Market Summaries

People's Republic of China

Yield Movements

Between 1 March and 15 May, the local currency (LCY) government bond yield curve in the People's Republic of China (PRC) shifted upward, with yields for all tenors rising **(Figure 1)**. The largest increase was for the 1-year tenor, which rose 17 basis points (bps). The rise in yields was less pronounced at the longer-end of the curve, with yields for tenors more than 5 years rising only 2–4 bps. As a result, the 2-year versus 10-year spread fell from 39 bps on 1 March to 34 bps on 15 May.

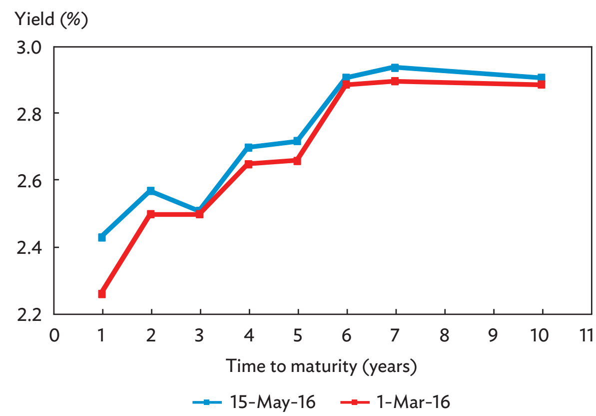
The rise in yields was in contrast to most of the economic data for the PRC. Gross domestic product growth slowed to 6.7% in the first quarter (Q1) of 2016 from 6.8% in the fourth quarter (Q4) of 2015. The slowdown was evident in all three major sectors of the economy. The agriculture sector's growth slowed to 2.9% in Q1 2016 from 4.1% in Q4 2015. The manufacturing sector's gross domestic product growth slowed to 5.8% in Q1 2016 from 6.1% in the prior quarter. Lastly, service sector growth fell to 7.6% from 8.2%.

Exports also remained weak. Monthly export data for Q1 2016 is somewhat distorted due to the varying timing of the Lunar New Year. Using January–April figures as a whole to remove this effect shows that exports fell 2.1% in renminbi terms and 7.6% in US dollar terms (due to the depreciation of the renminbi).

Inflation, however, showed signs of stabilizing. The consumer price inflation rate remained at 2.3% in February–April. Producer price inflation also showed some improvement, with the deflation rate falling to 3.4% in April from 4.3% in March.

To help spur the economy, the People's Bank of China (PBOC) reduced the reserve requirement ratio of financial institutions by 50 bps effective 1 March. The cut effectively reduced the reserve requirement ratio on large banks to 17.0%.

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



Source: Based on data from Bloomberg LP.

Despite the weak economic growth and reserve requirement ratio cut, the yield curve shifted upward in the PRC from 1 March to 15 May. An increased supply of government bonds for a debt swap program, particularly local government bonds, placed pressure on yields to rise.

The rise in yields was also driven by uncertainty over implementation of the new value-added tax (VAT), which is to be expanded to some financial transactions. While the details have not been finalized, markets were initially concerned that the value would increase borrowing costs for repurchase (repo) transactions and reduce income from policy bank bond holdings.

Negative risk sentiment weighed on bonds overall, driven by concerns over rising debt levels and corporate bond defaults in the PRC. In April, China Railway Materials announced that it would seek to restructure debt. In the same month, Dongbei Special Steel Group, Baoding Tianwei Group, and Chinacoal Group Shanxi Huayu Energy missed debt payments.

Size and Composition

Outstanding LCY bonds in the PRC grew 5.1% quarter-on-quarter (q-o-q) and 28.3% year-on-year (y-o-y) to CNY42.0 trillion (USD6.5 trillion) at the end of Q1 2016 **(Table 1)**.

Government Bonds. LCY government bonds outstanding stood at CNY27.8 trillion in Q1 2016 on q-o-q growth of 5.2% and y-o-y growth of 33.0%. Growth was driven by a large increase in Treasury bonds, which rose 5.8% q-o-q and 54.5% y-o-y. For the past few quarters, Treasury bonds have seen large increases due to continued issuances of local government bonds as local governments refinanced existing debt and reduced borrowing costs by swapping debt for municipal bonds. The total amount of local municipal bonds issued is covered by a cap, which has increased over time. The cap stands at CNY15 trillion and the government expects the debt swap program to be completed by the end of 2017.

Policy bank bonds continued to grow, though not at the same pace as Treasury bonds, with policy bank bonds expanding 4.6% q-o-q and 12.8% y-o-y. The outstanding amount of central bank bonds remained unchanged in Q1 2016 from the prior quarter as the PBOC has ceased issuing central bank bonds, using other tools to affect liquidity.

Corporate Bonds. Corporate bonds outstanding grew 4.9% q-o-q and 19.9% y-o-y to CNY14.2 trillion. Among the major bond categories, commercial paper and commercial bank bonds, and Tier 2 notes showed the strongest growth, rising 12.6% q-o-q and 9.3% q-o-q, respectively **(Table 2)**. Strong issuance by commercial banks and insurance companies continued to be driven by fund-raising efforts. However, medium-term notes outstanding rose only 1.8% q-o-q due to maturing debt.

Medium-term notes had the highest issuance level among the major bond categories in Q1 2016 **(Figure 2)**, but issuance was lower than in the prior quarter. Commercial bank bonds and Tier 2 notes issuance increased to CNY203 billion in Q1 2016 from CNY168 billion in Q4 2015 on continued fund-raising efforts.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At the end of Q1 2016, the top 30 corporate bond issuers accounted for CNY8.0 trillion worth of corporate bonds outstanding, or 56.7% of the PRC corporate market. Out of the top 30, the 10 largest issuers accounted for CNY4.8 trillion.

The top 30 issuer list is dominated by banks, owing to the continued issuances of commercial bank bonds as banks accelerate fund-raising. Among the top 30 corporate issuers, 20 of them were in the banking industry.

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

	Outstanding Amount (billion)						Growth Rates (%)			
	Q1 2015		Q4 2015		Q1 2016		Q1 2015		Q1 2016	
	CNY	USD	CNY	USD	CNY	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**32,731**	**5,279**	**39,938**	**6,150**	**41,983**	**6,505**	**1.6**	**12.0**	**5.1**	**28.3**
Government	20,894	3,370	26,408	4,067	27,791	4,306	1.0	10.0	5.2	33.0
Treasury Bonds	10,263	1,655	14,984	2,307	15,856	2,457	(0.4)	12.3	5.8	54.5
Central Bank Bonds	428	69	428	66	428	66	0.0	(22.5)	0.0	0.0
Policy Bank Bonds	10,203	1,646	10,996	1,693	11,507	1,783	2.5	9.6	4.6	12.8
Corporate	11,837	1,909	13,529	2,083	14,192	2,199	2.7	15.7	4.9	19.9
Policy Bank Bonds										
China Development Bank	6,337	1,022	6,601	1,017	6,816	1,056	1.1	5.8	3.3	7.6
Export–Import Bank of China	1,694	273	1,852	285	1,913	296	7.0	16.2	3.3	12.9
Agricultural Devt. Bank of China	2,172	350	2,543	392	2,778	430	3.0	16.4	9.2	27.9

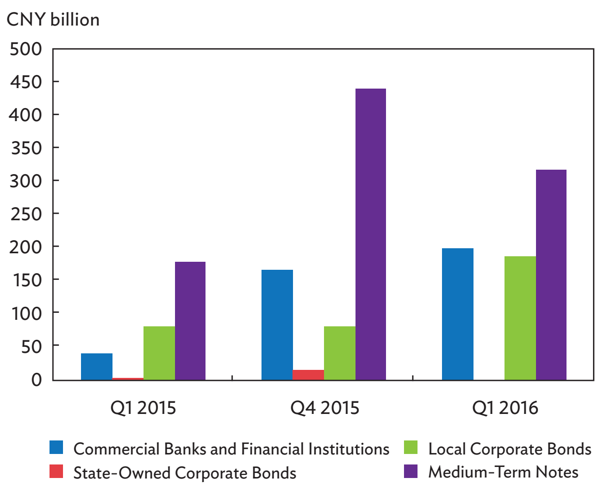
( ) = negative, CNY = Chinese yuan, q-o-q = quarter-on-quarter, Q1 = first quarter, Q4 = fourth quarter, USD = United States dollar, y-o-y = year-on-year.
Notes:
1. Calculated using data from national sources.
2. Treasury bonds include savings bonds and local government bonds.
3. Bloomberg LP end-of-period local currency–USD rate is used.
4. Growth rates are calculated from local currency 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 (%)			
				Q1 2015		Q1 2016	
	Q1 2015	Q4 2015	Q1 2016	q-o-q	y-o-y	q-o-q	y-o-y
Commercial Bank Bonds and Tier 2 Notes	1,639	2,009	2,196	1.0	22.0	9.3	34.0
SOE Bonds	612	588	583	1.0	(2.7)	(0.9)	(4.8)
Local Corporate Bonds	2,377	2,558	2,690	1.0	22.1	5.2	13.2
Commercial Paper	1,866	2,405	2,709	1.1	14.3	12.6	45.2
Medium-Term Notes	4,227	4,702	4,787	1.0	9.2	1.8	13.3

( ) = negative, CNY = Chinese yuan, q-o-q = quarter-on-quarter, Q1 = first quarter, Q4 = fourth quarter, SOE = state-owned enterprise, y-o-y = year-on-year.
Sources: *ChinaBond* and *Wind*.

Figure 2: Corporate Bond Issuance in Key Sectors



CNY = Chinese yuan, Q1 = first quarter, Q4 = fourth quarter.
Sources: *ChinaBond* and *Wind*.

Table 4 presents the most notable corporate bond issuances in Q1 2016. The list mainly comprises banks and oil companies, reflecting the fund-raising efforts of banks this year and the large financing needs of the oil industry.

Investor Profile

Treasury Bonds and Policy Bank Bonds. Banks remained the dominant investor group in Q1 2016, holding 71.9% of all Treasury bonds, including policy bank bonds **(Figure 3)**. This was down from the same period last year. The holdings of funds institutions, such as mutual funds, have steadily increased over time, comprising 10.3% in Q1 2016, up from 6.0% in Q1 2015.

Corporate Bonds. Banks were no longer the largest holders of corporate bonds at the end of Q1 2016. Banks' share of corporate bonds fell to 21.3% at the end of March 2016 from 26.6% a year earlier **(Figure 4)**. Funds institutions became the dominant holder of corporate bonds, holding 38.1% of the outstanding stock in Q1 2016, up from 23.3% a year earlier.

Figure 5 presents investor profiles across corporate bond categories at the end of March. Funds institutions are the dominant holders of local corporate bonds, with the percentage share of bank holdings declining over time. Banks and insurance companies are the dominant holders of commercial bank bonds, with commercial banks holding the majority of common bonds and insurance companies holding the most subordinated bonds.

Liquidity

Interest rate swap volumes fell 15.1% q-o-q, driven mostly by a decline in 7-day repo transactions. The 7-day repo interest rate swap is the most popular interest rate swap, accounting for nearly 82% of total transaction volume in Q1 2016 **(Table 5)**.

Figure 6 presents the turnover ratio of government bonds, broken down into Treasury bonds and policy bank bonds. In the later half of 2015 and in Q1 2016, trading volumes experienced an increase, particularly for policy bank bonds.

Table 3: Top 30 Issuers of Local Currency 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 (USD billion)			
1.	China Railway	1,253.5	194.23	Yes	No	Transportation
2.	Shanghai Pudong Development Bank	650.2	100.74	No	Yes	Banking
3.	Industrial Bank	573.6	88.88	No	Yes	Banking
4.	State Grid Corporation of China	368.1	57.04	Yes	No	Public Utilities
5.	China Merchants Bank	361.7	56.04	No	Yes	Banking
6.	China Citic Bank	334.4	51.81	No	Yes	Banking
7.	China Everbright Bank	330.1	51.14	Yes	Yes	Banking
8.	China National Petroleum	330.0	51.13	Yes	No	Energy
9.	Bank of China	310.6	48.12	Yes	Yes	Banking
10.	Industrial and Commercial Bank of China	283.1	43.86	Yes	Yes	Banking
11.	Ping An Bank	278.6	43.17	Yes	Yes	Banking
12.	Agricultural Bank of China	262.0	40.60	Yes	Yes	Banking
13.	Bank of Beijing	248.9	38.57	Yes	Yes	Banking
14.	China Construction Bank	218.1	33.80	Yes	Yes	Banking
15.	China Minsheng Bank	215.0	33.31	No	Yes	Banking
16.	Petrochina	201.3	31.19	Yes	Yes	Energy
17.	Huaxia Bank	188.6	29.22	Yes	No	Banking
18.	Evergrowing Bank	169.4	26.25	No	No	Banking
19.	Bank of Shanghai	167.1	25.90	Yes	Yes	Banking
20.	Bank of Beijing	150.2	23.27	Yes	Yes	Banking
21.	State Power Investment	144.0	22.31	Yes	No	Energy
22.	Bank of Communications	143.5	22.23	No	Yes	Banking
23.	Central Huijin Investment	127.7	19.78	Yes	No	Diversified Financial
24.	Senhua Group	118.5	18.36	Yes	No	Energy
25.	China Petroleum and Chemical	112.4	17.42	Yes	Yes	Energy
26.	China Three Gorges Project	112.0	17.35	Yes	No	Public Utilities
27.	China Southern Power Grid	109.0	16.89	Yes	No	Public Utilities
28.	Huishang Bank	99.6	15.44	Yes	Yes	Banking
29.	China Guangfa Bank	99.6	15.44	No	Yes	Banking
30.	China Zheshang Bank	87.9	13.62	No	No	Banking
Total Top 30 LCY Corporate Issuers		**8,048.53**	**1,247.14**			
Total LCY Corporate Bonds		**14,191.87**	**2,199.06**			
Top 30 as % of Total LCY Corporate Bonds		**56.7%**	**56.7%**			

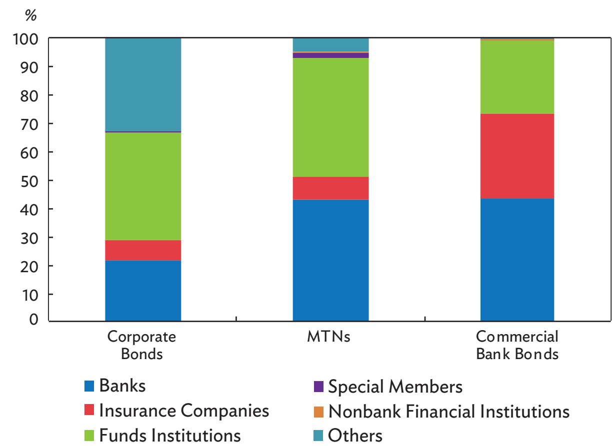
CNY = Chinese yuan, LCY = local currency, USD = United States dollar.
Notes:
1. Data as of end-March 2016.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg data.

Table 4: Notable Local Currency Corporate Bond Issuance in Q1 2016

Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
Huaxia Bank		
3-year bond	3.03	15
5-year bond	3.25	25
China National Petroleum		
3-year bond	3.05	20
Shanghai Pudong Development Bank		
3-year bond	2.95	20
Petrochina		
5-year bond	3.15	10
Founder Securities		
5-year bond	4.43	10
BOE Technology Group		
5-year bond	3.15	10

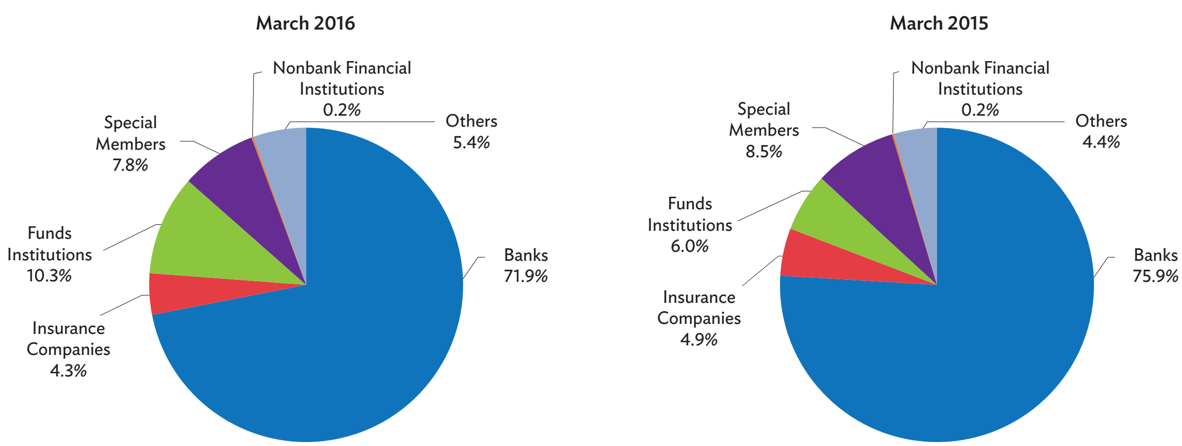
CNY = Chinese yuan, Q1 = first quarter.
Source: Based on data from Bloomberg LP.

Figure 5: Investor Profile across Bond Categories



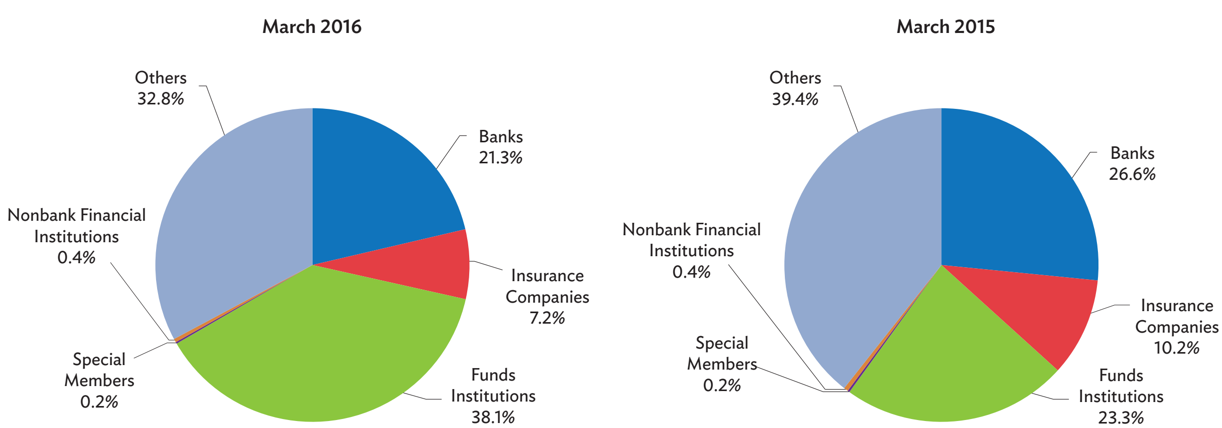
MTNs = medium-term notes.
Note: Data as of end-March 2016.
Source: *ChinaBond*.

Figure 3: Local Currency Treasury Bonds and Policy Bank Bonds Investor Profile



Source: *ChinaBond*.

Figure 4: Local Currency Corporate Bonds Investor Profile



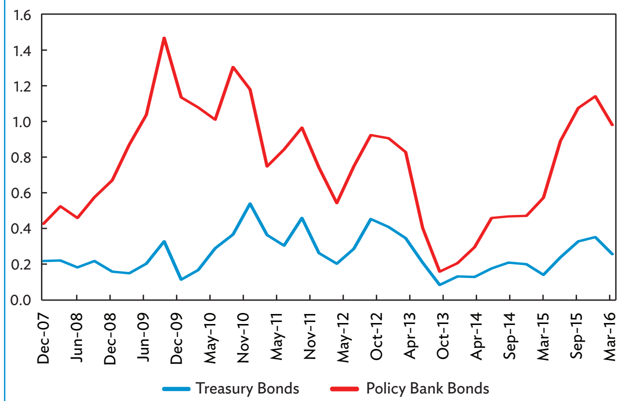
Source: *ChinaBond*.

Table 5: Notional Values of the People's Republic of China's Interest Rate Swap Market in Q1 2016

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	Percentage of Total Notional Amount (%)	Growth Rate (%)
	Q1 2016		q-o-q
7-Day Repo Rate	1,644.6	81.75	(16.95)
Overnight SHIBOR	120.3	5.98	(24.86)
3-Month SHIBOR	234.1	11.64	22.49
1-Year Term Deposit Rate	5.7	0.28	11.36
LIBOR	0.0	0.00	0.00
1-Year Lending Rate	6.4	0.32	(79.81)
LPR1Y	0.3	0.01	(55.99)
3-Year Lending Rate	0.4	0.02	0.00
5-Year Lending Rate	0.0	0.00	0.00
Total	**2,011.8**	**100.00**	**(15.08)**

( ) = negative, CNY = Chinese yuan, LIBOR = London Interbank Offered Rate, q-o-q = quarter-on-quarter, Q1 = first quarter, Repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate.
Note: Growth rate computed based on notional amounts.
Sources: *AsianBondsOnline* and *ChinaMoney*.

Figure 6: Turnover Ratios for Government Bonds



Source: *ChinaBond*.

Policy, Institutional, and Regulatory Developments

People's Bank of China Reduces Reserve Requirement Ratios

In March, the PBOC lowered the reserve requirement ratios of financial institutions by 50 bps. For large banks, the changes resulted in a reserve requirement ratio of 17.0%.

Value-Added Tax Applied to Financial Transactions

On 23 March, the PRC issued guidelines for the new VAT. Under the plan, the PRC will shift from levying a business tax on certain transactions and industries to a VAT-based one. The financial industry is one of the sectors affected, with interest income from loans and other income to be subject to a 6.0% VAT instead of a 5.5% business tax.