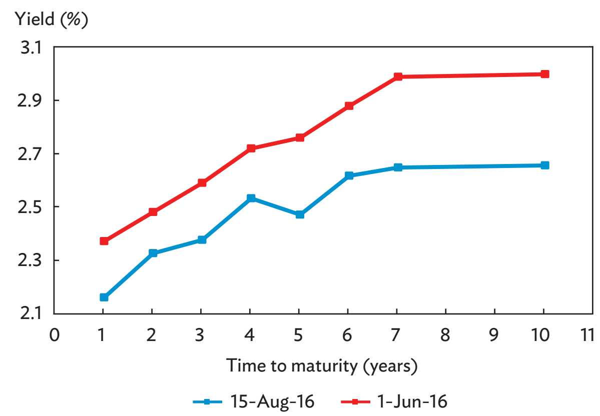
Market Summaries

People's Republic of China

Yield Movements

Between 1 June and 15 August, the People's Republic of China's (PRC) government bond yield curve shifted downward as yields fell for all tenors **(Figure 1)**. Yields dropped the most at the longer-end of the curve, with the 7-year and 10-year tenors falling 34 basis points (bps) each. The 2-year tenor fell the least, declining 16 bps, which led to the 2-year versus 10-year yield spread narrowing to 33 bps on 15 August from 52 bps on 1 June.

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



Source: Based on data from Bloomberg LP.

The fall in the PRC's yields was driven by recent macroeconomic data and demand factors for government bonds. The PRC's gross domestic product growth rate stood at 6.7% year-on-year (y-o-y) in the second quarter (Q2) of 2016, unchanged from the prior quarter. This growth rate is lower than that of the fourth quarter of 2015 when the PRC's economy expanded at a rate of 6.8%. Most analysts expect the PRC's economic growth to be slower moving forward compared to prior years.

Weak external demand has weighed on the economy. In United States dollar terms, exports fell 4.4% y-o-y in July, though this was a slightly better performance than June's 4.8% y-o-y drop. In addition, consumer price inflation has been on a downward trend, with consumer prices rising 1.8% y-o-y in July versus 1.9% y-o-y in June. Through the first 7 months of 2016, the inflation rate peaked at 2.3% y-o-y in February, March, and April.

Economic data also point to a softening economy in the PRC, which has pushed down yields and raised market expectations that the People's Bank of China will engage in another round of easing. The central bank last reduced reserve requirement ratios by 50 bps in February.

Yields in the PRC had risen early in the year due to increased supply risk in the LCY government bond market. While issuances of local government bonds have continued, markets have become increasingly concerned with credit risk in the corporate bond market sector. In a May 2016 news report, Deutsche Bank noted that there have been 40 defaults from bond issuers this year through April. As a result, there has been increased demand for safer assets such as government bonds, which has contributed to a fall in yields.

Size and Composition

LCY bonds in the PRC rose 8.0% quarter-on-quarter (q-o-q) and 30.6% y-o-y in Q2 2016, leading to CNY45.9 trillion (USD6.9 trillion) worth of bonds outstanding at the end of June **(Table 1)**.

Government Bonds. LCY government bonds outstanding rose 12.6% q-o-q in Q2 2016 versus 5.2% q-o-q in the prior quarter. The LCY government bond market grew 40.0% on a y-o-y basis. Treasury bonds were the main driver of q-o-q growth, rising 19.5% q-o-q. Within Treasury bonds, growth continues to be driven by the issuance of local government bonds. Outstanding local government bonds grew 45.5% q-o-q in Q2 2016. The rapid rise in issuance was due to an ongoing exchange of local government debt for bonds. In the first 6 months of 2016, total local government bond issuance stood at CNY3.6 trillion. In contrast,

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

	Outstanding Amount (billion)						Growth Rates (%)			
	Q2 2015		Q1 2016		Q2 2016		Q2 2015		Q2 2016	
	CNY	USD	CNY	USD	CNY	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**35,137**	**5,666**	**42,485**	**6,583**	**45,897**	**6,904**	**6.0**	**15.4**	**8.0**	**30.6**
Government	22,344	3,603	27,791	4,306	31,286	4,706	6.9	13.9	12.6	40.0
Treasury Bonds	11,284	1,820	15,856	2,457	18,955	2,851	9.9	19.3	19.5	68.0
Central Bank Bonds	428	69	428	66	428	64	0.0	(12.5)	0.0	0.0
Policy Bank Bonds	10,632	1,715	11,507	1,783	11,902	1,790	4.2	9.9	3.4	11.9
Corporate	12,793	2,063	14,694	2,277	14,611	2,198	4.4	18.1	(0.6)	14.2
Policy Bank Bonds										
China Development Bank	6,538	1,054	6,816	1,056	6,976	1,049	3.2	5.2	2.3	6.7
Export–Import Bank of China	1,797	290	1,913	296	1,988	299	6.1	21.4	3.9	10.6
Agricultural Devt. Bank of China	2,297	370	2,778	430	2,939	442	5.7	16.1	5.8	28.0

( ) = negative, CNY = Chinese yuan, q-o-q = quarter-on-quarter, Q1 = first quarter, Q2 = second 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 Info*, and Bloomberg LP

local governments issued CNY3.8 trillion during the whole of 2015. Out of the CNY3.5 trillion issued during the first half of 2016, CNY900 billion comprised new local government bonds issuance with the remainder coming from a debt swap. New bond issuance is already approaching the CNY1.18 trillion quota set by the PRC for total local government bond issuance for full-year 2016. The rise in issuance was also driven by maturing obligations in 2016, with an estimated CNY2.8 trillion due to mature in 2016, as well as increased funding demand driven by various local government projects.

Policy bank bonds continued to increase in Q2 2016, albeit at a slower pace than in the previous quarter, expanding 3.4% q-o-q and 11.9% y-o-y. The outstanding amount of central bank bonds remained unchanged in Q2 2016 from the prior quarter due to a lack of new issuance.

Corporate Bonds. Corporate bonds outstanding fell 0.6% q-o-q but rose 14.2% y-o-y to reach CNY14.6 trillion at the end of June **(Table 2)**. Within the major bond categories, commercial bank bonds and Tier 2 notes and local corporate bonds expanded 3.4% q-o-q and 3.6% q-o-q, respectively. Strong issuance by commercial banks and insurance companies also continued in Q2 2016. However, state-owned enterprise bonds, commercial paper, and medium-term notes outstanding all posted declines during the quarter. The largest decline was in commercial paper, which fell 6.7% q-o-q, as demand waned following several commercial paper defaults and the discovery of a trading scam involving two employees at Agricultural Bank of China.

Overall issuance levels declined in Q2 2016 versus Q1 2016 **(Figure 2)**. The overall decline in corporate bond issuance was due to increasing risk aversion among investors resulting from a rising number of corporate bond defaults. Medium-term note issuance still remains the highest among the major bond categories (excluding commercial paper) due to its relatively easy issuance process.

A relatively small number of issuers dominate the PRC's corporate bond market **(Table 3)**. At the end of June, the top 30 corporate bond issuers accounted for CNY5.6 trillion worth of corporate bonds outstanding, or about 38.6% of the total market. Out of the top 30, the 10 largest issuers accounted for CNY3.7 trillion.

The top 30 issuer list has become dominated by banks, owing to the continued issuance of commercial bank bonds as banks accelerate their fundraising. Among the top 30 corporate issuers at the end of June, 14 were in the banking industry.

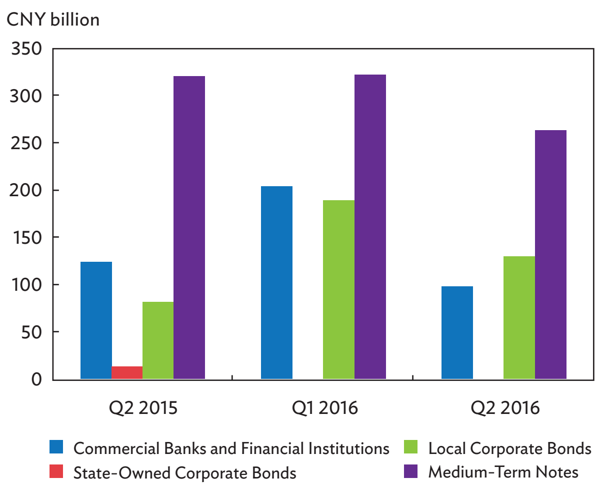
Table 4 presents the most notable corporate bond issuances in Q2 2016. The list mainly comprises financial institutions and infrastructure-related companies,

Table 2: Corporate Bonds Outstanding in Key Categories

	Amount (CNY billion)			Growth Rate (%)			
				Q2 2015		Q2 2016	
	Q2 2015	Q1 2016	Q2 2016	q-o-q	y-o-y	q-o-q	y-o-y
Commercial Bank Bonds and Tier 2 Notes	1,719	2,196	2,271	1.0	25.5	3.4	32.1
SOE Bonds	617	583	575	1.0	(0.3)	(1.4)	(6.8)
Local Corporate Bonds	2,443	2,690	2,787	1.0	17.1	3.6	14.1
Commercial Paper	2,249	2,820	2,632	1.0	22.1	(6.7)	17.1
Medium-Term Notes	4,043	4,512	4,496	1.0	8.4	(0.4)	11.2

( ) = negative, CNY = Chinese yuan, q-o-q = quarter-on-quarter, Q1 = first quarter, Q2 = second quarter, SOE = state-owned enterprise, y-o-y = year-on-year.
Sources: *ChinaBond* and *Wind Info*.

Figure 2: Corporate Bond Issuance in Key Sectors



CNY = Chinese yuan, Q1 = first quarter, Q2 = second quarter.
Sources: *ChinaBond* and *Wind Info*.

reflecting the fundraising efforts of banks and the significant financing needs of the oil industry.

Investor Profile

Treasury Bonds and Policy Bank Bonds. Banks held 69.9% of all Treasury bonds, including policy bank bonds, at the end of June **(Figure 3)**. This share was down from a year earlier. The holdings of funds institutions, such as mutual funds, have steadily increased over time, comprising 12.3% of all Treasury bonds and policy bank bonds at the end of June, up from 6.4% a year earlier.

Corporate Bonds. Banks were no longer the largest holder of LCY corporate bonds at the end of June. Their share of the corporate bond market fell to 19.5% at the end of June from 25.6% a year earlier **(Figure 4)**. Fund institutions became the dominant holder of corporate bonds, driven by mutual funds seeking higher yields, with a share of the outstanding stock that rose to 41.8% at the end of June from 26.0% a year earlier.

Figure 5 presents investor profiles across corporate bond categories at the end of June. Funds institutions were the dominant holder of both local corporate bonds and medium-term notes. On the other hand, the share of banks' holdings declined from a year earlier. Banks and insurance companies were the dominant holders of commercial bank bonds at the end of June, with banks holding the majority of common bonds and insurance companies holding the most subordinated bonds.

Liquidity

Interest rate swap volumes rose 17.7% q-o-q, driven mostly by an increase in 7-day repurchase transactions. The 7-day repurchase interest rate swap is the most popular interest rate swap, accounting for nearly 91% of total transaction volume in Q2 2016 **(Table 5)**.

Figure 6 presents the turnover ratio of government bonds, broken down into Treasury bonds and policy bank bonds. There was a surge in trading activity for both types of government bonds in Q2 2016 due to increased demand for safer assets owing to credit concerns in the corporate bond market.

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	1,258.5	189.31	Yes	No	Transportation
2.	State Grid Corporation of China	472.1	71.01	Yes	No	Public Utilities
3.	China National Petroleum	410.0	61.67	Yes	No	Energy
4.	Industrial and Commercial Bank of China	283.0	42.57	Yes	Yes	Banking
5.	Agricultural Bank of China	260.0	39.11	Yes	Yes	Banking
6.	Bank of China	258.9	38.94	Yes	Yes	Banking
7.	China Construction Bank	212.0	31.89	Yes	Yes	Banking
8.	Petrochina	181.0	27.23	Yes	Yes	Energy
9.	Industrial Bank	176.0	26.47	No	Yes	Banking
10.	Shanghai Pudong Development Bank	169.6	25.51	No	Yes	Banking
11.	Bank of Communications	149.0	22.41	No	Yes	Banking
12.	State Power Investment	136.2	20.49	Yes	No	Energy
13.	China Minsheng Bank	135.1	20.32	No	Yes	Banking
14.	Bank of Beijing	122.9	18.49	Yes	Yes	Banking
15.	Central Huijin Investment	109.0	16.40	Yes	No	Diversified Financial
16.	China Citic Bank	107.5	16.17	No	Yes	Banking
17.	Senhua Group	106.0	15.94	Yes	No	Energy
18.	China Petroleum and Chemical	98.5	14.82	Yes	Yes	Energy
19.	China United Network Communications	91.0	13.69	Yes	Yes	Telecommunications
20.	China Everbright Bank	88.9	13.37	Yes	Yes	Banking
21.	China Datang	86.7	13.04	Yes	Yes	Energy
22.	China Three Gorges Project	85.5	12.86	Yes	No	Public Utilities
23.	China Guangfa Bank	84.5	12.71	No	Yes	Banking
24.	Shaanxi Coal and Chemical Industry Group	83.5	12.56	Yes	Yes	Energy
25.	Huaxia Bank	80.4	12.09	Yes	No	Banking
26.	Tianjin Infrastructure Construction & Investment Group	79.4	11.94	Yes	No	Industrial
27.	China Merchants Bank	79.0	11.88	No	Yes	Banking
28.	Haitong Securities	78.0	11.73	Yes	Yes	Brokerage
29.	China Huarong Asset Management	77.0	11.58	Yes	Yes	Asset Management
30.	China Southern Power Grid	74.0	11.13	Yes	No	Public Utilities
Total Top 30 LCY Corporate Issuers		**5,633.20**	**847.35**			
Total LCY Corporate Bonds		**14,611.50**	**2,197.88**			
Top 30 as % of Total LCY Corporate Bonds		**38.6%**	**38.6%**			

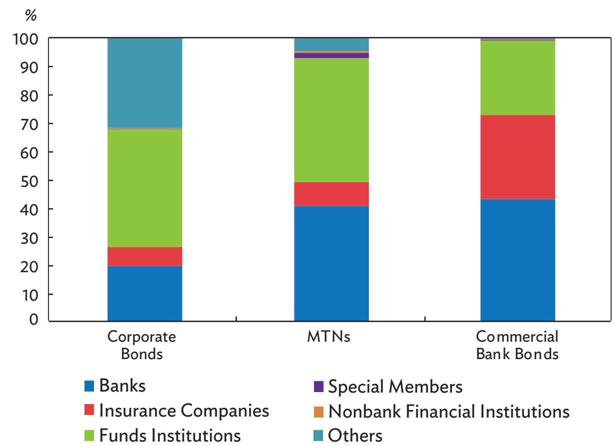
CNY = Chinese yuan, LCY = local currency, USD = United States dollar.
Notes:
1. Data as of end-June 2016.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

Table 4: Notable Local Currency Corporate Bond Issuance in Q2 2016

Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
China Railway		
5-year bond	3.35	15
10-year bond	3.46	20
Industrial Bank		
10-year bond	3.74	30
Haitong Securities		
4-year bond	3.60	15
China Guangfa Bank		
5-year bond	3.52	15
China Cinda Asset Masnagement		
10-year bond	3.70	10
Ping An Life Insurance		
10-year bond	3.82	10

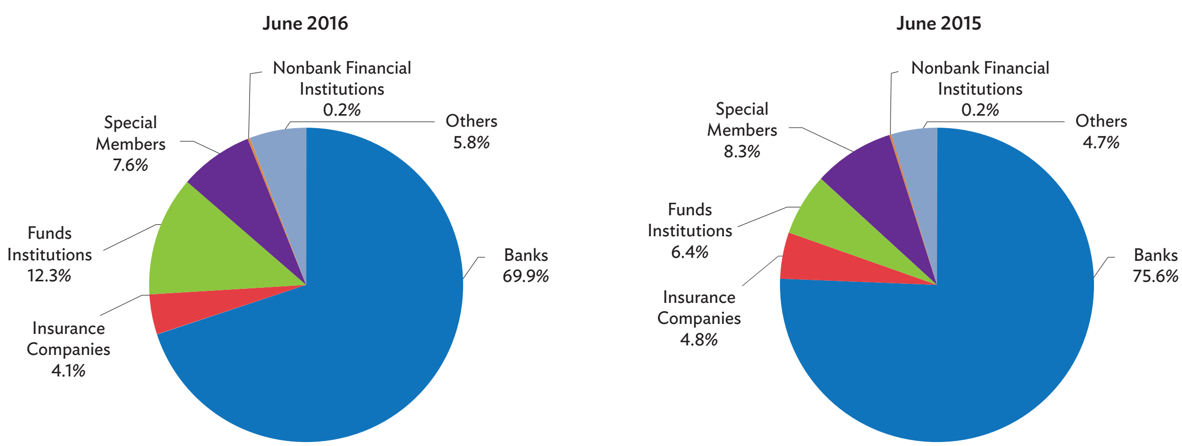
CNY = Chinese yuan, Q2 = second quarter.
Source: Based on data from Bloomberg LP.

Figure 5: Investor Profile across Bond Categories



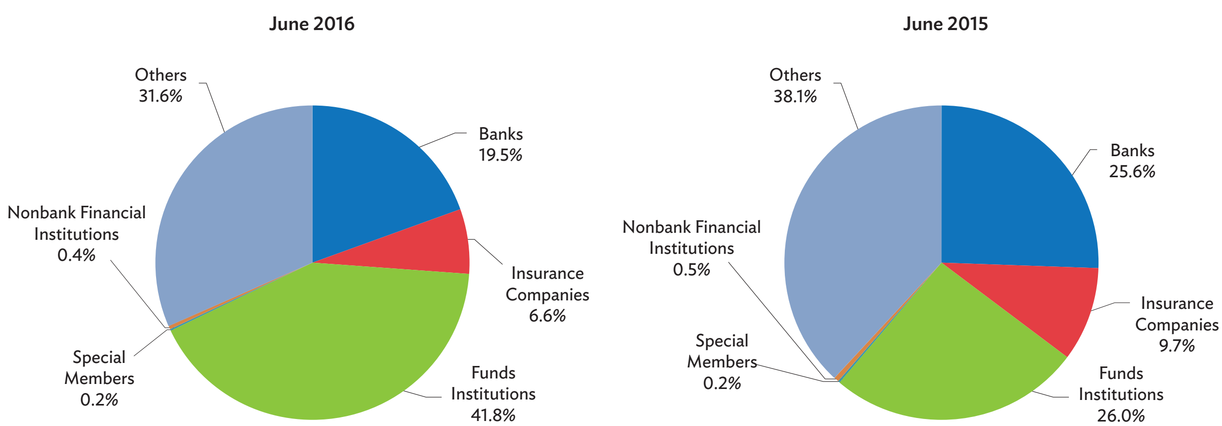
MTNs = medium-term notes.
Note: Data as of end-June 2016.
Source: *ChinaBond*.

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



Source: *ChinaBond*.

Figure 4: Local Currency Corporate Bonds Investor Profile



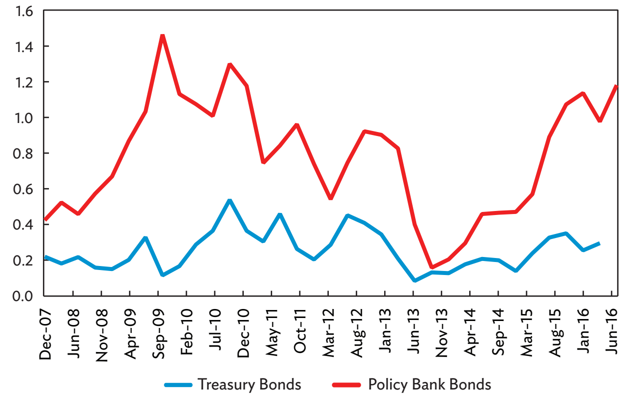
Source: *ChinaBond*.

Table 5: Notional Values of the People's Republic of China's Interest Rate Swap Market in Q2 2016

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	Percentage of Total Notional Amount (%)	Growth Rate (%)
	Q2 2016		q-o-q
7-Day Repo Rate	2,145.2	90.6	30.4
Overnight SHIBOR	53.0	2.2	(55.9)
3-Month SHIBOR	154.7	6.5	(33.9)
1-Year Term Deposit Rate	7.1	0.3	26.1
1-Year Lending Rate	8.0	0.3	23.6
3-Year Lending Rate	0.6	0.02	40.0
Total	**2,368.5**	**100.0**	**17.7**

( ) = negative, CNY = Chinese yuan, q-o-q = quarter-on-quarter, Q2 =second quarter, Repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate.
Notes:
1. Growth rate computed based on notional amounts.
2. London Interbank Offered Rate, 1-Year Loan Prime Rate, and 5-Year Lending Rate had no transaction for Q2 2016.
Sources: *AsianBondsOnline* and *ChinaMoney*.

Figure 6: Turnover Ratios for Government Bonds



Source: *ChinaBond*.

Policy, Institutional, and Regulatory Developments

Green Bonds Program Expanded

On 6 April, the government launched a pilot program to allow PRC-based issuers to issue and list green bonds on the Shanghai Stock Exchange. To qualify as a green bond, the most important requirement is that only green assets and projects can be funded by the proceeds of the bond.

World Bank Group to Issue Special Drawing Rights-Denominated Bonds in the Interbank Bond Market

On 21 August, the PRC approved the International Bank for Reconstruction and Development of the World Bank Group to issue Special Drawing Rights-denominated bonds in the PRC's interbank bond market. The issue size will be SDR2 billion and the bond will be settled in renminbi.