Market Summaries

People's Republic of China

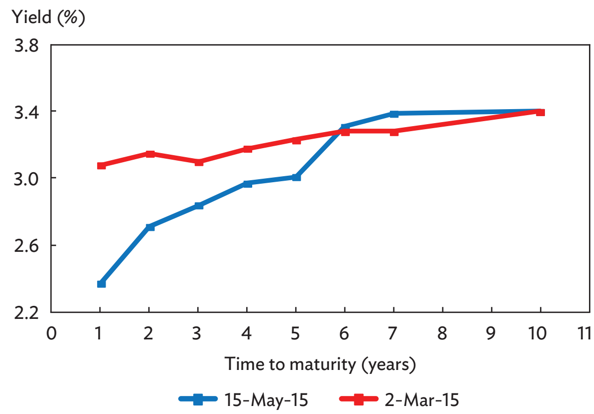
Yield Movements

From 2 March until 15 May, the yield curve of the People's Republic of China (PRC) shifted downward for tenors of 5 years or less, with yields falling between 21 basis points (bps) and 71 bps **(Figure 1)**. The biggest decrease was for the 1-year tenor, which fell 71 bps. For tenors longer than 5 years, yields rose between 3 bps and 11 bps. As a result, the 2-year versus 10-year spread rose from 25 bps to 69 bps in the same period.

The downward shift was largely in response to economic data showing that the PRC's economy is slowing. Gross domestic product (GDP) growth fell in 1Q15 to 7.0% year-on-year (y-o-y) from 7.3% y-o-y in 4Q14. The government's target for GDP growth in 2015 was set at 7.0%, compared with actual growth of 7.4% in 2014. Industrial production growth fell to 6.8% y-o-y in January–February from 7.9% y-o-y in December, and further to 5.6% y-o-y in March, before rising to 5.9% y-o-y in April. Private investment in fixed assets has also been on a downward trend, falling sharply to 12.7% y-o-y in January–April from 18.1% in full-year 2014. Inflation, on the other hand, has shown a mild upward trend in 2015. After falling to 0.8% y-o-y in January from 1.5% y-o-y in December, inflation rose to 1.4% y-o-y in February–March and to 1.5% y-o-y in April. Inflation, however, still remains below the government's 2015 target of 3.0%.

In response to the slowing economy, the People's Bank of China (PBOC) has pursued a number of easing measures in 2015. It reduced its policy rates—the benchmark 1-year lending rate and 1-year deposit rate—by 25 bps each on 1 March. In addition, the PBOC increased the band by which banks could set their deposit rates to 1.3 times that of the benchmark deposit rate. The PBOC said that it reduced interest rates due to an uncertain external environment that could put negative pressure on the local economy. With inflation below its target range, the PBOC felt it had sufficient room to ease rates by an additional 25 bps on 11 May. After the second rate reduction, the benchmark 1-year rate was 5.10% and the benchmark 1-year deposit rate was 2.25%. The deposit rate bond ceiling was also increased to 1.5 times. Other PBOC stimulus measures thus far in 2015 have included reducing reserve requirement ratios.

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



LCY = local currency.
Source: Bloomberg LP.

Despite the PBOC's easing measures, yields at the long-end of the curve rose on an expected increase in local government bond issuance as the PRC recently unveiled measures to swap existing debt for new local government bonds.

Size and Composition

The amount of outstanding LCY bonds in the PRC reached CNY32.7 trillion (US$5.3 trillion) at end-March, an increase of 1.6% quarter-on-quarter (q-o-q) and 12.0% y-o-y, largely driven by growth in policy bank and local corporate bonds **(Table 1)**.

Government Bonds. LCY government bonds outstanding grew 1.0% q-o-q and 10.0% y-o-y in 1Q15, driven by growth in policy bank bonds. Central bank bonds was unchanged as the PBOC opted to use other tools to manage liquidity (e.g., reverse repos). The amount of outstanding Treasury bonds fell 0.4% q-o-q but rose 12.3% y-o-y. The y-o-y

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

	Outstanding Amount (billion)						Growth Rates (%)			
	1Q14		4Q14		1Q15		1Q14		1Q15	
	CNY	US$	CNY	US$	CNY	US$	q-o-q	y-o-y	q-o-q	y-o-y
Total	**29,233**	**4,702**	**32,222**	**5,192**	**32,731**	**5,279**	**2.2**	**10.5**	**1.6**	**12.0**
Government	19,002	3,056	20,693	3,335	20,894	3,370	2.1	8.2	1.0	10.0
Treasury Bonds	9,136	1,470	10,308	1,661	10,263	1,655	(0.5)	13.2	(0.4)	12.3
Central Bank Bonds	552	89	428	69	428	69	0.0	(58.9)	0.0	(22.5)
Policy Bank Bonds	9,313	1,498	9,957	1,605	10,203	1,646	5.0	14.3	2.5	9.6
Corporate	10,231	1,646	11,529	1,858	11,837	1,909	2.3	15.0	2.7	15.7
Policy Bank Bonds										
China Development Bank	5,988	963	6,266	1,010	6,337	1,022	3.9	10.4	1.1	5.8
Export–Import Bank of China	1,458	235	1,583	255	1,694	273	8.9	23.2	7.0	16.2
Agricultural Devt. Bank of China	1,867	300	2,108	340	2,172	350	5.6	21.2	3.0	16.4

( ) = negative, LCY = local currency, 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.
Sources: *ChinaBond*, *Wind*, and Bloomberg LP

Table 2: Corporate Bonds Outstanding in Key Categories

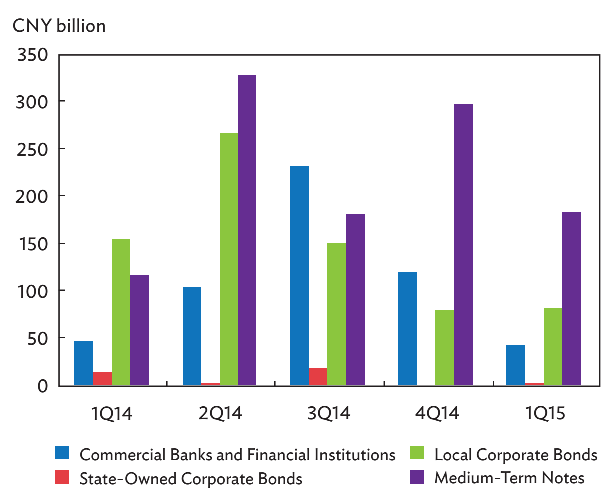
	Amount (CNY billion)				Growth Rate (%)				
					q-o-q				y-o-y
	2Q14	3Q14	4Q14	1Q15	2Q14	3Q14	4Q14	1Q15	1Q15
Commercial Bank Bonds and Tier 2 Notes	1,369	1,536	1,612	1,639	5.4	12.2	5.0	1.7	26.2
SOE Bonds	618	630	622	612	(4.5)	1.8	(1.2)	(1.5)	(5.4)
Local Corporate Bonds	2,085	2,231	2,306	2,377	28.3	7.0	3.4	3.1	46.2
Medium Term Notes	3,985	4,054	4,179	4,227	7.1	1.7	3.1	1.2	13.6

( ) = negative, q-o-q = quarter-on-quarter, SOE = state-owned enterprise, y-o-y = year-on-year.
Sources: *ChinaBond* and *Wind*.

increase was due mostly to a rise in local government bonds outstanding. Issuances of local government bonds increased due to a slowdown in local government revenues resulting from a weakening property market and the renovation of shantytowns as part of the PRC's urbanization process, among other factors. In addition, the PRC is allowing local governments to issue bonds directly for the first time, while limiting the use of local government and corporate financing vehicles.

Corporate Bonds. Corporate bonds outstanding grew 2.7% q-o-q and 15.7% y-o-y in 1Q15 to reach CNY11.8 trillion. Bonds with strong positive growth rates were those issued by banks and insurance companies, and local corporates, rising 1.7% q-o-q and 3.1% q-o-q, respectively **(Table 2)**. The strong growth in financial bonds was mostly due to issuance of subordinated bonds by financial institutions in 3Q14 to boost capital ratios.

Figure 2: Corporate Bond Issuance in Key Sectors



LCY = local currency.
Sources: *ChinaBond* and *Wind*.

Table 3: Top 30 Issuers of LCY Corporate Bonds in the People's Republic of China

	Issuers	Outstanding Amount		State-Owned	Listed Company	Type of Industry
		LCY Bonds (CNY billion)	LCY Bonds (US$ billion)			
1.	China Railway	1,068.5	172.35	Yes	No	Transportation
2.	State Grid Corporation of China	450.5	72.66	Yes	No	Public Utilities
3.	China National Petroleum	370.0	59.68	Yes	No	Energy
4.	Bank of China	300.9	48.53	Yes	Yes	Banking
5.	Industrial and Commercial Bank of China	290.5	46.86	Yes	Yes	Banking
6.	Agricultural Bank of China	270.0	43.55	Yes	Yes	Banking
7.	Industrial Bank	265.0	42.75	No	Yes	Banking
8.	Shanghai Pudong Development Bank	230.5	37.18	No	Yes	Banking
9.	China Construction Bank	200.0	32.26	Yes	Yes	Banking
10.	China Merchants Bank	159.0	25.65	No	Yes	Banking
11.	China Citic Bank	154.1	24.85	No	Yes	Banking
12.	China Minsheng Bank	153.7	24.79	No	Yes	Banking
13.	China Everbright Bank	143.7	23.18	Yes	Yes	Banking
14.	Bank of Communications	125.0	20.16	No	Yes	Banking
15.	China Power Investment	118.4	19.10	Yes	No	Public Utilities
16.	Senhua Group	111.6	17.99	Yes	No	Energy
17.	Central Huijin Investment	109.0	17.58	Yes	No	Diversified Financial
18.	Petrochina	106.0	17.10	Yes	Yes	Energy
19.	Bank of Beijing	94.4	15.23	No	Yes	Banking
20.	China Southern Power Grid	90.0	14.52	Yes	No	Public Utilities
21.	Ping An Bank	87.7	14.14	No	No	Banking
22.	China Petroleum and Chemical	79.5	12.82	Yes	Yes	Energy
23.	Bank of Shanghai	78.3	12.62	No	No	Banking
24.	China Guodian	76.2	12.28	Yes	No	Public Utilities
25.	China Three Gorges Project	74.5	12.02	Yes	No	Public Utilities
26.	China Datang	71.7	11.57	Yes	No	Energy
27.	Beijing State-owned Assets Operation & Management Center	71.5	11.53	Yes	No	Diversified Financial
28.	Tianjin Infrastructure Investment Group	69.1	11.15	Yes	No	Capital Goods
29.	Shananxi Coal and Chemical Industry Group	68.0	10.97	No	Yes	Energy
30.	China Life	68.0	10.97	Yes	Yes	Insurance
Total Top 30 LCY Corporate Issuers		**5,555.18**	**896.04**			
Total LCY Corporate Bonds		**11,836.72**	**1,909.24**			
Top 30 as % of Total LCY Corporate Bonds		**46.9%**	**46.9%**			

LCY = local currency.
Notes:
1. Data as of end-March 2015.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg data.

Corporate bond issuance was down in 1Q15. One reason is that banks and insurance companies completed most of their capital raising requirements in 2014 **(Figure 2)**. On the other hand, local corporate issuances remained strong in 1Q15.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At the end of 1Q15, the top 30 corporate bond issuers accounted for CNY5.6 trillion worth of corporate bonds outstanding, or about 47% of the market. The 10 largest issuers accounted for CNY3.6 trillion worth of bonds outstanding.

State-owned companies—defined as majority-owned by the government—continued to dominate the corporate bond market in 1Q15. Among the top 30 corporate issuers at end-March, 20 were state-owned. The top 30 is currently dominated by banks, largely as a result of their capital raising efforts under the PRC's implementation of Basel III.

Table 4 presents the most significant issuances of 1Q15. The largest of which came from issuance of subordinated debt.

Investor Profile

Treasury Bonds and Policy Bank Bonds. Banks remained the largest category of investors in the PRC's Treasury bond market, which includes policy bank bonds, accounting for a slightly smaller share of the market at end-March (75.9%) than in the same period a year earlier (76.7%) **(Figure 3)**.

Table 4: Notable LCY Corporate Bond Issuance in 3Q14

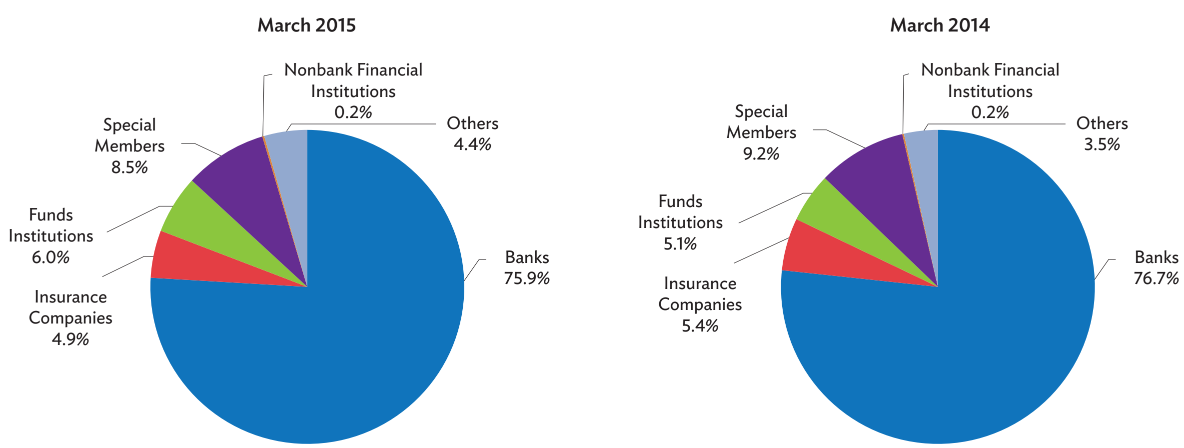
Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
Industrial Bank		
3-year bond	4.95	30
China Railway		
5-year bond	4.88	20
State Grid Corporation of China		
3-year bond	4.49	10
Shenhua Group		
5-year bond	4.88	9
Hutai Securities		
2-year bond	5.90	6
ZTE Corporation		
5-year bond	5.81	6

LCY = local currency.
Source: Bloomberg LP.

Corporate Bonds. Banks were also the largest holders of corporate bonds at the end of 1Q15, albeit with a comparatively smaller share than their holdings of Treasury bonds and policy bank bonds. Banks' share of corporate bonds fell to 26.6% at the end of 1Q15 from 30.2% a year earlier **(Figure 4)**. The second largest holders of corporate bonds were funds institutions, with a 23.3% share at end-March, down from a 22.8% share a year earlier.

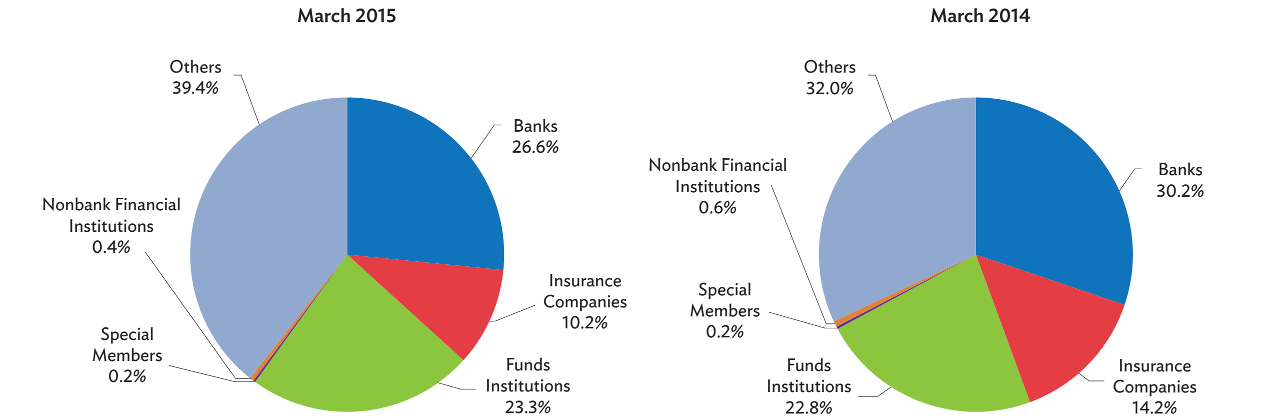
Figure 5 presents investor profiles across corporate bond categories at end-March. Banks were the largest holders

Figure 3: LCY Treasury Bonds and Policy Bank Bonds Investor Profile



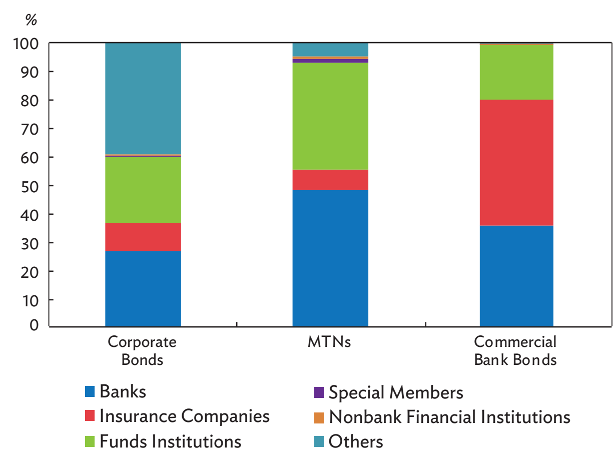
LCY = local currency.
Source: *ChinaBond*.

Figure 4: LCY Corporate Bonds Investor Profile



LCY = local currency.
Source: *ChinaBond*.

Figure 5: Investor Profile across Bond Categories



MTNs = medium-term notes.
Note: Data as of end-March 2015.
Source: *ChinaBond*.

Table 5: Notional Values of the PRC's Interest Rate Swap Market in 1Q15

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%) q-o-q
7-Day Repo Rate	1,525.5	91.8	16,523	29.4
Overnight SHIBOR	45.5	2.7	133	(39.1)
3-Month SHIBOR	70.9	4.3	595	(40.1)
1-Year Term Deposit Rate	13.9	0.8	132	252.1
LIBOR	0.0	0.0	0	0.0
1-Year Lending Rate	5.1	0.3	2	(49.8)
LPR1Y	0.0	0.0	0	0.0
3-Year Lending Rate	0.0	0.0	0	0.0
5-Year Lending Rate	0.0	0.0	0	0.0
Total	**1,660.9**	**100.0**	**17,385**	**19.8**

( ) = negative, PRC = People's Republic of China, LIBOR = London Interbank Offered Rate, q-o-q = quarter-on-quarter, Repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate.
Note: Growth rate computed based on notional amounts.
Sources: *AsianBondsOnline* and *ChinaMoney*.

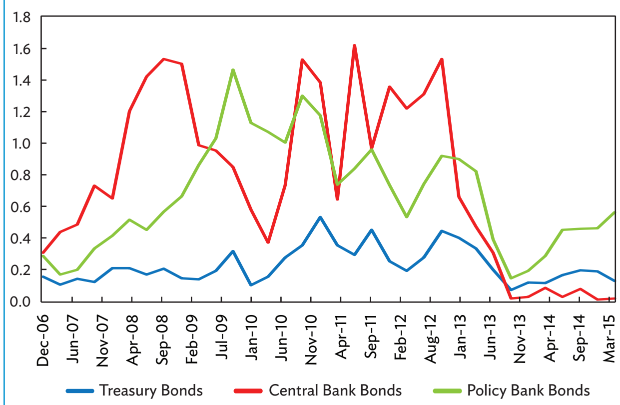
of medium-term notes with more than 50% of the total. Meanwhile, insurance companies were the largest holders of commercial bank bonds.

Liquidity

As a result of the uncertainty surrounding the timing of US monetary policy decisions and slowing domestic economic growth, the use of interest rate swaps increased in 1Q15, with volume rising 19.8% q-o-q. The bulk of interest rate swaps involved the 7-day repo rate, accounting for nearly 92% of all volume traded **(Table 5)**.

Figure 6 presents the turnover ratios for different categories of government bonds, which have seen a significant decline since 2013 owing to the tight liquidity conditions driven by the June 2013 SHIBOR shock and a crackdown on illegal bond trades. However, in 1Q15,

Figure 6: Turnover Ratios for Government Bonds



Source: *ChinaBond*.

trading activity in policy bank bonds increased while central bank bond trading continued to lag due to the lack of issuances.

Policy, Institutional, and Regulatory Developments

The PRC to Swap Local Government Debt

On 8 March, the Government of the PRC announced a CNY1 trillion quota for local governments to swap higher-yielding, maturing debt for municipal bonds, a plan that will cover roughly half of all high-yield debt maturing in 2015. The debt swap is targeted to be completed by the end of August. Issuance will be via private placement and the new bonds cannot be traded on the interbank or exchange bond markets. The bonds, however, can be used as collateral for the PBOC's repo transactions or its standing lending facilities.

PBOC Reduces Reserve Requirement Ratios

On 20 April, the PBOC reduced the reserve requirement ratio for deposit-taking financial institutions by 100 bps. In addition, the reserve requirement ratio for rural financial institutions, including rural credit cooperatives, and village and town banks, was reduced by an additional 100 bps. The reserve requirement ratio of the Agricultural Development Bank of China was reduced by an additional 200 bps, while banks with a certain level of loans to the agricultural sector or small enterprises qualify for an additional 50 bps reduction.

Asset Securitization Expanded

On 14 May, the State Council said that it would expand the current asset securitization pilot program by CNY500 billion in order to improve banks' liquidity. The government's plan is to use the funds generated by asset-backed security sales for housing renovation, water, and railway projects.