Market Summaries

People's Republic of China

Yield Movements

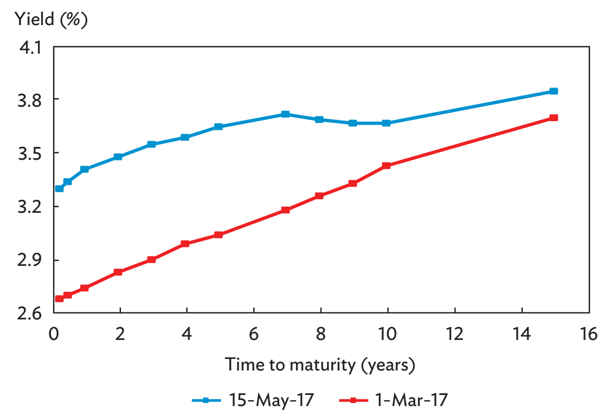
The local currency (LCY) government bond yield curve of the People's Republic of China (PRC) shifted strongly upward between 1 March and 15 May for all tenors (**Figure 1**). Yields gained the most for tenors of 5 years or less, with yields rising between 60 basis points (bps) and 67 bps. For tenors longer than 5 years, yields rose between 15 bps and 54 bps. As a result of the much faster rise at the short-end of the curve, the 2-year versus 10-year yield spread fell to 19 bps on 15 May from 60 bps on 1 March.

The rise in yields in the PRC was largely due to efforts by the government to reduce credit risk in its financial markets through a mix of regulatory and market-based measures. These measures include raising interest rates on various open market operation tools to reduce lending by financial institutions and increase costs for borrowers. On 24 January, the People's Bank of China (PBOC) raised interest rates on its 6-month and 1-year Medium-Term Lending Facility by 10 bps each. On 3 February, the central bank raised interest rates on its reverse repurchase agreements by 10 bps and on its Standing Lending Facility by 35 bps. The PBOC raised rates again on its reverse repurchase operations and Medium-Term Lending Facility by 10 bps each on 16 March.

In January, the PRC reportedly instructed banks to reduce lending, particularly mortgage lending, during the first quarter (Q1) of 2017. The PRC also sought to impose additional oversight on wealth management products by increasing disclosure requirements and, as of May 2017, was planning to raise capital requirements on banks.

Despite deleveraging efforts, the PRC reported real gross domestic product (GDP) growth of 6.9% year-on-year (y-o-y) in Q1 2017, up from GDP growth of 6.8% y-o-y in the fourth quarter (Q4) of 2016. The gains in the GDP growth rate were driven mostly by the manufacturing sector, which grew 6.4% y-o-y in Q1 2017 compared with 6.1% y-o-y in Q4 2016. The PRC is targeting slower GDP growth of 6.5% in full-year 2017 versus an actual growth of 6.7% in 2016.

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



Source: Based on data from Bloomberg LP.

Inflation in the PRC has been relatively soft. In 2017, consumer price inflation peaked at 2.5% y-o-y in January and fell to 0.8% y-o-y in February before rising slightly to 0.9% y-o-y in March and 1.2% in April.

Size and Composition

The PRC's outstanding LCY bonds rose 0.8% quarter-on-quarter (q-o-q) and 17.2% y-o-y to reach CNY49.9 trillion (USD7.2 trillion) at the end of March (**Table 1**).

Government Bonds. Growth in the PRC's bond market was driven mostly by increases in government bonds outstanding, which gained 1.6% q-o-q and 26.3% y-o-y to CNY35.1 trillion. The slower growth rates in Q1 2017 versus Q4 2016 were due to an overall decline in government bond issuance (except policy bank bonds) as authorities concerned with credit risk in the PRC's bond markets continued with efforts to reduce risk.

In particular, growth rates for municipal bonds slowed, with local government bonds outstanding growing 3.6% q-o-q in Q1 2017 after rising 9.3% q-o-q in Q4 2016. In April, the PRC announced that local government bond issuance would be governed by a formula to limit

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

	Outstanding Amount (billion)						Growth Rates (%)			
	Q1 2016		Q4 2016		Q1 2017		Q1 2016		Q1 2017	
	CNY	USD	CNY	USD	CNY	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**42,569**	**6,596**	**49,510**	**7,129**	**49,895**	**7,245**	**4.9**	**28.2**	**0.8**	**17.2**
Government	27,791	4,306	34,545	4,974	35,113	5,098	5.2	33.0	1.6	26.3
Treasury Bonds	15,856	2,457	22,142	3,188	22,510	3,268	5.8	54.5	1.66	42.0
Central Bank Bonds	428	66	6	1	0	0	0.0	0.0	(100.0)	(100.0)
Policy Bank Bonds	11,507	1,783	12,397	1,785	12,604	1,830	4.6	12.8	1.7	9.5
Corporate	14,778	2,290	14,965	2,155	14,782	2,146	4.3	20.1	(1.2)	0.03
Policy Bank Bonds										
China Development Bank	6,816	1,056	7,081	1,020	7,185	1,043	3.3	7.6	1.5	5.4
Export–Import Bank of China	1,913	296	2,133	307	2,190	318	3.3	12.9	2.7	14.5
Agricultural Devt. Bank of China	2,778	430	3,184	458	3,229	469	9.2	27.9	1.4	16.2

( ) = negative, CNY = Chinese yuan, LCY = local currency, 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 LCY–USD rate is used.
4. Growth rates are calculated from an LCY base and do not include currency effects.
Sources: *ChinaBond*, *Wind Info*, and Bloomberg LP.

debt issuance by riskier local governments. However, overall local government bond issuance is still expected to increase in 2017 as the quota for local government bonds outstanding was raised from CNY17.2 trillion to CNY18.8 trillion.

Central bank bonds outstanding fell to zero in Q1 2017 as all remaining central bank bonds have matured since the cessation of central bank bond issuance by the PBOC in 2014. In contrast to slowing growth in other government bonds, policy bank bonds grew 1.7% q-o-q in Q1 2017 versus 1.5% q-o-q in the previous quarter.

Corporate Bonds. Corporate bonds outstanding declined in Q1 2017, falling 1.2% q-o-q and growing only 0.03% y-o-y to CNY14.8 trillion at the end of March (**Table 2**). The decline was mostly due to slowing growth in medium-term notes and a dip in outstanding commercial paper. Medium-term notes expanded 0.5% q-o-q in Q1 2017, while commercial paper declined 10.8% q-o-q. All other major corporate bond categories showed q-o-q declines except commercial bank bonds and Tier 2 notes, albeit not to the extent of commercial paper. The decline in corporate bonds outstanding is a result of the PRC's continued deleveraging efforts, which has led to a decline in issuance amid rising interest rates. Commercial paper was most affected with the rise in interest rates, leading to a reluctance by corporate borrowers to issue short-term debt.

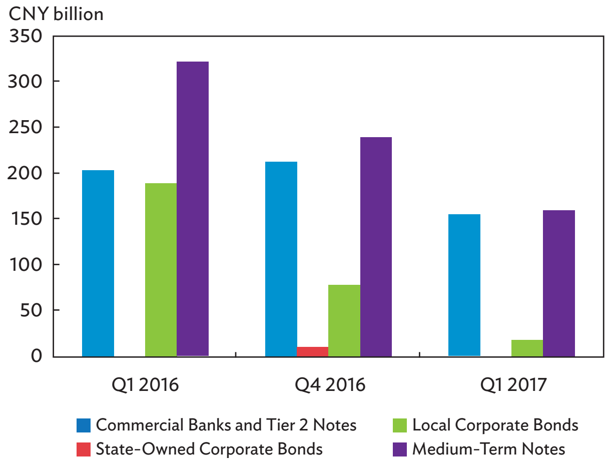
As a result of deleveraging, corporate bond issuance declined 39.1% q-o-q, with all major corporate bond categories showing declines in Q1 2017 (**Figure 2**). The smallest declines were seen in commercial bank bonds

Table 2: Corporate Bonds Outstanding in Key Categories

	Amount (CNY billion)			Growth Rate (%)			
				Q1 2016		Q1 2017	
	Q1 2016	Q4 2016	Q1 2017	q-o-q	y-o-y	q-o-q	y-o-y
Commercial Bank Bonds and Tier 2 Notes	2,196	2,522	2,534	1.1	34.0	0.5	15.4
SOE Bonds	583	546	542	1.0	(4.8)	(0.6)	(7.0)
Local Corporate Bonds	2,690	2,936	2,912	1.1	13.2	(0.8)	8.3
Commercial Paper	2,841	2,144	1,912	1.1	31.3	(10.8)	(32.7)
Medium-Term Notes	4,575	4,678	4,701	1.0	13.3	0.5	2.8

( ) = 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 Info*.

Figure 2: Corporate Bond Issuance in Key Sectors



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

and Tier 2 notes, where issuance fell 27.2% q-o-q as financial institutions continued issuance for the purpose of raising capital and boosting liquidity with long-term funding.

The decline in issuance stemmed from deleveraging, which raised borrowing costs for issuers. Risk aversion resulting from recent corporate bond defaults also led to rising interest rates.

The PRC's corporate bond market is dominated by a few big issuers (**Table 3**). At the end of Q4 2016, the top 30 corporate bond issuers accounted for CNY5.8 trillion worth of corporate bonds outstanding, or about 39.5% of the total market. Out of the top 30, the 10 largest issuers accounted for CNY3.8 trillion.

The top 30 issuer list is dominated by banks, owing to the continued issuance of commercial bank bonds as banks accelerate their fund-raising amid turmoil in credit markets in order to strengthen their capital base and improve liquidity by using long-term funding. Among the top 30 corporate issuers at the end of March, 14 were in the banking industry.

Table 4 lists the most notable corporate bond issuances in Q1 2017. Most companies on the list are from the banking sector, while one issuer, China Railway, is from the infrastructure sector.

Investor Profile

Treasury Bonds and Policy Bank Bonds. Banks' share of investments in Treasury bonds, including policy bank bonds, continued to fall in Q1 2017, declining to 67.9% at the end of March from 71.9% a year earlier (**Figure 3**). The share of funds institutions rose to 13.6% from 10.3% during the review period.

Corporate Bonds. Due to continued declines in the share of bank holdings of corporate bonds, funds institutions are now the largest investor in the PRC's LCY corporate bond market, with their share rising to 47.5% at the end of March from 38.1% a year earlier (**Figure 4**). Banks' share continued to decline in Q1 2017, falling to 15.9% from 21.3% in Q1 2016. The larger drop in banks' share of corporate bonds versus Treasury bonds was due to rising risk aversion driven by credit defaults as well as the PRC's deleveraging efforts.

Figure 5 details the investor profile across different corporate bond categories at the end of March. Funds institutions are the dominant buyer of both local corporate bonds and medium-term notes, while banks and insurance companies were the dominant holders of commercial bank bonds.

Liquidity

The volume of interest rate swaps declined 9.7% q-o-q. The 7-day repurchase interest rate is the most used interest rate swap, comprising an 89.4% share of interest rate swap volume during the review period (**Table 5**).

The rise in interest rates due to efforts by the PRC to deleverage has led to reduced trading activity owing to a negative outlook on bond prices (**Figure 6**).

Ratings Update

On 24 May, Moody's Investor Services reduced the PRC's long-term local and foreign currency ratings by one notch to A1. According to Moody's Investor Services, the downgrade reflects expectations that the PRC's overall debt levels will continue to rise as the economy's potential growth slows.

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	1,381.5	200.59	Yes	No	Transportation
2.	State Grid Corporation of China	450.8	65.45	Yes	No	Public Utilities
3.	China National Petroleum	355.0	51.54	Yes	No	Energy
4.	Agricultural Bank of China	278.0	40.36	Yes	Yes	Banking
5.	Industrial and Commercial Bank of China	268.0	38.91	Yes	Yes	Banking
6.	Bank of China	258.9	37.59	Yes	Yes	Banking
7.	Bank of Communications	215.0	31.22	Yes	Yes	Banking
8.	China Construction Bank	212.0	30.78	No	Yes	Banking
9.	Industrial Bank	185.0	26.86	No	Yes	Banking
10.	China Minsheng Banking	175.1	25.42	No	Yes	Banking
11.	Shanghai Pudong Development Bank	169.6	24.63	Yes	Yes	Energy
12.	PetroChina	155.0	22.51	No	Yes	Banking
13.	China Everbright Bank	154.9	22.49	Yes	No	Energy
14.	State Power Investment	134.5	19.53	Yes	Yes	Banking
15.	Bank of Beijing	122.9	17.84	Yes	No	Asset Management
16.	Central Huijin Investment	109.0	15.83	No	Yes	Banking
17.	China CITIC Bank	107.5	15.61	Yes	No	Energy
18.	Shenhua Group	104.5	15.17	Yes	Yes	Energy
19.	China Huarong Asset Management	96.0	13.94	Yes	Yes	Banking
20.	Tianjin Infrastructure Construction and Investment Group	91.5	13.29	Yes	Yes	Energy
21.	China Three Gorges	88.5	12.85	Yes	No	Public Utilities
22.	China Guangfa Bank	86.5	12.56	No	Yes	Banking
23.	Dalian Wanda Commercial Properties	85.0	12.34	Yes	No	Industrial
24.	Haitong Securities	81.2	11.80	Yes	Yes	Energy
25.	China United Network Communications	81.0	11.76	Yes	No	Banking
26.	Huatai Securities	79.9	11.60	No	Yes	Banking
27.	Guotai Junan Securities	79.0	11.47	Yes	Yes	Brokerage
28.	Huaxia Bank	78.4	11.38	Yes	Yes	Telecommunications
29.	Postal Savings Bank of China	75.0	10.89	Yes	Yes	Asset Management
30.	China Datang	74.7	10.85	Yes	No	Asset Management
Total Top 30 LCY Corporate Issuers		**5,833.94**	**847.07**			
Total LCY Corporate Bonds		**14,782.17**	**2,146.33**			
Top 30 as % of Total LCY Corporate Bonds		**39.5%**	**39.5%**			

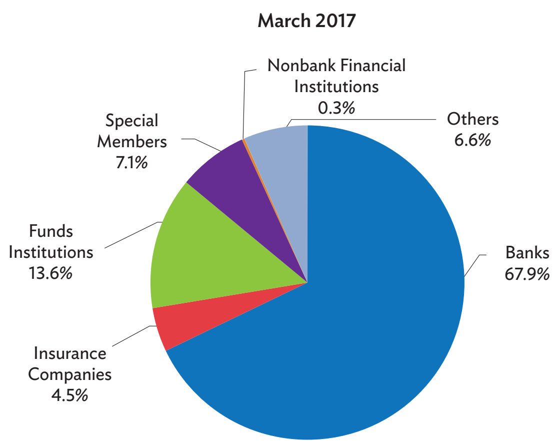
CNY = Chinese yuan, LCY = local currency, USD = United States dollar.
Notes:
1. Data as of end-March 2017.
2. State-owned firms are defined as those in which the government has more than a 50% ownership stake.
Source: *AsianBondsOnline* calculations based on Bloomberg LP data.

Table 4: Notable Local Currency Corporate Bond Issuance in the First Quarter of 2017

Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
China Railway		
180-day bond	3.92	20.0
3-year bond	3.87	20.0
5-year bond	4.30	15.0
10-year bond	4.25	5.0
China Everbright Bank		
3-year bond	4.00	28.0
10-year bond	4.60	28.0
Minsheng Banking		
3-year bond	4.00	30.0
Everbright Securities		
1-year bond	4.00	2.0
1-year bond	4.10	2.0
2-year bond	4.30	20.0
3-year bond	4.45	2.0
Postal Savings Bank		
10-year bond	4.50	20.0

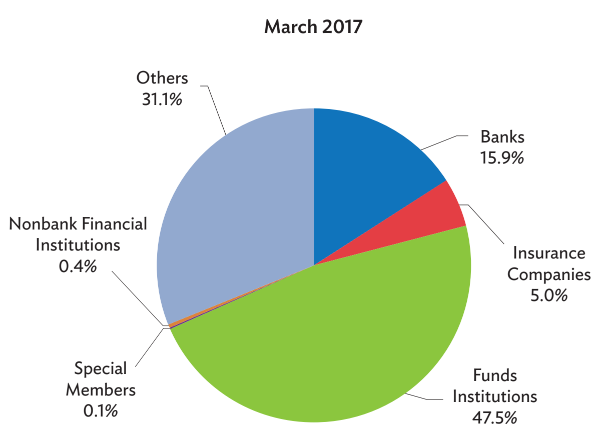
CNY = Chinese yuan.
Source: Based on data from Bloomberg LP.

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



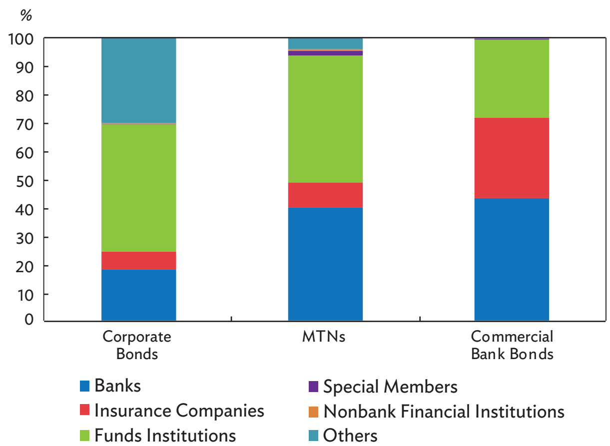
Source: *ChinaBond*.

Figure 4: Local Currency Corporate Bonds Investor Profile



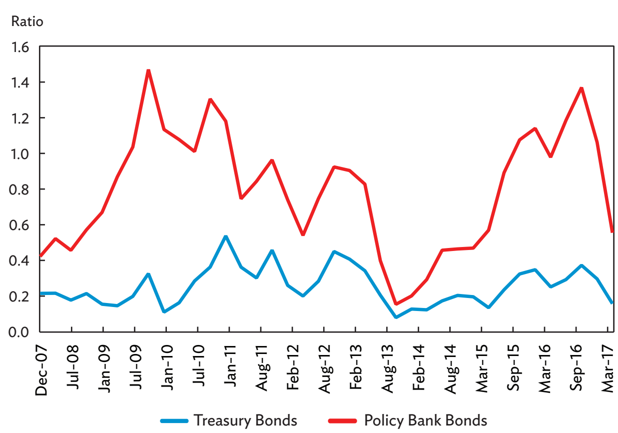
Source: *ChinaBond*.

Figure 5: Investor Profile across Bond Categories



MTNs = medium-term notes.
Note: Data as of end-March 2017.
Source: *ChinaBond*.

Figure 6: Turnover Ratios for Government Bonds



Source: *ChinaBond*.

Table 5: Notional Values of the People's Republic of China's Interest Rate Swap Market in the First Quarter of 2017

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	Percentage of Total Notional Amount (%)	Growth Rate (%)
	Q1 2017		q-o-q
7-Day Repo Rate	2,399.2	89.4	(4.6)
Overnight SHIBOR	17.8	0.7	(79.7)
3-Month SHIBOR	263.8	9.8	(27.9)
1-Year Term Deposit Rate	1.3	0.05	68.8
1-Year Lending Rate	0.7	0.02	(13.3)
LPR1Y	0.3	0.01	(84.2)
Total	**2,683.1**	**100.0**	**(9.7)**

( ) = negative, CNY = Chinese yuan, LPR1Y = 1-Year Loan Prime Rate, q-o-q = quarter-on-quarter, Q1 = first quarter, Repo = repurchase, SHIBOR = Shanghai Interbank Offered Rate.
Notes:
1. Growth rate computed based on notional amounts.
2. 3-Year Lending Rate and 5-Year Lending Rate had no transaction for Q1 2017.
Sources: *AsianBondsOnline* and *ChinaMoney*.

Policy, Institutional, and Regulatory Developments

New Regulations for the Issuance of Local Government Bonds

In February and March, the PRC announced new rules governing the issuance of local government bonds in Q1 2017 to limit the credit risk of local governments. The regulations will limit the total amount that a local government can issue, subject to a formula. In addition, local governments cannot issue more than 30% of the quota in a single quarter. Funds sourced from bonds issued from the debt swap program can only be used for the repayment of debt. The PRC also raised the quota of local government bond issuance from CNY17.2 trillion to CNY18.8 trillion.

Limits on Use of Low-Rated Bonds as Borrowing Collateral

On 7 April, the PRC issued rules prohibiting the use of corporate bonds with credit ratings lower than AAA or corporate bonds issued by corporates with a credit rating lower than AA as collateral for short-term borrowing. The new rule affects only corporate bonds issued after 7 April.