HKEX
香港交易所
November 2016

INSIDE RMB FIXED INCOME AND CURRENCY MONTHLY NEWSLETTER

Issue No 23

MONTHLY HIGHLIGHTS

- Compared with October 2016, TR/HKEX RXY Global CNH Index increased by 0.55 per cent to 95.49, while the People's Bank of China (PBOC) USD/CNY Fixing increased by 2 per cent to 6.8865 in November 2016.
- HKEX's USD/CNH futures had record high open interest (OI) of 42,257 contracts (US$4.2 billion notional) on 30 November 2016, the highest level among global exchanges and about two-thirds of world's total. The record highlights HKEX's leading role in RMB risk management. The futures' average daily volume also swelled, rising to 3,535 contracts (US$354 million notional) in November, its best level since February 2016.
- With the Shenzhen-Hong Kong Stock Connect rollout on 5 December 2016, HKEX's Chief China Economist, Professor Ba Shusong, explores the milestone programme's potential macro impact in the new era of mutual market access.
- In the Expert Corner, Natixis' Senior Economist of Greater China, Ms Iris Pang, discusses the market trends of dim sum bond and panda bond market.

RECAP ON HKEX'S EFFORTS IN PROMOTING THE OFFSHORE RMB FIC MARKETS

Julien Martin, Head of FIC Product Development, HKEX, participated in the panel on the key opportunities in 2017 at the Asian Fixed Income Insights Forum on 18 November in Shenzhen, China.

Prof. Ba Shusong, Chief China Economist of HKEX, gave a keynote speech at the Hong Kong Economic Summit on the new stage of RMB internationalisation and opportunities for Hong Kong.

FROM THE CHIEF CHINA ECONOMIST'S VANTAGE POINT

Potential Macro Impact of Shenzhen-Hong Kong Stock Connect

Professor Ba Shusong, Chief China Economist, HKEX

Market participants are watching the development of Shenzhen-Hong Kong Stock Connect closely after the date for its launch was announced on 25 November 2016. Particularly, it should be interesting to see how the programme would have a macro impact on the market, both theoretically and practically. First of all, there will be market speculation on whether the valuation discrepancies between the Hong Kong and Shenzhen markets will narrow after the launch of the programme. As a matter of fact, speculations like these were also plentiful in the early days of the launch of Shanghai-Hong Kong Stock Connect, but it turned out actual market operations were not exactly what were expected. At times, price discrepancies widened rather than narrowed. Against this background, how should we assess the market impact of Shenzhen-Hong Kong Stock Connect?

In terms of system design, Shenzhen-Hong Kong Stock Connect may be seen as a natural extension of Shanghai-Hong Kong Stock Connect with new breakthroughs in some areas. Apart from the extension of eligible stocks for trading to Shenzhen listed securities, trading under Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect will no longer be subject to an aggregate quota, a significant change as far as market participants are concerned. Previously, investors of Shanghai-Hong Kong Stock Connect were in constant fear of the programme's quota being used up during their asset allocation when the aggregate quota was in force. Abolition of the aggregate quota will attract medium to long term asset allocation and strengthen connection between the Hong Kong, Shanghai and Shenzhen markets.

(to be continued on page 9)

CHINA MACRO UPDATE

Fig 1: Chart of the Month: Drop in China's Yield Premium and the Recent Depreciation of RMB Against USD

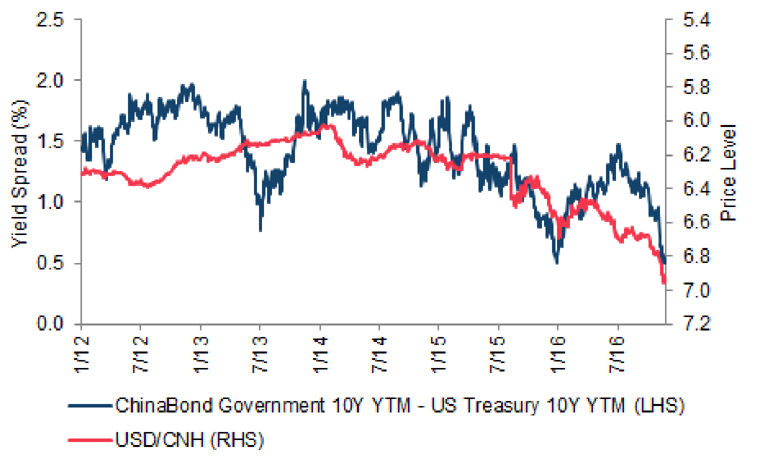
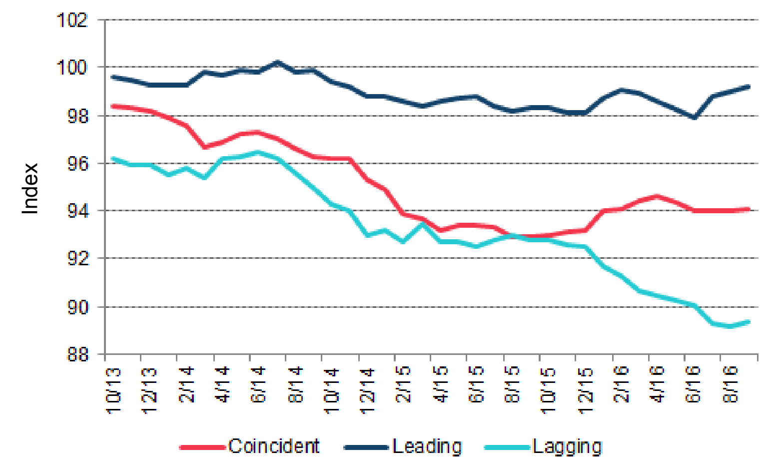


Fig 2: China's Macro-Economic Climate Index



- 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	⇨	17/01/2017
CPI (yoy %)	2.1	1.9	⇧	09/12/2016
PPI (yoy %)	1.2	0.1	⇧	09/12/2016
Industrial Production (yoy %)	6.1	6.1	⇨	13/12/2016
FAI (yoy %)	8.3	8.2	⇧	13/12/2016
Foreign Investment (yoy %)	1.2	5.7	⇩	08/12/2016
CFLP Manufacturing PMI	51.7	51.2	⇧	01/01/2017
PBOC Bankers Confidence Index	46.5	43.7	⇧	TBC
PBOC Bankers Loan Demand Index	55.7	56.7	⇩	TBC
Share of Payments via SWIFT in CNY (%)	1.67	2.03	⇩	29/12/2016
Exports (yoy %)	-7.3	-10	⇧	08/12/2016
Imports (yoy %)	-1.4	-1.9	⇧	08/12/2016
M2 Money Supply (yoy %)	11.6	11.5	⇧	10/12/2016
Retail Sales (yoy %)	10	10.7	⇩	13/12/2016
Consumer Confidence Index	114.9	117.1	⇩	04/01/2017
Regulated Reserve Ratio (%)	17.5	18.0	⇩	Infrequent
Official Foreign Exchange Reserves (USD bn)	3120.7	3166.4	⇩	07/12/2016
Three-Month SHIBOR (%)	3.07	2.81	⇧	Continuous
10-Year Gov't Bond Yield (%)	3.01	2.66	⇧	Continuous
USD/CNY Exchange Rate	6.88	6.75	⇧	Continuous
TR/HKEX RXY Global CNH Index	**95.49**	**94.97**	⇧	**Continuous**

Sources: Bloomberg, WIND, HKEX, Thomson Reuters, SWIFT

(30 November 2016)

CHART OF THE MONTH

- U.S. President-elect Donald Trump's fiscal stimulus plans drove up 10-year US Treasury yields, narrowing their discount to similar Chinese bonds to less than 50 basis points. The narrowing yield premium might make the RMB bonds less attractive to foreign investors.

REGULATORY/POLICY DEVELOPMENTS

- China Central Depository & Clearing Co., Ltd. (ChinaBond) organised its annual gathering for overseas investors on 22 November 2016 to promote investment opportunities at the interbank bond market in the backdrop of RMB internationalisation. Gao Fei, Division Chief of Bond Transaction Administration of the PBOC indicated at the seminar that the PBOC will allow overseas investors other than central bank-type institutions to engage in bond repo trading in due course. As of Q3 2016, China's treasury-bond holding by overseas investors exceeds RMB568 billion, up 33.7 per cent from the 2015 year-end.

MACRO ECONOMIC UPDATE

- China's economy will grow at 6.7 per cent this year, but edge down to 6.4 and 6.1 per cent in 2017 and 2018 respectively, the Paris-based Organisation for Economic Co-operation and Development (OECD) said on 28 November 2016 in its latest Economic Outlook published twice a year. Its three-year predictions are roughly consistent with the Chinese government's goal of achieving an average annual rate of 6.5 per cent during the 2016-20 period to realise its target of doubling the per capita income by 2020 from a 2010 base, although the OECD said China needs to stop the downward trend in 2019 and 2020 if it were to reach that goal.

MARKET/PRODUCT DEVELOPMENTS

- A mechanism should be set up for mainland and Hong Kong retail investors to access each other's bond market, both over-the-counter and exchange-traded, the Financial Services Development Council of Hong Kong recommended on 29 November 2016 in a report titled "Proposal on the Mainland-Hong Kong Bond Market Connect" which studied the possibility of establishing such a link.
- Yao Qian, the head of the PBOC digital currency preparatory team was quoted by the China Securities News on 16 November 2016 as saying that China's digital currency framework has finished two rounds of revisions and the digital currency is expected to be rolled out first in selected money markets and expanded gradually.
- RMB slipped one place to the third most-active currency for global trade finance, overtaken by the euro, global transaction service provider the Society for Worldwide Interbank Financial Telecommunication (SWIFT) said on 23 November 2016. The RMB's usage by value in traditional trade finance – letters of credit and collections – has been decreasing since 2014. Its market share fell to 4.61 per cent from 8.66 per cent three years ago partly due to slowing growth in the world's second-biggest economy and a recent crackdown on cross-border arbitrage activities.

OFFSHORE USD/RMB

- In November 2016, USD/CNY fixings moved between 6.7491 and 6.9168, and CNH was trading 2 per cent lower versus the US dollar from a month ago.
- On 25 November 2016, the PBOC set the CNY fixing to 6.9168, a fresh eight-year low. On 24 November 2016, the CNH rate also reached an all-time low of 6.9654 against US dollar, the weakest level since its introduction in 2010.
- China's economic conditions remain supportive to the RMB, Yi Gang, deputy governor of the PBOC, said on 27 November 2016, adding that the currency will stabilise after its recent volatility against the US dollar. According to him, China's "international balance of payments is basically stable, the merchandise trade surplus remains relatively large, and the RMB has the conditions to remain basically stable within a reasonable range in the future."

Fig 3: Onshore/Offshore RMB Price Range

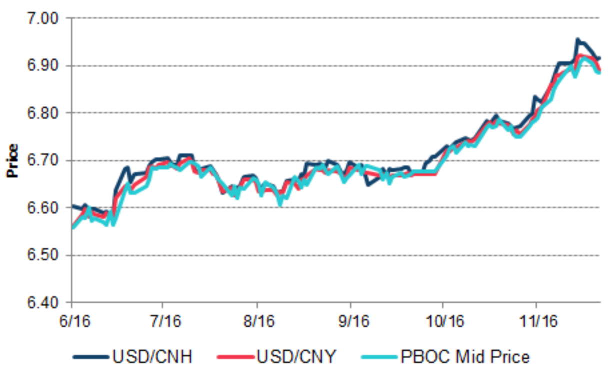


Fig 4: Implied Volatilities of OTC USD/CNH ATM Options

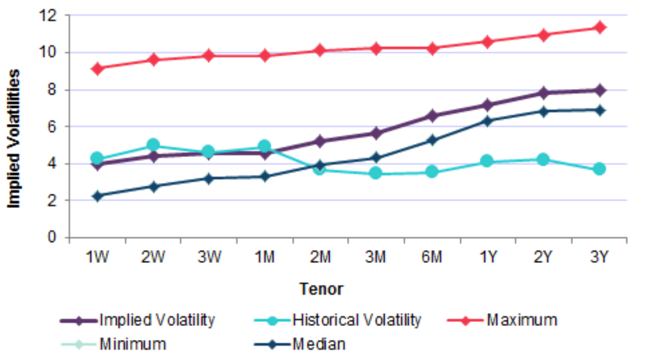
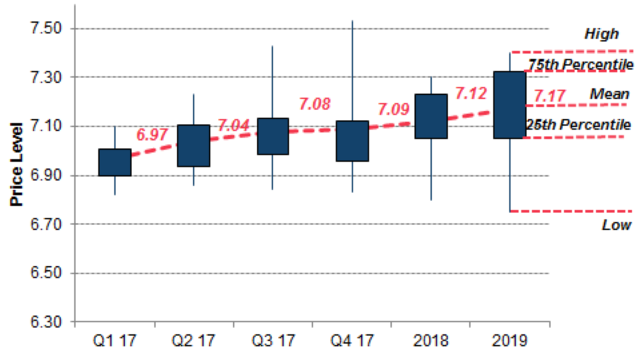


Fig 5: Market Forecasts for the Level of USD/CNH



HKEX'S USD/CNH FUTURES

PRODUCT HIGHLIGHTS

- Open interest (OI) was 42,257 contracts (US$4.2 billion notional) on 30 November 2016, a fresh all-time high, and an increase of more than 140 per cent year-on-year. OI is often used as an indicator of the market size of derivatives markets. HKEX has by far the highest OI level among global exchanges, representing about two-thirds of world's total. The record breaking OI highlights HKEX's leading role as a risk management venue during periods of RMB volatility.
- The contract's total volume swelled to 77,767 contracts (US$7.8 billion notional) in November 2016, an all-time high.
- The volume and open interest distribution is diversified at HKEX, reflecting an extremely well-balanced investor base. Trading volume was highest in the Dec-16, Mar-17, and Jun-17 contracts, which accounted for 65.1 per cent of total. Open interest concentrated in the Mar-17, Jun-17, and Sep-17 contracts, accounting for 58 per cent of total.

Fig 6: USD/CNH Futures Turnover and Open Interest

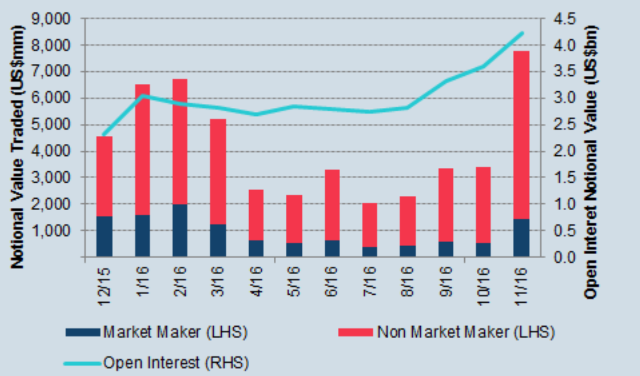


Fig 7: HKEX USD/CNH Futures Contract Provides

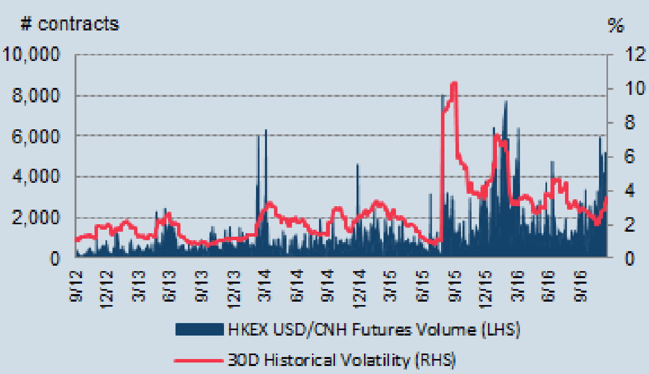


Fig 8: Breakdown of Volume by Contract Month (11/2016)

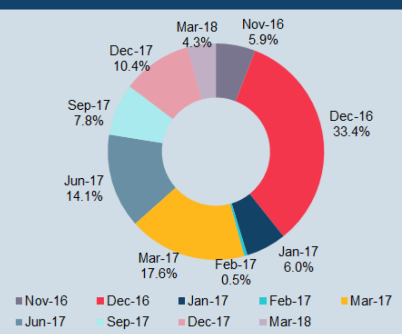
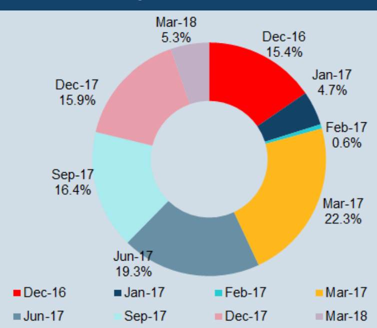


Fig 9: Breakdown of OI by Contract Month (30/11/2016)



TR/HKEX RMB CURRENCY INDICES (RXY)

- Compared with October 2016, TR/HKEX RXY Global CNH index increase by 0.55 per cent to 95.49 while the PBOC USD/CNY Fixing increased by 1.81 per cent to 6.8865 in November 2016.
- The largest contributor to the performance of the TR/HKEX RXY Global CNH Index in November 2016 was the JPY, which depreciated 7.45 per cent against the CNH comparing with end of October 2016.

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

	Return					Risk				
Indices	2016/11/1 - 2016/11/30 (Month)	2016/10/3 - 2016/10/31 (Month)	Chg	MTD	YTD	30-Day Realized Volatility (as of 2016/11/30)	30-Day Realized Volatility (as of 2016/10/31)	Chg	Correlation with China Foreign Exchange Trade System (CFETS) RMB Index	Beta vs CFETS RMB Index
TR/HKEX RXY Global CNH	0.55%	0.29%	↑	0.55%	-5.04%	3.19%	2.37%	↑	0.79	0.64
TR/HKEX RXY Global CNY	0.84%	0.27%	↑	0.84%	-5.76%	3.47%	3.45%	↑	0.74	0.55
TR/HKEX RXY Reference CNH	0.60%	0.00%	↑	0.60%	-5.01%	3.37%	3.83%	↓	0.75	0.60
TR/HKEX RXY Reference CNY	0.90%	-0.01%	↑	0.90%	-5.73%	3.28%	1.93%	↑	0.74	0.59

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

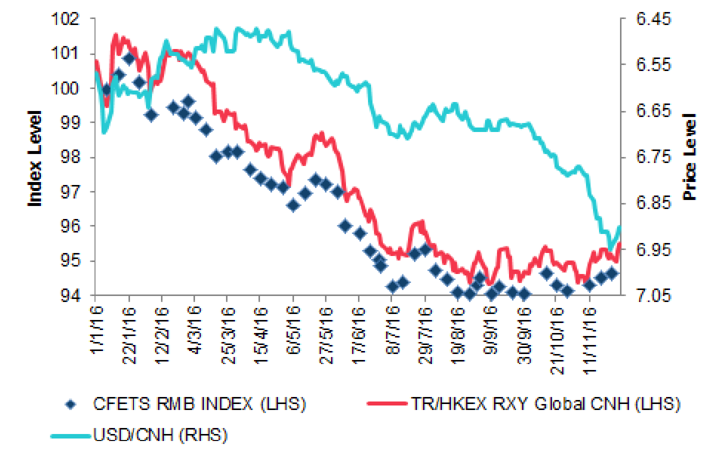
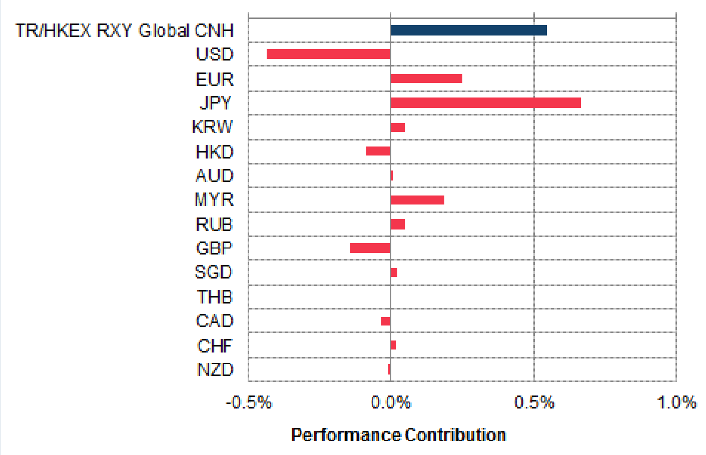


Fig 11: Monthly Performance Contribution Breakdown: TR/HKEX RXY Global CNH (November 2016)



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 29 September 2017

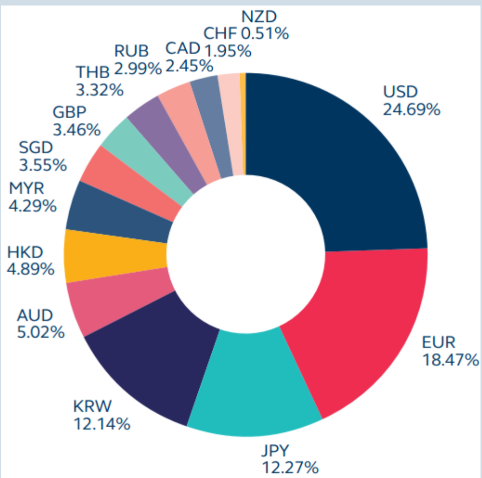


TABLE 3: Index Weights

Currency	RXY Global Currency Indices	RXY Reference Currency Indices	CFETS RMB Index
USD	24.69%	28.09%	26.40%
EUR	18.47%	21.03%	21.39%
JPY	12.27%	13.97%	14.68%
KRW	12.14%	0.00%	0.00%
AUD	5.02%	5.72%	6.27%
HKD	4.89%	5.56%	6.55%
MYR	4.29%	4.88%	4.67%
SGD	3.55%	4.04%	3.82%
GBP	3.46%	3.93%	3.86%
THB	3.32%	3.78%	3.33%
RUB	2.99%	3.41%	4.36%
CAD	2.45%	2.79%	2.53%
CHF	1.95%	2.22%	1.51%
NZD	0.51%	0.58%	0.65%

OFFSHORE RMB AGAINST OTHER CURRENCIES

EUR/CNH

- The CNH was trading 1.60 per cent higher against the EUR in November 2016 from a month ago, and remained in a range of 7.31 to 7.54.
- The implied volatility of 3M OTC options edged higher to around 8 per cent in November 2016, attributable to the US presidential election and its outcome which might have caught the markets by surprise.
- On the FX radar, the valuation and fundamental factors were well above their historical average, while the risk, momentum, and sentiment factors were below their historical average.

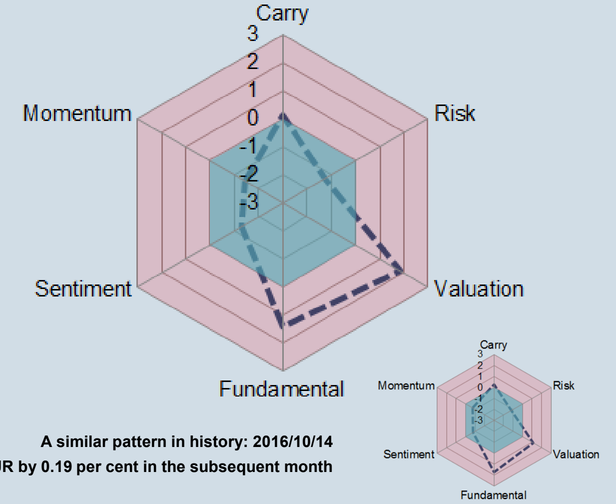
Monthly CNH Performance vs EUR

⬆ 1.60%

Implied Volatility

8.6%

Fig 13: FX Radar*



A similar pattern in history: 2016/10/14

The CNH depreciated against EUR by 0.19 per cent in the subsequent month

Fig 14: FX Volatility (3M Implied)

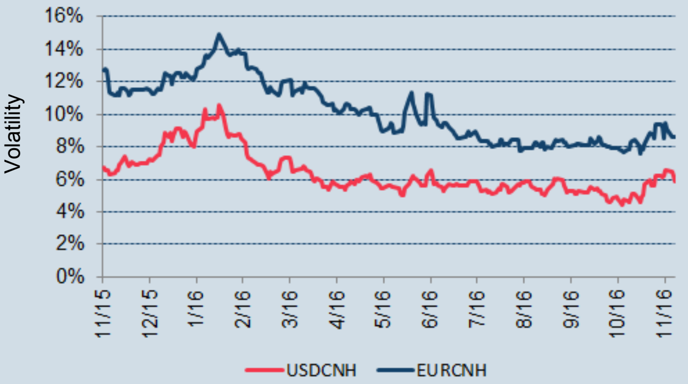
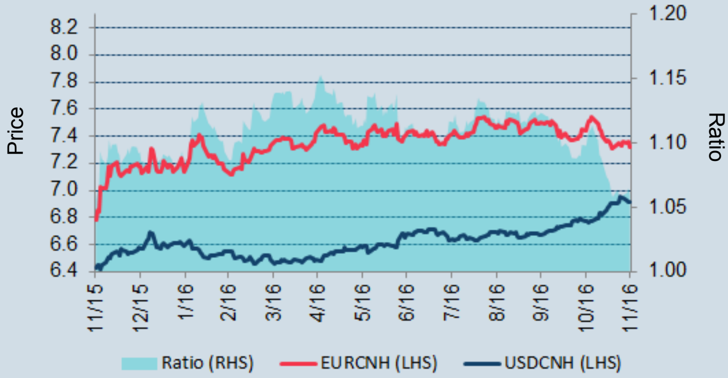


Fig 15: Price Ratio: EURCNH / USDCNH



AUD/CNH

- The CNH was trading 0.97 per cent higher against the Australian dollar (AUD) in November 2016 from a month ago, possibly due to weakness in the Australian building approvals data and a drop in iron ore spot prices.
- The implied volatility rebounded to near 10 per cent in November 2016.
- On the FX radar, the risk, momentum, and sentiment factors were below their historical average, while the valuation, carry, and fundamental factors were above their historical average.

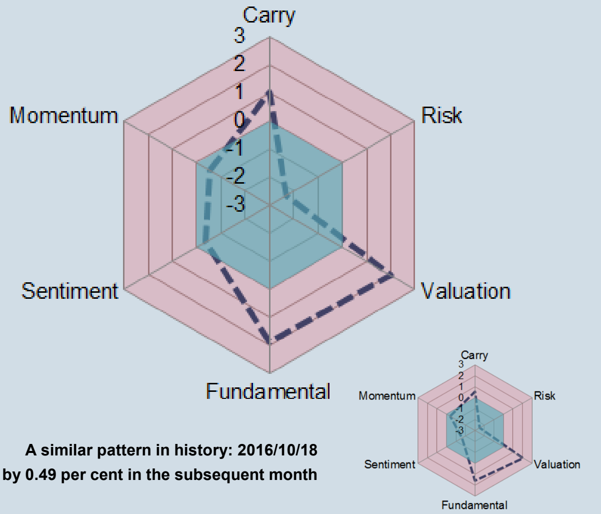
Monthly CNH Performance vs AUD

⬆ 0.97%

Implied Volatility

10.3%

Fig 16: FX Radar*



A similar pattern in history: 2016/10/18

The CNH depreciated against AUD by 0.49 per cent in the subsequent month

Fig 17: FX Volatility (3M Implied)

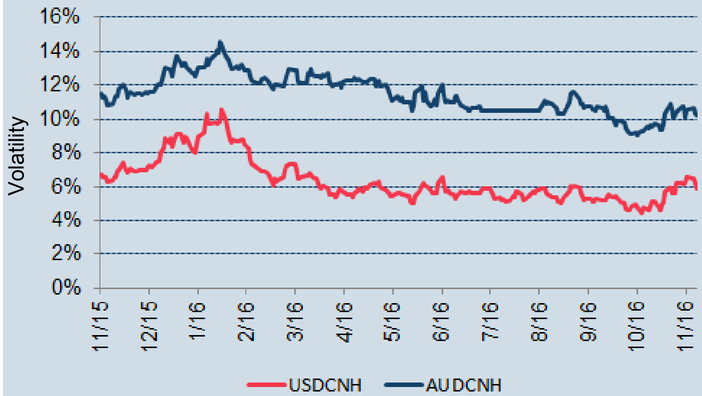
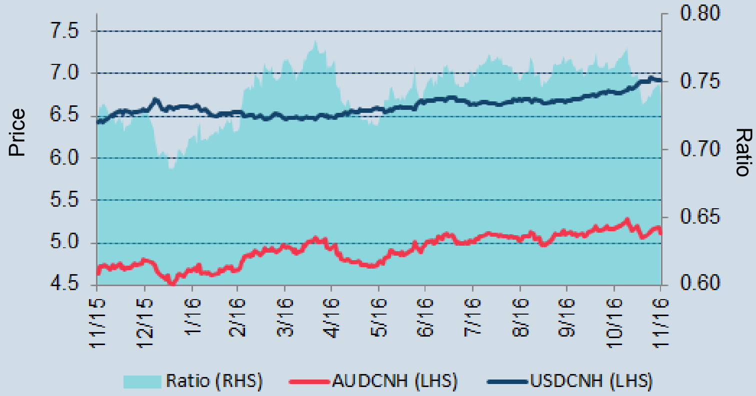


Fig 18: Price Ratio: AUDCNH / USDCNH



Sources: Bloomberg, WIND (30 November 2016)

Past performance is not a guide to the future

* For detailed information, please see appendix

JPY/CNH

- The CNH was trading 6.54 per cent higher against the JPY in November 2016 from a month ago, as the Bank of Japan's continued 'yield-curve control' policy has contributed to Yen weakness by dampening upward pressure on yields in Japan.
- The 3-month implied volatility OTC options rebounded to near 12 per cent in November 2016.
- On the FX radar, the sentiment and fundamental factors were above their historical average, while the valuation, risk, and momentum factors were below their historical average.

Monthly CNH Performance vs JPY

⬆ 6.54%

Implied Volatility

12.6%

Fig 19: FX Radar*

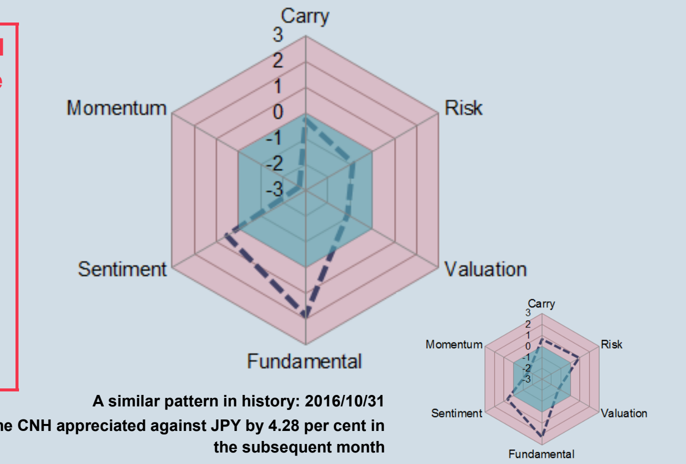


Fig 20: FX Volatility (3M Implied)

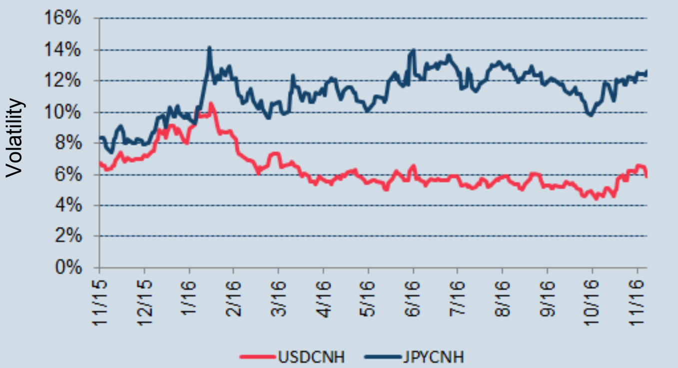


Fig 21: Price Ratio: JPYCNH / USDCNH

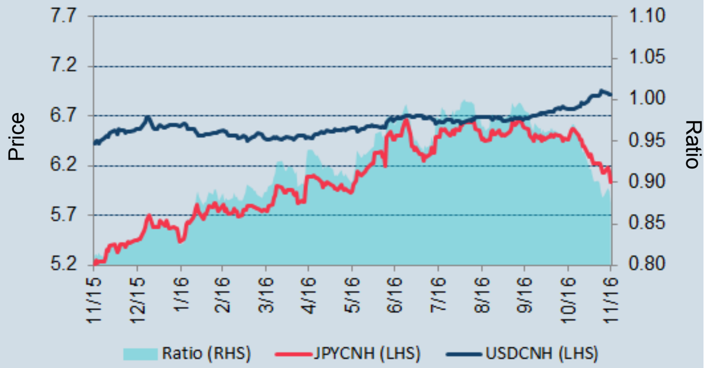


TABLE 4: Summary Table for RMB Currency Pairs

	Performance					Volatility					
	Nov	Oct	Chg	Prior 3 Month	YTD	Implied	Prior	Chg	Historical	Prior	Chg
USDCNH	-2.04%	-1.51%	⇩	-3.36%	-5.30%	5.9%	4.7%	⇧	3.0%	3.1%	⇩
EURCNH	1.60%	0.81%	⇧	1.91%	-1.99%	8.6%	7.8%	⇧	5.3%	5.9%	⇩
AUDCNH	0.97%	-0.81%	⇧	-1.54%	-6.72%	10.3%	9.6%	⇧	8.3%	8.9%	⇩
JPYCNH	6.54%	1.84%	⇧	6.60%	-10.91%	12.6%	10.8%	⇧	10.3%	13.4%	⇩

OFFSHORE BOND MARKET DYNAMICS

OFFSHORE RMB BOND MARKET COMMENTS

- RMB deposits in Hong Kong rebounded by 1.9 per cent month-on-month to RMB665.5 billion in September 2016.
- The total remittances of RMB for cross-border trade settlement amounted to RMB382.9 billion in September 2016, compared to RMB398.8 billion in August 2016.

Fig 22: Offshore RMB Deposits vs Dim Sum Bonds

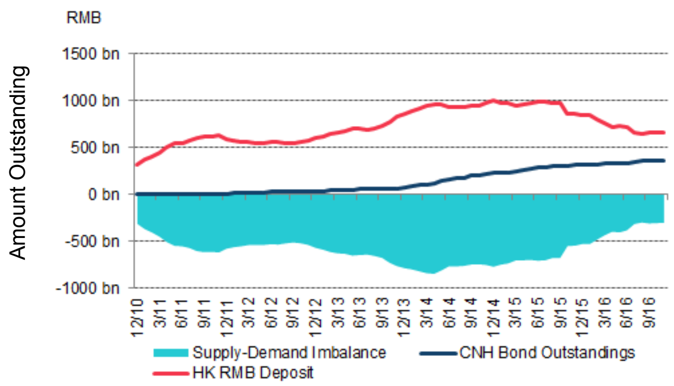


Fig 23: Offshore RMB Bond Issuances by Issuer Type

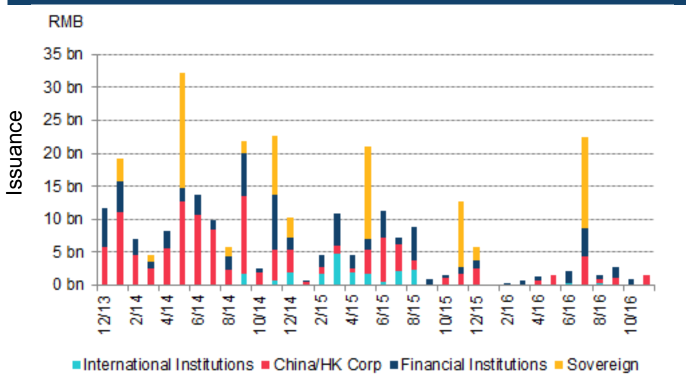
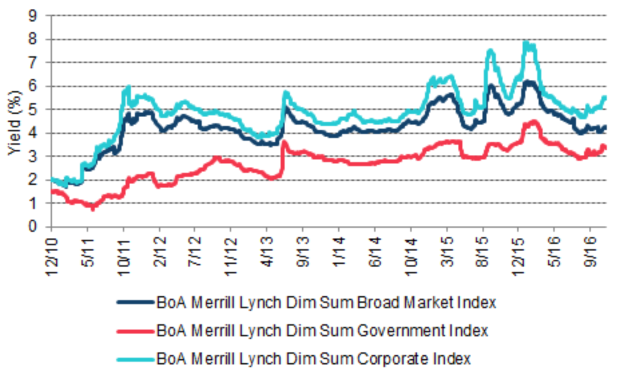


Fig 24: Dim Sum Bond Performance



ONSHORE RMB BOND MARKET COMMENTS

ONSHORE BOND MARKET DYNAMICS

- Onshore bond issuance increased 33.2 per cent to RMB 3.0 trillion in November 2016 from RMB 2.3 trillion in November 2015. Certificates of deposit (CDs) issuance in November 2016 was up nearly 80 per cent from a year ago.
- Further to PBOC's announcement of detailed China interbank bond market (CIBM) access procedures in May 2016, the foreign participation has increased to record levels, representing 2.48 per cent in holding (all-time highs) and 0.54 per cent on trading volume in the CIBM.
- Ease of moving funds, clear ownership rules, and clarity around tax laws are investors' top concerns when it comes to China's onshore bond markets outweighing worries over economic growth and property prices, a survey showed on 16 November 2016. The survey was led by the Asia Securities Industry & Financial Markets Association (ASIFMA).

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

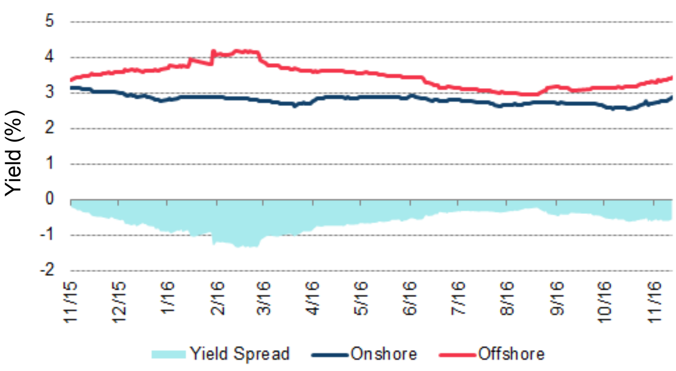


TABLE 5

Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types, for November 2016)

Bond Type	Number of Deals	Trading Value(RMB 100M)	Yield to Maturity(%)
Policy Financial Bond	53,750	48,348.65	3.0088
Treasury Bond	14,142	11,717.23	2.6857
Medium-term Note	11,951	7,901.69	5.0498
Corporate Bond	10,778	5,975.96	4.4765
CDs	13,016	31,456.65	3.2220
Commercial Paper	15,242	10,790.22	3.5102
Central Bank Paper	-	-	-
Others	5,220	6,615.72	4.1872
Total	**124,099**	**122,806.12**	**3.3118**

Fig 26: MoF T-Bond Outstanding Split by Tenor

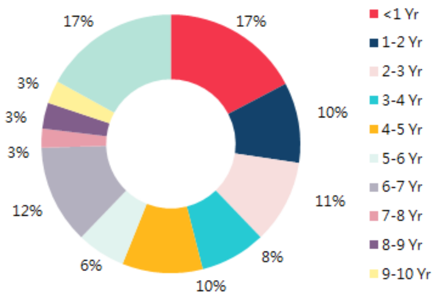


TABLE 6

NAFMII Guidance for Non Fixed Income Debt Issuing (as of 2016/11/30)

	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.13	↑	3.51	↑	3.69	↑	4.06	↑	4.31	↑	4.92	↑	5.09	↑	5.34	↑
AAA	3.30	↑	3.58	↑	3.88	↑	4.39	↑	4.61	↑	5.21	↑	5.55	↑	5.84	↑
AA+	3.53	↑	3.98	↑	4.31	↑	4.89	↑	5.25	↑	5.86	↑	6.24	↑	6.57	↑
AA	3.90	↑	4.46	↑	4.80	↑	5.54	↑	5.75	↑	6.59	↑	6.95	↑	7.41	↑
AA-	5.18	↑	5.78	↑	6.15	↑	7.23	↑	7.64	↑	8.25	↑	8.65	↑	8.95	↑

NAFMII – National Association of Financial Market Institutional Investors

Fig 27: Foreign Participation in the CIBM Market

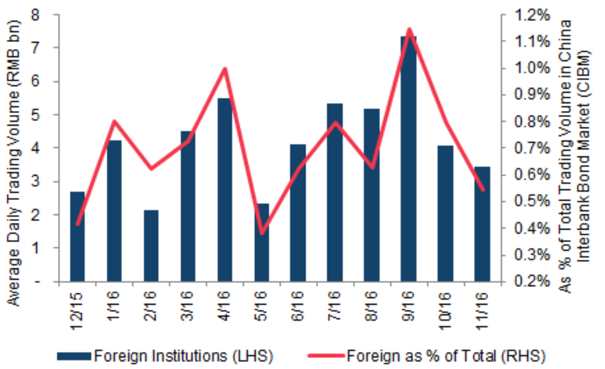


Fig 28: Onshore Bond Holdings by Foreign Institutions

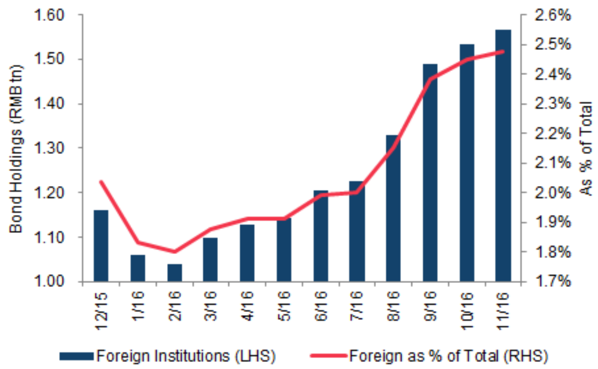


Fig 29: Bond Holdings Composition by Foreign Institutions

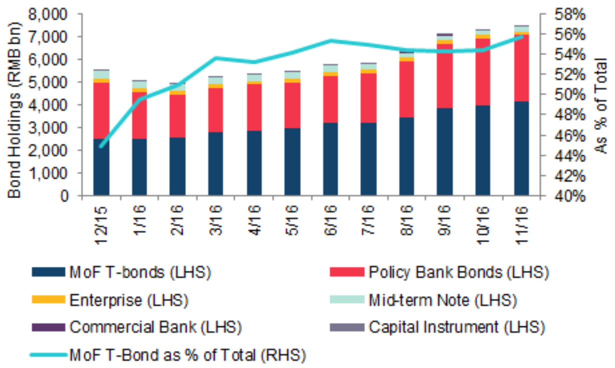
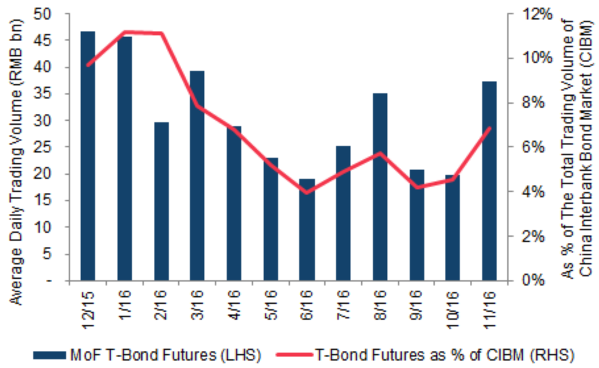


Fig 30: MoF T-Bond Futures Trading Volumes



ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- China's Central Bank has been tightening monetary policy through open market operations. The benchmark SHIBOR rate, a key barometer of money market liquidity and a measure of the cost at which Chinese banks lend to each another, rose across all tenors since the US presidential election on 9 November 2016. The 7-day SHIBOR rate increased to 2.502 per cent on 30 November 2016, a 15-month high since August 2015. The current cash-strapped condition in China's inter-bank market could be the result of drops in new RMB funds outstanding for foreign exchange since October.
- CNH HIBOR overnight loan rate rose to 2.94 per cent on 30 November 2016, 1.31 per cent increase from end of October. Analysts voiced suspicions that PBOC had circulated new rules for companies which make yuan-denominated loans to overseas entities, leaving market players concerned that offshore yuan liquidity will be further tightened.

Fig 31: CNH Implied Yield vs. USD/CNH

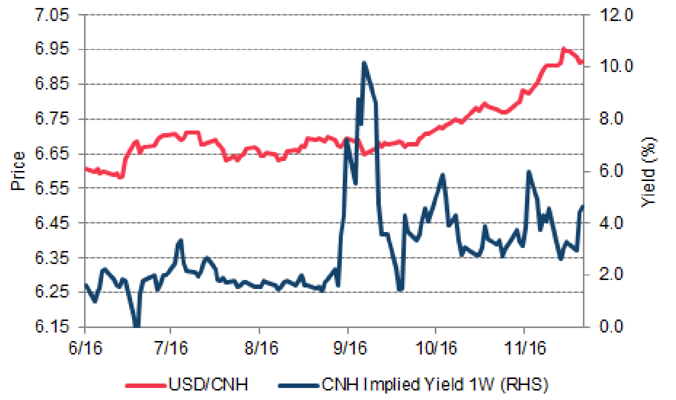


Fig 32: CNY SHIBOR Yield Curves

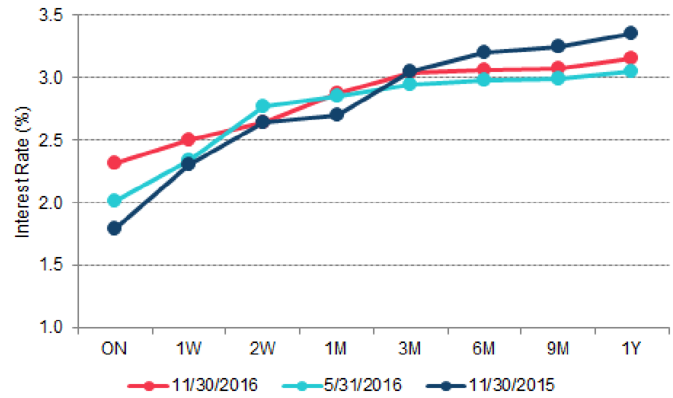


Fig 33: CNH HIBOR Yield Curves

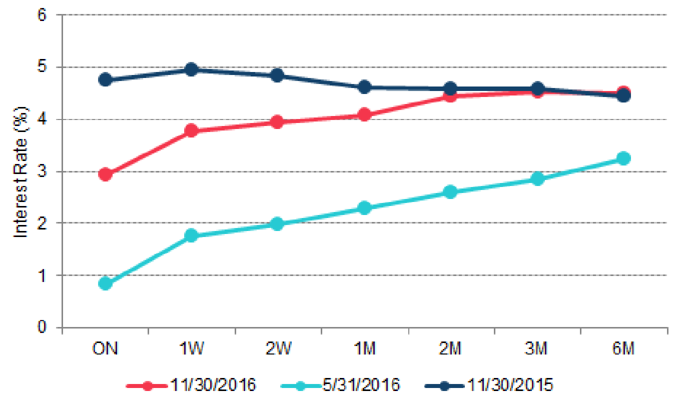


Fig 34: Onshore IRS (7D Repo) Yield Curves

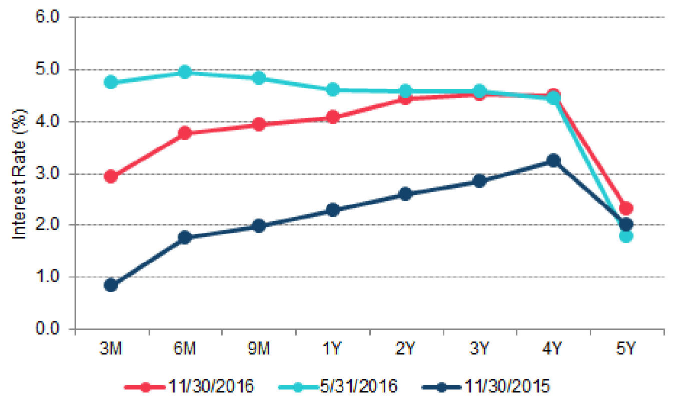


Fig 35: Onshore IRS Trading Notional Principal

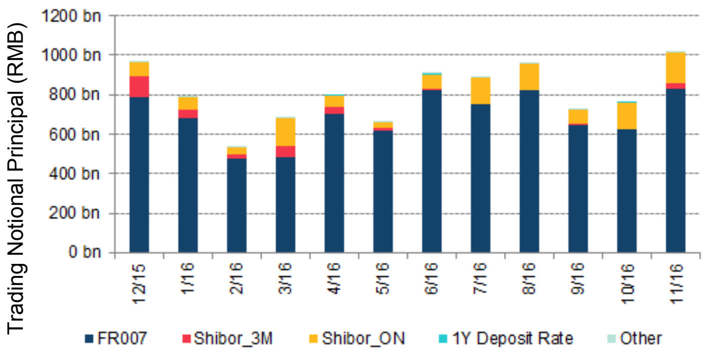


Fig 36: CNY SHIBOR vs CNH HIBOR

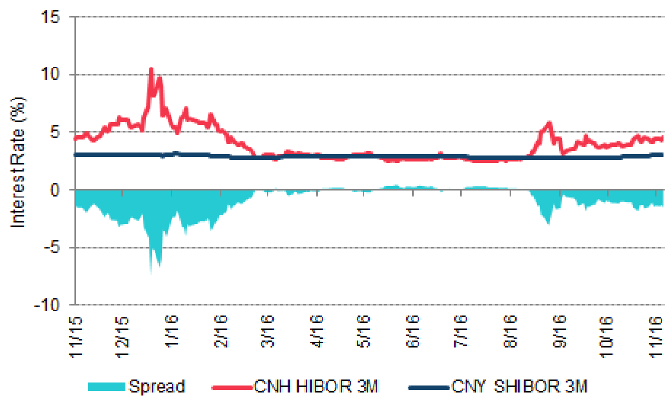
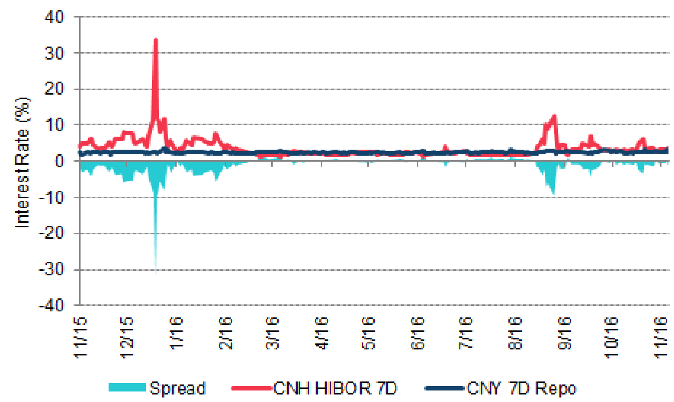


Fig 37: CNY 7D Repo vs CNH HIBOR



Sources: Bloomberg, CFETS (30 November 2016)

(Continued from page 1)

I. Shenzhen-Hong Kong Stock Connect opens up an era of Mutual Market between Hong Kong, Shanghai and Shenzhen

The launch of Shenzhen-Hong Kong Stock Connect, in particular the abolition of the aggregate quota, will effectively link up the Hong Kong, Shanghai and Shenzhen markets into a “mutual market”. Before the launch of the Stock Connect programme, each of the three markets was already among the world’s top ten in terms of market cap, though still lagging some distances behind a few major markets. The removal of the aggregate quota and the linking of the three exchanges will result in a sizable market with a total market cap of $70 trillion and a combined turnover rivaling those of NYSE and other leading major exchanges across the globe.

Two aspects could illustrate how the Stock Connect programme and the abolition of the aggregate quota will lead to a mutual market:

Firstly, the linking up of the Hong Kong, Shanghai and Shenzhen markets will significantly expand the investor base. On such a vast platform, investors may come from overseas, Hong Kong or the Mainland. If connectivity in the secondary market could be extended to the primary market, the appeal to high-quality listing candidates of various sectors will be enormous.

Secondly, the three exchanges will complement each other, widening the array of choices for investors. At present, a company planning for flotation has to decide between Hong Kong, Shanghai or Shenzhen. Hong Kong could appear to be at a disadvantage because valuations on average for its listed companies are lower. However, a comparative study of the various sectors would reveal that the lower valuations are mainly a result of domination of the Hang Seng Indexes by heavyweights in traditional cyclical sectors (e.g. finance and properties). Stock valuations of certain sectors, such as healthcare, are actually higher in Hong Kong than in the Mainland.

II. Shenzhen-Hong Kong Stock Connect is expected to trigger diversified market interactions

Shanghai-Hong Kong Stock Connect is a pilot program that is experimental and exploratory by nature. It takes time for investors to familiarise with it. According to statistics, both southbound and northbound trading under Shanghai-Hong Kong Stock Connect represents a very small percentage of the respective turnovers of the two markets. It is far from being able to affect the trading habits and cycles of the home markets. Southbound trading’s share of total stock market turnover in Hong Kong has been slowly increasing from 0.5-0.6 per cent to the current 3-5 per cent. Foreign funds investing in the Shanghai stock market represent only a meagre 0.5 - 0.9 per cent of that market’s turnover, given the abundant liquidity in the Mainland.

Will Shenzhen-Hong Kong Stock Connect change this status? The launch of Shenzhen-Hong Kong Stock Connect involves the removal of the aggregate quota and actively introducing new types of investors such as pension funds, so more interactions between the markets should be expected after the launch. Which parts of the market are expected to be more active after the launch of the Shenzhen Connect? Let’s look at the change of investors’ preferences under Shanghai-Hong Kong Stock Connect. In 2015, 61 per cent of southbound trades invested in large-cap stocks. Research on SMEs has been inadequate and their valuations sharply differed. Interestingly, although many investors thought that SME price differentials between the Shanghai and Hong Kong markets would narrow after the launch of Shanghai-Hong Kong Stock Connect, the gap in fact widened at that time. It showed even with the Stock Connect programme, Shanghai and Hong Kong markets were still operating according to their own cycles and market dynamics. Data showed Mainland funds started to invest in large-cap stocks in 2016. About 51 per cent of the funds were invested in large caps, mostly financial stocks. Given the apparent price differentials, low interest rates, a shortage of investable assets onshore, and Hong Kong market’s depth and liquidity to absorb pension fund investments, financial institutions have expanded their equity exposure.

III. Shenzhen-Hong Kong Stock Connect is expected to help Hong Kong strengthen its IFC role, and facilitate the two-way opening of the Mainland capital market to meet the need for overseas allocation of assets among market participants (investors, financial institutions and business enterprises)

Currently, the Mainland capital market is still highly restricted, which deprives Mainland market participants of an efficient platform for oversea asset allocation. Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, together with the abolition of the trading quota, have effectively created such a platform. For example, insurance companies in the Mainland are now permitted to invest as much as 15 per cent of their funds overseas, though their current foreign investments represent only around 2 per cent of total assets. Furthermore, despite Mainland being the world’s second largest economy and topping the world in international trade, quite few financial products in global capital markets are denominated in RMB. Thus, the potential of the Mainland capital market opening up further is huge. Investors have a compelling need for an efficient platform that allows them to invest and allocate their assets globally. Shanghai and Shenzhen-Hong Kong Stock Connect represent such a platform.

Historically, there were several phases in the opening up of Mainland’s capital market. From 1993 to 2000, Mainland enterprises listed overseas, primarily in Hong Kong, to raise international funds. Over HK$5 trillion has been raised in Hong Kong by Mainland enterprises since 1993. Between 2001 and 2010, QFII and QDII schemes were introduced amid rapid development of the Mainland capital market and breakthroughs in the reform of non-tradable shares. Now the opening up of Mainland’s capital market have entered its third stage, and progressing vigorously in the macro trend of the RMB internationalisation. An example is the shift of some RQFIIs from the secondary market to direct investment.

In the course of Mainland’s reform and opening up, Hong Kong successfully turned itself into an international financial center (IFC). Previously, companies listed in Hong Kong were basically small local enterprises. The Mainland’s market reform and opening offers Hong Kong the opportunity to serve as a bridge between the East and the West satisfying Mainland enterprises’ desire to raise funds and international investors’ ambition to venture into Mainland. International investors and listed companies from the Mainland were matched in the Hong Kong market. By performing this role efficiently, Hong Kong successfully turned itself into an IFC.

Now Mainland investors are looking to diversify their portfolios by approaching the international markets, meanwhile overseas financial products need new groups of investors, which in turns form a new ecosystem of capital flows. There is a need for Hong Kong to turn itself into a “financial supermarket” where international financial products across various asset classes are displayed for picking by Mainland investors. Equities, fixed income and currency (FIC) products and commodities products should be available for sale in such a financial supermarket. The next step could be the extension of connectivity between Hong Kong and the Mainland markets from the secondary to the primary equity market, and from equities to FIC and then to commodities.

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EXPERT CORNER

ALTHOUGH SMALLER DIM SUM HAS INCREASED ITS INTERNATIONAL FOOTPRINT

Contributed by Iris Pang, Senior Economist, Greater China, Natixis

It is obvious that the onshore bond market has grown tremendously, with government and quasi-government bonds contributing over 60 per cent of the total. The growth of the onshore bond market has been a result of tighter banking credit appetite as well as longer waiting time for IPO listing under the background of higher funding needs among onshore corporates.

For offshore issuers (including foreign subsidiaries of Mainland corporates), the focus of interest is the difference between issuing and investing in the Panda bond market relative to the Dim Sum bond market. We would like to point out that they are two very different markets.

The Panda: Growing Fast But Lack of Non-Mainland Background Issuers

The obvious benefit for foreign issuers to raise funds in the Panda bond market is that they have operation funding needs denominated in the yuan onshore so that the foreign issuers would avoid forex risk.

There has been only small foreign demand for Panda bonds due to the near zero interest rate in the U.S. and the negative interest rates in Europe and Japan. This explains that the fact that most of the issuers in the Panda market is Mainland's overseas subsidiaries or Hong Kong corporates.

However, this trend may change in 2017. The dollar funding costs have increased in 2016, and if this continues in 2017, the cost of funds raised in the dollar bond market and top up the cost with fx hedging could become similar to the level of raising funds in the Panda bond market.

The Dim Sum: Mainland-background offshore issuers favor Dim Sum to capture RMB internationalisation potential

Arguably, Dim sum bonds also offer the forex natural hedges for foreign corporates who would need RMB funding for their Mainland operations. Because of this similarity, the Dim Sum bond market faces the same challenge as the Panda bond market as raising funds in the dollar market should be less expensive.

However, there is one more challenge for the Dim Sum bond market. The coupon rates onshore and offshore are different. Chart 4 shows that interest rates onshore have been lower than offshore since late 2015. The negative interest rate spread (i.e. onshore funding even cheaper) means that when foreign issuers consider to issuer RMB denominated bonds they may prefer Panda to Dim Sum if they have Mainland operation.

From the changing pattern of issuers by their country of risks, we can tell that the higher costs of fund in the Dim Sum bond market should be a critical factor for Mainland-background corporates to consider when they chose between Panda and Dim Sum.

Moving towards internationalisation

But not every issuer faces the same demand function. The composition of dim sum issuance shows that non-Mainland, non-Hong Kong issuers have had more interest to issue dim sum bond than Mainland background issuers. This characteristic is usually overlooked by market participants when the Panda market is compared to the Dim Sum market.

For foreign issuers, the Dim Sum market provides an extra flexibility on the use of funds offshore. In contrast, the funds raised in the Panda market should be used only at onshore. The flexibility provided by the Dim Sum market means that issuers and therefore investors from the rest of the world can create a portfolio that is consists of the a well-known issuers in the currency of RMB in order to capture the potential of RMB internationalisation.

The group of Australian banks has been the largest foreign issuer (excluding Hong Kong) in 2016 in terms of number as well as the monetary value of the issuance. Issuing in a depreciating currency benefits the issuers as the coupon payment should be at lower costs, and the repayment of principal when the bond is matured will also be cheaper compared to issuance in AUD.

Depreciation of RMB is the main reason behind the quieter market

Regardless of the high composition of Aussie banks supporting the Dim Sum market, the overall sentiment for RMB assets have decreased. The smaller issuance of the dim sum bond market so far compared to the same period in 2015 was due to the depreciating RMB. When the RMB weakens, the investment demand for RMB bonds fade with the expectation of capital gain in the exchange rate. This is also the main underlying reason for a falling pool of RMB deposits and CDs offshore this year. if RMB continues to depreciate, the volume of Dim Sum bond market is likely to shrink even if there is support from issuance by foreign banks that try to capture the potential of RMB internationalisation.

Conclusion

As we have shown in the analysis, the demand function of issuers for the Panda bond market is different from that for Dim Sum bond. The lack of flexibility on the use of funds of Panda bond is the dividing line between the two. And for the same reason bond issuers and offshore investors could capture the potential of RMB internationalisation via the Dim Sum market offshore.

Fig 38: Onshore Bond Issuance

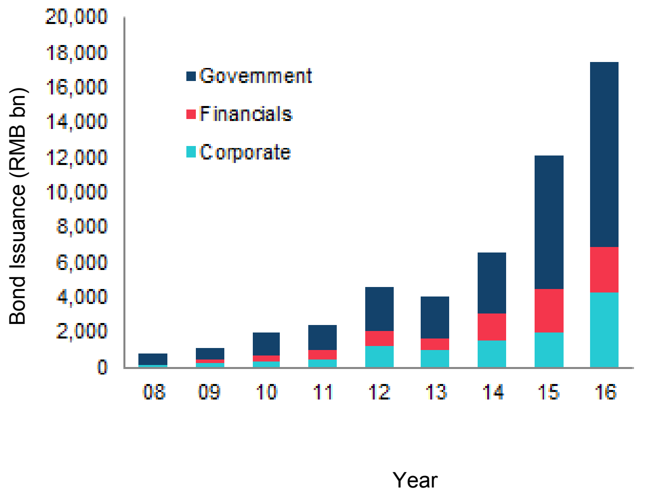


Fig 39: Panda Bond Issuance

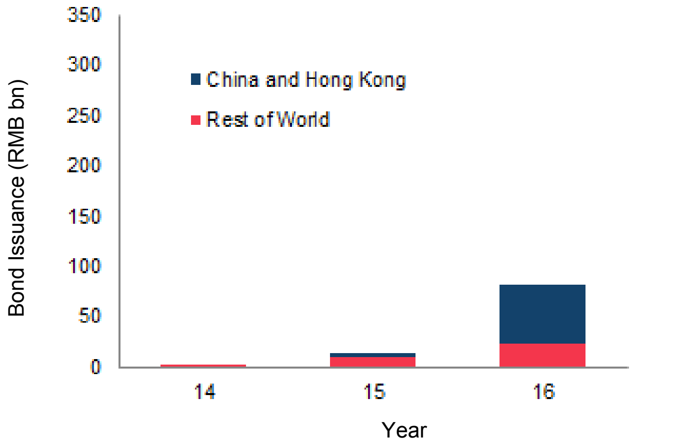


Fig 40: Dim Sum Bond Issuance

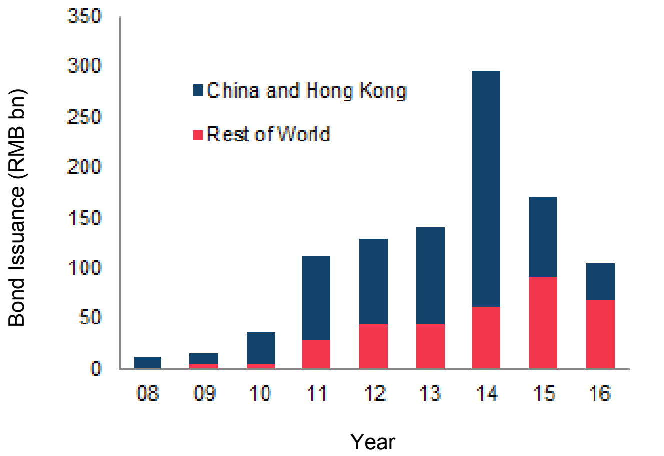


Fig 41: USD/CNH and 1Y Deposit Rate Spread

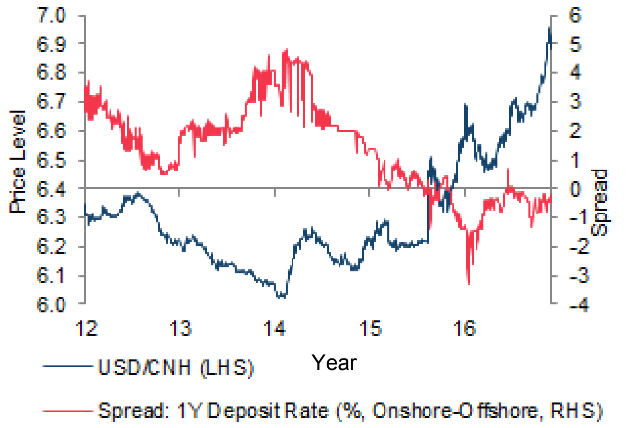


Fig 42: Dim Sum Bond Issuance by Country of Risk (as of 10 November 2016)

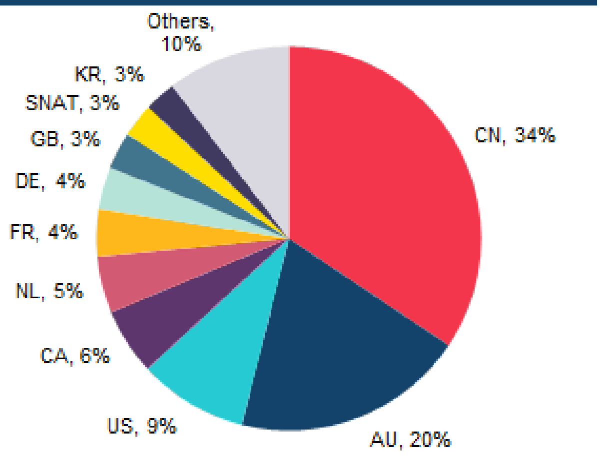
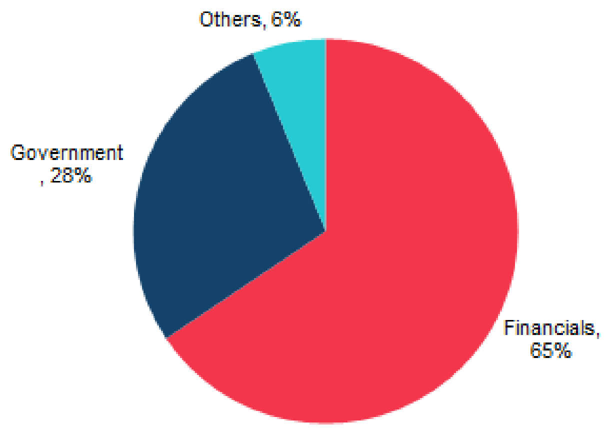


Fig 43: Dim Sum Bond Issuance by Sector (as of 10 November 2016)



SNAT, supranational, an international organization or union in which member states transcend national boundaries or interests to share in the decision making and vote on issues pertaining to the wider grouping.

Source: Natixis, Bloomberg (10 November 2016)

Fig 44: Key Dim Sum Bond Issuance by Financials

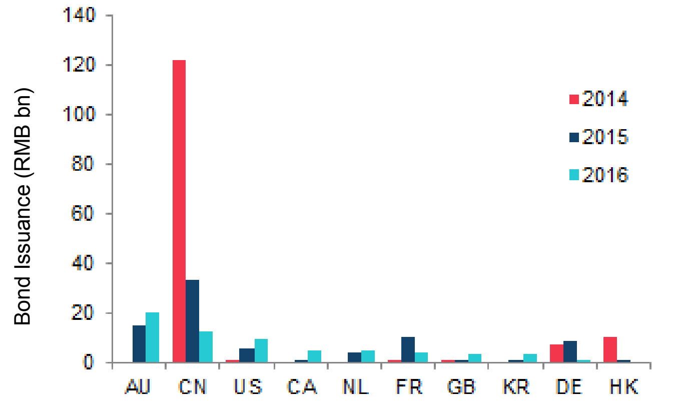


Fig 45: Dim Sum Bond Issuance by Australian Financials

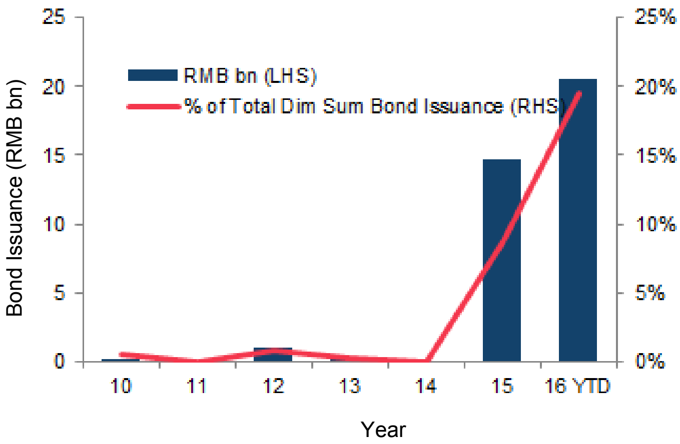


Fig 46: RMB Exchange Rate

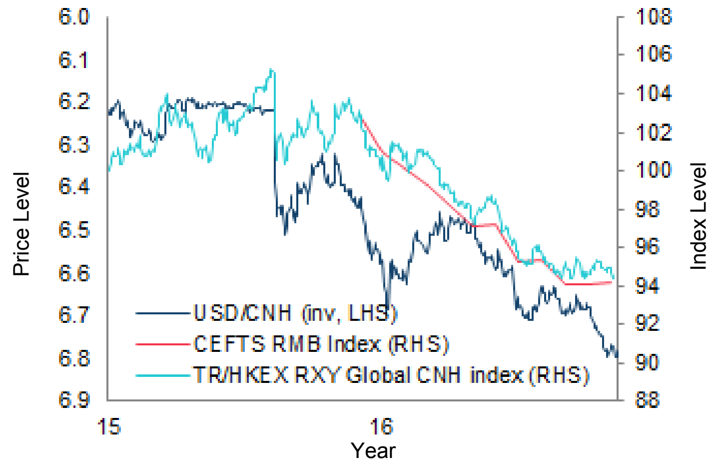


Fig 47: RMB Offshore Deposits

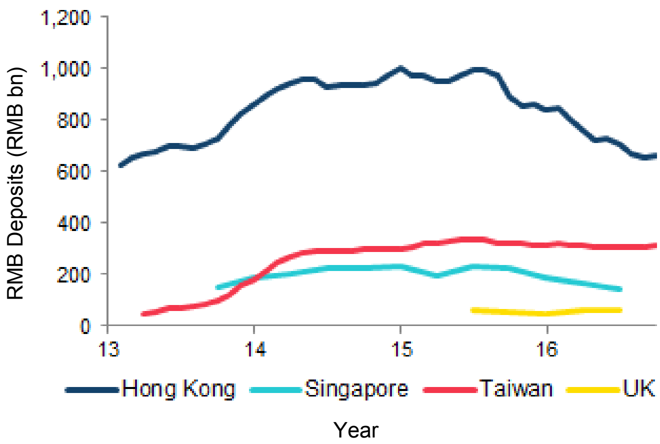
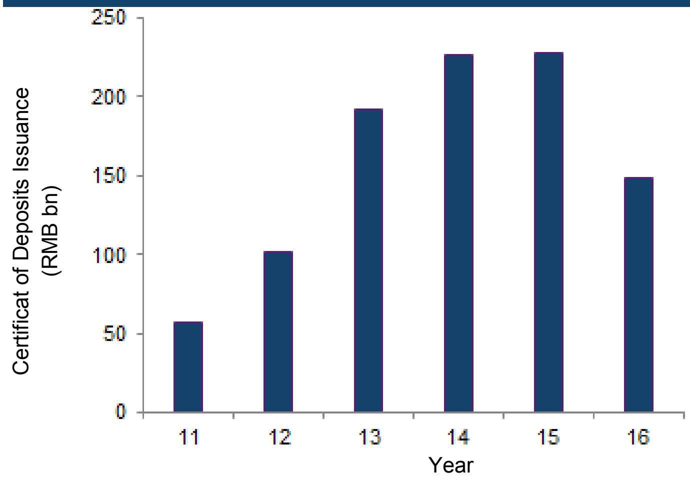


Fig 48: Offshore Certificate of Deposits Issuance by Chinese Banks' Overseas Branches



Iris Pang joined Natixis in January 2016 as Senior Economist, Greater China. She has over ten years of experience, with a focus on the economies of Greater China, including as Chief Economist at OCBC Wing Hang Bank. She is a graduate of the University of New South Wales and the University of Auckland, and has a PhD in Economics from Hong Kong University of Science and Technology.

Source: Natixis, Bloomberg, HKEX, Bank of England, City of London (10 November 2016)

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 normalised 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 optimisation across the six driving factors. The historical price movement of that particular period is shown for reference.

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