

Market Summaries

People's Republic of China—Update

Yield Movements

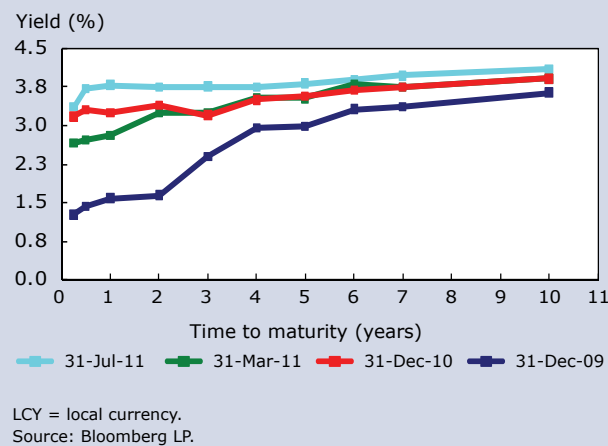
The People's Republic of China's (PRC) government bond yield curve flattened between end-March and end-July as a result of continued monetary tightening (**Figure 1**). Yields rose between 71 basis points (bps) and 99 bps on tenors of less than 1 year; yields in the belly of the curve rose between 10 bps to 49 bps; and yields on the 7- and 10-year tenors rose 22 bps and 18 bps, respectively.

Due to the much larger increase in short-term yields versus longer-term yields, the spread between 2- and 10-year government bonds narrowed to 34 bps at end-July from 51 bps at end-December 2010. The result was a yield curve at end-July that was significantly flatter than the yield curve at end-March when the spread was 65 bps.

Recent market volatility and changes in the yield curve, particularly at the short-end of the curve, are a response to efforts by the PRC to slow inflation and credit growth. The People's Bank of China (PBOC) has hiked the reserve requirement ratio six times—by 50 bps each time—since January. The PRC has also hiked its benchmark interest rates three times since January, bringing the 1-year lending rate to 6.56% and the 1-year deposit rate to 3.50%. Meanwhile, inflation reached a 37-month high in July of 6.4% year-on-year (y-o-y).

Concerns over the PRC's credit growth remain. S&P recently downgraded the outlook of Chinese property companies to negative. It was also reported that local government debt stands at CNY10.7 trillion (US\$1.66 trillion). The PRC's tightening has had some effect, with the M2 money supply growing 15.1% y-o-y in May, down from 15.3% growth in April and 17.2% in January. However, M2 money supply growth accelerated again in June to 15.9%.

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



The Purchasing Managers' Index (PMI) for manufacturing fell to 50.1 in May, the lowest level in 11 months. Gross domestic product (GDP) growth in 2Q11 was also down slightly to 9.5% y-o-y from 9.7% in 1Q11. Despite the monetary tightening, new loans in June amounted to a higher-than-forecast CNY633.9 billion.

Size and Composition

The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY20.6 trillion (US\$3.19 trillion) at end-June, representing a y-o-y increase of 6.7% and a quarter-on-quarter (q-o-q) rise of 2.7% (**Table 1**).

Corporate Bonds

With the exception of asset- and mortgage-backed securities, key sectors of the corporate bond market grew by double digits in 2Q11. Medium-term notes (MTNs) grew 40.8% y-o-y, while commercial paper and local corporate bonds posted y-o-y

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

	Amount (billion)						Growth Rates (%)											
	Mar-11		Apr-11		May-11		Jun-11		Mar-11		Apr-11		May-11		Jun-11			
	CNY	US\$	CNY	US\$	CNY	US\$	CNY	US\$	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	
Total	20,078	3,066	20,244	3,118	20,458	3,158	20,619	3,190	11.1	(0.5)	0.8	11.1	(0.5)	1.1	6.7	2.7	0.8	
Government	15,518	2,370	15,617	2,405	15,736	2,429	15,773	2,440	5.4	(2.5)	0.6	5.4	(2.5)	0.8	1.0	1.6	0.2	
Treasury Bonds	6,667	1,018	6,735	1,037	6,829	1,054	6,943	1,074	16.6	0.1	1.0	16.6	0.1	1.4	14.4	4.1	1.7	
Central Bank Bonds	3,179	485	3,002	462	2,974	459	2,785	431	(27.4)	(22.2)	(5.6)	(27.4)	(22.2)	(0.9)	(41.3)	(12.4)	(6.4)	
Policy Bank Bonds	5,672	866	5,880	906	5,933	916	6,045	935	22.7	9.9	3.7	22.7	9.9	0.9	25.9	6.6	1.9	
Corporate	4,560	696	4,627	713	4,722	729	4,846	750	35.9	7.0	1.5	35.9	7.0	2.1	30.8	6.3	2.6	
Policy Bank Bonds																		
China Development Bank	4,075	622	4,185	645	4,225	652	4,285	663	21.6	10.7	2.7	21.6	10.7	1.0	23.8	5.2	1.4	
Export-Import Bank of China	608	93	648	100	660	102	684	106	37.0	9.9	6.6	37.0	9.9	1.9	42.3	12.6	3.7	
Agricultural Devt. Bank of China	990	151	1,048	161	1,048	162	1,077	167	19.3	6.8	5.8	19.3	6.8	0.1	25.6	8.7	2.7	

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-US\$ rate is used.
 4. Growth rates are calculated from LCY base and do not include currency effects.
- Source: *ChinaBond* and Bloomberg LP.

growth rates of 11.7% and 54.7%, respectively. State-owned corporate bonds (SOE bonds) grew 12.3% y-o-y and commercial bank bonds grew 24.7%. In contrast, the amount of asset- and mortgage-backed securities outstanding has been on a steady decline for several years, with no new issuance since 4Q08.

On a q-o-q basis, growth slowed in all sectors in 2Q11 with the exception of asset-backed securities, which continued to decline in 2Q11, albeit at a much slower rate. Commercial bank bonds saw a noticeable uptick in growth to become the fastest growing segment of the corporate bond sector in 2Q11. SOE bonds declined 0.3% in 2Q11, after remaining unchanged in 1Q11 (**Table 2**). Local corporate bonds expanded 9.3% in 2Q11, following 14.7% growth in 1Q11. Growth of MTNs slowed to 5.8% in 2Q11 from 13.2% in 1Q11. Commercial paper outstanding declined 0.6% in 2Q11 compared with positive growth of 4.6% in 1Q11.

MTNs consistently enjoyed double-digit q-o-q growth rates for several quarters prior to 4Q10, reflecting continued strong corporate sector demand and improved investor access to MTNs due to the relatively quick issuance approval processes. The MTN market's slower growth rate in 2Q11 likely reflects the PBOC's tightening of monetary policy in recent months and the prospect of rising interest rates in the near-term.

Issuance of corporate bonds slowed in 2Q11 from 1Q11 (**Figure 2**), with the exception of commercial bank bonds, which experienced a massive surge as issuance climbed to CNY144.0 billion from CNY19.5 billion. The rise in commercial bank bond issuance was driven mostly by increases in subordinated debt issuance as the China Banking Regulatory Commission (CBRC) has issued new capital adequacy requirements that will take effect starting in 2012.

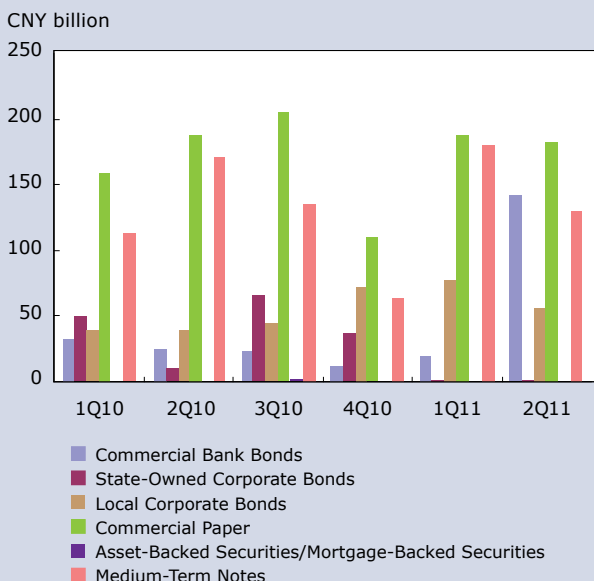
Looking at the PRC's top corporate issuers (**Table 3**), it is clear that only a handful of issuers dominate the market. The top 50 corporate bond issuers accounted for CNY3.14 trillion as of end-

Table 2: Corporate Bonds Outstanding in Key Sectors

	Amount (CNY billion)						Growth Rates (%)					
	1Q10		2Q10		3Q10		4Q10		1Q11		2Q11	
	1Q10	2Q10	3Q10	4Q10	1Q11	2Q11	2Q10	3Q10	4Q10	1Q11	2Q11	2Q11
Commercial Bank Bonds	589.6	608.5	609.0	609.5	625.0	758.8	3.2	0.1	0.1	2.5	21.4	24.7
State-Owned Corporate Bonds	771.1	781.1	842.6	879.6	879.6	877.1	1.3	7.9	4.4	0.0	(0.3)	12.3
Local Corporate Bonds	420.0	461.7	501.3	569.4	653.1	714.1	9.9	8.6	13.6	14.7	9.3	54.7
Commercial Paper	508.8	615.4	670.6	653.0	683.3	687.1	21.0	9.0	(2.6)	4.6	0.6	11.7
Asset/Mortgage-Backed Securities	31.1	26.5	21.9	18.2	10.8	10.1	(14.8)	(17.2)	(16.8)	(41.0)	(6.1)	(61.8)
Medium-Term Notes	976.4	1,151.2	1,289.5	1,353.6	1,532.5	1,621.4	17.9	12.0	5.0	13.2	5.8	40.8

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

Figure 2: Corporate Bond Issuance in Key Sectors, 1Q10-2Q11



Source: ChinaBond.

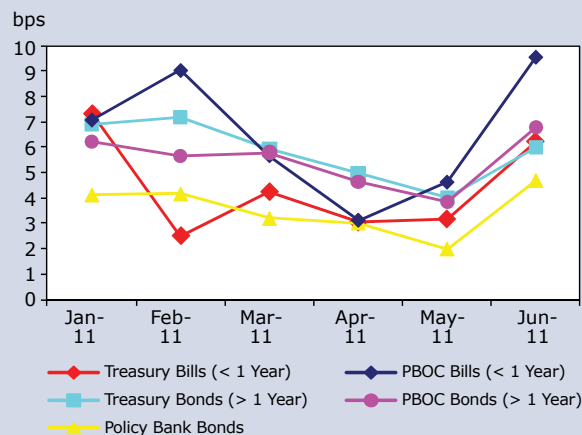
June, or 65% of total corporate bonds outstanding. Furthermore, the 10 largest corporate issuers accounted for CNY1.9 trillion, or 60.5% of the total.

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 CNY2.8 trillion worth of bonds outstanding.

Bid-Ask Spreads

Bid-ask spreads rose for all government bonds in May and June (Figure 3), reflecting volatility in the bond market resulting from expectations that the PBOC would raise interest rates in June.

Figure 3: Average Bid-Ask Spreads in the PRC, January-June 2011



bps = basis points, PBOC = People's Bank of China, PRC = People's Republic of China.
Source: Wind.

Investor Profile

Treasury bonds. Banks remain the largest category of investors in the PRC treasury bond market, holding a larger share of these bonds at end-June (63%) than at end-December 2010

Table 3: Top 50 Issuers of LCY Corporate Bonds in the People's Republic of China (as of June 2011)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed Company	Type of Industry
	LCY Bonds (CNY billion)	LCY Bonds (US\$ billion)				
1. Ministry of Railways	548.0	84.78	Yes	No	No	Transportation
2. State Grid Corporation of China	262.5	40.61	Yes	No	No	Public Utilities
3. China National Petroleum	206.0	31.87	Yes	No	No	Energy
4. Bank of China	196.9	30.46	Yes	No	Yes	Banking
5. Industrial and Commercial Bank of China	160.0	24.75	Yes	No	Yes	Banking
6. China Petroleum & Chemical	136.5	21.12	Yes	No	Yes	Energy
7. China Construction Bank	120.0	18.56	Yes	No	Yes	Banking
8. Central Huijin Investment	109.0	16.86	Yes	No	No	Diversified Financial
9. Agricultural Bank of China	100.0	15.47	Yes	No	Yes	Banking
10. Petrochina	99.5	15.39	Yes	No	Yes	Energy
11. Industrial Bank	73.0	11.29	No	Yes	Yes	Banking
12. China Guodian	57.4	8.88	Yes	No	No	Public Utilities
13. Bank of Communications	50.0	7.74	No	Yes	Yes	Banking
14. Shenhua Group	48.4	7.49	Yes	No	No	Energy
15. China Telecom	40.0	6.19	Yes	No	Yes	Telecom
16. China United Network Communications	39.0	6.03	No	Yes	Yes	Telecom
17. China Three Gorges Project	38.5	5.96	Yes	No	No	Public Utilities
18. China Minsheng Bank	38.3	5.93	No	Yes	Yes	Banking
19. Citic Group	37.0	5.72	Yes	No	No	Diversified Financial
20. China Southern Power Grid	36.0	5.57	Yes	No	No	Public Utilities
21. China Resources	35.0	5.41	Yes	No	No	Capital Goods
22. State-Owned Capital Operation and Management Center of Beijing	35.0	5.41	Yes	No	No	Diversified Financial
23. China Power Investment	34.6	5.35	Yes	No	No	Public Utilities
24. Shougang Group	33.0	5.11	Yes	No	No	Capital Goods
25. China Guangdong Nuclear Power Holding	32.9	5.09	Yes	No	No	Public Utilities
26. Metallurgical Corporation of China	32.6	5.04	Yes	No	Yes	Capital Goods
27. Aluminum Corporation of China	31.0	4.80	Yes	No	Yes	Raw Materials
28. China Merchants Bank	30.0	4.64	No	Yes	Yes	Banking
29. China Huaneng Group	28.7	4.44	Yes	No	No	Public Utilities
30. COFCO	28.6	4.42	Yes	No	No	Retail
31. Beijing Infrastructure Investment	27.0	4.18	Yes	No	No	Capital Goods
32. China Railway Group	26.7	4.13	Yes	No	Yes	Capital Goods
33. Aviation Industry Corporation of China	25.0	3.87	Yes	No	No	Capital Goods
34. Huaxia Bank	24.0	3.72	No	Yes	Yes	Banking
35. Wuhan Iron and Steel	24.0	3.71	Yes	No	Yes	Raw Materials
36. Bank of Beijing	23.5	3.64	No	Yes	Yes	Banking
37. China Citic Bank	22.5	3.48	Yes	No	Yes	Banking
38. China State Construction Engineering	22.2	3.43	Yes	No	Yes	Capital Goods
39. China Datang	22.2	3.43	Yes	No	No	Public Utilities
40. Shanghai Chengtou	21.2	3.28	Yes	No	No	Diversified Financial
41. Tianjin Infrastructure Construction Investment Group	20.2	3.13	Yes	No	No	Capital Goods
42. Baoshan Iron and Steel	20.0	3.09	Yes	No	Yes	Raw Materials
43. State Development and Investment	19.5	3.02	Yes	No	No	Capital Goods
44. Huaneng Power International	19.0	2.94	Yes	No	Yes	Public Utilities
45. Shanghai Pudong Development Bank	18.8	2.91	No	Yes	Yes	Banking
46. China Yangtze Power	18.5	2.86	Yes	No	Yes	Public Utilities
47. Hebei Iron and Steel	18.0	2.78	Yes	No	No	Raw Materials

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Table 3 *continued*

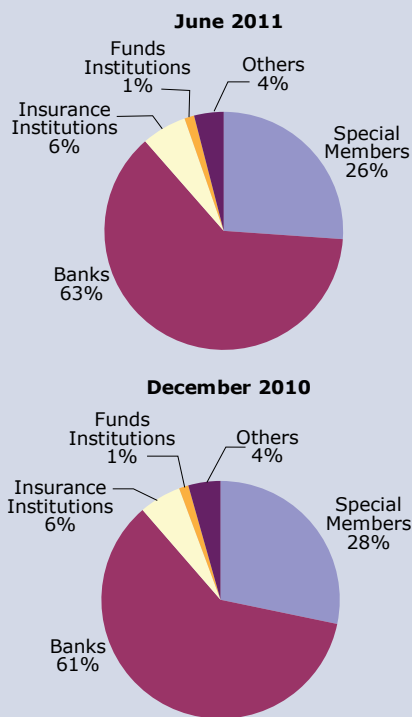
Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed Company	Type of Industry
	LCY Bonds (CNY billion)	LCY Bonds (US\$ billion)				
48. China Minmetals	17.8	2.75	Yes	No	No	Capital Goods
49. China Everbright Bank	16.0	2.48	Yes	No	Yes	Banking
50. Capital Airports Holding	15.9	2.46	Yes	No	No	Transportation
Total Top 50 LCY Corporate Issuers	3,139.4	485.69				
Total LCY Corporate Bonds	4,846.4	749.76				
Top 50 as % of Total LCY Corporate Bonds	65%	65%				

LCY = local currency.
Source: Bloomberg LP and Wind.

(61%) (**Figure 4**). The share held by the second largest group of holders, special members, dropped to 26% at end-June from 28% at end-December 2010. Special members comprise the PBOC, Ministry of Finance, policy banks, China Government Securities Depository Trust and Clearing Co., and the China Securities Depository and Clearing Corporation.

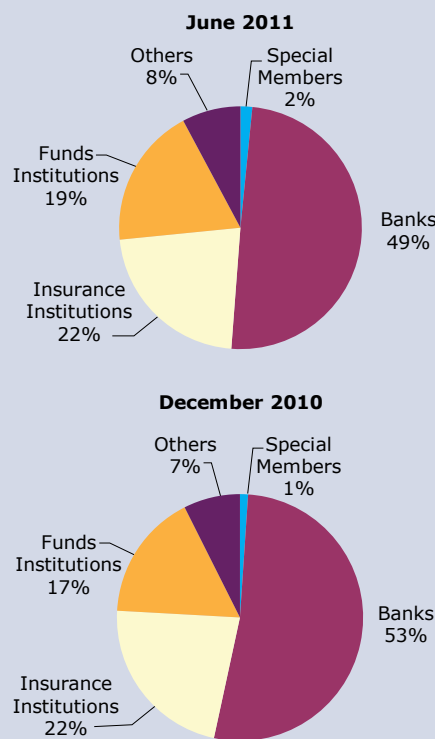
Corporate Bonds. Banks remained the largest holder of corporate bonds at end-June, however, their share declined to 49% from 53% at end-December 2010 (**Figure 5**). The share held by insurance institutions remained the same between December and June, while the share of corporate bonds held by funds increased to 19% from 17%.

Figure 4: Treasury Bonds Investor Profile



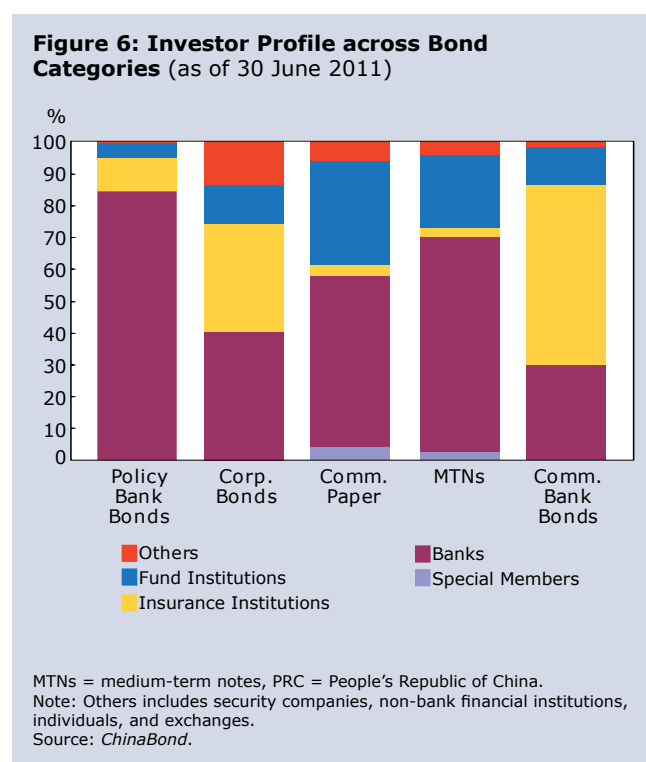
Note: Others includes security companies, non-bank institutions, individuals, and exchanges.
Source: ChinaBond.

Figure 5: Corporate Bonds Investor Profile



Source: ChinaBond.

Figure 6 presents the investor profile across different bond categories, with banks as the largest group of holders of treasury bonds and policy bank bonds at end-June, including slightly more than 80% of outstanding policy bank bonds. Meanwhile, insurance institutions were the largest holders of commercial bank bonds.



Interest Rate Swaps

Table 4 provides information on the total notional amount traded in the interest rate swap (IRS) market in 1H11 compared with the same period in 2010. Growth in the IRS market has been substantial as volumes of most benchmark instruments more than doubled from 1H2010 to 1H11. Overall, the IRS market expanded 150% y-o-y over this period.

During 1H11, the 7-day repo rate remained the most widely used benchmark among the various IRS benchmarks, accounting for 60% of the total notional amount traded. However, the overnight Shanghai Interbank Offered Rate (SHIBOR) and the SHIBOR 3-month rate have also become more widely used as benchmarks in 1H11.

Policy, Institutional, and Regulatory Developments

PBOC Hikes Reserve Requirement Ratios

In response to rising inflation and growing credit risks, the PBOC embarked on a series of reserve requirement ratio hikes, raising the ratio 50 bps in every month in 1H11. As of end-June, the reserve requirement ratio stood at 21.5% for large financial institutions and 19.5% for small and medium-sized institutions.

Table 4: Notional Values of the PRC's Interest Rate Swap Market

Interest Rate Swap Benchmarks	1H11 IRS Notional Amount (CNY billion)	% of Total Notional Amount	1H10 IRS Notional Amount (CNY billion)	% of Total Notional Amount
7-Day Repo Rate	730.9	60.0%	323.4	66.7%
Overnight SHIBOR	224.7	18.4%	69.0	14.2%
1-Week SHIBOR	0.6	0.0%	0.05	0.01%
3-Month SHIBOR	208.5	17.1%	71.0	14.6%
1-Year Term Deposit Rate	52.2	4.3%	21.1	4.4%
1-Year Lending Rate	0.1	0.01%	0.2	0.04%
5-Year and Above Lending Rate	1.4	0.1%	0.0	0%
Total	1,218.4	100.0%	484.7	100.0%

IRS = interest rate swap, PRC = People's Republic of China, repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate.
 Source: *ChinaMoney*, *Wind*, and *AsianBondsOnline*.

CBRC Issues Stricter Bank Rules

On 4 May, the China Banking Regulatory Commission (CBRC) issued new guidelines to be adopted in 2012 that will impose stricter capital adequacy requirements and loan provisions, and liquidity provisions. There will be a number of changes to the capital adequacy rules such as differentiating between core Tier 1 and other types of Tier 1 capital. Operational risk will also be included in the guidelines and risk weights of certain assets will be increased. Banks will be required to maintain a leverage ratio of core capital to total assets of at least 4.0%. There is also a provision ratio requirement that will require banks to set aside reserves equal to 2.5% of outstanding loans.

NPL Requirements Reduced for Loans to Small Firms

On 7 June, the CBRC announced new measures to improve access to credit for smaller firms. Among the measures, loans of less than CNY5 million will not be subject to loan-to-deposit ratio requirements and a differentiated nonperforming loan (NPL) ratio requirement will be implemented for loans to small firms.

Foreign Banks Allowed to Underwrite Corporate Debt

On 17 June, the National Association of Financial Market Institutional Investors (NAFMII) gave permission to the local units of HSBC and Citibank to underwrite corporate debt, making them the first foreign banks with this underwriting authority.