Market Summaries

People's Republic of China

Yield Movements

In the second quarter (Q2) of 2017, the yield curve of the People's Republic of China (PRC) experienced unusual movements. Between 1 June and 15 August, the PRC's yield curve rose at the longer-end and declined at the shorter-end (**Figure 1**). Yields rose between 5 basis points (bps) and 10 bps for tenors of 9 years or longer. In contrast, yields for tenors of 3 years or less fell between 11–16 bps during the review period, while tenors between 4 years and 7 years fell 3–7 bps.

The yield movements during the review period reflect a correction of the inverted yield curve that occurred in May. On 24 May, the 5-year yield had risen to 3.75%, while the 7-year, 8-year, and 9-year tenors had fallen to 3.74%, 3.73%, and 3.74%, respectively. Tenors of less than 5 years experienced a rapid rise in yields in May.

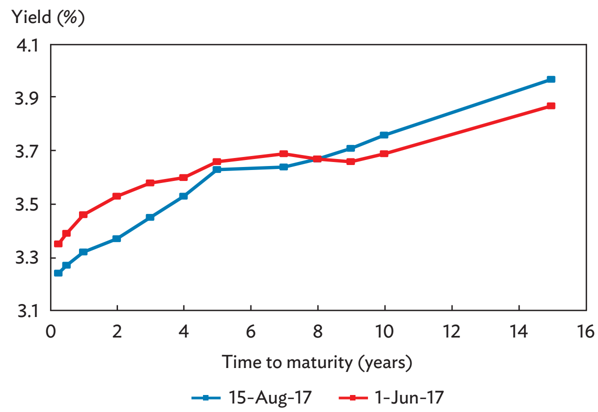
The yield curve's inversion reflected the tightening liquidity situation in the PRC driven by deleveraging. In Q1 2017, the PRC raised rates on its open market operations to reduce demand for credit. The tight liquidity situation particularly affected shorter-term yields as borrowing costs were pushed up.

Concerns that the PRC's economy would slow down, partly as a result of deleveraging, also caused some yields to decline at the longer-end of the curve during the period. However, concerns regarding the health of the domestic economy abated when the PRC reported real gross domestic product growth of 6.9% year-on-year (y-o-y) in Q2 2017, the same pace as in Q1 2017.

Industrial production growth in the first half of 2017 was better than the same period in 2016. While industrial production growth fell to 6.4% y-o-y in July from 7.6% y-o-y in June, growth rates were still better compared with year ago levels.

The improved growth prospects helped restore market confidence in the PRC's economy, causing interest rates to rise at the longer-end of the curve. Furthermore, the People's Bank of China (PBOC) helped ease the liquidity situation by injecting a net CNY220 billion into the financial system on 23 July through open market operations. Market participants, however, believe this does not change the PBOC's stance toward deleveraging. Rather, it is viewed as part of efforts to manage financial conditions to prevent a cash crunch as the PBOC continues guarding against credit risk. The easing of financial conditions helped pushed down rates at the shorter-end and increase them at the longer-end of the curve as expectations of better growth led to the yield curve shift seen between 1 June and 15 August.

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



Source: Based on data from Bloomberg LP.

Inflation eased slightly to 1.4% y-o-y in July from 1.5% y-o-y in June.

Size and Composition

LCY bonds outstanding expanded 4.1% quarter-on quarter (q-o-q) and 12.9% y-o-y in Q2 2017 to reach CNY51.9 trillion at the end of June. The pace of growth quickened from Q1 2017's 0.8% q-o-q (**Table 1**).

Government bonds. Growth in the PRC's bond market was driven by increases in the government bond

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

	Outstanding Amount (billion)						Growth Rates (%)			
	Q2 2016		Q1 2017		Q2 2017		Q2 2016		Q2 2017	
	CNY	USD	CNY	USD	CNY	USD	q-o-q	y-o-y	q-o-q	y-o-y
Total	**45,980**	**6,916**	**49,895**	**7,245**	**51,931**	**7,658**	**8.0**	**30.6**	**4.1**	**12.9**
Government	31,286	4,706	35,113	5,098	37,159	5,480	12.6	40.0	5.8	18.8
Treasury Bonds	18,955	2,851	22,510	3,268	24,405	3,599	19.5	68.0	8.42	28.7
Central Bank Bonds	428	64	0	0	0	0	0.0	0.0	(100.0)	(100.0)
Policy Bank Bonds	11,902	1,790	12,604	1,830	12,755	1,881	3.4	11.9	1.2	7.2
Corporate	14,694	2,210	14,782	2,146	14,771	2,178	(0.6)	14.3	(0.1)	0.5
Policy Bank Bonds										
China Development Bank	6,976	1,049	7,185	1,043	7,183	1,059	2.3	6.7	(0.03)	3.0
Export–Import Bank of China	1,988	299	2,190	318	2,217	327	3.9	10.6	1.2	11.5
Agricultural Devt. Bank of China	2,939	442	3,229	469	3,355	495	5.8	28.0	3.9	14.1

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

segment. Government bonds outstanding increased 5.8% q-o-q in Q2 2017, up from 1.6% q-o-q growth in the previous quarter, mainly led by local government bonds outstanding, which grew 13.0% q-o-q in Q2 2017 versus 3.6% q-o-q in Q1 2017.

Despite ongoing deleveraging in the PRC, local governments continued to issue bonds to refinance debt and obtain additional funding. In addition, the central government increased the local government bond quota limit for 2017 to CNY18.8 trillion. However, the pace of growth in Q2 2017 was down on a y-o-y basis, rising 50.0% y-o-y versus 93.2% y-o-y in Q2 2016.

There were no central bank bonds outstanding in Q2 2017 as the PBOC no longer issues such bonds.

Corporate bonds. Corporate bonds outstanding continued to decline in Q2 2017, albeit at a slower pace, falling 0.1% q-o-q in Q2 2017 to CNY14.8 trillion, following a 1.2% q-o-q decline in Q1 2017, as the ongoing deleveraging in the PRC led to reduced corporate demand for funding. The biggest decline came from commercial paper, which fell 13.3% q-o-q as rising rates, particularly for shorter-dated tenors, made companies reluctant to issue funds with short maturities (**Table 2**). State-owned enterprise bonds also fell in Q2 2017, declining 4.3% q-o-q, followed by medium-term notes, which dropped 0.8% q-o-q.

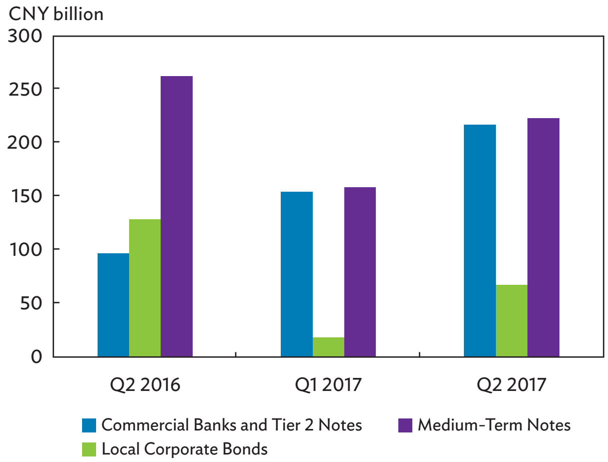
Issuance has recovered somewhat in 2017, rising 23.0% q-o-q in Q2 2017 due to the refinancing of maturing corporate bonds; outstanding corporate bonds

Table 2: Corporate Bonds Outstanding in Key Categories

	Amount (CNY billion)			Growth Rate (%)			
				Q2 2016		Q2 2017	
	Q2 2016	Q1 2017	Q2 2017	q-o-q	y-o-y	q-o-q	y-o-y
Commercial Bank Bonds and Tier 2 Notes	2,271	2,534	2,713	1.0	29.9	7.1	19.5
SOE Bonds	575	542	519	1.0	(6.1)	(4.3)	(9.7)
Local Corporate Bonds	2,787	2,912	2,932	1.0	13.5	0.7	5.2
Commercial Paper	2,652	1,912	1,657	0.9	15.0	(13.3)	(37.5)
Medium-Term Notes	4,559	4,701	4,662	1.0	9.8	(0.8)	2.3

( ) = 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*.

fell only 0.1% q-o-q. However, on a y-o-y basis corporate bond issuances fell 18.4% in Q2 2017. The q-o-q rise in issuance was mostly in the form of medium-term notes and issuances by financial institutions (**Figure 2**).

The PRC's corporate bond market is dominated by a few big issuers (**Table 3**). At the end of June, the top 30 corporate bond issuers accounted for CNY5.9 trillion worth of corporate bonds outstanding, or about 40.3% of the total market. Of the top 30, the 10 largest issuers accounted for CNY3.8 trillion.

The top 30 issuer includes 14 banks, which continue to dominate the list as they generate funding in order to beef up their capital bases and liquidity, and lengthen their maturity profiles.

Table 4 lists the largest corporate bond issuances in Q2 2017. All of the companies on the list are financial institutions, except for one firm engaged in asset management.

Investor Profile

Treasury bonds and policy bank bonds. The share of Treasury bonds, including policy bank bonds, held by banks declined to 67.3% of the total at the end of June from 69.9% in June 2016 (**Figure 3**). Fund institutions' share rose to 14.8% from 12.3% during the review period.

Corporate bonds. Funds institutions' share of total corporate bonds outstanding rose to 47.5% at the end of June from 41.8% a year earlier due to increased demand for yield (**Figure 4**). In addition, the share of banks' holdings of corporate bonds fell to 15.9% from 19.5% during the review period.

Figure 5 presents investor profiles across different corporate bond categories at the end of June. Funds institutions remain the dominant buyers of both local corporate bonds and medium-term notes, while banks and funds institutions were the dominant holders of commercial bank bonds.

Liquidity

The volume of interest rate swaps rose 6.0% q-o-q due to volatile interest rate movements in Q2 2017. The 7-day repurchase interest rate remained the most used interest rate swap, comprising an 88.6% share of the total interest rate swap volume during the quarter (**Table 5**).

There was an uptick in turnover volume in Q2 2017 for government bonds, owing to the fall in interest rates at the longer-end of the curve (**Figure 6**).

Policy, Institutional, and Regulatory Developments

Rules Issued for Bond Connect

In June, the PRC issued regulations governing foreign investment in the interbank bond market through Bond Connect, a program that links the PRC's and Hong Kong, China's bond markets. Under the Bond Connect regulations, foreign investors can purchase bonds in the PRC's interbank bond market using either renminbi or a foreign currency. Qualified investors include foreign central banks, sovereign wealth funds, international organizations, investors under the Renminbi Qualified Foreign Institutional Investor program, and financial institutions.

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	1,436.5	211.85	Yes	No	Transportation
2.	State Grid Corporation of China	420.8	62.06	Yes	No	Public Utilities
3.	China National Petroleum	315.0	46.45	Yes	No	Energy
4.	Agricultural Bank of China	278.0	41.00	Yes	Yes	Banking
5.	Industrial and Commercial Bank of China	268.0	39.52	Yes	Yes	Banking
6.	Bank of China	258.9	38.18	Yes	Yes	Banking
7.	Bank of Communications	245.0	36.13	Yes	Yes	Banking
8.	China Construction Bank	212.0	31.26	Yes	Yes	Banking
9.	Shanghai Pudong Development Bank	191.6	28.26	No	Yes	Banking
10.	Industrial Bank	185.0	27.28	No	Yes	Banking
11.	China CITIC Bank	157.5	23.23	No	Yes	Banking
12.	China Minsheng Banking	155.1	22.87	No	Yes	Banking
13.	China Everbright Bank	154.9	22.84	Yes	Yes	Banking
14.	State Power Investment	139.1	20.52	Yes	Yes	Energy
15.	Bank of Beijing	137.9	20.34	Yes	Yes	Banking
16.	PetroChina	135.0	19.91	Yes	Yes	Energy
17.	Central Huijin Investment	109.0	16.07	Yes	Yes	Asset Management
18.	Huaxia Bank	108.4	15.99	Yes	Yes	Banking
19.	China Huarong Asset Management	106.0	15.63	Yes	Yes	Asset Management
20.	Shenhua Group	96.5	14.23	Yes	Yes	Mining
21.	Dalian Wanda Commercial Properties	93.0	13.71	No	Yes	Real Estate
22.	China Cinda Asset Management	91.0	13.42	Yes	Yes	Asset Management
23.	China Three Gorges	90.0	13.27	Yes	Yes	Public Utilities
24.	Tianjin Infrastructure Construction and Investment Group	87.3	12.87	Yes	No	Construction
25.	China Guangfa Bank	86.5	12.76	Yes	Yes	Banking
26.	Haitong Securities	81.2	11.98	No	Yes	Brokerage
27.	Guotai Junan Securities	79.0	11.65	No	Yes	Brokerage
28.	Lu'An Mining Industry Group	77.6	11.44	Yes	No	Mining
29.	China Merchants Bank	77.0	11.36	Yes	Yes	Banking
30.	Datong Coal Mine Group	76.8	11.33	Yes	No	Mining
Total Top 30 LCY Corporate Issuers		**5,949.62**	**877.41**			
Total LCY Corporate Bonds		**14,771.24**	**2,178.36**			
Top 30 as % of Total LCY Corporate Bonds		**40.3%**	**40.3%**			

CNY = Chinese yuan, LCY = local currency, USD = United States dollar.
Notes:
1. Data as of end-June 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 Second Quarter of 2017

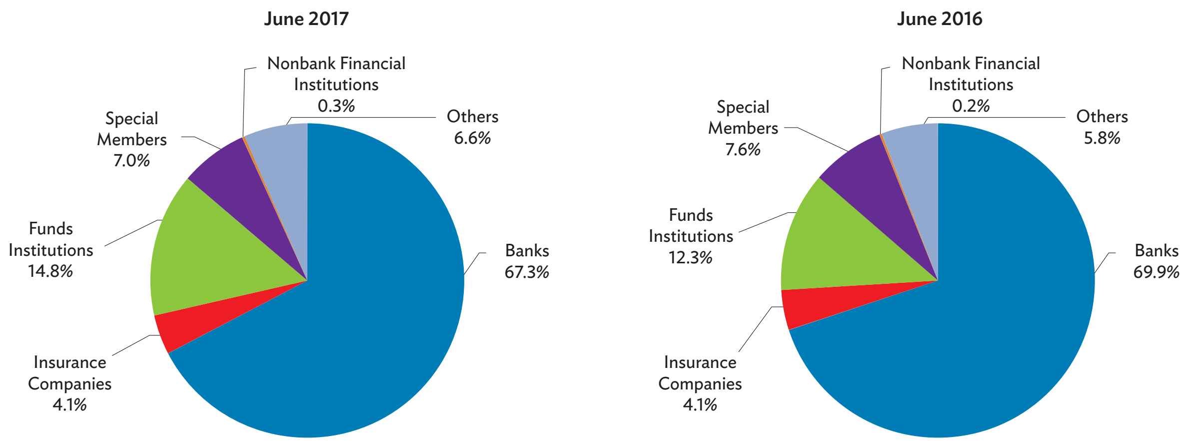
Corporate Issuers	Coupon Rate (%)	Issued Amount (CNY billion)
China CITIC Bank		
3-year bond	4.20	50.0
Bank of Communications		
10-year bond	4.50	30.0
Huaxia Bank		
10-year bond	4.80	30.0
China Cinda Asset Management		
3-year bond	4.30	2.0
5-year bond	4.40	4.0
10-year bond	4.75	24.0
Shanghai Pudong Development Bank		
3-year bond	4.20	22.0

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

Rules Issued to Distinguish between Ordinary and Professional Investors

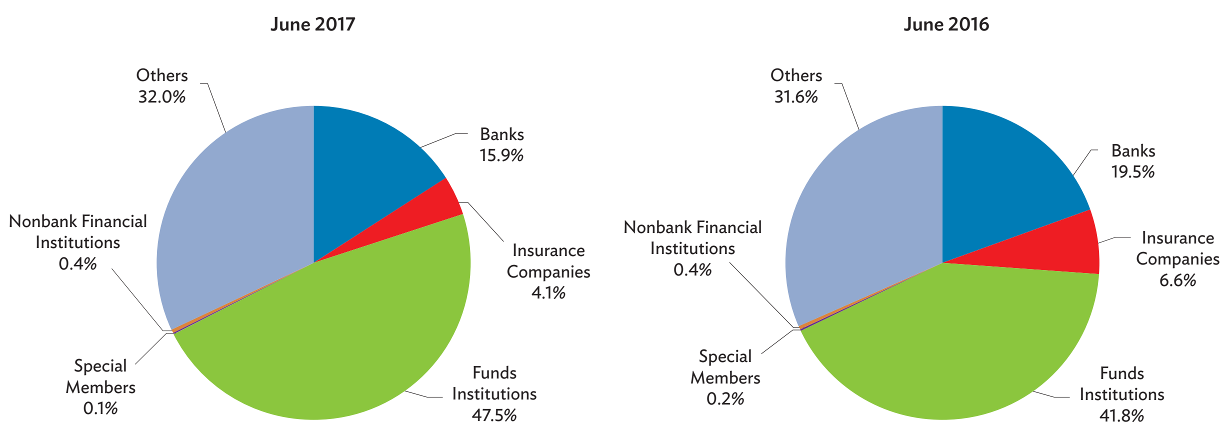
In July, the PRC issued regulations that require investors in securities to be classified as either professional or ordinary investors based on asset size, earnings, and investment experience. To be classified as professional, investors must have assets of at least CNY5 million or yearly income of at least CNY500,000. They must also have at least 2 years of investment experience. The rule does not prevent ordinary investors from purchasing riskier products, rather they must be informed about the riskiness of the investment if they seek to purchase assets deemed to be above their risk level

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



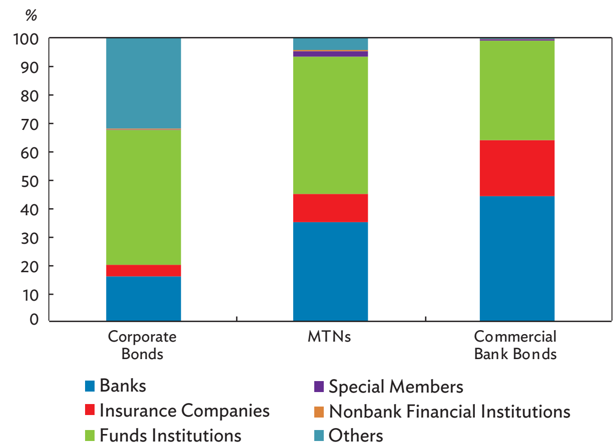
Source: *ChinaBond*.

Figure 4: Local Currency Corporate Bonds Investor Profile



Source: *ChinaBond*.

Figure 5: Investor Profile across Bond Categories



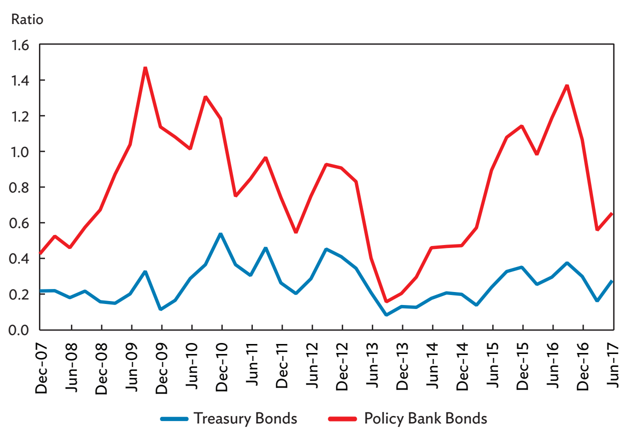
MTNs = medium-term notes.
Note: Data as of end-June 2017.
Source: *ChinaBond*.

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

Interest Rate Swap Benchmarks	Notional Amount (CNY billion)	Share of Total Notional Amount (%)	Growth Rate (%)
	Q2 2017		q-o-q
7-Day Repo Rate	2,519.4	88.59	5.01
Overnight SHIBOR	8.7	0.31	(51.26)
3-Month SHIBOR	312.8	11.00	18.57
1-Year Term Deposit Rate	1.2	0.04	(7.69)
1-Year Lending Rate	0.6	0.02	(7.54)
3-Year Lending Rate	1.2	0.04	100.00
Total	**2,844.0**	**100.00**	**6.00**

( ) = negative, CNY = Chinese yuan, 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*.