

Market Summaries

People's Republic of China—Update

Yield Movements

The government bond yield curve for the People's Republic of China (PRC) flattened between end-December 2009 and mid-August 2010. Yields for maturities ranging from 3 months to 2 years rose significantly, while yields fell for maturities further out along the curve. At the short-end of the curve, yield increases ranged from a low of 29 basis points for the 3-month tenor to a high of 54 basis points for the 2-year tenor. Meanwhile, the yield on the 3-year tenor declined slightly by 8 basis points, while yields posted hefty declines at the longer-end of the curve, ranging from 34 basis points for 5-year bonds to 55 basis points for 6-year bonds (**Figure 1**).

Due to the rise in short-term yields and a decline in yields for longer-term bonds, the spread between 2- and 10-year government bonds decreased to 110 basis points in mid-August from 199 basis points at end-December.

In 2Q10, the PRC's gross domestic product (GDP)

growth rate moderated to 10.3% year-on-year (y-o-y) after having surged to 11.9% in 1Q10. Economic data releases in July pointed towards a continuing moderation of economic growth. Industrial output grew at 13.4% y-o-y in July, down from 13.7% in June. Cumulative (year-to-date) urban fixed-asset investment through July rose 24.9% compared with the same period in 2009. However, for the first 6 months of the year, cumulative urban fixed-asset investment grew 25.5% y-o-y. Finally, new loans extended in July amounted to CNY532.8 billion, compared with CNY603.4 billion in June.

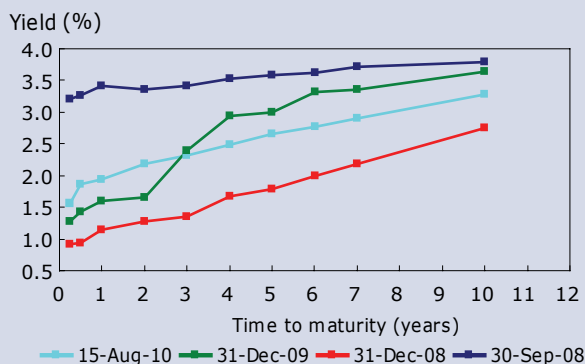
Consumer price inflation stood at 3.1% y-o-y in May, fell to 2.9% in June, and then rose to 3.3% in July. The July spike in inflation was expected to be temporary, as it was largely driven by rising food prices brought on by crop destruction due to recent floods. Despite this, inflationary pressures remain due to wage increases earlier in the year and the large amounts of liquidity still in the financial system. The People's Bank of China (PBOC), which in the first half of the year increased requirements for banks' reserve ratios three separate times in an effort to curb loan growth and asset price inflation, maintained its 1-year lending and deposit rates at 5.31% and 2.25%, respectively.

Size and Composition

The outstanding amount of local currency (LCY) bonds in the PRC reached CNY19.3 trillion at the end of June, representing a y-o-y increase of 22.5% and a quarter-on-quarter (q-o-q) rise of 6.9% (**Table 1**).

Government bonds outstanding increased 17.0% y-o-y and 6.0% q-o-q in 2Q10, while corporate bonds rose 52.7% y-o-y and 10.4% q-o-q. In the government sector, policy bank bonds posted the highest y-o-y increase, growing 25.1%, followed by central bank and

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



LCY = local currency.
Source: Bloomberg LP.

Table 1: Size and Composition of the LCY Bond Market in the PRC

	Amount (billion)						Growth Rates (%)												
	Mar-10		Apr-10		May-10		Jun-10		Mar-10		Apr-10		May-10		Jun-10				
	CNY	USD	CNY	USD	CNY	USD	CNY	USD	Y-o-Y	Q-o-Q	M-o-M	Y-o-Y	Q-o-Q	M-o-M	Y-o-Y	Q-o-Q	M-o-M		
	18,077	2,648	18,504	2,711	18,883	2,765	19,316	2,848	20.7	3.1	2.4	2.0	22.5	6.9	2.3	22.5	6.9	2.3	
Government	14,721	2,157	15,016	2,200	15,237	2,232	15,611	2,302	13.5	2.1	2.0	1.5	17.0	6.0	2.5	17.0	6.0	2.5	
Treasury Bonds	5,717	837	5,769	845	5,855	858	6,069	895	16.7	(0.4)	0.9	1.5	13.5	6.1	3.6	13.5	6.1	3.6	
Central Bank Bonds	4,381	642	4,602	674	4,648	681	4,743	699	0.8	3.5	5.0	1.0	14.0	8.3	2.0	14.0	8.3	2.0	
Policy Bank Bonds	4,624	677	4,646	681	4,734	693	4,800	708	24.0	3.9	0.5	1.9	25.1	3.8	1.4	25.1	3.8	1.4	
Corporate	3,356	492	3,488	511	3,646	534	3,705	546	67.5	8.2	3.9	4.5	52.7	10.4	1.6	52.7	10.4	1.6	
Policy Bank Bonds																			
China Development Bank	3,351	491	3,383	496	3,456	506	3,462	510	24.4	4.7	1.0	2.2	25.0	3.3	0.2	25.0	3.3	0.2	
Export-Import Bank of China	443	65	433	63	448	66	481	71	37.7	1.1	(2.3)	3.5	42.1	8.4	7.2	42.1	8.4	7.2	
Agricultural Dvt. Bank of China	830	122	830	122	830	122	857	126	16.3	2.3	0.0	0.0	17.3	3.3	3.3	17.3	3.3	3.3	

LCY = local currency, 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 LP end-of-period LCY-USD rate is used.

4. Growth rates are calculated from LCY base and do not include currency effects.

Source: ChinaBond.

treasury bonds, which posted growth rates of 14.0% and 13.5% respectively. On a q-o-q basis, however, the growth rates of central bank bonds and treasury bonds in 2Q10 outpaced the growth of policy bank bonds. Central bank and treasury bonds expanded 6.1% and 6.0% q-o-q, respectively, while policy bank bonds grew 3.8%, approximating their 1Q10 q-o-q growth rate.

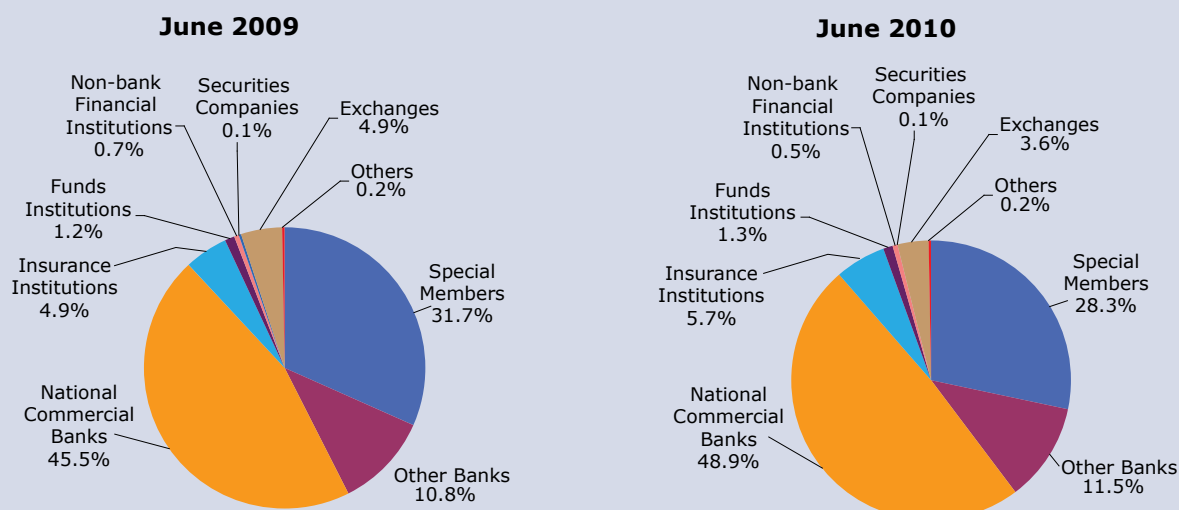
Treasury Investor Profile

Banks remained the largest category of treasury bond investors in the PRC in 2Q10, holding a larger share of these bonds at the end of June 2010 compared with end-June 2009 (**Figure 2**). In June 2010, banks held 60.4% of treasury bonds outstanding, compared with 56.3% in June 2009. The share held by PRC Special Members dropped to 28.3% in June from 31.7% a year earlier. Special Members comprise the PBOC, Ministry of Finance, policy banks, China Government Securities Depository Trust and Clearing Co., and China Securities Depository and Clearing Corporation.

Corporate Bonds

With the exception of asset- and mortgage-backed securities, which have been declining since 2Q09, key sectors of the corporate bond market experienced double-digit y-o-y growth in 2Q10. Medium-term notes (MTNs) grew by 94.4% y-o-y, while commercial paper and local corporate bonds posted growth rates of 60.1% and 56.1%, respectively. Meanwhile, state-owned corporate bonds (or state-owned enterprises [SOE] bonds) grew by 38.2% y-o-y and commercial bank bonds grew 25.1%.

On a q-o-q basis, MTNs, commercial paper, and commercial bank bonds posted higher growth rates in 2Q10 compared with the previous quarter (**Table 2**). MTNs increased 17.9% q-o-q, compared with 13.2% in the previous quarter. Commercial paper grew 21.0% q-o-q, compared with 11.5% in 1Q10. Meanwhile, commercial bank bonds grew at a more subdued pace of 3.2% q-o-q in 2Q10, up from 0.2% in 1Q10.

Figure 2: Treasury Bonds Investor Profile

Source: ChinaBond.

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

	Amount						Growth Rates (%)						
							q-o-q				y-o-y		
	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	1Q09	2Q09	3Q09	4Q09	1Q10	2Q10	2Q10
Commercial Bank Bonds	437.7	486.4	589.2	588.4	589.6	608.5	12.6	11.1	21.1	(0.1)	0.2	3.2	25.1
State-Owned Corporate Bonds (SOE)	526.5	565.3	619.3	720.2	771.1	781.1	0.9	7.4	9.6	16.3	7.1	1.3	38.2
Local Corporate Bonds	196.9	295.7	328.8	376.9	420.0	461.7	24.3	50.1	11.2	14.6	11.4	9.9	56.1
Commercial Papers	409.4	384.3	353.1	456.1	508.8	615.4	(2.6)	(6.1)	(8.1)	29.2	11.5	21.0	60.1
Asset/Mortgage-Backed Securities	56.6	55.4	46.0	39.9	31.1	26.5	2.7	(2.1)	(16.9)	(13.4)	(22.1)	(14.8)	(52.2)
Medium Term Notes	340.8	592.1	742.1	862.2	976.4	1,151.2	103.8	73.7	25.3	16.2	13.2	17.9	94.4

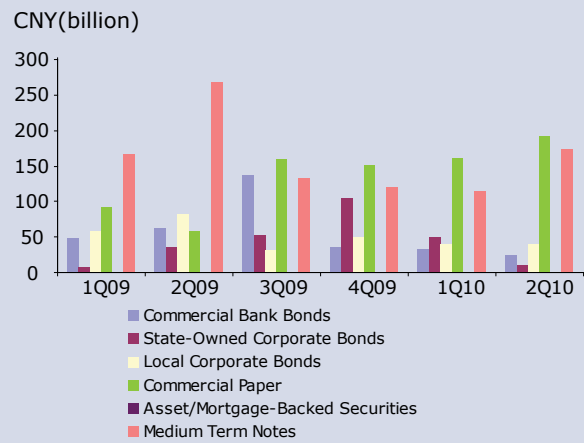
q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Source: ChinaBond.

In contrast to MTNs and commercial paper, the growth rates of SOE bonds and local corporate bonds in 2Q10 declined from the previous quarter. As can be seen in Table 2, the q-o-q growth rate of local corporate bonds declined from 14.6% in 4Q09 to 9.9% in 2Q10, while the growth rate of SOE bonds fell more dramatically, from 16.3% in 4Q09 to 1.3% in 2Q10.

The rise in q-o-q growth figures for MTNs and commercial paper in 2Q10 reflected continued strong corporate sector demand for medium- to short-term funds, access to which has been facilitated by the relatively quick issuance approval process for these issuance windows.

Consistent with growth in the outstanding amount of MTNs in 2Q10, MTN issuance rebounded from CNY114.9 billion in 1Q10 to CNY174.1 billion in 2Q10, for a q-o-q increase of 51.5%. Issuance of MTNs had been on a downward trend since peaking at CNY268.6 billion in 2Q09 (**Figure 3**). Notable MTN issuers in 2Q10 were China National Petroleum Corporation, Petrochina, and State Grid Corporation of China.

Also in line with the q-o-q increase in commercial paper outstanding, issuance of commercial paper rose 18.2% from CNY162.1 billion in 1Q10 to CNY191.5 billion in 2Q10.

Figure 3: Corporate Bond Issuance in Key Sectors

Source: ChinaBond.

Policy, Institutional, and Regulatory Developments

PBOC Signals Greater Yuan Flexibility

On 20 June, the PBOC announced that the yuan's exchange rate would be allowed to adjust based on floating bands. The announcement signaled a move towards a more flexible exchange rate regime. The PBOC, however, ruled out a one-time revaluation of the currency and no timeframe was announced for the shift in policy.

Yuan Settlement Pilot Program Expanded

The PBOC announced on 22 June that it would expand coverage of its pilot yuan settlement program to include the rest of the world. Previously, the program, which allows for use of the yuan for trade settlement, had been limited to members of the Association of Southeast Asian Nations (ASEAN); Macao, China; and Hong Kong, China. The PBOC also expanded the number of provinces and municipalities participating in the pilot program by eighteen. The pilot program was introduced in July 2009. Shanghai and four cities

in Guangdong province were the first cities in the PRC to be allowed to settle external trade using the yuan.

Insurance Regulator Sets Rules on Insurers' Investments

The PRC's insurance regulator, the China Insurance Regulatory Commission, issued a detailed set of rules on insurers' investments on 5 August. According to the Provisional Measures on Insurance Capital Uses, insurance companies will not be permitted to invest more than 10% of their assets (as of the most recent quarter) in the property market. The rules also set ceilings on investments in different asset classes. Insurance companies can invest up to 20% of their assets in equities and up to 5% in stakes in unlisted enterprises. Insurers will also be allowed to invest up to 20% of their assets in unsecured corporate bonds and the debt of non-financial firms, and up to 5% in debt associated with infrastructure projects. PRC insurance companies' assets totaled CNY4.5 trillion at the end of 2Q10, with equity investments accounting for 10% of these assets.

Mini-QFII Program Under Consideration

In July, the PRC was reported to be considering the establishment of a "mini-Qualified Foreign Institutional Investor (QFII)" scheme on a pilot basis. Under the scheme, the Hong Kong, China subsidiaries of PRC-based brokerages and fund managers would be permitted to channel offshore yuan back into the PRC's domestic capital markets, providing them with an expanded range of CNY-denominated investment opportunities. The scheme is reportedly set to be implemented in late 2010 or early 2011. The program, along with the opening up of the PRC's interbank bond market to overseas investors (see below), is part of the PRC's efforts to promote international use of the yuan.

PRC Begins to Open Interbank Bond Market to Overseas Investors

On 17 August, the PBOC announced that it would permit non-resident financial institutions greater access to the PRC's interbank bond market as part of

a pilot program to promote cross-border yuan trade settlement and broaden investment channels for yuan to flow back to the PRC. Foreign investment in the PRC's capital markets had previously been limited to QFII program participants.

Under the measures announced by the PBOC, central banks, yuan-clearing banks, and banks based in Hong Kong, China and Macao, China that are participating in the PRC's yuan trade settlement program will be allowed to invest their yuan holdings in the PRC's interbank bond market. Institutions approved to participate in the program will be subject to investment quotas set by the PBOC.