HKEX 香港交易所

Inside Fixed Income and Currency (FIC) Monthly Newsletter

Issue No 13

January 2016

Monthly Highlights

- **On 18 January 2016, the People's Bank of China (PBOC) announced new reserve requirements for offshore RMB dealers' accounts with onshore entities to curb speculation on CNH/CNY.**
- **HKEX's USD/CNH futures contract had an average daily volume, or ADV, of 3,264 contracts (US$326 mn notional) in January 2016, an all-time high and a 58 per cent increase from December last year. Open interest reached 30,516 contracts (US$3,052 mn notional) at the end of January 2016, a 27 per cent increase from the end of December last year.**
- **HKEX's Chief China Economist, Dr Ba Shusong, considers that with the reform of the RMB's central parity rate formation mechanism, the RMB exchange rate is expected to become more flexible in 2016.**
- **In the Expert Corner, Becky Liu of Standard Chartered Bank says 2016 is likely to be a challenging year for both the RMB exchange rate and the dim sum bond market.**

From the Chief China Economist's Vantage Point

RMB Exchange Rate Outlook 2016

Dr Ba Shusong, Chief China Economist, HKEX

With the reform of the RMB's central parity rate formation mechanism, the inclusion of the RMB into the International Monetary Fund's (IMF's) Special Drawing Rights (SDR) basket and the shift of the major RMB benchmark from RMB against US dollar to RMB against a basket of currencies, the RMB exchange rate is expected to become more flexible in 2016. The RMB is the first emerging market currency to be included in the SDR basket. The inclusion ensures the relative stability of the RMB's exchange rate against a basket of emerging economy currencies and allows more flexibility for the USD/CNY exchange rate. The inclusion has multilateral significance for the internationalisation of the RMB. From the perspective of monetary policy, a flexible exchange rate facilitates prudent balancing of internal and external goals and ensures flexibility to give priority to internal goals.

I. Flexibility of RMB exchange rate is set to increase, while pricing benchmark shifts to a basket of currencies

In 2015, the US economy entered into a relatively stable stage while the Chinese economy came under downward pressure as it went through a transition via capacity reduction and deleveraging. In terms of international capital flows, with major developed countries implementing low or zero interest rates policies since 2009, interest rate spreads between the RMB and major currencies increased and there were RMB capital inflows that resulted from expectations of an appreciation in the RMB and corporate bonds. Differences between US and Chinese currency policies and the narrowing of interest spreads together with increasing expectations of a US interest rate hike have led to short-term expectations for a depreciation of the RMB against the US dollar.

Figure1: Percentage of Imports from China

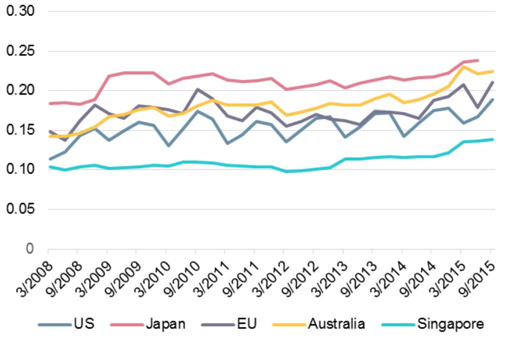
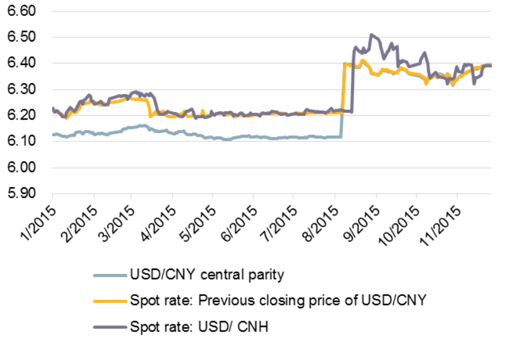


Figure 2: USD/CNY Midpoint and Last Close



However, according to historical foreign trade data (see Figure 1), the percentage of Chinese merchandise imported by the US, Japan, EU, Australia and Singapore has risen rather than dropped, which indicates that China's current poor trade performance has been caused by reduced overseas demand. **China's exports remain competitive. There is no need for China to boost exports through RMB depreciation**. On the other hand, this also implies that the RMB's **passive appreciation against the US dollar has caused the RMB to deviate from its internal equilibrium price, which is one of the main reasons for the increasing expectations of RMB depreciation**. Hence, while the US dollar continues to appreciate, the RMB should maintain its strength not through stabilising against the US dollar, **but through a gradual shift to a pricing benchmark made up of a basket of currencies**.

The PBOC's reform of the RMB central parity pricing mechanism on 11 August 2015 has increased the flexibility of the RMB exchange rate. It should be noted that even before the exchange rate reform, market demand and supply, as well as changes in the RMB exchange rate against a basket of currencies were already taken into account in the calculation of the RMB central parity rate. However, at the time the opening quote was reset every morning, and as a result it had quite a low correlation with the previous day's central parity close. The formation of a continuous exchange rate curve was therefore difficult, and as the central parity mainly reflects the policy intention of the PBOC, there were frequently substantial gaps between the market open price and previous day's close. For example, the USD/CNY exchange rate in the first half of 2015 (see Figure 2), the USD/CNY central parity persistently deviated from the market price before the exchange rate reform. After the exchange rate reform, the central parity rate converged with the market price and the RMB exchange rate became more flexible.

Figure 3: Index of Effective Exchange Rates of Major Currencies

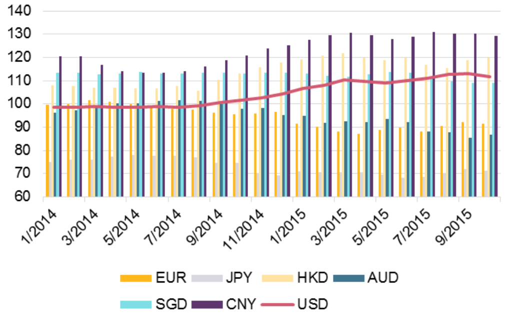


Figure 4: A Comparison of RMB Exchange Rate Index and USD/CNY Movements

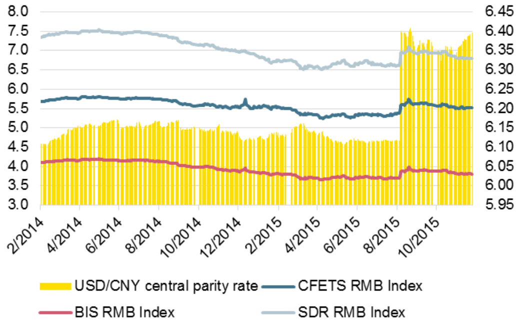


Table 1: A Comparison of RMB Exchange Rate Indices Calculation

Currencies	CFETS RMB Exchange Rate Index[1]	RMB Exchange Rate Index referencing BIS currency basket[2]	RMB Exchange Rate Index referencing SDR[3]
USD/CNY	0.264	0.178	0.419
EUR/CNY	0.2139	0.187	0.374
JPY/CNY	0.1468	0.141	0.094
HKD/CNY	0.0655	0.008	
GBP/CNY	0.0386	0.029	0.113
AUD/CNY	0.0627	0.015	
NZD/CNY	0.0065	0.002	
SGD/CNY	0.0382	0.027	
CHF/CNY	0.0151	0.014	
CAD/CNY	0.0253	0.021	
CNY/MYR	0.0467	0.022	
CNY/RUB	0.0436	0.018	
CNY/THB	0.0333	0.021	

1) The sample currencies are trade weighted and enter pot trade factors are taken into account. The values are RMB central parity rates and trade reference prices of the day. The base date is 31 December 2014 and the base point is 100.

2) The weightings of the Bank for International Settlements (BIS) currency basket are adopted. For currencies traded in CFETS, the values are RMB central parity rates and trade reference prices of the day. For currencies not traded in CFETS, the values are calculated from USD/CNY central parity rate and the currencies' exchange rate against the US dollar on the relevant day. The base date is 31 December 2014 and the base point is 100.

3) The weightings are calculated from the weightings of the currencies in the SDR currency basket. The values are the RMB central parity rates of the day. The base date is 31 December 2014 and the base point is 100.

From **a pricing benchmark perspective**, the RMB exchange rate has long been benchmarked against the US dollar. At times when the US dollar value was relatively stable, the difference between the USD/CNY rate and the weighted exchange rate of the RMB against a basket of currencies was not obvious. However, when the US dollar started appreciating (see Figure 3) from the second half of 2014 with its effective exchange rate index rising from 98 to 110.80, it caused the RMB to appreciate passively along with it. If the principal yardstick for valuing the RMB continues to be the USD/CNY exchange rate, it will generate further RMB exchange rate deviation from a fair level. Exchange rate movements are intended to adjust trade and investment among trade partners. In the current international financial environment, the USD/CNY exchange rate cannot by itself fully reflect the prices of traded products. In the future, the main reference point for valuing the RMB will gradually shift from the US dollar to a basket of currencies. This will facilitate management of market expectations and allow the RMB exchange rate to better serve its purpose of adjusting international trade, investments and balances of payments. Even compared to a floating exchange rate mechanism, referring to a basket of currencies can also avoid substantial short-term over-adjustment.

On 11 December 2015, the China Foreign Exchange Trade System & National Interbank Funding Centre (CFETS) released the CFETS RMB exchange rate index, aiming to guide the market away from only looking at the USD/CNY exchange rate, and gradually towards referring to the exchange rate of the RMB against a basket of currencies when assessing the RMB exchange rate. The new index provides a quantitative indicator for the market to change its perspective about the RMB exchange rate and allows the RMB exchange rate to reflect market changes more comprehensively and accurately. Table 1 above compares the currency weightings of the **CFETS RMB exchange rate index and those in the Bank for International Settlements (BIS) currency basket as well as in the SDR basket. According to Table 1, the CFETS RMB exchange rate index is choosing and also allocating weights among the countries/currencies based on their foreign trade relationships with China, and it gives relatively bigger weightings to currencies from major Asia Pacific markets. The different weightings among the HKD, the AUD, the SGD and the RUB have demonstrated this clearly**. A comparison of the RMB exchange rate index and the USD/CNY central parity price (see Figure 4) shows that **although the RMB has tended to depreciate against the US dollar recently, it has slightly appreciated overall against other major currencies since 2014 if referring to a basket of currencies**. Even after the exchange rate reform on 11 August 2015, the RMB's depreciation against major currencies has been limited. According to data released by CFETS, the CFETS RMB exchange rate index has been relatively stable since 2015. On 30 November 2015, it was 102.93, up 2.93 per cent from the end of 2014. So as a matter of fact, the RMB has slightly appreciated against a basket of currencies, meaning it remains strong among international currencies.

II. RMB's inclusion into the SDR basket has limited short-term effects but medium to long-term effects will gradually become visible

In the short term, the inclusion of the RMB in the SDR basket has limited effect on the currency's movements, which remain largely under the influence of the economic environment in China and overseas. **From a medium to long-term perspective, the RMB will, after its inclusion into the SDR basket, increasingly supplement and gradually replace the existing international reserve currencies chosen by emerging markets and peripheral countries**. Hence, China's RMB exchange rate policy should focus on stabilising the RMB exchange rate against emerging market currencies while maintaining appropriate flexibility against the US dollar in order to break the RMB's synchrony with the US dollar and increase the RMB's independent influence among international currencies. To achieve this goal, the PBOC reformed the central parity pricing mechanism and stressed the importance of reference to a basket of currencies before and after the RMB's inclusion into the SDR basket. It demonstrated once again China's determination to strengthen the independent position of the RMB in the international market.

In the medium to long term, the PBOC's monetary policy framework will be reshaped on a balancing of internal and external priorities. As the RMB becomes an international reserve currency, international coordination on monetary policies will become more important and the effects of the PBOC's independent monetary policies will be weakened while China's economic growth will become a global economic development issue. China is now under pressure from economic restructuring and transition. As financial reforms intensify, policy makers will have to strike a balance between growth objectives and the stability of the RMB exchange rate. The dilemma is not unlike those faced by the monetary authorities of Latin American and Asian countries in the 1980s and 1990s. As the world's second largest economy, **China ought to implement monetary policies that first ensure the country has room for independent decision making to achieve internal growth objectives, and also provide relatively flexible RMB rates that are stable and strong against emerging countries' currencies while moving into a wider trading band against the US dollar**.

III. Reform measures for the RMB's internationalisation set to improve further

Although the basic reform framework for the RMB exchange rate has been completed, there is still room for further improvement of essential policy support and assistance tools. For example the exchange rate reform on 11 August 2015; along with greater exchange rate flexibility from the reform, there has been increased volatility in the CNH market (see Figure 5). Before 11 August 2015, the daily price gap between CNY and CNY stayed steady at about 100 basis points. After 11 August 2015, that gap widened rapidly to about 1,000 basis points with increased volatility during the day, undermining the RMB's stability. The phenomenon indicates there is **a need for the CNH pricing mechanism to improve** and a need for a greater number of diversified products nominated in CNH. In particular, there is a need for a strengthened bond market. First, the CNH market needs to expand further. Benchmark interest rates based on the interbank market have to be established and the CNH bond market has to be further strengthened to **increase the effectiveness of the benchmark interest rates**. Second, the yield curve of CNH bonds should be improved. For example, CNH bonds issued in Hong Kong (see Figure 6 and 7) are mainly short to medium- term bonds both in terms of size and tranches. Bonds with maturities between one and three years account for 56.36 per cent of the total issued bonds by size and 49.86 per cent by tranches, while these percentages for bonds with maturities of five years or below account for 80 per cent or more. In comparison, another notable feature is the absence of long-term bonds. Hence, more long-term CHN bond issuance and **improvement of the CNH bond yield curve to mitigate disruption to the CNH market** will help narrow the CNY-CNH price gap thereby enhancing the RMB exchange rate formulation mechanism. Third, Hong Kong should be encouraged to develop diversified products for the purpose of risk management against future fluctuations in the RMB exchange rate. Fourth, development of a CNH-denominated commodities market offshore should be explored. It would not only allow Chinese commodities to influence RMB commodity pricing right in the Asian time zone but also improve the depth of Hong Kong's CNH market, further strengthening Hong Kong's position as an offshore RMB hub.

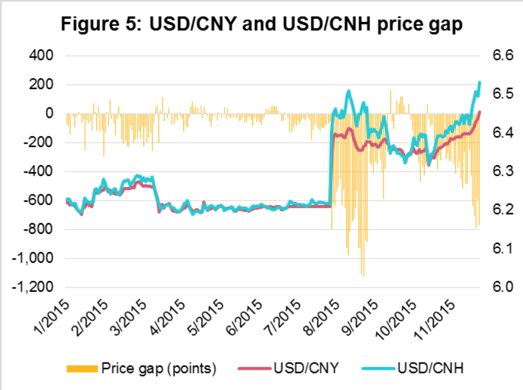


Figure 5: USD/CNY and USD/CNH price gap
400
200
0
-200
-400
-600
-800
-1,000
-1,200
6.6
6.5
6.4
6.3
6.2
6.1
6.0
1/2015
2/2015
3/2015
4/2015
5/2015
6/2015
7/2015
8/2015
9/2015
10/2015
11/2015
Price gap (points)
USD/CNY
USD/CNH

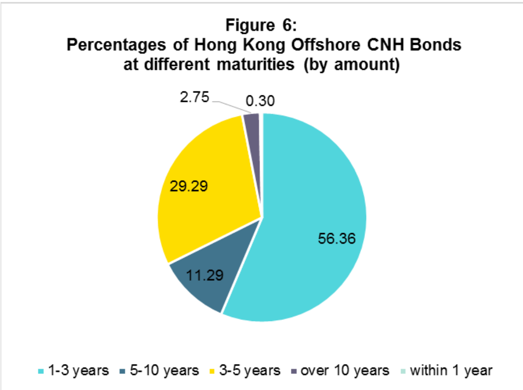


Figure 6:
Percentages of Hong Kong Offshore CNH Bonds at different maturities (by amount)
2.75
0.30
29.29
56.36
11.29
1-3 years
5-10 years
3-5 years
over 10 years
within 1 year

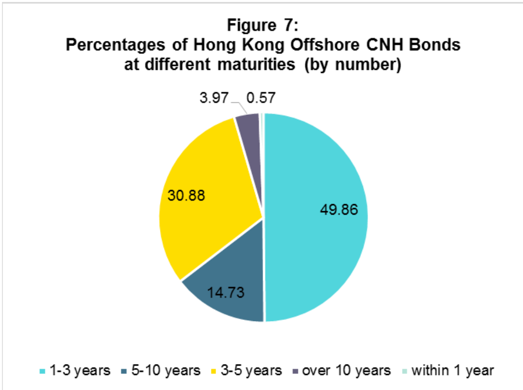


Figure 7:
Percentages of Hong Kong Offshore CNH Bonds at different maturities (by number)
3.97
0.57
30.88
49.86
14.73
1-3 years
5-10 years
3-5 years
over 10 years
within 1 year

China Macro Update

Figure 8: CFETS RMB TWI vs DXY

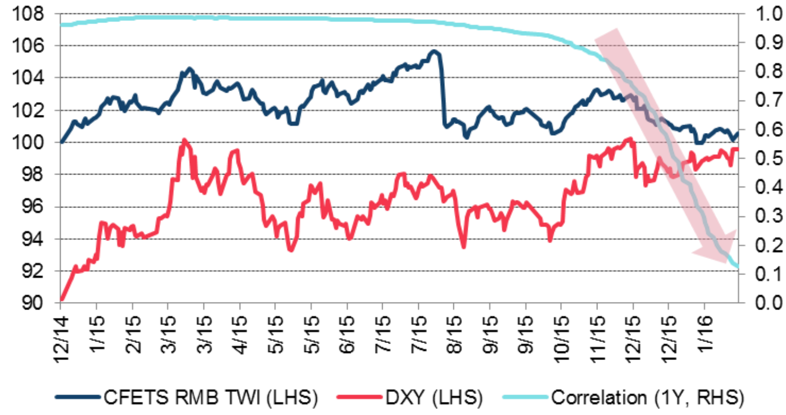


Figure 9: Macro-Economic Climate Index

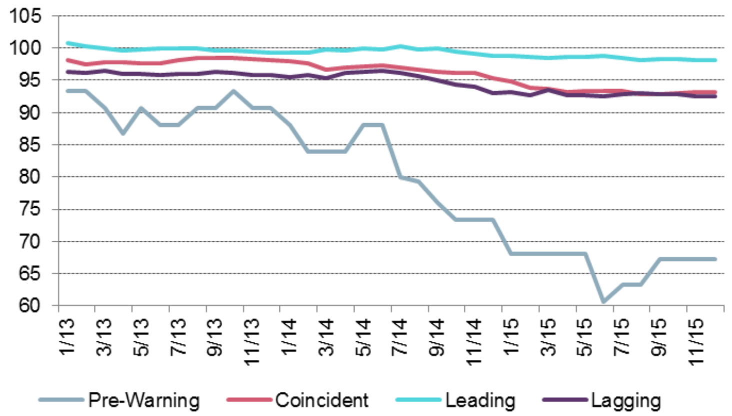


Table 2

China Key Economic Indicators	Current	Prior	Chg	Next Release Date
Real GDP (yoy %)	6.8	6.9	⇩	04/15/2016 10:00
CPI (yoy %)	1.6	1.5	⇧	02/18/2016 09:30
PPI (yoy %)	-5.9	-5.9	⇨	02/18/2016 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 %)	-5.8	1.9	⇩	02/08/2016 02/12
CFLP Manufacturing PMI	49.4	49.7	⇩	02/01/2016 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	⇨	02/28/2016 02/29
Exports (yoy %)	-1.4	-6.8	⇧	02/15/2016
Imports (yoy %)	-7.6	-8.7	⇧	02/15/2016
M2 Money Supply (yoy %)	13.3	13.7	⇩	02/10/2016 02/15
Retail Sales (yoy %)	11.1	11.2	⇩	04/15/2016 10:00
Consumer Confidence Index	114.9	113.7	⇧	02/24/2016 09:45
Regulated Reserve Ratio (%)	17.5	18	⇩	Infrequent
Official Foreign Exchange Reserves (USD bn)	3330.36	3438.3	⇩	02/07/2016
Three-Month SHIBOR (%)	3.08	3.05	⇧	Continuous
10-Year Gov't Bond Yield (%)	2.87	3.04	⇩	Continuous
CNY/USD Exchange Rate	6.5539	6.4814	⇧	Continuous

Regulatory/Policy Developments

- The PBOC has always maintained a managed floating rate system based on market supply and demand with reference to, but no peg, to a basket of currencies. The CFETS CNY TWI had historically tracked closely to the US dollar index (DXY) but began to decouple recently. The annualised correlation between the two indices started to decrease in August 2015 and went down to less than 20 per cent recently.
- On 18 January 2016, the PBOC announced measures to charge its reserve requirements for offshore RMB dealers' accounts with onshore entities. The planned increase was designed to soak up additional liquidity in the offshore RMB market as the PBOC aims to curb speculation on CNH/CNY.
- The PBOC is expanding a pilot programme, which was tested in the Shanghai free trade zone, that relaxes controls on foreign borrowing. The central bank will let 27 companies and financial institutions in the Fujian, Guangzhou, Shanghai and Tianjin free trade zones engage in cross-border financing in the RMB and foreign currency without government pre-approval.

Macro Economic Update

- Consensus is growing that China is not on the road to economic crisis but laying the groundwork for a brighter future, International Monetary Fund chief Christine Lagarde said. "We were fearing that there would be [a] hard landing in China, but almost everybody here at Davos now feels that it is not going to be a hard landing. We are going to see an evolution, not a hard landing, and a move towards a sustainable growth." (The World Economic Forum at the session "Where Is the Chinese Economy Heading?" in Switzerland, 21 Jan 2016)

Market/Product Developments

- The Canadian province of British Columbia issued a Panda bond on 21 January 2016, the first by a foreign country in China's interbank bond market. The three-year bond, priced to yield 2.95 per cent, raised RMB3 billion, or about US$455 million. It was oversubscribed and investors included policy banks, commercial banks, fund managers and brokerage firms.
- The PBOC on 20 January 2016 announced that it will try to issue digital currency "as soon as possible" to cut the costs of circulating traditional paper money and boost policymakers' control of money supply.

Key Research Reports/Conferences

- According to the most recent monthly survey of exporting firms conducted by FT Confidential Research, a Financial Times research service, 56 per cent of export manufacturers said they were not worried about the impact of the RMB exchange rate on their profits. This was below November's 72 per cent — the highest proportion in the survey's three-plus-year history — but well above the series average of 31 per cent.

Sources: Bloomberg, WIND (29 Jan 2016), The World Economic Forum (21 Jan 2016)

RMB FX Market Dynamics

Offshore RMB FX Market Comments

- On 4 January 2016, the PBOC surprised the market by setting the daily reference rate for the RMB below 6.5 against USD, the lowest in more than four years.
- On 7 January 2016, the CNH/CNY spread climbed to over 2,000 pips, the highest in four years. Such divergence reflects differences in sentiment between CNH, with no restriction on use and price range, and CNY, which is still heavily regulated.
- In December 2015, Chinese FX reserves declined by a record US$108 billion to US$3.33 trillion, indicating that CNY was supported through FX purchase operations.

Figure 10: Onshore/Offshore RMB Price Range

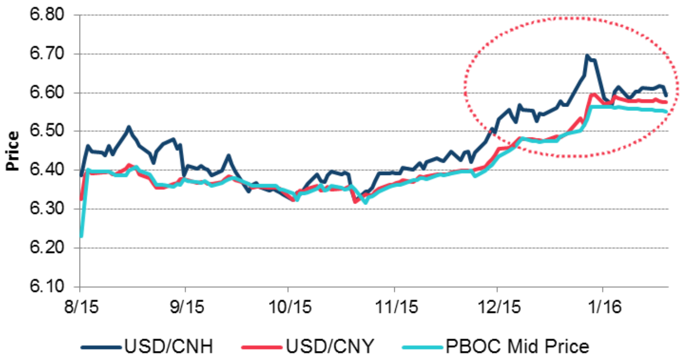


Figure 11: Implied Volatilities of OTC USD/CNH ATM Options

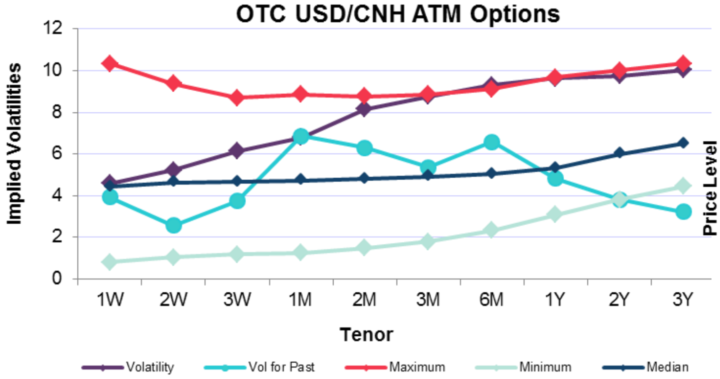
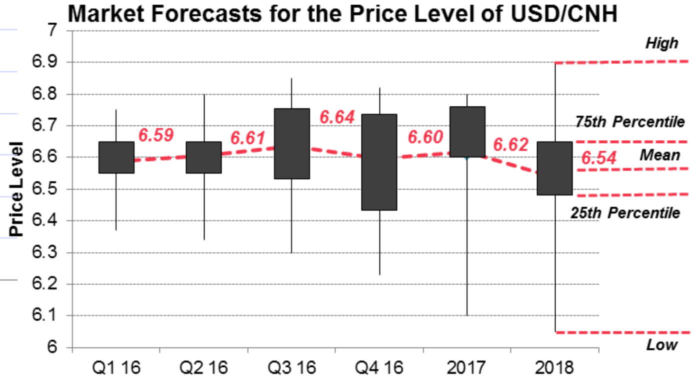


Figure 12: Market Forecasts for the Price Level of USD/CNH



HKEX's USD/CNH Futures

Product Highlights

- HKEX's USD/CNH futures contract had a record high ADV of 3,264 contracts (US$326 mn notional) in January 2016. ADV was up 58 per cent from December 2015. Open interest also rose, ending the month at 30,516 contracts (US$3,052 mn notional) for a 27 per cent increase from end of last month.
- Trading volume was high in the March 2016, June 2016 and December 2016 contracts, which accounted for 60 per cent of total volume in January 2016. Open interest was high in the June 2016, December 2016 and March 2017 contracts, which accounted for 71 per cent of total open interest at the end of January.
- Starting from February 2016, real-time price information for HKEX's USD/CNH futures can be accessed via "Futures and Options Prices and Charts" in the Investment Service Centre of the HKEX website ([webpage]).

Figure 13: USD/CNH Futures Turnover and OI

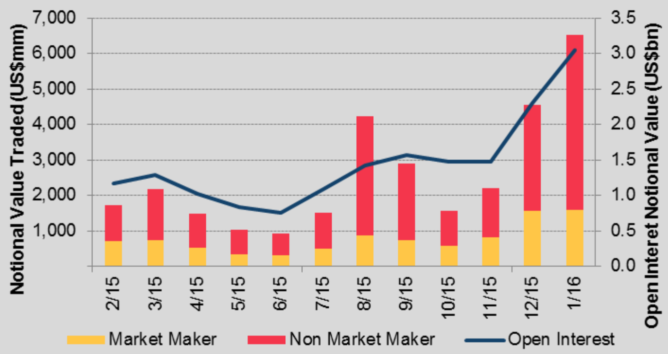
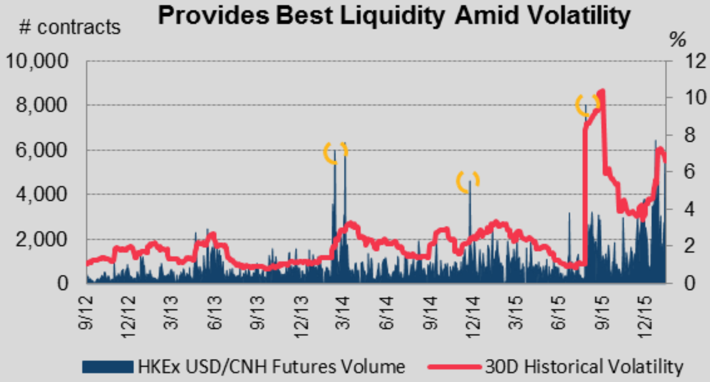


Figure 14: HKEx USD/CNH Futures Contract Provides Best Liquidity Amid Volatility



Figures 15: Breakdown of Volume by Contract Month (1/2016)

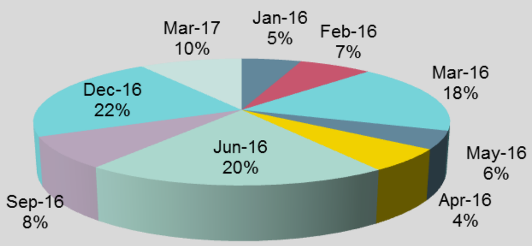
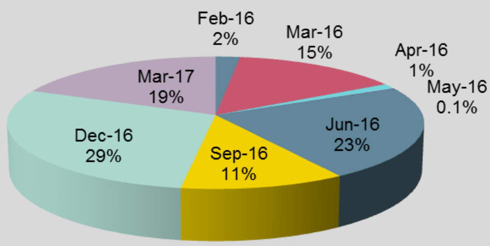


Figure 16: Breakdown of OI by Contract Month (29/1/2016)

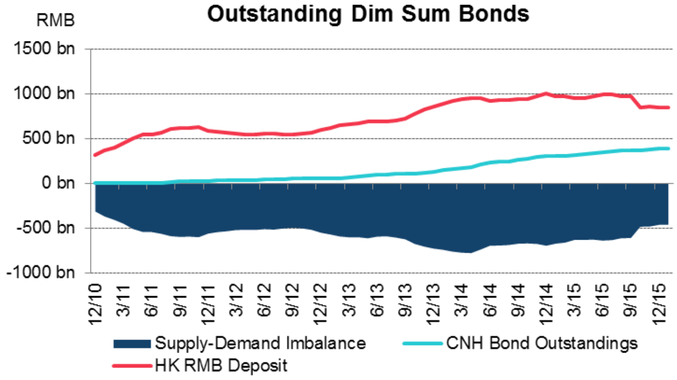


Offshore Bond Market Dynamics

Offshore RMB Bond Market Comments

- There were no primary issues in CNH in January 2016. RMB deposits in Hong Kong decreased by 1.5 per cent MoM to RMB851.1 billion at the end of December 2015. The total remittances of RMB for cross-border trade settlement amounted to RMB667.5 billion in November 2015, compared to RMB508.9 billion in October 2015.
- As the new year got underway, the Dim Sum bond yield climbed further and at a faster pace, following the rebound that started in November 2015. There's also been a further widening in the gap between offshore and onshore MoF T-Bond five-year yields in recent months.

Figure 17: Offshore RMB Deposits vs Outstanding Dim Sum Bonds



Figures 18: RMB Bond Issuances by Issuer Type

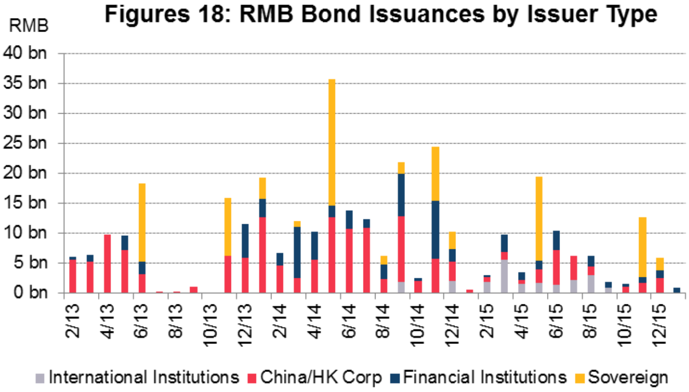
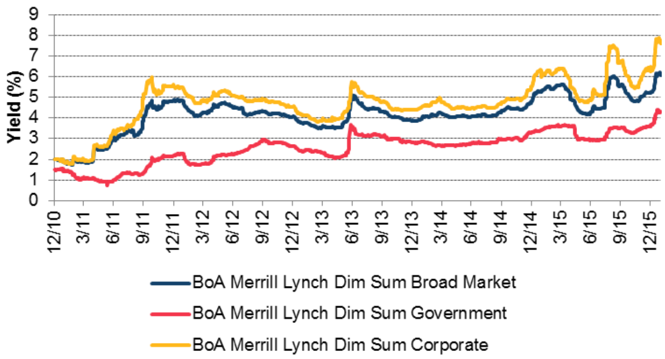


Figure 19: Dim Sum Bond Performance



Onshore Bond Market Dynamics

Onshore RMB Bond Market Comments

- Onshore bond issuance decreased 11.9 per cent to RMB2.7 trillion in January 2016 from RMB3 trillion in December 2015.
- China's reopened Panda bond market has continued to gather momentum, as it recently had its first issues from offshore listed companies since it was closed. The International Finance Corporation (IFC) predicted that the market will surpass US$48.64 billion in the next five years.
- China's corporate bond issuers have more flexibility after the National Development and Reform Commission eased market procedures. The regulator is also removing limits on issue by corporates rated at least AA and calling on insurers to offer default swaps and bond default insurance.

Figure 20: MoF T-Bond Yield 5Y: Onshore vs Offshore (%)

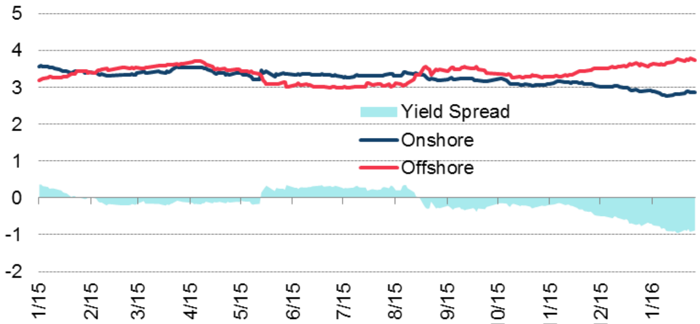


Table 3

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	38,577	40,241.90	2.9431
Treasury Bond	10,992	9,409.91	2.6682
Medium-term Note	13,250	10,390.47	4.9210
Corporate Bond	11,803	7,569.74	4.6501
CDs	4,121	8,994.63	3.1868
Commercial Paper	16,497	13,106.20	3.4931
Central Bank Paper	86	259.51	2.7794
Others	3,077	3,125.62	4.8602
Total	**98,403**	**93,097.98**	**3.4466**

Figure 21: MoF T-Bond Outstanding Split by Tenor

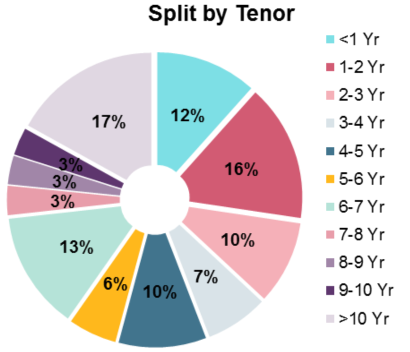


Table 4

NAFMII Guidance for Non FI Debt Issuing (as of 2016/1/27)																
	1Yr	MoM	3Yr	MoM	5Yr	MoM	7Yr	MoM	10Yr	MoM	15Yr	MoM	20Yr	MoM	30Yr	MoM
AAA+	3.16	↓	3.69	↓	3.92	↓	4.22	↓	4.44	↓	5.02	↓	5.19	↓	5.46	↓
AAA	3.35	↓	3.84	↓	4.11	↓	4.51	↓	4.74	↓	5.34	↓	5.62	↓	5.91	↓
AA+	3.59	↓	4.21	↓	4.59	↓	5.00	↓	5.39	↓	5.97	↓	6.34	↓	6.64	↓
AA	4.08	↓	4.71	↓	5.15	↓	5.63	↓	5.95	↓	6.66	↓	7.01	↓	7.47	↓
AA-	5.46	↓	6.02	↓	6.52	↓	7.37	↓	7.84	↓	8.34	↓	8.72	↓	8.99	↓

Onshore/Offshore Short-Term Interest Rate Dynamics

Onshore/Offshore RMB STIR Market Comments

- Overnight Treasury Markets Association (TMA)'s CNH HIBOR jumped to a record high of 66.82 per cent on 12 January 2016 in a side effect of a campaign by the PBOC to curb arbitrage between offshore and onshore RMB interest rates.
- As the spread between CNY and CNH has narrowed substantially to around 100 - 200 pips, China eased its purchases of offshore RMB and overnight TMA CNH HIBOR has dropped back to a normal level of 2 to 3 per cent.
- The CNH HIBOR yield curve looked much different at the end of January this year than it did at the end of January and July of last year. (see Figure 24)

Figure 22: CNH Implied Yield Spike Driven by FX Movement

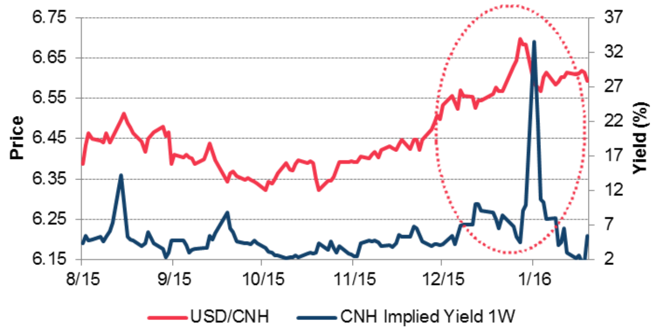


Figure 23: CNY SHIBOR Yield Curves

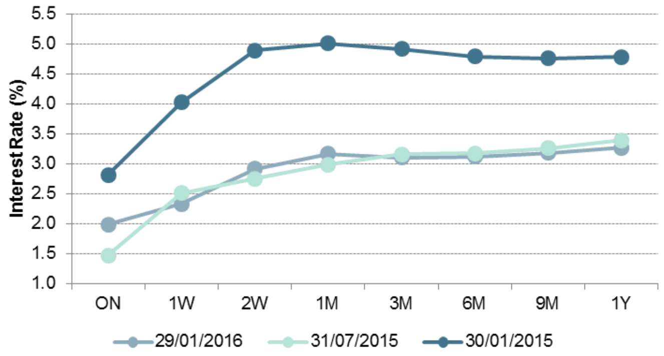


Figure 24: CNH HIBOR Yield Curves

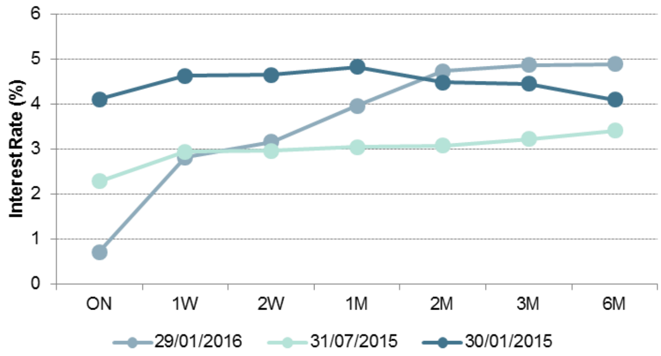


Figure 25: Onshore IRS (7D Repo) Yield Curves

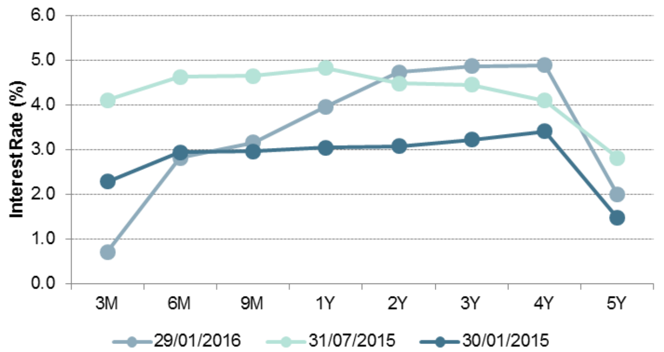


Figure 26: Onshore IRS Trading Notional Principal

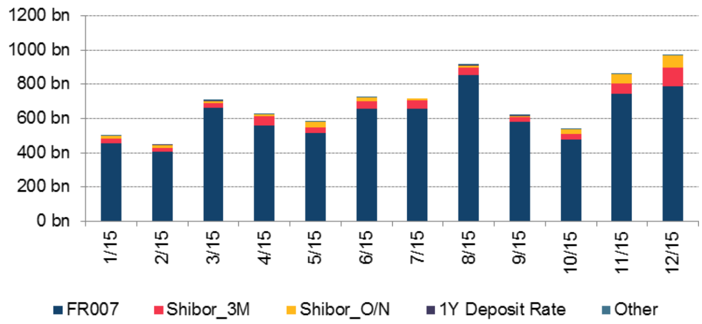


Figure 27: CNY SHIBOR vs CNH HIBOR

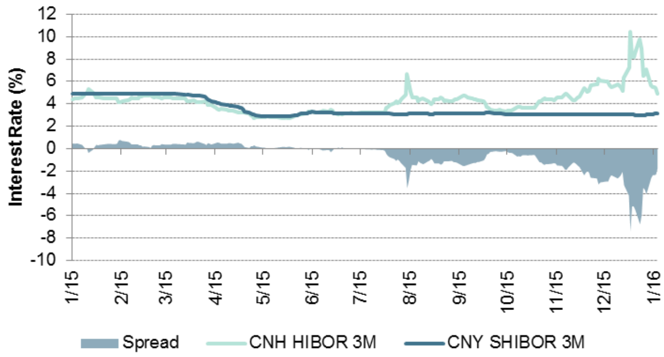
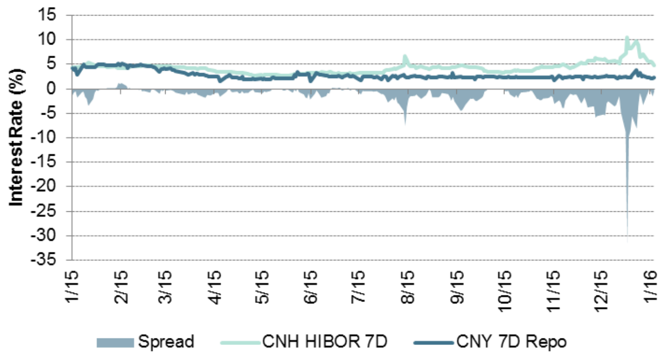


Figure 28: CNY 7D Repo vs CNH HIBOR



Expert Corner

Contributed by Becky Liu, Senior Rates Strategist, Global Research, Standard Chartered Bank (HK) Ltd

Dim Sum bond and RMB FX outlook for 2016 – a challenging year

2016 is likely to be a challenging year for both the RMB exchange rate and the Dim Sum bond market. We expect: 1) RMB FX is likely to be under further pressure in the near future; 2) CNH cost of funding is likely to persistently stay higher than onshore; 3) Dim Sum bond market size is likely to shrink for the first time. But it is not all gloomy. The RMB's SDR inclusion has greatly increased the global awareness of the asset class, and the China markets have become too big to be ignored. We believe international investments into China are likely to materially increase as soon as the FX outlook stabilises.

First, RMB is likely to face more depreciation pressure. China and the US are going through monetary policy divergence – while the Fed enters a rate hiking cycle, China is likely to ease further. China's introduction of the CFETS basket in late 2015 was a de facto de-peg from the US dollar, suggesting the likelihood of further depreciation of the RMB against the US dollar if the dollar continues to strengthen. Moreover, Chinese corporates' repayments of foreign currency liabilities also weigh on the RMB FX. Since the fixing reform in August, the outstanding amount of China's domestic foreign currency loans have declined by 10 per cent. We believe the reduction of China's foreign currency liability is likely to be of similar, if not faster, speed as the currency's FX outlook weakened. The low cost of funding in China's onshore market currently also provides corporates a strong incentive to borrow at a lower cost from the onshore market, and pay off their offshore foreign currency liabilities (which have costs). We expect USD/CNY to further depreciate to 6.65 and USD/CNH to 6.75 by end Q1 2016, before slightly recovering in H2 2016.

Second, we expect CNH funding costs to stay persistently higher than onshore costs for at least H1 2016, if not the entire year. After a few quarters of on-offshore interest rate convergence, the two rates sharply diverged – while onshore bond yields are breaking new record lows, the overnight CNH HIBOR rates surged to its highest on record of 67 per cent in early 2016. Already, Dim Sum bonds are yielding higher than their onshore peers across the board. For example, short-dated offshore CGBs are yielding more than 100 bps higher than their onshore peers; 1Y CNH deposits has risen beyond 5 per cent, while the onshore 1Y deposits stays around 2 per cent.

The Chinese authorities now favour a tight CNH liquidity condition, in our view, in order to increase the cost of shorting RMB in the offshore market. This is a different approach as the traditional direct intervention. Since November 2015, the Chinese authorities have been gradually disconnecting the liquidity pool between the onshore and offshore markets, such as suspending offshore banks' access to the onshore repo market. As such, CNH liquidity conditions can be tightened, while onshore liquidity conditions remain accommodative to support economic growth. We believe this approach is likely to continue, until the RMB's FX pressure is alleviated.

Third, offshore RMB bond market size is likely to see the first YoY decline. In 2015, gross issuance of Dim Sum bonds, Formosa bonds, and CDs, slid by 26 per cent from the previous year to CNY424 bn. Outstanding market managed to grow by 6 per cent in 2015, thanks to a sharp increase of Formosa bond issuance. In 2016, we expect primary issuance to stay light, and could again decline by more than 20 per cent, given much higher funding costs in the CNH market than onshore, and improved issuance channels in the domestic capital market such as via the Panda bond programme. As redemption is very high in the offshore RMB market – at CNY379 bn, or 46 per cent of total outstanding market – a primary issuance that's lower than this amount will result in a decline of total market size.

Lastly, foreign investments in China should increase materially as soon as FX stabilises. RMB internationalisation achieved great progress in 2015: RMB has been formally recognised as a world reserve currency after the IMF's SDR inclusion, RQFII programme has been expanded to 16 centres, and CNY can now be directly converted with 13 currencies. China's markets have become too big to be ignored – China's onshore bond market has become the third largest in the world, and China's corporate credit market has become the second largest in the world. Foreign ownership in China's onshore bond market is still less than 2 per cent currently, versus 10-60 per cent for other SDR currencies; China's onshore yields are also staying higher than its SDR peers' yields. With the Chinese authorities aiming to maintain a stable exchange rate against the new CFETS basket, the RMB could still perform decently against many EM currencies even it further depreciates against the US dollar.

Becky joined Standard Chartered bank in November 2012 as a senior rates strategist, focusing on China (both on- and offshore) and Hong Kong rates markets.

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