2016 will be a year of ups and downs for the Mainland bond market. The first half of the year has proven us right. In the second half, the Mainland bond market, driven by domestic and external factors, will continue to see many changes. This paper aims to look at the bond market and its outlook from the perspectives of macroeconomics, overseas development, policies, bond strategies and asset allocation.

Macroeconomics: mild recovery and structural adjustment

First, "sub-inflation" remains with good performance in the non-food sector. Non-food prices rose noticeably due to consumption upgrade and the second child effect and this is expected to be a long-term trend. Abnormal marginal effects from storms and flooding etc. may offset the high base of food prices. The fall in food prices including pork prices is expected to slow while vegetable prices will keep rising. The fall in Producer Price Index (PPI) will continue to narrow. Prices of industrial products will continue to rise. PPI growth is expected to return to the positive territory in Q32016 at the earliest. PPI's influence on Consumer Price Index (CPI) will become more prominent, thus pushing inflation mildly upwards.

Second, infrastructure will replace housing as the next driver and mild recovery continues. Consumption staged a strong rebound demonstrating the success of economic transformation. Overall investment growth steadily declined. The housing market would see a soft landing as property investment has already started cooling down. Infrastructure will succeed housing as the driver of stable growth. Investment in manufacturing and private investment remains weak, but more policies that direct and support private investment are expected to be introduced. Foreign trade remains steady despite pressure. We expect Renminbi will stay weak. In addition, industrial improvement is continuing, and mild economic recovery remains unchanged. Stabilizing economic growth and structural adjustment works in parallel. The excessive pessimism that overwhelmed the market is expected to change. Expansionary fiscal policies are expected to replace monetary easing policies. Better than expected credit and social financing and M2 demonstrate strong growth. We expect China's fiscal policies will become more expansionary while monetary policies will remain neutral and prudent.

Overseas factor: as expectations of a US Fed rate hike increase, global monetary easing becomes less likely

First, the overall US economy is growing strong, so sooner or later there will be a rate hike. While the US Fed may still need more supporting data for an improving economy to decide the timing of a rate hike, market expectations for a rate hike have already increased. We reiterate our projection that the US adopt at least one rate hike this year. **Secondly, global monetary easing has become less likely.** The Bank of Japan's monetary easing turned out to be less rigorous than expected. Stimulus fiscal measures involving JPY28 trillion were rolled out. No action was taken by the Bank of England and the European Central Bank (ECB). Central banks over the world are staying on the sidelines.

Monetary policies: internally, neutral and steady; externally, progressive depreciation

Internally, maintain a neutral and prudent monetary policy. The current policy to stabilize the money market is to inject capital precisely into the right sectors. With increased probability of a US Fed rate hike, Mainland inflation retreating and economic deleveraging being inevitable, there is limited room for monetary policy adjustment so a neutral direction remains unchanged. **Externally, the renminbi will gradually depreciate.** It will benefit exports, lower asset prices and restrain hot money. The currency's depreciation is having its positive effects.

Liquidity is significantly fragmented and cyclical, while money remains balanced but tight. Several critical price levels (such as a reverse repo rate of 2.25 per cent and an overnight SLF (Short-term Lending Facility) rate of 2.75 per cent) set out of a neutral and prudent monetary policy explain why the money market remains balanced but tight. Fragmentation and cycle-prone also characterize the entire market. Interest rates on the money market are, under the cost-return logic, one of the underlying constraints on bond yields. With tight liquidity, bonds will suffer followed by equities. Investors shall pay more attention to fundamentals in future asset rebalancing.

In terms of quantity of money, the scissors gap between M1 and M2 growth is expanding. China's quantity of money has three characteristics. First, zombie enterprises which are liquidity black holes, together with the inefficient local financing platforms, have reduced money velocity. Second, bubbles have gradually brewed in the financial system as money flows into it from the real economy. Then, the expanding gap between M1 and M2 growth reflects defects in the money and credit formation mechanism and monetary easing policy has been stuck in the deadlock. **In terms of the impact of high growth in money quantity on the real economy and asset prices,** M2 is closely correlated with economic growth and M1 with consumption, so high growth in M1 inevitably results in price increases while M2 has a higher correlation with asset prices. However, with monetary policies being materially prudent and M2 at a low level, equity and bond markets will see volatility. In the recent overheated bond market, bond investment has become risky with little price advantage, so equities have turned out to be better investment choices. Generally speaking, both equities and commodities are better investment choices than bonds.

Bond market strategy for second half: beware of bond market overheating and use swing trading to manage risks

In terms of fundamentals, housing market growth is slowing, infrastructure is propping up the economic growth and consumption is strong. This together with a ramped-up fiscal policies and a progressive currency devaluation strategy that encourages exports make us believe recovery will continue to be moderate, which is a negative for the mainland bond market. In terms of policies, with the tightening and increasing prudence of monetary policies and the continuation of financial deleveraging, liquidity will become more and more cyclical and fragmented and this is expected add to the mainland bond market's volatility.

Source: CITIC Securities International (18 August 2016)

In terms of supply and demand, given the expected higher deficit in the year, using fiscal expansion policies and credit easing to sustain growth in place of monetary easing and the continued shift of indirect finance to direct finance, bond supply will remain ample in 2H16 and the bond market will test its bottom further. **In a volatile market where defensive strategies come first, profit opportunities only arise during market adjustments. The term spreads of bonds have bottomed. We forecast the equilibrium yields on 10-year government bonds to be 2.8 per cent.**

In terms of allocation into major classes of assets, equities and commodities are better than bonds. First, on the supply side, commodity production remains weak with inventories continuing to fall. The government's intention to reduce capacity is unchanged. On the demand side, housing and infrastructure have provided steady support to demand and there is growth momentum for commodity prices as fundamentals softly recover. Secondly, the current widespread price rises confirm exactly the monetary rationale (monetary easing will result in more liquidity, which will in turn drive up demand for investment) amid expectations of monetary easing. As these expectations fade, fundamentals will be dominant again and commodities will fare better than bonds. Equities are better positioned in both fundamentals and prices amid the fighting for existing capitals. Generally speaking, equities and commodities are better investment choices than bonds.

Fig 41: 10-Year Government Bond Yield and 7-Day Repo Spread for China

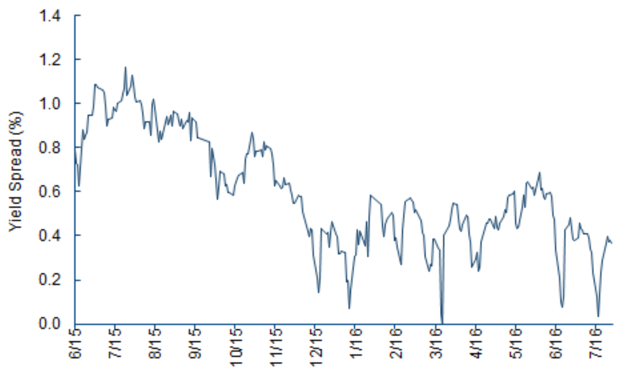


Fig 42: 20-Year and 30-Year Government Bond and 14-Day Pledged Repo Spread for China

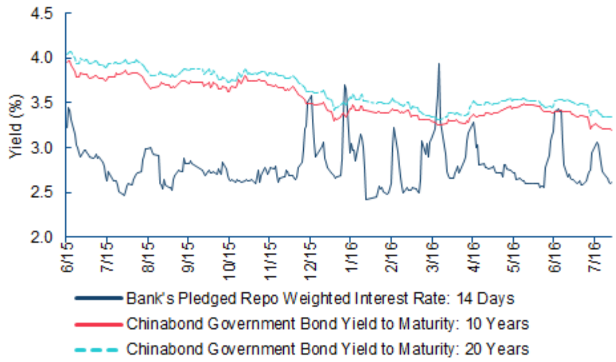


Fig 43: Credit and Housing Price Trends for China

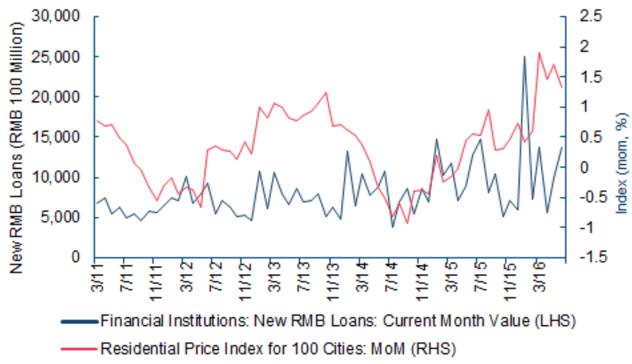


Fig 44: The Scissors Gap Between M2 and M1 Growth is Expanding for China

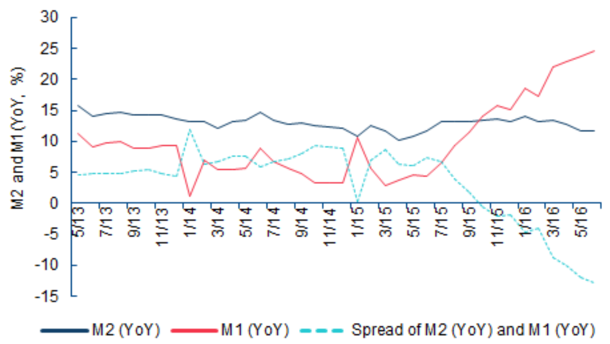


Fig 45: Quantity of Money and Price Levels for China

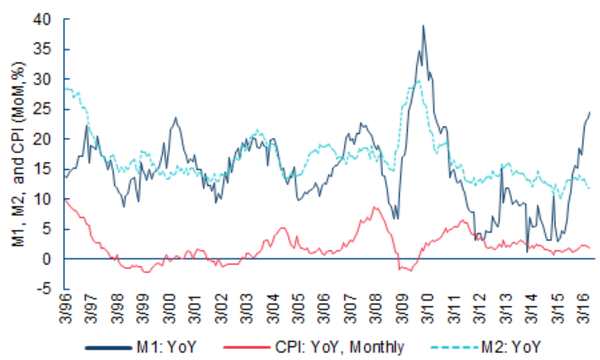
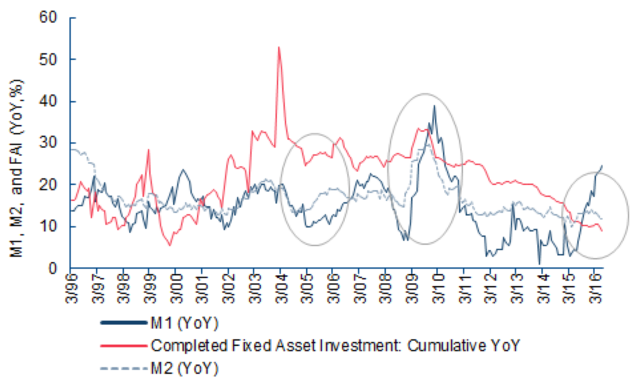


Fig 46: Relationships between M1, M2 and Investment for China



Ming Ming worked in the Monetary Policy Department I and II at The People's Bank of China from July 2008 to August 2015. He was responsible for works including research and implementation of monetary policies, RMB internationalisation and capital account liberalisation. He specializes in macro economy research, exchange rates and interest rates policies, liquidity management and cross-border capital flows. He joined CITIC Securities' research department in September 2015, as head of fixed income research.

Ming Ming holds a master degree from the PBC School of Finance at Tsinghua University and a PhD from the Chinese Academy of Social Sciences. He has published a book Liquidity Theory and Analysis. He has been involved in numerous research projects on both the national and provincial levels, and has issued several research papers on key trades.

APPENDIX: DEFINITION OF THE FX RADAR

We selected a number of factors that drive RMB currency pairs, including carry (yield spread), risk (volatility), valuation (terms of trade), fundamentals (trade balance), sentiment (risk reversal), and momentum (three-month return). Factor values were normalized based on the most recent one-year data and plotted on our FX radar graph. For example, a factor value of 1 for "carry" indicates that the current yield spread is one standard deviation above its mean over the past year.

The black dotted line represents the prevailing factor dynamics of the specific RMB FX pair. Against the current factor dynamics, we identified the most similar patterns in past history by means of optimization across the six driving factors. The historical price movement of that particular period is shown for reference.

For more information about the USD/CNH Futures,
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