HKEX 香港交易所

# INSIDE FIXED INCOME AND CURRENCY MONTHLY NEWSLETTER

Jun 2016 Issue No 18

## MONTHLY HIGHLIGHTS

- TR/HKEX RMB Currency Indices (RXY) are live: On 23 June 2016, HKEX and Thomson Reuters launched a series of tradable Renminbi (RMB) indices, which measure the intraday performance of the RMB against China's most important and relevant trading partners' currencies.
- HKEX's Chief China Economist, Dr Ba Shusong, sees that the People's Bank of China's (PBOC) now relies on market forces coupled with due market intervention to help with its adjustment of RMB exchange rate movements to reduce market expectations of the currency's devaluation.
- In the Expert Corner, Mr Kun Shan and Mr Mirza Baig of BNP Paribas sees that China is starting to control its overall leveraging including overcapacity industries and its capital markets, which would have a long-term positive impact on the market.

## RECAP ON HKEX'S RMB CURRENCY INDICES LAUNCH EVENT

HKEX's RMB Currency Indices launch event was held on 23 June 2016. During the event, the representatives of HKEX and Thomson Reuters explained about the new Indices and external speakers discussed market applications of RMB Currency Indices. Please refer to page 4 for the details of the indices.



## FROM THE CHIEF CHINA ECONOMIST'S VANTAGE POINT

### RMB EXCHANGE RATE SEES GREATER FLEXIBILITY

**Dr Ba Shusong, Chief China Economist, HKEX**

As Mainland economic growth tests its bottom, the main sources of economic growth in Mainland including demography, resources, investment (such as the housing market), trade and household savings are now diminishing. There is a need to find new growth engines and a need to address challenges posed by the economic reform including capacity reduction, deleveraging and destocking. For the time being, the Mainland's property market turnover which exceeded RMB10 trillion is having an enormous and immediate impact on the Mainland economy. It is now expected that the clearance of unsold properties and the bottoming of property investment will be immediately followed by a corresponding bottoming of Mainland economic growth. In the FX market, there has been evidently greater flexibility in the RMB's exchange rate. Before the exchange rate reform on 11 August 2015, even a slight fluctuation in the value of the RMB would cause dramatic market speculation and short-term volatility. However, nowadays we have been seeing RMB exchange rate easily move 100-200 basis points in a single day without jittery in the FX market, which implied that the currency's movements have become notably more flexible and the market is now better digesting such movements. The greater flexibility has stimulated trading in RMB-related risk-management products.

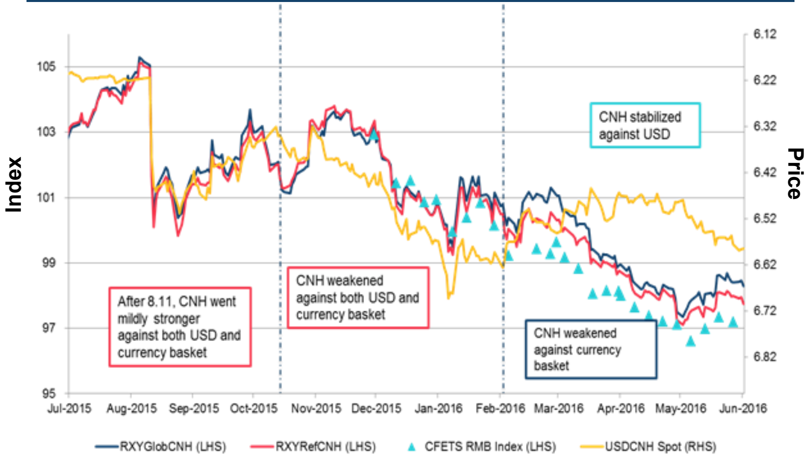
**Unsold properties in first-tier cities increase while home prices become more volatile**

The economic data for May 2016 announced by the Mainland's National Bureau of Statistics on 13th June 2016 was worse than expected. Compared with the same period last year, in May 2016, the industrial added value with significant annual revenue increased 6 per cent and total retail sales of consumer goods increased 10 per cent. In the first five months of 2016, fixed asset investment increased only 9.6 per cent year on year, the smallest increase in the past 16 years. There are many factors contributing to the decline in investment growth, among which large numbers of unsold properties in third- and fourth-tier cities and a decline in private investment are the major ones. It is worthy to note that while home sales evidently improved in 2016, inventories continued to build up and the pressure to clear unsold properties remains strong in third- and fourth-tier cities.

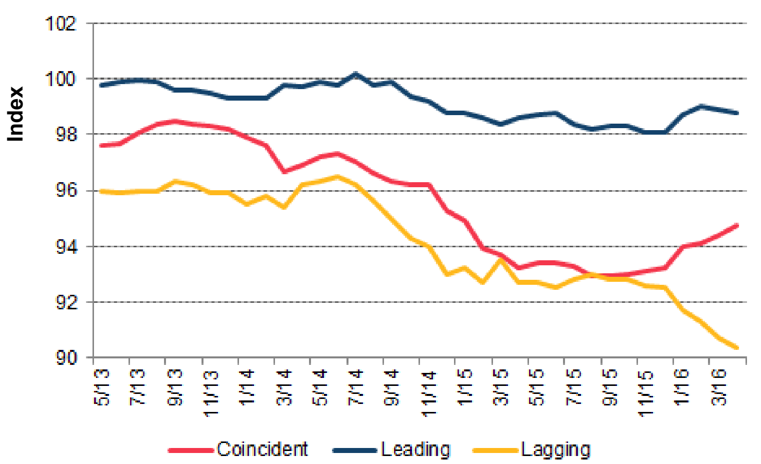
**(continued on page 9)**

## CHINA MACRO UPDATE

### Fig 1- Chart of the Month: CNH Currency Basket Performance Diverged from USD/CNH




### 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 | 6.8 | ↓ | 07/15/2016 |
| CPI (yoy %) | 2 | 2.3 | ↓ | 07/10/2016 |
| PPI (yoy %) | -2.8 | -3.4 | ↑ | 07/10/2016 |
| Industrial Production (yoy %) | 6.0 | 6 | → | 07/15/2016 |
| FAI (yoy %) | 9.6 | 10.5 | ↓ | 07/15/2016 |
| Foreign Investment (yoy %) | -1.0 | 6 | ↓ | 07/08/2016 |
| CFLP Manufacturing PMI | 50 | 50.1 | ↓ | 08/01/2016 |
| 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 | 1.82 | ↑ | 07/28/2016 |
| Exports (yoy %) | -4.1 | -1.8 | ↓ | 07/13/2016 |
| Imports (yoy %) | -0.4 | -10.9 | ↑ | 07/13/2016 |
| M2 Money Supply (yoy %) | 11.8 | 12.8 | ↓ | 07/10/2016 |
| Retail Sales (yoy %) | 10 | 10.1 | ↓ | 07/15/2016 |
| Consumer Confidence Index | 115.9 | 114.2 | ↑ | 07/27/2016 |
| Regulated Reserve Ratio (%) | 17.5 | 18.0 | ↓ | Infrequent |
| Official Foreign Exchange Reserves (USD bn) | 3191.7 | 3219.7 | ↓ | 07/07/2016 |
| Three-Month SHIBOR (%) | 2.97 | 2.93 | ↑ | Continuous |
| 10-Year Gov't Bond Yield (%) | 2.86 | 2.92 | ↓ | Continuous |
| CNY/USD Exchange Rate | 6.65 | 6.5531 | ↑ | Continuous |
| **TR/HKEX RXY Global CNH Currency Index** | **95.78** | **98.31** | ↓ | **Continuous** |

Sources: Bloomberg, WIND, HKEX, Thomson Reuters (30 Jun 2016)

## CHART OF THE MONTH

- Following the PBOC's USD/CNY fixing regime reform on 11 August 2015, the CNH's performance against a basket of currencies (as shown by the RXY Index) was mostly in line with its performance against the USD until recently. Since March this year, CNH has weakened against a basket of currencies but stabilized in range against the USD. The CNY followed similar trends.

## REGULATORY/POLICY DEVELOPMENTS

- On 21 June 2016, the National Interbank Funding Center, under the PBOC, revised regulations to allow foreign financial institutions and other institutions recognised by the PBOC to invest in Negotiable Certificate of Deposit (NCD), an important funding source for Mainland funds and commercial banks.
- The National Development and Reform Commission (NDRC) stated on 7 June 2016 that China is carrying out external debt administration reform in 6 provinces/cities where free-trade-zones are located. Enterprises incorporated in these regions could obtain overseas debt registration certificates at local NDRC offices for their debt issuance and international commercial loans. They are also encouraged to issue overseas debts by their onshore parent companies and send proceeds back to Mainland to support key projects such as the Belt-and-Road initiative.
- The PBOC stated on 3 June 2016 that it has amended the methodology to assess the amount of reserves that banks are required to hold. Starting from 15 July 2016, the reserve ratio will be calculated based on the average level of deposits during a certain period, rather than the snapshot at the end of the period. Onshore deposits held by offshore banks are subject to the reserve requirement according to the average level of daily outstanding deposits in the previous quarter.

## MACRO ECONOMIC UPDATE

- The Monetary Authority of Singapore (MAS) announced on 22 June 2016 that it would include RMB investments as part of its official foreign reserves from June 2016. As of May 2016, the MAS held USD $244.5 billion in foreign exchange reserves, the 11th largest reserve holder globally. Take for an example, a five-percent allocation will mean a USD $12.2 billion of reallocation to RMB assets.

## MARKET/PRODUCT DEVELOPMENTS

- On 23 June 2016, HKEX and Thomson Reuters launched a series of RMB indices which measure the intraday performance of the RMB against China's most important and relevant trading partners' currencies. The primary index, TR/HKEX RXY Global CNH Currency Index, measures the performance of CNH against a basket of 14 key currencies. The indices allow market participants to view intraday RMB movements according to a transparent, rules-based methodology. For more details, a complete methodology document is available at: financial.thomsonreuters.com/fxindices

## RMB FX MARKET DYNAMICS

### OFFSHORE USD/RMB

- In June 2016, CNY fixings moved between 6.5497 and 6.6528, and CNH was trading 1.3 per cent lower versus the US dollar from a month ago, as the PBOC lowered the CNY fixing to 6.6528 on 28 June 2016, the weakest level since December 2010, as the UK voted to leave the EU on 23 June 2016 (Brexit).
- On 24 June 2016, Xiao Lisheng, a senior research fellow at the Chinese Academy of Social Science Institute of World Economics and Politics said that China is concerned over London's role in further internationalization of the RMB in the European region in the wake of the Brexit vote, given the UK is the leading financial hub for the Chinese currency in Europe.

**Fig 3: Onshore/Offshore RMB Price Range**

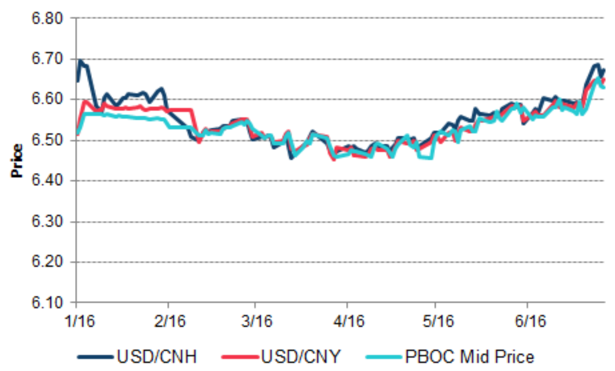



**Fig 4: Implied Volatilities of OTC USD/CNH ATM Options**

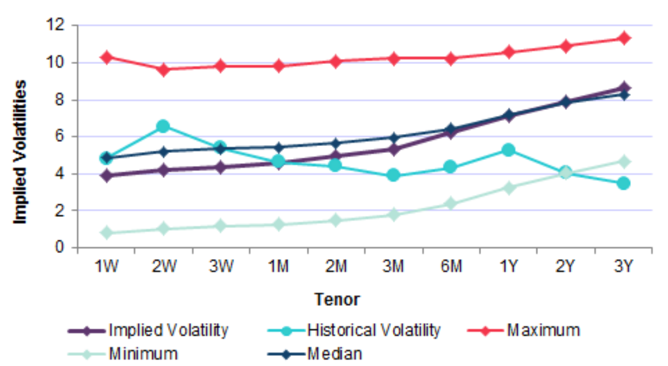
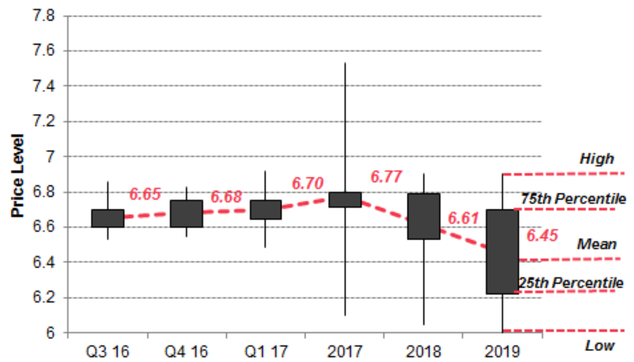



**Fig 5: Market Forecasts for the Level of USD/CNH**




## HKEX'S USD/CNH FUTURES

### PRODUCT HIGHLIGHTS

- Average daily volume of HKEX's USD/CNH futures was 1,512 contracts (US$151 million notional) in June 2016. Open interest (OI) was 27,819 contracts (US$2.8 billion notional) as of the end of June 2016.
- Trading volume was high in the Jun-16, Sep-16, and Dec-16 contracts, which accounted for 60 per cent of total volume in June 2016. Open interest concentrated in the Sep-16, Dec-16, and Mar-17 contracts, accounting for 77 per cent of total open interest at the end of June 2016.

**Fig 6: USD/CNH Futures Turnover and Open Interest**

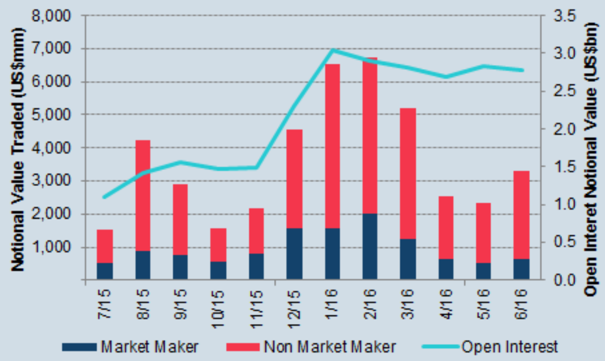



**Fig 7: HKEX USD/CNH Futures Contract Provides Best Liquidity in Volatile Market**

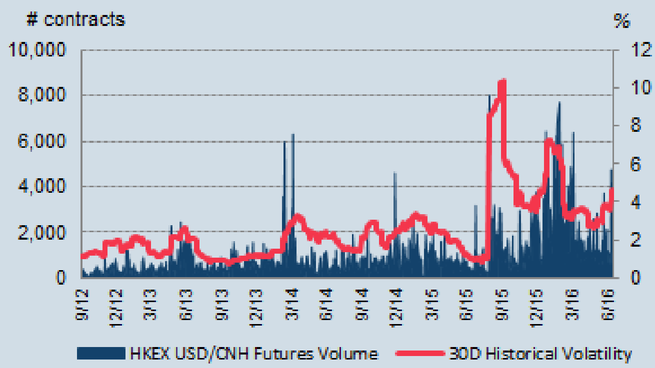



**Fig 8: Breakdown of Volume by Contract Month (6/2016)**

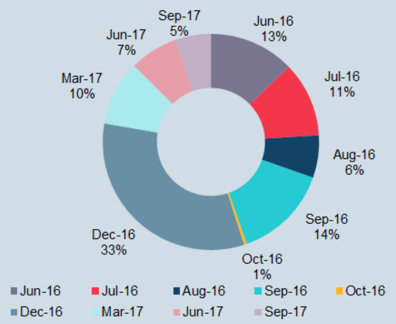
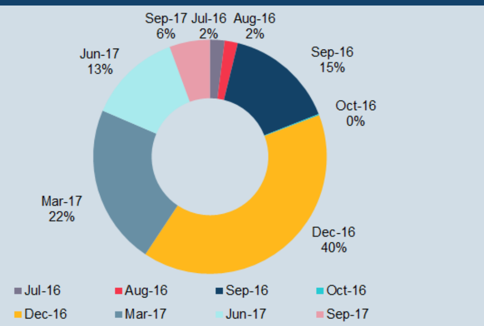



**Fig 9: Breakdown of OI by Contract Month (30/6/2016)**



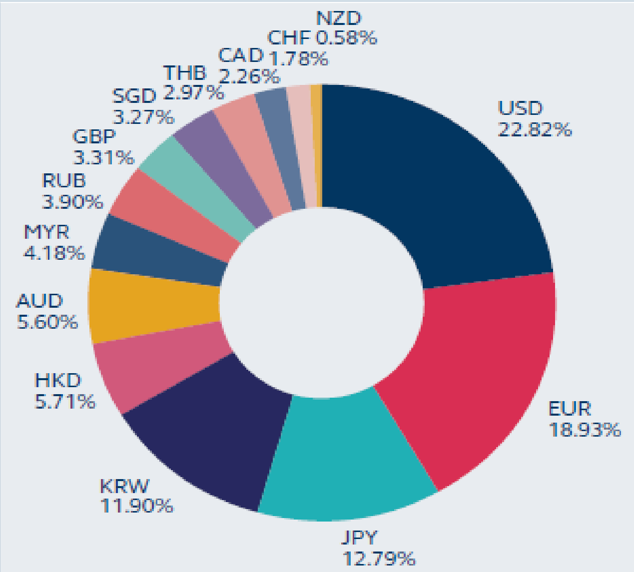
## TR/HKEX RMB CURRENCY INDICES (RXY)

### 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.

**Fig 10: TR/HKEX RXY Global CNH Currency Index**

**Index Weights: Valid Until 30 September 2016**




- After 11 August 2015, the volatility of CNY against a basket of currencies peaked towards 8 per cent, before descending to the range of 3-5 per cent towards the end of year.
- Since February this year, the PBOC's policy of keeping the CNY "stable against a basket of currencies" has had a significant impact in the market, with the volatility of the CNY against a basket of currencies trending down to the range of 3-4 per cent. On the back of low volatility of the CNY against a basket of currencies, the USD/CNY fixing rate could show more volatility going forward.

### 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 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

**TABLE 2: Index Weights**

| Currency | RXY Global Currency Indices | RXY Reference Currency Indices | CFETS RMB Index |
|---|---|---|---|
| USD | 22.81% | 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% |

**Fig 11: 30-Day Realised Volatility of RXYRY and PBOC USD/CNY Fixing**

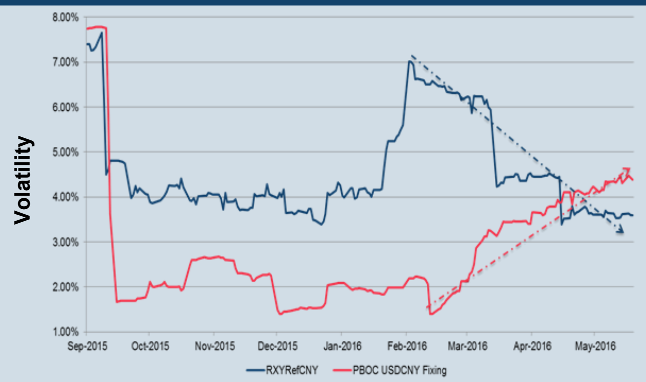
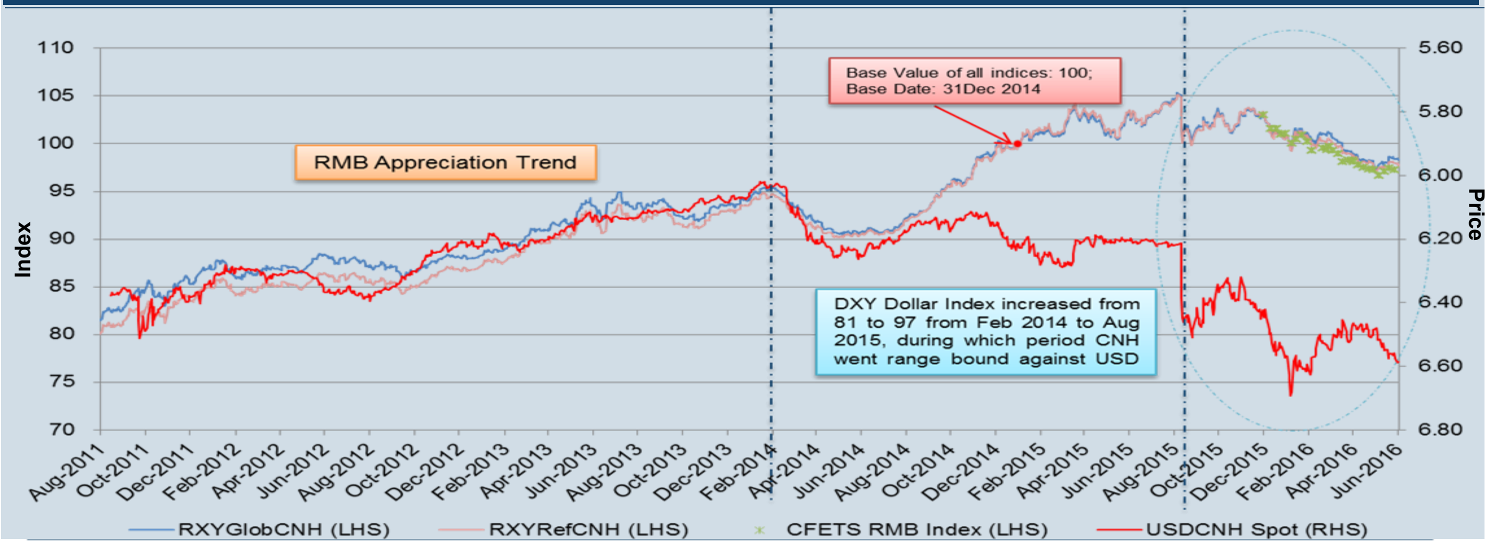



**Fig 12: Historical Performance of RXY CNH Indices**



## OFFSHORE RMB AGAINST OTHER CURRENCIES

### EUR/CNH

- The CNH was trading 1.0 per cent lower against the EUR in June 2016 from a month ago and remained in a relatively tight range of 7.35 to 7.49.
- The implied volatility of 3M OTC options rebounded to above 9.6 per cent in June 2016. The impact from Brexit - which already generated much turmoil in global equity, commodity and bond markets - was expected to continue due to its likely negative effect on the European economic and political landscape.
- On the FX radar, the fundamental, carry, and risk factors were well below their historical average, while the valuation factor was above its historical average.

**Monthly CNH Performance vs EUR**

**↓ 1.0%**

**Implied Volatility**

**9.6%**

**Fig 13: FX Radar***

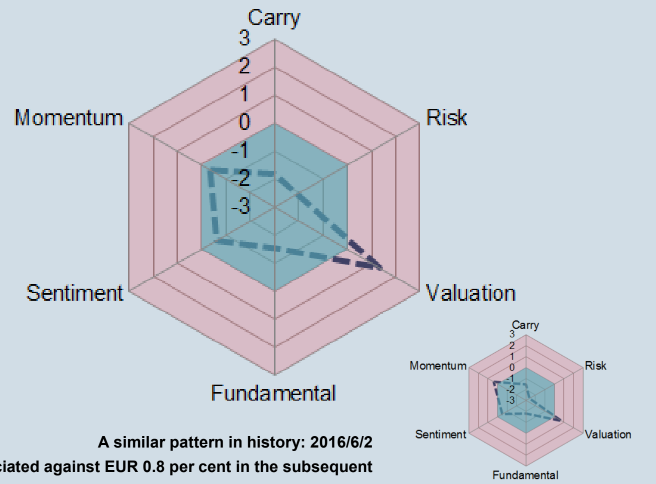



**Fig 14: FX Volatility (3M Implied, %)**

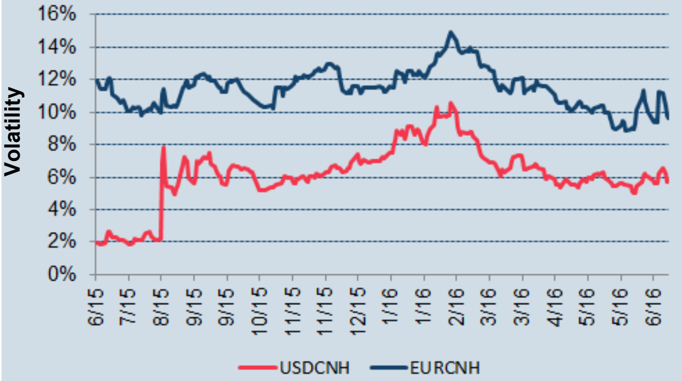
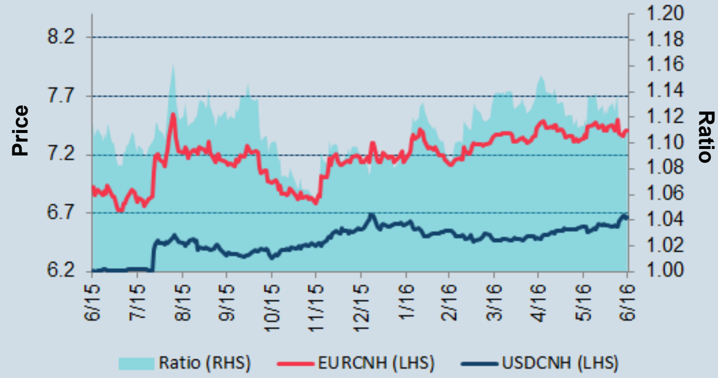



**Fig 15: Price Ratio: EURCNH / USDCNH**




### AUD/CNH

- The CNH continued its downward trend and was trading 4.3 per cent lower against the Australian dollar (AUD) in June 2016 from a month ago. Stronger Australian building approvals and private sector credit figures helped to shore up the appeal of the AUD exchange rate, boosting confidence in the domestic economy.
- The implied volatility rebounded to 11 per cent in June 2016.
- On the FX radar, the fundamental and carry factors were below their historical average, while the valuation factor was above its historical average.

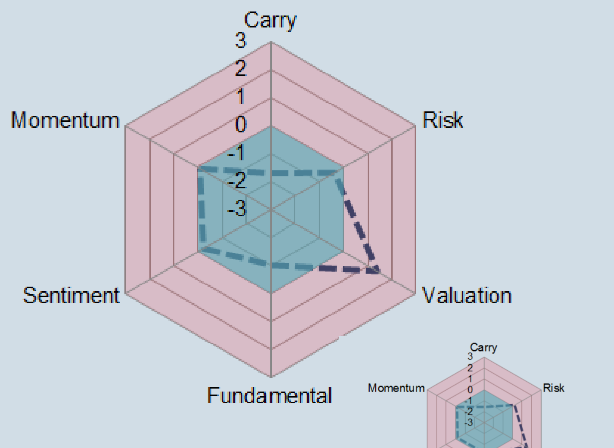
**Monthly CNH Performance vs AUD**

**↓ 4.3%**

**Implied Volatility**

**11.0%**

**Fig 16: FX Radar***




A similar pattern in history: 2013/12/16
The CNH depreciated against AUD 0.5 per cent in the subsequent month

**Fig 17: FX Volatility (3M Implied, %)**

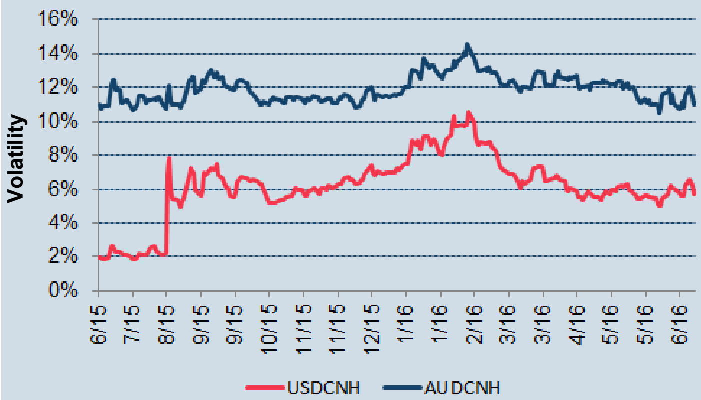
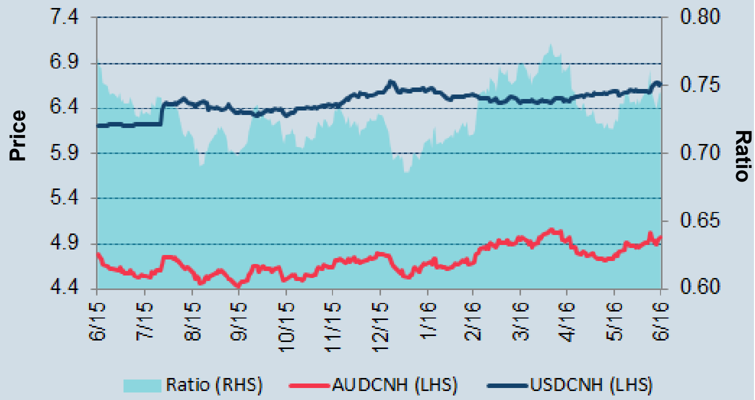



**Fig 18: Price Ratio: AUDCNH / USDCNH**



## JPY/CNH

- The CNH was trading 8.7 per cent lower against the JPY in June 2016 from a month ago, after JPY/CNH reached its one-year high of 6.53 on 28 June 2016. Japan has emerged as a "safe haven" target after the fallout from the U.K.'s vote to leave the European Union. The strength of the yen continues to stress the Bank of Japan and the Finance Ministry as the strong yen will weigh on exports.
- The 3-month implied volatility OTC options surged to above 12 per cent in June 2016.
- On the FX radar, the momentum, risk, and sentiment factor were above their historical average, while the valuation and carry factors were below their historical average.

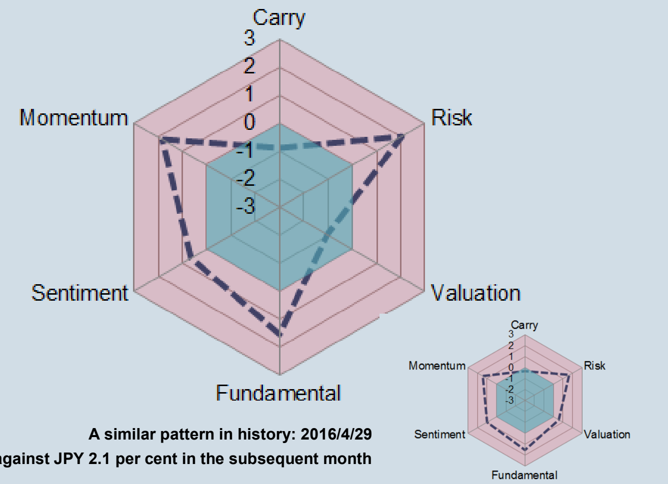
**Monthly CNH Performance vs JPY**

**8.7%**

**Implied Volatility**

**12.4%**

**Fig 19: FX Radar***




**A similar pattern in history: 2016/4/29**

**The CNH appreciated against JPY 2.1 per cent in the subsequent month**

**Fig 20: FX Volatility (3M Implied, %)**

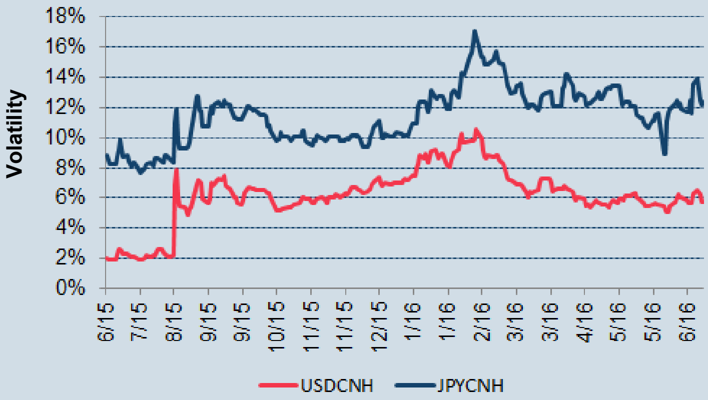



**Fig 21: Price Ratio: JPYCNH / USDCNH**

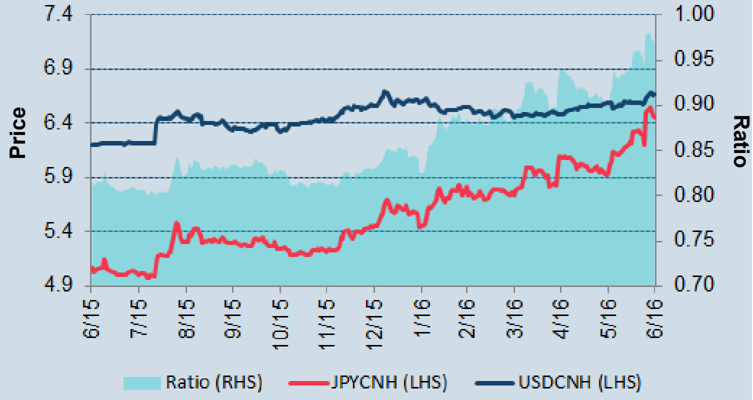



**TABLE 3: Summary Table for RMB Currency Pairs**

| Performance | | | | | | |
|---|---|---|---|---|---|---|
| | Current Month | Prior Month | Chg | Prior 3 Month | YTD | Correlation with USDCNH |
| USDCNH | -1.3% | -1.5% | ↑ | -3.2% | -1.6% | 1.00 |
| EURCNH | -1.0% | 1.3% | ↓ | -0.7% | -3.2% | 0.29 |
| AUDCNH | -4.3% | 3.4% | ↓ | -0.4% | -3.8% | 0.02 |
| JPYCNH | -8.7% | 2.4% | ↓ | -12.6% | -18.6% | 0.41 |

| Volatility | | | | | | |
|---|---|---|---|---|---|---|
| | Implied | Prior | Chg | Historical | Prior | Chg |
| USDCNH | 5.8% | 5.6% | ↑ | 3.6% | 3.3% | ↑ |
| EURCNH | 9.6% | 9.2% | ↑ | 6.9% | 7.1% | ↓ |
| AUDCNH | 11.0% | 11.1% | ↓ | 10.9% | 11.5% | ↓ |
| JPYCNH | 12.4% | 11.1% | ↑ | 13.4% | 11.5% | ↑ |

Sources: Bloomberg, WIND (30 June 2016)

* For detailed information, please see appendix

## OFFSHORE BOND MARKET DYNAMICS

## OFFSHORE RMB BOND MARKET COMMENTS

- China's Finance Ministry issued 14 billion yuan worth of yuan-denominated treasury bonds in Hong Kong on 29 June 2016 and plan to issue an additional 14 billion yuan in the second half of the year. The dim sum bond market has faced strong headwinds this year as Chinese issuers moved to the onshore debt market to raise funds more cheaply.
- RMB deposits in Hong Kong decreased by 1.3 per cent month-on-month to RMB732 billion in May 2016. The total remittances of RMB for cross-border trade settlement amounted to RMB417.3 billion in May 2016, compared to RMB358.1 billion in April 2016.

**Fig 22: Offshore RMB Deposits vs Outstanding Dim Sum Bonds**

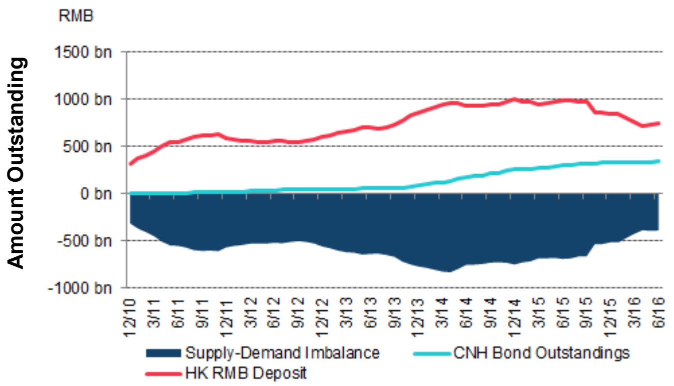



**Fig 23: RMB Bond Issuances by Issuer Type**

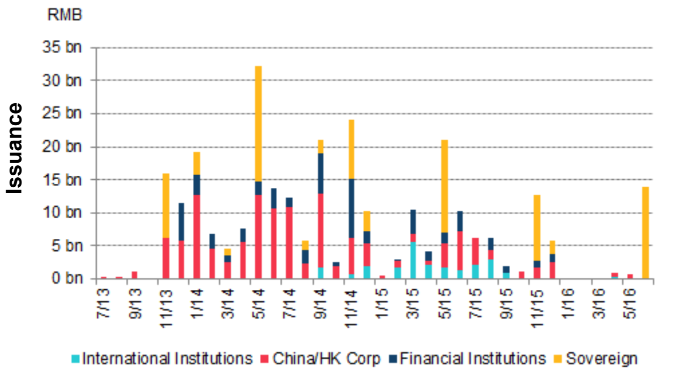
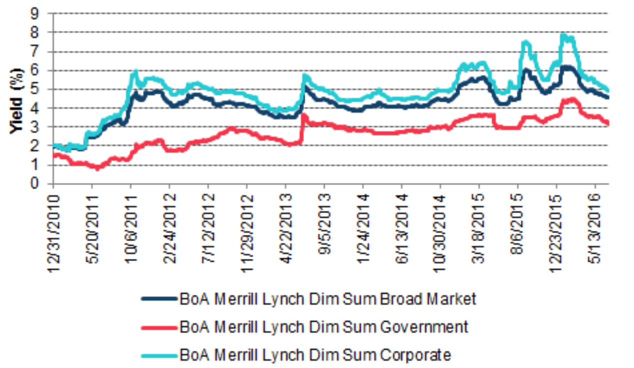



**Fig 24: Dim Sum Bond Performance**




## ONSHORE BOND MARKET DYNAMICS

## ONSHORE RMB BOND MARKET COMMENTS

- Onshore bond issuance increased 58 per cent to RMB 3.6 trillion in June 2016 from RMB 2.3 trillion in June 2015. Corporate bonds issuance in June 2016 was up 658 per cent from a year ago.
- The onshore/offshore five-year Ministry of Finance (MoF) Treasury Bond (T-Bond) yield spread continued to narrow in June 2016. The spread narrowed to around 0.45 per cent, as the five-year MoF T-Bonds were trading at 2.84 per cent onshore versus 3.27 per cent offshore towards the end of June 2016.

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

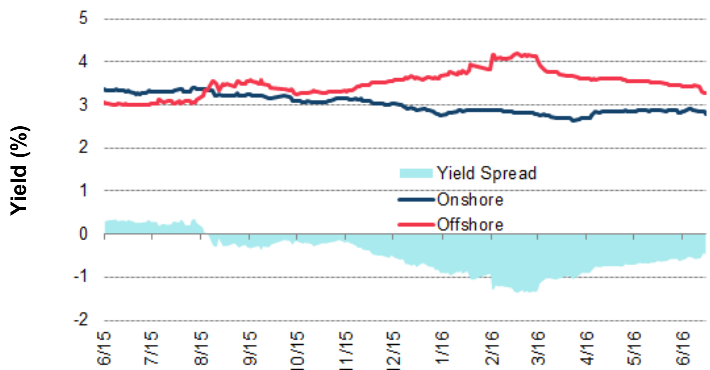



**TABLE 4**

| Key Figures on Interbank Market Cash Bond Transactions (classified as per bond types) | | | |
|---|---|---|---|
| Bond Type | Number of Deals | Trading Value(RMB 100M) | Yield to Maturity(%) |
| Policy Financial Bond | 51,343 | 52,372.16 | 3.0422 |
| Treasury Bond | 9,562 | 11,080.35 | 2.6984 |
| Medium-term Note | 11,487 | 8,616.98 | 4.8645 |
| Corporate Bond | 9,858 | 5,853.02 | 4.6504 |
| CDs | 5,620 | 12,755.11 | 3.1142 |
| Commercial Paper | 14,650 | 12,036.65 | 3.6886 |
| Central Bank Paper | 103 | 342.77 | 2.4000 |
| Others | 4,088 | 5,155.58 | 3.4725 |
| **Total** | **106,711** | **108,212.62** | **3.3678** |

**Fig 26: MoF T-Bond Outstanding Split by Tenor**

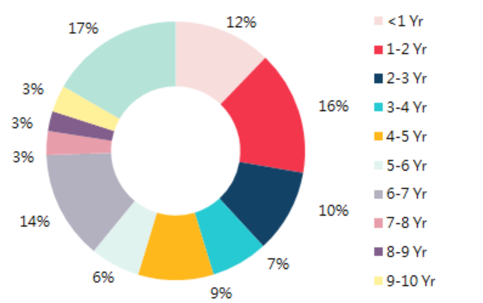



**TABLE 5**

| NAFMII Guidance for Non Fixed Income Debt Issuing (as of 2016/6/29) | | | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1Yr | MoM | 3Yr | MoM | 5Yr | MoM | 7Yr | MoM | 10Yr | MoM | 15Yr | MoM | 20Yr | MoM | 30Yr | MoM |
| AAA+ | 3.05 | ↓ | 3.54 | ↓ | 3.76 | ↓ | 4.13 | ↓ | 4.39 | ↓ | 5.01 | ↓ | 5.18 | ↓ | 5.44 | ↓ |
| AAA | 3.24 | ↓ | 3.68 | ↓ | 3.95 | ↓ | 4.46 | ↓ | 4.71 | ↓ | 5.32 | ↓ | 5.61 | ↓ | 5.89 | ↓ |
| AA+ | 3.47 | ↓ | 4.05 | ↓ | 4.43 | ↓ | 4.95 | ↓ | 5.35 | ↓ | 5.94 | ↓ | 6.30 | ↓ | 6.63 | ↓ |
| AA | 4.00 | ↓ | 4.62 | ↓ | 4.99 | ↓ | 5.63 | ↓ | 5.90 | ↓ | 6.65 | ↓ | 7.00 | ↓ | 7.46 | ↓ |
| AA- | 5.43 | ↓ | 6.00 | ↓ | 6.45 | ↓ | 7.34 | ↓ | 7.76 | ↓ | 8.32 | ↓ | 8.72 | ↓ | 9.00 | ↓ |

NAFMII – National Association of Financial Market Institutional Investors

Sources: Bloomberg, WIND, NAFMII (30 June 2016)

## ONSHORE/OFFSHORE SHORT-TERM INTEREST RATE DYNAMICS

## ONSHORE/OFFSHORE RMB STIR MARKET COMMENTS

- Hong Kong's overnight Treasury Markets Association CNH HIBOR stayed below 1 per cent for most of the time in June 2016, as CNH liquidity remained broadly stable.
- The Treasury Markets Association (TMA) announced on 3 May 2016 that the TMA USD/HKD 11am Spot Rate and USD/CNY(HK) 11am Spot Rate (collectively known as the "Spot Rates") will adopt a transaction-based determination mechanism with effect from 1 August 2016. Details on the change in calculation methodology can be found at press release.
- The CNY SHIBOR yield curve was flatter at the end of June 2016 than it was at the end of June 2015 (see Figure 28).
- The CNH HIBOR yield curve was steeper at the end of June 2016 than it was at the end of June 2015 (see Figure 29).

**Fig 27: CNH Implied Yield vs. USD/CNH**

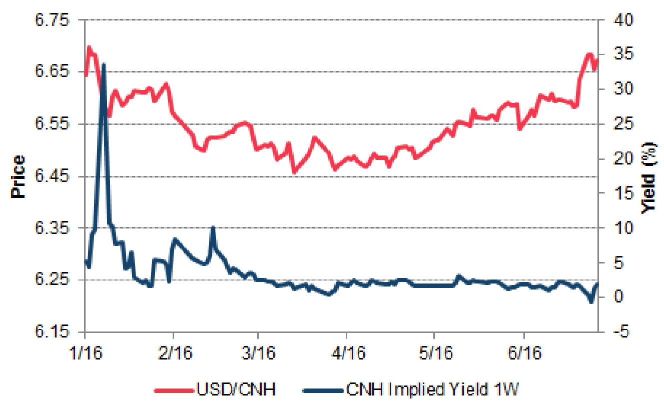



**Fig 28: CNY SHIBOR Yield Curves**

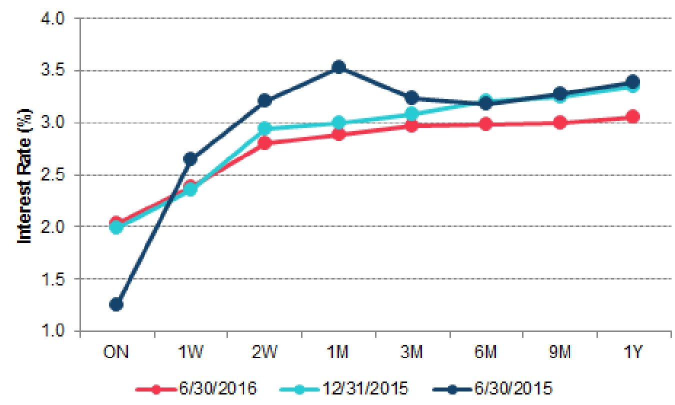



**Fig 29: CNH HIBOR Yield Curves**

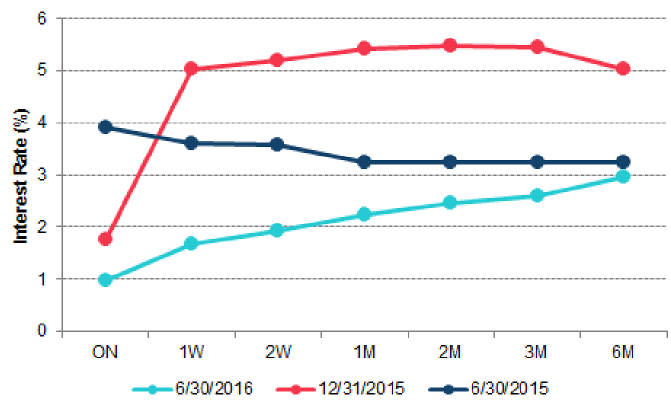



**Fig 30: Onshore IRS (7D Repo) Yield Curves**

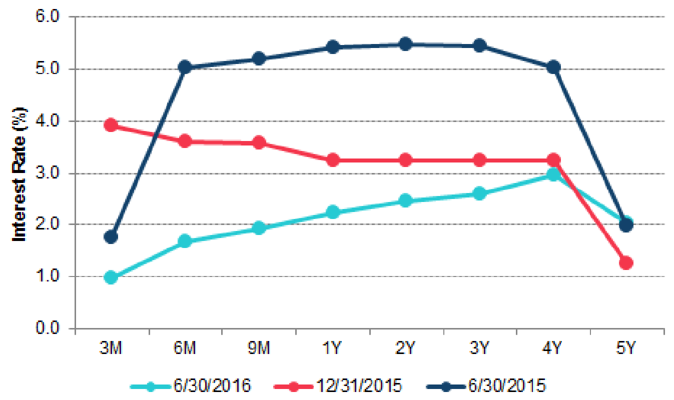



**Fig 31: Onshore IRS Trading Notional Principal**

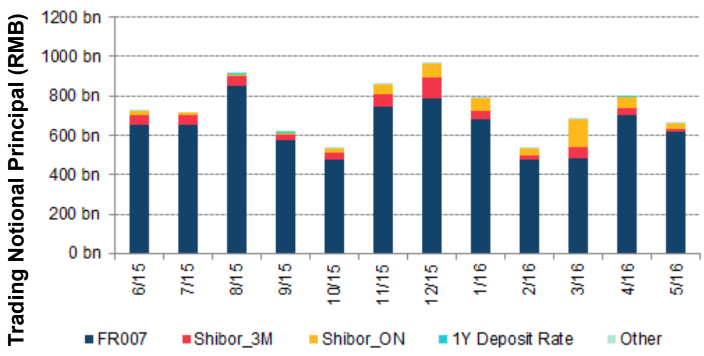



**Fig 32: CNY SHIBOR vs CNH HIBOR**

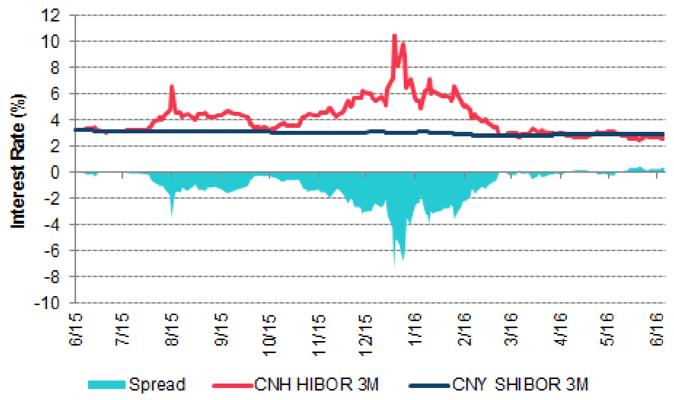
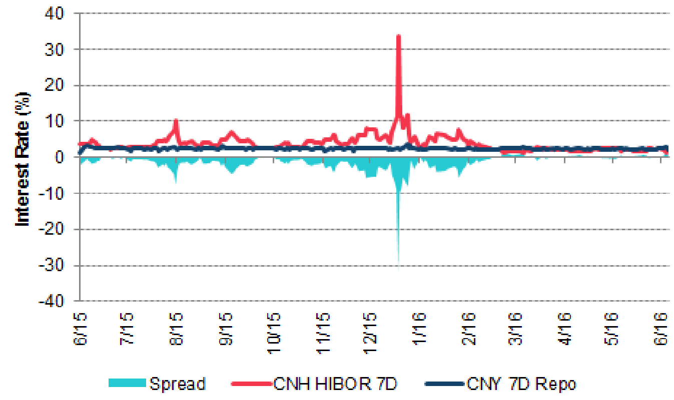



**Fig 33: CNY 7D Repo vs CNH HIBOR**



**(Continued from page 1)**

Profound changes are being seen in the Mainland's property sector. In first-tier cities, buy/sell of second hand properties rather than new properties now accounts for the most in property transactions, changing the pricing mechanism in property market. Slower population growth in first-tier cities and sometimes even a net outflow of population from those cities could increase price volatility in the property market. Cities recording the sharpest rise in home prices last year could be the same ones with home prices dropping the fastest in 2016. Property demand in the Mainland has changed from inelastic demand to demand for property upgrades. The continuous rise of home prices is expected to undermine the residential purchasing power.

### US interest rate hikes would have less impact on RMB than the 11 August reform

Since 2016, under a managed floating exchange rate mechanism, RMB exchange rate movements have been anchoring either a basket of currencies or the US dollar, whichever is weaker. Such a policy operation implies that the PBOC is proactively managing the controlled devaluation of the RMB in an instigating forward looking manner and is continuing enhancing the flexibilities in RMB exchange rate movements. If the US Federal Reserve's interest rate hike triggers appreciation in the US dollar, it may even be possible for the RMB to weaken against the greenback in response to market forces, but the impact on the market would likely be significantly less than that brought by the currency reform on 11 August 2015. This is because through asymmetric devaluation, adjustment has been made to the RMB's exchange rate and also flexibilities in RMB exchange rate movements have now notably increased.

**Fig 34: CNY Fixing and USD Dollar Index**

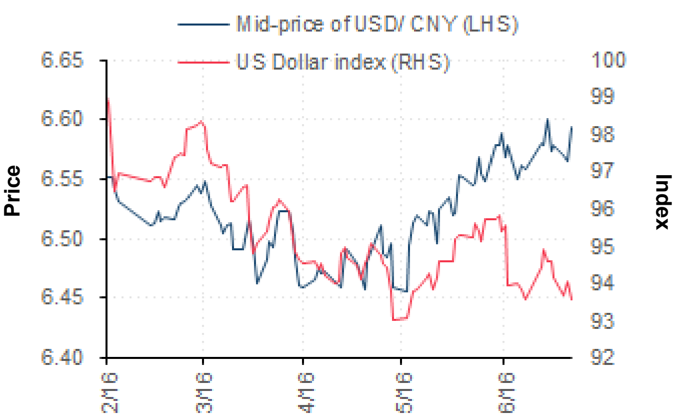
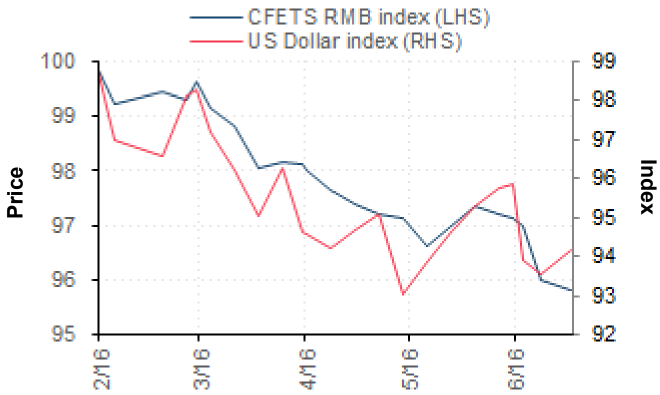



**Fig 35: CFETS RMB Index and US Dollar Index**




Source: Wind

The PBOC is also seen to be increasingly focused on maintaining the stability of the spread between onshore and offshore RMB exchange rates to reduce the room for arbitrage and manage market expectations. As RMB becomes more internationalised, the central bank will require a greater range of RMB-denominated products in the offshore market so that in addition to operations in the spot market, it also has a basket of financial tools at its disposal to achieve its goals.

**Fig 36: CNH and Offshore/Onshore RMB FX Spread**

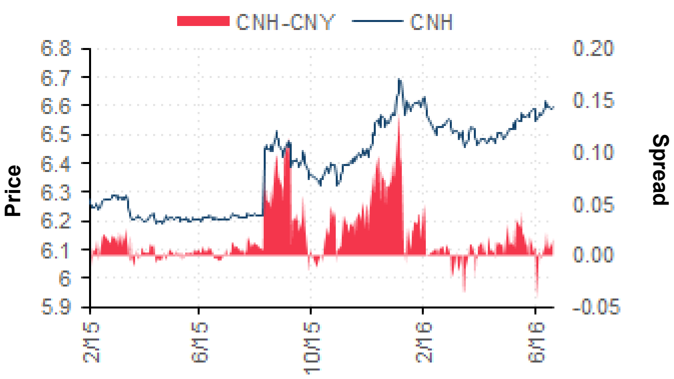
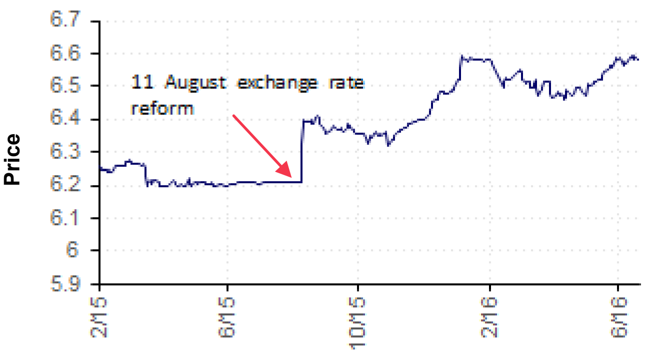



**Fig 37: Onshore RMB Spot Rate**




Source: Wind

There were times in the past when a strong US dollar gave depreciation pressure to some emerging economies, who then implemented capital controls against such pressure. In many cases, the outcomes were not ideal. In particular, capital controls easily led to international expectations of imminent devaluation in the domestic currency and also panic in the domestic market which together would usually send enormous shockwaves across the financial market. Therefore, flexible management of exchange rates rather than hasty implementation of capital controls has been a very important lesson for emerging economies in the prior strengthening cycles of the US dollar.

Learning from the success of the "11 August" RMB exchange rate reform in tackling currency depreciation, the Mainland's central bank now relies on market forces coupled with due market intervention to help with its adjustment of RMB exchange rate movements to reduce market expectations of the currency's devaluation. To continue influencing the FX market, short-term intervention backed by the foreign exchange reserve and exchange rate adjustment must work together.

**Disclaimer:** The information contained herein is a translation from a Chinese version. In the event of any conflict or inconsistency between any terms of such information contained herein and the Chinese version of these terms, the Chinese version shall prevail.

## DELEVERAGING OF THE CAPITAL MARKET IN CHINA

**Contributed by Mr Kun Shan, Head of Local Market Strategy, Global Markets for BNP Paribas (China) Limited; and Mr Mirza Baig, Head of Local Markets FX/Rate Strategy, Asia Pacific, Global Markets for BNP Paribas**

China is having a positive progress of tackling the high levels of leverage throughout its economy. On May 9, 2016, People's Daily published an exclusive interview with an unnamed "authoritative insider" who addressed five key areas, including China's economic growth, macro policies, supply-side structural reform, social expectation management, and systematic regional financial risks. As quoted by the insider, "High leverage inevitably leads to high risks. The risks of foreign exchange market, equity market, fixed income market, property market, and bank loans will increase; in which without proper management, can trigger a systematic financial crisis and negative economic growth." With that in mind, one of the key responsibilities for regional and central governments in the near future is around deleveraging.

Following the warning on bad loans that also extended to illegal financing, a number of deleveraging measures have been introduced by Chinese regulators. The deleveraging efforts are to mitigate the systematic financial risks that are embedded in China's banking system from debt in State-Owned Enterprises (SOEs), leveraged Wealth Management Products (WMPs) issued by banks, and China internet finance (such as peer-to-peer and crowdfunding). It is now a clear signal that, for China, controlling the leverage in industry and capital markets is a fundamental necessity.

### Liquidity not entering real economy

The deleveraging target does not only apply to China's highly leveraged SOEs as it also affects the overall financial market. The issue that Chinese authorities are currently facing is that excess liquidity has flown through the entire market and among different asset classes using leverage.

That said, liquidity has not effectively flown into the targeted real economy, given the economic structural constraints. Investors are hesitant to invest in the real economy due to regulatory thresholds, high funding costs, and low returns. The easing monetary policies implemented by the People's Bank of China (PBOC) continue to fuel financial products (equity, fixed income, commodity and non-standard products) and the property market. If the Chinese authorities are not able to control debt leverage, the state-owned banking system will face systematic financial risks.

### Bond sell-off

The deleveraging measures raise the concern of bonds sell-off and this supports our view on a bear-steepening of the swap curve. The PBOC will continue to implement prudent monetary policy and keep repo funding anchored to respond to this. We expect investors will continue to sell-off swaps to hedge their bond positions in the current market environment.

The overall market concerns around leveraged structured products in China's bond market lies mainly on the exchange bond market, which only take up a small portion (10 per cent) of the entire Chinese market. A common way to add leverage is via credit repo (pledged) and products with classified format (senior/junior tranches), designed by securities and third-party managed funds. At BNP Paribas, we view the recent deleveraging measures in the bond market as a reinforcement of the negative sentiment, but the overall leverage ratio remains very low, at below 2x.

### Bringing funds out of the shadows

Since 2012, the China Securities Regulatory Commission (CSRC) has allowed fund managers to establish subsidiaries. This structure has become a key channel for shadow banking business using leverage. The flow and quality of assets in them are not clear as there is no proper regulation in place. In Q1 2016, the 79 fund managers with subsidiaries had reached an AUM of RMB9.84 trillion.

This sizable area of leverage investment is now under scrutiny as the CSRC issued a new draft legislation on May 17, 2016. Under the proposed new rules, fund managers will have set thresholds for establishing subsidiaries and a set capital ratio to control leverage, i.e., no more than RMB20 billion in AUM (excluding money-market funds) supported by a minimum of RMB600 million in net assets. In addition, net assets should not be lower than 20 per cent of its liability, as a control on the leverage ratio.

### Worrying WMPs

In light of the deleveraging efforts, the China Banking Regulatory Commission (CBRC) requested some commercial banks to suspend issuance of classified asset management products (structured products with different tranches). This new measure applies only to certain city commercial banks in China, which are the main issuers of the highly leveraged classified asset management products with expected returns of 4-5 per cent. However, it is still a small portion of the RMB23.5 trillion WMPs issued by banks.

The business model of WMPs issued by Chinese commercial banks is not sustainable in our view. There has been a sharp jump in the total outstanding WMPs issued by banks, to over RMB23.5 trillion at the end of 2015, up from RMB15 trillion in 2014 (+56.5 per cent year-on-year). Such a rise has been driven by public perception that WMPs issued by banks are an alternative deposit mechanism offering higher yield; banks are fuelling these products by fund pooling and using the duration mismatch between different products to rollover the short-term obligations (i.e. 3-month, 6-month or 9-month) to reach the expected returns of retail investors.

Source: BNP Paribas (20 June 2016)

Generally speaking, the asset allocations of WMPs are cash bonds (45 per cent), money market funds (26 per cent), non-standard products (20 per cent), and equity related products (9 per cent). Banks have limited resources and capacity to manage or invest financial assets by themselves. Thus, we have seen them entrusting other financial institutions to manage funds and achieve the high target yield in a low interest-rate environment. These delegated institutions are third-party managed funds, the asset management arm of securities firms, trust companies, and hedge funds. Although banks have more limitations on their product structure and leverage, there are looser regulations in other areas and products that can be highly leveraged. At BNP Paribas, we estimate the total size of the entrusted fund including trading books of banks and insurance companies to have reach RMB14 trillion.

**Deleveraging is happening**

Many international investors will be happy in the long-term about the moves to start deleveraging, but in the short-term there might be a few challenges that are shaken out by these moves. The first areas of focus by the regulators in terms of the SOEs, WMPs and shadow-banking are all important to tackle in order to ensure sustainability.

As these measures further roll out, investors should be aware of other indicators and connected developments, such as the bear-steepening of the swaps curve. This will come as the deleveraging in the capital market weighs on the tight money market liquidity towards end of May and into June. At the moment, the PBOC has been injecting short-term liquidity to “fine-tune”, favouring this over a cut in lenders’ reserve requirement ratio (RRR) and keeping the repo funding anchored.

The recent deleveraging mechanism sends a clear signal that China is starting to control its overall leveraging including overcapacity industries and the capital market, which will have a long-term positive impact on the market. It is important for investors to stay on top of this development for new opportunities.

**Disclaimer**: This content is for general information purposes only and should not be used as a substitute for consultation with professional advisors.

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Prior to joining BNP Paribas, Mirza worked at Deutsche Bank for ten years, where he held roles in FX Strategy and trading.

## APPENDIX: DEFINING 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.

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