Market Summaries

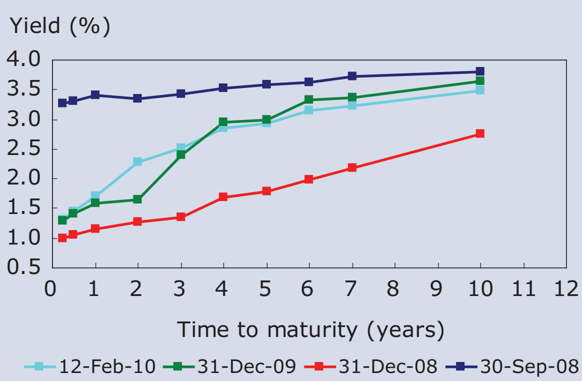
People's Republic of China—Update

Yield Movements

Yields on government bonds have increased significantly from their December 2008 levels. Yields for maturities ranging from 3 months to 3 years rose compared to their end-December 2009 levels, but fell for longer maturities. At the short-end of the curve, the most pronounced yield increase was that of the 2-year bond, which rose 63 basis points, while yields from the middle to the long-end of the curve declined between 5 and 18 basis points **(Figure 1)**.

Due to the surge in yields on 2-year bonds, and the decline in the yields of longer dated bonds, the spread between 2- and 10-year government bonds decreased from 199 basis points at end-December 2009 to 121 basis points as of 12 February. Given that yield levels were elevated compared to their levels in December 2008, the upward movements of the curve, particularly at the shorter end, reflects ongoing concerns over monetary tightening and inflation, as well as investors' focus on equities, property, and other asset classes.

Figure 1: People's Republic of China's Benchmark Yield Curve—Local Currency Government Bonds



Source: Bloomberg LP.

For the full year 2009, the PRC's gross domestic product (GDP) grew a higher-than-expected 8.7% year-on-year (y-o-y), fuelled by a surge in bank lending that had been encouraged by the government earlier in the year. On a quarterly basis, the country registered GDP growth of 10.7% y-o-y in 4Q09, compared with growth rates of 9.1% in 3Q09, 7.9% in 2Q09, and 6.2% in 1Q09.

New loans extended during 2009 totaled CNY9.58 trillion, which was nearly double the government's annual target of CNY5.0 trillion. In 4Q09, however, new loans amounted to CNY927.54 billion. This compares with new loan totals of CNY1.28 trillion in 3Q09, CNY2.79 trillion in 2Q09, and CNY4.58 trillion in 1Q09. M2 money supply, meanwhile, grew 27.68% in December, compared to growth rates of 29.74% and 29.51% in November and October, respectively.

The slowdown in loan growth was partially due to guidance from the China Banking Regulatory Commission (CBRC) aimed at decreasing the pace of commercial bank lending and limiting the flow of funds towards property and equity markets, both of which were showing increasingly attractive returns. The fall-off in 4Q09 loans was also due to the adoption of policies to restrain investment in steel, cement, and other sectors in which investment is deemed to be overly concentrated. While the total amount of new loans extended in 4Q09 was markedly lower than loan figures in the prior three quarters, the quarterly total for 4Q09 masked a sequential rise in lending in the quarter: new loans in December totaled CNY379.8 billion, compared to November's CNY294.76 billion and October's CNY252.98 billion.

Table 1: Size and Composition of Local Currency Bond Market in the People's Republic of China

	Amount (billion)								**Growth Rate** (%)						
	Sep-09		**Oct-09**		**Nov-09**		**Dec-09**		**Sep-09**		**Oct-09**	**Nov-09**	**Dec-09**		
	CNY	**USD**	**CNY**	**USD**	**CNY**	**USD**	**CNY**	**USD**	**y-o-y**	**q-o-q**	**m-o-m**	**m-o-m**	**y-o-y**	**q-o-q**	**m-o-m**
Total	16,483	2,415	16,687	2,444	17,218	2,522	17,525	2,567	13.9	4.5	1.2	3.2	16.0	6.3	1.8
Government	13,753	2,015	13,853	2,029	14,214	2,082	14,424	2,113	5.7	3.1	0.7	2.6	8.0	4.9	1.5
Treasury Bonds	5,655	828	5,629	824	5,746	842	5,741	841	18.3	5.8	(0.5)	2.1	17.8	1.5	(0.1)
Central Bank Bonds	4,020	589	4,081	598	4,070	596	4,233	620	(16.4)	(3.4)	1.5	(0.3)	(12.0)	5.3	4.0
Policy Bank Bonds	4,078	597	4,143	607	4,398	644	4,450	652	19.0	6.3	1.6	6.2	21.2	9.1	1.2
Corporate	2,729	400	2,834	415	3,004	440	3,102	454	87.7	12.5	3.8	6.0	77.5	13.6	3.3
Policy Bank Bonds															
China Development Bank	2,939	431	2,994	439	3,134	459	3,201	469	14.8	6.2	1.9	4.7	18.3	8.9	2.1
Export-Import Bank of China	373	55	373	55	438	64	438	64	38.1	10.3	0.0	17.4	38.8	17.4	0.0
Agricultural Dvt. Bank of China	766	112	776	114	826	121	811	119	28.5	4.8	1.3	6.4	24.8	5.9	(1.8)

m-o-m = month-on-month, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Note:
1. Calculated using data from national sources.
2. Treasury bonds include savings bonds and local government bonds.
3. Bloomberg end-of-period LCY—USD rate is used.
4. Growth rates are calculated from LCY base and do not include currency effects.
Source: *ChinaBond* and Bloomberg LP.

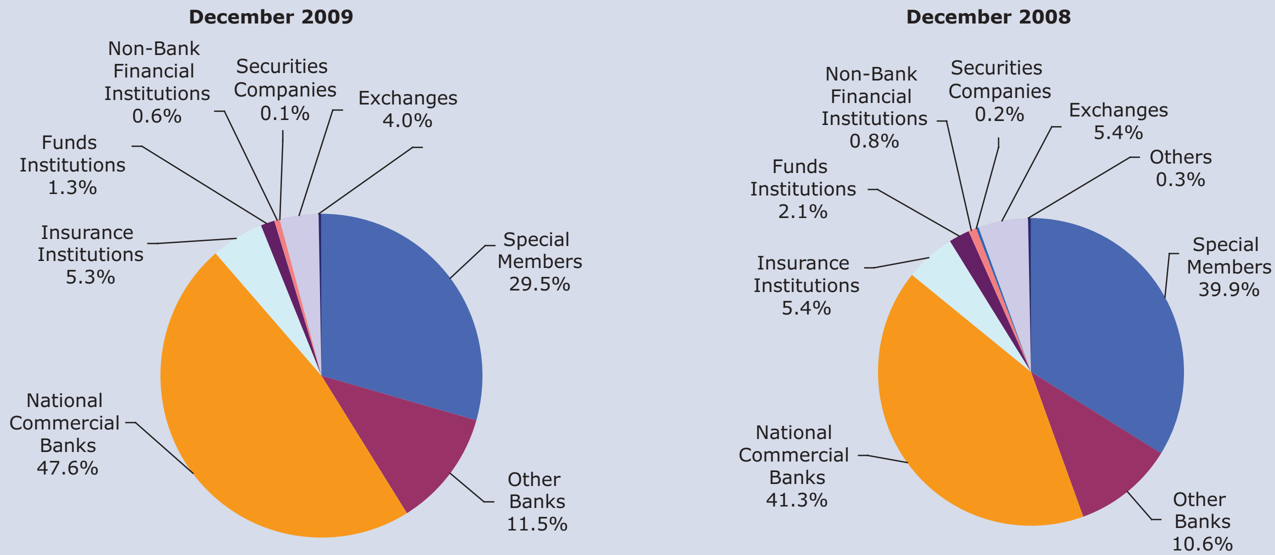
In January 2010, the People's Bank of China (PBOC) increased banks' reserve ratios by 0.5 percentage points—the first such increase since 2008—and accepted higher yields on 3-month and 1-year bills in two successive auctions. These measures were followed by an additional 0.5 percentage point increase in banks' reserve ratios in February. New loans for January 2010 alone, which amounted to CNY1.39 trillion, far exceeded the total for the whole of 4Q08 despite the measures taken to moderate loan growth.

Consumer price inflation, which had been negative for much of 2009, climbed from -0.5% y-o-y in October to 0.6% and 1.9% in November and December, respectively. Inflation then moderated to 1.5% in January before rising to 2.7% in February. Commercial and residential property prices in 70 large and medium-sized cities rose 10.7% y-o-y in February from 9.8% in the previous month. However, new loans extended in February amounted to CNY700 billion, down from CNY1.39 trillion in January. These and other steps taken to tighten liquidity are indicative of policymakers' cautious approach towards managing the country's economic recovery.

Size and Composition

The PRC's outstanding amount of local currency (LCY) bonds stood at CNY17.525 trillion at the end of 4Q09, representing a y-o-y rise of 16.0% and a q-o-q increase of 6.3% **(Table 1)**. Government bonds outstanding increased 4.9% q-o-q, and 8.0% y-o-y, while corporate bonds rose 13.6% q-o-q and 77.5% y-o-y. All three major categories of government bonds—treasury, central bank, and policy bank—posted single-digit gains on a q-o-q basis. However, policy bank and treasury bonds had positive double-digit growth rates on a y-o-y basis, while central bank bonds declined 12.0%.

Figure 2: Treasury Bonds Investor Profile



Note:
Special members include the People's Bank of China (PBOC), Ministry of Finance, policy banks, China Government Securities Depository Trust and Clearing Co., and China Securities Depository and Clearing Corporation.

Source: *ChinaBond*.

Treasury Investor Profile

Banks remain the largest category of treasury bond investors in the country, holding a larger share of these bonds in 2009 compared to their share in the previous year **(Figure 2)**. As of December 2009, banks as a group held 59.1% of treasury bonds outstanding compared to their December 2008 share of 51.9%. As was the case at end-September, the share of Treasury bonds held by all other investor classes—most notably institutional investors such as insurance companies—fell compared to their holdings at the end of 2008.

Corporate Bonds

There was remarkable expansion in the outstanding amount of PRC corporate bonds in 2009 **(Table 2)**, which to a large extent mirrored the growth of new loans during the year. At the end of 2009, medium-term notes (MTNs) outstanding had grown 415.7% y-o-y. Local corporate bonds outstanding grew 137.9% y-o-y, while the bonds of commercial banks and state-owned corporations increased 51.4% and 38.0%, respectively. Meanwhile, commercial paper increased 8.5% y-o-y. In terms of bonds outstanding at the end of 2009, MTNs represented the largest issuer category, with CNY862.2 billion of notes outstanding. The second- and third-largest categories were state-owned corporations (CNY720.2 billion) and commercial banks (CNY588.4 billion).

The emergence of MTNs as the largest sector of the corporate bond market is extraordinary given that MTN issuance only began in earnest in 2Q08. As noted in previous issues of the Asia Bond Monitor, the growth of MTNs was due to an apparent shift from the traditional issuance windows towards the MTN window, under which the issuance approval process tends to be quicker. The MTN window is regulated by the National Association of Financial Market Institutional Investors (NAFMII).

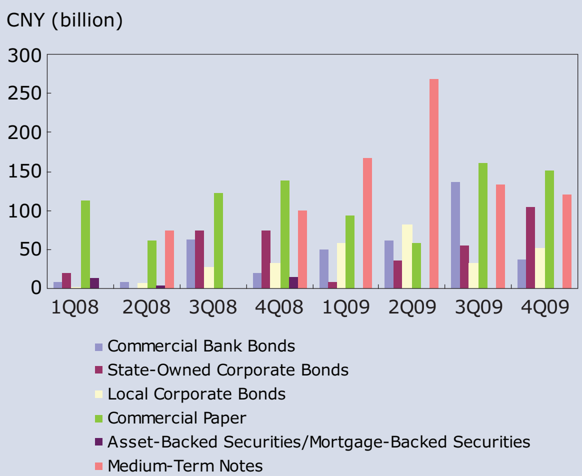
Compared to 3Q09, corporate bond issuance in 4Q09 was marked by a fall-off in MTN and

Table 2: Corporate Bonds Outstanding in Key Sectors (CNY billion)

	Amount								Growth Rates (%)				
									q-o-q				y-o-y
	1Q08	2Q08	3Q08	4Q08	1Q09	2Q09	3Q09	4Q09	1Q09	2Q09	3Q09	4Q09	4Q09
Commercial Bank Bonds	314.5	327.5	384.5	388.7	437.7	486.4	589.2	588.4	12.6	11.1	21.1	(0.1)	51.4
State-Owned Corporate Bonds	376.1	376.6	446.6	521.9	526.5	565.3	619.3	720.2	0.9	7.4	9.6	16.3	38.0
Local Corporate Bonds	92.8	100.2	125.2	158.4	196.9	295.7	328.8	376.9	24.3	50.1	11.2	14.6	137.9
Commercial Paper	371.6	313.4	344.8	420.3	409.4	384.3	353.1	456.1	(2.6)	(6.1)	(8.1)	29.2	8.5
Asset/Mortgage-Backed Securities	37.2	43.4	43.4	55.1	56.6	55.4	46.0	39.9	2.7	(2.1)	(16.9)	(13.4)	(27.7)
Medium-Term Notes	0.0	73.5	73.5	167.2	340.8	592.1	742.1	862.2	103.8	73.7	25.3	16.2	415.7

q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Source: *ChinaBond.*

Figure 3: Corporate Bond Issuance in Key Sectors



Source: *ChinaBond.*

commercial paper issuance, as well as a steep decline in commercial bank bond issuance **(Figure 3)**.

The decline in MTN issuance in 4Q09 was not unexpected in view of the heavy volume of MTN issuance in the prior three quarters. Nevertheless, MTN issuance levels in 4Q09 remained substantial compared to 3Q09 levels, when issuance fell off its 2Q09 peak.

One reason for the decline in commercial bank bond issuance in 4Q09 was the adoption of measures to curb lending in the latter half of 2009. However, in the first 3 quarters, there was an increased issuance of commercial bank bonds, largely in the form of subordinated debt, as banks boosted their capital positions to keep up with their rapidly expanding loan books.

In contrast to the q-o-q decline in MTN issuance and commercial bank bonds in 4Q09, issuance by state-owned corporations in 4Q09 was almost double the amount of the previous quarter and marked the highest level of quarterly issuance for this issuer category over the past 8 quarters. Local corporate bond issuance was also higher in 4Q09 compared to 3Q09, but was still below 1Q09 and 2Q09 levels.

Policy, Institutional, and Regulatory Developments

HSBC Becomes First Foreign Bank to Underwrite Domestic Issue

In November, HSBC, through its PRC unit, became the first foreign bank in the PRC to participate in the underwriting of a domestic, CNY-denominated issue. The issue was a Bank of Shanghai dual-tranche senior finance bond comprising a 3-year CNY2.0 billion tranche paying a fixed interest rate of 3.65% and a CNY3.0 billion floater paying interest of 92 basis points above the 1-year deposit rate. The joint lead managers for the issue were ICBC and Citic Securities. HSBC joined 25 other domestic banks and financial institutions in underwriting the issue.

The PRC Launches 50-year Bond, Extending the Yield Curve

The Ministry of Finance in late November sold the country's first 50-year treasury bond, which is the country's longest-dated issue. The CNY20 billion issue pays a coupon of 4.3%. Before the issuance of the 50-year bond, the longest-maturity government bond was a 30-year bond. The 50-year bond was well received by long-term investors, particularly insurers and pension funds, as bids totaled nearly twice the amount offered.

Among the reasons for the issue was to provide a benchmark for the pricing of long-dated issues. Given that institutional investors typically hold long-term bonds to maturity for asset–liability management purposes, the issue is expected to be thinly traded.

First Structured MTN Collective Issue

In November, the first structured MTN in the PRC was issued by the Shandong Zhu Cheng SME Collective, a group of eight small- and medium-sized enterprises (SMEs), each of which is responsible for a certain share of the total issue. The CNY500 million issue consisted of a CNY300 million senior tranche and a CNY200 million subordinated tranche. The issuance of the subordinated tranche is noteworthy as it represents the first such offering in the SME and MTN bond markets. The senior tranche is guaranteed by China Bond Insurance and is rated AAA by New Century, a domestic rating agency, while the subordinated tranche is rated AA-. Individually, the SMEs in the collective have domestic credit ratings of BBB or higher.

The issuance of the structured MTN is part of a larger effort to disperse the credit risk borne by the banking system. Authorities in the PRC have encouraged the establishment of credit enhancement firms such as China Bond Insurance to help broaden access to the bond market, which has mainly been restricted to large, highly-rated companies. The Shandong Zhu Cheng issue was followed by two other SME collective issues of commercial paper and MTNs. These issues are part of the first batch of wrapped, or credit-enhanced, SME collective paper.

Relaxation of Rules on Insurance Companies' Bond Investments

The China Insurance Regulatory Commission (CIRC) in October raised the limit on PRC insurers' corporate bond investments from 30% of their assets to 40%. Still, insurers' investments in bonds are limited to bonds of large state-owned enterprises; Hong Kong, China-listed "red chips"; and companies with "H-share" issuance. In addition, the bonds that insurers may invest in must be rated BBB or higher. The CIRC also lifted the requirement that insurers' bond investments be limited to companies that have been profitable for the prior 3 years, requiring instead that the issuer's average yearly profit in the prior 3 years be higher than the yearly interest payments on the issuer's bonds.

Domestic Bank Participation in Bond Trading on Exchanges

In early November, three large state-owned banks—the Bank of Communications (BOC), China Construction Bank (CCB), and the Industrial and Commercial Bank of China (ICBC)—received approval from the China Banking Regulatory Commission (CBRC) to engage in exchange-based bond trading. In addition to approval from regulators, the banks also need approval from by the stock exchanges. The BOC and CCB have already received approval from the Shanghai Stock Exchange.

To provide a bridge between the PRC's two primary venues for bond trading—the interbank market and stock exchanges—CBRC and the China Securities Regulatory Commission (CSRC) jointly issued preliminary rules in January permitting listed banks to trade bonds in the country's stock exchanges. The interbank bond market is much larger than the exchange-traded market. Regulations for the entry of domestically-listed banks into exchange-based bond trading were released in early July.

Banks' participation in exchange-based bond trading is aimed at strengthening demand for the bonds of listed companies and increasing confidence in the successful distribution of their bonds on the exchanges.