Market Summaries

People's Republic of China—Update

Yield Movements

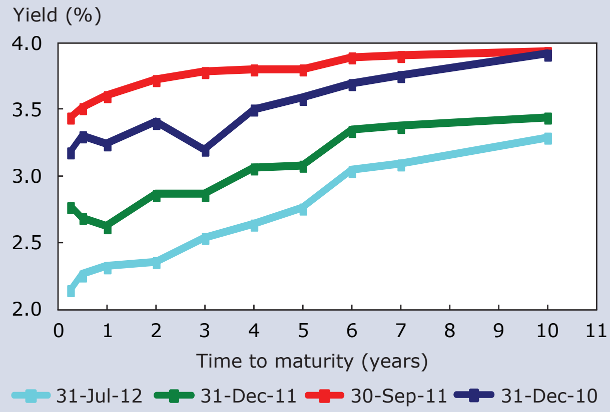
The government bond yield curve in the People's Republic of China (PRC) continued to shift downward through the end of July 2012, particularly at the shorter-end, as inflation continued to decline and the economy slowed. Yields fell between 43 basis points (bps) and 62 bps for tenors of less than 1 year, and between 30 bps and 50 bps for tenors of 1 year to 5 years **(Figure 1)**. Yields fell within a range of 15 bps and 30 bps for tenors longer than 5 years.

The fall in yields was driven mostly by the continued decline in the PRC's inflation rate. Inflation fell to 3.4% year-on-year (y-o-y) in April from 3.6% in March and has continued to fall since then, decelerating to 3.0% in May, 2.2% in June, and 1.8% in July. The decline in the inflation rate has been driven primarily by easing food prices.

Gross domestic product (GDP) growth has slowed in the PRC as a result of continued weakness in developed economies. GDP growth fell to 8.1% y-o-y in 1Q12 from 8.9% in 4Q11, and slipped further to 7.6% in 2Q12. In response to the weak economic data, the PRC has engaged in a number of easing measures. Policy rates were cut for the first time in 3 years by 25 bps each in the first week of June. Rates were cut again by 25 bps and 31 bps for the 1-year deposit rate and 1-year lending rate, respectively, in the first week of July. In addition, the People's Bank of China (PBOC) expanded the range in which banks could vary their deposit and lending rates from the benchmark policy rates.

Reserve requirement ratios were cut twice in the first half of 2012, each time by 50 bps. Furthermore, the PBOC has not issued any central bank bills or bonds this year, thereby increasing the money supply by allowing existing central bank bills and bonds to mature.

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



LCY = local currency.
Source: Bloomberg LP.

As a result of the easing measures, particularly the reduction in policy rates, the yield curve had steepened by the end of July 2012, with rates at the shorter-end falling much more than those at the longer-end. The yield spread between the 2- and 10-year tenors widened to 93 bps at end-July from 58 bps at end-December 2011.

Other economic data showed signs of weakness as well. Industrial production, as measured by gross valued added, expanded 11.9% y-o-y in March before growth slowed in May, June, and July to 9.6%, 9.5%, and 9.2%, respectively. The manufacturing purchasing managers' index (PMI) also declined from April's 53.3 figure to 50.1 in July.

New loans have also seen declines. New loans for July were at CNY540.1 billion compared with CNY919.8 billion in June.

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

	Amount (billion)								**Growth Rates** (%)						
	Mar-12		Apr-12		May-12		Jun-12		Mar-12		Apr-12	May-12	Jun-12		
	CNY	US$	CNY	US$	CNY	US$	CNY	US$	y-o-y	q-o-q	m-o-m	m-o-m	y-o-y	q-o-q	m-o-m
Total	21,725	3,449	21,631	3,445	21,724	3,411	22,042	3,469	8.2	1.7	(0.4)	0.4	6.9	1.5	1.5
Government	16,218	2,575	16,130	2,569	16,150	2,536	16,396	2,580	4.5	1.4	(0.5)	0.1	3.9	1.1	1.5
Treasury Bonds	7,420	1,178	7,424	1,182	7,397	1,162	7,500	1,180	11.3	0.5	0.1	(0.4)	8.0	1.1	1.4
Central Bank Bonds	1,928	306	1,751	279	1,659	260	1,644	259	(39.3)	(9.4)	(9.2)	(5.3)	(41.0)	(14.7)	(0.9)
Policy Bank Bonds	6,869	1,091	6,955	1,108	7,094	1,114	7,251	1,141	21.1	6.0	1.3	2.0	20.0	5.6	2.2
Corporate	5,502	874	5,501	876	5,574	875	5,646	889	20.6	2.7	(0.02)	1.3	16.5	2.6	1.3
Policy Bank Bonds															
China Development Bank	4,676	742	4,685	746	4,779	750	4,921	775	14.8	5.2	0.2	2.0	14.9	5.2	3.0
Export–Import Bank of China	902	143	937	149	952	149	930	146	48.5	8.2	3.9	1.6	36.0	3.1	(2.3)
Agricultural Devt. Bank of China	1,291	205	1,333	212	1,363	214	1,400	220	30.4	7.5	3.2	2.3	30.0	8.4	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.

Size and Composition

The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY22 trillion (US$3.5 trillion) at end-June, representing a y-o-y increase of 6.9% and a quarter-on-quarter (q-o-q) rise of 1.5% **(Table 1)**.

LCY government bonds outstanding grew 3.9% y-o-y and 1.1% q-o-q in 2Q12, while corporate bonds rose 16.5% y-o-y and 2.6% q-o-q. Central bank bonds continued to constrain overall government bond growth, falling 41.0% y-o-y and 14.7% q-o-q as a result of the PBOC's cessation of new bond issuance in 2012. In contrast, treasury bonds grew 8.0% y-o-y and 1.1% q-o-q, and policy bank bonds grew 20.0% y-o-y and 5.6% q-o-q.

Corporate Bonds. Overall, corporate bonds outstanding grew 16.5% y-o-y in 2Q12. Growth was driven mainly by an increase in outstanding commercial bank bonds, local corporate bonds, and medium-term notes (MTNs). Commercial bank bonds grew 44.9% y-o-y in 2Q12, due largely to issuance of subordinated notes as banks sought to bolster their capital bases in advance of the PRC's implementation of Basel III.

Local corporate bonds grew 38.2% and MTNs expanded 31.3% y-o-y in 2Q12, while state-owned corporate bonds rose 13.1% **(Table 2)**. Commercial paper outstanding fell a dramatic 79.9% in 2Q12, on the back of a sharp decline in issuance in 1Q12 and 2Q12. Asset-backed securities continued to decline as well, falling 18.4% in 2Q12 due to an ongoing lack of issuance.

On a q-o-q basis, most categories of LCY corporate bonds outstanding grew in 2Q12, with the exception of commercial paper and asset- and mortgage-backed securities. Local corporate bonds grew 12.6%, MTNs grew 4.9%, and state-owned enterprise bonds grew 4.1%.

Issuance of corporate bonds was up overall in both 1Q12 and 2Q12, compared with 4Q11 levels **(Figure 2)**, due to the low interest rate environment

Table 2: Corporate Bonds Outstanding in Key Sectors

	Amount (CNY billion)						Growth Rates (%)					
							q-o-q					y-o-y
	1Q11	2Q11	3Q11	4Q11	1Q12	2Q12	2Q11	3Q11	4Q11	1Q12	2Q12	2Q12
Commercial Bank Bonds	625.0	758.8	755.2	924.3	1,027.6	1,099.8	21.4	(0.5)	22.4	11.2	7.0	44.9
State-Owned Corporate Bonds	879.6	877.1	876.4	894.4	953.0	991.9	(0.3)	(0.1)	2.1	6.6	4.1	13.1
Local Corporate Bonds	653.1	714.1	727.3	782.1	876.3	987.0	9.3	1.8	7.5	12.0	12.6	38.2
Commercial Paper	683.3	687.1	616.5	502.4	329.1	138.4	0.6	(10.3)	(18.5)	(34.5)	(58.0)	(79.9)
Asset- and Mortgage-Backed Securities	10.8	10.1	9.9	9.5	8.6	8.2	(6.1)	(2.3)	(3.5)	(9.6)	(4.3)	(18.4)
Medium-Term Notes	1,532.5	1,621.4	1,768.6	1,974.3	2,029.9	2,129.1	5.8	9.1	11.6	2.8	4.9	31.3

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

stemming from low inflation. However, issuance declined in 1Q12 and 2Q12 for commercial paper, MTNs, and asset- and mortgage-backed securities.

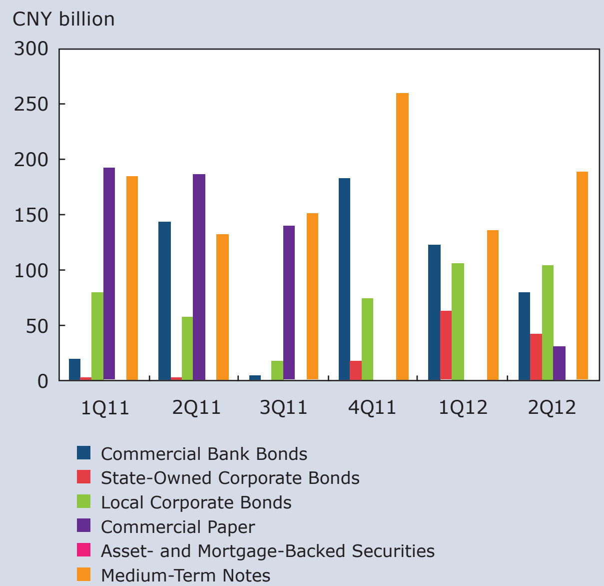
The lack of asset-backed securities stems from the PRC's decision to temporarily halt new issuance in 2008. However, a recently-expanded pilot program is currently underway. Commercial bank bond issuance was strong in 1Q12 and 2Q12, but lower than its peak levels in prior quarters, as banks sought to bolster their capital bases in preparation for the PRC's implementation of Basel III capital adequacy requirements.

Commercial paper issuance has been either weak or nonexistent since 4Q11, being negatively affected by the China Banking Regulatory Commission's (CBRC) decision to prevent banks from offering trust products that invest in commercial paper.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At end-June, the top 30 corporate bond issuers accounted for CNY3.4 trillion, or about 60% of total corporate bonds outstanding. Of the top 30 corporate issuers' bonds outstanding, the 10 largest issuers accounted for CNY2.3 trillion, or 68% of the total.

State-owned companies (defined as majority-owned by the government) dominate the corporate bond market in the PRC. Among the top 30 corporate bond issuers, 23 were state-owned, with a total of CNY2.9 trillion worth of bonds outstanding at end-June.

Figure 2: Corporate Bond Issuance in Key Sectors, 1Q11–2Q12



Source: *ChinaBond.*

SME Bonds. Collective bonds outstanding reached CNY3.5 billion as of 30 June 2011, and have fallen since then. The PRC has been promoting the development of small and medium-sized enterprises (SMEs) and diversifying the funding sources available to them. Past efforts included the launch of SME collective bonds. The SME collective bonds were first launched in 2007 and regulated by the National Development and Reform Council (NDRC). Due to the substantial application requirements, growth has been slow

Table 3: Top 30 Issuers of LCY Corporate Bonds in the People's Republic of China (as of end-June 2012)

Issuers	Outstanding Amount		State-Owned	Privately-Owned	Listed Company	Type of Industry
	LCY Bonds (CNY billion)	LCY Bonds (US$ billion)				
1. Ministry of Railways	632.0	99.46	Yes	No	No	Transportation
2. State Grid Corporation of China	301.5	47.45	Yes	No	No	Public Utilities
3. China National Petroleum	290.0	45.64	Yes	No	No	Energy
4. Industrial and Commercial Bank of China	230.0	36.20	Yes	No	Yes	Banking
5. Bank of China	196.9	30.99	Yes	No	Yes	Banking
6. China Petroleum & Chemical	163.2	25.68	Yes	No	Yes	Energy
7. China Construction Bank	160.0	25.18	Yes	No	Yes	Banking
8. Central Huijin Investment	109.0	17.15	Yes	No	No	Diversified Financial
9. Agricultural Bank of China	100.0	15.74	Yes	No	Yes	Banking
10. China Guodian	83.1	13.08	Yes	No	No	Public Utilities
11. China Minsheng Bank	82.3	12.95	No	Yes	Yes	Banking
12. Bank of Communications	76.0	11.96	No	Yes	Yes	Banking
13. Industrial Bank	72.1	11.34	No	Yes	Yes	Banking
14. Petrochina	67.5	10.62	Yes	No	Yes	Energy
15. Shanghai Pudong Development Bank	67.2	10.58	No	Yes	Yes	Banking
16. China Three Gorges Project	60.5	9.52	Yes	No	No	Public Utilities
17. China Power Investment	57.2	9.00	Yes	No	No	Public Utilities
18. Citic Group	53.5	8.42	Yes	No	No	Diversified Financial
19. China United Network Communications	53.0	8.34	Yes	No	Yes	Telecommunications
20. China Everbright Bank	52.7	8.29	No	Yes	Yes	Banking
21. Shenhua Group	52.0	8.18	Yes	No	No	Energy
22. China Southern Power Grid	51.0	8.03	Yes	No	No	Public Utilities
23. China Merchants Bank	50.0	7.87	No	Yes	Yes	Banking
24. China Huaneng Group	49.2	7.74	Yes	No	No	Public Utilities
25. State-Owned Capital Operation and Management Center of Beijing	45.0	7.08	Yes	No	No	Diversified Financial
26. China Citic Bank	42.5	6.69	No	Yes	Yes	Banking
27. Shougang Group	42.0	6.61	Yes	No	No	Raw Materials
28. China Telecom	40.0	6.30	Yes	No	Yes	Telecommunications
29. Metallurgical Corporation of China	39.6	6.23	Yes	No	Yes	Capital Goods
30. Huaneng Power International	39.0	6.14	Yes	No	Yes	Public Utilities
Total Top 30 LCY Corporate Issuers	**3,358.0**	**528.48**				
Total LCY Corporate Bonds	**5,645.9**	**888.56**				
Top 30 as % of Total LCY Corporate Bonds	**59.5%**	**59.5%**				

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

and outstanding SME collective bonds as of 30 June 2012 were only CNY3 billion. In 2009, the PRC also issued rules for SME collective notes, regulated by the PBOC and NAFMII. This facility was designed to have a much simpler application process, much like MTNs. Due to the easier application process, growth of the SME collective notes has been more rapid than that of SME collective bonds, and as of 30 June 2012 SME collective notes outstanding amounted to CNY13.3 billion.

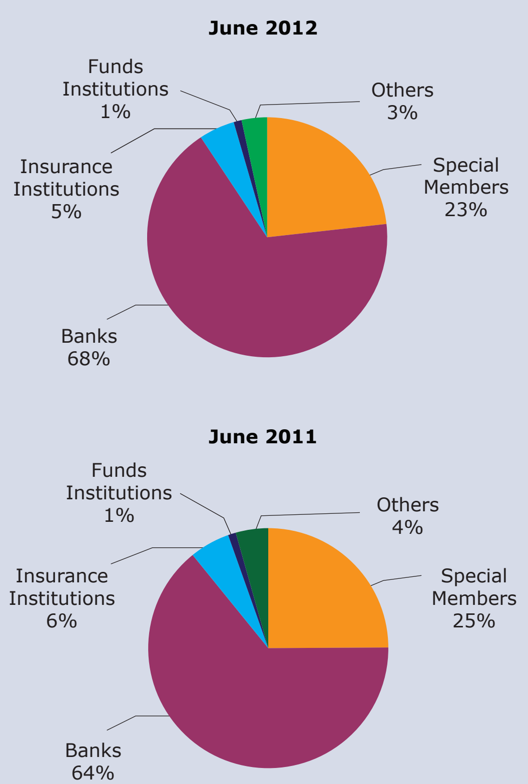
In May 2012, the PRC released a pilot program for the issuance of SME private placement bonds (See **Policy, Institutional, and Regulatory Developments** for more details). Unlike the SME collective notes and bonds, which are jointly issued by a group of SMEs, issuance for the SME private placement bonds are on an individual name basis and they typically carry higher yields. Since the launch of the program, there have been 33 issuances with a total cumulative amount of CNY3 billion.

Investor Profile

Treasury Bonds. Banks remained the largest category of investors in the PRC's treasury bond market, holding a slightly larger share of these bonds at end-June 2012 (68%) than at end-June 2011 (64%) **(Figure 3a)**. The shares held by special members fell to 23% from 25% during the same period. 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.

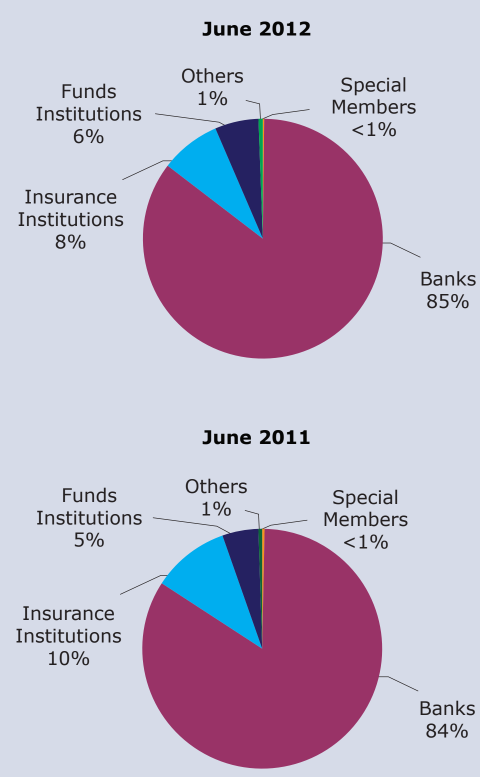
Banks are an even more significant holder of policy bank bonds **(Figure 3b)**. At end-June, banks

Figure 3a: LCY Treasury Bonds Investor Profile



LCY = local currency.
Source: *ChinaBond*.

Figure 3b: LCY Policy Bank Bonds Investor Profile



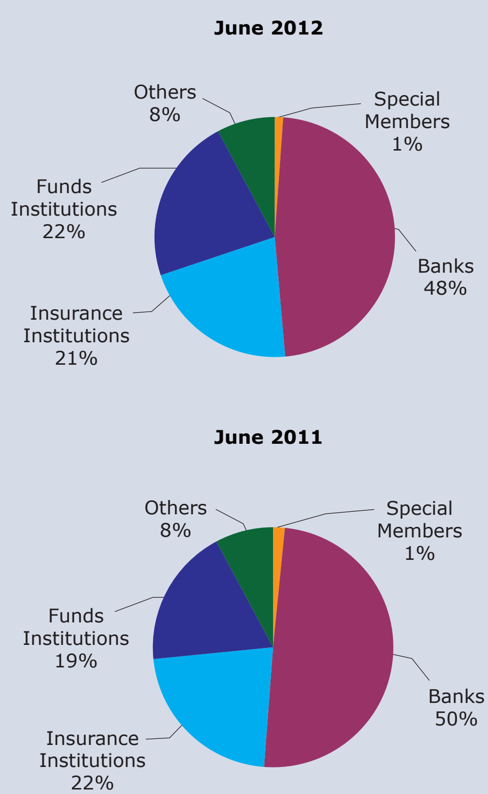
LCY = local currency.
Source: *ChinaBond*.

held 85% of outstanding policy bank bonds, up slightly from 84% at end-June 2011. Insurance institutions' holdings fell slightly to 8% at end-June from 10% a year earlier.

Corporate Bonds. Banks remained the largest holder of corporate bonds at end-June, albeit with a comparatively smaller share than bank holdings of treasury bonds and policy bank bonds. Banks' share of corporate bonds fell slightly to 48% at end-June from 50% at end-June 2011 **(Figure 4)**. The shares held by insurance and fund institutions at end-June were 21% and 22%, respectively, from 22% and 19% a year earlier.

Figure 5 presents the investor profile across different bond categories. Banks were the largest holder of treasury bonds and policy bank bonds at end-June, with a more than 80% share of outstanding policy bank bonds. Meanwhile, insurance institutions were the largest holder of commercial bank bonds.

Figure 4: LCY Corporate Bonds Investor Profile

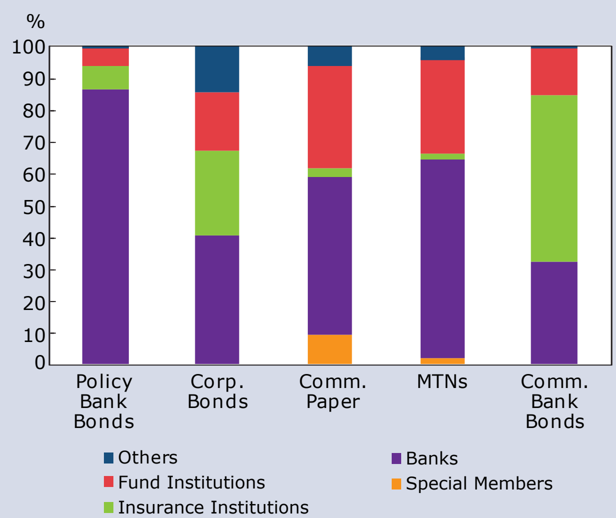


LCY = local currency.
Source: *ChinaBond*.

Liquidity

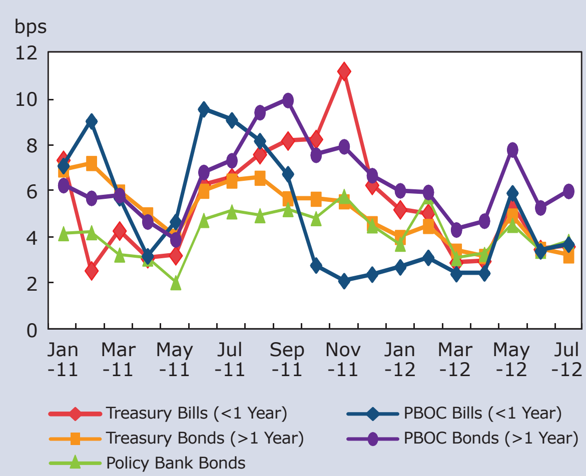
Liquidity for government bonds has showed a steady increase since the start of 2012 as evidenced by the decline in bid–ask spreads **(Figure 6)**.

Figure 5: Investor Profile across Bond Categories
(as of end-June 2011)



bps = basis points, MTNs = medium-term notes.
Source: *ChinaBond*.

Figure 6: Bid–Ask Spreads by Market Makers, January 2011–July 2012



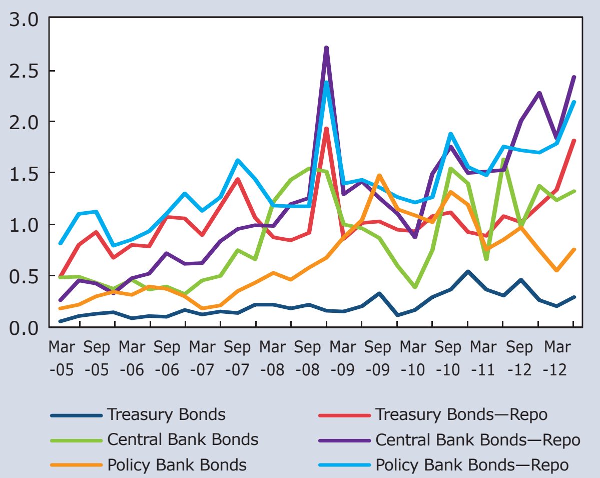
PBOC = People's Bank of China.
Source: *Wind*.

Demand for government bonds increased as the market expected the PBOC to continue easing as inflation declined over this period.

There was an uptick in bid–ask spreads, however, in May due to market concern that PBOC had yet to cut its policy rates. Bid–ask spreads then declined in June after PBOC cut its policy rates by 25 bps in the first week of June.

Figure 7 presents the turnover ratio for government bonds, including both spot trading as well as repo trading volume. As can be seen, the repo market is much more active, with volumes much larger than for spot trading.

Figure 7: Turnover Ratios for Government Bonds



Repo = repurchase.
Source: *ChinaBond*.

Interest Rate Swaps

The total notional amount traded in the interest rate swap (IRS) market rose 3.2% y-o-y and 39.0% q-o-q in 2Q12 to CNY682.1 billion, on a total of 5,173 transactions **(Table 4)**. The most popular benchmark is the 7-day repurchase (repo) rate, accounting for 51% of the notional amount traded, followed by the overnight SHIBOR at 34%. These two benchmarks were the most actively traded in 2Q12 because the primary participants in the PRC's onshore IRS market are commercial banks with large funding exposure in the form of repo transactions. Therefore, banks make extensive use of the repo rate as the base rate to hedge their funding.

Rating Changes

On 11 April, Fitch Ratings (Fitch) reaffirmed the PRC's foreign currency credit rating at A+ with a stable outlook **(Table 5)**. According to Fitch, the PRC's key rating strength is its strong on-balance sheet finances. Fitch also said that in 2011 the PRC had the second-strongest sovereign net foreign asset position in its rating group. The PRC's explicit sovereign debt also remains modest.

Table 4: Notional Values of the PRC's Interest Rate Swap Market in 2Q12

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%)	
	2Q12			q-o-q	y-o-y
7-Day Repo Rate	347.6	51.0%	3,711	35.8%	(6.0%)
Overnight SHIBOR	233.5	34.2%	524	103.9%	42.6%
1-Week SHIBOR	0.1	0.0%	1	–	–
3-Month SHIBOR	75.5	11.1%	608	(2.3%)	(16.3%)
1-Year Term Deposit Rate	21.0	3.1%	221	(48.1%)	(40.6%)
6-Month Lending Rate	0.2	0.0%	17	1,260.0%	1,940.0%
1-Year Lending Rate	2.4	0.4%	75	10.9%	12,536.8%
3-Year Lending Rate	0.4	0.1%	9	410.5%	–
5-Year Lending Rate	0.7	0.1%	5	122.3%	(52.4%)
Above 5-Year Lending Rate	0.6	0.1%	2	–	–
Total	**682.1**	**100.0%**	**5,173**	**39.0%**	**3.2%**

– = not applicable, PRC = People's Republic of China, q-o-q = quarter-on-quarter, Repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate, y-o-y = year on year.
Source: *ChinaMoney*, *Wind*, and *AsianBondsOnline*.

Table 5: Selected Sovereign Ratings and Outlook for the People's Republic of China

	Moody's	S&P	Fitch	R&I
Sovereign FCY LT Ratings	Aa3	A+	AA–	A+
Outlook	Positive	Stable	Stable	Stable

FCY = foreign currency, LT = long-term.
Source: Rating agencies.

Policy, Institutional, and Regulatory Developments

The PRC Widens CNY Trading Band

On 14 April, the PRC widened the band in which the CNY is allowed to trade against the United States (US) dollar. The trading band was widened from 0.5% to 1.0% above or below the daily reference rate.

PBOC and World Bank Sign Investment Agreement

On 23 April, the PBOC and the World Bank Group signed an agreement allowing the latter to invest in the PRC's interbank bond market.

The PRC, Japan, and the Republic of Korea Agree to Promote Cross-Border Bond Investment

On 3 May, the PRC, Japan, and the Republic of Korea agreed to enhance trilateral financial cooperation. The three countries agreed to promote investment by their respective foreign reserve authorities in each other's local bond markets.

PBOC Reduces Reserve Requirement Ratios

On 14 May, the PBOC cut banks' reserve requirement ratio by 50 bps. It was the second reserve requirement ratio cut this year.

Pilot Program for SME Bonds Launched

On 23 May, the PRC launched a pilot program for the issuance of private placement bonds by SMEs. The interest rates for the bonds will be capped at a maximum of three times the benchmark policy rate and the bonds must have maturities of 1 year or more.

The PRC and Japan Begin Direct CNY–JPY Trading

On 30 May, the PRC and Japan began directly trading their currencies, bypassing the need to first convert the currencies into US dollars. Also, unlike CNY–US$ trading, CNY–JPY trading conducted in Japan will not be subject to a peg. However, CNY–JPY trading conducted in the PRC will be subject to a trading peg. The PBOC said that the move will help develop the foreign exchange market and reduce trading costs between the two countries.

PRC Expands Asset-Backed Securitization Program for Banks

On 8 June, the PRC launched a pilot program for asset-backed securitization in the banking sector. The program is an expansion of a prior asset-backed securitization program that was halted in 2008. Under the new program, the investor base will be expanded to include insurance companies, investment funds, corporate pension funds, National Social Security Funds, and other qualified non-bank institutional investors. Ratings from two agencies will be required and the originator is required to maintain a 5% equity tranche in the securitized assets.

The PRC Cuts Benchmark Rates

On 8 June, the PRC cut interest rates by 25 bps for the first time in 3 years. In addition, it adjusted the bands by which banks can vary their rates from the benchmark policy rates. The upper limit for deposit rates was set at 110% and the floor for lending rates was set at 80%. The PRC cut interest rates again on 5 July, this time by 31 bps for the lending rate and 25 bps for the deposit rate. This set the 1-year benchmark lending rate to 6.0% and the deposit rate to 3.0%. Also, the floor for lending rates was adjusted to 70% of the benchmark.

The PRC and Ukraine Sign Currency Swap Agreement

On 26 June, the PRC and Ukraine signed a currency swap agreement worth CNY19 billion. The 3-year agreement is designed to improve financial cooperation, facilitate trade and investment, and promote regional stability.

The PRC Limits Local Government Bond Issuance

On 28 June, during the budget session of the Standing Committee of the National People's Congress, the government rescinded an article in a budget law that would have allowed local governments to issue bonds directly. The move was taken in order to help contain fiscal risks.

The move, however, will not affect the prior approval given to Shanghai, Shenzhen, Guangdong, and Zheijang to issue local government bonds subject to a quota.

NAFMII Issues Guidelines for Asset-Backed Securities of Non-Financial Companies

On 8 August, the National Association of Financial Market Institutional Investors (NAFMII) issued guidelines allowing non-financial corporations to issue asset-backed securities. Previously, only banks were allowed to issue asset-backed securities. Under the guidelines, the bonds can either be sold through the interbank market or via private placement. If the bonds will be sold through the interbank market, there should be at least two ratings from two different rating agencies. Ningbo Urban Construction Investment, Nanjing Public Holding Group, and Shanghai Pudong Road & Bridge Construction were the first to issue bonds under the new rules.