HKEx 香港交易所

Inside Fixed Income and Currency (FIC) Monthly Newsletter

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Monthly Highlights

- **USD 2.2 billion in contract value of USD/CNH Futures was traded in March 2015, with an average daily notional value of USD 99 million.**
- **Non Market Makers contributed 66 per cent of contract volume, up from 58 per cent in February 2015.**
- **Open interest was at 12,949 contracts (USD 1.3 billion notional) as of 31 March 2015, 11 per cent increase from last month.**
- **As the RMB FX market matures, the central bank will provide more room for the trading of the spot rate.**

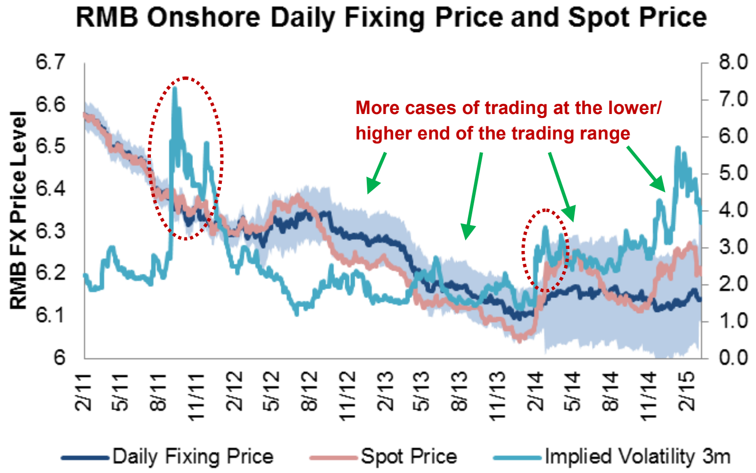
The reference rate that the People's Bank of China (PBC) announces on the morning of each trading day guides onshore trade of renminbi (RMB). The RMB traded in the onshore market is allowed to rise and fall by 2 per cent against this central parity rate each day. The spot trading divergence from the official guidance suggests growing market pressure to see the RMB strengthen or weaken against the US dollar (USD). This is a sign that the central bank has added teeth to a promise that it would allow market forces to play a greater role in the economy and its markets.

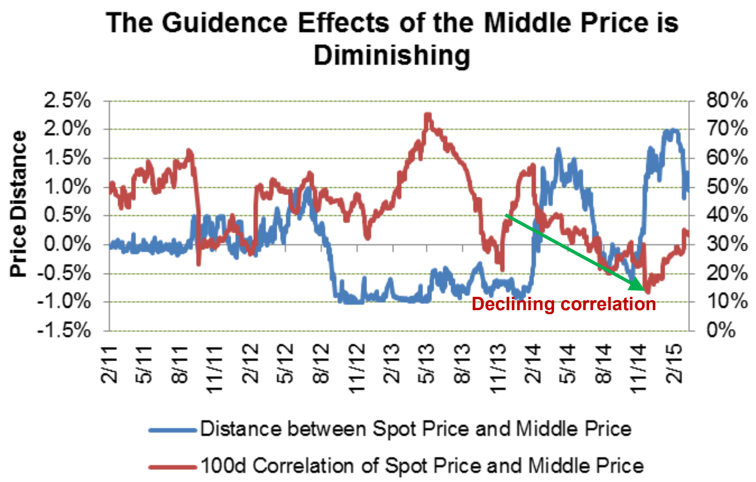
The RMB has been weakening recently and is trading at the lower end of the PBC's daily trading band. The currency has been within 0.1 percentage point of the lower end of its trading range for most day sessions since January 2015, resulting in the band's biggest test since it was doubled in March 2014. The spot rate's discount to the fixing widened to a record 1.99 per cent on 17 February 2015. Under the current exchange-rate system, a move to the limit would prompt the central bank to intervene, adjust the reference rate or widen the band.

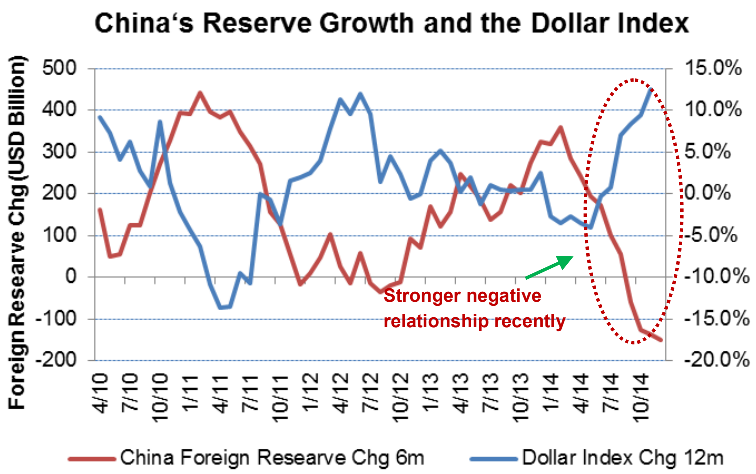
Going back to September 2011, the spot rate's premium/discount to the fixing widened significantly and touched the levels near 0.5 per cent on the downside from time to time before the PBC widened the trading band from 0.5 per cent to 1 per cent on 15 April 2012. Similarly, going back to June 2012, the spot rate's premium/discount to the fixing widened further and touched the levels near 1 per cent on the upside from time to time before the PBC widened the trading band from 1 per cent to 2 per cent on 17 March 2014. Those two PBC actions were precipitated at least in part by sudden spikes in the implied volatility of offshore OTC RMB options.

If the current trend towards a weaker RMB persists, the spot price will challenge the upper end of the USD-RMB trading band and might necessitate further RMB depreciation. The band could be widened to 3 per cent if it remains under pressure.

As the RMB FX market matures, the central bank will provide more room for the trading of the spot rate, therefore the guidance effect of the reference fixing rate on the spot rate will weaken over time. As shown in the second chart on this page, the correlation between the spot rate and





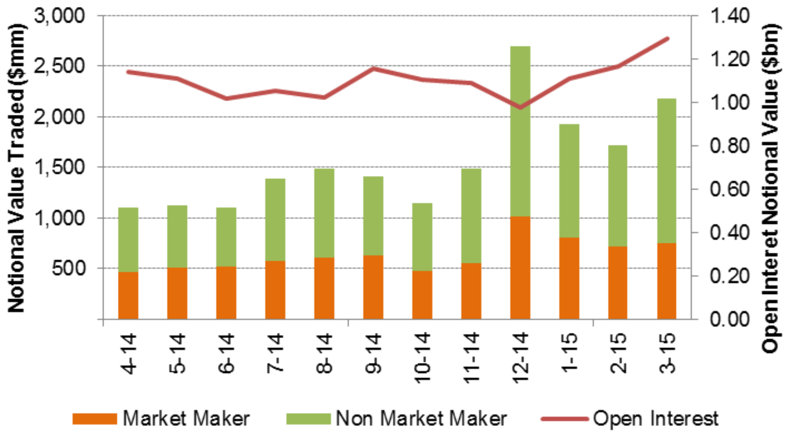


the fixing rate has dropped from a range of 40 to 60 per cent to a range of 10 to 30 per cent. On the other hand, the spot rate's premium/discount to the fixing touched the upper and lower limit of the daily trading range, which demonstrated that the movement of the onshore RMB FX rate is more and more driven by market supply/demand forces.

China's foreign exchange reserves dipped to USD3.8 trillion as of end-December 2014, from an all-time high of roughly USD4 trillion in June 2014. Research shows that a large and growing share of China's FX reserves has been allocated to non-USD currencies, notably the euro, Japanese yen and British pound, which together account for about one-third of the total. The FX reserves' trend since early 2014 is the result of further strengthening of the USD against other currencies (the third chart on page 1 shows the recent stronger negative relationship between the change of foreign reserves and the movement of the USD dollar index). The central bank is gradually phasing out what had been its normal foreign exchange market intervention to avoid the continuous build-up of its foreign reserves. This is consistent with the message recently sent by PBC governor Zhou Xiaochuan that the RMB reforms will accelerate in 2015, with a more flexible currency policy, further deregulation and more two-way portfolio flow channels, aiming to make the RMB convertible on the capital account.

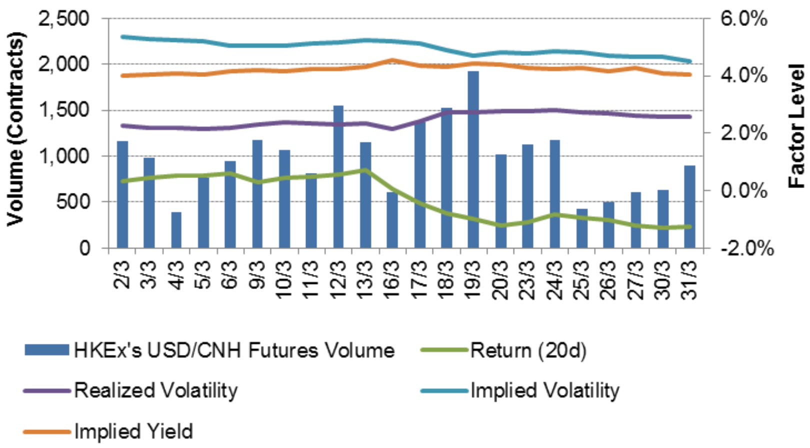
HKEx's USD/CNH Futures Market Statistics

USD/CNH Futures Turnover and OI



- In March 2015, a total of USD2.2 billion in contract value was traded, with an average daily notional value of USD99 million.
- Non Market Makers contributed 66 per cent of contract volume, up from 58 per cent in February 2015

Key Driving Factors of USD/CNH Futures Volume



The following have been identified as the key driving factors behind the CNH futures volume:

- Cumulative return of CNH/USD,
- Realised volatility (20d),
- Implied volatility (USD/CNH 1Y ATM Implied Volatility from Bloomberg)
- 12 month forward implied yield

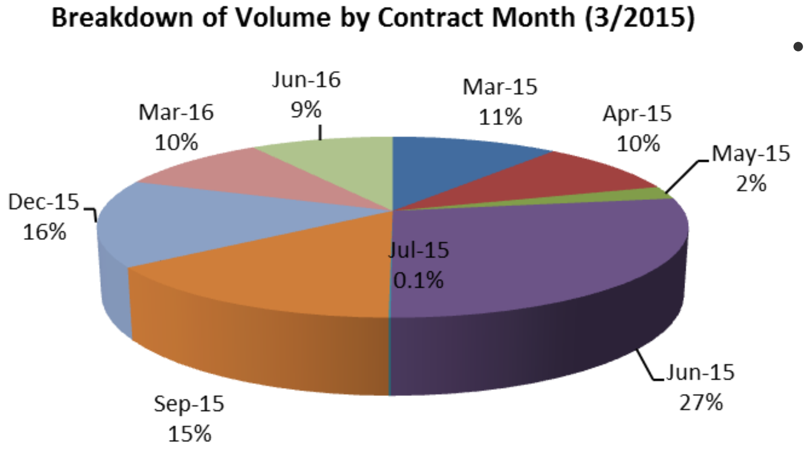
USD/CNH Futures Prices and Average Bid-Ask Spread

Contract Month	31 March Closing	Average Bid/Ask Spread*
Mar-15	-	0.0016
Apr-15	6.2743	0.0020
May-15	6.2956	0.0023
Jun-15	6.3145	0.0019
Jul-15	6.3361	0.0027
Sep-15	6.3521	0.0019
Dec-15	6.4013	0.0019
Mar-16	6.4457	0.0022
Jun-16	6.4911	0.0021

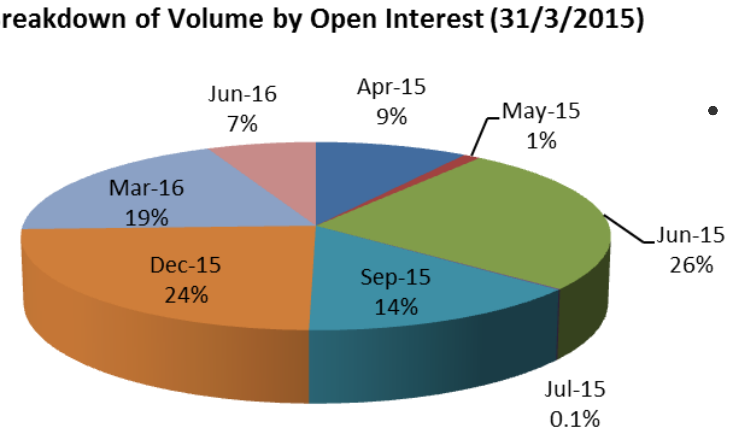
*Average Bid/Ask Spread between 9:30 am and 4:00 pm during the month

- During the day session, the average bid-ask spread of the March 2015 contract was 0.0016.

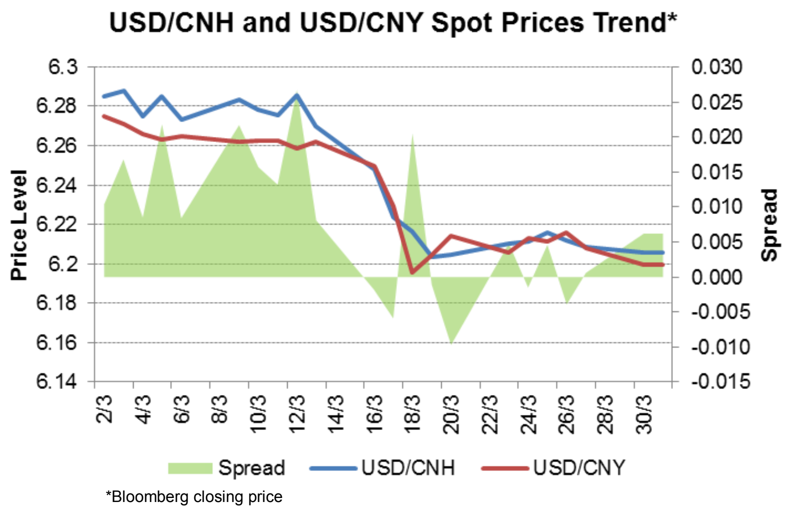
HKEx's USD/CNH Futures Market Statistics



- Trading volume was highest in the June 2015 contract, and evenly spread across front and far month contracts

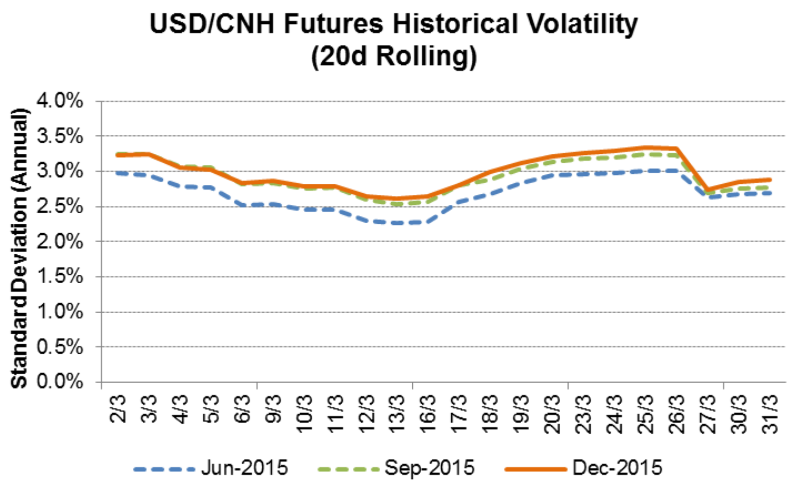


- Open interest was high in the June and December 2015 contracts, which accounted for 50 per cent of total open interest at the end of March.



*Bloomberg closing price

- The spread between the USD/CNH and the USD/CNY narrowed towards the end of March to less than 0.005. The CNH was trading at a discount to the CNY against the USD.



- Volatility in USD/CNH Futures ranged between 2 to 3.5 per cent in March 2015.
- The volatility spreads across far month contracts and front month contracts were at par compared to February 2015.

Expert Corner

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

Liquidity Injections are Needed to Bring Repo Rates Sustainably Lower

In onshore China, there has been an easing in front-end CNY rates, finally. Usually, in the run-up to the Chinese New Year, front-end CNY rates get pushed up as market participants get prepared for the holidays. Afterwards, money will be released back to the system. However, interest rates movements in the weeks after the holidays suggested that the money back (if any) was not enough. FX intervention to defend the CNY could have been one factor that drained domestic liquidity.

With the one-year (1Y) repo-IRS remaining below the 7-day repo (the floating leg of the IRS), further easing is priced in by the market. Active liquidity injections, rather than interest rate cuts, by the PBC are needed to bring repo rates sustainably lower, in our view. The 25 bp cut in the 1Y benchmark deposit rate at the end of February, among cuts on other deposit rates, has had little impact on repo rates – the money market benchmark. First, the upper band of bank deposit rates was at the same time raised to 1.3 times the benchmark deposit rate, making the effective rate cut (if we take the maximum 1Y deposit rate) small at 5 bp only. Second, the transmission from deposit rates to repo rates has always been weak.

Recent actions by the PBC do give the CNY interest rates market some comfort. These actions include some liquidity injections via short-term reverse repos and lowered rates on reverse repo operations done by the PBC. Required reserve ratio (RRR) cuts, however, are seen as having a more long-lasting impact than short-term open market operations. We do believe that the onshore liquidity situation will ultimately get easier upon further PBC easing – we expect two 50 bp RRR cuts and one 25 bp cut in benchmark deposit rates in Q2. The repo-IRS curve could steepen further then. On the bond side, we see slightly higher long-end Chinese government bond (CGB) yields, amidst competition for capital later in the year and upon a marginal impact from the wider fiscal deficits.

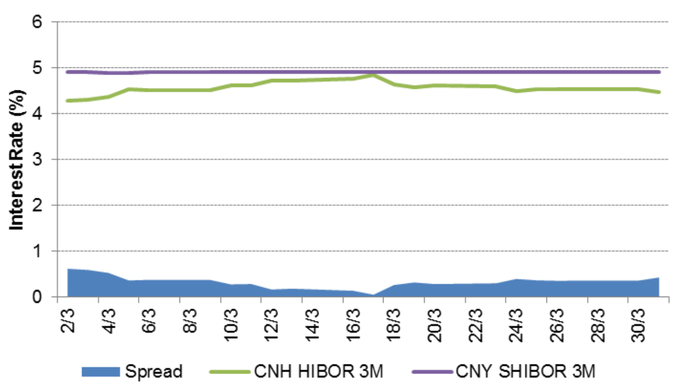
In the offshore CNH market, CNH rates have been on a broad, upward trend for an extended period. CNH cross currency swaps (CNH CCS) have risen to levels that render asset swap trades (“borrowing” CNH via CCS and investing the money into offshore CNH products) unattractive. As an illustration, offshore CGB with a remaining maturity of about 3.5 years yield around 3.6 per cent (indicative only as the secondary market is illiquid), while 3Y and 4Y CNH CCS are above 4.0 per cent. That said, paying flows continue, possibility in relation to some investment opportunities in the onshore CNY markets, and/or to FX hedging activities. Apart from changing expectations on the RMB, we see two factors from the interest rates perspective that can potentially cap CNH CCS or even bring the rates lower. First, if onshore liquidity becomes looser as we expect, then the upward pressure on offshore CNH rates arising from cross-border flows will subside. Second, issuer flows is key if the uptrend in CNH CCS is to be bucked.

Offshore RMB bond issuance as a whole so far this year has not been impressive, but there are a couple of observations worth noting. First, the primary RMB bond market in Taiwan is becoming more active. Second, according to Taipei Exchange (previously known as GreTai), recently there have been international issuers issuing RMB bonds in Taiwan and swapping the proceeds back into USD. When these issuers swap their RMB proceeds into USD, they receive CNH CCS – ie exert downward pressure on these rates. We also believe that some issuers are tempted to take advantage of the high CNH CCS to issue in RMB even when their needs could be, for example, the USD. In this regard, the 2-4Y part of the CNH CCS curve is particularly high. That said, real money demand is needed for these RMB bonds to be readily absorbed. On balance, we see downside risk rather than upside risk to CNH CCS.

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

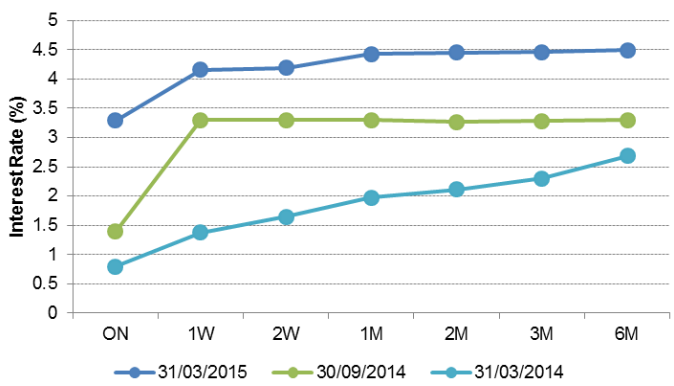
RMB FIC Market Review - Short-Term Interest Rates and Fixed Income

CNY SHIBOR vs. CNH HIBOR



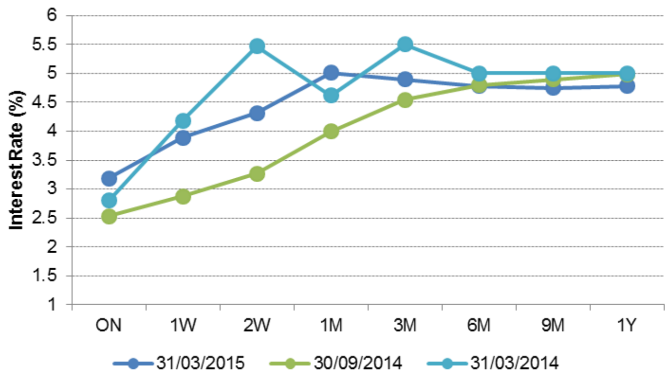
Onshore rates (CNY SHIBOR) remain higher than offshore rates (CNH HIBOR). However, the spread between them was tighter towards the end of March 2015.

CNH HIBOR Yield Curves



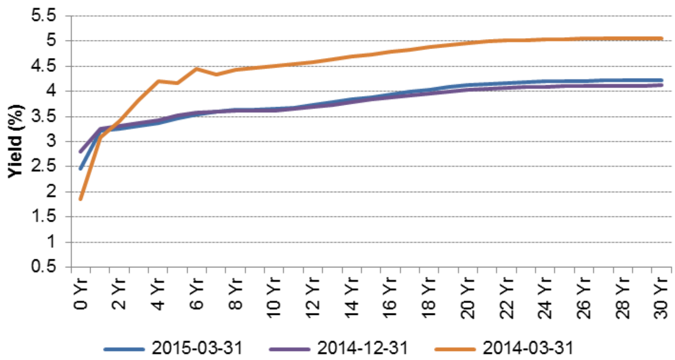
The CNH HIBOR yield curve was flatter in March 2015 than in March 2014.

CNY SHIBOR Yield Curves



The short end of the CNY SHIBOR yield curve steepened in March 2015 while the long end remained relatively stable.

MoF T-Bond Yield Curve



The MoF T-Bond yield curve was gradually moving down through 2014. Compared to the short end of the yield curve, the long end dropped more during that period.

For more information about the USD/CNH Futures Contract Specifications,

please visit: http://www.hkex.com.hk/eng/prod/drprod/rmb/cnhspecs.htm

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