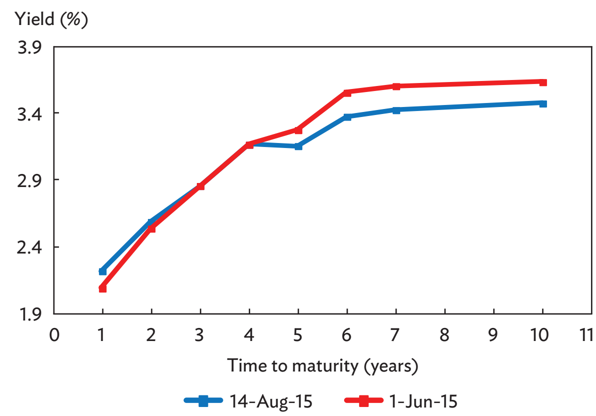
Market Summaries

People's Republic of China

Yield Movements

Between 1 June and 14 August, the local currency (LCY) government bond yield curve in the People's Republic of China (PRC) shifted downward for tenors of 5 years or more, with yields falling between 12 basis points (bps) and 18 bps **(Figure 1)**. The 6-year and 7-year tenors both fell by 18 bps. For the 1-year tenor, yields rose 13 bps, and the 2-year tenor rose 5 bps. The 3-year and 4-year tenors remained unchanged. As a result of the yield curve's movements, the 2-year versus 10-year spread fell to 89 bps from 110 bps during the period under review.

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



LCY = local currency.
Source: Bloomberg LP.

The downward shift at the longer-end of the curve was mostly due to the continued slowdown of the PRC's economy. Gross domestic product growth remained unchanged in 2Q15 from 1Q15 at 7.0% year-on-year (y-o-y), compared with growth of 7.4% in full-year 2014. Other economic indicators also showed a slowdown. Industrial production growth fell to 6.0% y-o-y in July from 6.8% y-o-y in June. Growth in private investment in fixed assets also continued to decline, falling to 11.2% y-o-y in January–July from 11.4% in January–June.

The PRC's growth has also been hampered by lower external demand. Exports fell 8.3% y-o-y in July after rising 2.8% y-o-y in June, driven by lower demand from advanced economies. The slower growth outlook prompted the People's Bank of China (PBOC) to implement additional easing measures in 2Q15. In June, the PBOC implemented a targeted reduction in deposit-taking institutions' reserve requirement ratios (See Policy, Institutional, and Regulatory Developments at the end of this Market Summary for more details.) The central bank also reduced its policy rates by 25 bps, taking the 1-year lending rate to 4.85% and the 1-year deposit rate to 2.00%. In August, the PBOC again reduced policy rates by another 25 bps, resulting in a 1-year lending rate of 4.6% and a 1-year deposit rate of 1.75%. The PBOC also reduced reserve requirement ratios and revised the central parity exchange-rate-setting mechanism. While the PBOC said the goal was a more market-oriented exchange rate, the move resulted in a depreciation of 1.9% on the day it was first implemented and a 1.6% decline on the second day.

Despite the PBOC's easing measures, yields at the shorter-end of the curve rose, driven mostly by increased liquidity demands following the stock market crash in June. Between 1 June and 14 August, the Shanghai Stock Exchange Composite Index fell about 18%. The stock market crash also contributed to the fall in yields at the longer-end of the curve as investors flocked to the safety of bond market assets. However, the stock market crash increased the liquidity requirements of financial institutions amid investors' demand for cash, driving short-term rates upward.

Size and Composition

The amount of outstanding LCY bonds in the PRC reached CNY34.7 trillion (US$5.6 trillion) at end-June, an increase of 5.9% quarter-on-quarter (q-o-q) and 13.8% y-o-y, largely driven by growth in Treasury bonds and local corporate bonds **(Table 1)**.

Government Bonds. LCY government bonds outstanding grew 6.9% q-o-q and 13.9% y-o-y in 2Q15, driven by growth

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

	Outstanding Amount (billion)						Growth Rates (%)			
	2Q14		1Q15		2Q15		2Q14		2Q15	
	CNY	US$	CNY	US$	CNY	US$	q-o-q	y-o-y	q-o-q	y-o-y
Total	**30,462**	**4,911**	**32,731**	**5,279**	**34,666**	**5,590**	**4.2**	**11.7**	**5.9**	**13.8**
Government	19,625	3,164	20,894	3,370	22,344	3,603	3.3	10.1	6.9	13.9
Treasury Bonds	9,461	1,525	10,263	1,655	11,284	1,820	3.6	12.1	9.9	19.3
Central Bank Bonds	489	79	428	69	428	69	(11.4)	(50.8)	0.0	(12.5)
Policy Bank Bonds	9,675	1,560	10,203	1,646	10,632	1,715	3.9	15.2	4.2	9.9
Corporate	10,837	1,747	11,837	1,909	12,322	1,987	5.9	14.6	4.1	13.7
Policy Bank Bonds										
China Development Bank	6,217	1,002	6,337	1,022	6,538	1,054	3.8	12.5	3.2	5.2
Export–Import Bank of China	1,480	239	1,694	273	1,797	290	1.5	16.7	6.1	21.4
Agricultural Devt. Bank of China	1,978	319	2,172	350	2,297	370	5.9	23.3	5.7	16.1

( ) = 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
	3Q14	4Q14	1Q15	2Q15	3Q14	4Q14	1Q15	2Q15	2Q15
Commercial Bank Bonds and Tier 2 Notes	1,536	1,612	1,639	1,748	18.6	5.0	1.7	6.6	35.0
SOE Bonds	630	622	612	612	(0.1)	(1.2)	(1.5)	(0.1)	(2.9)
Local Corporate Bonds	2,231	2,306	2,377	2,456	31.1	3.4	3.1	3.3	44.3
Commercial Papers	1,768	1,738	1,866	2,038	19.5	(1.7)	7.3	9.2	37.7
Medium Term Notes	4,054	4,179	4,227	4,342	5.4	3.1	1.2	2.7	12.9

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

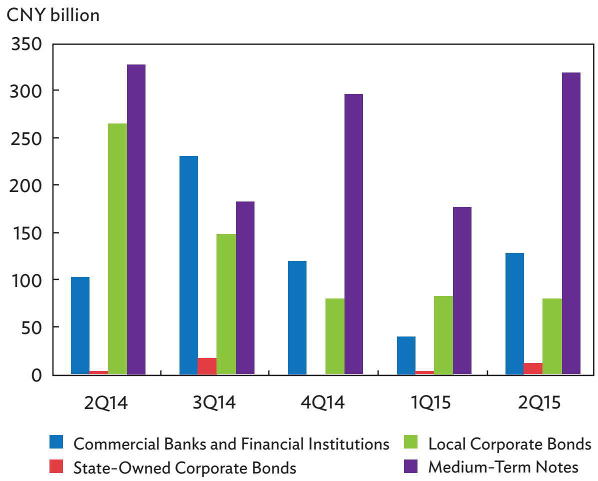
in policy bank bonds and Treasury bonds. The growth in Treasury bonds was dominated by a rapid increase in local government bonds. Local government bonds grew 61.0% q-o-q to CNY1.8 trillion. The rise in local government bonds was due to the central government's local government debt swap program, which sought to ease financing pressure as a large amount of local government debt was set to mature this year. Local government finances have also weakened this year, owing to lower revenue (due to lower property taxes) as well as increased government expenditures (e.g., shantytown renovations).

The amount of central bank bonds was steady on a q-o-q basis but fell on a y-o-y basis as the PBOC continued to opt to use other tools to manage liquidity, such as reverse repos, having not issued central bank bonds since December 2013.

Corporate Bonds. Corporate bonds outstanding grew 4.1% q-o-q and 13.7% y-o-y in 2Q15 to reach CNY12.3 trillion **(Table 2)**. Bonds with strong positive growth rates were those issued by banks and insurance companies, commercial paper, and local corporates. Commercial paper increased 9.2% q-o-q, while bonds issued by commercial banks and insurance companies rose 6.6% q-o-q. Local corporate bonds rose 3.3% q-o-q.

The rise in bonds issued by commercial bank bonds and insurance companies was due to a resurgence in the issuance of subordinated debt in 2Q15 versus 1Q15 as

Figure 2: Corporate Bond Issuance in Key Sectors



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

financial companies sought to bolster their capital bases **(Figure 2)**. Of the major corporate bond categories, however, medium-term notes were the largest in terms of issuance in 2Q15, due to refinancing as a number of medium-term notes matured.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At the end of 2Q15, the top 30 corporate bond issuers accounted for CNY5.0 trillion worth of corporate bonds outstanding, or about 41% of the market. The 10 largest issuers accounted for CNY3.3 trillion worth of bonds outstanding.

State-owned companies—defined as majority-owned by the government—continued to dominate the corporate bond market in 2Q15. Among the top 30 corporate issuers at end-June, 21 were state-owned. By industry, the top 30 list is 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 notable corporate bond issuances in 2Q15.

Investor Profile

Treasury Bonds and Policy Bank Bonds. Banks remained the investor category comprising the largest share of the PRC's Treasury bond market, which includes policy bank bonds, accounting for a slightly smaller share of the market at end-June (75.6%) than in the same period a year earlier (76.7%) **(Figure 3)**.

Corporate Bonds. Banks were also the largest holders of corporate bonds at the end of 2Q15, albeit with a comparatively smaller share than their holdings of Treasury bonds and policy bank bonds. Banks' share of corporate bonds fell to 25.6% at the end of 2Q15 from 28.9% a year earlier **(Figure 4)**. The second largest holders of corporate bonds were funds institutions, with a 26.0% share at end-June, up from a 22.9% share a year earlier.

Figure 5 presents investor profiles across corporate bond categories at end-June. Banks were the largest holders of medium-term notes with almost 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 a US interest rate hike and slowing domestic economic growth, the use of interest rate swaps increased in 2Q15, with the total volume of swaps rising 16.8% q-o-q. The bulk of interest rate swaps involved the 7-day repo rate, which accounted for 89% 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 Shanghai Interbank Offered Rate (SHIBOR) shock and a crackdown on illegal bond trades. However, 2Q15 showed a massive uptick in trading for all types of government bonds. The increased demand for government bonds was due to a flight to safety as the PRC's stock market experienced a significant decline in 2Q15.

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	1,133.5	182.79	Yes	No	Transportation
2.	State Grid Corporation of China	450.5	72.65	Yes	No	Public Utilities
3.	China National Petroleum	350.0	56.44	Yes	No	Energy
4.	Bank of China	298.9	48.20	Yes	Yes	Banking
5.	Industrial and Commercial Bank of China	260.0	41.93	Yes	Yes	Banking
6.	Agricultural Bank of China	260.0	41.93	Yes	Yes	Banking
7.	China Construction Bank	188.0	30.32	Yes	Yes	Banking
8.	China Minsheng Bank	136.5	22.01	No	Yes	Banking
9.	Petrochina	136.0	21.93	Yes	Yes	Energy
10.	Industrial Bank	136.0	21.93	No	Yes	Banking
11.	Shanghai Pudong Development Bank	124.2	20.03	No	Yes	Banking
12.	China Power Investment	121.4	19.58	Yes	No	Public Utilities
13.	Bank of Communications	119.0	19.19	No	Yes	Banking
14.	Central Huijin Investment	109.0	17.58	Yes	No	Diversified Financial
15.	Senhua Group	109.0	17.57	Yes	No	Energy
16.	China Citic Bank	103.5	16.69	No	Yes	Banking
17.	China Everbright Bank	88.9	14.34	Yes	Yes	Banking
18.	China Merchants Bank	79.0	12.74	No	Yes	Banking
19.	China Three Gorges Project	76.5	12.34	Yes	No	Public Utilities
20.	China Southern Power Grid	75.0	12.09	Yes	No	Public Utilities
21.	China Guodian	73.4	11.83	Yes	No	Public Utilities
22.	Haitong Securities	71.0	11.45	No	Yes	Financial Services
23.	Beijing State-owned Assets Operation & Management Center	70.5	11.37	Yes	No	Diversified Financial
24.	China Datang	69.2	11.16	Yes	No	Energy
25.	Shaanxi Coal and Chemical Industry Group	69.0	11.13	Yes	No	Energy
26.	China Petroleum and Chemical	68.5	11.05	Yes	Yes	Energy
27.	China Life	68.0	10.97	Yes	Yes	Insurance
28.	Tianjin Infrastructure Investment Group	67.9	10.95	Yes	No	Capital Goods
29.	Bank of Beijing	61.5	9.92	No	Yes	Banking
30.	CITIC Securities	58.3	9.40	No	Yes	Financial Services
Total Top 30 LCY Corporate Issuers		**5,032.13**	**811.50**			
Total LCY Corporate Bonds		**12,322.09**	**1,987.11**			
Top 30 as % of Total LCY Corporate Bonds		**40.8%**	**40.8%**			

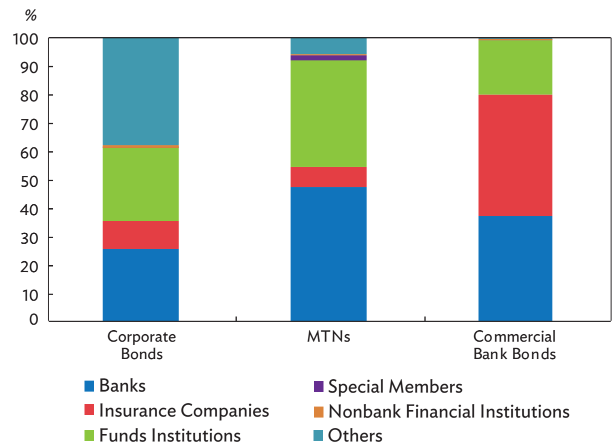
LCY = local currency.
Notes:
1. Data as of end-June 2015.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg data.

Table 4: Notable LCY Corporate Bond Issuance in 2Q15

Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
China Railway Corp.		
10-year bond	4.28	15
10-year bond	4.3	15
10-year bond	4.24	10
Haitong Securities Co. Ltd.		
3-year bond	5.3	15
5-year bond	5.5	15
China Minsheng Bank		
10-year bond	5.4	20
Petrochina		
3-year bond	4.03	20
China Cinda Asset Management		
5-year bond	4.3	10
State Grid Corporation of China		
1-year bond	3.4	10

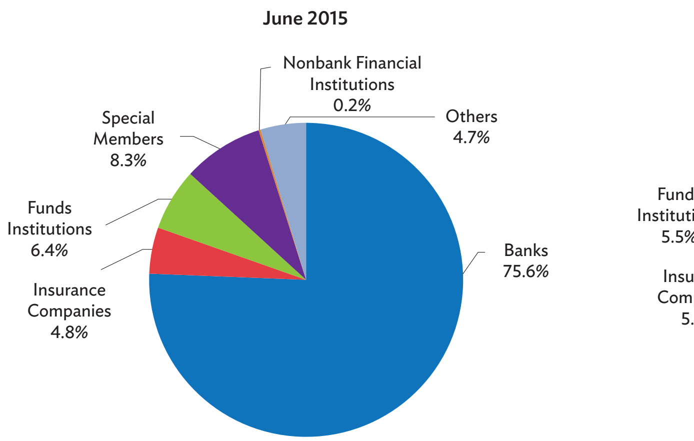
LCY = local currency.
Source: Bloomberg LP.

Figure 5: Investor Profile across Bond Categories



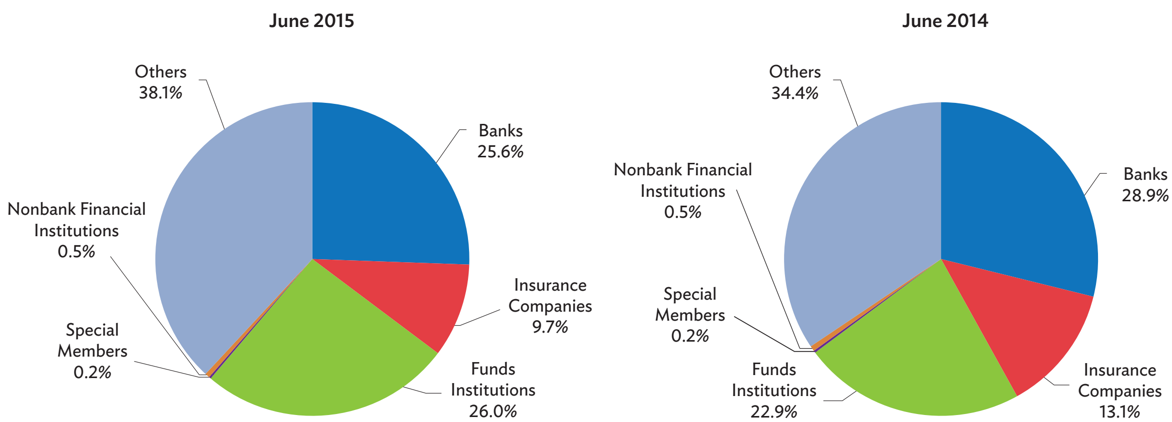
MTNs = medium-term notes.
Note: Data as of end-June 2015.
Source: *ChinaBond*.

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



LCY = local currency.
Source: *ChinaBond*.

Figure 4: LCY Corporate Bonds Investor Profile



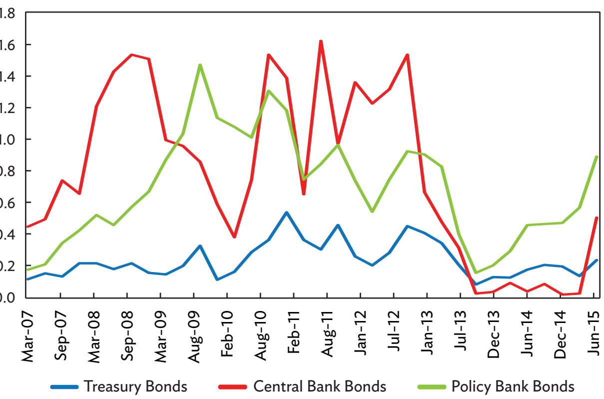
LCY = local currency.
Source: *ChinaBond*.

Table 5: Notional Values of the PRC's Interest Rate Swap Market in 2Q15

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	% of Total Notional Amount	Number of Transactions	Growth Rate (%) q-o-q
7-Day Repo Rate	1,727.5	89.1	15,569	13.2
Overnight SHIBOR	62.0	3.2	237	36.4
3-Month SHIBOR	136.6	7.0	1,270	92.5
1-Year Term Deposit Rate	5.1	0.3	34	(63.4)
LIBOR	0.0	0.0	0	0.0
1-Year Lending Rate	8.2	0.4	10	61.2
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	**1,939.3**	**100.0**	**17,120**	**16.8**

( ) = 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: *ChinaMoney*.

Figure 6: Turnover Ratios for Government Bonds



Source: *ChinaBond*.

Policy, Institutional, and Regulatory Developments

PBOC Reduces Reserve Requirement Ratios

On 28 June, the PBOC lowered the reserve requirement ratios of select financial institutions. City commercial banks and village and town commercial banks with a certain level of agricultural loans will be entitled to a 50-bps reduction in their reserve requirement ratios. Other banks—such as foreign banks and state-owned commercial banks that have met a certain level of loans to the agricultural sector or small enterprises—are entitled to a 50-bps reduction in their reserve requirement ratios. Finally, finance companies will have their reserve requirement ratios reduced by 300 bps.

PBOC Removes Bond Quotas for Sovereign Wealth Funds and Central Banks

On 16 July, the PBOC removed investment bond quotas for foreign central banks, sovereign wealth funds, and certain international financial institutions, such as the World Bank, investing in the interbank bond market. In addition, the application process for these institutions was streamlined and now requires simply registering with the PBOC before investing.

PBOC Revises Exchange-Rate-Setting Mechanism

On 11 August, the PBOC revised its central parity exchange-rate-setting mechanism. The PBOC said that under the new guidelines, market makers should submit quotes based on the prior closing of the interbank foreign exchange market, along with current demand and supply conditions. The quote should also take into account exchange rate movements in other currencies. According to the PBOC, external factors such as a recovering economy in the United States, weaker growth in the European Union and Japan (among other economies), and a strong trade surplus have led to a disparity in market expectations in the renminbi exchange rate versus the current exchange rate being set. The new mechanism is designed to move the central parity exchange rate more in line with market expectations