Asia FI & FX Strategy Viewpoint

China rates – double whammy of elevated issuances and tight funding

23 October 2023

GEM FI & FX Strategy
Asia

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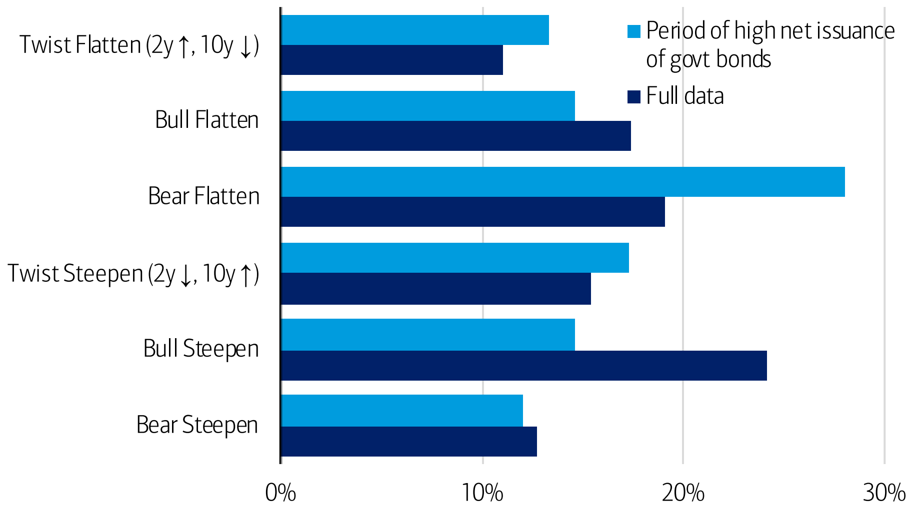
There has been a lot of market focus lately on China's fiscal policy and government bond issuance outlook. Since early October, 19 provincial governments have announced plans to issue special refinancing bonds (LGSRBs) worth more than CNY900bn combined. The National People's Congress (NPC) Standing Committee is scheduled to meet during Oct 20-24th and review a bill that allows the State Council to pre-release local government debt quotas.

We revise up our 4Q issuance estimates and now expect around CNY2,900bn net supply of government bonds. If our estimates turn out to be correct, that means 4Q23 would mark the 2nd highest quarterly net supply besides 2Q20 (Exhibit 2). More than half of 4Q net supply would take place in October, driven by concentrated issuance of LGSRBs. Therefore, supply pressure should ease in November and December under our base case.

Against the backdrop of elevated net supply and tighter funding conditions, CGBs 2s10s curve has bear-flattened to the lowest level since 4Q20. While we wouldn't rule out the possibility of the spread dropping further by another 5-10bp, the next big move should probably be curve steepening. Data of recent years show that bull-steepening is more likely than bear-steepening outside of high issuance episodes. However, for front-end bonds to rally, we probably need to see the catalyst of improving liquidity conditions, which in turn is contingent on FX moves and the PBoC's policy reaction function.

Exhibit 1: Historical distribution of 2s10s curve weekly moves (Jan 2018 – Oct 2023)
There's a higher probability for curve to bear-flatten when net issuances are high



Source: BofA Global Research, CEIC

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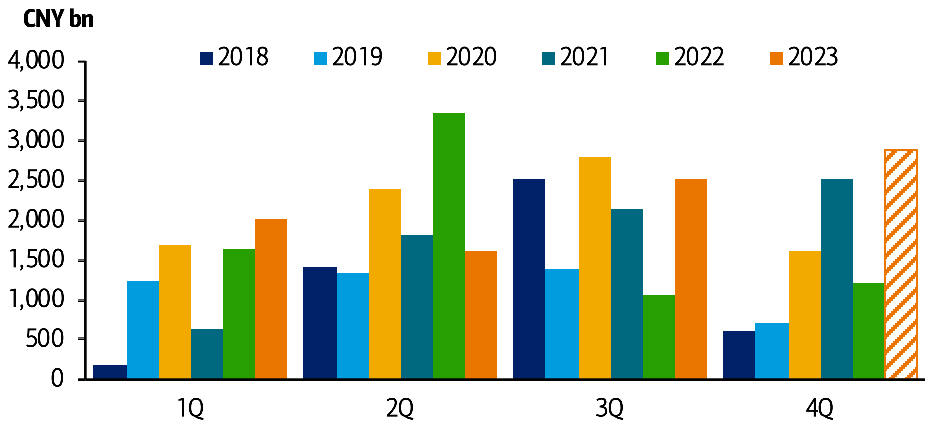
Govt bonds supply outlook – a heavier-than-usual 4Q

Given the recent developments, we revise up our 4Q issuance estimates and now expect around CNY2,900bn net supply of government bonds, based on the following assumptions: 1) local governments would issue around CNY1,250tn special refinancing bonds; 2) the central government will sell additional CNY300bn of debts using the quota carried over from previous years; 3) early release of next year's LGSB quota, but issuance will only start in Jan-2024; and 4) no issuance of special treasury bonds or long-term construction CGBs. We will discuss those assumptions elaborately in the following paragraphs.

If our estimates turn out to be correct, that means 4Q would see even higher supply pressure compared to 3Q. In fact, it would mark the 2nd highest quarterly net supply following 2Q22 (Exhibit 2). In terms of monthly distribution, more than half of 4Q net supply would take place in October, driven by concentrated issuance of LGSRBs. Therefore, supply pressure should ease in November and December under our base case.

Exhibit 2: Quarterly net supply of government bonds (central & local)
4Q23 could potentially see 2nd highest quarterly net supply



Source: BofA Global Research, Wind
Note: 2023Q4 net supply is based on our own estimates.

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1) Issuance of special refinancing bonds begins

Back in August, local media reported that part of the historical unused quotas of LGBs would be reallocated to local governments, allowing them to issue CNY1-1.5tn special refinancing bonds (LGSRB). The unused quotas are essentially the difference between the debt limits set by the NPC and outstanding debts. As of end-2022, the outstanding LGGBs and LGSBs were below their respective debt limits by CNY1.43tn and CNY1.15tn, offering some room to issue additional debts (Exhibit 6).

Unlike typical refinancing bonds that are used to rollover maturing LGBs, proceeds from LGSRBs would be used to swap non-standard, high-yield debt obligations of local governments, including account payables. As of Oct 20, 19 provinces plus one city have either issued or announced issuance plans of LGSRBs. According to *Wind* data, from Oct 9 to Oct 26, total supply of special issuance bonds would amount to CNY910bn.

Our economists believe such measure should help ease near-term liquidity risks but think more actions are needed to tackle the LGFV debt issues (see more in China Watch - Defusing LGFV debt series (2): refinancing bonds to tackle liquidity risks).

2) LGSB supply to pick up in 1Q24 upon early quota release

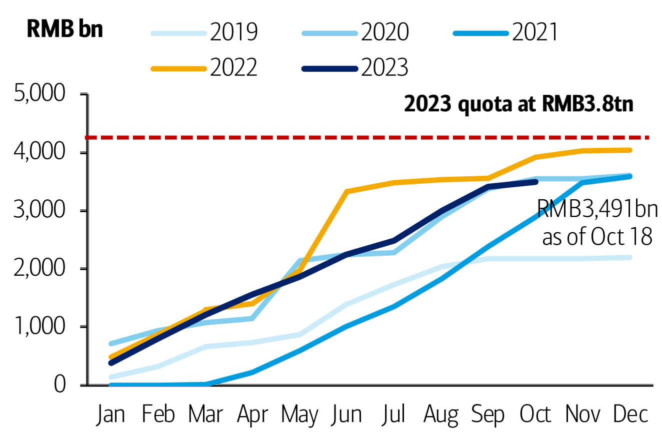
As of Oct 18th, the issuance of local government special-purpose bonds (LGSBs) has reached CNY3.5tn, which is close to the annual quota of CNY3.8tn (Exhibit 3). Yet, the amount left to be issued for the rest of 4Q still seems to be larger than in most of the previous years except for 2022, when an additional quota of CNY500bn was added in Sep.

The NPC Standing Committee's Oct meeting agenda also suggests the government has an intention to assign quotas for local government bonds ahead of time so that they could be issued early next year. Note that the local government bond quota is officially announced at the NPC (usually in March every year). To avoid funding gap between 1Q and the preceding 4Q, starting from 2018, part of the local government bond issuance quotas for the following year had typically been released "in advance" toward the yearend (though actual issuance can only take place when the new year starts; Exhibit 3 & Exhibit 5).

In Dec 2018, the NPC authorized the State Council to pre-assign local government bond quota for the following year (capped at 60% of the current year's quota), effective until end-2022. As this legal authorization already expired, another bill will need to be passed to allow the State Council to continue the practice of pre-assigning quotas.

In our view, the government likely has a strong incentive to frontload the issuance of LGSBs towards 1H24. With property investment remaining a significant drag to the economy (Exhibit 4), faster LGSB issuance in 1H24 could help support infrastructure FAI and mitigate the headwinds on investment growth. Meanwhile, as local governments are now given the green light to issue LGSBs to fund urban village revamp projects, this also helps mitigate potential concerns about insufficient project pipeline in early 2024.

Exhibit 3: LGSB net issuance
LGSB net issuance reached RMB3,491bn, as of Oct 18



Note: Data as of Oct 18
Source: Wind

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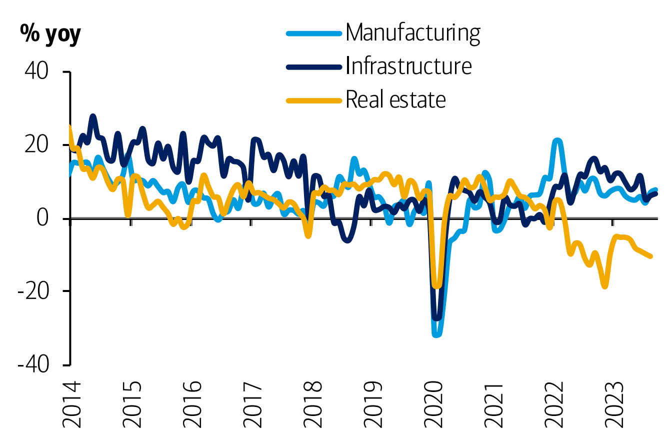
Exhibit 4: Fixed-asset investment (FAI) growth: industry breakdown
Property investment remains under pressure



Note: 2021 growth was calculated as 2-year average vs. 2019 level.
Source: BofA Global Research, CEIC

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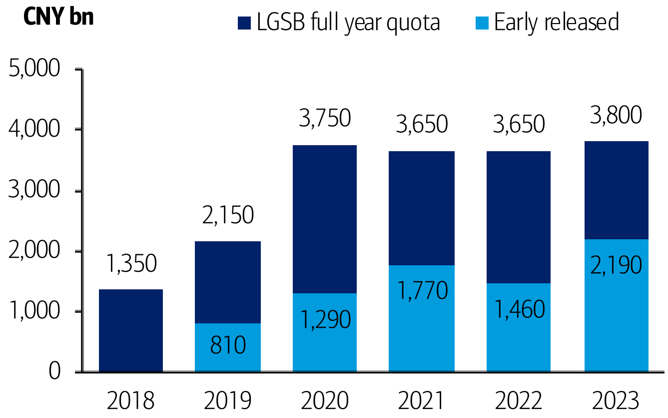
Exhibit 5: Annual & early released LGSB issuance quota
Since 2018, part of the LGB issuance quotas had been released "in advance"



Source: BofA Global Research, Wind, Ministry of Finance

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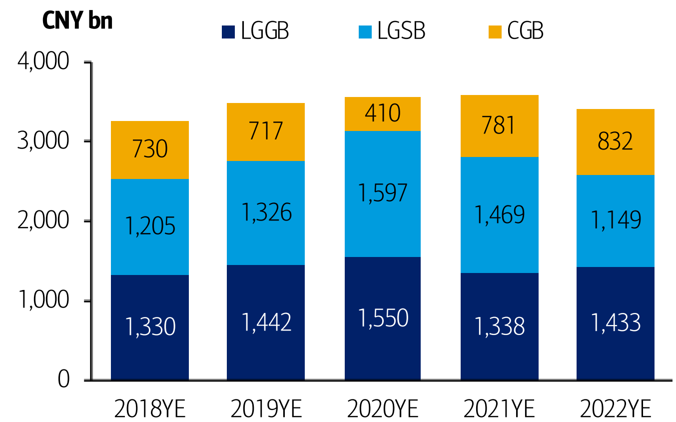
Exhibit 6: Gap between debt limits and outstanding debts
Both local and central govts have some extra room to issue debts



Source: BofA Global Research, CEIC, Ministry of Finance

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3) CGBs – net issuance in 2023 may overshoot budgeted deficits

Same as local governments, the central government also needs to adhere to the debt limit. If for a given calendar year, the central government's actual increase in deficits undershoots budgeted amounts, then the unused part would be carried over, providing some extra debt space for the future. For example, in 2020, the central government issued more bonds than budgeted, which corresponded to a reduction in the unused deficit room. As of end-2022, that extra space for central government debts was around CNY832bn (Exhibit 6).

In our baseline estimates, we assume they'll use CNY300bn out of that previously saved amount in the coming months, bringing the total net increase in central government debts to CNY3,460bn this year. The key to watch is whether and how much the MoF will reduce the auction sizes for CGBs going into Nov and Dec. Under our baseline, we think the auction sizes should be reduced by about CNY30bn to CNY80bn for key tenor CGBs.

4) Long-term construction CGBs/special treasury bonds – unlikely in near term

Bloomberg reported last week that China is considering an additional issuance of CNY1tn+ treasury bonds this year to support infrastructure projects. Yet, any potential increase in fiscal deficit or issuance of special treasury bonds would need to be approved by the NPC standing committee. As the topic is not included in the Oct NPC Standing Committee meeting agenda, we think the likelihood of issuing long-term construction CGBs or special treasury bonds (Exhibit 7) before the year-end is low.

Exhibit 7: Long-term construction CGBs vs. special treasury bonds

The likelihood of issuing long-term construction CGBs or special treasury bonds before the year-end is low

	Long-term construction CGBs	Special treasury bonds
Issuer	Ministry of Finance	Ministry of Finance
Fiscal deficit category	Included under the General Public Fiscal account (Historically, more than 70% were under the central govt's fiscal deficit while the remaining 30% went to local govts)	Included under the National Government-managed Fund account
Historical use	Initiated in 1998, with a total issuance amount of RMB1.1tn during 1998-2008	1998 (RMB270bn) 2007 (RMB1.55tn) 2020 (RMB1tn)
Usage of funds	Mostly Infrastructure construction and development in western areas	Mostly announced during crisis times Used to enhance the capitalization of small- and medium-sized banks (1998), manage China's foreign-exchange reserves (2007) and fight pandemic (2020)
Approval process	Approval from the NPC Standing Committee needed	Approval from the NPC or NPC Standing Committee needed

Source: BofA Global Research, CEIC

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CGB curve dynamics in light of high issuances

In the backdrop of elevated net supply of government bonds and tighter funding conditions, CGBs have been facing sell-off pressures, and the 2s10s curve has reached the flattest level since late-2020.

In this section, we examine the curve dynamics in recent years (Jan 2018 to Oct 2023) using 1) the full sample, and 2) a sub-sample when net government bonds supply is high. Specifically, we calculated the weekly changes in 2s10s spread and classified the curve dynamics into six groups: 1) twist-flattening (2y yield ↑, 10y yield ↓), 2) bull-flattening, 3) bear-flattening, 4) twist-steepening (2y yield ↓, 10y yield ↑), 5) bull-steepening, and 6) bear-steepening.

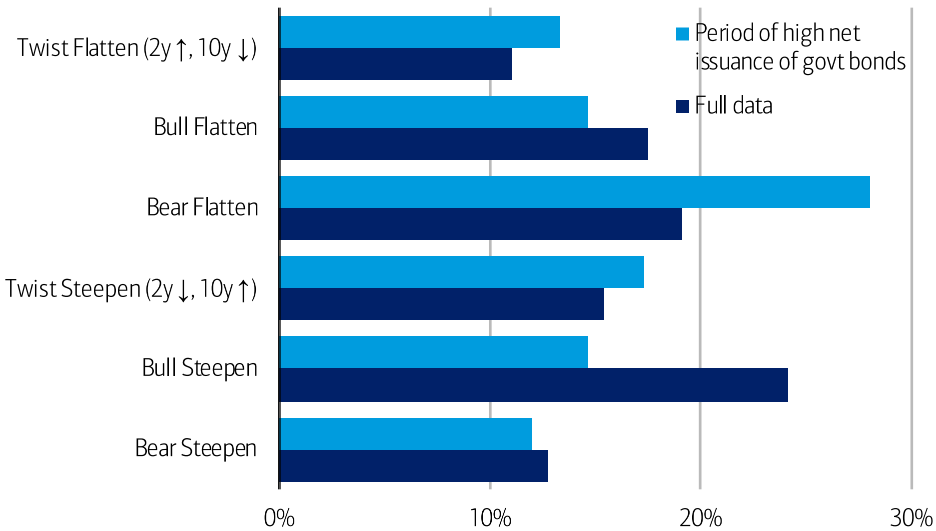
Exhibit 8 shows the historical distribution across six curve dynamics under the full and restricted samples. Firstly, there are some interesting observations from the full-sample results.

- It is not very uncommon for 2y and 10y yields to move in different directions for a given week. Within our sample period, 15%/11% of the time the curve twist steepened/flattened.
- Among the other four more traditional types of curve moves, bull-steepening has the highest occurrences (24%), while bear-steepening occurred least frequently (13%). In other words, from probability perspective, the steepening of the curve is more likely to be driven by front-end rally rather than back-end sell-off since 2018.
- As for curve-flattening trend, the probability of bear-flattening and bull-flattening is similar at 19% and 17%, respectively.

Next, we restricted the sample to weeks during which net government bonds supply (including both CGBs and LGBs) was at the top-25th percentile in each calendar year. Our intuition – probably same as market's common perception – is that CGB curve should be more prone to bear-steepening pressure under high issuances episodes given the larger share of long-duration bonds. However, as shown in Exhibit 8, the actual results paint a different and somehow counterintuitive picture.

Comparing with the full-sample results, CGB curve has a higher probability of bear-flattening and a lower probability of bull-steepening in the restricted sample. In other words, front-end rates are more likely to rise and underperform back-end when net government bonds issuances are high. Moreover, in contrast to our intuition, the probabilities of CGB curve bear-steepening are actually very similar under the two different samples.

Exhibit 8: Historical distribution of 2s10s curve weekly moves (Jan 2018 – Oct 2023)
There's a higher probability for curve to bear-flatten when net issuances are high



Source: BofA Global Research, CEIC

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So, is heavy bonds supply problematic for CGB market or not? And how come short-end bonds can potentially face greater sell-off pressure than back-end amid heavy supply?

The key point we'd like to make is that we should not assess the bonds supply issue in isolation, but rather need to look at it in combination with economic backdrop and funding conditions. When growth momentum is weak and interbank funding is very cheap, elevated bonds supply is unlikely to be an issue. For example, CGBs were mostly trading in range-bound in 2Q22 and 4Q21, despite elevated bonds supply. On the flip side, if the economy starts to rebound and liquidity gets tightened, then more bonds supply can dampen bond market sentiment further and exacerbate the sell-off pressure, which was the exact backdrop behind the sharp compression of 2s10s spread in 3Q20.

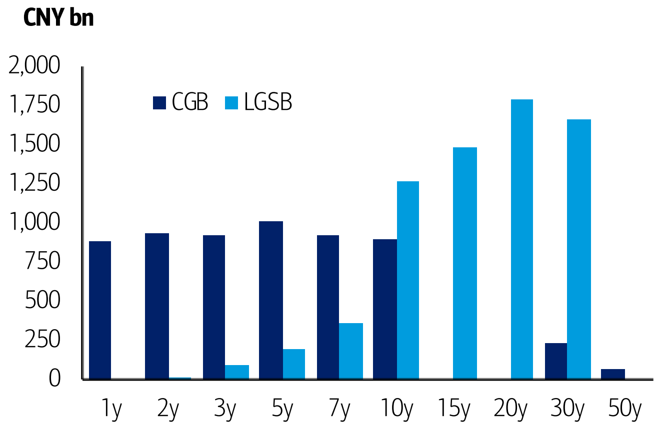
In the most recent high issuance episode from August onwards, 2s10s curve has bear-flattened by more than 20bp. In hindsight, it is another classic example of the double whammy from higher issuance and tighter liquidity. Earlier this year when liquidity was flush, bond market investors having been building up leverages by borrowing overnight repo to fund bond positions (more on the front-end). Therefore, the rising repo rates and associated carry trades unwound have exerted more pressure on front-end CGBs and CDBs.

Moreover, even though it is the common perception that more government bonds supply is more unfavorable for the back-end, we think it is important to make a distinction as the average duration/maturity distribution differs a lot across government bonds types.

As shown in Exhibit 9, LGSBs that are used to fund infrastructure projects typically have long maturities ranging from 10y to 30y. On the other hand, for CGBs, the auction sizes for a given month are usually the same across 1y, 2y, 3y, 5y, 7y, and 10y. The average duration of CGBs issued year to date was 6.2 years, versus 18.2 years of LGSBs. As for LGSRBs, the most common tenors are 3y, 5y, 7y, and 10y, with a few exceptions of 30y bonds. Based on the actual and planned issuances so far, the weighted average maturity was around 8 years, suggesting the more supply pressure at the belly of the curve.

In September, the high net supply was mainly driven by CGBs, which means front-end bonds face pressures from both leverage unwinding and heavy primary market supply (Exhibit 10). In October, the bonds supply mostly comes from LGSRBs, which also has shorter average maturity relative to LGSBs.

Exhibit 9: Maturity distribution for CGBs and LGSBs
LGSBs have much higher average duration than CGBs



Source: BofA Global Research, Wind

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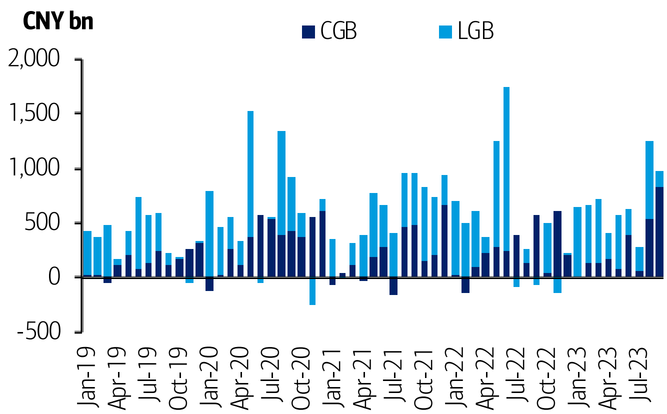
Exhibit 10: Net supply of CGBs and LGBs
The high net supply in Sep 2023 was mainly driven by CGBs



Source: BofA Global Research, Wind

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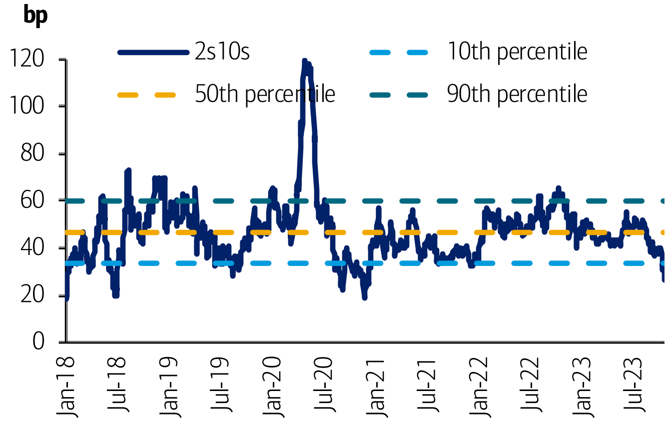
How would the curve move from here?

Currently, the term spread has dropped to 28bp, below the 10th percentile of the historical spread and lowest level since 4Q20 (Exhibit 11). While we wouldn't rule out the possibility for the curve to flatten further by another 5-10bp, the next big move should probably be curve steepening. Recent years data show that outside of high issuances episodes, bull-steepening is more likely than bear-steepening. That said, for front-end bonds to rally, we probably need the catalyst of looser funding conditions.

As we've noted previously, the connection between FX market and bond market has become stronger through the liquidity channel (see details in Asia FI & FX Strategy Watch - Potential triggers for CGB curve to re-steepen). Over the past two months, USDCNY has been trading in the stable range around 7.3. In the meantime, 1y CGB yield have backed-up by almost 50bp. There seems to be a policy dilemma to achieve both FX and rates stability, when interest rate differential is quite unfavorable and confidence on the economy remains weak. While further loosening in liquidity condition would be more helpful for the economic recovery, given persisting currency depreciation pressure in the near term, the PBoC will probably be reluctant to see a notable drop in repo rates.

Valuations of CGBs relative to policy rates have becoming more attractive, especially for front-end bonds (Exhibit 12). However, to reach a turning point in the bond market, we probably need to see some relief on FX first (lower USDCNY), or a change in PBoC's stance to allow more flexibilities in the exchange rate.

Exhibit 11: CGB 2s10s curve
The curve has reached the flattest level since 4Q20



Source: BofA Global Research, Bloomberg

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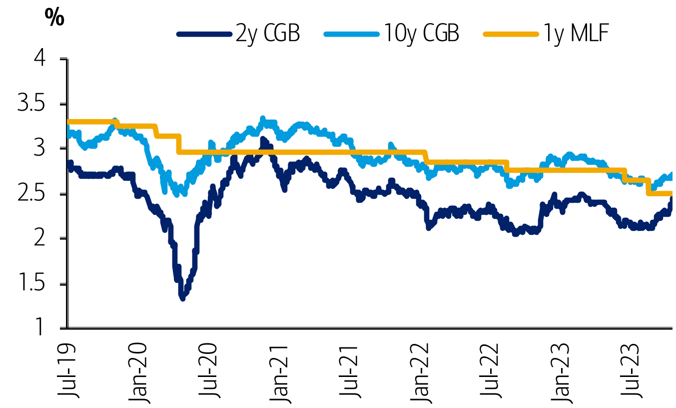
Exhibit 12: CGB yields relative to MLF policy rate
Valuations of CGBs have becoming more attractive relative to policy rates, especially for front-end bonds



Source: BofA Global Research, Bloomberg

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Acronyms

CGB – China government bond

CDB – China Development Bank bond

LGB – Local government bond

LGFV – Local government financing vehicle

LGGB – Local government general purpose bond

LGSB – Local government special purpose bond

LGSRB – Local government special refinancing bond

MLF – Medium-term lending facility

NPC – National People's Congress

PBoC – People's Bank of China

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