Market Summaries

People's Republic of China—Update

Yield Movements

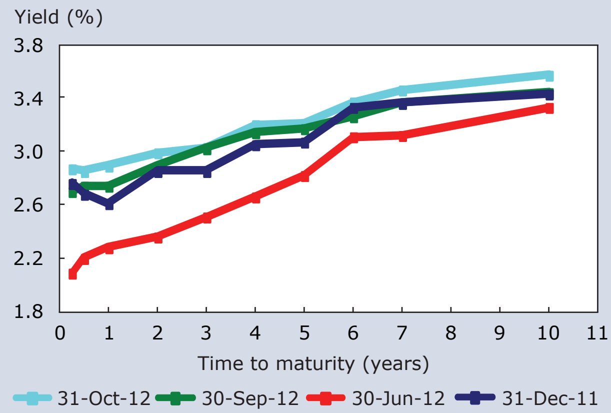
The government bond yield curve in the People's Republic of China (PRC) shifted upward from end-June to end-September, particularly at the shorter-end. Yields rose between 46 basis points (bps) and 61 bps for tenors of 1-year or less in 3Q12. Meanwhile, yields rose 15 bps–53 bps between the 2- and the 6-year tenors, and 11 bps–24 bps between the 7- and 10-year tenors **(Figure 1)**.

As a result of the rise in interest rates, particularly at the shorter-end of the curve, the yield curve flattened in 3Q12. From end-September to end-October, yields rose again, with the yields rising 11 bps to 17 bps for tenors of 1-year or less. The 7-year tenor rose 10 bps while the 10-year tenor rose 13 bps. By 31 October, the yield spread between 2- and 10-year maturities had narrowed further to 58 bps, a level similar to that at end-December 2011.

The rise in yields in September was primarily due to the cautious monetary policy of the People's Bank of China (PBOC), which ceased issuing new bills and notes in 2012, while also using reverse repurchase agreements to increase liquidity. In the last week of October, the PBOC injected CNY395 billion into the money supply through reverse repurchase agreements.

Seasonal factors also contributed to the rise in yields in September as banks' need for liquidity increased during the PRC's Golden Week. In addition, economic data suggested a bottoming out of the PRC's economic growth, putting further upward pressure on yields in October. While inflation has remained low, it is no longer falling and seems to have stabilized. The consumer price inflation rate was at 2.0%, 1.9%, and 1.7% year-on-year (y-o-y) for the months of August, September, and October, respectively.

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



LCY = local currency.
Source: Bloomberg LP.

Gross domestic product (GDP) growth slowed further as the economy expanded 7.4% y-o-y in 3Q12 from 7.6% in 2Q12. Exports posted a strong rebound in September, growing 9.9% y-o-y from 2.7% in August. Manufacturing activity has also picked up, as indicated by the manufacturing purchasing managers' index (PMI), which rose to 50.2 in October from 49.8 in September. Industrial production also grew 9.6% y-o-y in October from 9.2% in August.

In spite of a few positive signs, the external and domestic environments remain challenging. Foreign direct investment (FDI) has been declining on a y-o-y basis since June. FDI in January–September was at US$83.4 billion, or 3.8% less than in the same period last year.

On 7 September, the government announced a CNY1.0 trillion package to fund 60 infrastructure projects. Local governments have also begun planning their own stimulus packages. Tianjin announced that it would spend CNY1.5 trillion on 10 industries, including petrochemicals,

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

	Amount (billion)								Growth Rates (%)						
	Jun-12		Jul-12		Aug-12		Sep-12		Jun-12		Jul-12	Aug-12	Sep-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	22,042	3,469	22,337	3,511	22,737	3,581	22,963	3,654	6.9	1.5	1.3	1.8	10.8	4.2	1.0
Government	16,396	2,580	16,682	2,622	16,981	2,675	17,036	2,711	3.9	1.1	1.7	1.8	7.9	3.9	0.3
Treasury Bonds	7,500	1,180	7,630	1,199	7,811	1,230	7,915	1,259	8.0	1.1	1.7	2.4	8.8	5.5	1.3
Central Bank Bonds	1,644	259	1,631	256	1,619	255	1,514	241	(41.0)	(14.7)	(0.8)	(0.7)	(28.5)	(7.9)	(6.5)
Policy Bank Bonds	7,251	1,141	7,421	1,166	7,551	1,189	7,606	1,210	20.0	5.6	2.3	1.8	18.9	4.9	0.7
Corporate	5,646	889	5,655	889	5,756	907	5,927	943	16.5	2.5	0.2	1.8	20.2	5.0	3.0
Policy Bank Bonds															
China Development Bank	4,921	775	5,031	791	5,131	808	5,142	818	14.9	5.2	2.2	2.0	15.4	4.5	0.2
Export–Import Bank of China	930	146	960	151	990	156	1,008	160	36.0	3.1	3.2	3.1	29.2	8.4	1.8
Agricultural Devt. Bank of China	1,400	220	1,429	225	1,430	225	1,457	232	30.0	8.4	2.1	0.1	25.4	4.1	1.9

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.

port equipment, and aerospace. Chongqing announced that it would spend CNY1.5 trillion over a period of 3 years in industries such as electronics, information technology (IT), and automobiles. Other local governments have announced plans for stimulus packages, including Nanjing, Guangzhou, and Changsha. For example, Changsha said that it plans to spend up to CNY829 billion on construction projects such as airports and subway lines.

Size and Composition

The amount of outstanding local currency (LCY) bonds in the PRC market reached CNY23 trillion (US$3.7 trillion) at end-September, representing a y-o-y increase of 10.8% and a quarter-on-quarter (q-o-q) rise of 4.2% **(Table 1)**.

LCY government bonds outstanding grew 7.9% y-o-y and 3.9% q-o-q in 3Q12, while corporate bonds rose 20.2% y-o-y and 5.0% q-o-q. Central bank bonds continued to act as a drag on government bond growth, falling 28.5% y-o-y and 7.9% q-o-q as a result of fewer sterilization activities and additional monetary easing by the PBOC. In contrast, treasury bonds grew 8.8% y-o-y and 5.5% q-o-q, and policy bank bonds grew 18.9% y-o-y and 4.9% q-o-q.

Corporate Bonds. Corporate bonds outstanding grew 20.2% y-o-y in 3Q12. Growth was driven mainly by an increase in outstanding commercial bank bonds, local corporate bonds, and medium-term notes (MTNs). Commercial bank bonds grew 46.5% y-o-y in 3Q12, due largely to a carryover from the issuance of subordinated notes in 2Q12 as banks sought to bolster their capital bases in advance of the PRC's implementation of Basel III capital adequacy requirements.

Local corporate bonds grew 51.7% y-o-y and MTNs expanded 32.3% in 3Q12, while state-owned corporate bonds rose 13.1% **(Table 2)**. Asset-backed securities continued to decline as well, falling 16.5% in 3Q12 due to an ongoing lack of issuance.

Table 2: Corporate Bonds Outstanding in Key Sectors

	Amount (CNY billion)						Growth Rates (%)					
							q-o-q					y-o-y
	2Q11	3Q11	4Q11	1Q12	2Q12	3Q12	3Q11	4Q11	1Q12	2Q12	3Q12	3Q12
Commercial Bank Bonds	759	755	924	1,028	1,100	1,106	(0.5)	22.4	11.2	7.0	0.6	46.5
State-Owned Corporate Bonds	877	876	894	953	992	991	(0.1)	2.1	6.6	4.1	(0.1)	13.1
Local Corporate Bonds	714	727	782	876	987	1,103	1.8	7.5	12.0	12.6	11.8	51.7
Asset- and Mortgage-Backed Securities	10	10	10	9	8	8	(2.3)	(3.5)	(9.6)	(4.3)	–	(16.5)
Medium-Term Notes	1,621	1,769	1,974	2,030	2,129	2,340	9.1	11.6	2.8	4.9	9.9	32.3

– = not available, q-o-q = quarter-on-quarter, y-o-y = year-on-year.
Source: *ChinaBond.*

On a q-o-q basis, local corporate bonds and MTNs showed the strongest growth: local corporate bonds grew 11.8% and MTNs grew 9.9%. Commercial bank bonds grew only 0.6% q-o-q as banks conducted most of their capital-raising efforts in 2Q12.

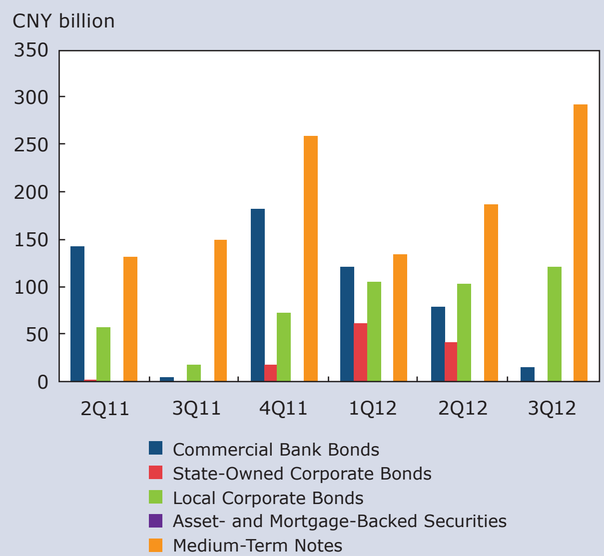
Overall issuance of corporate bonds was down in 3Q12 from 2Q12 levels **(Figure 2)**, with the exception of local corporate bonds and MTNs.

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 underway. Commercial bank bond issuance was strong in 1Q12 and 2Q12, but still lower than its peak level in prior quarters, as banks sought to bolster their capital bases in preparation for the PRC's implementation of Basel III.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At end-September, the top 30 corporate bond issuers accounted for CNY3.5 trillion worth of corporate bonds outstanding, or about 60% of the total market. Among the top 30 corporate issuers, the 10 largest accounted for CNY2.4 trillion worth of bonds outstanding.

State-owned companies (defined as majority-owned by the government) dominate the corporate bond market in the PRC. Among the top 30 corporate issuers at end-September, 23 were state-owned, with a total of CNY3.1 trillion worth of bonds outstanding.

Figure 2: Corporate Bond Issuance in Key Sectors, 2Q11–3Q12



Source: *ChinaBond.*

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-September 2012 (68%) than at end-September 2011 (65%) **(Figure 3a)**. The shares held by special members fell to 22% from 24% 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.

Table 3: Top 30 Issuers of LCY Corporate Bonds in the People's Republic of China (as of end-September 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	697.0	110.9	Yes	No	No	Transportation
2. State Grid Corporation of China	326.5	52.0	Yes	No	No	Public Utilities
3. China National Petroleum	310.0	49.3	Yes	No	No	Energy
4. Industrial and Commercial Bank of China	230.0	36.6	Yes	No	Yes	Banking
5. Bank of China	196.9	31.3	Yes	No	Yes	Banking
6. China Construction Bank	160.0	25.5	Yes	No	Yes	Banking
7. China Petroleum & Chemical	158.2	25.2	Yes	No	Yes	Energy
8. Central Huijin Investment	109.0	17.3	Yes	No	No	Diversified Financial
9. Agricultural Bank of China	100.0	15.9	Yes	No	Yes	Banking
10. Shenhua Group	92.0	14.6	Yes	No	No	Energy
11. China Minsheng Bank	82.3	13.1	No	Yes	Yes	Banking
12. Bank of Communications	76.0	12.1	No	Yes	Yes	Banking
13. China Guodian	74.9	11.9	Yes	No	No	Public Utilities
14. Industrial Bank	72.1	11.5	No	Yes	Yes	Banking
15. Petrochina	67.5	10.7	Yes	No	Yes	Energy
16. Shanghai Pudong Development Bank	67.2	10.7	No	Yes	Yes	Banking
17. China Three Gorges Project	65.5	10.4	Yes	No	No	Public Utilities
18. China Power Investment	60.3	9.6	Yes	No	No	Public Utilities
19. China Life	58.0	9.2	Yes	No	Yes	Insurance
20. State-Owned Capital Operation and Management Center of Beijing	55.0	8.8	Yes	No	No	Diversified Financial
21. Citic Group	53.5	8.5	Yes	No	No	Diversified Financial
22. China United Network Communications	53.0	8.4	Yes	No	Yes	Telecommunications
23. China Everbright Bank	52.7	8.4	No	Yes	Yes	Banking
24. China Huaneng Group	52.2	8.3	Yes	No	No	Public Utilities
25. China Merchants Bank	50.0	8.0	No	Yes	Yes	Banking
26. Huaneng Power International	49.0	7.8	Yes	No	Yes	Public Utilities
27. Metallurgical Corporation of China	45.6	7.3	Yes	No	Yes	Capital Goods
28. China Southern Power Grid	44.0	7.0	Yes	No	No	Public Utilities
29. China Citic Bank	42.5	6.8	No	Yes	Yes	Banking
30. Shougang Group	42.0	6.7	Yes	No	No	Raw Materials
Total Top 30 LCY Corporate Issuers	**3,542.9**	**563.7**				
Total LCY Corporate Bonds	**5,927.2**	**943.1**				
Top 30 as % of Total LCY Corporate Bonds	**59.8%**	**59.8%**				

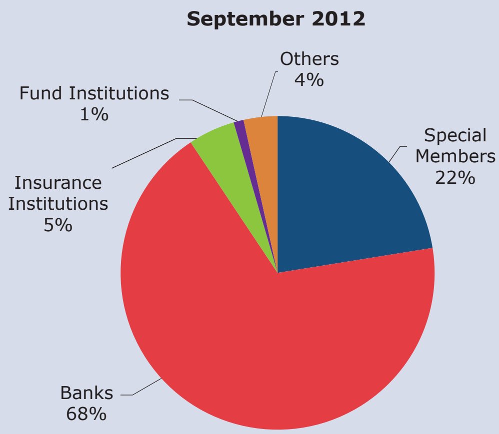
LCY = local currency.
Source: Bloomberg LP and Wind.

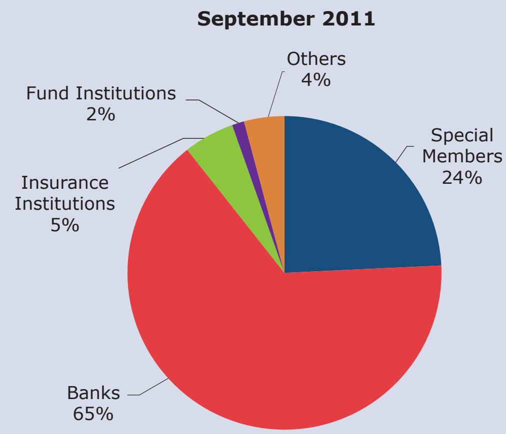
Banks are a much more significant holder of policy bank bonds **(Figure 3b)**. At end-September, banks held 85% of outstanding policy bank bonds, up slightly from 84% at end-September 2011. Insurance institutions' holdings fell slightly to 8% at end-September from 10% a year earlier.

Corporate Bonds. Banks remained the largest holder of corporate bonds at end-September, albeit with a comparatively smaller share than bank holdings of treasury bonds and policy bank bonds. Banks' share of corporate bonds fell slightly to 45% at end-September from 50% at end-September 2011 **(Figure 4)**. The shares held by insurance and fund institutions at end-September were 21% and 25%, respectively, from 21% and 20% 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-September, with a more than 80% share of outstanding policy bank bonds. Meanwhile, insurance institutions were the largest holder of commercial bank bonds.

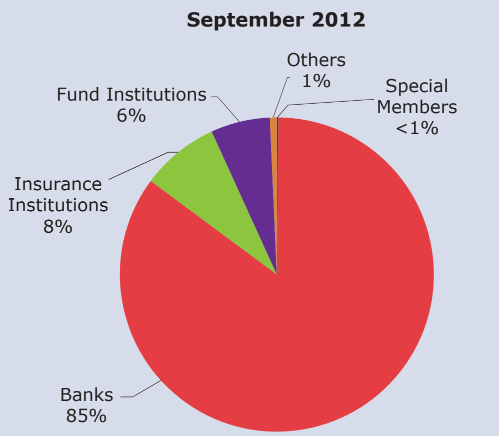
Figure 3a: LCY Treasury Bonds Investor Profile

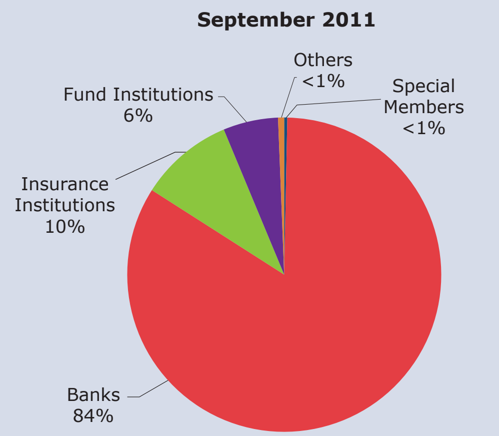




LCY = local currency.
Source: *ChinaBond*.

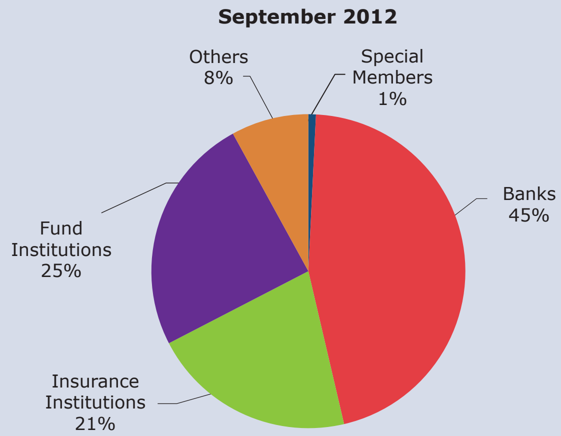
Figure 3b: LCY Policy Bank Bonds Investor Profile





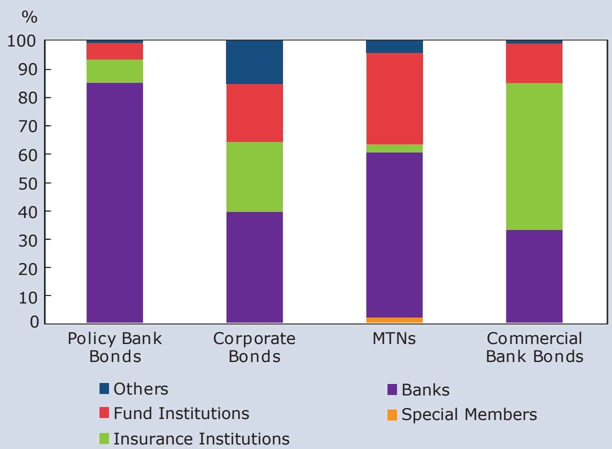
LCY = local currency.
Source: *ChinaBond*.

Figure 4: LCY Corporate Bonds Investor Profile



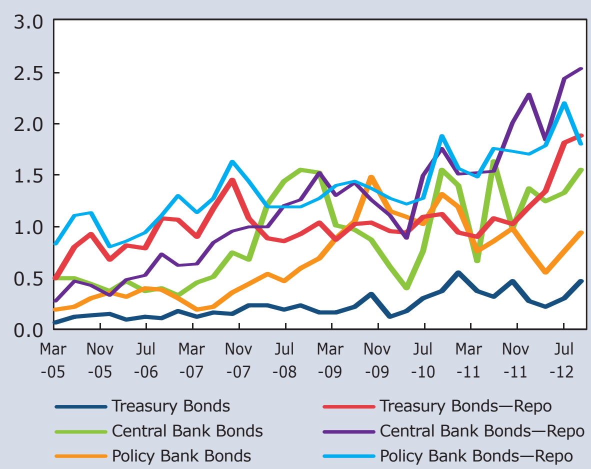
LCY = local currency.
Source: *ChinaBond*.

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



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

Figure 6: Turnover Ratios for Government Bonds



Repo = repurchase.
Source: *ChinaBond*.

Liquidity

Figure 6 presents the turnover ratio for government bonds, including both spot trading as well as repo trading volumes. As can be seen, the repo market is the more active of the two, with volumes much larger than spot trading.

Interest Rate Swaps

The total notional amount traded in the interest rate swap (IRS) market rose 1.4% y-o-y and 17.4% q-o-q in 3Q12 to CNY801 billion on 6,662 transactions **(Table 4)**. The most popular benchmark was the 7-day repurchase (repo) rate, accounting for 53% of the notional amount

Table 4: Notional Values of the PRC's Interest Rate Swap Market (as of 3Q12)

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%)	
	3Q12			q-o-q	y-o-y
7-Day Repo Rate	424.1	52.9	4,699	22.0	4.4
Overnight SHIBOR	253.5	31.6	629	8.5	(9.0)
3-Month SHIBOR	78.7	9.8	791	4.2	(3.6)
1-Year Term Deposit Rate	26.8	3.3	237	27.7	16.1
6-Month Lending Rate	0.07	0.0	4	(65.2)	787.5
1-Year Lending Rate	13.4	1.7	257	458.1	14,955.1
3-Year Lending Rate	3.2	0.4	22	639.4	–
5-Year Lending Rate	0.9	0.1	21	38.7	–
Above 5-Year Lending Rate	0.3	0.0	2	55.6)	–
Total	**801.0**	**100.0**	**6,662**	**17.4**	**1.4**

– = 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: *AsianBondsOnline* and *ChinaMoney*.

traded, followed by the overnight SHIBOR at 32%. These two benchmarks were the most actively traded in 3Q12 because the primary participants in the PRC's onshore IRS market are commercial banks with high levels of 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.

Policy, Institutional, and Regulatory Developments

Allowable Investments for QFIIs Expanded

On 28 July, the China Securities Regulatory Commission (CSRC) issued new rules allowing Qualified Foreign Institutional Investors (QFIIs) to invest in the interbank market. QFIIs were previously only allowed to trade in the exchange market. The new regulations also allow QFIIs to invest in private placement bonds issued by small and medium-sized enterprises (SMEs). Finally, the 20% stake limit in a listed company was raised to 30%.

Home Price Controls to Continue

On 29 August, an official from the National Development and Reform Council (NDRC) said that it would take measures to prevent rising home prices. These measures include restricting speculation and increasing the housing supply, particularly small and medium-sized homes.

CSRC Approves First Direct Offshore Bond Fund

On 16 October, the CSRC approved Huaxia Asset Management's bid to launch a bond fund investing in offshore bonds under the Qualified Domestic Institutional Investor (QDII) program. The fund will invest 80% of its assets in bonds, unlike existing QDII funds that invest mostly in equities. The fund will also invest in bonds directly, rather than indirectly, as is the case with other QDII bond funds.

Allowable Offshore Investments of Insurance Companies Expanded

On 23 October, the China Insurance Regulatory Commission (CIRC) began allowing insurance companies to invest offshore in countries other than Hong Kong, China. The list of allowable countries was expanded to 45 and the allowable investments were expanded from bonds and equity to also include real estate, currency products, and fixed-income products other than bonds.

Bank of Communications Prices First ABS under Pilot Program

On 2 November, Bank of Communications priced the first asset-back security (ABS) under the new ABS pilot scheme. The security comprises three tranches. The A1-rated tranche had a size of CNY850 million and was priced at 4.2%. The A2-rated tranche had a size of CNY1.6 billion with a floating rate of 140 bps over the 1-year deposit rate. The B-rated tranche was sized at CNY310 million with a floating rate of 300 bps over the 1-year deposit rate. An unrated subordinated tranche worth CNY263.3 billion will also be privately placed. The collateral for the notes comprises 60 corporate loans from 34 borrowers.