

Market Summaries

People's Republic of China—Update

Yield Movements

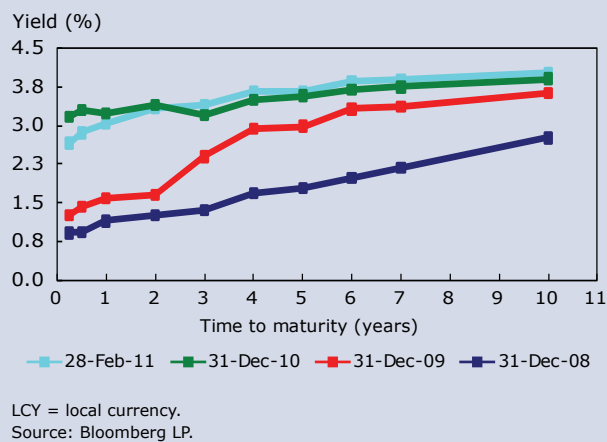
The People's Republic of China's (PRC) government bond yield curve rose and flattened in 2010, especially at the short-end of the curve, reflecting concern about inflationary pressures due to rising food prices. The People's Bank of China (PBOC) began to raise its policy rates and reserve requirement ratios in the latter part of the year in order to slow liquidity growth (**Figure 1**).

More recently, the government bond yield curve steepened between end-December and end-February. Yields on tenors of 1 year or less fell by 21–52 basis points. The largest drop was seen in the 3-month rate, which fell 52 basis points. The long-end of the curve experienced a rise in yields, with yields for 10- and 7-year tenors rising by 15 and 12 basis points, respectively. Meanwhile, yields for the 6-year tenor rose by 16 basis points, while yields for the 5-year tenor rose by 9 basis points.

Due to a drop in short-term yields and increases in yields for longer-term bonds, the spread between 2- and 10-year government bonds increased to 70 basis points at end-February from 51 basis points at end-December.

Changes in the yield curve as well as recent market volatility, particularly at the shorter-end of the curve, are a response to efforts by the PRC to slow down inflation and credit growth. The PBOC has hiked the reserve requirement ratio six times (by 50 basis points each time) since November. The PRC also hiked its benchmark interest rates in December for the second time in 2010, raising the 1-year lending rate to 5.81% and the 1-year deposit rate to 2.75%. Inflation for the year peaked in November, reaching 5.1%, before slowing slightly in December to 4.6%. However, inflation picked up again in January, reaching

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



4.9%, driven mostly by rising food costs. The January inflation figure also reflects a re-weighting of the basket used to calculate inflation, with an increase in housing-related items such as rent and utilities, while other categories in the basket received a smaller weighting. The PRC again hiked benchmark interest rates by 25 basis points on 8 February, bringing the 1-year lending rate to 6.06% and the 1-year deposit rate to 3.0%.

New loans for full-year 2010 hit CNY7.95 billion, exceeding the government's target of CNY7.5 billion and raising concerns about the pace of credit growth. The M2 measure of money supply also showed an uptick in 2010, including growth rates of 19.7% in December and 19.5% in November. The recent efforts of the PBOC to tighten the money supply have had an effect, with M2 money supply growth slowing to 15.7% in February.

The rise in property prices has also prompted some concern, with the PRC government unveiling a number of measures to reduce speculation.

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

	Amount (billion)						Growth Rates (%)									
	Sep-10		Oct-10		Nov-10		Dec-10		Sep-10		Oct-10		Nov-10		Dec-10	
	CNY	USD	CNY	USD	CNY	USD	CNY	USD	y-o-y	q-o-q	m-o-m	q-o-q	m-o-m	y-o-y	q-o-q	m-o-m
Total	20,013	2,991	19,896	2,983	20,176	3,026	20,165	3,052	21.4	3.6	1.4	15.1	0.8	15.1	0.8	(0.1)
Government	15,905	2,377	15,744	2,360	15,943	2,391	15,908	2,408	15.6	1.9	1.3	10.3	0.02	10.3	0.02	(0.2)
Treasury Bonds	6,398	956	6,444	966	6,544	982	6,663	1,008	13.1	5.4	1.6	16.1	4.1	16.1	4.1	1.8
Central Bank Bonds	4,442	664	4,208	631	4,232	635	4,085	618	10.5	(6.3)	0.6	(3.5)	(8.0)	(3.5)	(8.0)	(3.5)
Policy Bank Bonds	5,064	757	5,092	763	5,167	775	5,160	781	24.2	5.5	1.5	16.0	1.9	16.0	1.9	(0.1)
Corporate	4,108	614	4,151	622	4,233	635	4,257	644	50.5	10.9	2.0	37.2	3.6	37.2	3.6	0.6
Policy Bank Bonds																
China Development Bank	3,662	547	3,672	551	3,738	561	3,680	557	24.6	5.8	1.8	15.0	0.5	15.0	0.5	(1.5)
Export-Import Bank of China	509	76	518	78	518	78	553	84	36.3	5.9	0.0	26.1	8.6	26.1	8.6	6.8
Agricultural Dvt. Bank of China	892	133	902	135	912	137	927	140	16.5	4.1	1.1	14.3	3.9	14.3	3.9	1.7

LCY = local currency, m-o-m = month on month, q-o-q = quarter on quarter, y-o-y = year on year.

Notes:

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 and Bloomberg LP.

Property prices posted their fourth straight month-on-month (m-o-m) increase in December, rising by 0.3%. On a y-o-y basis, property prices rose 6.4%.

Tighter monetary conditions in 4Q10 led to significant volatility in the bond market. **Figure 2** presents the historical bid-ask spreads for government bonds. Bid-ask spreads were at their tightest in September 2010, before rising dramatically in 4Q10.

Size and Composition

Figure 2. PRC Government Bonds Historical Bid-Ask Spreads



The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY20.2 trillion at the end of December, representing a y-o-y increase of 15.1% and a quarter-on-quarter (q-o-q) rise of 0.8% (**Table 1**).

Government bonds outstanding increased by 10.3% y-o-y as of end-December and were flat on a q-o-q basis, while corporate bonds rose 37.2% y-o-y and 3.6% q-o-q. In the government sector, treasury bonds and policy bank bonds expanded 16.1% and 16.0%, respectively, while central bank bonds declined by 3.5% y-o-y. On a q-o-q basis, growth rates in 4Q10 were down from the previous quarter, with treasury bonds and

central bank bonds posting growth rates of 4.1% and 1.9%, respectively. Furthermore, central bank bonds declined by 8.0% q-o-q in 4Q10.

Interest Rate Swaps

Table 2 provides information on the total notional amount traded in interest rate swaps (IRSs) during February 2010–January 2011. Based on the table, much of the market in IRSs is concentrated in shorter-term benchmark rates, the 7-day repurchase (repo) rate, and the overnight Shanghai Interbank Offered Rate (SHIBOR). In terms of market size, the IRS based on the 7-day repo rate accounts for 56% of the total market, while the IRS for the SHIBOR accounts for 39%. The IRS based on the 7-day repo rate is a key instrument helping banks to manage funding costs since banks can tap the repo market for short-term funding needs. Among the various repo market tenors, the 7-day repo remains the most popular.

Table 2: PRC Interest Rate Swaps (IRS)—Market Notional Values

Benchmark	Total Notional Amount (CNY100 Million)	% of Total Notional Amount
7-Day Repo Rate	899	56.0%
SHIBOR Overnight	354	22.1%
SHIBOR 3-Month	270	16.8%
SHIBOR 3-Months 10-Day	0	0.0%
SHIBOR 1-Week	0	0.0%
1-Year Term Deposit Interest Rate	79	4.9%
1-Year Lending Interest Rate	3	0.2%
3-Year Lending Interest Rate	0	0.0%
Total	1,606	100.0%

PRC = People's Republic of China, SHIBOR = Shanghai Interbank Offered Rate.
Source: Chinamoney.

Corporate Bonds

With the exception of asset- and mortgage-backed securities, and commercial bank bonds, the remaining key sectors of the corporate bond market grew by double digits in 4Q10. Medium-term notes (MTNs) grew by 57.0% y-o-y, while

commercial paper and local corporate bonds posted y-o-y growth rates of 43.2% and 51.1%, respectively. State-owned corporate bonds (or SOE bonds) grew by 22.1% y-o-y, and commercial bank bonds grew 3.6%. In contrast to these other sectors, the amount of asset- and mortgage-backed securities has been on a steady decline, with no new issuance since 4Q08.

On a q-o-q basis, all sectors showed slower growth rates in 4Q10 compared with the prior quarter, with the exception of local corporate bonds (**Table 3**). Local corporate bonds expanded by 13.6% in 4Q10 from 8.6% growth in 3Q10. Growth of MTNs slowed to 5.0% in 4Q10 from 12.0% in 3Q10. Commercial paper showed the greatest change between quarters, declining 2.6% in 4Q10 compared with positive growth of 9.0% in 3Q10. Commercial bank bonds grew at an anemic rate of 0.1% in 4Q10, the same growth rate posted in 3Q10.

MTNs had consistently enjoyed double-digit q-o-q growth rates for the past few quarters prior to 4Q10, reflecting continued strong corporate sector demand and improved access to MTNs facilitated by the relatively quick issuance approval processes. The MTN market's slowing growth rate in 4Q10 seems to reflect the PBOC's tightening of monetary policy in recent months and the prospect of rising interest rates in the near term.

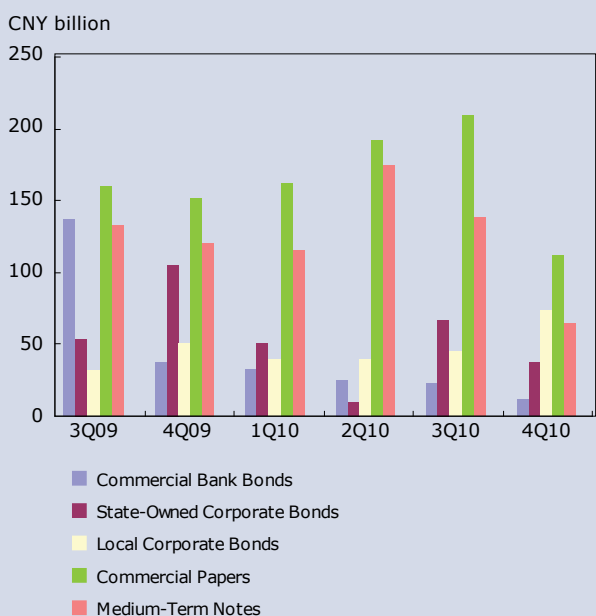
Possibly as a reflection of tighter monetary conditions, issuance for all sectors except commercial paper experienced a q-o-q decline in 4Q10 (**Figure 3**). Monetary conditions continue to be challenging in 2011 as evident by recent news that a planned China Development Bank bond issuance was reduced in size by one-half to CNY10 billion and offered with a much higher yield than was offered by the bank in most of its issues over the past year.

Looking at the PRC's top issuers (**Table 4**), it is clear that only a handful of issuers dominate the corporate bond market. The top 50 corporate bond issuers account for CNY2.5 trillion, which is more than half of the outstanding corporate bond market. Furthermore, issuer size rapidly begins

Table 3: Corporate Bonds Outstanding in Key Sectors

	Amount (CNY billion)						Growth Rates (%)					
							q-o-q				y-o-y	
	3Q09	4Q09	1Q10	2Q10	3Q10	4Q10	4Q09	1Q10	2Q10	3Q10	4Q10	4Q10
Commercial Bank Bonds	589.2	588.4	589.6	608.5	609.0	609.5	(0.1)	0.2	3.2	0.1	0.1	3.6
State-Owned Corporate Bonds	619.3	720.2	771.1	781.1	842.6	879.6	16.3	7.1	1.3	7.9	4.4	22.1
Local Corporate Bonds	328.8	376.9	420.0	461.7	501.3	569.4	14.6	11.4	9.9	8.6	13.6	51.1
Commercial Papers	353.1	456.1	508.8	615.4	670.6	653.0	29.2	11.5	21.0	9.0	(2.6)	43.2
Asset/Mortgage-Backed Securities	46.0	39.9	31.1	26.5	21.9	18.2	(13.4)	(22.1)	(14.8)	(17.2)	(16.8)	(54.3)
Medium-Term Notes	742.1	862.2	976.4	1,151.2	1,289.5	1,353.6	16.2	13.2	17.9	12.0	5.0	57.0

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

Figure 3: Corporate Bond Issuance in Key Sectors

Source: *ChinaBond*.

to drop further down the rankings. In fact, out of the CNY2.5 trillion of outstanding corporate bonds issued by the top 50 corporates, CNY1.5 trillion (61%) is from the top 10 corporate issuers.

State-owned companies (defined as majority-owned by the government) dominate the corporate bond market in the PRC. Out of the top 50 corporate bond issuers, 42 are state-owned, with a total of CNY2.3 trillion worth of bonds outstanding. All eight of the companies that are not state-owned are listed on stock exchanges.

The largest sector in the corporate bond market is transportation (**Figure 4**). However, the transportation sector is highly skewed as it is dominated by a single issuer, the Ministry of Railways, which accounts for more than half of the transportation sector's outstanding bonds. Following closely in terms of bonds outstanding are the banking sector and the capital goods sector. A large portion of bonds issued within the banking sector is closely related to the banks'

Table 4: Top 50 Issuers of LCY Corporate Bonds in the People's Republic of China

Issuer	Bonds Outstanding		State-Owned	Privately-Owned	Listed Company	Sector
	LCY Bonds (CNY billion)	LCY Bonds (USD billion)				
1.Ministry of Railways	526.0	79.61	Yes	No	No	Transportation
2.State Grid Corporation of China	233.0	35.27	Yes	No	No	Public Utilities
3.China National Petroleum Corporation	158.0	23.91	Yes	No	No	Energy
4.Bank of China	124.9	18.91	Yes	No	Yes	Banking
5.China Construction Bank	120.0	18.16	Yes	No	Yes	Banking

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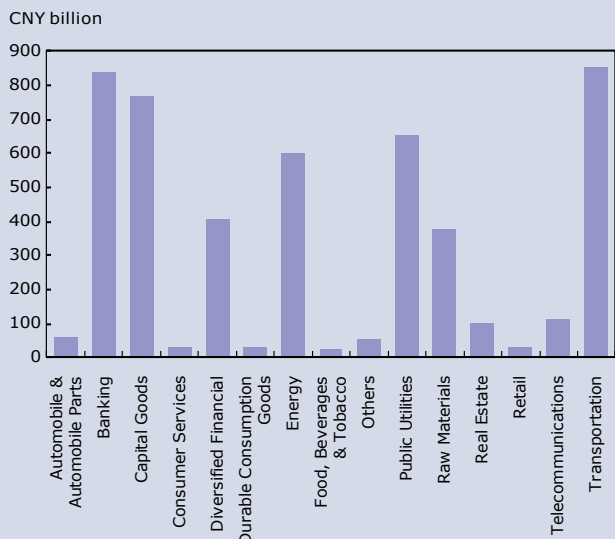
Table 4 continued

Issuer	Bonds Outstanding		State-Owned	Privately-Owned	Listed Company	Sector
	LCY Bonds (CNY billion)	LCY Bonds (USD billion)				
6.Petrochina Company Limited	97.5	14.76	Yes	No	Yes	Energy
7.Industrial and Commercial Bank of China	97.0	14.68	Yes	No	Yes	Banking
8.Industrial Bank	68.0	10.29	No	Yes	Yes	Banking
9.China Petroleum and Chemical Corporation	58.5	8.85	Yes	No	Yes	Energy
10.Aluminum Corporation of China	55.0	8.32	Yes	No	Yes	Raw Material
11.Agricultural Bank of China	50.0	7.57	Yes	No	Yes	Banking
12.Bank of Communications	50.0	7.57	No	Yes	Yes	Banking
13.China Telecom Corporation Limited	50.0	7.57	Yes	No	Yes	Telecomm
14.China Guodian Corporation	38.0	5.75	Yes	No	No	Public Utilities
15.China United Network Communications Corporation Limited	38.0	5.75	No	Yes	Yes	Telecomm
16.Shenhua Group Corporation Limited	37.9	5.74	Yes	No	No	Energy
17.Citic Group	37.0	5.60	Yes	No	No	Capital Goods
18.China Southern Power Grid Co., Ltd.	36.0	5.45	Yes	No	No	Public Utilities
19.Shougang Group	33.0	4.99	Yes	No	No	Capital Goods
20.China Huaneng Group	30.0	4.54	Yes	No	No	Public Utilities
21.China Merchants Bank	30.0	4.54	No	Yes	Yes	Banking
22.China Three Gorges Project Corporation	28.5	4.31	Yes	No	No	Public Utilities
23.China Minsheng Bank	28.3	4.28	No	Yes	Yes	Banking
24.China Guangdong Nuclear Power Holding Co., Ltd.	27.8	4.21	Yes	No	No	Public Utilities
25.China Power Investment Corporation	27.6	4.18	Yes	No	No	Public Utilities
26.State-owned Capital Operation and Management Center of Beijing	25.0	3.78	No	Yes	Yes	Banking
27.Huaxia Bank	24.0	3.64	Yes	No	Yes	Banking
28.China Citic Bank	22.5	3.41	Yes	No	Yes	Raw Material
29.Wuhan Iron and Steel (Group) Corporation	22.0	3.33	Yes	No	Yes	Capital Goods
30.China Metallurgical Group Corporation	21.3	3.22	Yes	No	No	Capital Goods
31.China Resources National Corporation	20.5	3.10	Yes	No	No	Capital Goods
32.Tianjin Infrastructure Construction Investment (Group) Co., Ltd.	20.2	3.06	Yes	No	No	Capital Goods
33.Aviation Industry Corporation of China	20.0	3.03	No	Yes	Yes	Banking
34.Bank of Beijing	20.0	3.03	Yes	No	No	Transportation
35.Beijing Infrastructure Investmenet Co., Ltd.	19.0	2.88	No	Yes	Yes	Banking
36.Shanghai Pudong Development Bank	18.8	2.85	Yes	No	Yes	Capital Goods
37.Metallurgical Corporation of China Ltd.	18.4	2.78	Yes	No	No	Public Utilities
38.China Datang Corporation	18.2	2.75	Yes	No	No	Diversified Financial
39.Shanghai Chengtou Corporation	18.2	2.75	Yes	No	No	Retail
40.Cofco Limited	18.1	2.74	Yes	No	Yes	Capital Goods
41.China State Construction Engineering Corp., Ltd.	16.2	2.45	Yes	No	Yes	Banking
42.China Everbright Bank	16.0	2.42	Yes	No	No	Transportation
43.Capital Airports Holding Company	15.9	2.41	Yes	No	No	Capital Goods
44.China Minmetals Corporation	15.8	2.39	Yes	No	No	Capital Goods
45.China North Industries Group Corporation	15.2	2.30	Yes	No	No	Transportation
46.Jiangsu Communication Holding Company	15.1	2.29	Yes	No	Yes	Transportation
47.China Cosco Holdings Company Limited	15.0	2.27	Yes	No	Yes	Capital Goods
48.China Railway Construction Company Ltd.	15.0	2.27	Yes	No	No	Diversified Financial
49.State Development and Investment Corporation	14.5	2.19	Yes	No	No	Capital Goods
50.Anshan Iron and Steel Group Corporation	14.0	2.12	Yes	No	Yes	Raw Material
Total Top 50	2539.0	384.28				

LCY = local currency.

Source: Bloomberg LP, ChinaBond, and Wind.

Figure 4. LCY Corporate Bonds Outstanding by Sector (CNY billion)



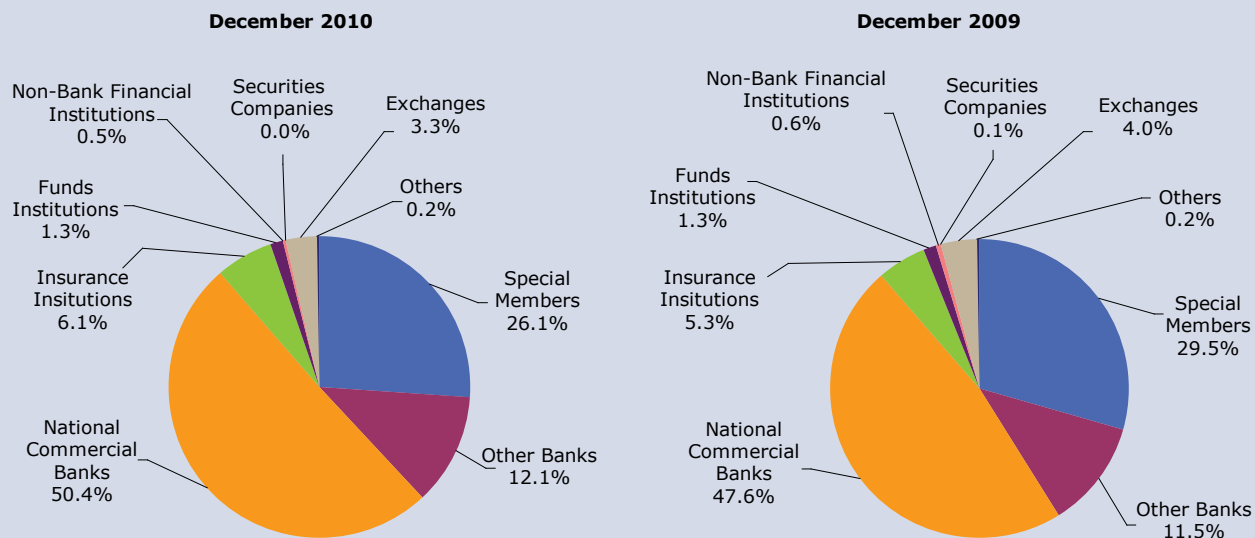
LCY = local currency.
 Note: Others includes Commercial & Specialized Services, Family & Personal Goods, Food & Main Products Retail, Insurance, Media, Pharmaceutical, BioTech & Life Sciences, Semi-Conductor/Semi-Conductor Production Equipments, Software & Services, Technology, Hardware & Equipments
 Source: Wind & ChinaBond.

capital-raising efforts through the issuance of subordinated debt that can be classified as Tier 2 capital. Banks in the PRC have been using Tier 2 capital to support their loan-making activities, which grew at a rapid pace in 2010 and exceeded the PBOC’s official loan target. The capital goods sector follows as the third largest component of outstanding corporate bonds.

Investor Profile

Treasury Bonds. Banks remained the largest category of investors in the PRC Treasury bond market, holding a larger share of these bonds at end-December 2010 (62.5%) than end-December 2009 (59.1%) (Figure 5). The share held by special members dropped to 26.1% in December 2010 from 29.5% 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.

Figure 5: Treasury Bonds Investor Profile



Source: ChinaBond.

Corporate Bonds. In terms of the investor profile for corporate bonds, the largest holders are banks, which hold 63% of outstanding corporate bonds, followed by insurance institutions which hold 22%. (Figure 6)

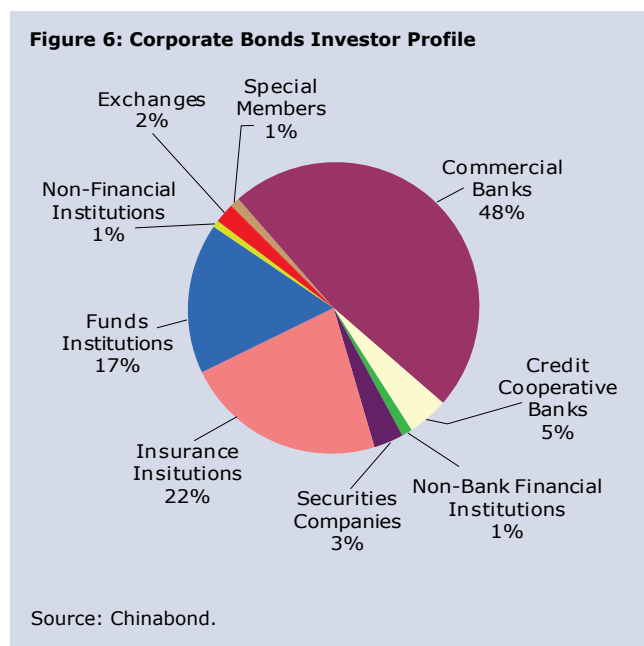


Figure 7 presents the investor profile across different bond categories. Based on the graph, banks are the largest holders when it comes to treasury bonds and policy bank bonds. In particular, banks hold roughly 80% of outstanding policy bank bonds. On the other hand, insurance institutions are the largest holders of commercial bank bonds.

Rating Changes

Following Moody’s Investors Service ratings upgrade for the PRC in November, Standard & Poor’s (S&P) upgraded the FCY long-term and LCY long-term sovereign ratings of the PRC by one notch to AA- on 16 December, with a stable outlook for both (Table 5). S&P cited the PRC’s substantial foreign exchange reserves, strong fiscal position, and growth prospects as reasons for the upgrade. S&P also said that it might raise its ratings further

Figure 7: Investor Profile across Bond Categories

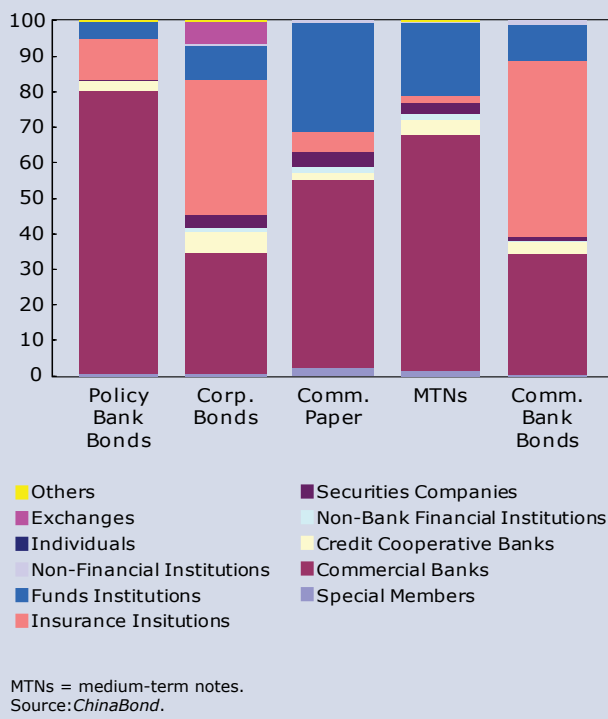


Table 5: Selected Sovereign Ratings and Outlook for the PRC

	Moody’s	S&P	Fitch
Sovereign FCY LT Ratings	Aa3	AA-	A+
Outlook	Positive	Stable	Stable

FCY = foreign currency, LT = long-term, PRC = People’s Republic of China.
Source: Rating agencies

if structural reforms led to sustained economic growth and average income levels improved.

Policy, Institutional, and Regulatory Developments

PBOC Hikes Reserve Requirement Ratio of Banks

Since November, the PRC has implemented a series of increases in the reserve requirement ratios for financial institutions, reflecting continued concerns over inflation and the pace of credit growth. New loans granted in 2010 exceeded the official target of CNY7.5 billion to reach CNY7.95 billion.

By mid-March, the PBOC had hiked the reserve requirement ratio six times—by 50 basis points each time—since November 2010. These hikes effectively brought the reserve requirement rate to 20.5% for several major banks, 20.0% for other large financial institutions, and 18.0% for small and medium-sized financial institutions.

CSRC Grants Additional QFII Licenses

On 12 January, the China Regulatory Securities Commission (CRSC) announced that it had issued three additional licenses in December under the Qualified Foreign Institutional Investor (QFII) scheme. The licenses were issued to BMO Investments Inc., Julius Bear & Co. Ltd., and KTB Asset Management. As of end-2010, 106 institutions had been granted QFII licenses.

Draft on QFII Index Futures Trading Issued

On 25 January, the CSRC issued a draft regulation for foreign investors under the QFII program allowing them to trade local stock index futures. Under the rules, foreign investors, like local investors, can only trade the index futures for hedging purposes. There will also be limits on trading volume, and the number of investors under the QFII program will be restricted by a quota.

PRC Implements Additional Property Measures

The State Council announced on 26 January that it would increase the minimum down payment for second-home buyers from 50% to 60%. The State Council also asked local governments to set price targets for property. Two days later, the PRC approved a property tax trial scheme in Shanghai and Chongqing. In Shanghai, the property tax will be 0.6% for all taxable residential properties, but will be reduced to 0.4% for houses with a purchase price of less than twice the average price of commercial homes. In Chongqing, only homes with a purchase price of more than twice the average will be taxed. In addition, the Ministry of Finance announced that residential properties

sold within 5 years of purchase will be subject to transaction taxes.

Bank Clients Allowed to Invest in Currency Swaps

On 31 January, the State Administration of Foreign Exchange (SAFE) issued a circular that will allow banks to offer currency swap products to their corporate clients, effective 3 March. Prior to this, currency swaps were only available on the interbank market. Under the new guidelines, banks that have been trading currency swaps for at least 1 year may offer the facility to their clients.

PBOC Implements Individualized Reserve Requirement Ratios on Some Banks

On 10 February, the PBOC imposed a differentiated reserve requirement ratio on several small and medium-sized financial institutions. Under such a scheme, the financial institutions will have individualized reserve requirement ratios.

CPI Basket Weights Changed

On 11 February, when the inflation figures for January were released, it was also announced that there were changes in the basket weights used to calculate inflation. Housing-related items such as rent and utilities saw an increase in their basket weights, while other categories received a smaller weighting.

Renminbi Forex Options to Be Traded

On 17 February, SAFE announced that it will allow the trading of renminbi foreign exchange options on 1 April. The trading of the options will be limited to hedging purposes as opposed to speculation, and only European-style call options will be allowed to be traded. Furthermore, once a party purchases an option, they are prohibited from reselling it.