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Emerging Insight

China rates – double whammy of elevated issuance and tight funding

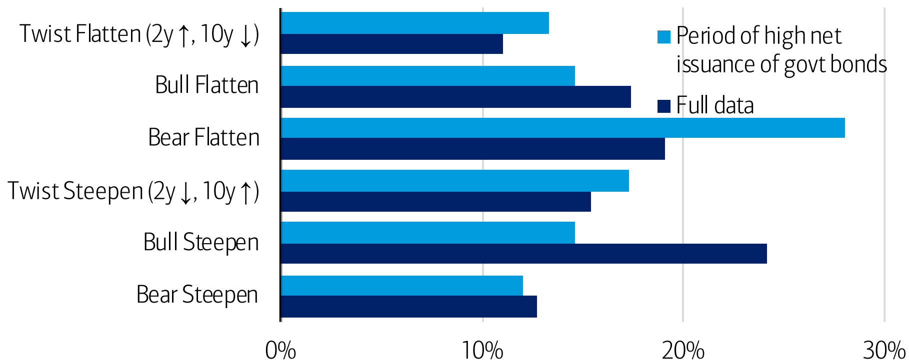
Key takeaways

- 19 provinces have announced plans to issue special refinancing bonds in Oct, boosting our 4Q net supply estimates.
- We also see a decent chance that CGB supply would exceed the budgeted amount.
- CGB 2s10s spread has reached the lowest level since 4Q20. Looser liquidity is likely a precondition for curve to re-steepen.

By Janice Xue & Miao Ouyang

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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China in focus

There has been a lot of market focus lately on China's fiscal policy and government bond issuance outlook. Since early Oct, 19 provincial governments have announced plans to issue special refinancing bonds. The NPC Standing Committee is scheduled to meet and review a bill that allows the State Council to pre-release local government debt quotas.

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. 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.

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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

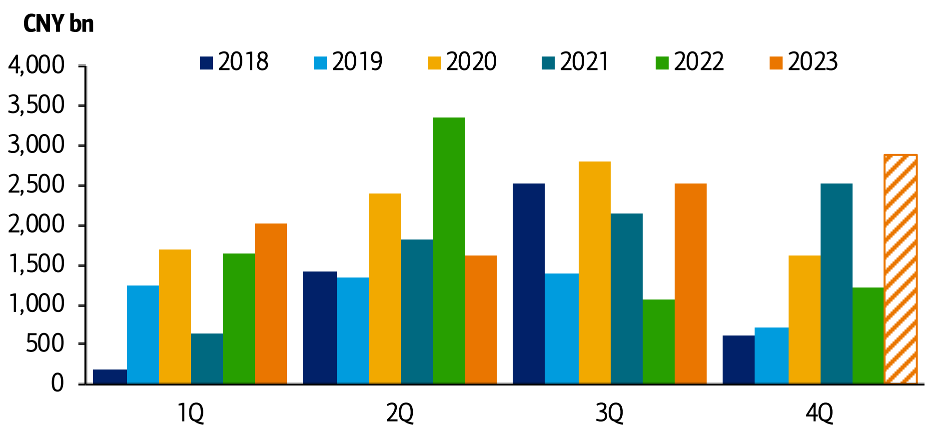
Complete report: [Asia FI & FX Strategy Viewpoint: China rates – double whammy of elevated issuance and tight funding]()

Total govt bond 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.

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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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 2 shows the historical distribution across six curve dynamics under the full and restricted samples. 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.

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?

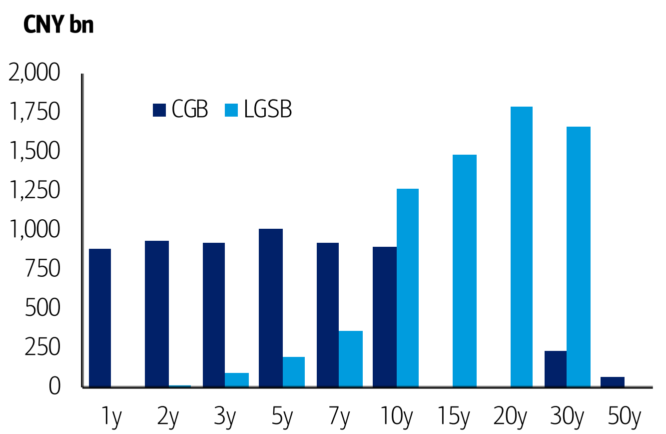
The key point we'd like to make is that we should not assess the bonds supply issue in isolation, but rather need to look at it in combination with economic backdrop and funding conditions. When growth momentum is weak and interbank funding is very cheap, elevated bonds supply is unlikely to be an issue. For eg, 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 3, 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.

Exhibit 3: Maturity distribution for CGBs and LGSBs
LGSBs have much higher average duration than CGBs



Source: BofA Global Research, Wind

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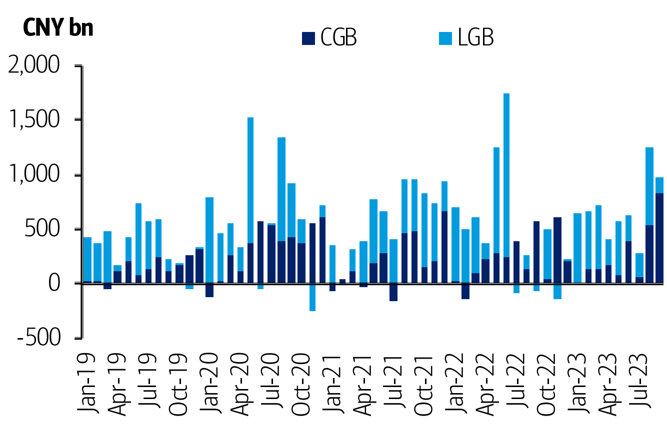
Exhibit 4: Net supply of CGBs and LGBs
The high net supply in Sep 2023 was mainly driven by CGBs



Source: BofA Global Research, Wind

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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 4). In October, the bonds supply mostly comes from LGSRBs, which also has shorter average maturity relative to LGSBs.

How would the curve move from here?

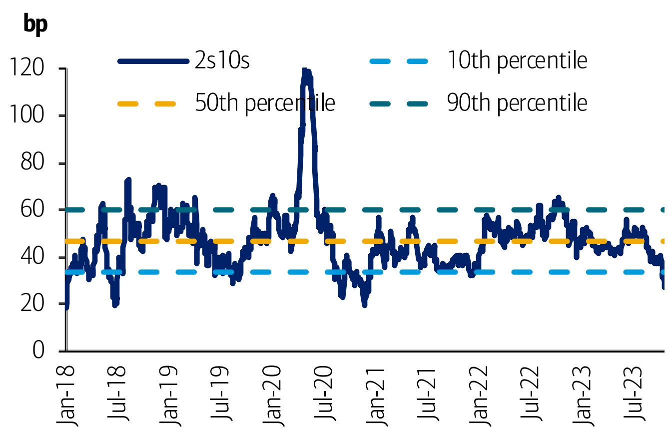
Currently, the term spread has dropped to 28bp, below the 10th percentile of the historical spread and lowest level since 4Q20 (Exhibit 5). While we wouldn't rule out the possibility for the curve to flatten further by another 5-10bp, the next big move should probably be curve steepening. Recent years 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 6). 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 5: CGB 2s10s curve

The curve has reached the flattest level since 4Q20



Source: BofA Global Research, Bloomberg

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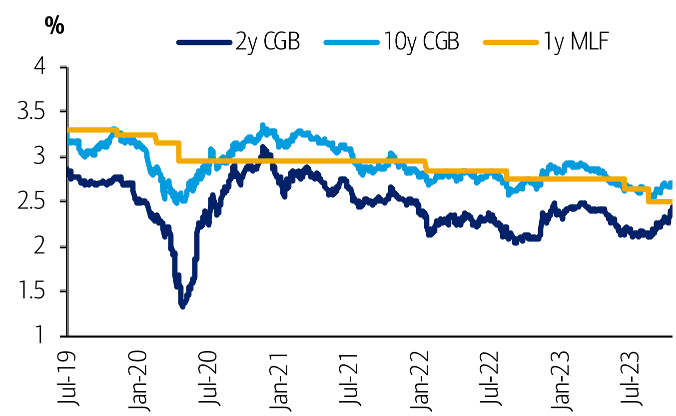
Exhibit 6: CGB yields relative to MLF policy rate

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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News and Views

Brazil: August Economic Activity Index declined 0.77% momsa, reinforcing weaker 2H23

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Economic Activity (IBC-Br Index) declined 0.77% momsa in August, against an 0.42% momsa increase in July (revised down from 0.44% momsa), according to the Brazilian Central Bank (BCB). The number was below our (-0.5%) and market expectations (-0.6/%). In yoy terms, IBC-Br increased by 1.28% yoy, accelerating from 0.83% yoy in the previous month (revised up from 0.66% yoy). The statistical carry-over for 2023 is at 2.66% for the IBC-Br. This marginal drop happened in line with weak readings of the services sector (-0.9% momsa) and core retail sales (-1.3% momsa), while just industrial production went up (+0.5 momsa).

- **To follow:** Our preliminary forecast for IBC-Br in October is an increase of 0.2% momsa. The slight deceleration in activity during 2H23 continues to support our view of GDP growth and monetary policy. We expect the selic at 11.75% in 23YE and 9.50% in 24YE. All in, after 2Q23 GDP statistical carry-over is at 3.1% for this year. We continue to expect growth at 3.0% this year and 2.2% next year.

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